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Why we will be bailed out by 'print baby print' ----- market forecasts for 2012

Key Issues---a euro-zone depression is looming while speculative bubbles burst around the emerging world. But the world's central banks, including the ECB, will eventually stave off the worst disaster scenarios for financial markets.

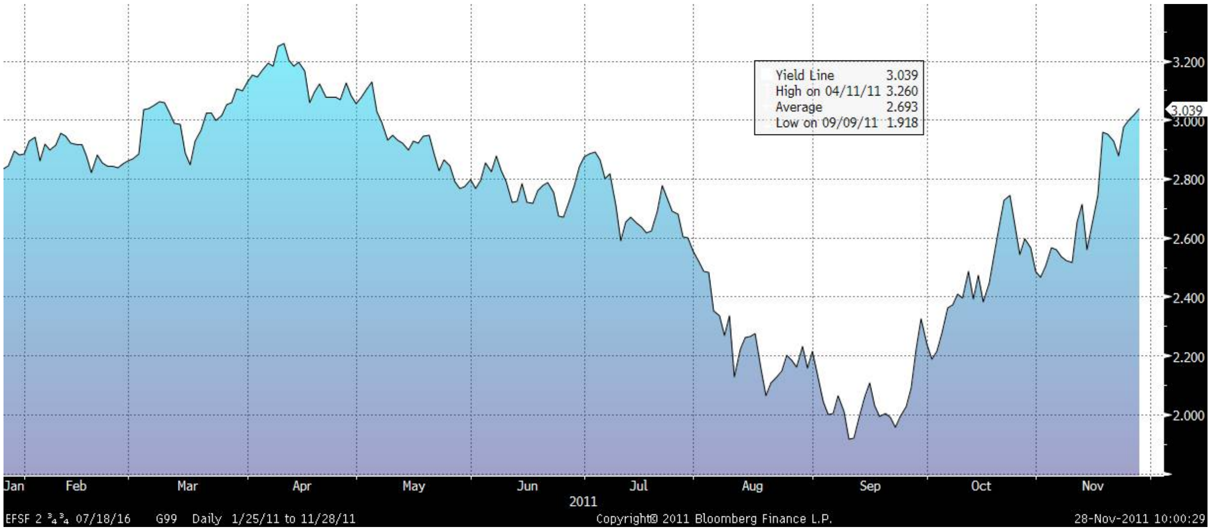
Key Recommendations----markets are poised for a blow off low in early 2012. Investors should use this opportunity to 'never let a good crisis go to waste' (Jim O'Neill IB Times 11/12/11) and re-engage risk by increasing exposure to equities.

With a nod to Sarah Palin who we slightly misquote above (the actual quote was 'drill baby drill' and referred to the US's dependence on oil imports), we rather like the immediacy her words imply. This is the point as we all wait for the cavalry to arrive. As the crisis escalates it is far more likely that in democracies the cry 'something must be done' will drown out arcane theories of sound money; even in autocracies fear of the people is likely to be the most compelling driver of policy.

Bigger Crisis coming

It may seem a trifle uninspired to predict a crisis when we have experienced such a lively year. However, as we have exhausted the recent round of European summits -and rescue plans with the markets (at least in sovereign debt terms) are back at the lows, and at unsustainable interest rates. There are little prospects for more immediate **political juice** to bail things out. To some extent the **German veto** of mass purchases of euro-zone debt has only belatedly been played, sufficiently so for the Bundesbank President to even vote against the 25bp cut at the last ECB meeting (so cementing the institutions' reputation as prone to sabotage the whole euro project.) The various acronyms ESFS, ESM etc have been created, but with the markets struggling to see where the money is coming from to finance these vehicles, they have not provided the silver bullet to restore confidence.

EFSF yield chart—difficult to imagine issuing 400bn another euro.



Source Bloomberg

The Brussels summit produced nothing greater than an expanded 'stability pact' that has so dramatically failed the euro. As Martin Wolf put it 'an instability and stagnation union .... the euro-zone has no credible plan to fix the flaws apart from greater fiscal austerity' (FT 14/12/11.)

Portugal—private sector involvement has not returned

European politicians and commentators have put **confidence at the heart of the matter**. Austerity led programmes often formulated by technocratic governments are to be instigated, the assumption being that the markets will then resume buying sovereign debt.

'Portugal is following an austerity package with oversight from the Troika (of the IMF/EU/ECB) and is receiving precautionary loans from the IMF. It is well funded forward, is adhering to the Troika's timetable and requests, yet its **two year yield is at 16%. These are distressed levels and investors are therefore continuing to express extreme caution'** (source kgmcapital.com.) Private investors are effectively still shunning involvement despite all the so-called credible action of the country's deficit, leaving financing entirely in the hands of outside help. This does not auger well for those countries like Italy that are still feeling their way towards having their programmes even accepted by the Troika.

Stuck on Gold

'The euro today is in our opinion creating the same problems for Europe as the gold standard did in the 1930's' (Deutsche Bank Credit Outlook 2012.)

In the UK a divide has opened up between the Coalition and the Labour opposition over the speed of government spending cuts. As The Spectator magazine describes Labour's 'Keynesian Rottweiler' Ed Balls (source: BBC.co.uk 27/9/11), has explained as cuts undermine growth, tax receipts will then fall thereby necessitating more cuts. As sobering restrictions have already bitten Europe wide, there is no certainty that all the pain of spending cuts will actually produce lower deficits.

The market has picked this up, and not given the benefit to those economies effectively caught in a complex downward/fiscal/economic spiral. With deficits already so high simply trying to arrest the problem is too simplistic a response. **'Italy's problem is not its fiscal deficit, in fact in every year since 1991 Italy has run a cyclically adjusted primary balance (that is crucially before interest payments are taken into account), it is the weight of the accumulated debt burden and low growth'** (source: Italian Economy watch 17/8/11.)

Within the confines of the euro economies states such as Italy face years of tightened belts before the legacy of high debt can be eaten into, at the same time they will be fearful that Keynesian forces may undo all the good work.

Trigger points for the next phase down

As we move into the 'phoney war' phase over year end, markets and central banks have exhausted themselves into a stalemate. While Eurozone bond yields have slightly drawn back from the precipice, some stability has coincided with short covering rallies in equity markets.

However, the accumulated deficits, and hence the attendant re-financing requirements, leave little room for complacency with private sector enthusiasm so limited. 'Italy deserves special mention as it faces redemptions and coupons equivalent to 23.9% of GDP in 2012. Indeed, **the three month period between February and April sees this number at e161bn'** (source: Deutsch Bank Credit outlook 2012.) We view this sheer quantity combined with large funding requirements for France, Spain and others as potential powder kegs which are likely to cause real problems for the market.

With downward momentum in most major risk asset classes, a US political process distracted by the impending election and most EM countries stalling out we expect the crisis to reach a crescendo in early 2012.

Waiting for the cavalry

'Europe's debt crisis has become an existential moment for not only the euro, but perhaps the European Union itself' - Dr Thomas Mayer Chief Economist Deutsche Bank (source: Atlantic council 24/8/11.) We may take issue with the timing, or indeed the actual final trigger, but what is certain is that a real crisis is looming. If the private sector is unwilling, or unable to rescue the severe indebtedness of the public sector, then how can the inevitable consequences to be avoided?

'Everything—every asset class-depends—on if Italy blows up, a depression is upon us' - Edward Harrison (source Credit Writedowns 15/11/11.)

Something must be done---a cry for help

Several apparently unconnected stories around the globe attest to a common underlying story. Newt Gingrich leading the Republican primary race, Chinese villagers in Wukan defying the communist hierarchy declaring a version of UDI, a summer of rioting in Britain , Russia's flawed election being challenged and the 'Occupy Wall Street' protest spawning copy cat action all over the globe.

Democracies hoping to maintain endless austerity programmes will need effective selling of these measures by their politicians, but when even economists are divided on the merits of such policies it is easy to imagine chinks in their resolve emerging. **Will voters really want to face the music**, or will they prefer to embrace the economic make-believe of, for example, Gingrich's unfunded tax cuts?

For the dictators an uneasy mood must already prevail with the Arab spring already claiming several scalps. Will these rulers fear a fate worse than the comfortable retirement that Western leaders can look forward to?

Sound money—where do we look?

'Capital must protect itself in every possible way, both by combination and legislation. Debts must be collected, mortgages foreclosed as rapidly as possible. When, through process of law, the common people lose their homes, they will become more docile and more easily governed through the strong arm of the government applied by a central power of wealth under leading financiers.' No, that was not Ben Bernanke or even the President of the

Bundesbank, but rather Montague Norman, Governor of the Bank of England, speaking in 1924 (source US Bankers Association, New York.)

An interesting historical anecdote but hardly where modern Central Banks stand. Whether it's the dual mandate for the Fed or the political requirements of 24 hour television our current guardians of the currency are many a mile from this hard core 'sound money'. With the political pressure building let's see what they have done, and what they say they are going to do.

Balance sheets Fed/BOE/BOJ/ECB—hardly a refuge (source Bloomberg)

Why stop here?

The Federal Reserve statement spooked some in the markets who had hoped that a move towards further QE was imminent, but by reading the statement we can see they are merely pausing to review data as it comes through. 'The committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate' (source FOMC statement Washington Post 14/12/11.) If we are right about the direction of the markets, even the US, then this is not far away.

'If Fed decides to ease again, price could hit $1trillion' (source Jeff Cox CNBC.com 12/12/11.) In anyone's language a large number, and one that WILL move risky assets.

The BOE is already engaged in another round of QE and committing to take today's current programme of £75bn further if required. Likewise the SNB is busily printing Swiss francs in an attempt to staunch the appreciation of the currency, while the BOJ sporadically unleashes a salvo as Japan's anguish becomes too great.

The ECB <u>will</u> join mass QE—and have cover from other Central Banks

Yes, it is reluctant and fighting a rear guard action from the Germans. However, with political efforts largely stalled out, recent comments by Mario Draghi have unearthed an answer.

While the ECB's President has paid service to Article 123 prohibition of financing of fiscal deficits, the Italian has recognised the crisis and dangers of deflation.

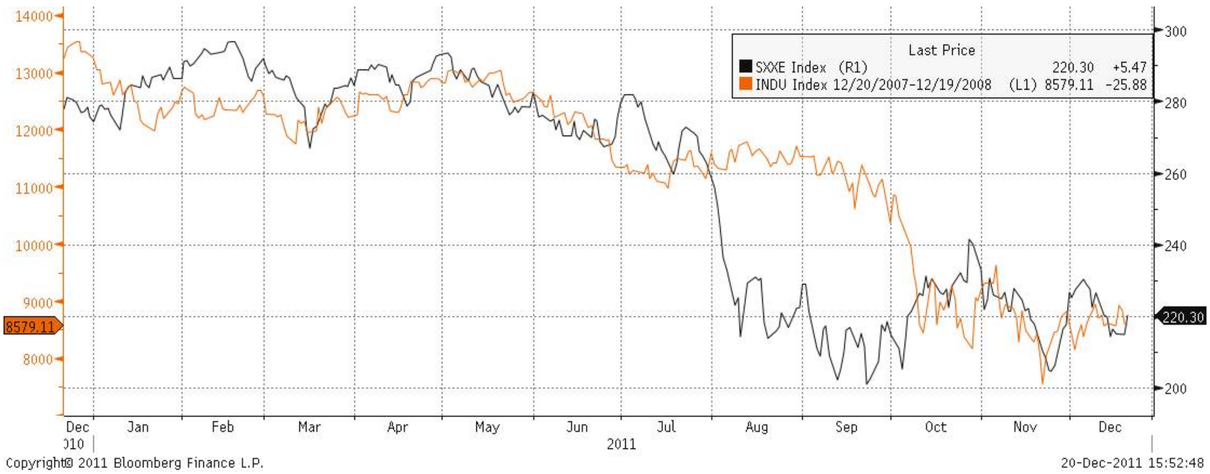
'The ECB's monetary policy is constantly guided by the goal of maintaining price stability....and when I say this, I mean **price stability in either direction'** (source Statement to the European Parliament 1/12/11.) This affirmation of an **asymmetric target** is new, and provides an entire open gambit of policy measures. With deflation on the horizon, any central bank will find an obligation to act. If there is coordinated action from other players the ECB will move to full QE across **all euro zone** government bond markets, while a large amount will be wasted on German bunds the message will be writ large to markets (much in the same way that the Fed's purchases of more treasuries is largely symbolic.) This is not a different stance from Melvyn King or Ben Bernanke who hardly telegraph their bond purchases as a means of funding fiscal deficits, far from it. **QE is sold as a means of tackling deflation or a lack of demand in the economy.**

The ECB must take its responsibilities seriously to defend the overall stability in the euro zone. **Markets versus politicians are not likely to be a pretty outcome, but markets versus politicians and central banks are a different story.**

US Economy—holding in well

Despite many problems around the globe, and the tribulations in the summer over the debt ceiling, the American economy seems to have found a steady level of expansion with around 2% growth.

'Most of the economists are missing the underlying strength' in (what is) the world's largest economy Joel Naroff (source Bloomberg.com 12/12/11.) The key here seems to be housing that has started to stabilise and hence no longer act as a drag on activity. Combined with further the monetary stimulus to come, this completes our desire to use any market weakness as a major buying opportunity.



Same stage in the crisis Dow Jones 30 in 2008 and EuroStoxx 2011, we know what happened in 09 (source: Bloomberg)

Outcome---be brave and ready

Chart 2009, blow off low followed by rapid recovery

Our forecasts for 2012 year end as follows;

S&P 500 1450 with a low at 900

US 10 year Treasury 2.50%

$/euro 1.35 with a low at 1.15

$/£ 1.70 with a low at 1.50

Gold spot $1850

WTI Nymex $100

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