Investing Opportunities in the Euro Area

October 2011

- *Short-term interest rates will rise substantially in the coming years*
- *Bond yield divergences will narrow with Bund yields probably rising*
- *The euro is not under any obvious major pressure to rise or fall.*

Economic growth resumed in 2009 and economic activity has expanded at a moderate pace during the past two years. The public sector will be a negative influence in the coming couple of years and economic growth will probably be unspectacular at best. In the immediate future, a renewed economic downturn is possible but the solid financial position of the corporate sector suggests that a meaningful recession is unlikely. Inflation has increased this year as commodity prices have risen but overall consumer inflation should remain contained through the coming years (see table of key forecasts).

The European Central Bank kept monetary policy settings at “emergency” levels longer in 2010 and 2011 than it probably wanted to, largely because of financial market troubles. The process of moving back to “neutral” began in the first half of this year. Current financial market turbulence combined with poor recent economic data could lead the ECB to consider pausing or even temporarily reversing direction. However, if the economic environment unfolds in line with our expectations and any downturn is short-lived, then the general thrust of policy in 2012 and beyond will be removing stimulus. With futures prices implying that official rates will be below current levels two years from now (see top chart), the risks are heavily skewed towards higher interest rates than those currently incorporated in financial markets.

Government bond yields across the euro area have diverged substantially in 2011 as concerns have mounted about possible government defaults. Bund yields have declined with global yields and are at multi-decade lows below 2% (see middle chart). Meanwhile, yields in many other euro area countries have risen and the average euro-area bond yield is close to its highest level in almost ten years. Most countries confronted with rising interest rates have announced fiscal consolidation plans and if these are implemented with a reasonable degree of success, bond yields in these countries are likely to decline relative to both Bund yields and global yields. Conversely, Bund yields seem highly likely to rise, particularly if global yields rise.

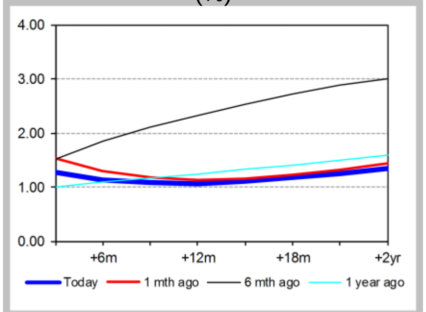
The euro has been stable during the past year at levels close to historical norms (see bottom chart). Despite continued financial market problems, the fact that the euro area’s external position is close to balance and that interest rates are similar to those of many other countries means that there is little obvious pressure on the euro to either rise or fall.

European equity markets have fallen sharply in recent months in line with global equity markets. This has contributed to a negative return exceeding -15% during the past twelve months. It is possible that current market turbulence could continue to take equity prices down but the combination of extremely favourable financial conditions and ongoing economic expansion should be supportive for the corporate sector in the coming year.

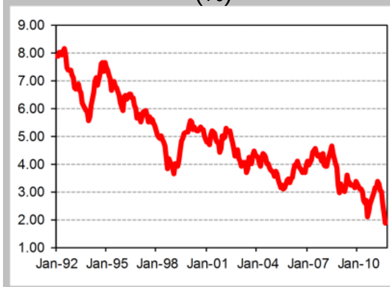
Key Forecasts

	Dec-11	Dec-12	Dec-13
GDP	2	2	2
CPI	3	2	2
Repo	1.50	4.00	4.50
Bund	3.00	4.75	5.00
EUR/USD	1.40	1.25	1.18
EUR/STG	0.85	0.75	0.70
EUR/YEN	112	125	129

90 Day Futures
(%)



10 Year Bund Yields
(%)



Real Exchange Rate
(ECB index)