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WEEKLY ECONOMIC AND MONETARY REPORT

24 February 2012

G20 finance ministers - who meet in Mexico City tomorrow - are going to have a lot on their hands. One of the less contentious issues is likely to be the succession to Bob Zoellick at the World Bank - unless the Mexicans or Brazilians choose top pick a fight with the US (which is clearly in no mood to give this post up just yet). More contentious are likely to be proposals to expand IMF resources - not least, because of the Fund's crucial role in the eurozone bailout. This could easily pit emerging markets against the Europeans - with the former complaining (quite rightly) that the Fund is being used beyond its mandate to avoid rich European countries taking the kinds of tough decisions that, traditionally, the IMF has imposed on its developing country clients.

In the meantime, the general feeling in the Europe seems to be that the eurozone crisis is nearer resolution. As a result, 'risk is on' - though that optimism may well prove misplaced. Indeed, the political backlash to the latest bailout deal for Greece appears to be building -not least in Germany, where Merkel may well need SPD support on Monday to ensure that the Bundestag does not derail the €130 billion package.

I EUROZONE CRISIS

It is very difficult to say whether the crisis is nearer resolution, or if the optimism in the markets is simply misguided. But there is some optimism - as evidenced, in particular, in the bond markets. Yesterday, for instance, Italy sold 2-year paper at an average yield of just 3.013% - down from 3.763% at the end of January. Its 10-year yield is now just 5.43%, down from over 7% a month or so ago. Similarly with Spain, where the 10-year yield is now 5.10%. In contrast, however, Portugal - which is still not out of the woods - is paying 12.43%, and Greek 10-year yields are still over 33%. (The CDS market is also still pricing the probability of a Greek default at over 90%, with Portugal at 62%, Ireland at 39%, Italy at 28% and Spain at 27%.)

It is a mixed picture. That said, there has undoubtedly been progress - not least in Greece, where the Parliament swallowed its doubts and approved the bailout package (and all the conditions attached thereto) on Thursday. Among other things, that commits Greece to another list of at least 38 specific tax and fiscal reforms that the troika is imposing on it. It also commits it to accept something very close to colonial status - with a permanent EU/IMF presence in Athens to monitor government decisions across the board. Given the volatility of Greek politics, that will be hard to accept.

In return for this, Greece gets... nothing. Or, at least, that is how critics of the deal will paint the concessions that the Papademos government has made. The €130 billion that is being lent (not given) to Greece will go into an escrow account, and will be earmarked for debt service payments to foreign creditors - which leaves a big question mark over where any growth is going to come from in the next few years. That problem was highlighted in a very significant report - marked 'strictly confidential' - by the troika that was leaked to the *FT* at the beginning of the week. It predicted that the impact of the deal on Greek GDP would be so severe that the debt ratio - which is supposed to fall to120% of GDP by 2020 - would never come close to that level. In the view of the IMF (which seems to be taking the lead on this), Greece is likely to need at least another €50 billion beyond what it is getting from the bailout package and from the debt reduction deal.

That deal is also extremely controversial. From Greece's point of view, the good thing is that the haircut being imposed on private holders of Greek debt is a bit tougher than previously discussed (around 53.5%) - and the interest rate on the new 30-year bonds is a bit lower (2% for 2012-15, 3% for 2016-21 and 4.3% thereafter). All in all, it amounts to a cut in the NPV of the debt of around 73-75%. However, the Greeks have made some big concessions. One is the establishment of an escrow account. Another (which has not been given enough attention) is that the new bonds will be governed by English law. At present, more than 90% of Greek debt is subject to Greek law - which is why the government can (as it is doing now) retroactively impose collective action clauses to force a restructuring. That will not be possible with the new bonds - which will remain a

euro-denominated obligation even if Greece is (as many still believe likely) forced out of the eurozone. Future Greek government may regret this concession. Plus, there is a big - and murky - issue over whether the debt conversion deal is 'voluntary' or coercive.

The reason the Greek parliament has retrofitted existing debt with CACs is because the government does not expect to get the 90% voluntary participation in the deal by private debt holders that it needs for the conversion to go through. Instead, it will probably get around 70-75%. That means ISDA's Determinations Committee will almost certainly find that Greece is in default - and that will then trigger CDS protection for the few creditors who have bought it. It may also trigger a host of legal challenges by debt holders who will sue the Greek government for breach of contract. This is standard procedure for 'vulture funds' that buy distressed debt in the markets, but it could still derail plans for an orderly restructuring.

There is also some anger at the attitude of both the ECB and the national central banks in the eurozone. Last week, the ECB quietly swapped its €40-50 billion holdings of Greek debt into the new securities - but without taking a haircut. Instead, it said it would redistribute any profits it made on the deal (since it had, like the vulture funds, bought Greek debt in the market) to its NCB shareholders. Apparently, the NCBs themselves also did the same. So the effective relief that the Greeks are getting is rather less than some observers had expected.

It is important to appreciate that the Greek bailout still has to win Parliamentary approval in a number of countries. As noted, Germany votes on Monday - and the outcome is not a sure thing. Other countries may take their lead from Berlin.

There is also a broader issue of preventing 'contagion'. Most eurozone countries have come to the conclusion that the best way to ensure that the Greek crisis can be contained is to greatly increase the resources of the new European Stability Mechanism, currently capped at €500 billion. One way to do that would be to combine it with its predecessor, the EFSF - which would give it approximately €750 billion in usable funds.

That is what The Netherlands, France and Finland (apparently) want; however, so far, the Germans remain adamantly opposed. One may query whether there is that big a difference between €500 billion and €750 billion, but the refusal of the Germans to go along is indicative of a deeper ambivalence within the German political establishment that could still upset the entire eurozone. By the end of next week, things should be clearer - the G20 will have made its views known (and may have boosted IMF resources), the Bundestag will have voted, and ISDA will probably have made a decision on CDS protection. The rating agencies will also probably have weighed in - almost certainly declaring that the restructuring is too severe to be considered 'voluntary'.

II RECENT ECONOMIC AND MARKET DEVELOPMENTS

No big change this week. Sentiment is still strong in the US, where equities continue to flirt with new highs. European data, on the other hand, has been weak. On both sides of the Atlantic, political issues are playing an increasing role.

In the US, next Tuesday could well be crucial for the Republicans. The Michigan and Arizona primaries could make or break the candidacy of former Massachusetts Governor Mitt Romney - the only Republican with a fair chance of defeating Obama in a general election. If he loses Michigan (where his father used to be governor), he would be in big trouble. In Europe, national parliaments have to vote on the Greek bailout; there is also an important eurozone Summit on Thursday. Even further afield, Australia's ruling party has a leadership ballot on Monday, following the resignation of Foreign Minister (and former PM) Kevin Rudd and his decision to challenge the incumbent PM, Julia Gillard. Betting is that Rudd (who is widely popular with the Australian people, if not with his political colleagues) will get his old job back.

A THE US: There are two big issues in the US today with regard to the economy. One is gasoline prices, and the other is the surge in equities.

On gas prices, the Republicans are trying to paint Obama as captive to Middle East oil interests and as a soft-hearted environmentalist for (allegedly) blocking the proposed Keystone pipeline from Canada. He is trying to paint them as captives of Big Oil, with one answer - 'drill, drill, drill'. It is not very edifying. In the meantime, however, average pump prices have hit US $3.65/US gallon - and one of the Republican candidates, Newt Gingrich, is making the promise of US $2.50 gas an election platform. This is an issue that will not go away. As for equities, the US is very close to a technical bull market. The DJIA, for instance, is currently flirting with 13,000, and is up 6% year-to-date. The S&P 500 is up 8%, and the tech-heavy Nasdaq Composite is up a massive 13%.

As for the broader economy, it was reported this week:

- that existing home sales rose 4.3% in January to an 18-monyth high;
- that first time jobless claims were unchanged in the latest week - pushing the four week moving average down to a four-year low;
- the final reading for the Michigan confidence index in February came in at 75.3, up from 75 in January and considerably better than the 73 that had been expected; and
- new home sales were also better than expected - though they actually fell 0.9% in January, albeit only because December sales were revised up sharply (and the inventory of unsold homes hit a record low).

As a result, the sense of the market is still that the US recovery is coming along quite nicely.

B **EUROPE**: Earlier this week, the Commission released new economic forecasts that are significantly gloomier than its previous predictions. Overall, it is now expecting that eurozone GDP will shrink 0.3% this year - down from +0.5% in November. However, as usual, it is the diversity that is more interesting. Germany, for instance, is expected to grow 0.6% this year, France by 0.4%. In contrast, Italy is expected to shrink 1.3% and Spain 1.0%. Greece and Portugal, of course, are much worse - with GDP

falling by 4% or more. In contrast, the only EU member states likely to grow more than 2% are Latvia, Lithuania and Poland, none of which are eurozone members. Overall, the Commission is predicting a 'mild recession' - but it will feel a lot more than 'mild' in Southern Europe.

That message was reinforced by an unexpected fall in the eurozone's February PMI - which dropped from 50.4 to just 49.7, signifying an overall shrinkage. That was much worse than expected - and it suggests that even Germany is not immune to a downturn. Indeed, it was reported today that - although Germany's GDP was up 1.5% year-on-year in the fourth quarter - the quarter-on-quarter fall was a sharper than expected 0.8%. That said, the IFO business climate index was up again for the fourth month in a row in February, and the latest Bundesbank monthly report noted that the economic outlook had 'perceptively improved'.

There were a few other better than expected releases this week elsewhere in the eurozone. In France, for instance, it was reported:

- that Insee's business confidence index held at 92 in February, which was a surprise; and
- that its consumer confidence index actually rose, from 81 to 82.

Same in Italy, where it was reported that industrial orders rose 5.5% month-on-month in December, while industrial sales were up 5.6% - both good leading indicators. That said, the Commissions' data and the PMIs probably carry more weight going forward.

As for the UK, the latest IoD survey of one thousand corporate directors showed 35% believing that there is a high or very high risk of recession this year - which was better than expected .However, another 53% believed there is a moderate risk. Given that GDP shrank 0.2% in the fourth quarter, with business investment down 0.5%, that may be a bit optimistic. Certainly the minutes of the February MPC meeting suggest there is a fierce internal debate going on within the BoE on the appropriate monetary

policy. Although the Committee voted 9:0 for an extra GBP 50 billion in QE, what was significant was that two members wanted a lot more. There is a growing body of opinion that wants a significant rethink of the government's austerity programme. In the meantime, the government's fiscal situation does seem to be improving. The public sector actually paid down GBP 7.8 billion of debt in January - the biggest surplus for the month in four years. For FY2011-12, the deficit now looks likely to come in at around GBP 117 billion - substantially better than expected. As a result, there may be some room for a modest stimulus in the forthcoming budget.

A couple of words on the political situation in Europe:

- First, Merkel managed to find a quick and easy solution to the problem posed by Christian Wulff's forced resignation as German President - but it involved a significant political defeat. She was forced to accept as the new President Joachim Gauck - an Evangelical Protestant Pastor who had been a leader of East Germany's anti-Communist dissidents prior to reunification. Despite the similarities in their backgrounds, Merkel has never got on with Gauck -and, indeed, vetoed him in favour of Wulff only two years ago. There will be a formal election on March 18, but Gauck is unlikely to be opposed.

- Second, in France, there are signs that Sarkozy's campaign is starting to make an impact on Hollande's lead. The Socialists were also hit this week with yet another scandal involving former IMF MD (and Socialist star) Dominique Strauss-Kahn - who spent one night in jail as a result of a police investigation into French prostitution rings in which he had been an apparently unwitting participant.

C **JAPAN**: It has been another strong week for the Nikkei-225, which has just closed at 9,647 - up around 3% for the week. It is now at a six-month high. That has come about, however, despite a record trade deficit of Y1.48 trillion in January. For the month, imports were up 9.8% year-on-year, while exports were down 9.3%. There are

obviously special circumstances related to the tsunami, but this was a shock. Nevertheless, this week, S&P confirmed Japan's AA- credit rating.

D **CHINA**: Chinese stocks are following those in the US. The Shanghai Composite is up 3.5% this week, and has now risen for six consecutive weeks. The reasons appear to be a conviction that further monetary easing is inevitable, combined with a (less comprehensible) conviction that the government will free up the property market. Certainly, the PBoC has helped cultivate this mood - not least by announcing over the weekend that it would cut bank reserve requirements by a further half point as of February 24.

Will that be enough? The World Bank is apparently about to release a report (aimed at the next Party Congress, at which China's new leaders will be chosen) which stresses the structural problems that the country faces, notably:

- the need to cut back the public sector;
- the need to run state companies more like private companies; and
- the danger of a sharp deceleration in growth.

III FOREIGN EXCHANGE MARKET DEVELOPMENTS

Currency volatility is at a three-year low, risk is generally back on again - and the result is that there has been a sharp move out of the dollar into euro (and more generally into higher yielding currencies).

Last week, the euro actually fell slightly - from €1.319/US $ to €1.316. This week, it has picked up sharply, and is currently trading around US $1.342. This is essentially a risk rally, reflecting improved confidence that a deal over Greece can be done. The euro has also strengthened against sterling - which was hit by the revelation that at least two MPC members were sufficiently concerned about the UK economic outlook to urge a much bigger monetary boost. The yen has also fallen against the euro - and is currently

trading around Y107.9/€, its third weekly decline. The *WSJ* has queried how long this euro rally can last - and some scepticism is in order, particularly given the need for Parliamentary approval of the Greek bailout package in several eurozone member states. Certainly, the continued rise in the gold price - up US $65/oz this week - suggests that there are still plenty of currency bears out there.

IV OIL

This has been International Petroleum Week in London - which means that rumours can spread even faster than usual. And there are certainly plenty of rumours to spread about (for instance):

- the July 1 EU embargo on Iranian oil - and what (if anything) Tehran is doing to counter it;
- supply problems in South Sudan, Yemen, Nigeria, Syria etc.; and
- the oversupply situation in Cushing, OK and the impact (if any) that reversal of the Seaway pipeline (scheduled for June) will have on the US supply/demand balance.

The Iranian situation (exacerbated by Teheran's decision preemptively to cut off supplies to both the UK and France) and the supply problems in the Middle East and West Africa have clearly squeezed the Brent market. Front month Brent rose US $2.27/barrel last week, to close on Friday at US $119.58. This week, it has risen pretty steadily, and is currently trading at US $125.36 - which is an all-time record in both euro and sterling terms. The IEA is adamant that the market can cope with a cut-off of Iranian supplies - claiming, in particular, that OPEC has 2.8million b/d of spare capacity. But will OPEC make that available? And is OPEC's output sufficiently fungible with Iranian crudes to avoid massive disruption to refineries? The market is clearly less optimistic than the IEA. Indeed, Vitol - the independent oil trader - predicted this week that prices would go to US $150. Clearly, for Europe at least, the supply side is a mess.

As for the US, the situation is hard to read. Last week, the price of WTI jumped sharply - up US $4.57/barrel to US $103.24.This week, it has risen again, and is currently trading at US $108.41. That is despite a 1.63 million barrel increase in US crude stocks in the latest week, and a steep build-up of stocks at Cushing in particular. One factor is clearly the belief that reversal of the Seaway pipeline in June will very quickly clear any oversupply situation. Another is the growing confidence that the US economy is recovering. Whatever, the price of WTI has now risen for seven straight days - which is its longest run since 2010.

VI BANKING

Although there is a lot of attention today on bank results - particularly the fourth quarter losses announced by RBS, Credit Agricole and Dexia (and the disappointing results from Commerz) - there are two other stories that may be more significant.

One is the revelation earlier in the week that the eight big European banks (including Deutsche, Barclays, Santander and Credit Suisse) had a total of US $816 billion in cash and deposits with national central banks as of December 31 - up 50% year-on-year. Quite simply, banks are not doing what they are supposed to be doing: they are not lending. The other is the coordinated attack on the so-called Volcker rule - which was described this week in the *NYT* as being 'as good as dead'. Obviously some foreign banks are less certain: as a result UK Chancellor Osborne and Japanese FM Azumi co-authored an article in the *FT* urging a rethink on the grounds that (in their view) the Volcker rule as currently envisaged would virtually destroy the global sovereign debt market.

VII NEXT WEEK

As noted, G20 Finance Ministers are meeting in Mexico City this weekend with IMF funding and the euro crisis on the agenda, and eurozone Finance Ministers in Brussels on Thursday to take stock of the situation and to settle the size of the so-called 'firewall'.

In between, Germany has to vote on the Greek bailout package, and Australia has to decide whether to dump its Prime Minister yet again.

As far as the eurozone crisis is concerned, another key date is Wednesday, which is when the ECB reveals the size of its next LTRO auction. It had been expected that this might be as much as €1 trillion, but expectations have now been scaled back given the fact that many European banks are obviously flush with cash.

As for the US, Fed Chairman Bernanke makes his semi-annual trip to Congress this week - and what he says will be pored over by the markets for signs of any shift in Fed policy.

As far as economic releases are concerned, the most significant are likely to be the February PMIs, which are due in the US, Europe and China, along with auto sales in the US.

Regards,
Economic Evaluation (London) Ltd