RICHES FLORES RESEARCH

GLOBAL MACRO & THEMATIC INDEPENDENT RESEARCH

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GLOBAL MACRO

Mind your Back!

France is stumbling, Germany weakening, the U.S. wobbling, Brazil is down a match point and J. Bullard has promised us rate hikes by March… the summer is going to be a real barn burner! Will M&A activity be robust enough to continue to fuel investor confidence? It's looking like things are getting tight, considering recent economic developments and central banks' bungled messages. Let's take a closer look at the most disruptive factors from the week.

Euro area: if Germany is a locomotive, is France the caboose?

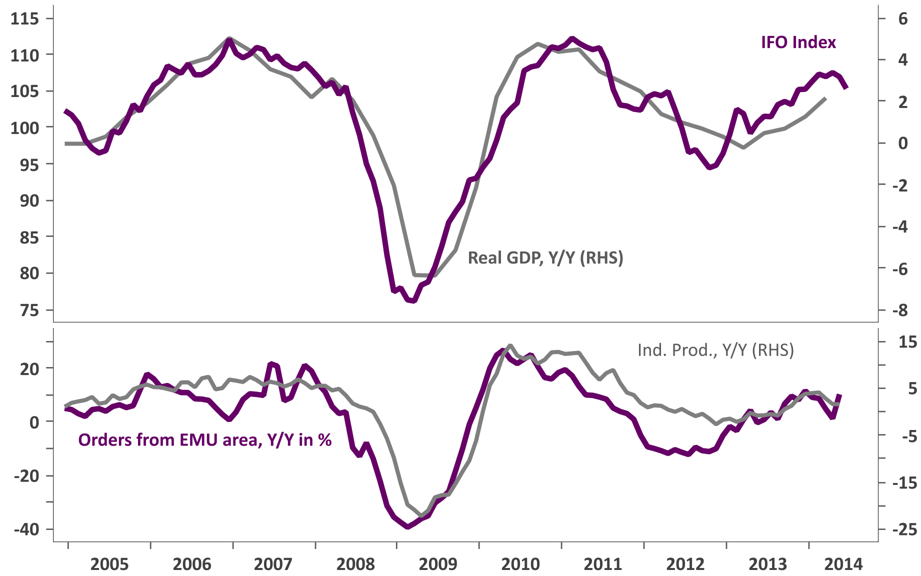
It's been a few months now that we've seen signs that the euro area recovery is out of gas, which has had the following effects:

1- to grind German export growth to a halt, whose pick-up in H2 2013 was solely attributable to the improvement in intra-euro area markets

2- to drag German inflation down alongside other countries, defying the conventional wisdom that expects it to aid the convergence, over time, of euro area economies.

The trend is slipping in Germany, as illustrated by the increasingly marked slowdown in the IFO index. With no catalysts emerging from the rest of the world, disappointing exports quickly dimmed the flicker of light on the consumption front. After a first quarter driven by a mild winter and a contribution of 0.70 from corporate stocks to the growth rate of 0.8%, second quarter growth could come out to zero or even negative if inventory build-up were to cool. It is hard to see how Germany will meet the consensus' forecast of 2% growth for the year. In fact, growth may not even surpass 1.5%, particularly if France sags, as a growing number of indicators seem to point to.

German Real GDP Growth and Main Indicators



Sources: RichesFlores Research, Macrobond

French data has been worrisome. Despite the good news of a rebound in consumption for May, which will undoubtedly rescue Q3 GDP growth, bad news came from all areas of the economy this week, including unemployment, real estate and - last but not least - business sentiment. For the first time since May 2013, the industrial trend indicator published by INSEE moved deep into negative territory this month. In fact, at -0.87 it is at its lowest since end-2012 and close to the low-end of the band within which it is supposed to fluctuate (+/-1).

In line with PMI surveys, the INSEE figures are troublesome for the months to come. France is sickly, the outlook for the greater euro area is muddled and drifting ever further from the consensus forecast on inflation and growth.

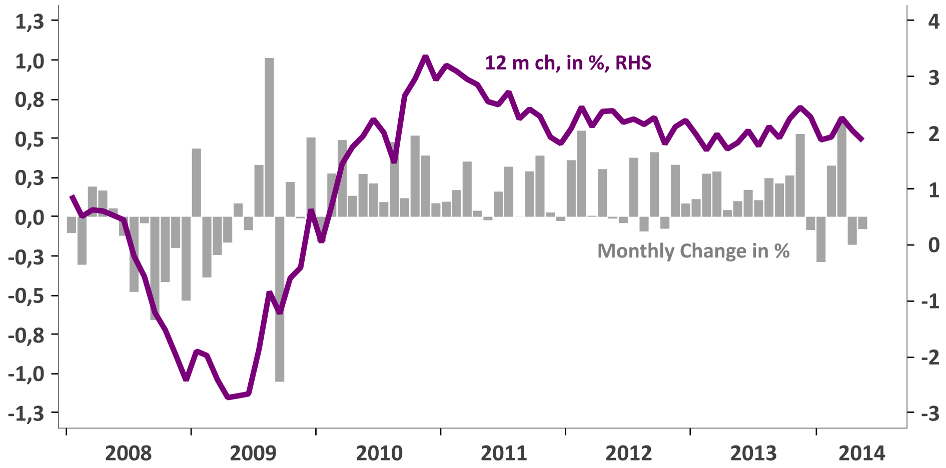
U.S. growth will not exceed 1.5% this year

If the American economy were, as promised, to rebound, we might be able to expect more from the euro area economy. But, despite reassurance from many market observers, a U.S. up-tick does not seem to be on the horizon.

Here again, disappointments abound, particularly on the consumption front, which contracted for two consecutive months in April and May. On the corporate front, developments are hardly any more encouraging where, despite a slight improvement in SME confidence for the last two months, the investment outlook continues to stall. In addition to being unstable, durable goods orders are also very weak and there is no guarantee that things will get better any time soon. We have a hard time seeing how Q2 growth will offset losses from the first quarter, which are now pegged at a sizeable -2.9%. Unless the situation gets better soon, the official forecasts - even after the FOMC's revision from June 19th - are going to be a big stretch. **The hope, which has now been dashed, of**

seeing growth in the vicinity of 4% on annualized basis in the second quarter would put full-year 2014 growth at a maximum of 1.5%...

US Household Consumption, Cst Prices



Sources: RichesFlores Research, Macrobond

Business activity trends, while not particularly poor, remain mediocre, leaving little room for optimism on the pace of growth and jobs, which would be needed to reverse the price trajectory. Souring German industrial sentiment, which has been confirmed by the deterioration of export orders, and the return of disappointments in France has dimmed the hopes of an improvement. The recovery in the euro area has plateaued as illustrated by the drop, in recent months, in the European Commission's Economic Sentiment Indicator. Another few months (again, optimistically) will be needed before the outlook on business activity - and therefore consumer prices - picks up.

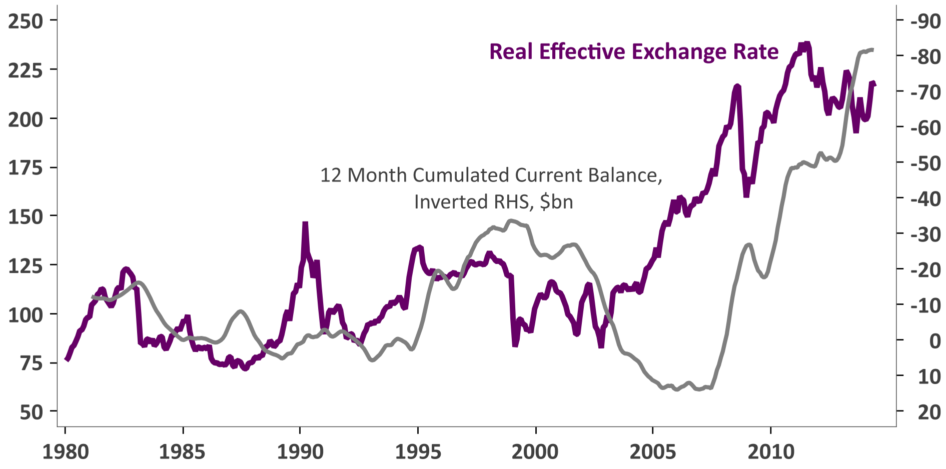
The ECB's forecast for a gradual return of 2% inflation in the euro area seems, for the time being, like a pipe dream. For want of more ambitious initiatives from the ECB or governments, disappointments will abound

It's match point in Brazil

Lastly, the situation in the emerging markets is struggling to brighten. Indicators in China may have stopped deteriorating but it is not nearly enough to fuel the recovery that would be necessary to dispel the risks of another economic slowdown that are threatening a number of developing countries, particularly Brazil and of course Russia and Eastern European countries facing the risks posed by the current crisis.

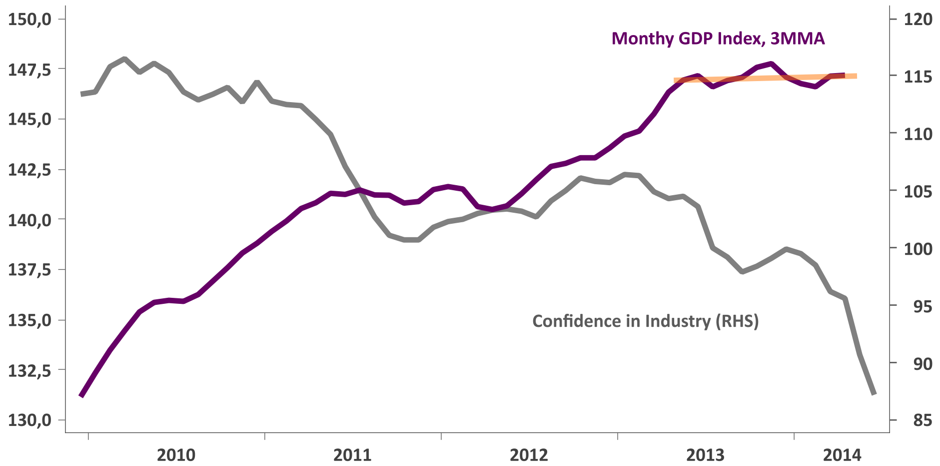
In April, the monthly GDP indicator in Brazil was on par with levels in June 2013, reflecting a prolonged period of economic stagnation. Despite the lift from the 2014 World Cup, most economic indicators are poor, the social climate remains deeply unsettled and inflation is too high to write off the risk of a fresh rate hike, as the central bank has already announced.

Real Exchange Rate of Brazilian Real and Current Account Balance



Sources: RichesFlores Research, Macrobond

IBC Activity Index and Industry Confidence in Brazil



Sources: RichesFlores Research, Macrobond

When the country wakes up from the World Cup, it might find itself in a collective hangover, both from a business activity perspective and a currency one. In fact, the real is still considerably overvalued and is exposed to investor wariness.

The Brazilian economy may not have much impact on the international scene, but fresh tension in Brazil could be the event that sparks widespread instability in the emerging world where low growth and an increasing number of geopolitical lightning rods have brought the situation to a head.

Beware of the impatience of certain central bankers

Given the tense situation, communication blunders made by monetary policy chiefs are a source of growing instability. Mr. Carney in the United Kingdom and James Bullard in the United States have been the source of communication miscues that could prove to be very costly indeed. The asymmetry of risks between potentially being behind or ahead of the inflation curve is important given the present situation. Hasty conclusions could cost the capital markets - and future growth - dearly.

Those in charge of monetary policy are walking on thin ice. Let's hope that the message conveyed by Ms. Yellen on June 18th will match what was said during the FOMC meeting on the same day. The minutes from the meeting are slated to be released on July 9th. Let's also hope that Mr. Draghi will be more convincing in his next press conference in July!

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