



# Monthly Economic and Market Summary

10 February 2010

## Executive Summary

- **Global recession ended**, supported by unprecedented coordinated fiscal and monetary action.
- **2010 GDP growth forecast**: start strong before slowing down in the second half, to then fade to mild growth in 2011 as tax rates move up and interest rates rise along with inflation rates. Long-term structural issues.
- We are even **more positive** than the consensus for 2010, especially for the first half of the year.
- Since September, we have been **more optimistic** than the consensus on the US labour market due to very good corporate earnings and profitability.
- We are **more pessimistic** than the consensus for 2011, as exit strategies will be implemented. Higher interest rates, lower public spending, higher taxes to deal with the growing debts and more regulation will lower growth potential.
- Growth in the **euro zone will be slower than in the US**.
- The ongoing **re-balancing of the global economy** implies that the dispersion in growth rates between the over-indebted, ageing Western world and the cash-rich, young and dynamic Emerging countries will continue.
- **Budget deficits** have exploded in 2009. Strict fiscal discipline is required.
- **Inflationary pressures** are increasing, becoming a longer-term issue.
- **Interest rates** will likely be kept low for now; the turning point is expected to be the end of 2010.
- **EM** are expected to increase rates sooner as better growth will lead to inflation pressure.

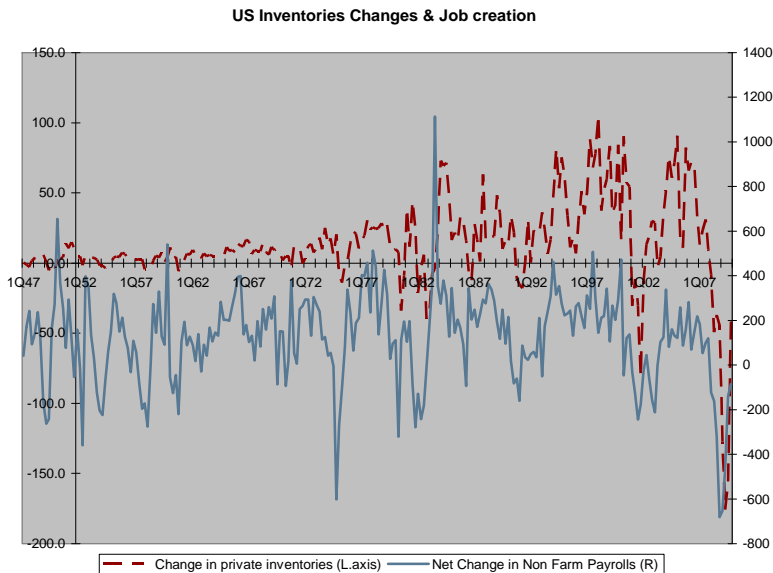
## Executive Summary

- **January correction**, but still in the cyclical trend. In the second half of the year, markets are expected to be driven more by structural issues.
- **Less liquidity** means that **de-correlation** will be back.
  - **Equities** OW (3mo) N(12mo)
    - Good environment due to inventory build-up, positive earnings revision, good liquidity and improved US labour market.
    - EM equities: N(3mo) N(12mo).
  - **Fixed income** UW(3mo) UW(12mo)
    - Markets performed well in January.
    - We are bearish on government bonds due to sovereign debt sustainability issues and expectations of monetary tightening. We are more positive on corporate bonds and EM local currency debt. We recommend inflation-linked bonds and favour short duration.
  - **Forex** OW(3mo) UW(12mo)
    - Recent positive USD trend, likely followed by renewed weakness in the medium term. Pressure on the EUR.
  - **Commodities** N(3mo) N(12mo)
    - 2009 positive trend has reversed as more challenging environment in 2010.
- **Risks** include long-term structural issues, policy mistake, exit strategies, China's growth, quality of growth, surge in government debt and new regulatory regime.

# Global Macroeconomic Outlook

## Global Growth

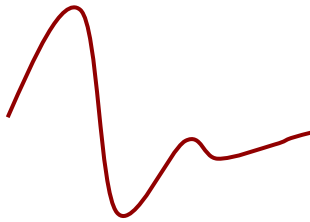
- **Global recession ended**, supported by unprecedented coordinated fiscal and monetary action. GDP growth consensus forecasts are up for 2010. The year will see economic growth start strong before slowing down in the second half to then fade to mild growth in 2011 as tax rates move up and interest rates rise along with inflation rates. Slow growth is also due to the existing structural issues and the absence of long-term growth drivers.



- We are even **more positive** than the consensus for 2010, especially the first half of the year, as short-term growth is driven by strong inventory build-up and investment – consumption on the other hand is still affected by de-leveraging. This impacts positively the employment market and, since September, we have been **more optimistic** than the consensus, believing the US job market will improve more and more rapidly due to very good corporate earnings and profitability. US corporations have managed very well their cost structure and have adapted extremely quickly to the financials crisis. So unemployment grew fast and strong - dramatic job losses in the US - and inventory fell in 2009 to extreme levels – worst inventory drawdown since WWII. Today, companies remain prudent on their hiring plans but the environment is slowly improving. US GDP grew by 5.7% in Q4/09, which was a positive surprise.

## Global Macroeconomic Outlook

### Scenario A



(Probability 60%)

- We are however **more pessimistic** than the consensus for 2011, as exit strategies will be implemented. Higher interest rates, lower public spending, higher taxes to deal with the growing debts and more regulation will lower growth potential. → Sub-par long-term growth. Our main scenario presents economic rebound, potentially followed by another small dip, then slower, sub-par growth in the longer term (US GDP around 2.0%).
- The **euro zone** will witness **slower growth** than in the US as it is less flexible. Also, incentives have been modest and budget deficits are high. Furthermore, as exemplified by the recent debt crisis in Greece, Europe is struggling with its weaker members (Portugal, Italy, Spain).
- The ongoing **re-balancing of the global economy** implies that the dispersion in growth rates between the over-indebted, ageing Western world and the cash-rich, young and dynamic Emerging countries will continue. Emerging Market (EM) economies are in a better shape than mature economies, they have healthier finances and benefit from higher growth potential. We expect EM to witness stronger and faster recovery also because they were less leveraged and did not burden their debt positions by adopting massive 'rescue packages'.

# Global MacroEconomic Outlook

## Public finance

- Budget deficits have exploded in 2009. They should decrease slightly this year, helped by the expected mild growth. Simultaneous government retrenchment and monetary tightening would clearly increase the risk of a double-dip scenario. Although markets are trying to force immediate fiscal rigour, we expect monetary policy to be tightened before fiscal policy because many countries are facing an election year and most central bankers understand that continued liquidity flooding is a risk. The sub-par growth rates anticipated for the longer term would leave structural deficits untouched, which will eventually require **strict fiscal discipline**. This will likely impact growth for the next 3-5 years.

### Global budget deficits

| Country                  | 2002  | 2003  | 2004  | 2005  | 2006  | 2007  | 2008  | 2009   | 2010  | 2011  |
|--------------------------|-------|-------|-------|-------|-------|-------|-------|--------|-------|-------|
| United States (% of GDP) | -2.2  | -3.5  | -3.3  | -2.5  | -1.5  | -1.3  | -4.7  | -10.2  | -9.1  | -7.2  |
| Euro (% of GDP)          | -2.6  | -3.1  | -2.9  | -2.5  | -1.3  | -0.6  | -2    | -6.15  | -6.95 | -6    |
| Japan (% of GDP)         | -8.03 | -7.89 | -6.15 | -6.7  | -1.63 | -2.39 | -2.12 | -6.6   | --    | --    |
| United Kingdom (% of GD  | -1.78 | -3.27 | -3.51 | -3.28 | -2.52 | -2.31 | -2.68 | -12.6  | -11.9 | -9.4  |
| Canada (% of GDP)        | -0.1  | -0.1  | 0.9   | 1.5   | 1.6   | 1.6   | 0.1   | -4.8   | -2.65 | -1.6  |
| Australia (% of GDP)     | --    | --    | --    | --    | --    | --    | --    | --     | -4.1  | -2.31 |
| New Zealand (% of GDP)   | --    | --    | --    | --    | --    | --    | --    | --     | --    | --    |
| Switzerland (% of GDP)   | --    | --    | --    | --    | --    | --    | --    | -1     | -1.5  | -0.85 |
| Denmark (% of GDP)       | --    | --    | --    | --    | --    | --    | --    | --     | --    | --    |
| Norway (% of GDP)        | --    | --    | --    | --    | --    | --    | --    | --     | --    | --    |
| Sweden (% of GDP)        | --    | --    | --    | --    | --    | --    | --    | -2.2   | -3.3  | -2.6  |
| Germany (% of GDP)       | -3.7  | -4    | -3.8  | -3.3  | -1.6  | 0.2   | 0     | -3.2   | -5.35 | -4.25 |
| France (% of GDP)        | -3.1  | -4.1  | -3.6  | -2.9  | -2.3  | -2.7  | -3.4  | -8     | -8.3  | -7.5  |
| Italy (% of GDP)         | -2.9  | -3.5  | -3.5  | -4.3  | -3.3  | -1.5  | -2.7  | 5.2    | 5.3   | 4.5   |
| Spain (% of GDP)         | -0.5  | -0.2  | -0.3  | 1     | 2     | 1.9   | -4.1  | -10.95 | -10.5 | -9.5  |

Source: Bloomberg – Feb 2010

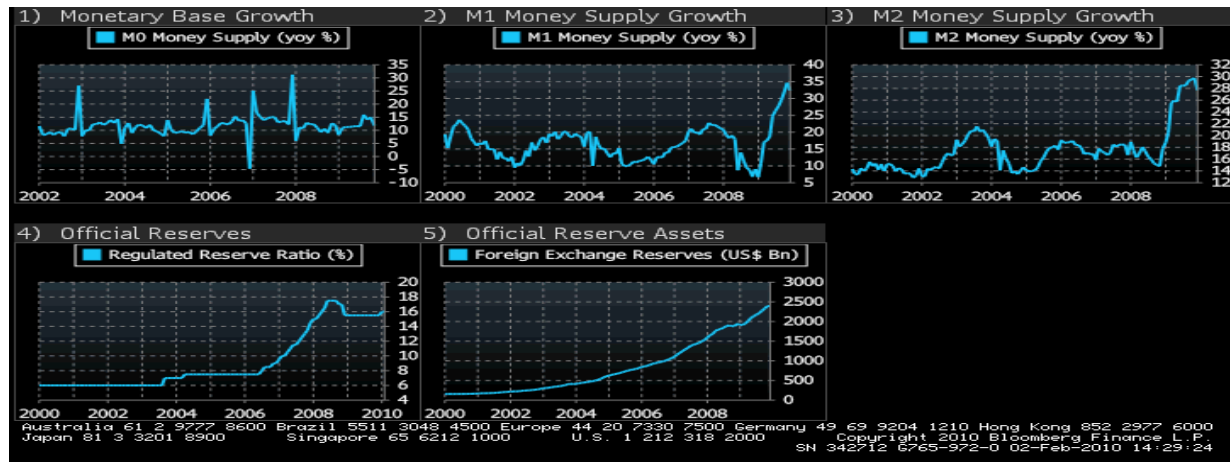
## Inflation

- Given the poor public finance situation, the fiscal constraint is so large governments could be tempted to let inflation rise to deal with part of the surging deficits and rapidly increasing debts. Asset prices are expressing that future **inflation is a sure thing**. There is no near-term risk in the developed world yet (except in the UK), but in the longer term (2011-2013) US CPI could reach 4-6%. The question is: how much inflation will central bankers tolerate?
- There is a higher short-term risk on the Emerging economies as their growth will be more dynamic.

# Monetary Policy

- US Federal Reserve: 0-025%: European Central Bank: 1.00%; Bank of England: 0.50%; Bank of Japan: 0.10%; Swiss National Bank: 0.25%.
- Rates will likely be kept **low for now** as growth is fragile and de-leveraging is still going on. Inflation pressures are not a short-term issue and public debt to GDP ratios are high and increasing, so growth is needed. Nevertheless, expectations of rate hikes in the medium term are increasing due to stronger US data, especially in the labour market. The US and the UK are expected to start tightening at the end of 2010 (turning point). Exit strategies in the developed world are likely to be a slow and gradual.
- The European Central Bank is facing a credibility test with the credit crisis in Greece.
- **EM** are expected to **tighten their monetary policy sooner** and, maybe, faster as better growth will lead to inflation pressure. They are also less indebted. China has already hiked its reserve requirements and curbed down loan growth.

## Monetary conditions in China



Source Bloomberg

## Markets

- In 2009, markets rebounded fast and strongly, driven by a cyclical, short-term trend. 2010 is expected to be different and the **January correction** came from markets being driven by structural, longer-term issues. Will this last?
- As the short-term momentum is quite good, we still expect the first half of the year to keep a cyclical bias, but will monitor closely the evolution on the markets to see how the recent correction is absorbed.
- In the second half of the year, markets are expected to be driven more by **structural issues**.
- The recent equity correction implied that the strong 2009 rebound was based on extraordinary (and temporary) stimulus measures by governments and central banks. The latest market moves were closer to reality than the synchronized rallies of 2009.
- **Less liquidity** will make things more difficult – investors need to be more selective.
- With lower liquidity, markets are expected to de-correlate again.
- There will be **de-correlation** among countries as well; some will be early in the recovery, others will be laggards.
- Volatility has come down but it is expected to increase when exit strategies are implemented.
- **Diversification** is key because the outlook is uncertain and risks abound.

## Equities OW(3mo) N(12mo)



Source Bloomberg

Past performance is not necessarily a guide to the future.

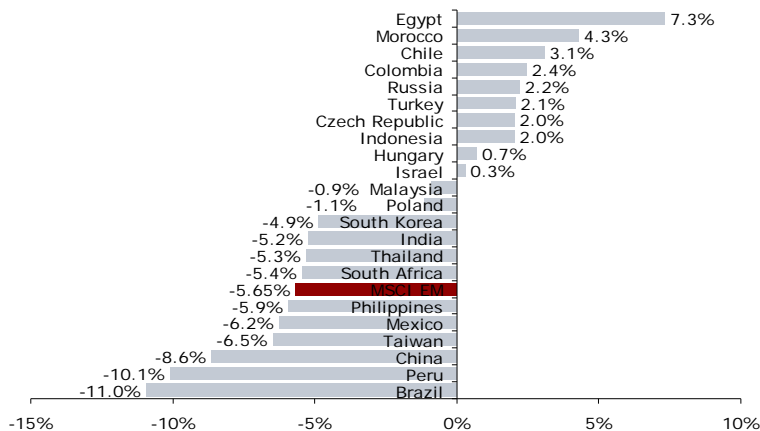
- Equities went through a **healthy correction in January**. They were down for the month – MSCI World index fell by 4.2% and EM dropped by 5.6%. This was a bit of a surprise and due to a change in sentiment, more towards long-term, structural issues.
- Volatility is otherwise due to expectations of exit strategies, the Chinese monetary tightening, the debt crisis in Greece, President Obama's proposed tighter rules on Wall Street and the fact that equities had reached a good level relative to earnings.
- The economic momentum is positive for equities – inventory build-up, positive earnings revision to continue, although at a slower pace, still good liquidity and expected improvement of the US labour market. We foresee a higher level of M&A from a very low base – Investment Idea.

## Equities OW(3mo) N(12mo)

| Operating EPS growth | EPS bottom up | EPS top down | % growth bottom up | % growth top down |
|----------------------|---------------|--------------|--------------------|-------------------|
| 2008                 | 49.50         | 49.50        | -40.0%             | -40.0%            |
| 2009                 | 56.44         | 59.00        | 14.0%              | 19.2%             |
| 2010                 | 77.72         | 73.50        | 37.7%              | 24.6%             |
| 2011                 | 93.21         | NA           | 19.9%              | NA                |

Source: Goldman Sachs

MSCI EM Index in January 2010, in USD



Past performance is not necessarily a guide to the future.

- We have a **positive long-term view on equities**, even though we anticipate lower returns than those achieved in prior upturns. Companies in developed markets have experienced the most pronounced earnings decline since the 1930s. In the US, and based on the S&P 500 index, earnings dropped from their peak reached in June 2007 to their bottom in September 2009 by a staggering 57%. Investors will therefore see earnings growth resuming in 2010 and beyond from a very low base, driving stock prices higher.
- We favour Europe and Japan.
- Valuation is fair, even attractive in Europe.
- Historically, once central banks increase their interest rates, there is a negative impact on valuation and sentiment, thus our 12-month rating is Neutral.
- The short-term momentum means that cyclical and value stocks are still good; in the longer-term, H2/2010 will likely see a lower growth environment where growth/defensive stocks will be a better bet.
- Risk premium will increase when exit strategies are implemented.
- **EM equities: N(3mo) N(12mo)** Emerging equities corrected even more strongly. Emerging countries benefit from healthier economies overall but valuation is already dear and inflation pressure as well as interest rate increases are expected sooner than in the mature economies. Therefore, in the short term, we prefer major markets.

## Fixed Income UW(3mo) UW(12mo)

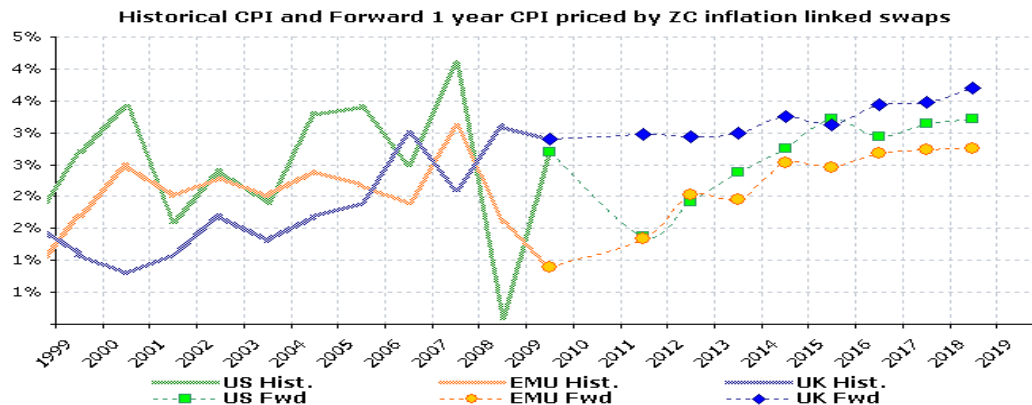
| FM AM Forecasts     |       |       |       | Expected Return |         |
|---------------------|-------|-------|-------|-----------------|---------|
| 3-Feb-10            | SPOT  | 3M    | 1Y    | 3M              | 1Y      |
| US Federal Fund     | 0.25% | 0.25% | 1.00% | 0.06%           | 0.63%   |
| US Treasury 2Y      | 0.86% | 1.20% | 2.25% | -0.41%          | -1.15%  |
| US Treasury 10Y     | 3.66% | 4.05% | 4.45% | -2.28%          | -2.37%  |
| US Treasury 30Y     | 4.57% | 4.85% | 5.25% | -3.26%          | -5.61%  |
| ECB Eonia Target    | 1.00% | 1.00% | 1.33% | 0.24%           | 1.16%   |
| German Bund 2Y      | 1.15% | 1.50% | 2.50% | -0.37%          | -0.81%  |
| German Bund 10Y     | 3.23% | 3.50% | 3.70% | -1.48%          | -0.49%  |
| German Bund 30Y     | 3.96% | 4.20% | 4.40% | -3.19%          | -3.34%  |
| BoE Base Rate       | 0.50% | 0.50% | 1.50% | 0.12%           | 1.00%   |
| UK Gilt 2Y          | 1.21% | 1.50% | 3.20% | -0.24%          | -1.65%  |
| UK Gilt 10Y         | 3.92% | 4.30% | 4.85% | -2.05%          | -3.01%  |
| UK Gilt 30Y         | 4.40% | 4.69% | 5.00% | -3.48%          | -4.80%  |
| Swiss Target Rate   | 0.25% | 0.25% | 0.75% | 0.06%           | 0.50%   |
| Swiss Conf 2Y       | 0.26% | 0.50% | 1.25% | -0.38%          | -1.19%  |
| Swiss Conf 10Y      | 2.01% | 2.15% | 2.60% | -0.72%          | -2.89%  |
| Swiss Conf 30Y      | 2.24% | 2.45% | 2.90% | -3.93%          | -11.13% |
| BoJ O/N Call Target | 0.10% | 0.10% | 0.10% | 0.02%           | 0.10%   |
| JGB 2Y              | 0.15% | 0.25% | 0.75% | -0.15%          | -0.74%  |
| JGB 10Y             | 1.36% | 1.45% | 2.25% | -0.54%          | -6.32%  |
| JGB 30Y             | 2.32% | 2.45% | 3.50% | -2.22%          | -20.53% |

The forecast of future performance is not a reliable indicator of actual future performance.

- With weakness in the equity and commodity markets, cash poured into bond markets, especially the short end of government bonds (govies) – in particular the US and the UK. Govies' yields came down and other sectors of the **fixed income market performed well** as investors were trying to generate some sort of yield. The bond market is overpriced given the ongoing risk of default (at all levels). Funding needs are massive so interest rates will have to move higher.
- We are **bearish on government bonds**, due to a better near-term economic environment, expectations of monetary tightening, high budget deficits, which all push bond prices down. Public finance difficulties raise the spectre of sovereign default. We expect 10Y US at 4.5% in 2011 (today 3.6%).
- Surging public deficits are inflationary, which is bad news for bonds. Pressure is increasing on the yields of long govies along with expectations of rising interest rates. Govies and long maturities are negatively impacted 6-8 months before rates increase. Already now, **expected higher interest rates** are affecting the long end of the curve. Since short-term rates are close to zero, investors may have moved to longer maturities, but there is a risk as higher rates mean lower prices.

## Fixed Income UW(3mo) UW(12mo)

- The main concern is **sovereign debt sustainability** – sovereign CDS are on the rise. We recommend switching out of nominal US and UK debt and into **inflation-linked bonds** (linkers) - TIPS (Treasury Inflation Protected Securities) and Gilt linkers, which offer a real yield that reflects changes in the CPI, as well as **solvent nations' debts** (Germany, Canada, Norway, Australia) - *Investment Idea*.
- Both TIPS and Gilt linkers are expensive as the price of hedging for inflation increases and supply is relatively low.
- We are **more positive on corporate bonds**, as corporations have de-leveraged (shift of the debt from the private sector to the public sector) and look rather good. In the long term, it could even be safer than highly-indebted sovereigns.
- High-yields were the stars of 2009; we are still positive for the first half of the year due to good economic momentum.
- Favour **short duration**, especially for govies, and short maturities.
- We are positive on the Emerging debt as the Emerging countries did not leverage like the mature economies. We prefer **local currency debt** due to the expected USD volatility.



## Forex – USD OW(3mo) UW(12mo)

| Targets Major Currencies against the US dollar |        |               |                 |              |                |              |
|--|--------|---------------|-----------------|--------------|----------------|--------------|
| Countries                                      | CCY    | Current rates | 3-Month Targets | % to Targets | 1-Year Targets | % to Targets |
| Euro zone                                      | EUR    | 1.3862        | 1.3250          | -4.4%        | 1.4200         | 2.4%         |
| UK   | GBP    | 1.6002        | 1.5500          | -3.1%        | 1.6550         | 3.4%         |
| Switzerland                                    | CHF    | 1.0604        | 1.1000          | -3.6%        | 1.0550         | 0.5%         |
| Japan  | JPY    | 90.30         | 87.00           | 3.8%         | 92.50          | -2.4%        |
| Australia                                      | Dollar | 0.8845        | 0.8500          | -3.9%        | 0.9050         | 2.3%         |
| Canada   | Dollar | 1.0696        | 1.1100          | -3.6%        | 1.0500         | 1.9%         |

| Targets Major currency pairs |               |                 |              |                |              |
|------------------------------|---------------|-----------------|--------------|----------------|--------------|
| Currency pairs               | Current rates | 3-Month Targets | % to Targets | 1-Year Targets | % to Targets |
| EUR / CHF                    | 1.4699        | 1.4575          | -0.8%        | 1.4981         | 1.9%         |
| EUR / GBP                    | 0.8663        | 0.8548          | -1.3%        | 0.8580         | -1.0%        |
| EUR / JPY                    | 125.17        | 115.28          | -7.9%        | 131.35         | 4.9%         |
| EUR / AUD                    | 1.5672        | 1.5588          | -0.5%        | 1.5691         | 0.1%         |
| GBP / CHF                    | 1.6969        | 1.7050          | 0.5%         | 1.7460         | 2.9%         |
| GBP / JPY                    | 144.50        | 134.85          | -6.7%        | 153.09         | 5.9%         |
| GBP / AUD                    | 1.8092        | 1.8235          | 0.8%         | 1.8287         | 1.1%         |
| GBP / AUD                    | 1.7116        | 1.7205          | 0.5%         | 1.7378         | 1.5%         |
| JPY / CHF                    | 1.1743        | 1.2644          | 7.7%         | 1.1405         | -2.9%        |

The forecast of future performance is not a reliable indicator of actual future performance.

- After falling for months, the USD reversed its trend at the end of the year and rose broadly due to concerns about China's monetary tightening and good US data, particularly in the labour market. It had a very solid month in January - *Investment Idea*.
- This **positive USD trend** could continue as expectations increase of a change in monetary policy. USD rallies historically take place ahead of monetary decision, based on expectations of a turn of rate cycle.
- We forecast a further appreciation of the USD against other major currencies, **followed by renewed weakness**. The US currency follows our macroeconomic scenario for the US with good growth and improved job market in H1, slowdown in H2.
- We could be seeing the unwind of the dollar carry trades that dominated markets in 2009.
- **Pressure on the EUR** as the Single Currency is facing its first serious test. The sovereign debt crisis (Greece) is threatening the credibility of the EUR and questions arise on the adequacy of the financial European institutions. Until this issue is sustainably tackled, we expect further down pressure.
- Sterling will likely remain weak as the Bank of England keeps rates low to help to stabilise a feeble economic recovery.
- Commodity currencies are expected to devalue.
- Relative economic performance and differences in interest rate expectations will remain the key drivers of the FX markets.

## Commodities N(3mo) N(12mo)

| Performance major commodities |        |               |            |            |              |
|-------------------------------|--------|---------------|------------|------------|--------------|
|                               | CCY    | Codes Reuters | 31.12.2009 | 31.01.2010 | January 2010 |
| <b>Commodity Index</b>        | Dollar | .DJUBS        | 139.19     | 129.05     | -7.3%        |
| CRB                           | Dollar | .CRB          | 283.38     | 265.59     | -6.3%        |
| CRX                           | Dollar | .CRX          | 772.91     | 719.43     | -6.9%        |
| GSCI                          | Dollar | .SPGSCITR     | 4534.17    | 4176.22    | -7.9%        |
| <b>Precious metals</b>        | Dollar | .DJUBSPR      | 160.82     | 158.13     | -1.7%        |
| Gold                          | Dollar | XAU=          | 1095.70    | 1081.05    | -1.3%        |
| Silver                        | Dollar | XAG=          | 16.83      | 16.16      | -4.0%        |
| Platinum                      | Dollar | XPT=          | 1467.00    | 1500.50    | 2.3%         |
| Palladium                     | Dollar | XPD=          | 405.50     | 415.00     | 2.3%         |
| <b>Base metals</b>            | Dollar | .DJUBSIN      | 174.17     | 158.91     | -8.8%        |
| Aluminium                     | Dollar | MALc1         | 2203.50    | 2053.50    | -6.8%        |
| Copper                        | Dollar | MCUc1         | 7351.50    | 6730.25    | -8.5%        |
| Zinc                          | Dollar | MZNC1         | 2534.75    | 2090.00    | -17.5%       |
| Tin                           | Dollar | MSNC1         | 16893.00   | 17148.00   | 1.5%         |
| Lead                          | Dollar | MPBc1         | 2409.00    | 2007.50    | -16.7%       |
| Nickel                        | Dollar | MNIC1         | 18467.00   | 18447.00   | -0.1%        |
| Steel                         | Dollar | DSLc1         | 460.00     | 460.00     | 0.0%         |

| Performance major commodities |        |              |            |            |              |
|-------------------------------|--------|--------------|------------|------------|--------------|
|                               | CCY    | Code Reuters | 31.12.2009 | 31.01.2010 | January 2010 |
| <b>Energy</b>                 | Dollar | .DJUBSEN     | 130.79     | 120.05     | -8.2%        |
| Light Crude Oil               | Dollar | CLc1         | 79.36      | 72.89      | -8.2%        |
| Brent Crude                   | Dollar | BRT-         | 78.26      | 71.70      | -8.4%        |
| WTI Cushing                   | Dollar | WTC-         | 79.39      | 72.85      | -8.2%        |
| Natural Gas                   | Dollar | NGc1         | 5.57       | 5.13       | -7.9%        |
| Gas Oil                       | Dollar | LGOc1        | 635.50     | 586.50     | -7.7%        |
| Heating Oil                   | Dollar | HOc1         | 2.12       | 1.90       | -10.2%       |
| Coal                          | Dollar | QLc1         | 49.10      | 53.17      | 8.3%         |
| <b>Agriculture</b>            | Dollar | .DJUBSAG     | 65.70      | 59.78      | -9.0%        |
| Wheat                         | Dollar | Wc1          | 541.50     | 474.00     | -12.5%       |
| Corn                          | Dollar | Cc1          | 414.50     | 356.50     | -14.0%       |
| Soybeans                      | Dollar | Sc1          | 1039.75    | 914.00     | -12.1%       |
| Sugar                         | Dollar | SBc1         | 26.95      | 29.90      | 10.9%        |
| Cotton                        | Dollar | CTc1         | 75.60      | 69.03      | -8.7%        |
| Cocoa                         | Dollar | CCc1         | 3289.00    | 3184.00    | -3.2%        |
| Coffee                        | Dollar | KCC1         | 135.95     | 131.70     | -3.1%        |
| Rice                          | Dollar | RRc1         | 14.57      | 14.20      | -2.5%        |

- Very good 2009 performance – incentive programmes and high liquidity pushed prices higher than supported by fundamental supply and demand.
- This **positive trend has already started to reverse** as the USD strengthens and liquidity is expected to decrease. Also, large inventories, particularly in the energy and base metals and ample supply in the agriculture sector do not justify continued high prices.
- Exit strategies (less liquidity) will be negative for commodities. The commodity market reacted negatively to China restricting bank lending, a sign that the country could reduce its commodity demand. China's demand was the main driver of commodity prices in 2009.
- After the recent sell-off, our targets have almost been reached. Indeed, our anticipation of good economic surprise in the developed world would be positive in the coming months. In the US, we expect corporations to be adding inventories, which could indirectly boost commodity prices. A possible mild setback of the US dollar after the recent sharp rally could provide some added support. We therefore have a neutral position.
- We expect a moderate rise of energy prices over 2010.
- Fundamentals for precious metals remain positive.

## Risks and Opportunities

- The short-term economic momentum (the cyclical recovery) does not reflect the **long-term structural issues**. Sustainably tackling the latter will require some political courage (fiscal discipline, higher rates).
- Risk premium is low, it will have to increase to compensate for the risks existing in the environment – main risk is of **policy mistake**.
- **Exit strategies** will lower liquidity. Their implementation implies risks: volatility has been decreasing but exit strategies could create a lot of volatility, especially on the forex markets (through the differentials in interest rates among currencies). Uncoordinated strategies would be even worse. Expectations need to be managed carefully.
- The excessive postponement of exit strategies also implies risks: new asset bubble, inflation pressures with a risk of inflation spiral, which is very hard to stop and would lead to a new recession through aggressively increased rates.
- **Global re-balancing** requires a de-pegging of the Yuan from the USD so China can focus on domestic consumption and away from export dependency. There is a misallocation of capital in favour of export sectors (over-capacity) at the expense of domestic sectors. The only sustainable engine of growth is domestic.
- The short-term risk for EM is their excessive dependency on **China's growth** and commodity markets. There is a risk of China making a policy mistake, which increases volatility. In the long-term, nevertheless, the EM story remains compelling.
- China's massive incentive programme drives growth but could create volatility and be artificial – question on the **quality of growth** for the US economy as well, as a big part of the US current growth consists of inventory build-up from a very low base. Consumers (the end demand) are still struggling with de-leveraging.
- The **surge in government debt** could become the mother of all bubbles. Japan holds the record with 220% debt/GDP. The US debt is getting close to 100% of GDP; in the EU, the crisis in Greece has reminded investors that the PIGS (Portugal, Italy, Greece and Spain) all carry public debts above or headed for 100% of GDP. Britain, Ireland and Iceland are following the same path. Japan and the US, being the world's largest economies, can sustain such deficits better than smaller economies. Yet, even powerful economies can see investors turn away from their debt they have long considered safe – *[Investment Idea](#)*.
- The new **regulatory regime** and higher taxes will likely restrict long-term growth.

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