Interview

Neil MacKinnon
Kit Juckes

Contributors:
Neil MacKinnon
Global Macro Strategy Adviser
Kit Juckes
FX & Fixed Income Adviser
Andrew Rozanov
Head of Institutions

Weekly Report
**July 15
2015**

Receding Risks Put US Rate Hike Back in Play

In this issue:

Page
1 Greek drama
4 The US
6 The rest of the world

- **In a surprise move Greece capitulates, but long-term problems remain**
- **Markets now re-focusing on US economy and Federal Reserve**
- **China contains equity market collapse, still weighs heavily on commodities**

1 Greek drama

Q Andrew Rozanov

Another week, another twist in the never-ending Greek drama! Just as one thought the resounding 'No' vote in last week's referendum set the country on course for default and 'Grexit', PM Alexis Tsipras does a 180-degree turn and capitulates to all of the creditors' demands… What do you make of the developments over the previous week?

A Kit Juckes

Well, that was a third week – and a third weekend! – entirely dominated by Greece, while the Chinese authorities' attempts at stabilising the equity market (so far, so good), and the never-ending debate about when (or if) the US Fed will finally raise interest rates for the first time, played second fiddle. Falling oil prices and a UK Budget played minor roles too, but the big story, yet again, was Greece.

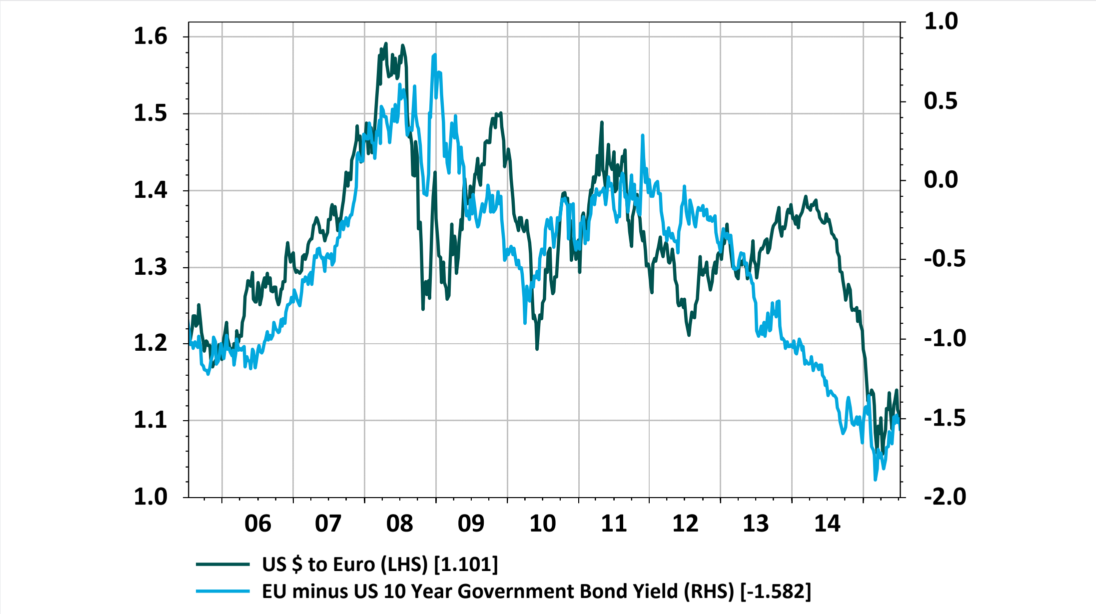
e: research@ecugroup.com
w: research.ecugroup.com

Last week started with the Greek electorate voting to reject the terms that had been offered by Greece's creditors in return for further lending, and it ended with the Greek government capitulating to pressure to accept even harsher terms, which will require handing over public sector assets into a special purpose vehicle for privatisation, as well as further austerity measures. Legislation needs to be passed by the middle of this week and, even if this is achieved, inter-European relations have been damaged. The IMF, the French government and much of Southern Europe accept the need for Greece's debt to be restructured. Germany and much of Northern Europe, on the other hand, are suspicious of all Greece's proposed austerity measures, not trusting them to deliver what has been promised and opposed to any overt debt reduction through a 'haircut'.

"Only an irredeemable optimist will now rule out 'Grexit' completely!"

A compromise can be found with greater supervision of Greece's delivery of the agreed austerity measures and through maturity extension and interest holidays to ease the debt burden, but it's at best a compromise with bitterness on both sides. It's hard to be confident that even if the Greek and other European parliaments vote for this deal, it will last the course. Only an irredeemable optimist will now rule out 'Grexit' completely! The result is that the EUR/USD rate is trading at the lower end of its recent 1.09-1.15 range, with the focus shifting back to the humdrum of US economic data and this week's semi-annual testimony by Fed Chair Janet Yellen.

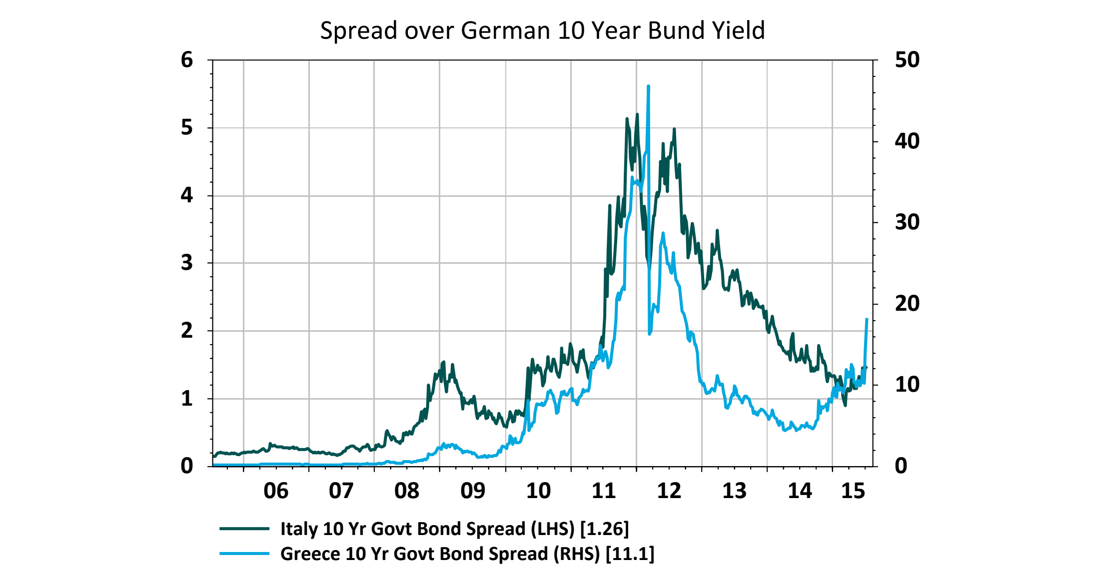
US $ to Euro and EU-US 10 year Yield Spread



Source: DataStream, The ECU Group plc

Still, 10-year Italian government bonds are some 20 basis points below their recent highs as stress levels ease in the European government bond market, and European bourses are up strongly to start the week.

Peripheral EU Govt Bond Spreads



Source: DataStream, The ECU Group plc

The currency market looks set to take the brunt of further nerves about Greece and further Fed/ECB policy divergence. The ECB has too much firepower to make a widespread loss of confidence in European bond markets likely and equities are likely to find inflows at these levels of the currency too.

A Neil MacKinnon

Well, at the risk of stating something in the firm belief that the Greek crisis is over, from my perspective, the "deal" or "pre-deal" between the Greek government and its official creditors may end up being the worst of both worlds for all parties concerned. Just to recap, the main elements of the Greek deal are three-fold:

- A set of detailed proposals on VAT and pension reforms that has to be passed by the Greek parliament on Wednesday 15 July. Once passed, this triggers national parliamentary approval processes commencing with the Bundestag this Friday. The 'sigh of relief' on the part of the financial markets when the 'last-second' agreement was announced on Monday morning may prove short-lived. PM Alexis Tsipras looks like 'political toast' after capitulating to the creditors' demands. Political turmoil, fresh elections and a change of government can easily derail the process. Other national parliaments might protest against 'bailing' Greece out again to the tune of the best part of €90 billion. Some might have thought a 'Grexit' would have been a better idea! Should the approval process actually run smoothly, then Greece will be the recipient of bridge financing that helps keep the economy afloat, at least over the rest of the summer. Of course, there is the problem of actual implementation of these reforms by the Greek government. It might be wishful thinking that there is any significant progress here.

- The agreement contained no debt restructuring and therefore no 'haircut' for creditors. However, there may be some debt 're-profiling' though a lengthening of debt maturities or some degree of further interest rate relief. In my view, the absence of debt restructuring misses the point. The IMF acknowledge that Greek debt is unsustainable. None of the creditors' measures look as though the debt dynamics can be improved – i.e., that nominal GDP growth actually exceeds funding costs for any period of time. In this regard, the Greek debt-GDP ratio, which currently stands at 180%, will most likely head towards 200%. All the creditors have done is 'extend-and-pretend'.

- The third element is the establishment of a €50 billion privatisation fund, of which €12.5 billion will be used to pay back ESM funds used for bank recapitalisation, €12.5 billion for 'growth initiatives', and €25 billion for debt repayments. Expecting a socialist government to make these privatisations when previous (conservative) Greek governments failed miserably does not look encouraging. The Greek government has only been able to raise €3 billion in privatisation proceeds over the last five years.

"Angela Merkel ... will have a hard job selling a third Greek bailout to disgruntled German voters and taxpayers."

For what it's worth, my assessment is that this is a bad deal. Angela Merkel, the German Chancellor, will have a hard job selling a third Greek bailout to disgruntled German voters and taxpayers. In addition, Germany is receiving a lot of criticism in handling the Greek situation. I tend to agree with the analysis of *FT* commentators such as Wolfgang Munchau and Martin Sandbu. The whole thing is not a good advert for the European Project and the objective of further integration now looks totally ambitious. I also agree with George Magnus, who wrote in the *Prospect* magazine that a Grexit has "only been postponed."

As far as Greek banks are concerned, the prospect of insolvency is a real one, and recapitalisation costs could amount to €25 billion alongside a restructuring of the banking system. There is also speculation of a depositor 'bail-in', which can only encourage depositors in the rest of the 'EU-South' to transfer their funds to safer banks in 'EU-North'. Greek capital controls are likely to stay in place for a long period – remember that capital controls in Cyprus lasted two years.

2 The US

Q Andrew Rozanov

What about the US? Last week we all thought that, on the balance of probabilities, increased prospects of a Greek default and ensuing chaos, combined with the stock market collapse in China, the Federal Reserve might seriously consider delaying yet again their first interest rate hike. But both risks seem to have declined materially over the previous week… Does that mean an earlier rate hike is back on the agenda?

A Neil MacKinnon

Well, with the prospect of a 'Grexit' fading, at least for now, the US dollar is firmer. In other words, the FX market indeed seems to think that an important obstacle to a Fed rate hike has been removed. In addition, some might argue that a third Greek bailout increases the risks for the EU system, which is a negative for the common currency. Janet Yellen said in a speech on

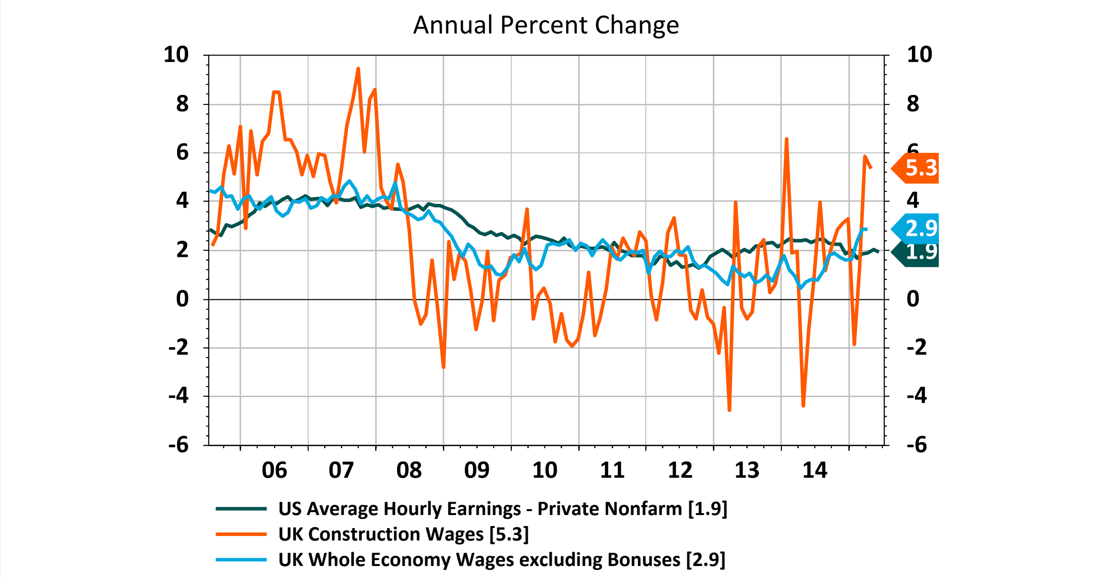
e: research@ecugroup.com
w: research.ecugroup.com

the US economic outlook last Friday that a rate hike during the rest of this year is likely. Take your pick whether it is September or December – or both! Janet Yellen's semi-annual Congressional testimony on monetary policy this week will provide fresh clues.

A Kit Juckes

As Neil mentioned just now, we have Fed Chair Janet Yellen's semi-annual testimony on monetary policy to Congress to look forward to. Will Ms Yellen use this opportunity to warn markets that it really is only a matter of time before rates have to increase, or will she be seduced by the modest pace of growth and the absence of any signs of inflationary pressure? Soft oil prices and modest increases in wage growth – despite a low and falling unemployment rate – do nothing to alarm her. Yet the acceleration in UK wage growth since the start of this year is an example of the speed with which a tight labour market can cause wage trends to change.

UK and US Wages



Source: DataStream, The ECU Group plc

If I were in Ms Yellen's shoes, I would want to get the rate hiking process gently priced in and underway before the unemployment rate dips below 5%. But the Fed has repeatedly erred on the side of keeping policy too easy too long, fuelling asset price inflation in the process. This week's testimony is a chance to set the tone for market mood over the summer. The risk that the Fed Chair simply maintains the dovish bias to her comments is reflected in current market pricing.

3 The rest of the world

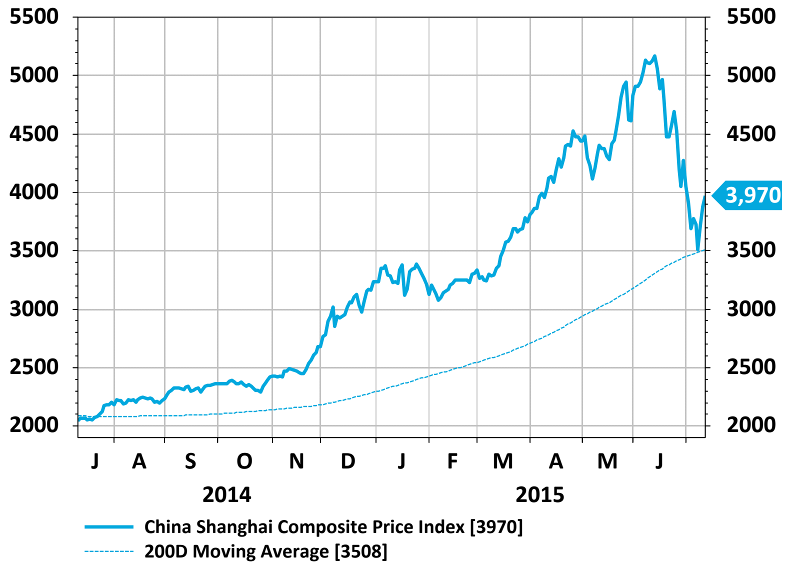
Q Andrew Rozanov

What about the rest of the world? Kit – you mentioned, in addition to China, some noteworthy developments in the UK and also in the oil market. What has been happening there?

A Kit Juckes

For the time being, Chinese stocks seem to be a receding driver of global market sentiment, partly because the authorities' methods to calm the equity market, however ham-fisted they may be, appear to be working.

China Shanghai Composite Price Index



Source: DataStream, The ECU Group plc

"... calmer equity markets won't do much to stabilise global commodity markets."

The long-term threat to global markets and growth from China's deflating credit and investment bubbles remains, but equity market volatility has relatively little impact. Its importance to economic sentiment in China is far lower than would be the case in, for example, the US. By the same token, calmer equity markets won't do much to stabilise global commodity markets, which are still reeling from the twin effects of increased supply and slower demand growth. On which note, while reports of a deal with Iran to curb nuclear development don't necessarily mean that increased oil exports are imminent in the very near term, the effect on a market where supply is already booming (thanks to Saudi policy) is clear. Oil prices are drifting lower again, threatening the market consensus that they would settle in their recent range.

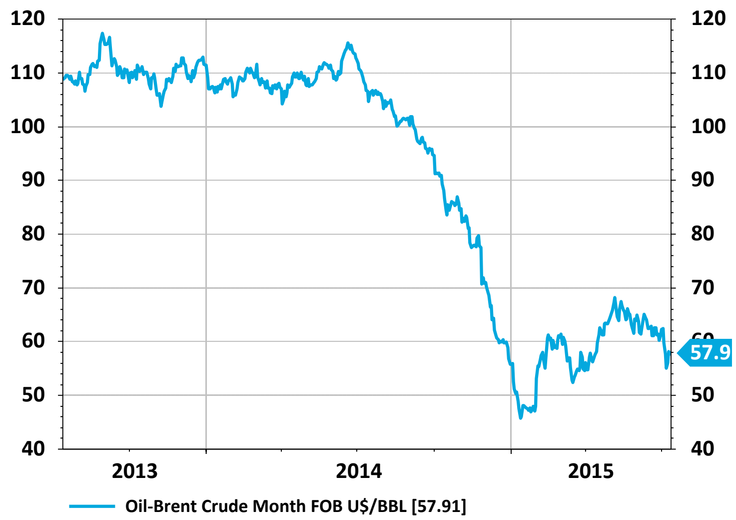
The UK budget was much more about politics than economics as far as I could see, but the upcoming data will have an impact on rate expectations. UK average earnings growth, excluding volatile bonuses, has picked up from under 1% per annum a year ago to almost 3% now. CPI and

PPI data may be well behaved, but it is nevertheless surprising that financial markets continue to price in the first rate hike no earlier than next spring. Any further acceleration, or indeed any further upside economic surprises, could see a market re-think, as MPC hawks become more outspoken. That would drive yields at the front end of the Gilt curve a little higher, and could take EUR/GBP down through the 0.70 level. EUR/GBP hasn't managed a daily close below that level since 2007.

A Neil MacKinnon

Well, speaking of oil prices, there are reports that Iran has reached a deal over its nuclear programme, raising speculation that it will raise production up to 1 million barrels per day within seven months. Don't forget: Iran once was OPEC's second biggest oil producer! Supply still outpaces demand, and Brent oil fell on the Iran news. It had already dipped below the US$60 level.

Brent Oil Price

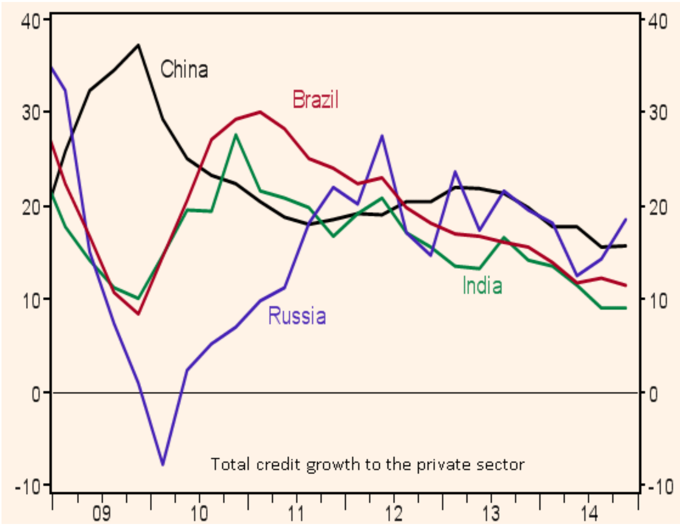


Source: DataStream; The ECU Group plc

China's recent equity market crash will do little to alleviate worries of a 'hard landing' for the Chinese economy, where meeting the official 7% GDP growth target is already looking unrealistic. Looking more generally at the BRICs, which account for 20% of the global economy, Brazil and Russia are in recession, though their long-run underlying growth rate has slowed further. And China accounts for 56% of the BRICs GDP. The IMF expects only a modest recovery in 2016. Commodity prices, and especially base metals, are at multi-year lows, reflecting reduced import demand from China.

This week sees the publication of the Chinese GDP data for Q2 2015. My view is that the official GDP data is bogus and doesn't really tell us what is going on. PBOC, though, is set to cut interest rates again and reduce banks' reserve requirements further. This will do little to dampen credit growth, which in the latest data published Tuesday 14 July runs at a high rate. Indeed, credit growth for the BRICs still remains high, which poses possible problems for financial stability. The illustrative BIS chart below was highlighted by Gavyn Davies in his recent article on the *FT* blog "Whatever happened to the BRICs?"

BRICs credit growth remains very high, though slowing somewhat



Source: BIS, The Financial Times

Andrew Rozanov

Gentlemen, thank you for your views and comments.

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.

e: research@ecugroup.com
w: research.ecugroup.com

For more information on our other strategies, please contact Bansi.Jashapara@ECUgroup.com

Our Strategies

Global Macro Viewpoint
Neil MacKinnon, Kit Juckes


Weekly: Global Investment Q&A	Chaired by Andrew Rozanov, we provide a "Start the Week" client-driven Q & A discussion between Neil MacKinnon and Kit Juckes focussing on topical issues and driving forces influencing major asset classes.
Daily: Daily Bullets	A "Start the Day" roundup, providing opinion and strategy, and highlighting key events, data releases and global market news.

FX Strategy
Stephen L Jen

Fortnightly: Briefing Notes	Stephen Jen provides a detailed and rigorous study of a key topical investment theme or global market issue.
Weekly: My Thoughts on Currencies	Stephen delivers a strategic analysis of key global issues driving currency markets.

Asset Allocation Roadmap
Robin Griffiths

Quarterly: The Big Picture	Chief Technical Strategist Robin Griffiths takes a look at the longer term trends prevailing in global asset classes.
Monthly: Asset Allocation Roadmap	Robin uses ECU's proprietary models and qualitative analysis to give monthly strategic opinions and updates.

Thematic Pieces
Professor Charles Goodhart, George Magnus


Monthly: Think Piece	Professor Charles Goodhart and George Magnus write topical and thought provoking pieces that explore longer term themes in the market and issues that affect the global economy.

Why ECU?

Our People
Our leading and broad based macroeconomic research team comprise highly respected and internationally renowned strategists. As a collective, our principal team is actively engaged with and advise the world's foremost central banks, ministries of finance and leading global institutions.

Unbiased Research
Free from conflicts of interest, members of our macroeconomic team provide their independent, unedited and insightful viewpoints, reflecting their individual core competency and deep first-hand knowledge, experience and understanding of the chosen subject matter.

Market Timing
Our strategists are actively involved in global markets, in the context of managing money and/or risk. Their collective inputs, derived from their own knowledge and proficiency, provide money managers highly pertinent, concise, and timely event driven analysis and direction.

Advisory
A key element to our top tier research offering is in our ability to offer exclusive access to clients who appreciate the value of receiving unbiased, unscripted advice at the highest possible level, in a format that can be customised to address the specific needs and concerns of each.

Disclaimer

This Information Service is provided by The ECU Group plc ("ECU"), a Public Limited Company with Company Number: 2296619, registered in England with Registered Office Address 20-22 Bedford Row, London WC1R 4JS. The ECU Group plc is authorised and regulated by the Financial Conduct Authority (FRN 153704).

This research document is formulated by the Global Macro Team of The ECU Group plc, and is intended only for Professional Investors. The opinions, estimates and projections in this report constitute the current judgement of the author as of the date of this report. They do not necessarily reflect the opinions of The ECU Group plc and may be subject to change. The views in this report are based upon information from sources, which the author believes to be reliable at the time of publication and is not to be construed as a representation by The ECU Group plc. Prices and availability of financial instruments also are subject to change. This report is provided for informational purposes only. It is not to be construed as an offer to buy or sell or a solicitation of an offer to buy or sell any investments or financial instruments or to participate in any particular trading strategy in any jurisdiction in which such an offer or solicitation would violate applicable laws or regulations.

The markets or financial instruments discussed in this report may not be suitable for all investors and investors must make their own investment decisions using their own independent advisors as they believe necessary and based upon their own specific financial situations and investment objectives. If a financial instrument is denominated in a currency other than an investor's currency, a change in exchange rates may adversely affect the price or value of, or the income derived from, the financial instrument, and such investor effectively assumes currency risk. Furthermore, income from an investment may fluctuate and the price or value of exchange rates and/ or financial instruments described in this report, either directly or indirectly, may rise or fall.

The ECU Group plc discloses any interests, financial or otherwise, and any conflicts of interest or potential conflicts of interests, which could reasonably be seen to impair the objectivity of any research publications. This note is provided in accordance with s.54(1) of The Financial Services and Markets Act 2000 (Regulated

Activities) Order 2001, which provides that the giving of advice in this way is neither that of: (a) the regulated activity of giving advice; nor (b) leading or enabling persons to buy, sell, subscribe for or underwrite securities or contractually based investments.

Past performance is not a reliable indicator of future results, and should not therefore form the basis of a decision whether or not to invest in any market or financial instrument mentioned herein. For reprints, additional copies, or for permission to use any of the content of this research material please contact your account manager at The ECU Group plc or email research@ecugroup.com.

This document may not be reproduced, redistributed or copied in whole or in part for any purpose. Neither this document, nor any copy or part thereof, may be distributed in any other jurisdictions where its distribution may be restricted by law and persons into whose possession the material comes should inform themselves about, and observe, any such restrictions ECU expressly reserves all rights in connection with its intellectual property, including without limitation the right to block the transfer of its products and services and/or to track usage thereof, through electronic tracking technology, and all other lawful means, now known or hereafter devised. ECU reserves the right, without further notice, to pursue to the fullest extent allowed by the law any and all criminal and civil remedies for the violation of its rights.