

Weekly Economic Commentary – July 31, 2011

Markets

The European deal on the new Greek plan and the changes in the EFSF and ESM have not allayed fears in the market which have resumed to the downward trend. Markets continued to remain volatile as the US continues to be in a stalemate regarding the debt ceiling debate so close to the Aug 2 deadline. Regional markets mirrored their global counterparts. The two uncertainties led to a weaker dollar, an all-time record high for the Swiss franc, drove up demand for the yen and caused a gold price rally, which rose to a high \$1631.2 per oz.

Global Developments

Americas:

- The S&P Case Shiller Home Price Index fell 4.5% yoy in May (Apr: -4.2%), with unemployment, foreclosures and low demand constraining a rebound in the housing market.
- New single family homes sales slipped 1.0% yoy to 312 sa in June. However, median price for a new home increased 5.8% mom (7.2% yoy) to USD 235K, a signal that home values might be starting to stabilize.
- Durable goods orders unexpectedly declined by 2.1% mom in June (May: +1.9%), weighed down by transportation equipment. Excluding the volatile transportation equipment, orders increased 0.1% (0.7%).
- US Q2 advance GDP showed a growth of 1.3% yoy, after a significantly revised down 0.4% growth in Q1 down from the previous estimate of 1.9% gain. While the Q1 revision was largely due to less than estimated buildup in inventory, Q2 growth was propped up by business

investment and exports.

- Core inflation rate was up 2.1% in Q1, significantly above the 1.6% clocked in Q1 while PCE index increased 3.1% in Q2 (Q1: 3.9%).
- Initial jobless claims fell more than market consensus, by 24k to 398k in the week ended July 23.

Europe:

- Moody's downgraded Greece's debt by another notch from Caal to Ca, because creditors will incur losses as result of last week's agreement. S&P followed downgrading Greece from CCC to CC with a negative outlook. Banks, insurances and funds are demanding more clarity on the 'voluntary' swap scheme to extend debt maturity to 15 or 30 years and reduce interests.
- UK GDP slowed to 0.2% qoq in Q2 (Q1: 0.5%) – the construction sector recovered, growing by 0.5% (Q1: -3.4%), offsetting the 1.4% drop in industrial production.
- Moody's downgrades Cyprus government bond ratings by two notches to Baal from A2, moving it closer to being the fourth potential EZ country to need a bailout in the future.
- German retail sales rose 6.3% mom in June (May: -2.5%), recording the strongest increase since 1991. The increase is linked to the encouraging fall in unemployment which enhanced household purchasing power.
- Eurozone CPI declined to 2.5% yoy in June, slowing from May's 2.7%, but exceeding the ECB's 2% ceiling.

Asia and Pacific:

- The Reserve Bank of India raised the repo rate by an aggressive 50bps to 8.0%, while hinting at more hikes in the offing after 11 moves since March 2010, making the RBI one of the most aggressive inflation fighting

central bank. Philippines Central Bank, in its latest meeting, left overnight rates unchanged but raised the reserve requirement by 1%-pt to the pre-crisis level of 21%, citing liquidity concerns.

- South Korea GDP growth slowed to 0.8% in Q2 (Q1: 1.3%), a soft patch caused by lower exports and inventories, while internal demand held up. Slower export growth and manufacturing also led to Taiwan's Q2 GDP growing at a slower pace of 4.88% yoy compared to Q1's 6.55%.
- Japan retail sales rose for the first time since the tsunami in June, growing 1.1% mom as sales of household appliances and electronic products jumped 15.2% though automobile production was down 17.3%.
- Singapore CPI rose to a five-month high of 5.2% yoy in June, driven by higher housing, transport and food costs. Higher income classes were more affected from significant increases in the price of cars and petrol.
- Indonesia plans to issue its first ever Islamic treasury bills on Aug. 2, with the T-bills having a 6 month maturity, in an effort to diversify its Islamic bond instruments according to a Ministry of Finance official.

Bottom line:

US GDP and another spate of figures confirmed the weakness of the mature economies: the head-in-the-sand approach, hinging on the soft patch narrative, is giving way to a sense of despair as the fiscal crisis in the US is deepening and Europe has put all decision on hold until September. Over the summer, with lower liquidity and decision makers on vacation, risks are lurking.

Regional Developments

- UNCTAD's World Investment Report 2011 reported that the foreign direct investments into GCC fell 15% yoy to USD 39.9bn. Saudi Arabia received the most inflows at USD

28bn, followed by Qatar (USD 5.5bn), while inflow into the UAE remained unchanged at USD 4bn.

- Inter-Arab Investment Guarantee Corporation reported that inter-Arab FDI flows dropped a whopping 76.4% to USD 5.4bn in 2010, the lowest level since 2003. Saudi Arabia attracted USD 21.5bn in 2010, down 40.9% compared to 2009's USD 36.4bn in 2009 – accounting for bulk of the drop in FDI.
- Inflation in Kuwait rose to 5.0% yoy and 0.2% from a month ago in June. The slight pick-up can be traced to a 1% mom increase in transport and communication and a 0.7% hike in the educational and health services, while food prices declined by 0.6%.
- Qatar's inflation recorded an increase of 0.1 % for June compared to May and an increase of 1.8% when compared to June 2010.
- Oman's Capital Markets Authority is expected to reintroduce margin trading to improve trading volumes in the Muscat Securities Exchange. One of the conditions is that the proposed margin trading scheme will allow only a maximum of 30% of loan money for purchasing shares compared to the 50% limit previously.
- Saudi Arabia's Aramco will provide three Indian refiners with an additional 1 million barrels each in August, after India's deal with Iran failed to materialise. Iranian oil normally meets about 12% of India's total demand of 3.46mn barrels per day.
- Aramco and Dow Chemical have formed a joint venture to build and operate one of the world's largest integrated chemicals facilities in Jubail, at an estimated cost of USD 20bn producing over 3 million metric tons of chemical products and performance plastics a year.
- Jordan has received a grant of close to USD 1bn from Saudi Arabia, to meet its budget deficit; this is in addition to the USD 400mn received previously for the budget and more support is expected in the form of Saudi crude oil at discounted prices.

UAE Focus

- Abu Dhabi's nominal GDP jumped 15.9% in 2010, supported by higher oil prices and growth in the non-oil sectors to AED 620.2bn, up from AED 546.5bn in 2009 and AED 666.7bn in 2008. Figures on real GDP growth have not been released.
- UAE central bank's Islamic certificates of deposits have risen by close to AED 13bn since the end of 2010 to AED 17.6bn in June. Total certificate of deposits, at AED 117.9bn meanwhile was down 1.3% mom and compares to a total AED 94bn at the end of 2010.
- The UAE Central Bank reported growth in bank credit by 0.7% mom to AED 1.06 trillion in June, recording the largest monthly increase since Jan while deposit growth edged up 0.2% to AED 1.13 trillion.
- UAE foreign trade rose 28% at annual rate to AED 228.4bn in Q1 with the following breakdown: exports AED 24.4bn (42%), re-exports AED 57.2bn (30%) and imports AED 146.7bn (25%).
- Abu Dhabi's non-oil exports for 2010 grew 22.1% yoy to AED 11.6bn while imports registered a decline of 7.8% to AED 86.6bn. Re-exports clocked in at AED 11bn, with machinery and transport equipment topping the list of goods while Bahrain ranked on top destination of re-export.
- UAE inter-bank offer rates hit a 7-year low last week while the gap between the UAE three-month interbank rate and the US three-month interbank rate has narrowed to about 124 bps, the smallest since 2008 implying an improvement in liquidity conditions.
- OPEC's 2010-11 annual report placed UAE's oil revenues in 2010 at USD 74.02bn, up 28.7% from USD 57.5bn in 2009. This was largely due to the \$15 increase in oil prices from a year ago, but also helped by the rise in UAE crude oil production to around 2.32mn barrels per day (bpd) from 2.17mn bpd in 2009.

- Dubai airport passenger traffic was up 8.9% in H1 to 24.6 million passengers up from 22.6 million over the same period in 2010.
- DP World recorded a 11% rise in volumes in H1 2011 to 26.2 million TEUs, helped by the strong growth in emerging markets in Asia and Africa, including the recently opened port in Qingdao, China.
- DP World filed a request for arbitration against Peru with the International Centre for Settlement of Investment Disputes arguing that Peru blocked it from a public tender process to operate the northern terminal at the Port of Callao, Peru's largest. DP World seeks monetary reparations.
- Emaar net profits dropped 69% in Q2 as it handed over fewer homes and wrote off its investments in Dubai Bank.

Annex: US debt crisis

As the date Aug 2 looms nearer, the US is increasingly under pressure to reach an agreement on a deficit reduction plan to accompany the extension of the debt ceiling. It seems unlikely that Obama's wish of USD 4 billion spending cut would ever materialise, but the tentative framework being discussed includes spending cuts of close to USD 1.0 trillion and a further \$1.8 trillion would be recommended by a special committee appointed by Congress. While Bloomberg is already citing inside sources that a temporary solution has been reached, it is worthwhile to understand the repercussions of a default, if any.

What is a debt ceiling?

It refers to the legal limit to the amount of money the federal government is allowed to borrow. It includes debt owed to the public in the form of US Treasury bonds and debt owed to government trust funds such as Social Security and Medicare. The first limit was set in 1917 at USD 11.5 billion.

Since 1962, the debt ceiling has been raised 72 separate times, with 10 in the past decade alone. The current limit is \$14.294 trillion, with the US government borrowing about 40 cents for every dollar it spends. When the US federal government reached the borrowing limit of USD 14.3 trillion in May this year, the Treasury's temporary plans helped the government financing for a few weeks.

Though the US has never defaulted before, a paper by Terry Zivney and Richard Marcus (titled "The Day the United States Defaulted on Treasury Bills" discusses a computer glitch that led to USD 122 million in Treasury payments being delayed in 1979. This led to a 0.6% permanent increase in interest rates, which resulted in \$12 billion in additional annual debt payments.

What if a resolution is not reached?

If a resolution is not reached, it would simply mean that the borrowing authority of the US government will be exhausted and that the US government could default on its debt (non-payment of interest on its outstanding obligations). If the debt ceiling is not raised, it means that the government would need to prioritise what it wants to pay first – including critical benefits like social security, military wages etc. It will also lead to an increase in interest rates, making borrowing costlier.

The three ratings agencies have already warned of a downgrade to the U.S credit rating in case of a delay in interest payments on Treasuries, with Moody's even arguing that the debt ceiling needs to be eliminated altogether. In the event that a default does occur on interest payments, the ratings on US government bonds will only be reduced to the Aa range from the triple A rating currently.

The impact on US Treasuries would be substantial – considered almost as safe as cash, a US default could lead to global panic and even question the role of the USD as the global currency. If the US defaults on Aug 2, it will lead to an

almost catastrophic reaction in the FX market – a total collapse in risk appetite, maybe even in a larger magnitude when compares to the Lehmann collapse.

Rates on \$91 billion of Treasury bills due August 4, the first to mature after the August 2 deadline, spiked to 28 basis points on Friday, the highest rate the bills have paid since they were issued in February. The Treasury has ruled out a fire-sale of its assets, including remaining mortgage-backed securities (MBS) holdings (\$94.5 billion as of July 6), to raise cash, so as to avoid negative repercussions in these markets. Financial markets have already been very volatile during the current and still ongoing talks: The S&P 500 fell 3.9% last week, recording its worst fall in a year. The yields on 10Y notes are at the lowest since last Nov, while the spread for 1-year US Treasury CDS rose to 75bps as of Friday (from 53 a week ago). If no deal is agreed upon, these spreads will only widen further.

According to Nouriel Roubini, the real worry should be fiscal sustainability – what is required at this stage is medium to long-term fiscal discipline and short-term stimulus. But what the US is currently looking at is a massive looming short-term fiscal drag and no credible plan to tackle deficits and debts in the medium to long term.