Global Economic & Market Monthly Review: Increased Probability of Positive Surprises

ECONOMIC ANALYSIS & RESEARCH DIVISION

Executive Summary

- In the US, the combination of low interest rates, a significant recovery in the housing market and, an even marginal, labour market recovery could result in higher growth in real personal spending in the coming months.
- The Eurozone economy remains on a trajectory of economic deterioration, while we may not have yet seen the low of the current negative cycle in core European countries including Germany.
- In Japan, an aggressive monetary policy is contributing to the current trend of global liquidity, which could have a short-term positive impact on growth, but is also adding to the overall global structural risks.
- In China, the government's announcements of a relatively low growth target of 7.5%, but more importantly comments about "quality" growth as opposed to "quantity" may contribute to a convergence of investor expectations on a different model of economic growth, which ultimately will be positive for assets such as Chinese equities and cyclical commodities.
- The likelihood of medium-term positive surprises in the US economy, developments in China and Japan and the current positive momentum in the Eurozone crisis front suggest a continuation of the upward momentum in equity markets with an increased probability of acceleration in emerging markets. On bonds, we maintain a neutral view on German Bunds and a negative one on US Treasuries. Currently, the EURUSD exchange rate has positive short-term momentum, but exaggerates macroeconomic and political realities. At the same time, recent developments suggest a higher fair value. We revise upwards our 12-month target to 1.26 from 1.19. Our view on commodities remains neutral, but we note the significant improvement in the technical picture of the price of oil (crude).

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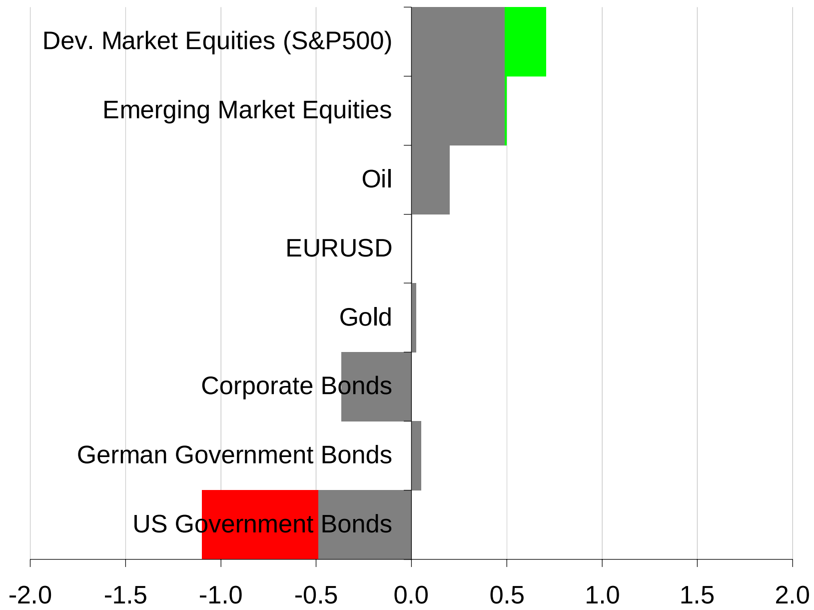
Global Market Risk-Return Scoring

(6-9 month horizon)

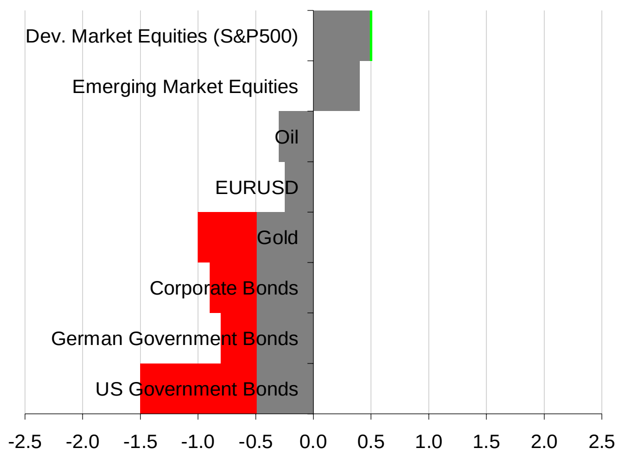


Scoring between -2.5 and 2.5, reflects an average estimate (50%) quantitative fundamental, & (50%) technical factors affecting individual markets.

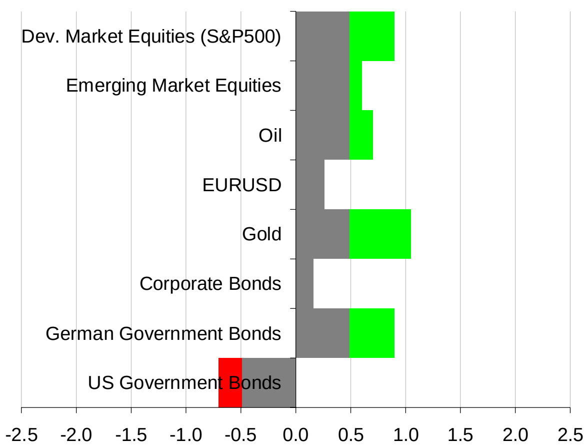
- *-0.49 to 0.49 neutral assessment*
- *0.5 to 1.49 positive assessment (-0.5 to -1.49 negative assessment)*
- *> 1.5 very positive assessment (<-1.5 very negative assessment)*

For long-term estimates (+9 months), more weight should be given to fundamental and quantitative factors, while for the medium term (3-6 months), more weight should be given to technical factors.

Fundamental & Quantitative Estimates



Technical Picture



Fundamental & Quantitative Estimates: Deviations from long-term average value measures (e.g. P/E for stocks, nominal growth for bonds, ppp for fx) as quantified by estimated "fair values" using for each the appropriate market & economic fundamentals. Technical Picture: Standardized display of figures such as MACD, RSI and other technical analysis measures

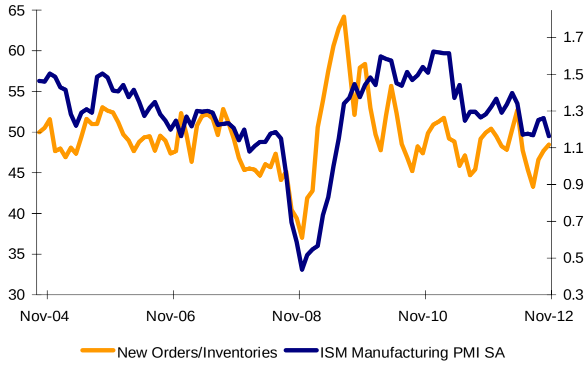
Economic Developments

USA: Possible Acceleration of Demand

- The US economy is still suffering the side-effects of hurricane "Sandy" and the negotiations over the fiscal cliff resolution, leading to an increase in uncertainty that is negatively affecting various leading confidence indicators. Additionally, business inventories remain high compared to sales and new orders (although the ratio is decreasing), while the ISM manufacturing indicator is expected to remain below the 51 mark.

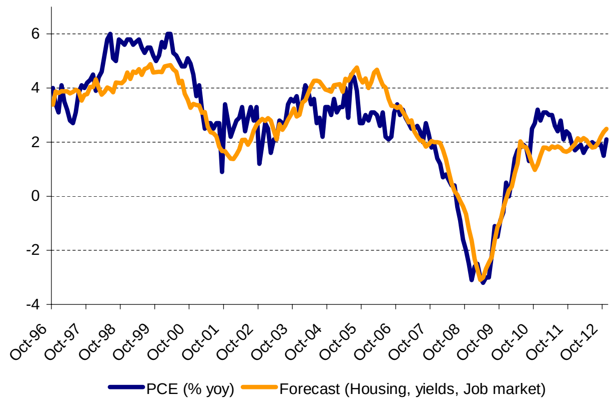
- On the other hand, demand side fundamentals seem to be positive, as low interest rates and the housing market recovery (the leading indicator of the National Association of Homebuilders rose to the 2006 level) signal an annual growth rate of 2.5% for personal outlays, higher than the current 1.3%. Therefore, sales and new orders are anticipated to increase compared to inventories, leading to a more auspicious picture for the US economy. Of course, it is necessary to resolve the fiscal cliff dispute.

ISM Index vs. New Order / Inventory Ratio



Source: Bloomberg, Piraeus Bank Research

Personal Consumption Expenditure & Estimate



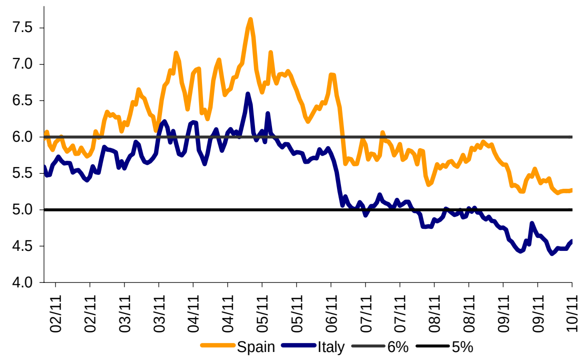
Source: Bloomberg, Piraeus Bank Research

Eurozone: Deterioration in the Core

- The Euro area economy seems to be deteriorating, as retails sales, industrial production and construction have retreated to a sizable extent. Although the ECB left its policy rate unchanged (at 0.75%), it downgraded its macroeconomic projections for 2013 (from 0.5% to -0.3%), signalling lower future policy rates. Positive signs come from the slight increase in the PMI Services Indicator and business confidence indicators in Germany (IFO and ZEW).

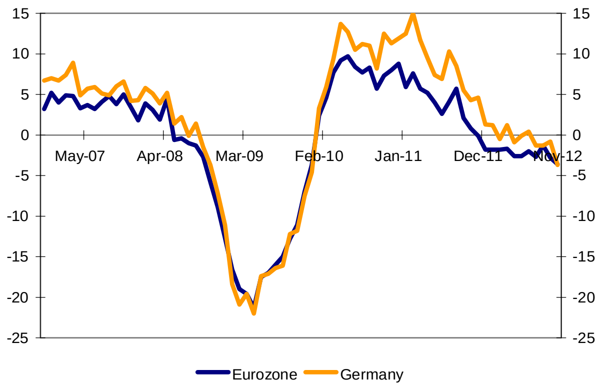
- The leading indicators probably signify an improvement in the economic environment, as a result of the Draghi's announcements and fall in the periphery's spreads. Nevertheless, the negative economic environment will probably persist due to the austerity policies in the periphery countries and the still deteriorating picture in the core countries including Germany. At the same time, as financial market pressures abate, the danger arises that banking and fiscal union efforts will diminish.

10 year Yields Spain-Italy



Source: Bloomberg, Piraeus Bank Research

Eurozone Industrial Production



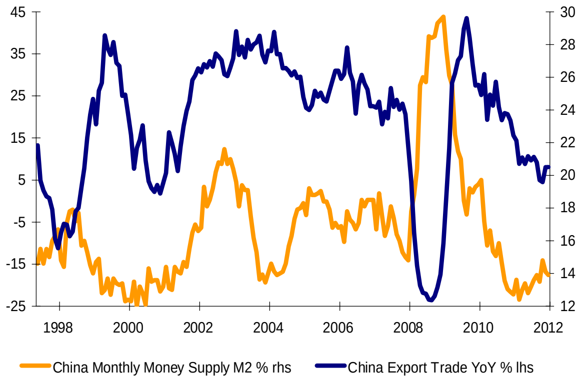
Source: Bloomberg, Piraeus Bank Research

Japan & China at the Forefront

- The new Japanese government's expansionary policies and pressure on the Bank of Japan to further relax its monetary policy (more quantitative easing) indicate better short- to medium-term prospects for the Japanese economy. On the other hand, an aggressively expansionary monetary policy in an environment characterized by high deficit and debt figures along with decelerating productivity could increase the long term inflationary and, consequently, the global economy risks alarmingly. In the meantime, most economic indicators (capital spending, Tankan survey) continue to point to a further economic deceleration from the current 0.5%.

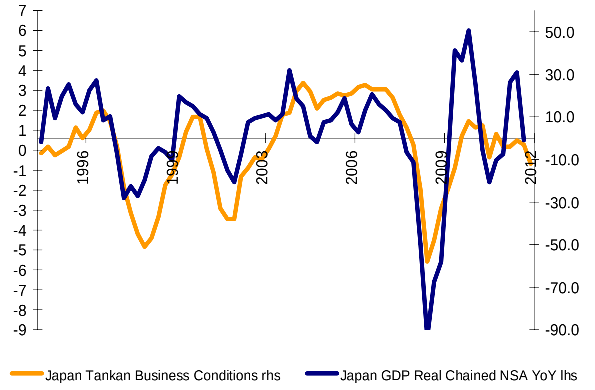
- Although, the Chinese economy continues to decelerate, there are some positive surprises, such as industrial production and retail sales figures. On the other hand, exports and monetary growth surprised negatively. These trends are in tandem with the government's efforts to re-orient the economy from an export and investment-based model to a consumption-based one. After the recent government announcements of a lower target growth rate (7.5%) and emphasis on the quality of the growth composition rather than its size, investor's expectations will probably adjust to a different growth model, which is likely to favour equities and cyclical commodities. We must note that the ongoing "cooling" of the financial sector is a negative for markets and some stabilization there is required in order to sustain a positive investment climate.

China: Exports & M2, 12mΔ%



Source: Bloomberg, Piraeus Bank Research

Japan: Growth & Tankan Index



Source: Bloomberg, Piraeus Bank Research

Markets: An Overview for 2012 – Factors for 2013

- Despite concerns at the end of 2011, 2012 was ultimately a positive year for risky securities. Equity markets yielded double-digit gains (end of December): The S&P500: 13%, the Eurostoxx50: 14%, the DAX: 29%, MSCI Emerging Market Equity: 15% and the Greek stock market: 33%. Also, most European periphery markets displayed equally positive behaviour, with Italian ten-year yields falling by 260 bps, Portuguese by 640 bps, and Greek (after the March PSI) by 700 bps. The Spanish and the Irish markets were almost unchanged. Corporate bonds indices also returned 11% (BBB USD) and 15% (high yield USD). The EURUSD exchange rate increased by about 2%, while the trade-weighted dollar index was virtually unchanged, along with the Continuous Commodity Index (CCI). In commodities, precious metals outperformed (Gold 6%, Platinum 9%), growth-linked commodities (Copper4%, Oil Brent 3%, Crude -8%) and agricultural commodities (-2%). Significant pressure was observed on freight rates (Baltic Dry Index -60%). Despite the rise in equity markets, growth and emerging markets underperformed. Government bond returns were also positive. A portfolio of European government bonds returned 11% (with the safest, German ten-year, returning 6%), and a portfolio of US Treasury bonds yielded about 2%.

- These unusual correlations (positive bonds/equity correlation & underperformance of growth stocks) is probably due to the combination of a) lingering investor concerns in the wake of the global crisis of 2008-2009 and the European one of 2010-2011 and b) the direct purchase of bonds by central banks. As mentioned previously, the combination of expectations of low interest rates, and the presence of structural concerns supports a negative bonds / equity correlation as investors move aggressively from stocks to bonds (free from worries of rising interest rates), depending on their expectations for growth and profits, and the general investment climate. As the maximum impact of the Fed's policies is behind us, in 2013 we expect that markets will return to more "normal" correlations between markets, but also within the set of risky securities (outperformance of "growth" when equities are rising with relatively inferior positive returns for the raw materials due to a stable dollar). Certainly, in the case of a negative scenario, which is not linked to an inflation shock but to growth disappointment, these relationships would be symmetrically reversed (positive bonds with shares falling, underperformance of growth).

- Markets surprised positively in 2012, as investors misjudged two main factors: 1) the European political will to maintain a united Eurozone, where the "noise" of negotiations was mistakenly taken for centrifugal tendencies and 2) the determination of central banks to either kick-start the economy (the Fed) or to provide protection from structural weaknesses (the ECB). Moreover, the succession process at the top of the Chinese Communist Party and the effort to shift the economy away from exports & investment in the consumer sector, has led to excessive concerns about the long-term dynamics of the economy, a factor that will prove crucial in 2013, as markets currently underestimate the policy aspect behind the recent slowdown in China.

- At the end of 2012, the markets are in wait–and-see mode regarding the possibility of a financial impasse in the US and have not incorporated any negative scenario at this point. This is correct, in our view; however, apart from any short-term dynamics, the 102% ratio of government debt to GDP and the 6.9% deficit remain significant obstacles for a sustainable long-term economic acceleration. Of course, as the FED continues to buy Treasuries, inflation expectations remain contained and foreign central banks (Asia) remain buyers, the US debt would have little medium-term effect on growth. On the other hand, the low ratio of investment to GDP (7%) could be a starting point for an increase in investment especially as corporate liquidity ratios are close to decade highs. Overall, as we mentioned in the section on the US, possible surprises are expected to be on the positive side.

- Although in 2012 markets underestimated the European will to preserve the Union, we could be approaching the point where they begin to overestimate the governments' ability to actually take the necessary steps for deeper integration. In the future, the state parliaments and the people of Europe will be asked to relinquish part of their sovereignty for the sake of saving monetary union. Although the analysis of such a project lies more in the realm of socio-political and historical research, we can say with relative safety, that such a task seems difficult at a time of weak global growth and lack of a common vision and / or external threat. The German elections in the autumn provide an excuse for trying to limit market fluctuations but, by a certain point, investors will be highly susceptible to even marginal centrifugal signs. For now, however, the momentum is positive and likely to remain so for the beginning of 2013. The depth of the economic slowdown in the core countries of the EZ and the rhetoric in the lead-up to the German elections could cause a reversal of this.

- Given the developments in Chinese equity markets, cyclical commodities and freight rates, investors probably remain worried about the state of the Chinese economy. In this climate, and given that the 7.5% target growth rate of the Chinese authorities is at the bottom of the 6.0% - 12.4%, zone that held between 1998-2012, the potential for positive surprises in 2013 is high. Over the years the Chinese authorities have proved effective at managing their economy by implementing a gradual approach to planning and liberalizing the economy (as opposed to the abrupt transition to capitalism in Eastern Europe). Moreover, the goal of reorienting the economy towards consumption is correct, given the overheating and the expected absence of future demand in the West. The risks lie on the political front as, at some point, a prosperous middle class will demand political rights as well.

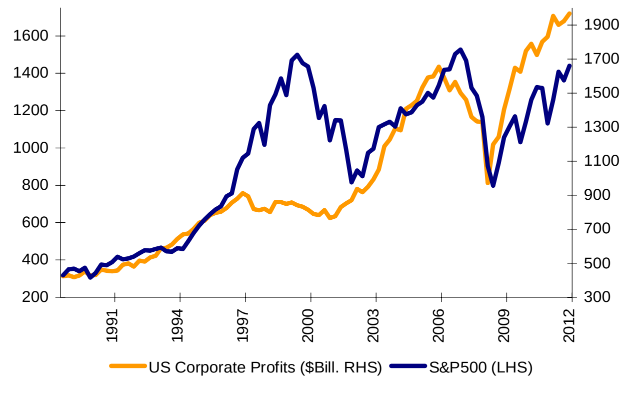
- Finally, it should be emphasized that the American (and global) economy remain on a path of structural transition to a more moderate growth trajectory under the weight of the major shock of private deleveraging of 2008 and the ensuing need for aggregate demand "immigration" from West to East. Because of this feature, any positive medium-term trend will be judged more strictly.

Equities

- Although the growth rate of US corporate profits follows a diminishing path, the outlook for equity markets is positive for at least the first half of 2013 due to the expected positive developments in the US and Chinese economies and the positive momentum in the resolution of the Euro area crisis. The annual growth rate in S&P500 corporate profits is 7%, which is equal to its average since 1991. Analysts estimate that it will be around 10% in 2013, but we judge that this will be difficult to accomplish. The Fed's expansionary policy and the fiscal cliff resolution can probably maintain the economic recovery, leading to an annual growth rate in corporate profits of 7% - 10%. We should note that since the low of 2009, the S&P500 Index has increased by 95%, while its corporate profits rose by 103%, signalling higher potential equity prices. Hence, we upgrade our fundamental view to marginally positive which, in combination with the positive technical view, results in a positive general view. We should note that risks may arise from the last quarter of 2013, when markets respond to the Fed starting to withdraw from its expansionary policy.

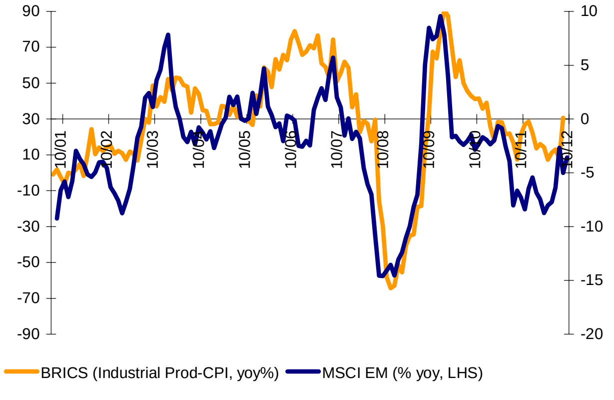
- In emerging economies, the equity markets picture has stabilized and has also posted the first positive signs, as it is the first time since February of 2011 that the annual growth rate in industrial production is higher than the inflation rate in the BRIC countries. In China, the annual growth rate path in corporate profits is still uncertain (but improving), as it is negative (-6% from -3% in June) for Shanghai's equities and positive (3% from 2%) for Hong Kong traded equities. Overall we observe improvements in fundamental factors (still neutral with a positive bias), which combined with the now positive technical view results in a marginally positive general assessment.

S&P500 & Corporate Profits



Source: Bloomberg, Piraeus Bank Research

EM Equities, BRICs Industrial Prod-CPI 12m% yoy



Source: Bloomberg, Piraeus Bank Research

Bonds

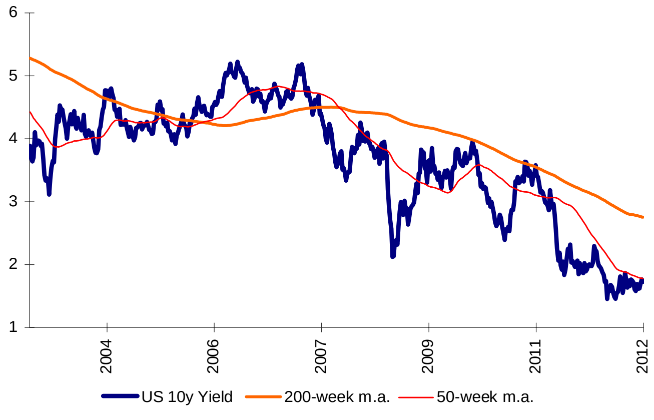
- Government bond yields remain at very low levels if we take into consideration the developments in industrial production, consumer prices, money supply and mainly deficit and debt. The divergence is more evident in the case of the USA, as the Fed's policy of purchasing more Treasuries has heightened their safe haven role, despite the fiscal dispute on deficit and debt.

- Our scenario (which is consistent with fiscal cliff resolution) for US Treasuries predicts an increase in their yields, but this is expected to be limited, as long as the markets continue to believe that the Fed will stick to its policy. The announcement of the Fed's adoption of definite thresholds (relaxation in monetary policy will continue as long as the unemployment rate is higher than 6.5% and the inflation rate is lower than 2.5%) reduces the probability of the Fed missing its inflation target. However, at the same time, yields will become more volatile upon data releases, as the markets will increasingly try to predict when the thresholds have been met, triggering the termination of the expansionary monetary policy. Unemployment has gradually retreated (from 10% in Oct. 2009 to 7.7%), indicating that a fall below 6.5% will probably occur during the fourth quarter of 2014. On the other hand, it is not possible during the next nine months for the annual growth rate of the PCE core to increase to 2.5%, due to the relatively high unemployment rate, low credit expansion and restrained international energy and commodity prices. The reduction in Asian countries' current account surpluses constitutes a possible threat for US Treasuries, as it will lead to the reversal of Greenspan's conundrum. Furthermore, if it is coupled with the end of the Fed's relaxation in monetary policy, Treasury yields could go worryingly higher.

- Despite the improvement in the Euro area crisis resolution, Bund yields remain at relatively low levels due to the persistent recessionary outlook and uncertainty on debt mutualisation, which would play a key role in a substantial fiscal union.

- Hence, the picture has clearly become negative in the case of US Treasuries, while it is still mixed in the case of German Bunds, as the positive technical view counterbalances the negative fundamental view.

USA 10-year Bond Yield



Source: Bloomberg, Piraeus Bank Research

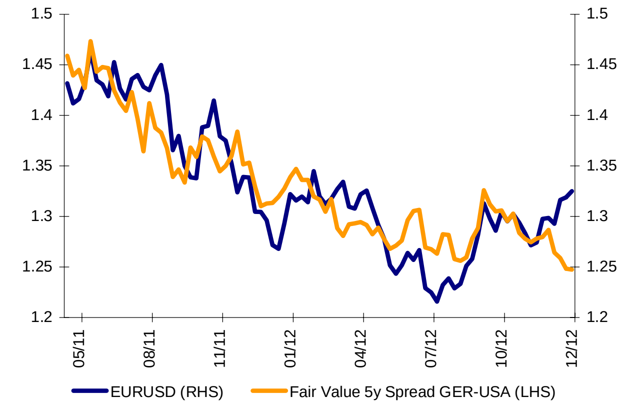
Germany 10-year Bond Yield

Source: Bloomberg, Piraeus Bank Research

FOREX

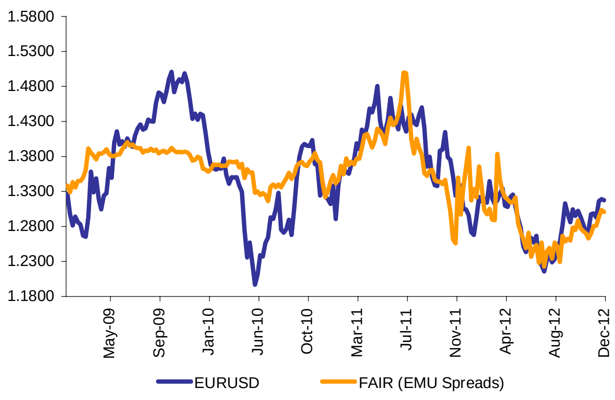
- Despite the stronger cyclical growth dynamics of the US economy (compared to the Euro area economy) and the reduction in the government bond yield spread between the Bund and US Treasury, the EUR/USD exchange rate seems to be maintaining its upward path. Uncertainty over the fiscal cliff dispute and JPY depreciation place the Euro currency in the safe haven class. Moreover, fundamental macroeconomic factors, such as the increase in the Euro area trade surplus and the reduction in the difference in the money supply annual growth rate between the US and Euro area lead to an increase in our long-term estimates for the EUR/USD exchange rate. The US economy will probably continue to post stronger cyclical growth dynamics, which coupled with the tepid attitude for complete euro area unification initiatives could be good reasons for correction. At this stage, both fundamental and technical pictures are neutral (with negative tendency). We suggest an upward revision of our twelve-month target to 1.26 (from 1.19). For the next two months we expect the exchange rate to be in the range of 1.3050 – 1.3500 and for the next six months the range of 1.2650 – 1.3750.

EURUSD, 5year Bond yield Spread Germany-USA



Source: Bloomberg, Piraeus Bank Research

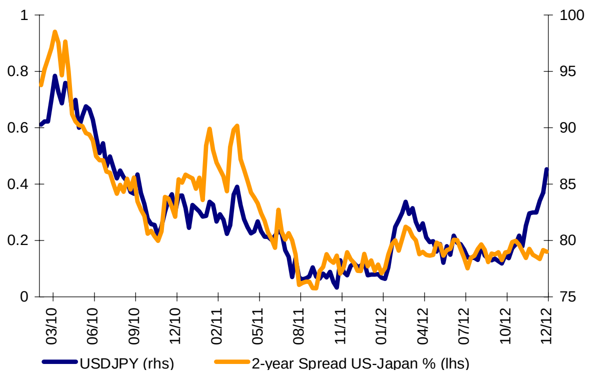
EURUSD vs. Eurozone-Germany Spreads



Source: Bloomberg, Piraeus Bank Research

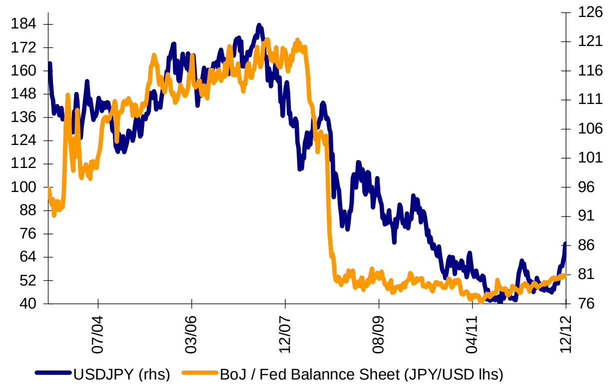
- The JPY remained under pressure against the USD, as the USD/JPY exchange rate has gained almost 12% since September approaching the area of 87. During December, the exchange rate fell by almost 6%, as the new government (Shinzo Abe is the new prime minister) prompted the Central Bank of Japan to heighten its corporate and government bond purchases, aiming at an exit from the deflationary environment. The BoJ decided to increase its purchases by ¥10 trl to ¥76 trl. The BoJ is expected to heighten its relaxation tempo in order to follow the Fed's policy. Comparing the balance sheet size of the Fed and BoJ and its historical relation, we believe that the USD/JPY exchange rate will remain between 84 and 88.50. Additionally, the exchange rate remains at a relatively high level if we take into consideration the government bond yield spread between the two economies. We maintain our target at 84.50, despite the possibility of more aggressive monetary policy relaxation from the BoJ, which would probably lead to more USD appreciation against the JPY.

USDJPY & 2year spread USA-Japan



Source: Bloomberg, Piraeus Bank Research

USDJPY – Balance Sheet Ratio BoJ / FED



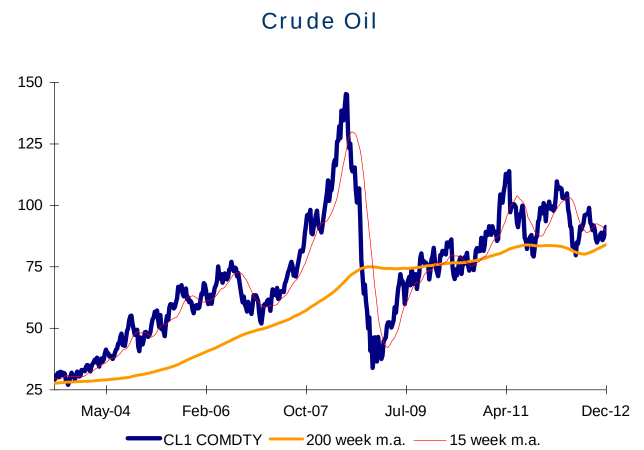
Source: Bloomberg, Piraeus Bank Research

Commodities

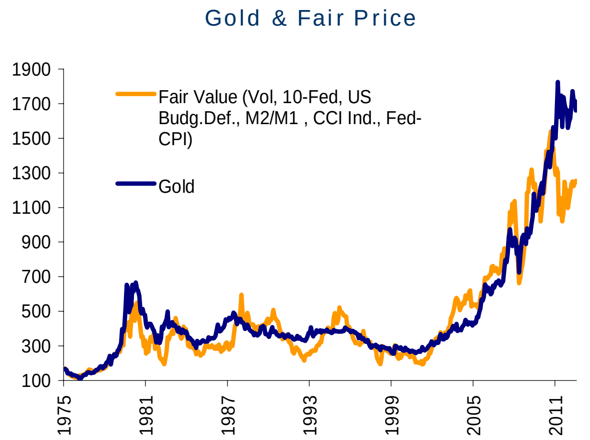
- The technical outlook for the CCI (Continuous Commodity Index) remains negative due to agricultural commodities and the cyclical and precious metals. Uncertainty on fiscal cliff resolution and the USD appreciation against the JPY affect metals negatively. But, the possible rapid fiscal cliff resolution and positive data from the Chinese economy could lead to over performance in cyclical metals.

- The price of gold gained 8% during 2012 and its technical picture remains positive. Recently the gold price has undergone a fall of 8% despite the central banks' decisions (for aggressive relaxation in monetary policy) and the Euro appreciation against the USD (positive correlation exists between Euro appreciation and gold price increase). The increase in US Treasury yields, reduction in the core inflation rate and fall in the unemployment rate leads, on one hand, to an increase in US real interest rates and, on the other, provides a framework for ending QE. At the same time, the USD appreciation against the JPY and possibly against other Asian currencies in the future constitutes another negative factor for the gold price. We continue to maintain that the gold price already incorporates a multitude of supporting factors whose reversal could already be underway (such as high volatility, aggressive monetary expansion, and negative real interest rates). We continue to maintain a neutral view due to the positive technical view.

- The price of crude oil price fell by 8% during 2012 due to the aforementioned reasons, the deterioration in the relationship between production and demand and the structural change in the US oil production profile, via the exploitation of shale gas and oil, resulting in a lower fair value. On the other hand, possible positive developments in the US and Chinese economies will lead to higher price. The technical view has turned from neutral to positive, while the fundamental view remains neutral. Hence, the general view is now neutral with a positive bias.



Source: Bloomberg, Piraeus Bank Research



Source: Bloomberg, Piraeus Bank Research

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