The Year of Living Dangerously Begins
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FOREX.com 1Q 2012 Markets Outlook

Risk sentiment remains behind the wheel
As we enter 2012, we expect investor risk sentiment to remain the principal driver of key markets' direction. We will continue to focus on the differentiated reaction of so-called risk assets (e.g. stocks, commodities, minor/EM FX, and precious metals) versus safe havens (e.g. US Treasuries, German Bunds, the USD, CHF and JPY) against the backdrop of unfolding data and events. When interpreting incoming economic data, financial events and policy responses, we will continue to ask the simple question: “Is this good or bad for risk sentiment?” to determine the likely market reaction across asset classes.

In terms of key risk themes to monitor, we think the underlying global growth story is paramount, despite all the attention the EU and US debt problems have received over the past year. After all, with sufficient growth, most debt burdens are manageable in the long run. It’s when growth stagnates or turns negative that high debt levels become unsustainable and trigger investor anxiety, in our view. To be sure, though, we think developments in the EU and US debt dramas will remain front and center in the headlines as short-term market drivers.

Following the year-end rout in most major risk markets, we think risk appetite is poised to enter 2012 on highly unstable footing. Looking at the major developed economies, emerging growth data suggests Europe is likely already in recession, which we think will only exacerbate investor fears of excessive Eurozone peripheral debt levels. In the US, the 4Q pick-up in growth may prove unsustainable, and we will be alert for any backsliding in 1Q data given still historically high unemployment and a severely depressed housing market, among other factors. China is responding to a sharper than expected slowdown following sustained weak demand globally, while also trying to relieve pressure in a potential domestic real estate bubble. The recovery in the UK remains extremely fragile and may weaken further as a potential Eurozone recession takes hold. Japan, still recovering from the tsunami devastation, may have already seen the zenith of its reconstruction-led recovery. Globally, 2012 growth forecasts from the UN suggest a global recession is a non-trivial risk.

Against this bleak growth backdrop, we don’t foresee much potential for any sustained risk-positive trends to develop, and mostly expect to see a predominance of risk-off trading conditions over the next quarter. We are not anticipating an outright collapse of risk markets, but we do expect heightened downside volatility for risk assets, meaning price declines may be sharper and steeper than rebounds, potentially leading to overall trends lower in risk assets.

At the same time, possible policy responses by central banks and governments are likely to trigger periods of stabilization or consolidation. For instance, the US Congress seems most likely to pass a payroll tax cut extension, despite all the public bickering, and at least maintain the status quo for US consumers. Similarly, we think China is likely to lower its required reserve ratio further and perhaps undertake additional easing measures. We think the biggest risk-positive bang may come from additional quantitative easing (or indications of such) from key central banks (see our discussion on QE later), but this may require conditions to worsen further before the central banks step in.

From a strategy standpoint, then, we are biased to using strength/rebounds in risk markets as an opportunity to establish short-risk positions. But we also think exposures should be...
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“...we are biased to using strength/rebounds in risk markets as an opportunity to establish short-risk positions”

**Figure 1**

US, EU, Japan, UK GDP QoQ

![GDP QoQ Graph](source: Bloomberg, FOREX.com)

“The outlook for the global economy depends largely on policy decisions related to the European debt crisis and U.S. fiscal policy. ”

**Figure 2**

Confidence Sinking in Major Economies

![Confidence Graph](source: Bloomberg, FOREX.com)

Reduced on any subsequent declines to actively manage risk, leaving room to re-express the same strategy in the event of rebounds. Despite the late-year sell-off in risk markets, we think investors are mostly positioned bearishly on risk, potentially limiting near-term declines. We would also not be surprised to see some rebounds in risk assets at the start of the year, as bargain hunters emerge and doomsday shorts get squeezed.

**Global growth to remain fragile and uneven**

Global growth in Q1 2012 is likely to remain fragile and uneven. Activity in the developed economies has slowed as a result of persistent high unemployment, unresolved structural issues, tightening financial conditions and declining confidence (see Figure 1). Inflation is under pressure as a result of slowing growth and uncertainty is extraordinarily high as the Eurozone tackles a debt crisis, U.S. policymakers struggle to come up with a deficit reduction plan and China strives to avoid a hard landing.

In response to deteriorating growth outlooks and downwards pressure on inflation due to slowing growth, central banks have taken a more accommodative stance to already easy monetary policy. The Fed has kept rates near zero and continues to lengthen the maturity of its bond holdings. Members have discussed additional easing and increasing transparency, keeping QE3 on the table (see our discussion of QE in Prospects for New Rounds of Quantitative Easing). China, the world’s second largest economy, has shifted from a cycle of tightening monetary policy towards one of easing as underscored by its recent cut to the reserve requirement ratio. The ECB under new president Mario Draghi, has cut rates by 25bps at each of the last two policy meetings citing that inflationary pressures have dampened due to sluggish growth. In the U.K., policymakers have increased asset purchases and may continue to expand the size of QE to avert a recession. Unfortunately, monetary policy can only go so far to boost growth and must be balanced with credible, supportive fiscal policy.

The outlook for the global economy depends largely on policy decisions related to the European debt crisis and U.S. fiscal policy. In the U.S., policy makers continue to struggle with long term deficit reduction measures and face decisions on extending unemployment benefits and the expiration of the payroll tax cut. The Congressional Budget Office indicates that unemployment insurance extensions through 2012 would raise GDP by roughly 0.5%. Not only does this have a direct impact on consumption, but credible fiscal policy will also prevent drastic loss of confidence which puts pressure on financial conditions and growth. On the other hand, much tighter fiscal policy can dampen growth as evidenced by severe austerity measures taken in Europe. In our view, we assume that the payroll tax cut and unemployment benefits will be extended through 2012. The risk is that these measures will not be passed which could put pressure on growth and potentially tip the U.S. economy into recession.

We think it’s likely that the euro zone is in the midst of contraction as indicated by many officials as well as suggested by leading indicators (see Figure 2). The EU stated Europe could face a “deep and prolonged recession”, ECB’s Draghi has noted that Europe is heading towards a “mild recession”, BoC Governor Carney has stated that the bank sees Europe now in a recession to name just a few. Moreover, at its most recent meeting, the ECB revised lower its 2012 GDP growth forecast to -0.4% to 1.0% from +0.4% to 2.2%. The harsh austerity measures that are being implemented in the periphery is an impediment to growth and leading indicators in Germany suggest the economy there may tip into recession.

Japan has rebounded from a recent recession after the devastating earthquake and tsunami that struck the country earlier this year. Growth jumped to 1.4% in Q3 from the prior two quarters of negative GDP growth. While it is encouraging that the island nation is getting back on its feet, the jump in economic activity due to reconstruction is seen as temporary
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and the economy may face several external headwinds. The slowing of economies around the world will weigh on the export-driven economy of Japan as external demand remains low. As reconstruction efforts fade, growth in Japan is also likely to moderate.

China’s economy has slowed over the past several quarters with growth remaining relatively strong at 9.1% y/y GDP growth in Q3 (prior 9.5%). Inflation has eased to 4.2% at last reading from the July peak of 6.5%. Manufacturing PMI’s have fallen below 50 indicating a contraction and exports saw the weakest growth in November since 2009. The PBoC has responded by recently cutting its reserve requirement ratio and the bank is likely to continue to fine tune policy in the coming quarter to avoid a hard landing. In our view, we believe that growth in China will continue to slow in the coming quarter but maintain the view of a soft landing.

U.S. GDP growth is expected to hold up relatively well compared to the rest of the developed economies but is likely to remain fairly subdued in Q1. Bright spots can be seen as leading indicators have ticked higher – ISM manufacturing remains above 50 (rising to 52.7 in Nov. from 50.8) indicating continued expansion in the manufacturing sector, consumer confidence rose to 56.0 from 40.9 and building permits rose to the highest level since March 2010. Persistent high unemployment will continue to weigh on growth and fiscal tightening remains a risk.

Overall, we believe that the global economy remains vulnerable while uncertainty is elevated. Unless policymakers can act decisively in a constructive way, the outlook continues to be tilted to the downside. We think this will bias risk sentiment negatively and likely lead to overall weakness in risk assets. As such, we favor safe havens such as the USD and JPY and prefer to sell risk on rallies.

No end in sight for the EU debt crisis
The Eurozone debt crisis is about to enter its third year and the crisis seems to be snowballing. Back in early 2010 Greece was the only country in the firing line; today Italy and Spain have been affected by the debt contagion that still threatens to topple the currency bloc.

When we look back at 2011 the steps taken by the EU’s high command to stem this crisis have been woefully inadequate. Firstly there was the July summit where Merkel touted the idea of private sector haircuts on Greek debt. Next there was the notorious October summit that “agreed” to leverage the EFSF rescue fund. But within days Italian bond yields had surged above the critical 7% level and cue another summit in early December.

The latest marathon session of EU leaders agreed on closer fiscal union, but no increase in the immediate funds needed to stem this crisis. As we end the year we have 26 out of 27 EU members (the UK vetoed closer fiscal union after it failed to get a waiver for a planned financial transaction tax) who have agreed to implement strict budgetary controls and automatic penalties if a member state’s annual budget deficit exceeds the 3% ceiling.

As we enter 2012 the EU has to find a way to implement these new budget rules. The UK’s veto means that there can be no formal Treaty changes (for that you need the consent of all EU members) and instead the other members need to come to an official agreement. Although there are precedents whereby some EU members can implement new rules on their own, closer fiscal unity hasn’t got off to the best start.

Added to this, these new fiscal rules may not be that easy to implement. They have always been in place and were actually flaunted by Germany and France over the last decade. EU leaders hope that penalties will lead to stricter adherence to the rules, but often the Eurozone
rules, especially fiscal ones, have been made to be broken.

So where does this leave the debt crisis as we start 2012? Europe’s political leaders are focusing on long-term solutions to stop another debt crisis from happening again. However, that doesn’t do anything to help deal with the current crisis. Some commentators are calling the latest EU “breakthrough” fiscal union-lite. A true fiscal union would include a pooling of funds or essentially Eurobonds.

The German Chancellor continues to resist calls for Eurobonds, probably because although it would reduce borrowing costs for the weaker peripheral states, it would increase costs for Germany. Merkel has continued to say that fiscal union must come before Eurobonds, but the truth is that Merkel knows that Eurobonds are political dynamite and she has her own re-election coming up in 2013, which could be a major hurdle to Eurobonds ever seeing the light of day.

But to stabilize debt levels and debt funding costs in the long term we see three options:
1. growth 2. Eurobonds or 3. default. Since the EU has ruled out defaults apart from those negotiated for Greece and growth is likely to be hobbled by years of austerity. The only other option is the pooling of funds, which looks increasingly unlikely to be achieved in the medium-term.

The more pressing problem for the currency bloc is the immediate funding needs of Europe’s largest states. Italy and Spain are set to auction EUR 145 billion of debt in the first quarter of 2012 (see Figure 3). With Italian bond yields on the rise once more the chance of a failed debt auction have increased.

It seems that no matter what action the EU authorities take it is never enough to reduce upward pressure on peripheral bond yields. This is primarily because the ECB is unwilling to take on the role of lender of last resort. This was confirmed when new ECB President Draghi ruled it out at the ECB’s December meeting when he said that it was not in line with the “spirit” of the ECB Treaty.

However, without a lender of last resort Eurozone debt can never be “risk free”. Unlike the US or UK who can print their own money to repay sovereign investors, members of the Eurozone can’t do this and the ECB will not do this for them. Thus, investors continue to charge a higher risk premium to hold Spanish and Italian debt than they do to hold US Treasuries, UK Gilts and even German Bunds – presumably because investors assume the ECB would step in if Germany got into trouble.

However, if we see Italy run into trouble as it tries to re-finance debt in the first three months of next year then the ECB may have no choice but to step in. The outcome of the latest summit did not boost the EFSF rescue fund, and the longer-term rescue fund - the ESM - is only coming on line in mid-2012. Even the proposal for EU central banks to lend to the IMF, thus circumventing the Treaty, could run up against many obstacles. So there isn’t enough ready money either at the IMF or in the current rescue fund to bailout Italy leaving the ECB the only entity with the firepower necessary to do it (see Figure 4). So there is a chance that the ECB will be forced to change its tune regarding sovereign bond purchases at some point in the next quarter (see our discussion of ECB options in the QE section).

The other trigger point that could force a more dramatic solution to this crisis would be a cut in the Eurozone’s sovereign debt rating. Standard & Poor’s said before the December summit that it was putting 15 out of 17 Eurozone members on review for downgrade pending the outcome.

"A true fiscal union would include a pooling of funds or essentially Eurobonds.

"Italy and Spain are set to auction EUR 145 billion of debt in the first quarter of 2012."

Figure 3

![Italy debt issuance (EUR billion)](source: Bloomberg, FOREX.com)

Figure 4

![ECB cumulative bond purchases EU million](source: Bloomberg, FOREX.com)
of the summit. Now that the summit has been and gone with little in the way of a sustainable near-term solution to the crisis we should expect downgrades at some stage in the next quarter. If the S&P cuts ratings then expect Moody’s and Fitch to follow suit.

Since six Eurozone members have a triple A credit rating if these are cut then we would expect the rating of the EFSF, Europe’s rescue fund, to also get cut. This would make it more expensive to fund the bailouts of Greece, Ireland and Portugal and threatens funding for any other states that get into trouble like Italy or Spain.

There is one bright spot as we enter 2012. The ECB has provided ample liquidity to Europe’s banking sector that can now access euro and dollar-based funding at extremely cheap levels. This reduces the chance of a Lehman Brothers-like event from happening in the currency bloc and since banks are some of the largest purchasers of sovereign debt, by ensuring their liquidity needs are taken care of this could ensure demand of members’ debt in the medium-term.

So as we move into a new year there are some hefty challenges ahead for EU leaders and central bankers, and while the currency bloc may live to fight another day after the December summit its long-term future remains as precarious as ever.

Sovereigns and banks - the fight for funds
Going into 2012, both countries in the Eurozone and banks throughout the world are on the cusp of a potential credit crunch. The OECD is scheduled to publish a report this month showing that the borrowing of industrialized nations has breached $10 trillion and is forecast to grow to $10.5 trillion in 2012; this creates a significant amount of roll-over risk. If a bank or country cannot fulfill its debts when they fall due then by definition they default. For banks this will usually mean they will file for bankruptcy and suffer a complete devaluation of their stock, and for sovereigns it means that their debt becomes worthless and the resulting run will likely lead to the financial collapse of the nation in question.

The major banks in the US, Europe and the UK have around €700 billion of debt to re-finance next year, and the key sovereigns (Germany, France, Greece, Spain and Italy) have around €1 trillion (see Figure 5). This is a significant amount of debt, especially for European banks that also have to fund dollar-based liabilities. On the other hand, banks in the US do not have the same problem, and their exposure to Europe is not that significant when we compare it to the size of their respective balance sheets.

Usually, banks can count on their peers in the industry as a source of liquidity. Yet, as confidence within the banking sector, especially in Europe, has withered, the cost of inter-bank lending has become increasingly expensive. The 3-month dollar Libor rate, is now sitting around 0.5400, a level we have not seen since mid-2010. Furthermore, we cannot see the cost of inter-bank borrowing ease without renewed faith in banks, and we are not seeing this. Even coordinated action from the world’s major central banks failed to decrease the cost of borrowing in the money markets. Instead, banks in Europe are increasingly looking towards the ECB. Recent figures show that the amount of dollar funds being paid-out by the ECB has significantly increased since the biggest central banks in the world decided to lower the price on euro-dollar swaps by 50 bps.

So what are the other funding options available to European banks? Firstly, they can sell assets to provide much needed liquidity, or they can ask their respective centrals banks for liquidity. Another option is a strategy known as Asset Liability Management, which involves banks buying or selling assets in order to effectively manage their risk. These avenues worked well
for banks in Ireland, and we think this will become an increasing popular option heading into 2012.

If banks fail to raise enough capital in the markets, they can theoretically turn to the EFSF. However, its current size of €440 billion means the rescue fund doesn’t have the firepower to support all of the debt laden European nations and the banks. Also, it doesn’t look like the ECB will step in and become the bond-buying bazooka that the Eurozone needs, at least not until they absolutely have to. Instead, what we expect to see from the ECB is continued support for the banks throughout 2012, making it easier for banks to re-finance but not directly taking any debt off their balance sheets (see Figure 6).

In our opinion, Europe needs to seek help beyond its own borders - assuming anyone is willing to help. If countries like China step in and provide assistance they could not only help ease liquidity problems, they could also reassure the market and bring bond yields in the region down, thereby taking some pressure off of struggling sovereigns. This is especially a concern for Italy right now, with its 10-year bond yield still hovering uncomfortably close to 7%.

The EU summit did announce plans for tighter fiscal integration of the Eurozone and possibly some other EU countries. Nevertheless, despite what officials in Europe are saying, the kind of treaty changes required will take time. So, we remain concerned about the ability of Greece, Italy and Spain to repay their debts, which could put France’s AAA rating under pressure due to their banks’ exposures to Italian and Greek debt, and in turn jeopardize the rating of the EFSF.

In terms of FX, we do not see this having a direct impact on currencies, apart from some possible repatriation effects from foreign asset selling by EU banks. Instead, these re-financing issues will affect the foreign exchange market through overall risk sentiment. If policy makers do not come up with any short-term measures to provide liquidity to struggling nations and banks, we could see risk sentiment suffer as a result.
Prospects for new rounds of quantitative easing

With fresh fiscal stimulus unlikely to materialize in any of the G-10 economies in the quarters ahead, and as fiscal austerity measures increase the drag on recoveries, we think pressure will build on key central banks to provide additional monetary stimulus through quantitative easing. In particular, we think the chances of additional asset purchases (QE) are greatest in the US, UK and, perhaps surprisingly, the Eurozone.

In the US, recent comments from various FOMC policymakers indicate that QE3 is one of a number of policy alternatives under consideration to support the US recovery. As of mid-December, market analysts are about evenly split over whether QE3 may be adopted, according to Bloomberg surveys, with the share expecting QE3 declining from about 2/3's in recent weeks following a string of more upbeat US data. The relevant dynamic is pretty straightforward to our thinking: the stronger the US outlook, the lower the necessity for QE3, and vice versa.

But with the Fed falling way short of meeting its dual mandate, especially on the employment front, we think the Fed will ultimately find consensus on the need to provide additional stimulus. Incoming data will of course continue to drive the debate, but with the Fed’s own forecasts predicting an unemployment rate of 8.5-8.7% at the end of 2012, we wonder what they’re waiting for. Relative to its central bank peers, the Fed has plenty of room to maneuver (see Figure 8).

We think the pick-up in US momentum seen in the 4Q is likely to fade in the 1Q, as cyclical inventory rebuilding runs its course following the 2-3Q slowdown. Without a meaningful improvement in the US labor market, which we don’t foresee anytime soon, we think overall demand in the US will remain around levels experienced in 2011 on average. We also expect weaker demand out of the Eurozone in early 2012 likely to weigh on the US export sector overall, and could also work to undermine corporate profitability of US multinationals, potentially damping stock market performance and restraining consumer sentiment via the wealth effect. We would need to see monthly job gains (change in NFP) accelerate to above +200K per month to alter our thinking.

In terms of timing, our preferred scenario sees US data plateauing and possibly declining over the course of the 1Q, leading to rejuvenated market speculation of impending QE3. The FOMC’s first meeting on Jan. 25 will likely not allow for enough fresh data to move the Fed off the sidelines, but by the March 13 meeting, we think the Fed will have enough evidence to begin preparing markets for QE3 sometime in the 2Q. We would look for the Fed to outline a program of asset purchases focused on mortgage-backed securities to directly address one of the major headwinds plaguing the US recovery. Reducing refinancing costs can support consumer spending in the short-run, and stimulating the housing sector can yield significant employment multiplier effects in the long-run, providing two levers to support the US recovery, in our view. We look for a program of USD 500 bio, and potentially much larger, to be announced at the April 25 meeting, and to run over the following 9-12 months.

The prospects for US QE3 will likely play a significant role in the risk sentiment dynamic, likely second only to developments in the Eurozone debt crisis. Following the 4Q pick-up, we expect the US outlook to stay healthy early in the 1Q but to gradually fade in later months. We think this will reduce the prospects for QE3 initially and see risk aversion largely dominate the first half of 1Q, aided in no small part by further strains emanating from Europe. We would therefore expect the USD and other safe haven currencies (CHF and JPY) to remain resilient over this period, and risk assets (stock/commodities) to see further pressure. Once US data begin to show some backsliding, we would expect risk sentiment to initially weaken further,
but that it will eventually transition to renewed optimism as prospects for QE3 improve. Fed speeches are the most likely vehicle for communicating a growing consensus that QE3 is necessary and we will of course be paying close attention, but incoming US data will hold the key to policymakers’ own expectations.

In the UK, the Bank of England’s MPC appears to be further along in reaching consensus that additional asset purchases may be needed. The economic recovery remains anemic and the unemployment rate has been ticking steadily higher since summer and now stands at 8.3%, the highest level since 1996. Deteriorating growth prospects across Europe further darken the near-term outlook. Against this backdrop, the Conservative/Lib Dem government remains insistent on pursuing its austerity program, suggesting no fiscal light at the end of the tunnel. Meanwhile inflation, which seemed to terrify some policymakers just a few months ago, is set to drop rapidly at the beginning of 2012 as base effects like the VAT increase drop out of the calculation. UK debt markets suggest 5-year inflation expectations are now around 2%, opening the door for additional MPC easing.

We think renewed asset purchases by the BOE is more a question of ‘when’ and ‘how much’ rather than ‘if’. The BOE initiated a second round of GBP 75 bio in asset purchases in October and looks set to complete the program by the end of March. We would look for the MPC to announce a third round of asset purchases either at the March 8 or April 5 meetings. The next BOE quarterly inflation report is due in February, and if CPI ratchets lower early in 2012 as we expect, and the inflation report confirms a CPI trajectory to below target, the MPC will have plenty of political cover to pursue further asset purchases. We would look for another GBP 50-75 bio in the next round, but think there is also potential for something even larger. Sterling is likely to remain under pressure as a result of the weak economic outlook and increasing likelihood of QE3 from the BOE.

Quantitative easing out of the ECB is a much trickier prospect, given that the ECB to date has ruled out significant asset purchases beyond its ‘finite and temporary’ securities market purchases (SMP) program. However, repeated failed attempts to increase the lending capacity of the EF SF and the ESM have only fueled market fears that larger Eurozone economies, like Italy or Spain, may be shut out of credit markets just as massive amounts of maturing debt loom on the horizon in 2012 (see discussion on ‘Sovereigns and Banks—the fight for funds’).

There are two main schools of thought on how the EU debt crisis plays out—we’ll call them pessimists and optimists. The pessimists think the ECB will stick by its Teutonic guns and refuse to provide sufficient buying support for beleaguered Eurozone governments and that one or more will be forced into default and out of the euro in the next year or two. The pessimists also think recently agreed provisions to tighten EU fiscal governance doom many EU economies to years of stagnant growth and potential social upheaval.

The optimists hold the view that the ECB, when push comes to shove, will ultimately ensure sufficient funding is available to buy troubled EU sovereigns enough time for fiscal consolidation to take effect and restore market credibility to the most indebted nations. But that is a process that will likely take years and may still result in defaults and a departure from the single currency for several EU members.

For the immediate future, we would side with the optimists and look for the ECB to eventually hold its nose and provide the necessary support in one form or another. For example, without violating its treaty obligations by directly lending to sovereign governments, the ECB could potentially increase the amount of its secondary market purchases through the SMP to its self-imposed weekly maximum of EUR 20 bio, for a total of over a trillion EUR in 2012 alone.
reaching the magical number markets have been seeking to inspire confidence. Recent ECB SMP weekly purchase totals have been extremely small, so there is plenty of unused ammunition there.

But a more aggressive use of the SMP would seemingly conflict with the ECB’s ‘finite and temporary’ characterization of the program, but they never said that a trillion EUR or a few years wasn’t finite or temporary. Simply the appearance of a stepped-up SMP program may be sufficient to alter market expectations and instill greater investor confidence. As well, the ECB has been sterilizing its SMP purchases to prevent the operation from being characterized as debt monetization or money-printing. Recently, though, the ECB came up short in sterilizing the full amount it sought, which calls into question the viability of the SMP approach on a larger scale.

Alternatively, the ECB could use its unlimited 3-year long-term refinancing operations (LTRO’s) to lend to Eurozone banks, which would then buy troubled sovereign debt and park it back at the ECB for use as collateral for additional borrowing from the ECB. Or some combination of SMP and LTRO’s or still another back door route as yet undetermined.

In the quarter ahead, we’ll be following ECB LTRO and SMP amounts closely for signs they’re being used to support sovereign borrowing. We’ll also monitor the ECB’s success at sterilizing future SMP buying. The more the ECB deploys its balance sheet to support EU governments, the more markets may conclude the ECB is in fact monetizing EU debt, which would severely damage the ECB’s credibility and undermine the euro. Overall, we look for the ECB to provide just enough support to keep the market stressed, but ultimately satisfied, meaning the EU debt crisis will continue to drag on until the next EU Summit in March.

Further SNB and BOJ intervention in the cards
Is it time to test the SNB’s resolve? At the beginning of September the SNB reacted to significant Franc strength by setting a floor in EUR/CHF at 1.20. This has so far proven successful as the pair has not only remained above 1.20, but has yet to even test it. However, with Switzerland’s CPI falling into negative territory in October and November (-0.1% & -0.5% YoY respectively) it has sparked fears of deflation. Consequently, rumors began to circulate that the SNB may raise the floor to 1.25 and even negative interest rates were speculated. Thus, the December 15th SNB meeting carried even greater importance as the market believed this would be an appropriate time to take action with the EU summit out of the way and their next scheduled meeting not occurring until mid-March.

The SNB clearly had other intentions as they decided to leave the EUR/CHF floor at 1.20, citing a potential escalation of the European sovereign debt crisis as a chief concern heading into the first quarter. Moreover, they highlighted their close ties with many of the EU nations and how their ultimate outcomes could affect the Swiss economy. As such, the SNB decided to take more of a wait and see approach at their December meeting and this sent EUR/CHF back towards the midpoint of the recent 1.2120-1.2440 range over the past few months. Given the troubled EU outlook heading into 2012, coupled with global growth concerns, it suggests the possibility of another significant bout of risk aversion. Should this occur and with the SNB currently on the sidelines, we would not be shocked to see the market test the SNB’s resolve and make a run at the 1.20 floor in EUR/CHF. However, we believe such a move towards 1.2000/50 could be an opportunity to establish a bullish EUR/CHF bias as “the SNB stands ready to take further measures at any time if the economic outlook and the risk of deflation so require.” Thus we would not be surprised to see the floor raised at some point in Q1 as the domestic data has been abysmal and looks set to worsen.
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below 1.2000 and should rise into the noted zone heading into January.

The Bank of Japan (BOJ) and Ministry of Finance (MOF) are notorious for stirring the market with fears of intervention. During 4Q 2011 authorities in Tokyo repeatedly stated that the detrimental impact of the historically high yen on the Japanese economy would result in action to stem the rise of the currency, and on occasion the central bank backed up this threat and sold yen. However, the long-term impact of these moves has come under scrutiny from the markets, and the yen remains a safe haven trade of choice for traders. Thus, intervention at this stage - when market uncertainty remains so high caused by European issues and global growth fears – could be a wasted effort by the BOJ. As such, we expect them to keep up the rhetoric regarding the yen, but they may not engage in more direct intervention unless the 75.00 level in USD/JPY is threatened.

We are looking for a push above the 79.50 – 80.00 level for USDJPY to signal further upside potential. The pair has not managed to break the 80.00 level since August’s intervention by the BOJ, and even then the break could not be sustained. On the downside, around 75.00 remains a key level for more intervention and further push towards 70.00.

The X factor: why markets can’t discount politics in 2012

2011 will be remembered as the year when politicians caused havoc in the financial markets. This affects Europe; leaders in Brussels have not been able to find a solution to the debt crisis nearly 2 years after cracks in Greece started to appear.

US politicians have also had their fair share of clangers; the most dramatic was the political deadlock in the summer when Republicans and Democrats could not agree to spending cuts for the 2012 budget that nearly caused a shut-down of the US government and a default on the US’s enormous debt. This was averted at the last minute, but it wasn’t enough to protect the US credit rating. Standard & Poor’s cut the US from triple A to AA+ on the back of the tussle on Capitol Hill. As we approach 2012 the US, which has a $14 trillion debt burden, still has no credible fiscal plan going and this could cause more downgrades next year.

Politicians, especially in developed markets, seem well able to spend money, but they are finding it hard to scale back now that the global economic outlook has darkened. Fiscal folly is likely to be a major theme next year, although the US and Europe are likely to be on either end of the spectrum.

Europe’s response to the sovereign debt crisis, led by Germany, is one of more austerity (for more, see our section on the Eurozone debt crisis) while the US seems to be delaying the day of reckoning and has no fiscally coherent plan as we start a new year.

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In the US no politician wants to cut spending in an election year, yet the US’s spending is out of control. Combined with the huge cohort of baby-boomers approaching retirement and unfunded pension liabilities – including state pensions – then the US is getting into a deeper fiscal mess by the day.

Investors also need to be prepared for election risks. This will affect developed and emerging economies alike. Malaysia, Taiwan and South Korea face elections next year. Meanwhile protests have erupted in Russia after December’s Parliamentary elections where Prime Minister Putin’s party scraped a win, however accusations of electoral fraud abound. This ups the stakes
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for the March Presidential elections, where Putin is hoping to regain the Presidency.

News that billionaire and Putin foe Mikhail Prokhorov will challenge the PM was welcomed by the protestors, although Putin is still expected to win. However, the Russian leader is looking more politically vulnerable and unpopular than at any other stage in his career and if he is re-elected expect more protests. While we don’t think Russia is about to embark on its own “Arab Spring” next March, we can’t rule it out completely. If this happens then oil prices could surge as Russia is the world’s largest daily oil producer.

But the market’s political focus is likely to be on the French election. This is due to take place on 22 April 2012. President Sarkozy is eligible to run for a second term, however retaining the Presidency is likely to be an uphill struggle for the French leader. His popularity ratings are low, French growth is weak and Sarkozy has just signed up to a years of austerity by agreeing to closer fiscal union and automatic penalties for running deficits in excess of 3% of GDP. Since France spent more than it earned in 2010 to the tune of 7.1% of GDP in 2010, it will take a huge austerity push to get its finances within EU legal limits.

Added to this, France’s triple A credit rating is at risk of a two-notch downgrade from Standard & Poor’s who put France along with 14 other Eurozone member states on review for downgrade early in December. It is hard to see Sarkozy holding on to the Presidency if France is downgraded on his watch. The candidates who are planning to run against Sarkozy include Dominique de Villepin from Sarkozy’s own center-right party and the Socialist candidate Francois Hollande.

Not much is known about de Villepin, however Hollande has pledged to re-negotiate Europe’s latest agreement on fiscal discipline agreed on 9th December. He has complained that the new accord doesn’t do enough to calm markets and will press for a greater role for the ECB. This adds to uncertainty and risks for investors, as the political rhetoric in France picks up in the first quarter expect market volatility to rise with it.

Spain’s Prime Minister elect Mariano Rajoy will officially take office in January. We think he will stick to the Socialists plans for fiscal austerity and there is more risk from weak growth and growing bad debts in the Spanish banking sector than political wobbles from the new center-right government.

While we don’t think that US political risk will heat up until later in 2012 – Presidential elections take place in early November, the Republican candidate should become apparent following early state primaries in January. However, political bickering and any delay to fiscal consolidation plans and/ or an extension to the payrolls tax cut are the biggest political risks as we head to the end of 2011 and into 2012.

Not only do investors need to judge financial risks in 2012, there are also significant political ones too that could make it a volatile quarter.

EM (Emerging Markets) FX – The search for relative value

With just under 15 trading days left for currency markets in 2011, the lack of clarity from yet another emergency EU summit on Dec. 8th, still elevated government bond yields in Europe’s periphery, and potential ratings downgrades to AAA credit in the core may see EM FX remain under pressure as 2012 gets underway. On the flip side, any significant progress towards

“...the market’s political focus is likely to be on the French election.”
a long term EU debt crisis resolution would pose the biggest threat to a spill-over of EM FX weakness into the coming quarter; although we believe such material progress seems more likely to occur around the latter portion of the 1Q ‘12. Overall, we look for risk sentiment to be the primary driver of EM investment flows in the coming quarter.

Beyond the never-ending EU debt crisis, we expect struggling recoveries in most of the developed world to restrain overall demand, potentially undermining EM economies in the process. But some EM countries are seeing stronger domestic dynamics that may make them more resilient to global headwinds, suggesting differentiated, relative value strategies may prove more successful than a ‘one-size fits all’ EM investment approach. In particular, we would argue that better relative value may exist in being long Turkish Lira and/or South African Rand funded via EUR and/or USD due to a higher probability that large scale ECB and/or FED asset purchases would provide the necessary support to prop up financial markets in the backdrop of an intensifying debt crisis.

**Unconventional tightening may see TRY outperform its EM peers**

Despite relatively firm GDP growth of +8.2% y/y in the 3Q ‘11, negative current account imbalances (~4.2bn deficit in October) alongside depleting currency reserves ($85.2bn as of 12.02.11) has seen the CBT (Turkey’s central bank) resort to unconventional tightening measures – mainly liquidity management – to defend against excessive TRY weakness. Regardless, the CBT’s hawkish stance has lent some much needed support for the lira as evidenced by TRY outperformance relative to its EM peers since October.

While we maintain a bullish TRY stance in the medium term, we would be remiss to completely dismiss potential short term downside risks stemming from an unrelenting Euro area debt crisis due to Turkey’s heavy export dependence to neighboring Euro-area economies and heightened sensitivity to Euro-area deleveraging risks.

Turkey’s inflation readings may surpass growth rate and even climb to double digit territory as CPI rose at an annual clip of +9.48% in November. This is well above the CBT’s 5% target and will most likely see the central bank maintain its hawkish policy stance, possibly even forcing the central bank’s hand to hike the main repo rate which we think carries a rather low probability of implementation.

Overall, we don’t think unconventional policy tightening deters the prospects for medium term TRY strength; more specifically versus EUR due to further diverging central bank policy directions and on potential large scale ECB asset purchases if debt contagion fears fail to subside in the 1Q ‘12.

**ZAR outlook may depend on advanced CB monetary policy measures**

While near term risks for South Africa’s Rand (ZAR) are certainly skewed to the downside, we think further deterioration in the global growth outlook may ultimately translate to medium term ZAR strength. This is premised on potential implementation of major asset purchase programs by the ECB and possibly even the US FED and its implication for commodities as well as high beta commodity currencies.

South Africa’s central bank (SARB) faces the same problem handcuffing most other EM economies from responding to deteriorating growth conditions – concurrent spikes in inflation. CPI y/y rose to the upper end of the SARB’s 3-6% target range in October while the current account deficit widened more than expected in Q3 to -114.6bln or -3.8% as a percentage of GDP. Manufacturing production fell -3.6% in October (the consensus of Bloomberg economists surveyed expected a +0.5% rise) reflecting a much more rapid
Markets Outlook 1Q 2012

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**Q1 2012 commodity outlook: deciphering the commodity conundrum**

Heading into 2012 we cannot help but notice the daunting challenges which face the global economy. In this context the commodity arena could head towards either end of the spectrum (extremely bullish or bearish) depending on how these problems play out in Q1. So what exactly do we have to contend with over the coming quarter? 1) Despite summit after summit, the EU sovereign debt crisis still looms large as contagion begins to spread from the ‘periphery’ to the ‘core’ of Europe. 2) Fiscal austerity measures and global deleveraging are beginning to take their toll on growth, especially in Europe where GDP could slip back into negative territory – This is highly problematic as Emerging markets were the primary reasons commodities have been able to stay afloat in the past. 3) Central banks, both developed and emerging, have embarked on non-conventional easing measures (Quantitative easing & currency intervention) and yet the economy as a whole continues to sputter…what now?
There are a few other things to contemplate outside of the basic fundamentals when dealing with commodities. Remember, most commodities are primarily priced in USD’s and we think the dollar looks set to strengthen into Q1 on greater risk aversion. Consequently, a USD rally would generally be bearish for commodity prices overall. However, we also have to consider the reasons behind a potential U.S. dollar rally as they have nearly polar opposite effects on commodities – Should the USD strengthen on the back of a flight-to-quality (risk aversion), as there’s a lack of viable currency alternatives with the SNB and BoJ intervening to weaken their currencies, this would be commodity negative. But if the USD strengthens on the premise of a stronger U.S. economic outlook then this would be commodity bullish. We view the former to be more probable than the latter given the global economic backdrop, thus we are rather bearish on commodities overall.

The technical outlook also comes down on the bearish side, according to our analysis. The broad-based CRB commodity index looks to have broken below trendline support at around 300, which dates back to the start of the 2009 commodity advance (see Figure 11). Further weakness below a key horizontal pivot at about 290/92 would suggest sharper downside ahead and we could foresee potential to around the 250 area, or approximately 14-15% lower.

However, not all commodities were created equal. Even though recent commodity correlations are trading closer to ‘1’ (meaning their day to day movements look very similar) does not mean they will continue to do so in the future. Accordingly, we believe it makes sense to think of these as a ‘relative’ play, rather than outright against the USD.

**Metals outlook**

Given the perceived ‘safe-haven’ view of precious metals and the global economic challenges upon us, we believe the best way to play a potential slowdown in growth is to establish a bullish bias in Gold and Silver relative to other commodities (i.e. Softs & Agriculture). In the immediate short-term we envision a potential correction into the holidays as gold closed below the 150 and 200 day sma’s for the first time since the beginning of 2009. The September low near $1535 may prove supportive initially, however we would view a further decline towards the weekly Ichimoku cloud top, which rises to $1492 at the beginning of Q1 and 38.2% retracement of the rise since 2008 around $1445/50 as an opportunity to establish this bullish relative bias as we head into 2011. As for Silver, we would prefer waiting for a deeper correction towards $25-27 (key 2010 pivot and September 2011 low) before viewing it as a ‘safe-haven’ alternative since silver accounts for a much larger share of industrial demand than gold, consequently it tends to under-perform gold once economies begin to slow. Lastly, let’s not forget about another one of our metals products, Copper. In general, base metals tend to vastly underperform other commodities when faced with a global economic slowdown since they are highly cyclical in nature, however copper supply remains rather thin and China’s stockpiles have greatly diminished over 2H 2011. Accordingly, we could see them look to rebuild these reserves should it fall below $3.00 which could temporarily buoying copper into Q1. For those who prefer to remove the USD variable from the trade, gold priced in euros (XAU/EUR) may be a clever alternative should the European situation dramatically worsen over the coming months. Consequently, XAU/EUR could see less downside than its traditional counterpart (XAU/USD) and could make a run at the November €1325 highs into the first quarter.

**Energy outlook**

Crude Oil has seen strong gains during the 4th quarter as global supply remains tight with supply shortages, due to the turmoil in the MENA regions from earlier in the year, still loom...
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and the broader ‘risk’ trade was back in vogue as the prospects of a double-dip here in the U.S. diminished. However, supply from Libya is beginning to come back on line and higher prices have kept OPEC pumping at an increased capacity. This has seen the spread between U.K. (Brent) and U.S. (WTI) oil narrow, from as wide as 24 in August to back below 10. As global demand growth is beginning to weaken, with the U.S. and Japan leading the way on greater efficiency, and slowing GDP growth in EM and developed countries alike, crude could come under pressure into Q1. Accordingly, we believe U.K. Oil (Brent) could see lower towards $92/97 and U.S. Oil (WTI) trade lower to $85/90 over the coming months. This would suggest to us that the spreads continue to tighten, closer to $5 by March. The risk to this view is if renewed tensions with Iran intensify, as they announced plans to hold ‘drills’ to close the Strait of Hormuz – If shut, this would cause major supply disruptions and could likely send oil sharply higher. Meanwhile, another product to consider is Natural Gas, which sees prices continue to erode on an overabundance of US supply due to new discoveries coming online. This, combined with a return to more typical temperatures, has translated into higher inventories. Natural Gas has broken below $4 in Q4 and may even challenge below $3, towards $2.75, into early Q1 2012 where we think even perma-bears may even believe it’s simply too cheap.

Agricultural outlook

The Ag commodities (Corn, Soybeans and Wheat) have pulled back sharply in 2H 2011, wiping out a large amount of their gains from late 2010/early 2011. While wheat has underperformed despite production shortfalls here in the US, cheaper global alternatives came online which saw a supply deficit turn into a surplus. Consequently, wheat prices were undermined as they broke below the 2010 lows near $6.00. Soybeans recently reached the double top (using the Feb. & August 2011 highs) measured move objective around $0.1115/20 in December, which comes just above the 61.8% retracement around $0.1100 (using the Oct. 2009 low & Feb. 2011 high). Corn continues to be our preferred Ag play as supply remains tight and viable substitutes/ramp up in production remains grim until the 2H 2012. Technically, corn has found temporary support near the 50% retracement around $5.90 (from July 2010 low), however a more meaningful level to focus on is the $5.55/65 area which sees a congregation of multiple prior highs and lows. Meanwhile, rallies towards $6.65/75 may prove resistive as this sees the 100 & 200-day sma’s converge as well as the Q4 highs.

Softs outlook

As we head into Q1, cotton and sugar are likely to remain under pressure in our view. Cotton has been negatively affected by a pullback in the global consumer, specifically seen in the retail sales numbers over the past few weeks, and this looks unlikely to change heading into the first quarter when demand typically diminishes after the holiday season. We believe cotton is headed towards $0.80 by the end of March. Meanwhile $0.94/96 may prove resistive and could be viewed as an area to establish a bearish bias. Sugar doubled in price from Q2 2010 to Q3 2011 ($0.15 to $0.30), however it has begun to pull back in the 2H 2011. We believe sugar is likely to fall further into Q1 as additional global supply comes on board, specifically from Brazil and India. Currently, it is supported by the 50% retracement of the aforementioned move around $0.2275. However we envision a decline towards $0.2100 which sees the convergence of the 61.8% retracement and May 2011 lows ahead of the psychological $0.2000 level.
1Q Outlook Indices

EUROPE

ESTX50
Equities in Europe face some significant headwinds in 2012. A lot of European companies have considerable exposure to domestic conditions, with around 57% of total sales by European companies coming from within Europe. Therefore, given that we are expecting a recession in Europe through 2012, we look for corporate profits in the region to continue to fall.

However, we are not expecting a global recession next year, and at face value equity prices in Europe look fairly cheap, so there might be some opportunity in companies that do most of their business off-shore. Nevertheless, our overall outlook for the ESTX50 is that we can see downside risk heading into Q1 2012, stemming from falling profits and significant amounts of deleveraging.

ESTX50 is in a precarious position, with the RSI close to breaking below the 42 level, a break of around this level in July was followed by a large sell-off (see Figure 14). Furthermore, a sustained break below the bottom of the daily ichimoku could signal a slide lower towards the yearly low around 1924.

Figure 14
EuroStoxx 50

AMERICA

SPX 500
The outlook for US equities is better than Europe but still not great in our view. S&P earnings growth has slowed significantly since mid-2010, amidst concerns surrounding the European debt crisis. Yet, earnings growth has managed to hover around 15%, which is still fairly healthy. Nevertheless, we do not expect growth to get much higher before the November 2012 elections, and we therefore think we could witness some fairly range bound price action.

The downside should be protected by pretty reasonable valuations and deleveraging progress. On the upside, the story will be much the same, with any gains being capped by the uncertainty surrounding Europe and the potential prolonged recession in the region, due to sovereigns and the financial sector struggling with unsustainable debt levels.
The index is floating in the middle of its daily ichimoku cloud (see Figure 15) and we could see some downside support around the bottom of the cloud at 1183. Below this level could see a further decline to the October low at approximately 1060.

**Figure 15**

**S&P 500 Daily Ichimoku**

ASIA

Japan

The Japanese economy was severely affected by the natural disasters that hit the country earlier in the year and, combined with the negative impact that the high yen is having on exports, it is not surprising that the Japanese government has had to draw up three supplementary budgets, with a fourth one in the works. The additional spending will be used to finance relief programs and to fund other government efforts, yet we don’t think this will boost growth appreciably.

Furthermore, Japanese manufacturers have experienced disruptions from the floods in Thailand, especially producers of electrical machinery and parts, who have seen output drop dramatically since the floods began in September. Yet, once we see the disruptions dissipate we could see industrial production for Q4 around 1.2% higher than Q3, and continuing to rebound into 2012.

However, if the yen continues to strengthen it will limit growth in industrial production and could accelerate the hollowing out of industry. This could lead more companies to shift production overseas next year.

Technically, on the upside the index is struggling to break the 61.8% retracement level from the quarterly highs of around 9150 (see Figure 16). Below this level we see some further resistance from the daily Ichimoku cloud between 8747-8822. However, the RSI is rolling over to the downside in confirmation with price, suggesting to us greater downside potential ahead. We would look for a break below recent 8135 lows to target further weakness to the 7500-7600 area.
AUSTRALIA

AUS200

Like equity markets throughout the world, Australian stocks have suffered significantly as a result of the European crisis. However, the difference we think is that fundamentally Australia remains fairly strong. Corporate profits increased 4.8% in the third quarter and GDP continues to grow at a healthy 1% q/q. At face value, this might make equities in the country look cheap. However, the economy is split in two, with the mining sector accounting for most of the gains in business profits and GDP growth. The rest of the economy is clearly suffering from the European debt crisis and a slowdown in China’s economy. This will remain a problem heading into Q1 2012, and could significantly affect demand for Australian resources.

Looking at a daily chart (see Figure 17), AUS200 is around the middle of a potential long-term bear flag consolidation channel and a break below the flag base at 3920/30 (and rising) could provide a signal that losses are resuming. Strength above the top of the flag at 4475/85 (and rising) would invalidate the pattern and suggest further upside potential. A break below the base of the daily Ichimoku cloud at 4128 may also serve as an interim bearish signal.
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