BANKING / INVESTMENTS \ ADVISORY

ABLV

Global Financial Market: Topical Issues in July

Contents

Results of July 2012

Macroeconomic reports published in July, including the first preliminary data on GDP of several countries for Q2 2012, pointed to a significant weakening of global economic growth, which is largely due to continuing debt crisis in the euro area.

At the corporate level, reports for Q2 2012 published in July also sounded negative. 350 US companies of S&P 500 that already published their reports, showed an average drop in profits of 0.3% – the first drop since Q3 2009.

Even worse were the reports of European corporations, and after 208 companies of BE 500 index (the 500 largest companies in Europe) published their reports, there was an average drop in quarterly profit (compared with Q2 2011) by 13.7% recorded!

But the focus of financial markets investors and speculators in July was still the debt crisis in the euro area. And the emphasis fell on the developments around Spain, now becoming aggravated, now calming down.

Accordingly, rise and fall trends alternated in the global stock market, where only due to the increase last week, most of the leading indexes managed to close the month with an increase and MSCI World Index rose by 1.2%.

In the bond market July was very positive for the sector of emerging markets (+4.4% on the EMBI+ index). Whereas in the PIIGS sector the trends differed: securities of Greece and Ireland have increased, while those of Italy, Portugal and Spain fell.

The Spanish ten-year ones reached a new historical minimum price and maximum yield after the 20th of July, the latter exceeding 7.7%.

In the safe haven bond markets increase in prices was dominating, and the month was also marked by a number of auctions of short euro area securities, placed with a negative return, and not only German, but also the EFSF, and even those of France and Belgium.

In the currency market, in the last month there was a slight increase of the dollar against most developed currencies and equally slight decline against a number of leading emerging currencies.

The precious metals markets in July were not very volatile, with the trends again being different – silver, gold and palladium rose by 1% -1.5%, while platinum fell by 2%.

In the oil market July was marked by a significant increase in prices, following four months of decline. The monthly increase in Brent prices reached almost 11%, and the price of a barrel of the same was back above $100, amounting to $106.

Situation in financial and economic system

Macroeconomic reports published in July, including the first preliminary data on GDP for Q2 2012, pointed to a significant weakening of global economic growth, which is largely due to continuing debt crisis in the euro area.

UK GDP in Q2 2012 (according to preliminary data) fell significantly by 0.7% (q/q). And this is the third consecutive quarter of falling British economy (-0.4% in Q1 2012 and -0.3% in Q4 2011).

GDP of Spain was also falling for the third consecutive quarter, despite the forecasted growth resumption in Q2 2012.

In the US, GDP growth in Q2 2012 amounted to 1.5% (y/y, and +0.38 q/q), which was the weakest rate in the last three quarters.

The US July data on the index of business activity in manufacturing were also very negative. For the second consecutive month, the index points to the sector reduction, first recorded in August 2009 (see Fig. 1).

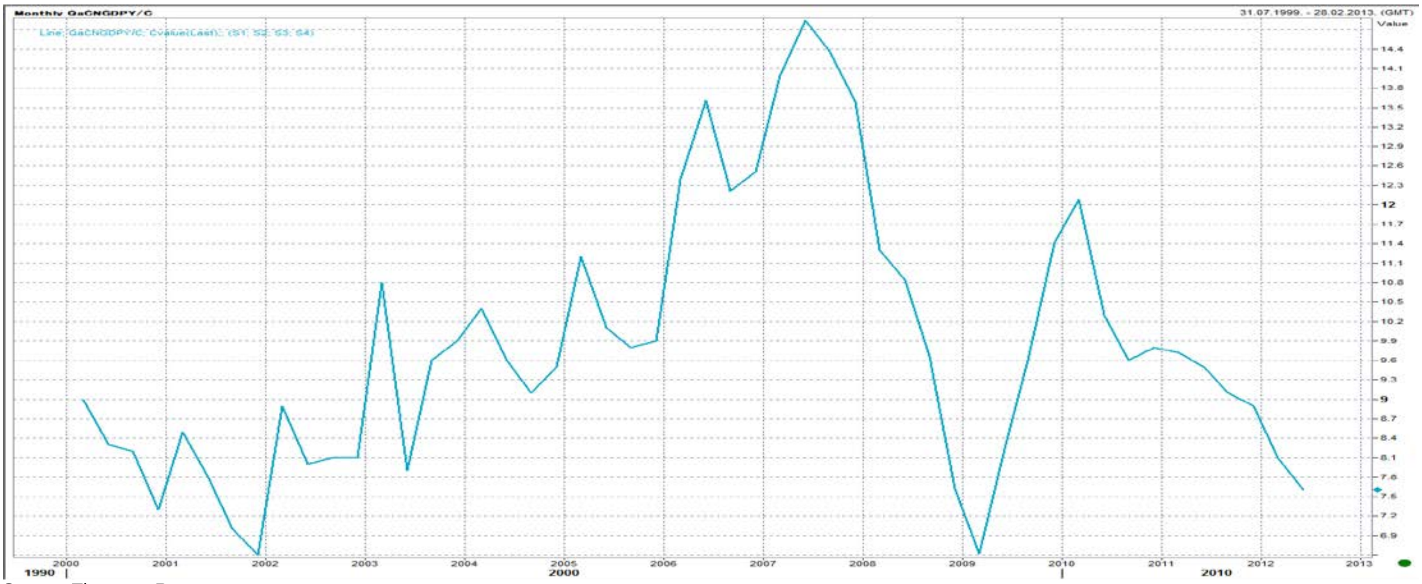
Fig. 1. Dynamics of the movement of index of business activity in the US manufacturing

Source: Thomson Reuters

Unemployment in the US also rose in July (for the second time during the last three months) to reach the level of 8.3%, however, the number of new jobs – Nonfarm Payrols – amounted to considerable 163000 in July, which can reduce unemployment in August.

Released in July, preliminary data on the Chinese GDP in Q2 2012 showed an increase by only 7.6% (y/y, +1.8% q/q), and this is the worst quarterly result since the crisis in the 2008-2009 and indicators in 2001 (see Fig. 2).

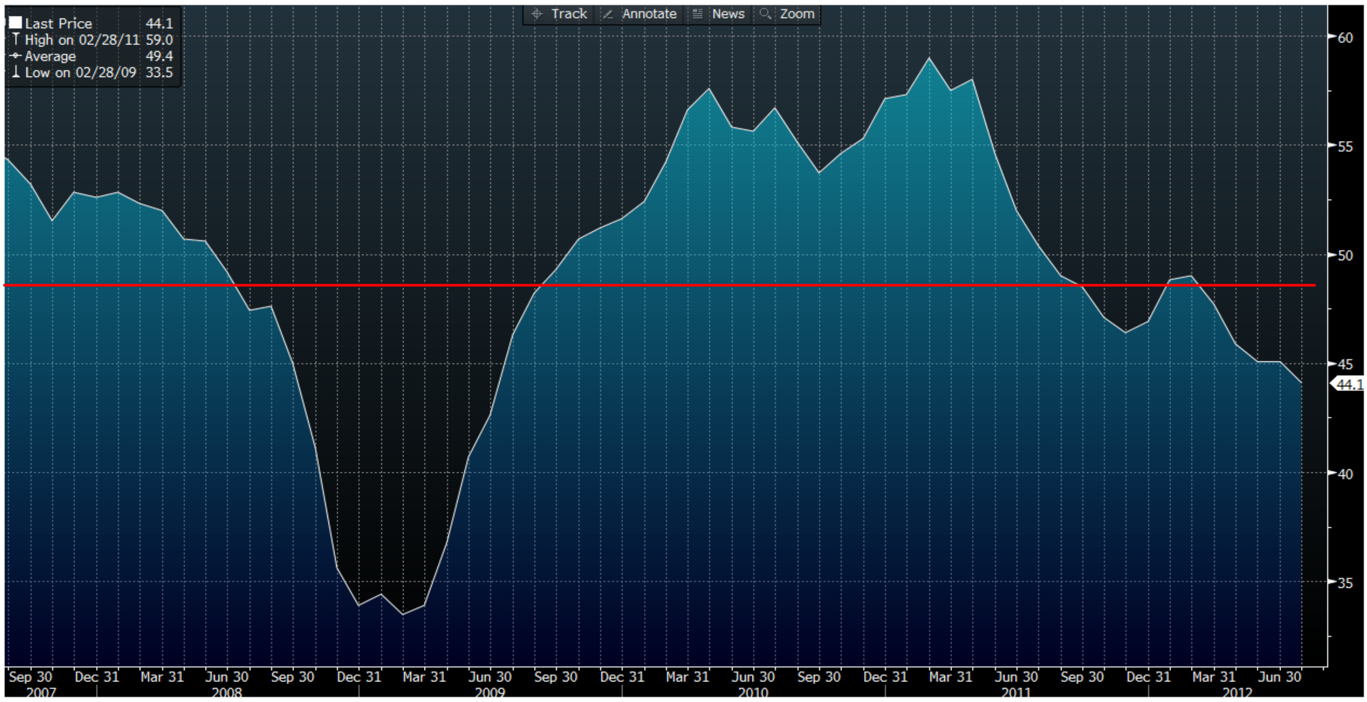
Fig. 2. Dynamics of quarterly GDP growth in China (y/y)



Source: Thomson Reuters

Data on the euro area GDP will be released only in August, but the economic situation there remains extremely difficult, and in July, the manufacturing index of business activity fell to 44.1 – a new low since 2009, and a reduction in the sector is observed since mid-2011 (see Fig. 3).

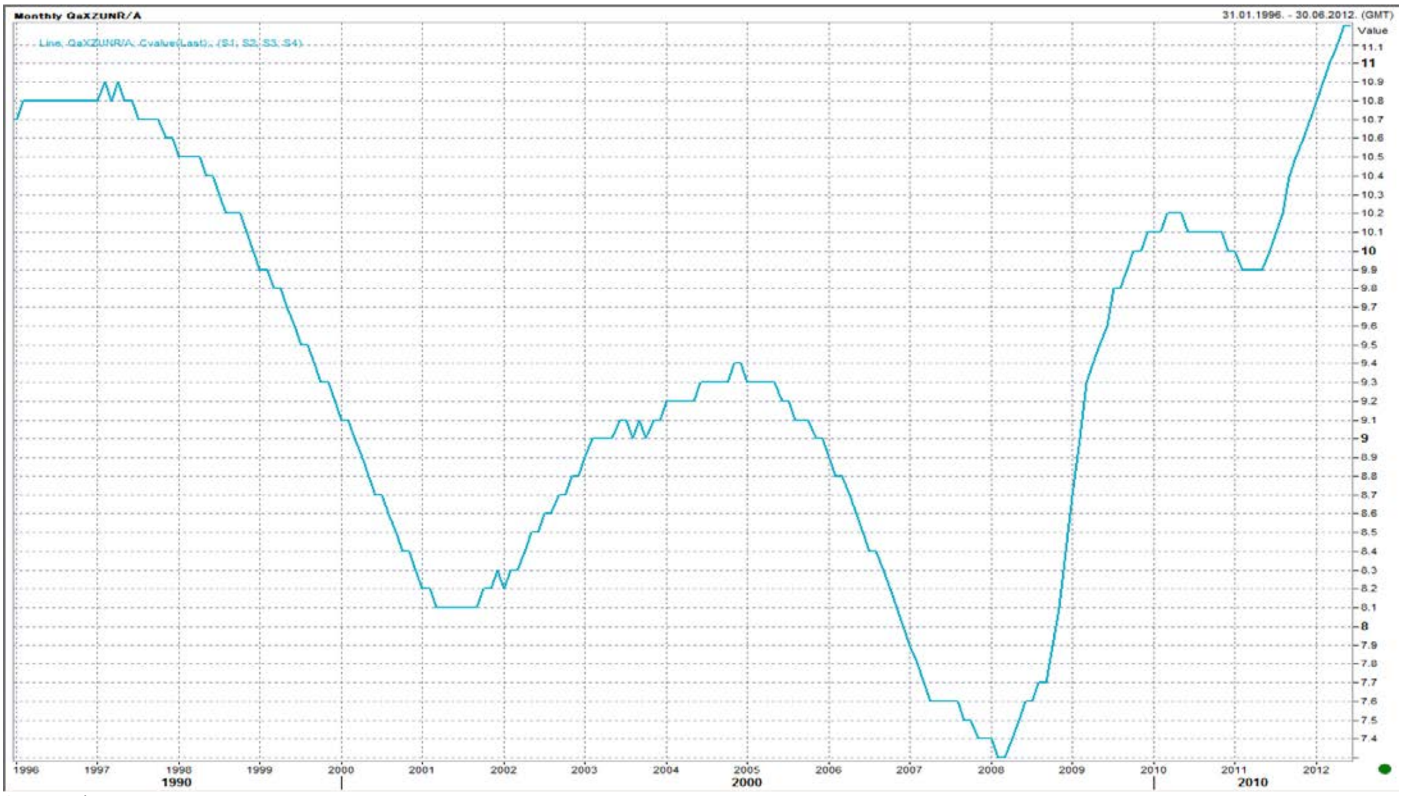
Fig. 3. Dynamics of the movement of index of business activity in the euro area manufacturing



Source: Bloomberg

In turn, the unemployment rate in the euro area in June set another historical record – 11.2% (see Fig. 4).

Fig. 4. Dynamics of changes in the level of unemployment in the euro area, monthly lines



Source: Thomson Reuters

In response to this situation, at the beginning of July, three of the world's leading central banks adopted new measures on massive economy stimulation – the ECB and the Bank of China cut rates, and the Bank of England expanded the QE programme.

The ECB cut its benchmark interest rate by 0.25% to 0.75% and dropped to zero overnight deposit rate for commercial banks from 0.25% to 0%.

By doing this, the central bank hopes to stimulate interbank lending (interbank overnight also dipped from 0.26% to 0.07% afterwards), and consequently, lending to the economy.

In China, the key rates under one-year loans and deposits were reduced by 0.31% to 6% and by 0.25% to 3%, in order to avoid a "hard landing." It was the second rate cut during the month: on 7 June, both rates were reduced by 0.25%.

In turn, the Bank of England announced an expansion of the program of buying assets by another £50 billion, increasing the quantitative easing (QE) programme to £375 billion in order to stimulate economic growth.

Moreover, in late July, the ECB head said the phrase quoted by all leading agencies: "Within its powers, the ECB will do whatever it takes to protect the euro. And believe me, it will be enough."

However, at a meeting in early August, the ECB did not make any new steps to support the euro and the European economy.

At its meeting, also held in early August, the FRS had not adopted new incentives as well.

Despite the fact that in the July report to the Senate the FRS Chairman Bernanke emphasized the weakness of the economic recovery and the labour market, which, according to many experts, may signal a launch of QE3 soon.

In our opinion, the next step will be the FRS repeating the ECB actions performed in July – the abolition of interest payments on excess reserves of commercial banks that are held with the FRS (currently 0.25% on almost $1.5 trillion!).

Debt crisis in the euro area, July 2012

In July, rating agencies continued an offensive against the euro area countries, and in the middle of the month, Moody's downgraded Italy's rating by two points at once from A3 to Baa2, and then the ratings of 13 banks in the country, including the largest ones.

In addition, Moody's has placed on review for possible downgrade (negative outlook) credit ratings of Germany, the Netherlands and Luxembourg, referring to "growing uncertainty" in the euro area.

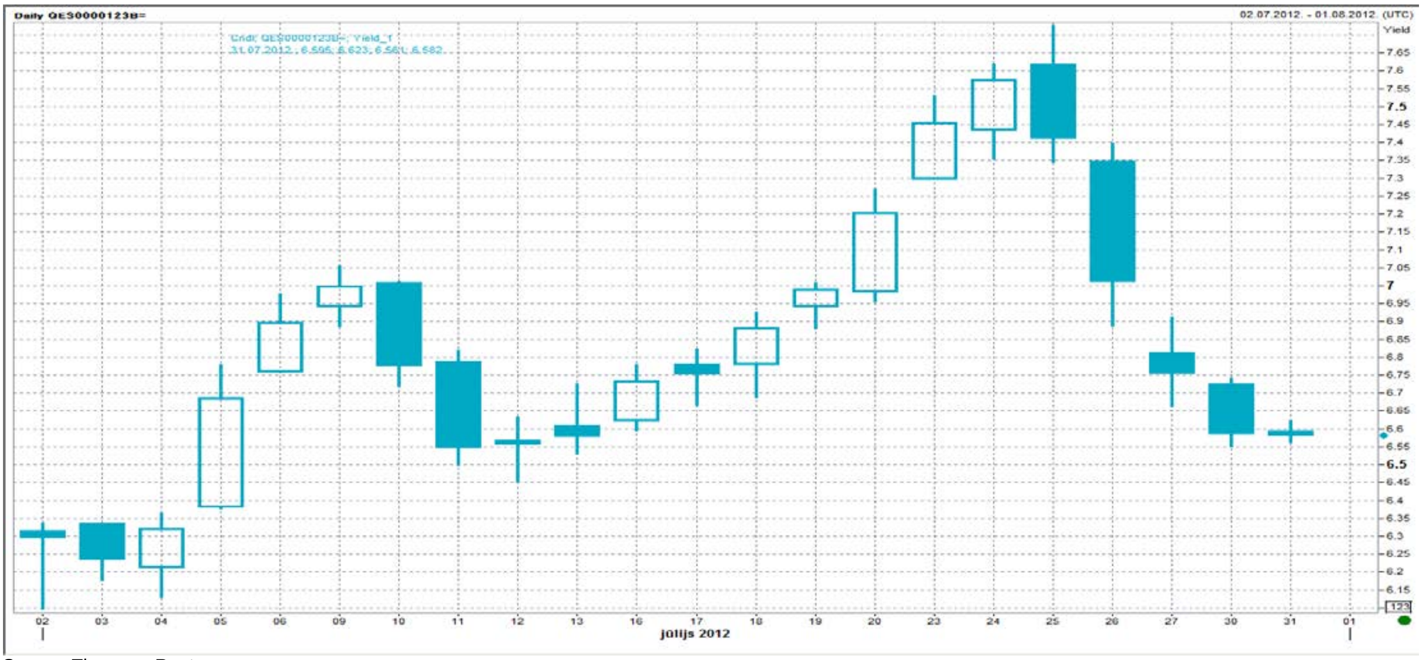
The negative outlook indicates a 50 percent probability of rating downgrades in the next three months.
But the brunt of the market in July was taken by Spain, which in June officially became the fourth euro area country, which will be provided aid by the European institutions (see Fig. 5).

Fig. 5. Approved aid to PIGS countries compared with their GDP

Source: Financial Times

As a result, on 25 July the 10-year bonds of Spain updated historic low of prices, and their yield rose to a new historic maximum above 7.7% (see Fig. 6).

Fig. 6. Dynamics of yield movements of 10-year bonds of Spain, daily bars



Source: Thomson Reuters

Things were even worse in July for the fifth candidate to receiving aid – Cyprus, where, after an official request for aid at the end of June, the estimated aid amount – €13 billion was announced in July.

However, at the talks between the island authorities and the IMF, the European Commission and the ECB, held at the end of July, negotiation of the loan conditions failed.

Cyprus Minister of Finance Shiarli criticized European proposals and said that his country will not agree to punitive conditions in exchange for a financial aid package.

In turn, head of the European Commission President Barroso criticized Cyprus for engaging in talks with Russia on a loan of €5 billion (in addition to €2.5 billion granted in December 2011), which can reduce the impact of Europe on the Cyprus fiscal policy.

Meanwhile Cyprus bonds resumed to decline in prices in July, and the yield on the securities of the 20th year rose above 16% (see Fig. 7).

Fig. 7. Dynamics of the yield of 8-year bonds of Cyprus, the monthly line

Source: Bloomberg

Signal of growing crisis also were the results of several auctions of short securities of non-troubled euro area countries held in July, where negative yield was recorded , and not only German, but also the EFSF, and even those of France and Belgium.

Another signal of "preparing" for the crisis was a temporary ban on short-selling introduced in July by regulators of Italy and Spain. Longer and more extensive became Spanish ban on short selling of all shares lasting for three months.
It should be noted that many countries resorted to such measures in 2008-2009, and in August 2011 France, Belgium, Spain and Italy imposed a temporary ban on "short selling" of shares of financial companies in order to stabilize markets of sharply cheapening bank securities.

However, the Eurogroup decision on the immediate provision of first €30 billion to Spain by the ECB taken in the last week of the month and the ECB head’s promise to "do everything to protect the euro" eased tensions in the debt markets.
However, the lack of particular measures taken at the ECB meeting in early August again aggravated the situation in the markets of troubled euro area countries.

Global stock market

In the global stock market rising and falling trends alternated in July, but thanks to a surge of optimism last week growth trends still managed to prevail in most markets. This allowed most of indexes monitored by us to consolidate in positive territory compared with the opening of the year (see Tab. 1).

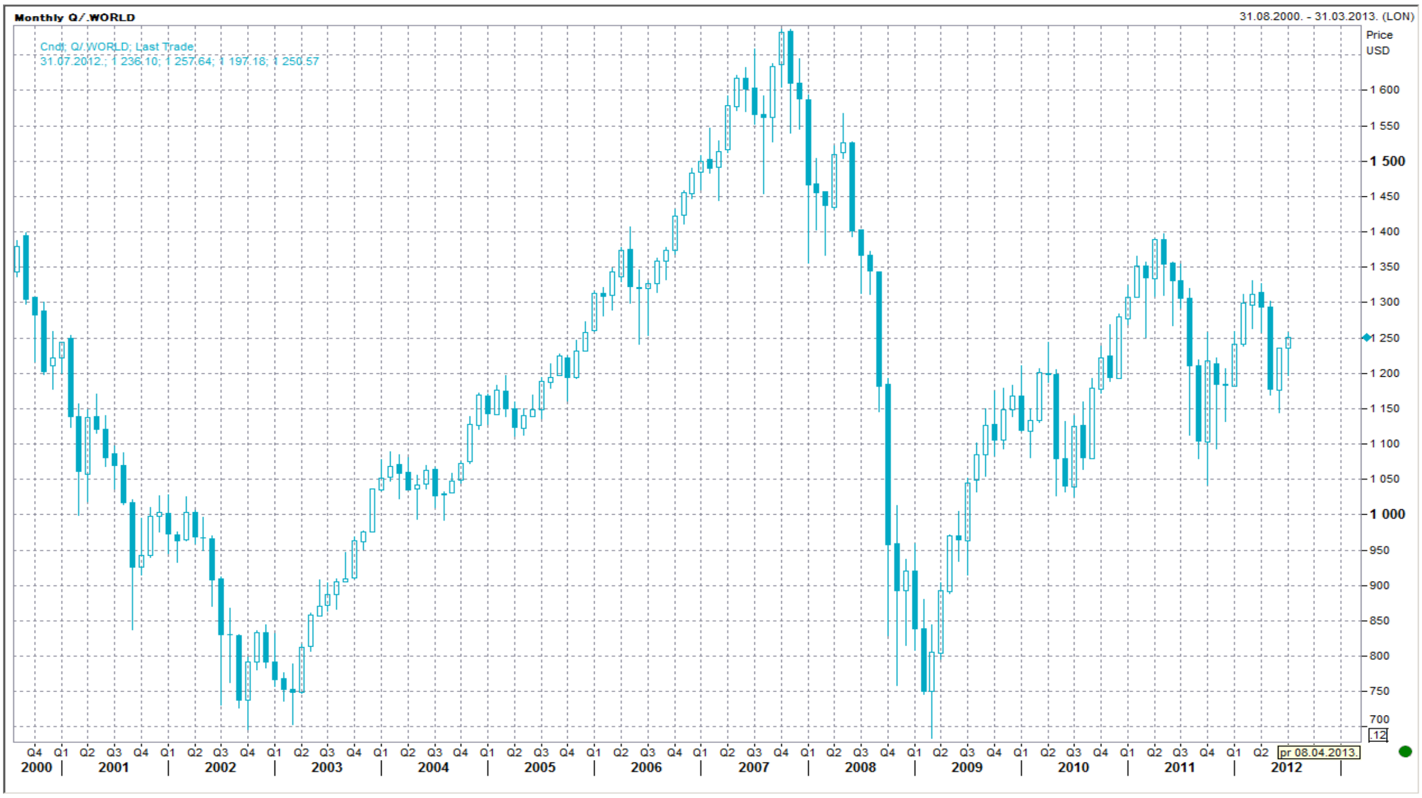
Table 1. The dynamics of movements of several leading world stock market indexes

Stock index	P/E	Div. Yield	2003-2007	2008	2009	2010	2011	Q1 2012	Q2 2012	July 2012	Since the beginning of 2012
DJI (USA)	12.7	2.6	59.0%	-33.8%	18.8%	11.0%	5.5%	8.1%	-2.5%	1.0%	6.5%
S&P 500 (USA)	13.4	2.1	66.9%	-38.5%	23.5%	12.7%	0.0%	12.0%	-3.3%	1.2%	9.7%
Nasdaq Comp. (USA)	16.1	1.1	98.6%	-40.5%	43.9%	16.9%	-1.8%	18.7%	-5.0%	0.1%	12.8%
GDAX (Germany)	13.8	3.5	178.9%	-40.4%	23.8%	16.1%	-14.7%	17.8%	-7.6%	5.5%	14.8%
FTSE (UK)	10.6	4.2	61.5%	-31.0%	23.2%	9.0%	-5.6%	3.5%	-3.4%	1.1%	1.1%
CAC (France)	10.1	5.9	83.2%	-42.7%	22.3%	-3.4%	-17.0%	8.4%	-6.7%	3.2%	4.4%
N225 (Japan)	21.5	2.3	78.4%	-42.1%	19.0%	-3.0%	-17.3%	19.3%	-10.7%	-3.5%	2.8%
RTS (Russia)	4.8	3.7	537.9%	-72.4%	128.6%	22.5%	-22.0%	18.8%	-17.7%	2.0%	-0.2%
MICEX (Russia)	4.4	3.8	492.3%	-67.2%	121.1%	23.2%	-16.9%	8.3%	-8.7%	1.5%	0.4%
SSEC (China)	16	1	287.4%	-65.4%	80.0%	-14.3%	-21.7%	2.9%	-1.6%	-5.5%	-4.4%
HSI (Hong Kong)	9.2	3.1	198.4%	-48.3%	52.0%	5.3%	-20.0%	11.5%	-5.4%	1.8%	7.4%
KOSPI (Korea)	20.3	1.4	202.3%	-40.7%	49.7%	21.9%	-11.0%	10.4%	-7.9%	1.5%	3.1%
TWII (Taiwan)	21.6	4.4	91.0%	-46.0%	78.3%	9.6%	-21.2%	12.9%	-8.6%	-0.4%	2.8%
SENSEX (India)	14.1	1.5	500.7%	-52.4%	81.0%	17.4%	-24.6%	12.6%	0.1%	-1.1%	11.5%
BOVESPA (Brazil)	11.8	4.6	467.0%	-41.2%	82.7%	1.0%	-18.1%	13.7%	-15.7%	3.2%	-1.2%
IPC (Mexico)	15.7	1.5	382.1%	-24.2%	43.5%	20.0%	-3.8%	6.6%	1.7%	1.3%	9.8%
TOP40 (South Africa)	11.2	3.4	202.4%	-25.9%	28.6%	14.6%	-0.6%	4.0%	0.1%	2.5%	6.7%
MSCI WD (world)			100.6%	-42.1%	27.0%	9.6%	-7.7%	11.0%	-5.9%	1.2%	5.8%
MSCI EM (emerging)			326.6%	-54.5%	74.4%	16.4%	-20.4%	13.6%	-10.0%	1.6%	3.9%

Source: Thomson Reuters, Bloomberg, ABLV Bank

While MSCI World Index for July rose by 1.2%, rising since the beginning of the year by 5.8% (see Fig. 8).

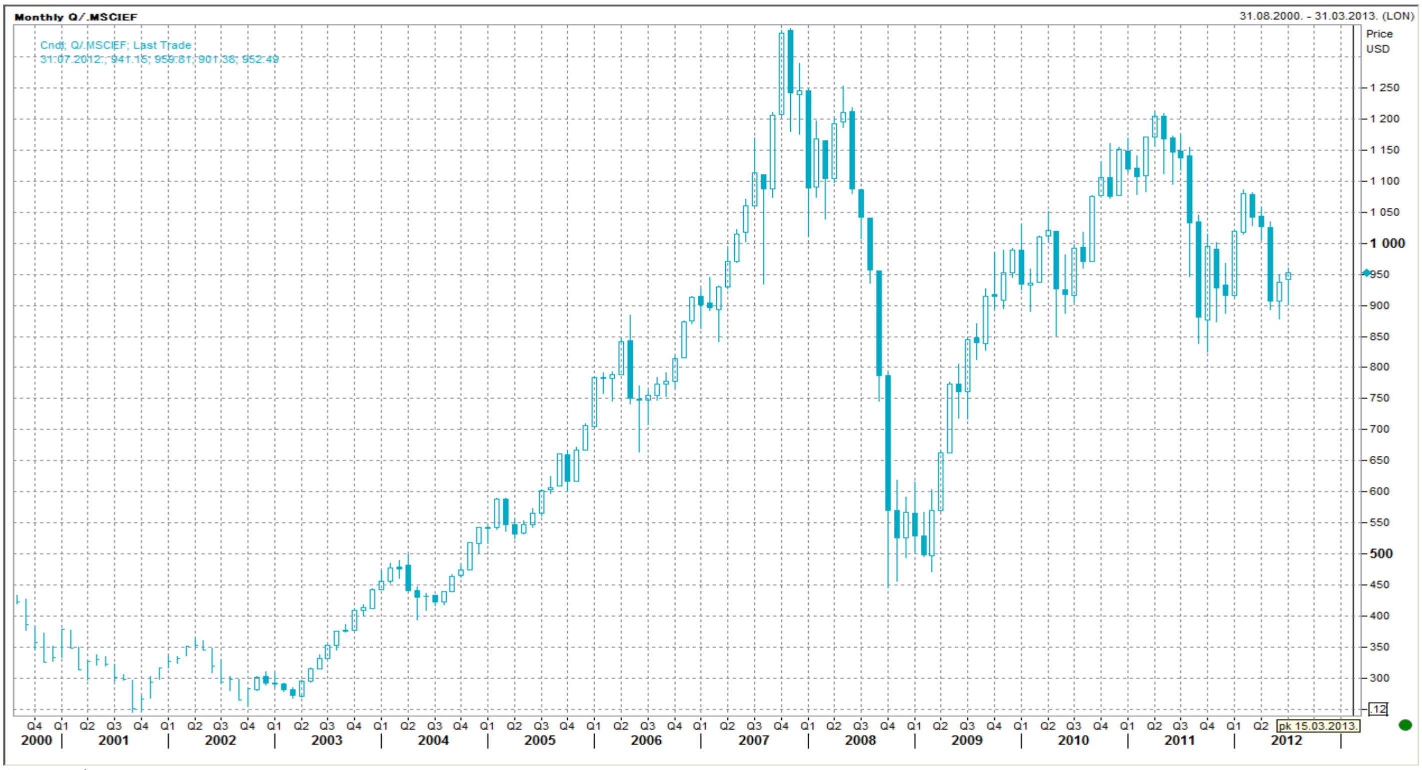
Fig. 8. Dynamics of the MSCI WORLD index, monthly bars



Source: Thomson Reuters

Emerging Markets Index MSCI EM has grown a little more – by 1.6% (see Fig. 9), but because of its greater fall in the second quarter, it was only 3.9% higher than the opening of trading in 2012.

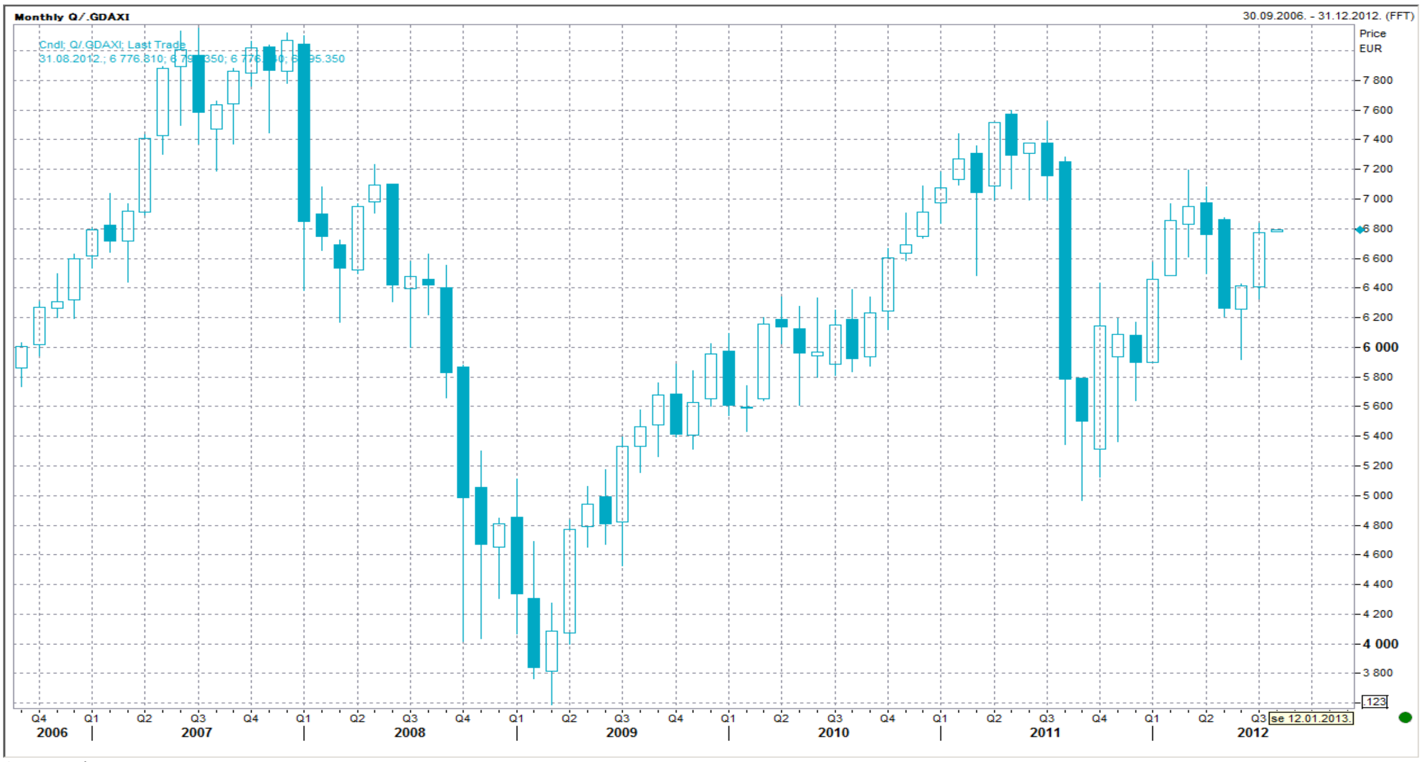
Fig. 9. Dynamics of the MSCI EMERGING MARKETS index, monthly bars



Source: Thomson Reuters

The highest growth among leading world indexes monitored by us in July showed the German DAX, which grew over the month by 5.5% (see Fig. 10). This allowed the index to become a leader since the beginning of the year +14.8%.

Fig. 10. Dynamics of DAX index, monthly bars



Source: Thomson Reuters

The largest decline among indexes monitored us this time was demonstrated by the Chinese SSEC, which fell in July by 5.5%, after falling by 6.2% in June (see Fig. 11), which ensured this index the worst dynamics since the beginning of the year: -4.4%. Additional negative on the market, of course, is brought by the anticipated slowdown in the Chinese economy.

Fig. 11. Dynamics of SSEC index, monthly bars

Source: Thomson Reuters

Russian RTS showed the "average" dynamics in July and increased by 2% (see Fig. 12), which brought it closer to the opening level of the year, but it still remained below 0.2%.

Fig. 12. Dynamics of RTS index, monthly bars

Source: Thomson Reuters

Our assessment of future scenarios

The situation in the global stock market remains highly volatile, and the strengthening the debt crisis in the euro area may return 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. Yield (see table 1).

Even if strong 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 under government bonds of the leading countries. Whereas in case growth is resumed, the investor will gain considerable profit due to increase in stock prices.

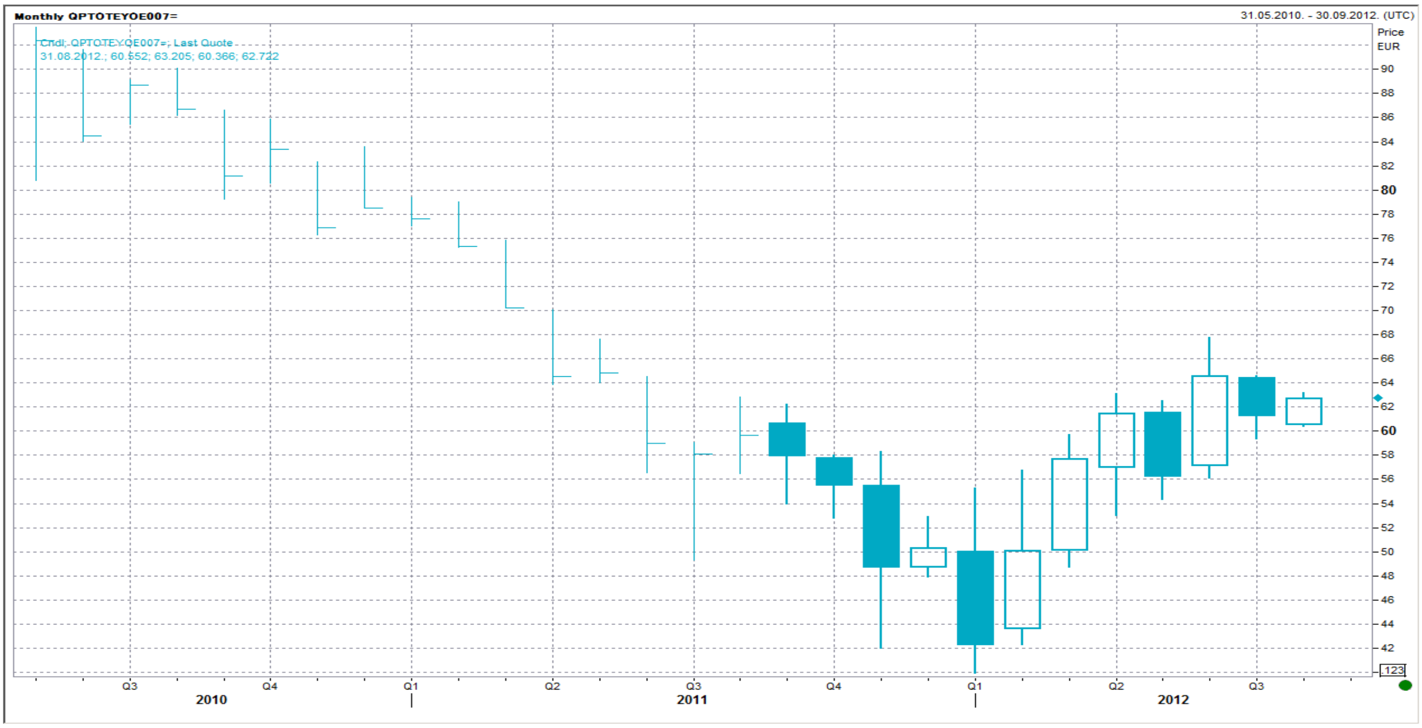
Global bond market

In the bond market, July was extremely positive for the emerging markets sector (+4.4% on the EMBI+ index), but the trends in the PIIGS sector were different: securities of Greece and Ireland have increased, while those of Italy, Portugal and Spain fell.

In the safe haven bond markets increase in prices was dominating in July, and the month was also marked by a number of auctions of short euro area securities with a negative return, and not only German, but also the EFSF, and even those of France and Belgium.

Among the PIIGS securities, the largest monthly movement occurred in the securities of Portugal, where the monthly fall in prices on 10-year bonds was 5% (see Fig. 13), and their yield rose from 10.3% to 11%.

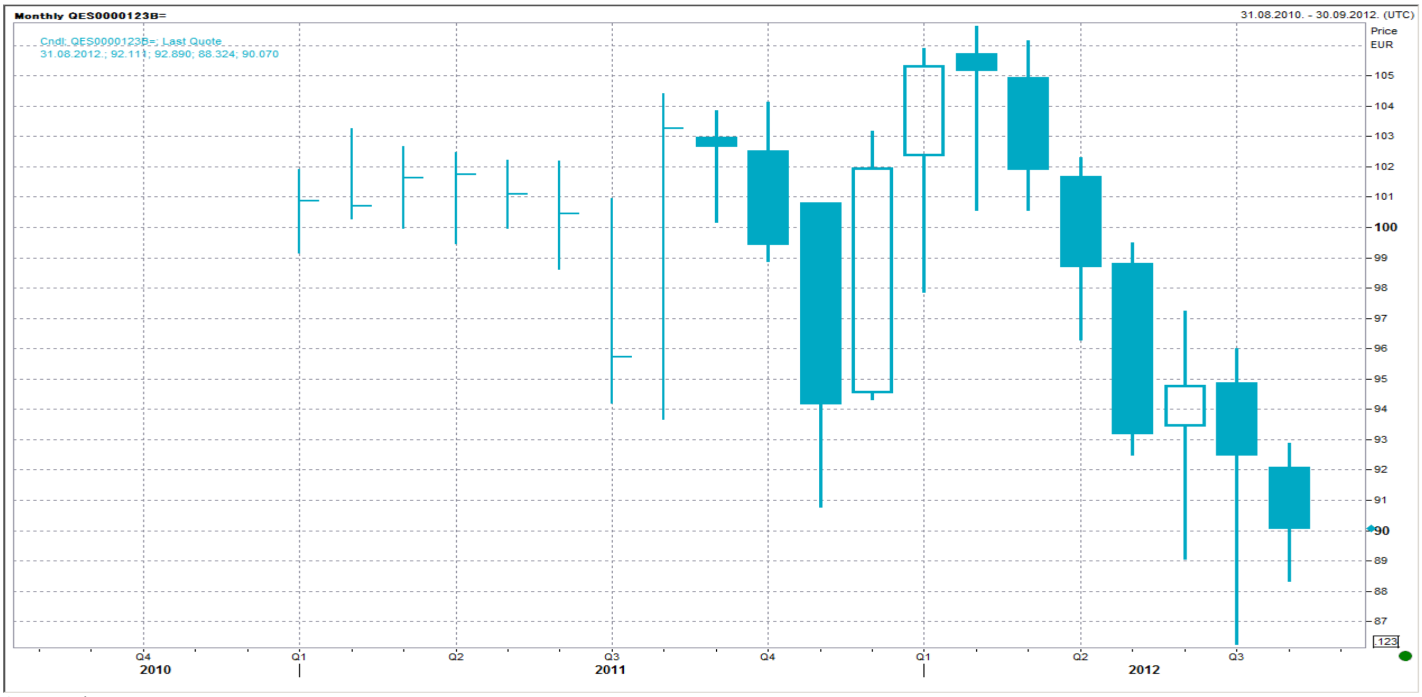
Fig. 13. Dynamics of price movements of 10-year bonds of Portugal, monthly bars



Source: Thomson Reuters

However, during the month the largest drop was demonstrated by Spanish securities, where a new low of prices was achieved, and the amount of the fall from opening to the minimum price for the benchmark 10-year bonds of Spain was 9% (see Fig. 14).

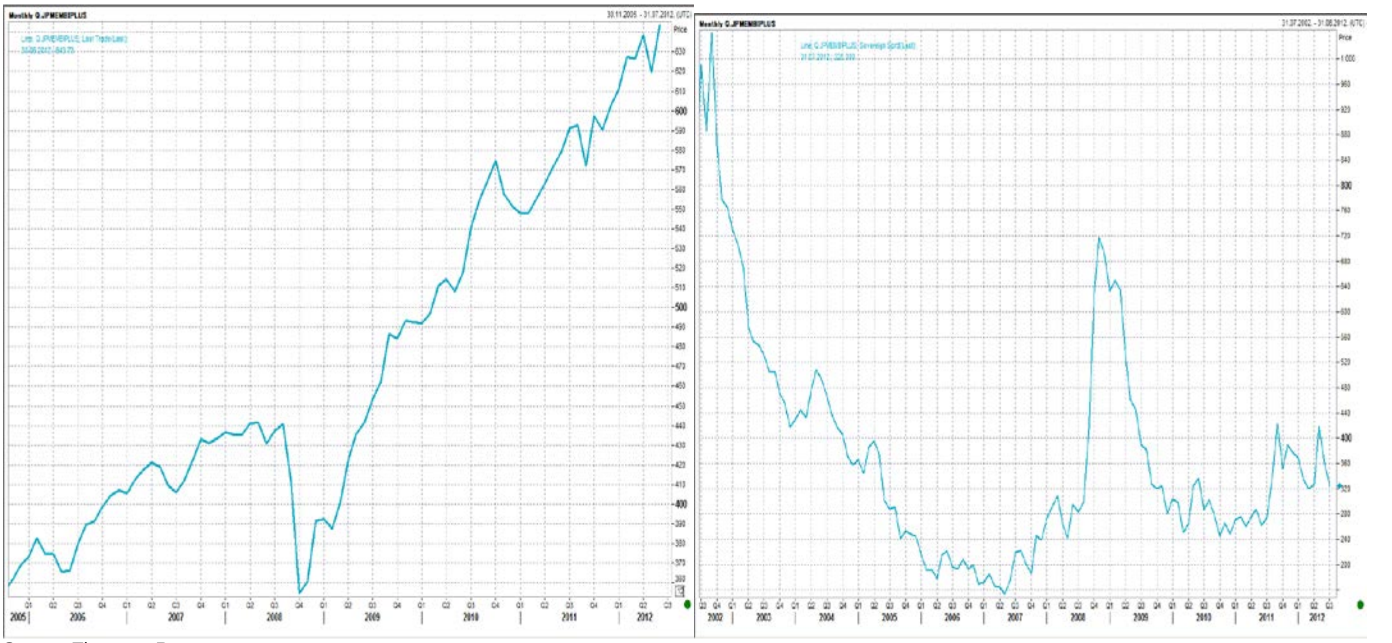
Fig. 14. Dynamics of yield movements of 10-year bonds of Spain, monthly bars



Source: Thomson Reuters

In the sector of public debt of developing countries, in July as in June, there was a significant increase in prices, and the EMBI+ closed July with an increase by 4.4%, following the growth by 3.85% in June, and its spread to treasuries declined by almost 100 basis points to reach 3.2% over two months (see Fig. 15).

Fig. 15. Dynamics of the EMBI+ index and index spread, monthly closures line



Source: Thomson Reuters

In the emerging market corporate bonds there was a smaller growth, and the index CEMBI rose over July just by 2.6%.

In the markets of US bonds in July, amid worsening situation around Spain, there was an increase in prices and the yield on 10-year treasuries fell to a new record low of 1.47% (dropping to 1.38%, see Fig. 16).

Fig. 16. Yield dynamics of the US 10-year government bonds, monthly bars

Source: Thomson Reuters

The US 30-year securities have also grown, and their yield decreased from 2.75% to 2.55% over the month.

In the German securities, which play the role of safe haven in the euro area, there was an increase in prices as well, and the yield on 10-year securities fell from 1.6% to 1.3%, and that of 30-year securities fell from 2.35% to 2.17%.

In the euro area July was marked by a number of auctions of short euro area securities with negative yield, and not only German, but also the EFSF, and even those of France and Belgium.

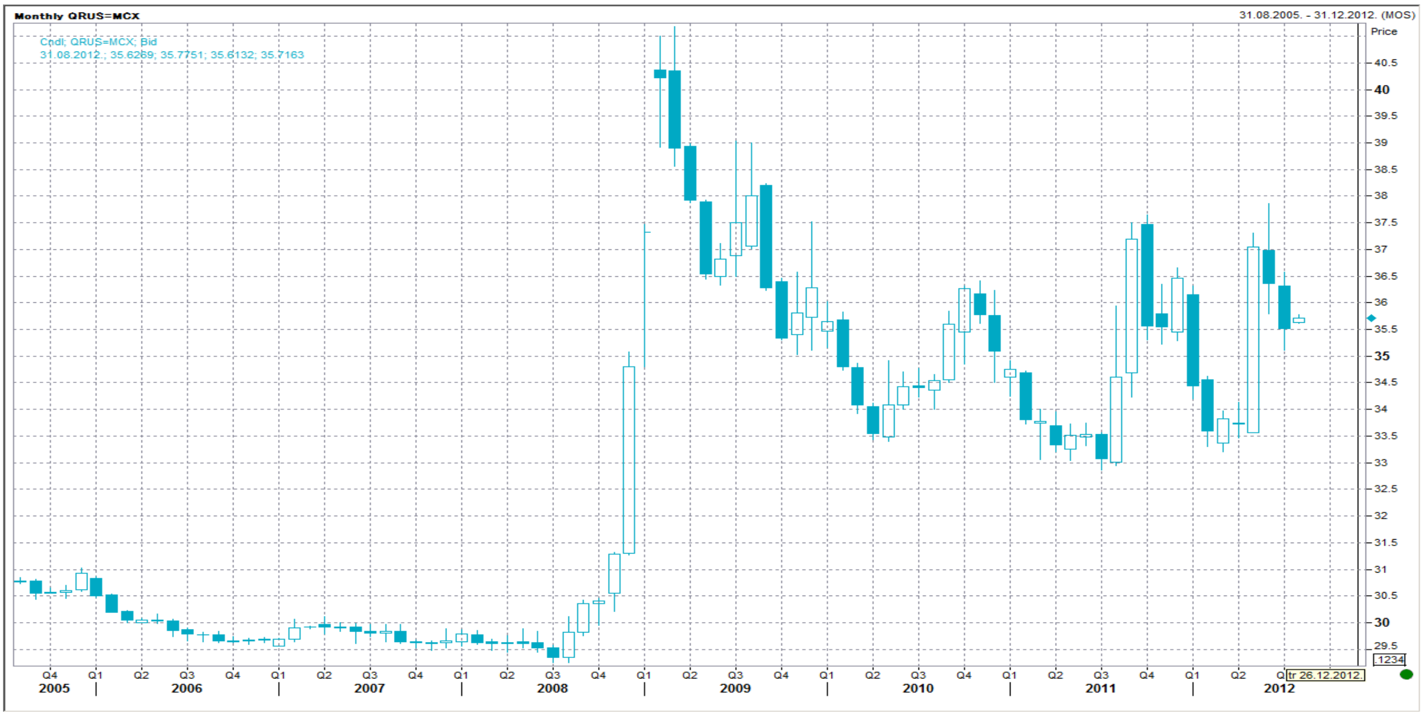
The negative yield for the first time was fixed at an auction of 2-year German bonds.

Global currency market

In the currency market, in the last month there was a slight increase of the dollar against most developed currencies and equally slight decline against a number of leading emerging currencies.

Growth of the Russian rouble against the dollar was just 0.7%, but the growth against the euro-dollar basket was 3% (see Fig. 17).

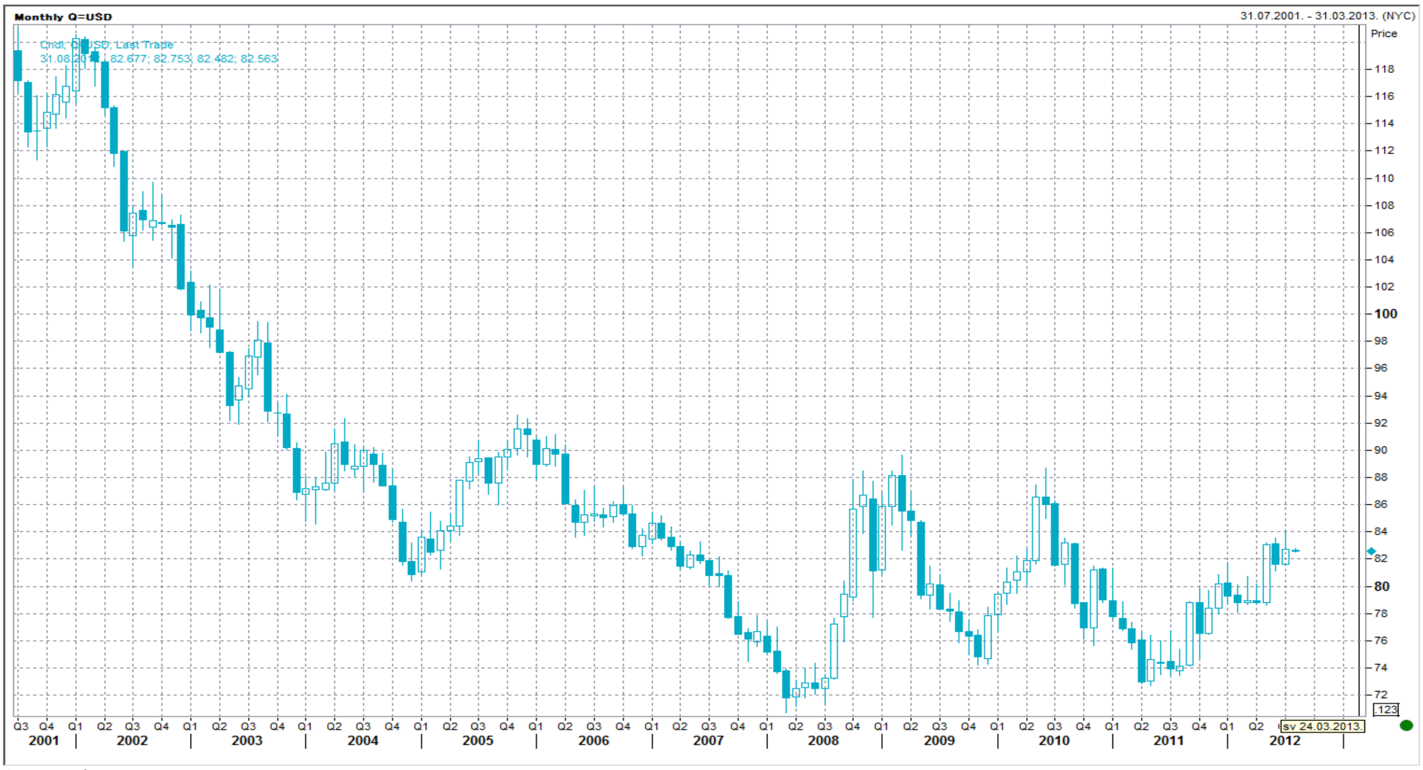
Fig. 17. Dynamics of the Russian rouble to euro-dollar basket, monthly bars



Source: Thomson Reuters

The dollar index – dollar's rate against six leading world currencies – closed July with an increase by 1.3%, compensating most of the decline in June (see Fig. 18).

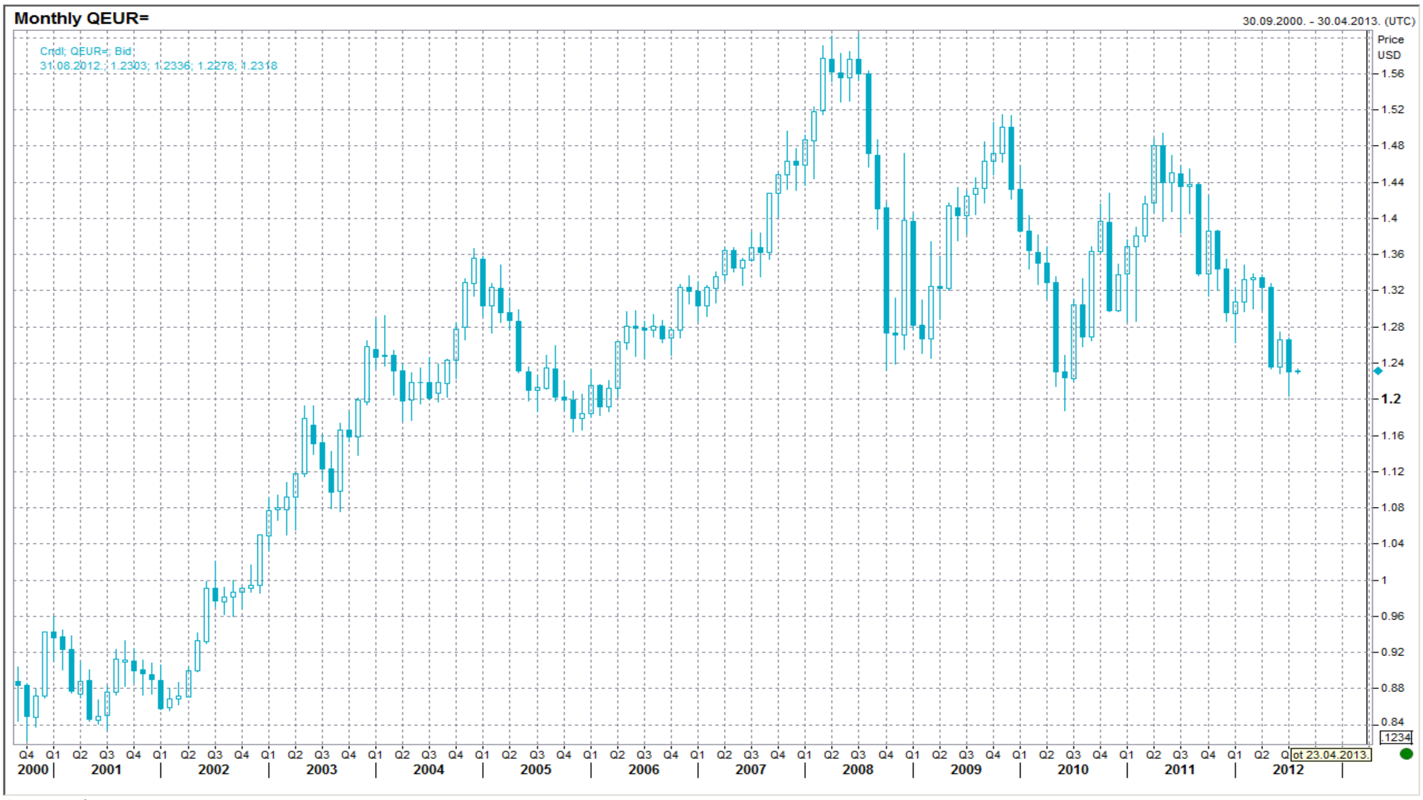
Fig. 18. Dollar index dynamics, monthly bars



Source: Thomson Reuters

As for the main rival of the dollar – euro, the US currency grew by 2.7% over the month, completely compensating the decrease by 2.4% in June (see Fig. 19).

Fig. 19. Dynamics of euro against dollar, monthly bars



Source: Thomson Reuters

Our assessment of future scenarios

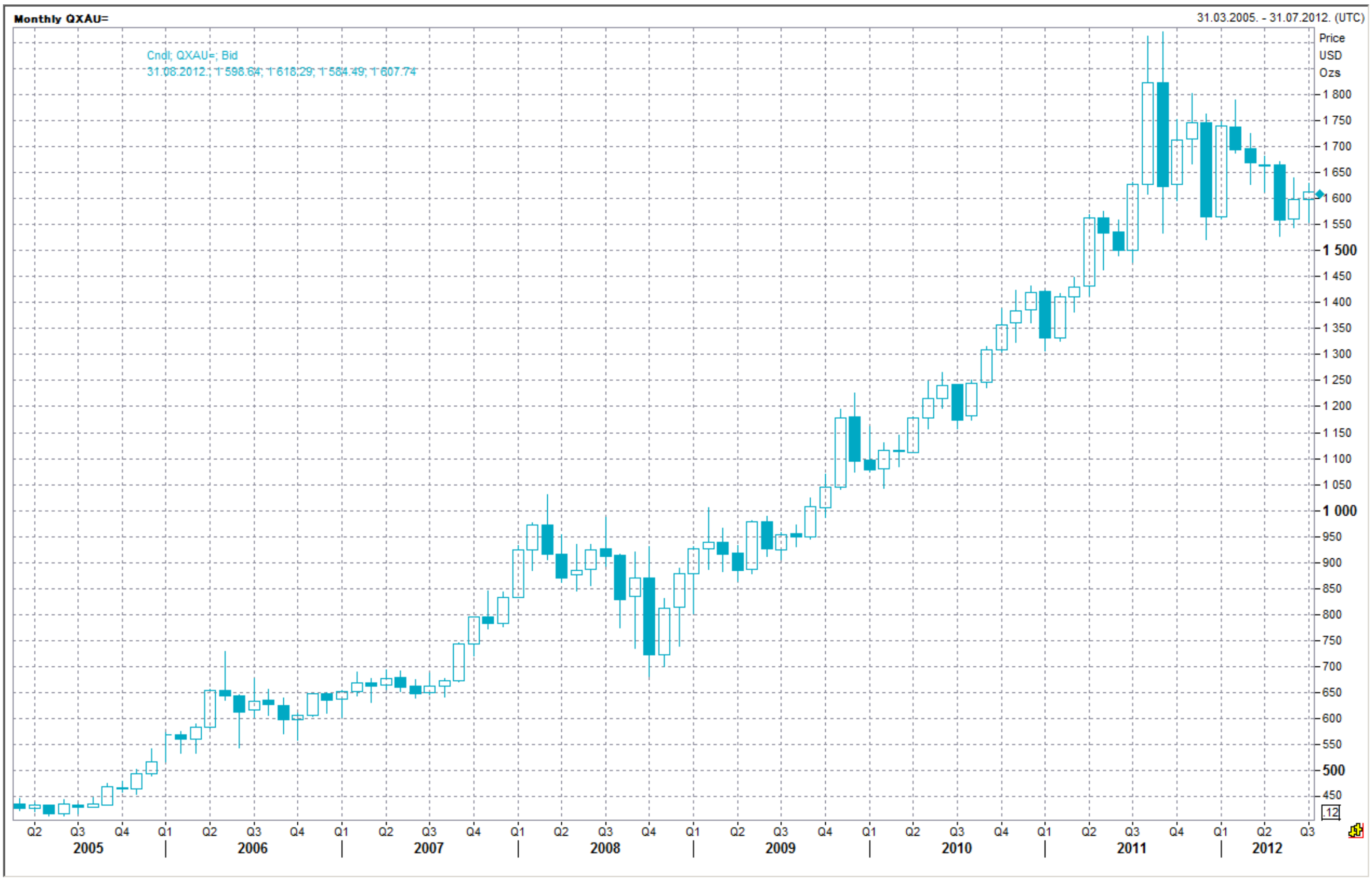
Our main scenario for the euro-dollar market remains unchanged. According to this scenario, the dollar minimum reached in July 2008 at the level of 1.6040 EUR/USD, is the end point of the long-term trend of the dollar falling against euro and the beginning of the trend for its long-term growth.

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

In the gold market in July rise in prices was continued, and the price of an ounce rose by 1% to reach $1613 per ounce (see Fig. 20).

Fig. 20. 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. From a technical point of view, the current growth trend can be considered active until support zone of $1400-$1500 is not broken.

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

Trends in the silver market in July correlated with trends in the gold market. Here, too, there was a slight increase in prices – by 1.6% (see Fig. 21).

Fig. 21. 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.

Platinum

In July, the price of platinum showed the dynamics different from the rest of precious metals, and there was a decline by 2% (see Fig. 22).

Fig. 22. Dynamics of platinum prices, monthly bars

Source: Thomson Reuters

Our assessment of future scenarios

Giving forecasts for the movements in the platinum market, it should be noted that in 2004-2008 the speculators have already "played" the market. In 2004, after many years of history the price of platinum diverged from gold price and soared almost 3 times over 4 years (by 200%), and then fell by 65% in 2008 (i.e. again nearly three times).

After 2008, the correlation between the markets of platinum and gold was resumed, but now gold shows larger growth. We expect that in case gold prices resume growth and reach the range of $2000-$2500 per ounce, platinum prices will increase as well, but their growth will be less significant.

Palladium

In July palladium, as well as gold and silver, showed a slight increase by 1.2%, but the price of an ounce so far failed to return the important psychological level of $600 (see Fig. 23).

Fig. 23. Dynamics of palladium prices, monthly bars

Source: Thomson Reuters

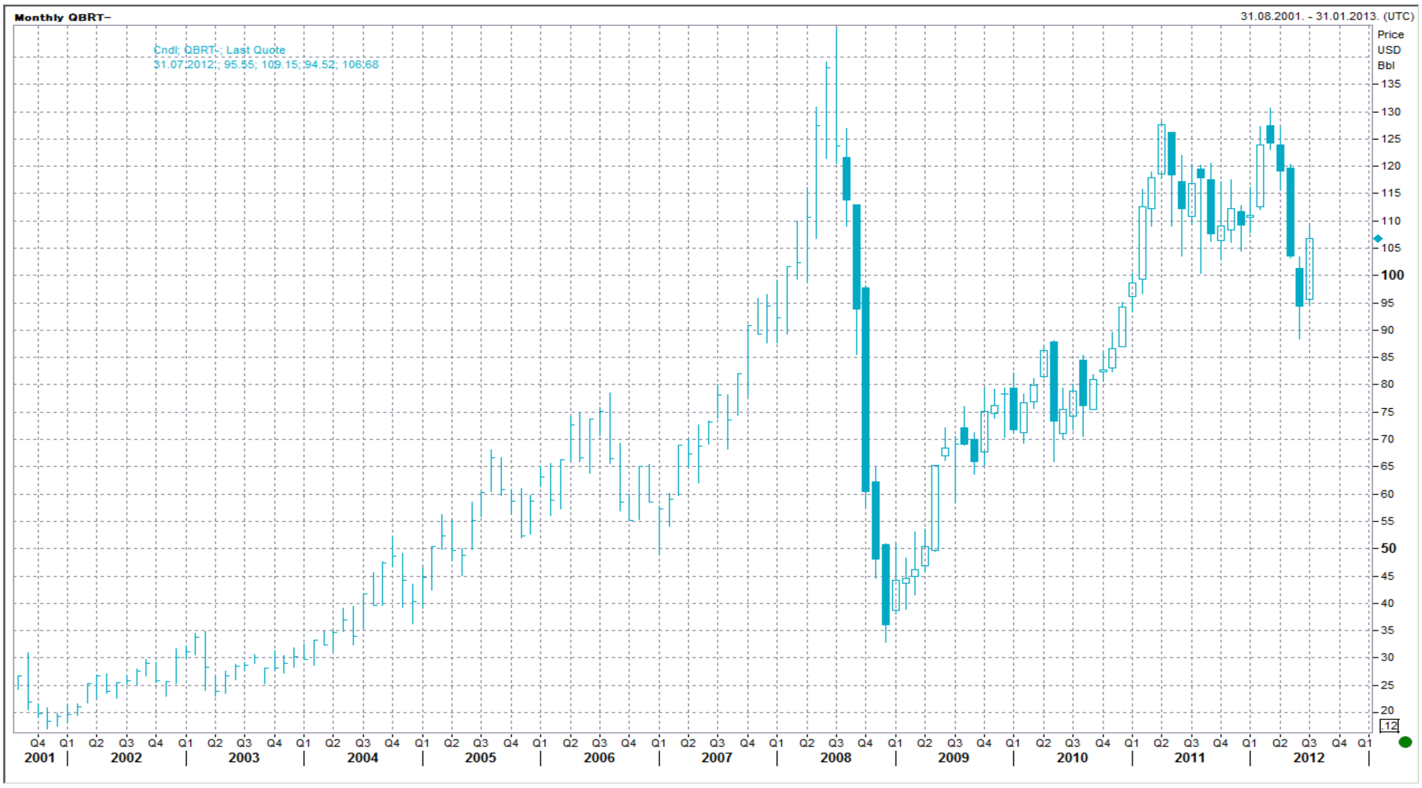
Our assessment of future scenarios

Palladium market has already experienced its "bubbling" – in 1998-2001 price of an ounce increased more than 5 times (by 400%), and then dropped 5 times in 2002-2003. Since 2009, there is a new, more moderate growth trend observed in this market. And after the correction in August - October 2011 from $850 to $550 per ounce, we expect further consolidation movement in the corridor of $550-$750 per ounce, followed by a more likely resumption of growth in prices.

Oil

In the oil market the month was marked by a significant increase in prices, which was almost 11% for Brent, and the price of a barrel of the same was back above $100, reaching $106 (see Fig. 24). In the past two months there was a significant growth of the spread between the prices of WTI and Brent – from $12 to $17 in favour of the latter.

Fig. 24. Brent price dynamics, monthly bars



Source: Bloomberg

Our assessment of future scenarios

Movements in May and June have confirmed our expectations of the organization of medium-term price correction in the market, with their drop below $100 a barrel. However, the movement in July did not confirm our expectations of price consolidation in the corridor of $85 - $105 per barrel during several months. But we do not expect prices to reach new local maximums, and we consider lateral movement of prices in the wider corridor to be the most likely scenario.

Review information

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