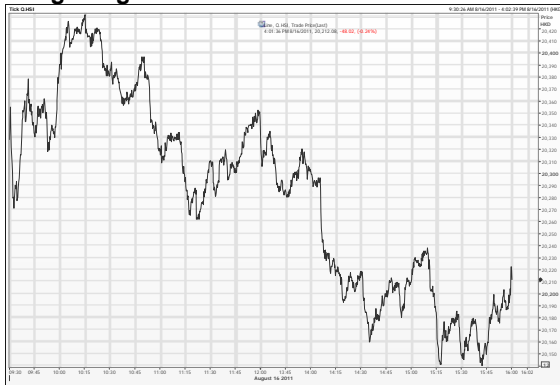


Market Watch

17 August 2011

Intra-day price action

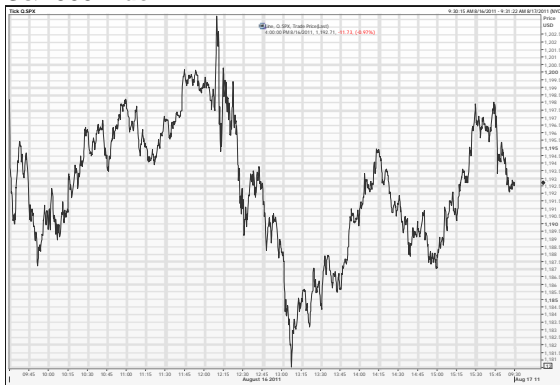
Hang Seng Index



Eurostoxx50 index



S&P500 index



Source: ThomsonReuters, Standard Chartered

Analyst
Steve Brice

Europe disappoints

SUMMARY

- Meeting between Merkel and Sarkozy failed to deliver any policy initiatives likely to encourage hopes for an early end to the crisis in Europe

Yesterday's summit reinforces the picture of Europe's leadership remaining behind the curve and the view that Europe is likely to remain a source of negative volatility in the coming weeks and months.

- German H1 GDP disappoints
- US industrial production surprises on the upside

This reinforces our view that US growth is expected to be a source of positive surprises in H2, although we doubt this will extend into 2012. Of course, consumer confidence and business confidence indicators remain weak which suggest the strength of the recovery is likely to be gradual and subject to setbacks.

- The lack of follow through on early equity market weakness in Europe merely highlights that sentiment has improved with technicals more supportive for now

Franco-German summit fails to deliver

As discussed yesterday, markets were too optimistic on the likely policy response from yesterday's meeting between German Chancellor Merkel and French President Sarkozy and got disappointed.

The controversial, but good from a market confidence perspective, idea of issuing Euro bonds was mentioned at the press conference, but Sarkozy's comments that such a move comes 'at the end of the integration process not at the beginning' hardly suggests this is imminent. Merkel appeared to relate the possibility more to where we are in the crisis rather than being an obvious next step in the whole integration process. She stressed that she did not believe 'Europe is at the point of needing its last resort', reinforcing the view

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that while business leaders are increasingly supportive of a shift in this direction, the German government is not willing to consider it for now.

That said, the measures proposed are consistent with moves towards fiscal union over the longer term. Merkel and Sarkozy proposed implementing a rule for targeting balanced budgets, a commitment from governments to respond to any criticism from the EU executive and an 'economic government' with a president to be elected to 2 ½ years. They also proposed Euro zone members having mandatory deficit-limiting rules in their constitution.

If we were not in the middle of a sovereign debt crisis, such steps would be viewed positively. Ever since the Euro zone was touted as an idea, the question of whether monetary union could succeed without fiscal (and political?) union was viewed as largely theoretical by the single currency area's proponents. The crisis in Greece and then elsewhere appears to have answered this question.

We have argued for some time that Germany and France need to make up their mind whether they want to leave the single currency area or accept fiscal union. Yesterday was a step forward to answering the question. However, Germany remains very reluctant and it appears it will only consider either when countries get their fiscal positions in order or when the crisis deteriorates to such a degree that they have no choice. The ability of countries to rectify their fiscal positions in order is questionable in our opinion and, even if they could, we doubt that financial markets will be that patient.

Mixed economic data

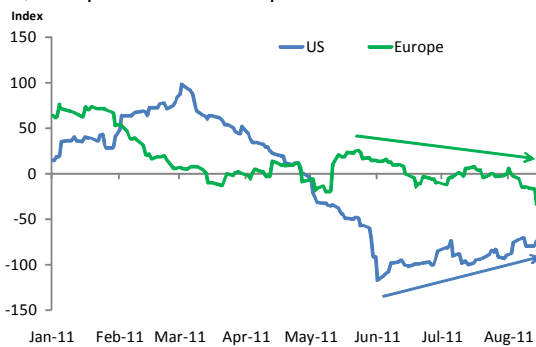
On the growth side, European data disappointed with German Q2 GDP rising a mere 0.1% q/q compared to an expectation for a 0.5% increase. Meanwhile, Q1 GDP growth was revised lower to 1.3% q/q from 1.5% q/q. This, together with disappointing French GDP data (released last week), dragged Euro zone GDP growth to a meagre 0.2% in Q2 compared to 0.8% in Q1.

On the positive side, US July industrial production data surprised significantly on the upside yesterday rising 0.9% m/m compared to expectations for a still strong 0.5% increase. Additionally, June industrial production data was revised higher to growth of 0.4% m/m compared to the 0.2% initial release.

The good news

The good news is US markets did not react to the news from Europe (which came out at the end of the European trading day) with outsized losses, which suggests some sort of normality is returning to markets, at least for now. European stocks closed at almost the high for the day, suggesting markets are more actively seeking out positive inferences from the EU summit than the more blatant negatives. In the US, markets closed modestly lower, but in the middle of the day's range. The lesson over the past three weeks is that this can quickly change, but for now sentiment looks likely to have stabilised.

US data on an uptrend versus expectations
US, Europe Economic Surprises Index



Source: Bloomberg, Citi, Standard Chartered

Equity market volatility has fallen markedly in the past week, but remains elevated
VIX index



Source: ThomsonReuters, Standard Chartered

Disclosure Appendix

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