

The Year of the Swan

Kit Juckes

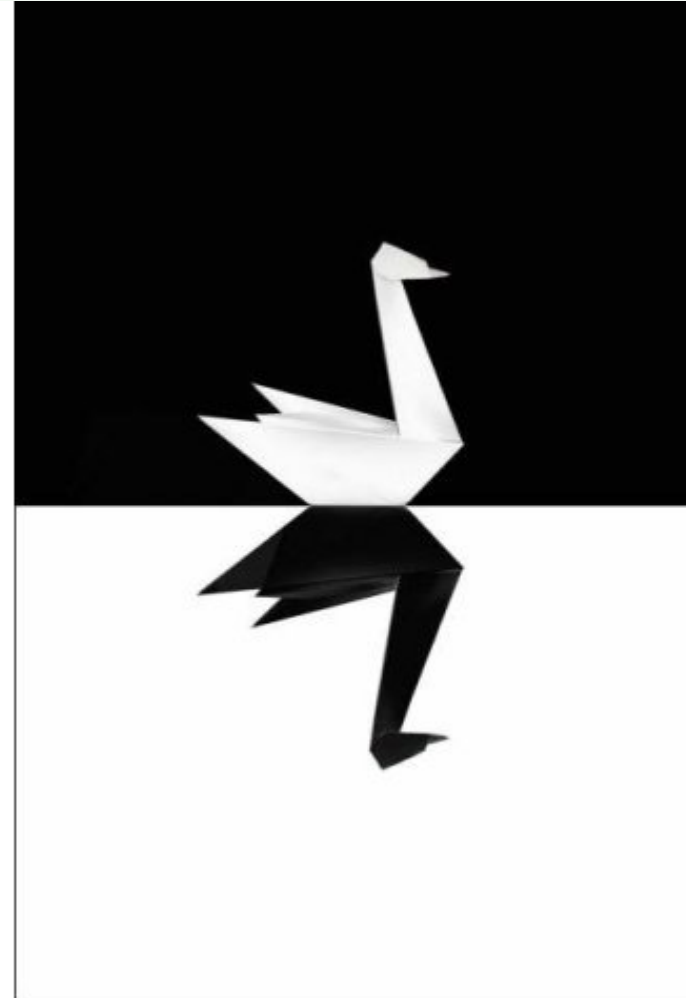
The ECU Group

January 8, 2010



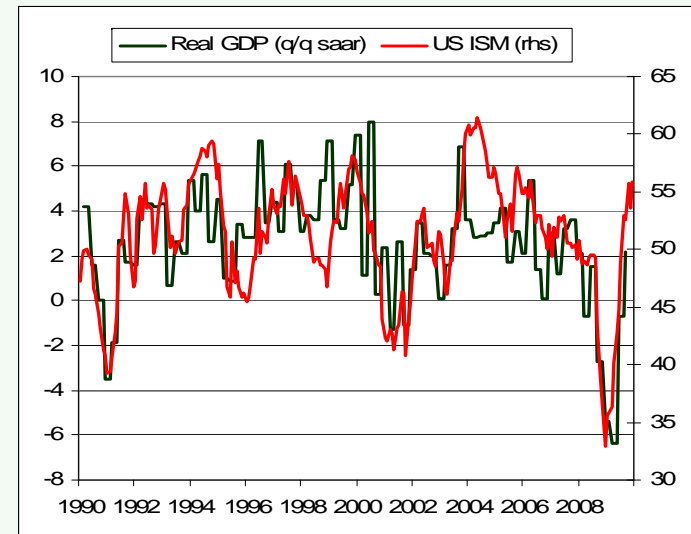
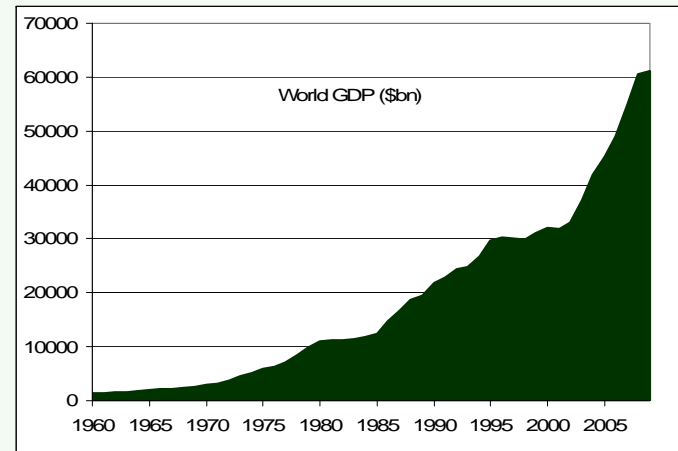
2009 was the year of the swan

- 2009's 'black swan' event was that massive, co-ordinated G7 monetary reflation actually WORKED. Was that a black swan event or just a predictable white swan event?
- 'FASTER GROWTH OF MONEY WILL IMPROVE BALANCE SHEETS, HELP ASSET PRICES AND BRING THE RECESSION TO AN END. AFTER THE MANY POLICY BLUNDERS OF THE PAST FEW YEARS, THE BANK OF ENGLAND HAS FINALLY CHOSEN THE CORRECT COURSE OF ACTION. THERE IS NO NEED FOR SIR SAMUEL (Brittan, FT columnist) OR ANYONE ELSE TO FRET ABOUT THIS PARTICULAR TOPIC.'
Tim Congdon, FT, March 2009
- 2010 may be about the limitations of monetary reflation. Boosting the asset side of a balance sheet does not have the same reparative qualities as reducing the liability side.



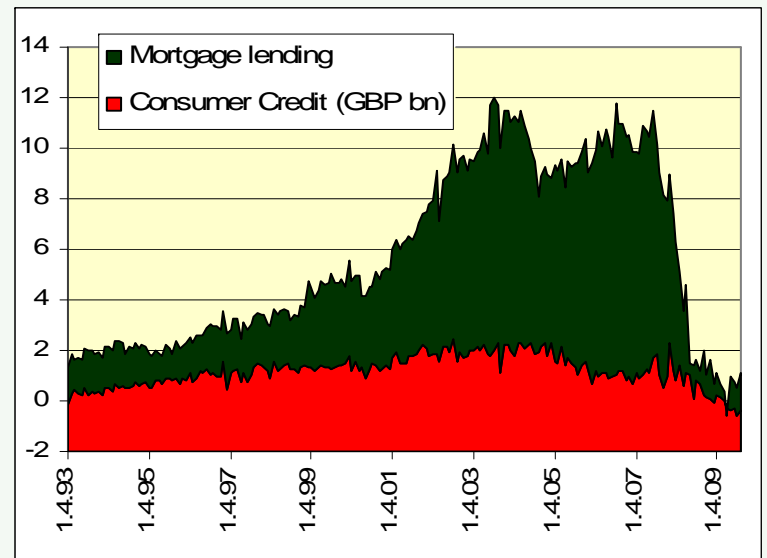
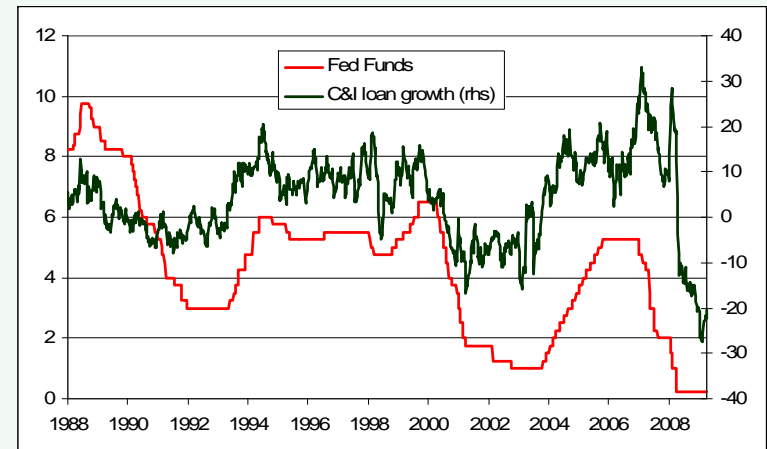
So far so good... where next

- World real GDP probably fell by about 1 ½% in 2009, after a near 5% rate between 2003 and 2007.
- Hopes of a return to 'business as usual' in 2010 with OECD growth averaging 2.5-3% in the years ahead, are unrealistic in the face of a huge debt burden
- 2010 will however see global growth exceed 4%, most of it outside the G7 and front-loaded
- And the US could lead the charge with Q4/Q1 growth close to a 5% rate



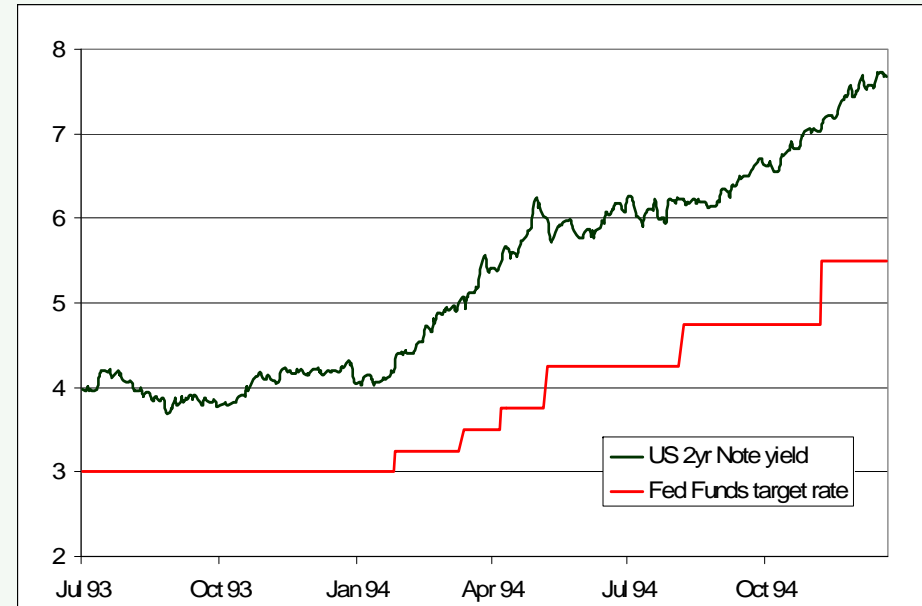
Central bank tightening – not yet

- Absence of bank lending reflects both supply and demand problems – bank balance sheets are still fragile, and loan demand is very weak as borrowers reduce debt.
- In both the US and the UK, surveys and leading indicators of credit availability point to improving trends, but actual lending remains very soft.
- Is it realistic to look for higher rates or the reversal of QE before banks start lending again?
- Surprise would be that QE were NOT unwound – it could even be increased. Rates may stay on hold, the Dollar remain weak, and asset-friendly policies remain in place, for longer than expected.
- A positive outlook for equities and for commodities, while 'bubble' and overheating risks remain in emerging markets.



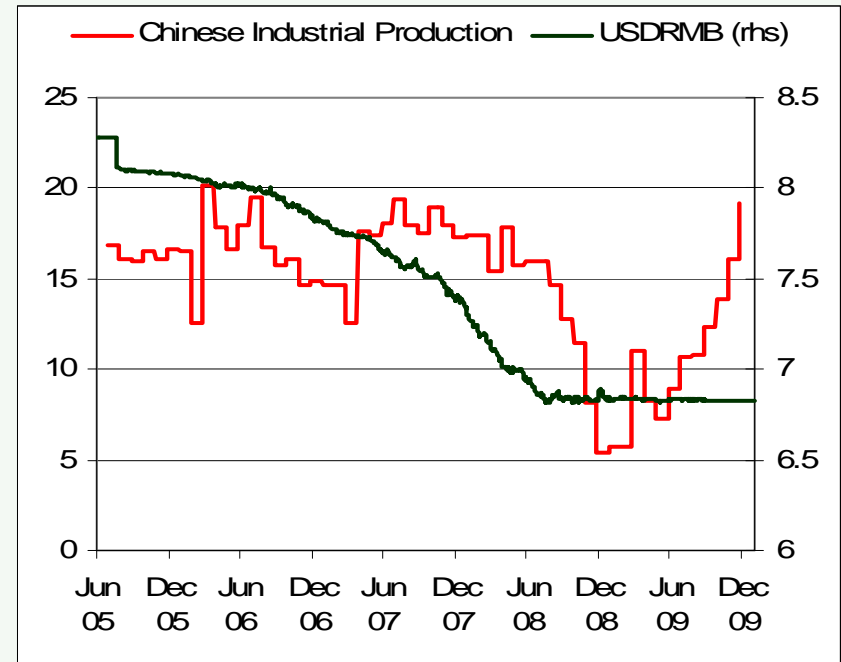
And if they do tighten...

- History suggests markets are likely to over-react.
- 1993 – Fed on hold all year and bond yields traded with relatively steady spreads to Fed Funds.
- 1994 – as soon as the Fed hiked, the Treasury market sold off sharply, with 2yr yields rising MORE than Fed Funds throughout the hiking cycle.
- Neutral rates are still probably above 4%, so scope for 2yr yields to rise from current 1.1% is HUGE once rates rise unless Fed prepares the ground carefully (or doesn't hike)
- This makes the Q1 outlook for Treasuries volatile, as market expectations of tightening ebb and flow. But the bottom line – even if growth picks up, as long as wage growth and core inflation measures are benign, Fed will inclined to sit and watch rather than risk a sharp rise in yields and a repeat of 1937's premature tightening.



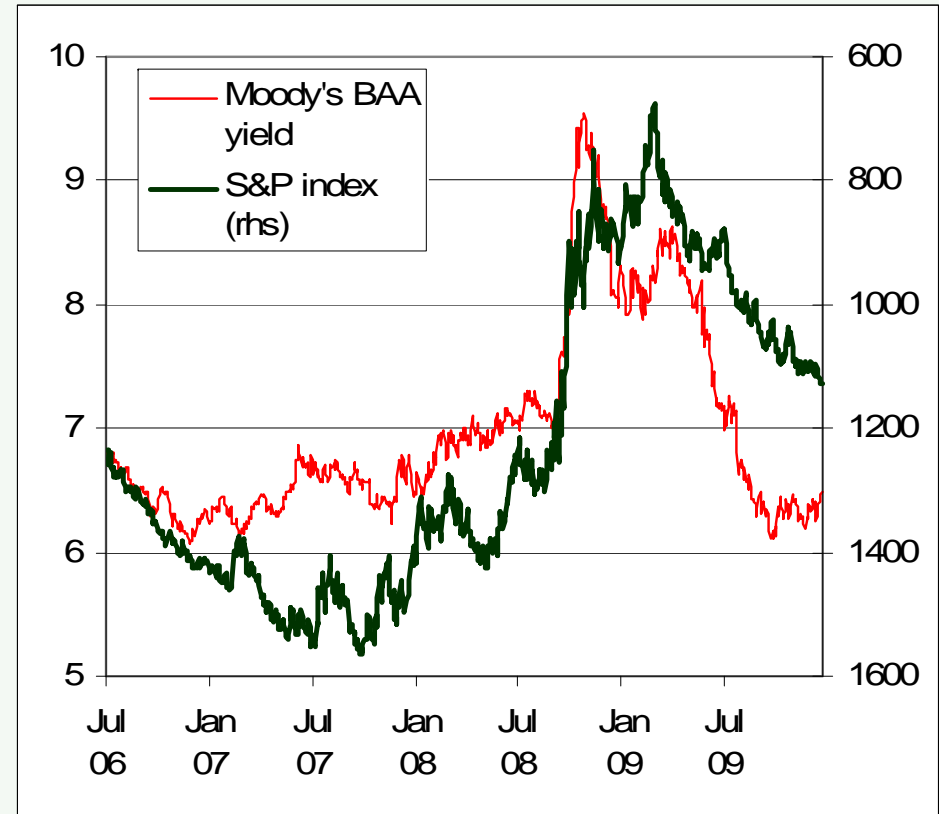
Chinese revaluation implications

- Chinese industrial production growth is back at levels seen when they started currency appreciation in 2005, and capital inflows will prove de-stabilising unless checked.
- Yet China is very reluctant to remove stimulus of a stable USDRMB rate either too early, or as a result of external pressure.
- Early revaluation would send bond yields up, bring forward G7 policy tightening and trigger at least a significant short-term dollar bounce

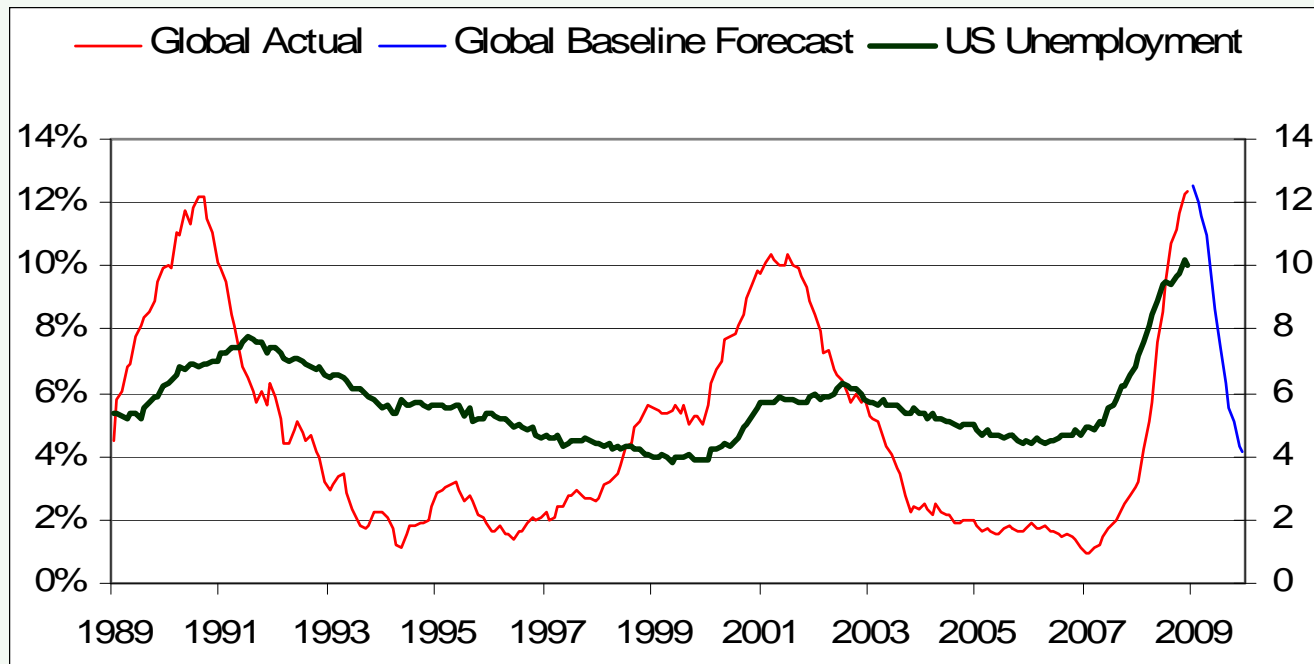


Easy money drove credit spreads

- A 350bp fall in BAA yields has allowed large-cap companies to tap the bond market as an alternative to bank lending and provides considerable relief to stretched balance sheets.
- Is and will continue to be a driver of an M&A revival.
- Reduced funding costs and higher cost of investing in corporate bonds have been a major driver of equity markets,
- Credit is expensive relative to equities at these levels. Buy equities vs credit (and bonds in general).



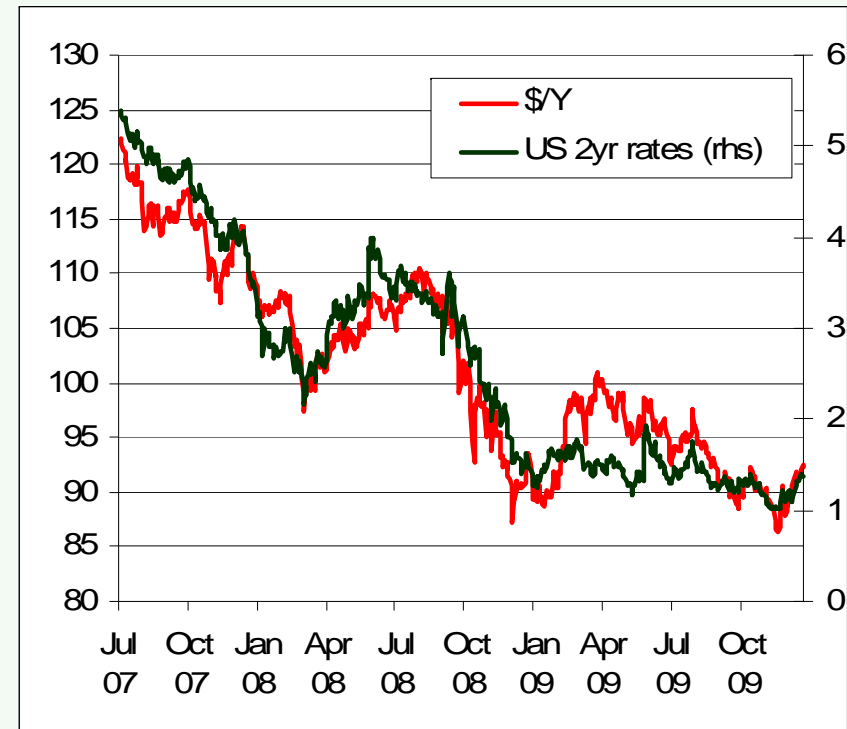
Moody's spec-grade defaults



- Ratings agencies are seeing new defaults slow, and the trailing default rate is expected to peak imminently. It is high, but barely higher than in the 1990 recession – whereas indicators like unemployment confirm that this is a much deeper crisis than that.
- That is a major success of the monetary reaction to the crisis – low rates prevented companies running into a cash flow crisis. But, offsetting the negative effects of leverage doesn't remove the leverage on its own.

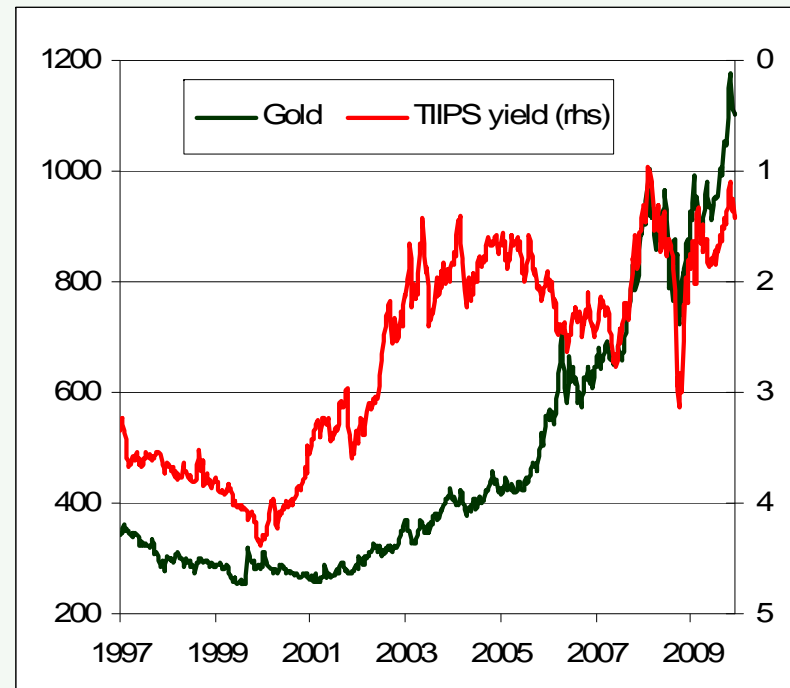
Currencies – more about rates than risk

- Since mid-2009, the relationship between rates and currencies has become stronger again.
- Market commentators focus on 'risk on/risk off' but monetary policy prospects are more important now
- In general, relative rates matter most, but in this cycle and relative to Japan (the land of zero) it's about US rates
- If the Fed hikes, \$/Y is a huge buy. If the Fed stays on hold, we've seen the low.

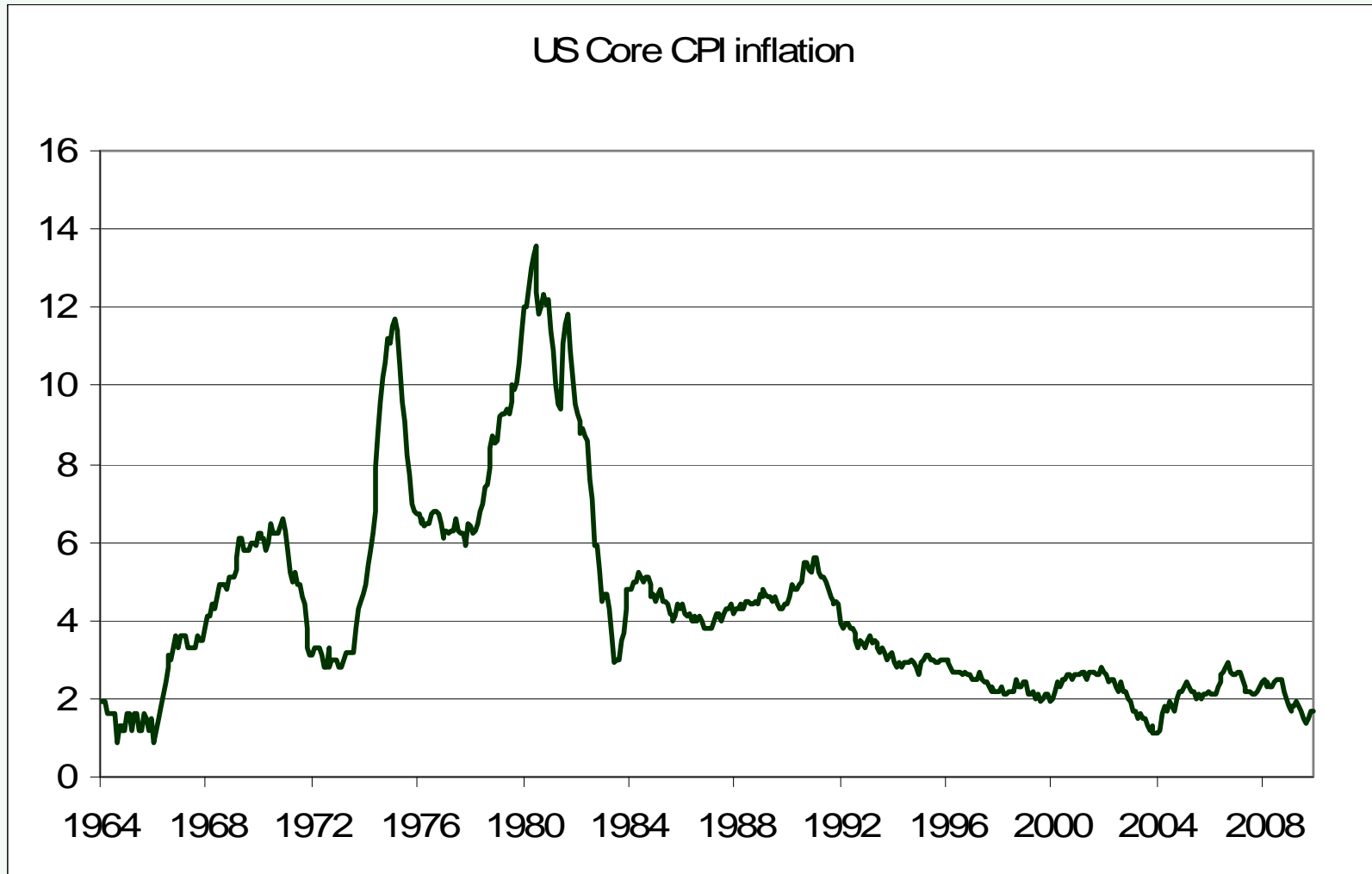


Gold – boosted by cheap money

- Since 2008, the price of gold has accelerated higher, in tandem with falling real yields on TIIPS.
- Gold rally reflects falling return on paper money and increased concern that paper money is being debased by QE.
- Less QE won't of itself de-rail the Gold rally if CBs are slow/reluctant to raise rates

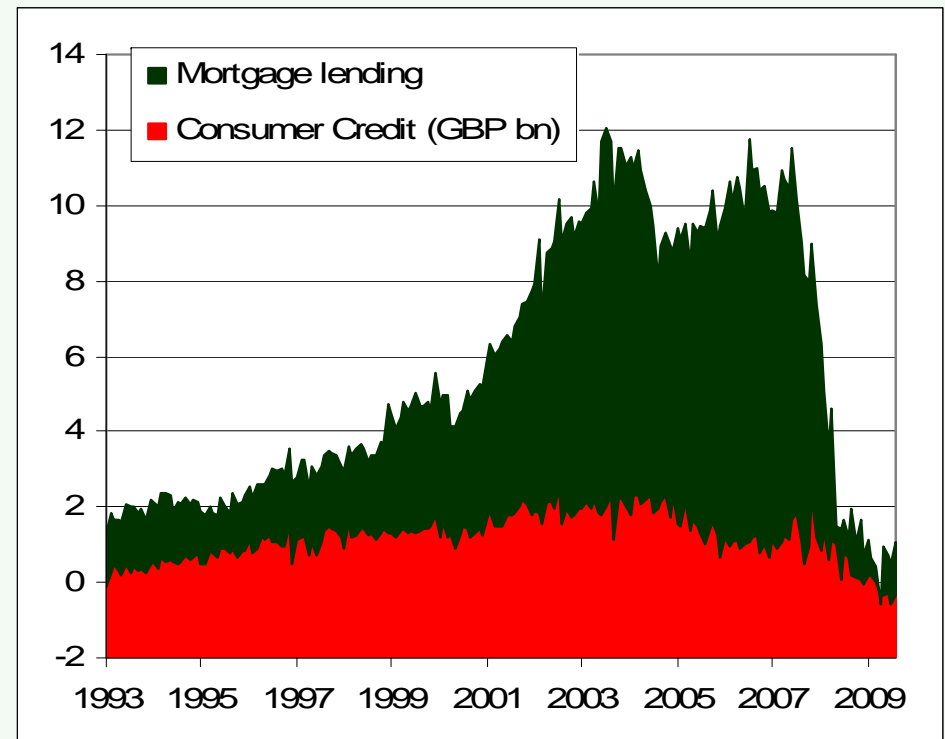


Neither inflation nor deflation



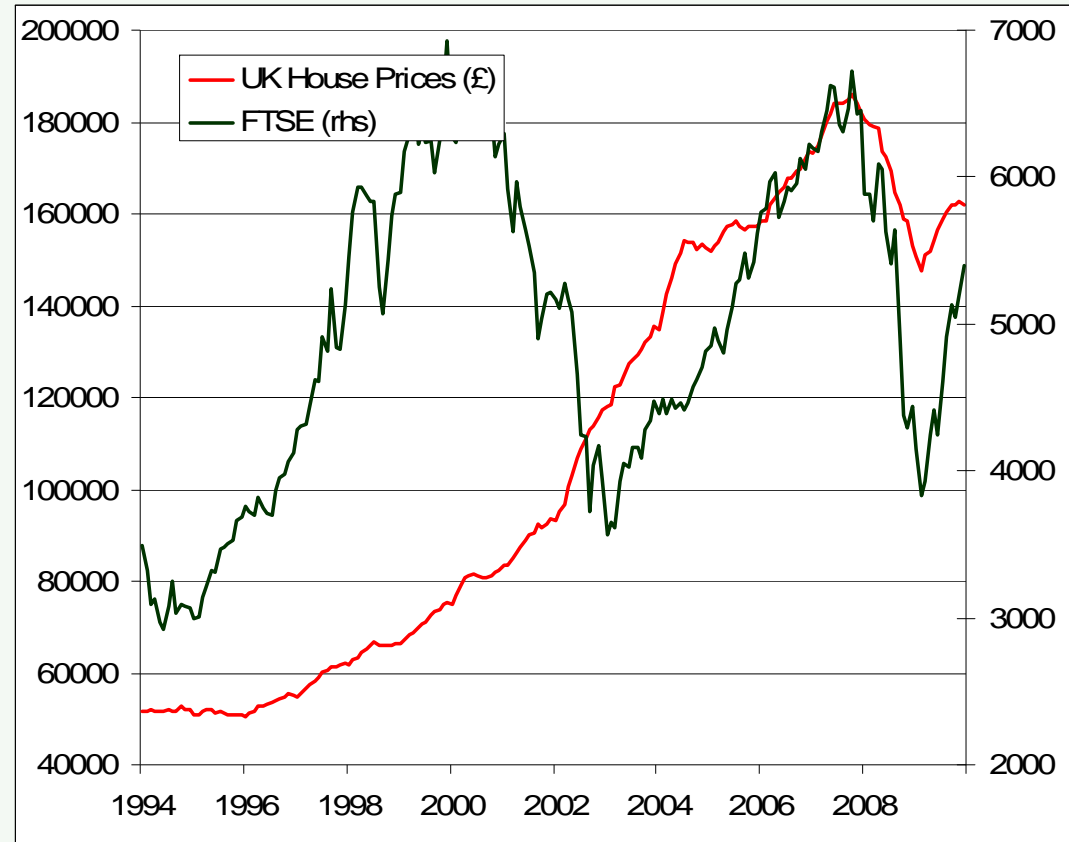
UK consumer lending still weak

- Relative to the worst days of 2009, the latest consumer credit and mortgage lending data are encouraging, but we are still a long, long way from 'normal' let alone the boom years.



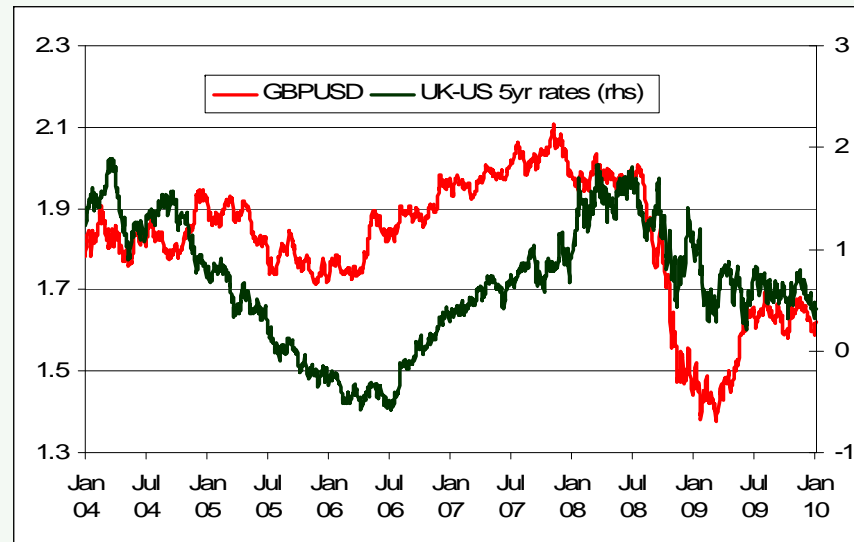
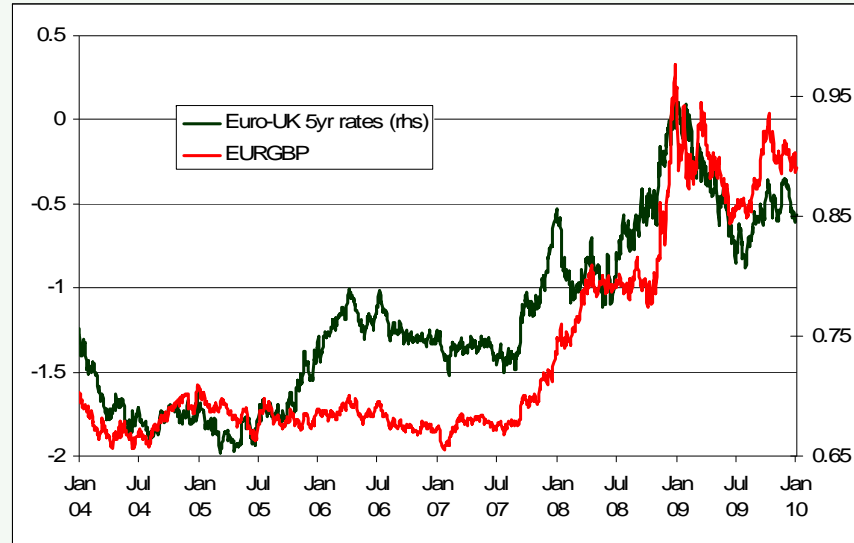
Why QE may work in the UK

- UK housing has been a better investment than equities in recent years. The virtues of a small island with limited housing supply are pretty clearly to see
- This matters because the UK economy is more sensitive to rising house prices than to rising equity prices, so if QE and asset reflation work anywhere, they may work in the UK



Sterling is forming a base

- UK rates fell dramatically between mid-2007 and early 2009, dragging sterling down.
- Path ahead is far from clear, with UK triple-A rating under threat in the absence of a credible deficit-reduction plan, with households still heavily indebted, and with the risk of a hung parliament lingering on, but rates have troughed, and are many pot-holes ahead, but monetary reflation has boosted house prices, consumer demand has bounced, and the only question is when – not if – rates go up.



- Strong start to global (inc US/UK/Eurozone) growth in 2010, but debt concerns will act as brake, in H2.
- Bank lending will revive very slowly and monetary policy will remain super-accommodative – with QE measures in place- for most if not all of 2010 and far longer in Japan.
- Stocks start well, do OK – better than credit.
- Bond yields rise early in 2010 but in the absence of rate hikes, or inflation, new major bear market is postponed. UK yields rise most.
- Low rates and a slower withdrawal of QE, are good for EM growth, and assets, and for commodities (including gold).
- G7 currencies underperform the rest. Yen is weakest of G7, but Dollar is back in downtrend in H2. None of the 'majors' looks attractive, but sterling may be the least ugly.

What's priced into forward rates?

3-m rates	Now	End 2010	ECU F'Cast	End 2011	ECU F'cast
US	0.25	1.5	1.0	2.77	3.0
Euro	0.7	1.76	1.8	2.73	3.0
Japan	0.28	0.44	0.3	0.52	0.3
UK	0.61	2.05	1.8	3.58	4.0
Switzerland	0.25	0.90	1.0	1.52	2.0
Australia	4.2	5.21	5.5	5.76	6.5
Canada	0.44	1.67	1.5	2.81	3.5

Currency Consensus

- Market is only convinced of one significant theme in 2010 – a weaker yen.
- EUR/USD, GBP/USD, and Gold all forecast to remain firmly in current trading ranges.
- ECU Conclusion –
 - BUY Gold
 - Buy AUD
 - SELL Swiss Franc

	Now	Q2	Q4
EUR/USD	1.44	1.49	1.45
USD/JPY	92	93	98
GBP/USD	1.62	1.66	1.66
USD/CHF	1.03	1.02	1.08
USD/CAD	1.05	1.03	1.08
AUD/USD	0.90	0.94	0.90
Gold	1106	1050	1100