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Eurobank EFG

# GLOBAL ECONOMIC & MARKET OUTLOOK

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## Main Macro Views and Market Strategy

- Leading indicators suggest that what was initially thought of as a soft patch of the global economy due to soaring energy prices and the events in Japan turns out to be a persistent slowdown, mainly due to the escalation of the euro area debt crisis.
- Absent a severe deterioration in the sovereign crisis front, the global slowdown should be a controlled mid-cycle descent, mainly supported by solid demand growth in EMs and additional monetary easing. Our estimates suggest a deceleration of global growth from 5.1% in 2010 to about 3.8% in 2011 and 3.8% in 2012.
- Global economic activity is expected to be adversely affected by fiscal consolidation, reduced credit, the erosion of household net worth and subdued personal outlays owing to persistently high unemployment and continued deleveraging.
- In the US, we see a lower growth trajectory in the medium-term, but reduced risks of a near-term recession. However, an escalation of the Euro area sovereign debt crisis could lead the US economy to a shallow and short-lived recession, through weaker exports, tighter financial conditions and constrained bank credit.
- The euro area economy will probably post the weakest growth readings in the next few quarters, with a technical recession being a likely scenario around the end of the year. Real GDP growth is expected to decelerate to a below trend average of 0.5% in 2012 from 1.5% in 2011.
- Missing details pertaining to the recent initiatives taken by European leaders to combat the debt crisis are important for successful implementation of the new PSI deal and to attract external investors' funds. With respect to the ECB, although it did not take center stage in the recent decisions, we believe that its theoretically unlimited ability for intervention is required to contain contagion and should be implemented whenever the need arises.
- The decided EFSF scheme as first loss ensurer is likely to place a further burden on public finances, as countries need to take an additional EFSF loan to guarantee newly issued bonds.
- Higher capital requirements are likely to result in tighter credit conditions, as banks may choose to deleverage in order to avoid state aid that leads to shareholders' dilution.
- Emerging economies are well-positioned to withstand deepening turbulence in the global economy and growth is expected to remain robust, despite the ongoing slowdown.
- Commodity prices should remain around current elevated levels through the end of 2011, supported by robust demand from emerging economies and the persistence of tight supply/demand fundamentals in most commodity complexes.

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# Executive Summary

Global economic activity has slowed remarkably over the summer, owing to a lower growth trajectory in most advanced economies, as well as fiscal and financial uncertainty that skyrocketed since August. Leading indicators suggest that what was initially thought of as a soft patch of the global economy due to soaring energy prices and the events in Japan turns out to be a persistent slowdown. The unwinding of temporary shocks in the first half of the year has not given its way to a restoration of confidence or a stabilization of economic conditions. Consumer and business confidence indicators in advanced economies continue to hover near levels historically associated with recession, as uncertainty about the Greek debt sustainability and its repercussions to systemic euro area member countries have recently prevailed. However, absent a severe deterioration in the European sovereign crisis, the global slowdown should be a controlled mid-cycle descent rather than a recession, mainly supported by solid demand growth in emerging economies and additional monetary easing, as well as a sharp recovery in Japan and favorable capex fundamentals in both advanced and emerging market economies. Our estimates suggest a deceleration of global growth from 5.1% in 2010 to about 3.8% in 2011 and 3.8% in 2012, with the largest risk being the European sovereign debt crisis. Negative factors for global economic activity will also be fiscal consolidation, combined with reduced credit, the erosion of household net worth and subdued personal outlays owing to persistently high unemployment and continued deleveraging. While many advanced economies in the euro area are expected to flirt with recession, emerging and developing economies are expected to remain the locomotive of global growth.

The euro area economy will probably post the weakest growth readings in the next few quarters, with a technical recession being a likely scenario around the end of the year. In such a case, the recession will most likely be shallow, resembling a stagnation of growth rather than an outright recession. According to our estimates, real GDP growth is expected to decelerate to a below trend average of 0.5% in 2012 from 1.5% in 2011, mainly due to frontloaded fiscal consolidation measures and tensions in Eurozone financial markets.

In the US, we see a lower growth trajectory in the medium-term, but reduced risks of near-term recession on the back of decent personal consumption and favorable fundamentals for capital spending. However, an escalation of the Euro area sovereign debt crisis could affect the US economy through weaker exports, tighter financial conditions and constrained bank credit, leading to a shallow and short-lived recession. Our baseline estimates suggest a below-trend growth of 2.0% in 2012 from 1.7% in 2011, as weak employment growth and persistent economic slack continue to weigh on personal income.

The global environment is largely determined by developments in the euro area crisis front. The shockwaves of the debt crisis have spread around the globe, as is evident by the sharp deterioration in global business sentiment and rising tensions in money markets. In the recent round of meetings euro area policymakers tried to get to grips with the three main risk factors that prevent markets from calming down and require urgent action: i) bank recapitalization, ii) dealing with Greece's sovereign debt dynamics and iii) ring-fencing solvent but illiquid countries, most notably Spain and Italy, from adverse developments in Greece. Our overall assessment is that the decisions taken constitute positive steps towards a solution to the euro area woes but policymakers provided only broad guidelines on how to tackle the three problem areas. Concrete though highly important details are missing, left to be negotiated in the coming weeks. Doubts remain on the ability of the recent steps to appease market concerns and help improve the debt sustainability of strained members. While the initiatives address tail risks, stemming mainly from adverse developments in Greece, they fall short of constituting a permanent solution. To this end, bold political action both to push through structural reforms and to provide a credible anti-contagion mechanism is still required. With respect to the ECB, although it did not take center stage in the recent decisions, we believe that its theoretically unlimited ability for intervention is required to contain contagion and should be implemented whenever the need arises.

**Dimitris Malliaropulos**

**Economic Research Advisor**

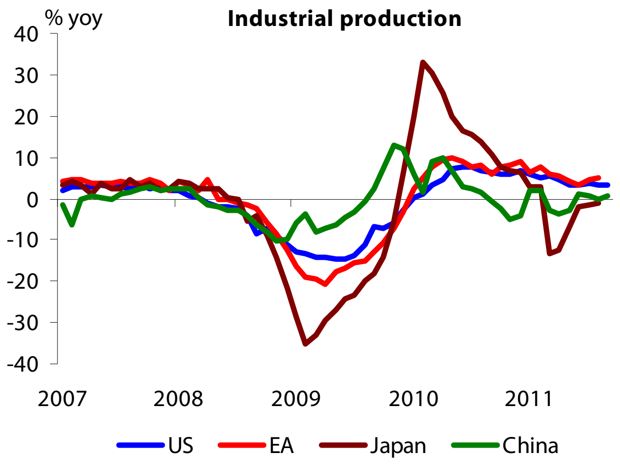
# I. Global Outlook

Dimitris Malliaropulos, Olga Kosma, Vasilis Zarkos

**Global growth to muddle through the heightened fiscal and financial uncertainty, albeit at a sub-trend pace**

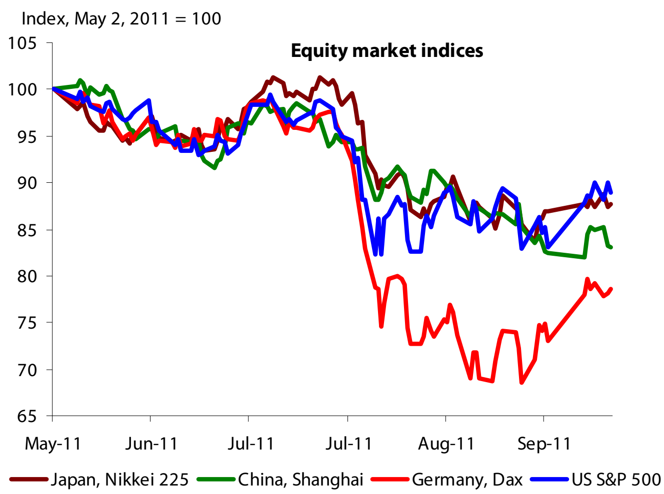
Global economic activity has slowed remarkably over the summer, owing to a lower growth trajectory in most advanced economies, as well as fiscal and financial uncertainty that skyrocketed since August. Surging oil prices and the impact of the events in Japan have led the global industrial sector to a mid-cycle slowdown (Figure 1), a rather temporary effect on global growth that is currently beginning to fade. As mentioned in the latest IMF's World Economic Outlook report, various estimates suggest that these two temporary factors may have reduced output in advanced economies by about 0.5%, concentrated mainly on the second quarter of 2011. In addition, uncertainty over the European debt crisis, the US debt sustainability and the debt ceiling debacle led to a sharp plunge of investors' confidence. Thus, risk aversion has increased significantly and global financial conditions deteriorated sharply in recent months, with global stock markets falling by about 18% from their peak in early May (Figure 2).

**Figure 1**




*Source: US Federal Reserve, Eurostat, Ministry of Economy, Trade and Industry (METI, Japan), National Bureau of Statistics of China*

**Figure 2**

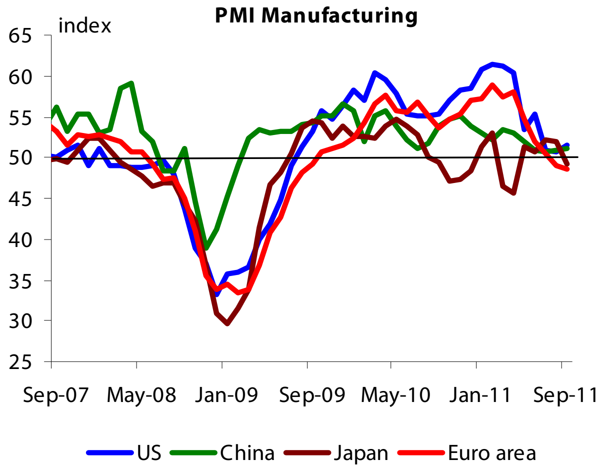



*Source: Bloomberg*

Leading indicators suggest that what was initially thought of as a soft patch of the global economy due to soaring energy prices and the events in Japan turns out to be a persistent slowdown. The unwinding of temporary shocks in the first half of the year has not given its way to a restoration of confidence or a stabilization of economic conditions. Consumer and business confidence indicators in advanced economies continue to hover near levels historically associated with recession, as uncertainty about the Greek debt sustainability and its repercussions to systemic euro area member countries have recently prevailed. The manufacturing PMI reports point to poor momentum in the global manufacturing sector in the near term, with the forward-looking new orders component in many countries falling below the threshold of 50 that distinguishes expansion from contraction (Figure 3).

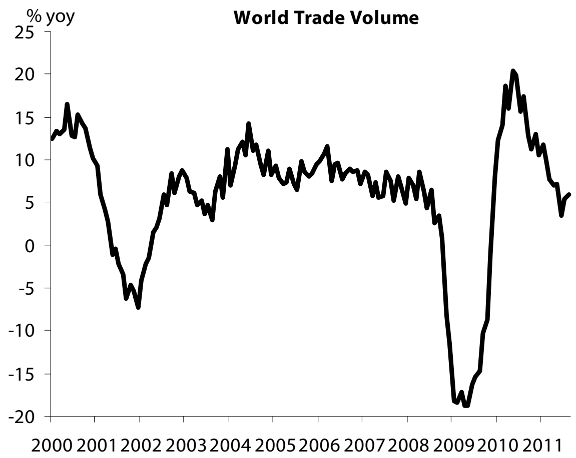
However, absent a severe deterioration in the European sovereign crisis, the global slowdown should be a controlled mid-cycle descent rather than a recession, mainly supported by solid demand growth in emerging economies and additional monetary easing, as well as a sharp recovery in Japan and favorable capex fundamentals in both advanced and emerging market economies. Our estimates suggest a deceleration of global growth from 5.1% in 2010 to about 3.8% in 2011 and 3.8% in 2012, with Q4 2011 and Q1 2012 likely to be the weakest quarters in a number of economies. The largest risk is the European sovereign debt crisis, which affects global growth through direct trade linkages (Figure 4), or indirectly through financial market conditions. Negative factors for global economic activity will be consolidation measures in several economies, combined with reduced availability of credit, the erosion of household net worth and subdued personal outlays owing to persistently high unemployment and continued deleveraging. While many advanced economies in the euro area are expected to flirt with recession, emerging and developing economies are expected to remain the locomotive of global growth. Growth in emerging economies will probably be moderating to more sustainable rates over the next few years[1], however it still remains fairly robust and essentially stronger than growth in advanced economies. Meanwhile, the share of emerging and developing economies in global GDP has increased substantially over time -from 37% in 2000 to 48% in 2010- and is expected to surpass the advanced economies' share (52% in 2010 versus 63% in 2000) over the next two years[2].

**Figure 3**




*Source: Bloomberg*

**Figure 4**




*Source: CPB Netherlands Bureau for Economic Policy Analysis*

The euro area economy will probably post the weakest growth readings in the next few quarters, with a technical recession, i.e. two consecutive quarters of negative growth, being a likely scenario around the end of the year. In such a case, the recession will most likely be shallow, resembling a stagnation of growth rather than an outright recession. Growth divergence between core and periphery will continue, although it is expected to fade to some extent, as core euro area members have been also affected by financial turmoil. According to our estimates, real GDP growth is expected to decelerate to a below trend average of 0.5% in 2012 from 1.5% in 2011, mainly due to frontloaded fiscal consolidation measures and tensions in Eurozone financial markets.

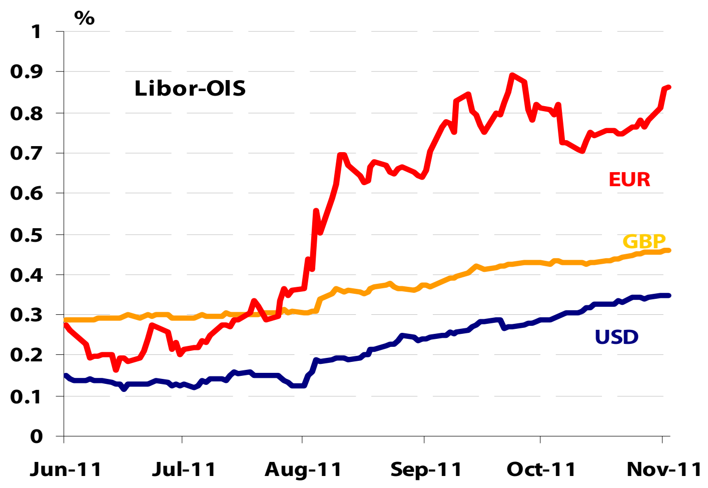
In the US, we see a lower growth trajectory in the medium-term, but reduced risks of near-term recession on the back of decent in personal consumption and favorable fundamentals for equipment and software spending. However, an escalation of the Euro area sovereign debt crisis could affect the US economy through weaker exports, tighter financial conditions and constrained bank credit, leading to a shallow and short-lived recession. Our baseline estimates suggest a below-trend growth of 2.0% in 2012 from 1.7% in 2011, as weak employment growth and persistent economic slack continue to weigh on personal income. The $447bn fiscal stimulus proposed by the Obama administration represents a short-term removal of scheduled fiscal tightening. Thus, fiscal policy in the US will probably boost real GDP growth only modestly by about 0.2% in 2012, should the proposed stimulus plan is finally enacted in its entirety.

[1] *According to the latest IMF forecasts (World Economic Outlook, September 2011), growth in emerging and developing economies is expected to moderate from 7.3% in 2010 to 6.4% in 2011 and 6.1% in 2012.*
[2] *IMF estimates, World Economic Outlook, September 2011.*

**European sovereign debt crisis: positive steps but details are important**

The global environment is largely determined by developments in the euro area crisis front. The shockwaves of the debt crisis have spread around the globe, as is evident by the sharp deterioration in global business sentiment and rising tensions in money markets (Figure 5). In the recent round of meetings euro area policymakers tried to get to grips with the three main risk factors that prevent markets from calming down and require urgent action: i) bank recapitalization, ii) dealing with Greece's sovereign debt dynamics and iii) ring-fencing solvent but illiquid countries, most notably Spain and Italy, from adverse developments in Greece. Our overall assessment is that the decisions taken constitute positive steps towards a solution to the euro area woes but policymakers provided only broad guidelines on how to tackle the three problem areas. Concrete though highly important details are missing, left to be negotiated in the coming weeks. Doubts remain on the ability of the recent steps to appease market concerns and help improve the debt sustainability of strained members. While the initiatives address tail risks, stemming mainly from adverse developments in Greece, they fall short of constituting a permanent solution. To this end, bold political action both to push through structural reforms and to provide a credible anti-contagion mechanism is still required. With respect to the ECB, although it did not take center stage in the recent decisions, we believe that its theoretically unlimited ability for intervention is required to contain contagion and should be implemented whenever the need arises.

**Figure 5**




*Source: Bloomberg*

With respect to the EFSF leverage, a noteworthy merit of the proposed scheme is that it increases its firing power while circumventing a new round of parliamentary approval with doubtful result. However, its ability to attract funds from external investors lies on the ability of euro area authorities to attain investors' confidence. Moreover, the countries which tap the mechanism will have to take an EFSF loan to guarantee the new bond. For example, assuming 20% insurance, the country that issues an insured bond worth €1bn needs to borrow €1.2bn in total. In other words, insurance places an extra burden on weak members' public finances. In a similar vein, decisions aiming at restoring confidence in the banking system may put further stress on sovereigns, as the later may have to guarantee term funding and contribute to the strengthening of banks' capital base. Higher capital requirements raise fears for additional constraint on bank lending to the real economy, as banks may chose to deleverage in order to avoid state aid that would result in shareholders dilution.

EFSF leverage and bank recapitalization provide the necessary backstop mechanisms that allow euro area policymakers to push through a deeper private sector involvement in the Greek debt relief. A nominal discount as high as 50% was decided in order to help the Greek debt recede to 120% of GDP by 2020. Once again, the summit revealed only guidelines of the new PSI deal, while specific terms have yet to be agreed. Negotiations between banks and policymakers in the coming weeks will remain intense, while the missing details will most likely determine the voluntary character of the deal. In any case, Greece needs to strictly adhere to its structural reforms program and find the courage to push through painful changes in order to achieve an economic rebound. Reentering an economic recovery path is what will ultimately put the country's debt dynamics to a sustainable path.

To this end, the agreement between the two leading Greek political parties to form a unity government is a positive development. A coalition government may restore international confidence on Greece, after the later was severely hit by an abrupt increase in domestic political uncertainty. Broad political consensus may accelerate the implementation of the bail-out decisions of the October 27 EU summit, while sharing of the political cost may render it easier to curb resistance of interest groups and push through structural reforms and privatizations.

**Monetary policy to remain supportive for global growth**

The monetary policy concern in many advanced and emerging economies in late 2010 and in H1 2011 has been rising inflation, with a number of central banks moving to tighter monetary conditions. However, easing inflationary pressures and a broad-based slowdown in global growth has led to an easing bias across the board. In addition to expanding its liquidity operations and reactivating its Securities Market Program, the ECB is expected to fully reverse its tightening cycle by the end of the year due to dismal economic conditions. In the US, after committing to keep rates at exceptionally low levels at least until mid-2013, the Federal Reserve announced a Maturity Extension Program for the next nine months in order to put downward pressure on long-term interest rates, create more accommodative financial conditions and support the mortgage market. Should economic and financial market conditions weaken further towards the end of the year, the Fed could announce a third round of quantitative easing (QE3) so as to monetize its debt. In our view, given that growth in advanced economies will likely remain subdued over the next few years, monetary authorities should maintain monetary policy loose, even if that means tolerating inflation persistently above their target. Meanwhile, the emerging markets policy tightening cycle has already reached its peak, causing a number of countries to either hold interest rates or even ease. It seems that even policymakers in emerging economies are showing growing tolerance for higher inflation, turning their attention from fighting inflation to supporting growth.

# II. Global Economic Outlook

## 1. The US economy

Dimitris Malliaropulos, Olga Kosma

- Continued market stress and widespread business and consumer pessimism over the summer have raised concerns of a return to an outright US recession.
- Real GDP growth accelerated in Q3, on the back of stronger-than-expected personal consumption and solid gains in capex spending. Stronger final sales and weaker inventory growth in Q3 is an encouraging sign for economic activity in Q4.
- However, our estimates suggest a below-trend growth of 2.0% in 2012 from 1.7% in 2011, as weak employment growth and persistent economic slack continue to weigh on personal income.
- Absent a severe European meltdown or other shock, the deceleration in the US economy should be a controlled mid-cycle slowdown rather than a recession, supported by additional Fed monetary easing if needed.
- A new round of quantitative easing, in the form of renewed asset purchases of long-term Treasuries as well as agency mortgage securities, would help inflate away some public and private sector debt, and therefore aid the deleveraging process.

**Overview**

US economic activity decelerated significantly from an annual rate of 2.8% in H2 2010 to 1.1% in H1 2011, mainly attributed to the temporary factors of higher oil prices and Japanese-related automotive supply disruptions. Meanwhile, continued market stress and widespread business and consumer pessimism since August -owing to the European sovereign debt crisis, the S&P downgrade of US sovereign debt and the debt ceiling debacle- have raised concerns of a return to an outright US recession. Consumer confidence indices have plunged by an average of 33% from their peaks at the beginning of the year, equity market indices have declined by about 20% from their peaks in late April, while the ISM manufacturing index has been hovering around the threshold of 50 that distinguishes industrial expansion from contraction.

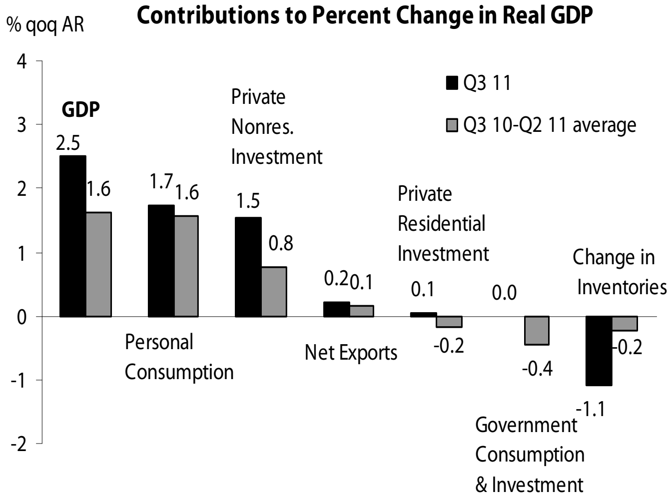
Our baseline estimates suggest that the ongoing slowdown signifies a mid-cycle slowdown rather than the onset of a recession. Recent GDP data are consistent with a modest acceleration in real economic growth in the second half of the year, relative to the low bar set in H1. Consumer sentiment seems to have stabilized -albeit at low levels- and industrial production has recently improved, confirming a rather subdued but steady growth in the industrial sector. We expect real GDP growth to cruise around 2% q-o-q saar in Q4, supported by decent personal consumption and robust capex spending. Overall, we have revised upwards our 2011 real GDP forecast to1.7% y-o-y from 1.5%, due to the government's upward revision to Q2 and better-than-expected GDP data for Q3 2011.

Looking ahead, we expect below-trend growth through next year, averaging at around 2.0% from 1.7% in 2011, as weak employment growth and persistent economic slack will probably continue to weigh on personal income. The $447bn fiscal stimulus package proposed by the Obama administration represents a short-term removal of scheduled fiscal tightening. Thus, should the proposed package is enacted in its entirety, fiscal policy will probably be neutral for economic activity in 2012, boosting only modestly real GDP growth by about 0.2% in 2012. Key for the pace of the US recovery will be trends in the labor market, one of the most worrying aspects of the US economy, as well as future changes in household net wealth, including movements in house and equity prices. Absent a severe European meltdown or other shock, the recent US slowdown should be a controlled mid-cycle descent, supported by additional Fed monetary easing if needed. Should economic and financial conditions weaken further towards the end of the year, the Federal Reserve will act to prevent a faltering US economy from falling into a renewed recession. In such a case, a new round of quantitative easing, in the form of renewed asset purchases of long-term Treasuries as well as agency mortgage securities, would help inflate away some public and private sector debt, and therefore aid the deleveraging process.

**GDP growth better-than-expected in Q3, …**

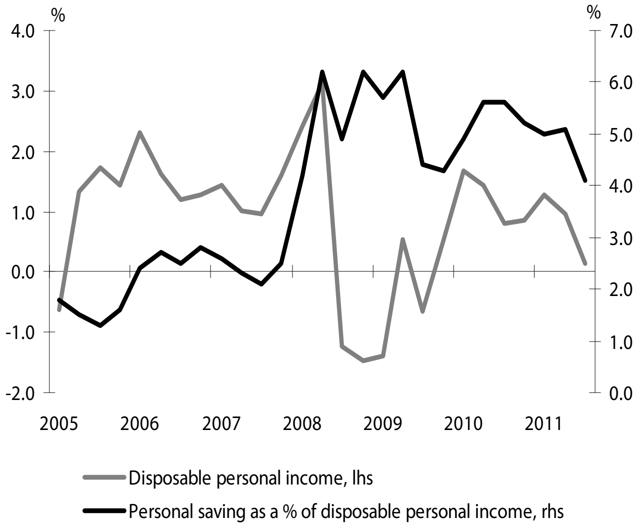
According to the advance estimate of Bureau of Economic Analysis (BEA), real GDP retrieved its pre-recession level in Q3 2011, increasing 2.5% q-o-q saar, the strongest gain since Q3 2010. The acceleration in real economic activity relative to the 1.3% growth reported in the previous quarter was mainly driven by stronger-than-expected personal consumption growth and robust business investment (Figure 1.1). Real final sales rose 3.6% q-o-q saar, reporting the strongest growth rate since Q4 2010, as the deduction in inventories subtracted 1.1% from real GDP growth. Stronger final sales and weaker inventory growth is a positive sign for economic activity ahead. The large inventory drag in Q3 may be reflecting companies' reaction to the softness of domestic demand in H1 2011, setting the stage for stronger growth in Q4 as businesses build back stocks. Meanwhile, net exports added 0.2% to real growth, as export growth of 4% q-o-q saar was partly offset by a 1.9% increase in imports. Last but not least, after three quarters of negative contribution, government consumption and investment remained essentially flat in Q3, as the increase reported at the federal level was fully offset by a decline at the state and local level.

**Figure 1.1**




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

**Figure 1.2**

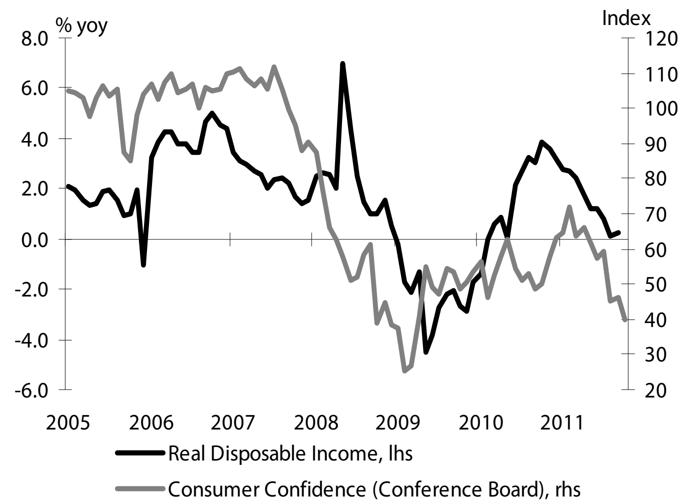



Source: US Bureau of Economic Analysis (BEA)

Real personal consumption expenditures increased 2.4% q-o-q saar, reflecting strength in both the goods sector and the more heavily weighted services sector. In particular, durable goods increased 4.1% q-o-q saar, after a large contraction of 5.3% in Q2, and services consumption rose 3%, reporting the strongest reading in more than 5 years. Surprisingly, the rebound in durable goods was not driven by motor vehicles but from non-motor vehicles consumption, as auto spending reported a modest decline, subtracting 0.1% from growth. This suggests that spending on durable goods could post another solid gain in Q4, once auto sales feed into the data. Indeed, vehicles sales for October are consistent with a stronger bounce in Q4, after the 24% q-o-q saar decline in Q2, when sales were hit by supply constraints from the events in Japan.

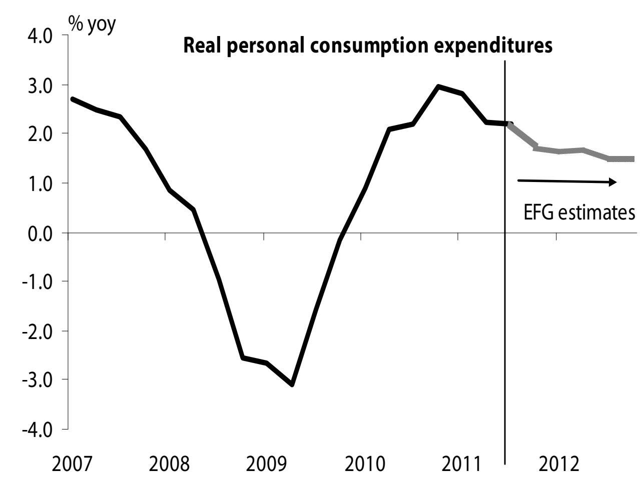
However, the rebound in consumption growth was not accompanied by an increase in personal income, but rather reflected a decline in savings. Real disposable income declined by 0.4% q-o-q in Q3, increasing just 0.4% from a year earlier. Although the weakness in real disposable income partly reflected the strength of consumer price inflation, nominal disposable income trend softened as well, increasing by a mere 0.1% q-o-q in Q3 from 1% in Q2. As a result, households used their savings to offset weak income, with the savings rate falling gradually to 3.6% in September from 5.3% in June 2011 (Figure 1.2). Continued labor market weakness appears to be restraining disposable income and exerting downward pressure on consumer sentiment. The Conference Board's index of consumer confidence posted another decline in October, reporting the weakest reading since March 2009. In particular, the index plunged to 39.8 from 46.4 in September, reflecting declines in both the present situation and expectations components (Figure 1.3). The current state of consumer confidence and the underlying weakness in income growth suggests that the jump in personal spending in Q3 will prove to be temporary. The upward trend in the services consumption component and a likely boost to the goods component from auto sales in Q4 will be partially damaged by a softer trend in employees' wages, denting households' disposable income. According to our estimates, real consumption growth will decelerate from 2.4% q-o-q saar in Q3 to about 1.6% in the final quarter of the year, leaving the annual average at 2.2% for 2011. Looking ahead, we believe that further weakness in real disposable income and further drawdown in the savings rate will lead to a deceleration of annual consumption growth to 1.6% in 2012, half the average growth during the post war II period since 1947 (Figure 1.4).

**Figure 1.3**




*Source: US Bureau of Economic Analysis (BEA), Conference Board*

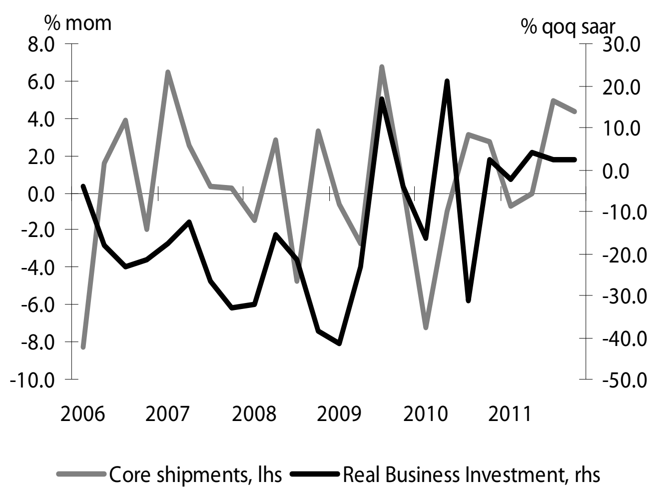
**Figure 1.4**




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

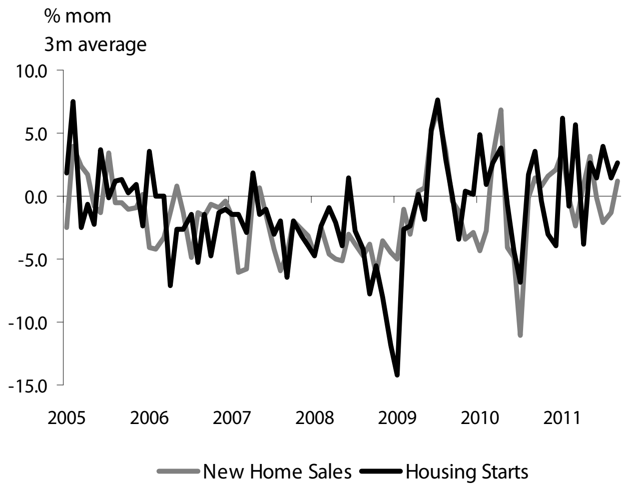
On the investment front, real business investment surged at a 16.3% pace, on the back of stronger investment in equipment and software which contributed 1.2% to Q3 GDP growth. Supported by solid growth in corporate earnings and accelerated deductions for the cost of certain investments, equipment and software -which accounts for three fourths of business capex- will probably continue to boost growth for the remaining of 2011. However, the recent softness in the pace of core capital goods shipments (Figure 1.5), the most important input for estimating equipment and software spending, indicates some easing in the pace of spending growth ahead. We expect real non-residential investment growth to gradually decelerate from an annual average of 9.0% in 2011 to 5.0% in 2012, close to levels seen in 2010.

**Figure 1.5**




*Source: US Bureau of Economic Analysis (BEA), US Census Bureau*

**Figure 1.6**




*Source: US Bureau of Economic Analysis (BEA), US Census Bureau*

Residential investment rose 2.4% q-o-q saar in Q3 after a 4.2% increase in Q2, contributing a mere 0.05% to real economic activity. The housing recovery is being protracted, given the massive overhang of excess supply. Although there are some recent signs of stabilization, with new home sales and housing starts reporting solid monthly increases in September (Figure 1.6), the recent soft trend in house prices suggests continued weakness in the property market due to the large overhang inventory of foreclosed properties. Our view for a prolonged housing recovery remains intact, with residential investment picking up only gradually from -1.6% y-o-y in 2011 to 3.5% in 2012.

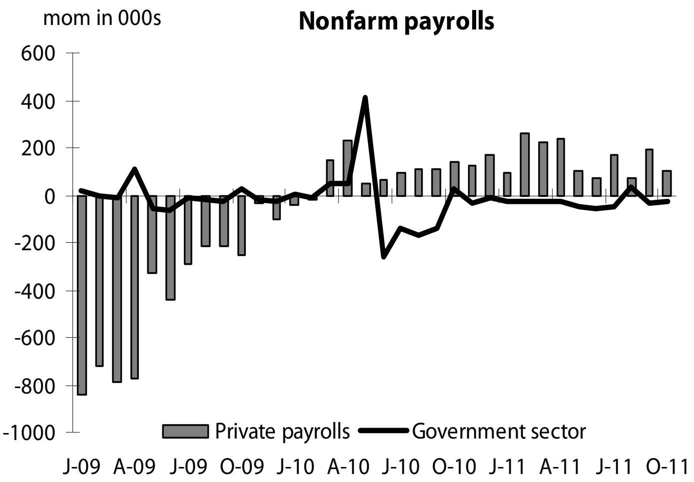
### …but more persistent factors will continue to weigh on the pace of the recovery

While the components of the GDP report were generally favorable, providing reasons for encouragement for GDP growth in Q4, the key for a sustained economic recovery is the performance of the US labor market and its effect on personal income and spending. The October employment report was generally positive, reporting a 80k increase in total nonfarm payrolls and a 102k upward revision to payrolls in the prior three months (Figure 1.7). The strong household employment for a third month in a row resulted in a decline in the unemployment rate from 9.1% to 9.0%, as the rise in the labor force by 181k was more than offset by a 277k increase in civilian employment. Although the labor market seems to be performing relatively better than expected a couple of months ago, the employment trend is still far from strong jobs growth that could push the unemployment rate further down. With a stable labor participation rate, the US economy has to create about 130k jobs per month in order to see a gradual decline of 0.1% per month in the unemployment rate towards the end of the year.

Meanwhile, the median duration of unemployment has ranged between 20 and 22 weeks since mid-2010, with about 6 million people being out of work and looking for a job for more than six months. As Chairman Bernanke and other Fed officials have recently said, FOMC participants have become increasingly concerned about long-term unemployment, as it constitutes not only hardship for many US households, but also a risk to supply-side potential of the economy. Weak employment growth and persistent economic slack are holding back employees' wages, denting households' disposable income. The trend in hours and earnings is softer relative to previous trends, with average weekly earnings of all private employees slowing to 0.2% m-o-m in October from an average monthly growth of 4.0% in the first five months of 2011. According to our baseline forecasts, given the slowdown to a lower US growth trajectory, weak payroll growth over the next few months is expected to be sufficient to push the unemployment rate down only marginally towards 8.7% by year-end 2012, keeping the year average at the high level of 8.8% in 2012 from 9.1% in 2011.

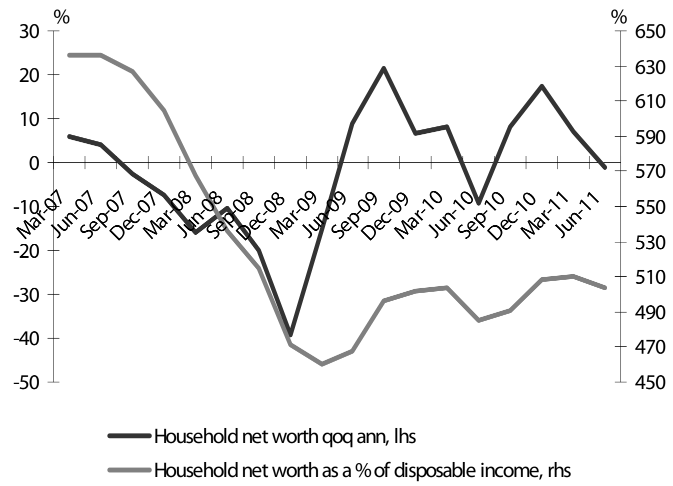
In addition, the substantial erosion of household net worth seems to be contributing to a subdued pace of recovery. The Federal Reserve's Flow of Funds report revealed that household net worth -the difference between the value of assets and liabilities- shrunk about $150bn in Q2 2011, reporting a 1% q-o-q annualized decline (Figure 1.8). Household debt has been steadily decreasing since Q3 2008, primarily reflecting declining levels of mortgage debt. Moreover, households and nonprofit organizations realized a significant loss in their financial assets. In particular, global financial shares have fallen about 20% from their peaks in early May, sparked by the Eurozone sovereign crisis, the US debt ceiling debacle and the downgrade of the US's AAA credit rating. Moreover, the significant decline in real estate property provides evidence for the negative wealth effect between changes in house prices and total consumer demand for goods and services. The strength of the housing market in the 1996-2006 decade has allowed millions of homeowners to borrow extra money secured on the value of their property. The housing market dip that followed had exactly the opposite effect, with mortgage equity withdrawal turning negative in 2008. The double-dip in US house prices in 2010-11 has affected the willingness of people to make major spending commitments and, consequently, the prospects of the US economy. Although the annual rate of US house prices will probably fall further in coming months due to base effects from the boost to prices from government stimulus last year, underlying price dynamics suggest a broad stabilization in home prices on a monthly basis. Given that the share of distressed properties as a percent of total sales starts to moderate, we believe that the worst for the US housing market are behind us. However, the weak housing sector will continue to weigh on household net worth, until we see a substantial improvement, sufficient to lead to positive mortgage equity withdrawal.

**Figure 1.7**




*Source: US Bureau of Labor Statistics*

**Figure 1.8**

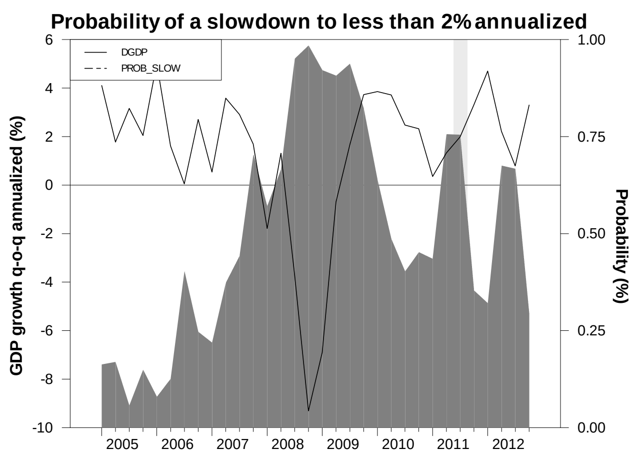



*Source: Federal Reserve*

## Risks for a weaker growth trajectory are skewed to the downside

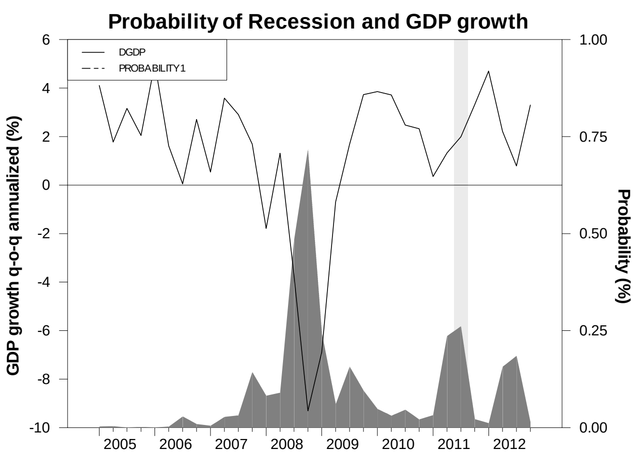
Given the labor market deterioration and the erosion of household net worth, our estimates suggest that the risk of a slowdown of GDP growth to a lower trajectory remains high for the remainder of 2011 and in 2012. In order to assess this risk, we use our GDP probit model, linking the probability of a slowdown to less than 2% q-o-q annualized to the quarterly change in nonfarm payrolls, real house prices and the ISM manufacturing index. Using the latest available data, the probability stays above 30% for H2 2011 and 2012, skyrocketing to about 70% in mid-2012 (Figure 1.9). On the other hand, using the traditional definition of a recession of two consecutive quarters of negative growth, the probability of renewed recession is hardly one-in-three (Figure 1.10). The historical experience of the US economy seems consistent with the idea that after 2 years into recovery, it is very likely to have a mid-cycle slowdown that lasts between 1-3 quarters. According to our research, following the six out of ten US recessions in the post war II period, there was a slowdown after 2-2.5 years of expansion.

**Figure 1.9**




*Source: EFG model estimates*

**Figure 1.10**




*Source: EFG model estimates*

The sub-trend pace of real economic activity suggests that the US economy remains particularly vulnerable to external shocks, such as losses in equity markets due to sustained tensions from the Euro area sovereign debt crisis, upside risks on commodity prices and a more protracted house price recovery than currently assumed. Even in such a case, the downturn in real GDP growth would probably be relatively shallow and short-lived (lasting about 1-2 quarters), given that the US economy is already operating at a reduced level of resource utilization. The role of US fiscal authorities is of vital importance so as to come up with a fix plan for federal finances by this fall, a plan that puts public debt on a sustainable path in the medium-term, while supporting the short-term US recovery. If the Joint Select Committee on deficit reduction fails to reach an agreement before 23 November, an enforcement mechanism will be used imposing more front-loaded spending cuts than currently expected, putting further downward pressure on growth.

**Fed to prevent the US economy from falling into a renewed recession**

Worried about the weak state of the US economy, the FOMC announced at its September meeting another round of monetary easing implemented between October 2011 and June 2012, in order to put downward pressure on long-term interest rates, create more accommodative financial conditions and support the mortgage market. Under its Maturity Extension Program ("Operation Twist"), the Federal Reserve plans to sell $400bn short-term Treasury securities with remaining maturities 3 years or less, and reinvest the proceeds in longer-term Treasury securities with remaining maturities of 6 to 30 years. Furthermore, the FOMC announced the reinvestment of principal payments on agency debt and agency mortgage-backed securities rather than Treasury debt, in order to "help support conditions in the mortgage markets". In addition, the Fed left the interest on excess reserves holdings unchanged at 0.25%, as it apparently judged that the costs of such an action would be higher than the expected benefits, while repeating that it expects to hold the federal funds rate at exceptionally low levels until at least mid-2013.

The recent "Operation Twist" of $400bn, which is the third easing program in a row following the 2007-09 crisis, is expected to increase the average duration of the Treasury portfolio from about 75 months currently to about 100 months by the end of 2012. Given the distribution across five sectors based on the approximate weights reported by the Federal Reserve Bank of New York (Table 1), we estimate that implementation of this "twist" will extend the total duration of securities holdings on the Fed's balance sheet by about $400bn in ten-year equivalents. This is close to QE2, when the Fed absorbed almost $390bn in ten-year equivalents. Hence, the impact of the maturity extension program on 10y Treasury yields will likely be comparable to QE2, in the range of 15-20 bps. The cumulative effects would correspond to a federal funds target rate cut of roughly 45-60 basis points[3], with the potential to offer a modest benefit of about 0.3% to headline growth over the next year[4].

**Table 1: Maturity Extension Program**

| Nominal Coupon Securities by Maturity Range | | | | |
|---|---|---|---|---|
| 6-8 years | 8-10 years | 10-20 years | 20-30 years | TIPS, 6-30 years |
| 32% | 32% | 4% | 29% | 3% |

*Source: Federal Reserve Bank of New York*

The main transmission channels of unconventional easing measures to the real economy are the following: (a) low real cost of capital throughout the economy by effectively keeping real yields at low levels to stimulate the economy. This could provide a boost to growth through consumption and investment, as well as help refinancing high government deficits and debt. (b) Higher expected inflation, pushing down real interest rates and stimulating real economic activity. Increasing inflationary pressures could also help inflate away some private sector debt and, therefore, help the deleveraging process. (c) Weaken the dollar to promote net exports and imported inflation. (d) Prevent a sharp increase of longer-term interest rates, driven by concerns about high budget imbalances and a fast-rising federal debt.

Focusing on the most recent monetary policy response, the reduction in duration supply from the market lowers the risk premium of US Treasuries, thus lowering the risk premia of other assets, i.e. higher equity prices, lower borrowing costs and mortgage rates. The immediate market reaction of the Fed's announcement was rather atypical for monetary easing: while 10y Treasuries fell about 15 basis points, the US dollar appreciated, and US equities and commodity prices

3 *Rudebusch D. Glenn, "The Fed's Exit Strategy for Monetary Policy" San Francisco Fed Economic Letter No. 2010–18*

4 *See "Aggregate Disturbances, Monetary Policy and the Macroeconomy: The FRB/US Perspective," Federal Reserve Bulletin, January 1999, where the Fed's model implies that a 100bps fed funds rate cut has a positive effect on real GDP by 0.6% after 1 year and by 1.7% after 2 years.*

experienced significant declines. Although it may take some time for asset prices to respond to this kind of action, possible reasons for the investors' immediate reaction may be the following: (a) Markets may have been disappointed because the Fed did not announce a new round of quantitative easing (QE3), but rather an extension of the average duration of its balance sheet, or (b) Markets may fear that "Operation Twist" will be ineffective and will not be enough by itself to push the economy to a rapid recovery. Besides, Fed Chairman Ben Bernanke has noted that monetary policy responses cannot be a panacea for the fragile state of the US economy. Unfortunately, in the current environment, the positive effect from low real cost of capital is been reduced by the state of the housing sector, given the large amount of unoccupied inventory and the households' inability to extract equity from homes through refinancing due to negative equity. In addition, the maturity extension program does not expand the Fed's balance sheet, so it should spark fewer inflation concerns. Hence, we expect only a modest boost for the economy, with a gradual recovery process.

Given the more positive economic outlook since its September meeting, the FOMC decided to keep policy unchanged at its November meeting. In terms of potential additional stimulus, should economic and financial market conditions weaken further towards the end of the year, the Fed could announce a third round of quantitative easing (QE3) so as to expand further its balance sheet and, therefore, monetize its debt. In such a case, renewed asset purchases of long-term Treasuries and, particularly, agency mortgage-backed securities (MBS) in order to support the depressed housing market, could help inflate away some public and private sector debt, and therefore aid the deleveraging process. Fed speeches over the last few days suggested a bias for further monetary easing between most FOMC members. In particular, Board Governor Daniel Tarullo made the case for moving large-scale asset purchases of agency MBS toward the top of the list of monetary policy options if further support is finally needed. In addition, Chicago Fed president Evans has recently proposed the FOMC to keep the federal funds rate at zero levels until the unemployment rate falls to 7-7.5%, while keeping the medium-term core inflation below 3%. Meanwhile, Evans dissented against November's decisions to stay on hold, favouring additional monetary easing. As clearly stated by Fed Chairman Bernanke, the FOMC is actively discussing further changes in its communication policy, providing forward guidance about the future path of the fed funds rate through published forecasts in the Survey of Economic Projections, or through tying the fed funds rate path to specific economic conditions (along with Chicago Fed president Evans's proposal). We believe that if in 2012 it is judged that the labor market is not recovering fast enough, there is a good chance that the Fed could provide further policy accommodation, committing to Treasuries' and MBS' purchases until the unemployment rate and/or inflation rate and/or nominal GDP have reached specified thresholds, in order to support economic activity more effectively compared with a standard Taylor rule.

# 2. The Euro area economy

Dimitris Malliaropulos, Vasilis Zarkos

- Economic sentiment has deteriorated sharply as the debt crisis escalated affecting core euro area members. We have revised downwards our GDP growth projections for this year (1.6%) and 2012 (0.5%) on the backdrop of tighter austerity and a less favorable global environment.
- A technical recession is likely around the end of the year. In our view, the recession will most likely be shallow, resembling more a stagnation of growth than an outright recession.
- The ECB is likely to fully reverse its tightening cycle, on the backdrop of mounting headwinds and elevated market tensions. Looking ahead, the ECB should be more tolerant to relatively high inflation and keep rates low, in order to boost growth amid strict fiscal austerity.
- A permanent solution to the debt crisis that attains full market confidence is required to save the euro area from the low growth trap. The recent anti-contagion initiatives constitute positive steps. However, policymakers provided only broad guidelines, while attaining markets' confidence depends on concrete details yet to be ironed out.

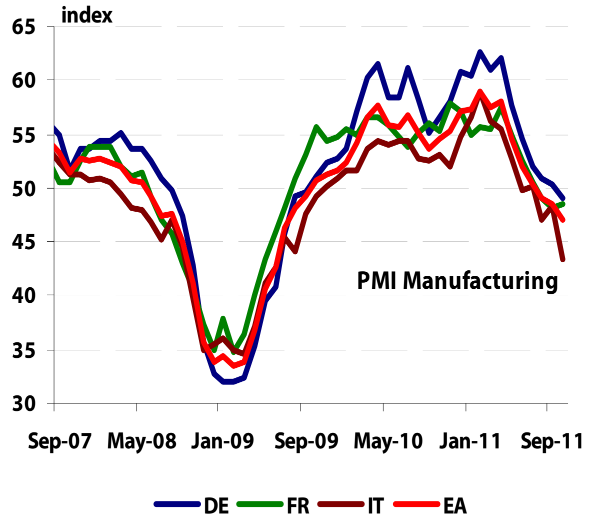
### Euro area growth is expected to stagnate

A dynamic start in the first quarter of the year has given way to sluggish growth in the second quarter, when euro area GDP expanded by a meager 0.2% q-o-q. Besides debt laden periphery members, core countries also performed poorly, as the contribution from net exports shrunk substantially, while domestic demand had a subtractive effect on growth (-0.1%). We initially interpreted this shortfall in growth as the adverse effect of a series of temporary effects. In particular, unusually harsh weather conditions brought about distortions in the German construction sector, weighing negatively on second quarter growth. Moreover, energy prices soared due to the destabilization of the MENA region, eroding households' disposable income. Finally, the massive earthquake in Japan caused distortions in supply chains, mainly affecting auto manufacturers.

What was initially thought of as a soft patch is most likely to turn out as a persistent slowdown of economic activity. The economic recovery could gain strength in the second half of the year, on the backdrop of more favorable commodity prices, a halt in the Chinese monetary tightening cycle and restoration of supply chains. However, since the summer, the debt crisis took a turn for the worse. Economic sentiment has deteriorated severely due to mounting uncertainty about the Greek debt sustainability and its repercussions to other week members and the euro area financial sector. Fiscal slippages in the Greek budget execution and slow political developments towards a permanent solution of the sovereign debt crisis are fueling markets concerns. Contagion risk to systemic countries is rising, as is evident by the widening of Spanish and Italian spreads to uncomfortable levels.

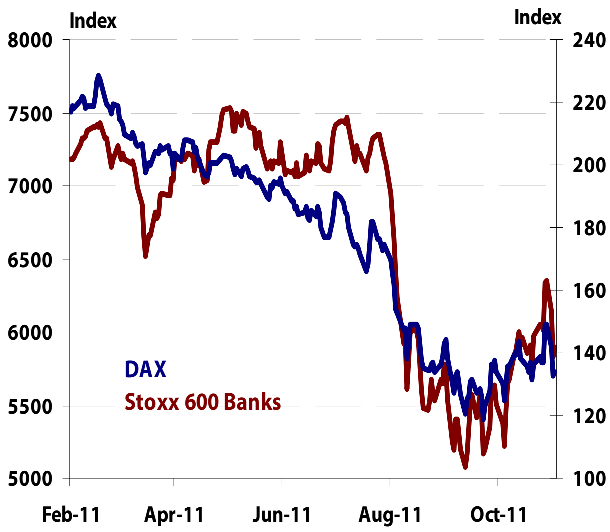
Against the adverse backdrop on the debt crisis front, leading indicators have come out very disappointing during the last few months. The euro area economic confidence index has slumped to its lowest level in almost two years. In a similar vein, the euro area PMI Manufacturing Indicator has entered recessionary territory since August (Figure 2.1). The slowdown exhibits synchronicity, as both periphery and core members are affected. Fiscal austerity takes a heavy toll in the periphery, as weak members struggle to turn to an export-oriented growth model, while domestic demand remains anemic or contracts. Core counties are also suffering from mounting uncertainty over the debt crisis and weaker trade activity, as global growth seems to be receding to a lower trajectory, most notably in the US. While Germany has served as the locomotive that dragged the euro area economy out of recession, growth is expected to moderate in the period ahead. The Ifo Expectations index has droped to a two year low, while the German PMI Index fell below the 50 threshold, reflecting a less confident business climate. Equity markets were hit, adding to confidence wearing down (Figure 2.2).

**Figure 2.1**




*Source: Bloomberg*

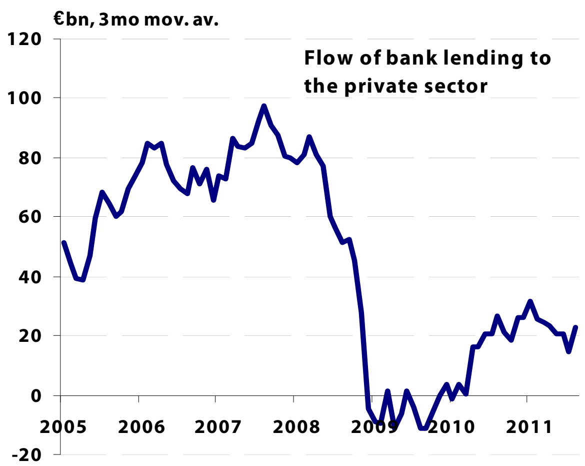
**Figure 2.2**




*Source: Bloomberg*

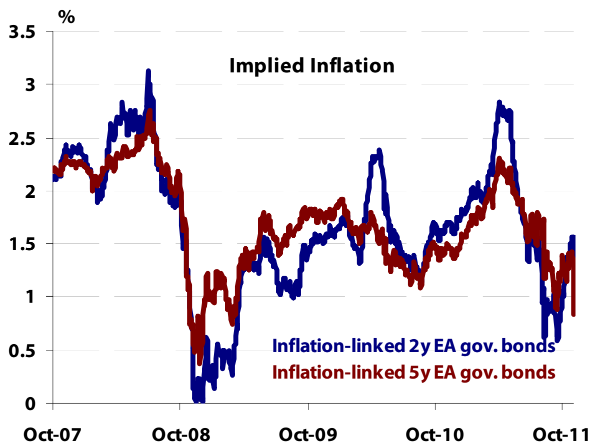
In light of the recent developments, we have revised downwards our euro area growth projections. We now expect GDP to expand by 1.5% this year, mainly attributed to robust performance in the first quarter. In 2012, real GDP is expected to print a 0.5% growth rate, substantially below trend. Several members including Italy, France and Spain, have adopted additional austerity measures and frontloaded their fiscal consolidation programs, in order to stem rising borrowing costs due to market pressures. As a result, the fiscal drag is expected to be more pronounced, affecting particularly growth in 2012. The flow of bank lending is expected to remain constrained (Figure 2.3), as already hampered financial institutions' balance sheets are facing mounting pressures due to the sector's exposure to sovereign paper. Moreover, firms are expected to put off investment plans due to gloomy prospects of future demand, while the contribution from exports is likely to turn out weak. Finally, personal consumption has little potential to compensate for weaknesses in other sectors, as persistently high unemployment at the aggregate level and continued deleveraging is expected to keep households' consumption subdued.

**Figure 2.3**




*Source: ECB*

**Figure 2.4**




*Source: Ecowin*

Growth divergence between core and periphery will continue, although it is expected to fade to some extent, as core members have been affected by financial turmoil. Germany and Greece will remain at the two ends of the spectrum. The former is expected to keep outperforming due to relatively stronger fundamentals. Private demand may benefit from favorable labor market conditions and rising wage compensation, while relatively healthy public finances call for mild adjustments. The openness of the German economy may allow both net exports and investment to take advantage from solid growth in emerging markets. Cash rich corporates and high levels of capacity utilization (currently standing above its record average) suggest that a pick up in capital spending could materialize once perceptions about future prospects improve. On the other hand, the recession of the Greek economy is deepening, as the country failed to push through structural reforms that could reverse the negative climate and prevent the free fall of economic activity.

## Debt crisis: positive steps but details yet to be clarified

Since late summer, the euro area debt crisis has escalated both in severity and complexity as it engulfed more systemic members, namely Spain and Italy. In the recent round of meetings, euro area policymakers tried to get to grips with the three main risk factors that prevent markets from calming down and require urgent action: i) bank recapitalization, ii) dealing with Greece's sovereign debt dynamics and iii) ring-fencing solvent but illiquid countries, most notably Spain and Italy, from adverse developments in Greece.

To ring-fence weak but solvent members from contagion, the policymakers agreed on leveraging the EFSF's firing power via an insurance scheme that offers first-loss guarantee on newly issued government bonds. In addition, the EFSF's resources may be enhanced by funds contributed by the IMF as well as private and public financial institutions and investors (e.g. EM sovereign wealth funds), via the establishment of Special Purpose Vehicles. A noteworthy merit of this scheme is that it does not require a new round of parliamentary ratification. The first-loss insurance intends to lower the borrowing costs for stressed members and improve the sustainability of their public finances. However, its effect is debatable since the countries which tap the mechanism will have to take an EFSF loan to guarantee the new bond. For example, assuming 20% insurance, the country that issues an insured bond worth €1bn needs to borrow €1.2bn in total. In addition, the EFSF insurance cannot fully remove credit risk. This means that bond purchases in the secondary market may remain crucial to manage the crisis. The SPVs could take this role. However, its ability to attract funds is tied to the ability of euro area authorities to attain investors' confidence, an issue that depends on the details yet to be ironed out. This implies that the ECB may have to be ready to intervene in the government bonds market in order to keep spreads in check, at least until the new EFSF scheme becomes operational.

Leveraging the EFSF as opposed to directly upsizing it, tries to circumvent the issue of putting additional pressure on the fiscal stance of strained core countries. The most notable example is France, whose top credit rating is already under question. Yet, the risk of stressing the public finances of guarantor countries is not entirely lifted. The provision of insurance, as opposed to outright debt purchases, entails the risk of zero amount spent if all ends up well, but also of zero recovery if things do not work out well.

With respect to the banking sector, the EU summit has decided on measures to ensure the medium-term funding of the financial institutions and to enhance their capital strength. Both initiatives aim at restoring the confidence in the banking sector and avoid a credit crunch. As regards to term funding, a scheme at the EU level will be providing guarantees on bank liabilities, allowing banks to use their guaranteed debt as collateral for ECB liquidity. Details on how the scheme will work need to be worked out. This initiative along with ECB's recent measures to scale up liquidity provision should facilitate bank funding. On the other hand, it may further strain public budgets, as sovereigns are most likely to provide these guarantees. This is particularly the case in countries where the negative feedback loop between banks and public finances is more intense, i.e. Spain and Italy.

As regards to capitalization of banks, stressed core Tier 1 capital has to reach 9% of risk weighted assets, after accounting for market valuation of sovereign debt exposures as of 30 September. Capital gaps have to be closed by end June 2012. In line with a recent proposal by the European Commission, policymakers decided that banks which need to strengthen their capital base should first seek private funds and, if that does not prove fruitful, sovereigns should step in and inject money to the banking sector. The plan leaves taping EFSF as solution of last resort. The EFSF should provide funds directly to banks as opposed to the state in order to avoid placing a burden on public finances. The EBA has provided preliminary estimates of recapitalization needs, identifying that additional capital requirements amount to €106.5bn. This amount is significantly lower than other estimates, including the IMF estimate of €200bn. In our view, the inclusion of sovereign exposures both in the trading and in the banking books valued at market prices add to the credibility of the EBA's calculations. On the negative side, banks may try to avoid state aid so as to avert shareholders dilution. In addition, current stock prices do not present banks with high incentive to sell shares. As a result, extensive deleveraging is likely, suggesting a negative impact on credit conditions and bank lending to the real economy. Once again, this is particularly likely in countries where cost of funds for banks is affected by strained public finances, namely Spain and Italy.

Greece's sovereign debt dynamics remain at the epicenter of the debt crisis, as lack of progress on structural reforms and privatizations resulted in larger funding gaps, corroborating markets disbelief about the country's debt sustainability. As it became evident that the country cannot return to markets soon, the euro area policymakers, spearheaded by Germany, demanded a deeper private sector involvement in the Greek debt relief. A nominal discount as high as 50% was decided in order to help the Greek debt recede to 120% of GDP by 2020, compared to 152% in the IMF scenario. Sweeteners up to €30bn will be offered to increase participation, while an additional program of €100bn will be provided. €30bn will be allocated to support Greek banks' capital adequacy. The new aid will come with increased surveillance, as the establishment of a monitoring capacity in Greece was announced, in order to ensure proper implementation of the reforms.

Once again, the summit revealed only guidelines of the new PSI deal, while specific terms have yet to be agreed. Negotiations between banks and policymakers in the coming weeks will remain intense, while the missing details will most likely determine the voluntary character of the deal. In any case, Greece needs to strictly adhere to its structural reforms program and find the courage to push through painful changes in order to achieve an economic rebound. Reentering an economic recovery path is what will ultimately put the country's debt dynamics to a sustainable path.

To this end, the agreement between the two leading Greek political parties to form a unity government is a positive development. A coalition government may restore international confidence on Greece, after the later was severely hit by an abrupt increase in domestic political uncertainty. Broad political consensus may accelerate the implementation of the bail-out decisions of the October 27 EU summit, while sharing of the political cost may render it easier to curb resistance of interest groups and push through structural reforms and privatizations.

The EU summit reiterated that a PSI scheme is necessary to Greece as an exceptional and unique solution and expects all other countries to honor fully their debt commitments. However, other program countries might ask for a similar debt relief, especially if their economy weakens further, putting increasing pressure for additional austerity in order to hit the program's fiscal goals. Nonetheless, strict monitoring that a PSI scheme entails may finally deter other members from requiring similar solutions.

In sum, the decisions taken provided only broad guidelines on how to tackle the three problem areas. Concrete though highly important details are missing, left to be negotiated in the coming weeks. Doubts remain on the ability of the recent steps to appease market concerns and help improve the debt sustainability of strained members. While the initiatives address tail risks, stemming mainly from adverse developments in Greece, they fall short of constituting a permanent solution. To this end, bold political action both to push through structural reforms and to provide a credible anti-contagion mechanism is still required. With respect to the ECB, although it did not take center stage in the recent decisions, we believe that its theoretically unlimited ability for intervention is required, and should be implemented if need be, to contain contagion.

**The ECB is expected to fully reverse its tightening cycle.**

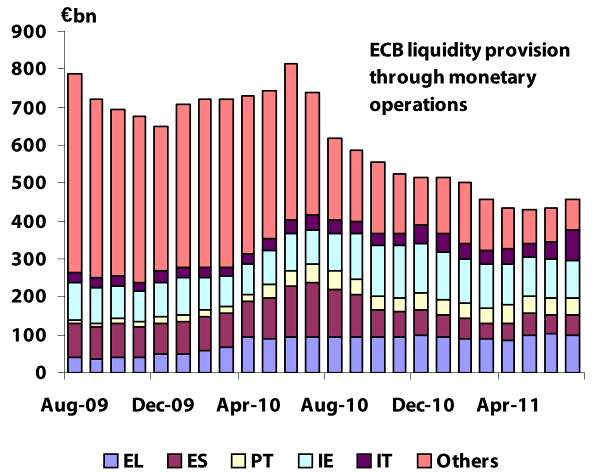
The ECB cut its main policy rate by 25bps to 1.25%, after pausing its tightening cycle in September, due to materializing downside risks to the economy and escalating tensions in the debt crisis front. Rate hikes earlier in the year were justified by soaring commodity prices and robust performance in core countries, most notably in Germany. However the recent economic slowdown is synchronized, affecting both periphery and core members. As inflation expectations have abated since last summer (Figure 2.4), rhetoric about price pressures has changed, with risks to inflation now considered as balanced. The new President of the ECB, Mr. Draghi, mentioned that GDP growth projection for 2012 is very likely to be revised downwards in December, which we interpret as a strong signal of further rate cuts. In our central scenario, the ECB will further lower its policy rate by 25bps in December.

As debt crisis tensions spill over to the financial sector, money markets remain hampered and several financial institutions, especially in the periphery, remain heavily dependent on the ECB for liquidity provision (Figure 2.5). Against this backdrop, the ECB has been prompted to inject more liquidity to the banking sector. In particular, the bank performed a six-month refinancing operation and has announced three US dollar provision operations. It has also eased collateral requirements for banks, by accepting as collateral assets that are not traded in regulated markets (effective from January 2012). In the October meeting, the ECB scaled up significantly its liquidity provision measures. In particular, it extended the period during which MROs and 3month LTROs are conducted at full allotment until at least the end of H1 2012, while it also announced a 12month and a 13month LTRO at full allotment. In addition it launched a new covered bond purchase program worth €40bn expected to be fully implemented by end-October 2012. The ECB reactivated its Securities Market Program in August, when Spanish and Italian spreads started widening to uncomfortable levels. While the program is highly controversial among ECB members, with German objections standing out, the ECB sovereign bond purchases may remain crucial in the debt crisis management.

While the ECB is anticipated to fully reverse its tightening cycle by a cumulative 50 basis points rate cut, further reduction of the intervention rate below 1% seems unlikely due to the fact that inflation is expected to recede in 2012 but remain close to the 2% threshold on the backdrop of tight energy fundamentals. Instead, further provision of liquidity would be favored, if need be, in order to smooth financial tensions while at the same time preserving the bank's credibility.

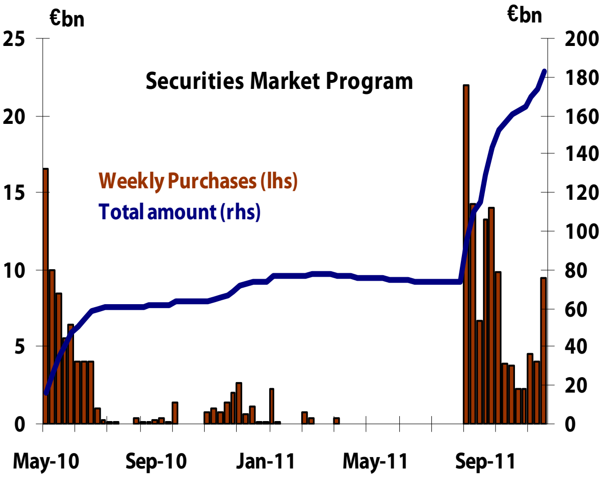
In the next few years, growth in the euro area will likely remain subdued due to large scale fiscal consolidation and a weak banking system. In our view, the ECB should maintain monetary policy loose, even if that means tolerating inflation persistently above the 2% threshold. That way, easy monetary conditions could counteract the drag from fiscal austerity.

**Figure 2.5**




*Source: Bloomberg, ECB*

**Figure 2.6**




*Source: Bloomberg*

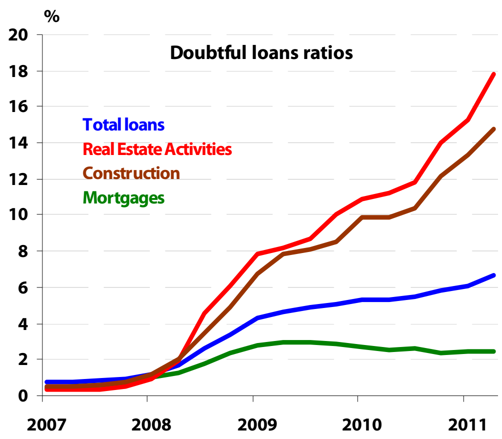
**Box 1. Restructuring Spanish banks**

Excesses in the real estate sector during the last two decades have inflated Spanish banks' balance sheets. Real investment in housing surpassed 9% of GDP in its peak in 2007, second only to Ireland in the Euro area. Since the onset of the financial crisis, followed by the Euro area debt crisis, banks have been suffering due to the burst of the housing bubble and the adverse macroeconomic environment. Savings banks, which represent about 40% of the banking system in terms of assets, were the weak link of the domestic banking system, mainly due to their highly concentrated risk in household loans, both for house purchases and consumption.

In 2009, the Spanish Government initiated a restructuring procedure centered on savings banks, in order to improve the soundness and the efficiency of credit institutions, increase their transparency, reduce overcapacity, improve corporate management and strengthen the capital adequacy of banks. The Fund for the Orderly restructuring of the Banking Sector (FROB) was created to manage the restructuring process and contribute to the reinforcement of capital position. Initially 45 savings banks have been reduced through mergers and other integration processes down to 15. The fragmentation of the sector has been reduced as the average of total assets per institution has risen from €29bn to €72bn. Overcapacity has also been reduced as both the number of branches and employees has on average declined, by 17.2% and 16.9% respectively, since end-2008. The FROB has injected aid of €11.6bn in the process. In 2009, a new legal framework allowed savings banks to transfer their banking activities to commercial banks, thus making easier for the former to tap the markets for funding.

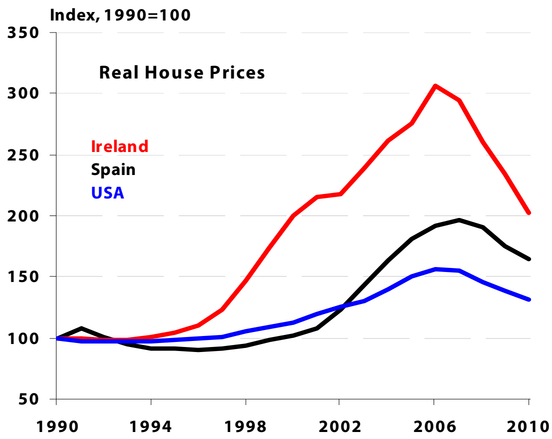
In early 2011, the government required all banks to achieve core Tier 1 level of at least 8% of risk weighted assets (elevated to 10% for those entities that rely on wholesale funding for more than 20% of total funding and less that 20% of their equity is held by third parties). According to Bank of Spain's calculations, thirteen banks (four commercial and nine savings banks) did not comply with the new solvency regulation and had to increase their capital by around €17bn (of which more than €14bn needed to be raised by savings banks). Institutions should first address markets to raise capital, resorting to the FROB if that proves not feasible. Recapitalization plans of most institutions (96.4% of the sector's assets) have been concluded by 30 September 2011. Of the thirteen institutions, four savings banks have included in their strategy FROB funds as a primary option for recapitalization. Overall, the recapitalization of banks has cost €13.39bn, of which €7.56bn have been contributed by the FROB.

**Figure 1**




*Source: Bank of Spain*

**Figure 2**




*Source: OECD*

Despite serious efforts and wide reforms undertaken to restructure the Spanish banking system, uncertainty remains about the strength of the sector and the final cost of its recapitalization to the state, as FROB borrowing is state guaranteed. From 2008 to mid 2011, cumulative write-downs amount to €105bn (10% of GDP or 3.0% of banks' total assets). Moody's and Fitch estimate that in adverse conditions, the government aid to capitalize banks might reach €100bn.

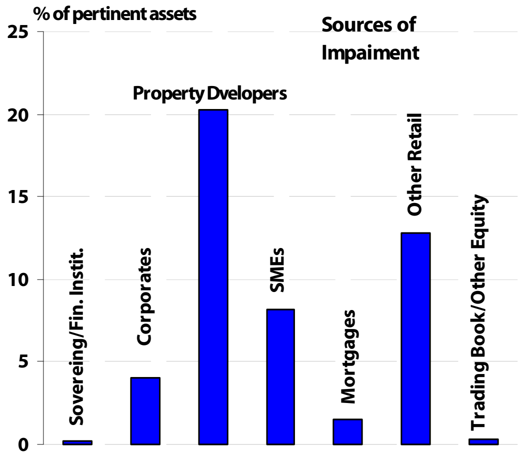
Real estate overhang stands out as the most important source of concern. Loans for construction and loans to real estate developers account for about 23% of total loans. Doubtful loans in these sectors are rising at an undiminished rate, raising fears about potential losses (Figure 1). According to the latest data (Q2 2011), doubtful loans for real estate activities and construction climbed to 17.8% and 14.7%, respectively. Real estate activities represent 45% of total doubtful loans. The Bank of Spain claims that for savings banks, 46% of total lending to construction and real estate development firms is potentially troubled.

Real house prices have fallen by about 17% cumulatively, since their peak in 2007 (Figure 2). Housing market will most likely experience further correction, exerting further pressure on banks balance sheets. Besides doubtful loans, bank assets include a large amount of repossessed real estate assets from developers who fell in distress. There is uncertainty as to what their true valuation is, while they are expected to be hit by falling prices.

On a positive tone, the July 2011 stress tests, which represented 95% of the financial system, revealed that all financial entities were successful in achieving core Tier 1 ratio above 5% in the adverse scenario, if all provisions and capital recently raised are taken into account. According to the tests, the largest source of impairment (cumulative for 2011-2012) in the adverse scenario stems from exposure to the real estate sector (Figure 3).

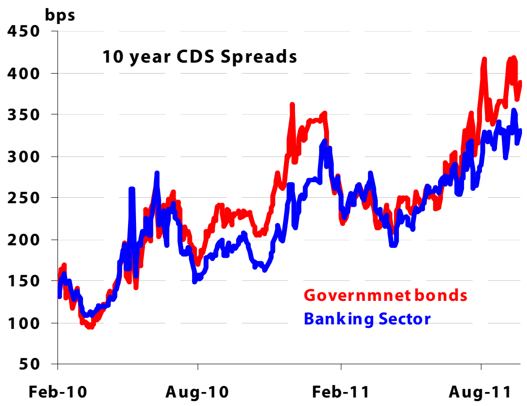
Tensions due to the euro area debt crisis affect adversely Spanish banks (Figure 4). Gross exposure to Spanish and foreign sovereign debt amounts to 6.91% of total assets (while the trading book figure declines down to 0.34%). Spain remains vulnerable to contagion due to anaemic growth, which raises doubt on the country's ability to put its public finances on a sustainable path. In addition, low quality banking assets raise fears on the soundness of the banking sector and the possible aid the state needs to inject in the system, creating a negative feedback loop between potential write-downs and government borrowing costs.

**Figure 3**




*Source: Bank of Spain*

**Figure 4**




*Source: Bloomberg*
*Note: Banking Sector CDS is the weighted average of respective CDS for Santander, BBVA and La Caixa*

# 3. The Japanese economy

Dimitris Malliaropulos, Vasilis Zarkos

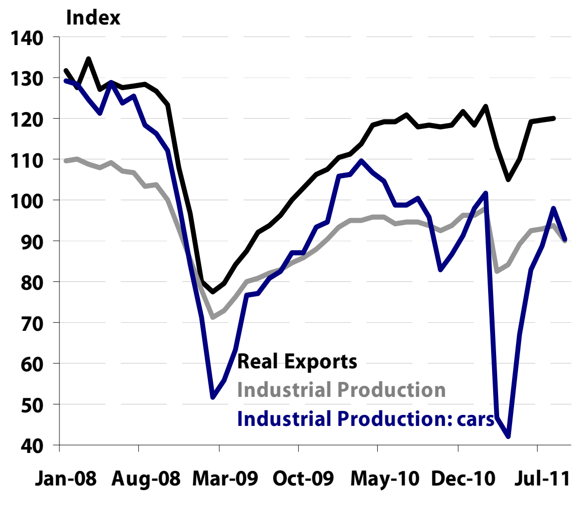
- Production and export activity has recovered since the March disaster. We expect the sharp economic rebound to peak in Q3 and recede to a more sustainable track thereafter. Reconstruction is anticipated to boost GDP growth in 2012, partially insulating the economy from global weaknesses.

- Fragile economic conditions in major developed countries and lower growth in emerging markets have made us lower our GDP growth projection for 2012 down to 2.3% from 2.8% a quarter earlier. Risks to the Japanese economy stem mainly from weakness in global demand and a rising yen.

- The BoJ is expected to keep its policy rate unchanged at least until the end of 2012. Further appreciation of the yen, most likely triggered by further erosion of global risk appetite and/or QE3 launched by the Fed, may prompt the BoJ to take additional action.

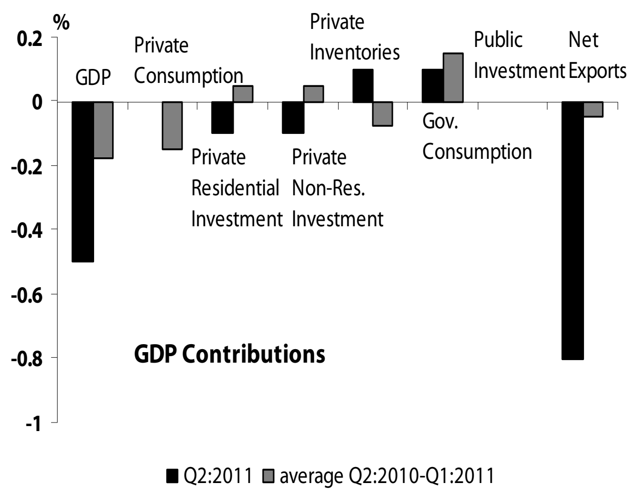
As was broadly expected, a V-shaped recovery followed the abrupt halt caused by the massive earthquake in March (Figure 3.1). Supply chains have been broadly restored while according to the Ministry of Economy, Trade and Industry 93% of the manufacturing bases directly hit by the disaster and 83% of those indirectly hit have recovered their production level. As a result, industrial production and real exports in August have almost reached their February levels (95.7% and 97.6%, respectively). In addition, yearly vehicle production growth entered positive territory in August. Electricity supply conditions are gradually normalizing as is evident by the end in restrictions on the electricity use in early September.

**Figure 3.1**




*Source: Bloomberg*

**Figure 3.2**



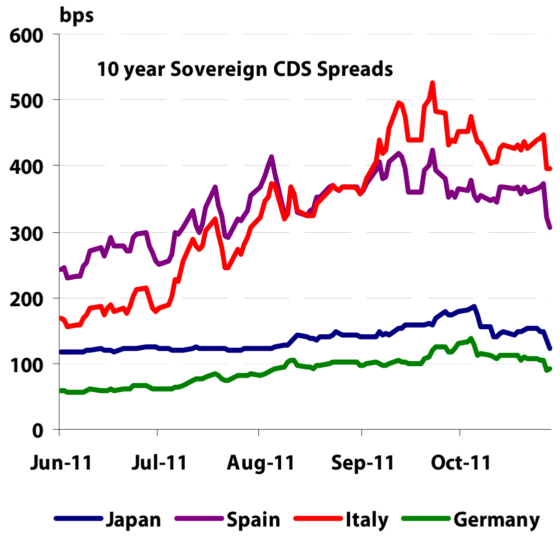

*Source: Cabinet Office*

The earthquake caused the Japanese economy to contract by 0.5% q-o-q in Q2, posting the third quarterly negative growth reading in a row (Figure 3.2). GDP shrunk mainly due to a slump in net exports and disappointing private capital expenditures. We expect GDP to post a sharp rebound in Q3, on the backdrop of fast restoration of the damages caused by the earthquake. The economic activity will most likely peak in Q3 and recede to a more sustainable trajectory thereafter. In particular, the economy is anticipated to loose momentum towards the end of the year, as base effects fade away, extensive reconstruction is not expected to kick in earlier than Q2 2012 and exports will now be constrained by weaker global demand rather than by supply distortions. Later in 2012, we expect economic growth to accelerate boosted by public reconstruction expenditures, higher export volumes, provided that global economic sentiment improves and fading burden due to energy imports, as nuclear stations are likely to resume operation (at the moment, about 35% of nuclear reactors operate).

Consumption is expected to rebound in Q3 due to base effects and a resurge in car sales. However, a plunge in TV sales is likely to have a negative impact, after Japanese rushed to buy new TV sets prior to transition to digital signal. Looking ahead, household expenditures are likely to take advantage from reconstruction, the eco car tax reduction program and a likely revival of the eco appliances point system financed by the third supplementary budget. That said, we anticipate subdued consumption growth in 2012 as business sentiment is expected to remain stressed, while labor market conditions remain relatively adverse. The September labor survey is the first since February to include disaster affected prefectures. The survey reveals that the nationwide unemployment rate declined to 4.1%, compared to 4.6% in February. Yet, one should read the figures with caution, as since February, the labor force declined by 970000, while employed persons are 560000 less. Persons not in labor force jumped by 1960000 compared to a month earlier (when disaster areas were not included), suggesting that employment conditions in the afflicted regions remain harsh.

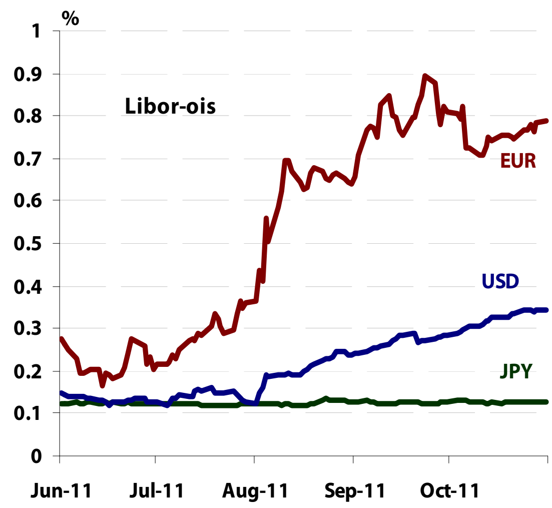
Unlike other major developed countries, where growth is forecast to stagnate or even contract, the Japanese economy will benefit from reconstruction expenditures that may partially insulate the country from global demand weaknesses. Prime Minister Noda has proposed a third supplementary budget for reconstruction worth ¥12tn, above the initially assumed figure of ¥10tn. This adds to the first and second supplementary budgets worth ¥6tn and the sum matches the government estimated damages of about ¥17tn. However, uncertainty remains about the final size and time of implementation of the plan, as the government needs opposition party cooperation for parliamentary approval. Besides issuing government bonds, large spending cuts, privatizations and higher taxes levied on individual incomes and corporations are proposed to finance the budget, implying that political disputes may delay the implementation of the reconstruction policies. That said, in our baseline scenario the budget is likely to start affecting economic growth from the beginning of the new fiscal year, i.e. Q2 2012.

**Figure 3.3**




*Source: Bloomberg*

**Figure 3.4**

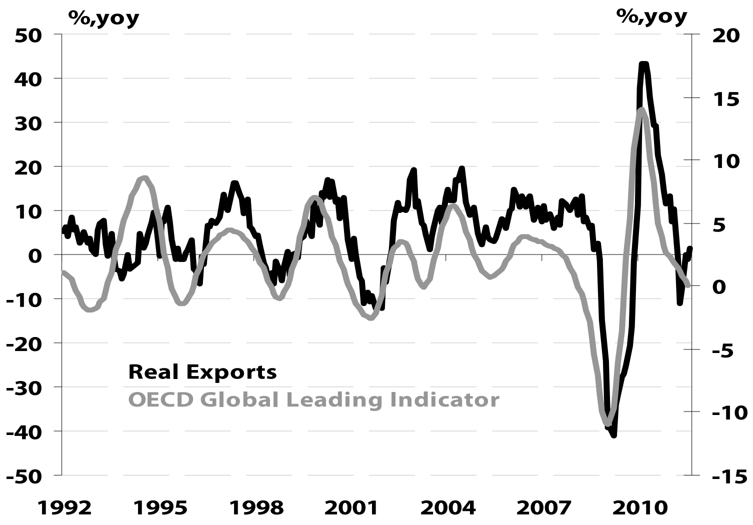



*Source: Bloomberg*

Core inflation, i.e. inflation excluding fresh food, turned positive mainly due to soaring energy prices in the first half of the year. However, core inflation is expected to return to negative territory, most likely in October, as the cigarette tax hike and the one-off increase in casualty insurance premia come full circle. Looking ahead, core inflation is expected to remain negative throughout 2012, on the backdrop of lower energy prices, yen appreciation and weak domestic demand.

Risks to the Japanese economy stem mainly from weakness in global demand and a rising yen. Fragile economic conditions in major developed countries and lower growth in emerging markets have made us lower our Japanese growth projection for 2012 down to 2.3% from 2.8% a quarter earlier. Financial turbulence in the euro area has reached Japan, though at a muted extent. Some contagion is evident in sovereign CDS widening (Figure 3.3), however, markets do not seem to worry much about the country's stressed public finances. On the other hand, unaffected JPY Libor suggests that there is no significant stress in interbank lending (Figure 3.4). This does not come as a surprise, given the low exposure of Japanese banks to euro area debt. Nonetheless, further escalation of the sovereign debt crisis in the euro area would have negative repercussions for the economy, as Japanese exports are highly dependent on external demand (Figure 3.5). In addition mounting uncertainties in Europe keep the yen at persistently elevated levels, due to it safe heaven status. This erodes competitiveness of Japanese products, companies' repatriated profits and their stock valuations, thus offering firms incentives to move production overseas, to the detriment of employment and domestic demand.

**Figure 3.5**




*Source: Bloomberg*

The Bank of Japan acknowledged in its October meetings the rising risks to the economy due to the global slowdown and the appreciating yen. The bank has recently decided to enhance its monetary easing by increasing the total size of its asset purchases by ¥5tn. The additional easing came after the USD/JPY cross dropped to new record lows, revealing the bank's increasing concern about the strengthening of the currency. After the recent expansion, the central banks' unconventional measures currently stand at ¥55tn, comprising of ¥35tn in liquidity provision and asset purchases worth ¥20tn. As of the end of September, fund supply stands at about ¥31.2tn while asset purchases sum up to slightly above ¥6tn. In our view, the BoJ will remain on a loose monetary policy mood due to the deflationary environment and the strong yen. Further appreciation of the yen, most likely triggered by further erosion of global risk appetite and/or QE3 launched by the Fed, may prompt the BoJ to take additional action. This could include i) extending the maturity of bond purchases ii) additional scaling up of the asset purchases ceiling, iii) increasing the pace of asset purchases. With respect to the uncollateralized overnight call rate, the BoJ is expected to keep it unchanged at 0-0.1% until at least the end of 2012.

# 4. Emerging Markets: Growth expected to remain robust, though moderate to more sustainable rates

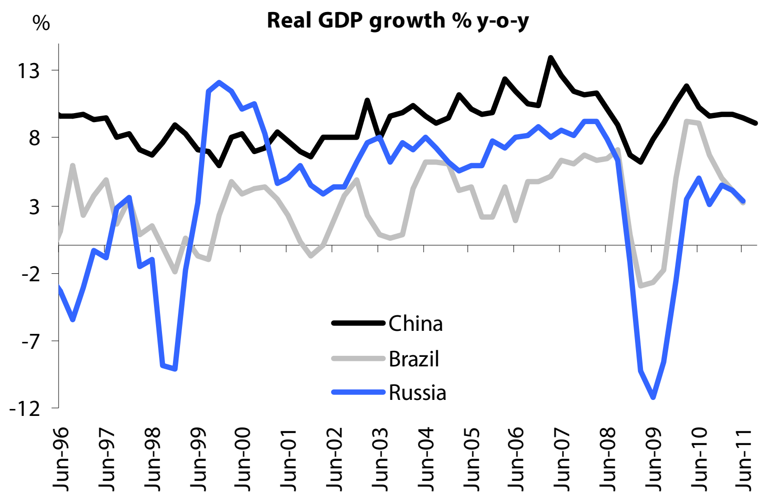
Dimitris Malliaropulos, Maria Prandeka

- The significant deceleration of economic growth in advanced economies along with monetary tightening has resulted in the moderation in emerging markets' economic expansion over the past year.
- Economic sentiment indicators across all emerging market regions point to further weakness in the remainder of 2011.
- Inflation in most emerging markets is expected to come down only gradually, given that there are still risks of second-round effects from past food and energy hikes and spill over of still high producer prices into core inflation.
- The emerging market policy tightening cycle has likely reached its peak, easing some of the headwinds that interest rate hikes brought to real incomes and private consumption.
- We believe that most emerging economies are well-positioned to withstand deepening turbulence in the global economy and growth is expected to remain robust, despite the ongoing slowdown.

## Slowdown in emerging markets is underway

The significant deceleration of economic growth in most parts of the developed world along with monetary tightening has taken its toll on emerging markets (EM) economies over the past year. Recent data on real GDP growth confirm the moderation in the pace of expansion (Figure 4.1).

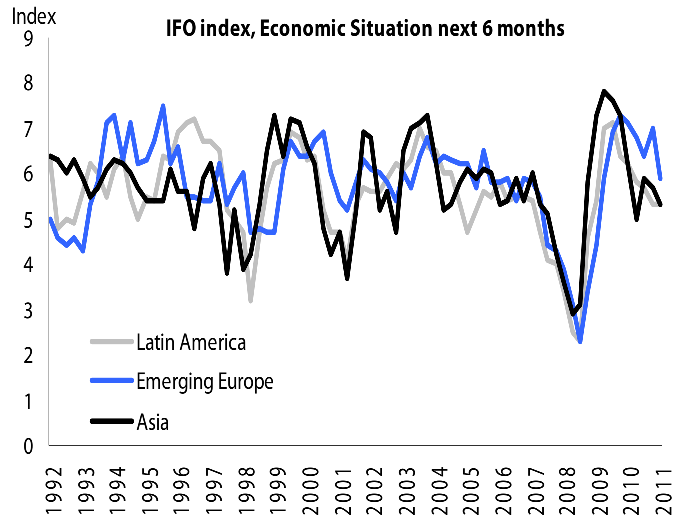
**Figure 4.1**




Source: Bloomberg

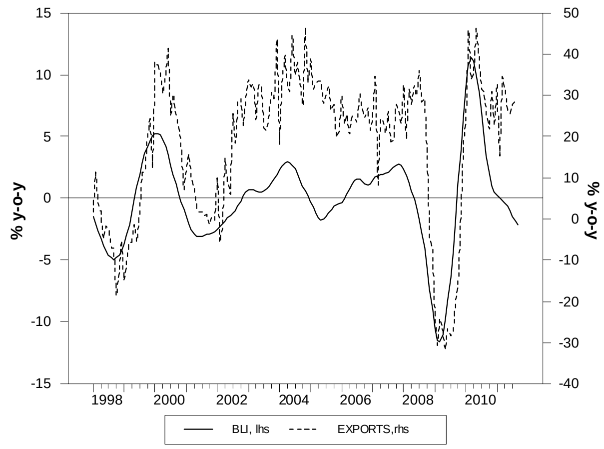
In line with real GDP data, economic sentiment indicators across all EM regions have been trending down since 2010 and point to further weakness in the remainder of 2011. However, they remain above the 5-point-level that indicates expansion (Figure 4.2). As Figure 4.3 depicts, until recently, the slowdown of global growth has not hurt EMs' nominal exports that much, partly because of elevated commodity prices. The latter have receded recently and downside risks to global growth have grown substantially, suggesting that external demand in EM would likely deteriorate in the coming months, which is strongly confirmed by our BRICs leading indicator[5]. Among emerging economies, those having a larger degree of openness to international trade are more vulnerable to a sudden global shock. Figure 4.4 illustrates that China and India are likely to see a quicker transmission of slowing external demand into domestic activity than Russia and Brazil. However, it is worth noting that trade openness has been shrinking in recent years, particularly in China where a rebalancing of the economy towards consumption is underway, a fact that helps in cushioning spillovers from weakening advanced economies.

**Figure 4.2**



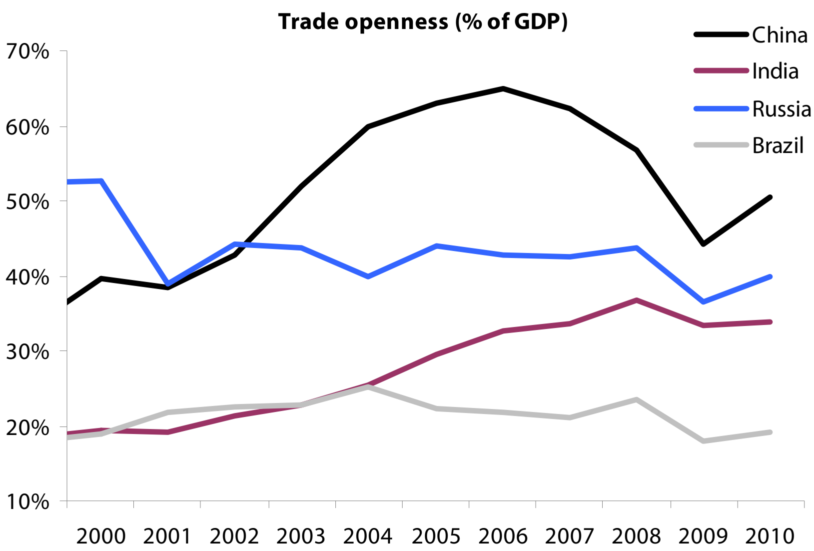

Source: Ecowin

**Figure 4.3**
**BRICs Leading Indicator***




* 3 month forward
Source: Eurobank EFG

**Figure 4.4**




*Source: IMF, Directional of Trade Statistics & World Economic Outlook Database September 2011*

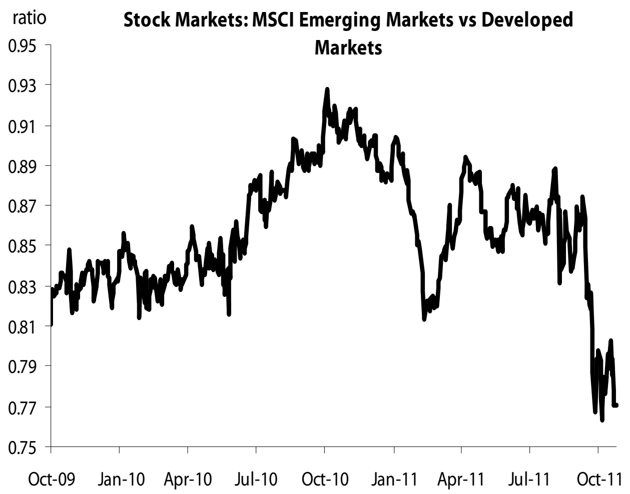
[5] *We compute the BRICs leading indicator as the weighted sum of each country's monthly OECD composite leading indicator. The weights are the corresponding gross domestic product based on purchasing-power-parity (PPP) share of world total. BRIC's leading indicator identifies the signals of changes in the economy almost three months before the actual turning points are found in the economic activity.*

The adverse impact of the global turmoil is also evident in emerging economies' financial markets. Concerns about the ongoing risk to growth from tighter monetary policy in EM and slowing external demand weighted on investors' sentiment, leading to the underperformance of emerging market equities versus developed market (DM) equities. Since the beginning of the year, EM equities underperformed DM equities by about 15% (Figure 4.5).

### Inflation has receded recently, though is expected to remain relatively elevated

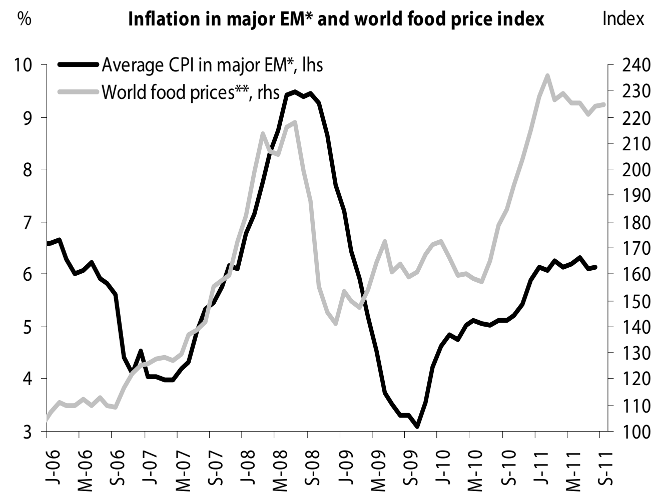
Average headline inflation across major EM economies has been on the rise since 2009, on the back of rising food and commodity prices. In fact, it has increased from 4.5% in 2009 to 5.1% in 2010, while over the first half of 2011 it has risen further to an average of 6.2% y-o-y (Figure 4.6). Since mid-summer, headline inflation in most EM appears to be losing some momentum but only to a small extent. Food prices, which have a large weight in the consumer price baskets across the emergers, have receded only modestly from their 2011 peaks and are likely to stabilize at present elevated levels. Low inventories, climate change, expanding income and population growth and structural changes in consumption patterns in developing countries are just some of the leading causes expected to keep food prices relatively elevated and volatile. Notwithstanding the recent drop in food prices, and even if food prices not reaccelerate in the coming months, we expect inflation in EMs to come down only gradually, given that there are still risks of second-round effects from past food and energy hikes and spillover of still high producer prices into core inflation.

**Figure 4.5**




Source: Bloomberg

**Figure 4.6**




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

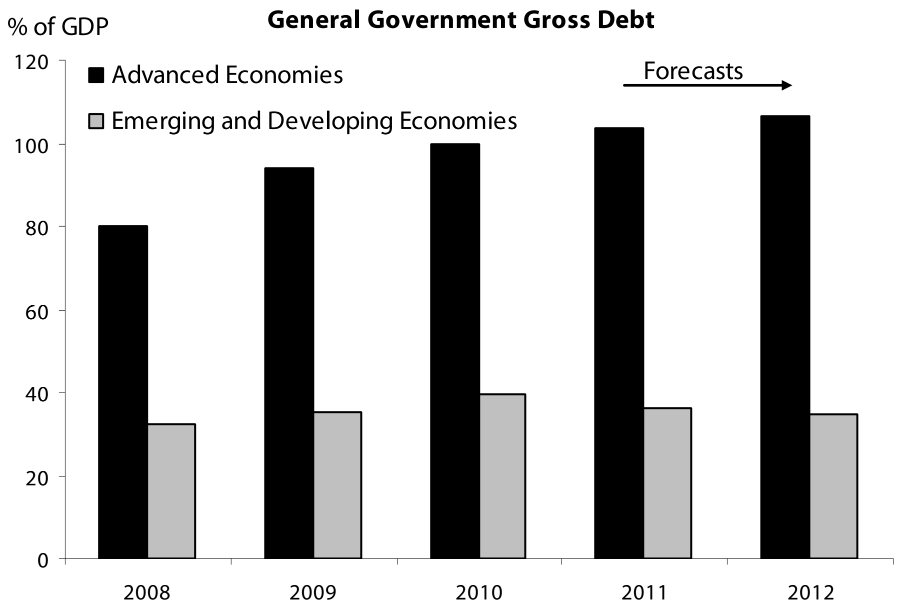
### Monetary tightening has likely peaked, supporting growth

As a result of easing inflationary pressures and a broad-based slowdown in global growth, the EMs policy tightening cycle has likely reached its peak, causing a number of countries to either hold interest rates or ease. In particular, Brazil's central bank cut its key policy rate 100bp to 11.50% in two moves since end-August, after a tightening cycle that began in April 2010 and resulted in policy rates higher by 375 basis points. This surprising interest rate cut came at a time when inflation is running at a six-year high of 7.3% y-o-y in September 2011. In fact, Brazil's monetary authorities believe that in order to promptly mitigate the effects of a more restrictive global environment, a moderate adjustment in the level of the policy rate is consistent with inflation converging to the target in 2012. Indeed, it seems that policymakers in EMs are showing growing tolerance for higher inflation, turning their attention from fighting inflation to supporting growth.

**Despite the ongoing slowdown, growth in most EM economies is expected to remain robust**

Looking forward, we believe that most emerging economies are well-positioned to withstand deepening turbulence in the global economy and sustain moderate growth in 2012. First, there is still room for fiscal easing to support growth, given that EMs' fiscal situation is relatively healthy compared to advanced economies. General government gross debt in emerging and developing economies was 39.3% of GDP in 2010, well below that of advanced economies (100% of GDP in 2010) (Figure 4.7). Second, the end of the monetary tightening cycle is expected to ease some of the headwinds that interest rate hikes brought to real incomes and private consumption since the tightening cycle in EM has started, approximately a year ago. Third, domestic demand in EM is particularly strong and a number of EM, in particular China, have already indicate policy reforms aiming at rebalancing their economies from foreign to domestic demand and, thus, supporting steady improvement in private consumption.

**Figure 4.7**




*Source: IMF*

All in all, growth in EM remains fairly robust, although it is moderating and EM economies 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[6], in 2011 and 2012, growth in emerging and developing economies is expected to moderate to still buoyant growth rates of 6.4% and 6.1%, respectively, well above the thirty year average of 4.5%. In addition, these rates are significantly higher than the expected growth rates of 1.6% and 1.9% in advanced economies. Over the past decade, EM economies have increased significantly their share in global GDP (from 37% in 2000 to 48% in 2010) and are expected to surpass advanced economies over the next two years, becoming gradually the world's largest economies. It is worth noting that advanced economies' share in global GDP has declined through time (52% in 2010 versus 63% in 2000).

As far as particular EM regions are concerned, in Emerging Asia the significant momentum in economic activity implies that the region will continue to outperform its peers. China and India will continue to play the most important role in the region and robust domestic demand will spread from these countries to their Asian peers. In Latin America, the possibility of further correction in commodity prices would play a significant role in determining the slowdown in the region. Emerging Europe's main challenge is the impact that the deterioration in the economic and financial situation in the Euro area will have on the region's activity.

[6] *IMF, World Economic Outlook Update, September 2011*

# Focus China: A soft landing amid a global slowdown

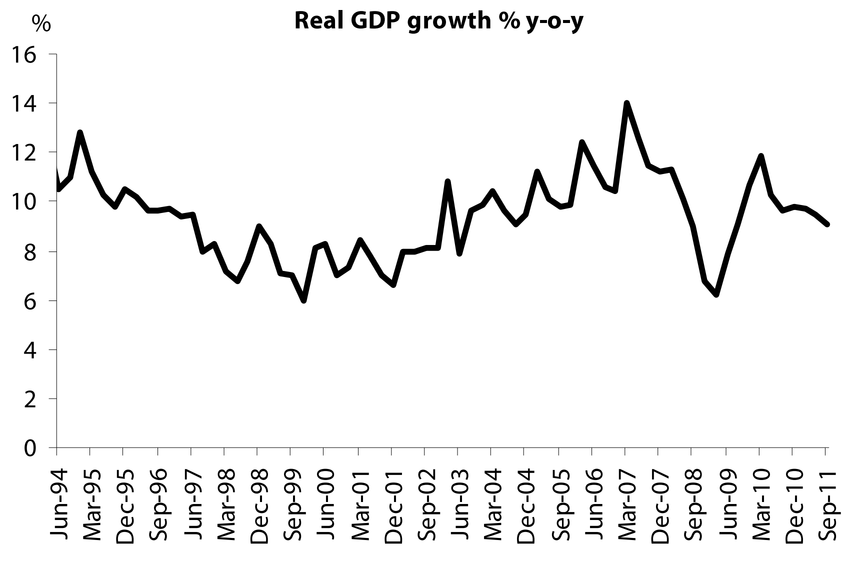
Dimitris Malliaropulos, Maria Prandeka

- China's economy has eased moderately over the first nine months of 2011, strongly affected by the monetary tightening, the slowdown in demand from its major export partners, and supply-side bottlenecks.
- A rebalancing of the economy towards consumption could be underway, since the contribution of consumption to real GDP growth has increased significantly from 2010.
- Easing investment activity is expected to constitute the main drag on real GDP growth in 2011 and 2012.
- Overall, real GDP growth is projected to moderate to 9.3% y-o-y in 2011 and 8.9% y-o-y in 2012. This moderation can be considered a soft landing, with the risk of a marked slowdown rather low.
- In our view, even if advanced economies deteriorate much more sharply than anticipated, the downside risks to China's growth outlook are limited by its flexible policy regime.

With uncertainties in the global economy on the rise and weaker outlook in the US and Europe, China's growth prospects have weakened, creating heightened worries about the extent to which China will slow down, given its growing global economic weight. Indeed, China's economy has eased moderately over the first nine months of 2011, strongly affected by the monetary tightening, the slowdown in demand from its major export partners, particularly US and Europe, which account for about 40% of China's total exports, and supply-side bottlenecks (domestic power shortages due to severe drought conditions and supply chain disruptions from the earthquake in Japan). According to the latest data, real GDP growth eased to an average of 9.4% y-o-y in the first three quarters of 2011, down from 10.3% y-o-y in 2010 (Figure 4.8).

Domestic demand was the main driver of growth, with investment and consumption contributing 5.1% and 4.6% respectively. Indeed, the gradual pick up of China's National Bureau of Statistics (NBS) PMI manufacturing index in September (to 51.2 from 50.7 in July and 50.9 in August 2011), is a reassuring sign that domestic demand remains robust. Net exports subtracted 0.1 percentage points of GDP growth, while in 2010 net exports added 1pp to real GDP growth.

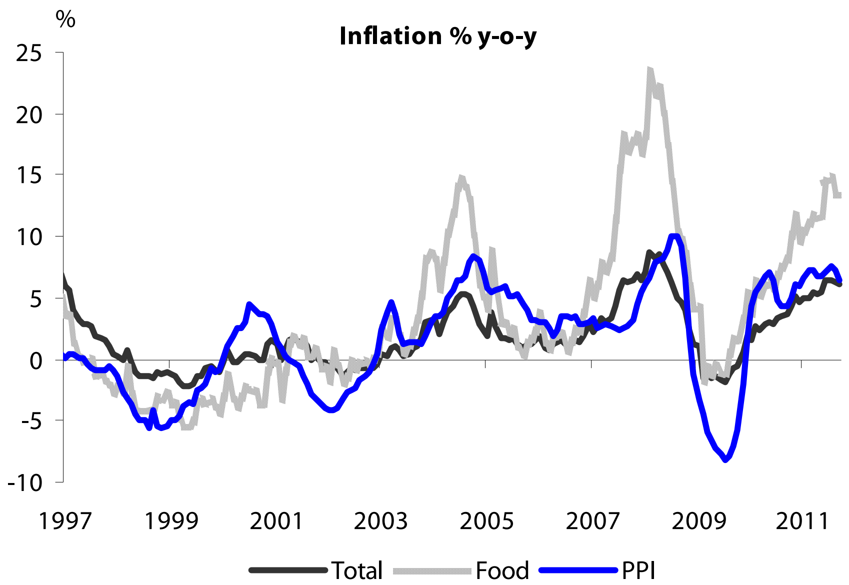
**Figure 4.8**




Source: Bloomberg

Looking at the components of real GDP, it seems that a rebalancing of the economy towards consumption could be underway, since the contribution of consumption to real GDP growth increased to 4.6pp from 3.8pp in 2010, with private's consumption contribution increasing the most (0.6pp), from 2.8pp in 2010 to 3.4pp in the first nine months of 2011. Looking forward, we expect private consumption to display some resilience for several reasons. The government will accelerate policy reforms, which would aim at rebalancing the economy and thus support steady improvement in private consumption. Moreover, moderating inflation should underpin consumers' purchasing power. As a result of easing inflation and significant external uncertainties, we believe that monetary tightening most likely will come to a halt, easing some of the headwinds that interest rate hikes brought to real incomes and private consumption since the tightening cycle has started a year ago. However, we do not expect the People's Bank of China to shift toward an easing bias soon, either. Although the September reading of CPI inflation shows that China's inflation eased gradually to 6.1% y-o-y from a three-year high of 6.5% y-o-y in July 2011, there are still some risks of a spill over of still high producer prices (6.5% y-o-y in September 2011) and food prices into consumer prices, suggesting that inflation will come down only gradually (Figure 4.9).

**Figure 4.9**




*Source: Bloomberg*

Contrary to consumption, the contribution of investment to real GDP growth decreased to 5.1pp in the first three quarters of 2011 from 5.6pp in 2010 and 8.4pp in 2009, when the Chinese government introduced a CNY 4 trillion stimulus package. We expect easing investment activity to constitute the main drag on real GDP growth in 2011 and 2012. Investment growth is expected to slow further for several reasons. Taking into account that manufacturing accounts for more than 30% of total fixed asset investment, the ongoing exports slowdown is likely to affect about one third of China's investment activity. Moreover, real estate investment which accounts for about 25% of total fixed asset investment is expected to worsen due to persistent tightening measures to slow property price increases (Figure 4.10).

**Figure 4.10**


*Source: Bloomberg*

Looking forward, we expect real GDP growth to moderate to 9.3% y-o-y in 2011 and 8.9% y-o-y in 2012. This moderation can be considered a soft landing, with the risk of a marked slowdown rather low. China's economic performance will remain robust and steady growth rates should continue. Indeed, China is expected to remain the leader of global growth, growing substantially faster than advanced economies over the next few years. China's share to global GDP has increased substantially since 1980, accounting for 13.6% of GDP in 2010, significantly up from 2.2% in 1980. Indeed, according to the latest IMF forecasts[7], based on PPP data, China is expected to overtake the US and become the world's largest economy by 2016.

In our view, even if advanced economies deteriorate much more sharply than anticipated, the downside risks to China's growth outlook are limited by its flexible policy regime. Although the policy space for stimulus is more constrained than in 2008 because the economy still faces the consequences of the stimulus package, including elevated inflation, local government debt and asset bubbles, we believe that a sharp external growth slowdown would trigger a quick policy response, with the introduction of a new stimulus package, albeit significantly limited compared to the previous package. Indeed, China's fiscal situation is relatively healthy. National government debt (including local governments' debt) is about 45% of GDP, which is well below that of advanced economies. Meanwhile, fiscal revenues have been growing at an average rate of about 32% y-o-y over the first eight months of 2011, enhancing the government's capability to respond to a marked slowdown in growth.

[7] *IMF, World Economic Outlook Database, September 2011*

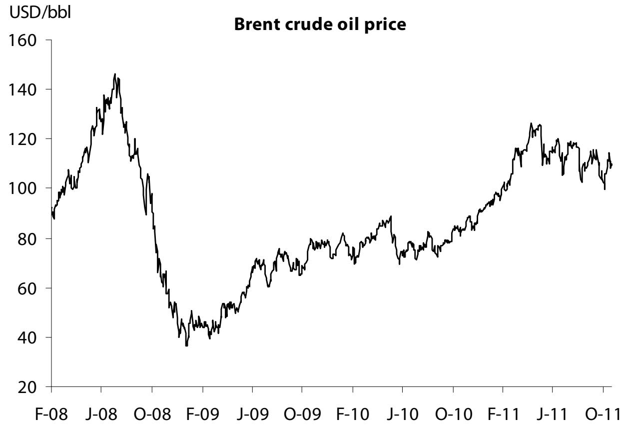
# 5. Commodities: Lower prices across commodity complexes, but upside risks persist

Dimitris Malliaropulos, Maria Prandeka

- The steady increase in commodity prices over the past year has been followed by a meaningful correction over the summer, due to concerns over weaker global growth prospects.
- However, most commodity prices remain relatively high compared to historical levels mainly due to tight supplies.
- We believe that commodity prices should remain around current elevated levels through the end of 2011, supported by robust demand from emerging economies and the persistence of tight supply/demand fundamentals in most commodity complexes.
- Precious metals, even if global economic environment deteriorates further, have the highest upside potential, due to investment-related factors.
- Tight supply and demand dynamics are expected to keep oil prices at historically relatively high levels and leave the oil market rather sensitive to potential supply disruptions from geopolitical or other kinds of risks.
- In the agricultural sector, factors such as low inventory levels, elevated oil prices, increasing frequency of extreme weather events, geopolitical turmoil and structural changes in consumption patterns in emerging economies are expected to continue to exert upward pressures on agricultural prices in the medium term.
- Robust growth in emerging economies is expected to provide a floor to downside risks on base metal prices.

Since mid-2010, commodity prices have risen significantly, mainly on the back of strong gains in global demand and disruptions to global supply. Brent crude oil prices have soared above US$ 125/bbl in early April 2011 (Figure 5.1), while gold prices hit an all-time nominal high of $1895/toz (Figure 5.2). Agricultural prices as well as industrial metals also performed well, reaching new multi-year highs. However, in early May, concerns over weaker global growth prospects, which had been steadily growing over the summer, finally manifested in equity markets. In particular, mounting fears that the US will slide into recession and that emerging economies will eventually be affected triggered excessive liquidations in equity markets across the globe. The heavy liquidations also spread to commodity markets amid worries for the economic outlook of

**Figure 5.1**




*Source: Bloomberg*

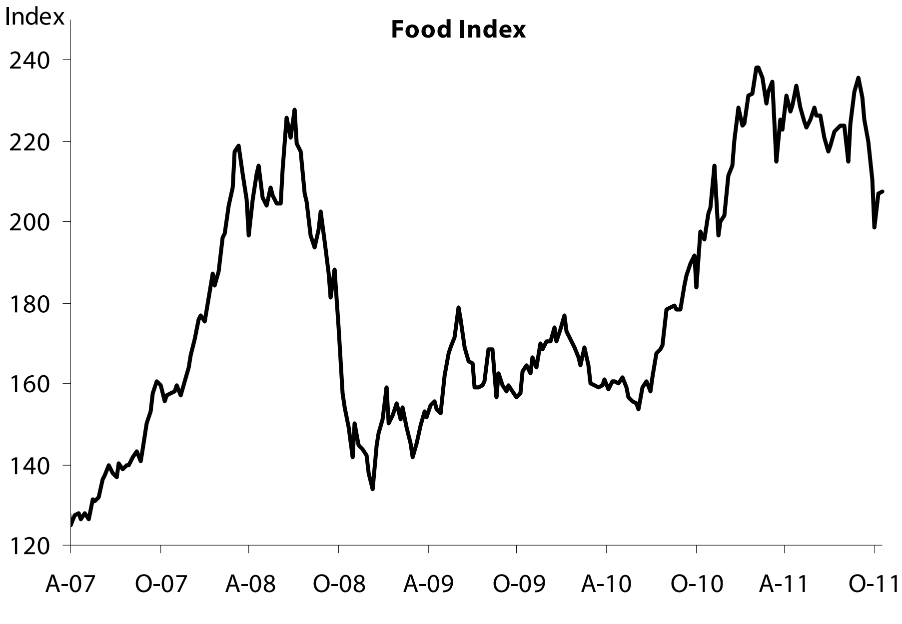
**Figure 5.2**


*Source: Eurobank EFG*

emerging economies, which have been the main source of accelerating commodity demand growth in recent years. The sales in commodity markets are also attributed to a large extent to investors taking profits, in order to offset losses in other asset classes. As a result, the steady increase in commodity prices has been followed by a meaningful correction over the summer.

However, most commodity prices remain relatively high compared to historical levels. Brent crude oil prices are about 35% above its levels a year earlier. Although gold prices slipped to below $1700/toz at the end of September, their gains for the year to date are standing at about 20%. Food prices are more than 10% higher than a year ago and close to their 2008 highs (Figure 5.3).

**Figure 5.3**




*Source: Ecowin, The Economist Food Price Index*

In most commodity complexes, tight supplies help explain why some commodity assets such as oil and gold have proved very resilient in the face of recent economic and financial uncertainty. The 2008-2009 recession along with the current financial meltdown has had significant implications for capacity expansion in many commodity markets and has played a significant role in reducing the pace of supply growth. The latter has also taken a hit from extreme weather events and the escalation of geopolitical turmoil in the Middle East.

Looking forward, we believe that commodity prices should remain around current elevated levels through the end of 2011, though should remain particularly volatile, due to the high level of uncertainty surrounding the global economic environment. Robust demand from emerging economies and the persistence of tight supply/demand fundamentals in most commodity complexes are expected to support high levels of commodity prices. Particularly, downside risks on commodity prices from the weakening demand in developed economies will be more than offset by emerging economies, the major driver of commodity demand. In fact, the emerging world accounts for about half of global oil and gold demand, while China is today the largest consumer of a number of base metals. In these countries, as we have already mentioned, despite the ongoing slowdown, growth is expected to remain robust. Meanwhile, the abovementioned significant implications for capacity expansion in many commodity markets are likely to continue to contribute in reducing the pace of supply growth over the coming years. The recent surge in both the frequency of extreme weather events and geopolitical threats, in combination with low inventory levels and falling surplus capacity contribute to increased upside risks on commodity prices.

Concerning the main commodity complexes, as we analyze below, precious metals have the highest upside potential, due to investment-related factors. In particular, gold will continue to benefit from safe haven demand from both the private and the official sector, given the still heightened uncertainty concerning the extent of the sovereign debt crisis and, most importantly, the potential spillovers to the real economy. It is worth noting that, according to the World Gold Council (WGC), in 2010, the official sector became a net buyer of gold for the first time in 21 years.

Regarding the energy complex, tight supply and demand dynamics are expected to limit downside risks to oil prices, stemming from declining demand from developed economies. Indeed, tight dynamics keep oil prices at historically relatively high levels and leave the oil market rather sensitive to potential supply disruptions from geopolitical or other kinds of risks. On the supply side, non-OPEC oil production has proved disappointing since the beginning of the year. According to the latest US Energy Information Administration's (EIA's) forecasts, non-OPEC oil production, which accounts for about 60% of world oil supply, is projected to increase by 490 thousand bbl/d (0.9% y-o-y) in 2011. This represents the lowest annual increase since 2008 in terms of both absolute and percentage change. As far as oil demand is concerned, solid Chinese demand should continue to provide support to oil prices. China's economic performance is expected to remain robust and steady growth rates should continue, underpinning both consumer and industrial demand growth. EIA's latest forecasts suggest that China's oil consumption will increase by 9.0% y-o-y in 2011, which is the third largest annual growth rate since 2004. Increased demand for oil is also stemming from Japan in the aftermath of the Tohoku earthquake, since the latter forced the shutdown of oil refineries and nuclear power plants in Japan. A boost to Japan's oil demand is expected during the period of reconstruction which is more likely to take place mainly over the end of the year and in 2012. Following Japan's earthquake, Germany has decided to close its nuclear plants, suggesting that the ongoing substitution of more conventional sources of energy for nuclear power will constitute a significant factor for upside pressures to oil prices.

In the agricultural sector, factors such as low inventory levels, elevated oil prices, increasing frequency of extreme weather events and geopolitical turmoil are expected to continue to exert upward pressures on agricultural prices in the medium term. 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 agricultural prices in the long term.

Base metals have been proved the weakest commodity sector as it is the most economic growth-sensitive commodity complex (Figure 5.4). The LME (London Metal Exchange) Metals Index has fallen by about 30% since its peaks in April 2011. With the risk to the global economic outlook still elevated, vulnerabilities across base metals are on the upside in the short-term. However, economic weakness is mainly concentrated in developed markets, which are not the key driver of base metals demand growth. In contrast to developed markets, emerging markets' and particularly China's demand for base metals has been the main determinant of increasing prices over the past years, given that these economies are undergoing a phase of industrialization and infrastructure building. Hence, we believe that the expected resilience of emerging economies is likely to provide a floor to further downside in base metal prices.

**Figure 5.4**

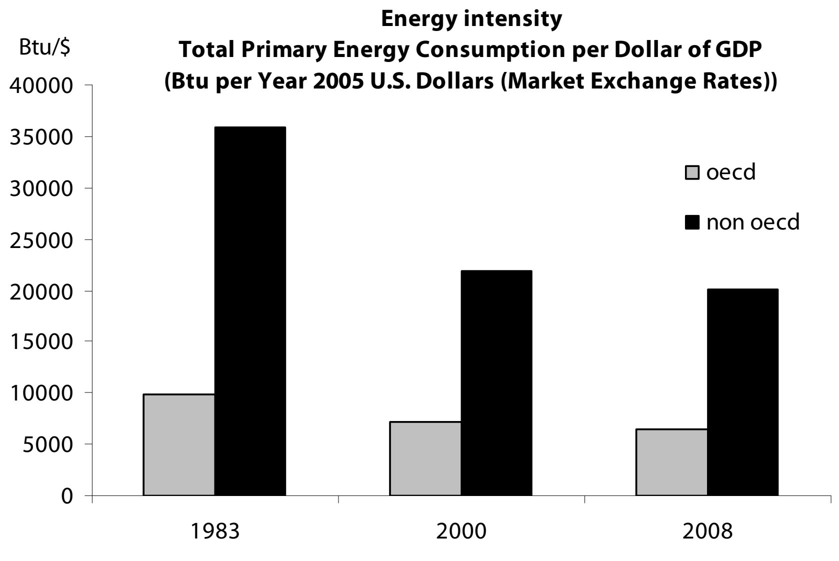

*Source: Ecowin*

**Box 1. Oil: The impact of high oil prices on the global economy**

The sharp oil price increase over the past year constitutes a major risk for the global economy. Overall, an oil price shock affects the global economy mainly through the terms of trade channel, transferring income from oil importing to oil exporting countries. Higher oil prices result in increased production costs for businesses and reduced disposable income for households, weighting on economic activity. The purchasing power of households is reduced, thereby avoid or reduce spending on durable goods and services. From the producer perspective, high oil prices lead to increased input costs and a simultaneous decrease in demand for their products, thus limiting profit margins and resulting in a potential reduction of production and investment. The vulnerability of each individual country to higher oil prices depends mainly on whether the country is a net oil importer, its oil intensity[6] and its flexibility to substitute less expensive sources of energy for oil. Meanwhile, high oil prices will have a greater adverse economic impact on oil-importing emerging economies than on advanced economies. This is because oil accounts for a larger part of total consumption and overall incomes are lower in these countries. Moreover, energy intensity in emerging economies is higher compared to advanced economies (Figure 5.5).

There are several studies that estimate the size of the negative impact on economic activity and inflation of oil shocks.[7] Indeed, researchers argue that the negative effect of oil price shocks on growth has fallen significantly through time, since countries have gradually reduced their energy intensity (Figure 5.5). The results of the above empirical studies indicate that a 10% increase in the price of oil will cut approximately 0.2% off global growth. Therefore, we estimate that current levels of oil prices (about 40% higher than 2010), should they persist, will shave 0.5-1.0% of global economic growth over the next 1-2 years. Apart from economic growth, higher oil prices have also a key impact on inflation. According to IMF (2000)[1], a permanent 10% increase in crude oil prices raises core inflation after one year by 0.2% in the US and Euro area, 0.3% in Latin America, and 0.4% in Asia.

**Figure 5.5**




*Source: EIA*

[6] *Oil intensity indicates how much oil a country uses to produce its goods and services. High oil intensities indicate a high price or cost of converting oil into GDP.*

[7] *International Energy Agency, 2004, "Analysis of the impact of high oil prices on the global economy",*
*IMF, 2000, "The impact of higher oil prices on the global economy",*
*IMF. 2005, "Oil Market Developments and Issues".*

As far as Euro area is concerned, according to the European Central Bank[8], a 10% increase in oil prices reduces Euro area's real GDP by 0.24% over a horizon of three years. The impact of high oil prices would be greater in Belgium, Germany, Italy and Greece compared to the rest countries in the region (Table 1). Regarding inflation, a 10% increase in oil prices leads to a rise in the Euro area HICP inflation of about 0.45% in the third year, with the corresponding impact on Greece being the third largest in the region after Slovakia's and Slovenia's (0.65% versus 0.90% and 0.82%, respectively). In Greece, the increase of the existing tax on heating oil, as part of the austerity plan, is likely to amplify the economic effects of high oil prices on the real economy.

To sum up, we believe that oil fundamentals will remain tight enough over the course of the year to sustain oil prices at current levels, although further downside in the short-term cannot be ruled out. Increased concerns over the long-term supply environment of the oil market will continue to be a major factor adding to upside risks to oil prices. Consequently, elevated oil prices will most likely remain a drag on global growth and inflation over the remainder of 2011. Furthermore, another abrupt increase in oil prices triggered by an additional shock to the global economy would have a severe impact on the global economy, 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 still loose.

**Table 1**

**Effect of a 10% oil price increase on real GDP in the Euro area countries**

(cumulative percentage deviation in 3 years from baseline scenario, annual averages)

| | Year 1 | Year 2 | Year 3 |
|---|---|---|---|
| Belgium | -0.09 | -0.30 | -0.40 |
| Germany | -0.16 | -0.33 | -0.37 |
| Italy | -0.07 | -0.25 | -0.36 |
| Greece | -0.03 | -0.13 | -0.34 |
| Spain | -0.04 | -0.21 | -0.25 |
| Portugal | -0.05 | -0.11 | -0.20 |
| Malta | -0.27 | -0.26 | -0.16 |
| Cyprus | -0.03 | -0.08 | -0.15 |
| Slovakia | -0.10 | -0.14 | -0.14 |
| Austria | -0.07 | -0.09 | -0.07 |
| Slovenia | 0.01 | -0.01 | -0.06 |
| France | -0.01 | -0.02 | -0.05 |
| Ireland | 0.00 | -0.03 | -0.05 |
| Luxembourg | 0.00 | -0.03 | -0.03 |

*Source: ECB*

[8] *ECB, 2010, "Energy markets and the euro area macroeconomy".*

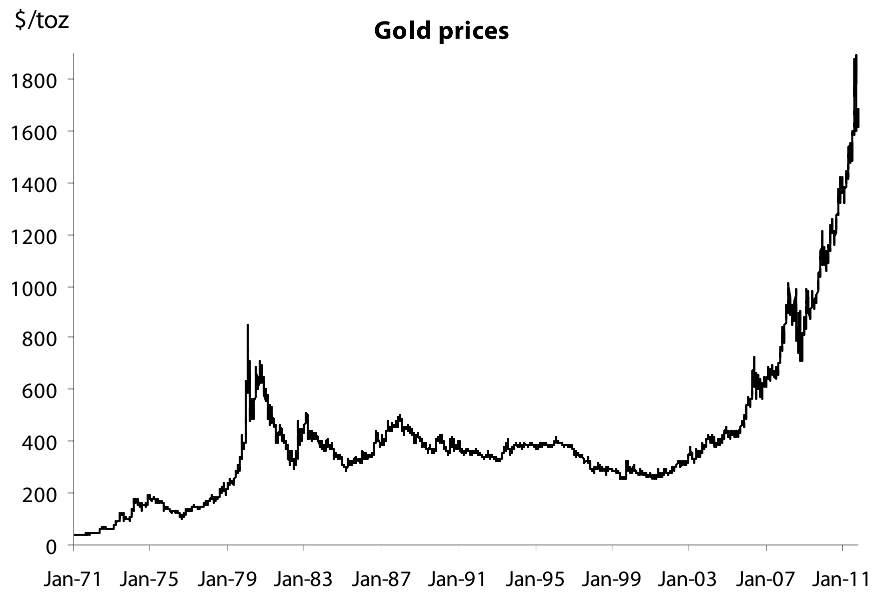
# Focus: Gold is likely to continue to provide a safe haven to investors

Dimitris Malliaropulos, Maria Prandeka

- Gold prices have climbed to all-time nominal highs of $1895/toz in early September 2011, benefiting from the official sector's return as net gold buyer and from investors seeking protection against growing concerns over the sovereign debt crisis.
- The medium term outlook for gold is positive since the same factors that pushed gold prices to historical nominal highs are expected to shape price dynamics over the next quarters.
- Inverted US 10 year real yields, which exhibit a very strong correlation with gold, are likely to decline further, suggesting upside risk to gold prices, as the long term opportunity cost of holding gold declines.
- However repetition of short-term price corrections cannot be ruled out, considering further liquidations for profit taking by short-term investors losing money in other asset classes.

In a period of economic uncertainty and increased volatility across the markets, gold prices have climbed to all-time nominal highs of $1895/toz in early September 2011, benefiting from safe haven demand (Figure 5.6). Gold's price gains for the year to date are now standing at about 17%. The price upturn was mostly driven by the official sector's return as net gold buyer and from investors seeking protection against the growing fears about the impact that the sovereign crisis in the US and Europe will have on the real economy.

**Figure 5.6**




*Source: Ecowin*

Meanwhile, gold prices slipped to below $1700/toz at the end of September, as turmoil in global financial markets led investors losing money in other asset classes to leave the market in favour of cash, ignoring the safe-haven appeal of gold.

Nevertheless, the medium term outlook for gold is positive since the same factors that pushed gold prices to historical nominal highs are expected to shape price dynamics over the next quarters.

In particular, there is still heightened uncertainty concerning the extent of the sovereign debt crisis and, most importantly, the potential spillovers to the real economy. Moreover, inverted US 10 year real yields, which exhibits a very strong correlation with gold (Figure 5.7), are likely to decline further. One main reason for this is US Federal Open Market Committee's (FOMC) announcement of "Operation Twist". This policy is attempting to reduce long-term US interest rates by changing the composition of its balance sheet. Under such a scenario, real long-term yields are likely to decline, due to the dual effect of lower nominal rates and an increase in future inflation expectations. This suggests upside risk to gold prices, as the long-term opportunity cost of holding gold declines.

**Figure 5.7**


*Source: Ecowin*

In the meantime, according to the World Gold Council (WGC), in 2010, the official sector became a net buyer of gold for the first time in 21 years. This switch of the official sector is in itself a positive factor for gold price dynamics, given that the sector has been a significant supplier of the metal over the period 1989-2007 at an average release of 400-500 tones/year. It is worth noting that central banks of major emerging economies, such as Russia, Mexico, Thailand and South Korea have added to their reserves this year, in a move to reduce their exposure to the dollar. We believe that the official sector will continue to purchase gold, as a result of intensifying concerns over sovereign debt issues and the turbulence in the currency markets.

Looking at the supply and demand side of the gold market, the data are particularly supportive for gold. According to the latest Gold Demand Trends report from the WGC, demand for gold in Q2 2011 was 919.8 tones –the second highest quarterly value on record. The report notes that demand was broad-based across sectors and geographies, with India and China, once again, the major contributors to overall growth, accounting for 52% of global bar and coin demand and 55% of global jewellery demand. In 2010, jewellery and bar and coin demand accounted for almost 80% of total gold demand. In line with our expectations, the WGC expects gold demand to continue to be supported by China and India for the remainder of 2011. They quote several supporting factors for this, including relative economic prosperity and high inflation rates for both countries and a good monsoon and strong seasonal demand in India. On the supply side, mine production was the only component of supply to make a positive contribution. However, mine supply growth was offset by declining scrap supply and the official sector switching to a net buyer of gold. We believe that robust demand coupled with the continuation of the official sector net purchases and scrap supply responding to higher gold prices is expected to keep gold prices at historically high levels in the medium term.

To sum up, we expect that as long as the uncertainty in the global economic environment continues, gold prices will be supported, since safe-haven buying by both the private and official sector will continue to dominate price formation. When heightened worries over sovereign debt issues settle down and increased volatility in financial markets abates, gold's price upward trend might be interrupted. It is worth noting that according to a survey at the London Bullion Market Association precious metals annual conference in Montreal, Gold may surpass $2000 an ounce in 2012 amid surging investor demand. However, short-term price corrections cannot be ruled out, considering further liquidations for profit taking by short-term investors losing money in other asset classes.

# III. Macro Forecasts

| Real GDP growth | | | | | | |
|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011f | | 2012f | |
| | | | Eurobank EFG | Consensus | Eurobank EFG | Consensus |
| **US** | -3.5 | 3.0 | 1.7 | 1.7<br>(1.3 – 2.5) | 2.0 | 2.1<br>(0.4 – 3.9) |
| **EA** | -4.1 | 1.8 | 1.5 | 1.6<br>(1.5 – 1.8) | 0.5 | 0.7<br>(-0.5 – 1.3) |
| **Japan** | -6.3 | 4.0 | -0.5 | -0.4<br>(-0.7 – -0.2) | 2.3 | 2.5<br>(1.7 – 3.1) |
| **China** | 9.2 | 10.3 | 9.3 | 9.0<br>(8.6 – 9.5) | 8.9 | 8.5<br>(8.2 – 9.0) |
| **India** | 7.0 | 8.9 | 7.5 | 7.6<br>(7.2 – 8.0) | 7.6 | 7.7<br>(7.2 – 8.5) |
| **Russia** | -7.8 | 4.0 | 4.3 | 4.6<br>(2.9 – 4.7) | 4.4 | 4.4<br>(2.2 – 5.2) |
| **Brazil** | -0.6 | 7.5 | 3.5 | 3.4<br>(2.9 – 3.8) | 3.9 | 3.6<br>(3.0 – 3.9) |

| Inflation | | | | | | |
|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011f | | 2012f | |
| | | | Eurobank EFG | Consensus | Eurobank EFG | Consensus |
| **US** | -0.3 | 1.6 | 3.2 | 3.1<br>(3.0 – 3.4) | 2.3 | 2.1<br>(1.0 – 5.3) |
| **EA** | 0.3 | 1.6 | 2.7 | 2.6<br>(2.5 – 2.7) | 1.8 | 1.8<br>(1.5 – 2.4) |
| **Japan** | -1.3 | -0.7 | -0.2 | -0.2<br>(-0.5 – 0.0) | -0.1 | -0.2<br>(-0.7 – 0.1) |
| **China** | -0.7 | 3.3 | 5.5 | 5.4<br>(5.3 – 5.5) | 4.0 | 3.3<br>(2.8 – 4.0) |
| **India (WPI)** | 2.4 | 9.6 | 9.4 | 9.4<br>(9.3 – 9.4) | 6.5 | 6.1<br>(5.5 – 6.5) |
| **Russia** | 11.7 | 6.9 | 8.5 | 8.6<br>(7.2 – 9.2) | 7.0 | 7.0<br>(6.1 – 8.4) |
| **Brazil** | 4.9 | 5.0 | 6.5 | 6.3<br>(6.0 – 6.6) | 5.2 | 5.3<br>(4.7 – 6.2) |

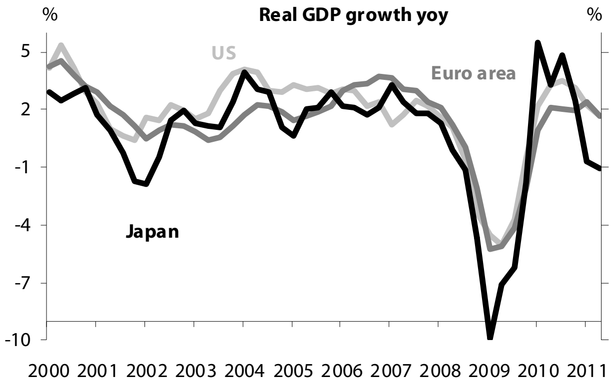
*Note: Range of forecasts by Bloomberg's survey in parentheses below point estimates.*

| Policy Rates | | | | | |
|---|---|---|---|---|---|
| | | Eurobank EFG | | | |
| | Current | Q4 11f | Q1 12f | Q2 12f | Q3 12f |
| **US** | 0.00 – 0.25 | 0.00 – 0.25 | 0.00 – 0.25 | 0.00 – 0.25 | 0.00 – 0.25 |
| **EA** | 1.50 | 1.00 | 1.00 | 1.00 | 1.00 |
| **Japan** | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 |
| **China** | 6.56 | 6.56 | 6.56 | 6.56 | 6.56 |
| **India** | 8.50 | 8.50 | 8.50 | 8.50 | 8.50 |
| **Russia** | 8.25 | 8.25 | 8.25 | 8.25 | 8.25 |
| **Brazil** | 11.50 | 11.00 | 11.00 | 11.00 | 11.00 |

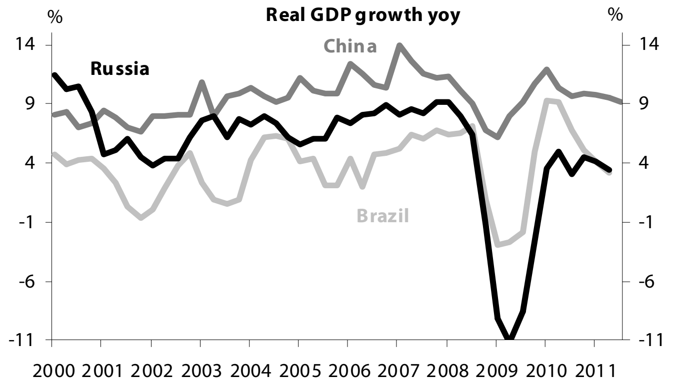
# IV. GRAPHS

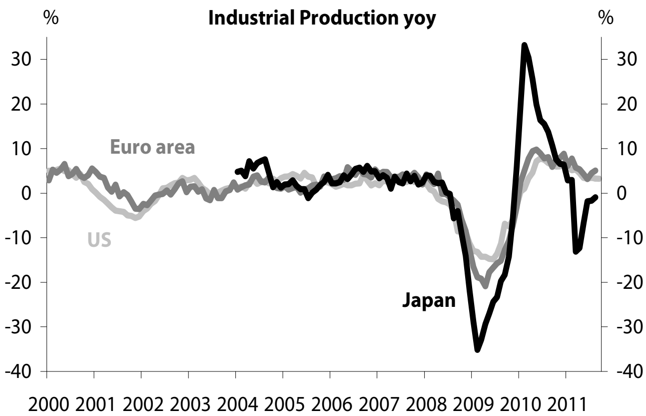
## Global Economic Indicators

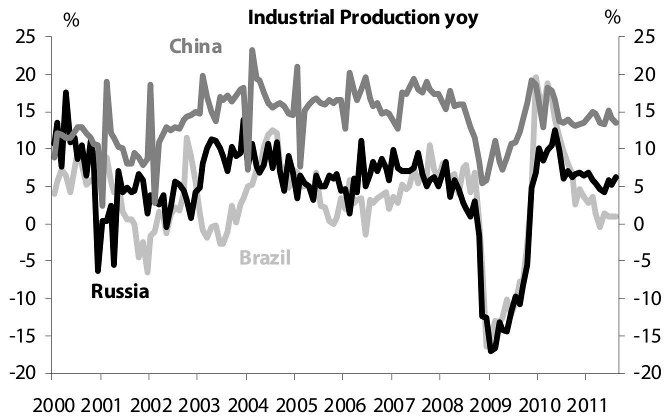
### Advanced Economies

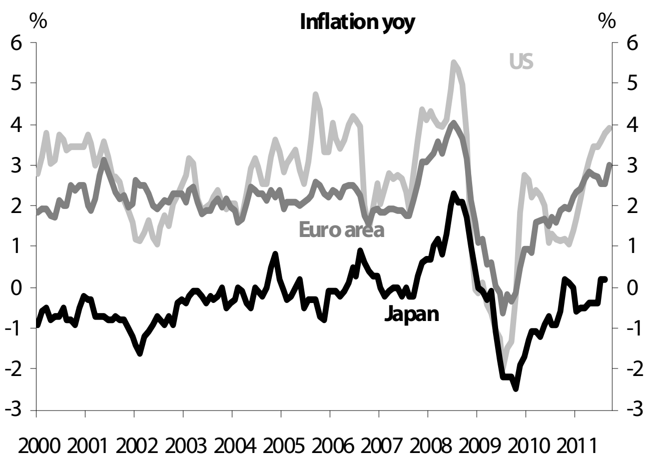


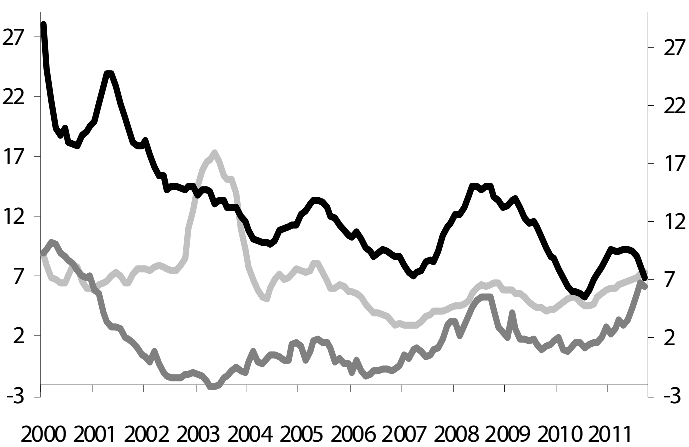

### Emerging Economies



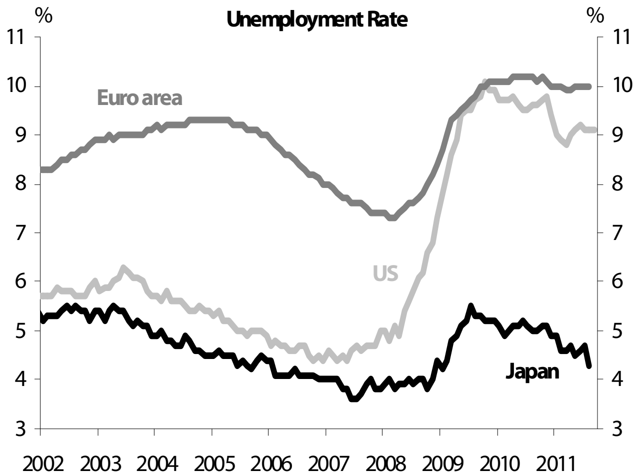



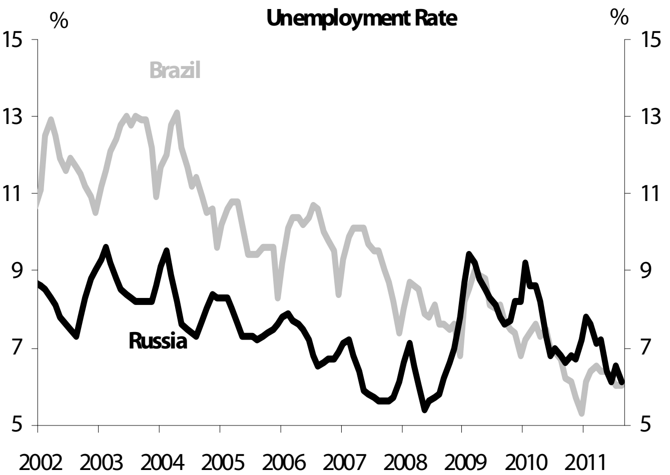
*Source: Bloomberg, Ecowin*

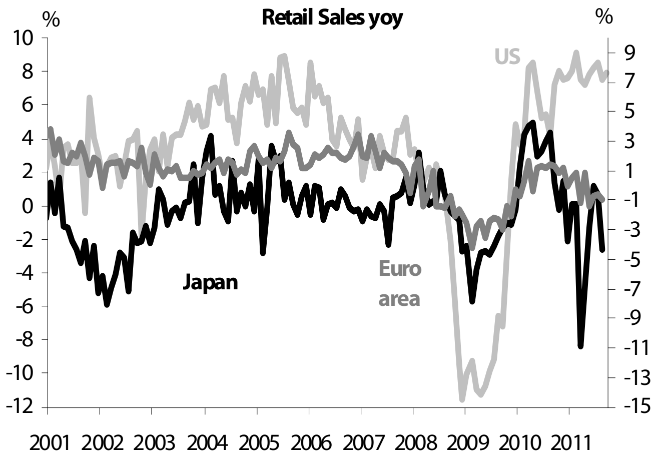
# Global Economic Indicators

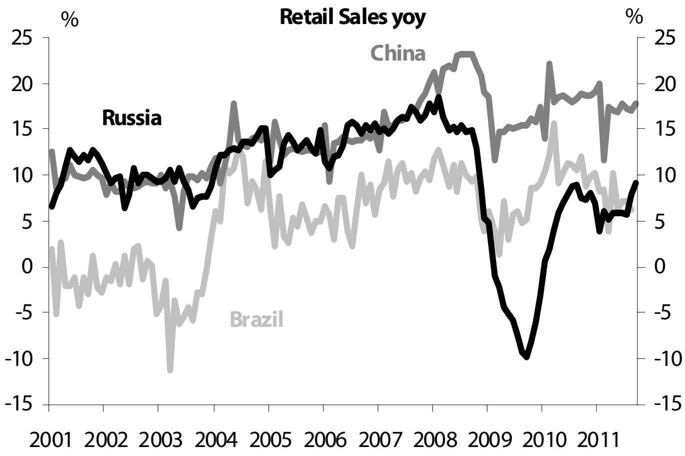
## Advanced Economies


## Emerging Economies

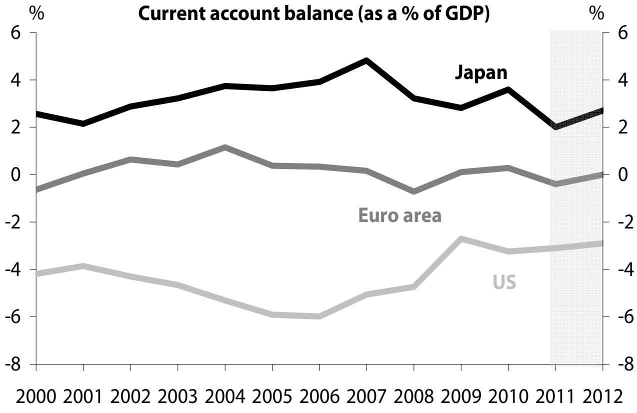



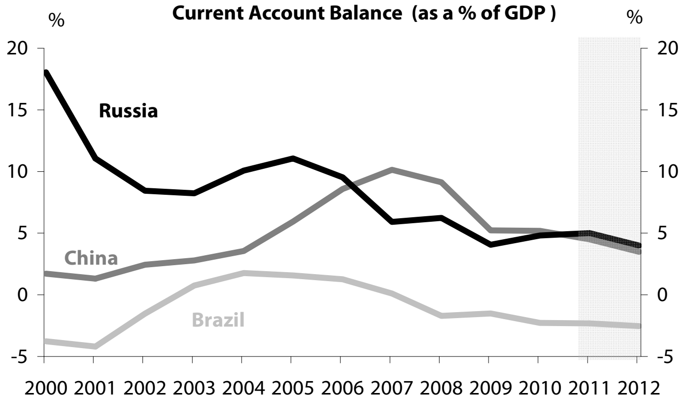

*Source: Bloomberg, Ecowin*

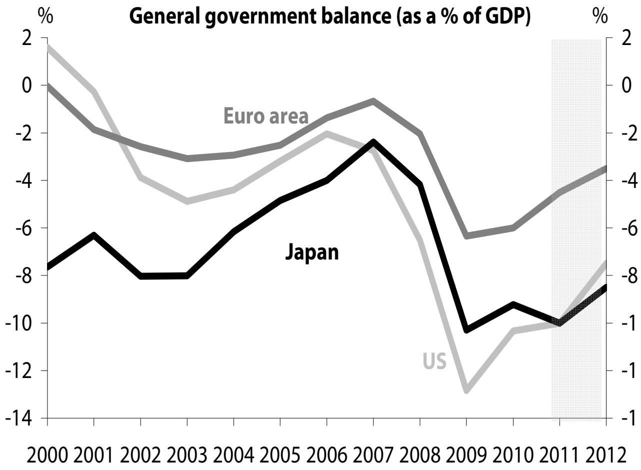
# Global Economic Indicators

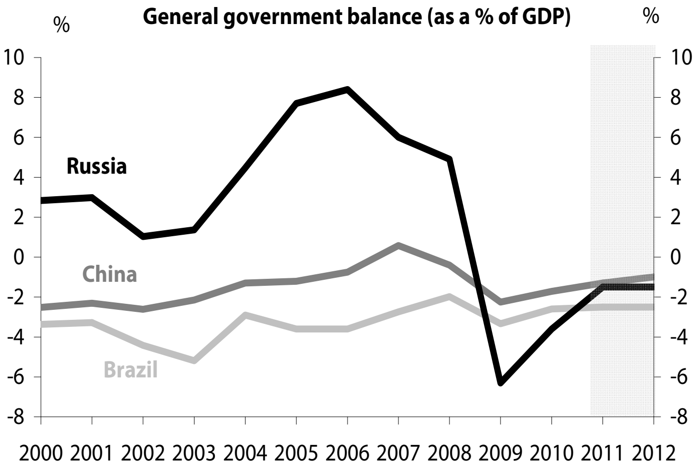
## Advanced Economies

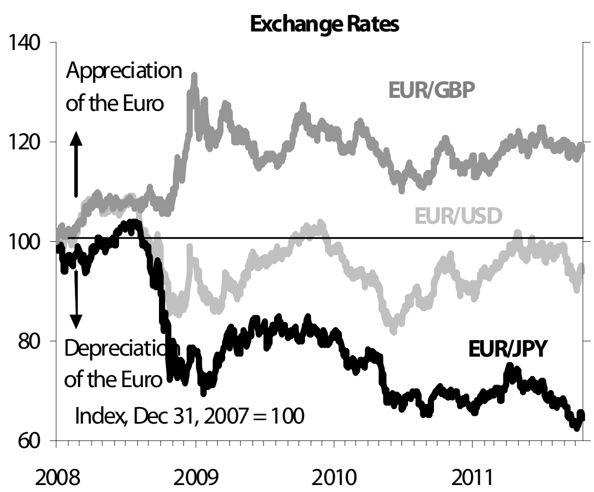


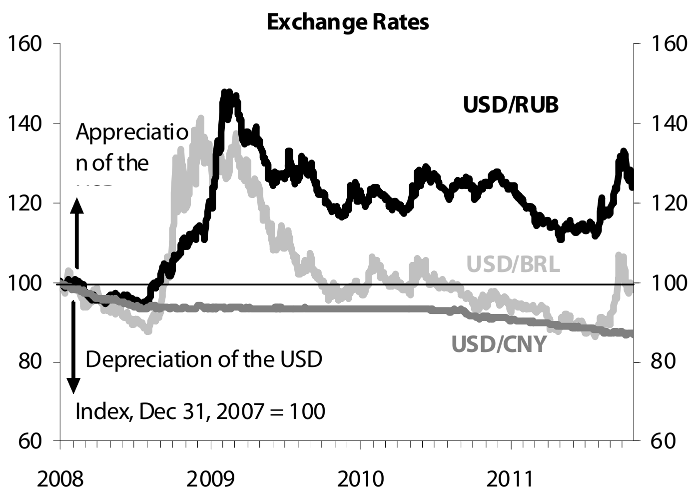

## Emerging Economies



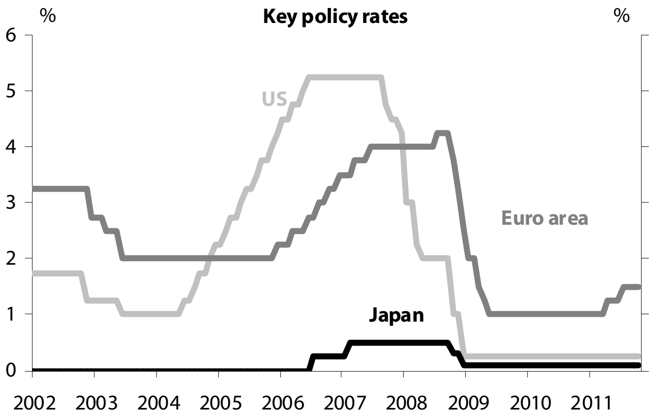



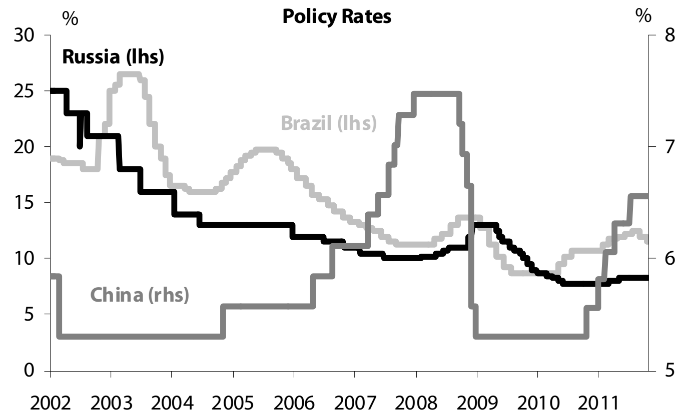



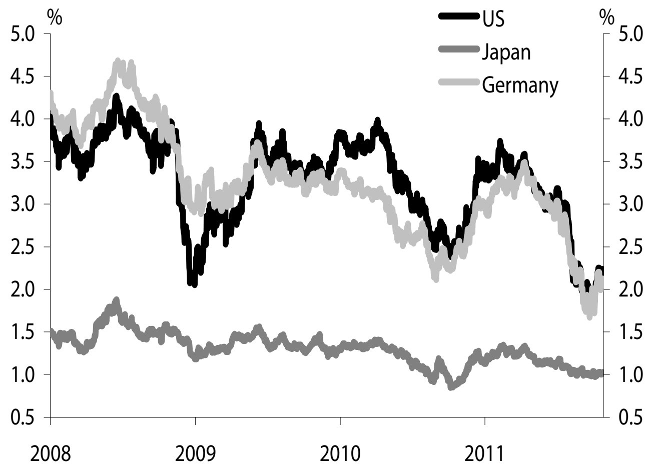

*Source: Bloomberg, Ecowin, IMF*

# Global Economic Indicators

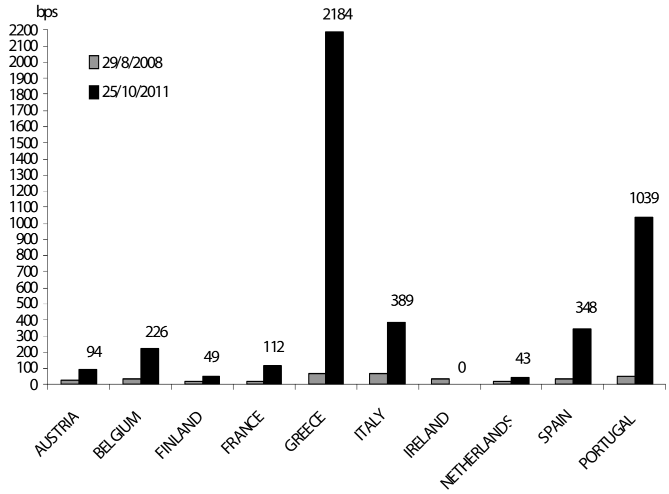


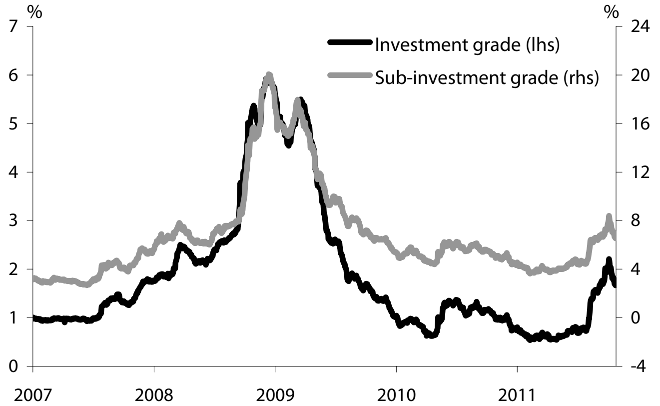

## 10y Government Bonds



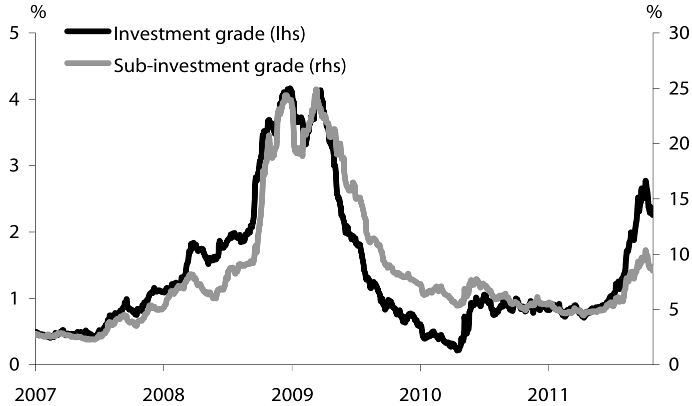

## 10yr government spreads vs Germany




## 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 November 2, 2011**

**Global Equity Indices (in local currency)**

| Region | Index | Last Price | 1w | 1m | 6m | 12m | YTD | 2010 |
|---|---|---|---|---|---|---|---|---|
| US | S&P 500 | 1237.9 | -0.3 | 12.6 | -8.8 | 3.3 | -1.6 | 12.8 |
| EURO AREA | DJ Euro Stoxx 50 | 2291.9 | -7.5 | 7.2 | -23.6 | -19.0 | -17.9 | -5.8 |
| GERMANY | DAX | 5965.6 | -5.9 | 11.0 | -20.5 | -9.9 | -13.7 | 16.1 |
| FRANCE | CAC 40 | 3110.6 | -7.7 | 6.3 | -24.1 | -19.1 | -18.2 | -3.3 |
| UK | FTSE 100 | 5484.1 | -4.0 | 8.1 | -9.8 | -4.6 | -7.0 | 9.0 |
| JAPAN | Nikkei | 8640.4 | -1.2 | 1.1 | -13.6 | -5.7 | -15.5 | -3.0 |
| CHINA | CSI 300 | 2742.4 | 3.2 | 6.2 | -14.6 | -19.8 | -12.3 | -12.5 |
| INDIA | SENSEX | 17464.9 | 1.0 | 8.1 | -5.8 | -14.7 | -14.8 | 17.4 |
| RUSSIA | MICEX | 1488.9 | -2.4 | 10.7 | -12.0 | -3.3 | -11.8 | 23.2 |
| BRAZIL | IBOV | 57322.8 | 1.8 | 9.6 | -12.4 | -19.9 | -17.3 | 1.0 |

*Source: Bloomberg*

**Sector performance as of November 2, 2011**

**US Sector Indices (in USD)**

| US – S&P 500 | Last | 1w | 1m | 6m | 12m | YTD | 2010 |
|---|---|---|---|---|---|---|---|
| 1. Consumer Discretionary | 377.5 | -0.7 | 10.6 | -4.5 | 10.3 | 4.3 | 27.7 |
| 2. Consumer Staples | 465.5 | -1.2 | 3.5 | -1.0 | 9.9 | 7.0 | 14.1 |
| 3. Energy | 760.3 | -0.6 | 16.6 | -11.7 | 17.2 | 3.3 | 20.5 |
| 4. Financials | 258.5 | -0.2 | 12.1 | -18.3 | -8.0 | -16.1 | 12.1 |
| 5. Health Care | 504.8 | -0.8 | 4.3 | -5.9 | 7.5 | 6.9 | 2.9 |
| 6. Industrials | 392.2 | 0.5 | 12.5 | -14.0 | 3.7 | -4.0 | 26.7 |
| 7. Information Technology | 452.8 | -0.3 | 9.6 | -2.7 | 5.5 | 3.2 | 10.2 |
| 8. Materials | 313.8 | 1.2 | 17.3 | -13.6 | 1.4 | -8.3 | 22.2 |
| 9. Telecommunication Services | 220.3 | 0.9 | 2.6 | -5.1 | 6.1 | 1.1 | 19.0 |
| 10 Utilities | 354.3 | 0.5 | 3.2 | 6.9 | 13.9 | 14.3 | 5.5 |

*Source: Bloomberg, Ecowin*

# Global Equities & Sector Performance

**Sector performance as of November 2, 2011**

**European Sector Indices (in €)**

| Europe - DJ Stoxx 600 | Last | 1w | 1m | 6m | 12m | YTD | 2010 |
|---|---|---|---|---|---|---|---|
| **1. Consumer Discretionary** | | | | | | | |
| Automobiles & Components | 414.1 | -7.2 | 16.8 | -21.7 | -7.7 | -16.6 | 45.3 |
| Travel & Leisure | 178.9 | -3.8 | 5.0 | -12.2 | -11.9 | -16.8 | 28.4 |
| Media | 250.2 | -3.9 | 6.1 | -12.0 | -9.4 | -11.2 | 17.2 |
| Retail | 412.6 | -3.2 | 6.1 | -6.4 | -9.0 | -7.3 | 13.2 |
| **2. Consumer Staples** | | | | | | | |
| Food & Beverage | 579.8 | -1.3 | 2.6 | -0.7 | 7.2 | -0.3 | 22.3 |
| Personal & Household Goods | 679.9 | -2.1 | 8.0 | -1.4 | 4.0 | -0.6 | 30.6 |
| **3. Energy** | | | | | | | |
| Oil & Gas | 614.1 | -3.6 | 13.9 | -5.4 | 5.0 | -1.5 | 3.3 |
| **4. Financials** | | | | | | | |
| Banks | 258.2 | -10.1 | 3.2 | -32.4 | -33.3 | -29.9 | -9.6 |
| Financial Services | 381.4 | -6.4 | 3.3 | -23.1 | -13.4 | -19.8 | 18.6 |
| Insurance | 220.5 | -9.7 | 7.9 | -21.8 | -10.4 | -10.8 | 4.7 |
| Real Estate | 105.3 | -3.3 | 5.0 | -15.9 | -8.9 | -10.6 | 11.7 |
| **5. Health Care** | 581.0 | -1.2 | 0.0 | 0.2 | 7.7 | 4.1 | 9.1 |
| **6. Industrials** | | | | | | | |
| Industrial Goods & Services | 421.7 | -5.9 | 7.8 | -20.5 | -9.1 | -17.1 | 35.6 |
| **7. Information Technology** | 196.6 | -3.6 | 10.7 | -15.2 | -1.4 | -8.9 | 16.9 |
| **8. Materials** | | | | | | | |
| Basic Resources | 782.8 | -5.0 | 14.1 | -23.2 | -18.2 | -28.9 | 28.6 |
| Chemicals | 862.6 | -4.8 | 12.0 | -18.1 | -4.1 | -10.7 | 25.2 |
| Construction & Materials | 377.5 | -8.3 | 7.5 | -24.3 | -9.1 | -18.5 | 4.7 |
| **9. Telecommunication Services** | 474.1 | -3.5 | 2.8 | -5.9 | -7.2 | -3.3 | 8.9 |
| **10. Utilities** | 547.5 | -5.6 | -1.4 | -17.5 | -12.9 | -12.9 | -4.5 |

*Source: Bloomberg*

**Sector performance as of November 2, 2011**

**Asia Sector Indices (in USD)**

| Asia – S&P 50 Index* | Last | 1w | 1m | 6m | 12m | YTD | 2010 |
|---|---|---|---|---|---|---|---|
| **1. Consumer Discretionary** | 10637.5 | 1.9 | 11.4 | -19.3 | -1.1 | -2.7 | 33.2 |
| **2. Consumer Staples** | 14021.1 | -1.0 | 5.7 | 1.3 | -6.0 | 5.3 | 1.7 |
| **3. Energy** | 12424.9 | 1.5 | 12.4 | -13.9 | 0.1 | -8.3 | 36.4 |
| **4. Financials** | 3203.7 | 4.3 | 19.0 | -20.2 | -6.9 | -19.8 | 9.2 |
| **5. Industrials** | 2627.3 | 0.9 | 19.2 | -29.8 | -10.6 | -18.1 | 74.6 |
| **6. Information Technology** | 9078.5 | 3.3 | 16.1 | -9.0 | 13.8 | -5.7 | 21.6 |
| **7. Materials** | 4179.3 | 0.9 | 7.8 | -25.1 | -7.7 | -15.8 | 10.5 |
| **8. Telecommunication Services** | 2573.0 | 0.1 | 2.1 | 4.7 | 0.5 | 1.4 | 7.7 |
| **9. Utilities** | 3536.6 | 0.5 | 3.6 | 7.5 | 9.0 | 9.9 | 10.6 |

*Source: Ecowin*

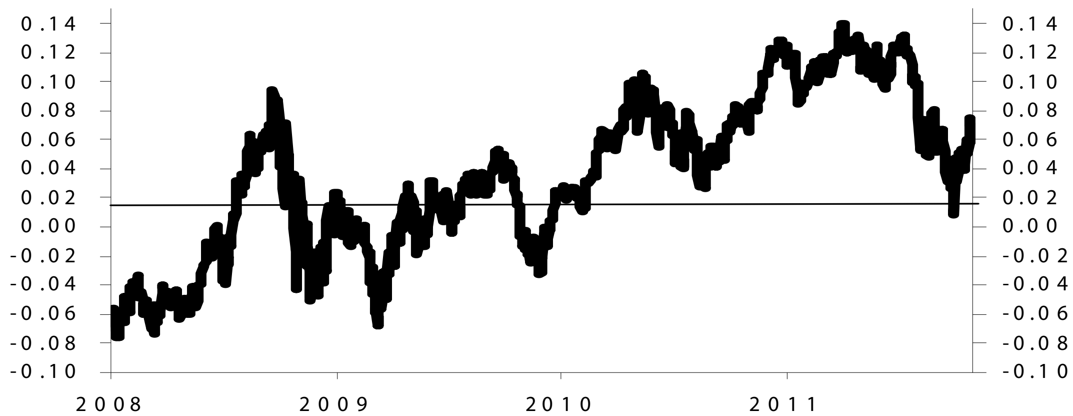
# US Style Equity Indices

**Total Return (%) as of November 2, 2011**

**US Style Indices (in USD)**

| Index | Last Price | 1w | 1m | 6m | 12m | YTD | 2010 |
|---|---|---|---|---|---|---|---|
| **Russell 1000 (Large Cap)** | 683.8 | -0.3 | 13.1 | -9.3 | 3.3 | -1.9 | 13.9 |
| **Russell 2000 (Small Cap)** | 733.3 | 0.8 | 20.3 | -13.1 | 2.5 | -6.4 | 25.3 |
| **Relative performance (Small vs Large)** | | 1.1 | 7.2 | -3.8 | -0.8 | -4.6 | 11.4 |
| **Russell 1000 Value** | 611.2 | -0.6 | 13.4 | -11.5 | 1.2 | -4.4 | 12.9 |
| **Russell 1000 Growth** | 578.7 | 0.0 | 12.9 | -7.0 | 5.6 | 0.7 | 14.9 |
| **Relative performance (Value vs Growth)** | | -0.6 | 0.5 | -4.5 | -4.5 | -5.1 | -2.0 |

**Relative Performance (small vs large)**
**(logarithmic scale)**




**Relative Performance (value vs growth)**
**(logarithmic scale)**

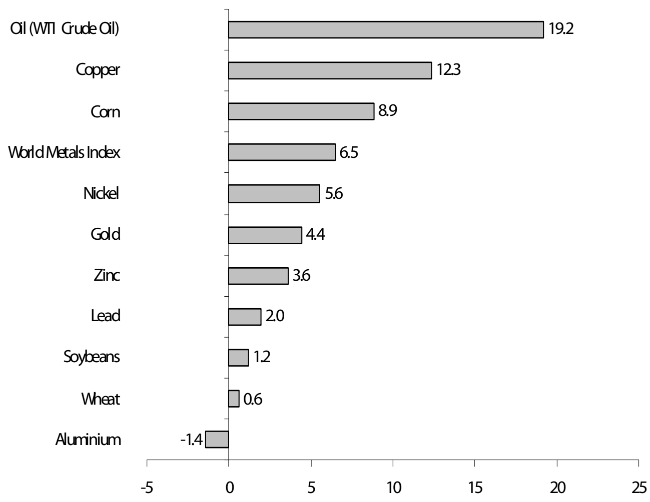

*Source: Bloomberg*

# Commodities

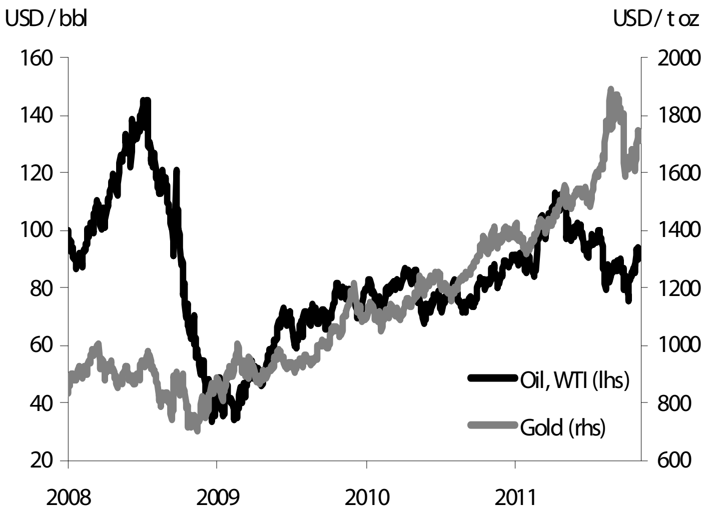
Commodity Performance (%) as of November 2, 2011

| | Commodities | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Units | Last Price | 1w | 1m | 6m | 12m | YTD | 2010 |
| **Oil (WTI Crude Oil)** | USD/bbl | 92.5 | -1.5 | 19.2 | -16.7 | 9.2 | 1.2 | 15.1 |
| **Gold** | USD/t oz | 1729.6 | -1.0 | 4.4 | 12.3 | 29.3 | 21.7 | 29.7 |
| **Base Metals** | | | | | | | | |
| **World Metals Index** | | 3441.3 | -3.7 | 6.5 | -20.1 | -10.2 | -18.3 | 23.8 |
| **Aluminium** | USD/lb | 2127.0 | -4.0 | -1.4 | -23.1 | -12.5 | -13.9 | 10.8 |
| **Copper** | USD/mt | 7885.0 | 2.7 | 12.3 | -15.4 | -6.5 | -17.9 | 30.2 |
| **Lead** | USD/mt | 2024.0 | 5.2 | 2.0 | -18.7 | -18.7 | -20.6 | 4.9 |
| **Nickel** | USD/mt | 18580.0 | -2.8 | 5.6 | -30.8 | -20.9 | -24.9 | 33.6 |
| **Zinc** | USD/mt | 1927.0 | 3.9 | 3.6 | -14.2 | -21.4 | -21.5 | -4.1 |
| **Agriculture** | | | | | | | | |
| **Corn** | USD/bu | 645.0 | -1.0 | 8.9 | -10.3 | 11.0 | 2.5 | 51.7 |
| **Soybeans** | USD/bu | 1202.8 | -3.3 | 1.2 | -11.7 | 1.1 | -8.3 | 29.2 |
| **Wheat** | USD/bu | 623.5 | -3.2 | 0.6 | -18.0 | -9.7 | -21.5 | 46.7 |

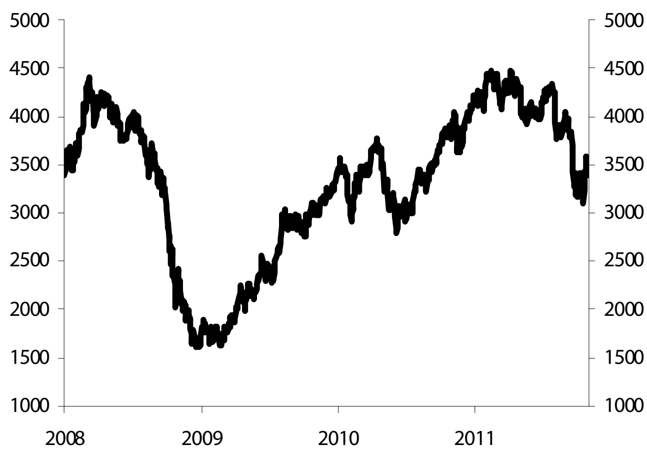
## 1-Month Return




## Oil & Gold




## World Metals Index




*Source: Bloomberg*

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

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