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# Strategy and economic research

## Market Insights

## KEY TOPICS

### United Kingdom: A highly ambitious budget plan

The Emergency Budget announced on June 22nd is consistent with the campaign promises of the Conservative party in that it plans to reduce the public deficit from 11.3% of GDP in fiscal year 2009 to 1.2% in 2015. This budgetary tightening should weigh on growth in 2011, and delay the first hike in key rates until the second quarter of the same year at the earliest. While the drastic cuts announced have reassured the ratings agencies, the coalition's ability to ensure their concrete implementation remains unknown.

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### Equity markets at the crossroads

From May onwards, equity markets began to see the first real warning signs since the start of the market cycle in March 2009. Looking beyond the short term, we observe that developed countries are grappling with structural issues such as debt, regulation and governance, whereas emerging markets are facing just a cyclical slowdown. Any significant gains in developed country equity indices would make them ripe for profit-taking, while a sizeable correction in emerging markets would be a buying opportunity.

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### Ghana: in the spotlight

Ghana's successful run in the 2010 World Cup has recently captivated soccer fans throughout the world. Yet many emerging markets investors have increased their bets on Ghana over the past year, based partly on expectations that the long-awaited production from the Jubilee oil field would come on line by the end of 2010. Investors have also been encouraged by efforts from the new government to stabilize the domestic economy. Although progress on some reforms remains slow, we think Ghana is generally headed in the right direction. We are particularly encouraged by the government's commitment to prudently manage future oil revenues. It should help reduce domestic imbalances going forward.

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### > The plan should reassure ratings agencies…

The budgetary savings announced depend on both an increase in taxes and cuts in spending (by over 75%). In terms of revenues, the government has announced a 2.5 point increase in VAT, taking it to 20% in January 2011. Capital gains taxes will be increased for high-income earners and a new balance sheet levy imposed on banks. At the same time, other tax revenues will be reduced. In particular, corporation tax will be cut by 1 pp annually over 4 years starting next April (from 28 to 24%), and the small companies' tax rate reduced from 21 to 20%. Finally, the rebate for 23 million basic rate taxpayers will be increased.

A major cut in departmental spending and investment should reduce the ratio of public spending to GDP from 48 to 40% between now and 2015. A two-year pay freeze for public sector workers has been announced (low-paid workers, however, will receive a flat pay rise), and various family allowances will be reduced. Compared to the measures announced by the Labour government in March, this plan represents a tightening of 2.8% of GDP by 2015. Government debt should peak at 85.5% of GDP in 2012, before dropping to 80.4% in 2015. It is plain to see: the plan is extremely ambitious.

| % of GDP | 2009 | 2012 | 2015 |
|---|---|---|---|
| **Public Sector Deficit** | 11,3 | 5,6 | 1,2 |
| **Cyclically-adjusted Deficit** | 8,7 | 3,4 | 0,3 |
| **Public Debt** | 55,8 | 85,5 | 80,4 |

Source: HM Treasury ; Fiscal years (from March)

Whether or not it is feasible, however, remains uncertain and we will have to wait until October 20th before the government announces the sacrifices to be made by each ministry. Given its commitment to maintaining health spending and leaving overseas aid unchanged, as well as to limiting the cuts in education and defence spending to 10%, the other ministries will see their budgets slashed by 33% in real terms! While ratings agencies Moody's and Fitch have welcomed the plan, the latter has nonetheless specified that it will be difficult to assess the credibility of these cuts until further details have been given.

### > …but it confirms that growth will be weak in 2011

The Emergency Budget will have a negative impact on growth and inflation short term. In terms of prices, the rise in VAT will mean a knock-on increase in inflation as of January 2011. Assuming that companies will be able to pass on the full increase in their sales prices (i.e. that their margins will remain unchanged), inflation should stay well above the Bank of England's (BoE) target rate of 2% throughout the whole of 2011 (approximately 3%). If the central bank believes that this will have a significant impact on inflation forecasts, it is likely to bring forward its first rate increase - all the more so given the differences in opinion within the Monetary Policy Committee as to inflationary risk, with the latest meeting minutes recording a vote in favour of an increase in rates.

We believe that this scenario is very unlikely and that the first increase will not come until the second quarter of 2011. On the contrary, lower-than-expected growth (between 1.5 and 2% in 2011) pleads for a more accommodating monetary policy. In the short term, the cut in government spending will weigh on growth, and the increase in VAT will have a negative impact on household spending in 2011. The BoE will be particularly cautious as the multiplier effects of the proposed plan on activity are difficult to quantify, to the extent that the risk of another recession in the short term cannot be completely discarded. From 2012 onwards, these measures should have a positive impact on activity, notably because the drop in interest rates linked to the reduction in government debt will stimulate an increase in investment. Against this backdrop, we expect growth to be moderate and close to its potential (2.5%) in the coming years.

Buoyed by the moderate increase in activity and renewed faith in the United Kingdom's ability to stabilise public debt in the medium term, the appreciation of the Sterling seen in June should persist over the next months, particularly since it remains well below its equilibrium value against the euro and dollar (approximately 15%). Furthermore, in light of stronger inflationary pressure in the United Kingdom than in the Eurozone, the BoE should pre-empt the ECB in the normalisation of its monetary policy. Nonetheless, the cohesion of the ruling coalition and its ability to implement the drastic budget cuts announced will come under close scrutiny over the next few months.

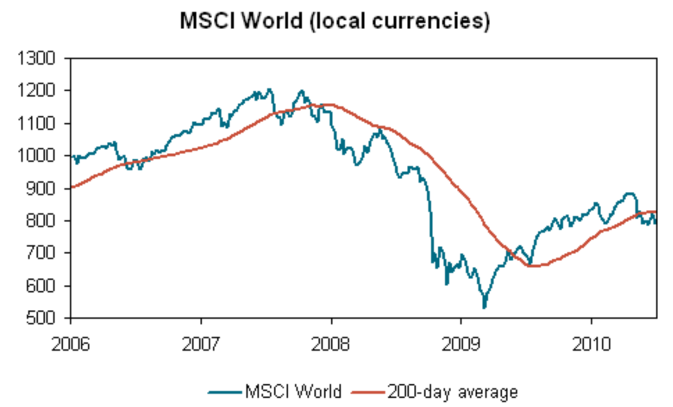
*Julien Marcilly*

# Equity markets: at the crossroads

## > Buy or sell?

The global equity index recovered more than 80% in local currencies between March 2009, the cyclical low, and the end of April 2010 before correcting by around 17%. After 14 months of gains, equities ran into the first major correction of this cycle, which obviously raises questions. Is the cyclical bull market over? Should investors buy or sell?

These questions are especially relevant because major bear markets tend to occur after a cyclical rise of more than 50% over 14 months.




Source: Datastream, Amundi Strategy

Let's take a look at the upswing, then at the correction before drawing a conclusion. The rally since March 2009 has been steep and widespread, based on the observation that monetary authorities and governments had regained control over the situation, albeit at the cost of a huge increase in government debt. This coincided with a cyclical improvement both in the major economic indicators and in corporate results, which remain surprisingly good around the world.

There are three reasons for the market correction since May 2010:

- The sovereign debt crisis is the most visible of these, especially in Europe. It has come to a head in Greece, the most vulnerable country in the euro zone, itself weakened by its governance. Let there be no mistake: the problem of converting private debt to public debt is shared by most developed countries.
- The second cause originates in China, which has become the second market – with the USA – setting the tone for the rest of the world. And the Chinese economy is slowing. As in any slowdown, the question for markets is how well authorities are managing the slowdown.
- The third question mark for investors is the USA. With fiscal incentives expiring, will the dollar's recent resurgence undermine the growth of the world's leading economy?

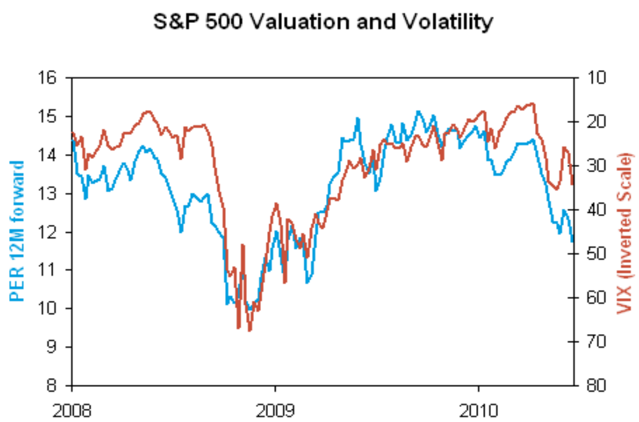
## > Different markets, different responses

While the initial market rally lifted all boats, we believe the cycle is now entering a period of differentiation.

Investor concerns are stirring authorities into action, and the responses are different. Europe, including the UK, is responding with austerity measures, which are necessary to maintain a high credit rating and thus an acceptable cost of borrowing. The USA, which still has a bellwether currency in the dollar and is a global safe haven, has the luxury of being able to extend its accommodative fiscal policies a while longer. China will begin allowing its currency to appreciate gradually. All these measures make sense, but they follow different approaches. Thus, there will be winners and losers.

For the moment, the euro's decline is a boon for the German market, for example, vis-à-vis countries in southern Europe. This is likely to continue.

Equity markets are not expensive overall. P/E ratios in both developed and emerging markets are below average considering current inflation. In this respect, European markets are the least expensive in the world and emerging markets the most expensive. The USA is in between. However, valuation is not really the issue right now. In the short term, valuation is fluctuating at the same pace as markets' implied volatility, and the road could be bumpy for the rest of the summer.




Source: Datastream, Amundi Strategy

Our conclusion needs to take this into account:
Developed countries are trying to sort out a structural crisis, which will take several years. Emerging countries, China foremost among them, are facing a cyclical slowdown. Given where we are in the cycle, any significant gains in developed country equity indices would make them ripe for profit-taking, whereas a sizeable correction in emerging markets would be a buying opportunity.

*Eric Mijot*

## Ghana: in the spotlight

Ghana's successful run in the 2010 World Cup has recently captivated soccer fans throughout the world. Yet many emerging markets investors have increased their bets on Ghana over the past year, based partly on expectations that the long-awaited production from the Jubilee oil field would come on line by the end of 2010. Investors have also been encouraged by efforts from the new government (elected towards the end of 2008) to stabilize the domestic economy. Although progress on some reforms remains slow, we think Ghana is generally headed in the right direction. We are particularly encouraged by the government's commitment to prudently manage future oil revenues. Although the scale of the oil production will not be sufficient to completely alter the structure of Ghana's economy, it should help reduce domestic imbalances going forward.

### > Despite missed targets, fiscal backdrop still improving

According to government figures, Ghana posted a budget deficit of 9.9% of GDP in 2009. Although that figure was higher than the target originally agreed upon with the IMF, it was still much lower than the 14.5% of GDP budget deficit recorded in 2008. Realizing that the 2010 targets were no longer achievable, the IMF recently revised Ghana's fiscal program and reduced the 2010 fiscal deficit target to just 8% of GDP. Looking ahead to 2011-12, the government plans to cut the budget deficit even further to 3-5% of GDP. While we think the 2010 target should be attainable, the 2011-12 targets could prove to be a bit too optimistic after considering challenges posed by higher debt service repayments and rising domestic arrears.

At the same time, there are a number of potential risks on the revenue front. The current fiscal program is counting on a 3.5% increase in revenues from a combination of higher mining royalties, an increase in import duties, and higher capital gains taxes. However, given the fragile state of the global economic backdrop, the government may need to consider contingency plans for revenue shortfalls. Although the government is finalizing the oil-revenue management bill, we wouldn't get too excited about prospects for an immediate oil dividend. In its current form, the oil revenue bill discusses splitting excess oil revenues into a stabilization fund (70%) and a heritage fund (30%). The stabilization fund could be drawn on during times of downturn, whereas the heritage fund could only be drawn on after the stabilization fund has been depleted.

The national petroleum company expects to ramp up oil production within three months, to reach peak output of 120,000 barrels per dryer year. During Phase I, they will be able to produce at these peak levels for about 3-4 years, but then it should start to decline towards about half of that. Under Phase II, a second platform could be up and running by 2014. The big hope is that further exploration will result in even higher proven oil reserves (currently at 300mn barrels).

Everyone talks about the oil revenues, but nobody is talking about potential gas revenues. Along with the 120,000 barrels of oil each day will come a substantial amount of cubic meters of natural gas. At present, the government is not projecting any revenues from that natural gas, because they haven't yet made clear plans about how to transport it. There is some scope for using the gas to power the oil platform, but most of it would have to be piped to a local power plant, which would have to be converted to take gas. If that doesn't happen, then officials could choose to burn it off, or inject the gas back into the oil well and hope that it might be recovered later.

### > Disinflation should allow further rate cuts

Inflation in Ghana has dropped considerably since peaking at more than 20%y/y in 2009. According to inflation data recently released by the central bank, Ghana's headline CPI slowed to 10.7%y/y in May, from 11.7%y/y in April. The figure was in line with market expectations, and reinforces our view that the Bank of Ghana will cut its key policy rate by 100bp during the monetary policy meeting scheduled to begin July 12. Remember, the central bank cut rates by 100bp in April (to 15%), bringing the total to 350bp since the easing cycle began last fall. The central bank's 2010 year-end inflation target is 9.2%. Although we could see that figure within the next couple of months due to a favorable base effect, rising m/m inflation suggests that headline CPI could be back into the low-double digits by the end of this year. CPI jumped 1.9% m/m in May, up from a 1.5% m/m increase in April.

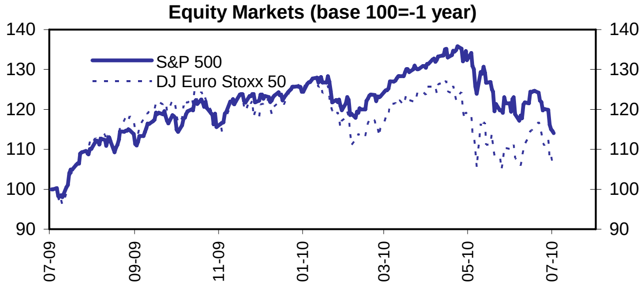
There are also potential inflationary pressures in the pipeline from planned hikes in electricity tariffs and government wages. Although some analysts argue that these inflation risks suggest that that the Bank of Ghana will cut only 50bp in July, I still think they will go for the full 100bp to encourage banks to lower their lending rates. So far, banks haven't really responded to the 350bp of officials rate cuts, because they believe that rising inflation pressures will actually force the central bank to hike rates sooner than later. Although there may be some credibility to that argument, it's important to remember that inflation is currently a full 10 percentage points lower than its 2009 peak of 20.7%.

Ghana's government has taken advantage of the lower interest rates and started issuing longer-term local currency sovereign debt. Because foreigners cannot own local paper issued with a maturity of less than three years, strong foreign demand has helped compress yields at the longer end of the curve. And while the currency (GHS, or cedi) has weakened 2% versus the U.S. dollar over the past couple of months, compared to the wild swings in other developed and emerging market currencies over the same time period, we still think GHS will hold up relatively well. Looking ahead, the government has announced that it will not likely issue any more 3-year local paper this year. Instead, the government is considering issuing another USD bond early next year.

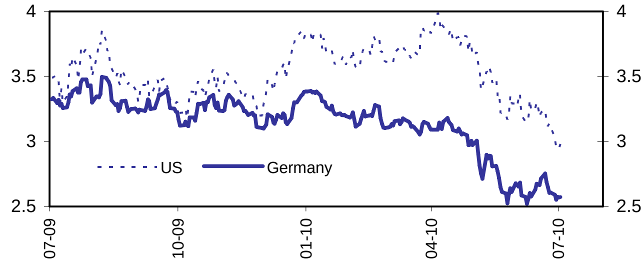
*Brett Rowley*

## Market Data

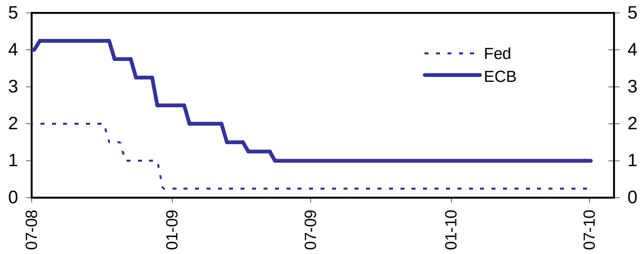
**Equity Markets (base 100=-1 year)**



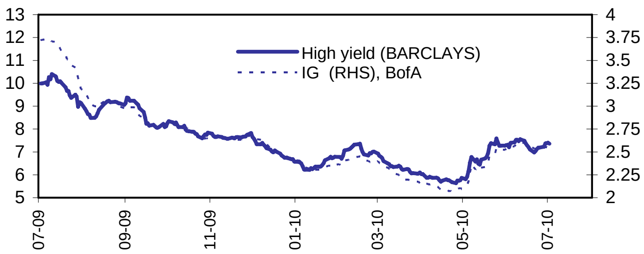

**10 years bond yields (%)**



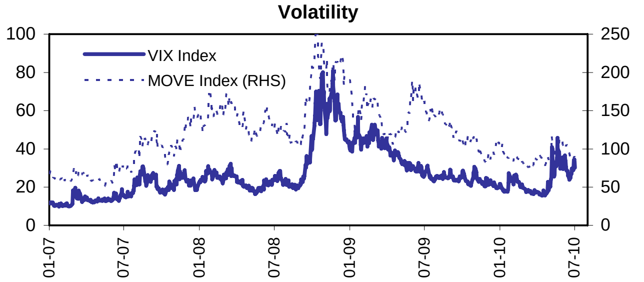

**Key rates (%)**



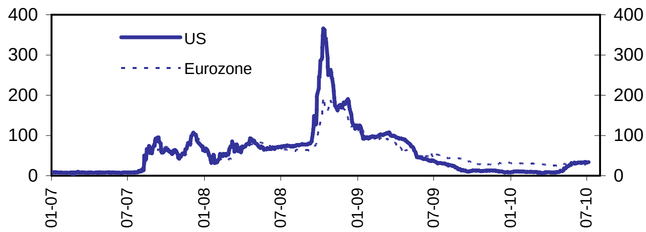

**Credit spreads (US, %)**



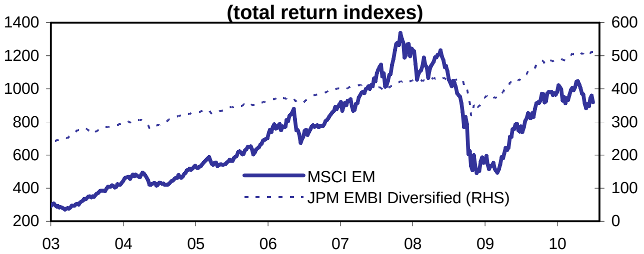

**Volatility**



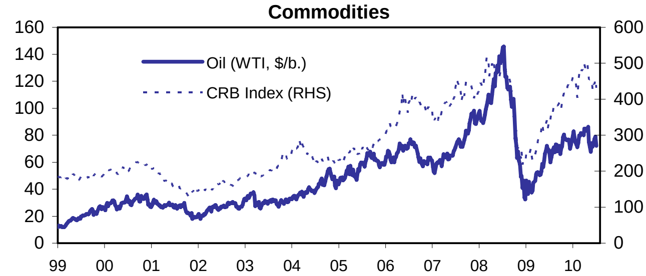

**Spread between 3-month LIBOR and the 3-month Overnight Swap Rates (bp)**




**Emerging equity and bond markets (total return indexes)**




**Commodities**




**Select Global Exchange Rates (July 2, 2010)**

| | F/X Rate | % Ch. WoW | % Ch. YTD | End year 2009 | 2008 | 2007 | 2006 |
|---|---|---|---|---|---|---|---|
| **USD/EUR** | 1.25 | 2.1% | -12.9% | 1.44 | 1.39 | 1.47 | 1.32 |
| **USD/GBP** | 1.52 | 1.9% | -6.3% | 1.62 | 1.46 | 2.01 | 1.96 |
| **GBP/EUR** | 0.83 | -0.2% | 7.6% | 0.89 | 0.95 | 0.73 | 0.67 |
| **JPY/USD** | 87.57 | 2.2% | 5.6% | 92.43 | 90.64 | 112.04 | 119.16 |
| **JPY/EUR** | 109.9 | 0.1% | 21.2% | 133.2 | 126.1 | 164.9 | 156.9 |
| **CHF/USD** | 1.07 | 3.3% | -3.4% | 1.03 | 1.07 | 1.12 | 1.22 |
| **CHF/EUR** | 1.34 | 1.2% | 10.9% | 1.48 | 1.49 | 1.65 | 1.61 |

Sources: Strategy and Economic Research Amundi Group, Datastream and Bloomberg.

Disclaimer

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