WEEKLY ECONOMIC AND MONETARY REPORT

25 November 2011

Not as good news this week on the US economy. The downward revision of the third quarter growth rate from 2.5% to 2.0% was a nasty surprise, and the lack of agreement within the FOMC on the need for additional stimulus didn't help. That said, the focus this week has been squarely on the eurozone – with the prospect of a break-up (something that would have been absolutely unthinkable a few months ago) now on everyone's mind.

I EUROZONE CRISIS

Two things in particular scared the markets this week:

- On Wednesday, a routine German bond auction almost failed. Only €3.6 billion out of €6 billion in 10-year Notes were sold. Although the Bundesbank always keeps around 10% of an issue (and although the interest rate, at 1.98%, was historically low), the lack of demand is being interpreted as a sign that investors – particularly US institutions – now believe there is no safe haven in the eurozone, and that a break-up is possible, indeed quite likely.

- At the same time, the yield on 10-year UK gilts briefly fell below the yield on comparable German *bunds* – despite a much higher level of debt and deficit in the UK, and despite its generally appalling fiscal situation.

That's not all. Other developments that have spooked the markets this week include:

- the success of the Greek electricity workers union, in getting the local courts to stop the power company cutting electric services to homes that are refusing to pay the new (and controversial) property tax, which has been added to their bills;

- reports that ECB lending to eurozone banks hit a new high of €250 billion last week – which is being taken as evidence that they are increasingly being shut out of wholesale markets (and that other banks may be cutting lines);
- a decision by the Austrian authorities to tighten curbs on lending by Austrian banks to Eastern Europe, so as to protect the country's AAA rating – a decision that has caused near-panic in Hungary, which has seen its credit rating cut to junk by Moody's as a result;
- reports that plans to 'leverage' the resources of the EFSF from its current €440 billion (actually, more like €380 billion, given money already drawn down) to around €1 trillion are failing because potential investors are not prepared to take the risk; and
- a general strike in Portugal that was the biggest demonstration in 30 years – and which prompted Fitch to downgrade Portuguese debt from BBB- to BB+ (which is junk).

The impact of all this in the markets has been devastating. Yesterday, for instance, the Portuguese 10-year yield was 12.21%. Italian 10-year paper was back at 7.22%; even Belgium was having to pay 5.74%. Today, it has just been reported that Italy had to pay 6.504% on €8 billion of 6-month bills – up from 3.54% last month.

<u>The German government's position has not helped</u>. As we have emphasised before, majority opinion among European economists (which we do not share, though it is reflected in both the *Financial Times* and *Economist*) is that the only way out of the current impasse is for the ECB to become the lender of the last resort for the eurozone – which means it must buy, without limit, the sovereign debt of member countries. (This is directly counter to the Treaties of Maastricht and Lisbon, but the *FT* has suggested a neat way round the problem: The EFSF could be reconstituted as a bank, and could be given an unlimited line of credit from the ECB to buy on its behalf.) This approach is strongly favoured by France and (not surprisingly) by Italy. It was, therefore, widely expected that Sarkozy and Monti would be able to lean on Chancellor Merkel when they met in a mini-Summit at Strasbourg on Tuesday.

Not so. Although all three committed themselves to greater fiscal integration, they also pledged to "respect the independence" of the ECB – and the Bank's new President, Mario Draghi, has made it clear that, for the moment at least, he is not prepared to go beyond the ECB's legal mandate.

That has also undermined the growing pressure from Brussels for the ECB to issue so-called eurobonds (ie bonds backed by the full faith and credit of the 17 member governments of the eurozone) – though this is another idea that keeps coming back. Indeed, on Wednesday, the Commission put a formal proposal for what is called "stability bonds" on the table.

This proposal offered three options:

- a complete substitution of all existing national bond issues for these "stability bonds" – a move that, the Commission acknowledged, would require extensive treaty changes;
- a limited guarantee (say, up to 20-30%) by all eurozone states of new bond issues by member states; and
- full eurozone backing for all new issues up to a certain level of indebtedness – with the understanding that, above that, eurozone members will have to stand on their own.

Unfortunately for the Commission, that ran up against German opposition as well. Merkel's spokesman insisted that stability bonds would be "no panacea". Juergen Stark (who is stepping down from the ECB) was tougher: "Eurobonds, even if called 'stability bonds', won't solve the sovereign debt crisis because they don't tackle the structural problems some countries are facing". It is hard to disagree with that. The 'structural problem' to which he refers is the 30% loss of competitiveness that Southern Europe has experienced *vis-à-vis* Germany since the euro was introduced.

Where does that leave the eurozone? According to a survey of one thousand clients by Barclays Capital:

- 50% now expect one or more countries to leave the eurozone in the next year;
- 5% think all five 'peripheral' countries will quit; and
- only 3% think a workable solution to the eurozone's problems will be found in the next three months.

The result is that there is increasingly open speculation about a eurozone break-up. Over the weekend, for instance, it was reported that Nomura had produced an 18-page guide to what might happen to financial markets if the eurozone broke up – focusing, in particular, on so-called 'redenomination risk'. (It pointed out that, of Greece's sovereign debt – which it put at just over €300 billion – only €16 billion was written under foreign law; the Greek government would therefore have the right to redenominate the vast majority of its debt into, say, New Drachmae if it quit the euro.) Subsequently, it was reported that CLS Bank (the pan-European settlement organisation, owned by 63 banks) was testing its systems for a euro breakup, and the head of banking supervision at the FSA acknowledged that he had asked all UK banks to put contingency plans in place in case of a euro breakup.

Is there any good news? Well, the new technocratic governments in Greece and Italy are still pushing ahead with their (near-suicidal) austerity programmes. And, in the case of Greece, Antonis Samaras – the controversial leader of the center-right New Democracy party – has finally committed to support PM Papademos. Other than that, however, there has been very little to cheer eurozone Finance Ministers – who meet again next week in Brussels.

One final point: The French have now officially nominated Benoit Coeuré, 42, to take Lorenzo Bini Smaghi's place on the ECB Board. He is currently second-in-command at the Trésor. He is (apparently) a fluent Japanese speaker, and co-chaired the Paris Club for a couple of years. As a result, France will no longer be unrepresented on the Board.

II RECENT ECONOMIC AND MARKET DEVELOPMENTS

A **THE US**: As noted, it hasn't been such a good week for the US economy – which was a bit of a surprise since recent economic data had been strong, leading some to predict that the GDP growth rate in the fourth quarter could be as high as 3.5%.

What turned the mood around was an unexpected downward revision of the third quarter growth rate from 2.5% to 2.0%, largely because of lower inventories. The upside to this is that inventory restocking could mean a sharp rebound in the fourth quarter, but the immediate response of the market was negative. Other than that, economic releases this week (shorter than usual, because of yesterday's Thanksgiving holiday) have been mixed.

On the positive side, it was reported:

- that existing home sales rose 1.4% in October, pushing the inventory of unsold homes to its lowest level of the year – though sales were still down 4.7% year-on-year;
- that personal income rose 0.4% last month – though consumer spending rose only 0.1% (pushing the savings rate up marginally, from 3.3% to 3.5%);
- that initial jobless claims fell 2,000 in the latest week; and
- that the final reading for the November Michigan confidence index was a relatively strong 64.1.

On the other hand, durable goods orders were down 0.7% in October – and September's drop was revised from -0.6% to -1.5%.

Perhaps more disappointing were the FOMC minutes from the November 1-2 meeting. These focused on a new committee that Bernanke is setting up to look into the feasibility

of short-term interest rate forecasting. There was no sign that the Committee as a whole is ready to do more on boosting the economy.

As for the so-called Congressional 'Super-committee' on the budget, that was – as expected – a dud. It disbanded on Monday, without agreement on how to achieve a lower deficit. As a result, unless President Obama exercises his veto automatic spending cuts of US $1.2 trillion are supposed to be phased in – albeit, not beginning until 2013 (ie after the next election). These are to be split 50:50 between domestic programmes and military spending. It is worth noting that the failure of the Super-committee has provided the President with a politically acceptable excuse to let the Bush tax cuts expire at the end of this year – which *could* mean US $3.3 trillion of extra revenue over 10 years. For this reason, most commentators (and the rating agencies) appear to be quite relaxed about the US fiscal problem. However, it is worth emphasising that – unless the political environment changes radically – chances are slim to zero that military spending will really be cut. It just won't happen – because it never does.

That said, the combination of a global economic downturn and the failure of the Super-committee to make any progress has certainly hit US equity markets. Although markets are up slightly in early trading on Friday, they are still down for the week – the DJIA by 4.0%, the S&P500 by 3.9% and the Nasdaq Composite by 4.0%. Over the same period, however, the 'safe haven' appeal of US Treasuries has meant the yield on the benchmark 10-year Note has fallen from 2.01% to 1.92%, while the 30-year yield has dropped from 3.00% to 2.88%. The money that seems to be coming out of the eurozone has to go somewhere.

B **EUROPE**: US economic data may have been disappointing this week, but European data wasn't much better. At the eurozone level, for instance, it was reported:

- that new industrial orders fell 6.4% in September month-on-month;

- that the consumer confidence index fell this month from -19.9 to a 28-month low of -20.4; and
- that the composite Markit PMI for the eurozone remained below 50 in November (which indicates continued contraction), though it rose from 46.5 to 47.2.

The consensus is now that the eurozone economy as a whole will probably contract around 0.6% in the fourth quarter.

As far as individual eurozone members are concerned, the good news is that, in Germany, the IFO confidence index rose from 106.4 to 106.6 this month – significantly better than was expected. In addition, the BDI industry association reported that German industrial order books are still "well-filled". On the other hand, however:

- the Bundesbank has just cut its GDP growth forecast for next year from 1.8% to 0.5-1.0%; and
- the Cologne-based IER institute has also cut its forecast, from 1.25% to 1.0%.

Whatever, the markets have voted. Until today, the Xetra Dax had fallen for nine straight sessions; even though it is up around 70 points today, it is still down over 5% for the week – following a drop of 4.2% last week.

France isn't much better off. This week, it was reported that the SXXP consumer confidence index fell from 82 to 79 this month, while Insee's business sentiment index also fell. In addition, the Xetra Dax is off 4.4% for the week.

Nowhere else is doing much better. However, at least Spain has a change of government. As expected, Mariano Rajoy's Popular Party won a resounding victory, which gives him an overall majority of 11 seats. He – like the new governments in Greece and Italy – is ostensibly committed to austerity, but his task is compounded by the enormous fiscal problems of Spain's 17 autonomous regions.

As for the UK, it is truly astonishing that the markets are rating gilts as being safe or safer than German *bunds*. This is (presumably) testimony to the Coalition government's continuing insistence that "there is no Plan B" – it is austerity and spending cuts for the UK as far as the eye can see. That was also the message from this week's MPC minutes; it had been expected that there would be a hint of further stimulus by the BofE – but nothing appeared.

C **JAPAN**: Yesterday, the IMF published a "Japan sustainability report" – which warned explicitly that Tokyo has to do something to get its debt under control. If it doesn't, the Fund warned, there is possibility of an interest rate spike – and a descent into what it called 'fiscal chaos'. Perhaps as a result of that, the yield on 10-year JGBs jumped 3.5 basis points today, to a 10-year high of 1.03%. That is still extraordinarily low, but it must be measured against the domestic price level – and it was also reported today that Japan had fallen back into deflation, with consumer prices down 0.1% year-on-year in October. Partly as a result, equities were down another 2.6% this week, following a drop of 1.6% last week.

B **CHINA**: Not even China is immune. This week, for instance, it was reported:

- that the (unofficial) HSBC 'flash' PMI for manufacturing hit its lowest level in 32 months this month, falling from 51.0 to 48.1 – which indicates actual contraction; and
- that sales of residential real estate were off 11.6% year-on-year in October.

No surprise, therefore, that the Shanghai composite exchange has fallen for 10 of the last 11 sessions, and that it is down over 15% for the year-to-date. It looks increasingly unrealistic to depend on China to act as the locomotive for the global economy.

III FOREIGN EXCHANGE MARKET DEVELOPMENTS

Last week, the only real winner was the yen – which rose 2.0% against the euro and 0.2% against the US dollar. The euro generally took a bit of a pounding on the increasing debt risk in the 'core' eurozone area. Perhaps surprisingly, this risk did not translate into a higher gold price; indeed, spot gold fell US $34.40/oz last week to close on Friday at US $1,725.75.

This week, the euro has again come under some pressure. Although it has recovered a little bit today, it is generally weaker:

- against the dollar, it has fallen from US $1.352/€ at the close last week to US $1.328 – or by 1.8%; and
- against the yen, it has fallen from Y104.0/€ to Y103.0 – its third weekly decline.

However, it has been broadly flat against the Swiss franc, and it is actually up against sterling – which has fallen from €2.13/GBP to €2.06. Given that UK gilts are being seen as a safe haven, sterling's weakness is a bit of a puzzle. Nevertheless, the pound is also down 1.8% against the dollar. As for gold, it fell as low as US $1,680/oz, but has since recovered to US $1,696 – still down 1.7% for the week.

What is significant is the US dollar's recovery against commodity currencies. For the week as a whole, "risk is off" – which means the dollar has firmed 3.8% against the Australian dollar and 2.6% against the Canadian dollar. Of course, the commodity currency sector as a whole is also sensitive to the global economic outlook – which is less and less encouraging.

IV OIL

One might also expect that to be true of the oil market.

However, for the last couple of weeks, the main factor in the market has been the narrowing of the Brent/WTI spread, as traders have come to believe that the chronic oversupply situation in the US Mid-West might be resolved. Overall, prices of the key marker crudes have not reacted as much as one might have expected to the global economy – or to the disarray in Europe.

That has also been true this week. Through late trading on Friday:

- the price of front-month WTI has fallen just 45 cents/barrel, from US $97.67 to US $97.22; while
- the price of front-month (January) Brent has risen marginally, from US $107.56/barrel to US $107.57.

It would appear that (short-term) bullish and (longer-term) bearish factors are broadly balanced.

In the former category, it was reported this week that US crude inventories had fallen by a bigger than expected 6.22 million barrels in the latest reporting period. Distillate stocks were also down 1.1 million. It was also reported:

- that, having (apparently) reached its target capacity of 12 million b/d, Saudi Arabia is halting plans for further expansion; and
- that European crude and product stocks in September were at their lowest since November 2007 - and that (according to preliminary reports) they fell even further in October.

On top of that, political factors are becoming increasingly important. On Monday, for instance, the US, the UK and Canada announced new sanctions against Iran – and France followed up yesterday with a proposal that the EU should embargo all imports of Iranian oil. Since oil is fungible, this might not make a difference in the longer term

(China would surely absorb whatever part of Iran's 2.2 million b/d exports the Europeans didn't take); but short-term disruption would tend to push prices up.

Beyond that, SocGen has just raised its 2012 average price forecast for Brent from US $100 a barrel to US $110 – though JPMorgan has cut its January forecast from US $115 to US $105.

There is one other factor that has got quite a lot of attention this week: the rise in the price of Dubai and Oman crudes, relative to Brent. The Brent/Dubai spread is now down to US $3.16 a barrel, compared with US $7.61 in April. Political considerations also play a part here.

V BANKING

A EUROPE: As noted, a major concern among European authorities is that the banking crisis is spreading from the eurozone to Eastern Europe – with Hungary, Croatia and Latvia particularly exposed. The Austrian authorities' decision to force Austrian banks to shrink their East European books will not help, since Greek banks are already pulling out.

The other significant development in Europe was publication of the Bank of England's latest semi-annual survey of risks to the financial system, based on interviews with 68 institutions in September/October. No surprise that the top risk (cited by 76% of respondents) was a government debt default. After that, there was a lot of concern abut individual institutions' ability to fund themselves in the market (cited by 57%). The other main message was that the markets are now much more aware of the danger of a "high impact" event.

B US: The main development this week was an announcement by the Fed that it will require a new series of bank stress tests. The key assumptions to be built in are:

- a 13% unemployment rate in the US; and (for banks with big trading operations)
- a 6.9% drop in eurozone GDP.

Other than that, it may be significant that the cost of CDS protection against a default by BofA has risen to 495 bp – which is extraordinarily high. And it was reported early in the week that Hank Greenberg (the former chairman and CEO of AIG) has launched a US $25 billion suit against the US government and the Fed for not giving AIG the same access to the Fed's discount window that it gave to banks (like JPMorgan, Citi and Goldman Sachs) in 2008. As a result, he says, he lost 80% of his investment in the insurer. No one really believes this suit will succeed, but it certainly has a nuisance value.

VI NEXT WEEK

As noted, EU and eurozone Finance Ministers meet yet again next week – to discuss the crisis.

As far as US economic releases are concerned, it is a big week. The most important is likely to be non-farm payrolls for November, expected to be up only around 75,000. Other significant releases include:

- new home sales for October, expected to be flat;
- consumer confidence for November, expected to be up;
- construction spending for October, expected to be up 0.2%; and
- auto sales for December.

The Fed's Beige Book survey of economic conditions will also be published.

Elsewhere, markets will focus on:

- the UK's Distributive Trades Survey;
- eurozone unemployment; and
- Japan's industrial production.

Regards,

Economic Evaluation (London) Ltd