

Stock Market Review



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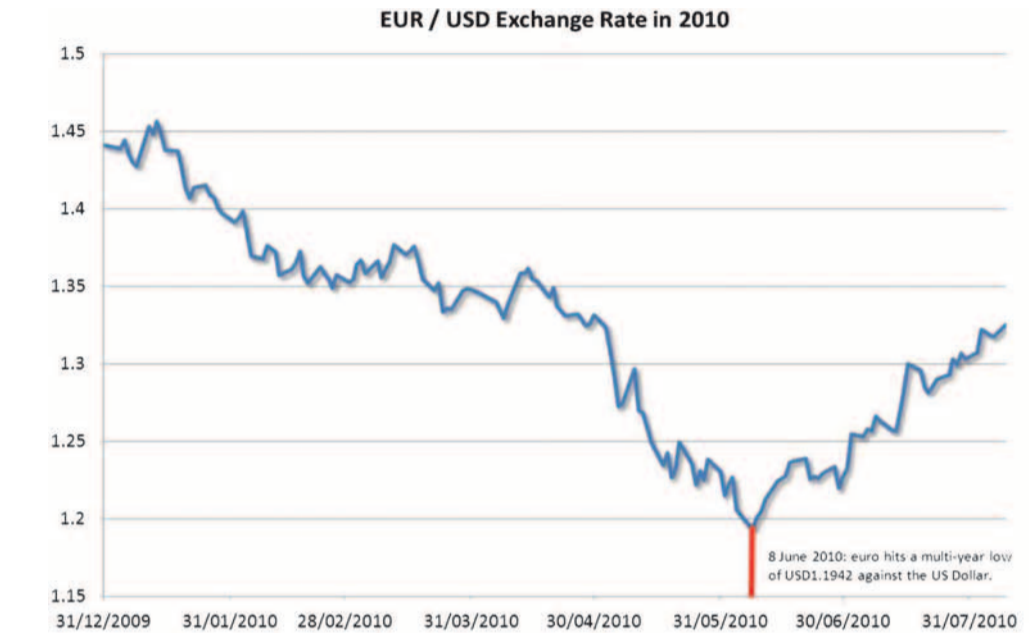
Improved sentiment towards the eurozone

Euro up 10% against the US dollar

A few weeks ago the euro was hitting the news headlines as it declined to a four-year low against the US dollar (€1/\$1.19) amid widespread fear that Greece would have to default on its debt, and possible contagion among other severely indebted eurozone countries. In June, a few international commentators were also predicting the demise of the euro as the €110 billion bailout for Greece and a \$1 trillion financial safety net for the rest of the 16-nation single currency area announced within a short period of time failed to calm the markets. Some bankers were even suggesting that euro/dollar parity could be reached by Q1 2011.

However, just two months later, the eurozone's crisis seems to have eased considerably and there are signs of a return of investor confidence as evidenced by the quick rebound of the value of the euro against the US dollar. After dropping to a low of €1 / \$1.19, the exchange rate has strengthened to €1 / US\$1.32 for a variety of reasons, namely: (i) the economic recovery in the euro area is more robust than previously anticipated; (ii) interbank lending has improved following the publication of stress test results on European banks; (iii) a positive assessment on Greece from the International Monetary Fund and the European Commission; and (iv) healthy first half earnings from a number of companies including the major eurozone banks.

Recent economic data published in Europe suggests that economies will perhaps avoid slipping back into recession while business surveys painted a brighter picture for the economy. Moreover there was encouraging news from Greece, Ireland and Spain which were at the centre of the sovereign debt crisis. Economic statistics published in Ireland showed that the "celtic tiger" emerged from recession as GDP advanced by 2.7 per cent in Q1 2010 while Greece successfully managed to reduce its budget deficit in the first few months of the year. This provided reassurance for investors with new Spanish, Greek and Irish sovereign bonds being issued without a major hitch and enabling credit spreads to reduce. The risk premium to hold the debt of peripheral eurozone states such as Spain, Portugal, Italy and Ireland shrunk to the lowest levels since April.



The publication of the stress tests on European banks also helped the recovery in sentiment across the eurozone and boosted confidence in the euro area banking system. According to the report produced by the Committee of European Banking Supervisors (CEBS), only seven of the 91 European banks subjected to stress tests failed. These banks (five Spanish savings banks, Greece's ATEbank and Germany's Hypo Real Estate) were deemed not to be capable of maintaining a Tier 1 capital ratio of at least six per cent when submitted to the toughest scenario employed by CEBS for its stress tests. Even though there was some criticism of the way in which these tests were formulated and conducted, publication of the results was warmly welcomed by the markets sending bond yields lower and helping banks to issue new debt.

Concurrently with the improving scenario within the eurozone, recent data from the US indicates that the economic recovery is losing momentum and further stimulus may be needed by the Federal Reserve to spur economic growth. The US economy has begun to decelerate, with GDP expanding by just 2.4 per cent in Q2 2010 from 3.7 per cent q/q (annualised) in Q1 and the growth rate looking set to level-off below potential. Moreover, employment growth has slowed sharply, with unemployment still at extremely high levels.

Against this backdrop, policymakers are increasingly concerned by the risk of deflation. The Federal Reserve will be keen to avoid repli-

cating Japan's experience, where deflation was symptomatic of, and in part a reason for, more than a decade of economic underperformance. Earlier this week, in the face of a weaker-than-anticipated economic recovery, the Fed reversed plans to exit from aggressive monetary stimulus. The US Central Bank left interest rates near zero and renewed its pledge to keep them low for an extended period. The immediate reaction was a further strengthening of the euro versus the dollar.

With this volatility in sentiment in such a short period of time, the international media is questioning whether the eurozone crisis has disappeared completely or whether it could be another major cause of concern in the second half of 2010 and early 2011.

ECB President Jean-Claude Trichet urged caution and explained that despite the improved scenario, money markets have not yet returned to normal. Smaller banks, especially in southern Europe, are still shut out of interbank lending as counterparties doubt their solvency.

Meanwhile, the eurozone economic recovery is likely to slow as austerity measures curb public and private demand, making it harder to reduce unemployment. Governments across the eurozone will require several years of unpopular cost-cutting reforms of pensions, welfare benefits and the public sector to reduce bloated budget deficits and national debt piles while unemployment remains high at 10 per cent.

Moreover, despite the upbeat progress report, Greece may yet have to restructure its massive debt, with some commentators claiming that bondholders may be required to take a "haircut" although this could be postponed for three to five years due to the EU/IMF bailout.

The state of affairs in Europe remains cloudy with the situation looking very different from one country to another. Above all, there exist economic imbalances and sharp differences in competitiveness between northern European states led by Germany and Mediterranean eurozone countries. The export-driven German economy is powering ahead while Greece languishes in an austerity-induced recession and Spain and Portugal struggle with anaemic growth while trying to curb their budget deficits. As a result of the uncertainty in the recovery prospects for both the US and the eurozone coupled with subdued inflationary expectations, various international economists are now claiming that interest rate rises are unlikely to take place anytime soon and are earmarking possible hikes not before the third quarter of 2011. They also see the dollar weakening further against the euro in the short-term, before eventually recovering towards \$1.20.

Against this backdrop of an extended period of low interest rates, demand for fixed interest securities is likely to remain robust as evidenced also locally by the strong take-up of the bond issue by Mediterranean Investments Holding plc and last week's Malta Government Stock offerings.

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