Weekly Economic Commentary – August 07, 2011

Markets

The US debt deal had temporarily lifted the markets' mood, but increased probability of a double dip, the S&P US downgrade and the European debt/fiscal crisis caused the most severe global equity downturn since 2008, leaving almost no markets untouched. Finance ministers from the G7 major economic powers are holding emergency talks on how to calm the markets before they reopen on Monday. The regional markets are likely to see the impact hit this week – mirroring Saudi Arabia, which recorded the largest intra-day loss since last March on Saturday. Regional markets plummeted on opening today, with the DFM dipping close to 5% in early trading before paring losses and recording a 3.7% decline at close; both Abu Dhabi and Qatar's indices tumbled 2.5%. To make a comparison, DP World which is listed on Nasdaq Dubai shed 7.1% today and on the London Stock Exchange fell 14% during Thur-Fri last week. As the safe-haven demand continued to rise, both the Bank of Japan and Swiss National Bank took steps to halt currency appreciation while Asian currencies posted their biggest weekly decline since Nov, led by the Malaysian Ringgit and Indian rupee. Meanwhile, gold prices continued to surge.

Global Developments

Americas:

- S&P downgraded US rating one grade from AAA to AA+, also keeping a negative outlook: *the attached Annex includes an extended discussion of potential consequences.*
- US ISM manufacturing index dived to 50.9 in July (June: 55.3) signalling an accelerating trend towards

recession. Construction spending was slightly better, but this was the only consolation as many major components declined: new orders index fell 2.4 points to 49.2, ie. contraction; new orders/inventories gap improved slightly to -0.1 from -2.5 but remains low; crucially the employment index fell 6.4 points to 53.5.

- US nominal consumer spending fell 0.2% (mom) in June, against expectations for a small gain. In real terms consumer spending was unchanged in June, and revised figures show 0.1% declines in both May and April. Nominal personal income increased by 0.1% (mom), also slightly less than expected.
- US core PCE price index rose in June 0.1% mom or +1.3% yoy. This inflation measure was significantly below the level implied by CPI and PPI data probably due to weakness in “non-market” prices (e.g. the “price” of free checking accounts).
- Improved labour market indicators failed to revive the markets: non-farm payrolls rose by 117k (Jun: 46k); unemployment rate dropped to 9.1% (9.2%) though part of this decline was associated to discouraged workers leaving the workforce. Meanwhile, Initial Jobless Claims fell to 400k in the week ended July 30.

Europe:

- European services and manufacturing growth weakened in July. The PMI composite index fell to 51.1 in July (June: 53.3), with services declining to 51.6 (53.7) and manufacturing down to 50.4 (52).
- EZ retail sales slightly increased in June (0.9% mom) inverting the previous month’s trend (-1.3%).
- European PPI was unchanged in June (May: – 0.2%), reflecting the drop in crude-oil costs (17% over the past 3 months) and the rise in capital goods price including equipment & machinery (+1.4% mom).
- The ECB left the benchmark lending rate unchanged at

1.5%, but reactivated a bond-buying programme. The ECB is discussing intervening to buy Italian bonds, which represent 20% of EU government debt.

- German manufacturing factory orders rose 1.8% mom in June (May: 1.5%), boosted by investment goods and a change in demand from German (-10.8% mom) to foreign (+13.7%, including EU) customers.

Asia and Pacific:

- China's PMI fell to 50.7 in July from 50.9 in June, the fourth straight monthly decline, and just a notch above the 50 figure which represent the cut off between expansion and contraction. Although the reading was higher than expected, the Chinese locomotive is clearly losing steam. A silver lining came from the component measuring new orders, which confirmed a reasonably healthy pipeline.
- In India the PMI rose to 58.2 in July (June: 56.1) while the manufacturing equivalent fell to 53.6 from 55.3 in the same period.
- South Korea's July trade surplus reached a record USD 7.2bn, as a strengthening Won and rise in exports of steel and automobiles to emerging markets lifted exports by 27.3% yoy (Jun: 13.6%) to USD 51.4bn.
- Korean inflation rose to 4.7% in July (June: 4.4%) driven by higher food and oil prices; even core inflation rose 3.8%, a tad below the previous 3.9% peak in May 2009. Thailand's CPI increased 4.08% yoy on rising prices of core food commodities like rice as well as the rising costs of electricity and retail oil prices.

Bottom line:

The sense of relief from the US debt ceiling agreement was short-lived: the S&P downgrade and global equity market

declines are hogging the headlines. Markets are still to come to terms with reality that a rebound is not in the cards without a drastic change in the policy mix, particularly on the fiscal front. The US acrimonious Congressional debate has hinged on the issue of tax versus expenditures, but the fundamental issue is waste versus efficiency in public outlays, which calls for a drastic revamp of the public sector architecture. Unfortunately such an issue is unlikely to be tacked by a feeble US administration ruthlessly pressured by an intransigent Congress faction or within the current dysfunctional decision making framework in the EU. It is likely that the situation will further deteriorate in mature economies, although opinions diverge on the extent and the duration. However, the likelihood of a double dip recession has increased.

Regional Developments

- Saudi Arabia’s private expansion is showing signs of slowing – as indicated by the PMI for July, which registered a 10-month low of 60.0 (June: 62.8).
- A World Gold Council report places Saudi Arabia with 322.9 tonnes of gold reserves on top in the region, followed by Lebanon with 286.6 tonnes. Globally, US has the maximum, with 8,133.5 tonnes, followed by Germany and the IMF, at 3401 and 2814 tonnes respectively.
- Mergers & Acquisitions activity increased in H1 2011 compared to 2010 according to a report by Zawya: there was a 33% increase in number of deals to 173 while the total deal value was also up 30% to USD 21.17bn. UAE ranked on top in terms of deal volume with 32 deals and also secured the largest M&A transaction worth USD 5.06bn.
- The annual Barclays Corporate Global Banking Survey results indicate that banking and insurance services in the Middle East is expected to become more competitive in the coming two years. Asia and Africa will grow

faster, while Europe and North America are expected to fall behind.

- According to the International Air Transport Association, Middle East carriers recorded a 6.4% rise in passenger demand in June against a capacity increase by 8.4%. This rise however fell behind that of both European and Latin American carriers.

UAE Focus

- The UAE Central Bank announced that it did not hold any US Treasury bills or other US Government financial instruments in its reserves and clarified that this decision was based on the low returns to these instruments.
- UAE July PMI fell to 53.3, recording a seven-month low from June's 55.2. While new orders component showed a weakness, job creation was at a 3-month high, as medium sized firms were hiring at a faster pace compared to either small and/or larger firms.
- Total value of property transactions in Dubai in H1 2011 was AED 30bn, with almost a quarter of the investment (AED 6.8bn) made by investors from other GCC countries, according to the director general of Dubai's land and property corporation.
- Bank lending to the real estate sector fell by 1.4% in Jan-May 2011 to AED 160.4bn at the end-May. Total resident loans were up by a slight 0.5% during the same period while deposits rose by over AED 75bn from end-2010.
- The IIF has revised upwards UAE's 2011 growth forecasts to 4.4% from 3.8% previously, citing a stronger rise in real economic activity.
- Nakheel's proposed AED 4.8bn Sukuk issue in H1 2011 was delayed due to administrative procedures according to the Chairman, while maintaining that this was the top priority for the company.

- UAE has pumped a total of 28bn barrels of oil till end of 2010, accounting for about 6.2% of total oil output by all OPEC countries since 1960, also making it the sixth largest output in OPEC.
- UAE’s auto market grew 19.7% to USD 11.1bn in 2010, as per a recent study conducted by the Ministry of Foreign Trade. The volume of car sales meanwhile increased by 10% to USD 42.4bn.
- The CEO of Du announced that the company now held 43.6% of the total market share in the UAE, taking total customers to 4,775,900 after adding 171.1k new customers in Q2 alone.

Annex: Sovereign debt crisis

On Friday 5 August, S&P, the credit rating agency downgraded US Long Term sovereign to AA+ from triple-A previously while a negative outlook, noting that: “The downgrade reflects our opinion that the fiscal consolidation plan that Congress and the Administration recently agreed to falls short of what, in our view, would be necessary to stabilize the government’s medium-term debt dynamics. More broadly, the downgrade reflects our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges to a degree more than we envisioned”. This ratings downgrade was widely anticipated in the markets, given that the S&P were demanding wanted roughly USD 4 trillion in deficit reduction and a credible plan to fix longer-term deficit problems, but neither of these were met. China’s Dagong Global had (on Wednesday) already cut the credit rating on U.S. sovereign debt to A from A+. The agency had also put the U.S. on negative outlook.
The US Treasury responded to the announcement casting doubt on the credibility of this decision and claiming that the rating agencies made a USD 2 trillion mistake. While clarifying their assumption on discretionary spending growth, the S&P cleared

their stand stating that “primary focus remained on the current level of debt, the trajectory of debt as a share of the economy, and the lack of apparent willingness of elected officials as a group to deal with the U.S. medium term fiscal outlook”. However, S&P said that the revisions would not affect their near-term outlook for the economy.

Last week, the US equity markets saw their worst week since 2008: the Dow Jones Industrial Average dropped 5.8%, the S&P 500 fell 7.2% and the Nasdaq ended 8.1% lower. World stocks fell for an eighth day on Friday with around USD 2.5 trillion wiped off the value of global equities last week. The downgrade will likely result in an increase in borrowing costs and the USD is likely to weaken further over the medium term as creditors and US dollar asset holders are likely to diversify their currency holdings away from the USD. The downgrade will likely also mean that Government sponsored entities like Fannie Mae and Freddie Mac and insurance companies could be at higher risks for a downgrade. The yields on 10Y notes fell as low as 2.34%, while the net notional exposure arising from US credit default swaps rose to new high of USD 5.6bn, from USD 3bn in the beginning of the year, and more interestingly, outpacing Greece (at USD 4.5bn), which recently was the subject of a second bail-out!

The timing of this crisis in the US cannot have come at a worse point: The European debt crisis has not yet been resolved fully: it continued to provide worsening signals last week, after Italian and Spanish bond yields rose relative to German bunds for a second week. The 10-year yield spread with bunds reached a high of 416 bps for Italian debt and of 418 bps for Spanish debt. Market concerns over the European periphery had driven the EUR / USD to a 4-month low of $1.39 on July 12, However, the EUR / USD exchange rate has recently shown some resilience, as the market has also viewed the US situation as worrisome.

Bottomline is that there is now a full blown sovereign debt crisis, given that both the US and European mini-crises have happened at the same time with contagion acting both ways.

The downgrade in ratings was expected, but what does it mean for emerging market economies which predominantly use the dollar? Dollar holdings make up a large share of official foreign exchange reserves (more than 60%), the foreign currency deposits and bonds maintained by central banks and monetary authorities. In international trade, the dollar is widely used for invoicing and settling import and export transactions around the world. The dollar remains prominent in exchange rate arrangements: seven countries currently are dollarized or have currency boards using the dollar and eighty-nine have a pegged exchange rate against the dollar. So, what does this mean for the GCC dollar based economies?
As the world starts to question the need for an alternative to the USD as a reserve currency, with no credible alternative as yet, all eyes are on the Renminbi. Increasingly emerging market economies (notably China) are urging the move towards a multi-currency financial system, as was the case before World War 1. Or, could the financial map benefit from being anchored to an asset such as gold which is not issued by a national authority? The DIFC Economic Note 13, "The Role of Gold in the New Financial Architecture" makes the case for developing a "Hard SDR": international liquidity should be supplied on a large scale by an international currency such as the SDR, whose value should be tied to a basket of major currencies, USD, Euro, Yen and Yuan and gold, with the weight of the latter set at 20-25%.
Food for thought: Can the US bounce back and impose fiscal discipline? If yes, the more important and interesting question is when. 16 nations enjoy AAA rating from S&P. Since 1980, five countries have lost it, only to regain it at a later stage.