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WEEKLY ECONOMIC AND MONETARY REPORT

21 January 2011

For once, a (fairly) quiet week, as far as economic developments are concerned.

There was a lot of attention focussed on the visit of Chinese President Hu Jintao to Washington, but even that failed to generate much controversy. Instead of the public row that many had expected over the undervaluation of the renminbi, the big story was trade – and, specifically, China's order for US$45 billion of US manufactured exports (including US$19 billion for Boeing), plus a promise to buy US soybeans. There was a minor embarrassment over China's human rights record, but even that was quickly glossed over. The central message is that China is now America's No1 global partner – a status which was reinforced by two news stories this week:

- that (depending on the exchange rate used) China's GDP overtook Japan last year, making it the second largest economy in the world; and
- that, over the last two years, China has lent more money to the developing countries than the World Bank – US$110 billion, compared with US$100.3 billion.

The US policy shift in favour of China (and, therefore, away from traditional links with Japan and Europe) has, so far, received a very warm reception. However, the longer-term implications need more careful assessment.

I **WORLD ECONOMIC FORUM**

Davos starts next Wednesday. Surprisingly perhaps, it has attracted very little attention in the press this year – aside from the usual scepticism about its relevance at a time of fiscal austerity.

There are, apparently, four "thematic clusters":

- 'Responding to the new reality' – which is intended to emphasise the economic and political importance of new players like China, India and Brazil;
- 'The economic outlook and inclusive growth' – which is supposed to weigh the dangers of inflation and a possible double-dip;
- 'Supporting the G20 agenda' – which, again, focuses on bringing the BRICs into the global mainstream; and
- 'Building a risk/responsibility network' – which is being interpreted to mean making bankers a bit more sensitive to political and social pressures.

There are workshops on the recovery of the financial system (with the COO of Goldman Sachs), on the global economic outlook (with the CEO of Barclays and the Indian Finance Minister), on cybersecurity, on the environment, on the intractable problem of unemployment and on the problem of natural resource depletion. In other words, the usual mix of ostentatious wealth, political influence and corporate social responsibility.

II EUROZONE CRISIS

As noted, there have been no significant developments this week. That said, the two-day ECOFIN meeting at the beginning of the week was interesting. It appears to have focused on two issues:

- the future of the European Financial Stability Facility; and
- the possibility that troubled peripheral eurozone members might start to buy back their own distressed debt – either directly from the market or from the ECB.

On the EFSF, there now seems to be agreement that it must be able to lend the full €440 billion that it is authorized to borrow in the markets. (At the moment, the need to post collateral means its effective lending limit is €250 billion.) However, there is no agreement on whether it should be permitted to buy up the bonds of eurozone member states. Nor is there any agreement on whether its total resources should be increased, or on whether the proposal for so-called E-bonds (endorsed in today's issue of *The Economist*) is worth pursuing. The Commission is pushing for all these questions to be resolved by early February; Germany, however, wants a wider package that would also include new assurances on fiscal policy. That might delay a deal to late March.

On the issue of debt buybacks, one possibility is that issuing countries could start by buying back the €76 billion in distressed paper that the ECB currently holds. It is thought that this would avoid the problem that banks might have to write down the value of the eurozone member debt that they do not sell and that remains on their books.

In the meantime, the markets have been kinder to peripheral eurozone members than in recent weeks. In particular, Spain managed to sell €12.5 billion of 10 and 15-year bonds this week on better terms than in December, and Portugal managed to raise €750 million in 12-month notes at just 4.03%, down from 5.28% last month.

That said, the eurozone is not out of the woods. In particular, it was reported that Spain has been forced to provide still more financial support to its troubled *caja* lenders. And Ireland's embattled PM, Brian Cowan, has called a general election for March 11 that his Fianna Fail party is virtually certain to lose; there is no guarantee that the next government will adopt the same austerity package that Cowan introduced.

Finally, there is a new acronym in town… Instead of 'PIGS' (a term coined by Goldman Sachs), JP Morgan now talks of 'GIPSIs' – which has the advantage of including Italy, whose public finances are clearly in a mess.

III RECENT ECONOMIC AND MARKET DEVELOPMENT

The big issue – particularly outside the US – continues to be inflation. The reason is that, virtually everywhere except the US, inflation is increasing. As shown below, consensus forecasts are that, in most countries (again, except the US), inflation will have doubled between 2009 and 2011:

Selected inflation rates

	end-2009	2010 (projected)
Eurozone	0.9%	2.2%
Greece	2.6%	5.6%
Italy	1.1%	2.1%
France	1.0%	2.0%
Germany	0.8%	1.9%
UK	2.9%	3.7%
US	2.7%	1.5%

To a large extent, this appears to be commodity-led, with food and energy at the top of the list. The R/J CRB commodity index is up about 17% year-on-year, Brent crude is up about 27% and WTI is up 14%. This has clearly started to affect ECB thinking, with Trichet increasingly vociferous about the need to drive inflation down. It is also having an impact on the G20; it was reported this week that France (which holds the Presidency of the group this year) is pushing for more transparency in oil and gas prices, and that it wants to beef up the Joint Oil Data Initiative (an open database on oil).

One other report, published this week, warrants attention. Yesterday, the OECD released a report on housing policies among its members. The prompt for this was the belief that housing was one of the main causes of the post-2007 financial crisis. In general, the OECD report opposes any attempts by government to increase home ownership. It also blames financial innovations in the mortgage area for driving up house prices. It recommends:

- removing any remaining tax advantages relating to home ownership over renting; and
- lifting any restrictions on rents.

This is a controversial report, and its recommendations will not be welcome to politicians – particularly in the US and Europe.

A **THE US:** The FOMC meets next week – and it is expected to discuss what (if anything) to do after the current QE programme ends in June. It is significant that two of the new members – Dick Fisher (Dallas) and Charles Plosser (Philadelphia) – are known to be sceptical. Indeed, Plosser gave an important speech this week, in which he argued that we now expect too much from monetary policy in general, not just from QE. In his opinion, it "can sometimes, temporarily, stimulate real economic activity in the short run" – but that's all. It cannot (for instance) revive the housing market, and it also "distorts price signals".

Under these circumstances, it seems most unlikely that the Fed will agree to another round of QE.

And maybe it doesn't need to. Most of the US economic releases this week have been positive. In particular, it was reported:

- that the Empire State (NY) manufacturing index rose from 10.6 to 11.9 in January;
- that first-time jobless claims fell sharply, by 37,000, in the latest week, suggesting that the trend is now clearly down;
- that the Conference Board's index of leading indicators rose 1% in December (after a 1.1% increase in November), with the current conditions indicator also up 0.2%; and
- that sales of previously-owned homes rose 13% in December.

On the other hand, new home construction was down 4.3% last month (though new permits were up 17%), and the Philadelphia Fed's activity index fell unexpectedly from 24.3 to 19.3 this month. So, there are still problems. But there are clear signs that the employment situation in manufacturing is, finally, improving. And there is no sign that foreigners are yet losing faith. Indeed, TIC data for November shows that foreign purchases of Treasury securities jumped from US$27.6 billion to US$85.1 billion.

Moreover, markets have been fairly firm. The DJIA, for instance, is up around 0.9% for the week through mid-day Friday. However, the yield on the 10-year Treasury benchmark has risen from 3.33% to 3.42%, and there continues to be a great deal of nervousness about state and local finances and the impact on the massive municipal bond market. Perhaps not surprisingly, both S&P and Moody's this week warned that the US should not take its triple-A rating (which it has had since 1917) for granted.

Finally, it was announced today that Jeff Immelt – the legendary CEO of GE – has agreed to head a new Council on Jobs and Competitiveness. This will replace Paul Volcker's Economic Recovery Advisory Board. (Volcker announced yesterday that he would step down on February 6.)

B **<u>EUROPE</u>:** As noted, the ECB's latest Monthly Report highlights <u>the growing threat of inflation in Europe</u>. However, that is not the only problem. The eurozone's current account deficit also hit a two-year high of €11.2 billion in November – despite Germany's astonishingly strong export performance.

The problem is the widening gap between North and South in the eurozone. In France, for instance, it was reported this week that Insee's business confidence index jumped this month from 102 to a three-year high of 108, while industrial output grew at its fastest rate in 10 months in November. In Germany, the situation is even more encouraging. Even though inflation jumped from 1.5% to 1.7% last month, it was also reported:

- that the ZEW confidence index rose from 4.3 to a six-month high of 15.4 in January; and
- that the IFO business climate index rose from 109.8 to 110.3.

As a result, the government has increased its forecast for GDP growth this year from 1.8% last October to 2-2.24%. One inevitable consequence is that German interest rates are starting to nudge up; the yield on the 10-year *bund*, for instance, has risen from 3.05% to 3.18% this week.

<u>As for the UK</u>, it too (according to the rabidly Keynesian *FT*) is suffering a bout of "inflation phobia", occasioned by an unexpectedly severe jump in the CPI from 3.3% to 3.7% last month – almost double the BofE's 2% target. While the *FT* urges the Bank to do nothing on interest rates, pressure for an increase is clearly growing – particularly since the rise in VAT earlier this month will almost certainly push inflation through 4%.

The problem is that, unlike the US, the British recovery is still fragile. For instance, it was reported this week:

- that unemployment rose 49,000 to 2.5 million (or 7.9%) in the September-November quarter;
- that mortgage lending hit a nine year low in December, dropping a further 6%; and
- that retail sales volume was unchanged year-on-year in December.

On the other hand, the CBI's latest Industrial Trends Survey suggests that (as in the US) there is some pick up in manufacturing, and that more companies are finally starting to hire. That could be good news for the Coalition government.

C **JAPAN:** The big news was a cabinet reshuffle over the weekend that saw 72-year old Kaoru Yosano replace Banri Kaieda as Minister for Economic and Fiscal Policy. This is an important shift – not least because Yosano (who is a maverick independent) published a book last year attacking the DPJ's economic policy. He believes Japan's finances are at a critical point, and he warned earlier today that, unless something is done, the budget deficit will be US$280 billion by 2020 – which would be devastating to market confidence. What he wants (and has long advocated) is an increase in the controversial sales tax – currently set at an unrealistically low 5%. That seems certain to provoke a major fight with the LDP – a prospect which hit Japanese equity markets, with the Nikkei-225 down 2.1% for the week.

D **CHINA:** Domestically, the main news this week was the announcement that GDP growth last year was a phenomenal 10.3%, up from 9.2% in 2009.

The problem is that this is almost certainly unsustainable. It appears to be the product of a monetary bubble. Money supply is up 50% in two years, and there has been a huge increase in domestic lending by Chinese banks – much of it (apparently) off-balance sheet. There is now a pretty strong consensus that the government will push up interest rates sharp to slow the economy down – which may be one reason why Hu apparently got such an easy ride in Washington.

III FOREIGN EXCHANGE MARKET DEVELOPMENTS

It has not been a good week for the US dollar, which is down virtually across the board:

- US$/euro: At the close last week, the euro was worth US$1.335, with the markets nervous ahead of this week's ECOFIN meeting. The dollar recovered to US$1.329/€ on Monday, but has since fallen back. It is currently trading at US$1.357/€ - down 1.5% for the week.
- US$/sterling: The pound closed last week at US$1.588. The consensus in the market at that time seemed to be that it was a one-way bet, in that higher UK inflation was bound to force interest rates up. Whatever, it hit a high of US$1.599/GBP on Wednesday. Even though it has eased fractionally to US$1.597 at the present time, it is still up 0.6% for the week.
- Yen/US$: The dollar has done a bit better against the yen. At the close last week, it was trading at Y82.92/US$. It fell as low as Y81.9 on Wednesday when the renminbi also hit a record high, but has since recovered to Y82.71 – down just 0.3% week-on-week.
- US$/SF: The SNB has become increasingly concerned about the strength of the Swiss franc – which continues to trade through parity with the dollar. At the close last Friday, the dollar was worth SF0.964. It fell as low as SF0.955 on Wednesday, and is currently trading at SF0.959 – down a further 0.5%.

The dollar also had a bad week against most commodity currencies. However, the release of China's GDP data yesterday seems to have convinced the market that the PBoC must take action soon to cool the economy. As a result, the Australian dollar fell from US$1.012 to US$0.984 – though it has since bounced back to US$1.01. Same with the Canadian dollar; it fell from Can$0.992/US$ to Can$1.002, before recovering today to Can$0.99.

In the meantime, the price of gold has also fallen – dropping 2.1% this week, from US$1,373/oz to US$1,344.

IV OIL

It has been another strong week in the markets – though both key marker crudes have fallen back a little after a very strong run-up in recent weeks:

- WTI: Last week, the price of WTI for February delivery rose US$3.51 a barrel (or approximately 4%) to US$91.54. By Thursday of this week, WTI had fallen back to US$88.86, but it has recovered somewhat, and it is currently trading at US$89.56 a barrel – down 2.2% for the week.
- Brent: Last week, Brent rose US$5.35 a barrel (or 5.7%), to close at US$98.68 – a most unusual spread of US$7.14 a barrel over WTI. That was its highest price since October 2008. Although it has eased this week to US$97.20 (down 1.5%), it is still very firm – and the spread over WTI gas widened to US$7.64.

What is going on?

First, the strength in oil markets is general. Indeed, Nigerian Bonny and most Asian crudes have been trading at more than US$100 a barrel for some time – which would seem to suggest that it is Asian (ie Chinese) demand that is driving the market. But that cannot be the whole story – particularly since there are a number a factors that ought to be driving prices lower (and, indeed, they have come off this week).

One is the global stock situation, which is generally comfortable. In the US, in particular, crude inventories rose 2.6 million in the latest week, with distillate and gasoline stocks also up. Even though stocks at Cushing, OK fell for the second week, they, too, are comfortable. Another is the fact that the trans-Alaska pipeline (which had been ruptured) was brought back on steam very quickly. More important, the IEA continues to insist that OPEC (and, in particular, Saudi Arabia) has been 'stealthily' increasing its production.

So, what is keeping prices up? Obviously, demand is important. The IEA now claims that 2010 demand rose more than it previously estimated, by 2.7 million b/d to 87.7 million – and that demand this year will average 89.1 million b/d. In addition, however, there are stories of massive speculative positions being built up – as well as big physical positions. One story involves Hetco – a US trader – which is said to have bought up 10 North Sea cargoes. If true, this might go some way to explaining the size of the Brent premium.

All of that aside, it is worth emphasising that the latest Bloomberg survey of Wall St analysts shows 23 out of 40 expecting oil prices to fall next week.

Finally, BP (which has plenty of problems of its own, not least with its new Russian 'partner' Rosneft) published an interesting forecast of the oil market in 2030 this week. Although this did not include price forecasts, it did suggest:

- that there is no looming oil shortage;
- that the OECD countries will continue to increase their oil consumption, albeit 'only' by 6%;
- that the share of natural gas in the energy mix will continue to grow; and, most significant,
- that OPEC's importance will grow as it comes to control more and more of the additional oil supply.

V BANKING

There have been several developments this week that are worth noting:

- First, the US Financial Stability Oversight Council released an 81-page report on implementation of the so-called "Volcker rule" (which purports to stop banks using Federally-guaranteed funds for proprietary trading). This appears to be a mixed bag. In a big concession to the banks, hedging contracts will be considered on a case-by-case basis to see if they meet the criteria. On the other hand, the report also recommends that (in an echo of Sarbanes-Oxley) CEOs should have to personally sign off on their institutions' compliance with the rule.
- Second, it was reported that four Russian employees of the EBRD in London – including a former Executive Director – had been arrested on suspicion of corruption. No details have been forthcoming, but the ED in question, Elena Kotova, is a former World Bank economist.

- Third, the former head of Bank Julius Baer's Cayman Islands operation was reported to have given Wikileaks confidential data on over 2,000 of the bank's clients who had stashed money offshore – including (in his words) "politicians and pillars of society". Wikileaks is apparently reviewing the data.

In addition, US banks have been reporting 2010 earnings. They are a mixed bag. Markets were impressed that Citi reported its first profit since 2007 – US$10.6 billion. Wells Fargo's results were also strong (US$12.4 billion), as were those of JP Morgan (US$17.4 billion). However, Goldman Sachs disappointed with a 38% year-on-year fall in net profits to US$8.4 billion. That, however, did not stop management increasing bonuses by 36% - which did not go down well with politicians in the US or UK.

VI NEXT WEEK

In the US, key economic releases next week include:

- the Case-Shiller house price index for November;
- consumer confidence for January;
- new home sales for December (expected to be up 1%);
- durable goods orders for December (expected to be up 1.9%); and
- the flash estimate of GDP growth in the fourth quarter (expected to be 3.8%, up from 2.6% in the third quarter).

The FOMC is also meeting.

Elsewhere, key releases include:

- the PMI for the eurozone;
- GfK consumer sentiment in Germany; and
- UK GDP data.

Japan's MPC meets on Monday, and (as noted) the WEF begins in Davos on Wednesday.