

JVB Financial Group, LLC

# CRONIN'S CORNER MONTHLY

END OF YEAR - 2011

## A Perspective on the International Economy

by Keith Cronin, JVB Senior Vice President of US Credits and International Sovereign Trading

As the year shuffles towards the inexorable ember of its being, there was a lot in 2011 to arouse much in many. From the significant Arab Spring to the banal Royal Wedding in England and from the earthquake and tsunami catastrophe in Japan to the deaths of Gadhafi and Bin Laden, the world may seem like it has spun upon an axis of profound change. In many ways it has and in many others it, inevitably, has not. There are multitudes that will feel that life's quality has deteriorated in the past year as global economic turbulence grew more pronounced and detestable global political ineptitude pullulated across a weary planet. As an economy the US finally began to experience seedlings of recovery as hope continued to waft in the face of unsustainable joblessness and fatuous politics in Washington. As a continent Europe arguably stole the headlines and as a country Germany arguably tried to avoid them. As the New Year wags us forth we all question whether things will improve or not. Is it actually possible that things could get even worse? Of course. Is it likely? Probably, yes.

The American economy will hardly overwhelm in the New Year but at least the world's economic behemoth looks very unlikely to double dip back into a recession. Consumer sentiment indices and, more significantly, consumer purchasing patterns seem poised to end the year on a limited upswing. Retail sales are at least recording positive returns month over month and the beleaguered real estate sector may finally be experiencing some relief as housing starts in November hit a one year high. Monetary policy will almost certainly remain more than accommodative for all of next year as Operation Twist continues to be implemented and rates stay close to zero. We doubt Bernanke and his team of policy makers will have to ululate over upward price pressures either as we feel that headline inflation should remain contained as the global economy, and in particular Europe, continues to splutter. However, whilst the latest unemployment numbers showed a marked improvement, and a jobless rate of lower than nine percent, we doubt that the unemployment rate will breach the eight percent level next year as the recovery, despite improving data, is likely to remain languid. The US economy will face further internal risks in an election year whence the political japes and partisan posturing that were displayed this year in trying to deal with the country's national debt and budget cuts, will likely only intensify. The effluvium of despicable incongruity that oozed from Washington that nearly caused a federal government shut down on at least three occasions and took US debt to the brink of default has revealed congress for what it is – a circus of Muppets. With income tax cuts destined to expire and automatic spending cuts primed to kick in, house leaders, senate leaders and a foundering President need to break the splenetic political stalemate that could cost the US economy trillions of Dollars. The gimcrack that has become Washington is

a very real threat to America's economic stability and while the decoupling thesis might continue to garner more support the US remains vulnerable also to arguably the greatest threat posed to the global economic theater in the past three years – Europe.

This year has seen summit upon summit across a geographical lesson of European dithering which has yielded pretty pictures and rousing rhetoric but little or no definitive solutions to a worsening crisis. The trilogy of woes smacked across European brows that emanated from the Sovereign and leaked to the financial, will likely continue to remain very much rooted in the macro.

One of the few areas of apparent adamancy and transparency from Europe has come recently from the ECB and new boss Mario Draghi. His repeated insistence is that the ECB's top priority is to bring price stability to the Euro-zone and to act as a guardian for the financial industry and not to solve the fiscal issues facing the area's sovereigns. In this regard he has, thus far, been true to his mandate as the ECB has colluded and also acted alone in an attempt to ensure that the region's banks are funded and thus able to lend to consumers and to themselves. The coordinated central bank initiative to cut the rate on the Dollar swap lines by fifty basis points and to extend their tenure by another six months was cheered and immediately following the announcement relief risk traded with aplomb. The initial reaction was one of aspiring will rather than of fundamental assurance and deep down many knew that this was not going to rid Europe of its plight and that its effectiveness would eventually amount only to a symbolic show of global unity. The ECB's Long Term Refinancing Operation (LTFO) has generated cautious overtones of a QE initiative and a surreptitious way for the ECB to generate more demand for sovereign debt. The LTFO was met with almost vulpine acclaim upon its formal introduction as over five hundred European lenders borrowed nearly five hundred billion Euros over a period of about three years. The recent retreat in peripheral yields and relatively successful auctions may have been as a result of European banks buying the debt only to then use that same debt as collateral against these ultra cheap loans (at 1%) from the ECB. However, we doubt that many – if any – European lenders will be tempted into a blatant carry trade of borrowing at 1% and buying bonds with yields of over 6%. European banks that are already exposed to the Sovereign space, we feel, have no incentive to augment that exposure because whilst programs like the LTFO have addressed banks' funding issues they have not addressed the sovereign solvency issues at all. Therefore, if the LTFO was intended to furtively push sovereign yields lower, it has and will continue to fail. Default risk across the European periphery

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Financial Group, LLC. With almost a decade of fixed income trading experience, he began on HSBC's retail desk and moved on to HSBC's proprietary trading desk, wherein his specialty became trading Investment grade US Corporate Bonds. Mr. Cronin is a graduate of the University of Cork in the Republic of Ireland with an Honors Masters Degree in Economics.

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remains palpable with Greece to the fore as a conflict between the IMF and the country's creditors seemingly likely to erupt. The Washington based fund is asking for lenders to accept a lower coupon – and thus assume greater losses - on the bonds that will be issued by the Greek government which was part of the debt swap deal agreed in conjunction with the second bailout of one hundred and thirty billion Euros back in October. Essentially we are closer to a Greek default this January than we were last January and even the Germans themselves have come to the realization that a Greek default is now, a very real possibility. If Greece can default in an orderly fashion (and this might in itself be a paradox) whilst still a member of the Euro zone, then the fall out might be containable. Certainly a default would release the Greeks from the huge debt burden that smothers them and would allow the authorities to reverse the draconian austerity measures that have been imposed on conditionality for the loans which would allow them to then focus on injecting growth policies back into the beleaguered economy. Undoubtedly the contagion trade would erupt upon a Greek default but at this stage with the economy destined to shrink at least five percent in 2012 the austerity measures are simply making life in Greece unbearable by simply procrastinating the unavoidable. Europe can survive a Greek, and even perhaps a Portuguese and Irish default, but the specters of Italy and Spain going the same way would be catastrophic and would surely amount to a dismantling of the Euro-zone as it exists today. Thus, the forthcoming months will, we think, bring an intensification rather than a diminution of events in Europe. The tighter fiscal pact that should be crafted by March that will include automatic punitive sanctions upon fiscal recalcitrance is but a lambent mirage of optimism and we expect the pleas for further and deeper ECB intervention to permeate market sentiment significantly. Additionally, the European economy is probably already in a recession and thus we expect the ECB to cut rates further in an attempt to unravel the truckled calamitous monetary ideals of the departed Trichet. The slowing European economy will certainly drag upon American exports but the vulnerability of Europe's banks – despite the LTFO et al. wherein most of the money lent was put back on deposit with the ECB – could further strain US institutions which might result in these same lenders shoring up their balance sheets instead of supplying credit. An already reluctant consumer would be put to the sword on a reemergence of tighter credit in the US which would then probably tip the borderline American economy back into the red. With Greece already castigated to the annals of the egregious and the irredeemable across most market metrics, focus will certainly shift from Athens to Rome in the forthcoming year with the dilatory cabinet in Berlin the perpetual last word on any European salve.

As Europe garnered most of the press in 2011 events in China seemed largely sterile but we feel that next year China's weighty global affect will resurface as the Chinese economy continues to slow. The events in Europe have, it seems, finally waded east and since Europe is China's biggest customer, the developing slowdown on the continent will only serve to further develop the slowdown in China in the forthcoming

period. Chinese exports have been falling and will continue to do so next year. In 2010 export growth was over thirty percent. In 2011 it will likely be just over twenty percent and although the numbers taken in absolute terms are still phenomenal the economy will likely only grow close to eight percent next year. The People's Bank of China (PBOC) will likely cut bank reserve requirements again – as they did recently to twenty one percent- and we are likely to see a gradual reduction on bank reserve ratios as a looser form of monetary policy be implemented against a backdrop of stubborn inflation. Inflation concerns may prevent interest rates from being cut directly but another fiscal stimulus is also a possibility but not likely to be as grand (at least initially) as the six hundred billion plus package implemented during the financial crisis. If China's export markets start to wither, the domestic market will not be enough to sustain China and combined fiscal and monetary policy may be required to energize the world's second largest economy. Certainly Chinese policy will have implications across all market sectors as pro growth policies might be commodity bullish and put downward pressure upon the Dollar and perceived haven assets. Conversely, if the European economy's recession is too deep, then we are likely to see further selling of commodities and risk in general and the currency units that are thus affiliated. The other issue that could affect China in the forthcoming year, and unavoidably the global theater, is the country's property market and the local government debt. Local authorities have limited sources of funding themselves so they have, for years, sold public property to developers and as property prices continued to rise (property prices increased about fivefold in the past decade) Chinese investments were keen to be involved. In fact, property investment in China accounts for about ten percent of GDP and thus its influence is potent. In November about 70% of cities reported falling property prices and reports suggest that about 22 months of unsold real estate inventory exists in Beijing and in Shanghai. Authorities are now restricting the number of properties that people are allowed to buy and having raised interest rates to curb inflation property prices have been pushed lower. The Chinese stock market has been aware of the country's developing woes and this year the Shanghai Composite Index fell just under twenty three percent as internal and well as global frailties have been emphasized. The Renimbi appreciated just under five percent versus the US Dollar but if the European slowdown becomes exacerbated we are likely to see the rate of appreciation tempered which will undoubtedly provoke further caterwauling from Washington and Berlin. As the Chinese year of the dragon is ushered in, policy makers in Beijing will, we think, wrestle with their dilemma to ensure at all costs that the economy does not hard land. The Chinese puzzle will be how to continue and cool the property market whilst also insulating the economy from a global economic slowdown and at the same time juggling the potential political fallout from a possible weaker currency and appearing to support the European Sovereign whilst protecting the country's vast foreign exchange reserves. A conundrum capable of slaying any dragon.

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