

Thursday, June 25, 2009

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## SUMMARY

### Hopes of a V-shaped recovery

Many investors and economists expect stock markets and the economy to make a V-shaped recovery. They feel supported in this by improving figures and a reasonably strong recovery of stock and commodity prices. In the coming years we foresee this expectation turning into disappointment. Figures will, indeed, improve for the time being, due to large-scale fiscal and monetary stimulation, (cautious) build-up of stocks and statistical effects. These are only temporary effects, however. A reduction in debts and consumers saving more will exert continual downward pressure on the economy in the coming years. The call for even more fiscal and monetary stimulation will therefore remain loud.

Governments will want far more say in how that money is spent and under what conditions, however. In other words, we will increasingly have to account for government policy and increased regulation (in the financial sector, in particular). In the short term, this benefits the economy, but in the long term increased regulation will be at the cost of the dynamics of the economy. Moreover, the tax burden will have to increase if public finances are not to get completely out of hand.

### Implications for the financial markets

The extent to which governments and central banks continue stimulation depends increasingly on whether the bond markets tolerate it. With higher budget deficits and fears of future inflation, long-term interest rates are rising to levels that are too harmful for the economy and growth expectations are falling. We therefore expect falling stock prices and interest rates in the coming weeks to months. Yields on 10-year US Treasuries could then fall to 3.4% and the S&P 500 index to 800. We then envisage pressure on the authorities to implement further stimulation, growth expectations rising, the S&P 500 index rising to 1050 and 10-year yields rising to around 5%. In our view, this will then be the end of the bear market rally.

We foresee EUR/USD following the course of stock prices and falling over the coming weeks to months to around 1.30 (chart-technically the rate then has to remain below 1.417), followed by a rise to around 1.40 – 1.50. As we expect the differences in growth and interest rates between the US and Europe to increase, however, we don't fore see EUR/USD rising much further than 1.40. After that, we expect a fall to 1.10.

## HOPES OF A V-SHAPED RECOVERY

*Despite the large-scale stimulation, the World Bank has adjusted the economic forecasts downwards.*

The world economy is still in a deep recession. Two well-known economists have compared the current world crisis with the Great Depression of the late 1920s and early 1930s. Based on comparisons of stock prices, international trade and industrial production, they conclude that the current crisis is at least as bad as the first few years of the Great Depression. The big difference is, though, that far more monetary and fiscal stimulation is being implemented this time than in the 1930s. The economies should therefore do better now than at that time. The only question is how much effect the stimulation will actually have. The World Bank's forecasts are a good example. At the beginning of the week, the World Bank issued an update on economic forecasts, adjusted downwards. The world economy is expected to shrink this year by 2.9% (in March, the World Bank only expected a shrinkage of 1.7%). Distributed by region, shrinkage of 3% is expected for the US, 4.5% for the EMU and 6.8% for Japan.

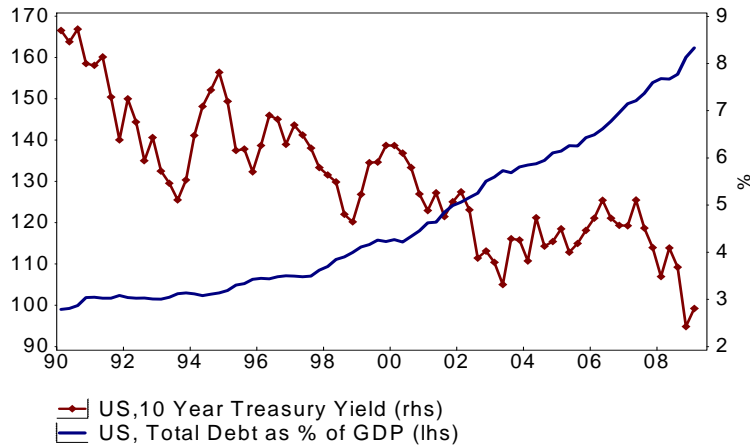
*But stock prices have actually risen sharply over the past few months.*

These expectations seem to be rather at odds with the sharp rise in stock prices and growth expectations of the past few months. This is not completely contradictory, though. The World Bank's expectations apply to the whole year. Investors – and many economists – expect the economy to be able to swiftly pull itself out of the dip after a dramatic first six months, however, due to all the stimulation. In short, what most people expect is a V-shaped recovery, primarily owing to the effect of the monetary and fiscal stimulation and an end to the stock corrections. In those countries that are being stimulated hardest – the US, Great Britain and China – the first recovery is expected or, in the case of China, the highest growth. Countries not willing to stimulate so hard (the EMU) or able to do so (Japan) are declining far more rapidly.

*Economic recovery now depends primarily on stimulation by governments and central banks, as growth without government aid seems unlikely, since the credit bubble burst.*

Now that the effect of the end of the stock corrections is in sight, a future recovery of the economy will chiefly depend on the degree to which central banks and governments continue stimulating and when the economy is capable of growing further without government aid. The latter is not on the cards for the foreseeable future. When the asset price and credit bubbles burst, it became clear that consumption growth, in the US particularly, prompted by increasing borrowing is a thing of the past for now. Over the past few decades, a spiral had been created in the West of falling interest rates, rising asset prices, decreasing savings and increasing debts, rising consumption, mounting investments and higher growth. Normally, higher growth would lead to further upward pressure on asset prices and rising interest rates, which would break the spiral. This did not happen, though; with the emergence of Asian countries and Eastern Europe, high productivity increases and limited wage rises continually exerted downward pressure on inflation. Interest rates were therefore dragged down, which was further aggravated by many Asian countries investing their capital surpluses in the West. When the two bubbles burst, this spiral came to an end and turned into a negative spiral. Asset prices fell, banks suffered further losses and were more reluctant to extend credit, consumption and investments stagnated and growth therefore declined, and so forth.

**Decennium long declining interest rates encouraged borrowing and supported a debt bubble**



Source: Reuters EcoWin / ECR

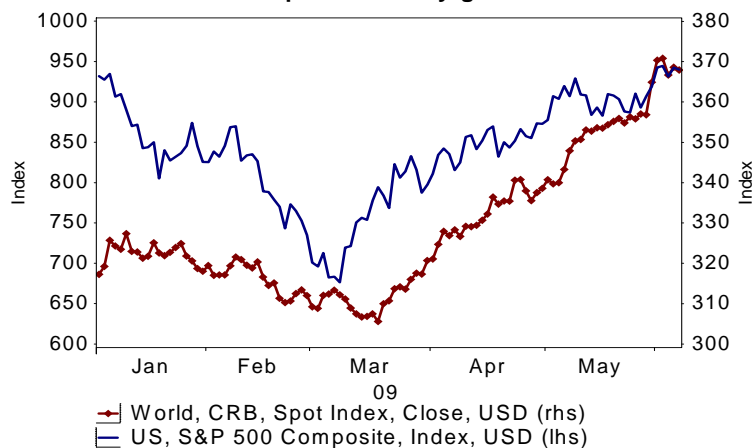
*An attempt is being made to spread the economic pain out over a longer period through massive government intervention.*

Had the authorities failed to intervene, most economies would have collapsed under the great burden of debt and slid into a depression. An immediate decline in growth of 25% and a long period of deflation would then have been no surprise. No one would have survived it. Such a blow in the past has led to mounting social and political tensions with sometimes disastrous consequences. From this point of view alone, it is better for governments to try and spread the inevitable economic decline out over several years. This has to be done by the government borrowing more to support the financial system and stimulate the economy. The central banks have also intervened and filled the gap left in the credit markets by bankers and investors. Short-term interest rates have been lowered, banks' credit facilities have been relaxed considerably and many central banks have created extra money to buy up bonds and money-market paper. The idea is to suppress long-term interest rates and increase the money supply to avert the threat of deflation.

*So far, the markets have been relieved, but the question is for how long.*

The call for more government intervention in the economy has been successful and virtually no one doubts its necessity. The financial markets have also shown their relief. The past few months, investors have been stepping into increasingly risky positions (stocks, company bonds and commodities) and primarily selling Treasuries and dollars. The question is, though, to what extent the authorities are actually capable of leading the economies towards higher growth (which could push stock and commodity prices up even further) and what drawbacks this entails.

**Financial markets show enthusiasm as hopes on V-shaped recovery grow**



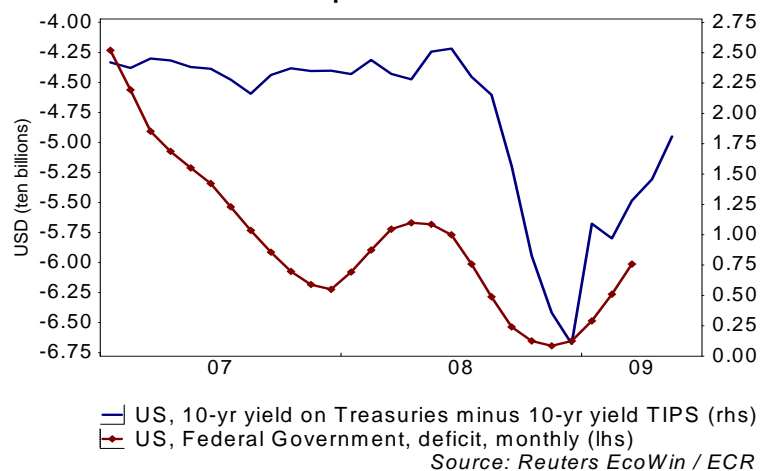
Source: Reuters EcoWin / ECR

## STIMULATION NOT LEADING TO SUSTAINABLE GROWTH RECOVERY

*Massive government intervention has led to high interest rates from fear of excessive budget deficits.*

To start with the first question, the bond markets have made it clear in recent weeks that central banks and governments can't go on stimulating the economy indefinitely. Such high budget deficits are now expected in the US that there is virtually continual upward pressure on long-term interest rates. In the beginning, this was overshadowed by safe haven flows towards Treasuries and the Fed buying bonds for its own account. As growth expectations grew, however, long-term yields on Treasuries and long-term interest rates rose, too. This didn't generate any problems to begin with, as credit spreads were narrowing more rapidly than long-term interest rates rose. Now this has changed over the past few weeks, it is becoming increasingly clear that the economy and housing market are simply unable to bear higher interest rates. In other words, if the economy doesn't grow naturally, then sustainable recovery based on government intervention is impossible. The counterargument some are offering is that the current crisis and high debts can be fought by implementing a (light) inflation policy. They are forgetting, however, that this was also attempted in the 1970s, but the bond markets quickly demanded such high interest rates that it soon became a heavier burden on the economy than the 'positive' effect of higher inflation. This already became clear in the recent months, when rising inflation expectations were closely followed by rising long-term yields on Treasuries.

**Increasing US federal deficit triggers inflation expectations**



*The Western economies are under pressure due to falling exports, the reduction of old debts and increasing saving.*

The chance of the economy achieving a sustainable recovery on its own strength appears to be nil, however. As a result of the positive spiral before the crisis, it was Western consumers – and US consumers in particular – that kept the world economy running. Now, with vastly depreciated asset prices, rising unemployment and falling incomes, Western consumers will want (and have) to save more and repay old debts. Even if they wanted to borrow and consumer more, banks are no longer necessarily willing to facilitate this. With major losses, a weak economy and falling asset prices, banks have become far more cautious in lending money. In this climate, companies will also invest less. The last option is then to grow by exporting more. But where to? In the past, the emerging economies grew rapidly primarily by exporting to the West. Turning these economies into more consumption-driven economies takes a long time. Until then, the demand from emerging countries for (expensive) Western consumer goods will be limited.

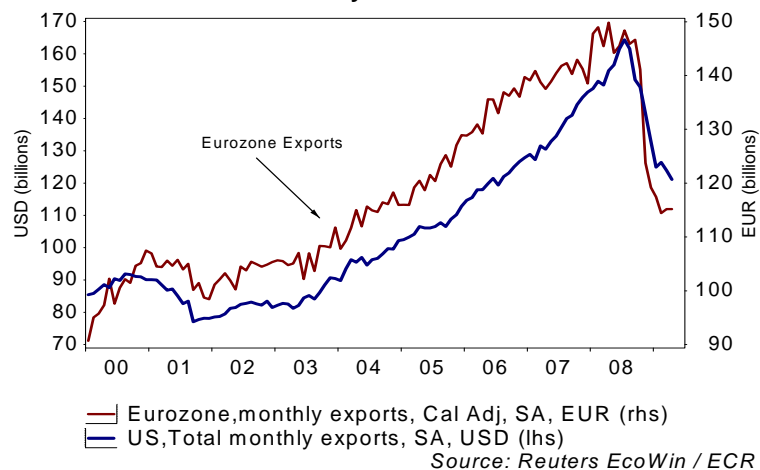
The most Western economies are likely to achieve is therefore a situation where:

*The best that can be achieved would appear to be little or no growth, based on fiscal and monetary stimulation.*

- The government and central banks stimulate the economy enough to protect it from a long, deep recession with all the social and political consequences involved.
- The growth achieved is not used only for consumption but also for repaying old debts.
- A more balanced growth model needs to be found for the Western economies. In other words, based less on rising asset prices, increasing debts and high consumption growth and more on devising new products and technologies and successfully marketing them.

This is where the second question comes in. Is it a good thing for the government to gain an increasing role in the economy or does this also entail major drawbacks?

**Foreign demand not the holy grail for economic recovery in the West**



## **NO UNCONDITIONAL GOVERNMENT INTERVENTION**

*Governments are now expected to regulate the financial world more strictly and maintain prosperity and employment as far as possible.*

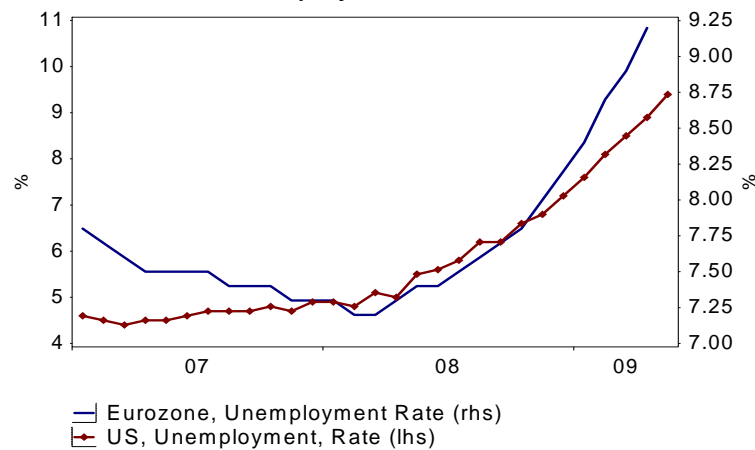
It is generally accepted that more government intervention was needed. Otherwise, the financial system would have collapsed and taken the economy down with it. The government is now the only party that can counter the downward forces on the economy. Otherwise, the economy would be in an even worse position and unemployment would be far higher. At the same time, public opinion is critical. There is the feeling that governments are coming to the aid of bankers and speculators at the expense of the ordinary tax payer. They are often seen as causers of the crisis. This is disputable (we personally have a far more nuanced opinion), but the fact remains that the pressure on governments to prevent this situation next time is enormous. As a result, the government has to:

- Impose increased regulation on banks and other financial institutions. All kinds of bonus structures meant bankers were too focused on realising 'fast' profits, without looking at the long-term implications. As many banks had grown

tremendously, a lot of them proved too big to fail. Governments were therefore put on the spot. Either take the risk of a collapse of the financial system or intervene. The government should therefore have more supervision of bonuses and salaries, prevent the creation of large banks and improve supervision of financial institutions.

- The capitalist system has proved less infallible than was claimed. Now that the failure of the capitalist system has caused a major crisis and governments have to clear up the mess, it is also justifiable for governments to have more of a say in the economy. In other words, the government should interfere more to guide the economy along the right lines and maintain prosperity (and jobs).

**Calls for more government support will rise as unemployment rises fast**



Source: Reuters EcoWin / ECR

*The higher unemployment rises, the louder the call for more government intervention.*

Judging by past experience, the more unemployment rises and the longer the economy remains shaky, the louder we can expect the call for further government intervention to be. At the end of the roaring twenties, a period characterised by less government intervention and great confidence in capitalism, 1929 saw the Wall Street Crash on Black Thursday. Years of consumption on credit and driving up stock prices to record highs finally took their toll. With falling asset prices, repayment of debts and a collapse of world trade resulted, the world economy was hit by the Great Depression. President Roosevelt, a democrat, implemented 'The New Deal' in answer to the recession. The two major pillars of the policy were that the government should stimulate while the economy floundered and that it should have an organisational, planning function in the economy. A number of bodies were established for regulating the economy, such as the Securities and Exchange Commission, Fannie Mae and the Federal Deposit Insurance Company.

*(Financial) crises therefore often lead to increased government intervention.*

More general is the tendency for increased government intervention and regulation to take place after a (financial) crisis or heavy recession. This also applies vice versa. When the economy is doing well, the government takes a step back and deregulation is introduced. After a long period of economic stability, with rising asset prices and less regulation, debts mount so high that instability follows. Everyone than wants to prevent that happening next time. The guilty parties are indicated and increased regulation follows. There is a high risk of more government intervention then automatically being seen as a good thing. This is not so.

*From the past, we also know that recessions have a function as a healing process: dead wood is cut out of the economy.*

First of all, we know from the past that periods of high growth are always followed by recessions and recession always by periods of high growth. Recessions therefore have a function. Recessions cut out the dead wood of inefficient companies, unproductive employees and bad debts, after which the economy as a whole again has a healthy basis for further growth. In deep recessions, old industries often disappear and new, more productive industries are born. In the long term, this is positive, however painful a recession may be for most people. The question is therefore whether the government should prevent a recession at all and therefore shore up inefficient companies. Secondly, increased government intervention and regulation also has major drawbacks for the economy:

- Measures for guiding the economy generally have unintended negative implications in the longer term. Fannie Mae and Freddie Mac, for example, are often cited as causes of the housing price bubble. Both companies granted house buyers artificially cheap loans, so more and more people bought houses, but more and more people were then able to help push up prices.
- Although public opinion is now highly critical of free market capitalism, this system was the corner stone of Western economies and had a major influence on many Asian economies. One of the main reasons is that few regulations and low tax ensure dynamism. People and companies with good ideas will be more likely to execute them if they don't first have to comply with all kinds of regulations and then see the majority of the profits going in taxes.
- More government intervention and regulation increase not only the number of regulations companies have to comply with; in time they also lead to higher taxes. A larger government and increased government expenditure have to be paid for.
- There can even be major drawbacks to extra government expenditure for protecting the economy from excessive decline. As we already mentioned, long-term interest rates have risen substantially over the past months, owing to the high budget deficits and fears that these deficits will be financed monetarily (by the central bank). This also pushes up interest rates for mortgage and company loans, often resulting in more economic damage than support.
- When the government intervenes in difficult times, the pressure on the government to protect and favour its own economy increases tremendously. When all governments start doing so, this causes a hard blow to international trade and therefore the world economy. Protectionism was one of the major causes of the enduring economic malaise during the Great Depression.

*Government intervention further reduces the dynamics of an economy, ultimately leads to higher taxes, can push up interest rates from fear of excessive budget deficits and can lead to a protectionism spiral.*

The conclusion is that increased government intervention and regulation are understandable and often desirable in a heavy recession (to prevent great social unrest). In the longer term, however, increased government interference often has major drawbacks for economic growth. Moreover, inefficient companies are often maintained, on the basis of political preference, which could better have disappeared to make room for more efficient companies.

## **INCREASED REGULATION, PARTICULARLY OF FINANCIAL SECTOR**

*Plans for stricter regulation of the financial sector have*

The financial sector is seen as the major culprit in the current crisis. American and European governments have therefore made proposals this past week for regulating this sector better. Both proposals call for better control of both the banks themselves

*been presented over the past week in Europe and the US.*

and the financial system as a whole, to prevent bubbles being created in the future that eventually lead to a crisis. The US government also wants to control major hedge funds, regulate a number of over-the-counter markets (so trading takes place through the stock market), maintain supervision of the derivatives market and demand that it no longer be permitted to resell bundled (mortgage) loans. All these proposals are intended to prevent a similar crisis happening in the future.

*The plans fit in with the picture of more direct government involvement in the economy.*

More worrying, however, is the proposal to investigate whether the Fed can continue not having to account for itself to the government. This follows criticism that the Fed sometimes came to the aid of banks rather too easily. As long as the government interference with the Fed is limited to whether assistance is granted to banks in need there is little to worry about. This changes, however, as soon as investors get the feeling that the Fed's independence will be affected. It is ultimately the Fed's independence in determining monetary policy that is maintaining the dollar's value. Encroachment on the Fed's independence will increase restlessness in the currency markets. Anything to do with the Fed's independence is a controversial issue.

The above proposals still have to be adopted by Congress, so it will be some time before it is known how the new laws will be structured and when they will come into force. In the meantime, it is becoming increasingly clear that governments are interfering far more directly in the economy:

- Big companies in difficulties are being supported directly.
- Fiscal stimulation is being implemented not so much by lowering taxes or giving all households a cheque, but more through direct expenditure on energy-saving projects, for example.
- Banks receiving support are being put under 'gentle' pressure to continue lending money, in particular.

The above measures are, naturally, quite understandable. Big car manufacturers, for example, are being helped because bankruptcy (without an immediate restart) would also jeopardise thousands of jobs at suppliers. By spending fiscal stimulation directly, political objectives can be immediately achieved and by putting banks under pressure to lend more, the economy is stimulated and promising companies can obtain finance. This is also necessary, as more regulation of credit extension outside the banking system will probably lead to far less credit extension by investors. Banks can then fill this gap.

**Financial market-based lending has collapsed as investors flee**



— US, Asset-Backed Corporate Paper, Amount Outstanding  
Source: Reuters EcoWin / ECR

*The economy is currently also too weak to survive without fiscal and monetary stimulation.*

We also have to bear in mind that the economy currently remains too weak to survive without fiscal and monetary stimulation. If the government limits its expenditure or increases taxes, then the economy will quickly fall back into a recession, if not a depression. This is what happened in the 1930s, incidentally. 'The New Deal' initially appeared to be working, so President Roosevelt decided to cut government expenditure and repay part of the public debt. This pushed the US back into recession. We have to remember, though, that the longer governments maintain fiscal stimulation the higher public debt mounts. To justify this to tax payers, the government will demand an increasing say in how the money is spent.

*Consumers, companies and banks will primarily want to repay debts and the increasing government intervention will not benefit growth opportunities in the long run.*

In our view, this means the following for the economy and companies in the coming years:

- In our opinion, the bursting of the asset price and credit bubbles has caused a structural change in a number of areas. After years of saving less and borrowing more, Western consumers will now borrow less and save more to secure their pensions and build up a financial buffer in these uncertain times of high unemployment. Not only consumers but also companies and financial institutions (and major investors) will want to reduce their debts, either because they find the risk or the costs too high, or because they are forced to by banks and other lenders. Finally, government intervention in the economy will increase and there will be more regulation. Higher savings and a reduction of debts will exert heavy pressure on the economy in the coming years. In the short term, extra stimulation will counter this, but in the long term, more regulation and a larger government will only lead to fewer dynamics in the economy and therefore fewer growth opportunities. In short, our expectation of ailing Western economies in the coming years (with growth figures of -2% to 2% for the US and slightly lower for Europe) is reinforced by more government intervention in the economy.
- Government policy will become increasingly important for companies and investors. Instead of competing primarily on price/quality, it will also be important for companies to somehow align their products with government policy or the objectives the government sets. The degree of influence the government acquires on the economy and demands on banks in the coming years will become more important for sales opportunities and possibly even for financing conditions. For investors it is already important to take the policy of governments and central banks into account. Questions such as 'which bonds or money market paper will the authorities buy if they want to suppress interest rates?' and 'What influence is the fiscal stimulation having on the dollar?' are becoming increasingly important.

*Government intervention will also change companies' strategy.*

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## **IMPLICATIONS FOR THE FINANCIAL MARKETS**

*At first sight, a V-shaped recovery seems plausible, but we don't expect this.*

In our opinion, investors who expect stock markets and the economy to make a V-shaped recovery will be disappointed. It is, incidentally, quite understandable why a V-shaped recovery is expected. In recent decades, every recession was followed by a relatively rapid recovery. The current recession may be heavier and deeper, but on the other hand governments and central banks have implemented far more stimulation than ever, in a short time. Additionally, the sharp rises in stock and commodity prices have made confidence grow, especially as figures are fast improving and some even indicate growth.

*Stock prices rose sharply primarily due to excess liquidity and in response to panic in February.*

We have serious doubts about this expectation:

- The recovery of the financial markets is largely because the economy is no longer expected to slide into a deflationary spiral, due to the large-scale fiscal and monetary stimulation. In other words, a large proportion of the rise up to now has been a correction of panic selling in February 2009. Moreover, the central banks have recently been pumping far more money into the economy than the real economy can absorb. Part of this excess liquidity has flowed to the asset markets and driven up prices.
- The better (or less gloomy) figures are primarily due to the fiscal stimulation and because companies are now replenishing their stocks again after first having drastically reduced them. Furthermore, statistical effects will ensure better figures in the coming months. House building in the US, for example, has declined so far that a 10% fall has a far less negative effect on the economy than two years ago. The last two are one-off factors that are supporting growth, but it is becoming increasingly clear that this also applies to stimulation. Bond markets already made it clear at an early stage, with a sharp rise in long-term interest rates, that they will not tolerate further stimulation. After all, this would only fuel fears of higher inflation in the future and concerns regarding untenable budget deficits and public debt. We then swiftly arrive at a situation where rising long-term interest rates hurt the economy more than stimulation supports it.
- Any recovery therefore primarily depends on a recovery of the asset markets to levels of two years ago, growing consumption and investment (we don't expect either in the coming years) or growing dynamics in the economy. More government regulation will not benefit these dynamics, however.

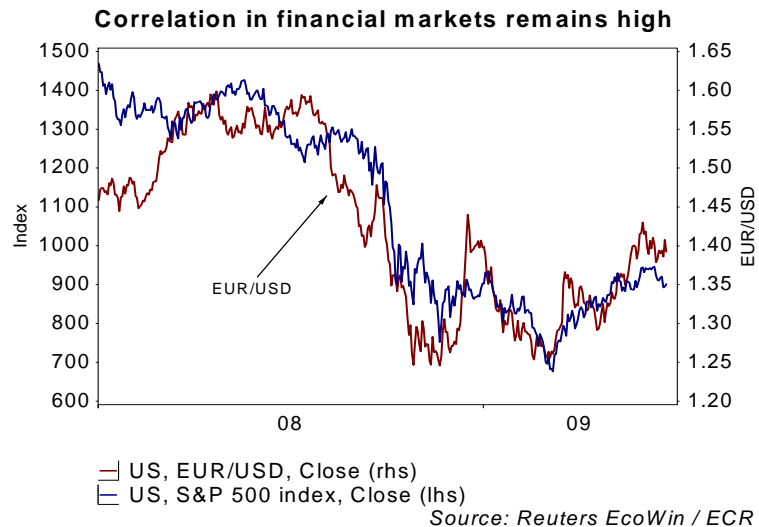
*Statistical effects and the stock correction are also giving a false picture and the necessary economic dynamics are being inhibited by increased government intervention.*

*The markets will not tolerate further stimulation, which is reflected in higher interest rates.*

In other words, a sustainable recovery depends on the degree to which the authorities can stimulate the economy, which in turn depends on the degree to which the bond markets allow this. Due to higher long-term interest rates the financial markets appear to have come up against a wall. Setting aside any last brief rise, we foresee stock prices falling in the coming weeks to months until long-term interest rates have fallen far enough and the pressure on the authorities to implement further stimulation has increased considerably. We expect this once yields on 10-year US and German Treasuries (now around 3.7% and 3.4% respectively) reach 3.45% and 3.25% respectively and the S&P 500 index falls to around 800. We then envisage the authorities implementing further stimulation, so growth expectations could increase and commodity and stock prices rise (we expect the S&P 500 index to then rise to around 1050). At that point, we expect concerns for future budget deficits and inflation risks to grow, which will push up long-term interest rates. We eventually expect yields on US and German Treasuries to rise to 5% and 4% respectively. We then foresee the bear market rally ending, stock prices plunging to new lows and long-term interest rates falling.

*We first expect EUR/USD to fall to 1.30, before rising to 1.40 -1.50.*

In recent months, the currency, stock and interest rate markets have reacted strongly to one another. If growth expectations rise, then stock prices and interest rates rise, too, the dollar falls and vice versa. This would mean that, over the coming weeks to months, EUR/USD could first fall to around 1.30 (chart-technically, a breakthrough to 1.38 – 1.36 would be an initial confirmation). After that, EUR/USD could rise along with stock prices and interest rates towards 1.40 – 1.50. For this scenario, EUR/USD does have to remain below the resistance level of 1.417. After all, if it breaks through this level, the rate could easily rise to 1.43 and 1.47 before embarking on a fall towards 1.30. Although we don't expect this, it could happen if stock prices now first rise.



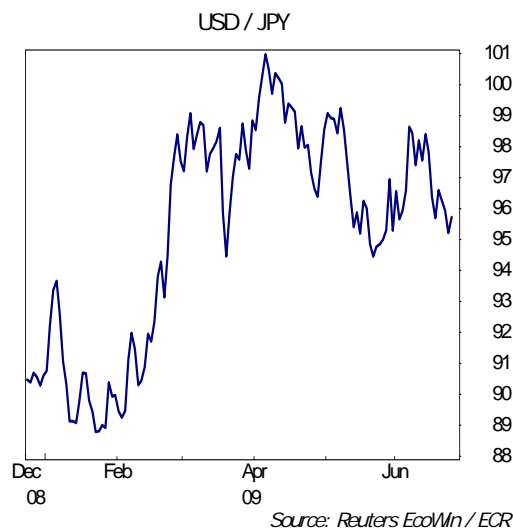
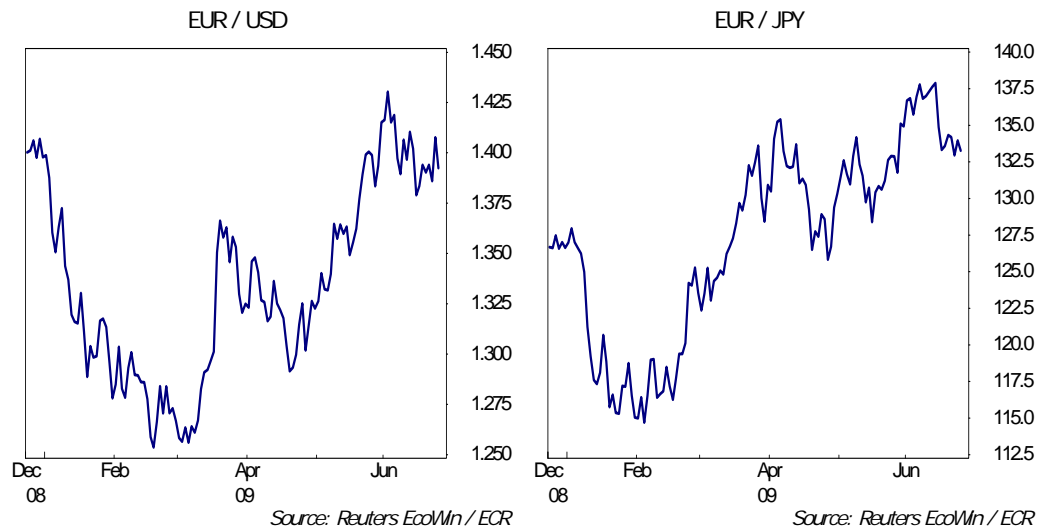
*Downward pressure on the euro is increasing, however.*

Personally, we think that EUR/USD will not rise much further than 1.40 once stock prices start rising again. After all, we expect the following developments to exert increasing downward pressure on EUR/USD.

- As more fiscal and monetary stimulation is being implemented in the US, we expect growth differences to increase to the advantage of the US and American long-term interest rates to rise more rapidly than those in Germany. It is becoming increasingly attractive to invest in the US in relation to Europe. Moreover, we foresee the weak European economy having difficulty bearing a EUR/USD rate higher than 1.40.
- European banks are experiencing greater difficulties than the US banks. Not only are their capital buffers for absorbing losses smaller; European banks also have sizeable credit portfolios of loans in emerging industrial countries, in Eastern Europe in particular. Major losses are expected on these loans, while the economic situation in Europe itself has also deteriorated badly, housing prices are falling and unemployment is mounting steeply. The economic situation in the US has also deteriorated badly, but American banks have already sustained a relatively large proportion of the losses on outstanding loans.
- US monetary policy is far more directly focuses on making it easier and cheaper for companies and consumers to borrow, while increasing the money supply. The ECB's monetary policy is far more indirect in comparison and depends more on the banks' cooperation. Most of the ECB's measures, for instance, are aimed at making it cheaper and easier for banks to borrow, in the hope that they will then lend this money to companies and consumers at lower interest rates. Due to the worsened economic situation, falling housing prices and rising unemployment, however, the demand for credit is tailing off and banks are becoming far more cautious in lending. This will only be aggravated once the banks' losses actually mount considerably.
- This week, the Fed announced that it will not be easing monetary policy for the time being, due to decreased concerns deflation concerns. The ECB, on the other hand, announced this week that banks have taken out around 440 million euros' worth of loans at 1% interest. As soon as banks start lending this, or using it to buy bonds with a higher return, the amount of euros in the economy will also increase. This is negative for EUR/USD.

*In the US, more stimulation is being implemented, banks now appear to be in a better condition and a far more direct monetary policy is being implemented.*

In other words, in the coming months to quarters we expect the relationship between EUR/USD and the stock markets to be maintained, but the downward pressure on EUR/USD will gradually increase, even if stock prices are rising. Finally, we expect EUR/USD to fall to around 1.10 in 2010.



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