Review of global markets
Week ending Friday 29 August 2008

INFLATION FEARS STEER ECB AWAY FROM RATE CUTS

While latest figures show that inflation across the eurozone's 15-country region has fallen to 3.9% or 3.8% from the record 4% in July, inflation still remains significantly higher than the European Central Bank's (ECB) goal of an annual rate "below but close to" 2%. Lucas Papademos, ECB vice-president, warned in a speech in Buenos Aires that labour cost growth had accelerated and that inflation was likely to remain above the ECB's target "for a considerable period of time before declining only gradually in the course of 2009". The ECB's fear is that high inflation rates will become entrenched through "second-round effects" with slower growth having little dampening effect. Unlike the US Federal Reserve – which has slashed US borrowing costs in the past year – the ECB sees its job as focused on controlling inflation rather than riding to the rescue of economic growth. The emergence of a wage-price spiral would "require a stronger degree of monetary tightening in order to achieve price stability", Mr Papademos warned. Jürgen Stark, an ECB executive board member, told a German newspaper that second-round effects had become "broad-based". Heightening the ECB's concerns, IG Metall, Germany's powerful engineering trade union, has indicated it could demand a wage increase of up to 8% in forthcoming wage negotiations. The ECB policymakers' comments reinforced expectations that ECB interest rates would remain on hold at least until well into next year. Meantime, Eurozone wages and prices are also slower to adjust than in other economies, strengthening the case for a more cautious stance by the ECB. However, the ECB is sticking to its forecast that eurozone growth could pick up this year. Gross domestic product contracted by 0.2% in the second quarter and activity would remain "subdued" in coming months but "gradually recover in the fourth quarter of this year and in the course of 2009," Mr Papademos said. The ECB raised its main interest rate to 4.25% in July largely to underscore its determination to counter second-round effects.

DOUBLE DIGIT DECLINE IN UK HOME PRICES

Adding to a litany of dismal economic data, a 1.9% drop in UK House prices in the month, which took the annual fall to 10.5%, marked the first double digit annual decline since the lender began collecting monthly data in 1991. Fionnuala Earley, Nationwide's chief economist, said higher stocks of properties on estate agents' books would stop prices recovering in the short term. Nationwide's index shows house prices started falling last November, with the average price falling from a peak of £186,044 to £164,654 this month. Further despondency came from a survey by the CBI employers' body showing most retailers thought sales were lower than a year ago in August, while more were cutting jobs in preparation for tougher times. "This has been a summer that many retailers would rather forget," said Andy Clarke, chairman of the CBI's distributive trades panel and Asda's retail director. A net balance of 46% of retailers said business had deteriorated – the weakest reading in the survey's 25-year history. In some sectors the gloom was universal; all retailers of household goods and furniture said sales were down. Coupled with the dire housing data, the figures helped push sterling temporarily to a near record low against the euro. They suggest a much weaker trend in retail spending than the relatively robust sales growth shown in recent official data that has strained the credulity of economists and Bank of England policymakers. Analysts said the unexpectedly weak CBI survey added to the case for lower interest rates, but most economists polled by Reuters think the Bank will keep interest rates on hold until next year, waiting for the peak in inflation to pass. David Blanchflower, the monetary policy committee member who has consistently favoured lower interest rates but has been outvoted, told Reuters on Thursday that "things I have been fearful about have come to pass", predicting inflation would "plummet like a rock" in 18 months after several quarters of negative economic growth.

FED CUTS GROWTH FORECAST

Boosted by stronger exports and healthier business inventory figures, the US economy grew much faster in the second quarter than first reported at an annualised rate of 3.3%. But in light of a weak jobs market, unfavourable financial conditions, a lack of consumer and business confidence and falling manufacturing activity - Fed staff cut their forecast for growth in the second half of 2008 and in 2009. The staff forecast that core inflation would "pick up somewhat in the second half of this year" then "edge down in 2009" as the impetus from past increases in commodity and import prices faded and widening economic slack moderated price pressures. Having toned down their the emerging hawkishness of recent months, Fed policymakers expressed "significant concerns" about the risks to inflation and, with interest rates at 2%, retained a de facto inflation bias or orientation towards raising rates. Continuing "pressures" on Fannie Mae and Freddie Mac, the mortgage giants, have pushed up mortgage rates. Banks have reported that "terms and standards have been tightened on nearly all categories of loans." US home prices posted a record annual decline of 15.9% in June, but the pace of monthly falls slowed significantly, offering hope that the ailing US housing market is edging towards a rebound. Meantime, according to the Conference Board, consumer confidence rose more than expected in August to 56.9, from 51.9 in July, ahead of the 53 reading forecast by economists. Orders for US durable goods unexpectedly increased in July, indicating that growing demand from abroad is still helping companies weather a slump in domestic spending. However, the boost from exports, which kept the US expanding last quarter, may wane because the European and Japanese economies are now contracting, while the dollar is rallying.

JAPAN'S INFLATION RATE EXCEEDS 2%

Japan's inflation rate exceeded 2% for the first time in a decade as companies passed higher costs onto households, deterring spending and weakening the economy. However, with the economy on the brink of a recession, the Bank of Japan is unlikely to raise interest rates from 0.5% anytime soon — despite price increases which (excluding fresh food), climbed 2.4% in July from a year earlier (after rising 1.9% in June). Energy-related products accounted for more than half of the increase in core prices, today's report showed. Food goods added a third. Excluding food and energy, prices rose for only the third time since 1998, climbing 0.2% from a year earlier after increasing 0.1% in June. The world's second-largest economy is slowing because higher prices of oil and raw materials are eroding incomes and the global slowdown is weakening exports, central bank Governor Masaaki Shirakawa said this week. "With the outlook getting murkier, the BOJ can't move at all,'' said Hiroaki Muto, a senior economist at Sumitomo Mitsui Asset Management Co. in Tokyo. "The downturn could have some staying power, so the policy rate will probably be unchanged all throughout fiscal 2009,'' or the year ending March 2010. Meanwhile, Japan's unemployment rate stayed near the highest level since 2006 and job prospects worsened, signalling consumers are unlikely to bolster an economy that shrank last quarter. The jobless rate fell to 4% in July, the statistics bureau said today in Tokyo.

RUSSIA'S RUBLE DROPS AMID PUTIN THREATS

Russia's ruble weakened against its dollar-euro basket as the country's stock market fell following Prime Minister Vladimir Putin's iterations that Russia may pull out of its bid to join the World Trade Organisation (WTO). The currency slid to the lowest level in more than two weeks versus the basket as Russia's benchmark Micex Index dropped to a 23-month low. The world's largest energy exporter has had "no benefit'' from talks to join the WTO, Putin said yesterday, further worsening Russia's relations with the West since the country's five-day war with neighbouring Georgia. "WTO membership and the liberalisation of trade is generally thought to be good for economic growth,'' said Neil Shearing, an economist focused on European emerging markets at Capital Economics Ltd. in London. "There is plenty for investors to be cautious about and the exit from equities has helped the ruble's fall.'' Russia's currency has lost 4.1% against the dollar and about 1.4% to the basket since August 7 when Georgia is alleged to have attacked Russian peacekeepers and citizens in the separatist region of South Ossetia, causing Russia to send in troops. "The pressure on the ruble is coming partly from the stock market,'' said Yaroslav Lissovolik, chief economist in Moscow at Deutsche Bank AG, the world's largest currency trader. `"its leading people in the forex market to close off long positions.''

LULA RAISES BRAZIL'S SPENDING 13% IN 09

According to government budget proposals for next year, Brazil's President Luiz Inacio Lula da Silva plans to boost spending, excluding interest payments by 13% in 2009. The federal government plans to spend 607.8 billion reais ($375 billion) in 2009, compared with 539.1 billion reais authorised for this year, the Budget Ministry said today in a statement distributed in Brasilia. The budget estimates economic growth next year will slow to 4.5%, compared with 5% this year and 5.4% in 2007. Inflation in 2009 will slow to 4.5% from 6.4% this year. `"Growth is going to slow because the government took measures such as increasing interest rates and containing the credit expansion to fight inflation,'' Budget Minister Paulo Bernardo told reporters. The country's target for the surplus before interest payments was kept at 3.8% of gross domestic product. The budget also seeks permission from lawmakers to increase that target by 0.5 percentage point to contribute to a proposed sovereign wealth fund still under consideration by congress. Spending on personnel will increase 16.5% to 155.3 billion as the government hires more workers and increases salaries. Revenue, excluding transfers to state and municipalities, is expected to increase 12.5% to 662.3 billion reais. Meantime, Brazilian bank lending expanded last month at the slowest pace since February as rising interest rates made borrowing more expensive and damped the consumer spending that has driven growth to record levels. State and non-state bank lending climbed to 1.086 trillion reais ($669.5 billion) last month, a 1.7% rise from a revised 1.068 trillion reais in June, the central bank said. Lending rose 32.7% from the year-earlier month.

MAJOR CORPORATE NEWS

Having recently posted a 55% jump in underlying earnings to $5.5 billion - due largely to higher iron ore volumes and prices and the acquisition of Alcan - Rio Tinto reaffirmed plans to use its growing relationship with shareholder Chinalco to pursue JVs globally. While some analysts think Chinalco has bought the shares as a way to block rival BHP Billiton's hostile takeover bid for Rio, others see it as a way to be first in the queue if BHP succeeds but is forced to sell assets as part of the deal. Included among possible opportunities for RIO Tinto are the joint construction of port and rail infrastructure in Queensland, Australia, and better access to China's mineral deposits. Other news flow to dominate the week included revelations that Fannie Mae and Freddie Mac on sold a combined $3 billion of short-term debt, helping to reassure stock markets that the two beleaguered US mortgage financiers could still fund their operations without a government rescue. Fannie sold $2 billion in three and six-month bills and Freddie sold $1 billion of one-month paper with stronger-than-usual investor demand as buyers were attracted by higher interest rates. The sales helped to boost Fannie's shares by 11.4% in early trade, while Freddie was 13.6% higher. Meanwhile, Toyota Motor cut its 2009 sales forecast by 700,000 vehicles, about 7%, as it acknowledged that the downturn in the US car market would last at least until the end of next year. It now expects to sell 9.7 million cars and trucks worldwide next year instead of 10.4 million. Toyota, Japan's leading carmaker, said there had been a "structural change" in demand in the US, the world's biggest car market, as the high cost of fuel pushed customers away from large trucks and 4x4 vehicles, suggesting that lower sales in those once-profitable segments would continue beyond the economic downturn. In a sign of its renewed focus on fuel-efficient vehicles, Toyota said it would bring forward the launch of a "plug-in" petrol-electric hybrid, which it will offer to fleet buyers by the end of next year. Katsuaki Watanabe, chief executive, said Toyota was also accelerating development of a small all-electric commuter car, which should be ready for commercial production next decade. "We have to respond flexibly to market conditions," he said. The carmaker cut its North American forecast by 300,000 units to 2.7 million – the same volume it expects this year – and sliced 150,000 units each off its projections for Europe, Japan and the rest of Asia. Toyota cut its 2008 estimates last month. High prices for steel and other raw materials have made it difficult for carmakers to cut prices to stimulate demand. Toyota announced its first increase in domestic vehicle prices for 16 years, though it limited the rises to commercial trucks and vans and sought-after hybrid models. On a more cheery note, Germany's Lufthansa took the next steps on its mission to become one of Europe's dominant scheduled carriers by pitching to take over Brussels Airlines and putting its low-cost carrier Germanwings up for a three-way merger. The airline said it was in talks to buy 45% of Brussels Airlines for €65 million ($95.7 million) and take an option to buy the remaining 55% in 2010.

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