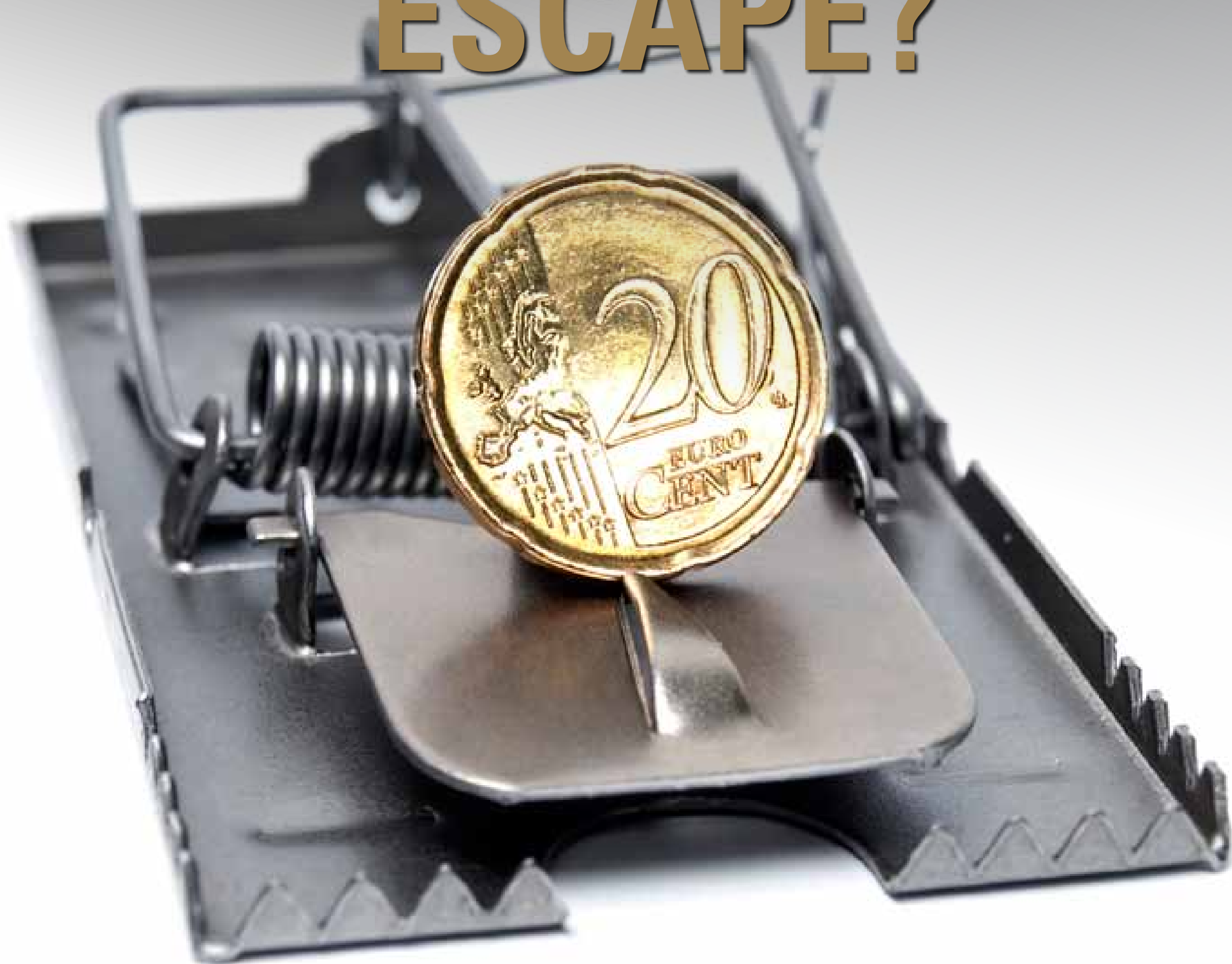
Foreign Exchange
2012 First Quarter Report

Brown Brothers Harriman

CAN THE EURO ESCAPE?



Investment Strategies for Interesting Times

Basel's Faulty and the Deathly Hallows

Impact of Thailand Flooding

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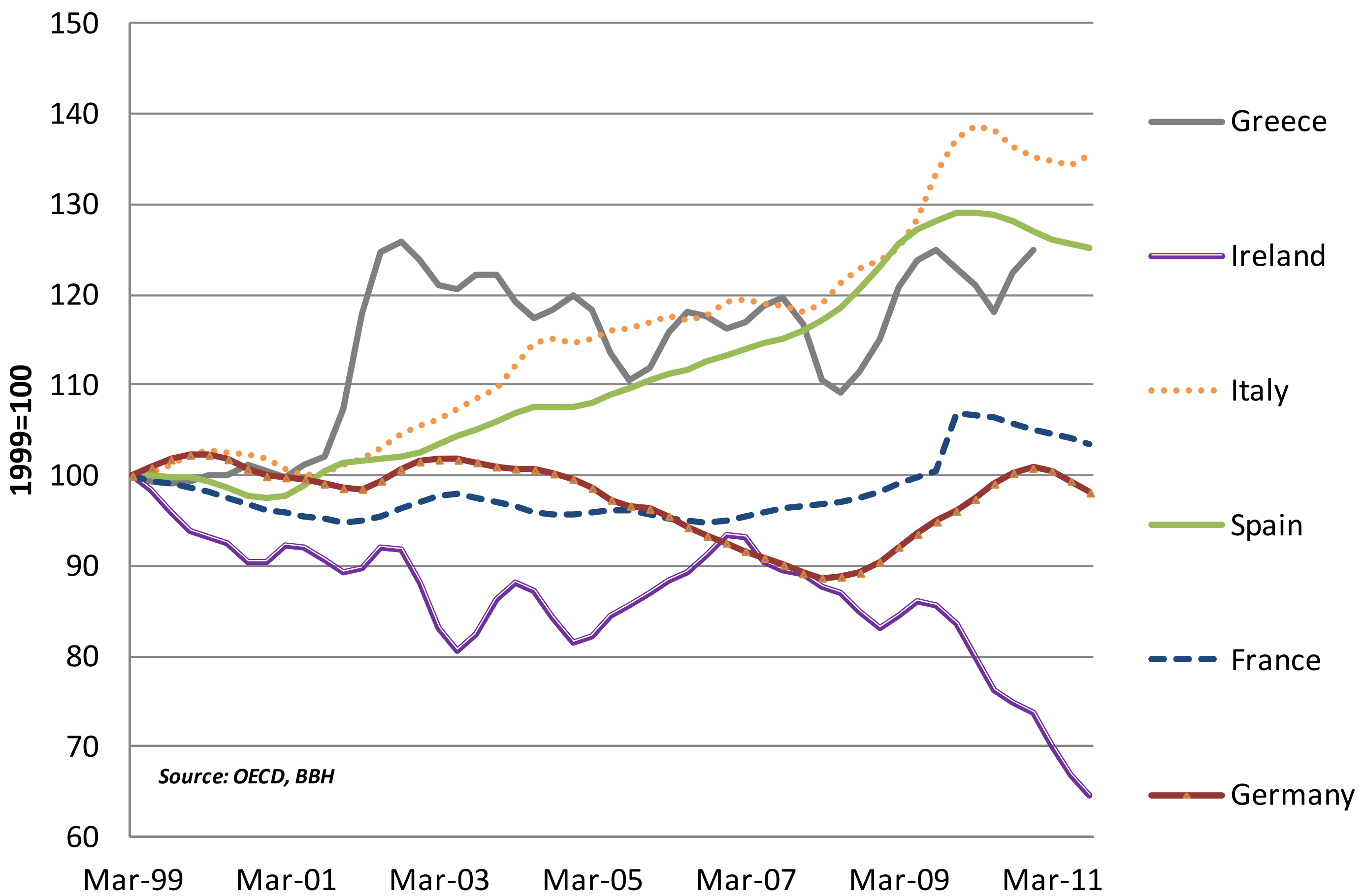

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Overview

The inability of European officials to put closure on the debt crisis, which is extending into its third year, will remain the key determinant for the general investment climate and global capital markets. The regime of austerity that is being adopted throughout the region risks producing a deep and/or protracted economic downturn. The large amount of debt issuance by the region's sovereigns and banks, concentrated in the first part of the year during a period in which investor confidence has been lost, provides the tinder that is looking for a spark.

The economic and financial linkages cannot be underestimated even though the European Union trades mostly with itself. Already there has been a significant drop in Asian exports to Europe, for example. U.S. businesses and many Japanese businesses meet European demand more through local production than exports. This, coupled with what we believe will be an environment of unfavorable currency translation, will still impact corporate balance sheets.

The scope for financial contagion may be even greater than the economic implications. European banks are under pressure from investors and regulators to strengthen their balance sheets. The ability and/or price to raise new capital, without an EU-wide guarantee, may be prohibitive.

The adjustment process will take place through some cosmetic maneuvers, like tweaking models of risk weighted assets, and through the sales of assets and the pulling back of credit lines. The avoidance of a severe credit crunch depends on the ability of other agents to fill the gap. This will create opportunities for foreign banks and for a new "shadow banking" system to emerge. Some asset managers and private equity funds have been reported to be among the buyers of loan portfolios, for example.

We have developed a nuanced view of the European crisis. We do not expect the ECB to backstop sovereigns nor do we anticipate a European bond. Yet, we think the euro zone survives, contrary to what seems like a growing body of opinion. Muddling through is the second best outcome, and we believe it is still the most likely scenario. One of the results will be a weaker euro, but barring an outright collapse, depreciation is likely to be broadly welcomed by European officials and businesses. A weaker euro is also consistent with the easing of monetary policy.

We expect that the Swiss National Bank will continue to enjoy greater success, even without altering its current cap on the franc, than the Bank of Japan in deterring safe haven flows. The major part of Japan's macro-economic recovery from the catastrophe in March is behind it and deflationary forces have re-emerged.

The main challenge that Japan faces is no longer recycling its trade surplus. In fact it has reported monthly deficits half the time in the January-October period and ran a modest deficit over the period as a whole. Instead, the problem is in the circuit of capital. The combination of the large investment income surplus and foreign purchases of Japanese securities overwhelms Japan's capital exports.

November OECD Growth Forecasts, change vs. May

	2012	change	2013
OECD	**1.6%**	**-1.2%**	**2.3%**
U.S.	2.0%	-1.1%	2.5%
Euro Area	0.2%	-1.8%	1.4%
Germany	0.6%	-1.9%	1.9%
France	0.3%	-1.8%	1.4%
Italy	-0.5%	-2.1%	0.5%
Switzerland	0.8%	-1.7%	1.9%
Japan	2.0%	-0.2%	1.6%
U.K.	0.5%	-1.3%	1.8%
Canada	1.9%	-0.9%	2.5%
Mexico	3.3%	-0.5%	3.6%
Korea	3.8%	-0.7%	4.3%
Australia	4.0%	-0.5%	3.2%

Source: OECD

We expect the U.S. economy to grow around 2.0%-2.5% in 2012. While we recognize the risk of another round of asset purchase (probably mortgage backed securities) by the Federal Reserve, we think the focus of officials in the first part of the year will be in terms of communication. We think it takes either serious threat of economic contraction or of deflation to make what would be QE3 more probable.

The Emerging Markets (EM) will find it, as usual, difficult to truly decouple from the major economies. Many in EM have had a mini-policy cycle, like the European Central Bank, which raised rates and then within months began unwinding them. Monetary policy is being eased again in a number of countries, including China, Brazil, Indonesia, and Turkey. We expect others, especially in Asia, to follow suit in Q1 2012.

We expect China to engineer a soft landing for the world's second largest economy. Part of the policy response may be a more stable yuan. The yuan was the strongest currency in Asia in 2011, appreciating about 3.8% (through mid-December). In the generally firm U.S. dollar environment we are forecasting through the first half of 2012, we expect yuan appreciation to be minimal.

This quarterly updates our G10 and EM currency forecasts, and we also update our EM FX, Equity Allocation, and sovereign ratings models. Given the difficult and interconnected investment environment, we are happy to include the analysis from two other parts of Brown Brothers Harriman in addition to our currency strategy team's work. Scott Clemons, Chief Investment Officer for our Wealth Management Group, offers insight into portfolio construction for difficult times. Andrew Hofer, who heads up Fixed Income Research, shares his thoughts about financial institution risk and how it may change credit markets.

-Marc Chandler

Outlook for G-10: Euro Zone to Remain In the Spotlight

New Year, Old Crisis

The Mayan calendar ends on the winter solstice of 2012 with a number of astrological developments perhaps fanning anxiety in some quarters, but investors will have more pressing concerns than the "end of days." The debt crisis that began in mid-2007 is not over. It has morphed and mutated, but the seeds sown in the mispricing of risk for an extended period of time will continue to be reaped in the quarters ahead.

That is the overreaching theme of the current investment climate. It means that policy rates will remain near zero, with scope for the European Central Bank to lower its key repo rate below the 1% floor seen earlier in the crisis. It means that some countries, like Australia, will extend its easing cycle that began in 2011. It means other central banks, especially in the U.K. and Japan, will continue to rely on unconventional measures, such as asset purchases.

When adjusted for inflation, or inflation expectations, interest rates in the United States, Canada, Germany and the U.K. will remain negative. Negative real interest rates are the result of low nominal rates (as a function of weak economic activity), safe haven flows, purposeful policies by central banks, and elevated commodity prices. They are the bane of fixed income investors, who struggle to preserve the purchasing power of their capital.

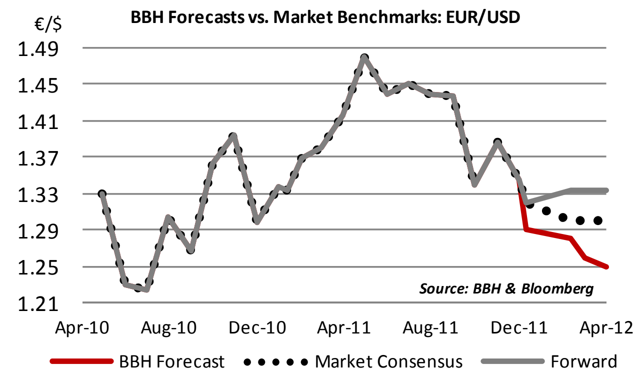
While negative interest rates make competitive investments such as equities more attractive, the political and economic climate is not conducive for aggressive risk taking. The first part of 2012 will likely see the euro zone, in whole or significant parts, contract. The U.S. will remain mired in slow growth that barely stabilizes the labor market, at a politically unacceptable level of unemployment. Households' ability to draw down savings (3.3% in September from 5.8% in June 2010) to fuel consumption in 2012 is limited. On the income side, wages are not keeping pace with inflation. The housing market may be showing some preliminary signs of stabilization, but cannot be an engine of growth in coming quarters.

Reconstruction spending in the public and private sectors in Japan may help soften the drift lower, but growth in the world's third largest economy will be too slow to provide much contribution to the world economy. The inflation associated with higher commodity prices and the supply disruptions from last March's tragedy has proved to be temporary and the underlying deflationary forces, arguably exacerbated by the strength of the yen, are reclaiming their grip.

Europe: The Irresistible Force Meets the Immovable Object

From one perspective, the European debt crisis is the continuation of re-pricing of risk that began with the implosion of the subprime real estate market in the United States. In the years before the crisis, banks were lending money to households with weak balance sheets on nearly as favorable terms as those with strong balance sheets. European banks were lending to countries like Greece and Portugal on roughly the same terms as they were lending to Germany and the Netherlands.

As European banks fled the US mortgage-backed securities market, they appear to have jumped from the proverbial fire and into the frying pan by increasing their exposures to the periphery of Europe. To err is human, but to make the same error twice in quick succession is unforgiveable, and has severe consequences.



The ability to leverage the European Financial Stabilization Facility (EFSF) has been compromised by the lack of investor confidence. The insurance type of facility that was contemplated was undermined by Europe's ability to get private investors to "voluntarily" agree to a 50% haircut on Greek holdings while not triggering the insurance purchased in the form of credit default swaps.

The seeming inability of politicians to hammer out a resolution leaves two potential courses of action, according to most observers. The first is the ECB to act as the lender of last resort to sovereigns as well as European banks. This would require it to dramatically increase its sovereign bond purchases in the secondary market.

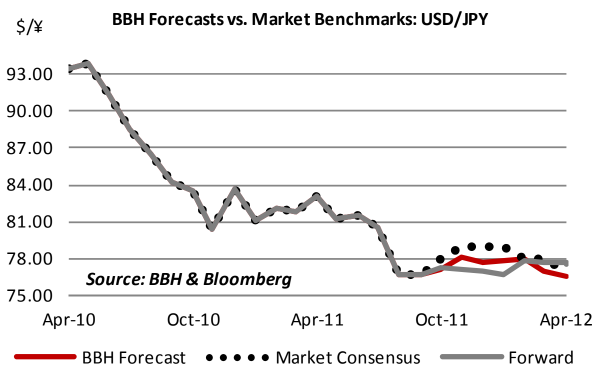
This would transform the relatively small and sterilized operation into a full-fledged quantitative easing. Sovereigns in the periphery are projected to issue around EUR1.5 trillion of bonds and bills in 2012 (Italy alone will sell at least EUR440 billion in bonds and bills). It is difficult to envision strong private sector demand and, if the ECB does not step up, the general argument goes; a sovereign funding crisis could be triggered. A sovereign funding crisis would also intensify pressure on banks and exacerbate their own funding crisis.

The second course of action that many see as the only alternative to a dramatic worsening of a sovereign and banking crisis is a European bond. There are various forms of this proposal, but they share the idea that some part of sovereign debt should be covered by a common bond market. This would ensure market access—something that Greece, Ireland and Portugal do not enjoy, and that appears to be increasingly at risk for Spain and Italy.

EMU—Everyone Must Unite

A more active ECB or a European bond is so obviously the only way to avert a disastrous outcome that many cannot comprehend Germany's reluctance to assent. It is important to recognize that Germany is not as isolated as may appear in the media. The ECB in word and in deed appears to support the German position, as do a few of the other northern European creditor nations like the Netherlands and Finland. Many EU Commissioners and EC President Herman Van Rompuy seem supportive as well.

This perhaps suggests an under-appreciated institutional problem within the euro zone. Factions, or special interests, were acceptable, James Madison taught in Federalist 10, but to avoid an oppressive special interest, it is important that there were no permanent factions.



Yet in the euro zone, the creditor/debtor issue cuts across nearly all the important issues of the day, especially the response to the crisis and the evolution of European institutions. Moreover, the two pillars of EMU, Germany and France, are increasingly on opposite sides of the divide.

The argument against the central bank being the back stop is that it blurs the distinction between monetary and fiscal policy, compromises the ECB's independence, and has a dubious legal basis. The subtext is that large scale bond buying would weaken the incentives for countries to quickly get their fiscal houses in order. By this reckoning, unsterilized large scale bond purchases also risk fueling inflation.

The creditor nations are also wary of a common bond and place emphasis on the moral hazards. A joint bond would reward those who have been profligate at the expense of the prudent and disciplined. It would be a transfer from the higher rated countries to the less so. It also mitigates the incentives for countries to reform. The short-run fix could aggravate the long-term problem.

A common bond may be possible, and arguably necessary, when countries ceded fiscal sovereignty. A common bond would be an effect of greater fiscal union, or what Germany has called "stability union", rather than a form of transfer that is an incalculable and near unlimited liability for the creditor nations.

It took a large unpredictable shock, the fall of the Berlin Wall and the subsequent ERM crisis in the early 1990s, to prepare European officials to cede monetary authority. The current existential crisis may be a sufficient spur to cede fiscal authority. However, the crisis may need to deepen further first and that is the risk in the first part of 2012, when sovereign and private sector bond maturities peak.

Looming Downside Risks

The euro zone's Composite Purchasing Managers Index remained below the 50 boom/bust level during Q4 2011. The ECB has eased monetary policy proper and increased its liquidity-providing facilities. Since Draghi became the head of the ECB in November, the April and July rate hikes under Trichet have been fully unwound. The ECB cut required reserves in half (worth about EUR100 billion). It also offered new lending facilities to its member banks for three years. It has liberalized collateral rules. Separately, dollar liquidity was enhanced by the reduction in the punitive rate in the central bank auction.

Peripheral countries, especially Spain and Italy, are vulnerable to credit downgrades in Q1 2012, and we are increasingly concerned that France's AAA rating is at risk. In addition, any kind of shock at this juncture, a deeper economic downturn, larger demands from the banking system (see, for example, Dexia), or even continued increase in interest rates, may be a sufficient spur. We expect the euro to trend lower against the US dollar through the months ahead.

We note that all the G10 currencies trade above fair value against the U.S. dollar. This would suggest that what some call the "euro's resilience" may have something to do with the measure, that is the economic assumptions in the models, or perhaps it is about the structure of the international political economy.

While the dollar is undervalued against the major currencies, it appears overvalued against many emerging market currencies, especially in Asia, but also Eastern and Central Europe (Hungary, Poland and Turkey) and some Latam countries, like Mexico. This suggests that an important imbalance exists between these countries, and the G10 may account for some residual of the euro's "resilience".

Chugging Along in America

After a dreadful first half, U.S. economic growth accelerated in H2 2012, but the economy is uneven. Those sectors that are enjoying strong growth, like manufacturing, mining and drilling, and agriculture, are no longer labor-intensive operations. The U.S. economy is producing more goods and services than ever before, but is doing so with about 6 million fewer private sector workers. The consensus calls for the U.S. economy to expand 2.0-2.5% next year, and unemployment is likely to prove sticky. We share the view and see it based on a couple of policy assumptions that are worth exploring.

First, while the failure of the super-committee to reach a compromise is unfortunate, on substantive grounds it is of little impact for the coming months. The automatic cuts are not

implemented until 2013 and are largely back-loaded. The fact that the early cuts are focused on sectors that have strong constituencies, like defense and education, means that there will be plenty of incentives and opportunities to strike a bargain.

The larger fiscal drag next year comes from the expiration of the payroll savings tax holiday and the emergency unemployment benefits. We are assuming that, especially in the election year, an extension of both will be reached even though the larger structural fiscal issues remain unaddressed. If for some reason these initiatives are not renewed, the outlook for U.S. growth disintegrates markedly.

The Federal Reserve does not seem content yet that monetary policy is doing everything it can to support the economy. Several key officials, including the Chairman and Vice Chairman, as well as the NY Fed President, have suggested the need for additional action.

We expect this action to be in the realm of communication rather than an expansion of the Fed's balance sheet. The recent minutes (from November's meeting) signaled this option, rather than renewed MBS purchases, commanded more discussion. Providing greater guidance may become evident in the early part of 2012, concurrent with the ongoing Operation Twist.

There remains a risk that the Fed does implement a new asset purchase program, but we continue to believe the bar to exercising this option is quite high. It requires either a new threat of deflation or signs that the U.S. economy was headed for a renewed recession.

The U.S. private sector has been adding jobs every month since February 2010. The data suggest that the job growth during this recovery has been on par with the recovery at the start of the decade. Similarly, economic growth in the nine quarters since the trough has only been about a quarter percentage point less than the earlier recovery.

Other Policy Decisions

We expect the ECB to cut its key repo rate to 0.75% by the end of Q1 2012 in response to economic prospects, which in turn, with the help of softer energy prices, will ease price pressures. Inflation in the U.K. is also likely to fall sharply in the coming months, partly as a function of base effects, and we anticipate the Bank of England to extend its current gilt purchase program, which is set to be completed by the end of the first quarter.

The Swiss National Bank was highly successful in capping the franc's appreciation against the euro. It managed to achieve more than a 20% depreciation of the franc, and appears to have been achieved relatively cheaply.

By most measures, even with EUR/CHF at 1.20, the Swiss franc is still too strong. The policy issue for the SNB is whether to seek to lower the franc's cap (raise the euro's floor from CHF1.20 to CHF1.25 or CHF1.30). The issue for investors is whether the franc can be a funding currency.

There is some risk that the SNB, enjoying its success, presses the point and seeks to push the franc closer to where it believes is fair value. However, on balance, we suspect the SNB will choose not to risk what they have achieved for what appears to be marginal additional gains. For most of Q4 2011, the euro was trading around CHF1.23.

The Bank of Japan has not nearly enjoyed the same success as the Swiss National Bank despite spending a record amount on intervention, with the last unilateral effort appearing to involve the purchase of $100 billion in a single day. Leaving aside qualitative judgments about credibility and tactics, the fact of the matter is that the yen market is many times larger than the euro-franc market.

Data from the Bank for International Settlements triennial 2010 FX survey show the average daily dollar-yen turnover was almost $570 billion, while the average daily euro-franc market was a little more than $70 billion. That alone suggests a challenge of a different magnitude. We suspect upward pressure on the yen will remain and will express itself more acutely in a weaker dollar environment.

The key imbalance we identify is not the traditional answer of Japan's trade account. Rather we locate it in the capital account, as the income from past investments (dividends, interest, licensing fees, royalties, etc.) swamps the trade account. On the other hand, in a strong dollar environment, we expect the yen to be largely stable.

On balance, additional bouts of BOJ intervention, which serve to recycle the capital imports, cannot be ruled out. The tactics were essentially the same in the August and October operations, with comparable and generally disappointing results.

Key Points

We generally expect the U.S. dollar to trade higher in Q1 2012 against the major foreign currencies. The European debt crisis will again remain the main driver of the global capital markets, where risk-assets remain highly correlated.

We look for continued easing of policy by the ECB, BOE, BOJ, Norges Bank, and RBA. We see increased risk that Sweden's Riksbank also eases monetary policy. During the continued implementation of Operation Twist, we expect the Federal Reserve to limit its policy initiatives to modifications to its communications with the market.

We expect the European debt crisis to worsen, with more downgrades, and highlight the downgrade risks to France. Both the sovereigns and the banks have large sums of bonds maturing in 2012 which risks disruptions to the markets.

Significant risks to our view include a marked slowing of the U.S. economy that brings forward a new expansion of the Fed's balance sheet, a positive resolution of the European debt crisis or the end to EMU.

-Marc Chandler

Currency Forecasts

Major Markets

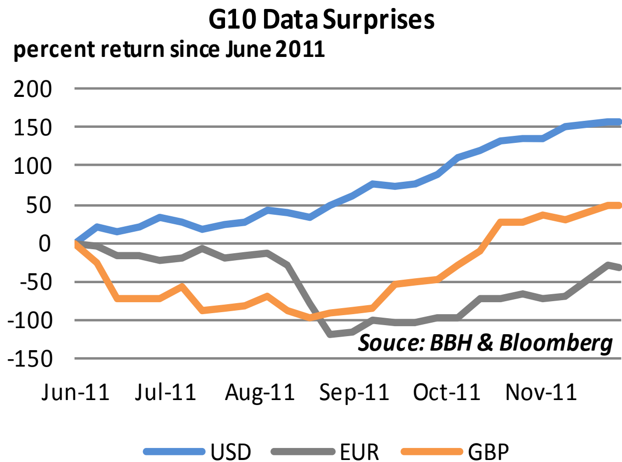
In U.S. Dollar Terms	Current	Q1 2012	Q2 2012	Q3 2012	Q4 2012
Euro	1.31	1.24	1.20	1.23	1.27
Yen	78	77	76	78	80
Sterling	1.57	1.50	1.49	1.52	1.53
Canadian Dollar	1.03	1.06	1.05	1.03	1.01
Australian Dollar	1.00	0.94	0.92	0.95	0.99
New Zealand Dollar	0.77	0.72	0.69	0.72	0.75
Swedish Krona	6.85	7.30	7.55	7.35	7.04
Norwegian Krone	5.88	6.24	6.55	6.35	6.05
Swiss Franc	0.93	1.00	1.04	1.00	0.97
In Euro Terms	**Current**	**Q1 2012**	**Q2 2012**	**Q3 2012**	**Q4 2012**
Yen	102	95	91	96	102
Sterling	0.84	0.83	0.81	0.81	0.83
Swiss Franc	1.22	1.24	1.25	1.23	1.23
Swedish Krona	8.98	9.05	9.06	9.04	8.94
Norwegian Krone	7.71	7.74	7.86	7.81	7.68

Emerging Markets

In U.S. Dollar Terms	Current	Q1 2012	Q2 2012	Q3 2012	Q4 2012
Chinese Yuan	6.35	6.34	6.34	6.30	6.26
Hong Kong Dollar	7.78	7.79	7.78	7.77	7.77
Indian Rupee	52.89	56.00	56.00	55.00	54.00
South Korean Won	1162	1210	1200	1175	1150
Indonesian Rupiah	9080	9200	9200	9000	8800
Malaysian Ringgit	3.18	3.25	3.25	3.20	3.10
Philippine Peso	43.82	44.75	44.75	44.00	43.50
Singapore Dollar	1.30	1.32	1.30	1.28	1.25
New Taiwan Dollar	30.34	30.75	30.50	30.00	29.50
Thai Baht	31.27	31.75	31.50	31.00	30.50
Brazilian Real	1.85	1.90	1.85	1.82	1.80
Mexican Peso	13.76	14.10	14.00	13.50	13.25
Czech Koruna	19.43	20.97	21.50	20.73	19.84
Hungarian Forint	229	252	258	248	240
Polish Zloty	3.40	3.71	3.75	3.58	3.39
Russian Ruble	32.0	33.0	32.5	32.0	31.5
South African Rand	8.25	8.65	8.60	8.40	8.20
Turkish Lira	1.89	1.95	1.90	1.85	1.80
In Euro Terms	**Current**	**Q1 2012**	**Q2 2012**	**Q3 2012**	**Q4 2012**
Czech Koruna	25.47	26.00	25.80	25.50	25.20
Hungarian Forint	300	312	310	305	305
Polish Zloty	4.46	4.60	4.50	4.40	4.30

United States

- **We outline three potential economic scenarios for the outlook of the U.S. economy in Q1 2012, and our baseline scenario expects the U.S. economy to grow between 2-2.5% and no QE3.**
- **The second and third scenarios underpin the extremes, with our current bias suggesting the downside risks to the economy due to external factors and domestic weakness are likely to outweigh the upside risks of above trend growth.**
- **The muddle through approach for the U.S. economy, together with the intensification of the euro zone debt crisis, suggest that the dollar is likely to remain firm into 2012, although a policy response from the Fed is likely to challenge potential dollar strength.**



Key Drivers

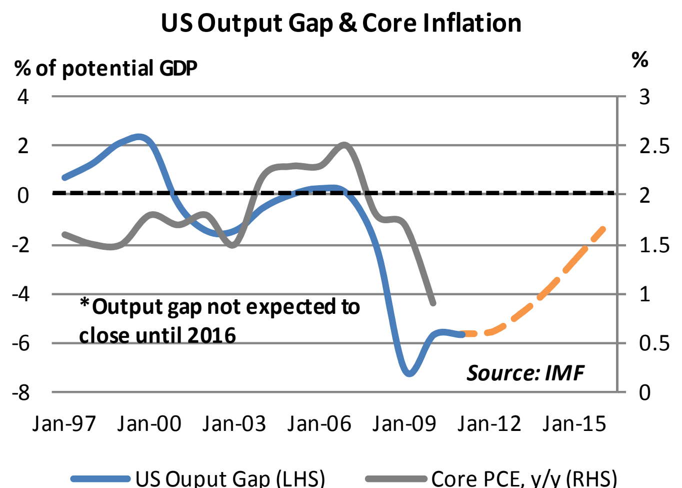
After a marked slowdown in the first half of the year, the US economy looks poised to rebound in the second half of the year and into 2012. Heading into Q1 2012, the pace of U.S. economic growth should remain above trend, driven by the strength of consumer spending and business investment. The recent slide in inflation should also help restore household purchases, which was a major squeeze to household purchasing power in H1 2011. Despite muted income growth, consumer spending remains resilient due in part to the draw-down in savings, which over time is unlikely to be sustainable. We see the potential for a few scenarios to play out next year.

The first scenario, in which we place roughly a 67% chance of outcome, is that US policymakers agree to rollover the temporary stimulus measures enacted last year. As a result, the U.S. economy avoids a fiscal drag, totaling nearly 1-2% of GDP, and the economy then grows at a pace of around 2-2.5% in H1. In this scenario the unemployment rate is likely to remain sticky, prompting more aggressive policy measures from the Fed. Initially, we suspect that the first move would be to alter the communication strategy, rather than an expansion of the Fed's balance sheet. Ultimately, this is unlikely to weigh on the dollar much, given the potential for intensification of the sovereign debt crisis in Europe. Considerable spare capacity in the labor market (measured by the output gap) is likely to underpin a benign inflation outlook, with wages constrained by the excess supply of labor (see chart below).

The second and third scenarios represent the extremes, with our current bias suggesting that the downside risks to the economy from external factors and domestic weakness likely outweigh the upside risks. In our second scenario, which we place odds of around 20% on outcome, U.S. economic growth sputters in Q1 2012 due to negative spillover from Europe (credit and bank lending, in particular) and sharp fiscal drag due to political paralysis ahead of the election. This downbeat scenario sees the threat of deflation and softening economy activity as catalysts for the Fed to pursue further QE in order to try and resuscitate the economy. At the same time, we place a 13% chance on the optimistic scenario, which sees the U.S. economy growing above trend and outstripping consensus expectations for the quarter ahead. This view is driven by a sharp rebound in housing and a resilient consumer, who continues to spend off the back of the combination of employment and income growth.

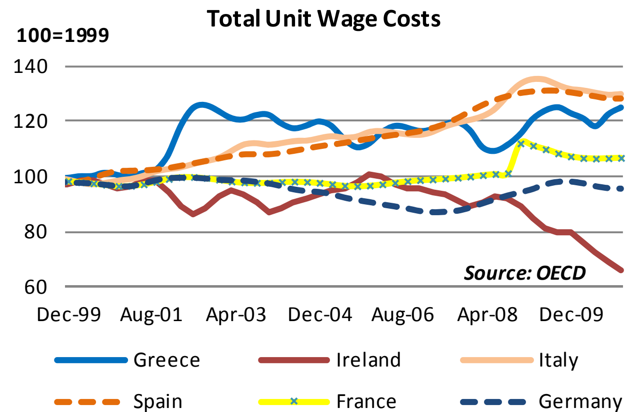
Dollar

Our baseline scenario envisages a muddle-through approach for the U.S. economy. Against the backdrop of an intensification of the EZ debt crisis this is likely to keep the dollar firm amid the demand for safe haven assets, including U.S. Treasuries. (This is also the likely outcome for scenario two as well.) While this scenario might lead to more aggressive policy from the Fed, we suspect that EZ economic headwinds (and a more aggressive ECB response) will ultimately see the USD continue to advance against the euro. Nonetheless, the effect of continued monetary easing is likely to counterbalance the demand for USD amid a persistently risk-averse environment, suggesting more choppy conditions ahead. Scenario three, meanwhile, is likely to lead to a broad dollar selloff amid the decline in safe haven demand and resulting outflow of capital. Indeed, strong U.S. growth and a resolution of EZ crisis are likely to see the USD return to a funding vehicle, limiting the ability of the U.S. to close its wide external deficit.



Euro Zone

- **Ongoing tensions in the euro zone banking and credit markets have led to elevated financial stress and tighter financial conditions, which is weighing on lending, sapping confidence and likely to see forthcoming activity contract.**
- **As a result, the expected contraction in EZ economic activity should lead to a softer inflation backdrop over the coming quarter. In turn we expect the ECB to cut rates by another 50bps in an attempt to boost growth.**
- **The potential for a French downgrade, continued political brinkmanship, together with slow political progress towards integration, are all factors that should keep markets uncertain and highly volatile, thereby leading to a further decline in the euro.**



Key Drivers

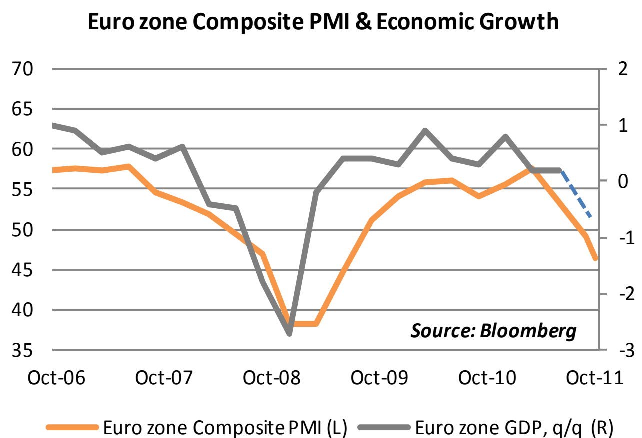
The EZ continues to inch steadily into recession with economic activity likely to contract in the coming quarters. This is a result of the intensification of financial stress and political uncertainty that has been ongoing since the beginning of the summer. After multiple summits, it appears that EZ policymakers continue to find themselves sprinting to catch up to developments, yet failing to get decisively ahead. The negative feedback loop from the sharp rise in volatility has resulted in higher banking and credit costs, which in turn have begun to impact the real economy as households and businesses delay spending decisions. Altogether, policymakers' failure to get the crisis under control, together with rigid austerity, has now fed into the real economy. For example, the October composite PMI suggests economic activity is likely to shrink in the coming months (see chart).

At the heart of the issues lies the combination of sovereign indebtedness and regional imbalances among euro zone members. The current debt dynamics require that some members implement tough austerity measures in order to pacify bond market vigilantes. At the same time, regional imbalances can only be restored once structural economic policies are put in place to enhance the periphery's competitiveness (see chart). While structural reform is necessary to improve long-run growth potential, austerity in the periphery alone will only weigh on economic activity in the short run. Inflows into euro zone debt instruments have softened as private sector investors have started to reduce exposure to the periphery. But repatriation flows from euro zone banks have to some extent neutralized this impact of weaker inflows, reducing overall selling pressure on the euro. Nevertheless, financial stress and deleveraging from peripheral countries have caused a tightening of credit standards and a reduction in loan supply as witnessed by the ECB's latest lending survey.

Looking ahead, we still see few signs that euro zone policymakers are nearing a "game changer" that ends the sovereign debt crisis. Rather, we suspect policymakers to take incremental, piecemeal steps towards stronger economic governance and closer fiscal unity. This means that while piecemeal steps towards a resolution are likely enough to avoid a meltdown, we suspect the potential for ratings downgrades in any of the AAA-rated countries is likely to weigh on sentiment in Q1 2012. What's more, policymakers have also suggested that Treaty changes will be required for further fiscal integration, which means all 17 members will be required to vote on the measure before implementation, which is unlikely to happen before April. As a result, we feel the ECB will be the only credible source to act as lender of last resort and mitigate the impacts of the crisis on the periphery debt market. Yet, the ECB has been unwilling to take a more aggressive stance to mitigate the crisis amid concerns of inflation and moral hazard. Altogether, in the months ahead we think additional easing by the ECB and more work from policymakers will be needed, with the euro likely to weaken in response.

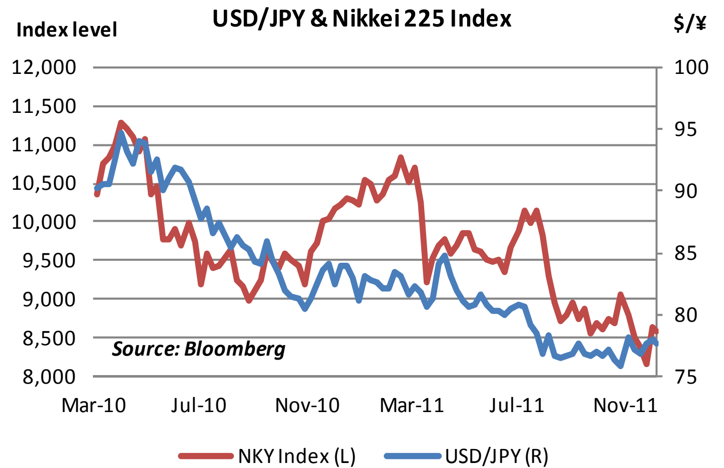
Euro

We expect the euro to trend lower against the US dollar through the months ahead. The euro continues to trade above fair value, which many models, including the OECD's measure of purchasing power parity, estimate to be in the lower 1.20 area. Repatriation and the ongoing diversification of reserve inflows appear to help account why the euro is still trading rich to value. Yet on balance we understand these forces to influence the pace of the euro's decline but not reverse it. From a cyclical perspective the euro is also sensitive to economic weakness amid the push for tough austerity in the periphery and negative feedback loops from the increase in financial market stress. This, above all, creates downside risk to the outlook for the ECB policy rate and increases the euro risk premium. As a consequence, we expect the euro to finish Q1 2012 at 1.24.



Japan

- **After a modest recovery from the Japanese earthquake, the Japanese economy is starting to show signs of fatigue amid the sharp rise in the yen and general slowdown of the global economy.**
- **We suspect that some of this slowdown is driven in part by flooding in Thailand and will prove to be temporary. Still, we feel with public finances likely to deteriorate further into 2012, the BOJ is likely to expand its assets purchase program further.**
- **The yen is likely to remain among the top performers in the G10 in Q1 2012 due in part to the demand for safe havens, together with the Japan's inability to recycle its current account surplus. Additional bouts of intervention cannot be ruled out.**



Key Drivers

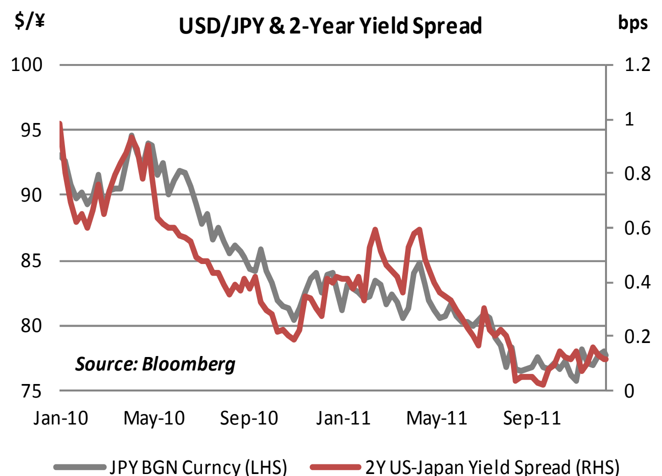
The Japanese economy is marking a modest turn after the earthquake disaster in H1 2011 driven in part by the boost in government capital expenditures. This boost is likely to come from the third supplementary budget, which includes ¥9.1 trillion in measures to combat yen strength and construction projects. Normalization of manufacturing production activities, together with recovery in the post-quake re-construction and the one-off boost from home electric appliance sales into July were likely the main drivers for recent bounce in economic growth. We also suspect that while the floods from Thailand are likely to impact economic growth in Q4 2011, the moderation will prove temporary. As a result, we expect the economy to pick up steam again in early 2012.

One growing concern is the economy has already lost upward momentum since August, amid the sharp rise in the yen and slowdown of the global economy. As you can see from the above chart Japanese stocks have continued to weaken in lockstep with the strengthening yen. Some of this slowdown is likely to prove temporary and should provide a boost to activity in H1 2012. Yet, in the coming months we doubt the normalization of production will provide as much as a boost to economic activity as seen in the past. What's more, the negative impact of slowing overseas economies, together with a strong yen and weak stock prices, are likely to be strong external headwinds facing the Japanese economy in early 2012. This has led Prime Minister Noda to draw up a fourth supplementary budget, in order to boost growth, with initial estimates putting this one to around ¥2 trillion.

While these measures are expected to be temporary and targeted, they nonetheless will add to Japan's bulging government deficit, which at 233% of GDP is one of the largest in the G10, according to data from the IMF. Indeed, the cyclically adjusted deficit is so big, that even a sharp, rapid expansion of GDP will make little difference. Standard and Poors, the credit rating agency, and the IMF both warned publicly that policymakers are not doing enough to tackle the debt burden and wrest public finances under control. However, it remains clear that more needs to be done to address the potential global slowdown, and with Japanese public finances likely to remain under scrutiny by policymakers and the rating agencies alike, we suspect it is only a matter of time before the BoJ expands its asset purchase program again, together with the looming possibility of further intervention.

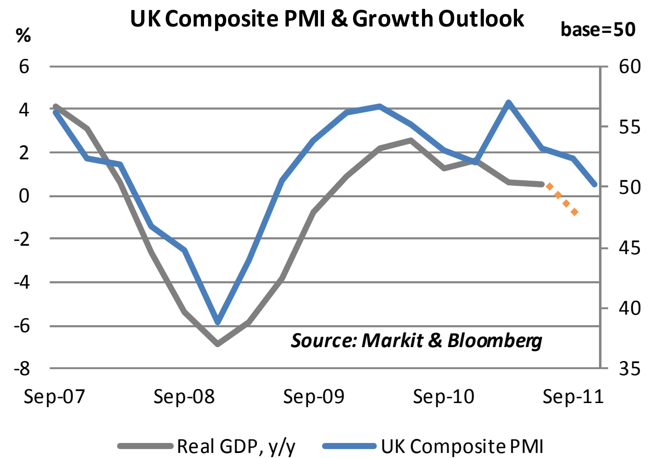
Yen

We expect the JPY to maintain its status as a safe haven currency and continue to remain among the top performers in the G10 in the quarter ahead driven by a few key factors. One, with most industrial central banks focusing on easing financial conditions, pressure on rate differential is likely to persist (see chart). That means the relative attractiveness of yen funding carry trades is likely to diminish. Two, this is likely to limit the scope for capital outflows and therefore make it harder for Japan to recycle its capital account surplus. What's more, inflows from foreign investors and repatriation pressures on the stock of foreign assets are likely to see sustained demand for the yen. Third, the expected yen appreciation is likely to keep the prospects for BOJ intervention rife. Finally, while the potential for periodic intervention is likely to be an important consideration the next quarter, we do not expect the BOJ to establish a definitive floor in the USD/JPY.



United Kingdom

- **In the past few months economic activity has generally outperformed weak expectations. Yet, looking ahead into Q1 2012 the combination of external risks and slowing domestic growth should keep growth remaining sluggish. But also we expect the economy to avoid an outright contraction in Q1 2012.**
- **In a scenario where growth rather than inflation remains the driver of international policy expectations, we expect the MPC to extend QE2 in Q1 2012. This time we expect the MPC to extend its asset purchases by an additional £50-100 billion in 2012.**
- **In spite of weak economic fundamentals we continue to expect sterling to remain a beneficiary of euro zone financial stresses. However, a softer growth outlook, together with deterioration to public finances and banking exposures to the EZ, are likely to limit sterling's advance against non-European currencies.**



Key Drivers

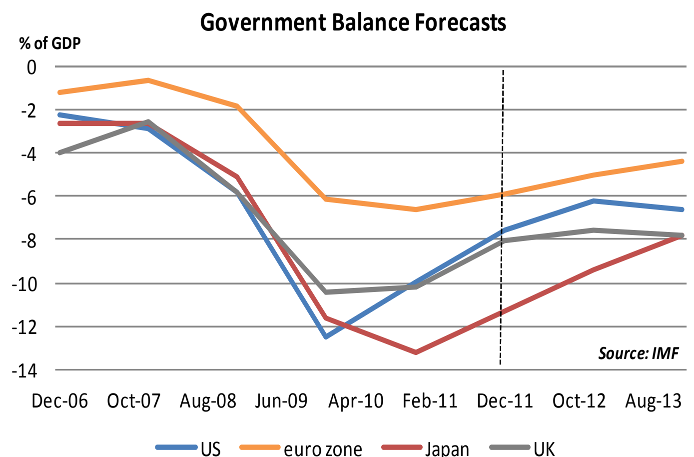
UK economic activity over the past few months, while showing some resilience against negative expectations, is likely to slow markedly in the coming months. The Office for Budget Responsibility (OBR) in fact has recently lowered its GDP forecasts this year and next, to 0.9% and 0.7%, respectively, versus 1.7% and 2.5% at the time of the Budget. What's more, while business surveys were consistent with above trend growth just a few months back, they now point to growth that is significantly below trend (see chart above). The dominant driver of the weaker growth outlook continues to be external shocks from the EZ sovereign debt crisis and weak domestic demand. Above all, we suspect the growth outlook is likely to remain sluggish in Q1 2012, but we do expect the UK to avoid an outright contraction in GDP.

To counteract these economic headwinds, the MPC has recently decided to embark on further large-scale asset purchases (QE) by announcing its intention to purchase £75 billion (5% of GDP) worth of gilts. Not only was the £75 billion QE target somewhat higher than market expectations, but further increases can be expected during early 2012 as growth concerns outstrip inflation concerns. BOE economists have recently estimated that the £200 billion (13% of GDP) in asset purchases under QE1 was broadly equivalent in its effect to cutting Bank Rate by 150-300bp and that it boosted the level of GDP by 1.5-2%. Looking ahead, with inflation expected to moderate off the back of softening economic activity and shift in the base effects, we expect the MPC to extend QE by an additional £50-100 billion in Q1 2012 in an attempt to boost economic growth prospects.

Many observers continue to suggest that sterling continues to trade like a European safe haven of sorts, especially following the move by Swiss policymakers to peg the CHF to the EUR. While price action in the respective bond markets and capital flow data into U.K. suggest many are indeed seeking refuge in gilts, we would downplay the country's role as a credible safe haven. We base this on two assumptions: U.K. banking exposure to the euro zone and erosion of public finances (see chart). Indeed, the U.K. economy remains quite sensitive to the euro zone sovereign debt crisis through its banking system, with recent lending data suggesting large U.K. banks, together with public and private borrowers alike, represent roughly 30% of GDP. An intensification of the sovereign debt crisis is only likely to worsen financial stress in the U.K. banking system, undermining lending and credit growth. What's more, a worsening economic outlook is likely to lead to deterioration in the U.K. fiscal outlook, potentially complicating the government's ability to achieve its deficit targets.

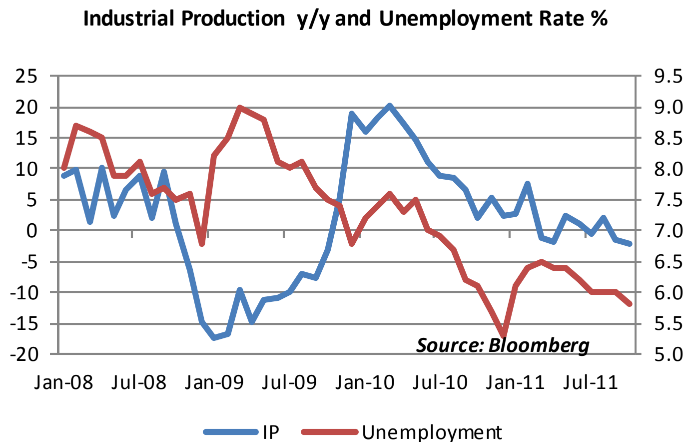
Sterling

Despite the recent upside economic data surprises, we continue to expect that the economic growth outlook for the UK will most likely remain sluggish. This coupled with persistently high inflation (which reduces the real interest rate) is likely to weigh on sterling in broader terms, though we suspect that sterling's losses against the euro may be limited due to the demand for gilts. Following the move by Swiss policymakers to peg the CHF to the EUR, the shortage of reserve currency alternatives to the EUR implies that the GBP may continue to see demand from reserve managers despite QE. However, significant deterioration in the euro zone would likely weaken the U.K. recovery and prompt further easing from the Bank of England. Altogether, the combination of relatively tighter fiscal policy and looser monetary policy is likely negative for a currency, which underpins our negative sterling outlook for Q1 2012.



Brazil

- **The slowdown in the Brazilian economy has accelerated across most sectors. Inflation is moderating, but it remains at very elevated levels. FDI still very healthy and the current account deficit narrowing, but it is expected to widen in 2012.**
- **The central bank was largely justified in cutting rates given the sharp downward revisions to growth. The SELIC rate is expected to reach a low of 9.5% in 2012, and the government will continue by loosening macro prudential regulations.**
- **Policymaking has become more erratic and looks set to continue that way. President Dilma has already lost seven ministers to corruption scandals since taking power in January. In the economic front there is a new legislation in the Senate proposing to change the central bank's mandate to include growth along with inflation as the policy target.**



Key Drivers

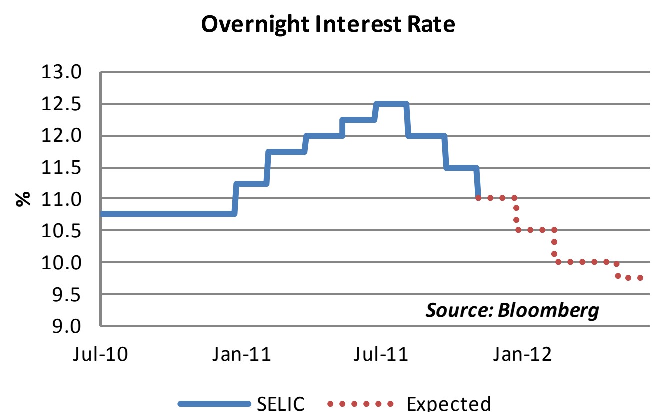
Q3 2011 GDP growth came in at 2.1% y/y and 0.0% q/q, in contrast with Finance Minister Mantega's expectations of 0.3% q/q growth. The manufacturing sector has been particularly weak, contracting for the last three consecutive months. Retail sales have also been moderating, but at a more gradual pace. The service sector is slowing but remains relatively strong and the unemployment rate is low at 5.8% in October. The external sector remains supportive, with the current account deficit trending lower and FDI trending higher. The current account deficit is expected to come in slightly above -2% of GDP in 2011 but increase a bit in 2012. Inflation has been and will remain well above the center of the central bank's 4.5% target. Consensus forecast sees inflation finishing 2011 at 6.5% y/y and 2012 at 5.5% y/y. Of note, changes in the CPI weights will lead to a technical decline in inflation by as much as 0.5 percentage points in 2012.

The central bank has embarked on an easing cycle that will probably bring the overnight rate down to 9.5% next year. The dramatic shift in tone is partially justified by the unexpectedly sharp economic slowdown in Brazil and uncertainty abroad, but it is also largely politically driven. In our view, the Dilma government and the central bank are overreacting to the current business cycle. Despite the weak industrial sector, inflation is still elevated and unemployment very low, which would call for a bit more moderation to assure that inflation expectations remain in check. Aside from rate cuts, the government has begun to reverse the credit restricting measures enacted during the tightening cycle. It has also reduced taxes on foreign investments for various private sector financial assets, including the 2% tax on equity transactions. Moreover, there is a new piece of legislation currently being discussed in the Senate which would change the mandate of the central bank from inflation targeting to a dual mandate (like the Fed). We think the legislation has a very high chance of being passed into law.

Part of the Dilma's government nervousness regarding growth may be interpreted as an effort to divert the attention from her lackluster first year in power, which is likely to be remembered more by corruption scandals and cabinet reshuffling than sound policymaking. In addition, the negative effects of the regulatory overload from macro prudential measures are starting to affect the private sector, as investors and corporates are blaming the government for the Bovespa's underperformance. Still, Dilma remains extremely popular despite the economic slowdown and the corruption cases, and we see no reason to think this will change over the near-term.

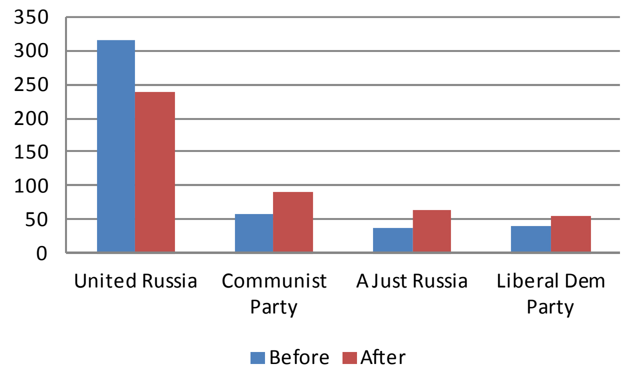
Real

We see USD/BRL moving within a broad range between 1.80-1.90 in Q1 2012. Elevated volatility means that the market is prone to overshooting, but the Brazil-specific near-term risks seem roughly balanced in our view. On the positive side, long BRL positioning is much lighter, the current account deficit is easily covered by FDI, the economy is slowing but not falling off a cliff, interest rates will remain elevated by global standards, and Brazil is relatively insulated from direct euro-zone contagion beyond asset price volatility. On the negative side, interest rate expectations may yet be revised lower, risks of outflows from the fixed income and equity markets remain a threat, commodity prices have come down substantially, and Brazilian assets will remain vulnerable to swings in global risk appetite. BRL in particular is a high-beta currency.



Russia

- **The Russian economy is slowing along with global growth, but activity remains well supported given still-robust domestic demand and elevated oil prices. Industrial production began to moderate around the middle of the year, but recent manufacturing PMI readings point to a turn around.**
- **CPI is moderating faster than the market had expected despite loose fiscal policy and low unemployment. Still, the central bank is unlikely to change rates for the time being, as the risks seem roughly balanced. In 2012, however, economic slowdown and the election backdrop mean that a cut is more likely than a hike.**
- **The ruling party of Medvedev and Putin suffered an important loss in December parliamentary elections. While this is a bad omen for the March 2012 presidential vote, there is little chance of any surprise to the outcome. The main risk is that fiscal policy will loosen further, and protests are unlikely to continue.**



Key Drivers

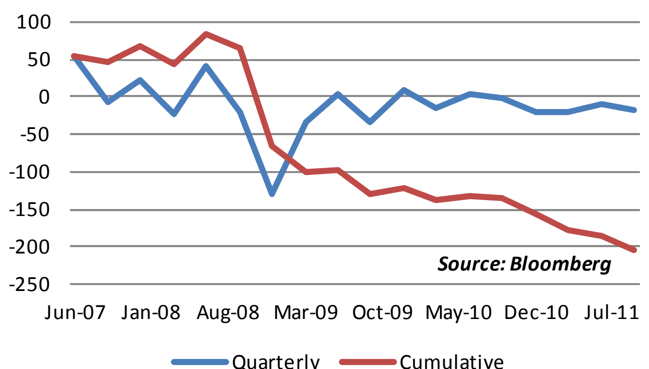
Russia is expected to grow around 4% in 2011, about the same rate as last year. The weakness in activity is largely stemming from the industrial sector, as industrial production began trending lower at the middle of the year. However, four consecutive strong PMI manufacturing readings suggest a possible change in this outlook. The labor market is still tight and retail sales growth remains strong. With the price of oil still elevated, consumer demand robust, and the unemployment rate low, the chances of a more severe downturn for the Russian economy hinge entirely on the external environment. Russia's external position should stay in solid surplus. The current account is expected to end 2011 at 4.9% of GDP before falling in 2012.

CPI is moderating faster than the market had expected despite the government's loose fiscal policy. CPI reached a 15-month low in November at 6.8% y/y. The declines are being led by still fairly tight monetary policy and the deflationary effects of falling food prices. Still, the central bank is unlikely to change rates for the time being as the risks seem roughly balanced. The central bank's refi rate stands at 8.25% and the deposit rate at 3.75%. In 2012, however, the economic slowdown and the political backdrop mean that a cut is more likely than a hike – but again, this largely depends on the external demand.

United Russia's poor showing in the December parliamentary elections will probably not have a major impact on policymaking or asset prices in the short term, but it could mean increased fiscal spending ahead of next year's presidential election. United Russia received fewer than 50% of total votes, compared with 64.3% in the 2007 elections. To be clear, we are not entertaining the idea that Putin may not be Russia's next president. Strengthening his mandate and keeping the opposition as weak as possible is what matters, especially after the protests that occurred following the elections. At this point, we find it unlikely that the protests will continue, but it could become a source of headline risk as seen by the negative impact on equity markets. We have no concerns about Russia's fiscal numbers as long as oil prices remain elevated. Instead, we are more cautious about the impact that further spending will have on inflation as Putin tries to erode support for the Communist party. Moreover, capital flight has picked up significantly since Q4 2010 and could intensify further due to heightened political uncertainty.

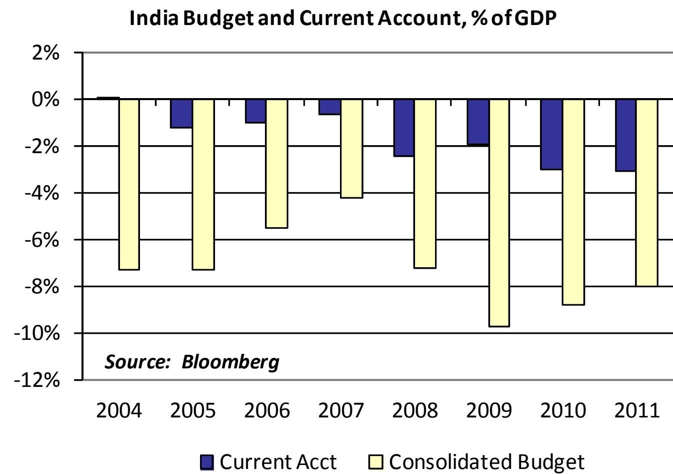
Ruble

The outlook for the ruble will continue to be dictated by three factors: (1) broad risk appetite; (2) the price of oil; and (3) the prospects for capital outflows. Indeed, outflows are expected to exceed the official forecast of $80 billion this year, and may accelerate if fundamentals deteriorate further. We do not think the risk-rewards are particularly favorable for the ruble at this point. However, we recognize that the central bank is committed to keeping the ruble volatility low and has the resources to do so. As such, we find it unlikely that the ruble will weaken in Q1 2012 beyond the 37.59 level observed in October 2011.



India

- **The Indian economy has slowed remarkably as consumption was suppressed by high inflation and high interest rates. Fixed capital investment seems to have peaked and industrial production has turned negative.**
- **Twin deficits remain an important risk to the INR. With capital flows from foreign investors becoming less reliable, funding the current account deficit could become increasingly difficult.**
- **INR remains vulnerable to risk aversion stemming from developed markets. Wide interest rate differentials and new defensive measures by Indian policy makers will support INR, but their commitment is not as strong as in most other Asian countries.**



Key Drivers

The Indian economy has slowed remarkably. GDP rose 6.9% y/y in 3Q 2011, the lowest growth since 2Q 2009 and below its 8% y/y potential growth rate. Private consumption has been suppressed by high inflation and the recent monetary tightening, which brought the repo rate to 8.5%. Recently, Foreign Direct Investment into India seems to have peaked and fixed capital investment has been a drag on the economy. Moreover, industrial production has turned sharply negative, falling 5.1% y/y in October.

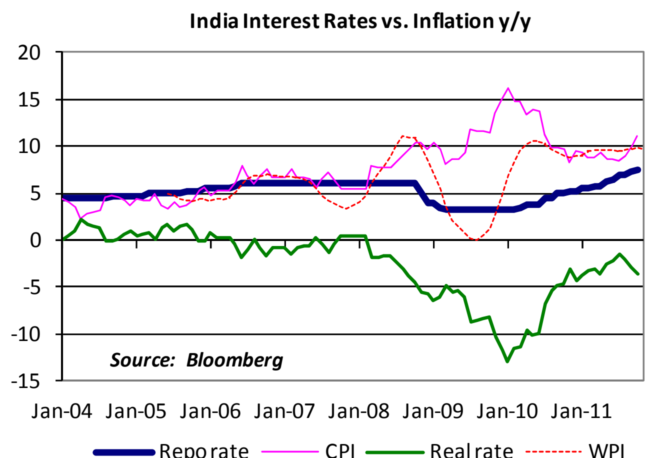
Inflation pressures have moderated recently but remain elevated. Food inflation has come down sharply towards the end of the year with WPI declining from 12.21% in October to 6.60% in late November. However, import prices which are affected by the weaker INR could continue to put upwards pressure on inflation in the months ahead.

The Indian twin deficits, current account deficit and fiscal deficit, remain the key risk factor to the economy. The slowdown in exports due to a weaker global economic environment led to a wider trade deficit, although imports should also continue trending lower due to slowdown in domestic demand. India cannot count on FDI inflows to cover its current account deficit, and will continue to depend on volatile portfolio inflows. On the fiscal side, the Indian government continues its expansionary stance through large-scale public investment for the current fiscal year, even though fiscal revenues are slowing due to weakening economy. The accumulated budget deficit through October has doubled compared to last year.

RBI hiked its policy rates in October, the thirteenth consecutive hike, but then left policy unchanged at its December meeting. It expects inflation to remain elevated, though base effects should bring the numbers down December 2011. This will strengthen the case for interest rate cuts in 2012, but this is by no means assured. RBI has kept their forecast for inflation to converge towards 7% y/y by the end of March 2012, but the weaker INR poses a risk to that forecast. Official commentary from the RBI has also been considerably more dovish, albeit still cautious on inflation risks.

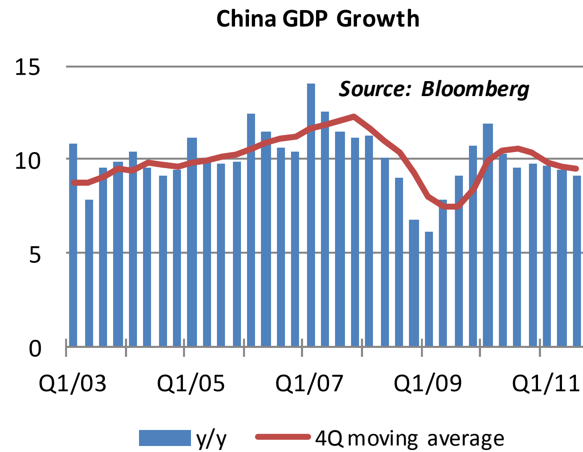
Rupee

INR underperformed most other EM currencies during this year as markets focused on twin deficits and high inflation. This trend should continue in the months ahead. The RBI has adopted a more aggressive posture towards defending the INR against further depreciation, but we view their commitment as weaker than that of other countries in the region. Latest move from the RBI this month was to put restrictions on rupee forward contracts. While this is thought to affect mainly domestic export companies, foreign investors have been put on notice that the weak rupee is a growing concern. On a positive note, wide interest rate differentials compared with DM or other EM will provide some support for the INR. Moreover, the turmoil in global financial markets should not necessarily weigh on government bond sales because most of Indian sovereign debt issuance is covered by domestic funds.



China

- **The PBOC surprised markets with a 50 bp cut in the reserve requirement in December to 21%. The move was earlier than expected, and suggests the Mainland economy is slowing faster than desired. Further easing measures are expected in the coming months.**
- **PBOC is likely to continue easing into 2012 with a combination of policy rate cuts and reserve requirement cuts; fiscal stimulus will also likely be used to help boost growth. This is similar to what we saw in 2008, when policymakers responded aggressively to an economy that was slowing faster than desired from Phase I of the financial crisis.**
- **We see further modest yuan appreciation in 2012, but the risk is that a deteriorating global environment could lead to a pause in appreciation, as we saw from mid-2008 to mid-2010. Development of offshore yuan markets should continue in 2012.**



Key Drivers

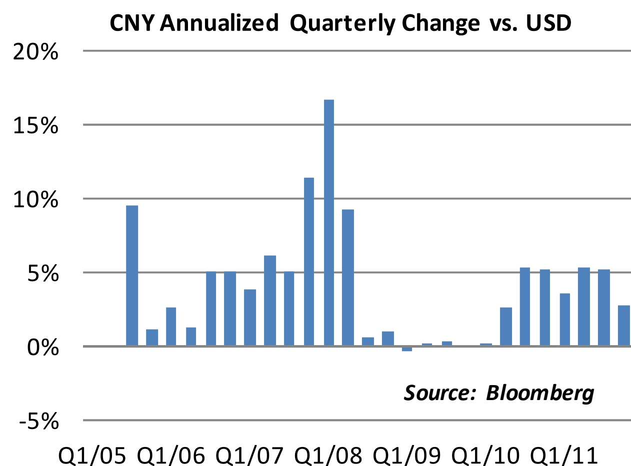
The Chinese economy is slowing, and the recent 50 bp cut in reserve requirements suggests rising concerns as to the pace of the slowdown. Real sector data have shown some signs of slowing in recent months, while CPI inflation eased to 4.2% y/y in November from 5.5% y/y in October. The central bank hiked lending and deposit rates as well as reserve requirements numerous times during the tightening cycle, and so we see all three levers being pulled the other way in the coming months. Loan growth is moderating and growing at less than half the pace of the 2009 peak rates. While we could see further specific measures to prevent excessive lending in the property sector, we think slow loan growth will allow more aggressive PBOC easing. GDP is expected to grow over 9% in both 2011 and 2012, down from 10% in 2010, but the risks are tilted towards the downside. We believe policymakers will reverse tightening more aggressively if the economy slows too much, but we think hard landing fears for China are still overblown.

China's external balances remain in surplus, but are on a narrowing trend as export growth slows. Huge inflows of Foreign Direct Investment are still CNY-supportive, but slowing exports express rising external vulnerability ahead. Despite professed efforts at rebalancing the Chinese economy, this is a gradual multi-year process. Domestic consumption for now does not appear to be able to forestall a slowdown in the overall economy. Foreign reserves were basically steady at $3.2 trillion at the end of Q3 2011, posting an increase of only $4 billion from the previous quarter. This is the smallest quarterly gain since Q2 2010.

The five-year plan for 2011-2015 calls for 7% average GDP growth over that period, marginally slower than the 7.5% target for 2006-2010 that was vastly exceeded by an actual average of 11.2%. Political uncertainty will pick up in late 2012, when the Communist Party Congress will select a new party leadership, followed by the selection of new state leadership in 2013. Both President Hu and Premier Wen will see their terms end in 2013. In 2010, Vice President Xi Jinping was promoted within the Central Military Commission and signaled the likelihood that he is in line to succeed President Hu. Whoever leads China after 2013 is unlikely to deviate from the current ongoing strategy of economic liberalization coupled with minimal political liberalization.

Yuan

We continue to expect that the economic growth outlook for China will most likely soften into 2012. This coupled with moderating price pressures could lead policymakers to slow or even halt yuan appreciation for some period of time. Indeed, we are already seeing this. As of this writing, CNY has gained only 0.7% vs. USD quarter to date, well down from 1.3% or so in recent quarters. 12-month CNY NDFs are pricing in about 1% depreciation over the next year. While we acknowledge the risks of a temporary halt in CNY gains until the global backdrop improves, we do not think that outright depreciation will be engineered. Coming in a U.S. election year, it would be like waving a red flag in front of a bull. Internationalization of the yuan will continue in small, measured steps.



Composition of the US Government and the Dollar

Ahead of the 2012 U.S. Presidential Election, many observers in the currency market will continue to wonder whether political developments in the world's largest economy will have any impact on the U.S. dollar. After all, over the past three and a half decades the dollar has performed better when the President and Congress were divided between different parties. Against the backdrop of continued political intransigence, however, we would treat the historical parallels with caution.

The latest data from intrade.com point to a little more than a one-in-two chance of Barak Obama being elected and nearly a three-in-four chance that the Republicans control the House of Representatives. It appears as if markets are pricing in a decent chance that the U.S. government remains divided. So while global asset markets have been dominated by the developments in Europe for some time, the composition of the US government may in fact have some influence over the direction of the dollar, given the importance of fiscal policy and the economic outlook in the years ahead.

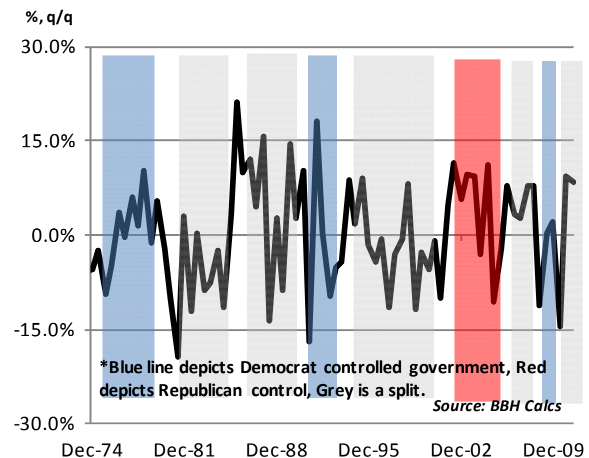
As we head into the 2012 election season policymakers remain split on a number of key issues, ranging from taxes in particular and fiscal policy in general. However, given the considerable uncertainty over future policy paths, we leave the general policy discussion outside of the scope of this report. Rather, we focus on the behavior of the U.S. dollar around U.S. election cycles, taking into account U.S. governance structure, together with the dollar's performance during Presidential terms.

To determine if there is a connection between the U.S. governance structure and the U.S. dollar, we framed the dollar's performance in terms of Presidential terms and structure of the government during the floating exchange-rate period. Limiting the analysis to the most actively traded currency pair, the dollar vs. the euro (and vs. the synthetic euro and German deutschemark before it), we analyzed how the dollar fared around the election cycles and Presidential terms, taking into account party divisions between the President and Congress — the results of which appear in Figure 1. Overall, given the relatively small sample size, this framework should not be viewed as a robust statistical approach but rather simply a study to provide some historical context ahead of the 2012 election.

The first observation is that the fourth year of a President's term appears to have a stronger dollar bias, with the dollar rising six out of nine times by an average of nearly +4% (max is +16% and min-10%). The range of worst to best dollar performance in the fourth year appears somewhat narrower than in the other years, suggesting that the variation between returns is the smallest during the fourth year in office. At the same time, the strongest connection occurs in the second year of the president's term, during which the dollar fell seven of the past nine times by an average of nearly -12% (max is +7% and min is -23%). The dollar's performance this year has contrasted with this historical pattern, though, with the dollar averaging monthly losses of -0.8% (max is +4.6% and min is -6.2%).

Another observation is that despite the apparent link between political parties and policy tools, the data suggests political composition has little impact on the dollar's performance. Over the past three and a half decades, for instance, the dollar performed better against the euro when the President and Congress were divided along party lines. What's more, there also appears to be little variation in the dollar's performance during the second year under Republican and Democrat presidents with the dollar's performance almost identical. In both the first and third years, the dollar tends to rise more under Democrats than Republicans.

Figure 1: Dollar Returns & US Governance



When measured in terms of the dollar's yearly performance, the dollar rose by nearly +1.5% (max is +33%, min is -26%) during the years when at least one chamber of Congress was in opposition to the President. Alternatively, the dollar fell by an average of nearly 4% during the years when one party controlled both the Presidency and Congress. Furthermore, historical evidence suggests that the two episodes of the dollar's best performance took place during a divided government: 1) In the early 1980s under Republican President Reagan and a Democratic House of Representatives and 2) in the second half of the 1990s under Democratic President Clinton and a Republican Congress.

The 2012 election will take place against a backdrop of a particularly challenging landscape where tough choices related to debt and fiscal policy will likely be necessary. As the primary season kicks off, we suspect the implications for the dollar will not depend on headlines and rhetoric. Instead, we expect the dollar will be more sensitive to whether the President and Congress will provide a more balanced approach to public policy or simply more political gridlock. While the statistical results do suggest that the dollar has a preference for divided government, we would take the results with a grain of salt as there are many other driving factors that are likely to dominate price action. History shows that the dollar may be more responsive to thoughtful policy, rather than political gridlock.

-Mark McCormick

Investment Strategies for Interesting Times

The ancient and oft-quoted Chinese curse "may you live in interesting times" rained down on our heads repeatedly throughout 2011, offering a useful reminder that the future – even in the near term – always and forever remains a mysterious place. Who could have foreseen the litany of social, political, market and economic events that unfolded over the past twelve months, including 1) the Arab Spring, 2) the Japanese tsunami and devastating earthquake, 3) the one-two punch of an earth quake and hurricane hitting East Coast of the U.S., 4) U.S. rating downgrade, 5) the Occupy Wall Street movement and 6) the acceleration of the euro zone sovereign debt crisis?

As investors, we have to analyze and understand the financial environment in which we're putting capital to work. But rather than spend all of our time in the fruitless pursuit of perfect foreknowledge, we prefer instead to focus our attention on investing prudently in a state of perpetual uncertainty. The paramount goal of investing is preservation and growth of capital, and that requires management of risk as well as the search for return. Risk simply means that more things can happen than will happen, and understanding and preparing for that range of possible outcomes, even if improbable, is the central activity of investing and risk management.

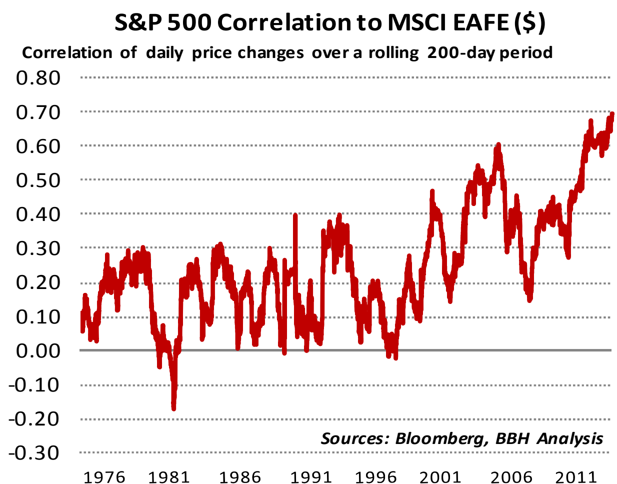
That strategic investment approach isn't dictated by the calendar, or even a specific set of market conditions, but as we close the books on 2011 and prepare to flip the calendar page to 2012, it is worth emphasizing a few elements of our investment strategy that guide our thinking in the current market and economic environment.

Since the beginning of July, the S&P 500 has experienced 32 days in which the index moved by 2% or more in a single trading session, versus only 2 days in the first half of the year. Volatility is the watchword of the market, and the breadth and depth of uncertainty that continue to characterize the global economic and financial landscape imply that financial markets will remain volatile into 2012 as well. Sources for that volatility are already evident: the ongoing debt crisis in Europe will continue to dominate headlines next year, as will the pace of economic activity in China, one of the sole remaining global engines of robust growth.

Here at home, the U.S. economy faces monumental challenges, too, which an election year and all the rhetoric that accompanies political campaigns will only magnify. The market response to developments on all these fronts – both positive and negative – will likely be amplified by the growing pervasiveness of high frequency trading, and the tendency of institutional investors to tactically place "risk on" or "risk off" trades.

As investors, we are accustomed to regarding price volatility as our enemy. Modern Portfolio Theory goes a step further and states that price volatility is the very definition of risk, and posits diversification as the answer to the threat that risk poses to a portfolio. We object to the idea that price volatility is the most potent risk facing investors (more on that below), and furthermore observe that diversification cannot always be counted on to reduce the volatility of an overall portfolio. This is not to deny the role of appropriate diversification in building an investment portfolio, only to recognize that in an increasingly global marketplace it does not deliver the benefit it once did. When correlations between asset classes rise, the power of diversification wanes.

This dynamic has already taken place. The graph below illustrates the correlation of daily moves of the domestic S&P 500 index and the MSCI Europe, Australia and Far East (EAFE) index as measured in dollars.



Correlations have grown over time, as one would expect in an increasingly integrated global economy, but as the global economic crisis intensified and as a European crisis now threatens contagion around the world, correlations stand at all-time high levels. With 1.00 signifying perfect correlation, where prices move in lockstep with each other, the U.S. and European markets currently have a record high correlation of nearly 0.70. This is not to deny the appeal of companies outside the United States as investment opportunities, merely to observe that investing abroad in pursuit of the benefits of diversification does not provide the solution it once did. Diversification is a fickle friend. Precisely when you need it most, in times of exaggerated stress and volatility, it cannot always be counted on to deliver the goods.

Value to the Rescue

For the disciplined and patience investor, heightened volatility needn't be bad news. Unlike the definition of risk imbedded in Modern Portfolio Theory, we believe that investment risk is better defined as the probability of a permanent impairment to the value of an investment. Price volatility is risk only if you think that being rich and then being poor is an equivalent state of affairs to being poor and then being rich. The best way to protect against the risk of value impairment is to understand deeply the underlying value

of the asset being acquired, and to purchase that asset at a discount to the intrinsic value of the investment.

Price is a powerful concept in investing, and it comes with attractive attributes. It has the benefit of transparency – we can all agree on the price of a security or market, since those prices are disseminated widely. Furthermore, security prices are calculated frequently and are available instantaneously to anyone with an internet connection. The downside to price, as noted above, is that it is volatile.

Value, on the other hand, lacks the transparency, frequency and availability that accompany price. Value, in short, is hard to derive. It is usually the result of a proprietary process, and investors therefore often disagree widely on the value of the same asset. Meanwhile, the value of a security tends to be far more durable than price.

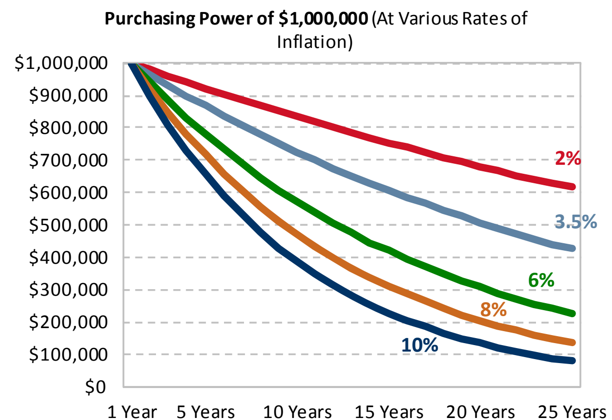
The optimal approach to risk management, therefore, lies in understanding these different attributes of price and value and in turn making them work for you, rather than against you. Indeed, acquiring assets at a price which reflects a discount to the underlying intrinsic value of the asset creates a margin of safety, and helps to protect a portfolio against price risk. As a result, we find this value-based approach a far better way to manage the real risk in a portfolio and critically important in an environment marked by continued price volatility.

The Threat of Inflation

It may seem misplaced to worry about inflation when the global economy is faced with so many obstacles that ought to exert deflationary pressures on prices. We note, nevertheless, that inflation would provide welcome relief to a number of those challenges. Just as inflation is the worst enemy of the holder of financial wealth, it is the best friend of the debtor. Here in the United States inflation would help lift housing prices and rescue that estimated 29% of home owners whose houses are worth less than the outstanding principal on their mortgages.

Inflation would furthermore help lower the real obligation of outstanding sovereign debt, while boosting wages and inflating tax revenues. From a political perspective, inflation has the wonderful advantage of never coming to the floor for a vote. Politicians have to vote for or against tax increases or spending cuts, but they can never be held accountable for voting for inflation. This is not to say that inflation would ever become the explicit policy of the United States or European governments, just to note that benign neglect can go a long way, and investors should take this threat into account when building portfolios.

And it does not take much inflation to ruin your day. We're all familiar with the miracle of compound interest – how even a small amount of wealth at even a modest interest rate can compound into a great fortune over time. Inflation is its evil twin, as it can cause a great fortune – at even a modest rate of inflation – to lose substantial purchasing power over time. As the graph below illustrates, even at modest inflation of 2% an investor loses almost 40% of their purchasing power over a 25-year period, and at the current (still modest) inflation rate of 3.5% that loss rises to almost 60%. In other words, inflation does not need to rise to scary levels to warrant close attention in portfolio construction.



Compounding this threat is the fact that the very asset classes on which investors have historically relied for safety, stability, income and liquidity are falling down on the job. Fixed income traditionally plays all these roles in a well-balanced portfolio, but with monetary policy as easy as it is (and likely to remain so), yields on high quality fixed income instruments are mostly lower than the current rate of inflation. Earning a negative real rate of return is not a good way to preserve and grow wealth, and traditional fixed income therefore plays a reduced role in our asset allocation. It continues to be important from the standpoint of liquidity planning, but liquidity now comes at a price, whereas in a more normal interest rate environment, it comes with a yield.

In recognition that the ultimate goal of investing is the protection and growth of wealth in a real (inflation-adjusted) sense, we have positioned our clients' portfolios to be overweight equities, with an emphasis on the United States, where we find a more optimal tradeoff of valuation, opportunity and macroeconomic risk. We acknowledge that this allocation exposes portfolios more directly to the price volatility that we believe will continue to plague the markets, but, as noted above, that volatility need not necessarily be the enemy of investment strategy. Fixed income provides liquidity to a portfolio, but as a generator of meaningful income or inflation hedge it falls far short, and so remains underweight in our asset allocation policies.

Our crystal ball for 2012 is no clearer than anyone else's. As the track record of surprises in 2011 illustrates, we might not be able to predict, but we can prepare. We are confident that unanticipated things will take place in 2012, and we're confident that a combination of appropriate diversification, attention to value and a healthy dose of patience will serve investors well in an environment which is likely to remain uncertain and volatile.

-Scott Clemons, Chief Investment Officer, Wealth Management

Basel's Faulty and the Deathly Hallows

No Capital Required

The first proposed Basel Framework (1987) created the idea of "risk-weighted assets", assigning different capital requirements to asset classes in proportion to their perceived risks. The first framework proposed that holding OECD debt (and all sovereign debt under a year in maturity) require no risk capital at all from financial institutions, in essence designating a large class of issuers as "risk free". Obligations of OECD banks would require one-fifth as much capital as loans - a 20% risk-weighting.

Basel II increased the risk-weighting for non-AAA sovereigns to 20%, but also allowed AAA securitized and corporate obligations the same preferred 20% risk weight. Thus the Basel framework required less than 2% capital against a huge chunk of the bond market, and made much of the OECD's sovereign debt infinitely leverageable. Collectively, we'll call these highly-rated and sovereign obligations "Highly Leverageable Securities" or "HLS."

Thanks to these rules, financial institutions could buy HLS, set aside 1.8% of their value in capital, then "repo" them for additional liquidity to buy assets with more yield - often a highly-rated securitized instrument. For every $4 in capital, a bank could thus hold $300 or more in securities. Courtesy of the low risk-weight of its own debt, a large audience for repurchase agreements and the implicit sovereign backing of deposits, these assets often yielded more than the cost of borrowed funds. One-quarter of one percent of 'carry' could produce a 20% return on the required Basel equity.

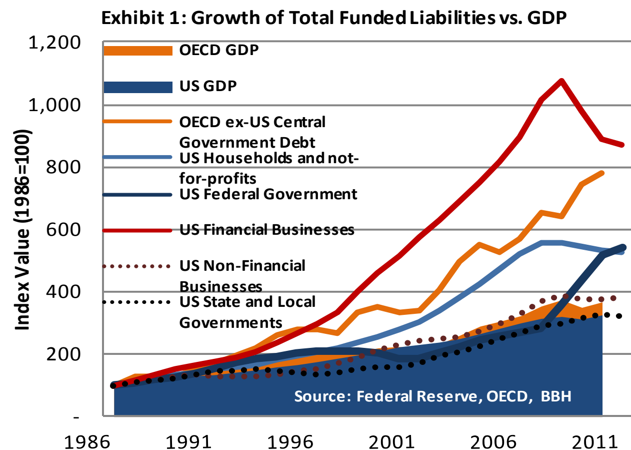
During the same two decades that saw the promulgation of Basel, money market funds increasingly became the preferred place for large stashes of risk-averse money. Money funds have no capital at all to support their fixed net asset value, as long as they follow the SECs 2a-7 rule. These rules also focus on the self-same group of HLS, adding maturity restrictions. Between the enormous demand for OECD sovereign debt from recycled Asian trade surpluses and savers appetite for 'risk-free' money funds, there was a ready source of money keeping HLS bank debt and sovereign debt extremely cheap.

To keep their maturities short, money funds and other liquidity pools (SIVs) use repurchase agreements, in which HLS collateral was provided to secure overnight indebtedness of financial institutions. Liquidity pools, SIVs and the repurchase market constitute the shadow banking system, which provided collateralized wholesale funding against HLS to financial institutions that, in turn, purchased consumer debt.

The U.S. Credit Explosion and European Banks

The symbiosis of new capital rules and the shadow banking system facilitated dramatic credit market growth. Between 1987 and 2007 the US shadow banking sector swelled tenfold from about $2 trillion to $20 trillion, while the traditional banking sector merely quadrupled from $3 trillion to $12 trillion. Exhibit 1 depicts the growth of various types of credit and the developed economies (GDP) indexed to 1986 levels. Financial institution debt, central government debt and U.S. household debt all grew at multiples of GDP growth, in contrast to other sectors.

A review of the academic literature and individual bank behavior connect the macro-level view of debt and leverage growth with the Basel-related leverage dynamics described above. One popular explanation of the rapid credit growth that ultimately led to the financial crisis is the "savings glut" hypothesis, suggesting it was driven by the recycling of current account imbalances between countries.



Certainly the appetite of surplus countries for sovereign debt supported the price of U.S. and European sovereign debt over the last few decades. However, several recently published papers have looked closely at aggregate flow of funds data and suggested this thesis is incomplete.

Princeton's Hyung-Song Shin, for instance, points out that the European banks and investors, in contrast to their Asian counterparts, owned the bulk of non-government AAA securities. These papers focus on the role of European banks in U.S. credit intermediation. A large and central dynamic of the financial crisis, these authors show, was European banks (and U.S. investment banks) levering sovereign holdings, issuing deposits, commercial paper into money funds and SIVs and purchasing AAA mortgage-backed securities. European bank exposure in these areas peaked at about $5.5 trillion in 2007 and then collapsed rapidly to $3.5 trillion by 2010 as the subprime mortgage crisis played out.

The standard Basel leverage metrics serve to obfuscate the leverage built during this credit expansion. Bank capitalization was typically expressed as a percent of Risk-Weighted Assets ("RWA"), almost magically reducing the stock of assets in proportion to their risk-weighting. As shown in Exhibit 2 at the end of this section, large banks, particularly in Europe, were able to achieve very high levels of nominal leverage by tweaking their asset mix towards HLS, resulting in a low and shrinking ratio of risk-weighted assets to total assets.

The Federal Reserve placed somewhat more emphasis on absolute leverage in commercial banks. To be sure, the market generally assumed the big banks would be backed by their sovereigns as well. The rolling financial crises put policymakers in a tight spot. If all the over-leveraged consumers, financial institutions and governments were to default, the resulting drop in wealth could cause deflation and an economic depression.

The alternative is that some or all of the excess leverage can be piled into the remaining creditworthy entities, governments can pursue other stimulative policies, and all can hope that economic growth will allow those obligations to shrink in relative magnitude to a manageable size. The latter has been the more popular path, by far.

The U.S. and Europe weighted these policies differently, with the U.S. leaning harder on stimulative policies (until recently), while Europe has been more willing to back the banking system and impose austerity than to directly bail out the over-leveraged peripheral sovereigns.

In the United States, the government took over the largest non-government issuers of AAA debt (Fannie and Freddie) and expanded their balance sheets with $1 trillion of new low-income loans; passed a debt-funded $1 trillion stimulus; helped banks issue government guaranteed debt; and engaged in debt-financed quantitative easing.

The major European economies increased their total public debt by 15-35% of GDP just from 2007-2011, driven by a combination of financial sector support, revenue shortfalls or just increased debt servicing burden. European countries conceived and formed vehicles to purchase and enhance debt from the "periphery", backed by the euro zone's aggregated credit (the EFSF and the not-yet launched ESM), and there are plans to leverage those pools.

The ECB expanded their already loose guidelines on borrowing collateral to continue to admit deteriorating periphery bonds as collateral, then began to buy periphery bonds and, more recently, bonds issued by Italy and Spain as well. ECB assets swelled to nearly 50% of euro zone GDP from nearly 20% in 2007. Of course, any credit that ends in ECB, EFSF or ESM hands is effectively mutualized across the euro zone, further burdening the remaining strong issuers such as Germany, France and the northern bloc.

While the approaches in the U.S. and Europe are different, all of these solutions have the practical effect of offsetting or avoiding credit destruction from the "formerly riskless" by replacing it with highly-rated US and Northern European sovereign debt.

Swollen Sovereigns and Austerity will Amplify Deleveraging

Unfortunately, these so called "bail-ups" lead to sovereigns swollen with debt. These added obligations will continue to stretch the carrying capacity of the remaining AAA countries and erode their perceived credit quality. Now the doubts surrounding these formerly risk-free assets have become quite visible in both credit spreads and collateral shortages. The "bilateral" or private markets are simultaneously increasing credit quality of repo collateral and withdrawing liquidity from the European bank market, creating a "collateral squeeze." Even the Bundesbank may be running out of securities to sell to fund its contributions to ECB lending.

The new head of the ECB, Mario Draghi, said before the European Parliament that the ECB has observed "serious credit tightening." A recent IMF paper measures a $5 trillion drop in eligible collateral in the U.S., standing in stark contrast to the more stable trajectory of M2 money supply. This shrinkage in the levered base of the financial markets is akin to restrictive monetary policy. To slow this process, the ECB is rapidly easing collateral requirements, and the Basel Committee on Banking Supervision agreed on December 6 to de-emphasize the role of sovereign debt in bank liquidity requirements.

We saw hints of an endgame in this process when the Bundesbank came to market and found themselves paying higher long rates in the midst of continued high demand for their short-term instruments. The market is downgrading their fundamentals even as they need Bunds for repo collateral.

Pundits who crow that the U.S. has no spending constraints with interest rates so low, would do well to examine the above rate trends and consider how rapidly that could change. There is a reason bond mega-investor Bill Gross is hardly effulgent on US Treasuries, calling them "the cleanest dirty shirts available."

In the U.S. the government is pushing financial institutions to recapitalize and de-lever, targeting capital levels that could survive "stress tests." The government will also look to private sector players to bear the risk of mortgage debt currently guaranteed by Fannie Mae and Freddie Mac, the twin wards of the Treasury. European banks are also facing much tougher capitalization requirements. With far more absolute leverage to shed (see Exhibit II on the following page) and little new equity raised to-date, the deleveraging will be all the more difficult and dislocating. Lastly, the euro zone seems headed down the path of increased austerity.

The Future of the Credit Markets

It is possible that traditional banking channels will pick up some of the slack in the future, but currently U.S. banks have a "fortress balance sheet" attitude and are unlikely to contribute much to credit growth. Borrowers will face more finicky creditors and risk-averse investors will be forced to accept no compensation in bank deposits or invest in more risk-bearing long portfolios of credit.

There are already more patient vehicles emerging. In press accounts, large alternative managers describe their excitement at using a rapidly growing store of permanent capital to purchase assets currently residing on bank balance sheets, particularly "formerly riskless" structured securities and/or the loans and assets no longer packaged within them. Their return objectives, however, will be far different from those demanded from the old, geared institutional market, and their investors are committed to a longer holding period.

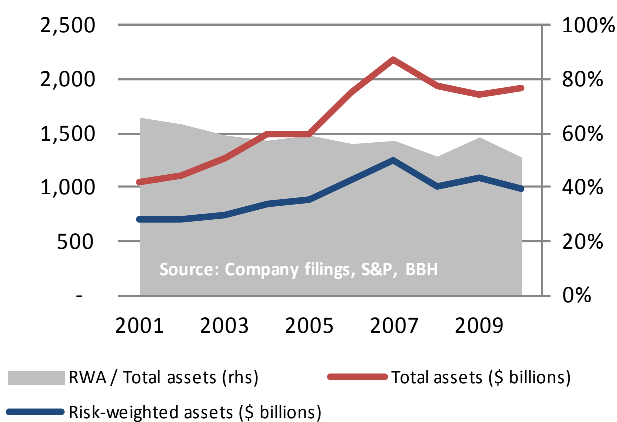
A few years ago, as an alternative for our Wealth Management clients to longer term money fund holdings, we created a vehicle that invests in a diversified pool of intermediate credit instruments but hedges out a great deal of the interest rate risk. By definition, this type of product cannot provide a fixed NAV, but offers liquidity and some return with a relatively stable value. These types of strategies, which leave the erstwhile money market investor accepting some price volatility and income investors giving up some liquidity, are likely to become the norm. This may lead to more systemic stability in the long run, but it is unlikely to support a return to the kind of credit growth most of us grew up with.

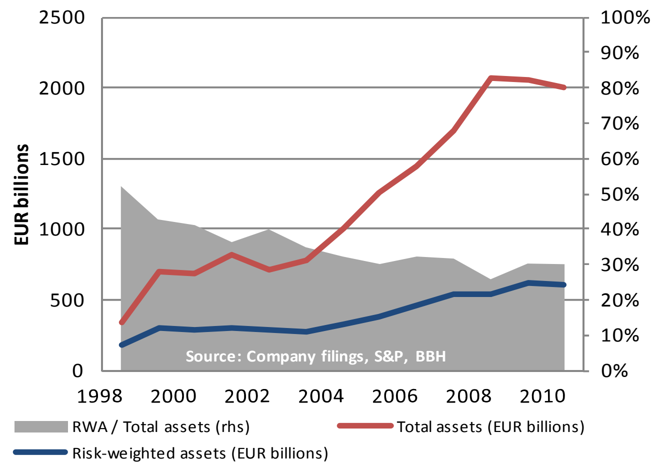
Expect somewhat higher spreads, lower credit growth, less liquidity and no real yield from zero-volatility investments. We also believe that companies that can repay debt with proceeds from real assets, even cyclical companies, and should be perceived as relatively better credits than they have been. They will suffer less from both the potential debasement of currencies and the business model challenges of the banking system while benefiting from disposable income gains in the Emerging Markets.

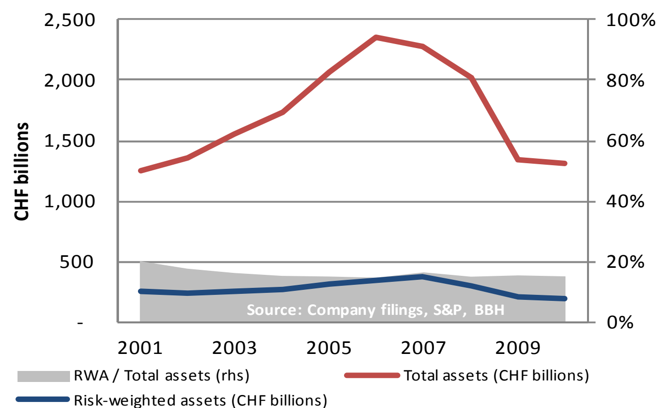
The risk-free issuer and the infinitely-levered asset are like the Cloak of Invisibility and Elder Wand, the first two thirds of the Deathly Hallows sought by the Dark Lord of the Harry Potter series. Once we have passed through this painful deleveraging phase, it would be best if banking regulators never find the Resurrection Stone and bring these zombie concepts back.

-Andrew Hofer, Head of Fixed Income Research

Exhibit 2: Leverage by Global Banks







Outlook for EM: Still Subject To G-10 Developments

EM Comes Under Increasing Pressure

The Emerging Markets (EM) have remained under continuous pressure since the end of the summer, when concerns regarding the euro zone intensified. As of this writing, the EU summit was completed and Europe took some steps towards fiscal union. However, subsequent price action suggests that policymakers did not deliver the bazooka that the markets were looking for. As such, we remain concerned that EM will remain under pressure as we move into 2012. The last several EM corrections were triggered by Developed Markets (DM) events, not by EM events. This past month, most EM currencies weakened beyond the levels reached during the spring 2010 correction, including BRL, MXN, HUF, PLN, ZAR, and INR.

Still, we note again that despite being regularly buffeted by events in the euro zone, EM this past year has remained resilient. The ongoing debt crises in Europe, political turbulence in the Middle East, and the nuclear crisis in Japan have all taken a toll at some point this year on EM currencies, and yet they have held up well and eventually recovered. Euro zone is likely to continue muddling through in the coming months, with incremental progress seen towards greater fiscal union. If such progress is seen, we remain confident that EM FX will end 2012 stronger than when 2012 began.

Under these assumptions, we believe EM currencies will remain under pressure in Q1 before rallying later in 2012. However, with the euro zone situation still unsettled, EM will be subject to periodic and potentially violent swings in risk appetite. The DM growth outlook has certainly deteriorated and brought on fears of a deeper global slowdown. However, we think the global backdrop will ultimately remain EM-supportive once an end-game to the euro zone debt crisis is seen.

November OECD Growth Forecasts, change vs. May			
	2012	**change**	**2013**
OECD	**1.6%**	**-1.2%**	**2.3%**
U.S.	2.0%	-1.1%	2.5%
Chile	4.0%	-1.1%	4.7%
Mexico	3.3%	-0.5%	3.6%
Czech Republic	1.6%	-1.9%	3.0%
Hungary	-0.6%	-3.7%	1.1%
Poland	2.5%	-1.3%	2.5%
Turkey	3.0%	-2.3%	4.5%
Korea	3.8%	-0.7%	4.3%
Israel	2.9%	-1.8%	3.9%
Euro Zone	0.2%	-1.8%	1.4%

Source: OECD

Global Growth Outlook Is Deteriorating

After remaining strong for much of 2011, EM exports and growth have slowed significantly in Q4. The OECD recognized this with sizable downward revisions to its global growth forecasts in its November Economic Outlook. As of this writing, the IMF's December WEO update has not been released but we would expect further markdowns in its global forecasts as well. The Brazilian central bank was the first to respond to this slowdown by starting its easing cycle back in August, and was quickly followed by easing in Israel (September), Indonesia (October), Singapore (October), Pakistan (October), Thailand (November), and China (November). While Colombia was still hiking in November, most EM central banks have remained in wait-and-see mode.

More and more are expected to reverse course and ease policy in 2012. However, we note that EM is starting this stage of the crisis with less degrees of freedom. That is, the aggressive easing in 2008-2009 was only partially taken back in the ensuing years, and so most EM policymakers now have less room to cut rates. The same goes for fiscal policy. After an aggressive policy response and recession left many EM fiscal balances in the red, so the room for fiscal stimulus is not as open as it once was.

DM Banking Woes to Add To EM Growth Headwinds

Besides the impact from slower global growth on EM exports, there is another channel of impact that is very worrisome. As euro zone commercial banks are forced to deleverage and shrink their balance sheets, inter-bank funding for EM-domiciled commercial banks will end up seeing their balance sheets reduced as well. Lending activity in the home EM country will be impacted negatively, which in turn will be another headwind on growth. The consensus thinking is that Eastern Europe will be most at risk from deleveraging in Western European banks. However, we note that European banks have also been very active in Latin America and Asia as well, so we believe no region will be spared.

EM Will Continue to Influence Exchange Rates

It was interesting to see that after months and months of intervening to prevent local currency strength earlier in the year, most policymakers did not hesitate to act to limit currency weakness during this fall's EM swoon. Most of the Asian reserve managers continued to take active roles in managing their exchange rates. Turkey stepped up its intervention via dollar auctions and spot dollar sales, while Hungary recently hiked rates 50 bp to help support the forint. Even Mexico, which is typically hands-off with regards to the exchange rate, recently put new circuit breakers into place that are triggered by a 2% daily drop in the peso. India too has signaled concerns about the weak rupee and recently enacted tighter controls on rupee forward contracts.

On the other hand, even as Brazil was eliminating the IOF tax on foreign equity investment to help limit BRL weakness, Finance Minister Mantega warned that he would not hesitate to adjust policy on FX derivatives if the real gets too strong again. That suggests to us that Brazil is trying to find a "Goldilocks" outcome for BRL – not too strong, not too weak, but just right. Our view remains that Brazil is trying too hard to fine tune the currency. Instead, it should concentrate on limiting inflation and improving fundamentals. The rest will take care of itself.

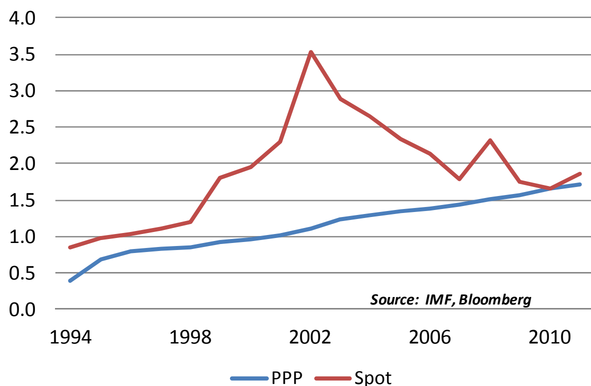
Weaker global growth will keep most EM policymakers concerned about stronger currencies. However, that point is moot if the euro zone debt crisis continues to impact EM. If and when the EM FX rally finally resumes, EM policymakers could quickly revert back to the "currency wars." Note that Brazil Finance Minister Mantega said recently that he will not let the real strengthen to the 1.60 level and threatened further measures on FX derivatives if needed.

China Slows…

Despite fairly robust economic data in recent months, concerns about a hard landing in China are ongoing. We have long been in the soft landing camp, but acknowledge that last month's surprise reserve requirement cut is a sign that the Mainland economy is likely slowing faster than desired. This is a similar dynamic to what we saw in 2008, when the PBOC quickly reversed two years of tightening and eased aggressively when the economy was hit by the global financial crisis.

We think the authorities will continue to ease well into 2012, as price pressures have eased enough to permit this. CPI rose a lower than expected 4.2% y/y in November, down from the 6.5% y/y peak in July. China is expected to grow close to 9% in both 2011 and 2012. However, if external conditions push China into a harder landing, we remain confident that policymakers will pull the right fiscal and monetary levers to boost growth again. In 2008, China's fiscal response was ranked at the top of the world as a share of GDP.

Within the context of a soft landing, we see CNY appreciation continuing, perhaps on the order of 3-5% in 2012. However, the risk here is that appreciation is lessened due to a harder landing for the real economy. In this worst case scenario, we could envision another period of relative stability in the exchange rate such as the period from mid-2008 to mid-2010. However, we do not think China will depreciate the yuan.

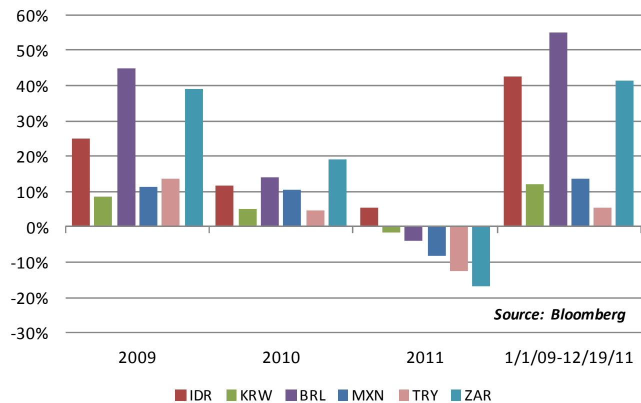


…Along with Brazil

Brazil has been one of the most proactive countries in EM with regards to boosting the economy, as it started the EM easing cycle back in August with a 50 bp cut. The central bank is likely to continue easing into 2012. Monetary stimulus has recently been complemented by fiscal stimulus, with tax cuts recently announced for a variety of white goods. GDP stagnated q/q in Q3 and is likely to see a negative q/q reading in Q4 before rebounding in 2012. However, we think that government growth forecasts for 4-5% next year are too optimistic, and we could see more aggressive stimulus if growth comes up short in the coming quarters.

EM Should Eventually Strengthen

As we noted earlier, every DM-related EM selloff has been followed by an EM rally, as longer-term investors add EM exposure at better levels. While the global backdrop has deteriorated, the fundamental divergences between EM and DM are set to continue in 2012. DM countries are still likely to get downgraded by the agencies next year, while the EM world for the most part should continue to see upgrades.



Investors Must Differentiate but EM Contains Many Good Stories

With regards to the risks to EM coming from potential bouts of risk off trading, we believe that differentiation will continue to be the watchword for EM in 2012. In this current environment, we believe Asian currencies look most attractive now, with EMEA the least, and Latin America somewhere in between but closer to Asia. During the 2008-2009 EM sell-off, high-beta currencies that suffered most were PLN, HUF, RUB, MXN, BRL, KRW, and TRY. Low-betas that did OK were CNY, PHP, THB, PEN, SGD, MYR, and TWD. We think similar dynamics will continue for the current sell-off.

Over the past several months, markets have punished countries that have high inflation and large current account and budget deficits. We see this continuing, and note that most of the offenders here are in EMEA (Turkey, Poland, South Africa) but with some outliers in Asia (India).

Furthermore, we continue to believe that Eastern Europe is the most vulnerable EM region to problems stemming from the debt crisis in Western Europe. Besides having the weakest underlying fundamentals in EM, Eastern Europe also has a very high dependence on Western Europe through trade and financial ties. As a result, Eastern Europe remains most at risk from a protracted Euro Zone crisis that hurts regional growth and banking systems.

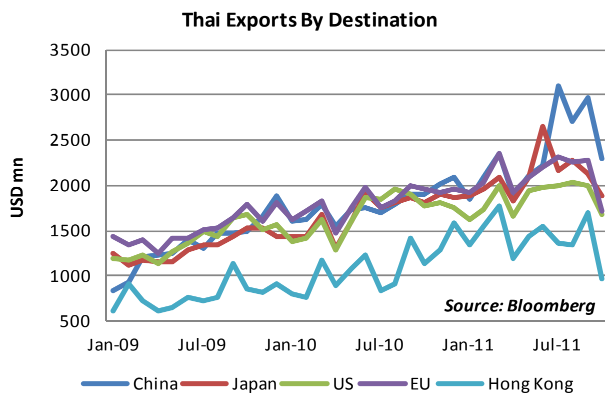
Lastly, given what appears to be a less benign global growth backdrop, we think that countries that are less open and less dependent on exports should do better in 2012. This group includes (but is not limited to) Brazil, Poland, Turkey, India, and Indonesia. Some of these countries have other vulnerabilities, but they can at least depend on a large domestic market to generate some demand to offset external headwinds.

-Win Thin

Emerging Markets: Impact of Thailand Flooding

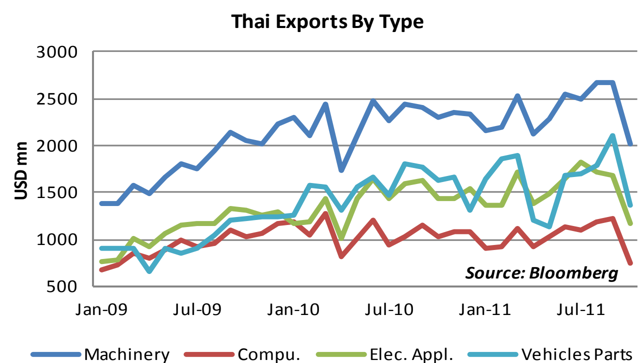
Severe flooding occurred in the northern part of Thailand this year, following heavy rains from the end of July. Flooding has moved south and flowed into metropolitan Bangkok in late October. According to the Ministry of Industry, industrial production for Q4 will decrease by THB328 billion owing to the flood damage of seven industrial complexes. As Thailand plays a growing role in the most integrated industries in ASEAN and has played a major role as a global hub for components supply in recent years, the flood damage will have a bad influence on global production by cutting into its component distribution network, particularly in ASEAN.

Manufacturing exports account for approximately 90% of total exports from Thailand, while machinery equipment, transport equipment, electronic components and consumer electronics account for approximately 40% of total manufacturing exports. Thailand has one of the most stable power supplies in ASEAN, along with a large-scale port and airport that affords convenient access to the ASEAN market. In addition, the Thai government has arranged a good investment environment, led by Thailand Investment Committee, in attracting foreign companies. This is very positive for trade liberalization, as Thailand has concluded EPA (Economic Partnership Agreement) and FTA (Free Trade Agreement) with many countries and areas. As a result, Thailand has very strong competitiveness as an export base, and has become one of the only countries capable of consistent production from upstream to downstream within ASEAN.



In recent years, manufacturing firms from developed countries have tended to go into ASEAN countries other than Thailand, but we feel Thailand still has the advantages in term of infrastructure. Still, the halt in production and exports by the flooding has had a negative impact on the world economy, not only on ASEAN but also on Australia, China, India, the U.S., Japan, and South Africa as production falls due to the cutoff of the component distribution network. For example, Japan's exports to Thailand decreased -5.1% y/y in October from an increase of 16.1% y/y in September, while total Japanese export growth in October decreased by 0.2 percentage points due to Thailand flooding.

However, the damage to plants in Thailand by the flooding is thought to be less likely to limit production activity for the whole of East Asia, unlike the influence caused by the earthquake disaster of Japan. Most products exported by Japan are special order products such as microcomputers. As a result, the influence of the decrease in production was intensified by the scarcity factor. Contrast this with products exported by Thailand, which are mainly commoditized. In many industries, Japan and China are promoting alternative procurement from other Asian countries instead of Thailand. It is expected that the downward pressures on production in East Asia due to Thailand flooding will cease to have much impact after a fairly short period of time.



Looking at the most recent data, we note a sharp slowdown in trade to Thailand's top destination. Exports in October declined 43% to Hong Kong, 25% to the EU, 22% to China, 16% to the US and 12% to Japan, when compared to the September numbers. In terms of type, computer parts were down 39%, vehicle parts were down 35%, electric appliances were down 27%, and machinery exports were down 25% over the same time period.

Economic Impact of Floods in Thailand

Meanwhile, despite the Thai economy experiencing increasingly severe flood damage, GDP growth accelerated to 3.5% y/y in Q3 from 2.5% y/y in 2Q. This did not prevent the Thai government from cutting its growth forecast for 2011 with the release of 3Q GDP data to 1.5% from 3.5-4.0% back in August. This growth forecast for 2011 thus assumed Q4 contraction around -3.2% y/y, the first negative reading since Q3 2009. Thailand manufacturing production index dropped -35.8% y/y in October, the largest decline since January 2000. Although resumption of production has been seen at some factories, it will still take several months to resolve the flood damage in the industrial complex, and 2011 growth could be even lower than the government forecast.

No surprise then that the Bank of Thailand cut its policy rate by 25 bp to 3.25% on November 30, in response to the rapid economic downturn. Moreover, BOT revised its growth forecast downward to 1.8% from 2.6% in late October (which was cut from 4.1% previously). Note that BOT announced that further rate cuts could be seen if the restoration and revival from flood damage run into

difficulties. Inflation pressure is expected to come mainly from food prices going into the first half of 2012. The emergency import of necessaries into Thailand could help keep inflation down. CPI in November rose 4.19% y/y, steady from October.

The Thailand government unveiled the "New Thailand" plan totaling THB900 billion (8.9% of nominal GDP) on October 30 for dealing with flood damage. THB100 billion will be used for repairing the industrial complex and THB800 billion towards river management and an economic stimulus package. Domestic production will remain stagnant near-term, mainly in automobile and electronic equipment. In addition, exports will continue to suffer from production curtailment. The reduction in exports will surely depress the economy as exports as a share of GDP are 70%.

It seems that CAPEX will also be sluggish since submerged land regions take time to recover. Consumption will be limited by decreased income and heightened uncertainty due to flooding. Consumers are holding back on spending durable goods such as cars and white goods, while the demand for necessaries such as drinking water and food has increased. However, from 2012, the authorities should make solid progress in restoring submerged equipment, and production activity should normalize gradually. Then, consumption is also likely to head for recovery with the normalization of production. By mid-2012, the recovery pace of the economy should strengthen as reconstruction efforts intensify.

Thailand Political Outlook Changed By the Flood

The flood damage in Thailand was a touchstone for the Yingluck government, which has been in power only since July 2011. She had no political experience before becoming prime minister, as she took the position as a substitute for Thaksin, ex-prime minister and her elder brother. After spreading flood damage, her competence has come under question for her response, which at times has lacked strong decision-making under difficult circumstances.

Yingluck installed a victim relief center in the Don Muang airport in northern Bangkok on October 8. The relief center was placed there under expectations that Bangkok would not have the flood damage, but Don Muang airport was also flooded and the center was moved further south. Furthermore, distribution of aid and support from the relief center was reportedly unreliable.

Cooperation between the government of Thailand and the local Bangkok administration has been lacking, perhaps because Bangkok Governor Sukhumbhand belongs to the opposition Democrat Party. For example, Governor of Sukhumbhand was opposed to Yingluck's decision on the sluice opening of the Samwa canal of the Bangkok north. While the government demanded the further opening of the sluice, Bangkok opposed it due to fears of further flood damage of a downstream industrial complex. Although Yingluck has repeatedly mentioned that all authorities should respond to the crisis together and overcome the political divisions, political conflict has in fact led to some unnecessary confusion.

The flooding has adversely affected the popularity of the Yingluck government. On the other hand, the standing of the Thai Army seems to have increased due to efforts made to repair the dike and to provide relief. Resignation demands for Yingluck have surfaced, and a disagreement begins to appear within the ruling party. For this reason, Thaksin (who is thought to support Yingluck discreetly) may raise his presence again. There are some reports that amnesty for Thaksin was decided in secrecy at the cabinet meeting, which would cause controversy.

Still, the approval rate is still relatively high for Yingluck. According to opinion polls of the inhabitants of 17 prefectures across the country, 75% supported Yingluck and 83% rejected the need for her to resign. Governor Sukhumbhand could not capitalize on the flood issue, and support for the Democratic Party has not risen.

THB Impact

Downward pressure on a currency usually picks up when its economic outlook is revised downward. However, THB has outperformed within EM and is virtually flat against USD since October 3, when the flood damage started to be reported globally. INR declined 8.5% and IDR declined 2.1% over the same period. Note that THB was one of the best EM performers during the 2008-2009 bloodbath, and so its recent outperformance is not surprising.

Perhaps the market is rewarding the solid financial condition of Thailand. Its foreign reserves are less than international liabilities, similar to Indonesia and South Korea. But Thailand's foreign reserves are bigger than the total of portfolio and other borrowing, meaning Thailand can cover all international borrowing except foreign direct investment, which is less liquid, with its foreign reserves. On the other hand, foreign reserves in South Korea and Indonesia cannot cover international borrowing, and both countries tend to be vulnerable to unstable global financial conditions. For this reason, THB can remain relatively stable even in current unsettled global conditions.

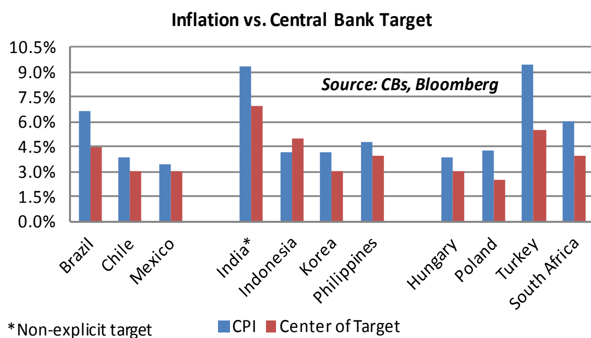
However, it is necessary to pay attention to the risk that foreign companies may push their production base out of Thailand due to flood damage. In addition, the Thailand government plans to raise the minimum wage by 40% in April 2012 and so we fear that the attractiveness of Thailand as an investment destination will decline. Japanese automobile-related companies have already relocated some factories from Thailand to Indonesia. Electrical equipment manufacturers may relocate a factory to Vietnam, and labor-intensive industries such as textile may be moved to Cambodia, Laos, and Myanmar, which supplies labor at lower cost.

It is also concerning that the political strife continues among the anti-Thaksin groups strong in urban areas with the Thaksin group (the current ruling bloc) strong in rural areas. Political unrest in Thailand subsided when the Thaksin supporters won an overwhelming victory in the July general elections, but criticism of Yingluck has increased due to flood response, and the political situation may become confused again. In the medium term, these factors may reduce direct investment into Thailand and impact THB.

-Masashi Murata

Emerging Markets: Central Banks in Focus

Inflation in many Emerging Market (EM) countries is running well above the targets, yet many central banks have either already started cutting rates or communicated a clear easing bias. This disconnect is mostly justified by forward looking indicators which are pointing to a decidedly worse economic outlook for most EM and Developed Market (DM) countries, as well as financial uncertainties stemming from the euro-zone. Moreover, the remarkable assertiveness with which authorities have stepped up to defend their currencies against depreciation has provided additional degrees of freedom for central banks to cut rates. Even the central banks of Mexico and India, historically amongst the most passive in FX markets, have shifted toward a more interventionist approach.



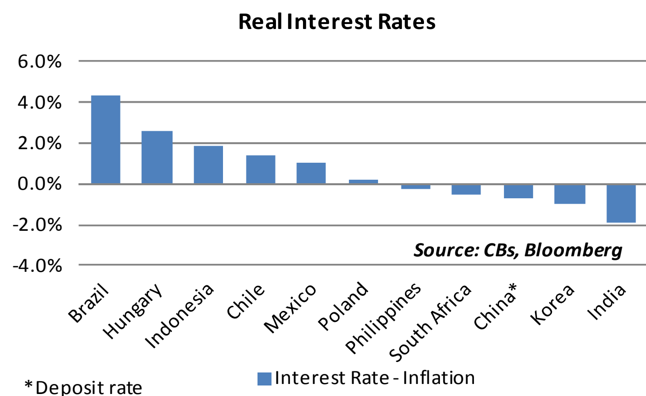
The resilience of the US economy has already surprised most observers, and so has the speed with which policymakers in EM have begun to ease monetary conditions through frontloading cuts and relaxing credit. Some examples of this include recent steps by the Chinese, Brazilian and Indonesian authorities. Moreover, exchange rates in most EM countries are still considerably weaker than they were just a few months ago. Despite many governments' best efforts to control the moves, pass-through to inflation is likely to become a concern in many countries.

This setup creates a number of risks for EM policymakers and/or investors to get caught wrong-footed. First, the assumption of a severe slowdown in growth leading to much lower rates in EM could be challenged in some cases, such as Brazil and Indonesia. Second, markets may still be underestimating the extent of easing in some countries, such as China, for example. Third, a few central banks are simultaneously facing high inflation and slowing growth, such as India and South Africa. This group will have to start making some difficult decisions soon, possibly to the displeasure of the markets.

How Much Easing and for How Long?

After the recent measures taken by the Brazilian government to complement the rate cuts by the central bank (Bacen), we think that the risks have shifted towards either fewer cuts than are currently priced in or a sooner-than-expected reversal of policy. These risks arise from the combined effect of further easing by the central bank on top of the 150bp of easing already done since August, a weaker currency, and high likelihood that the government will continue reversing its macro prudential measures and credit restrictions. In our view, it is becoming much more likely that the central bank will deliver less than the expected 150bp of cuts by mid-2012.

If this proves correct, it could mean that Brazilian investors may gradually begin to shift from the widely popular receiving rates trade to going long equities, especially in light of the recent cut in the IOF on foreign equity investment. That said, we also recognize that authorities have made a point of changing the focus away from inflation – epitomized by new legislation proposing a dual mandate for the central bank – and we may just have to get used to the idea that Brazil will have higher inflation in the medium term.



The Bank of Indonesia (BI) kept rates on hold in December but left the door open for further cuts if the external picture deteriorates further. The risk is that the BI will frustrate any calls for further cuts. The bank frontloaded the easing cycle, surprising the markets with a 50bp cut in its November meeting, having delivered 75bp of cuts since October. Inflation at 4.2% y/y in November is still close to the bottom of the 4-6% target range and may fall further, but the BI still forecasts strong growth of 6.3-6.7% y/y in 2012 and higher than that in 2013.

Perhaps more importantly, the IDR remains relatively weak despite the central bank's decisive efforts to support the currency. This is due in part to the divestment of local government bonds by foreigners from around IDR250 trillion to IDR225 trillion, or a 10% drop. Further cuts or dovish signals would only make the central bank's task of keeping IDR stable more difficult.

In China, the risk is that the market is under pricing authorities' resolve to ease policy and stimulate the economy. We see the government's official policy shift to "fine-tuning" and "selective easing" as a euphemism. Actions have moved well ahead of rhetoric as the government has already lowered bond auction rates, cut commercial bank reserve requirements, and reportedly

boosted lending by the larger Chinese banks. The bottom line is that the Chinese will not take any risks on the growth front.

In a Tight Spot

There is a group of countries where policymakers are caught in a difficult position as inflation remains elevated but at the same time growth is faltering. The risk here is that we will return to the days when markets start to punish countries that are lacking credibility in the inflation front. India and South Africa are seen as the worst cases. Inflation is running at 9.4% y/y in India, while GDP has slowed from 8.3% y/y in Q4 10 to 6.9% y/y in Q3 11.

In South Africa, GDP growth has topped out just above 3% y/y in the past few quarters and is likely to move below 3% in 2012. South Africa's unemployment rate remains around 25%, but inflation has accelerated from a low of 3.2% y/y in late 2010 to 6.0% y/y now (at the top of the central bank's target of 3-6%). In both cases we think that cuts in 2012 are likely, and that the credibility of the central banks will be tested, possibly weighing on asset prices. In addition, both countries are saddled with high and rising "twin deficits," which have been another focal point for investors.

Other EM countries are also facing similar dilemmas, though not nearly as challenging due to more solid fundamentals. The Mexican central bank has maintained its easing bias despite the improvement of U.S. economic indicators. The bank has disappointed markets calls for both cuts and hikes over the last two years as it kept rates on hold at 4.50%, and it may do so again.

In Chile, the central bank's cautious tone contrasts with inflation at 3.9% y/y (at top end of the target). Of note, the newly appointed central bank governor Rodrigo Vergara is thought to be more hawkish than his predecessor and may raise the bar for a rate cut next year. However, growth is clearly slowing in Chile.

Turning to Asia, CPI in Korea rose 4.2% y/y in November, back above the BOK's 2-4% target range, after two months within it. High inflation is eroding the popularity of the government, and so more hawkish rhetoric has emerged in recent months. Still, the economy is slowing and so we think 2012 will bring a shift towards boosting growth. Indeed, the BoK recently cut its 2012 growth forecast by almost one percentage point, from 4.6% y/y to 3.7% y/y.

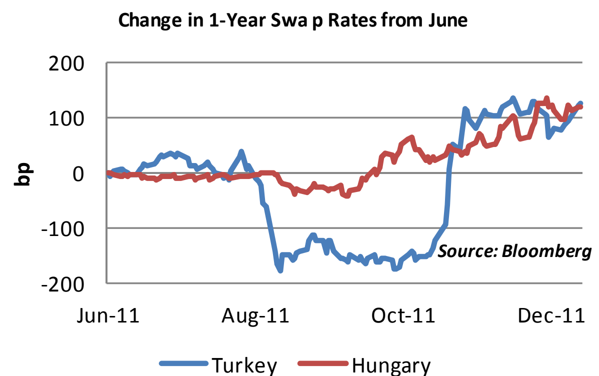
In the Philippines, CPI rose to 5.2% y/y in November, the cycle high and above the central bank's 3-5% target range. And yet the economic slowdown will likely lead BSP to start the easing cycle in 2012. Q3 GDP was weaker than expected and due in large part to the external sector, and so the authorities will look for ways to stimulate the domestic sector.

In Thailand, CPI rose 4.2% y/y in both October and November, while core rose 2.9% and is right at the top of the BOT's 0.5-3.0% target range. And yet the economic slowdown from the flooding led the central banks to start the easing cycle with a 25 bp cut in November. More BOT easing is seen in 2012.

Policymakers in Hungary are also in a difficult position, but instead of balancing weak growth against inflation as in the cases above, the central bank was driven to embark in a tightening cycle to defend the forint despite a worsening economic outlook for the country in 2012. The Hungarian economy will probably have to contend with a severe tightening of credit from the local banking system. Banks are being squeezed by a combination of government measures (taxes and sharing of losses on FX-linked mortgages) and from less credit provided by European banks to their subsidiaries in Eastern Europe given new capital requirements. Higher rates are only going to make the situation worse.

The challenge facing the Turkish central bank is slightly different than that in Hungary, and the risk is that rates will rise faster than the market expects. Inflation is once again proving a headache for the Turkish central bank, rising 9.5% y/y in November. Meanwhile, GDP grew 8.8% y/y in Q3. We are moving back into highly contentious territory in policymaking in Turkey, when the reaction of the central bank to these pressures will be very influential in asset prices. Authorities have been able to fulfill their immediate objectives of keeping the lira from weakening further and have managed to contain the widening of the current account deficit.

The cost, however, is more confusion about the bank's policy framework. The bank has so far widened its interest rate corridor and focused on tightening lira liquidity through repo auctions and selling USD from the FX reserves. Given that these measures have clearly not been enough, they may finally be forced to shift towards a more conventional policy framework, which would entail raising policy rates in an attempt to anchor inflation expectations.



We note that EM is starting this stage of the crisis with fewer bullets to spend. That is, the aggressive easing in 2008-2009 was only partially taken back in the ensuing years, and so most EM policymakers now have much less room to cut rates than they did previously. The same goes for fiscal policy. All in all, we do expect EM policymakers to take whatever steps they can to ward off the growing risks of economic slowdown in 2012.

-Ilan Solot

Sovereign Ratings Models

Emerging Markets (EM) Ratings Model

We have produced the following Emerging Markets Country Risk Index (CRI) to assist fixed income investors in assessing relative sovereign risk. An EM country's CRI score directly reflects its creditworthiness and underlying ability to service its external debt obligations. Each EM country's CRI score is determined through a weighted compilation of fifteen economic and political indicators, which include external debt/GDP, short-term debt/reserves, import cover, current account/GDP, GDP growth, Gross Fixed Capital Formation/GDP, budget balance, and FDI/GDP. We find that our sovereign model is very useful in predicting rating changes by the major agencies, and we summarize our ratings conclusions below. We have added Kenya and Tanzania to our EM model, bringing the total number of rated EM countries to 44.

We continue to see an ongoing divergence in ratings trajectories between the stronger Emerging Markets (EM) and Developed Markets (DM). However, cracks in EM are appearing in the weaker credits, and ratings agencies have not hesitated to downgrade them. The DM outlook continues to deteriorate and virtually every DM rating action has been a downgrade this year. Our model points to more DM downgrades ahead in 2012.

EM Ratings Summary for Q4

EMEA remains the weak link in EM, and ratings are being adjusted accordingly. Of the MENA countries, Egypt continues to be downgraded most. S&P cut Egypt twice this quarter, from BB to BB- and then again to B+, while Moody's downgraded it from Ba3 to B1. Moody's also moved the outlook on South Africa's A3 rating from stable to negative. Our model shows it at BBB+/Baa1/BBB+ and so a downgrade is warranted.

Bulgaria, Czech Republic, Latvia, and Lithuania all saw their outlooks cut at the same time from positive to stable by Fitch this month. Fitch said that "Strong economic and financial linkages mean that countries in central and Eastern Europe are being adversely affected by downward revisions to economic growth prospects and heightened financial stress in the euro zone." We concur. Moody's also moved the outlook on Ukraine's B2 rating from positive to stable.

All three agencies put a negative outlook on Hungary during the quarter, but only Hungary so far has followed through as it cut the rating one notch from Baa3 to a junk Ba1. We expect the other two to follow suit in 2012. Indeed, our model now has Hungary at an implied BB/Ba2/BB vs. BB+/Ba1/BB+ in the previous round, and so the fundamentals continue to deteriorate. Fitch moved the outlook on Turkey's BB+ rating from positive to stable, and also moved the outlook on Ukraine's rating from positive to stable.

Kazakhstan was one of the few in the region to buck the negative trend, as S&P upgraded it from BBB to BBB+ with stable outlook and Fitch upgraded it from BBB- to BBB with positive outlook. Our model has Kazakhstan as BBB+/Baa1/BBB+. Elsewhere, S&P moved the outlook on Iceland's BBB- rating from negative to stable.

Fitch moved the outlook on Korea's A+ rating from stable to positive, and an upgrade to AA- would move Korea above our implied A+/A1/A+. Fitch upgraded Indonesia from BB+ to investment grade BBB-, and our implied ratings of A-/A3/A- suggest many more upgrades ahead for this country. Lastly, S&P raised the outlook on its BB rating for the Philippines from stable to positive.

Fitch upgraded Peru from BBB- to BBB with a stable outlook, moving it into line with S&P's BBB but well below our implied rating of A-/A3/A-. Actual Peru ratings of BBB/Baa3/BBB remain too low. S&P upgraded Brazil from BBB- to BBB with a stable outlook. This too brings it into line with the other agencies, but still below our implied rating of BBB+/Baa1/BBB+. Both Peru and Brazil should continue to see upgrades in 2012.

EM COUNTRY RISK INDEX Q1 12

Country	Current Score	Change vs. last	BBH Implied Rating	Agency Ratings S&P	Moody's	Fitch	5-Yr CDS (bp)	5-Yr Spread to US (bp) *to 5-Yr German (bp)	
Singapore	6.9	-1.3	AAA	AAA	Aaa	AAA			
Hong Kong	12.7	-0.6	AA+	AAA	Aa1	AA+	102	116	
Taiwan	16.6	-2.9	AA	AA-	Aa3	A+			
China	19.4	-4.4	AA-	AA-	Aa3	A+	149	84	
Chile	19.5	1.2	AA-	A+	Aa3	A+	133	10	
Israel	21.0	-1.3	A+	A+	A1	A	198	129	
Malaysia	21.2	0.3	A+	A-	A3	A-	147	218	
Korea	21.7	-1.3	A+	A	A1	A+	169	147	
Czech Rep.	25.8	-1.9	A	A	A1	A +	172	154	*
Indonesia	26.9	0.0	A-	BB+	Ba1	BBB-	208	258	
Peru	27.3	0.0	A-	BBB	Baa3	BBB	175	179	
Uruguay	28.5	0.0	A-	BB+	Ba1	BB+		164	
Algeria	30.6	0.0	BBB+	NR	NR	NR			
Mexico	30.7	0.0	BBB+	BBB	Baa1	BBB	157	163	
Russia	31.3	0.8	BBB+	BBB	Baa1	BBB	275	291	
Colombia	31.3	0.0	BBB+	BBB-	Baa3	BBB-	158	204	
So. Africa	31.6	0.6	BBB+	BBB+	A3	BBB+	198	193	
Nigeria	31.6	-1.3	BBB+	B+	NR	BB-			
Kazakhstan	32.0	1.1	BBB+	BBB+	Baa2	BBB	295		
Thailand	32.3	2.5	BBB+	BBB+	Baa1	BBB	188	269	
Brazil	32.4	0.0	BBB+	BBB	Baa2	BBB	165	112	
Bulgaria	33.5	-1.6	BBB	BBB	Baa2	BBB-	404	355	
Lithuania	34.1	-1.1	BBB	BBB	Baa1	BBB	368	445	
Jordan	34.1	-0.6	BBB	BB	Ba2	NR		518	
Panama	35.3	-0.6	BBB	BBB-	Baa3	BBB	155	168	
Philippines	36.2	0.6	BBB	BB	Ba2	BB+	197	169	
India	37.6	1.9	BBB-	BBB-	Baa3	BBB-			
Romania	38.5	-0.6	BBB-	BB+	Baa3	BBB-	428	460	*
Morocco	38.5	2.5	BBB-	BBB-	Ba1	BBB-	260		
Poland	39.8	2.5	BBB-	A-	A2	A-	274	288	
Latvia	40.9	0.0	BB+	BB+	Baa3	BBB-	369	343	*
Turkey	41.5	1.9	BB+	BB	Ba2	BB+	287	376	
Sri Lanka	41.5	-2.9	BB+	B+	B1	BB-		503	
Argentina	41.8	0.4	BB+	B	B3	B	979	1026	
Egypt	42.6	-0.6	BB+	B+	B1	BB	656		
Tunisia	42.7	1.3	BB+	BBB-	Baa3	BBB-			
Iceland	43.0	-1.3	BB+	BBB-	Baa3	BB+	334		
Hungary	45.5	4.0	BB	BBB-	Ba1	BBB-	516	625	
Tanzania	47.7	n/a	BB-	NR	NR	NR			
Vietnam	48.7	0.0	BB-	BB-	B1	B+	411	736	
Venezuela	49.3	0.0	BB-	B+	B2	B+	944	1213	
Pakistan	49.3	-0.6	BB-	B-	B3	NR	1024	1313	
Kenya	50.3	n/a	B+	B+	NR	B+			
Ukraine	51.6	0.0	B+	B+	B2	B	853	958	

Source: BBH, Bloomberg

EM Rating Outlook

Looking ahead, we identify several more candidates for upgrades in the coming year. China improved by two notches and moved up to AA-/Aa3/AA- from A/A2/A previously. As such, China's actual ratings of A+ from Fitch should be upgraded, while the AA- and Aa3 ratings from S&P and Moody's, respectively, appear to be on target. Indonesia was steady at an implied A-/A3/A-, supporting our view that actual ratings of BB+/Ba1/BBB- will be moved upward next year and further into investment grade territory. Malaysia's implied rating was steady at A+/A1/A+, and so actual ratings of A-/A3/A- should be adjusted higher in 2012. Taiwan's implied rating rose one notch to AA/Aa2/AA and so upgrades appear likely for actual ratings of AA-/Aa3/A+. The Philippines' implied ratings of BBB/Baa2/BBB suggest upgrades ahead for actual ratings of BB/Ba2/BB+. As noted earlier, Indonesia is a candidate for multiple downgrades ahead.

Besides the upgrade risks mentioned earlier for Brazil and Peru, other countries in the Latin American region are ripe for upgrades. Despite a poor history of economic management, Argentina has still seen its score improve over the years to stand at an implied BB+/Ba1/BB+ vs. actual ratings of B/B3/B. Colombia stands at an implied BBB+/Baa1/BBB+ and so we see upgrades ahead to its actual BBB-/Baa3/BBB- ratings in 2012.

Nigeria's rating remained at BBB+/Baa1/BBB+ but upgrades to actual B+/NR/BB- ratings seem unlikely near-term as the threat of lower oil prices poses a risk to the country. Kenya appears correctly rated, as our implied rating of B+/B1/B+ lines up with B+ rating from both S&P and Fitch. Tanzania is not rated by any agencies, but our model shows it as an implied BB/Ba2/BB.

Scores and ratings for MENA countries stabilized, as the negative economic impact of "Arab Spring" starts to ease. Our model shows Algeria steady at an implied BBB+/Baa1/BBB+, Tunisia steady at an implied BB+/Ba1/BB+, and Egypt steady at an implied BB+/Ba1/BB+. Of these, we note that Tunisia faces some downgrade risk to its BBB-/Baa3/BBB- ratings.

Downgrade risks are also seen in the weaker credits in Eastern Europe. Besides Hungary's implied rating falling a notch this round and supporting further downgrades, we point out that Poland remains overrated as its implied rating of BBB-/Baa3/BBB- suggests actual A-/A2/A- ratings are vulnerable to a downgrade. Agencies have warned of a deteriorating fiscal stance in Poland might lead to rating cuts, and we think some cuts will be seen in 2012. Turkey saw its implied rating fall one notch to BB+/Ba1/BB+, which dovetails nicely with Fitch's decision to move the outlook on its BB+ rating from positive to stable. Investment grade for Turkey seems unlikely in 2012 given deteriorating fundamentals.

Developed Markets (DM) Ratings Model

Given the success of our EM Sovereign Ratings Model, we produce the Developed Markets Country Risk Index to assist investors in assessing relative sovereign risk over a wider range of countries. As in the case of the EM model, DM CRI scores directly reflect a country's creditworthiness and its underlying ability to service sovereign debt obligations. Each country's CRI score is determined through a weighted compilation of fifteen economic and political indicators, which include government debt/GDP, current account/GDP, GDP growth, Gross Fixed Capital Formation/GDP, actual and structural budget balance, per capita GDP, banking sector strength, and inflation. Please note that the score is scaled differently than our EM model.

The United States is a special case and deserves a mention. Because the dollar is the world's reserve currency (and will remain so for decades to come), the U.S. simply gets more leeway from the ratings agencies than other countries with regards to policy risks. In our model, we have put in a dummy variable that boosts the U.S. score for having reserve currency status.

DEVELOPED COUNTRY RISK INDEX Q1 12

Country	Current Score	Change vs. last	BBH Implied Rating	S&P	Agency Ratings Moody's	Fitch	5-Yr CDS (bp)	5-Yr Spread to US (bp) *to Germany	
Sweden	5.6	0.0	AAA	AAA	Aaa	AAA	80	22	*
Switzerland	6.6	-1.0	AAA	AAA	Aaa	AAA	60	-66	*
Norway	10.3	0.0	AAA	AAA	Aaa	AAA	45	192	*
Luxembourg	11.6	0.0	AAA	AAA	Aaa	AAA			
Australia	15.0	0.0	AAA	AAA	Aaa	AAA	86	233	
Canada	16.9	-1.6	AAA	AAA	Aaa	AAA		37	
Netherlands	16.9	-0.3	AAA	AAA	Aaa	AAA	124	43	*
Germany	20.1	0.6	AAA	AAA	Aaa	AAA	107	2	
New Zealand	20.4	1.3	AAA	AA	Aaa	AA	98	246	
Austria	23.2	-1.0	AAA	AAA	Aaa	AAA	197	151	*
US	27.4	-1.6	AAA	AA+	Aaa	AAA	52		
France	31.5	0.6	AA+	AAA	Aaa	AAA	227	120	*
Belgium	32.6	-0.3	AA	AA	Aa3	AA+	325	257	*
UK	33.5	0.3	AA	AAA	Aaa	AAA	98	26	
Japan	37.3	0.0	AA-	AA-	Aa3	AA	142	-49	
Spain	42.7	-0.6	A-	AA-	A1	AA-	402	348	*
Italy	43.8	0.0	A-	A	A2	A+	520	511	*
Ireland	54.2	-1.3	BB+	BBB+	Ba1	BBB+	730	724	*
Portugal	57.8	-0.7	BB-	BBB-	Ba2	BB+	1099	1484	*
Greece	72.8	-1.6	CCC-	CC	Ca	CCC	6554	5304	*

Source: BBH, Bloomberg

Developed Country Ratings Summary

All three ratings agencies have signaled a more aggressive approach with regards to the euro zone debt crisis. S&P was the most aggressive in putting 15 euro zone nations on CreditWatch negative this month (Cyprus and Greece were already there), and then following this up by putting the EFSF on notice as well. While we have long been negative on France and the other weaker AAA credits, it is hard for us to justify Germany and the other strong credits being put on watch. We view this as S&P trying to become relevant again, as it did with its August U.S. downgrade to AA+.

Moody's also warned that "The continued rapid escalation of the euro area sovereign and banking credit crisis is threatening the credit standing of all European sovereigns. In the absence of policy measures that stabilize market conditions over the short term, or those conditions stabilizing for any other reason, credit risk will continue to rise." However, Moody's showed more restraint than S&P by promising to review euro zone ratings in Q1 2012. It did, however, cut Belgium two notches from Aa1 to Aa3 and kept the negative outlook. Fitch cut the outlook on France's AAA rating from stable to negative, and also put every euro zone country rated below AAA on Rating Watch Negative. Those reviews are expected to be completed in January.

Another sign that ratings agencies remain behind the curve was that downgrades of DM countries continued in Q4, sometimes multi-notch. Greece was left untouched for a change, but Italy came under intense scrutiny that resulted in multiple downgrades as it was cut by Moody's from Aa2 to A2, and cut by Fitch from AA- to A+, both with negative outlooks kept. S&P cut Italy last quarter. Portugal was cut by Fitch from BBB- to BB+ with a negative outlook. Moody's cut Spain from Aa2 to A1, S&P cut from AA to AA-, and Fitch cut Spain from AA+ to AA-. All three have maintained negative outlooks, and so further cuts for Spain remain likely as our model rates it as A-/A3/A- still.

Outside of the periphery, it is noteworthy that "core" Belgium finally succumbed. S&P cut Belgium from AA+ to AA with a negative outlook, while Moody's put its Aa1 rating on review for possible downgrade. On the other hand, Fitch upgraded Australia from AA+ to AAA, bringing it into line with the other agencies and with our model. This was the only positive DM rating action in Q4.

Developed Country Rating Outlook

Peripheral euro zone stresses have remained in the spotlight for much of this year, despite ongoing efforts by European policy-makers to address the crisis. This round, most implied ratings in DM were stable to higher and so ratings actions were largely catch-up. However, with high borrowing costs and recession spreading from the periphery to the core, most debt ratios will deteriorate in 2012, adding to downward ratings pressure on the entire region.

Greece's implied rating remained at CCC-/Caa3/CCC. However, we believe actual CC/Ca/CCC ratings are still vulnerable to downward pressure as market sentiment continues to deteriorate. S&P has a negative outlook, Moody's has a developing outlook, while Fitch took Greece off Rating Watch Negative after its last downgrade this July.

Ireland's implied rating improved slightly to BB+/Ba1/BB+ from BB/Ba2/BB previously. As such, we believe actual ratings of BBB+/Ba1/BBB+ are not quite as vulnerable to downgrade risk. S&P moved its outlook from negative to stable, while both Moody's and Fitch have maintained negative outlooks on Ireland.

Portugal's implied rating stayed at BB-/Ba3/BB- this round. With all three agencies keeping a negative outlook, further downgrades to actual ratings of BBB-/Ba2/BB+ are likely. Spain's implied rating remained steady at A-/A3/A- but further downgrades are warranted as current actual ratings of AA-/A1/A- remain too high. All three agencies have maintained negative outlook on Spain.

All three agencies have negative outlooks on Italy. Italy showed remarkable stability in its credit standing the early part of the crisis. However, it has succumbed in recent months and now stands at A-/A3/A-. Fitch's A+ rating is now most out of line, with S&P and Moody's slightly less so at A and A2, respectively.

Looking beyond the peripheral Euro Zone, Belgium's implied rating was steady at AA/Aa2/AA but the agencies are finally catching up with our view. S&P downgraded Belgium from AA+ to AA and Moody's downgraded from Aa1 to Aa3. Downgrade risk for Belgium remains strong given that a negative outlook was kept by all three agencies. Political risk has been a negative risk factor for Belgium over the past year and a half, but the country finally appears to have come up with a working government this month. Agencies will be looking for signs that the fiscal trajectory is improving, otherwise more downgrades appear likely.

After Belgium, the next weakest in the core countries is France. We note that France remains in AA+/Aa1/AA+ territory and given the increased scrutiny on the country, a down grade appears likely in 2012. The fact that Moody's downgraded several French banks in 2011 due to Greece exposure suggests that the sovereign will come under increasing pressure. Fitch moved the outlook on its AAA to negative, while S&P has put the entire euro zone on Rating Watch Negative. Either S&P or Fitch appears likely to be the first to pull the trigger on stripping France of its AAA.

We believe the U.K. also remains vulnerable to losing its AAA rating despite the aggressive fiscal tightening implemented by the Tory-led government. Austerity is taking a toll on the recovery, which will in turn hurt tax revenues. U.K.'s implied rating was steady at AA/Aa2/AA vs. actual ratings of AAA/Aaa/AAA. It has gotten a pass from the agencies, but we think a slowing economy will bring attention back on the AAA. We see U.K. downgrades in 2012.

Japan's rating was steady this round at an implied AA-/Aa3/AA-, but we note that the increased spending that will be needed after the recent disaster could put further downward pressure on its actual AA-/Aa3/AA ratings. For now, Japan appears to be correctly rated but since both S&P and Fitch have negative outlooks, Japan still faces some downgrade risk. After cutting Japan to Aa3 in August, Moody's moved its outlook back to stable.

We believe that Austria, Germany, and the rest of the core Euro Zone are all correctly rated at AAA. As we said before, the S&P move to put the entire euro zone on Negative Watch can be seen as a desperate cry for attention. We believe that the dollar bloc and the Scandinavian bloc are correctly rated at AAA.

Concerns about the AAA ratings for the U.S. built for much of this year before coming to a head with S&P's downgrade to AA+. However, contrary to Chicken Littles everywhere, the sky did not fall and the world instead continued to turn. Indeed, U.S. borrowing costs are lower now than before the downgrade.

This is perhaps the lesson that European policymakers should take to heart. Loss of AAA is not the end of the world, and one could make the case that AA is the new AAA. Regardless of the U.S. rating, we think markets will remain nervous about the rising debt U.S. load. However, the agencies have signaled that 2013 will be the key turning point for future ratings actions on the U.S.

-Win Thin

Emerging Markets: FX Model

Our FX Risk Ranking (FXRR) covers 25 countries, with each country's FXRR score determined by a weighted composite ranking of 13 economic indicators that are each ranked against the rest of our model emerging markets universe for each category. Categories are external debt/GDP, interest rate differentials, short-term debt/reserves, import cover, external debt/exports, current account/GDP, export growth, GDP growth, FDI/GDP, nominal M3 growth, budget deficit/GDP, and inflation. We recently added the percentage deviation from PPP as a variable to our model, as we believe EM currencies that are near their PPP valuations have less room to appreciate than those that are very undervalued and far from PPP.

EM FX Summary

The 10 countries that are at the top of our table have VERY STRONG (1) or STRONG (2) fundamentals relative to our EM universe, while the 10 at the bottom have WEAK (4) or VERY WEAK (5) fundamentals. Those five in the middle have NEUTRAL (3) fundamentals. FXRR scores do not imply a greater return for those countries with a higher ranking. Rather, our models simply seek to identify those currencies that are backed up by better underlying fundamentals compared to their EM peers. We stress that the composite rankings contained in this model are a relative measure, not an absolute one.

We note that those currencies with STRONG and VERY STRONG fundamentals have gained an average of 0.1% (0.7% average gain for VERY STRONG, -0.4% average loss for STRONG) against the dollar from 9/30/11-12/19/11, the period since we issued our last FXRR update. This compares to an average loss of -2.3% during the same period for those with WEAK and VERY WEAK fundamentals (-2.4% average loss for WEAK, -2.3% average loss for VERY WEAK) and a -1.4% average loss versus USD for those with NEUTRAL fundamentals. Our FX model thus had excellent results identifying the likely under- and out-performers during this quarter.

We believe that early 2012 will see continued weakness in EM currencies before a resumption of the rally in EM assets later in 2012. This is based on our view that the euro zone crisis will get worse before it gets better. We feel that investors will continue to put more weight on fundamentals and less on pure yield during this period, a process that was started this past year. While currencies such as TRY, ZAR, and HUF are always going to attract some investor interest due to high yields, the return of heightened global risk no longer makes these high yielders a sure thing. Indeed, the high-beta currencies that suffered most in 2008-2009 (PLN, HUF, RUB, MXN, BRL, LRW, TRY, and CZK) are also suffering most during this current EM sell-off. Conversely, PEN, PHP, THB, TWD, and others continue to be low-beta plays.

With risks from Europe still ongoing, we are going to continue focusing on the currencies that have solid fundamentals. Carry will become more difficult to achieve since virtually all of the regional EM central banks are likely to embark on easing cycles in the coming months. But again, we recommend focusing on fundamentals as opposed to yield for the time being. Note that four of the top five currency picks this round are in Asia, similar to the last round with Peru the one non-Asian in this group. This lines up with the conventional wisdom that Asia is well-placed to ride out this crisis, with most of the low-beta currencies in this region.

Latin American currencies have been compelling given past aggressive tightening in the region and adherence to sound budgetary policies. Even though most will be cutting rates in 2012, the underlying fundamentals remain sound. We note that many Latin American currencies have moved up towards the top of our league table. A key risk for this region is lower commodity prices.

High yielders in the EMEA will always elicit investor interest but often do not have strong fundamental backing. Add in vulnerability of Eastern Europe to developments in troubled Western Europe, and one can see headwinds ahead for EMEA currencies this coming year. Many from the EMEA region are near the bottom of our league table, and are also part of the high-beta grouping that typically underperforms during periods of market stress.

-Win Thin

Current Rating	Country	FXRR Score	FX vs. USD (* vs. EUR) 9/30/11-12/19/11	Previous Rating
1	China	6.4	0.7%	1
1	Singapore	7.6	-0.1%	1
1	Taiwan	8.0	0.3%	1
1	Peru	8.5	2.8%	2
1	Malaysia	8.6	0.2%	1
2	Indonesia	10.1	-2.1%	2
2	Thailand	10.4	-0.4%	1
2	Korea	10.8	0.3%	2
2	Russia	10.8	0.3%	3
2	Colombia	11.3	-0.2%	2
3	Mexico	11.7	0.0%	4
3	Chile	11.7	-0.2%	2
3	India	11.7	-7.4%	3
3	Brazil	12.0	0.6%	3
3	Philippines	12.2	-0.5%	3
4	Israel	12.2	-1.4%	4
4	Argentina	12.8	-2.0%	5
4	So. Africa	13.0	-3.6%	3
4	Czech Rep.*	13.2	-2.8%	4
4	Hungary*	13.3	-3.2%	4
5	Egypt	13.5	-1.0%	4
5	Iceland	14.2	-2.9%	5
5	Turkey	15.8	-2.4%	5
5	Poland*	16.5	-1.5%	5
5	Pakistan	16.6	-2.6%	5

Source: BBH, Bloomberg

Emerging Markets: Equity Allocation Model

We have produced the following Equity Risk Rankings (ERR) model to assist equity investors in assessing relative sovereign risk and optimal asset allocation across countries in the emerging markets universe. The countries covered include 20 of the 21 countries in the MSCI Emerging Markets (EM) Index as well as three (Israel, Hong Kong, and Singapore) from the MSCI Developed Markets (DM) Index and two (Argentina and Pakistan) from the MSCI Frontier Markets Index. A country's ERR is determined through a weighted composite of 15 economic and political indicators that are each ranked against the other 24 in our model EM universe. Categories include industrial production growth, real interest rates, export growth, expected P/E ratio, bank lending, current account, real money growth, GDP growth, GFCF/GDP, inflation, ease of doing business, economic freedom, and FDI/GDP. We have added retail sales growth as an indicator.

EM Ratings Summary

A country's ERR directly reflects its attractiveness for equity investors – the likelihood that its equity market will outperform the rest of our Emerging Markets universe over the next 3-6 months. A country that is typically ranked first in many of the categories will end up at the top of our ERR composite ranking. Exchange rate fluctuations can have significant effects on the dollar return to foreign investors, and so we have chosen several variables that tend to highlight exchange rate risk. Others were chosen as leading indicators of economic growth.

From 9/30/11 to 12/19/11, the MSCI EM Index rose 0.9% while the MSCI Developed Market Index rose 2.8%. From a regional EM standpoint, MSCI Asia was down -0.2%, MSCI Latin America was up 5.1%, and MSCI EMEA was down -0.5%. This is somewhat consistent with the widely held view that the EMEA region has the worst fundamentals, with Asia and Latin America being viewed as having the best. With concerns picking up in Western Europe again, we believe that EMEA equities are likely to still underperform over the next forecast period. On the other hand, falling commodity prices are likely to hit Latin America hard.

Let's see how our EM model has done during the forecast period from 9/30/11-12/19/11. Within our model universe of 25 EM countries, those that were in the top fifth of our rankings with a 1 rating (VERY OVERWEIGHT equity position) rose an average 5.4% during this period. Those with a 2 rating (SLIGHTLY OVERWEIGHT) fell an average -0.7%, while those with a 3 rating (NEUTRAL) fell an average -6.2%. This compares to an average gain of 3.5% during the same period for those with a 4 rating (UNDERWEIGHT) and a -1.4% average loss for those with a 5 rating (VERY UNDERWEIGHT). Combined 1 and 2 rose an average 2.4% while combined 4 and 5 rose an average 1.0%.

Thus, our model performed well this quarter. The 3 (NEUTRAL) category was skewed lower by subpar performances in Turkey and India, while the 4 category was skewed higher by good performances in Malaysia and Israel.

We believe that the difficult EM backdrop in 2011 and the ongoing correction in EM markets have helped fundamentals to matter more. The easy part of this EM rally is over, so it will remain very important for global investors to continue focusing on the fundamentals in 2012. We remain optimistic that risk assets (including EM) will bounce back after the current period of turmoil ebbs. However, we acknowledge that this asset class remains hostage to swings in generalized risk appetite. We remain very concerned that the European crisis will deteriorate further in the coming months, which will surely impact EM negatively. However, we remain confident that the strongest EM credits will be able to outperform even under a generalized loss of risk appetite.

Looking ahead, we acknowledge that the global environment has become less constructive for EM. Recent data suggest that the euro zone is tipping into recession, while the 2.0% SAAR growth posted by the US in Q3 may not be sustainable. The Mainland China economy is also slowing, and has led the PBOC to start an easing cycle. As a result of the slowing global backdrop, export and growth numbers are already slowing significantly for most of EM, and so we believe most EM central banks will be cutting rates and easing monetary policy in 2012. This will be a very challenging year ahead for EM investors but for now, we believe that picking the EM equity markets with solid fundamentals remains a good strategy for global equity managers in this current environment.

-Win Thin

Current Rating	Country	ERR Score	MSCI 9/30/11-12/19/11	Previous Rating	ETF
1	Singapore	5.8	-3.4%	1	EWS
1	Peru	8.3	9.2%	1	EPU
1	Hong Kong	9.3	2.7%	1	EWH
1	China	9.7	6.0%	1	FXI
1	Thailand	9.9	12.6%	1	THD
2	Russia	10.5	4.2%	3	ERUS
2	Chile	10.6	6.0%	2	ECH
2	Malaysia	10.8	6.5%	4	EWM
2	Colombia	10.9	1.2%	2	COLX
2	Indonesia	11.0	4.3%	3	EIDO
3	Argentina	11.1	-7.8%	2	ARGT
3	Taiwan	11.3	-7.0%	2	EWT
3	Korea	11.4	0.8%	2	EWY
3	Turkey	11.6	-17.2%	3	TUR
3	Mexico	12.4	5.2%	4	EWW
4	India	12.4	-13.8%	3	INP
4	Israel	13.0	9.0%	4	EIS
4	Czech Rep.	13.6	-5.2%	3	
4	Poland	14.1	-8.3%	4	EPOL
4	Brazil	14.1	5.0%	4	EWZ
5	Philippines	16.4	4.7%	5	EPHE
5	South Africa	16.8	0.9%	5	EZA
5	Hungary	16.9	5.3%	5	
5	Egypt	18.4	-8.4%	5	EGPT
5	Pakistan	19.2	-9.6%	5	

Source: Bloomberg, BBH, iShares

Case Study: Iceland's Liberalization of Capital Controls

Overview

While economists, bankers, and governments argue the pros and cons of privatization, protectionist quotas, and securitization, Iceland managed to combine these policies to turn fishermen into seeming financial wizards with maximum efficiency and employment opportunities, at least for a time. What gave the Icelandic economy a boost for almost ten years – large foreign inflows – then self-destructed when those fishermen-turned-traders became greedy, and borrowed and leveraged themselves overboard.

Traditionally, Iceland's economy was highly regulated and politicized, but after joining the European Economic Area in the early 1990's and gradually reducing government control over the economy, Iceland was given access to ample capital in international markets. Iceland took advantage of this capital and bought as many assets as possible on borrowed funds. In just four years, from 2002 to 2006, its banking system grew to about ten times the size of its economy. Its currency, the Icelandic Krona (ISK), appreciated by more than 30%, while its current account deficit increased sharply and the capital of its three largest banks increased eightfold.

Unfortunately, this wealth was short-lived. During the global financial crisis, in October of 2008, Iceland's three largest banks collapsed all within a week; over 85% of its stock market value vanished and ISK depreciated by more than 70% against USD.

Government and IMF Intervention

The pandemonium of the global financial crisis magnified confidence problems for Iceland. As the market realized that Iceland's banking system was far too big relative to the size of its economy, investors started pulling out of the country, which quickly caused trouble for the ISK. Both foreign and domestic investors tried to sell ISK but could not find enough buyers. As a result, there was a gap of 30-40% between the offshore and onshore rate of ISK.

These events pressed the Central Bank of Iceland (CBI) to impose strict capital controls. With the backing of the IMF and their USD2.1 billion loan, Iceland's plan was to use monetary and exchange rate policies to protect the value of ISK and stabilize the financial sector. To counter inflation, it reversed its initial cut in interest rates to 12% from 15.5% and then raised them to a record high of 18%.

The capital controls have led to a form of exchange rate stability, with the annualized volatility of the USD/ISK exchange rate over the past year at over 11%. By contrast, the USD/SEK volatility has been over 18% and the EUR/USD volatility almost 20%.

Liberalization of Capital Controls

In the past few months, Iceland's efforts have been targeted to liberalize the capital controls put in place three years ago. The latest review and approval from the IMF have given Iceland the green light to introduce a program designed to absorb the exchange rate shock of foreign investors trying to sell their ISK holdings. This strategy for liberalization of capital controls comes in two phases. The first phase is to introduce a series of foreign currency auctions to investors of offshore ISK holdings. The CBI will then offer these offshore ISK to other investors who are willing to purchase long-term government bonds, which would tie them to the program for at least 5 years. The holders of ISK who do not use CBI's program to repatriate the currency will most likely face an exit fee/tax.

The program is therefore designed to ensure that the offshore rate (currently at 203.84 to the USD) and onshore rate (at 121.92 to the USD) of ISK converge. So by making investors hold on to long-term ISK assets, the closer they will get to being able to exchange their holdings using the onshore exchange rate.

Looking Ahead

Perhaps one of the most encouraging factors going forward is the possibility of Iceland joining the European Union and benefiting from the broad institutional support that it offers. This idea is gaining wider support as those who would make this decision are encouraged by the return of economic stability as evidenced by a strengthening ISK. Reflecting on the disastrous consequences that Iceland's financial crisis has had on both their economy and their trade relations, membership in the EU is considered a plausible step to help avert a repeat of future economic catastrophe.

On September 20, 2011, the IMF made some positive economic predictions for the country. In response to Iceland's improving economy, the IMF foresees their economy growing faster than the euro-area average this year and next. They have forecast economic growth at 2.5% this year and next, versus 1.6% in the euro area this year and 1.1% in 2012. The cost of ensuring against an Icelandic default, using credit default swaps, is lower than the average for the euro area.

All told, it appears that Iceland has made successful and concerted efforts to dig themselves out of economic crisis and is taking serious steps to avert any return to the past. In recognition of this economic turnaround, the IMF has weighed-in by making positive growth predictions for Iceland going forward.

Just as we saw in the case of Malaysia during the Asian crisis, there may be a role played by selective capital controls that can help crisis countries avoid even deeper turmoil. Indeed, this can be seen in the IMF's subtle shift towards now accepting such controls.

-Atdhe Matoshi

Central Bank Watch: Majors

Country	Policy Rates	Exit Strategy Status
U.S.	Policy Rate: 0.25% Cut from 1%, December 2008 Policy stance: neutral Deviation from inflation target: in range	Our baseline scenario suggests that the US economy is likely to grow above or near trend next quarter and as a result we suspect the Fed is unlikely to embark on Q3 in H1 2012. However, we do believe the next step is for the Fed to tweak its communication style to provide more transparency in regards to Fed policy.
Japan	Policy Rate: 0.10% Cut 20bp, December 2008 Policy stance: easing Deviation from inflation target: in range	The tug of war between deflation and yen strength is likely to keep the BOJ biased towards loose monetary policy in order to boost financial conditions. Recall that the BOJ Governor recently said that the Bank had taken bold steps in response to downside risks. The asset buying program was boosted by JPY5 trillion to JPY20 trillion in October, but left at JPY20 trillion in November. Looking ahead, we expect another expansion of the asset purchase program, with possibility of a policy rate cut.
Euro Zone	Policy Rate: 1.00% Cut 50bp over the past two meetings Policy stance: easing Deviation from inflation target: +100bp	Over the past two meetings the ECB has unwound Richet's previous two rate hikes, together with providing greater support for banks by recently announcing two three-year repo operations, reduced collateral requirements and reserve requirements. However, the ECB continues to dent hopes that the ECB will take much more decisive action to address the sovereign debt crisis. Looking ahead, the strong message from the ECB downplays hopes that it is likely to engage in QE but we still expect the bank to cut its policy rate by another 25bp in Q1 2012.
U.K.	Policy Rate: 0.50% Cut 25bp, March 2009 Policy stance: easing Deviation from inflation target: +250bp	The BOE recently announced an increase in the size of the asset purchase facility (QE2) by £75bln, bringing the total to £275 billion of unsterilized gilt purchases. The injection is designed to support the economic slowdown amid government austerity and private sector de-leveraging through borrowing costs, which are meant to spur investments. With the economy likely to moderate more from here we suspect that the BOE is likely to increase the size of its asset purchases in Q1 2012.
Switzerland	Policy Rate : 0.00% Cut 25bp, March 2009 Policy stance: easing Deviation from inflation target: -50bp	The SNB has set a currency target of 1.20 against the EUR in an attempt to stem the rise of the CHF. The CHF's rise has been prompted by safe haven flows as the euro zone debt crisis continues. Looking ahead, we expect the SNB to pursue measures to prompt a negative yield on deposits, rather than an increase in the peg.
Canada	Policy Rate: 1.00% Hiked 25bp September 2010 Policy stance: neutral Deviation from inflation target: in range	The recent tone of the BOC has been noticeably more dovish yet our core view is that the BOC remains on the sidelines. While policymakers have recently commented on the spillover effects from financial market stress, we suspect a resilient US economy is likely to keep the BOC in wait and see mode in Q1 2012.
Australia	Policy Rate: 4.25% Cut 50bp over past two meetings Policy stance: easing Deviation from inflation target: +50bp	The combination of deteriorating economic fundamentals and external headwinds due to the moderation of the global economy has led to a shift in the RBA. Policymakers have delivered two 25bp hikes ahead of 2012 and looking ahead we expect them to cut by another 25bp in Q1 2012.
New Zealand	Policy Rate: 2.50% Cut 50bp, March 2011 Policy stance: neutral Deviation from inflation target: +160bp	The RBNZ is likely to be one of the more neutral central banks over the coming months due in part to the rebuilding efforts following the Christchurch earthquake. Downside risk from international financial market stress, moderating inflation and only modest domestic economic growth are likely to keep the RBNZ on hold in Q1 2012.
Norway	Policy Rate: 1.75% Cut 50bp, December 2011 Policy stance: easing Deviation from inflation target: -130bp	The Norges Bank remains concerned about the impact external risks will have on the economy. As a result, it recently surprised markets by easing policy more aggressively than expected, with a 50bp rate cut versus market expectations of 25bp. Further intensification of the euro zone financial stress is likely to result in more easing at next meeting in March.
Sweden	Policy Rate: 2.00% Hiked 25bp, July 2011 Policy stance: neutral (likely to begin easing) Deviation from inflation target: +60bp	The Riksbank has clearly shifted its tone, as evidenced by recent monetary policy meeting minutes. Given Sweden's economic exposure to the euro zone through trade and financial market stress, leading to a weaker growth outlook, we expect the Riksbank to cut by 25bp in Q1 2012.

Central Bank Watch: Emerging Markets

Country	Policy Rate	Country	Policy Rate
Eastern Europe and Africa			
Czech Republic	Official Rate: 0.75% Cut 25bp, May 2010 CPI 2.5% y/y, Target 1-3% Central bank moving away from dovish tone given recent sharp CZK depreciation.	**Hungary**	Official Rate: 6.5% Hiked 50bp, November 2011 CPI 4.3% y/y, Target 2-4% Central bank hiking to defend the HUF despite deteriorating economic outlook.
Poland	Official Rate: 4.5% Hiked 25bp, June 2011 CPI 4.8% y/y, Target 1.5-3.5% NBP tightening cycle has ended; central bank on a wait and see mode.	**Russia**	Refi Rate: 8.25%; Deposit Rate: 3.75% Hiked Refi Rate 25bp, April 2011 Hiked Depo Rate 25bp, October 2011 CPI 6.8% y/y, Target 5-7% Central bank will likely enter easing mode by 2012 in light of weaker economy.
South Africa	Official Rate: 5.5% Cut 50bp, November 2010 CPI 6.1% y/y, Target 3-6% Weak growth and high unemployment will push the SARB into cutting rates in 2012, despite high inflation.	**Turkey**	Official Rate: 5.75% Cut 50bp, August 2011 CPI 9.5% y/y, Target 3.5-7.5% Central bank began tightening liquidity through repo auctions, but still reluctant to hike rates.
Latin America			
Argentina	Repo Rate: 11.5% Actual inflation much higher than reported. CPI 9.5% y/y, No Explicit Target Limited central bank independence preventing an orthodox policy response to price pressures.	**Brazil**	Official Rate: 11.0% Cut 50bp, November 2011 CPI 6.6% y/y, Target 2.5-6.5% Central bank will continue cutting rates into 2012 and also will ease credit measures.
Chile	Official Rate: 5.25% Hiked 25bp, June 2011 CPI 3..9% y/y, Target 2-4% Central bank is likely to start easing in Q1 2012 as domestic and external conditions deteriorate	**Mexico**	Official Rate: 4.5% Cut 25bp, July 2009 CPI 3.5% y/y, Target 2-4% Market sees first hike in Q1 2012, but this depends on U.S. economic outlook.
Asia			
China	1-year Lending Rate: 6.56%, Hiked 25bp, July 2011 Reserve Req: 21.0%, Cut 50bp, December 2011 CPI 4.2% y/y, No Explicit Target PBOC easing has begun, with combination of reserve requirement and policy rate cuts seen in 2012.	**Hong Kong**	Base Rate: 0.5% CPI 5.8% y/y, No Explicit Target Inflation finally easing; HKMA likely to continue trying to limit real estate speculation.
India	Repo Rate: 8.5%, Hiked 25bp, October 2011 Reserve Requirement: 6%, Hiked 25bp, April 2010 CPI 9.4% y/y, No Explicit Target RBI has likely reached the end of its tightening cycle despite higher inflation; next move likely a cut.	**Indonesia**	Official Rate: 6.0% Cut 50bp, November 2011 CPI 4.2% y/y, Target 4-6% BI easing cycle began very aggressively but it stayed on hold in December; more easing seen.
Malaysia	Official Rate: 3.0% Hiked 25bp, May 2011 CPI 3.4% y/y, No Explicit Target Central bank hiked reserve requirement in March, last policy rate hike in May. Easing likely in 2012.	**Philippines**	Official Rate: 4.5% Hiked 25bp, May 2011 CPI 4.8% y/y, Target 3-5% Central bank on hold and waiting for chance to cut once inflation eases.
Singapore	Monetary policy managed via undisclosed trade-weighted currency basket (NEER). CPI 5.4% y/y, No Explicit Target Eased policy by flattening slope of S$NEER band in October 2011; more easing likely April 2012.	**South Korea**	Official Rate: 3.25% Hiked 25bp, June 2011 CPI 4.2% y/y, Target 2-4% BOK rate hikes have ended, but cuts unlikely near-term due to still-high inflation.
Taiwan	Official Rate: 1.875% Hiked 12.5bp, June 2011 CPI 1.0% y/y, No Explicit Target CBC hiking is at an end, despite the modest pace 12.5bp per quarter seen so far.	**Thailand**	Official Rate: 3.25% Cut 25bp, November 2011 Core CPI 2.9% y/y, Target 0.5-3% BOT easing has begun as growth outlook being downgraded by floods; more easing in 2012.

Global Currency Strategy Team

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Marc Chandler joined Brown Brothers Harriman in October 2005 as the Global Head of Currency Strategy. Previously he was the chief currency strategist for HSBC Bank USA and Mellon Bank. A prolific writer and speaker, Chandler's essays have been published in the Financial Times, Barron's, Euromoney, Corporate Finance, and Foreign Affairs. Marc holds a Masters in American history (1982) from Northern Illinois University and a Masters in International Political Economy from the University of Pittsburgh (1984). He has taught classes on International Political Economy at New York University since the early 1990s. In 2009, his first book, ***Making Sense of the Dollar***, was published by Bloomberg Press.

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Jon recently joined the BBH Currency Strategy team in New York, providing comparative economic analysis of G-10 currencies. He spent several years as the manager responsible for the corporate-wide currency risk management program at a Fortune 100 company before joining BBH. At BBH, Jon has worked on the FX trading desk, working with clients searching for solutions to the problems inherent in hedging, including timing, and determining the most appropriate instruments to meet their needs. Jon has an MBA from Columbia University.

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Win Thin is the Global Head of Emerging Markets Currency Strategy, and has over twenty years of investment experience. He has a broad international background with a special interest in developing markets. Prior to joining BBH in June of 2007, he founded Mandalay Advisors, an independent research firm that provided sovereign EM analysis to institutional investors. Prior to that, Win covered the major EM countries in Asia and Latin America for Alliance Capital Management and HSBC. Win received his PhD in Economics from Columbia University in 1995, his Masters from Georgetown University in 1985, and his BA from Brandeis University in 1983.

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Masashi Murata joined the BBH Currency Strategy team in Tokyo, providing regional and Emerging Markets coverage. Previously, Masashi held the role of chief economist at GCI Capital and economist at Mitsubishi UFJ, and is well known in the Japanese financial media, appearing regularly on CNBC. Masashi has a Masters in International Relations from Columbia University as well as a Masters in Engineering from the Tokyo Institute of Technology. He is also a Chartered Financial Analyst.

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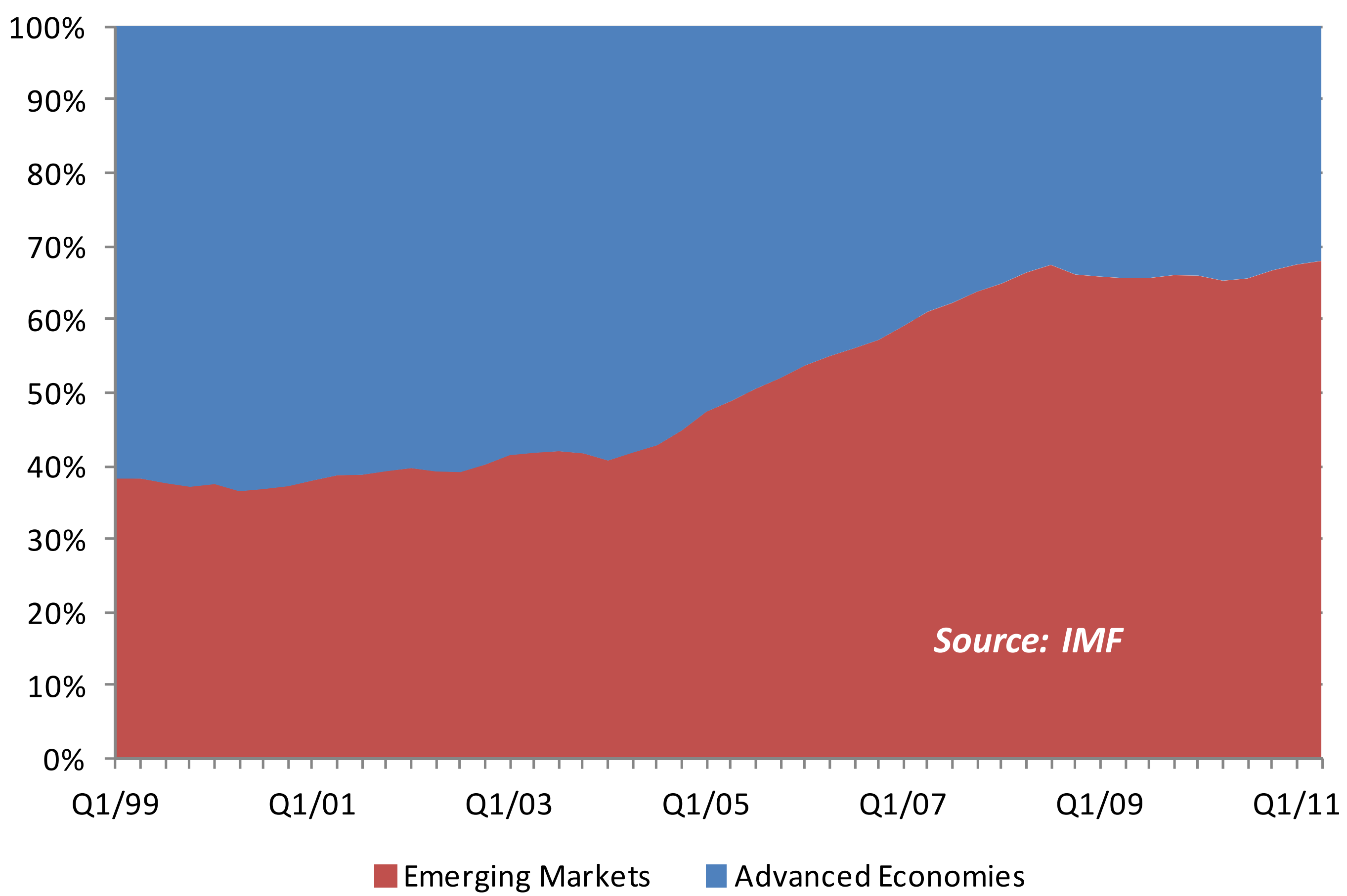
Share of Global Foreign Reserves
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Q1/99
Q1/01
Q1/03
Q1/05
Q1/07
Q1/09
Q1/11
Source: IMF
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