

Avon Pension Fund

Macro-economic outlook:

Will the oil shock and inflation derail the world economy?

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Client Director
24 June 2011



Schroders

Themes for 2011

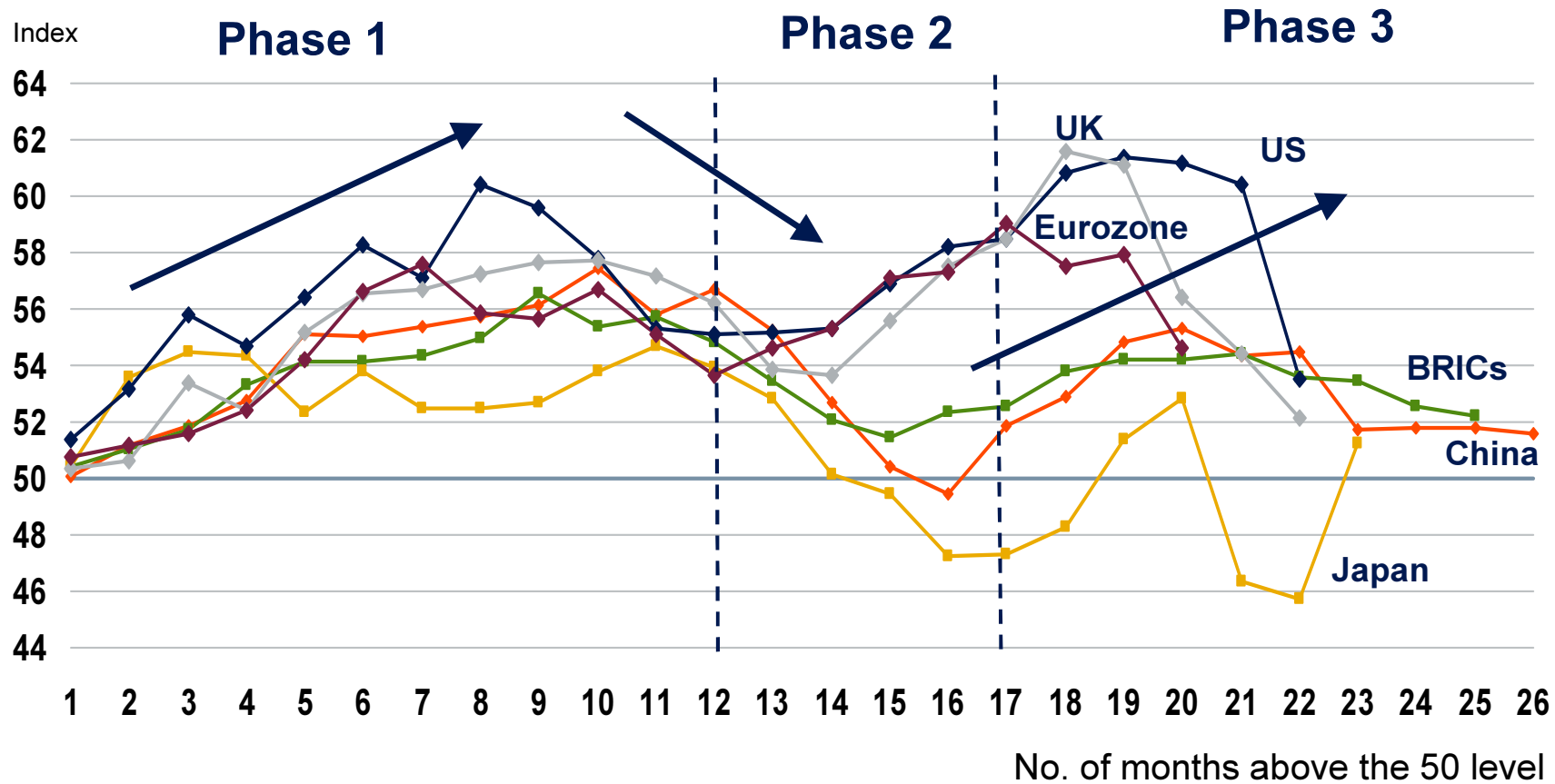
- Sweet spot for risk assets
- Search for yield
- East/ west divergence
- Sovereign debt restructuring in Eurozone



Sweet spot under threat

Oil, Japanese earthquake present near term challenge to recovery

Manufacturing Purchasing Managers Index



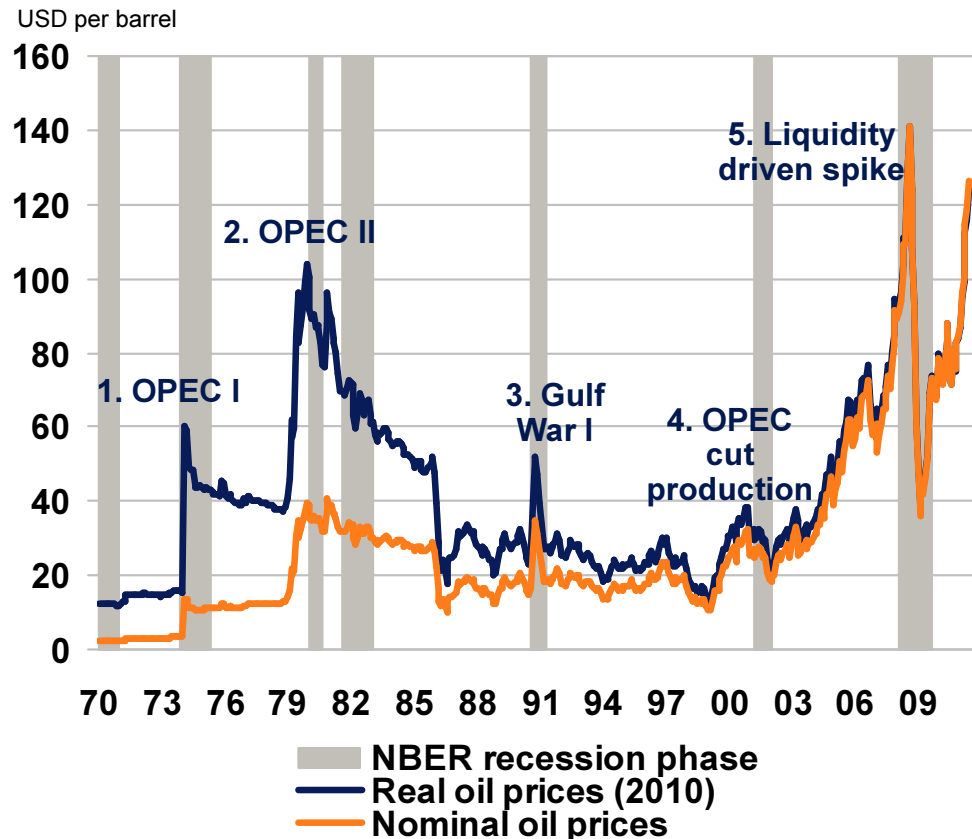
Source: Schrodgers, Markit PMI, June 2011. BRIC: Brazil, China, India & Russia. GDP weights based on nominal GDP in USD from IMF.



Will the rise in oil prices cause another recession?

Latest rise in oil prices is smaller than previous shocks

Oil prices in nominal and real terms (2010)



Oil shocks compared

Period	Oil price: % rise trough to peak		Duration	1-year after peak vs. trough
	Nominal	Real		
Dec-73 to Jan-74	293%	286%	1 month	179%
Nov-78 to Nov-79	201%	170%	12 months	170%
Jun-90 to Oct-90	133%	128%	4 months	-40%
Mar-99 to Nov-00	151%	142%	20 months	138%
Jul-07 to Jul-08	92%	83%	12 months	-10%
Jul-10 to May-11?	77%	73%	10 months	?

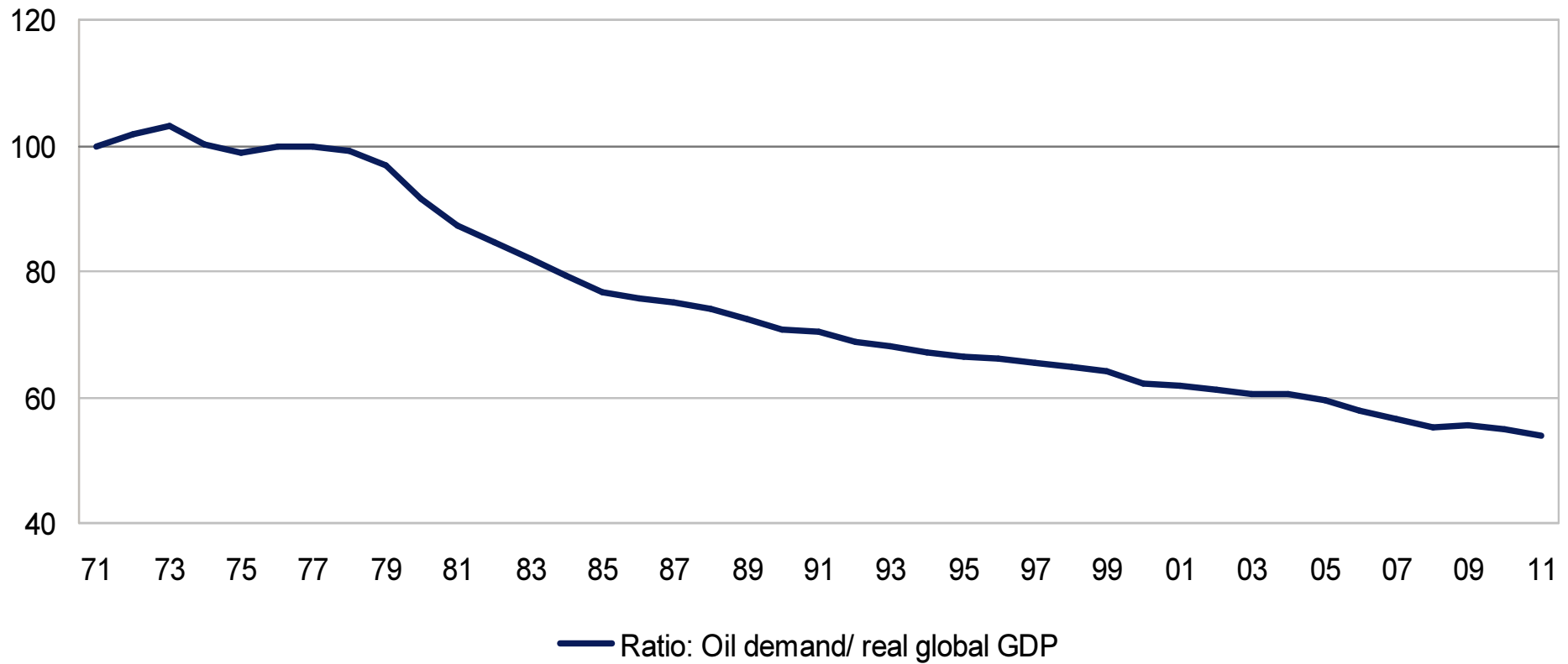
Source: Thomson Datastream, NBER (National bureau of Economic Research), Schroders, 19 May 2011.



Energy intensity has fallen

Oil's role in the world economy has halved

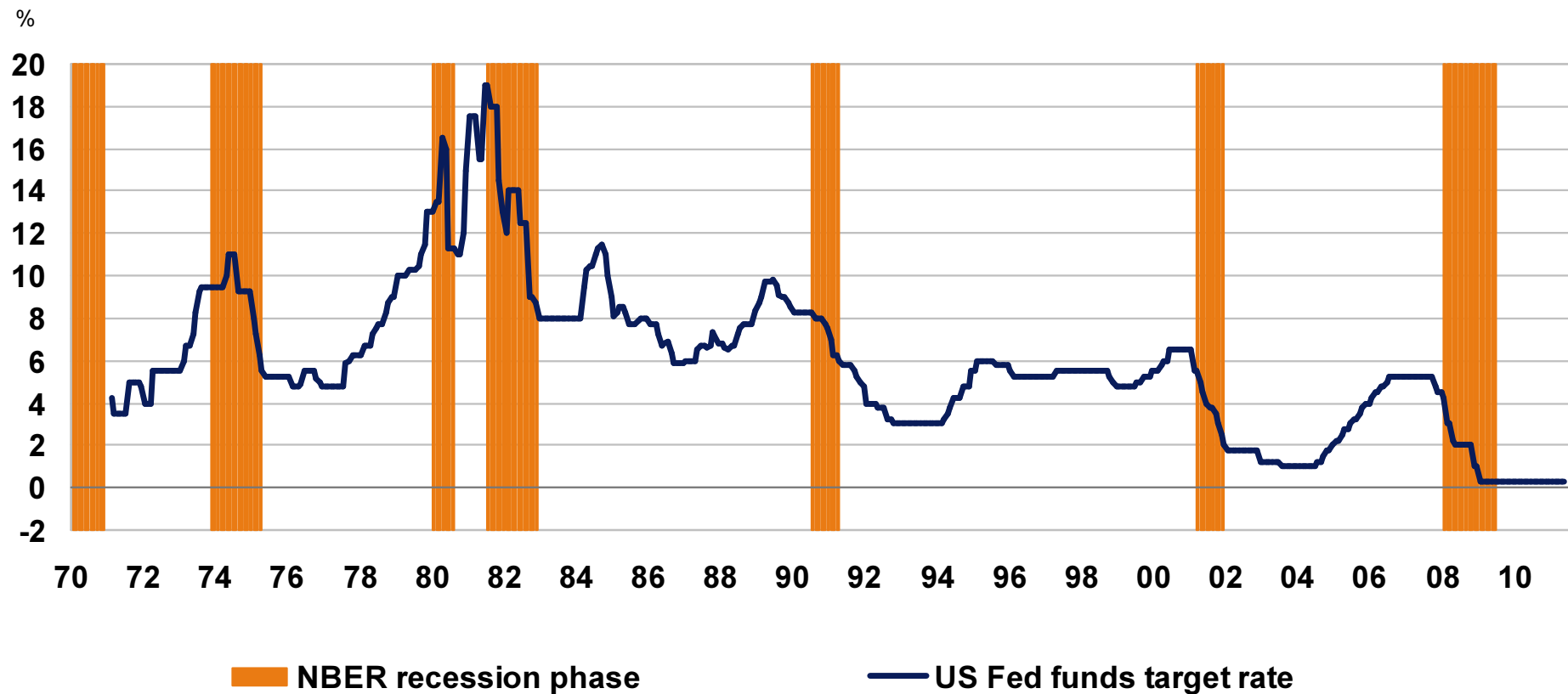
Global oil demand to GDP (1971=100)



Source: Thomson Datastream, 19 May 2011

Link between interest rates and recessions is stronger

Policy response to oil price shocks critical and dependent on second round effects

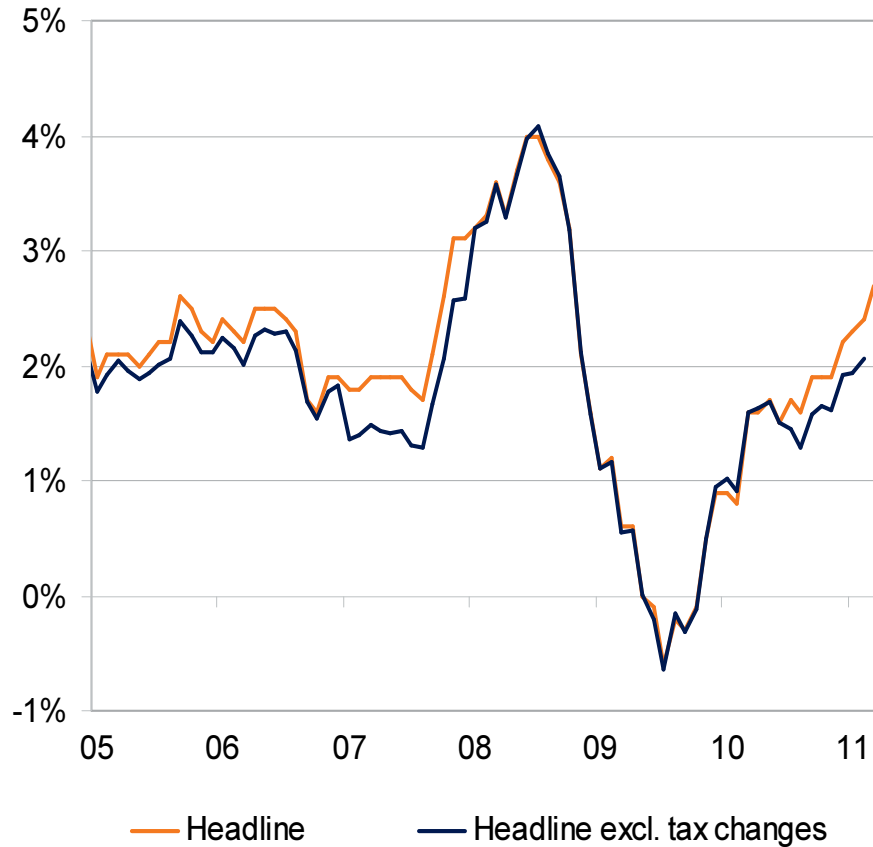


Source: Thomson Datastream, NBER (National bureau of Economic Research), 19 May 2011.

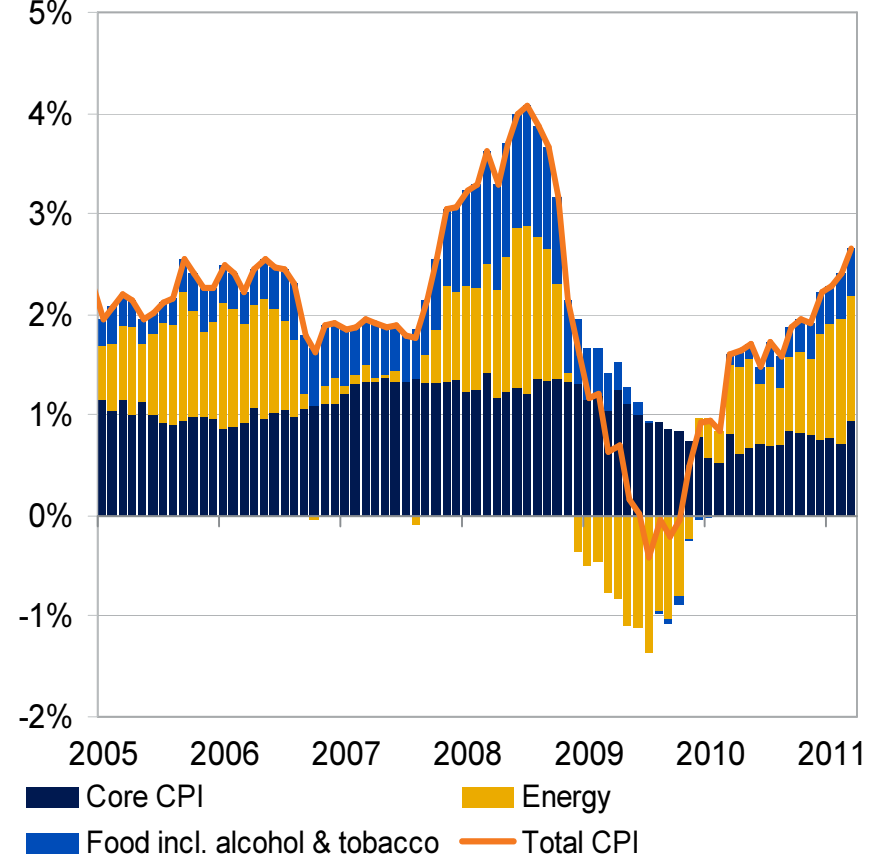
The ECB has started raising interest rates

Taxes and energy price inflation hurting consumers

Inflation, y/y



Y/Y



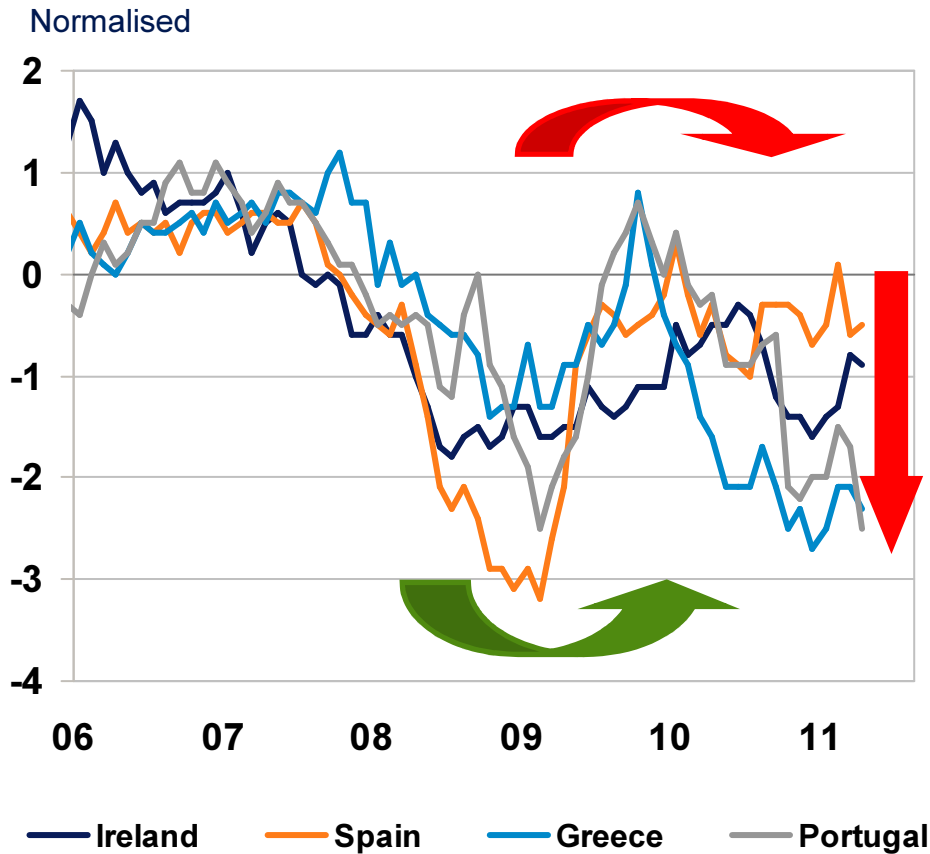
Source: Thompson Datastream. Updated 5 May 2011.



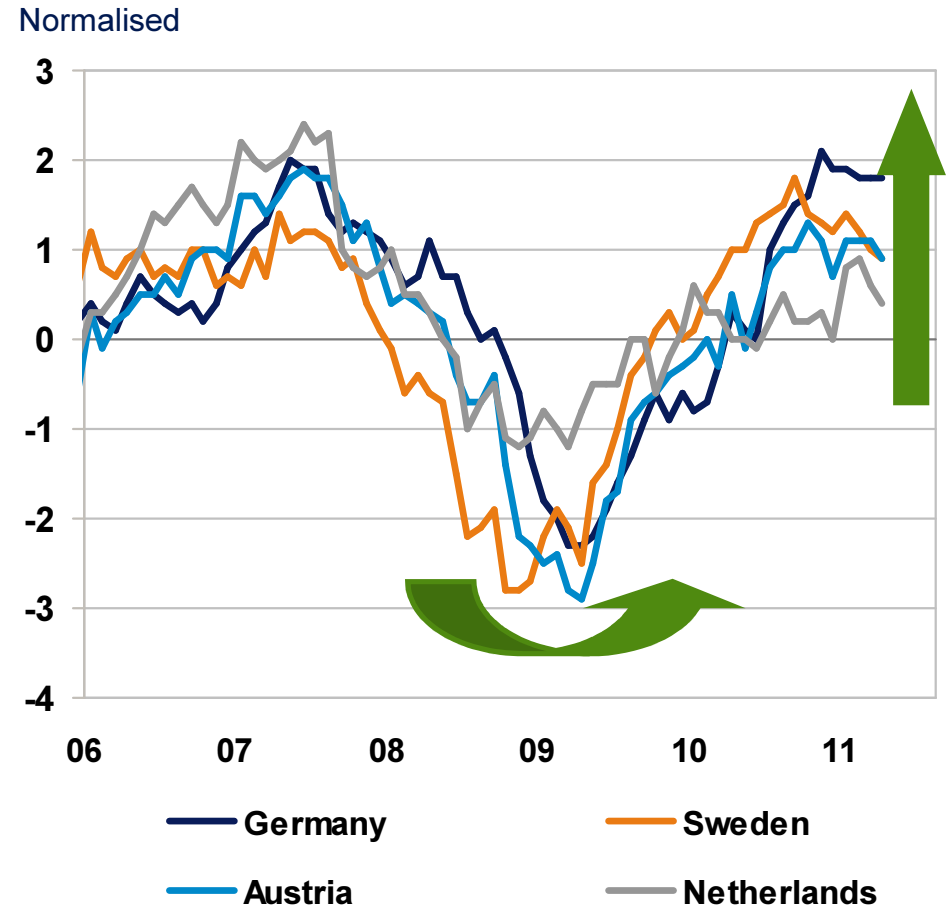
Growth divergence within Europe

A tale of two consumers

Peripheral consumer confidence



Core consumer confidence

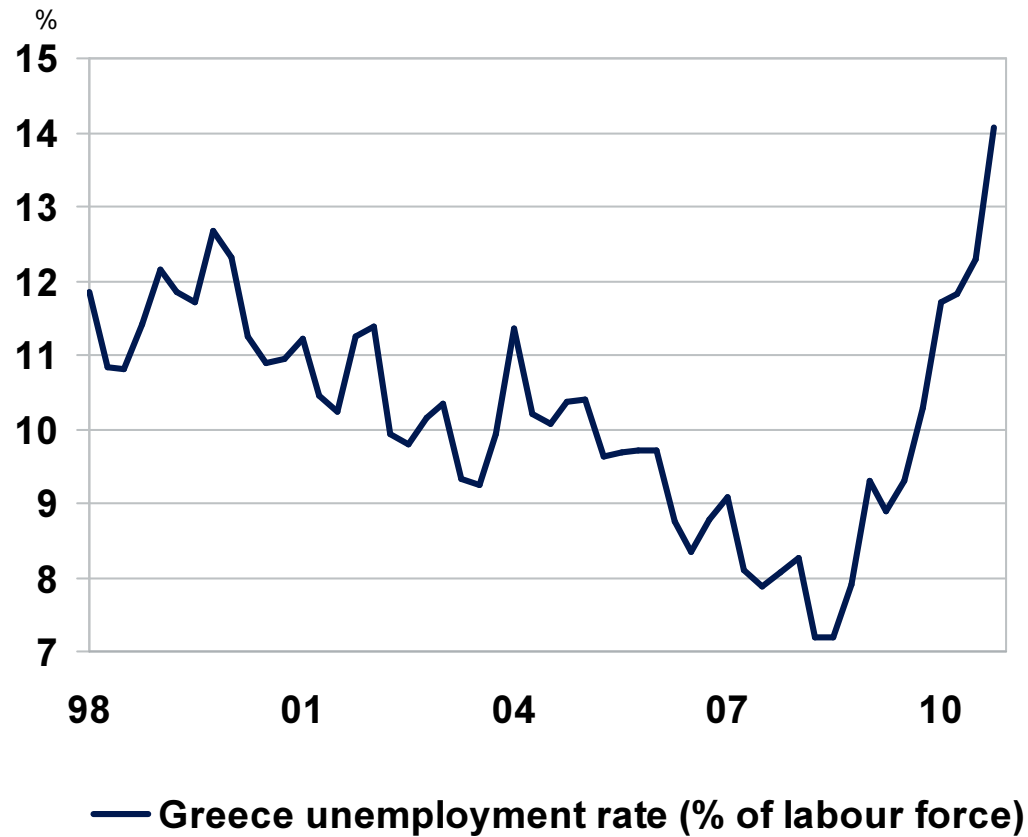


Source: Thomson Datastream, European Commission, 18 May 2011.



The Euro crisis

How far can government's cut spending?

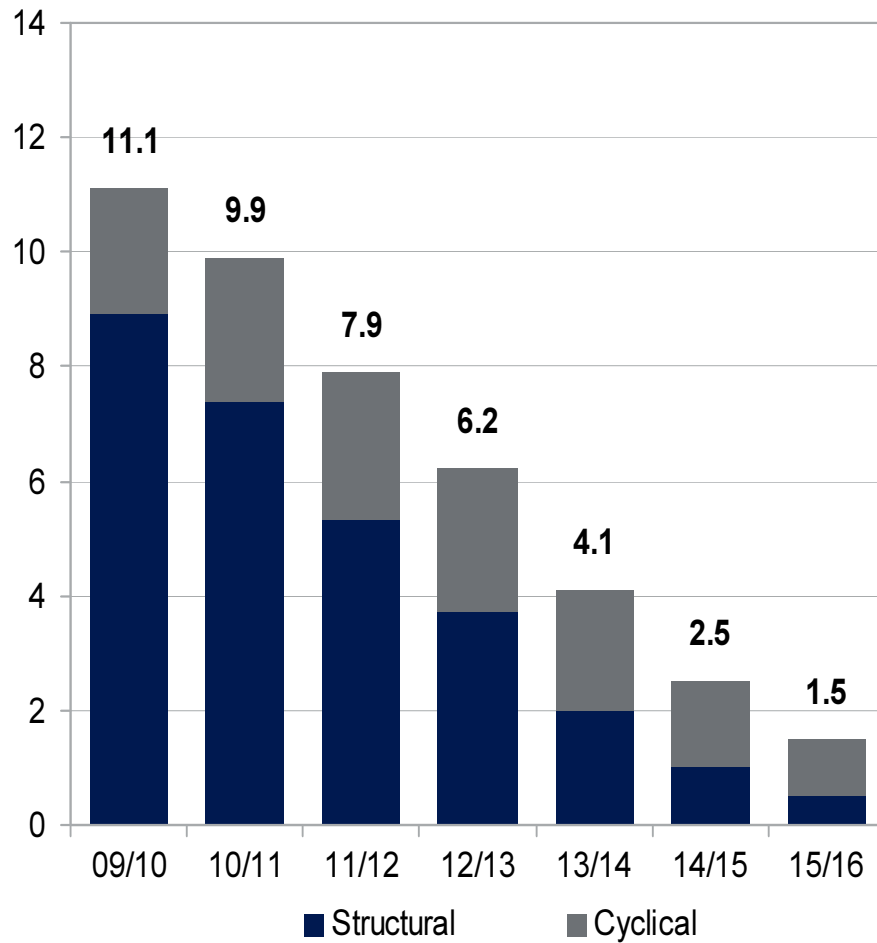


Source: Thomson Datastream, 19 May 2011, BBC

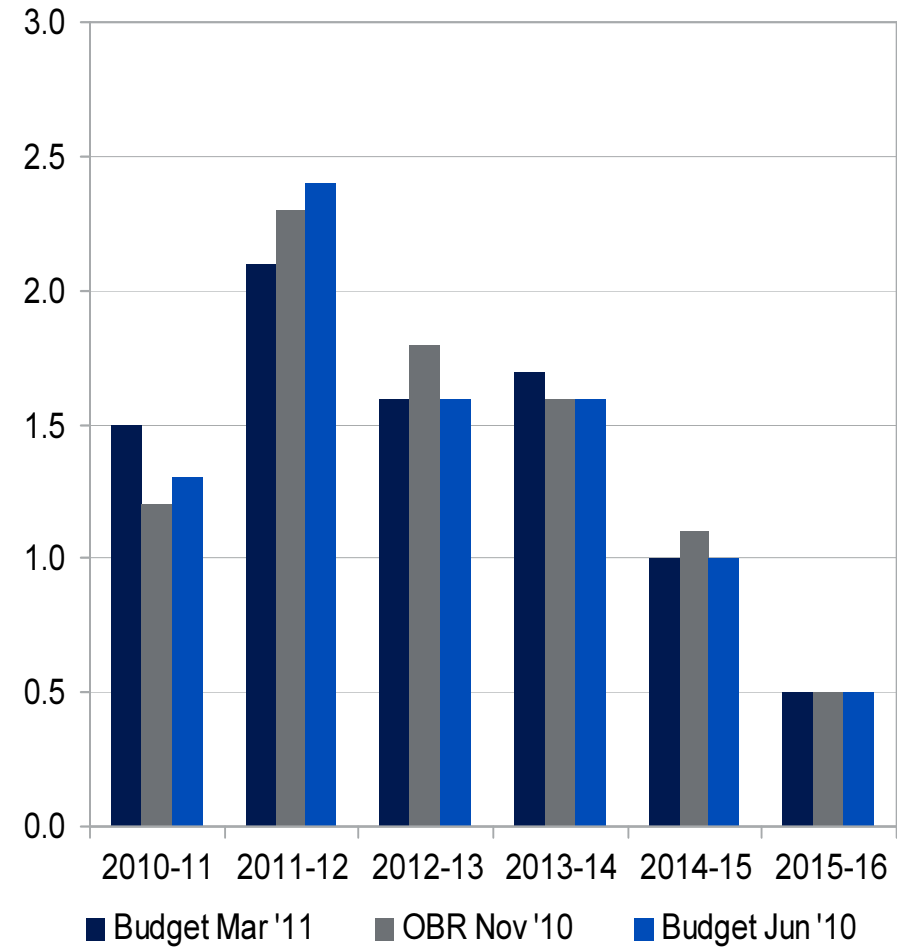
Still following Plan A

Path of fiscal tightening in the UK

PSBR, % of GDP



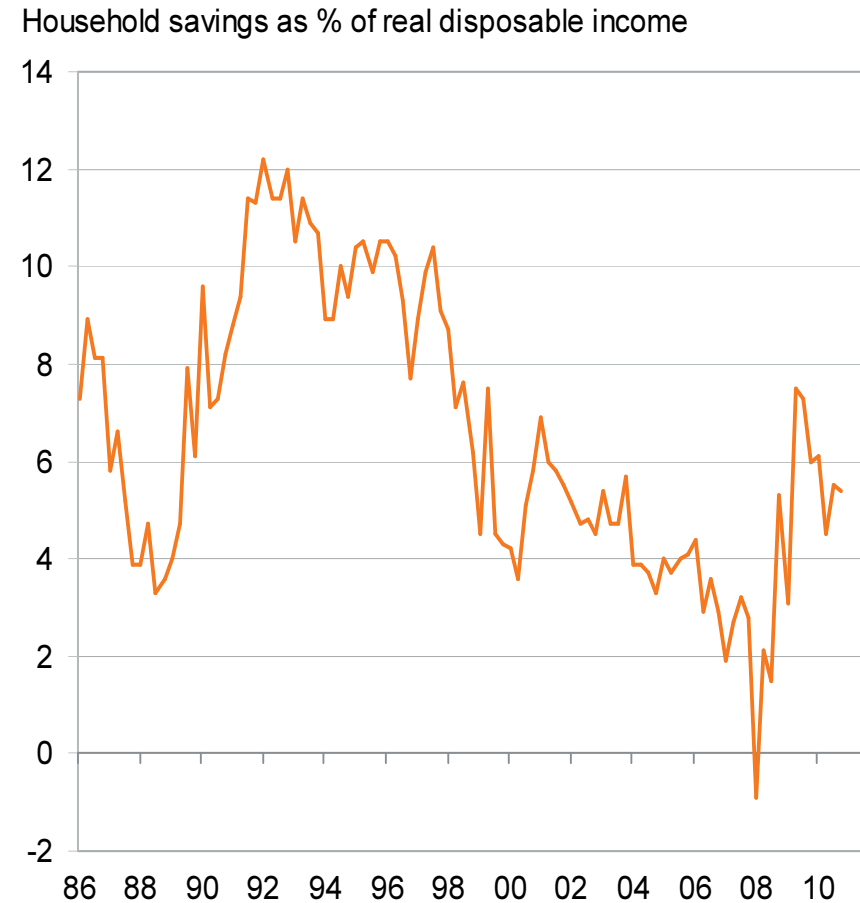
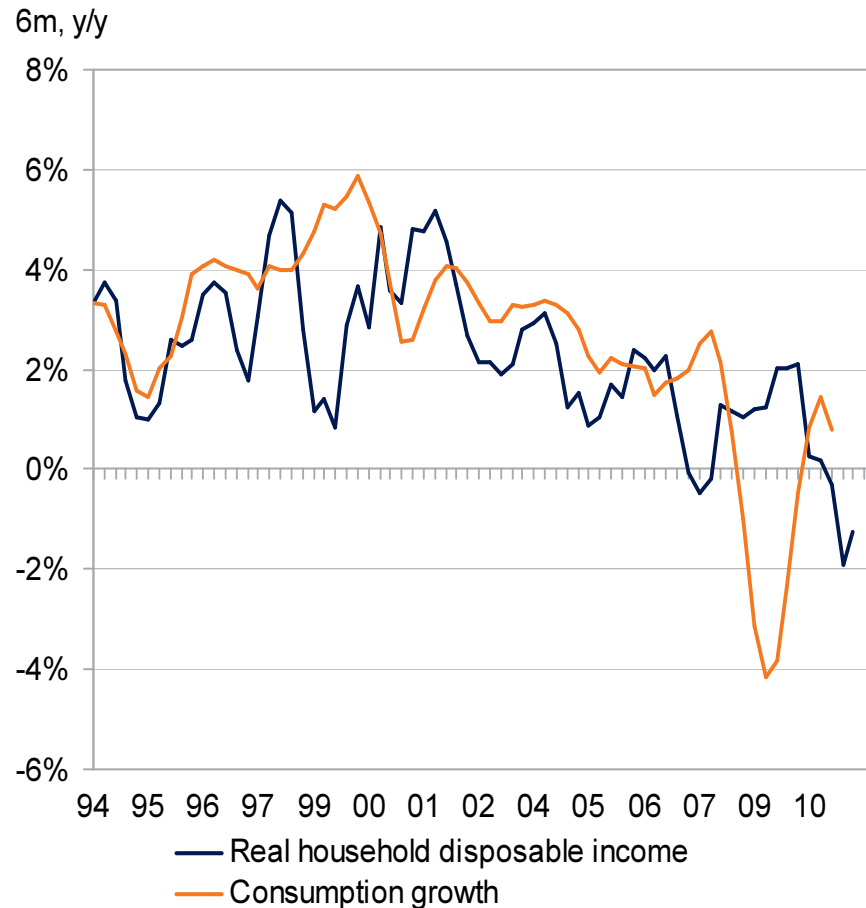
% of GDP Change in PSBR



Source: ONS, Datastream, OBR, Budget March 2011, Schroders. 30 March 2011

But can the UK withstand the fiscal squeeze?

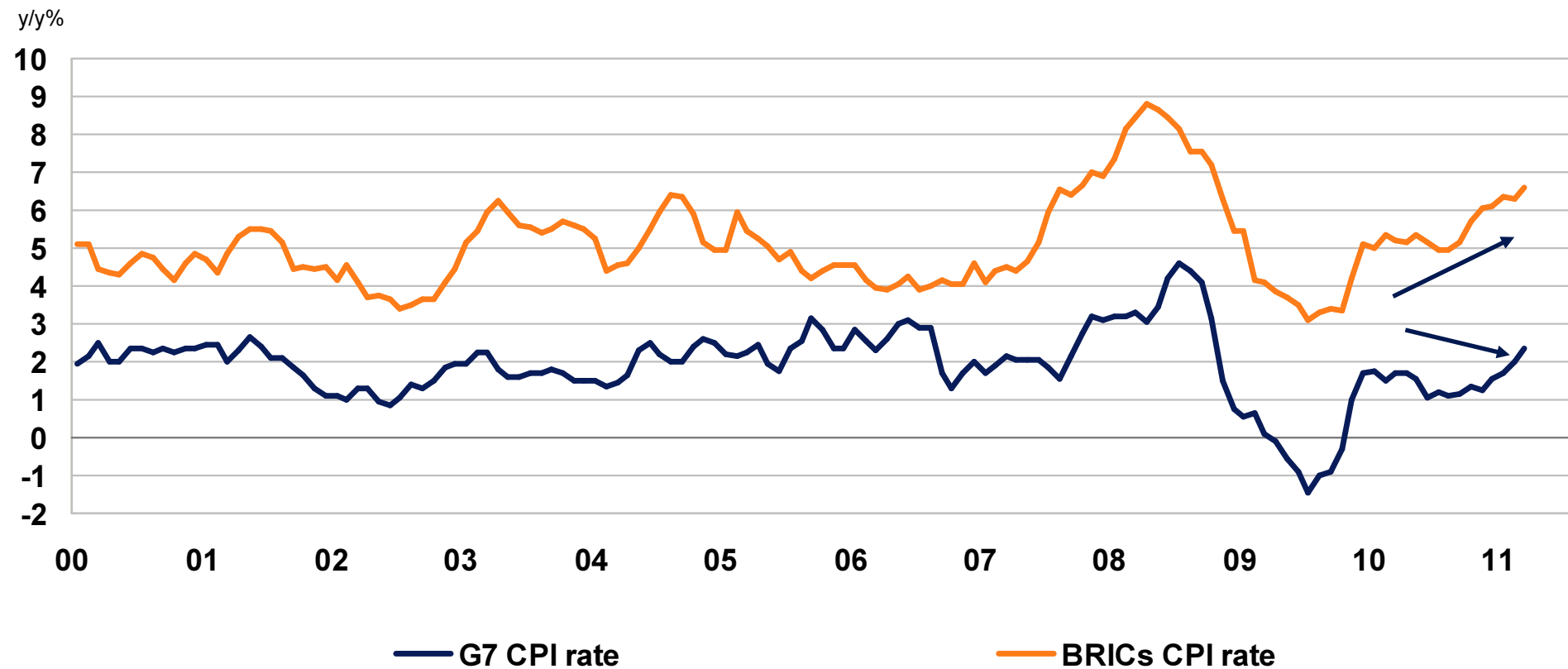
Growth reliant on fall in savings ratio



Source: ONS, Datastream. Updated 5 April 2011.

East/ west divergence

Inflation is diverging in the developed and emerging worlds

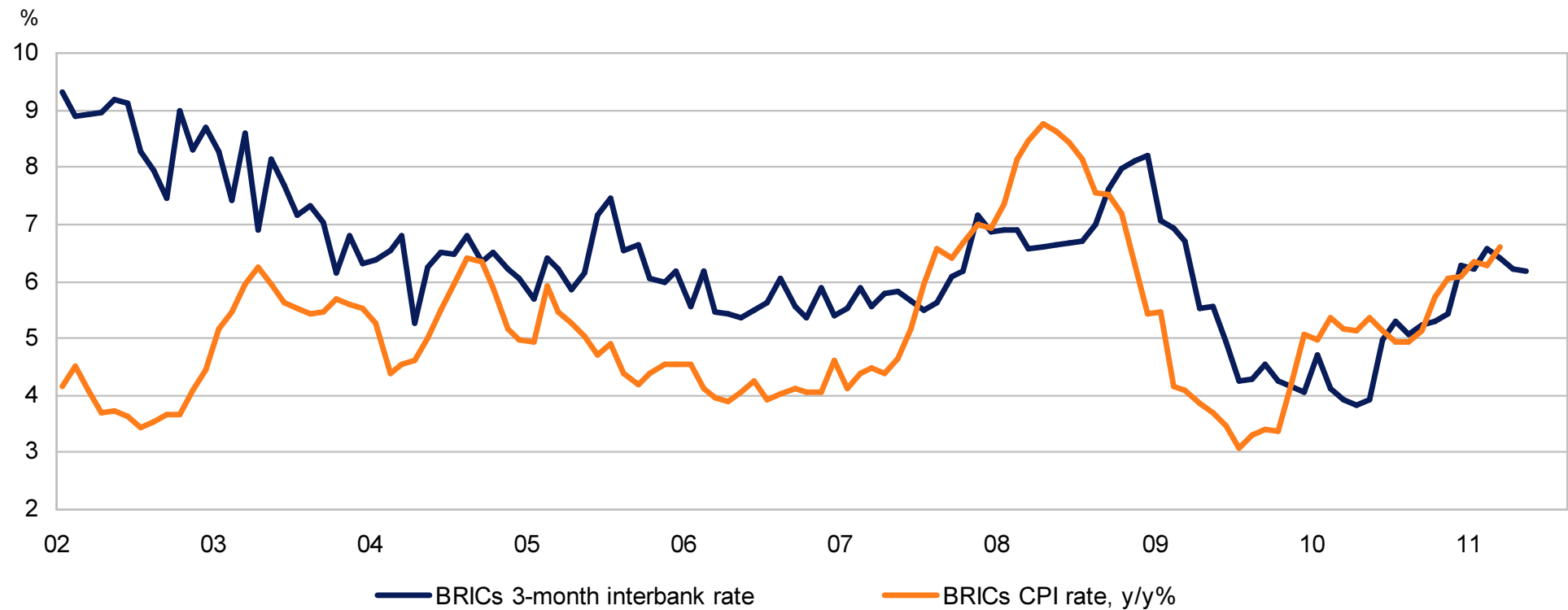


Source: Thomson Datastream, Schroders, 19 May 2011.
BRICs: Brazil, Russia, India and China. USD GDP-weighted.



Tighter policy in emerging markets

Inflation and rates in the BRIC's



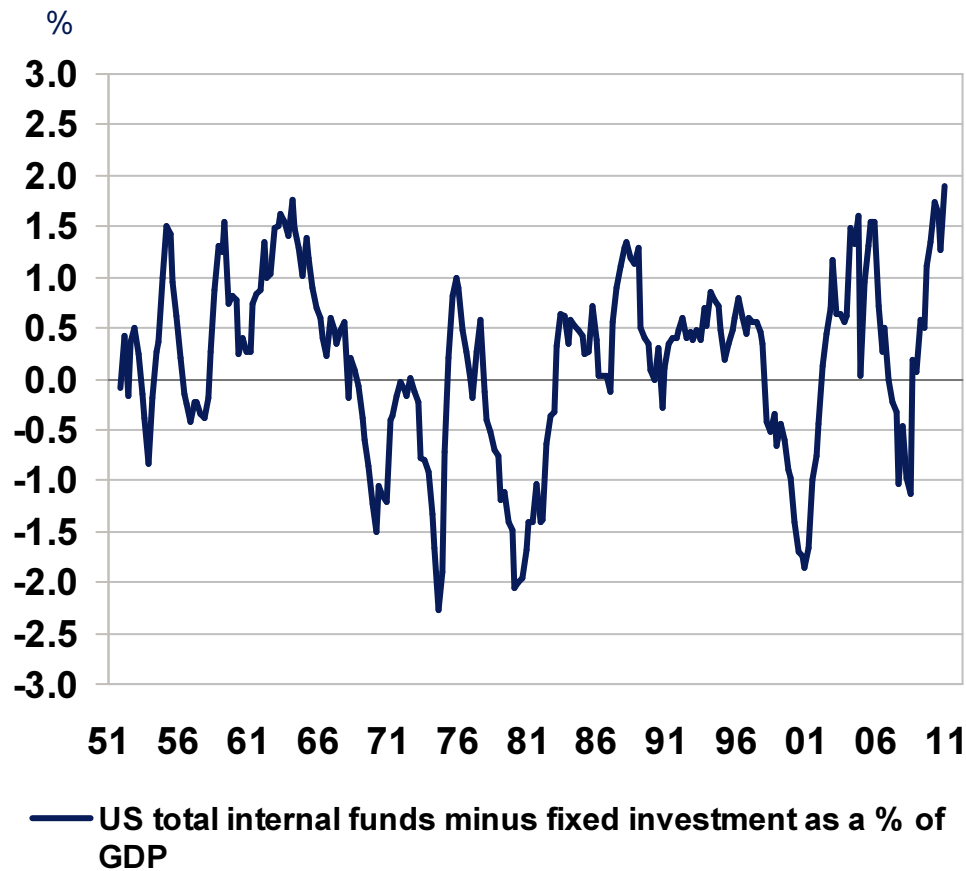
Source: Thomson Datastream, Schroders, 19 May 2011.
BRICs: Brazil, Russia, India and China. USD GDP-weighted.



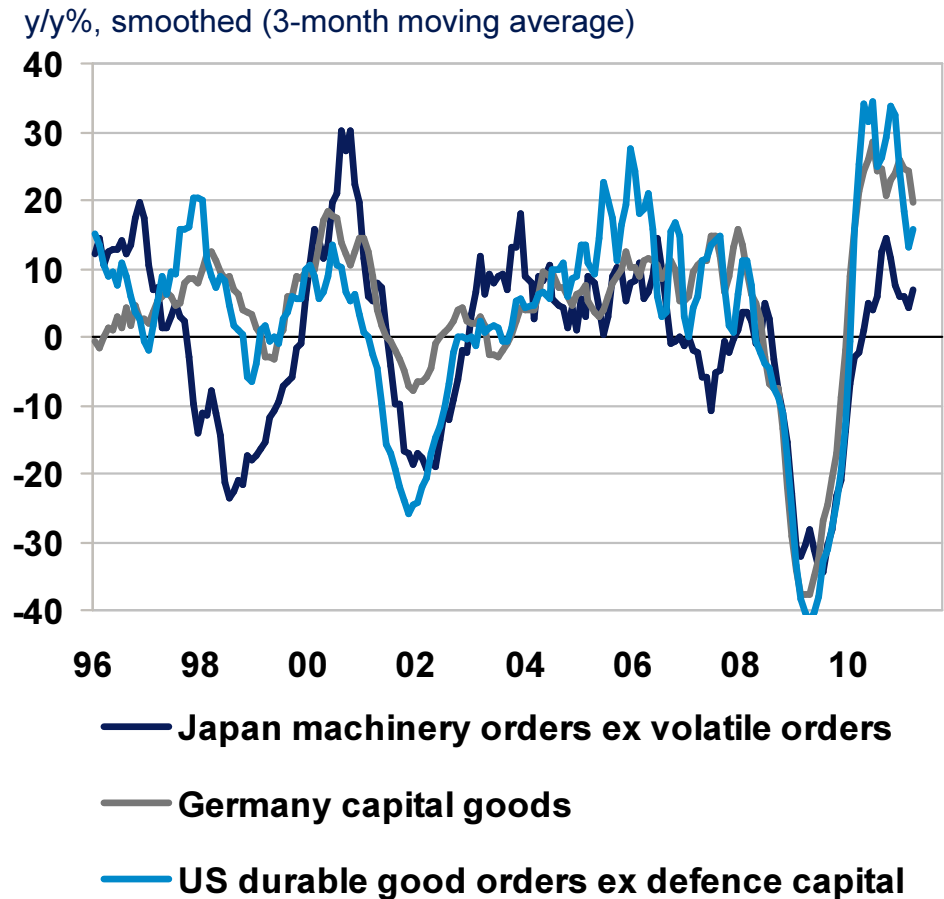
Corporate spending is recovering

Cash flow surges – capex accelerates

Corporate cash flow



Business capex orders

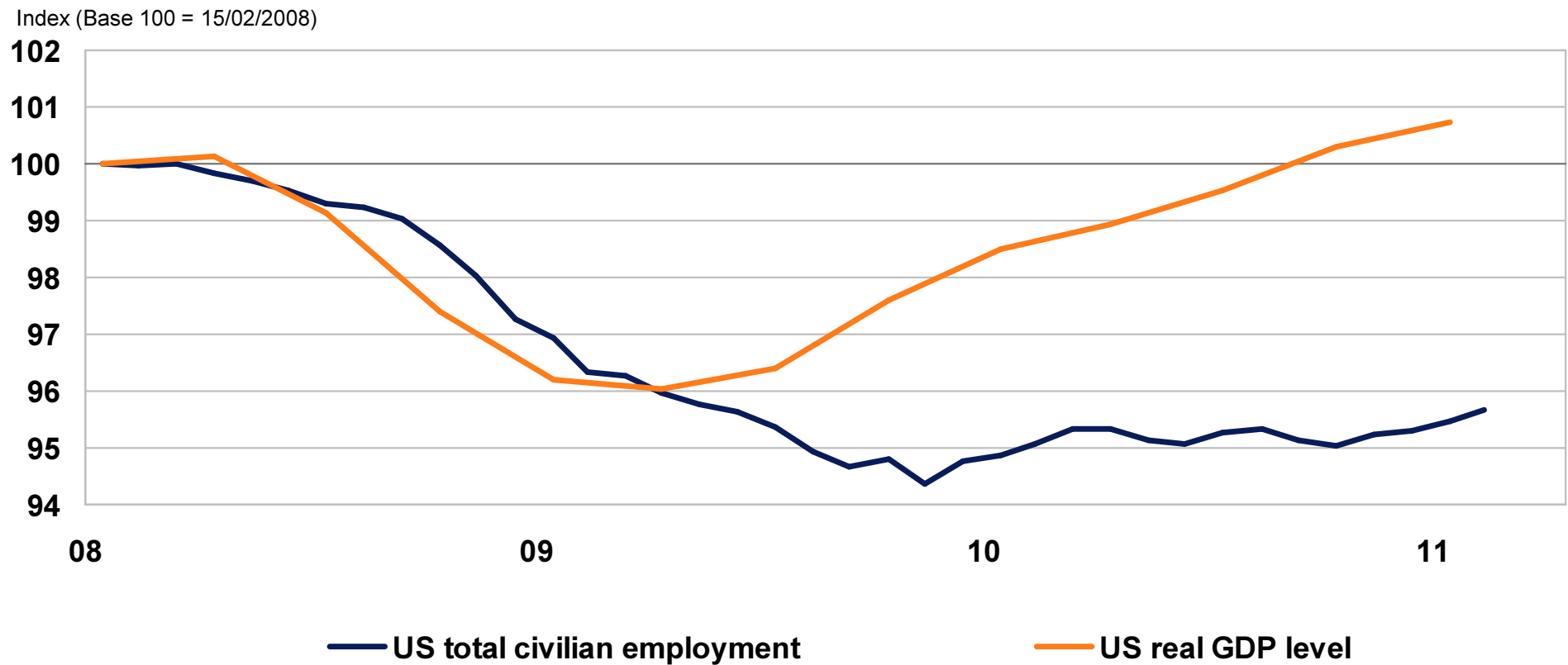


Source: Schroders, Thomson Datastream, 19 May 2011



Waiting for a recovery in jobs

US GDP and jobs



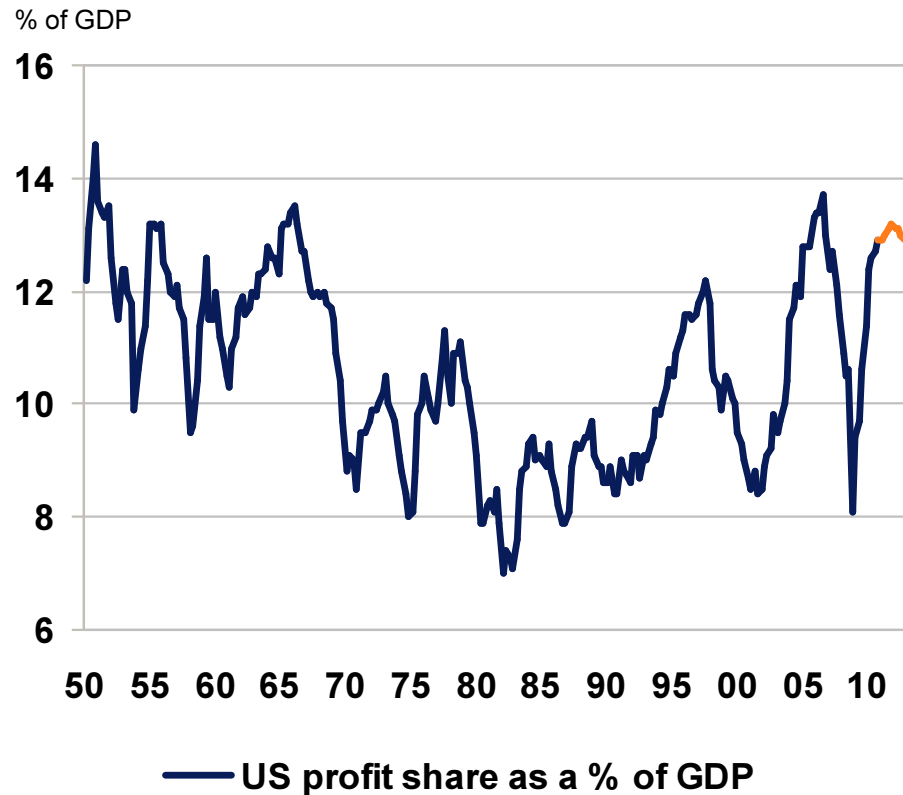
Source: Thomson Datastream, 19 May 2011.

Asset allocation



Equities: corporate profits are buoyant

Profit margins have risen sharply in the US



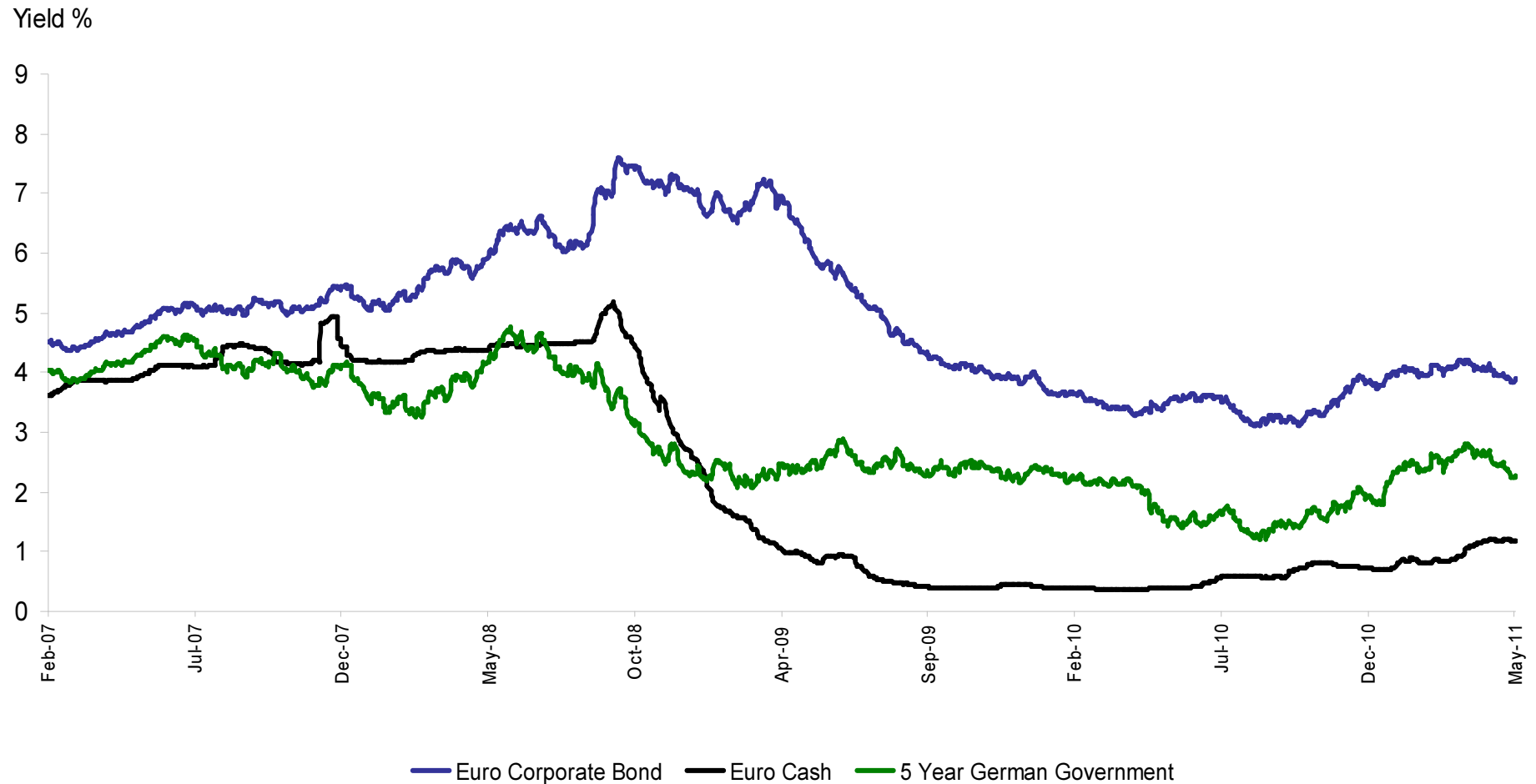
Source: Schroders, Thomson Datastream, Data to Q4 2010, 19 May 2011

Table: Profit and EPS forecasts

	2009	2010	2011	2012
Economic profits				
y/y%	-9.7	49.7	9.6	6.3
Nonfinancial share % GDP				
	5.8	8.2	8.7	8.8
S&P 500 EPS				
Operating \$	\$57	\$84	\$92	\$98
y/y%	15	47	10	6
Reported \$	\$51	\$77	\$86	\$93
y/y%	243	51	11	8
S&P 500 PE market at:	1115.1	1257.64	1330	1330
Based on operating EPS	19.6	15	14.4	13.5
Based on reported EPS	21.9	16.3	15.5	14.3

Source: S&P, Schroders, 1 March 2011

Bonds: where is the bubble... ...and where is the opportunity today?



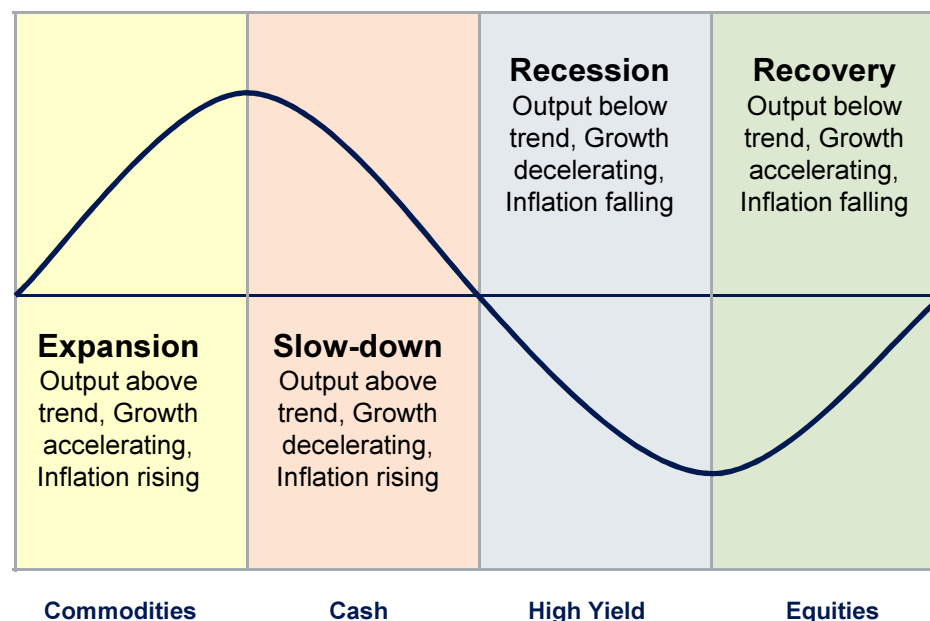
Source: Bank of America Merrill Lynch Indices using yield to worst (conventional) : ER00. Bloomberg 5 year government bond (GDBR5) BBA 1 month LIBOR (EU0001M Index). Month end dates. 31 May 2011



Risk assets perform well in the recovery phase

“History does not repeat itself...but it does rhyme”

Phase/ Asset		Recovery	Expansion	Slowdown	Recession
Equity	Excess return*	8.6	8.4	-8.4	7.4
Government Bonds	Excess return	1.0	-1.0	0.0	2.1
High Yield	Excess return	6.7	2.0	-11.9	11.7
Investment Grade	Excess return	5.2	2.9	-1.9	7.3
Commodity	Excess return	2.9	15.3	7.9	-4.4



Source: Thomson DataStream, Schroders.

Data: Equity S&P 500 TR & US 10yr Govt. bonds from 1950 to 2010, BarCap US High Yield from 1983 -2010, BarCap US Corporate Investment Grade from 1973 -2010, S&P GSCI Commodity.

Data for capacity utilisation and the unemployment rate in the US are used to estimate the output gap.

All risk return figures are in % and annualised for each phase of the cycle. Risk return numbers are relative to cash.



Asset allocation: themes and views

- Sweet spot for risk assets
 - Overweight equity/ underweight govt bonds
- Search for yield
 - Underweight cash/ Overweight high yield
- East/ west divergence
 - Underweight emerging market bonds/ neutral EM equity/ overweight EM currencies
- Sovereign debt restructuring in Eurozone
 - Underweight Eurozone equity/ overweight US



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