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Eurobank EFG

GLOBAL ECONOMIC & MARKET OUTLOOK

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Main Macro Views and Market Strategy

- The world economy continued expanding in Q1 2011 and the global recovery remains firmly on track. Emerging markets are expected to remain the locomotive of the global economy. Looking forward, we expect global growth to remain strong, though recede to a lower rate.

- In the US, most indicators confirm that the economic recovery has strengthened, with real GDP retrieving its pre-recession level. In the euro area, the recovery remains solid but uneven, with Germany remaining the locomotive of the euro area recovery and the debt laden periphery struggling to regain market confidence through severe fiscal retrenchment.

- ESM seniority along with private participation in losses may scare new private investors away from periphery sovereign debt as their bonds will have junior status. Hence, spreads may remain wide beyond 2013, despite efforts by periphery members to restore credibility, limiting their ability to return to markets for borrowing at affordable costs.

- Emerging markets' economic growth is expected to moderate in response to the gradual withdrawal of policy stimulus and policy tightening measures adopted to fight mounting inflationary pressures.

- Whereas the earthquake in Japan is expected to have a minor temporary effect on global growth, mainly through supply chain disruptions, the main risk to global growth stems, in our view, from an escalation of political unrest in oil producing countries. A sharp increase in oil prices would weigh on global economic activity by reducing real incomes and profit margins and, consequently, consumption and investment.

- Tighter monetary stance, in response to climbing inflation fears, is likely to put a lid on growth and global trade activity, affecting both emerging and developed markets.

- We view the ECB as the most likely candidate for a pre-emptive interest rate hike in April, as headline inflation has recently climbed above the ECB's comfort level of 2%. We expect the ECB to increase interest rates to 1.75% until December (from 1% currently) and to 2.75% during 2012. In contrast, the Fed is likely to keep fed funds rate at zero until December as core inflation remains relatively low. However, with inflation expectations recently surging upwards, the Fed is likely to start hiking rates in September.

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Executive Summary

After a slowdown in the last quarter of 2010, economic activity in developed economies picked up in Q1, confirming that the global recovery remains firmly on track. Recent data corroborate the broadening of the recovery. Private consumption is gaining momentum in advanced economies on the backdrop of improving labor conditions. In the US, most indicators confirm that the economic recovery has strengthened, with real GDP retrieving its pre-recession level. In the euro area, the recovery remains solid but uneven. Germany remains the locomotive of the euro area recovery, whereas the debt laden periphery struggles to regain market confidence through severe fiscal retrenchment. We expect emerging market economies to continue to fuel the global recovery, though their growth is expected to moderate in response to the gradual withdrawal of policy stimulus and policy tightening measures.

We view an escalation of political unrest in oil producing countries as a serious headwind to global growth. A sharp increase in oil prices would weigh on global economic activity by reducing real incomes and profit margins and, consequently, consumption and investment. The impact would likely be even more severe, given that countries remain rather vulnerable to economic shocks, as there is not much room for economic policy to accommodate an oil shock. The fiscal stance in several economies is already overstretched, while monetary policies extremely loose.

Looking ahead, we expect global growth to remain strong, though recede to a lower rate. Indeed, we expect global economic growth to moderate to 4.2% in 2011 from 5.0% in 2010. In light of climbing inflation fears, due to rising commodity prices, several central banks, particularly in emerging markets, have already been forced to tighten monetary policy in order to anchor inflation expectations and prevent rising commodity prices from spilling into core inflation. In our view, tighter monetary policy is likely to put a lid on growth and global trade activity, affecting both emerging and developed markets.

In the developed world, we view the ECB as the most likely candidate for a pre-emptive interest rate hike in April, as headline inflation has recently climbed above the ECB's comfort level of 2%. In sharp contrast to the ECB that seems to focus on headline inflation, the Fed insists on a dovish approach as it focuses on core inflation, which is rather subdued. While endorsing a more upbeat tone in its last meeting, the Fed will complete the second round of its asset purchase program in mid-2011. Unless commodity price hikes and increased inflation expectations prove more sustained, we expect the Fed to hold its policy rate near zero until December. With inflation expectations remaining at currently elevated levels and labor market conditions improving, the risk of an early tightening (likely in September) is on the upside.

We view the EFSF/ESM facilities and the Euro Plus Pact as a compromise between strong core countries and weak members, as the former demand increased fiscal discipline by the latter to provide them with financial assistance. Ensuring the proper implementation and enforcement of the decided measures is of critical importance, given the disappointing track record of the Stability and Growth Pact to achieve fiscal discipline in the past. Moreover, the EFSF/ESM scheme may not have turned out as flexible as markets would like, as it is not allowed to buy debt at the secondary market. ESM seniority along with private participation in losses may scare new private investors away from periphery sovereign debt as their bonds will have junior status. Hence, spreads may remain wide beyond 2013, despite efforts by periphery members to restore credibility, limiting their ability to return to markets for borrowing at affordable costs.

Dimitris Malliaropulos

Research Advisor

I. Global Outlook

Dimitris Malliaropulos, Vasilis Zarkos

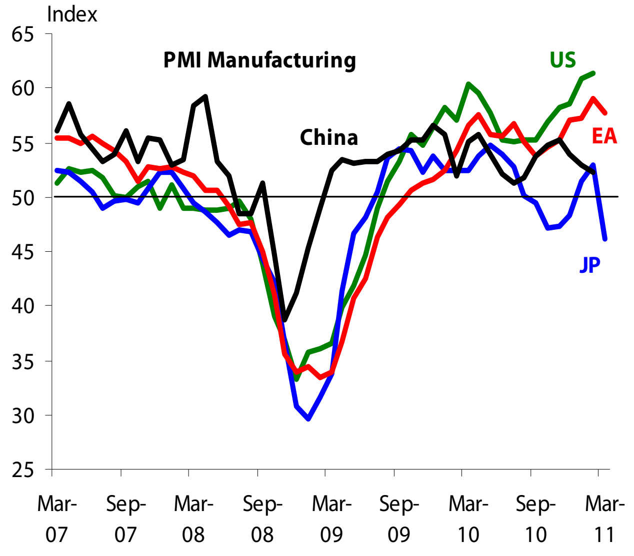
Global growth will likely slip lower in Q2 but it remains firmly on track.

After a slowdown in the last quarter of 2010, economic activity in developed economies picked up in Q1, confirming that the global recovery remains firmly on track. Recent data corroborate the broadening of the recovery. Private consumption is gaining momentum in advanced economies on the backdrop of improving labor conditions. Leading indicators reveal improving sentiment about labor markets. The strengthening of the private sector reassures further economic expansion as fiscal stimulus is fading, or even turning to a drag. The PMI leading indicators (Figure 1) suggest a solid growth ahead, as both the manufacturing and the services sectors convey positive business sentiment.

In our view, unemployment will likely recede at a slow pace, as excess capacity holds firms back from aggressive hiring. In addition, improving conditions are expected to increase labor participation, preventing unemployment from a rapid decline. That said, we believe we have seen the peak in unemployment and our baseline scenario points to clear improvements in the following quarters (Figure 2).

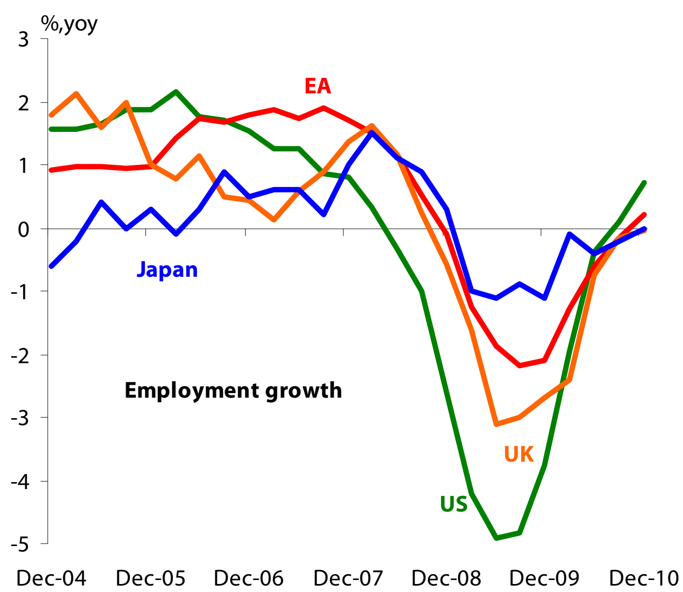
Looking ahead, we expect global growth to remain strong, though slip to a lower rate. Indeed, we expect global economic growth to moderate to 4.2% in 2011 from 5.0% in 2010. Commodity prices are rising due to strong demand but also due to the ongoing geopolitical turmoil in North Africa and the Middle East. Central banks in several emerging countries are forced to tighten monetary policy in order to anchor inflation expectations stemming from both strong domestic growth and imported inflation. We view that tighter monetary stance is likely to put a lid on growth and global trade activity, affecting both emerging and developed markets. Despite upbeat global leading indices, we view recent declines in the Chinese PMI as a signal of moderation in the pace of global growth. The earthquake in Japan is expected to have a minor temporary effect on global growth, mainly through supply chain disruptions.

Figure 1



Source: Bloomberg

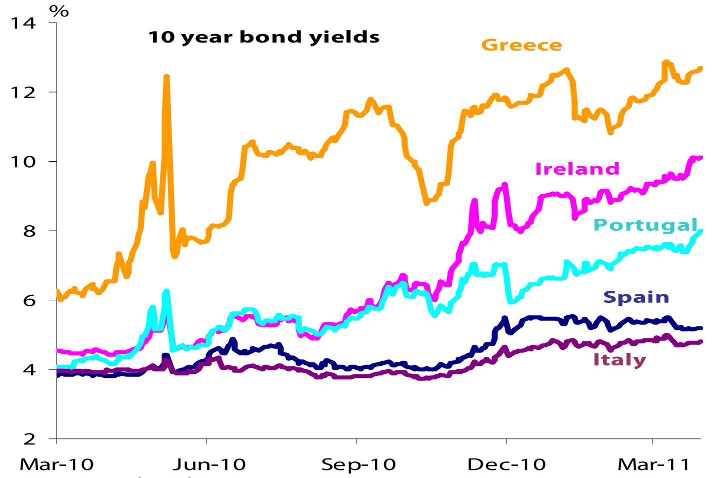
Figure 2



Source: Bloomberg

In the euro area, the recovery remains solid but uneven. Germany remains the locomotive of the euro area recovery, whereas the debt laden periphery struggles to regain market confidence through severe fiscal retrenchment. Within the periphery group, one could distinguish two subgroups. On the one hand, Spain and Italy remain on investors' radars but their borrowing costs have flattened, implying markets' tame concern about their solvency. On the contrary, Greece Ireland and Portugal continue fueling investors' skepticism about debt sustainability and the final outcome of Irish bank restructuring (Figure 3).

Figure 3



Source: Bloomberg

In a series of recent summits, euro area policymakers agreed on a permanent resolution mechanism (EFSF/ESM), expected to alleviate market fears and allow weak periphery members to borrow at more affordable costs. In addition, policymakers agreed on a set of measures, namely the Euro Plus Pact, aiming at enhancing economic governance in the euro area and improving the competitiveness of its members. We view the EFSF/ESM facilities and the Euro Plus Pact as a compromise between strong core countries and weak members, as the former demand increased fiscal discipline by the latter to provide them with financial assistance.

While recent agreements are steps to the right direction in order to strengthen the euro zone and avert future imbalances, concerns remain. Ensuring the proper implementation and enforcement of the decided measures is of critical importance, given the disappointing track record of the Stability and Growth Pact to achieve fiscal discipline in the past. Moreover, the EFSF/ESM scheme may not have turned out as flexible as markets would like, as it is not allowed to buy debt at the secondary market. It seems that core members insisted on restricting bonds purchases at the primary market, as this will reassure seniority and facilitate the implementation of conditionalities. We view this constraint to play out as spreads widening to unsustainable levels in the event that banking recapitalization costs in Spain rise dramatically, as the mechanism cannot intervene to stem panic. ESM seniority along with private participation in losses may scare new private investors away from periphery sovereign debt as their bonds will have junior status. Hence, spreads may remain wide beyond 2013, despite efforts by periphery members to restore credibility, limiting their ability to return to markets for borrowing at affordable costs.

In the US, most indicators confirm that the economic recovery has strengthened, with real GDP retrieving its pre-recession level. Despite the continuing weakness of the housing market and private sector deleveraging, real economic activity accelerated further in Q4 2010, driven by final domestic demand and not by inventory rebuilding as had been the case at the beginning of the recovery. The most upbeat economic news has been the improvement in the labor market, with the rate of unemployment falling almost 1% over the last three months. The persistence of above-trend growth over the next quarters will probably translate into higher gains in employment growth, pushing the unemployment rate down towards 8.0% by year-end 2011. However, the risk presented by rising commodity and, particularly, oil prices has intensified. Rising food and energy prices exert upward pressure on inflation. The upward trend in core PPI suggests that the ongoing price pressures in core prices will continue to build in 2011. According to our estimates, higher oil prices will pull down US growth in 2011 by about 0.5%-0.6%. Overall, we expect the US economy to grow by 3.2% in 2011 from 2.8% in 2010, boosted by the ongoing fiscal and monetary stimulus. Beyond 2011, however, we believe that structural weaknesses are likely to cause the economy to slow, as policy support is withdrawn.

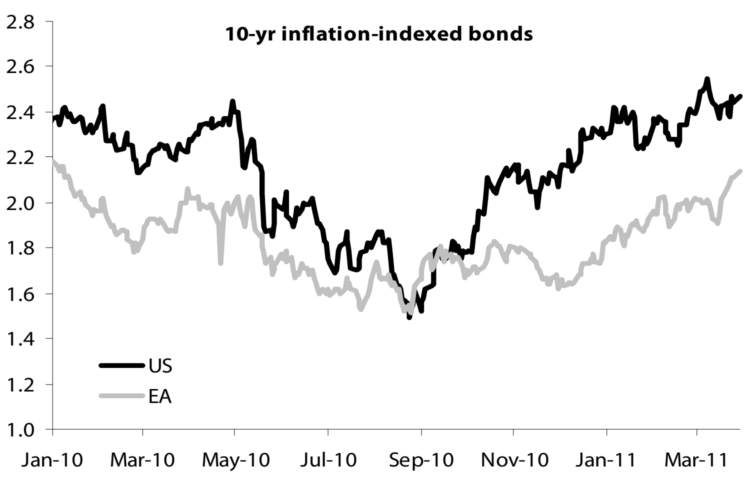
In 2010, emerging market (EM) economies expanded more than twice as much as advanced economies (8.0% and 3.5%, respectively)[1]. Looking ahead, we expect EMs to continue to fuel the global recovery, though their growth is expected to moderate in response to the gradual withdrawal of policy stimulus and policy tightening measures. The latter are mainly a result of mounting inflationary pressures, stemming from rising commodity prices and particularly food prices. Notwithstanding the recent drop in food prices from their peak in early March, we expect inflation in EM to remain elevated until mid-2011, given that a price shock to international food prices feeds into local consumer prices with a time lag of around six months. 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. These factors are extreme weather conditions, geopolitical turmoil, expanding income and population growth and structural changes in consumption patterns in emerging economies.

Headwinds to global growth due to mounting inflationary pressures.

Inflationary pressures are mounting (Figure 4) on the backdrop of rising commodities and have led us revise upwards our headline inflation projections for 2011. Commodity prices are expected to remain elevated due to abundant liquidity and strong demand, particularly by emerging markets, posing a major challenge to growth. In addition, Japan is expected to ramp up oil imports to offset the energy loss from the destroyed nuclear plants, as well as building material imports for reconstruction purposes. Rising inflationary expectations, combined with elevated unemployment, create a dangerous mix for the global economy. Terms of trade worsen for households, whose purchasing power declines, as well as for manufacturers, who confront increasing input prices. Given that unemployment is high and households in several developed countries are still deleveraging, firms posses a diminished pricing power, implying reduction in their profit margins. This in turn, may put a lid in production and in manufacturers hiring plans, eventually constraining global growth. Inverstors sentiment will likely remain volatile in view of risks of oil supply disruptions due to ongoing upheaval in the North Africa/Middle East region.

We view an escalation of political unrest in oil producing countries as a serious headwind to global growth. The main risk stems from political tensions spilling over to major oil producers, most notably Saudi Arabia. Although not very likely, if this scenario materializes, oil prices are expected to skyrocket. While gradual oil price hikes may reduce global growth but are unlikely to derail the recovery, a sharp increase could throw the global economy back into recession. The impact would likely be even more severe, given that countries remain rather vulnerable to economic shocks, as there is not much room for economic policy to accommodate an oil shock. The fiscal stance in several economies is already overstretched, while monetary policies extremely loose.

Figure 4



Source: Bloomberg

[1] *IMF, World Economic Outlook Update, January 2011*

Monetary policy: attention shifted to rising inflationary pressures.

In light of climbing inflation fears, several central banks have been tightening their monetary policy to curb inflationary expectations and prevent rising commodity prices from spilling into core inflation. This is most evident in emerging markets that experience high growth rates, as domestic demand driven inflationary pressures are amplified by imported inflation. Hence, second round effects from commodity prices are easier to appear in developing countries.

In the event of escalating oil price pressures, we view risks to our global growth outlook stemming from central banks engaging in abrupt monetary tightening, in their attempt to anchor firmly inflation expectations. Strict monetary policy combined with the fact that several major economies have embarked on fiscal consolidation, would create a policy mix that could hurt the global economy.

In the developed world, we view the ECB as the most likely candidate for a pre-emptive interest rate hike in April, as headline inflation has recently climbed above the ECB's comfort level of 2%. In the last meeting, the ECB switched to a rather hawkish rhetoric, taking markets by surprise. We now expect the first rate hike as early as in April, as opposed to our previous call for a rate hike taking place in the fall. We believe that the remaining vulnerabilities of the euro zone and especially its banking sector plagues do not bode well with such an early rate hike. In this context, we interpret the ECB's hawkish stance as an intention to send a clear message of its independence. Not least, it also sends a clear message to the sovereigns that they need to adhere to their fiscal consolidation plans.

In sharp contrast to the ECB that seems to focus on headline inflation, the Fed insists on a dovish approach as it focuses on core inflation, which is rather subdued. While endorsing a more upbeat tone in its last meeting, the Fed will complete the second round of its asset purchase program. Unless commodity price hikes and increased inflation expectations prove more sustained, we expect the Fed to hold its policy rate near zero until December. With inflation expectations remaining at currently elevated levels and labor market conditions improving, the risk of an early tightening (likely in September) is on the upside. We view that withdrawal of excess liquidity by the Fed sooner rather than later would help keep commodity prices close to levels justified by global fundamentals.

II. Global Economic Outlook

1. The US economy

Dimitris Malliaropulos, Olga Kosma

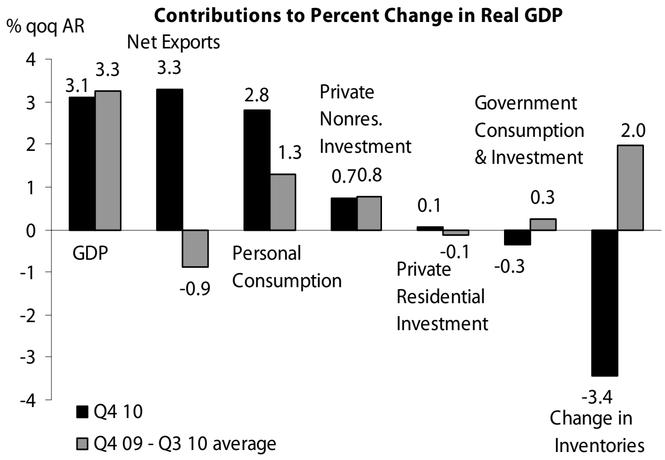
- Recent data suggest that the US economic recovery has strengthened, with real GDP retrieving its pre-recession level in Q4 2010.
- Boosted by the ongoing fiscal and monetary stimulus, we expect US economic growth to accelerate to 3.2% in 2011 from 2.8% in 2010, despite the continuing weakness of the housing market and private sector deleveraging.
- Beyond 2011, we believe that structural weaknesses are likely to cause the economy to slow, as policy support is withdrawn.
- The persistence of above-trend growth over the next quarters will translate into higher gains in employment growth, pushing the unemployment rate down towards 8.0% by year-end 2011.
- Rising food and energy prices exert upward pressure on inflation. The upward trend in core PPI suggests that the ongoing price pressures in core prices will continue to build in 2011.
- Unless commodity price hikes prove more sustained and core inflation climbs markedly, we expect the Fed to hold its policy rate near zero into early 2012.

Overview

Recent economic data suggest that the US economic recovery has strengthened, with real GDP retrieving its pre-recession level. Despite some ongoing weaknesses concerning the housing market and private sector deleveraging, real economic activity accelerated to 3.1% quarterly annualized rate in Q4 2010, driven by final domestic demand and not by inventory rebuilding as had been the case during the early stage of the recovery (Figure 1.1). The most upbeat economic news has been the improvement in the labor market, with the rate of unemployment falling almost 1% over the last three months. Leading indicators reveal a continuation of solid activity in the following months, with the ISM manufacturing index increasing in February to 61.4, its highest level since May 2004. The survey results confirm that the recovery is no longer confined to the manufacturing sector, but spread more widely to the non-manufacturing sector. The non-manufacturing ISM index rose to 59.7, reporting its highest reading for the last 5.5 years (Figure 1.2). The details of both surveys are very positive for all sectors of the economy, including business activity, new orders, production and employment. The only negative point was the rise in the prices paid indices, reflecting the sharp rise in commodity prices.

Indeed, the risk presented by rising commodity and, particularly, oil prices has intensified. The price of Brent crude oil has risen to $115/barrel at the end of March from $73/barrel at the end of last summer, following sharp increases since mid-February owing to the Middle East political turmoil. According to the Fed, a rise in the price of oil of $10/barrel, if sustained for a year, could shave about 0.2% from real GDP growth. According to our estimates, higher oil prices will pull down US growth in 2011 by about 0.5%-0.6%. Overall, we expect the US economy to grow by 3.2% in 2011 from 2.8% in 2010, boosted by the ongoing fiscal and monetary stimulus. In contrast to Europe, US authorities passed a deal regarding tax policy (business and payroll tax cuts of about 200bn) effective in January for the next one to two years, while launching a $600bn large-scale asset purchase program until mid 2011. Beyond 2011, however, we believe that structural weaknesses are likely to cause the economy to slow as policy support is withdrawn. Hence, we expect a slowdown in real economic activity to 3% in 2012, with a combination of tighter fiscal and a gradually tightening monetary policy.

Figure 1.1



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

Figure 1.2

Source: Bloomberg

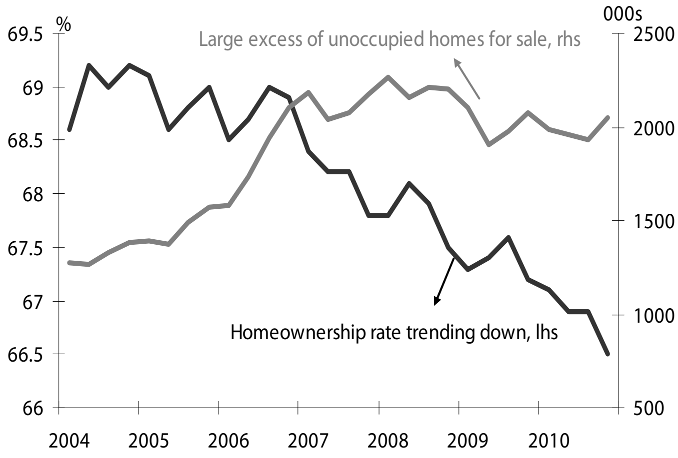
Signs of a self-sustaining momentum, with economic activity recovering to pre-recession levels

According to the third estimate of BEA, real GDP retrieved its pre-recession level in Q4 2010, increasing 3.1% q-o-q saar. Real final sales of domestic product -GDP less change in private inventories- surged 6.7% q-o-q saar, reporting the strongest reading in more than 7 years. Real economic activity is no longer driven by a temporary inventory cycle, but by robust underlying demand, with private consumption reporting an impressive increase of 4.0% q-o-q saar in Q4, the strongest reading by far for more than 4 years. Real personal consumption actually surpassed its pre-recession level, contributing 2.8% to real GDP growth (Figure 1.1). Reinforcing the positive outlook for 2011, retail sales rose 1% m-o-m in February, following an upwardly revised 0.7% m-o-m (from 0.3%) in the previous month. The new payroll tax cut agreed to compensate for the expiring Making Work Pay (MWP) tax credit, the extension of the Emergency Unemployment Compensation program and the extension of the Bush 2001/2003 tax cuts seem to be supporting the strong momentum of personal consumption into 2011.

Our forecasts are consistent with a slower but still solid pace of consumer spending in Q1 2011. Real personal consumption expenditures have increased by a total of 0.2% in the first two months of Q1 2011, while the respective increase in Q4 2010 was 0.8%. In addition, core retail sales -excluding gasoline, auto dealers and building materials- were at 4.4% in February on a 3-month annualized basis, robust but more moderate than the extraordinarily strong 6.5% in December. In line with the softness in the retail sales trend, the University of Michigan index of consumer confidence dropped to 68.2 in March after successive increases that drove the headline index to 77.5 in February. Consumer confidence was probably hit by higher gasoline prices and the Middle East political turmoil, with the future expectations index declining by 13.3pp and the present conditions index by 3.3pp. Furthermore, the Conference Board's monthly consumer confidence survey dropped sharply in March to 63.4 from an upwardly-revised level of 72 in February, driven by a more pessimistic consumers' assessment of future economic conditions. According to our estimates, private consumption growth will slow to around 2.5% q-o-q saar in Q1 2011 from a rapid 4.0% in the final quarter of 2010. Supported by improving labor market conditions and fiscal transfers including the payroll tax cut, real personal consumption growth will accelerate gradually in the remainder of the year towards 3.5%-4.0% q-o-q saar, with an average growth rate close to 3.2% y-o-y in 2011 from 1.8% in 2010.

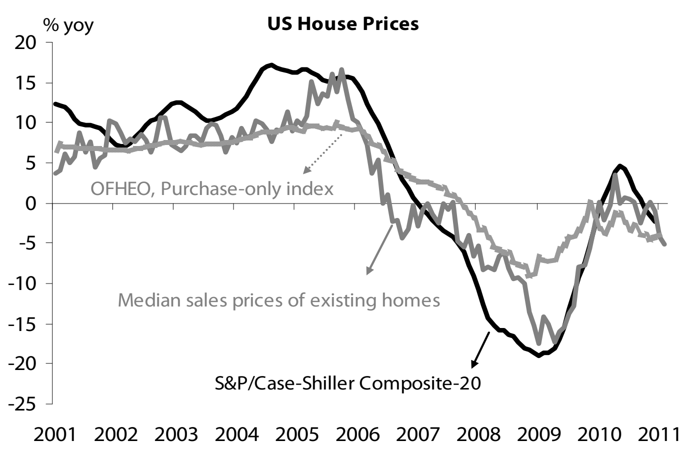
Real nonresidential fixed investment accelerated to 6.8% in Q4 2010, from 1.5% in the previous quarter, contributing 0.7% to real GDP growth. In line with our forecasts in our previous Global Issues, spending on equipment and software slowed to a 7.7% quarterly increase in Q4 2010, from an average of about 19% in the previous four quarters. In contrast, investment spending on structures turned positive in Q4 (+7.6% q-o-q saar) after a nine-quarter streak of consecutive declines. Given the negative quarterly rates in core durable goods orders in January and February, which closely track domestic capital spending on equipment and software, we expect a slower beginning to investment in Q1 2011. However, it is well known that durable goods orders are exceptionally noisy, so we keep our positive outlook for nonresidential investment and expect a positive payback in March. Industrial production of business equipment continues its upward trend and the industrial surveys surprise on the upside, with the Philly Fed survey of capex spending plans surging to an 11-year high in March. Given the favorable treatment of capital equipment in the recently passed tax package, we still expect strong equipment and software spending in 2011, with an average close to 12% from 15% in 2010.

Figure 1.3



Source: US Census Bureau, Ecowin

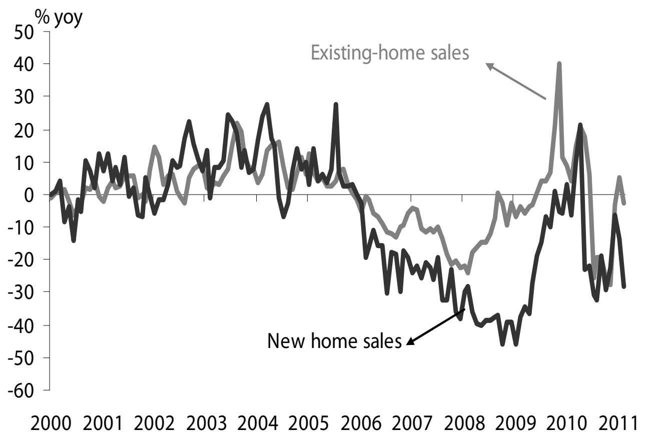
Figure 1.4



Source: FHFA, US Census Bureau, Bloomberg

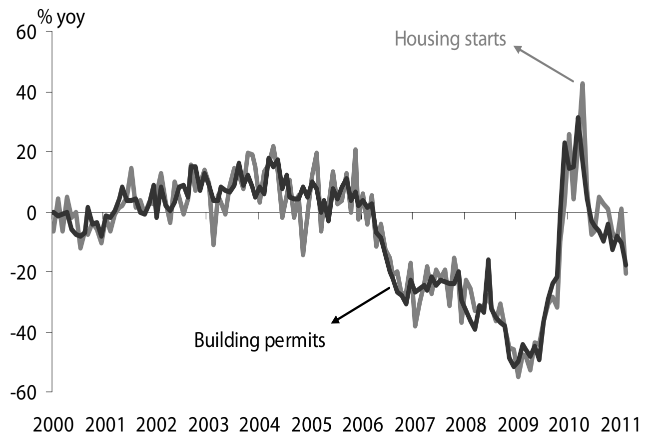
Residential investment rose 3.3% q-o-q saar in Q4 2010 after falling 27.3% in Q3, contributing a mere 0.07% to real economic activity. The housing recovery is being protracted, given the massive overhang of excess supply (Figure 1.3). House prices are falling again after a short period of stabilization driven by the now-expired tax credit. According to the latest data released, the S&P/Case-Shiller index covering the 20 largest metropolitan areas declined by 0.4% m-o-m in December, pushing the annual growth rate down to -2.4%, the largest decline in a year (Figure 1.4). February's data for home sales have reinforced the view that the property market is still a black spot for the recovery, as existing home sales declined 9.6% m-o-m, after three months of solid increases, while new home sales plummeted 16.9%, falling to the lowest reading (250k) since the records began in 1963 (Figure 1.5). Meanwhile, housing starts remain well depressed by historical standards. February data revealed a 22.5% m-o-m collapse, bringing the annual average down to about -21%. Last but not least, building permits have lost about 15.5 over the last couple of months, bringing the annual average down to about -18%, the lowest annual rate since October 2009 (Figure 1.6). Our view for a prolonged housing recovery remains intact, with residential investment picking up only gradually over the course of the year to about 3% in 2011 after falling 3% in 2010.

Figure 1.5



Source: US Department of Commerce, National Association of Realtors

Figure 1.6



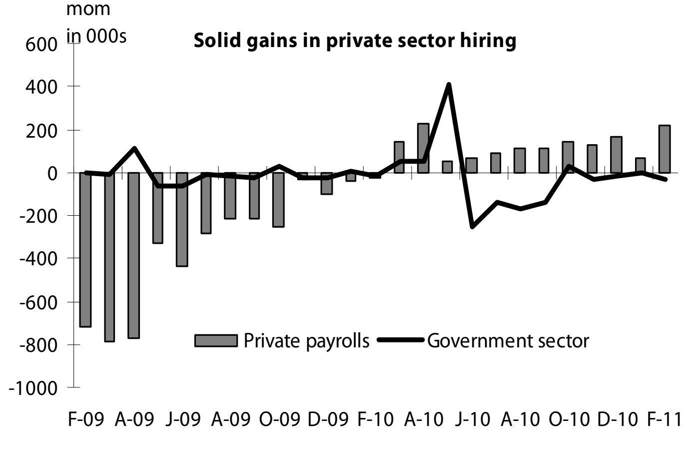
Source: US Department of Commerce

Significant contribution to headline growth in Q4 2010 did not come only from personal consumption expenditures, but also from an improvement in net trade (+3.3pp), primarily due to the sharp fall in imports. Imports of goods and services collapsed 12.6% q-o-q saar, after three consecutive quarters of double-digit growth, while exports remained resilient with a 8.6% quarterly annualized growth, after rising 6.8% in the previous quarter. The collapse in imports was mostly attributed to the swing in the inventory cycle. The change in inventories subtracted 3.4% from Q4 real GDP growth, marking the end of the inventory cycle. For the year 2010 as a whole, net exports subtracted 0.6% from real economic activity, because the rise in imports outweighed the rise in exports as producers built up production and accumulated inventories. Given the correlation between inventories and imported goods, we anticipate that inventories will subtract from real GDP in the coming quarters as trade contributes positively well into 2011. Although the trade deficit widened in January to $46.3bn from $40.3bn in the previous month, we expect a narrowing in the trade balance for the following months, with trade contributing positively to US growth in the first quarter of the year.

Gradual improvement in the labour market

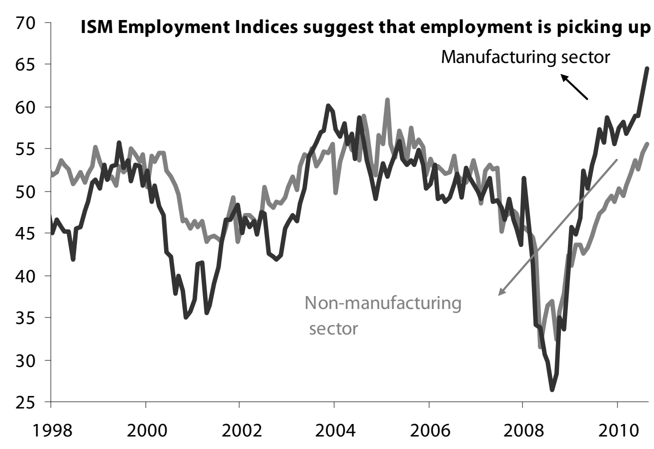
Another sign that the economic recovery is on a self-sustaining path is the improving underlying trend in job growth. The February employment report came in stronger than the consensus expected, with nonfarm payrolls increasing 192k, a substantial improvement from the upwardly revised level of 63k in January. Private sector hiring reported a 222k gain, with the two previous monthly gains revised higher. The gain in private payrolls contained a welcome bounce back after the weather related disruption in January, but nevertheless marked the twelfth consecutive monthly gain (Figure 1.7). Meanwhile, the unemployment rate also declined to 8.9% in February from 9% in the month prior, as the household survey showed a pickup in employment, while the labor force participation rate remained unchanged. The unemployment rate has now fallen almost 1% over the last three months, while the median duration of unemployment has been on a downward trend over the last couple of months. Consistent with the gradual improvement in the labor market, the decline in weekly jobless initial claims has accelerated in recent weeks, driving the four week average of initial unemployment claims down to the level crossed in mid 2008 (~386k), close to its long-term average. Meanwhile, the Employment index in both the manufacturing and the services sectors increased further in the first two months of 2011, with the manufacturing sector ISM Employment index surging to 64.5 in February. Moreover, the March ADP National Employment Report estimate of private employment growth removes any remaining doubt that private nonfarm payroll employment accelerated heading into 2011. Private-sector employment increased by 201k from February to March on a seasonally adjusted basis, with the manufacturing sector employment reporting the largest increase in jobs since the series started in December 2000. Our job market model suggests that the positive trend in employment growth that started in September 2010 will accelerate gradually well into 2011, with civilian employment growth increasing to a year average of 1% in 2011 from -0.2% in 2010 (Figure 1.9). According to our estimates, the persistence of above-trend growth over the next quarters will translate into higher gains in employment growth, pushing the unemployment rate down towards 8.0% by year-end 2011.

Figure 1.7



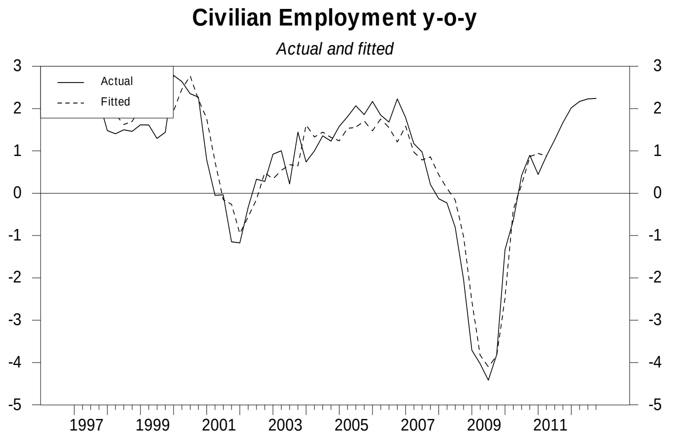
Source: Bloomberg

Figure 1.8



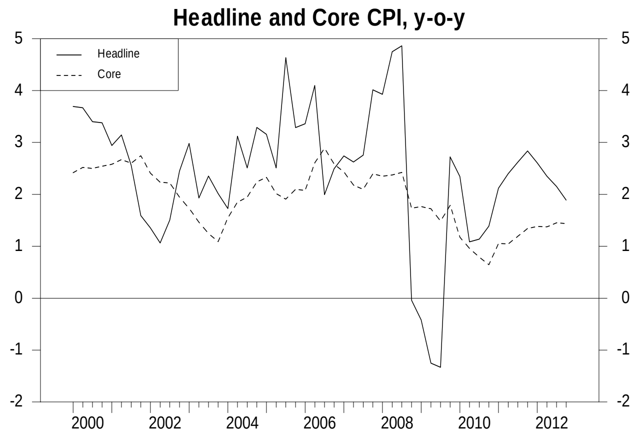
Source: Bloomberg

Figure 1.9



Source: Eurobank EFG estimates

Figure 1.10



Source: Eurobank EFG estimates

Rising food and energy prices exert upward pressure on inflation

The February CPI report came in stronger than expected, with both headline and core inflation surprising to the upside. Headline CPI rose by 0.5% m-o-m, after a 0.4% gain in January and another 0.5% gain in December, on the back of higher food and energy prices. Energy prices have been rising since mid 2010 -reflecting increased demand as the global economy picked up-, and the upward trend was reinforced by the recent turmoil in the Middle East, particularly the fighting in Libya. Moreover, food prices reported their strongest monthly gain in the last 2.5 years, suggesting that soaring commodity food prices have started to push up food costs for consumers.

While higher food and energy prices led the gain, core CPI (excluding energy and food components) also advanced 0.2% for the second consecutive month, reporting the highest monthly increase since October 2009. Strength in core prices was not only attributed to the upward trend in the rent of shelter indexes, which account for a large share of the core CPI basket, but was rather more broad based. The CPI report in February provided evidence of core unexpected strength in both core durable and nondurable goods prices. Moreover, the trend in core PPI suggests that the ongoing price pressures in core prices will continue to build in 2011.

Meanwhile, the University of Michigan index revealed that one-year inflation expectations surged to 4.6% in March from 3.4% in February. Looking back, there have only been three occasions since 1983 when one-year inflation expectations in the University of Michigan survey have increased that high (1990, 2005 and 2008). In all these occasions, the headline price consumer index has subsequently surged to an average of 5.5%. Although we see inflationary pressures mounting, we expect them to only gradually translate into higher core inflation, as unemployment and excess capacity remain high. We expect average headline CPI inflation to increase to 2.8% in 2011 from 1.6% in 2010 and, average core inflation to 1.3% in 2011 from 1% in 2010.

Fed to hold its policy rate near zero until December, unless commodity price hikes prove more sustained

While tighter monetary conditions pervade in the rest of the world, monetary policy in the US remains supportive. The Fed seems determined to complete -but not extend- its $600bn program of purchasing longer-term US Treasuries in mid 2011. The end of the large-scale asset purchases will mark an important turning point, as the Fed will gradually start preparing the ground for monetary tightening. The March FOMC statement reflected an upgrade to the US economic outlook, with the recovery on a "firmer footing" and the labor market conditions "improving gradually", even as new global risks have intensified. Higher commodity prices have led towards a more hawkish tone, moving away the deflationary fears. The committee changed its description of inflation, recognizing that it is "subdued", as opposed to "trending downwards". Pointing to concerns about oil price hikes as contributing to elevated inflationary pressures, the FOMC stated that it would pay "close attention to developments in inflation and inflation expectations". Unless commodity price hikes and increased inflation expectations prove more sustained, we expect the Fed to hold its policy rate near zero until December. With inflation expectations remaining at currently elevated levels and labor market conditions improving, the risk of an early tightening (likely in September) is on the upside.

2. The Euro area economy

Dimitris Malliaropulos, Vasilis Zarkos

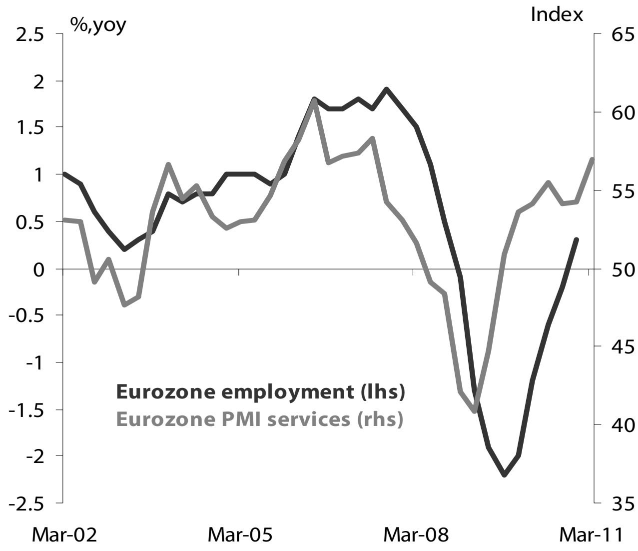
- The euro area recovery remains on track, though the divergence between core and periphery persists.
- Doubts remain whether recent agreements on the permanent crisis resolution mechanism may facilitate the return of weak members to markets for borrowing at affordable costs.
- Downside risks to our growth outlook stem from a deterioration in terms of trade due to rising commodity prices.
- The ECB seems determined to defend its price stability mandate by raising rates as early as April. Nonetheless, it is expected to follow the separation principle and maintain its liquidity provision tools for weak members.

Positive underline momentum will support a moderate euro area recovery.

Recent soft and hard data bode well for stronger growth in Q1, after a shortfall in the final quarter of 2010, mainly due to unusually harsh weather that postponed construction activity. The German Composite Ifo index has risen to record high levels, while high values of the PMI services index confirm the broadening of the recovery (Figure 2.1). Industrial new orders have been improving steadily since October on a month-on-month basis as they benefited from a surge in global demand, pointing to a strong Q1.

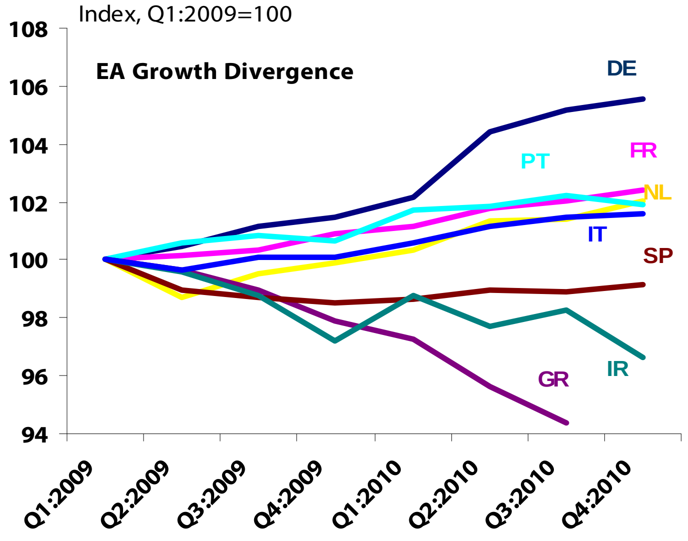
Looking ahead, we expect slower growth in Q2, as the gains from the winter effect that postponed activity in Q4 are expected to fade. Although edging higher, the PMI services index shows signs of flattening. The manufacturing component in March slipped lower, implying that it has peaked. This is in line with the expected downbeat tone in leading indicators post Q1, on the backdrop of rising commodity prices and a likely fall in external demand due to monetary tightening in several emerging markets. In addition, recent fall in PMI indices in several emerging markets, including China, signal a less upbeat economic activity. Yet, we view this as a normalization of GDP growth rather than a worrisome trend reversal.

Figure 2.1



Source: Bloomberg

Figure 2.2



Source: Bloomberg

We expect modest increase in personal consumption, mainly in core countries, on the grounds of strong economic sentiment and improving labor market conditions. Euro area employment growth turned positive in Q4 for the first time since the end of 2008. Moreover, investment expenditures are likely to post bigger contributions to GDP growth than in the previous year, on the backdrop of strong global growth that keeps exports in robust shape. As noted in our previous issue, we see scope for capital formation. Recent encouraging figures of new orders for capital goods coupled with rising capacity utilization are in line with our assessment. Despite relatively tight credit conditions, companies are able to fund their investment plans through their cash rich balance sheets.

That said, the divergent growth pattern (Figure 2.2) is expected to continue as Germany remains the locomotive of the euro area recovery, whereas the debt laden periphery struggles to regain markets confidence through severe fiscal retrenchment. Despite strict fiscal austerity, markets remain concerned about the sustainability of debt dynamics of weak members. As a result, pressures on funding costs in the periphery remain elevated.

Spain is of particular concern due to the critical size of its economy and the implied amount of rescue funds in case borrowing costs become prohibitive. However, Spain seems to have decoupled from Greece, Ireland and Portugal, making a bailout less likely, as the Spanish government has set forth several structural reforms which have had a positive impact on its debt dynamics outlook. Recent data confirm achievement of 2010 budget execution goals. That said, Spain remains vulnerable to sovereign debt crisis contagion due to its fragile banking system. The stress test results may reveal that the cost of recapitalization of savings banks to the state may exceed government estimations, affecting adversely Spain's rising public debt. The final recapitalization cost depends on the ability of savings banks to raise capital directly in the markets, in order to fulfill capital requirements (set at 8%-10% of risk weighted assets). Although non performing loans have not risen dramatically, risks are to the downside, given the anemic growth rate and high unemployment. Rate hikes by the ECB would affect adversely mortgage loans, as the majority of them are denominated at floating rate. Our outlook for the Spanish economy remains weak due to record high unemployment and the deleveraging private sector which is expected to constrain private demand. External demand remains the major source of growth.

The Irish banking system remains under severe liquidity pressure and is heavily dependent on the ECB for funding. By the end of 2010, borrowing from the ECB stood at about €94bn, in addition to €51bn from the central bank of Ireland, through the Emergency Liquidity Assistance scheme. As of December 2010, deposits from the private sector have declined 8.5% on a y-o-y basis. According to IMF data, non performing loans have risen to 10.4% of total loans (June 2010), compared to 0.8% in 2007. With house prices still declining, skyrocketing unemployment and 40% of outstanding loans to the private sector extended for house purchases, risks for the final cost to the sovereign of bailing out the Irish banking sector are to the upside.

Towards enhanced economic governance. Concerns remain.

At the recent summits, euro area leaders agreed on a series of measures aiming at alleviating market concerns and backstop contagion fears over the sovereign debt crisis in weak periphery members. Most notably, the euro area countries agreed on the following:

1. The ESM, effective on June 2013, will have an overall lending capacity of €500bn, while the lending capacity of the EFSF of the €440bn will become fully effective. We note that before recent decisions, the EFSF's effective lending capacity was restricted to €260bn, due to over-collateralization in order for the mechanism to achieve an AAA rating. Details on the funding structure of the EFSF have been postponed until June.
2. On exceptional occasions, the EFSF and the ESM are allowed to buy government bonds at the primary market. This kind of financial aid will come with strict conditionalities under an adjustment program.
3. Lending rates of the EFSF should be lowered in order to assist debt laden members to redirect their debt dynamics towards a sustainable path.
4. A rule about yearly reduction of public debt by 1/20, in case it exceeds the 60% rule, will be set.

In addition, euro area policymakers have decided to adopt the 'Euro Plus Pact" to strengthen the economic pillar of the monetary union. Six non euro area EU members have adopted the framework, too. The Euro Plus Pact draws from the Competitiveness Pact originally proposed by the German and French governments. The most notable initiatives are the following:

1. Wages should evolve in line with productivity developments

2. Wage setting arrangements, the degree of centralization in the bargaining process and the indexation mechanisms should be reviewed.
3. Measures to improve competitiveness should include further opening of sheltered sectors, efforts to promote R&D, remove red tape and improve the business regulatory framework.
4. Undeclared work and taxes on labor should be reduced
5. The pension system should be aligned to the national demographic situation, while early retirement schemes should be limited.
6. Members commit to introduce a strict and stable fiscal framework with the strongest possible legal basis
7. Bank stress tests will be regularly conducted, to achieve financial stability.
8. Member states commit to engage on discussions about the formation of a common corporate tax base.

As expected, Greece got a reduction of the interest rate on its loans from the EU by 100bps, while the maturity of the loans will be increased to 7.5 years. Assuming that Greece borrows the full amount of €80bn from the EU, the interest reduction translates into a €0.8bn benefit annually. In return, Greece agreed to put forward a €50bn privatization real estate program. Portugal is expected to benefit from an expected spread tightening, on the backdrop of recent developments. However, if worse comes to worse and the country needs to tap the EFSF, it will likely borrow at a lower cost. The upsizing of the funds lending capacity is particularly relevant to Spain, as it means that there will be sufficient funds in the unlikely event the country needs financial support.

Our overall assessment of the March 11 summit is that it surprised on the upside, as euro area leaders managed to reach a binding agreement despite the divergent views on several issues (such as the wage indexation and the constitutional debt brake, to name a few). We view that the euro area sends a clear message that there is political commitment to stand up for the monetary union. In particular, we view the upsizing of the EFSF and the decision to lower the pricing as powerful measures to backstop contagion risk, allowing weak members to borrow at more affordable costs. Moreover, we view commitments on the Euro Plus Pact as the result of tough negotiations between core members and weak countries, as the former require increased fiscal discipline and fiscal monitoring in order to grant financial aid. It is a step towards the right direction in order to strengthen the euro area economic governance and foster rules to prevent imbalances in the future. Ensuring the proper implementation and enforcement of the measures is of critical importance, given the disappointing track record of the Stability and Growth Pact to achieve fiscal discipline in the past.

On the negative side, the EFSF/ESM scheme may not have turned out as flexible as markets would like, as it is not allowed to buy debt in the secondary market. It seems that core members insisted on restricting bonds purchases at the primary market, as this will reassure seniority and facilitate the implementation of conditionalities. We view this constraint to play out as spreads widening to unsustainable levels in the event that banking recapitalization costs in Spain or Ireland rise dramatically, as the mechanism cannot intervene to stem panic. Furthermore, ESM seniority, along with collective action clauses, may scare new private investors away from periphery sovereign debt as they will have junior status. Hence, spreads may remain wide beyond 2013, despite efforts by periphery members to restore credibility, limiting their ability to return to markets for borrowing at affordable costs.

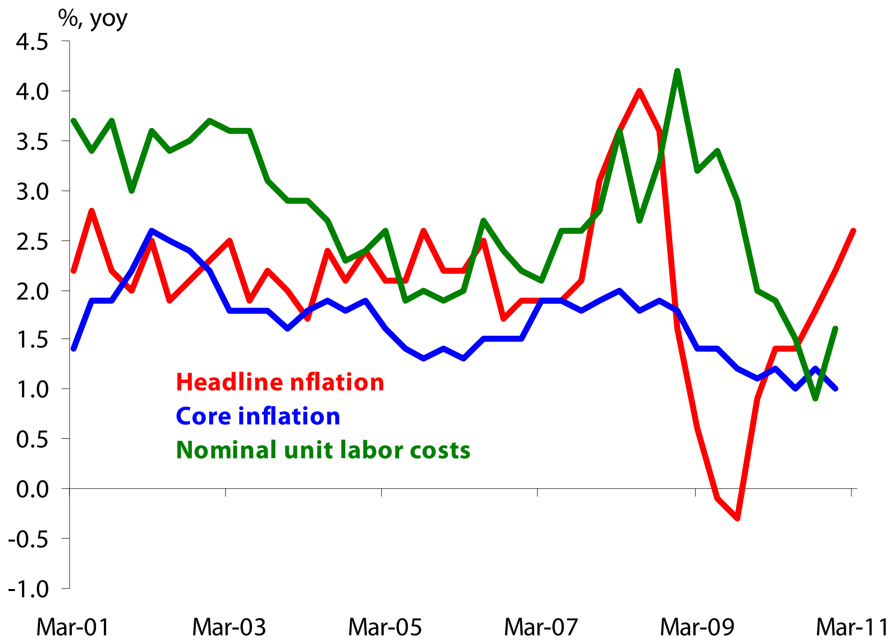
Inflationary pressures pose downside risk to our euro area outlook.

Headline inflation reached 2.4% in February, above the ECB's target of 2% (Figure 2.3). The Producers Price Index has also been soaring up, reflecting rising cost of input goods. Demand for oil is strong on the backdrop of solid global growth and uncertainty on the supply side remains high, as unrest is likely to persist in North Africa and Middle East countries. Hence, oil prices are expected to remain elevated, exerting upward pressure on headline inflation. If geopolitical tensions spread to major oil producers, most importantly to Saudi Arabia, oil prices will likely rise sharply, increasing the risk of unsettling inflation expectations.

We view rising oil and food prices as a major downside risk to our euro area economic outlook. A sustained increase in oil prices is expected to hurt particularly the peripheral countries as it may erode their efforts to improve their competitiveness and their potential to attract foreign investment. As the external sector is the main source of growth for periphery members, a shortfall in expected export activity is likely to deepen the recession and worsen the outlook of public debt dynamics. Consequently, more belt-tightening may be needed, which could challenge the already stretched political willingness to adopt tough austerity measures and social consent to accept more painful austerity measures. On the positive side for the euro area, the strengthening of the euro due to divergent monetary policies by the Fed and the ECB, is expected to diminish the effect of surging commodity prices.

Core inflation is expected to increase at a more gradual pace due to the remaining economic slack. We expect modest increases in personal expenditures, while elevated unemployment will most likely constrain labor unions' power to negotiate higher wages. Nonetheless, we expect positive contributions to core inflation from its two components with the biggest weights, namely transport and housing. Transport is directly affected by energy prices, while ECB data show that housing services prices have likely stabilized at their lowest growth rate, implying faster price rebound in the medium term.

Figure 2.3



Source: Bloomberg

Overall, we expect inflationary pressures to remain upbeat in the first half of the year with a possible easing in the second half, provided that strains in oil producing countries calm down. As a result, we have revised upwards our 2011 outlook to 2.4%.

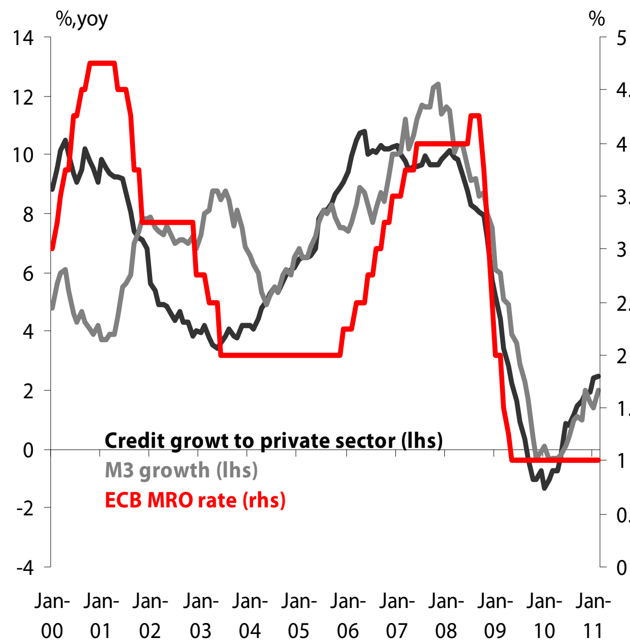
ECB seems determined to defend its price stability mandate.

The ECB will most likely embark on tighter monetary policy in April, by a 25bps rate increase. On the backdrop of strengthening recovery in the euro area, the ECB expressed its concern about price stability due to rising commodity prices. Switching to a clearly more hawkish tone compared to the rhetoric just a month earlier, the ECB seems to favor a pre-emptive action to anchor inflation expectations. However, we view this as a premature rate hike. While improving financial conditions are reflected on the ECB's shrinking balance sheet due to the phasing out of excess liquidity, the euro area banking sector remains under stress. Despite the improvement in terms of money and credit supply growth, a rate hike in April seems rather early, compared to the situation in 2004 (Figure 2.4). In addition, the upper end of the latest ECB staff projection range for 2011 real GDP growth remained intact (at 2.1%), implying that the ECB is not particularly worried about demand driven inflationary pressures. This is in accordance with the remaining economic slack in the euro area economy that limits the dynamic of second round effects on core inflation from rising oil prices. In this context, we view the ECB's hawkish stance as an attempt to send a signal that it remains independent and determined to serve its mandate of price stability. Not least, it also sends a clear message to the sovereigns that they need to adhere to their fiscal consolidation plans.

The ECB is still facing the "one size fits all" problem due to the uneven pattern of the recovery (Figure 2.5). Strong growth and rising inflation in Germany call for tighter monetary policy, whereas the banking sector in periphery members continue to rely heavily on ECB for funding. Hence, the ECB will follow the separation principle, meaning that it will raise rates while keeping in place the exceptional liquidity provision measures, in order to facilitate the undergoing banking sector restructuring process in periphery countries. In particular, the ECB announced that for the next three maintenance periods it will keep offering liquidity with full allotment fixed rate 1-week and 1-month operations, while the 3-month operations remain full allotment at a floating rate (determined by the policy rates prevailing over the life of the operation). In addition, the ECB is expected to continue accepting poor rated assets as collateral throughout 2011. Given that the EFSF is eligible to buy bonds only at the primary market, we expect the ECB to continue buying bonds at the secondary market, though only as a last resort to avert investors' panic.

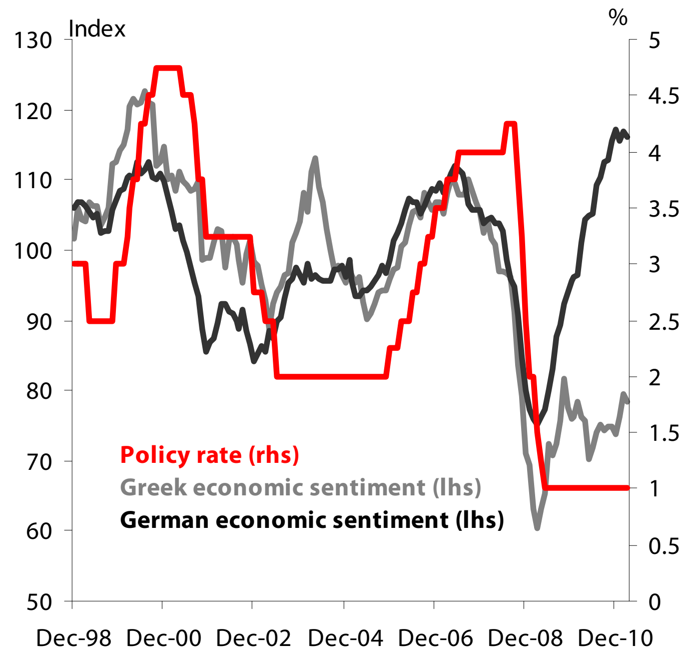
Looking ahead, we expect the ECB to increase its key rate by a total of 75bps until December. Meanwhile, it may shift from full to fixed allotment. In that case, we believe that large amounts will be offered at each fixed allotment operation so as to avoid financial disturbance. The forthcoming stress tests deserve particular attention, as they may have a major impact on markets concerns about the soundness of the banking sector. The restructuring of the Spanish cajas, set to be completed by September, is expected to weigh on future ECB decisions.

Figure 2.4



Source: Bloomberg

Figure 2.5



Source: Bloomberg

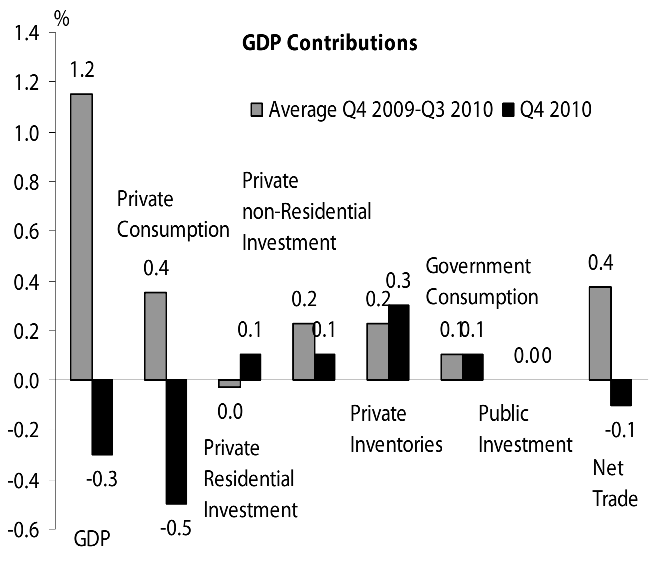
3. The Japanese economy

Dimitris Malliaropulos, Vasilis Zarkos

- The Japanese economy has recovered in Q1 2011 from a fall out in the previous quarter. However, it is expected to slump in Q2 2011 due to the earthquake and rebound thereafter. Power outages and the nuclear threat remain the main concerns with respect to the earthquake.
- Solid global demand is expected to support Japanese exports and capital investment in 2011. However, we expect a smaller positive contribution on GDP from exports in 2011, due to waning base effects and a likely slowdown in emerging markets due to tightening monetary policies.
- Personal consumption expenditures are expected weak, as fiscal stimulus fades and household sentiment deteriorates due to the earthquake.
- The Bank of Japan is expected to maintain its accommodative monetary policy to facilitate the recovery from the earthquake shock.

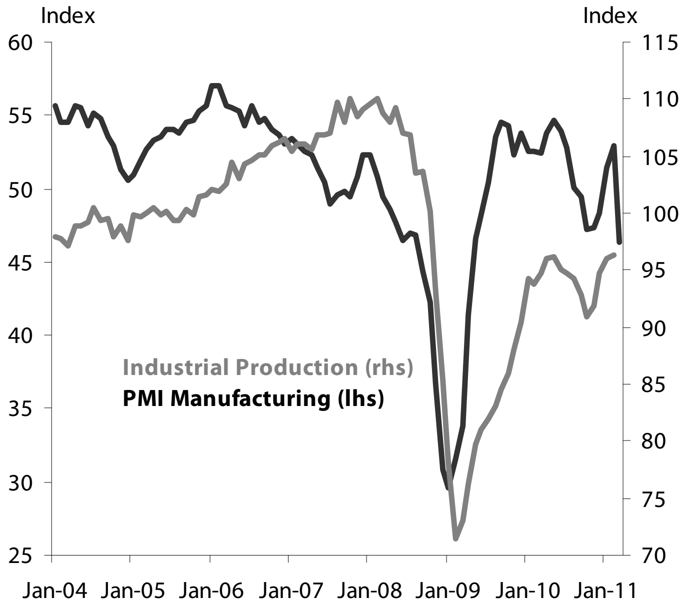
In our view, the recent massive earthquake will likely have a temporary impact on the Japanese economy with a moderate downside effect on 2011 GDP growth. Economic activity will most likely slump in Q2, as is already evident by a sharp decline of the PMI manufacturing index form 52.9 to 46.4 in March. However, we expect the economy to rebound in Q3. Based on the Kobe earthquake experience in 1995, industrial production will certainly fall in the short term, but it is expected to rebound thereafter. Capacity utilization is about 7.5% lower than its average pre-crisis level, suggesting that a pick up in production in other areas of the country may partially compensate for production disruption in the affected areas. Household consumption of the afflicted population is likely to fall. Consumer sentiment in the country may decline in the short term, followed by a rebound later on. We expect a significant boost to the economy from rebuilding of the damaged infrastructure and housing investment. Downside risks stem from prolonged power outages, impeding a fast

Figure 3.1



Source: Cabinet office

Figure 3.2

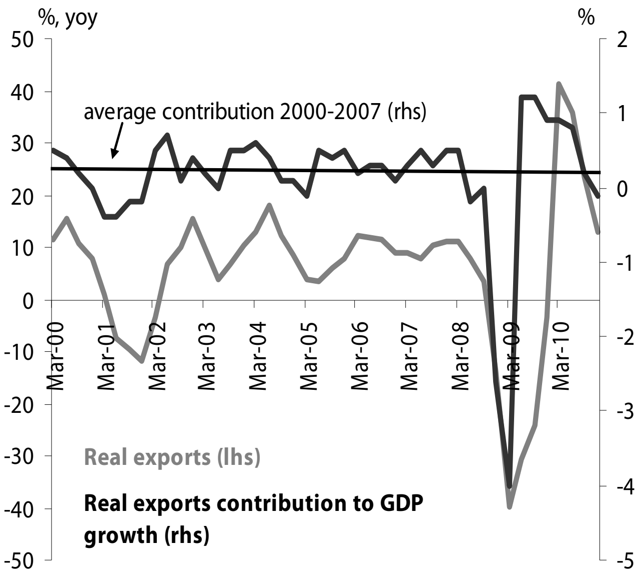


Source: Bloomberg

recovery in industrial production. Our main concern is an escalation of the nuclear crisis that could lead to uncontrolled radioactivity leakage, having a lasting effect on the country's economy. We are optimistic about the earthquake impact on the global economy, as Japan represents a small fraction of imports from developed markets. Limited risk stems from supply chain disruptions.

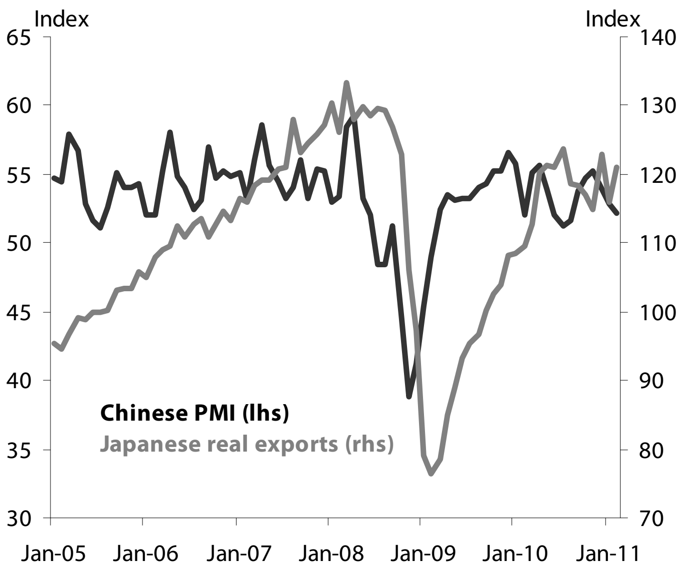
Public finances are expected to be adversely affected, as the government needs to ramp up spending for rebuilding purposes. This comes at a moment when bond markets seem to become increasingly concerned about Japanese public debt that has reached almost 190% of GDP. However, one should note that foreign investors hold a mere 5% of Japan's public debt, while net debt (debt after liabilities of one public entity to another are netted out) stands at about 100%. We also view a likely deterioration in trade balance, as Japan is expected to increase imports of rebuilding materials and energy.

Figure 3.3



Source: Bloomberg

Figure 3.4



Source: Bloomberg

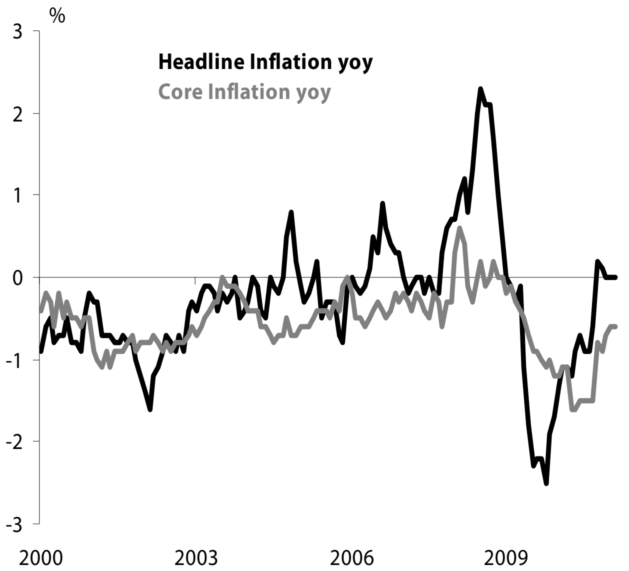
Japanese growth posted a fall out in the last quarter of 2010 by -1.3% annualized (Figure 3.1). From a key growth driver in Q3, private consumption became the main source of contraction, due to the winding down of the subsidies program for eco friendly durable goods. In a similar tone, net exports that dragged the economy out of recession so far, posted a negative contribution for the second quarter in a row, due to a sharp decline in exports, suggesting that the Japanese economy remains vulnerable to business sentiment abroad.

Encouraging consumption and employment data in the US are expected to support Japanese exports and domestic industrial production Q1 2011. Rising demand for capital goods is reflected on recent data for machinery orders, which picked up in January. Orders from overseas jumped by an impressive 71.4% in January after two months of decline. Industrial production has demonstrated a significant rebound, while the PMI manufacturing index had switched to expansionary territory before it slumped in March due to the earthquake (Figure 3.2). However, we expect a smaller positive contribution on GDP from exports in 2011, as their contribution to GDP is expected to normalize towards its long term pre-crisis average, due to waning base effects (Figure 3.3). Furthermore, downside risks to Japanese exports stem from a likely slowdown in emerging markets due to tightening monetary policies. China's PMI dropped in February, possibly signaling a normalization of its growth rate. As correlation between Japanese exports and business sentiment in China has increased (Figure 3.4), a likely soft landing in Chinese activity may imply a less bright future for production in

Japan. This is in line with deterioration in business expectations, as revealed by the latest (February) Economy Watchers Survey.

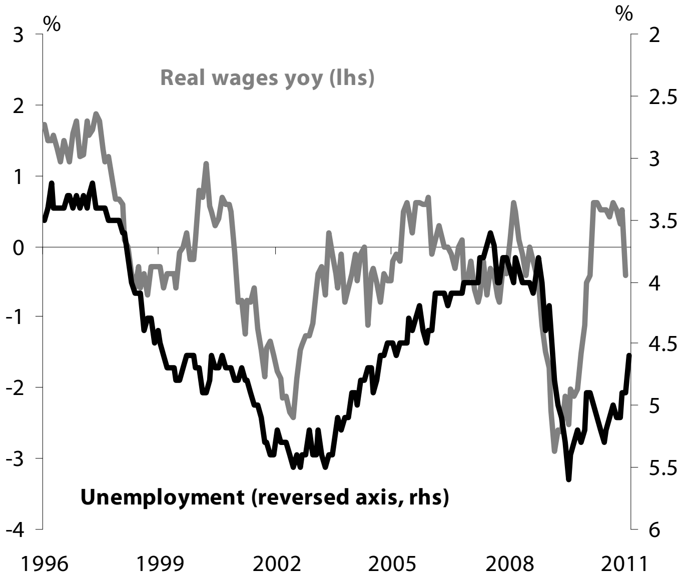
We expect capital investment to pick up, mainly beyond H1, when the country is expected to start recovering from the earthquake. Domestic machinery orders (excluding volatile items), a leading indicator for capital spending, seem to gain momentum, implying a pick up in domestic capital expenditures. On the positive side for capital spending, corporate profits have been increasing strongly for five consecutive quarters, implying that cash-rich firms may be able to finance investment plans.

Figure 3.5



Source: Bloomberg

Figure 3.6



Source: Bloomberg

On the household expenditures front, consumption is expected to remain weak due to the unwinding of fiscal stimulus and the deterioration in sentiment after the earthquake. Wage growth has been anemic, while it returned to negative territory on a yearly basis in January (Figure 3.5). On the positive side for the Japanese consumer, unemployment has been steadily declining. It receded to 4.6% in February, down from 4.9% a month earlier, suggesting that the recovery was on track before the earthquake. The jobs-to-applicants ratio has been moving higher, though at small increments. In the short term, unemployment is likely to follow a bumpy way due to the earthquake disruption. Looking further ahead, we see gradual labor market improvements, as firms are likely to step up hiring in order to address solid global demand.

Worsening terms of trade due to rising commodity prices pose downside risks to GDP growth. Food prices are of particular importance, as they bear an unusually high weight (26%) for an advanced economy on Japanese CPI. The shut down of nuclear plants renders Japan more exposed to oil price movements. We view headline CPI (Figure 3.6) turning slightly positive in 2011. CPI excluding food and energy is expected to remain on negative territory on the backdrop of weak demand and sluggish growth of real wages.

In light of the modest recovery pace, monetary policy is expected to remain accommodative throughout 2011. To assure normal functioning of the financial system in the aftermath of the earthquake, the Bank of Japan decided to inject increased amount of liquidity while it doubled its assets purchase program to ¥10tn. Most of the purchases are directed to commercial paper and corporate bonds, suggesting that the central bank intents to assist firms having difficulty in tapping markets for funding due to poor credit rating. An upsizing of the assets purchase program is likely, particularly if the impact from the earthquake proves stronger.

4. Emerging Markets

Dimitris Malliaropulos, Maria Prandeka

- The global growth recovery is expected to continue to be fueled by emerging economies, where fundamentals are stronger.
- Growth in emerging and developing economies is expected to moderate in 2011, in response to the gradual withdrawal of policy stimulus and policy tightening measures.
- The major challenge to the emerging markets growth outlook is inflationary pressures that have already started to mount, owing to rising food and commodity prices.

With domestic demand particularly resilient, improving labor market conditions and a strong bounce back in external trade, emerging and developing economies expanded more than twice as much as advanced economies in 2010 (8% and 3.5%, respectively)[2]. Their economic prospects remain robust due to stronger fundamentals, such as a less leveraged private sector and better external balances. Thus, 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[1], in 2011, growth in emerging and developing economies is expected to moderate to a still buoyant growth rate of 6.5%, significantly higher than the expected growth rate of 2.5% in advanced economies. Indeed, the contribution of EMs real GDP growth to global growth (measured in ppp) is expected to be almost double that of advanced economies. Although advanced economies account for the biggest fraction of global GDP in terms of purchasing power parity (53%), EM economies have increased significantly their share in global GDP since 2000 (from 37% to 47%) 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 (63% in 2000).

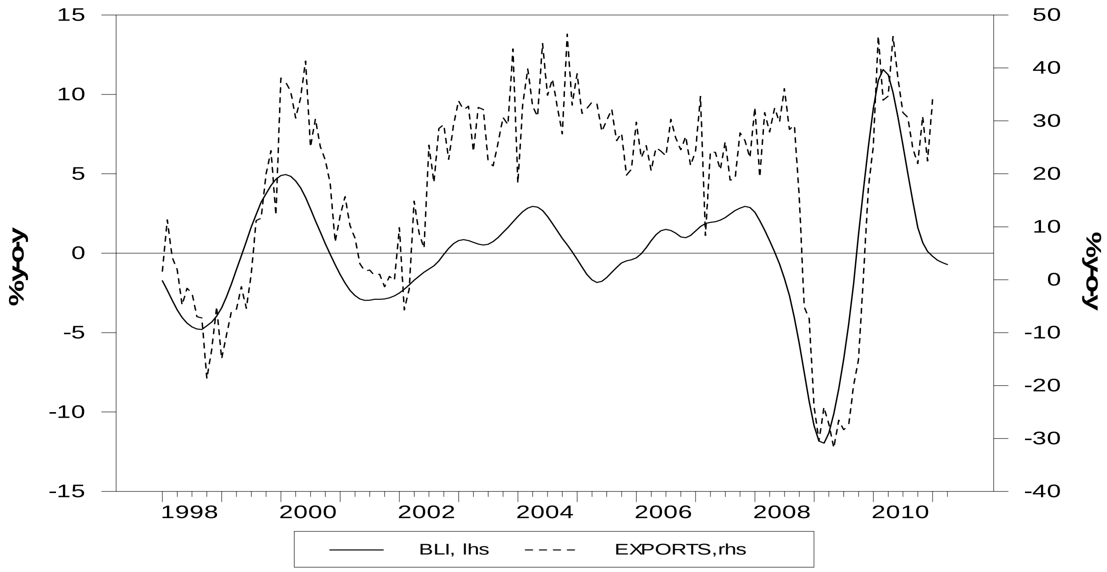
We continue to believe that the major risk to the EMs' upbeat growth outlook is inflationary pressures, stemming mainly from rising commodity prices and particularly food prices. Indeed, consumer prices in EM economies are projected to increase by 6% in 2011, compared to 6.3% and 5.2% in 2010 and in 2009, respectively. 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. In contrast, commodity producers, such as Brazil, are more resilient given their limited dependence on exports and their reliance on domestic demand. On the monetary policy front, EMs' central banks have already shifted to a tightening monetary stance 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, such tightening can exacerbate strong capital inflows into commodities and other assets in EMs, due to interest rate differentials given that G3 central banks are still keeping interest rates at historical lows. The persistent strength in private capital inflows raises substantive concerns for EMs' authorities, as it generates currency appreciation pressures and feeds credit and asset bubbles at a time when inflation and overheating constitute major concerns. In the meantime, EMs are trying to prevent a nominal appreciation via foreign exchange intervention. As Figure 4.2 depicts, the real effective exchange rates appreciate, given that inflation is rising in these countries. 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 4.1).

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 a

[2] *IMF, World Economic Outlook Update, January 2011*

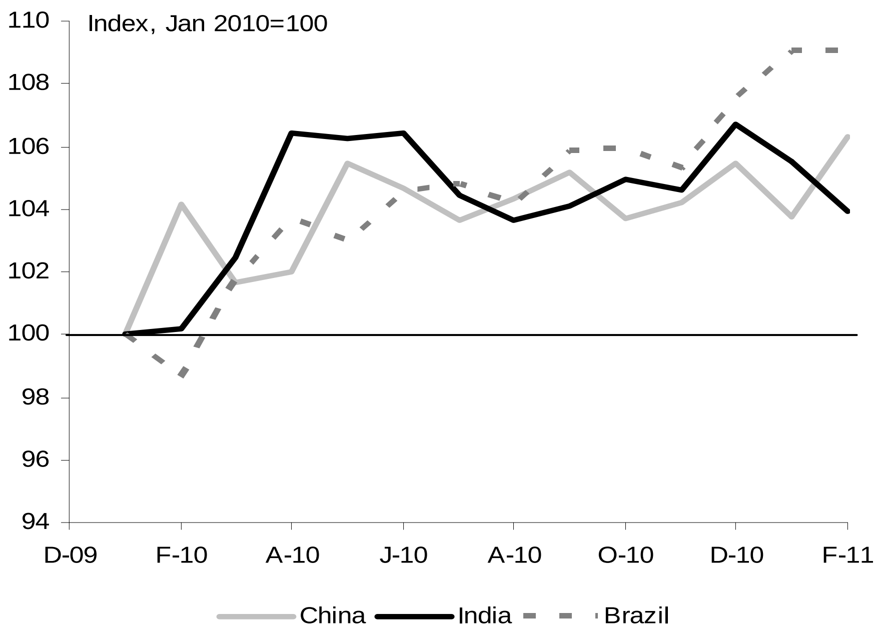
slowdown in the Euro area -its main trading partner- due to the impact of fiscal austerity measures on EA's real economic activity.

Figure 4.1
BRICs Leading Indicator*



** 3 month forward*
Source: Eurobank EFG

Figure 4.2
Real Effective Exchange Rate



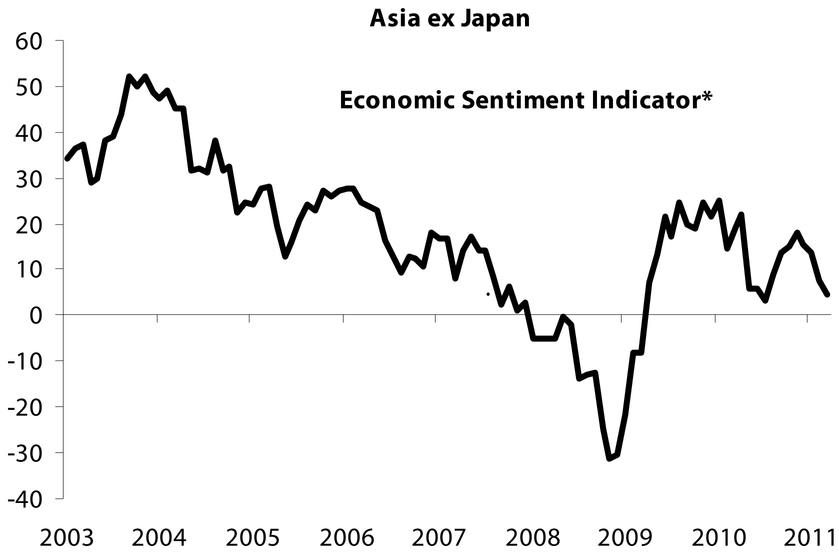
Source: Ecowin, BIS

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 being on a downward trend since December 2010 (Figure 4.3). However, in general, real GDP growth is expanding at or above pre-crisis levels, on the back of robust exports, resilient investment and a healthy state of the region's banks that ensures credit availability. China and India are playing the most important role in the region and robust domestic demand spread from these countries to other Asian economies. 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 9.5% 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 8.0% in 2011, down from 8.7% in 2010.

The major challenge to the region's positive growth outlook is increasing inflationary pressures mainly due to rising food and commodity prices. It is important to point out that food accounts for a large proportion of the consumer price baskets in the region. In India WPI inflation (ex food) increased by an average of 9.5% y-o-y in 2010, significantly up from 2.2% in 2009. As a result, the Reserve Bank of India has been forced to hike the repo rate so far by a total of 200 basis points since March 2010, much more than it did during the 2007-2008 food crisis (125bps). In China, the benchmark lending rate has been raised in three steps since October by a total of 75 basis points. In our view, central banks across the region will continue to give a priority in controlling inflation rather than sustaining potential growth, since higher commodity prices and narrowing output gaps have already started to generate core inflation pressures. Another challenge for the region is the withdrawal of fiscal stimulus, now that the recovery is well established. Countries in the region should rebalance 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.

Figure 4.3



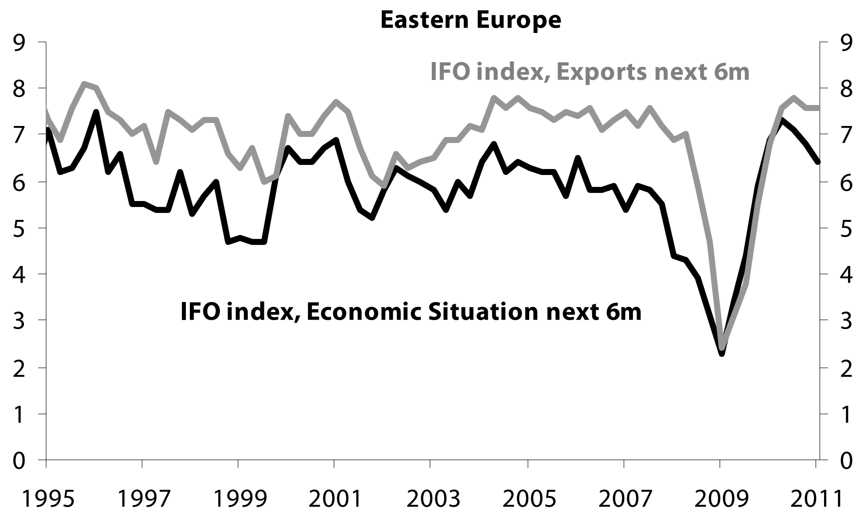
The sentix sentiment indicator is a monthly survey among financial analysts and institutional investors about the expected economic situation.

Source: Ecowin

Emerging Europe

Although the region continues to lag behind emerging Asia and Latin America in the recovery, its economic performance has improved significantly in 2010, with industry being the main driver of growth. In Russia, for example, industrial production expanded by an average of 8.3% y-o-y in 2010, in contrast to a contraction of 9.2% in 2009. This is reasonable if we think of the manufacturing led recovery in Germany, which is Emerging Europe's key export destination. Meanwhile, leading indicators suggest that the region's current strong pace of growth will likely moderate in 2011. Both the Eastern Europe IFO economic situation index and the index for export volumes over the next six months, even though they remain above the 5-point-level that indicates expansion, have started to decline since end-2010 (Figure 4.4). Indeed, the challenging outlook of the Euro area constitutes a major headwind for the region's external demand. In the short term, we expect activity, particularly in energy exporters such as Russia, to be boosted by the rise in oil prices. However, the positive effect of higher oil prices will be offseted by the recent inflationary spike which is squeezing households' purchasing power and is forcing central banks to proceed with interest rate hikes. Indeed, russian central bank has raised its refinancing rate by 25 basis points to 8% in February, for the first time since the easing cycle has initiated in early 2009. Meanwhile, sizeable deterioration in public finances, due to massive fiscal stimulus, suggests that there is little scope for further fiscal easing, impeding the recovery in the region.

Figure 4.4



Source: Ecowin

Latin America

The region's real GDP growth picked up strongly in 2010, on the back of strong domestic demand, favourable business and consumer confidence, solid macroeconomic fundamentals and strong commodity revenues. Meanwhile, labor market conditions remain favorable. In Brazil, the rate of unemployment has fallen significantly to an average of 6.7% in 2010, the lowest average annual rate since at least 2002. Regional GDP increased by about 6% in 2010, significantly up from -1.7% in 2009. However, economic activity is expected to moderate in 2011, as a result of monetary policy tightening. This is strongly confirmed by the Latin America IFO expectations index that has declined gradually from its peak in Q1 10 (Figure 4.5). In addition, the moderation of economic activity across the globe, particularly in Asian economies which are a key destination of LA's exports, will constitute a headwind for the region. The Latin America IFO index for export volumes over the next six months has been on a downward trend since Q3 10 (Figure 4.6). Solid commodity prices will continue to contribute positively to growth in the region and support LA currencies. Nevertheless, sharply increased capital inflows are resulting in stronger local currencies, a case that brings important challenges to policymakers that are becoming more cautious about tightening. Deteriorating inflation dynamics have forced most inflation targeting central banks in the region to start raising policy rates in order to bring them closer to neutral levels. The Brazilian Central Bank (BCB) resumed monetary tightening in January 2011, after a six month pause, in an effort to re-anchor inflation expectations. Indeed, the BCB has raised the selic rate by a total of 300 basis points since April 2010.

Figure 4.5

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

Source: Eurobank EFG, Ecowin

Figure 4.6

Source: Ecowin

III. Special Issue: Emerging markets' inflation on the rise

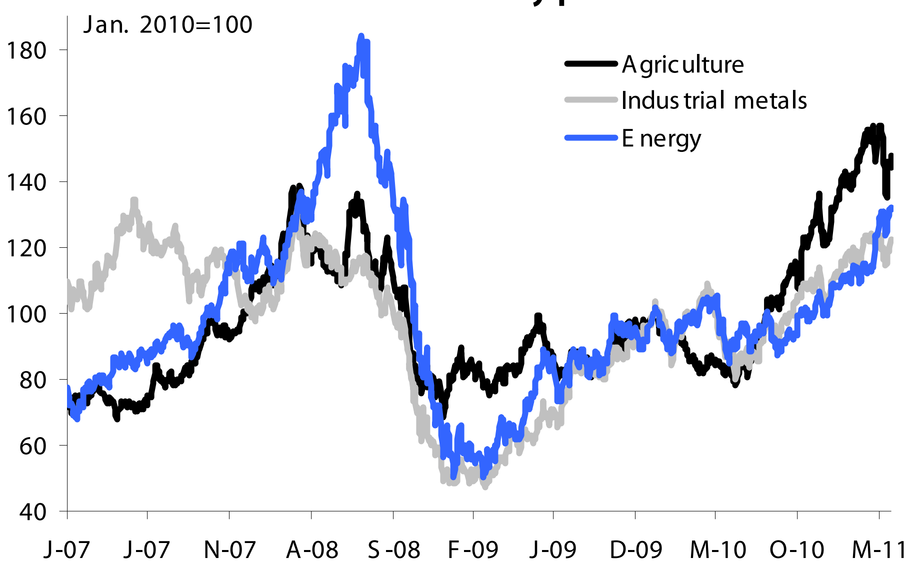
Dimitris Malliaropulos, Maria Prandeka

With the global recovery strengthening and commodity prices rising sharply, inflation has accelerated significantly over the past several months in most emerging market economies. Commodity prices have risen steadily over the past two years along with the recovery in the global economy. Starting in mid-2010, commodity prices embarked on a very significant rally on the back of supply constraints and robust demand stemming mainly from emerging markets. In particular, the S&P GSCI, the most heavily tracked commodity index, is up by about 54% since June 2010. Both energy and industrial metals have increased significantly by about 55% over the same period. However, agricultural prices have been pushed sharply higher, driven mainly by weather disturbances. The S&P GSCI agricultural index has risen 100% since mid-2010, while in terms of levels the index has exceeded its 2008 peak (Figure 1).

The strong upward trend in global food prices has had a substantial impact on EMs' inflation, due to the large weight of food in the consumer price baskets across the emergers. Since 2009, average headline inflation across major EM economies has risen from 4.4% to 5.1% in 2010, while over the first two months of 2011 it has picked further to an average of 5.8% y-o-y (Figure 2). In the meantime, elevated headline inflation has had important challenges so far for EM economies. Specifically, in response to increasing inflation, a large part of EMs central banks has forced to bring forward more of this year's anticipated tightening into the first half of 2011. Indeed, in some EM economies, such as Brazil and India, policymakers have raised policy rates by more than they did in 2007-2008 (Figure 3). Concerns about inflation and the ongoing risk to growth from tighter monetary policy in EMs, coupled with political uncertainty in Middle East and North Africa, have proved significant headwinds for EM equity markets. Indeed, markets discounted the monetary policy tightening, leading to the underperformance of emerging markets equities versus developed market equities. Over the first two months of the year, EM equities underperformed DM equities by almost 10% (Figure 4). Meanwhile, rising food prices was also one of the key factors that triggered the social unrest in North Africa, as increases in the cost of living have been greater than nominal income growth for poorer households.

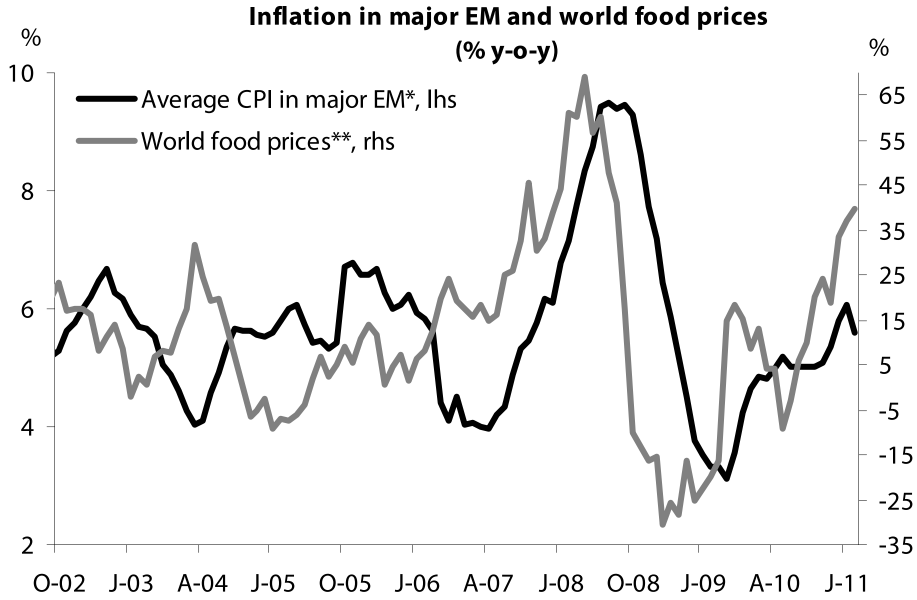
Figure 1

Basic commodity prices



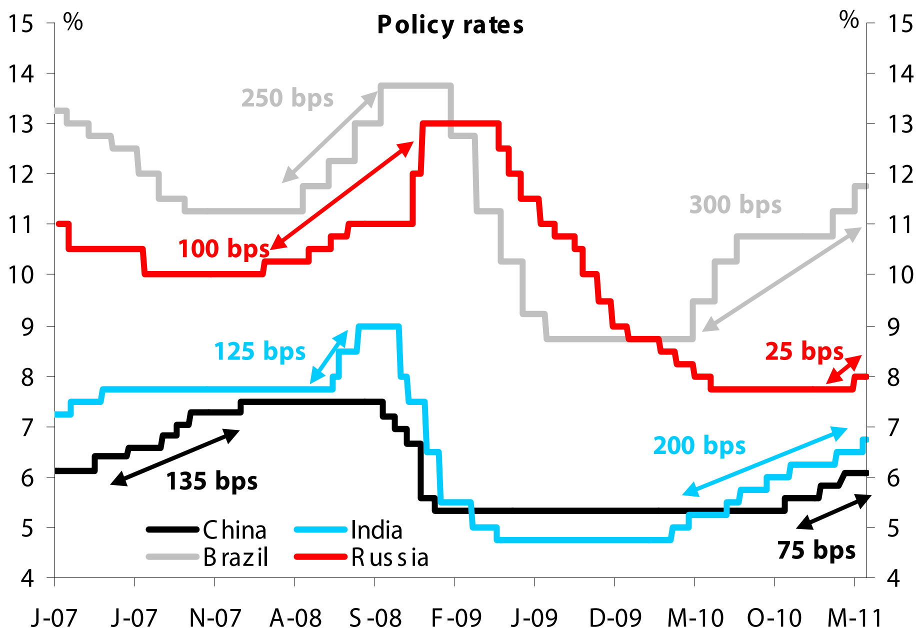
Note: Commodities = S&P GSCI Spot Return Indices
Source: Ecowin

Figure 2



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

Figure 3



Source: Ecowin

Figure 4

Source: Bloomberg

Meanwhile, increasing geopolitical risks have driven oil prices further up. The Brent crude oil price has risen by about US$ 40/bbl over the past seven months (e.g. nearly 55%). Roughly one third of this increase (US$ 15/bbl) is attributed to the escalation of the turmoil in the Middle East in early February. These developments are intensifying the inflationary pressures in EM economies. Any further escalation of the turmoil in the Middle East and Saudi Arabia may lead oil prices significantly higher. A scenario under which oil prices would rise for another US$15/bbl and stay at this level for some time would weigh on economic activity by reducing real incomes and profit margins and, consequently, consumption and investment. Elevated input costs stemming from rising commodities have already started to be translated into higher producer prices and, in turn, into higher non-food inflation. In China, for example, core inflation rose to 2.6% y-o-y in January -its highest rate in at least eight years- from an average of 1.4% y-o-y in 2010.

Overall, notwithstanding the recent drop in food prices from their peak in early March, and even if food prices not reaccelerate in the coming months, we expect inflation in EM to remain elevated until mid-2011, given that a price shock to international food prices feeds into local consumer prices with a time lag of around six months (Figure 2). In mid-2011, 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. Unfavorable weather conditions, as for example drought in Russia last summer and La Nina-related weather disruptions, 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. 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.

Macro Forecasts

Real GDP growth						
	2009	2010	2011f		2012f	
			Eurobank EFG	Consensus	Eurobank EFG	Consensus
US	-2.6	2.8	3.2	3.1 (2.1 – 4.0)	3.0	3.0 (2.0 – 5.3)
EA	-4.1	1.7	1.6	1.7 (1.4 – 2.9)	1.8	1.7 (1.2 – 2.0)
Japan	-6.3	3.9	1.6	1.5 (0.7 – 2.0)	2.0	1.9 (1.7 – 2.8)
China	9.2	10.3	9.5	9.5 (8.5 – 9.8)	9.0	9.0 (8.6 – 9.5)
India	6.8	8.7	8.0	8.1 (7.8 – 8.7)	8.0	8.3 (7.9 – 8.8)
Russia	-7.8	4.0	5.0	4.4 (3.0 – 5.4)	5.5	4.4 (3.0 – 5.7)
Brazil	-0.6	7.5	4.0	4.1 (3.5 – 5.4)	4.3	4.5 (4.0 – 5.9)

Inflation						
	2009	2010	2011f		2012f	
			Eurobank EFG	Consensus	Eurobank EFG	Consensus
US	-0.3	1.6	2.8	2.3 (0.9 – 3.9)	2.6	1.9 (0.4 – 5.0)
EA	0.3	1.6	2.4	2.2 (1.6 – 2.5)	2.0	2.0 (1.4 – 2.5)
Japan	-1.4	-1.0	0.1	0.0 (-0.4 – 0.6)	0.2	0.3 (-0.6 – 0.5)
China	-0.7	3.3	4.5	4.6 (3.9 – 5.5)	3.5	3.4 (3.0 – 4.0)
India (WPI)	2.2	9.5	7.5	7.4 (6.7 – 7.5)	6.5	6.1 (5.4 – 6.5)
Russia	11.7	6.9	9.0	9.0 (7.5 – 12.5)	7.0	8.0 (6.1 – 10.0)
Brazil	4.9	5.0	5.8	5.5 (5.0 – 6.2)	4.8	4.6 (4.2 – 5.1)

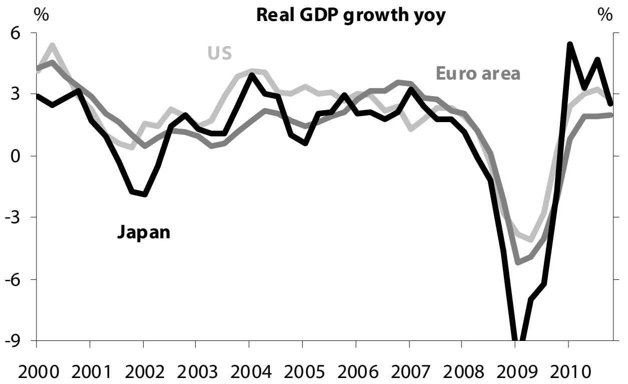
Note: Range of forecasts by Bloomberg's survey in parentheses below point estimates.

Policy Rates					
		Eurobank EFG			
	Current	Q2 11f	Q3 11f	Q4 11f	Q1 12f
US	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.50
EA	1.00	1.25	1.50	1.75	2.25
Japan	0.10	0.10	0.10	0.10	0.10
China	6.06	6.56	6.56	6.56	6.56
India	6.75	7.00	7.25	7.50	7.50
Russia	8.00	8.25	8.50	8.50	8.50
Brazil	11.75	12.25	12.50	12.50	12.50

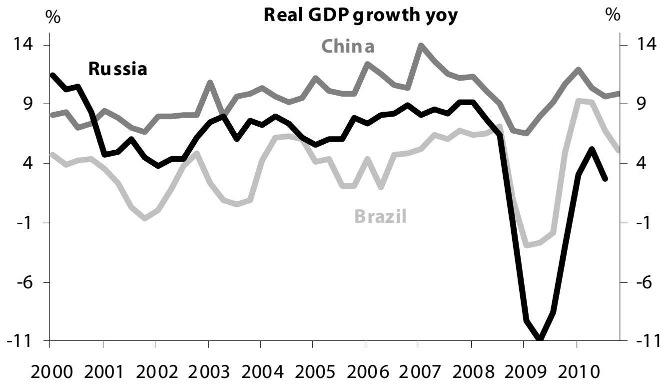
IV. GRAPHS

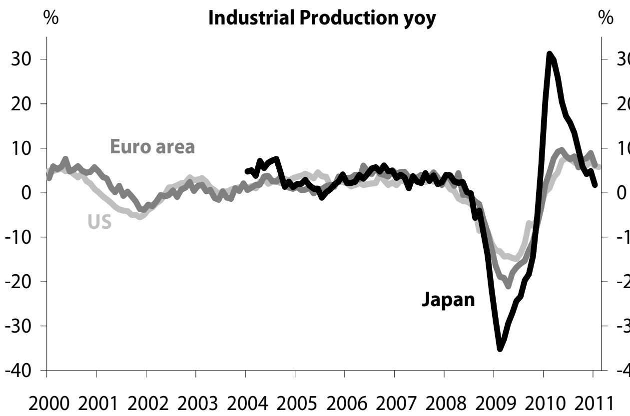
Global Economic Indicators

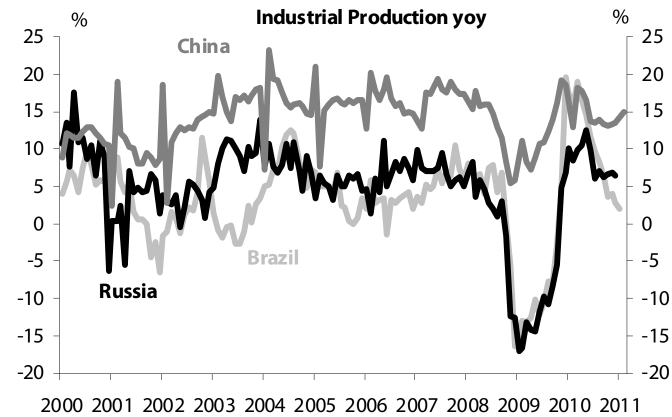
Advanced Economies

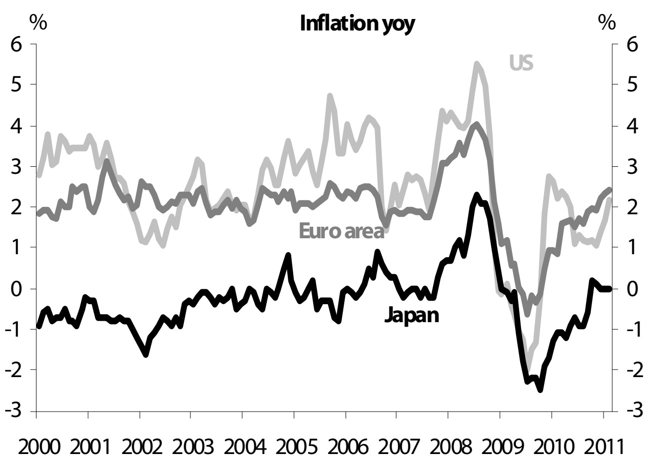


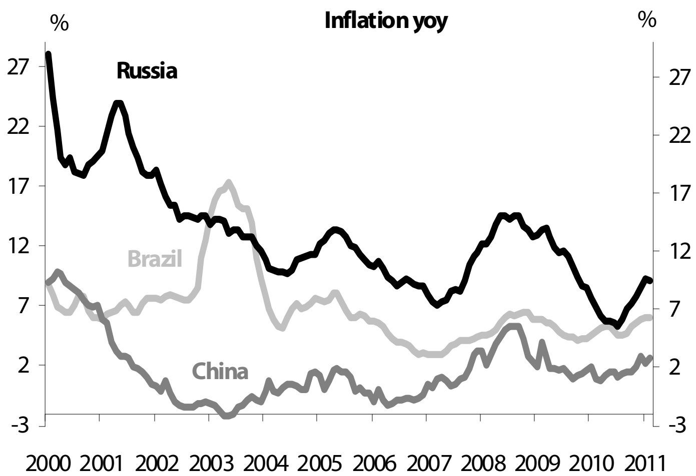
Emerging Economies







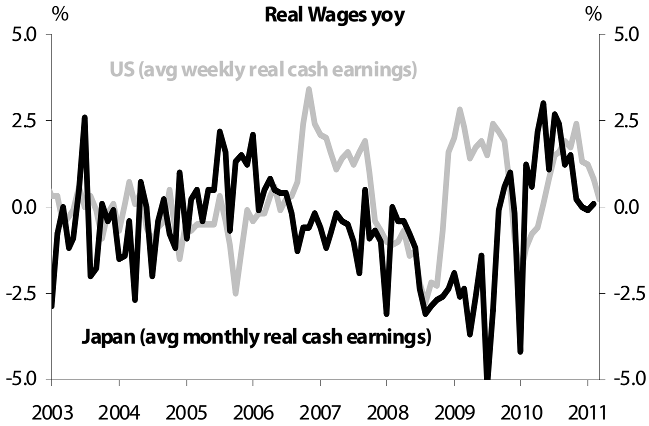




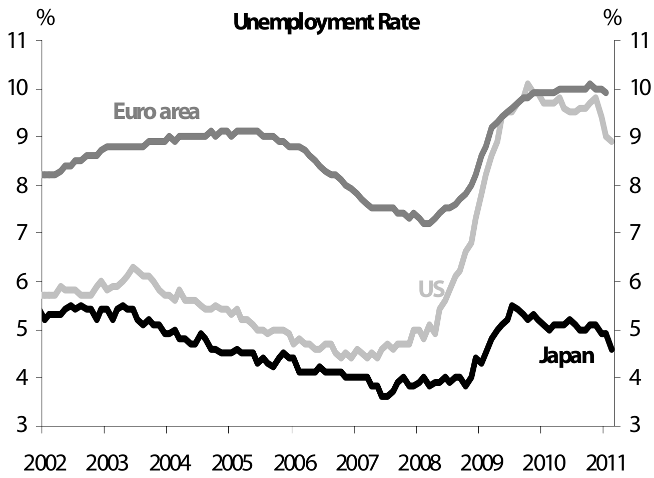
Source: Bloomberg, Ecowin

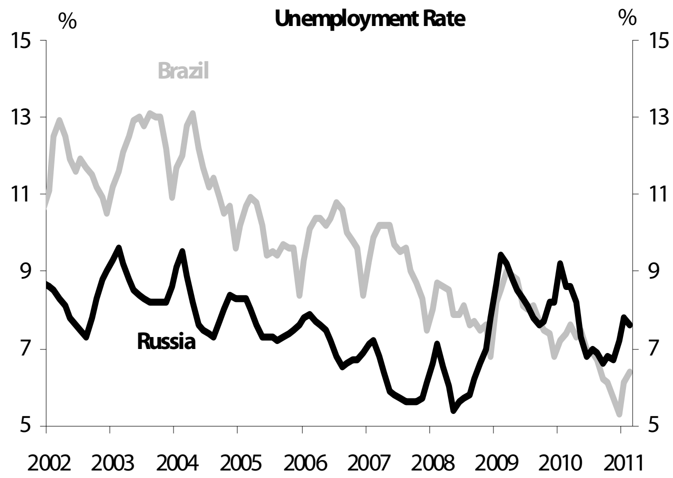
Global Economic Indicators

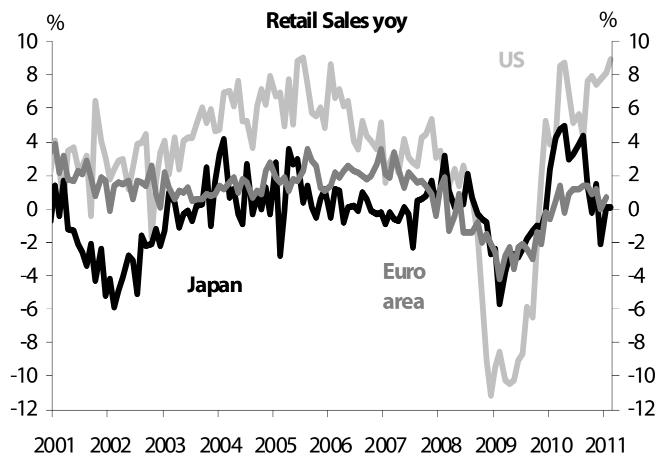
Advanced Economies

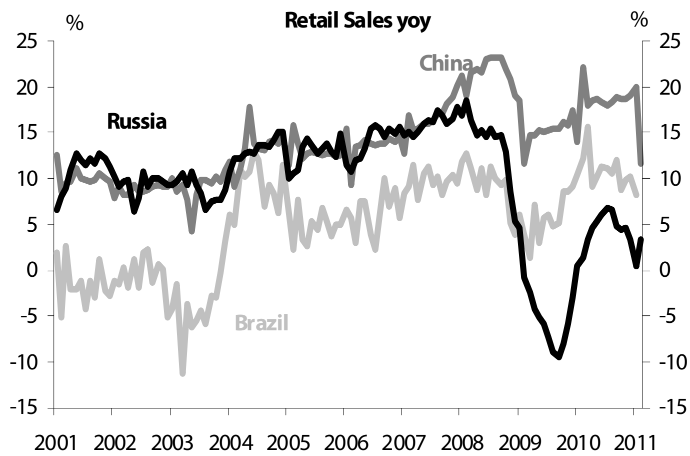


Emerging Economies





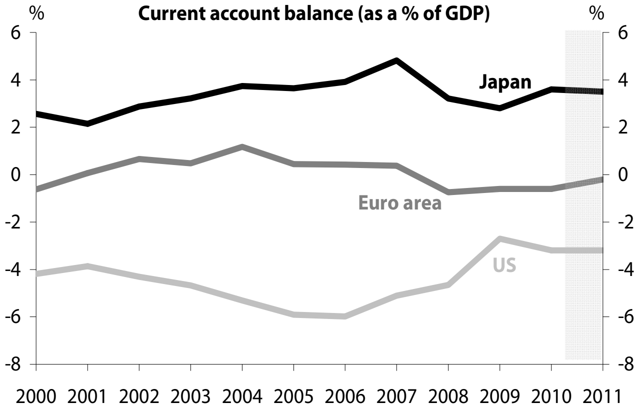




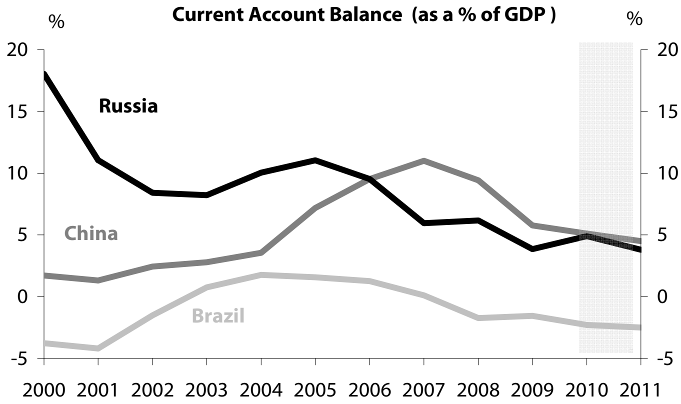
Source: Bloomberg, Ecowin

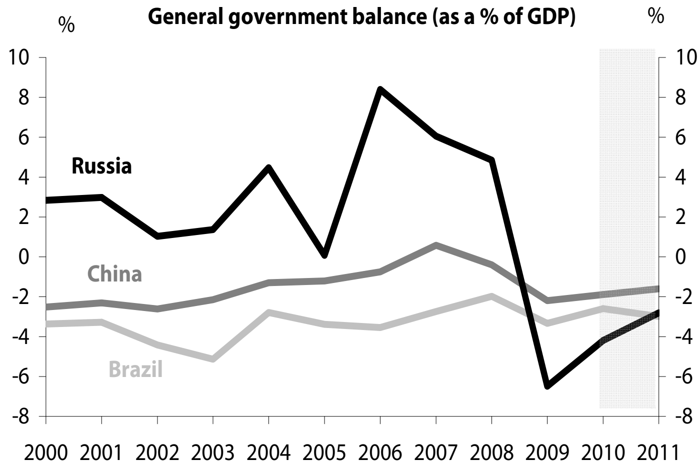
Global Economic Indicators

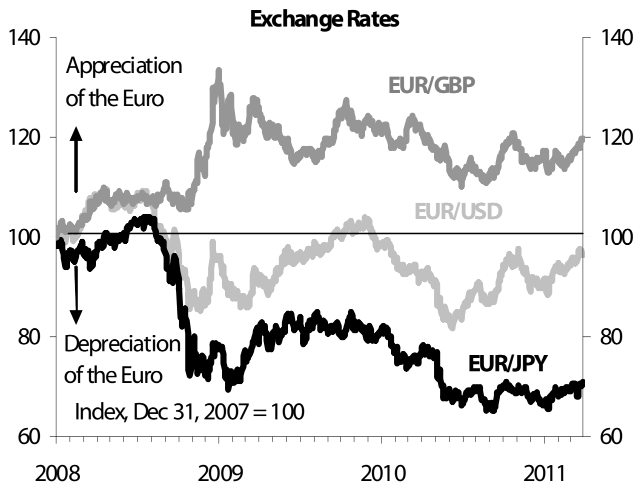
Advanced Economies

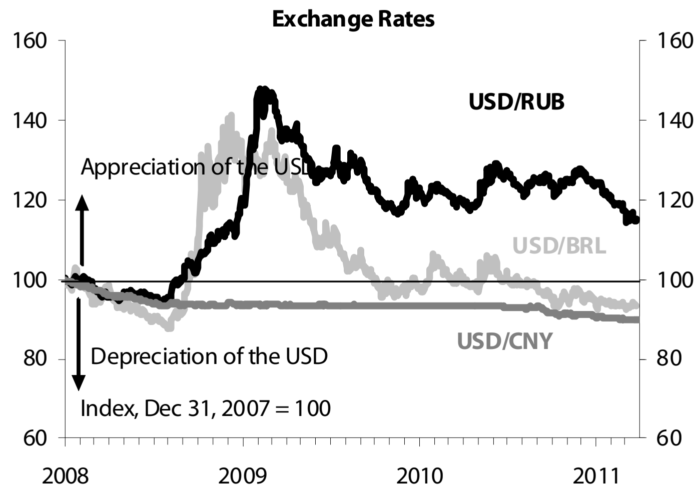


Emerging Economies



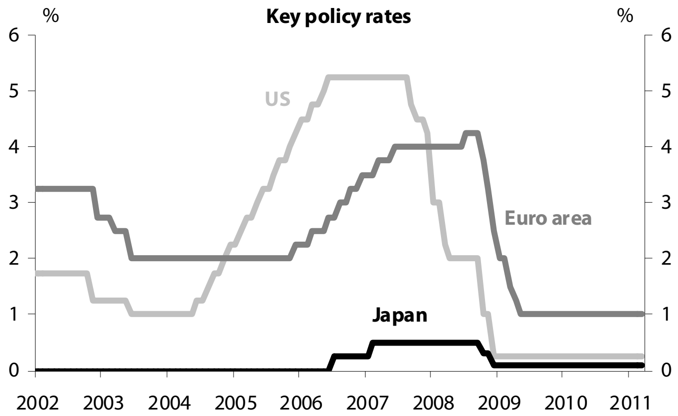


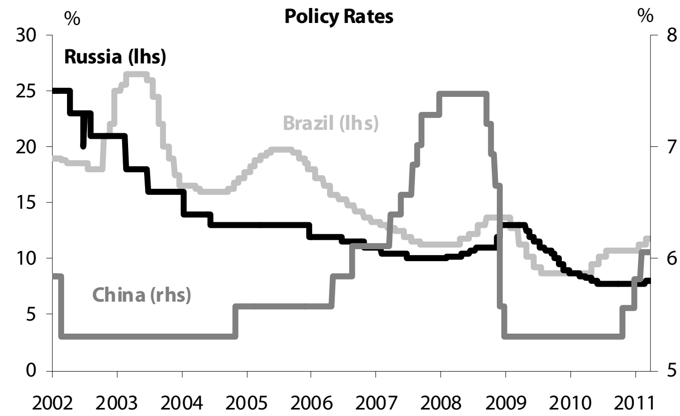




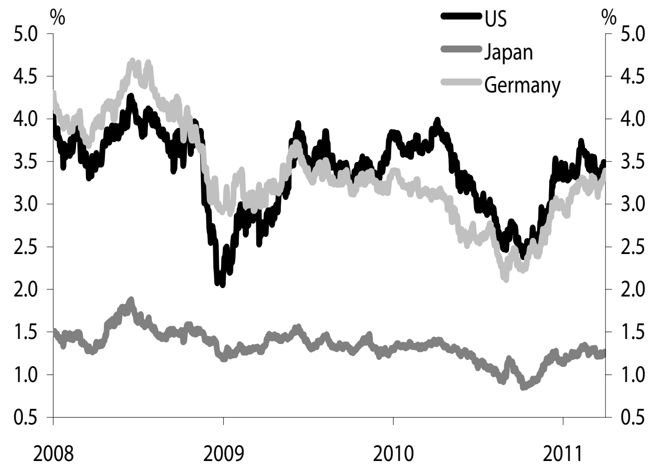
Source: Bloomberg, Ecowin, IMF

Global Economic Indicators

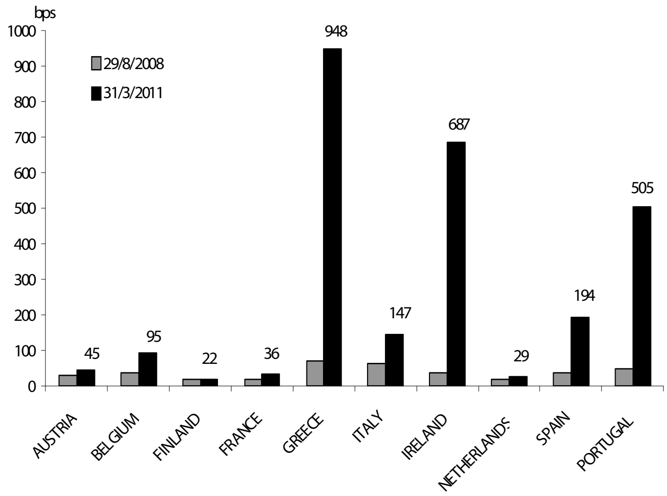




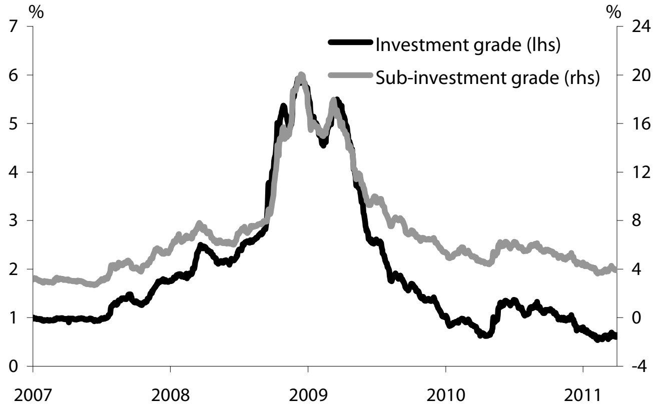
10y Government Bonds



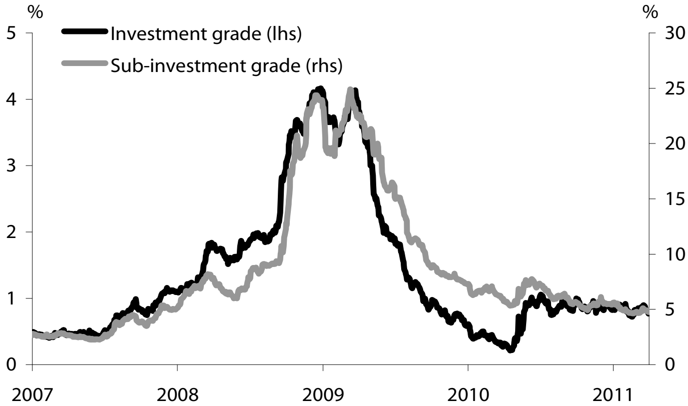
10yr government spreads vs Germany



US Corporate bond yield spreads vs 10-yr government bond



EU Corporate bond yield spreads vs 10-yr government bond



Source: Bloomberg, Ecowin

Global Equities & Sector Performance

Total Return (%) as of March 31, 2011

Global Equity Indices (in local currency)

Region	Index	Last Price	1w	1m	6m	12m	YTD	2010
US	S&P 500	1325.8	1.2	1.5	15.7	12.5	5.4	12.8
EURO AREA	DJ Euro Stoxx 50	2910.9	0.0	-2.4	6.5	-2.3	4.2	-5.8
GERMANY	DAX	7041.3	1.4	-2.5	13.4	12.9	1.8	16.1
FRANCE	CAC 40	3989.2	0.4	-1.9	8.0	-1.1	4.8	-3.3
UK	FTSE 100	5908.8	0.1	-0.5	5.6	2.9	0.1	9.0
JAPAN	Nikkei	9755.1	2.3	-9.3	3.7	-13.2	-4.6	-3.0
CHINA	CSI 300	3223.3	-2.2	-1.0	9.8	-5.0	3.0	-12.5
INDIA	SENSEX	19445.2	3.3	5.4	-4.9	9.9	-5.2	17.4
RUSSIA	MICEX	1813.6	0.3	3.1	24.6	22.6	7.4	23.2
BRAZIL	IBOV	68586.7	1.6	3.5	-2.3	-3.6	-1.0	1.0

Source: Bloomberg

Sector performance as of March 31, 2011

US Sector Indices (in USD)

US – S&P 500	Last	1w	1m	6m	12m	YTD	2010
1. Consumer Discretionary	379.1	0.8	-0.5	17.9	21.0	4.7	27.7
2. Consumer Staples	445.9	0.9	1.6	8.8	10.6	2.5	14.1
3. Energy	859.3	2.3	1.5	41.9	39.8	16.8	20.5
4. Financials	317.6	0.5	-2.6	15.0	3.9	3.0	12.1
5. Health Care	498.7	1.6	1.9	9.5	5.1	5.6	2.9
6. Industrials	444.3	1.9	1.8	21.6	21.9	8.8	26.7
7. Information Technology	453.9	0.2	-2.6	14.1	11.9	3.5	10.2
8. Materials	357.6	2.6	1.9	24.4	24.2	4.5	22.2
9. Telecommunication Services	228.6	5.1	5.3	12.5	30.4	4.9	19.0
10 Utilities	318.3	1.6	0.3	3.9	12.3	2.7	5.5

Source: Bloomberg, Ecowin

Global Equities & Sector Performance

Sector performance as of March 31, 2011

European Sector Indices (in €)

Europe - DJ Stoxx 600	Last	1w	1m	6m	12m	YTD	2010
1. Consumer Discretionary							
Automobiles & Components	485.3	0.9	-2.9	17.0	42.2	-2.3	45.3
Travel & Leisure	200.3	-0.1	-3.5	4.8	2.2	-6.9	28.4
Media	282.5	1.4	-3.7	6.0	8.2	0.2	17.2
Retail	414.3	-2.0	-5.1	-8.3	-2.7	-6.9	13.2
2. Consumer Staples							
Food & Beverage	557.2	0.6	-0.7	4.6	7.9	-4.2	22.3
Personal & Household Goods	658.8	1.3	-2.2	4.6	11.9	-3.7	30.6
3. Energy							
Oil & Gas	658.5	-0.9	-2.2	15.3	5.4	5.6	3.3
4. Financials							
Banks	375.5	-3.0	-6.9	-3.5	-10.1	2.0	-9.6
Financial Services	481.3	0.3	-1.6	14.3	15.7	1.2	18.6
Insurance	269.1	-0.6	-4.2	12.6	6.4	8.9	4.7
Real Estate	121.4	-0.2	-0.6	7.2	12.4	3.2	11.7
5. Health Care	544.9	0.0	-4.0	1.6	1.1	-2.4	9.1
6. Industrials							
Industrial Goods & Services	514.8	1.2	-0.6	15.3	21.7	1.2	35.6
7. Information Technology	227.4	1.1	-2.3	14.5	4.1	5.3	16.9
8. Materials							
Basic Resources	1045.3	1.5	-2.4	15.2	7.0	-5.1	28.6
Chemicals	958.1	1.8	-0.3	15.1	20.8	-0.8	25.2
Construction & Materials	480.4	0.5	1.0	20.2	6.1	3.7	4.7
9. Telecommunication Services	508.0	0.1	-1.3	5.7	13.3	3.7	8.9
10. Utilities	642.6	1.4	-2.1	7.6	-1.0	2.2	-4.5

Source: Bloomberg

Sector performance as of March 31, 2011

Asia Sector Indices (in USD)

Asia – S&P 50 Index*	Last	1w	1m	6m	12m	YTD	2010
1. Consumer Discretionary	11448.1	3.1	8.2	18.6	38.9	4.8	33.2
2. Consumer Staples	12529.5	3.8	5.6	-8.6	-7.3	-5.9	1.7
3. Energy	14511.3	3.9	10.0	28.7	46.9	7.1	36.4
4. Financials	3942.5	3.5	4.6	8.4	14.6	-1.3	9.2
5. Industrials	3528.3	5.1	10.4	35.8	69.2	10.0	74.6
6. Information Technology	9458.2	5.2	2.4	18.8	21.1	-1.8	21.6
7. Materials	5377.9	3.5	8.1	21.2	23.8	8.4	10.5
8. Telecommunication Services	2415.0	2.7	0.1	-4.7	1.1	-4.9	7.7
9. Utilities	3207.2	2.6	2.5	1.2	6.2	-0.3	10.6

Source: Ecowin

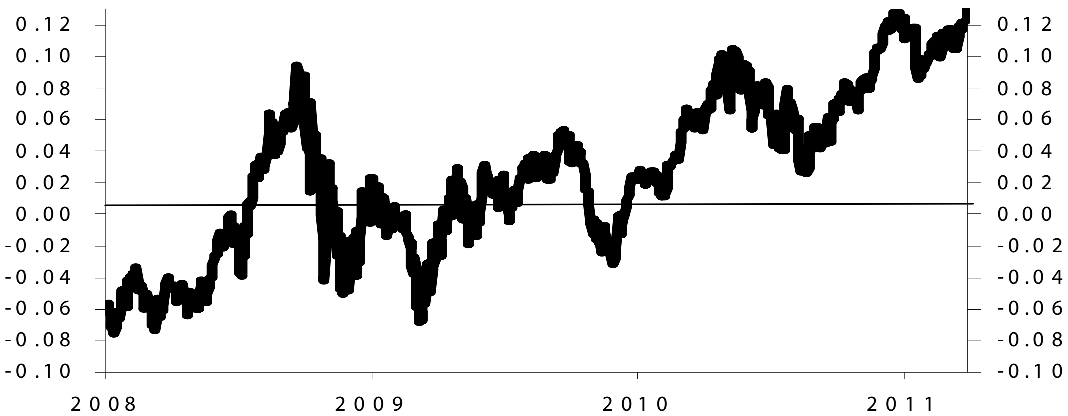
US Style Equity Indices

Total Return (%) as of March 31, 2011

US Style Indices (in USD)

Index	Last Price	1w	1m	6m	12m	YTD	2010
Russell 1000 (Large Cap)	737.1	1.4	1.7	16.5	13.6	5.8	13.9
Russell 2000 (Small Cap)	843.6	3.2	4.5	24.2	23.3	7.6	25.3
Relative performance (Small vs Large)		1.8	2.8	7.6	9.7	1.9	11.4
Russell 1000 Value	676.8	1.4	1.9	15.7	11.4	5.9	12.9
Russell 1000 Growth	607.2	1.4	1.6	17.4	15.8	5.7	14.9
Relative performance (Value vs Growth)		-0.1	0.3	-1.7	-4.4	0.2	-2.0

Relative Performance (small vs large)
(logarithmic scale)



Relative Performance (value vs growth)
(logarithmic scale)

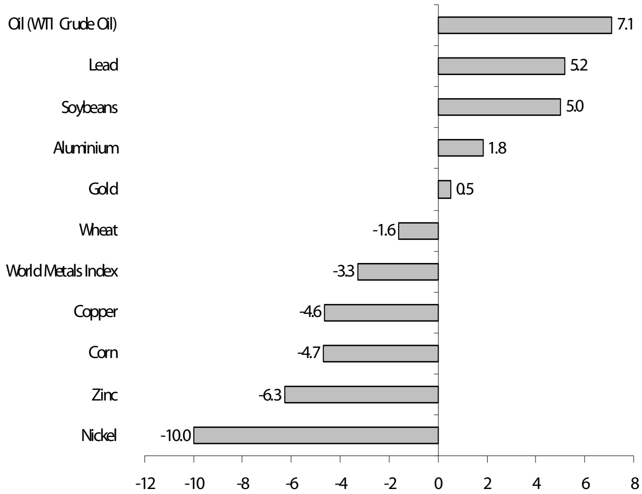
Source: Bloomberg

Commodities

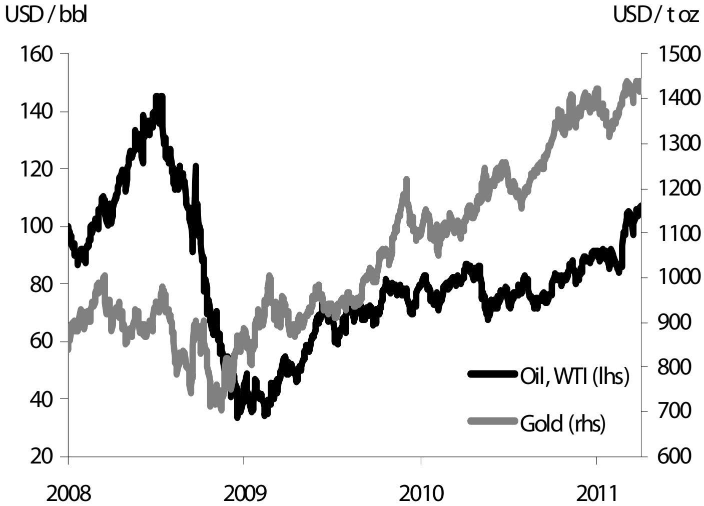
Commodity Performance (%) as of March 31, 2011

Commodities	Units	Last Price	1w	1m	6m	12m	YTD	2010
Oil (WTI Crude Oil)	USD/bbl	106.7	1.3	7.1	30.8	25.7	16.8	15.1
Gold	USD/t oz	1438.9	0.9	0.5	9.3	27.9	1.2	29.7
Base Metals								
World Metals Index		4278.6	-1.7	-3.3	14.8	17.2	1.6	23.8
Aluminium	USD/lb	2648.0	0.7	1.8	12.6	14.0	7.2	10.8
Copper	USD/mt	9428.0	-3.0	-4.6	17.6	21.0	-1.8	30.2
Lead	USD/mt	2695.0	0.2	5.2	18.3	25.5	5.7	4.9
Nickel	USD/mt	26095.0	-4.1	-10.0	11.5	4.4	5.4	33.6
Zinc	USD/mt	2362.0	-2.4	-6.3	7.6	-0.5	-3.7	-4.1
Agriculture								
Corn	USD/bu	693.3	0.5	-4.7	48.8	101.2	10.2	51.7
Soybeans	USD/bu	1395.0	3.3	5.0	33.7	47.3	6.6	29.9
Wheat	USD/bu	763.3	4.1	-1.6	16.5	67.8	-3.9	46.7

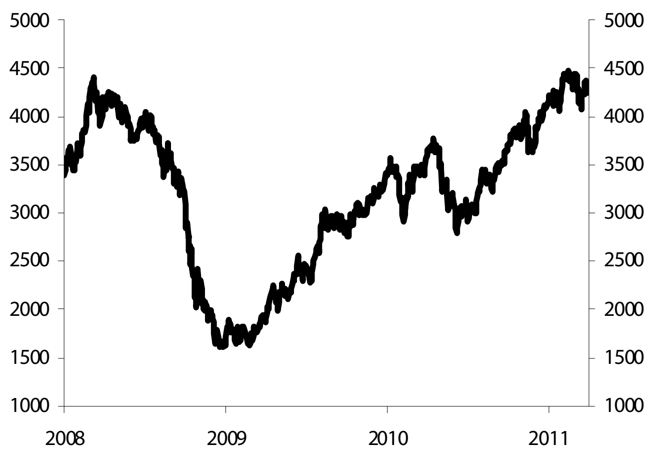
1-Month Return



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

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