ecr research

Knock-on effects

Thursday, April 18, 2024

CONTENT

Questions or Comments?

Edward Markus

+31(0)30 232 8000

ecr@ecrresearch.com

Executive summary

- Until recently, the markets assumed that sharply higher interest rates would soon lead to far lower economic growth, wage increases and inflation. Interest rates could subsequently decline.
- Inflation can be combated quickly and effectively through a recession. Because of far higher total debt/GDP ratios, however, many central banks fear that a recession will trigger a new credit crisis. In the current circumstances, it will be very difficult to combat a recession.
- This is why central banks are nowadays more intent on achieving a so-called soft landing. This is a positive growth rate that remains below potential growth (US potential growth is currently around 2.3%, but this rate will soon decline. Potential growth in Europe is around 1%).
- It is very difficult for the ECB to manoeuvre in this situation. Indeed, if growth is to decline below 1%, a recession will quickly follow. However, growth is currently at around 1% and wage increases and inflation are expected to decelerate. This is why the central bank assumes it can start with rate cuts before long, as, otherwise, the risk of recession would be too high.
- The Fed has far more scope before a recession occurs, but the US economy is still growing above potential.
- Both the Fed and the ECB believe that interest rates are now so high that they are slowing economic growth. Once this actually starts to happen, inflation will also decline and current interest rates will start to slow growth even more.
- However, it is increasingly doubtful that current interest rates are really slowing growth. Indeed, the combination of large public deficits, the presence of vast amounts of excess liquidity and loose monetary conditions is stimulating growth. The question is what has more impact.
- We are increasingly getting the impression that, for the time being, interest rates in Europe and the US will be lowered less than the markets are currently pricing in. This particularly applies to the US. As a result, longer-term interest rates will also remain under upward pressure for the time being.
- In these circumstances, the dollar looks set to remain a strong currency for now. However, the West is exerting mounting pressure on China and Japan to keep their currencies from depreciating further and to prevent all sorts of Chinese and Japanese items from being dumped in the West. This is not conducive to the easing of geopolitical tensions.
- For many emerging markets, it is becoming progressively difficult to keep their currencies stable.

- A potential escalation of the war in the Middle East will undoubtedly rattle many market prices, but experience shows that this generally blows over quickly.

- Before long, we expect currency interventions that serve to depress the dollar rate, and especially against Asian currencies. We do not expect these interventions to have a long-term effect, but they may trigger a few price shocks for a while.

- This year, short-term interest rates in the US and Europe will likely be lowered less than widely assumed at this point, meaning that, on balance, longer-term interest rates will remain under upward pressure for the time being.

- The S&P 500 index is unlikely to far exceed 5,300 for the time being and, on balance, it will fall back to around 4,600. In the ensuing period, there will be a sizeable recovery, but the longer-term outlook is not too favourable in our view due to stubbornly high public deficits.

- EUR/USD is unlikely to far exceed 1.10 for now and, on balance, the pair will slide down towards 1.00.

- USD/CNH will initially continue to hover around its current rate of around 7.25 for a while, but the pair will subsequently start an uptrend towards 7.75.

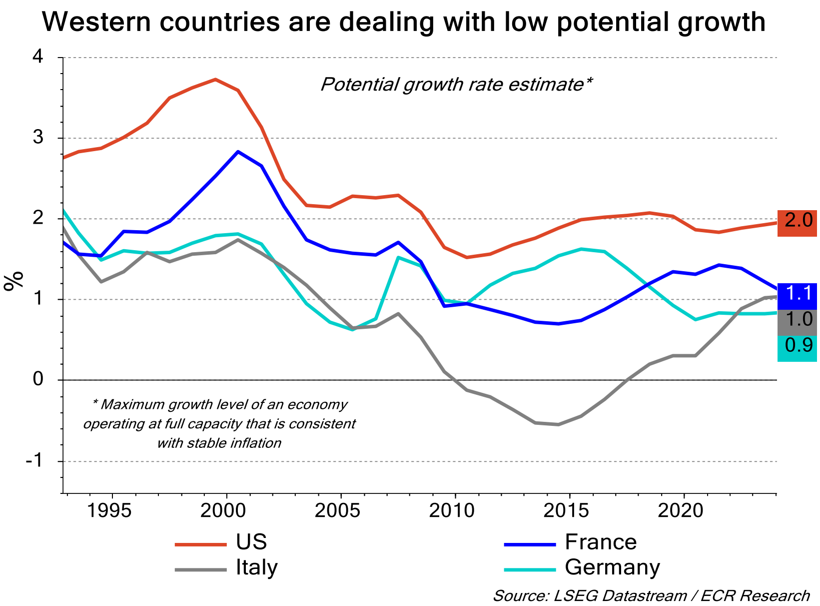
- EUR/CNH will keep hovering around 7.75 for now, but the pair will subsequently crawl up somewhat towards 8.00.

- The gold price might initially fall back to around $2,200. On balance, however, we expect a further rise to around $2,700 in the coming months or quarters.

The decelerating impact of high interest rates is lower than assumed

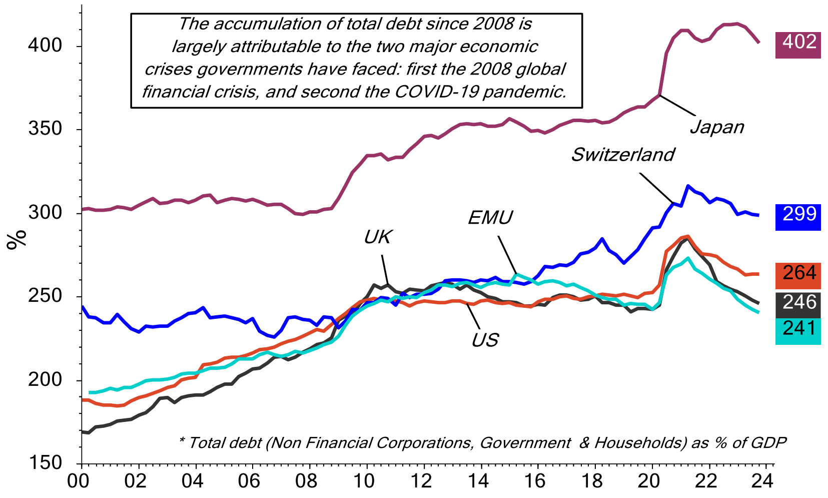
Until early this year, the markets were convinced that the Fed and the ECB would proceed with rapid rate cuts in June. Indeed, last year's sharp rise in interest rates was going to cause a considerable decline in economic growth, wage increases and inflation. This accounts for the enthusiasm in the stock markets. By subsequently hitting the monetary 'gas' in time after the cooling of the economy, the economy would avoid a recession and interest rates would start to decline. This is a great prospect for shares, especially if wage increases and inflation have also been curbed, meaning there is no need to lift interest rates any time soon.

It is also important to keep the theoretical framework in mind. In the period between 2020-2022, inflation rose too far, so it had to be fought in 2023. This is done by lowering the growth rate of the economy to below potential growth. Potential growth is the sum of workforce growth and productivity growth. If the economy grows below this level, unemployment will rise, as a result of which wage increases will decelerate. This, in turn, slows consumption - and thereby the economy - as well as inflation. Incidentally, there are three important comments to be made here:



- It is possible to combat inflation by keeping growth below potential growth, but this will proceed very slowly. If this is to proceed rapidly, a recession will be required. However, a complicating factor nowadays is that global total debt/GDP ratios have risen sharply. As a result, a recession may turn into a credit crisis far sooner than in the past. Unlike the 2008 credit crisis, it is nowadays far more difficult to fight a new credit crisis because of already high public deficits and debts, and also because vast amounts of surplus money have been created over the last decade. So, as long as the inflation rate that has to be curbed is not excessively high, central banks prefer to achieve so-called soft-landing. This means a still positive growth rate that remains well below potential growth. This is far easier for the US than for Europe, as potential growth in the US is far higher than in Europe (where potential growth is estimated at only about 1%). This is why Europe will soon lapse into recession if inflation has to be fought.

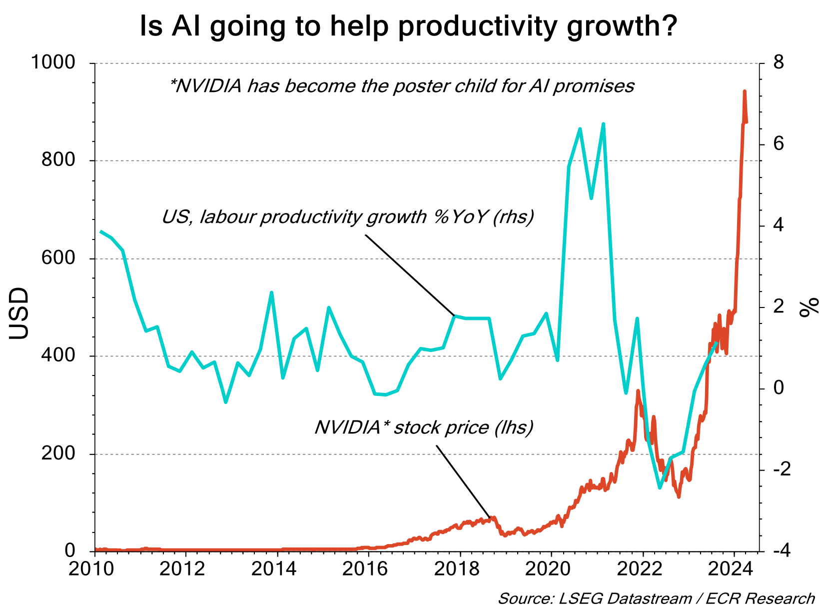
Total debt-to-GDP ratios* in most Western countries are very high. Could a new credit crisis be on the horizon?



Source: LSEG Datastream / ECR Research

- US potential growth is temporarily higher than the common estimate of 1.8%. Indeed, in a recent study, the Fed concluded that workforce growth is currently far higher than assumed until recently. This is due to far more immigration and an increase in people who had stopped working during the corona pandemic but who are now re-entering the labour market. US potential growth is therefore probably at 2.3% at this point. However, it should be considered that the number of people returning to the labour market after corona is rapidly declining. Furthermore, both Democrats and Republicans want to severely restrict immigration after the election. Hence, US potential growth looks set to return quickly towards 1.8% next year.

- Opinions are still sharply divided as to the extent to which and how fast artificial intelligence will boost productivity growth. Most experts believe that this will have a fairly limited effect on the overall economy over the next few years. However, there are certainly also experts who expect productivity growth to increase far more quickly. If the latter group is proved right, potential growth will be correspondingly higher.



The conclusion is that, in theory, it is easy to argue that, in order to combat inflation, growth must be below potential. In practice, however, it is difficult to pinpoint the level of potential growth. Hence, central banks are paying particular attention to labour market data. If these data indicate that the labour market is becoming less tight, then economic growth is moving towards potential growth, and if unemployment is rising, then growth is probably already below potential.

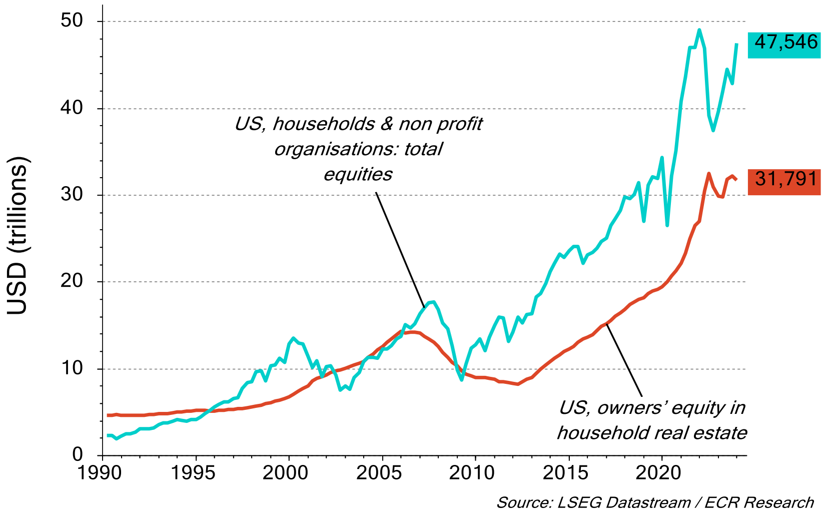
Loose monetary conditions

At this point, it is fairly widely assumed that inflation will continue to decline if US growth ends up below 2% and growth in Europe ends up below 1%. However, according to the latest data, the growth rate of the US economy is currently at 2.75% and that of the EMU countries at around 1%. This is markedly higher growth than many economists expected after the fierce rate hike in the last year. The question is how this is possible. We believe the following should be considered in particular:

- Governments are still stimulating the economy as public deficits remain high, and these deficits are largely financed with surplus money that has been created over the past decade and for which no use has been found to date.

- Higher share prices and property prices create a significant wealth effect, making consumers more inclined to consume more and save less.

Real estate (and equities) have been the engines of US household wealth generation in the past decade(s)

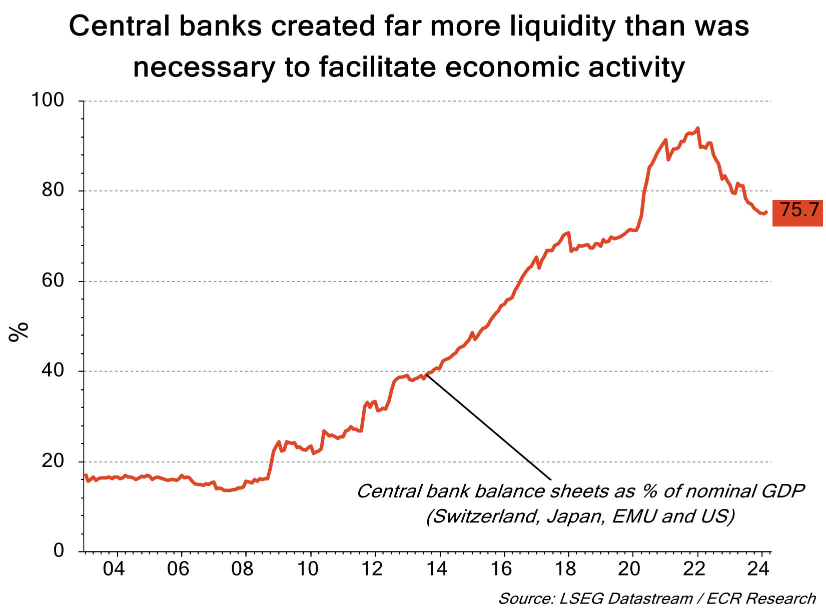


- When interest rates were close to 0%, many parties fixed the interest rate on their loans for longer periods of time. This limits the negative impact of higher short-term interest rates on the economy.

- Monetary conditions were very loose until recently; in Europe but especially in the US.

The latter can be explained as follows. High interest rates basically slow an economy, but not to any great extent. Indeed, high interest rates are favourable for savers. Factors that slow the economy at least as much are the side effects triggered by higher interest rates: a stronger currency, lower asset prices, widening credit spreads, higher real interest rates, et cetera. Many institutions have created so-called monetary (or financial) indices based on these factors, almost all of which are now at levels that stimulate rather than slow growth, and especially in the US. The next question is how it is possible that monetary conditions are still so loose, despite the sharp rise in interest rates. This is probably due to the combination of the following two factors:

- From 2009 through 2022, central banks created far more liquidity than the real economy was able to absorb.



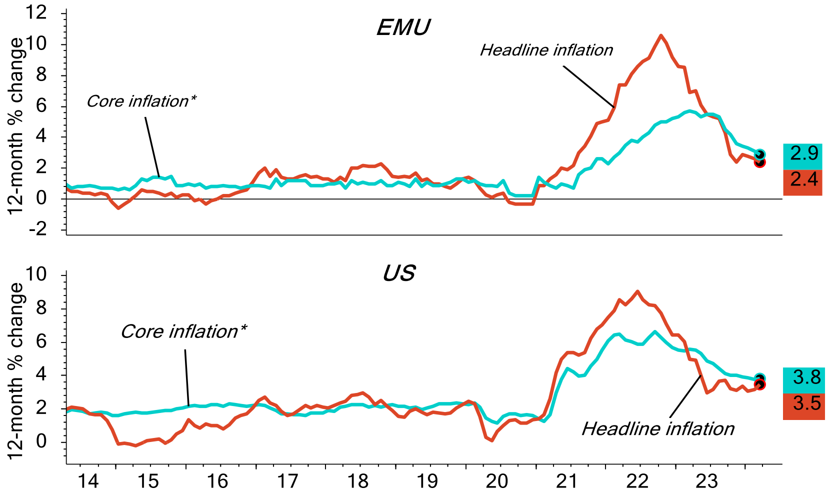
- The objective of central banks in recent years has been clear, namely to achieve a soft-landing and avoid a recession. At the same time, investors have pinned their hopes on higher productivity growth as a result of AI.

The combination of the two ensured that confidence in the economic future remained high and that plenty of liquidity was available to respond to this. Higher interest rates were just a bump in the road that could be ignored. Indeed, a very favourable future would beckon once interest rate declines were imminent. This is why, in spite of rising interest rates, asset prices continued to rise, credit spreads remained very low, and so on. Combined with fiscal stimulus, this has kept the growth rate of the economy far higher than expected based on the higher interest rates. However, higher-than-expected growth also comes at a price. Indeed, unemployment levels will remain low, while wage increases will accelerate too much. This, in turn, results in stubbornly high inflation, certainly if commodity prices - especially oil prices - continue to rise due to the Ukraine war and tensions in the Middle East.

The reaction of central banks

Both the ECB and the Fed assume that interest rates are now so high that they are slowing economic growth. As mentioned before, these statements should be taken with a pinch of salt as long as monetary conditions remain loose. This applies more to the US, as growth in Europe is already very low and wage increases and inflation are under downward pressure. However, the key question is whether this is sufficiently the case to permanently depress inflation to the 2% target. This will succeed if European growth quickly returns to around 0.5%, but the question is how certain this is. A potential escalation in the Ukraine and/or the Middle East could trigger this, but this would also drive up inflation.

Inflationary pressure more persistent in the US than in the EMU



* Excluding food, energy, alcohol and tobacco

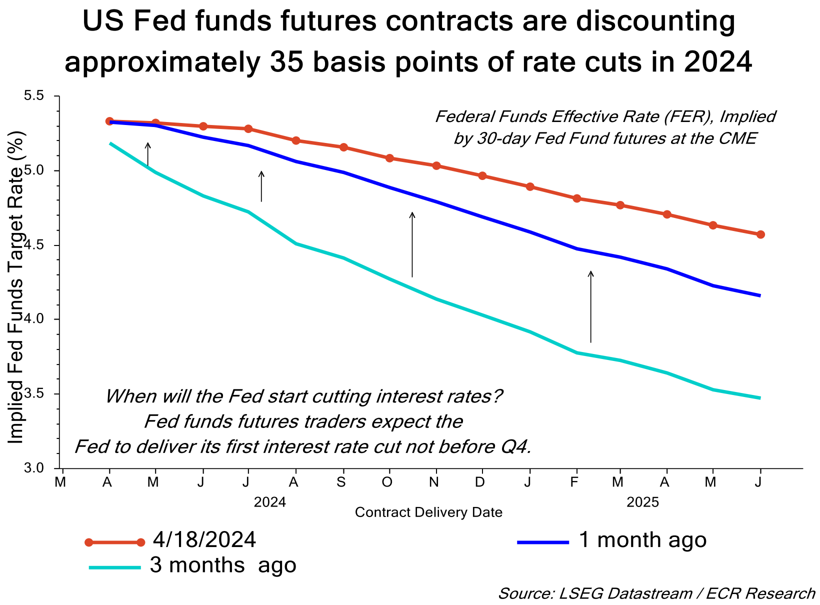
Source: LSEG Datastream / ECR Research

In any case, the ECB is clearly signalling that it expects growth and inflation to decline to the point where the central bank could start with rate cuts in June. If the ECB did not do this, the risk of recession would become too high according to the central bank. The markets share this view, as they anticipate about three further rate cuts of 0.25 percentage points this year and four more such cuts in the first half of 2025. We certainly do not want to rule out this scenario, but are beginning to feel increasingly uncomfortable with this expectation. Indeed, it is generally assumed that Brussels will force the EMU countries to increase fiscal discipline, which will slow growth. However, we fear that public deficits will actually widen rather than narrow due to far more spending on defence, the energy transition and climate change control in general. High interest charges are another factor. Combined with monetary conditions that struggle to tighten, this may well keep growth in Europe at 1% or even higher.

The practical consequence is that the ECB should ensure that monetary conditions tighten until the growth rate of the European economy reaches around 0.5%. We do not want to go so far as to claim that the central bank has to raise its rates even further for this, but it may well be that the ECB has to keep its rates at current levels for far longer than the markets are currently assuming.

As mentioned, the situation is more complex for the Fed. This is because US economic growth and US inflation have been under more upward pressure since the turn of the year. According to the latest estimates, the US economy is currently growing at about 2.8%, which is above potential. This means that if growth does not weaken soon, the Fed must also start providing tighter monetary conditions; far more so than the ECB.

It is therefore understandable that analysts at UBS, for example, believe that a further Fed rate hike from around 5.35% to around 6.35% cannot be ruled out. In this case, the rate cuts that the markets are currently pricing in will not materialise for the time being. This is certainly quite drastic in our view, but we would not be surprised if, in order to tighten monetary conditions sufficiently, the Fed kept its rates constant for the time being, or at least cut them less than the markets are still pricing in at this point.



This is also why we see share prices and bond prices remaining under downward pressure in the period ahead. Unless US economic growth were to suddenly drop to 1.75% or lower - which is not at all likely - monetary conditions will have to be tightened, implying lower share prices and bond prices. A few comments are justified here:

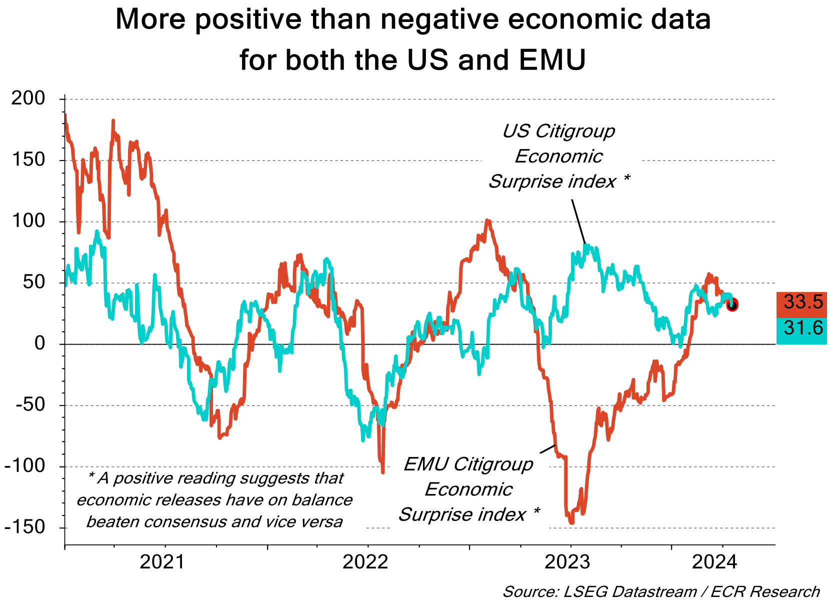
- When interest rates were at ultra-low levels, many parties fixed the interest rate on their loans for extended periods of time. Gradually, however, these loans have to be refinanced, so the high interest rates will gradually begin to hurt more.

- Once asset prices start to decline, this will start to slow economic growth, which will quickly reduce the upward pressure on interest rates, and this upward pressure may even turn into downward pressure.

- Should the price of oil continue to rise as a result of mounting tensions in the Middle East (we consider the probability of this to be less than 50%), this would hit the European economy particularly hard. Europe currently has to import vast amounts of oil, while the US is largely self-sufficient. Higher oil prices would boost inflation both in Europe and the US. However, this would exert more upward pressure on US interest rates than on European interest rates.

A knock-on effect

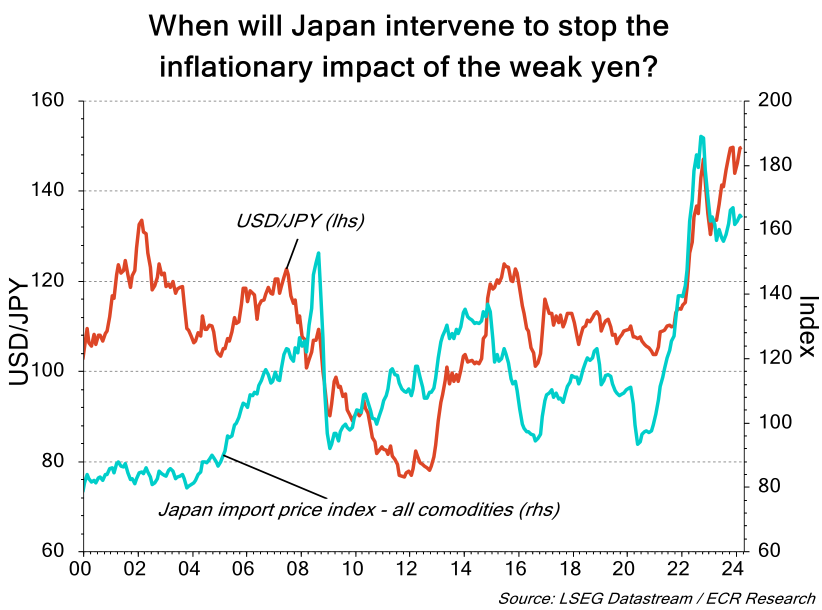
As mentioned above, we only see interest rates coming under significant downward pressure if growth starts to fall back soon. This cannot be ruled out in the current situation, but on balance, economic indicators suggest that growth is more likely to crawl up.



Therefore, our assumption now is that interest rates will not decline to any great extent for the time being. However, this was still partially priced in until recently. Understandably, there is a reaction to this now, and this is apparent in the foreign exchange market, for example. The dollar is strengthening, but at the same time the currencies of a number of key emerging markets are weakening:

- The Chinese economy is heavily stimulated. As the property market bubble has burst, however, consumption is lagging behind production capacity. Consequently, a situation of overcapacity has arisen in China. This is why there is deflation. The natural reaction to this is a decline in the yuan's exchange rate. However, a variety of officials from both the US and Europe have already travelled to Beijing to make it clear to the Chinese government that the dumping of China's surpluses on Western markets will not be tolerated. This possibly means that new import barriers will be raised, and that there will be considerable pressure on the Chinese government not to let the yuan rate depreciate too much. However, in order to keep the yuan stable in these circumstances - a well-running US economy with upward pressure on interest rates and a very poorly running Chinese economy - Chinese interest rates must be kept fairly high. This goes against stimulating growth. The end result is that Chinese interest rates cannot decline, while the yuan will still gradually decline.

- Japan is faced with a shrinking workforce and an exceedingly high total debt/GDP ratio. As a result, the Japanese economy is struggling to get off the ground and deflationary forces remain strong. Hence, the Bank of Japan is still keeping interest rates very low (0.1%). This is in stark contrast to US monetary policy. It is therefore understandable that the yen has long been under significant downward pressure. The latest measurements indicate that the currency is undervalued by roughly 35% measured on purchasing power parity. In other words, Japan is increasingly gaining an unfair competitive advantage. This has already prompted Tokyo to try to raise the yen rate through verbal interventions, but these attempts are not really successful. This is why, before too long, Japan will actually intervene by raising the yen rate with support purchases. However, experience shows that, as long as monetary conditions do not change, interventions will only dampen the pace of the decline, they will not reverse it. It is therefore to be hoped for Japan that Western interest rates will soon start to decline. As mentioned above, hopes for this are fading fast. This means that either Japanese interest rates must be lifted quickly or the yen rate will decline significantly further. We fear the latter will happen. Western countermeasures are bound to follow in this case.



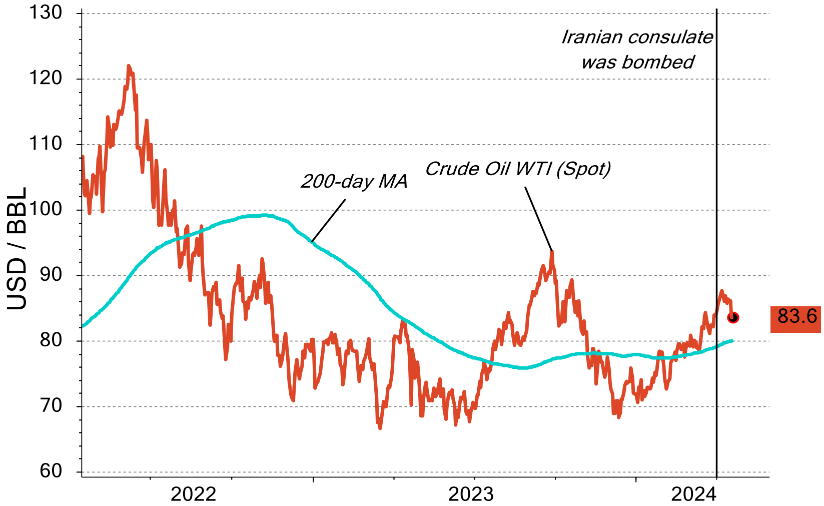
The combination of downward pressure on the Chinese yuan and the Japanese yen, and a strong dollar and persistent high US interest rates is very negative for many emerging markets. Indeed, they have borrowed heavily in dollars in the past and have to continue to do so. However, their currencies are being dragged down by the decline in the yuan and the yen, which means these dollar debts are weighing increasingly heavily on the economy. These markets would also have to defend their currencies via rate hikes, but their economies are generally too weak to bear this.

What if?

Many wonder what will happen to market prices should Israel decide to launch an attack on Iran. Tehran would have to respond to this attack, et cetera. It goes without saying this will create a very explosive situation, if only because the US and Russia may become involved. This is why, in such a situation, the following initial reactions can be expected:

- Gold and the dollar would go up as they would be seen as safe havens.
- Oil prices would go up because of a rising risk premium in case Iran closes the Strait of Hormuz.

Impact Israel Iran conflict hardly visible in oil prices



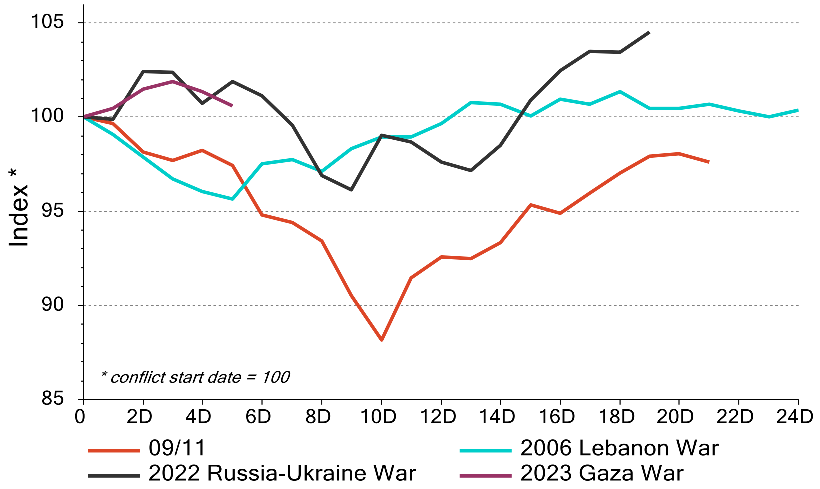
Source: LSEG Datastream / ECR Research

- Share prices would decline due to concerns about the global economy being harmed by high uncertainty and higher oil prices as well as a possible disruption of all sorts of supply routes.

- In all likelihood, Western government bond yields would initially decline as a result of a search for safety. Credit spreads, on the other hand, would widen in the face of uncertainty. Also, short-term interest rates in the West may be kept high for longer amid rising inflationary risks, but this depends very much on the extent to which economic growth is affected at the same time. It cannot be predicted which of these two opposing forces will weigh more heavily.

It should be kept in mind, however, that there are not many parties who see a great advantage in escalation of the war. Looking at the past, it is evident that military actions do not usually keep influencing prices for long periods of time. This is why we basically believe the aforementioned price reactions will be reversed fairly soon, unless the situation really spins out of control.

Apart from a short-term reaction, the impact of armed conflicts is often limited for stock markets



Source: LSEG Datastream / ECR Research

Consequences for the financial markets

At this point, all sorts of leading figures in the financial world are gathered in Washington for the IMF's annual meeting. It seems that there are frantic talks going on behind the scenes about interventions to counter the rise of the dollar.

As mentioned before, the Chinese yuan and the Japanese yen have their own problems, thereby dragging down the currencies of many emerging markets. Apart from this, however, the dollar is strengthening of its own accord due to the current expectation that, for the time being, US interest rates will remain higher than assumed until recently. Moreover, the dollar is also an important safe-haven currency in the current circumstances. It therefore makes sense that many emerging-market currencies are under downward pressure. This is positive for their exports, but this is outweighed by the negative effects of rising import prices, rising foreign debts measured in their own currencies and higher interest charges. It is virtually impossible for them to defend their currencies by raising interest rates. Most emerging market economies are too weak for this. Intervention in the foreign exchange market is therefore the only remaining option. Apparently, the US is also willing to co-operate here. It is therefore quite possible that financial markets will be rattled by currency interventions in the period ahead. The question, then, is how this should be viewed.

The determining factor here is to what extent the interventions are sterilised or not. This can be explained as follows. For example, if the central bank in Japan buys yens and sells dollars, it reduces the amount of yen in the economic system. Indeed, the supply of domestic currencies at a central bank does not form part of the relevant country's money supply. This is why the money market - in this case that of Japan - will basically tighten as a result of interventions to support the domestic currency. A tighter money market will subsequently drive Japanese interest rates higher. This is exactly 'what the doctor ordered' to make the yen more appealing.

But higher interest rates also slow the Japanese economy. This is generally considered too big a sacrifice. Especially because higher interest rates slow the economy to the point where this leads to mounting speculation about lower interest rates in the future. Hence, higher interest rates will weaken rather than support the yen. This is why interventions are generally sterilised. That is to say, the amount of yen taken out of the system through interventions is pumped back into it in another way; by having the central bank buy bonds in the market, for example. In this case, yens that sat in the central bank's vault up until then will enter the financial circuit.

The major problem, however, is that when currency interventions are sterilised, investors have no reason whatsoever to stop weakening the weak currency (in this case, the yen). On the contrary, as a result of interventions, the yen rate will rise for a while, thereby providing a favourable selling opportunity. This is why currency interventions generally take place on a large scale - the foreign exchange market is very large - and over a long period of time. Even then, the end result is not that the weak currency is going to rise for a prolonged period of time. Its decline will only be slowed. The same applies to the money and capital markets. These are temporarily disrupted by currency interventions, but since these are mostly sterilised interventions, this will also blow over fairly quickly.

Interest rates

As also shown by the recent IMF forecast, the US is one of the few countries where the economy is running at more or less full capacity utilisation and growing at or above potential growth. However, growth should actually be below potential in view of overinflation. The Fed believes this will occur of its own accord at current interest rates. Indeed, according to the central bank, interest rates are at levels where growth is being slowed. Increasingly, however, the markets are beginning to doubt this and investors are wondering whether interest rates should remain around current levels for a long time or even be raised further.

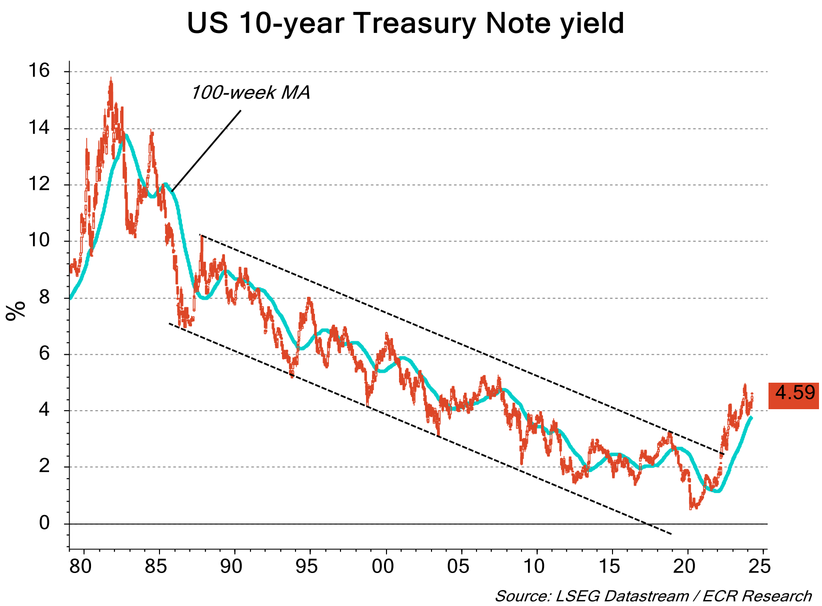
In our view, current interest rates are not slowing growth too much (they are currently around the nominal growth rate of the US economy, which is generally considered to be neutral). By the end of the year, however, a number of other factors that are currently driving growth will likely weaken if not reverse. For example, more and more refinancing will have to occur at higher interest rates, fiscal stimulus will gradually decrease, and the positive wealth effect is likely to decline as well.

Incidentally, this is offset - in part - by the fact that current expectations in terms of the downward pressure on wage increases due to high immigration are exaggerated. This largely concerns workers who are difficult to incorporate into the production process. Moreover, immigration will likely decline sharply from the end of this year. Hence, we see the US labour market remaining tight for quite some time, keeping upward pressure on wage increases. This is unpleasant in terms of inflation control, but it also maintains purchasing power and thereby economic growth.

All things considered, our conclusion is that, between now and the end of this year, we will likely see anything between zero rate cuts and two Fed rate cuts of 0.25 percentage points. This will depend mainly on further developments in the oil price. The more it rises, the less US interest rates can be cut this year.

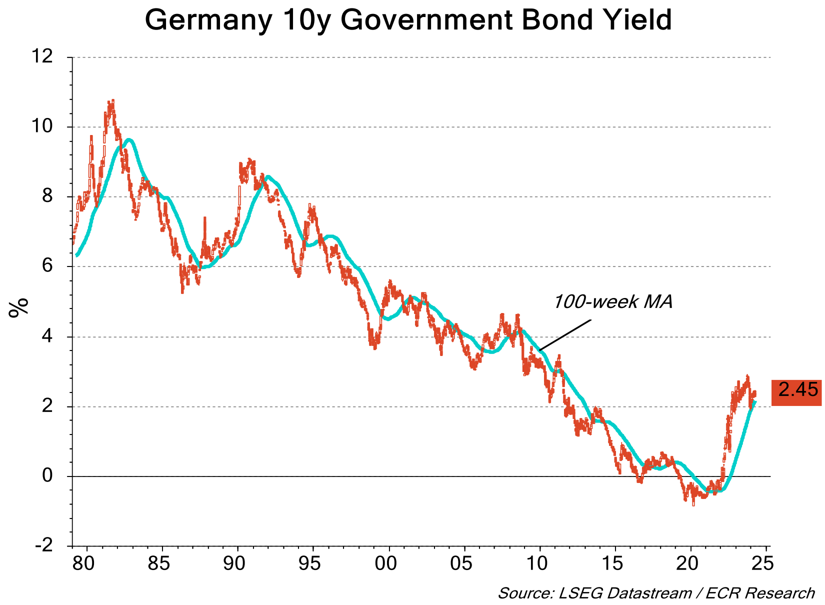
Next year, however, we expect a more distinct weakening of growth and inflation, meaning we expect the Fed to employ roughly four rate cuts of 0.25 percentage points in the first half of 2025. This expectation is also based on the assumption that the Fed will let monetary conditions tighten to the point where growth will be well below potential following the election.

As for long-term interest rates: currency interventions can temporarily cause more dollars to enter the financial system. This may briefly depress longer-term interest rates. However, this will soon be overshadowed by the growing expectation that the Fed cannot lower its rates to any great extent for the time being. Hence, 10-year US government bond yields - currently around 4.6% - are unlikely to decline far below 4.5% for the time being and, on balance, they will continue to rise towards 4.75-5%.



As for the situation in Europe, it differs from the US in that growth is low and wage increases as well as inflation are under downward pressure. However, even though growth is low, it is not clearly below potential. So again, the issue is whether interest rates are currently at levels that, on balance, are slowing growth. We do not really have this impression. Hence, we assume that the ECB will indeed cut its rates by 0.25 percentage points in June. Indeed, the central bank has largely committed to this. In the ensuing period, however, the pace of rate cuts will be slower than the markets are currently pricing in, and certainly this year. A total of about two cuts of 0.25 percentage points this year would not surprise us. In the first half of 2025, interest rates could be reduced four more times by 0.25 percentage points.

In this scenario, 10-year German government bond yields - now around 2.45% - are unlikely to decline far below 2.35% in the period ahead and, on balance, they will rise to around 2.6%.

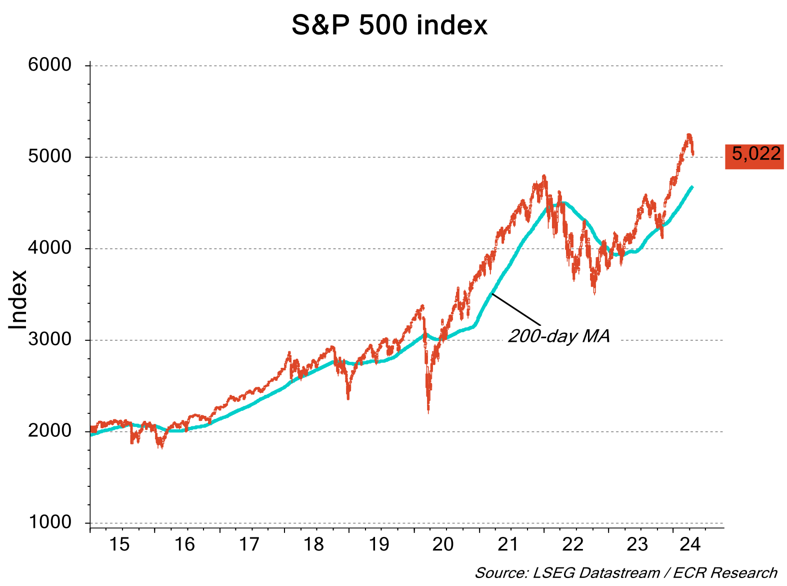


Shares

As indicated above, we expect the Fed and the ECB to tighten monetary conditions to the point where economic growth in the US will fall back to around 1.5%, with growth in Europe declining to around 0.5%. This includes the assumption that interest rates will remain higher than currently assumed, while share prices will decline and credit spreads will widen.

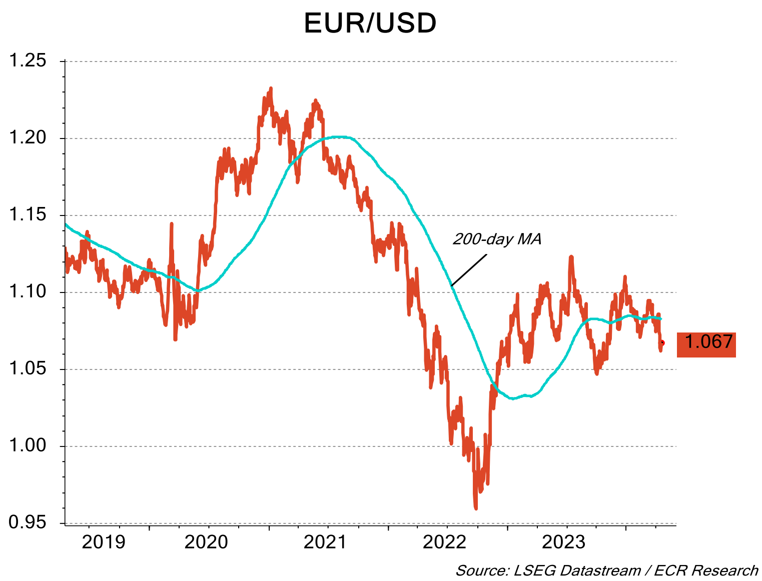
This is why the S&P 500 is unlikely to far exceed 5,300 for the time being and, on balance, the index will gradually sink to around 4,600. In the ensuing period, another sizeable rally may start, especially if there is a prospect of central banks easing off the monetary brakes some more. That said, in the longer term, persistent, excessively high public deficits will increasingly throw a spanner in the works.

For the time being, shares in most emerging markets will perform relatively worse than the S&P 500 index, while European shares will perform slightly better, in relative terms, as the ECB has more scope for monetary easing.



EUR/USD

We basically expect EUR/USD to remain under downward pressure for the time being due to a rising interest rate differential and more demand for dollars as a safe haven. However, we also expect an intervention before long to counter the rise in the dollar. This is unlikely to happen to EUR/USD to any great extent, as its current rate is not causing much trouble. That said, if there is an intervention in other currencies, more dollars will enter the foreign exchange market, which may also temporarily depress the dollar against the euro somewhat. As mentioned before, however, interventions will ultimately only dampen the dollar's rise rather than reverse it. This is why EUR/USD is unlikely to exceed 1.10 for the time being and, on balance, the pair will decline towards 1.00.

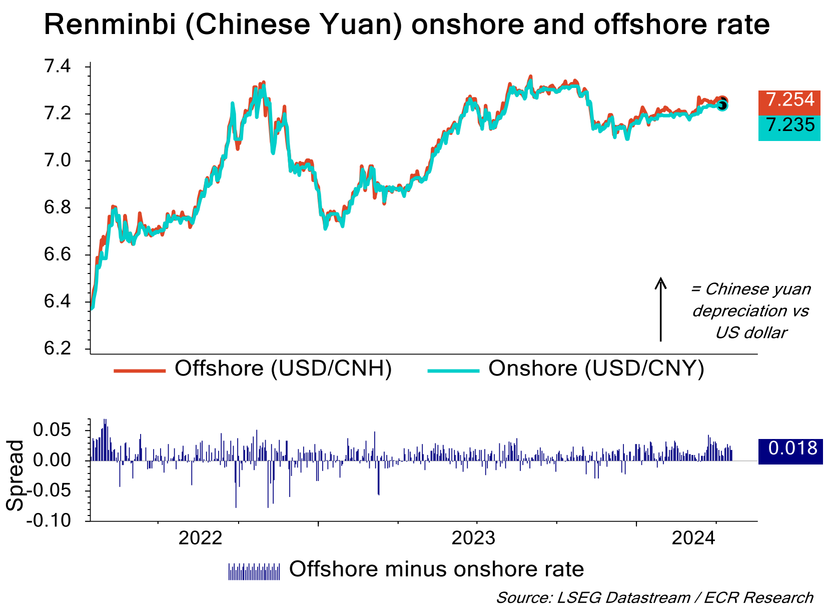


The Chinese yuan

The major problem China is currently facing is that investment has been boosted for a long time, while consumption has lagged behind. This has increasingly created a situation of overcapacity and thereby deflation. In theory, this could be solved by allowing the yuan rate to decline sharply, thereby boosting exports and reducing imports. However, the West has already signalled it will not tolerate this. This adds to the dilemma, as Beijing will then have to boost consumption far more. This, in turn, requires an ultra-loose monetary policy if deflation is to disappear, but this will also depress the yuan rate.

We fear the latter option will indeed be selected. This may lead to many more import barriers. Moreover, it may also drag down the currencies of all sorts of emerging markets in the process.

In this scenario, USD/CNH will likely continue to hover around 7.25 for a while, after which the pair will start an uptrend towards 7.75. EUR/CNH may initially keep hovering around its current level of around 7.75 for the time being. In the ensuing period, the pair will gradually crawl up to around 8.00.



Gold

Gold has basically faced quite a few headwinds lately. Examples include a strong dollar, central banks being engaged in inflation control and rising (real) interest rates. Yet the price of gold has risen rapidly, probably for the following reasons:

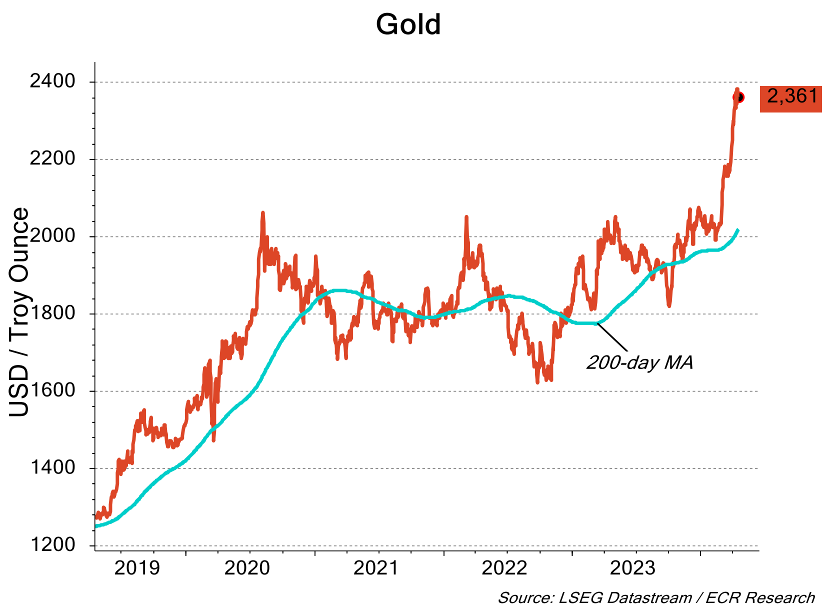
- Rising geopolitical tensions. Gold always forms a safe haven in this case.

- Both the US and Europe have recently shown that, when tensions rise, they do not hesitate to block if not confiscate assets held in the West by enemies. Many managers of large reserve funds outside the West are therefore seeking alternatives, where this risk is avoided. This search will soon lead them to gold.

- Social services are poor in China, which is why the Chinese put aside much of their income. However, a growing number of Chinese doubt the extent to which their currency will remain inflation-proof. This is why they prefer to hold investments in dollars, euros and Swiss francs and so on. However, this is often thwarted by government policies. Hence, they increasingly seek refuge in gold. To a lesser extent, this also applies to many other Asian countries.

This last factor has probably been dominant lately. However, there is a vast difference between Chinese and European investors. The latter usually tend to sell once an uptrend lasts longer. For Chinese investors, however, this is often a reason to buy (more).

This is why we certainly expect a correction in gold - say to around $2,200 – but we suspect that Chinese investors will be quick to use any price declines to buy. This is why we see the gold price rising further to around $2,700 over the next few months or quarters. In the long term, we expect a far greater increase.



Other inflation hedges

In most countries, house prices have been fairly unfazed by higher interest rates. This is because the market is tight, particularly as a result of immigration. In addition, salaries have risen substantially, allowing home buyers to borrow more. This trend will likely continue for some time, although price increases will probably proceed more slowly due to central banks' policies. None of this applies to commercial property, meaning that prospects for this type of property remain far less favourable.

Commodity demand is reasonable, as most economies continue to run reasonably well. However, supply is limited supply due to past underinvestment in production. That said, the latter is starting to change, so we expect limited price increases for most commodities. Also, demand will increase less when growth in the West is curbed somewhat.