

Executive Summary

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- Five years after the credit crisis began, Western economies are confronting the prospect of a lost decade of growth, and international diplomats are warning the damage could get even worse if Europe allows its sovereign debt crisis to fester much longer. ***The World Bank already sees the damage taking hold as European banks pull back their lending to emerging economies. It recently slashed its growth forecast more than one percentage point to 2.5% for 2012, a pace not seen since 2008 when the world was last in a global recession.***

- Still, the economic data in the first few weeks of 2012 have been better than expected, with the two global powerhouses, the United States and China holding in quite well. Even the Eurozone is surprising, with the preliminary services PMI for January suggesting the region may yet avoid recession. But, clearly, risks remain, and ***it is important that Europe's policymakers get their act together as quickly as possible in sorting out the Eurozone debt crisis once and for all, not just for the well being of the region itself but the world as a whole.***

- The extra return demanded by holders of European equities over safe-haven sovereign debt is set to retreat from record highs unless investors' worst fears over global growth come true. ***Eurozone blue chips fell 17% last year, largely on macro-economic concerns, but dividends are healthy, companies are cash rich and many can tap into growth around the world. That makes them attractive in income terms for investors shopping around and finding a negative real return on UK Gilts, US Treasuries and German Bunds when inflation is factored in.***

Swedish 10-year Government Bond Yield %



- Outside Eurozone government debt, we still remain bullish on Swedish and UK bonds, and are also keen on Norwegian paper. ***Sweden's AAA status is extremely secure and we think the debt dynamics of the country look very positive.*** Unlike most of Europe, where recriminations about irresponsible fiscal policy are the order of the day, Sweden's prudence and strong public finances have been widely praised. ***While Sweden mulls over how to maintain debt market liquidity amid low issuance, much of Europe has debt more than 100% of GDP and remains under threat of downgrades.***

- On the currency front, the US economic recovery alone is expected to push capital flows into the dollar. If growth does take root more firmly, it will reduce bets on more monetary easing, which has been a debilitating weakness for the dollar since the 2008 financial crisis. ***While it may remain above the \$1.30 level to the euro in the near-term following the Fed's first policy announcement of the year, we see the dollar appreciating back through \$1.25 towards \$1.20 over the course of 2012.***

World Economy:

Five years after the credit crisis began, Western economies are confronting the prospect of a lost decade of growth, and international diplomats are warning the damage could get even worse if Europe allows its sovereign debt crisis to fester much longer. **The World Bank already sees the damage taking hold as European banks pull back their lending to emerging economies. It recently slashed its growth forecast more than one percentage point to 2.5% for 2012, a pace not seen since 2008 when the world was last in a global recession.** Although the United States has shown encouraging signs in recent weeks, the economy remains far too feeble for any upturn to be either strong or sustained. Europe is no better off and already appears to have fallen back into a mild recession. *Goldman Sachs* calculates that per capita GDP growth in the United States has shrunk by 0.7% each year between 2007 and 2011, compared with 2.0% growth in the decade prior to the recession. In the Eurozone, the decline has been similar, 0.6% drop against a 1.8% pre-recession growth rate. The concern is that the destruction of skills and capital investment caused by recession and slow growth rates will lead to a structurally lower rate of growth and higher rate of unemployment for a protracted period. If left unchecked, it would make it even harder to handle huge government debt loads, making the growth outlook even less stable. **Some analysts believe the United States will be trapped in a low growth cycle throughout the rest of this decade, at least until household debt levels are paid down, businesses have restructured to regain competitiveness and wage growth has returned.**

- **lost decade of growth for the West?**

World GDP Forecasts

%	2010	2011 (f)	2012 (f)	2013 (f)
World	5.1	2.8	2.6	3.2
US	3.0	1.8	2.2	2.7
Japan	4.0	-0.8	1.9	2.0
China	10.4	9.2	8.5	9.0
Eurozone	1.9	1.0	0.2	1.0
UK	1.8	0.4	0.2	1.0
Ireland	-0.4	0.8	0.5	2.0

Canada's moment in the sun as the fastest-growing economy in the G7 club of rich countries is set to end this year, when it will likely under-perform the United States for the first time in seven years and struggle with a mounting household debt problem. A potential housing market downturn has emerged as the top threat to the economy from within, along with the grim realisation that a bad ending to the European debt crisis could set back growth in Canada, the world's 10th largest economy. Even some perennially optimistic Canadians say the economy has lost its shine, pointing to late 2011 as the turning point. **In the base case scenario, the housing situation will dampen growth as house prices grow faster than people's incomes and demand slows. In the worst case scenario, a crash could force many Canadians to default on their mortgages and really hurt the economy, although nobody expects a downturn as dramatic as the US housing price collapse.** Canada had a remarkably swift recovery from the 2008-09 economic recession and leapt ahead of the US in jobs growth, recovering the jobs lost in the recession by January 2011. But its job-creation machine has now ground to a halt and for the first time in five years it no longer leads the US in employment creation, although its jobless rate is still lower. The Bank of Canada has held its key interest rate frozen at an ultra-low 1.00% for a record sixteen months in a sign it too fears more turbulence ahead. Europe's problems, previously brushed off as having little direct impact on Canada, now loom large. **Canada has little direct exposure to European debt but the impact on the global economy of a full-blown European banking crisis could squeeze its exports, hurt confidence and make borrowings harder.** Central bank chief Mark Carney said in January that the European crisis was the biggest threat to his country by far. He also predicted the household debt to income ratio would rise further from an already alarming 153% record reached last year. But he assured business leaders that no matter how tough the times get, the banks are healthy and willing to lend.

- **Canada losing its shine**

Official Interest-Rate/Monetary Policy Outlook:

Federal Reserve Chairman Ben Bernanke said after the first FOMC meeting of 2012 that the US central bank was ready to offer the economy additional stimulus after it announced it would likely keep official interest rates near zero until at least 2014. The Fed also took the historic step of adopting an explicit inflation target, though Bernanke took pains to stress that officials would be flexible about reining in price growth when unemployment was too high. The late 2014 timeframe for the first rate hike was considerably later than investors had expected and some 18 months later than the Fed suggested last year. **Speaking at a news conference after the two-day policy meeting in January, Bernanke was cautious about recent improvements in the US economy and left the door open to further Fed bond purchases.** In response to the deepest recession in generations, the US central bank slashed the overnight federal funds rate to near zero in December 2008. It has also more than tripled the size of its balance sheet to around €2.9trillion through two separate bond purchase programmes. The policy is credited with preventing an even more devastating downturn, but it has been insufficient to bring US unemployment down to levels considered normal during good economic times.

• **first US rate hike now unlikely until 2014**

Official Interest Rates 2012

	Current	End Mar (f)	End June (f)	End Sept (f)	End Dec (f)
US	0.25	0.25	0.25	0.25	0.25
Eurozone	1.00	0.75	0.75	0.75	0.75
Japan	0	0	0	0	0
UK	0.50	0.50	0.50	0.50	0.50
Canada	1.00	1.00	1.00	1.00	1.00
Sweden	1.75	1.50	1.50	1.50	1.75
Norway	1.75	1.75	1.75	1.75	2.00
Switzerland	0	0	0	0	0.25
Australia	4.25	4.00	4.00	4.00	4.25
New Zealand	2.50	2.50	2.50	2.50	3.00
China	6.56	6.56	6.29	6.02	6.02

Fed officials agreed that a goal of 2.0% inflation would be in keeping with their congressional mandate of price stability. By their favourite measure, core inflation is running at about 1.7%. They declined to announce a target for unemployment, saying the labour market was often influenced by forces beyond their control. **In another key shift touted as part of an effort toward greater transparency, the Fed for the first time published policymakers' projections for the appropriate path of the benchmark overnight federal funds rate.** Those showed a wide range of views, from the three of 17 policymakers who said they thought rates should rise this year to two who want to hold off any increase until 2016. Still, the biggest concentration of estimates, five of 2017, was around 2014. In its announcement, the central bank repeated its view that the economy faced "significant downside risks", an expression that has become code for the threat Europe's debt crisis poses to the United States. In economic forecasts accompanying the rate projections, the Fed pointed to somewhat weaker GDP growth this year and next, compared with estimates published in November. Meanwhile, the unemployment rate, which hit 8.5% in December, was seen coming down only slowly. **Richmond Federal Reserve Bank President Jeffrey Lacker, an inflation hawk who rotated into a voting panel seat on the FOMC this year, dissented against the policy decision, preferring to omit the late-2014 date from the Fed's post-meeting statement.** The central bank appeared more sanguine on inflation than it had after its last meeting in December, saying prices were likely to run close to or just below its target. The statement dropped a reference to the Fed monitoring inflation and inflation expectations. Overall, though, aside from the 2014 rate pledge, the January statement hewed closely to the Fed's last policy announcement in mid-December.

• **range of views**

Currencies:

The dollar's many detractors may have missed it, but the much-maligned US currency is on the rise. The greenback, thought to be on life support and mostly surviving on safe-haven flows, hit bottom three years ago and is now in a long-term recovery. The greenback has been climbing since it struck record lows against the euro in July 2008, helped recently by the Eurozone debt crisis, an improving American economy and a return to the dollar as the reserve currency of choice. The US economic recovery alone is expected to push capital flows into the dollar. If growth does take root more firmly, it will reduce bets on more monetary easing, which has been a debilitating weakness for the dollar since the 2008 financial crisis. The market is starting to agree in a way that it hasn't in nearly a decade. **A key factor that points to more dollar strength can be found in the options market, where bets on the greenback's path against the yen is closer to favouring the dollar more than at any time in the last nine years.** Although up 13.6% from the trough in 2008, the ICE Futures US dollar index is currently closer to that bottom than its peak, suggesting more room for improvement. **With the euro, which comprises 57.6% of the index, expected to fall towards \$1.20 over the next few months, the index is bound to move higher.** The euro has lost 19.5% since its last peak in 2008. The six-member dollar index, composed of the euro, Japanese yen, British pound, Canadian dollar, Swedish krona and Swiss franc, troughed at 70.698 on March 17, 2008 as the euro was testing its peak.

- **options market points to dollar strength**

Spot Exchange Rates 2012

	Current	End Mar (f)	End June (f)	End Sep (f)	End Dec (f)
€/GBP	0.8380	0.8300	0.8200	0.8200	0.8300
€/\$	1.32	1.27	1.24	1.22	1.25
€/Yen	102	98	96	98	102
\$/Yen	78	77	77	80	82
GBP/\$	1.57	1.53	1.51	1.49	1.51

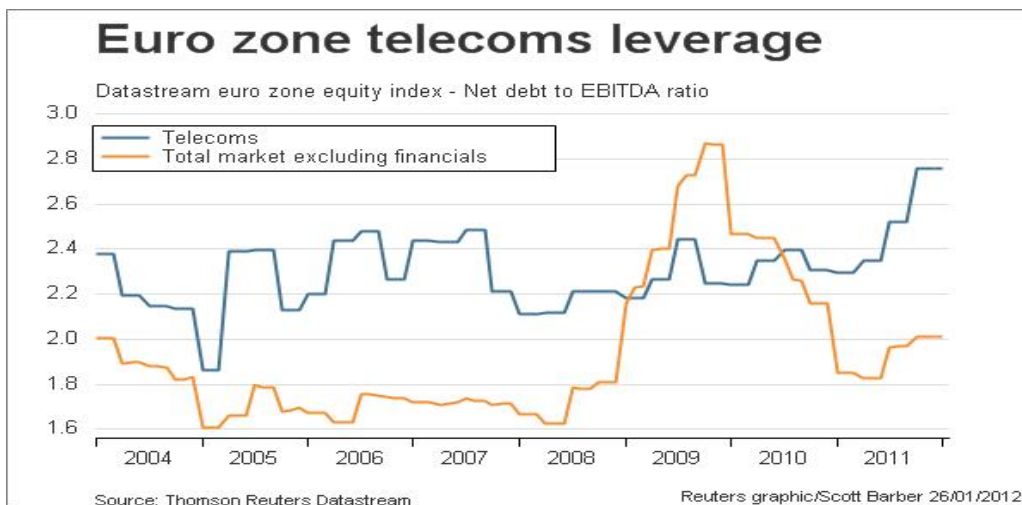
International foreign currency reserves data also point to better days for the dollar despite rhetoric in recent years about finding alternatives to the greenback. *The International Monetary Fund's Currency Composition of Official Foreign Exchange Reserves* data show the dollar's share of known global currency reserves rose 1.9% in the third quarter over the second quarter to 61.7%, while the euro's holdings were down 0.9% to 25.7% from a year earlier. **The dollar comprised 62.1% of known reserves as late as the second quarter of 2010 before falling to 60.2% in the second quarter of 2011.** Now it's again rising, indicating higher dollar demand that will lift the US currency. Other countries appear unenthused about assuming a bigger role as an international reserve, especially if it means export-dampening currency appreciation. Many thought the euro would rival the dollar as the world's reserve currency, but that notion faded in the face of fears that the Eurozone's days might actually be numbered. Japan and Switzerland have made clear they will not tolerate further appreciation in their currencies, traditionally seen as safe havens. The Swiss National Bank imposed a floor on the euro/franc at 1.20 which also keeps the Swiss currency weak against the dollar. The Bank of Japan intervened heavily against yen strength on October 31 last when the dollar hit a record low against the yen. China's yuan has been allowed to slowly appreciate against the dollar and the Middle Kingdom may have goals that include the yuan becoming a reserve currency. But there are still too few currencies that are convertible against the yuan, and its moves are tightly controlled by the Chinese authorities. Though the dollar's record lows came before the Eurozone debt crisis erupted, it is difficult to ignore the effects of Europe's troubles in aiding the greenback's resurgence. For several years, investors saw the dollar mainly as a safe-haven currency to be bought in times of uncertainty, but rock-bottom US interest rates meant they abandoned the greenback when they began to feel more optimistic about global growth. Now that correlation has broken down and positive US data have led both the dollar and US stocks higher. **Ultimately, a currency has to be supported by fundamentals, and here the United States appears to be improving, with the jobless rate dropping to 8.5% in December after a 10% peak in October 2009.**

- **reserves data also dollar positive**

Equities:

Europe's telecom shares have long been seen as safe houses when the wolf is at the door, but recession, fierce competition and costly network upgrades are huffing and puffing at their capacity to pay generous dividends. The first walls came down when *Telefonica* and *Telekom Austria* cut their dividends in December, breaking a taboo in a sector that has compensated investors for low growth with high dividend yields. Now the feeling among analysts is that *France Telecom*, *Telecom Italia* and *Portugal Telecom* could be next to cut payouts for this year or next. With lower dividends, the traditional operators, especially the former state-owned monopolies saddled with high costs and debt, have little left to woo equity investors. **Unlike US peers such as AT&T and Verizon, Europe's telcos have not yet managed to translate consumers' growing appetite for smart-phones and tablet computers into profit. Competition is pushing mobile prices down in many markets, while the need to invest heavily in fibre broadband build-outs and new fourth generation mobile networks is pressing.**

- **generous dividends seen on the chopping block**



To be sure, some companies in the sector still have something to offer, including growth-oriented shares like France's new mobile entrant *Iliad* and cable operators like *Kabel Deutschland*. But among the big telcos, only *Vodafone* and *Telenor* seem made of brick, fortified by their growth in the emerging markets of Asia and Africa, and the relative strength of their European units. Both have been increasing dividends in recent years and aim to keep doing so. Overall, European telecom sector shares are trading near 10-year lows. The sector's 12-month forward price-to-earnings ratio is 9.5, compared with 9.9 for utilities, 11.4 for healthcare and 14.7 for consumer goods. Meanwhile, the sector's average dividend yield is 7.2%, a high not seen since 1987, and more than double the average yield for the broader European market. While such high yields may seem attractive at first glance, they are a product of weak valuations, which are paradoxically a sign that investors no longer believe in the companies' ability to keep paying bumper dividends. **Investors looking for places to ride out market shocks are increasingly preferring other defensive sectors, such as healthcare or food and beverages. In the past year, European telecom shares have fallen 10.3%, while healthcare has risen 13.2% and food and beverages are up 7.2%.**

- **investors moving away to other defensive sectors**

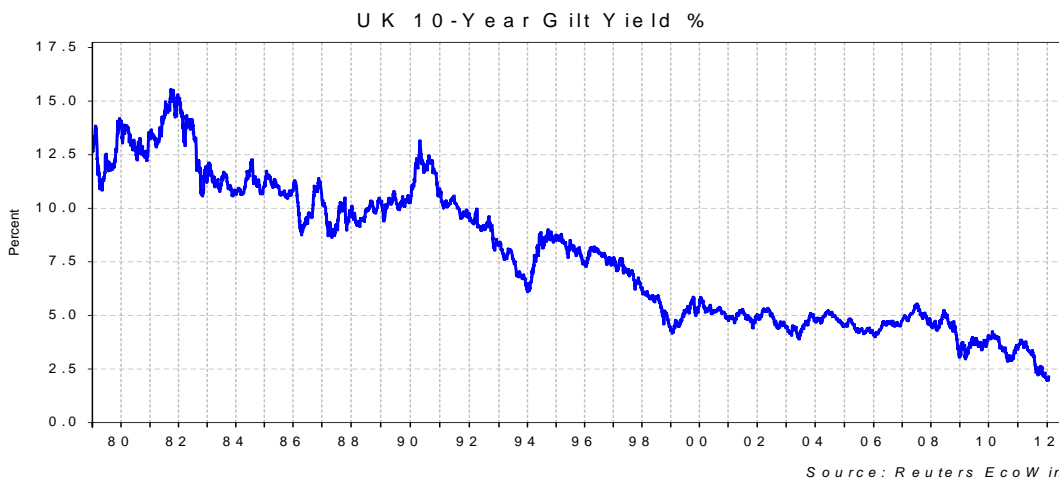
Europe's deep sovereign debt crisis is aggravating matters for the telecoms majors, with the risks of higher taxes from cash-strapped governments, austerity measures taking cash out of the hands of consumers, and rising debt costs. Operators in Italy, Spain, Portugal and Greece in particular have seen borrowing costs rise as credit conditions tighten. **Telecom operators have long been able to raise large amounts of debt on bond markets at relatively favourable rates because of their steady cash flows, and so tend to be highly leveraged. Now investors are directly linking telecom operators to their respective country's credit rating.**

- **Eurozone telecoms will face higher borrowing costs as result of sovereign debt crisis**

Bonds:

Outside of the Eurozone, we remain particularly keen Sweden and its bond market. Swedish government bonds look set to make further gains this year as investors look for a safe-haven for their cash and the country's central bank lowers rates again to help a slowing economy. Investors have piled into Swedish assets recently, pushing government debt yields to record lows and helping the currency hold near 10-year highs versus the euro despite a historic tendency to weaken during periods of economic turmoil. Strong government finances, in contrast to most of Europe, are limiting debt issuance and, together with the expectation of easier monetary policy, will support prices over the coming year. **Sweden's AAA status is extremely secure and we think the debt dynamics of the country look very positive.** There is still a relative scarcity of Swedish government debt and in the grand scheme of things there is going to be continued global demand for an AAA country like Sweden. Unlike most of Europe, where recriminations about irresponsible fiscal policy are the order of the day, Sweden's prudence and strong public finances have been widely praised. After a sharp recession in 2009, the Swedish government has restored a balanced budget and debt levels are expected to drop below 30% of national output in the coming years. **While Sweden mulls over how to maintain debt market liquidity amid low issuance, much of Europe has debt more than 100% of GDP and remains under threat of downgrades.**

- **Sweden's AAA status very secure**



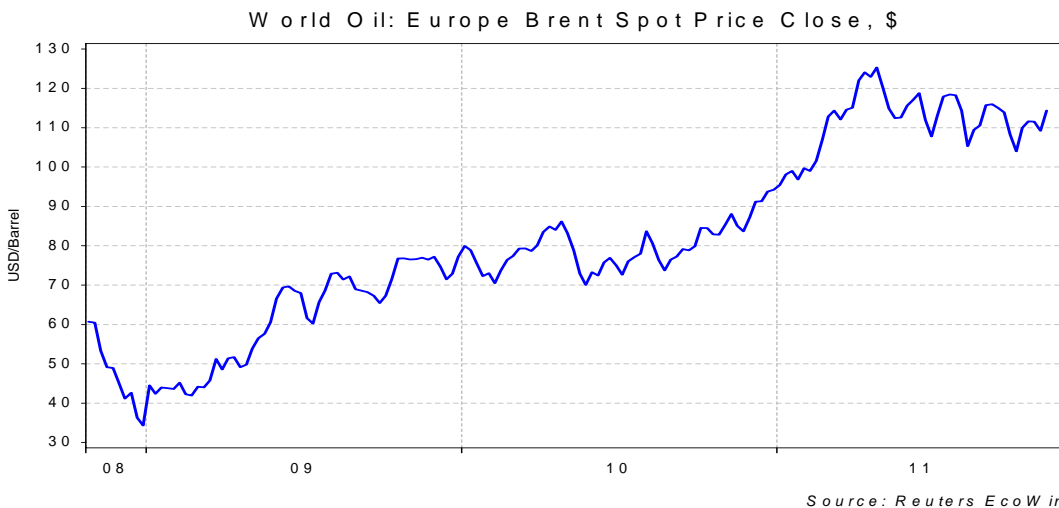
Meanwhile, the latest data from the Bank of England showed foreign appetite for Gilts remained strong in November and the break of the psychological 2.00% level on benchmark 10-year bonds in December suggests the buyers remained active. The figures showed net purchases surged to £16.3bn for November and followed £12.5bn purchases in October and £9.2bn in September. **The purchases over these three months were the strongest since the Bank started to collect the data in 1982.** We continue to see a positive case for Gilts based on (1) a shrinking universe of safe havens; (2) the premium markets attach to the policy flexibility enjoyed by the UK and (3) the fact the Bank is buying and expected to buy more bonds creating a favourable supply/demand backdrop. We saw a dip below 2.00% in December but we can in our view look forward to more sustained trading below 2.00% over the coming months as investors continue to shun risk in favour of preserving capital. Now that 2.00% has been broken there is no reason why we cannot see yields pushing down towards 1.00%. Clearly such a scenario for Gilt yields rests on the world continuing to be a risky place for investors. It is worth remembering how during the 1990s, 10-year JGB yields were seen with a floor at 2.50% only to give way below 2.00%, and then fall below 1.00%, and then briefly in 2003 for yields to dip below 0.50%. **We don't expect things to move in a linear/straight-line fashion and while bears will have their day on a periodic basis, we still see Gilt yields moving lower still.** Even if the UK loses its AAA status we think this will be a temporary blip to the case for much lower Gilt yields. A material change in the economic growth landscape would be needed for us to change our opinion that UK government bond yields are headed lower. There may be some concerns on the currency front, but even allowing for the probability of more quantitative easing, we think sterling will appreciate versus the euro on a 6-month view.

- **Gilt yields have further to fall**

Oil:

Saudi Arabia's endorsement of an oil price of \$100 a barrel increases OPEC unity over a triple-digit price aspiration, making agreement on policy easier and adding support for the market. Ali al-Naimi, oil minister for the world's top oil exporter, said earlier this month he hoped to stabilise oil prices at "around \$100" for an average of crudes worldwide. Other members of the Organisation of the Petroleum Exporting Countries (OPEC) such as price hawks Iran and Venezuela have long called for prices to be at or above \$100, but not Saudi Arabia, its largest producer and most influential member. **Brent is currently trading at just over \$110 a barrel, down from a 2011 peak of \$127 and an all-time high of \$147 reached in 2008. Last year's annual average for Brent around \$111 was the highest ever.** However, Naimi did not make clear which benchmark oil price he was referring to. As well as that, other OPEC members have said it is wrong to see the comments as setting a price target, adding that while Saudi Arabia hoped for oil at around \$100 a barrel, no single player can dictate what the price is. That said, the feeling in the market is that there appears to be increased signs of unity within the 12-member group, which pumps more than a third of the world's oil. Before Naimi's comments, Riyadh had not specified a preferred price level since it said it favoured \$75 a barrel in November 2008, although he later said that was no longer valid.

- **Saudi broadens OPEC consensus around \$100 oil**



OPEC's hawks and doves fell out last year over the group's response to the loss of Libyan crude during the country's civil war. Iran, Venezuela and African countries opposed a Saudi-led proposal to boost output at OPEC's June 2011 meeting. The meeting collapsed without agreement, and Saudi Arabia and the Gulf Arab countries raised supplies anyway. The group settled the argument in Saudi Arabia's favour at a meeting in December, held in Vienna. **The greater unity over prices could make it even easier for OPEC to reach consensus on policy and provide a point to rally around.** At December's talks in Vienna, OPEC adopted a supply target of 30 million barrels per day. This brought the extra oil the Gulf countries had pumped to meet the Libyan shortfall within official OPEC limits. Naimi's comments also acknowledged the reality that oil prices are subject to upward pressures stemming from social developments in North Africa and the Middle East, as well as industry trends. Oil revenue needs in OPEC countries have risen sharply following announcements of increased social spending on their growing populations as they seek to counter Arab Spring unrest. And oil industry costs are rising as companies work on more complex projects. BP Chief Executive Bob Dudley said in October more people were pencilling in \$90 to \$100 when asked what price his company needed to make money from new ventures. The OPEC price hawks, compared with the Gulf Arab countries, have large populations and little or no ability to earn extra dollars by pumping more oil at short notice. While the gap in their price aspirations has narrowed, it is still there. OPEC countries are increasingly united around higher prices, but out of necessity rather than because they share a common outlook. **Crucially, the hawks still in general terms need prices to be at least \$100 a barrel or even slightly more to balance their budgets, while for Saudi Arabia it is still a level of considerable comfort.**

- **two camps**

Eurozone Debt Crisis:

There are weeks when it can sound as if the European sovereign debt crisis is going round in circles. Barbed exchanges between Italian Prime Minister Mario Monti and German Chancellor Angela Merkel carry echoes of a prolonged dialogue of the deaf between Greece and Germany two years ago when Berlin was resisting calls to bail out Athens. Then as now, a debt-stricken government pushing through spending cuts, tax rises and economic reforms pleaded for lower interest rates and stronger European (read German) support to convince citizens the pain is worthwhile. Once again, a Chancellor constrained by public hostility in her own country to bailouts and convinced only market pressure can keep profligate nations on a path of righteousness is turning a deaf ear, saying there is no need to act since no one is requesting aid. **The delay in acting to help Greece in early 2010 undermined financial market confidence in the 17-nation single European currency, which has still not been wholly restored, and raised the cost of the eventual rescue.** But it's not all déjà vu, because Germany has far more confidence in Monti's Italy than it ever had in Greece. As a result, **EU officials expect Merkel to relent and agree to a bigger European financial firewall in March once Eurozone leaders have signed two key treaties sought by Berlin on budget discipline and the rules of a permanent rescue fund.** In the meantime, Italians fretting about tax rises and public spending cuts can draw some consolation from their country's declining borrowing costs on the bond market despite Standard & Poor's double-notch downgrade of Italy's credit rating to BBB+ on January 13.

- *same old same old*

If there is no tangible reward for their efforts, Italians could turn against Europe and against Germany, Monti has warned. **He has also voiced support for common Eurozone bonds as a longer-term solution, which is anathema to Merkel.** In the short-term, Monti wants Berlin to increase the size of the Eurozone's rescue fund for countries shut out of capital markets. He believes that the more money is pledged to the fund, the less likely it is to have to spend a single euro. But Germany has ruled out increasing its contribution to the rescue fund. In public, Merkel has expressed admiration for Monti's bold pension and business reforms, and the Italian leader has lauded Germany's social market economy as a model for all of Europe. Privately, though, German and Italian officials are sometimes less complimentary about each other. While they respect Monti, a former EU Commissioner, the Germans are quick to recall that his predecessor, Silvio Berlusconi, went back on promised deficit reduction steps as soon as the European Central Bank stepped in to rescue Rome last August by buying its bonds.

- *once-bitten, twice shy*

Italy could apply for the European Financial Stability Facility (EFSF) to buy or insure its new bonds. But some in Berlin say Rome wants to avoid the stigma and the strict conditions and intrusive supervision that would come with such assistance. In German eyes, it seems perverse to press for a bigger firewall when the money in the existing temporary rescue fund is not being tapped. Increasing the amount available might only whet the market's appetite for more. Besides, it would be difficult to get Merkel's centre-right coalition to approve another increase in parliament after she repeatedly promised lawmakers last year that Germany's total liability would be pegged at €211bn. **European officials expect Berlin will eventually allow the two rescue funds — the temporary European Financial Stability Facility and the permanent European Stability Mechanism (ESM), to run in parallel from July for an extended period.** That would provide a combined capacity of nearly €1 trillion, even if the EFSF has to live with an AA+ rather than a triple-A credit rating after some of its key guarantors, especially France, were downgraded.

- *EFSF and ESM funds to run in parallel?*

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