

Schroders

Economic and Strategy Viewpoint

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Global: The macro impact of China (page 2)

- China tail risks have risen and are uppermost in investors' minds (see chart). The emerging markets are most affected by a hard landing in China, but the developed economies would still suffer a loss of 0.5% p.a. in GDP growth. This compares with a loss of 2% p.a. for the emerging markets.
- We still see a gradual slowdown rather than collapse in China, but the economic effects are already being felt in the steel industry and, more generally in an echo of past crises, will help depress inflation. With central banks lacking firepower, the response will be to keep rates lower for longer and we have pushed out our first rate rise from the US to March 2016.

Eurozone: Sino slowdown meets refugee crisis (page 6)

- Recent figures bode well for the second half of the year; however, concerns over China have hit European bourses hard. Germany has the highest exposure of the big four member states through exports to China and emerging markets, with capital investment abroad key to those exports.
- The refugee crisis in Europe has morphed from a humanitarian crisis into a political one over the burden of receiving asylum seekers. The macro impact is positive as in the short-term it prompts fiscal spending and over the medium-term helps ease Europe's demographic challenge.

Will the FX fall save EM? (page 12)

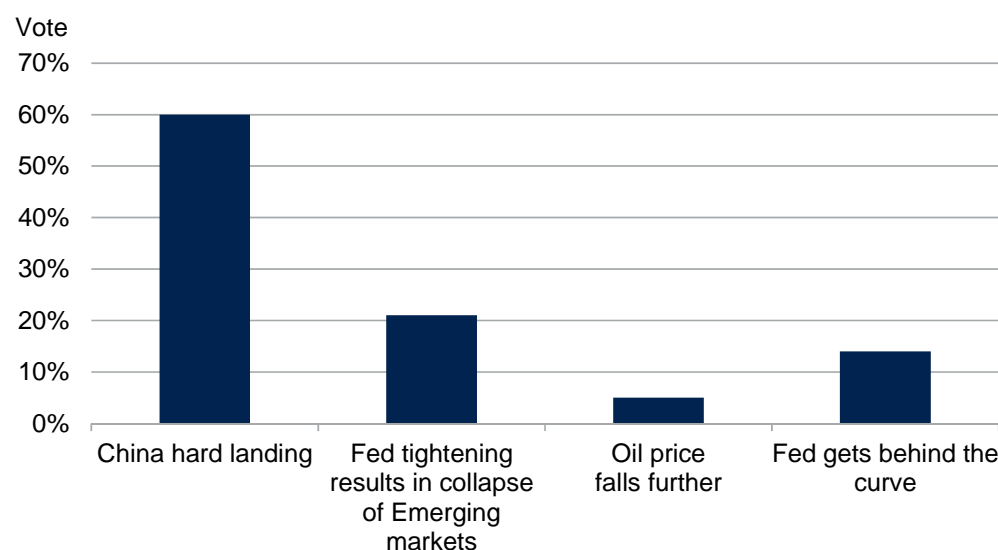
- Emerging market trade and currencies have suffered a great deal over the last year. A trade revival rests more on a resurgence in global growth than on further depreciation, which in any case carries risks.

Views at a glance (page 17)

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

Chart. Survey shows China risk dominates investor sentiment

The biggest risk to the world economy is:



Source: Schroders Investment Conference, 17 September 2015.



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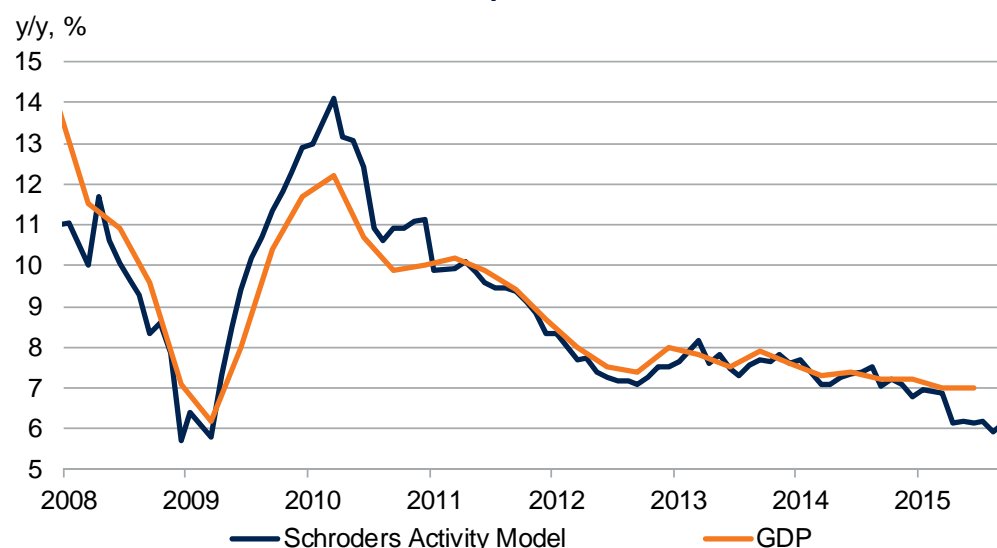
China tail risk uppermost in investors' minds

The macro impact of China

Since the beginning of August, China and the emerging markets have been the focus of financial market attention. At our recent European conference, clients said they saw a hard landing in China as the biggest tail risk facing their portfolios (see chart front page). Our own asset allocation committee has the same concern and the decision by the US Federal Reserve this month not to raise rates was heavily influenced by developments in the world's second largest economy.

Our central view on China remains that the economy will continue to struggle in coming quarters, but will not experience a sudden collapse. This is supported by our G-tracker (chart 1) which shows the economy slowing, but not collapsing. The picture is better than that shown by indicators such as the Li Keqiang index which is biased toward heavy industry and the "old" China of the state owned enterprises (SOE's). These dinosaurs are a drag on Chinese and global activity, but to solely focus on them is to ignore the more dynamic service and property sectors which represent about two-thirds of activity and are better captured in our tracker.

Chart 1: China, slowdown not slump



Source: Schroders Economics Group, 29 September 2015.

Policymaker authority falls, hard landing risks rise

Nonetheless, the risk of a hard landing has risen. Confidence in the ability of the Chinese authorities has been shaken by events in August when first, they caught markets by surprise with a devaluation of the CNY and, second, a sharp fall in the Shanghai equity market was met with a clumsy response, which probably made the situation worse. The authorities are preparing further fiscal stimulus which should be apparent in the Q4 data. Nonetheless, the risk premium on China has risen and consequently we have looked more closely at the impact of a hard landing on the rest of the world.

Analysis from macro models¹ shows that of the world's economies, it is the emerging markets which will feel the brunt of a China hard landing. In this analysis a hard landing is primarily generated by a slowdown in investment and is defined as a slowdown in Chinese GDP growth to 3% by 2017 where it then remains until the end of 2019. This is compared with a base case where growth slows more gradually to 6.4% by end-2019.

On this basis global growth is just over 1% per annum (p.a.) weaker compared to

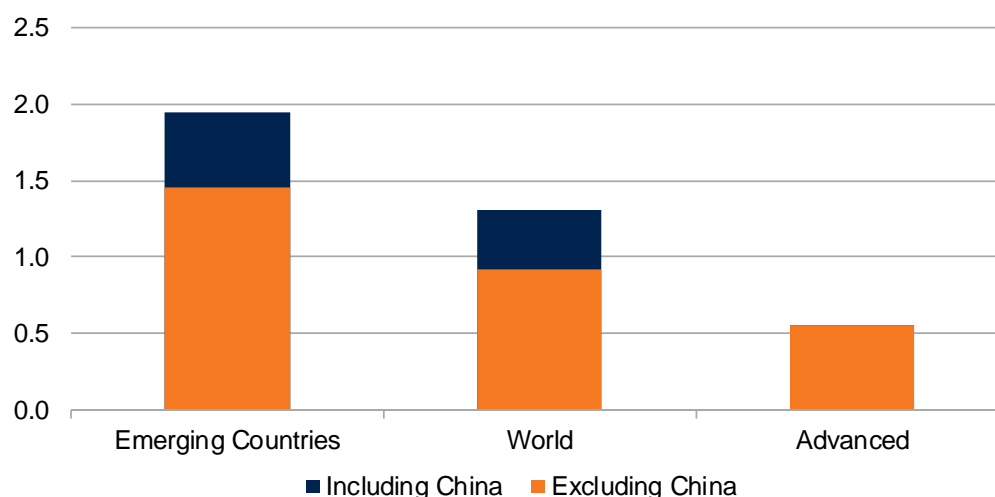
¹For example, see Towards Recoupling? Assessing the Global Impact of a Chinese Hard Landing through Trade and Commodity Price Channels. Ludovic Gauvin and Cyril Rebillard. Banque de France July 2015.

the base with the impact being primarily felt by the emerging markets (EM) which are some 2% p.a. weaker. Much of this is due to the slowdown in China itself but even ex.China the emerging economies grow at 1.5% p.a. less than in the base case. For the Advanced economies the hit is 0.5% p.a., not insignificant but considerably less and such that the growth gap between emerging and developed economies narrows (chart 2).

Chart 2: Impact of China hard landing on global activity

Annualised loss over 5 years after a China hard landing* (%)

Emerging economies feel the brunt of the hit from China



Source: Banque de France, July 2015.

*China hard landing assumes Chinese GDP growth falls over 2 years to 3% y/y and then remains at that level for the rest of the forecast horizon compared to base where economy slows to 6.4% by end-2019.

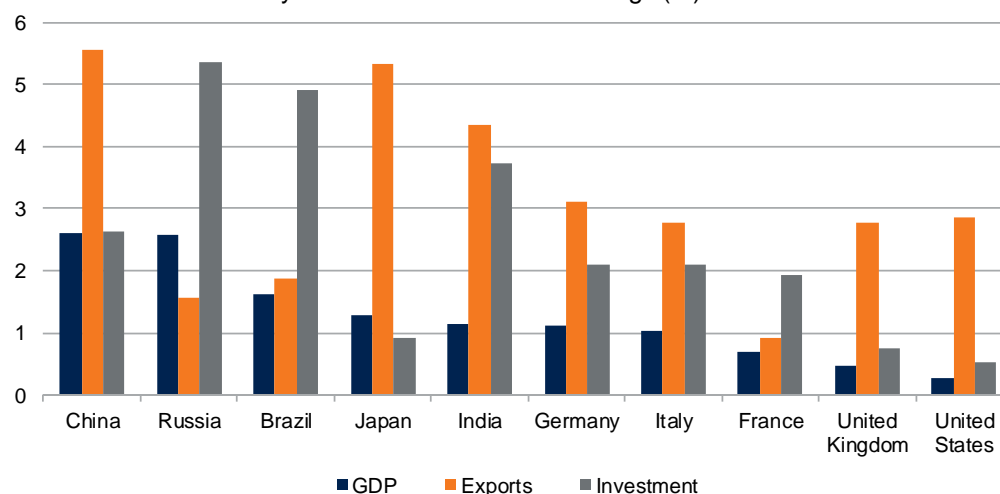
The transmission mechanism is initially through lower oil and metals prices which hit the value of exports and fiscal balances in the commodity exporters. Weaker incomes then result in weaker exports generally to China, particularly hitting China's geographical neighbours in Asia. Investment is then cut in the commodity sector and by governments as fiscal constraints bite. Negative multiplier effects are then likely to hit trade further. Finally, an appreciation of the USD will hit those economies who are pegged or closely linked to the US currency.

Japan and Germany are most vulnerable of the developed economies

Looking in more detail at the country breakdown we can see that cutbacks in investment account for much of the reduction in growth in commodity rich Brazil and Russia. For India it is a loss of exports which has the greater effect on GDP. Amongst the developed economies, Japan is most affected by the nature of its close trade links to China (18% of exports) and suffers annual losses of just over 1% p.a. However, Germany is not far behind as weaker Chinese demand hits trade with one of the world's leading exporters. Italy is also quite vulnerable. Meanwhile, the impact on France, the UK and US is considerably less. For more on the effect on Europe please see section below.

Chart 3: Impact of China hard landing – country breakdown

Annualised loss over 5 years after a China hard landing* (%)



Source: Banque de France, July 2015.

*China hard landing assumes Chinese GDP growth falls over 2 years to 3% y/y and then remains at that level for the rest of the forecast horizon compared to base where economy slows to 6.4% by end-2019.

These effects may understate the full impact as they do not take account of financial linkages through equity markets. The hard landing is also likely to trigger an increase in risk aversion hitting global equity markets as growth expectations are revised down.

With rates close to zero, central banks are not well placed to react to shocks

Central banks: running out of ammo?

More generally, equity investors are also concerned that the ability of central banks to respond to adverse shocks of this type is constrained as interest rates are already at or close to zero and there are doubts about the effectiveness of further QE. Even in the UK, where the economy is performing reasonably well, the Bank of England's chief economist is talking of negative interest rates and the new leader of the opposition has proposed "People's" QE where the Bank prints money to directly fund infrastructure spending. We seem to be moving closer to Milton Friedman's 'helicopter money'.

From an investor perspective such talk is not encouraging and is consistent with an increased risk premium on equities and other assets that rely on economic growth. In short, the central bank "put" whereby monetary policy can underwrite growth for investors is becoming less credible as the authorities begin to run out of ammunition.

Reassessing the Fed rate path

Such considerations would have been in the minds of the US Fed when they decided to leave policy on hold in September. Citing global factors, the Fed said it wanted to see a further improvement in the labour market before it could be confident that inflation would return to its 2% target. In subsequent comments Bill Dudley of the New York Federal Reserve and Fed Chair Janet Yellen have both indicated that given the deflationary pressures from abroad, they would deliberately look to overheat the jobs market in order to gain confidence that inflation will return to target.

Fed doves rule the roost

Although Chair Yellen has said she expects to raise rates this year, the decision is data dependent and in the absence of a rapid turn in China and the emerging markets this timescale seems unlikely. Unemployment is expected to fall further in coming months (as we originally forecast), but the hurdle to trigger a Fed lift off has been raised by the global environment. We have now pushed out our

forecast for the first Fed funds increase to March next year and flattened the rate trajectory such that rates reach 1% by end 2016. Our previous forecast had rates at 2% at this point and we still believe that such a tightening would be appropriate for the base line view of the US. The change reflects the rise in the US dollar, greater global risks and a recognition that the Yellen Fed is simply uber dovish.

World economy looking more like 1997

There have been a lot of comparisons with 2013 recently with the Fed ducking a decision to tighten policy in response to market pressures. Back then it was the decision to start to taper QE, which was subsequently delayed until the following January. However, today's global environment seems more like that of the late 1990's, specifically 1997-98 when the Asian financial crisis eventually caused the Fed to pause in its tightening cycle and actually cut rates in 1998 following the Russian default. There were concerns then about deflation and a global recession. That recession did not materialise and the developed economies continued to enjoy robust growth until 2000/2001.

Asia crisis in late 1990s triggered fears of global deflation

Today the EM are a bigger part of global GDP and the central banks have less ammunition to fight a downturn with interest rates at zero or even negative in the Eurozone, Sweden and Switzerland. So the risks are greater. Furthermore, as shown above, a hard landing in China would have a significant impact on developed markets, cutting annual GDP growth by 0.5%, which is notable when growth is only running at around 2%.

However, even some 20 years after the Asian financial crisis, the Emerging Markets are not significant drivers of global demand. They are important for commodities, but in general are the world economy's suppliers of manufactures. The slowdown we have seen since the global financial crisis reflects the slowdown in domestic demand in the west, particularly the US and Europe, which has then hit trade and EM GDP growth. The EM consumer has great potential, but does not drive the world economy.

We need to watch the US dollar which will appreciate further in a weak EM environment as investors seek safe havens. We also need to recognise that many global multi-nationals and hence a big chunk of the equity and bond markets are exposed to international trade. It is estimated that Volkswagen (which now has wider problems) sells 1 in 3 of its cars to China. The response of EM companies is important: for example take the steel industry in China, rather than cut production they are increasing exports as their domestic demand has slowed. Some would say they are dumping on global markets and Korea and India have put on anti-dumping legislation to protect their industries. Meanwhile, one of the UK's largest steel plants is to close with the loss of 1,700 jobs.

One consequence of the Asia financial crisis was that it brought a long period of low inflation sometimes known as the great moderation. The emerging economies devalued much as they are doing today, and as their domestic economies were squeezed by a withdrawal of capital they re-orientated their efforts towards exporting to the west.

And led to the great moderation: an extended period of low inflation and interest rates

Low inflation keeps central banks on hold for longer. Central bank policy rates will not rise as much as expected, which will keep DM growth skewed toward services and domestic activity. The downside is that it could create more financial market bubbles (as in the late 1990s) and, given the low level of rates, it may also mean that the currency wars will continue. Beware the risk of a further CNY devaluation.

Eurozone: Sino slowdown meets refugee crisis

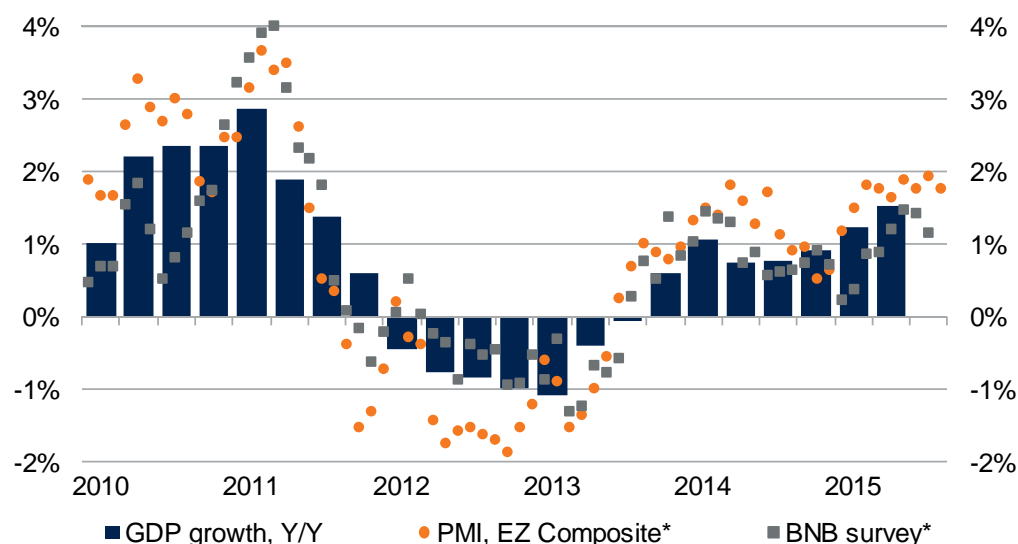
It has been another summer where Europe has lurched from one crisis to the next. Greece eventually accepted the terms of its creditors to unlock additional funds and avoided leaving the euro, but only after a veiled threat of eviction. More recently, focus has shifted to the slowdown in China and the wider emerging markets, and the implications for the monetary union. In addition, the refugee crisis has dominated the political agenda, with enforced quotas causing fierce infighting between member states.

Growth better than previously recorded

**Eurozone
growth in H1
revised up**

There has, however, been some encouraging news on the macro front. The updated estimate of GDP revised up growth for both the first and second quarters of this year. Year-on-year growth in the second quarter is now estimated at 1.5% (from 1.2%), which suggests healthier activity levels and continued positive momentum in the reduction of excess capacity. In particular, Italy had its Q2 GDP revised up from 0.5% y/y to 0.7% y/y, while Finland saw its GDP revised up from -1% y/y to flat.

Chart 4: Growth improves, but for how long?



Source: Thomson Datastream, Markit, Schroders Economics Group. 23 September 2015.
*Standardised using GDP.

**Business
surveys provide
a mixed outlook**

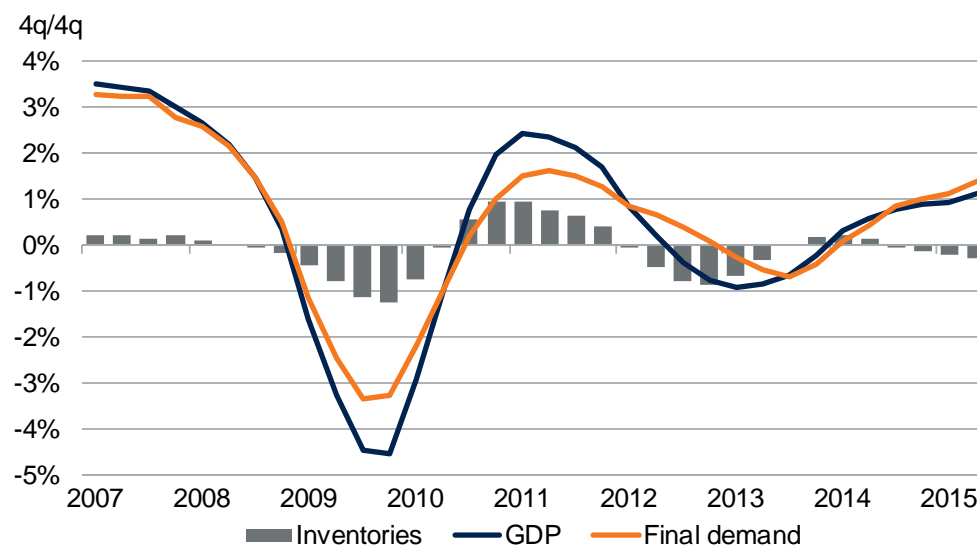
Leading activity indicators have been a little more mixed of late. The purchasing managers indices continue to signal solid growth, with the new orders performing well (chart 4 above). On the other hand, the Belgian National Bank survey suggests that a slowdown may be underway to around 1%.

The latest GDP release also included the breakdown of expenditure, which showed continued solid growth in household consumption and government expenditure. However, investment fell back on the quarter after a sharp rise at the start of the year. Meanwhile, the strong external performance continues largely unabated, aided by the depreciation of the euro over the past year. Exports are up by 5.2% y/y – the fastest pace of exports growth since Q3 2011 – despite the slowdown in global export volumes (see section three). Imports, on the other hand, grew by 1.8% y/y, helping to ensure net trade continues to make a positive contribution overall.

Finally, it is worth mentioning that inventories made yet another negative contribution to GDP growth – four in the last five quarters. This means that final demand has been running ahead of output for some time, which is unusual during the upswing of a recovery (chart 5).

Inventory rebuilding could provide another tailwind for growth

Chart 5: Another tailwind on the horizon



Source: Thomson Datastream, Schroders Economics Group. 23 September 2015.

It may be that the repair of the credit channel has been slow to rebuild output growth, or that firms remain cautious and prefer to keep inventories to a minimum. In any case, it suggests that there is plenty of room for inventory rebuilding to become a tailwind for the economy over the next year or so.

Sino slowdown and the implications for Europe

The relative underperformance of emerging markets compared to developed markets is a theme we have been discussing for some time. As discussed above, much of the underperformance stems from lower demand from developed markets for goods and services exported from emerging markets, but the commodities axis provides the other source of weakness. Excess supply in global oil markets is a factor, but for many other commodities such as industrial metals, prices have declined over concerns of a China slowdown.

While many investors are genuinely concerned about a China hard-landing, our central view remains that China is experiencing a controlled structural slowdown. As described in last month's Economic and Strategy Viewpoint, investors should not read too much into the recent bursting of the Chinese equity market bubble as the wealth effects are much smaller than in many other countries. Despite this, investors have taken fright from markets associated with heavy exposure to China. While the US S&P composite index has fallen 7.9% since the start of August, the Euro STOXX 50 index has fallen 14.4%, more than wiping out any gains year-to-date².

To assess the direct impact of a China hard-landing, or even a wider emerging markets crisis, we need to examine the share of exports to these countries. Chart 6 (next page) details the proportion of total goods exports heading to China, Hong Kong, Brazil, Russia, India, Turkey and South Africa. These are the major emerging markets that we believe are at risk of a slowdown against a backdrop of tightening global liquidity. Hong Kong is the exception and is only included because a significant amount of trade with mainland China goes through the island and is therefore hidden in the statistics.

The EU overall has 9.5% of its non-EU trade heading to these seven countries (nominal exports for 2014) which amounts to 3.1% of nominal GDP. Germany has the largest exposure to the group of seven and, in particular, China. A

Concerns over China have hit European bourses hard

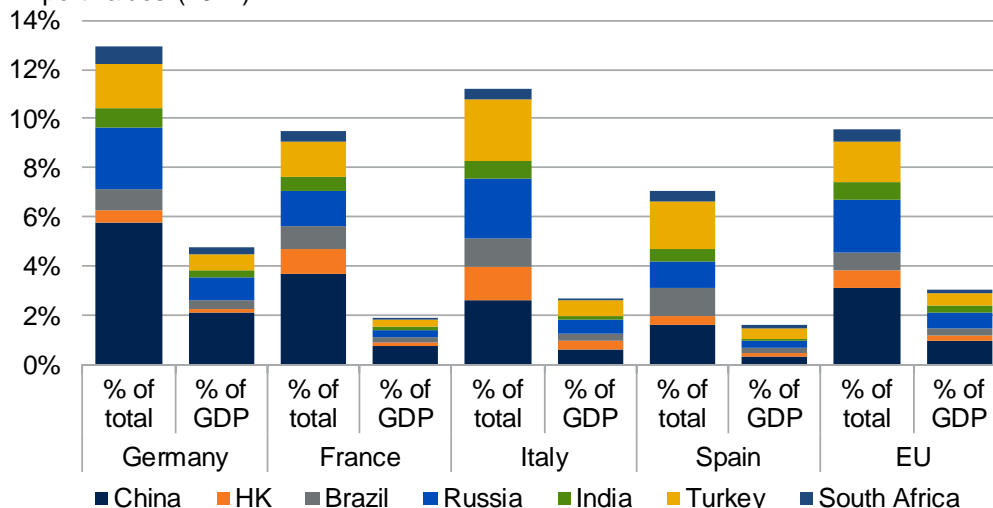
²Prices at close on 25 September 2015.

combined 6.3% of German exports go to China and Hong Kong, the equivalent of 2.3% of German GDP. France, Italy and Spain also have a sizeable amount being exported to China and Hong Kong, but as a share of GDP, each has less than 1% exposure.

Chart 6: European exports exposure to EM

Export values (2014)

Germany has relatively high exposure to China compared to other Eurozone members



Source: Thomson Datastream, IMF DOTS, Schroders Economics Group. 22 September 2015.

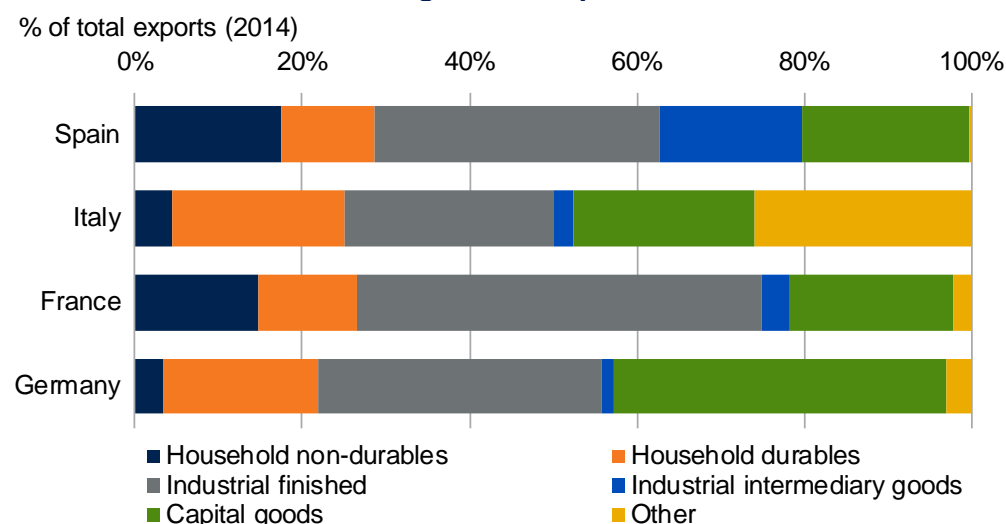
In a China hard-landing scenario where, for example, domestic demand growth were to halve, then we could assume that exports to China could also halve³. This is an over-simplification, but a good guide to the potential impact on a given exporter. It is worth noting that the above figures do not include exports in services and so underestimate the total potential impact.

In addition to the share of exports, the type of goods being exported matters (chart 7). For example, 40% of Germany's exports to the countries in question are made up of capital goods. These tend to be machines used in the production of other goods and are referred to as capital goods because spending on such goods tends to be recorded as capital expenditure. Another 34% of German exports are finished industrial goods. These tend to be goods consumed by industry as part of the manufacturing process of other goods. 19% fall under the category of household durables, which are mostly autos for Germany.

³ Assuming an even impact on demand for domestic and imported goods. In reality, many imported goods from Europe tend to be luxury items, which usually face a larger drop in demand relative to other goods and services (high price elasticity of demand).

Germany mainly exports capital goods, which requires capex abroad

Chart 7: Broad economic categories of exports to EM



Source: UN Comtrade, Schrodgers Economics Group. 22 September 2015.

From Germany's breakdown, we can make two conclusions. The first is that Germany is very susceptible to a slowdown in capital expenditure, which has been the case in China. The second conclusion is that if manufacturing more generally is struggling, which has also been the case globally, then demand for finished industrial goods will also be hit. However, exports of high value-added autos should benefit as China shifts its growth from trade and investment to household consumption – as long as the emerging markets can live with higher fuel emissions for a certain brand that recently made the headlines.

France also relies on the manufacturing sector for demand for its industrial goods, but capital goods are less important than is the case for Germany. Italy and Spain have a well-diversified set of categories for their exports, but it is worth noting that Spain has far more exports of industrial intermediary goods than the rest of the big four. As intermediary goods tend to be unfinished part-produced goods, they tend not to benefit from depreciation in the currency. This is because intermediary goods usually have a high import content, due to the needs of manufacturing processes for goods to often cross borders several times before being deemed 'finished' and ready to sell to an end consumer. However, finished goods (including capital goods) do benefit from higher demand after depreciation in the currency.

A China hard-landing scenario would have a negative impact on European exports

Overall, with regards to trade with China and the rest of the large emerging markets, Europe would see a significant hit in a hard-landing scenario. However, our baseline view of a structural slowdown rather than a hard-landing leads us to believe that exports more generally could hold up reasonably well, especially as the other developed markets still make up the lion's share of total exports, with certain markets such as the US and UK growing at a robust pace.

Europe's refugee crisis

The summer's news coverage was dominated by Europe's refugee crisis. The media initially focused on the tragic deaths of many families attempting to reach Europe's shores, but more recently, the crisis has morphed into a political argument over the burden of receiving so many displaced families and individuals.

Europe's surge in refugees has been exacerbated by fighting in Syria

Eurostat estimates that the European Union received 542,575 first time asylum applications from January to August this year. This is only slightly less than the 562,675 applications received over the whole of last year, and is a 71% increase on the same period a year earlier. There is no doubt that the ongoing civil war in

Syria and the presence of ISIS have exacerbated the situation. In the second quarter of this year, 21% of Europe's first time asylum seekers held Syrian nationality. The other of the top five nationalities of asylum seekers are Afghanistan (13%), Albania (8%), Iraq (6%) and Kosovo (5%).

By historical comparisons, the recent influx of Syrian refugees is very large; however, the statistics should be put into context. The United Nations estimates there to be 149,700 Syrian refugees in the wider European continent, compared to 1.6 million in Turkey, 1.1 million in Lebanon, 623,000 in Jordan and 234,000 in Iraq.

Nevertheless, the rise in asylum seekers has raised anti-immigration sentiment in many EU member states, especially those on the front line that are struggling to cope. Coastguard patrols have been stepped up off the coast of Italy and Greece, while a largely ineffective razor-wire fence is being erected along the border with Serbia and Croatia by Hungary.

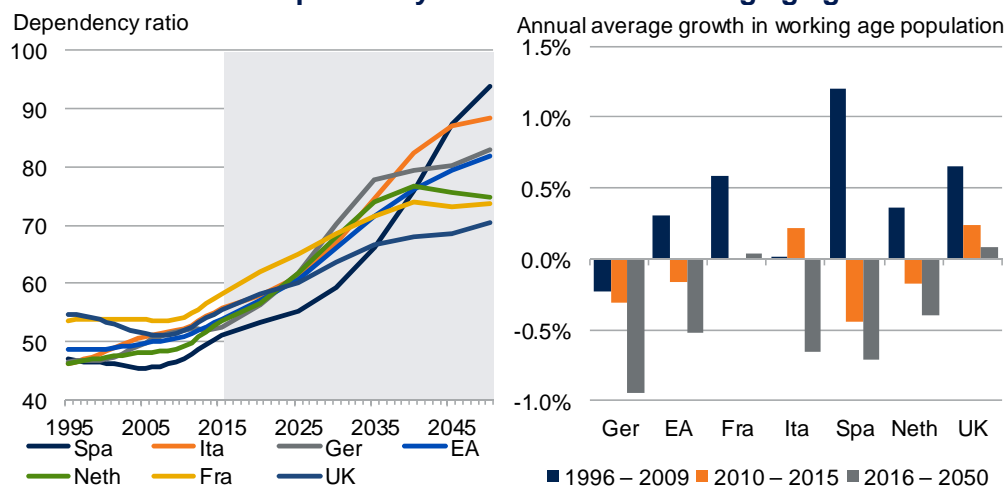
German Chancellor Angela Merkel has been fiercely criticised by right-wing members of her own party for welcoming hundreds of thousands of refugees, but the Chancellor held firm in her belief that genuine refugees should be welcomed. Despite the openly welcoming message, which has made Germany one of the most-preferred destinations, Germany suspended the Schengen-Agreement and reintroduced broader controls with Austria. Moreover, European politicians are fighting fiercely over the proposed introduction of a quota system to force member states to accommodate refugees.

While Germany welcomes migrants, it has re-introduced border controls

The macro impact of migrants in the short-term is the same as a fiscal stimulus...

From a macro perspective, the impact of arriving refugees is generally positive. In the short-term, additional state spending on services along with income support for migrants amounts to a fiscal stimulus. Also, as refugees tend to have little to no wealth upon arrival, they are likely to spend most of the resources they receive causing the fiscal multiplier effect to be relatively high. The cost will fall on the government's public finances, and so deficits will be a little higher. For example, the German government expects to receive 800,000 refugees in 2015. With local governments being paid between €12,000 to €13,000 per refugee, the total stimulus could reach approximately 0.3% of German GDP – not a huge amount, but helpful nonetheless. Note, though, that the stimulus may not go beyond this if the government chooses to keep its balanced budget target, as seems likely.

The increase in the working age population will also help boost GDP growth over the medium to long-term. By how much will depend on the ability of a nation to integrate its new arrivals. For Europe, migration will be an important relief to the ageing population problem that is unfolding. The euro-area had a dependency ratio of 53.2% in 2014, but according to the World Bank's population and demographics projections, this is set to reach 81.7% by 2050. The worst of the big four member states is Spain, where the ratio is forecast to reach 93.8% (chart 8).

Chart 8: Eurozone dependency ratios Chart 9: Working age growth rates

Source: World Bank, Schrodgers Economics Group. 20 September 2015.

...while in the medium term, it can help ease the demographic challenge

Germany's demographics are also poor and are potentially already detracting from its potential growth rate. Between 2010 and 2015, Germany's working age population is estimated to have declined by an average of 0.3% per annum; however, the average rate of decline is forecast to triple between 2016 and 2050 (chart 9).

The impact of Europe's demographic challenge will eventually slow growth significantly, which may put public finances under severe pressure. Certainly, many European governments had planned to simply increase public debt to pay for the future aging population. That option is less acceptable now after the financial crisis led to a severe rise in public debt, and the experience of the sovereign debt crisis. Increased migration is one of the answers to this secular problem, which would also be helpful to the many people fleeing war and persecution in their home countries.

Will the FX fall save EM?

Trade performance is undoubtedly poor...

We have written before, and no doubt will again, about global trade. Currently, it is in a sorry state. The negative headline numbers coming out of China draw a lot of the attention, but it is far from the only emerging market economy to report large declines. Across Asia, Europe, and South America, the EM export story is the same disastrous refrain. Of the 19 EM economies whose exports we track, only one reported a positive export performance in July (August data is not available for all countries).

To many, this points to a lack of demand globally, and to some even a global recession in the making. This impression is reinforced by the apparent failure of currency depreciation to boost exports, with nearly all EM currencies depreciating markedly against the dollar in the last year.

...but it is not a cause for panic

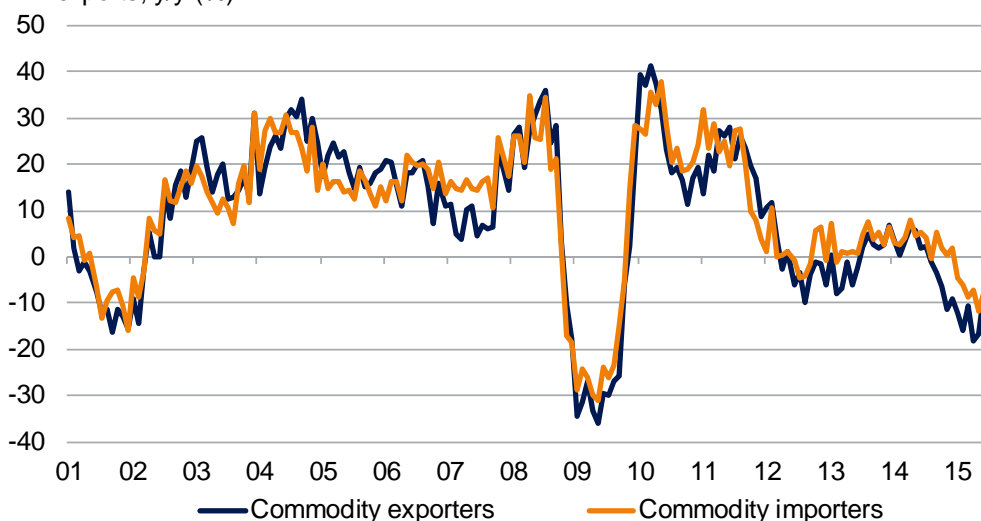
We are not in the collapsing demand camp, but there is no disputing that the global economy has been abandoned by the trade winds and left, for now, in the doldrums. But can we expect this state of affairs to persist? And for emerging markets, can they still hope for currency weakness to promote trade and growth, or has the export growth model had its day?

Trade and global demand

First, let's consider the global trade picture as discussed above. See chart 10, below. Exports from EM have very clearly taken a beating since the end of 2014, despite a stronger growth picture in the US and Europe. It makes sense that with oil and various industrial metals at roughly half (or less) of their 2014 prices, the value of commodity exports would be lower. Yet manufactured goods exporters are also suffering, so this can not be the entire explanation.

Chart 10: Export collapse not a commodity specific story

EM exports, y/y (%)



Source: Thomson Datastream, Schroders Economics Group. 25 September 2015.

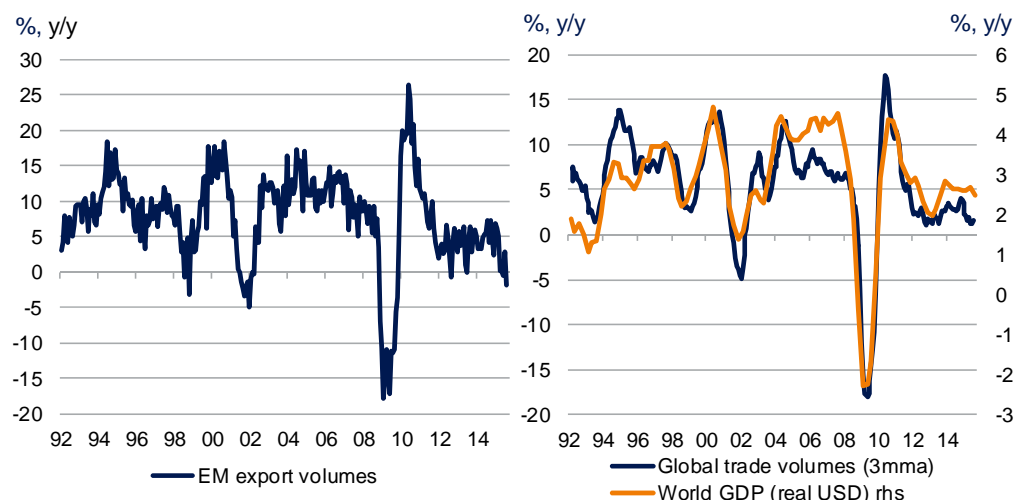
Bear in mind that this chart depicts the dollar value of exports. One possibility, in that case, is that the weakness is a result of local currencies falling in value against the dollar. Given that a stronger dollar has been a prominent feature of the global economy for some time, this seems perfectly possible.

Perhaps the easiest way to check whether this has been the case is to examine trade volumes, instead of values. We should then get a much cleaner picture of demand, stripped of price and currency effects. So, see chart 11.

Big fall in the dollar value of trade...

Chart 11: Trade volumes have also slowed

...but quantities
are less
dramatically
impacted



Source: Thomson Datastream, Schroders Economics Group. 25 September 2015.

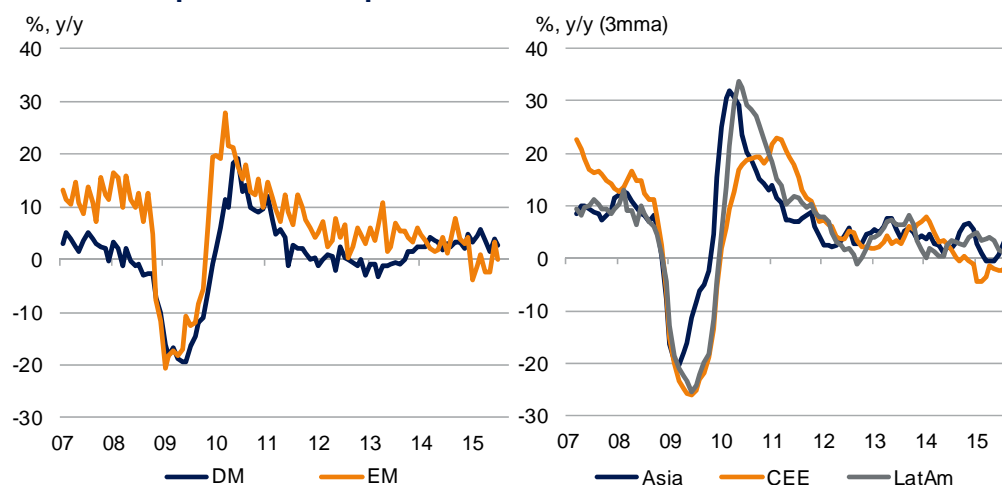
The picture still does not look great; we seem to have just entered contraction in volume terms. But a contraction of around 1% compared to the 10 – 15% contraction seen in export values should indicate the currency and price effects at work.

Globally, trade volumes remain positive, but are growing very slowly so it does look as though global demand is weaker, something backed up by the performance of real GDP growth. However, we should also note that the relationship between trade volumes and GDP does not look that different to the mid-2000s, suggesting that is not a “new normal”. That is, trade multipliers are working as well as always, we just have lower growth.

Relationship with
GDP unaltered,
the new normal?

In this respect we cannot expect trade to “normalise” – relative to GDP growth: it is already normal. In terms of its contribution to real economic growth, at current activity levels, this is likely as good as it gets. Of course, things could improve in value terms – and probably will once the base effect of cheaper commodities and currency weakness drop out from December – but for a volumes improvement, we need stronger growth.

The next question then is where this weakness is coming from. Is it a generic global malaise, or something more specific?

Chart 12: Import volumes point to EM demand weakness

Source: Thomson Datastream, Schroders Economics Group. 28 September 2015.

Chart 12 shows import volumes by region, and we can see that while DM has

Trade weakness emanating from EM

been gradually growing its import demand since 2013, EM has been on a volatile but downward slope over the same period. Both regions have seen a downward move more recently, but again EM looks worse. This is even more apparent when compared with the past eight years, where EM import growth has typically outperformed DM import growth. So, it would appear that overall trade weakness has its roots in EM, rather than DM.

The second panel of chart 12 breaks EM down into regions (further granularity is not available). All regions are clearly underperforming their pre-crisis norm. Central and Eastern Europe (CEE) is the worst performer, but a large part of this will be a result of Russian import sanctions. Only Asia is providing positive import demand growth at the moment, at a similar pace to DM.

Given Russia's presence in the CEE bloc, and the commodity dependence of Latin America, weaker demand in those two regions versus Asia perhaps comes as no surprise. Can we expect a revival? Commodity exporting South America is likely to struggle for some time yet, and in the case of Brazil we could be looking at several years before growth returns. In the CEE region, meanwhile, growth is picking up, and Russia's import ban will remain in place but drop out of the year on year comparison.

The overall message here though is that global trade volumes are not out of kilter with global growth. Stronger growth would therefore feed through to stronger trade, and we do expect slightly stronger activity in 2016. More importantly for equity investors, the assorted price and currency base effects currently dragging on earnings performance will begin to drop out towards the end of this year, leading to improved headline numbers.

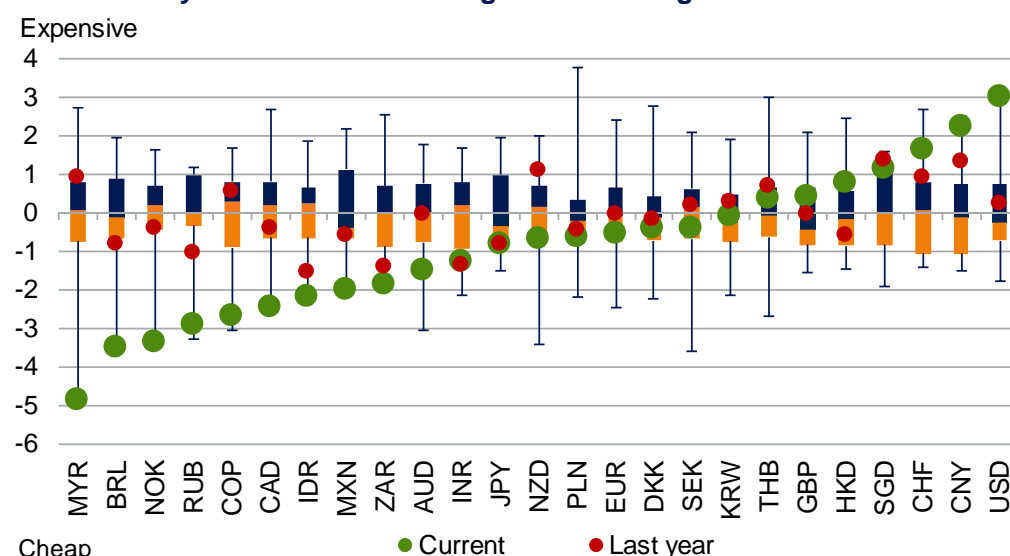
Depreciation and trade growth

Depreciation a standard trade promotion tool...

Historically, of course, currency depreciation has been seen as a quick way to boost growth by trade dependent economies. So perhaps this is an option for policymakers too impatient to wait for a global growth pick up, or if global growth never recovers.

But if that were the case, surely we would have seen it already? Chart 13 shows that a great many currencies are at very cheap levels on a trade weighted basis compared to their own histories. Yet as we saw above, trade performance is universally poor in EM.

Chart 13: 10 year Z scores for a range of trade weighted currencies



Source: Bloomberg, Schrodgers Economics Group. 24 September 2015.

...but it may not be working any more

Part of the problem is hinted at by the chart itself. The sheer number of currencies which have weakened dramatically means in many cases economies

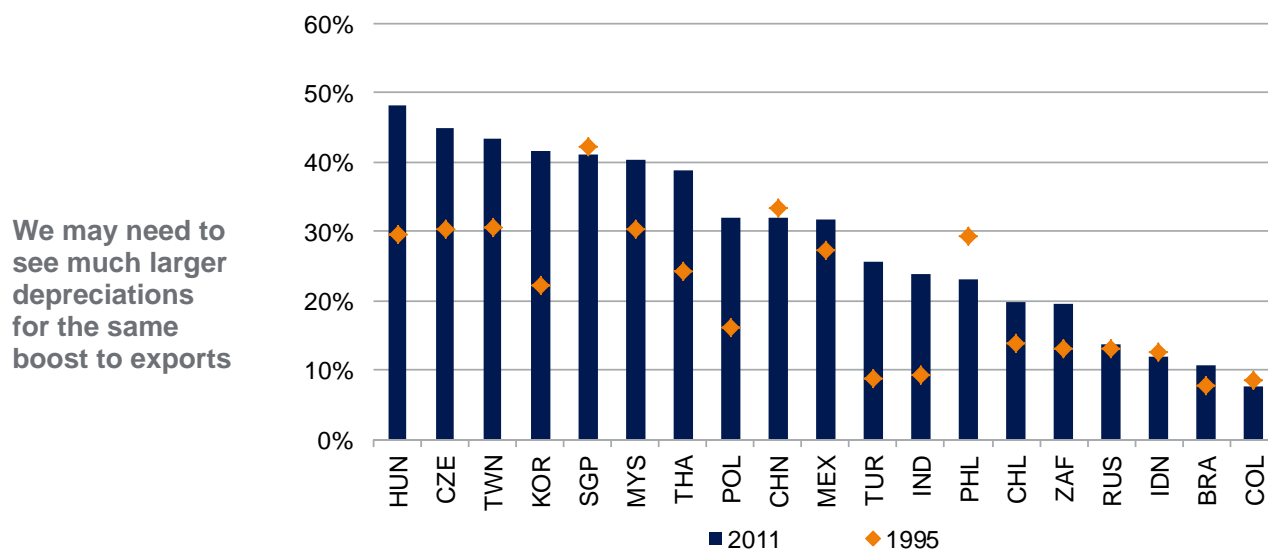
are running to stand still. The “currency wars” have many participants, leaving only a handful of non-combatants to perform the reciprocal strengthening. In this case, the world looks to be depreciating largely against the dollar and renminbi. But if all the strengthening is being done by the dollar and renminbi, depreciations won’t be helping to boost exports to economies beyond the US and China. It is rare for these two to account for more than 30% of a country’s exports between them, so this could be one reason currency depreciation is less effective in the current environment.

A recent World Bank study⁴ also provides some useful information. The report looked at the impact of REER depreciations on exports and the key finding was that the effectiveness of depreciation as a policy tool to promote growth via exports has been declining for almost 20 years. That the decline began before the Global Financial Crisis suggests it is not simply a low trade growth story.

The paper’s authors suggest four reasons for the decline, but focus on one in particular; the increased prominence of global value chains, or cross border production linkages. These reduce the effectiveness of depreciation because imported goods needed in the production of exports become more expensive.

Why does this matter? If FX depreciation is less powerful than in the past, countries will find a bigger depreciation is needed to achieve a given growth goal. Currency wars could get a lot more vicious. The question then becomes, how do we identify those countries most affected? It turns out that a key indicator is the share of imported content in a country’s exports. The larger the share, the more the impact of a competitive depreciation is diluted. Chart 14 below shows those EM economies for whom data is available (based on the OECD World Bank TiVa dataset).

Chart 14: Share of imported goods in exports



Source: OECD World Bank TiVa dataset, Schroders Economics Group. 19 August 2015.

It would appear that a competitive devaluation will be least effective in the European and Asian manufacturers, an unsurprising result given their position in regional supply chains. The change since 1995 is fairly one sided (2011 is the most recent data available). Import content in exports has increased for most of the sample, suggesting depreciation is less useful than it used to be. Countries in this grouping may find they have to go further than they are historically accustomed in order to boost exports. Finally, looking at the economies with the lowest share of imported content in their exports, it is worth noting that they are

⁴Ahmed, S., Appendino, M., Ruta, M. “Depreciations without Exports? Global value chains and the exchange rate elasticity of exports” Policy Research Working Paper 7390, World Bank Group, August 2015

dominated by commodities exporters. Commodities are low import content (being essentially dug up and sold), but demand is also insensitive to price changes. So a large devaluation would still be needed, albeit for different reasons. The best positioned countries then are probably those in the middle of the chart: Turkey, India and the Philippines, for example.

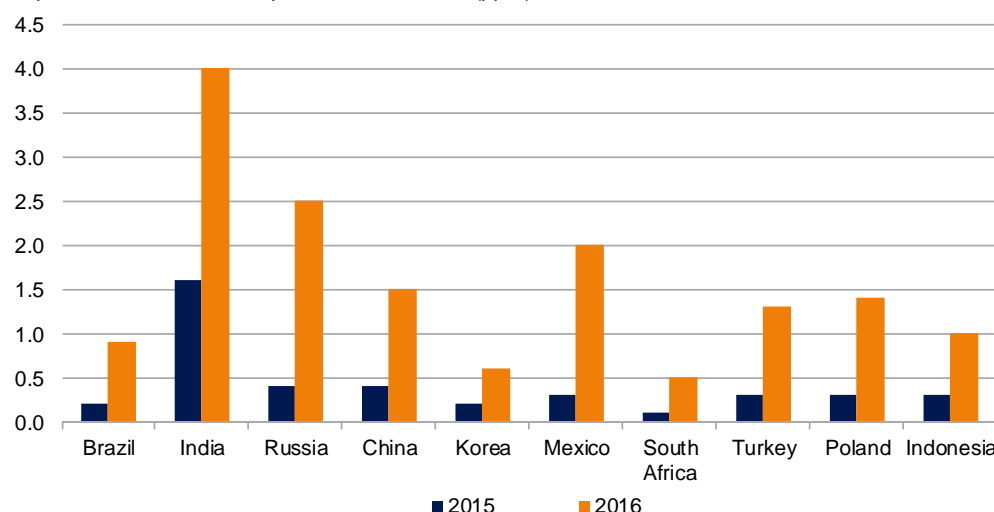
Finally, depreciation will not be without its risks domestically. Currency depreciation is less painful for EM sovereigns than it used to be, as they hold a lower proportion of their debt in dollars. Corporates, however, are more exposed than in 1997, as we have written about before. So while a 'successful' depreciation could help export performance, it could also result in more higher debt servicing costs for exporters, rendering it counterproductive.

Even where dollar debt is not a concern, depreciation is a double edged sword domestically because of its inflationary consequences. A weaker currency pushes up the cost of imported goods, and for emerging markets this can be a substantial contribution to overall inflation. However, the degree of this 'inflation pass-through' varies from economy to economy. We present estimates from the Oxford Economics model in chart 15. We assume a 10% depreciation versus the dollar which then persists for six quarters, and present the cumulative impact on inflation over that period.

**Larger
depreciations
mean more
inflation**

Chart 15: Inflation pass-through in EM

Impact on CPI of 10% depreciation vs. USD (ppts)



Source: Oxford Economics, Schroders Economics Group. 28 September 2015.

The inflationary risks are clearly more significant for some economies than others, while for a few an aggressive devaluation policy can be followed without fear of the inflationary consequences. This should be of comfort to economies like Korea, with a high import content in their exported goods, and hence a need for greater devaluation than economies like the Philippines, to achieve the same export boost. The commodity exporters should also find they can devalue in pursuit of growth without massive inflationary consequences – though in most cases they are already struggling with high inflation, rendering the point somewhat moot.

In summary, trade is weak, and policymakers have limited options available to restore it to its former glory. The effectiveness of depreciation appears greatly diminished, and economic growth is looking softer globally. Trade values should improve as various base effects disappear, supporting some asset prices, but the weaker volumes may be here to stay. On the positive side, this level of trade does not imply a global recession or that outright collapse in demand is occurring.

Schroder Economics Group: Views at a glance

Macro summary – September 2015

Key points

Baseline

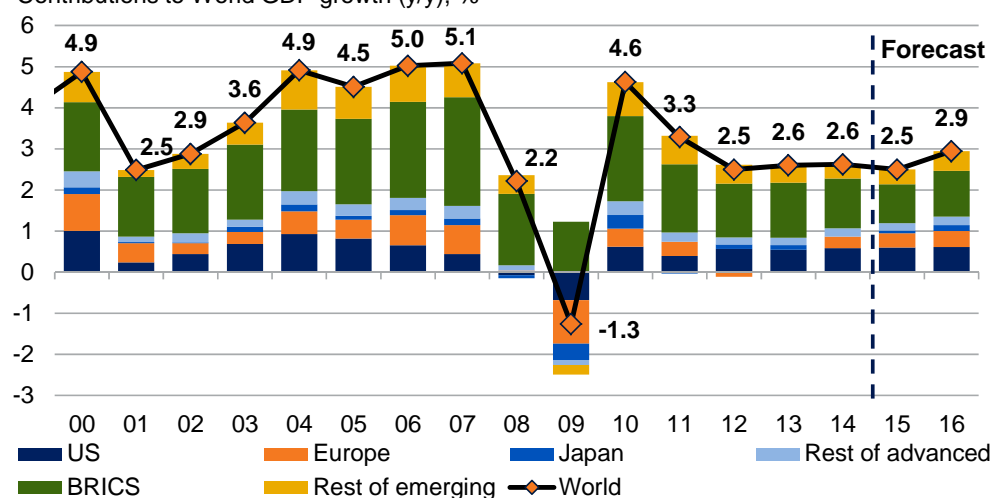
- After a poor start to the year global growth is now forecast at 2.4% for 2015, slightly lower than 2014. Activity is still expected to pick-up as we move through the year, but parts of the world economy are taking longer than expected to respond to the fall in energy costs.
- Despite a weak first quarter, the US economy rebounded in the second and is on a self sustaining path with unemployment set to fall below the NAIRU in 2015, however global pressures are likely to delay Fed tightening until 2016. **First rate rise expected in March 2016 with rates rising to 1% by year end.**
- UK recovery to continue, but to moderate in 2016 with the resumption of austerity. Interest rate normalisation to begin with first rate rise in May 2016 after the trough in CPI inflation. BoE to move cautiously with rates at 1.5% by end 2016 and peaking at around 2.5% in 2017.
- Eurozone recovery picks up as fiscal austerity and credit conditions ease whilst lower euro and energy prices support activity. Inflation to remain close to zero throughout 2015, but to turn positive again in 2016. ECB to keep rates on hold and continue sovereign QE through to September 2016.
- Japanese growth supported by weaker yen, lower oil prices and absence of fiscal tightening in 2015. Momentum to be maintained in 2016 as labour market continues to tighten, but Abenomics faces considerable challenge over the medium-term to balance recovery with fiscal consolidation.
- US still leading the cycle, but Japan and Europe begin to close the gap in 2015. Dollar to remain firm as the Fed tightens, but to appreciate less than in recent months as ECB and BoJ policy is mostly priced in.
- Emerging economies benefit from advanced economy upswing, but tighter US monetary policy, a firm dollar and weak commodity prices weigh on growth. Concerns over China's growth rising as financial market bubbles are inflated further by government policy. Further easing from the PBoC is likely.

Risks

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

Chart: World GDP forecast

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



Source: Thomson Datastream, Schroders Economics Group. August 2015 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	2.6	2.4	↓ (2.5)	2.4	2.9	(2.9)	2.9
Advanced*	63.2	1.7	1.8	↓ (1.9)	1.9	2.2	↑ (2.1)	2.2
US	24.5	2.4	2.3	↓ (2.4)	2.5	2.7	↑ (2.5)	2.7
Eurozone	19.2	0.9	1.3	↓ (1.4)	1.4	1.7	↑ (1.6)	1.7
Germany	5.4	1.6	1.3	↓ (1.6)	1.8	2.1	(2.1)	1.9
UK	3.9	3.0	2.5	↑ (2.2)	2.6	2.1	↑ (1.9)	2.5
Japan	7.2	-0.1	0.7	↓ (0.9)	0.7	1.8	↓ (2.0)	1.5
Total Emerging**	36.8	4.3	3.4	↓ (3.6)	3.4	4.1	↓ (4.3)	4.1
BRICs	22.6	5.4	4.1	↓ (4.2)	4.1	4.7	↓ (4.9)	4.8
China	13.5	7.4	6.8	(6.8)	6.8	6.4	↓ (6.5)	6.6

Inflation CPI

y/y%	Wt (%)	2014	2015	Prev.	Consensus	2016	Prev.	Consensus
World	100	2.8	2.9	↑ (2.8)	2.9	3.3	↑ (3.1)	3.3
Advanced*	63.2	1.4	0.5	↓ (0.6)	0.3	1.7	(1.7)	1.5
US	24.5	1.6	0.6	↓ (0.9)	0.2	2.3	(2.3)	1.9
Eurozone	19.2	0.4	0.0	↓ (0.2)	0.2	1.1	↓ (1.2)	1.2
Germany	5.4	0.8	0.2	↓ (0.5)	0.4	1.5	↓ (1.7)	1.5
UK	3.9	1.5	0.0	↓ (0.4)	0.1	1.6	↓ (1.8)	1.4
Japan	7.2	2.7	1.1	↑ (0.8)	0.7	1.1	(1.1)	0.8
Total Emerging**	36.8	5.1	7.0	↑ (6.4)	7.2	6.1	↑ (5.4)	6.4
BRICs	22.6	4.0	4.8	↑ (4.7)	4.6	3.8	↑ (3.6)	3.7
China	13.5	2.0	1.4	(1.4)	1.5	2.0	(2.0)	2.0

Interest rates

% (Month of Dec)	Current	2014	2015	Prev.	Market	2016	Prev.	Market
US***	0.25	0.25	0.25	↓ (0.75)	0.42	1.00	↓ (2.00)	1.01
UK	0.50	0.50	0.50	(0.50)	0.61	1.50	(1.50)	0.98
Eurozone	0.05	0.05	0.05	(0.05)	-0.05	0.05	(0.05)	-0.02
Japan	0.10	0.10	0.10	(0.10)	0.18	0.10	(0.10)	0.16
China	4.60	5.60	4.60	(4.60)	-	4.00	(4.00)	-

Other monetary policy

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

Key variables

FX (Month of Dec)	Current	2014	2015	Prev.	Y/Y(%)	2016	Prev.	Y/Y(%)
USD/GBP	1.52	1.56	1.53	↑ (1.52)	-1.9	1.50	(1.50)	-2.0
USD/EUR	1.12	1.21	1.08	(1.08)	-10.7	1.02	↑ (1.00)	-5.6
JPY/USD	120.8	119.9	120.0	↑ (118)	0.1	120.0	↑ (115)	0.0
GBP/EUR	0.74	0.78	0.71	↓ (0.71)	-9.0	0.68	↑ (0.67)	-3.7
RMB/USD	6.37	6.20	6.30	(6.30)	1.5	6.40	(6.40)	1.6
Commodities (over year)								
Brent Crude	47.6	55.8	55.0	↓ (64)	-1.6	55.5	↓ (71)	0.9

Source: Schroders, Thomson Datastream, Consensus Economics, September 2015

Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.

Market data as at 25/09/2015

Previous forecast refers to May 2015

* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, Sweden, Switzerland, United Kingdom, United States.** **Emerging markets:** Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

*** The forecast for US policy interest rates was updated this month, with the previous forecast referring to the August update.

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

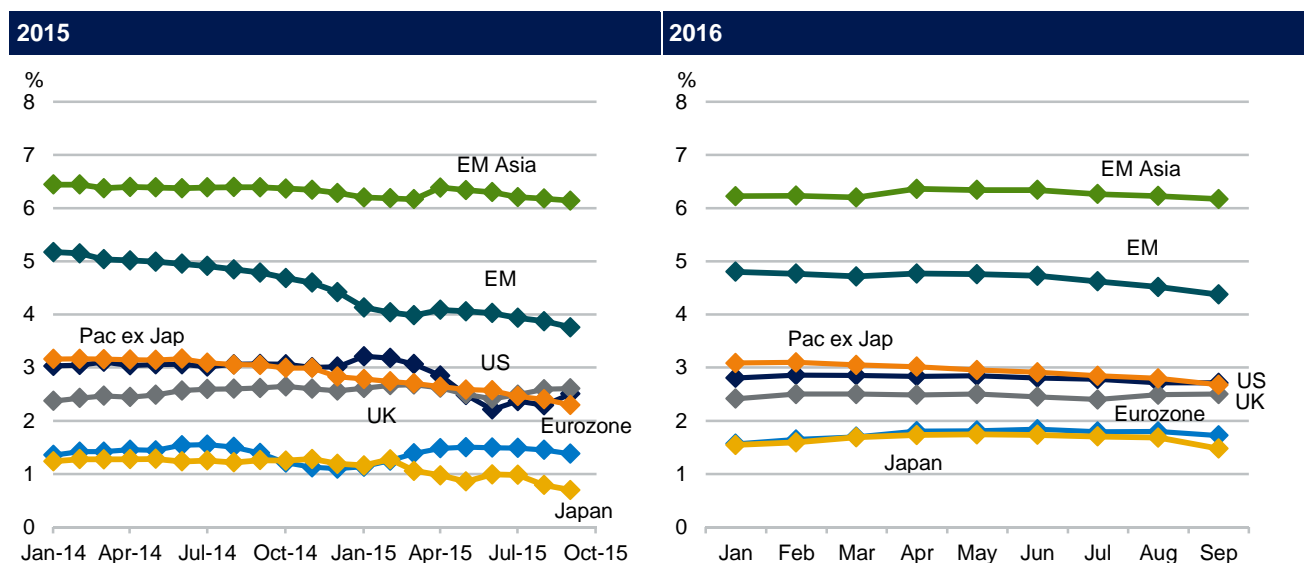
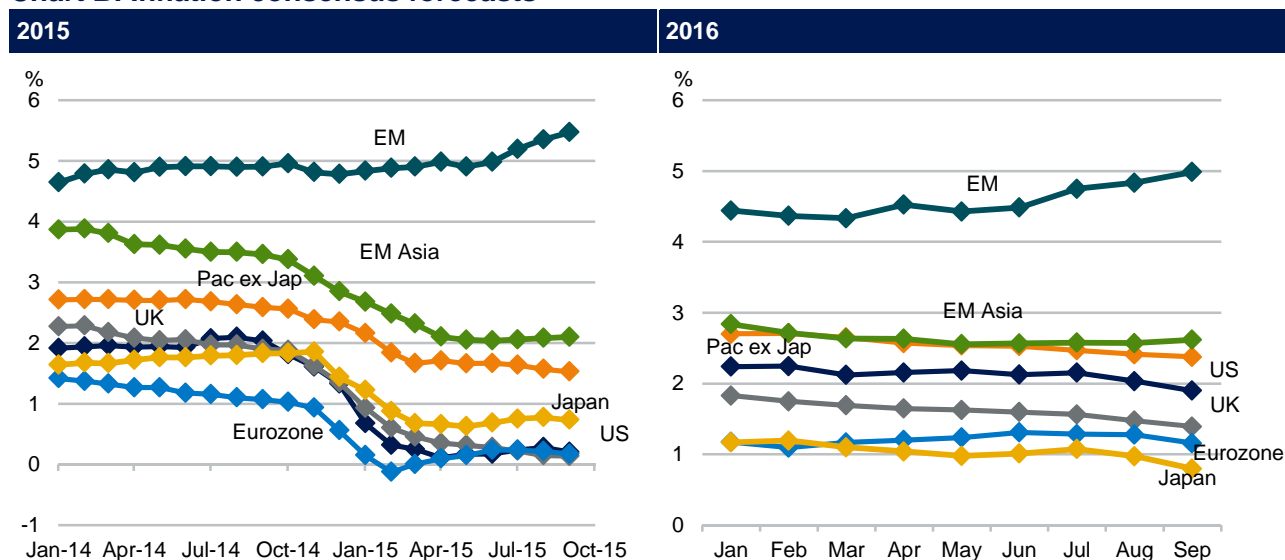


Chart B: Inflation consensus forecasts



Source: Consensus Economics (September 2015), 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.

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