Eurobank Research

Eurobank EFG

Global Economic & Market Outlook

November 2006

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Main Views and Market Strategy:

- Global growth is expected to soften somewhat but remain fairly robust into 2007, despite the US slowdown, as Japan, emerging Asia and Europe are due to maintain their positive momentum.
- US growth is expected to moderate significantly in 2007 to a more sustainable level of around 2.3% y-o-y from 3.4% y-o-y in 2006, as a result of the downturn in the housing market.
- The Fed is likely to hike once more by 25bps in Q1:07 as core inflation remains elevated. Fed funds are likely to decline in H2:07 to support economic activity. The ECB will likely hike rates to 4% by mid-07 and go on hold afterwards.
- With a slowing economy and increasing pressure from unit labour costs on profit margins, corporate profit growth in the US is expected to decelerate sharply in 2007. The profit slowdown will be the major theme in 2007.
- Current yields of US Treasuries discount that the next move of the Fed will be a cut rather than a hike. With some negative core inflation news in the pipeline, we remain cautious especially for the short end of the yield curve and under weight government bonds as an asset class.
- Equity valuations are supportive on a long-term basis. However, risks have increased that a profit slowdown in the US will hurt markets in the short term. We overweight Europe and Japan relative to the US and EMs and underweight small and medium caps with higher exposure to the US cycle relative to large caps.

Summary of Asset Allocation Themes

Main theme	Rationale	Strategy
Global growth	Global growth is expected to soften somewhat but remain fairly robust into 2007, despite the US slowdown, as Japan, emerging Asia and Europe maintain their positive momentum.	Stay neutral in equities as an asset class. Underweight EM equity as it will likely suffer most from a slowdown of the US economy.
US growth	The second round effect of the housing correction on the economy will be larger than currently anticipated. We expect US growth to moderate significantly in 2007 to a more sustainable level of around 2.3% y-o-y from 3.4% y-o-y in 2006.	Underweight construction and cyclical consumer sectors in US equity as these sectors are likely to suffer most from the slowdown.
US inflation	Tightness of the labor market has increased to levels above the average of the past three business cycles, pushing up wages and core inflation. We expect core inflation to remain at elevated levels during the rest of the year and for most of H1:07.	Take long positions in US inflation indexed bonds to hedge against core inflation surprises over the coming months.
Interest rates	The Fed is likely to hike once more by 25bps in Q1:07, as core inflation remains elevated. Fed funds are likely to decline in H2:07 to support economic activity. The ECB will likely hike rates to 4% by mid-07 and go on hold afterwards.	We see more upside in the refi rate than currently priced in. We recommend going short the front end of the yield curve.
US profits	With slowing US GDP growth and increasing unit labour costs, corporate profit growth is expected to decelerate sharply in 2007. The profit slowdown will be the major theme in 2007.	Underweight US equity, go short on small and mid-cap US equity and long on big caps to hedge against the risk of a downturn in the profit cycle.
Bonds	Current yields of US Treasuries discount that the next move of the Fed will be a cut rather than a hike. With some negative core inflation news in the pipeline, we remain cautious especially for the short end of the yield curve.	Given our view about Fed policy, we remain under-weight on government bonds as an asset class. On relative trades, we prefer Treasuries to bunds.
Equities	Valuations are supportive on a long-term basis. However, risks have increased that a profit slowdown in the US will hurt equity markets in the short term.	Overweight Europe and Japan relative to US and EMs. Overweight equities as an asset class after a market correction.

Macro Forecasts

	2006	2007 Eurobank EFG	2007 Consensus
Real GDP Growth (y-o-y average)			
US	3.4	2.3	2.6 (2.2 – 3.0)
EU-12	2.6	2.0	1.9 (1.6 – 2.5)
Japan	2.8	2.4	2.2 (2.2 – 2.6)
CPI Inflation (y-o-y average)			
US	3.5	2.7	2.4 (1.9 – 2.8)
EU-12	2.2	2.1	2.1 (2.1 – 2.2)
Japan	0.3	0.5	0.5 (0.3 – 0.7)
Short Term Interest Rates (end of year)			
US	5.25	4.75	5.00 (4.00 – 6.00)
EU-12	3.50	4.00	3.75 (3.00 – 4.00)
Japan	0.50	0.75	1.25 (0.75 – 1.50)

Note: Range of forecasts in parentheses below point estimates.

Table of contents

Global Outlook and Asset Allocation

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1. Summary

Global growth is expected to soften but remain fairly solid

Global growth is expected to remain robust into 2007 despite a marked slowdown of the US economy, as Japan, emerging Asia and Europe are due to maintain their positive momentum. With global liquidity conditions remaining supportive, oil prices at relatively low levels and equity and bond markets reversing their losses of the May/June setback, global growth will downshift somewhat from its current peaks of 5.1% to 4.7%, but remain firm. However, global demand will be rebalanced away from the US, where the downturn in the housing market, the build up of capacity constraints and past monetary tightening is expected to push economic growth to below potential.

Financial markets have already discounted the end of the Fed tightening cycle as the slowdown of the US economy in the second half of 2006 and into 2007 seems to alleviate inflationary pressures and Fed funds rates are likely to decline further into 2007 to support economic activity.

In the US, core inflation continues to drift higher,...

However, inflationary pressures are still on the upside in the US, as the labor market has tightened significantly during the current economic rebound and wage increases are pushing unit labor costs upwards. Unlike headline inflation, which has trended lower in recent months, mainly due to the decline in oil prices since mid-year, core inflation measures continue to drift higher in Q4 with the core CPI expected to reach 3% y-o-y by December. With core inflation on the rise and growth slowing, the Fed faces a serious dilemma. Inflationary pressures are still too high to cut interest rates even though the slowdown of the real economy would demand to do so. Our central scenario suggests that core inflation will remain stubbornly high until Q3:2007, increasing the likelihood of one further interest rate hike by 25 bps in Fed funds to 5.50% in Q1:2007, before an easing of monetary policy in the second half of 2007.

...increasing the likelihood of another rate hike, before easing of Fed policy in H2:07

We remain underweight in bonds

Given our view about Fed policy, we remain underweight in government bonds, as current yields discount that the next move of the Fed will be a cut rather than a hike, although postponed by most analysts until mid-2007. With some negative core inflation news in the pipeline over the next few months, we remain cautious especially for the short end of the yield curve, which will be more vulnerable to changes in consensus expectations of short-term interest rates. Regarding relative trades, we prefer 10-year US Treasuries relative to bunds as we expect the yield differential between Treasuries and bunds to shrink as the result of a monetary tightening in the Euro area relative to the US, where the interest rate cycle is more advanced. Our view is in line with our expectation that the ECB will likely continue to hike short-term interest rates up to 4% by mid-2007, from 3.25 currently, in order to curb inflationary pressures.

US growth will moderate significantly due to housing correction

Although the risk of a recession in the US is currently low, we expect growth to moderate significantly in 2007 to a more sustainable level of around 2.3% y-o-y from 3.4% y-o-y in 2006. Our view on the US economy is at odds with current consensus estimates. The consensus of analysts seems to expect a rather moderate slowdown of the US economy to 2.6% y-o-y. We are more pessimistic on the growth prospects of the US economy as we expect that the second-round effects from the housing downturn on economic activity, mainly personal consumption, will be more severe than currently discounted by the average economic analyst.

A large part of the slowdown of the US economy is due to the impact of lower residential investment on economic activity. This direct impact of the housing market on the US economy has already cut one percentage point from Q3 GDP growth and is expected to continue to drag economic activity in the coming quarters, although at a lower pace. Overall, we expect the drag from construction activity to cut on average ½ pp from y-o-y GDP growth in 2007. The extent of the slowdown of the US economy, however, will largely depend on the indirect effect of the housing market downturn on personal consumption. This effect works through the wealth channel and depends on whether and by how much house prices decline. Our estimates suggest that even a modest decline in house prices of 1% in nominal terms over the next few quarters will likely lead to a deceleration of personal consumption growth by nearly ¾ of a percentage point in 2007.

The housing market has played an important role in supporting personal consumption over the past few years. According to our estimates, for every 10% y-o-y increase in real house prices, personal consumption has increased by 0.8% y-o-y. Hence, the consequences of the housing downturn on the US economy will be lasting. We expect that, even if house prices stabilize at current levels, the annual growth rate of household consumption and, hence, the growth rate of US GDP will decline over the next 5-7 years by total of 5% and 3%, respectively, as the positive wealth effect from the housing market will be withdrawn.

Equity valuations seem supportive in the long term,...

With the global economy experiencing its strongest growth during 2004-2006 since the early 1970's, global stock markets have entered a bull period which is now lasting for nearly four years. Despite the strong price gains, however, equity valuations remain attractive as companies' earnings have increased substantially at the same time. As a result, P/E multiples are below historical averages both in developed and most emerging markets. With the world economy continuing to grow at near the current rates, global liquidity still-abundant and high earnings yields over bond yields, we continue to expect out-performance of equities relative to government bonds.

...but, risks are on the upside in the short-term, as corporate profit growth is expected to decelerate sharply in 2007

However, there are significant risks ahead related to corporate profits in the US. We believe that the impressive growth of the US economy during the current rebound was mainly due to two factors: the booming housing market, which supported personal consumption, and the subdue development of unit labor costs, which fuelled companies' earnings and supported fixed non-residential investment.

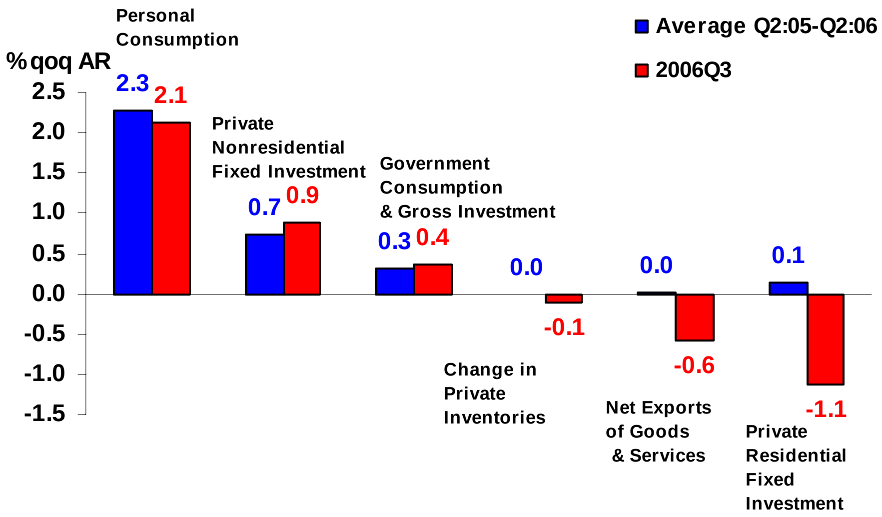
Both forces are now faltering. As a result, corporate profit growth in the US is expected to slow markedly into 2007 as economic growth decelerates and wage increases squeeze profit margins of companies. This negative development is not yet fully discounted in market consensus earnings forecasts, providing the potential of negative surprises. On the other hand, equity valuations (both in the US and elsewhere) remain supportive compared with historical standards, providing some protection against a turn in the US profit cycle. Hence, we acknowledge the risk of a likely correction in stock markets, most likely in early 2007, driven by negative earnings surprises, but remain constructive for equities as an asset class in the longer term.

2. The US economy

Growth is slowing due to housing market correction

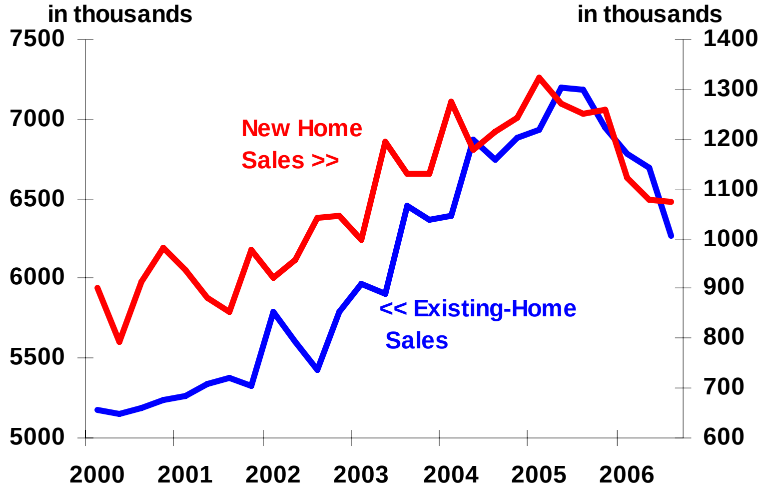
The slowdown in the US broadened in Q3:2006 with GDP growth decelerating from 2.6% in Q2 to 1.6% annualised--the slowest pace since early 2003-- owing to a slide in residential investment. Early indications are already pointing to a slight reacceleration in Q4:2006, as far as recent declines in energy prices and interest rates since the summer fuel consumer and business spending growth. The improvement in various measures of consumer confidence in recent weeks also points in this direction. Private consumption remains for now the main driving force of growth, followed by fixed nonresidential investment and government consumption and gross investment, while residential investment and net exports turned into a drag (Figure 2.1).

Figure 2.1: Contributions to GDP growth



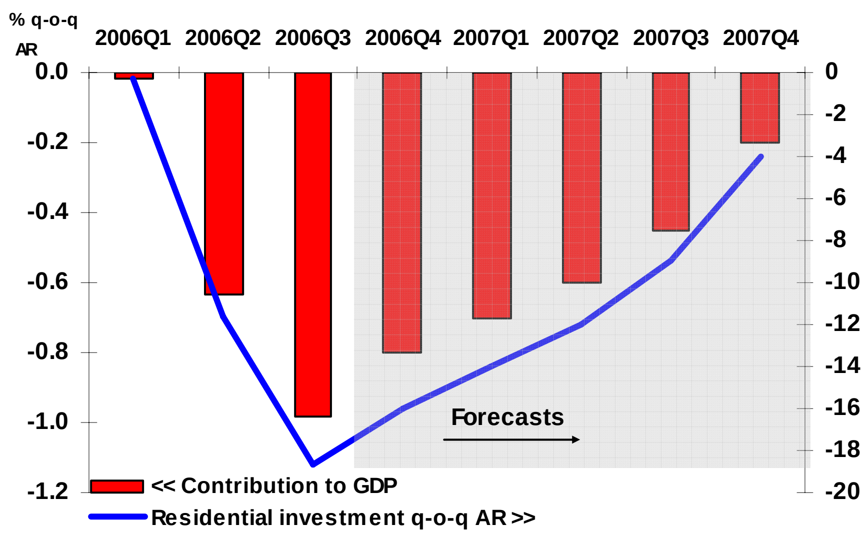
Indeed, economic activity in the US is slowing markedly as a result of the downturn of the housing sector. Housing starts and building permits have been falling all year, and are 17.9% and 26.9% below their previous year levels, respectively. The steady decline in building permits suggests that starts have further to fall. Similarly, home sales have dropped to three-year lows, resulting in increased inventory of homes available for sale (Figure 2.2). Furthermore, residential investment fell at an average annualized rate of 10.2% q-o-q during the first three quarters of the year.

Figure 2.2: Housing market is cooling rapidly



Given a weight of the construction sector of about 6% in total GDP, the decline in residential investment has already cut 0.6pp from GDP growth in 2006. The direct drag from homebuilding on real GDP growth will continue in Q4 and into 2007, but at a slower pace. We expect a total drag of 0.60pp in 2006 and 0.50pp in 2007 as the inventory overhang unwinds gradually (Figure 2.3).

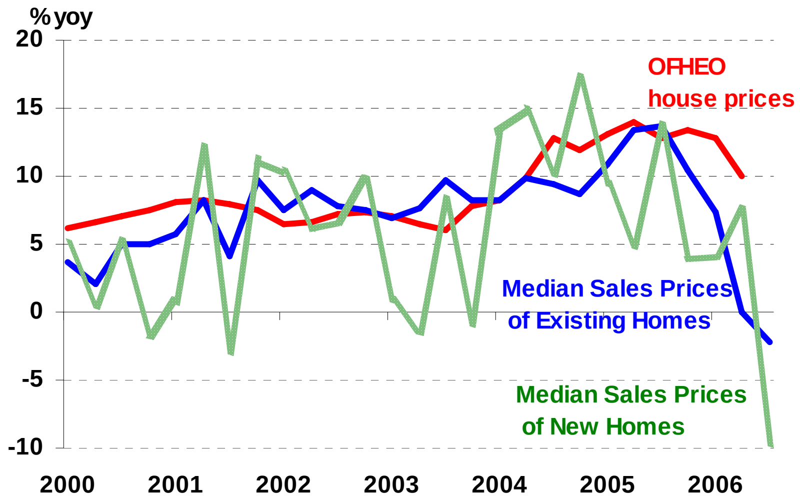
Figure 2.3: Contribution of residential investment to real GDP growth



Whereas the direct drag from homebuilding on real activity is relatively easy to calculate, the uncertainty concentrates on how the current downturn in housing activity will feed into the rest of the economy. So far, there has been little evidence of spill over from the weakness in the housing sector to the rest of the economy. The extent of the slowdown of the US economy, however, will largely depend on the indirect effect of the housing downturn on personal consumption. This effect works mainly through the wealth channel and depends on whether and by how much house prices decline.

Median house prices are declining rapidly with median sales prices of new homes in a freefall; the median price of existing homes fell in Q3:2006 by 2.2% y-o-y, the biggest drop ever recorded, whereas the median price of new homes fell by 9.7%, the biggest drop since 1970 (Figure 2.4). Unlike the median measure, house price indices based on repeat sales such as the OFHEO price index, which control for quality of homes sold, have not declined sharply yet but are expected to decline further over the next few months.

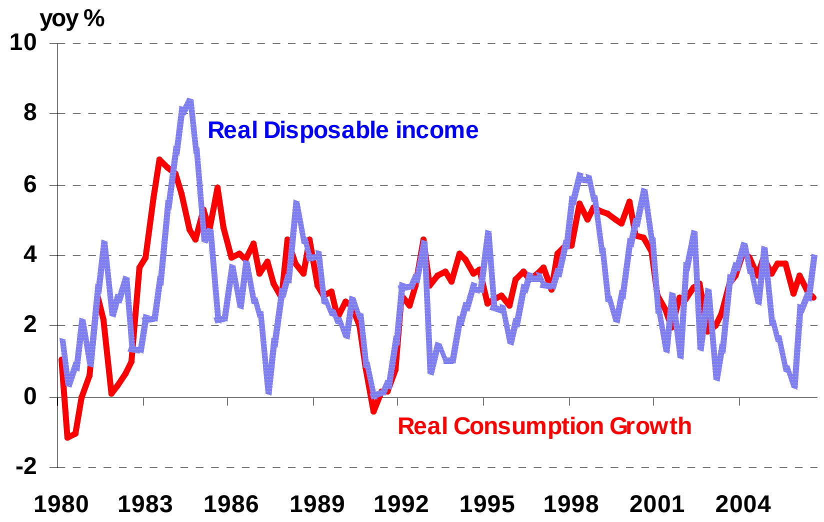
Figure 2.4: Sharp decline in house prices



The trend in real consumer spending through the spring and summer averaged at about 3% y-o-y, despite the effects of rising fuel prices in H1 and a faltering housing market. The housing downturn has not put a significant crimp on personal consumption, even as mortgage equity withdrawal (MEW) falls sharply. Rising short-term interest rates have not yet affected households' purchasing power and delinquency rates on consumer loans are generally still at very low levels.

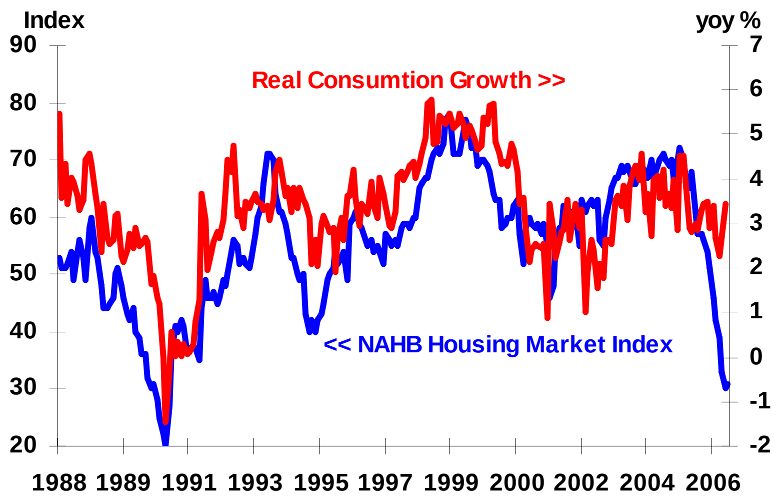
One year into the housing downturn, there is still no evidence that households have become more cautious, and acting to increase their saving rate rather than spending. To the contrary, the household saving rate averaged -0.5% over the past 3 months, near its lows for the expansion. It seems that lower gasoline prices and higher wages gave a significant boost to real disposable income, supporting personal consumption through the first three quarters of the year (Figure 2.5).

Figure 2.5: Higher disposable income supports personal consumption



However, sentiment measures of the construction sector, such as the NAHB Housing Market Index, have plunged recently to 15-year lows, predicting a significant slowdown in personal consumption over the next few quarters (Figure 2.6).

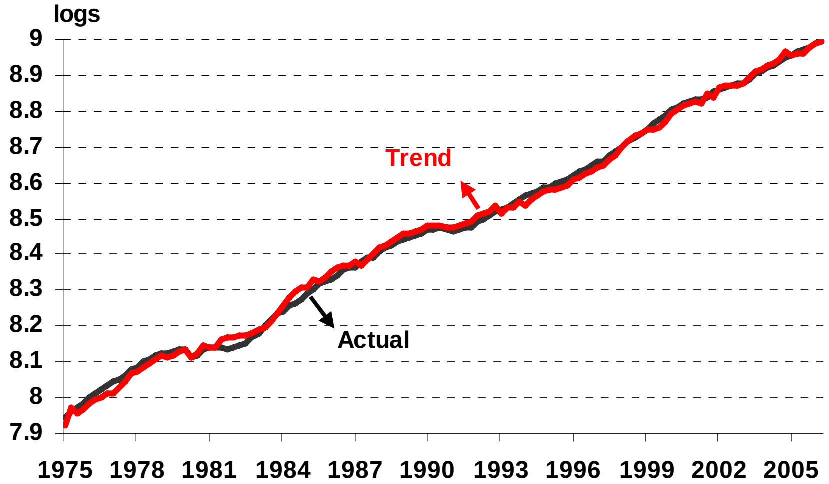
Figure 2.6: Construction sector sentiment falters, predicting a slowdown in personal consumption



The housing downturn will affect the US consumer

The resilience of personal consumption to the housing sector is in our view the result of healthy gains in real disposable income, which continued to support consumption in 2006. Figure 2.7 shows that real personal consumption is currently in line with its long run trend based on real disposable income and deflated house prices. Note that the long-run income elasticity of consumption is 1.08, about 13 times larger than the elasticity with respect to real house prices (0.08). As a result, even small gains in real disposable income are able to balance the negative wealth effect of declining house prices on consumption.

Figure 2.7: Real personal consumption and long-run trend



Note: trend consumption is estimated as:

Log(Consumption) = -1.17 + 1.08*log(Income) + 0.08*log(OFHEO Real House Prices)

(-23.40) (146.57) (5.30)

Adjusted $R^2 = 0.99$ (sample= 1975Q1 – 2006Q2)
t-statistics in parentheses

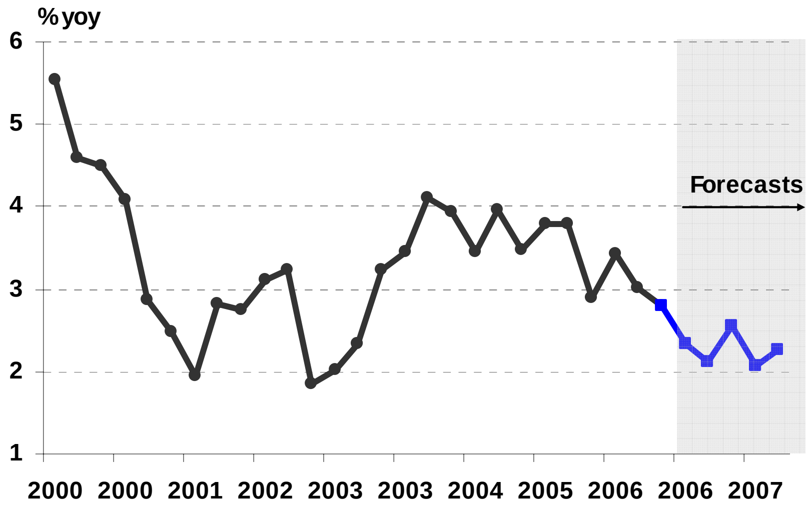
However, the housing downturn will likely spread to the consumer sector, although in a gradual way. Reduced house price appreciation will crimp spending through wealth and confidence effects. Reduced MEW, which declined from 10.5% to 5.9% of disposable income since Q3:2005, may cause dramatically slower spending growth and higher interest payments on adjustable rate mortgages might dull purchasing power.

Our estimates of the driving forces of household consumption suggest that a decline in real house prices by 10% will subtract 0.8 pp from personal consumption and more than ½ pp from GDP growth. Provided that real house prices will stabilize at a level 10% lower than current levels, this effect will be permanent. Given that real house prices have grown by an average of 9% y-o-y over the past seven years, the negative wealth effect on real activity will be significant even if house prices stabilise in real terms at current levels, i.e. house prices continue to increase at a pace of about 2-3% y-o-y in nominal terms over the next years.

According to our estimates, more than 5% of the increase in personal consumption over the period 1999-2006 was due to house price appreciation. Hence, even if real house prices stabilize at current levels over the next 5-7 years, personal consumption growth will decline by an average of 0.7% per year until 2013. The total effect of the housing downturn in consumption will be probably stronger if employment in the construction sector declines as a result of the current investment hangover in this sector.

Our short to medium-term projections of real personal consumption suggest that even a modest decline in house prices of 1% in nominal terms will likely lead to a deceleration of personal consumption growth by about ¾ of a percentage point in 2007 (Figure 2.8). This implies a negative contribution of the housing sector downturn to GDP growth of ½ pp in 2007. Adding this effect to the direct effect of the decline in residential investment, we expect US real GDP growth to decelerate from 3.4% y-o-y in 2006 to 2.3% y-o-y in 2007.

Figure 2.8: Personal consumption growth forecast



Note: personal consumption growth is estimated as:

ΔConsumption= 2.53 + 0.16*ΔIncome + 0.17*ΔOfheo Real House Prices(-1)

(8.85) (2.55) (3.58)

Adjusted R^2 = 0.16 (sample= 1980Q1 – 2006Q2)
t-statistics in parentheses

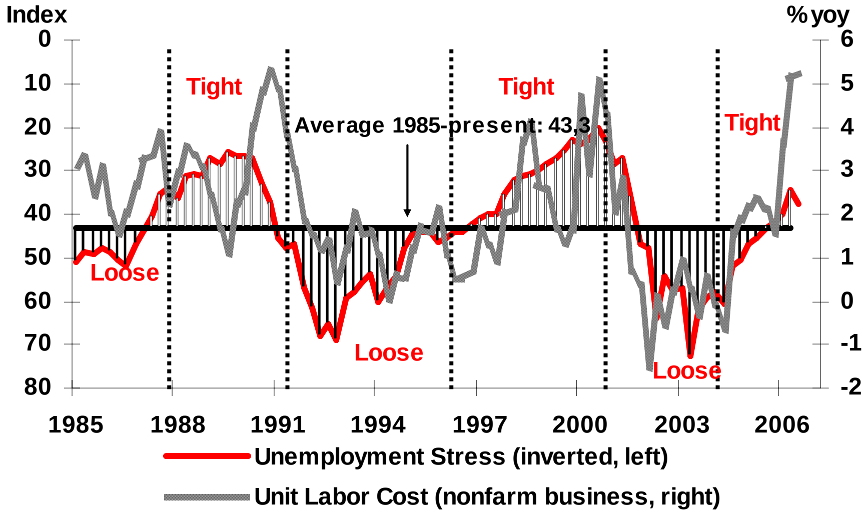
The labor market has tightened, leading to substantial wage increases

The acceleration in labor costs marks a dramatic reversal of earlier trends in employee compensation relative to productivity: in Q3 2006 unit labor costs ran at an annual rate of 5.3% (from 3.6% in Q1 and 5.1% in Q2), the highest increase since Q4 1990. The surprising element in the recent acceleration in unit labor costs has been in the compensation figures. Recent revisions to the income data show that the tight labor market is already putting upward pressure on employee compensation, which surged at a 8.3% y-o-y in Q2 and 7.5% in Q3.

Several analysts attribute this increase to year-end bonuses rather than to wage increases, claiming that given that the magnitude of the boom in wages and salaries is not hinted at in the average hourly earnings data, the obvious suspect for the increase is a surge in nonrecurring pay such as bonus payments and stock options, which are less inflationary than wage income. Unfortunately, the aggregate data do not allow to break out bonuses and options from the other forms of pay, but the large upward revisions to payrolls are consistent with the rapid growth in wage and salary income in recent quarters and suggest that less of the pay rise may be related to bonus and stock option income.

The upward pressure on wages and unit labor costs is in line with the current state of the labor market. The continued decline in unemployment since 2003 has led to a significant tightening of labor market conditions which eventually led to higher pressure on wages. Figure 2.9 displays unemployment stress, a measure of the tightness of the labor market computed as the product of the rate of unemployment and the median duration of unemployment. Tightness of the labor market has increased to levels above the average of the past three business cycles, in line with alternative measures of economic slack such as the degree of capacity utilization and the output gap.

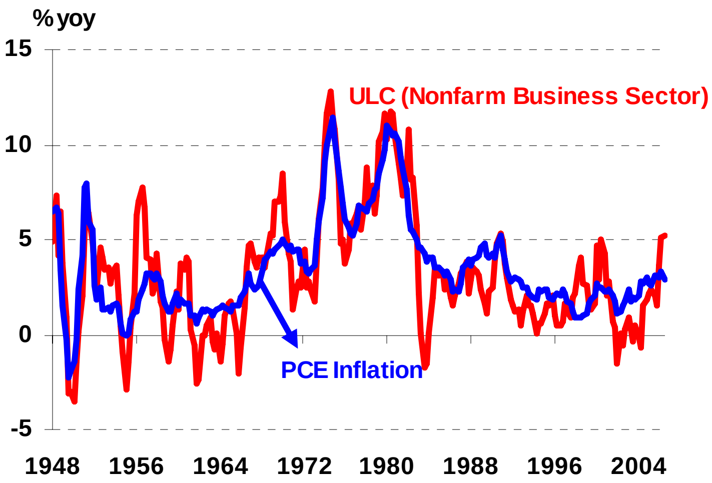
Figure 2.9: Wage demands are increasing as labor market tightens



Core inflation to remain at elevated levels until H2:07

These cost pressures represent a second round to the inflation uptrend and should tend to keep core inflation elevated even if some of the initial drivers such as higher energy costs fade. Figure 2.10 shows that unit labor costs have been one the key drivers of consumer price inflation. The recent acceleration in ULCs will likely keep core inflation at elevated levels for a significant period of time.

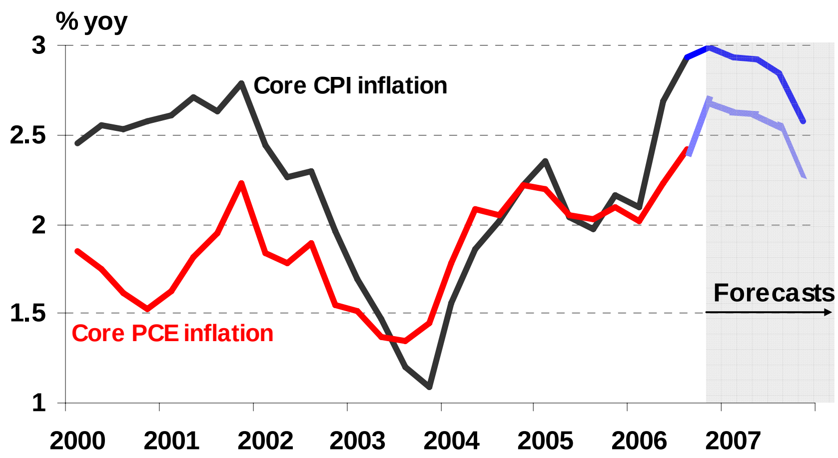
Figure 2.10: Inflation commoves with unit labor costs



Unit labor costs are not the only determinant of core inflation. Core producer prices are also important, as they reflect the cost of raw materials, energy and intermediate goods. Companies tend to pass the increase in these costs to final prices, although with a lag, as changing profit margins absorb some of the initial cost pressure. Finally, inflation expectations are a long-run determinant of core inflation, as they provide an anchor for nominal wage demands and, thus, determine the trend of inflation.

Core CPI inflation reached 2.9% y-o-y in September, the largest annual increase in more than a decade. Our estimates suggest that core CPI inflation will peak at 3% in Q4 and will remain at the current elevated levels of about 2.9% during H1 2007 (Figure 2.11). Declining ULC growth (3% on average in 2007, compared to 3.7% in 2006) and inflation expectations (2.6% on average in 2007 from 3.1% in 2006) will drive down core inflation to 2.6% in H2 2007.

Figure 2.11: Core inflation on the rise in the short term



Note: core infaltion is estimated as:

$$\Delta QCPIcore = \underset{(0.97)}{0.56} + \underset{(2.19)}{0.06}*\Delta QULC(-1) + \underset{(1.95)}{0.06}*\Delta QULC(-2) + \underset{(3.45)}{0.18}*\Delta QPPIcore(-3) + \underset{(3.03)}{0.16}*\Delta QPPIcore(-4)$$

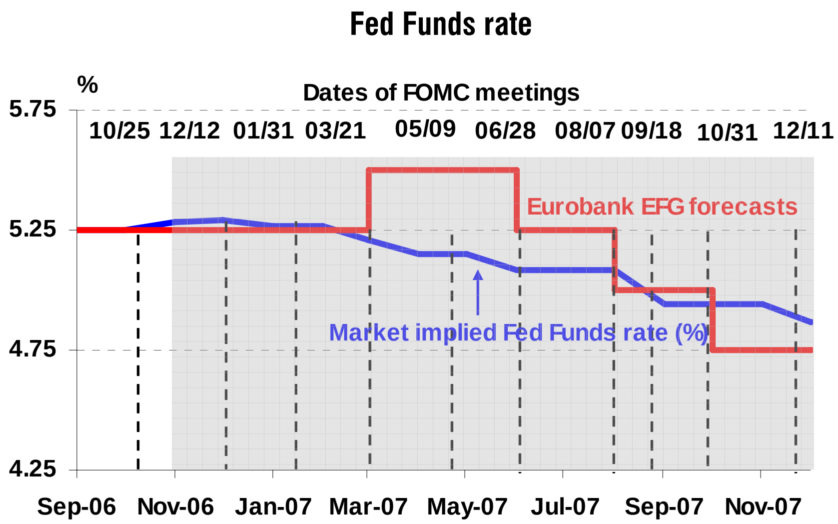
$$+ \underset{(4.36)}{0.22}*\Delta QPPIcore(-5) + \underset{(1.82)}{0.40} * \text{Infl. expectationsMichigan 1y}$$

Adjusted $R^2 = 0.58$ (sample= 1985Q1 – 2006Q2)
t-statistics in parentheses

Fed funds: Risks are to the upside in the short term

Our view on inflation makes us less confident that the Fed will relax monetary policy any time soon. With core PCE inflation at current elevated levels, the Fed may not be willing to ease policy despite the slowing of the economy until H2 2007. In fact, our Fed reaction function points at one more rate hike to 5.50% in Q1 2007. With the economy slowing below trend and core inflation decelerating in H2 2007, we expect the Fed to cut Fed funds rates by a total of 75 bps after June (Figure 2.12).

Figure 2.12: Fed policy will ease in H2:07. But, upward surprises are in the pipeline in the short term



Note: fed funds rate is estimated according to the policy reaction function:

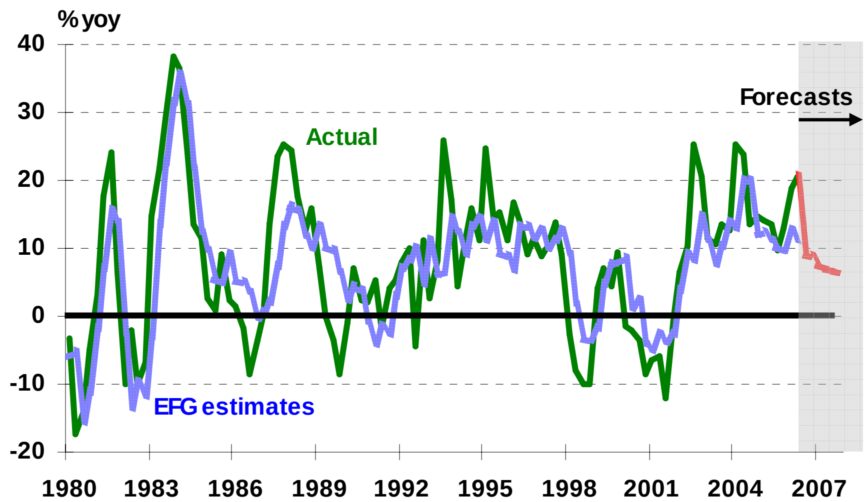
$$\text{Effective fed funds rate} = \underset{(14.5)}{6.94} - \underset{(-13.8)}{0.12}\ \text{Unemployment Stress} + \underset{(10.7)}{1.14}\ \Delta PCEcore$$

Adjusted $R^2 = 0.81$ (sample= 1987Q1 – 2006Q2)
t-statistics in parentheses

Corporate profits are expected to slide into 2007

Corporate profits have grown at an impressive rate during the current upturn, as economic activity picked up, wage costs remained low and productivity advances lowered unit labour costs, boosting profit margins to multi-year peaks. Most recent published data indicate that corporate profits with inventory valuation adjustment and capital consumption adjustment ran at an annual rate of 20.5% y-o-y in Q2 2006. Q3 earnings reports suggest that the dynamic growth of corporate earnings continues at a slightly higher pace. The positive surprise in Q3 earnings was largely due to the insurance sector, which had a very good quarter compared to one year ago, when the Katrina hurricane had led to big catastrophic losses in the sector. However, with slowing GDP growth and increasing unit labour costs, corporate profits are expected to slide into 2007. Our estimates suggest that the slowdown of the US economy, combined with the profit squeeze of rising unit labor costs, will lead to a deceleration of corporate profit growth to 6.4% y-o-y in 2007 (Figure 2.13).

Figure 2.13: Corporate profits heading lower



Note: corporate profit growth is estimated as:

Δprofits= -0.66 + 1.75 *(ΔBusiness deflator-ΔULC) +1.58*ΔGDP +0.39*Δprofits (-1)

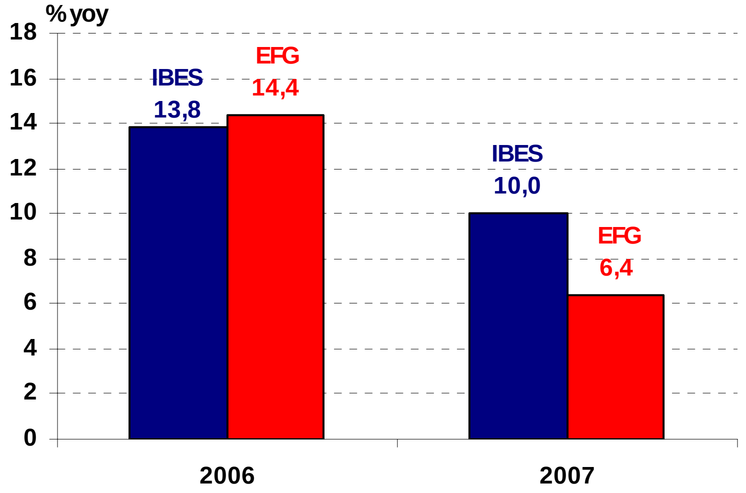
(-0.72) (4.62) (6.27) (6.92)

Adjusted R^2 = 0.67 (sample= 1948Q2 – 2006Q2)

t-statistics in parentheses

This negative development is not fully discounted yet in market consensus earnings forecasts, providing the potential of negative surprises in earnings expectations and equity market valuations (Figure 2.14). Based on our model projections, the negative surprise on EPS growth for 2007 is estimated at 3.6%, from the current IBES EPS forecast of 10% to 6.4%.

Figure 2.14: EPS Growth Forecast % y-o-y



3. The Euro area economy

The rebound of the Euro area economy has gathered momentum with Q2 2006 GDP growth climbing to 0.9% q-o-q -- the fastest pace since Q2 2000 and the first time the Euro area has grown faster than the US since the 2001 recession (Figure 3.1). Encouragingly, growth is becoming more broad-based with investment and short-term consumer prospects improving in the major economies (Figure 3.2). Gross capital formation and personal consumption were the main drivers of growth. This strengthening of domestic demand has led to increased confidence that growth in Europe will be resilient to a slowing in the US.

Figure 3.1: Real GDP growth is supported by domestic demand

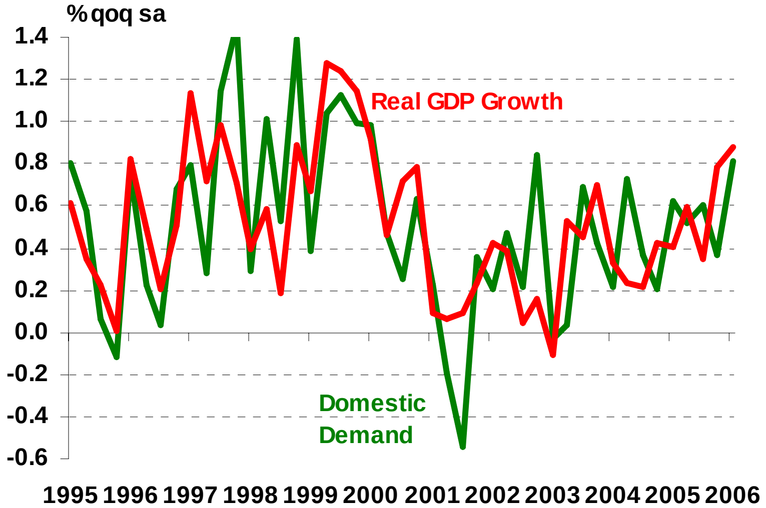
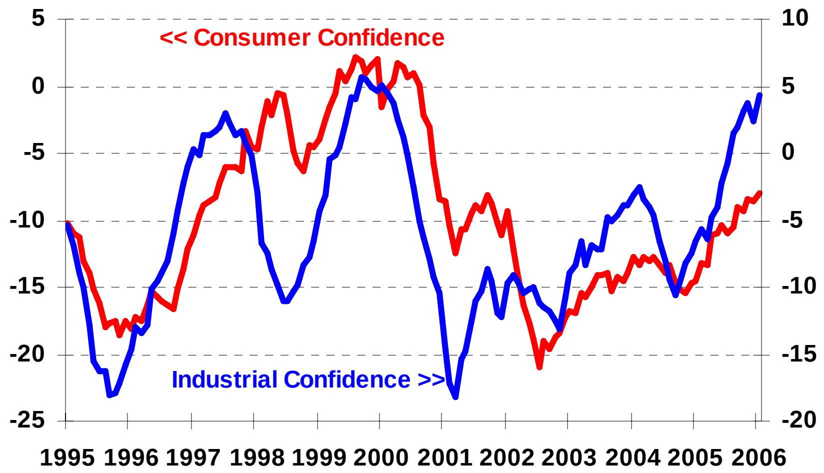
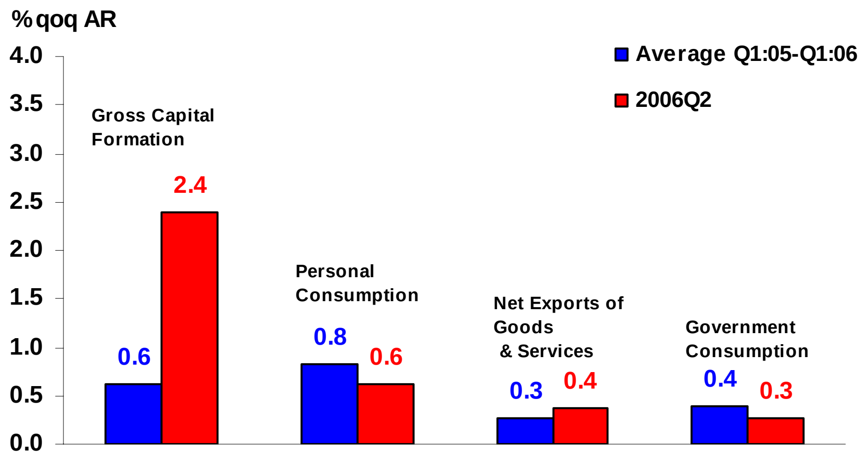


Figure 3.2: Increased consumer and industrial confidence



Gross capital formation seems to be the main driver of growth in the Euro area, contributing 2.4% q-o-q annualized to GDP growth in Q2 2006, far ahead of the second biggest component, personal consumption, which contributes 0.8% q-o-q annualized to GDP growth (Figure 3.3). The investment recovery in the Euro area is being driven to a large extent by Germany, where the labor market is recovering and corporate restructuring has contributed to the surge in corporate profit margins. Given that German investment as a share of GDP is still very low, there is substantial fundamental potential for investments to rise further in Germany. We expect the recent rotation in growth drivers towards investment to support employment and, therefore, soften the impact from indirect tax increases in Germany on consumer spending in early 2007.

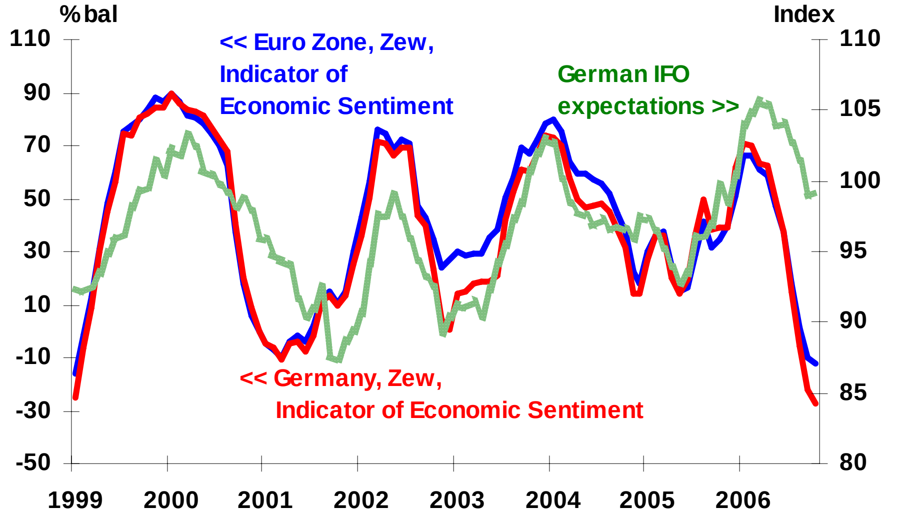
Figure 3.3: Contributions to GDP Growth: Investment is the driving force



Households will probably get a purchasing power lift towards year-end, owning to the decline in energy prices since the summer, as consumption takes a while to adjust to changes in terms of trade. At the same time, German households will be bringing forward spending on durables ahead due to 3% VAT increase, which will take place in January 2007, so consumption growth is expected to accelerate toward year end.

Fears of a negative impact of the German VAT hike in January on personal consumption and, thus, on growth prospects of the German economy and the Euro area as a whole have led to a sharp fall of leading indicators in recent months. The German ZEW survey of analysts' expectations posted another sharp decline in October, down from -22.2 in September to -27.4 (Figure 3.4). A similar picture gave the Euro zone ZEW survey of analysts' expectations, which was down from -10.2 in September to -12.5 in October. Meanwhile, the assessment of current conditions continued to climb for Germany, as well as the Euro zone.

Figure 3.4: Leading indicators likely overstate the extent of the slowdown

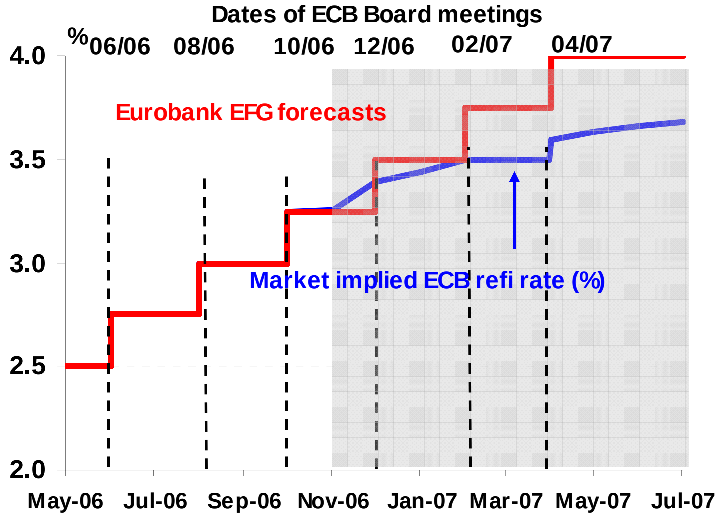


Given increasing recognition of the current strength of the German economy and growing concerns about the outlook, the deterioration of businesses' expectations relative to current conditions is not surprising. The striking declines in expectations of business conditions highlight three key concerns: a softening of the global economy, the temporary impact of the VAT increase in Germany and gradual interest rate increases from their historical lows by the ECB.

Although leading indicators such as the expectations component of the ZEW survey are useful for identifying turning points in economic activity, they seem to overstate the extent of the slowdown. It is true that there are downside risks for the German growth in Q1 2007. In our view, the recent drop in the expectations component of the ZEW survey in fact predicts a slowdown in German spending in 2007 relative to 2006 as a result of the VAT hike, but this is mainly because there is a surge in spending in Q4 2006, as households bring forward spending on durables ahead of the VAT hike.

The uncertainty around the pace of growth at the beginning of 2007 creates uncertainty about the level at which interest rates will settle in early 2007. One further hike in the refi rate from the current 3.25% in December is already discounted in market expectations. There is a definite bias towards further tightening, as the ECB seems to be determined to increase rates towards a level considered as the "neutral interest rate". We expect the ECB to gradually raise rates by 75bp untill Q3:07 to 4.00% (Figure 3.5). Our view differs from the consensus view that the ECB will probably go on hold after December or March mainly for three reasons: (i) the ECB is concerned that strong credit growth creates medium-term inflationary pressures, as loans to the private sector are increasing currently at the fastest pace since the launch of the euro in 1999, (ii) the ECB is concerned about wage pressures especially in Germany and would like to signal its determination to preserve price stability, and (iii) the ECB has the unique chance since its inception of getting inflation below the 2% threshold.

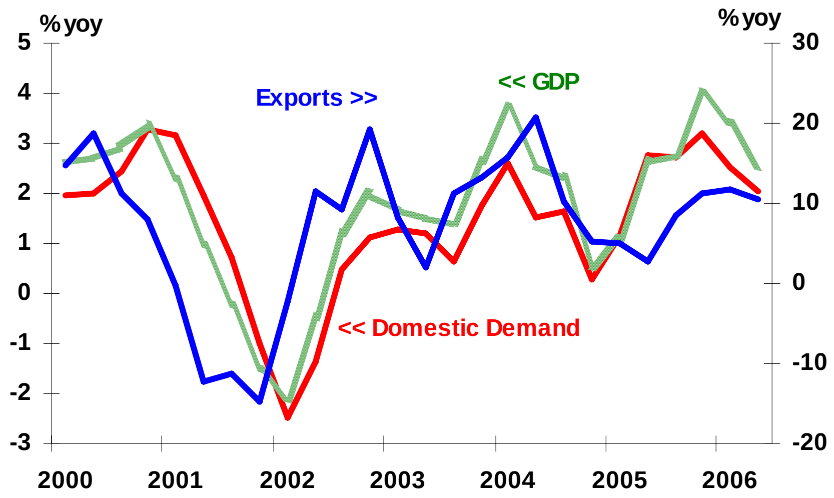
Figure 3.5: ECB refi rate is heading up



4. The Japanese economy

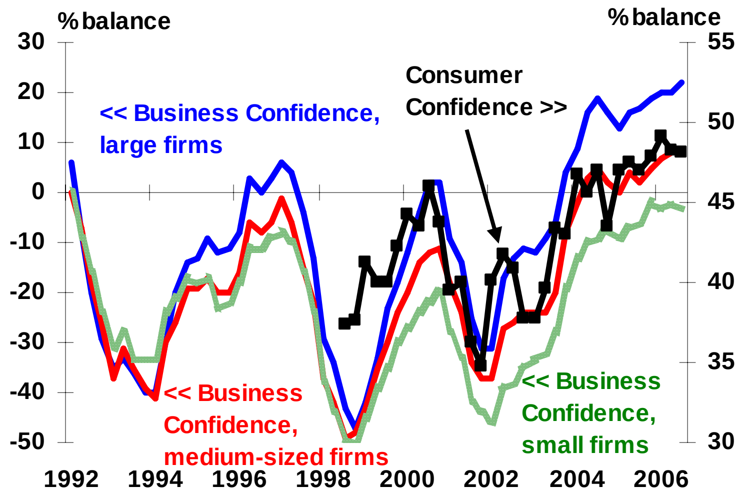
The Japanese economy is in its best shape since 1991. The expansion remains robust as domestic demand has been the main driver of growth since 2005, contributing almost 2% out of 2.5% GDP growth in Q2:2006 (Figure 4.1). After two strong quarters, real GDP growth slowed in the second quarter of the year, owing to inventories and a sharp decrease in public investment and external demand. The major drag on growth was net trade; imports increased by around 2%, in contrast to exports which expanded at their slowest pace in more than a year, increasing by only 0.9%.

Figure 4.1: Real GDP growth slowing, but upward trend remains intact



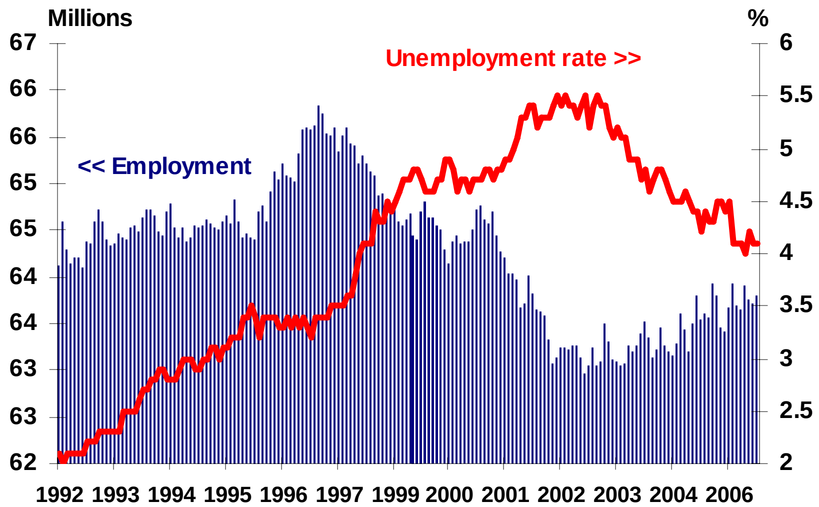
According to the Household's survey of expenditures and to the Cabinet Office's monthly report, private consumption growth is showing signs of slowing in the third quarter of the year. The monthly data releases suggest that the possible temporary decrease in domestic demand and public investment will be partially offset by a surge in exports, as the yen has declined to historic lows. But generally the expectations for net trade are to the downside due to slower growth in the US economy, which is Japan's biggest export market with more than a fifth of Japanese exports going to the US. However, the fundamentals of the economy remain solid and the domestic recovery seems to be on a firm footing, making us more confident that a slowdown in external demand will not pull down the economy. The underlying strength of the economy is confirmed by consumer confidence as well as business confidence indicators, such as the Tankan survey, which is at multi-year peaks (Figure 4.2).

Figure 4.2: Consumer confidence (Cabinet Office) & Business Conditions (BoJ Tankan survey)



The dynamic recovery of domestic demand is clearly supported by improving labor market conditions. Although the unemployment rate rose slightly in September, the underlying trend remains intact; unemployment has actually fallen this year to its lowest levels since 2003 (Figure 4.3). The number of jobs available has climbed to the highest levels in almost 15 years and the job-to-applicant ratio, as well as the employment conditions index, are at their strongest levels for nearly 14 years, indicating that the labor market is recovering in a fundamental way.

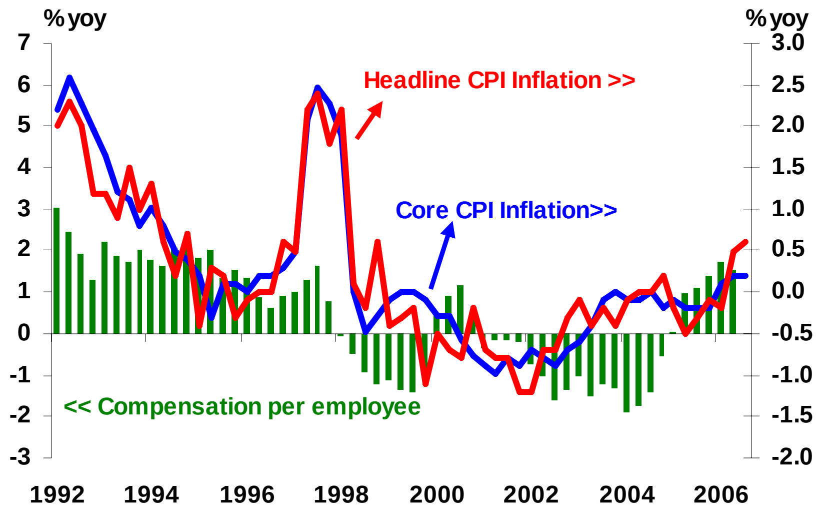
Figure 4.3: Labor market conditions improving steadily



On the other hand, wage increases have been surprisingly flat since the beginning of this year, despite tightened labor market conditions. BoJ Governor Fukui commented that labor income gains are expected to accelerate as soon as the unemployment rate falls below 4%. We believe that increasing corporate profits and investment will eventually lead to further gains in employment and households' disposable income. Indeed, retail sales remained firm in September and increased as a whole 0.6% y-o-y in Q3:2006, returning to positive territory after declining in Q2. This provides further evidence that consumer activity, which showed weakness during the summer months due to bad weather, will recover steadily.

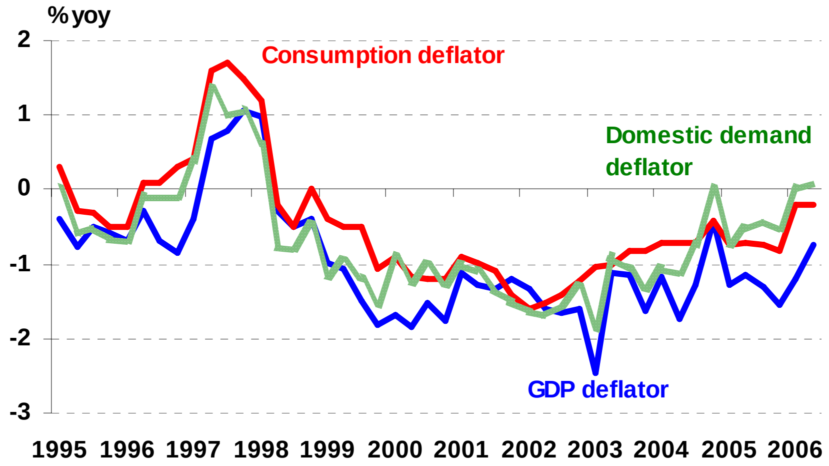
There are clear signs that Japan has finally come out of the period of sustained deflation after seven years of declining prices. Headline as well as core CPI has returned to positive territory in recent months (Figure 4.4). Consumer prices accelerated in August to 0.9% y-o-y, mostly due to strong food and energy prices and slowed a little bit to 0.6% y-o-y in September due to the recent decrease in oil prices, and core CPI inflation has averaged 0.2% since May 2006. Although the GDP deflator continues to decrease on a y-o-y basis, the decline is actually narrowing since the beginning of the year and changes in the final domestic demand deflator have returned to positive territory in Q2:2006 (Figure 4.5). Meanwhile, household inflation expectations are steadily improving. According to the Opinion Survey of the Bank of Japan, the number of households forecasting higher prices in one year has increased from 65.5% in June to 68.4% in September.

Figure 4.4: Headline and core CPI inflation firmly in positive territory, supported by wages



Deflation should not be a major problem for the Japanese economy any longer. Sustained price rises will strongly depend on wage and unit labor cost increases. Although wage growth is undoubtedly still at low levels and working conditions continue to make it difficult for wages to grow on average faster than productivity, we expect wage growth to gain momentum gradually in 2007 as the labor market gets tighter, putting further upward pressure on prices. At the same time, ULC growth may still be negative, but the margin of the decline has narrowed considerably and is expected to narrow further in the future, contributing positively to price increases.

Figure 4.5: Narrowing decline in GDP deflator

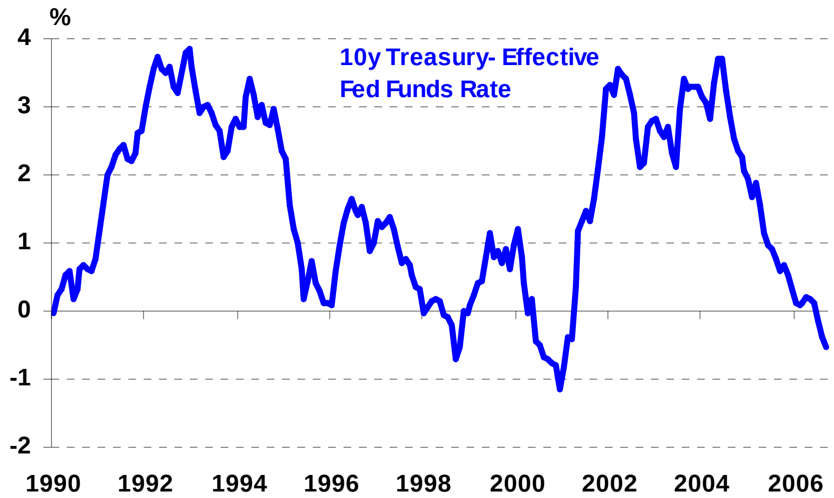


Provided the economic outlook remains strong, the Bank of Japan has not ruled out the possibility of another rate hike before the end of the year. In our opinion, however, the odds of a rate hike before year-end are low. Prices remain low for the time being and the continuing correction in oil prices, which will have impact on headline as well as core prices, will make it difficult for the BoJ to justify another hike, at least from the inflation point of view. At the same time, wages, unit labor costs and personal consumption remain relatively weak. The next rate hike may, therefore, be delayed for the first quarter of 2007. Any indications of underlying strength in the data of the following months, particularly in relation to personal consumption and wages, should result in gradual normalization of BoJ's monetary policy early next year.

5. Global bonds and equities

Expectations of a slowing of the US economy and the perceived end of the tightening cycle of the Fed have led 10-year Treasury yields to decline from their June peaks of 5.11%. In addition, the sharp drop in oil prices in the second half of the year has eased inflation expectations, also helping bond markets rally. The slope of the yield curve has slipped further into negative territory, reflecting concerns that the ongoing correction of the US housing market will eventually affect the US consumer. As a result, the yield differential between 10-year Treasury yields and Fed funds rates has declined further to -53 bps, the widest negative slope since January 2001, when the US economy slipped into a recession (Figure 5.1).

Figure 5.1: Slope of the US yield curve is at cyclical lows



Stock markets have rebounded from their setback in May/June, when fears that the Fed would go for an overkill of the US economy has led global stock markets to tumble. Stock prices reversed since mid-June as markets gradually became more confident that the Fed would go on hold due to the sharp weakening of the US housing market and the slowdown of the US economy. In contrast to bond markets, stock investors seem to currently take a more positive view on the US economy than bond investors, as valuations have largely overshot their mid-year levels despite the continuing correction in the housing market and the sharp slowdown in Q3 economic activity. To a large extent, stock markets were driven by the strong earnings results in Q3, as positive surprises have dominated, alleviating concerns of a deteriorating economic outlook.

With the global economy experiencing its strongest growth during 2004-2006 since the early 1970's, global stock markets have entered a bull period which is now lasting for nearly four years. Despite the strong price gains, however, equity valuations remain attractive as companies' earnings have increased substantially at the same time. As a result, P/E multiples are way below historical averages both in developed and emerging markets (see Table 5.1).

Table 5.1: Stock market valuations remain supportive

P/E (Price to current year earnings ratio)		1990-2005	2005	2006E*	2007E*
US	S&P 500	22	20	16	15
Europe	MSCI EMU	17	16	14	13
Japan	MSCI Japan	49	19	18	16
UK	MSCI UK	17	16	15	14
Greece	ASE	16	19	16	14
Emerging Markets	MSCI EM	NA	17	14	13
World	MSCI AC World	21	18	16	15

E: Based on EFG earnings estimates
*: Current prices to 2007 EFG earnings estimates

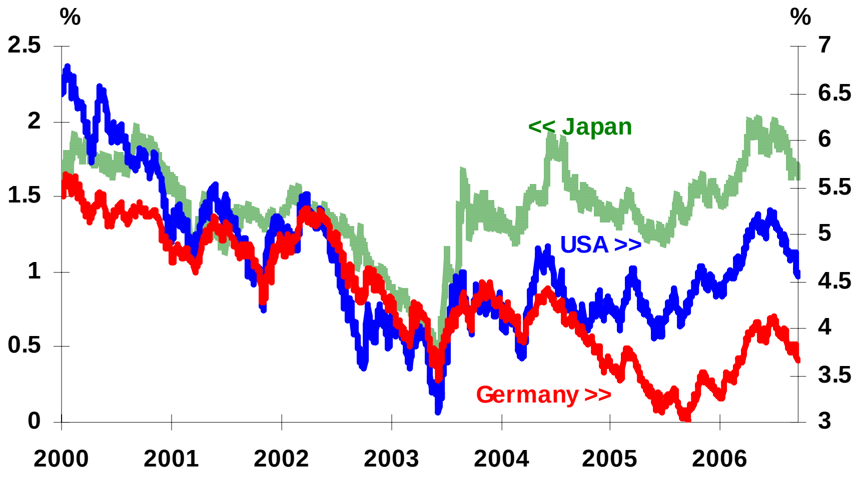
With the world economy continuing to grow at near the current rates, global liquidity still-abundant and high earnings yields over bond yields, we continue to expect out-performance of equities relative to government bonds as an asset class. We remain positive on the global profit cycle despite a slight moderation expected in 2007 as a result of the profit slowdown in the US, as global GDP growth is expected to remain strong and global business confidence continues to be at cyclical highs.

6. Implications for Global Asset Allocation

Bonds

Our view that the US economy is facing a period of adverse growth shocks emanating from the housing market downturn, combined with increased inflationary pressures in the short-term, suggests increased cautiousness on the side of investors. With short-term interest rates remaining at elevated levels for a longer period than markets currently seem to anticipate, and even going up somewhat, bond markets will likely continue to correct (with 10-year Treasury bond yields heading up towards 5.25) until clear signs of a reversal in Fed policy become evident. To the extent that the growth slowdown in the US will prove to be more severe than currently anticipated, Treasury yields are expected to decline towards the recent lows of 4.65 (Figure 6.1). Overall, we expect higher volatility in government bond markets as conflicting news about growth and inflation will increase uncertainty about the underlying trend in the direction of yields.

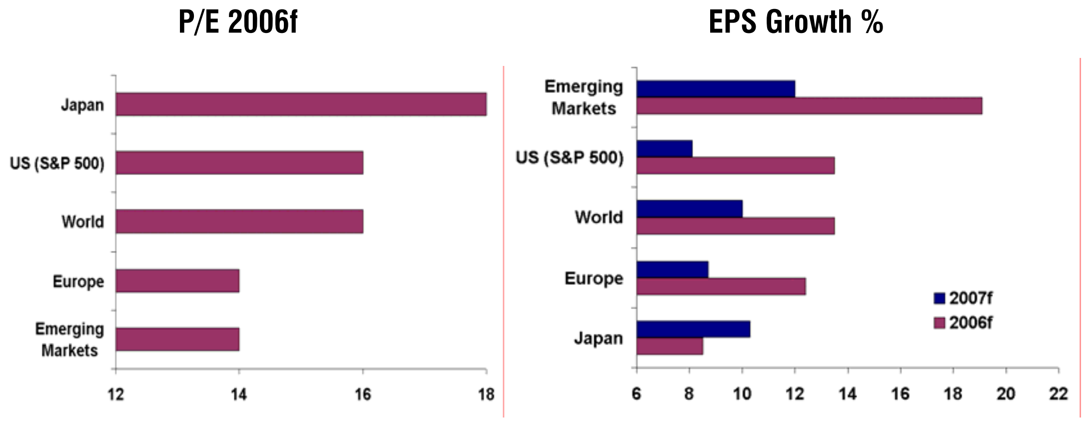
Figure 6.1: 10-year government bond yields



Equities

Given our view that the global economy will hold up well in the face of increased headwinds from the US housing market, global equities remain fundamentally cheap relative to bonds. Equity valuations, which seem to be supported by strong global growth, low P/E ratios as well as relatively rich risk premia, are supportive compared with historical standards (see Table 5.1 and Figures 6.2-6.3).

Figure 6.2&6.3: Stock market valuations (P/Es) and earnings growth
(MSCI indices, unless otherwise indicated)

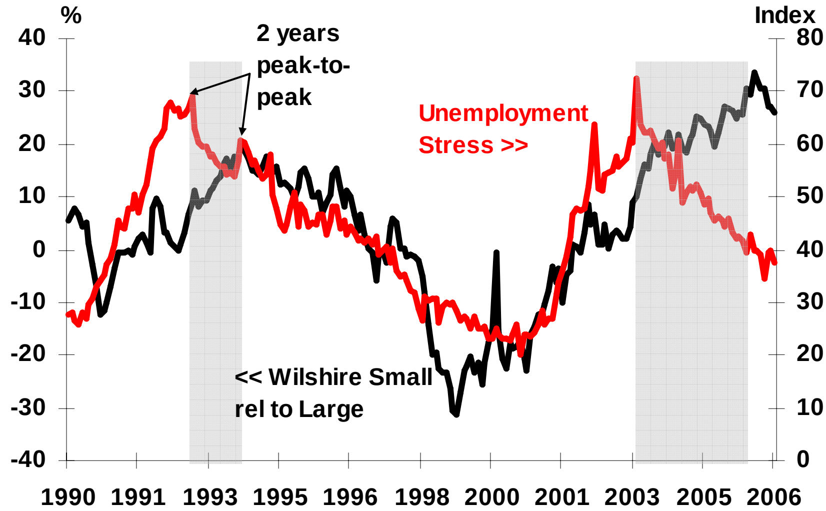


However, risks have increased that a profit slowdown in the US will hurt equity valuations in the short term, likely in early 2007. Having acknowledged this risk, the response of global stock markets will likely be muted relative the May/June setback, as valuations are relatively cheap on a long-term basis, providing some protection against a turn in the US profit cycle.

Style positioning

Regarding style positioning in the US stock market, we prefer large capitalization companies over small and medium caps, as the latter are more sensitive to negative growth and inflation surprises. Our research suggests that the small cap cycle in the US, which started during the early phase of the latest economic rebound in March 2002, has likely come to an end with the May/June 06 setback. Small caps tend to commove with unemployment stress, a measure of the state of the business cycle which we compute as the product of the rate of unemployment and the median duration of unemployment. Unemployment stress increases during economic slums, peaking at recessions, and declines during periods of strong economic growth, bottoming at peaks of the business cycle. Overall, unemployment stress is highly correlated with the commonly used measure of output gap but contains considerably less measurement error than output gap, because it is directly observable and far less subject to data revisions, compared to common measures of the output gap. Our measure of the state of the economy is highly correlated with the relative performance of small capitalization stocks versus large capitalization stocks (see Figure 6.4).

Figure 6.4: US small cap out performance has probably come to an end



During the latest economic cycle (1991-2001), small caps have underperformed large caps from 1994 (nearly two years after the start of the rebound) until the 2001 recession by a total of 40 percentage points. The small cap cycle restarted at the beginning of 2002, a few months after the last recession leading to a cumulative outperformance of small caps of about 50 percentage points relative to large caps until May 06. The business cycle pattern of the relative performance of small-to-large caps suggests that correct style-positioning rewards investors with returns in the range of 40-50% over a period of three to four years. These returns are mainly due to alpha exposure since the market exposure (beta) of the short-long position in styles is relatively low.

As unemployment stress has currently declined to cyclical lows, we project that large caps will over-perform small to medium caps for the rest of the current economic cycle. The rationale is that large caps' earnings are more diversified internationally compared to small and medium caps --which mostly depend on domestic demand-- and thus are less sensitive to a slowdown of the US economy. Hence, we propose a long-short position (long in large caps, short in small and medium caps) in investors' portfolios as a hedge against the slowdown of the US economy.

Global equity allocation

European shares are better priced than US shares both on the basis of lower P/E multiples --which may provide some support to downside risk-- and on projected EPS growth, as the recovery of the Euro area economy is on a strong footing and mergers and acquisitions of European companies continue to drive markets (see Figures 6.2-6.3). On a long-term basis, we also prefer Japanese stocks compared to US stocks, as the Japanese economy is rebounding and the Yen has depreciated in real terms against a broad basket of currencies by more than 30% during the past decade, increasing export competitiveness of Japanese companies.

A few words about EFG Eurobank Ergasias S.A. (Eurobank EFG)

EFG Eurobank Ergasias S.A. (Eurobank EFG), is the second largest bank in Greece with assets of around €45 billion. Founded in 1990, Eurobank EFG has received high marks from the most reputable international rating agencies (Standard & Poor's, Fitch and Moody's), not only for its financial strength, but also, for the Group's client focus, high level of services, its heavy investment in modern technologies and its professional and dynamic management and personnel. As a member of EFG Group – a Geneva-based banking Group – it has access to all European financial markets.

Eurobank EFG offers a comprehensive array of banking products and services for individuals, corporations and institutions. It currently employs more than 17,000 people in Greece and abroad and runs a distribution network of over 900 branches and alternative distribution channels. In recent years, the Bank has expanded into Bulgaria, Romania, Serbia, Turkey, Poland and Ukraine.

More information about Eurobank EFG can be found at http://www.eurobank.gr

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