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Economic Growth

Not much has changed over the past quarter. The global economy remains weak. The euro area, in particular, continues to suffer from the deterioration of economic growth which turned negative in the first quarter of 2012. If it were not for Germany, the number would be even more disastrous. However, in Germany, too, economic growth rates have been declining steadily and the increase was only 1.2 per cent in the first quarter of 2012. Interestingly the same trend as noted for the euro zone applies to the United Kingdom. British growth continues to be low. Respectively for the Eurozone and the UK, growth rates were 0.7 per cent versus 0.8 per cent in the fourth quarter and 0.1 per cent negative for both the first quarter of 2012.

A picture a little brighter is shown by the United States and Japan. Economic growth rose to 2.0 per cent in the U.S. and 2.6 per cent in Japan. Yet one must take into consideration that Japan had a negative growth rate in the previous four quarters. Nevertheless, the numbers of economic growth of the U.S. and Japan are confirmed by the numbers of industrial production. Industrial production in the United States rose 3.8 per cent in the first quarter and 3.1 per cent in Japan

The current economic crisis which began in the USA and then spread to Europe becomes increasingly globalized. There is no locomotive in sight that could pull out the world economy of its doldrums. What is happening to the world economy is slow decay, a decline step by step that seems to go on without end. Both fiscal and monetary policies are at their limits. While interest rates are close to its absolute minimum. Now we are in a situation where more fiscal stimulus with more debt could have an effect as negative as more austerity.

International trade

There have been no dramatic changes in international trade over the past quarters. The U.S. has a current account deficit of more than three per cent of its gross domestic product (gdp). The same as was the case for decades. The current account deficit for the U.S. was 3.2 per cent in the last quarter of 2011 and, as such, it is only slightly lower than previous quarters, when it reached 3.4 per cent in the second quarter and third quarter of 2011.

Germany continues to register high surpluses and in the fourth quarter of 2011 its current account surplus reached 7.4 per cent of gdp, the same as it was in the first quarter of 2010. Compared to Germany, the current account surpluses of Japan and China are more moderate. In the last quarter of 2011 Japan had a current account surplus of 0.8 per cent, while China had a surplus of 3.0 per cent in the third quarter of 2011.

More serious than the current account deficit the U.S. are the current account deficits of the United Kingdom because the British pound has only a rudimentary role as a global currency. Even with a negative growth rate in the first quarter of 2012, the UK recorded a current account deficit of 1.9 per cent in the last quarter of 2011, after having a deficit of 3.4 per cent in the third quarter of 2011.

Interest rates

With the exception of China, interest rates are at an extremely low level in the major economies of the world. The U.S. central bank kept its policy rate steady at 0.25 per cent since 2011, while the UK has maintained a rate of 0.50 per cent. The European Central Bank lowered the interest rate to one per cent in January 2012 and to 0.75 per cent on July 4th. The Bank of Japan did not change its interest rates which are already at the extremely low level of 0.10 per cent, while China's central bank has slightly lowered its rate from 6.56 per cent since July 2011 to 6% after having cut it 6.31 % only a while ago. The US, Japan and Europe have reached the dead-end of interest rate policies. Now it is only "quantitative easing" that is left to "stimulate" the economy. In the same way that fiscal policy is at dead-end, monetary policy has hit the wall. The errors were made in the past and not repair work can put Humpty Dumpty together again.

Exchange rates and prices

In the face of turbulence and uncertainty in Europe, it came as no surprise that the euro weakened against the U.S. dollar. The rate fell from 1.43 dollars to the euro in May 2011 to 1.28 dollars per euro in May 2012 and fell further to 1.25 when the European Central Bank lowered its policy interest rate in July 2012. The fall of the euro is fully in line with the international scenario. In fact, the surprise is not that the euro has fallen, but that the value has fallen relatively little.

The rate of the dollar against the British pound has remained relatively stable as it has been the case with the yen-dollar exchange rate, while the Chinese currency has strengthened slightly against the dollar. To the relief of the Brazilian government the dollar continued to rise and surpassed the two real level in June 2012 after having hit a low below 1.60 real to the dollar only a couple of months ago in August 2011.

The gold price was surprisingly stable at slightly above US \$ 1,500 over the past 12 months. Currently, investors regard the dollar as a safe haven more than gold. Yet this may change anytime soon when US debt comes to the forefront of attention again.

Commodities

Commodity prices are falling. Oil, which was still \$ 122.7 per barrel in February of 2012, has fallen below the hundred dollar level in the meanwhile. Corn, coffee and sugar are all down from their peaks. Only the price of soybeans remained relatively firm.

Given the fall in commodity prices and oil in particular, as well as taking into account the price of gold as an indicator of inflationary expectations, one must note that inflation does not represent an immediate risk.

Financial Markets

Stock and bond markets have been relatively stable over the past quarter. There have no major discernible shifts of investor sentiment other than a shift from the European periphery to the center. As in the months and years before, US treasuries have been a favored investment in the global context.

Stock markets also not see major changes of trend. There have been ups and downs but these fluctuations have been within the regular degree of volatility.

Yet this situation is no reason to feel complacent. On the contrary: All too often markets play it soft for some period of time before they enter the wild phase. There are too many unresolved economic problems in many parts of the world in order to be confident that

stock prices could strongly rise and there is too much debt in the world in order to feel comfortable with the current level of interest rates.

While confidence in many European countries has been eroding over the past quarters, a loss of confidence may also happen any time soon when it comes to the United States. In Europe it was mainly churning that has happened in so far as investors who left Spain and Italy could buy German bonds. Yet where can investors flee to when confidence in the US begins to erode? Let's keep our eyes open and watch out where the smart money will run to in the second half of 2012. Gold? Back into euro bonds? Commodities again? Could it be that when a more realistic assessment will replace the current tide of prejudice, investors will notice that the one place where assets sell below value could be Europe? It is better not to pre-program one's mind and make premature predictions yet let's be aware that when things will change, they probably will change dramatically this time.

Antony Mueller, July 2012