

EURO ZONE CONFIDENCE RETURNS

- Growth forecasts rise in Europe as some confidence returns
- European Central Bank has calmed nerves but not solved the problems
- Negotiations continue in Greece but political interference does not help
- Regional bond markets to benefit from low US \$ interest rates
- Gold one of the best asset classes in January



It is easy to get carried away with a positive view of the markets. Interest rates are falling, markets are rising and global economic activity has surprised to the upside. To be sure the European's have at least stabilised the crisis. However we have to remain mindful that stability does not mean solutions. Europe faces a multi-year adjustment of very low growth, high unemployment and a fragile financial sector. We remain cautiously optimistic recognizing that a slip up in Europe still has the power to drag down the markets after the recent rally.

Global economic data has gently surprised to the upside on a broad front in recent weeks. Indeed even in the Euro area we have seen economists upgrading their 2012 GDP growth forecasts. The flash estimate of European area industrial confidence for January improved from 48.3 to 50.4, well ahead of market expectations. In particular German and French confidence improved reflecting more stable financial conditions. The overall level of Euro zone confidence is consistent with a Euro zone economy that is marginally growing rather than in recession.

There is no doubting that European Central Bank action to stabilise the Euro zone financial system has worked. Late last year the ECB gave the banks the opportunity to swap illiquid poor quality assets for higher quality capital for a period of three years. The banks were thus able to materially improve their balance sheets without having to resort to the panic selling of assets at distressed prices. In late February the ECB will again offer a further tranche of the same facility. We expect a number of Euro zone financial institutions to take the opportunity to rebuild their balance sheets. With €1.2 trillion of bank debt maturing in the next two years banks will want to use the opportunity to prefund themselves.

The greater confidence in the Euro zone has led to materially lower long term interest rates in much but not all of the Euro zone. Italian 10 year yields have fallen below 6% and Spanish yields below 5%. German 30 year bond yields have fallen to the lowest level (2.6%) since the inception of the Euro. However it is not all good news. Portuguese 10 year yields have risen to a record high of 14.5%.

Let's not fool ourselves – there may be a good measure of positive news there are also a number of challenges. The situation in Greece continues to lurch backwards and forwards. Negotiations to restructure Greek debt continue without conclusion although expectations are still high that an agreement can be reached. More disturbing is the attitude of the IMF and

certain Euro zone governments that believe they can in some way dictate to Greece what they can and can't do with taxes and government spending. Greece is a democracy where the people choose their leaders. For other countries to suggest that they would impose their will on a sovereign country is obscene. The imposition by any unelected officials on a Greek nation is a recipe for geopolitical disaster. The IMF, French and German governments need to back off.

Low dollar interest rates could be with us for some time to come. In the first ever survey of US Federal Reserve governors the majority view was that the US would maintain near zero interest rates until 2014. Dollars could be flowing around the world seeking enhanced returns for some time to come. We cannot stress strongly enough the potential upside for regional bonds and emerging market bonds. A near zero interest rate until 2014 would encourage more and more investors to seek out other dollar or dollar linked fixed income securities such as Dirham bonds for enhanced yield.

It may be difficult for equities to push too much higher unless there is some particular positive. The markets are getting close to their recent three year high which may prove to be something of a challenge for the markets in the near term. To push through these levels will require even greater confidence that the news flow will remain consistently positive. In the very near term attention will remain on fourth quarter company results. In the US, with about 20% of companies having reported around 60% of companies have reported profits ahead of expectations. In Europe there is more of a struggle as earnings forecasts for 2012 continue to fall reflecting the weakness of the economy in the fourth quarter. The recent improvement in industrial confidence has yet to lead to companies signaling that profit growth is also improving.

The early part of the year has seen the partial recovery of the Indian financial markets. Investors were given a positive surprise last week when the Central Bank surprised investors by cutting the reserve requirements of banks by 50 basis points. The reserve requirement was previously aggressively increased to curb lending by banks. In the year-to-date foreign investors have bought US\$700million of cash equities and US\$200million of fixed income securities. We are still skeptical that the Indian equity market can give consistent positive returns to investors this year. The Indian equity market trades at a relatively high valuation compared to other emerging markets and the economy is still not clear of problems. Indian economic growth will be constrained by the need of the government to rein in spending. Without spending cuts the central bank is unlikely to give the interest rate cuts markets desire.

As at late January Gold was the best performing asset class in the year-to-date with a return of close to 11% to a price of \$1730. The recovery from the slump to 1550 in late December is all the more remarkable given the marked weakness of demand from India seen in late 2011. The Fed's statement that US interest rates will remain low for longer has provided a further spur to demand for gold. Low interest rates mean that investors do not have to forgo significant interest income by investing in gold. Gold has also benefitted from news of persistent buying by Chinese institutions and individuals.

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