ECU

Interview

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The Three Risks to Watch

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- **Greek crisis: is the moment of truth finally upon us?**
- **Non-farm payroll report: a make-or-break point for an early rate rise?**
- **OPEC semi-annual meeting: do they still have what it takes?**

1 Friday 5 June

Q Andrew Rozanov

Well, the month of June is now underway, and we have an important week ahead for macro news, with a particular focus on Friday 5 June, which will see the release of the US labour market report, the semi-annual OPEC meeting, and the first scheduled June payment by the Greek government to its creditors… What are your expectations?

A Kit Juckes

You are correct. I expect the markets to focus primarily on these three issues – the US economy, Greek debt and the oil price. Let me start with Greece and the Eurozone. There's absolutely nothing new to add with regard to the Greek crisis. **Early June payments are likely to be made**, but the chances that enough cash can be found under mattresses and behind cupboards to get through the whole month are remote. Alexis Tsipras, the Prime Minister, is bemoaning the lack of flexibility from Greece's creditors. That said, **a last-minute deal is still more likely than not…** The Eurozone's latest batch of economic data was pretty consistent with the previous

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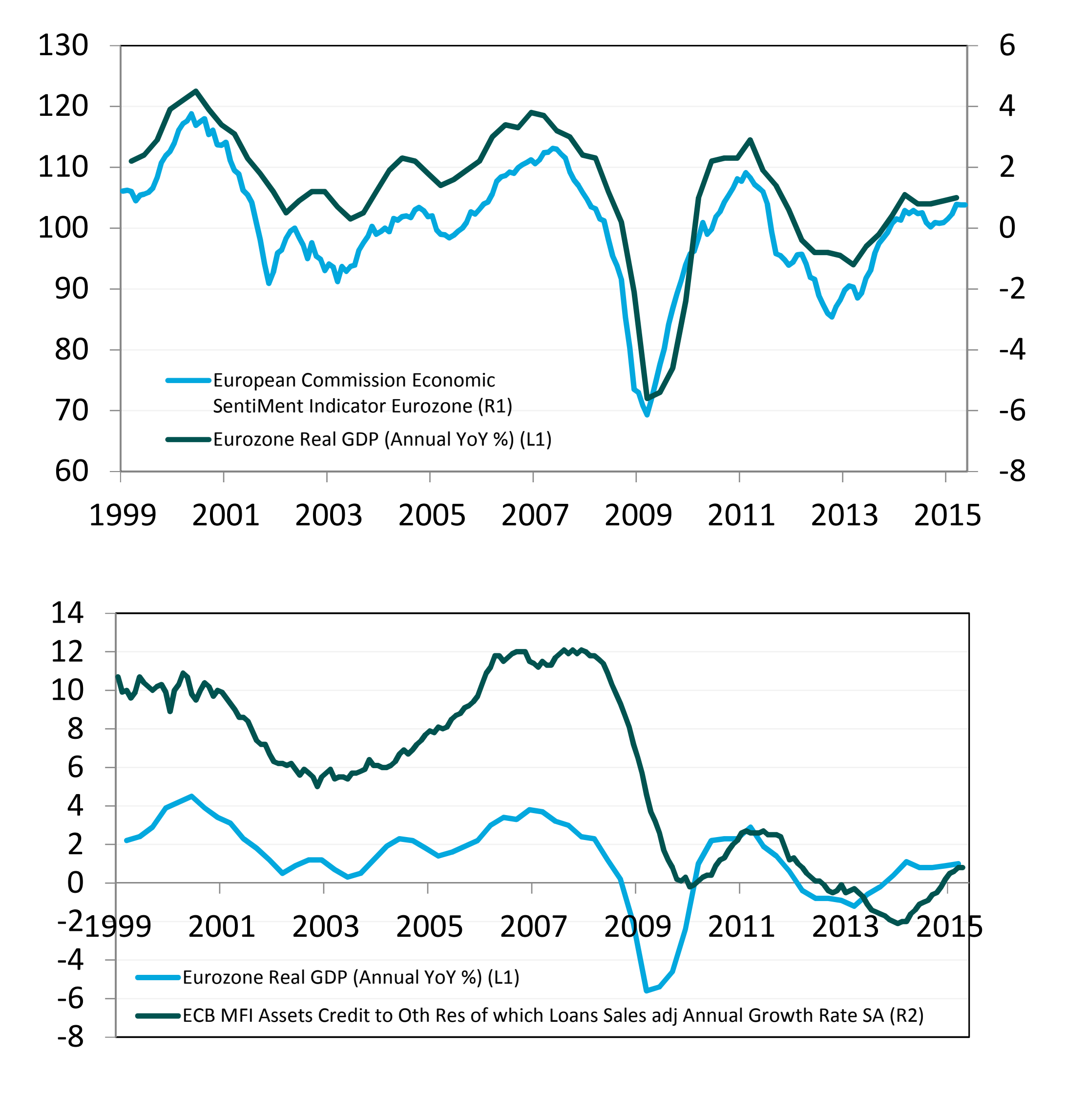
week's 'Flash' PMI. That is to say, it was OK, but suggests that the acceleration in growth we have been seeing – and which was a factor prompting the rise in bond yields and the Euro bounce – has now stalled. The composite PMI had fallen from 53.9 to a perfectly respectable 53.4. The European Commission economic sentiment indicator for May was unchanged at 103.8, and the best measure of private sector credit creation – bank lending excluding securitisation – was also steady at 0.8% per annum.

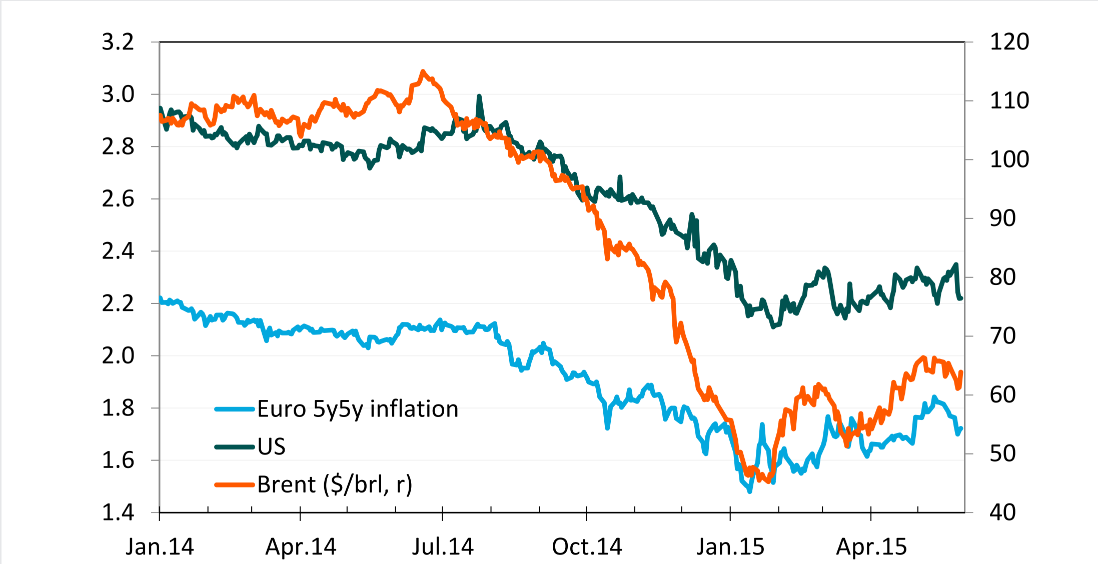
Eurozone Sentiment, Real GDP and Bank Lending (excluding securitisation)



Source: The ECU Group plc, DataStream

Again, there's nothing wrong with that, but growth expectations will also plateau just above 1.5%. Inflation expectations too have drifted lower in both the US and Eurozone, partly because oil prices have fallen as well.

Brent Crude, USD and Eurozone inflation



Source: The ECU Group plc, DataStream

The result of growth flattening out, nerves about the Greek debt talks dragging on, and inflation expectations dipping was another 12 basis point drop in 10-year Bund yields. The Euro fell a little further on the week against this backdrop.

A Neil MacKinnon

Indeed, the US dollar has recovered its poise after the wobble which took it to 1.15 against the euro. At the time, I said this mainly reflected an unwinding of short euro positions that were at very stretched levels. With the ECB stepping up its monthly bond purchases in the next few weeks and with the Greek situation very uncertain, **I think that short-term technical support around 1.0850 will come under pressure, especially if Friday's US jobs report is better than expected**.

"There are tentative signs of a cyclical economic recovery..."

The ECB meets this week, but is not expected to spring any surprises. Mario Draghi is likely to re-affirm his commitment to completing the QE programme. There are tentative signs of a cyclical economic recovery, which this week's PMI data is expected to confirm. Eurozone money supply growth is also increasing. The main focus at the ECB's press conference will be Greece.

Now, Greek bank deposits are at a record low, and it is difficult to call a lasting and satisfactory resolution to the talks between the Greek government and its official creditors. The IMF is reported to have given the Greeks the opportunity of bundling its scheduled IMF payments over the next three weeks into a single payment at the end of this month. This buys time but nothing else. The news-flow is volatile, with hopes of a last-minute deal being suddenly scotched by fresh resistance on the Greek side to any pressure on their "red lines".

As Kit alluded just now, the comments by Greek PM Alexis Tsipras in Le Monde on the weekend captured the mood well when he said that the lack of agreement "is due to the insistence of certain institutional actors on submitting absurd proposals" and "the desire of some to not admit their mistakes". This is clearly directed at Germany, and **the philosophical chasm between Greece and Germany over "austerity" (and how it has impacted the Greek economy) makes one think that a Greek exit from monetary union looks inevitable**.

"... recent regional elections in Spain also highlighted the shift to anti-austerity policies..."

Beyond Greece, recent regional elections in Spain also highlighted the shift to anti-austerity policies, and the weekend's regional elections in Italy featured disappointing results for Prime Minister Matteo Renzi. With the UK Prime Minister David Cameron looking to muster support for a renegotiation of powers from the EU, I think he will be disappointed. Treaty changes are not up for grabs. Sometimes I wonder whether Mr Cameron actually understands the politics of the EU project.

2 The US

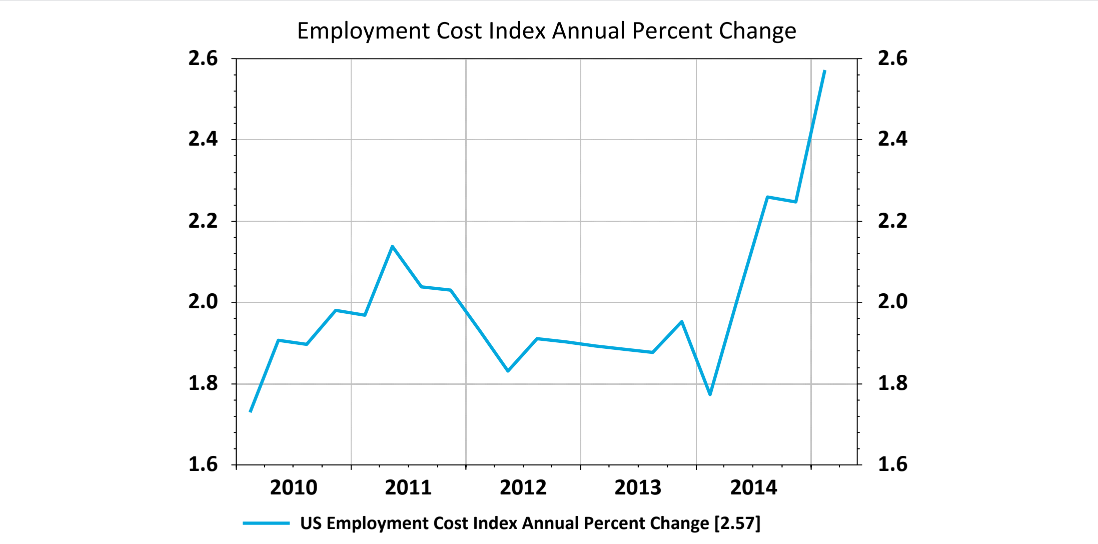
Q Andrew Rozanov

So I suppose of the three events to watch this week, Greece is the tail risk – in other words, a still low-probability, but potentially very high-impact event if things go badly wrong… What about the US? Neil, you have been flagging the importance of the upcoming labour report on 5 June for a while now.

A Neil MacKinnon

Indeed, the main economic data highlight of the week will be the US non-farm payroll report published on Friday. The market is discounting an increase of up to 250,000 jobs, with the

US Wages



Source: The ECU Group plc, DataStream

unemployment rate edging down further towards its long-term rate. The markets will also be keeping an eye on any pick-up in average earnings growth which has been static in nominal terms, but has been picking up in real terms.

Recent US data has tended to fall short of expectations. Last Friday's data saw the Chicago PMI dip to 46.2 from 53.0, while GDP for Q1 2015 was revised down to minus 0.7% at an annualised rate from the initial estimate of a gain of 0.2%. However, the market has "looked past" the revised 0.7% contraction in US GDP in the first quarter and is with the Fed in expecting a rebound in activity. Also, on the positive side, Michigan consumer sentiment was revised up to 90.7 from 88.6. So the indicators have been mixed so far in this regard.

The next FOMC meeting is scheduled for 16-17 June. The Fed will publish updated economic forecasts and there will be a press conference. My prediction of **a June lift-off in rates requires a bumper jobs number on Friday**, otherwise it will then be between July and the consensus view of September.

A Kit Juckes

"The downward revision to first quarter GDP is backward-looking and less important than further signs of strength..."

Indeed, as Neil said, the US economic data remain mixed, but I think, on balance, still point to stronger Q2 growth. The downward revision to first quarter GDP is backward-looking and less important than further signs of strength – for example, with the uptrend resuming in housing. On we go now to the ISM data and then to the monthly labour market report. If that shows a similar pattern to what we have seen in recent months – further downward pressure on unemployment as jobs growth remains respectable – then I think investor expectations about the timing of lift-off for the Fed Funds rate will further centre on September.

We almost certainly won't see any policy changes from the ECB and the BoE MPC this week, and indeed a move by the RBA in Australia seems unlikely too. For now, all the major central banks are on hold, but that will just leave the focus on when the Fed might act. If, as seems likely, there remains in place a trend for a flatter US yield curve and somewhat higher short-dated yields, the dollar will remain well-supported as the contrast between the Fed policy outlook and that in Europe or Asia will remain clear.

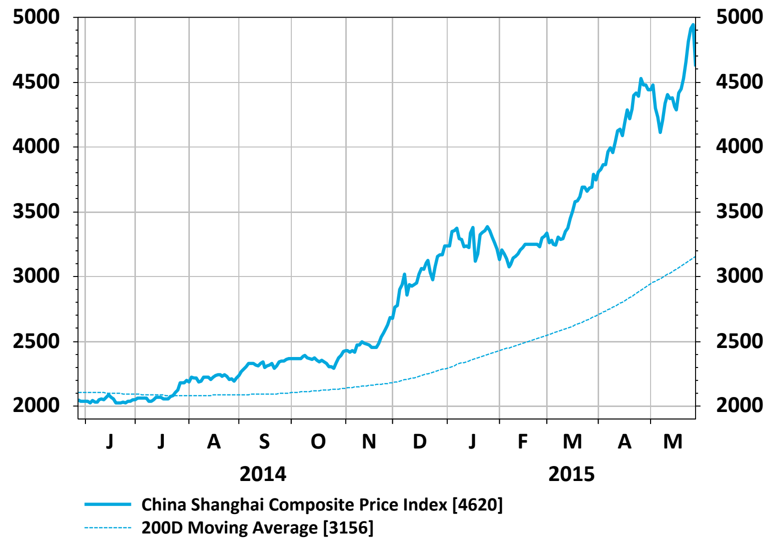
A Neil MacKinnon

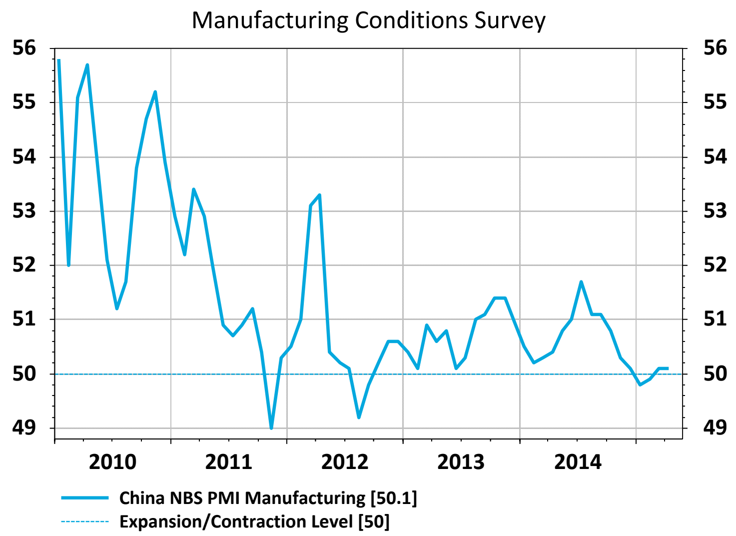
On the BoE MPC meeting, I agree with Kit that, just like with the ECB, we shouldn't expect any change in policy. The Bank recently lowered its GDP forecast for the year, and with CPI inflation at zero, they seem to be in no hurry to raise rates. In the recent Inflation Report and the MPC minutes of 7-8 May, the Bank endorsed the market's view of forward rates, which is pricing in an increase to 75 basis points by the third quarter of 2016.

Elsewhere on the currency front, clearly, the US dollar has been a star performer against the Japanese yen, although the MoF and BoJ usually resort to some degree of verbal intervention if JPY depreciation becomes too pronounced. But my guess is that the US Treasury can probably live with a USD/JPY rate up to 130. And a weak yen is good for the Nikkei as it bolsters corporate profitability.

In China, the Shanghai Composite remains a star performer, although as we discussed many times before, it has all the hallmarks of a bubble.

Shanghai Composite and China Purchasing Managers Index





Source: The ECU Group plc, DataStream

The MSCI is to decide on 9 June on whether to include China's A shares in its global indices. A positive decision could augur an additional inflow of foreign capital into the already overheated Chinese stock market. Likewise, the IMF last week noted that the renminbi is "fairly valued" and expects to see the currency included in the SDR basket in 2-3 years at the latest. I think investors need to monitor the developments in the Chinese markets very closely in the next few months.

A Kit Juckes

With respect to currency markets, I would just like to make three observations. First, although last week we saw the euro weaken, the real story in the currency markets was the drop in commodity prices and how it translated into weakness for the Norwegian krona, the Canadian dollar, and both Australian and New Zealand dollars. The Russian rouble and Brazilian real also fell. As, slightly more surprisingly, did the yen.

Second, while I'm happy to be long of the US dollar in principle, I suggest that it may not be so wise – at least at this point in time – to express this view against the euro. **If we do get some kind of a last-minute Greek deal in the coming days, even though it will not get rid of long-term concerns and would be unlikely to resolve the underlying problem, it could trigger a bounce in EUR/USD**. Therefore, I would rather be long USD against CAD, AUD, JPY and GBP instead.

Third, what I'd like to see in order to propel the US dollar higher, is a more marked move in US real yields. When I look at 5-year TIIPS yields, I struggle to believe we won't get back to, say, a 1% real yield, as and when the Fed normalises policy. I don't think the dollar's rally is going to be over until that happens, unless policy changes in Europe and Japan send their real yields higher first. On that basis, **I'd look for the US dollar to peak, in real terms, 5-10% above current levels in the first half of 2016**.

3 Oil

Q Andrew Rozanov

Finally, we mentioned the upcoming OPEC meeting and the price of oil as one of the three key areas to watch this week… Neil, what are your thoughts on this?

A Neil MacKinnon

Indeed, the semi-annual meeting of OPEC also takes place on Friday 5 June. Total crude oil production from OPEC rose to 31.58mb/d in May, which was a 67kb/d increase from a month earlier. OPEC has now been producing above its 30mb/d target for 12 consecutive months, with Saudi production at a record high. OPEC-watchers think that the cartel will focus on long-term market share and not short-term price relief. Most market estimates of the oil price are quite wide – anywhere between US$40 and 90. Having reached a peak of US$68 at the beginning of May, there was a move back to US$62 by the end of the month.

"US crude oil production is rising, with the US now less dependent on imported oil..."

OPEC's power to influence the oil price is diminishing, and many OPEC producers need an oil price of US$90-100 to balance their budgets. US crude oil production is rising, with the US now less dependent on imported oil. The supply/demand imbalance has diminished since the start of the year, so there is less chance of a pronounced drop in the oil price. World-wide oil production now exceeds demand by 2mb/d according to the IEA. In addition, policies to combat climate change might result in oil demand peaking, which again undermines OPEC as an influential cartel.

Andrew Rozanov

Gentlemen, thank you for your input and your analysis.

Biographies

Biography
Neil MacKinnon
Global Macro Strategy Adviser

Neil MacKinnon is a long-standing and independent member of ECU's Global Macro Team and Global Macro Strategist at VTB Capital, having been ECU's Chief Currency Strategist for six years.

Previous roles include Chief Currency Strategist at both Citibank and Merrill Lynch. From 1982 to 1986, Neil was an economist with HM Treasury, where he worked for the Chancellor of the Exchequer and other UK Treasury ministers.

Neil sits on the Advisory Council of Business for Britain.

Biography
Kit Juckes
FX & Fixed Income Adviser

Kit Juckes is a long-standing and independent member of ECU's Global Macro Team and Head of FX Strategy at Société Générale.

Kit has over 25 years' experience having commenced his career in 1985 with Money Market Services International (which became part of Standard & Poor's).

His former roles include Chief Economist at ECU, Global Head of Research at RBS Global Banking & Markets and Head of Bond and FX Strategy at NatWest Markets.

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Neil MacKinnon, Kit Juckes


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