PENRICH
CAPITAL

Economic & Financial Market Themes

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Economic Themes

Global

(1) Government deficits / debt levels are high
- sizeable consolidation programmes are being implemented
- debt servicing costs are not yet high but will be under upwards pressure if interest rates normalise
- financial markets may impose risk premia upon problematic countries

(2) Financial markets are nervous and have negatively influenced real economic activity
- monetary authorities have eased policy to try to ensure liquidity concerns are reduced
- business and consumer confidence have fallen sharply
- banks' ability and willingness to lend has been hampered
- corrective fiscal policy action should allow financial market concerns to ease through 2012

(3) Households wish to improve their balance sheets
- savings rates low in some Anglo-Saxon countries and in Japan and may rise once interest rates rise
- households are less comfortable now with their outstanding debt levels than in recent years due to
    a) potential liquidity problems with their assets
    b) heightened uncertainty about incomes

(4) Corporate profitability is high and balance sheets are strong
- firms are well placed to increase their output if they desire ,helped by low financing costs
- a large pool of labour exists for firms to tap into when they wish to expand
- economic growth and low labour costs have allowed firms to reduced financial liabilities

(5) Monetary policy is very accommodative and central banks will look to normalise policy
- countering financial market contagion is delaying the "normalisation" process
- some countries utilised "non-conventional" policy during the recession which will need to be reversed
- large movements in interest rates will be required before "normal" levels are reached again

(6) The downward pressure on wages from globalisation may be starting to dissipate
- opening borders has enabled lower cost workers to enter the global labour force.
- competitive pressures are strong on "high wage" countries.
- initial signs of generalised wage pressures have started to appear in the "low wage" countries.
- as unemployment declines again in "high wage" countries, some pressures will probably re-emerge

(7) High unemployment is pervasive
- high unemployment is constraining real wage increases
- household income growth will initially come more from employment growth than real wage increases

Regional

US
- Households may wish to save more in the future if interest rates rise.
- Residential investment spending is very low and is beginning to provide a boost to growth.
- Firms are well placed to increase investment spending and hire staff.
- Firms are increasing inventories at a normal pace so there is no need for an inventory cycle.
- Government is not taking significant fiscal action in 2012 but will need to consolidate in 2013-2014.
- Monetary conditions are very expansionary and will become less supportive through 2012-2014.
- Employment growth is initial source of rising h/hold income. Real wage growth resumes in 2013.
- Inflation will be constrained by competitive pressures and available spare resources, particularly labour.
- A rebound of the dollar may be a downward influence on prices in 2013-2014.
- External deficit narrows due to gains from very low USD but 2012-14 appreciation halts the narrowing.
- Fiscal deficit remains very large in 2012 but narrows in 2013-14 due to growth and fiscal consolidation.

Euro area
- Household savings are lower than the historical norm so consumption could rise less than incomes.
- Residential investment has fallen sharply and its downward influence on growth may have ended.
- Investment is low due to weak nonresidential construction. Firms have scope to expand capacity further.
- Firms are increasing inventories at a normal pace so there is no need for an inventory cycle.
- Govts are reducing deficits/debt with substantial further effort in 2012 and, to a lesser extent, 2013.
- Monetary conditions are very expansionary but become less so in 2013-14 as banking stress subsides.
- Income shift to the h/hold sector begins in 2013 through solid employment growth and rising real wages.
- The availability of spare resources will constrain inflation as will international competition.
- The euro has not been moving substantially and may not be a major influence upon prices.
- The current account remains close to balance with high oil prices leading to very small deficits.
- Fiscal deficits decline back to being small due to further fiscal consolidation in 2012-2013.

Japan
- Household savings are low but this may be due to demographics. Consumption rises with incomes.
- Residential investment increases in 2012 onwards from current depressed levels.
- Firms have cut expenditure sharply and will increase investment through 2012-2014.
- Inventories were run down in 2011. A positive inventory boost is likely in 2012.
- Government provides a boost during the earthquake recovery but begins to consolidate in 2013.
- Monetary conditions remain accommodative into 2013 before beginning to normalise in 2013-14.
- Real wages stabilise in 2012 and begin to grow, thus ending the decline in unit labour costs .
- Inflation re-emerged in 2011 but remains subdued by ongoing competitive pressures.
- The yen has not been a major determining factor of inflation and will remain relatively unimportant.
- External surplus will remain due to competitiveness gains from past falls in unit labour costs.
- Fiscal deficit peaked in 2011 and is reduced in coming years by growth and fiscal consolidation.

UK
- Household sector may increase their savings when interest rates rise.
- Residential investment will rise from low levels.
- Firms have been investing less than normal and a rise is likely.
- Firms are increasing inventories at a normal pace so there is no need for an inventory cycle.
- Government is undertaking a substantial consolidation programme through 2012-2014.
- Monetary conditions are very supportive but will become less accomodative in 2013 and beyond.
- Employment growth is initial source of household real income growth with real wages rising from 2013.
- Inflation will be constrained by spare labour resources and international competitive forces.

- A rising currency could help contain inflation in 2012-2014.
- External deficit is reduced by low GBP in 2012 but this effect subsides as currency appreciates.
- Fiscal deficit is large but declines each year due to economic growth and consolidation programme.

Switzerland
- Household sector is happy with balance sheet and savings rate. There is scope for some fall in savings.
- Construction expenditure is lower than historic norms and could be a source of growth in 2012-2014.
- Firms are investing strongly and may maintain this as long as interest rates stay extremely low.
- Firms have run down their inventories rapidly, but this is part of a longer-term trend that could continue.
- Fiscal policy has not been playing a substantial role to date and no dominant role is planned.
- Monetary conditions should shift to higher rates and lower CHF as risk aversion dissipates.
- Unemployment is relatively low so real wages are likely to rise together with employment.
- Inflation is initially contained by the high level of the Swiss franc and ongoing competitive pressures.
- A depreciating franc and limited spare resources could lead to a rise in inflation in later years.
- The external surplus would reduce sharply if CHF remains high but CHF is likely to fall
- The fiscal position is basically in balance and remains so throughout the coming years.

Sweden
- Household sector saving is in line with historical norms. Consumption rises in line with incomes
- Residential investment is near historic norms so should not be a major contributor to economic growth.
- Firms are investing at high levels. Growth in investment will slow.
- Inventories have been built up quickly in 2011 and this pace will slow in 2012.
- Fiscal policy does not look likely to be a significant influence in the coming years.
- Monetary conditions are very supportive but will become less so through 2012-2013.
- Low unemployment will contribute to slower employment growth and higher real wage increases.
- Inflation will be constrained by international competition but boosted by domestic capacity constraints.
- The currency has helped constrain inflation in recent years but this influence is waning.
- External surplus remains large but declines as rising currency reduces competitiveness
- Fiscal position is basically in balance and remains so throughout the coming years.

Norway
- Household savings are in line with historic norms so consumption may rise in line with incomes.
- Residential investment is above historic norms and may be a negative contributor to economic growth.
- Firms are investing at normal rates and continue to do so in the coming years
- Inventories were increased at a normal pace in late 2011 so no inventory cycle is forecast
- Government was expansionary in 2010 and 2011. Further plans will be influenced by oil prices.
- Monetary conditions are very expansionary but will become less supportive in 2012-2013
- Labour market tightness leads to slower employment growth and faster real wage increases.
- Inflation will be constrained by international competition but boosted by domestic capacity constraints.
- The currency has been constraining inflation in 2011 but this influence will end in 2012-2013
- External surplus is extremely large depending upon changes in oil prices
- Fiscal surplus will be extremely large depending upon oil prices

Canada
- The household sector may wish to raise their savings when interest rates rise.
- Real residential investment is near historic norms so is not major influence on growth in 2012-14.
- Firms are investing at high levels, supported by high terms of trade. High investment may continue.
- Firms are increasing inventories at a normal pace so there is no need for an inventory cycle.
- The Government is likely to run contractionary policy in 2012-2013, but should finish in 2014.
- Monetary conditions remain extremely accomodative. The support is likely to be reduced in 2012-2014.
- Both rising employment and rising real wages should contribute to growth in household incomes.

- Inflation will be contained by international competition and relatively low capacity utilisation.
- The currency will probably fall against the USD but no major currency impact upon prices is likely.
- External balance could return to a small surplus depending upon energy prices and US imports.
- Fiscal deficit may be reduced by economic growth and fiscal consolidation

Australia
- Household sector is happy with its recently increased savings rate so consumption rises with incomes.
- Residential investment spending is relatively low and construction could accelerate somewhat.
- Investment growth slows after years of very fast increases supported by rising commodity prices
- Firms are increasing inventories at a normal pace so there is no need for an inventory cycle.
- Fiscal consolidation should continue in 2012-13, but its impact on growth is likely to be minor.
- Monetary conditions will probably move towards higher interest rates and a lower currency
- Real wage increases supplement employment growth as sources of household income.
- Inflation should be contained by ongoing international competitive pressures
- The dollar will probably not have a major impact on inflation, but sharp falls could be inflationary.
- The external deficit narrows as investment decelerates and the terms of trade remain very high.
- The fiscal position returns to a small deficit helped by some policy tightening.

NZ
- Household savings are low and need to rise. Consumption rises by less than incomes.
- Residential investment is low but will become high as Canterbury is rebuilt.
- Firms will need to rebuild their capital stock so a period of high investment may be required
- Firms have lost inventories and these will need to be increased.
- The government has begun consolidating after its major expansionary role in 2010-2011.
- Monetary policy is extremely supportive and will become less so through 2012-2013
- A tightening labour market will boost real wage increases with skill shortages apparent in construction.
- Inflation will be constrained by international competitive pressures.
- The dollar may not be a major influence upon prices during the coming years.
- Fiscal deficit is eliminated through economic growth and fiscal consolidation

Financial Market Themes

Currencies

- monetary policy stances are playing an important role in currencies and should continue to do so
- very high terms of trade are providing support to the commodity currencies
- safe-haven flows appear to be boosting the Swiss franc and intervention will persist if needed

USD
- The USD is very low and could be subject to upwards pressures from a narrowing current account.
- US interest rate differentials remain low in 2012 before normalising and providing support for the USD.

EUR
- The euro is close to normal levels with no obvious forces acting to force a rise or fall.
- The current negative risk premium will fade through 2012 if fiscal issues are perceived to be resolved.

YEN
- The yen is near historic norms and is not under pressure in either direction from the external position.
- Japanese interest differentials are less negative than normal but will become more negative in 2012-14.

STG
- The pound is very low and subject to upwards pressure from a narrowing current account deficit.
- UK interest differentials are lower than normal and this gap should begin to narrow in 2013.

CHF
- CHF is very high and could be subjected to downward pressures from a deteriorating external position.
- Swiss interest differentials are less negative than normal but will become more negative in 2012-14.
- FX intervention will capping the CHF until risk aversion subsides and the need for intervention ends.

SEK
- SEK has risen to normal levels but may still be subject to upward pressures from the external surplus.
- Swedish interest rate differentials will probably not play any major role influencing the currency.

NOK
- The krone is high but there are no obvious reasons why it should depreciate
- Norwegian interest rate differentials will probably not play any major role influencing the currency in the coming years.

CAD
- CAD is high vs USD but not generally. Upwards pressure may exist if an external surplus emerges.
- Canadian interest differentials are near historic norms. They are unlikely to have an influence on CAD.

AUD
- The AUD is very high due to commodity prices. We do not forecast any change in commodity prices.
- Australian interest differentials are high and will probably decline placing downward pressure on AUD.

NZD
- The NZD is high and could experience downwards pressure from a widening current account deficit.
- Earthquake insurance payments have reduced the external deficit but will end in 2012/2013.
- NZ interest differentials are narrow and likely to widen in 2012-2014 providing support to the NZD.

Money Markets

- monetary policy remains extremely accommodative in most countries
- tightening paths have been interrupted by financial market turbulences

US
- Real official rates are negative and policy is extremely “accommodative”
- The Federal Reserve is trying to lower long-term bond yields.
- Fed funds may stay near 0% until early 2013, meaning rates rise later than in the other major countries

Euro Area
- Real short-term rates are -1 1/2 %, which is very “accommodative”
- The ECB reversed its 2011 hikes. Concerns should subside and rates resume their rise in 2012.

Japan
- Real official interest rates are around 0% as are nominal rates
- Bank of Japan will wait until inflation returns on a sustained basis before beginning to normalise policy
- Difficult to gauge “neutral” policy because rates have been “abnormal” for more than a decade

UK
- Real official interest rates are negative and the BoE is buying bonds. Policy is very accommodative.
- BoE is under pressure with inflation exceeding its target but remains concerned about downside risks
- Official interest rates may start to be raised in late 2012 and continue increasing through 2013-14.

Switzerland
- Real official interest rates are around 0% which has made the Swiss National Bank uncomfortable
- CHF rise was excessive in SNB's eyes prompting lower interest rates and fx intervention.
- Interest rate rises are likely to take place as the CHF moves back towards normal levels in 2012-13.

Sweden
- Riksbank has reduced interest rates recently and real rates are near 0%.
-The rise in SEK during 2010 and 2011 contributed to tightening of monetary conditions
- Policy will resume its “normalisation” through 2012-2013.

Norway
- Norges Bank has reduced interest rates to offset the rising NOK. Real interest rates are near 0%
- Resource constraints have emerged and interest rates are likely to resume rising through 2012-2013

Canada
- The Bank of Canada tightened in 2010 but real rates are still -2%. Policy is extremely “accommodative”
- The strength of the Canadian dollar vs the USD has influenced the BoC's decisions on interest rates.
- BoC should resume policy rate “normalisation” and continue hiking gradually into 2014

Australia
- Real official interest rates of 1 1/2 % are fairly low but the high AUD is acting as additional tightening
- Resource constraints have eased reudcing the pressure on policymakers to tighten.
- If commodity prices remain high, tightening will resume but the cycle may finish earlier than elsewhere.

NZ
- Real official short-term interest rates are -2%, making policy extremely “accommodative”
- RBNZ cut rates in response to the earthquakes, but activity has been better than expected.
- Policy will start moving back to “normal” in 2012, with further hikes through 2013

Bonds

- bond yields have fluctuated during the past six months and are very low by historical standards
- central banks are purchasing government bonds with a view to lowering yields
- yield curves are not steep as would be expected given extremely low policy rates

US

- Real bond yields are extremely low at -1%, which is unprecedented in recent history
- Despite extremely low policy rates, the curve is not steep. It will steepen prior to policy tightening.
- Bond yields are likely to rise, and probably by more than in other countries
- Until a credible fiscal consolidation programme is enacted, there is a chance of a risk premium

Euro Area

- German real bond yields of 1/2 % are extremely low, bond yields in the rest of the euro area are higher.
- The German yield curve is flat but the euro area curve is normally shaped. Germany should steepen.
-Yields will rise by less in the rest of the euro area than in Germany and in the rest of the world.
- If fiscal positions improve the risk premium attached to euro-area bonds will diminish

Japan

- Bond yields of 1% imply real yields of ½-1%, which is fairly low by historical standards
- The Japanese curve is relatively normally shaped. It is likely to steepen ahead of BoJ policy rate rises.
- Japanese yields will probably not rise as quickly as global bond yields
- BoJ is buying large quantities of government bonds as part of its monetary policy settings

UK

- Real bond yields are negative which is extremely rare at times of normal inflation
- The yield curve is flat relative to the level of short rates. Bond yields will rise before rate hikes begin.
- Bond yields will rise relative to global yields, particularly if inflation does not fall as sharply as hoped
- There is a potential for concern to emerge that fiscal consolidation plans are insufficient

Switzerland

- Real bond yields are only slightly lower than normal, at 1 1/2 %, given negative inflation.
- The yield curve is relatively flat. The curve should steepen prior to rate hikes beginning.
- Bond yields could rise less than global yields helped by the fiscal situation and inflation outlook

Sweden

- Real bond yields are very low at near 0%
- The yield curve is inverted. A normalisation will require bond yields to rise.
- Bond yields are likely to rise in relation to global yields particularly as policy tightens

Norway

- Real bond yields of 1% are low by historical standards
- The yield curve is flat. If short rates rise, bond yields will have to rise by more for the curve to normalise.
- Bond yields will rise with global yields or faster if capacity constraints lead to higher inflation.
- If fiscal positions become a important for global yields, Norway’s strong position could reduce spreads.

Canada

- Canadian real bond yields are around 0%, which is historically extremely low
- The yield curve is relatively flat and is likely to steepen in 2012, even as short term interest rates rise.
- Bond yields are likely to rise a little faster than global yields as policy tightens, causing spreads to widen

Australia
- Current real bond yields of around 1% are fairly low by historical standards
- The yield curve is inverted so rising short-term interest rates will put upwards pressure on bond yields.
- Bond spreads are higher than usual and Australian yields are likely to rise by less than global yields.

NZ
- Real bond yields are well below historical norms
- The yield curve is normally shaped and bond yields may not rise as much as short-term interest rates.
- NZ bond spreads are high and NZ yields are likely to rise by less than global yields.

Equities

- reverting to the strong gains of 2009-2011, equities have risen solidly in the last six months recovering the fall of the previous six months
- corporate sectors are generally well placed to expand with profitability high
- equities are attractive relative to bonds in light of the very low level of bond yields

US
- corporate sector is well placed with profitability extremely high
- labour productivity has exceeded wage growth boosting profits
- the poor fiscal position could lead to increased tax burdens

Euro Area
- corporate sector is well placed with profit share very high
- higher wage claims might put some pressure on profit share
- concerns about sovereign solvency has led to substantial falls in some national equity markets

Japan
- equities have continued to under-perform global markets
- labour costs have continued to fall providing a boost to the corporate sector margins

UK
- the low exchange rate is assisting the competitiveness of firms
- corporate profitability is very high
- the poor fiscal position could lead to increased tax burdens

Switzerland
- the high exchange rate is impacting negatively upon competitiveness
- banking sector pressures are placing some strains

Sweden
- corporate profitability is very high supported by declining labour costs

Norway
- high oil prices have supported profitability

Canada
- the low USD is harming competitiveness of tradeable goods producers

Australia
- high commodity prices have provided a major boost to corporate incomes
- corporate sector is well placed, particularly in the resource sector
- investment is extremely high which is placing demands on firms’ cashflows

NZ
- the high terms of trade are assisting incomes, particularly in the rural sector