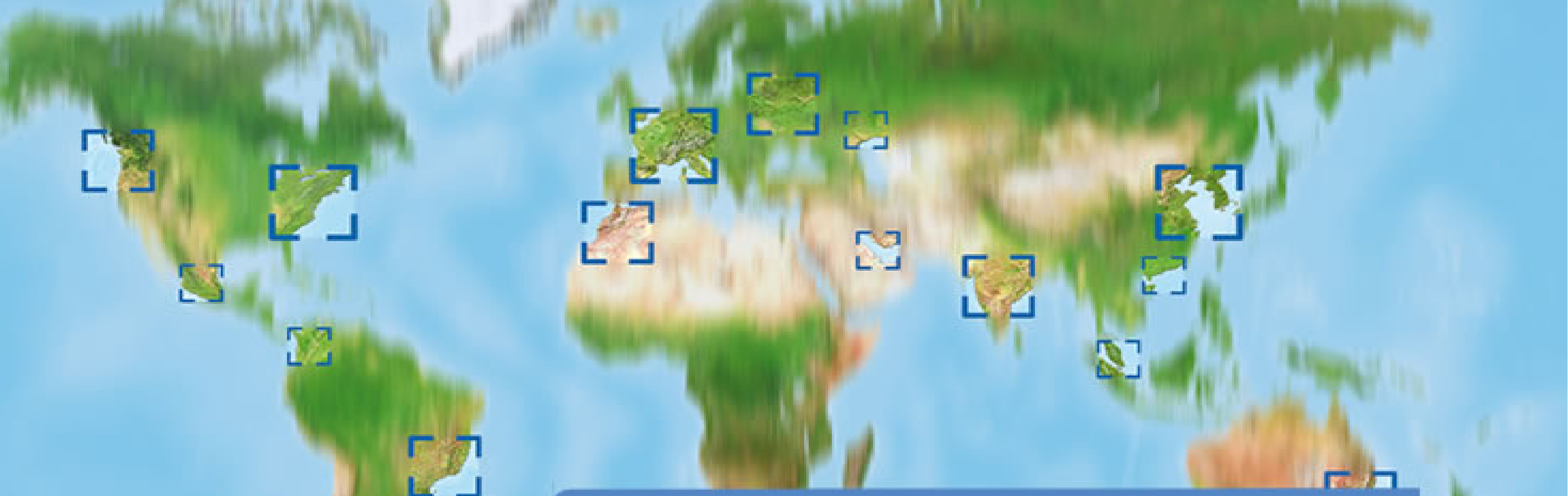

Weekly Export Risk Outlook

EULER HERMES
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25 July 2012

In the Headlines

FIGURE OF THE WEEK: -13% >YR/YR DECLINE IN ALL-COMMODITY PRICE INDEX

Eurozone: Crisis update

Finance Ministers formally approved the bail-out for Spain's banks last week, but this did not stop the country's sovereign 10-yr bond yields rising through 7.5% and increasing across the yield curve this week. The immediate trigger seems to have been the request by Valencia for access to central government funds set aside to help regional governments' debt redemptions and confirmation that Catalonia will also need support, set against a backdrop of persistent recession, high unemployment, social protests, approval of softer budget targets, mounting bank NPLs and continued capital flight. Spain has a lower interest/government revenue ratio than Portugal or Greece and is better able to withstand high yields, but there also needs to be some positive news, such as progress towards implementation of the decision to allow Spain's banks to be re-capitalised directly by the EZ fund. Meanwhile, Greece is moving back to the fore, with the "Troika" in Athens to assess progress with the financing programme, and Moody's assigned a negative sovereign risk outlook to Germany, Netherlands and Luxembourg.

US: Mostly negative

The Index of Leading Indicators, designed to predict economic activity six to nine months ahead, fell in June for the second time in three months. Only one of the ten components, the yield spread between the ten-year Treasury note and the Fed Funds rate, was strongly positive. The Index has been trending downward since the end of Q3 2011 and it is noteworthy because it is one of the most predictive indicators. Meanwhile, housing data remain mostly negative. Although housing starts increased by 6.9% in June (only the second increase in five months), permits fell 3.7%, the second decline in three months, and sales of existing homes fell by 5.1%, although prices firmed. Moreover, unseasonal weather patterns, including drought, may cut agricultural output, contributing further to economic uncertainties.

Eurozone: PMI data signal contraction…

The flash Markit PMI composite output index for July suggests that economic contraction continues. For the 11th consecutive month, the index, at 46.4, was below the 50 mark that signifies expansion. All the sub-components within the index showed weakness, with the manufacturing PMI down 1pps to 44.1 (Germany 43.3 from 45.0 and France 43.6 from 45.2). Although the Services Activity Index increased moderately (47.6 from 47.1) it remained below expansion. The outlook continues to appear unfavourable, with a further decrease—for the 12th consecutive month—in new orders.

China: …but improvement here

The flash Markit/HSBC manufacturing PMI for July released this week indicates that manufacturing is improving, picking up to 49.5, from the final June reading of 48.2, and although still below 50 is the highest level since February. The pick-up was also widely based, with the output component crossing the 50 threshold and the orders component also increasing after two months in which it had fallen. This is hardly the harbinger of strong recovery and by no means the only indicator, but it does tend to suggest that policy loosening may be beginning to have some success, strengthening the prospects of a soft landing.

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Countries in Focus

Mediterranean, Africa & Middle East – *South Africa: Repo cut*

The key policy interest rate (repo) was cut last week, by 50bps to 5.0%. While reduced inflationary pressures provided some scope for monetary relaxation, concerns relating to growth were also probably to the fore in the decision-making process. The official forecast is that inflation (5.5% yr/yr in June, 5.7% in May) will moderate further, reaching a low of 4.9% yr/yr in Q2 2013 and remaining around the 5% level to the end of 2014. With real rates now in negative territory, however, do not expect further cuts to materialise in the ST. Moreover, a weakening ZAR and potential for increased food/commodity prices may exert upward inflationary pressures, complicating policy formulation. Expect GDP growth to remain lacklustre, given social/development needs, within a range of 2-3% in 2012 and 2013.

Americas – *Peru: Cabinet reshuffle*

Approaching the end of his first year in office, President Humala re-shuffled his cabinet as he tries to find a more successful way of resolving the wave of social protests over regional mining projects. The new prime minister is Juan Jiminez, formerly minister of justice and a lawyer, replacing retired army officer Oscar Valdes, who had taken a hard-line stance against protesters and declared three states of emergency (regional) during his tenure. Minister of Economy Castilla is retained, a sign of continuity in fiscal and monetary policies associated with sustained growth and resilience to external shocks. The minister of mining and energy is also retained, which suggests continuity in the basic thrust of resource development policy. Meanwhile, monthly data put GDP growth in May at 6.5% yr/yr.

Asia-Pacific – *Indonesia: Economy update*

Domestic demand continues to boom and drive economic expansion, but also supports robust import growth. As exports have been affected by the global slowdown and lower commodity prices, this has been reflected in a weaker external balance. The current account moved into deficit in Q4 2011 and shortfalls in merchandise trade were recorded in April and May 2012. The weakening in the external accounts caused downward pressure on the IDR which, at end-May, had depreciated against the USD by around 5% since end-2011, and by 11% yr/yr. Since then, the IDR has stabilised as a result of central bank intervention. FX reserves fell by 9% in May-June, although, at USD99bn, they are still ample and should mitigate near-term concerns. Headline inflation remained stable at 4.5% yr/yr in June.

Europe – *Ukraine: Risk update*

Real GDP growth slowed to 2% yr/yr in Q1 from 5% in Q4 2011. The main driver was private consumption (up 9.8% after 16.8% in Q4). Fixed investment growth moderated to 7.6% (16.8% in Q4), which suggests that there was large inventory destocking in the first quarter. Exports continued to decline, by 6.8% in Q1 (-9.2% in Q4). Imports also fell, by 4.3% (+2.4% in Q4). Early Q2 data for industrial output (weak) and retail sales (robust) indicate a continuation of Q1 trends. External liquidity risk remains high, reflected in a continuing current account deficit (USD2.6bn in January-May), increased investment outflows in Q2 and a 24% yr/yr fall in FX reserves in June. Downward pressure on the quasi-fixed UAH/USD exchange rate has intensified recently.

Worth knowing

UK

Q2 GDP contracted by 0.7% qtr/qtr. The third consecutive quarterly contraction was driven mainly by construction output, but was also affected by poor weather and an extra public holiday, making this preliminary estimate more uncertain than usual.

Nigeria

Yesterday, the central bank increased the cash reserve ratio (CRR) by an unexpected 400bps, to 12%, while keeping the key policy rate (MPR) unchanged at 12%. Adjustment of the CRR rather than the MPR suggests an aggressive tightening stance.

Political leadership

Ghana: President John Evans Atta Mills died on 24 July and VP John Dramani Mahama was sworn into office. Presidential elections are due in December. **Egypt:** President Mohamed Morsi asked Hisham Kandil, the irrigation minister, to become PM and form a new government. **Saudi Arabia:** Prince Bandar bin Sultan al-Saud was appointed Director for General Intelligence.

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