Eurobank Research
GLOBAL ECONOMIC & MARKET OUTLOOK
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Main Macro Views and Market Strategy:

- The global expansion has broadened and matured further, in line with our expectations three months ago. Looking forward, we expect the global economy to remain on a sustainable recovery path, with emerging markets to remain the leaders of global growth.

- In the US, we expect a slowdown in economic growth in mid-year, as the effect of fiscal stimulus and inventory rebuilding start to fade, and a rebound towards the end of the year.

- In the Euro area, fiscal consolidation in South European countries will impede the revival of growth prospects in the region as a whole. We expect a bumpy and weak recovery ahead, with considerable divergence in economic growth between core and peripheral members.

- In our view, the major downside risk to our global growth outlook is that the sovereign crisis spreads to the rest of south European countries, with significant contagion into the UK and the US, eroding confidence in equity and credit markets and resulting in a renewed bout of global risk aversion.

- While uncertainty remains regarding the impact of fiscal austerity on economic growth of peripheral euro area countries, we believe there is room for growth provided that key structural reforms are carried out in order to increase competitiveness and turn economic activity towards exports, which are currently offering the brightest growth potential.

- As market pressures for fiscal consolidation are mounting, monetary policy is expected to remain accommodative in order to counter-balance the negative impact of fiscal retrenchment on the economic recovery. In the longer term, we expect central banks to tolerate above-average inflation, in order to support the expansion and help improve fiscal positions.

Macro Forecasts

Real GDP growth						
	2008	2009	2010f		2011f	
			Eurobank EFG	Consensus	Eurobank EFG	Consensus
US	0.4	-2.4	3.2	3.2 (2.1 – 4.1)	3.4	3.1 (0.7 – 5.2)
EA	0.6	-4.1	1.0	1.1 (0.5 – 1.7)	1.8	1.4 (1.0 – 2.1)
Japan	-0.7	-5.2	1.7	2.1 (1.2 – 4.0)	1.9	1.9 (0.7 – 2.3)
China	9.6	8.7	10.0	10.1 (8.8 – 11.0)	9.5	9.3 (8.0 – 10.0)
India	7.5	6.5	8.0	8.4 (8.2 – 8.6)	8.5	8.5 (8.2 – 8.7)
Russia	5.6	-7.9	4.5	4.1 (2.9 – 6.2)	5.0	4.2 (2.7 – 6.0)
Brazil	5.2	-0.2	6.5	5.3 (4.5 – 7.5)	4.5	4.3 (3.0 – 5.8)

Inflation						
			2010f		2011f	
	2008	2009	Eurobank EFG	Consensus	Eurobank EFG	Consensus
US	3.8	-0.4	2.4	2.1 (1.0 – 3.4)	2.5	1.9 (0.3 – 5.3)
EA	3.3	0.3	1.2	1.4 (1.1 – 1.8)	1.5	1.6 (0.8 – 2.1)
Japan	1.4	-1.4	-0.7	-1.2 (-1.4 – -0.6)	-0.5	-0.4 (-1.0 – -0.1)
China	5.9	-0.7	3.5	3.4 (2.5 – 5.1)	3.5	3.5 (2.5 – 4.0)
India (WPI)	8.4	2.2	7.0	7.5 (7.0 – 8.1)	5.5	5.9 (5.5 – 6.3)
Russia	14.1	11.7	6.5	6.9 (6.4 – 8.9)	7.5	8.5 (6.0 – 10.3)
Brazil	5.7	4.9	5.3	4.8 (4.0 – 5.7)	4.8	4.6 (4.3 – 5.5)

Note: Range of forecasts by Bloomberg's survey in parentheses below point estimates.

Policy Rates						
			Eurobank EFG			
	2009	Current	Q2 10f	Q3 10f	Q4 10f	Dec 11f
US	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	1.25
EA	1.00	1.00	1.00	1.00	1.00	1.50
Japan	0.10	0.10	0.10	0.10	0.10	0.10
China	5.31	5.31	5.31	5.85	6.12	6.66
India	4.75	5.25	5.50	5.75	6.25	7.50
Russia	8.75	8.00	7.75	7.50	7.50	7.50
Brazil	8.75	9.50	10.00	10.75	11.25	12.50

Table of contents

Executive Summary

The global expansion has broadened and matured further, in line with our expectations three months ago. Global growth has rebounded strongly since the middle of 2009, financial sector healing has continued and global equity markets have rebounded sharply over the past 13 months. Looking forward, we expect the global economy to remain on a sustainable recovery path, with emerging markets remaining the leaders of global growth, as domestic demand has proved particularly resilient during the crisis, labour market conditions are improving and exports have bounced back due to the strong rebound of global trade.

In the US, the rebound of economic growth since mid-2009 was due to fiscal stimulus and inventory rebuilding. We believe that these forces will fade significantly in H2 2010 and expect a slowdown in economic growth in mid-year, and a rebound towards the end of the year. Regarding inflation, there is still a large amount of spare capacity and labor market slack, pushing core inflation further down.

In the Euro area, most major countries have emerged from recession in Q1 2010, after having stalled in Q4 09. Fiscal consolidation in South European countries will impede the revival of growth prospects in the Euro area as a whole. Hence, we expect a bumpy and weak recovery ahead. Most of the growth is expected to be export-led, with considerable diverging recoveries between core Euro area countries and peripheral members.

In our view, the major downside risk to our global growth outlook is that the sovereign crisis in south European countries escalates further to a global sovereign credit crisis. However, we believe that this risk is limited. Having experienced from the Lehman episode, European policymakers are determined to support the economies which are under stress. Indeed, the announcement of the €750bn EU-IMF financial stability fund along with the decision of the ECB to buy government debt in the secondary market has already led to a normalization of government spreads.

Given that both monetary and fiscal policy are currently super-loose and bond markets push for fiscal restraint, we believe that monetary policy will remain accommodative to allow governments to tighten fiscal policy, without jeopardising the economic recovery. In our view, central banks in G3 will tolerate above-average inflation at a time of fiscal tightening, in order to support the expansion and help improve fiscal positions.

Dimitris Malliaropulos
Research Advisor

I. Global Outlook

Dimitris Malliaropulos, Maria Prandeka, Olga Kosma, Vasilis Zarkos

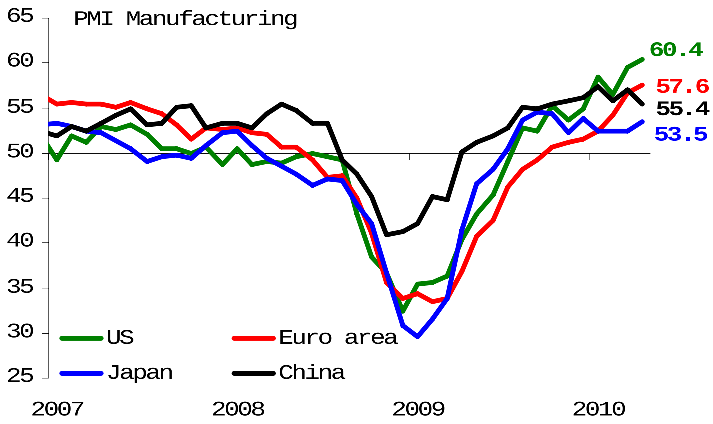
Global economy: a broad-based and sustainable recovery

The global expansion has broadened and matured further, in line with our expectations three months ago. Global growth has rebounded strongly since the middle of 2009, financial sector healing has continued and global equity markets have rebounded sharply over the past 13 months. Leading indicators of economic activity continue to show substantial gains. Surveys of manufacturing and business activity, tentatively confirm the substantial improvement, with the US ISM manufacturing index registering in April its strongest reading since June 2004 (Figure 1). Our global leading indicator[1], which is designed to capture turning points in economic activity, approximately three months in advance, predicts further gains in industrial production recovery (Figure 2). Indeed, global industrial production has already recovered almost half of its cumulative loss from mid-2008. The Chinese economy continued to be the main driver of global growth, with industrial production up 18% y-o-y and imports having recovered fully from their through, providing a significant boost to global growth. The rest of Asia has benefited from Chinese growth, in particular Japan, where industrial production has increased more than 30% y-o-y. The strength of the Chinese recovery appears to have removed all available slack and the economy is beginning to show signs of overheating, putting upward pressure to inflation. We expect growth in Asia to ease back in the coming quarters, as China's monetary tightening takes hold and the renmibi appreciates gradually.

Looking forward, we expect the global economy to remain on a sustainable recovery path. Our projections include a significant acceleration of global GDP growth to 4% y-o-y in 2010 from -0.6% y-o-y in 2009, as a synchronised rebound of economic activity has already magnified itself, leading to multiplier effects through global trade linkages. The considerable improvement in global growth and manufacturing activity has already fed through to global trade that has increased by a total of 15% on a monthly basis since June 2009. Indeed, as we have already stated in our previous issue (February 2010), world export growth will accelerate to an annual growth rate of 10% by 2011, from a contraction of 10.5% in 2009. We expect emerging markets to remain the leaders of global growth, as domestic demand has proved particularly resilient during the crisis, labor market conditions are improving and exports have bounced back due to the strong rebound of global trade.

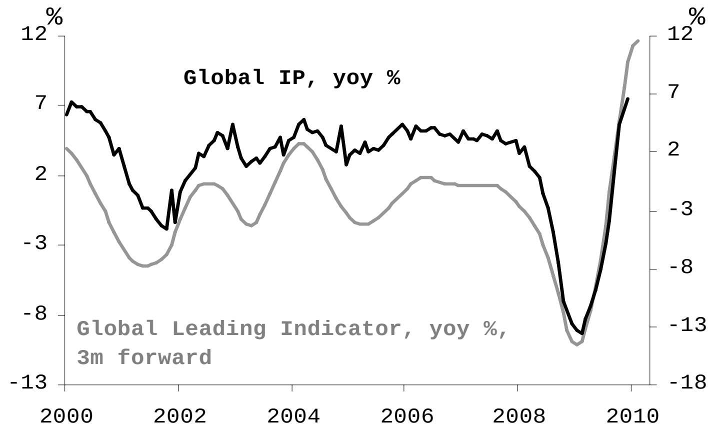
[1] Our global leading indicator is a GDP-weighted average of the OECD Composite Leading Indicators (CLIs) for both developed and developing economies.

Figure 1



Source: Bloomberg, Ecowin

Figure 2



Source: OECD, Eurobank EFG estimates

In the US, a sustainable recovery is in place with labor market conditions improving significantly in recent months and personal consumption rebounding strongly in the past two quarters. It is true that to a large part, the rebound of economic growth since mid-2009 was due to fiscal stimulus and inventory rebuilding. We believe that these forces will fade significantly in H2 2010 and expect to see a slowdown in economic growth in mid-year, before it rebounds, probably in Q4 (U-shaped pattern of growth). Regarding inflation, there is still a large amount of spare capacity and labor market slack, pushing core inflation further down. This factor, coupled with the risk of contagion from Eurozone sovereign stress to the US, reinforce the view that the Fed will not raise interest rates until 2011.

In our view, there are three main risk factors to our US outlook:

i) Private demand may not be able to match fading effect of fiscal stimulus and inventory rebuilding, resulting in a marked slowdown in growth,

ii) as the effect of temporary Census hiring vanishes, a sudden reversal of payroll gains may take place,

iii) should sovereign debt problems in Europe cross the Atlantic, the soaring US debt could potentially become an urgent issue for the economy and, as the Greek experience has already shown, this would have strong repercussions in markets, sentiment and consumption.

Euro area: plagued by fiscal crisis

In the Euro area, most major countries have emerged from recession in Q1 2010, after having stalled in Q4 09. Fiscal consolidation in South European countries will impede the revival of growth prospects in the Euro area as a whole. Hence, we expect a bumpy and weak recovery ahead and we downgraded our 2010 GDP growth forecasts to 1% (from 1.4%). Most of the growth is expected to be export-led, on the back of higher external demand and euro weakening due to sovereign sustainability concerns. The latter, along with the recent sovereign volatility, imply considerable diverging recoveries between core Euro area countries and peripheral members. First, not all countries in the region are equally benefiting from trade activity, due to a highly-differentiated degree of openness among individual member states.

Second, fiscal consolidation in periphery countries is expected to be sharper compared to the rest Euro area countries, thus leading to rising unemployment and, consequently, weighing on private consumption.

In our view, there are three main risks to our Euro area growth outlook:

(a) *Contagion of the Greek crisis may increase the potential for a "coordination failure,* i.e. core Euro area countries (mainly Germany but also France) and the ECB may not be willing to be as expansionary as periphery countries (such as Greece, Portugal, Spain, Italy and Ireland) need to avoid a long and painful adjustment. We believe that this risk is limited in the short term, due to the significant rescue package announced by the EU and the IMF. The €750bn Stability Mechanism is more than enough to cover the financing needs of Greece, Spain, Portugal and Ireland for the next three years.

(b) *Speculative attacks on sovereign debt of periphery countries become self-fulfilling.* Back in the ERM crisis of 1992-93, markets had put bets that the ERM would break down. Markets won this bet as Germany was not willing to support the pound sterling, which was devalued and eventually pushed out of the ERM. Can history repeat itself? We believe no, as the current situation is quite different compared to 1992: i) The cost of exit for a country from the euro is enormous, making it unlikely that a country such as Greece, Portugal or Spain will leave the Euro area, ii) the ECB has crossed the red line and announced that it will be buying government bonds in order to ensure depth and liquidity in the government bond market, iii) the bailout package for Greece has been followed by the introduction of a Stability Mechanism, iv) the ECB has lots of ammunition to use, if needed, to defend the euro (extra liquidity operations, further easing of collateral standards). All these factors make it, in our view, less likely that market attacks on the debt of weak Euro area countries will become self-fulfilling.

(c) *Bank liquidity crisis.* The widening of the sovereign crisis may turn into a bank liquidity crisis. We believe that this risk is limited, as the ECB is determined to provide unlimited liquidity and act as a lender of last resort.

Massive financial force along with super accommodative ECB policy have led to a normalization of government spreads, while they have diminished the risk of speculative attacks on sovereign debt becoming self-fulfilling. The €750bn mechanism is expected to allow debt burdened countries to buy time in order to implement required fiscal adjustments, while tighter fiscal surveillance is expected to restore investors' confidence.

While the EU package and the ECB intervention alleviates fears for a generalized liquidity and banking crisis, concerns remain regarding the extent to which euro area countries will succeed in turning their debt dynamics to a sustainable path. Given that financial aid is dependent on strict conditionalities, downside risks for peripheral members arise from the austerity of the fiscal retrenchment, which, along with the absence of the option of currency devaluation, may eventually strangle the economy. However, we believe that there is room for growth, provided that decisive measures are taken to improve the entrepreneurial framework, attract foreign investment capital, provide a stable tax system, increase the efficiency of the tax collection mechanism and ease labor market conditions. Key reforms in the aforementioned fields may lay the foundations for sustainable growth by improving the private sector's confidence, and turning the economic activity towards exports, which are currently offering the brightest growth potential

Monetary policy to remain loose for long

Overall, we expect monetary policy in the world economy to remain loose for an extended period of time (with the exception of China). In the policy rates front, the Fed is expected to keep interest rates near historical lows for at least the rest of the year, in order to ensure that the economy will settle back to a more sustainable path. Thereafter, the Fed will probably not embark on a large-scale tightening right away, so as to avoid any adverse effects by a likely market overreaction. In addition, the ECB is expected to keep the policy rate at current levels until at least mid-2011. Given that both monetary and fiscal policy are currently super-loose and bond markets push for fiscal restraint, we believe that major central banks will provide liquidity to allow governments to tighten fiscal policy, without jeopardising the economic recovery. This is particularly true in the Euro area, where the Greek debt crisis and the risk of contagion will lead to a general fiscal tightening in Europe with adverse effects on economic growth. In our view, central banks in G3 will tolerate above-average inflation at a time of fiscal tightening, in order to support the expansion and help improve fiscal positions. In other words, moderate inflation is welcome for governments since it inflates away part of the debt and helps improve fiscal deficits as a fraction of GDP.

II. Global Economic Outlook

1. The US economy

Dimitris Malliaropulos, Olga Kosma

- Real economic activity increased by a solid 3% q-o-q saar in Q1 2010, mainly supported by the temporary factors of supportive fiscal policy and the turn in the inventory cycle.
- The recovery in consumer spending will continue, although we expect to see some slowdown in H2 2010, as the fiscal impulse fades.
- The contribution from the supportive fiscal policy and the inventory rebuilding seems to have peaked in Q4 2009. Hence, real economic activity in the US will likely recede to a lower trajectory in mid-year, with a U-shaped pattern in quarterly GDP growth rates.
- Positive gains in employment should support wage income and, consequently, consumption expenditures, sustaining the broader economic recovery once the temporary factors of supportive fiscal policy and the turn in the inventory cycle are phased out.
- Low unit labor costs, restrained bank lending, high rental vacancies and low levels of capacity utilization will put a lid on price pressures, thus constraining both headline and core inflation.
- Benign inflation trends and the financial turmoil to delay further the normalization of monetary policy in the US. We expect the Fed not to raise the fed funds target rate until 2011.

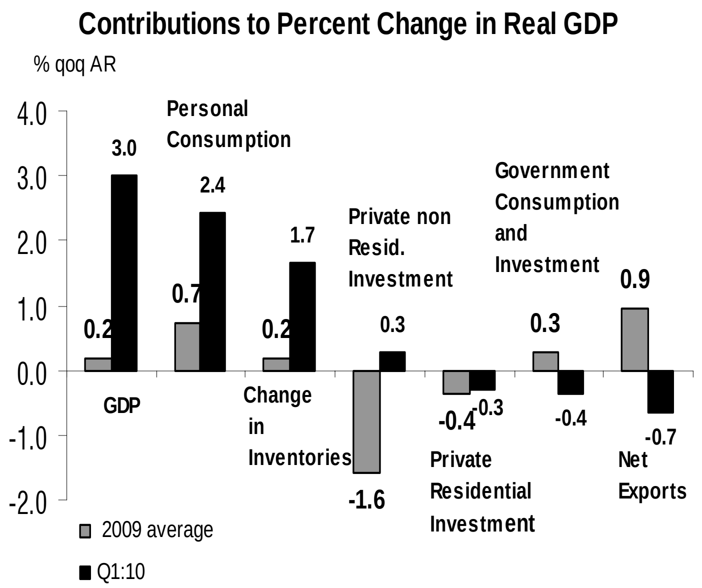
Solid growth in Q1 2010, as the fiscal impulse is still supporting the US economy

According to the advance GDP estimate released by the US Bureau of Economic Analysis (BEA), real economic activity showed solid growth for the third consecutive quarter, with GDP increasing 3% q-o-q saar in Q1 2010 (Figure 1.1). The cyclical components of GDP supported growth, with inventories increasing for the first time since Q1 2008. Real consumer spending accelerated in the first quarter of the year, contributing 2.4% to quarterly GDP growth. The climb in consumption was driven by a drop in the households' savings rate to 3.1% from 3.9% in the preceding two quarters. Consumption expenditures on a level basis have returned to the pre-crisis level thanks to the fiscal stimulus and the significant recovery in household wealth, stemming from rising house prices and large gains in the stock market in the second half of 2009.

Non-residential fixed investment increased significantly for a second quarter in a row (+3.1% q-o-q saar), as business spending in equipment and software more than offset another sharp decline in structures, increasing by 12.7% q-o-q saar, after a 19% surge in the previous quarter. On the backdrop of improving business activity, the significant gains in the latest durable goods orders (particularly, computers, metals and machinery) suggest that momentum in capital expenditures will likely pick up in Q2 2010.

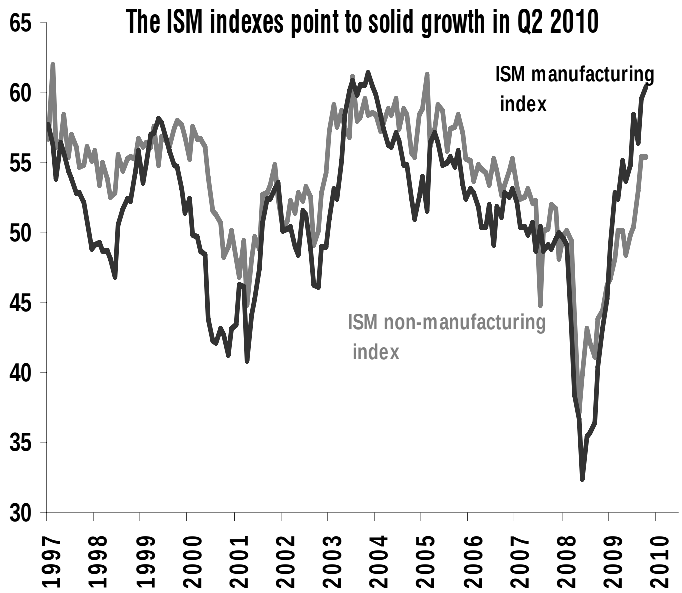
Meanwhile, the incoming economic data point to strong GDP growth in the second quarter of the year, as the April employment report showed further improvement in the labor marker conditions and the ISM readings both in the manufacturing and in the services sectors are consistent with solid growth. In particular, the ISM manufacturing index improved further from 59.6 in March to 60.4 in April, reporting its highest reading for almost 6 years. In addition, the ISM services index remained perfectly unchanged in April, at 55.4, hitting its highest reading since May 2006 (Figure 1.2).

Figure 1.1



Source: Bureau of Economic Analysis (BEA), Eurobank EFG estimates

Figure 1.2



Source: Bloomberg

Growth to slow in H2 2010, as the fiscal impulse and the inventory accumulation fade

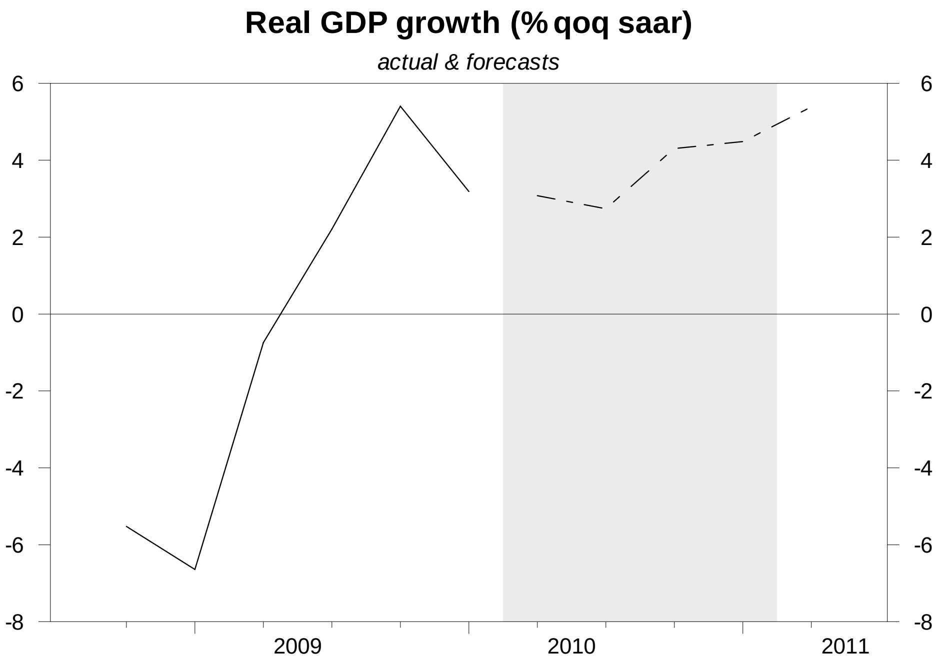
Although the US consumer has rebounded sharply in early 2010, the question remains whether the strength is sustainable, as it was actually the result of a fall in the savings rate and not the result of an improvement in income from wages, salaries and assets. Robust household consumption is still benefiting from substantial fiscal support, so we expect to see some slowdown in the second half of this year, as the fiscal impulse fades. Besides, retail sales in April, in combination with the set back in auto sales, point to a moderation in real consumer spending in the coming quarters. Our model projections include a significant slowdown of real consumption growth from 1.2% q-o-q in H1 2010 to 0.3% in H2 2010.

To a large part, the rebound of economic growth since mid-2009 was due to fiscal stimulus, as well as inventory rebuilding. A slower pace of inventory destocking contributed positively to real GDP growth in Q3 and Q4 2009. The inventory depletion over the last couple of years paved the way for inventory restocking in Q1 2010. However, the contribution from the fiscal impulse and the inventory rebuilding seems to have peaked in Q4 2009. Although these forces continued to support growth in Q1 2010 and will probably continue doing so in Q2 2010, we believe that these forces will fade significantly in H2 2010.

Moreover, the housing market is expected to recede to a more muted growth pace after the impact of the tax credit program has faded by the end of April (June for existing homes). Both existing and new home sales spiked in March 2010, as buyers rushed to take benefit from the expiring tax relief. An anticipated strong home sales April report, along with recent healthy gains in building permits and improved sentiment among home builders, suggest a considerable positive contribution of residential construction to Q2 GDP growth. However, harsh weather conditions have delayed house purchases, whereas the tax benefit has brought forward future demand, implying increased volatility and moderate activity in the housing sector in the second half of the year. On the positive side for home builders is the stabilization of house prices, high housing affordability, improving labor conditions and stable mortgage lending rates despite the completion of the Fed's MBS purchase program. On the other hand, the housing market will likely be experiencing trouble in gaining momentum in H2 2010, due to high vacancy rates and muted demand on the backdrop of deleveraging households and high unemployment. Meanwhile, foreclosures are expected to affect adversely house prices and keep offering better bargains on existing homes, thus restraining construction activity.

The expected consumption growth deceleration, coupled with a smaller contribution from the rate of change in inventories to real GDP growth, a moderate activity in the housing sector and the recent dollar appreciation which will probably act as a drag on US exports, will probably weigh on economic growth in H2 2010. Hence, we expect to see a U-shaped pattern in quarterly GDP growth of the US economy, with annualized growth rates of about 3% in Q2, 2.7% in Q3 and 4.3% in Q4 2010 (Figure 1.3).

Figure 1.3

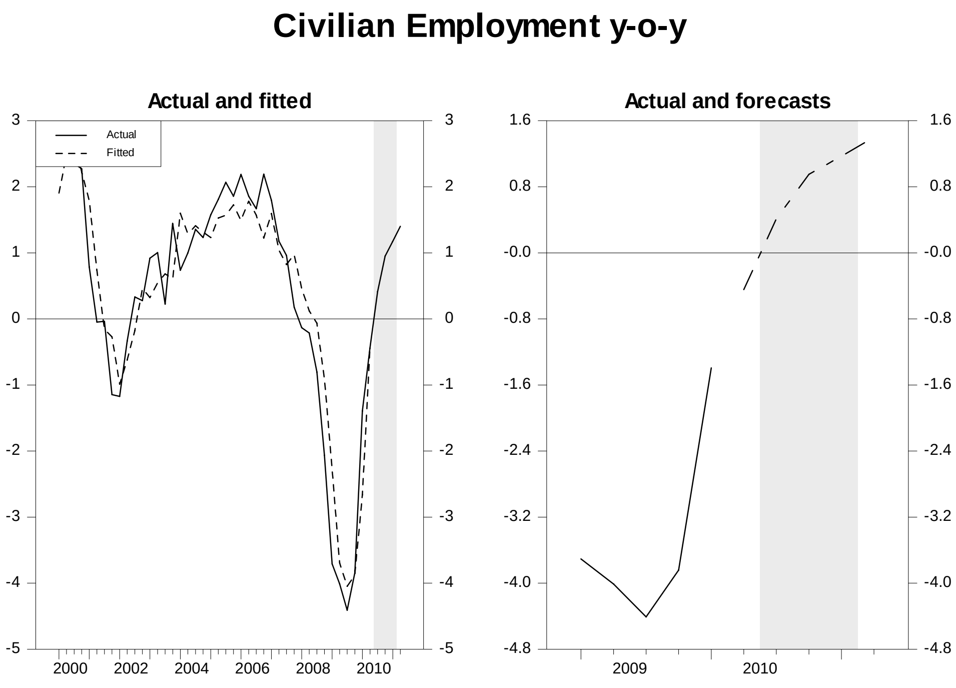


Source: Eurobank EFG estimates

Positive gains in employment should support labor income, partly offsetting the negative effect from the fiscal impulse fade-out

The recovery is finally showing up in the labor market conditions, with nonfarm payrolls rising by 290k in April. The latest US employment report was very encouraging, with a total of 80% of the job gains occurring in the private sector rather than in the federal government sector. The surge in private employment for a second consecutive month points to a generalized labor market recovery, not just as a result of the federal government's hiring of temporary Census workers. The signs for employment in the manufacturing sector continue to improve, as the ISM's Employment Index registered its fifth consecutive month of growth. Given that productivity growth is expected to normalize to lower levels, firms need to hire new employees in order to meet increasing demand. Job creation is also expected to gain momentum thanks to government hiring for census purposes in the coming couple of months. Government initiatives of tax relief for new hires are expected to add to job growth, while more job packages are likely to follow in view of the mid–term elections. Our job market model suggests that as the economic rebound gathers pace, monthly payroll gains will lead to a positive employment growth on a y-o-y basis in the second half of the year (Figure 1.4).

Figure 1.4



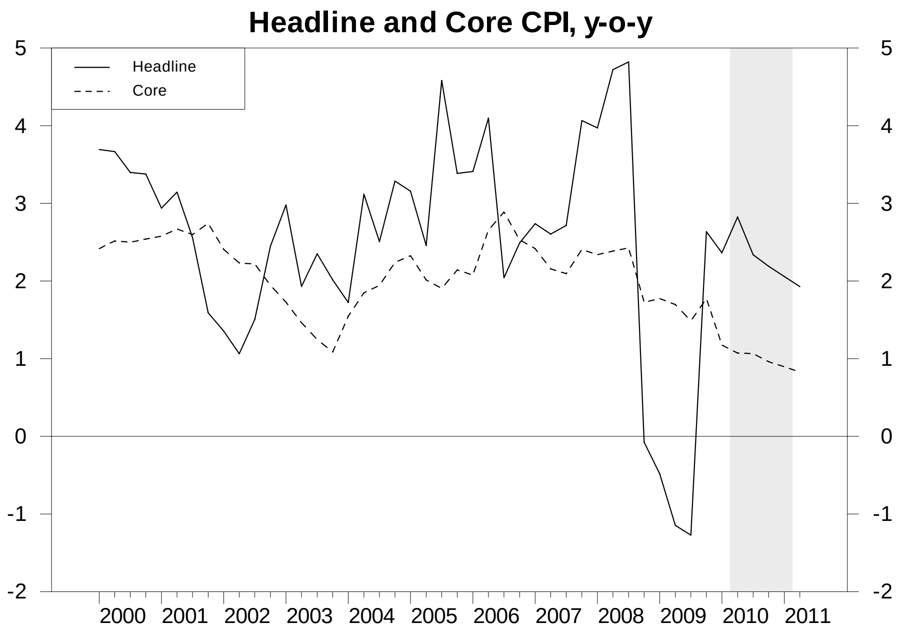
Source: Eurobank EFG estimates

Although the unemployment rate edged up to 9.9% from a stable 9.7% for the first 3 months of the year, the increase actually reflected the rise in the size of the labor force (+805k). As labor conditions improve and people get back to job hunting, the labor force will be increasing, adding to the high level of unemployment. Therefore, the unemployment rate is expected to remain elevated for an extended period of time, with a year average of about 10% in 2010. There is a large number of part time workers for economic reasons who will first turn to full time status before firms start hiring new employees. Sectoral reallocation of workers is also expected to keep unemployment high, as the depth of the recent downturn destroyed permanently jobs in sectors such as the financial and information business.

Further downward pressure on core prices due to a large amount of spare capacity and labor market slack

Headline CPI fell for the first time in the past thirteen months, by 0.1% m-o-m in April, following a 0.1% gain in March 2010. On an annual basis, headline inflation edged down marginally, to 2.2% in April from 2.3% in the previous month. The decline in headline CPI in April was mainly driven by a 1.4% m-o-m decline in the energy index, due to lower prices for gasoline and natural gas. Core consumer prices remained flat in April on a monthly basis for a third consecutive month, with the annual rate decreasing to the 44-year low of 0.9%. Looking ahead, various key determining factors will support the ongoing downward trend in core consumer price inflation, including notably the labor market slack and a large amount of spare capacity. In particular, high vacancy rates in the housing sector continue to suppress rents. Meanwhile, the index for owners equivalent rent has a very large weighting in core CPI (over 40%), driving core inflation further South in the coming months. We expect headline CPI inflation to come in at around 2.4% in 2010, while core inflation will continue moving downwards in 2010, averaging at about 1% y-o-y (Figure 1.5).

Figure 1.5



Source: Eurobank EFG estimates

Benign inflation trends and the financial turmoil to delay further the normalization of monetary policy in the US

The FOMC decided at its April 28 meeting to keep its fed funds rate target unchanged at 0-0.25%. The minutes of the meeting revealed that “low rates of resource utilization, subdued inflation trends and stable inflation expectations are likely to warrant exceptionally low levels of the federal funds rate for an extended period”. Meanwhile the recent turmoil in the markets is likely to delay further policy normalization, as a fed funds rate increase would require stabilization in financial markets. We believe that the Fed will remove more cautiously its accommodative monetary policy than otherwise because of the risk of greater contagion. Meanwhile, we expect the Fed to be reluctant to raise its target rate until there are clear signs of a sustained recovery in the US labor market i.e. the unemployment rate is falling. Given our forecast for a prolonged period of high unemployment in 2010, our Taylor rule model suggests that the first rate hike will not occur before Q1 2011.

2. The Euro area economy

Dimitris Malliaropulos, Vasilis Zarkos

- We expect moderate economic growth in the Euro Area, led by exports-oriented core euro area countries, on the backdrop of a weak euro and rising demand from emerging countries.
- Diversifications in the recovery trajectories of euro area members are expected, as debt burdened peripheral countries will experience severe reduction in domestic demand due to front loaded fiscal adjustments.
- A large EU-IMF package combined with ECB initiatives have alleviated fears for a generalized liquidity and banking crisis, thus lowering the risk of speculative attacks on sovereign debt becoming self-fulfilling.
- Markets now focus on the implementation of fiscal measures and their impact on growth performance.
- Inflation in the euro area is expected to remain subdued due to moderate growth and fiscal retrenchment in the periphery. We do not anticipate any policy rate hike by the ECB until the second half of 2011.

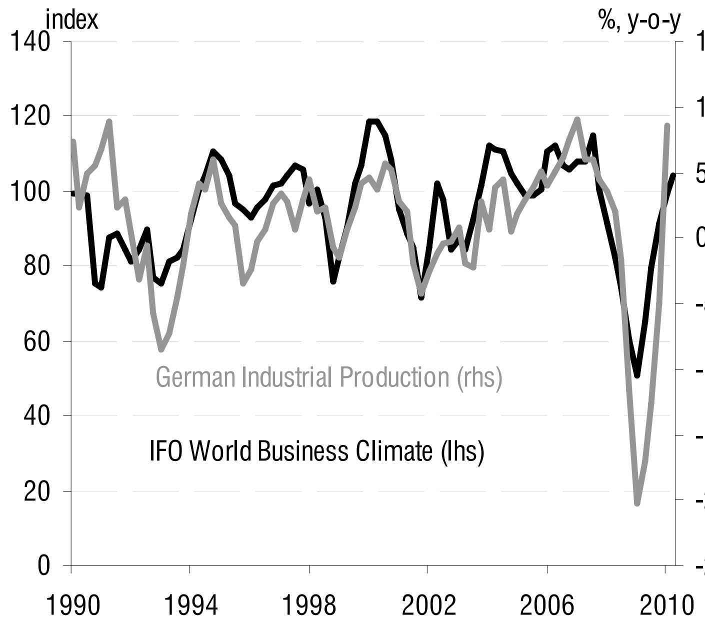
After a halt at the end of the previous year, the euro area economy grew by 0.2% q-o-q in the first quarter of 2010, slightly above consensus. Exports have been the main driver of economic rebound, with Germany being the locomotive of euro area growth. On the backdrop of resurgent export activity, euro zone industrial production is rising above consensus, showing the dynamism of the euro area economy. Increasing PMI manufacturing indices reflect increasing production in order to meet export orders. While leading indicators in several countries slowed slightly in May due to financial turmoil in April, the euro zone composite PMI penciled increases in both manufacturing and services sectors. The composite PMI new orders index climbed to its highest value since August 2007. Meanwhile, the German economic recovery is picking up momentum (Figure 2.1). The IFO business climate index jumped to a two-year high in March, while the survey posts improving future business conditions as well. Recent figures about German factory orders, industrial production and retail sales have beaten expectations, while the unemployment rate fell to 7.8% in April, posting the largest drop since January 2008. As a result of increasing industrial activity, German domestic demand in Q1 posted its first positive growth since the first quarter of 2008. In France, manufacturing production growth returned to positive territory in the first quarter while the services sector surprised on the upside in May.

World trade is expected to further stimulate the euro zone recovery for the following reasons. Increasing exports to emerging markets suggests that European exporters will benefit from developing countries, which are leading the global recovery (Figure 2.2). The revival of the US consumer will also add to export orders for European businesses. European firms' competitiveness is rising on the backdrop of a weak euro, which has already declined by almost 15% against the US dollar since the beginning of the year, with prospects of further depreciation. Moreover, a likely Chinese Yuan appreciation will add to the competitiveness of European goods. Finally, on the positive side for euro area manufactures, the strong US dollar and a possible slowdown in Chinese growth due to monetary tightening will likely keep increases in commodity prices moderate, thus putting a lid on production costs.

Construction will be another driver of the economy in the near term. The worst winter in the last fourteen years curbed construction in Q1. However, a sharp decline in construction by 7.2% in February was followed by a vigorous rise by

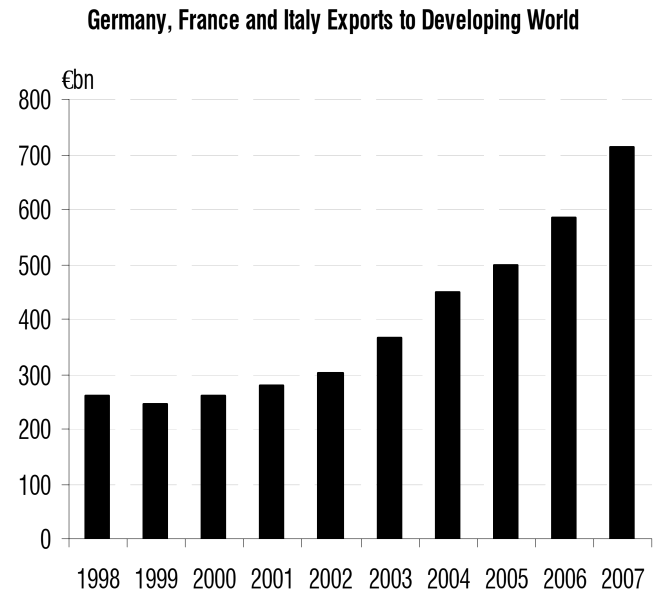
7.6% on a monthly basis in March, while further gains are expected in the next quarters. Germany led the way by posting an impressive 26.7% increase in construction activity.

Figure 2.1



Source: Ecowin, Bloomberg

Figure 2.2



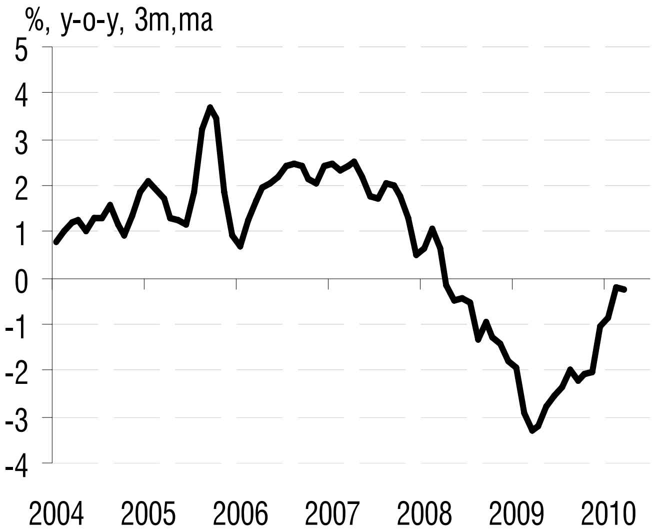
Source: Ecowin

On the backdrop of increasing construction and manufacturing activity along with improved weather conditions, we expect an increase in consumption expenditures in core countries. Euro zone retail sales have stabilized on a y-o-y basis (Figure 2.3). On the positive side for the euro area consumer, fiscal adjustments will be mild in countries which do not face urgent financing strains. Fiscal stance in Germany remains expansionary in 2010, with tax cuts and infrastructure spending totaling 3% of GDP. Meanwhile, employment seems to be close to a turning point (Figure 2.4), as job creation in core large economies is anticipated to outpace job losses due to fiscal woes in the periphery. Yet, we expect private consumption growth to remain relatively weak, as real income of households will most likely remain adversely affected by high unemployment (almost 10% in Q1 2010) and low wages.

While export-led countries of central Europe are expected to benefit from rising global demand for goods and services, debt burdened peripheral countries, whose growth model was based primarily on consumption (Figure 2.5), are expected to post sluggish or even negative growth due to fiscal consolidation programs. Domestic demand is expected to contract substantially in peripheral countries, which need to bring their fiscal deficits back to a sustainable level. Deprived from monetary policy tools, Spain and Portugal have followed Greece in adopting strict front loaded fiscal adjustment programs. As a result of market pressures, wage cuts, tax hikes and public spending reductions have been put forward in order to improve their financials and increase their competitiveness.

Figure 2.3

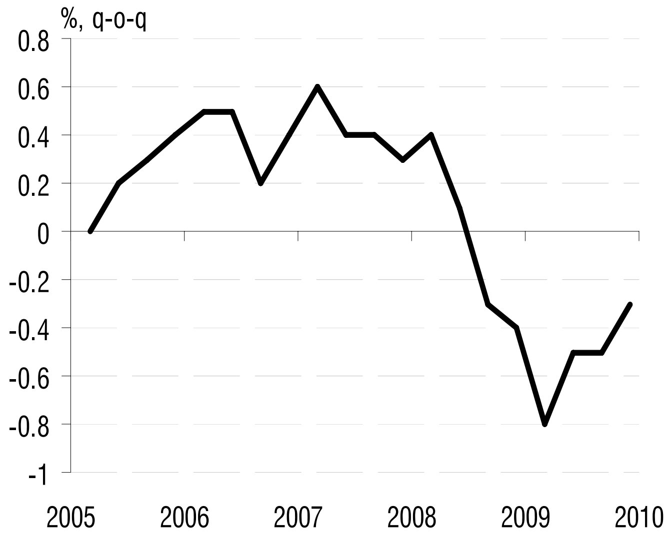
Euro Area Retail Sales



Source: Bloomberg

Figure 2.4

Euro Area Employment



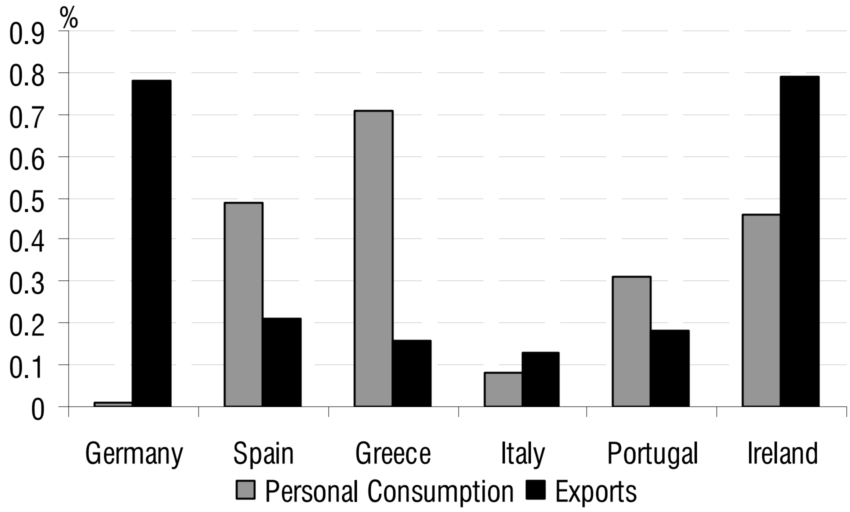
Source: Bloomberg

In consequence of different economic standpoints, we expect considerable divergence in output growth across the members of the euro area in the following years. Each country's economic growth trajectory is closely related to the size of the adjustments of domestic imbalances it needs to perform. Overall, we expect that improving fundamentals in core euro area countries will overwhelm economic slowdown due to fiscal burdens in peripheral members, suggesting a stronger pace of overall output growth in the following quarters. Yet, the recovery pace will remain moderate, substantially below that of the US.

The major headwinds against euro area recovery come from a generalized sovereign debt crisis in the peripheral countries. Investors are extremely concerned about the ability of countries which run large deficits to reign over their financial situation. Moreover, concerns about the banking sector recovery have risen, as a sovereign crisis would pull down the banking system as well. A large EU-IMF package of €110bn to Greece provided only temporary relief, as it did not prove enough to prevent a spill over of the debt crisis from Greece to southern Europe countries. Signs of a global contagion became evident in April when costs of borrowing for southern European countries started climbing (Figure 2.6), inter-bank lending rates soared and risky assets sold off.

Figure 2.5

Median Contribution to GDP from Q2:01 to Q2:08



Source: ECB

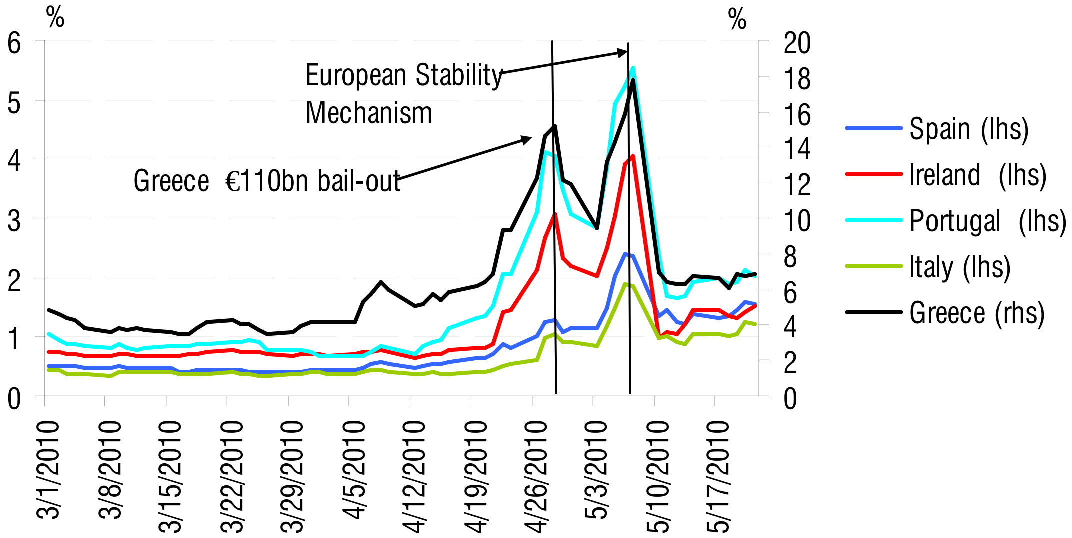
After a prolonged period of hesitation, the Euro area authorities surprised on the upside by agreeing, along with the IMF, on an enormous fiscal aid package (Stability Mechanism) for countries facing challenges in meeting their financing needs. The package consists of €60bn allocated by the European Commission, €440bn guaranteed by euro area members and at least €220bn allocated by the IMF. This totals to €750bn, which is more than enough to cover the financing needs of Greece, Spain, Portugal and Ireland for the next three years. This package is in addition to the €110bn package for the Greece bail-out.

As the stability of the euro got under serious threat, the ECB has crossed the red line by announcing its intention to conduct interventions in the euro area public and private debt securities markets in order to ensure depth and liquidity in these markets. The ECB had previously announced that it would continue to accept as collateral assets in the BBB credit rating area throughout 2010, while it will accept Greek government bonds as collateral despite their poor credit rating. Given that inflation will not be a concern in the near term due to moderate growth and reduced domestic demand in the peripheral countries, the ECB policy rate is expected to remain unchanged until the second half of 2011, while there are risks of further rate cuts. Moreover, the ECB will inject liquidity to the euro area banking system as it decided:

- to adopt a fixed-rate tender procedure with full allotment in the regular 3-month longer-term refinancing operations (LTRO) to be allotted on 26 May and on 30 June 2010,
- to conduct a 6-month LTRO with full allotment on 12 May 2010, at a rate which will be fixed at the average minimum bid rate of the main refinancing operations (MROs) over the life of this operation,
- to reactivate the temporary liquidity swap lines with the Federal Reserve, by conducting operations at terms of 7 and 84 days with full allotment

Figure 2.6

2 year Government Spreads to Bund



Source: Bloomberg

Massive financial force along with super accommodative ECB policy have led to a normalization of government spreads (Figure 2.6), while they have diminished the risk of speculative attacks on sovereign debt becoming self-fulfilling. The €750bn mechanism is expected to allow debt burdened countries to buy time in order to implement required fiscal adjustments, while tighter fiscal surveillance is expected to restore investors' confidence. The ECB's low policy rate is on the positive side for peripheral countries, while the weak euro enhances their competitiveness.

While the EU package and the ECB intervention alleviates fears for a generalized liquidity and banking crisis, concerns remain regarding the extent to which Euro area countries will adjust their public finances. Countries themselves are responsible for turning their debt dynamics to a sustainable path and getting their houses in order. Given that the financial aid is dependent on strict conditionalities, downside risks for peripheral members arise from the austerity of the fiscal retrenchment, which, along with the absence of the option of currency devaluation, may eventually strangle the economy. However, we believe that there is room for growth, provided that decisive measures are taken to improve the entrepreneurial framework, attract foreign investment capital, provide a stable tax system, increase the efficiency of the tax collection mechanism and ease labor market conditions. Key reforms in the aforementioned fields may lay the foundations for sustainable growth by improving the private sector's confidence and turning the economic activity towards exports, which are currently offering the brightest growth potential.

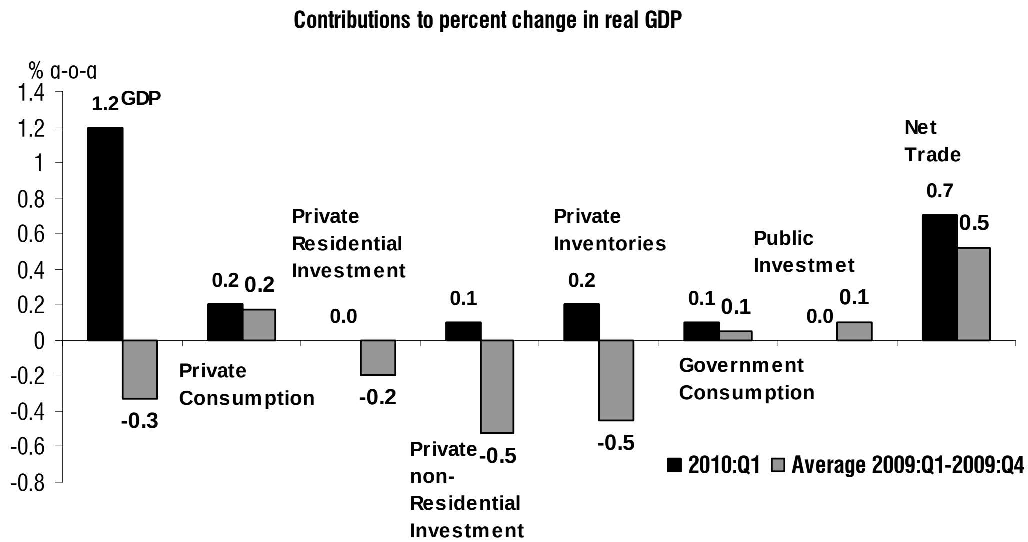
3. The Japanese economy

Dimitris Malliaropulos, Vasilis Zarkos

- The Japanese economy grew by 4.9% annualized in Q1 2010, mainly due to exports on the backdrop of strong demand from emerging economies.
- Recent figures reveal signs of a broadening recovery as benefits from export activity are spilling over to several economic sectors.
- However, we expect moderate growth as private consumption remains weak and the impact from exports and fiscal aid will eventually lose momentum.
- The Bank of Japan is expected to remain accommodative in order to curb deflation and prevent yen appreciation. We expect the Bank to maintain its policy rate unchanged at 0.10% until H2 2011.

The Japanese economy posted the fourth consecutive quarter of growth in Q1 at a rate of 1.2% q-o-q (Figure 3.1). More than one half of the output growth came from net exports. The global economic recovery has dragged Japan out of recession and is expected to further boost its economy in the quarters to come (Figure 3.2). Japan's main export partners, China and the US, are on a firm recovery track, suggesting continuing demand for goods, which is expected to further boost Japanese industrial production. Indeed, the March Tankan survey marks the fourth consecutive quarter of improving sentiment regarding business conditions. Prospects are even better for large manufacturers, who benefit more from external trade activity. Unlike the Japanese central bank, major central banks have already entered on exit paths. As a result, the yen is expected to depreciate further, which will likely favor Japanese exports. On the backdrop of increasing industrial production, we expect capital spending to support output growth. Moreover, we believe that a likely RMB appreciation will have a muted effect on Japanese exports as it will happen at a rather gradual pace.

Figure 3.1



Source: Cabinet Office

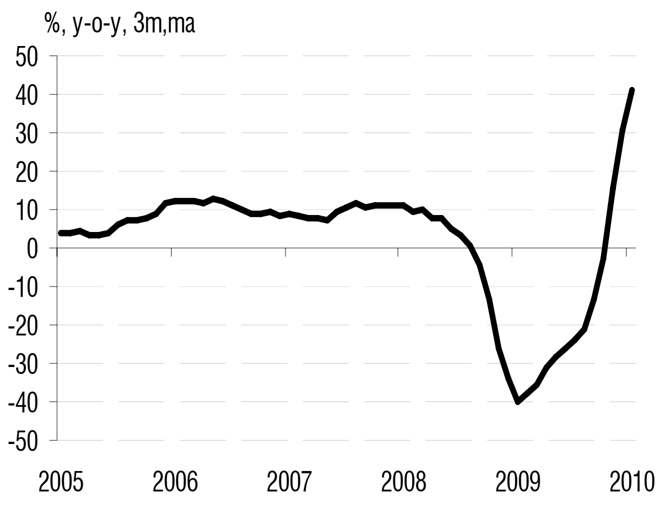
A deeper look at the GDP figures reveals signs of a broadening recovery as benefits from export activity are spilling over to several economic sectors. Residential investment growth returned to positive territory in Q1 after four quarters of decline, while capital expenditures penciled in their second consecutive increase, on the backdrop of industrial production resurgence (Figure 3.3). Moreover, private inventories had a positive contribution to GDP for the first time after a year, as their liquidation pace fell from ¥996bn in Q4 2009 to ¥22bn in Q1.

In line with recent GDP figures, signs of a broader recovery are emerging from the recent Tankan survey, as well. Business sentiment for large non-manufacturing firms has improved considerably, while conditions for small enterprises improved more than expected. Nevertheless, small firms are still burdened by the recent economic downturn as they have not gained much from the export led recovery, while they have constrained access to bank lending compared to large companies. Downside risks for future corporate profitability stem from the firms' reduced pricing power due to the deflationary environment at the same time that increasing commodity prices lift production cost.

As the recovery is spilling over to the non manufacturing sector, employment sentiment is improving. Both the Tankan and the Economy Watchers survey reveal rising optimism about labor conditions. Labor earnings rose for the first time after twenty two months in March. The jobs to applicants ratio has been inching higher for three months in a row, reaching 0.49. Even so, the ratio remains low and the unemployment rate, currently at 5% (Figure 3.4), is expected to remain elevated for an extended period of time as firms are reluctant to hire aggressively due to weak domestic demand.

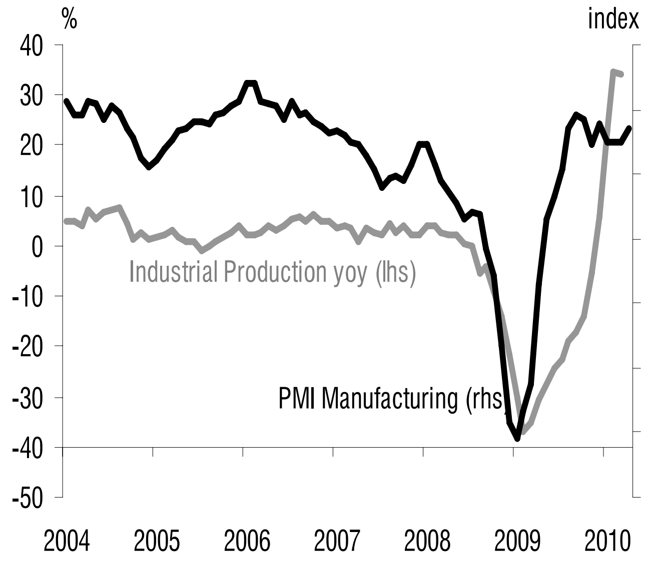
Figure 3.2

Real Exports



Source: Ecowin

Figure 3.3

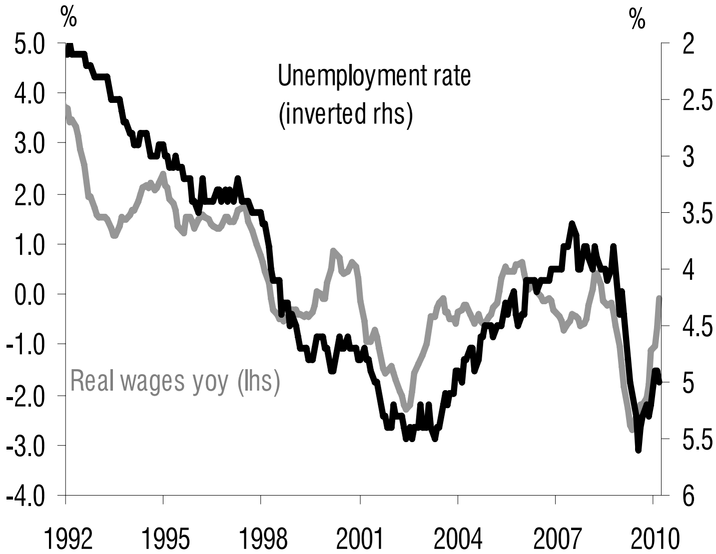


Source: Bloomberg

Household consumption contributed only about one fifth to GDP growth in the first quarter of 2010 and it is mainly supported by fiscal initiatives such as tax credits for eco friendly appliances and cars. While the impact of fiscal support on durable goods purchases is fading, personal consumption is expected to gain momentum as the childhood allowance program comes into effect in June. However, the Japanese economy is spooked by persistent concerns about whether personal spending can be sustainable when fiscal aid fades. In the medium term, weak private consumption points to moderate economic growth as fiscal aid and exports will eventually lose momentum. In the longer term, structural changes will be needed to tackle the issue of traditional low domestic demand, which renders the Japanese economy vulnerable to swings of global demand and deprives it from autonomous drivers.

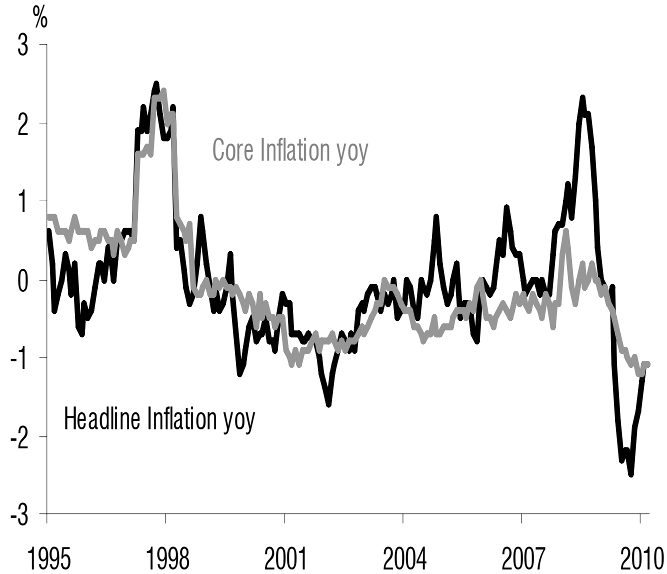
In view of persistent deflation (Figure 3.5) and government pressures on the Bank of Japan to fight deflation, the Bank doubled the funds supply program to 20tr yen, while it maintained its policy rate at 0.10%. Furthermore, the Bank of Japan announced a preliminary framework for more credit easing that will facilitate lending to firms. The initiative consists of re-financable loans to commercial banks against pooled collateral with duration of one year at the overnight call rate. In line with other major central banks, the Bank of Japan re-established a dollar liquidity swap arrangement with the U.S. Federal Reserve Bank. We expect the Bank to maintain its policy rate unchanged at 0.10% until H1 of 2011.

Figure 3.4



Source: Ecowin, Bloomberg

Figure 3.5



Source: Bloomberg

Downside risks for the Japanese economy stem from an escalation of the debt crisis in Europe. While exports to Europe represent a small share of total Japanese exports, loss of market confidence in sovereign debt could slow down global growth and trigger an appreciation of the yen due to risk aversion. Both developments would affect adversely Japanese exports. The Bank of Japan responded to a sharp yen appreciation in early May due to the debt crisis by injecting ¥2tn of overnight funds in inter bank funding markets. Going forward, should the yen appreciate in a sustainable manner, likely further steps the Bank could take would include more government bond purchases and extension of the duration of the funds supplied from currently three months to six.

4. Emerging Markets

Dimitris Malliaropulos, Maria Prandeka

- The global growth recovery is expected to continue to be fueled by emerging economies, where domestic demand remains resilient and export demand improves significantly.
- The major challenge to the Emerging Asia's upbeat growth outlook is inflationary pressures that have already started to mount, owing to rising food and commodity prices and accelerating credit growth.
- The sustainability of Emerging Europe's recovery has recently been put under question, due to the worsening outlook of the Euro area -its main trading partner.
- In Latin America, the recovery in economic activity continues to gain ground, on the back of strong domestic demand and favourable business and consumer confidence.

In an environment where advanced economies plummeted by 3.2%, emerging markets (EM) economies have managed to partly offset this decline, increasing by 2.4% in 2009. In fact, they are expected to remain the leaders of global growth, as domestic demand has proved particularly resilient during the crisis, labor market conditions are improving and exports have bounced back due to the strong rebound of global trade. According to our estimates, world export growth will accelerate to a y-o-y growth rate of 10% by 2011, from a contraction of 10.5% in 2009[2]. Indeed, although our BRICs leading indicator has eased slightly over the past two months, it continues to point to strong exports ahead (Figure 4.1).

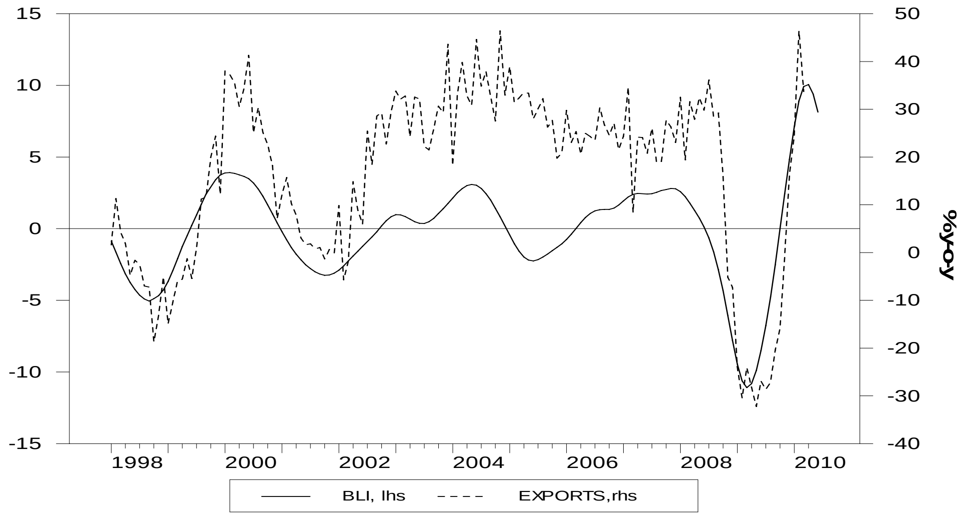
Although advanced economies account for the biggest fraction of global GDP in terms of purchasing power parity (53%), EM economies have increased significantly their share in global GDP since 2000 (from 37% to 46%), becoming gradually a major engine of the world economy. In fact, advanced economies' share in global GDP has declined through time (63% in 2000). According to the latest IMF forecasts[3], in 2010, emerging and developing economies will contribute 3.2% to global growth (measured in ppp), double the contribution of advanced economies (1.6%).

We continue to believe that the major challenge to the EMs' upbeat growth outlook is inflationary pressures, stemming mainly from rising commodity prices and the rebound in capital inflows, owing to a resurgence in risk appetite. Indeed, central banks of major emerging economies (such as Brazil and India) have already embarked on a tightening path, as pressures on consumer price inflation have intensified in these countries. As a result of inflationary pressures, we might see currency appreciation in EMs, particularly in countries such as China where exports have rebounded strongly, as it would help contain inflation and manage capital inflows.

As far as single regions are concerned, Emerging Asia is leading the recovery, due to aggressive monetary and fiscal policy easing. In Latin America economic activity continues to gain ground, on the back of strong domestic demand and favourable business and consumer confidence. Elsewhere, the sustainability of Emerging Europe's recovery has recently been put under question, due to the worsening outlook of the Euro area -its main trading partner.

[2] See our previous edition: Global Economic & Market Outlook, February 2010.
[3] IMF, World Economic Outlook, April 2010.

Figure 4.1
BRICs Leading Indicator*, % yoy

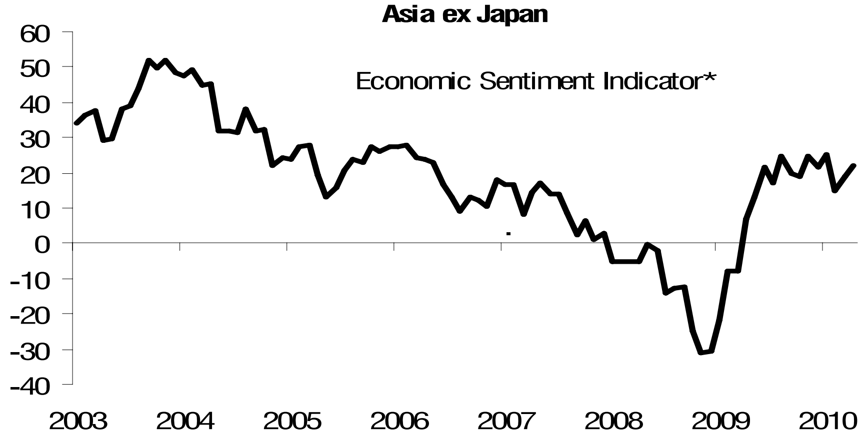


* 3 month forward
Source: Eurobank EFG

Emerging Asia

After having bounced back from the global downturn much more strongly than any others, emerging Asian economies' growth momentum remains particularly strong. Leading indicators suggest improving economic activity across the region, with the Asia ex Japan economic sentiment indicator being on an upward trend for more than a year (Figure 4.2). Real GDP growth across the region continued to gain ground in Q1 10, on the back of robust private consumption, large fiscal spending and surging exports. The most pronounced evidence of the v-shaped recovery in the region was witnessed in China, where real GDP growth accelerated to a two-year high of 11.9% y-o-y in Q1 10. Also, in Korea real GDP rose 1.8% q-o-q sa in Q1 10, compared to 0.2% q-o-q sa in Q4 09.

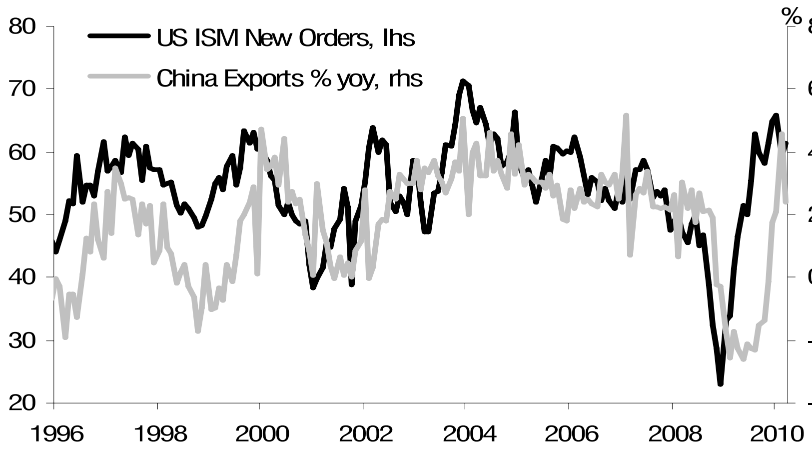
Figure 4.2



* The sentix sentiment indicator is a monthly survey among financial analysts and institutional investors about the expected economic situation.
Source: Ecowin

The strong rebound in exports of goods and services has continued in Q1 10 and hard data do not show any sign of a slowdown yet. In China, the PMI new export orders index rose for the twelfth consecutive month above the threshold of 50 in April (to 54.5), suggesting that the pace of exports revival should gain further momentum in the coming months. Indeed, the US ISM new orders index, which has increased significantly from its trough level in December 2008, reinforces this view (Figure 4.3). Strong exports will continue to underpin industrial activity, which is back at pre-crisis levels. Both trade and industrial activity were strongly supported by inventories restocking in Q1 10. Moreover, buoyant property market will continue to boost real estate investment –the key driver of private investment growth. In China, home prices in 70 major cities rebounded to an all-time high of 11.7% y-o-y in March. Additionally, the big share of infrastructure investment in the fiscal stimulus packages will underpin long-term growth prospects, as its effect is spread over several years. Given the revival in private domestic demand and improving labor markets, a sustained recovery in the region now seems more likely.

Figure 4.3



Source: Ecowin

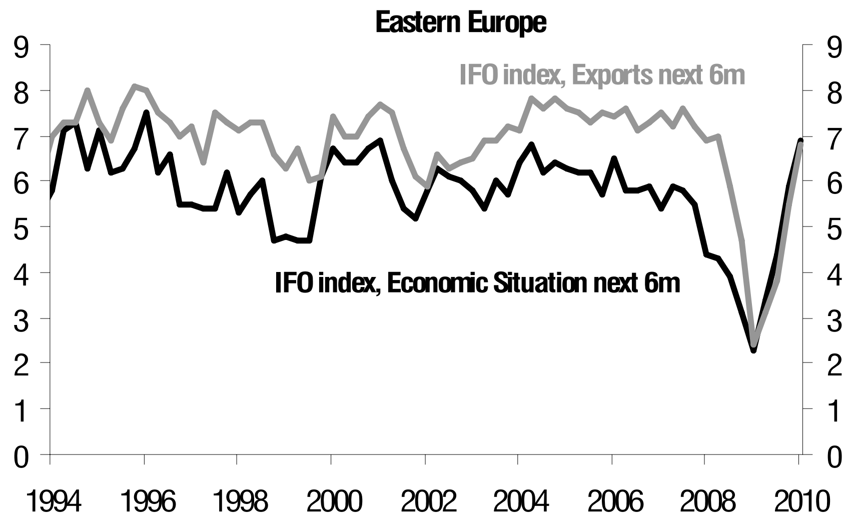
Nevertheless, the major challenge to the region's upbeat growth outlook is inflationary pressures that have already started to mount, owing to rising food and commodity prices and accelerating credit growth. In India WPI inflation (ex food) climbed to 9.9% y-o-y in March, forcing the Reserve Bank of India to follow China in tightening policy. The latter has raised the reserve requirement ratio by a total of 150 bps and has proceeded with a number of measures, such as raising mortgage rates, in order to curb lending. As a result of elevated inflation and record-low policy rates, real interest rates have started to turn negative across the region. Thus, we expect central banks in emerging Asia to start hiking policy rates in Q2 10. Moreover, we believe that currency appreciation will be a part of the central banks' efforts to control inflationary pressures.

Emerging Europe

Most economies in Emerging Europe have returned to positive growth, albeit the region continues to lag behind emerging Asia and Latin America in the recovery. Indeed, in Q1 10, both the Eastern Europe IFO economic situation index and the index for export volumes over the next six months rose above the 5-point-level that indicates expansion for the first time since Q3 08 (Figure 4.4). Manufacturing PMI indices across the region improved further in recent months, boosted mainly by an inventory rebound, and this has already shown in industrial production numbers. In Russia, for example, PMI rose for the fourth consecutive month above the threshold of 50, which indicates expansion, in April, while industrial production expanded by an average of 5.1% y-o-y in Q1 10, in contrast to a contraction of 10.7% in 2009.

Nevertheless, the sustainability of the region's recovery has recently been put under question. As we have already stated in our previous issue (February 2010), domestic demand in Emerging Europe will remain relatively subdue over the course of the year on account of several factors. To begin with, in some countries labor market conditions continue to be under stress, intensifying downside risks for consumer spending. Russian unemployment remains elevated, adding to the pressures faced by some economies in the region that are heavily dependent on Russia for remittances. Furthermore, in those countries with a fragile banking sector, constrains in bank credit are likely to continue. Meanwhile, sizeable deterioration in public finances, due to massive fiscal stimulus, suggests that there is little scope for further fiscal easing, impeding the recovery in the region. Consequently, the recovery in Emerging Europe would be mainly export driven. Therefore, the worsening outlook of the Euro area -its main trading partner- adds to the headwinds already weighing on the region's recovery process. As far as inflation is concerned, we believe that prospects for the region remain favorable, owing to excess spare capacity, currency strength and low wage growth.

Figure 4.4



Source: Ecowin

Latin America

Recent economic indicators suggest that the recovery in economic activity continues to gain ground, on the back of strong domestic demand and favourable business and consumer confidence. Indeed, the Latin America IFO economic expectations index has increased further in Q1 10, suggesting that LA's real GDP growth will gain further momentum for at least the second quarter of the year (Figure 4.5). This is largely supported by the strong recovery of Asian economies, particularly China, a key destination of LA's exports. In addition, the benign US growth outlook will also be beneficiary for the region. In line with the positive outlook for the region's export growth, which has been a key factor driving the recent improved growth performance, the Latin America IFO index for export volumes over the next six months has increased further in Q1 10 (Figure 4.6). Meanwhile, labor market conditions remain favorable, albeit they start to show some signs of growth moderation. In Brazil, the rate of unemployment has fallen significantly to 7.6% in March from its peak of 9% a year earlier, due to significant gains in employment. Indeed, net formal job creation reached 657k in Q1 10, while the total level for the whole 2009 was 995k net new jobs. Solid commodity prices will continue to contribute positively to growth in the region and support LA currencies.

Figure 4.5

Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Venezuela

Source: Eurobank EFG, Ecowin

We continue to believe that a key issue for the region will be widening current account deficits, as import growth is likely to outpace that of exports, mainly because domestic demand is expected to prove stronger than external demand. Nevertheless, strong capital inflows, due to increasing risk appetite, will finance the deficits, deterring balance of payments risks. At the monetary policy front, deteriorating inflation dynamics have prompted the Brazilian Central Bank (BCB) to initiate the tightening cycle in the region in an effort to re-anchor inflation expectations. Indeed, the BCB raised the selic rate by 75 basis points in April. The other countries in the region with inflation targeting regimes (Chile, Colombia, Mexico and Peru) will likely follow Brazil's steps in H2 10. All in all, we believe that central banks across the region will manage to keep inflation within its target levels. In our view, the major risk to LA's upbeat growth outlook is weaker than expected global growth prospects, given the region's dependence on external demand. Moreover, given the region's sensitivity to the commodity cycle, a negative surprise to commodity prices may weigh on the region's growth outlook.

Figure 4.6

Source: Ecowin

Special Issue: The small cap cycle

Dimitris Malliaropulos, Maria Prandeka

Over the past year small capitalization stocks recorded a significant outperformance relative to large capitalization stocks in the US. Measured by the Russell indices, small caps were up 108.6% since their March 2009 low, while large caps were up 75.8% over the same period. In addition, year-to-date, small stocks have advanced by 14.5%, whereas the Russell 1000 has risen by 5.6%. The crucial question is whether small caps will continue to outperform large caps. Looking back at the average performance of small versus large caps during four major bull markets in the S&P500, we found that the strategy's performance so far (12.6%, 15 months after the market trough) is roughly in line with the corresponding average of the previous bull markets (16%). However, the average overall out-performance of small caps was 27.9% and lasted on average 29 months (Table 1). Therefore, historical experience suggests that the Russell 2000 has some scope to rise further versus the Russell 1000.

Except for the historical experience, there are a number of reasons suggesting that small stocks may continue to outperform large stocks in the near term. First, small business surveys have started to show some signs of improvement in the sector. According to the April 2010 Fed Senior Loan Officer Survey, almost all domestic banks reported no change in their lending standards on commercial and industrial (C&I) loans to smaller firms, compared to a net balance of 42.3% of banks reporting tighter standards a year ago. Moreover, on the demand side, the ratio of banks reporting that demand for C&I loans from small businesses weakened further over the past three months has improved gradually to -9.3% from its bottom of -63.5% in Q2 09. As Figure 1 depicts, the above indicators of credit conditions in small businesses have not improved so far as sharp as they have deteriorated during the recession, suggesting that the recovery in the sector has further way to go.

Table 1
Relative performance between small and large cap stocks during four major bull markets

NBER US	Market Trough	Market Peak	Small vs Large Trough	Small vs Large Peak	Duration from trough to peak (months)	Relative Performance Small vs Large from trough to peak	Relative Performance Small vs Large 15 months after market trough
01/80 - 07/80	Feb-78	Nov-80	Dec-78	Nov-80	23	23.4%	
07/81 - 11/82	Jul-82	Aug-87	Aug-82	Jul-83	11	24.1%	14.8%
07/90 - 03/91	Oct-90	Aug-00	Oct-90	Feb-94	40	33.4%	21.8%
03/01 - 11/01	Sep-02	Oct-07	Oct-02	Mar-06	41	30.6%	11.3%
	Average				**29**	**27.9%**	**16.0%**
12/07 - ?	Feb-09	-	Feb-09	-	15*	12.6%*	12.6%

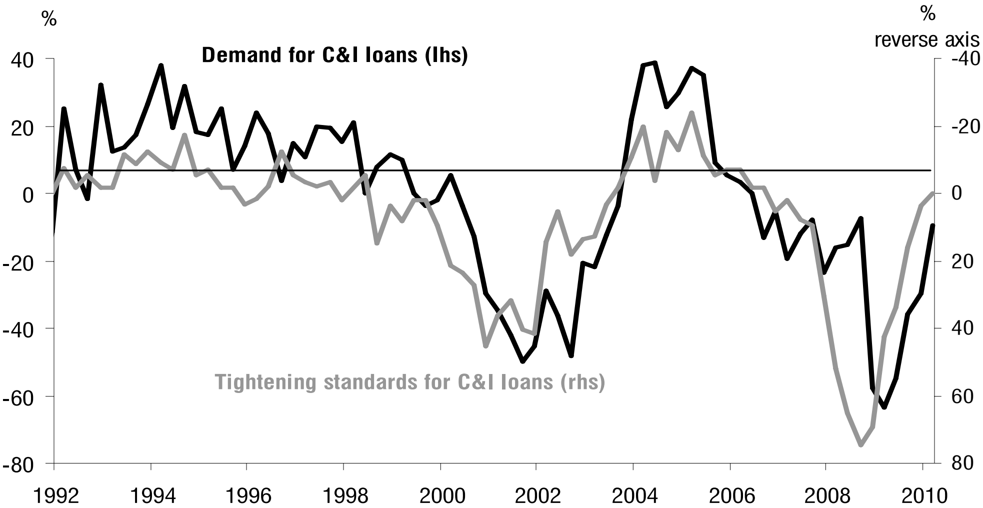
* From end-February 2009 to mid-May 2010

In the meantime, the National Federation of Independent Business (NFIB) survey reveals that, although conditions in small businesses remain weak in historical terms, they have improved somewhat in April. Indeed, the NFIB index of small business optimism expanded by 3.8 points to 90.6, surpassing the barrier of 90 for the first time in 18 months (Figure 2, left). According to the survey, trends in sales have started to show significant signs of improvement, as the net percentage of firms reporting higher nominal sales picked up to -15% from -25%, which is the best reading since September 2008 (Figure 2, right). Moreover, the net percentage of employers reporting increasing employment has improved by 13 points to -12% since its trough a year ago. Indeed, hiring plans are encouraging as an increasing percentage of firms reported higher earnings and plans to build up inventories (Figure 2, right). Another piece of somewhat encouraging news came from the ADP small business employment report, according to which private employment among small businesses increased by a total of 5,000 over the past couple of months, after 23 consecutive months of losses. Meanwhile, given that small businesses account for about 55% of jobs in the US, president Obama announced in his FY2011 budget a new fiscal stimulus proposal (the $18 billion "Jobs Bill") in order to promote job creation and support the flow of credit to small businesses.

Second, small companies tend to perform better during low interest rate environments, because the cost of borrowing is lower than during periods of rising interest rates. Indeed, we expect the Fed to keep interest rates near historical lows for at least the rest of the year, in order to ensure that the economy will settle back to a more sustainable path. Thereafter, the Fed will probably not embark on a large-scale tightening right away, so as to avoid any adverse effects by a likely market overreaction.

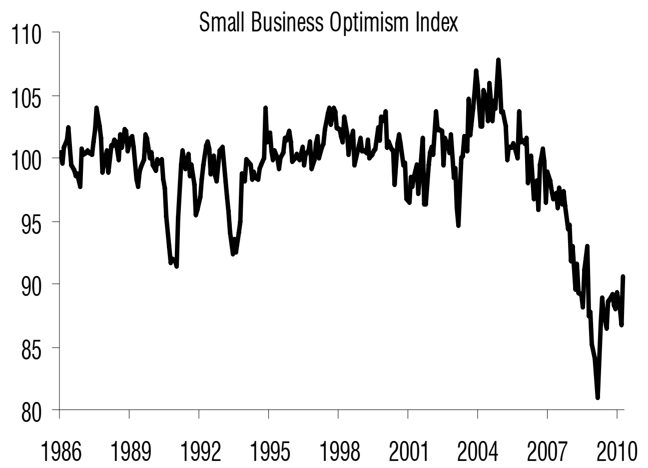
Third, small companies are more domestically dependent, in contrast to their larger peers which are more internationally focused. Thus, the out-performance of the US dollar against major currencies, particularly the EUR and the JPY, should hurt large companies as it will make their products more expensive overseas.

Figure 1
Fed Senior Loan Officer Survey, Small Businesses

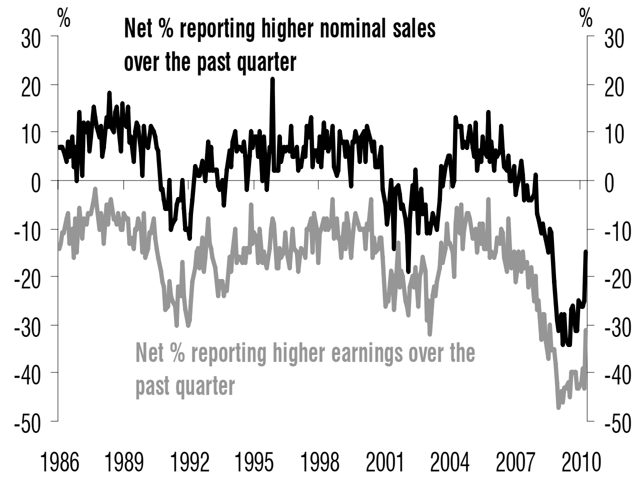


Source: Ecowin

Figure 2
Federation of Independent Business (NFIB) survey
Small Businesses



Source: Ecowin

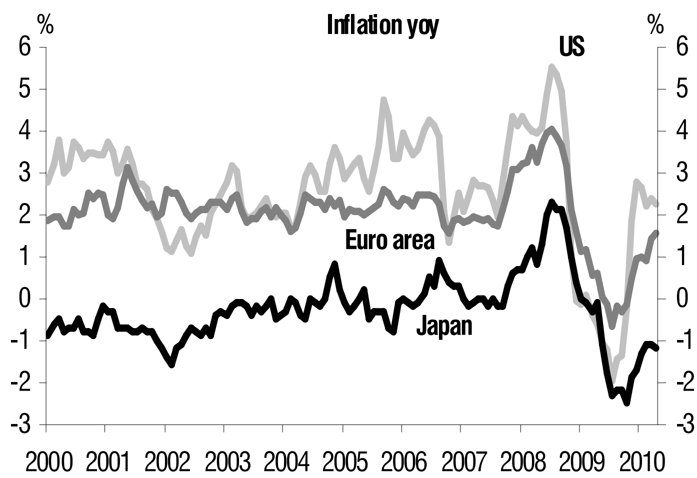


Source: Ecowin

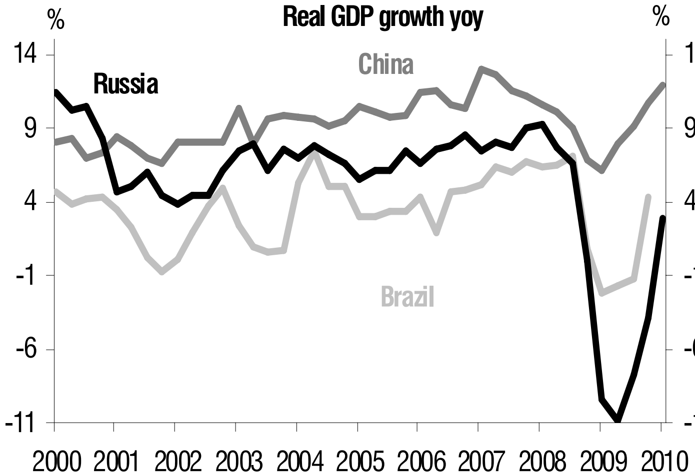
III. GRAPHS

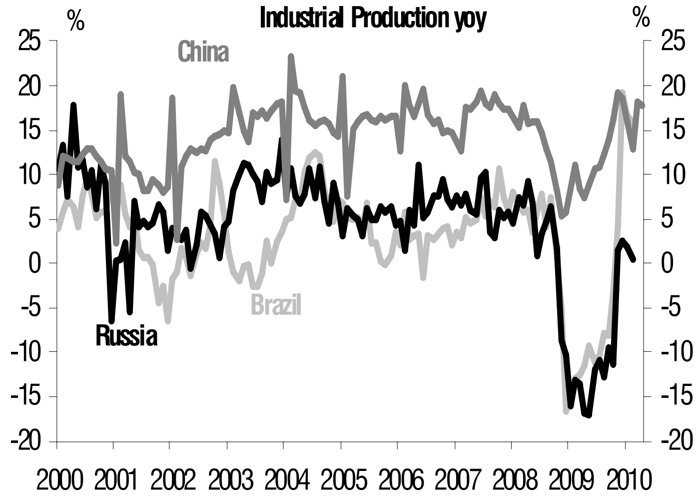
Global Economic Indicators

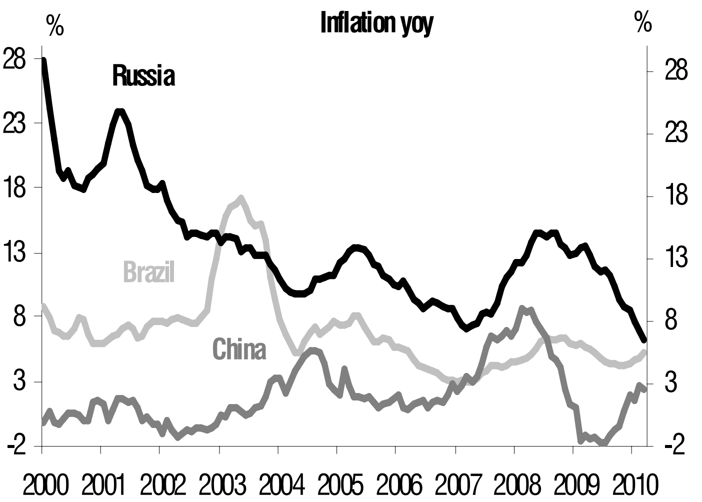
Advanced Economies



Emerging Economies



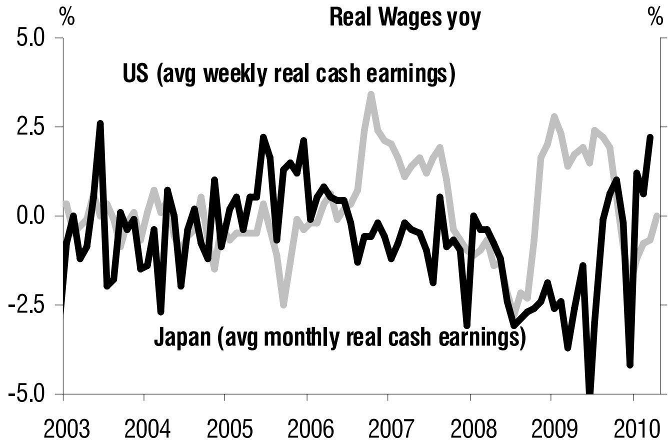




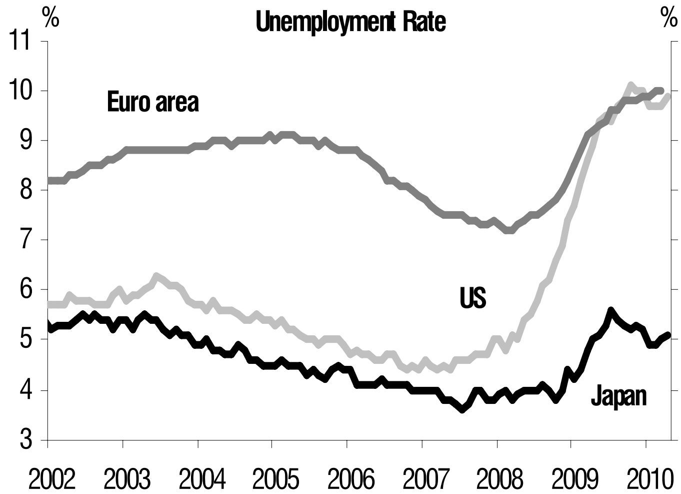
Source: Bloomberg, Ecowin

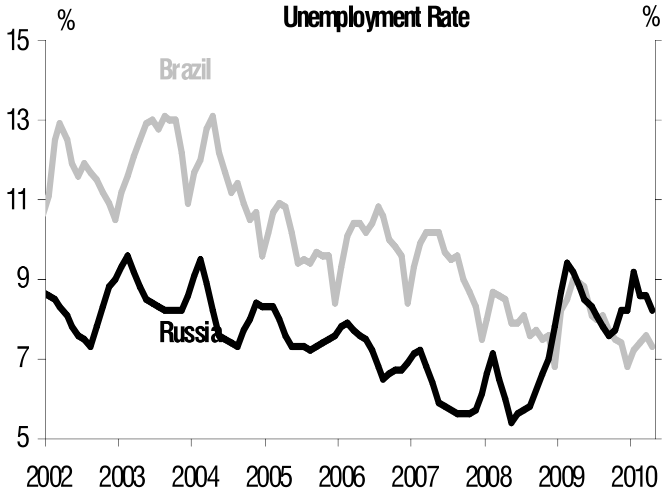
Global Economic Indicators

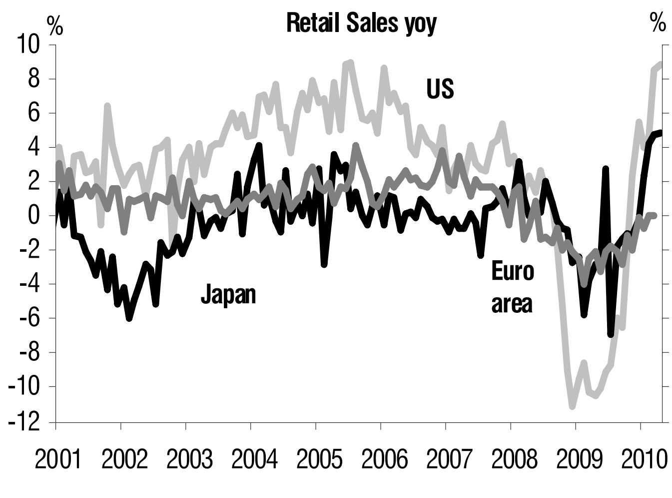
Advanced Economies



Emerging Economies



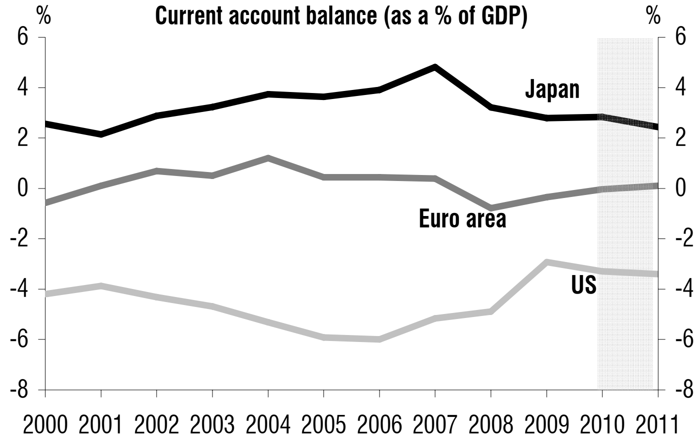


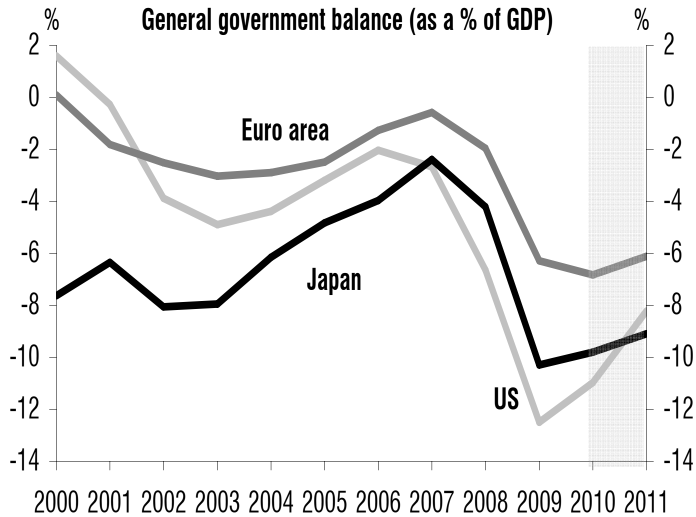


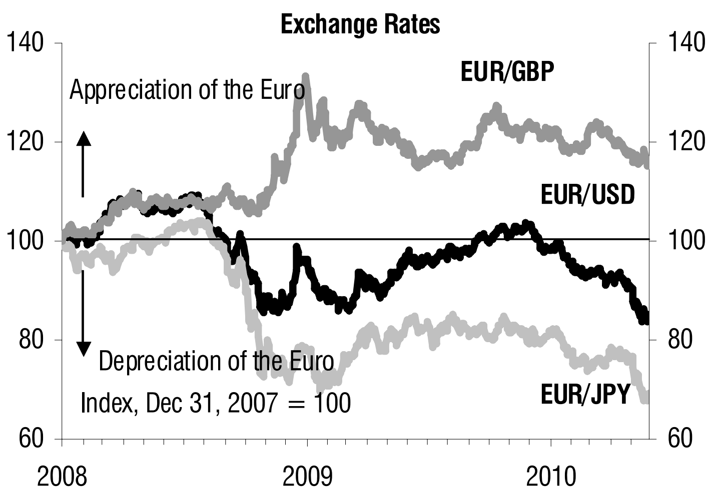
Source: Bloomberg, Ecowin

Global Economic Indicators

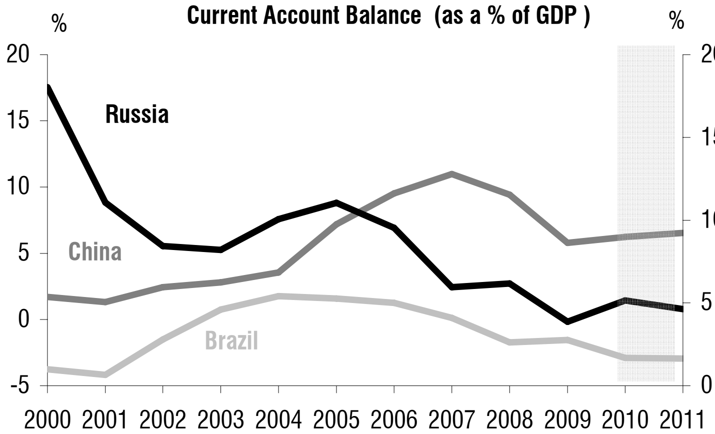
Advanced Economies

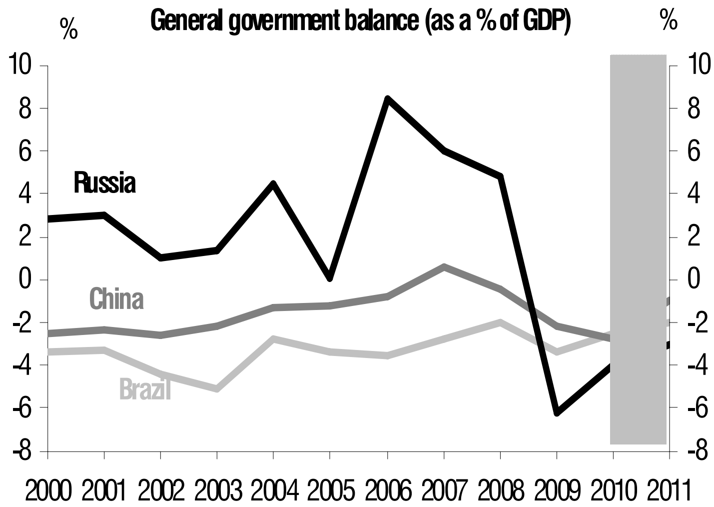


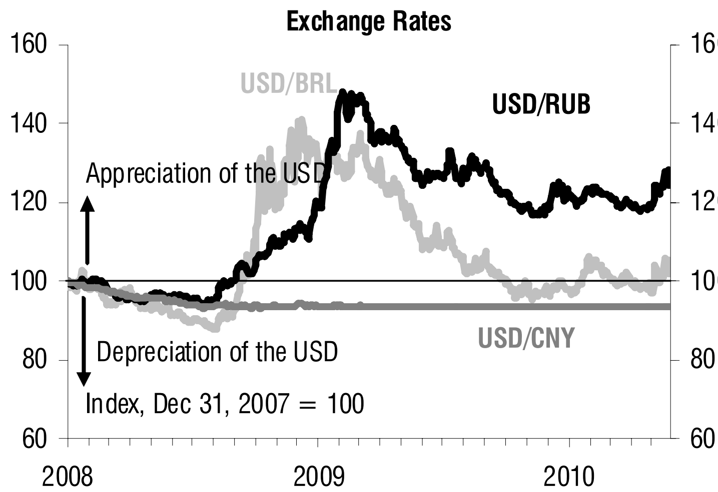




Emerging Economies

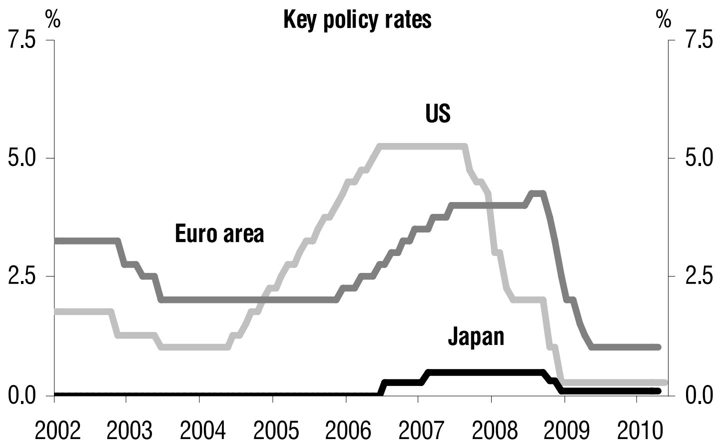


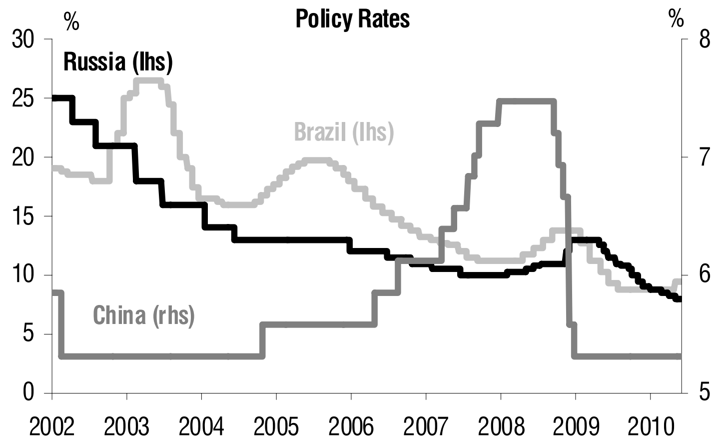




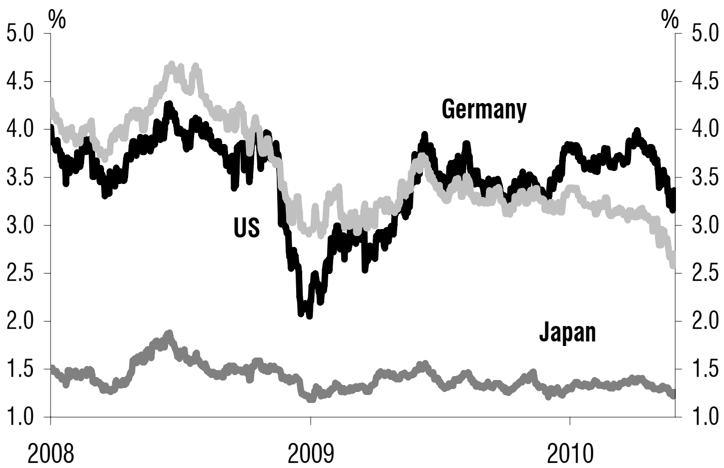
Source: Bloomberg, Ecowin, IMF

Global Economic Indicators

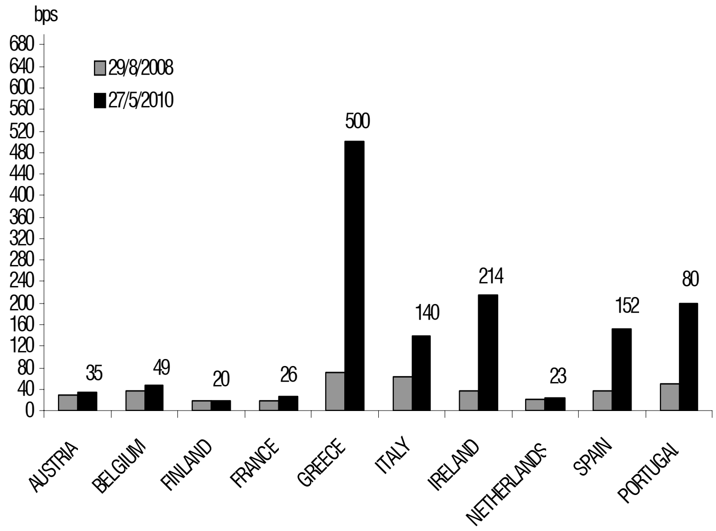




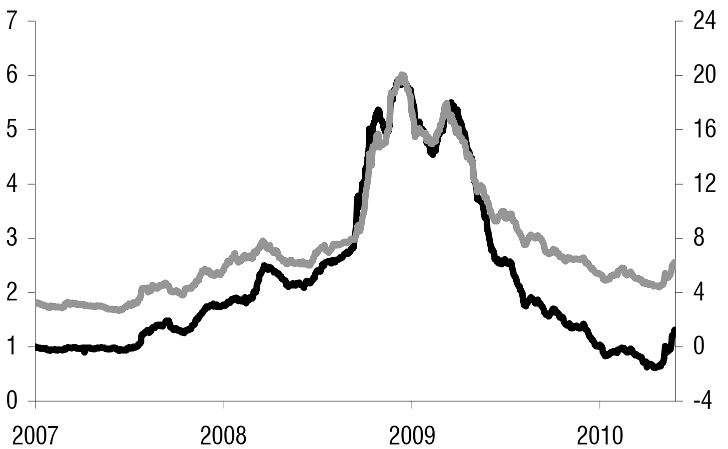
10y Government Bonds



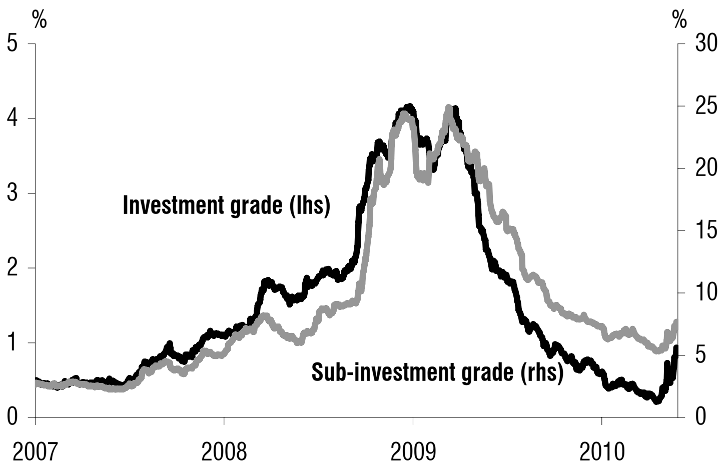
10yr government spreads vs Germany



US Corporate bond yield spreads vs 10-yr government bond



EU Corporate bond yield spreads vs 10-yr government bond



Source: Bloomberg, Ecowin

Global Equities & Sector Performance

Total Return (%) as of May 27, 2010

Global Equity Indices (in local currency)

Region	Index	Last Price	1w	1m	6m	12m	YTD	2009
US	S&P 500	1103.1	2.9	-7.4	1.1	21.6	-1.1	23.5
EURO AREA	DJ Euro Stoxx 50	2619.4	1.8	-6.1	-7.5	6.8	-11.7	21.1
GERMANY	DAX	5937.1	1.9	-2.4	4.4	20.4	-0.3	23.8
FRANCE	CAC 40	3525.3	2.8	-6.9	-5.3	8.0	-10.4	22.3
UK	FTSE 100	5195.2	2.6	-7.0	-1.0	18.4	-4.0	22.1
JAPAN	Nikkei	9639.7	-1.5	-11.8	6.1	2.0	-8.6	19.0
CHINA	CSI 300	2860.0	3.3	-7.7	-15.4	3.6	-20.0	96.7
INDIA	SENSEX	16666.4	1.3	-4.1	0.2	16.6	-4.6	81.0
RUSSIA	MICEX	1306.0	3.2	-8.7	1.6	21.5	-4.7	121.1
BRAZIL	IBOV	62091.8	6.7	-6.8	-7.4	17.1	-9.5	82.7

Source: Bloomberg

Sector performance as of May 27, 2010

US Sector Indices (in USD)

US – S&P 500	Last	1w	1m	6m	12m	YTD	2009
1. Consumer Discretionary	302.4	1.7	-9.3	11.1	41.2	6.6	41.3
2. Consumer Staples	373.7	-2.2	-5.5	-2.7	17.7	-2.0	14.9
3. Energy	556.8	-0.8	-13.2	-9.6	5.4	-8.8	13.8
4. Financials	275.2	0.8	-10.0	1.3	25.3	0.1	17.2
5. Health Care	419.7	-1.0	-7.3	-6.9	14.5	-8.5	19.7
6. Industrials	337.2	0.1	-10.6	6.1	35.1	4.6	20.9
7. Information Technology	369.7	-0.8	-11.4	-1.6	28.2	-7.1	61.7
8. Materials	256.5	1.6	-11.2	-6.3	19.1	-8.4	48.6
9. Telecommunication Services	165.9	-1.6	-4.8	-5.7	6.2	-9.5	8.9
10 Utilities	269.1	-1.1	-6.0	-2.5	13.1	-8.4	11.9

Source: Bloomberg, Ecowin

Global Equities & Sector Performance

Sector performance as of May 27, 2010

European Sector Indices (in €)

Europe - DJ Stoxx 600	Last	1w	1m	6m	12m	YTD	2009
1. Consumer Discretionary							
Automobiles & Components	345.7	3.3	-1.0	5.2	14.9	1.2	19.4
Travel & Leisure	185.0	3.4	-4.6	17.7	21.8	10.4	18.5
Media	246.5	3.3	-4.0	10.6	22.5	2.5	23.4
Retail	416.0	3.5	-3.6	7.8	23.3	5.8	37.4
2. Consumer Staples							
Food & Beverage	506.4	3.3	0.3	13.7	41.4	6.4	35.2
Personal & Household Goods	564.9	4.1	-1.9	16.8	40.6	7.9	42.0
3. Energy							
Oil & Gas	574.9	4.2	-7.8	0.1	9.3	-4.7	29.9
4. Financials							
Banks	364.5	1.6	-7.4	-10.4	10.5	-10.5	50.7
Financial Services	393.1	3.9	-3.2	0.9	13.0	-2.0	33.6
Insurance	225.7	3.3	-2.8	-1.0	16.5	-4.4	17.0
Real Estate	96.2	2.4	-5.8	-5.9	22.2	-8.7	27.0
5. Health Care	510.7	3.2	-2.7	5.4	24.0	-0.2	16.8
6. Industrials							
Industrial Goods & Services	407.4	3.6	-2.3	15.1	40.4	8.6	41.2
7. Information Technology	195.2	2.6	-5.9	9.5	14.1	5.7	20.5
8. Materials							
Basic Resources	851.1	8.7	-6.7	9.3	43.7	-0.7	105.9
Chemicals	745.1	2.6	-3.7	3.6	29.9	-3.3	48.7
Construction & Materials	413.4	3.4	-8.1	-0.2	20.1	-6.5	39.9
9. Telecommunication Services	421.3	3.9	-1.4	-3.8	18.3	-6.4	17.5
10. Utilities	591.1	1.8	-5.4	-3.9	0.5	-10.2	6.2

Source: Bloomberg

Sector performance as of May 27, 2010

Asia Sector Indices (in USD)

Asia – S&P 50 Index*	Last	1w	1m	6m	12m	YTD	2009
1. Consumer Discretionary	8039.7	-0.9	-11.2	17.7	50.2	0.7	116.2
2. Consumer Staples	11576.8	0.0	-15.0	-11.3	13.2	-10.6	47.6
3. Energy	9050.9	-0.1	-11.9	-4.9	9.7	-7.0	58.0
4. Financials	3204.7	-0.7	-8.7	-7.6	-6.9	-10.7	69.1
5. Industrials	1808.6	-0.8	-17.5	8.4	3.0	-0.2	32.5
6. Information Technology	7114.9	-0.8	-14.4	0.9	23.5	-9.4	91.4
7. Materials	3682.1	-1.5	-18.2	-9.1	19.1	-17.8	72.7
8. Telecommunication Services	2259.7	-2.6	-8.5	-1.3	-2.1	-3.6	-0.2
9. Utilities	2855.2	-1.9	-6.7	4.2	15.3	-1.0	25.3

Source: Ecowin

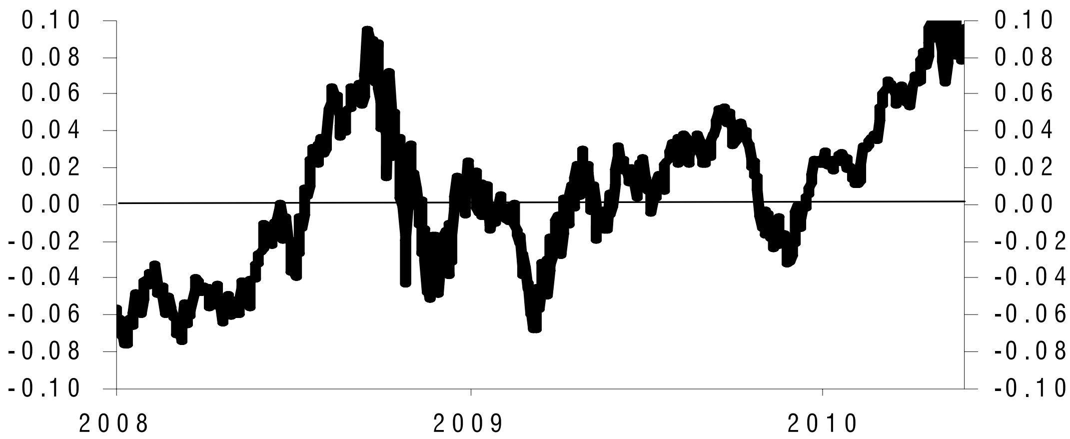
US Style Equity Indices

Total Return (%) as of May 27, 2010

US Style Indices (in USD)

Index	Last Price	1w	1m	6m	12m	YTD	2009
Russell 1000 (Large Cap)	609.1	3.2	-7.4	2.1	23.0	-0.5	25.5
Russell 2000 (Small Cap)	670.5	4.8	-7.2	16.2	36.2	7.2	25.2
Relative performance (Small vs Large)		1.6	0.2	14.0	13.2	7.7	-0.3
Russell 1000 Value	572.0	4.0	-7.4	3.2	23.3	1.0	16.3
Russell 1000 Growth	490.6	2.4	-7.3	1.1	22.5	-1.9	34.8
Relative performance (Value vs Growth)		1.6	-0.1	2.2	0.8	2.9	-18.5

Relative Performance (small vs large)
(logarithmic scale)



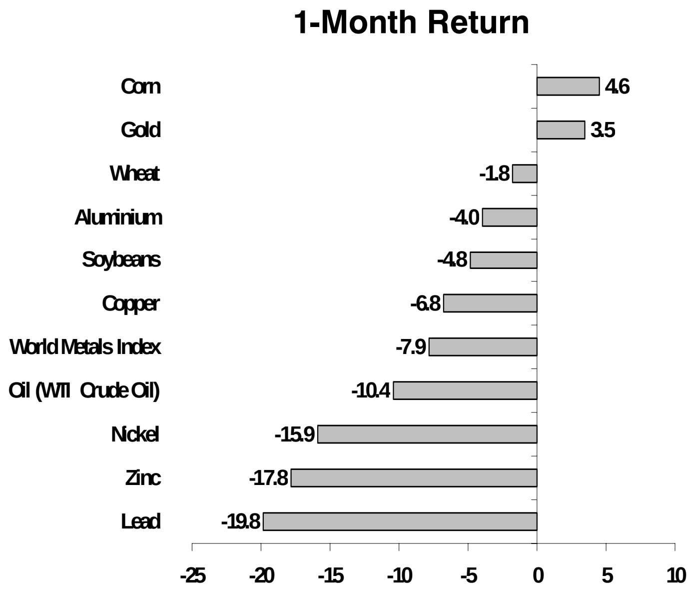
Relative Performance (value vs growth)
(logarithmic scale)

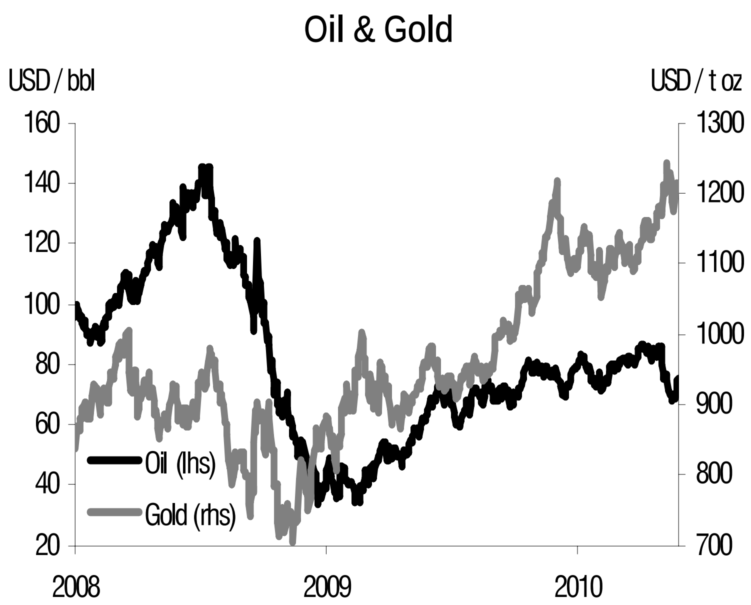
Source: Bloomberg

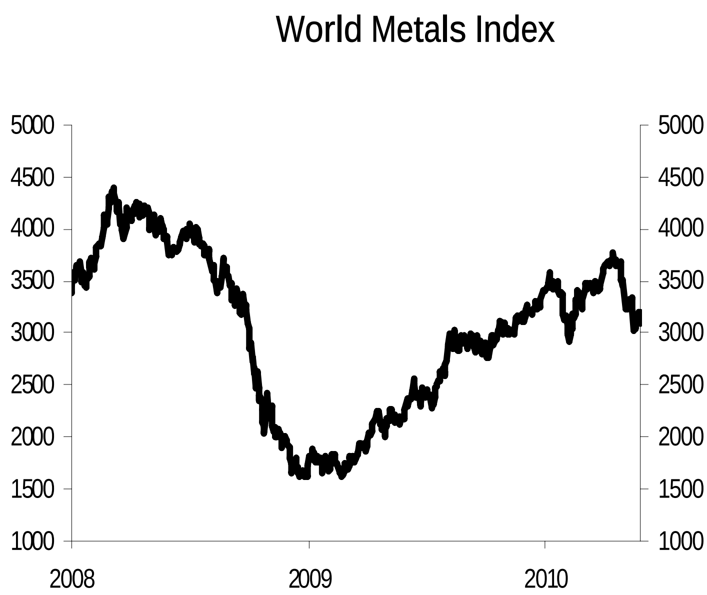
Commodities

Commodity Performance (%) as of May 27, 2010

Commodities	Units	Last Price	1w	1m	6m	12m	YTD	2009
Oil (WTI Crude Oil)	USD/bbl	74.6	6.4	-10.4	-2.0	14.6	-6.1	77.9
Gold	USD/t oz	1211.9	3.0	3.5	3.2	26.0	10.6	24.0
Base Metals								
World Metals Index		3204.1	1.6	-7.9	3.2	45.4	-5.9	97.5
Aluminium	USD/lb	2065.0	3.7	-4.0	2.4	47.0	-7.4	44.8
Copper	USD/mt	6984.0	5.7	-6.8	1.9	49.7	-5.3	140.2
Lead	USD/mt	1844.0	5.7	-19.8	-19.8	27.6	-24.2	143.4
Nickel	USD/mt	21800.0	2.8	-15.9	35.5	62.7	17.7	58.3
Zinc	USD/mt	1940.0	3.5	-17.8	-13.0	32.9	-24.2	111.9
Agriculture								
Corn	USD/bu	373.3	1.2	4.6	-6.0	-12.9	-10.0	1.8
Soybeans	USD/bu	918.8	1.2	-4.8	-12.3	-5.9	-9.4	-0.3
Wheat	USD/bu	467.8	-0.9	-1.8	-14.8	-25.8	-13.6	-11.3







Source: Bloomberg

Eurobank EFG

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