Research & Strategy I Asia-Pacific

DR FRANK SHOSTAK
T: + 612 8273 8814
fshostak@mfglobal.com

PETER STELLIOS
+ 612 8273 8813
pstellios@mfglobal.com

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MF Global Weekly Report

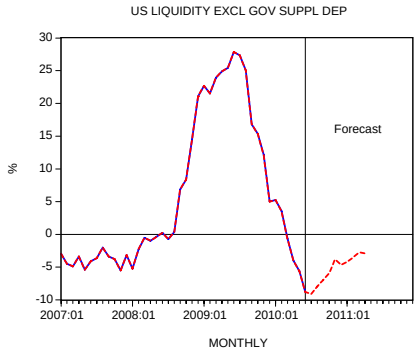
GLOBAL FOCUS

CONTENTS

What lies ahead for the US stock market?

Based on the past money supply rate of growth we have estimated that the growth momentum of US industrial production could come under pressure from the second half of this year. Also based on the past money supply rate of growth, price inflation in terms of the CPI is forecast to hover above **2**% during July to April next year. Given the likely further strengthening in the growth momentum of inflationary commercial bank credit and sideways movement in the growth momentum of Fed's balance sheet, we expect the yearly rate of growth of liquidity to bottom by July this year. Based on this our model expects the S&P500 to remain under pressure until November this year. Now if the pool of real savings is in serious trouble we suggest that the rebound in November unlikely to be sustainable. In the meantime, Japanese economic activity remains stagnant. In the UK industrial production had a visible strengthening in May. In Australia the unemployment rate stood at **5.1**% in June against **5.8**% in June last year.

KEY GRAPH

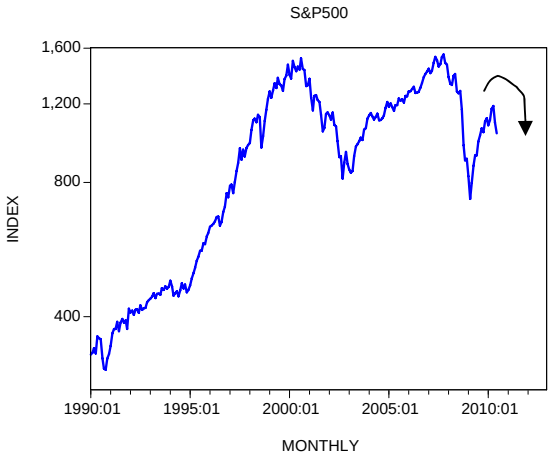


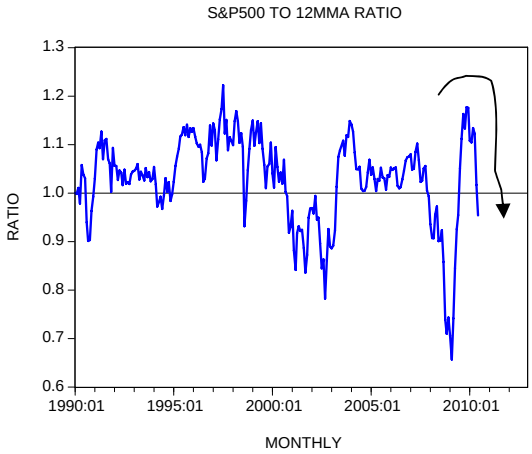
Eco-flash

According to our model the price of gold could fall to below $**1,100** by January (see p 8).

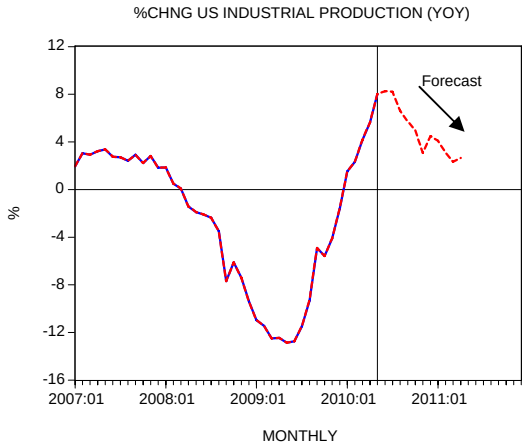
Prospects for S&P500

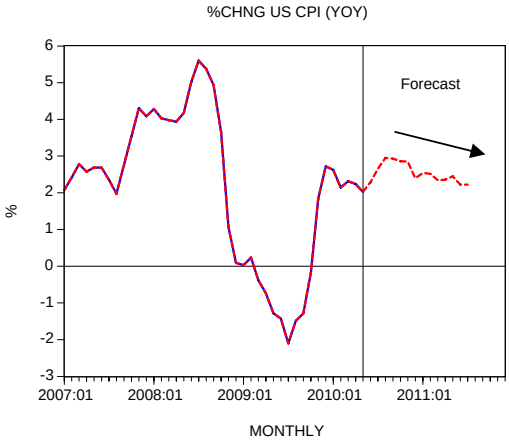
At the end of June the S&P500 closed at **1,030.71** – a fall of **5.4**% from May. This was the 2nd consecutive monthly decline. The growth momentum of the S&P500 displays a visible decline. The yearly rate of growth fell to **12.1**% last month from **18.5**% in May and **50.3**% in February. The S&P500 to its 12-month moving average fell to **0.95** in June from **1.017** in May. From this perspective the stock price index has fallen into an undervalued area.



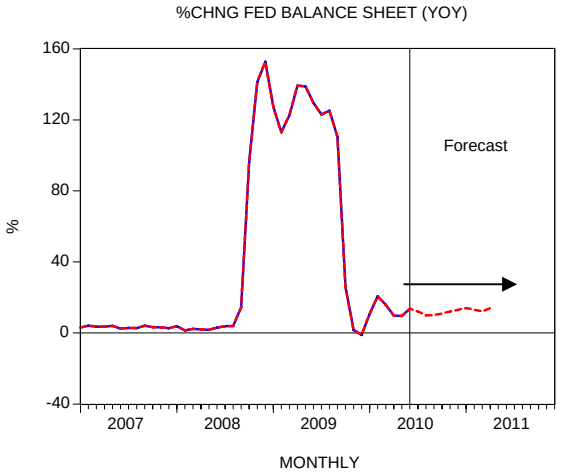


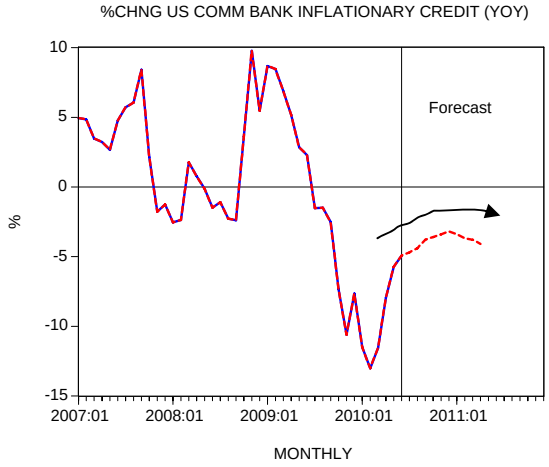
To assess the future direction of the S&P500 we have employed our stock market model. We have run the model until April next year. The key driving variable of the model is monetary liquidity depicted by the gap between the yearly rate of growth of money supply and the yearly rate of growth of nominal economic activity. (Note that monetary liquidity mirrors the interaction between the supply and the demand for money). Based on the past money supply rate of growth we have estimated that the yearly rate of growth of industrial production after rising to **8**% in May could fall to **4.5**% by December before settling at **2.7**% in April next year. Also based on the past money supply rate of growth the yearly rate of growth of the CPI is forecast to rise to **2.9**% by September from **2**% in May before falling to **2.4**% in April.



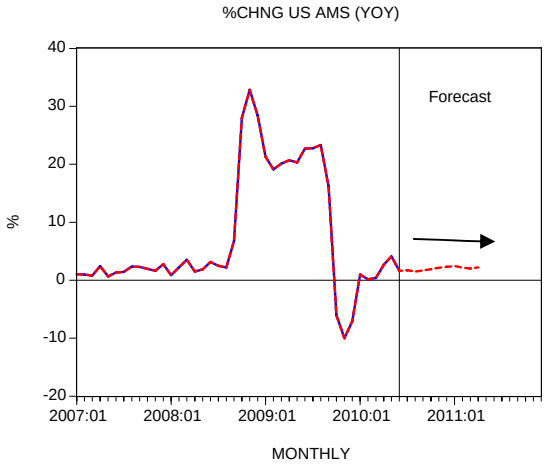


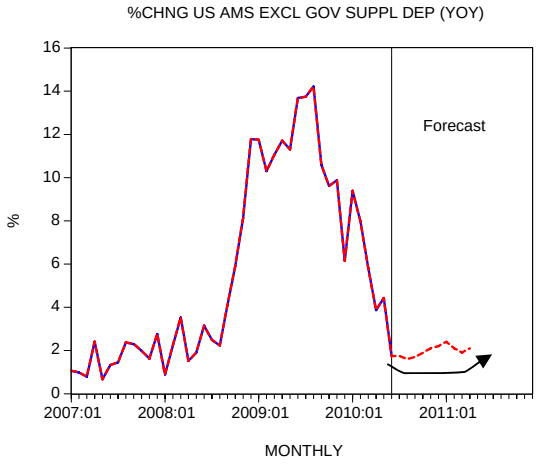
The key driving variables of our monetary measure AMS are the balance sheet of the Fed and the inflationary credit of commercial banks. After closing at **13.7**% in June the yearly rate of growth of the US central bank balance sheet is forecast to ease to **10**% by September before rising to **14**% in April. In short, we forecast the rate of growth to hover at around **12**% during July 2010 to April 2011. The yearly rate of growth of inflationary credit, which stood at minus **4.9**% in June is forecast to increase to minus **3.2**% by December before falling to minus **4.1**% by April next year.



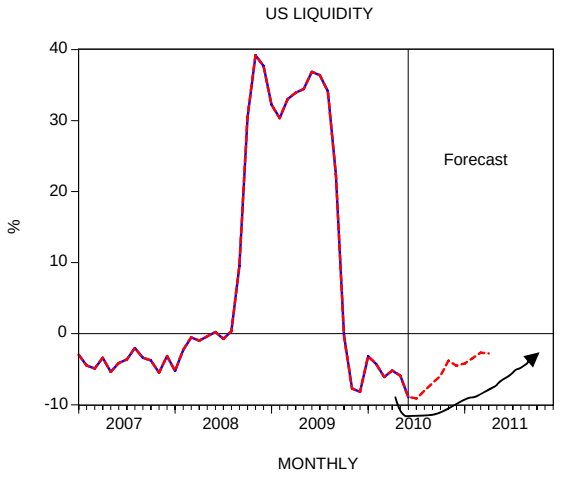


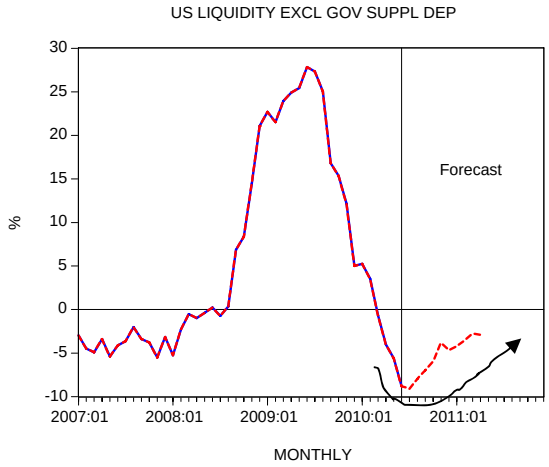
Based on these inputs the yearly rate of growth of our US monetary measure AMS is forecast to ease to **1.5**% by August before climbing to **2.4**% by January. By April the yearly rate of growth is forecast to close at **2.2**%. Also the growth momentum of AMS, which excludes the Treasury supplementary financing program, is forecast to bottom by August. Year-on-year the rate of growth is forecast to close at **1.6**% in August before rising to **2.4**% by January. By April next year the rate of growth is forecast to be at **2.1**%.



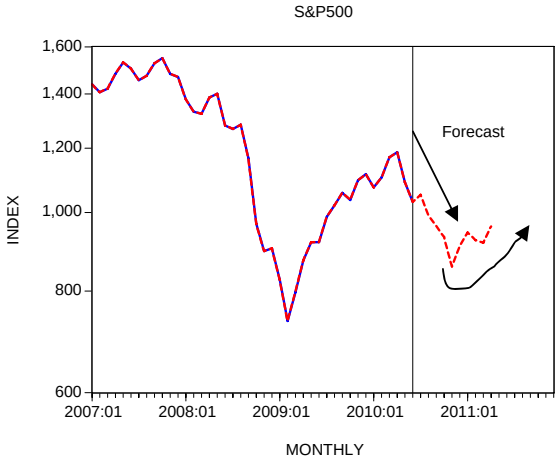


Given our forecast for AMS coupled with the forecast for industrial production and the consumer price index, our liquidity measure is forecast to bottom by July before resuming a visible increase. The yearly rate of growth of our liquidity measure is forecast to fall to minus **9.1**% by July before climbing to minus **2.8**% by April next year. Also, our measure of liquidity derived from AMS adjusted for the government supplementary financing program is forecast to bottom by July. Year-on-year the rate of growth is forecast to rise to minus **2.9**% by April next year from minus **9.1**% in July this year.





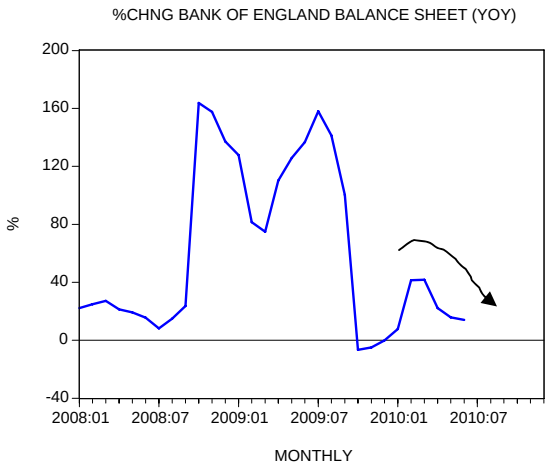
In our model we also employ the unemployment rate as a supporting variable. We don't expect a significant improvement in the unemployment rate during the period from now through April 2011. The unemployment rate is forecast to ease to **9.3**% by September before rising to **9.5**% by April. In short, we forecast the unemployment rate to hover on average at **9.4**% during this period. Given all these inputs our stock market model expects the S&P500 to bottom by November this year at **860** before resuming a rebound – a fall of **16.5**% from the end of June. By April next year the stock price index is forecast to rise to **960**. Now if the pool of real savings is in serious trouble it is unlikely that the rebound of the index will be sustainable.

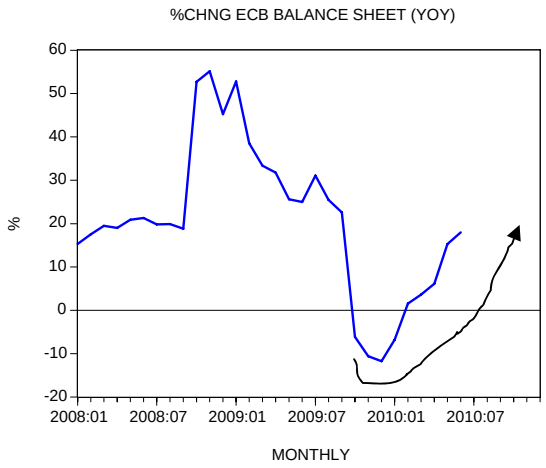


Focus on major central banks balance sheets

The growth momentum of the Bank of England (BOE) balance sheet has eased further in June. The yearly rate of growth fell to **14.1**% from **15.8**% in May and **22.2**% in April. Note that in March the rate of growth stood at **41.8**%. Observe that in June last year the yearly rate of growth stood at **136.7**%.

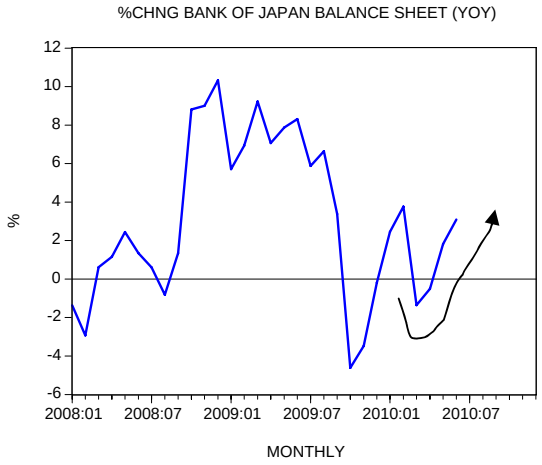
In contrast the growth momentum of the European central bank (ECB) balance sheet strengthened further last month. Year-on-year the rate of growth climbed to **18**% from **15.3**% in May and **6.1**% in April. Note that the yearly rate of growth stood at **25**% in June 2009.

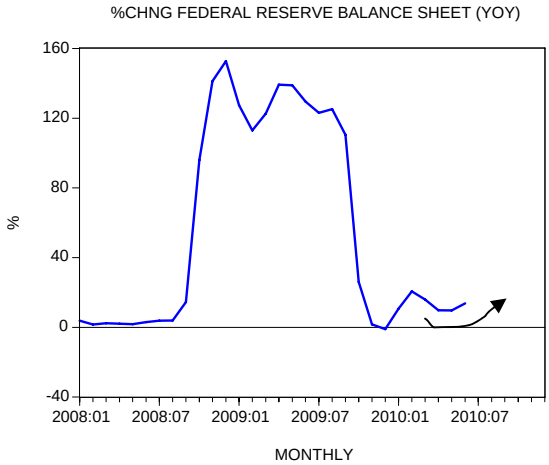




The growth momentum of the Bank of Japan (BOJ) balance sheet strengthened in June from May. The yearly rate of growth rose to **3.1**% from **1.8**% in May and minus **0.5**% in April. In June last year the yearly rate of growth stood at **8.3**%.

The growth momentum of the Federal Reserve balance sheet strengthened visibly in June. Year-on-year the rate of growth climbed to **13.7**% from **9.6**% in May and **9.8**% in April. Observe that in June last year the yearly rate of growth stood at **129.6**%.

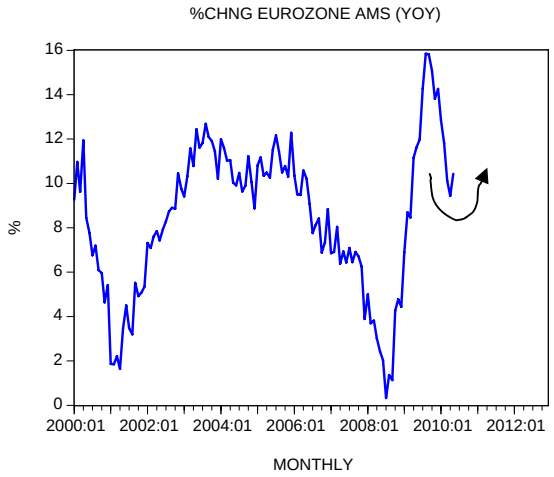


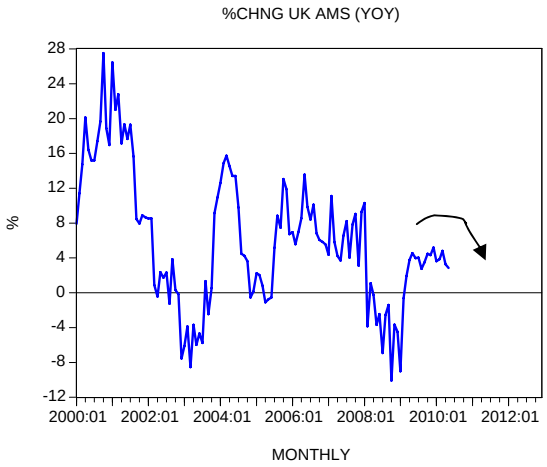


Latest trends in the money supply of major non-US economies

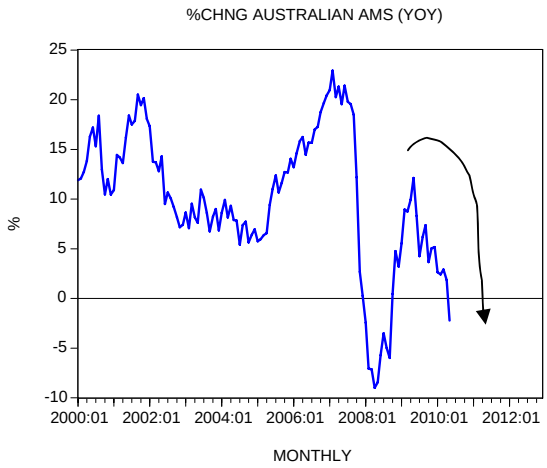
The growth momentum of Euro-zone AMS strengthened in May. Year-on-year the rate of growth rose to **10.4**% from **9.4**% in April. Note that in May last year the yearly rate of growth stood at **11.6**%.

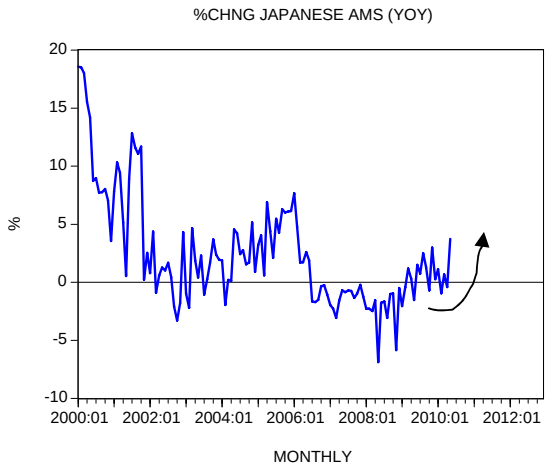
In contrast the growth momentum of UK money supply has eased in May. The yearly rate of growth fell to **2.8**% from **3.3**% in April and **4.8**% in March. Also note that in May last year the yearly rate of growth stood at **4.5**%.





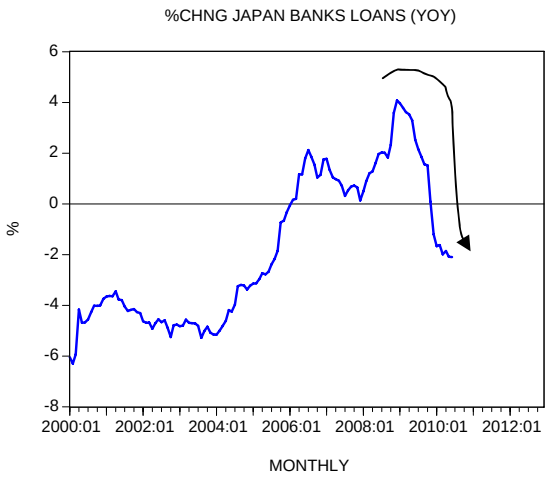
The growth momentum of Australian monetary measure displays a visible decline. After rising to **12.1**% in May last year the yearly rate of growth plunged to minus **2.2**% in May this year. Observe that in April the yearly rate of growth stood at **1.9**% and **2.9**% in March. The yearly rate of growth of Japanese AMS has visibly strengthened in May. The rate of growth climbed to **3.7**% from minus **0.4**% in April and minus **1.5**% in May last year.

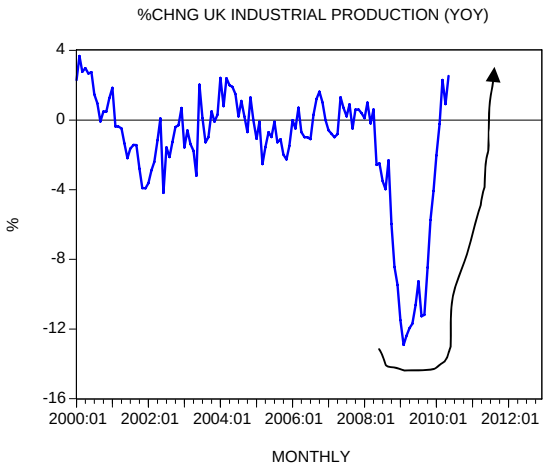




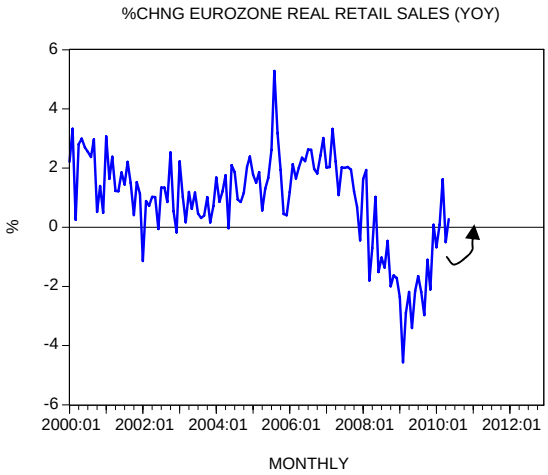
Focus on non-US economic indicators

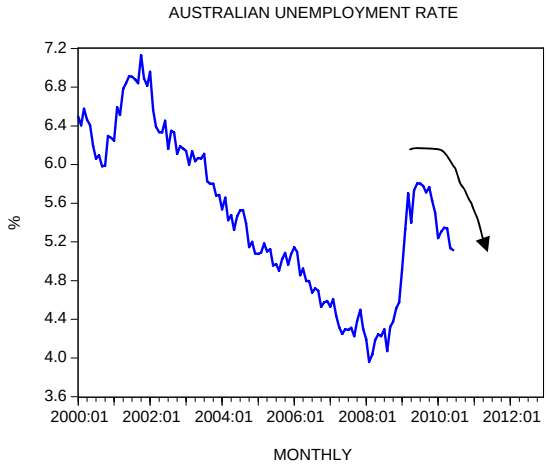
The growth momentum of Japanese banks lending continues to display a visible weakening. The yearly rate of growth of bank lending, which excludes credit unions, stood at minus **2.1**% in June after minus **2.1**% in the month before. Note that in June last year the yearly rate of growth stood at **2.5**%. In the meantime, Japan's core machinery orders fell by **9.1**% in May after rising by **4**% in April. In the UK the yearly rate of growth of industrial production has visibly strengthened in May. The rate of growth jumped to **2.5**% from **0.9**% in April.





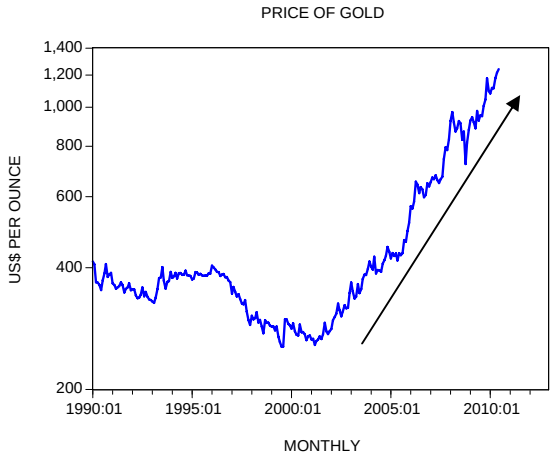
Euro-zone seasonally adjusted real retail sales rose in May by **0.2**% after declining by **0.9**% in April. Also the growth momentum of retail sales has strengthened in May. Year-on-year the rate of growth jumped to **0.3**% from minus **0.5**% in April. Meanwhile the Australian unemployment rate seasonally adjusted stood at **5.1**% in June against **5.8**% in June last year. Furthermore, total employment seasonally adjusted increased by **45,900** last month to **11.101** million.

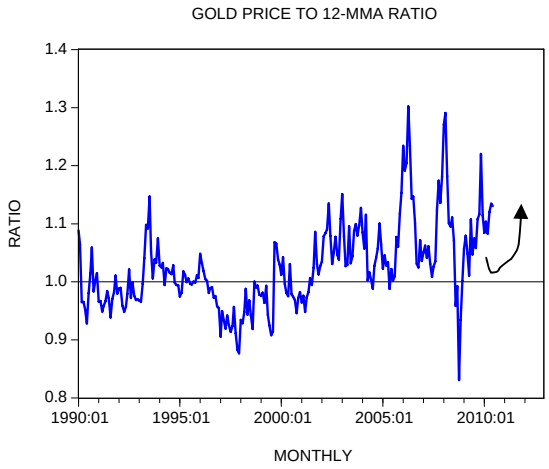




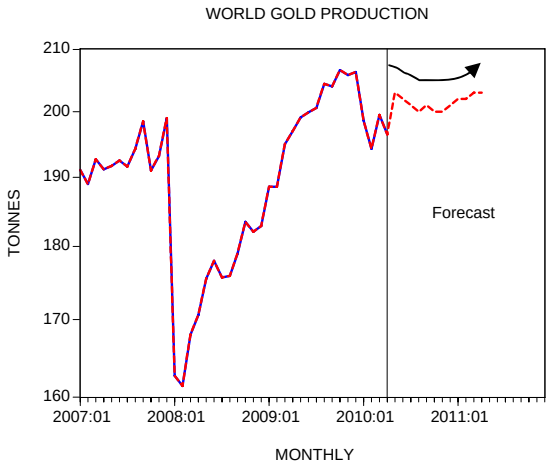
The price of gold could come under pressure

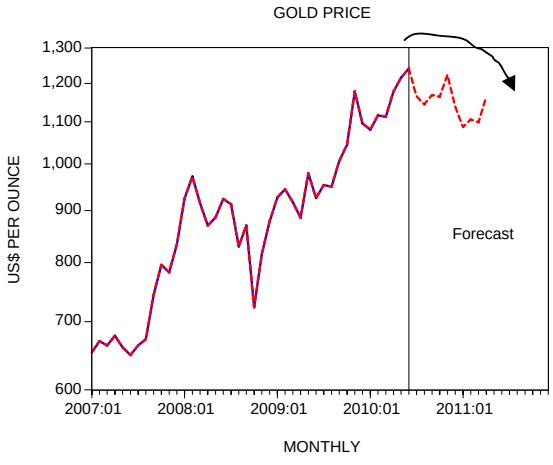
At the end of June the price of gold closed at $**1,241.35**/oz against $**1,215.71** at the end of May – an increase of **2.1**%. The growth momentum of the price of gold has strengthened further. Year-on-year the rate of growth climbed to **34.1**% from **24.2**% in May and **0.2**% in June last year. The ratio of the price of gold to its 12-month moving average has eased to **1.131** in June from **1.135** in the month before. Note that in June last year the ratio stood at **1.047**.





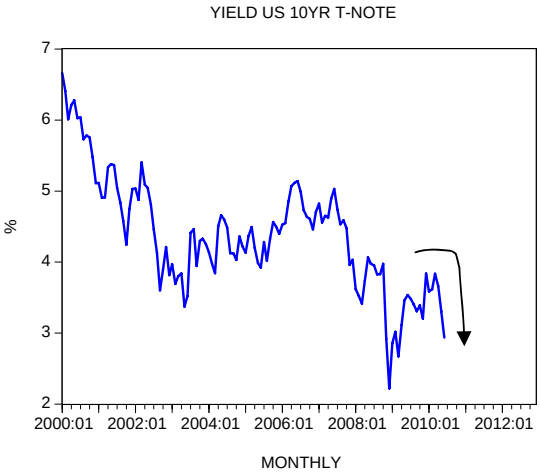
The World production of gold stood at **196.5** tonnes in April against **199.5** tonnes in the previous month. The yearly rate of growth of gold production stood at minus **0.3**% in April against **2.3**% in March and **15.5**% in April last year. We forecast that by April next year the World production of gold will close at **203** tonnes. We have employed our gold model to assess the future course of the price of the yellow metal. The model is driven by the state of US economic activity, US monetary liquidity, the state of China's economic activity and the production of gold. According to our model the price of gold is forecast to close at $**1,140** by August before bouncing to $**1,220** in November. Afterwards the price is forecast to come under pressure falling to $**1,090** by January before rallying to $**1,160** in April.

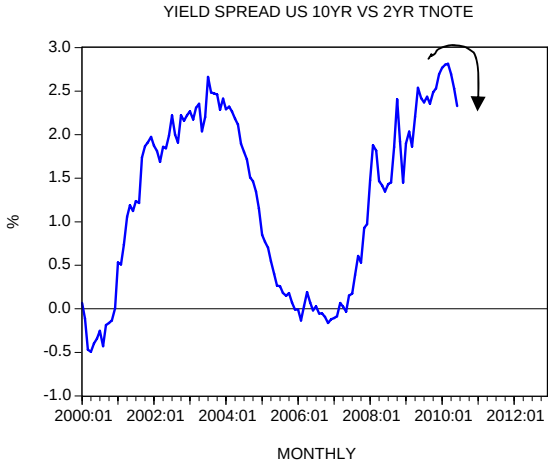




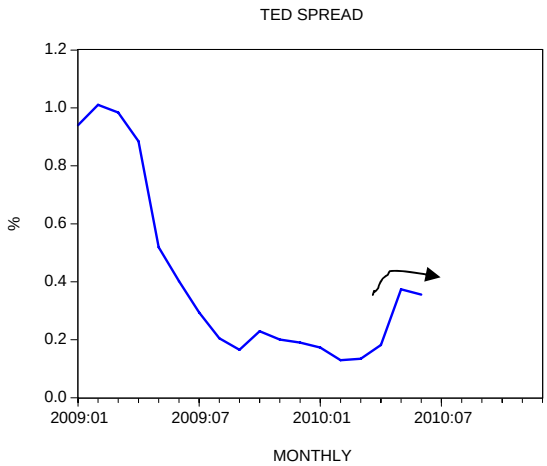
Where the yields on US long-term Treasuries are heading?

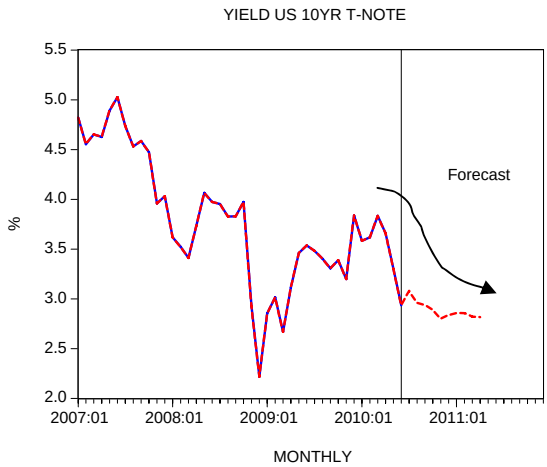
At the end of June the yield on the 10-year T-Note closed at **2.935**% against **3.303**% at the end of May. Note that in June last year the yield stood at **3.536**%. The yield spread between the 10-year and the 2-year T-Note fell to **2.33**% from **2.53**% at the end of May. The ratio of the yield on the 10-year T-Note to its 12-month moving average fell to **0.848** at the end of June from **0.94** at the end of May. This raises the likelihood that the 10-year T-Note is visibly over-valued.





The "TED" spread fell to **0.356**% in June from **0.374**% in the month before. The spread is the difference between the 3-month rate to borrow US dollars in the London inter-bank market and the rate on the 3-month US T-bill. We have employed our bond model to assess the future course of the yield on the 10-year T-Note. In this forecast we have assumed that the Fed will keep the fed funds rate target at **0.25**% rather than lifting the rate by **0.25**% to **0.5**% from the second half of this year. According to our model the yield on the 10-year T-Note is forecast to close at **3**% by August. By April next year the yield is forecast to settle at **2.8**%.





How much money should there be?

Most economists are of the view that a growing economy requires a growing money stock, on grounds that growth gives rise to a greater demand for money which must be accommodated. Failing to do so, it is maintained, will lead to a decline in the prices of goods and services, which in turn will de-stabilise the economy and lead to an economic recession, or even worse, depression.

The whole idea that money must grow in order to sustain economic growth gives the impression that money somehow sustains economic activity. If this were the case, then most Third World economies by now would have eliminated poverty through printing large quantities of money.

According to Rothbard,

> Money, *per se*, cannot be consumed and cannot be used directly as a producers' good in the productive process. Money *per se* is therefore unproductive; it is dead stock and produces nothing[1].

Money's main job is simply to fulfill the role of the medium of exchange. Money doesn't sustain or fund real economic activity. The means of sustenance, or funding, is provided by saved real goods and services. By fulfilling its role of the medium of exchange money simply facilitates the flow of goods and services.

Historically, many different goods have been used as the medium of exchange. On this, Mises observed that over time,

> . . . there would be an inevitable tendency for the less marketable of the series of goods used as media of exchange to be one by one rejected until at last only a single commodity remained, which was universally employed as a medium of exchange; in a word, money[2].

Through an ongoing process of selection people settled on gold as the general medium of exchange. Most mainstream economists, while accepting this historical evolution, cast doubt that gold can fulfill the role of money in the modern world. It is held that, relative to the growing demand for money as a result of growing economies, the supply of gold is not adequate.

If one takes into the account that a large portion of gold mined is used for jewellery, this leaves the stock of money almost unchanged over the period of time. It is held then that the free market, by failing to provide enough gold, can cause money supply shortages. This, in turn, runs the risk of destabilising the economy. It is for this reason that most economists - even those who express sympathy toward the idea of a free market - endorse the view that the government must control the money supply.

In a free market, in similarity to other goods, the price of money is determined by supply and demand. Consequently, if there is less money, its exchange value will increase. Conversely, the exchange value will fall when there is more money. Within the framework of a free market there cannot be such thing as "too little" or "too much" money. As long as the market is allowed to clear, no shortage of money can emerge.

Consequently, once the market has chosen a particular commodity as money, the given stock of this commodity will always be sufficient to secure the services that money provides. Hence, in a free market, the whole idea of the optimum rate of growth of money is absurd.

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[1] Murray N. Rothbard, *Man, Economy and State* (Los Angeles: Nash Publishing, 1970), p.670.
[2] Ludwig von Mises, The Theory of Money and Credit (Irvington-on-Hudson, N.Y: The Foundation of Economic Education, 1971) pp. 32-33.

According to Mises,

> As the operation of the market tends to determine the final state of money's purchasing power at a height at which the supply of and the demand for money coincide, there can never be an excess or deficiency of money. Each individual and all individuals together always enjoy fully the advantages which they can derive from indirect exchange and the use of money, no matter whether the total quantity of money is great, or small. . . . the services which money renders can be neither improved nor repaired by changing the supply of money. . . . The quantity of money available in the whole economy is always sufficient to secure for everybody all that money does and can do[3].

[3] Ibid.

GLOSSARY

Money AMS - stands for the Austrian School of Economics money supply definition. The aim of this definition is to ascertain as accurately as possible the amount of money in an economy.

Monetary liquidity - stands for the yearly rate of growth of money AMS adjusted for the rate of growth of nominal economic activity.

The pool of funding - stands for the stock of final goods ready for human consumption. The state of the pool sets the limit for economic growth.

Real savings – the amount of consumer goods produced locally less the amount taken by the producers of these goods.

The reshuffling process - the diversion of real savings from wealth generating activities towards activities that sprang up on the back of loose monetary policy.

Productive consumption - consumption that is preceded by production of wealth i.e. consumption that is backed up by the production of wealth.

Non-productive consumption - consumption that arises as a result of monetary pumping and is not supported by wealth production. This type of consumption weakens the flow of real savings.

Unbacked loans - lending that is not backed up by real savings. This type of lending is created through fractional reserve banking i.e. lending out of "thin air".