Schroders

Economic and Strategy Viewpoint

Strong dollar and cheap oil favour advanced over emerging

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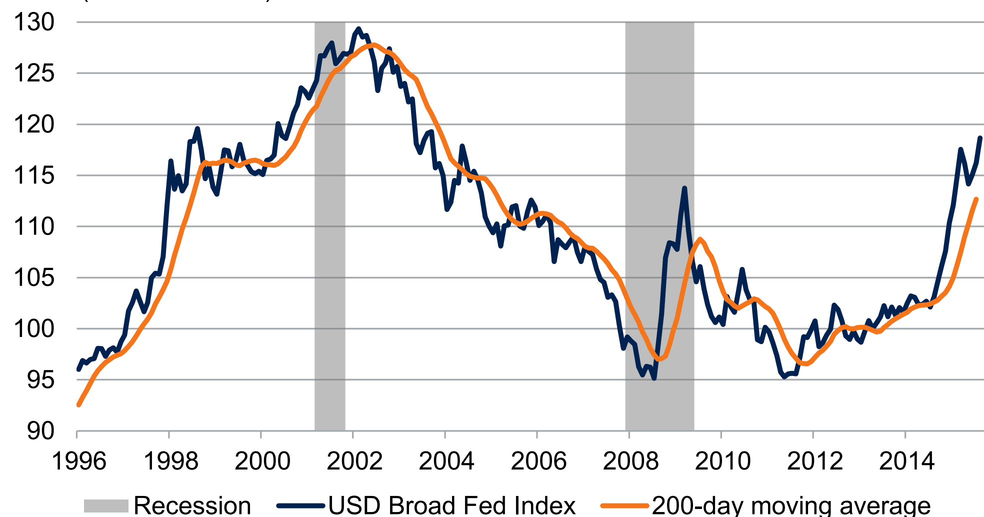
Global: Strong dollar and cheap oil favour advanced over emerging (page 2)

- Our updated forecasts show a modest cut in global growth expectations for this year and a cut in inflation for the advanced economies. Next year we still see a modest pick up in activity as the world economy responds to lower oil prices, looser fiscal policy and a stabilisation in the emerging economies
- We have not altered our China forecasts, but we remain below consensus and see the mix of a strong dollar and weak commodity prices as a drag on the emerging market complex. It is not surprising that there are doubts about China's motivation for devaluing the yuan: on our measures they have a long way to go to restore competitiveness

EM forecast update (page 8)

- A weaker picture for the BRICs this year as domestic concerns and falling commodity prices take their toll. 2016 looks brighter but the skies are still mainly cloudy

Chart: US dollar reaches highest level for a decade



Source: Thomson Datastream, Schroders Economics Group. 12 August 2015.

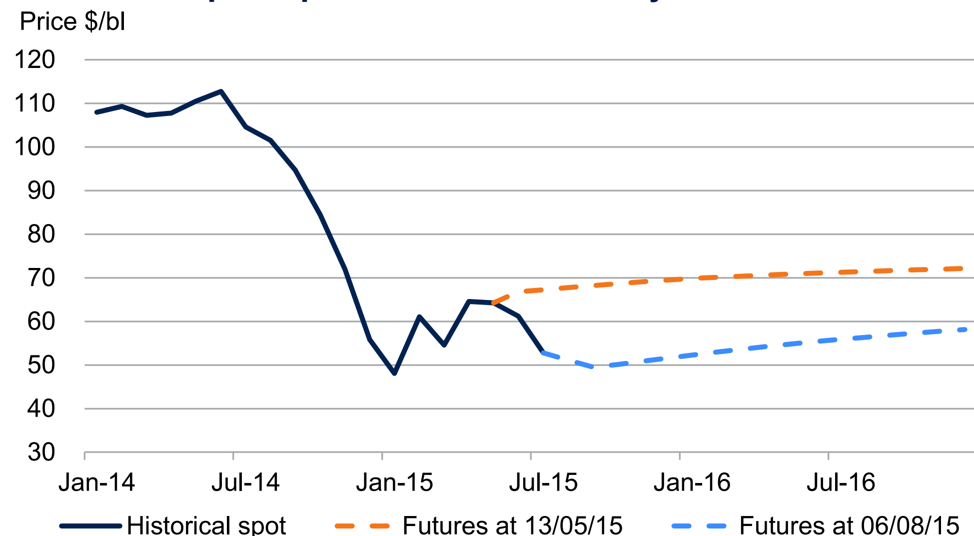
Global: Strong dollar and cheap oil favour advanced over emerging

Growth forecast trimmed, but recovery still on track

We have trimmed our forecast for global growth to 2.4% for 2015 (previously 2.5%) as a result of modest downgrades to the advanced and emerging markets. Although global demand picked up in the second quarter, it has not been quite as strong as expected and there are signs that an excess of inventory has built up, particularly in the emerging markets. However, we still see recovery in the oil-consuming economies as the benefits from lower oil prices continue to support consumer spending.

Oil prices are now lower than when we made our previous forecast in May and, on the basis of futures rates, we are assuming that prices are some $9 lower this year and $16 next (chart 1). This will help support developed world consumption, although will weigh on emerging markets given their greater dependence on energy production and the lower level of pass-through of reduced energy costs to households and business in those economies. Lower oil prices could also cause further disruption to energy investment in the US, which had shown tentative signs of stabilisation as measured by the rig count.

Chart 1: Oil price profile is considerably lower



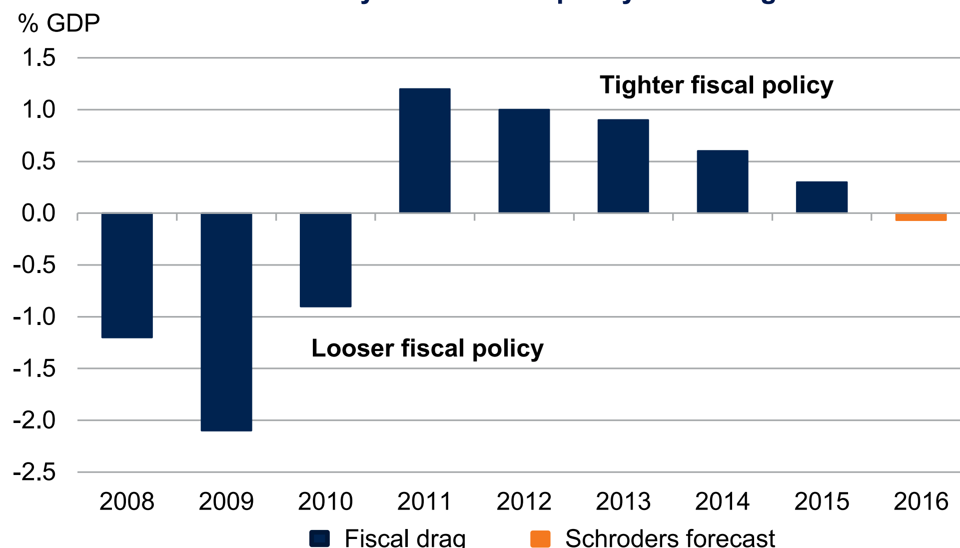
Source: Thomson Datastream, Schroders Economics Group. 6 August 2015.

Lags from cheaper oil to stronger growth longer than expected

It is true that the lags from cheaper energy to stronger growth have been longer this time, probably due to the increased importance of the emerging economies in global GDP and the rise of shale gas in the US. Nonetheless, we still believe that lower oil prices will translate into higher spending and global growth in coming quarters as expenditure by oil consumers outstrips the cutbacks by producers. As the International Monetary Fund (IMF) recently noted: “Although oil price gains and losses across producers and consumers sum to zero, the net effect on global activity is positive”. We have already seen this in the US second quarter GDP figures where consumption strengthened and outweighed the effect of weaker capital expenditure in the energy sector. However, not all developed economies have benefitted with Japan, for example, experiencing a soft patch in Q2 as consumption faltered causing us to downgrade our forecast for 2015.

For 2016, the picture is improved by an end to austerity in the G20 advanced economies with fiscal policy expected to loosen in the US (where the government sector has been hiring again) and become neutral in the Eurozone and Japan (chart 2). The UK stands out as the G7 economy pursuing fiscal austerity next year.

Chart 2: An end to austerity – G-20 fiscal policy becoming less restrictive



Note. Chart shows the change in the cyclically adjusted primary deficit for the G-20 advanced economies. Source: IMF, Schroders Economics Group. 10 August 2015. Please note the forecast warning at the back of the document.

Emerging economies take a stagflationary turn

For the emerging economies, China is forecast to continue to decelerate in 2016, but signs of stability in Russia and Brazil result in a better year for the BRIC's. The global growth forecast for next year is unchanged at 2.9%, but the balance between advanced and emerging has tilted further toward the former. This largely reflects the firm US dollar and lower profile for commodity prices.

Inflation is expected to remain low in 2015, but downward revisions to advanced economy inflation are offset by upward revisions in the emerging economies. Currency weakness and a lack of pass-through from lower energy costs account for the disappointing performance in the emerging world. The combination of lower growth and higher inflation means that the emerging economies have taken a turn in a stagflationary direction.

Fed to move in September (but then more slowly)

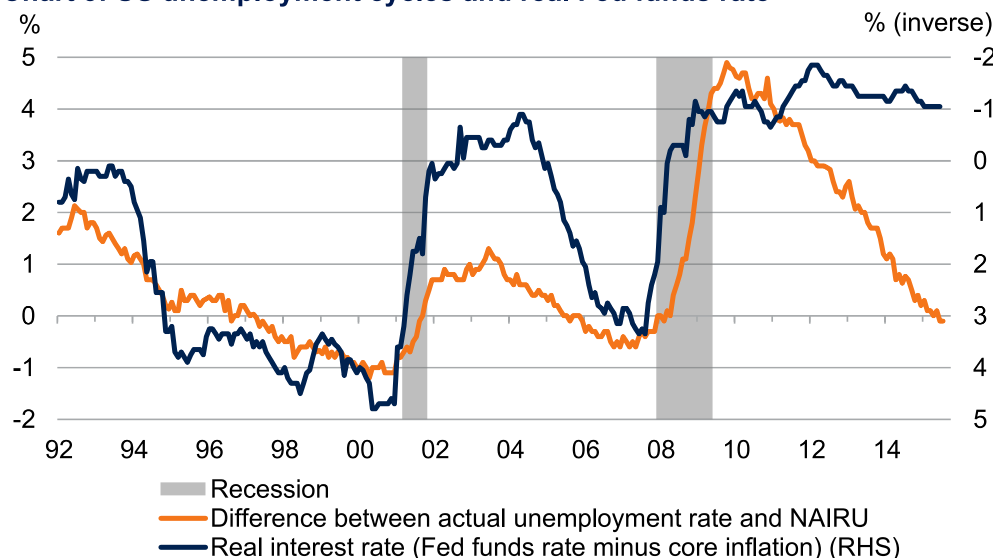
Slower policy tightening in US and UK

Meanwhile, the US Federal Reserve (Fed) is still expected to look through the current low headline CPI rate and focus on a firmer core rate of inflation and a tightening labour market so as to raise rates in September 2015. We expect the Fed funds rate to rise to 0.75% by end-2015 and 2% by end-2016 (previously 1% and 2.5% respectively). The pace of tightening is slower than before, with the Fed raising rates every other meeting to coincide with press conferences, to acknowledge the rise in the US dollar and fall in commodity prices, factors which depress the near-term inflation outlook.

However, although low inflation will give policy makers more time, we still believe that they will tighten given that interest rates are still negative in real terms whilst the unemployment rate has closed in on the equilibrium or NAIRU[1] (chart 3 on next page). The dollar will give the Fed pause for thought especially now that China has allowed the yuan to devalue, but the domestic case for a move toward a more normal interest rate is still likely to carry the day. The labour market remains key to this call with unemployment expected to edge down further in coming months.

[1]Non-accelerating inflation rate of unemployment. In other words, the lowest unemployment rate at which inflation does not increase (a lower unemployment rate will cause inflation to rise).

Chart 3: US unemployment cycles and real Fed funds rate



Source: Thomson Datastream, Schroders Economics Group. 11 August 2015.

BoE rate rise pushed out

We look for the European Central Bank (ECB) to implement quantitative easing (QE) through to September 2016 and leave rates on hold, whilst for the UK we now expect the first rate hike in May 2016. Although an earlier move by the Bank of England might be warranted, it will be difficult to tighten when headline inflation is below 1% as we expect in the first quarter of next year (see below for more details). In Japan, the Bank of Japan (BoJ) will keep the threat of more quantitative and qualitative easing (QQE) on the table, but is now likely to let the weaker yen support the economy and refrain from further loosening. China is expected to cut interest rates and the reserve requirement ratio (RRR) further and pursue other means of stimulating activity in selected sectors.

Exchange rates and commodity prices skew global growth

We can break down the impulse to activity from these different channels. For example, the rise in the USD will weigh on growth in the US and dollar-linked economies such as China. The counterpart is the positive effect of a weaker euro and yen on the Eurozone and Japan. On interest rates, continued QE in Japan and the Eurozone is seen as positive as are rate cuts in China. The US and UK are moved to neutral to reflect interest rate rises in coming months. We have not made the score negative to reflect low rate levels in real terms, easing bank lending conditions and positive credit growth.

Adding in the effects of fiscal policy and commodity prices gives an indication of the headwinds and tailwinds on growth going forward (table 1). This is a qualitative exercise and does not predict overall growth. The aim is to consider the impulse in the context of current activity and ask whether we will see policy change. For example, the top scorers Japan and the Eurozone have deflationary concerns and need the boost provided by policy. However, we might question whether China has enough stimulus, even assuming it can provide another fiscal boost. It remains to be seen whether it will join the currency war and use the renminbi as a macro tool to support activity. Emerging market commodity exporters remain in a bind as currency weakness is keeping interest rates high as export revenues deteriorate. The UK is tightening both fiscal and monetary policy next year and hence is forecast to lose momentum. Fiscal austerity will limit Bank of England rate rises.

Table 1: Growth scoreboard 2015 – 16 – headwinds and tailwinds

	US	Eurozone	UK	Japan	China	EM commodity exporters
Monetary						
Interest rate	0	+	0	+	+	-
Exchange rate	-	+	0	+	-	+
Fiscal	+	0	-	0	+	0
Commodity prices	+	+	+	+	+	-
Net	**+1**	**+3**	**0**	**+3**	**+2**	**-1**

NB. +/-, adds/subtracts from growth, scores are qualitative. Source: Schroders Economics Group. August 2015. Please note the forecast warning at the back of the document.

Scenarios

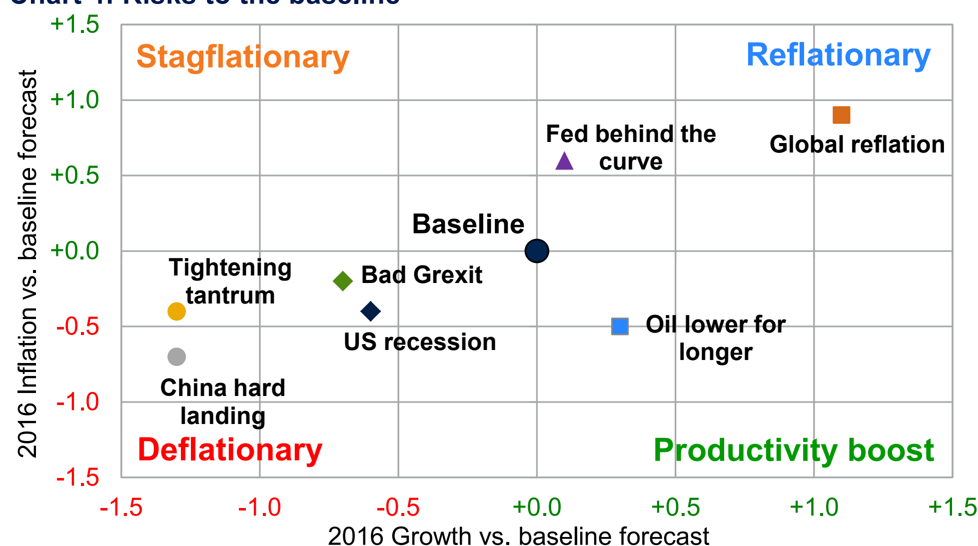
We have adjusted and updated our scenarios to reflect the risks around the baseline. The balance of risks is still tilted toward a deflationary outcome of weaker growth and inflation with the "China hard landing" seen as the highest probability. We have removed the "Eurozone deflationary spiral" as the risk of such an outcome has reduced with inflation turning positive and the ECB easing policy. The weakening of the euro in particular should help ease pressure on prices whilst boosting activity.

Bad Grexit scenario replaces deflationary spiral in Eurozone

However, the Eurozone is not off the hook as we have brought in a "Grexit" scenario. Although the Greek government has secured a third bailout, it is still possible an agreement ultimately falters given the need to secure some level of debt forgiveness. For this scenario to register at the global level it needs to be disorderly and accompanied by contagion, hence it is labelled "Bad Grexit". Like the scenario it replaced, it is deflationary as a sell off in peripheral debt and loss of confidence hits Eurozone growth. Eurozone activity weakens with knock on consequences for the rest of the world.

The other change is to introduce a "US recession" scenario. There are fears that the US economy is still fragile and could tip into recession in the face of an unexpected shock. To differentiate this scenario from the others which could trigger a significant US downturn, we have assumed an internally generated shock where a corporate bankruptcy undermines confidence in the business sector leading to a sharp retrenchment in employment and capital expenditure.

Chart 4: Risks to the baseline



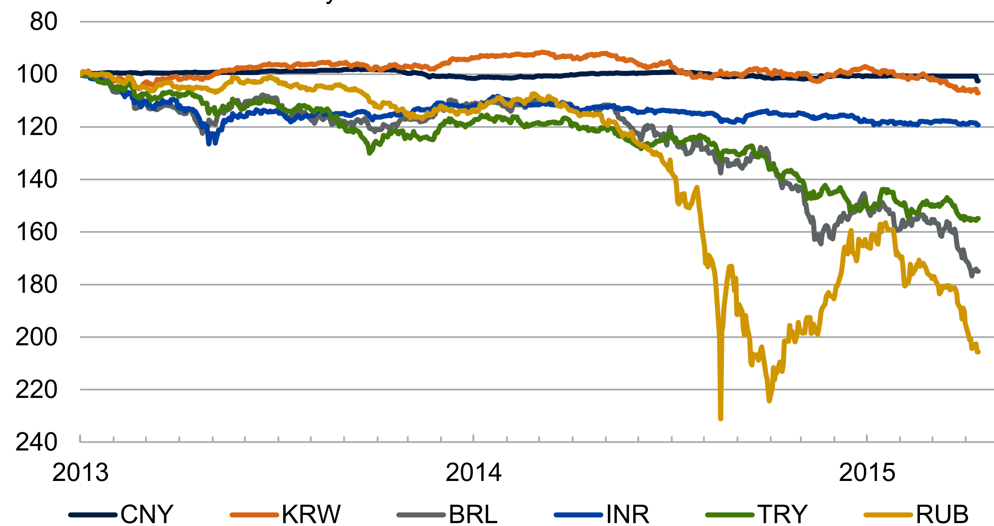
Source: Schroders Economics Group. 12 August 2015. Please note the forecast warning at the back of the document.

Has the tightening tantrum started already?

In terms of the other deflationary scenarios, the “China hard landing” and “Tightening tantrum” remain with the former adjusted such that the weakness is now seen to originate in the equity market which collapses despite government efforts. This then causes a loss of confidence in the banking sector which experiences an outflow of deposits, prompting an economy-wide credit crunch. In this way, the problems in the equity market infect housing which triggers a more significant slump in consumption and investment. At the global level, the scenario results in lower commodity prices, lower inflation and easier monetary policy around the world.

The “Tightening tantrum” is designed to capture the impact of Fed tightening on emerging markets and higher risk credits generally. In many ways, given recent market volatility, some of this is already playing out with EM currencies weakening as the prospect of the first move from the Fed draws closer (chart 5).

Chart 5: After the “taper” now the “tightening” tantrum for EM currencies

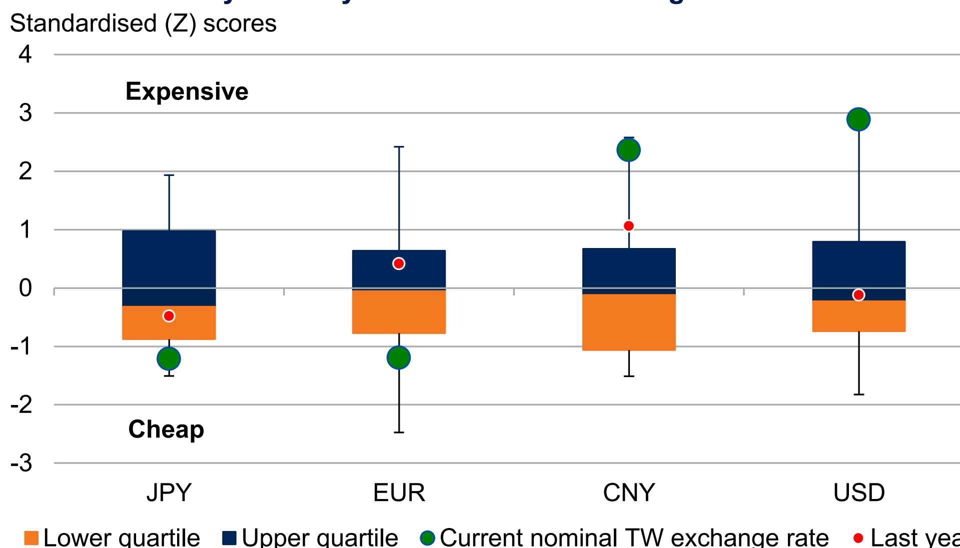


Source: Thomson Datastream, Schroders Economics Group. 12 August 2015.

The recent devaluation by China has added a new dimension to the currency crisis by prompting a round of depreciations across Asia Pacific. These currencies, which had previously been resilient, are reacting to the potential loss of competitiveness from the move in the currency of one of their largest trading partners. Whilst China may attract criticism for such a move we should remember that the real problems started with the devaluation of the Japanese yen. On our box and whisker charts, it is the yen and euro which are still winning the currency war.

Balance of risks tilts toward deflation led by China risk

Chart 6: Currency wars – yen and euro still winning



NB. Chart shows the range for the trade-weighted exchange rate, normalised over the past 10 years. Source: Schroders Economics Group. 12 August 2015.

Of the remaining scenarios, we continue to see a risk of "Global reflation" where policymakers increase fiscal stimulus in the world economy beyond the move shown in chart 2. The "Fed behind the curve" scenario also results in a more reflationary outcome compared with the baseline as the US central bank delays raising rates for a year. We would caution though that this is really a stagflationary scenario as subsequent Fed tightening to quell rising inflation results in weaker activity in 2017.

Finally we continue to include the "Oil lower for longer" scenario. Although it could be argued that this is playing out with the recent tumble in energy costs, the scenario assumes that prices fall just below $40 per barrel and remain there through 2016.

Risk summary

In terms of the balance of probabilities the deflationary scenarios continue to increase largely as a result of the concerns over China. The decline in reflationary outcomes reflects the lower weight put on "Fed behind the curve" as we see delay by the Fed as less likely given recent policy statements.

Table 2: Balance of probabilities by scenario outcome vs. baseline

Scenario	Probability August 2015, %	Probability May 2015, %	Change, %
Deflationary	22	20	+2
Reflationary	10 (5)	15 (5)	-5 (0)
Productivity boost	7	6	+1
Stagflationary	0 (5)	0 (10)	0 (-5)
Baseline	57	55	+2

Figures in brackets reflect alternative classification of Fed behind the curve. Source: Schroders Economics Group. 12 August 2015.

EM forecast update

Downward revisions to the BRIC forecasts

This quarter has seen largely downward revisions to the growth outlook for the BRIC economies. Only China avoids a downgrade in 2015 after weak real economy growth in the first half was compensated for by a strong financial sector, although this will unwind and weigh on growth next year. Weaker data in the other BRICs prompts downgrades this year, while for Brazil the misery now looks set to continue into 2016. On inflation, while cheaper oil might be benefiting developed markets, it is bad news for Russia and Brazil where it leads to currency weakness and imported inflation. In India and China, the impact on inflation will be limited, but it should accrue to further fiscal benefit as subsidies can be scaled back.

Table 3: Summary of BRIC forecasts

% per annum	GDP			Inflation		
	2014	2015F	2016F	2014	2015F	2016F
China	7.4	6.8→	6.4↓	2.0	1.4→	2.0→
Brazil	0.2	-2.0↓	-0.1↓	6.3	8.8↑	5.8↑
India	6.9	7.3↓	7.8→	7.2	5.1↓	6.2→
Russia	0.6	-4.1↓	-0.1→	7.8	15.2↑	7.0↑

Source: Bloomberg, Thomson Datastream, Schroders Economics Group. 13 August 2015.

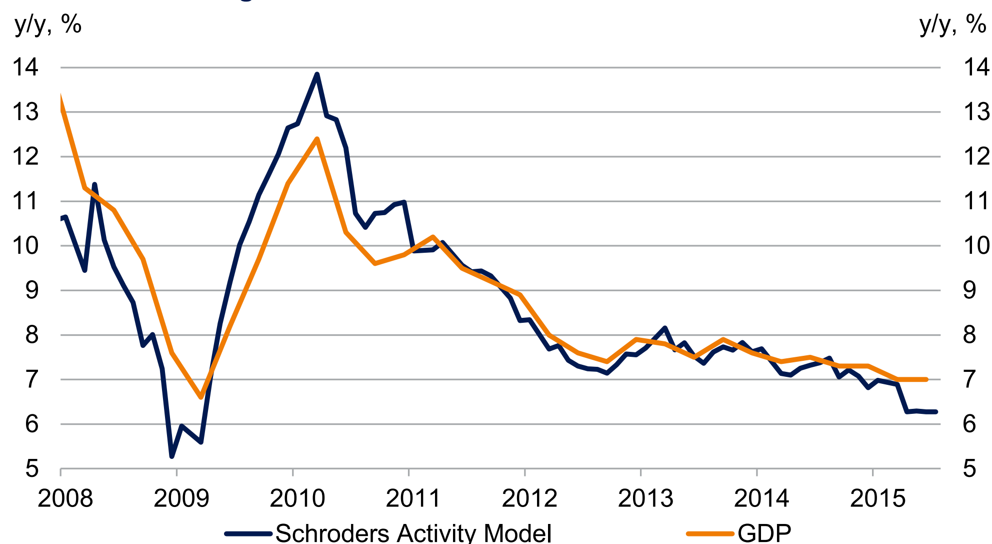
China: shaky foundations

Contrary to what our models had led us to expect, China beat consensus expectations for GDP growth in the second quarter, posting a 7% year-on-year increase in activity, the same as in the first quarter, and exactly in line with the official target (conveniently).

First half growth belies real weakness

While it would be easy to claim this is as a classic case of the authorities fudging the numbers, we will resist temptation. A detailed breakdown suggests it was the financial sector that drove the outperformance versus our model. We wrote on this extensively last month, but essentially the financial sector contributed twice as much as usual to aggregate growth, in nominal terms. This seems a clear result of the rally in the stockmarket. Our view is that GDP growth built on an equity market bubble is unsustainable, and with a weaker equity market performance likely in the second half of the year, a repeat GDP shock seems unlikely. Without that support, and with weak data in the rest of the economy (chart 12), a relative slowdown in the second half of the year should see growth in 2015 finish below 7%.

Chart 7: Chinese growth will slow further



Source: Thomson Datastream, Schroders Economics Group. 14 August 2015.

As for next year, we expect China to suffer withdrawal symptoms in the absence of a new equity boom; a weaker year-on-year performance by the financial sector will weigh on growth in the first half of the year. This will only compound the challenges posed by declining credit effectiveness and reduced scope for government stimulus to deliver the same gains as in the past. The slump in the market also implies a failure, for now, of attempts to rebalance away from a debt-heavy system, which will drag on investment financing.

To reflect this weaker growth environment, we have assumed an increase in government stimulus efforts. We now expect an additional 50bps of cuts to the reserve requirement ratio (RRR) this year, and an additional 50bps of cuts next year, such that the RRR ends 2016 at 16%.

We finalised our forecast numbers ahead of the decision by the People's Bank of China (PBoC) to alter the way in which it fixes the yuan, which resulted in a 2% overnight depreciation. But contrary to many media headlines, we do not believe this is primarily a policy aimed at providing stimulus to exporters. Total depreciation of 3% since the change will not see a boom in Chinese exports. Far more important is the increased role of the market in determining the value of the currency. Consequently, we see this more as a reform aimed at Special Drawing Right (SDR) inclusion, than at boosting growth.

That said, the PBoC's chief economist has said that the central bank will stabilise market expectations to ensure an orderly transition to the new regime. This is not the end of intervention. Indeed, we think it would be unwise to allow a large depreciation at this time, given the sizeable capital outflows recorded in the first half of the year. Entrenching expectations of depreciation would serve only to exacerbate those outflows and potentially destabilise the financial system.

Will we see much more depreciation from here? Beyond the risk of capital outflows, which should discourage policy led depreciation, there remain structural supports, particularly in the form of the current account surplus. But the reference to the closing spot rate, in current market conditions, will exert some depreciation pressure. PBoC intervention will be needed to alter market expectations if they want to head off depreciation. One final change to note is that the fixing will also be determined by the exchange rate movements of major currencies. That possibly implies a move away from a pure dollar peg to a basket of currencies. If this is so, and the PBoC wants to peg the yuan in trade-weighted terms, depreciation versus the dollar becomes more likely, particularly if the wave of dollar strength continues. Still, we believe financial

and social stability remain the overriding concerns of policymakers, and so a large devaluation is not on the horizon. The yuan will likely end the year between RMB 6.4 and RMB 6.5 to the dollar.

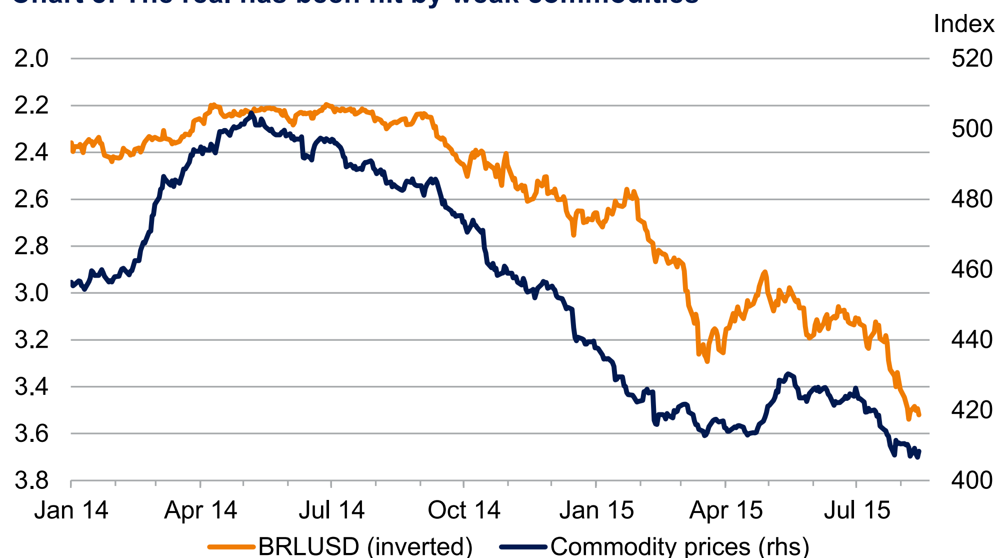
Brazil: battered by a perfect storm

It seems like the pain never ends for Brazil. Nearly every day brings a fresh set of scalps in the corruption scandal, as the investigation widens out to include more and more of the economic and political worlds. With Eletrobras and the state-backed development bank, BNDES, under investigation, potential investment has taken another hit. The first formal charges against politicians are expected this month, along with a mass anti-government protest. Reform efforts will be hindered, to say the least, in this environment.

Politics, policy and China hurting prospects

In addition, Brazil has edged ever closer to junk status, with downgrades from ratings agencies following the announcement that the fiscal target will be missed this year. The Planning Ministry said the target would be reduced from 1.2% of GDP to 0.15%, as a result of weaker tax revenues. Along with weak growth in China pulling down commodity prices, the threat of the ratings downgrade has seen the Brazilian real weaken dramatically (chart 13), which will add to inflation pressures.

Chart 8: The real has been hit by weak commodities



Source: Thomson Datastream, Schroders Economics Group. 14 August 2015.

So far, the central bank has been more hawkish than we expected, delivering additional rate hikes despite a rapidly deteriorating growth backdrop. The hiking cycle has been paused for now, and we still think it could make sense to cut at the end of this year. The risks to this view are, however, building, and cuts could be pushed to the first quarter of 2016.

With weaker data this year, and a tighter monetary policy stance, we find ourselves compelled to downgrade growth prospects. Furthermore, with the current political paralysis, we find it hard to see a turning point for Brazil; we could be looking at several years of weak growth.

India: political deadlock a concern

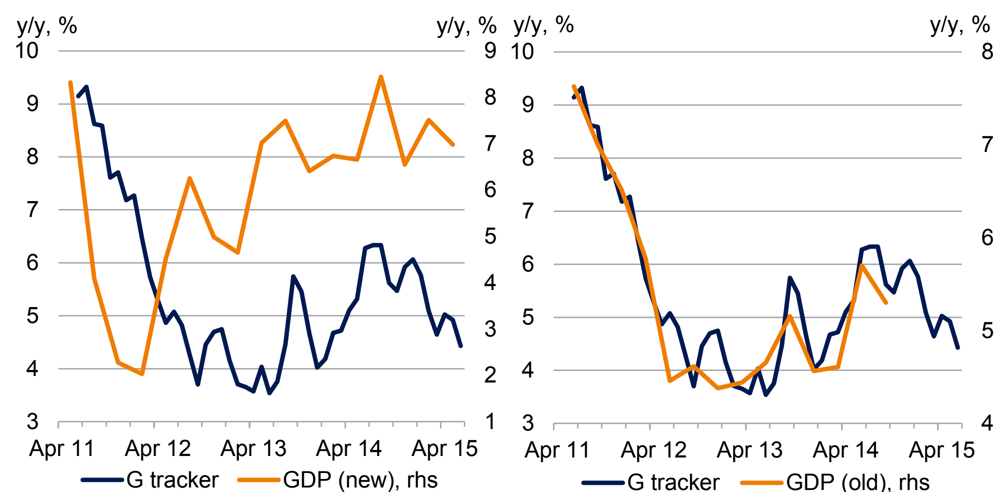
We apply a small downgrade to our forecast for Indian GDP this year thanks to weaker data so far. However, we remain somewhat sceptical on the official GDP numbers since the methodology revision, which seems to have introduced discrepancies between the quarterly GDP and monthly high frequency data. Our own growth tracker, which combines a range of activity measures,

demonstrated a strong relationship with the old (and discontinued) GDP series, but seems greatly at odds with the new (charts 14 & 15). Still, we think activity in general should edge higher with a more business-friendly environment in place, and a reportedly more efficient bureaucracy.

Disappointment crystalizes in zero achievement parliament

While India has the highest growth forecast (and will be accelerating even as China slows), the rosiness of the outlook is dimmed by disappointments on reform. The monsoon session of parliament ended with no laws passed, thanks to efforts by the opposition party to block their passage. Previously, we have written that market disappointment was overdone, given the scale of the task, and that we believed progress would still be made. Yet now we find ourselves disappointed – an inability to pass even the Goods and Services Tax (GST) comes as a surprise.

Charts 9 & 10: India's new GDP series seems out of line with other data



Source: Thomson Datastream, Schroders Economics Group. 14 August 2015. The G tracker is standardised using the new GDP figures.

GST rollout had been expected for the second quarter of 2016, and this now looks severely in doubt, as does the ability of the government to pass other reforms, particularly the more contentious land acquisition laws.

On the positive side, inflation pressures remain weak (by Indian standards). CPI inflation fell to 3.8% year-on-year in July, finally following the Wholesale Price Index (WPI) lower. We therefore remain of the view that another rate cut (25bps, to 7%) will be forthcoming this year. After that, however, rates will likely remain on hold in 2016 given the 4% inflation target.

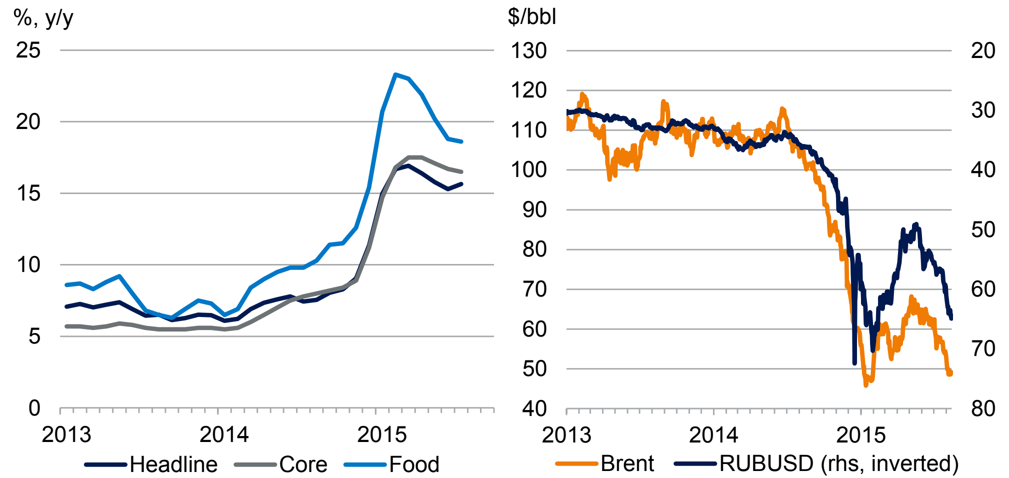
Russia: same old story

Russia is as dependent as ever on oil

Russian growth has performed more or less as expected so far, with our slight downgrade reflecting a revision to first quarter GDP. Second quarter GDP contracted even more rapidly year-on-year, at 4.6% as the fiscal support frontloaded in the first quarter dropped away. A detailed breakdown of the second quarter is not yet available, but high frequency data suggest a much weaker performance from the private sector, particularly industry. This suggests the import substitution which provided some support to domestic activity in the first quarter (along with a frontloading of consumption in a high inflation environment) is exhausted as a growth driver.

Meanwhile, the continued weakness in oil has contributed to a matching weakness in the rouble, and will keep inflationary pressures high – though still greatly reduced from the peak following the overshooting of the currency. The central bank will likely feel comfortable cutting rates a little further, given the rapid cooling of inflation and the crunching collapse in activity. Still, one eye will be kept on the oil price, so we do not expect a huge amount of monetary easing from this point.

Charts 11 & 12: Inflation is easing, but cheap oil will worry policymakers



Source: Thomson Datastream, Schroders Economics Group. 14 August 2015.

Looking further ahead, oil is very much the dominant economic driver, and while the economy will contract by less next year, the lack of investment which results from such cheap oil will weigh on growth for some time to come. Particularly when government spending is also oil reliant, and the consumer is burdened by falling incomes and high debt.

Schroder Economics Group: Views at a glance

Macro summary – August 2015

Key points

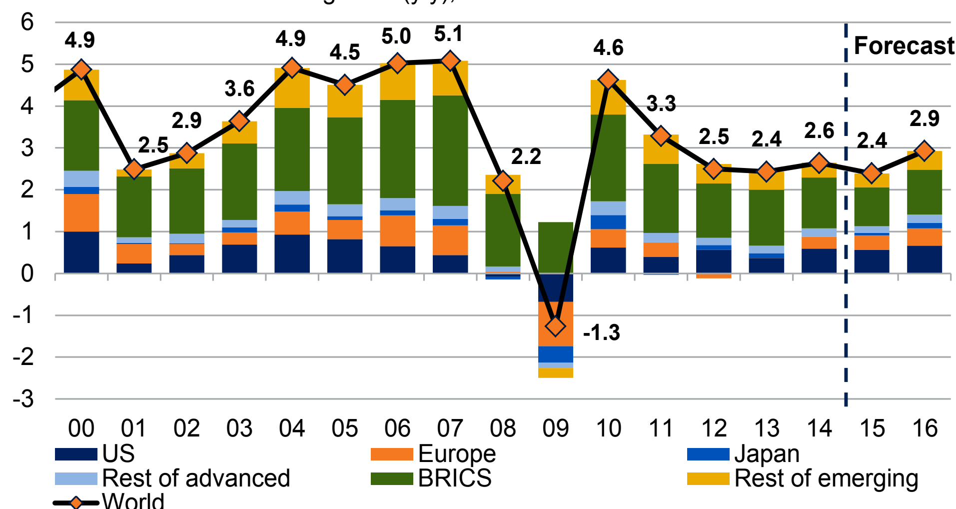
Baseline

- After a poor start to the year global growth is now forecast at 2.4% for 2015, slightly lower than 2014. Activity is still expected to pick-up as we move through the year, but parts of the world economy are taking longer than expected to respond to the fall in energy costs.
- Despite a weak first quarter, the US economy rebounded in the second and is on a self sustaining path with unemployment set to fall below the NAIRU in 2015, prompting greater inflationary pressure and Fed tightening. First rate rise expected in September 2015 with rates rising to 0.75% by year end. Policy rates to reach 2.0% in 2016 before peaking at 2.5% 2017.
- UK recovery to continue, but to moderate in 2016 with the resumption of austerity. Interest rate normalisation to begin with first rate rise in May 2016 after the trough in CPI inflation. BoE to move cautiously with rates at 1.5% by end 2016 and peaking at around 2.5% in 2017.
- Eurozone recovery picks up as fiscal austerity and credit conditions ease whilst lower euro and energy prices support activity. Inflation to remain close to zero throughout 2015, but to turn positive again in 2016. ECB to keep rates on hold and continue sovereign QE through to September 2016.
- Japanese growth supported by weaker yen, lower oil prices and absence of fiscal tightening in 2015. Momentum to be maintained in 2016 as labour market continues to tighten, but Abenomics faces considerable challenge over the medium-term to balance recovery with fiscal consolidation.
- US still leading the cycle, but Japan and Europe begin to close the gap in 2015. Dollar to remain firm as the Fed tightens, but to appreciate less than in recent months as ECB and BoJ policy is mostly priced in.
- Emerging economies benefit from advanced economy upswing, but tighter US monetary policy, a firm dollar and weak commodity prices weigh on growth. Concerns over China's growth rising as financial market bubbles are inflated further by government policy. Further easing from the PBoC is likely.

Risks

- Risks are skewed towards deflation on fears of, China hard landing a bad Grexit and a US recession. The risk that Fed rate hikes lead to a tightening tantrum (similar to 2013) would also push the world economy in a deflationary direction as higher bond yields tighten financial conditions. Inflationary risks stem from a delay to Fed tightening, or a global push toward reflation by policymakers. Although disruptive in the near term, further falls in oil prices would boost output and reduce inflation.

Chart: World GDP forecast



Source: Thomson Datastream, Schroders Economics Group. August 2015 forecast. Please note the forecast warning at the back of the document.

Schroders Forecast Scenarios

Scenario	Summary	Macro impact	Probability*	Global vs. 2016 baseline Growth	Global vs. 2016 baseline Inflation
Baseline	We have cut our forecast for global growth to 2.5% for 2015 primarily as a result of a downgrade to the US where the economy stalled in q1. We have also downgraded Japan and the UK following a weaker than expected start to the year. US growth is expected to pick-up going forward, but is now expected to reach 2.4% this year (previously 3.2%) the same as in 2014. The benefits of lower oil prices are taking longer to come through than expected and were offset by cuts in capex, a dock strike and bad weather in q1. By contrast, our forecast for the Eurozone is marginally stronger at 1.4% (prev.1.3%) whilst that for the emerging markets is little changed. Both regions have performed as expected in q1 with the former enjoying ongoing recovery, whilst the latter have continued to struggle. For 2016, global growth is forecast to pick-up slightly to 2.9% led by a better performance in the emerging markets and further recovery in the Eurozone and Japan.	Inflation is expected to remain low in 2015, but we have nudged our forecast slightly higher to reflect the recovery in oil prices. Global inflation is expected to come in at 2.8% for 2015 with a significant reduction for the Advanced economies to 0.6% from 1.4% in 2014 as falling energy prices impact on CPI inflation. The US Fed is still expected to look through this fall and focus on a firmer core rate of inflation and tightening labour market so as to raise rates in 2015. We expect the Fed funds rate to rise to 1% by end 2015 and then peak at 2.5% in 2016. Deflation concerns in the Eurozone are expected to ease as inflation picks up in 2016 thanks to the depressing effect of lower oil prices dropping out of the index and the weaker Euro. We expect the ECB to implement QE through to September 2016 and leave rates on hold, whilst for the UK, we now expect the first rate hike in February 2016. In Japan, the BoJ will keep the threat of more QQE on the table, but is now likely to let the weaker JPY support the economy and refrain from further loosening. China is expected to cut interest rates and the RRR further and pursue other means of stimulating activity in selected sectors.	55%	-	-
1. EZ deflationary spiral	Despite the best efforts of the ECB, weak economic activity weighs on Eurozone prices with the region slipping into deflation. Households and companies lower their inflation expectations and start to delay spending with the expectation that prices will fall further. The rise in savings rates deepens the downturn in demand and prices, thus reinforcing the fall in inflation expectations. Falling nominal GDP makes debt reduction more difficult, further depressing activity particularly in the heavily indebted peripheral economies.	Deflationary: weaker growth and lower inflation persists throughout the scenario. ECB reacts by cutting interest rates below zero and extending QE, but the policy response is too little, too late. As a significant part of the world economy (around one-fifth), Eurozone weakness drags on activity elsewhere, while the deflationary impact is also imported through lower oil prices and by trade partners through a weaker Euro. Global growth and inflation are about 0.5% weaker this year and 1% weaker in 2016 compared to the baseline. No rate rise from the Fed in this scenario.	2%	-1.1%	-1.1%
2. Global reflation	Frustration with the weakness of global activity leads policy makers to increase fiscal stimulus in the world economy. This then triggers an increase in animal spirits which further boosts demand through stronger capex. Global growth reaches 3% this year and 4% next. However, higher commodity prices (oil heading toward $90/ b) and tighter labour markets push inflation higher by nearly 1% in 2016.	Reflationary: stronger growth and higher inflation compared to the baseline. Central banks respond to the increase in inflationary pressure with the fastest response coming from the US and UK which are more advanced in the cycle compared with the Eurozone where there is considerable slack. The US Fed raises rates to 4% by end-2016 and starts to actively unwind QE by reducing its balance sheet. Although there is little slack in Japan, higher wage and price inflation is welcomed as the economy approaches its 2% inflation target. This is likely to lead the BoJ to signal a tapering of QQE, but no increase in interest rates. Inflation concerns result in tighter monetary policy in the emerging markets with all the BRIC economies raising rates in 2016.	5%	+1.1%	+0.9%
3. Oil lower for longer	Saudi Arabia becomes frustrated at the slow response of US oil production and drives prices lower in a determined effort to make a permanent impact on US shale producers. Meanwhile, Iraq and Russia continue to grow production sharply. This means a significant period of low prices with Brent crude falling to just below $40 by end 2015 and remaining there through 2016.	Stronger growth/ lower inflation with the benefits primarily felt in the oil consuming Advanced economies. For the emerging economies , activity is only marginally better as gains and losses roughly offset one another although China and India are net winners. On the policy front, lower inflation allows the Fed to move slightly less rapidly, but interest rates still rise. The rate profile is also slightly lower in China, Brazil and India, but Russia has to keep policy tighter to stabilise the currency. No change in the Eurozone or Japan where policymakers balance lower inflation against stronger growth.	6%	+0.3%	-0.4%
4. Secular stagnation	Weak demand weighs on global growth as households and corporates are reluctant to spend. Animal spirits remain subdued and capex and innovation depressed. Households prefer to de-lever rather than borrow. Adjustment is slow with over capacity persisting around the world, particularly in China, with the result that commodity prices and inflation are also depressed.	Deflationary: weaker growth and inflation vs. baseline. Although not as deflationary as China hard landing or the Eurozone deflationary spiral, the world economy experiences a slow grind lower in activity. As the effect from secular stagnation is more of a chronic than acute condition, this does not prevent policy makers from initially raising rates in the US although this is then reversed as it becomes apparent that the economy is losing momentum. Overall, global interest rates are lower than in the base and we would expect the ECB and BoJ to prolong their QE programmes.	8%	-0.7%	-0.5%
5. China hard landing	Official efforts to deliver a soft landing in China's housing market fail and house prices collapse. Housing investment slumps and household consumption is weakened by the loss of wealth. Losses at housing developers increase NPL's, resulting in a retrenchment by the banking system and a further contraction in credit and activity. Growth in China slows to less than 5% this year and under 3% in 2016.	Deflationary: Global growth slows as China demand weakens with commodity producers hit hardest. However, the fall in commodity prices will push down inflation to the benefit of consumers. Monetary policy is likely to ease/ stay on hold while the deflationary shock works through the world economy.	5%	-1.4%	-0.7%
6. Fed behind the curve	Concerns about the strength of the economic recovery and the impact of tighter monetary policy causes the Fed to delay raising rates until the second half of 2016. Meanwhile the labour market continues to tighten, wages accelerate and inflation increases. US rates then have to rise more rapidly but still end 2016 at 1.5%, lower than in the baseline. Interest rates would continue to rise in 2017 as the Fed battles to bring inflation under control.	Reflationary in 2016: stronger growth and higher inflation compared to the baseline. Note that this scenario will turn stagflationary in 2017 as growth slows whilst inflation remains elevated. Better growth in the US provides a modest stimulus to activity elsewhere, however this is likely to be tempered by a more volatile financial environment with long yields rising as inflation expectations rise.	10%	+0.3%	+0.6%
7. Tightening tantrum	Bond markets sell off in response to Fed tightening with US 10 year Treasury yields rising 200 basis points compared to the baseline. This has a knock on effect to the rest of the world as yields rise in both the developed and emerging markets. Equity markets and risk assets generally weaken as the search for yield begins to reverse causing capital outflows from economies with weak external accounts and negative wealth effects.	Deflationary: weaker growth and inflation vs. baseline. Economic weakness causes the Fed to bring its tightening cycle to an early end with rates peaking at 1% and then reversing toward the end of 2016 as further stimulus is required. Emerging markets experience weaker growth, but are more resilient than in the 2013 "taper tantrum" given improvements in their external financiing requirements. Global policy rates are generally lower by end-2016.	5%	-0.7%	-0.2%
8. Other			4%	-	-

*Scenario probabilities are based on mutually exclusive scenarios. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2014	2015		Prev.	Consensus	2016		Prev.	Consensus
World	100	2.6	2.4	↓	(2.5)	2.5	2.9		(2.9)	3.0
Advanced*	63.2	1.7	1.8	↓	(1.9)	1.8	2.2	↑	(2.1)	2.3
US	24.5	2.4	2.3	↓	(2.4)	2.3	2.7	↑	(2.5)	2.7
Eurozone	19.2	0.9	1.3	↓	(1.4)	1.5	1.7	↑	(1.6)	1.8
Germany	5.4	1.6	1.3	↓	(1.6)	1.9	2.1		(2.1)	2.0
UK	3.9	3.0	2.5	↑	(2.2)	2.6	2.1	↑	(1.9)	2.5
Japan	7.2	-0.1	0.7	↓	(0.9)	0.8	1.8	↓	(2.0)	1.7
Total Emerging**	36.8	4.3	3.4	↓	(3.6)	3.5	4.1	↓	(4.3)	4.3
BRICs	22.6	5.4	4.1	↓	(4.2)	4.3	4.7	↓	(4.9)	5.1
China	13.5	7.4	6.8		(6.8)	6.9	6.4	↓	(6.5)	6.7

Inflation CPI

y/y%	Wt (%)	2014	2015		Prev.	Consensus	2016		Prev.	Consensus
World	100	2.8	2.9	↑	(2.8)	2.7	3.3	↑	(3.1)	3.2
Advanced*	63.2	1.4	0.5	↓	(0.6)	0.4	1.7		(1.7)	1.6
US	24.5	1.6	0.6	↓	(0.9)	0.3	2.3		(2.3)	2.0
Eurozone	19.2	0.4	0.0	↓	(0.2)	0.2	1.1	↓	(1.2)	1.3
Germany	5.4	0.8	0.2	↓	(0.5)	0.5	1.5	↓	(1.7)	1.6
UK	3.9	1.5	0.0	↓	(0.4)	0.2	1.6	↓	(1.8)	1.5
Japan	7.2	2.7	1.1	↑	(0.8)	0.8	1.1		(1.1)	1.0
Total Emerging**	36.8	5.1	7.0	↑	(6.4)	6.7	6.1	↑	(5.4)	6.0
BRICs	22.6	4.0	4.8	↑	(4.7)	4.4	3.8	↑	(3.6)	3.5
China	13.5	2.0	1.4		(1.4)	1.4	2.0		(2.0)	1.9

Interest rates

% (Month of Dec)	Current	2014	2015		Prev.	Market	2016		Prev.	Market
US	0.25	0.25	0.75	↓	(1.00)	0.55	2.00	↓	(2.50)	1.35
UK	0.50	0.50	0.50		(0.50)	0.71	1.50		(1.50)	1.34
Eurozone	0.05	0.05	0.05		(0.05)	-0.03	0.05		(0.05)	0.04
Japan	0.10	0.10	0.10		(0.10)	0.18	0.10		(0.10)	0.16
China	4.85	5.60	4.60		(4.60)	-	4.00		(4.00)	-

Other monetary policy

(Over year or by Dec)	Current	2014	2015		Prev.		2016		Prev.
US QE ($Bn)	4495	4498	4504	↑	(4494)		4522	↑	(4512)
EZ QE (€Bn)	103	31	649		(649)		1189		(1189)
UK QE (£Bn)	375	375	375		(375)		375		(375)
JP QE (¥Tn)	345	300	389		(389)		406		(406)
China RRR (%)	18.00	20.00	17.50	↓	18.00		16.00	↓	17.00

Key variables

FX (Month of Dec)	Current	2014	2015		Prev.	Y/Y(%)	2016		Prev.	Y/Y(%)
USD/GBP	1.56	1.56	1.53	↑	(1.52)	-1.9	1.50		(1.50)	-2.0
USD/EUR	1.09	1.21	1.08		(1.08)	-10.7	1.02	↑	(1.00)	-5.6
JPY/USD	125.0	119.9	120.0	↑	(118)	0.1	120.0	↑	(115)	0.0
GBP/EUR	0.70	0.78	0.71	↓	(0.71)	-9.0	0.68	↑	(0.67)	-3.7
RMB/USD	6.21	6.20	6.30		(6.30)	1.5	6.40		(6.40)	1.6
Commodities (over year)										
Brent Crude	49.9	55.8	55.0	↓	(64)	-1.6	55.5	↓	(71)	0.9

Source: Schroders, Thomson Datastream, Consensus Economics, August 2015
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 05/08/2015
Previous forecast refers to May 2015
* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, Sweden, Switzerland, United Kingdom, United States.
** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

Schroders

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

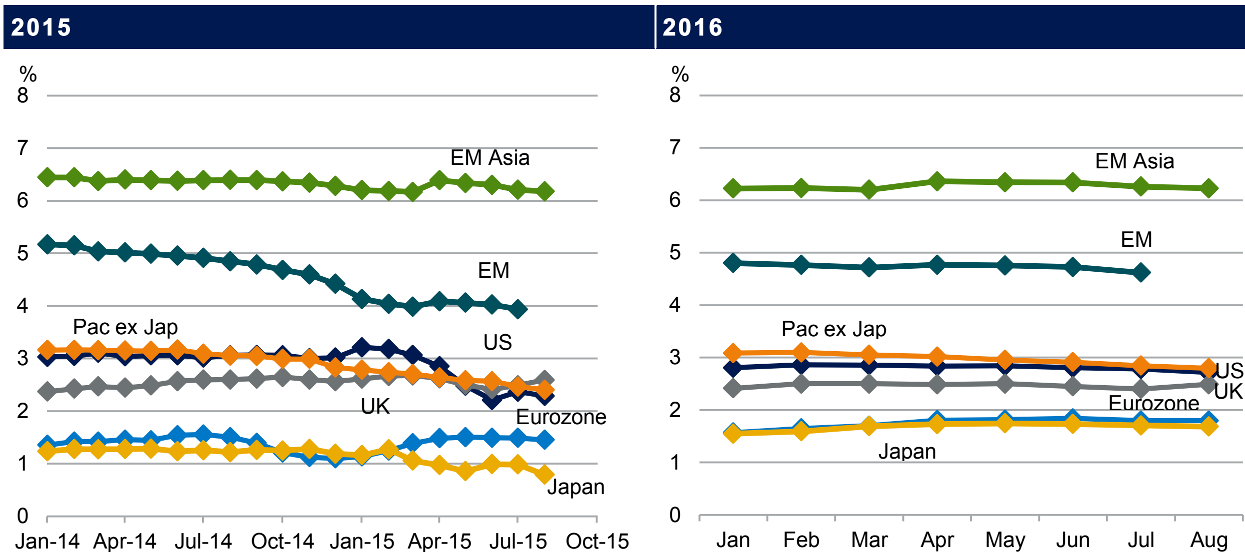
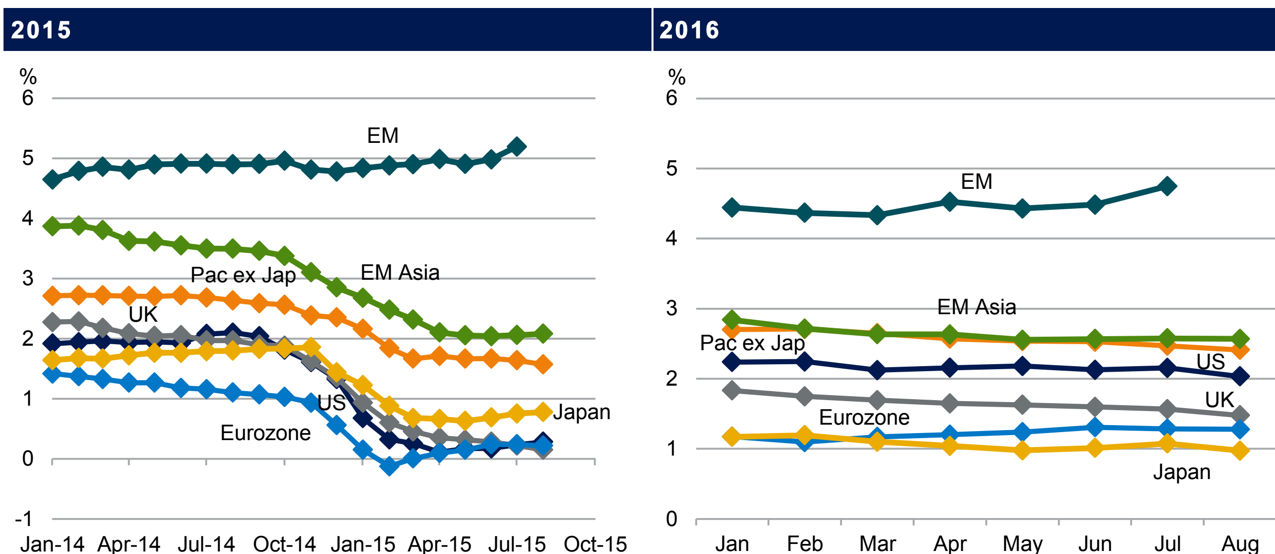


Chart B: Inflation consensus forecasts



Source: Consensus Economics (August 2015), Schroders Economics Group.

Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.

Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.

Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

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