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WEEKLY ECONOMIC AND MONETARY REPORT

5 March 2010

The first Friday of each month is usually dominated by the US employment data – which is taken as a proxy for how well the US economy is doing.

Today is no exception. The 36,000 drop in non-farm payrolls that was reported today was a bit better than expected, and it is likely to give the dollar a modest boost. However, even though bad weather had led most analysts to expect that payrolls would be down around 70,000, it is not a particularly strong figure - and it does not give any great confidence that the US economy is out of the woods. Indeed, it reinforces the mood of concern that we noted last week. Economically, the advanced countries are still in a hole; financially, the banks are still refusing to lend; politically, Europe is now in serious trouble.

I THE "CLUB MED" CRISIS

Greek PM Papandreou is on a last ditch trip to cobble together a deal. He saw Eurogroup President Juncker today, is now on his way to Merkel, and will meet Sarkozy on Saturday. After that, he goes to Washington. All of this follows a (relatively) successful bond issue yesterday, that saw the Greek government raise €5 billion in 10-year money at an interest rate of "only" 6.37% - better than the 7% or more that would have been demanded if the issue had gone ahead last week, but twice what Germany would pay and 200 bp more than Portugal would expect to pay. Nevertheless, the issue was oversubscribed almost three times, and was considered a success. Fund managers picked up 40% of the issue, banks and pension funds picked up 25% apiece, while central banks and other official institutions bought just 7%. By nationality, the biggest buyers were (ironically) the British and Germans, each with around one-third, while Greek investors bought 23%.

The bond issue capped a good few days for Papandreou, who had unveiled yet another austerity package on Wednesday – this one designed to convince the markets that Greece can cut four percentage points off its fiscal deficit this year. It included:

- a cut in civil servants' entitlements – including a 30% cut in their customary bonuses and a one-year freeze on pensions;
- a 5% cut in government spending on public works;
- increases in VAT on newspapers, books, food, medicines, clothing and footwear;
- new fuel taxes;
- sharp tax increases on cigarettes and alcohol; and
- a new "luxury" tax on cars, boats, helicopters and jewellery.

<u>It sounds fine</u> – and the markets responded. The cost of cover in the CDS market, for instance, has fallen sharply – from 425 bp to below 300 bp (however, the comparable German rate is still just 35) – and the Athens stock market has bounced back. Papandreou himself has said that, as a result of these measures, "we are now justly awaiting EU support". And he seems likely to get it. In the last couple of days, Juncker and ECB Vice-President Draghi have both insisted that Greece "won't be left alone", and the assumption is that <u>a deal will be announced before the March 16 ECOFIN meeting</u>.

This deal is likely to include an initial commitment by German and French banks to purchase Greek government debt to a total of around €30 billion, with guarantees from KfW and Caisse des depôts. Other eurozone governments are then expected to join the group on similar terms.

Although this would clearly be against the *spirit* of the Lisbon and Maastricht treaties (which forbid the bailout of any eurozone member), it would apparently not breach the letter of the law, because the guarantees would be extended through state-owned agencies, rather than by the German and French governments themselves. It also has the big advantage – for French President Sarkozy, at least – of not involving the IMF.

He seems almost paranoid about IMF MD Strauss-Kahn, who has indicated that he will run against Sarko for the French Presidency in 2012 (and who is currently ahead in the polls), and he has made it very clear that the Fund is to be kept out of Greece's problems – despite the fact that DS-K has said he would be "very happy" to help. No surprise that ECB President Trichet has sided with Sarko – saying (rather incoherently) that: "I do not trust that it would be appropriate to have the introduction of the IMF as a supplier of help".

But is it *really* a done deal? There are several reasons for concern.

First, there is tremendous political and popular opposition to a Greek bailout in Germany. On Monday, for instance, *Bild* polled 73,000 of its readers – and 80% opposed any aid for Greece. One of Merkel's senior colleagues added his concern: "How can the German taxpayer be asked to subsidize Greece when their civil service retire at 53 and ours are being asked to work until they are 67?" Yesterday, Economics Minister Brüderle (who must agree any deal) added his contribution: Greece will not get "one cent" from Germany. Merkel is going to have to tread very carefully, or risk splitting her own party.

Second, the U-turn which Papandreou has made – abandoning the promises on which PASOK was elected less than six months ago, in favour of policies that appear to have been dictated by the financial markets – are proving very hard for the Greek left to accept. The PM has already lost the support of ADEDY, the public sector union, and Greece is being hit by wave after wave of strikes. His personal popularity remains high, but his ability to implement the measures he has promised remains in doubt – particularly if the Greek economy tanks. (The official forecast is for a drop in GDP this year of just 0.3%, but a private think-tank was predicting a drop of 2.2% even before the latest measures.)

One thing that does work in Greece's favour is the row that has blown up around speculation in the CDS market – which (probably unfairly) is being blamed for exacerbating Greece's problems.

The EU's new Commissioner for the internal market, Michel Barnier, and the German regulator, Bafin, have both announced that they will investigate the speculative positions that were taken by hedge funds (and others) in the CDS market. Greece will endeavor to prove that it was at the mercy of the markets, and that "naked" shorting by "Anglo-Saxon" institutions was the root cause of its problems – not its own economic mismanagement or corruption.

II BANKING

A LEGAL MOVES: As noted, the European Commission and EU national regulators have pledged to investigate the sovereign CDS market. The aim seems to be to outlaw "naked" shorting of any country's sovereign debts.

At the same time, the US Department of Justice has announced that it is looking into the shorting of the euro by US-based hedge funds. This is important. The DoJ alleges that, at a February 8 dinner organized by Monness Crespi Hardt (a boutique equity advisory firm), four hedge funds – SAC Capital , Greenlight, Paulson & Co. and Soros – colluded to drive the euro down by taking big short euro positions. The firms argue that their bearishness on the euro was simply a result of the "facts" as presented to them by Monness.

B THE "VOLCKER RULE": The other important development this week was yesterday's release by the US Treasury of a five-page draft of what a so-called "Volcker rule" would look like.

The key element of the rule is that it would prevent banks who accept Federally-insured deposits from investing in hedge funds or private equity, and would ban them from proprietary trading. The rule would be implemented over two years.

What is new in the latest proposal is that it would apply to *any* major financial institution – and not just Federally-chartered banks. As it stands, therefore, the rule would apply to

Goldman Sachs and Morgan Stanley even if they decided to dump their Federal banking licenses. This, alone, virtually guarantees that the proposal will be rejected by Congress. Particularly in the Senate, there is no support for an absolute prohibition on proprietary trading – let alone prop trading by non-banks.

C **LENDING VOLUME:** Over the weekend, the BIS published its latest report on the volume of global bank lending.

It makes depressing reading. Despite unparalleled amounts of liquidity being pumped into the system, global bank lending fell US$360 billion in the third quarter of last year – the fourth consecutive quarter of falling lending. The volume of debt securities fell 10% to US$1.778 trillion, while net issuance dropped 30% to US$303 billion. The process of debt contraction is still continuing.

D **THE FED:** It was announced on Monday that the Fed's Vice-chairman, Donald Kohn, will retire in June. He has been at the Fed for 30 years, and virtually ran it during Greenspan's tenure. That means Obama will have three vacancies to fill on the seven-member Board.

III TRADE

There is a mix of good and bad new in the trade area this week.

On the positive side, the (Dutch) Bureau for Economic Policy Analysis reported on Monday that its composite index of global trade volume jumped 4.8% in December – meaning that the index as a whole rose 6% in the fourth quarter.

On the other hand, however, there are growing concerns in Japan that the US Administration is using the problems of Toyota (whose chairman has repeatedly been paraded before Congressional Committees as though he was a war criminal) to help GM and Ford. Naturally, the US denies that Toyota is being held to a higher standard than

US firms, but Toyota's US sales have fallen 8% since the crisis broke (actually, that is less than expected) – and the US manufacturers have benefited accordingly.

Finally, it is often pointed out that the EU is broadly balanced as far as trade is concerned. That is true. However, within the EU, the picture is more complicated – as figures released last weekend revealed:

EU: Trade deficit/surplus 2009
(€ billion)

Germany	+136	Italy	-4	France	-55
The Netherlands	+40	Portugal	-19	UK	-93
Ireland	+36	Greece	-28		
Belgium	+13	Spain	-52		

How relevant this is within a single monetary zone is hard to judge. But – as the problems of Greece suggest – it is not irrelevant.

IV RECENT ECONOMIC AND MARKET DEVELOPMENTS

As noted, there is a real (and growing) concern that bond markets are starting to seize control of the economic debate. The "bond market vigilantes" (it is said) are likely to determine how much policy leeway governments have as they try to "exit" from two years of unparalleled monetary easing. The following table indicates just where they may start to target their efforts:

Major bond market vulnerabilities

	Sovereign rating	10-year yield	Debt service as % of 2011 fiscal revenues
Germany	AAA	3.14%	6.2%
US	AAA	3.65%	7.4%
France	AAA	3.44%	6.1%
UK	AAA	4.07%	8.7%
Japan	AA	1.31%	4.5%
Italy	A +	4.03%	11.0%

(Note that this implies a considerable recovery in UK government finances from FY 2009/10.)

Whatever, the BIS has also published what it believes are the average <u>primary surpluses</u> that major economies need to run if they are to *stabilise* (ie not to eliminate, or even reduce) their debt levels over the next decade. In the UK, it is 5.8% of GDP; in Japan, it is 6.4%. In France and the US, it is 4.3%. As the BIS says, the West risks a slow grind into debt deflation. It sees worrying echoes of 1931.

A THE US : How much weight should be placed on today's announcement that 36,000 non-farm jobs were lost in January, while the US unemployment rate (calculated separately) was unchanged at 9.7%?

<u>The answer is probably Not Much</u>, since the figures were so distorted by the weather. Nevertheless, the general feeling is that US labour markets are improving, particularly in manufacturing – and that has been reflected in equities. The DJIA, for instance, is currently up about 87 points (0.8%) for the day – and 2% for the week. The S&P500 is up 11 points for the day, and 2.6% for the week, and the Nasdaq is up 25 points for the day, and 3.5% for the week.

That said, other economic releases this week have been all over the place.

<u>On the positive side</u>, for instance, it was reported:

- that personal spending was up 0.5% in January, the fourth straight rise;
- that the ISM services index for February rose from 50.5 to 53 – its highest level since October 2007;
- that (according to RetailMetrics) retail sales were up 4.1% year-on-year last month, the best performance for over two years; and
- that factory orders rose a seasonally-adjusted 1.7% in January.

On the other hand, it was also reported:

- that personal incomes rose just 0.1% in January – pushing the savings rate down from 4.2% to 3.3%;
- that the ISM manufacturing index fell from 58.4 to 56.5 in February (which, admittedly, is still quite strong);
- that the NAR's pending home sales index fell an astonishing 7.6% in January;
- that construction spending fell 0.6% in January; and
- that automobile sales dropped around 3% last month.

In addition, the Fed's latest 'Beige Book' survey was a bit disappointing. The US economy is still recovering – but at a significantly slower pace. Individual Fed districts pointed, in particular, to weak loan demand and to growing problems in commercial real estate.

On top of all that, markets are starting to focus on what could easily become a major crisis in the state and municipal bond markets. The Economic Policy Institute estimates that, collectively, US states face a funding shortfall of US$156 billion in FY2010. Since many are barred constitutionally from running deficits, they will effectively see "internal devaluation" – or massive deflation in the public sector. Those that can still sells bonds will find the market moving sharply against them. This is certainly something to watch.

B **EUROPE:** On Wednesday, the Commission released its latest longer-term strategy paper. Entitled *"Europe 2020"*, it spells out how the EU intends to generate an extra 2% of GDP over the next decade. Its (rather puny) targets include:

- increasing adult employment from 69% to 75% of the workforce;
- increasing the number of college graduates from 30% to 40%;
- lifting public and private R&D expenditure to 3% of GDP;
- cutting poverty from 80 million to 60 million; and
- cutting total energy use, while shifting the mix to renewables.

The general feeling is that it is a rather sad and unambitious document – reflecting a general malaise within the EU that has been aggravated by a row between the new European Presidency (van Rompuy and his head of foreign policy, Cathy Ashton), the old Commission President (Barroso) and individual member states. Despite signing up to the Lisbon treaty, it is quite clear that big member states are not prepared to cede significant power in foreign affairs. Barroso - who has appointed a close aide, Joao Vale de Almeida, as EU representative to the US – is now also undermining Ashton.

Another row may be brewing on the fiscal side. The new Commissioner for taxation, Algirdas Semeta, is floating the idea of an EU carbon tax – an idea that has, in the past, been supported by France (which gets much of its power from nuclear) and Sweden. Britain and Germany are implacably opposed, but could be outvoted. There is also a political row brewing with the Dutch, following municipal elections in which the far-right PVV did very well. There is now talk that its leader, Geert Wilders, could end up as PM after national elections on June 9 – a possibility that scares most of Brussels since his popularity is based in his anti-immigrant stance.

As far as the eurozone economy is concerned, the ECB raised its short-term growth forecast this week from 0.2-2.2% to 0.5-2.5% for 2011. However, this week's economic releases have been only mixed. On the one hand, it was reported on Monday that eurozone manufacturing output rose in February to a 30-month high. However, that was largely due to a sharp increase in Germany. Output growth in Italy and France slowed sharply – and it actually contracted in Spain, Ireland and Greece. Indeed, it appears that Spain fell back into recession in the fourth quarter, with GDP falling 0.6%. Plus, eurozone retail sales fell 0.3% in January by volume, and were down 1.3% year-on-year. Prices in the eurozone are also weak: the CPI rose at an annual rate of just 0.9% last month, a good deal lower than expected.

Not surprisingly, the ECB left its key reference rate unchanged at 1% when its policy committee met yesterday. Although it outlined its plans for unwinding the liquidity it has pumped into the system over the last year, it also made it clear that it would do nothing for a while.

As for the UK, the situation is becoming surreal.

On the one hand, there is a growing realisation that, with a fiscal deficit of around 12% and its triple-A rating under serious threat (gilts are already trading at prices consistent with an AA+ rating), there isn't that much to choose between Britain and the PIGS. On the other hand, despite a history of progressively worse economic mismanagement, the Labour government of PM Brown is enjoying a mini-surge in the opinion polls. Although the Conservative opposition is still ahead, the margin is such that, if the election were held today, the outcome would probably be a "hung" Parliament, in which Brown could cling to power in an alliance with the centre-left LibDems.

The reason is that the full awfulness of the UK's economic position has not yet dawned on the average man-in-the-street. Indeed, this week, it was reported:

- that broad money (M4) grew at an annual rate of 1.9% in the November-January quarter, suggesting (finally) that Quantitative Easing was starting to have an impact;
- that the CIPS/Markit manufacturing PMI held at a 15-year high of 56.6 in February, largely thanks to strong export orders, while the services PMI rose from 54.5 to 58.4;
- that the REC/KPMG labour index jumped last month from 60.5 to 63.2, reflecting an increase in permanent jobs;
- that the Nationwide consumer confidence index rose from 74 to 80 in February, the highest reading in over two years; and
- that automobile sales jumped an astonishing 26.4% year-on-year.

On the other hand, however, house prices are starting to wobble again. The Halifax housing price index fell 1.5% in February, after seven straight increases, while the

Nationwide index dropped 1%. As a result, the BofE's MPC left interest rates unchanged at 0.5% for the 12th straight month when it met yesterday – though it did confirm that it has no plans to reintroduce QE any time soon.

This is a tricky situation. Sterling is increasingly vulnerable to the political outlook, and there has to be a serious danger that the "bond market vigilantes" will start to target UK gilts – particularly in view of rising inflationary pressures. Today's announcement that producer prices were up 4.1% year-on-year in February – the biggest jump since December 2008 – is bound to increase nervousness. No wonder, therefore, that the government is tempted to call an election earlier than the May 6 date that had been expected; the latest rumour is that the election will be on April 15 (which would also avoid the need for another budget presentation).

C **JAPAN**: The good news this week was that the unemployment rate hit a 10-month low in January, falling from 5.2% to 4.7%. In addition, household spending was up 1.7% year-on-year in February, the sixth straight monthly rise (albeit, this was a bit lower than the 2.4% that had been expected). Perhaps predictably, auto sales were especially strong – up 21% year-on-year, perhaps as a reaction to the US attack on Toyota. That is certainly one reason why the Nikkei-225 has just finished its strongest week of the year-to-date, up 2.4%.

As in the US and Europe, however, there is a lot of concern about the bond market. The rating agencies have again warned that Japan must get its borrowing under control. In total, indebtedness is now over 200% of GDP, and PM Kan is being pressed to increase the sales tax (now 5%) to bring Japan's finances under control. At the same time, however, he has also been urging the BoJ to do more to boost the economy through lower interest rates – the standard tactic of a politician without the political support (or moral standing) to take tough decisions on the spending side.

D **<u>CHINA</u>:** Today is the first day of the Communist Party's annual Congress. It began with the government's "work report", delivered by PM Wen Jiaobao. The highlights of this included:

- a warning of "latent risks" in Chinese banks;
- a threat to crack down on property speculation;
- a warning that inflation will be a major threat (and that higher interest rates may, therefore, be required); and
- a pledge that the renminbi will remain "basically stable".

Wen also said that the government will underwrite RMB 200 billion of bonds for local authority infrastructure projects.

With the exception of the pledge on the renminbi; this will be broadly welcome.

The other major development of the week was the announcement that growth in China's military budget will be cut back this year. Military spending rose 15% last year; this year, it is now expected to grow "only" 7.5%.

V <u>FOREIGN EXCHANGE MARKET DEVELOPMENTS</u>

Surprisingly perhaps, the market's initial reaction after release of (slightly) better-than-expected US employment data today was:

- to buy the dollar against the yen, pushing it up from Y89.31/US$ at the Thursday close to Y90.57; but
- to sell the dollar against both the euro and sterling – which rose from US$1.358/€ to US$1.362 and from US$1.503/GBP to US$1.512 respectively.

The dollar also fell slightly against the Swiss franc and against most commodity currencies.

For the week as a whole, the big loser in currency markets has probably been sterling – which has been hit by the fear of a 'hung' Parliament. As the *WSJ* put it, the pound faces three big problems:

- fear that the BofE will restart its programme of QE;
- the danger of electoral deadlock; and
- concerns about the depth of the UK recovery.

Against the dollar, the pound is down around 0.8%; against the euro, it is off about the same. For the year-to-date, it is off 8.5% against the dollar. The problem is that, since the UK is outside the eurozone, the government may be tempted to try to devalue its way out of its problems; if it does, there will be no ECB to say No.

In contrast, the expectation in the markets – or, at least, among 'technical' traders and chartists – is that the yen could strengthen. According to Mizuho, it is now close to an *ichimoku* formation, which could push it as high as Y 84.33/US$.

One of the big issues in the market is interest rate differentials. At the moment, US 10-year Treasury yields are around 3.69% - and rising. Ten-year German yields are about 3.10%; This is the highest spread in two and a half years. If there is a deal over Greece, it may be enough to ensure a major snap back for the euro.

V OIL

It has been a strong week for oil prices – and today's US payrolls data appears to have been enough to push front-month WTI through the US$81 a barrel barrier that it has been nudging all week. That isn't really a surprise. At the end of last week, the general sense was that the market was tightening – a contrast with the situation today, when opinion is sharply divided on which way the market will turn in the run-up up the March 17 OPEC meeting in Vienna.

Whatever, through mid-day trading today:

- April WTI is up US$1.80 a barrel, or 2.3%, since the Friday close - and is currently trading at US$81.86 ; while
- April Brent is up US$2.65, or 3.4% - and is currently trading at US$80.24.

In the meantime the broader R/J CRB commodity price index has risen 2.7% since Friday - which suggests that part of the reason for oil's strong performance this week is the general strength of commodity prices. That certainly seems to have offset higher-than-expected US crude stocks. According to the EIA, crude stocks rose 4.1 million barrels in the latest week, sharply higher than the 1.4 million rise that had been expected. In addition, gasoline stocks were up 900,000 barrels, compared with an expected 600,000, though distillate stocks fell 900,000 barrels thanks to the continuing cold weather.

It seems that prices will continue to be firm until the OPEC meeting – where it is expected that Saudi Arabia will again suggest that US$75 is a realistic long-term price.

VII NEXT WEEK

Tomorrow (Saturday), there is a potentially very important referendum in Iceland.

As noted before, Iceland has to vote on whether or not to accept the debt rescheduling deal negotiated with the UK and The Netherlands as a result of the collapse of Icesave. The three parties have negotiated all week, to avoid a rejection – and a new deal could still be announced. If it is not, the latest polls show 74% against the terms of the agreement as they stand. If Icelanders do turn the deal down, the result will be one more crisis in Europe.

As far as next week's economic releases are concerned, the most significant for the US are:

- the trade deficit for January, expected to be broadly unchanged (around US$42 billion);
- retail sales for February, expected to be up 0.1%; and
- the preliminary Michigan sentiment index for March, expected to be flat.

Elsewhere, key releases will be:

- eurozone investor confidence for March , and industrial production for January;
- UK trade for January, and retail sales for February; and
- the Japanese economy-watchers' survey for February, and machine orders for January.

Regards,

GISE AG