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WEEKLY ECONOMIC AND MONETARY REPORT

29 July 2011

For once, the problems of the eurozone have been unequivocally eclipsed by analysts' increasingly hysterical reaction to the possibility/probability that the US will not have approved an increase in the US $14.29 trillion Federal debt ceiling by the (allegedly) "drop-dead" date of April 2. So far, the markets have been a lot more relaxed than the press (and commentators generally); but there are signs that this is changing. In the meantime, the doubts we raised last week about the latest bailout package for Greece are now becoming commonplace. No one really understands the details; parts of the package require Parliamentary approval in one or more eurozone countries; the enhanced powers for the EFSF may not be in place until year-end... As a result, the new consensus seems to be that the Summit succeeded in "kicking the can down the road" – but not very far.

I US DEBT/DEFICIT

As noted, the markets were still fairly optimistic (at least, until today) that the US will not actually default – in that there will either be some kind of temporary stop-gap measure (it is already too late for Congress to write up a comprehensive bill before August 2) or, if there is no agreement, some kind of orderly procedure for the Treasury to prioritise payments with whatever funds it has. (It is estimated that US government revenues in August will be US $172 billion; interest due in the month on Treasury debt is US $29 billion. However, total debt maturing in the month is US $507 billion – with the first US $100 billion tranche falling due on August 4.)

If the Treasury does decide to prioritise its payments, the expectation is that interest payments on Federal debt will be top of the list, probably followed by Social Security payments, military salaries and the first tranche of maturing debt. As a result, the yield on the benchmark 10-year Treasury has barely moved this week, sticking at around

2.97% until Thursday - and actually falling to 2.88% after release of weaker than expected GDP data on Friday morning.

On the other hand, however, US equities have started to show signs of nerves: the DJIA, for instance, was down 3.5% through Thursday, and the S&P500 was off 3.3%. In Friday trading, the S&P futures index is down a further 0.9%.

We have already discussed (at length) the political dynamics that have made agreement on raising the debt limit so much more difficult this time – mainstream Republicans are afraid of being targeted by "tea party" radicals (who believe this is their last/best chance of slashing government spending back to its 'traditional' level of around 20% of GDP), while Democrats don't want to go into next year's elections having cut Medicare or Social Security. Positions have become increasingly entrenched – as evidenced by the fact that Rep Boehner (who is widely considered a moderate) was forced to drop his plans to force a vote on his own, fairly aggressive, compromise proposal on Thursday night, because he was afraid that not enough Republicans would back him. (It was always understood that Boehner's proposal would be defeated in the Senate by the Democratic majority; what is stunning is that he could not even get his own party in the House to sign up.)

There is talk that Boehner will re-present an amended version of his bill again today. But, whatever happens, it looks very much as if the US will (temporarily at least) lose its triple-A rating. However, there is little agreement what that will mean. Optimists point out that Australia (which is one of only 17 AAA-rated countries) currently pays 4.9% for 10-year money, while Japan (AA) only pays 1.1%. Pessimists, however, point out:

- that even a half-point increase in interest rates would cost the US US $435 billion on its Federal debt over 10 years;
- that some investment institutions would be forced to dump US securities if they lost their triple-A rating;

- that a downgrade might well disrupt the US $4 trillion repo market, which depends on government securities as collateral; and
- that US banks may well find their capital and liquidity ratios under pressure if Treasuries fall in value.

There is also nervousness about the US $684 billion in US money market funds, much of which is in Treasuries. If the value of these starts to fall, there is a fear of a run by depositors.

There is one other big unknown: Will the Obama Administration try to challenge the legality of the debt ceiling?

Until recently, this had seemed most unlikely, since the only supporters of this approach were left-wing nut-jobs. Now, however, some important figures (including ex-President Clinton) are suggesting that the 14th Amendment to the Constitution, backed up by a subsequent Supreme Court decision, means Congress does not have the right to pass legislation that would result in the non-payment of Federal debt obligations. So far, the Treasury has insisted it will not test this, but, *in extremis*, the legal arguments appear plausible.

This point is that no one knows whether failure to lift the debt ceiling will be like Y2K or like Lehman Bros. Certainly, there is a risk – and the IMF (which published an Article 4 survey of the US economy this week) made its view clear. The US *must* raise the debt ceiling. Much will probably depend on the plan that the Treasury was scheduled to put forward after markets close today – detailing what it would do if no deal can be done by August 2. However, there is now speculation that publication of this may be delayed if the Treasury decides that Congress must get its act together first.

II EUROZONE CRISIS

There are really three separate issues stemming from last week's Summit:

- No one really understands the deal that was agreed last week, and it is unclear exactly when all the details will be ironed out. Merkel, for instance, said she wouldn't have all the information ready until the Bundestag returns in September.
- In so far as people do understand it, parts of the deal are turning out either to be controversial or implausible. In particular, critics have focussed on the assumption that banks with exposure to Greece which mature before the end of 2013 will be willing to extend (or rollover) that exposure, rather than insist on full repayment.
- While the focus has been on Greece, the situation elsewhere in the eurozone countries to deteriorate. Yesterday, for instance, Italy had to pay 5.77% on a €7.97 billion 10-year auction, up from 4.94% a month ago, while Spain is paying 6.13%. In contrast, the yield on the 10-year German *bund* is just 2.60%. Plus, contagion has spread to Cyprus – where the problem of bank exposure to Greece is compounded by an incompetent, Communist-led government and huge economic strains caused by power shortages.

Looking first at last week's deal, the *FT* reflected the confusion on Wednesday: "How much will the eurozone's €440 billion need to raise for Athens – and how quickly? Is the estimated €33 billion in Greek bonds to be repurchased in a buy-back programme any more than a number plucked out of thin air? And is the IMF going to shell out a third of the €109 total bailout package, as in the past, or just a third of the €34 billion in new direct loans…".

There are also questions over whether the proposal to let the EFSF buy bonds in the secondary market is possible – both legally and practically. It apparently requires unanimous agreement by eurozone governments – as well as ECB approval. As the *WSJ* put it, "It may be months before the EFSF is actually able to exercise its new-found flexibility".

As for the assumption that over 90% of banks who lent money to Greece will voluntarily accept one of the four options on offer for maturities falling due before end-2013 – all of which imply a "haircut" of somewhere around 20-25% - that seems wildly optimistic, given that the fifth option is that they will be paid out in full. But even if they do have their arms twisted, the "haircut" simply isn't big enough to cut Greece's debt ratio significantly below an unsustainable 150% of GDP. As the *WSJ* put it: "Another Summit, another deal, another disappointment."

And, in the meantime, the wagon-train moves on... This week, it has been reported, *inter alia*:

- that Moody's has downgraded Greece by a further three notches to Ca – the second-lowest rating on its scale – on the grounds that it is already in default;
- that S&P has followed suit, cutting Greece's rating two notches to CC;
- that Moody's has put Spain's Aa2 rating on negative credit watch;
- that developing countries on the IMF's Executive Board have begun to question whether the Fund's involvement in Greece is appropriate – and whether it is showing excessive generosity to European bond holders; and
- that Moody's has downgraded Cyprus's sovereign rating two notches to Baa1, while also bashing its banks.

On the other hand, the so-called 'troika' confirmed today that Greece will receive the next €8 billion tranche of the (first) bail-out package in September, as agreed.

The new consensus is that last week's deal may have bought the eurozone a month or so of (relative) peace and quiet, but that <u>the markets will be back in September</u>. Given the widening of spreads, and the increased pressure on Spain and Italy (not to mention the speculation that Cyprus may need an emergency bailout within the next couple of weeks), even that may be optimistic.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

The global economy continues to send out very mixed signals. At the moment, the problems of the US and eurozone mean the mood is generally negative. However, earlier this week, UNCTAD released its 2010 survey of foreign direct investment – indicating that total cross-border investment jumped 5% last year, and is up again this year. For the first time ever, FDI in emerging markets outpaced FDI in developed economies:

FDI inflows: UNCTAD 2010 (US $ billion)

	2009	2010
US	153	228
China	95	106
Hong Kong	52	69
Belgium	24	62
Brazil	26	48
Germany	38	46
UK	71	46
Russia	36	41
Singapore	15	39
France	34	34

Total FDI last year was US $1.24 trillion.

A THE US: Clearly the debt/deficit talks have dominated the news – and, as noted, there is evidence that (finally) the markets are starting to notice. (That is still more true of equities than bonds, which seems surprising.) However, that is not all that happened this week.

In particular, the IMF released its first report on the US economy. In addition to urging a solution to the problem of the debt ceiling, it projected real GDP growth of 2.5% this year and 2.7% in 2011 – which was a bit better than the so-called "new normal". Moreover, it suggested that unemployment will start to fall. It put the jobless rate at the end of this year at 9.0%, and at 8.4% in 2012 – which, it should be remembered, is a Presidential election year. (One of the iron rules of US elections is that incumbents don't get re-elected unless unemployment is falling.)

That said, economic releases this week have mostly been disappointing. There are some exceptions. In particular:

- the Conference Board's consumer confidence index rose from 57.6 to 59.5 this month (though the present conditions sub-index fell from 36.6 to 35.7);
- previously-owned home sales rose 2.4%; and
- the latest weekly figure for first-time employment claims fell unexpectedly, by 24,000 to 398,000.

On the other hand, however, it was also reported:

- that (according to the 'flash' advance estimate) the GDP growth rate in the second quarter was just 1.3% - substantially below the 1.8% that had been expected (moreover, the first quarter rate was revised down from 1.9% to just 0.4%);
- that the Case-Shiller 20-City home price index was down 4.5% year-on-year in May, with prices falling in 19 of the 20 cities in the survey;
- that new home sales fell unexpectedly by 1% in June;
- that durable goods orders fell 2.1% last month, with non-defence capital goods orders off 0.4%;
- that the Michigan confidence index fell from 63.8 to 63.7 this month;
- that the Chicago PMI for July fell from 61.1 to 58.8;
- that the Fed's 'Beige Book' survey for July detected increasing weakness in eight out of the 12 Fed districts, compared with only four in June; and
- that Bloomberg's "consumer comfort" index dropped last week from -43.3 to -46.8 – its lowest level since May.

The result of all this is a perception of increased economic fragility – which makes the possible ramifications of a failure to do a deal on the debt ceiling even more serious.

B **EUROPE**: The same goes for Europe. While attention is focussed on the eurozone crisis, there are other economic issues that are worth a look – notably the widening divergence in both performance and outlook between Germany and the rest.

In Germany, for instance, it was reported this week:

- that unemployment fell in July for the 25th straight month, and is now just 2.96 million; and
- that retail sales surged by 6.3% in June – the biggest one-month jump in over 10 years.

There is a downside. The preliminary CPI data for July suggest that prices were up 0.4%, or 2.4% year-on-year. But most of the evidence suggests that the German economy is still going like gangbusters.

There is, however, one piece of evidence that points in a different direction. That is the eurozone's Economic Sentiment Index, which fell from 105.1 to 103.2 this month. What is surprising (and worrying) about this is that weakness was not confined to the Southern member States. Indeed, even though sentiment in Germany is still strong, it fell significantly in July:

Eurozone Economic Sentiment Index

	June	July
Germany	114.5	112.7
France	107.4	106.9
Italy	99.3	94.8

That said, the level of economic optimism does tend to fall the further away one is from Germany. In Italy, for instance, there continue to be rumours that Finance Minister Tremonti is about to quit – not least because Berlusconi continues to prioritise his own political/ethical problems ahead of tackling Italy's growing economic difficulties. Typical of that was today's confidence vote in the Senate – the 48th Berlusconi had used –

which was intended to block attempts to bring him to court on corruption charges. Not surprisingly, he won the vote – 160/139 – even at the risk of bringing his administration into further disrepute.

Meanwhile, the big news in the UK this week was the second quarter growth data – which was even more disappointing than in the US. GDP was up just 0.2%, or 0.7% year-on-year. That compared with 0.5% in the first quarter, and it has (reportedly) led to clashes on policy between PM Cameron and his Chancellor, George Osborne. There were extenuating factors (eg the Royal wedding); but the fact is that the UK economy is slowing down – even before the full weight of spending cuts has hit. Reflecting this, it was also announced:

- that lending by UK banks to private non-financial companies fell again in June, by GBP 2.5 billion month-on-month;
- that, according to the CBI's Distributive Trades Survey, retail sales have weakened sharply, with the CBI's index falling from -2 to -5 this month; and
- that the GfK consumer confidence index dropped in July from -25 to -30.

No surprise, therefore, that the FTSE-100 is off around 110 points this week – despite some support for UK assets as a safe haven from turmoil in both the eurozone and US.

C **JAPAN**: The yen has also benefitted as a safe haven – but, rather surprisingly, not the Nikkei, which has just closed at 9,833. That is a drop of 3% for the week – its biggest fall since March.

The ostensible reason for this was a statement from the BoJ saying that it will not intervene in the markets to hold down the yen – which, it is felt, will put Japanese exporters under pressure. There is also the issue of political succession. Earlier in the week, the Diet approved a Y2 trillion supplemental budget for disaster relief – which was one of the conditions PM Kan had set for announcing the date on which he will step down.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

Last week, the big news was the recovery of the euro, which hit a two-week high after announcement of the second Greek bailout. Week-on-week, it rose from US $1.412/€ to US $1.437, and from Y111.7/€ to Y112.6. Meanwhile, the dollar continued to slide – not just against major currencies, but also against commodity currencies like the Australian, New Zealand and Canadian dollars.

This week, the US dollar has continued under pressure. It hit a series of record lows against the Swiss franc, which briefly broke through SF0.80/US $, and also fell sharply against the Australian dollar (from A$0.921/US $ to a 29-year low of A$0.901, before recovering to A$0.914), the Canadian dollar (from Can $0.950/US $ to a low of Can$0.943) and the New Zealand dollar (from NZ$1.157/US $ to NZ$1.146). Against the major currencies, however, the dollar has been mixed:

- US $/euro: As noted, at the close last week, the euro was trading at US $1.437. This week, it hit a high of US $1.449 on Tuesday as the full force of the US budget battle hit the markets. Thereafter, the dollar has recovered somewhat. Earlier today, it was currently trading at US $1.427/€ - up 0.7% for the week – though the weak GDP data has pushed it back down to US $1.435.
- US $/sterling: Last week, the pound firmed from US $1.612 to US $1.631 – a gain of 1.2%. By this morning, it had eased to US $1.629, despite the fact that sterling *ought* to be a safe haven from the ills of the eurozone and despite the fact that gilt prices have firmed sharply (with the 10-year gilt yield falling from 3.11% to jut 2.94%). However, once again, the poor GDP data has hit the US dollar, and it has now fallen to US $1.637/GBP – a drop of 0.4% for the week.
- Yen/US $: Last week, the dollar fell against the yen from Y79.00/US $ to Y78.36. This week, it fell further, breaking Y78 yesterday and falling to a new

post-War low. It is currently trading at Y77.2 – down 1.1% week-on-week. Clearly, while sterling has failed as a safe-haven, the yen has succeeded.

- SF/US $: So has the Swiss franc. Given that it is widely seen as a proxy for gold, that is no surprise – and, indeed, it has been strengthening for some time. This week, it has firmed from SF 0.816/US $ to US $0.791 – or over 3%.

As for gold itself, it rose another US $2.65 last week, to close on Friday at US $1,589-90 oz. This week, it hit another nominal record, touching US $1.631-20 yesterday – up 14% year-to-date. Even though it has eased to US $1,626 today, there are many who expect it to bounce still further if the US debt standoff continues.

V OIL

Last week, WTI for September delivery rose US $1.63 to close at US $99.87/barrel, while September Brent rose US $1.41 to US $118.67 – leaving the spread between the two at US $18.80. The general feeling was that the main factor keeping prices so firm was the IEA's decision not to release any more strategic stocks into the market.

This week, prices have been softer. WTI, for instance, is currently trading at US $95.34/barrel – down US $4.53 (or 4.5%) week-on-week. Brent is trading at US $116.05 – down US $2.62 (or 2.2%). That means the spread in favour of Brent has widened to US $20.71.

There are two big reasons for the widening spread:

- the supply shortage in Europe, particularly for light sweet crudes, which has been caused by the Libyan war; and
- the oversupply situation in the American Mid-West.

The latter is particularly important. This week, it was reported that total US crude inventories rose 2.3 million barrels last week (the first rise in eight weeks), with gasoline

inventories up 1.02 million and distillate up 3.39 million. However, what was more important was that stocks at Cushing, OK rose 430,000 barrels. Given the constraints on supply chains (particularly to the South and East), that has held down the price of WTI. It is also expected to continue. Indeed, some commentators are suggesting that the Brent/WTI spread could go as high as US $50.

The other factors influencing the market this week (particularly in the US) are, more obviously:

- overall demand in the US, which is very much dependent on economic growth; and
- the weather - particularly prospects for Tropical Storm Don (the fourth storm of the hurricane season), which is due to make landfall in Texas today.

VI **TRADE**

It is hard to say whether it is important or not, but, at the beginning of this week, Iran and China announced a bilateral agreement in which Iran will barter its oil for Chinese finished goods. The intention is apparently to get round US/UN sanctions on trade with Iran – and also for China to work off around US $20 billion in unpaid invoices. This is a throwback to a practise than was common in the 1970s and before, ie before most currencies had become convertible.

VII **BANKING**

Equally, it is difficult to say whether the row that has been simmering for some months over the setting of LIBOR (and of other reference interest rates, notably TIBOR and PIBOR) is serious, or just 'silly season' fun. However, the LIBOR situation did get more serious this week, with the announcement of an official probe into whether banks gave false information to the British Bankers Association (which sets LIBOR on the basis of submissions from leading banks) at the height of the crisis. At first, it was assumed that,

if this did happen, it was just that banks did not want to reveal the strains they were under. Now, the suggestion is that several banks (notably Barclays) may have been taking derivative positions ahead of the LIBOR fixing - and, therefore, were able to benefit from the false information they were providing.

VIII NEXT WEEK

Next week is a big one for economic releases in the US. The most important is the non-farm payrolls number for July. Markets will expect an increase far higher than June's 18,000. Anything less than 100,000 will be viewed negatively (though some forecasts are as low as 50,000). Other releases include:

- the ISM (purchasing managers) index for July;
- construction spending for June;
- personal income and expenditure for June; and
- factory orders for June.

In Europe, the main releases are:

- EU-27 purchasing managers data for July;
- eurozone retail sales for July; and
- German factory orders for June.

The BofE's MPC and the ECB's Council both meet. The focus will be on whether the BoE indicates any willingness to restart its QE programme.

In China, PMI data is also due, while in Japan the focus will be on leading economic indicators.

Regards,
GISE