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WEEKLY ECONOMIC AND MONETARY REPORT

4 February 2011

Today's US employment data – the first meaningful US economic release for January – is obviously important. Non-farm payrolls increased only 36,000, far less than the (upwardly-revised) expected increase of 140,000 – which is consistent with concerns about a double dip recession. However, the real issue in the markets this week has been inflation – fear of which has been compounded by the impact that unrest in Egypt (and Yemen) may have on commodity prices and on transportation.

Academic (and official) thinking on inflation is all over the place – but the influential neo-Keynesian pop-economist, Paul Krugman (whose belief that the threat of inflation is both overrated and far less significant than the threat of a 'double-dip' recession may be vindicated by today's employment data) insists that the ECB is the spiritual home of inflation "hawks", and that its president, Jean-Claude Trichet, has succeeded in convincing Fed Chairman Bernanke that the US also faces an imminent inflationary threat.

There is indeed plenty of evidence that prices are rising. Brent crude, for instance, has broken US$100 a barrel this week, copper and tin prices hit record highs following the cyclone in Australia, and the cost of basic foodstuffs has soared – putting huge pressure on the poorest countries. Over the last 12 months, for example, wheat prices are up 110%, corn is up 87%, soy is up 59% and sugar is up 22%. The R/J CRB composite commodity price index is now up 30% year-on-year. This is taking its time to work through to the consumer price level, but it was reported this week that both the eurozone CPI and PPI hit a two-year high last month, and prices are now rising substantially faster than central bank targets almost everywhere except Japan) where a cabinet minister this week predicted two more years of deflation).

I DAVOS

Even less came out of this year's WEF than usual, in terms of substance – not least, because it was ill-equipped to provide any insight into what was happening in North

Africa. Instead, much of the debate in Davos centred on Europe's own problems, and on efforts by the banks to demonstrate that the post-2007 crisis is behind them and that they have learned whatever lessons were there to be learned. That prompted French Finance Minister Lagarde to insist that the eurozone "has turned the corner" and her German counterpart, Wolfgang Schauble, to assert that "I don't expect that there will be further major shocks…"

Maybe not, but the IMF's First Deputy MD, John Lipsky, felt moved to deplore the "air of complacency" at the WEF. He warned, in particular, that the bailouts of Greece and Ireland have "no guarantee of success", and that any restructuring of sovereign debt (which he seemed to suggest is inevitable) will not be without cost.

II EUROZONE CRISIS

The optimism displayed by Lagarde and Schauble in Davos is now widely held – and it is reinforced by sharp falls in the price of CDS protection and credit spreads for peripheral eurozone members. Spain, for instance, saw its spread over the cost of *bunds* fall this week from 220 basis points to 180 bp, and Portugal had a very successful debt auction.

The reason for this is the widespread belief that today's EU Summit in Brussels will produce a broad outline agreement for the economic/financial management of the eurozone. This 'Grand Bargain' will apparently be finalized by the end of next month – and euro-enthusiasts see it as a big step forward in the creation of a single European economic space. Based on what we know so far, it is likely to include:

- A limited expansion of the European Financial Stability Facility, so that it is able to lend the full €440 billion, coupled with agreement on a new, permanent bailout fund when the EFSF expires in 2013.
- A revision of the bailout terms which Greece and Ireland are currently labouring under. This is likely to include interest rates and (much) longer maturities. (Spain and Portugal may also be pressed to accept money on these new terms, since Germany and France both believe that it would be better to act pre-emptively than to wait for the markets to target weak eurozone members again.)

- A new "Competitiveness Pact" for the eurozone-17, which would include tougher limits on budget deficits, a uniform retirement age corporate tax harmonization and some procedure for vetting economic policies of the weaker member states. Germany is also said to be pushing for the eurozone as a whole to adopt the commitment it has already made to eliminate the structural fiscal deficit by 2016.

The first two items are non-contentious (except within Germany itself, which will have to pay the bill); however, the third will be seen as a surrender of sovereignty by the weaker states. They will *probably* go along, but it is worth remembering that Ireland faces a general election on February 25 – and Fine Gael, which is likely to emerge as the largest party, has already said it is not bound by the previous government's commitments. (That prompted S&P to cut Ireland's credit rating by a further notch, to A– .)

III G20

French President Sarkozy – the current Chairman of the G20 – gave an important speech in Addis Ababa over the weekend, in which he indicated that the issue of food security will be high on the agenda for the G20 Summit in Paris in June. He called commodity speculation "simply extortion", and added that "it is pillaging" the global economy. That seems certain to bring him into conflict with both the US and UK, whose financial industries are, to a considerable degree, based on speculation.

Another issue that will be on the Paris agenda will be growing income inequality. In a speech in Singapore on Tuesday, IMF Managing Director Strauss-Kahn warned that "global unemployment remains at record highs, with widening income inequality adding to social strains".

IV RECENT ECONOMIC AND MARKET DEVELOPMENTS

One of the reasons that the international focus has shifted to inflation is that, in most advanced countries, economic growth is recovering quite nicely. This is well illustrated by recent PMI (purchasing managers) data.

According to the JP Morgan/Markit index, the global PMI rose last month from 55.6 to a two and a half year high of 57.2 (readings over 50 denote growth). Fifteen of the 24 national PMIs that Markit tracks rose, including:

- the US (from 58.5 to 60.8);
- the eurozone (from 57.1 to 57.3);
- the UK (from 58.7 to 62);
- Brazil (from 52.4 to 53.1); and
- India (from 56.7 to 56.8).

China's official PMI actually fell, but the unofficial index constructed by HSBC rose from 54.4 to 54.5. With the IMF now warning that the Asian economy may overheat, it is no surprise that inflation is moving up the agenda.

A **THE US:** It is not just the manufacturing PMI that was up in the US. This week, it was also reported that the services ISM (PMI) rose last month from 57.1 to 59.4, and that the Chicago PMI rose from 66.8 to 68.8. These are all very strong numbers and they tend to undermine the negative message of today's employment data (though it is worth pointing out that the unemployment rate, calculated separately, fell from 9.4% to 9%. In addition, it was reported this week:

- that personal income rose 0.4% in December;
- that consumer spending rose 0.7% (implying a fall in the Savings rate);
- that automobile sales jumped a hefty 17% month-on-month in January;
- that factory orders rose 0.2% in December (better than the 0.5% drop that had been expected); and
- that first-time jobless claims fell very sharply in the latest week, by 42,000 to 415,000.

All of that is good – and (more important) stronger than expected. However, leaving aside the employment data, there is one big problem area. According to the *WSJ*, all 28 major metropolitan areas saw further house price falls is the last quarter of 2010, and construction spending fell 2.5% in December, significantly worse than the 0.4% drop that has been expected. Some of this probably has to do with harsh winter weather, but it is clear that housing and construction are still in trouble.

What does this mean for the markets? Well, one implication of the combination of faster growth and a still-sluggish jobs market in higher productivity – up at an annual rate of 2.6% in the fourth quarter. That continues to underpin US corporate profits – and the equity market. Following very modest declines last week, all the major stock indices are up this week. Through early trading on Friday, the DJIA, for instance, is up 2.01%, the S&P500 is up 2.43%, and the Nasdaq Composite is up 2.49%. However, the bond markets are starting to reflect the fear of inflation: the benchmark 10-year Treasury yield, for instance, has risen this week from 3.33% to 3.54% and the yield on the long bond has gone from 4.53% to 4.66%. In contrast, it is worth noting that the overnight rate is still below 0.20%. This prompted some commentators to urge the Treasury to lock in low rates now, by issuing ultra-long dated bonds – perhaps out as far as 50 years.

B EUROPE: As noted, inflation is a growing concern at both the eurozone and national level. In particular, it was reported this week:

- that eurozone producer prices rose 0.8% in December, or 5.3% year-on-year – the biggest jump in over tow years; and
- that consumer price inflation was running at 2.4% last month, up from 2.2% in December.

After yesterday's ECB meeting, Trichet deliberately downplayed the danger of inflation – and the markets responded accordingly. However, what is said, with some confidence, to concern Trichet is that EU labour unions are starting to make sharply higher wage demands.

At the individual member state level, economic releases this week have been mixed.

In Germany, for instance, it was reported that the (seasonally adjusted) unemployment rate fell from 7.5% to 7.4% in January – but it was also reported that retail sales fell unexpectedly by 0.3% in December. That was the second straight month of falling sales. Elsewhere, it was reported:

- that Italian business confidence hit a three year high in December, with the ISAE index rising from 103.1 to 103.6; but

- that Spanish unemployment rose again last month, bringing the jobless total to 4.2 million – or 20.3% of the workforce.

It is worth pointing out that the political crisis in Italy is not over. Berlusconi's Northern League ally, Umberto Bossi, is using the PM's weakness to try to extract major concessions – in particular, shifting taxation from the federal to the provincial level, as part of his plan for regional autonomy. A key congressional vote on this was held yesterday – and it did not go Berlusconi' way. He is likely to represent the issue to the full Parliament and to win further fiscal devolution. However, if he does not, Bossi could still pull the rug from under the Coalition.

As for the UK, the parallels with the US continue to become more glaring.

On the one hand, the manufacturing and services PMIs in the UK continue to be very strong (the services PMI rose from 49.7 to 54.5 last month), and there is evidence that export industries are booming. On the other hand, it was also reported this week that (according to the Nationwide building society) house prices fell again last month – albeit, only by 0.1% - and that net mortgage lending in 2010 was the lowest since records began. Moreover, it was also reported that lending to businesses and households was very weak in December – falling GBP6.3 billion year-on-year.

As a result, the (semi-official) National Institute's latest forecast is that UK GDP will grow just 1.5% this year, while inflation will come in around 3.8% - or almost twice the BofE's target. That level of growth is not going to be enough to make a significant dent in unemployment, and the (well-respected) Institute of Fiscal Studies issued a warning this week that the UK could face the same kind of "jobless recovery" as the US. It urged the Coalition government to rethink its current austerity programme – though without offering much of a hint what 'Plan B' should look like. It is worth noting that, in any event, the UK's freedom of action is severely circumscribed by the markets; already concerns about inflation have pushed the 10-year UK gilt yield up to 3.77%.

C **JAPAN:** The good news in Japan is that industrial output rose in December by 3.1% - more than expected, and the second rise in a row. In addition, it was reported

yesterday that the services PMI edged up last month from 50.2 to 50.4 – evidence that non-manufacturing activity may be more resilient than manufacturing. The bad news is that, despite speculation to the contrary, PM Kan appears to think he does not yet have enough political support to push through the rise in consumption tax that (almost) everyone feels is key to getting Japan's finances back in order. The reason is that support for his government has fallen back below 30%.

One reason for this is that the DPJ is still tearing itself apart. This week, the former party Chairman (and strongman) Ichiro Ozawa was indicted on various political funding charges. His trial (if it comes to that) could be very damaging to Kan.

D **CHINA:** Morgan Stanley's China expert, Stephen Roach, has just put-out a warning note suggesting:

- that China's trade deficit could disappear much quicker than people expect; and
- that, in the medium term, Beijing will take active policy steps to reduce its savings rate and to increase consumption.

So far, however, signs are that - post-Davos - China feels less need to accommodate its trading partners. Indeed, the current rate of renminbi appreciation – around 5.7% a year – seems enough to keep the US happy. That said, there have been rumours in the market that the PBoC will mark the beginning of the Chinese New Year (it is the year of the rabbit) with an interest rate rise. It has already warned that "inflationary pressure is quite big", and it has indicated that it would like to slow down the growth rate of M2 to no more than 16%.

V FOREIGN EXCHANGE MARKET DEVELOPMENTS

Last week, the dollar weakened 0.3% against the euro and 0.4% against the yen. However, it strengthened 0.9% against the pound. This week, though early trading on Friday, the dollar has remained in a very narrow range:

- On Friday, the euro closed at US$1.361. By Tuesday, it had strengthened to US$1.383. However, in early New York trade today, it is around US$1.363 – up 0.15% for the week.

- Last week, sterling closed at US$1.586. It then recovered sharply, hitting a two-month high of US$1.617 on Wednesday and US$1.621 yesterday. In early trading today, the pound is at US$1.6094 – up 1.48% for the week.
- As for the yen, it closed last Friday at Y82.1/US$. It strengthened to Y81.36 on Tuesday, and is currently trading around Y81.63 – up 0.56% for the week.

Sterling's recovery has been driven largely by the belief that the BofE (whose Monetary Policy Committee meets next week) will have no choice but to increase interest rates. The euro has improved along with the belief that today's EU Summit will lead to a period of eurozone stability. In the meantime, gold (which fell 2.5% last week) has bounced back; it is currently trading at US$1,353.6/oz – up 3.1% for the week. However, that is broadly unchanged when one accounts for the dollar's recent weakness.

VI OIL

Last week, front-month WTI rose 0.23%, to close at US$89.34 a barrel in New York on Friday. Over the same period, March Brent rose 1.82% to close at US$99.40 – pushing the premium for Brent out from US$8.49 a barrel to US$10.06, or over 11%. Given that, historically, WTI has generally traded at a premium to Brent, this is highly significant – and most observers do not expect it to last.

This week, however, both the general level of process and the spread in favour of Brent have increased still further. In late trading on Thursday, for instance, March WTI was trading at US$90.40 a barrel (up 1.2% for the week), while Brent was at US$101.81 (up 2.4%) – a spread of US$11.41. In fact, the spread hit US$11.50 on Wednesday – a new record.

The overall level of oil prices has obviously been affected by problems in North Africa and Yemen. So far, the main oil producers in the region (Algeria and Libya) have been relatively unaffected, but traders are very concerned that Suez canal traffic could be disrupted and/or that the Sumed pipeline (from Suez to Alexandria) could be closed. The pipeline is currently carrying about 2.5 million b/d, while the canal is

handling around 600,000 b/d. OPEC has already warned that the turmoil could hit prices, and it is clear that, at various times this week, markets were near panic.

That said, however, parallels with Iran in 1979 are clearly nonsense – and it may be significant that (despite continuing unrest in Egypt) both oil and equity markets in the region stabilized on Thursday.

The key point is that OPEC has sufficient spare capacity to handle even a brief closure of the canal, and, in any case, the global supply system has much higher levels of stocks than it did a decade or so ago.

Indicative of this is the high level of US/crude oil and product stocks at Cushing, OK – which seems to be the reason for the relative weakness of WTI. In the latest week, total US crude inventories rose 2.59 million barrels – but the key is the oversupply situation in Cushing, which has been caused in part by irregular supplies from Canada. That has artificially depressed the price of WTI, though it is a problem that will correct itself.

As far as the price outlook is concerned, the political situation is clearly paramount. However, it is also important to appreciate that oil is only part of a more general commodity boom; there may well be a strong speculative element to this, but, for the moment, no one expects a major price correction.

VI BANKING

According to BIS data, the major bank exposures to Egypt are:

- France US$18 billion;
- the UK US$10.7 billion;
- Italy US$6.3 billion; and
- the US US$5.4 billion.

A good indicator of how things are going is the cost of CDS cover. Earlier in the week, it was costing US$440,000 to insure US$10 million of Egyptian debt for five

years, US$400,000 for Lebanon, US$441,000 for Dubai, US$222,000 for Morocco and only US$120,000 for Saudi Arabia.

One other point, yesterday, the heads of the three European Supervisory Authorities – the cross-border agencies that will oversee EU financial regulation – were announced. They are:

- Andrea Enria, an Italian central banker, who will head the EBA in London;
- Steven Maijoor, a Dutch regulator, who will head ESMA in Paris; and
- Gabriel Bernadino, who will head EIOPA in Frankfurt.

Of the three, ESMA is the most important.

VII NEXT WEEK

In the US, next week is a relatively light one for economic releases. Probably most important is the trade deficit for December, expected to be around US$40 billion. Other releases include:

- the preliminary Michigan sentiment index for February; and
- the Federal government's budget deficit for January.

In Europe, the eurozone investor confidence index for February will be published, along with:

- German factory orders and industrial production;
- the UK trade deficit and industrial production; and
- French industrial production.

Both the ECB and BofE meet on interest rates. A rise in rates in the UK is possible – particularly following hawkish comments from two MPC members (Bean and Sentence). There may also be an increase in eurozone tensions, given an expected 24-hour strike by Greek civil servants.

In Japan, the key releases next week are:

- leading economic indicators for December;

- the current account surplus for December;
- consumer confidence for January; and
- machinery orders for December.

Regards,

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