Archivo

WEEKLY ECONOMIC AND MONETARY REPORT

29 May 2009

Markets around the world are still astonishingly bullish. Through Thursday, the DJIA was up 127 points (or 1.5%), the S&P 500 was up 20 points (2.3%) and the Nasdaq Composite was up 60 points (3.5%). All were up again in early trading today, though the weaker than expected Chicago PMI has caused a rethink. In Europe, the FTSE was up 1.2% through late trade today, while the Xetra Dax was up 0.4%. In Asia, the Nikkei-225 has just closed up 3.2% for the week. This has been the best month for global equities since the crisis began, with short sellers having been whipsawed. Markets are up close to 40% since the beginning of March, and even the imminent bankruptcy of GM (which, as a result, will drop out of the Dow) has not affected the mood. The bulls are back.

Of course, there are many (indeed, most) economists who believe that equities have got way ahead of themselves, and that this recovery is not justified by "fundamentals". There are also more and more economists (and investors) who are concerned about the impact of extraordinarily accommodating fiscal and monetary policies (particularly in the US, UK and Japan) on bond markets. Indeed, after the euphoria over equities, the biggest story this week has probably been the run-up in US bond yields, with the 10-year Treasury benchmark hitting 3.75% on Wednesdays. As the *Wall St. Journal* put it, there is a battle brewing in the markets between Bernanke and the "bond market vigilantes", who are convinced that Fed policies condemn the US to hyperinflation.

I THE FINANCIAL CRISIS

The main story this week has been the regulatory response.

In the US, for instance, the Committee on Capital Markets Regulation (chaired by Harvard Law School's Hal Scott) published its 300-page blueprint for regulatory reform on Wednesday. This advocates a new role for the Fed as the sole US regulator of systemically important financial institutions. It would also tighten the regulatory net on hedge funds.

Not surprisingly, the Committee's report has sparked controversy. On Capitol Hill, the Senate Banking Committee is (apparently) reluctant to give the Fed the new powers it seeks, and both the FDIC (chaired by Sheila Bair) and the SEC (Mary Schapiro) are fighting against what they see as a power grab by Bernanke. Even Rep. Barney Frank – who chairs the House Banking Committee, and who has tended to be supportive of the Fed – seems to be having second thoughts about giving the Fed so much power.

<u>In Europe</u>, an even more important proposal was released – also on Wednesday.

This was <u>the Commission's formal response to the de Larosiere report</u>, which it intends to push through (primarily by regulation, rather than directives) by the middle of next year. Comments are due by July 15, and formal legislation will be ready in early Autumn. The aim is to create a two-tier regulatory system throughout the EU. At the top, there will be a European Systemic Risk Council, made up of central bank governors (with regulators as observers). This will be chaired by the head of the ECB. Even though it will not have a separate legal identity and will not be able to impose its decisions on national regulators, the intention is that it will have great influence – influence, essentially, amounting to power.

Beneath the ESRC will be a European System of Financial Supervisors, incorporating the so-called Lamfalussy Committees (to be given new powers as Authorities). This will have the ability to impose its will on national regulators.

These proposals are extremely important. Initial responses suggest that (as usual) the British will oppose them – and will get some support from the Dutch and Irish. However, the British position has been much weakened by the problems of London as a financial centre and by the admission of the FSA itself that change is inevitable. As a result, the consensus is that <u>the Commission will probably get its way</u>.

In other news:

- BaFin reported on Tuesday that German banks still have bad assets on their books amounting to US $280 billion.
- The BofE's new Deputy Governor, Paul Tucker, suggested (in a speech in Tokyo) that Western Governments should "claim back the eventual cost" of the bailouts from the banks through some sort of special tax. He also suggested that, in future, the banks themselves ought to set up some sort of insurance scheme to cover the cost of any bailout.
- In the US, the FDIC reported that the number of "at risk" banks rose 21% in the first quarter to a new record. The total net income of the 8,200 banks insured by the FDIC dropped 61% last year, to US $7.6 billion – with 20% reporting a net loss. The FDIC's "problem list" now includes 305 banks.
- In the UK, a row has broken out (as in the US) about the assumptions used by the FSA in its recent stress tests of British banks – which only the (relatively small) Dunfermline Building Society failed. It turns out that the key criteria included a 60% fall in commercial property prices (they are already down 43%) and a 6% drop in GDP (which will almost certainly be achieved by the end of this year).
- In Ireland, it was reported today that Anglo-Irish Bank (which made a record loss of €3.77 billion in the half-year to March 31) will get up to €4 billion from the government as an equity infusion. For a relatively small bank, that is an enormous sum.

II **RECENT ECONOMIC AND MARKET DEVELOPMENTS**

For those who believe that the recession is over, the OECD provided a dose of realism on Monday. Within the 30-nation group, GDP fell 2.1% quarter-on-quarter in January-March – slightly worse than the 2.0% recorded in the fourth quarter of 2008. This was the biggest drop since 1960. Even though the Organisation noted that 'free fall' seems to be over, it is clear that the global economy is still a long way from being out of the woods.

A **THE US**: The big story this week has been the growing certainty that GM will declare bankruptcy on Monday. The Chapter 11 filing will (almost certainly) leave the government holding 72.5% of the 'new' GM, with existing bondholders getting 10% and the UAW the rest. The sweetener for bondholders is that they will get warrants entitling them to a further 15% if GM hits key profit targets.

The only thing that can derail this scheme is commonsense. According to press reports, GM (which has already received US $20 billion in government funding) will get an *additional* US $50 billion. However one looks at it, that means the US government (ie the taxpayer) is paying at least US $250,000 for each GM job – with no guarantee that the rescue will succeed. Most serious economists think this is an appalling waste of government money.

As for the wider US economy, the news is (as usual) mixed. For instance, it was reported today that the first quarter GDP growth rate had been revised from an initial estimate of -6.1% to 'only' -5.7%. That, however, was a steeper fall than the drop of 5.5% that the market had expected – and it means that the US has just experienced its worst six months in over 50 years.

There were some positive signs in the GDP report: consumer spending, for instance, rose at a 1.5% annual rate in the first quarter. But, even though the second quarter will be far stronger than the first, the US economy is still in trouble.

In addition, it was reported this week:

- that (according to the Case-Shiller index) house prices in 20 major US cities fell a further 2.25 in March, or 18.7% year-on-year;

- that the Chicago PMI for May came in substantially lower than expected, at just 34.9; and
- that a record 9.1% of all US mortgages (ie prime, as well as sub-prime) were in default as of end-March – largely because of the back-up of interest rates.

On the other hand, it was also reported:

- that the Conference Board's consumer confidence index jumped from 40.8 to 54.9 in May – the biggest one-month jump in five years;
- that existing home sales rose 2.9% in April, with sales in the North East particularly strong;
- that sales of new single family homes rose 0.3% last month;
- that durable goods orders rose 1.9% in April (after a fall of 2.1% in March), with transportation up 5.4%; and
- that the Michigan sentiment index for May rose from 67.9 to a higher-than-expected 68.7.

And, of course, equities were up strongly – despite the rise in commodity prices, the concerns in the bond market, and the threat of confrontation with North Korea.

B **EUROPE**: The mismatch between financial markets and the real economy is equally acute in Europe – particularly in the eurozone, where it was reported:

- that industrial orders fell a further 0.8% in March, and are now down 26.9% year-on-year;
- that the EuroCoin economic activity index showed negative growth again in May, though the actual reading improved from -1.09 to -0.89; and
- that consumer inflation actually fell to zero in May (from +0.6% in April).

There were, however, some modest signs of recovery. The eurozone Purchasing Managers Index, for instance, rose from 41.1 to an eight-month high of 41.9 in May, and the eurozone Economic Sentiment Index jumped from 67.2 to 69.3 (though it was 95.9 last June). Perhaps the best that can be said is that the eurozone economy is bumping along the bottom.

That is also probably true of Germany, where the GfK consumer sentiment index was unchanged in June (at a very low 2.5) for the third month in a row. In addition, it was confirmed this week that GDP fell 3.8% in the first quarter (or 6.9% year-on-year), largely because of an astonishing 9.7% drop in exports and a disturbing 7.9% fall in investment. On the other hand, however:

- the IFO index (which measures expectations, as well as the current situation) rose from 83.7 to 84.2 in May; and
- retail sales rose 0.5% (seasonally adjusted) in April, the first rise in four months.

It is a mixed picture – and confidence will not be helped by the continuing controversy over the future of GM's German subsidiary, Opel (which employs 25,000 workers). GM's problems have thrown Opel's future into doubt, and the US Treasury's ruling earlier this week that public funds cannot be used to support an overseas subsidiary have meant that foreign buyers (including Fiat) may be scared off. If Opel collapses, the knock-on effect could be considerable – also in the UK, where GM has a smaller subsidiary, Vauxhall.

Things may be a bit better in France – where it was reported this week that consumer confidence is up and that (thanks to an incentive programme) consumer spending rose 0.7% in April, with automobile sales up 3.7%. However, there is concern about the escalating government deficit, which hit €56.3 billion last year – far higher than the official prediction of €41.7 billion.

What about the UK – where the news remains dominated by the scandal over MPs' expenses?

Politically, all the major parties are in trouble going into the European and local elections (which, in Britain, are on June 4) – but the ruling Labour party is likely to be hit hardest. As a result, there is a strong rumour that a cabal of Labour cabinet ministers will press PM Brown to resign immediately after the elections – with the aim of replacing him with the Health Secretary, Alan Johnson (one of the few leading politicians not implicated in the expenses scandal).

Economically, there is some sign that the UK (which was hit earlier and harder by the downturn) may be past the worst. In particular, it was reported this week:

- that (according to the Nationwide) house prices rose a surprising 1.2% in May, though they are still down 11.3% year-on-year;
- that mortgage approvals rose 3.8% in April; and
- that the GfK/NOP consumer confidence index was unchanged last month – which means it remains at an 11-month high.

On the other hand, the CBI's Distributive Trades Survey showed a fall in High Street sales in May, with the positive/negative balance falling from +3 to -17.

Whatever, Britain's deteriorating government finances will be a drag on the economy for years to come. On Tuesday, the Treasury acknowledged the possibility of a STG 70 billion 'hole' in the budget over the next four years. <u>As in the US, public finances are likely to become a very big issue</u>.

C **<u>JAPAN</u>**: Better news, for once... Although it was reported today that unemployment had hit a 5-year high in April, with the jobless rate rising from 4.8% to 5.0%, and that household spending was down 1.3% year-on-year, there are signs that the Japanese economy is improving. In particular, it was reported this week:

- that exports rose 1.9% in April, the second month of positive growth (though they were still down a massive 39% year-on-year);
- that retail sales rose 0.6%, seasonally-adjusted, last month; and
- that factory output rose an astonishing 5.6% month-on-month in April, far better than expected – though, admittedly, from a very low base.

As a result, the BoJ has upgraded its assessment of the economy, and has predicted that it will show positive growth in the second half of the year (after a devastating 15.2% fall in the first quarter). The danger, however, remains deflation. It was reported this week that core consumer prices (ie ex-fresh food) fell 0.1% in April year-on-year. It was also reported that Tokyo prices were down 0.7% in May – the biggest drop in six years. In addition – and notwithstanding the very strong performance of Japanese equity markets – it is worth noting that Moody's downgraded Sony this week, the first time it has done so since 2005. Japan is not quite out of the woods.

D **OTHER MARKETS**: There have been significant developments in several other countries this week:

- Russia: Bizarrely enough, Russia's stock markets have been the best-performing in the world this year. That is despite the fact that it was reported this week that unemployment hit 7.7 million, or 10.2% of the workforce, in April, and that retail sales were down 5.3% year-on-year – the third monthly decline in a row.
- China: Better news here. Bloomberg's latest survey of China-watchers shows a higher consensus forecast of GDP growth for this year – now 7.5%, up from 7.1% in February. That also compares with an actual growth rate of 6.1% in the first quarter.
- Ukraine: In sharp contrast, it was reported that Ukrainian GDP fell an astonishing 23% in the first quarter. That is particularly disturbing because of the continuing political differences within the country, and between Kiev and Moscow.

- South Africa: Given the economic and political expectations raised by Jacob Zuma's election as President, the latest news of the South African economy is also bad news. GDP was down 6.4% quarter-on-quarter in January-March – far worse than the 1.8% fall in the fourth quarter of last year. Although higher commodity prices may be helping now, mining was down a devastating 30% in the first quarter.

III FOREIGN EXCHANGE MARKET DEVELOPMENTS

The good news, as far as the dollar is concerned, is that China still seems to be buying US Treasury securities – despite increasingly shrill warnings of imminent collapse as a result of the Fed's embrace of quantitative easing. Data released over the weekend suggests China's holdings of US Treasuries rose US $23.7 billion in March, to US $768 billion (out of total reserves of US $1.95 trillion).

The bad news, however, is that, despite this, the dollar has come under some pressure this week – and the pressure seems to be intensifying:

- US $/euro: At the close last Friday, the euro was trading at US $1.402 – having broken US $1.40 on fears of US indebtedness. By Wednesday, the dollar had recovered to US $1.396/€, but it has since fallen again, and the euro is now trading around US $1.413 – up 0.8% for the week.
- US $/sterling: At the close last week, the pound was trading around US $1.591 – having risen sharply on Friday. At the beginning of this week, it consolidated, before rising again on Wednesday to US $1.60 on signs that the UK housing market may be recovering. Earlier today, sterling hit a high of US $1.614 – its strongest since last November. Even though it has since eased to US $1.606, it is still up 0.9% for the week.
- Yen/US $: At the close last week, the dollar was trading at Y94.43. By the close on Wednesday, it had strengthened marginally to Y94.94. Yesterday,

the dollar rose sharply, closing at Y96.80. Today, however, it has eased back to Y95.53 – but that is still up 1.2% for the week.

The reason for the weakness of the yen must be the political crisis caused by North Korea's belligerence. Any escalation of the tension in the region would hit all Asian countries – even though it is unrealistic to believe that North Korea poses any genuine threat to Japan. (South Korea is a different proposition, since Seoul is only 30 miles from the border.)

IV OIL

It has been a big week for oil prices, which look likely to record their biggest monthly gain in a decade. At the close last week, July WTI was trading at US $61.67 a barrel (up 9.4% week-on-week), while July Brent was trading at US $60.78. In early trading today:

- July WTI is at US $66.03 (having been as high as US $66.17) – up 7.1% for the week (and 28% since May); and
- July Brent is at US $65.17 – up 7.2% for the week.

What has been driving this very substantial price increase?

First, inevitably, is the belief (mistaken or otherwise) that the worst of the global recession is over. This was reflected in comments by Saudi Arabia's Oil Minister at this week's OPEC Ministerial Meeting, which were largely unchallenged, that the global economy is now "strong enough" to support an oil price of US $75-80 a barrel. In addition, oil prices are being supported by a more general rise in commodity prices (for the same reason), which has seen the Baltic Dry freight index rise almost 10% week-on-week.

Another important factor was the OPEC meeting itself. Although, as expected, the meeting did not result in any further decision to cut global oil production, it reinforced the idea that the Organisation is better able to impose discipline that it has been for some time.

In addition, there was the latest US inventory data, released by the EIA yesterday. Overall, US crude stocks fell a much sharper-than-expected 5.4 million barrels in the latest week, to 363.1 million. Gasoline stocks also fell 600,000 barrels. Even though distillate stocks rose 300,000 barrels – and even though overall crude inventories in the OECD are at a very comfortable 62 days demand – the impression is that the market in the US is tightening. Reinforcing this, it was also reported that refinery utilisation in the US rose in the latest week from 81.8% to a (fairly high) 85.1%.

Other factors pushing prices up this week have included:

- the failure of the EU and Russia to negotiate a new long-term agreement on gas supplies;
- more disruption in Nigeria, with Chevron shutting in exports of 100,000 b/d after attacks in the Niger delta; and
- comments by US Energy Secretary Chu, acknowledging that a sharp rise in gasoline taxes (which most experts believe would be the best way to curtail US demand) is politically unfeasible.

However, if (as we believe) the economic outlook is less optimistic than the markets currently believe, the likelihood has to be that prices may settle back somewhat.

V NEXT WEEK

The big news is Obama's trip to the Middle East – and, specifically, the late change to his itinerary that sends him in Riyadh on June 3, ahead of his speech in Cairo.

Speculation in Washington about his visit to the Kingdom is rife. Is it an attempt to undercut Egypt? Is he preparing the way for an attack on Iran? Or is he finally going to take a more active role in resolution of the Israel-Palestine impasse? Inevitably, oil prices will also come up, as will (presumably) the US need to fund its deficits.

At the same time, Treasury Secretary Geithner will be in China, where his agenda is said to include pressing Beijing not to diversify out of the dollar.

As far as economic releases are concerned, the major ones due in the US next week include:

- non-farm payrolls for May, expected to be down 550,000;
- personal income and spending for April, both of which are expected to be down 0.2%;
- the ISM index for May, expected to be 42.0; and
- factory orders for April, expected to be up 0.3%.

Elsewhere, markets will focus on:

- purchasing managers data for the UK; and
- Japanese capital expenditure for the first quarter.

EU Parliamentary elections are to be held between June 4 and June 7, with the results due on Monday, June 8. The UN also holds a Global Summit on the World Financial and Economic Crisis next week. This is intended to focus on developing countries. To no great surprise, a leading role in this conference is being played by Joe Stiglitz, the Nobel prize-winning economist (and opponent of globalisation).

Regards,
GISE