Eurobank Research
www.eurobank.gr/research
research@eurobank.gr

GLOBAL ECONOMIC & MARKET OUTLOOK

Eurobank EFG

June/July, 2011

Gikas Hardouvelis:
Chief Economist & Director of Research

Written By:

Dimitris Malliaropulos:
Research Advisor
dmalliaropoulos@eurobank.gr

Olga Kosma:
Economic Analyst
okosma@eurobank.gr

Maria Prandeka:
Economic Analyst
mprandeka@eurobank.gr

Vasilis Zarkos:
Economic Analyst
vzarkos@eurobank.gr

DISCLAIMER
This report has been issued by EFG Eurobank Ergasias S.A. (Eurobank EFG), and may not be reproduced or publicized in any manner. The information contained and the opinions expressed herein are for informative purposes only and they do not constitute a solicitation to buy or sell any securities or effect any other investment. EFG Eurobank Ergasias S.A. (Eurobank EFG), as well as its directors, officers and employees may perform for their own account, for clients or third party persons, investments concurrent or opposed to the opinions expressed in the report. This report is based on information obtained from sources believed to be reliable and all due diligence has been taken for its process. However, the data have not been verified by EFG Eurobank Ergasias S.A. (Eurobank EFG), and no warranty expressed or implicit is made as to their accuracy, completeness, or timeliness. All opinions and estimates are valid as of the date of the report and remain subject to change without notice. Investment decisions must be made upon investor's individual judgement and based on own information and evaluation of undertaken risk. The investments mentioned or suggested in the report may not be suitable for certain investors depending on their investment objectives and financial condition. The aforesaid brief statements do not describe comprehensively the risks and other significant aspects relating to an investment choice. EFG Eurobank Ergasias S.A. (Eurobank EFG), as well as its directors, officers and employees accept no liability for any loss or damage, direct or indirect, that may occur from the use of this report.

Main Macro Views and Market Strategy

- A combination of temporary factors, coupled with tighter monetary and fiscal policies, have caused global growth to lose momentum in the first half of the year. However, the global economy will likely gain strength in the second half of the year, as supply chain disruptions due to the earthquake in Japan are restored, energy prices have fallen from their recent peak and confidence improves, on the backdrop of abating sovereign debt tensions in the euro area.

- Bold political action is required to bring stretched public finances back in order in several developed economies, after unprecedented fiscal support during the financial crisis. Elevated bond holders' concerns suggest that policymakers need to adhere to tight public finances and push through painful structural reforms.

- In the US, it is of vital importance to immediately address the debt ceiling and launch a deficit reduction plan, focused on reinforcing medium-term debt sustainability. However, given the recent softness of the US recovery, consolidation and reform plans should be gradual and well-paced, so as not to curb growth prospects.

- In the euro area, policymakers are increasingly realizing that joint fiscal responsibility is the only way out of the sovereign crisis. Greece will be granted an extended bailout package. However, implementation risk due to political and social reform fatigue remains.

- The economic recovery in euro area is broadening. Domestic demand is expected to keep printing higher contributions to GDP growth, suggesting the recovery becomes self-sustained and less vulnerable to external demand shocks. Divergence persists, as Germany's outstanding performance contrasts with anaemic growth in the periphery.

- In the US, we look for a rebound in GDP growth in H2, supported by strong corporate profits, a low interest rate environment, easier credit standards, a gradually improving labor market and robust growth in emerging markets.

- In most emerging economies, recent indicators point to a moderation in the pace of expansion, on the back of monetary tightening and high commodity prices. However their economic performance will remain robust and they are expected to remain the leaders of global growth.

- Oil fundamentals will remain tight enough over the course of the year to sustain oil prices at current levels, although further downside in the short-term cannot be ruled out.

- Further monetary tightening in emerging markets seems appropriate due to inflationary pressures. The ECB will continue its tightening cycle, unless recent weakness in the euro area persists. The Fed seems stuck between sub-par growth and rising price pressures, which makes it less likely to move forward to an interest rate hike before mid-2012, so as to ensure a sustained period of stronger economic growth and solid job creation.

Table of contents

Executive Summary 3

I. Global Outlook 4

II. Global Economic Outlook

1. The US economy 7
2. The Euro area economy 15
3. The Japanese economy 21
4. Emerging Markets 24

III. Special Issue: Oil prices to remain elevated over the course of the year 30

IV. Macro Forecasts 34

V. Graphs

1. Global Economic Indicators 35
2. Global Equities & Sector Performance 39
3. US Style Equity Indices 41
4. Commodities 42

Executive Summary

A combination of temporary factors, coupled with tighter monetary and fiscal policies, have caused the global recovery to lose momentum in H1 2011. The massive earthquake in Japan has caused supply chain disruptions that had a negative impact worldwide, particularly in the car manufacturing industry. Furthermore, large increases in commodity prices have contributed to the slowdown in global economic activity, as terms of trade in importing countries have deteriorated. However, we believe that the global economy will likely gain strength in H2, as supply chain disruptions due to the earthquake in Japan are restored, oil prices have fallen from their recent peak and confidence improves, on the backdrop of abating sovereign debt tensions in the euro area. Indeed, global demand remains strong, supporting global trade. In addition, the recovery is broadening, with more factors, most notably investment, contributing to growth. This provides evidence of strong fundamentals despite the headwinds. Emerging markets are expected to remain the locomotive of the global economy, whereas growth in several advanced countries will remain modest, due to ongoing deleveraging in the public and private sectors. In the euro area, export oriented countries that do not face debt issues are expected to outperform, with Germany being the growth engine among developed economies.

In the developed world, bold political action is required to bring stretched public finances back in order, after unprecedented fiscal support during the 2008 financial crisis. Elevated bond holders' concerns suggest that policymakers need to adhere to tight public finances and push through painful structural reforms. Whereas EU and UK governments have made decisive steps towards fiscal consolidation, the US has lagged behind.

In the European sovereign crisis, the recent disputes over a new rescue program to Greece dramatize the difficulties in reaching a permanent solution to the issue. Despite disagreement on private investors' participation, the repercussions of a Greek default finally made policymakers realize that they have no other option than to offer Greece a new bailout package, including a voluntary rollover of maturing debt over the period 2011-2014 which is held by private sector bond holders. With the willingness of euro area authorities now in place, it lies with the Greek policymakers to adopt the far reaching structural reforms to restore the country's competitiveness and cure the economic imbalances.

In the US, it is of vital importance to immediately address the debt ceiling and launch a deficit reduction plan, focused on reinforcing medium-term debt sustainability. However, given the recent softness of the US recovery, fiscal consolidation and reform plans should be gradual and well-paced, so as not to curb growth prospects. Should the recent deceleration in the US recovery prove to be more persistent than currently projected, the pace of fiscal consolidation should be tailored accordingly. On the monetary front, eventual Fed tightening over the coming year will, in our view, result in a rise in bond yields, increasing the debt servicing burden and putting the US government under pressure to consolidate fiscal balances.

Emerging markets have been the first to tighten monetary policy to combat inflationary pressures stemming from shrinking output gaps and large increases in commodity prices. We view there is scope for further tightening in monetary conditions in those developing countries where growth is robust to prevent the economy from overheating due to domestic demand, most notably in China. In the euro area, rising inflation above the 2% threshold has led the ECB to take pre-emptive action to tame inflationary expectations and kick off a tightening cycle by hiking rates in April, while a second rate increase is expected in July. However, the monetary tightening may prove premature, as it combines with fiscal consolidation while the inflation upturn is mainly supply driven. The divergent growth pattern in the euro area complicates matters even more, as higher interest rates do not bode well with sluggish growth in the periphery.

In the US, the Fed seems stuck between sub-par growth and rising price pressures, which make it less likely to move forward to an interest rate hike before the first half of 2012, so as to ensure a sustained period of stronger economic growth and solid job creation. However, the large scale bond purchases have caused the Fed's balance sheet to expand enormously. Normalizing monetary conditions, while having to deal with the proper reduction of the balance sheet, is most likely to prove a difficult task. In our view, the main challenge the Fed faces is to adopt the right exit path so as not to disturb the healing of the economy and communicate it in a clear manner in order to prevent markets from overreacting.

Dimitris Malliaropulos

Research Advisor

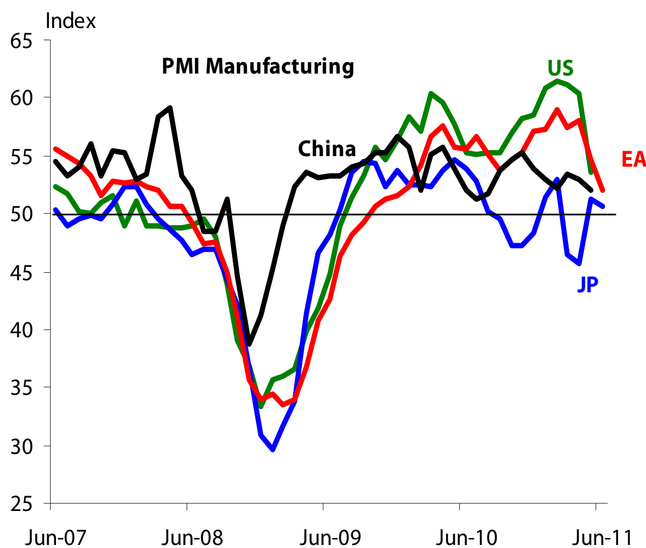
I. Global Outlook

Dimitris Malliaropulos, Vasilis Zarkos, Olga Kosma

After hitting a soft patch in H1 2011, the global economy is expected to reaccelerate in the second half of the year

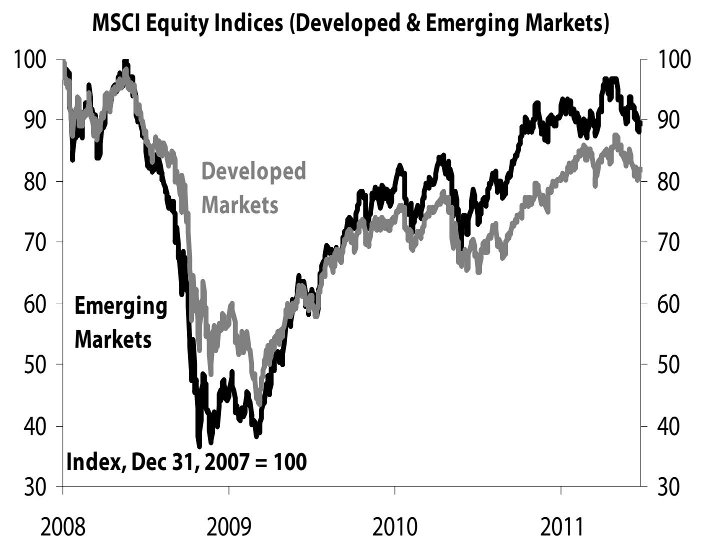
The global recovery has been losing momentum in the first half of the year, as is evident by both soft and hard data. Forward looking indicators such as manufacturing PMI indices have softened in both advanced and emerging economies in the second quarter of 2011 (Figure 1) and stock markets have been sliding in reaction to downbeat news (Figure 2). A wide range of data in the US has disappointed, as real GDP eased to the sub-trend growth of 1.8% in Q1, job growth has recently stalled, leading indicators edged lower while the housing sector remains the Achilles' heel of the economic expansion. However, we believe that the headwinds that have eroded the momentum of the global economy are of temporary nature and we expect the recent weakness to be a soft patch of the global economy rather than a prolonged slowdown.

Figure 1



Source: Bloomberg

Figure 2



Source: Bloomberg

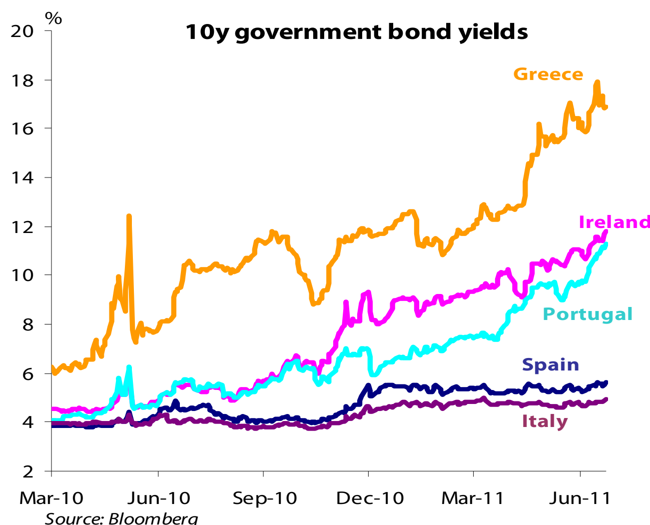
The massive earthquake in Japan in March has caused supply chain disruptions that had a negative impact worldwide, particularly in industry sectors such as the car manufacturing industry. However, a series of soft and hard data suggest that April was the trough in production and a sharp decline in production in Japan is expected to be followed by a robust rebound. Most notably, the Japanese PMI manufacturing index bounced strongly in May, rising above the expansion threshold of 50 (see Figure 1). Supply constraints due to damaged infrastructure and power outages have receded substantially, while further improvement is expected in the next few months, favoring the normalization of global production chains.

Large increases in commodity prices have contributed to the slowdown in global economic activity as terms of trade in importing countries have deteriorated. However, prices have recently decreased, to a large part due to the winding down of speculative positions, as the global economy has been losing strength. In our view, the fall of energy prices from their recent peaks will be supportive to economic growth in the period ahead. However, risks for oil prices are to the upside, as strong demand puts the sustainability of the recent decline into question.

Moreover, the recent escalation of sovereign debt jitters in the euro area is expected to reverse, having a positive impact on investors' confidence and financial markets. As it became evident that Greece could not return to markets in early 2012, as initially envisaged, the need of a new bailout program emerged. Disagreement on the extent of private sector participation has delayed a new rescue package being put in place. Brinkmanship between German policymakers who favored a debt exchange and the ECB that excluded any form of private participation that could be interpreted as default fueled bond holders' fears of an imminent default, causing borrowing costs to soar once again (Figure 3). Nonetheless, a new round of austerity measures is expected to be endorsed by the Greek parliament by end June and a new funding program is expected to be approved by the euro area authorities in early July, thus providing relief to global investors.

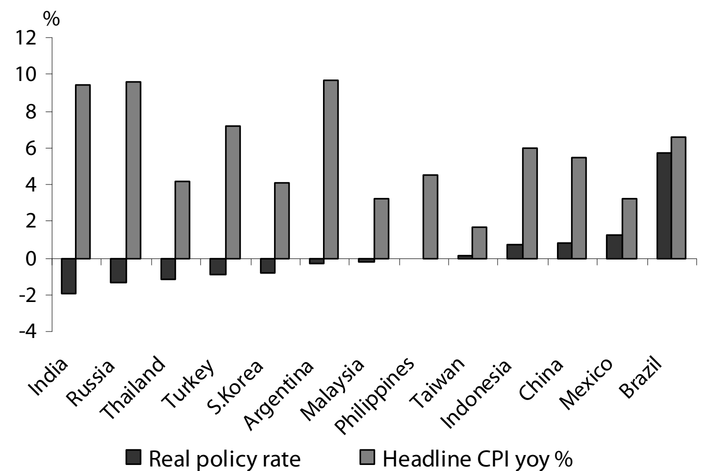
As the effect of the above headwinds fades, we expect the global economy to gain speed in H2. Global demand remains strong, supporting global trade. In addition, the recovery is broadening, with more factors, most notably investment, contributing to growth. This provides evidence of strong fundamentals despite the headwinds. Emerging markets are expected to remain the locomotive of the global economy, whereas growth in several advanced countries will remain modest, due to ongoing deleveraging in the public and private sectors. In the euro area, export oriented countries that do not face debt issues are expected to outperform, with Germany being the growth engine among developed economies.

Figure 3



Source: Bloomberg

Figure 4



Source: Bloomberg

Fiscal imbalances require bold political action

Massive fiscal expansion during the 2008 financial crisis has left developed economies with large debt burdens. Meanwhile, the modest pace of recovery is fueling investors concerns about sovereign debt sustainability. In the euro area, the debt to GDP ratio increased by almost 20 percentage points between 2007 and 2010, while in the US and the UK by 30% and 36%, respectively. Policymakers need to adhere to tight public finances and push trough painful structural reforms to maintain investors' confidence and increase long term potential growth. Whereas EU and UK policymakers have made decisive steps to towards fiscal consolidation, the US has lagged behind.

In the European sovereign crisis, the recent disputes over a new rescue program to Greece dramatize the difficulties in reaching a permanent solution to the issue. Despite disagreement on private investors' participation, the repercussions of a Greek default finally made policymakers realize that they have no other option than to offer Greece a new bailout package. With the willingness of euro area authorities now in place, it lies with the Greek policymakers to adopt the far reaching structural reforms to restore the country's competitiveness and cure the economic imbalances.

In the U.S., concerns about the unsustainable fiscal deficit resulted in a political dispute on spending cuts and the debt ceiling that has to be extended to prevent a government shutdown. The divided US government and the lack of bipartisanship are fueling investors' uncertainty that the government will fail to reign over public finances, while some credit rating agencies have already put US sovereign debt on negative watch. Indeed, implementing effective

consolidation and reform plans in a fragile US economic recovery will probably prove a real challenge for the US authorities. Given the recent softness of US economic data, fiscal consolidation focused on reinforcing medium-term debt sustainability should be gradual, so as not to curb growth prospects. Should the recent deceleration in the US recovery prove to be more persistent than currently projected, the pace of fiscal consolidation should be tailored accordingly. On the monetary front, eventual Fed tightening over the coming year will, in our view, result in a rise in bond yields, increasing the debt servicing burden. At present, there are no funding pressures, as private-sector deleveraging and headwinds to the global economic recovery are supporting demand for Treasuries (safe heaven), keeping bond yields at historical lows. Low bond yields mean that the cost of servicing the debt has remained relatively low despite its rapid expansion. However, as the significant demand from the Fed for US Treasuries disappears with the completion of QE2 and Fed policy takes a turn towards monetary tightening, the risk of a spike in bond yields will become imminent.

Monetary policy: a challenging tightening cycle

Emerging markets have been the first to tighten monetary policy to combat inflationary pressures stemming from shrinking output gaps and large increases in commodity prices. Nonetheless, real policy rates in several developing countries remain low (Figure 4). We view there is scope for further tightening in monetary conditions in those developing countries where growth is robust to prevent the economy from overheating due to domestic demand. In addition, emerging markets are more prone to commodity price changes, given that energy consumption per unit of GDP as well as the food weight in the consumer's basket is higher than in the developed world. Hence, tighter monetary policy seems appropriate to contain inflation expectations. Meanwhile, wider interest rate differentials between developed and emerging economies may cause larger speculative capital inflows to the latter. Although speculative capital flows have receded in 2011, we believe that the fundamentals benefiting a resurgence in capital inflows once risk aversion abates, remain intact. Therefore, while tighter monetary policy seems necessary to control domestic demand and imported inflation, it comes with the risk of fueling asset price bubbles.

In the developed world, rising inflation above the 2% threshold has led the ECB to take pre-emptive action to tame inflationary expectations. The ECB has kicked off a tightening cycle by hiking rates in April, while a second rate increase is expected in July. Cumulatively, we expect the policy rate to rise by 75bps by year end. The ECB has adopted a hawkish monetary stance, despite the ongoing sovereign debt problems and the Fed's accommodative policy. We interpret this as a clear sign that the ECB wants to defend its price stability mandate and its independence. However, the monetary tightening may prove premature, as it combines with fiscal consolidation while the inflation upturn is mainly supply driven. The divergent growth pattern in the euro area complicates matters even more, as higher interest rates do not bode well with sluggish growth in the periphery. Debt service payments for program countries, i.e. Ireland, Portugal and Greece, are tied to the Euribor. In addition, the majority of mortgage loans in countries such as Spain, Portugal and Italy have a floating rate fixation. As a result, higher policy rates place a bigger burden to public finances and the banking sector in vulnerable member countries. Not least, rising euro due to increasing interest rate differentials erodes the competitiveness of the European periphery.

In the US, the Fed seems stuck between sub-par growth and rising price pressures, which make it less likely to move forward to an interest rate hike before the first half of 2012, so as to ensure a sustained period of stronger economic growth and solid job creation. However, the large scale purchases have caused the Fed's balance sheet to expand enormously. Normalizing monetary conditions, while having to deal with the proper reduction of the balance sheet, is most likely to prove a difficult task. In our view, the main challenge the monetary policy makers are facing is to adopt the right exit path so as not to disturb the healing of the economy and communicate it in a clear manner in order to prevent markets from overreacting. In this context, a sharp rise in inflationary pressures, most likely due to a significant increase in commodity prices, may induce a more abrupt than expected progress of the tightening cycle, which could hurt economic growth. The risk of an aggressive rising of the cost of money becomes even more serious, as it would fun investors concerns about the sustainability of the US public finances.

II. Global Economic Outlook

1. The US economy

Dimitris Malliaropulos, Olga Kosma

- Economic growth has weakened significantly in H1 2011, largely due to rising energy prices, weaker global demand growth, bad weather conditions and supply-chain disruptions in the motor vehicle sector from the events in Japan.
- The growth slowdown is catching up with the labor market. The recent softness in consumption may be hitting job creation in the retail sector, while the government sector continues to be a drag on job growth amid large budget shortfalls, in contrast to all previous job recoveries, where the public sector contributed positively to payroll growth.
- However, as the temporary factors weakening economic activity in H1 look set to ease, we look for a rebound in growth in H2, supported by strong corporate profits, a low interest rate environment, easier credit standards, an improving labor market and robust -although slower- growth in emerging markets.
- The Fed seems stuck between sub-par growth and rising price pressures, which make it less likely to move forward to either an interest rate hike or renewed quantitative easing in the near term. We expect the Fed to be in no hurry to raise rates before mid-2012, so as to ensure a sustained period of stronger economic growth and solid job creation.
- On the fiscal front, it is of vital importance to immediately address the debt ceiling and launch a deficit reduction plan, focused on reinforcing medium-term debt sustainability. However, given the recent softness of the US recovery, consolidation and reform plans should be gradual and well-paced, so as not to curb growth prospects.

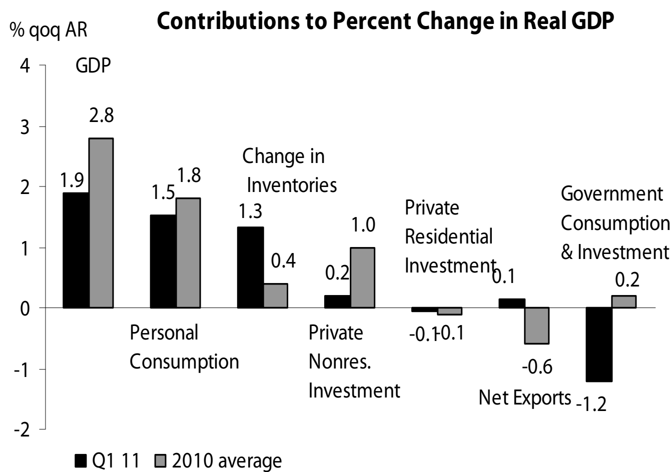
Overview

Recent economic indicators have worsened noticeably since the start of the year to a more subdued pace of recovery, with real GDP growth decelerating significantly to 1.9% q-o-q saar in Q1 2011 from 3.1% in the final quarter of 2010 (Figure 1.1). The increasingly downbeat news about the US economy in recent weeks have caused growth scares, with investors and economists starting to wonder whether a W-dip recession is in the cards, or whether the Fed will move to another round of large-scale asset purchases. Although we do not attach a high probability to a double dip or QE3, there is no denying that the soft landing that began in Q1 is being continued well into Q2. Leading indicators, such as the ISM manufacturing index, as well as hard data, such as consumer spending and industrial production, suggest that activity has indeed softened in the second quarter. The surge in oil prices, bad weather conditions and supply-chain disruptions in the motor vehicle sector from the earthquake and tsunami in Japan have undoubtedly weighed on household consumption and manufacturing production in H1 2011. Meanwhile, the growth slowdown is catching up with the labor market. The recent softness in consumption is probably hitting job creation in the retail sector, while the government sector continues to be a drag on job growth amid large budget shortfalls.

However, the temporary factors weakening economic activity in the first half of the year look set to ease in H2. Gasoline prices have edged lower, which should boost consumer demand in the US and other energy importers, while the Japanese industrial production survey is showing renewed optimism about the outlook for activity over the coming months. Meanwhile, the ISM manufacturing index rose to 55.3 in June from 53.5 in May, indicating expansion in new orders, production, employment and inventories. We therefore expect US GDP growth to recover slowly in the second half of the year to a rate of about 3.0-3.5% q-o-q saar, supported by continuing strength of corporate profits, a low interest rate environment, easier credit standards, a gradually improving labor market and robust -although slower- growth in emerging markets. Overall, we have revised down our 2011 real GDP forecast to 2.5% from 3.2%, due to the weaker start to

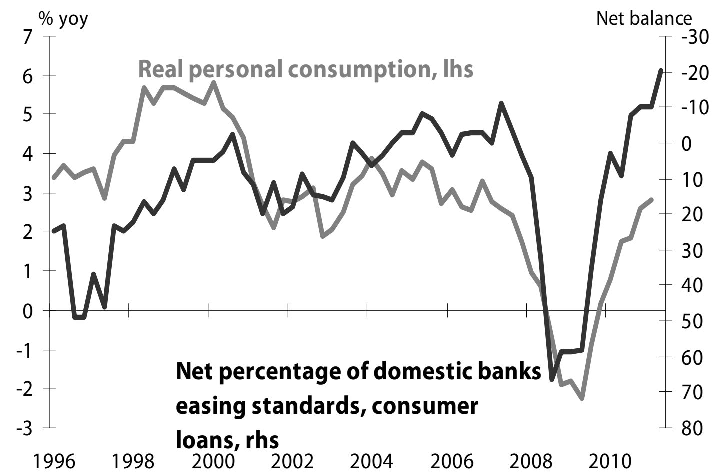
2011, while we continue to expect a 3% average growth in 2012, trimmed by tighter fiscal and a gradually tightening monetary policy.

Figure 1.1



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

Figure 1.2



Source: Federal Reserve, Bureau of Economic Analysis (BEA)

The US recovery is facing a soft patch in H1; growth to rebound in H2

According to the third estimate of the US Bureau of Economic Analysis (BEA) for Q1 2011, real GDP eased to an annualized 1.9% from 3.1% in Q4 2010, after three consecutive quarters of acceleration (Figure 1.1). Real final sales of domestic product -GDP less change in private inventories- grew 0.6% q-o-q saar, showing a sharp slowdown from the 6.7% surge in the previous quarter. The growth slowdown was attributed to a collapse in construction -particularly in the nonresidential sector-, a large drop in government expenditure and investment and slower growth in private consumption expenditures. Although inventory accumulation bounced back in the first quarter of the year, contributing 1.3% to real GDP growth, its rate of increase is still historically low, implying future gains in inventories in the coming quarters.

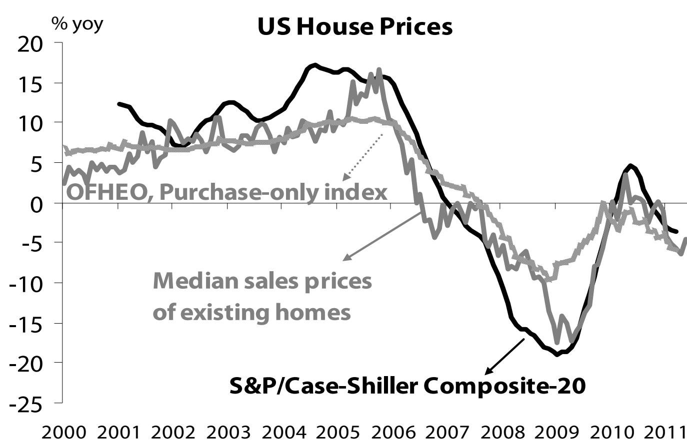
Real personal consumption moderated to a 2.2% q-o-q saar in Q1, after a surge of 4.0% in Q4, due to higher energy prices and a slowdown in the automotive sector as a result of the Japanese disaster on supply chains. Looking ahead, we expect that Q2 personal spending will also be soft, owing to a decline in auto sales and the impact on spending power of higher gasoline prices in an environment of weak income growth and high unemployment. Indeed, the trend in retail sales has softened in April and May, as car sales have decelerated significantly and the rise in core sales (excluding gasoline, auto dealers and building materials) has moderated. Real retail sales declined 0.1% m-o-m, after ten months of consecutive monthly gains. Real car sales are pulling down total retail sales, as motor vehicles and parts dealers fell 0.4% m-o-m, reporting the second monthly decline in a row. Meanwhile, personal consumer spending fell short of expectations in May, as real spending declined by 0.1%, after a downward-revised April reading. In line with the deceleration in the retail sales and real spending trend, the Conference Board's monthly consumer confidence survey dropped further to 58.5 in June from 61.7 in May, reporting its lowest reading since November 2010. The majority of the sharp decline was due to a large decline in the expectations index, falling from 76.7 down to 72.4 in June. According to our estimates, private consumption growth will slow marginally to around 1.5-2.0% q-o-q saar in the second quarter of the year, before accelerating in the remainder of the year towards 2.5-3.0% q-o-q saar, underpinned by gradually rising job growth, easier credit standards (Figure 1.2) and fiscal transfers, including the payroll tax cut.

Real nonresidential investment decelerated to 1.3% q-o-q saar in Q1, from 6.8% in Q4 2010, driven by a plunge in structures by -14.8%, reversing its brief gain of 7.6% in Q4, after nine consecutive quarters of decline since Q1 2008. However, investment in equipment and software accelerated to 8.8% from 7.7% in the previous quarter, led by a surge in transportation equipment. Looking ahead, the April decline in core durable capital goods orders by 2.7% m-o-m -a leading indicator of future shipments- and the decline in core durable capital goods shipments by 1.7%, which feed directly into the investment component of GDP, point at a slower start to nonresidential investment spending in Q2. However, we should take into account the pattern developed over the past several years, where core orders decline at the beginning of

each quarter and then rebound over the last one or two months of the quarter. This pattern showed off in Q1 2010, as core orders fell 4.8% in January, remained unchanged in February and bounced 5.4% in March, contributing to an acceleration in the quarterly growth rate of investment in equipment and software. A similar pattern seems to be emerging this time, as the May durable goods orders report was generally encouraging, with a positive payback of 1.9% m-o-m partly offsetting the April decline. Overall, we expect real non-residential investment to gradually accelerate towards the end of 2011, supported by strong corporate profits and the favorable treatment of capital equipment in the recently passed tax package, with an average close to 7.5% in 2011 from 5.7% in 2010.

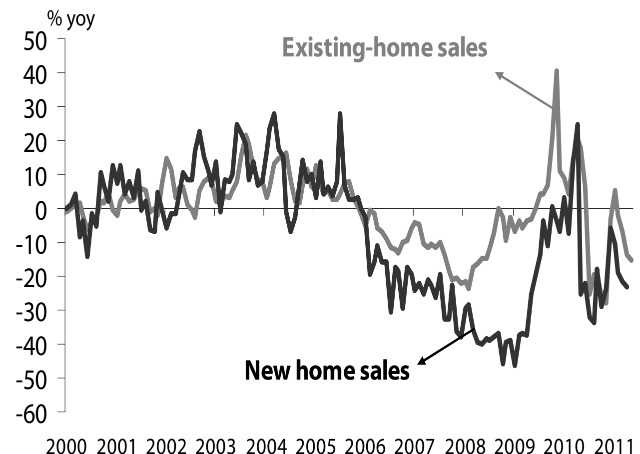
However, real estate investment remains very depressed, declining by 2.0% q-o-q saar in Q1 and partly offsetting its 3.3% increase at the end of 2010. The plethora of homes currently on the market continues to weigh on prices, which have reached a new cyclical low (Figure 1.3). The OFHEO house price index declined by 1% m-o-m on average in Q1, leaving prices down 5.9% y-o-y and at their lowest level since 2003. The gain in house prices from late 2009 through mid-2010 was due to the homebuyer tax credit, so the consequent sharp decline over the past quarters has been a reversal of this trend. Recent monthly gains in home sales are still patchy (Figure 1.4), with their current level well below their recent peak (more than 30% below the 2005 peak). Although the latest monthly readings of home prices for Q2 show some stability, prices are still down about 5-6% on a y-o-y basis, as the significant backlog of houses with delinquent mortgages continues to weigh on residential construction. According to our estimates, the dismal housing market will pick up only gradually towards the end of 2011, falling by about 1.7% on average in 2011 after declining 3% in 2010.

Figure 1.3



Source: FHFA, US Census Bureau, Bloomberg

Figure 1.4



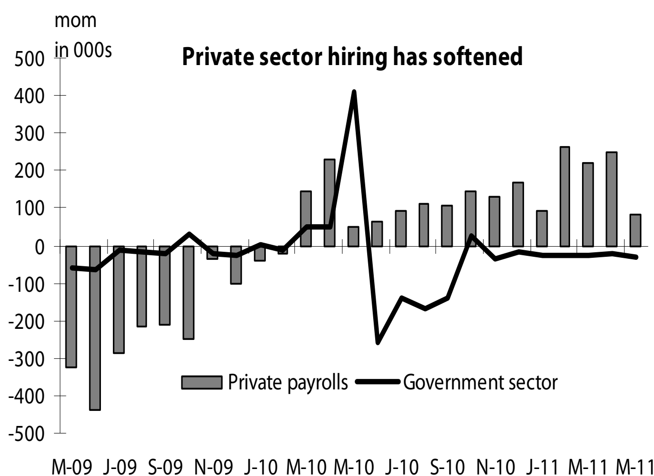
Source: FHFA, US Census Bureau, Bloomberg

Net exports were a minor contributor on real GDP growth in Q1, after adding 3.3% to Q4 growth. Looking ahead, the April trade data suggest that trade will be a positive contributor to Q2 real growth. The US trade deficit narrowed by 6.7% m-o-m to $43.7 bn, from a downward-revised deficit of $46.8 bn in March. We believe that the strong depreciation of the dollar due to the contrast between the Fed's still ultra loose monetary policy and the tightening monetary policy of other central banks -including the ECB- should support exports and act as a drag on imports in the near term. Moreover, nonfuel imports will probably be affected over the next two quarters by supply constraints in the auto sector due to the events in Japan. On balance, we expect a modestly narrower trade deficit and, hence, a small positive contribution from net exports to GDP growth over 2011. Given that global growth remains highly dependent on US consumption, the soft patch of the US economy may affect global demand and, consequently, partly offset the positive contribution from the dollar weakness to US exports. Therefore, income and consumption trends in emerging markets will determine whether US exports will be able to support growth even with a subdued pace of US consumption growth.

The growth slowdown is catching up with the labor market

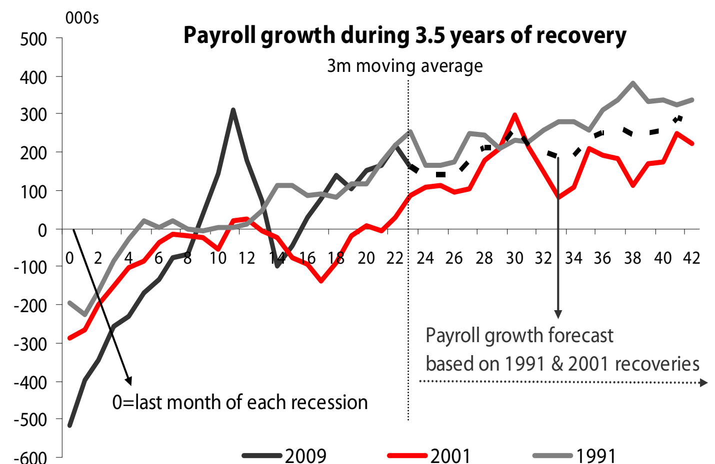
The growth slowdown seems to be catching up with the labor market, with nonfarm payrolls increasing by 54k in May, reporting a sharp plunge from an average monthly gain of 182k between January and April. The government sector continues to be a drag on growth, reporting the seventh drop in a row (-29k). Private sector hiring reported a 83k gain, slowing sharply from an average gain of 206k in the first four months of the year (Figure 1.5). Although the manufacturing sector contributed to the slowing of private payrolls, falling by 5k, the services sector decelerated significantly, increasing by 80k after a bounce of 213k in the previous month. The recent softness in consumption may be hitting job creation in the retail sector, as retail employment reported the sharpest fall (-8.5k), after jumping 64k in April. Meanwhile, the gloomy labor market picture was reinforced by the household employment survey, which reported a rise in the unemployment rate to 9.1% from 9%, as job creation increased less (+105k) than the civilian labor force (+272k).

Figure 1.5



Source: US Bureau of Labor Statistics

Figure 1.6



Source: US Bureau of Labor Statistics , Eurobank EFG estimates

Looking at the average monthly gain in nonfarm payrolls during the first two years of each US recovery since 1950[1], we conclude that there are two regimes concerning the US job market rebounds. The first regime includes the strong labor market recoveries starting in 1954, 1958, 1961, 1970, 1975 and 1982, with an average monthly payroll increase of 180k during the first 23 months of recovery (Table 1.1). The second regime includes the weak labor market recoveries of 1991, 2001 and 2009, with an average monthly increase of 17k, respectively. Decomposing the gain in nonfarm payrolls during prior recoveries into the major sectors, we find that typically during the beginning of a jobs recovery, the manufacturing, retail and construction sectors start hiring the fastest; strong job market recoveries have reported an average payrolls increase of 44k, 23k and 13k, respectively, within two years of recovery. Without the full contribution of the above mentioned sectors in 1991, 2001 and in the current cycle, the labor market recovery is limited. While the retail and manufacturing sectors have been in a better shape in today's recovery compared to the weak jobless recoveries of 1991 and 2001, the current recovery is being limited significantly by the construction sector, which has lost an average of 21k up to now, due to the weak US housing market that remains the Achilles' heel of the economic expansion. Moreover, in contrast to all previous job recoveries, where the government sector contributed positively to payroll growth by an average gain of 20k, today's recovery stands out: state and local governments have continued to cut jobs amid large budget shortfalls, keeping down the pace of total payroll growth.

Previous experience based on the two jobless recoveries of 1991 and 2001 suggest that nonfarm payrolls will be increasing by about 200k per month over the next year and by about 270k in H2 2012 (Figure 1.6). Past experience of the two most recent recoveries which are more close to today's recovery suggests that the monthly gain in payrolls will be translated into a 0.8% reduction in the unemployment rate -to 8.2% from its current level of 9.1%- until mid 2012, and a further

[1] We exclude the 1980 recession from our research, as it was followed by a second recession after one year.

reduction to 7.5% by the end of next year. Although we expect payroll growth to remain relatively weak over the next couple of months given the growth slowdown, payroll gains should be supported in H2 by a rebound in real economic activity. In line with past experience, our job market model suggests that nonfarm payrolls will be increasing by an average of 200k towards the end of 2011, with civilian employment growth increasing to a year average of 1.0% and 2.0% in 2011 and 2012, respectively, from -0.6% in 2010 (Figure 1.7). According to our estimates, substantial employment towards the end of the year and in 2012 will push the unemployment rate down towards 8.3% by year-end 2011 and 7.5% by year-end 2012, driving the year average down to 8.7% in 2011 and 7.8% in 2012 from 9.6% in 2010.

Figure 1.7

Source: Eurobank EFG estimates

Table 1.1: Nonfarm payroll growth during prior US recoveries

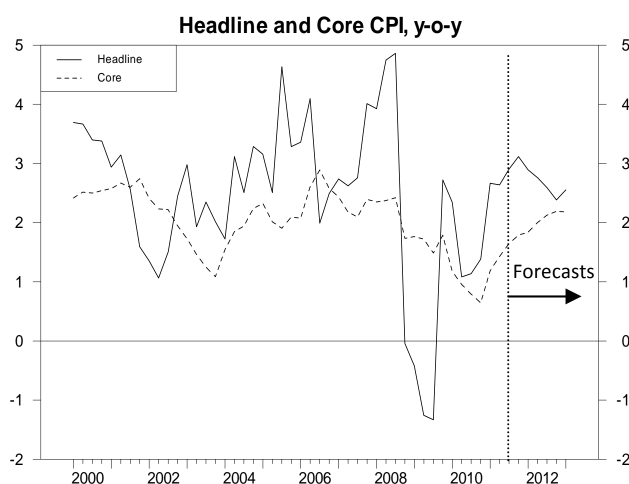
Average monthly change during first 23 months of recovery, 000s						
	Total	**Private**	**Government**	**Construction**	**Retail**	**Manufacturing**
1954	148	129	19	15	12	41
1958	149	121	29	3	16	52
1961	111	85	27	6	8	32
1970	185	152	34	17	29	38
1975	189	175	13	6	28	43
1982	297	285	13	28	45	57
1991	62	44	18	-7	-1	-15
2001	-34	-44	10	0	-8	-65
2009	24	43	-19	-21	0	-1

Sub-par growth and rising price pressures force the Fed to stay on hold

Consumer price inflation has picked up substantially over the past year, with the headline price index rising 3.6% y-o-y in May 2011, up from a growth rate of 2.0% in May 2010. After five months of headline CPI rising 0.4-0.5% per month, the pace of growth decelerated to 0.2% in May 2011. The energy component reversed ten straight months of gains, with the biggest decline reported in gasoline prices (-2.0%). Headline inflation is likely to fall further in the coming months, as the contribution from energy is fading due to the recent decline in oil prices (Figure 1.8). Indeed, the University of Michigan index revealed that one-year inflation expectations declined gradually to 4% in June from a recent peak of 4.6% in April, while the 5y inflation expectations from the respective government benchmark bonds have been on a downward trend, hovering around 1.9% in June from 2.5% in April (Figure 1.9). However, core consumer prices surprised on the upside, reporting the largest monthly gain in five years (+0.3%). Apart from the rental components of the CPI -residential rent and owners' equivalent rent-, which have contributed a large amount to the recent acceleration in core prices, there was more evidence in May of rising vehicles and apparel prices. Some of these sharp gains might be transitory due to the supply chain disruptions originating in Japan, but vehicle and imported apparel prices have been on an upward trend well before the events in Japan. As a result, core CPI inflation has been on a gradual accelerating trend, increasing by 1.5% over the past year, up from a cyclical low of 0.6%. Overall, we expect average headline CPI inflation to increase to 3.2% in 2011 from 1.6% in 2010 and average core CPI inflation to 1.5% in 2011 from 1% in 2010 (Figure 1.8).

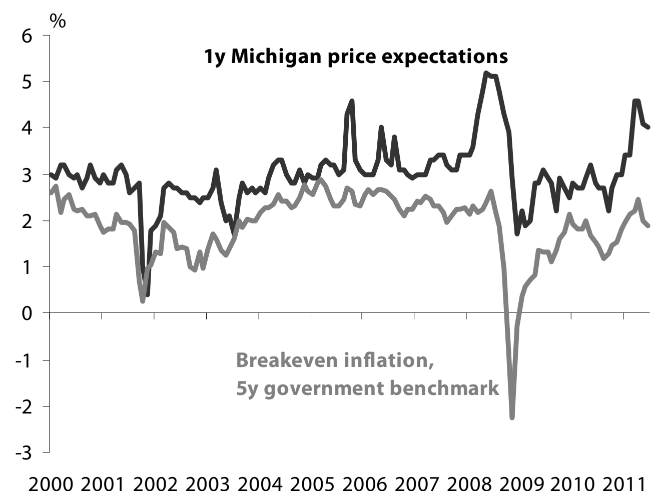
Although core CPI inflation still stands below the Fed's implicit 2% target, its upward trend makes it unlikely that the Fed will launch another round of assets purchases. QE2 launched at the end of 2010 was justified by fears of deflation, so in light of recent inflation developments it would be very difficult to support another round of quantitative easing (so-called QE3), unless there is strong evidence that the recovery is getting off track. The Fed seems stuck between sub-par growth and rising price pressures, which make it less likely to move forward to either an interest rate hike or renewed easing in the near term. We expect the Fed to be in no hurry to raise rates and look for the first rate hike in mid-2012, so as to ensure a sustained period of stronger economic growth and solid job creation. Given that the Fed is keeping close watch on inflation developments, it would have to see a remarkable threat of inflation persistently above its target range to exit sooner than H1 2012.

Figure 1.8



Source: Eurobank EFG estimates

Figure 1.9



Source: Federal Reserve Board, University of Michigan

Fiscal challenges pose a serious risk for the US recovery

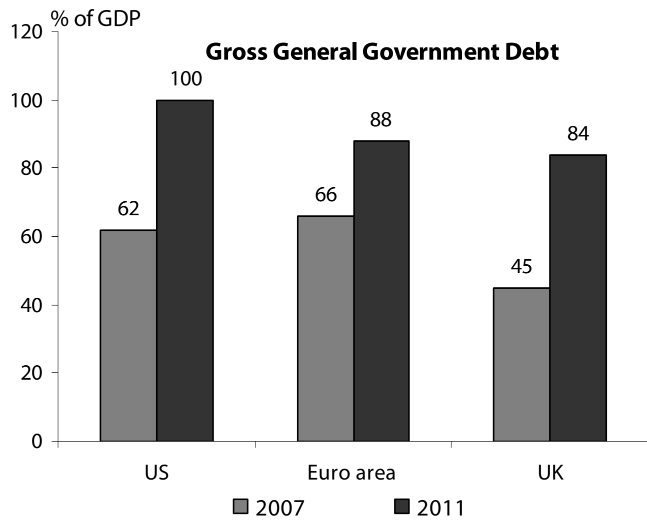
With a general debt-to-GDP ratio expected to rise by about 8% in 2011 (from 92% in 2010 to 100%), and a general government deficit of about 10% of GDP in 2011, the US needs a very large fiscal consolidation program, focused on reinforcing medium-term debt sustainability (Figure 1.10-1.11). Although some of the deficit is cyclical and an economic recovery provides some help for its reduction, most of it is structural and needs to be dealt with fiscal tightening at the state and local level. Furthermore, should the US recovery turn out substantially weaker than currently projected, this may act as a further drag for budget deficit and government debt.

On top of this, the divided US government and the lack of bipartisanship are fueling concerns that the government will fail to reign over public finances. Standard & Poor's downgraded on April 18 the outlook for its AAA rating of US debt from "stable" to "negative", reflecting its doubt about the ability of US policymakers to reach a political compromise on budget consolidation ahead of the presidential election in November 2012. Highlighting the divide in Congress, the Republicans and Democrats reached an agreement for the remaining six months of the FY 2011 budget on April 9, which will run until September 2011, thereby averting a partial government shutdown by just a few hours. The deal extended funding for the government, leaving government spending US$79 bn lower than the original FY2011 budget proposal from the President Obama and US$39 bn for the remainder of the fiscal year. The divide between the two parties will play out again with regards to the extension of the debt ceiling, with Republicans pressing for additional budget cuts (including healthcare benefits). The US federal government reached its debt ceiling of US$14,294 bn on May 16, 2011. According to the Treasury Secretary Timothy Geithner, the usual measures[2] that have been employed in the past to maneuver around the borrowing limit could be employed by August 2. The debt ceiling applies to almost all federal debt, such as marketable issuance, nonmarketable securities (special State & Local Government Securitities-SLGS), debt that the government owes to itself (trust fund obligations for civil service retirement, social security, Medicare etc.), so manipulations of intragovernmental obligations can create additional room to borrow from the market. Although the Treasury continues to urge Congress to avoid the catastrophic economic and market consequences of a default crisis by raising the statutory debt limit, Republicans are demanding upfront spending cuts that match the requested increase in the debt ceiling. We believe that Congress will extend the ceiling before the Treasury runs out of measures to create additional room. Moody's warning (on June 2) for a US government rating downgrade -if political disagreement with the debt limit continues in coming weeks- should put pressure on politicians to show progress in negotiations to raise the debt ceiling. However, the path to a compromise is very foggy at this point, so Congress may reach agreement at the very last minute under the imminent risk of a government shutdown. The risk surrounding the debt ceiling showdown is more about potential auction disruptions and investor uncertainty.

Hence, it is of vital importance for the US to immediately address the debt ceiling and launch a deficit reduction plan. However, given the recent softness of the US recovery, consolidation and reform plans should be gradual, so as not to curb growth prospects. Should the recent deceleration in the US recovery prove to be more persistent than currently expected, the pace of fiscal consolidation should be tailored accordingly. Furthermore, on the monetary side, eventual Fed tightening over the coming year could result in a rise in bond yields, undermining growth prospects and increasing the debt servicing burden. At present, there are no funding pressures, as private-sector deleveraging and headwinds to the global economic recovery are supporting demand for Treasuries, keeping bond yields low. Low bond yields mean that the cost of servicing the debt has remained relatively low despite its rapid expansion. However, as the significant demand from the Fed for US Treasuries disappears with the completion of QE2 and Fed policy takes a turn towards monetary tightening, the risk of a spike in bond yields will become imminent.

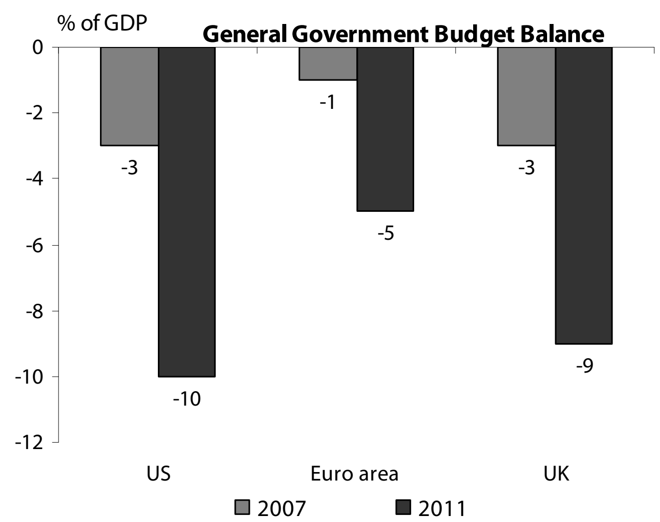
[2] E.g. suspend State & Local Government Securitities (SLGS) issuance, wind down Treasury Supplementary Financing Program (SFP), disinvest all of the G-fund (a money market fund offered to federal government workers), or part of the Civil Service Retirement Fund etc.

Figure 1.10



Source: AMECO, Eurobank EFG estimates

Figure 1.11



Source: AMECO, Eurobank EFG estimates

2. The Euro area economy

Dimitris Malliaropulos, Vasilis Zarkos

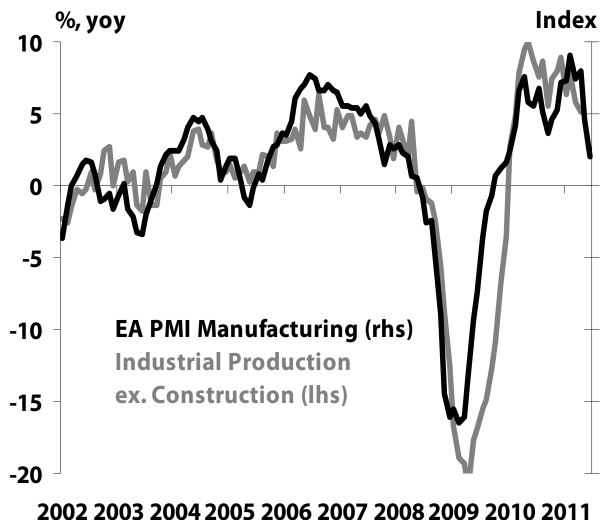
- The euro area economy is expected to hit a soft patch in Q2, mainly due to weakness in global demand. However, headwinds are likely to prove temporary, allowing stronger growth in the second half of the year.
- A larger contribution to growth by domestic demand provides evidence of a broadening recovery. However, the divergence in the growth pattern persists, as weaknesses in the periphery remain severe.
- The sovereign debt crisis will most likely linger for quite some time. Political and social reform fatigue remains the main risk in the European periphery, most notably in Greece.
- The ECB is expected to continue its tightening cycle, despite recent economic weakness and divergent growth. This is likely to keep inflation in check. However risks to the inflation outlook are on the upside. A shift of the ECB to fixed allotment is deferred to at least the end of Q3.

Growth is expected to pick up in H2 after a temporary slowdown

Economic growth in Q1 seems to have reached a local peack, as the economy was boosted by strong domestic demand and one-off factors, mainly inclement weather conditions that had postponed activity at the end of 2010. Indeed, construction capital formation in Germany rose by a remarkable 6.2% (qoq,s.a) in the first quarter, which is among the highest construction growth rates for the country.

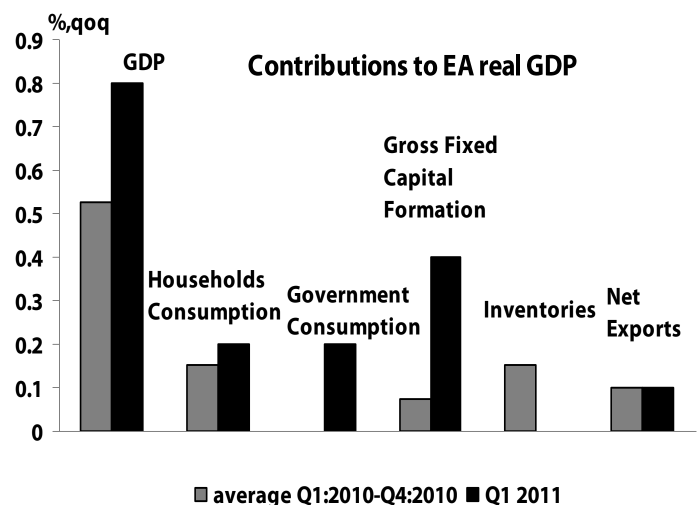
Growth in Q2 is expected to hit a soft patch, as one-off factors have faded and global growth has weakened. Higher commodity prices and tighter monetary conditions have taken their toll on growth dynamics in emerging markets, weighing negatively on euro area exports. Moreover, the Japanese earthquake in March has caused supply disruptions, affecting particular industrial sectors, such as car manufacturers. Supply constraints are expected to linger for a while, thus affecting euro area industrial production. In line with weaker data around the globe, the manufacturing components of the euro zone PMI have declined considerably form recent highs (Figure 2.1), suggesting a more muted economic expansion.

Figure 2.1



Source: Bloomberg

Figure 2.2



Source: Eurostat

However, it is worth noting that leading indicators have receded from very high levels, but they remain on expansionary territory, thus pointing to solid growth in industrial output. Economic expansion in emerging markets remains robust with risks on the upside for the second half of the year, having a positive impact on global trade. In addition, supply constraints in Japan are expected to gradually abate in the period ahead. Not least, sentiment is expected to improve as euro area policymakers have finally agreed on a second bailout package for Greece, removing market fears of an imminent default. Therefore, the downturn in the euro area economy is more likely to prove temporary and thus, unlikely to hurt the robustness of the recovery.

Broadening but divergent recovery

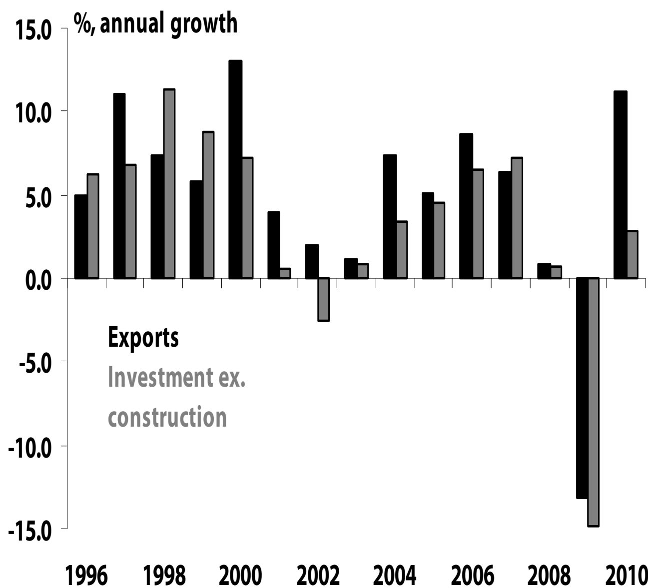
The broadening of the euro area recovery corroborates our view that growth in the region remains on track. While exports on the backdrop of a strong rebound in global demand led the recovery in 2010, Q1 GDP data provide evidence of a more balanced growth pattern in 2011, as consumption and investment pick up, posting more substantial contributions to GDP growth (Figure 2.2). At the country level, Germany remains the locomotive of the euro area economy, growing significantly above consensus estimates. Spain proved resilient despite heavy austerity, whereas Italy marked an anemic rate of growth in Q1 for the third quarter in a row.

The rebound in industrial activity since the end of the recession has translated into higher domestic demand in the euro area, which supports households' consumption and the services sector. As export oriented firms begun hiring on the backdrop of sustainable global demand, unemployment in several core countries has stabilized or entered a declining path, supporting higher households' expenditures. Brighter economic prospects have bolstered consumers' confidence. This is particularly evident in Germany, whose outstanding performance in exports has led the unemployment to fall to a record low, leading to higher net wages and triggering a decline in households' savings ratio. However, fiscal consolidation, ongoing deleveraging, tight credit conditions and higher expenses on food and energy are expected to restrain personal consumption growth, thus confining the euro area economy to a moderate overall growth.

Non-construction investment is expected to contribute substantially to 2011 GDP. Figure 2.3 shows that despite a large rebound in exports in 2010, capital expenditures posted a very muted pick-up. It is typical for investment to lag during the first phase of the recovery as capacity utilization remains low and economic uncertainty prevents firms from spending on equipment. As the recovery progresses, we expect investment to accelerate. The euro area capacity utilization ratio has reached its long term average level, implying a rising need for new capital input. This is in line with recent surveys revealing that an increasing number of manufacturers report capital shortage as a factor constraining production. Low interest rates are expected to favor investment plans. Indeed, according to the latest ECB's bank lending survey, there is increasing demand for loans from non-financial corporations, with fixed investment purposes contributing positively to the demand for the first time since the last quarter of 2007, i.e. the onset of the crisis.

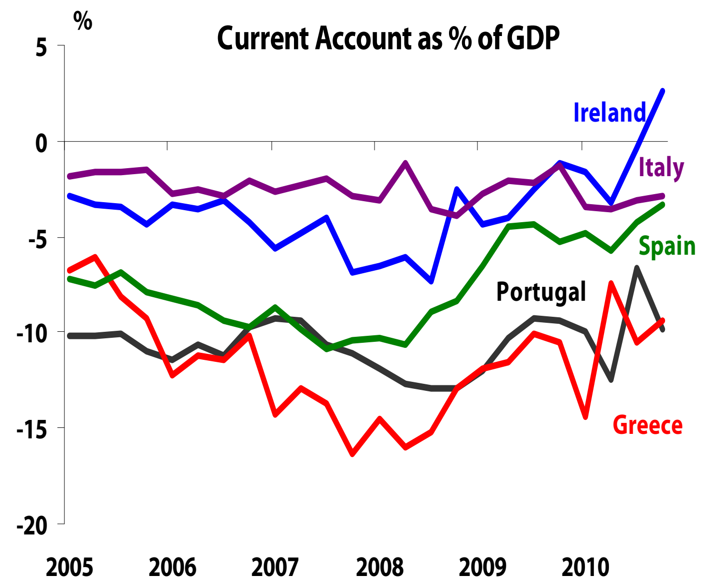
Despite the ongoing recovery, the euro area economy remains divergent, as strict frontloaded fiscal consolidation programs weigh heavily on growth prospects. As a result, domestic demand has dampened and unemployment has risen substantially in all periphery members. Consumption will most likely take long to pick up in these countries, as unemployment may rise even higher while more austerity is needed to put public finances on a sustainable path. For the time being, external trade is their main source of growth. As the current account position of periphery members suggests (Figure 2.4), solid global demand is expected to boost export oriented countries' growth (i.e. Ireland) and help them heal their imbalances faster than members suffering from low competitiveness (i.e. Greece and Portugal), which need to make more strenuous efforts to regain investors' confidence and return to growth.

Figure 2.3



Source: Eurostat

Figure 2.4



Source: Ecowin

Sovereign debt crisis: reform fatigue is the main risk.

Greece failed to deliver substantial improvement in its public finances in the first half of 2011 due to a revenue shortfall and stalling structural reforms. As a result, sovereign debt jitters intensified and borrowing costs for the country have climbed to prohibitive levels. Therefore Greece cannot return to markets for funding in early 2012, as previously envisaged, and the country needs an expansion of the initial program to cover its debt roll over needs in the years ahead. However, resistance to further fiscal sharing from the core euro area members has fanned investors concerns about the euro area sovereign debt crisis, evident in periphery spreads that widened further. Private participation to financial assistance has been in the center of the disagreement among the euro area authorities on how to deal with the Greek issue. Politicians claim that private bond holders should participate in losses in order to gain voters' and parliaments' approval for additional help to Greece. On the other hand, the ECB has kept a very strict stance on this issue, fearing that private losses could trigger a credit event that could throw the euro area financial sector in renewed turmoil and trigger contagion to other weak periphery members. To step up pressure on politicians to agree on a new rescue program for Greece, the ECB threatened that it would not accept default rated bonds as collateral in its liquidity provision operations.

Under the pressures of the dramatic repercussions of a likely Greek default, policymakers have realized that they have no other option than to offer Greece a new bailout package. The second funding program for Greece will be financed through both governments and private debt holders. Germany backed away from their debt exchange proposal and private participation was agreed to be clearly on a voluntary basis. Hence, roll over of existing Greek debt would not be interpreted as a selective default for Greece. Given the political agreement, technicalities about how to avoid a downgrade of Greek bond securities by the rating agencies to default status should not be a problem. The new package will likely be of similar magnitude to the first one, around €120bn, and cover Greece's financing needs for the next three years. The €50bn privatization program is part of the new bailout program.

The new rescue package can only address the liquidity problem of Greece. The sustainability of its debt dynamics remains challenging and heavily dependent on how successful the country will be in pushing through the far reaching structural reforms to restore the country's competitiveness and cure the economic imbalances. With the European willingness to help in place, the remaining risk in our view is the political and social reform fatigue in Greece.

We believe that now is the time for Greece to take advantage of the EU/IMF assistance and restore its economic imbalances. The Great Recession has left several countries, most notably in the developed world, with stressed public finances due to unprecedented fiscal support. This has increased bond investor's sensitivity to budget imbalances, as is evident by the negative outlook of the United States debt itself. If sovereign debt tensions escalate in the United States, borrowing costs for core euro area members will likely rise, in which case it would be more difficult for euro area members to provide Greece with financial help.

Beyond 2014, we think that there will be very small incentives for hard restructuring from the part of Greece. According to our calculations, by 2014, about 35% of Greek debt will be in EU/IMF hands. In addition around 27% is held by the ECB and other central banks. Taking also into account that about €90bn are held domestically, it leaves about 20% of the outstanding Greek debt in 2014 held by private foreign investors. Therefore, even a large haircut would have a small diminishing impact on the debt. On the contrary, losses from investors' confidence erosion would outweigh any resulting benefits. Instead of market based solutions that entail hard restructuring, we believe that the sustainability of the Greek debt will be meaningfully improved if official EU bond holders agree on a simultaneous maturity extension and a decline in the debt servicing interest rate.

Greek tensions have caused spreads of vulnerable members to widen, most notably Portugal and Ireland. A €78bn adjustment program approved by the EU-IMF buys Portugal time to perform structural reforms in order to enhance its low competitiveness and bring its budget deficit down to -3% of GDP by 2013. However, reforms remain challenging and the elevated spreads reveal markets' concerns about the country's solvency. As an open economy, Ireland has benefited from strong global demand. The stress tests revealed that the banking sector needs additional €24bn for recapitalization purposes, which was in line with market expectations, fully covered by the ear-marked €35bn for bank capitalization of the Irish program. However, creditors have a keen eye on the country due to the potential impact of weak real estate sector, high unemployment and sluggish growth on the country's banking sector. Spain has decoupled from the rest of the periphery, as spreads have remained broadly in check, while the economy has stabilized despite the austerity measures. However, the recent increase in Spanish spreads suggests that the country remains prone to contagion, therefore it should adhere to its reform efforts to grow its way out of the debt crisis. The final cost of the banking sector restructuring remains a source of concern. The Bank of Spain estimates of additional €15bn for banks recapitalization may not prove enough. The residential sector remains a source of vulnerability for the banking sector, as home prices continue to decline. Not least, the size of the economy and its implications on the amount of help if need be, is in itself a destabilizing factor. Italy has been the most shielded country so far, but pressure may rise if the country fails to deliver soon structural changes to increase the country's competitiveness and reduce its debt to GDP ratio, currently at 119%, second only to the Greek debt ratio in the euro zone. Overall, debt sovereign concerns will most likely linger in the euro zone for quite some time. While a default is unlikely, sovereign jitters will likely remain a recurring theme, eroding confidence and constraining the speed of the recovery.

Looking forward, the sovereign crisis has presented the euro area with an opportunity to remedy shortfalls and make decisive steps towards a fiscal union. We view that the institutional framework set forth in the March summit will contribute to prevent the formation of future imbalances and protect the euro from systemic threats The Euro Plus Pact aims at covering the gap of macroeconomic convergence, by attempting to address low competitiveness and growth imbalances among euro area members. The Excessive Imbalance Procedure targets the shortcoming of discipline and surveillance. The ESM is expected to serve as a backstop to fiscal tensions and support investors' confidence. The disagreement among authorities on how to deal with the Greek issue reveals the difficulties country members face in their

efforts to enhance the euro area economic governance However, joint responsibility is to the interest of all members of the euro area.

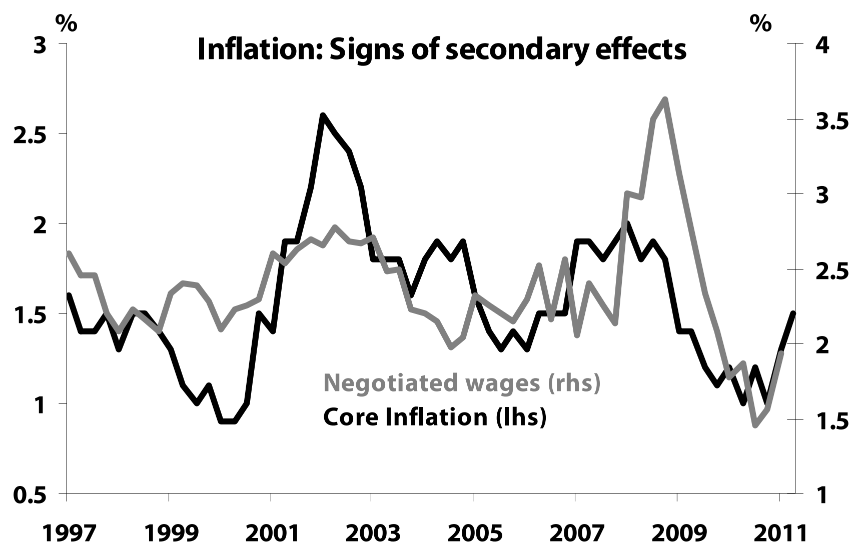
Inflationary pressures in check but risks remain on the upside

Headline inflation has risen substantially in 2011 on the backdrop of rising commodity prices, reaching 2.8% in April, before edging lower to 2.7%, mainly due to the recent decline in oil prices. Inflationary pressures are expected to be contained, as the ECB has embarked on pre-emptive monetary tightening action in order to anchor prices growth close to its comfort level of 2%. On the backdrop of tighter monetary policy, consumer expectations about prices started declining, though from very high levels. We forecast average headline inflation of 2.6% in 2011, while it is expected to recede to about 1.8% in 2012, mainly due to favorable base effects from energy prices.

The recent decline in commodity prices is supportive to our euro zone growth outlook. However, demand for commodities remains high due to robust global growth, while unrest in the MENA region is lingering and it could take a turn for the worse at any time. Moreover, Libya oil suppliers are expected to remain out of the market for long, while there is uncertainty as to whether other oil producing countries will ramp up their production to reduce energy costs. The recent OPEC meeting failed to reach a consensus on increasing oil supply. Furthermore, food prices are likely to remain on an upward trend due to the drought in Europe. Therefore, risks for inflation remain on the upside, with serious repercussions on households' purchasing power and firms' competitiveness, particularly those in debt laden periphery members.

Signs of second round effects have emerged as euro area core inflation jumped to 1.6% in April from 1% in February, before slipping lower by 0.1% in May. However, the remaining economic slack is expected to keep core inflation pressures contained. While negotiated wages (Figure 2.5) have started increasing as labor unions push for higher compensation, unemployment remains high and is expected to recede at a very slow pace. In addition, modest improvements in households' consumption is likely to depress firms' ability to pass through higher input prices to final consumers.

Figure 2.5



Source: Ecowin

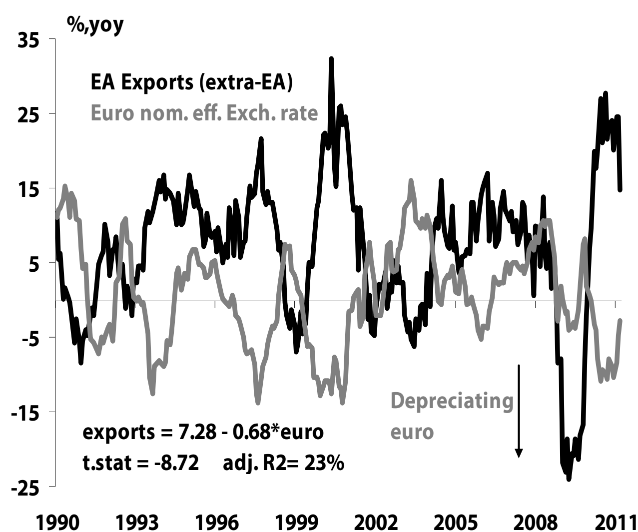
The ECB will continue its monetary tightening cycle.

Despite recent signs of weakness, the ECB has signaled another interest rate hike in July, raising the key policy rate by 25bps to 1.5%. The ECB points to upside risks for inflation and to a self sustained recovery to justify its hawkish stance. This is in line with an upward revision of the ECB's staff projection of the 2011 GDP (mid value from 1.7% annual growth in March to 1.9% in June) and 2011 headline inflation (from 2.3% in March to 2.6% in June). In our view, the ECB is determined to defend its independence and its adherence to the price stability mandate. It also makes it clear that the ECB has done its part in facing the debt crisis and it now lies with the governments to work out a permanent solution to the fiscal problem. Beyond July, we expect another rate hike by year end, provided that the current slow down of the euro area recovery proves temporary.

As we have argued before, the ECB faces the 'one size fits all problem' once again. The current low level of policy rates does not look appropriate for Germany's outstanding performance. At the same time, the euro area periphery needs accommodative policy to breathe. Higher rates in the euro zone coupled with strong headwinds to the US economy, have led to euro appreciation that could constrain euro area exports (Figure 2.6). The strong euro also affects adversely periphery members' efforts to improve their competitiveness and rebalance their growth towards external demand. In addition, higher rates place a heavier burden on borrowers in several countries, such as Spain, Italy and Ireland, where the majority of mortgage loans are floating rate indexed to the Euribor. Therefore, higher rates create a mix of tight monetary and fiscal policy which is unfavorable to growth in debt laden countries.

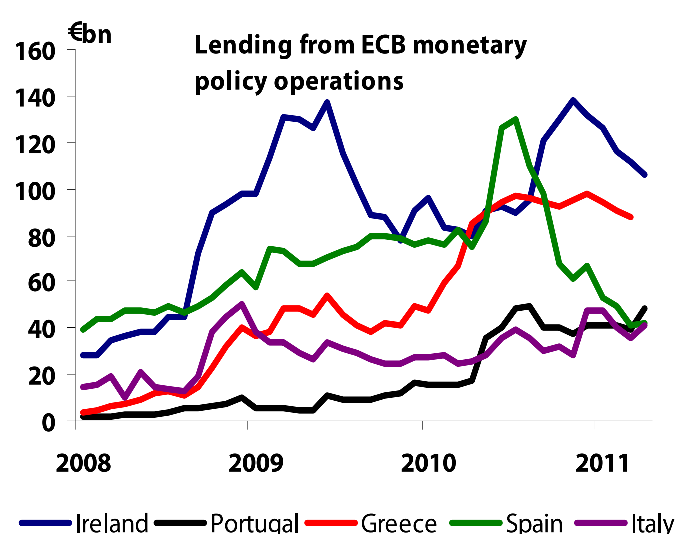
In line with its separation rule, the ECB has announced that it will keep providing liquidity at full allotment at least until October 2011. The ECB has put off the normalization of the liquidity provision procedure by one more quarter, as the banking sectors in several countries remain heavily dependent on ECB for liquidity due to sovereign tensions (Figure 2.7). Although the Spanish banks have been successful in raising funds at the money markets, we think ample liquidity provision from the ECB would support the ongoing banking recapitalization process. Shift to fixed allotment could materialize at the end of the year, provided that money market conditions keep improving. However, unlimited liquidity provision to addicted banks in program countries may continue.

Figure 2.6



Source: Ecowin

Figure 2.7



Source: National Central Banks

3. The Japanese economy

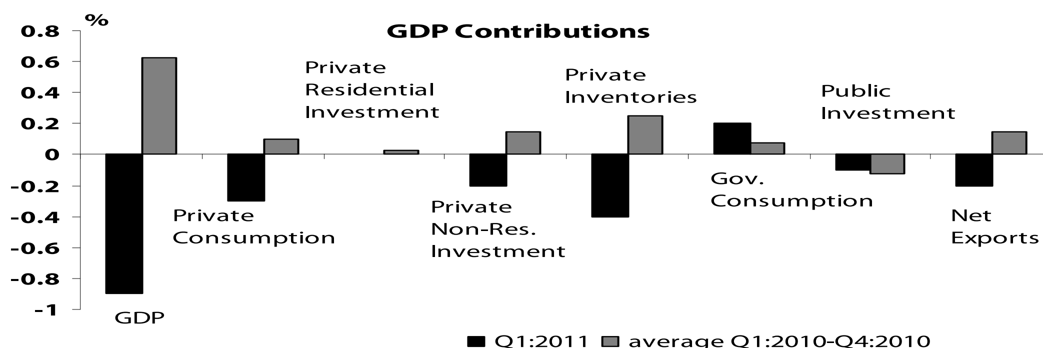
Dimitris Malliaropulos, Vasilis Zarkos

- A sharp rebound of the Japanese economy in the second half of 2011 is expected to follow the deep contraction due to the earthquake. A pick up in exports and reconstruction are expected to be the main sources of growth.
- Near term risks to our outlook stem mainly from prolonged power outages and slower global growth. In the longer term, potential GDP in Japan may decline as the earthquake may permanently reduce production.
- No further easing by the Bank of Japan is expected, unless headwinds to the recovery persist. The policy rate is expected to remain unchanged throughout 2011.

The Japanese economy slumped in the first half of the year as the massive March 11 earthquake triggered the worst post war disaster in Japan. Industrial production collapsed due to destructed plants and broken supply chains, causing exports to shrink considerably. In addition, inventories contracted sharply due to production suspension. The earthquake shock and concerns about the subsequent nuclear crisis have eroded consumer sentiment, leading to a decline in households' expenditures. As a result, the economy shrunk by 0.9% quarter on quarter in Q1 (Figure 3.1), following a contraction in the last quarter of 2010 (-0.7% qoq, s.a.), mainly due to the winding down of fiscal stimulus.

The economy is expected to contract for the third quarter in a raw in Q2, mainly due to a severe decline in activity in April. However, a series of soft data suggest that economic activity has likely hit bottom in April and sentiment among consumers and firms is now improving (Figure 3.2). The PMI manufacturing index returned to expansionary territory in May, after a free fall the previous two months. The Reuters Tankan diffusion index for manufacturers improved in June for the second consecutive month, in line with the positive outlook for manufacturers of the Bank of Japan Tankan survey. In a similar trend, the Economy Watchers survey reveals that expectations are climbing higher, suggesting an improvement in consumer confidence. According to the ministry of industry, about 90% of production bases are expected to be restored by the end of summer, allowing normalization in the production. Available hard data also corroborate a fast stabilization after the earthquake shock. Vehicle production seems to have troughed in April, while industrial production seems to have entered a firm recovery path, according to consensus. Following a sharp decline in March, industrial production rose sluggishly on a monthly basis in April, while it jumped by 5.7% in May. According to a Ministry of Economy Trade and Industry (METI) survey of firms, industrial production is forecasted to increase by 5.3% and 0.5% mom in June and July, respectively. The low figure for July is attributed to the imposition of power constraints from 1 July.

Figure 3.1

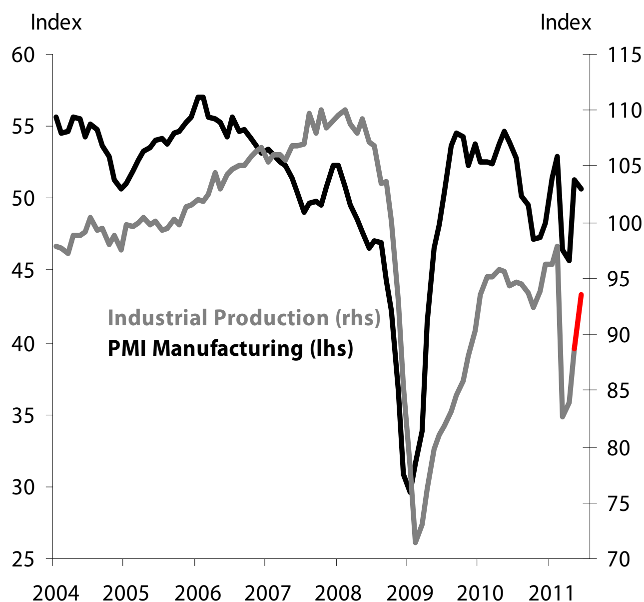


Source: Cabinet Office

As it is usual with disturbances caused by natural disasters, we expect a dramatic decline in economic activity to be followed by a sharp rebound, most likely in the second half of the year, led by a resurgence in exports and reconstruction expenditures. Despite a soft patch in the global economy, firm global growth remains supportive to Japanese exports, as was the case before the earthquake struck. Fast liquidation of inventories in Q1 provides evidence that demand remains solid. Therefore exports are likely to rebound, as supply side constraints from power outages and supply chain disruptions abate. Public spending to repair infrastructure is expected to rise substantially and extend into 2012. Companies also need to repair damages, therefore they are expected to increase expenditures on investment. Capital spending has lagged the recovery, hence firms are likely to launch investment plans, as downward production pressures abate. The June 2011 Tankan survey revealed that firms' investment plans for fiscal year 2011 have increased to 4.2% yoy from 0.4% in March.

Despite signs of reversal in consumer confidence, household consumption is likely to remain subdued, as risks are to the downside. The nuclear crisis situation remains severe, implying that consumer sentiment will improve at a rather gradual pace. Unfavorable labor market conditions are also expected to constrain personal expenditures. Unemployment inched lower to 4.5% in May (Figure 3.3), but risks are to the upside as the disaster affected areas are not included in the recent statistics. Labor cash earnings have dropped after the earthquake, eroding disposable income. Higher food and energy prices have a similar effect on households' purchasing power. In the longer term, we expect consumption to pick up, as employment conditions are likely to improve on the backdrop of rebuilding activity. However, households may refrain from increasing consumption substantially due to likely higher taxes to finance public reconstruction investment.

Figure 3.2



Source: Bloomberg, METI forecasts

Figure 3.3

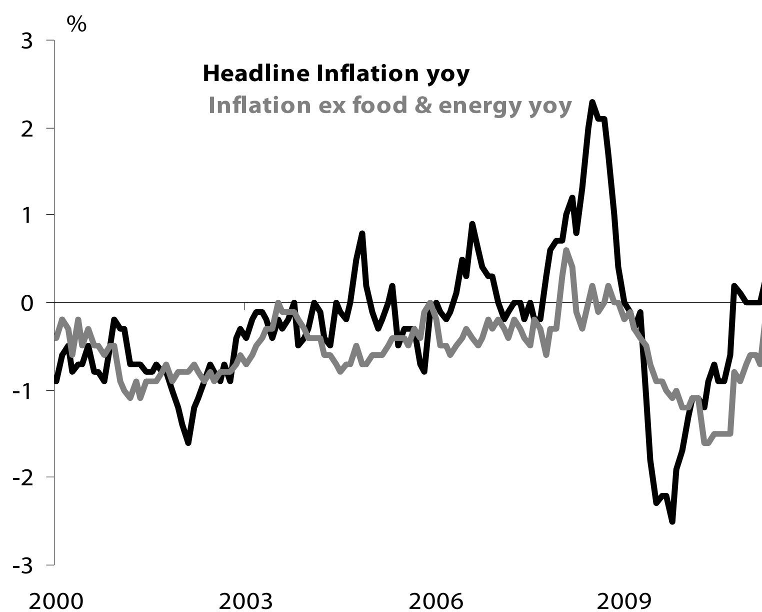
Source: Bloomberg

Risks to our economic outlook for Japan are to the downside. While we expect a temporary soft patch in the global economy, persistent pressures in commodity prices may lead to a prolonged slowdown in global demand, affecting adversely Japanese exports and companies' investment plans. Moreover, power shortages may increase in scale during the summer, thus obstructing the recovery in industrial production. Risks also stem from growing popular reluctance to restart nuclear plants which are shut down for inspection purposes (representing about 30% of Japan's total power generation, according to METI). Not least, the radiation crisis is severe and its full impact remains undetermined.

In the longer term, several risks rise for potential GDP growth. First, risks stem from permanent effects from supply chain disruptions. Japanese companies may permanently lose clients, mainly from overseas, who have substituted goods from competitors for Japanese goods. Second, firms may decide to shift production to overseas instead of rebuilding damaged factories in Japan, so as to avoid high corporate taxes in Japan. Third, a shift away from nuclear power towards conventional sources of energy may render the Japanese economy more vulnerable to oil supply shocks and deteriorate its trade balance. Fourth, longer term risk stems from public finances, which are expected to be adversely affected by government expenditures due to reconstruction. The government has estimated that the damage could rise to ¥25tn. A supplementary budget of ¥4tn has been approved, while more funds are expected to come. As gross debt has surpassed 200% of GDP, normalizing public finances, becomes an even more challenging task, amidst increasing sovereign bond vigilance and severe demographic pressures. On the negative side for the government debt, the ability of the private sector to finance budget deficits is likely to decline in the near term, as part of savings is expected to be used for rebuilding purposes.

Inflation excluding fresh food (core) jumped to 0.6% in April, entering positive territory for the first time in the last 28 months. This was in large part due to the fact that tuition fee elimination, effective from April 2010 to March 2011, came full circle. Upside risk to inflation stems from elevated commodity prices. In addition, increasing demand for reconstruction goods is likely to push prices up. Overall, we expect average core inflation to turn out slightly positive this year, at about 0.4%. Of particular importance is core CPI rebasing set to take place in August. Markets envisage an impact of about -0.5% that would throw average core CPI to deflationary territory.

Figure 3.4



Source: Bloomberg

In its last meeting, the Bank of Japan left its overnight uncollateralized call rate at 0.1%, while it mentioned signs of recovery on the supply side in its economic assessment. The BoJ kept its asset purchase program at ¥10tn. As of early June, it has used about 53% of this program. In our view, further easing by the BoJ is unlikely, unless risks to the production side materialize or the external environment turns less favorable. The policy rate is expected to remain unchanged at least in the next 12 months.

4. Emerging Markets

Dimitris Malliaropulos, Maria Prandeka

- The major challenge to the emerging markets' growth outlook stems from inflationary pressures, due to rising food and commodity prices.
- We expect economic activity in emerging economies to slow gradually, mainly due to monetary tightening.
- In Emerging Asia economic activity has already started to cool down mainly in response to the gradual withdrawal of fiscal policy stimulus and tightening of monetary policy.
- The most important source of concern for Latin America is the potential of a slump in commodity prices and a sharper than anticipated landing in Asian economic activity.
- Emerging Europe's main challenge is the probability that the impact of fiscal austerity measures on Euro area's periphery real economic activity will feed through to core European countries, particularly Germany -its main trading partner.

In most emerging economies recent indicators point to a moderation in the pace of expansion, on the back of monetary tightening and high commodity prices that undermined income and profits. However their economic performance will remain robust and they are expected to remain the leaders of global growth, growing substantially faster than advanced economies over the next few years. According to the latest IMF forecasts[3], in 2011, growth in emerging and developing economies is expected to moderate to a still buoyant growth rate of 6.6%, significantly higher than the expected growth rate of 2.2% in advanced economies. Indeed, EM economies have increased significantly their share in global GDP since 2000 (from 37% to 48%) and they are expected to surpass advanced economies over the next five years, becoming gradually the major engine of the world economy. It is worth noting that advanced economies' share in global GDP has declined through time (52% in 2010 versus 63% in 2000).

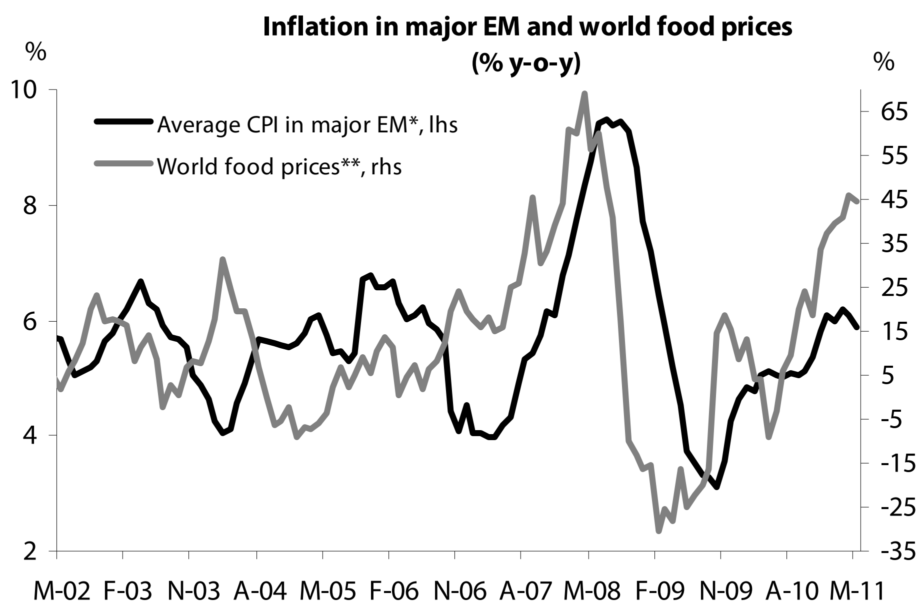
We continue to believe that the major risk to the EMs' growth outlook is inflationary pressures, stemming mainly from rising commodity prices and particularly food prices that have a large weight in the consumer price baskets across the emergers. Since 2009, average headline inflation across major EM economies has risen from 4.5% to 5.1% in 2010, while over the five months of 2011 it has picked further to an average of 6.1% y-o-y (Figure 4.1). Notwithstanding the recent drop in food prices from their peak in April, and even if food prices not reaccelerate in the coming months, we expect inflation in EMs to remain elevated over the course of the year, given that a price shock to international food prices feeds into local consumer prices with a time lag of around six months (Figure 4.1). Thereafter, we expect base effects to start pushing inflation lower. Looking ahead, we believe that food price risks are skewed towards the upside, since the same factors that pushed food prices to multi-year highs recently are expected to shape price dynamics both in the short and in the long term. Low inventories in combination with tight supply/demand balance imply that world food prices will remain high and volatile. Unfavorable weather conditions, as for example the recent drought in China and Europe, have been a key driver of recent upswings in food prices. Indeed, the majority of the scientific community agrees that climate change will increase the frequency of extreme weather events, suggesting upside risks for food prices. In addition, increasing geopolitical events is a growing source of upside risks for both food and energy prices. On top of that, elevated energy prices are pushing food prices higher, either through increases in input costs or by driving up demand for bio-fuels. Furthermore, expanding income and population growth and structural changes in consumption patterns in developing countries (e.g. rising incomes boost meat and dairy consumption) suggest increasing demand for agricultural products and, therefore, elevated global food prices in the long term.

[3] *IMF, World Economic Outlook Update, June 2011*

A significant challenge for EM economies, such as China, that rely mainly on exports, while private consumption comprises only a small fraction of GDP, is a worse-than-anticipated moderation of economic activity in advanced economies. Nevertheless, according to our main scenario this risk is contained, given that advanced economies are expected to rekindle their growth path in H2. Commodity producers, such as Brazil, are more vulnerable to a sudden decline in commodity prices. On the monetary policy front, EMs' central banks continue to tighten monetary policy in order to fight mounting inflationary pressures and prevent their economies from overheating, since output gaps have narrowed or even closed in some cases. However, in some countries central banks have been slow to hike policy rates due to concerns that higher rates will attract more capital inflows, generating further currency appreciation pressures and feeding credit and asset bubbles at a time when inflation and overheating constitute major concerns. Should inflation get out of control in the abovementioned countries, authorities may be forced to proceed with aggressive tightening, posing downside risks to growth. Generally, elevated headline inflation along with tight output gaps suggest that monetary tightening will continue in large part of emerging markets. Meanwhile, nominal exchange rate appreciation in EM coupled with high inflation rates has resulted in an appreciation of exchange rates in real effective terms in most counties (Figure 4.2). As a result, EMs are worried about loss of competitiveness and, consequently, a moderation in exports. Indeed, our BRICs leading indicator points to easing exports growth ahead (Figure 4.3).

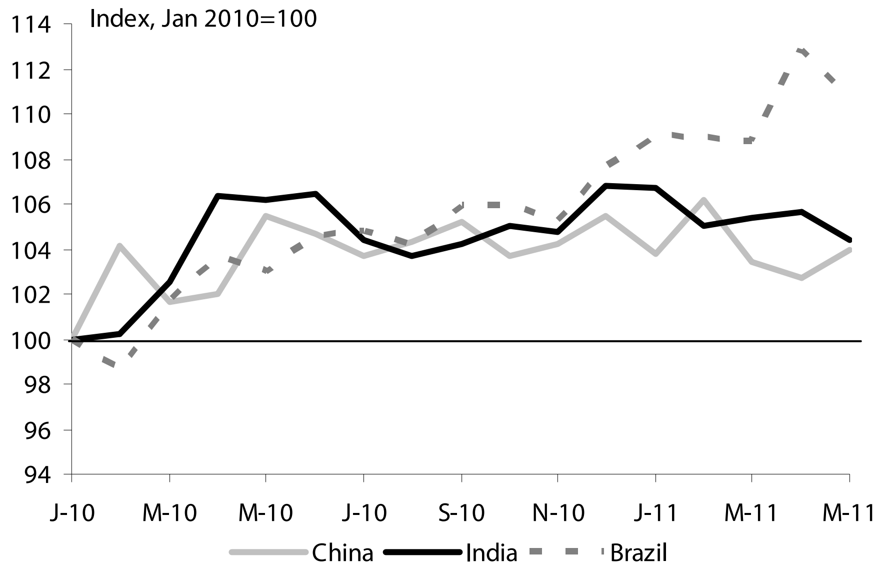
As far as particular EM regions are concerned, in Emerging Asia economic activity has started to cool down mainly in response to the gradual withdrawal of fiscal policy stimulus and tightening of monetary policy. In Latin America, elevated commodity prices will continue to contribute positively to the region's growth. Emerging Europe's main challenge is the probability that the impact of fiscal austerity measures on Euro area's periphery real economic activity will feed through to core European countries, particularly Germany -its main trading partner.

Figure 4.1



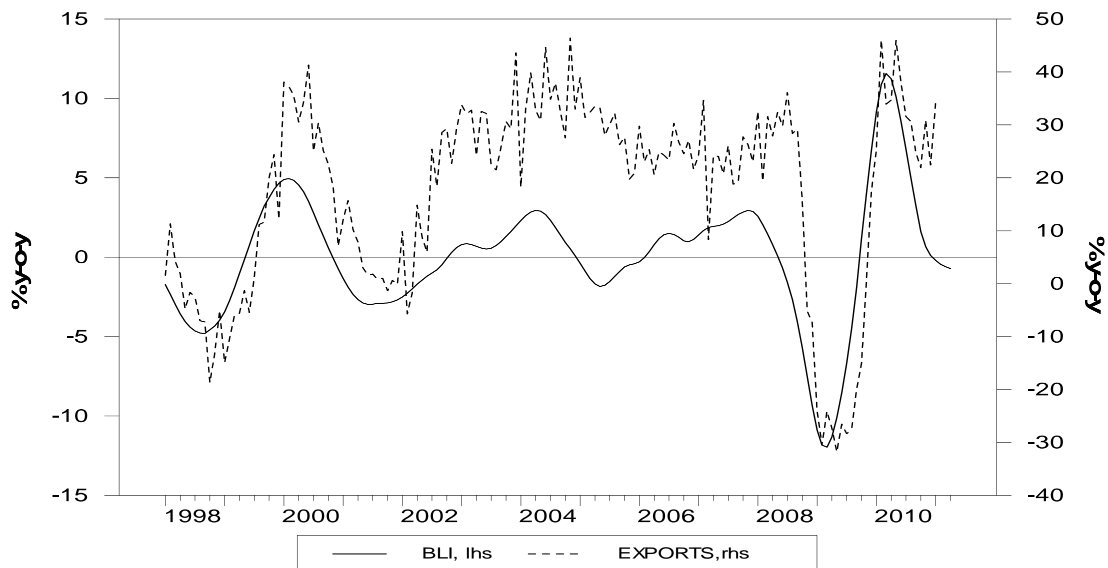
** Brazil, Chile, China, India, Indonesia, Philippines, Russia, Singapore*
*** The Economist Food Price Index*
Source: Ecowin

Figure 4.2
Real Effective Exchange Rate



Source: Ecowin, BIS

Figure 4.3
BRICs Leading Indicator*



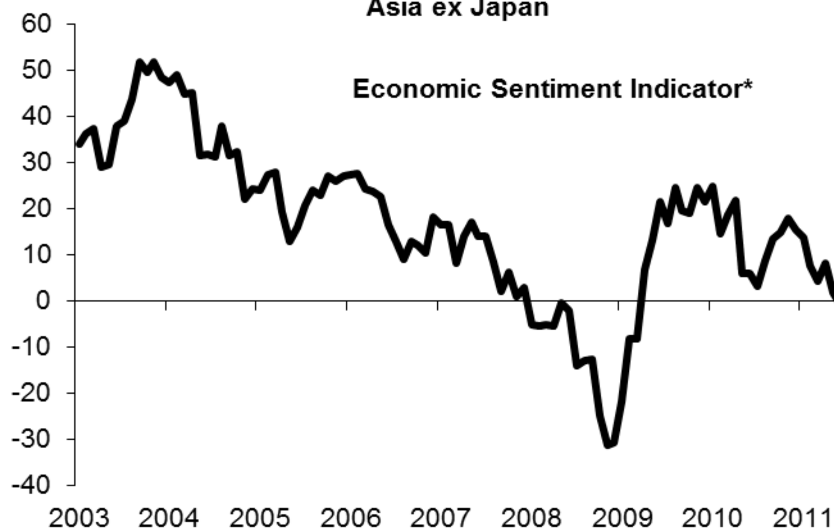
** 3 month forward*
Source: Eurobank EFG

Emerging Asia

After having bounced back from the global downturn much more strongly than others, emerging Asian economies' economic activity has started to cool down mainly in response to the gradual withdrawal of policy stimulus and policy tightening measures. Leading indicators confirm the moderation of output growth across the region, with the Asia ex

Japan economic sentiment indicator slipping to a negative territory for the first time since 2009 (Figure 4.4). However, real GDP growth is expanding at or above pre-crisis levels, on the back of robust exports, resilient investment and strong domestic consumption. Japan's earthquake does not seem to have created significant disruptions to the region's production through supply shortages. However, sectors such as electronics and automobiles may confront some constraints over the next few months. The major challenge to the region's positive growth outlook continues to be increasing inflationary pressures mainly due to rising food and commodity prices, since food accounts for a large proportion of the consumer price baskets in the region. In some economies, such as India, policymakers have raised policy rates by more than they did during the 2007-2008 food crisis (275 bps versus 125 bps respectively). In our view, central banks across the region will continue to give a priority in controlling inflation, since higher commodity prices and narrowing output gaps have already started to generate core inflation pressures. In China, core CPI has increased to its highest level in the past decade (2.9% y-o-y in May 2011 from an average of 1.4% y-o-y in 2010). Another challenge for the region is the rebalance of their economies towards domestic sources of growth, as they are highly dependent on external demand and, consequently, vulnerable to a sudden shock in the global economy. In sum, the slowdown in the region is consistent with a soft patch, while the significant momentum in economic activity implies that the region will continue to outperform its peers. China and India will continue to play the most important role in the region and robust domestic demand will spread from these countries to their Asian peers. In China, real GDP growth, after having returned to a double digit growth rate of 10.3% y-o-y in 2010, is projected to slow to 9.3% in 2011, with the official growth target for the current five-year plan being 7%. In addition, according to our estimates, India's real GDP will expand by 7.8% in 2011, down from 9.0% in 2010.

Figure 4.4



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

Source: Ecowin

Emerging Europe

Although the region continues to lag behind emerging Asia and Latin America in the recovery, its economic performance has proved fairly robust in H1 2011 and became more broad-based, on the back of high oil prices and resilient demand for exports from core European economies. Leading indicators confirm the region's current strong pace of growth. Both the Eastern Europe IFO economic situation index and the index for export volumes over the next six months, even though they

have posted a short decline recently, continue to hover at multi-year highs (Figure 4.5). We expect activity to continue to be boosted by the solid performance in core European counties and elevated oil prices (particularly in energy exporters such as Russia). However, the positive effect of higher oil prices will be offset by the recent inflationary spike which is squeezing households' purchasing power and is forcing central banks to proceed with interest rate hikes. Indeed, the Russian Central Bank has raised its refinancing rate by 50 basis points to 8.25% since February 2010. Taking into account the sharp increase in inflation (9.6% y-o-y in May 2011 compared to an average of 6.9% in 2010), it is obvious from the pace of interest rate hikes that policymakers are reluctant to tighten significantly, on concerns that the current slowdown in global growth will be accompanied by a slump in the country's external demand. Meanwhile, as in our view concerns over the global economy will start to fade in H2 2011, Emerging Europe economies will be confronted with country specific challenges. Particularly, upcoming elections in some countries (e.g. Russia) may lead to a pick up in fiscal expenditure, deteriorating fiscal finances and adding to inflationary pressures. In addition, elections create political uncertainty which, particularly in the case of Russia, has undermined investment and triggered capital outflows. On the other hand, some other countries will proceed with fiscal consolidation in 2011-2012 to meet IMF targets and the risk is that fiscal consolidation may slow growth. As far as the debt crisis in the Euro area periphery countries is concerned, we expect limited contagion effects. In our view, the challenging outlook of the European periphery constitutes a headwind for Emerging Europe's real economic activity, in the case that the crisis in periphery countries would cause a slowdown of core European growth.

Figure 4.5

Source: Ecowin

Latin America

After a strong rebound in 2010, growth in Latin America continues to show a solid momentum. As major commodity exporters, most countries in the region benefit from elevated commodity prices and strong performance of Asian economies, particularly China, a key destination of the region's exports. Furthermore, buoyant revenues from commodities and strong capital inflows fuel domestic demand, causing an overheating of the economy and giving rise to an acceleration of inflation. On top of that, in countries such as Brazil tight labor market conditions create further inflationary pressures. Deteriorating inflation dynamics have led most inflation targeting central banks in the region to adopt tighter monetary policy and introduce a number of macroprudential measures, which are expected to start taking their toll on economic activity in H2 2011. As a result, real GDP growth is expected to ease and gradually converge toward trend in H2 2011. This is strongly confirmed by the Latin America IFO expectations index that has been on a declining trend over the past year (Figure 4.6). Domestic demand will continue to be the main engine of economic growth. This implies that current

account deficits may widen further, as import growth is likely to outpace that of exports. Nevertheless, strong capital inflows, due to elevated risk appetite and interest rate differentials, will provide enough funding for the current account deficits, deterring balance of payments risks. On the other hand, sharply increased capital inflows are resulting in stronger local currencies, hurting international competitiveness of the region's exports. The Latin America IFO index for export volumes over the next six months has been on a downward trend since Q3 10 (Figure 4.7).

In our view, the most important source of concern for the region is the potential of a slump in commodity prices and a sharper than anticipated landing in Asian economic activity. However, our main scenario is that the moderation of economic activity across the globe will be proved temporary and that global activity will revive in H2. Consequently, the most likely scenario is that commodities demand will remain strong and, as a result, commodity prices elevated, suggesting the continuation of inflationary pressures. Thus, over the course of the year, policymakers will continue to face the dilemma of anchoring inflationary expectations without dampening economic growth.

Figure 4.6

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

Source: Eurobank EFG, Ecowin

Figure 4.7

Source: Ecowin

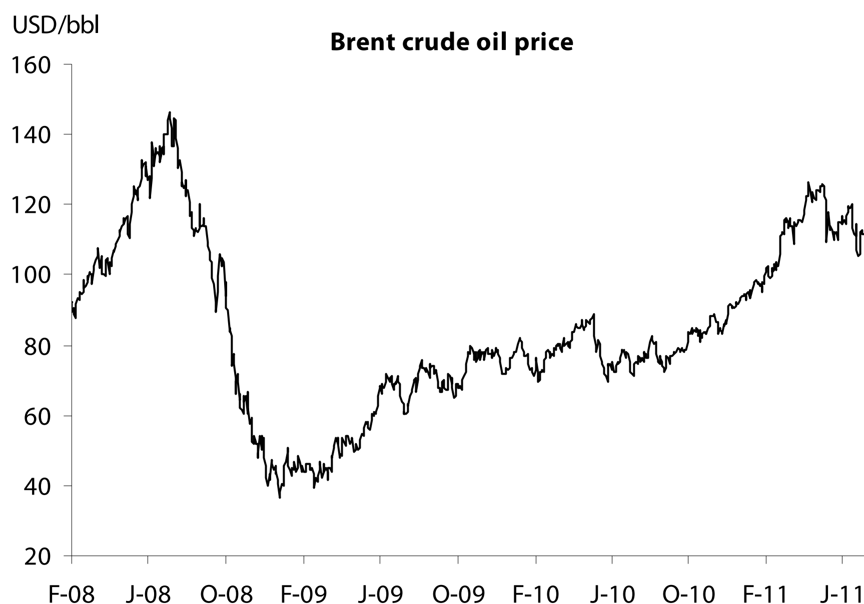
III. Special Issue: Oil prices to remain elevated over the course of the year

Dimitris Malliaropulos, Maria Prandeka

- Factors such as increasing concerns over global economic activity, tighter monetary conditions, worries concerning the European debt crisis and the end of QE2 exert downward pressures on oil prices in the short term.
- Tight supply and demand dynamics are expected to limit downside risks, since they keep oil prices at historically relatively high levels and leave the oil market rather sensitive to potential supply disruptions from geopolitical or other kinds of risks.

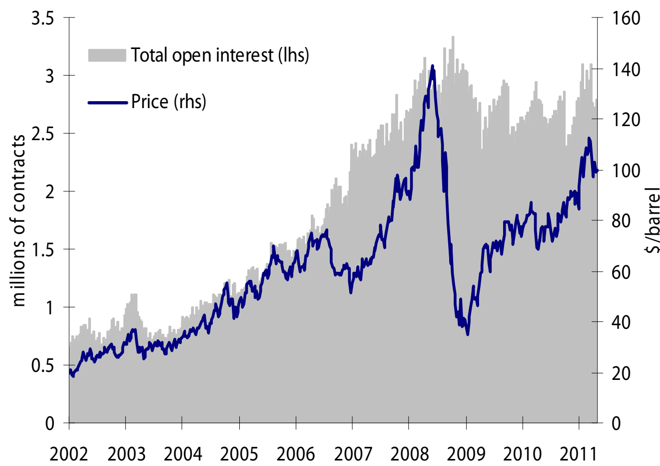
Since mid-2010 the prices of oil have risen significantly mainly on the back of strong gains in global demand and disruptions to global supply. Brent crude oil prices have soared above US$ 125/bbl in early April, a rise of about US$ 60/bbl over the past year (e.g. more than 80%) (Figure 1). Roughly one fourth of this increase (US$ 15/bbl) constitutes a heightened risk premium in the oil market which attributed to the escalation of the turmoil in the Middle East in early February and, consequently, worries about the prospect for more disruptions to global oil supply. The steady increase in oil prices has been followed by a sharp correction in early May (Brent fall over US$ 10/bbl in a one week period) and extreme volatility thereafter. Indeed, the marked oil price decline in May was initially triggered by massive fund liquidations amidst a sting of disappointing economic data that raised concerns over weaker global growth prospects. In May, both WTI oil future contracts in NYMEX and total net speculative long positions in oil declined sharply, though they are still significantly higher than in the beginning of 2004 (Figure 2, Figure 3). Thus, the recent sell-off provides a reminder that current elevated oil prices include both a speculative factor and a risk premium that has been attached to oil prices due to investors' need of a greater cushion of excess supply compared to historical norms. As a result, additional disappointing economic news could remove an extra portion of the risk premium, bringing oil prices further down. Specifically, increasing concerns over the outlook of global economic activity, tighter monetary conditions, particularly in emerging markets, worries concerning the contagion of the European debt crisis to the US and Japan and the end of QE2, are factors that maintain nervousness in the market, thus exert downward pressures on oil prices in the short-term.

Figure 1



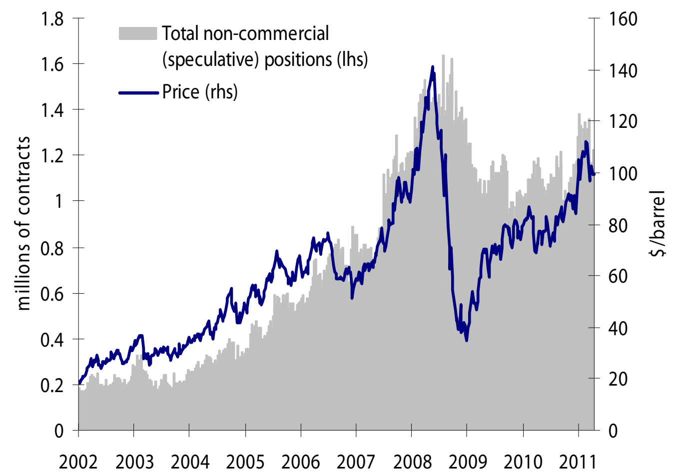
Source: Bloomberg

Figure 2
Front month future on contracts in WTI



Source: EIA, Ecowin

Figure 3
Speculative positions in WTI front-month futures



Source: EIA, Ecowin

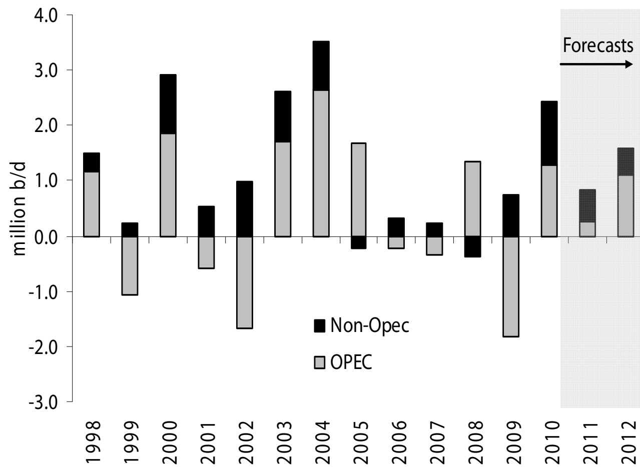
Indeed, tight supply/demand dynamics, which are expected to persist this year, limit downside risks on oil prices, since they provide a floor upon price dips and keep oil prices at historically relatively high levels. On the supply side, non-OPEC oil production has been proved disappointing since the beginning of the year. According to the latest US Energy Information Administration's (EIA's) forecasts, non-OPEC oil production, which account for about 60% of world oil supply, is projected to increase by 590 thousand bbl/d (1.1% y-o-y) in 2011 and by 490 thousand bbl/d (0.9% y-o-y) in 2012, which represents the lowest annual increase since 2008 in terms of both absolute and percentage change (Figure 4). The greatest declines in non-OPEC oil production during 2011 are expected to occur in the North Sea (due to problems in a number of fields), Mexico and the Middle East (due to geopolitical backdrop in Syria and Yemen). Meanwhile, OPEC's production has been dented by the disruption in Libyan's oil supply in the wake of the civil war. Still, the 1.5 mbbl/d Libyan oil supply remains off the market, as OPEC has so far failed to make up for this shortfall. Indeed, according to International Energy Agency (IEA)[4], OPEC's May crude oil supply remains 1.25 mbbl/d below the pre-Libyan crisis levels. Adding to this problem is OPEC's failure to reach an agreement on raising production targets to meet the Libyan shortfall at its meeting on June 8th, exerting further upward pressures on oil prices. Meanwhile, the IEA announced on June 23 that its member countries have agreed to release 60 million barrels of oil from their emergency stocks over 30 days, in response to the ongoing loss of Libyan supplies. As a result, Brent crude oil prices dropped by 9% to US$ 103.86/bbl. Nevertheless, we believe that the impact of the release would be proved temporary, since the re-filling of the US Strategic Petroleum Reserves (SPR) is likely to add new pressures on crude oil prices in the future.

Concerning oil demand, emerging economies' demand has remained very strong since the beginning of the year, offsetting weakening demand in the US and other developed countries (Figure 5). Actually, the shift in global demand towards the emerging world, which account for more than 50% of global growth, is a long-term factor for upside pressures to oil prices. Specifically, oil prices have been proved particularly sensitive to the strength of Chinese demand. In fact, the latter continues to surprise to the upside with several factors precipitating it. Indeed, the resilient strength of the Chinese economy continues to give a boost to both consumer and industrial demand growth. In addition, severe drought conditions have resulted in low levels of hydro power -a substantial source of Chinese electric generation-, leading to increased demand for diesel in order to fuel electricity shortfalls. Given that summer is a period of strong power consumption, we do not expect tightness in the Chinese power market to abate at least for the summer. EIA's latest forecasts suggest that China's oil consumption will increase by 7.6% y-o-y in 2011, which is the second largest annual growth rate since 2006. Increased demand for oil is also stemming from Japan in the aftermath of the Tohoku earthquake, since the latter forced the shutdown of oil refineries and nuclear power plants in Japan. A boost to Japan's oil demand is expected during the period of reconstruction which is more likely to take place mainly over the second half of the year.

[4] IEA Oil Market Report, June 2011

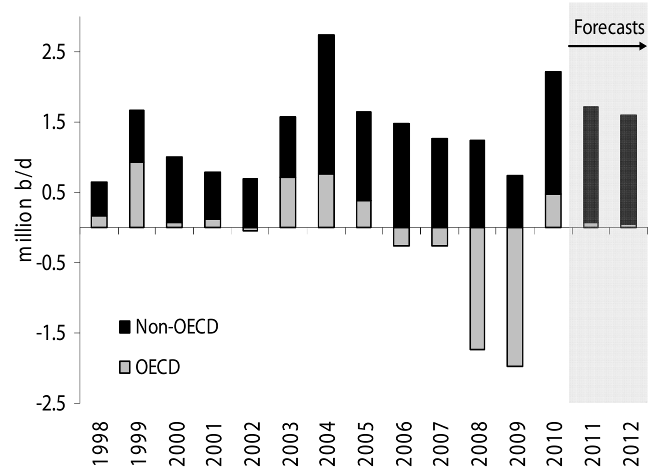
Following Japan's earthquake, Germany has decided to close its nuclear plants, suggesting that the ongoing substitution of nuclear power for more conventional sources of energy will constitute a long-term factor for upside pressures to oil prices. In the meantime, we expect oil demand to be supported by the reacceleration of economic growth in advanced economies in H2 2011, since the easing of economic activity in H1 has been proved only temporary.

Figure 4



Source: EIA, Ecowin

Figure 5

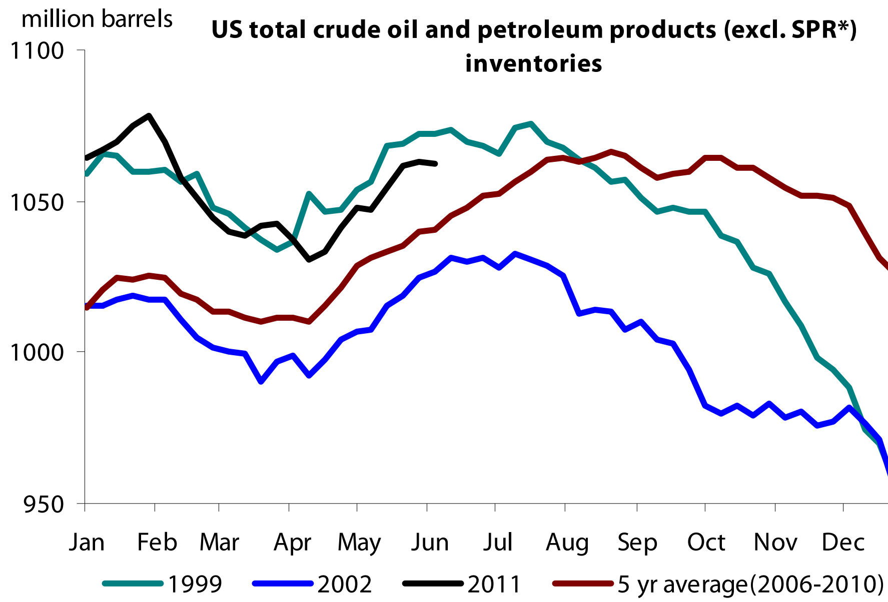


Source: EIA, Ecowin

With global economic activity expected to continue to support oil demand and global oil production expected to lag behind, the oil market continues to operate with a significant deficit. As a result, inventories and OPEC spare capacity fall. According to EIA's estimates, OPEC's surplus capacity will fall from 4 mbbl/d at end-2010 to 3.6 mbbl/d at end-2011 and 3.1mbbl/d at end-2012. Since global oil demand outpaces global oil supply, we believe that a counter-seasonal inventory draw in Q3 is very likely. Should we look at US total petroleum inventories, these are usually built in Q3 rather than drawn, so that the market can meet the increased seasonal demand in the winter ahead (Figure 6). The path of inventories so far in 2011 is similar with that of 1999 and 2002, when inventories were drawn in Q3, and oil prices spiked in the winter ahead. This implies that tight fundaments created during the course of the year are leaving the oil market rather sensitive to potential supply disruptions from geopolitical or other kinds of risks. This constitutes a significant upside risk for oil prices over the next quarters.

To sum up, we believe that oil fundamentals will remain tight enough over the course of the year to sustain oil prices at current levels, although further downside in the short-term cannot be ruled out. Increased concerns over the long-term supply environment of the oil market will continue to be a major factor adding to upside risks to oil prices.

Figure 6



** Strategic Petroleum Reserves (SPR)*

Source: EIA, Ecowin

Macro Forecasts

Real GDP growth						
	2009	2010	2011f		2012f	
			Eurobank EFG	Consensus	Eurobank EFG	Consensus
US	-2.6	2.9	2.5	2.5 (1.9 – 3.3)	3.0	3.0 (2.0 – 4.8)
EA	-4.1	1.7	1.9	2.0 (1.5 – 2.7)	1.8	1.7 (1.0 – 2.2)
Japan	-6.3	4.0	-0.5	-0.4 (-1.2 – 0.3)	2.8	2.8 (2.4 – 3.5)
China	9.2	10.3	9.3	9.5 (8.9 – 10.0)	8.9	8.9 (8.1 – 9.5)
India	7.0	9.0	7.8	7.8 (7.5 – 8.3)	8.0	8.0 (7.8 – 8.5)
Russia	-7.8	4.0	4.8	4.6 (3.0 – 5.5)	4.6	4.4 (3.3 – 5.7)
Brazil	-0.6	7.5	4.0	4.0 (3.4 – 4.7)	4.1	4.1 (3.7 – 4.6)

Inflation						
	2009	2010	2011f		2012f	
			Eurobank EFG	Consensus	Eurobank EFG	Consensus
US	-0.3	1.6	3.2	3.0 (2.1 – 3.8)	2.5	2.2 (0.8 – 5.0)
EA	0.3	1.6	2.6	2.7 (1.7 – 2.8)	2.0	2.0 (1.5 – 2.4)
Japan	-1.3	-0.7	0.4	0.4 (0.2 – 0.7)	0.2	0.3 (-0.5 – 0.9)
China	-0.7	3.3	5.0	4.7 (4.3 – 5.0)	4.0	3.5 (3.0 – 4.0)
India (WPI)	2.4	9.6	8.7	8.6 (7.8 – 9.1)	7.0	6.7 (6.0 – 7.2)
Russia	11.7	6.9	9.0	9.1 (7.3 – 10.5)	7.5	7.5 (5.9 – 10.5)
Brazil	4.9	5.0	6.2	6.2 (5.5 – 6.9)	5.2	5.0 (4.7 – 6.0)

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

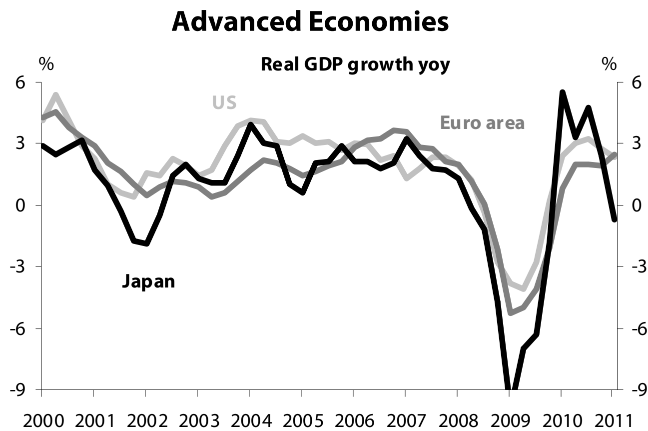
Policy Rates					
		Eurobank EFG			
	Current	Q3 11f	Q4 11f	Q1 12f	Q2 12f
US	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.50
EA	1.25	1.50	1.75	2.00	2.25
Japan	0.10	0.10	0.10	0.10	0.10
China	6.31	6.56	6.81	6.81	6.81
India	7.50	7.75	8.00	8.25	8.25
Russia	8.25	8.50	8.75	9.00	9.00
Brazil	12.25	12.50	12.75	12.75	12.75

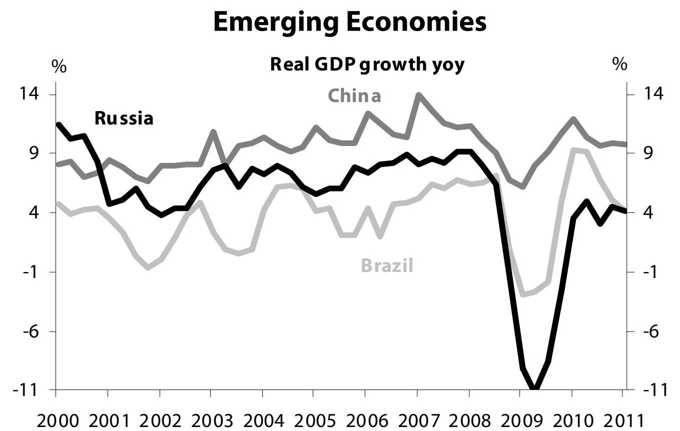
IV. GRAPHS

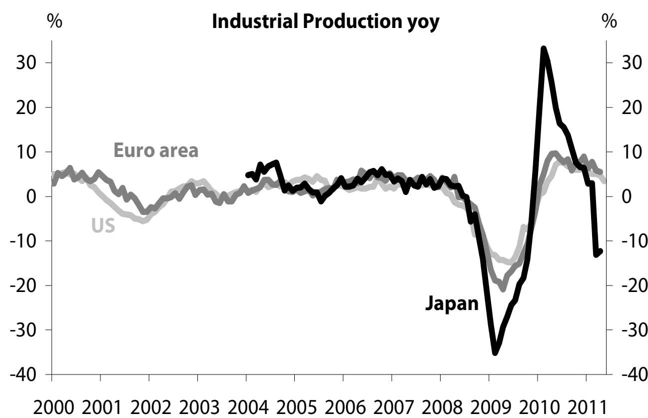
Global Economic Indicators

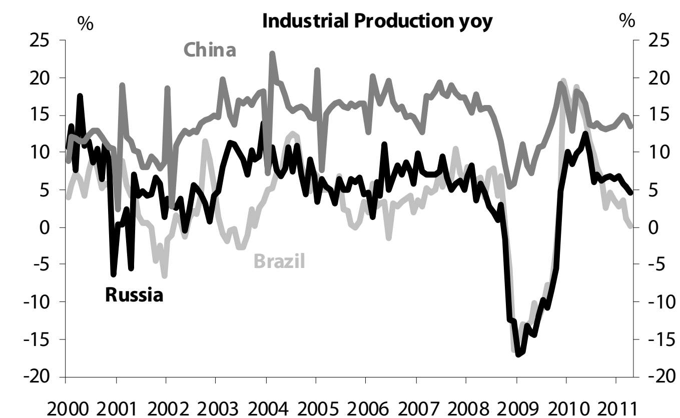
Advanced Economies

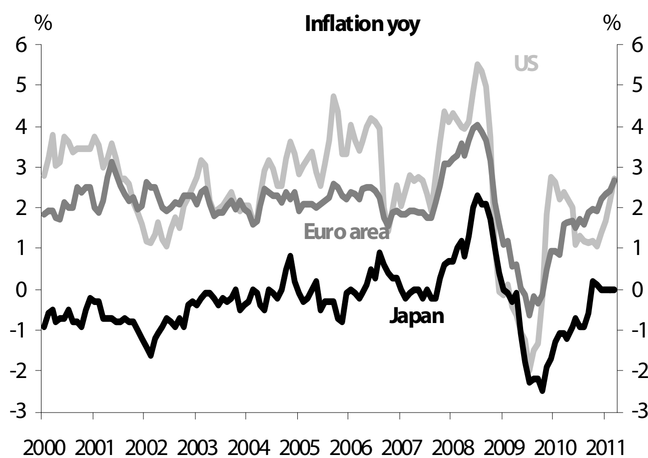
Emerging Economies

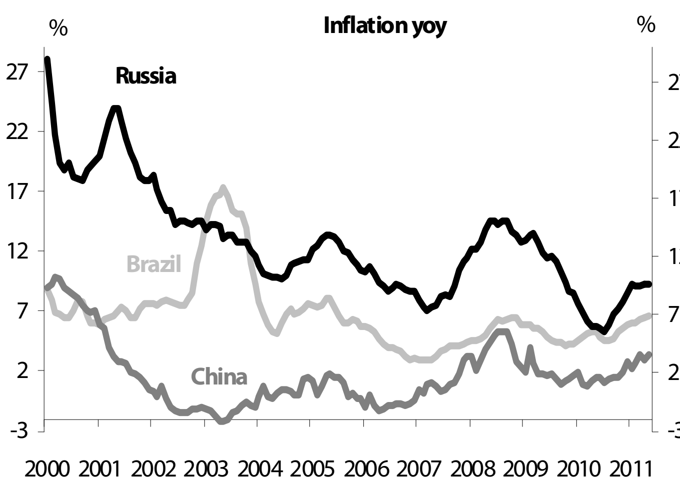










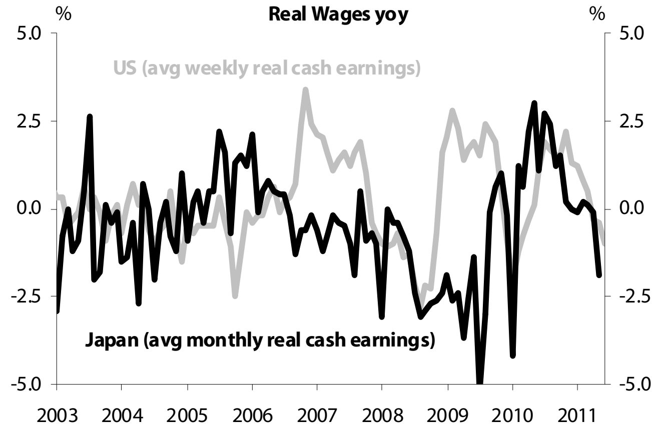


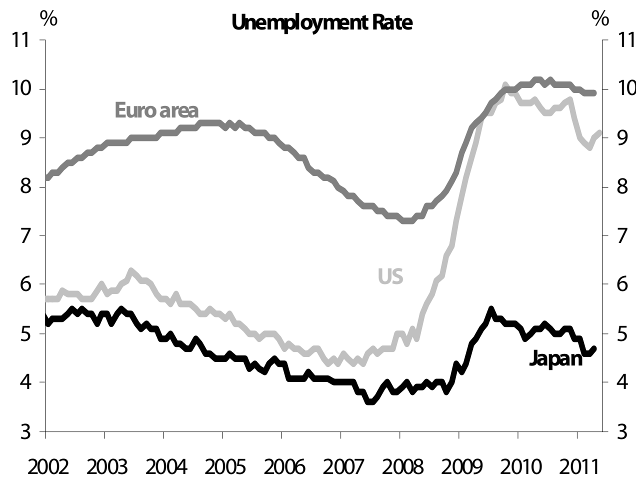
Source: Bloomberg, Ecowin

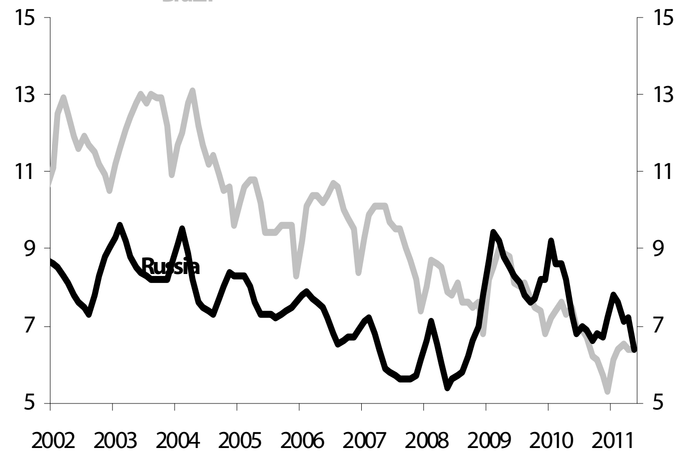
Global Economic Indicators

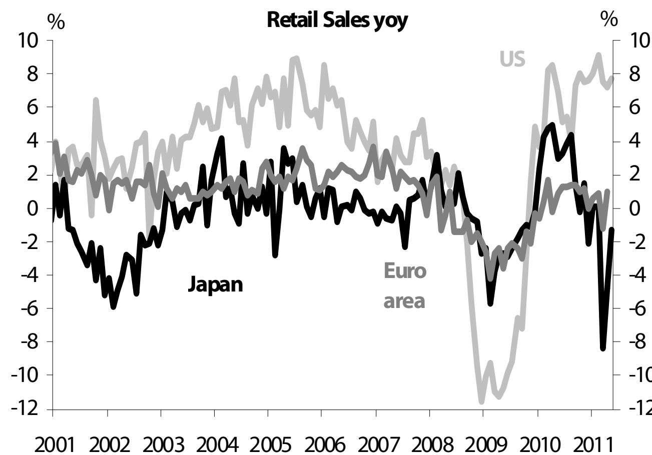
Advanced Economies

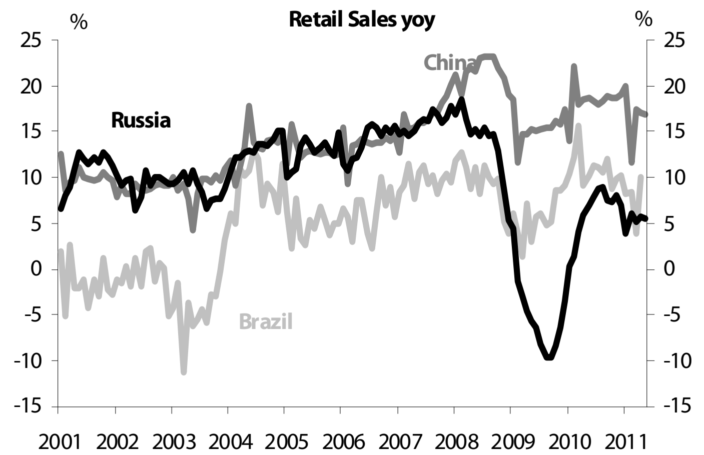
Emerging Economies







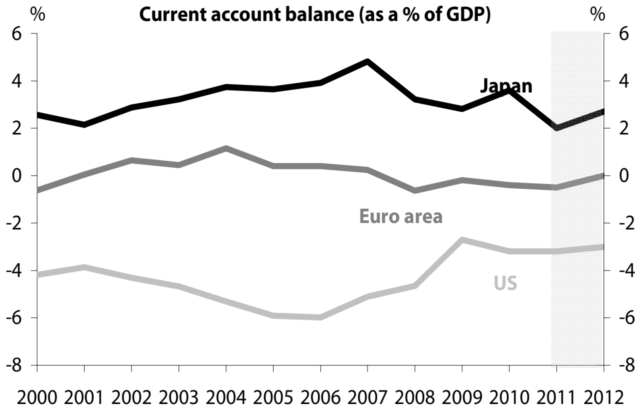




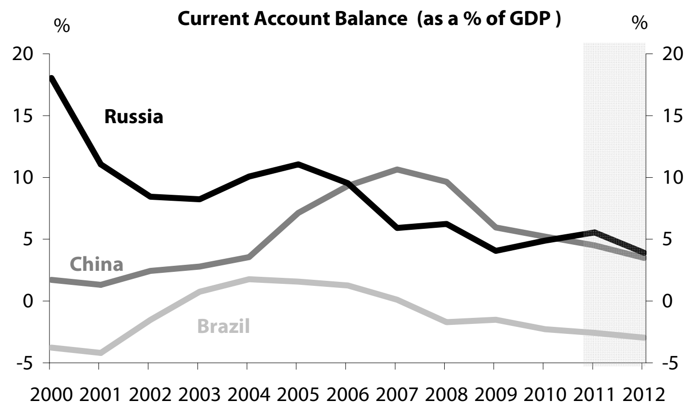
Source: Bloomberg, Ecowin

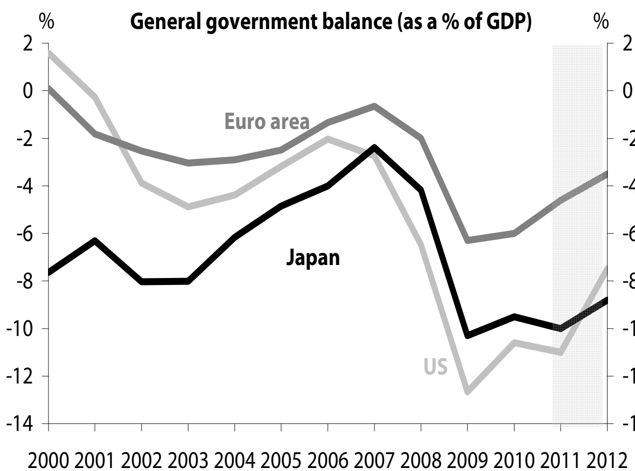
Global Economic Indicators

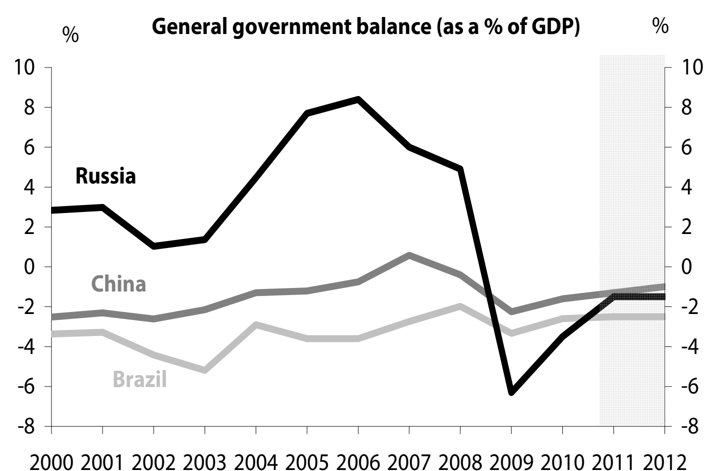
Advanced Economies

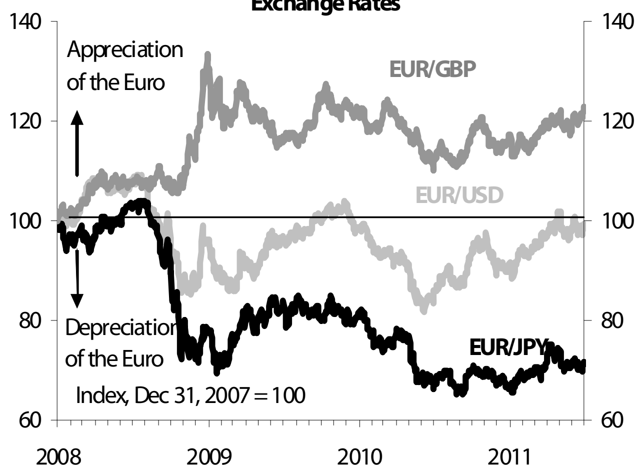


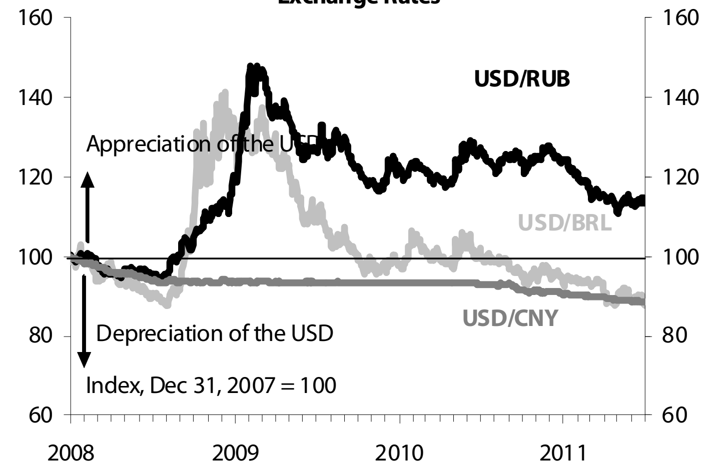
Emerging Economies





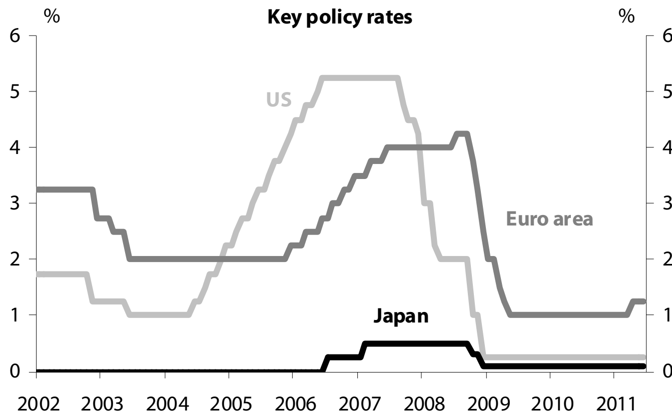


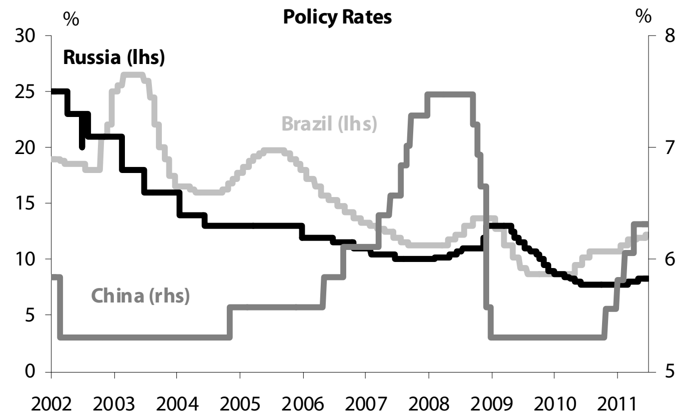


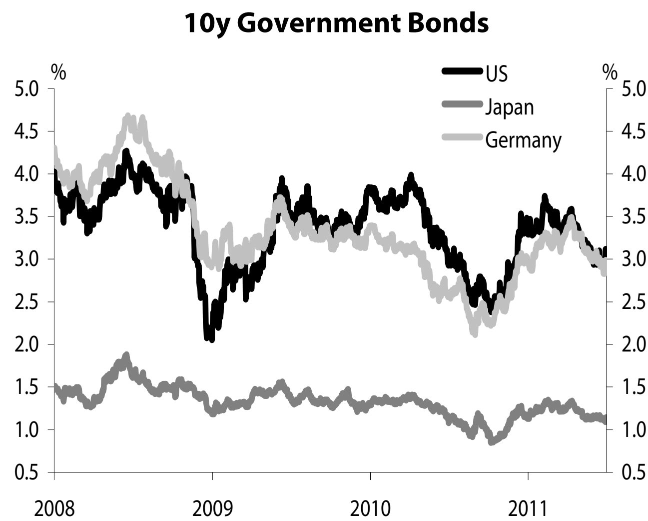


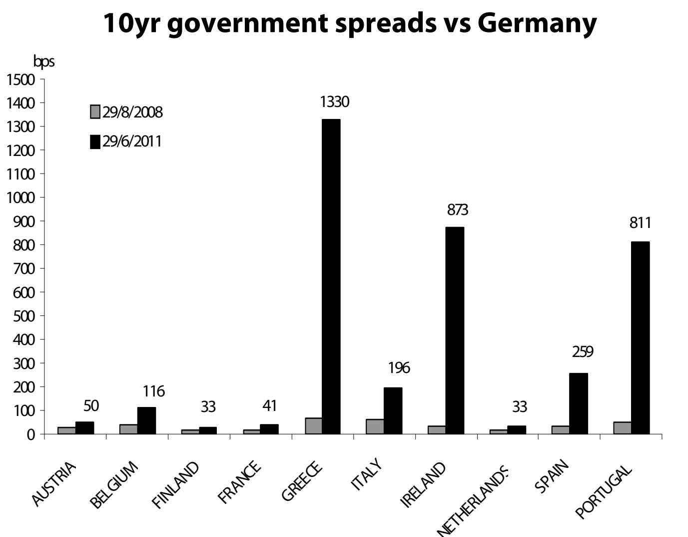
Source: Bloomberg, Ecowin, IMF

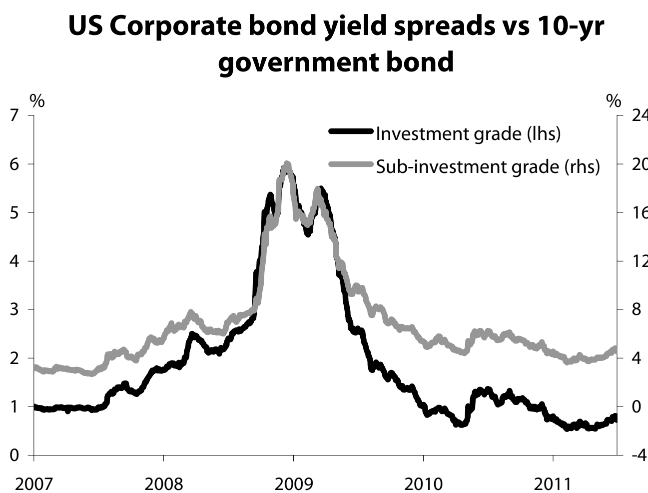
Global Economic Indicators

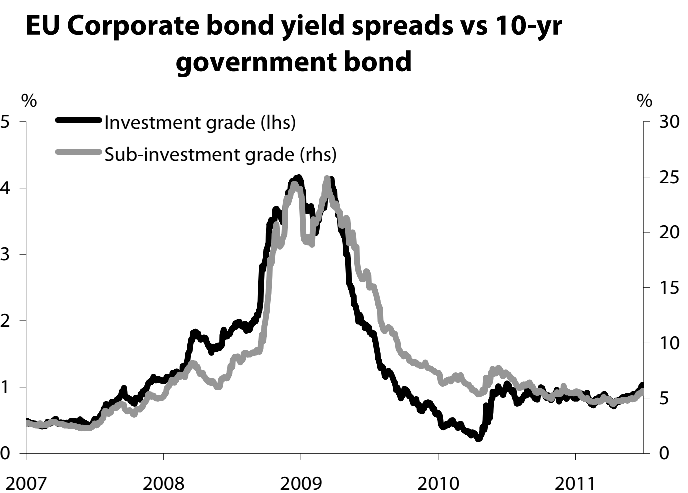












Source: Bloomberg, Ecowin

Global Equities & Sector Performance

Total Return (%) as of June 29, 2011

Global Equity Indices (in local currency)								
Region	**Index**	**Last Price**	**1w**	**1m**	**6m**	**12m**	**YTD**	**2010**
US	**S&P 500**	1307.4	1.6	-2.8	4.0	26.8	4.0	12.8
EURO AREA	**DJ Euro Stoxx 50**	2802.6	2.6	-2.1	0.3	8.9	0.3	-5.8
GERMANY	**DAX**	7294.1	2.0	0.0	5.5	22.3	5.5	16.1
FRANCE	**CAC 40**	3924.2	3.6	-2.1	3.1	14.0	3.1	-3.3
UK	**FTSE 100**	5856.0	3.2	-2.2	-0.7	19.1	-0.7	9.0
JAPAN	**Nikkei**	9797.3	2.1	1.1	-4.2	4.4	-4.2	-3.0
CHINA	**CSI 300**	3000.2	1.4	0.0	-4.1	17.1	-4.1	-12.5
INDIA	**SENSEX**	18693.9	5.5	1.0	-8.9	5.6	-8.9	17.4
RUSSIA	**MICEX**	1660.0	3.2	-0.4	-1.7	26.8	-1.7	23.2
BRAZIL	**IBOV**	62334.0	1.9	-3.5	-10.1	2.3	-10.1	1.0

Source: Bloomberg

Sector performance as of June 29, 2011

US Sector Indices (in USD)							
US – S&P 500	**Last**	**1w**	**1m**	**6m**	**12m**	**YTD**	**2010**
1. Consumer Discretionary	388.5	2.9	-0.5	7.0	37.6	7.3	27.7
2. Consumer Staples	465.2	-0.4	-2.4	6.9	24.6	7.0	14.1
3. Energy	807.3	1.4	-2.3	9.8	49.6	9.7	20.5
4. Financials	297.7	2.0	-2.2	-3.6	11.2	-3.4	12.1
5. Health Care	536.1	0.8	-0.3	13.1	27.1	13.6	2.9
6. Industrials	434.0	1.4	-1.3	6.2	35.0	6.2	26.7
7. Information Technology	441.3	2.5	-2.5	0.2	22.0	0.6	10.2
8. Materials	349.8	3.0	-0.5	2.3	41.6	2.3	22.2
9. Telecommunication Services	231.5	1.4	-1.4	6.6	36.0	6.2	19.0
10 Utilities	336.7	1.1	0.2	8.4	22.5	8.7	5.5

Source: Bloomberg, Ecowin

Global Equities & Sector Performance

Sector performance as of June 29, 2011

European Sector Indices (in €)

Europe - DJ Stoxx 600	Last	1w	1m	6m	12m	YTD	2010
1. Consumer Discretionary							
Automobiles & Components	551.3	5.8	6.9	11.0	52.8	11.0	45.3
Travel & Leisure	202.7	1.9	-2.6	-5.7	11.4	-5.7	28.4
Media	279.8	2.8	-2.0	-0.7	12.3	-0.7	17.2
Retail	427.2	0.9	-7.1	-4.0	3.3	-4.0	13.2
2. Consumer Staples							
Food & Beverage	587.4	0.7	-2.8	1.0	11.3	1.0	22.3
Personal & Household Goods	688.2	2.7	-3.0	0.6	16.6	0.6	30.6
3. Energy							
Oil & Gas	612.2	2.7	-4.9	-1.8	20.8	-1.8	3.3
4. Financials							
Banks	348.2	1.1	-7.1	-5.5	-3.5	-5.5	-9.6
Financial Services	462.2	2.3	-6.6	-2.8	17.6	-2.8	18.6
Insurance	263.5	1.1	-3.6	6.6	17.9	6.6	4.7
Real Estate	123.7	0.9	-3.0	5.1	26.5	5.1	11.7
5. Health Care	594.3	1.5	-4.0	6.5	10.4	6.5	9.1
6. Industrials							
Industrial Goods & Services	514.3	3.3	-3.5	1.1	24.0	1.1	35.6
7. Information Technology	213.6	3.5	-4.3	-1.0	10.3	-1.0	16.9
8. Materials							
Basic Resources	987.7	5.3	-2.7	-10.3	24.0	-10.3	28.6
Chemicals	1023.8	1.8	-1.7	6.0	34.0	6.0	25.2
Construction & Materials	462.9	2.8	-4.6	-0.1	15.0	-0.1	4.7
9. Telecommunication Services	487.2	0.4	-2.6	-0.6	12.1	-0.6	8.9
10. Utilities	625.4	1.9	-3.3	-0.5	9.3	-0.5	-4.5

Source: Bloomberg

Sector performance as of June 29, 2011

Asia Sector Indices (in USD)

Asia – S&P 50 Index*	Last	1w	1m	6m	12m	YTD	2010
1. Consumer Discretionary	12131.8	2.9	-3.1	14.5	48.1	11.0	33.2
2. Consumer Staples	13761.1	0.0	1.4	4.8	15.8	3.3	1.7
3. Energy	13956.5	0.8	-2.5	6.3	41.4	3.0	36.4
4. Financials	3731.4	0.8	-4.1	-4.0	8.4	-6.6	9.2
5. Industrials	3369.0	1.7	-2.3	7.5	75.6	5.0	74.6
6. Information Technology	9007.6	-1.2	-5.4	-3.7	25.8	-6.5	21.6
7. Materials	5078.2	1.4	-0.5	4.5	34.2	2.4	10.5
8. Telecommunication Services	2472.1	1.4	1.6	-1.9	2.7	-2.6	7.7
9. Utilities	3488.9	2.0	2.3	8.8	15.9	8.5	10.6

Source: Ecowin

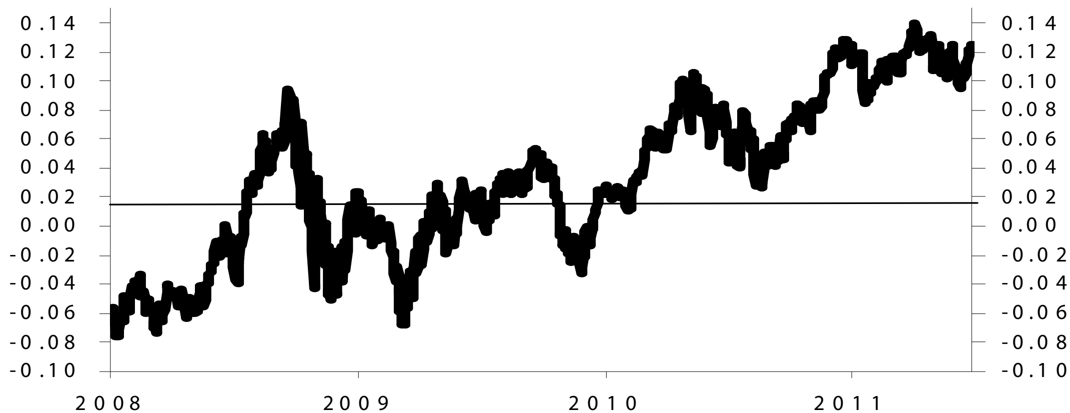
US Style Equity Indices

Total Return (%) as of June 29, 2011

US Style Indices (in USD)

Index	Last Price	1w	1m	6m	12m	YTD	2010
Russell 1000 (Large Cap)	727.4	1.6	-2.9	4.4	28.2	4.4	13.9
Russell 2000 (Small Cap)	819.9	2.5	-3.3	4.6	34.5	4.6	25.3
Relative performance (Small vs Large)		0.9	-0.5	0.3	6.3	0.3	11.4
Russell 1000 Value	663.7	1.2	-3.1	3.8	24.9	3.8	12.9
Russell 1000 Growth	603.0	2.1	-2.6	4.9	31.6	4.9	14.9
Relative performance (Value vs Growth)		-0.9	-0.5	-1.1	-6.7	-1.1	-2.0

Relative Performance (small vs large)
(logarithmic scale)



Relative Performance (value vs growth)
(logarithmic scale)

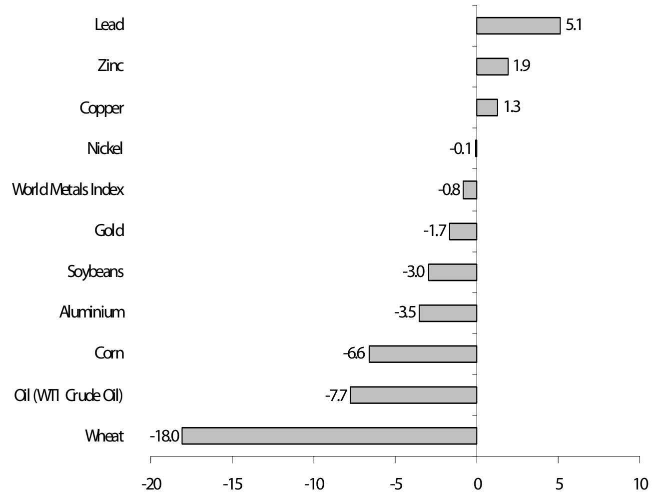
Source: Bloomberg

Commodities

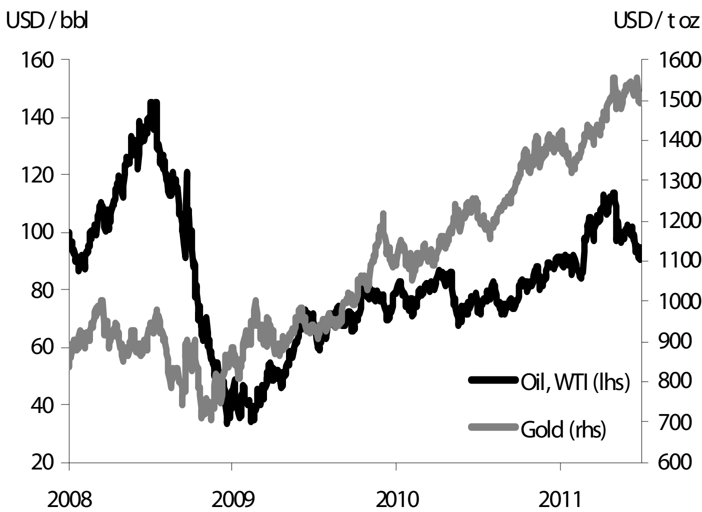
Commodity Performance (%) as of June 29, 2011

Commodities	Units	Last Price	1w	1m	6m	12m	YTD	2010
Oil (WTI Crude Oil)	USD/bbl	94.8	4.1	-7.7	3.7	25.3	3.7	15.1
Gold	USD/t oz	1510.4	-0.6	-1.7	6.3	21.2	6.3	29.7
Base Metals								
World Metals Index		4111.1	3.2	-0.8	-2.4	36.9	-2.4	23.8
Aluminium	USD/lb	2533.0	-0.7	-3.5	3.2	30.1	2.6	10.8
Copper	USD/mt	9320.0	3.4	1.3	-0.9	43.5	-2.9	30.2
Lead	USD/mt	2634.0	3.5	5.1	4.1	53.1	3.3	4.9
Nickel	USD/mt	23075.0	4.2	-0.1	-3.2	21.0	-6.8	33.6
Zinc	USD/mt	2317.0	2.9	1.9	-3.4	32.9	-5.6	-4.1
Agriculture								
Corn	USD/bu	698.0	2.6	-6.6	11.0	97.0	11.0	51.7
Soybeans	USD/bu	1323.0	0.4	-3.0	1.1	44.7	1.1	29.9
Wheat	USD/bu	641.3	-1.2	-18.0	-19.3	38.0	-19.3	46.7

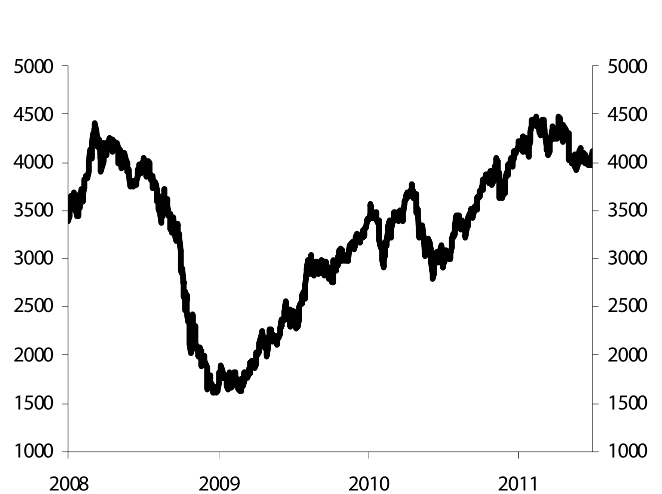
1-Month Return



Oil & Gold



World Metals Index



Source: Bloomberg

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

EFG Eurobank Ergasias S.A. (Eurobank EFG), is the second largest bank in Greece with assets of around €84 billion. Founded in 1990, Eurobank EFG has received high marks from the most reputable international rating agencies (Standard & Poor's, Fitch and Moody's), not only for its financial strength, but also, for the Group's client focus, high level of services, its heavy investment in modern technologies and its professional and dynamic management and personnel. As a member of EFG Group – a Geneva-based banking Group – it has access to all European financial markets.

Eurobank EFG offers a comprehensive array of banking products and services for individuals, corporations and institutions. It currently employs more than 23,000 people in Greece and abroad and runs a distribution network of over 1,600 branches and alternative distribution channels. In recent years, the Bank has expanded into Bulgaria, Romania, Serbia, Turkey, Poland, Ukraine, Luxemburg, United Kingdom and Cyprus.

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

Economic Research & Forecasting Division

Editor
Prof. Gikas Hardouvelis:
Ch ief Economist & Director of Research Eurobank EFG Group

Research Team
Dimitris Malliaropulos: *Economic Research Advisor*
Platon Monokroussos: *Head of Financial Markets Research Division*
Tasos Anastasatos: *Senior Economist*
Ioannis Gkionis: *Research Economist*
Stella Kanellopoulou: *Research Economist*
Theodosios Sampaniotis: *Senior Economic Analyst*
Theodoros Stamatiou: *Research Economist*
Olga Kosma: *Economic Analyst*
Maria Prandeka: *Economic Analyst*
Galatia Phoka: *Emerging Markets Analyst*
Paraskevi Petropoulou: *G10 Markets Analyst*
Vassilis Zarkos: *Economic Analyst*

Eurobank EFG, 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687,
web: http://www.eurobank.gr/research , contact email: Research@eurobank.gr

Eurobank EFG Economic Research

More research editions available at http://www.eurobank.gr/research

- New Europe: Economics & Strategy Monthly edition on the economies and the markets of New Europe
- Economy & Markets Monthly economic research edition
- Global Economic & Market Outlook Quarterly review of the international economy and financial markets

Subscribe electronically at http://www.eurobank.gr/research