

Special Global Market Update - August 5, 2011

Over the last few days, the market decline that began 2 weeks ago has accelerated and is responsible for significant declines in everything except for US Dollars, government bonds and gold bullion.

Many of the issues that we have written about over the last year are now directly affecting financial markets including:

- money printing by central banks
- weaker than expected economic growth
- fragile banking systems
- direct government involvement in financial markets

While media coverage can be confusing at times, we have broken down the main issues and markets as follows:

Primary Issue:

- The primary market concern is the European banking system.
- The European banking system has been under duress ever since Greece, Ireland and Portugal required bailouts from the Euro-zone countries lead by Germany and France.
- Although collectively the economies of these 3 countries are relatively small, their banking systems are larger. The fear is that a collapse of their banking systems will serve as a domino effect to also bring down the rest of Europe. In response, the Euro-zone countries have structured a bailout fund to help these countries survive.
- The reason markets have declined significantly over the last 2 days is due to the new risk of the banking systems in both Italy and Spain collapsing. France & Germany may be able to support Greece, Ireland and Portugal, but they cannot also support Spain & Italy.
- The escalation of this risk is resulting in money fleeing European banks. Individuals are withdrawing deposits and American money market funds are selling European bank commercial paper. This combination is serving to exasperate the problem.
- The secondary market concern is weaker than expected economic growth in the US.
- The combination of expiration of stimulus spending, the end of money printing (quantitative easing), and the certainty of less government spending and higher taxes will keep economic growth muted going forward.

Currencies:

- Japanese Yen and Swiss Franc (CHF) remain safe havens in the currency world
- USD and EUR are declining relative to the Yen and CHF
- Commodity currencies CAD and AUD have declined relative to the USD
- Gold has appreciated relative to all currencies
- Should financial stress continue, we expect these trends to continue
- Over the long-term we prefer the CAD and AUD over the above currencies

Stocks & Bonds:

- Government bonds have outperformed stocks
- The yield on the US 10-year Treasury has declined from 3.1% to 2.4% over the last couple of weeks (Note: a decline in bond yields means the price is rising). This is an extraordinary move in such a short time period and hi-lights the flight to safety.
- Should the crisis be resolved, we expect the 10-year yield to bounce back to the 3% range

Gold:

- Gold should be viewed as a currency and not a commodity
- Gold is the only currency in the World that is not supported by government guarantees and taxes. In addition, unlike the effect of quantitative easing (money printing) on paper currencies, the supply of gold cannot be increased.
- There will be a time to sell gold, however until the debt problems in the World have been corrected, we do not believe that time has come.

What to watch:

Over this weekend and next week, financial markets are expecting to see extraordinary responses from the following:

- 1) The European Union – to expand the EFSF (European Financial Stability Fund) to EUR 1.5 to 3 trillion. This amount will be enough to bail out both Spain and Italy. If no further expansion occurs, markets will remain nervous about Spain and Italy. The challenge with expanding the EFSF to these amounts is that it effectively places the entire burden of Europe on France and Germany – something that is not politically viable.
- 2) The US Federal Reserve – financial markets have become accustomed to being bailed out by the US Federal Reserve. The Fed is meeting next week and markets are hoping for an announcement of QE3 (quantitative easing 3). This would be another round of money printing to bailout the American banks and to stimulate the economy.
 - Should neither of these events occur, we expect market stress to continue.
- 3) Credit downgrade of US debt - one of many market rumours making the rounds this afternoon was of S&P downgrading American debt. Intuitively this would suggest a weaker USD, however it could actually have the adverse effect with investors thinking if US debt is bad, then debt from other countries must be even worse. Confusing yes, yet this is the financial world we are living in today.

During these volatile times, BCB's conservative approach has been successful at preserving capital. We will continue to be proactive and to seek opportunities as they arise.

As always, please feel to contact us with questions, comments and feedback. We enjoy hearing from you.

Sincerely,
Horst

Horst Finkbeiner, Director and COO
Bermuda Commercial Bank Limited
hfinkbeiner@bcb.bm
Tel: (441) 295-5678 ext. 673

