Schroders
Economic and Strategy Viewpoint

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Global update: growth downgraded, but inflation pressure builds on oil and ageing US cycle (page 2)

- Following a disappointing first quarter we have cut our 2015 forecast for global growth to 2.5% from 2.8%. Downgrades are focussed on the US, Japan and the UK. The emerging markets met our rather low expectations, whilst the bright spot was the Eurozone where we have upgraded our growth forecast.
- Lower growth has not led us to lower our inflation projections as oil prices have firmed and we see inflationary pressures building in the US where interest rates are expected to rise in September. Elsewhere though monetary policy is set to remain loose, or ease further in the case of China.
- Our updated scenario analysis reveals continued concerns about deflation, but an increasing focus on the risks around Fed policy.

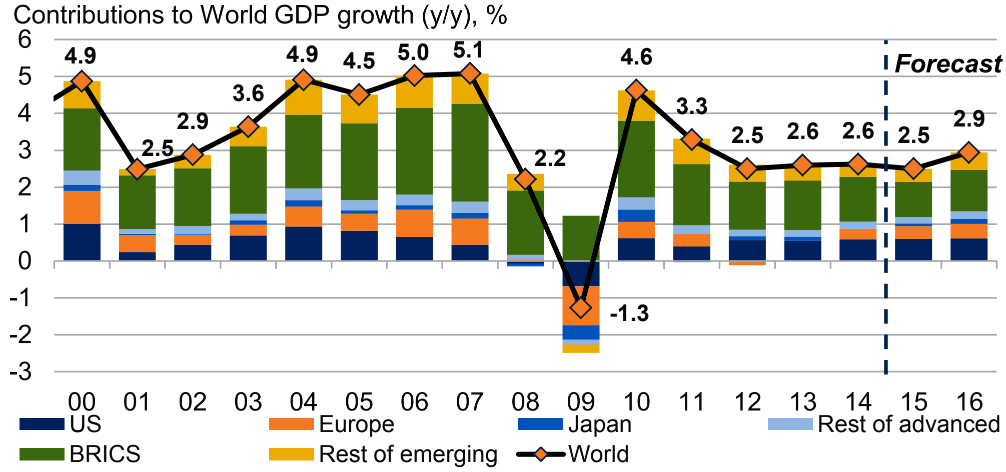
European forecasts on track (page 8)

- Growth in the Eurozone has largely been as forecast, although within the mix of member states, Spain, France and Italy outperformed expectations, while Germany disappointed slightly. However, a closer look supports our view that Germany will continue to drive the recovery, while the recovery in France still looks fragile.
- The UK's election uncertainty has passed, which should help the economy recover from the first quarter disappointment. However, the resumption of austerity will slow growth from 2016. Moreover, lower than expected inflation over this year is now expected to delay the first interest rate hike to 2016.

Views at a glance (page 14)

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

Chart: Global growth struggles to break above 2.5%



Source: Thomson Datastream, Schroders, 27 May 2015. Please note the forecast warning at the back of the document.

Global update: growth downgraded, but inflation pressure builds on oil and ageing US cycle

Overview

Global growth downgraded after disappointing first quarter

We have cut our 2015 forecast for global growth from 2.8% to 2.5%, primarily as a result of a downgrade to the US where the economy stalled in the first quarter. We have also downgraded Japan and the UK following a weaker-than-expected start to the year. US growth is anticipated to pick up going forward, but is now forecast to reach 2.4% this year (previously 3.2%), the same as in 2014. 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 the first quarter, 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 (both spot and forward). Global inflation is forecast to come in at 2.8% for 2015, but still with a significant reduction for the advanced economies to 0.6% from 1.4% in 2014. The US Federal Reserve (Fed) is still expected to look through this 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 likely to ease as inflation picks up in 2016 thanks to the depressing effect of lower oil prices dropping out of the annual comparison in combination with the weaker euro. We expect 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 February 2016. In Japan, the Bank of Japan (BoJ) will keep the threat of more QQE (quantitative and qualitative easing) on the table, but is expected to let the weaker yen support the economy and refrain from further loosening. We remain positive on the outlook given the benefits of lower energy inflation on household spending and the competitiveness of the yen. China is expected to cut interest rates and the reserve requirement ratio (RRR) further, and pursue other means of stimulating activity in selected sectors.

US puzzles

Sounds familiar?

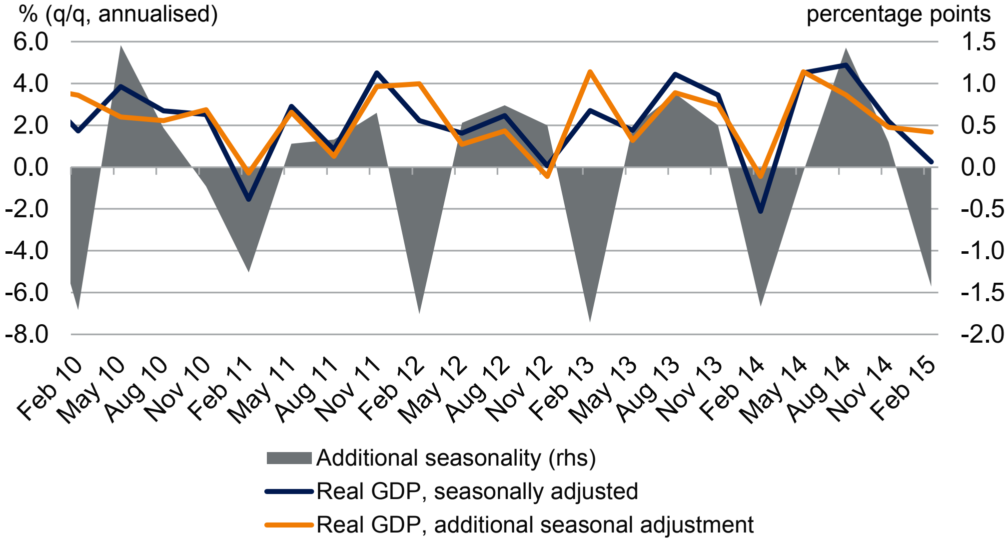
There is a sense of déjà vu about this month's US growth downgrade as we went through the same process last May in response to a weaker-than-expected start to the year. Bad weather took the blame last time and has played a role in the latest downgrade. Households were unable to travel to work or shop, and businesses faced problems operating and transporting goods as a freezing winter left many at home.

However, notwithstanding meteorological factors, a weak first quarter has been a feature of the US economy in recent years with growth persistently disappointing. Recent research from the San Francisco Federal Reserve[1] suggests that this is not a coincidence and they find evidence of faulty seasonal adjustment such that first quarters are consistently weak. Applying a seasonal adjustment filter to the official data, we found GDP growth in the first three months of the year was closer to 1.7% annualised then the initially recorded 0.2%. Note that this factor works the other way in the second and third quarters, giving a seasonal boost to growth (chart 1).

[1]See "The puzzle of weak first quarter GDP growth", FRBSF Economic letter, 18 May 2015.

Chart 1: First quarters are seasonally depressed in the US

Weak first quarter, followed by bounce in second and third is becoming a pattern

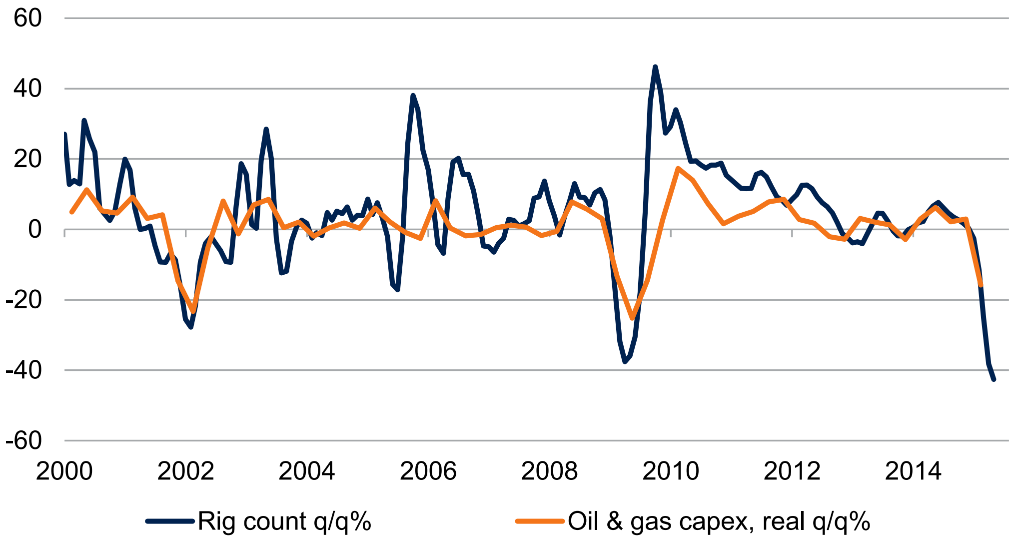


Source: Thomson Datastream, Schroders, 26 May 2015.

Cuts in energy capex have been swift, whilst consumers have yet to spend their gains

However, statistical factors are not the whole story. As acknowledged in our last Viewpoint, the benefits from lower oil prices seem to be taking longer than expected to feed through to the consumer. The consumer savings rate rose by nearly a percentage point in the first quarter, reducing consumption growth by a similar amount. Meanwhile, with energy capital spending falling around 16% quarter-on-quarter (not annualised) lower oil prices are having an immediate depressing effect on activity. This effect is likely to be even greater in the current span as the rig count has fallen at a faster quarterly rate (chart 2). On our estimates, this could amount to nearly 1% off annualised GDP, compared with just under 0.5% in the first quarter.

Chart 2: Oil weakness hits energy capital spending



Source: Thomson Datastream, Schroders, 27 May 2015.

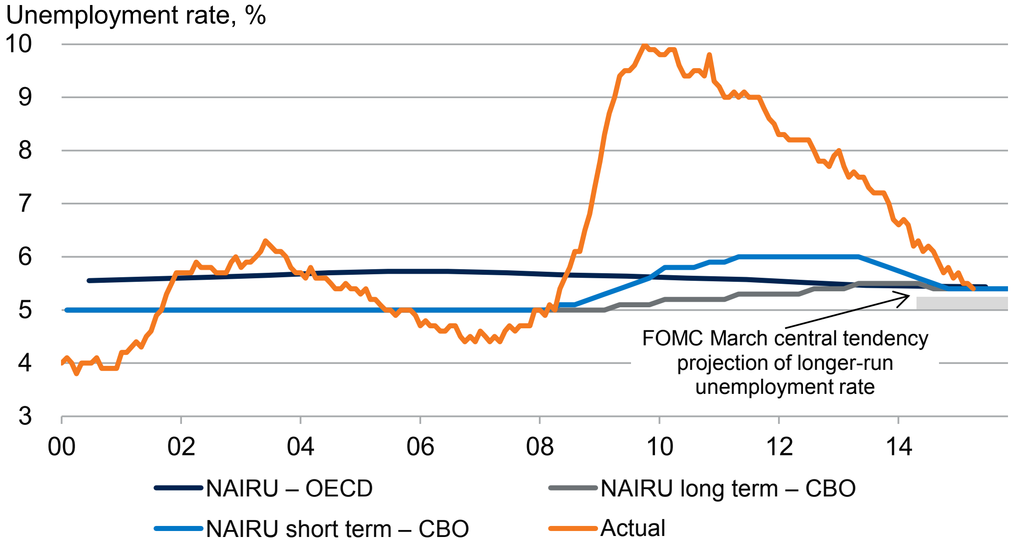
The drag should end in the third quarter if the stability in the oil price brings a pause in the adjustment to the rig count. Moreover, we should also see stronger consumption as real incomes continue to grow and the savings rate declines in response to the growth in wealth and consumer confidence. Given that energy capex is less than 10% of consumption, the balance should swing strongly in favour of growth in the second half of the year.

The end of the cycle?

Labour market returning to equilibrium following drop in unemployment

In another sign that there was something odd about the first quarter, we saw a further decline in US unemployment (from 5.7% to 5.4%), despite the apparent weakness in output. The unemployment rate is now at a level which many economists would consider to be close to equilibrium (chart 3). Confirmation of this can be seen in the pick-up in inflationary pressure in the form of higher wages, salaries and core CPI inflation.

Chart 3: US labour market in equilibrium



Source: Thomson Reuters Datastream/Fathom Consulting, 27 May 2015.

Slower productivity typical of an ageing cycle

The combination of weaker growth and rising inflation is typical of an economy nearing the end of its cycle. As the expansion matures, firms run into capacity constraints and have to add more workers. New entrants are initially less productive and consequently drag down productivity. Higher wage growth and lower productivity mean rising unit wage costs which constitute the greatest cost in the economy and accelerated to a 5% annualised rate in the first quarter of the year. From a macro viewpoint, this means we are entering the phase of the cycle where the trade-off between growth and inflation deteriorates. From a policy perspective, it means that the Fed will have to put increasing weight on inflation in its deliberations, and reinforces our view that monetary policy will need to tighten with the first move in rates coming in September.

There is one last puzzle to draw attention to: if wage costs were buoyant why did corporate profits appear to perform so well in the first quarter earnings season? Our top-down models suggest that margins were squeezed and sales were depressed in the first quarter; a combination which would point to poor profits performance. Corporate earnings for the S&P 500 did surprise positively in the recent reporting season with 330 companies beating expectations and 112 missing.

Pressure on US profits increasing from rising unit labour costs and the dollar

However, as has become the pattern, companies softened the market up with prior downgrades so as to create an easy base to beat on release day. Looking at the actual outcomes shows a clear pattern of deterioration with both operating and reported earnings falling in the first quarter on both a quarterly and annual basis. This follows a similar decline in the fourth quarter of last year.

So perhaps this is not a puzzle, but has simply been overlooked in the excitement of the US equity market reaching new highs. It can be argued that energy clearly played a role in this with earnings per share (EPS) turning negative at both the operating and reported level in the sector. If we adjust for this, the picture is stronger with operating EPS up 3% year-on-year compared with a decline of 5% for the overall index. Nonetheless, this is still relatively weak and alongside energy, four other sectors experienced a fall in EPS on the quarter. Of the five that rose, only financials and healthcare looked robust.

Returning to the aggregate picture and looking ahead, we expect a modest pick-up in S&P 500 EPS as the economy recovers. However, this is tempered by continued margin pressure as wage costs rise and consequently, is not enough to prevent an overall decline for 2015 at both the operating and reported level (table 1). Note that this is not driven by any particular sector (such as energy) as it reflects general pressure from rising costs in the economy. Dollar strength will also weigh on EPS by depressing overseas earnings and our forecasts are below consensus indicating more downgrades. It is possible that some companies will be able to reduce write-offs and increase share buy-backs so as to boost reported EPS, but they will struggle to turn aggregate EPS positive this year.

Table 1: US corporate earnings outlook

US	2011	2012	2013	2014	2015f
Economic profits					
y/y%	-2.9	23.4	4.3	16.6	1.0
Non.fin. share % GDP	7.6	8.9	8.9	10.0	9.8
S&P 500 EPS					
Operating $	$96	$97	$107	$113	$105
y/y%	15.1	0.4	10.8	5.3	-7.1
Reported $	$87	$87	$100	$102	$94
y/y%	12.4	-0.5	15.8	2.1	-8.2
S&P 500 end year	1,258	1,426	1,848	2,104	2,104
PE – operating EPS	13.0	14.7	17.2	18.6	20.0
PE – reported EPS	14.5	16.5	18.4	20.6	22.4

Source: S&P, Schroders, 27 May 2015. Please note the forecast warning at the back of the document.

Scenarios: rising concern over Fed tightening

We have introduced two new scenarios this quarter. Our concerns about inflation in the US and how a tentative central bank might react are represented by "Fed behind the curve". In this scenario, the Fed leaves rates on hold until September next year allowing inflationary pressure to build. They then have to react more aggressively as it becomes clear that inflation has to be reined in with Fed funds rising to 1.5% by December next year and to 3.5% in 2017. Compared to the baseline, this scenario is more reflationary for global growth and inflation in 2016. However, 2016 is also likely to see rising long yields and a steepening yield curve as inflation expectations increase and financial markets become increasingly volatile. As policy tightens, growth is expected to slow, but with inflation reacting with a lag we would see stagflation as the ultimate consequence of this scenario.

New scenarios capture fears over Fed tightening

The second new scenario is "Tightening tantrum" where the Fed's worst fears about the market reaction to higher rates are realised and global bond markets sell off sharply as tightening begins this September. As in the 2013 episode when the Fed signalled an end to QE, capital is likely to flow back into the US as investors unwind carry trades and the dollar strengthens. The Fed soldiers on with rate hikes but pauses at 1% and then reverses tack later in 2016 as it becomes clear that the de facto tightening of financial conditions is having a deflationary impact on global activity.

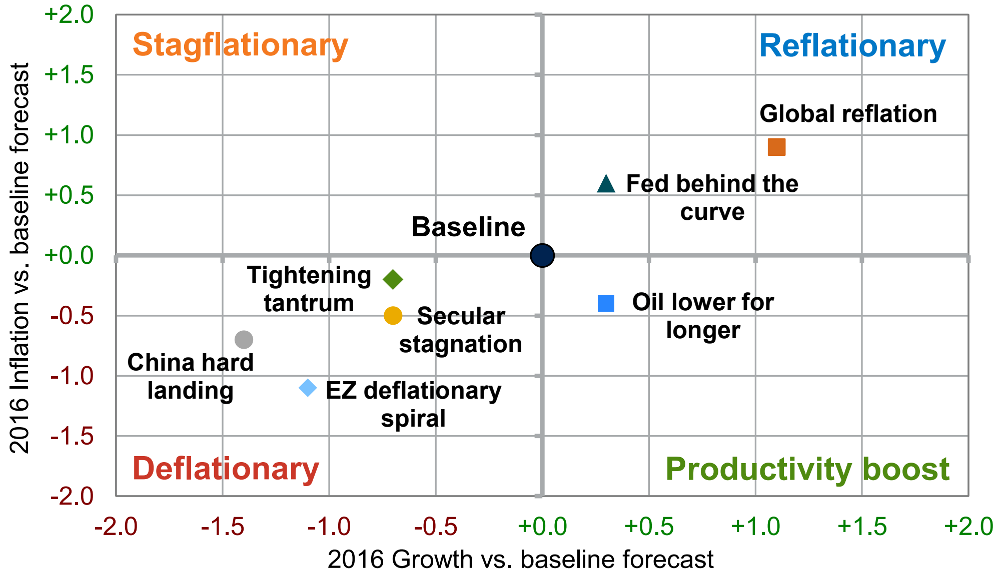
The new scenarios replace "Russian rumble" where the Ukraine crisis escalates into a full trade war between Russia and the West. Clearly this remains a risk and the situation may well deteriorate further but not necessarily on the scale of this scenario. We have also dropped the "Eurozone abandons austerity" scenario which has been rolled into the "Global reflation" scenario (a beefed-up version of the previous "G7 boom").

The other scenarios which have been carried over from last quarter are "Oil lower for longer" (where the oil price falls to $40 per barrel and stays there as Saudi Arabia turns the screws on US shale producers), "Secular stagnation" (a slow, grind lower in global activity), "China hard landing" (a collapse in property and banking results in recession in China) and "Eurozone deflationary spiral" (where the economy falls into a major Japan-style slump).

We have again resisted including a "Grexit" scenario where Greece leaves the euro, not because we think it is a low probability event, but rather because we believe the macro impact on the rest of the world would be minimal. Financial market volatility is likely to rise, but contagion should be limited by the ECB's ongoing bond buying. For a full description of each of the scenarios see table on page 21.

In terms of the balance of risks, the scenarios are still tilted toward deflation with four ("Secular stagnation", "China hard landing", "Eurozone deflationary spiral" and "Tightening tantrum") all producing outcomes of weaker growth and lower inflation than in the baseline (chart 4).

Chart 4: Scenario grid: outcomes vs. base



Source: Schroders, 27 May 2015.

Balance of risks still tilts toward deflation

The combined probability of a deflationary outcome is now 20%, higher than last quarter to reflect the addition of the "Tightening tantrum" scenario and a higher probability on "secular stagnation" given the latest downgrades to global growth. We have actually reduced the probability on "Eurozone deflationary spiral" and "China hard landing" following the better data in the former and greater-than-expected policy response by the authorities in the latter (see table 2).

Meanwhile, the increase in the reflationary outcome reflects the addition of the "Fed behind the curve" scenario which boosts growth and inflation in 2016 as monetary policy remains loose. However, as discussed above, this scenario is ultimately stagflationary and if classified as such would result in a reduction in the likelihood of this outcome. Finally, the "Oil lower for longer" fits into the productivity boost category of stronger growth and lower inflation. We have increased the probability on this given the ongoing imbalances in the oil market which some believe requires greater retrenchment on the supply side.

Table 2: Balance of probabilities by scenario outcome vs baseline

Scenario	Probability February 2015, %	Probability May 2015, %	Change, %
Deflationary	15	20	+5
Reflationary	7	15 (5)	+8 (-2)
Productivity boost	4	6	+2
Stagflationary	6	0 (10)	-6 (+4)
Baseline	65	55	-10

Source: Schroders, 27 May 2015.
Figures in brackets reflect alternative classification of Fed behind the curve. Please note the forecast warning at the back of the document.

European forecasts on track

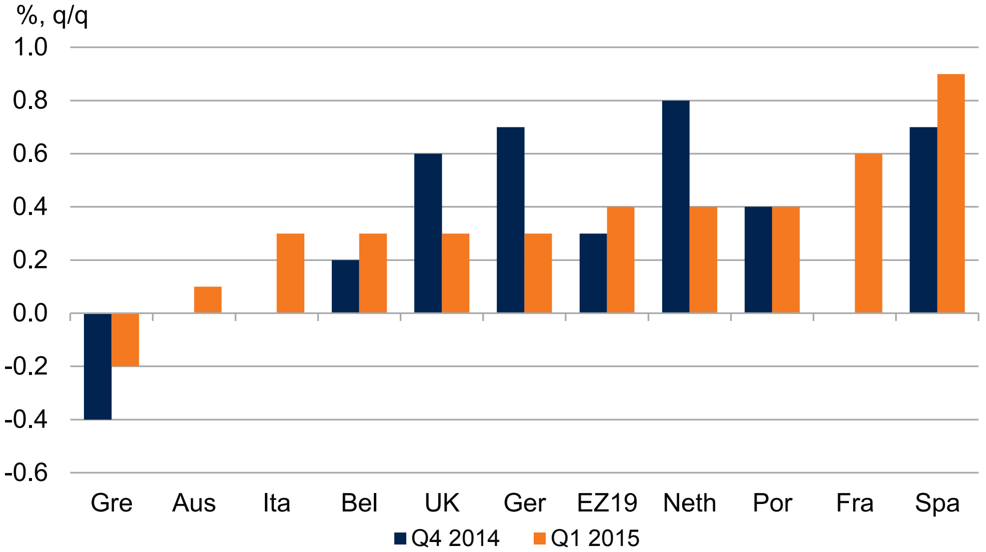
The economic recovery in Europe is progressing nicely and where there have been surprises, they have been to the upside. Thanks to the depreciation in the euro and rebound in energy prices, annual inflation is close to returning to positive territory. Meanwhile, the UK's election uncertainty is over with a surprise victory for the Conservative Party. Austerity is set to resume, which should dampen growth over the next couple of years.

Eurozone recovery on track

Growth in the Eurozone accelerated further in Q1…

Quarterly growth in the Eurozone picked up in the first quarter of 2015 to 0.4%, compared to 0.3% in the fourth quarter of 2014 (chart 5). Growth in the first quarter matched consensus estimates, but within the results of member states, there were some surprises.

Chart 5: Spain and France shine as Greece falls back into recession



Source: Eurostat, Schroders. 26 May 2015.

…however, Germany was not the star performer

In contrast to recent quarters, Germany was not the star performer in the latest set of figures. The German economy grew by 0.3%, compared to 0.7% in the previous quarter and against consensus expectations of 0.5% growth. The expenditure breakdown of Germany's GDP showed continued growth in household and government consumption, while investment also accelerated over the quarter. Exports also continued to grow, but the sharp pick-up in imports meant that net trade dragged down total growth. The pick-up in imports is a welcome sign that Germany may be rebalancing its economy at long last, which should, in time, benefit the European economy more widely (chart 6 on next page).

Meanwhile, France surprised on the upside, growing by 0.6% although the growth in the fourth quarter was revised away (to zero). Household consumption rose 0.8% in the first quarter – the fastest pace of growth since the fourth quarter of 2009. Investment remains in recession as it contracted for the fifth consecutive quarter, albeit at a slower pace. Government spending continued to grow while net trade was a negative contributor. However, most of the upside surprise in the French data was caused by a rise in inventories, which suggests that this pace of growth will not be maintained in the coming quarters (chart 7 on next page). Nevertheless, France should continue to grow at a reasonable pace over the rest of this year.

French growth is due to slow again as Q1 was driven by inventory growth

Chart 6: German consumption and imports

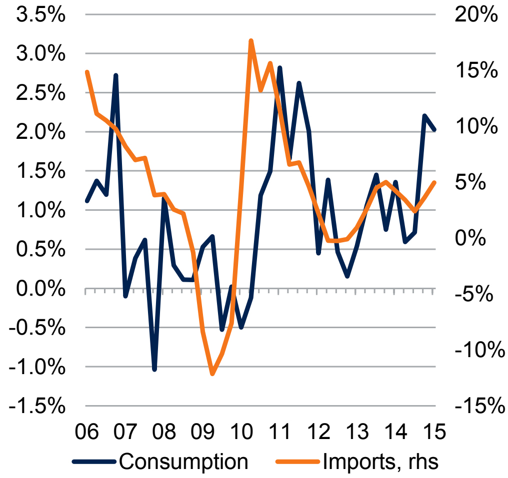
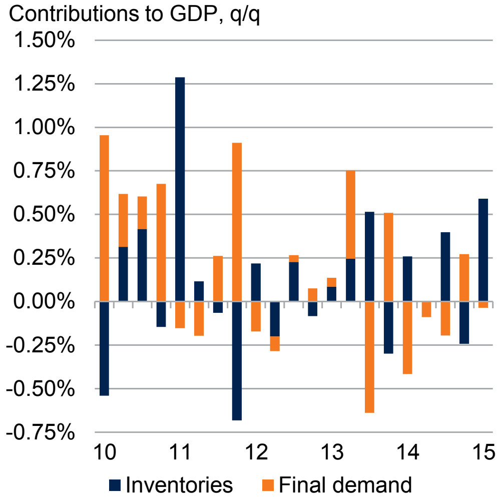


Chart 7: French GDP and inventories



Source: Thomson Datastream, Schroders. 26 May 2015.

In Italy, the economy is finally out of recession as it grew by 0.3%. It is the first quarter of positive growth since the third quarter of 2013. Meanwhile, Spain posted the best set of figures amongst the larger member states. The Spanish economy grew by 0.9% – the fastest quarter of growth since Q4 2007. Expenditure breakdowns are not yet available for Italy and Spain. Elsewhere, the Netherlands posted reasonable growth of 0.4%, while Austria grew by 0.1%.

Meanwhile, Greece has slumped back into recession after the self-inflicted political uncertainty

Most member states enjoyed a solid quarter of growth. The exception was Greece. Thanks to the self-induced political uncertainty about its future in the Eurozone, the Hellenic Republic is back in recession. Greece is still no closer to agreeing the terms of its next bailout – increasing the likelihood that it will default on the IMF in June. Whether Greece can then continue to be a member of the euro is a difficult question. The European Central Bank (ECB) may decide that with Greece defaulting, the ECB could no longer accept Greek collateral, cutting off Greek banks from much-needed liquidity. At this point, the government and the Central Bank of Greece may impose capital controls, and haircut depositors (in the same way as Cyprus), or they may choose to exit the euro and begin printing a new currency. Nothing is guaranteed at this stage other than the fact the disagreements will continue. The ECB may choose to maintain the lifeline for Greek banks, even if Greece missed the upcoming payments. The IMF may even decide to postpone the repayment schedule. In any case, it will be some time before corporates and investors will return to business as usual, even if Greece is bailed out. Our view remains that Greece is too small to have a substantial macro impact, especially with the ECB's QE programme in place.

Eurozone forecast: small upgrades

With regards to our forecast, we have nudged up our growth numbers, but most of these upgrades are due to base effects and better than expected recent data. Eurozone GDP growth has been revised down for most of 2014 since our last forecast in February. The revision to the base (y/y) makes the 2015 figures stronger when the annual comparison is made. As a result, Eurozone growth is forecast to rise from 0.9% in 2014 to 1.4% in 2015 (previously 1.3%), and then rise further to 1.6% in 2016 (unchanged) – see table 3.

It is worth mentioning that consensus amongst forecasters has risen from 1.2% to 1.8% for 2015 growth since our last forecast – taking us from being above the consensus to being below.

Table 3: Eurozone GDP forecast

	2015	Prev.	2016	Prev.
Germany	1.6	1.6	2.1	2.0
France	1.1	0.8	1.2	1.2
Italy	0.5	0.3	1.0	1.0
Spain	2.8	2.3	2.4	2.1
Eurozone	**1.4**	**1.3**	**1.6**	**1.6**

Source: Thomson Datastream, Schroders. 26 May 2015. Previous forecast from February 2015. Please note the forecast warning at the back of the document.

Our forecast for Spanish GDP saw the biggest upward revision as the economy accelerated further contrary to our expectations of a pull-back. The recent pace of growth not only suggests that trend growth may not have been as badly hit, but also that there is lots of spare capacity to grow into. Inflation remains negative on an annual basis, but is slowly becoming less negative. We also upgraded the growth profile for Germany, but due to the downside surprise in the first quarter, the 2015 average is unchanged. Stronger than expected retail sales and consumption are encouraging signs that households are reacting positively to lower energy prices and rising real wages. The forecasts for Italy and France were also nudged up for 2015 although as we are less confident in the momentum in those economies, we have not upgraded 2016.

Eurozone growth and inflation forecasts nudged up

Chart 8: EZ GDP forecast

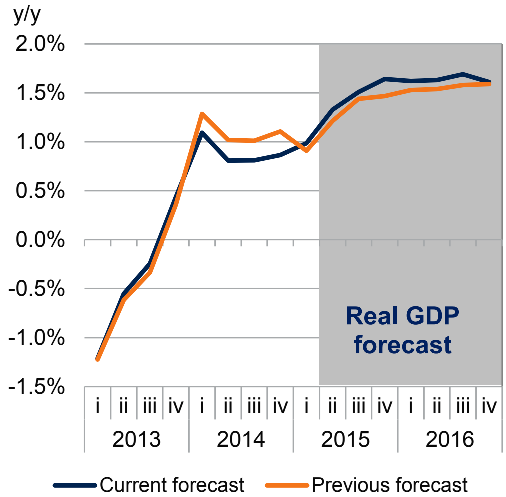
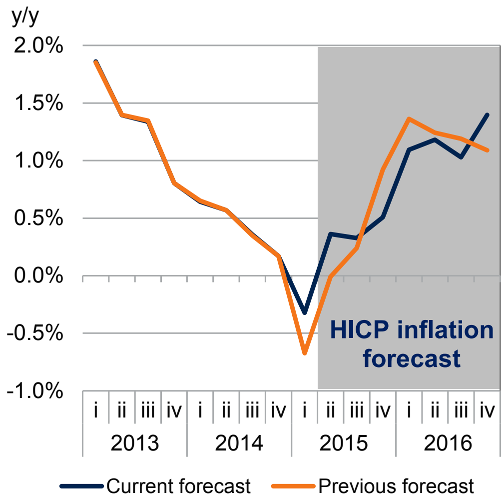


Chart 9: EZ inflation forecast



Source: Thomson Datastream, Schroders. 26 May 2015. Previous forecast from February 2015. Please note the forecast warning at the back of the document.

The Eurozone inflation forecast has not changed much. Less deflation in the first quarter helped lift the annual average, while a slightly faster rise in global energy prices than anticipated will also help. To the downside, European wholesale gas prices have not followed oil prices higher (yet), while food price inflation is likely to remain weak as global agricultural commodity prices show few signs of recovery. Overall, we have raised the HICP inflation forecast from 0.1% to 0.2% for 2015, while leaving the 2016 forecast unchanged at 1.2%.

ECB likely to keep QE purchases going until September 2016

As for the ECB, according to recent policy meeting minutes, members of the Governing Council continue to be sceptical over the robustness of the recovery. This suggests that with the ECB staff's optimistic projections, the Governing Council is unlikely to change its policy mix if our forecast is correct. The ECB is now publishing data on the mix of its asset purchases, and so we have updated our baseline forecast to reflect purchases of covered bonds and asset backed securities which began before March 2015. We continue to expect the ECB to buy €60 billion of assets per month until September 2016, with interest rates kept on hold.

UK election uncertainty ends

With a majority victory for the Conservatives, political uncertainty has lifted.

The UK's general election was supposed to be the closest contest in decades, according to both polls and betting markets. However, a last minute surge of support for the Conservative Party lead to an outright majority for David Cameron's party. The astonishing and totally unexpected result of a clear victor removes a tremendous amount of uncertainty in the near-term over the ability of the government to govern and legislate. This helped lift UK equities and sterling immediately after the results were announced.

In time, the focus of investors will shift to the uncertainty that will come ahead of the proposed referendum on the UK's membership of the European Union in 2017, which could prompt some domestic and overseas investment to be delayed. Latest polls on the question suggest that those who want to remain in the union have a small lead, but that the undecided are large enough to push the result in either direction.

Otherwise, in the near term, the clarity delivered by the election will boost activity as households and businesses can take investment decisions with greater certainty over tax and regulation. Looking further out, the projected election results give the Conservatives the mandate to continue to implement its austerity plan, even if that plan has been eased in recent years. Government spending cuts are likely to continue, particularly in welfare payments where the government had sought to increase the relative gains for a return to work versus living on welfare. More information will be available on the 8th of July when the Chancellor delivers his summer Budget.

UK forecast: small tweaks

Weaker Q1 GDP has prompted a small downgrade to our 2015 GDP forecast…

Our UK forecast has not changed much, but some tweaks have been made to take account of recent data and events. The forecast for UK growth has been downgraded for 2015 from 2.6% to 2.2%, partly due to the much weaker than expected outturn in the first quarter, but also due to negative base effects caused by an upward revision to 2014 (chart 10). Overall, the UK economy looks in good stead for the rest of this year. We expect firms to resume business investment having slowed activity ahead of the general election. As mentioned above, the bounce is likely to be temporary as new uncertainty over the UK's membership of the European Union is called into doubt. Household consumption continues to grow at a robust pace. Retail sales adjusted for inflation and excluding motor fuel rose by 1.2% in the month of April (4.7% y/y), as households took advantage of additional real disposable income thanks to lower consumer price inflation.

CPI inflation fell to -0.1% y/y in April – the first annual fall in UK since records began in 1996, and the first time since 1960 based on comparable historic estimates. While the latest print was lower than expected, there appears to be some seasonal factors related to the timing of Easter that may be overstating deflationary pressures.

Like much of Europe, UK inflation has been low and falling for some time, largely due to the fall in global oil prices pushing fuel and energy bills lower. Global agricultural prices have also been falling, helping to lower food price inflation. However even the core rate of inflation (which excludes the more volatile energy, food, alcohol and tobacco categories) fell from 1% to 0.8% in April – much lower than in the US for example where core inflation is running at 1.8% y/y. The strength of the pound versus the euro is helping to lower import price inflation and also partly explains recent trends.

Overall, we are not concerned by a single negative reading. Lower inflation is helping to boost the spending power of households, raising demand in the economy, which should raise inflation rates in time. In any case, we expect the UK to see higher inflation as we progress through the year and the impact from lower energy prices falls out of the annual comparison. However, we have revised down our CPI forecast from 0.6% to 0.4% for 2015, again, due to weaker core inflation (chart 11).

…while lower core inflation also prompted a CPI downgrade

Chart 10: UK GDP forecast

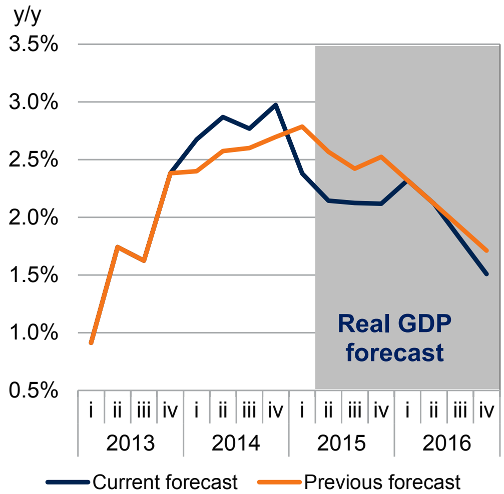
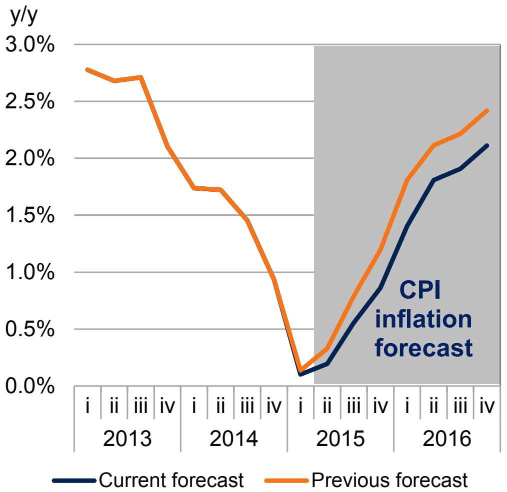


Chart 11: UK inflation forecast



Source: Thomson Datastream, Schroders. 26 May 2015. Previous forecast from February 2015. Please note the forecast warning at the back of the document.

Bank of England's first hike pushed out

We have pushed out the first BoE rate hike to Q1 2016 due to our lower inflation forecast

In updating our forecast, we decided to push out the first rate hike from November this year to February 2016. As we downgraded our inflation forecast (see above), we felt that the BoE would not be able to raise interest rates while inflation is still below 1% – the BoE's lower bound of its target. We forecast the BoE to then hike four times each quarter by 0.25%, taking the policy rate to 1.50% by the end of 2016.

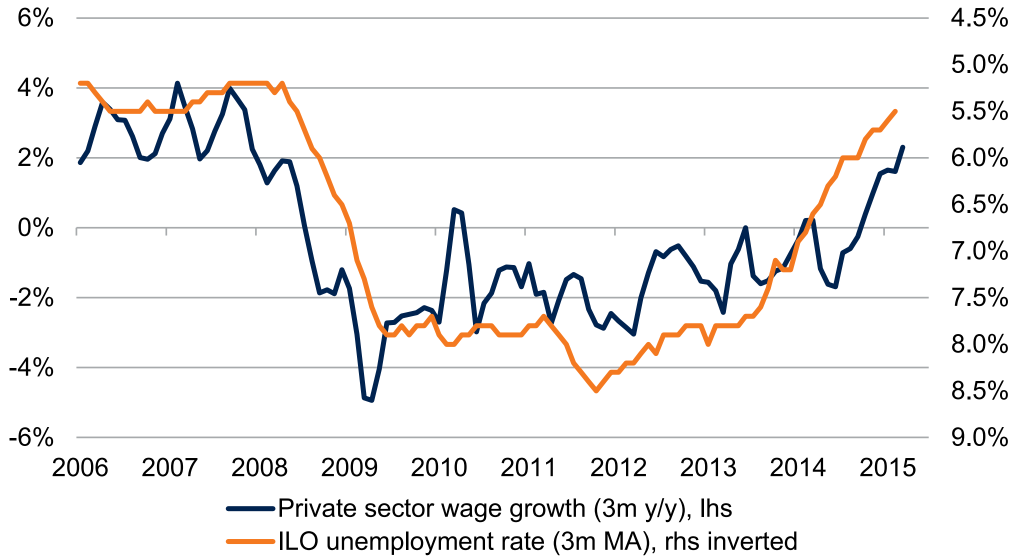
When assessing the outlook for monetary policy, we have to consider both the warning signs that are clearly appearing, but also the Monetary Policy Committee's (MPC) reaction function. In our view, there is very little slack remaining in the economy. By our estimates, the output-gap will be closed by the end of this year, which means the economy should begin to generate excessive inflation. In theory, interest rates should be reaching a neutral level – assumed to be around 2.5% – in time to meet the closing of the output-gap in order to avoid excessive inflation. The BoE shares our analysis on the output-gap, but has clearly decided to take a dovish stance and keep interest rates on hold. It is aware that it takes time for the impact of interest rate rises to feed through to the real economy, but it has decided that in order to return inflation back to its 2% central target as soon as possible, it needs to keep monetary policy ultra-loose.

Interestingly, the MPC appears to differ internally on the degree of accommodation that is now required. The minutes from the last two MPC meetings show that "…for two members, the immediate policy decision remained finely balanced between voting to hold or raise Bank Rate". We suspect the two more hawkish members may be Ian McCafferty and Martin Weale, who previously voted for hikes in a minority.

We do not expect these two to win the internal battle, but as the economy continues to grow and as inflation recovers, the strength of the labour market risks causing an overshoot of the BoE's inflation target. Recent continued strong gains in employment have helped push the unemployment rate down to 5.5% in the first quarter – roughly our estimate of the non-accelerating inflation rate of unemployment (NAIRU) – the point where we think wage inflation starts to rise beyond real productivity gains. Wage inflation in nominal terms remains muted with average weekly earnings (including bonuses) growing by 2.4% in the three months to March compared to the same period a year earlier. However, in real terms, wages are now growing at their fastest pace since 2008 (chart 12). To a certain extent, low inflation is masking the significant improvement to the purchasing power of households.

The risks are rising from running ultra-loose monetary policy

Chart 12: Private real wage growth vs. unemployment rate



Source: Thomson Datastream, ONS, Schroders. 26 May 2015.

As explained above, inflation should start to rise over the rest of this year. The risk of keeping interest rates on hold is that companies start to increase wages as inflation picks up. However, the counter risk is that wages do not track inflation higher, and policy tightening is not yet warranted. Our analysis on the amount of spare capacity suggests that on the balance of probabilities, we are likely to see higher wage inflation and therefore higher consumer price inflation. However, this is a risk the Bank of England appears happy to run in order to get inflation back to its target.

Schroder Economics Group: Views at a glance

Macro summary – May 2015

Key points

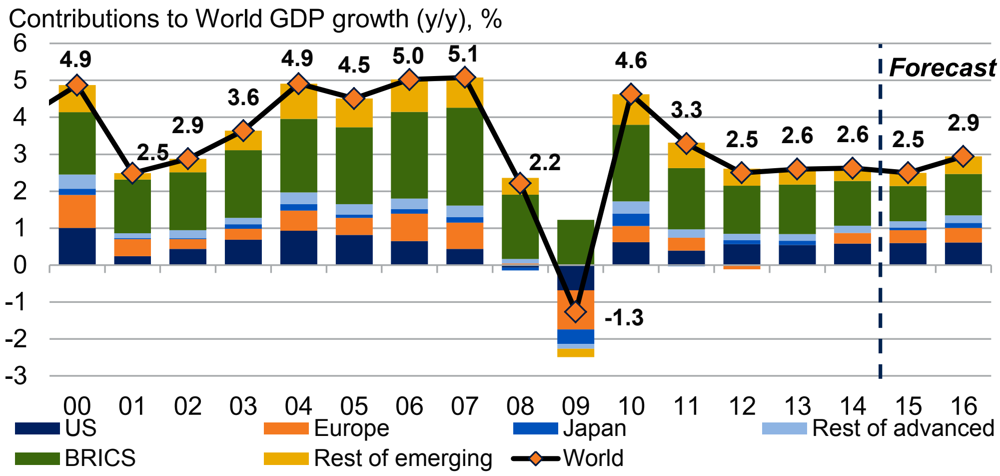
Baseline

- After a poor start to the year global growth is now forecast at 2.5% for 2015, similar to 2014. Activity is still expected to pick-up as we move through the year, but the world economy is taking longer than expected to respond to the fall in energy costs.
- Despite a weak first quarter, the US economy 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 1% by year end. Policy rates to peak at 2.5% in 2016.
- UK recovery to moderate in 2016 with cooling housing market and resumption of austerity. Interest rate normalisation to begin with first rate rise in February 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. China growth downshifting as the property market cools and business capex is held back by overcapacity. Further easing from the PBoC to follow.

Risks

- Risks are skewed towards deflation on fears of Eurozone deflationary spiral, China hard landing and secular stagnation. 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 27 May 2015. Please note the forecast warning at the back of the document.

Schroders Forecast Scenarios

Scenario	Summary	Macro impact	Probability*	Global vs. 2016 baseline Growth	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	2.5	↓	(2.8)	2.6	2.9	↓	(3.0)	3.1
Advanced*	63.2	1.7	1.9	↓	(2.2)	2.0	2.1	↓	(2.2)	2.3
US	24.5	2.4	2.4	↓	(3.2)	2.5	2.5	↓	(2.7)	2.8
Eurozone	19.2	0.9	1.4	↑	(1.3)	1.5	1.6		(1.6)	1.8
Germany	5.4	1.6	1.6		(1.6)	2.0	2.1	↑	(2.0)	2.0
UK	3.9	2.8	2.2	↓	(2.6)	2.5	1.9	↓	(2.0)	2.5
Japan	7.2	-0.1	0.9	↓	(1.6)	0.9	2.0	↓	(2.2)	1.8
Total Emerging**	36.8	4.3	3.6	↓	(3.7)	3.7	4.3	↓	(4.4)	4.5
BRICs	22.6	5.4	4.2		(4.2)	4.4	4.9		(4.9)	5.2
China	13.5	7.4	6.8		(6.8)	6.9	6.5		(6.5)	6.7

Inflation CPI

y/y%	Wt (%)	2014	2015		Prev.	Consensus	2016		Prev.	Consensus
World	100	2.8	2.8	↑	(2.5)	2.5	3.1	↑	(3.0)	3.0
Advanced*	63.2	1.4	0.6	↑	(0.5)	0.3	1.7	↓	(1.8)	1.7
US	24.5	1.6	0.9	↑	(0.7)	0.2	2.3	↑	(2.2)	2.2
Eurozone	19.2	0.4	0.2	↑	(0.1)	0.2	1.2		(1.2)	1.2
Germany	5.4	0.8	0.5	↑	(0.4)	0.4	1.7		(1.7)	1.6
UK	3.9	1.5	0.4	↓	(0.6)	0.3	1.8	↓	(2.1)	1.6
Japan	7.2	2.7	0.8	↑	(0.6)	0.6	1.1	↓	(1.3)	1.0
Total Emerging**	36.8	5.1	6.4	↑	(5.9)	6.2	5.4	↑	(5.0)	5.3
BRICs	22.6	4.0	4.7	↑	(4.5)	4.3	3.6		(3.6)	3.5
China	13.5	2.0	1.4	↓	(1.7)	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	1.00		(1.00)	0.56	2.50		(2.50)	1.43
UK	0.50	0.50	0.50	↓	(0.75)	0.72	1.50		(1.50)	1.32
Eurozone	0.05	0.05	0.05		(0.05)	0.01	0.05		(0.05)	0.11
Japan	0.10	0.10	0.10		(0.10)	0.10	0.10		(0.10)	0.10
China	5.10	5.60	4.60	↓	(5.00)	-	4.00	↓	(4.50)	-

Other monetary policy

(Over year or by Dec)	Current	2014	2015		Prev.	2016		Prev.
US QE ($Bn)	4481	4498	4494	↓	(4562)	4512	↓	(4617)
EZ QE (€Bn)	68	31	649	↑	(600)	1189	↑	(1140)
UK QE (£Bn)	375	375	375		(375)	375		(375)
JP QE (¥Tn)	323	300	389		(389)	406		(406)
China RRR (%)	19.50	20.00	18.00	↓	19.00	17.00	↓	18.00

Key variables

FX (Month of Dec)	Current	2014	2015		Prev.	Y/Y(%)	2016		Prev.	Y/Y(%)
USD/GBP	1.57	1.56	1.52	↑	(1.50)	-2.5	1.50	↑	(1.48)	-1.3
USD/EUR	1.14	1.21	1.08	↓	(1.12)	-10.7	1.00	↓	(1.09)	-7.4
JPY/USD	119.1	119.9	118.0	↓	(120)	-1.6	115.0	↓	(125)	-2.5
GBP/EUR	0.72	0.78	0.71	↓	(0.75)	-8.4	0.67	↓	(0.74)	-6.2
RMB/USD	6.20	6.20	6.30		(6.30)	1.5	6.40		(6.40)	1.6
Commodities (over year)										
Brent Crude	67.4	55.8	64.3	↑	(62)	15.1	71.1	↑	(70)	10.6

Source: Schroders, Thomson Datastream, Consensus Economics, May 2015
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 13/05/2015
Previous forecast refers to February 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.

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

2015	2016

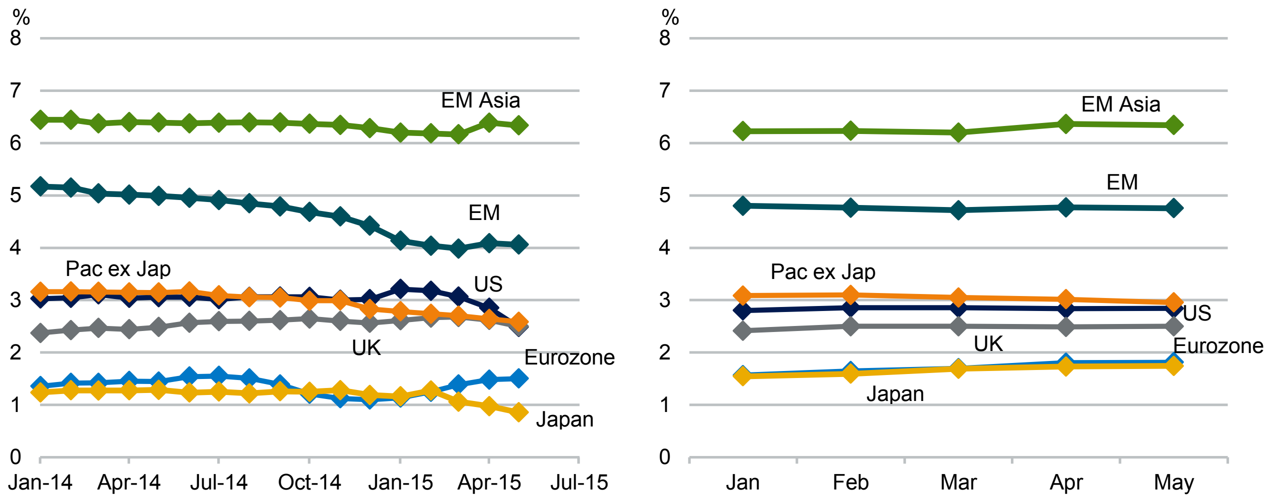
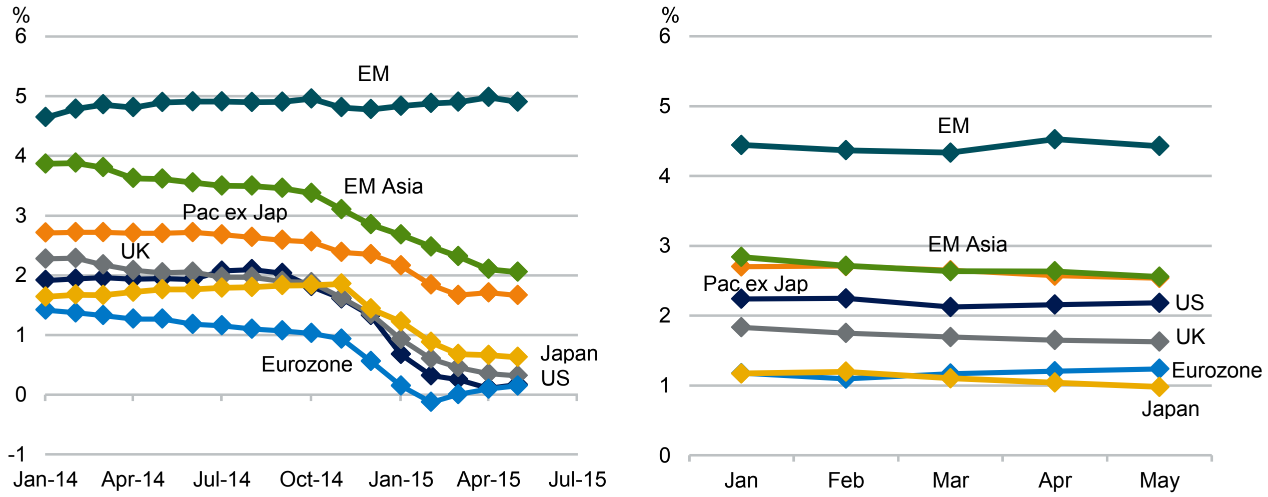


Chart B: Inflation consensus forecasts

2015	2016



Source: Consensus Economics (May 2015), Schroders. Please note the forecast warning at the back of the document.

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.