



# Market Wrap-Up

Week Ending November 25, 2012



## Investment Strategy

## Does gold still deserve a place in your portfolio?

By Max Stainton, Co-Editor 2<sup>nd</sup> year Economics, Politics & International Studies

The position of gold within an investor's portfolio has long been debated amongst market analysts, investment strategists and portfolio managers. However, since gold's remarkable performance during the worst of the financial crisis (see chart below) the discussion had turned into one a way monologue with analyst after analyst touting gold's safe haven and inflation protecting properties. The question for investors therefore is whether this was ever the case, and if it was whether it still is.

Let us start by analysing gold's safe haven properties. As we can see from the chart, during the worst of the financial crisis gold (blue line) performed remarkably well, up 13.6% versus a fall in the S&P 500 (red line) of more than 50%. Gold exhibited this resilience to crises again in during the debt ceiling debacle and Eurozone fears that rocked markets during the summer of 2011. During this time, gold rallied by more than 22% to its peak compared to a fall in the S&P 500 of 19% at its trough, during the same period. In and of itself this fantastic positive relationship to risk off periods during market turmoil would merit a position in gold for almost all investors with a diversified portfolio. However, gold bugs further argue that gold also provides a store of value,



particularly during times of inflation. This claim, while not exactly robustly tested in any meaningful way, is centred on the argument that fiat money and the governments that back it is being serially debased by governments who are utterly indebted.

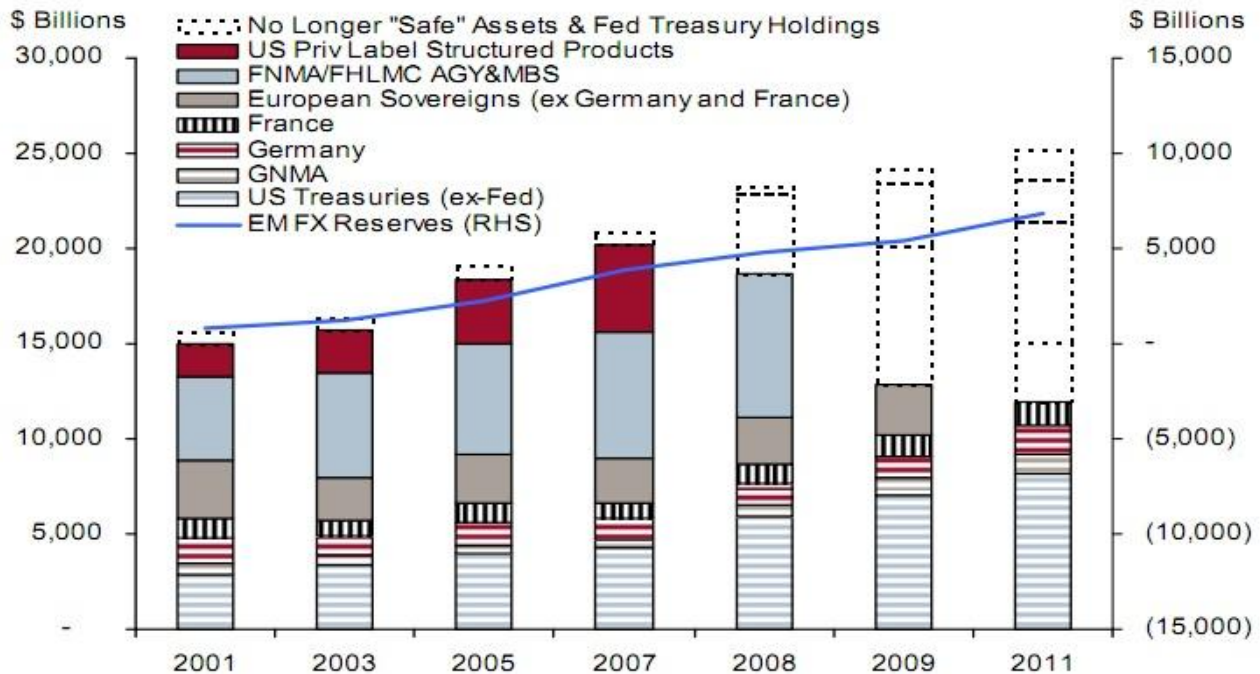


Consequently, the argument goes, it is necessary to hold an asset that has been used as money in the past, but cannot be debased by any particular government because its supply is fundamentally linked to the rate at which it is mined. This rationale has become ingrained within the gold market. Consequently, every time the market perceives there to be an inflationary threat, gold quickly rises. And right now, the biggest inflationary threat that the gold market perceives is quantitative easing. As the above chart demonstrates, quantitative easing has become a significant driver of the gold price; the different timing of its effects simply being attributable to the market's ability to forecast, and therefore price in the possibility of QE. However, such an analysis ultimately begs the question; to what extent is quantitative easing inflationary? If one's answer to this question is that QE is not very inflationary then either you are wrong, and thus the market appears to be reacting in the right way, or the market is wrong and consequently the gold price appears incredibly inflated.

Furthermore, the question remains, why is gold behaving like other safe haven assets such as U.S. Treasury bills or cash? It appears that the primary reason for this is a psychological one in which investors, looking to history, see gold as the quintessential asset to own in times of crisis. However, a rational step back would quickly reveal that

if we ever got to a state in which gold became the only viable means of exchange then it would appear that the average investor would have bigger problems at hand than the one of trying to protect his/her wealth. It therefore seems that a classic feedback loop is also taking place, in which, because investors perceive gold to be a safe haven asset they buy it in times of crisis. This therefore pushes up the price of gold during these periods and thus further reinforces investors' view that gold is a safe haven asset. While it is almost certainly the case that such a feedback loop is taking place, it is also possible to find a more fundamental reason for gold's seemingly perpetual rise. This fundamental analysis can be found by turning to the Credit Suisse 2012 Global Outlook which has the below chart which shows how the world's outstanding stock of safe haven assets denominated in either dollars or euros has evolved. As one can clearly see the stock (or supply) of "safe" assets has demonstrably diminished since 2007. Indeed, if one views France as no longer worthy of the "safe haven" status than the pool will have shrunk even further in 2012, nearly halving since 2007. The consequences of this diminishing universe are stark. This is because, if one takes emerging market foreign

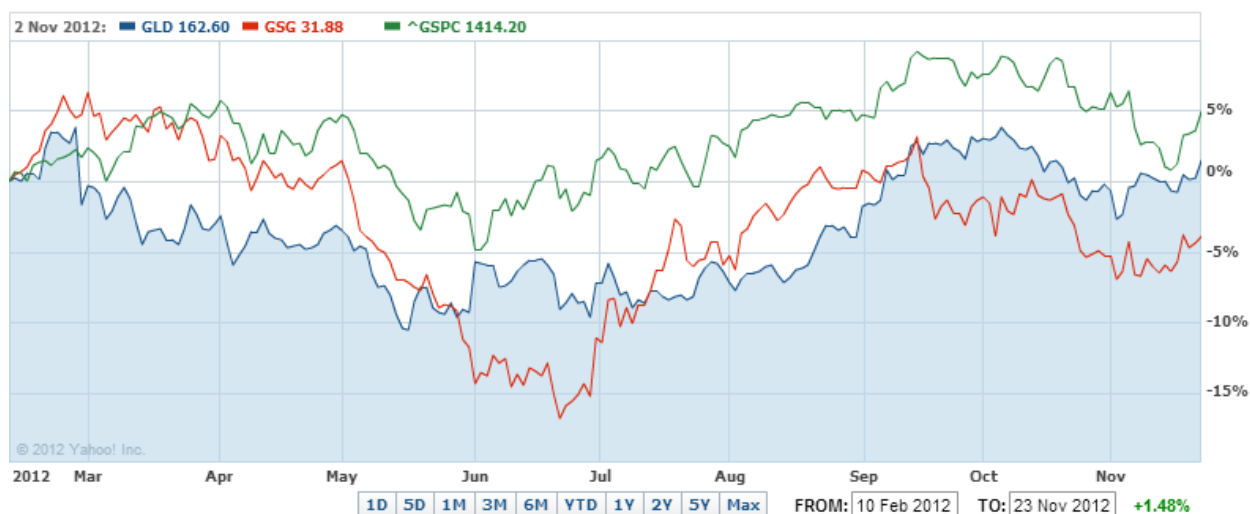
**Exhibit 174: Shrinking universe of "safe" assets in the primary reserve currencies (USD and EUR)**



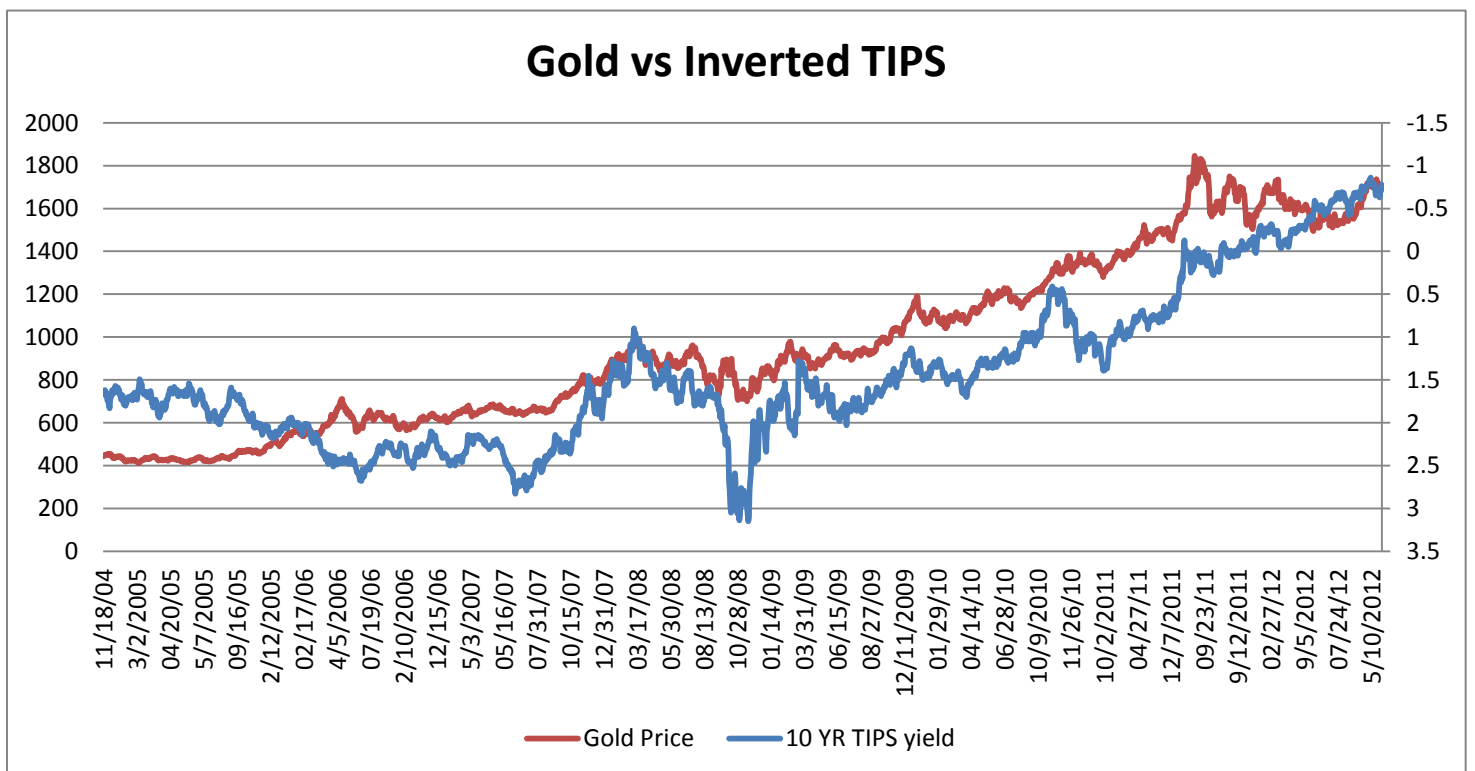
Source: Federal Reserve, Haver Analytics®, Credit Suisse

exchange reserves (blue line on chart) as a good measure of safe asset demand then it quickly becomes apparent that a supply and demand imbalance has emerged. Consequently, with safe asset demand having risen since 2007 then, using a simple supply and demand analysis will tell you that the price of the safe haven assets has to rise. This coupled with the twin facts that general investors have become much more nervous since 2007 and regulators are driving pension and insurance funds into safer assets and it becomes clear that demand for these assets has grown by much more than is indicated by emerging market FX reserves. Furthermore, these reserves are not simply being channelled into the safe assets listed in the chart, but are in fact also being used to buy gold itself. As if to demonstrate this point further, within the last week it has become public knowledge that Brazil has boosted its gold holdings for the second straight month, and to the highest level in 11 years. This is not simply a Brazilian phenomenon, but is happening throughout the emerging world for instance, as a group, central banks are set to buy almost 500 tonnes of gold this year, the most in more than four decades. Central banks in Latin America have recently joined those in Asia and the Middle East in adding to their gold reserves as they try to diversify their FX reserves away from government bonds, particularly US Treasuries. Consequently, given investors' perception of the safe haven nature of gold and it becomes apparent that the price of gold will surely rise because of this imbalance between the supply and demand of safe haven assets.

This analysis would therefore seem to indicate that gold certainly does have a place in



an investor's portfolio particularly if you believe that quantitative easing will be inflationary and that the stock of safe havens is not going to rise anytime soon. However, since February this year, gold (see chart previous page) has started to behave less like a risk off asset and more like any other commodity with their clear positive relationship to risk on periods. As one can see from the chart, gold (blue) tracked almost perfectly the broad Goldman Sachs Commodity Index (red) even when the S&P 500 was also falling (Green). Why was this happening? One explanation is that even gold lost its safe haven status during this volatile year. However, another turns to the simple economic idea of opportunity cost. As one can see from the below chart gold is incredibly negatively correlated with the 10 year TIPS yield. The reason given for this is that as the opportunity cost for holding gold (in this case indicated by the TIPS yield) lowers the amount of money investors are willing to allocate to gold increases. This chart also explains why gold appeared to lose its safe haven properties since the middle of 2011 as the price became increasingly disconnected from the TIPS yield. Therefore, it appears that the most important thing to consider about holding gold going forward is where you think the TIPS yield is going to go.



## Eurozone

# France: The Road Ahead

*By John Peter Ong, Analyst, 1<sup>st</sup> year Economics and Industrial Organization*

As one of the main pillars of the Eurozone, France's recent credit downgrade by Moody's from its top rating had a remarkably small effect on markets, with yields on government bonds rising just a few basis points following the announcement. In light of this, one might reason that investors had already priced in France's credit risk appropriately, given that Standard and Poor's lowered France's rating similarly earlier in the year. Another more likely explanation is that France, while battered, still retains much of its luster, and can yet revive its economy with a concerted effort by its government.

In its appraisal, Moody's cites external and internal factors affecting France. On the external front, it points to the woes of the Eurozone, which not only implicate France through its exposure to the troubled peripheral economies, but also through its commitment to the European Stability Mechanism, to which it contributes 20 percent of total capital, second only to Germany. On internal matters, Moody's lists intrinsic structural difficulties of France's economy, encompassing labor rigidity, stifled innovation, and deteriorating export competitiveness. It also notes that government fiscal policy thus far, involving tax hikes on high-income earners and companies, is likely to hamper economic growth, if any. Certainly, these issues faced by France are of significant concern; France's labor costs have risen by more than 10 percent in the past decade, and its current account balance went from a surplus to a deficit during the same period. However, France still has fundamental strengths on which the government can build upon, and should not be discounted prematurely.

France has many positive traits in itself. It is the world's fifth largest economy by nominal terms and its sixth largest exporter, having a particular competitive advantage at producing high-end goods and services. It has more companies in the Global 500 than Germany and Britain. Also, it has excellent infrastructure, especially in energy and

transport. These features, along with its world-class healthcare sector, make for a healthy mix of business activity, productivity and diversification within the economy,

### **Eurozone (continued)**

which, while in recent decline, present opportunities for growth if stimulated with the right government policy.

So far, Hollande has taken steps in the right direction, recently unveiling a plan to boost competitiveness within the economy which involved €20 billion worth of corporate tax rebates and reduced red tape for companies. He has also lead negotiations between businesses and unions in an attempt to reform the labor market. While these measures are hardly groundbreaking, they reflect a greater focus on the key economic issues impeding growth, and are heartening indicators that France will soon embrace reform. Indeed, Hollande, with power in the legislature and most municipalities, could very well push through a string of reformative policies. Yet, doing so risks provoking dissension amongst the party's leftist ranks, as well as stirring social unrest; unemployment in France is currently 10.8 percent, and is even higher amongst youth. One can hope that Hollande will navigate the waters of economic decline and political tension judiciously.

Barring another Eurozone debacle, France's economic position remains steady. On top of commitment to structural reform, its government has also taken a serious stance on reducing its deficit, pledging to bring it in line with European rules next year. Furthermore, markets have rewarded France with record low bond yields; this aids its bid for fiscal consolidation greatly. France has a path forward, but it needs strong leadership, time, and a whole lot of luck to get where it wants to go.

## Credit Rating Agencies

# On credit rating agencies: industry problems

*By Vassil Kirtchev, Co-editor, 3rd year EPAIS*

The credit ratings industry exists to analyze and rate the creditworthiness of bonds and institutions. They give ratings based on the risk of default. This is to deal with any informational asymmetries that exist in the financial markets in order to make it a 'fair game' for all parties involved, particularly investors. In the United States, a small number of firms are granted oligopoly rights to be Nationally Recognized Statistical Rating Organizations (NRSROs). This has created a very inefficient system where a small number of large firms that occupy a crucial role in the financial sector have too much power. Credit ratings agencies can influence the movement of market prices, which can cause considerable market volatility. It can also influence whole countries and economies through sovereign-debt ratings, which can cause increases in borrowing costs and a loss of confidence. Another problem is that it is the issuers of debt instruments rather than investors that pay the fees for the ratings. This creates a conflict of interest due to incentives for short-term gain, where a more prudent strategy would cause forgone profits to competitors. To solve the problems that come about from the market structure, competition in a freer market needs to be allowed. This would allow more analyses to be conducted and would hopefully decrease information asymmetries. Compensation levels in the industry could also be increased to attract more talent. There also needs to be an elimination of the conflict of interest that exists by making investors pay for ratings. Globalization could have positive impacts by allowing global opinions to be represented.

The credit ratings industry consists of three main players: Standard and Poor's, Moody's and Fitch. In economic terms, one might define this particular market structure as an oligopoly, where a small number of firms compete and each has a significant share of the market. The role of credit ratings agencies is to assess the risk of default of a financial instrument such as a bond. In other words, ratings agencies judge the creditworthiness of bonds, or "the likelihood that a bond will make the repayments

## Credit Rating Agencies (continued)

that it promised on time, and in full.”<sup>1</sup> A bond that is believed to have the least risk of default (less than 1-in-10000 chance of defaulting in the first year) is given an AAA rating by S&P.

It is clear why credit ratings agencies are needed and why they play an important role in the financial markets. As the financial market becomes increasingly complex and more diversified, the role of credit ratings agencies becomes more important. In theory, fully independent ratings agencies that specialize in risk analysis are needed to add credibility to financial instruments traded in the financial markets and to eliminate conflict of interests. Primarily, this is to inform investors in helping them make decisions regarding financial products. The credit ratings model outlined here protects investors by reducing any information asymmetries that are bound to exist between actors in the financial markets. This becomes increasingly important as the financial products become more complex. It makes sense to have financial institutions that solely specialize in analyzing financial instruments to determine their risk. If the system is effective, it can have substantial impact on reducing costs pertaining to capital market access and other opportunity costs.

The Securities and Exchange Commission (SEC) in the United States gave the prerogative to seven Nationally Recognized Statistical Rating Organizations (NRSROs), where Standard & Poor’s, Moody’s and Fitch Ratings have a combined market share of 90 per cent.<sup>2</sup> “...money market funds and brokerages have no choice but to hold securities rated by them. To this day, the Fed will only accept assets as collateral if they carry high ratings from S&P, Moody's and Fitch.”<sup>3</sup> In other words, the Federal Reserve System and the SEC are in control over which firms are allowed to rate credit risk. This system has naturally allowed these firms to grow larger, and given the position they

---

<sup>1</sup> Philip Booth, *Verdict on the crash: causes and policy implications* (London: Institute of Economic Affairs, 2009), 119.

<sup>2</sup> Booth (2009), 125; White, Lawrence. "The Credit Rating Industry: An Industrial Organization Analysis." *NYU Working Papers 2* (2001). [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1292667](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1292667), 11.

<sup>3</sup> "A Triple-A Idea," *Wall Street Journal*, [online.wsj.com/article/SB123976320479019717.html](http://online.wsj.com/article/SB123976320479019717.html)

### Credit Rating Agencies (continued)

represent in the US financial sector, one could argue that this has caused them to wield significant power internationally too.

### Analysis of problems associated with the industry structure

In an oligopolistic market structure, each firm has a substantial amount of market power. This is precisely the problem with the credit ratings industry because they can, in essence, dictate the prices of various financial instruments and have an overall impact on the financial industry and, at times, whole economies. Here, there are fewer opinions (ratings) being reported and there is a higher chance of special-interests corruption.

In an artificially created oligopolistic market structure, each firm is given more power to wield influence and the way this particular sector is integrated with the financial industry, decisions made by the firms have enormous impacts. An excessive amount of power by such important financial bodies, where there is a smaller chance of errors being noticed in the financial markets (2008) or where decisions can have huge ramifications on countries and financial markets (US debt downgrade), is not a desirable system.

IMF reports: *The increase in references to ratings in regulations over time, combined with limited competition, has created "a more or less 'guaranteed market' with few incentives to compete on the basis of rating quality."*<sup>4</sup>

The problem when credit ratings agencies have too much influence over markets is that it can cause periods of serious market volatility (also in both equity and commodities markets). Many studies and analyses have revealed that prices are based on the ratings given to financial instruments and that these move based on changes in ratings.

The prevailing industry structure also gives rise to a conflict of interest. From the 1970s and onward, issuers of debt instruments have started to pay for ratings rather than

---

<sup>4</sup> Judges with tenure." The Economist. [www.economist.com/node/21525936](http://www.economist.com/node/21525936)

## Credit Rating Agencies (continued)

investors.<sup>5</sup> “When a ratings agency relies for fees upon the firm whose creditworthiness it evaluates, one might expect it to lower its standards so as to increase the level of business it generates.”<sup>6</sup> In an oligopolistic market structure such as the credit ratings industry, to prioritize long term reputational qualities ahead of short term financial gain and forgoing profits to competitors is unlikely to occur, which is also why the system is flawed and may be unable to provide insightful and truthful analysis (An analogy of this is hedge funds operating during a financial bubble. Despite knowledge of this hedge funds are unlikely to abandon any profitable investments because clients would otherwise strongly object to this strategy while other hedge funds continue profiteering from the bubble). The system allowed for dishonest practice, particularly during the housing bubble that led to the 2008 crash:

*The long answer was that there were huge sums of money to be made, if you could somehow get [triple-B rated mortgage bonds] re-rated as triple-A, thereby lowering their perceived risk, however dishonestly and artificially...The rating agencies, who were paid fat fees by Goldman Sachs and other Wall Street firms for each deal they rated, pronounced 80 percent of the new tower of debt triple-A.<sup>7</sup>*

The modeling assumptions used by the ratings agencies were optimistic and there were misratings based on computer errors.<sup>8</sup> In addition, for the most complex financial instruments (such as Collateralized Debt Obligations, which was essentially a number of Credit Default Swaps, for instance, repackaged into one instrument) the agencies did not have a model to base ratings on.<sup>9</sup> Mortgage bonds in general were clearly overrated, as seen by how there was a surge in subprime mortgage bonds created by investment banks before S&P would impose a stricter rating model, and the many loopholes that existed in the ratings framework. This does nothing to improve the information asymmetries in the financial markets.

---

<sup>5</sup> Johan Norberg *Financial fiasco: how America's infatuation with homeownership and easy money created the economic crisis* (Washington, D.C.: Cato Institute, 2009), 61.

<sup>6</sup> Booth (2009), 123.

<sup>7</sup> Michael Lewis, *The Big Short Inside the Doomsday Machine* (London: Penguin, 2011), 73.

<sup>8</sup> Booth (2009), 122.

<sup>9</sup> Lewis (2011), 76.

## Japan's Economy

*By Will Caffrey, Analyst, 1st year, Economics*

Recent data for Japan has been very negative. It shows that exports are down for the 5<sup>th</sup> successive month, with a 6.5% fall in October. GDP also took a hit, falling 3.5% last month. Many are predicting a further contraction of 0.4% next month, meaning Japan will be in recession for the third time since 2008. The trade deficit also reached a record high of ¥75.3tr for the year, after four successive monthly trade deficits.

So, what has been hurting the Japanese economy? There are three primary causes of the weakness in Japan's economy. An on-going trade dispute with China, the Eurocrisis and a persistently strong Yen.

### Weak Exports

The first two causes of Japan's woes can be categorised together because they both have the same effect on the economy. That is, they hurt exports. The current dispute with China over ownership of a group of small islands caused many protests in China against Japanese business interests. This has manifested itself in a large fall in trade between the countries. Exports to China have fallen 11.6%, a lot when you consider that China is Japan's largest trading partner. Last year, exports to China came to \$161bn. Auto sales in particular have taken a hit, falling 82% in October from the previous year. Analysts are suggesting that a bottoming out of the Chinese economy will cause a slight reversal on this trend, but the dispute will continue to have a significant effect on exports. There is, however, some solace in auto exports to the US, which have increased by 3.1% in October from the previous year. This is due to stronger consumer sentiment in the US which has manifested itself in stronger auto sales.

Poor economic performance in Europe due to the Eurocrisis has further affected Japanese exports. The Euro's weakness has exacerbated the problems stemming from the Yen's strength and has reduced demand for relatively expensive Japanese goods. Last week Fitch, a ratings company, downgraded two major Japanese firms' credit ratings to junk bond status on the back of record losses and a poor outlook on demand

## Japan's Economy (continued)

for their products. Panasonic was cut to a rating of BB, while Sony's rating was cut to BB-.

## Strong Yen

Being a net exporting country, Japan's manufacturers are very exposed to exchange rate risk. It generally benefits exporting countries to have a weak currency, which makes their products cheaper abroad, driving demand. However, when the crisis struck in 2007/08, many investors looking for an alternate 'safe haven' fled the US dollar to Yen, causing an appreciation of the currency. This year, the Yen has depreciated 8.8%, but still remains about 30% higher than it was five years ago. After a week of depreciation against all its 16 counterpart currencies, the Yen climbed 0.2% on Friday against the Euro, after poor economic data from Europe. The reversal is likely due to a realisation on the part of traders that the sell-off was too rapid according to Bloomberg. However, with poor economic performance and with uncertainty over future leadership in Tokyo, the Yen is set for a further drop of 1.2% next week.

## Pressure on the BOJ

Poor economic performance has put pressure on the BOJ to commit to increased stimulus programmes in the form of monetary easing. After increasing its bond buying programmes to ¥91trillion in August and September, the BOJ has decided to keep it steady in October. The BOJ's main critic is Shinzo Abe, the leader of the Liberal Democratic Party, who is likely to succeed current Prime Minister, Yoshihiko Noda, at elections on Dec 16. Abe promises to force the BOJ to increase its stimulus programme and commit to a target of 3% inflation, up from the current target of 1%.

Mr Abe believes that negative interest rates, which imply that borrowers get paid for borrowing money, as well as unlimited bond buying is key to turning Japan's economy around. The likely effectiveness of further monetary stimulus however, is up for debate as many believe that once interest rates reach the lower bound i.e. 0%, monetary easing becomes ineffective.

## Chinese Hard Landing

# The Dragon is Getting Ready for the Investment Cliff

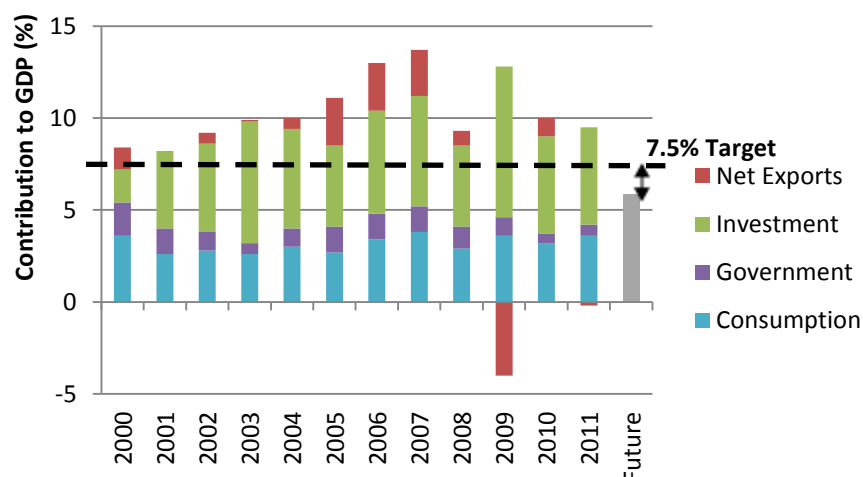
By Richard Low, Analyst, MSc in Finance & Economics

There are growing concerns about a Chinese hard landing – reducing investments off too quickly and mismanaging the transition from an investment driven towards a consumption centric growth model. This article explores the current dynamics of the Chinese growth model and explains why slower growth is inevitable for China.

In the last decade, China's Gross Domestic Product (GDP) has averaged just under than 11%, which is a remarkable feat given that this growth was sustained amidst the worst financial crisis since the Great Depression. To understand the link between investment and GDP, we should examine how GDP is defined. GDP is the arithmetic sum of all the economic value that has been created within the country in a given time period and it is calculated by the formula below.

$$\text{GDP} = \text{Consumption} + \text{Investment} + \text{Government Spending} + \text{Net Exports}$$

From the graph below, we see that China's GDP growth comes from two main sources – investments and consumption, with a larger portion coming from investments. So if investments have worked in the past, what is wrong with an investment driven model?



### Chinese Hard Landing (continued)

This main worry is that for China to continue growing at its current pace, she will need to spend an ever increasing amount on new investment projects. That means that even if China continues building the same number of roads, airports, railways and new cities, there is no contribution to overall GDP growth and there is really a physical limitation on how much she can build. In addition, China's newer investment projects are already suffering from diminishing marginal returns. Although investments raise the overall long term growth prospects of the country, many of the new investment projects (especially in the country's interior regions and residential construction subsector) are currently not generating the expected level of returns and boom will probably end sooner rather than later.

So the real question is, given that the investment driven model is not sustainable in the medium term, when will the Central Government *accept* a lower growth paradigm and can it *facilitate* a smooth transition to more consumption led growth? More clarity will come out of the Central Economic Work Conference in December, but it is widely expected that officials will shift down the country's growth trajectory and rely more on the government spending and consumption as the drivers for economic growth.

At this point, it is worth a thought exercise to understand how large the adjustment in consumption will be to offset a large drop in investments. Assuming that investment grow at a third of its current levels, then expected GDP growth will be 6% (as denoted by the grey bar in the graph above). If the growth target is 7.5% and all the slack is taken up by a growth in consumption, then consumption will need to increase by 50% or about 1.5% of the current GDP.

Given the track record of the Chinese, one might think that a switch of this magnitude is easy. However, George Magus, senior economic advisor to UBS, believes that this is much harder because China does not possess the right transmission mechanisms to bring the economy to a higher level of consumer spending. Traditional, pro-consumer policies, such as a stronger exchange rate and higher wages, are likely to hurt corporate earnings and investments, which might cause the much feared "hard landing". In

### Chinese Hard Landing (continued)

In addition, Chinese corporations and State Owned Enterprises (SOEs) have relied heavily on debt financing rather than equity financing, and the level of corporate debt has risen to over 100% of GDP, which is above the 90% warning level that the Bank for International Settlements announced this year. Chinese companies are highly sensitive to changes in the macroeconomic variables and government needs to understand the effects of any pro-consumer policy changes before implementing them.

China will need to rebalance its growth engine. Investment led growth is not sustainable in the medium term and in-coming President Xi Jinping has his work cut out for him. To grow consumption and minimise the effects on private and public sector, he will need to be innovative and patient in helping Asia's largest economy adjust. New ideas might come from the incoming Premier, Li Ke Qiang, a well-known technocrat armed with an Economics PhD, and then, we might see China avoid the middle income trap that estranged her neighbours, Korea and Japan, when they tried to switch to more consumption led growth.

## Currencies

# USD/JPY: Will the trend last?

*By Marco Ross, Co-editor, 3rd year, Accounting and Finance*

The Japanese Yen (JPY) is the world's third-most traded currency and an exemplary low-yielding, safe-haven asset<sup>10</sup>. USDJPY has been notable for its long-term decline which accelerated following the inception of the crisis given increased demand for safety – the asset declined from 124 to as low as 75.6 by late 2011 (see figure 1). The Yen's strength has been vehemently opposed by the government due its detrimental impact on exports and the difficulty of escaping deflation with a powerful JPY; to little avail, several interventions were carried out (most recently in November 2011), each pushing the pair up several hundred pips, though incapable of sustaining an uptrend. However, since mid-2011 the pair has also failed to break substantially lower and a strong upwards movement has materialised beginning with October this year. On the back of a progressively deteriorating economy and associated political tumult, expectations of exceedingly powerful monetary easing have lent forceful support to USDJPY – this northward trend and the prospect of its long-term sustenance will be the focus of this article.

Figure 1: USDJPY since 1998



<sup>10</sup> During times of market distress heavy flows into the Yen are observed whereas higher risk appetite translates into a weaker Yen as investors seek to free up funds to invest in higher-return assets.

### Currencies (continued)

The foundation for the current move up can be traced to September. With slumping exports, an economy growing at just 0.2% in the second quarter (quarterly basis), and constant deflationary pressure since June, the ruling Democratic Party of Japan has been under increasing pressure to revive the economy – a major component of which would entail a weaker Yen in order to drive up inflation and exports. With the opposition Liberal Democratic Party gaining ground, expectations of powerful last-ditch easing policies increased – for instance, talk of BoJ purchases of foreign bonds to weaken the domestic currency became more pronounced with the DPJ even publishing a manifesto calling for such purchases. In addition however, Japanese authorities' standard rhetoric warning of FX intervention also became more determined and the Bank of Japan increased its asset purchase programme to JPY 55tr (\$670bn).

The current trend commenced in earnest in early October (see figure 2) as pressure mounted on the BoJ to consider further and bolder monetary policy action. Particularly, significant easing expectations were attached to the 30 October BoJ policy meeting which however only saw an increase in its quantitative easing programme of JPY 11tr – approximately in line with cautious predictions, explaining the slump in early November. Most significantly, early-/mid-November came with increased anticipation of mid-December elections which were confirmed on 16 November. With the LDP, headed by the extremely dovish Shinzo Abe, expected to take the helm again, USDJPY rallied forcefully through the psychologically critical 80.00 level. Abe continuously intensified pressure on the BoJ to purchase debt while also seeking to raise the inflation target from the current (unachieved) 1% to 2%, which, Barclays argues, would lead to an 18% “inflation tax” that would devalue both Japanese Government Bonds and the JPY.

## Currencies (continued)

Figure 2: USDJPY short-term trend



Since mid-November the rally has been largely unrelenting; while such a move, unassisted by intervention, is unprecedented in recent future it is questionable whether a long-term trend can materialise out of this short-term development. With Q3 growth showing a striking annualised 3.5% decline, the globe's major economies far from strong recovery and a resultant persistence of JPY safe-haven demand, as well as stubbornly low inflation despite one of the world's most powerful easing programmes, the fundamental perspective currently lends little credence to a long-term sustenance of the positive trend. Moreover, while hardly dubitable that more powerful easing will be pursued under the LDP's rule, the independence of the BoJ, which is being vigorously defended by its Governor, renders the extent of such easing uncertain. Finally, multi-timeframe analysis evidences the relative insignificance of the recent move, while the

**Currencies (continued)**

Treasury yields-USDJPY divergence (the two typically move in line) is further unsupportive of an entirely bullish view. However, it seems plausible that the asset will, in the medium-term, move higher and re-attain stability at the higher rate as it adjusts for more powerful easing and thus inflationary expectations come next year; nevertheless, downward pressure should be sustained in the long-run for as long as a significant turnaround in both the global and Japanese economic environments is lacking.

## Ireland's Economy

# Ireland heading for recovery?

*By Eleanor Gaffney, Analyst, 2nd year Economics*

Undoubtedly the Irish economy has suffered a turbulent time over the past few years. The 1995 to 2007 period of very high economic growth, with the highest growth rates in Europe, led many to call the country the Celtic Tiger. Yet this was to be short lived. The Financial Crisis of 2008 affected the Irish economy severely, compounding domestic economic problems related to the collapse of the Irish property bubble. Between 1984 and 2007 Ireland experienced consistent positive economic growth, however during the period from quarter two to quarter three of 2007 the country encountered a short technical recession, followed by a long two year recession from quarter one of 2008 to quarter four of 2009. In March 2008, Ireland had the highest level of household debt relative to disposable income in the developed world at 190%. This caused a further slump in private consumption, and thus also being one of the reasons for the long lasting recession. However, while serious economic concerns do still persist, arguably late 2012 seems to have shown the first positive signs, hinting that Ireland could be one of the first periphery countries to experience a recovery.

The Economic and Social Research Institute forecasted some very positive growth expectations for Ireland In September, with real GDP expected to rise 1.8% overall in 2012 and increase a further 2.1% in 2013. However, while the European Commission forecasted some lower growth expectations in November, these expectations nonetheless remained positive with them now expected to be at 0.4% overall in 2012 and 1.1% in 2013. Furthermore Ireland's adherence to its European Union and International Monetary Fund programme, its return to economic growth last year and continuing political stability are also easing investor fears. Commercial property prices are also stabilising following falls of more than 65 per cent from their peak in 2007. Collectively this has led private equity groups to seek out bargains amid hopes the country's economy has stabilised.

### **Ireland's Economy (continued)**

Firms such as Apollo Global Management, Kennedy Wilson and Blackstone this week invested almost €400m acquiring distressed loans and commercial properties in Ireland at a fraction of their face value. Interest is also ripe amongst other private equity groups including Oaktree Capital Management, Lone Star, Carlyle Group and KKR who are eagerly watching €50bn in non-core assets, which are targeted for sale as banks shrink their balance sheets.

The increased availability of debt financing has significantly helped to drive more private equity deals. The FT reported that last month Lone Star, the Texas based private equity group, bought a 660m portfolio of AIM loans at a discount of 60 percent, with Nomura agreeing to provide €200m debt financing on the deal. According to the FT several other international banks are also willing to finance deals including Bank of America and Deutsche Bank. This is a positive sign that investor fears are starting to diminish, even if this is a gradual process.

Yet Ireland's image as the success story among European Bailout countries should be treated with much caution. Ireland's public finances and investor appetite for its debt will still hinge crucially on what happens elsewhere in the euro zone. Domestically, the economy remains weak, with little sign that demand is picking up. Nor will it, as long as household debt is about 190 per cent of disposable income and Irish people and companies continue to deleverage. But Ireland is also gaining credit for its improved economic prospects, for efforts to rein in public debt, for restructuring its banking industry and for meeting the demands of its bail-out programme. So it seems Ireland still has a hard road to travel, as it faces a number of years of continuing austerity, and perhaps time will only tell if Ireland will be the first periphery economy to recover.