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Newsletter: June 2008

## Government Bond Markets

There have been fairly hawkish comments from the Fed, despite the latest reduction in the federal funds target rate to 2%; and also from the European Central Bank and the Bank of England, about the inflation dangers; and inter-bank rates have remained high, as a result long-term term yields have moved slightly higher in all the major markets, and there have been sharper increases in short-term yields.

The state of the US economy remains a key factor in assessing the prospects for the bond markets, and it continues to perform in a way which should provide considerable support for the markets. The meeting approved a further reduction in the target rate for federal funds to 2%.

However, the bank also expects an increase in the overall inflation rate to between 3.1% and 3.4%, well above its implicit target rate, with core inflation, which excludes food and energy prices, also well above its target rate at between 2.2% and 2.4%. The European Central Bank therefore faces a similar dilemma to the Fed; but its response is entirely different. It remains focused on the danger of inflation, and so there has been no move to lower rates, and every indication that they might be pushed higher.

There has been a similar response from the Bank of England in very similar circumstances. The UK economy is also weakening significantly, with retail sales falling, both the manufacturing and services sectors reporting lower levels of activity, and the housing sector remaining depressed. There is therefore at least the possibility of a move into recession. But the Bank, whilst recognising the risk, nevertheless chose to leave interest rates unchanged at the last meeting of its Monetary Policy Committee, because it expects the official inflation rate to move over 3%, and believes that a slowdown in activity is required to bring the rate back towards the target rate of 2%. As with the ECB, it is not clear that this policy stance can or should be maintained.

The Japanese bond market has also been unable to recover from the sharp fall that occurred in April. Economic conditions have continued to deteriorate in Japan, and there is the real threat of a move back into recession. The IMF is currently forecasting growth this year at a 1.4% rate, with most of the increase the result of rising exports to emerging countries in Asia; but the latest monthly report from the government Cabinet Office reports that "growth in exports is slowing as shipments to Asia, and especially China, are decelerating". This weakening export performance seems to be confirmed by the trade returns for April, which show that exports only increased by 4%; and this result, and the sharp fall in industrial output in March, does suggest that growth in the current quarter will be very low. Once again therefore there appears to be a need for the central bank to lower interest rates. But they were left unchanged at the last policy board meeting of the Bank of Japan.

## Emerging Markets

India's GDP growth will be around 8% for 2008 09. The monsoon season is expected to be better than normal and hence, the overall growth scenario will continue to remain strong with investment as the main driver. Domestic private consumption demand will also provide some support to the economy against slowing external demand. With a better than normal monsoon season this year, we expect agriculture to grow more than 3%.

Inflation continues to rise even though the government is shielding consumers from the oil price hike. To control inflation, which is hovering around 8%, the government has banned forward market trading in many food items such as rice, wheat, soy oil, chick peas and potatoes, and is confident that measures to tame inflation will take effect in about two months. On the back of inflation and poor infrastructure, India's main opposition party — Bhartiya Janata Party — has won a key election in the home state of Bangalore ahead of a general election due by early next year.

## China

India's main Communist party has vowed to continue to block approval of a landmark civil nuclear deal with the US. According to US officials, if India does not give its final stamp of approval in coming weeks, there will be no time left to ratify the agreement in the US Senate.

China's economy will continue to grow rapidly this year but what is worrying the government is the persistent rise in consumer prices. They rose 8.5% in April compared with a year earlier. It was just below a near-12-year high of 8.7% registered in February.

China's central bank has further tightened the monetary stance in response to the continuously rising consumer-prices and steady growth of exports. Beginning 20th May, the central bank has ordered most commercial banks to keep 16.5% of their deposits in reserves, up from 16%. This is the fourth time this year the central bank has raised its reserve requirement ratio. The move suggests that Beijing remains focused more on curbing inflation as it remains a key risk to the country's economic performance. By requiring banks to hold more of their deposits in reserve, the central bank constrains their ability to lend money.

China's exports in April grew 21.8% from a year earlier down from March's 30.6% rise, which was driven by a low base in the same month last year. Imports are to rise approximately 27%. China's trade surplus widened to \$16.68 billion in April from \$13.4 billion in March. Interestingly, U.S. exports to China are growing five times faster than any other export market. This is less a function of the falling dollar and more of rising Chinese demand for U.S. products. China needs what the US makes — from chemicals and components to turbines and telecommunications, from drugs and medical devices to sewage and sanitation equipment. If a product requires modern technology and precise engineering, chances are, China needs it.

The earthquake which had its epicentre in southwest China has devastated the whole region. Chinese officials estimate that it will take three years to rebuild the area of Sichuan affected by the earthquake and there are some indications of unrest among the millions of people affected by the tragedy. The government on its part has freed the affected families from mortgage loans, car loans and other debts.

Suggestions from the Chinese banking regulator to western governments on oversight of financial markets and the need to improve cross-border regulatory co-operation came as a surprise to many observers as some Chinese banks had exposure to derivative products based on sub-prime products. Hu Jintao, the Chinese president, visited Japan in May as part of the effort to soften China's image ahead of this summer's Olympic Games.

## South Korea

South Korea's economy may grow at a slower rate in the April-June period; a slow down in investments and slowing exports caused its gross domestic product to expand 0.7% in the first quarter according to the Bank of Korea. The central bank may cut its key interest rate to give a fillip to the economy. It has left its benchmark interest rate unchanged at 5% since August.

South Korean prosecutors have launched corruption investigations into more than 20 state-owned companies in an apparent response to campaign pledges by Lee Myung-bak, the new president. These raids were carried out as part of inquiries into corruption and negligence. The government is keen to make public companies more transparent and competitive to speed up their privatization. Mr. Lee has vowed to push for privatization of the Korean Development Bank and other public companies to revitalize the economy. South Korean authorities intervened to support the won after the currency dropped to a 2½-year low against the dollar in the month of May. The won hit 1,057.20 against the dollar, its lowest level since October 2005.

## Taiwan

Taiwan's composite index of leading economic indicators fell 0.4% in April from the previous month and the coincident indicator, a barometer of current economic conditions, rose 0.4% in April from March. The government is unlikely to deliver on its promise of 5% growth for Taiwan's economy this year. However, it has pledged a big stimulus drive over the next seven months to prop up domestic demand and offset soaring prices in raw materials, power and food. The fear of inflation has forced the government to water down plans to deregulate domestic oil prices.

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The cabinet had earlier taken the decision to allow domestic fuel prices to reflect the cost of crude as of 1st June, and take a similar move for electricity prices from July. As petrol and diesel prices have been frozen since September, the deregulation would have increased fuel prices up to 20%. Even now inflation would rise above 3% and the jump in consumer prices would trim the economic growth rate by half a percentage point for the full year. GDP growth is expected to be around 4.8% this year.

Ma Ying-jeou, the new president, began his four-year term with a conciliatory speech striking the balance that is expected to define his presidency. He promised to start a dialogue with China, in contrast to the animosity that defined relations across the Taiwan Strait under his predecessor. He would like to promote “harmony” and “political reconciliation” in Taiwan.

Prosecutors launched a corruption investigation into the previous president Chen Shui-bian. He admitted using third-party receipts to obtain disbursements, but said that they were used for secret diplomacy.

## Brazil

Economic growth in Brazil is expected to be about 4.8% this year, and so, for the second consecutive year, Brazil's economy is growing at around 5%. Brazilians are rejoicing in its investment grade rating assigned by the S&P. Brazil's economy has turned a big corner. Already a global power in agriculture and natural resources, its currency is now stable. In turn, the country has witnessed in three decades foreign investors by the score and is providing a growth engine for a flagging global economy.

Brazil is following in the footsteps of China and Persian Gulf oil states in setting up a sovereign-wealth fund, worth between \$10 billion and \$20 billion, to invest abroad. In addition to the fund, Finance Minister Guido Mantega has unveiled a new \$125 billion industrial policy plan to stimulate new export and high-tech industries at home through tax breaks, venture capital and other incentives.

The recently discovered Carioca field might hold massive 33bn barrels of recoverable oil reserves. Brazil announced plans to spend at least \$5 billion to develop deep-water oil finds, build ships and hire rigs as soaring world fuel prices increase demand for drilling equipment. State-run Oil Company Petróleo Brasileiro SA, or Petrobras, will spend the \$5 billion to build 146 ships and plans to hire 40 deep-water drilling rigs and platforms. Brazil's president, Lula da Silva, wants his country to join OPEC. Brazil recently made some vast new offshore oil discoveries; it uses a lot of oil, so it cannot hope to be a big net exporter.

## Commodity Markets

After rallying strongly through to April, commodity prices have weakened in May. As a result, over the past month there have been falls in base metal prices, and especially in the prices of lead and nickel; lower prices for cocoa and sugar amongst foods and beverages; and another decline in the wheat price.

However corn and soya-bean prices are higher again because of the expected consequences of the increase in ethanol production; and the outstanding feature of the month has been the further dramatic increase in oil prices because of intense speculative activity based on fears about an imbalance between available supply and demand.

Oil prices are subject to special factors, and may move still higher; but if a reassessment of prospects for the general levels of commodity prices is now underway, it is to be welcomed.

The best result amongst the major metals has been in the aluminium market because of fears about the possible effects of the recent earthquake on production in China. China is the world's largest producer of the metal, and there were reports of widespread damage to aluminium smelters and to hydro-electric dams in the earthquake area which might have led to lower output levels. But the damage appears to be less serious than had been feared, and so aluminium prices have fallen back. Elsewhere there have been very sharp falls in the prices of lead and nickel, and copper and zinc prices are also lower. Tin prices have held close to record levels because of supply fears after the restrictions placed on exports by the Indonesian authorities to stop illegal trading.

Soft commodities have produced a more varied performance over the past month. The divergence between corn and wheat price trends has become even wider as corn prices have continued to move higher on expectations of higher ethanol production, and wheat prices have fallen again after the latest forecast from the US Department of Agriculture of a record wheat harvest in the season starting in September.

The USDA now expects global wheat production to reach a record 656 million tons in 2008/09, up 8% from 2007/08 when extreme weather conditions damaged crops in key exporting countries; and this has helped to reduce the wheat price by around one-third over the past three months.

Corn prices on the other hand have strengthened almost without pause over the past six months, and are around 50% higher than in November last year.

Elsewhere there have been sharp falls in cocoa and sugar prices, but a higher price for soya-beans and for some non-food agricultural products.

The mixed performance amongst food and other soft commodity prices has raised hopes that the dramatic upward trend in prices in recent months may be losing momentum. The United Nations Food and Agriculture Organisation's food price index fell for the first time in fifteen months in April, and the fall has probably continued into May.

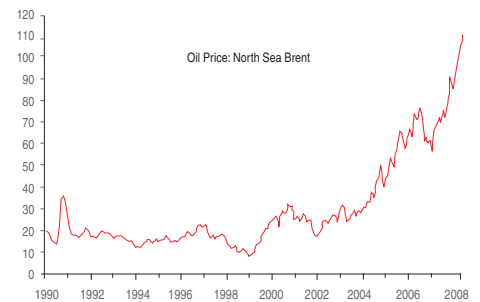
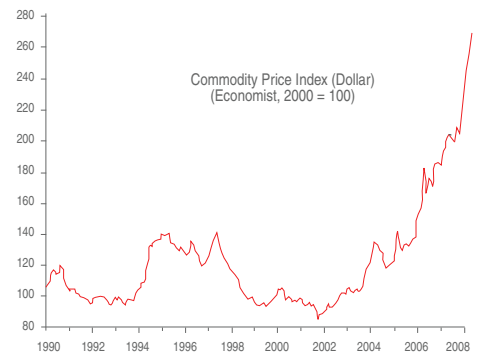
This has encouraged the FAO to argue that, with the exception of corn and rice, food price inflation appears to be "reaching its peak", although it does not expect that prices will now start falling. The OECD also thinks that there will be some short-term easing in pressures; but it has warned that prices have undergone a "paradigm shift" and are unlikely to fall back to pre-crisis levels for at least ten years because of supply problems and low stock levels.

The threat of serious social problems resulting from the scarcity of supplies and higher prices therefore seems likely to continue, and to further complicate the problems arising from the slowdown in the global economy. There would clearly be considerable benefits if the hopes that the upward trend in food prices is losing momentum prove to be justified.

Oil prices have continued to surge over the past month, and have reached record high levels. There has been no indication that OPEC will respond to requests from consuming countries for a general increase in output quotas, despite Saudi Arabia's offer to boost its output by 300,000 barrels per day to make up for declines by other producers; and a drop in US crude oil inventory levels and evidence of a continuing surge in Chinese imports has convinced the markets that demand levels are likely to stay high, despite the developing weakness in major parts of the global economy.

The situation has therefore favoured the big increase in speculative activity that has occurred; but it is still difficult to understand the dramatic increase in prices.

In discussions during the recent visit by President Bush to Saudi Arabia, Saudi officials argued again that the market movements were not the result of any shortage of supply, but were due to a number of factors including increased speculation, political uncertainty in the Gulf region and elsewhere, refining capacity that often is not well-suited to current conditions, and unjustified pessimism about longer-term supplies.



They therefore said that it would be wrong to increase supply at this stage, and particularly against the background of the weakening global economy.

We believe that there is some justification for this view; but there is also no doubt that the present level of prices is having a detrimental effect on a global economy that is not performing very well anyway, and that the adverse consequences are likely to get worse if prices do not fall back.

The best hope appears to be that the present level of prices will lead to a reduction in demand, especially in the US, which relies on imports for about 60% of its 20 million-barrels-per-day consumption level, and that this reduction can be achieved without too adverse an effect on economic activity.