

### Executive Summary

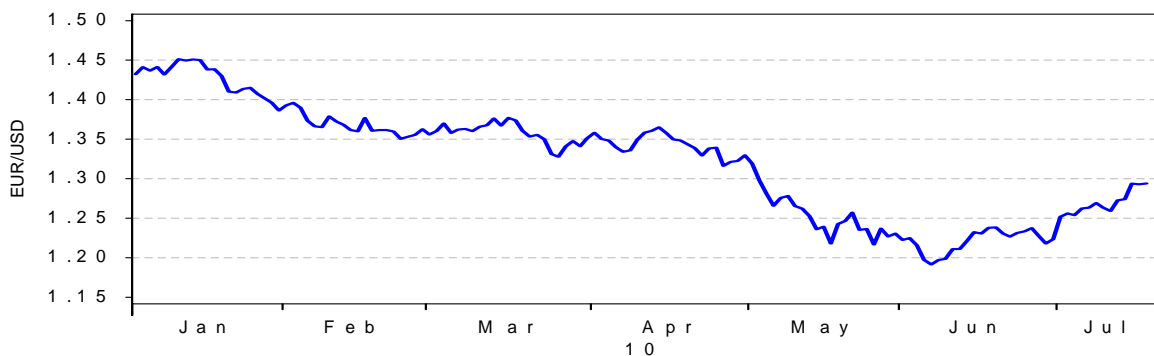
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- All the talk at the moment is of the global economy heading back into a double-dip recession. There is no doubt that the recent data have supported the generally bearish view in the markets as regards the outlook for the world economy. However, ***we think the markets are in danger of overreacting. In particular, the recoveries in the United States and China appear to be slowing to a more sustainable pace, rather than coming to a complete halt.***

- The slowdown in global economic activity means that interest rates will be held lower for longer. ***The Federal Reserve is now unlikely to be increasing the fed funds rate until the first half of 2011, and the European Central Bank is not seen hiking its key interest rate before the third quarter of next year at the earliest.***

- The basic theme in the currency market is competitive devaluation. The euro has come down from its recent high and the fiscal debt crisis in the Eurozone may still weigh on the European common currency. Although the structural forces for the euro remain negative, the dollar's recent rebound has been very sharp and substantial. Many indicators suggest that a retracement of the dollar's recent gains was inevitable. However, ***from a cyclical viewpoint, the dollar should still trend higher against the European currency, and we continue to believe that it will end the year in the \$1.10-1.20 range.***

Euro/Dollar Exchange Rate



- From the beginning of 2010 we have been consistent in the view that sterling would appreciate to around the 0.80 level versus the euro by year-end. In fact, it almost got there at the end of June. However, since then, the pound has weakened back to close on the 0.85 level. But, ***we still firmly believe that on a purchasing-power-parity basis (PPP) sterling is grossly undervalued. Although the structural problems affecting the country's public finances are serious, they are not particularly worse than those in the US. And in Euroland there is more than just one of the 16 member countries with fiscal debt problems, making it far more difficult to reach a satisfactory solution there.***

- The impact of debt, deflation and deleveraging will be felt by financial markets for some time, and these problems will also create a tough environment to sustain nominal output growth. The last ten years have been a 'lost decade' for equities. It is stunning that stocks have under-performed almost every asset class in the world, including US government bonds. Going forward, a key question to ask is whether this distressing pattern for stock prices will continue. ***Our sense is that the broad macro conditions for the G7 economies could get worse before they get better. Therefore, it is logical to argue that the macro backdrop for equities will stay uninspiring for some time to come.***

- For the government bond market the call is essentially whether the G7 economy looks decisively similar to that of post-crash Japan. If it is then bond prices have further to gain and equity prices have more to lose. But, ***we don't believe a Japanese-style liquidity trap will prevail in the United States, though the G7 bond market will face new equilibrium ranges in terms of bond yields.***

## World Economy:

All the talk at the moment is of the global economy heading back into a double-dip recession. There is no doubt that the recent data have supported the generally bearish view in the markets as regards the outlook for the world economy. However, we think the markets are in danger of overreacting. In particular, the recoveries in the United States and China appear to be slowing to a more sustainable pace, rather than coming to a complete halt. There has been a clear shift in focus away from the fiscal problems in Europe towards concerns about growth in the US. This shift has been helped, on the one side, by diminishing fears of an imminent sovereign default in Euroland and by signs of a stronger industrial recovery in Germany and, on the other, by a run of disappointing data from the US. The dollar has been one obvious casualty. But, **in our view, fears that the United States will drag the rest of the world into a double-dip recession are exaggerated. The recovery in America was kick-started by the combination of massive policy stimulus, the turn in the inventory cycle, the revival in world trade, and the restarting of projects put on hold during the darkest days of the global crisis. Growth was always likely to slow once these boosts began to fade.** However, this slowdown need not develop into a double-dip. The incoming data on investment and consumer spending have actually been quite encouraging, with shipments of capital goods and household real incomes both continuing to recover. Business surveys such as the ISM have dropped back from what were unsustainably high levels, but are consistent with continued recovery. The renewed weakness of the consumer surveys may simply be a lagged response to the slide in equity markets. As stock prices stabilise, so should confidence. Housing **is the one sector of the US economy which does appear to be entering a double-dip.** That said, the previous crash had left activity at such low levels that the housing sector is now much less important for the wider US economy. The downside for prices is also limited by the fact that they are no longer so over-valued.

- **double-dip will be avoided**

## World GDP Forecasts

%	2008	2009	2010 (f)	2011 (f)
<b>World</b>	<b>3.0</b>	<b>-0.6</b>	<b>4.3</b>	<b>4.1</b>
US	1.2	-2.4	3.2	2.5
Japan	-0.7	-5.2	1.8	2.0
China	9.0	8.7	10.5	10.2
Eurozone	0.7	-4.1	1.2	1.8
UK	0.7	-4.9	1.2	2.3
<b>Ireland</b>	<b>-3.5</b>	<b>-7.6</b>	<b>1.2</b>	<b>3.5</b>

The upshot is that the incoming data are consistent with the view that the US economy will slow again heading into 2011, with average GDP growth of 2.5% forecast as against 3.2% in 2010. This would be less than the consensus had been hoping for, but not the double-dip recession that some now fear. **The story for China is also reassuring. In quarter-on-quarter terms, China's growth probably peaked in the middle of last year. The markets have been slow to pick this up, in part because the headline year-on-year data had been flattered by the favourable comparison with the depths of the global recession.** Many commentators have also been sidetracked by the search for a property bubble which, some local hotspots aside, does not exist. The upshot here is that China's economy is already cooling without the need for aggressive policy tightening. Indeed, fading inflation pressures and a strong budget position mean that Beijing could loosen policy again if the slowdown threatened to become a hard landing. Nonetheless, there are still many headwinds that could well keep the global recovery weak. It is certainly far too early to sound the all-clear on the Eurozone, which cannot thrive on the basis of an export-led surge in Germany alone. What's more, while Europe has been first, fiscally policy will soon turn restrictive at the global level too. Still-high levels of spare capacity and unemployment will keep private-sector demand subdued and ensure that deflation remains a significant risk. Finally, while the financial sector as a whole is in much better shape now than it was in early 2009, the banks are unlikely to be able or willing to contribute as much to sustaining the economic recovery as they would normally do. One implication is that the dollar is likely to resume its climb, particularly against the euro. **The recovery in the US may not be as impressive as some had hoped, but at least there is one, and without any structural problems on a par with the challenge of keeping the Eurozone together.** We should also keep in mind that the slowdown in the US recovery is consistent with the 1975 and 1983 recessions when the data started to turn 'soft' a number of quarters after the initial quarter of recovery. So what's happening now is little different to then. But the uncertainty over the recovery will keep official interest rates lower for longer and that in itself should be a key factor in ensuring that we don't go back into a double-dip recession.

- **US GDP growth of 2.5% projected for 2011**

## Official Interest-Rate/Monetary Policy Outlook:

Federal Reserve officials in June felt they should be ready to consider additional steps to boost the US economy if an already softening outlook took a noticeable turn for the worse. "As a result of the change in financial conditions, most participants revised down slightly their outlook for economic growth," minutes of the June 22-23 meeting of the Fed's policy panel showed. "The committee would need to consider whether further policy stimulus might become appropriate if the outlook were to worsen appreciably," they said. **The minutes did not detail any steps the Fed might take if it believed the economy needed more help, but in our view buying more longer-term US government debt or mortgage-related securities would be the most obvious thing to do.** A number of Fed officials believed risks to economic growth had shifted to the downside, the minutes said. They believe it could take years for the economy to return to full health. The US central bank has held overnight rates near zero since December 2008 and has pumped more than \$1 trillion into the economy to try to spur economic growth. In a statement after its June meeting, it had struck a cautious tone about the economy, saying only that the recovery is "proceeding," while it renewed its promise to hold rates exceptionally low for an extended period. The minutes showed that, in general, the Fed believed the flagging of the recovery was modest enough not to call for any additional easing beyond what was already in place. Still, Fed officials felt continued labour market weakness would depress consumer sentiment, and they projected house prices to remain flat or decline in the near-term. Even as it contemplated the possibility of further easing financial conditions, the central bank continued discussions at the meeting of how to shrink its vastly expanded balance sheet when the time is right. Officials debated whether to stop reinvesting in maturing Treasury securities or whether to reinvest the proceeds in shorter-dated government debt. **Irrespective of which option they choose, it is now clear that official US interest rates will remain on hold in 2010 and possibly well into 2011.**

• **Fed mulled further credit easing**

### Official Interest Rates 2010/2011

	Current	End Sep (f)	End Dec (f)	End Mar (f)	End June (f)
US	0.25	0.25	0.25	0.50	0.75
Eurozone	1.00	1.00	1.00	1.00	1.00
Japan	0.10	0.10	0.10	0.10	0.10
UK	0.50	0.50	0.75	1.00	1.25
Canada	0.75	1.00	1.00	1.25	1.50
Sweden	0.50	0.75	1.00	1.25	1.50
Norway	2.00	2.00	2.25	2.50	2.75
Switzerland	0.25	0.50	0.75	1.00	1.25
Australia	4.50	4.75	5.00	5.25	5.25
New Zealand	2.75	3.25	3.50	3.75	4.00
China	5.31	5.31	5.58	5.85	6.12

The Eurozone's economic recovery will likely just plod along, forcing the central bank to keep interest rates low, but the chance of a dip back into recession is fading, according to the latest Reuters monthly poll of around 40 economists. **The sluggish Euroland recovery means the European Central Bank is unlikely to be raising interest rates from their record low of 1.00% until July 2011 at the earliest.** Benchmark interest rates are seen rising to 1.25% in the third quarter of next year and then rising by a further 25bps in the final quarter, to close next year at 1.50%. Inflation is seen averaging 1.4% this year and then nudging up slightly to 1.5% in 2011, remaining significantly below the central bank's 2.0% ceiling, and another reason to justify no change in interest rates for another year yet. Although it looks like both US and Eurozone interest rates will remain on hold for the rest of this year, the same cannot be said of the UK, where differences of opinion among policymakers are coming to the surface as regards the amount of spare capacity in the British economy and the outlook for inflation. Renowned 'hawk' Andrew Sentance surprised the markets by going out on a limb in the June monetary policy meeting and voting for a 25bps rate increase to 0.75%. He has since made it clear that he remains concerned that inflation will not come down as steadily as some of his fellow policymakers think, and the Bank needs to start to gradually remove stimulus now. However, Sentance's ex colleague David Blanchflower believes more stimulus, in the form of quantitative easing, to ward off deflationary threats are needed. **While the debate in the UK is less clear cut than either the US or Eurozone, most analysts believe that the Bank of England too will hold monetary policy steady until the first half of 2011, though we wouldn't be surprised to see a 25bps hike in the final quarter of this year, especially if inflation remains stubbornly high.**

• **ECB rates seen on hold until Q3 2011**

## Currencies:

The basic theme in the currency market is competitive devaluation. The euro has come down from its recent high and the fiscal debt crisis in the Eurozone may still weigh on the European common currency. Although the structural forces for the euro remain negative, the dollar's recent rebound has been very sharp and substantial. Many indicators suggest that a retracement of the dollar's recent gains was inevitable. From **a cyclical viewpoint, the dollar should still trend higher against the European currency.** The Euroland 'peripherals' are facing the classic choice between devaluation and deflation. Although the euro will never drop to the level required to stabilise and stimulate the crisis-stricken Eurozone economies, the fact remains that the cheaper the euro, the better it is for the region's economy. Nevertheless, there is an interesting balancing act playing out in the foreign-exchange market. The negative correlation between US equity prices and the greenback suggests that financial markets are concerned dollar strength could siphon off US economic growth and introduce deflationary impulses. However, the reality has been that the foreign-exchange market has been an effective mechanism for redistributing deflation pressures among nations. For example, although the euro has dropped precipitously against the dollar this year, the greenback has been appreciating only modestly in trade-weighted terms. **This suggests that while the dollar has been strengthening against the euro, it has also weakened against many other currencies. In this vein, our bet is that the stronger the dollar becomes against the euro, the more pressure the Chinese authorities will face from the US for renminbi appreciation.**

- **a balancing act**

### Spot Exchange Rates 2010/2011

	Current	End Sept (f)	End Dec (f)	End Mar (f)	End June (f)
€/GBP	0.8430	0.8150	0.8000	0.7800	0.7500
€/\$	1.29	1.15	1.10	1.05	1.03
€/Yen	112	106	103	100	100
\$/Yen	87	92	94	95	97
GBP/\$	1.53	1.41	1.38	1.35	1.37

Renminbi appreciation serves as a pressure-releasing valve, allowing the US to push deflationary pressures into the Chinese economy. Therefore, a substantial revaluation of the renminbi will help rebalance debt-deflation pressures and create conditions for other Asian currencies to strengthen. How much will the Chinese authorities let the renminbi appreciate? Not more than 10% in the coming 10-12 months. The Chinese economy is also slowing and profits could be under pressure. In addition, Beijing has already removed its VAT rebate to exporters, which basically amounts to de facto appreciation. All in all, the Chinese authorities will be very reluctant to let the currency up sharply. **Without dramatic renminbi appreciation, the dollar will not be able to make significant and quick gains versus the euro. Rather, the greenback's rise against the euro is likely to be gradual and hesitant.** The Japanese yen's surprising strength is destroying the stock market as well as the corporate sector's pricing power. Furthermore, price declines may be accelerating. It is still unclear why the Bank of Japan continues to refuse to beef up its balance sheet to combat deflation. It is anyone's guess as to why politicians and monetary authorities have chosen a path of extreme pain to deflate their own economy and destroy asset values. All we know is that such a policy is not sustainable and the fundamental picture for the yen is negative. However, **the timing of a collapse in the yen is uncertain.**

- **renminbi appreciation needed for dollar to make sharp gains versus the euro**

From the beginning of the year we have been consistent in the view that sterling would appreciate to around the 0.80 level versus the euro by year-end. In fact, it almost got there at the end of June. However, since then, the pound has weakened back to close on the 0.85 level. But, we still firmly believe that on a purchasing-power-parity basis (PPP) sterling is grossly undervalued. Although the structural problems affecting the country's public finances are serious, they are not particularly worse than those in the US. And in Euroland there is more than just one of the 16 member countries with fiscal debt problems, making it far more difficult to reach a satisfactory solution there. **Financial markets have made huge adjustments, and have already priced in the problems in the UK. We're not sure the same can be said of the Eurozone. As such, we are sticking to the original forecast of a year-end euro/sterling exchange rate of 0.80.** Finally, we recommend clients to buy the Australian dollar. Australia has a solid economic picture with strong growth, minimal imbalances and high yields, and is the envy of many of its G20 peers.

- **sterling is grossly undervalued**

## Equities:

The impact of debt, deflation and deleveraging will be felt by financial markets for some time, and these problems will also create a tough environment to sustain nominal output growth. From time-to-time, policymakers may be under pressure to lend support to the economy in order to sustain the business-cycle expansion. The view out there is that “ice” rather than “fire” will characterise the overall investment market. In fact, ever since the Asian crisis in the late 1990s and the bursting of the technology bubble at the beginning of the last decade, deflation rather than inflation has been the dominant threat to the world economy. This has been reflected by the poor performance of equities as a whole. The last ten years have been a ‘lost decade’ for equities. It is stunning that stocks have under-performed almost every asset class in the world, including US government bonds. Going forward, a key question to ask is whether this distressing pattern for stock prices will continue. **Our sense is that broad macro conditions for the G7 economy could get worse before they get better. Therefore, it is logical to argue that the macro backdrop for equities will stay uninspiring for some time to come.**

- **deflation the main threat to world economy**

Several major investment themes will likely emerge, dominating the global investment market for some years ahead. (1) The G7 equity markets will face many structural issues and problems going forward, making the rally from March 2009 more likely to be cyclical in nature within a broad, secular bear market. **Over the last 110 years, the US equity market has had three secular bear markets: in the 1930s, the 1970s, and since 2000.** Each of these secular bear markets has keyed off a dominant economic theme or problem. For instance, in the 1930s, the problem was debt deflation, supply gluts and bank failures. In the 1970s the Western world was plagued by excess demand and soaring inflation. Since 2000, the dominant problem for the world economy has been over-competition, debt, deflation and financial instability. Moreover, it looks like the latest secular bear market, which has lasted for a decade, remains young in terms of age. Therefore, investors must readjust their return expectations to take into consideration the many negative forces that will continue to have an impact on the world economy and asset prices. (2) A lack of nominal growth means investors will likely seek out markets with higher profit growth potential. The average investor will also be willing to pay a premium for better growth. In this regard, emerging markets are the place to be. The BRIC countries, for example, have not had a public-sector finance crisis and have significantly higher nominal growth potential. There are no apparent external or internal imbalances. Therefore, although emerging markets have out-performed the G7 markets for the past 10 years, it is logical to think that this out-performance will continue. In fact, **emerging markets as an asset class were trading at a big discount to the developed markets in the 1990s. Since 2007, however, the emerging market universe has been assigned a premium to the G7 markets.** (3) In a world that is lacking nominal GDP growth, is full of deflationary tendencies and has zero interest rates, the natural instinct for all national governments and authorities is to pursue a “beggar thy neighbour” policy via competitive devaluation. In addition, in a world of zero interest rates, foreign-exchange rates become the key lever to regulate the economy. Along these lines, there has been a persistent phenomenon that has prevailed in many countries of late: **the cheaper the currency, the better the stock-market performance. The out-performance of the UK stock market on a weakening British pound is a classic example.** German equities have also soared relative to the global benchmark on the recent drop in the euro.

- **the cheaper the currency, the better the stock-market performance**

Stock markets in the G7 may experience shorter cycles and higher volatility going forward. This is primarily due to the fact that interest rates have been brought to zero and fiscal policy is hamstrung by gaping deficits and debt levels. As such, the impact of both monetary and fiscal policy on the underlying economy and asset markets has been greatly diminished. Financial markets will feel the rhythm of the real business cycle much more than the impact of policy manipulation. Inventory and capital-spending cycles will play a much bigger role in dictating the stock-market cycle. In the meantime, asset volatility will likely trend up, reflecting the diminished ability on the part of the authorities to reduce and smooth out business-cycle fluctuations. The G7 equity markets have been under chronic pressure to compress their multiples ever since the technology bubble collapsed in 2000. This has much to do with the fact that the disinflationary process, which began in the early 1980s, has ended, and the transition toward very low inflation or deflation has begun. Investors should realise that with interest rates having fallen to zero, the only direction they are headed is up. Hence, the best investors can hope for is to see equity prices go up in tandem with underlying profit growth. **Most likely, equity market gains will be less than corporate profit growth due to the eventual rise in interest rates. In fact, the cyclical bull market between 2003 and 2007 saw multiples come down by about 40%.**

- **shorter cycles, greater volatility**

## Bonds:

The big question for financial markets at the moment is whether the current economic slowdown will degenerate into a renewed business-cycle contraction. If the answer is yes, then the recent drop in global equity prices is just the beginning of a major cyclical breakdown. If the answer is no, then the recent shakeout has created another opportunity to buy equities on the cheap. The critical issue is whether the negative forces that are impacting on the markets at present will continue to gather momentum and culminate into a vicious dynamic that is strong enough to push the world economy into another period of renewed financial instability and economic contraction. Despite all the negative forces and key risks, our gut feeling is that the world economy in general and the US economy in particular will escape a double-dip recession. The G7 economy will most likely settle on to a path of soggy growth with periodic threats of deflation. The environment is “soft”, but non-contractory. Gibson’s Paradox refers to the positive correlation between stock prices and government bond yields. In fact, Gibson’s Paradox has prevailed after the Asian crisis, which in our view was the watershed event that marked the beginning of a new era characterised by increasing deflationary tendencies, over-competition, relative abundance and supply gluts. Obviously, in a world of deflation or very low inflation, bond yields tend to converge with real economic growth. As such, higher bond yields are usually consistent with higher economic growth and hence higher stock prices, and vice versa. ***This positive correlation between bond yields and stock prices is unlikely to change anytime soon, making switching between equities and bonds as part of asset allocation all the more important.***

- ***correlation between bonds and equities unlikely to change anytime soon***

### 2010/2011 Native Global Bond Yield Forecasts %

	Current	End Sept (f)	End Dec (f)	End Mar (f)	End June (f)
<b>US</b>					
2 Year Treasury	0.59	1.05	1.45	1.95	2.45
5 Year Treasury	1.70	2.15	2.45	2.85	3.25
10 Year Treasury	2.96	3.30	3.55	3.85	4.15
30 Year Treasury	3.98	4.25	4.45	4.70	5.00
<b>Germany</b>					
2 Year Bund	0.77	0.85	1.15	1.50	1.85
5 Year Bund	1.64	1.65	1.90	2.20	2.50
10 Year Bund	2.66	2.75	2.95	3.20	3.45
30 Year Bund	3.34	3.45	3.65	3.90	4.15
<b>UK</b>					
2 Year Gilt	0.80	1.10	1.45	1.85	2.25
5 Year Gilt	2.09	2.40	2.70	3.05	3.40
10 Year Gilt	3.37	3.60	3.85	4.15	4.45
30 Year Gilt	4.24	4.40	4.65	4.95	5.25

For the government bond market the call is essentially whether the G7 economy looks decisively similar to that of post-crash Japan. If it is then bond prices have further to gain and equity prices have more to lose. But, we don’t believe a Japanese-style liquidity trap will prevail in the United States, though the G7 bond market will face new equilibrium ranges in terms of bond yields. For the US Treasury market, the equilibrium of 10-year bond yields could range between 3-4%, with a central tendency of 3.5%: real growth at 2.5% plus steady-state inflation of 1.0%. For German Bunds, the range should be 2-3%, with a central tendency of 2.5%: real growth of 1.5% plus inflation at 1%. For Japan, JGBs should yield between 1% and 2%. Obviously, yields on 10-year Treasury bonds have breached below the lower band. Real 10-year yields, measured as nominal yields minus inflation swaps, have fallen to levels last seen at the end of 2008. Real yields in Euroland are at record lows, and the yield curve has also flattened across the G7. Clearly, the fixed-income market is behaving as if a double-dip is a foregone conclusion. ***Unless the world economy is indeed plunging into a new recession, the path of least resistance for bond yields should be up rather than down. Furthermore, in our view the G7 government bond market is overvalued. At any rate, it is a sensible strategy to cut duration to underweight.*** The only real bond market that is worth buying in the developed world is Australia. The Australian 10-year bond yield is currently yielding 5.20% while the Aussie dollar has weakened sharply over the last few months. ***All in all, we think that even if long-term bond yields remain flat, investors will likely benefit from a strong Australian dollar, making the bond market look attractive.***

- ***path of least resistance for bond yields is up***

## Gold:

The past eight years have been good for gold. Since 2002, the price of gold has surged over 500%. While the S&P remains 30% below its October 2007 high, gold prices are up about 50% since then. As its price has soared, the word “bubble” has increasingly been used in the same sentence as gold. Indeed, the trajectory of gold prices over the past few years looks eerily similar to the dotcom boom in the late 1990s. In some sense, it is hard to regard gold as anything but a bubble asset: it does not generate any earnings nor pay a dividend. Or to put it another way, **aside from the fact that gold has a number of technological applications and is really shiny and pretty, bullion only derives its value from the fact that others find it valuable. By definition, that makes it a bubble asset.** Indeed, Warren Buffet said it best: “Gold gets dug out of the ground in Africa, or some place. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head.” Yet, if gold is a bubble asset, the same can be equally said about paper money: people only find paper money valuable because they assume that others will also find it valuable. This brings us to the rub of the matter: When people begin to question the integrity of paper money, they seek a different store of wealth. Gold’s distinct properties—the fact that it is malleable, corrosion-resistant, virtually indestructible and extremely scarce (the entire stock of above-ground gold would only fill a 21 cubic-metre cube) make it a natural alternative to fiat money.

- **huge boom in gold prices in recent years**

It is not surprising therefore that the price of gold has tended to increase during episodes when the appeal of holding fiat money diminishes. Broadly speaking, such episodes can be broken down into two categories. (1) When real interest rates decrease: **The price of gold and real interest rates have tended to be inversely correlated. This is not surprising since lower real interest rates reduce the opportunity cost of holding gold, and thus make it a more attractive investment.** Real rates can decrease for two reasons. One, when inflation accelerates and nominal interest rates fail to keep pace with rising prices. This is what drove gold prices higher in the late 1970s and early 80s. It was not until Paul Volcker’s commitment to “break the back of inflation” that gold prices finally peaked and began a two-decade descent. Conversely, real interest rates fall faster than the decline in inflation. After the dotcom bust, the combination of low Fed interest rates and sizeable capital inflows from China and the oil exporting economies into US fixed-income markets—the so-called “savings glut” - helped push down both short-term and long-term interest rates. This helped light the match under the gold market. (2) When solvency risk escalates: If people don’t trust banks to safeguard their money, they will often shift their assets into gold. Such concerns were at the heart of the recent financial crisis.

- **gold and real interest rates conversely correlated**

Over the past year between 30% and 40% of respondents to the University of Michigan consumer sentiment survey indicated that they expected consumer prices to fall over the next twelve months. So if most people don’t think inflation is a problem, then why is the price of gold going up? The answer is that what most people think does not matter as much for gold as it does for other asset markets. The gold market is quite small relative to other asset markets. Thus, a small minority of market participants can have a significant impact on gold prices. And even 10% to 15% of respondents in the Michigan survey expecting inflation to rise sharply over the next twelve months corresponds to about 30 to 40 million Americans. For these people, not only are ex ante real interest rates low, but they are extremely negative. Therefore, it is no wonder many of them might seek the putative safety of gold. For those worried about inflation, the massive expansion of central bank balance sheets over the past two years has added fuel to the fire. Thus far, the resulting surge in liquidity from central bank lending programmes and asset purchases has not led to rapid credit growth as commercial banks are quite happy to hold excess reserves. However, those who fear inflation worry that once these excess reserves begin to be lent out, this will lead to a rapid acceleration in prices. **And even if banks do remain hesitant to lend, the high level of liquidity sloshing around the banking system could still push up gold prices.** Indeed, liquidity in the financial sector is very much like a river: it tends to flow along the path of least resistance and not to where people may be most thirsty. **And the gold market clearly lies along the path of least resistance. Since the gold market is quite small compared to other asset markets, it does not take that much in the way of additional investor interest in gold to send prices soaring.** The entire stock of above-ground gold amounts to about 165,000 tonnes, or roughly \$7 trillion at current prices. Although this is hardly a small figure, it amounts to less than 3% of the total global stock of bonds, equities and bank deposits. **The only way for the aggregate value of gold held for investment purposes to increase is for the price of gold to rise. A one percentage point increase in the share of gold in investors’ portfolios would be consistent with the tripling in gold prices from current levels.**

- **gold market quite small**

## EU Bank Stress Testing:

In an effort to reassure financial markets about the health of the European Union's banking system, the bloc's countries are stress-testing a large number of their banks and will publish the results on July 23. Ninety-one banks comprising 65% of the European banking sector by assets are being tested. They range from Germany's Deutsche Bank to Malta's Bank of Valletta. They include seven of Germany's eight regional landesbanks, the exception being tiny Saar LB. All of Spain's 19 cajas, or unlisted savings banks, are included. In each EU state, the sample includes enough banks, in descending order of size, to cover at least 50% of the national banking sector. National supervisors are carrying out the tests, which are being coordinated by the Committee of European Banking Supervisors (CEBS), a London-Based umbrella group for financial supervisors. The tests simulate how banks cope with financial pressures on their loans and other assets in a worsening recession. Results will be released for individual banks, though the degree of public disclosure remains unclear. The test scenario assumes a 3 percentage point deviation of the EU's GDP from the European Commission's forecasts over a 2-year horizon. **It also assumes a "sovereign risk shock" in which some government bond prices would be marked down further from the depressed levels of early May. The size of such haircuts has not been officially announced and conflicting reports about them suggest national regulators may not be applying them consistently. Market rumours suggest the haircut on Greek sovereign bonds is 23% off "current market prices".** Banks are being tested on how their so-called Tier 1 capital, a key measure of financial strength, bears up. The ECB wants to see if the ratio of this capital to assets stays above a minimum benchmark of 6% of assets in the tests. Although this is higher than the 4% legal minimum, it is lower than most bank shareholders are happy with. Deutsche Bank, for example, now has more than 11%. **The aggregate outcome of the tests will be published on July at 17.00 BST on the CEBS website [www.c-eps.org](http://www.c-eps.org). Banks and national supervisors will publish individual bank results on their respective websites also from 17.00 BST on the same day.**

- **degree of public disclosure remains unclear**

For Europe's biggest banks, the results are not expected to reveal serious problems as they have strengthened themselves since the global credit crisis of 2007-2009 and have retained their ability to raise funds from the private money markets. There is much more concern about the possibility of serious balance sheet weaknesses being discovered among smaller, second- and third-tier banks, such as the landesbanks and the cajas. Few believe the state owners of Germany's landesbanks, for example, have revealed the full extent of their problems. Many banks in Greece and Portugal have largely lost access to the private markets during the countries' sovereign debt crises, and are surviving on funding from the ECB. However, **officials from the ECB and EU governments have insisted that the stress tests will show the European banking system is fundamentally healthy.** Many bankers and analysts think that to bolster the credibility of the tests without alarming markets, regulators will arrange to have the tests reveal isolated problems at some banks, but that the problems disclosed will not be serious enough to threaten national banking systems. **The market estimate is that up to 20 banks may be directed to raise capital after the tests, and that European banks will need to raise as much as €90bn, including €37bn for Germany's regional banks and €12bn for Spain's savings banks.**

- **some banks likely to be directed to raise capital after the tests**

Limited stress tests of a small number of European banks last year, the results of which were not released for individual institutions, failed to reassure the markets. This time, the tests appear closer in scope, rigour and transparency to stress tests of US banks undertaken during the global crisis. Those tests did succeed to some degree in easing investor worries. **But there is a danger that if the scenarios seem too soft on the banks, or if only partial results are made public, investors could view the tests merely as attempts to manipulate market opinion and hide deep-seated problems. In that case, the tests could actually increase market jitters.**

- **market reassurance not guaranteed**

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