



10 KEY PREDICTIONS FOR 2011

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INVESTMENT IN UNCERTAINTY TIMES: 10 KEY PREDICTIONS FOR 2011

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Global financial markets are going through a period of change and consolidation following the tumultuous events of the past few years. As expected post- November 2010 we have reached a period of relative calm, although this might be seen with hindsight as being little more than another period of false optimism. That would mean that things were not actually getting better, rather they were getting worse more slowly than before. The financial landscape remains bumpy with major potholes lurking around the corner.

Previous Global Risk Updates have referred to some of the regulatory changes that are now in process, with Basel III and the emergence of OTC derivative central counterparties being at the heart of the response. Due to the timetables envisaged for their implementation you should not expect these regulations to have a major impact on markets this year, but in succeeding periods there will be direct consequences, many of which are unintended. In the near term the uncertainty which results from developing new solutions to the challenges posed by regulation will have an impact, causing levels of banking activity to remain subdued throughout the year. This of course is unlikely to be good news for the economy or unemployment prospects. In this article we will review the prospects for 2011 from both a UK and global viewpoint. Recognise that Risk Reward Limited does not trade financial products or services in any way, so our views are expressed on the basis of the research conducted and are not influenced by any on-going trading relationships.

I The Sovereign Debt Crisis

We are now in the position that the debts of the Southern Euro zone countries are at a higher rate than the so-called developing world. Global debt is not reducing, although in some cases the rate of increase is reducing. The largest borrowers will still borrow this year, and next year and... This is combined with what might also be referred to as a quasi sovereign crisis caused by the build up of difficult to service debt in municipal and semi-state entities globally. The inability of global organisations to effectively deal with the

burgeoning debt crisis still is at the heart of the concerns that overhang the market and this appears unlikely to change significantly this year. It is unrealistic to solve problems in Europe in isolation – a world solution is needed.



There remain significant uncertainties in Q2/2011 and Q4/2011 both caused by the volume of parties that are seeking to tap international capital markets at the same time. They will not all succeed. Looking to Western Europe for the next default is unlikely to be the case and we would suggest that problems from much further afield are more likely to be at the heart of the issue.

We continue to expect the Euro to stumble on, although its credit rating will be impacted. By the end of the year we anticipate a clamour for the creation of a currency additional to the Euro which would be backed by the reserves of the strongest Euro member to be used in international trade only.

II Inflation

During the course of 2011 inflation will clearly become of global significance. There are two main types of inflation we consider – that which you experience and those balanced figures produced by governments. Since food price inflation is a major concern for 2011 with many staple prices

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significantly increasing, perceived inflation is actually greater than reported inflation. You can already see a number of developing world countries starting to take action to attempt to curb inflation enthusiasm. There will be more of this during the year as significant increases in commodity prices ensue.

We remain concerned that some developing world countries may find it increasingly difficult to obtain the food required to adequately feed their population. For the UK the impact of the taxation changes announced has been reduced by the extremely competitive trading environment. Consequently the effect of the changes will not be felt immediately in all areas, but when combined with the commodity increase, then further rises in inflation must be anticipated to perhaps 4.5%

III GDP

There has been a reduction in GDP in many countries as a result of the crisis, and accordingly growth will be calculated from a lower base than would otherwise have been the case. It is hard to be optimistic regarding many of the global markets. Financial uncertainty exacerbates a shortage of activity in the banking sector, making it more difficult for companies to obtain the capital they require for growth.

For most countries a modest growth in GDP from the reduced baseline position can be anticipated with the UK probably achieving around 2% due to companies learning how to survive in difficult financial markets. It will not feel like growth and it will not create significant optimism. This could all be blown off course were a major sovereign default to occur, but our expectation is that there will be more muddling though in 2011.

IV The Banking System

To be a bank you need a licence and this is generally required to enable a firm to take deposits. Many companies lend money but are not banks. Others of course do fund transmission or wealth management. The changes set out in new regulations are likely to put banks at a competitive disadvantage to their often unregulated competitors. Remember there is nothing stopping you lending money to anyone – it does not make you a bank. A fool maybe, but not a bank.

In the course of 2011 you will see a number of new entrants into the financial markets who will be seeking to extract competitive advantage from the poorly drafted revised regulations. Most of these will not be banks in the traditional sense, but instead pockets of assets available to be leveraged and take these opportunities. There will be a slowly developing understanding of the impact of regulations and rules which are developed in isolation being individually appropriate yet in combination dangerous. The global market needs a financial services sector that is robust and profitable to become the engine for growth.

V Political Issues

The austerity packages that are now being introduced will remain unpopular and there will be sporadic outpourings of ineffective social unrest. In some extreme cases there will be political upheaval and many governments around the world appear to be moving into a period of increased uncertainty. Clearly in this article we will not specify where change is likely, but both the submerging countries of the West and the emerging countries of the developing world are all at risk. The solution to these crises is always wealth creation – making the populace feel part of the greater success of their nation. This is of course difficult to achieve when the markets themselves are so complex.

VI Interest Rates

The yield curves for major markets are easy to read and interpret, clearly showing that interest rates at some stage are likely to rise. The only questions are when and how far. If inflation is aligned with our expectations as set out above then a benign increase in interest rates can be anticipated. For the UK, for example, an increase of 50bp by the end of the year may well be achieved.

There are problems though. If the US, for example, suffers a major inflationary scenario then their willingness to increase interest rates to effectively choke this off would be understandable. The impact of this would be increased unemployment and reduced GDP, none of which are



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acceptable. Accordingly a US increase of no more than 50 basis points would also appear appropriate.

VII Bonds

Why does anyone now buy a fixed rate bond other than a zero coupon bond? The yield curve clearly shows that interest rates are likely to rise, which will directly reduce the value of bonds. The sell-off that we anticipated last year has now begun to bite and will accelerate. This is unlikely to be a good year for anyone involved in long fixed-income strategies.

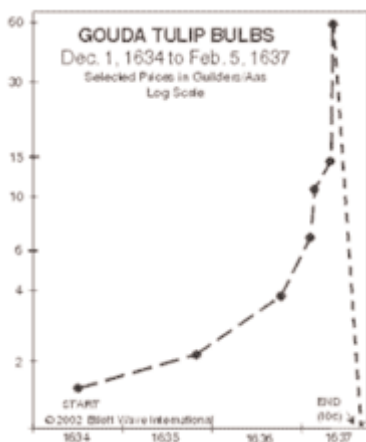
Of course zero coupon bonds with their repayment floor remain acceptable, but we do anticipate increased issuance of floating rate paper – or variants of the same. However the major reduction in value is likely to be in 2012 and 2013, not 2011.

VIII Gold

The gold price is at an all time high. Gold has some uses, but not many and in times of stress it is perceived as a store of wealth. The graph of the increase in the gold price is as follows:



From 2004 the gold market has moved to replicate the standard bubble chart.



The 17th century Dutch bulb crisis illustrates the same growth pattern and then the fall from grace. In the case of gold there is a resistance band around 250-450, so a fall to nil is not likely under any realistic scenario. However when some form of market stability returns the gold price will fall – but from which peak? We do expect a fall to occur this year to perhaps 1,000, but from a peak higher than that currently exists.

IX Equity Markets

Then there are the equity markets. There is some buoyancy at present. There are four main choices for investment – equities, bonds, commodities and money market. Since the money market is producing negative real returns (yields are below inflation), bonds are declining and commodities appear well priced, there are few alternatives. Accordingly much of the growth in the equity markets is driven by money having nowhere else to go. Companies are also finding ways to remain profitable in times of stress through flexing their business models.

This would suggest a growth in equity markets. Further we anticipate that much of the regulation implemented during 1982-2009 which encouraged the acquisition of fixed-income securities will reverse also creating equity market growth. Already many of the developing market securities appear to be well priced, but on balance we anticipate global growth of perhaps 20% over 2010.

X Looking Head

There are many things that result from this analysis. From an individual investor point of view it is incumbent on each of us to review our existing investment strategy and identify changes to meet the demands of the changed paradigm. In terms of financial service firms they will need to see the opportunities and challenges that this changing environment presents and balance their resources to enable full advantage to be taken. The brave and most flexible will probably show the greatest success.

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