MACRO HIGHLIGHTS

JANUARY 12TH 2015

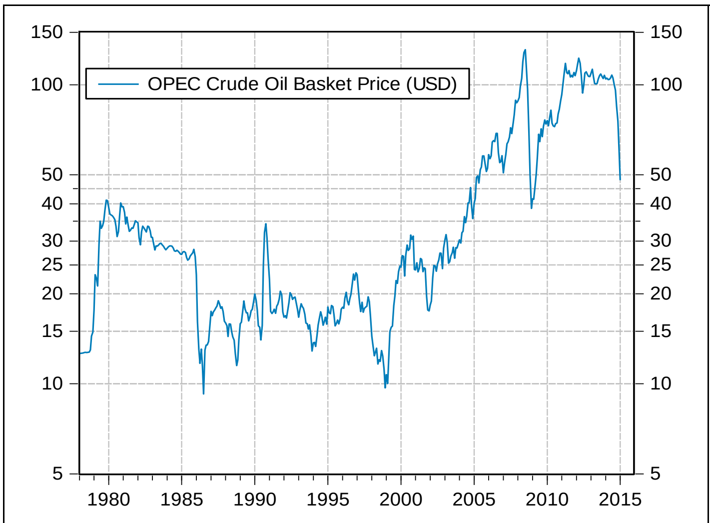
OUR ROUNDUP:

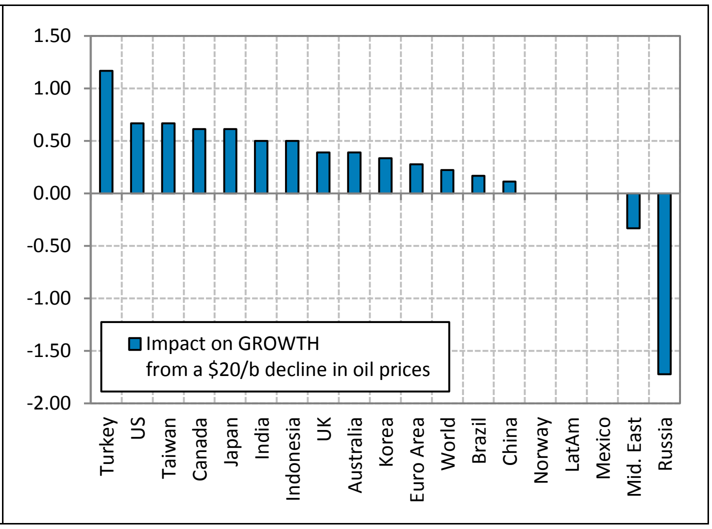
- Falling oil prices and a drop in US wage growth are temporarily weighing on the dollar.
- Lituania has joined the euro. Will Greece wave goodbye?

MARKETS

THE DOLLAR COULD WEAKEN SOON

Oil prices are falling relentlessly. After already plunging 50% in 2014, the value of crude petroleum has shed another 11% since the beginning of the year and now seems to be settling **below the psychologically important level of $50 a barrel** (see left-hand chart below).

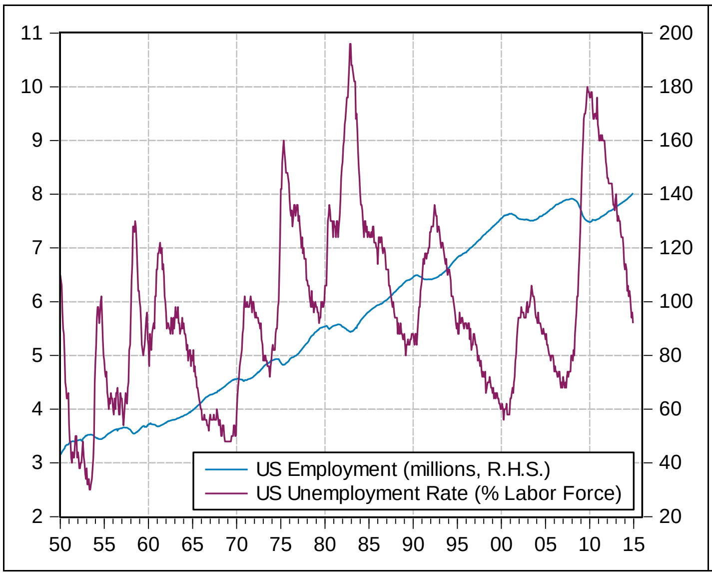


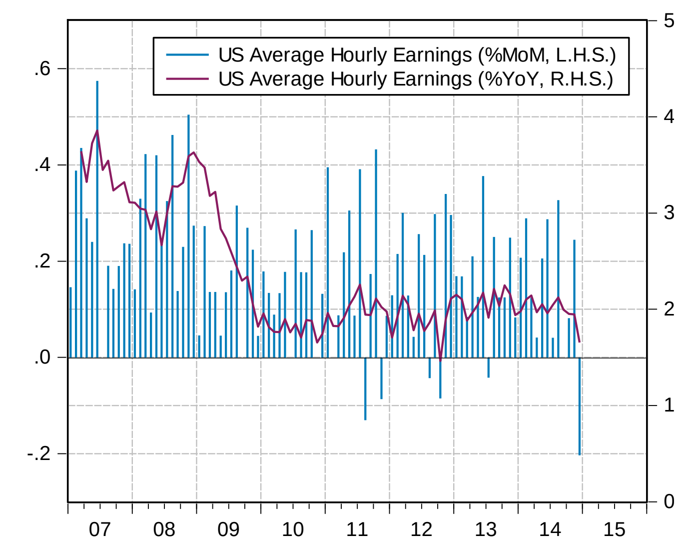


The global economy will benefit from this decline, since lower energy costs will provide consumers with additional purchasing power and ultimately **add about 0.5% to GDP worldwide** (see right-hand chart above).

And there is more good news: in 2014 the US economy created the largest number of new jobs in 15 years (see left-hand chart below). In December the national unemployment rate eased to 5.6%, its lowest level since June 2008.

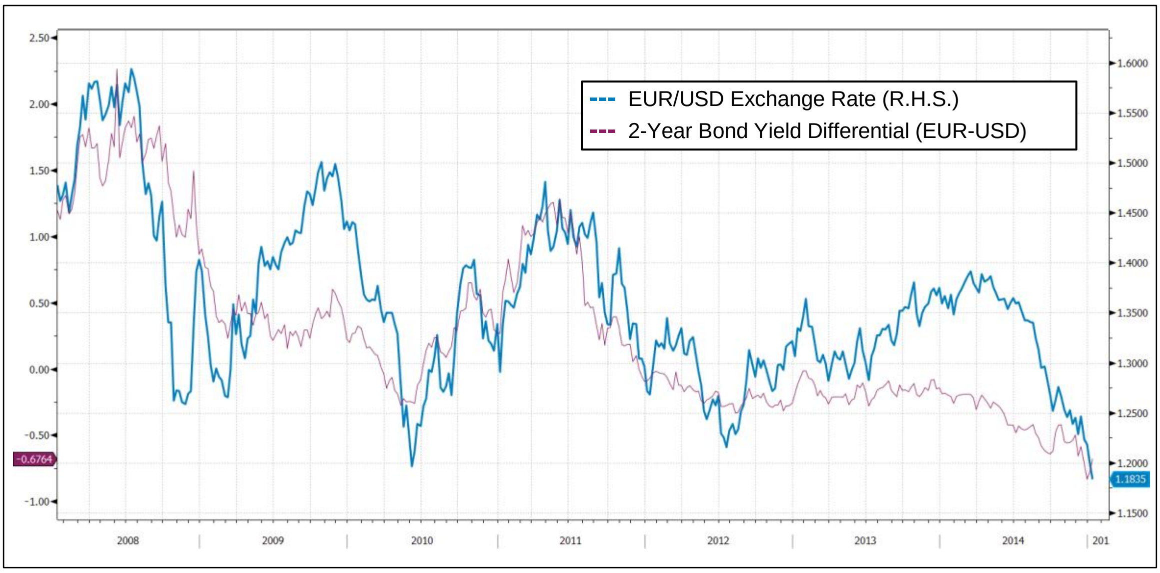
America's glowing December jobs data were nevertheless tarnished by wage figures. **Contrary to our scenario, average hourly earnings fell 0.2%**, the largest drop since 2006 (see right-hand chart below). While it is still too early to know whether this marks the start of a trend, **the issue of wage-driven inflation is vital to foreseeing and understanding how financial markets will perform in 2015**.



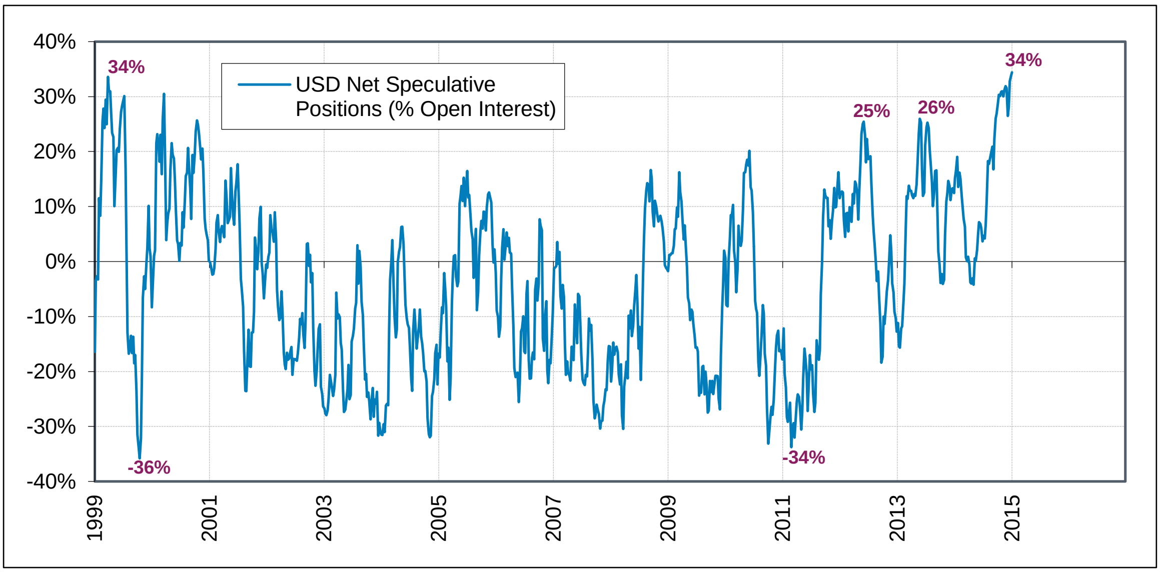


Easing inflationary pressure could prompt the US Federal Reserve to put off its first hike in interest rates. As long as it views the labour market as convalescent and lacking momentum, the Fed will conclude that employers are not finding it hard enough to recruit workers to initiate a wage-price spiral where rising pay would push up the cost of living and vice-versa.

If that were actually the case the dollar could come under downside pressure, despite expectations of quantitative easing by the European Central Bank. The euro would then win back some of the ground it has lost, perhaps rising as far as 1.28 against the greenback, in the coming months. But a retracement of this kind would not change the US currency's underlying uptrend, which is fuelled by the divergence between monetary policies on either side of the Atlantic (see chart below). It would merely provide the euro with some wiggle room before resuming its fundamental depreciation, which is bound to last several years.



A euro retracement would also allow investors to catch their breath. Since last June everyone has been buying dollars massively. **Open interest among forex traders is currently at its highest level in the 15-year history of this data set** (see chart below). **The temporary unwinding of positions could add six to eleven cents to the euro's value against the greenback**, like in the summers of 2012 and 2013. If the movement started tomorrow, the single currency could be worth between \$1.23 and \$1.28 within a few months. Stay tuned…



EUROPE

LITHUANIA HAS COME ABOARD. WILL GREECE DISEMBARK?

The Euro Zone continues to attract new members. After Estonia in 2011 and Latvia last year, **Lithuania completes the Baltic region's roster.** European Monetary Union now includes 19 countries (see chart below). Even though it looks constantly embattled as it struggles to rein in debt levels, create jobs, kick-start the economy and generate inflation, this did not put off Lithuanians. For the record, the tiny country applied for membership several years ago and was only narrowly turned down in 2006, owing to what looked like a bout of inflation (see the July 10th edition of *Macro Highlights*). In January 2010 it again hoped to join the euro, but this time its plans were thwarted by the debt crisis. Now Lithuania has finally added its population of 3 million to the 337 million who already use the euro as their common currency. After the rouble (from 1940 to 1991), the talon (from 1991 to 1993) and the litas (from 1993 to 2014), the euro will be its fourth currency in 25 years.

Euro Zone		Other EU countries
1 - Germany	11 - Ireland	20 – United Kingdom
2 - France	12 - Slovakia	21 - Poland
3 - Italy	13 - Luxembourg	22 - Sweden
4 - Spain	14 - Slovenia	23 - Denmark
5 - Netherlands	15 - Lithuania	24 – Czech Rep.
6 - Belgium	16 - Cyprus	25 - Romania
7 - Austria	17 - Estonia	26 - Hungary
8 - Greece	18 – Malta	27 - Croatia
9 - Finland	19 - Latvia	28 - Bulgaria
10 - Portugal		

Lithuania had to go to considerable lengths to comply with the Maastricht convergence criteria, which include controlling inflation, balancing the government budget and steadying the exchange rate and long-term interest rates (see table below). As in most Western countries, the 2008 financial crisis led to a severe recession in Lithuania in 2009. But the government refused to give in to the temptation to devalue its currency and courageously opted for austerity measures instead. In the end, despite stepped-up emigration, the economy remained on track. Deprivation even made Lithuanians a bit reluctant to join the Euro Zone. According to opinion surveys, the main reason for the idea of accession regaining popularity was the Ukraine crisis. Thus the move into the euro camp was undoubtedly motivated at least as much by geopolitics as by economic arguments.

Main features of country forecast - LITHUANIA

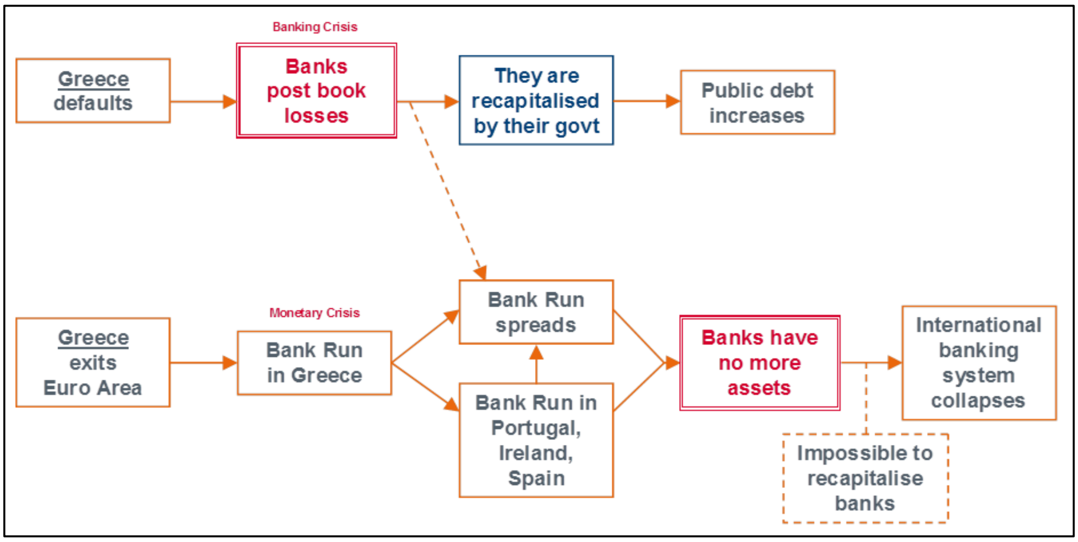
	2013			Annual percentage change						
	bn EUR	Curr. prices	% GDP	95-10	2011	2012	2013	2014	2015	2016
GDP		35.0	100.0	4.4	6.1	3.8	3.3	**2.7**	**3.1**	**3.4**
Employment				-1.2	0.5	1.8	1.3	**0.6**	**1.2**	**1.3**
Unemployment rate (a)				11.0	15.4	13.4	11.8	**11.2**	**10.4**	**9.5**
Real unit labour cost				0.5	-4.2	-0.5	1.4	**0.6**	**1.4**	**0.9**
Saving rate of households (b)				2.6	4.2	0.9	-	**-**	**-**	**-**
GDP deflator				6.4	5.2	2.7	1.6	**0.8**	**1.6**	**2.1**
Harmonised index of consumer prices				-	4.1	3.2	1.2	**0.3**	**1.3**	**1.9**
Terms of trade goods				-	0.1	-0.4	1.9	**-0.2**	**-0.1**	**0.0**
Trade balance (goods) (c)				-10.7	-6.6	-3.3	-2.6	**-4.0**	**-4.8**	**-5.6**
Current-account balance (c)				-7.6	-3.7	-0.9	1.6	**0.8**	**-0.4**	**-1.4**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-6.7	-0.5	2.1	4.5	**4.4**	**2.0**	**0.7**
General government balance (c)				-	-9.0	-3.2	-2.6	**-1.2**	**-1.4**	**-0.8**
Cyclically-adjusted budget balance (c)				-	-7.5	-2.7	-2.6 -	**-1.2**	**-1.5**	**-1.0**
Structural budget balance (c)				-	-3.8	-2.8	-2.2 -	**-1.8**	**-1.6**	**-1.1**
General government gross debt (c)				-	37.3	39.9	39.0	**41.3**	**41.6**	**41.3**

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.

But even as new countries enter the Euro Zone, others could exit. That is the gist of an interview that the German chancellor, Angela Merkel, gave to the German newspaper *Der Spiegel* just over a week ago. **Merkel thinks a "Grexit" will be inevitable** if the left-wing party Syriza wins the general election on 25 January, abandons budget discipline and repudiates the country's debt. She also believes that the Euro Zone is now capable of sustaining the shock of a member leaving. Most economic commentators seem to share this view. Here is a brief summary of the stakes involved:

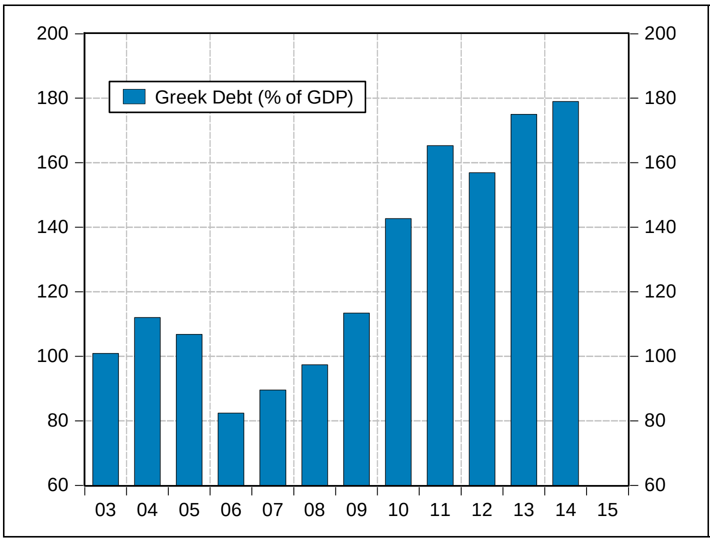
- **The first thing is not to confuse the risk of Greece defaulting on its debt and that of it leaving the Euro Zone** (see diagram below). While a default is quite manageable, a Grexit could unleash the worst financial catastrophe in history.

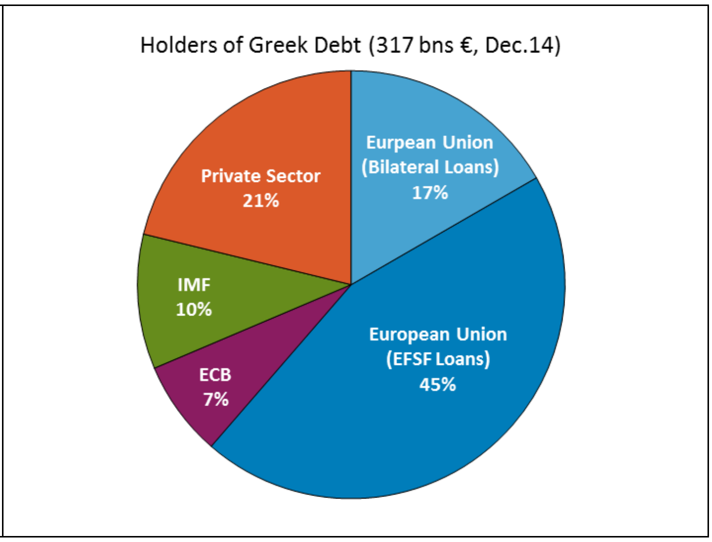
Defaulting and exiting the Euroland: two very distinct situations



- **Greece rightly believes that it should default on part of its debt.** It already did this in 2012 but its debt-to-GDP ratio still stands at 179% (see left-hand chart below). Everyone agrees that this level is unsustainable. Merkel is certainly aware of the problem, too, so her comment about a Grexit being inevitable looks more like political posturing than an economic assessment. Some people may have forgotten, but the reason why a Greek default was not organised back in 2010 was to spare large European banks (German ones, in particular), which owned the bulk of the zone's risky debt securities. Since then they have reduced their positions without suffering large losses.

- **Private-sector debt is not included when a country defaults.** What is more, since 2012 banks have not held much Greek debt at all. It is mainly owned by European public bodies (state treasuries, the European Financial Stability Facility and the ECB) and the IMF (see right-hand chart below). To bring Greece's national debt down to between 60% and 120% of GDP, Syriza would propose to default on two-thirds of it, mainly on the public portion. This is where the Greek debt problem becomes politically charged.





- **Greece has not implemented all the reforms ordered by the *troïka*** (the EU, the ECB and the IMF) and could thus be said to be shirking its responsibility. But one has to admit, in Greece's defence, that the demands were unreasonably harsh. The financial aid provided in recent years by the *troika* was not a gift; it was a series of loans that have added to Greece's debt burden.

- **Syriza, like a large majority of Greek citizens, has no intention of leaving the Euro Zone.** Returning to a devalued drachma would be a nightmare scenario, since Greece imports four times more than it exports. It is Angela Merkel who has raised this spectre, which (let it be said) runs counter to the EU treaties.

- **A Grexit could lead to a breakup of the euro itself,** via a domino effect. It would be controllable but highly damaging. European construction would come to an end. Euro members would pay a heavy tribute as they would have to bring back their national currencies in the midst of recession and wildly swinging prices.

- **<u>The point that we mustn't underestimate is that a Grexit could generate systemic risk</u>** and even trigger a collapse of the international financial system via a bank run. Depositors in struggling Euroland countries (and not only Greeks) would queue up around the block to transfer their savings abroad or, more simply, take the money in cash and stuff it in a mattress. This would cause banks in Greece, across Europe and even farther afield to topple. In the case of a Grexit, unlike in that of a payment default, banks would not only suffer book losses but would also see their assets vanish (see chart on p. 5). They could not be recapitalised by their government because that would mean injecting trillions of euros to counterbalance capital flight. No public body has that kind of money. To avoid such an implosion of the banking system, authorities would have to find a way to stop the contagion. To keep a bank run confined to Greece and prevent it from spreading to Portugal, Ireland, Spain, etc., they could sign a treaty guaranteeing that they would never leave European Monetary Union. But who would believe them after all the flip-flopping we have seen since EMU was created?

- **The only way to allow a member to leave the Euro Zone is, first of all, to mutualise debt and set up a budget union with binding rules.** Then and only then could a country exit the zone without the putting the remaining members' relationship in jeopardy. Exiting is thus an easy political decision to take, in theory, but is fraught with difficulties when it comes to implementation. As proof, Europe has been running into this wall for decades.

We mustn't fool ourselves: a Grexit, like the collapse of Lehman Brothers in September 2008, could deal a devastating blow to the international banking system. That is why, at the risk of ruffling feathers and seeming brazen, we believe a Grexit would be devastating for financial markets. It won't happen.

ECONOMIC FORECASTS

Contributions to global GDP growth

Economic Activity	GDP 2013	GDP 2014 Economist Estimates	GDP 2015 Economist Estimates	Country Weights	Contribution 2014
United States	1.9%	2.3%	3.0%	21.8%	0.50%
Canada	1.8%	2.4%	2.5%	2.1%	0.05%
Euro Area	-0.4%	0.8%	1.1%	15.4%	0.12%
United Kingdom	1.8%	3.0%	2.6%	3.7%	0.11%
Switzerland	1.9%	1.8%	1.8%	0.7%	0.01%
Russia	1.3%	0.5%	-1.8%	2.6%	0.01%
Japan	1.7%	0.2%	1.0%	5.4%	0.01%
China	7.7%	7.4%	7.0%	15.3%	1.13%
India	5.0%	5.4%	5.5%	3.1%	0.17%
Brazil	2.2%	0.2%	0.9%	2.9%	0.01%
Mexico	1.2%	2.2%	3.4%	1.7%	0.04%
Others	5.0%	4.5%	6.0%	25.4%	1.15%
WORLD	**3.3%**	**3.3%**	**3.8%**	**100%**	**3.3%**

Source : Bloomberg ⇧ ⇨ ⇩ Momentum (vs Last Estimates) Performance (Over \ Under)

Comments

- The GDP growth rates shown above are actual for 2013 and projections for 2014 and 2015.
- Each country's weighting is based on its GDP in US dollars as calculated by the World Bank.
- Contributions to global expansion are calculated by multiplying the GDP growth of each country by its weight. The sum of the contributions works out to 3.8%, a good estimate of global GDP growth for 2015.

RETURNS ON FINANCIAL ASSETS

Major benchmarks and currencies

Markets Performances (local currencies)	Last Price	1-Week (%)	1-Month (%)	Year-to-Date (%)	Last Year (%)
Equities					
World (MSCI)	412	-1.0%	-1.9%	-1.3%	4.8%
United States (S&P 500)	2'045	-0.6%	-0.6%	-0.6%	13.7%
Euro Area (DJ EuroStoxx)	317	-2.2%	-2.4%	-2.3%	5.0%
United Kingdom (FTSE 100)	6'528	-0.7%	-0.4%	-1.0%	1.0%
Switzerland (SMI)	9'194	1.4%	0.6%	1.4%	12.0%
Japan (NIKKEI)	17'198	-1.5%	-3.4%	-1.5%	8.9%
Emerging (MSCI)	961	0.8%	-0.3%	0.6%	-2.1%
Bonds (Bloomberg/EFFAS)					
United States (7-10 Yr)	1.97%	1.4%	2.2%	1.9%	8.9%
Euro Area (7-10 Yr)	1.55%	-0.1%	1.3%	0.5%	14.0%
Germany (7-10 Yr)	0.50%	0.1%	1.4%	0.3%	12.0%
United Kingdom (7-10 Yr)	1.61%	0.8%	2.1%	1.1%	11.7%
Switzerland (7-10 Yr)	0.23%	0.9%	0.7%	0.9%	7.2%
Japan (7-10 Yr)	0.28%	0.4%	1.1%	0.4%	5.0%
Emerging (5-10 Yr)	4.60%	-0.1%	-1.0%	0.0%	7.7%
United States (IG Corp.)	2.97%	1.0%	1.7%	1.3%	7.6%
Euro Area (IG Corp.)	0.94%	0.1%	0.6%	0.2%	8.1%
Emerging (IG Corp.)	4.65%	0.1%	-0.1%	0.2%	5.7%
United States (HY Corp.)	7.02%	-0.1%	-0.1%	-0.1%	1.6%
Euro Area (HY Corp.)	4.08%	0.1%	-0.3%	0.2%	5.5%
Emerging (HY Corp.)	10.50%	-1.4%	-2.4%	-1.6%	-2.6%
United States (Convert. Barclays)	47	-0.1%	-0.7%	0.0%	7.7%
Euro Area (Convert. Exane)	6'994	0.4%	0.5%	0.4%	4.5%
Real Estate					
World (MSCI)	199	1.8%	2.7%	2.6%	15.2%
United States (MSCI)	208	3.2%	5.0%	4.7%	28.1%
Euro Area (MSCI)	192	2.6%	5.6%	2.6%	19.1%
United Kingdom (FTSE)	6'030	0.1%	0.7%	0.1%	19.7%
Switzerland (DBRB)	3'507	1.5%	5.1%	1.5%	14.6%
Japan (MSCI)	265	-2.4%	-3.9%	-2.4%	-6.3%
Emerging (MSCI)	114	0.2%	0.7%	2.8%	-1.7%
Hedge Funds (Dow Jones)					
Hedge Funds Industry	554	n.a.	1.5%	n.a.	4.1%
Distressed	772	n.a.	0.1%	n.a.	3.1%
Event Driven	636	n.a.	0.6%	n.a.	2.1%
Fixed Income	301	n.a.	0.2%	n.a.	4.4%
Global Macro	885	n.a.	1.7%	n.a.	3.4%
Long/Short	652	n.a.	1.9%	n.a.	5.2%
Managed Futures (CTA's)	314	n.a.	7.5%	n.a.	16.4%
Market Neutral	266	n.a.	0.6%	n.a.	-0.5%
Multi-Strategy	500	n.a.	1.2%	n.a.	5.7%
Short Bias	30	n.a.	0.6%	n.a.	-6.5%
Commodities					
Commodities (CRB)	448	0.2%	-5.2%	0.2%	-11.9%
Gold (Troy Ounce)	1'220	1.6%	-0.3%	2.7%	-1.1%
Oil (Brent, Barrel)	48	-11.4%	-25.1%	-11.5%	-49.7%
Currencies					
USD	92.2	0.9%	4.4%	2.2%	12.8%
EUR	1.18	-1.1%	-5.3%	-2.4%	-12.0%
GBP	1.51	-0.8%	-3.7%	-2.9%	-5.9%
CHF	1.02	-1.0%	-5.2%	-2.3%	-10.2%
JPY	119.3	0.3%	-0.4%	0.4%	-12.1%

Source : Bloomberg   Momentum (1-week / 1-month / 3-month)   Performance (Negative \ Positive)

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