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Global Financial Market: Topical Issues in March

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Contents

Results of March 2012

Macroeconomic reports published in March continued to indicate a worsening economic situation in the euro area, whereas situation in the U.S. economy was more stable, though not brilliant.

Signs of cooldown continued to be observed in the Chinese economy playing the role of the world locomotive, where the index of business activity fell sharply in March, remaining below 50 for several months already,

Some problems went down to the corporate level, where, according to Bloomberg forecasts, Q1 2012 will be the first quarter of falling profits since Q3 2009 for companies of S&P 500 index.

At the same time, March was another month of easing tensions over the debt problems of the euro area after the "voluntary" restructuring of the Greek debt and the signing of the budget pact by 25 of 27 EU countries.

However, the surge of optimism among some leading European politicians caused by these events may be premature.

As far as financial markets are concerned, there were mixed trends observed at the world stock market with a predominance of growth in the stock exchanges of developed markets and the decline in emerging markets.

The bond market was also marked by opposite trends both in the sector of emerging markets and that of PIIGS, with prices of the U.S. securities falling. But the value of all movements was insignificant.

In the currency market the month was relatively quiet, with no significant changes in value of the dollar to developed and developing currencies (except its growth to the Brazilian real by 6%), and the dollar index (the dollar’s rate to the basket of six leading world currencies) closed the month almost on the level of opening.

In the commodity markets, the month was not very volatile as well.

In the gold market, prices continued to fall, and their decrease amounted to 1.7%, after falling by 2% in February, and the price of an ounce dropped to $1668. But prices are still far from the local minimum reached in December 2011 at $1520 per ounce.

The fall in silver prices was greater – by 7.8% to $32.2 per ounce, but it should be noted that silver closed February with an increase by 4%, and the overall result over two months is the same as that of gold.

In the oil market in March there was a significant divergence of trends in movements of Brent and WTI prices. Brent price virtually has not changed over the month, while the price of WTI fell by almost 4%. Consequently, the spread between them increased again to $20 in favour of Brent.

Situation in financial and economic system

Macroeconomic reports published in March continued to indicate that the post-crisis model of economic management in Europe gives much worse results than the American model of management.

In February, unemployment in the euro area rose to 10.8% – a new record high since the formation of monetary union.

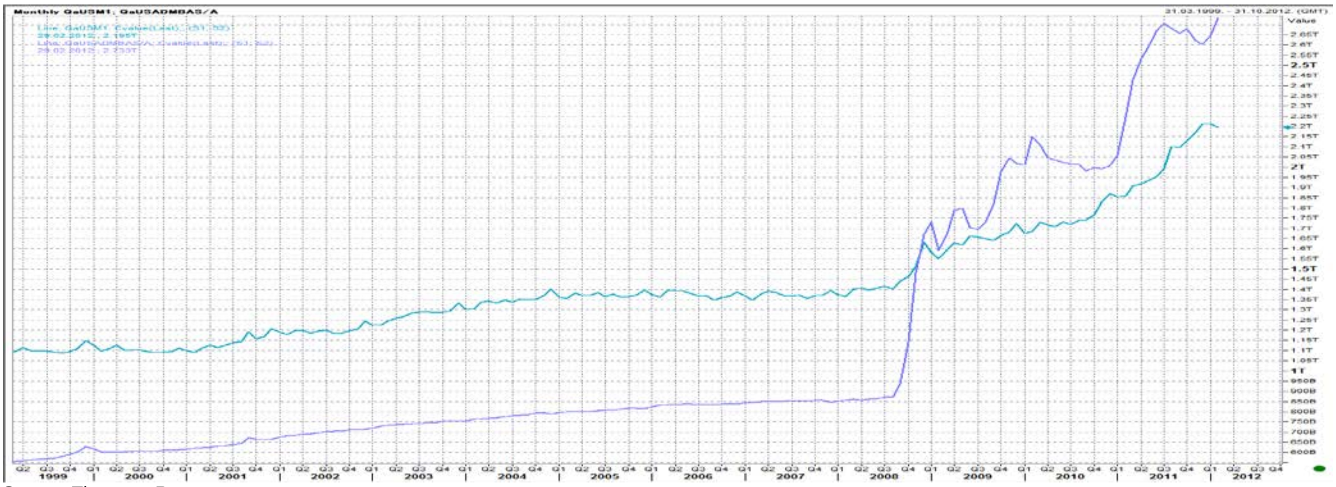
The euro area business activity index for March amounted to 47.7 in the manufacturing sector and 49.2 in services, and both indexes remained below the equilibrium level of 50 since mid-2011, indicating a continued reduction of business activity.

At the same time, the U.S. unemployment stands at 8.3%, almost 2% below the peak reached in October 2009, and indexes of business activity in manufacturing and services remain above 50 since the beginning of 2010.

Given such situation, though promises "to continue soft monetary policy" were given at the March FRS meeting and in a statement made on 26 March, no signs of the expected QE3 followed.

Nevertheless, in recent months the dollar monetary base and the FRS balance resumed growth, but the monetary aggregate M1 even decreased in February, which indicates a continuation of deleverage in the U.S. economy (see Fig. 1).

Fig. 1. Dynamics of the U.S. monetary aggregates MB and M1, monthly lines



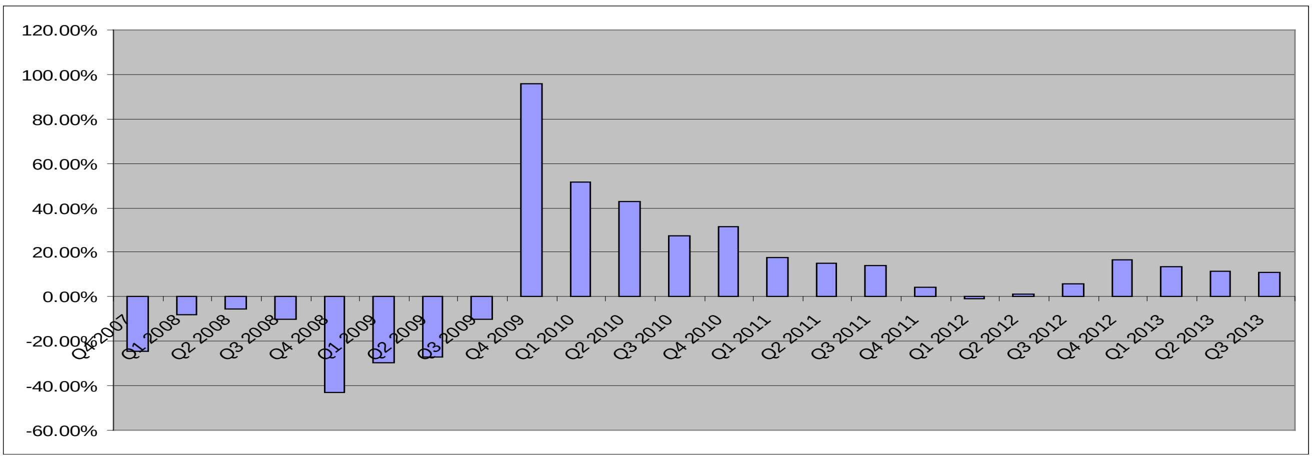
Source: Thomson Reuters

In turn, the balance of the ECB is increasing in recent years even more rapidly, and since mid-2011 till present it has grown from €2 trillion to €3 trillion, largely due to the LTRO program, under which the Central Bank issued (i.e. printed) three-year loans worth €1 trillion in December and February.

The March data also confirm that the cooling trends also reached the world locomotive – Chinese economy.

In March, the index of business activity in the manufacturing sector in China, according to HSBC, has plummeted to the level of 48.3 and is decreasing already for the 5th month in a row (although, according to the National Bureau of Statistics, the index rose to 53.1). At the micro level the situation also begins to deteriorate, and, according to Bloomberg, the S&P 500 companies will demonstrate overall decrease of the last-quarter profits year-on-year, for the first time since Q4 2009 (see Fig. 2).

Fig. 2. Change dynamics and the forecast of profit growth of S&P 500 companies



Source: Bloomberg, ABLV Bank

Euro area: the crisis is over, forget about it?

In early March, leaders of 25 out of 27 EU countries (except Great Britain and the Czech Republic) have signed a pact on budget stability, aimed at ensuring a more rigorous financial discipline in the euro area and the EU member states.

According to the pact, state budget deficit may not exceed 0.5% of GDP (1% for countries having public debt below 60% of GDP), which will be governed at the level of constitutional law, and for in case of budget deficit amounting to 3% of GDP, a system of automatic sanctions of up to 1% of GDP will be introduced.

The pact will enter into force only after ratification by 12 of the 17 countries in monetary union, which is not expected until early 2013.

By mid-March the restructuring of bond debt of Greece has also been technically completed, as a result of which private investors have written off 50% of the debt, i.e. about €107 billion.

Following this, Greece has received a loan of €39.4 billion from the euro area countries and a loan of €28 billion from the IMF, as a part of the second batch of activated country's support program of €130 billion, which helped to stabilize the state treasury.

These measures, alongside several months of calm in the market of government bonds of the euro area problematic countries have caused a surge of optimism among some leading European politicians.

EU President Herman Van Rompuy and ECB President Mario Draghi hastened to declare that "turning point in the crisis" has been already reached, and FRG Chancellor Merkel said that "it is a milestone in the history of the European Union."

However, the head of IMF Christine Lagarde spoke more cautiously: "On the back of these collective efforts, the world economy has stepped back from the brink and we have cause to be more optimistic."

Nevertheless, objective look at the situation shows that these "collective efforts" yielded no particular positive changes in the fundamental state of the financial and economic system of the euro area.

The euro area countries are still very burdened with public debts, and even after restructuring the public debt of Greece remains to be 125%-130% of GDP, which does not eliminate the risk of another default in the future (see Table 1).

Table 1. Table of public debt and budget deficits of some countries with high debt

		2011 (forecast)		2010		2009		2008	
Country	**Public debt**	**Public debt to GDP**	**Budget to GDP**	**Public debt to GDP**	**Budget to GDP**	**Public debt to GDP**	**Budget to GDP**	**Public debt to GDP**	**Budget to GDP**
Japan	$12 trillion	233%	-10%	220.3%	-9.5%	216.3%	-10.3%	195%	-4.2%
Greece*	€253 bn	130%	-7.4%	142.8%	-10.5%	127.1%	-15.4%	110.7%	-9.8%
Italy	€1.9 trillion	121%	-4.4%	119.0%	-4.6%	116.1%	-5.4%	106.3%	-2.7%
Ireland	€177 bn	106%	-10.8%	96.2%	-32.4%	65.6%	-14.3%	44.4%	-7.3%
Belgium	€355 bn	100%	-3.9%	97.1%	-4.1%	96.2%	-5.9%	89.6%	-1.3%
USA	$15 trillion	100%	-10.3%	91.6%	-10.6%	84.6%	-12.7%	71.2%	-6.4%
Portugal	€156 bn	93%	-5.6%	93.0%	-9.1%	83.0%	-10.1%	71.6%	-3.5%
France	€1.7 trillion	87%	-6.0%	81.7%	-7.0%	78.3%	-7.5%	67.7%	-3.3%
England	£1.3 trillion	86%	-8.4%	80.0%	-10.4%	69.6%	-11.4%	54.4%	-5.0%
Germany	€2.1 trillion	85%	-2.3%	83.2%	-3.3%	73.5%	-3.0%	66.3%	0.1%
Spain	€693 bn	68%	-6.1%	60.1%	-9.2%	53.3%	-11.1%	39.8%	-4.2%

Source: Bloomberg, Eurostat, EconomyWatch
* after restructuring in March 2012, public debt of Greece fell from €360 billion to €253 billion, and its ratio to GDP from 165% to 130%

The losses of €107 billion resulting from the restructuring of the Greek debt are mainly borne by participants in the European financial system, and the negative effects of this shock to the system are difficult to assess.

But it is clear that the banking systems of countries such as Greece and Cyprus will now plunge in a massive crisis with the possible need for the nationalization of major banks.

Thus, comparing the pros and cons of restructuring for the financial system of the euro area, it is likely that negative effects prevail.

What regards the Stability Pact, it still has to be ratified, and there can be serious problems.

The proposed limit on deficits, equal to 0.5% of GDP, is very difficult to comply with. Especially in the current situation where the deficits are far from the proposed value (see Table 1) and the overall economy of the area is expected to enter recession.

Given the growth of public discontent in Europe regarding adopted austerity measures, the ratification of the pact becomes politically dangerous. But even if 12 countries ratify it, the pact will be difficult to implement in practice.

In order to comply with the limits set in the agreement, it will be necessary to significantly reduce public spending.

But the sharp decline in public spending has a negative impact on the economy. Revenues are falling and achievement of the declared budget parameters fails (what we now see demonstrated by problematic countries).

The only serious "positive" shift that did occur in the system was the ECB lending (printing) more than €1 trillion to commercial banks for the period of 3 years at two auctions in December and February.

Therefore, the practice has finally confirmed that the authorities have not yet found other tool of stabilizing markets of growing public debts, apart from indirect monetization.

However, this medicine in large doses can be a poison for the financial system. Therefore, the further extension of QE is dangerous, and the possibilities of using this tool are limited.

Writing off of Greece debts actually became a touchstone of exploring other methods to be used to control the accumulated public debts.

But the obtained "positive" result is unlikely to be useful in case of restructuring of the debtors such as Italy, USA, Japan or Germany. For the financial system their debts are "too big to fail", i.e. in case of a crisis in those markets the whole system could collapse.

Global stock market

In the global stock market March was less optimistic than the first two months of the year, with a predominance of growth in developed markets and fall in emerging ones (see Table 2). But over the three months, all the indexes monitored by us managed to show very good growth.

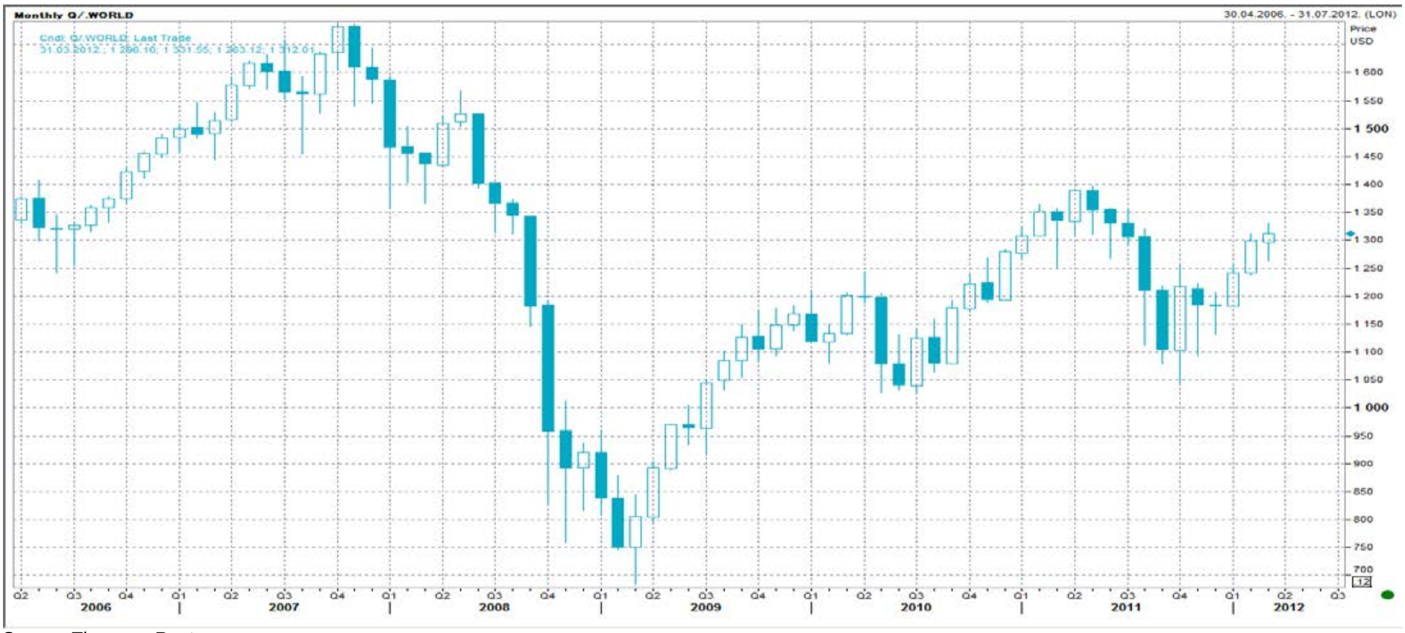
Table 2. The dynamics of movements of several leading world stock market indexes

Stock index	P/E	Div.Yeld	2003-2007	2008	2009	2010	2011	January 2012	February 2012	March 2012	2012
DJI (USA)	13.3	2.5	59.0%	-33.8%	18.8%	11.0%	5.5%	3.4%	2.5%	2.0%	8.1%
S&P 500 (USA)	14.1	2	66.9%	-38.5%	23.5%	12.7%	0.0%	4.4%	4.0%	3.2%	12.0%
Nasdaq Comp. (USA)	24.1	1	98.6%	-40.5%	43.9%	16.9%	-1.8%	8.0%	5.4%	4.2%	18.7%
GDAX (Germany)	12	3.6	178.9%	-40.4%	23.8%	16.1%	-14.7%	9.5%	6.2%	1.3%	17.8%
N225 (Japan)	25.4	2	78.4%	-42.1%	19.0%	-3.0%	-17.3%	4.1%	10.5%	3.7%	19.3%
FTSE (England)	11.1	3.8	61.5%	-31.0%	23.2%	9.0%	-5.6%	2.0%	3.3%	-1.8%	3.5%
CAC (France)	10.9	4.5	83.2%	-42.7%	22.3%	-3.4%	-17.0%	4.4%	4.7%	-0.8%	8.4%
RTS (Russia)	5.9	2.2	537.9%	-72.4%	128.6%	22.5%	-22.0%	14.3%	10.0%	-5.4%	18.8%
MICEX (Russia)	5.2	1.9	492.3%	-67.2%	121.1%	23.2%	-16.9%	8.0%	5.5%	-4.9%	8.3%
SSEC (China)	12.7	2	287.4%	-65.4%	80.0%	-14.3%	-21.7%	4.2%	5.9%	-6.8%	2.9%
HSI (Hong Kong)	9.9	3.2	198.4%	-48.3%	52.0%	5.3%	-20.0%	10.6%	6.3%	-5.2%	11.5%
KOSPI (Korea)	22.6	1.2	202.3%	-40.7%	49.7%	21.9%	-11.0%	7.1%	3.8%	-0.8%	10.4%
TWII (Taiwan)	19.1	4.1	91.0%	-46.0%	78.3%	9.6%	-21.2%	6.3%	8.0%	-1.7%	12.9%
SENSEX (India)	15.9	1.4	500.7%	-52.4%	81.0%	17.4%	-24.6%	11.3%	3.3%	-2.0%	12.6%
BOVESPA (Brazil)	11.7	3.6	467.0%	-41.2%	82.7%	1.0%	-18.1%	11.1%	4.3%	-2.0%	13.7%
IPC (Mexico)	18.7	1.4	382.1%	-24.2%	43.5%	20.0%	-3.8%	0.9%	1.1%	4.5%	6.6%
TOP40 (South Africa)	12.8	2.9	202.4%	-25.9%	28.6%	14.6%	-0.6%	6.0%	1.2%	-3.1%	4.0%
MSCI WD (World)			100.6%	-42.1%	27.0%	9.6%	-7.7%	4.9%	4.7%	1.1%	11.0%
MSCI EM (Emerging)			326.6%	-54.5%	74.4%	16.4%	-20.4%	11.2%	5.9%	-3.5%	13.6%

Source: Thomson Reuters,Bloomberg, ABLV Bank

The rise in prices on the world MSCI World Index for the month amounted to modest 1.1% (see Fig. 3), due to the fact that the sector of emerging market showed negative dynamics, but the overall increase in the index since the beginning of the year was significant – 11%.

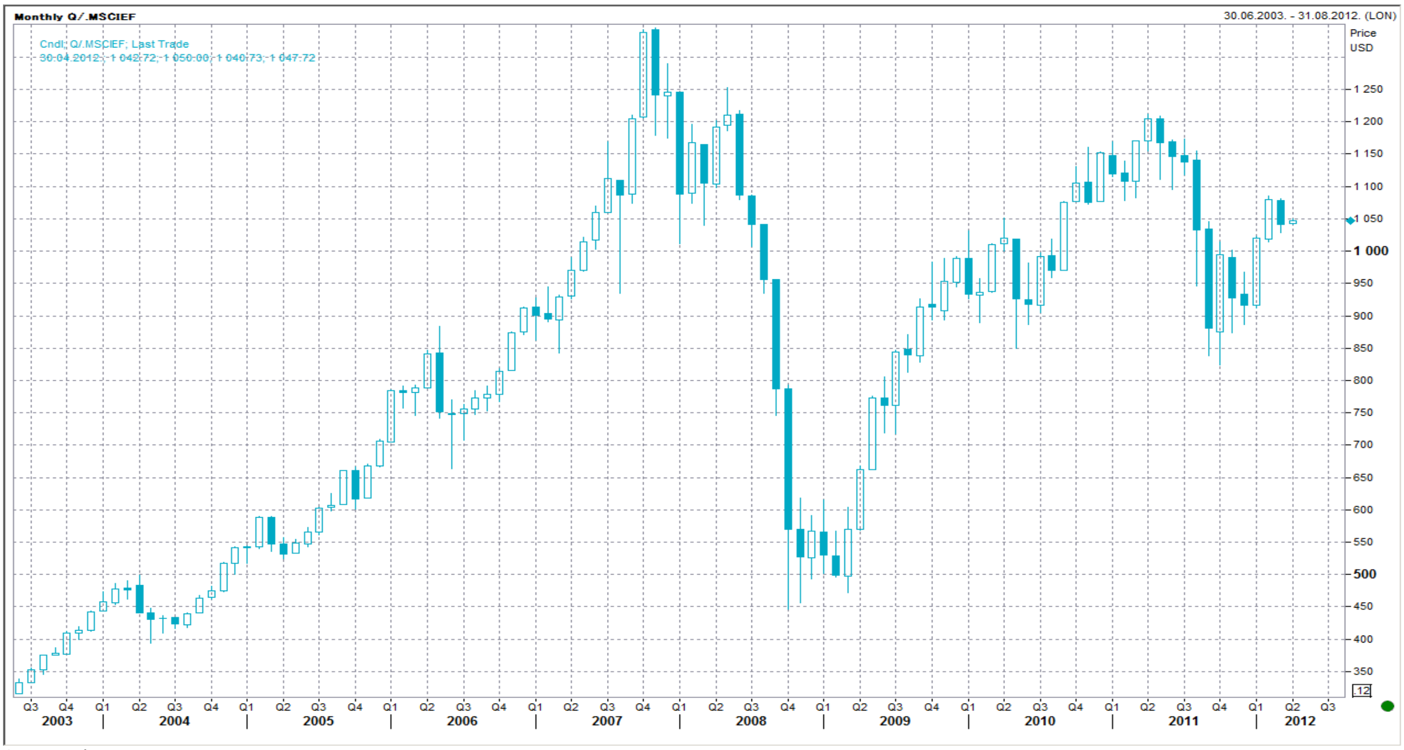
Fig. 3. Dynamics of the MSCI WORLD index, monthly bars



Source: Thomson Reuters

The index of the developing countries MSCI EM showed a drop by 3.5% in March (see Fig. 4), which included all the BRIC countries as well. However, due to strong growth in January and February, the quarterly growth in emerging market amounted to 13.6%, far surpassing the quarterly growth in developed market.

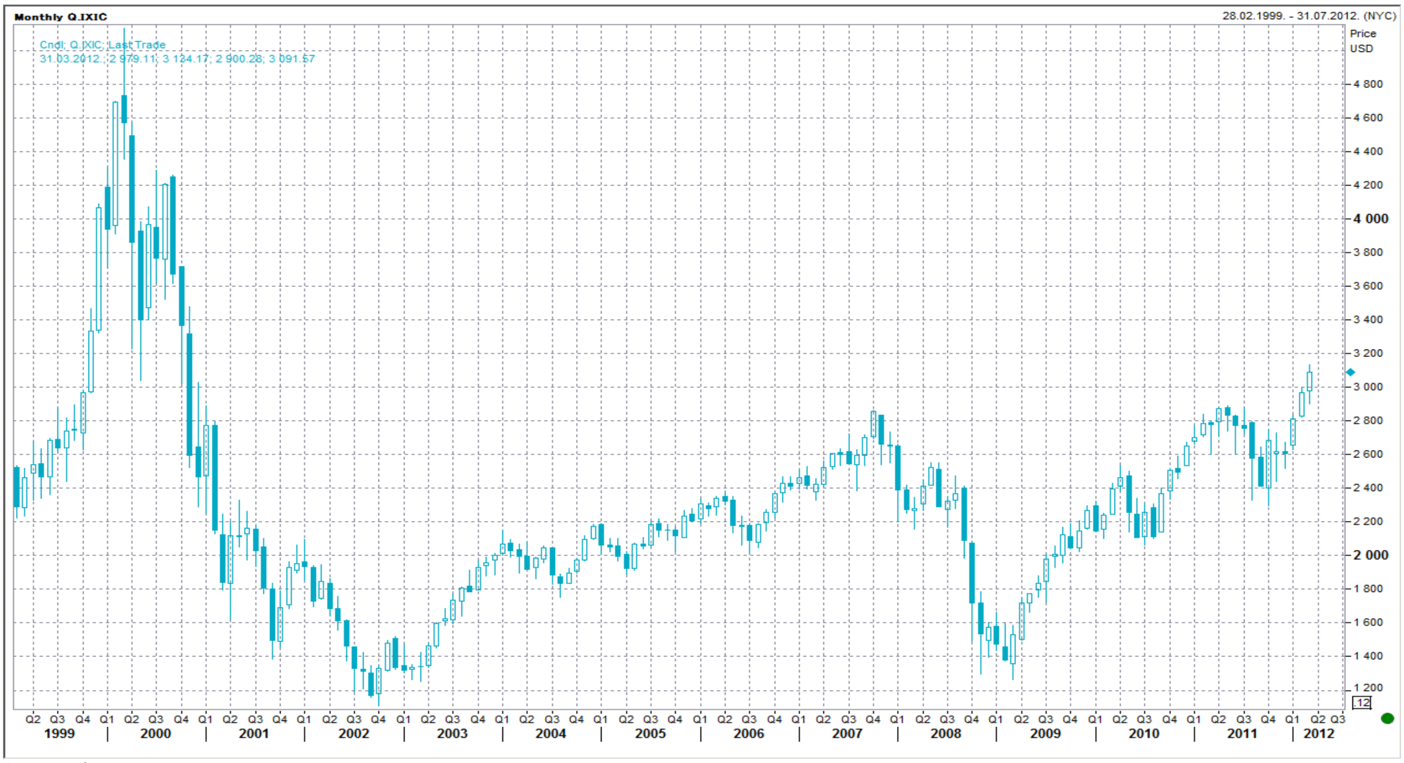
Fig. 4. Dynamics of the MSCI EMERGING MARKETS index, monthly bars



Source: Thomson Reuters

In March, the highest growth among the developed indexes monitored by us was shown by the U.S. NASDAQ, growing by 4.2% (see Fig. 5). This also allowed the index to achieve one of the best results since the beginning of the year – an increase by 18.7%.

Fig. 5. Dynamics of NASDAQ index, monthly bars



Source: Thomson Reuters

The worst dynamics among the indexes monitored by us was demonstrated by China's SSEC, which fell by 6.8% (see Fig. 6). This also led to the worst quarterly dynamics – the growth by 2.9% only.

Fig. 6. Dynamics of SSEC index, monthly bars

Source: Thomson Reuters

Our assessment of future scenarios

Despite the significant rise in prices at the beginning of the year, the situation in the global stock market remains highly uncertain. On the one hand, the observed growth of monetary bases of leading currencies is a good stimulus for further growth in stock prices. On the other hand, the possibility of increasing debt crisis in the euro area can bring back strong negative trends to the market.

However, one can continue to adhere to our proposed strategy for entering the market, choosing the "strong" companies (or indexes) with low P/E and high Div. Yeld (see table).

Even if negative trends return to the market, the high level of dividends will allow investors to outwait the period of market decline, receiving a steady cash flow in the form of dividends, which currently exceeds yield on government bonds of the leading countries.

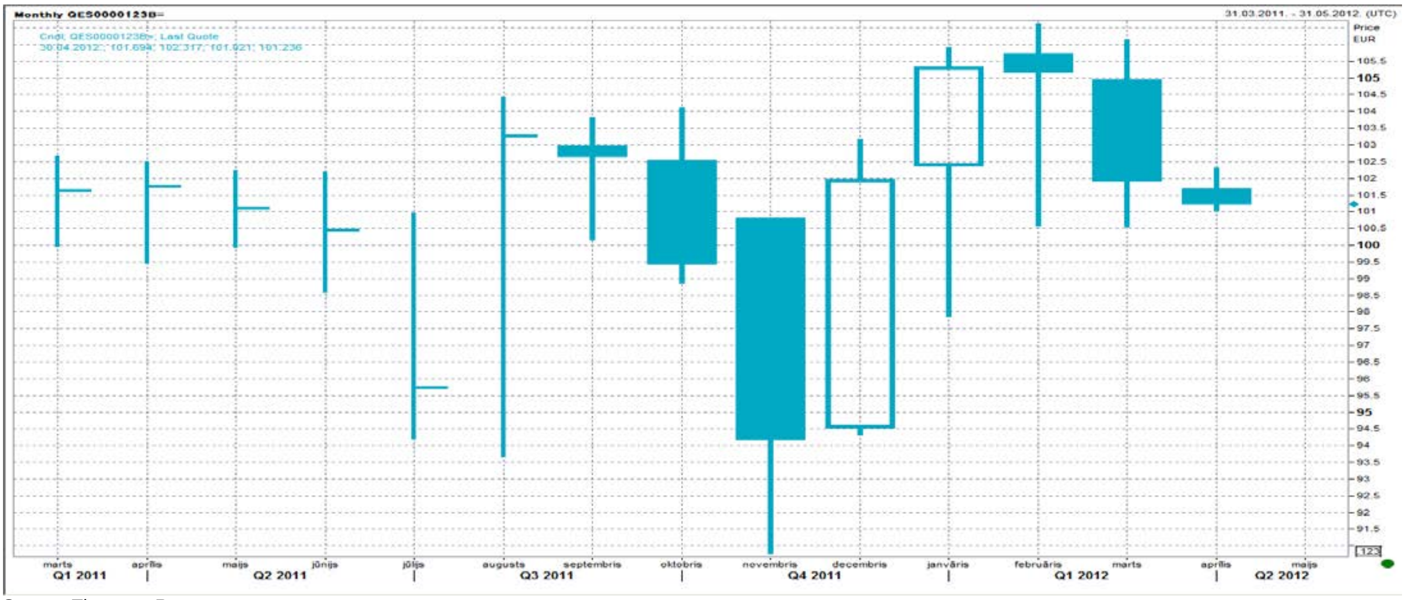
Whereas in case growth continues, the investor will gain considerable profit due to increase in stock prices.

Global bond market

The bond market was also marked by opposite trends both in the sector of emerging markets and that of PIIGS, with prices of the U.S. securities falling. But the value of all movements was insignificant.

The trends of PIIGS securities varied in March. The largest drop was demonstrated by Spanish securities, the pressure on which increased due to the release of negative data on this country. As a result, over the month 10-year Spanish bonds fell nearly by 3% (see Fig. 7), and their yield increased from 4.8 to 5.2%.

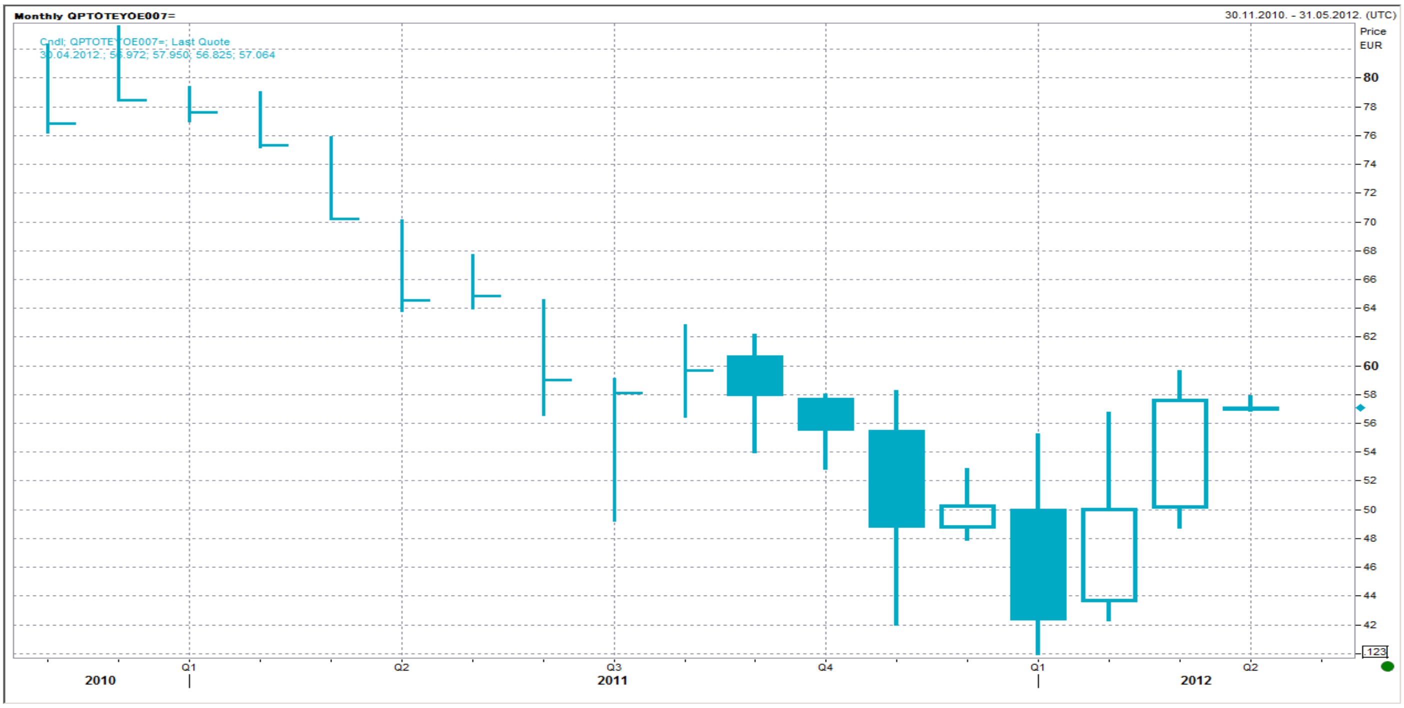
Fig. 7. Dynamics of price movements of 10-year bonds of Spain, monthly bars



Source: Thomson Reuters

The largest growth among the PIIGS securities was that of Portugal securities, where 10-year securities rose by 15%, following even larger growth by 19% in February (see Fig. 8). As a result, prices are back to the level of November 2011, and their yield has fallen below 12%.

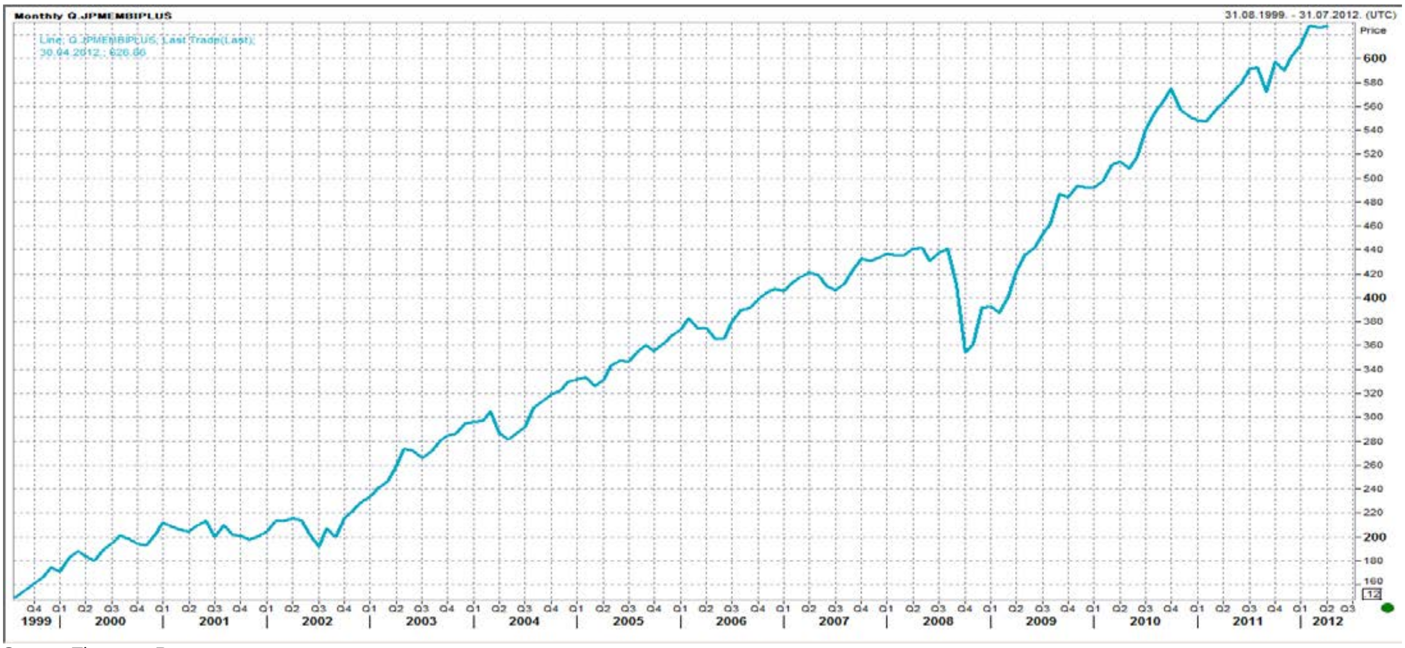
Fig. 8. Dynamics of price movements of 10-year bonds of Portugal, monthly bars



Source: Thomson Reuters

In the sector of public debts of developing countries, the movement was small, dominated by the fall, and the index EMBI + closed the month falling by 0.7% by 2.7% (see Fig. 9).

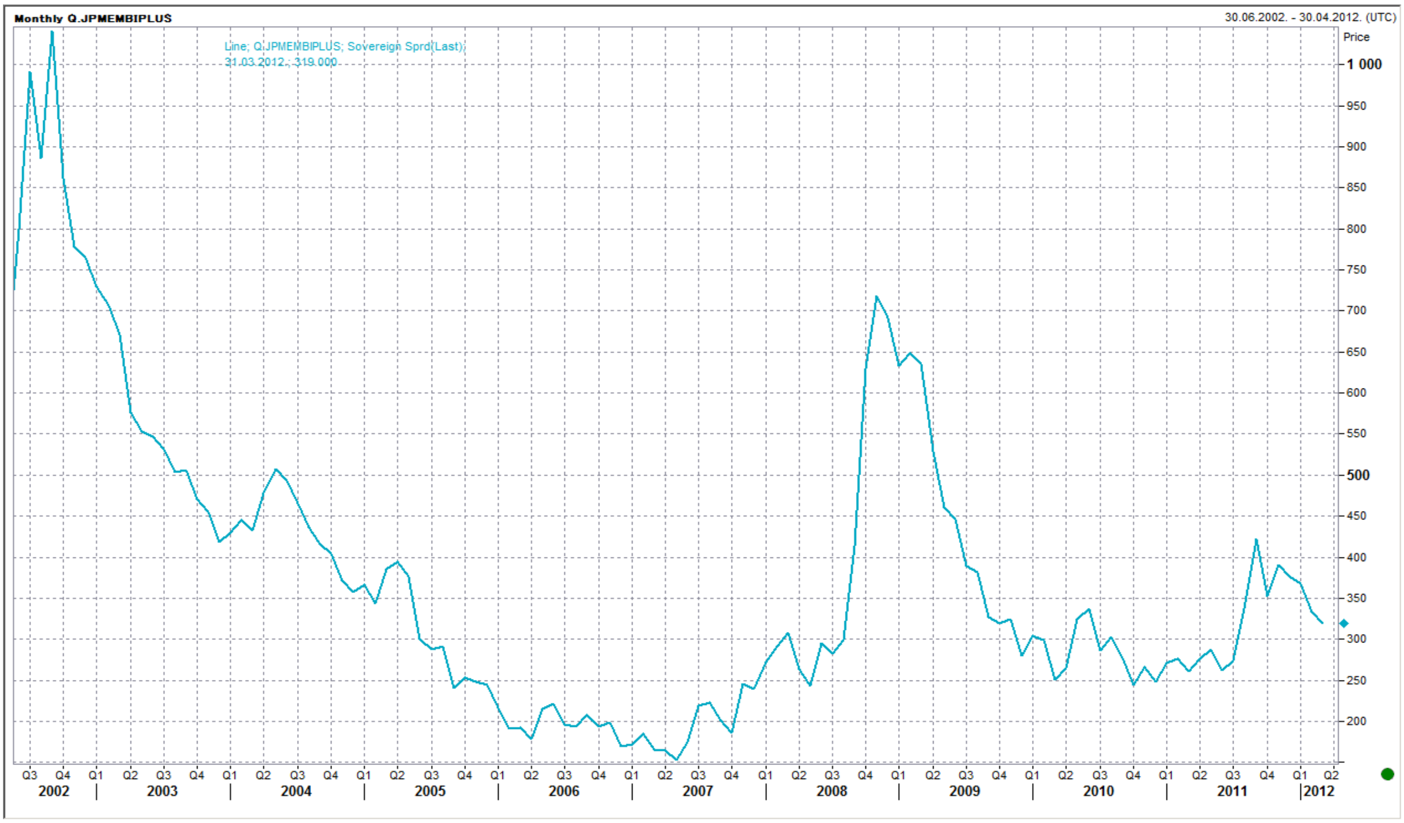
Fig. 9. Dynamics of the EMBI + index, the monthly closures line



Source: Thomson Reuters

However, due to even greater decrease in the U.S. securities, EMBI + spread to treasuries has narrowed by 15 basis points over the last month, amounting to 3.19% (see Fig. 10).

Fig. 10. Dynamics of the EMBI + index spread, the monthly closures line

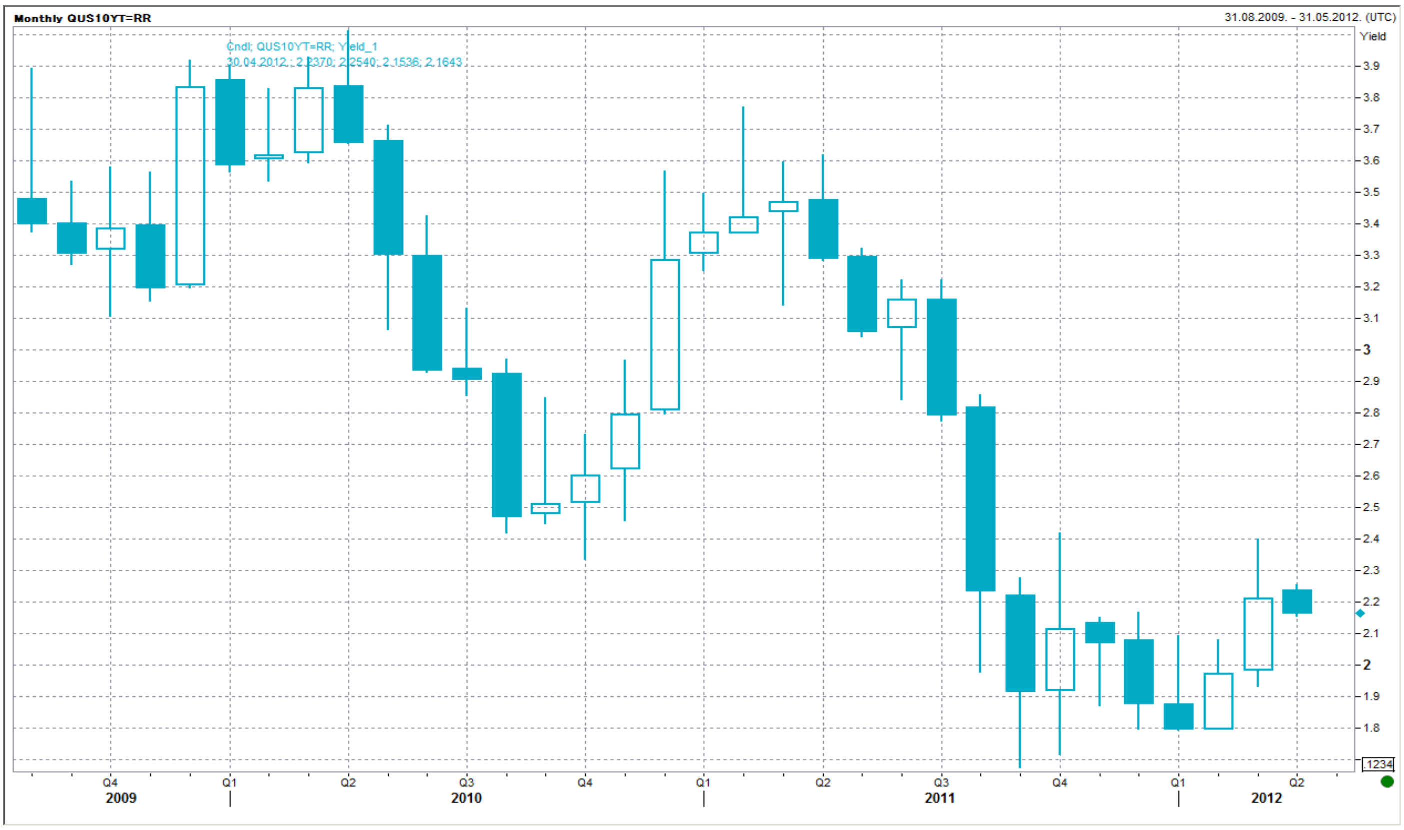


Source: Thomson Reuters

In the emerging market corporate bonds there was a slight increase, and the index CEMBI rose over the month by 0.13%, but the Russian RUBI index of corporate securities showed a more significant increase by 0.82%.

In the U.S. bond market in March, the drop in prices prevailed, and 10-year treasuries fell by more than 2% after nearly 2% drop in February. As a result, their yield increased from 2% to 2.2% over the month (see Fig. 11).

Fig. 11. Yield dynamics of the U.S. 10-year government bonds, monthly bars



Source: Thomson Reuters

30-year U.S. securities also showed a fall, and their yield increased from 3.1% to 3.3%.

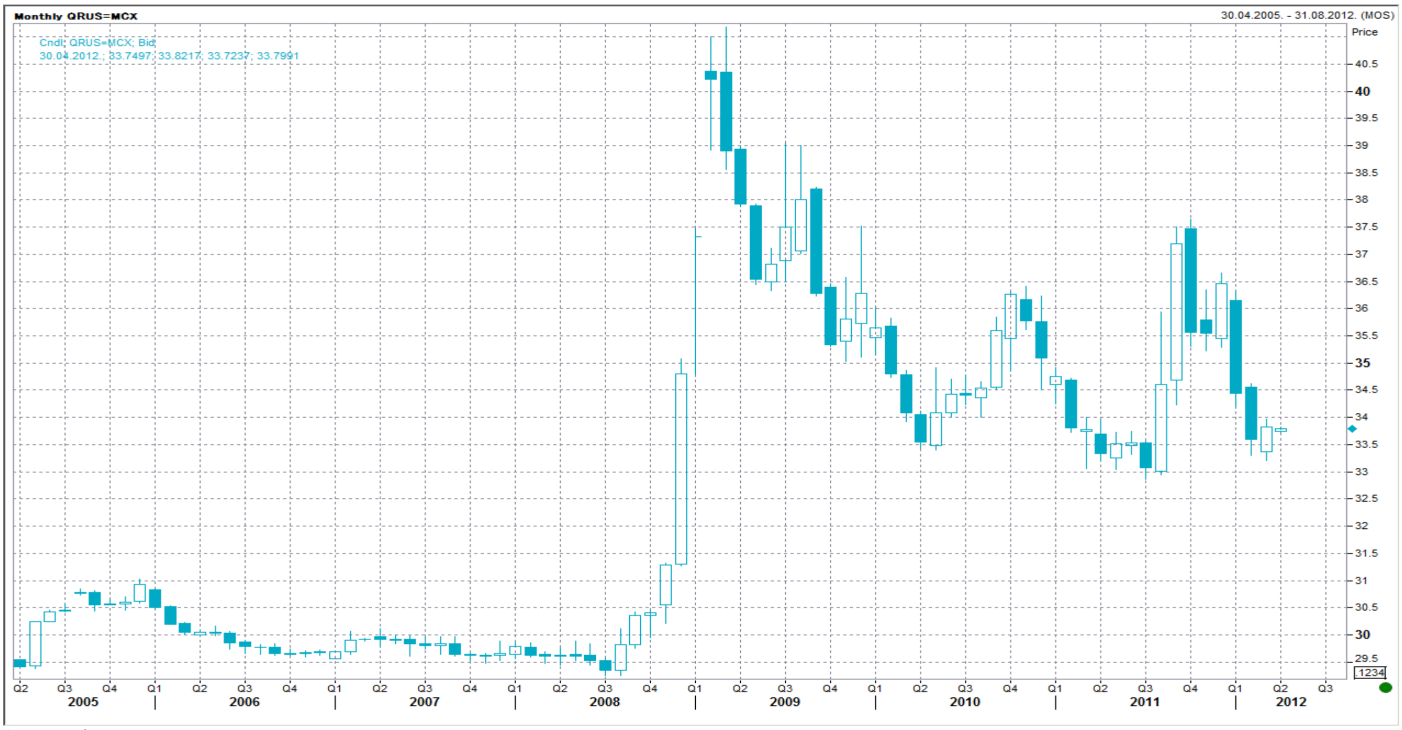
In the German securities, playing the role of safe haven in the euro area, the yield on 10-year bunds remained near the level of 1.8%, and on 30-year securities – near 2.45%.

Global currency market

In the currency market, the month was relatively quiet, with no significant changes in value of the dollar to the developed and developing currencies, except for its growth in the Brazilian real by 6%.

In March, Russian rouble weakened against dollar, but just by 0.7%, and its fall to the euro-dollar basket reached almost 0.9% (see Fig. 12).

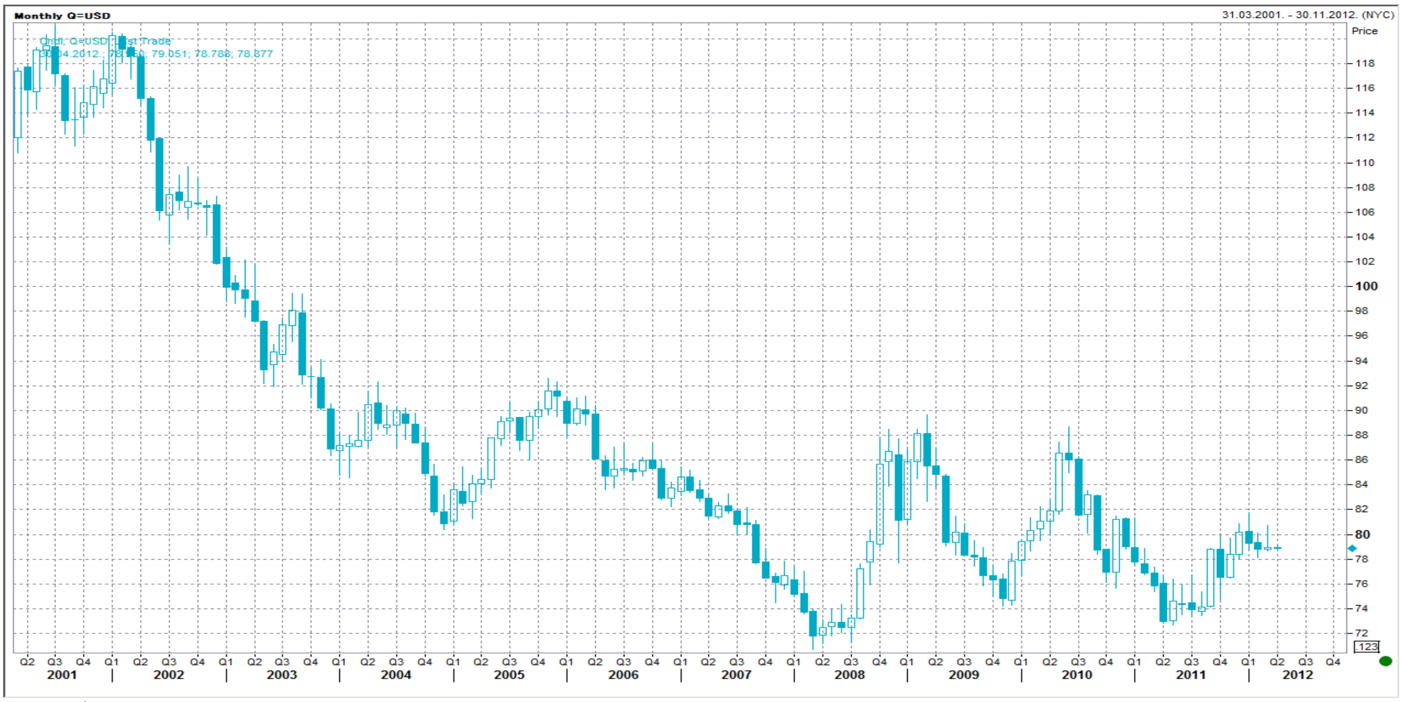
Fig. 12. Dynamics of the Russian rouble to euro-dollar basket, monthly bars



Source: Thomson Reuters

The dollar index – dollar's rate against six leading world currencies – closed the month almost at the opening level (see Fig. 13).

Fig. 13. Dollar index dynamics, monthly bars



Source: Thomson Reuters

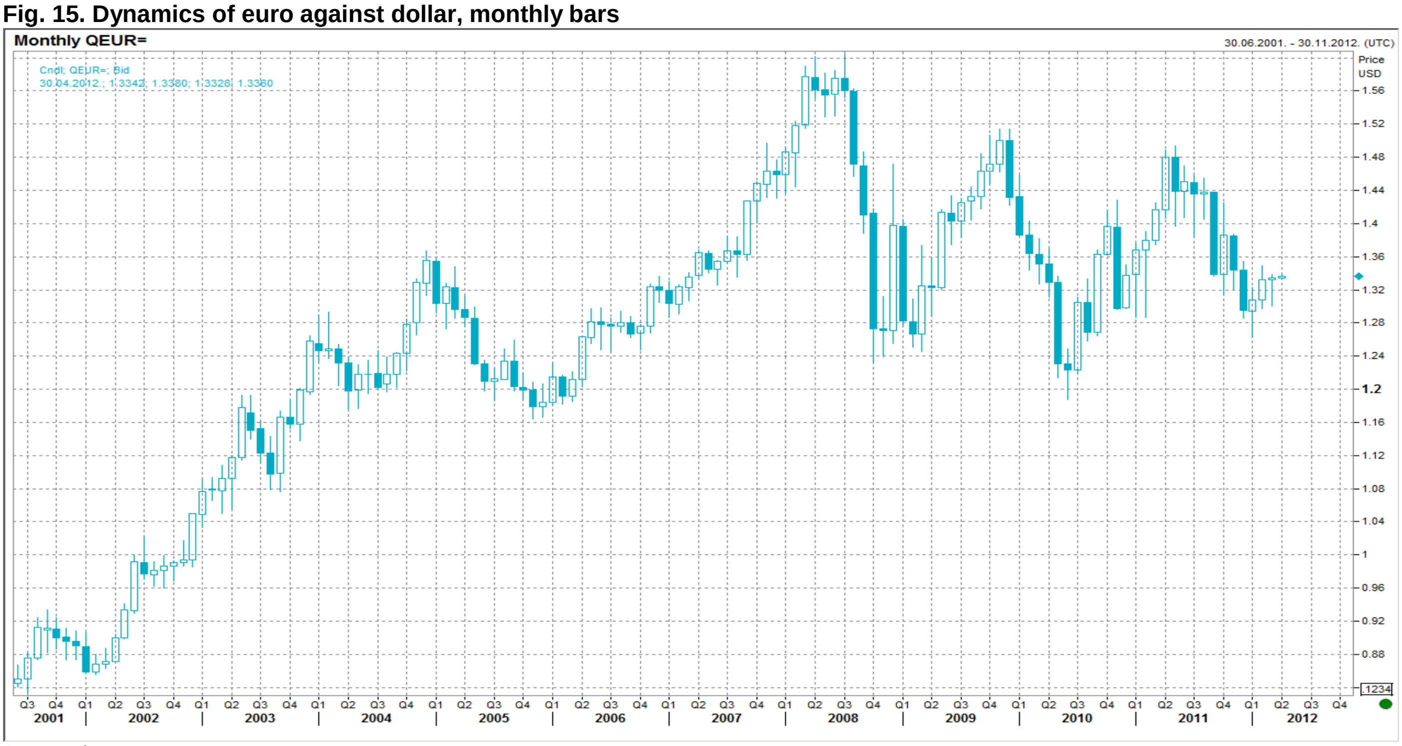
In March, the dollar continued to decline against the yen, the drop amounting to 2% after falling by 6.5% in February (see Fig. 14).

Fig. 14. Dynamics of the dollar against yen, monthly bars

Source: Thomson Reuters

As for the main rival of the dollar – euro, the U.S. currency began the month with growth, but closed almost at the opening level (see Fig. 15).

Fig. 15. Dynamics of euro against dollar, monthly bars



Source: Thomson Reuters

Our assessment of future scenarios

Our main scenario for the euro-dollar market remains unchanged. According to this scenario, the dollar minimum reached in July 2008 at the level of 1.6040 EUR/USD, is the end point of the long-term trend of the dollar falling against euro and the beginning of the trend for its long-term growth.

Consequently, we do not change our fundamental outlook for the market, according to which exchange of the euro to the dollar will fall to parity-close levels (1 EUR/USD) in 1-1.5 years.

Gold

March was the second consecutive month of moderate decrease in gold prices, declining by 1.7% over the month following the fall by 2% in February (see Fig. 16), and the price of an ounce dropped to $1668. But prices are still far from the local minimum reached in December 2011 at $1520 per ounce.

Fig. 16. Dynamics of gold prices, monthly bars

Source: Thomson Reuters

Our assessment of future scenarios

Gold prices have already entered the corridor of $1750-$2000 per ounce, which at the beginning of the year 2011 was considered in our reviews a target one for the current growth trend and a level where the basis for the trend reversal will be formed. However, given the strength of the growth trend, it is still very likely that prices will continue to grow, reaching the level of $2000-$2500 per ounce.

But it should be noted that the movement in gold prices in recent years is strikingly speculative, and prices are unlikely to remain at high levels for long periods of time. Later, we are likely to see a rapid fall in prices, often observed in other speculative bubbles. Of course, it is possible that prices do not go back to previous levels of $300-$400 per ounce, but return to levels near $1000 is very likely.

A possible signal for the bubble break can be a sharp rise in prices for a short time, similar to the silver price movements in February-April 2011, but with greater amplitude and during a shorter time.

Silver

The fall in silver prices was greater – by 7.8% to $32.2 per ounce, but it should be noted that silver closed February with an increase by 4%, and the overall result over two months is the same as that of gold (see Fig. 17).

Fig. 17. Dynamics of silver prices, monthly bars

Source: Thomson Reuters

Our assessment of future scenarios

The sharp rise and the subsequent strong drop in the price of silver in 2011 indicate that the price bubble of 2010-2011 actually burst in this market.

However, the dynamics of further movement in prices is still uncertain and may depend on price movements in the gold market.

Oil

In the oil market in March there was a significant divergence of trends in movements of Brent and WTI prices. Brent began the month with a growth, but closed it near the level of $124 per barrel (see Fig. 18). At the same time, the price of WTI fell in March by almost 4%, resulting in the spread between them increasing almost to $20 in favour of Brent.

Fig. 18. Brent price dynamics, monthly bars

Source: Bloomberg

Our assessment of future scenarios

We continue to believe that the current rise in prices for Brent oil will not be a long-term one, and prices surpassing $150 seems unlikely in the current cycle. In our opinion, the scenario of restricting this growth to not more than $130-$140 per barrel, with a subsequent sharp fall below $100, currently looks a more likely one.

Review information

This review is supposed to be for information only and cannot be treated as investment advice, investment research, or a consultation on investment.

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