Schroders
Economic and Strategy Viewpoint

Keith Wade
Chief Economist
& Strategist

Craig Botham
Emerging Markets
Economist

Forecast update: Global tilt toward advanced economies (page 2)

- An acceleration in the advanced economies is offset by weaker growth in the emerging markets to leave our global growth forecast at 2.8% in 2015. Lower oil prices, a stronger US dollar and Fed tightening tip the benefits of growth toward the developed markets. "Beggar thy neighbour" currency devaluation should help the Eurozone and Japan beat consensus, but at the expense of others.
- Inflation in the advanced economies is expected to record its lowest rate for five years in 2015, but pick up in 2016 as the impact of the lower energy price fades. We do not expect the Eurozone or the wider world economy to slip into sustained deflation, although our scenario analysis shows the risks to the baseline are still weighted in this direction.

EM forecast update: Oil on troubled waters or fuel for the fire? (page 7)

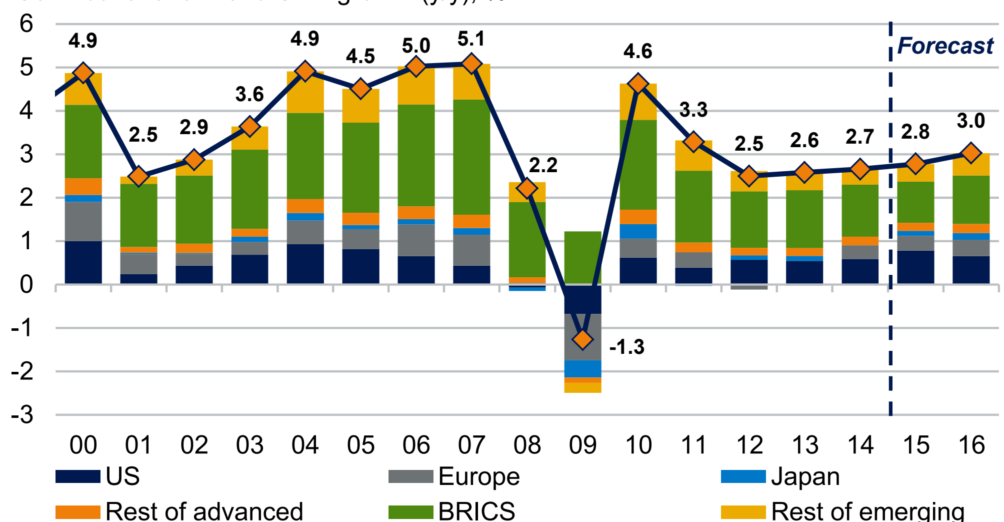
- Oil's decline has a mixed impact on the BRIC economies, with Russia an obvious loser. While inflation falls in India and China, the growth benefit is limited, and Brazil's domestic problems outweigh international considerations. Meanwhile, the Fed hike looms and emerging markets are still looking vulnerable.

Views at a glance (page 13)

- A short summary of our main macro views and where we see the risks to the world economy.

Chart: Global growth shifts from EM to DM

Contributions to World GDP growth (y/y), %



Source: Thomson Datastream, Schroders. 20 February 2015. Please note the forecast warning at the back of the document.

Schroders

Forecast update: Global tilt toward advanced economies

Growth upgrade to advanced economies offset by cut to emerging markets

An increase in our growth projection for the advanced economies is offset by a cut to the emerging markets outlook to leave our global forecast at 2.8% year on year (y/y) for 2015. The former are expected to pick up to 2.2% y/y this year, an increase of 0.5% on 2014, with US growth expected to reach 3.2% y/y (previously 2.8%), the best performance since 2005. The Eurozone and Japan are also expected to fare better and we have raised our forecasts for both by just under 0.5% for 2015 to 1.3% and 1.6% y/y respectively. However, at the global level the boost to growth from the advanced economies is offset by weaker emerging markets where growth is expected to slow to 3.7% from 4.2% in 2014.

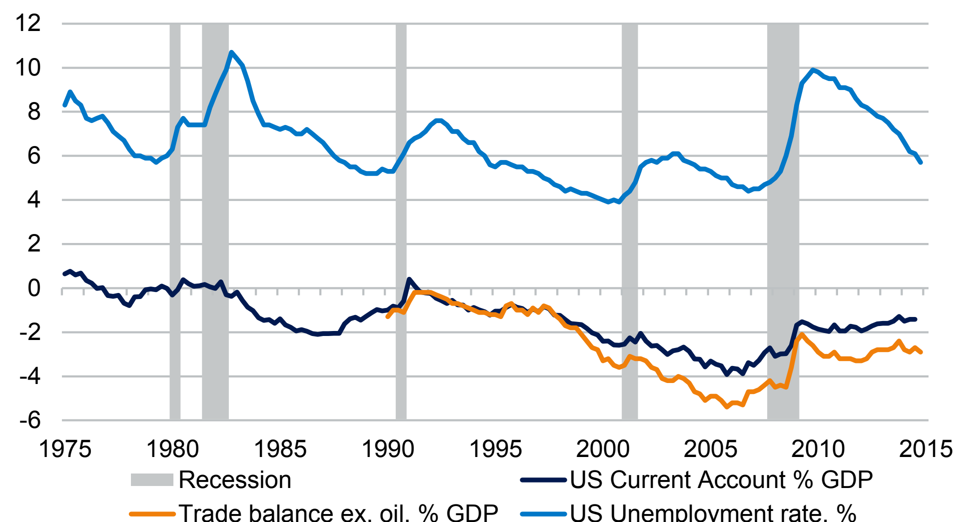
The shift in the outlook in favour of the advanced at the expense of the emerging market economies reflects several factors.

Gains from lower oil prices are skewed toward advanced economies

First, the decline in oil prices favours the advanced over emerging economies as the former are net oil consumers whilst the latter include a number of significant producers. In addition, the feed-through from lower oil prices is more rapid in the advanced economies where the government does not attempt to fix the price of fuel through subsidies. This is a generalisation as there are a number of economies in the emerging universe which benefit from lower oil prices e.g. many Asian countries are significant oil importers. Nonetheless, although we assume a modest uptrend in the oil price over the forecast period, prices are some $20 per barrel lower than when we last updated our forecasts in November. The overall effect on emerging economies is negative compared to their developed counterparts, an outcome compounded in the near term as the losers tend to cut back faster than the winners.

Second, there has been a lack of spill-over from developed economy demand to emerging markets in recent years, a factor we expect to persist. The effect can be seen in the US trade balance which has been remarkably steady during the recovery from the global financial crisis. In the last three cycles, economic recovery in the US has been accompanied by a significant deterioration in the trade and current account balances. That deterioration has been driven by an upsurge in US imports thus boosting growth in the rest of the world with the emerging economies the principal beneficiaries. In this cycle, however, the deficit has been stable or narrowing (depending on whether oil is included) as the economy has recovered, as shown by falling unemployment in chart 1. US imports have recovered, but not as rapidly as in previous cycles, whilst US exports have continued to grow.

Chart 1: Limited spill-over from US recovery to rest of the world

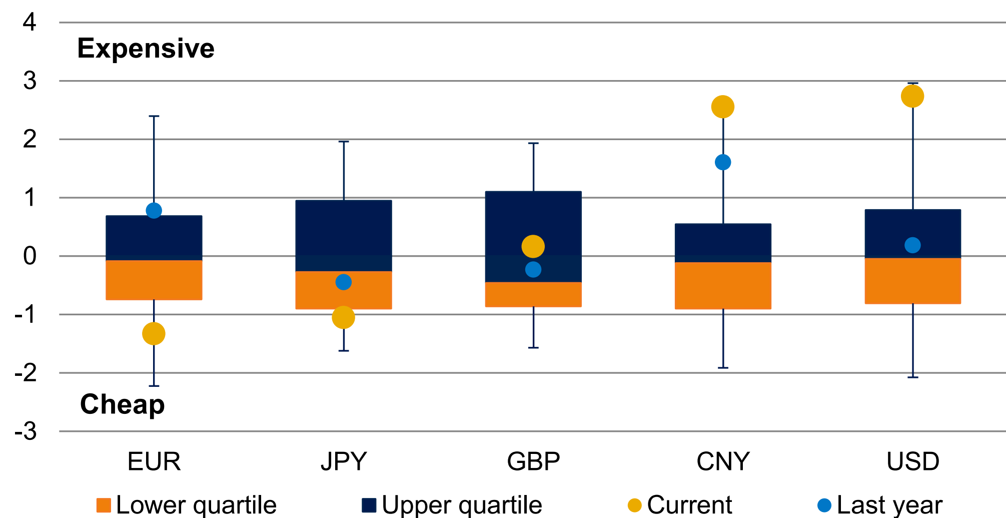


Source: Thomson Datastream, Schroders, 24 February 2015.

Third, recent currency movements favour developed over emerging market competitiveness. The rise of shale oil production, US technological leadership and a competitive US dollar have all been factors directing US demand toward domestic rather than overseas firms. However, we would note that as far as the currency goes, this has been changing as the dollar has appreciated significantly over the past year. Based on our calculations, the trade-weighted US dollar is now at the top of its range of the past 10 years (chart 2).

Currency shifts favour Japan and Eurozone whilst China is losing the currency war

Chart 2: FX valuation: USD and CNY expensive, JPY and EUR cheap



Source: Thomson Datastream, Schroders, 24 February 2015.

The world economy today is one where demand growth remains tepid and well below that which was achieved before the global financial crisis, and central banks are using currency depreciation to gain a greater share of a smaller pie. In the absence of a revival in credit growth, the main transmission mechanism from loose monetary policy to an economy is through a weaker exchange rate. It has become a “beggar thy neighbour” world.

At present, the counterpart to dollar strength has been a depreciation in the euro and Japanese yen, which are both trading in the lower quartile of their 10-year range. The decline in the euro over the past year has been significant since the European Central Bank (ECB) moved to loosen monetary policy through quantitative easing (QE). By contrast, the Chinese currency (CNY) has experienced a significant appreciation due to its tie with the US dollar. In trade-weighted terms, the CNY is at the top of its 10-year range and more than two standard deviations above its mean.

These measures are not adjusted for relative inflation or wage costs, but they indicate that Japan and the Eurozone are well placed competitively to gain from stronger US demand. Our forecast incorporates a better performance from China’s trade sector in 2015 as external demand improves, but this will be tempered by the level of the CNY. The Chinese authorities have eschewed the use of the currency as a tool to boost growth and instead have emphasised a stable exchange rate as part of a strategy to internationalise the CNY. To this end they have allowed a little flexibility, but overall it is clear that China, the largest emerging economy, is a loser in the current round of currency wars.

Strong US dollar to continue to weigh on emerging markets

More generally, a strong US dollar weighs on the emerging markets in part through the policy links described above but also through commodity prices, which tend to be depressed during periods of dollar strength. In our forecasts, we see a modest further appreciation of the dollar as we continue to expect the US Federal Reserve to raise interest rates in June this year and to continue tightening into 2016. By

contrast, policy in the Eurozone, Japan and China is expected to be loose or loosening. Although the Federal Reserve (Fed) will be keen to avoid a repeat of 2013's taper tantrum, tighter US monetary policy is set to create volatility in financial markets as investors repatriate capital from higher yielding markets. Those in the emerging world that have been significant beneficiaries of looser US monetary policy and have seen an explosion of growth in their credit markets are likely to be most affected.

Finally, in explaining the tilt toward the advanced economies, there are a number of idiosyncratic effects which will impede the emerging world in 2015, such as the increasing international isolation of Russia and the Petrobras scandal in Brazil. India remains the bright spot amongst the BRICs (see the emerging markets section below).

The combination of lower oil prices and a stronger US dollar indicate that although the macro environment is improving, the greater gains will be seen in the advanced rather than the emerging economies.

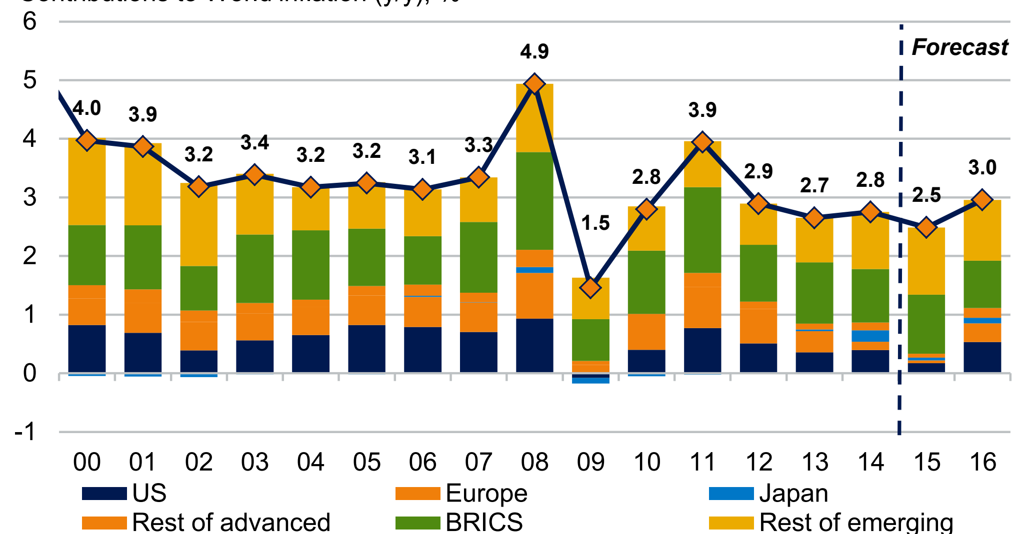
For 2016, US growth moderates as the boost from oil fades and higher interest rates and a stronger dollar begin to weigh on growth. However, the overall global growth forecast ticks up to 3% next year on further improvement in Europe and Japan as well as continued strength from India.

Inflation and central bank policy

Lowest inflation rate since 2009 in the advanced world

Our inflation forecasts have been cut in response to lower than expected outturns in recent months and the further fall in energy prices. Global inflation is expected to come in at 2.5% for 2015 after 2.8% in 2014. The decline would have been greater but for a pickup in emerging market inflation from 5.1% to 5.9%. We expect a significant reduction for the advanced economies to 0.5% from 1.4% (chart 3). For the latter, this will be the lowest inflation rate since 2009, another year influenced by a drop in the oil price.

Chart 3: Global inflation – regional breakdown



Source: Thomson Datastream, Schroders. 20 February 2015. Please note the forecast warning at the back of the document.

Inflation to lift as oil price effect drops out in H2 2015

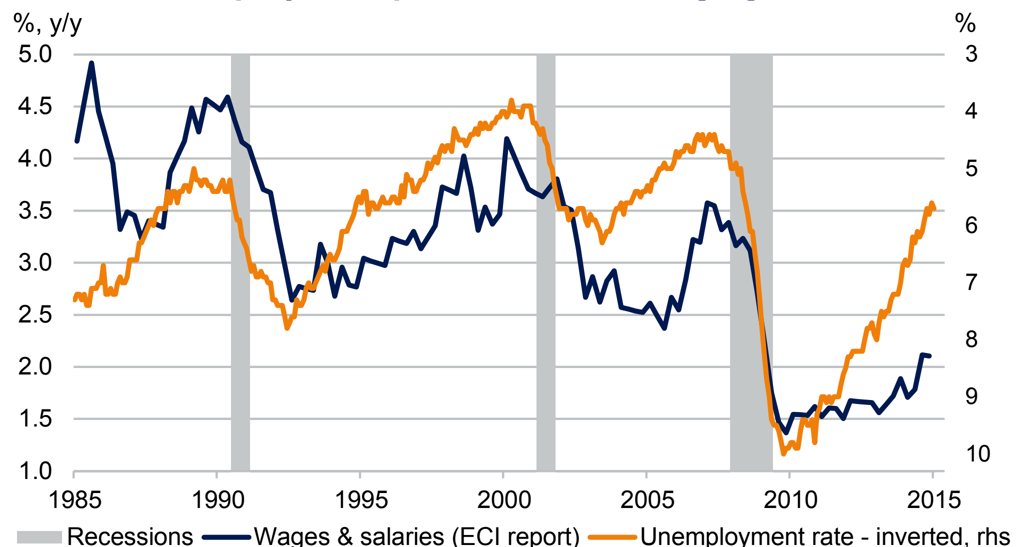
As mentioned above, government controls can limit the pass-through from lower market prices to lower inflation in the emerging world as some authorities will take the opportunity to reduce subsidies. The aggregate emerging market figure is also boosted by a surge in inflation in Russia (following the collapse of the rouble and the effect of sanctions on imported goods, particularly food) and Brazil (weak currency and tariff increases on electricity). Inflation in China and India is lower.

Importantly, we expect inflation to pick up again in 2016, dispelling deflation fears. Whilst core inflation rates have moderated, the sharp fall in headline rates largely reflects the fall in oil prices, which have now stabilised. On this basis, annual inflation rates will decline further until the third quarter of this year and could turn negative in a number of economies, but they should then bounce back as base effects drop out. Near-term evidence from PriceStats (who collect real time price data from the internet) suggests this is already happening with just another month of falling energy prices to impact the data. More generally, we do not see the fall in public inflation expectations or nominal wages which would herald a shift to permanent deflation.

In the meantime, low inflation can keep monetary policy on hold or loose. The exception in our view is still the US, where the economy is close to normalising with the unemployment rate now close to, or at equilibrium. The Fed is still expected to look through the fall in headline inflation and focus on a stable core rate of inflation and tightening labour market so as to raise rates in 2015. Key to this view will be further evidence of rising wage growth as signalled by the fall in unemployment (chart 4). We expect the Fed funds rate to rise to 1.25% by end 2015 and then peak at 2.5% in 2016.

The US is returning to equilibrium unemployment, the cue for the Fed to start to normalise rates

Chart 4: Unemployment points to faster wage growth in the US



Source: Thomson Datastream, Schroders. 24 February 2015.

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 reflationary effect of a weaker euro. We expect the ECB to implement QE through to September 2016 and leave rates on hold, whilst for the UK, we stick with our call for the first rate hike in November 2015. In Japan, the Bank of Japan (BoJ) will keep the threat of more QQE (quantitative and qualitative easing) on the table, but is now likely to let the weaker Japanese yen support the economy and refrain from stepping up the asset purchase programme. China is expected to cut interest rates and the reserve requirement ratio (RRR) further and pursue other means of stimulating activity in selected sectors.

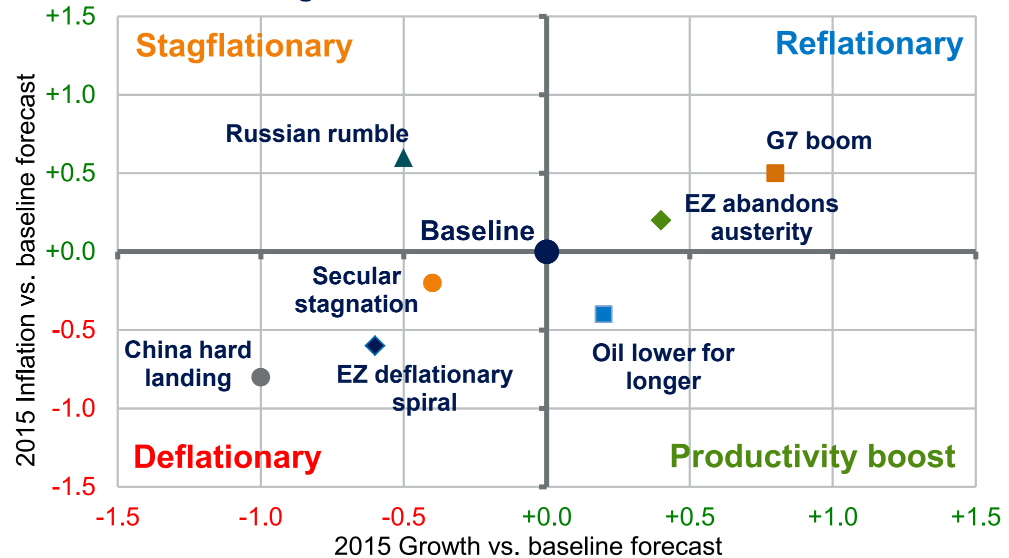
Scenarios

We have refreshed our scenario analysis. Out go “JPY collapses” (better growth means less pressure on the BoJ to keep printing money), “Capacity limits bite” (seems distant from a global perspective) and “Productivity recovers” (recent data heading in the opposite direction in the US). In come “Oil lower for longer” (where the oil price falls to $30 per barrel and stays there as the Saudi Arabians turn the screws on US shale producers), “Secular stagnation” (a slow, structural grind lower in global activity) and “Eurozone abandons austerity” (Euro governments embark

on fiscal easing to head off political backlash against austerity). Note that the "Eurozone deflation" scenario has become a more severe "Eurozone deflationary spiral" where the economy falls into a major slump from which it is hard to escape, rather than just a period of negative inflation. Note that we have not added a Grexit scenario as the impact on the rest of the world would be minimal in our view (see Europe section below). For a full description of each of the scenarios see table on page 19.

In terms of the balance of risks, the scenarios are still tilted toward deflation with three (Secular stagnation, China hard landing and Eurozone deflationary spiral) all producing outcomes of weaker growth and lower inflation than in the baseline (chart 5).

Chart 5: Scenario grid: outcomes vs. 2015 base



Source: Thomson Datastream, Schroders. 20 February 2015. Please note the forecast warning at the back of the document.

Balance of risks still tilts toward deflation

The combined probability of a deflationary outcome is now 15%, slightly lower than last quarter to reflect the removal of the "JPY collapse" scenario and a slightly reduced probability on the more severe "Eurozone deflationary spiral" following the fall in the euro and the greater-than-expected commitment to QE by the ECB (see table 1).

Meanwhile, the addition of the "Eurozone abandons austerity" scenario means the probability of reflation (stronger growth and higher inflation than baseline) has risen from 4% to 7% when combined with the "G7 boom" (see table 1). There is a reduction in stagflation as a result of dropping the capacity limits scenario. Nonetheless, despite the recent ceasefire, the "Russian rumble" (where conflict in the Ukraine culminates in the cut off of energy supplies to Europe) remains one of the greater individual risks.

Table 1: Balance of scenario probabilities by macro outcome vs. baseline

Scenario	Probability Feb.2015, %	Probability Nov.2014, %	Change, %
Deflationary	15	17	-2
Reflationary	7	4	+3
Productivity boost	4	4	0
Stagflationary	6	11	-5

Source: Schroders, 24 February 2015.

EM forecast update: Oil on troubled waters or fuel for the fire?

A more negative outlook in general for the BRICs…

This quarter has seen revisions to the growth outlook for 2015 for all countries bar China. The inflation outlook is broadly lower, due to the same oil price effect. In Russia, however, sanctions and rouble weakness will keep inflation high. India's numbers have undergone substantial revisions thanks to a change in the accounting methodology used, but our growth path expectations are broadly unchanged.

Table 3: Summary of BRIC forecasts

% per annum	GDP			Inflation		
	2014(f)	2015(f)	2016(f)	2014	2015(f)	2016(f)
China	7.4 ↑	6.8 →	6.5 →	2.0	1.7 ↓	2.0 ↓
Brazil	0.1 ↓	-0.6 ↓	0.9 ↓	6.3	6.7 ↑	5.7 →
India	7.2 ↑	7.5 ↑	7.8 ↑	7.2	5.6 ↓	6.0 ↑
Russia	0.4 ↓	-4.9 ↓	-0.4 ↓	7.8	13.4 ↑	6.2 →

Source: Bloomberg, Thomson Datastream, Schroders. 23 February 2015.

Separately, concerns have been building recently about EM vulnerabilities in the event of a Fed rate rise. Of course, these concerns are not new, but interest in the issue has been revived as we approach the putative day of reckoning. In part, this has been thanks to data from the Bank of International Settlements (BIS) and a report from the OECD[1], flagging a large increase in corporate bond issuance in the developing world. Chinese corporates are now the largest issuers of corporate bonds through private placements, receiving 41% of all money raised through such placements in 2013. Total EM issuance has risen close to 15 times since 2000, to stand at $467 billion.

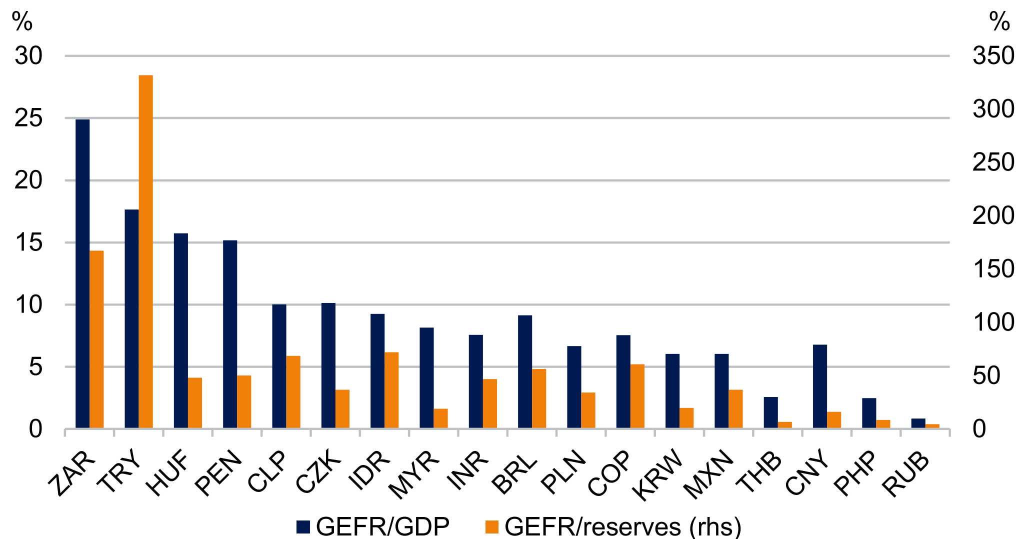
…while EM as a whole faces disruption

This signals a growing dependence on dollar liquidity, a risk we have flagged before when looking at the gross external financing requirement (GEFR)[2]. The danger is that a hike by the Fed, particularly if it comes earlier than the market expects, could trigger EM corporate defaults and economic slowdown, if not crisis. We do not believe the summer will see a 1998 style EM-wide crisis, but certain countries are at particular risk. Turkey and South Africa are most exposed on the GEFR metric (chart 11), and could see financial and corporate distress as dollar liquidity tightens.

[1] Çelik, S., G. Demirtaş and M. Isaksson (2015), "Corporate Bonds, Bondholders and Corporate Governance", OECD Corporate Governance Working Papers, No. 16, OECD Publishing. http://dx.doi.org/10.1787/5js69lj4hvnw-en.

[2] Current account deficit + short term external financing.

Chart 11: Gross external financing requirement in EM



Source: Thomson Datastream, JEDH, Schroders. 25 February 2015.

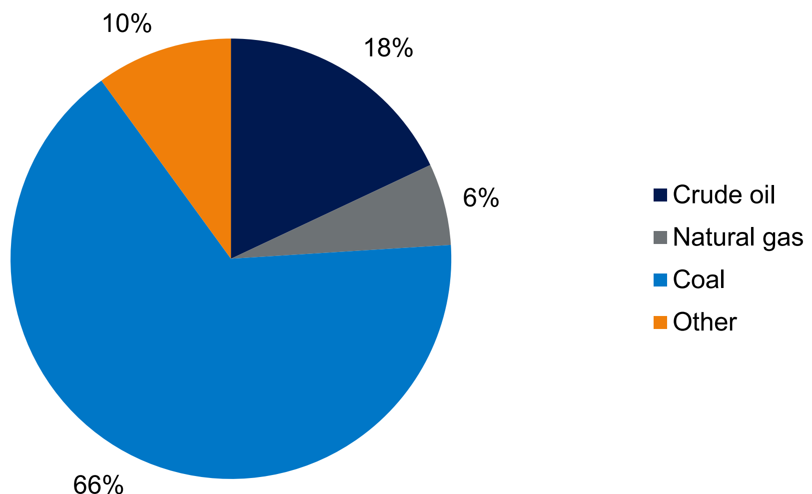
China – oil eases the path of reform

Oil has helped China but growth impact will be limited

The growth outlook for China this year and next is unchanged. Stimulus efforts in 2014 struggled to raise growth to the 7.5% target, and we continue to expect the growth target for 2015 to be lowered to around 7% in March. We say "around", because this wording gives the government wiggle room in undershooting the target as they come to realise that the level of stimulus needed will once again build fragilities.

One implication is that the significant fall in the oil price has limited growth benefits for China. The first reason is that, even under better domestic circumstances, the impact and pass-through would be limited. According to UBS, oil accounts for 18% of Chinese energy, of which household consumption is one third (chart 12). Domestic oil prices have also fallen by much less than the global price, due in part to a tax increase. Furthermore, in a heavily state controlled economy, many of the prices which would normally be impacted by cheaper oil are controlled. So rather than passing on price falls, the government takes the opportunity to reduce subsidies. So while the oil price fall is good for China because it enables accelerated energy price reforms, the boost to consumption will be limited.

Chart 12: Chinese energy consumption dominated by coal



Source: UBS Macro Keys, 20 January 2015.

On the investment side, as indicated by Producer Price Index (PPI) deflation, overcapacity remains a significant problem in China. Gains to industry accruing from lower input costs therefore seem unlikely to be spent on investment, and increases will be offset in any case by lower investment in the oil and energy sectors.

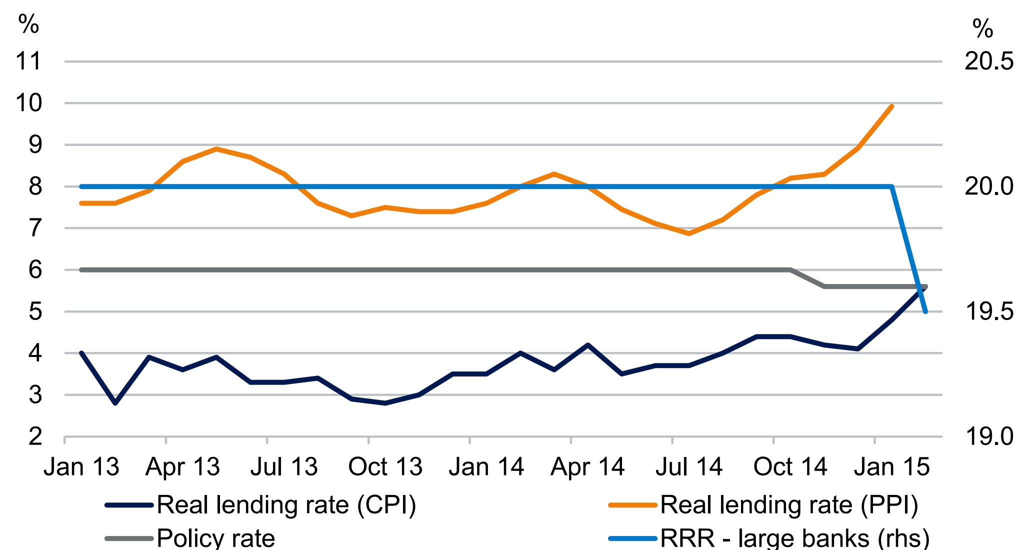
Normally, faster growth in the advanced economies, as we are forecasting, would drive export growth for the emerging world, including China. However, as argued above this relationship seems to have weakened since the financial crisis and so we are not disposed to assume significant gains through this channel.

On balance, while lower oil costs present some small upside growth risks, the impact remains uncertain. We are also of the view that government fiscal support for the economy (via infrastructure investment) would be moderated in the event of stronger growth, in an attempt to keep some powder dry for the long slowdown ahead. Still, our unchanged growth number does now carry more upside risks than before.

Disinflation gives ample scope for easing

Inflation has seen some downward pressure thanks to the lower oil price, touching 0.8% in January. Though unlikely to stay so low throughout 2015, the oil price profile does suggest continued disinflation, in addition to what might be expected from overcapacity and moderating domestic demand. Consequently we have revised down our inflation numbers for the forecast period. We continue to expect monetary easing, but in part this is to hold down real rates (which continue to rise – see chart 13) more than boost growth; the authorities remain cautious over adding further to the leverage problem. We expect this easing to lead to further currency depreciation despite the trade surplus China enjoys, but do not believe the authorities will resort to devaluation as a growth tool.

Chart 13: Chinese real rates climb despite monetary easing



Source: Thomson Datastream, Schroders. 24 February 2015.

Brazil – something is rotten in the state of Rio

A trifecta of issues imperils Brazil

We have downgraded our growth outlook for Brazil on the back of the growing Petrobras scandal and greater-than-expected fiscal consolidation plans. Also, while the country is a net importer of oil products, the price declines will further hit Petrobras and negatively impact capital expenditure. There is also a downside risk posed by possible water shortages, which could prompt electricity rationing.

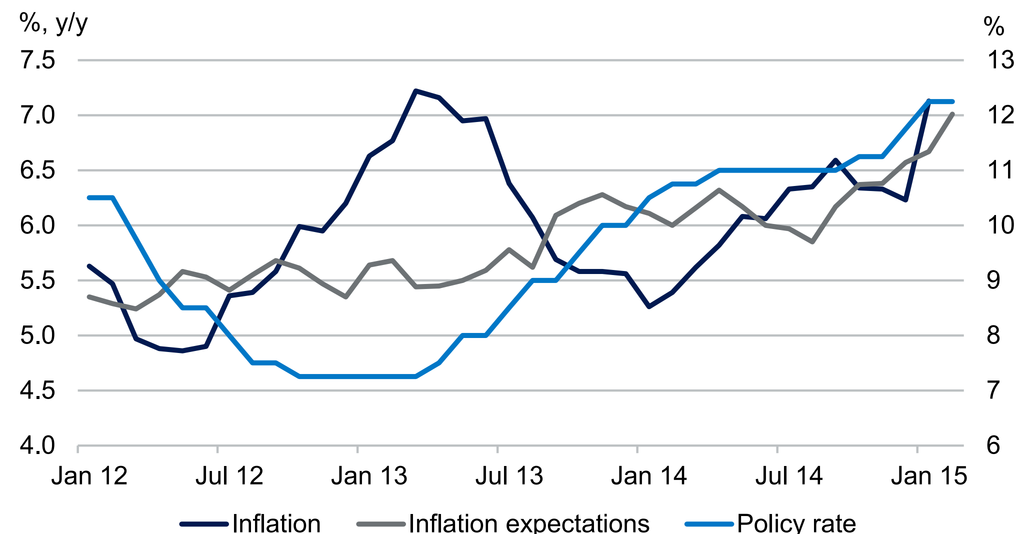
A quick summary of the Petrobras scandal is that, allegedly, executives of the state owned oil company have operated a kick-back scheme for the past decade. Payments were made to companies and politicians, mainly associated with the ruling Workers' Party, financed by inflating the value of contracts for infrastructure

projects. Officials conducting the police investigation – Operation Car Wash – believe contracts worth a total of $22 billion are suspicious. Beyond the consequences for the firm, whose revenues were equivalent to 5% of Brazilian GDP in 2013, the investigation has also ensnared a large number of suppliers. Affected firms will greatly reduce their capital spend this year, enough to knock 0.3-0.5% off GDP according to estimates from Capital Economics. The scandal also threatens to engulf the ruling party and severely impede reforms. We could be looking at a lost half decade for Brazil.

Fiscal consolidation actually represents a bright spot, despite the macroeconomic impact. That is, it is a rare sign of good economic policy in Brazil. Finance Minister Joaquim Levy's appointment provided a boost to Brazilian assets, precisely because he is a credible fiscal reformer. He has announced a primary fiscal surplus target of 1.2% for 2015 and a series of measures aimed at attaining this goal. However, while the fiscal package he announced on 19 January is comprised of "low hanging fruit'", it will bring in only 0.4% of GDP in revenues – the rest of the adjustment requires legislative efforts which are likely to be impaired by the Petrobras scandal. Nonetheless, there can be little fiscal support for growth this year.

As for water shortages, Brazil is suffering its worst drought in 80 years and reservoirs are approaching dangerously low levels in many areas. Almost 100 Brazilian cities have implemented water rationing. With 76% of electricity generated by hydroelectric dams, electricity rationing might have to follow. The last time this happened, in 2001, economic growth was reduced by 0.5 – 1.0%. This is currently not our base case but does provide a clear downside risk.

Chart 14: Inflation faces pressure from currency and tariff hikes



Source: Thomson Datastream, Schroders. 24 February 2015.

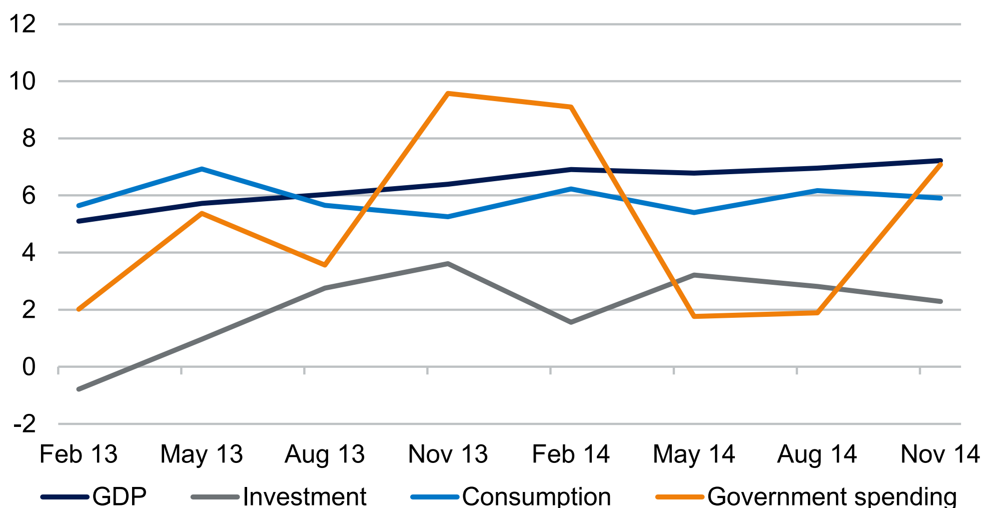
The central bank once again faces an unpleasant dilemma

Inflation, meanwhile, is likely to get worse before it gets better. Our increase to the forecast for 2015 reflects the one off impact of electricity tariff increases and pass-through from the continuing depreciation of the currency. We expect further rate hikes from the central bank before the current cycle comes to an end, but then believe we could see cuts in the second half of the year as growth sours markedly. While inflation will be higher, the central bank should be able to treat this as transitory given that it will chiefly arise from one off factors.

India – waiting for reform

A significant upward revision to growth sees India outpacing China in economic growth – Modi works fast! Sadly though, this is the result of a change in GDP calculation rather than due to a raft of successful reforms, which have so far been lacking. Investment growth remains weak (Chart 15), and it will take a real, rather than accounting, change to remedy this situation.

Chart 15: Indian GDP revisions "boost" growth but investment still weak



Source: Thomson Datastream, Schroders. 25 February 2015.

Still positive on India, but we need to see reform soon

Nonetheless, sentiment remains positive, and the political day is young. Even absent "big bang" reforms, things are improving in India. We visited India earlier this month, and businesses spoke positively of the heightened engagement and efficiency of the government bureaucracy, with response times greatly reduced. The scope for further gains here was also highlighted at several meetings, particularly as regards the $300 billion in stalled projects, at least half of which are held up by regulatory or other bureaucratic issues. Land acquisition is a particular problem, accounting for 33% of stalled projects.

Reforms are being delayed, in part, by the lack of a ruling party majority in the upper house, preventing passage of key bills. For now, the government is attempting to overcome this blockage via executive fiat, issuing ordinances to enact reforms on a short term basis. But with a six month life span these are not providing sufficient assurances for investors. Prospects for corporate capital expenditure are also limited by low capacity utilisation (currently around 65%), a problem only economic growth can address. In general, the repeated refrain was that India has seen a qualitative but not quantitative change, and that things must change "on the ground" before investment will revive.

A separate but still important issue is this year's budget, due 28 February. It was seen by everyone we met as a key indicator of government intentions. Although corporate capital expenditure may take time to recover, the budget offers the possibility of a pick up in infrastructure expenditure, even while staying on track for fiscal consolidation. To achieve this, the government would need to switch some current expenditure to capital expenditure – important politically because it would signal a commitment to longer term planning, and important economically because infrastructure is in dire need of investment. This is where cheaper oil's benefits can be felt in India – it has enabled the reduction of subsidies and the hiking of taxes on oil, boosting fiscal accounts and creating room for increased infrastructure investment.

Oil has also helped drive down inflation, with Wholesale Price Index (WPI) inflation actually turning negative in January. Central bank governor Rajan has begun cutting interest rates and signalled willingness to do more, provided the budget is sufficiently 'prudent'. Our expectation is for rates to reach 7% by the third quarter and then stay there, with the ultimate 4% inflation target staying the central bank's hand from further easing.

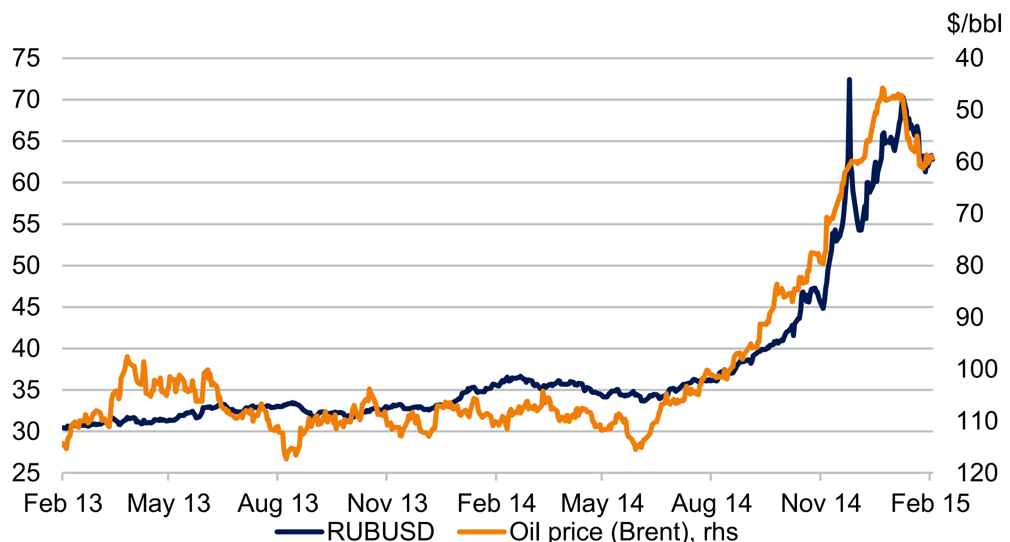
Russia – oil creates a slippery slope

A weaker oil price is, unsurprisingly, bad news for Russia. As well as contributing to currency weakness and a worsening current account position, it reduces the scope for fiscal support for the economy. 2014's budget assumed a $114 per barrel price – 2015 will have to see substantial cutbacks. Combined with sanctions and still high tensions in Ukraine, we have turned more negative on the country's growth outlook, particularly in light of the move in the oil price since we last published our forecasts.

Russia's outlook seems increasingly out of its control

Russia's fortunes are irrevocably intertwined with the oil price; the relationship between the rouble and oil is extremely strong (see chart 16). So not only does weaker oil hurt exports (two thirds of which are rooted in the energy sector), fiscal revenues (roughly half of which are derived from energy exports) and investment, it also drives higher inflation at a time when prices are already being pushed up by sanctions. This has led us to revise our inflation forecast for Russia significantly upwards to 13.4% in 2015 (previously 7.6%).

Chart 16: Oil weakness spells trouble for the rouble



Source: Thomson Datastream, Schroders. 25 February 2015.

The year, as told by activity data, has started badly. Retail sales and investment figures both showed contraction, with only limited growth in industrial production which coincided with a spike in real public spending (likely on preparations for the construction of gas pipelines to Turkey and China). The inevitable fiscal consolidation will see industry slide into contraction.

Meanwhile, on the political front, there seems no reason to suppose the current ceasefire in Ukraine will provide any more lasting a peace than previous attempts. The Ukrainian government forces' withdrawal from Debaltseve has earned a brief reprieve from violence, but a rebel offensive against Mariupol looks likely given the current massing of forces nearby. Consequently, we expect sanctions to persist and Russian exporters to struggle despite a weaker rouble.

Schroder Economics Group: Views at a glance

Macro summary – February 2015

Key points

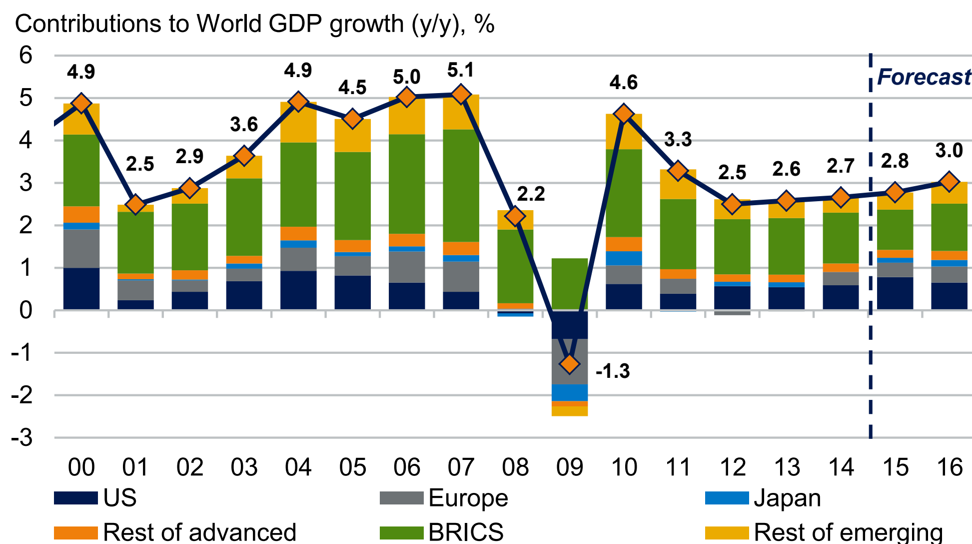
Baseline

- Global recovery to continue at modest pace as the upswing in the advanced economies is offset by slower growth in the emerging markets. Lower energy prices will push inflation in the advanced economies to its lowest level since 2009.
- US economy on a self sustaining path with unemployment set to fall below the non-accelerating rate of unemployment (NAIRU) in 2015, prompting Fed tightening. First rate rise expected in June 2015 with rates rising to 1.25% by year end. Policy rates to peak at 2.5% in 2016.
- UK recovery to moderate in 2015 with cooling housing market, political uncertainty and resumption of austerity. Interest rate normalisation to begin with first rate rise in November 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 firms 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 as ECB and BoJ policy is now largely priced in.
- Emerging economies benefit from advanced economy upswing, but tighter US monetary policy, a firm dollar and weak commodity prices weigh on growth. China growth shifting downward as the property market cools and business capex is held back by overcapacity. Further easing from the PBoC to follow.

Risks

- Risks still skewed towards deflation on fears of Eurozone deflationary spiral, China hard landing and secular stagnation. Upside growth risks on a return of animal spirits and a G7 boom, fiscal stimulus in the Eurozone and lower energy prices. Stagflationary risks centre around a further deterioration in the Russia/ Ukraine crisis culminating in a cut off in energy supply to Western Europe.

Chart: World GDP forecast



Source: Thomson Datastream, Schroders 20 February 2014 forecast. 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	2.7	2.8		(2.8)	2.8	3.0	↑	(2.8)	3.1
Advanced*	63.2	1.7	2.2	↑	(2.0)	2.2	2.2	↑	(2.1)	2.3
US	24.5	2.4	3.2	↑	(2.8)	3.2	2.7	↑	(2.4)	2.9
Eurozone	19.2	1.1	1.3	↑	(0.9)	1.2	1.6	↑	(1.4)	1.7
Germany	5.4	1.6	1.6	↑	(1.2)	1.5	2.0	↑	(1.8)	1.9
UK	3.9	2.6	2.6	↑	(2.5)	2.7	2.0	↑	(1.8)	2.5
Japan	7.2	0.0	1.6	↑	(1.1)	1.3	2.2		(2.2)	1.6
Total Emerging**	36.8	4.2	3.7	↓	(4.1)	3.8	4.4	↑	(4.1)	4.6
BRICs	22.6	5.3	4.2	↓	(4.8)	4.4	4.9	↑	(4.7)	5.2
China	13.5	7.4	6.8		(6.8)	7.0	6.5		(6.5)	6.9

Inflation CPI

y/y%	Wt (%)	2014	2015		Prev.	Consensus	2016		Prev.	Consensus
World	100	2.8	2.5	↓	(2.9)	2.3	3.0	↓	(3.2)	3.0
Advanced*	63.2	1.4	0.5	↓	(1.3)	0.3	1.8		(1.8)	1.7
US	24.5	1.6	0.7	↓	(1.5)	0.3	2.2	↓	(2.4)	2.3
Eurozone	19.2	0.4	0.1	↓	(0.8)	-0.1	1.2	↑	(1.1)	1.1
Germany	5.4	0.8	0.4	↓	(1.4)	0.3	1.7		(1.7)	1.6
UK	3.9	1.5	0.6	↓	(1.3)	0.6	2.1	↑	(2.0)	1.8
Japan	7.2	2.7	0.6	↓	(1.3)	0.9	1.3	↓	(1.4)	1.2
Total Emerging**	36.8	5.1	5.9	↑	(5.6)	5.8	5.0	↓	(5.6)	5.1
BRICs	22.6	4.0	4.5	↑	(4.0)	4.3	3.6	↓	(4.0)	3.7
China	13.5	2.0	1.7	↓	(2.2)	1.7	2.0	↓	(2.7)	2.1

Interest rates

% (Month of Dec)	Current	2014	2015		Prev.	Market	2016		Prev.	Market
US	0.25	0.25	1.25		(1.25)	0.84	2.50		(2.50)	1.66
UK	0.50	0.50	0.75		(0.75)	0.77	1.50		(1.50)	1.29
Eurozone	0.05	0.05	0.05		(0.05)	0.03	0.05		(0.05)	0.08
Japan	0.10	0.10	0.10		(0.10)	0.10	0.10		(0.10)	0.10
China	5.60	5.60	5.00	↓	(5.20)	-	4.50	↓	(5.00)	-

Other monetary policy

(Over year or by Dec)	Current	2014	2015		Prev.	2016		Prev.
US QE ($Bn)	4498	4498	4607	↑	(4594)	4662	↑	(4557)
EZ QE (€Bn)	0	0	600		-	1140		-
UK QE (£Bn)	375	375	375		(375)	375		(375)
JP QE (¥Tn)	300	295	383		(383)	400	↑	(383)
China RRR (%)	20.00	20.00	19.00		19.00	18.00		18.00

Key variables

FX (Month of Dec)	Current	2014	2015		Prev.	Y/Y(%)	2016		Prev.	Y/Y(%)
USD/GBP	1.54	1.56	1.50		(1.50)	-5.9	1.48		(1.48)	-3.8
USD/EUR	1.14	1.21	1.12	↓	(1.18)	-12.2	1.09	↓	(1.14)	-7.4
JPY/USD	118.7	119.9	120.0	↓	(125)	14.1	125.0	↓	(130)	0.1
GBP/EUR	0.74	0.78	0.75	↓	(0.79)	-6.7	0.74	↓	(0.77)	-3.8
RMB/USD	6.24	6.20	6.30	↑	(6.20)	2.5	6.40	↑	(6.35)	1.5
Commodities (over year)										
Brent Crude	60.7	55.8	61.6	↓	(82)	-49.9	69.7	↓	(86)	10.3

Source: Schroders, Thomson Datastream, Consensus Economics, February 2015
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 13/02/2015
Previous forecast refers to November 2014

* **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 Forecast Scenarios

Scenario	Summary	Macro impact	Probability*	Global vs. 2015 baseline Growth	Inflation
Baseline	An increase in our projection for the Advanced economies is offset by a cut to the Emerging markets to leave our global growth forecast at 2.8% for 2015. US growth is expected to reach 3.2% this year, the best performance for 10 years as the benefits of lower oil prices feed through to consumers and business. Europe and Japan also gain from cheap oil and a more competitive currency. However, at the global level the boost to growth from lower oil prices is largely offset by continuing structural headwinds in the emerging world particularly strength in the USD. Our China forecast is unchanged as we balance the positives of better external demand and looser monetary policy against the ongoing weakness in housing and capex. Forecasts for Brazil and Russia have been cut to reflect domestic problems with the latter becoming increasingly isolated from the world economy. For 2016, US growth moderates as the boost from oil fades and higher interest rates and a stronger USD begin to weigh on growth. However, the overall global growth forecast ticks up to 3% next year on further improvement in Europe and Japan as well as continued strength from India.	Our inflation forecasts have been cut in response to lower than expected out turns in recent months and the further fall in oil prices. Global inflation is expected to come in at 2.5% for 2015 with a significant reduction for the Advanced economies to 0.5% 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 stable core rate of inflation and tightening labour market so as to raise rates in 2015. We expect the Fed funds rate to rise to 1.25% 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. We expect the ECB to implement QE through to September 2016 and leave rates on hold, whilst for the UK, we stick with our call for the first rate hike in November 2015. 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.	65%	-	-
1. EZ deflationary spiral	Despite the best efforts of Mario Draghi and 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 continuing 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 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.	4%	-0.6%	-0.6%
2. G7 boom	After a prolonged period of balance sheet repair, animal spirits return to the private sector which finally responds to ultra-loose monetary policy and the gains in asset prices. Advanced economy growth picks up more rapidly than in the base as the corporate sector increases capex and consumers spend more rapidly as banks increase lending. Stronger G7 demand spills over to the emerging markets taking global growth above 4% in 2016. Labour markets tighten more rapidly and commodity prices increase relative to the base resulting in a pick-up in inflation.	Reflationary: stronger growth and inflation vs. 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. 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 change in interest rates. Inflation concerns result in tighter monetary policy in the emerging markets with China and India raising rates in 2016. The US Fed starts to actively unwind QE by reducing its balance sheet.	4%	+0.8%	+0.5%
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. Given the flexibility of the latter this means a significant period of low prices with Brent crude falling to $30 by end 2015 and remaining there through 2016.	Better 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 Chian, 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.	4%	+0.2%	-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.	5%	-0.4%	-0.2%
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.	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.	6%	-1.0%	-0.8%
6. Russian rumble	Despite the "ceasefire", fighting continues in East Ukraine between government forces and rebels supported by Russian troops. Putin continues to supply the rebels and the West retaliates by sending weapons to the Ukraine army and significantly increasing sanctions. Russia responds by cutting gas and oil supplies to Europe. The shortage of energy pushes oil prices back to $90 p/bbl in short order.	Stagflationary. Europe is hit by the disruption to energy supply resulting in a fall in output whilst alternative sources are put in place. Higher oil prices hit global inflation and the breakdown of relations between Russia and the west damages household and business confidence and creates significant volatility in financial markets. Policy rates are considerably lower as central banks wish to avoid damaging confidence further and look through the rise in inflation.	6%	-0.5%	+0.6%
7. EZ abandons austerity	Disappointment with the results of austerity and fearful of a growing political backlash the Eurozone reverses course. Governments ease fiscal policy significantly, increasing spending and cutting taxes whilst the EU fully implements the €300bn Juncker plan of public-private infrastructure spending.	Reflationary: stronger growth and inflation vs. baseline. Eurozone growth picks up sharply and the increase in demand supports growth in developed and emerging markets. As the EZ's largest trading partner, UK GDP growth accelerates to over 3% whilst overall global growth is some 0.4% higher. Commodity prices and inflation are marginally higher but less so than in the G7 boom as the increase in activity is concentrated on the region with the most slack in the world economy. Policy rates are marginally higher, although not in the EZ or Japan. However the ECB is likely to end QE after September 2016 in this scenario.	3%	+0.4%	+0.2%
8. Other			3%	-	-

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

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

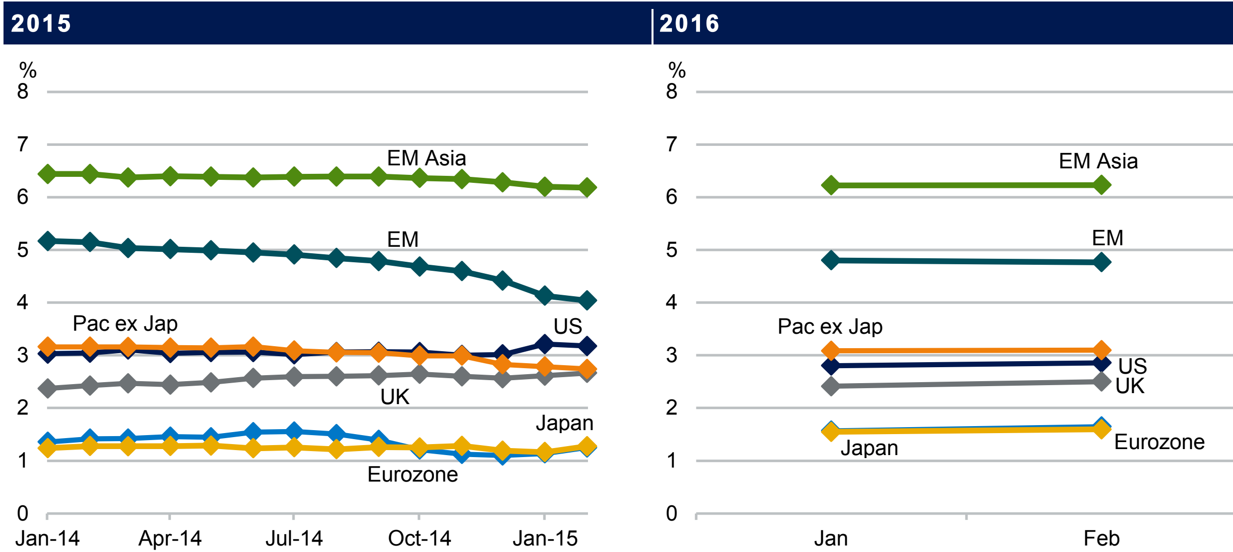
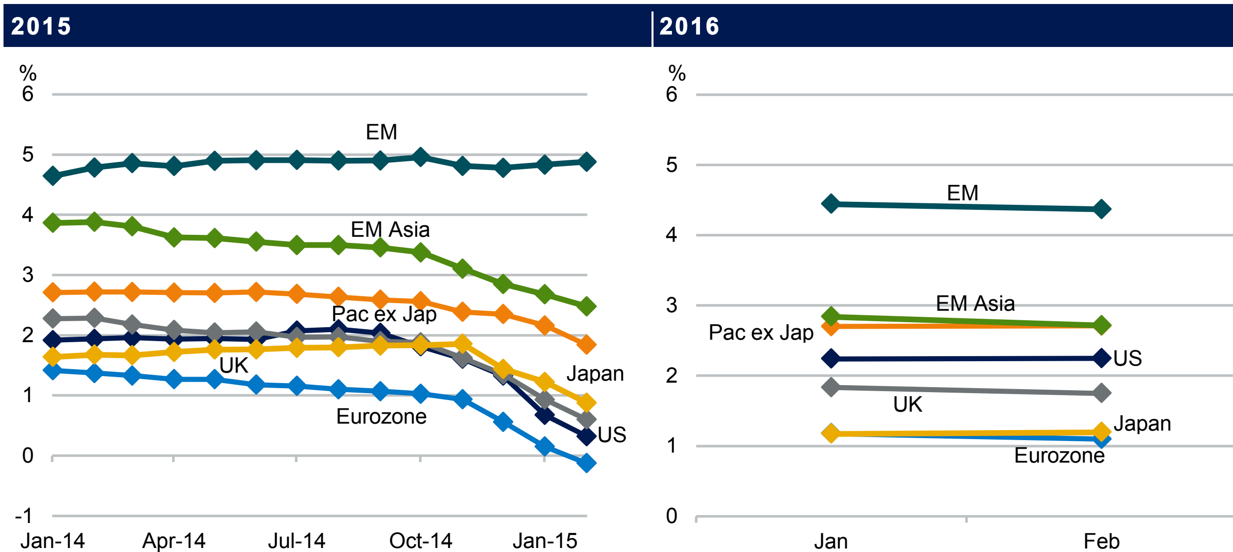


Chart B: Inflation consensus forecasts



Source: Consensus Economics (February 2014), Schroders
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

Important Information: For professional investors only. This material is not suitable for retail clients.
The views and opinions contained herein are those of Schroder Investments Management's Economics team, and may not necessarily represent views expressed or reflected in other Schroders communications, strategies or funds. This document is intended to be for information purposes only and it is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Schroders has expressed its own views and opinions in this document and these may change. The material is not intended to provide, and should not be relied on for, accounting, legal or tax advice, or investment recommendations. Information herein is believed to be reliable but Schroder Investment Management Ltd (Schroders) does not warrant its completeness or accuracy. The data has been sourced by Schroders and should be independently verified before further publication or use. No responsibility can be accepted for error of fact or opinion. This does not exclude or restrict any duty or liability that Schroders has to its customers under the Financial Services and Markets Act 2000 (as amended from time to time) or any other regulatory system. Reliance should not be placed on the views and information in the document when taking individual investment and/or strategic decisions. The forecasts included should not be relied upon, are not guaranteed and are provided only as at the date of issue. Our forecasts are based on our own assumptions which may change. We accept no responsibility for any errors of fact or opinion and assume no obligation to provide you with any changes to our assumptions or forecasts. Forecasts and assumptions may be affected by external economic or other factors. For your security, communications may be taped or monitored. Issued in January 2015 by Schroder Investment Management Limited, 31 Gresham Street, London EC2V 7QA. Registered No. 1893220 England. Authorised and regulated by the Financial Conduct Authority.