WEEKLY ECONOMIC AND MONETARY REPORT

22 May 2009

Next Monday is a market holiday in the US, and trading normally winds down well ahead of time. However, things were thrown into confusion yesterday after S&P unexpectedly put the UK's AAA sovereign rating on negative credit watch. Historically, this means that there is a one in three chance that Britain's rating will be cut in the next two years.

Is this important? Well, yes – for the UK. With a budget deficit heading inexorably to more than 12% of GDP and with total public sector debt likely to exceed 100% of GDP within the next two years, the British government has to sell around STG 220 billion of Treasury paper this fiscal year. Even the threat of a downgrade will make this more expensive – particularly since many investors are not allowed to buy anything other than triple-A paper.

However, Britain would be far from the first industrialised country to be downgraded in this way. Others include: Norway (1987), Finland (1990), Sweden (1991), Canada (1994), Japan (1998) and Spain and Ireland (2009). Japan's case is particularly significant, in that the downgrade had very little impact on the demand for Japanese paper. However, in the case of the UK, the potential vulnerability of sterling is a big issue; approximately 3% of global reserves are held in sterling – but there have been reports that up to 10% of Russian reserves are in pounds. That gives Moscow considerable leverage over London.

Are the markets right to be worried that the US could also be downgraded? That was the suggestion made yesterday by PIMCO's Bill Gross, based on the fact that US public sector debt is already close to 70% of GDP and that, like the UK, it is heading to 100% or more. As a result, the yield on the 10-year Treasury benchmark immediately jumped 17 basis points.

There is no doubt that US public finances are in a mess. It is not just the massive boost to government spending; it is also the slump in tax revenues as a result of slower growth. So far, however, there is no sign that the global appetite for US paper is on the wane; indeed, latest TIC data shows foreign demand is holding up well. That said, the enormous holdings that countries like China and Japan have of dollar assets mean that even a few veiled threats of diversification can create near-panic. It is not unreasonable to suggest that China, in particular, will be quite prepared to use this power from time to time. Indeed, earlier this week, it sent another signal to the markets by letting units of HSBC and the Bank of East Asia issue bonds denominated in renminbi; the corollary of progressive internationalisation of the RMB is modestly increasing pressure on the dollar.

I FINANCIAL CRISIS

The situation is generally positive. LIBOR has fallen sharply this week – along with other key indicators, like the so-called VIX index (which broke 30 for the first time since the collapse of Lehman Bros). It genuinely seems that markets are starting to work again.

One consequence of that in the US is that big banks are now queuing up to repay the money they have received from the TARP, so that they can get rid of the constraints which the Treasury imposed on them (not least, on executive compensation). Not surprisingly, this is controversial – particularly since the banks (led by Goldman Sachs JP Morgan and Amex, with Morgan Stanley and State St. close behind) want to pay off the government not to exercise its right to convert equity warrants into ordinary stock. The problem is that (based on a precedent set by the Treasury's treatment of tiny Old National Bancorp) they want an 80% discount on these payments. Essentially, the banks are demanding that the US taxpayer should forego almost all of the upside on the bailout that they received over the last year. The rationale for their position is that even relatively healthy banks were not given any choice about participating in the TARP: recently released transcripts of meetings with then-Treasury Secretary Paulson make it clear that all the big banks had to sign up together.

That said, there has been genuine progress. On Wednesday, for instance, Treasury Secretary Geithner told the Senate Banking Committee that the 19 major US banks are on track to raise a total of US$56 billion in new capital. Of that, BofA has already raised US$13.5 billion through stock sales and the sale of its share of China Construction Bank. Geithner also indicated that smaller US banks still need to raise a further US$24 billion, but that appears to be feasible.

There is also some progress in the UK – where the government's holding company, UKFI, is (apparently) trying to interest Sovereign Wealth Funds in buying all or part of its stake in RBS, LloydsTSB, Northern Rock etc. However, unlike the US, Britain's FSA is so far refusing to release the results of the stress tests that it has just completed on RBS and Lloyds – allegedly to avoid "instability".

There are also important regulatory initiatives underway on both sides of the Atlantic. In the US, for instance, Rep. Barney Frank's House Banking Committee is due to start hearings on a thorough regulatory overhaul within the next couple of weeks. In Brussels, the European Commission is due to publish its own regulatory plan next week. This is likely to be based on the Larosière report, and will push for:

- a two-tier regulatory structure, including a (pan-European) Systemic Risk Council and a European System of Financial Supervisors, based on national bodies; and
- an upgrade of the three so-called Lamfalussy Committees (CESR, CEBS and CEIOPS) to give them real executive powers.

Inevitably, this will provoke a row with the UK.

Finally, the BIS has just released its semi-annual review of the global derivatives market – and it makes fascinating reading. For the first time since the crisis began, the total gross volume of derivative contracts appears to be shrinking. Between June and

December 2008, the notional total of OTC derivative contracts (which constitute the vast majority) fell 13% to US$592 trillion. The drop was across-the-board:

- interest rate derivatives fell 9% to US$419 trillion;
- currency derivatives fell 21% to US$49.8 trillion;
- credit derivatives fell 27% to US$41.9 trillion;
- equity derivatives fell 36% to US$6.5 trillion; and
- commodity derivatives fell 67% to US$4.4 trillion.

That is probably good news – though gross positions outstanding are still grotesquely large. The continuing saga of unwinding Lehman's positions (PwC has 750 consultants working full-time on the problem) shows just how dangerous these positions are, even if they (allegedly) net close to zero

II RECENT ECONOMIC AND MARKET DEVELOPMENTS

As noted, governments around the world are talking the global economy back up. However, the IMF's Dominique Strauss-Kahn may be closer to the truth. At the end of last week, he warned that the world is still in the grip of a "Great Recession", and that "there will be further tests ahead" – particularly in Continental Europe, where he criticised German policy (which remains apposed to quantitative easing) as "bankrupt".

A THE US: Last week, the DJIA fell 3.8% - its worst week in two months. However, it bounced back sharply on Monday – rising 235 points (2.9%), primarily on prospects that the banks will be able to exit the TARP. In addition, there was (apparently) a surge in confidence around the world as a result of the unexpectedly decisive victory by the (relatively) pro-Western Congress Party in India's election. Despite that, however, the markets sold off again on Tuesday, though they are up modestly today. As of early Friday, for instance, the DJIA is up just 1.1% for the week, the S&P500 is up 1.4% and the Nasdaq Composite is up 1.6%. That is up around 26% since the lows in March,

though the powerful upward momentum of recent weeks may have been broken – which seems odd given the remorseless optimism calling out of the Treasury.

One concern is obviously the fear of a US ratings downgrade, which pushed the yield on the 10-year Treasury Note up from 3.20% to 3.36% yesterday. Another is the virtual certainty that both Chrysler and GM will declare Chapter 11 bankruptcy – in the latter case, as early as next week. It is said that GM has already committed itself to bankruptcy, and that the government will immediately step in with debtor-in-possession emergency financing. Fine, perhaps – but there has never been a bankruptcy on this scale in the US, and there remains a significant possibility that the ripple effect throughout the economy could get out of hand.

In addition, the latest FOMC Minutes, released on Wednesday, were more pessimistic than expected. The Fed has now cut its GDP growth forecast for the fourth quarter from a range of -0.5% to -1.3% to -1.3% to -2%. And it has increased its forecast jobless rate to 9.2-9.6%. Coupled with that, it was reported this week:

- that industrial production fell 0.5% in April – the fifteenth fall in the last 16 months; and
- that housing starts dropped 12.8% in April, to the lowest level since 1959.

That said, there were a few "green shoots". In particular:

- the NAHB's homebuilder confidence index rose in May from 14 to 16 (admittedly still well below the neutral 50 level) – suggesting that April's construction data may have represented a low;
- the Conference Board's index of leading indicators rose 1% in April, its first rise in 10 months; and
- the Philadelphia Fed's regional activity index improved slightly this month, from -24.4 to -22.6.

On balance, however, it is hard to imagine that the US economy is strong enough to shrug off a GM collapse.

B **EUROPE**: It is worth emphasising that pan-EU elections to the European Parliament will be held in two weeks. In many countries, turnout could be 20% or lower. However, two trends are worth watching:

- In Germany, will there be significant support for the far left parties, particularly Lafontaine's *Linkspartei*?
- In the UK, how will the current revulsion for the entire political system show itself? Will people simply refuse to vote? Or will they vote for fringe parties – the (anti-EU) UKIP or the (far-right) BNP?

Germany also holds a Presidential election this weekend – though, since this is restricted to parliamentary representatives at the Federal and *Lõnder* levels, the result is more predictable. Former IMF MD Köhler will get a second term.

In the meantime, Brussels is talking up hopes of economic recovery in the eurozone. Although first quarter GDP data was almost uniformly awful, it was reported yesterday that the eurozone purchasing managers index for May jumped from 41.1 to 43.9 – its highest level since September (though the twelfth month under 50). Perhaps most significant was the jump in Germany's PMI from 40.1 to 44.1. That accords with the ZEW investor confidence index, which rose in May from 13 to 31.1 – the seventh straight rise. That said, it is worth noting that, on Tuesday, BaFin specifically warned German banks to prepare for tough times ahead.

Outside the eurozone, the focus has been on the UK – albeit mostly because of the utter collapse of confidence in the political class as a result of the row over Parliamentary expenses.

We have already noted that it was S&P's warning about UK creditworthiness that prompted similar concerns about the US. The main reason for this is the massive deterioration in public finances as a result of quantitative easing, a huge boost to public spending and a collapsing tax base. The problem is that – according to the BofE itself – there isn't much sign yet that its policies are working. Indeed, it reported this week that lending by the UK banks actually slowed in April, and that mortgage lending fell. In addition, it was confirmed today that UK GDP fell 1.9% in the first quarter – largely because of a 3.8% drop in business investment and a 1.2% fall in consumer spending.

There are positive signs, however. For instance:

- the CBI's industrial trends survey showed the positive/negative spread improving from -32 in April to -17, the best reading since before the Lehman collapse; and
- retail sales (calculated according to a new methodology) rose 0.9% in April, or 2.6% year-on-year – which was substantially better than expected.

However, deflation is still a worry. Indeed, the RPI (which includes housing) fell 1.2% in the year to April, which was the lowest ever recorded. Even though the CPI (ex-housing) rose 2.3%, the government is still concerned.

C **JAPAN**: Politically, the (opposition) DPJ has probably done itself a favour by choosing as its new leader, Yukio Hatoyama, 62. He is a plausible candidate for PM; indeed he is the grandson of a PM and the son of a Foreign Minister. In the dynastic world of Japanese politics, that gives him credibility. As a result, PM Aso's future probably depends on turning the economy round.

On that, the news was mixed (at best) this week.

On the positive side, the BofJ has just raised its view of the Japanese economy for the first time in three years – suggesting that the recession bottomed out in the first quarter. Unfortunately, that "bottoming out" was brutal. It was reported on Wednesday that first

quarter GDP fell at a record annual rate of 15.2%, or 4% quarter-on-quarter. In addition, it was also reported that core machinery orders fell 9.9% in the first quarter, and were down 1.3% month-on-month in March.

The central bank has announced that it will expand its own quantitative easing programme, and that may have underpinned the stock market. Nevertheless, the Nikkei-225 did close down again this week, following a 2% loss last week.

D **INDIA**: As noted, the victory for the Congress-led coalition (which won 261 seats, as against 159 for the Hindu nationalist BJP) was a pleasant surprise for the markets – as well as being the best electoral result for Congress in 25 years. The Mumbai Sensex index jumped 17% in one day, and sparked a global rally.

The main reason for this reaction was the news that Manmohan Singh, 76 – who is widely credited with revitalising the Indian economy – will remain PM. He is the first Indian PM since Nehru to get a second full term. The real winner of the election, however, was Sonia Gandhi – the (Italian-born) widow of Rajiv Gandhi, who heads the Congress party, and who has been preparing the way for her son, Rahul, 38, to take over at some stage.

III FOREIGN EXCHANGE DEVELOPMENTS

The focus this week has been on the precariousness of the dollar's position. Indeed, the dollar has fallen sharply, hitting a series of four month lows against the euro in particular. This ought to be extremely worrying for the Treasury, given that the US still has to sell over US$1billion a day to fund the current account deficit – and even more to fund its stimulus programme.

What are the main pressures on the dollar? This week, it would appear that the major factors pushing the dollar down have been:

- Geithner's own talk (on Wednesday) of "healing" in the markets – which apparently convinced some traders that the worst of the financial crisis is over, and that they can now shift from the 'safe haven' of the dollar to higher-yielding currencies; and
- the announcement by Brazil and China that they intend to use their own currencies in bilateral trade, rather than clearing through the dollar – which prompted a series of stories in the press about reserve asset diversification (particularly by China).

There was also some speculation that the decision by the UAE not to participate in a single currency for the GCC region might have prompted some dollar-selling, though it is hard to see the link. Whatever, the dollar is down across the board:

- US$/euro: At the close last week, the euro was trading at US$1.355. By the close yesterday, it had strengthened to US$1.381 – and, in early trading today, it is at US$1.398, pushing the dollar down 3.2% for the week.
- US$/sterling: At the close last week, the pound was trading at US$1.523. In early trade today, it is at US$1.587 – up 4.2% against the dollar.
- Yen/US$: At the close last Friday, the dollar was trading at Y95.02. It hit a high of Y96.14 on Monday, but has since eased to Y94.24 – down 0.8% for the week.
- SF/US$: At the close last week, the dollar was trading at SF1.114/US%. It is currently SF1.087 – which means the dollar has fallen 2.4% for the week.

For the moment at least, markets are extremely bearish on the dollar.

IV OIL

The weakness of the dollar is one of the more convincing reasons for the fact that oil prices have risen quite sharply this week – albeit, following a drop of around 4% last week (leading most commodities down). At the close last Friday, for instance:

- June WTI was trading at US$56.34 a barrel, with the July contract at US$57.00; and
- July Brent was at US$55.98.

On Monday, the June WTI contract expired at US$59.03, with the July contract taking over as the benchmark at US$61.64. In early trading today, WTI is at US$61.64 a barrel – up 9.4% from the reference crude last Friday. Over the same period, July Brent has risen to US$60.38 – up 7.9%.

Obviously, it is not just the weakness of the dollar (in which oil sales are denominated) that has driven prices. In addition:

- there was an unexpected drop in US inventories in the latest week, with crude stocks down 2.1 million barrels (they were expected to be down 200,000) and gasoline stocks down 4.3 million;
- there was a serious refinery fire at the Marcus Hook plant near Philadelphia; and
- there has been a deterioration in the security situation in the Niger delta, with Eni (in particular) declaring *force majeure* on several supply contracts.

In addition, there is the longer term problem of falling investment in exploration – flagged by the IEA on Tuesday. The major concern is apparently the collapse of investment in more difficult areas, notably Canada's oil sands, which require a longer-term price of US$60 or more to be viable. Add to that some uncertainty as to what may or may not come out of next week's OPEC meeting in Geneva, and this week's run-up in oil prices to a six-month high seems less inexplicable. Nevertheless, unless there is much more evidence of economic recovery, it does not really appear sustainable.

V NEXT WEEK

As noted, Monday is a holiday in the US (and in the UK). However, there are several significant economic releases due next week, including:

- the Case-Shiller house price index for March (expected to be down 18% year-on-year);
- consumer confidence for May (expected to be up);
- durable goods orders for April (expected to be up 0.5%); and
- the preliminary GDP growth rate for the first quarter (expected to be down at an annual rate of 5.5%).

In Europe, the major releases are:

- the IFO index for May in Germany;
- consumer confidence for April in France; and
- eurozone consumer sentiment for May.

In Japan, the BoJ's *Monthly Report* will be published. The purchasing managers index is also due.

Regards.
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