WEEKLY ECONOMIC AND MONETARY REPORT

8 July 2011

Today's US employment data came as a great shock to the markets – which had been confidently expecting a much stronger figure. That has renewed fears that the US is sliding back into recession, and it will make the Administration's efforts to cut the budget deficit even more difficult. Meanwhile, there has been little progress on the eurozone's debt problems. The can has indeed been kicked a bit further down the road – but no serious observer believes a real solution is in sight.

I IMF

So far, Christine Lagarde – who took over as MD on Tuesday – has said all the right things: Diversity, "the highest standards of ethical conduct", a more inclusive style etc. However, it is far too early to say whether anything will change. As noted last week, one of her predecessors, Jacques de Larosiere, has been warning about the 'politicisation' of the Fund under Strauss-Kahn, and this week, Simon Johnson – an influential former chief economist at the IMF – added his voice. In his opinion, Lagarde may lack "impartiality" when it comes to Greece, in that (as a former Finance Minister) she may be beholden to the French banks who are heavily exposed.

II EUROZONE CRISIS

Although most of the focus this week has continued to be on Greece, the danger of contagion was emphasised on Tuesday, when Moody's downgraded Portugal's sovereign debt four notches to 'junk' – pushing the country's two-year yield up to a record 16.7%.

That prompted the usual attacks on the credit raters. Portugal's PM, for instance, called the downgrade "a punch in the stomach". Finance Minister Victor Gaspar insisted that it ignored the political consensus in the country on austerity (very different to Greece).

European Commission President Barroso argued that Moody's is guilty of "mistakes and exaggerations". And German Finance Minister Schauble warned that "we have to break the oligopoly of the rating agencies". The problem is that the rating agencies are damned if they do, and damned if they don't; they were criticised for not downgrading Enron and Lehman Bros before they collapsed. Now, they are being attacked for downgrading European sovereigns too aggressively. There is a huge inconsistency here – but it may not be enough to stop EU officials from promoting their pet idea of a 'captive' European rating agency that would do as EU governments want it to.

In the meantime, the ECB has announced that it will continue to accept Greek (and, by extension, Portuguese) debt until all four recognised rating agencies declare a sovereign default. This is extremely important – not least for the Greek banks, which depend on the ECB for their liquidity. There is, however, one problem; only three of the raters (Moody's, S&P and Fitch) currently rate Greece – though the fourth (DBRS) may take this opportunity to start coverage. (It has a reputation for being more 'generous' than the others with its ratings, which may appeal to the Commission.)

As for Greece itself, there has not been much progress.

The first problem is that the 'voluntary' debt restructuring proposal put forward last week by the French banks (which was subsequently picked up by the IIF) has been comprehensively rubbished by analysts. The *FT* called it a "dirty little con trick" – pointing out that it is a bailout of the banks, not of Greece. As one columnist said, it "effectively transfers seniority and value from Europe's taxpayers to French banks". S&P added its contribution, saying that, if it were ever implemented, the French plan would still be classified as a "selective default" – which would require banks to write down their holdings of Greek debt.

All of this has forced the IIF to think again – though, so far, without much success. Greece's major bank creditors met in Paris on Wednesday (under IIF auspices) to try to finalise an improved offer. There seems to be agreement in principle that the banks

should agree to roll over a higher percentage of maturing debt (probably 70%) and that Greece should pay a lower interest rate, but negotiations are continuing. No new deal is yet on the table.

This is important, since many European banks are heavily exposed to Greece. The table below was published this week, and is probably a fairly accurate reflection of who is most at risk:

Greece: Major bank creditors (€ billion)

Greek		Foreign	
National Bank	13.2	FMS (Depfa/Hypo)	6.3
Eurobank/EFG	9.0	BNP Paribas	5.0
Piraeus	8.0	Dexia	3.5
ATE	4.6	Generali	3.0
Alpha	3.7	Commerz	2.9
Hellenic Postbank	3.1	SocGen	2.9

That said, the *WSJ* reported on Tuesday that European banks have been quietly selling off their Greek exposure into the market – even though many had given a pledge that they would not do so. The reason is clear: almost everyone accepts that a Greek default is inevitable at some stage – and, when it happens, it seems very likely to drag Portugal and Ireland down with it. That was emphasised by new figures from Citigroup, which now projects that Greece's debt/GDP ratio will hit 180% in 2014. The comparable figures for Ireland and Portugal are not that far behind – 145% and 135% respectively. As Citi points out, market access usually closes after 80%.

What this means is that Greece would need a 65% cut in debt service costs before it could realistically hope to regain market access – while Ireland would need a 50% cut and Portugal 45%.

The arithmetic looks overwhelming. However, the ECB persists with its belief that Greece can survive without a restructuring so long as it gets the second bailout package (probably around €120 billion) that has been talked about. That, however, depends on a resolution of the dispute between Germany and the ECB on private sector involvement –

as well as signs that Greece is actually implementing the austerity/privatisation package to which it is formally committed. In the meantime, the IMF Board is meeting today and will rubber-stamp release of the next €12 billion tranche of the first bail-out package to Greece, probably next week. That will enable Athens to meet the next debt payment, which falls due on July 15.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

This week, the OECD reported that GDP growth among its 34 members was 0.5% in the first quarter, with consumer spending up just 0.2% and business investment flat. What might cause concern is that one of the major drivers of growth was inventory accumulation – which could easily go into reverse if final demand stays weak.

The other concern is inflation. OECD consumer prices rose 3.2% in the year to May, up from 2.9% for the year to April. The major items were food (up 3.9%) and energy (up 14.2%). However, core inflation was also up 1.7% - its highest level since July 2009.

The FAO has also been warning about inflation. Its food price index rose last month to 234 – up 39% year on year, and only just below the record 238 hit in March.

A THE US: Today's non-farm payrolls data – the first significant economic release for June – was much worse than expected, and it is bound to have a big impact on market sentiment.

Yesterday, it was reported by ADP that private sector hiring was up 157,000 last month – twice what was expected. Coupled with a 14,000 drop in first-time jobless claims in the latest week, that set the markets up for strong jobs data today. Indeed, it was widely felt that the consensus estimate – that non-farm payrolls would be up 80-100,000 – was far too pessimistic. In fact, however, it was reported earlier today that non-farm payrolls rose just 18,000 last month, pushing the unemployment rate up from 9.1% to 9.2%.

Weakness was across-the-board. The government shed 39,000 workers, construction shed 9,000. The total private sector added just 57,000 jobs last month – compared with an expected increase of 132,000. Plus – and this is particularly worrying – the underemployment rate (which includes those who have stopped looking for work and those who can only find part-time work) is now 16.2%, up from 15.8% in May.

The impact on the markets has been immediate. Through the close on Thursday, the DJIA (which rose 5.4% last week) was up 1.1%, the S&P500 (up 5.6% last week) was up 1.0% and the Nasdaq Composite (up 6.2% last week) was up 2.0%. In early trading today, the DJIA (which had shown strong gains in the futures market ahead of the jobs data) is down 141 points (1.1%), the S&P500 is down 18 (1.3%) and the Nasdaq is off 38 (1.3%).

That said, US bond markets are strong. The yield on the benchmark 10-year Treasury, for instance, is around 3.01% - down from 3.20% last Friday (and from 3.17% immediately before the jobs data was released).

<u>Other US economic data related this week has been mixed</u>. On the one hand, for instance, it was reported:

- that the ISM services index fell in June from 54.6 to 53.3 (though that was still the 19th straight month above 50); and
- that Bloomberg's consumer "comfort" index fell in the latest week from -43.9 to -45.5.

On the other hand, it was also reported:

- that US factory orders were up 0.8% in May; and
- that retail sales at stores open more than one year were up 7.2% year-on-year – substantially stronger than expected.

On balance, however, concern about the pace of economic recovery is growing. The *WSJ*, for instance, carried an extensive analysis of the recovery at the beginning of this week – and came to the conclusion that the pattern of recovery is far weaker than the average for all post-recession periods since 1945. The closest parallel is with the 1980 recession.

Moreover, the outlook isn't very promising, given the continued partisan deadlock over the Federal debt ceiling.

This is a tricky one, since both sides are grandstanding. But the situation is, broadly, that the White House and Congress have to agree a resolution to increase the US $14.3 trillion debt ceiling not later than July 22, so that detailed legislation can be drafted by the time the money runs out (allegedly) on August 2. Two major 'Summits' have already been held at the White House, and Obama has claimed that "constructive progress" has been made. However, the Republican leadership is under intense pressure from the right-wing 'tea party' faction not to accept *any* tax increases – which makes it very hard for the House Speaker, John Boehner, to do a deal.

Although there is said to be a 50% chance of a budget deal in the next 48 hours (there is a third White House 'Summit' on Sunday), there is also a very good chance that talks will break down yet again.

B EUROPE: No surprise that the ECB raised its reference interest rate yesterday, from 1.25% to 1.50%. The move had been trailed well in advance, and it reflects Trichet's conviction that the biggest danger in Europe remains inflation. Peripheral eurozone currencies may disagree, but (as has been repeatedly pointed out) a country like Greece only accounts for 2-3% of total eurozone GDP; it must accept that monetary policy will be focused on what Germany needs – not what Greece wants.

And, for once, the economic news from Germany has been pretty strong. It was, for instance, reported this week:

- that industrial production rose 1.2% in May (or 7.6% year-on-year);
- that manufacturing orders were up 1.8%, with demand for luxury automobiles particularly strong; and
- that exports were up 4.3% seasonally-adjusted – far better than the 1.5% increase that had been expected.

Unfortunately, the news elsewhere in the eurozone has not been as good.

In Italy, for instance, it was reported this week:

- that the unemployment rate rose to 8.1% in May; and
- that the manufacturing PMI fell from 52.8 to 49.9 in June.

However, Berlusconi (who has, once again, insisted that he will not run again as PM when his term ends in 2013) did manage to push through a 3-year austerity budget – even though he was forced to drop a controversial clause that would have meant his businesses would have had the right to avoid paying fines they had incurred for regulatory breaches while the judicial process was under review.

More important, perhaps, a new scandal has exploded in Rome – this time, not involving Berlusconi. Instead, the well-respected Finance Minister, Guido Tremonti (a rival to Berlusconi, with his own power base) is being accused of accepting favours from another legislator, Marco Milanese – who has, among other things, paid for Tremonti's apartment. This affair has the potential to suck Italy into the crisis of the peripheral eurozone area if Tremonti is forced to step down.

As for France, its exporters are not doing as well as Germany. It was reported yesterday that the trade deficit widened in June from €7.17 billion to €7.42 billion – largely because of a drop in exports.

Perhaps the most successful EU economy at the moment is not even in the eurozone. This week, Sweden raised its benchmark interest rate to 2% - the seventh increase in the last 12 months. Last year, Swedish GDP rose 5.7% - which is clearly unsustainable. This year, however, growth is expected to be a still-impressive 4.4%.

As for the UK, the National Institute has just published its latest projections, which foresee GDP rising just 0.1% in the second quarter. This reflects a growing view that the British economy is virtually dead in the water.

That said, it was also reported this week that manufacturing output rose 1.8% in May – the biggest one month jump since March 2010. It is now up 2.8% year-on-year, which is hard to reconcile with the perception that the economy is sliding back into recession. One problem is that job creation is lagging behind output. Indeed, both permanent and temporary jobs grew at their slowest pace for 22 and eight months respectively in June. However, with inflation still subdued (the PPI rose just 0.1% in June), there is little pressure on the MPC to push up UK interest rates – at least, not yet.

As far as European markets are concerned, there have been a few wobbles this week – particularly within the eurozone. However, it is worth noting that the yield on the 10-year German *bund* has fallen this week from 3.02% to 2.95%, while the Xetra Dax has essentially been flat for the week.

C JAPAN: The Nikkei-225 has just closed up 2.7% for the week at 10,138 – its highest close since the earthquake/tsunami. The reason seems to be a faster than expected bounceback in exports, with the current account surplus coming in at Y591 billion in May. Although that was down 52% year-on-year, it was significantly bigger than expected.

D CHINA: On Wednesday, the PBoC raised Chinese interest rates for the fifth time in the last eight months. Its key lending rate was increased from 6.39% to 6.56%, while the one year deposit rate went up from 3.25% to 3.50%.

The consensus in the market is that this will probably be the last increase this year – though that probably depends on inflation data, which is due to be released in the next few days. On this score, it is also worth bearing in mind a Moody's report on Tuesday which emphasised the fragile position of many Chinese banks – who are wildly over-exposed to local governments. This will be very hard for Beijing to 'manage down' without precipitating a major crisis.

It is worth noting that there are strong rumours that Ziang Zemin, China's former President (from 1993 to 2003), has either died or is on the verge of death. It can be assumed that his funeral will be a large-scale state event, given his role in opening up the Chinese economy.

E THAILAND: As expected, Puea Thai – the party headed by former PM Thaksin Shinawatra's sister, Yingluck – won last weekend's parliamentary elections, picking up 262 of the 500 seats. Given that Yingluck is widely accepted to be a proxy for her highly controversial brother (who is loathed by the Thai elite, by the Royal Family and by the military), that is probably bad news. Investors, who have been very wary of Thailand in the last couple of years, will be even more cautious – whatever Yingluck says.

However, predictions of military intervention may be too pessimistic. Yingluck (who has an MPA from Kentucky State, and who used to run one of her brother's telecom companies) has apparently negotiated a deal with top military leaders. Known as the 'Brunei Declaration', this pledges no return to Thailand for Thaksin and no intervention by the generals.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

Today's US jobs data came as a blow to the dollar – which fell against most major currencies, though it did strengthen against commodity currencies (eg the Australian and Canadian dollars), which are vulnerable to a global downturn because of their

dependence on raw material exports. Prior to that, however, it had been a pretty good week for the US dollar.

Last week, the dollar was off sharply. Through Friday, it had fallen 2.2% against the euro, 0.5% against sterling and 0.6% against the Japanese yen. This week, it recovered – at least until the employment data. Through early trading on Friday, the dollar was up 1.2% against the euro, 0.5% against sterling, and 0.6% against the yen. It was also up against the Swiss franc, albeit only by 0.1%.

However, today's payrolls data hit the dollar hard. In the course of a few minutes, it fell:

- from US $1.4305/€ to US $1.4329;
- from US $1.5969/GBP to US $1.6065;
- from Y81.35/US $ to Y80.59; and
- from SF 0.849/US $ to SF 0.839.

However, as noted, commodity currencies have also been hit. The Australian dollar fell from A$0.928/US $ to A$0.932 and the Canadian dollar fell from Can $0.959/US $ to Can $0.963.

Meanwhile, gold's rise has resumed. At the close last Friday, it was trading at US $1,488/oz – a six-week low. By the close yesterday, it had recovered to US $1,530, and it is currently trading at US $1,543-20 up 3.7% for the week. Gold's rise undoubtedly reflects concern over the direction of US monetary policy and its impact on the dollar. In the second quarter as a whole, the dollar fell 2.4% against the euro and a massive 8.6% against the Swiss franc. The markets are clearly not convinced that Bernanke has the dollar's interests at heart.

V OIL

The unexpectedly weak US employment data has rather knocked the stuffing out of oil markets – particularly out of WTI.

Prior to the announcement, WTI for August delivery was trading at US $98.53 a barrel – up US $3.59 (or 3.8%) since the close last Friday. Since WTI had risen 4.1% the previous week, that was a rise of almost 8% in 10 days. However, WTI has now fallen back to US $96.85 a barrel – still up 2% for the week, but well down on earlier highs. Brent has also fallen back. Last week, it rose 6.3% to US $111.77 a barrel. Prior to today's employment announcement, it was trading at US $117.62 – up another 5.2%. Now, it has fallen back to US $117.34.

That means the spread in favour of Brent has widened again. At the close last Friday, it was around US $16.83; by this morning, it had widened to US $19.39. Now, it is US $20.49 – reflecting both the problems in Europe associated with the cut-off of Libyan oil and the sudden weakness of the US economy.

What is significant is how little lasting impact the 60 million barrel drawdown that the IEA announced a couple of weeks ago has had. Even with today's drop in prices, the market is pretty much back where it was when the drawdown was announced – which has caused many analysts to query whether it was the right strategy. One problem may well be technical. While some countries (eg the US) have actually been selling the oil, others (including the UK) have sought to achieve the same impact by permitting oil companies to run down stocks. That may look like the same thing, but it sends a very different message to the market.

What else is affecting the market? One factor is (as always) the level of US inventories. In the latest week, total crude inventories fell 889,000 barrels, with stocks at Cushing, OK down 460,000. That has to be bullish for prices. In addition, Goldman Sachs has

(yet again) issued new forecasts. It now expects the price of Brent six months from now to be around US $120; 12 months from now, it should be US $130.

Longer term, Japan appears determined to go 'nuclear-free' – closing its last nuclear plant by next May. If that is the case, there will be no alternative but to increase oil/gas imports from the West.

VI BANKING

The focus this week has been on Europe.

The first issue has been the stress tests that European banks and insurance companies have been conducting. The bank tests have (controversially) been delayed, allegedly for 'technical' reasons, and will not be released until next week. However, the insurance tests were published. Generally, the results seem fairly benign; out of 129 insurance groups that were tested, only 13 breached the Minimum Capital Requirement that they are required to hold. However, it is worth noting that the MCR is well below the Solvency Capital Requirement that insurers will be required to hold under Solvency II.

The other issue relates to an interview that EU Competition Commissioner Almunia (who had the Economics portfolio in the last Commission) gave to the *FT*. In his view, the main problems that Europe faces in the financial field are:

- that it has too many banks;
- that it lacks an integrated payments system; and
- that it does not have enough super-scale cross-border banks that can compete with US and Chinese institutions.

It seems that Almunia's comments run directly counter to the current work of the Basel Committee, which is setting supplemental capital charges for so-called SIFIs to reflect the greater damage that they can do if they get in trouble.

VII NEXT WEEK

It is a big week in the US for economic releases. In addition to the latest FOMC minutes, the markets will be watching for:

- the trade deficit for May (likely to be around US $40 billion);
- retail sales for June;
- the CPI and PPI for June; and
- industrial production for June.

In addition, as noted, there is an important 'Summit' at the White House this Sunday, and Fed Chairman Bernanke will testify to the House Financial Services Committee on Wednesday on monetary policy.

In Europe, there is (yet another) meeting of eurozone Finance Ministers on Monday to discuss Greece. The ECB also publishes its *Monthly Bulletin* next week. Among the key economic releases that are due, markets will focus on:

- inflation data for all major EU members;
- French industrial production; and
- UK unemployment.

Key releases in Japan include:

- consumer confidence in June; and
- industrial production for May.

The BoJ will also publish its *Monthly Economic Report* next week.

China also releases its second quarter GDP data on Friday.

Regards,
GISE