

### Executive Summary

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- The outlook for the global economy remains clouded in uncertainty with monthly data from around the world still quite mixed. However, **boosted by continued 'easy' monetary policy we believe that a healthy global expansion is under way, but it will take time to reduce economic slack and repair damaged balanced sheets.**

- Despite the surprise 25bps increase in the US discount rate on February 18 to 0.75%, we don't expect any immediate change in the key fed funds rate. **With inflationary pressures still very subdued and the unemployment rate uncomfortably high at 9.7%, the Federal Reserve is likely to hold off until the Summer at least before contemplating raising its main interest rate. And even then, any tightening of monetary policy this year is likely to be relatively small.**

- Recent comments from ECB officials suggest that there is no reason to change official interest rates at the moment given that there is no inflation risk in the Eurozone economy. The economic recovery remains precarious and inflation expectations remain firmly anchored. **The ECB is due to decide in March how it will handle the unwinding of emergency leading measures in the second quarter, although no change in the official interest rate of 1.00% is anticipated at this juncture, or indeed until September/October 2010 at the earliest.**

- The Eurozone's fiscal woes have spooked investors, boosting bullish dollar positions in the options market well into the next 12 months, reflecting fears that problems there could persist for some time. **Given current market sentiment, further dollar appreciation to \$1.30 versus the euro looks possible by mid-year.**

Euro/Canadian Dollar Exchange Rate



- The Canadian dollar may be attractive for investors looking for a safe home given the uncertainties hanging over the global economy. Russia's central bank is already on board, with first deputy chairman Alexei Ulyukayev saying recently that some reserves would be put into Canadian deposits and bonds. Moscow's confidence is well-placed in our view. **With its domestic economy on the up and no impediments to its international trade relations, Canada's currency looks set for further appreciation.**

- We are concerned that the imploding economies in Southern Europe could further drag down global risky assets. **Although the recent fall in share prices remains within the range of a typical correction in a cyclical bull market, the brewing crisis in Europe and the panic reaction in the marketplace suggest investors need to take precautionary steps to protect their portfolios.** Wealth preservation is the top priority, especially after prices have rallied so much from their March 2009 lows.

- Steepening bond yield curves in the US and Germany are likely to remain the order of the day in the short-term. **While looking for yields to push higher in the coming months, we don't anticipate any major break-out in levels in the immediate future.**

## World Economy:

In their latest outlook on the American economy, released in mid-February, a group of US business economists raised their forecast for economic growth over the coming year, saying economic expansion was firmly on track. **The National Association for Business Economists (NABE) predicted US GDP would expand by 3.1% in real terms this year, up from its previous forecast, released in November, of 2.9% growth. The NABE is predicting 3.2% growth in 2011.** The group said economic expansion is on track for a resumption of job growth in the near-term and they are "sticking with their November prediction of an end to the jobless recovery." The median forecast is for an average monthly increase of 50,000 jobs during the first quarter of 2010, up from November's prediction of no change. The jobless rate is expected to decline to 9.6% by the fourth quarter, comparable with November's forecast of 9.5%. President Barack Obama has made job creation his top priority in 2010 in an effort to rein in stubbornly high unemployment. The American economy has shed 8.4 million jobs since December 2007, when the recession began. The NABE said they expect US interest rates would remain low and don't expect the Federal Reserve to raise the federal funds rate until late in the third quarter of this year, followed by a series of increases at a measured pace. It expects the core personal consumption expenditures deflator to rise 1.5% this year and 1.7% in 2011. Inflation will remain low mostly because of expectations that unit labour costs will show no net increase over the year. Government spending will grow slowly over the next two years, but the federal budget gap will remain very high. **Although not as optimistic as regards US economic growth this year, we would in general terms agree with the NABE that a healthy expansion is under way, but it will take time to reduce economic slack and repair damaged balanced sheets.**

- **business economists up 2010 US growth outlook**

## World GDP Forecasts

%	2008	2009 (f)	2010 (f)	2011 (f)
<b>World</b>	<b>3.0</b>	<b>-1.2</b>	<b>3.4</b>	<b>4.0</b>
US	1.2	-2.4	2.5	3.2
Japan	-0.7	-4.8	1.5	1.7
China	9.0	8.7	10.5	10.2
Eurozone	0.7	-4.0	1.5	2.0
UK	0.7	-4.8	1.5	2.0
<b>Ireland</b>	<b>-3.0</b>	<b>-7.2</b>	<b>-0.8</b>	<b>3.0</b>

German analyst and investor sentiment fell less sharply than expected in February, suggesting Europe's largest economy may be more resilient than feared. The closely watched *Mannheim-based ZEW* economic think tank's monthly poll of economic sentiment fell for the fifth month running, to 45.1 from 47.2 in January as renewed risk aversion in financial markets weighed on sentiment. But the index figure, which was based on a survey of 278 analysts and investors conducted between February 1 and February 15 was well ahead of a median market forecast for a fall to 42.0. **The ZEW data fit into the picture of a moderate economic recovery for Germany. We expect to see average growth of around 1.5% this year, though the recovery will be bumpy.** The German economy stalled in the final quarter of last year, dealing a setback to a recovery from its deepest recession since World War Two, and harsh weather has hampered activity at the start of 2010. The lower ZEW sentiment was followed by a fall in February in the Ifo economic institute's measure of business sentiment, which had hit its highest level in one and a half years in January. Other economic indicators too point to a bumpy recovery. Manufacturing orders for December shocked markets with a 2.3% monthly fall, hit by a drop in foreign demand. Industrial output also fell sharply in the same month, putting Germany's manufacturing core on a weakened footing for 2010. The German government expects its economy to grow by 1.4% in real terms this year. ThyssenKrupp, Germany's biggest steelmaker said recently that its markets would be slow to recover from last year's slump. *"In Europe, the NAFTA region and Japan, demand will be higher than in 2009 mainly due to restocking, but there will not yet be any return to the production and demand levels of previous years,"* it said. Meanwhile, an economic sentiment reading for the broader Eurozone fell to 40.2 from 46.4 in January and this may reflect concerns about debt woes in Greece and other 'peripheral' Eurozone countries. Despite this latest dip the economy's underlying trend remains good. **That said, the numbers are mixed, and it would be no great surprise if there were a number of disappointments on the recovery path. A lot will also depend on the how quickly stimulus is removed.** The European Central Bank, in particular, could damage the recovery process by raising interest rates too soon, but we don't see any rate hike until September/October at the earliest, and in overall terms the risks on the monetary tightening front remain tilted to the downside at this juncture.

- **German investor morale falls less than expected**

**Official Interest-Rate/Monetary Policy Outlook:**

The sharp financial market reaction to the Federal Reserve's discount rate increase, despite its assurances that the hike is not monetary tightening, shows the tricky communication task officials face as they tiptoe toward an eventual change in rate policy. The Fed's announcement on February 18 that it was increasing the rate it charges banks for emergency loans to 0.75% from 0.50% knocked down global equities and commodity prices and pushed up the US dollar. It also prompted futures traders to boost bets the Fed will raise its benchmark short-term interest-rate target by September, even though the American central bank signalled it is still committed to holding that rate ultra low for an "extended period." **To some extent, the market's negative reaction must be quite perturbing for the Fed, and the concern must be what happens when the central bank really wants to do something substantive.** The discount rate move was the first increase in any of the Fed's lending rates since the financial crisis blew up in 2007 and the first rate change since December 2008. Fed Chairman Ben Bernanke had in the week before said the central bank would soon consider raising the discount rate, but the timing of the move still caught markets off guard. **Usually, the discount rate would move in lock-step with the interbank federal funds rate.** Bernanke also took pains to explain that a discount rate hike would only signal a return to more normal conditions, not a change in monetary policy. But markets did not fully heed the message. **We still think that the key fed funds rate will be increased at sometime over the Summer.**

• **rate hike furore underlines delicate task ahead for Fed**

**Official Interest Rates 2010**

	Current	End Mar (f)	End Jun (f)	End Sep (f)	End Dec (f)
US	0.25	0.25	0.50	0.75	1.00
Eurozone	1.00	1.00	1.00	1.25	1.50
Japan	0.10	0.10	0.10	0.10	0.10
UK	0.50	0.50	0.75	1.00	1.25
Canada	0.25	0.25	0.50	0.75	1.00
Sweden	0.25	0.25	0.50	0.75	1.00
Norway	1.75	2.00	2.25	2.50	2.75
Switzerland	0.25	0.25	0.50	0.75	1.00
Australia	3.75	4.00	4.25	4.50	4.50
New Zealand	2.50	2.50	2.75	3.00	3.25
China	5.31	5.31	5.58	5.85	6.12

Recent comments from ECB officials suggest that there is no reason to change official interest rates at the moment given that there is no inflation risk in the Eurozone economy. The economic recovery remains precarious and inflation expectations remain firmly anchored. The European Central Bank kept its main interest rate at a record low of 1.00% at its February policy meeting and promised to lay out the next stage of plans for a further pull-back from crisis measures. Many ECB policymakers have described the central bank's current monetary policy stance as "particularly" accommodating. **The problem for the Bank is that cutting back the emergency measures too early risks a new decline in economic activity, but delaying things for too long could lead to a new financial derailment.** In our view, the exit strategy needs to be gradual. Supporting our stance, ECB Governing Council member Athanasios Orphanides said recently that the ECB has to keep its monetary policy accommodative while it continues unwinding some of its crisis liquidity measures. In a newswire interview on February 12, Orphanides, an internationally acclaimed economist, and the head of the Central Bank of Cyprus, said that "the phasing out of some unconventional measures should not be misinterpreted as a desire to remove policy accommodation from the economy." He also said the ECB had to be symmetrical in its quest for price stability, meaning it should react as forcefully to inflation undershooting as overshooting its target. Orphanides also said that the ECB should not lightly drop its full allotment policy in all liquidity tenders. For once, the comments of Orphanides chide with renowned ECB 'hawk' Axel Weber who told newswire reporters in the middle of February that commercial banks would probably need unlimited funds at the ECB's regular weekly lending operations for some time to come, but other steps would be gradually phased out. **The ECB is due to decide in March how it will handle the unwinding of emergency leading measures in the second quarter, although no change in the official interest rate of 1.00% is anticipated at this juncture, or indeed until the second half of 2010 at the earliest.**

• **ECB on hold for another few months at least**

## Currencies:

The outlook for the Swiss franc is improving and while the Swiss National Bank (SNB) continues to act against excessive franc appreciation, its activity looks to be focused on moderating the pace of the fall in euro/Swiss. Any SNB-induced euro/franc rallies should therefore be seen as opportunities to sell the cross. The SNB announced measures, including intervention, last March to fight deflation. Since then it has intervened several times to limit the franc's appreciation against the euro. However, **as the franc continues to rally, the SNB no longer seems to wish to sustain interventions over long periods to anchor the cross at higher levels.** Perhaps it is too expensive to do so. Maybe the central bank realises the demand for Swiss francs is too great to resist and that its actions must therefore be restricted to occasional broadsides as it manages a gradual decline in the euro/Swiss exchange rate. Either way, dealers will see the unsustainable nature of the spikes as opportunities to sell euro. Some are leaving euro/Swiss sell orders in Asia near the recent 1.49 high to take advantage of anymore central bank sorties in the wee small hours of the European night. But aside from flows and sentiment, there is a good argument for saying the franc should firm. For one thing, Switzerland, outside the Eurozone, is not mired in any of the uncertainty surrounding Greece and other debt-burdened member states. Negativity about the euro has already arguably weighed on the euro/franc cross. Furthermore, **the very need for European Union support measures for Greece might make investors think the euro is only as strong as its weakest member, weighing on its value generally and, in this case, against the Swiss franc in particular.**

- **SNB-led euro/Swiss franc rallies may be chance to sell**

## Spot Exchange Rates 2010

	Current	End Mar (f)	End June (f)	End Sept (f)	End Dec (f)
€/GBP	0.8765	0.8700	0.8500	0.8250	0.8000
€/£	1.35	1.35	1.30	1.30	1.32
€/Yen	122	123	125	128	130
\$/Yen	90	91	96	98	98
GBP/\$	1.54	1.55	1.53	1.58	1.65

The Canadian dollar may be attractive for investors looking for a safe home given the uncertainties hanging over the global economy. Russia's central bank is already on board, with first deputy chairman Alexei Ulyukayev saying recently that some reserves would be put into Canadian deposits and bonds. Moscow's confidence is well-placed. Bank of Canada Governor Mark Carney, for one, is upbeat on the prospects for the Canadian economy, saying in early February "*The recovery has begun. After a brutal economic Winter, Spring is within sight.*" Recent economic data would seem to back up that assertion. Canada's Ivey Purchasing Managers Index edged up to 50.8 in January from 48.4, consistent with mild economic growth since Canada exited recession in the third quarter. Canadian housing is booming. The value of building permits rose by 2.4% in December from November and ended 2009 having largely recouped losses suffered during the recession. Housing starts rose by a larger than expected 5.8% in January. Meanwhile, Canada's employment report for January contrasted with the disappointing US non-farm payrolls release for the same month. Canada added 43,000 jobs in January with the unemployment rate falling to 8.3% from December's 8.4%. The Canadian dollar, or *loonie* as it is known, is currently trading around the 1.06 level to the US dollar. But foreign-exchange dealers will recall that it firmed as far as C\$0.9060 to the greenback in November 2007. More recently, the *loonie's* attempts to strengthen have petered out just above parity, reaching C\$1.0220 on January 14 this year. **On domestic considerations alone, the Canadian dollar should have room to re-test that C\$1.02 area in the near-term.** But the arguments in favour of the *loonie* are not merely domestic. With China-US relations strained and raising the spectre of economic protectionism, Canada is well-placed to avoid being dragged into such disputes. Membership of the North American Free Trade Association already ensures open access for Canadian companies to US markets, a critical fact given that 75% of Canadian exports go to their southern neighbour. Moreover, Canada recently reached a tentative deal with the United States to end a dispute over "*Buy American*" provisions in US legislation. Canada also looks to Asia and has been very open to Asian investment into Canadian companies and infrastructure. The Korean National Oil Company sealed a \$1.7bn takeover of Canada's Harvest Energy in October and on January 21, Ontario announced South Korea's Samsung C&T Corp. would lead a \$6.7bn energy investment. **China too is looking to access Canadian markets. China has granted Canada "approved destination status" which will boost Chinese tourist numbers in Canada.** This followed Beijing's decision in October to invest in a huge potash plant in Saskatchewan to ease China's own tight supply of fertiliser. **The bottom line is that with its domestic economy on the up and no impediments to its international trade relations, the Canadian dollar looks set for more appreciation in the coming months.**

- **global uncertainty favours Canadian dollar**

## Equities:

Warnings emerging markets are inching towards bubble territory are misplaced so far but the volume of securities on offer must rise fast to accommodate the new cash that is expected to join the sector in coming years. Emerging assets have become very desirable as the financial crunch damaged western balance sheets and budgets and further enhanced the relative growth attractions of the emerging world. With emerging markets roaring back from the slump of 2008, crises in the likes of Eurozone member Greece, and also two years back in Iceland, have challenged decades-old assumptions that sovereign risk was inherent only to developing economies. ***In theory, that should be positive for emerging markets, which are on the whole, hugely under-represented in global portfolios, especially of more conservative but cash-rich investors such as pension funds.*** But the reality is that relative to the developed world, emerging bond, stock and currency markets remain underdeveloped, small and illiquid. All of which means a large-scale cash influx can quickly inflate asset prices to unsustainable levels, risking a repeat of the familiar boom-bust emerging market cycles. Quite simply, too much money chasing too little market cap is potentially a big concern. It was a concern in 2007-2008 when there was a lot of euphoria over emerging markets and this wall of money came in. We are starting to see that kind of euphoria again. ***The 37-country MSCI emerging markets index (MSCI EM) has market capitalisation of \$3 trillion, just over a tenth of the MSCI World's \$20.5 trillion and a third of the US S&P 500.*** And the \$5.5 trillion in local currency bonds issued by every emerging nation in the world are worth less than the US Treasuries outstanding. Flows are tipped to grow, as the pull of emerging markets, rising incomes, growth, relatively sound public finances, couple with "push" factors from the developed world — anaemic growth, falling populations and rising debt.

- ***emerging assets have become very desirable***

Emerging equity and bond funds got inflows of \$75bn in 2009, dwarfing all fund groups except US bond funds. This year, private capital flows: direct and portfolio investments; to emerging markets will rise 66% to \$722bn, the Institute for International Finance says. That is over three times more than levels a decade back. There are signs pension funds, pressured to boost returns, are increasing emerging market allocations. Indeed, a Barings study last November found that a third of UK pension funds would consider investing in emerging markets, up from under 5% in 2007. The problem is that even a small re-allocation from a deep market to a relatively shallow one can cause substantial swings. Take for instance pension funds. ***With \$23 trillion in assets globally, just a 1% extra allocation to emerging stocks would bring inflows of \$230bn, almost a tenth of the existing capitalisation of the MSCI EM.*** Volumes of existing securities would have to rise by a comparable amount, possibly via stock listings, to avoid the wild swings such large-scale capital inflows would cause. With all this money flowing in, we are going to see an inflating of price-earnings ratios, and it is important to watch earnings growth relative to the volume inflows. So far, ***valuations are looking fair around 11.5 times one-year forward earnings or a 13% discount to developed stocks and a 10% discount below their own historical average. If earnings keep up, emerging markets could justify a premium to developed markets on a P/E basis.*** A bubble implies that there is not a fundamental underpinning to the price. This is not the case at the moment.

- ***more inflows?***

Asset bubbles may emerge in some hotspots but most say the fear is premature. The MSCI index is still trading about a third off its 2007 peaks and current valuations are fair. We ourselves don't have a problem with crowded trades in emerging markets yet. Emerging markets are never more than 15% of a globally diversified portfolio, and there has to be a sea change in investor attitudes for it to grow significantly. And for big funds liquidity is the key constraint. Compare Britain's Vodafone and Indian telco Bharti. Reuters data show an average 1.2 million trades a day on the latter, versus 131 million daily trades on Vodafone. Less than a million daily trades is not something fund managers really want to be involved in. Still, ***one has to acknowledge that the market is growing. MSCI EM now has 13% of the global market cap, up from 5% in 2000.*** And more stock listings and bond issues will increase market depth. ThomsonReuters data show a steady increase in emerging IPOs. They accounted for 70% of global stock offerings in 2009, up from a quarter in 2005.

- ***market maturing***

## Bonds:

Fears that the British government may soon be unable to fund its record budget deficit are overdone because of new rules obliging banks to hold more gilts and sterling's status as a reserve currency. With Britain's budget deficit expected to top 12% of GDP this year, opposition policymakers have raised the spectre of a Greek-style debt crisis and some analysts have said that UK gilts are a ticking time bomb. A General Election expected on May 6 is adding to investor uncertainty especially as recent opinion polls have been pointing to a hung parliament, where no party has an outright majority, and which could make unpopular fiscal consolidation harder to deliver. Britain had to sell about £225bn worth of government bonds in this financial year but that was almost balanced by the amount bought by the Bank of England via its asset purchase scheme to pump money into the UK economy. With that programme now on hold and only a little less in government bonds to be sold next year, simple laws of supply and demand should put gilts on shaky ground. In fact, they still have a lot going for them in the medium-term. ***If one bypasses the political risk, gilts look decent value: bank regulations, pension regulations, a higher savings rate and lower growth during the transition to a better fiscal position are all positives for the UK market.*** Having its own widely traded reserve currency will also help Britain attract overseas investors, not least because the pound's weakness has made UK assets much cheaper to buy while a subdued economic outlook should help underpin safe-haven flows.

- **fears of gilt market blowout are overdone**

### 2010 Native Global Bond Yield Forecasts %

2010 Native Global Bond Yield Forecasts %					
	Current	End Mar (f)	End June (f)	End Sept (f)	End Dec (f)
<b>US</b>					
2 Year Treasury	0.90	1.00	1.15	1.40	1.75
5 Year Treasury	2.37	2.50	2.70	2.90	3.20
10 Year Treasury	3.70	3.90	4.10	4.25	4.50
30 Year Treasury	4.64	4.85	5.05	5.20	5.40
<b>Germany</b>					
2 Year Bund	0.92	1.05	1.20	1.40	1.70
5 Year Bund	2.17	2.30	2.45	2.60	2.85
10 Year Bund	3.14	3.30	3.50	3.60	3.80
30 Year Bund	3.89	4.05	4.25	4.35	4.50
<b>UK</b>					
2 Year Gilt	1.08	1.20	1.40	1.65	2.00
5 Year Gilt	2.90	3.05	3.25	3.45	3.75
10 Year Gilt	4.13	4.30	4.45	4.60	4.80
30 Year Gilt	4.64	4.80	4.95	5.10	5.25

Perhaps the biggest factor to maintain support for gilts going forward is that from this year banks operating in Britain will have to increase the amount of safe, highly-liquid assets they own, effectively forcing them to buy government bonds. ***In our view, that could translate into £160bn of gilts that need to be bought over the next two to three years.*** It could also swallow most short-dated issuance to come. Meanwhile, pension funds and insurance companies, which must hold enough assets to meet their future liabilities, are still clamouring for more long-dated bonds, even though supply in this area has doubled over the last three years. Between July and September 2009 net gilt issuance by such funds rose to a 5-year high of £8.185bn, according to official data. Despite the record gilt issuance of £225bn pencilled in for this year, apart from one failed auction in March 2009, the UK government has had little difficulty in attracting buyers for its debt. Gilt bears say that is only because until a few weeks ago, the Bank of England's quantitative easing programme, buying assets with newly created money, meant there was constant demand from the central bank. The Bank put a hold on its £200bn scheme in February, having bought some £198bn of gilts since last March, but auctions have continued to go well, though of course prices have drifted lower in recent months. Yields on most maturities have risen by around 20bps this year and we see the rate on benchmark 10-year gilts hitting 4.75% or higher by year-end, but still low by historical standards. ***The other big uncertainty hanging over gilts will soon disappear once the election is out of the way. The chances are that fiscal policy will be tightened whoever wins power.*** Certainly, the opposition Conservatives, who are tipped to win, have promised speedier fiscal tightening but there is consensus the deficit has to be tackled at some point.

- **new rules**

## Gold:

The International Monetary Fund's long-planned sale of its 403 tonnes of gold has taken on a new twist that may chip away at one of the fundamental drivers for higher gold prices. The IMF's strategy to capitalise on surging gold to raise new resources for lending was first announced in 2008 and had been comfortably received by the market, with expectations for enthusiastic takers among Asia's central banks. Its sale of 200 tonnes of this quota to India, announced in early November, and small disposals to Sri Lanka and Mauritius prompted a frenzy of speculation over further sales. But the key take-away for some analysts from the IMF's announcement in mid-February that it would soon begin phased open-market sales for its remaining 191.3 tonnes of gold was that central bank appetite for bullion may not be as robust as first thought. **Quite simply, it could be viewed quite negatively that central banks, who obviously would have been favoured as buyers for the remaining gold, have found current price levels unattractive.** The 191.3 tonnes on offer compares with total identifiable demand in 2009 put at 3,385.8 tonnes in the World Gold Council (WGC) demand trends survey. Central bank activity has been seen as a key foundation of gold's ability to rally even as other fundamentals, such as dollar weakness, faltered. A third European central bank pact to limit sales seemed to cement that fundamental support, assuring investors that any official sector sales would be orderly. Spot gold hit a record \$1,226.10 per ounce in 2009 and is still up almost 1% since the start of this year, even after a sustained period of falls. **Although some countries could sell gold reserves to cover budget deficits, the trend is unlikely to be big enough in our view to damage the market.**

- **IMF gold plan poses tricky twist**

### Gold, Spot Price, \$



No one can be sure what the psychology was behind the latest IMF development, but if the hope was to entice new official sector buyers, early indications have been lukewarm, with Sri Lanka's central bank saying it was unlikely to buy more IMF gold right now as the nation has already reached its required reserve level. Analysts have previously identified China, which late last year said it had been adding substantially to its gold reserves in recent years, as a potential buyer of IMF gold. But former officials poured cold water on that idea last year, pointing out that it would be cheaper for China, the world's biggest gold miner, to buy domestic supply to boost reserves, and that near-record prices made IMF gold too expensive. After an initial knee-jerk drop to the IMF plan, gold prices have recovered some poise, and are now hovering above \$1,100 per ounce. Indeed, central banks that were waiting on the sidelines may now see an opportunity to buy. However, **with a clouded demand picture from central banks, and uncertainty on the dollar's trajectory, some in the market are beginning to wonder about where the impetus to take gold higher from here will come from.** The fiscal crisis in Greece has helped send gold prices in euro to record highs. All in all, it doesn't feel like we've reached the top of the market, but the problem is the huge amount of investment demand that has been behind the latest price increase. It just doesn't seem to be there at the moment. That said, you never quite know where the investment demand is going to come from, and the Greece issue may be the catalyst for European investors to buy gold. So it's not all over yet, and **we still think the price of gold is headed higher over the course of 2010.**

- **lukewarm reception**

## Greece: Should it default?

The drama unfolding in Athens contains all the usual ingredients for a modern crisis: poorly disclosed derivative transactions, inadequate accounting for off-balance sheet liabilities, investment banks eager to structure complex transactions in return for fat fees, and a furtive but gullible government that thought it could get something for nothing. Life is a lottery; some loans go wrong in the ordinary course of events. But behind every really bad loan or class of loans, like sub-prime mortgages, there are greedy and foolish bankers and equally culpable borrowers. Greece is no exception. The Greek state has only its itself to blame for manipulating accounting rules and derivatives markets to run up unsustainable debts. **However, the banks that structured those transactions are hardly blameless and cannot really complain if they do not get all their money back.** One part of the problem is the use of swap transactions to provide upfront payments to the Greek state in return for deferred payments, ensuring Greece would scrape in under the Maastricht criteria for euro membership. Swap transactions involve the exchange of one stream of payments for another. But these are confidential bilateral deals. The terms need not be actuarially fair or at current market prices. In this instance, the terms of the swap transactions ensured that Greece was a net recipient of funds in the early years but would pay the money back later. These were credits. But **because they were structured as swap transactions rather than loans they did not have to be recorded as debt or count against the country's compliance with the Maastricht criteria for Eurozone membership, which was precisely why they were so attractive.** The swap transactions were perfectly legitimate. They were not the only cause of this financial crisis. But they have helped Greece accumulate more debt that would otherwise have been possible, pushing the country closer to the brink.

- **Greece has only itself to blame**

Most commentators have concentrated on the need for the EU to bail out Greece. But in reality any rescue would be another subsidy for excessive-risk taking by the country's bankers and the institutions that have sold credit default swaps (CDS) on Greek debt. Forcing the country into an austerity programme and arranging an emergency loan from other EU members or the IMF would ensure the bankers got their money back (again), but inflict years of misery on the country's households and businesses. **If market discipline is ever to be re-established after the boom and bailouts of the last five years, it is imperative creditors face the real prospect of making losses if they extend large loans and fail to price the risk on them properly.** The sellers of CDS insurance must face up to making real payouts in return for all the premiums they pocket. Bailing out Greece would be wrong. Not because it would harm the Eurozone's credibility, but because it would reinforce the rampant moral hazard in financial markets. It would perpetuate the inequitable and politically unacceptable situation where structuring fees are retained by the banks as private profits while credit losses are socialised and passed on to taxpayers. **Greece would do everyone a favour by declaring a moratorium and forcing a rescheduling. The country faces years of misery in any case. The threat of being shut out of capital markets rings hollow. But by triggering losses on these derivative transactions and a credit event under the CDS it would help ensure a much more prudent approach in international banking markets.** Bailing out Greece so everyone can pretend the country can remain "current" on its loans when it patently cannot would simply deepen the moral-hazard crisis. If market discipline is ever to be re-established (something which everyone agrees is desirable) then at some point creditors must take a loss. Greece is a good place to start.

- **bailing out the banks again**

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