



Market Wrap-Up

Week Ending November 11, 2012



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Europe

United or Divided?

A quick summary of the crisis in the Eurozone

By Christopher Viggor, Analyst, MSc Economics

Amidst all the coverage of the US elections as well as talk of green shoots one can be forgiven for forgetting about the ongoing crisis in the Eurozone, a conscious decision as much as an unconscious one I imagine. However one need only look at the striking divergence between indicators of business sentiment, such as capital spending, which are weakening, and consumers sentiment, which are strengthening; consumer confidence, for example, is at its highest since February 2008, to see that it is far from over.

Mario Draghi's succession of grand solutions to the Euro's plight, successive because each solution proceeds to crumble within a matter of weeks, unfortunately misses the point. It is assumed that the Eurocrisis is merely a product of high-borrowing costs in the periphery and that if these can be brought down to more manageable levels then governments can continue to pay their staff, unemployment will drop and the Euro area can return to prosperity. High-borrowing costs are however only a reaction to an underlying problem. So what is the underlying problem?

In several member countries, government finances are perilously weak and are growing weaker due to substantial budget deficits. Combined with little to no economic growth, and in some cases economies are even contracting, **debt** in these member countries **is** rising rapidly. Bailout funds and intermittent bond purchases by the ECB can keep profligate/heavily indebted governments ticking along for a while. But if their borrowing needs cannot be balanced in the long term then no amount of money can prevent bankruptcy and avoid potential political upheaval, possibly even conflict, in these indebted countries. Reminding ourselves that borrowing costs reflect investors' views on how likely they are to recover their principal investment back at maturity of the loan, higher borrowing costs for peripheral governments mean that investors are growing less confident about retrieving money they have lent.

Of course the logical solution to high indebtedness is to reduce your borrowings. In the case of the Eurozone, which is the same for most developed nations including Britain's,

the governments that are struggling made what have now turned out to be unaffordable concessions to their electorates during the boom years leading up to the financial crisis. More often than not these concessions were not in the aid of private enterprise, i.e. infrastructure spending - a pursuit that can actually be very beneficial to growth in the long run. One need only refer Roosevelt's expansionism following the Great Depression to see this in action. Too often it was put towards political ends whose benefits are far more difficult to quantify economically. In Greece, for example, public sector wages rose 50% between 1999 and 2007 – far faster than in any other Eurozone country. The money used to finance these promises was borrowed from the financial markets. More money flowing through an economy consequently leads to a real and nominal rise in prices, even though productivity may well be unchanged. This effectively means that vendors are now charging more for the same goods and services that they were offering before. Now when you expand this situation out of a one country scenario to a world economy where you are competing with workers from other countries to sell your goods at the lowest price one can easily deduce that you are steadily making yourself increasingly uncompetitive. All the while your borrowings are increasing.

The fact that government debt continued to rise throughout the boom years is a clear indication that any increase in growth that resulted from this increased borrowing was unsustainable. The classic IMF cure to government over borrowing and subsequent uncompetitive economy is austerity and devaluation, usually via an unofficial higher inflation target, to return costs, i.e. wages, to competitive levels vis-à-vis the world market. This makes it possible for the private sector to fill the gap the government leaves in the economy when it cuts spending.

This is the crux of the problem many Eurozone countries are currently facing. Governments are employing the necessary austerity measures to reduce spending but because they are a member of the Euro, whose operators are vehemently opposed to any unnecessary inflation, they have been unable to devalue and so regain competitiveness. It must be noted that devaluation has basically the same effect as just cutting wages throughout an economy. This is being done in the absence of the ability to devalue, but as can be seen from numerous examples across Europe – Greece, Spain etc. – increasing competitiveness through wage cuts is far more difficult to achieve. The private sector has been unable to capitalise on the extra availability of manpower that

was reliant on public spending. Therefore austerity is only leading to increased unemployment, which in turn results in more government borrowing through automatic stabilisers, e.g. unemployment benefit. A catch-22 scenario prevails making the already heavily indebted countries even more indebted. As mentioned earlier bailing out a government can keep the country ticking along in the short term – as long as there are enough bailout funds to do so - but cannot return its economy to competitiveness, which is required if it is to stand on its own two feet.

Therefore the only solution is to regain competitiveness. The only way of achieving this is either to permit the ECB to increase inflation, achieved through direct ECB government financing, in order to effectively devalue the Euro. To remove the moral hazard dilemma this is only possible if the troubled member states are willing to give up sovereignty of their fiscal budgets to an appointed Euro overlord. Or the other way is for member states to leave the Euro and return to their original currencies that they can control to their individual own ends. They cannot continue indefinitely on the same path. This begs the question – will they unite or will they divide? An even more delectable question is if the Euro elites continue to turn a blind eye to the underlying causes of the crisis and so continue with their misguided strategy of austerity and bailouts, what happens when the lenders, read Germany, Finland etc., overcommit their own taxpayers and run out of cash themselves?

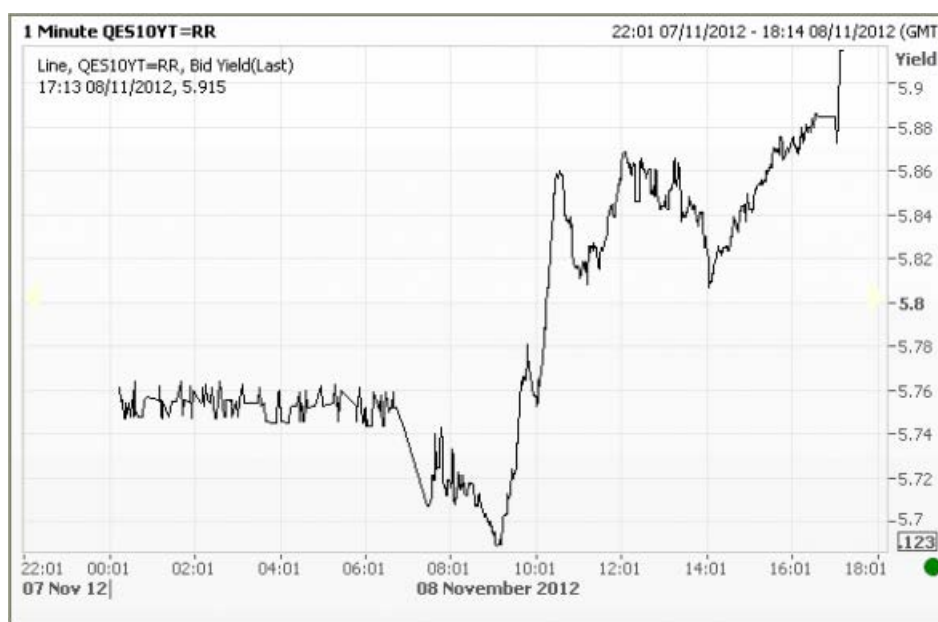
Eurozone

Spain and deficit forecasts

By *Andrei Damaschin, Co-editor, 3rd year Accounting and Finance*

Spain's fiscal management seems to increasingly be a case of plugging holes, watching new ones appear, ignoring them, then relenting and also plugging those - all while delaying a clearly inevitable request for assistance from Brussels. On the positive side, the auction on 8 November marked the completion of the country's planned funding for this year (€86bn; and also €10bn in private placements issuance). On the negative side, the €4.7bn debt sale saw unenthusiastic demand, which has helped spook investors and driven 10-year yields up.

Spanish 10-year yields rose to 5.86%, up 14 bps to their highest since mid-October, with yields across the curve rising by a similar amount and fellow struggler Italy's debt also being pressured. Here is the 10-year yield action during Thursday:



It is increasingly apparent that Madrid has underestimated its 2012 funding needs, meaning that the remaining three auctions planned for this year will also be utilised towards plugging this gap.

It is important to note that while Madrid updated in August its original central government deficit and public deficit projections (of 3.5% and 5.3% of GDP) to 4.5% and

6.3% of GDP respectively, it maintained its original €86bn borrowing target. The funding that Spain is likely to carry out by issuing bonds at its remaining 3 auctions in 2012 will be used to fund the additional budget shortfall of around €10bn already accounted for by the Spanish government rather than to pre-fund Spain's borrowing needs in 2013.

The negative revision European Commission's estimate of Spain's 2012 budget deficit (to 8% of GDP) suggests that the extra €10bn is not sufficient to cover the deficit gap. This further overshooting vs. the government's official deficit estimate would imply an additional increase in Spain's borrowing requirements by around €15bn this year, which may result in a significant reduction of the cash buffer currently available to the Spanish Treasury.

This contrasts to boasts by Inigo Fernandez de Mesa, the country's Treasury minister, last month that the funding needs for 2012 are almost covered, at 95%, and intentions are to start funding the Treasury for the upcoming year. The Spanish government has a tendency to see things through rose-tinted glasses. This view is only reinforced following the revision of Brussels's forecasts for Spain. There is now a divergence between what the EU Commission expects to happen, and what the Spanish government is anticipating. For example, the official deficit forecast for 2013 is 4.5%, and 2.8% for 2014, which is some way off the EC's respective estimates of 6% and 6.4%. The differences in estimates are largely explained by very different ideas as to how much contraction the Spanish economy is going to be experiencing in the next two years.

Mr Rajoy and his colleagues drew up their latest austerity plan on the basis that Spain's GDP would contract by only 0.5% in 2013. That seemed unrealistically sanguine at the time; now the EU Commission is saying that the Spanish economy will contract by 1.4% next year, when earlier this year it was expecting it to shrink by only 0.3%. Economic conditions are rapidly deteriorating in Spain; the EU Commission appears to be more up with events than the government in Madrid, which may well have political reasons for basing its projections on over-optimistic output assumptions. Combined with the record gross bond issuance expected from Spain in 2013 of around € 123bn, there is a significant risk that the country may need to ask for financial assistance from the ESM and the ECB by the end of Q1 2013.

For now, however, the hole-plugging approach is holding up, helped by €24bn in coupon and redemption payments that were due at the end of October, which would have returned some firepower to domestic banks' balance sheets. With this they should be able to lap up the bond supplies until the end of the year at least.

As long as domestic players continue to guarantee a decent participation to Spain's regular auctions, the market's perception of Spain's refinancing risk will likely remain low and the impact of the weaker fundamentals on Spanish bonds may be contained. For the time being this is likely to allow Spain to withstand external pressures to apply for a bail-out and should also provide ongoing support to the upcoming auctions.

Asia

Who will replace Hu?

Economic challenges facing new Chinese leaders

By Wodzik Kicinski, Analyst, 2nd year Economics

With all eyes on the US election last week some have forgotten about a leadership transition in China. Even though the successors were known long ago, and a meticulously arranged power-shift in the Middle Kingdom cannot compete with the riveting race for the White House, the economic challenges the new leaders will face, make the transition equally important to the American one.

At the end of a week-long 18th National Congress of the Communist Party of China (CPC), which begun on November 8th, Xi Jinping is going to replace Hu Jintao as the secretary general of the CPC (later in March he will also become the prime minister) and Li Keqiang will succeed Wen Jiabao as Chinese prime minister. The new leaders will have to firstly deal with a threat of the economic hard landing and then focus on transforming the economy from an investment-reliant one to a consumption-driven one.

Messrs Xi and Li take office at the time of slow GDP growth relative to impressive 9.9% average during the last decade. The World Bank recently cut its 2012 China growth forecast to 7.7% from 8.2%, while the government itself is even more pessimistic, predicting the economy to grow by 7.5%. Global uncertainty depressing Chinese exports provides one of the explanations for this outlook. However one has to look no further than Chinese domestic market to see the most significant causes of the slowdown.

Over-investment in the residential real estate, caused by excessive credit growth, is one of the most severe threats for the economy. With house-ownership rate at 90% there is little scope for further demand increase. Unsold inventories rise and developers postpone new projects. The real estate market, together with sectors directly linked to it, accounts for 10% of the GDP, so current deleveraging of the property sector adversely affects the economy. Real estate bubble is even more significant because it corresponds directly to another Chinese woe - local governments' indebtedness. As the land sale

revenues fall, the local governments are deprived of their most lucrative source of revenue and will struggle to pay their interest rate obligations.

But even if Beijing succeeds in supporting the economy, by likely monetary and fiscal easing, it still needs to address the fundamental imbalance - low GDP consumption share (estimated to be only 35% far less than a value of around 60% for developed economies). So far growth was achieved by forcing up the saving rate and repressing consumption. Household wealth was transferred through low interest rates, undervalued currency and slow wage increases to generate rapid GDP growth. Exceptionally high investment rate combined with price distortions resulted in over-investment which makes growth unsustainable.

Therefore in the future China will need to increase interest rates and open up its capital account allowing appreciation of renminbi. Such changes can make capital allocation more efficient and also increase middle-class' spending.

Recent decision of the People's Bank of China to widen floating band of deposit and lending rates suggests that the CPC slowly begins to move towards interest rate liberalisation. Beijing's decision in 2009 to allow Chinese companies to settle their imports and exports in renminbi resulted in 11% of total trade settled in the domestic currency in the last two quarters. If it will match predictions and reach a level of 30% in the next two years, renminbi will become one of the top three global trade settlement currencies. Even though it does not mean free convertibility it can be regarded as a step towards it.

Such decisions and many more are needed for China to fully develop. The CPC officials become increasingly aware that continuous growth can come only with continuous reforms. No matter how reluctant they are towards political changes, rebalancing of the economy is necessary. It is therefore the way in which Messrs Xi and Li deal with these challenges that will determine their term of office and, more importantly, future prospects for China.

United States Elections

What it means for us

By Melson Chun, 2nd Year Law

By any measures, the recent United States election has been groundbreaking on many levels. Most notably, no United States president since Franklin Roosevelt in 1936 has ever won a re-election with an unemployment rate above 7.2%. Barack Obama put up a courageous fight against the capitalist Mitt Romney from the Republicans and created history by winning the re-election. Amid all these fanfare, what does Obama's re-election actually mean to us?

It means averting an outright currency war with the second largest economy in the world, China. Romney has promised, in his campaign, to declare China as a 'currency manipulator' on the first day of his presidency. Such a move would definitely elicit an unwelcomed response from the twitchy Beijing which has, on numerous occasions, declared that its currency is not undervalued and is in line with the underlying economic fundamentals. Both the U.S. and China are eager to keep their currency low to maximise returns to keep their export industries humming along. With Obama's re-election, it does not necessarily mean that the US\$ 540 billion trading relationship will change any time soon – it simply means that the current situation will remain status quo until several of the challenges facing both the U.S. and China can be resolved, and resolution of these challenges require much internal political will.

Regardless of the sentiment, China watchers say Obama's re-election, while not greeted with elation in Beijing, still provides some element of predictability going forward. There was perhaps greater concern if Mitt Romney had won, given how the Republican presidential candidate had turned China into the ultimate foreign policy bogeyman in the presidential campaign. Chinese officials made clear that any attempt to label their country a currency manipulator, as Romney pledged he would do his first day in office, would complicate the already complicated bilateral relationship even further. Also, another factor worth bearing in mind is how the new Chinese leaders will respond, given that the next succession of leadership is still far from certain.

Obama's re-election means that there will still be no single party with a meaningful control over the political leadership with leadership split right down to the middle. The

Democrats hold the White House and the Senate or the Upper House, and the Republicans control the all-important House of Representatives – the equivalent of the Lower House in the U.K. parliament. The only winner last week was gridlock. This lack of dominant control at Washington can only mean that we can expect much brinkmanship in the upcoming fiscal cliff debate - when the terms of the Budget Control Act of 2011 are scheduled to go into effect. The fiscal cliff is a series of spending cuts and tax increases that economists estimate will shave up to 3% off the U.S. annual GDP. We have witnessed how split the different parties were when the debate over raising the U.S. debt ceiling almost brought the world to a halt and a repeat of the scenario would not be an appealing sight. It is almost certain that should the automatic cuts and tax increases kick in, the feeble U.S. economy would tip back into recession, bringing the whole world into the abyss with it. The most likely result is another set of stop-gap measures that would delay a more permanent policy change.

All being said and done, there is hope that Washington might not be as divided as previously thought to be. A latest report on Financial Times tells us that both parties are willing to compromise should a mutually desirable decision be made as both parties are unwilling to repeat the scene witnessed in 2011.

Investment Strategy

Obama and the Fiscal Cliff

Its implications and consequences for asset prices

By Max Stainton, Co-Editor 2nd year Economics, Politics & International Studies

With Barack Obama being re-elected for a 2nd term and Congress remaining divided, with the Republicans maintaining their control over the House of Representatives and the Democrats extending their majority in the Senate, investors are now having to assess what a continuation of the status quo means for asset prices. The market's initial reaction to the news was an immediate drop in the S&P 500 by 2.4%, a sharp rise in gold by 2.1% and yields on 10 year benchmark US Treasuries falling by 13 basis points. All this clearly demonstrates that the market's initial reaction to Obama's re-election was demonstrably negative with a classic flight to safety taking place. However, why did this flight to safety take place, and are these initial moves indicative of things to come?



Perhaps the easiest move to explain is gold's reaction to Obama's re-election. Throughout the campaign, and particularly during the primaries, Romney persistently attacked the Federal Reserve's loose monetary policy, particularly its programme of quantitative easing. Consequently, with the threat of a much more hawkish Fed Chairman being selected in 2014 and the possibility of political pressure in the interim being removed, markets clearly believe that the extraordinary monetary policy measures that are being conducted will continue for the foreseeable future. Consequently, because of the fear that such unconventional policy will stoke higher

inflation, gold, with its inflation protecting properties, seems like the natural place for investors to flee to. However, how sustainable is this reaction? Before the election result, gold had been trending down since early October on the back of improving employment and unemployment data. The reason for this is that Chairman Bernanke explicitly tied the latest round of quantitative easing (QE3) to a significant improvement in the labour market. Consequently, with the labour market appearing to improve the timescale for the current unlimited quantitative easing seems to be retreating and hence gold's downward moves since October. The continuation of this trend in the labour market, however, is far from certain because of the looming fiscal cliff that threatens to engulf America if its politicians do not come to an agreement before the 1 January 2013. And it is this that I believe is the true driver of both the gold price and the moves in equity and bond prices.

In order to understand why this is the case, it is first necessary to understand the implications of the fiscal cliff and why markets seem to believe that the probability of falling off it is greater under the status quo. Essentially, the fiscal Cliff originated when a fiscal super committee of Democrats and Republicans failed to agree a holistic and long-term debt reduction plan for the US. To compensate for this major failure, they instead agreed to automatic sequesters, in both defence and social security, if Congress and the President could not agree a more sustainable, long-term debt reduction programme by 1 January 2013. These sequesters, totalling more than \$600 billion, would essentially wipe out 4 percentage points of GDP during 2013. With such a large fiscal shock happening over such a short period of time, it seems almost certain that the labour market would severely contract under such a situation, hence lengthening the time period of QE3 and thus heightening gold's attractiveness to investors. Furthermore, with the effects of the fiscal cliff put in stark relief, it is much clearer why the equity and fixed income markets reacted in the ways they did. For equities, the possibility of such a deep fiscal shock happening to the US economy will undoubtedly impact their earnings streams and hence their valuations. Furthermore, the downward moves in Treasury yields appears, on the face of it, most understandable. As one can see from the below chart the fiscal cliff has a clear positive impact on the debt profile of the United States, putting it on to a much more sustainable fiscal footing. This, coupled with the fact that Treasuries are the natural go to for investors during times of recession and the drop in their yields seems even more understandable.

However, all these moves seem to be based on the premise that, because of a resumption of the status quo, the United States will simply ride over the fiscal cliff instead of seeking out a bipartisan agreement which will spare much of this short-term contraction, instead agreeing upon a much more rigorous longer term solution. The primary reason for this belief is that over the last 2 years, the current status quo has failed to achieve this longer-term solution and therefore why should markets believe that a re-elected Obama will be able to accomplish this within the space of 2 months. On the face of it, this seems to be a wholly justifiable conclusion. This seems particularly true because of the very close nature of the election. While Obama did, in the end, manage a sizeable victory in the presidential Electoral College votes, the popular vote was far closer. Consequently, one can envisage both sides taking heart from these results and hence becoming even more intransigent. However, I believe such an analysis fails to appreciate the heat shock that this result is to the Republican Party. On almost every single metric, be it GDP growth, unemployment etc, Obama should not have won this election. This was Romney's, and Republicans', election for the taking. They are therefore seems to be a fundamental misalignment between the Republican Party and the general population and one is beginning to see senior Republicans take heed of this. Consequently, as long as President Obama takes the initiative and reaches out to the Republicans I believe America can avoid falling off the fiscal cliff. As a result, now may be the perfect time to trim one's allocation to gold and Treasuries, and reallocate this to global cyclical corporations' equity and debt. However, a note of warning, because of the brinkmanship that is likely to take place, the situation for these corporate's equity and debt is likely to get worse before it gets better, hence timing, once again, will be everything.

Equities

Driving off the fiscal cliff

by Swasti Gupta, Analyst, 2nd year Economics

Wednesday 6th November saw Barack Obama's presidential win coincide with a 3% decline in the General Motors share price from its 6 month high. Obama's extension of rescue packages to the automotive industry has been a key to his presidential success. But with slow growth in the industry and as the fiscal cliff draws closer, what will the government do about its 32% share ownership of General Motors.

But first, what is the fiscal cliff?

Bush-era tax cuts and fiscal stimulus worth \$600 billion are set to expire at the end of the year. Analysts fear that these austerity measures will lead to a fall over the fiscal cliff, resulting in the single largest debt reduction in history (of \$1.1trillion) over the next two years. Moreover, the reduction in aggregate demand could contract GDP by 3%, enough to send the US economy into another recession.

In contrast, the Congressional Budget Office (CBO) predicts that if the economy continues on the current trajectory, it could grow by up to 1.7% next year. However, in doing so the trade off between growth and debt as given by the debt to GDP ratio could rise up to 86%, compared to pre-crisis levels of 65%. And moreover, in order to fund this, the debt ceiling, which is a legal limit on the amount of borrowing currently standing at \$16.4 trillion, will have to be increased. While this may be a short term resolution to the fiscal cliff, more sustainable measures must be undertaken by the US government in the long run to reduce national debt and increase investor confidence.

Earlier this week, the S&P 500 declined 4% from its 52 week September high amidst speculation that the government would struggle to agree on fiscal policy by the end of the year. Perhaps the government should look for other sources of revenue to fund expenditure.

TARP & “Government Motors”

As part of the Emergency Economic Stabilisation Act 2008, the Target Asset Relief Programme (TARP) originally pumped \$412¹ billion into troubled financial institutions under the Bush administration, in the height of the financial crisis.

Shortly after taking office for his first term, President Obama extended TARP, to car manufacturers including General Motors (GM). Unlike the bailout of the 707 financial institutions, the GM rescue was widely popular, providing \$49.5 billion in emergency funds to support 1.5 million more jobs, giving Obama a leading edge in critical swing states such as Ohio.

Four years on and 89% of the total funds disbursed under TARP have been recovered, with profit. Bank programmes returned 10%, and more recently AIG made a \$9.4 billion profit on the \$182 billion loan from the Maiden Lanes II & III projects. The automotive industry however has fared less well in comparison with just over half of the funds recovered. After the 2010 IPO, the government still owns 500 million shares in General Motors (32% of the company), and remaining investors are concerned that it may stay that way in light of the recent presidential outcome.

In order to break even on taxpayers’ investment, GM must be sold at a price of \$53 or more per share. With \$1.8 billion losses in Europe, GM is currently trading at \$ 25 per share, and a complete sale now would actually result in a loss for the government. So instead, while treasury yields remain low at 1.6% amidst speculation over the fiscal cliff, the government prefers to continue funding this by borrowing more money.

However, as with the successful exit from AIG, if the government was to slowly sell its stake over time, investor confidence would once again increase in the company. According to analysts, a co-ordinated repurchase of 200 million shares, at \$28 per share would act as a positive signal to the market and increase the value of remaining shares by 12%². Moreover, the initial investor optimism would fuel further increases in the stock value, and the over time the government’s initial investment could yield high returns.

¹ <http://www.treasury.gov/initiatives/financial-stability/Pages/default.aspx>

² <http://www.businessweek.com/news/2012-11-08/obama-finds-what-s-good-for-gm-not-so-good-for-taxpayers>

A win-win situation

As national debt reaches its upper limit, it becomes even more critical that the government actively works to recover its remaining assets from TARP. Having acquired an \$11 billion credit facility to start buying back shares, GM presents the best opportunity to do so. But until further action is taken, the “Government Motors” label of the company will continue to depress its share price, and vital government funds will remain locked into its assets.

Monetary Policy

Quantitative Easing vs. The World

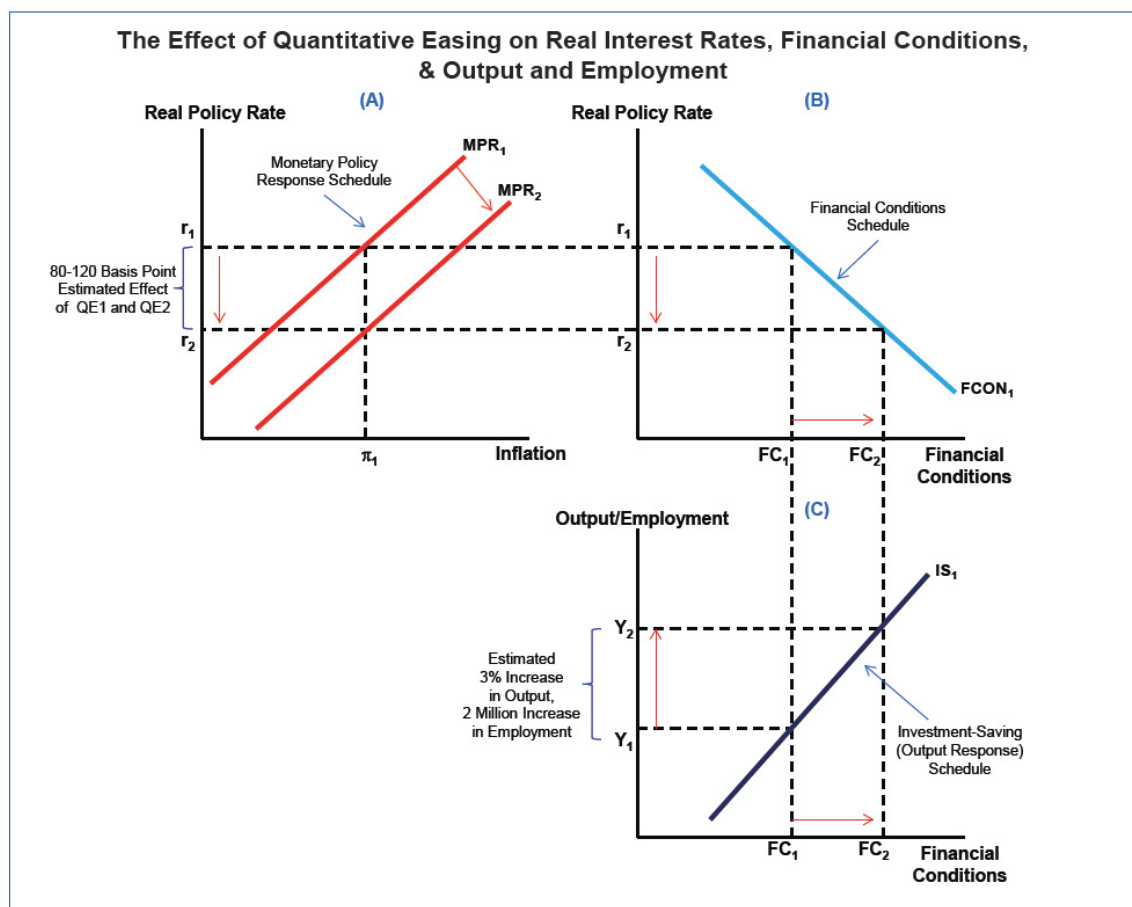
Another weapon of mass destruction?

By Elliott Anderson, Co-Editor, 3rd year BSc of Management

Quantitative Easing (QE) reemerged into the public's lexicon from the late 2008. The Fed (US Central Bank) started its first round of QE, resulting only in a brief investment spree. However, 4 years on, a re-elected president later, calls for a third round of QE from some investors are putting pressure on the Fed to act. If the first round didn't work, why are we talking about a third shot at this monetary policy?

How does QE work?

The theory is well explained by Bloomberg in the following chart.



In theory (I'll explain the emphasis further on), by cutting interest rates, i.e. by making money cheaper, it would improve financial conditions to spur investment, leading to output and great employment.

But, economists are economists. Because when it comes to explaining why a square peg won't fit into a round hole, only an economist will tell you, over and over, that it will eventually happen, one must just tweak the theory a little first, and then reality will promptly follow.



This theory has 2 key assumptions in my opinion that make QE weapons flawed. The first is of course that it assumes inflation will stay fixed. The second, more important reason is the assumption that we know the slopes coefficients! Imagine that FCON1 was in fact steeper, or that IS1 was flatter – are the marginal increases worth the increase in inflation?

QE more problems than solution?

In a FT Post entitled 'Mugabenomics: Inflation in UK Higher than in Zimbabwe', Guido Fawkes points out how Vince Cable once warned that Quantitative Easing (QE) was "Mugabenomics." Alas as the blog rightly warns, "In government Osborne has overseen the printing of more money than any other Chancellor in British history. A quarter of the national debt – all this government's overspending – has been bought by the Bank of England via QE." "So it is not a shock that inflation in Zimbabwe (3.63%) is now lower than inflation in the UK (3.66%, August 2011-July 2012)."



The inflation risks associated with QE are real and may be already in effect!

With QE come lower bond yields, since the central banks repurchase them. This has arguably led to higher oil prices too. OPEC countries have reported they are maxing out on foreign exchange reserves because it is no longer interesting to invest in low yielding US treasuries. Whilst the US and Europe would like them to produce more, US interest rates are so low they would have extra money with nothing to do about it. In short, the opportunity cost of not producing oil has fallen dramatically. Thus, OPEC policy makers feel little pressure to increase production to lower oil prices.

Many countries have also complained about QE due to exchange rates. Interventions end up lowering interest rates internationally, rather than just propping up demand in the country which is buying the foreign exchange. The hot flow of dollars around the world has led to EM currencies having difficulty to appear competitive. Furthermore, economies can face structural issues.

The problem starts with an excessively low cost of capital. Average interest rates on new corporate loans, both short and long term, are down to an unprecedented level in Japan of almost 1 per cent, while the average interest rate paid on overall corporate lending is just under 1.5 per cent. At these levels too many inefficient businesses are being kept alive, says Jesper Koll, head of equity research at JPMorgan in Tokyo.

What after QE?

The Bank of England suspended its emergency bond-purchasing programme on Thursday, raising doubts about whether quantitative easing has lost its power to boost the economy. Some economists speculated that the BoE believed the economic recovery would remain weak and faster growth further stoke inflation, which is likely to remain above its 2 per cent target through 2013. Poland on the other hand, rather anti-QE, attempted to raise its interest rates to 4.75, before reducing them to previous levels.

The pro and counter arguments for using QE are prevalent, but I doubt we will get a final answer soon: we will have to wait and see how everything unfolds (let's not hope for hyperflation).

When Mario Draghi insisted last week that central banks buying short-term government debt falls "within the range of classical monetary policy instruments", he wasn't wrong! The Fed conducted the first bout of QE during the Great Depression, buying Gold to support the dollar for it guaranteed the dollar/gold convertibility. Next up was a more unlikely candidate. In 1975, the Bundesbank bought around DEM 7.6bn of public bonds (post, telecom and sovereign bonds) in the secondary market. This was equivalent to around 1% of GDP. History might be on Mr Draghi's side, but the markets change in characteristics, and QE just doesn't seem to be doing the job here.

Note from the Team

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