PICTET
1805

2½%
US GDP growth rate for Q3 2010 estimated from monthly statistics, compared to +1.7% in Q2
Page 4

5.1 bn
Size, in euro, of the Portuguese government's most recent deficit-cutting package
Page 5

QE2
The commonly used term for the second round of quantitative easing likely to be implemented by the Fed
Page 6

2.9%
Return delivered by high-yield corporate bonds in September
Page 10

1,300
The level that the gold price, in dollars, exceeded in early October
Page 11

175 bn
The extent of fiscal tightening, in dollars, implied by imminent expiry of the various tax breaks introduced in 2001 and 2003 by the Bush government
Page 12

8.9%
The predicted size of the US budget deficit, as a percentage of GDP, for the 2010 fiscal year
Page 13

Economic policy's time has come

October 2010

Perspectives

EDITORIAL OUTLOOK

Smart Ben

Yves Bonzon
Chief Investment Officer

The rally in risky assets in September took us by surprise, since our basic macroeconomic scenario has been quite correct. Developed economies, led by the United States, have indeed slowed significantly in recent months. According to our route map, such a slowdown would lead to a new policy mix, including a second round of quantitative easing in US monetary policy. We know that Ben Bernanke has an unparalleled understanding of the mechanisms at work in a balance-sheet recession. In such a recession, the monetary-policy transmission variable is no longer interest rates, but the price of assets, houses and stocks. However, we thought that he would wait for a new episode of stress in the markets to ensure the necessary political consensus to deploy a new programme of asset purchases using the Fed's balance sheet.

We were wrong. The lack of recovery in US employment and the resulting stress among US politicians have already created the conditions for the FOMC to pre-announce 'QE2' (quantitative easing 2). In a broken credit system, you can't win both ways. Either one manages to stimulate asset prices and the currency declines, or the dollar rises and the S&P500 goes down. To benefit from this monetary stimulus, we must buy assets in dollars or dollar-related commodities, while hedging against currency risk. Otherwise, measured against a stable value standard, the real gain is much lower or even zero: in gold or Swiss francs, the S&P has made just half its gain in dollars since QE2 has been in the air.

The impact of a radical announcement on the range of monetary policy tools available is impressively demonstrated by the behaviour of markets before QE2 has begun and even before it has been formally decided. Ben Bernanke deserves top marks for his skilful conduct of monetary policy. Under his leadership, America is unlikely to experience deflation even if markets are likely to scare themselves a few more times before the threat is finally extinguished.

Although the context is different, this cannot be said of the ECB, since it has mutually incompatible objectives, that is to say, to reconcile the needs of 'core' countries

without plunging the periphery into a depression. On the euro, too, we have underestimated the ability of Europeans, unlike the Americans, to drag the eurozone into deflation. It is now clear that the euro area only managed to stabilise the desperate situation it had fallen into in June with the providential help of Beijing. The Chinese fortress and its USD2,600 billion of reserves came to the rescue of the euro area in distress. Macro managers with their short positions in European assets were taken by surprise, but the consequences of this helping hand from the Chinese is now clear and certainly disastrous. As we wrote here a few months ago, "1.33 to the euro is still expensive and has no reason to remain". Today the euro is at 1.375 against the dollar.

The euro is so far the biggest loser of what the Brazilian Minister of Finance has recently characterised the 'war of currencies'. The Chinese are making a little effort to appease Washington and the Americans are putting in place the conditions necessary to avoid deflation. In Europe, deflation may yet be avoided, but unfortunately this will require a new major crisis, a crisis that is bound to happen when the periphery suffocates under the weight of austerity policies coupled with too strong a currency.

MACROECONOMICS

Waiting for QE2

Worries about economies sinking back into recession were largely dispelled during September, while statements from the Fed nurtured hopes of a second round of quantitative easing, known as 'QE2'. Nevertheless, the US economy has been slowing, and Europe has clearly been moving in the same direction. *Bernard Lambert and Jean-Pierre Durante*

The state of affairs in which the US economic upswing was less robust than the recovery in the eurozone did not last long. Unmistakable signs of a slowdown in Europe were confirmed in Q3 2010. This is likely to restore the conventional wisdom that the recovery will ultimately be more solid in the US. In the circumstances, fresh concerns about a eurozone member state defaulting and the single European currency falling apart might well unnerve the markets once again.

Growth in the US levelling off gently

The downturn in US economic growth in Q2 2010 fortunately did not extend into the third quarter. Monthly statistics released so far have even been pointing towards a growth rate close to 2½% in Q3, up from 1.7% in Q2. This is essentially a technical rebound though, connected to the spike in import growth in Q2 and a favourable reverse effect in Q3. Looking past the pattern of short-term figures, the US economy would appear to have moved from quite a robust rate of expansion over the 2009-10 winter months (almost 4½%) to a much more sedate tempo over the two spring and summer quarters (around 2%).

Looking ahead to the next few quarters, we would expect to see moderate growth (in the region of 2¼%), but whether that is feasible will depend on how the fiscal/monetary policy mix plays out. What happens on the budget front will have a crucial bearing (see 'Topic of the Month'), but monetary policy decisions will also affect dynamics in the economy.

Likelihood of a second round of quantitative easing

After the Federal Open Market Committee's September meeting, the Fed officially confirmed that it was prepared to push through further quantitative easing (referred to as 'QE2') if required. It commented that this decision had been prompted not just by the prolonged spell of sluggishness in the economy, but also by inflation remaining persistently below the rate required under its mandate. The chances of QE2 becoming a reality have risen markedly.

Indeed, the financial markets already appear to have taken a fresh wave of quantitative easing for granted when the FOMC next meets in early November. We believe that markets may be jumping the gun. Complete unanimity inside the Fed about the nature of QE2 measures is by no means the case. Whether a programme of QE2 is launched in November will depend on what is happening in the economy; the Fed might conceivably postpone its decision, especially as the really crucial decisions on fiscal policy are unlikely to be taken by Congress until the last few weeks of the year (if then). However, while its announcement might be put off until December or even January next year, in our view there is little chance of QE2 not being implemented.

The US economy would appear to have moved from robust expansion over the 2009-10 winter months to a more sedate tempo over the spring/summer quarters.

What form might QE2 take? The Fed's track record suggests that it is inclined towards a fresh bond-buying programme. However, unlike the previous scheme, it will probably not involve buying any mortgage-backed securities. Second time around, the Fed is also more likely to pursue a softly-softly approach, making announcements about purchases on a month-by-month basis, adjusting the programme to the economic climate.

Even though QE2 will not be the panacea to cure all US economic ills, such measures on a broad enough scale would certainly support the economy. Low interest rates alone will not be enough to get the credit ball rolling again, but they should give it a shove in the right direction or, at the very least, stop it rolling even further backwards. Moreover, the more indirect, favourable influence on the economy from a weaker dollar and rising asset prices should not be underestimated.

Economic slowdown in the eurozone confirmed in Q3 2010

In the wake of the impressive GDP growth in Q2 2010 (+3.9% annualised q-o-q rate for the eurozone as a whole, +9.0% for Germany), the recent flow of economic news in Europe has tended to confirm fears of an economic slowdown. The PMI in particular plunged between July and September. Those purchasing managers polled were concerned about future business prospects and expect to see order books dwindling. Worse still, Germany has experienced the most severe deterioration. If businesses in the main eurozone engine are worried about future growth, it is because Germany faces a marked slowdown in export demand. Even emerging economies, especially those in Asia, which have shown the most dynamism during the upswing, are reporting imports of German goods shrinking between May and July. With the global economy losing momentum, the cornerstone of European economic recovery, that is, the export-led up-cycle in manufacturing industries, has been undermined. In a nutshell, the evidence is pointing towards annualised q-o-q GDP growth in the eurozone slackening to around 1.2% in Q3 and Q4 this year.

Fears of a default on the eurozone periphery still high

All the encouraging economic news for Q2 2010 failed to dispel market worries about some eurozone countries' ability to honour their debts. So the probable slowdown in the second half, if it materialises, looks likely to fuel the fears. With Ireland revealing that the final bill for bailing out its banking system would drive its public-sector deficit to over 30% of GDP, Portugal announcing a further deficit-cutting programme worth 5.1 billion euro and Greece still struggling to drag itself out of recession, the chances of seeing one of these three sink into a spiral of feeble growth, deflation and deepening debt are greater than ever. This poisonous cocktail could well rekindle market fears about the fate of the single European currency, in a replay of the crisis that flared up this spring.

Tensions inside the eurozone back close to previous heights

Yield spreads between 10-year Irish and Portuguese government bonds and German Bunds stretched to new highs in September.

Sources: Pictet & Cie, Datastream

The well-being of the eurozone is no longer exclusively reliant on what happens in Europe or on what the Europeans do, but will turn on hopes of a robust revival in the global economy.

Fed setting the tone for the markets

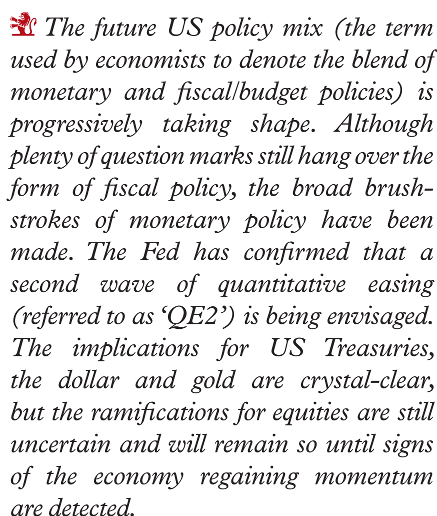
The shape of future US economic policy will be a focus for financial markets. The likely move towards fresh quantitative easing has undermined the US dollar, kept interest rates low and sent gold soaring to record highs. The budget piece of the policy-mix puzzle is still missing, preventing shares from locking back onto an uptrend. *Christophe Donay*

Financial markets

Local-currency returns in % from financial markets. Data as of 30.09.2010

		Indice	Since 31.12.2009	Previous month
US equities*	USD	S&P 500	3.9%	8.9%
European equities	EUR	STOXX 600	2.3%	3.3%
Emerging-market equities*	USD	MSCI Emerging Markets	11.0%	11.1%
US government bonds*	USD	JPM GBI US 1-10y	7.4%	0.3%
US investment grade*	USD	ML Corp. 1-5y	6.8%	0.8%
US high yield*	USD	ML US High Yield Master II	11.8%	3.0%
Hedge funds	USD	Credit Suisse Tremont Index global**	2.5%	1.8%
Commodities	USD	Reuters Commodities Index	1.2%	8.6%
Gold	USD	Gold Troy Ounce	18.7%	4.4%

* Dividends reinvested ** End-August



The future US policy mix (the term used by economists to denote the blend of monetary and fiscal/budget policies) is progressively taking shape. Although plenty of question marks still hang over the form of fiscal policy, the broad brush-strokes of monetary policy have been made. The Fed has confirmed that a second wave of quantitative easing (referred to as 'QE2') is being envisaged. The implications for US Treasuries, the dollar and gold are crystal-clear, but the ramifications for equities are still uncertain and will remain so until signs of the economy regaining momentum are detected.

Dollar under pressure against the euro

Exchange rates have been swinging around quite wildly since the beginning of the year. Such movements are hardly welcome as, by undermining exports, they disrupt the mechanisms of economic growth in emerging nations. Brazil has been one of the hardest hit, prompting the country's prime minister to go so far as to declare that a 'currency war' has begun. This is the first time that a leading policymaker has been so explicit about exchange rates being wielded by governments as a policy tool to stimulate economies.

Against this background, the expectation of a more stimulative monetary policy in the US had a bigger effect on the dollar's exchange rate against leading currencies, especially the euro: the dollar headed back past 1.37 to the euro. As for economic fundamentals, there are no really compelling reasons for the dollar to suffer lasting weakness against the euro. Europe's economy is on course to slow down in the latter half of this year, with the growth rate dipping below the US. This turnaround in the relative dynamics behind the two economies ought to work against the euro, but, in the immediate term, the move towards a normalised eurozone monetary policy, and the prospect of a much more accommodating line from the Fed, will be a drag on the dollar.

Bond yields staying persistently low

For those economies where deflation is the dominant policy issue, as is the case in Europe and the US, yields on longer-dated government bonds are at rock-bottom levels. The story of the past few decades provides plenty of reasons to suppose that yields on 10-year sovereign debt in the developed world will stay very low. The Fed is likely to start buying US

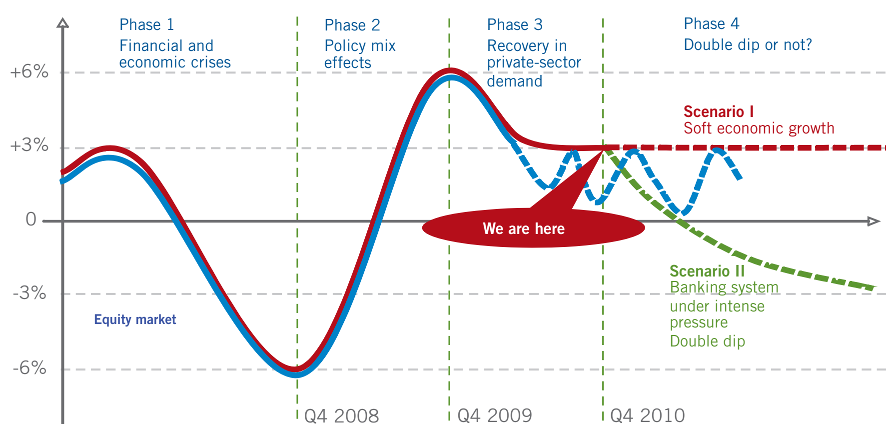
Growth in profits for the STOXX 600 and key sector sub-indices

How is potential earnings growth shaping up for the markets in 2011 and 2012?

	2010 Profit growth	2011 Profit growth	2012 Profit growth
STOXX 600	44%	17%	13%
STOXX 600 excl. financials	35%	15%	12%
Consumer discretionary	20%	15%	13%
Information technology	50%	22%	12%
Consumer staples	93%	18%	15%
Financials	84%	26%	17%
Utilities	-2%	3%	8%
Energy	38%	16%	11%
Health care	5%	8%	3%
Telecommunications	3%	4%	5%
Basic materials	84%	30%	10%
Industrials	64%	16%	16%
Large-cap stocks	39%	16%	12%
Mid-cap stocks	56%	19%	16%
Small-cap stocks	37%	16%	21%

Sources: FactSet, Pictet & Cie

Economic and market paths



Source: Pictet & Cie

Treasuries again with a prime objective to keep real interest rates low. Another key aim is to drive out expectations of deflation. With these two goals it should be feasible to keep financing costs in the economy at the lowest possible real interest rates.

It follows that the interest paid out on coupons on US Treasuries is likely to remain pretty thin, contributing to this asset class's low return.

Equities need a fiscal tonic

Stimulating monetary policy is vital. But that alone will not enough to revitalise economic growth in the developed world. Reflationary budgetary programmes need to be formulated and implemented quickly. On this score, the outlook is cloudy. Most countries in Europe have adopted Germany's approach, slashing government spending to bring discipline to public-sector deficits. Kick-starting economies does not seem to feature on the policy agenda.

Uncertainties are widespread in the US, too (see the 'Topic of the Month'). This leaves US and European stock markets hanging in the air. At the time of writing, shares are trading towards the upper end of their nine-month trading range. The chance of their breaking out on the upside depends on the future policy mix.

As things stand, three scenarios appear plausible. The most propitious would require fiscal policy as clearly delineated as the Fed's monetary policy. The worst case scenario would see grave mistakes in economic policy at a time when the cycle is reaching a critical point. Taking the overall balance of risks into account, we consider it makes sense to shift the allocation accorded to equities from underweight to neutral.

The middle scenario would envisage the successful implementation of monetary policy, matched by fiscal policy remaining underpowered and failing to persuade investors that the economic policy mix would deliver the required boost to growth. If that happened, we would expect shares to continue drifting sideways inside their comparatively broad trading band.

Gold, a win-win asset… in dollars

When inflation fears resurface, the bullion price rises. When deflation is the dominant influence and central bankers press ahead with quantitative easing, the bullion price also rises. The current climate seems ideally suited to gold, which looks like an asset for all seasons. However, gold's recent performance in euro or Swiss franc terms is less glittering; the bullion price has fallen by some 10% in Swiss francs since early June. Nonetheless, the underlying trend on the gold price is intact. After more than doubling since 2003, irrespective of the currency, gold remains the one of the assets we continue to favour in our allocations.

HEADLINE NEWS FROM AROUND THE WORLD

Economic cycles round the world out of line with each other

Emerging economies are registering impressive rates of growth whereas developed economies are desperately in need of a stimulus from economic policy.

50 billion euro

The final bill for bailing out the country's ailing banks could well cost Ireland 50 billion euro, the equivalent of one-third of GDP.

7,262 billion dollars

The debt of US non-financial companies had, by mid-2010, exceeded 7,000 billion dollars, an all-time high. After a short-lived, gentle dip in the second half of 2009, **businesses resumed their borrowing in the first six months this year** (mainly through bond issuance).

+1.2%

The rate of q-o-q growth in Brazil's economy in the spring quarter was half that of Q1 2010. This cooling will have pleased Brazil's monetary authorities, if not the leading Presidential candidates.

+0.1%

Dubai's economy has been perking up again after the shock in 2009 when GDP shrank by 3%. Growth should reach 2.5% in 2011, after just creeping into positive territory this year.

Aa1

Following downgrades for other European countries, **Moody's lowered Spain's sovereign debt rating to Aa1 to allow for the country's gloomy economic prospects in the coming few years.**

+9.2%

July's **retail sales growth in China surprised the market positively**, fuelled by a surge in car sales.

23 billion dollars

Tired of the threat to the economic recovery from the rising yen, **the Bank of Japan pushed down the yen with a massive dollar purchase on 15 September.**

5th

Dealing volumes in **the Australian dollar surpassed the level of forex trading in the Swiss franc**, promoting the currency to the No. 5 slot behind the US dollar, euro, yen and pound.

346 trillion won

Total tax revenues – equivalent to USD300 billion – the South Korean government hopes to raise in 2011 through a 5.2% tax hike as the economy recovers. It should cut the budget deficit from 2.7% to 2% of GDP.

13.7 billion dollars

Robust **growth in India's economy has been sucking in imports**, causing the trade deficit to worsen to over 13 billion dollars in Q2 2010.

Monetary policy influencing the markets

Financial markets are convinced that the US Federal Reserve will embark on a second round of highly accommodating monetary policy. The repercussions for financial markets will differ depending on the assets concerned: yields on government bonds will stay low; the dollar will weaken against all leading currencies. Equity markets are looking expectantly for a fresh boost to the economy from new fiscal policy measures.

Equities

Economic policy dominating markets

Despite September's strength, equity markets have failed to break out of the horizontal band that has confined them for the past nine months. More decisive US economic policy should help shares to break out upwards.

The future shape of the US economic policy mix will be key in dictating what happens on US and European stock markets. In September, the belief that the Fed would push through further quantitative easing before the year is out gradually gained ground, and it is now being taken more or less for granted. Stock markets have welcomed this prospect enthusiastically, with leading US and European share indices recording gains of around 9% for the month.

Despite this impressive monthly rise, share indices are still in the sideways corridor in which they have been trapped since the outset of the year.

Some sort of shock is needed to help them break free from these shackles. Implementation of fiscal policies in the US that would be liable to kick-start economic growth in 2011 would be seen as a key signal by the markets. Although the monetary aspect of the policy mix is significant, stimulus from this source alone will not be enough. The budgetary side to the economic-policy equation has still not been formulated. The Obama administration's hands are ostensibly tied by the looming mid-term elections on 2 November. However, on this score, American pragmatism may come to the rescue. We have thus increased exposure to equities in portfolios, lifting them from underweight to neutral.

Bonds

Bonds yo-yo in September

Yields on US Treasuries eased late in September despite fears of a double dip in the US subsiding.

Rates on 10-year US Treasury bonds bounced back and forth during September, climbing from 2.45% to 2.85% in the opening fortnight before eventually drifting back down to 2.45% at the end of the month.

With fears of a double-dip recession in the US diminishing, yields ought to have been subject to some upward pressure. However, hopes of a fresh wave of quantitative easing by the Fed lay behind the driftdown in interest rates.

The pattern was fairly similar in Europe, with 10-year German Bund yields edging up from 2.1% to 2.5% before sliding back to 2.2%. These movements in Europe were, however, more in line with economic news: after the robust GDP growth reported for Germany in Q2 2010 (+2.2%), German industry began to show some signs of weakening.

Moreover, investors continued to be sceptical about the ability of debt-burdened smaller eurozone countries to honour their debt payments. Spreads between German and Irish or Portuguese 10-year sovereign debt stretched to record highs. The slowdown in Europe is likely to deepen fears that these economies will default, with these anxieties set to sustain the downward pressure on German bond yields on account of Bunds' safe-haven status. Upside on sovereign bonds looks fairly limited, prompting us to stick with our underweighting of this asset class.

Corporate bonds

A return in risk appetite boosting high-yield bonds

Diminishing fears of a double dip in the US worked in favour of corporate bonds.

In September, dollar-denominated corporate bonds delivered a +0.8% return, slightly outperforming sovereign debt (+0.3%), but falling well short of the gains notched up by equities (+9%), their biggest monthly score since 1939. This pattern of performance can be explained by receding worries about a double-dip recession thanks to more encouraging news coming out of China and the prospect of a second wave of quantitative easing from the Fed. This turn of events understandably worked best to the advantage of high-yield corporates as they registered a 2.9% rise, with those sectors hardest hit by the crisis impressing most: banks, insurers and financials in general.

Corporate bonds have extended their excellent year-to-date performance (+11.3%), continuing to outpace sovereign bonds (+8.8%) and equities (+3.9%).

Retaining exposure to corporates in portfolios remains fully justified on the grounds of the persistently high degree of uncertainty. This particular asset class offers some protection should the risks of a slowdown build up again, but it also stands to benefit from companies' earnings growth if the recovery gains momentum. Corporates thus provide investors with a useful dual-purpose hedge against any future shifts in expectations.

Hedge funds

Diversifying away from uncertain trends

Trading strategies once again demonstrated strong resilience to market uncertainties

Trading strategies were the clear contributors to performance as they delivered some much needed resilience in August. Global Macro and CTA managers were rewarded in particular by their allocations to fixed income, currency markets and short energy. They were able simultaneously to minimise downsides and offset the losses from their long equity and commodity exposures. Net long equity managers, whose convictions had paid off handsomely in July, posted disappointing results as the trend faltered and a stock pickers' environment prevailed.

A preliminary assessment of the economy's impact on hedge fund performances in September offers a favourable return to an environment suitable for directional strategies. With clear trends hard to discern in August owing to ongoing macro uncertainties, managers could be compensated by upside directional bets in September.

Hedge fund managers' overall consensus going forward stresses a few key themes. First, that a double-dip scenario is less likely, but below-par growth is to be expected in the US and Europe. Second, low interest rates in developed markets coupled with uncertain markets have made emerging economies highly attractive for many investors. Lastly, shorting the USD may very well be the trade of 2011.

Precious metals

Gold breaks through 1,300 dollars an ounce

Concerns over runaway inflation owing to central banks monetising debt have given way to fears of deflation.

The possibility of the Fed embarking on another round of quantitative easing has sparked renewed interest in gold. As a result, the price rose to over 1,300 dollars an ounce and the dollar fell to 1.36 against the euro in September.

While the price of gold in dollar terms was stagnating, the sovereign debt crisis in Europe caused the price in euro terms to rise by 25% since the start of the year. Now, however, the reverse is true, with the price of gold in euro terms down slightly, and the price in dollar terms soaring.

Such a volte-face shows that the return of risk aversion this time is related to the US economy, since the medium-term outlook for the eurozone appears to be slightly improved.

The performance of gold has thus once again become dependent on the currency in which it is priced. Nevertheless, even though fears of deflation are increasingly present and markets are expecting additional monetary easing measures – on both sides of the Atlantic – the outlook for gold remains good as long as investors' risk appetite remains subdued.

Currencies

Markets under pressure

The decline in the US dollar will go down as the main change of September. It was the direct consequence of the likely monetary easing in the US.

Forex markets continued to react strongly to the policy mixes being introduced on both sides of the Atlantic in September. In the US, the high prospect that the Fed might extend quantitative easing, coupled with a raft of downbeat economic figures, weighed heavily on the dollar. In Europe, on the other hand, the sovereign debt crisis seemed long forgotten as the euro was bid up from 1.28 dollars to over 1.37.

Commodity currencies made further gains over the month as well, with the Australian dollar (up nearly 20% since April) extending its rally against the US dollar, to come within a whisker of its pre-crisis peak. These currencies are now overvalued according to our models.

The Swiss franc, meanwhile, has been holding firm, and by the end of the month a dollar could be bought for less than a franc.

We think the franc and commodity currencies will remain strong over the coming months, while the euro and dollar will probably be vulnerable to bouts of volatility as they react to shifts in monetary policy statements and macroeconomic indicators.

TOPIC OF THE MONTH: US FISCAL POLICY IN 2011

Budget policy: make-or-break factor for growth

If Congress fails to pass any measures in the near future, the US economy will be heading for drastic budget tightening in the year ahead (equivalent to 2¾%-3% of GDP). That scenario, which would apply a powerful brake to growth, will probably be partly averted, but there is little doubt that fiscal policy will still be restrictive in 2011. This likelihood prompts us to err very much on the side of caution about the US economy's growth prospects.

The US economy appears to be running out of steam. There are grounds for concern that any possible new round of quantitative easing from the Fed is unlikely to have much impact in driving growth. Given this prospect, fiscal policy becomes of key relevance. What shape and form budget measures take will have an influential bearing on how the US economy fares in the coming quarters.

No decisions will not mean no impact

Unfortunately, the current situation is complicated. It cannot be taken for granted that fiscal policy will be geared towards lending support to the economy. In normal circumstances, if no measures were taken by Congress in the weeks ahead, the impact of budget policy would be neutral. That will be far from the case this time, as no action will automatically mean fiscal policy is effectively being tightened up quite drastically.

Moreover, in response to the ballooning federal budget deficit (10% of GDP in 2009) and the sovereign debt crisis in Europe, backing from voters and legislators for budgetary stimulus programmes has diminished considerably in recent months. The mood has changed so much that the Obama administration has studiously been avoiding the word 'stimulus' when talking about fresh reflationary measures.

Bernard Lambert
Economist

Economy still needs a supportive fiscal policy mix

Indeed, new measures to underpin the economy look necessary in the wake of the recent slowdown and the risk of the economy decelerating further. In our opinion, steps will need to be taken as quickly as possible, with action being directed towards the housing market, which remains in a miserably depressed state, and at creating jobs. Job creation could be achieved by pushing through more attractive incentives to persuade businesses to hire employees, as companies on the whole are in good financial shape. On this score, President Obama's recent proposals to foster corporate investment (see below) is somewhat surprising as business capital expenditure is the one component of domestic demand that is already recovering strongly.

Below, we have run the rule over what is actually at stake in gauging the direction of fiscal policy in the near future.

1. Expiry of Bush era tax cuts

Tax breaks pushed through in 2001 and 2003 by President Bush (reductions on taxes on income and dividends, capital gains tax and inheritance tax) expire at the end of this year. Unless legislative action is taken, expiry of these tax cuts will equate to a sharp tightening of fiscal screws, amounting to around USD175 billion for the 2011 calendar year (1.2% of GDP).

There may, however, be some ground for political consensus as Republicans seem keen to retain the tax breaks for all income brackets, while Democrats only want to see taxes rise for upper-income households, which would limit fiscal tightening to around USD50 billion. Unfortunately, these differences may conceivably result in complete gridlock until early next year, with tax bills rising steeply, at least in the first few months of 2011.

The Senate wing of the US Capitol

2. Gradual expiry of the 2009 reflationary programme

The USD800bn stimulus package approved in 2009 will continue to deliver benefits in 2011. However, with some measures running their course

and some spending being curtailed, budgetary tightening will put a brake on GDP growth (roughly 1 percentage point between Q4 2010 and Q4 2011). That said, several programmes in the Obama reflationary package have been renewed, some even several times over. This is true for the extension of unemployment insurance rights which, after being rolled over several times as well as being temporarily suspended in July, will again expire at the end of November this year. Moreover, a sizeable annual package (36 billion dollars or 0.25% of GDP) of grants to states was extended by a vote in early August (relating to Medicaid and education). This decision was crucial considering the parlous state of finances in individual US states.

In contrast, the fate of a key component of the 2009 package looks more in doubt: the Making Work Pay Tax Credit. This sizeable programme (USD60 billion dollars for the 2011 calendar year, or 0.4% of GDP) runs out at the end of this year. The Obama administration's 2011 budget, originally tabled in February, but still stalled in Congress, envisages prolonging this programme by a year, but no decision has yet been made.

3. New budget measures to underpin the economy

In parallel with the rolling-over of some parts of the 2009 reflationary package, new pro-economy measures have been formulated or are planned. Some of these extra projects have already made their impact and have expired ('Cash for Clunkers' car-buying incentive and Homebuyer Tax Credit schemes). Others have recently been approved by Congress (mainly the plan to assist small businesses).

In addition, other budgetary stimulus programmes are still on the drawing-board. This is the case for a string of measures recently mooted by President Obama. These fall into three categories: fresh spending on infrastructure (USD50 billion); allowance for companies to write off new investments 100% against tax in 2011; extension of tax relief on R&D spending.

Even though the Administration's estimates for the likely economic impact of this three-pronged programme do seem overstated, the proposals are fairly wide-ranging. They would probably involve budgetary stimulus amounting to some USD150 billion over the 2011 calendar year (1% of GDP). There seems little chance of this package being passed by Congress, at least in its current form, this year.

Mid-term Congressional elections muddying the waters

It is already particularly hard to forecast the likely fiscal policy mix, without the political agenda further complicating matters. Mid-term Congressional elections are scheduled for 2 November this year.

The Democrats are in danger of losing their majority in the House of Representatives and, perhaps, in the Senate as well. With voting day looming, campaigning is hotting up. So, even though the current session of Congress has not yet been completed (it is scheduled to end by 8 October at the latest), important decisions look unlikely to be made before the elections, as neither party is keen to hand any sort of advantage to rivals. Moreover, a lame-duck session (after the elections and before the new Congressmen and women take their seats in early 2011) looks on the cards, clearly not conducive to any debates on important legislation. So, although some decisions on budgetary matters need to be taken urgently before the year is out, political uncertainty remains exceptionally high. A lot will come down to brinkmanship in the last few weeks of the year.

Several budget scenarios still plausible

When it comes to predicting the likely fiscal policy mix, feasible scenarios range across the whole spectrum, from, at one extreme, a steep rise in taxation to, at the other, no tax rises and fresh, substantive reflationary packages. Below, we have outlined what we believe to be the most plausible outcome: tax cuts inherited from President Bush will be extended for all income brackets and some fresh measures – or rolling-over of existing programmes – will be agreed, but not on any great scale. If this scenario proves correct and on the basis of our assumptions about individual states' fiscal policy, the degree of budgetary tightening for next year, while still significant, should not be too daconian, at around 1½% of GDP.

This renewed restrictiveness will, unfortunately, come at a time when the economic cycle itself is reaching a delicate pass.

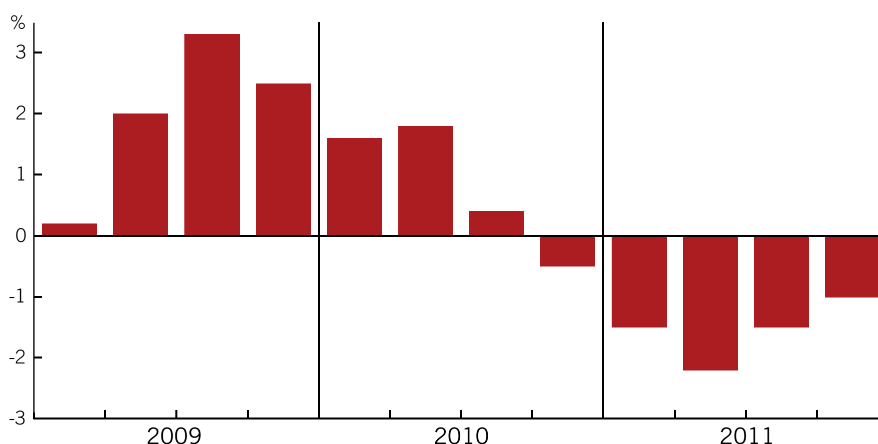
Sluggish growth on the cards for 2011

This tightening of fiscal screws in 2011 is the main reason that we remain circumspect about US economic growth prospects in the coming quarters.

We are forecasting GDP growth at just 2%-2¼% in 2011, down from probably around 2¾% this year. These projections are, however, tinged with a high degree of uncertainty. Any decisions taken over the next few weeks by Congress are likely to have a significant bearing on how robust US economic growth is in 2011.

US budget policy impact on annualised q-o-q GDP growth

US fiscal policy is likely to be noticeably tightened in 2011.



Source: Pictet & Cie estimates

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Dollar unmistakably weak

Dollar exchange rates have been moving around spectacularly in recent weeks. Shifts in asset prices are being dictated by fluctuations in the dollar's value, with a rising dollar sending asset prices down, and vice versa.

Data in charts and tables dated as of 30.09.2010

Main economic indicators

GDP growth rates

Estimations Pictet – (consensus)

	2008	2009	2010E	2011E
US	0.0%	-2.6%	2.8% (2.7%)	2.2% (2.4%)
Eurozone	0.3%	-4.0%	1.4% (1.6%)	1.1% (1.4%)
Switzerland	1.9%	-1.9%	2.8% (2.6%)	2.0% (1.8%)
UK	-0.1%	-4.9%	1.6% (1.5%)	2.0% (2.1%)
Japan	-1.2%	-5.2%	3.0% (3.0%)	1.7% (1.3%)
China	9.0%	8.7%	9.5% (9.9%)	9.0% (9.0%)
Brazil	5.1%	-0.2%	7.7% (7.5%)	4.5% (4.4%)
Russia	5.6%	-7.9%	5.2% (4.9%)	4.6% (4.4%)

Inflation (CPI)

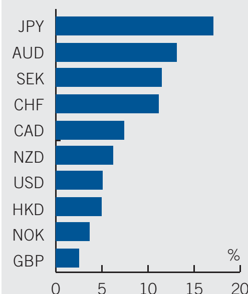
Annual average, except year-end for Brazil

Pictet estimates – (consensus)

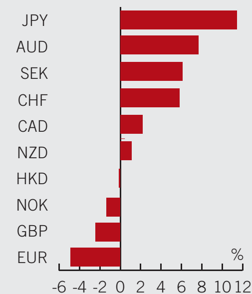
	2008	2009	2010E	2011E
US	3.8%	-0.4%	1.5% (1.6%)	1.3% (1.4%)
Eurozone	3.3%	0.3%	1.5% (1.5%)	1.4% (1.6%)
Switzerland	2.4%	-0.5%	0.7% (0.8%)	1.0% (0.9%)
UK	3.6%	2.2%	3.1% (3.1%)	2.3% (2.6%)
Japan	1.4%	-1.4%	-1.1% (-0.9%)	0.0% (-0.3%)
China	5.9%	-0.7%	2.8% (2.8%)	3.0% (3.1%)
Brazil	5.9%	4.3%	4.3% (5.1%)	4.8% (4.8%)
Russia	13.3%	8.8%	6.6% (7.4%)	6.9% (7.4%)

Exchange-rate movements (since 31.12.2009)

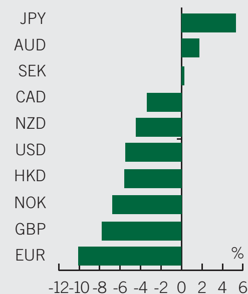
Against EUR



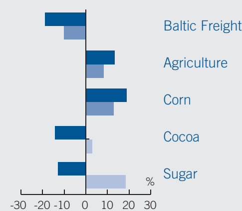
Against USD

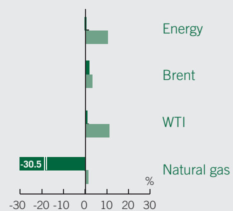


Against CHF



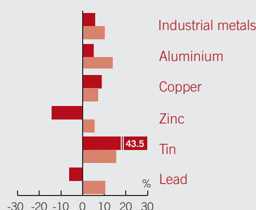
Commodities

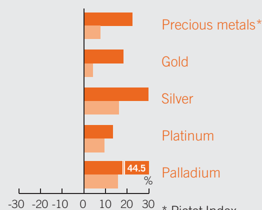




Dark: Returns since 31.12.2009

Light: Returns for previous month





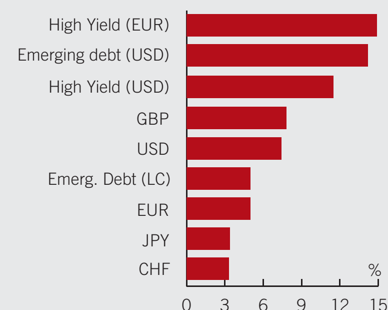
* Pictet Index

Interest rates

	Short (3-mth)	Long (10-yr)
US	0.1%	2.5%
Eurozone	1.0%	2.2%
Switzerland	0.25%	1.3%
UK	0.5%	3.1%
Japan	0.1%	1.1%
China	5.3% (1 year)	3.3%
Brazil	10.8%	12.0%

Bond markets

Returns since 31.12.2009



Stock markets

Returns since 31.12.2009

	USD	EUR	CHF	GBP
MSCI World*	3.0%	8.3%	-2.6%	5.6%
S&P 500*	3.9%	9.2%	-1.8%	6.5%
MSCI Europe*	-0.1%	5.0%	-5.6%	2.4%
Tokyo SE (Topix)*	3.7%	9.0%	-2.0%	6.3%
MSCI Pacific ex. Japan*	10.1%	15.7%	4.1%	12.9%
SPI*	5.2%	10.6%	-0.6%	7.8%
Nasdaq	4.4%	9.7%	-1.4%	7.0%
MSCI Em. Markets*	11.0%	16.7%	4.9%	13.8%
Russell 2000	8.1%	13.6%	2.2%	10.8%

* Dividends reinvested

Sectors

Returns since 31.12.2009

	USA	Europe
Industrials	11.5%	10.4%
IT	-0.8%	6.9%
Materials	1.2%	4.5%
Telecommunications	6.0%	1.7%
Health care	-2.3%	2.7%
Energy	-2.5%	-9.2%
Utilities	0.9%	-12.1%
Financials	-0.3%	-3.6%
Consumer staples	5.1%	15.2%
Consumer discretionary	12.1%	11.4%

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