WEEKLY ECONOMIC AND MONETARY REPORT

18 November 2011

While the markets remain focussed (even fixated) on the never-ending eurozone crisis, one could make a case that the real story is the recovery of the US economy, at least in relative terms. Europe seems to be sinking ever deeper into economic despondency, but (finally) the US is showing signs of life.

I THE EUROZONE CRISIS

Two of the eurozone's problem countries – Greece and Italy – now have new leaders who are more in tune with the thinking of the "Franco-German couple" (as Sarkozy and Merkel are being called) that increasingly runs Europe. Both Papademos and Monti are bureaucrats/academics who have no political background – or democratic legitimacy. They also belong to the class that got their countries into the mess in the first place. Papademos, for instance, was Governor of the Bank of Greece at the time that local banks were expanding credit at an unsustainable rate, both domestically and internationally; Monti was an EU Commissioner at a time when eurozone members were openly flouting the Stability & Growth Pact (which was supposed to control debt and deficits). On top of that, his newly-appointed 'Super-minister' of the economy is Corrado Passera, 56 – formerly the CEO of Intesa Sanpaolo Bank, and before that a consultant with McKinsey. Like Monti, Passera has no political experience – and virtually no experience of what it is like to be an 'ordinary' Italian.

More important, perhaps, both Papademos and Monti are politically vulnerable. In Italy, ex-PM Berlusconi continues to threaten that he can bring down Monti's government at any time. Although his People of Liberty party supported Monti in two confidence votes yesterday and today, this threat should be taken seriously. In Greece, New Democracy's leader, Antonis Samaras, continues to send out conflicting signals. While ND has joined Papademos's coalition, Samaras himself is still refusing to sign the commitment letter that the 'troika' insists all parties agree to as part of the austerity

package. In the end, ND will support Papademos on the 2012 budget that he put before the Cabinet today (which projects a cut in the deficit from 9% of GDP to 5.4%, thanks in part to salary and pension cuts). However, there are at least some commentators in Greece who believe Samaras is trying to provoke a disorderly collapse of the eurozone for his own political benefit – even if it is not easy to see how that would help him.

And then there's Spain – where national elections, to be held this weekend, are virtually certain to see PM Zapatero replaced by the (centre-right) Popular Party's Mariano Rajoy. Although Rajoy has not said anything that would rock the boat, the markets have suddenly started to focus on Spain – particularly on the real estate exposure of its banks. As a result, the average yield on a €3.3 billion 10-year Spanish Treasury auction on Thursday hit 6.98% - the highest yield since 1997, and up from 5.43% a month ago. The general rule-of-thumb in the eurozone these days is that, when 10-year rates hit 7%, it is time to panic.

There are certainly signs of panic.

The French, for instance, claim to have been outraged this week by fairly innocuous comments from UK Chancellor Osborne that they may be next in line. PM Cameron has now been summoned to Berlin, and has been warned very bluntly by Merkel (a) that Britain should not stand in the way of any EU treaty changes that Germany and France agree are necessary to handle the crisis; and (b) that the UK will be expected to help, both through its contribution to the EFSF and through the IMF. If Britain is not cooperative (or if Cameron tries to use the crisis as an excuse to 'repatriate' powers to London from Brussels), the threat is clear: France and Germany will press for measures (eg a Financial Transaction Tax) that will do serious damage to the City of London.

The reference to the IMF is important.

So far, the Fund has lent Greece around €300 billion (32 times its quota). It has also lent €26 billion to Portugal (23 x quota) and €22.5 billion to Ireland (24 x quota).

Relative to quota, these are the biggest commitments it has ever made – but they would be dwarfed by Spain and Italy if they needed help. At the moment, the belief is that existing eurozone facilities could not handle Spain or Italy, and that – if the situation deteriorated – they would have to turn to the Fund. One possibility is the (untried) Precautionary Liquidity Line – which is also under consideration for Hungary. More likely is activation of the so-called New Arrangements to Borrow. Either way, non-EU borrowers may well resist this monopolization of Fund resources by 'rich' European countries.

In the meantime, there is pressure on Merkel (not least from Sarkozy) to let the ECB become a true 'lender of last resort' for the eurozone.

It seems to be taken for granted that the only 'solution' to the eurozone's problems is for the ECB to buy up Italian and Spanish government bonds without limit, so as to keep interest rates from exploding upwards. It has certainly been buying Italian bonds this week – and that has pushed Italy's 10-year rate down from 7.5% to below 7%. However, the ECB is explicitly prohibited by treaty from buying bonds directly from issuing governments, though it can buy them in the secondary market. Sarkozy apparently wants this restriction to be ignored – which Merkel is said to be resisting. An alternative (put forward this week by the *FT*) would be for the EFSF to be re-established as a bank, which would have an unlimited line of credit with the ECB. It could then use that line to purchase the bonds.

We are sceptical that piling more debt on to countries whose problem is that they already have too much debt is really a 'solution'. And it is worth noting that both German public opinion and the Bundesbank are adamantly opposed. However, that seems to be the way the French, in particular, are thinking.

In the meantime, talks are going on in Athens today (and over the weekend) on implementation of the debt reduction agreement negotiated with the IIF. Although the

principle of a 50% 'haircut' on Greek sovereign debt held by the private banks is accepted, there are several sticking points – including:

- a potential upside for bondholders if the Greek situation improves; and (more contentiously)
- a proposal that the new bonds should be written under English, not Greek, law (which would mean they could not be redenominated in local currency if Greece dropped out of the eurozone).

There are also all sorts of rumours floating around – including a report that Germany is proposing creation of a 'European Monetary Fund' which would have the power to take failing eurozone member states into some kind of receivership, and then to administer their economies. This kind of rumour is bound to feed growing anti-German sentiment in Southern Europe – which got a big boost earlier this week when the CDU's leader, Volker Kauder, told the party's annual conference (with evident satisfaction) that, at last, "Europe is speaking German".

Whatever clever plans are being cooked up in Berlin, Paris or Brussels, it is important to emphasise the economic sacrifice that eurozone members are making. Although Monti warned yesterday that the collapse of the euro would "take us back to the 1950s", efforts to hold it together are also extracting a price. Greek GDP, for instance, is now expected to fall 6.0% this year, on top of 7% in 2010, and with the French/German 10-year bond spread now 195 basis points, even core eurozone economies are starting to suffer. At some point, a political backlash seems inevitable.

II RECENT ECONOMIC AND MARKET DEVELOPMENTS

While it is broadly correct that the global economy is not doing too badly – buoyed, in particular, by East Asia and Latin America – it is significant that the OECD's index of composite lending indicators has just reported its seventh straight monthly decline,

falling from 100.9 to 100.4 in September. That means there is still positive growth – but it is slowing down sharply.

A THE US: One of the few OECD countries where growth is still positive is the US; indeed, recent economic data suggests that growth may actually be picking up again. In particular, it was reported this week:

- that retail sales rose 0.5% last month, or 0.6% ex-autos;
- that the Empire State (NY) business activity index showed its first positive reading in five months, jumping from -8.5 in September to +0.6;
- that single family home construction jumped 3.9% in October;
- that homebuilding sentiment hit an 18-month high in November;
- that initial jobless claims fell 5,000 to a seven-month low last week; and
- that the Conference Board's index of leading indicators jumped 0.9% in October – the biggest rise since February.

Just about the only negative surprise was a drop in the Philadelphia Fed's activity index from 8.7 to 3.6. On balance, the US economy seems to be holding up better than expected – and that has caused a number of forecasters to upgrade their projections for next year. JP Morgan, for instance, is now looking at a 3% growth rate for the first quarter, up from 2.5%.

Plus, there is no sign yet that foreigners are starting to sour on the dollar – or on the US more generally. Indeed, the latest TIC data shows that net foreign purchases of long-term Treasury securities jumped in September from US $58 billion to US $68.8 billion – with the biggest increase coming at the longer end of the market.

Despite that, it is worth noting that two Fed governors – Williams of San Francisco and Rosengren of Boston – joined the call this week for the Fed to add more stimulus. With inflation insignificant (the CPI fell 0.1% in October, while the PPI fell 0.3%), the FOMC clearly has room to move – and most expect that it will do so.

In the meantime, however, there is growing concern that the so-called Congressional 'Super-committee' – which is supposed to come up with a bipartisan plan to trim US $1.2 trillion off the Federal deficit over 10 years – has deadlocked. If it doesn't come up with a plan by November 23, across-the-board spending cuts (including defense) are supposed to kick in automatically. <u>It won't happen</u>. Although the Committee will not agree to a complete package, there will probably be just enough agreement to avoid automatic cuts – and, in any case, no Congressman (of either party) is yet willing to cut defense spending, even though it is clearly out of control. (The US now outspends every other nation added together – even though it is winding down its military involvement in both Iraq and Afghanistan.)

Nevertheless, <u>the failure of the Super committee may well spook the markets</u>, at least temporarily.

That won't be too hard to do. In the first four days of this week, the DJIA was down 3.2%, the S&P500 was off 3.8% and the Nasdaq Composite was down 3.4%. That was in spite of 'safe haven' buying of US securities that saw the 10-year Treasury yield fall from 2.06% to 1.96% and the 30-year yield drop from 3.11% to 2.97%.

B **<u>EUROPE</u>**: In contrast to the US, <u>the EU economy looks pretty dreadful</u>. That said, it was reported (to some surprise) this week that third quarter GDP growth was still positive – although only 0.2% (or 1.4% year-on-year) for both the eurozone and the EU-27. It is confidently expected that <u>growth will be negative for the current quarter</u>.

As shown below, it is a very mixed picture – with Germany, the UK and some of the smaller countries still doing quite well. However, it is worth emphasising that data for several countries (notably Italy and Greece) is still lacking:

EU: GDP growth (3Q/2011)

Country	Growth	Country	Growth	Country	Growth
UK	+0.5%	Germany	+0.5%	Lithuania	+1.3%
Netherlands	-0.3%	Czech Rep.	0.0%	Estonia	+0.8%
Belgium	0.0%	Austria	+0.3%	Slovakia	+0.7%
France	+0.4%	Finland	+0.3%	Romania	+1.9%
Spain	0.0%	Cyprus	-0.7%		
Portugal	-0.4%	Latvia	+1.3%		

It is also worth pointing out that Italian industrial orders fell 8.3% month-on-month in September – indicating just how devastating the impact of the debt crisis has been. Even in Germany, it was reported that the ZEW industrial sentiment index fell this month from -48.3 to -55.2. It has now been in negative territory for nine straight months.

As for the UK, it cannot escape the problems of the eurozone – which remains far and away its biggest trading partner. It was reported this week that unemployment rose 129,000 in the third quarter, to a seven-year high of 2.62 million. Youth unemployment is now 21.9%. Even though retail sales were up a stronger than expected 0.6% last month, apparently thanks to early holiday discounting, the BofE has cut its GDP forecast for next year from 2.2% to 0.9%. It also used its quarterly *Inflation Report* to hint at another round of QE – perhaps as soon as next month.

The next big test for UK market confidence will be the Treasury's Autumn Statement on November 29. This is likely to confirm that next year looks very tricky indeed.

C JAPAN: In contrast, the Japanese economy is now bouncing back strongly from the twin disasters of last March. It was reported this week that third quarter growth was 1.5% - or 6% annualised. In addition, bank lending jumped sharply in September as the economy started to absorb demand that had been pent up since March. Despite that, however, the Nikkei-DJ has just closed down 1.6% for the week – following a 3.3% drop last week. This reflects the dependence of Japan's export sector on markets in Europe and North America.

D **CHINA**: Two important reports were published this week on Chinese-US relations:

- The US-China Economic and Social Review, chaired by the President of the National Foreign Trade Council, published its annual report, in which it claimed that the renminbi could become a global challenger to the US dollar within a decade. It also deplored China's continued subsidization and its so-called "indigenous innovation policy".
- The Peterson Institute (formerly the Institute of International Economics) published new estimates of the renminbi's alleged overvaluation. On a trade-weighted basis, it claimed, its overvaluation had fallen from 16% to 11% since last April. On a fundamental equilibrium basis, however, it is still 24% overvalued against the dollar. That is the figure that will be seized on by those in Congress who want China to be designated as a 'currency manipulator'.

III FOREIGN EXCHANGE MARKET DEVELOPMENTS

Last week, the dollar was broadly unchanged against the euro and sterling (around US $1.373/€ and US $1.608/GBP respectively), while it weakened against the yen (from Y78.2/US $ to Y77.1). This week, it has strengthened against the euro, sterling and the yen – as well as against the Swiss franc:

- US $/euro: At the close last week, the euro was trading at US $1.373. By Tuesday, it had fallen to US $1.352 on fears of credit contagion within the eurozone. It dropped further yesterday, hitting a low of US $1.351. In mid-day trading today, it is around US $1.357/€- down 1.2% for the week. Despite that, the wonder is really that the euro is as strong as it is given the problems of the eurozone. One suggestion is that it is still being supported by capital inflows from Eastern and Central Europe – particularly from Hungary, where the forint has been under heavy pressure this week.

- US $/sterling: The pound closed last week at US $1.608/GBP. It then fell to a low of US $1.579 yesterday, before recovering slightly to US $1.5814 – down 1.7% for the week. Although sterling has benefitted from 'safe haven' inflows, the consensus seems to be that it is likely to fall. UBS, for instance, is now predicting US $1.55/GBP in one month and US $1.50 in three months.
- Yen/US $: The dollar closed last week at Y77.1/US $. Since then, it has traded in a very narrow range – though it has eased today to Y76.73.
- SF/US $: The Swiss franc closed last Friday at SF0.899/US $. It then eased to SF0.917 by Thursday. Although it has since firmed to SF0.913, it is still down 1.6% for the week. (Against the euro, the SF has been trading in a SF1.23-1.24/€ range – adding further fuel to rumours that the SNB may set SF1.24 or SF1.25 as a new ceiling.)

As noted, the Hungarian forint has come under heavy pressure this week, falling from HF310/€ to HF318. However, it has since recovered to HF305, although it remains vulnerable. The problem is that Hungary (like some other countries in the region) allowed homeowners to enter into FX-denominated mortgages, many of which are now under water.

As for gold, it fell US $3.05/oz last week, to close on Friday at US $1,760.15. This week, it hit a high of US $1,788, but it has since fallen sharply and is currently trading at US $1,725.90. There is strong resistance at US $1,800, though a bigger factor may be rumours of heavy gold sales by US hedge funds. On the other hand, central bank purchases seem to be putting a floor under the gold price. It was reported yesterday, for instance, that central banks bought a net 148.4 MT of gold in the third quarter – up from 66.5 MT in the second quarter.

IV OIL

The big development in oil markets this week has concerned WTI.

On Tuesday, it was announced that a Canadian oil company had bought a controlling interest in the Seaway pipeline, which links Cushing, OK to the Gulf of Mexico, with the intention of reversing the direction of flow so that it can drain excess crude supplies out of Cushing. These supplies total over 32 million barrels, and they are one reason that the price of WTI has been so low relative to Brent. The immediate reaction was to shrink the premium for Brent from over US $16 a barrel to under US $10. However, the market is now having second thoughts – thanks to the realisation that the pipeline reversal cannot happen until the second quarter of 2012, and that its initial capacity will be no more than 150,000 b/d.

Whatever, oil prices have been volatile this week.

Last week, WTI for December delivery rose US $4.73 a barrel, to close at US $98.99, while December Brent rose US $2.19 to US $114.16. By Wednesday, WTI had firmed to US $102.59, while January Brent (the new front month) was trading weaker at US $111.88. In mid-day trading today, Brent is at US $108.66 (down 4.8% for the week), while WTI is at US $99.60, virtually flat for the week.

This is obviously not just Seaway. Railcar shipments out of Cushing have also increased, which has started to impact the oversupply situation in the Mid-West. Plus, the overall US stock position has tightened, with crude inventories down 1.1 million barrels in the latest week. And JP Morgan has raised its average price forecast for WTI next year by US $12.50 a barrel, to US $110. Indeed, given the increasing disparity in US and European economic prospects, one might well expect the WTI market to strengthen consistently over the medium term.

V **TRADE**

The focus of attention this week was the APEC meeting in Hawaii, at which Obama participated. This has led to an agreement in principle to establish a Trans-Pacific Partnership including nine Asia-Pacific countries (Australia, Brunei, Chile, Malaysia,

New Zealand, Peru, Singapore, the US and Vietnam). In the light of the breakdown of the Doha round, the aim is to get whatever bilateral (or parti-lateral) deals that are on offer – including non-tariff barriers, barriers to government procurement etc.

In addition, the WTO has announced that, at the request of Brazil, it has agreed to examine whether (or to what extent) governments can punish currency manipulators by imposing trade restrictive measures. This obviously has great relevance to the continuing row between the US and China over the latter's dollar peg.

VI NEXT WEEK

As noted, Spain holds elections this weekend which are expected to result in a substantial majority for the centre-right Popular Party.

Next Thursday is Thanksgiving in the US – which normally means a light week as far as economic events is concerned. However, markets will be focussed on the Super-committee's report, due by November 23. As far as US economic releases are concerned, the key are:

- existing home sales for October;
- the second estimate of third quarter GDP growth;
- personal income and consumption for October; and
- durable goods orders.

The FOMC minutes from the November 2 meeting will also be published.

Elsewhere, markets will look for:

- eurozone PMIs;
- China's flash PMI;
- the German IFO survey;

- UK GDP for the third quarter; and
- Japan's leading economic indicators.

It is also expected that the European Commission will propose its own package of measures for closer economic integration within the eurozone.

Regards,
Economic Evaluation (London) Ltd