

Weekly Economic Briefing

Strategic Planning Department – Economic Section

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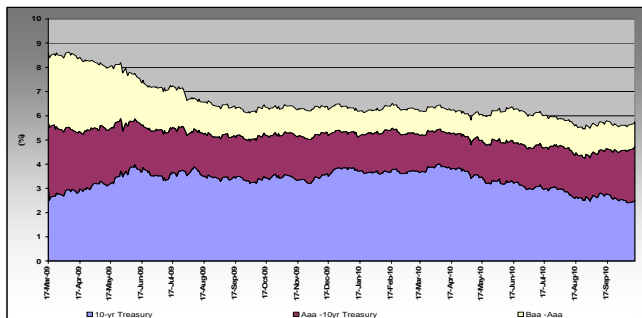
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COMMENTARY

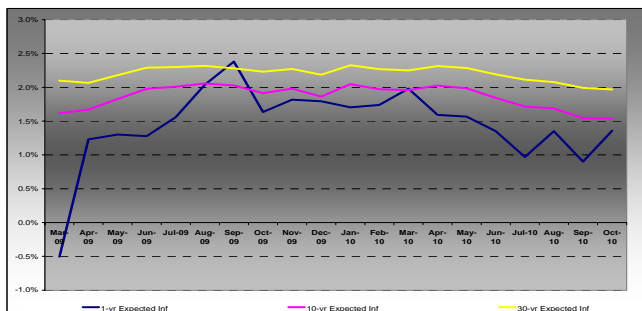
Bond Purchasing and the Priority of Avoiding Deflation

On his Friday's speech titled "Monetary Policy Objectives and Tools in a Low-Inflation Environment" the Federal Reserve Bank Chief stated that the statutory mandate of the Fed is to foster maximum employment and price stability, which he called the "dual mandate of longer-run sustainable rate of unemployment and the mandate-consistent inflation rate". Defining the longer-run sustainable rate of unemployment as the jobless rate that the economy can maintain without generating pressures on inflation. Similarly, the mandate-consistent inflation rate is the rate that best promotes the dual objectives in the long run. Additionally, June's FOMC minutes estimated the mandate-consistent inflation rate to be about 2%, while the longer-run unemployment rate to be about 5% to 5.25%. However, the current readings of inflation and unemployment rates are diverging from the above underlying values. The current annual inflation rate is around 1%, while the unemployment rate is close to 10%. Based on that, Bernanke said that the Federal Reserve may expand its holdings of longer-term securities, as empirical evidence suggests that the Fed's previous program of securities purchases was successful in bringing down longer-term interest rates and supporting the economic recovery.

The charts below show the impact of the Fed's previous program of purchasing long term securities on corporate rates and risk premiums, as well as on the inflation expectations as derived by the Federal Reserve Bank of Cleveland.



Since the Fed started its program in March 2009, the spread of Moody's 10 year Aaa & Baa bonds over the 10 year Treasuries declined notably from over 300 and 580 bps respectively on mid March to less than 140 bps and 240 bps in April & May 2010 before it widened to 220 bps and 320 bps in recent months. The same for inflation expectation; the previous bond program purchasing induced the annual expected inflation rate over the next year to increase from -0.5% before the program started to about the target rate of 2%. However, during the last few months, the one year annual expected inflation rate declined to less than 1%, while the expected average inflation rate over then next 10 years decline to around 1.5%.



The situation above supports the views of some Regional Federal Reserve presidents that unconventional monetary policy is more needed to support price level and to avoid deflation, as the current low inflation conditions make it hard to pursue growth targeted monetary policy.

GLOBAL STOCK MARKETS

	Current	Week Ago	YTD Change
US Dow Jones	11,062	11,006	6.08%
US NASDAQ	2,468	2,401	8.77%
US S&P500	1,176	1,165	5.47%
DE DAX	6,492	6,291	8.98%
UK FTSE100	5,703	5,657	5.38%
FR CAC40	3,827	3,763	-2.77%
SW SSMI	6,443	6,363	-1.56%
JP Nikkei	9,500	9,588	-9.92%
HK Hang Seng	23,757	22,944	8.62%
IN BSE Sensex	20,125	20,250	15.24%
Brazil Bovespa	71,830	70,808	4.73%

Global stocks ended the week on a positive territory, after the announcement from the Federal Reserve chairman saying that further action is needed to boost the economy, also stocks were boosted by a better than expected company earnings, as companies are on the edge to report their fourth straight quarterly earnings increase, with earnings by Google climbing 12% exceeding all estimates. Additionally, US stocks rose for the week on some better than expected news as retail sales rose more than estimated in September, rising 0.6 percent, while consumer prices increased less than projected. By the end of the week, the S&P 500 advanced 0.94%, while Nasdaq rose 2.79%. Dow Jones managed to add 0.51% for the week. On sectoral level, Financials, industrials, and telecom fell, while technology and consumer discretionary stocks rose.

European stocks advanced for the second week after the Fed said it will act to stimulate the economy. For the week, the German DAX gained 3.20%, France's CAC 40 rose 1.70%, and UK's FTSE 100 climbed around 0.81% for the week.

In Asia, stocks showed mixed performance for the week, as investors took profits from recent gains, despite expectations that Chinese banks will post strong quarterly profits. For the week, Japan's Nikkei 225 chopped 0.92%, as financial stocks fell. Hang Seng rose 3.54%, while Indian BSE fell 0.62% for the week.

REGIONAL STOCK MARKETS

	Current	Week Ago	YTD Change
Abu Dhabi	2,758	2,685	0.55%
Bahrain	1,459	1,458	0.07%
Kuwait	7,010	6,995	0.07%
Muscat	6,536	6,506	2.64%
Doha	7,821	7,765	12.39%
Dubai FM	1,746	1,722	-3.16%
Cairo SE	6,879	6,879	10.81%
Amman	2,328	2,327	-8.09%
Beirut Blom	1,418	1,411	-9.39%
Saudi Arabia	6,302	6,417	2.96%

Regional stocks posted positive results for the week. The Saudi all share Index (TASI) fell to a five week low sliding below the 6,400 points level after results from some companies came less than expected. The Saudi "TASI" lost 1.79% for the week, closing at 6,302 points and bringing its YTD to 2.96%.

FOREX

	Current	Week Ago	End2009
EURO/\$	1.397	1.393	1.432
EURO/YEN	113.8	114.1	133.2
\$/YEN	81.45	81.92	93.03
GBP/\$	1.599	1.596	1.615
\$/CHF	0.958	0.962	1.035

US dollar ended the week down against its major counterparts, matching a losing streak that ended in December 2008. The greenback continued to be under pressure amid worries the Federal Reserve will implement another round of bond-buying as part of a renewed quantitative-easing strategy as early as next month. The Fed continues to announce that further ease in monetary policy is needed to boost the economy given the current low inflation and the high unemployment rates. The demand for the dollar was also affected noticeably by the University of Michigan's consumer sentiment index for October which is 67.9, less than the 68.5 economist estimated, and the weakest level since July. The yen, on the other hand, managed to end the week up despite the Japanese Finance Minister announcement on Friday that Japan would again "take decisive steps when necessary" to curb excessive exchange-rate moves.

For the week, the dollar lost 0.57 percent against the yen to close at ¥81.45 per dollar after falling during trading to a fresh 15-year low of ¥80.88. Against the pound; it fell 0.19 percent to stand at \$1.599. Based on this weekly performance, the dollar index DXY dropped 0.44 percent to close at 76.96 from its level a week ago at 77.295.

From its side, the euro surged against the dollar for the fifth week in the longest stretch of losses for the dollar against the euro in almost two years. The euro climbed 0.29 percent versus the dollar for the week, but fell 0.26 percent versus the yen.

INTEREST RATES

	Current	Week Ago	End 2009
US3mth	0.29	0.28	0.25
US10yr	2.56	2.41	3.83
Euro3mth	0.93	0.90	0.66
Euro10y	2.37	2.25	3.39
UK3mth	0.74	0.73	0.61
UK10yr	2.94	2.87	4.02
SR3mth	0.72	0.72	0.77

US Treasuries ended the week down after a government report showed retail sales rose more than predicted in September and New York area manufacturing increased this month. The excellent data managed to shift traders away from bonds, despite the speculation that the Fed will act to stimulate the economy. By the end of the week, yields on 10-year note climbed 15 bps to close at 2.56 percent after it reached 2.59 percent earlier, the highest this month. The 2-year note yield, on the other hand, increased for the week, gaining 2 bps to 0.37 percent from its level a week ago at 0.35 percent. The thirty-year bonds fell for the week, pushing yields up 22 bps to 3.98 percent, the most since August 2009. As a result, the spread between 2-year note yields and 10-year note yields closed at 2.19 percentage points.

European bonds ended the week down after the good US retail sales data. By the end of the week, the yield on 10-year German bund increased 12 bps to 2.37 percent, and the 2-year note yield increased to 0.81 percent from 0.79 percent a week ago.

UK gilts, from its side, ended the week down, as stocks rose, limiting the appeal of gilts as a safe asset, after the US Fed announced that it's ready to buy more government debt. Accordingly, the yield on the 10-year gilt increased 7 bps for the week to 2.94 percent, while the 2-year note yields gain 5 bps to 0.67 percent from its level at 0.62 percent a week ago.

COMMODITIES

Crude oil prices posted negative results for the week, falling to the lowest level in two weeks, as Michigan's consumer sentiment fell for October to 67.9. US light sweet crude fell 1.70 percent for the week to settle at \$81.25 a barrel. Brent crude oil also declined for the week to \$82.45 a barrel, which is 1.88 percent lower than last week.

OPEC basket, from its side, ended the week higher by about 1 percent to close at \$80.95 a barrel.

Gold prices rose for the week with investors shifting to the precious metal after the disappointing US consumer sentiment. US gold futures gained 2.12% for the week reaching \$1372.

	Current	Week Ago	End 2009
Brent	\$82.45	\$84.03	\$77.20
OPEC Basket	\$80.95	\$80.14	\$76.19
WTI	\$81.25	\$82.66	\$79.36
Gold 100 OZ FUTR (USD/toz)	\$1,372	\$1,345	\$1,096

SELECTED ECONOMIC INDICATORS

Due Date:	Economic indicator	Latest Actual	Consensus forecast	Previous Actual
This Week				
18 Oct, Mon	Industrial Production, Sep	na	0.2%	0.2%
19 Oct, Tue	Housing Starts, Sep	na	575k	598k
21 Oct, Thu	Initial Claims, 10/16	na	455k	462k
Last Week				
15 Oct, Fri	CPI, Sep	0.1%	0.2%	0.3%
15 Oct, Fri	Retail Sales, Sep	0.6%	0.4%	0.7%
15 Oct, Fri	Mich Sentiment, Oct	67.9	68.5	68.2
KSA				
		Latest (W/W)	Previous (W/W)	YTD Change
22 Sept, Wed	Money Supply (M1), 16 Sept.	0.11%	0.29%	13.16%
22 Sept, Wed	Money Supply (M2), 16 Sept.	-0.38%	-0.67%	4.32%
22 Sept, Wed	Money Supply (M3), 16 Sept.	0.16%	-0.60%	0.94%

Color key to the numbers: Green means up, Red means down and Black means unchanged from 'Week ago'. In the 'Selected Economic Indicators' table: 'This Week', colors indicate whether markets expect the indicator to be higher, lower or the same as the 'previous' figure. In 'Last Week' colors mean higher, lower or the same as consensus. In the 'Previous actual' column, colors indicate revision up, down, or unchanged.

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