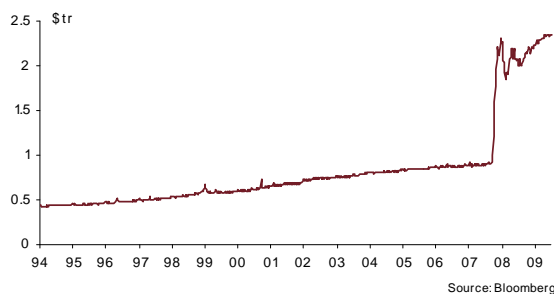


Central banks will offset tight fiscal policy with loose monetary policy

The co-ordinated fiscal support that fuelled the recovery in 2009 is now being succeeded by synchronised global fiscal tightening. We highlighted fiscal consolidation and deflation as key risks to the recovery in our *2010 Investment Outlook* at the beginning of the year, and it is now clear that these headwinds are becoming substantial. The EU and the UK have already put in place severe fiscal tightening programs in an attempt to calm bond investors and we believe the US will begin fiscal consolidation in 2011. Aggressive fiscal consolidation, when there is already plenty of spare capacity in the advanced economies, means deflation is the key threat that central bankers will be most concerned about.

Therefore, we think central banks will keep interest rates low for longer than generally anticipated. What's more, with evidence that the threat of deflation is increasing they will not unwind previous quantitative easing (QE), but rather embark on new measures, further expanding their balance sheets.

Federal Reserve Balance Sheet



Source: Bloomberg, as at 30/06/10

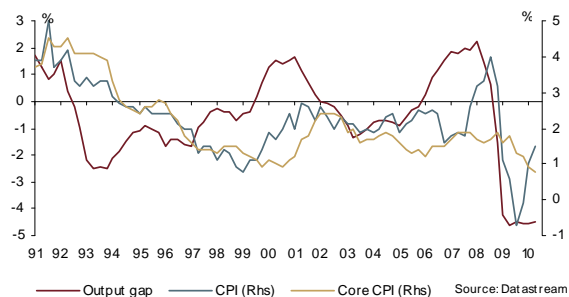
In the euro-zone QE will be needed sooner rather than later anyway to support euro-zone government bond markets and the wider financial

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system, as well as to offset the coming deflationary threat from weak growth and a large output gap. The 08/09 recession created enormous slack in the euro-zone economy.

Euro-zone output gap and inflation



Source: Bloomberg, as at 30/06/10

So far, the European Central Bank (ECB) has attempted to 'sterilise' its purchases of €51bn of euro-zone government bonds by removing liquidity elsewhere from the financial system. However, we believe it will soon take the final step of moving to unsterilised purchases, i.e. full-blown quantitative easing, and increase massively the amount of government bonds it buys too.

We think the ECB is simply biding its time to encourage further concrete action by euro-zone governments to consolidate deficits and coordinate fiscal policy. Once this happens it will 'reward' euro-zone governments by moving to full-blown and large-scale QE. Indeed, it may have to move to this anyway, if pressed by markets - for example by further sharp falls in equity markets or a further widening in euro-zone bond-yield spreads.

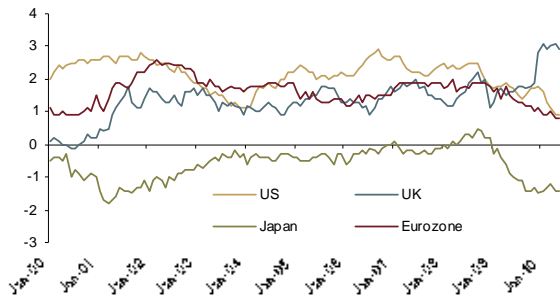
In the US, further aggressive quantitative easing is probably a bit further down the line than in the euro-zone and will be used principally to stave off deflation as this becomes a clearer threat. Core

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inflation has been falling for some time, and recently fell below 1% y/y.

Core inflation (% y/y)



Source: Bloomberg, as at 30/06/10

US Federal Reserve Chairman Ben Bernanke spent most of his academic career examining the causes of the Great Depression, as well as the Japanese experience with deflation, and what could have been done differently. In three seminal speeches and articles in 2002, 2003, 2004 he set out the case for extremely aggressive unconventional action by central bankers if deflation is becoming a problem. Bernanke made the general point that the US authorities have a tool called the 'printing press' that effectively allows them to create as many dollars as are required to overcome deflation. We have referred to his speeches and these methods before, but given recent market commentary, and the parallels for the euro-zone, it is worth reviewing some of the specific policy options that Bernanke set out.

One approach would be to commit to holding the overnight central bank interest rate at zero for some specified period. Long-term interest rates represent averages of current and expected future short-term rates plus a term premium. Providing it was credible, a commitment to keep short-term rates at zero for some time should induce a fall in longer-term rates. To some extent, we have already seen this with the Fed's use of the language of keeping interest rates extremely low 'for an extended period'. However, in a deflationary environment the commitment would be much stronger and explicit, e.g. for a year or two, or until inflation or the price level has reached a certain target.

Another method - which Bernanke stated that he favoured - would be for the Federal Reserve to announce explicit ceilings for yields on longer-maturity government debt.

These interest-rate ceilings would be enforced by committing to make unlimited purchases of securities at prices consistent with the targeted yields. If this programme were successful, not only would yields on medium-term government bonds fall, but yields on public and private debt would probably fall as well.

Indeed, there is precedent for this. The most striking episode of pegging bond prices occurred during the years before the Federal Reserve-Treasury Accord of 1951. Before that agreement, which freed the Fed from its responsibility to fix yields on government debt, the US central bank succeeded in maintaining a ceiling of 2.5% on long-term government bond yields for nearly a decade.

Another option for the Fed that Bernanke highlighted would be to buy private securities such as commercial and corporate debt, either directly or indirectly. Indeed, the Fed could even consider buying equities in an extreme scenario.

As deflation becomes an increasing threat in the US, we would expect the Fed to use some or all of these strategies, probably starting with further government bond purchases.

The key implication for investors is that, provided governments enact fiscal consolidation plans, short and long-term interest rates will stay low for longer than generally expected, supporting bond prices. In addition, as investors search for yield and as unconventional monetary policy extends to private debt securities, yields on investment grade corporate debt will fall too. Part of the US solution is also likely to be to target currency weakness, a tempting option for all indebted developed economies that will boost gold as the ultimate liquid store of value.

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