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Economic and Strategy Viewpoint

Dovish Fed risks liquidity bubble

Keith Wade
Chief Economist and Strategist

Azad Zangana
European Economist

Craig Botham
Emerging Markets Economist

- **The latest statement from the Fed and comments from chair Janet Yellen indicate the US central bank is in no hurry to increase interest rates, despite a pick up in inflation and signs of excess in financial markets. Our baseline view sees a tighter labour market and greater inflationary pressure and our Taylor rule model indicates that interest rates should already be rising.**
- **However we recognise that some of the old rules do not apply given the headwinds on activity: debt remains relatively high, bank lending spreads are greater and markets are more sensitive to higher rates. The danger for the Fed is that by delaying tightening we will either see higher inflation, or excess liquidity will continue to flow into asset markets, creating the risk of a bubble and so making the exit from loose policy more difficult.**

Scottish independence: economic and political challenges (page 6)

- **Scotland will hold a historic referendum that could see it end a 300-year long political and economic union with the rest of the UK. We analyse the political and economic implications for both an independent Scotland and the remaining UK.**
- **The results of our analysis are a concern: Scotland is likely to struggle to reign in a huge fiscal deficit, which is likely to be made worse by dwindling revenues from North Sea oil and gas production. A new central bank and currency are likely, but Scotland may struggle to gain the confidence of markets. Bottom line: an independent Scotland is highly likely to face severe economic challenges and pressures from financial markets.**

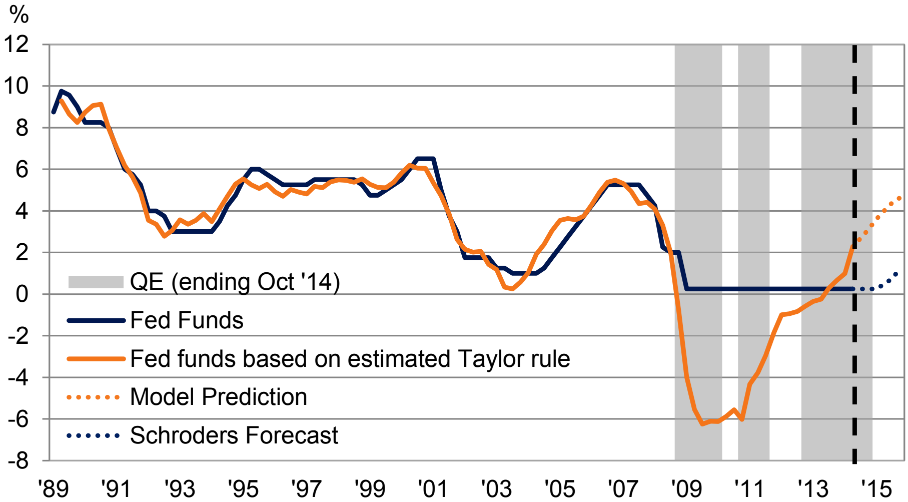
Indonesian elections: no swift turnaround on offer (page 14)

- **Another month, another Asian election, this time in Indonesia. While there is a market favoured candidate, we see less cause for optimism given the tightness in current polls and limited policy differences.**

Views at a glance (page 18)

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

Chart: Taylor rule model says the Fed should be tightening



Source: Thomson Datastream, Schroders, 26 June 2014

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Central banks go their separate ways

Central banks have been busy this month with the European Central Bank (ECB) easing, the Federal Reserve (Fed) continuing to taper and the Governor of the Bank of England warning markets that rates may rise faster than they expect. Meanwhile the Bank of Japan appears content with its strategy and has begun to quietly discuss an exit strategy from quantitative easing (QE). The divergence of monetary policy, one of our key themes, has certainly increased and we are bringing forward the first rate rise in the UK to February next year with rates ending 2015 at 1.5%.

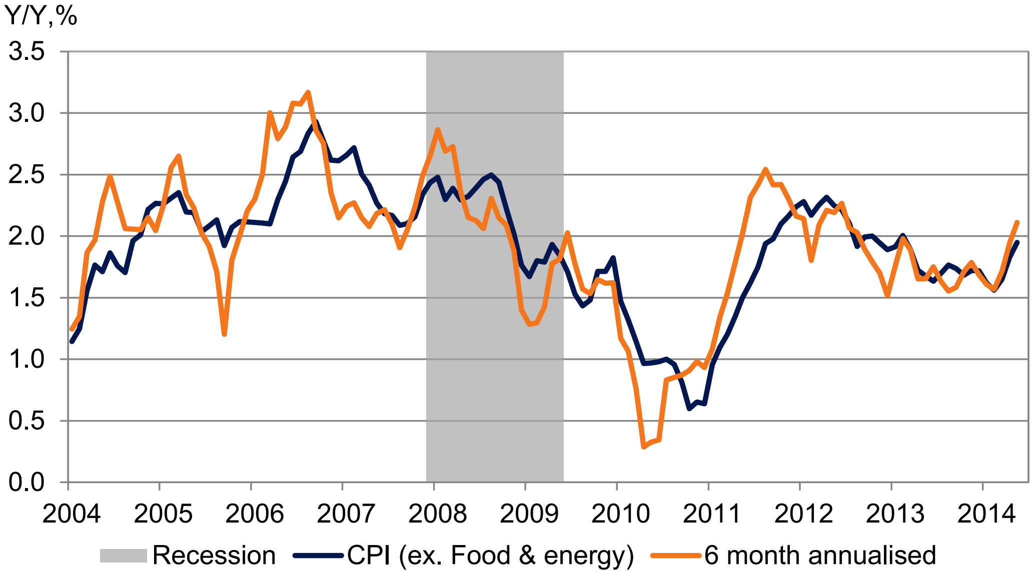
We are also revising up our profile for US policy rates and in this note we focus on the case for a more rapid normalisation of monetary policy. Whilst recognising the risks, we note that delay may make the eventual exit more difficult as investors see the Fed's dovish stance as a green light to add risk.

Striking a balance

We were surprised by the latest statement from the Federal Reserve's interest rate setting committee (the FOMC) and post meeting press conference as they seemed to ignore evidence of increasing inflationary pressure and excess risk taking in financial markets. Not that we expected a rate rise or an accelerated pace of tapering, but we had thought that a change in tone might be appropriate given the recovery in growth, pick up in CPI inflation and relentless narrowing of credit spreads. The Fed sees the economy rebounding in Q2 (a view unlikely to be affected by the latest downward revisions to Q1 GDP), but Fed chair Janet Yellen dismissed CPI concerns as "noise" and reminded investors that asset market valuations were within historical norms.

Dovish Fed ignores pick up in inflation, sees only modest fall in unemployment

Chart 1: US core CPI inflation picks up sharply



Source: Thomson Datastream, Schroders, June 26 2014

One reason the rate setters remain relaxed is that they do not see unemployment falling much further over the rest of the year with the jobless rate expected to fall to between 6 to 6.1% by Q4 2014 compared with 6.3% in May. Such an outcome would be consistent with steady wage growth and consequently the Fed forecast inflation[1] to remain in a 1.5 to 1.7% band this year and just below 2% thereafter.

Our view is that unemployment will fall faster and further as a result of healthy output growth and a continued decline in the participation rate. This in turn will put pressure on wages and eventually inflation. We forecast the jobless rate to fall from

[1] Using their preferred PCE measure, which runs slightly below CPI, but is closely correlated.

its current level of 6.3%, to 5.9% by the end of this year and 5.2% by end 2015.

The difference cannot be accounted for by growth forecasts with the Fed looking for similar GDP growth to us this year and a stronger figure in Q4 2015 (3 to 3.2% y/y vs. 2.4%). Clearly they are expecting a greater pick up in productivity which will contain unit wage costs and keep inflationary pressure muted.

Our forecast generates greater price pressure and a clear case for higher rates, however it would still be challenged if wages failed to pick up. One of the features of the US and other economies in recent years has been a relatively flat Phillips curve where lower unemployment does not feed through into higher wage growth or inflation. One explanation has been the increase in globalisation which has increased labour market competition and kept a lid on wage growth. Another would be the decline in trade unionism which has weakened worker bargaining power.

This stance though has been at the heart of policy error in the past when, in the absence of a clear inflationary signal, the Fed kept policy too loose for too long with the effect of creating imbalances in financial markets. The tech bubble of the 1990's and the housing bubble/ banking crisis of the 2000's were the result.

Fed's mandate is focussed on employment and inflation, not asset markets

The chances of the same thing happening again are not insignificant. Despite comments from St Louis Fed President James Bullard and others, the Fed does not seem unduly worried about imbalances in financial markets at present. Of course, the Fed's mandate is to control inflation whilst achieving the maximum level of employment, not set asset prices. However, it has historically been the build up of financial market imbalances which have been the early warning signal that policy is too loose with adverse consequences for the economy later on.

Where is "normal" for interest rates?

At present it is probably too early to worry about bubbles: banks are in better shape and equity markets are nothing like as stretched as in previous cycles. However, policy rates are still at the very low levels set during the darkest days of the financial crisis. Now that the worst of the crisis is over, they need to normalise.

Taylor rule model says rates should already be rising

We have updated our Taylor rule equation to determine where rates would be based on inflation and the amount of spare capacity in the economy. This relationship provided a good guide to rates prior to the crisis as can be seen from chart 2. The relationship broke down between 2009 and 2013 with the model indicating that Fed funds should be significantly negative. Nonetheless with nominal rates constrained by the zero bound, the model supported the case for unconventional policy in the form of QE (see chart front page).

Assuming that inflation, unemployment and capacity utilisation move in line with our baseline view then the model indicates that rates should have turned positive in Q3 last year and should now be moving to 3% by Q4 this year and 4 - 4.5% by the end of 2015. This is some way ahead of market expectations which currently anticipate rates at 0.25% by the end of 2014 and 0.75% by the end of 2015.

The Fed have made it clear that the headwinds on the economy may warrant keeping the target federal funds rate below levels seen as normal in the longer run, even when employment and inflation are near mandate-consistent levels. We would agree that the legacy of the crisis will mean that the old rules do not apply in the same way as before and would not look for rates to slavishly follow the Taylor model. Nonetheless, the message is clear that normalisation should be underway.

Fools rush in?

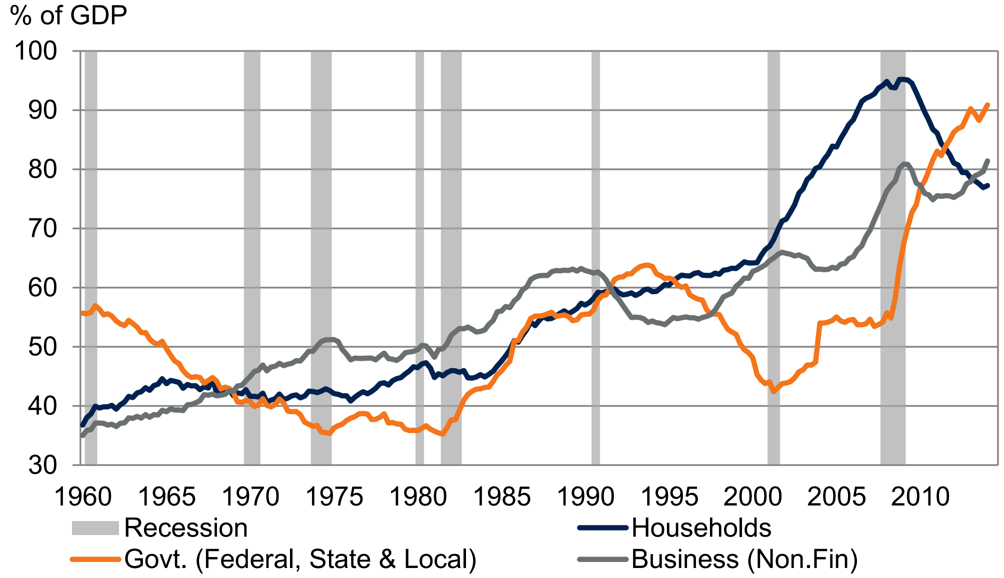
One reason for increased caution on tightening policy would be the concern that the US economy has become more sensitive to increased interest rates. These concerns stem from the experience of 2013 and the "taper tantrum" when the Fed signalled that it was considering an exit strategy from QE. We discussed the weakness of housing in the last Viewpoint which seemed to go beyond that which would be expected by the rise in mortgage rates. Recent figures show home sales recovering, although mortgage borrowing remains very subdued.

Looking at the bigger picture, the debt to GDP ratio in the household sector has fallen significantly since peaking in 2007 on the eve of the financial crisis. Mortgage borrowing is the principal driver of this ratio, whose fall initially reflected write-offs as homes were repossessed by banks, whereas more recently it has been driven by the weakness of new borrowing. The latest data show the ratio is now back to levels last seen in 2003 at just under 80% of GDP (chart 2).

The household sector has cut debt whilst corporates have re-leveraged

From this perspective the sensitivity of households to higher interest rates is reduced, but still significant. However, many will be protected by fixed mortgage rates so the increased cost of borrowing will take time to feed through. This is in marked contrast to the UK where two-thirds of household debt is on a variable rate and overall debt is higher at 140% of personal disposable income (vs. 100% in the US).

Chart 2: US debt by sector



Source: Thomson Datastream, Schroders. June 26 2014

By contrast, corporate sector gearing has been on a rising trend and now exceeds that of households as companies have issued debt, often to retire equity. This does suggest greater vulnerability to rising rates although the new debt is mostly fixed to take advantage of low rates and the investor appetite for credit as evidenced by the surge in issuance of "covenant-lite" bonds.

This analysis suggests that the Fed should tighten gradually as although household debt has declined, it remains high and corporate sector debt has risen further. The chart also shows the increase in public sector debt which, on the Ricardian basis that this is ultimately the responsibility of tax payers, can be seen as a further headwind on future demand. There are two further reasons for Fed caution.

- First, the spread between risk free policy rates and average bank rates charged is wider than before the crisis reflecting a better appreciation of risk by the banking sector. This should be welcomed as the root cause of the crisis was a mispricing of risk, but it will mean that credit will be permanently more expensive and/ or restricted to higher quality borrowers. Consequently any given level of policy rates will be consistent with higher borrowing costs.

- Second, as the events of last year made clear, financial market reaction can magnify the impact of higher interest rates. If the moves toward tighter policy are accompanied by a sell off in bond and equity markets the deflationary impact will be greater as borrowing costs rise along the curve and wealth effects go into reverse.

Policy moves will be more powerful than before…

There is evidence that markets have become more sensitive to policy with term premiums in the US being significantly depressed both by QE and the reduction in market volatility and interest rate uncertainty. Estimates from the IMF put this at around 100 basis points for the 10-year Treasury[2]. Such extremes will have to be unwound gradually unless the Fed wishes to deliver a significant shock to markets and the economy. The impact of higher yields on investors would be increased compared to past cycles as the search for yield means that bond holdings have risen and duration has extended since the crisis. Such moves could be exacerbated by the reduction in liquidity in fixed income credit markets.

…but delaying tightening may make the exit more difficult

The Fed are aware of these issues and are at pains to describe any future tightening as gradual and predictable so as to allow a smooth unwinding of bond market positions. However, the irony of the situation is that in treading carefully they are suppressing volatility and encouraging investors to take on more risk through extending duration, moving out along the credit curve and into carry trades. Consequently the unwind when it comes will be all the more difficult. In this respect by giving a green light to risk, Fed chair Yellen may be making life more difficult for herself and the FOMC further down the road.

So where does this leave our rate view? Balancing the pressures for higher rates against the dovish tendencies of the central bank means we do not expect any change in rates this year and expect QE to have ended by October, thereafter we look for the first Fed funds rate rise in June 2015. This would coincide with a scheduled press conference and allow the Fed chair to explain the shift in policy. We then look for rates to rise to 1.5% by the end of 2015 with rates rising 25 bps in each of the subsequent FOMC meetings. Our forecast is higher than before and is above the median of the Fed's projections made in June. Both forecasts are above the current view priced into interest rate markets.

The danger, as indicated by our model is that policy is too loose and inflation picks up more rapidly than in our baseline. Alternatively, the excess liquidity flows into financial markets, creating bubbles and a re-run of the past. In this respect Yellen would be following in the footsteps of her predecessors, Greenspan and Bernanke.

[2] See Global Financial Stability Report October 2013 (IMF)

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Scottish independence: economic and political challenges

Scotland will vote on whether to end its 300-year political union with the UK this Autumn

The 300 year marriage between Scotland and the rest of the United Kingdom could be heading for a messy divorce. On the 18th of September 2014, Scots will vote on whether to remain in the UK, or to leave and form a new state. If Scots vote in favour of independence, then 18 months of negotiations will follow, before Scotland declares independence in March 2016. The referendum could have huge implications for Scotland as well as the rest of the union, some of which may be more negative for both respective economies than are currently being appreciated. This note considers the political and economic implications of Scottish independence, along with the potential impact for investors.

Politics of independence

On the 15th of October 2012, the historic Edinburgh agreement was signed which would pave the way for Scotland to hold a referendum on its independence. Scotland has had a difficult relationship with its larger neighbour for hundreds of years. From the ‘wars of independence’ 700 years ago led by William Wallace and then Robert the Bruce, to the unification of the crowns in 1603, and the formal union in 1707, the path to the current union was not an easy one. Scotland retains its own legal system, churches and universities, but gave up political and economic sovereignty to Westminster. Talk of greater power being returned to Scots has also been muted for some time. Proposals to give Scotland ‘home rule’ were discussed in the era of William Gladstone in the 1880s. Attempts to do just that in 1913 and 1979 failed, but the Scottish parliament was re-established in 1999 after the devolution of power under Tony Blair’s government.

Alex Salmond, Scotland’s first minister since 2007 and leader of the Scottish National Party (SNP), has been hugely successful in bringing the issue of independence to the forefront. Several options have been discussed in the past termed ‘devo-max’ and ‘devo-plus’ – varying degrees of devolution. However, UK Prime Minister David Cameron pushed for a vote on independence or the status quo, with no third way in an attempt to draw a line under the questions being asked. While it appears inevitable that more powers will eventually be devolved to Scotland in the event of a no vote, a vote for independence would have far more serious consequences with regards to fiscal and monetary policy.

Based on recent voting intentions polls, the ‘better together’ or ‘no’ camp has a 10 percentage point lead over the independence camp. That lead is down from about 18 points at the start of this year, but has recently stabilised and even ticked up slightly. A 10 point lead might seem to be unassailable at first, however, undecided voters are worth about 18 percentage points, which could easily swing the decision towards independence (chart 3 next page).

The reliability of voting intentions polls generally are good, but are clearly untested on this issue in Scotland. For example, some of the pollsters have consistently shown a smaller gap between the 'yes' and 'no' camp than some of the others, which is unusual. Moreover, 16-17 year-olds are being allowed to vote in the referendum, introducing more uncertainty about follow through of those votes.

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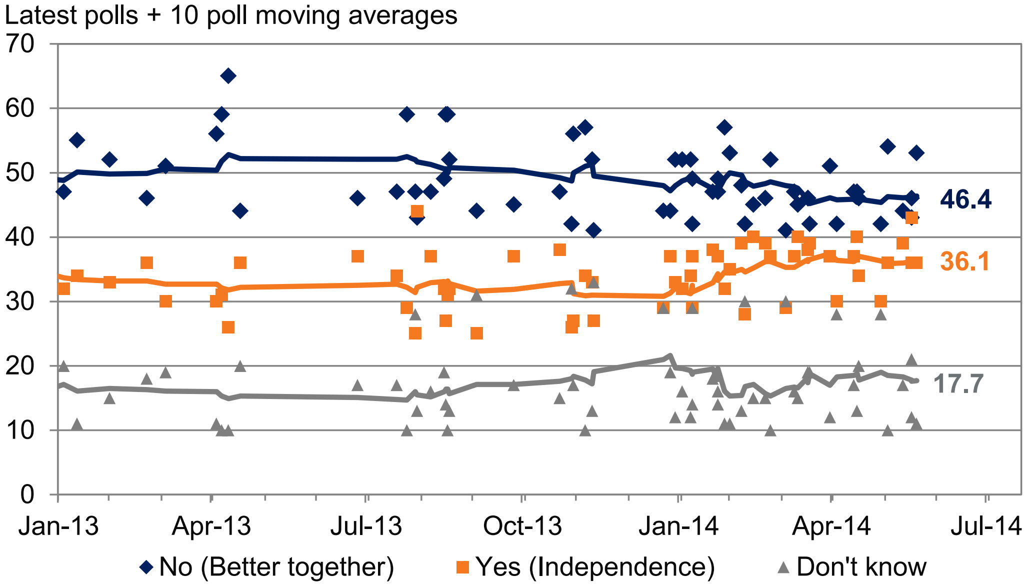
Based on voting polls, Scotland is set to reject the notion, however, the independence camp is closing the gap

Chart 3: Closing the gap - voters moving towards 'yes' vote



Source: www.ukpollingreport.co.uk; Schroders. 25 June 2014.

Scotland can hardly complain about being under represented in UK politics. 9.4% of Westminster constituency seats are located in Scotland, compared to Scotland having 8.4% of the UK's population, and 8.3% of GDP. The UK has also had seven Scottish born prime ministers, with the latest two being Tony Blair and Gordon Brown.

Since devolution, Scotland has reserved and gained many powers in key policy areas including housing, health, education, sport, agriculture, courts & police, tourism, environment and some transport. However, it continues to abrogate responsibility for the economy and currency, borders, defence, foreign affairs, welfare, broadcasting, energy regulation and the constitution. Recent comments by the government suggest that in future, more powers are likely to be devolved to Scotland, including the possibility of setting different income tax rates. Devolution of power seems inevitable, but the promise of more power may not be enough to stop a vote for independence.

For the rest of the UK, Scotland's departure from the union will have a significant impact on the political spectrum. In the event of separation, the opposition Labour party would lose about 16% of the seats it currently holds in parliament. The Liberal Democrats (junior coalition partners) would lose just over 20%, while the Conservative party (main coalition partners) would lose less than 1% - suggesting a swing towards the right for the rest of the UK.

Macroeconomic assessment

Scotland's economy is dynamic and well integrated with the rest of the UK

The Scottish economy has enjoyed reasonable success along with its neighbours in recent years. The close proximity, strong trade links, and cogent fiscal and monetary policy have enabled a near frictionless co-existence with the UK economy. Excluding North-Sea oil and gas, real gross value added (approximation for GDP) for both Scotland and the UK as a whole have tracked one another well. Scotland has lagged behind the UK aggregate since 1999, but did have a shallower recession in 2008/09, but also a less pronounced bounce back in the following three years (see chart 4). When North-Sea oil and gas (NSOG) is included in the growth figures for Scotland, the growth profile becomes more volatile, and less positive than in the past. This is because the contribution from NSOG is not only highly dependent on swings in oil prices, but also extraction rates, with the latter now clearly in long-term decline.

In terms of the labour market, Scotland also has a similar unemployment rate at present, but Scotland had actually lagged behind the UK average for many years prior to 2006. Scotland also endured a steeper rise in its unemployment rate than the UK average during the financial crisis, although the rise and subsequent fall came later (see chart 5).

Growth in Scotland has been similar to the UK aggregate growth, while the unemployment rate has caught up

Chart 4: Comparing GDP growth

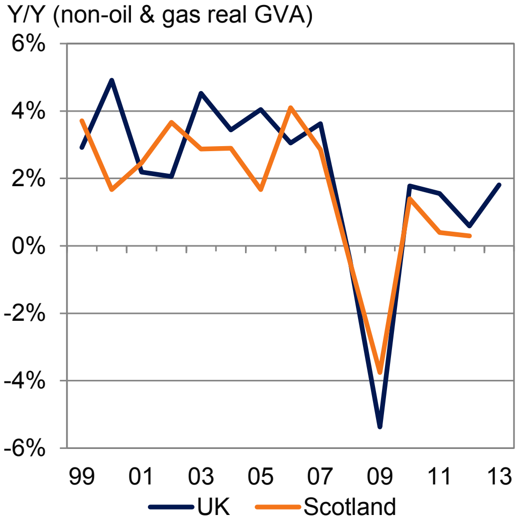
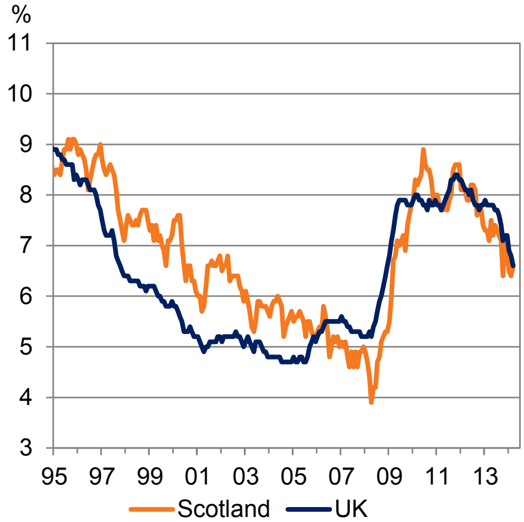


Chart 5: Comparing unemployment



Source: Thomson Datastream, ONS, Scottish Government, Schroders. 25 June 2014.

The Scottish economy is dynamic and well integrated with the rest of the UK. In 2012, 69.5% of total Scottish exports in goods and services (excluding NSOG) were to the rest of the UK, while imports from the rest of UK made up 74.1% of total Scottish imports (see chart 6). The Scottish trade deficit with the rest of the UK and the rest of the world was £12.2 billion in 2012, or 9.7% of GDP. This is a worryingly high figure on its own, but it does exclude the exports of NSOG.

Scotland is heavily reliant on trade with the rest of the UK, and without oil and gas revenues, would have a huge current account deficit

Chart 6: Scottish external trade

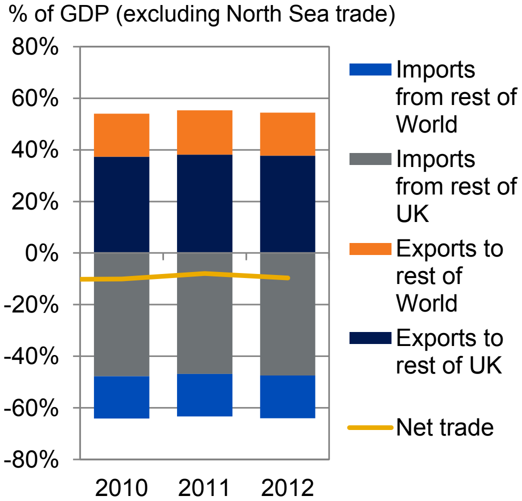
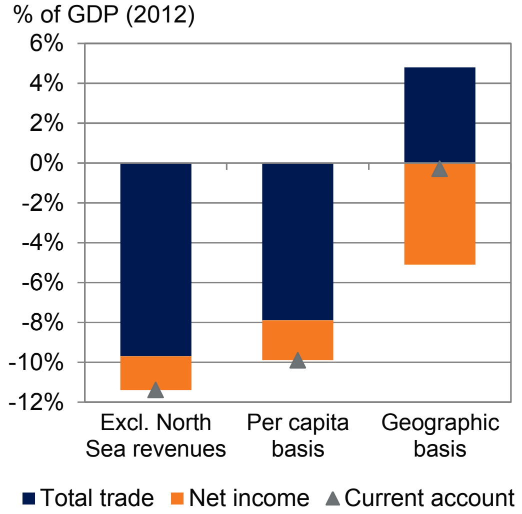


Chart 7: Scottish current account



Source: Scottish Government, Schroders. 25 June 2014.

There is uncertainty about how North Sea oil and gas revenues would be shared in the future…

The decision on how NSOG would be allocated in the event of independence will be a crucial negotiating point. If Scotland only receives its per capita share of NSOG (8.3% based on population estimates for 2012), then it would face severe problems on a number of fronts. The more likely allocation would be based on a geographic basis, which would give Scotland approximately 90% of future NSOG revenues.

Including NSOG on a geographic allocation basis, Scotland would have a positive trade balance with the rest of the world of about 4.8% of GDP. However, based on early work done by the Scottish Government to estimate net investment income

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(income earned overseas minus payments made on overseas owned investment in Scotland), most of the trade surplus achieved with the inclusion of NSOG would be eroded by payments to overseas owners of Scottish assets, which would leave Scotland with a small current account deficit. The Scottish Government estimates 60% of those net income payments are related to NSOG.

…a geographic split would give Scotland about 90% of future revenues

It is worth mentioning that the UK's current account balance would suffer in the event of a geographic split being applied to NSOG. The UK's current account deficit in 2012 would have been 5.1% of GDP instead of 3.8%. Latest estimates of the UK's current account deficit stand at around 4.5% of GDP and so applying the same gap from 2012, the UK's current account deficit could rise to 5.8% of GDP - potentially hurting confidence in sterling (GBP).

Monetary policy

The Scottish National Party's plans to retain GBP look to be in doubt

The future of Scotland's monetary policy is another area of great uncertainty. The Scottish National Party has stated that it wants to keep the pound in the event of independence and retain the Bank of England's services as its central bank. However HM Treasury and the Bank of England have advised against this type of currency union and so the three biggest political parties in the UK oppose the notion (making the SNP's plans very unlikely). The main concern comes from an independent Scotland's ability to manage its own public finances, which as we have seen in the Eurozone, creates a risk of mismanagement with no possibility of fiscal transfers to correct the matter. Scotland may run into fiscal problems which would require a depreciation in its currency to help the recovery - not an option if the pound was retained. Similarly, the setting of policy interest rates may not be appropriate for Scotland given the difference in fiscal policy. The Bank of England has enough problems setting interest rates for different regions as it stands and is often accused of tightening policy to cool London and the South East to the detriment of other regions.

One option would be to peg to GBP, but it would leave the new currency open to speculative attacks

In the event that Scotland is forced to introduce a new currency, it could attempt to peg to GBP. This could work for some time but, if markets were to pressure the new currency to depreciate, then the Scottish central bank would be forced to use its currency reserves to maintain its peg to GBP. As the UK learnt from its exit of the European Exchange Rate Mechanism (ERM) in 1992, such a defence can only last as long as your reserves. Pressure from markets to push the new currency upwards can easily be managed by increasing the supply of the currency, but managing downside pressure is very costly, and could easily break the peg. Also, with a peg, Scotland would be indirectly importing Bank of England monetary policy without the central bank paying any attention to the Scottish economy, potentially leading to a severe mismatch in monetary policy and the needs of the economy.

Another option would be to adopt the Euro, but this also looks unrealistic

A further option no longer being advocated by the SNP, but had been preferred in the past, would be to join the Euro. The SNP's position changed after the European sovereign debt crisis, although it still wants to *"…maintain its membership of the European Union"*. The first point to make is that as a new state, Scotland would have to apply for EU membership and cannot continue its current arrangement. While Scotland's legal system is already compatible with European law, there are many criteria that would need to be satisfied that the SNP have not accounted for. For example, candidate member states must satisfy criteria on the running of certain institutions, including an independent central bank. Moreover, there are now strict tests for the candidate country's economy, including satisfying the Maastricht Criteria, and successfully managing a currency in the ERM II (a tight corridor against the Euro) for at least two years. The country should run low inflation (which we have no Scottish data on), run a reasonable current account balance (can only be achieved with a geographic split on NSOG) and run a budget deficit of less than 3% of GDP (almost impossible for Scotland in the near-term, see below). In addition, new member states have an obligation to join the Euro, which the SNP believes it can avoid.

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Finally, the biggest obstacle to EU and Euro membership is the system of unanimous agreement amongst existing member states. Turkey's accession to the EU has repeatedly been blocked by France, Greece and Cyprus due to the diplomatic issues over the Turkish northern side of Cyprus. Regardless of the merits of Turkey's application on certain issues, the trio has repeatedly blocked Turkey's progress and arguably sowed the seeds for the political problems escalating there today. For Scotland, the main obstacle is Spain which in no circumstance wants to show that a break-up of an EU member state could be followed by EU membership, due to calls for independence in the Catalan region of Spain. As long as Catalonians (and separately the Basque region) continue to call for independence, Scotland can expect Spain to block every attempt at membership without compromise.

This leaves Scotland with the only possible option of managing a free floating currency. This may be the most risky option from a stability point of view, but it also provides the greatest degree of flexibility in case Scotland finds itself in difficulty. This puts the onus on the new Scottish central bank to manage its affairs more carefully. The new central bank could attempt to manage volatility in currency markets, and should look through inflation caused by such volatility. The most important role of the central bank will be to build the confidence of overseas investors in the currency, but also the central bank as an institution.

Public finances

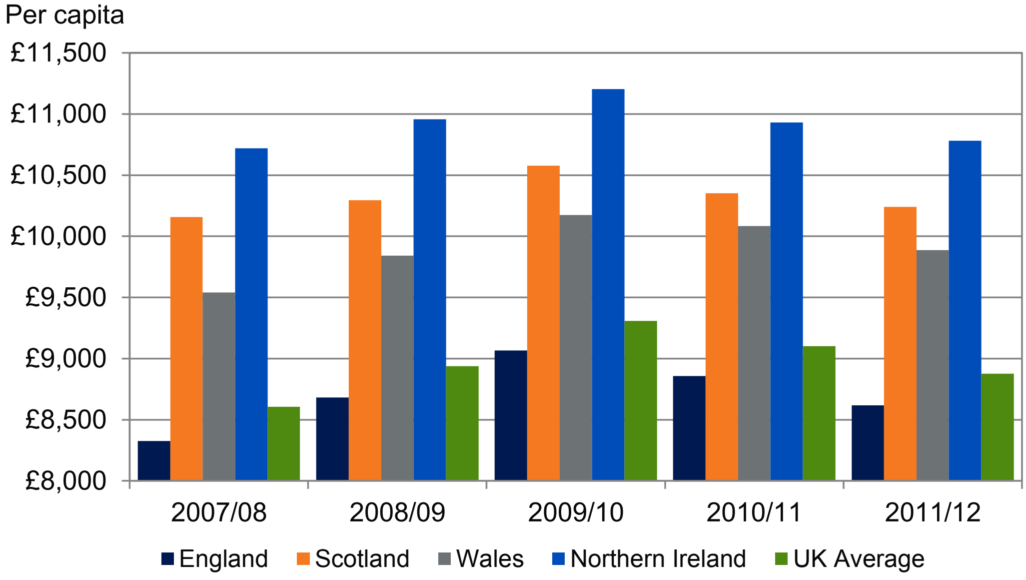
Even if the new Scottish central bank manages to persuade investors that it is a competent manager of monetary policy, if Scotland's new ministry of finance fails to run prudent public finances, then the central bank may be powerless to stop a debt and currency crisis.

The starting point in our assessment is to examine the latest available official data, largely provided by the Scottish government and the Office for National Statistics, before examining the analysis conducted by both camps, along with the independent Office for Budgetary Responsibility (OBR) and the Institute for Fiscal Studies (IFS).

Scotland has enjoyed an enviable share of UK public spending…

Scotland has enjoyed higher public sector expenditure than the UK average for many years thanks to the Barnett formula. The formula which was devised in the run up to political devolution in 1979 maintains a near constant rate of growth in public sector expenditure in Scotland, Wales and Northern Ireland based on spending in England. The proportions are altered to reflect changes in populations, but are clearly more favourable on a per capita basis for all except for England (see chart 8). In the five years to financial year 2011/12, Scotland has seen public spending average £1,358 more spent per head, per year, or 15.1% above the UK average. The formula is not applied to all spending, but its critics point to the lack of consideration for needs. For example, the formula does not consider the differing cost of services in different regions; it does not consider the amounts raised by taxation in each of the home nations, nor fiscal needs including, unemployment rates, health, crime rates, inequality etc.

Chart 8: Government spending per head in each home country

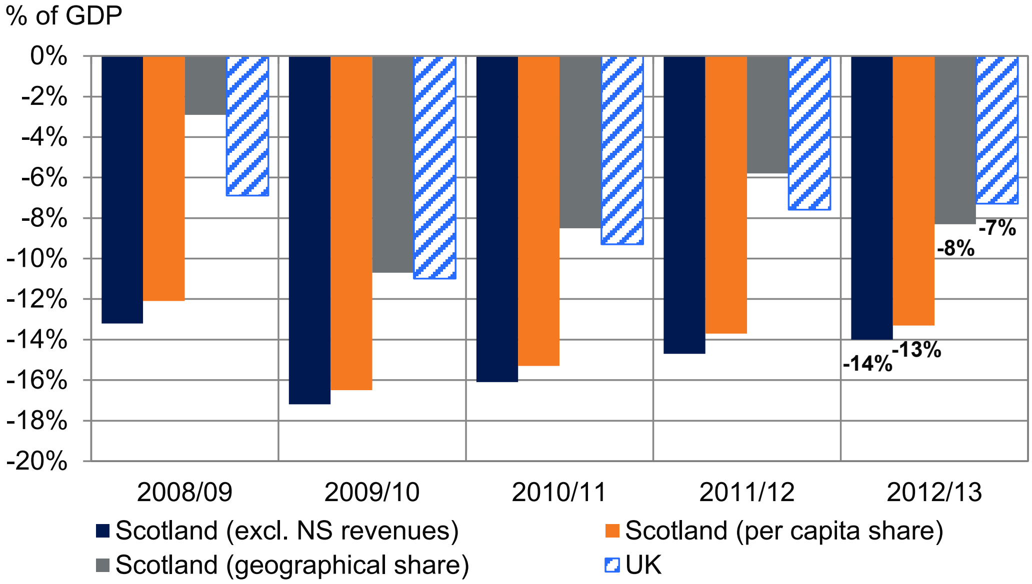


Source: Scottish Government, Schroders. 25 June 2014

…but beyond oil and gas revenues, has run a serious fiscal deficit

While Scotland has enjoyed plentiful public expenditure, it has struggled to generate enough tax revenues to balance the books. Depending on the share of NSOG allocated, Scotland's net fiscal balance was between -14% of GDP to -8.3% of GDP in 2012/13, compared a UK wide deficit of 7% of GDP (chart 9). Scotland has in the past been able to run smaller deficits than the UK when the geographical share of NSOG is applied; however, the contribution from NSOG has been shrinking dramatically as the North Sea Basin becomes less economically viable. According to Oil and GAS UK, NSOG production peaked at around 4.5 million equivalent barrels per day in 1999, and has since declined by 69%. Global oil prices and taxation on production/extraction have played their roles in reducing output; however, the downward trend in output is certain to continue, meaning that an independent Scotland will have to find alternative ways of closing its huge fiscal deficit.

Chart 9: Scottish net fiscal balance with alternative North Sea oil shares



Source: Scottish Government, Schroders. 25 June 2014.

The final area in our assessment is the division of existing public debt. Again, several scenarios could apply depending on whether Scotland takes a per capita split of the UK's debts, or a GDP/GVA share, but also on how North Sea oil and gas revenues are divided. Table 1 provides illustrative calculations on how a division of debt could play out, with the split of NSOG shown across the top, and different scenarios for the debt division along the side of the table. For the rest of the UK, public sector net debt (excluding financial services interventions) is likely to be between 77 and 78% of GDP in our more likely scenarios. Meanwhile, Scotland could take on between 68 and 79% of (Scottish) GDP. Our view is that Scotland is likely to receive a geographical split of NSOG, and a per capita share of the UK's debts, which would lead to Scottish debt of approximately 70% of GDP, and rest of UK debt of approximately 79% of GDP. However, the SNP has warned that past Scottish (NSOG) contributions towards the UK's fiscal balance may be taken into account, especially if Scotland is denied access to the use of sterling. In this case, the rest of UK could easily push for Scotland to pay for the £65 billion spent on bailing out the Royal Bank of Scotland, and Lloyds banks (following the Bank of Scotland take over). This would take Scottish debt to between 111%-127% of GDP - far less sustainable.

The division of government debt is yet another uncertain area…

Table 1: Scenarios for public sector net debt distribution (2013)*

	Per capita oil split			Geographical oil split		
		£bn	% of GDP		£bn	% of GDP
Per capita debt split	Scotland	£105	78.9%	Scotland	£105	69.6%
	Rest of UK	£1,150	77.6%	Rest of UK	£1,150	78.6%
		£bn	% of GDP		£bn	% of GDP
GVA debts split	Scotland	£103	77.8%	Scotland	£103	68.6%
	Rest of UK	£1,152	77.8%	Rest of UK	£1,152	78.7%
		£bn	% of GDP		£bn	% of GDP
GVA debt + banks split	Scotland	£168	126.8%	Scotland	£168	111.8%
	Rest of UK	£1,087	73.4%	Rest of UK	£1,087	74.3%

*UK 2013 growth rate assumed for Scottish GDP. Source: ONS, Scottish Government, Schroders. 25 June 2014.

There are many other factors that should eventually be to take into consideration such as planned policy changes, the cost of setting up new public institutions, and the higher cost of living Scots are likely to face as economies of scale are eroded (especially in the supply of energy and other key utilities). The proposed re-nationalisation of Royal Mail in Scotland will at best prove to be very expensive and at worst illegal. At this stage, there is little point in assessing the impact of potential policy changes as an election will be held in May 2016 which could yield a non-SNP government, and therefore significant changes to policy proposals. However, both the independent Institute for Fiscal Studies (IFS) and the Office for Budgetary Responsibility (OBR) have published analysis that suggests Scotland's public debt as a share of GDP would most probably hit an unsustainable trajectory in the medium to long-term.

The IFS points to poor demographics, high public expenditure and doubts over the sustainability of NSOG revenues, and concludes that without significant fiscal tightening, Scottish debt would exceed 100% of GDP by 2033-34 and 200% of GDP by 2057-58. Meanwhile, the IFS predicts that the UK's debt would not exceed the peak it forecasts in 2016/17.

The ONS's 2010-based population projections show that Scotland will see 27.7% of its population over the age of 65, while the UK average will be lower at 25.4%.

We agree with the IFS's analysis on dwindling NSOG revenues, and have no objections to the conclusion on the sustainability of Scottish debt. In fact, we believe there is a risk that Scotland's debt situation becomes far more unsustainable sooner as markets are unlikely to tolerate a slow grind towards such an outcome. Given the balance of risks around Scotland's possible future public finances, and the lessons learnt from the Eurozone sovereign debt crisis about how markets tend to exacerbate problems, independence is highly likely to bring about major challenges for the management of economic policy.

Conclusions

In our analysis, we have tried to be as objective as possible and the views presented in this document reflect the views of the Economics group, and not necessarily the views of the Schroders Group.

…however, our analysis suggests that Scotland is likely to face severe pressure from markets

We expect an independent Scotland to be forced to have its own currency, which would introduce risks to both the domestic economy and Scottish exporters. An independent Scotland is likely to face severe difficulties in tightening fiscal policy sufficiently in order to win over the confidence of investors. A combination of major public spending cut backs and severe tax increases will be required, which is likely to drive many companies and individuals south of the border. We believe the likelihood of a significant depreciation in the new currency, and a sharp rise in Scottish bond yields is high.

The UK would also face some risks. North Sea oil and gas net exports have helped hide a growing current account deficit, which could put sterling under pressure in the future. We have assumed a fairly benign scenario for the division of public assets and liabilities, however, there is a risk that both sides struggle to agree, which would be enough to raise alarm for overseas investors. Even if Scotland votes against independence, if the margin is sufficiently small, then the issue is likely to persist, as in the case in of Quebec and the rest of Canada. The result of years of uncertainty was the balkanisation of an otherwise prosperous region.

Overall, the risks identified in our analysis are a concern. We currently do not believe financial markets have taken this political risk into account, and therefore we must conclude that if the risk of Scottish independence rises, financial markets may react negatively towards GBP, gilts and UK equities, but in particular to companies with significant exposure to Scotland.

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Indonesian elections: no swift turnaround on offer

Only two men are left standing for July's election

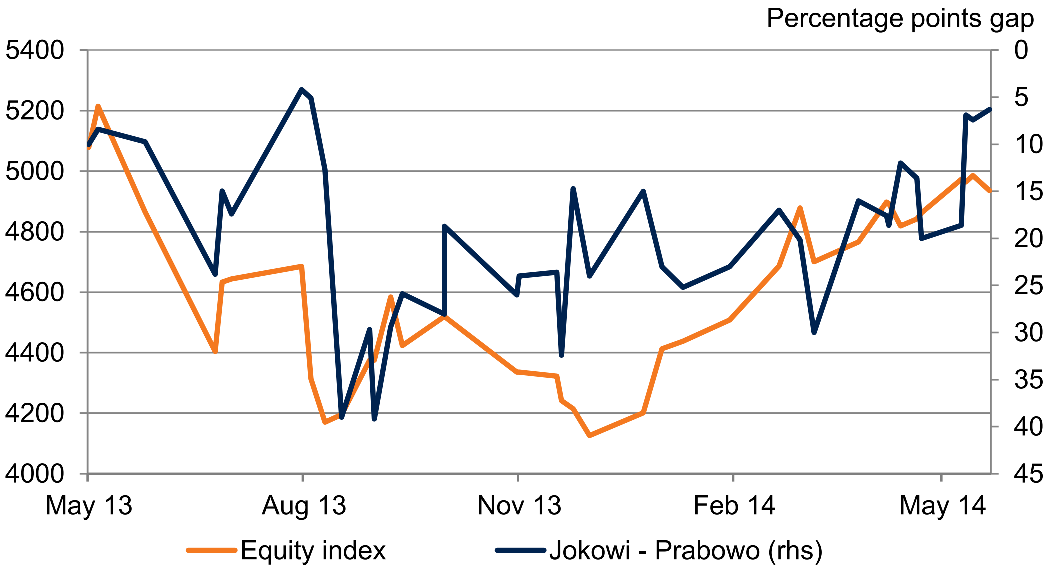
Following legislative elections earlier this year, the presidential election on the 9th July will pit two coalitions against each other. With only two candidates, the uncertainty of a second round is removed, but the outcome is far from certain. In one corner, we have the plucky newcomer Joko "Jokowi" Widodo, governor of Jakarta, and in the other a formidable veteran slugger in the form of Prabowo Prabowo, businessman, politician, and former Lieutenant General.

Of course, Indonesia is not the only large Asian democracy with an election this year, and many investors are hoping Indonesia repeats India's recent experience, with a considerable market rally during and post the election. Any analogy with India's election should place Jokowi in the role of Modi insofar as he is regarded as investors' favourite on the back of his record in infrastructure investment as governor of Jakarta and his generally market friendly stance. By contrast, Prabowo is regarded as a more populist and controversial candidate.

In a common EM theme, the reform candidate is the market favourite

A reflection of these differing perceptions can be found in investor intentions. A survey conducted by Deutsche Bank showed 87% of 70 institutional investors interviewed said the election would affect their investment decisions. 72% said they would buy Indonesian assets in the event of a Jokowi victory, while 56% would sell if Prabowo won. It seems then that for a market rally to occur, Jokowi would need to win. Unfortunately for markets, Jokowi's lead over Prabowo has narrowed to just 6 percentage points, down from a 13 point lead in May, and from much greater highs last year (chart 10). Surprisingly however, the market has if anything rallied, rather than weakened as Jokowi's chances have slimmed. Perhaps investors are choosing to turn a blind eye to the polls and assuming a Jokowi victory. If so, this is risky; disappointment seems increasingly likely.

Chart 10: Jokowi's lead over Prabowo in opinion polls has narrowed



Source: Goldman Sachs, Schroders. 24 June 2014

Indonesia's twin deficit has not gone away…

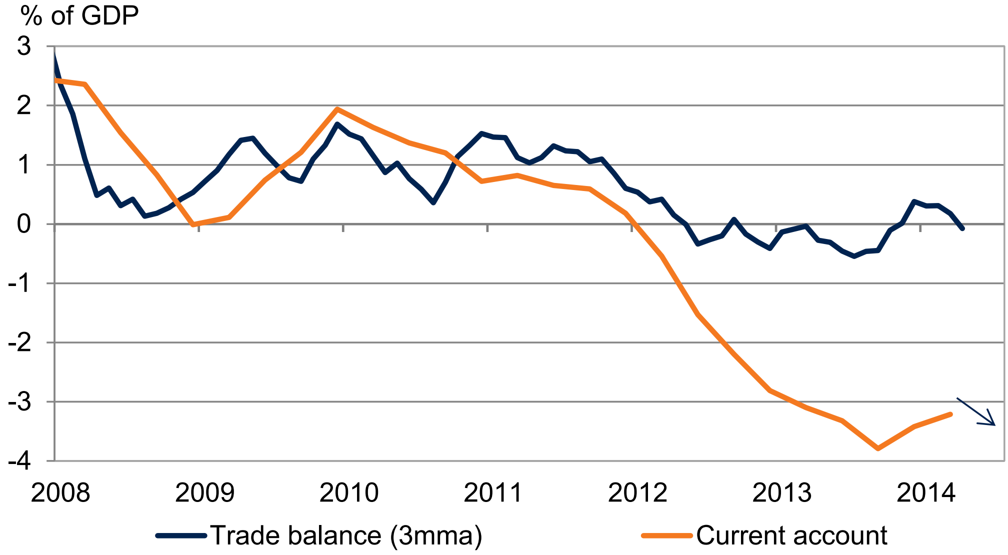
Whoever wins will have to tackle Indonesia's fiscal and current account deficits. The current account reached a nadir of -3.8% in the third quarter of last year (on a 12 month rolling basis) but has improved since to a deficit of 3.2%. Unfortunately, more recent trade data suggests deterioration even from this very modest improvement. (chart 11).

Indonesia's weak external performance probably stems chiefly from structural issues, particularly its reliance on commodity exports (non-food commodities accounted for 62% of exports in 2013). The recent ban on a range of metal ores has not helped; exports of nickel, copper ore, and bauxite are now negligible. It should be noted that both candidates have pledged to keep this ban in place, so there seems little prospect of relief post-elections. However, mineral shipments, excluding coal, accounted for just 3.6% of total exports in 2013.

…and may be getting worse

Meanwhile, coal exports (13% of total exports in 2013) are struggling and will likely continue to do so in the face of lower Chinese demand, excess supply from producing countries, and a government cap on production to support price levels.

Chart 11: Trade account suggests current account deficit will widen



Source: Bloomberg, Thomson Datastream, Schroders. 25 June 2014

As mentioned, however, the main issue is structural, not cyclical. As with many commodity exporters, the country has experienced a Dutch Disease problem; under-development of other industry leading to high import dependence, overreliance on commodity exports and the consequent decline of manufacturing. While the export ban aims to address this by forcing the construction of domestic processing capacity, it will take several years to have any effect. The country also has significant fuel price subsidies which do much to explain its fiscal weakness.

Fuel subsidies need to go

Fuel subsidies are driving both legs of the deficit

After a mid-year budget revision, the targeted budget deficit will be 2.4% of GDP, an increase of 0.7 percentage points. Both fuel and electricity subsidies were increased, and partly funded by cuts to the budgets for both current and capital expenditure. The reduction of infrastructure spending to finance an inefficient consumption boosting subsidy exemplifies poor fiscal management. Given the legal requirement that the fiscal deficit not exceed 3% of GDP, the fuel subsidy is not a sustainable policy measure, and will probably result in further infrastructure cuts if not reduced or scrapped. From what we have seen of the candidates' manifestos so far, only Jokowi has said he would reduce the fuel subsidy through reductions over the next four to five years (with the savings to be spent on infrastructure), by contrast Prabowo would maintain the current subsidies but attempt to prevent the rich benefitting through taxation.

This appears to be one of the few differences in the candidates' manifestos, so it is worth examining its significance. A fuel subsidy not only increases the risk of fiscal slippage, it also, by increasing demand for imported oil, worsens the current account and reduces incentives for greater energy efficiency. Consequently, cutting the subsidy will ease pressure on Indonesia's twin deficits immediately. Furthermore, if the savings are spent on infrastructure investment, as Jokowi plans, the longer term picture for the country's balance sheet also improves.

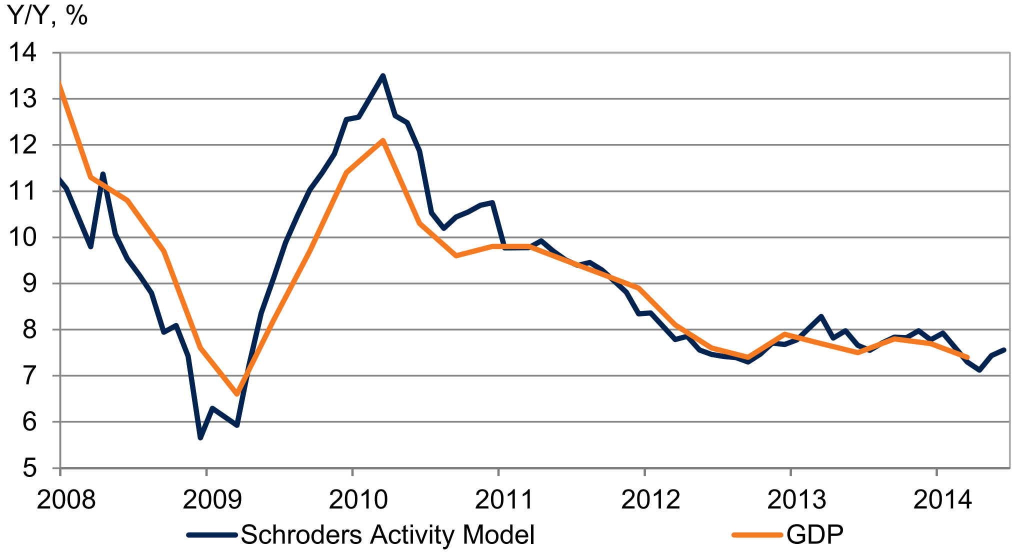
Overall, it is difficult to be overly optimistic about the elections in Indonesia. Not only is there a vanishingly small margin of voter preference between the two candidates, but also a similar narrowing in their policy stances. The position on fuel subsidies notwithstanding, Jokowi has been forced to move closer to Prabowo by his diminishing lead in the polls, hinting at barriers to foreign investment to protect domestic firms. We can hope this nationalism is not genuine, but it is not a promising sign. Arguably there is less of a case for a large market rally in the event of a Jokowi win than there was following Modi's victory - but that doesn't mean it won't happen.

China update: stabilising for now

Data suggests a temporary stabilisation in China

China's set of mini-stimulus packages appear to be feeding through to growth. Data has been stabilising and our in-house model points to a potential small rebound for the second quarter in activity (chart 12). A look at the components reveals that this is driven primarily by exports and new orders. Real estate continues to act as a drag.

Chart 12: Chinese growth has stabilised on mini-stimulus



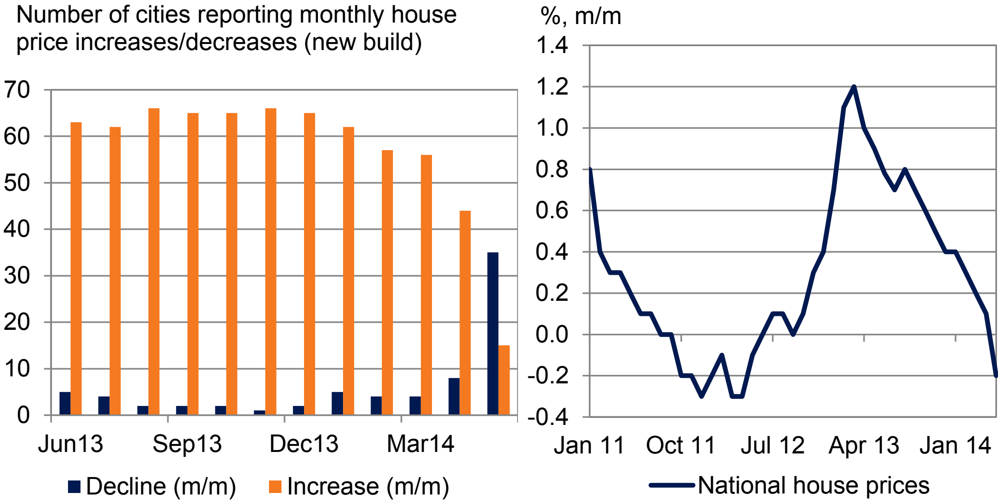
Source: Thomson Datastream, Schroders. 16 June 2014

The stimulus packages have been a mix of fiscal (increased infrastructure spending) and monetary (reserve ratio requirement cuts for rural banks, and "relending"). The impact of monetary easing can be observed in the credit growth numbers. After declining every month since August of last year, total social financing growth was unchanged at 17.8% year on year. The combined effect of the mini-monetary stimulus packages has been more than equivalent to a system wide reserve ratio requirement cut of 50 basis points, adding around $88 billion. This should prove supportive for investment overall but we suspect much of it will find its way to infrastructure rather than property as in the past, though some, perhaps as much as $50 billion, will be allocated to support social housing.

On the subject of housing, as noted, it continues to drag on growth. The sector has been exhibiting serious weakness for four months now. Starts and sales have been contracting since the start of the year, and prices have accelerated their decline, falling month on month on a national basis for the first time since May 2012 (charts 13 & 14).

Property is still struggling, but price declines may be drawing buyers back

Charts 13 & 14: Property sector is still struggling



Source: Thomson Datastream, Schroders. 25 June 2014

Several provincial governments have been allowed to relax house purchase restrictions, but more aggressive support has not been forthcoming. RRR cuts have been targeted at the rural sector, and other loans have been channelled toward construction of new (social) housing rather than supporting the demand side. The government seems happy to allow the market to correct for now. That wider spread price declines have coincided with a slowdown in the rate of decline in starts and sales suggests this may be happening.

We believe this is a temporary stabilisation at best; the effects of the mini-stimulus will fade with time; we forecast growth slowing to 6.8% next year from 7.1% in 2014. The measures taken are also not sustainable on an ongoing basis; credit growth must slow further, and maintaining a reliance on investment for growth directly conflicts with the goal of rebalancing. Still, the success of the measures does pose an upside risk to our current year GDP forecast.

Schroder Economics Group: Views at a glance

Macro summary – June 2014

Key points

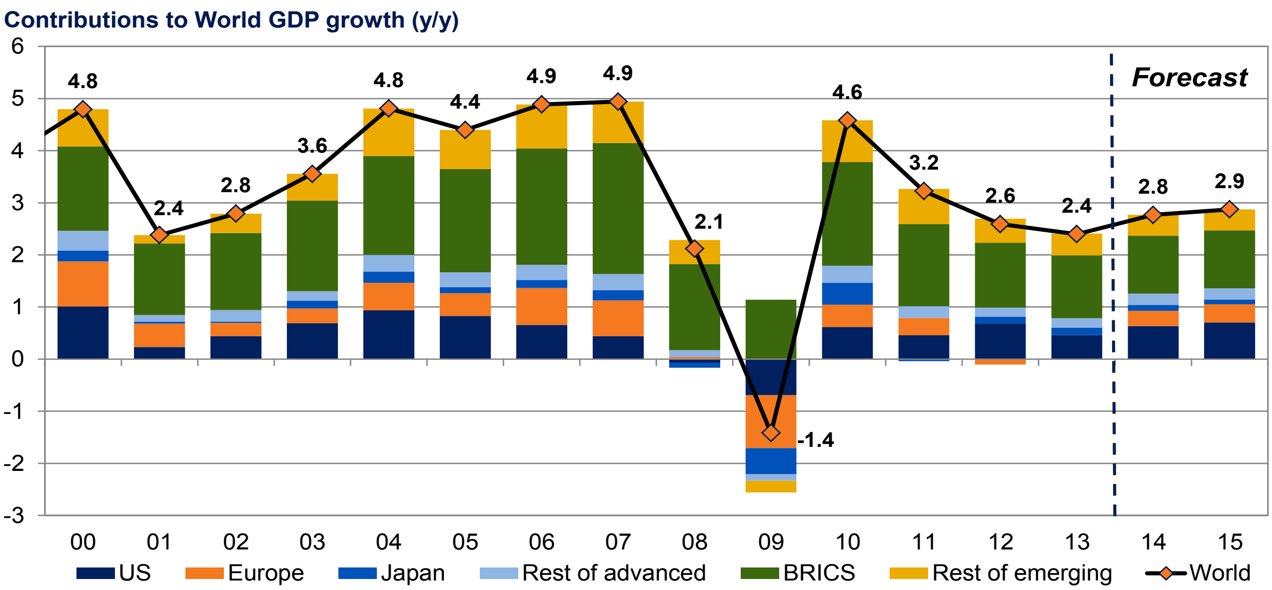
Baseline

- World economy on track for modest recovery as monetary stimulus feeds through and fiscal headwinds fade in 2014. Inflation to remain well contained.
- US to rebound in q2 after weather related dip in q1. Economy beginning to normalise as banks return to health and the pace of de-leveraging eases. Unemployment to fall faster than Fed expects and central bank to complete tapering of asset purchases by October 2014. First rate rise expected in June 2015 with rates rising 25 bps per meeting to 1.5% by year end.
- UK recovery to be sustained by robust housing and consumer demand whilst economic slack should limit the pick up in inflation. Growth likely to moderate next year with general election and resumption of austerity. Interest rates to rise in February 2015 and reach 1.5% by year end.
- Eurozone recovery becomes more established as fiscal austerity and credit conditions ease in 2014. ECB on hold after cutting rates and taking measures to reduce the cost of credit, otherwise on hold through 2015. Deflation to be avoided, but strong possibility of QE (purchases of asset backed securities) in response to deflation fears.
- "Abenomics" achieving good results so far, but Japan faces significant challenges to eliminate deflation and repair its fiscal position. Bank of Japan to step up asset purchases as growth and inflation fall back later in 2014.
- US leading Japan and Europe (excluding UK). De-synchronised cycle implies divergence in monetary policy with the Fed eventually tightening ahead of ECB and BoJ, resulting in a firmer USD.
- Tighter US monetary policy weighs on emerging economies. Region to benefit from advanced country cyclical upswing, but China growth downshifting as past tailwinds (strong external demand, weak USD and falling global rates) go into reverse and the authorities seek to deleverage the economy. Deflationary for world economy, especially commodity producers (e.g. Latin America).

Risks

- Risks are still skewed towards deflation, but are more balanced than in the past. Principal downside risk is a China financial crisis triggered by defaults in the shadow banking system. Some danger of inflation if capacity proves tighter than expected whilst upside risk is a return of animal spirits and a G7 boom.

Chart: World GDP forecast



Source: Thomson Datastream, Schroders 28 May 2014 forecast. Previous forecast from February 2014. Please note the forecast warning at the back of the document.

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Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2013	2014		Prev.	Consensus	2015		Prev.	Consensus
World	100	2.4	2.8	↓	(3.0)	2.7	2.9	↓	(3.1)	3.2
Advanced*	64.4	1.2	1.9	↓	(2.1)	1.9	2.1	↓	(2.2)	2.3
US	24.7	1.9	2.6	↓	(3.0)	2.2	2.9	↓	(3.0)	3.1
Eurozone	18.6	-0.4	1.0	↓	(1.1)	1.1	1.4		(1.4)	1.5
Germany	5.2	0.5	2.2	↑	(1.9)	2.0	2.3	↑	(2.2)	2.0
UK	3.8	1.7	2.9	↑	(2.6)	3.0	2.4	↑	(2.1)	2.6
Japan	9.1	1.6	1.2	↓	(1.4)	1.5	1.0	↓	(1.3)	1.2
Total Emerging**	35.6	4.6	4.2	↓	(4.4)	4.2	4.3	↓	(4.6)	4.7
BRICs	21.8	5.5	5.1	↓	(5.3)	5.2	5.1	↓	(5.6)	5.4
China	12.5	7.7	7.1		(7.1)	7.3	6.8	↓	(7.3)	7.1

Inflation CPI

y/y%	Wt (%)	2013	2014		Prev.	Consensus	2015		Prev.	Consensus
World	100	2.6	3.0	↑	(2.8)	3.0	3.1	↑	(2.8)	3.0
Advanced*	64.4	1.3	1.5	↑	(1.4)	1.6	1.6	↑	(1.5)	1.7
US	24.7	1.5	1.8	↑	(1.5)	1.8	1.9	↑	(1.4)	1.9
Eurozone	18.6	1.3	0.9	↑	(0.8)	0.7	1.2		(1.2)	1.2
Germany	5.2	1.6	1.3		(1.3)	1.2	2.0	↑	(1.7)	1.8
UK	3.8	2.6	1.9	↓	(2.3)	1.8	2.2	↓	(2.7)	2.1
Japan	9.1	0.1	2.0	↑	(1.9)	2.6	1.6	↑	(1.5)	1.8
Total Emerging**	35.6	4.9	5.7	↑	(5.4)	5.7	5.6	↑	(5.3)	5.4
BRICs	21.8	4.7	4.4	↑	(4.3)	4.3	4.4	↑	(4.1)	4.3
China	12.5	2.6	2.7		(2.7)	2.5	3.1	↑	(2.9)	2.9

Interest rates

% (Month of Dec)	Current	2013	2014		Prev.	Market	2015		Prev.	Market
US	0.25	0.25	0.25		(0.25)	0.26	1.50	↑	(0.50)	0.92
UK	0.50	0.50	0.50		(0.50)	0.72	1.50	↑	(0.50)	1.58
Eurozone	0.25	0.25	0.10		(0.10)	0.21	0.10		(0.10)	0.30
Japan	0.10	0.10	0.10		(0.10)	0.19	0.10		(0.10)	0.19
China	6.00	6.00	6.00		(6.00)	-	6.00		(6.00)	-

Other monetary policy

(Over year or by Dec)	Current	2013	2014		Prev.		2015		Prev.
US QE ($Bn)	4227	4033	4443		(4443)		4443		(4443)
UK QE (£Bn)	375	375	375		(375)		375		(375)
JP QE (¥Tn)	241	224	295		-		383		-
China RRR (%)	20.00	20.00	19.50	↓	20.00		19.50	↓	20.00

Key variables

FX	Current	2013	2014		Prev.	Y/Y(%)	2015		Prev.	Y/Y(%)
USD/GBP	1.68	1.61	1.68	↑	(1.63)	4.3	1.63	↑	(1.55)	-3.0
USD/EUR	1.37	1.34	1.35	↑	(1.34)	0.7	1.30	↑	(1.27)	-3.7
JPY/USD	101.5	100.0	105.0	↓	(110)	5.0	110.0	↓	(120)	4.8
GBP/EUR	0.81	0.83	0.80	↓	(0.82)	-3.5	0.80	↓	(0.82)	-0.7
RMB/USD	6.23	6.10	6.18	↑	(6.00)	1.3	6.10	↑	(5.95)	-1.3
Commodities										
Brent Crude	111.1	109.0	108.3	↑	(108)	-0.7	103.7	↑	(103)	-4.3

Source: Schroders, Thomson Datastream, Consensus Economics, June 2014
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Pleas note the forecast w arning at the back of the document.
Market data as at 16/05/2014
The current forecast refers to May 2014 and the previous refers to February 2014.
The US and UK interest rate forecasts w ere updated this month.

* **Advanced markets**: Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sw eden, Sw itzerland, Sw eden, Sw itzerland, United Kingdom, United States.

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

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I. 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

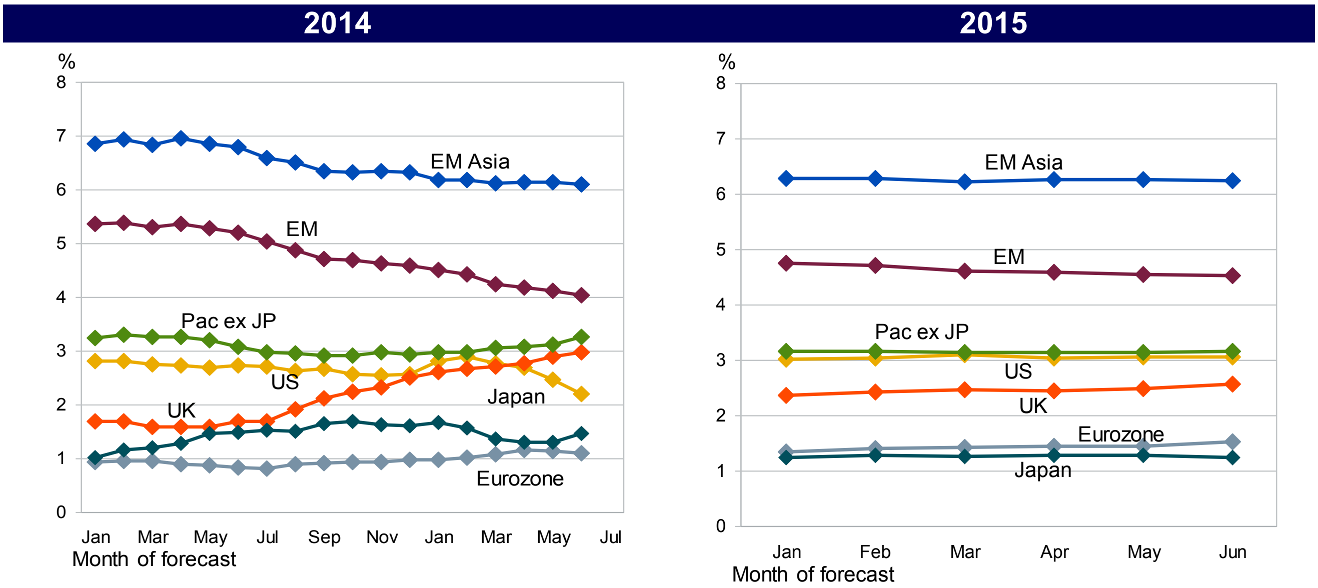
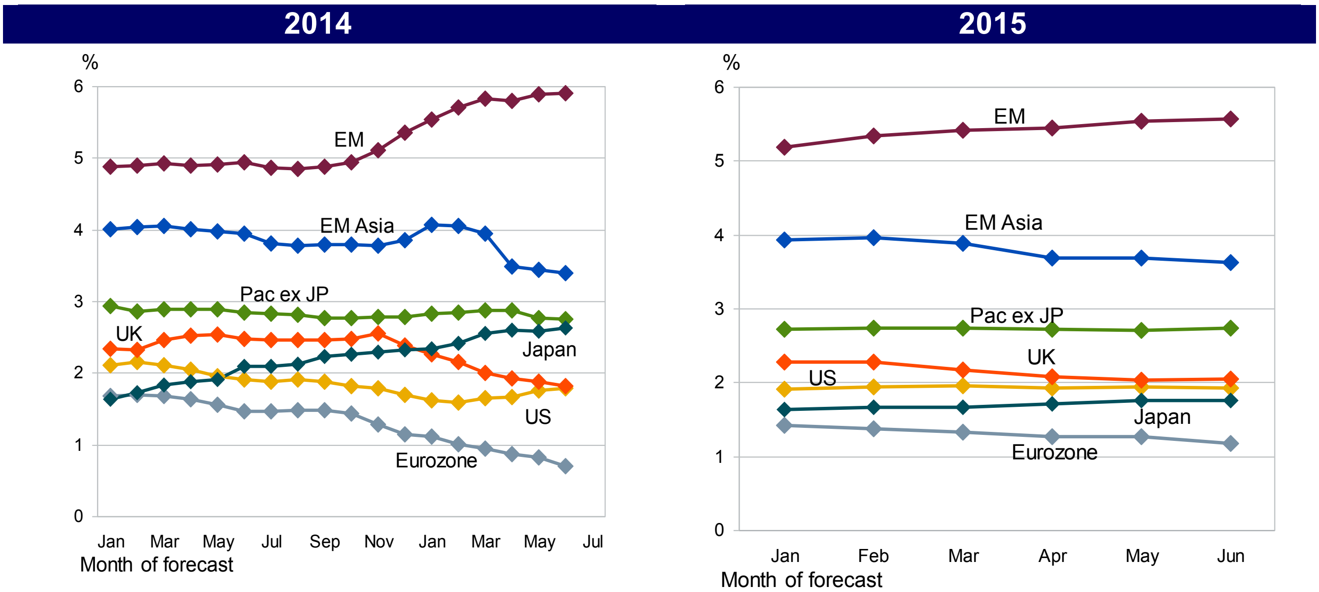


Chart B: Inflation consensus forecasts



Source: Consensus Economics (June 2014), Schroders
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand
Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

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