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Market Update

For immediate release

18 June 2009

Depression less likely as bond yields price in inflation, says F&C's Ted Scott

** Increased risk appetite since turn of the year implies global government action is working **

Introduction

It was not long ago that bond yields in both the UK and US were implying zero inflation or even the possibility of a deflationary outcome to the current economic crisis. This suggested that a depression was a distinct possibility, as the economy would fail to respond to monetary and fiscal stimuli. Indeed, at the beginning of this year the prevailing wisdom was that deflation was a much more likely outcome than inflation, and with the yield on US 10-year Treasuries bottoming at around 2% in December 2008 and UK 10-year gilts at near 3% in early March, the fixed interest markets said as much.

A few months later and much has changed. Equity markets across the globe have rallied strongly as appetite for risk assets has increased sharply. Correspondingly, there has been an extraordinary rise in benchmark yields as both UK and US yields have approached 4%. With index-linked gilts having remained around 1.25% to 1.5%, this now implies that the expected inflation rate is around 2.5%. This, in my view, rightly suggests that a deflationary depression is now regarded as much less likely, but why is this so?

A deep recession is not a depression

When comparing the current slowdown with previous depressions, the two most recent examples are the lost decade in Japan in the 1990s and the global depression of the 1930s. In both cases prices were stagnant or

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fell for many years, and this deflation is the defining feature of a depression and is why it is so difficult for policymakers to effect a recovery.

It is acknowledged that there were significant policy errors in Japan, from which the economy has still not fully recovered. The culture in Japan with an ageing population is one of saving not spending, which lends itself to a deflationary scenario, but this was exacerbated by a lack of reflationary policies in the early years, and later on by applying the fiscal and monetary brakes too early.

Perhaps a more interesting reference point is what happened in the 1930s as it was a global phenomenon, like today. The bears who argue that we will lapse into a 1930s-style depression believe there are many similarities. Not least is the amount of leverage in the economy following the boom in asset prices ahead of the 1929 Wall Street crash and the bursting of the housing bubble in 2007. However, there are key differences that, in my view, mean that the risk of debt-deflation (which the economist Irving Fisher highlighted in the 1930s) will be avoided. Indeed, the bond market has recently begun to reflect this more optimistic view as yields have risen sharply.

A lesson from the 1930s

Prior to the 1930s the prevailing international financial system was the Gold Standard. It had been in place since the end of the Napoleonic wars and apart from occasional periods of economic recession, like the 1870s, was credited with creating stable economic conditions and particularly stable prices that lasted for long unbroken periods. It was a self-correcting mechanism whereby if a country had a negative trade balance it would lose gold to the value that imports exceeded exports but the money supply would rise. The increasing money supply would tend to cause inflation, which in turn would correct the trade imbalance and the rise in prices would reverse. It was a beautifully simple mechanism that limited the power of governments to print money and hence kept inflation – and, crucially, inflationary expectations – low.

The only time inflation took hold was during wartime, and this was true of the First World War when Britain abandoned the Gold Standard in 1914 to pay for the ensuing conflict. In line with the classical economic thinking at the time it was felt that it was necessary to restore Britain to the Gold Standard at pre-war parity. In order to achieve it, the economy had to be deflated and Britain was finally able to rejoin the Gold Standard at pre-war parity in 1925. However, because of the continuing price declines (including wages) and the predictable depressionary effects, Britain eventually abandoned the Gold Standard permanently in 1931. Interestingly, countries like Britain that abandoned the Gold Standard early recovered before those like France that did so later.

Thus, it can be seen that the restrictive economic policies following the war were the main contributor to the continuing malaise in the 1930s. During that decade the rise of protectionism and nationalist governments

prolonged the depression as countries refused to cooperate with each other. Ultimately, the depression was ended by the huge expenditure on re-armament and the Second World War itself.

Returning to the present, there is very little similarity between economic management now and the inter-war years. The main lesson from then has been the Keynesian philosophy that it is sometimes necessary for banks and governments to intervene to reflate the economy even if it means running large deficits, because otherwise the economy can achieve equilibrium at a level well below full employment, as happened between the wars. In addition, exchange rates are largely floating now and while there is some evidence of increased appetite for tariff barriers, countries are largely cooperating in a combined effort to restore economic health.

Another key difference to previous major recessions has been the recent growth of emerging economies, especially China. Although the depth of the current crisis means that all countries have been severely affected, the emerging economies are still in the relatively early stages of industrialisation and have a lot further to go. The continued growth of these countries will provide a vital counterbalance to the debt-laden mature economies in the West.

The current policy response

The policymakers today want to avoid deflation almost at any cost. Having relatively recently observed the consequences in Japan, with the central bank and government there unable to lift the economy out of recession despite strenuous efforts, there is now a consensus that it is the worst of all evils. The Fed Governor, Ben Bernanke, is well known for his study of deflation and Japan in particular, and it is the US that has given the lead in stimulating the global economy. This has involved typical Keynesian demand management with tax cuts and increased public spending and, more recently and more controversially, quantitative easing (QE) on top of an extremely loose monetary policy with interest rates effectively set at zero.

The policies in the US have largely been replicated in the UK, where the banking system has been rescued via the taxpayer.

As the above shows, the authorities are doing everything within their power to avoid the looming threat of deflation. This partly involves managing expectations. If people start to believe that prices will fall then spending will be deferred and it will hasten the arrival of deflation. Indeed, the advent of QE has potentially opened the Pandora's box of high or even hyper- inflation, but that debate is for another time. Certainly, a healthy dose of inflation would help erode the value of the outstanding debt that is the root cause of the present recession. The authorities would welcome this even if publicly they will not say it.

In the meantime, the shift in bond yields is an admission that the risk of deflation and depression was overstated late last year and early this year by markets. The partial stabilisation of the banking system is an

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important step in this regard and already the banks in both the US and UK are beginning to repay some of the taxpayers' money earlier than expected. In terms of whether the economy is beginning to turn the corner, there is little evidence yet other than things are getting less bad. However, it looks as though the catastrophe of a debt-deflation vortex leading to another Great Depression has at least been rendered unlikely by the proactive and concerted policies of global authorities.

Ted Scott, Director, UK Strategy, F&C, June 2009

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Notes to Editors

F&C Investments

- F&C Asset Management (F&C) is a London Stock Exchange listed asset management group which traces its origins back to 1868 with the launch of Foreign & Colonial Investment Trust, the first ever publicly listed investment fund. Foreign & Colonial Investment Trust remains a client of F&C.
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- F&C now manages £92.7 billion (€100.1 billion) of assets* for a diverse range of institutional, insurance and retail clients across all major asset classes – equities, bonds, cash and property – as well as alternative and specialist product classes such as Socially Responsible Investment funds, hedge funds, private equity funds and Liability Driven Investments. F&C invests globally and has been a longstanding investor in emerging markets.
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- F&C manages assets principally from three investment centres: London, Amsterdam and Edinburgh.

The group has a global office network spanning twelve countries: China (Hong Kong), France

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- In March 2009 F&C signed a Memorandum of Agreement with Hua Xia Bank, one of China's twelve nationwide joint stock commercial banks, to establish a joint venture fund management company in China in which F&C will have a 19.5% interest.

* As at 31 March 2009.