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SUMMARY

Doubts regarding recovery. Justified, but for the wrong reason

Over the past few weeks, the financial markets have started having further doubts as to the recovery of the US economy. This is due to disappointing employment figures and surveys amongst small businesses. There are concerns that companies will soon have finished making up the cuts they made in their production, stocks, investments and workforce by the middle of the year.

In our view, though, there is a fairly good chance of employment and lending recovering so far that a self-perpetuating spiral of recovery and rising - underlying - growth is created. Only very temporarily, however. After all, as soon as growth really rises, we expect the recovery to cut its own throat with excessive rises in (long-term) interest rates.

In China, the economy is showing signs of overheating, so the government has started tightening monetary policy. This is not intended to curb growth by much, though. It is more to curb the increase in growth. This does increase the chance of the Chinese currency being revalued, though.

It looks as if growth in the EMU countries will remain low for the time being. In many member states, this is causing a deterioration in public finances, so measures have to be taken to reduce budget deficits. This suppresses growth even further, which can only be compensated for by maintaining an extremely easy monetary policy.

Implications for the financial markets

Over the coming months, we foresee long-term interest rates in the US and Germany rising by 0.75 – 1.5 and around 0.6 percentage points respectively, albeit with considerable downward corrections in the interim.

We expect EUR/USD to fall over the coming months to quarters to around 1.20, albeit with considerable rallies in the interim (at the moment, we don't envisage it rising further than to around 1.48).

DOUBTS REGARDING RECOVERY. JUSTIFIED, BUT FOR THE WRONG REASON

Doubts are arising regarding the recovery of the world economy.

Banks remain reticent and consumers are saving more.

Growth of the US economy will remain low. Monetary policy will therefore have to be kept easy.

China has indicated that it will raise interest rates.

Has enthusiasm regarding the world economy based on the improved economic figures been a little excessive?

Over the past few weeks, doubts about the economy have been increasing in the financial markets, especially those in the US. Long-term interest rates have responded by halting their rise and the dollar has weakened. After all, a persistently weak recovery of the American economy means that the Fed will continue implementing an extremely easy monetary policy for the time being. A number of Fed members have been indicating as much. They point out that banks are still reluctant to extend new loans and consumers want to save more and borrow less. In their view, the best that we can expect in such a climate is a weak recovery of the US economy. They don't therefore expect much solace from exports, either. Not because the economies outside the US are growing too slowly – a number of countries in Asia, in particular, are doing extremely well - but primarily because exports constitute too small a proportion of the total American economy. The same Fed members also point out that budget deficits have to be reduced as quickly as possible, and this will also inhibit economic growth.

In response to the disappointing employment figures in the US, many in the financial markets became convinced that growth of the US economy will remain weak for the present and that the Fed will have to maintain an extremely easy monetary policy for some time to come.

China has already started raising interest rates, prompting fears of lower growth in the Chinese economy, while China plays a leading role in the world where economic growth is concerned. This dampened spirits with regard to the world economy even further, so stock and commodity prices fell anyway, even though monetary policy outside the Far East - but also in Japan – is expected to remain extremely easy for the time being.

The question is therefore whether the response to improved economic figures has been too enthusiastic in many cases. This question is crucial for price forming in the financial markets; should the world economy indeed remain extremely weak, then interest rates will remain low, the dollar will weaken slightly and it is doubtful that stock and commodity prices will rise much further. We will therefore go into this issue in detail below.

Awareness of economic weakness might put an end to last year's rise in stocks and commodities



Source: Reuters EcoWin / ECR

MULTIPLIER EFFECTS

The Fed is right in saying that we can't expect continued higher growth.

In principle, the Fed members are quite right in saying that as long as banks remain reluctant to extend new loans and consumers want to save more and borrow less we can hardly expect continued higher growth. Especially as they are also quite right in saying that US budget deficits have to be reduced as quickly as possible and that exports constitute too small a proportion of the total economy to have much effect. This is aggravated by a recent rise in oil prices, which is hurting foreign trade.

The reasoning of certain Fed members does not reflect the current situation accurately.

In our opinion, however, this is too restricted a view of the current situation. To begin with, one might wonder how it is that the American economy still grew by 2.2% in the third quarter of 2009 and growth appears to have even risen as far as 4% - 5% in the fourth quarter. The explanation lies in two factors:

- Credit extension to the private sector may have dropped sharply, but that doesn't apply to the total US economy. First of all because the government has increased its borrowing tremendously. By more than lending to the private sector has shrunk. We have to remember that the money the government borrows is immediately ploughed into the economy. Furthermore, roughly 80% of lending is done by banks in the EMU countries, while that figure is only around 50% in the US. The rest is done through the money and capital markets. There are a number of indications that lending is recovering better in the money and capital markets than in the banking sector.
- When the credit crisis broke out, many American companies reacted strongly. They reduced their production, stocks, investments and workforce as far and as quickly as possible. By far more than turnover finally fell, due to all the fiscal support of the economy. Hence the current making up of the reductions. This is now helping economic growth on all fronts. Something that will probably continue for a number of quarters.

The high growth of the third and fourth quarters was due to inflated budget deficits and a snap reaction from the business community.

The trouble is that the catching up many American companies are doing now will be over in a few quarters' time and the government can't keep increasing budget deficits. As far as the latter point is concerned, the 'lesson' Greece is now learning is highly illustrative for the rest of the world. At some point, budget deficits and debts mount so far that the credit rating for the Treasuries of the country in question is downgraded. Credit default swaps rise in response. Interest rates in the country in question then immediately rise, so the interest payable item in the budget soars. Public finances deteriorate further and so forth. Admittedly, this risk seems not to be so great in most countries, if you look at the size of their current deficit and debts, but things look quite different if you take into account the implications for public finances of the ageing population. For most countries, therefore, it is asking for trouble if they inflate budget deficits any further now.

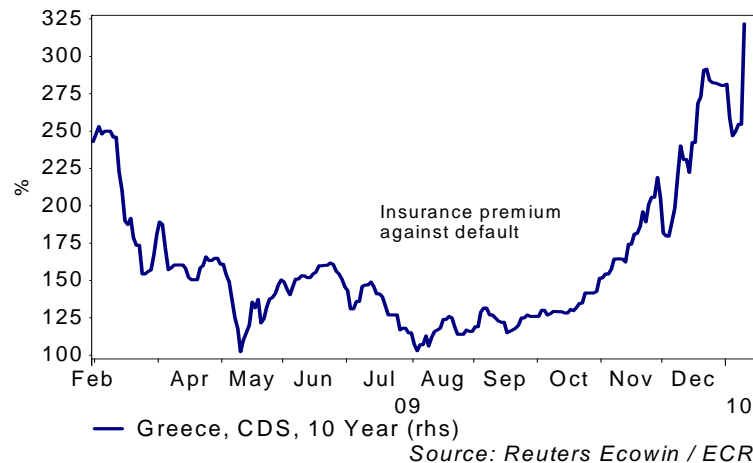
Companies making up their reductions and high government expenditure will not go on for ever, though.

Further inflating budget deficits leads to higher, untenable interest rates.

Against this background, low growth in 2011 seems probable.

Against this background, it therefore seems reasonable to expect lower growth again for 2011. The effect of companies making up their reductions will then be over completely and the government will probably then start reducing budget deficits. Things won't necessarily pan out like that; after all the economy could quite possibly start growing so rapidly due to the government stimulation and the making up companies are doing that employment quickly increases rather than shrinks. Experience has shown us that if this persists for a little while, both consumers and banks will gain more confidence in the future and start borrowing and lending more. If so, then rising employment and lending will increase consumer purchasing power by so much that companies will have to increase their production, stocks, investments and workforce even more. In other words, a self-perpetuating positive spiral is created. In technical terms, the multiplier effects start playing a significant role.

With the Greek drama in mind, fiscal budgets will be cut around the world, slowing down growth



If the current growth causes employment to rise, however, then banks and consumers will gain confidence.

This leads to a self-perpetuating positive spiral.

This is certainly not unthinkable in the current situation, where all leading indicators point to increased employment and the government being slow to economise.

A combination of the above points could even lead to a mini boom.

The chance of the above happening in the current situation is certainly not unthinkable:

- At the moment, all leading indicators for both employment and the economy in the US are clearly pointing upwards.
- There will be US Congress elections in November. There is therefore little chance of much being done before then to reduce budget deficits that will inhibit the economy. On the contrary, there is a good chance that everything will be done before then to provide extra support for the economy. We saw this recently with the aid for the housing market. Once it came to an end and the housing market responded by declining, the aid was immediately extended.
- There has been much political criticism of the Fed recently. Many Congress members found that the central bank was in some way to blame for the creation and bursting of the bubbles in the housing and credit markets. Numerous bills are currently being proposed to considerably reduce the power of the central bank and shift a large part of it to the government. This is a frightening prospect for any central bank. This should be combined with the fact that the 1930s depression was aggravated tremendously by fiscal and monetary policy being tightened too soon. The Fed will certainly not make the same mistake again. Especially as it would almost certainly cost it its independence, with the current mood in Congress. There is therefore every indication that the Fed will continue to aid the US economy as long as possible with as easy a monetary policy as possible and will err on the side of tightening too late rather than too soon. In other words, the US economy will continue to be stimulated both fiscally and monetarily. On an abnormally large scale, historically speaking.

We would like to go one step further, however. With the combination of the aforementioned points, something of a mini boom can't be ruled out, either. After all, we have to bear in mind that for some time the Fed, but also a number of other central banks, has been creating more extra money than the real economy can absorb. The consequent surplus of liquidity then largely flows to the asset markets. So

As soon as the housing market picks up, bank balance sheets improve considerably and consumers have more to spend.

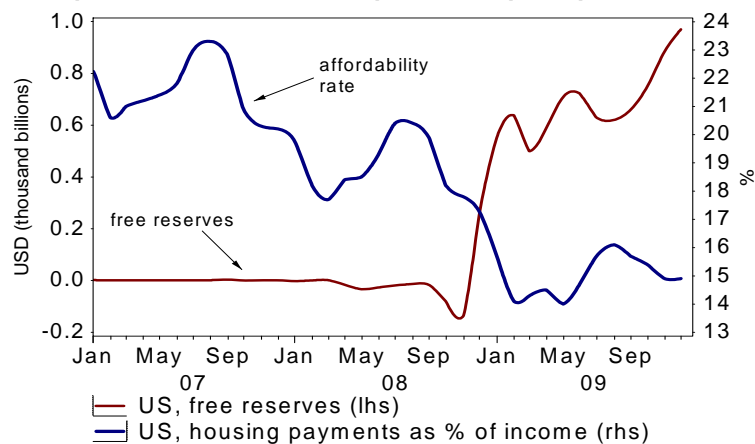
This sets a flywheel effect in motion, where asset prices rise further.

Only a shortage of liquidity could stop this.

far, it has primarily flowed to stocks and company bonds. These have reached levels where they are discounting an extremely positive situation for the economy, though. This does not apply in any way to the housing market. The prices in this market have just stabilised after falling by around 25%. This has created a situation where houses are starting to become relatively cheap within the bounds of investment possibilities. Especially if, as it looks now, employment recovers, boosting consumer incomes and therefore the ability to fulfil interest and repayment obligations.

Should this improve the housing market, then this will set a flywheel effect in motion. After all, as soon as the housing market recovers, all kinds of mortgage loans extended in the past, on which banks have had to make such drastic writedowns, will appreciate in value. In other words, an improvement in the housing market goes hand in hand with an improvement in the banks' position. As soon as the banks' position improves, however, they will start lending more and consumer purchasing power will increase even further. This will further support asset prices, too. A self-perpetuating spiral will therefore be created that can only be broken by a shortage of money (reserves) at the banks. That will not happen for the moment, though, as they actually have a surplus.

Improved affordability of houses and plenty of potential credit make positive spiral possible



HIGH GROWTH WILL NOT CONTINUE

The above does not imply that we are suddenly extremely positive about the US economy.

The above does not mean to say that we are now suddenly going to have a highly positive view of the US economy. After all, unfortunately we feel high growth will cut its own throat. The reason why we think so is actually simple. In our opinion, the credit crisis was caused by asset prices and debt positions being artificially inflated in the past (also see our recent reports). Far too many debts were created on the basis of assets with an artificially inflated value. When inflation began to rear its head in 2006 and the Fed had to tighten monetary policy, asset prices therefore immediately plunged. Consequentially, all kinds of loans depreciated in value or could not be repaid at all. This also created a negative spiral of loans that were worth less, mounting

Excessively inflated asset prices and easy monetary policy are what heralded the crisis.

losses for banks that then extended less credit, declining economic growth and further drops in asset prices, etc. If this situation had been allowed to take its course, it would certainly have led to a deep depression with at least 25% unemployment. Hence the massive monetary and fiscal stimulation.

To fight the crisis, asset prices were inflated again through monetary and fiscal stimulation.

What does this mean, though? Fiscal stimulation means increasing budget deficits. This has to be financed by the government issuing more debt securities. Easing monetary policy is also intended to increase the number of loans and reduce saving. In other words, the authorities are now attempting to solve a crisis created by excessively inflated asset prices and excessive debt positions by again artificially cranking up asset prices and further increasing indebtedness. We don't expect the financial markets to put up with this for long. As soon as the economy gets off the ground then we foresee interest rates – long-term interest rates in particular – rising so far that asset prices start falling and many parties will be forced to start saving more and borrowing less. Instead of increasing borrowing further, people will start repaying old loans.

Once the economy grows, the financial markets will not put up with the current situation.

We expect the mechanism that guides this process to be as follows:

First of all, long-term interest rates will rise as a result of the clash in demand for credit from the government and the private sector.

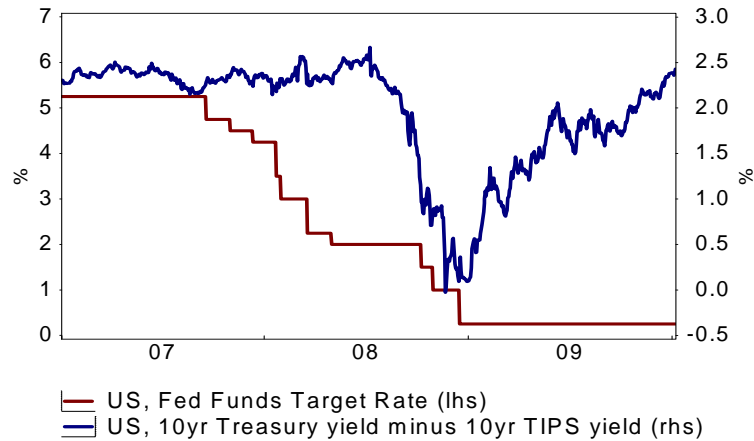
- The economy can only end up in a positive spiral if lending increases. This will primarily have to be in the private sector. The increasing demand for credit from the private sector will then clash with the persistent enormous demand for credit from the government, however. That will push up interest rates, both nominal and real. This, in principle, not only makes borrowing less attractive; it also encourages saving. It encourages the repayment of old debts. Rising interest rates also suppress asset prices. This has the same effect.

Secondly, an increase in the money velocity and inflation expectations will force central banks to tighten monetary policy.

- The Federal Reserve has more than doubled its balance sheet over the past year. That means a tremendous increase in the money supply, which would normally have resulted in a high risk of inflation. This is not the case now, however, as inflation is affected by not only the money supply but also the money velocity (how often the same dollar is spent). With the decline in lending, the money velocity has ground to a halt, however. This is why the enormous increase in the money supply has not led to inflation problems so far. In other words, the consumer price index has hardly risen. Asset prices are a different story, though. As we already mentioned, a surplus of money has been created and what has not been absorbed by the real economy has flowed to the asset markets, pushing up prices there (so far primarily the prices of stocks and company bonds). If the economy starts improving now and lending increases, then the money velocity will increase. That quickly creates an inflation risk. The central bank will then have to swiftly tighten monetary policy. This is negative for asset prices from two points of view. The central bank will create less new liquidity or even withdraw liquidity from the system. Additionally, the real economy starts absorbing more liquidity as growth picks up. Combining this with the rise in (real) interest rates that can then be expected, not will only this exert extra upward pressure on interest rates, but asset prices will also fall all the further.

Both developments will nip the rise in asset prices and the economic recovery in the bud.

Tighter monetary policy due to increased inflation expectations will hinder economic growth



Source: Reuters EcoWin / ECR

We therefore suspect that the higher growth of the US economy will not last long, as it will cut its own throat. In other words, the final result will be the same as the Fed is warning of now, but the route will differ considerably.

OUTSIDE INFLUENCES

Although the credit bubble was not inflated as far in the EU, the economy has shrunk by more than in the US.

The largest block in the world is currently the EU. As we explained in detail in previous reports, the credit bubble was never inflated as far there as in the US. When the credit bubble burst, the blow was therefore not as hard in Europe and there was less risk of deflation. Especially as the European economy and labour market are far less flexible, so prices and wages also fall far less easily than in the US. Understandably, therefore, there was also far less monetary and fiscal stimulation of the European economy after the outbreak of the credit crisis. Hence the unfortunate final result: the European economy has ultimately shrunk more than that in the US and less growth is expected in the European economy for the time being now that economies are starting to recover everywhere.

The European economy will also growth less as fiscal policy is tightened earlier.

The shrinkage is also certainly due to the fact that it looks as if fiscal policy will be tightened sooner and more drastically in Europe than in the US. There are a number of reasons for this:

- There has never been a real housing or credit bubble in Germany. The credit crisis has therefore hit the German economy relatively less hard, directly. This, in turn, makes it relatively easier for the Germans to quickly put their house in order where public finances are concerned. As this is the largest and most influential economy within the EU, the other member states have to swiftly follow suit.
- Especially as the limits set in the Maastricht Treaty have been exceeded virtually everywhere. If Germany now manages to get its public finances back within the levels, then that will show up the others even more clearly. As we already saw in the case of Greece, this can quickly lead to a downgrading of the credit rating and therefore to higher interest rates in the countries in question. This is forcing most of the EU member states to follow the example of Germany, where the reduction of budget deficits has now been set out in a law, as quickly as possible.

Some countries have not really experienced a bubble.

The Maastricht Treaty does not permit high budget deficits or public debt.

The ageing population is taking a heavy toll on public finances.

- The population is ageing far more quickly in Europe than in the US. This will therefore take a heavier toll on public finances. This prospect, too, is forcing many EU countries to reduce their budget deficits as quickly as possible.
- Finally, the US had a far better starting position than the EU. At the outbreak of the crisis, budget deficits and public debt were lower in the US than in the EU.

Fiscal tightening is necessary, but not in the short term.

This does not, incidentally, mean that we expect most countries in the EU to actually reduce their budget deficits in the short term. Countries such as Italy, Greece and Portugal are struggling with tremendous structural problems, while countries such as Spain and Ireland are suffering from the fall in property prices. In all these countries, the best that can therefore be expected for the time being is low growth. In such a climate, fiscal tightening is rather suicidal. After all, it suppresses the economy even further, so government revenue falls even further and expenditure rises even further. In other words, cutting costs is like cutting your own throat. We can therefore expect the reduction of budget deficits to be done slowly.

That would set the economies back even further.

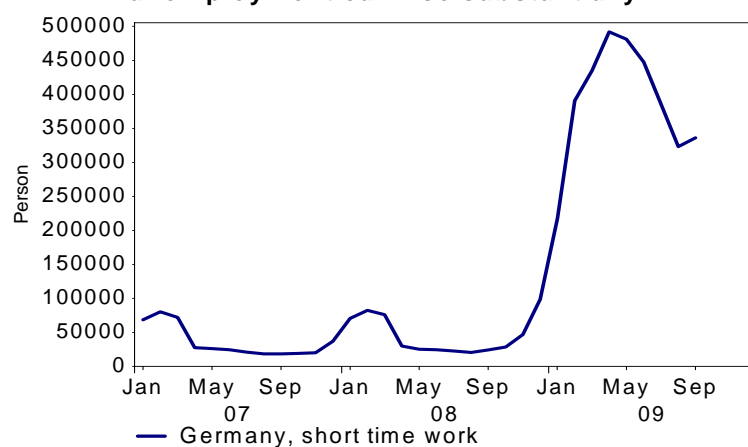
There is a major difference from the US, where stimulation has been much harder and a far stronger recovery is underway.

All this, however, means a major difference from the US. As there is no strong recovery in view for the EU for the time being – there is too little stimulation – it does not look as if the European economy will end up in a self-perpetuating spiral of increased employment, more consumer expenditure and investments, a further increase in employment and so forth. Especially as:

- As we mentioned above, fiscal policy will be tightened as far as possible. That will be the tendency, in any event.
- According to the IMF, European banks have not even declared 50% of their total losses. It is therefore highly likely that European banks will remain extremely reluctant to extend new loans for the time being.
- So far, there has only been a slight decline in employment in Europe. This is primarily thanks to all kinds of government measures to encourage employers to keep employees on, part-time in any event. The effect of these measures is beginning to wane, however, now that more and more companies are assuming that the fall in their turnover could well persist for some time.

The EU countries are keen to tighten fiscal policy earlier, banks have declared less than 50% of their losses and the decline in employment is limited.

When short time work arrangements taper off, unemployment can rise substantially



Source: Reuters Ecowin / ECR

With growth remaining low the ECB will keep monetary policy easy.

Only emergency measures will be reversed.

With many factors pointing to persistent low growth, the ECB will probably maintain an extremely easy monetary policy for some time to come. Now the European economy has stopped shrinking, the most the central bank will do is gradually reverse a number of the emergency measures, but this will not tighten policy much. This situation also means that the amount of surplus liquidity in Europe will fall less quickly. In terms of both the absorption of liquidity by the real economy and the creation of money by the central bank. We therefore also expect relatively better performances from stocks, bonds and property in Europe than in the US. Although we foresee US interest rates coming under increasing upward pressure, this could be slightly tempered by a continued high level of capital import from Europe to the US. Opportunities for US companies to export to Europe are limited, however, but trade between the US and Europe is already relatively limited anyway.

CHINESE ECONOMY PERFORMING BEST, BUT FOR HOW LONG?

Growth is by far the highest in China.

Growth is currently by far the highest in the Far East. Not in Japan, as the Japanese economy is struggling with tremendous structural problems, but primarily in China and its neighbouring countries. There are a number of reasons why the Chinese economy is growing so rapidly:

- When the credit crisis broke out, China started heavily stimulating its domestic economy. Due to the recovery of the world economy, Chinese exports are also picking up, however.
- The dollar rate has been under downward pressure over the past year. To keep the Chinese currency constant in relation to the dollar, the Chinese central bank has therefore had to buy a lot of dollars and sell a lot of yuans. This has increased the money supply in China tremendously.
- To retain the dollar peg on the yuan, China also has to keep its interest rates close to those in the US. This has left China with excessively low interest rates for the circumstances.

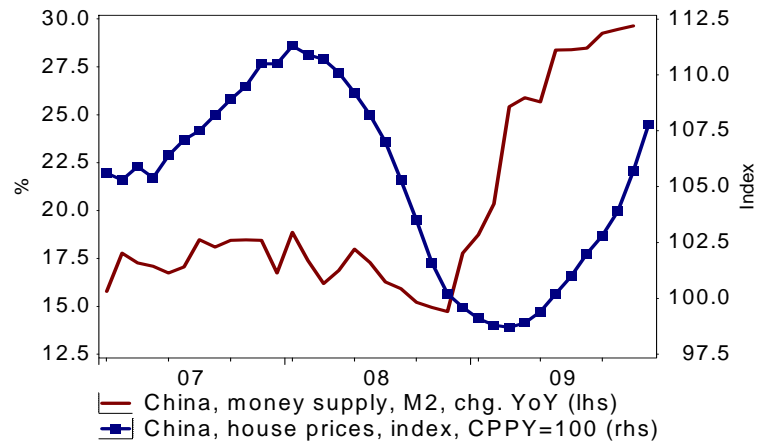
The Chinese economy is able to grow extremely rapidly due to the stimulation of the domestic economy, a high supply of yuans and excessively low interest rates.

This high growth is now beginning to lead to bubbles in the property market.

In addition to high economic growth, all this is now also starting to lead to bubbles in the property market and to a slight risk of inflation. China has therefore gradually started tightening monetary policy. It will probably be done extremely slowly for the time being, though. After all, China first wants to wait and see how far the economy recovers in the rest of the world, particularly in the US. Like the Fed, it is not yet convinced the recovery will last. In principle, this is also to the advantage of the US, as a lot of the surplus Chinese money is being invested there. This is suppressing US interest rates. We cannot rely too heavily on this, nevertheless, as China is increasingly investing its reserves in commodities rather than in the US. After all, China has hardly any commodities itself, while it will be needing more and more as the size of the Chinese economy increases. So it looks as if the capital flow from China to the US has passed its peak. The disadvantage of this for both the US and Europe is that China's policy is pushing up commodity prices and making imports more expensive.

China is responding by tightening its monetary policy, albeit slowly.

Excess money as a result of currency peg inflates asset bubbles in China



The most likely scenario is that growth will be high in the US over the coming quarters.

A self-perpetuating spiral will be created.

Long-term interest rates will seriously curb growth, however.

Conclusion

So far, there has been no increase in employment or bank lending in the US. As long as this continues, the American economy will not end up in a self-perpetuating spiral. This would also mean that the recent rising growth – 2.2% in the third quarter and around 4% for the fourth – is attributable purely to a number of one-off factors. These will come to an end in mid-2010, so after that we can expect extremely low growth again, if not a new recession. Things don't necessarily have to develop that way, though. In fact, this is not even the most likely scenario. After all, it is more likely that the growth over the coming quarters will remain on the high side as a result of monetary and fiscal stimulation, leading to increased employment and lending in the near future. The recovery will then not only end up in a self-perpetuating spiral; it will also become increasingly stronger. The big problem, however, is that this will probably cause a rapid rise in interest rates – particularly long-term interest rates – and growth will be seriously curbed again.

Where the financial markets are concerned, however, as long as employment and lending fail to really improve we have to allow for periods of doubt as to whether the recovery will actually get off the ground. Paradoxically, however, just at the point when such doubts disappear interest rates rise excessively and growth declines sharply.

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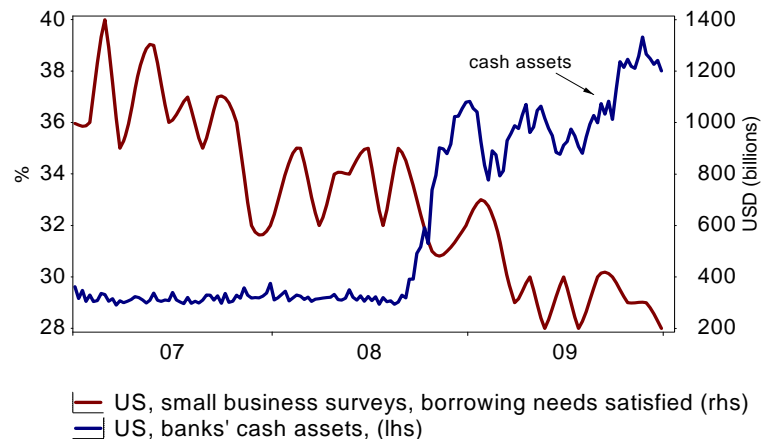
IMPLICATIONS FOR THE FINANCIAL MARKETS

There are doubts concerning the growth of the US economy.

We are currently in a period when there are concerns that the growth of the US economy will fall right back to around 0% in mid-2010. Understandably; according to the first provisional estimations, employment shrank by around 85,000 jobs over the past month and the latest survey among small businesses – where roughly 60% of the wages come from – indicates that they are unwilling to take on any extra personnel for the moment, due to a lack of financing facilities (small businesses are virtually entirely dependent on banks for their financing). Additionally, credit extension by

banks is still shrinking. It is difficult to say how long this period will last. Possibly a couple of weeks, as the figures published over the next few weeks could be disappointing, due to the recent cold weather.

Despite monetary easing and cash rich banks, smaller companies still have difficulties acquiring credit



Source: Reuters EcoWin / ECR

Even though monetary policy is easy, there could still be a correction in the stock market.

Due to the sharp rise, stocks are vulnerable to bad news.

As soon as the economy declines, new stimulation measures will be taken.

Disappointing economic figures will not, therefore, have much impact on the financial markets.

Yields on 10-year US Treasuries will rise towards 4.5% or even further, to 5.5%.

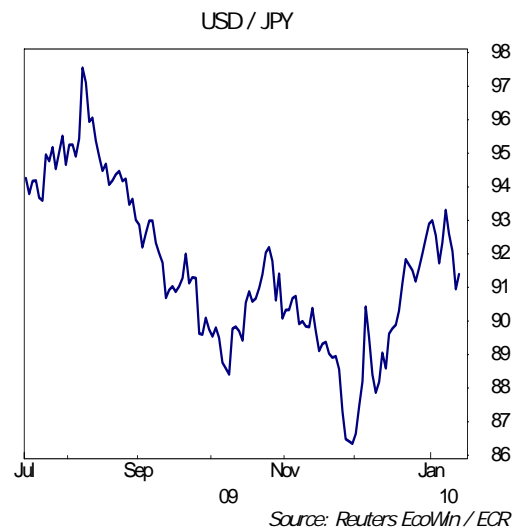
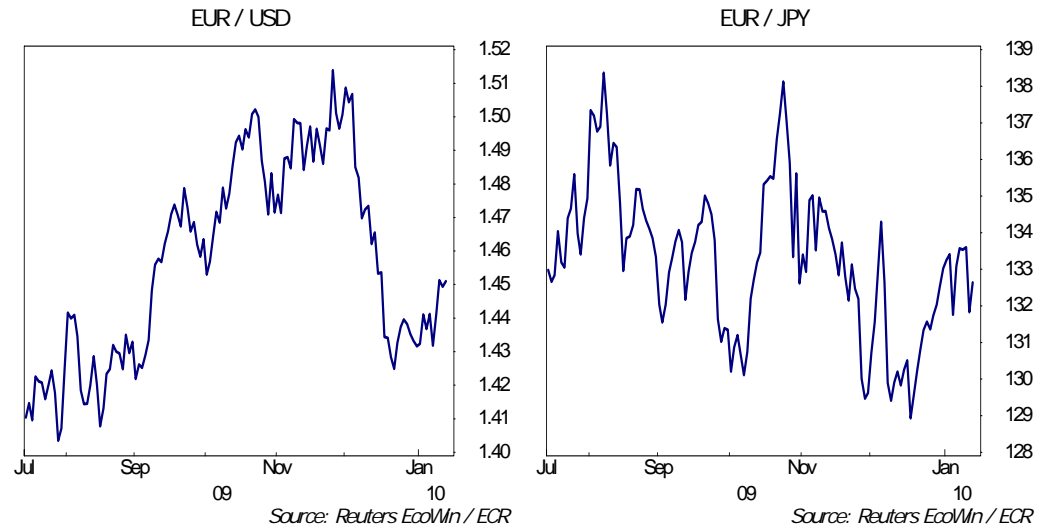
There could now easily be a correction in stocks. The advantage of disappointing growth is that the Fed's monetary policy will remain extremely easy for the time being. This creates money for the stock market. The only trouble is that stock prices have already risen so far. This makes them vulnerable to both disappointing growth and rising interest rates. There will be no rise in interest rates, however, if we are indeed at the beginning of a period of a couple of weeks in which there are doubts concerning the outlook for the US economy. Interest rates will even start falling, together with stock prices. Not by much, though, as if growth does decline again, then budget deficits will mount even further. The same then applies to the dollar. The drop in the dollar rate in relation to Far Eastern currencies may then continue, but it will probably remain extremely limited in relation to the yen and the euro. We don't then foresee USD/JPY falling much further than to around 89 or EUR/USD rising to any higher than 1.48. After all, we can't expect a stronger recovery in either Japan or the EMU countries, especially if the growth of the US economy declines again.

As we mentioned earlier, we don't think the period of doubt concerning the recovery in the US will last long. After all, now the Chinese economy is being curbed, too, that would mean the entire world economy falling back towards a recession. That would be unacceptable to policymakers, as it would quickly lead to deflation and therefore a negative spiral. We therefore then immediately expect extra stimulation measures both within and outside the US. This, in turn, then leads to rising asset prices, giving the economy an extra boost again. As this is the general assumption, though, there is a good chance that investors will already quickly be prepared to look past the dip. Even if economic figures are disappointing for a few weeks of months, we therefore don't see this having an effect on price forming in the financial markets for long.

Our conclusion is therefore that whether concerns for the US economy persist slightly longer or not, on balance interest rates will rise, EUR/USD will fall and stock and commodity prices will have little room to rise. In more concrete terms, this means that we envisage yields on 10-year Treasuries in the US (now around 3.75%) rising over the coming months to quarters to around 4.5% and those in Germany (now around

EUR/USD will fall further towards 1.20.

3.3%) to around 3.85%. We don't even rule out a rise to around 5.5% in the US. At the same time, we expect credit spreads to first narrow, but then to start rising in a few months' time. We foresee EUR/USD falling further in the same period to around 1.20. There is a fairly good chance, however, that this will be accompanied by considerable rallies in those periods of doubt regarding the recovery. We don't expect it to rise further than around 1.48 at the moment, though.



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