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CRONIN'S CORNER MONTHLY

A Perspective on the International Economy

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MAY 1, 2009

The ancient culture of Mesopotamia is one of the earliest known civilizations to be captured by history and it is also one of the most influential. This area, known as the 'Cradle of Civilization', came into being around 4000BC and some of the region's early denizens included the agricultural Sumerians and the scientific and architectural Babylonians. The peoples of Mesopotamia invented many technologies including glass making, textile weaving and irrigation. Even the origins of Philosophy can be traced back to ancient Mesopotamian thought which was to have a direct impact upon Greek philosophy many years later. Today this land continues to have a profound impact upon contemporary life. Although the name has changed, its global influence remains sustained. We know it today as the Middle East.

Whilst the earliest economies developed by the Sumerians were based on agriculture and trade this early 'laissez faire' economic model had nothing to do with oil. The oceans of oil in the Middle East were essentially discovered when industrialists decided that the U.S alone could not satiate the world's oil demands. As increasing numbers of countries began emerging into industrialized economies at the beginning of the twentieth century and industries like airlines began to mushroom oil became an indispensable commodity. As the demand for oil and petroleum products has grown so has the wealth of many nations in the Middle East. However, this almost one dimensional dependence upon a product carries its risks and the current economic blight has shown that it does not discriminate. Every continent, and arguably every country, in the world is being negatively impacted by the current recession and the Middle East is no exception.

Saudi Arabia, the largest economy in the Arab world, holds about twenty percent of the earth's reserves and is the world's largest exporter of oil. Nearly half of the country's GDP is accounted for by oil and over ninety percent of export revenues are derived from the black gold. Estimates have the country's average growth rate at about twenty five percent in the past six years but this year it may not be so. As oil prices have plunged from their highs in 2008 and OPEC has responded by cutting output, this may result in growth being virtually flat this year accompanied with further downside risks. It is also likely to see an outflow of foreign investments which will mean that the government will probably have to increase its role in financing the country's infrastructure and development of indigenous industry. However Saudi Arabia's banks seem to be well capitalized and the government has large amounts of savings which enables them to guarantee all bank deposits. This monarchy may remain vulnerable to oil prices and global demand but may emerge from the economic malaise in better shape than many of its neighbors.

Oil sales account for just over half of Kuwait's GDP, ninety percent of export revenues and close to one hundred percent of all government income. OPEC's agreement to cut production will obviously hamper oil output and exports will continue to fall as the Asian region in particular grapples with the global recession. The country's central bank has now cut its benchmark interest rate to 3.5 per cent is order to further stimulate the economy as well as implementing a proposal to inject over $5 billion into the country's financial institutions. Kuwait's banks seem to be a little more vulnerable and the banking sector rating for the country was recently lowered to BB. As the world's seventh largest oil exporter Kuwait is obviously hugely dependent on oil but Kuwait has a large store of foreign assets and its external surpluses should help the economy negotiate further declines in oil prices. Similar scenarios are likely to play out for countries like Bahrain and the United Arab Emirates whose economic models are tightly wound around oil and its variables but whose governments have

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had the resources to shore up the economies with readily available funds when deemed necessary.

As the demand for oil has fallen, OPEC has responded by cutting production in an attempt to find a floor for prices. Qatar however is defying economic theory, essentially ignoring shifting demand patterns and actually increasing production, not of oil but of natural gas. A country that maintains the US regional air base in the Middle East and the Mideast outpost of the U.S. military's central command, Qatar is forging ahead with ambitious plans that will involve the world wide distribution of natural gas. The impressive project will make Qatar the world's largest supplier and will ensure additional income which will solidify the tiny nation's clout in the region. In its first Sovereign bond issuance since 2000 Qatar issued a two billion Dollar 5 year paper and one billion of a 10 year piece earlier this month. This may help renew interest in the Middle Eastern bond market which may lead to a stronger and more active bond market in the region in the future. These bonds are rated AA and are trading at +241/5yr and +295 /10yr respectively at the time of writing which is about 100 basis points tighter from the issuance price.

The majority of the region's exchange rates have been pegged to the US Dollar for over two decades and up until last year the Dollar's role in this seemed to be pretty secure. Since oil and gas are traded in US Dollars a peg to the American unit had been successful in negating foreign exchange risk for exporters and therefore it has helped strengthen the region's wealth base. However, as the US Dollar capitulated last year, versus the Euro in particular, this created severe inflation problems in the region. Import costs into the Middle East soared and with a Dollar peg in effect the Federal Reserve's interest rate cuts left many Middle Eastern countries with little or no tools to fight the inflation spreading through the region. This scenario then led to speculation that the US Dollar would no longer be used as a peg since Kuwait had already dropped the peg in 2007 and instead pegged the Kuwaiti Dinar to a Dollar-heavy basket of currencies. It is unlikely though that we will see countries like the United Arab Emirates, Saudi Arabia, Qatar and Bahrain depart from the USD peg at this stage especially with so much economic certainty present on a global scale. 2010 is expected to herald in a single currency for the GCC (Gulf Cooperation Council) and it is likely that thereafter the US Dollar's role may be diluted. A situation like that of Kuwait wherein the new single currency will be pegged to a basket of currencies that is predominately weighted with the US Dollar is likely.

The EURO will likely have a more significant role in such a scenario though given that the EU is the GCC's number one trading partner. There have been calls from some oil producing countries to begin denominating oil in EUROs due to the inherent problems that a weaker Dollar brings with it. This would obviously lead to higher gas prices in the US, given where current exchange rates are, and possibly cause a rebalancing amongst central banks of their foreign exchange reserves. This would put severe downward pressure upon the greenback which would exacerbate inflationary problems in the US and push rates higher. Although a complete Dollar dismissal at this stage is unlikely, next year's single currency events within the GCC should be looked at very closely as it may herald a very slick patch for the Dollar in Middle Eastern financial operations. ▪

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