Eurobank Research

GLOBAL ECONOMIC & MARKET OUTLOOK

Eurobank EFG

www.eurobank.gr/research

September 2007

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Main Views and Market Strategy:

- Although the increased importance of BRICs in the global economy suggests that a significant US slowdown will not derail the world economy, global growth is due to moderate in 2008, as Japan and the Euro area will be hit by slowing exports to the US and a weaker dollar.

- Triggered by a deeper housing recession, we recognize more downside risks to economic growth in the US. The tightening of credit conditions and the ongoing labor market deterioration have led us to revise our US real growth forecast to 1.8% y-o-y in 2007 (down from 2%) and to 1.7% in 2008. The risks are on the downside, as the probability of a recession in the US has increased significantly to nearly 60% in Q4 07.

- With the US economy slowing significantly over the next few months and unemployment starting to rise, we expect the Fed to continue cutting rates by another 50 bps to 4.25% by January 08. In our view, further rate cuts are not likely as inflation is due to pick up by year-end, putting a floor to short term interest rates. However, the balance of risks to Fed funds rates is clearly on the downside, as the economic slowdown is likely to turn into a recession.

- The Treasury-Bund spread narrowing has probably reached a cyclical trough, as expectations about short-term interest rates in the two areas have gradually converged. We expect the spread to increase to near 40 bps by December and decline gradually towards its current levels of 30 bps during H2 08, when the US economic slowdown has fully worked out.

- The risks for the dollar are clearly on the downside as (a) the US economy is likely to move into a recession, (b) the dollar is in the epicentre of the evolving credit crunch, (c) the unwinding of carry trade positions will likely put the dollar under severe selling pressure, especially against the yen.

- The return of equity market volatility is probably here to stay for a considerable period of time. Our long-standing view remains that the risk of a retreat in global equity markets due to the US profit slowdown is considerable, a risk not sufficiently discounted in current market valuations.

- As the current profit slowdown hits small caps harder than large caps, we expect large caps to outperform small caps over the next twelve months.

- Although large value stocks may continue to benefit from the turn in the interest rate cycle, a weaker dollar and robust growth of the global economy, small- and medium-sized value stocks will likely suffer most from a slowdown in domestic demand.

Macro Forecasts

	2006	2007		2008	
		Eurobank EFG	Consensus	Eurobank EFG	Consensus
Real GDP Growth (y-o-y average)					
US	2.9	1.8	1.9 (1.9 – 2.5)	1.7	2.6 (1.8 – 2.6)
EU-12	2.9	2.5	2.7 (2.1 – 2.7)	2.0	2.3 (2.0 – 2.3)
Japan	2.2	2.0	2.4 (1.7 – 2.4)	2.0	2.1 (1.8 – 2.1)
CPI Inflation (y-o-y average)					
US	3.2	3.1	2.7 (2.6 – 3.3)	3.0	(2.3 – 3.0)
EU-12	2.2	2.0	2.0 (1.9 – 2.3)	2.0	(1.8 – 2.1)
Japan	0.1	0.0	0.0 (-0.1 – 0.1)	0.4	(0.0 – 0.6)
Short Term Interest Rates (end of year)	Current				
US	4.75	4.50	4.50 (4.25 – 4.75)	4.25	4.25 (4.00 – 5.50)
EU-12	4.00	4.00	4.00 (4.00 – 4.25)	4.25	4.00 (4.00 – 4.50)
Japan	0.50	0.50	0.75 (0.50 – 1.00)	1.00	1.00 (0.75 – 1.25)

Note: Range of forecasts in parentheses below point estimates.

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Global Outlook and Asset Allocation

1. Executive Summary

Dimitris Malliaropulos

Economic Outlook

In our May issue we expressed the view that the continuing housing market downturn and the collapse of the subprime mortgage market would leave consumers more exposed to negative wealth effects, resulting in a slowdown in personal consumption and GDP growth. This slowdown, in combination with the gradual labor market softening, would prompt the Fed to ease its monetary policy and lower Fed funds rate by 50bp by year end.

Concerns about a spillover from the US subprime mortgage market to the real economy have been confirmed during the past two months, underpinned by a substantial tightening of financial conditions. Stock markets have corrected, although temporarily, corporate spreads have widened and financial market volatility has reached its highest level since 2003. As several financial institutions revealed massive losses resulting from exposure in the subprime and leveraged credit derivative markets, short-term liquidity in the major money markets evaporated and many debt securities were trading at significantly higher rates. Global central banks acted appropriately by providing emergency liquidity support to global money markets and troubled financial institutions. The Federal Reserve took further action and lowered interest rates aggressively, signalling growing concerns about the growth outlook of the US economy.

Housing problems, combined with the ongoing credit crunch, are aggravating the greater downside risks to US economic growth. Therefore, triggered by a deeper and longer housing recession, we now recognize more downside potential to economic growth as falling house prices will impact on consumer confidence and spending growth through negative wealth effects. Tighter credit conditions, higher borrowing

costs and a sharp increase in credit spreads for the corporate sector will also squeeze business capital spending. All these factors, reinforced by the ongoing labor market deterioration, have pushed the probability of a recession in the US to its highest level during the current business cycle.

The probability of a severe slowdown was already significant even prior to the recent credit and liquidity crunch. In our May Global Issue, we had already acknowledged the risk of an extended slowdown of the US economy, as our model indicated that the probability of a significant slowdown to a GDP growth rate below 1.6% y-o-y in H2 07 had reached 50%. Although, at that time, an outright recession was not, in our view, the most likely outcome, we recognized that the probability of a recession had also increased to 23% in Q3 07 from 11% in Q2.

However, the financial turmoil, combined with the significant softening of the labor market, make the likelihood of a recession in the US now greater than ever since 2001. In fact, feeding the new data into our probability model of US growth, we find that the probability of a recession in the US has increased significantly to nearly 60% in Q4 07 from 11% in Q2 07. The main driver of this sharp re-pricing of recession risk is the decline in house prices, which translates into negative wealth effects for households and lower consumer spending. We expect US consumers to take a substantial hit from declining housing wealth, tighter lending conditions and rising unemployment. We also expect capital spending to weaken noticeably as consumer demand slows, corporate profits decline – increasing the financing gap of non-financial companies -- and the surge in libor rates and default risk has increased the cost of credit since early August. As the economy slows significantly over the next few months and unemployment starts to rise, the Fed will continue to cut rates by another 50 bps to 4.25% by January 08. Further cuts into 2008 will depend on the duration of the credit crunch, the response of the US economy and inflation developments. In our view, the scope for further rate cuts is limited as inflation will pick up by year-end, putting a floor to short term interest rates. However, the balance of risks to Fed funds rates is clearly on the downside, as the economic slowdown is likely to turn into a recession.

Given the risk of a broad-scale global credit crunch and a hard-landing of the US economy, the central question is whether the global economy will decouple from the US. Early signs of faltering business confidence and declining capex spending in the Euro area and Japan, combined with a strengthening of their currencies against the dollar suggest that these two major areas will likely not avoid a slowdown of economic activity below potential into 2008. However, the consensus view seems to be that a slowdown in the US will not derail the global economy as the growth outlook for the BRICs remains bright. We continue to share this view, although we must acknowledge that risks are on the upside as investors become fundamentally gloomy about the outlook of the global economy rather than being concerned about the US slowdown.

A different question is whether the current financial market turbulence, related to the spreading of the US subprime crisis into credit markets, has possible spillover effects to emerging market assets, especially for countries with large external deficits and low FDI inflows. Should the rise in the cost of capital in the major economies prove permanent, resulting in investment capital shortage, then international capital flows are likely to take a dip as institutions lower their risk exposures. Although emerging countries with large external debt positions and current account deficits will most likely suffer, emerging markets as a whole look currently less vulnerable to financial market volatility than 10 years ago, as a result of improved external positions and sound economic fundamentals. In particular, countries with large structural trade surpluses and central bank reserves, such as China, Russia and the OPEC bloc, may even prove to be a support for global liquidity. However, whether this excess liquidity will in fact be redirected to the troubled subprime and commercial paper market, where it is mostly needed, depends on investors' perceptions on whether these markets have bottomed out.

Implications for Asset Allocation

Our central view is that investors should get positioned for a sharp slowdown in the US which, combined with the ongoing re-pricing of credit risk, increases the likelihood of ripple effects on global financial markets. In our view, the liquidity injections by major central banks and the aggressive rate cuts by the Fed have eased the financing constraints in money markets only temporarily, as Libor rates still remain nearly 50 bps

above Fed funds target rates and many leveraged borrowers are still unable to obtain funding at any price. Hence, the process of de-leveraging and risk-reduction in credit markets, which has started in early August, will likely be set into motion again as financing conditions in many market segments are still far from normal.

The credit crunch has led to a noticeable "flight to quality" towards sovereign debt, emerging market equity and large caps. Investors seem to have turned their back to the troubled subprime and asset-backed commercial paper market in the US, redirecting liquidity towards emerging market debt and equity markets. Emerging market bonds have rallied, pushing sovereign risk premia close to their pre-August levels. Emerging equity markets have pushed to new record highs, increasing by some 30% from their lows in mid-August, outperforming the world MSCI index by a whole 20 percentage points. Large caps in the US have rallied too, although more modestly, as they are more exposed to the global economy than small and medium-size caps and can benefit from the weak dollar.

The driving force behind the recent performance of emerging markets and large caps is, in our view, the secular growth story of the largest emerging markets, in particular the BRICS. After the Fed has clearly indicated its willingness to ease monetary policy, investors seem to believe more than ever in the decoupling story, i.e. that growth in the BRICs will not be materially affected from the slowdown of the US economy. Unfortunately, the decoupling story cannot be tested as there is no similar event in the recent history of the global economy. Hence, only time will show whether investors are right. However, we believe that as the US slowdown unfolds, the risks are rising that the global economy will not be able to decouple from the US if growth takes a dip and turns negative.

The bottom line for investors is to build up defensive positions against a backdrop of risky asset markets as the US slowdown and the liquidity-squeeze unfolds. We view increased positions in growth versus value stocks, large versus small stocks and long positions in commodities, BRICs and volatility as a reasonable hedge against such a backdrop.

Government Bonds and Spread Products

Current bond market valuations have in our view fully priced in the probability of a severe US slowdown and an easing of monetary policy by another 50 bps by early-2008. Our fair value estimates of 10-year Treasury rates in fact suggest that current valuations are neutral with respect to the main fundamentals of the US economy and the short-term prospects for monetary policy. Looking forward, however, we believe that inflation worries will soon start to build up as a result of looser monetary conditions, putting a floor to Fed funds rates and leading to higher inflation premia in bond markets. Thus, we project 10-year Treasury bond yields to head up to 5% in Q4 as inflation rebounds and market expectations of aggressive rate cuts by the Fed gradually seize.

With the downturn of the housing market intensifying and labor market weakness cumulating over the next few quarters, we expect the yield spread between 10-year Treasuries and Fed funds – which is currently -25 bps, close to our May projections for Q4 (-22 bps) – to steepen significantly as monetary policy will eventually lag behind the curve and long-term yields will increasingly reflect mounting inflation worries. As a result, we expect long-short positions in 2-year versus 10-year Treasuries to outperform and suggest a restructuring of bond portfolios towards shorter durations.

On the Treasury-Bund spread, we believe that spread narrowing has already reached a cyclical trough as expectations about short-term interest rates in the two areas have gradually converged. We expect the Treasury-Bund spread to increase to near 40 bps by December and decline gradually towards its current levels of 30 bps during the second half of 2008, when the growth slowdown in the US economy has fully worked out. Hence, we continue to suggest long-short positions in 10-y Bunds versus Treasuries at current levels of the spread but acknowledge that (a) the potential of such trades is limited (20 bps) and (b) the risks are on the upside as interest rate volatility is clearly on the rise and the dollar will continue its downward trend.

Foreign exchange

Over the past four months, the dollar has continued to weaken against major currencies, as a result of the slowdown in the US economy, narrowing interest rate differentials and the unwinding of leveraged carry trade positions due to the turmoil in credit markets. We expect this trend to continue during the rest of the year, as Fed policy has clearly turned to an easing bias and the risks of a sharp slowdown of the US economy are currently on the rise. In addition, the global turmoil in credit markets creates increasing pressure on yen-funded carry trades, which start to unwind, putting high-yielding currencies such as the dollar under severe selling pressure. The risks for the dollar are clearly on the downside as (a) the US economy is likely to move into a recession, (b) the dollar is in the epicentre of the evolving credit crunch, which may eventually prove worse than expected, (c) the unwinding of carry trade positions will likely put the dollar under severe selling pressure, especially against the yen.

Our short-term fair value model of the EUR/USD exchange rate suggests that the decline of the dollar against the euro year-to-date is fully in line with the narrowing of the Treasury-Bund 10-year yield differential over the same period. The euro has already crossed the critical threshold of USD 1.40 in late September and we expect the currency to cross USD 1.45 in the next six months.

Equities

Volatility: Global equity markets have entered a new regime of higher volatility. Both realized and implied volatility have increased substantially since July as rising concerns about the effects of the unwinding credit crunch on the global economy has triggered a process of de-leveraging and general position reduction. In our view, the return of equity market volatility is here to stay for a considerable period of time, with VIX volatility likely to trade around a level of 20 rather than a level of 10-12, experienced over the past few years. The main driving force behind this development is the fact that the US economy has entered a period of cyclical weakness with economic uncertainty on the rise and tentative signs of rising slack in the labor market. The current episode of rising volatility looks in our view closer to the 1997-1998 episode (Asian crisis,

Russia's default, LTCM meltdown), when volatility increased permanently for many years, rather than the recent short-lived spikes of volatility in 2005-2006.

Corporate profits: Investors should get ready for a profit crunch in the US. Our long-standing view was that the risk of a retreat in global equity markets due to the US profit slowdown is considerable and this risk seems not to be sufficiently discounted in current market valuations. In our last Global issue in late May, we argued that investors should get ready for a significant deceleration of corporate profit growth in the US as profit spreads had already past their peak in 2006 and economic activity was showing clear signs of a slowdown since Q1 07. Our current projections suggest that the slowdown of the US economy will lead to even negative growth rates of corporate profits in Q3 and Q4 and a gradual rebound in the second half of 2008. Most of this profit crunch will affect small and medium-size companies, which are more dependent on the domestic business cycle. In our view, the easing of monetary policy by the Fed will not be sufficient to alter the negative trend in corporate profits, suggesting that valuations will get under increased pressure.

Valuations: Lower Fed funds rates provide only temporary relief to equity valuations. Based on estimates of our long-term fair value model of US equities versus bonds, we warned in May that the valuation gap between equities and government bonds has turned neutral in Q1, suggesting that stocks are not any more undervalued relative to bonds for the first time since Q1 04. Following the June sell-off in bond markets, the overvaluation of stocks increased to +8% relative to bonds and declined to +3% in Q3 after the rebound of the Treasury market in August. It appears that the aggressive rate cut by the Fed in September has helped to counterbalance the negative effect of rising slack in the labor market on the fair value of stocks versus bonds. Looking forward, however, we expect unemployment to increase and the labor market to normalize towards a cyclically neutral level in 2008. This will likely lead to a further decline of the fair value of equities relative to bonds, increasing the valuation gap to 8% in Q4 from 3% currently. We expect a rebound of the stock market in 2008, as economic growth picks up and corporate profits start to improve.

Large versus small caps: Our long-standing view has been that the long cycle of out-performance of small capitalization stocks relative to large capitalization stocks in the

US is nearing to an end. As the current profit slowdown hits small caps harder than large caps and the probability of a recession in the US has increased substantially, we expect large caps to outperform small caps over the next twelve months. Based on the state of the economy and the earnings-bond yield differential, large caps look currently undervalued relative to small caps by 5-10%. Faced with the risk of a sharper than expected slowdown of the US economy, the implication for investors is to increase short-long positions in small versus large caps as a hedge against a recession in the US. On top of the cyclical weakness of small caps, the risk of a sharp correction in the small cap market is in our view unusually high as a further tightening of credit conditions may lead to a large-scale unwinding of leveraged positions of hedge funds.

Growth versus value stocks: The turn in the US business cycle has also clear implications for style investing. Value stocks tend to outperform growth stocks when the economy rebounds (similar to small and medium capitalisation stocks) and underperform when the economy enters into a business cycle slowdown. Value stocks look currently overvalued relative to growth stocks by 5-10% based on the state of the economy and the earnings-bond yield differential. Although large value stocks may continue to benefit from the turn in the interest rate cycle, a weaker dollar and robust growth of the global economy, small- and medium-size value stocks will likely suffer from a slowdown in domestic demand.

EFG Macro Model Forecasts: US Economy & Markets

	2007:Q2	2007:Q3	2007:Q4	2008:Q1	2008:Q2	2006	2007	2008
GDP q-o-q saar	3.9	1.8	1.0	2.1	1.6	2.6	1.8	1.6
GDP y-o-y	1.9	2.1	1.8	2.2	1.6	2.8	1.8	1.7
Consumption y-o-y	2.8	2.5	2.2	2.4	2.2	3.0	2.6	2.3
Disp. Income y-o-y	3.1	2.3	1.9	2.2	2.1	2.9	2.7	2.1
Corp. Profits after tax y-o-y	3.4	-1.1	-1.9	-1.0	0.3	11.6	0.4	1.3
Labor Market								
Employment y-o-y	1.2	0.6	0.7	0.7	0.8	2.0	1.1	0.7
ULC y-o-y	4.8	4.0	3.5	3.0	2.7	2.9	4.1	2.6
Inflation								
Headline CPI y-o-y	2.6	3.2	3.9	3.5	2.9	3.0	3.1	3.1
Core CPI y-o-y	2.2	2.1	2.4	2.6	2.7	2.5	2.3	2.7
Core PCE y-o-y	1.9	1.9	2.0	2.0	2.3	2.2	2.0	2.2
Core PPI y-o-y	1.8	1.9	1.9	2.0	2.0	1.7	1.8	2.0
Interest Rates (% end of quarter)								
Fed Funds	5.25	4.75	4.50	4.32	4.16			
10-y Treasury yield	5.10	4.50	4.94	4.76	4.84			
Spreads (bps, end of period)								
10y Treasury-Fed funds rate	-15.0	-25.0	43.9	44.2	68.8			
10y Treasury-Bund	51.7	27.5	39.9	36.1	40.7			
Exchange Rates (end of quarter)								
USD/EUR	1.35	1.40	1.42	1.49	1.46			
Probability of								
Fed Funds Cut	0.46	0.50	0.68	0.57	0.55			
10y-1m Spread to increase	0.76	0.78	0.91	0.48	0.75			
S&P500 to outperform 10-y UST	0.40	0.25	0.37	0.36	0.38			
Bund to outperform 10-y UST	0.46	0.34	0.67	0.39	0.53			

Note: All forecasts are based on the estimates of a quarterly econometric model of the US economy and main financial markets. Point forecasts and probability estimates are subject to risks and should be only indicative of medium-term trends of the economy and financial markets.

2. The US economy

Dimitris Malliaropulos, Olga Kosma

- Triggered by a deeper housing recession, we recognize more downside risks to economic growth in the US and expect real GDP growth to slow to 1.8% y-o-y in 2007 and 1.7% y-o-y in 2008.
- The tightening of credit conditions and the ongoing labor market deterioration have increased the probability of a recession to nearly 60% in Q4 07.
- With the US economy slowing significantly over the next few months and unemployment staring to rise, we expect the Fed to continue cutting rates by another 50 bps to 4.25% by January 08.
- The housing downturn, reinforced by tightening credit standards and weaker labor market conditions, will weigh on personal consumption.
- Corporate profits are due to fall, increasing the risk of a market correction.

Recession risk rises exponentially, as the housing market slump intensifies...

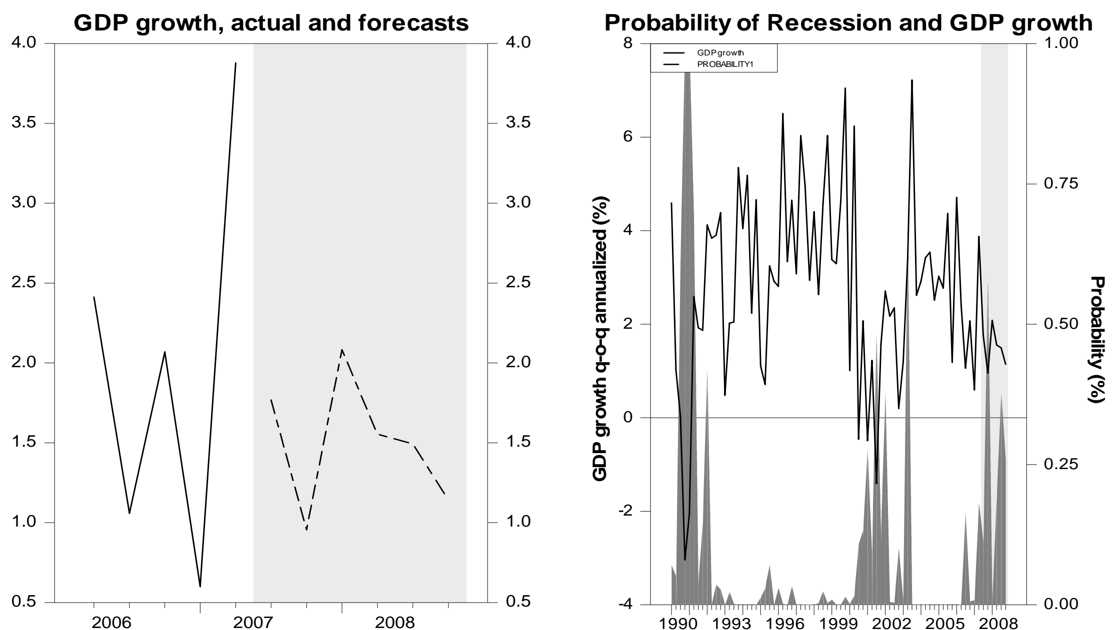
The housing market in the US continues to plunge, and the crisis in the sub-prime mortgage sector seems to be postponing the bottoming out of the contraction in residential construction. Housing problems, combined with the ongoing credit crunch, are aggravating the greater downside risks to US economic growth. Therefore, triggered by a deeper and longer housing recession, we now recognize more downside risks to economic growth and expect US real GDP growth to average 1.8% in 2007 (down from our 2% forecast of May) and 1.7% in 2008. Falling house prices will probably result in softer consumer confidence and spending growth through negative wealth effects. Tighter credit conditions, higher borrowing costs and a sharp increase in credit spreads for the corporate sector will also squeeze business capital spending. All these factors, reinforced by the ongoing labor market deterioration, will undoubtedly weigh on real economic growth.

The probability of a severe slowdown was already significant even prior to the recent credit and liquidity crunch. In our May Global Issue, we had already acknowledged the risk of an extended slowdown of the US economy. Our model indicated that the probability of a significant slowdown to a GDP growth rate below 1.6% y-o-y had reached 50% in Q3 07, and remained above 35% in H1 08. Although, at that time, an outright recession was not, in our view, a likely outcome, we recognized that the probability of a recession had increased to 23% in Q3 07 from 11% in Q2.

However, the financial turmoil, combined with the labor market and consumer spending that no longer appear immune to the general slowdown, makes the likelihood of a US economic recession even greater. In order to re-assess the current risk of a recession, we used our US GDP probit model, which links the probability of a recession to the quarterly change in real house prices and the ISM Manufacturing Index, as well as measures of the state of the labor market, such as non-farm payroll growth, the rate of unemployment and the median duration of unemployment. We find that the probability of a recession has currently increased to its highest levels of the past four years (Figure 2.1). The main driver of this sharp increase in the likelihood of a recession is the housing market downturn. Real house price increases, as measured by the OFHEO Index, have softened to 0.5% y-o-y in Q2 07, from 5.3% one year earlier. In nominal terms, house prices continued to increase by 3.1% y-o-y in Q2 07, compared to 9.5% in Q2 06, according to the OFHEO index, but alternative indices -such as the S&P/Case-Shiller Home Price Index- suggest that house prices have declined in Q2 07 by about 4% y-o-y. In our central scenario, we project real house prices to decline by 1.8% in Q4 07, measured by the OFHEO index. Under this scenario, the probability of a recession in the US by year-end increases to nearly 60% (Figure 2.1).

Figure 2.1

GDP growth, q-o-q saar



*Source: Eurobank EFG model estimates

Given the sharp deterioration of housing market indicators observed during the past few months, our central scenario is in our view still quite conservative as it assumes that, in nominal terms, house prices will continue to increase in 2007, albeit by a lower rate of 2% y-o-y, down from 8% y-o-y in 2006. Hence, the risk of a severe recession is currently -in our view- clearly on the upside. This is because the probability of a recession increases exponentially as real house prices drop. According to our estimates, a more severe housing market contraction, with a 3.5% house price decline in real terms, points to a recession probability of 93% in Q4 07. On the opposite direction, should the situation in the housing market prove to be better than incorporated in our central scenario, with a 1.3% y-o-y real OFHEO price decrease in Q4 07, then the probability of a recession holds back to 43% (Table 2.1).

Table 2.1
Probability of a recession in Q4 07 rises exponentially as house prices drop

Real house prices (OFHEO) % y-o-y	Implied nominal house prices % y-o-y	Probability of recession
-1.3%	2.6%	43%
-1.8%	2.1%	59%
-2.9%	1.0%	85%
-3.5%	0.4%	93%
-4.0%	-0.1%	97%

*Source: Eurobank EFG model estimates

Note: In order to assess the probability of a recession, we use our GDP probit model, linking the probability of a recession to the change in real house prices, the ISM manufacturing and measures of the state of the labor market, such as payroll growth, the unemployment rate and the duration of unemployment. In our baseline scenario, we assume that the ISM manufacturing index stands at 54.8 in Q4 07, payroll growth declines from 1% y-o-y in Q3 07 to 0.9% in Q4, while our standardized labor tightness indicator, moderates from 0.24 in Q3 07 to 0.06 in Q4 07.

…, forcing the Fed to shift from a tightening to an aggressive easing bias

Following the financial market turmoil in early August, the Fed shifted to a clear easing bias on concerns that the tightening of credit conditions and increased uncertainty will have an impact on growth forward. On August 17th, the Fed cut the discount rate by 50 bps, from 6.25% to 5.75%, recognising that the downside risks to growth have increased "appreciably". Following the

disappointing employment data of August, the FOMC made its aggressive stance even more clear at its September 18th meeting, cutting the Fed Funds rate by 50 bps to 4.75% and the discount rate by 50 bps to 5.25%.

In our view, it is the first time in more than a year that the Fed shifts to a strong easing bias, converging finally to the rate outlook expressed in our February and May issues. The Fed implicitly admitted that it had actually underestimated the downside risks to growth, emerging from the downturn in the housing market and the crisis in the sub-prime mortgage sector. Concerns about inflationary pressures as the most significant risk have vanished and concerns about the implications of financial market turbulence for US economic growth prospects have sharply increased.

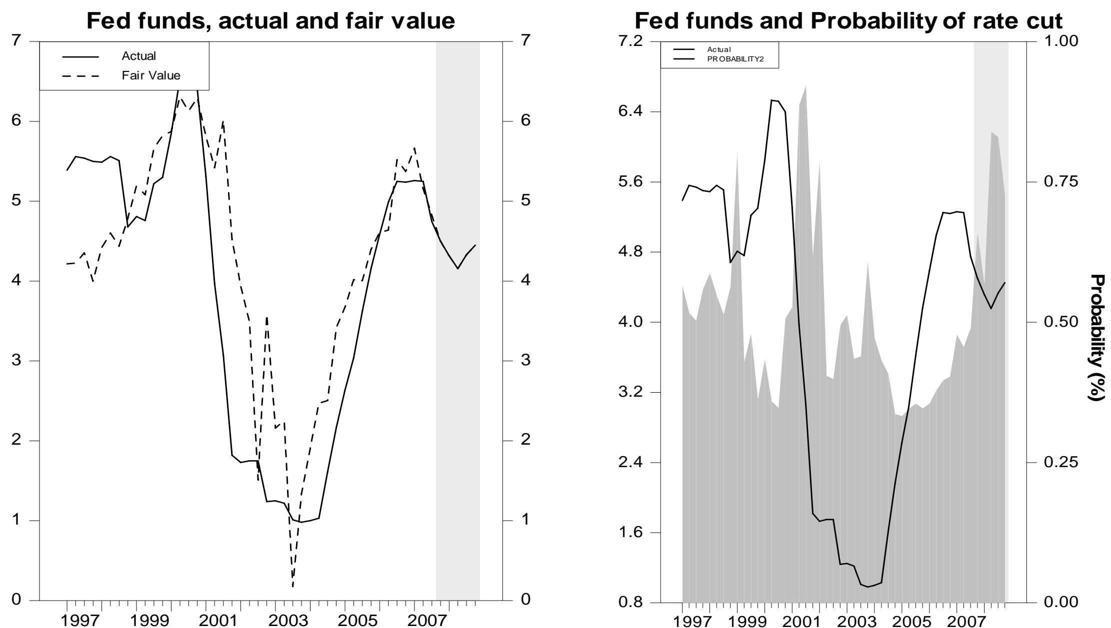
The prime trigger was the fallout from the US sub-prime mortgage market, but the current crisis is extending well beyond the mortgage sector. Several financial institutions with exposure to sub-prime paper and leveraged credit derivative markets revealed massive losses stemming from exposure in the sub-prime and leveraged credit derivative markets. Credit spreads on new securities backed by sub-prime mortgages have widened sharply and issuance of such assets linked to subprime securities has decreased, as lenders have been questioning even the AAA-rated tranches. US commercial and industrial (C&I) lending slowed considerably, as borrowers began to face tighter lending terms and standards. Concerns for counterparty risks have increased significantly, leading to a shortage of liquidity in the major money markets after several years of abundance.

The markets for asset-backed commercial paper and for low-rated unsecured commercial paper have suffered due to the reduction in investors' demand, so many debt securities have been gradually trading at significantly higher rates. Furthermore, demand for short-term government paper has surged, leading to a collapse of short-dated T-bill yields on some days. Three month T-Bill yields fell from 4.75% at the beginning of August to merely 3.1% August 20th. Companies dependent on the ability to roll over short-term funding have been experiencing great difficulty in obtaining financing. According to the Fed's release for the commercial paper market, outstanding commercial paper debt declined by $259.6bln in August 2007, implying that 11.9% of the $2.2 trillion commercial paper market in July could not be rolled over. Several financial institutions may now be forced to liquidate better quality assets (highly rated assets), in order to cover the losses and get access to funds.

According to our estimates, the Fed will continue to cut rates to 4.25% over the next three months, as labor market conditions deteriorate sharply and the risk of a recession increases (Figure 2.1). In fact, our probit model of Fed funds rates suggests that the probability of a rate cut is consistently above 55% until Q1 08 and moderates to 54%, 53% and 43% in Q2, Q3 and Q4 07, respectively (Figure 2.2). However, given the risks of a rebound of headline and core inflation over the next 3-6 months -as a combined result of monetary easing and base effects- we expect the Fed not to cut rates aggressively in the future, even if growth decelerates sharply.

Figure 2.2

Fed funds rate



*Source: Eurobank EFG model estimates

The US economy has been weakening even before the financial turmoil

Even before the August market turmoil and the tightening in financial conditions, US economic growth has been weakening significantly. Confirming our forecasts included in our February Global Issue, real GDP growth for 2006 has been revised downwards, from 3.3% to 2.8% y-o-y. Furthermore, real GDP growth in Q1 07 was also revised down, from 2% to 1.5% y-o-y.

The downturn in the housing market has continued to be the cause of much of the slowing in US economic growth. Real fixed residential investment fell at an annualized average rate of 15% q-o-q in H1 07. Existing home sales have remained on a downward trend during the first eight months of 2007, with an average y-o-y decline of 9.2%, sending the backlog of existing unsold houses to a 16-year high. New home sales fell even more on a y-o-y basis, averaging -20% since the beginning of the year. Realtors' sampling of pending home sales dropped sharply in July by 10% y-o-y, providing further evidence of weakening even before the financial market turmoil. The underlying trend for housing starts remains negative, following several months of weak permits number. Over the last eight months, building permits and housing starts have actually fallen by nearly 25% y-o-y on average. Meanwhile, the Homebuilders' Association Index, which tracks builders' perceptions of current market conditions and expectations for home sales, has gradually fallen to 22 in August and to 20 in September from its peak of 72 in June 2005, the lowest reading since January 1991 and the seventh-straight monthly decline.

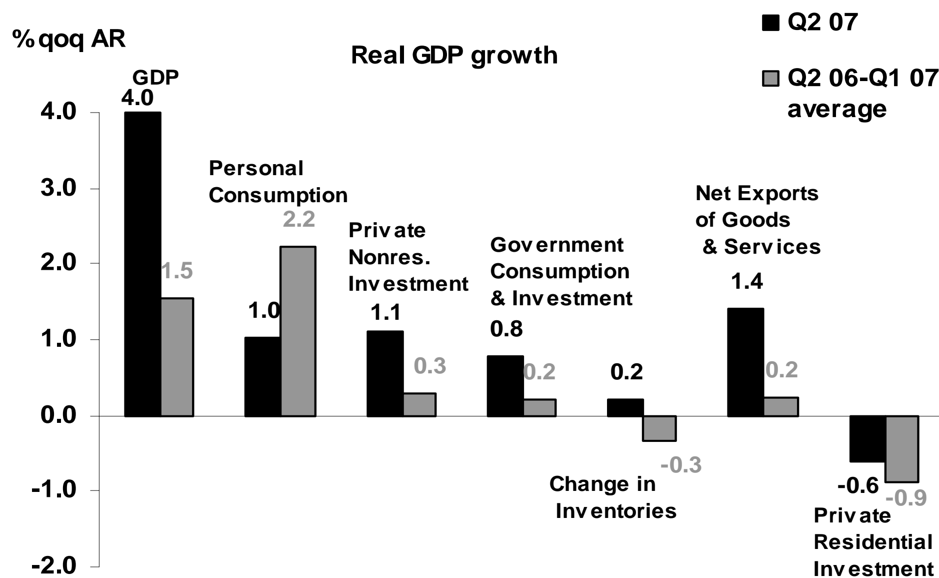
Apart from the housing sector, the labor market has shown increasing signs of deceleration during 2007 before the recent credit and financial turmoil. Our unemployment stress measure of labor market slack, computed as the product of the unemployment rate and the median duration of unemployment, has increased significantly from 32.9 in December 2006 to 39.6 in August 2007. Consequently, our standardized labor market tightness indicator, the inverse of unemployment stress, has already reached the cyclical high of 0.6 in Q4 06 and has been declining towards 0.2 in H1 07 (Figure 2.4).

Falling house prices, high commodity prices and a slackening labor market have led to a deceleration in US private spending. US personal consumption expenditures slowed to just 1.4% q-o-q saar growth in Q2 07, from 3.7% in Q1 07, contributing by a mere 1.03% to real economic growth, from 2.56% in Q1 07. Leading indicators, such as Consumer Confidence by the Conference Board, as well as Michigan Consumer Sentiment, point to lower consumption demand looking forward.

Although real GDP growth surged to 4% q-o-q saar in Q2 2007, the acceleration in real economic activity reflected a net trade deficit reduction and upturns in government spending rather than robust domestic demand (Figure 2.3). The reduction in the trade deficit was a reflection of the robust growth in foreign economies and the weaker dollar, combined with a strong decrease in domestic spending for imported goods. The main driver of growth was real exports of goods and services,

which surged to a 7.6% q-o-q saar growth in Q2 07 from 1.1% in the first quarter. Furthermore, real imports of goods and services decreased 3.2%, in contrast to an increase of 3.9% in the previous quarter. As a result, the net trade deficit improved by $41bln in Q2, the largest decline in more than 50 years, contributing by 1.4% to the strong rebound in the second-quarter growth.

Figure 2.3



The deceleration of employment was underway long before August

Employment growth, which was one of the main drivers of robust private spending in the past two years, is now consistent with slower personal consumption growth. The labor market has been expanding strongly during 2006, with non-farm payrolls increasing by 1.9% y-o-y on average. However, employment growth has shown stoutly signs of gradual deceleration in 2007, with a softening of average payrolls' increase to 1.4%. The US economy lost jobs in August for the first time in four years, as payroll growth declined by 4k. In addition to the August job losses, prior two months' job increases were revised down by 81k, leading to an average monthly gain of merely 44k since June, the weakest three-month change since the summer of 2003.

One of the key aspects of the job losses in August was the huge decrease in the manufacturing sector. Factory sector payrolls have fallen in every month since July 2006, but in August job losses slashed 46k (-1.5% y-o-y growth). Construction employment also declined in August by 22k, after

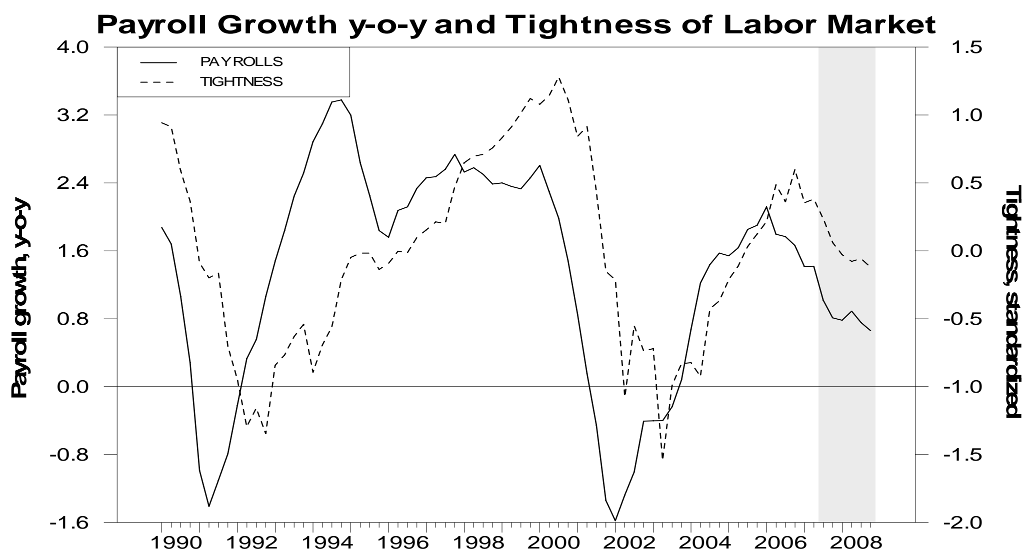
July's decrease, pointing to a y-o-y reduction of 1.2%. Even government payrolls fell for the third consecutive month by 28k (+0.6% y-o-y), adding a per month average of just 5k, compared with the 20k average during 2006. The employment slowdown in the construction and the manufacturing sector seems to spill over into the service sector of the economy. The payrolls' increases in the service sector have been gradually decelerating, adding an average of only 72k in the last three months of 2007, compared to the average of180k for the two previous years. The ISM employment index in the non manufacturing sector also declined from 51.7 in July to 47.9 in August, confirming the ongoing weakness in the service sector. Furthermore, the ADP National Employment Report showed a second consecutive weak monthly reading in August, increasing by 38k, the smallest gain ever reported since June 2003.

The August household survey of employment reported even a more serious contraction of 30k and 316k in July and August respectively, with the y-o-y growth gradually declining from 2% at the beginning of the year to 0.8% in August. Averaging over the year, this survey actually shows a 16.5k jobs' decline per month created so far in 2007. Nevertheless, the unemployment rate, which is calculated from the household survey, remained remarkably unchanged at 4.6% on the month. The reason the unemployment rate did not increase despite the decline in the civilian employment was due to the large monthly fall off in the labor force. Civilian labor force decreased by 340k in August, with the Bureau of Labor Statistics (BLS) pointing out that part of this decline (almost 75%) was driven by teenagers going back to school. The unemployment was, therefore, unchanged due to fewer people that left the labor force and were not counted among the unemployed. Had those who left the labor force instead been included in unemployed, the unemployment rate would have surged to about 4.9%. Besides, the trough in the unemployment rate in this cycle was probably reached in March at 4.395%, with the 3-month average gradually rising ever since.

The weakness revealed in the August employment report does not primarily reflect the impact of the credit crunch that began in August but rather highlights a lagged effect of dampening overall economic activity over the past several quarters. The payroll employment survey conducted by the BLS ended in the middle of the financial turbulence, on the 18th August, so the August employment data do not fully discount the recent financial crisis. The softness in the labor market has already started at the beginning of 2007. As we noted in our previous edition, our index of labor market tightness (defined as the inverse of unemployment stress) has already reached a cyclical high in Q4 06 and has been declining gradually during 2007 (Figure 2.4). Back in May, we projected that the Q1 deceleration in payroll growth was an early warning that the labor market was due to soften,

eventually pushing up the rate of unemployment and posing significant risks to personal consumption and growth of the US economy. A first sign of softness in the labor market was the increase in the median duration of unemployment from 7.3 weeks in December 2006 to 8.7 weeks in April 2007. Hence, despite a constant rate of unemployment, leading to the general perception that the labor market continued to tighten, our labor market tightness indicator has already weakened significantly in April due to higher duration of unemployment, giving an early warning of a generalized labor market downturn.

Figure 2.4

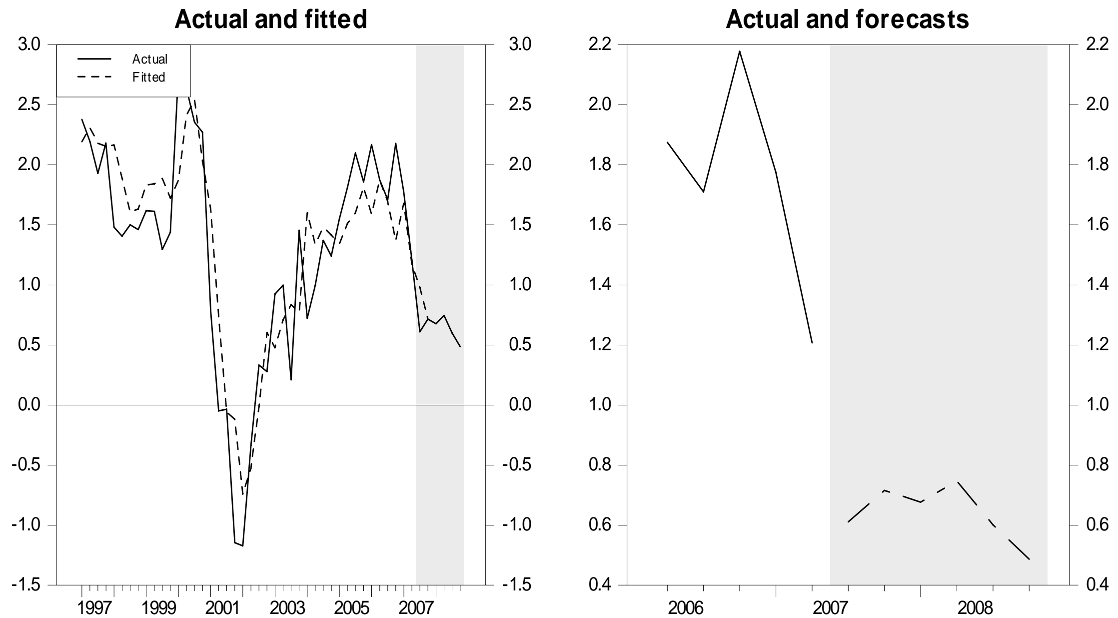


*Source: Eurobank EFG model estimates

The current financial and credit markets turmoil will probably lead to further declines in civilian employment. Looking forward, our job market model suggests that civilian employment growth will moderate sharply from the 2006 average of 2% to 1.1% in 2007 and 0.7% in 2008 (Figure 2.5). The labor market has already decelerated to 1.3% y-o-y average growth in Q2 07 and 1% y-o-y average growth in July and August, from 1.9% in Q1 07, confirming the projections expressed in our May issue.

Figure 2.5

Civilian Employment y-o-y



*Source: Eurobank EFG model estimates

The housing downturn, reinforced by tightening credit standards, will weigh on personal consumption

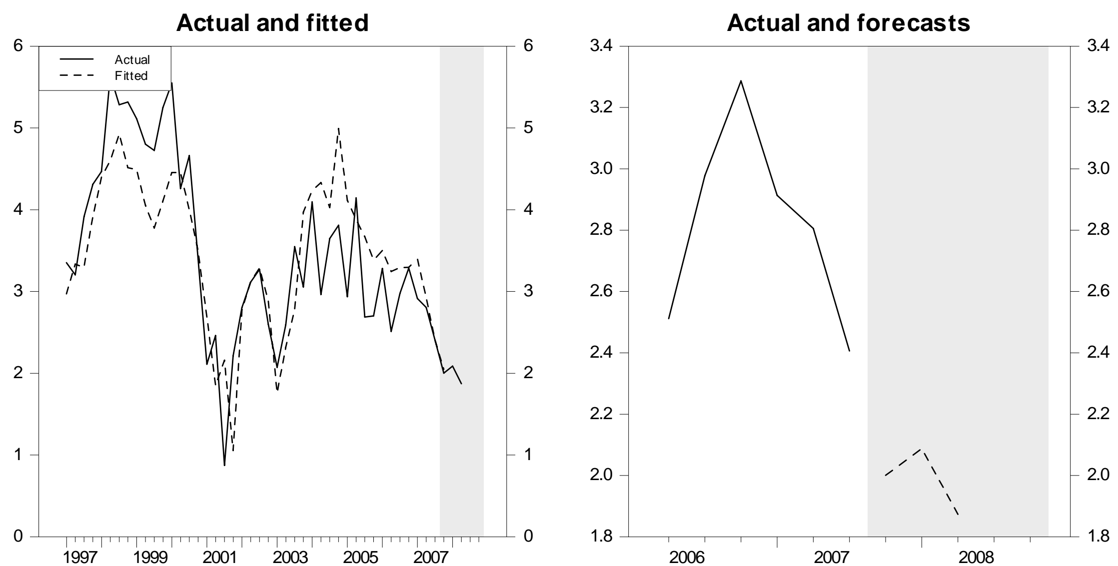
With financial conditions considerably tightening in credit markets, the impact on personal consumption expenditures will be even stronger in the near future. Falling house prices reduce home equity withdrawal, preventing households from spending due to negative wealth effects. The Case-Shiller home price index for 20 major cities decreased further from -3.5% y-o-y in June to -4.0% y-o-y in July. The composite index for the entire US weakened even more, reporting a -4.1% y-o-y decrease in Q2 07, from -1.8% y-o-y in Q1 07. Moreover, the OFHEO house price index slowed to 3.1% y-o-y growth in Q2 07 (0.1% q-o-q), from 4.4% in Q1 07 (0.6% q-o-q). The y-o-y increase in the OFHEO price index was the smallest increase ever reported since 1997, underpinning the ongoing pricing pressure in the housing market. Given that CPI inflation stands at 2.6% y-o-y in Q2 07, real house prices increased by a meager 0.5% y-o-y, down from 5.3% y-o-y in Q2 06.

According to the Conference Board, US consumer confidence weakened sharply in August and September. The consumer confidence index decreased to 99.8 in September from 105.6 in August,

the lowest level since November 2005. The decline was mainly attributed to views on the present situation, which fell to 121.7 from 130.1 in August, while the expectations index also declined to 85.2 from 89.2 in August. The Michigan sentiment index also dropped to 83.4 in August from 90.4 in July, pointing to softer consumer spending growth. Even though real personal spending exceeded expectations in July, increasing by 0.3% in July on a m-o-m basis, consumption expenditures in July do not entirely reflect the credit and stock market turmoil. Besides, real private consumption remains on a downward trend on a y-o-y basis, increasing by 2.5% in July 2007, compared to 3.3% growth at the beginning of the year.

Looking forward, we expect real house prices to continue their downward trend and disposable income to decelerate gradually from its current levels of 3.1% y-o-y growth in Q2 07 to 1.9% y-o-y growth in Q4 07. With increasing unemployment, the housing downturn, reinforced by tightening credit standards, will weigh on personal consumption through the impact of home equity extraction and consumer confidence. Therefore, we remain confident with our May forecasts of personal consumption and expect the y-o-y growth of personal spending to decelerate further from the current 2.8% y-o-y growth in Q2 07 to 2.6% y-o-y average growth in 2007 and 2.4% in 2008 (Figure 2.6).

Figure 2.6



*Source: Eurobank EFG model estimates

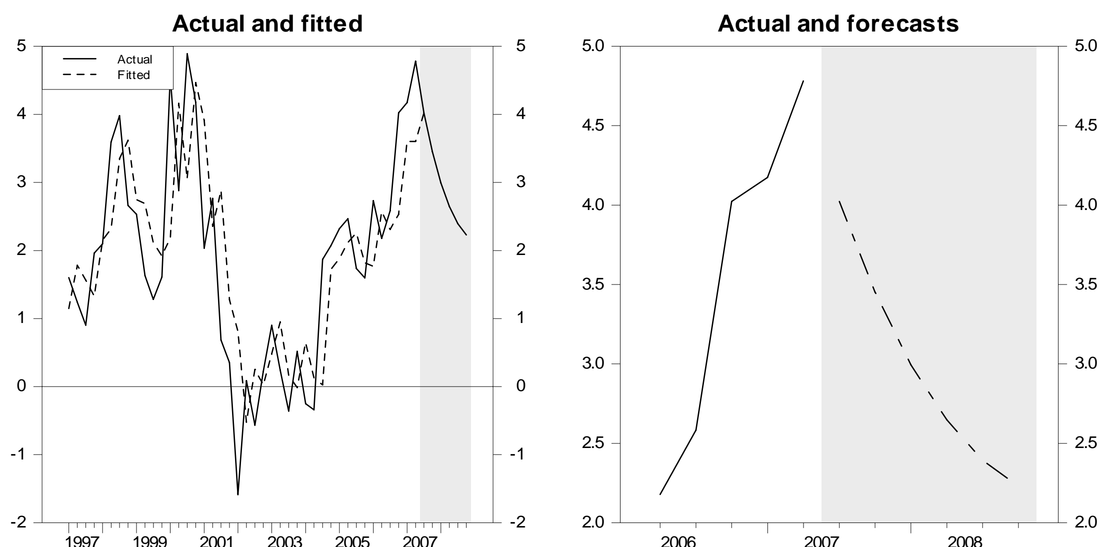
Weaker labor market conditions point to slower wage and labor cost growth

As we had noted in our May issue, the surprising slowdown of wage growth in Q1 07 was rather baffling, due to seasonal effects as unit labor cost had reached a cyclical peak in Q1 06. In fact, nonfarm business unit labor cost was revised in the first quarter from 1.3% y-o-y growth to 4.2% y-o-y. Furthermore, unit labor costs among US nonfarm businesses rose 4.8% y-o-y in Q2 07, the sharpest increase since Q3 2000. Non-farm business sector output per hour has slowed sharply from the peak of 4% y-o-y average growth in 2002, to 1% in 2006 and 0.6% in H1 07. According to the Fed, some of the recent acceleration in labor costs reflects special factors, such as the exercise of stock options. However, much of the upward revision in compensation per hour in Q1 07 from 2.4% y-o-y to 4.6% y-o-y growth seems to be more associated with wage cost pickup, rather than stock options gains.

In our view, the ongoing softening in the labor market will probably exert downward pressures on wages for the remainder of 2007 and 2008, resulting in a gradual deceleration in unit labor cost growth. Our estimates suggest that as labor market weakness cumulates over the next quarters, unit labor cost growth will gradually decline from its cyclical peak of 4.8% y-o-y growth in Q2 07 to an average growth of 2.6% in 2008 (Figure 2.7).

Figure 2.7

Unit Labor Costs y-o-y



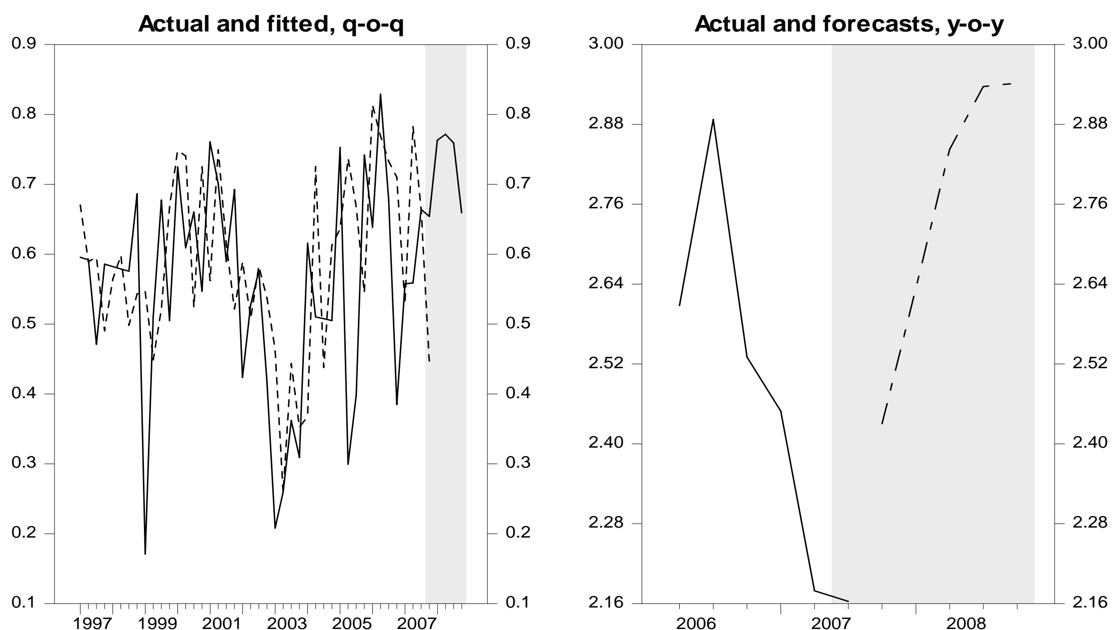
*Source: Eurobank EFG model estimates

Inflationary pressures have moderated, but concerns about inflation risks remain in the medium-term

The economy's lagged response to tighter monetary policy and slower demand growth seems to have constrained inflationary pressures. With diminished prospects for economic growth, core PCE inflation moderated to 1.9% y-o-y growth in June and July 2007, below the Fed's comfort zone of 1-2%. Furthermore, core consumer price inflation has eased to 2.1% y-o-y growth in August, from its recent peak of 2.7% y-o-y growth in February 2007. Increases in rents of primary residence and owners' equivalent rent, the most stable core CPI components, have been weakening since the beginning of the year, as a result of excess supply in the housing market.

Figure 2.8

Core CPI Inflation



*Source: Eurobank EFG model estimates

The trend in core inflation will largely depend on the development of unit labor costs and core producer price inflation, as well as the extent of the US economic slowdown. The recent acceleration in unit labor costs in Q2 07 to a 4.8% y-o-y growth and the surge in core producer price inflation to 2.3% y-o-y average growth over the last couple of months, the largest increase since September 2005, will probably have a lagged effect on core inflation towards year-end (Figure

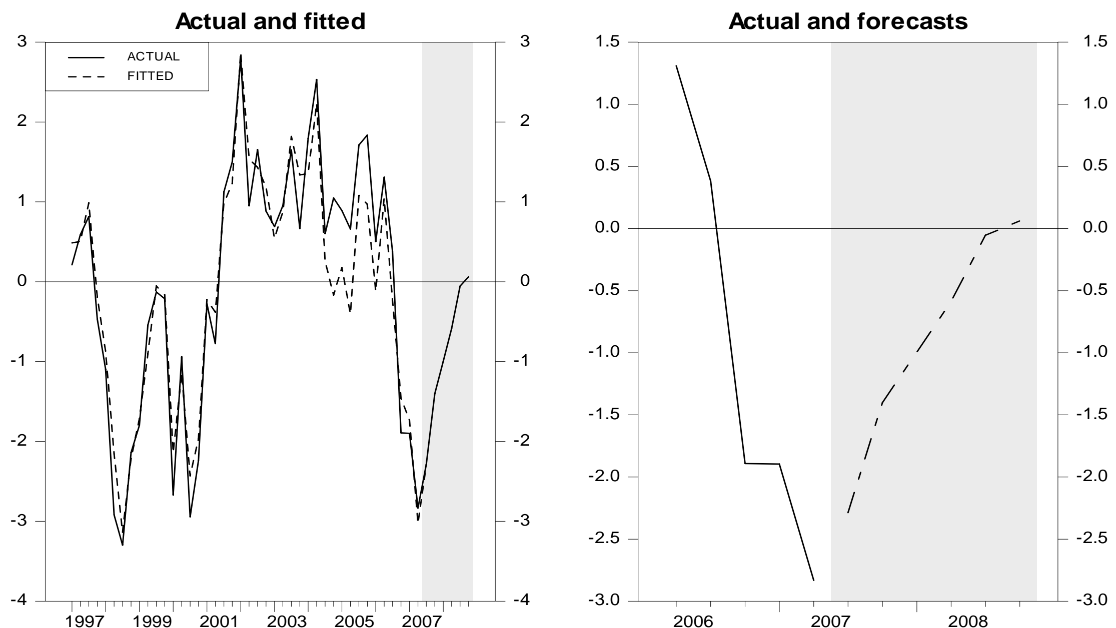
2.8). Moreover, the Fed's provision of liquidity support into the money market, the discount rate reduction and generally its policy change to an easing bias suggest that inflation worries may persist in the long-term, with core inflation climbing to 2.8% y-o-y in 2008. However, it should be noted that the inflation rebound that our model indicates is partly affected by base effects, due to the unusual q-o-q decline in core CPI inflation in Q4 06. Looking forward, rising inflation will put a clear floor to Fed funds rates, as inflation worries will gradually increase among FOMC members.

Corporate profits due to fall, increasing the risk of a market correction

US economy-wide corporate profits after tax decelerated sharply to a meager 1.2% y-o-y growth in Q1 07, from their 19.3% y-o-y peak in Q3 06. Profit shares have already peaked in Q3 06 and declined gradually ever since, as unit labor costs continued to accelerate. The first estimate for labor cost growth in Q1 07 was rather misleading, with nonfarm unit labor cost growth finally surging to 4.2% y-o-y in Q1 and 4.8% y-o-y in Q2 07. As a result, our proxy of corporate profit spread growth, computed as the difference between the annual change of business prices and unit labor costs, has decreased from 0.4% y-o-y in Q3 06 to -2.8% in Q2 07 (Figure 2.9).

Figure 2.9

Corporate Profit Spread y-o-y

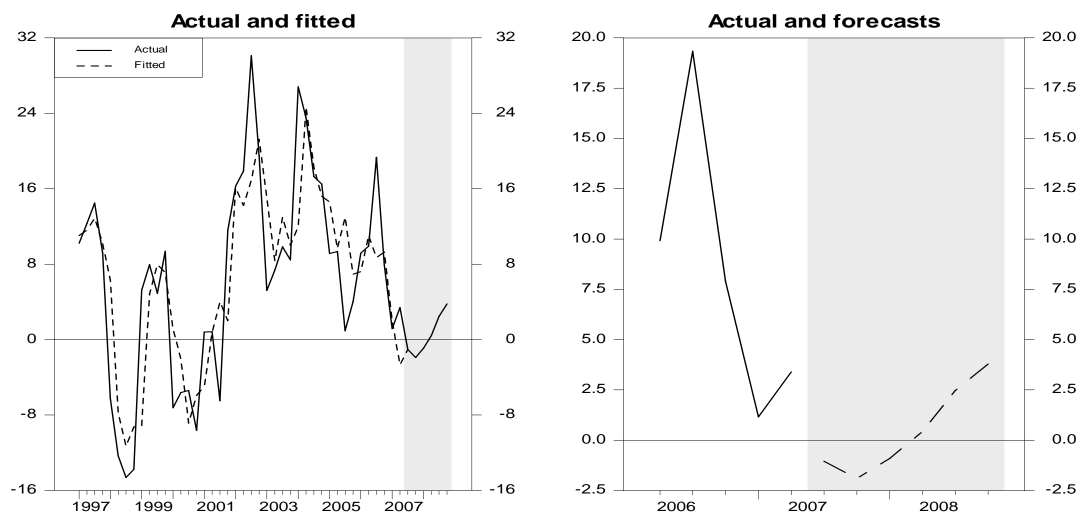


*Source: Eurobank EFG model estimates

This profit slowdown has largely hit small capitalization stocks rather than large capitalization stocks. S&P 500 operating profits' growth, a measure of the largest US stocks' earnings, has averaged 10.8% y-o-y during the first eight months of 2007. IBES consensus valuations (as of 14/09/07) point to an average earnings growth of 6.9% in 2007 and 11.4% in 2008. On the contrary, the economy wide corporate profits released by the Bureau of Economic Analysis (BEA) in the NIPA accounts have grown on average by just 2.3% y-o-y in H1 07. As we have pointed out in our previous Global issues in February and May, small caps' earnings are more dependent on the domestic cycle, compared to large cap earnings, which are more internationally diversified. Hence, the relative resilience of S&P500 earnings growth to a slowdown in US economic growth likely marks a sharp slowdown in small cap earnings Historical experience from previous cyclical downturns suggests that small caps will be hit most from a profit slowdown.

Looking forward, we expect the slowing in US GDP growth to put downward pressure on corporate profitability towards year-end, with economy-wide corporate profits declining by -1.9% in Q4 07 on a y-o-y basis. However, the gradual deceleration in unit labor costs due to the ongoing labor market softening, as well as the increasing inflationary pressures, will have a gradual positive effect on corporate profitability in the medium term. According to our estimates, corporate profits growth will accelerate from 0.4% y-o-y average growth in 2007 to 1.4% y-o-y in 2008 (Figure 2.10), setting the stage for a rebound in stock market valuations in H2 08.

Figure 2.10



*Source: Eurobank EFG model estimates

3. The Euro area economy

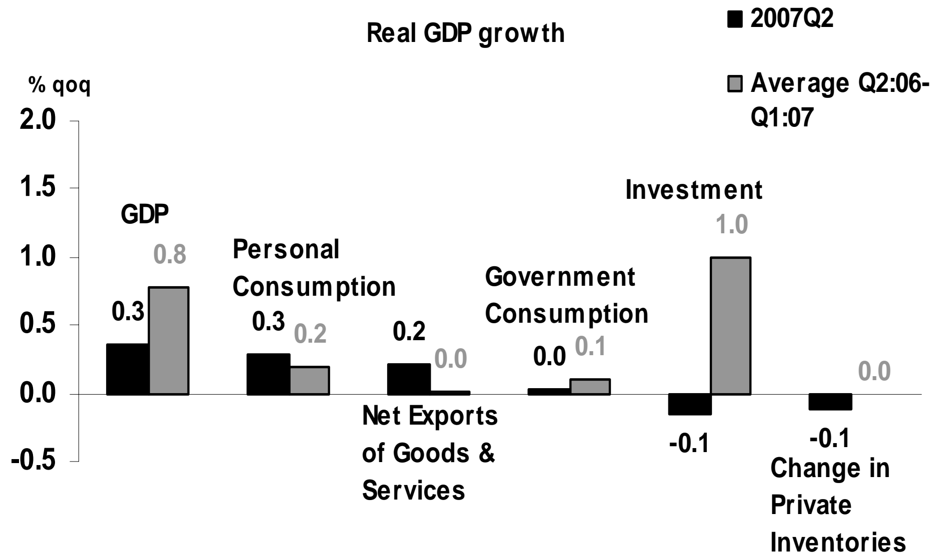
Dimitris Malliaropulos, Olga Kosma

- Real economic activity in the Euro area slowed significantly in Q2 07, mainly due to the contraction in investment.
- Business confidence deterioration seems to have captured the impact of the financial and credit crisis.
- The labor market remains healthy, boosting personal consumption growth.
- Strong money supply growth increases the risks to medium-term price stability.
- The current turmoil in global credit markets may force the ECB to hold back further tightening until year-end.

Real GDP growth in the Eurozone slowed in Q2 07 to a mere 0.3% q-o-q (2.5% y-o-y) -the slowest quarterly growth rate since 2004- from 0.7% in Q1 07 (3.2% y-o-y), with German and French GDP increasing just 0.3% and Italian GDP only 0.1% (Figure 3.1). Real private consumption was the main driver of growth, increasing by 0.5% q-o-q after stagnating in Q1 07 due to the German VAT hike at the start of the year. Net exports of goods and services also had a positive contribution to economic growth (0.2% q-o-q); real exports increased by 1.1% q-o-q, while imports reported a modest quarterly gain of 0.6%.

While the positive contribution from net exports continued to be largely offset by the negative contribution from inventories, real economic activity was also weighted down by a deceleration in government consumption growth, and mainly by the contraction in investment. Gross fixed capital formation decreased by 0.7% on a q-o-q basis, the first contraction in five years, resulting in a negative contribution of -0.1% to real GDP growth. Weak construction investment, particularly in Germany, exerted a significant drag on overall capital spending growth in the second quarter of the year due to weather-related effects; the unusually warm weather that had boosted construction investment in Q1 07 has resulted in a payback in Q2 07.

Figure 3.1



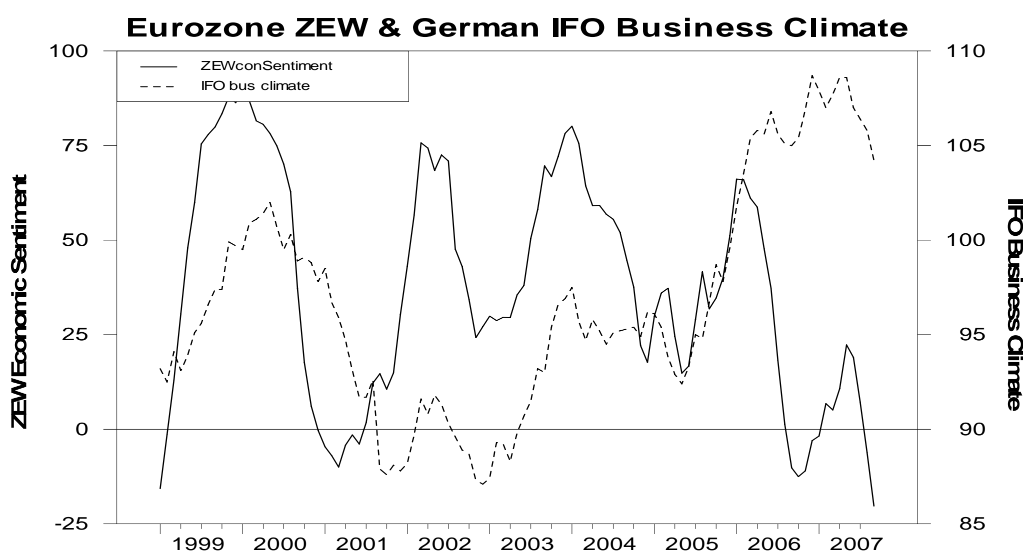
The overall outlook still remains robust and real economic growth is expected to bounce back in Q3 07, after the sharp slowdown in activity over the second quarter. The improvement in the labor market should underpin consumer spending through higher wage growth, while high profitability and robust foreign demand from Eastern European and Asian countries should support export growth and business investment, despite some signs of faltering in the second quarter of the year. However, we cannot ignore the downside risks to the outlook, as the strong euro, elevated oil prices as well as tighter credit conditions for both household and companies could weigh down markedly on Eurozone growth.

Indeed, the appreciation of the currency, combined with some moderation in global growth, could have a negative impact on Eurozone exports, limiting in turn companies' investment and employment. Furthermore, an extended tightening in credit conditions could also depress euro area business investment, due to higher risk premia and business confidence weakening. Acknowledging the potential downside risks which the market turmoil pose to the economic outlook, the ECB made an adjustment to its growth forecasts for 2007, lowering its projection from 2.6% to 2.5%. We remain confident with our forecast for GDP growth of 2.5% this year and expect growth to slow to 2.0% in 2008, as tighter monetary policy and deteriorating financing conditions rein in robust investment growth and the appreciation of the euro undermines the competitiveness of export companies.

Business confidence deterioration captures the impact of the financial and credit crisis

Business confidence has eased across Eurozone countries over the last three months suggesting an easing over the coming months, although the absolute levels of the leading indicators are still consistent with buoyant economic activity above potential (Figure 3.2). The IFO business climate index has declined from its peak of 108.6 in May to 104.2 in September, but remains well above its long-term average of 96.2. The euro zone ZEW survey of current business conditions and expectations revealed increasing concerns about the medium-term outlook for the Euro area countries, as it edged down for a third month in September. It seems that the appreciation of the euro, higher oil prices and the global financial turmoil has probably influenced analysts' expectations on the growth outlook.

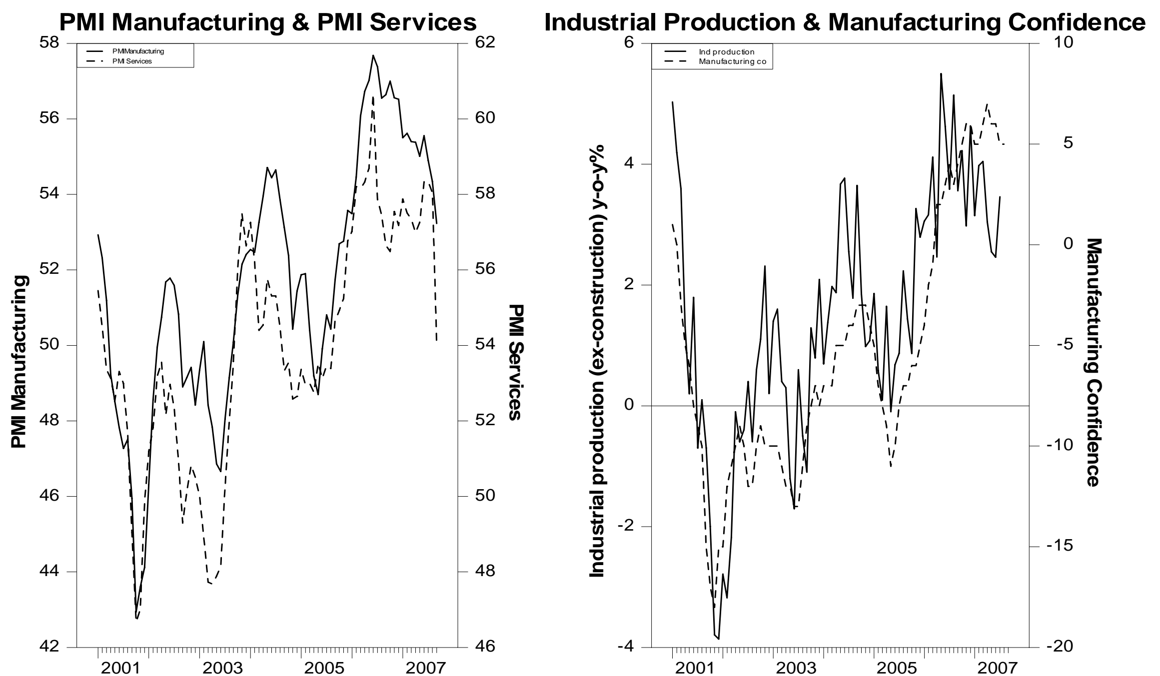
Figure 3.2



Confirming expectations of moderating growth, the Eurozone composite PMI index (flash estimate) declined sharply to 54.5 in September from 57.4 in August. The main driver of this negative performance was the PMI services index, which fell to 54.0 in September after 58.0 in August, standing below its long-term average of 55. The survey revealed that service-sector executives have become more pessimistic about the possible adverse effects of the recent financial turmoil on the real economy, but for the present the above 50-point level still indicates expansion. Despite a gradual setback in the PMI manufacturing index from its recent peaks of 55.5 in June to 53.2 in September, industrial confidence held steady at +5 in August, close to the record high of +7

reached in April 2007. Strong manufacturing confidence is underpinned by robust industrial production numbers, suggesting strong activity at the start of the third quarter of the year. Indeed, Euroland industrial production recovered in July from the weakness reported in the previous month, increasing by 0.5% m-o-m (3.5% y-o-y) from -0.1% m-o-m in June (2.5% y-o-y) (Figure 3.3).

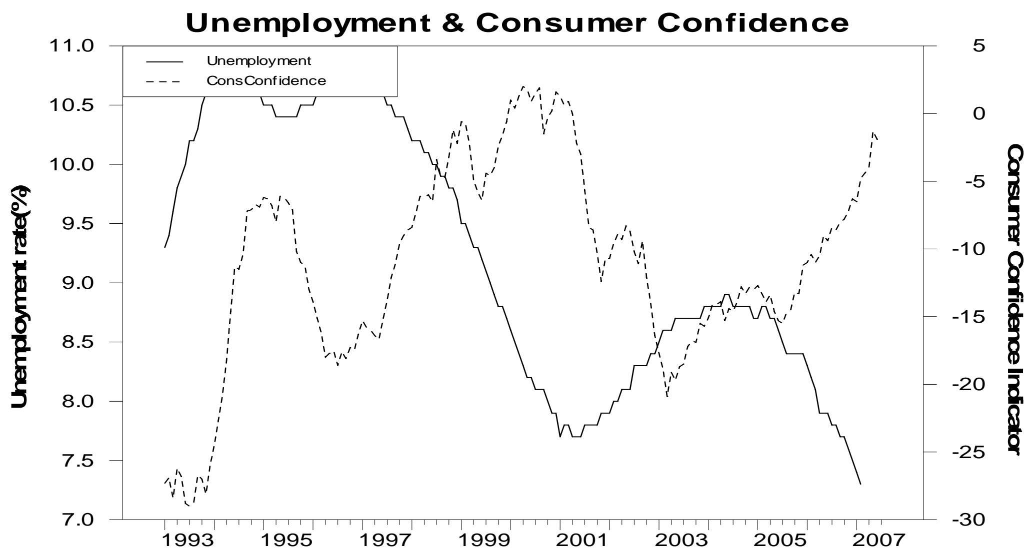
Figure 3.3



Improving labor market conditions to support personal consumption growth

Despite the considerable real economic slowdown in Q2 07, the labor market remains healthy. Employment growth continued to increase by 0.5% q-o-q (1.7% y-o-y) in Q2 07, after 0.6% q-o-q (1.7% y-o-y) in Q1 07. This figure is equivalent to a 776k increase in employment in the second quarter, following a 786k increase in Q1 07. The number of unemployed in the euro area has been gradually decreasing since the beginning of the year by 120k on average each month. As a result, the rate of unemployment edged down further to 6.9% in July, compared to 7.8% one year earlier, and it is actually the lowest unemployment rate ever reporter since the series started in 1993 (Figure 3.4).

Figure 3.4

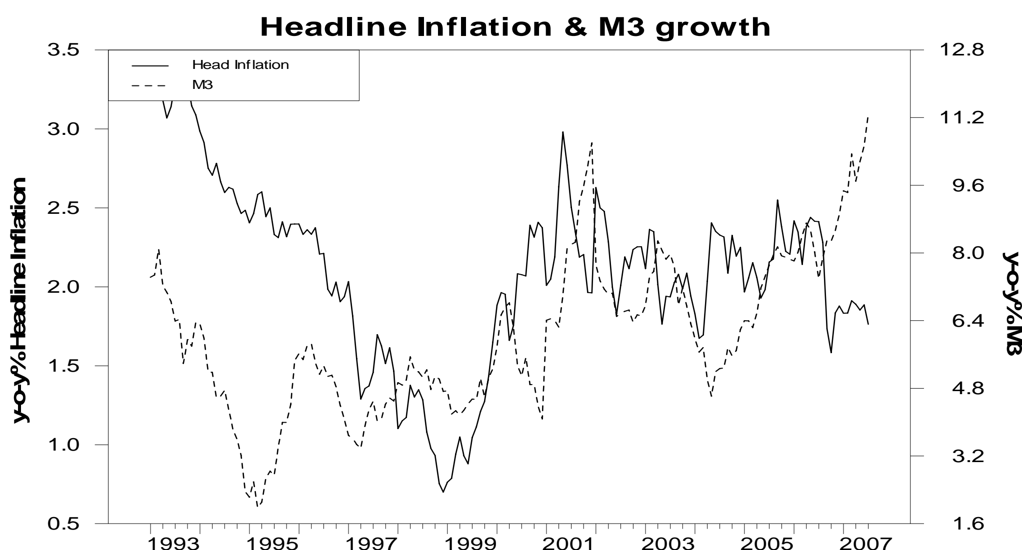


Strong employment gains could lead to a rise in real disposable income across the Eurozone countries, boosting private spending in the second half of the year. Personal consumption spending has already rebounded in Q2 07, after remaining flat in the previous quarter due to the German VAT hike. Retail sales rose a further 0.1% m-o-m (0.8% y-o-y) in July after 0.6% m-o-m (0.9% y-o-y) in June, suggesting that robust consumer spending growth continued over the summer.

Strong money supply growth increases the risks to medium-term price stability

Eurozone consumer price inflation eased to 1.7% y-o-y in August, after 1.8% in July. However, the decline in the y-o-y reading did not actually reflect a moderation in the current rate of inflation, but rather favourable base effects due to the sharp acceleration in oil and energy prices one year earlier. In our view, the ongoing deceleration in headline consumer inflation will not be sustained. Oil prices marked considerable declines last autumn, which seem unlikely to be repeated this year. Provided that oil prices remain at their current level, strong base effects will affect the y-o-y change in energy prices and, successively, total consumer prices. Moreover, there are increasing inflationary concerns owing to the global spike in food prices. Therefore, we expect inflation to increase above the ECB target of 2% towards year-end.

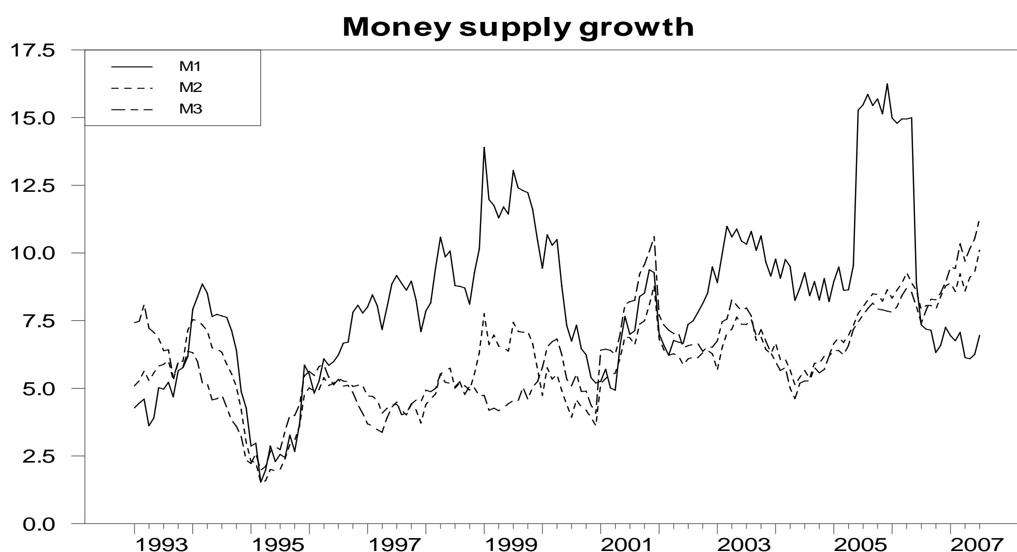
Figure 3.5



Money supply growth continues to accelerate, posing further upside risks to the medium-term inflation outlook. M3 growth has surged to a record high in July, increasing 11.7% y-o-y from 10.9% in June. Similarly, M2 has been growing by 10.1% y-o-y in July, up from 7.9% y-o-y one year ago. The growth rate of loans to the private sector has also increased to 10.9% y-o-y in July, from 10.8% in June and 10.4% in May. However, the downward trend of bank lending to households is evident since last September, when it actually reached the cycle high of 11.4% y-o-y. The slowdown in lending to households is largely offset by a surge in loans to the corporate sector, due to the investment recovery in the Euro area, particularly in Germany. Looking forward, however, corporate credit growth is expected to slow, as LBO activity is in serous trouble, following the tightening of financing conditions (Figure 3.5).

In contrast to M3, M1 growth has slowed considerably; the y-o-y growth rate of M1 was in double figures one year earlier, while the latest figures in July suggest that M1 growth stands at 6.9% y-o-y (Figure 3.6). M2 has been growing by 10.1% y-o-y in July, up from 7.9% y-o-y one year ago. The deceleration in M1 is consistent with the monetary policy tightening so far, as higher short-term interest rates have increased the opportunity costs of holding cash. In other words, the rise in interest rates has resulted in a massive shift from M1 to M2, i.e. from cash in circulation and overnight deposits to savings and time deposits.

Figure 3.6



Financial turbulences may force the ECB to hold back from further tightening

The recent turbulence in financial markets does add a considerable degree of uncertainty to the interest rate outlook. Instead of taking up the excess liquidity supply, the ECB was obliged to provide banks with additional liquidity in order to ease the stress in the money market caused by the financial market turmoil. Moreover, the short term refi rate was left unchanged at 4% on 6th September, refuting the "strong vigilance" statement one month earlier that signalled an interest rate hike at the next policy meeting.

Should the current turmoil in global credit markets persist, the ECB will likely hold back from raising interest rates further. The 4.0% could mark the peak in the current interest rate cycle, given that Euro area economic activity seems likely to be softer in 2008. In fact, despite the huge injection of liquidity by the ECB in the 3-month money market segment, money market rates remain significantly higher than the ECB refi rate, suggesting that monetary conditions have tightened considerably since early August. In addition, the euro has appreciated since early August by about 3.3% against the dollar, further contributing to the tightening of monetary conditions. Nevertheless, the ECB will likely remain concerned about the inflationary risks stemming from elevated oil and energy prices, labor market tightness, as well as strong money supply and credit growth.

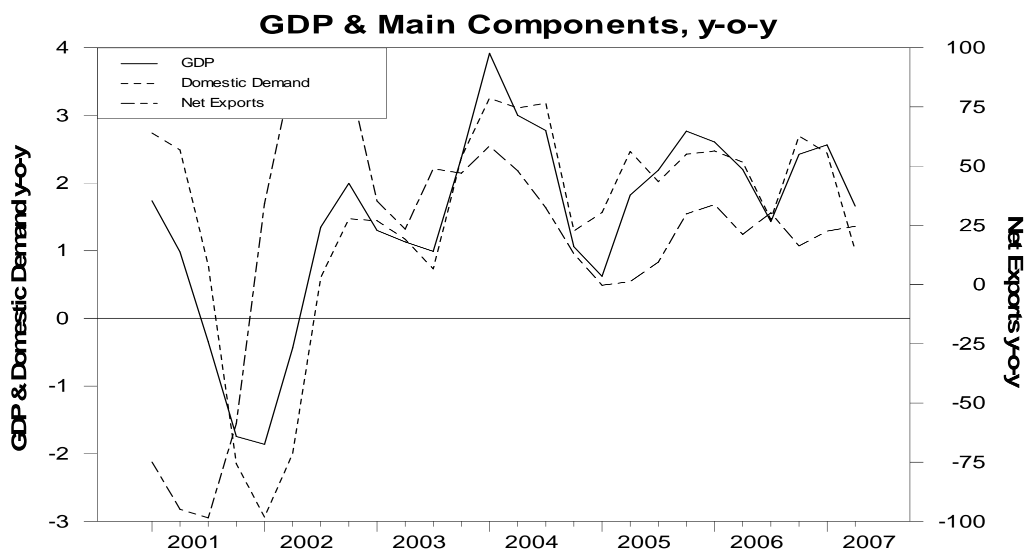
4. The Japanese economy

Dimitris Malliaropulos, Olga Kosma

- Real economic activity in Japan seems to be slowing, as real GDP decreased by 0.3% q-o-q in Q2 07, mainly due to the contraction in private investment.
- However, firm corporate earnings and the solid corporate balance sheet position of Japanese companies may support capital spending in H2 07.
- Real exports remained firm in Q2 07, although the rapid appreciation of the yen in recent weeks increases the risk for the contribution of net trade to real GDP growth in H2 07.
- The positive labor market conditions have not yet been translated into higher wages.
- Worsening credit conditions, combined with restrained economic growth and consumer price declines, will likely postpone the tightening process for H1 08.

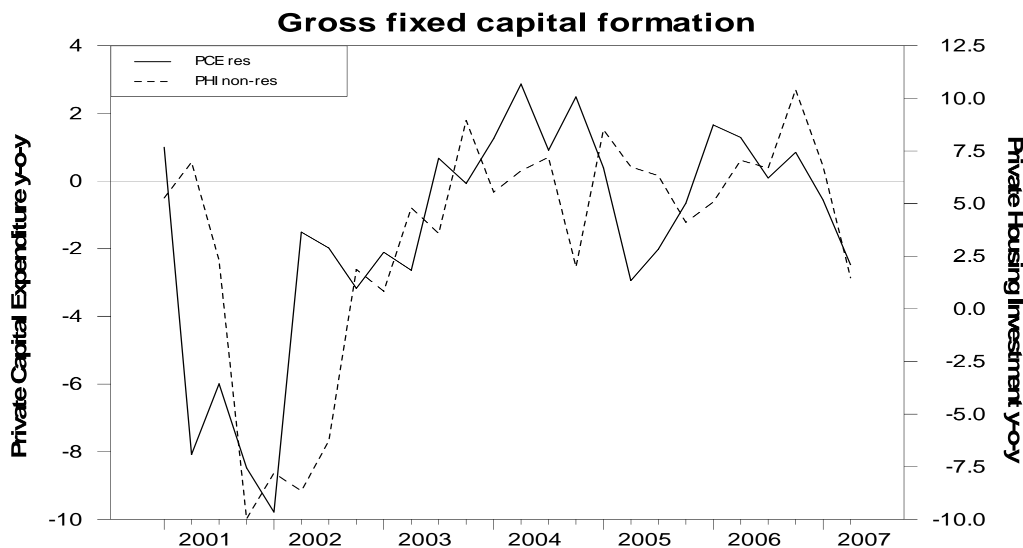
Economic activity seems to be softening as Q2 GDP growth has been revised downwards by a hefty 0.4% q-o-q. The second preliminary GDP estimates for April-June 2007 revealed a 0.3% q-o-q decrease, compared to the initial estimate of a 0.1% q-o-q increase, mainly reflecting the downward revision of private non-residential investment from a preliminary estimate of +1.2% q-o-q to -1.2% q-o-q. Total domestic demand contracted by 0.3%, after a 0.3% increase in the previous quarter. Real private consumption growth increased to 0.3%, following a 0.2% q-o-q decline in Q1 07, while fixed investment declined sharply by 1.8%. The investment figure, which was the worst since Q4 01, is largely attributed to residential investment, which declined by 3.2% q-o-q (Figure 4.1).

Figure 4.1



Even though the downward revision for capital expenditure reveals a considerable deterioration in non-manufacturing investment, we view this large drop in capital spending as a temporary phenomenon; it seems that changes in the way the investment data is collected posed calculation difficulties for investment and, in particular, for non-manufacturing investment. Survey samples are changed every year in the second quarter -the start of the Japanese fiscal year- and the change in survey samples may have had a negative impact on capital expenditure figures in Q2 07, exaggerating the scale of the contraction (Figure 4.2).

Figure 4.2



With firm corporate earnings and a solid corporate balance sheet position of Japanese companies, we expect capital spending to return to positive territory in H2 07. In fact, core machinery orders data, which showed a 17% m-o-m growth in July, suggest that there is a good likelihood of machinery investment gathering momentum in the second half of the year. However, there are also downside risks to total investment in Q3 07, stemming from soft construction orders and housing starts in July. Moreover, the US economic slowdown increases the concern for a sharp deterioration in the corporate sentiment.

Real exports remained firm in Q2 07, rising by 7.4% y-o-y, and July's 11.7% y-o-y increase points to solid export growth in Q3 07. However, the rapid appreciation of the yen in recent weeks will likely diminish the contribution of net trade to real GDP growth. Indeed, the yen has strengthened about 6% since July due to large scale carry trade unwinding, as some investors have sold yen-funded assets to cover losses in credit markets. Should we see further risk re-evaluation, investors

still involved in the yen carry trade could head for the exits, strengthening the currency even further. Furthermore, slowing exports to the US will probably have a negative impact on external demand growth. But as long as Japan's exports to Asia, which approximately account for 50% of total Japanese exports, remain solid, the contribution from net exports will continue to be positive.

Stagnant wage growth despite labor market expansion

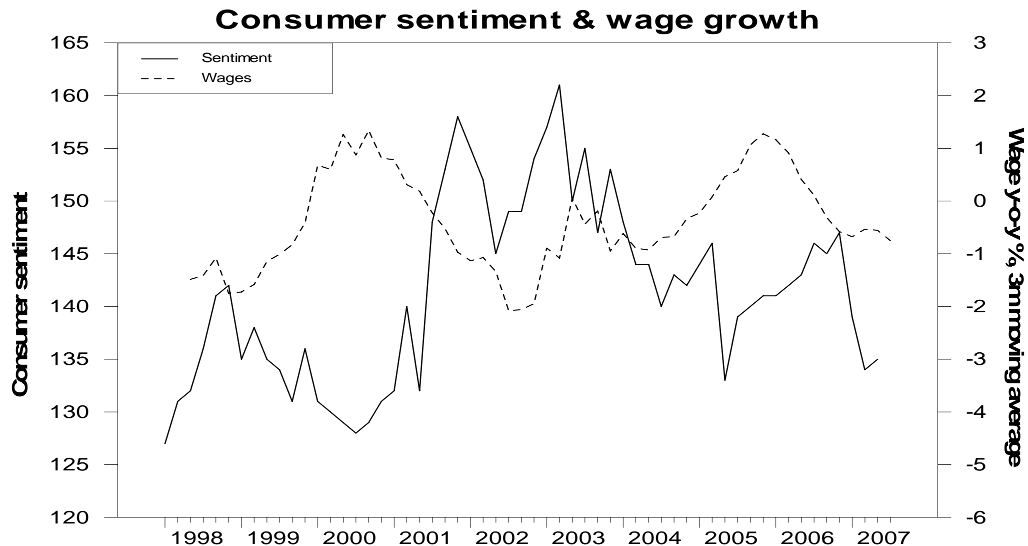
Prospects in the labor market remain solid. Overall employment increased by 1.6% y-o-y in July, following a 1.8% y-o-y growth in the previous month. The unemployment rate decreased further to 3.6% in July, from 3.7% in June, while the jobs to applicants ratio was unchanged from June at the relatively strong level of 1.07 (Figure 4.3). Nevertheless, the expansion in the labor market has not yet been translated into higher wages. Average wage growth per employee plunged to -1.9% y-o-y in July, after a -0.9% drop in June. The more stable category of basic wage suggests that the average wage decreased by 0.2% y-o-y for a second consecutive month, while one year ago it was rising by 3% y-o-y.

Figure 4.3

Therefore, the long-awaited recovery in wage growth that was expected to support personal consumption seems to be delayed, posing risks to personal consumption. Wage growth remains for the present slack, while real disposable income is being diminished by oil and food price increases, as well as stock market loses. Given that consumer sentiment continues to soften, combined with

the disappointing retail sales (-2.2% y-o-y) and real consumer spending numbers (-0.1% y-o-y) from the household survey in July, we cannot expect a major rebound in real consumer spending in the short-term (Figure 4.4). Consumption will probably gain momentum in 2008, when the effect of the tax reform that has dampened households' spending will start to fade away.

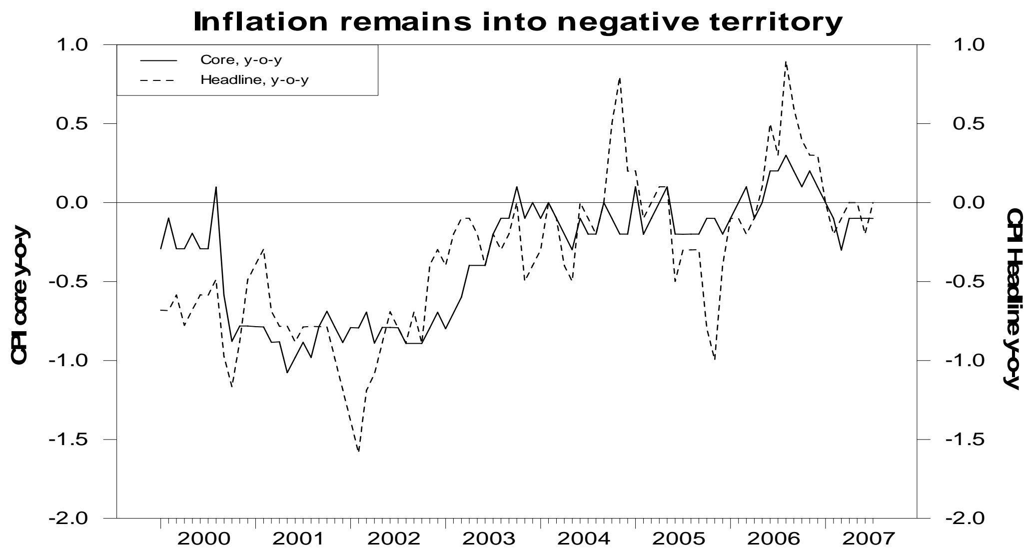
Figure 4.4



Deflationary fears, combined with a growth moderation, will likely postpone the tightening process for H1 08

The nationwide core consumer price index continues to hover into negative territory. Core inflation, excluding fresh food, declined by 0.1% in July, and it has actually been negative for the sixth successive month. Headline consumer inflation remained stable in July on a y-o-y basis, following a 0.2% drop in the previous month. Excluding energy, price inflation was even weaker, decreasing by 0.5% on a y-o-y basis in July (Figure 4.5). The combination of the recent turmoil in global financial markets with low inflationary pressures shown by the core CPI forced the BoJ to hold interest rates steady at 0.50% at its September 19th meeting. Although the BoJ is generally eager to tighten monetary policy and normalize interest rates, worsening credit conditions, combined with restrained economic growth in Q2 07 and consumer price declines, suggest that further tightening will be delayed for a while. We continue to believe that the next action by the BoJ will be a rate hike, as Japan's interest rates are extremely low given trend economic growth of about 2%. However, there is a strong possibility of no further hike by year-end, postponing the tightening process for the first half of 2008.

Figure 4.5



5. BRICs

Dimitris Malliaropulos, Olga Kosma

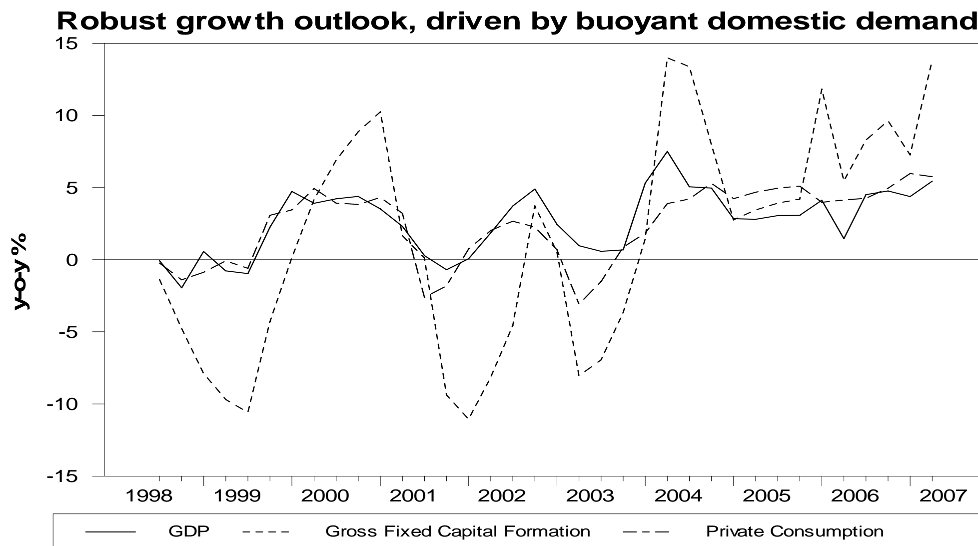
Brazil Economic Outlook

- Brazil's economic growth continues to strengthen, on the back of strong domestic demand and favourable external conditions.
- The economy has benefited greatly from the recent surge in global commodity prices, offsetting the negative impact of the currency appreciation on exports.
- As a result, the trade balance surplus has remained so far sizeable, despite the acceleration in imports.
- The trade surplus, the accumulation of international reserves, the low country risk premium as well as the relatively high interest rates seem to be supporting the Brazilian real.
- Benign inflation has prompted so far further a gradual monetary easing. However, rising commodity prices may prompt a more moderating monetary easing.

Brazil's economic performance continues to strengthen, supported by expansionary macroeconomic policies and a favorable global economic environment. Real GDP growth accelerated to 3.7% in 2006 from 3.0% in 2005, spurred by lower interest rates, with domestic demand being the main driver of growth. Economic activity gathered remarkable momentum in the final quarter of 2006, when real fixed investment bounced from 8.4% y-o-y in Q3 06 to 9.6% y-o-y in Q4 06. Although the rate of growth of GDP slowed to 4.4% y-o-y in Q1 07 from 4.8% in Q4 06 due to a slight lull in investment, improving labor market conditions, rising real labor income and strong consumer credit growth has boosted private consumption growth from 4.9% in Q4 06 to 6% in Q1 07.

Real GDP rebounded to 5.4% y-o-y growth in Q2 07, the fastest rate since Q2 04. The main driver of growth was gross fixed capital formation, which surged to 13.8% y-o-y in Q2 07, after 7.3% in the previous quarter. Real private consumption continued to benefit from low interest rates (through consumer credit), increasing by 5.7% on a y-o-y basis in Q2 07 (Figure 5.1). The contribution of the external sector remains negative despite the surge in export growth to 13% y-o-y in Q2 07 from 5.9% in Q1 07 (due to increased demand for agricultural products), as the strong currency boosted import demand by 18.7% y-o-y in Q2 07.

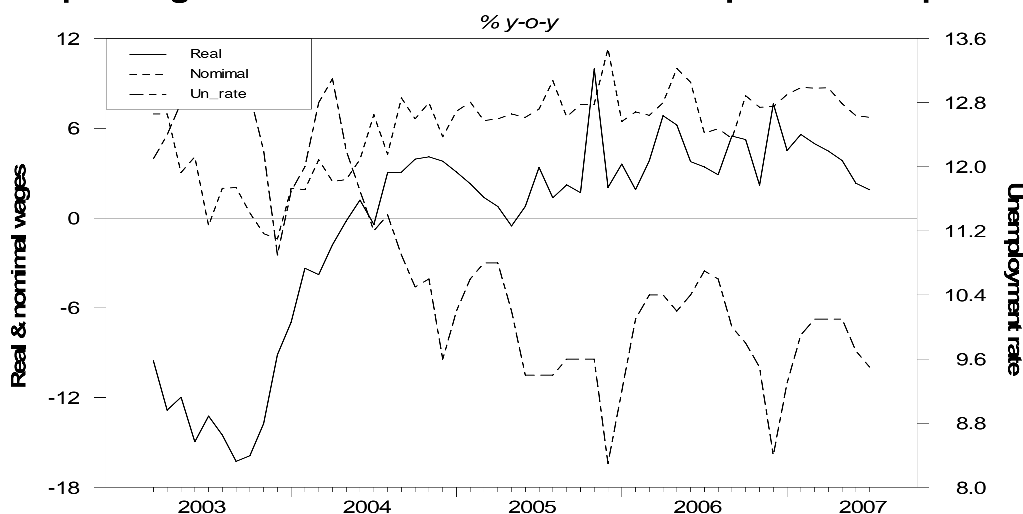
Figure 5.1



Job creation on the back of improving labor market conditions brought the unemployment rate down to 9.5% in July and August, from the recent peak of 10.1% in May. Nominal and real average wages have been increasing by an average y-o-y growth rate of 7.9% and 3.9%, respectively, for the first seven months of 2007 (Figure 5.2). Boosted by rising labor income and improving consumer confidence, consumption increased by 4.3% in 2006 and surged to 6% y-o-y in Q1 07. The most recent data suggest that expanding consumer spending is feeding into manufacturing production and, in particular, into the durable goods production which has been increasing over the last few months.

Gross fixed capital formation growth increased to 8.8% in 2006 from 3.6% in 2005, driven by declining interest rates, buoyant corporate profitability and strengthening of the Brazilian real against the dollar, which has been reducing the local currency cost of importing machinery and equipment. Real investment growth rebounded to 13.8% y-o-y in Q2 07, after a temporary plunge in Q1 07, as monetary easing gradually fosters capital investment growth as well as private consumer spending.

Figure 5.2

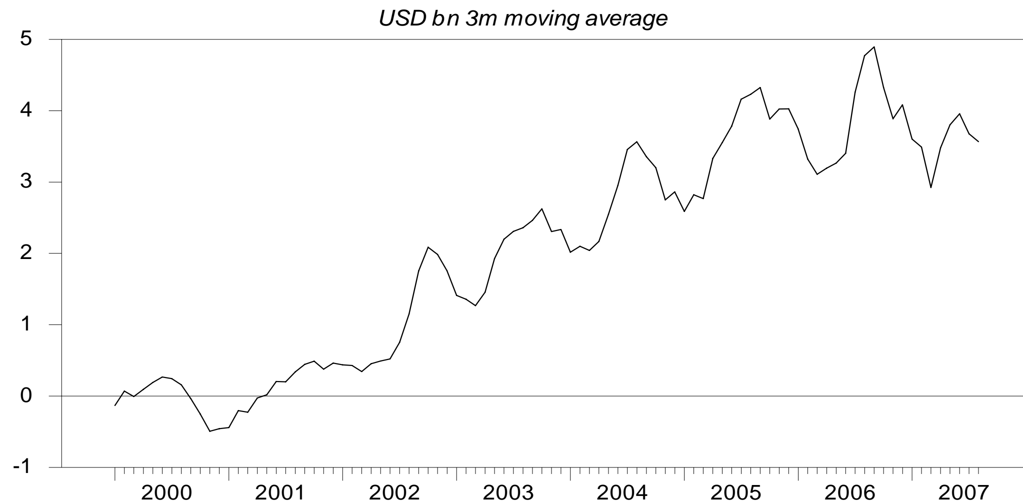


Brazil's external position has been improving substantially; while the trade surplus has decreased substantially from US$4.6bn in August 2006 to US$3.5bn in August 2007, it still remains at relatively high levels. There is a strong demand for Brazilian export goods, so the trade surplus remains sizeable, on the back of higher commodity prices, in spite of a surge in imports due to the strong Brazilian real. However, the external balance contributed negatively to economic growth in 2006, as an appreciation of the Brazilian currency has undermined the growth of exports in real terms and underpinned the growth of imports. The expansion in imports continues to outpace that of exports, and we expect that it will be sustained by a strong exchange rate and firm domestic demand (Figure 5.3).

Continuing strong portfolio capital inflows, underpinned by relatively high Brazilian real interest rates compared to international standards and strong trade performance, has led to a continued appreciation of the Brazilian real (BRL). Although the BCB has been intervening in the market this year to keep the BRL from appreciating too quickly, the latter has actually appreciated more than12% in nominal terms since the start of the year, the strongest appreciation of any other major currency. Robust global growth underpinned Brazilian equity and fixed income markets, which in turn made the real one of the best-performing Emerging Market currencies over the last four years. The recent financial turmoil increased the currency's volatility, with the Brazilian real now trading at USD/BRL1.86, after USD/BRL2.06 in mid-August. The latest shift was due to the market expectation of Fed rate cuts, making Brazilian bond yields more attractive to investors. As a result, the

accumulation of international reserves has been increasing to record levels (US$165bn in mid-September), surpassing the historical high of 10% of GDP. Falling external debt has led to a narrowing of sovereign interest spreads, therefore Brazil's long-term foreign-currency rating has been upgraded in May 2007 by both Fitch and S&P to one notch below investment grade.

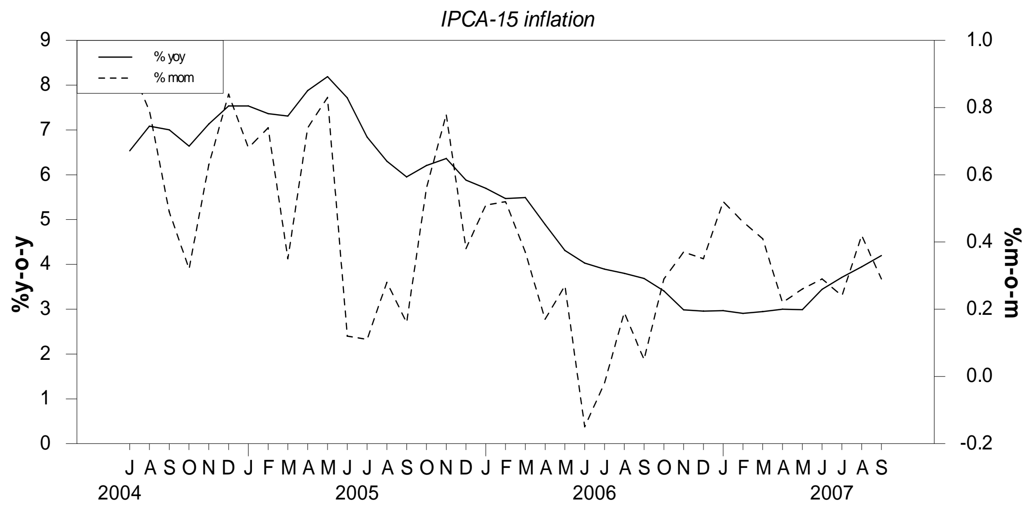
Figure 5.3



The strong performance of the Brazilian real has helped subdue inflationary pressures. IPCA-15 inflation, which is used by the Brazilian Central Bank (BCB) to set benchmark interest rates, eased to 0.29% m-o-m in September from 0.42% m-o-m in August, due to the deceleration in the food and beverage components. This increase actually raises Brazil's consumer inflation to 4.2% in September on a y-o-y basis, a relatively high level compared to the 3% y-o-y inflation six months ago. IPCA-15 inflation still remains within the BCB's target range of 4.5% for 2007, but the food (especially agricultural products) and raw material components of the IGP-10 inflation, in combination with higher inflationary expectations, suggest that the trend points toward a moderately higher rate of inflation (Figure 5.4).

Figure 5.4

Rising inflationary pressures may moderate the pace of monetary easing



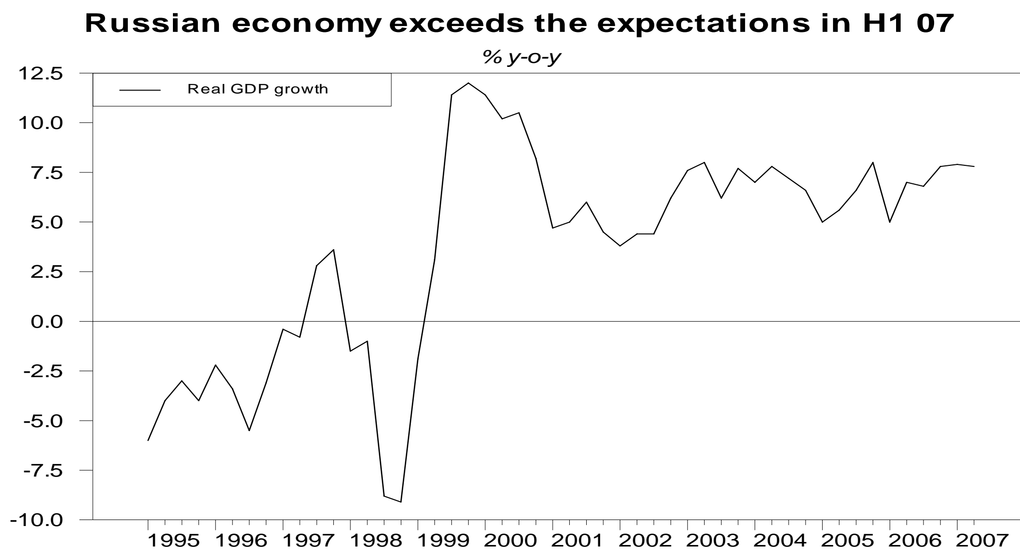
The inflation performance has allowed for successive policy interest-rate reductions, totaling 800bps since September 2005, when the ongoing easing cycle started. At that time, the Selic benchmark interest rate was as high as 19.75%, but it has been gradually reduced to the historical low of 11.75%, the lowest historical level for the overnight interest rate. With a benign inflation below the BCB's inflation target of 4.5% y-o-y, there was enough room for continued monetary easing. Nevertheless, rising commodity prices may continue to exert upward pressure on food prices, forcing the BCB to moderate the pace of monetary easing.

Russian Economic Outlook

- The economic outlook for Russia remains positive, with both private consumption and fixed investment expanding rapidly.
- Booming domestic demand growth, which continues to drive the economy, increases inflationary pressures.
- Rising inflation and high oil prices indicate a possible further appreciation of the rouble against its currency basket.
- Russia's current account surplus is shrinking, due to weak export growth in combination with buoyant import growth, supported by robust household consumption and investment.
- While the rapid acceleration in import growth is diminishing Russia's trade surplus, capital inflows boosted the balance of payments surplus to new record highs.

Real GDP expanded by 6.7% in 2006, following a 6.4% rise in the previous year. Activity was led by the service sector, which accounted for more than 50% of the increase in real economic growth. Buoyant growth was mainly driven by domestic demand; gross fixed capital formation rebounded significantly, from 8.3% y-o-y growth in 2005 to 13.9% y-o-y growth in 2006, offsetting the mild slowdown in private consumption growth and the negative contribution of net trade. Contrary to most analysts' expectations, Russian economic growth apparently accelerated in early 2007. Fiscal easing and a mild winter boosted real GDP growth to 7.8% y-o-y in H1 07 (Figure 5.5). Both private consumption and, in particular, fixed investment continue to grow strongly, underpinned by increasing real wages and record capital inflows, respectively.

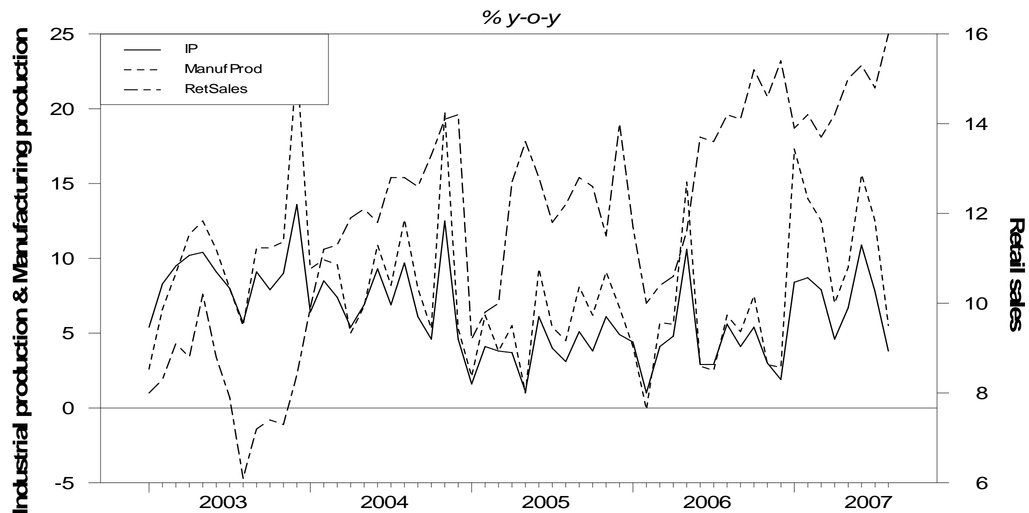
Figure 5.5



The domestic industry, which accelerated in June to a y-o-y growth of 10.9% from 6.7% y-o-y in May, seems to benefit greatly from the manufacturing sector. Manufacturing production expanded

by a rapid 12.6% y-o-y average growth in the first seven months of 2007, compared to 5% average growth for 2006. However, the industrial production growth eased to 3.8% y-o-y in August from 7.8% y-o-y in July, due to the slowdown in manufacturing production growth from 12.5% y-o-y in July to 5.5% y-o-y in August. This negative manufacturing outlook was to some extent due to one-off factors, so it seems rather a temporary phenomenon. Despite the downward risks on the corporate sector in Q3 07, recent data suggest that real private consumption will continue to contribute considerably in real economic growth. Retail sales surged to 16% y-o-y in August from 14.8% y-o-y in July, indicating that the surge in real incomes will underpin real private expenditure (Figure 5.6).

Figure 5.6



On the contrary, the contribution of real net exports has remained negative in H1 07. In spite of continued high oil prices, the current account surplus fell by about 35% to US$37.7bn in the first half of the year. Although the US dollar value of goods exports increased by a modest 8%, import values increased sharply by 39%. The trade surplus is currently diminishing and, given weak export volume growth and robust domestic demand boosting import growth, it will continue to narrow further. With high oil prices boosting export revenue, we expect the current account surplus to narrow only gradually from 9.6% of GDP that was in 2006.

While the rapid acceleration in import growth is diminishing Russia's current account, capital inflows boosted the balance of payments surplus to new record highs. Foreign direct investment into Russia surged to US$15.8bn in Q2 07, rising by about 146% y-o-y, compared to the same

period in 2006. Net inflows of foreign capital reached US$41bn in 2006 as a whole, while in the first six months of the year they actually exceeded US$67bn. As a result, the pace of foreign reserve accumulation in Russia has accelerated substantially, on the back of appreciation pressures on the rouble.

On the back of the rouble's strength and the impact of warm weather on food prices, consumer price inflation remained largely under control during the first quarter of 2007, within the yearly range target of 6.5-8%. However, inflation edged up in the following months, resulting in a 8.6% y-o-y inflation rate in August. Indeed, consumer prices increased by an average of 0.7% on a m-o-m basis over the last three months. The main driver for this acceleration was food prices and as long as there is an upward bias on international food price inflation, the 6.5-8% target range for 2007 seems very difficult to be achieved.

Figure 5.7

Rising inflation concerns, due to food prices & monetary pressure

Furthermore, money supply growth (M2) has increased to around 57% y-o-y on average for the second quarter of the year, and this adds further to the upside risk for the inflation outlook (Figure 5.7). The ample liquidity flooding the economy was underpinned by the central bank's purchases of US$105bn of reserves in H1 07. Central bank reserves of about US$417bn are the third largest in the world, as foreign exchange purchases are CBR's main channel of monetary policy.

Although the prevention of excessive currency appreciation has been one of the key targets of the Central Bank of Russia (CBR), the latter fights inflation by allowing the rouble to appreciate against a

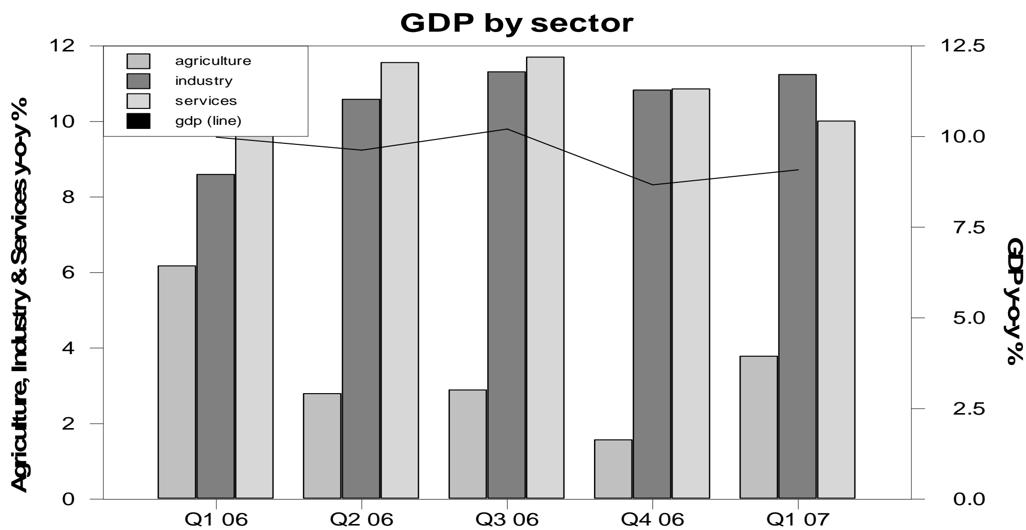
basket of US$ and euro. Therefore, monetary policy has focused on moderating inflation, so the rouble has been allowed to appreciate by about 4% in nominal trade-weighted terms since the beginning of the year. Should the inflationary pressures prove to be persistent, the central bank might be obliged to allow a faster appreciation of the exchange rate. We also expect the Russian Central Bank to raise further the deposit and interbank rate in order to absorb excess liquidity from the market.

India Economic Outlook

- India's economy drives through its fifth successive year of robust growth, driven by rising domestic demand and, particularly, domestic investment.
- The current account deficit remains the biggest drag of the economy, due to the recent large appreciation of the rupee, as well as the continued broadening of the trade deficit
- Monetary tightening over the past two and a half years may have started cooling some elements of domestic demand, pushing wholesale price inflation back within the Reserve Bank of India's (RBI) target.
- Although inflation has showed signs of deceleration, inflationary pressures will remain one of the major RBI's concerns, inducing the central bank to resume monetary tightening.

India's economy has been growing by 8.5% on average over the last three years, placing it amongst the fastest-developing economies. Strong economic performance has been led by rapid expansion in the industrial and service sectors, which have been rising by 10% and 9% y-o-y on average, respectively. Although the pace of economic expansion showed some signs of deceleration in Q4 06, mainly due to the weak agricultural sector growth, the latest GDP data show that the economy was still accelerating in H1 07, with real GDP growth increasing by 9.1% y-o-y in Q1 07 and accelerating to 9.3% y-o-y in Q2 07. Robust investment, increased consumer spending and strong export growth boosted real economic growth to 9.4% in the fiscal year ending March 2007 from 8.9% in the previous fiscal year (Figure 5.8).

Figure 5.8



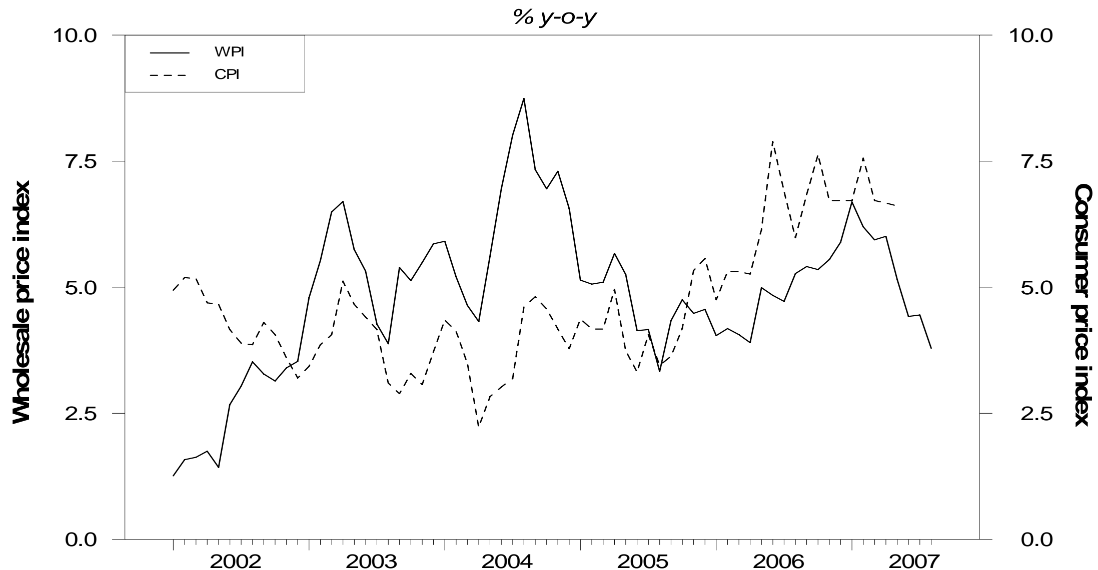
Although industrial production showed signs of moderation over the last couple of months partly due to base effects, its growth has reached a the multi-year high of 10.8% on average during the first seven months of 2007, attributed to the acceleration of manufacturing production (11.6% y-o-y in the period January-July 2007). Indeed, according to the manufacturing PMI, Indian manufacturing activity accelerated sharply to 57.9 in August from 52.9 in July. Despite the turbulence on financial and credit markets in August, the purchasing managers' index reported the strongest improvement in Indian manufacturing sector since November 2006, reflecting strengthening demand conditions and a revival of inflationary pressures.

Wholesale price inflation (WPI), the current benchmark for inflation in India, has been rising steadily during 2006 and 2007, reaching a 2-year high of 6.4% in April 2007, partly attributed to high-base effects and increased food prices. Since then, WPI inflation has fallen back to a 5-year low of 3.32% y-o-y due to base effects. Furthermore, tighter monetary policy, the government's reluctance to allow the domestic fuel price to increase and a number of other measures, such as one-off declines in the duties of import, may have started cooling domestic demand, pushing inflation back within the RBI's new target range of 4.5-5% for 2007/08 (down from 5-5.5% in 2006/07).

However, Consumer Price Index (CPI) inflation for industrial workers remains relatively high at an annual growth rate of 6.5% (July 2007) (Figure 5.9). Moreover, credit and monetary expansion remains strong (25-30% in the last two fiscal years), asset values are close to record highs and commodity prices are rising. All these factors combined with the capacity constraints faced by

India's economy, as real GDP growth is well above potential growth- we reach to the conclusion that, although inflation has showed signs of deceleration, inflationary pressures will remain one of the major RBI's concerns.

Figure 5.9

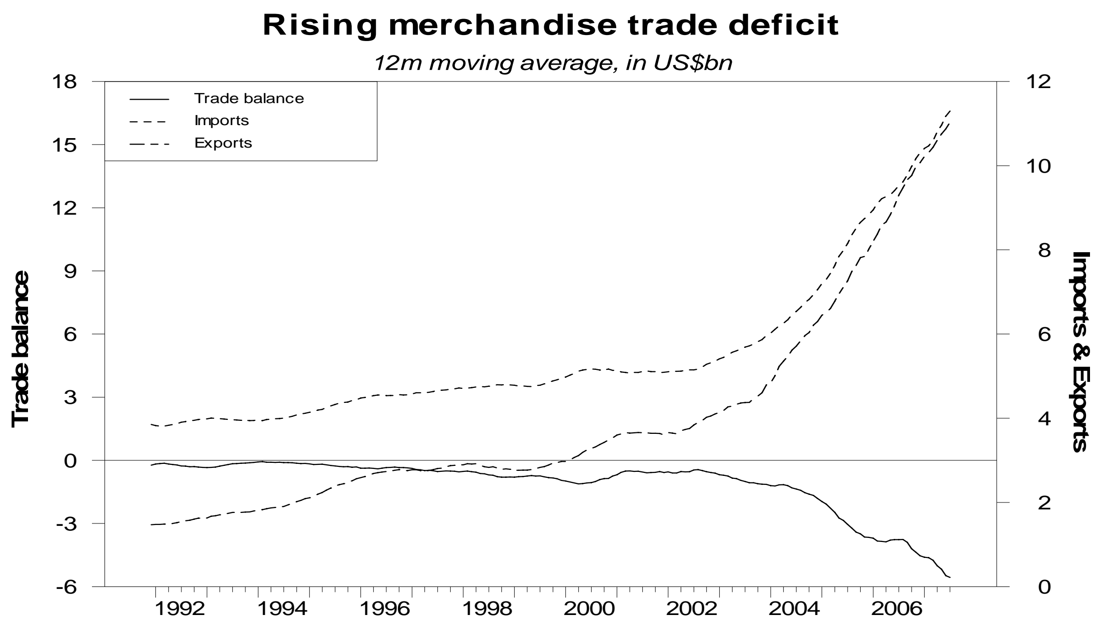


Wholesale price increases have also been limited by the recent appreciation of the local currency. The Indian Central Bank has actually allowed the rupee to appreciate more, in an attempt to ease import-led inflation. Although exchange rate policy for the past years has allowed limited fluctuations of the rupee within the trading range of Rs42.5-47/$, the latter rose from around Rs46.9/$ a year ago (July 2006) to a nine-year high of Rs40.3/$ at the end of July 2007. Its appreciation reflects accelerating economic growth, strong capital inflows and a weaker US dollar in the world's currency markets. As a result, the real effective exchange rate has actually appreciated by about 9% since the beginning of 2007. Given the fact that India is an attractive destination of foreign direct investment (FDI), the upward pressure on the rupee may continue. The latest annual data reported by the RBI reveal that FDI almost tripled from US$5.5bn in 2005/06 to US$16bn in 2006/07.

However, the current account deficit will probably widen, due to the recent large appreciation of the rupee, as well as the continued broadening of the trade deficit. In the financial year 2007 (April 2006-April 2007), the current account deficit stood at 1.2% of GDP, a level close to that recorded in

the 1990s. The widening current account deficit remains the biggest drag on economic growth, as imports continue to rise more quickly than exports. Despite the strong export performance, the trade deficit has increased steadily since 2002, driven by rapidly rising oil and non-oil imports. More specifically, exports increased by 20.9% y-o-y in 2006/07 to US$124.6bn, reflecting India's rising integration into the global economy, but imports surpassed goods and services exports, increasing by 26.4% y-o-y over the same period to US$181.3bn. The latest monthly trade data suggest that buoyant imports continued to offset exports in the first seven months of 2007, pushing up further the merchandise trade deficit; in the financial year to date (April-July 2007), exports increased by 18.2% y-o-y, while imports' growth surged to 30.6% y-o-y (Figure 5.10).

Figure 5.10



The Reserve Bank of India has shifted its policy towards a less expansionary stance. Monetary policy has been tightened gradually since 2004, with the repo rate reaching 7.75% on March 31th. The repurchase rate increase is aimed to discourage banks from borrowing funds from the RBI's to boost rapid credit growth. Although the Central Bank kept the benchmark repo and reverse repo rates stable on July 31st, it did raise the Cash Reserve Requirements (CRR) by 50 bps to 7% of eligible deposits. This rate increase actually removed a total of US$3.9bn (Rs160bn) from the banking system. The momentum of the current economic expansion suggests that demand pressures will persist, inducing the central bank to resume monetary tightening as real interest rates remain at low levels relative to real economic growth. The intensified monetary tightening in

combination with the ongoing fiscal consolidation and the sharp rupee appreciation is likely to dampen somewhat the expansion in economic activity experienced since 2003. The Central Bank of India expects the real GDP growth to moderate to about 8.5% in 2007/08, from a record high of 9.4% in fiscal year 2006/07, as growth moderates towards trend.

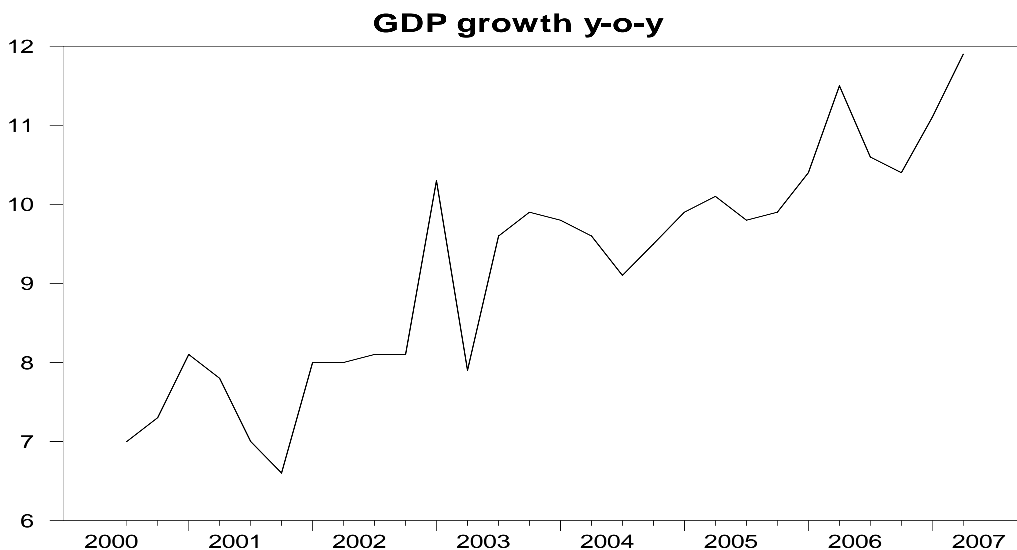
China Economic Outlook

- China's economy is on course for a fifth subsequent year of double-digit growth.
- Although domestic demand accelerated, the current account surplus increased due to the continued robust growth of exports.
- Consumer price inflation is rising at its fastest pace in more than two years, due to the acceleration in food price inflation.
- Growing risks of an end to the bull equity market.
- The acceleration of economic growth calls for further monetary tightening to control inflationary pressures.

China's economy slowed slightly to 10.5% y-o-y growth in the second half of 2006, after a very strong 11% y-o-y growth rate in the first half, due to restrictive measures that came into effect in the middle of the year. Nevertheless, the revision of 2006 real GDP growth suggests that real growth averaged 11.1% y-o-y in 2006, up 40bp from the original estimate of 10.7%. Economic indicators show that the economy maintains its momentum and shows no signs of slowing; GDP increased by 11.1% y-o-y in real terms during the first quarter of 2007 and accelerated to 11.9% y-o-y in the second quarter (Figure 5.11). Fixed asset investment seems to have rebounded in the first eight months of 2007. Despite the government's administrative constraints imposed to moderate investment in several sectors, fixed asset investment actually increased by 27.3% y-o-y in August, accelerating from 26.2% y-o-y in July. The tertiary sector accounts for more than half of total investment (about 55%), the secondary sector comprises about 44%, while the primary sector accounts for only 1%, indicating a low investment level in agriculture.

Apart from the recent rebound of fixed asset investment, consumer indicators suggest that consumption is finally starting to rise as a percentage of GDP. Retail sales accelerated from 16.4% y-o-y in July to 17.1% y-o-y in August on the back of higher inflation, the highest y-o-y growth rate since May 2004, when the monthly growth rate was 17.8%. Should we take into account expenditures in services, which are not included in retail sales, then consumption growth would probably be even higher.

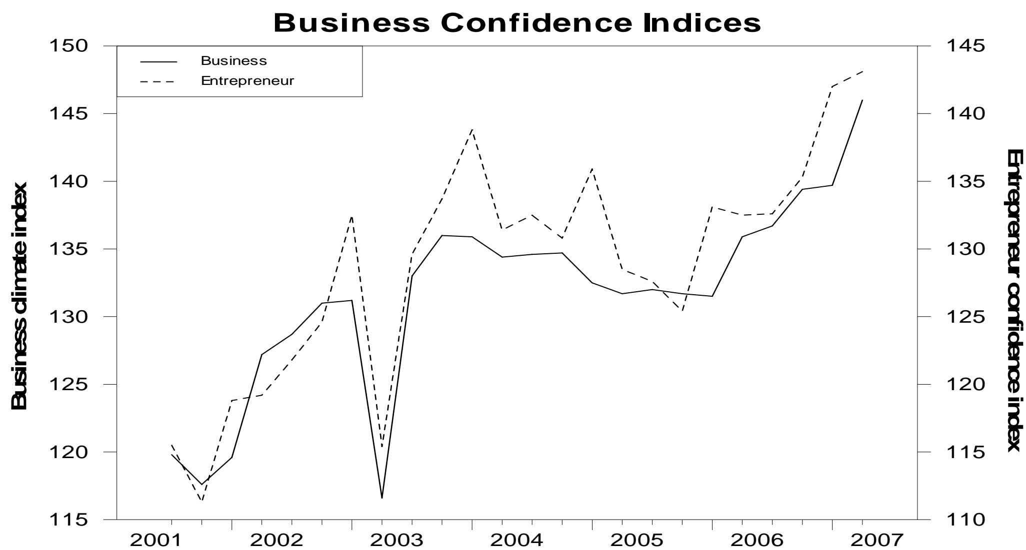
Figure 5.11



Personal consumption expenditure is increasingly being supported by rapid growth in real wages and rising consumer confidence. Indeed, incomes continue to increase impressively, especially in rural areas where real income growth is now at a 10-year peak. Rural disposable income per capita, which increased by 15.2% y-o-y in the first quarter of 2007 in nominal terms, has actually been boosted by increasing meat and grains prices and is expected to continue to benefit from higher grain prices. Strong retail sales growth, which increased from an average growth of 13.7% in 2006 to 16% average growth in H1 07 and finally reached 17.1% y-o-y growth in August, suggests that robust wage growth and the positive wealth effect from the bull equity market will underpin private consumption expenditures for the rest of the year.

Strong domestic demand, as well as demand from abroad, is evident in strong industrial production growth. Indeed, industrial production growth reached 19.4% y-o-y in June, the largest y-o-y monthly increase for the last 12 months. Even though industrial production growth moderated to 18% in July and 17.5% in August, partly due to the unusual weather conditions (floods) in many areas of the country and softer external demand, it continues to be at an elevated level. The profitability of industrial businesses has stayed relatively high in the first half of the year, especially in capital intensive sectors, such as steel, chemicals or electric power. As a result, business confidence indexes have risen at multi year peaks (Figure 5.12), resulting in expectations of further strong profit rises, which have in turn boosted equity prices.

Figure 5.12



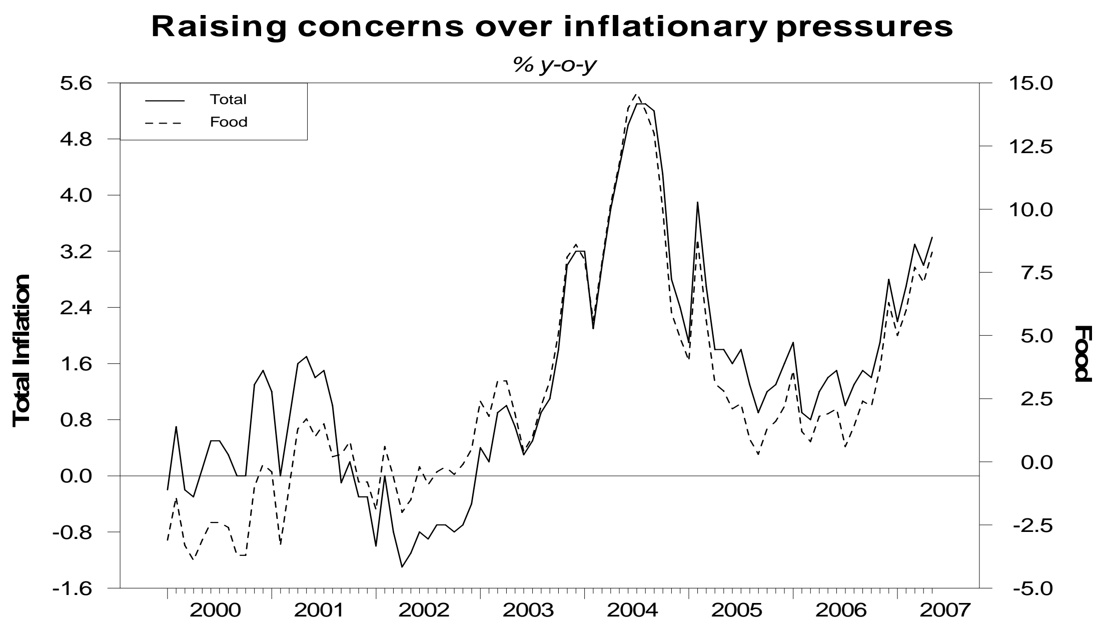
The Shanghai Composite Index has increased by around 200% in the last 12 months and by over 100% year to date. Households have withdrawn large volumes of their bank deposits in order to invest in equities; 3.1 million new accounts were opened for trades on A-shares stock exchanges in 2006. The number of new accounts reached 4.8 millions only in the first quarter of 2007. The long-term outlook for China's equity markets seems extremely positive at the moment, boosted by accelerating economic growth, improving corporate earnings and ample market liquidity entering the economy in the form of exports earnings. Despite a short-term correction in early February, China's equities rally seems to be continuing. However, given the recent financial market turmoil, the existing level of equity prices seems to enclose the risk of a market correction, especially in case the current profit corporate growth proves to be unsustainable.

The Consumer Price Index (CPI) is rising at its fastest pace in more than a decade (December 2006). The rate of inflation soared to 6.5% y-o-y in August from 5.6% y-o-y in July, as a result of a jump in the prices of many food products. Sharp increases in food prices, which contributed more than 90% of the rise headline inflation, are strongly related to domestic supply shortages and internationally high grain prices (Figure 5.13). CPI inflation has averaged 3.9% y-o-y in 2007 up to now, well above the Central Bank's original target for 2007 (3%), and slightly below its recently upward revised target of 4%. Under these circumstances, China has decided to freeze all government-controlled prices, such as oil, electricity, water etc. Therefore, there is strong evidence

that inflation may continue to surge, as it seems that inflationary pressures are beginning to spread to non-food products and services.

For the present, China's core inflation remains at low levels; apart from food, the prices of many core goods (such as tobacco and alcohol, household equipment and machinery) show modest increases compared to the same month one year ago, whereas prices of some goods such as clothing, transport and communications, education and cultural services are declining. In addition, producer prices, which increased to 2.6% in August from 2.4% y-o-y in July, are generally rising less than consumer prices; intense competition in many manufacturing industries continues to keep producer prices low, despite increasing raw-material costs (Purchasing Price Index).

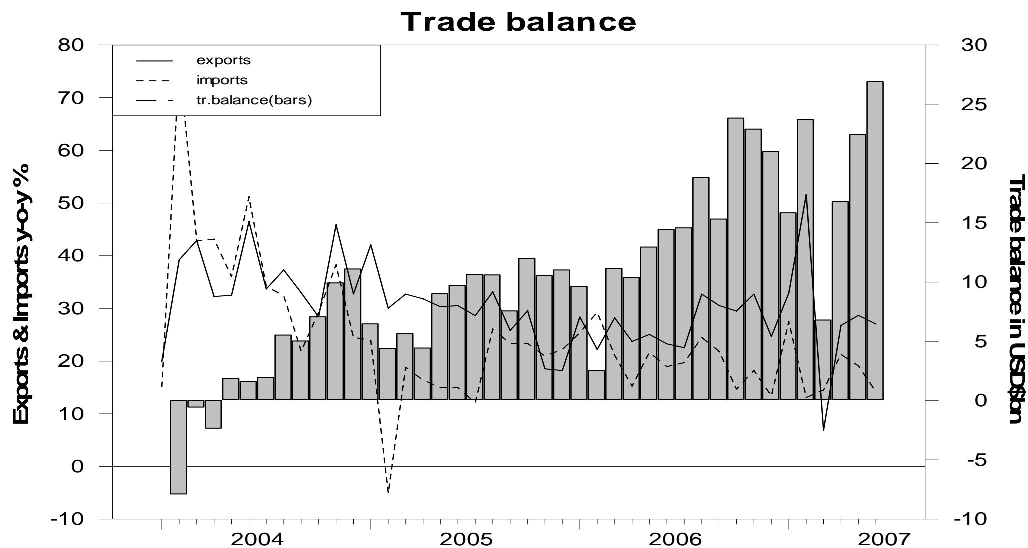
Figure 5.13



China's foreign trade recorded a substantial growth of 23.3% y-o-y for the first half of the year, with a total trade volume of US$981bn. Exports climbed to US$294.8bn in the second quarter of 2007, marking a 27.5% increase over the same period in 2006, while imports increased by 18.2% y-o-y over the same period. As a result, the trade surplus has been gradually increasing over the last few months and moderated somewhat to US$25.0bn in August, from a multi-year high of US$26.9bn in June (Figure 5.14). This moderation was largely due to the removal of export tax rebates, effective as of 1st July 2007, which encouraged exporters to bring their shipments forward into June. The pace of surplus acceleration seen in the first half of the year will probably not be sustained, although

we expect the surplus to continue its upward trend. The situation stresses the need for a faster appreciation of the CNY against the USD, which we expect to continue.

Figure 5.14



China's strong GDP growth and inflation data has raised concerns about overheating of the Chinese economy. Apart from commodities' inflationary pressures, asset prices in China are also booming. As a consequence, China's authorities raised again banks' cash required reserve ratio in September by another 50bp in order to contain credit growth. The People's Bank of China (PBoC) has actually raised the reserve ratio from 7.5% to 12.5% since July 2006 to tighten excess liquidity. Raising the level of reserves that banks must hold at the PBoC seems to be the favorite policy tool to tighten liquidity conditions. The latest increase of the reserve requirement may prove particularly useful, as it was combined with an interest rate increase of 27 bps and the widening of the daily trading band for the CNY against the USD to 0.50% from the previous 0.30%. Increases in lending, as well as deposit rates, are likely to be a more useful policy tool than the reserve ratio, as they could lead to bank lending reduction and bank deposits increases, instead of abundant liquidity in the equity market. The PBoC hiked the 1-year benchmark deposit rate by 27 bps to 3.87% and the 1-year lending rate by 27 bps to 7.29%, effective from September 15th 2007. A previous deposit and lending rate increase of 27 bps that took place in July was also combined with a reduction of the tax on deposit interest payments from 20% to 5%.

Following the recent deposit and lending rate increases and the tax reduction on deposits, which were positive steps towards restricting overheating pressures and anchoring inflation expectations

in the Chinese economy, we expect more gradual tightening measures in the future to cool off the economic expansion. The considerable money supply average growth (M2) of 18.3% y-o-y over the last couple of months emphasizes the need to control the overheating pressure in the overall economy.

6. Commodities

Dimitris Malliaropulos, Costas Lambrinoudakis

- Commodities weathered the latest financial market turmoil and outperformed both bonds and equities in Q3 07.
- Oil, gold and wheat were the top performers in Q3. Oil and wheat kept setting new all-time nominal highs in mid-September. Base metals had the worst performance due to growth-related worries.
- The surge in oil prices is attributed to supply side factors, namely the disappointing non-OPEC supply and OPEC's production cuts. Tight fundamentals increase the upside potential for the quarters ahead.
- Gold prices rose sharply, fuelled by weakening dollar, rising oil prices and ongoing economic uncertainty as the credit crisis still unfolds.
- The strength of the US economy and in particular its linkage effects on international economic growth will determine to a large extent base metal price dynamics.
- The surge in wheat prices is attributed to a draught-induced supply shock. Even though further price spikes cannot be ruled out yet, prices are expected to retreat from record highs and level off over the next quarters due to expected supply response and substitution away to other products.

Commodities weathered the credit-driven financial turmoil that hit the markets two months ago. In particular, the S&P GSCI, the most heavily tracked commodity index, rose in Q3[1] by 11% outperforming both the MSCI Global Equity Index and the JP Morgan Global Government Bond Index which edged up 0.7% and 6.1% higher respectively (Table 6.1). The best performer across the four commodity complexes was agriculture, driven by surging wheat prices, while the energy and the precious metals Sub-Indices returns moved also higher, as gold and oil prices rose sharply. The industrial metals Sub-Index declined by 2.6% as the particular complex was hit the most by the financial turbulence. This comes not as a surprise, since base metals are the most growth-sensitive commodities and therefore the potential implications of the credit crunch for economic growth weighed on the particular commodity group.

When the financial turbulence first unfolded at the end of July, all commodity groups but agriculture did not evade the heavy liquidations spread across most asset classes. The sell-off was primarily driven by the willingness of investors to obtain liquidity, to switch to less risky assets and by growing concerns that the credit crunch may affect economic growth. As the markets begun to

[1] Until September 21st, 2007.

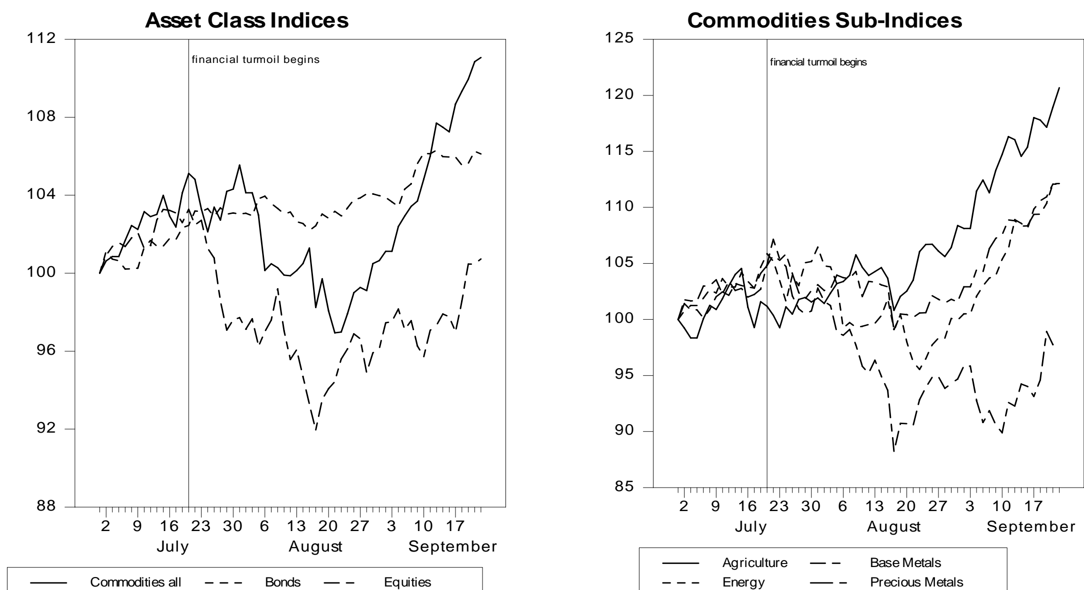
stabilize in the middle of August, commodity prices rebounded strongly reflecting strong underlying fundamentals in most of the complexes and some aggressive buying, which pushed most complex Sub-Indices above the end-of-July levels (Figure 6.1). Oil, wheat and gold prices experienced the most impressive performances, with the first two reaching new all-time nominal highs in September.

Table 6.1

Performance of Total Return Indices

	21 Sep 2007 level	QTD	2007YTD	2006	2005
Commodities					
S&P GSCI ALL	6663.55	11.06%	18.41%	-15.09%	25.55%
Energy	1636.50	12.08%	21.04%	-26.79%	31.19%
Industrial Metals	2096.98	-2.60%	7.80%	60.93%	36.32%
Precious Metals	1002.10	12.13%	13.14%	24.08%	18.63%
Agriculture	773.93	20.68%	19.11%	13.35%	2.35%
Equities					
MSCI World (Developed Markets)	1614.11	0.73%	8.80%	17.95%	7.56%
MSCI US	1441.08	1.47%	7.84%	13.18%	3.80%
Bonds					
JP Morgan GBI Global (Developed Markets)	474.48	6.12%	6.11%	9.77%	-4.69%
JP Morgan GBI US	361.67	3.68%	4.52%	2.39%	2.37%

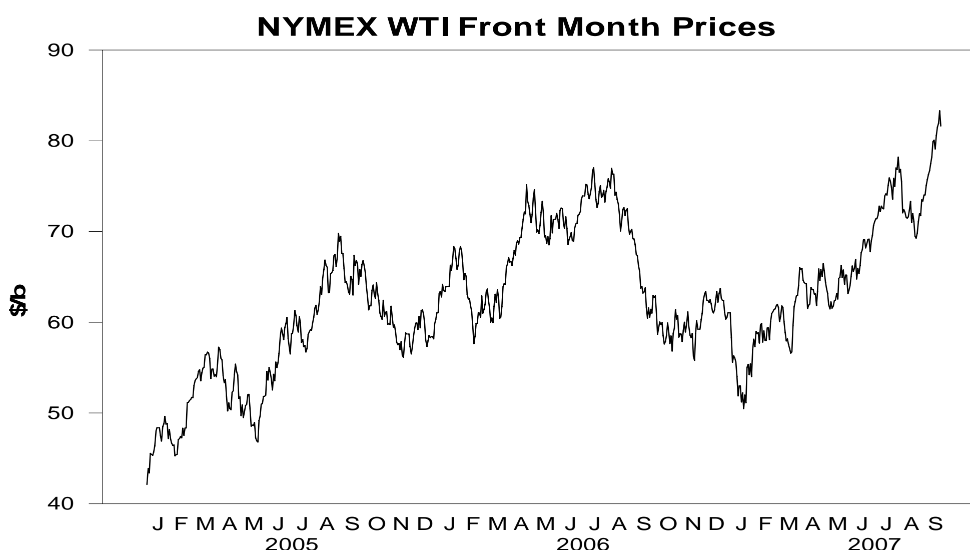
Figure 6.1



Oil

The oil price decline in August owed to fund liquidations amidst the financial market turbulence proved short-lived. NYMEX WTI prices, after following a 12-month long cycle of slump and recovery that started in the summer of 2006, reached a new all-time nominal high at $83.32/barrel on September 20th (Figure 6.2). The price surge in 2007, which has reached an impressive 60%[2] since January 2007, is attributed to supply-side factors. In particular, non-OPEC oil production in 2007 has been lower than expected, while OPEC switched to a price defence policy in late 2006 by significantly reducing output. The stagnant supply pushed the global oil market into deficit and accelerated inventory draws this year. According to IEA's estimates[3], global demand outpaced global supply in July and a counter-seasonal inventory draw in Q3 is very likely. In Q3 oil inventories are usually build rather than drawn, so that the market can meet the increased seasonal demand in the winter ahead.

Figure 6.2

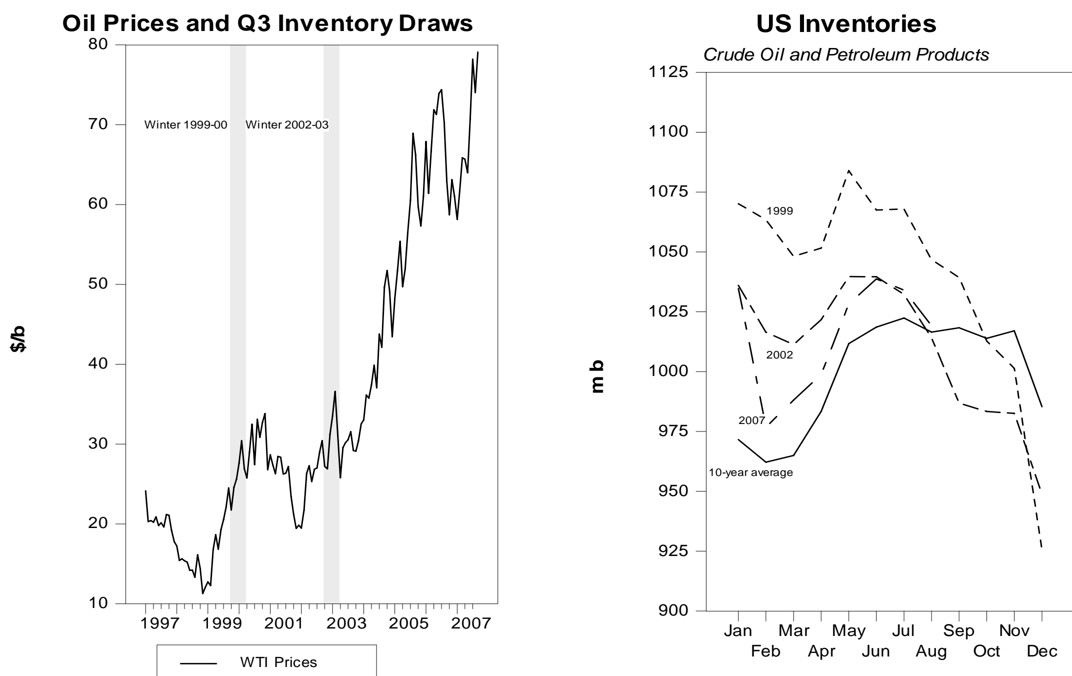


Taking into account the recent shifts in the oil market, OPEC announced on September 11th a 500,000 b/d output increase, effective from November 1st. However, oil prices kept rising even on the day of the announcement, reflecting market's perceptions that this production increase was not high enough or hasn't happened soon enough to have a significant impact on the global supply/demand balance in Q4 07.

[2] Until September 21st, 2007.
[3] IEA Oil Market Report, August 2007.

There have been only two Q3 inventory draws during the last 15 years, both following production cuts and both followed by price spikes in the winter ahead (Figure 6.3). This implies that tight fundamentals created during the course of the year are leaving the oil market rather sensitive to potential supply disruptions from geopolitical or other kind of risks, albeit inventories in late August were still close to the 10-year average (Figure 6.3). This is the more significant upside risk for oil prices over the next quarters. On the other hand, significant sources of downside risk are the potential for a severe economic slowdown that would dampen down demand for oil and the continued uncertainty in the financial markets that could trigger another sell-off like the one occurred in the latest turbulence. As far as the short-term is concerned, the increased non-commercial long positions for oil raise the probability of a price correction from the record highs reached recently.

Figure 6.3



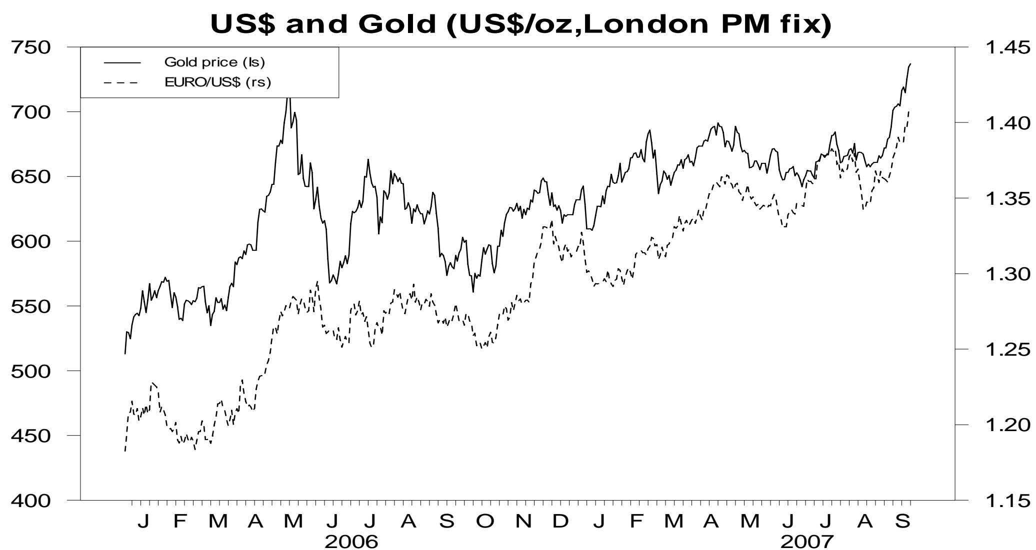
Gold

Gold price behaviour has been similar to that of the oil price during the recent crisis. When the fund liquidations eased in mid-August, gold prices rebounded strongly and after cracking the 700/oz level for the first time in 16 months, they reached a new 27-year nominal high of $737/oz on September 21st (Figure 6.4). The price upturn was mostly driven by investors seeking protection against the

falling dollar and the growing fears about the impact that the credit crunch will have on the real economy.

Price risks are skewed towards the upside since the same factors that pushed gold prices to new multi-year nominal highs are expected to shape price dynamics over the next quarters. In particular, the dollar, which exhibits a very strong negative correlation with gold (Figure 6.4), is expected to decline further since the FED seems to have shifted to an easing bias that will generate additional narrowing in interest rates differentials and growing inflation fears. Moreover, there is still uncertainty concerning the extent of the credit crisis and most importantly the potential spillovers to the real economy. Finally, the strong outlook for oil prices and the consequent inflationary pressures in the next two quarters post another supportive factor for gold prices. The upside risk is mitigated by factors concerning the physical demand and supply of gold, namely an expected decrease in producer's de-hedging[4] and an expected increase in central bank selling.

Figure 6.4



Net long non-commercial positions for gold have approached record levels, indicating that – despite strong prospects for gold prices over the next quarters – there is potential for a pullback from recent highs in the short-term as investors may be tempted to take profits.

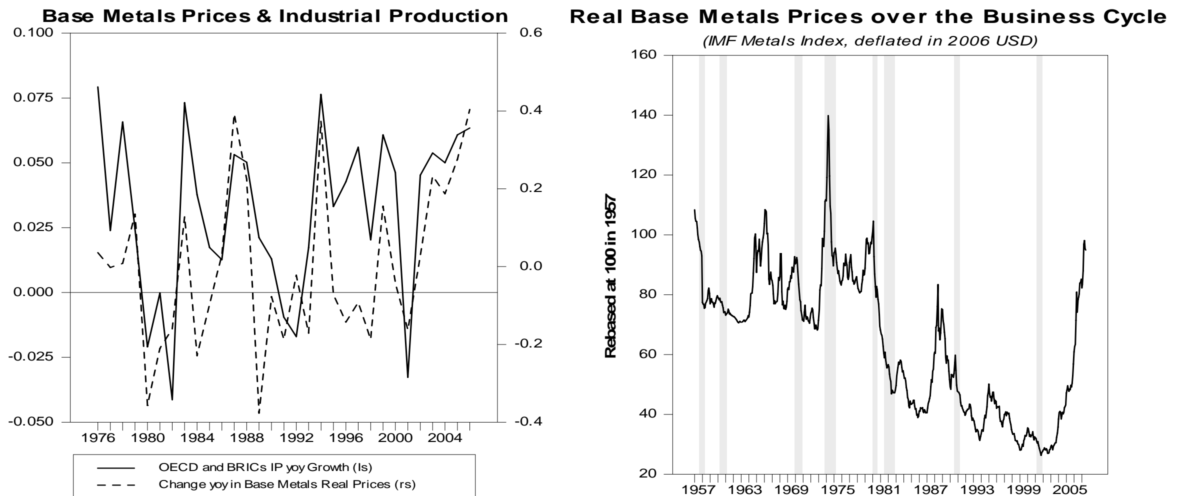
[4] Producers closing short positions in gold futures that had been opened during periods of declining gold prices.

Base Metals

The base metals complex was the one that suffered the most in the recent financial market turmoil. The S&P GSCI Industrial Metals Sub-Index was the only one that declined in Q3. Liquidations have been more intense in the particular complex because base metals are by far the most economic growth-sensitive commodities (Figure 6.5). Hence, growing fears of the credit crunch affecting eventually economic growth have weighed more on investors' sentiment on base metals relative to other commodity groups. Prices rebounded strongly after the 50 bp rate cut announcement by the FED, as the monetary easing indicated that the FED's first priority shifts to economic growth.

The main determinant of prices over the next quarters will be the strength of the US economy and in particular its effects on global economic growth. Emerging markets' and especially China's demand for base metals has been the main driver of the base metal's bull market over the last 5 years, as these economies are undergoing a phase of industrialization and infrastructure building. The contribution of China to total demand growth for base metals has been at least 50%, while it is striking that for some metals it has even exceeded net global demand growth. In contrast to the US economy, the Chinese economy, being on course for its fifth consecutive year of double-digit growth, does not show signs of slowing significantly, indicating that the worlds' largest emerging-market economy may be decoupling from the US economy. Hence, we believe that robust demand stemming from China mostly and other emerging-market economies will not abate any time soon and will continue to provide support to base metal prices. The upside price risk is mitigated by the potential of a slowdown in the US that will have an impact on demand growth, albeit smaller than in previous decades. The probability of another credit-driven financial market collapse that will trigger new derisking-induced liquidations in metals posts some downside price risk.

Figure 6.5



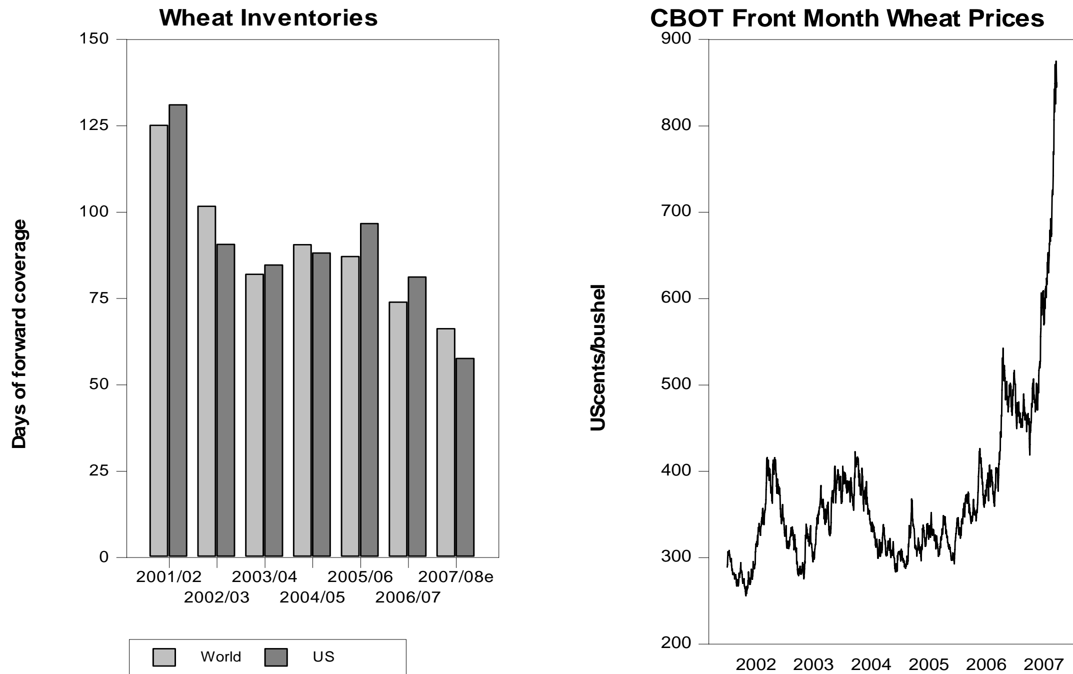
Note: shaded areas denote recessions

Agriculture

Wheat prices skyrocketed in 2007. CBOT wheat front month prices reached a new all-time nominal high of $8.75/bushel in mid September after having doubled in the last 6 months (Figure 6.6). The price rally is the result of declining production expectations that are induced by extreme draught conditions in Australia and adverse weather conditions in other wheat producing regions like Eastern Europe and Canada. The decline in this crop year's expected production further exacerbates the tight fundamentals that were created by two consecutive years of draught-induced poor harvests that brought the inventories to record low levels.

Depleting inventories leave the market vulnerable to any future supply disruption, so price spikes following bad news about production forecasts are not out of the picture. However, it seems that supply tightness is to a large extent priced in. Prices are expected to retreat from recent highs and level off over the next quarters as the increased prices are expected (a) to trigger a substantial shift of planting acreage towards wheat in the next planting season, as with the case of corn last year and (b) to induce some substitution away from wheat to corn and soybean in the livestock feed market.

Figure 6.6



Soybean and corn prices have moved to the opposite direction during 2007. Corn prices corrected in 2007 after having soared in H2 06, while soybean prices have been rising since late 2006. This was the result of a massive rotation in the US from soybean to corn planted acreage, which was driven by failing corn inventories and surging corn prices in 2006. Accordingly, this crop year's production is expected to be higher for corn and lower for soybean than last year's production. These expectations are reflected in both products' price changes in the course of this year. An upside risk is a potential pick up in demand for both corn and soybean due to substitution away from wheat in the livestock feed market. In addition, recent Chinese import tariff cuts on grains aiming at attracting more supplies and cool down domestic inflation may accelerate demand growth, lower global inventories and eventually drive prices higher.

7. Implications for asset allocation

Dimitris Malliaropulos

US Treasuries

Long-term Treasury yields moved lower in H2:06 as the slowing of the US economy and growing distress in the sub-prime market has led to a sharp re-pricing of the probability that Fed funds rates will move lower. As a result, 10-year Treasury yields declined sharply from their peaks of 5.26% in mid-June to near 4.40% in mid-September, close to our Q3 forecast of our last Global issue in May (4.43%). Current bond market valuations have in our view fully priced in the probability of a severe US slowdown and an easing of monetary policy by 100 bps by early-2008. Our fair value estimates of 10-year Treasury rates in fact suggest that current valuations are neutral with respect to the main fundamentals of the US economy and the medium-term prospects for monetary policy. Looking forward, however, we believe that inflation worries will soon start to build up as a result of looser monetary conditions, putting a floor to Fed funds rates and leading to higher inflation premia in bond markets. Thus, we project 10-year Treasury bond yields to head up to 5% in Q4 as inflation rebounds and market expectations of aggressive rate cuts by the Fed gradually seize (Figure 7.1). That said, it should be clear that bad news about the outlook of the US economy will continue to provide downward pressure on yields to levels near 4%.

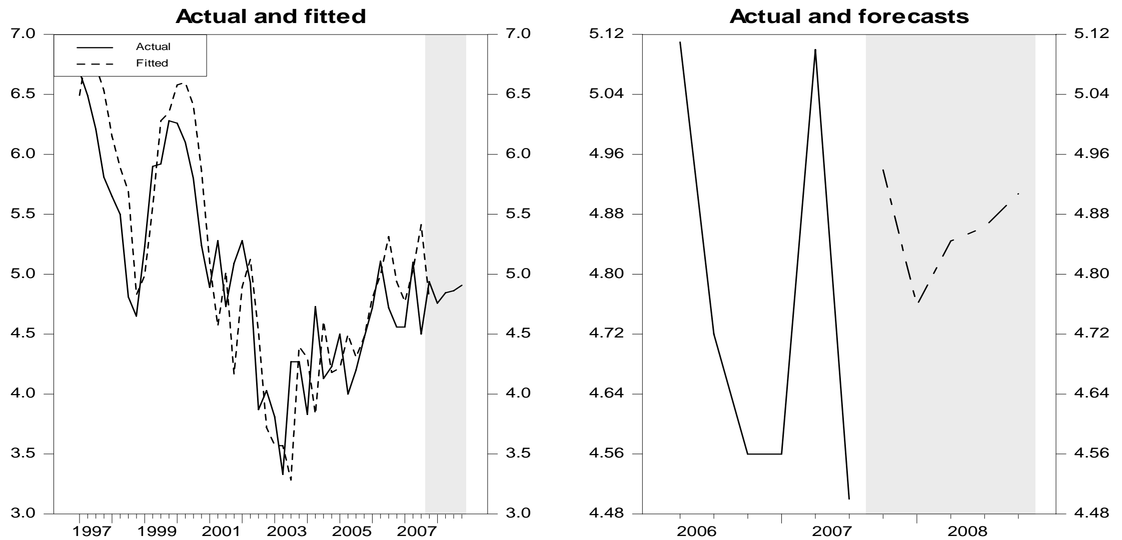
Slope of US Treasury Curve

With the downturn of the housing market intensifying and labor market weakness cumulating over the next few quarters, we expect the yield spread between 10-year Treasuries and Fed funds – which is currently -25 bps, close to our May projections for Q4 (-22 bps) – to steepen significantly as monetary policy will eventually lag behind the curve and long-term yields will increasingly reflect mounting inflation worries. Overall, we expect the slope of the term structure (10-year versus Fed funds) to steepen by up to 70 bps until year-end and by another 25 bps in H1:08 (Figure 7.2, right). The tightening of term spreads has been already set into motion during the 2nd quarter of the year as the median duration of unemployment has picked up significantly and payroll growth started to ease from its 2006 peaks. With labor market slack cumulating into 2008 (Figure 7.2, left) and inflation concerns on the upturn, we project the upward trend in term spreads to continue. In fact, our probit model estimates suggest that the probability of a steepening in the slope of the Treasury yield curve

increases from about 80% currently to more than 90% in Q4 and more than 50% throughout 2008. As a result, we expect long-short positions in 2-year versus 10-year Treasuries to outperform and suggest a restructuring of bond portfolios towards shorter durations.

Figure 7.1

10 year US Treasury rate

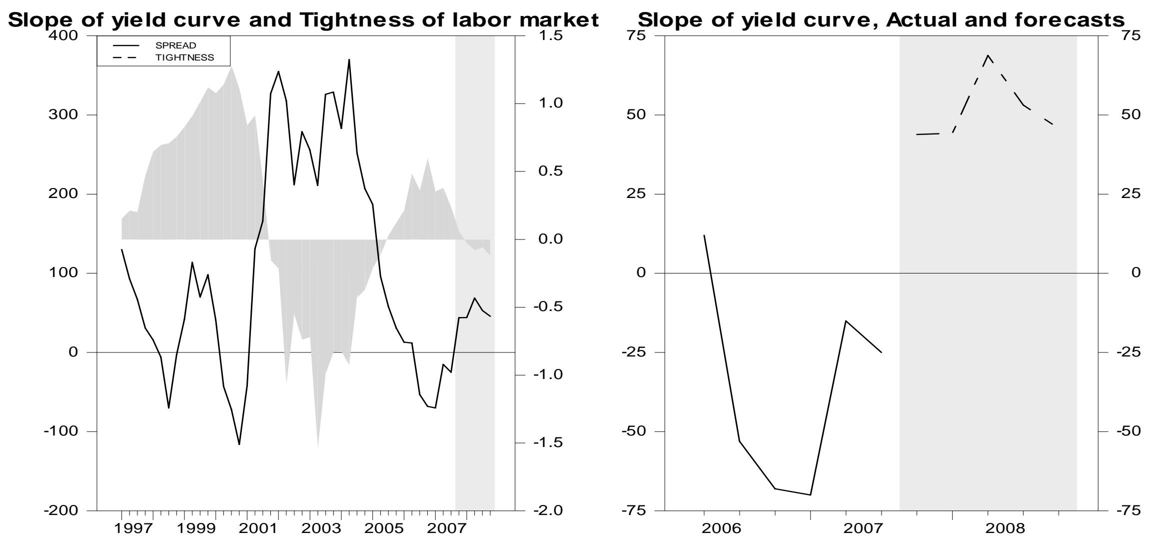


*Source: Eurobank EFG model estimates

Figure 7.2

Slope of Treasury Yield Curve

10-y US Treasury - Fed Funds



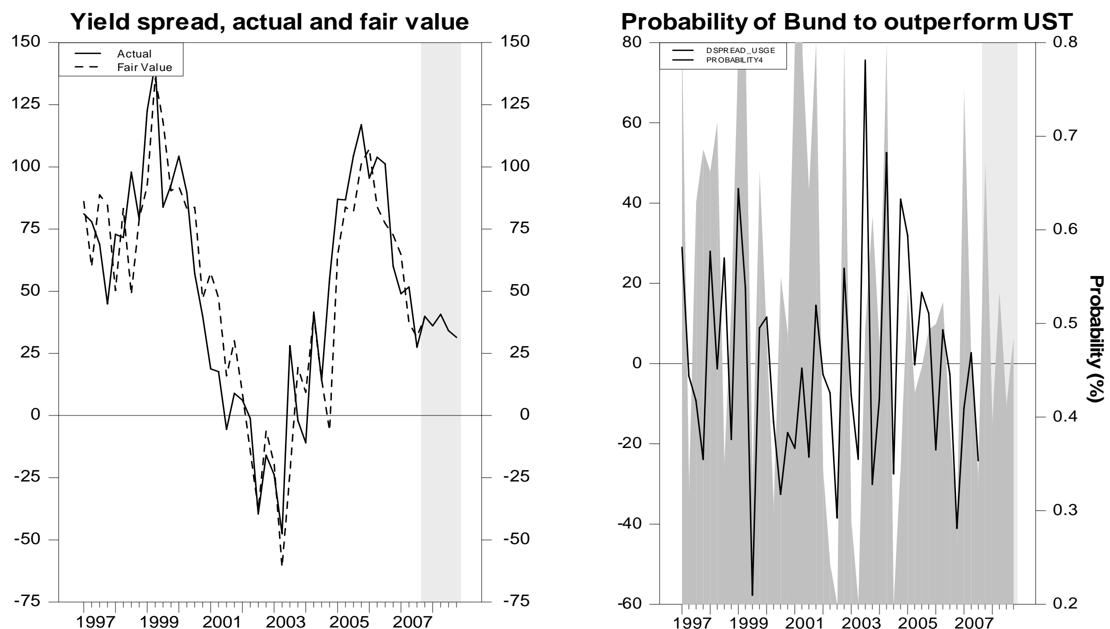
*Source: Eurobank EFG model estimates

Treasury-Bund spread

The Treasury-Bund spread has narrowed significantly from 50 bps in May to 30 bps in September, in line with our May projections (32 bps). According to our analysis back in May (Global Economic & Market Outlook, May 2007), this development was mainly driven by the weakness of the US economy relative to the euro area. Looking forward, we believe that spread narrowing has already reached a cyclical trough as expectations about short-term interest rates in the two areas have gradually converged. We expect the Treasury-Bund spread to increase to near 40 bps by December and decline gradually towards its current levels of 30 bps during the second half of 2008, when the growth slowdown in the US economy has fully worked out.

Figure 7.3

10-y Treasury - Bund Spread



*Source: Eurobank EFG model estimates

In fact, our probit model for the Treasury-Bund spread suggests that the probability of Bunds to outperform 10-year Treasuries increases to near 70% in Q4 from 34% in Q3 but subsequently declines below our threshold of 50% in Q1 08 (Figure 7.3, right). Hence, we continue to suggest long-short positions in 10-y Bunds versus Treasuries at current levels of the spread but acknowledge that (a) the potential of such trades is limited (20 bps) and (b) the risks are on the

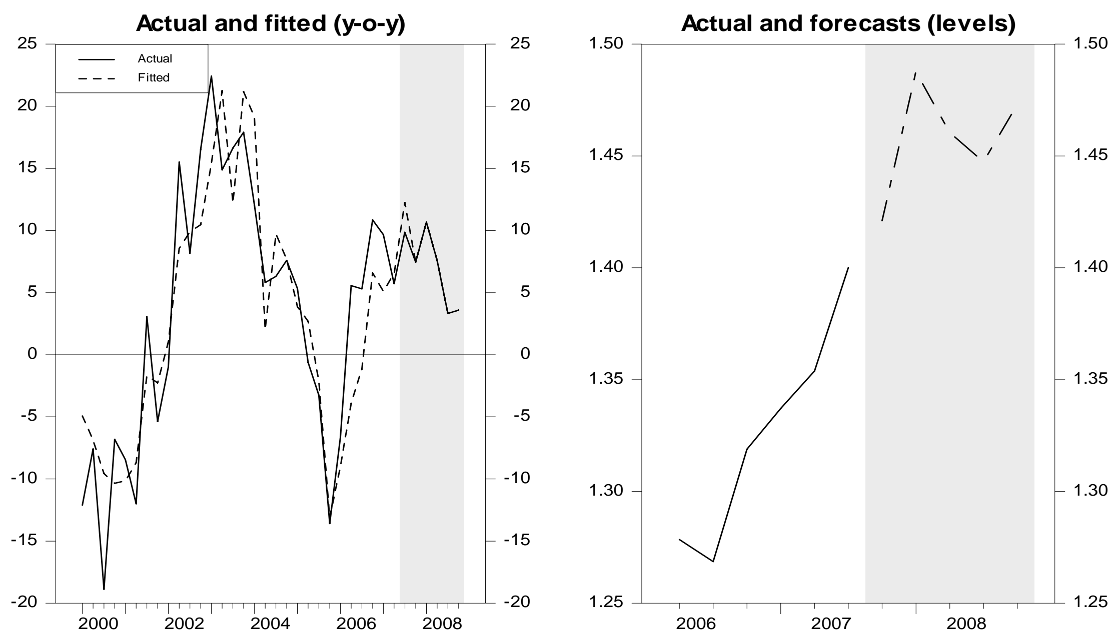
upside as interest rate volatility is clearly on the rise and the dollar will likely continue its downward trend.

Foreign exchange

Over the past four months, the dollar has continued to weaken against major currencies, as a result of the slowdown in the US economy, narrowing interest rate differentials and the unwinding of leveraged carry trade positions due to the turmoil in credit markets. On a trade-weighted basis, the dollar has depreciated by more than 5.5% over the past twelve months. We expect this trend to continue during the rest of the year, as Fed policy has clearly turned to an easing bias and the risks of a sharp slowdown of the US economy are currently on the rise. In addition, the global turmoil in credit markets creates increasing pressure on yen-funded carry trades, which start to unwind, putting high-yielding currencies such as the dollar under severe selling pressure. The risks for the dollar are clearly on the downside as (a) the US economy is likely to move into a recession, (b) the dollar is in the epicentre of the evolving credit crunch, which may eventually prove worse than expected.

Figure 7.4

EUR - US Dollar exchange rate



*Source: Eurobank EFG model estimates

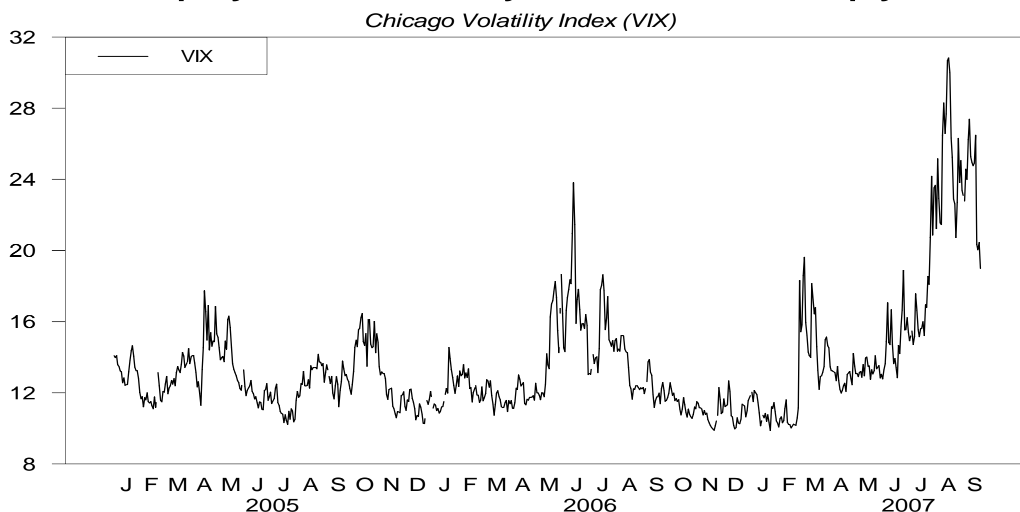
Our short-term fair value model of the EUR/USD exchange rate suggests that the decline of the dollar against the euro year-to-date is fully in line with the narrowing of the Treasury-Bund 10-year yield differential over the same period. The euro has already crossed the critical threshold of USD 1.40 in late September and we expect the currency to cross USD 1.45 in the next six months (Figure 7.4).

Equities

Higher volatility is here to stay

After four years of unusually low volatility and high risk appetite, global equity markets have, in our view, entered a new regime of higher volatility. Both realized and implied volatility have increased substantially since July as increasing concerns about the effects of the unwinding credit crunch on the global economy triggered a process of de-leveraging and general position reduction across a range of equity markets outside the US (Figure 7.5). Equities took a substantial hit, with the biggest losses concentrating among financials and cyclical sectors. However, equity markets rebounded quickly, encouraged by expectations that the Fed is willing to cut rates aggressively in order to end the credit crunch and protect the US economy from a substantial downturn.

Figure 7.5



In our view, the return of equity market volatility is here to stay for a considerable period of time, with VIX volatility likely to trade around a level of 20 rather than a level of 10-12, experienced over

the past few years. The main driving force behind this development is the fact that the US economy has entered a period of cyclical weakness with economic uncertainty on the rise and tentative signs of rising slack in the labor market. The current episode of rising volatility looks in our view closer to the 1997-1998 episode (Asian crisis, Russia's default, LTCM meltdown), when volatility increased permanently for several years, rather than the recent short-lived spikes of volatility in 2005-2006.

Investors should get ready for a profit crunch in the US

Our long-standing view has been that the risk of a retreat in global equity markets due to the US profit slowdown is considerable and this risk seems not to be sufficiently discounted in current market valuations. In our last Global issue in late May, we argued that investors should get ready for a significant deceleration of corporate profit growth in the US as profit spreads had already past their peak in 2006 and economic activity was showing clear signs of a slowdown since Q1 07. We also warned that the balance of risks for corporate profits is on the downside as Q1 wage growth estimates seemed much stronger than implied by the state of the labor market at the beginning of the year. In fact, economy-wide corporate profits after tax increased by a meagre 1.2% in Q1 and 3.4% in Q2, down from an average growth rate of 11.5% in 2006. To a large extent, the downturn in corporate profit growth reflects hefty downward revisions of Q1 data (by as much as -7.5% y-o-y), as wage growth in Q1 turned out to be stronger and productivity growth lower than first data releases back in May had suggested. Although the size of downward revisions was surprising even to us, we believe that the recent revised data on corporate profits are broadly in line with macro fundamentals of the US economy.

Lower Fed funds rates provide only temporary relief to equity valuations

Our current projections suggest that the slowdown of the US economy will lead to even negative growth rates of economy wide corporate profits in Q3 and Q4 and a gradual rebound in the second half of 2008. Most of this profit crunch will affect small and medium-size companies, which are more dependent on the domestic business cycle. In our view, the easing of monetary policy by the Fed will not be sufficient to alter the negative trend in corporate profits, suggesting that valuations will get under increased pressure.

Based on estimates of our long-term fair value model of US equities versus bonds, we warned in May that the valuation gap between equities and government bonds (measured by the relative value

of the S&P500 versus the 10-y Treasury Index) has turned neutral in Q1, suggesting that stocks are not any more undervalued relative to bonds for the first time since Q1 04. Following the June sell-off in bond markets, the overvaluation of stocks increased to +8% relative to bonds and declined to +3% in Q3 after the rebound of the Treasury market in August.

Table 7.1
Stocks versus Bonds Fair Value Calculations
(S&P 500 relative to 10-y Treasury Index)

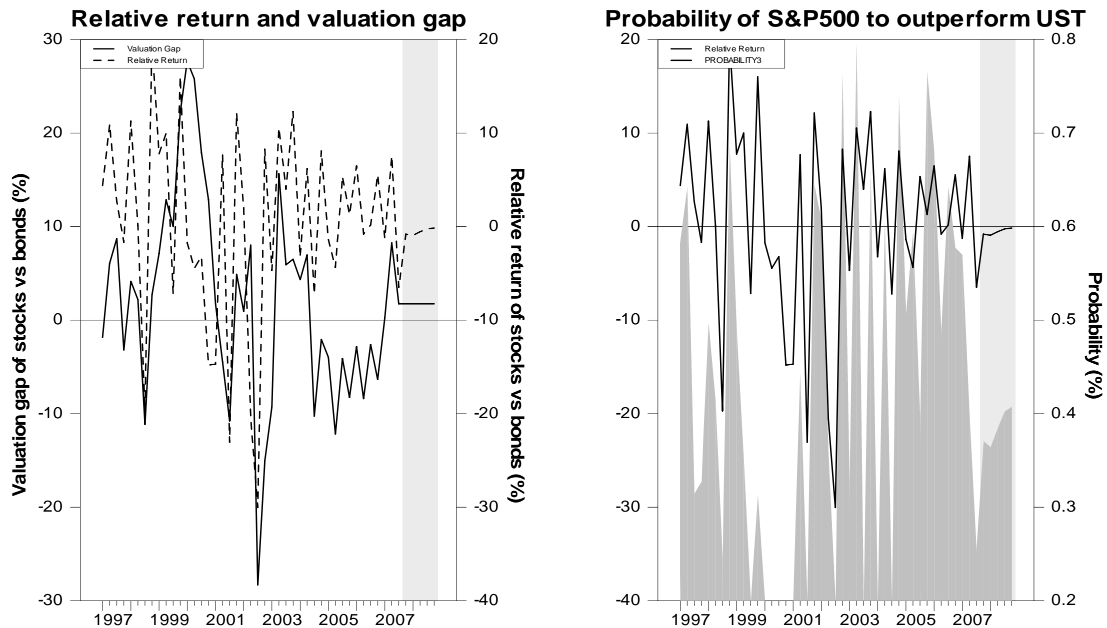
	Q2:07	Q3:07
Valuation gap (% deviation of market from fair value)	+8.0	+3.0
Contribution to fair value relative to Q2:07 (% change)		
Labor Market Tightness	-4.10	
Consumer Confidence	-0.10	
Fed funds	+4.20	
Volatility	+0.04	

*Source: Eurobank EFG model estimates

Table 7.1 reports the decomposition of the change in the fair value of stocks relative to bonds in Q3:07 relative to Q2:07. It appears that the aggressive rate cut by the Fed in September has helped to counterbalance the negative effect of rising slack in the labor market on the fair value of stocks versus bonds. Looking forward, however, we expect unemployment to increase and the labor market to normalize towards a cyclically neutral level in 2008. This will likely lead to a decline of the fair value of equities relative to bonds by another 5%, increasing the valuation gap to 8% in Q4 from 3% currently. Our relative equity-bond model estimates suggest that the probability of stocks to outperform government bonds over the next few quarters is less than 40% (Figure 7.6, right). We expect a rebound of the stock market in 2008, as economic growth picks up and corporate profits start to improve.

Figure 7.6

S&P500 relative to US Treasury



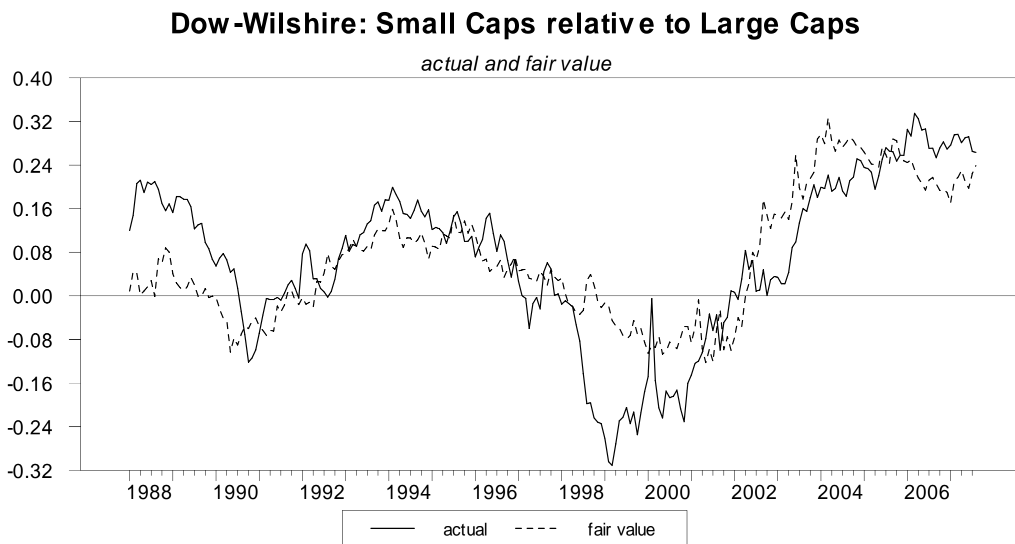
*Source: Eurobank EFG model estimates

Large caps due to outperform small caps

Our long-standing view since October 2006 has been that the long cycle of out-performance of small capitalization stocks relative to large capitalization stocks in the US is nearing to an end as the US profit slowdown will likely hit small caps harder than large caps because of a stronger dependence of small caps' earnings on the domestic business cycle. Measured by the Dow-Wilshire indices, small caps have underperformed large caps by 7% since March 2006, when the small-cap cycle seems to have peaked. In addition, year-to-date, the S&P500 has advanced by 4%, whereas the Russell 2000 has been flat. As the probability of a recession in the US has increased substantially over the past few months, we expect large caps to outperform small caps over the next twelve months. Large caps look currently undervalued relative to small caps by 5-10% based on the state of the economy (proxied by our index of labor market tightness and the PMI manufacturing index) and the earnings-bond yield differential (Figure 7.7). However, volatility of long-short positions in large versus small caps will remain high as new data arrive on the strength of the US economy and the outlook of short-term interest rates. On top of the cyclical weakness of small caps, the risk of a sharp correction in the market is in our view unusually high as a further

tightening of credit conditions may lead to a large-scale unwinding of leveraged positions of hedge funds. Faced with the risk of a sharper than expected slowdown of the US economy, the implication for investors is to increase short-long positions in small versus large caps as a hedge against a recession in the US.

Figure 7.7

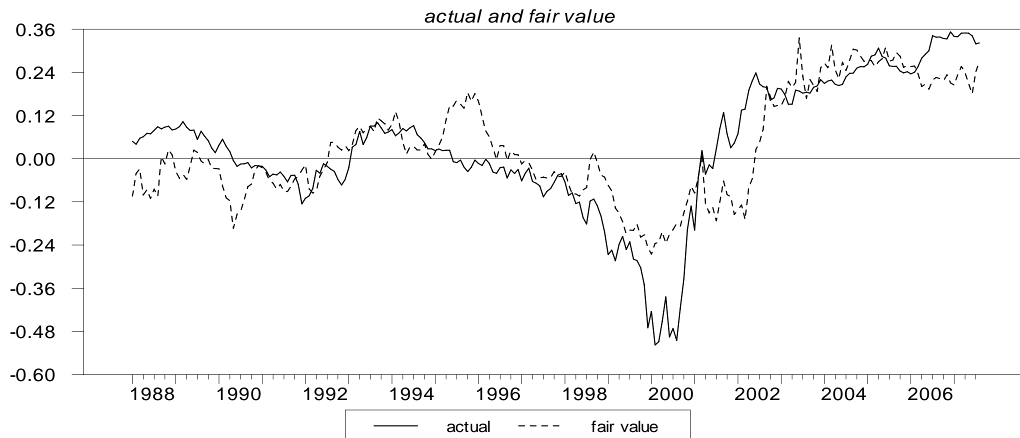


*Source: Eurobank EFG model estimates

Growth stocks due to outperform value stocks

The turn in the US business cycle has also clear implications for style investing. Value stocks tend to outperform growth stocks when the economy rebounds (similar to small and medium capitalisation stocks) and underperform when the economy enters into a business cycle slowdown. In fact, small value stocks seem to have lost their shine of the past few years. Measured by the Dow-Wilshire indices, small value stocks have retreated 1% since December 2006, whereas small growth stocks have gained 7%. Among the large stocks of the S&P500, growth stocks have gained 5% since December 2006, double as much as value stocks. Value stocks look currently overvalued relative to growth stocks by 5-10% based on the state of the economy (proxied by our index of labor market tightness) and the earnings-bond yield differential (Figure 7.8). Although large value stocks may continue to benefit from the turn in the interest rate cycle, a weaker dollar and robust growth of the global economy, small and medium-sized value stocks will likely suffer when domestic demand slows down significantly.

Figure 7.8



*Source: Eurobank EFG model estimates

Commodities

Commodities outperformed both bonds and equities in Q3 07, a quarter characterized by the credit-driven turmoil in the financial markets. The S&P GSCI Commodity Index increased by 11%, while the MSCI Global Equity Index and the JP Morgan Global Government Bond Index earned 0.7% and 6.1% respectively. The relative out-performance of commodities is consistent with the notion that commodities provide diversification benefits to bond and stock portfolios, that is they provide positive returns when one or both of the other two asset classes are underperforming. Oil, gold and wheat were the top performers.

Looking forward, we expect gold prices to continue their upward move, since the top-level factors affecting gold price dynamics are supportive: the dollar is expected to decline further, as the Fed cuts interest rates, prospects for oil prices are strong and economic uncertainty stemming from the credit crisis remains high. Oil price risk is skewed to the upside, as tight fundamentals induced by sluggish supply in 2007 continue to weigh on the global market. However, the sharp price rise and the increased net long non-commercial positions for both gold and oil indicate that there is increased risk of a short-term price correction from recent highs as investors will be tempted to take profits. Volatility in base metal prices is expected to persist and the direction of prices will eventually be determined by economic growth dynamics in the US and China. Although wheat prices may experience further price spikes if harvest estimates keep decreasing, eventually they are expected to retrace from recent highs as supply will respond with acreage rotation towards wheat in the next planting season and some wheat consumption will be substituted away to corn and soybeans.

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