



# PREDICTIONS FOR 2011: REAPING AND SOWING

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# PREFACE

The Reuters Breakingviews predictions book for 2010 was subtitled “Worried and Wary.” A year ago, our columnists spotted trouble brewing in the weaker economies of Europe, anticipated a better – but not great – year for global mergers and acquisitions, and forecast gridlock in the U.S. Congress after a big swing against the Democrats.

The rise of the gold price was another theme, and though we didn’t see Apple’s revolutionary iPad coming, we did note the disruption being wrought by smart cellphone handsets across the technology industry. Harder to pigeonhole was our sense that the gradual shift of economic power away from the United States would bring painful jolts. That was an undercurrent in 2010 that is likely to continue.

We weren’t right about everything, of course. Though generally pessimistic, some of our predictions turn out to have been too optimistic, including the idea that greener energy might be squarely on the agenda in 2010. That certainly didn’t happen in America, the biggest consumer of the world’s precious hydrocarbons.

Meanwhile, other prognostications didn’t come to pass, but might still – making them subjects for this book. These include the fallout from central banks and governments opening money spigots wide. This is particularly true of the United States, which continues to pursue a program of loose monetary policy even as austerity catches on in the UK and the periphery of Europe.

The net result, in terrestrial and meteorological terms, is that as 2011 begins the ground underfoot is more stable than a year ago and the sky is brighter – but the clouds on the horizon, while perhaps more distant, are still troublingly dark in places.

One such is Europe, where the dominoes of financial crisis are still teetering. Another is the United States, where long-term overspending, overlaid with short-term stimulus, risks bringing both credit trouble and



inflation. Still a third is China, where a significant economic stumble could spell trouble for Asia and the world – but where economic management, while hardly democratic, appears to be highly effective.

It's also possible to see 2011 as an intellectual study: of the different results of austerity versus spending, for instance, or of the consequences of reforms that started with the idea that institutions shouldn't be too big to fail but ended up – for better or worse – mandating special treatment for the largest of them.

Yet the new landscape is not fully defined. The fine print of financial regulations is still being hammered out, and governments are still heavily involved in markets. Hedge fund managers, for example, still can't just pick securities and ignore politics, as they used to.

That makes 2011 part of a potentially volatile transition period. Hence the subtitle of this book: "Reaping and Sowing." Happy reading!

Richard Beales  
Assistant U.S. Editor, Reuters Breakingviews  
January 2011

## CHAPTER 1

# THE GLOBAL PICTURE

### ANTI-DEPRESSION SIDE-EFFECTS

BY IAN CAMPBELL

In 2010, little more than a year after celebrations of the euro's 10th birthday, the very survival of the currency of the world's largest economic bloc came under threat – a reminder that the world's economic foundations are never completely stable. And so a prediction that the world will do better than generally expected in 2011 comes with big caveats.

It has taken extreme measures, primarily ultra-loose monetary policy and much debt creation in the United States and Europe, to resuscitate the world from the Great Recession. In the process, the seeds of future



*Policemen try to escape a fire from a petrol bomb during riots at a May Day rally in Athens May 1, 2010. REUTERS/John Kolesidis*

crises may have been sown – perhaps even in China, the bastion of growth through the recent crisis.

As the year turns, the edges of the euro zone remain the world's central economic drama. Greece and Ireland have received bailouts. Portugal is making efforts to cut its fiscal deficit, but its very poor trade position – with a current account deficit that is close to one tenth of GDP – and weak banks make a first Iberian bailout a near-certainty early in 2011.

It's very possible that Spain will need one, too. It continues to suffer from big government spending and trade deficits. Madrid's repair efforts are complicated by the autonomy enjoyed by regional governments and by a national unemployment rate of 20 percent.

If a Spanish bailout happens, the likes of Italy and Belgium could be next. But these countries should be more resilient. They have stronger industrial sectors, lower external financing needs and higher levels of domestic savings.

Despite continuing upheaval, the euro zone will still grow in 2011. Germany's pick-up in growth reflects the world's. France and Italy aren't in such bad shape, either. German exports are again growing fast and will receive further impetus if the euro weakens further. That's likely given ongoing uncertainty and low European Central Bank interest rates. A substantial drop to a level of, say, \$1.10 by the end of 2011 isn't impossible.

The U.S. dollar, meanwhile, should be on the recovery road. Money-printing by the Federal Reserve and ultra-low Treasury yields have weakened it. Both should end in 2011. After three years the U.S. consumer will stir – cheered by a housing market that appears to have bottomed. A virtuous circle of falling unemployment and rising consumer spending looks possible. U.S. growth may be stronger than markets expect in 2011.

That in turn will help Asia's exporters, led by Japan and China. Chinese growth looks set to remain strong, even though the government is trying to reduce the pace of money supply growth from the astonishingly high levels of recent years. India, too, is racing ahead, despite high inflation and rising

interest rates. New consumers are emerging in Asia. The demand for food, copper, cement, electricity and oil keeps growing. So the commodity price inflation seen in the second half of 2010 may continue and could worsen. Inflation is already a big problem in some emerging economies. It is likely to break out soon in the West.

In the United States – especially coupled with accelerating growth – inflation would force the Fed to consider raising interest rates. Though it seems unlikely now, that could happen before the end of 2011. Bond markets that prospered through the deflationary crisis would be hit hard. Stock investors would have to weigh higher growth against more expensive money.

The result: a resuscitated world, but not a wholly healthy one. In almost every major economy, government deficit and debt will have climbed steeply. The United States will have shown its great capacity to borrow, but even Uncle Sam will have to shift towards unaccustomed austerity. Until that happens, the U.S. consumer and a mammoth trade deficit of \$40 billion or more per month will again be one side of the world's imbalances.

For its part, China has maintained growth by permitting soaring foreign exchange reserves and money supply while increasing its export capacity. The Middle Kingdom's controlled currency is another cause of global economic imbalances. The government might allow the yuan to appreciate sharply if it finds inflation rising fast, which may well happen. But the leadership will also be wary of damaging the export sector and its jobs.

The structure of China's economy and the staggering money supply growth everywhere during the Great Recession might stoke future crises. But faster global recovery and the return of inflation should be 2011's main themes, punctuated by euro zone aftershocks. Not to mention the inevitable unforeseen surprises, both good and bad.

*Published December 23, 2010*

## A SMALLER LEAP FORWARD

BY JOHN FOLEY

China's global yuan plan got off to a racing start in 2010. Beijing decided it wanted the currency to become a global lingua franca, and presto: within a year, the framework for an international currency had been created. The region's banks were much exercised at the prospect of unimaginable new fee streams. It is hard to see how the yuan can live up to the hype.

Exporters and importers could already use the yuan to pay for trade, and individuals could put it in low-yielding bank deposits. But in 2010 they were finally given alternatives. Corporate bonds, mutual funds and even trading currency in the spot market took off after Hong Kong signed an agreement with the People's Bank in July, so that holders could get a respectable return, on top of what they might expect from the yuan's long-term appreciation against the U.S. dollar. In November, China's Ministry of Finance issued a 10-year offshore bond, creating the skeleton of a proper yield curve.

Hopes of appreciation have helped the market take off. Anyone outside China who believes the currency is undervalued has a strong reason to get their hands on it. Deposits quadrupled to \$33 billion in the first 11 months of 2010, and cross-border transactions settled in yuan rocketed. The spot market grew from almost nothing to \$300 million a day, according to Deutsche Bank.

Even without new initiatives, that momentum should continue. Assume 3 percent of imports into China are paid for in yuan next year, compared with 1.8 percent in the month of October. That could release a further \$42 billion. Tourism could add a further \$12 billion. Even if half of those flows are repatriated or invested elsewhere, that would still double Hong Kong's total yuan savings, taking them from 3.6 percent to 7 percent of the region's bank deposits.

But dismantling a big dam, even in small chunks, can unleash a lot of water. Many exporters were surprised by a Bank of China announcement which implied that it had used half its annual limit for currency conversions related to trade settlement in October alone. The bigger the yuan experiment grows, the higher the pressure behind the dam rises.

BREAKINGVIEWS



Capital controls, in particular, create distortions. The yuan now freely trades in Hong Kong at a different rate from that at which it can be exchanged on the mainland. The offshore premium has been as high as three percent – and when yuan trades at a premium in Hong Kong, exporters to China have more reason to accept it as payment. The markets aren't fungible, so there's no danger of the offshore yuan rate driving up the onshore one directly – but the bigger the premium gets, the bigger and more embarrassing the signal that Beijing is manipulating the value of its onshore currency.

The chance of capital controls being loosened has, if anything, reduced because of paranoia over the effect of speculative money flows targeting China's rapid growth. When the Bank of China reached its settlement quota in October, Beijing refrained from extending it. A plan to let foreign investors channel more money back into mainland shares was cancelled too, but that didn't stop capital inflows doubling to a near-record in October – about when the "trade-related" currency facility got maxed out.



*A \$100 banknote is placed next to 100 yuan banknotes in this picture illustration taken in Beijing October 16, 2010. REUTERS/Petar Kujundzic*

Even bigger may be the fear that hot money could flow the other way. China's banks are rich in deposits, which allows them to lend at low cost – but savers are penalized with low, and sometimes negative, returns on their deposits. They have tolerated that for years. But a thriving offshore market gives more opportunities for funds to be spirited out of the system. A depleting deposit base, even at the margin, would trouble China's monetary policy makers.

The yuan plan is probably here to stay. A globally accepted yuan would bring some tangible benefits for China in the long term, making the country's trade flows less vulnerable to currency fluctuations. It might one day create a credible alternative to the dollar that befits China's giant economy. But the thing about long-term goals is that they are easy to put back by a year or two. In 2011, reinforcing the capital dam may simply be a greater priority than dominating the world's currency markets.

*Published December 2, 2010*

## **KEEPING THE CROWN**

BY WEI GU

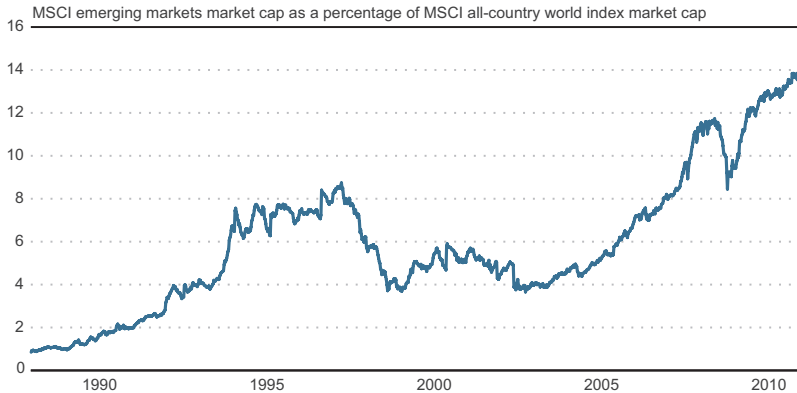
General Motors' triumphant return to Wall Street towards the end of 2010 showed that New York can still get the world's biggest capital markets deals done. But it was the Chinese exchanges that came out on top, and are likely to do so again in 2011.

China's big lead over its competitors will be difficult to trump. Hong Kong, Shanghai and Shenzhen together raised \$110 billion in initial public offering proceeds in the first eleven months of 2010, 1.4 times the amount raised in New York, Nasdaq and London combined. Greater China bourses received 46 percent of the global IPO volumes.

A few long-awaited big deals pumped up the numbers. Agricultural Bank's \$22 billion IPO flattered Shanghai's total, while Hong Kong hosted a portion of AgBank and also insurer AIA. New York had GM, the year's biggest IPO. But strip these three out, and the Chinese exchanges still raised twice as much as their biggest Western counterparts.

## **BREAKINGVIEWS**

## Emerging equities market cap share



Sources: Thomson Reuters Datastream, MSCI

Three themes should keep China's markets well stocked. Privatisation is one: though AgBank may have been the last of China's big bank privatisations, smaller deals such as Citic Group and Bank of Zhengzhou are still waiting. Fast-growing high-tech companies too are in great supply, such as Internet holding company Oak Pacific Interactive and anti-virus firm Qihu 360.

Then there are foreign firms, who may finally be able to list in Shanghai on a designated market in 2011. For global companies with their eye on China, such as lenders HSBC and Standard Chartered, listing shares in China would help to raise yuan capital for investment, and create a new currency with which to pay local employees. Hong Kong will continue to attract global brands who want to tap the "China premium" – with Prada and Samsonite already rumoured.

Other exchanges are unlikely to take this lying down. Nasdaq has always been the preferred home for Chinese Internet companies. Besides prestige, New York Stock Exchange brought 2010's Chinese IPOs such as SouFun Holdings and Country Style Cooking big first-day share gains. Singapore's

planned merger with Australia's ASX may set a precedent for those hoping to snag Chinese IPOs.

Still, China has two advantages: pent-up demand, and the ability to keep companies at home. New rules on foreign company structures have made it harder for domestic companies to list abroad. Foreign private equity firms have been encouraged to form yuan funds so they flip their investments locally. The launch of a growth market helped Shenzhen become the world's busiest exchange, with over 270 listings in 2010, three times more than Nasdaq.

This creates opportunities for ambitious Chinese brokerages. The top five underwriters in Asia during the first nine months of 2010 were all Chinese, led by CICC. Chinese megabank ICBC even popped up abroad, on the IPOs of GM and Petrobras. As China's capital markets expertise grows, traditionally dominant Western underwriters like Goldman Sachs and Morgan Stanley will have a fight on their hands.

*Published December 22, 2010*

## **BUMPY PLAYING FIELD**

BY MARTIN HUTCHINSON

The forces of globalization have been challenged by new global market barriers in the Great Recession. In 2011, the de-globalization process even could gather pace if commodity prices continue their surge or if there is another financial crisis.

The globalization of the last 20 years has been partly due to technology. The Internet and cellphones enabled companies to construct global supply, manufacturing and distribution networks not previously feasible. China, India and other emerging markets became integrated into the global economy, reducing costs for consumers and creating new demand. Since the formation of NAFTA and the World Trade Organization in 1994 and 1995, regulation has played only a minor role in greasing the process. Conversely, expansive monetary policies – which have reduced risk premiums for emerging market debt and produced pools of risk-seeking equity capital – have been critical.

## **BREAKINGVIEWS**

The technology is not going away, although the cost advantages of global sourcing decline as emerging market wages rise. But the recent crisis has brought a rise in anti-dumping actions and other limited tariff barriers. In addition, the disruptions from continued high global liquidity have led to currency manipulation by China, capital inflow taxes in Brazil and Thailand, and a general reduction in global economic cooperation, with the Free Trade Agreement between the European Union and Korea the notable exception.

The crisis may have passed its moment of greatest intensity. But political pressures in Western countries beset by prolonged high unemployment should continue these trends in 2011, counteracting technology's encouragement of further globalization.

There is an additional risk. A new financial crisis, or an inflation surge, could lead to sharply higher real interest rates, reducing the funds available for emerging market investment and raising risk premiums. China and other



*A migrant labourer works at a construction site in Shanghai August 1, 2010. REUTERS/Ally Song*

East Asian countries with high savings rates might have little difficulty in such a scenario, but India, with middling savings rates and an excessive budget deficit, could suffer from scarce capital availability. For the duration of the tight money period, globalization could grind to a halt, or worse.

Globalization is mostly economically beneficial, but by no means inevitable. In the next few years it may even reverse.

*Published January 4, 2011*

## **DON'T BLAME THE WEATHERMEN**

BY JOHN FOLEY

Food prices are rising to dangerous levels. There is talk of a coming crisis, like the ones that produced riots around the world in 2008 and 1974. Many of the ingredients of a disaster are present, but governments can stop it before it causes too much damage.

A warning sign is the price of traded staples like wheat, corn and rice. Prices shot up in 2010, soaring 20 percent from June to October and brushing 2008's peaks, according to the United Nations' FAO Food Price Index. That hits poor countries which import much of their food, such as the Philippines, Mexico, Nigeria and Pakistan. High prices deprive the poor, who already spend as much as half of their income on food. The market still clears, but at a riot-inducingly high price.

For most big countries, food prices are a domestic affair. Just 12 percent of cereals produced are traded across borders. In countries that grow their own, like China, Russia and India, buyers often pay government-set prices that have little link to global markets. Yet the self-servers are suffering too. China, which only really uses global markets for soybeans, is fretting over soaring shop prices for everything from pork to seaweed. In India, a fifth of the population is undernourished, according to the United Nations. Both countries have their quirks – in India, awful infrastructure means a third of produce spoils before it reaches the market – but something is clearly making the problem worse.

It isn't shortages. True, demand for staple grains is predicted to rise 2 percent in 2011, even as production falls 4 percent. But grain reserves run to almost 17 percent of total usage, according to Rabobank, around the level generally seen as a sensible buffer. Nor are the main problems population trends or changing eating habits in developing markets. That extra demand may be making the world a bit more crisis-prone, but more productive, mechanised farming methods in China, India and Africa have potential to create some slack.

The main cause looks to be too much money. Governments have effectively printed the stuff to help their economies recover. This has created two side effects. First, investors have bought exposure to commodities as an economic hedge. Second, the price of foodstuffs has been bid up as low interest rates reduce the opportunity cost of hoarding them – especially in China, where money supply grew by almost 20 percent in 2010.

Whether those high prices turn into a crisis depends on two things. First, short-sighted policy responses. Food producers often ban exports when they fear shortages or price spikes are coming. Sometimes they are right to worry – Russia's recent droughts have left it with a genuine wheat shortfall. But India introduced a rice export ban in 2007 when it still had a sizable surplus, helping to double the world price. By 2008, over 30 countries had some kind of controls in place. Export bans cause bubbles abroad; they also stop farmers from benefitting from high prices that would get them growing more.

The second flash point is the oil price. That increases transport costs for food. But it also encourages politicians to divert grains into biofuels, which become competitive when oil hits \$60 per barrel. The average oil price in 2011 is forecast at \$84, according to a Reuters poll. The United States, which supplies two-thirds of the world's corn exports, diverted huge amounts into biofuel in the run-up to 2008's crisis, causing 70 percent of the rise in corn prices, according to the IMF. That distortion was passed straight on to the world's poor.

Food riots in 2011 are possible, but not inevitable. Granted, the world will have to get used to more food scares as the population expands and the diets

of the poor get richer. But the moment when humanity outgrows the earth is thankfully not yet here. Cool-headed policies can still prevent a real crisis.

*Published December 28, 2010*



## CHAPTER 2

## THE OLD WORLD: EUROPE

**NO TIME TO SHORT**

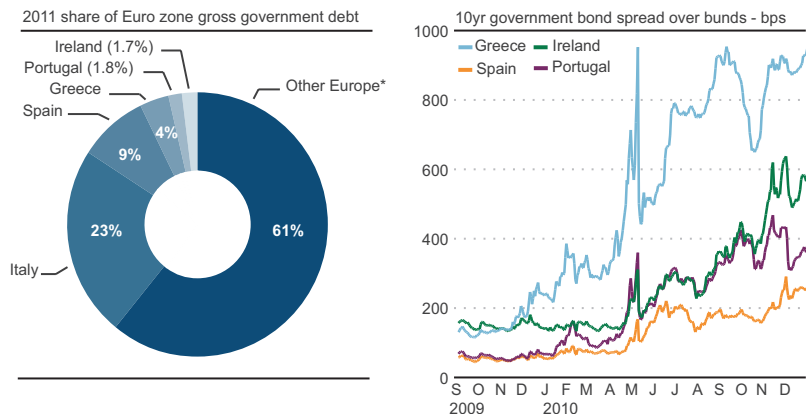
BY PIERRE BRIANÇON

Call it a serious credibility gap. European leaders' protests that the euro is for real, and that the common currency isn't facing the risk of implosion, are failing to convince. The game of dominoes – first Greece, then Ireland, now possibly Portugal, Spain and why not Italy and Belgium – is raising speculation that the 12-year old euro itself could end. It's too bad that the EU leaders' hesitations, conflicting statements, different agendas and overall bumbling have hit their credibility to the point that no one seems to listen when they talk. For they're right on the main issue: the euro will not implode.

Look at it from a reverse angle: what would the "death of the euro" look like? One of the smaller, weaker, so-called "periphery" members deciding to leave it? This would not prevent the rest of the zone from ploughing ahead, and in any case the event is near-impossible: in most conceivable scenarios the pain of leaving is higher than the pain of staying. Even more so for smaller countries, which depend most on foreign creditors and banks: leaving the euro, presumably with a default, would mean that most public debt would instantly be recast as foreign debt, and the new currency immediately weaken. There would no doubt be immediate competitive advantages, as for any devaluation, but the higher cost of foreign goods would also mean imported inflation. Meanwhile even more stringent fiscal plans would be needed to overcome markets' hostility (unless, that is, the departing country's government decides to opt for the North Korean model).

Would the end of the euro be triggered by one of its larger members heading for the exit? It's hard to fathom the political or financial circumstances that would make Spain or Italy want to leave the euro – considering that their leaving, just like for smaller members, would incur costs far higher than the supposed benefits. But the euro could go on nonetheless.

## Euro zone government debt and bond spreads



Sources: Thomson Reuters, OECD Economic Outlook

This wouldn't be the case if one of the two major players that created the euro, France or Germany, decided it would be better off without it: this would definitely be the final implosion. But that scenario ignores the sheer strength of the political will, both in France and Germany, that created the common currency and still keeps it together. "Pundits are underestimating the determination of governments", ECB President Jean-Claude Trichet rightly said on Nov. 30. The euro certainly was a political creation, but market operators are mistaken in thinking that it is, therefore, less solid. For either Paris or Berlin to give up on the euro would suppose events of such a magnitude – say, a far-right populist government taking over in Paris or Berlin, or irreconcilable differences on the ways to fight out-of-control inflation – that European unity would by then have become the least of anyone's concerns.

Finally – and this is also something markets underestimate – there are prosaic, practical obstacles to unwinding the euro. It would be hard to put the paste back into the tube. The example of Czechoslovakia, splitting up peacefully into the Czech Republic and Slovakia, shows that it's not

inconceivable. But the process would be lengthy (think only of the time needed to print bank notes and mint coins), hardly adapted to the type of crisis scenario that would suppose a euro implosion. Of course, Yugoslavia is also an example of how best to undo a currency: it took a five-year war to tear the country into seven different independent republics – one of which, incidentally, has since adopted the euro, while others are trying to join the EU.

*Published December 1, 2010*

## **AXEL GREASE**

BY PIERRE BRIANÇON

“Major pan-European institution, located in Frankfurt (Germany) seeks president for an eight-year, non-renewable term, starting in November 2011. The candidate must have some training and experience as an economist in the public or academic sphere. He must be able to act calmly and independently under pressure while handling sizable budgets. He must show strong capacities at team building, and be able to lead a group of sixteen executives from diverse backgrounds. Basic salary, €360K/pa, plus allowances and health care. Send resumé to European Council, Brussels, Belgium, for review and decision, first semester 2011.”

Does Axel Weber still want the job, as described in this faux advertisement? And are euro zone leaders ready to make him president of the European Central Bank? As head of the Bundesbank, the German central bank, Weber has been the hot favourite ever since Vítor Constâncio, formerly the governor of the Portuguese central bank, was appointed ECB vice president. One of the institution’s informal and not-so-subtle rules indicates that both the “north” and the “south” of the euro zone must be represented at the top of the central bank.

The north/south divide is often, and sometimes wrongly, equated with inflation hawks versus doves. In any case Constâncio’s appointment was taken as a sign that Axel Weber’s candidature had been informally approved by the French, whose de facto approval is required. But the debt mess has prompted a rethink. Weber has raised eyebrows – and not only in France – by voicing opposition to the ECB’s increasing, albeit reluctant, attempts to alleviate the euro zone’s financial difficulties.

That said, Weber has been careful. By toeing the Berlin line, the Buba boss has tried to ensure that chancellor Angela Merkel will not nominate another German candidate to head the ECB. Yet while sticking to a hard line in Frankfurt and Berlin, Weber has also made more dovish comments in France.

Some euro zone members think, or hope, that Mario Draghi, currently the head of Italy's central bank, has become a more credible rival. There's no doubt that Draghi is well qualified – he's a fiscal disciplinarian, a monetary hard liner, and has high-grade international experience as head of the Financial Stability Board. He also has the deft political touch that sometimes eludes Weber. Adversaries might suggest that he shouldn't be taken seriously because he is too close to the markets: Draghi once worked for Goldman Sachs, although he only stayed at the U.S. bank for two years. That he hails from Italy might also count against him. His homeland country is away from the center of the euro debt storm, but it still feels



*Managing Director of the International Monetary Fund Dominique Strauss-Kahn (L) talks to European Central Bank President Jean-Claude Trichet (R) during a euro zone finance ministers meeting at the European Union Council in Brussels December 6, 2010. REUTERS/Thierry Roge*

the strength of the winds. But Draghi's record, especially in terms of fiscal discipline, should be strong enough to drown out the naysayers.

If not Weber or Draghi, the euro zone might appoint a reformed or out-of-work politician eager for a comeback as a compromise candidate. This is a poor option. Much better would be to drop the horse-trading nationalism that too often dominates decisions about top international jobs and focus on the genuine merits of candidates. In that ideal scenario Nout Wellink, the current head of the Netherlands' central bank, would be among the top contenders. But in this highly politicized process, his chances are unfortunately close to zero just because the first president of the ECB, Wim Duisenberg, was Dutch.

In any case Angela Merkel seems to think Germany has been promised the job. After all, didn't she support Nicolas Sarkozy when he nominated a French man, Dominique Strauss-Kahn, for the International Monetary Fund's top job back in 2007?

The promise to Germany, if it exists, is neither firm nor official. But if President Sarkozy wants to deliver anyway, he may be comforted with the thought that the ECB, faced with the challenges ahead, has to help make the consequences of the financial crisis less dire. And who better than a German ECB chief could convince Berlin that a more accommodating approach is necessary?

The odds are still that Weber will get the job – if he retains the confidence of the French.

*Published December 21, 2010*

## **MEDVEDEV OR PUTIN?**

BY JASON BUSH

The uncertainty of the 2012 presidential election will loom over Russia's business climate in 2011. The government's official candidate will win. But who will it be? Will reform-minded incumbent Dmitry Medvedev run for a second term? Or will his steely predecessor, current premier Vladimir Putin, stage a Kremlin come-back?

Conventional wisdom has it for the second scenario, with Medvedev rolling over as if he was his mentor's puppet. But Reuters Breakingviews predicts that – with Putin's consent – Medvedev will be allowed another crack at the top job. Here's why:

- 1. He wants it.** Medvedev's statements leave little doubt. He "doesn't exclude the possibility...if there is public support" – politician-speak for "you betcha!" Putin has been far more ambiguous. Both leaders repeat the mantra that the decision will "depend on the situation in the country" – a formula for continuity. How likely is it that they would suddenly declare the situation so urgent that it requires a leadership change?
- 2. He can't be humiliated.** Given Medvedev's stated ambitions, his demotion would be an ignominy. This could cause tension within Russia's elite. After three years in the job, Medvedev has appointed numerous state officials, curried favour with business interests, and attracted elements of the intelligentsia with reformist rhetoric. Why disappoint them?
- 3. Putin is OK with it.** He has no reason to be unhappy with the status quo. Above all, he values stability. Russia weathered the global economic crisis without serious upheavals. Despite economic challenges, Putin remains popular. Medvedev's ratings have risen steadily and he is now as popular as Putin: he can now be "sold" to the public.
- 4. Russia doesn't want to be a joke.** Putin's return to the Kremlin would be viewed negatively in the West. It would be seen as a conservative backlash. That would be inconvenient to Putin as he devotes much of his energy to promoting Russian business interests abroad. Medvedev's pro-Western reputation helps him make up for Russia's poor image.
- 5. The hard-liners' power isn't absolute.** The popular view that Putin is hostage to ex-KGB hardliners who will insist on his return to the Kremlin exaggerates their influence. Putin's decision to anoint Medvedev as his heir three years ago showed that he's the one who decides. This will also be the case in 2012.

*Published December 23, 2010*

## CHAPTER 3

## THE NEW WORLD: THE AMERICAS

**ELEPHANT STAMPEDE**

BY JAMES PETHOKOUKIS

The Federal Reserve economic forecast is bleak. It predicts high unemployment will plague the rest of President Barack Obama's four-year term. The assessment provides the strongest reason yet for any Republican who ever dreamed of occupying the Oval Office to launch a campaign in 2011 to be the party's candidate to challenge Obama in November the following year. And many will. But the president remains a formidable opponent.

The midpoint of the November 2010 economic outlook from Fed policymakers has unemployment ending 2012 at around 8 percent. Even if Obama's trillion-dollar stimulus spared millions of jobs, Republican candidates will surely remind voters that the president's economic advisers promised to keep unemployment from ever hitting that lofty level.

Obama's team likes to compare its political plight to that of President Ronald Reagan. Unemployment was 8 percent or higher for half of the Republican's first term, the last time the country experienced a recession anywhere near as bad as this latest one. And Reagan still won by a landslide. But the economy was racing and the jobless rate tumbling when he faced voters in 1984. Another White House incumbent who looked a guaranteed loser was Harry Truman in 1948. But blistering 7 percent GDP in the first half of that year helped Truman pull off the biggest upset in U.S. presidential election history.

Obama probably won't have such wind at his back. An overhang of debt and housing problems should keep GDP growth moderate. Some at the Fed also reckon that even if growth picks up sharply, workers still won't have appropriate abilities for available positions.

Perhaps with that in mind, a herd of Republicans are sure they have just the right skills for Obama's job. The frontrunner, whether measured by polling,



Buttons are seen for sale at a Tea Party Express rally where former Alaska Governor and 2008 Republican vice presidential nominee Sarah Palin spoke, on Boston Commons in Boston, Massachusetts April 14, 2010. REUTERS/Brian Snyder

financial or betting market performance, is Mitt Romney, the former Massachusetts governor and head of private equity firm Bain Capital. But he will need to contend with a group of rivals that may include Sarah Palin, Minnesota Governor Tim Pawlenty and Senator John Thune of South Dakota. By late spring, the crowded field will be set.

GOP contenders shouldn't get cocky, however. By 2012, Obama could have unexpected economic improvements to boast about. And the president's own finances should be sound even if America's aren't. He could raise \$2 billion for a second run – and sitting U.S. presidents rarely lose. What's more, midterm election beatings seem to have little bearing on re-election odds. For now, those too are working in Obama's favor, suggesting a better than even chance at four more years.

*Published December 29, 2010*



## ENDING THE AMERICAN NIGHTMARE

BY AGNES T. CRANE

Could the U.S. government stop subsidizing mortgages altogether? Probably not in real life. But that is where the debate over reforming Fannie Mae and Freddie Mac, as well as righting the public-private sector balance in housing, should begin.

This unlikely dream imagines the government out of the business of guaranteeing housing finance within 10 years. That should be long enough to phase out subsidies slowly, preventing the still fragile housing market from dropping further. It would give private-sector banks time to absorb an estimated \$5 trillion of government-backed mortgages. And it would wean homeowners gently off the subsidized financing they've grown accustomed to. Just as importantly, though, 10 years is short enough to focus minds now.

The Treasury, due to propose ideas for Fannie and Freddie in January, has been prevaricating for two years. And the indecision has made the not-so-dynamic duo more powerful. They currently guarantee the highest percentage of U.S. home mortgages seen in the last 20 years, according to Barclays. They enjoy unlimited access to taxpayer funds and have expanded their affordable housing mission to include the well-off.

By laying out a clear exit plan in 2011, legislators could reverse the expansion that has already sucked down more than \$150 billion of taxpayer funds. It would also make it easier to roll back emergency measures put in place at the height of the recent crisis. For example, Fannie and Freddie are still guaranteeing roughly \$730,000 loans in high-cost areas even though the private sector is again strong enough to provide loans to rich homebuyers. Without a deadline such temporary measures risk becoming permanent.

While they are at it, U.S. lawmakers should consider ending the deduction of mortgage interest for tax purposes. It's another subsidy for home ownership – though it probably partly defeats itself by making homes more expensive at the same time as it makes mortgages cheaper.

Most important, though, is to start by re-examining the policy goals underlying today's subsidies: how far should the government push home ownership, and how

much support for affordable housing should be focused on buying rather than, say, renting. The usual Washington tinkering with the status quo isn't enough. To create a new, sustainable American dream, lawmakers need first to wake up.

*Published January 3, 2011*

## **BEEN HERE BEFORE**

BY MARTIN HUTCHINSON

Brazil's economy looks headed for disappointment in 2011. The country's public sector – too big and too indebted – has always been the country's weak link. Public spending has soared in 2010 and under newly elected President Dilma Rousseff is set to increase further. Easier money runs the risk of causing uncontrolled inflation and a debt crisis.

Brazil's public spending exceeds 40 percent of GDP, very high by emerging market standards. Rousseff has paid lip service to getting it under control, but during her recent campaign she said defending public spending cuts was a "crime." The public sector deficit in the 12 months through September was only 2.4 percent of GDP, but that includes \$42 billion of Petrobras stock transferred to the government for oil rights. And it doesn't include 171 billion reais (\$99 billion) in the year to October in development bank lending at subsidized rates funded by capital injections from the government.

With Rousseff's expansive attitude to the public sector, and monetary policy potentially less tightly controlled now that Henrique Meirelles has departed the central bank under pressure, Brazil looks headed towards larger public sector deficits and higher inflation. While global liquidity remains robust, debt and equity capital will no doubt flood in to balance the books.

Indeed, the recent 6 percent tax on capital inflows reflects Brazilian concern about upward exchange rate movements from such flows. Yet even now, while foreign investors hold two-thirds of the country's domestic debt, 84 percent of its obligations remain in foreign currency. Brazilian equity values, concentrated in commodity-producing behemoths like Petrobras and Vale, could also quickly decline if government meddling in those companies' operations was accompanied by a fall in commodity prices.

## BREAKINGVIEWS



*Shamans hold a photograph of Brazil's President-elect Dilma Rousseff as they perform a ritual for new year wishes in Lima December 29, 2010. The shamans wished for good luck for the new Brazilian government. REUTERS/Mariana Bazo*

Such declines could well occur if global liquidity is curtailed amid concerns about rising inflation, for example. That would widen Brazil's current account deficit, currently 3 percent of GDP, rapidly eat into its \$286 billion of foreign exchange reserves and worsen its debt position through the massive currency mismatch. In such a scenario, Brazil would revert to a position it knows from past experience: uncontrolled inflation and a hampered ability to service its foreign debt.

*Published November 30, 2010*

## **HOGARTH'S LATIN APPRENTICES**

BY MARTIN HUTCHINSON

Latin American economic policy has diverged toward extremes. With Hugo Chávez's Venezuela and Sebastián Piñera's Chile leading the way left and right, few countries now occupy the "Washington consensus" middle

ground or its variants. The strains and benefits of extreme policies are already showing, but full results will await the next credit crunch.

Latin American countries have historically tended to pursue similar economic policies. In 1960-80, there was considerable state control, often by undemocratic governments, with heavy state borrowing for investment in heavy industry. In the 1990s the centrist "Washington consensus" policies were in vogue, with subsidies and tariff barriers reduced, heavy industries privatized and economic interaction between countries increased. However continued central control of economic policy, poor education systems, pervasive cronyism, corruption and heavy government spending, as well as persistently low commodities prices, prevented an Asian-style economic takeoff and brought increasing income polarization.

Since 2002 commodity prices have soared, removing most constraints on Latin American governments' finances. In Venezuela and Argentina, this freedom has been used to expand government spending, expropriating private assets when funds get tight and largely closing the economy. Bolivia, Ecuador and Nicaragua have joined this group, which has had mixed success economically; current projections by the Economist magazine's forecasters suggest Venezuela remains mired in decline while Argentina has resumed brisk growth after the 2008-09 recession.

At the other extreme, Chile even under the center-left government of Michelle Bachelet built up a \$19 billion stabilization fund that cushioned the recession and has now embarked on a policy of free-market growth. Colombia has joined the free-market group and Peru is showing signs of doing so.

Brazil and Mexico remain imponderables. Brazil privatized during the 1990s, but has increased public spending recently. President-elect Dilma Rousseff has indicated she wants to see more state intervention in the economy and has replaced the monetarily cautious central bank chief. Mexico, in spite of a center-right government, never privatized its key energy sector. With the left well positioned for Mexico's 2012 election, continued cheap money may drive both countries leftward.

Other than in Venezuela, while money remains cheap there may be only modest differentiation between the economic performance of Latin America's two groups. The next credit crunch, possibly in 2011, will however sort them effectively.

*Published December 27, 2010*

## CHAPTER 4

## THE FINANCE BUSINESS

**LATEST SQUEEZE**

BY ANTONY CURRIE

This might seem like an unlikely time for a bidding war for investment bankers. After all, the industry's high-paying culture is still under scrutiny from regulators and politicians. And new capital rules and economic uncertainty mean returns may be lackluster again in 2011. So why is Wall Street limbering up for a battle for talent?

Strange as it may seem, anemic earnings have much to do with it. In recent quarters, the likes of Goldman Sachs and JPMorgan's investment bank generated a return of equity in the low teens at best – barely beating the



*Lloyd Blankfein (C), CEO of Goldman Sachs, reacts while listening to testimony before a Senate Homeland Security and Governmental Affairs Investigations Subcommittee hearing on Capitol Hill in Washington, April 27, 2010. REUTERS/Jason Reed*

## BREAKINGVIEWS

cost of equity. That puts the onus on executives to squeeze as much from their franchises as possible.

Some of that will come from cutting costs, including ditching employees who aren't bringing in the bacon, and from using expensive capital in smarter ways. But lower returns also mean any firm with pretensions of being a top tier player – in other words, all of them – will want the best people. And not just traders. Relationship bankers should be hot property, too. Outside Europe, the advisory and underwriting business has been fairly robust. It is also less capital-intensive.

Some firms took advantage of the crisis to lure bankers from defunct or wounded rivals. In the United States, Jefferies has been a big beneficiary, as have boutique advisory firms. Morgan Stanley has hired around 400 traders over the past 12 months. But the so-called “burning platforms” like Bank of America Merrill Lynch, Citigroup, UBS and RBS have largely recovered and are expanding again.

What's more, many bankers have far less skin in the game than before the crisis. Stock grants made in the boom have either mostly vested or are still out of the money. Much of the equity awarded in last year's bonus round has fallen in value.

That will embolden executives to go on the hunt. It must look like an embarrassment of potential riches for both sides. The danger, however, is that this will just drive up costs across the industry at a time when revenue is under pressure. If the bidding wars get out of hand, there could be red faces all round.

*Published December 29, 2010*

## **BLAST FROM THE PAST**

BY JEFFREY GOLDFARB

M&A bankers should prepare for a surge. If deal activity follows a similar pattern to previous cycles, 2011 ought to be a considerably better year.

The climb out of the doldrums has been slow. It took nearly 11 months for the 2010 deal tally to surpass the \$2 trillion notched up over the course of 2009. Economic uncertainty left companies only tentatively deploying their stockpiles of cash. Private equity firms were similarly cautious, or deterred by demanding valuations, despite having \$500 billion of dry powder. Blackstone's attempt at the industry's first post-crisis \$10 billion buyout, of Fidelity National Information Services, unwound quickly in the spring. Not even whispers of another one emerged.

The big deals that did get announced looked painstaking to complete. Mooted cross-border takeovers of U.S. biotech Genzyme by French pharmaceuticals giant Sanofi-Aventis and of British broadcaster BSkyB by lead shareholder News Corp are limping along. They could yet go the way of miner BHP Billiton's blocked offer for Canadian fertilizer giant Potash Corp and Prudential's failed attempt to build an Asian insurance powerhouse with a tilt at AIA.

There have been some juicy transactions, such as PepsiCo's agreed \$5.4 billion bid for Russian drinks group Wimm-Bill-Dann. But these are notable for being the exception. More often bankers have been busy with smaller, or humdrum, deals, like Coca-Cola buying back its own bottling system.

Still, the omens are favorable. In previous periods of depressed merger activity, there has been a clear bounce back by the end of the second year following the trough. For example, deal volume in 1991 was down 41 percent from its peak in 1989, according to Thomson Reuters data. By 1993, it was up by a third. Following two awful years in 2001 and 2002, when global mergers plummeted from \$3.4 trillion to \$1.2 trillion, there was a 56 percent surge from trough levels in 2004.

In the current downturn, the 2009 nadir was a 52 percent decline from the peak in 2007. If there is a rebound, and the pace of recovery relative to the pace of decline is roughly the same as in previous M&A cycles, then there should be about \$2.7 trillion worth of acquisitions in 2011. That may feel like a bonanza given the current climate. Alas, it would only take deal activity back to the levels seen in 2005.

*Published December 17, 2010*



## NOT ENOUGH BANKERS?

BY ROB COX

Bankers in the oil and gas business know a thing or two about the laws of supply and demand. But they're not accustomed to being the commodity in question. Some of the world's cities may be overrun with financial types, but with energy sector activity rising they're scarce in swampy, sprawling Houston. Bankers there may benefit accordingly in 2011.

As when rationalizing the price of crude, reasons for the popularity of energy specialists are easy to find. There are more buyers than ever for their talents, and there is a limited supply of professionals with both financial skills and those of a petroleum engineer or geophysicist.

First, the demand side of the equation. By one recruiter's count there are some two dozen managing director positions open in Houston at firms ranging from advisory house Lazard to Canadian powerhouse Bank of Montreal. Their hope is to grab a bigger slice of one of the few investment banking fee pools that's expected to grow nicely in 2011. So far this year, energy deals worth \$462 billion accounted for 21 percent of worldwide M&A – the highest percentage on record, according to Thomson Reuters data. In the United States, the share was even higher, 29 percent, making it the most active sector for deals.

Wall Street's top banks are trying to retain their positions as consiglieres to titans like Exxon Mobil and Chevron. But at the same time they're struggling to keep pace with the growing spectrum of equipment makers, seismic technologists, nimble drillers and pipeline operators whose valuations have been lifted by robust prices for crude, emerging markets' thirst for resources and a boom in U.S. natural gas activity.

Meanwhile, the global competition for hydrocarbons has brought new players into the business. Banks from Canada, Asia and Europe are trying to keep up with the rapidly expanding horizons of once-domestically focused oil groups, such as China's CNOOC, or India's Reliance. That requires on-the-ground expertise not just in Houston but in other centers of energy expertise such as Calgary, Rio de Janeiro and Toronto.

Now, what about supply? As far as Houston is concerned, a Gulf of Mexico posting may sound like hardship next to Paris. But it's not just that Hermes-tied bankers don't fancy the blue-flamed landscape of Texas City's refineries at twilight.

To be a credible adviser in the oil patch, it also helps to have a background in the business – for example as a former petroleum engineer. Some grey hair and a Texas drawl can also make locally based clients feel more at home. Since many banks only opened sizable outposts in Houston over the past decade, the selection of qualified talent isn't that big.

That explains Stephen Trauber. The former head of UBS's energy practice, along with a gaggle of colleagues, defected to Citigroup earlier this year for a pay package that news reports pegged at \$30 million. Because Citi already had a strong energy group – it actually ranked ahead of UBS in the corporate finance rankings – Trauber was named one of three co-heads.

Remarkably, Citi has thus far managed to retain the bulk of its existing team. The end result is that despite the movement of the UBS team, no new supply has been put into the market. UBS has simply joined the list of banks trying to beef up their presence.

There are ways to fill the Houston talent gap. Some banks say they may dispatch troops from cities where energy corporate finance activity, or the ability to generate juicy fees, has slowed of late, including London and Dubai.

The other option is to buy one of Houston's smaller boutiques. That's what Merrill Lynch did in 2006 with the purchase of Petrie Parkman. At the time Merrill was struggling to rebuild its energy business after a scandal involving Nigerian barges and Enron. Independent firms like Simmons & Company and Tudor, Pickering, Holt say they're not interested in selling. They're too busy making lots of money.

But Simmons, focused on the oilfield service and equipment industry, saw its founder pass away earlier this year. And three-year-old Tudor, Pickering is about to embark on global expansion. Economic logic would suggest one of the many banks hoping to satisfy demand for a Houston build-up with limited supply will soon be sniffing around.

*Published December 13, 2010*

## MORE OF THE SAME

BY NICHOLAS PAISNER

With a record \$70 billion of aborted new issues, 2010 looks like a year that equity capital markets bankers will want to forget. But it has hardly been a write-off: booming business in emerging markets means global volumes are set to be about 10 percent lower than in 2009, when company balance sheets underwent mass repair. Deal flow in 2011 should be comfortably higher if there is a sustained rebound in M&A financing and Western initial public offerings. But much depends on whether the market's festive cheer holds up.

Governments, financials and buyout firms are all keen to sell shares in both primary and secondary issues. The snag is that macro jitters mean that markets face further periods of temporary closure in between bouts of exuberance. Getting deals away in the good spells will be crucial.

Financials should keep the ECM business covering its costs. The largest lenders may say they can earn their way to higher capital levels. But expect a few big banks to follow Standard Chartered and raise capital opportunistically. M&A financings with a regulatory top-up – like Deutsche Bank's outsized rights issue for its full takeover of Deutsche Postbank – may feature too. Another big ticket will be Banco Santander's flotation of a quarter of its huge UK operations to raise capital.

Privatisations should also be plentiful, although governments can be tight on fees – especially in emerging markets. Russia and Poland plan to sell a string of assets; the UK may start offloading its bank holdings.

IPOs will be the key variable. Asia will remain the engine, even if investors need some time to digest recent jumbo deals like insurance giant AIA's \$20 billion float. Volumes in Europe, the Middle East and Africa could rise by up to 100 percent from this year's \$43 billion, one hopeful ECM chief reckons, driven by exits for ageing buyouts whose floats were deferred in 2010.

The United States could also provide a big boost from recent depressed levels of activity. Excluding General Motors' \$18 billion offering, U.S. IPO volumes this year have been around half the \$32 billion annual average of the past decade.

Market volatility will doubtless make it harder to get the more speculative deals sold. But there's enough pent-up share issuance to suggest ECM will enjoy a profitable – if erratic – year.

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## **EXPLOITING THE SOFTNESS**

BY JEFFREY GOLDFARB

The buyout industry should slowly emerge from its fundraising drought in 2011. After having more capital returned to them in 2010, investors will be more inclined to put money into private equity. But it's still a buyer's market, and the time is ripe for investors to push hard to overhaul the fees they pay.

It has been a brutal two years for LBO firms seeking fresh funds. It took the last seven quarters to match the \$365 billion the global industry raised in the first six months of 2008, according to research firm Preqin. There could be fresh momentum after an uptick in successful exits in 2010 and with big initial public offerings of HCA, Nielsen and Toys R Us among those teed up. But it still won't be easy for private equity firms to raise new capital.

Blackstone provides a cautionary tale. The blue-chip buyout shop expects to close its sixth fund with nearly \$15 billion. It's an impressive sum – but still only about two-thirds of its last effort. Meanwhile, BC Partners, the European firm, after selling several portfolio companies onto public markets this year, is ambitiously gunning for 6 billion euros, a little more than the fund it closed in 2005. Rivals that lack the brand equity and investment record of such industry giants will struggle to get anywhere near what they have raised before.

Even the best of breed, however, could find themselves over a barrel if investors find the will to use their negotiation leverage. Again, Blackstone provides some insight, at least on a small scale. The firm agreed to share 65 percent of any deal-related fees with its limited partners, up from 50 percent. That's nice, but there's more chiseling to be done.

First, investors should pound away at management fees. Most firms take out 1.5 percent, even on funds that aren't yet invested. The coming year presents an opportunity to pare back these fees, providing an extra incentive for private equity firms to find appropriate investments.

Second, the distribution of carried interests should be revisited. As it stands, buyout bosses immediately start receiving their 20 percent cut of increased valuations. For instance, take the example of a \$1 billion fund with 10 investments of \$100 million. If the first portfolio company sells for \$200 million, \$180 million is returned to investors. But the firm's managers also extract \$20 million – even though investors have yet to be made whole on their full commitments.

With many buyout firms fighting for survival and others hard-up for fresh funds, there's an opportunity for investors to reform the private equity model in their favor. They shouldn't squander it.

*Published December 21, 2010*

## CHAPTER 5

## FINANCIAL REGULATION

**PREVENTION OR CURE?**

BY PETER THAL LARSEN

The “too big to fail” problem will be partly fixed in 2011. Global regulators should end up agreeing to make a select group of big global banks hold higher levels of capital. That will make them safer, while removing some of the benefit they get from being big. But eliminating the taxpayer guarantee enjoyed by large lenders will require more fundamental measures. That will take years to achieve.

Regulators everywhere agree that banks deemed too big to fail are dangerous. Because of their importance they enjoy implicit – and sometimes explicit – government support. As a result, large lenders tend to have higher credit ratings and pay less for deposits and wholesale funding. This encourages them to become even larger and more interconnected.

Broadly speaking, there are two ways to tackle this problem. One is to make big banks less likely to fail. The other is to reorganise them so that they can be allowed to fail without threatening the system. In 2011, regulators are likely to concentrate on the first option.

The Basel Committee on Banking Supervision, which sets global rules, is planning to make large and interconnected banks hold more capital. Most big bank executives believe they will be forced to hold an additional buffer equivalent to at least 3 percent of risk-weighted assets. This will take their minimum capital ratios north of 10 percent, compared to 7 percent for smaller lenders. The buffer may be in the form of so-called contingent convertible bonds, or CoCos: debt that converts into equity if the bank gets into trouble. However, small countries with large banks may demand even bigger buffers. Swiss regulators have already told UBS and Credit Suisse to lift their capital ratios to 19 percent.

Higher capital ratios will make big banks safer, while the cost of the extra equity will offset some of the benefits of cheap funding. But the approach has flaws. First, it's not easy to spot systemic banks. Lehman Brothers, for instance, was not particularly large by U.S. standards. But it was so enmeshed in the financial system – and its failure so chaotic – that it triggered a global meltdown.

Second, by drawing up a list of systemic institutions, regulators risk sending a signal that these banks are totally safe – essentially making a commitment to bail them out. That would make the too-big-to-fail problem even worse. Finally, national regulators are bound to interpret the rules differently, creating an uneven playing field.

The alternative is to restructure banks so that they pose less of a risk. Here – setting aside the draconian idea of breaking them up into small pieces – there are two broad schools of thought. The first is to force lenders to organise themselves so that they can be wound down safely. This is why regulators have asked large banks to draw up so-called “living wills”,



*U.S. Treasury Secretary Timothy Geithner (L) and Federal Reserve Chairman Ben Bernanke leave a ceremony to debut the new design for the US\$100 note at the Department of the Treasury in Washington, April 21, 2010. REUTERS/Jim Young*

setting out what they will do if they get into trouble. This could involve selling a business to raise extra capital. But it could also involve ring-fencing important bits of the bank, like those that take deposits or process payments, while declaring less systemic parts insolvent.

This is what the Federal Deposit Insurance Corp already does with smaller U.S. lenders. But designing rules to tackle large cross-border banks is harder: it probably requires most of the world's developed economies to introduce new rules, and that will take years.

Meanwhile, some regulators are pushing to introduce mechanisms that will allow them to recapitalise failing banks without winding them down or bailing them out. This approach – known as the “bail-in” option – involves converting a bank's debt into equity when its capital ratios fall below a certain point. The advantage is that the bank remains intact, while creditors take a haircut and shareholders suffer what Thomas Huertas, of the UK's Financial Services Authority, has dubbed “death by dilution”.

It's too early to say whether living wills or bail-ins – or some combination of the two – will prevail. As long as the problem remains unsolved, politicians and regulators will remain under pressure to resort to more radical solutions, such as putting an explicit cap on bank size. Privately, regulators hope that the measures they do take will eventually prompt big lenders to voluntarily shrink or dissolve into their constituent parts.

What is clear is that just making big banks hold more capital will not solve the too-big-to-fail problem. But it is probably the best that regulators can hope to achieve in 2011.

*Published December 23, 2010*

## **IT'S THE FUNDING, STUPID**

BY HUGO DIXON

Running out of cash – rather than insolvency – is what causes financial crises such as the euro zone's. Yet the lion's share of the effort by policy makers around the globe has been to shore up solvency not funding. Unless that changes, the world will lurch from crisis to bailout and back again.

BREAKINGVIEWS



Ireland's bank crisis is only the latest example of how seemingly solvent institutions can be brought to the brink because they can't fund themselves. It was only four months ago that Allied Irish Banks (AIB) and Bank of Ireland were given a clean bill of health in the European Union's official stress tests. One weakness of these tests was that they only stressed solvency not liquidity, although that may be remedied next year.

Ireland's banks didn't have a large enough base of retail deposits. AIB's and BoI's loan-to-deposit ratios are just above 160 percent. That made them excessively dependent on wholesale money. When that dried up, they had to turn to the European Central Bank. When deposits from corporate customers also started to flee, emergency action was required.

Sadly, this is an all-too-familiar story. Funding was the Achilles' heel of banks that went to the brink in 2008. The likes of Lehman Brothers, Northern Rock, Washington Mutual, Royal Bank of Scotland and Fortis may have had inadequate equity. But death through insolvency is a slow one. Death, or near-death, through lack of liquidity is a rapid one.

If Portugal's banks also get sucked into the maelstrom, funding again will be the trigger. Banco Espírito Santo and Millennium BCP have high capital ratios; but they also have loan-to-deposit ratios of over 160 percent.

The issue isn't exactly the same for governments because they don't fund themselves through deposits. However, they do need to keep on rolling over debt as well as financing new deficits. The more stable their funding sources – typically if their own domestic private sector is flush with cash – the better.

The lack of such stable funding is the reason why the Spanish government is vulnerable. Its debt-to-GDP ratio is expected to end the year at 63 percent, below the euro zone average. But the country has a current account deficit of 4.4 percent of GDP – meaning it is dependent on attracting large sums of capital each year from abroad. The government's habit of funding itself with relatively short-term debt – it needs to refinance 149 billion euros next year – puts it even more at the mercy of the markets.

Unstable funding isn't just the main cause of crises; it also forces bailouts. It's thought too risky to let a bank (or government) go under because the creditors who get hurt will withdraw their cash from other banks (or governments) with similar funding profiles. That, indeed, was the experience with Lehman. It was also the argument used not to haircut the senior creditors of Ireland's banks. In a febrile climate, even such relatively small institutions are deemed too big to fail.

Given the danger posed by unstable funding, one would have thought policymakers would have done something about it. And they have done something: the new Basel III regime addresses the issue (which is better than Basel II, which didn't even mention it). But no action is required until 2018. Yes, 2018 – that's not a typo.

Similarly, some governments – notably the UK, France and Germany – are planning to impose higher taxes on banks the more that they rely on short-term hot money. This is an excellent idea, as it would give banks an incentive to secure more stable sources of funding. The snag is that this initiative has been diluted because it won't be global. A plan for such a levy in America by Barack Obama seems to have been killed off by Congress.

In the meantime, there will be more crises and bailouts. And banks, governments and their creditors will draw the logical conclusion: it pays to be foolish.

*Published November 29, 2010*

## **GROUND RULES**

BY PETER THAL LARSEN AND RICHARD BEALES

Policymakers and regulators around the world put in a lot of work in 2010 designing post-crisis regulations. But there are still plenty of question marks over implementation – and some knotty issues have barely been tackled. Meanwhile, a level global playing field looks an ever more distant dream. If financial institutions hoped that 2010 was the high watermark for regulation, they will be disappointed. Here's a look at potential developments in 2011.

## BREAKINGVIEWS

**Systemic risks:** One of the biggest post-crisis developments has been the creation of bodies that are supposed to identify and help prick financial bubbles. These so-called macro-prudential regulators are in various stages of being set up in the United States, the UK and Europe.

But the devil will be in the detail of how they work, for instance their interaction with monetary policy authorities such as the Federal Reserve, the Bank of England and the European Central Bank. That's still largely a work in progress.

**Bank structure:** Regulators will spend much of 2011 trying to ensure a future financial collapse doesn't do too much damage. The Dodd-Frank Act passed by the U.S. Congress gave regulators specific powers to wind down a failing financial institution. The UK passed similar rules. However, this approach is inadequate when it comes to winding down large cross-border banks. There's still plenty of room for debate and disagreement on how best to tackle this problem.

U.S. bankers and regulators, meanwhile, need to figure out what proprietary trading really is. Dodd-Frank included a near-ban on banks trading for their own accounts rather than for clients. But working out where to draw the line is a continuing headache.

And in September, the UK's Independent Commission on Banking is due to deliver its final report. It is likely to stop short of breaking up banks. But it may push for them to separate their investment and retail banking businesses more effectively.

**Bank capital:** The Basel III rules, agreed by global authorities in September, spelled out how to increase banks' capital strength. The challenge now is making sure they are consistently implemented.

This is far from assured: U.S. regulators never formally introduced the previous set of rules, while countries like Japan have been pushing for a slower timetable. To keep bankers on their toes, an additional capital buffer for too-big-to-fail banks is due to be agreed by mid-2011.

**Derivatives:** Dodd-Frank requires standardized derivatives to be cleared through central clearing houses, thereby reducing the risk that one bank's failure will drag down the system. Now the Commodity Futures Trading Commission, along with the Securities and Exchange Commission, must decide – in pretty short order – how the law will be implemented. For example, it must draw up governance requirements for clearing houses, avoiding, for instance, the danger that clearing houses themselves become systemically risky.

The European Union will in 2011 play catch-up with the United States on derivatives. Its proposed rules, published in September, concentrate mainly on central clearing. One big challenge will be trying to minimise the differences between the EU and U.S. approaches.

**Bonuses:** The Fed has set out high-level principles, but has no plans to set specific rules. This is in stark contrast with the EU, which has introduced specific limits on how much of a bankers' bonus can be paid in cash. Such differences put the likes of Barclays and Deutsche Bank at a distinct disadvantage when competing in New York or Singapore – making further contentious debate likely.

**Hedge funds:** Hedge funds are feeling their way into a more regulated world. Dodd-Frank requires them to be registered, while regulators will keep a closer eye on whether they are taking risks big enough to threaten the system. In Europe, hedge funds will also have to be more transparent, and subject to more scrutiny, to gain access to onshore investors.

**The rest of the world:** Europe and the United States have done the most to overhaul financial regulation – hardly surprising considering they suffered the worst effects of the recent crisis. But for new rules to be effective, there can't be big differences between jurisdictions. Most emerging economies have long demanded high capital ratios for their banks, so adopting Basel rules should not be too hard. But securing a level playing field for winding down big banks or regulating derivatives could prove more difficult.

This means Western governments will face a new dilemma in 2011. Will they follow through on tougher rules even if this prompts banks to shift

businesses to more friendly parts of the world? Or will they relent, at the risk of making future crises more likely? The mechanical and political machinations of financial reform have a long way to go.

*Published January 4, 2011*

## CHAPTER 6

## INVESTMENT

**STOCK UP**

BY ROBERT COLE

Valuation metrics make stocks look cheap. Growing corporate earnings and rising M&A activity both point to higher share prices, too. Meanwhile, major alternative types of assets, especially bonds, lack appeal. Though partly *faute de mieux*, equities could offer strong returns in 2011.

First, valuations. The MSCI World Index trades on a multiple of about 12.6 times estimated earnings, according to Thomson Reuters databases. Price-to-earnings ratios are a bit higher in America and a bit lower in Europe. But against a 20-year average PE ratio of 16, valuations are hardly stretched in any of the major markets.

Meanwhile, numbers crunched by StarMine suggest that S&P 500 companies will increase earnings per share by 14 percent in the next 12 months. Expected earnings growth in Europe is even better, with DJ Stoxx 600 companies forecast to deliver an average rise of 15 percent. Recent indicators suggest that the German and U.S. economies are proving their resilience, while China and India continue to surge. If corporate earnings respond as anticipated valuation multiples will fall, making stocks look even cheaper.

As for M&A, a survey conducted by Boston Consulting Group and UBS Investment Bank, published on Nov. 30, suggests that one of every three large European companies expects to make a large-scale acquisition in 2011. Meanwhile, worldwide M&A reached \$2.2 trillion in 2010, according to Thomson Reuters, a 19 percent rise on 2009. Greater acquisition interest is another reason share prices might rise – especially if leveraged buyouts gather momentum alongside strategic transactions.

At the same time, high grade government bond returns are hovering at around the same low level as blue-chip equity dividend yields – a rarity.

## BREAKINGVIEWS

This may, of course, indicate that bonds are expensive, not that shares are cheap. But equities, usually thought to be the riskier option, now look the safer bet. The confluence of these four powerful factors means that shares are a top pick for 2011.

*Published December 29, 2010*

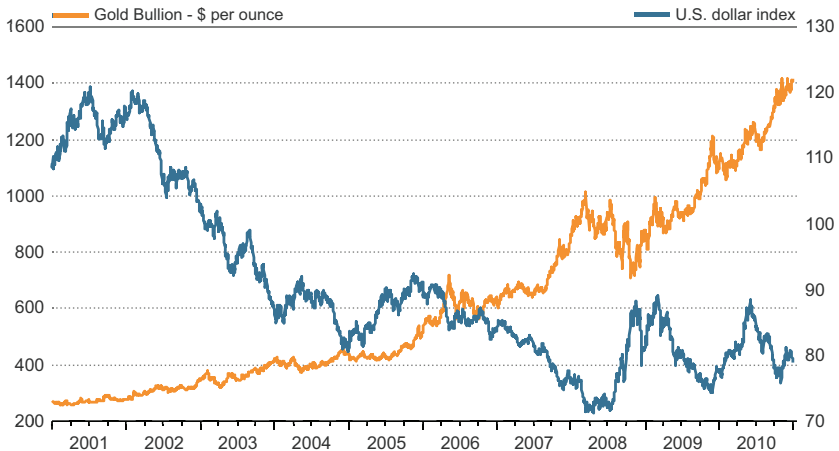
## BUGS ON THE LOOSE

BY MARTIN HUTCHINSON

It sounds like a gold bug's dream. But looking back to the last inflation-adjusted peak price in 1980, it's far from impossible that the gold price could soon go above \$5,000 an ounce.

The potential level of a new peak can be estimated in several ways. Based on consumer price inflation, the \$875 per ounce high seen in 1980 is equivalent to around \$2,400 today, almost twice the current gold price. But there's a case for taking account of economic expansion as well as price inflation. The world's economic output has increased about six-fold since

## Gold and the dollar



Source: Thomson Reuters Datastream

1980. Scale up the peak 30 years ago by that multiple, and the gold price could top out at around \$5,300.

Gold can also be regarded as an alternative to money. Broad global money supply, known as M3, is now in dollar terms about 10 times what it was in 1980. The total gold supply has also increased to some 170,000 tonnes from 110,000 tonnes over the same period as more of the metal has been mined. Scaling up by money supply and deflating by the gold supply, the 1980 peak price would be equivalent to about \$5,700 an ounce today.

Looking at money supply another way, today's potential gold price would be a bit lower than that. A narrower measure of global money, M1, is currently estimated at about \$17 trillion. If the 170,000 tonnes of gold mined through history were to substitute for this, the gold would be worth around \$3,100 per ounce. But that wouldn't account for the tendency of the thinly-traded gold market to overshoot sometimes to the upside, as for instance in 1980, and sometimes to the downside.

Of course, there is a considerable chance that gold and other commodity prices will peak at a lower level. But if a four-fold increase over a couple of years from today's gold price to more than \$5,000 an ounce seems impossibly extreme, that was the trajectory in 1978-1980. If governments continue to print money, whether for economic stimulus or to stave off defaults by themselves or others, fear of widespread currency debasement and the consequent inflation could create the conditions for just such a spike.

*Published May 13, 2010*

## **FALLING IDOLS**

BY ROBERT COLE

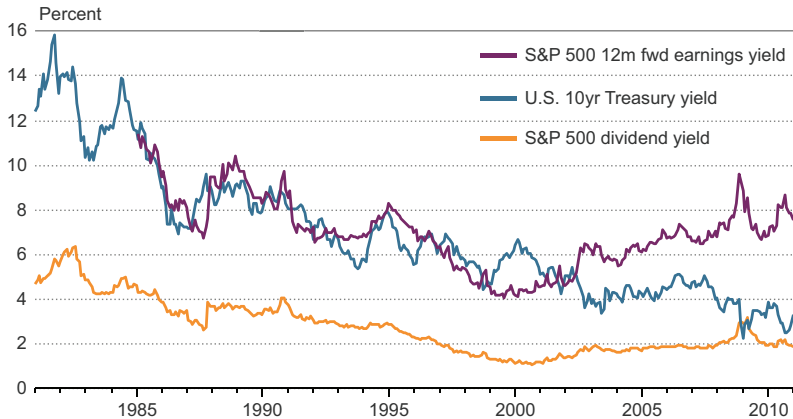
Investors' love affair with top grade government bonds is running out of steam. High prices, together with doubts about credit quality, suggest that even top sovereigns are heading for a fall.

First, price. Bonds usually yield more than equities. But since 2007 the premium – which was 600 basis points for the United States in 1995 – has been virtually rubbed out. In Japan and Germany, equities now yield more

## BREAKINGVIEWS



## U.S. bond and equity yields



Source: Thomson Reuters Datastream

than bonds. In the United States the gap has narrowed sharply: 10-year Treasuries yield 2.9 percent while the S&P yields 2.4 percent.

Since 1990 the global equity dividend yield, calculated by Datastream, has hovered at roughly 2 percent while 10-year Treasuries have paid an average of about 3 percentage points more. Yes, the world has changed and will change more, but if the bond-equity yield relationship reverts only half way to the 20-year mean, U.S. Treasury yields could climb 150 basis points.

Beside price, there is security. Government bonds issued by the United States, Germany and Japan are safe, notably in comparison to peripheral European Union nations' loans. But the nature of bond contracts may change. True, change is most likely in Europe, where German Chancellor Angela Merkel is among those pressing for private sector haircuts. Change will also only apply to new issues. But investors see sovereign debt contracts as sacrosanct. Some may roll out of bonds before they are rolled over.

At present, bonds give adequate compensation for the other big credit risk: inflation. U.S. Treasuries yield nearly twice as much as inflation and bonds

pay nearly three times German CPI. Bonds will remain popular as long as deflation threatens, too. But inflation is a bigger risk. U.S. Treasuries lost 1.9 percent a year between 1950 and 1980 in real terms, when stocks made a real 6.7 percent per year, according to research from Barclays Capital.

Bonds still have much to commend them, notably because they can secure pension funds' obligations. But even top grade sovereigns must be sustained by more than convenience. If investors' convictions are diluted, bonds could quickly lose ground.

*Published December 1, 2010*

## **TRASH BASH**

BY AGNES T. CRANE AND NEIL UNMACK

Easy money has been kind to risky companies and their lenders. Firms like Clearwire Communications and HCA found critical funding in 2010, while investors in their bonds have enjoyed stellar double digit returns, with the Bank of America Merrill Lynch high yield index returning nearly 14 percent by early December. So much money sloshing around the global financial system, however, also makes for outsized distortions and in 2011 could trigger a junk bond correction.

The overall high-yield market, essentially all corporate bonds rated below BBB- on the rating agencies' standard scale, isn't flashing bubble warnings. Though risk premiums in excess of benchmark Treasury yields have narrowed dramatically from their fear-driven heights a few years ago, for the asset-class as a whole they're more or less in line with the historical average of 6 percentage points.

Yet the dusty bottom shelf of the debt junkyard is telling a different story. In early December, risk premiums for CCC-rated debt were nearly 3 percentage points lower than their historical average of nearly 11 percentage points, according to BNP Paribas. That matters when this highly speculative class of debt represents almost 20 percent of the total junk bond market.

When times are good – and they’ve been very good to risky assets in the last two years – CCC-rated debt can be a star performer. With funds available to refinance debt, one big risk is removed for highly-leveraged borrowers. And with underlying interest rates ultra-low, investors fancy the relatively high yields available at the risky end of the spectrum, even if they don’t look as fat as they did. The problems begin when market sentiment turns and the dash for trash turns into a rush for the exit.

Leveraged companies typically need to grow into oversized debt loads, which on average means they do better in an expanding economy. So investors hoping for another good year in the high-yield market need growth. But they need a Goldilocks outcome: especially in the narrow CCC category, they could run into trouble if the economy gets too hot as well as too cold.

Disappointingly low growth would hurt revenues and increase the risk of default, with the riskiest junk borrowers first in line to fail. Moody’s is forecasting that just 1.8 percent of all corporate debt globally will default in the year to November 2011, down from 2.9 percent this year and 13.6 percent in 2009. If growth fails to pick up further, those numbers could rise again.

At the same time, higher-than-expected growth would spur investor appetite for equities, just a short step down the capital structure from the lowest-rated debt. That could make CCC paper less attractive – as could the rising interest rates that might well accompany healthy growth, because less risky, higher-rated bonds would suddenly deliver better yields than they have been doing.

In short, the riskiest end of the high yield spectrum looks priced for something like perfection. Euro zone troubles, Federal Reserve policy changes, a swing towards austerity in the U.S. Congress or an upside growth surprise could all upset the balance. All of which means that those investors reaching deepest into the junk bond garbage pail in 2011 could find something bites back.

*Published December 22, 2010*

## SEIZE THE MOMENT

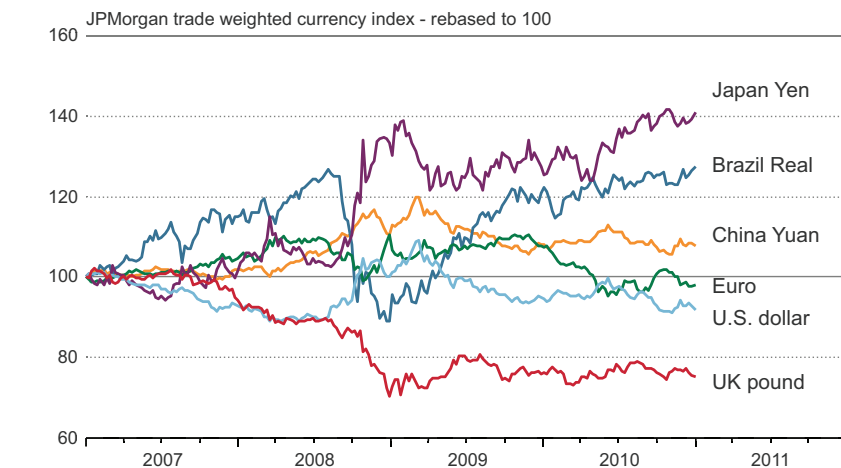
BY WEI GU

The Chinese currency rose just 3.6 percent in 2010. As political pressure ebbs and euro zone trouble spreads, traders now expect an even smaller gain for 2011. Beijing has said it wants to make the yuan more flexible. If it really means that, low expectations create a window of opportunity.

The People’s Bank of China managed to hold the yuan tight even in a year of high political pressure. Despite stern rhetoric from U.S. politicians ahead of mid-term elections and two G20 meetings, the currency strengthened 2.8 percent on a trade-weighted basis as at the end of November, 2010. By contrast, the yen, Thai Baht and Malaysia Ringgit each rose 11 percent against the dollar in 2010.

Less external pressure for Beijing in 2011 may lead to complacency. The threat of U.S. trade tariffs and G20 pressure both produced small upticks in the yuan. But the U.S. Treasury has delayed the currency report that might label China as a currency manipulator. The Senate and Congress

## Trade weighted exchange rates



failed to pass punitive bills on Chinese trade before mid-term elections. As for pressure from the G20, France, the host in 2011, has been encouraging China to style the yuan as a reserve currency, so may be less inclined to complain about the exchange rate.

Besides, China's authorities have other things on their minds. China's next leadership reshuffle is scheduled to take place in late 2012. The debt crisis in the European Union, China's biggest export buyer, has not been resolved. Chinese exports fell 6 percent in the month of October. These things help explain why non-deliverable yuan forwards are pricing in just 2.3 percent appreciation, around the lowest level in a year.

But this might in fact be the best chance for China to make changes to the yuan for its own good. Beijing could strengthen the currency more without appearing to reward speculators, or cave in to foreign pressure.

There are two reasons why it should do this. First, the cost of keeping the yuan cheap is rising. The central bank injected \$78 billion of liquidity, the largest amount in two years, into the domestic system in October alone through buying foreign currency from its banks. A stronger yuan may also alleviate some imported inflation – input prices have risen every month since July, according to the official Purchasing Managers' Index.

In the long term, a more expensive yuan should make Chinese people feel richer, and consume more. Policymakers consistently say that is what they want to happen. Besides, the decision-makers in Beijing seem to like surprises, as October's sudden late-night interest rate hike showed. Revaluing in 2011, when few expect it, could be just their style.

*Published December 31, 2010*

## **OILS WELL**

BY CHRISTOPHER SWANN

Oil bulls are once again kicking up dust. The intensifying struggle to lift output, they say, will collide with the insatiable thirst of an expanding Asia to push oil above \$100 a barrel. In fact, the cost of crude may be held down by a halving of demand growth as producers from Russia to Africa via Brazil ramp up supply.

Recent years have been humbling for oil bulls. In 2008 Goldman Sachs was arguing that crude would have risen to between \$150 and \$200 a barrel by now. Since then the notion of peak oil on which many such forecasts were based has taken a battering. Rather than bumping up against the limits of available oil – as peak theorists expected – drillers have uncovered an embarrassment of mineral riches. And this happened to occur just as hunger for oil slackened amid a deepening global recession.

Despite this setback, oil optimists, like Goldman's analysts, have recovered something of their former swagger. Surging demand from growing Asian economies, they argue, will outpace even the ingenuity of oil producers, forcing crude prices inexorably higher. Again there are reasons to be skeptical of such prognostications.

For a start, the unused pumping power of the OPEC cartel still stands at 5.4 million barrels a day – against less than 1 million when oil hit its \$147 apex in July 2008. So it would take several years of punchy demand growth to chip away at the cartel's spare capacity. And that's without counting an impressive range of oil industry investments that are coming on stream.

A steady upswing in oil prices since 2004 rekindled exploration spending and advances of drilling technology have also helped. Shrugging aside BP's deepwater disaster in the Gulf of Mexico, oil majors are stepping up production in once-inaccessible deposits off the coasts of Ghana and Brazil.

And improving recovery techniques are also prolonging the life of aging oil wells. This is particularly evident in the United States where a seemingly inexorable slide in production, stemming back to the 1970s, appears to have been arrested. Some of the same techniques that have been rejuvenating geriatric wells – including hydraulic fracturing and horizontal drilling – have brought a bountiful supply of oil within reach in the Bakken shale of North Dakota.

Meanwhile bumper gas finds have spewed out precious fluids. Output of these light natural gas liquids could climb by 700,000 barrels a day next year, according to Credit Suisse, up from a rise of 200,000 in 2009. Even OPEC members can pump these freely since they are not counted as part of

their quotas. This unexpected treasure trove of easily refined oil is helping relieve pressure on traditional crude.

Penny-pinching motorists across the globe can also look to Iraq for relief. Assuming the political situation continues to improve, output should rise strongly from 2011. And non-OPEC crude supply is expected to climb by 800,000 barrels a day. Tot all these extra sources up and global oil output could rise by around 1.6 million barrels a year, according to Credit Suisse.

Bulls will counter that even these new sources will not match demand. But here too their arguments look premature. True, demand rose by a monumental 2.3 million barrels a day in 2010. A repeat of this would indeed eat into OPEC spare capacity. This, however, looks unlikely. The International Energy Agency is braced for a more manageable increment of 1.2 million barrels a day in 2011. Rich countries even look likely to trim 300,000 barrels a day from their energy diet. This will offset three-quarters of the increase in demand from China – which though growing fast, still only burns 11 percent of the world's oil. And the IEA's cautious demand estimates could fall if the brewing financial crisis on Europe's periphery eats into economic growth.

Of course, predicting the price of oil requires the kind of omniscience that even mighty Goldman hasn't mustered. It involves accurately predicting global growth and output in dozens of countries, not to mention changes in efficiency technology, tax and regulatory policy as well as fickle market sentiment. Still, there are few signs of the bottlenecks that pushed oil through the roof in the summer of 2008. Consumers appear generously well supplied as the world's oilmen look to be keeping up with the rising appetite for crude.

*Published December 29, 2010*

## **ABSTRACT EXPRESSIONISM**

BY ROBERT CYRAN AND ROB COX

Facebook may at last become a real, rather than virtual, money spinner in 2011. The social network doesn't need capital to grow, but expectations from shareholders and employees for an IPO are too high for founder Mark

Zuckerberg to ignore. There's just one challenge: trading in Facebook's unlisted shares values the website at more than \$40 billion. Getting to that number requires some astonishing growth assumptions.

That's not to say it's impossible for Facebook to attain a public market value at least as big as its current implied worth. Facebook is both valuable and becoming more so. It has more than 500 million users and it's adding thousands by the minute. But rarely has a private company attracted such a large – and relatively liquid – financial status as Facebook.

So how can the firm founded in a Harvard dorm room fill out its \$40 billion britches? Facebook should double revenue to \$2 billion this year. If its margins are in line with Yahoo's, that would suggest it makes about \$300 million in profit. Thus its implicit valuation is somewhere around a stratospheric 133 times earnings.

But there's another way to look at it. Using a standard earnings growth model, Facebook could warrant its private-market value if it can grow its bottom line more than 25 percentage points faster than the average company for the next decade. Few firms ever manage to sustain this type of performance. Microsoft and Google may be among the few that managed something like it in their heydays.

Put another way, despite consumers spending perhaps a third of their media time online, the Internet accounts for less than 15 percent of all advertising dollars. Simply closing this gap would amount to \$50 billion in additional ad revenue, according to Morgan Stanley. If Facebook could nab half of that, at Yahoo-style profit margins it would earn some \$4 billion in annual profit – possibly enough to justify its valuation.

It's still a very long shot. Even though Facebook's web audience comes second only to Google, extracting more revenue from users could be problematic and set off privacy concerns. Users may simply grow fickle, as they did over at MySpace. And advertisers may never become as comfortable advertising online, particularly in the racier medium of social networks, as they are on, say, network broadcasters or billboards.



So although a Facebook IPO is something that may become real in the coming year, it's harder to tell whether the same will be true of its heady valuation.

*Published December 28, 2010*

## JUST FOLLOW THE CURVE

BY ROBERT CYRAN

The future is here – it has just not yet gone corporate. About a third of U.S. mobile subscribers now own smartphones, with about half of those powered by Google's Android and Apple's operating system. Yet they haven't made many inroads into banks and other large enterprises. Economic logic suggests technical improvements – and a healthy dose of envy – will change all that in the coming year.

The spread of new ideas and technologies typically follows what's called the S, or logistics, curve. According to this theory, a small number of people try things out early, a few are very late, and most tend to cluster around the middle. The amount of time it takes an invention to catch on varies – and not all do. But the basic shape is the same.



*Customer Han Ziwen holds up his iPads at an Apple flagship store in Beijing, September 17, 2010. REUTERS/Petar Kujundzic*

Two of the simpler explanations for the S-curve pattern are improvements and simply a form of keeping up with the Joneses. Research In Motion's stronghold in the business handsets market with its BlackBerry device appears threatened by both.

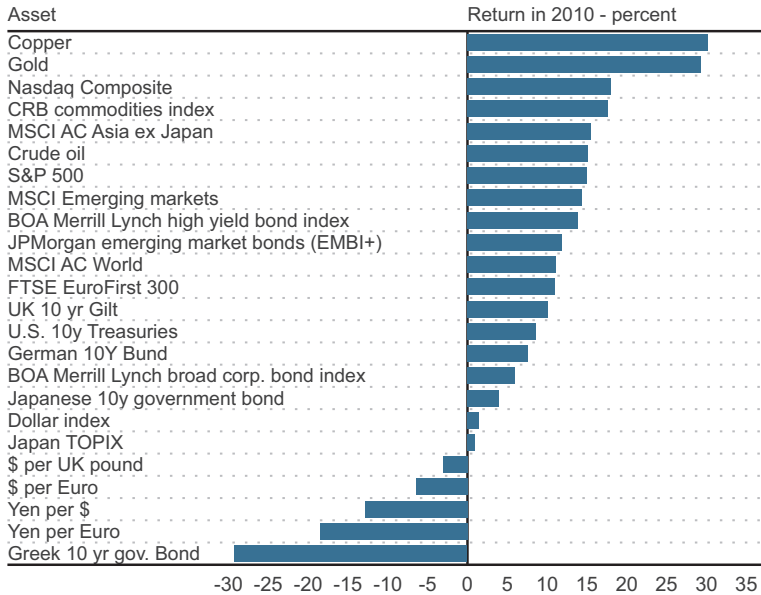
New gadgets often have flaws – and as these are ironed out, the device becomes more useful and popular. Security concerns have held back the adoption by large enterprises of Apple and Android-powered devices in the past. Companies generally have more to lose than consumers from technological risks.

But improvements to the security features of these consumer-popular handsets are being made, and the devices becoming safer to use. To wit, Citigroup, Bank of America, and Morgan Stanley are now considering letting their bankers use iPhones and Android-powered devices instead of their ubiquitous BlackBerries. Moreover, the iPad – which runs on the same operating system as the iPhone – is proving popular among corporations, and appears to be acting as a Trojan horse. Companies that adopt the iPad often figure they might as well let employees use iPhones.

The second explanation for the S-curve means this logjam is likely to break at some point, followed by mass corporate adoption. After all, there are few things that inspire consumption more than envy – and if there's one law that's worth noting, it's that financial professionals are not usually on the poorer end of that kind of trade.

*Published January 4, 2011*

# 2010 asset returns



Source: Thomson Reuters Datastream

\*All numbers total return in currency where asset is based except copper, gold and oil where the spot return is shown

## CHAPTER 7

## ENDNOTE

**UNLIKELY WISH LIST**

BY RICHARD BEALES AND ROB COX

The financial crises of the past couple years spawned myriad reforms of their own. But there are other undesirable situations around the globe that still need changing. Breakingviews highlights five financial headlines that investors should wish for – but are highly unlikely to appear.

- 1. “G20 agrees to scrap interest deduction.”** Corporate finance everywhere is skewed by the tax deductibility of interest, which encourages excessive leverage – one underlying cause of the recent financial crisis. And housing markets where borrowers can deduct large amounts of mortgage interest, notably the United States, suffer similar distortions, with predictably troublesome results. The UK phased out the mortgage deduction it used to have. But these are tricky political waters, and even isolated moves are unlikely, never mind a concerted global effort.
- 2. “Apple, Google, other global tech firms to pay huge special dividends.”** Sure, some, like Cisco, have talked about starting a payout of a modest size. But their stashes of cash are out of all proportion to the universe of sensible ways they could spend it. Most of the pile should go to shareholders. But that requires bosses to concede their growth prospects are finite and effectively shrinking the companies they run.
- 3. “China floats the yuan.”** Perhaps not completely freely – that could be asking too much, even for a rust-belt congressman. But it’s a needed move to ease global economic imbalances. Unfortunately stability and employment are over-riding objectives of the regime in Beijing, and any big step that threatens either won’t be taken.
- 4. “Bipartisan energy bill passes Congress with overwhelming support.”** A sweeping effort by the world’s top consumer of hydrocarbons could include eliminating inefficient subsidies for U.S. ethanol production,

the removal of import tariffs on Caribbean and Brazilian cane ethanol, a \$1 per gallon (or higher) gas tax, a mandate for all federal agencies to convert their vehicles to run on compressed natural gas and a carbon tax encouraging energy conservation and cleaner-burning fuels. Pigs might fly, too.

**5. “General Electric follows Citigroup and Bank of America with break-up plan.”** Separating GE into separate businesses and winding down GE Capital would create value for shareholders and show that Jeff Immelt, the chief executive, recognizes that the company’s conglomerate structure doesn’t create sufficient synergies to warrant keeping the undervalued assets together. The company may slowly be heading in that direction – but swallowing his pride and doing it quickly looks a step too far for Immelt.

*Published December 23, 2010*

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First row, photographers:

Denis Sinyakov, Shannon Stapleton, Robert Galbraith

Second row, photographers:

Issei Kato, Kevin Lamarque, Cathal McNaughton

Third row, photographers:

Vivek Prakash, Yuriko Nakao, Robert Galbraith

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# REUTERS BREAKINGVIEWS PREDICTIONS FOR 2011: REAPING AND SOWING

In this collection of pithy columns, Breakingviews journalists forecast stronger-than-expected growth in the United States, building inflation and a continuing rise in stock markets and, potentially, the gold price. We also predict a surprise revaluation of the Chinese yuan.

Meanwhile, further losses for government bond investors around the world look inevitable. Europe will continue to suffer debt-fueled jolts. And two recent strong performers, high-yield debt and Brazilian markets, could be ripe for setbacks. In the technology world, we outline the further disruption threatened by smartphones and related devices.

This book, ranging across global finance, economics and markets, aims to set the agenda for the year – and, whether eventually proven right or wrong, to provoke thought and debate.