BHF BANK
PRIVAT SEIT 1854

FX Briefing

13 January 2012

Highlights

- Restructuring negotiations in Greece ongoing
- Strong demand for Spanish and Italian bonds sends yields lower
- ECB leaves monetary policy unchanged, stresses that credit contraction might endanger growth
- Growth in US retail sales in December dampens optimism

EMU bond markets showing signs of easing: euro firmer

As the week began, the US dollar continued to strengthen on the back of the remarkably favourable US labour market report for December, which was the latest in a recent string of upbeat economic news from the United States. At first, Europe could offer very little compared to the brightening economic outlook in the US. The meetings between Merkel, Sarkozy and Lagarde primarily drew attention to the situation in Greece, where new gaps have appeared in the country's finances. The publication of Germany's GDP data for full-year 2011 came as a negative surprise for the markets: the Federal Statistical Office calculated robust growth of 3.0% for 2011, but indicates that GDP would decline by "around ¼%" in the fourth quarter.

The ongoing negotiations between Greece and its private creditors remain tricky. It now looks pretty likely that the haircut will amount to around 60%. According to the IMF, the Greek debt-to-GDP ratio will have to be lowered to 120% if the debt burden is to reach an sustainable level. As GDP has fallen much more sharply than forecast at the end of October and the deficit exceeds the target figure, private investors are now being asked to shoulder the difference. Yet it is unclear how substantial and how comprehensive the participation in the voluntary haircut will be and whether, and by what means, it will be possible to prevent "free riding". Recently, market observers have mainly been discussing the possibility of collective action clauses being introduced by law for the bonds issued under Greek law so that in the case of a restructuring agreement, a deal concluded with the required majority of creditors would become binding for all creditors without triggering a credit event within the meaning of the CDS contracts. But how can the ECB, for instance, which has substantial holdings of Greek bonds in its books, be excluded from such a "collective action"?

Against this background, EUR-USD retreated to well below 1.27 at times in the first half of the week. But this gave way to a trend reversal in the second half of the week that can mainly be attributed to the gradual easing on the European bond markets. The decline in bond yields in the crisis-ridden countries and the narrowing of yield spreads over German Bunds, which started in mid-December in the short- to medium-term segment, were clearly enhanced by the outcome of the Spanish and Italian bond auctions on Thursday.

Given the ample demand, Spain, for instance, managed to place three bonds with maturities between 3 ½ and 4 ¾ years and raised twice the scheduled bond volume – €10bn – at much more favourable terms. Italy, meanwhile, paid less than half of last month's rate – 2.74% instead of 5.95% – for 1-year bills in yesterday's auction. This is roughly the amount Italy had paid before yields exploded at the end of October.

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This gratifying development is probably due mostly to the measures taken by the ECB, first and foremost its massive supply of liquidity via the three-year refinancing operation in mid-December that provided the markets with €489bn.[1] It is above all the availability of favourable medium term funding – including the expansion of the collateral pool, the prospect of another three-year tender at the end of February and the hope that key rates will fall further – that will have bolstered the willingness of banks in the problem countries to participate in the auctions.

The development would, however, also suggest that confidence in public debtors has been restored to some extent. It was certainly important in this context that national governments made substantial efforts to consolidate their budgets, but it might also have helped that the ECB appears to be playing a more active role under its new leadership and that the global economy seems to have improved slightly. This confidence is, however, still fragile.

During its Thursday meeting, the ECB Governing Council largely confirmed its assessment of the state of the economy. Although it now sees tentative signs of stabilisation, the Council emphasised that economic activity is subject to significant risks from the persistent tension on the financial markets and the balance sheet adjustments within and outside the financial sector – in particular the risk of shrinking lending volumes. Key interest rates remained unchanged and there was no indication that they might be cut in February. However, the statement made no explicit reference to interest rate levels being "appropriate" and Draghi appeared to be open in principal for further measures.

Easing tension on the bond markets and unchanged key rates in Europe ought to have contributed to the recovery of the EUR-USD rate at the end of the week. As far as the US is concerned, this trend was supported by slightly weaker economic data, most importantly by a lower-than-expected increase in retail sales in December. In spite of many positive reports about Christmas shopping, the statistics show a rise of only 0.1% on the previous month. This result might, however, be slightly distorted by one-off effects as regards electronic equipment; and price trends - above all the decline in fuel prices - may well have dampened the increase in nominal sales data. In any case, EUR-USD rose back above 1.28 and thus closed the week with a slight gain.

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[1] The actual liquidity effect is, however, much lower: the deposits held by banks with the ECB rose by "only" around €150bn in the relevant period. The rest was offset by lower volumes of other refinancing operations and by other, autonomous factors.

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Key indicators and important events

Country	Indicator / Event	Release date	Forecast (in % mom/yoy)	Prev. period (in % mom/yoy)	Comments
China	GDP Q4	17.01.	– /8.7	2.3 / 9.1	% qoq / yoy
China	Industrial production / Dec	17.01	12.3	12.4	% yoy
UK	CPI / Dec	17.01.	0.4 / 4.2	0.2 / 4.8	% mom / yoy
EMU	HICP/ Dec fin.	17.01.	0.4 / 2.8	0.1 / 3.0	% mom / yoy
GE	ZEW-Econ. / Jan	17.01.	–53.8	–53.8	Index
US	NY Empire Mfg. Ind. / Jan	17.01	11.0	9.53	Index; annual revision
JP	Industrial prod. / Nov fin.	18.01.	–2.6 / –4.0	2.2 / 0.1	% mom / yoy
US	PPI / Dec	18.01.	0.1 / 5.1	0.3 / 5.7	% mom / yoy
US	Industrial prod. / Dec	18.01.	0.5	–0.2	% mom
Brazil	Monetary policy decision	18.01.	10.5%	11.0%	SELIC target rate
US	CPI / Dec – ex food. energy	19.01	0.1 / 3.1 0.1 / 2.2	0.0 / 3.4 0.2 / 2.2	% mom / yoy
US	Housing starts / Dec Building permits / Dec	19.01.	685k 685k	685k 681k	
US	Philadelphia Fed Index / Jan	19.01	9.0	6.8 (rev.)	Index
US	Existing home sales / Dec	20.01.	4.60	4.42	mn units

Money and foreign exchange market quotations

	Spot vs. EUR	Change vs. EUR	Interbank offered rates		
	dd/mm/11	in % week-on-week	1 month	3 months	6 months
EUR	–	–	0.78	1.17	1.46
USD	1.2777	0.1	0.29	0.57	0.79
JPY	98.08	0.5	0.14	0.20	0.34
GBP	0.8335	-1.0	0.78	1.09	1.39
CHF	1.2105	0.6	0.04	0.06	0.10
SEK	8.8720	-0.3	2.37	2.66	2.73
PLN	4.4090	1.8	4.72	4.95	5.00
CZK	25.425	1.3	1.03	1.18	1.45
CAD	1.3026	-0.1	1.18	1.36	1.49
AUD	1.2353	0.9	4.52	4.66	4.73
NZD	1.6094	1.6	2.76	2.88	3.07
SGD	1.6478	0.3	0.32	0.44	0.50
ZAR	10.2906	1.5	7.16	7.42	7.63

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