WEEKLY ECONOMIC AND MONETARY REPORT

16 April 2010

News that Goldman Sachs is being prosecuted by the SEC for fraudulently selling CDOs linked to sub-prime mortgages is a huge shock to the market. Although it is still too early to evaluate what it really means (the announcement only came mid-day on Friday), it has already hit bank stocks more generally. After all, Goldman was considered virtually untouchable.

Nevertheless, the general sense this week is that economic recovery is underway - and that it is being underestimated by policymakers, particularly in the US.

The general feeling is that the US is growing strongly, Asia is surging - and that only Europe is lagging. That may be true. However, it is also true that unemployment remains stubbornly high, and that the US recovery is essentially being driven by high corporate profits. Since they are largely a function of cost-cutting and low interest rates, it is unclear how long they can last - particularly when (as everyone expects) interest rates start to rise.

There is also the (separate) issue of financial reform. The IIF has just released a report warning that the authorities are not following through on reform. Since the IIF is a lobby group for big banks, its agenda may be suspect - but there is no doubt that the twin issues of economic recovery and financial reform will dominate next week's Spring meetings of the IMF and World Bank (assuming, of course, that the current disruption of air travel between Europe and the US permits them to take place).

I GREECE AND THE "CLUB MED" PROBLEM

Until the last day or so, it looked as though the Greek crisis was on its way to resolution. In particular, eurozone leaders, meeting over the weekend, firmed up their commitment to bail out Greece, pledging up to €30 billion in 3-year money at an interest rate of around 4.83%, available over the next year. In addition, there was a somewhat vaguer commitment that the IMF would provide an additional US$20 billion (apparently, at a highly concessional interest rate of 2.71%).

Given that the yield of Greek 3-year notes had been 7.26% last Friday, this was a very sweet deal indeed - clearly constituting a subsidy by the EU-16 (which is technically against eurozone rules).

As a result of this, on Monday, Greek 10-year yields fell from 7.2% to 6.7%, the Greek/German spread narrowed by 80 basis points, and the euro rose sharply. Athens took advantage of this on Tuesday to sell €1.56 billion in six and 12 month paper at interest rates of 4.55% and 4.85% respectively. Although this was twice what it had paid in January, the offer was six times oversubscribed, and was considered a success.

And then things started to go wrong...

First, the German Foreign ministry pointed out that the Bundestag would have to approve German participation in any bailout. Then a leading German economist announced that he would launch a legal challenge to what is clearly a (technically) illegal subsidy. More important, the markets started to target Portugal - whose debt problems, though less severe than those of Greece, are serious. (Its public debt is 90% of GDP, compared with 113% for Greece, its savings rate is low, and it needs to raise €24 billion this year.) The yield on its 10-year bond has now risen to 4.45%.

It was then reported that Greece has had to cut back its proposal to sell €5-10 billion in 10-year paper to US investors (the road show was due to start next week). It is apparently now looking to sell just €1-4 billion - and PIMCO has said it will not participate at all.

To make things worse, Morgan Stanley's influential economist, Joachim Fels, warned yesterday that Germany might quit the eurozone and try to form a smaller currency bloc, limited to Northern European states with healthier fiscal situations.

All of this, is, no doubt, being discussed at today's ECOFIN meeting in Madrid - though officials insist that no decisions will be taken. In the meantime, PM Papandreou has said Greece is making 'preparatory moves' to activate the eurozone/IMF rescue package. He has called for a meeting of EU, ECB and IMF officials in Athens next week, and the expectation is that (if the German courts permit it) Greece will get a first tranche of the money.

Ironically, while all of this has been going on, Argentine has been resolving the last outstanding issues posed by its unilateral debt rescheduling in 2005 – unveiling a US$20 billion debt swap that includes a 'haircut' of around 45%. In the end, Greece may well go the same way.

II BANKING

A **THE US**: Clearly, today's news about Goldman is a big shock - potentially a game-changer. Goldman spent over US$30 million last year in political donations to incumbent Congressmen, and it is most unlikely to take this indictment lying down.

The key issue is what it means for the broader issue of financial reform. The Obama Administration announced yesterday that it is convening a meeting of the President's financial reform advisory council next week, under the chairmanship of Paul Volcker, to give a boost to the process of financial reform - a process that seems to be in political trouble.

The Senate also plans hearings next week on Sen Chris Dodd's reform bill, which is backed by the Administration and which includes:

- restriction on proprietary trading by institutions that take guaranteed deposits (the so-called Volcker rule);

- a Consumer Protection Bureau; and
- new bank resolution powers for the Fed.

The industry is fighting hard against all three - particularly against restrictions on prop trading. Although Volcker is said to be optimistic, most observers believe serious reform is now in trouble.

At the same time, both the *New York Times* and *Wall Street Journal* have been conducting their own investigations in to the financial crisis:

- The *NYT* has been focusing on Leham Bros – particularly the way it used affiliated 'shadow' companies to hide the extent of its borrowing. The implication is that auditors and regulators went along with transactions that were essentially fraudulent.
- The *WSJ* has been concentrating on the collapse of WaMu. Despite the protestations of its former CEO (who also testified to Congress this week), the Journal alleged that it fraudulently ramped up risky lending as the crisis worsened.

Now we have the Goldman issue.

Meanwhile, the IMF is still promoting the idea of a global capital surcharge for systemically important banks - an idea that it will press at the Spring meetings.

B. **<u>EUROPE</u>**: The Icelandic government this week issued a 2,000-page report into the collapse of its banking sector (which saw the failure of all three big banks) - accusing ex-PM Haarde, ex-CB Governor Oddsson and ex-Bank Minister Sigurdsson of 'gross negligence'. It is not clear if criminal charges will follow.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

A THE US: As noted, there is a lot of optimism about economic recovery - though much of it reflects generally stronger then expected first quarter corporate earnings.

Indeed, the S&P500 has now seen six straight weeks of gains, and looks like finishing up again today, (having consolidated above 1,200) before the Goldman shock. That surprise hit the banking hard. Prior to that announcement, it has been especially strong, but the market was also impressed by a strong earnings forecast from UPS - a major air freight company that is seen as a lead indicator for US industry more generally.

In addition, it is true that most economic releases this week have been positive - with the notable exception of an unexpected 24,000 rise in first time jobless claims (which is being seen as further evidence of a so-called 'jobless recovery') and a surprise drop in the Michigan confidence index. In particular, it was reported:

- that retail sales rose 1.6% month-on-month in March, with auto sales up a very strong 6.8%; and
- that manufacturing output was up 0.9%, despite evidence that inventory restocking is almost over;
- that housing starts rose 1.6% in April.

In addition, the Fed's 'Beige Book' survey of industrial conditions showed a general increase in business activity, and the NY Fed's 'Empire State' survey confirmed a strong rally in early April.

As a result, there is a real sense that the US economy is taking off - even though the (semi-official) Business Cycle Dating Committee (run by the NBER) insisted it is still too early to say definitively that the recession is over. (Most observers now accept that it started in December 2007 and finished in June 2009 - and the NBER is expected eventually to endorse that.) However, there remain some problem areas.

Housing is one. Although there are signs that the market is picking up, home loan defaults are still rising sharply. Trade is another. It was reported this week that the US trade deficit jumped 7.4% in February, to a higher-than-expected US$39.7 billion. Even though the bilateral deficit with China fell from US$18.3 billion to US$16.5 billion, that is bad news.

In addition, there is the growing fiscal crisis at the state and municipal level - with California being the most egregious example. That prompted a proposal this week from the 81-year old Wall St veteran, Felix Rohatyn (who masterminded New York City's fiscal bailout in the 1980s), for a 'domestic IMF' - based on the old Reconstruction Finance Corporation. This would offer states and municipalities Federally-guaranteed loans - but with tough conditionality. We may hear more of this.

Whatever, Fed Chairman Bernanke was generally bullish in his testimony to Congress this week. As he put it, it 'looks like we are on a path to moderate recovery'.

However, it is not clear that this recovery will survive higher interest rates. And, on that score, it is worth noting that, although the Fed's target for the funds rate is 0-25 basis points, the actual rate is now 30 bp or higher - suggesting that the FOMC will have to push up rates sooner rather than later.

B. **EUROPE**: Last weekend's air crash, which killed Polish President Kaczynski and other top political, economic and political leaders was obviously a tragedy - but it will probably not have serious negative consequences. Kaczynski - who was considered a euro-sceptic, anti-German and anti-Russian - had become a fairly marginal figure in Poland (which is why Russian PM Putin had felt able not to invite him to the earlier, official memorial service at Katyn, where PM Tusk had gone instead). Although his Law & Justice party may get a temporary bounce in the polls (perhaps giving his twin brother, Jaroslaw, a chance of succeeding him), political power is firmly with Tusk - who is already using Kaczynski's death to improve relations with Russia.

For once, Poles (who are prone to conspiracy theories, many of which are justified) seem to accept that the crash was an accident - and not something more sinister. For that, Putin can take some credit.

Meanwhile, the EU economy continues to recover - albeit more hesitantly than the US. This week, for instance, it was reported:

- that EU automobile registrations were up a hefty 10.8% last month (ironically, led by Ireland which is supposed to be experiencing a draconian spending squeeze); and

- that eurozone industrial production was up a stronger-than-expected 0.9% in February.

The ECB's latest Monthly report reflected this optimism. However, it also warned about continuing global trade imbalances - particularly the chronic surpluses being run by China and other key emerging markets.

In the UK, attention is firmly focussed on the May 6 general election - with odds having shifted in favour of a so-called 'hung' Parliament (ie no over all control) following yesterday's televised debate involving the leaders of the three main parties. The 'winner' (predictably, given voter contempt with the other two) was the leader of the center-left LibDems, Nick Clegg. He now seems quite likely to end up holding the balance of power. If he agrees to join a coalition with Labour to keep Brown in office, the price could well be radical reform - including a shift to proportional representation, a more pro-EU foreign policy and a more interventionist approach to industrial policy.

Perhaps ironically, the FTSE100 hit a 22-month high this week, with all the other major European equity indices up as well.

C **JAPAN**: The Nikkei-225 has, however, just closed down 0.9% for the week - though it is still up around 5.5% for the year-to-date. What has dragged it down this week is primarily fears of a strong yen, coupled with concerns about Chinese policy. In addition, it was reported on Monday that bank lending had fallen sharply in March - down a further 2% year-on-year.

In response to this, 100 DPJ politicians signed a letter to PM Hatoyama demanding:

- 'dramatic' monetary easing;
- a 2% inflation target; and
- a currency objective of Y120/US$.

Further monetary easing will be opposed by the BoJ, and the inflation target simply looks unattainable. The idea of sharply depreciating the yen would trigger a massive fight with the US - and probably with China.

D **CHINA**: There continues to be endless speculation about a renminbi revaluation and/or higher domestic interest rates. Although Beijing itself is sending out conflicting signals, something is likely to be done. Yesterday, for instance, the government increased the deposit needed to obtain a home loan; it also said that 'more forceful' steps may be needed to cool speculative activity in the housing sector - which was immediately interpreted to mean higher interest rates.

As for the FX rate, US and Chinese officials met last weekend at the Bo'ao Forum on Hainan Island, and it was widely reported that some sort of deal had been done. However, pressure for an immediate revaluation was somewhat reduced when (as expected) China reported its first monthly trade deficit in six years. Following a surplus of US$7.61 billion in February, it recorded a deficit of US$7.24 billion in March - thanks to a 66% year-on-year rise in imports. No one expects this to last, and the surplus for the first quarter was actually up 77% year-on-year. But at least some Chinese officials see it as a pretext for doing nothing about the renminbi.

However, the situation is unsustainable. As Bernanke said in his Congressional testimony, China has used a deliberately undervalued currency to promote export-oriented growth - a point that was validated yesterday, when it was reported that China's GDP growth rate in the first quarter had jumped from 10.7% to an astonishing 11.9% (with industrial production up 18.1%). Clearly, the Chinese will have to make some sort of a gesture - and soon.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

At the beginning of this week, Dow Jones released the results of its regular poll of Wall St currency analysts. Their median forecast is that the euro will be trading at US$1.325 by the end of June, and at US$1.2775 by year-end - ie that the euro will weaken significantly against the dollar.

That would seem to make sense, given that the Greek crisis has still not been resolved - and that speculators are now starting to target Portugal. However, it is worth noting that that the euro - which closed at US$1.346/€ last Friday - is currently trading at US$1.353 - having been as high as US$1.363 on Wednesday. Clearly, other factors are at play besides Greece.

The dollar has also (if less surprisingly) weakened against the yen this week - albeit marginally. Last Friday, the dollar closed at Y93.43; today, it is trading around Y92.79. That is despite a brief flurry of yen selling in Tokyo after DPJ politicians had demanded 'dramatic' monetary easing.

As for sterling, it too has strengthened against the dollar this week - despite the forbidding prospect (which ought to alarm the markets) of a Labour/LibDem coalition. It closed last Friday at US$1.535, hit US$1.551 yesterday and is currently trading around US$1.546. Clearly, markets are generally negative on the dollar at the moment - despite the optimism about the US economy and problems elsewhere. That, however, could change if/when the Chinese can finally be convinced to revalue the renminbi.

V OIL

Two main trends have been evident in the oil markets this week:

- There has been a shift in the relative pricing of WTI and Brent, with front-month Brent now selling at a premium to WTI. The reason given for this is a glut of oil at Cushing, OK. Although, in its latest weekly report, the EIA reported that total US crude inventories fell 2.2 million barrels, stocks at Cushing rose 1.1 million - thereby, it would appear, depressing prices.
- Linked to this, there has been a steepening of the price curve, with the spread between May and June WTI having doubled in the last month to around US$1.25 a barrel.

As far as front month prices are concerned, the unusual situation in the US has meant that WTI for May delivery has fallen marginally. Last Friday, it closed at US$84.92 a barrel, up 0.05% week-on-week; it is currently trading around US$84.59 - having hit a high of US$85.84 on Wednesday. As for May Brent, it closed last week at US$84.83, hit US$87.58 yesterday and is currently trading around US$86.80.

The general feeling - repeated by the IEA on Tuesday - is that oil markets are overheating. It has revised its demand forecast for this year up to a record 86.6 million b/d - but it also emphasised that global stocks (which is says increased by 8 million barrels last month) are unusually high. OPEC's latest Monthly report makes the same point: high prices may well not persist. However, it is worth noting that oil is not alone: the entire commodity market is firm, with the R/J CRB index up 2% this week, to 279.8.

VI NEXT WEEK

In the US, the key releases due are:

- leading indicators for March (expected to be up1%);
- existing and new home sales for March (both expected to be up); and
- durable goods orders (expected to be flat).

Elsewhere, the key releases due are:

- eurozone consumer confidence for April;
- first quarter GDP growth un the UK (where the MPC minutes for March will also be released); and
- leading indicators for February in Japan.

Regards,
GISE