

A faint, light blue world map is visible in the background, centered behind the main text.

# eurex

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*The Outlook for the European  
Stock and Bond Markets*

*April 2010*

## Presenter

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**Managing Director,**  
**Optima Investment Research, an independent**  
**institutional futures research firm**

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- **Covering global financial markets for 25 years**
- **MBA, University of Chicago Graduate School of Business**
- **Editor of weekly *Eurex European Market Outlook* report for two years through January 2010**
- **Interviewed on CNBC, Bloomberg TV, Fox, National Public Radio**
- **Quoted by Dow Jones, Reuters, USA Today, Newsweek, others**

## Agenda

- **The Eurozone Macroeconomic Situation**
- **European Central Bank policy**
- **European Interest Rate Markets**
- **The Euro**
- **European Stock Index Markets**

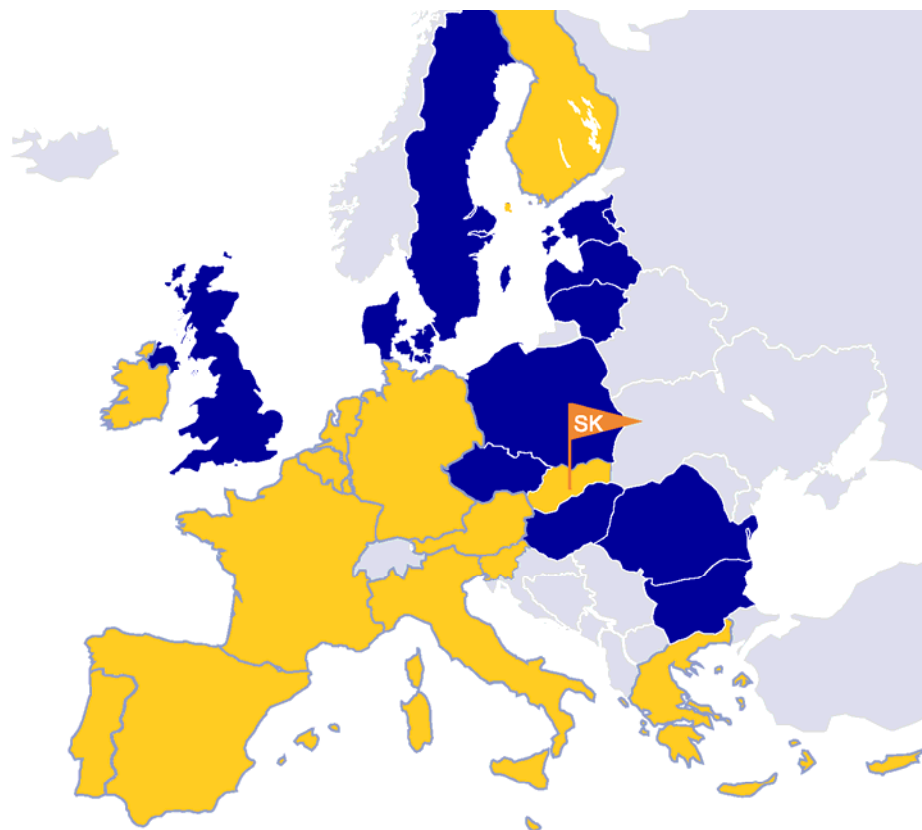
## Eurozone or Euro Area

**Eurozone – 16 of 27 EU Countries use the euro (in yellow)**

Germany, France, Italy, Spain, Netherlands, Belgium, Austria, Greece, Ireland, Finland, Portugal, Slovakia, Luxembourg, Slovenia, Cyprus, Malta

**11 EU Countries are not in the Eurozone (in blue)**

UK, Denmark, Sweden, Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania



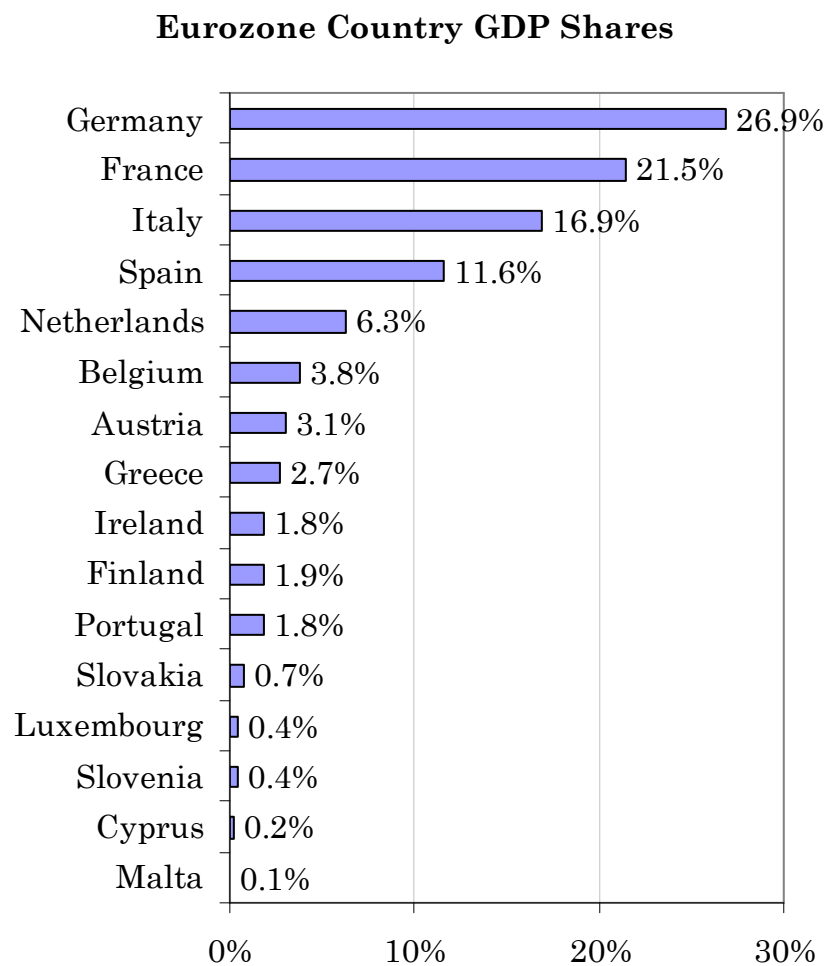
■ EU today   ■ Euro area   🚩 New member

2009

Graphics source: European Central Bank

## Country GDP Shares in Eurozone

**Big Four account for about three-quarters of Eurozone GDP (Germany, France, Italy, Spain).**



# Eurozone recession is over, but growth is weak...

## Eurozone GDP qtr-on-qtr:

- Negative for 5 quarters (Q2-2008 to Q2-2009); peak-to-trough  $-5.2\%$ , worse than  $-3.8\%$  in U.S.
- Weak for last two quarters ( $+0.4\%$  q/q in Q3-2009 and  $+0.0\%$  q/q in Q4-2009)

## Eurozone GDP yr-on-yr:

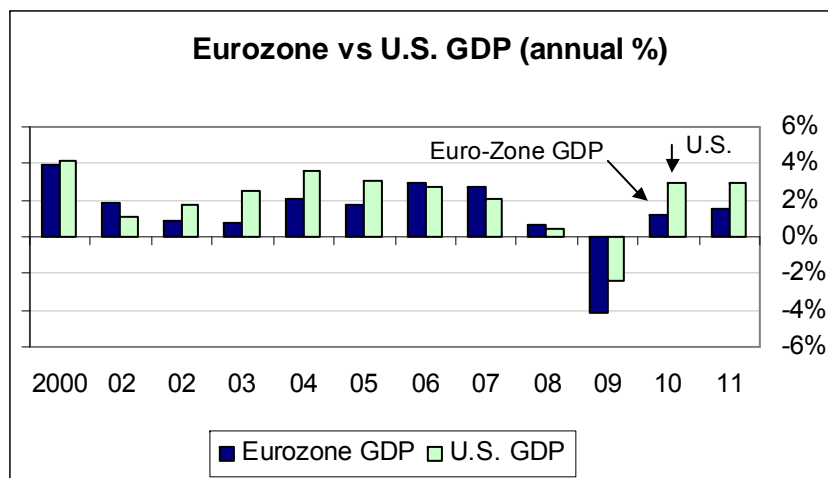
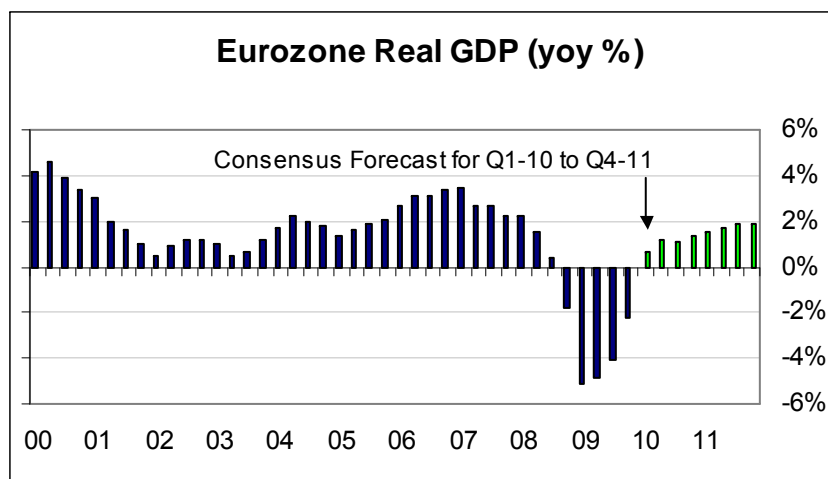
- Negative for 5 quarters (Q4-2008 to Q4-2009)
- Positive estimates for 2010 and beyond:  
 2010: Q1  $+0.7\%$ , Q2  $+1.2\%$ , Q3  $+1.1\%$ , Q4  $+1.4\%$   
 2011: Q1  $+1.5\%$ , Q2  $+1.7\%$ , Q3  $+1.9\%$ , Q4  $+1.9\%$

## Eurozone Annual GDP

- 2008:  $+0.6$  (US:  $+1.1\%$ )
- 2009:  $-4.1\%$  (US:  $-2.4\%$ )
- 2010: est  $+1.2\%$  (US:  $+3.0\%$ )
- 2011: est  $+1.5\%$  (US:  $+3.4\%$ )

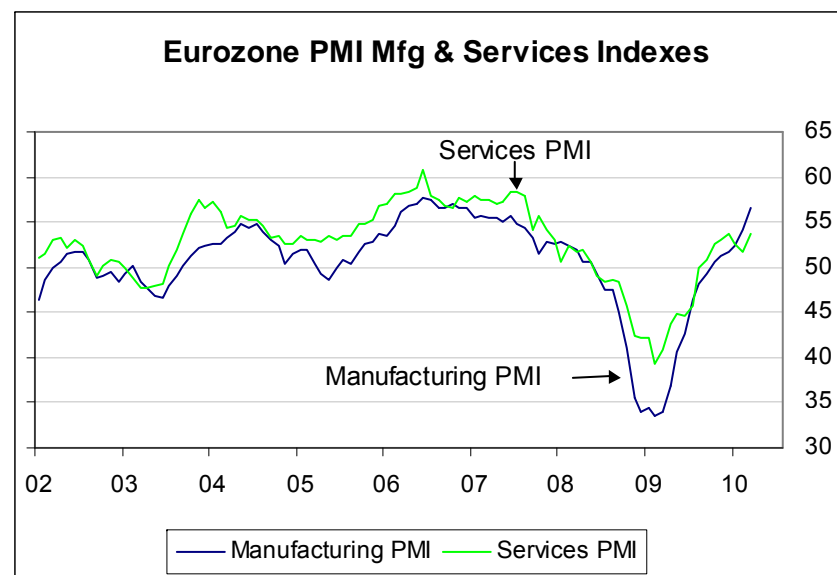
Eurozone 2000-09 avg GDP:  $2.1\%$   
 (0.5 pct points less than  $+2.6\%$  for U.S.)

Note: Consensus Forecasts from Bloomberg Survey



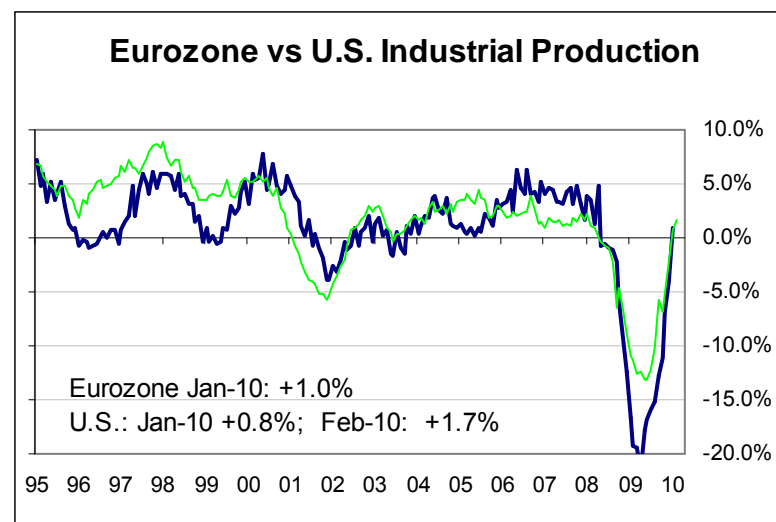
## Purchasing Managers Indexes Illustrate Recovery

- Survey of purchasing executives in the manufacturing and services sectors
- 50 is the boundary between a contraction/expansion in the sector
- Manufacturing PMI above 50 for six consecutive months since Oct-09; March level of 56.6 was a 3-1/2 year high
- Services PMI above 50 for 7 consecutive months since Sep-09; March level of 53.7 was 2-1/3 year high



## Industrial Production Shows Sharp Rebound

- Eurozone industrial production turned positive at +1.0% y/y in Jan for first time in 2 years
- Close behind US at +1.7% y/y in Feb

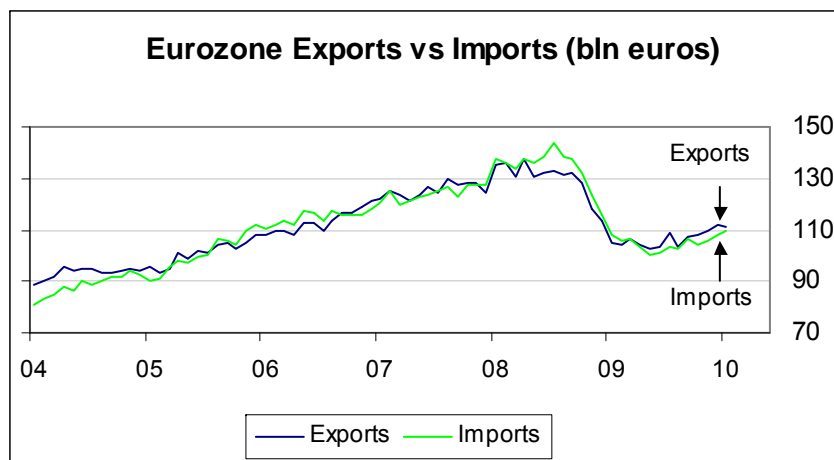
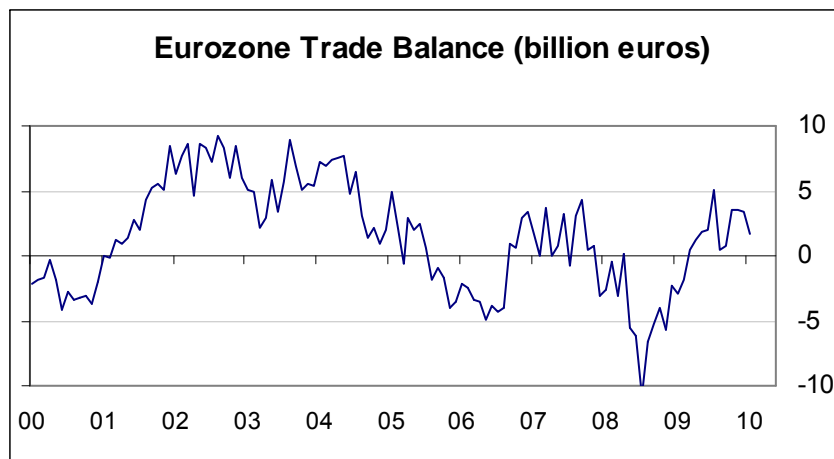


## Eurozone Trade Balance – Modest 9% Export Recovery

- Trade balance turned back to a trade surplus in March 2009; positive for euro
- Exports are important for Eurozone, accounting for about 22% of GDP vs 13% for U.S.

Jan exports +5.9% y/y  
Jan imports +1.4% y/y

Exports have risen 9% from May-09 trough of 102.3 bln euros, but still need to rise by another 24% to reach peak of 137.6 bln euros posted in April 2008.

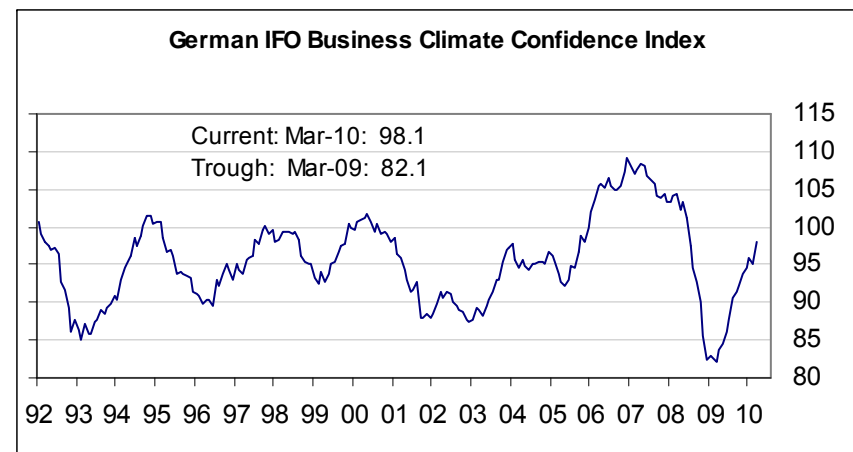
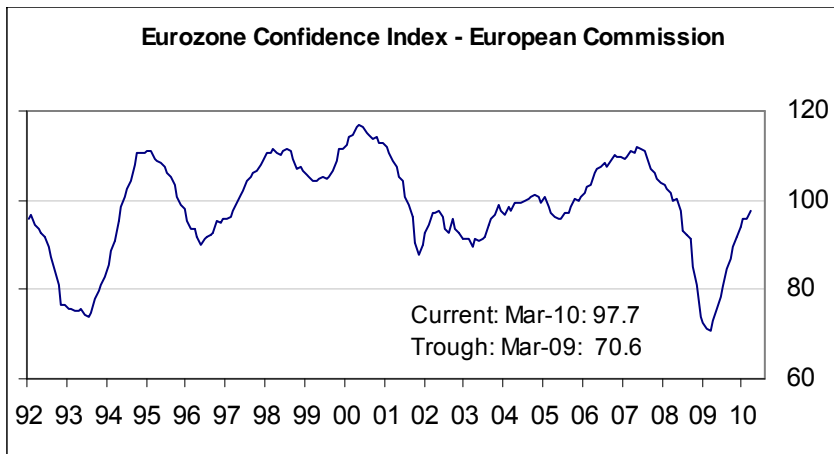
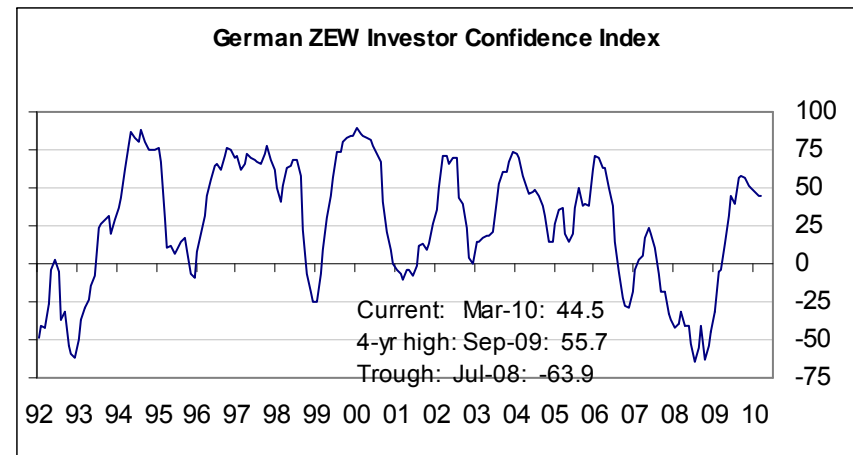


# European Confidence – Still Well Below Pre-crisis Level

**IFO – Business climate – survey of 7000 businesses**

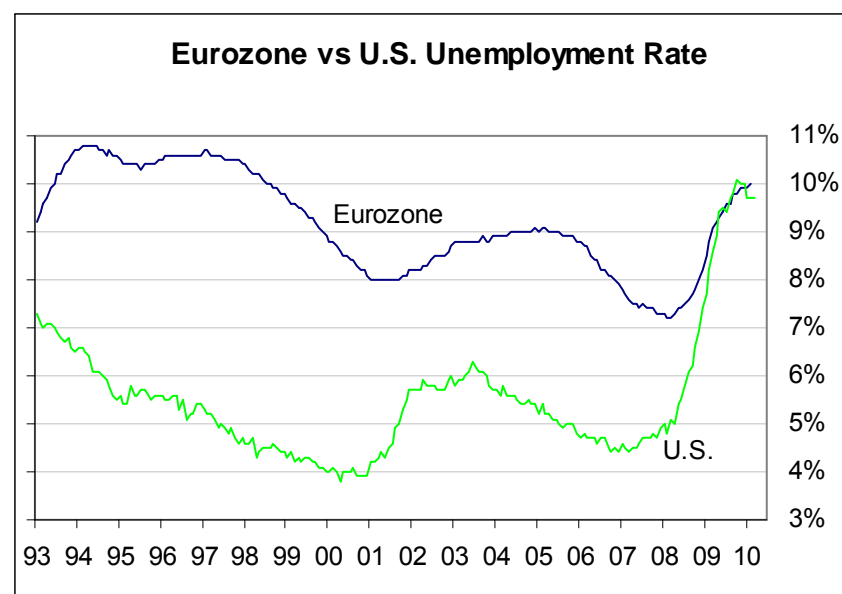
**ZEW – Investment professionals – survey of 350 institutional investors & analysts**

**Eurozone Confidence Index from the European Commission – broad survey of consumers and businesses**



## Eurozone Unemployment Rate

- Eurozone unemployment rate on average is 3.7 percentage points higher than U.S. due to generous unemployment benefits and structural labor market rigidity.
- Eurozone unemployment rate (Feb 10.0% at 11-year high) currently exceeds U.S. rate (Mar 9.7%) by 0.3 percentage points.
- Eurozone has seen less severe deterioration in labor market than U.S. due to work rules and protection from layoffs.



## Consumer Price Index

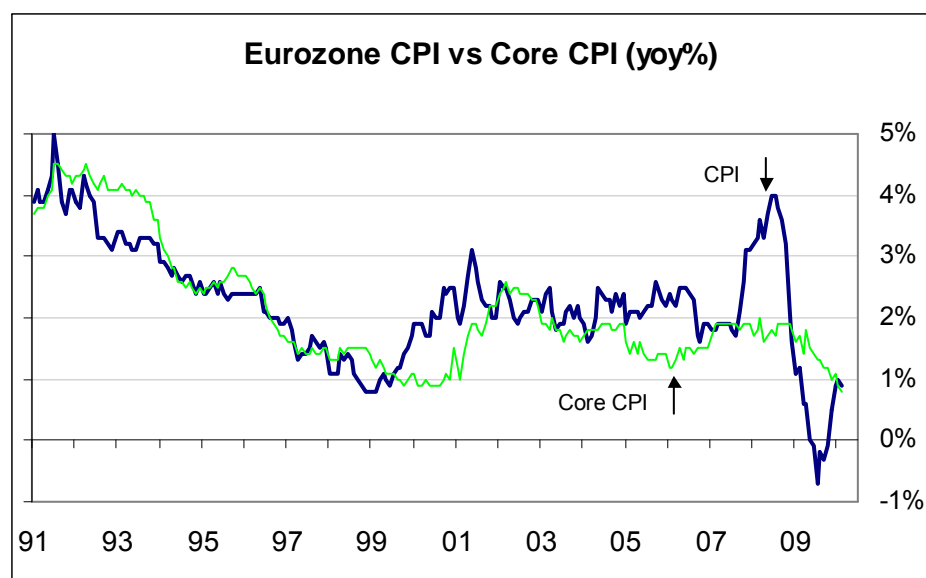
**ECB CPI Target:** “below, but close to, 2% over the medium term.”

**Current Eurozone CPI Figures:**

- Feb CPI: **+0.9% y/y**
- Feb “core” CPI (ex-food, energy, tobacco, alcohol): **+0.8% y/y**, a record low

**ECB Inflation View:**

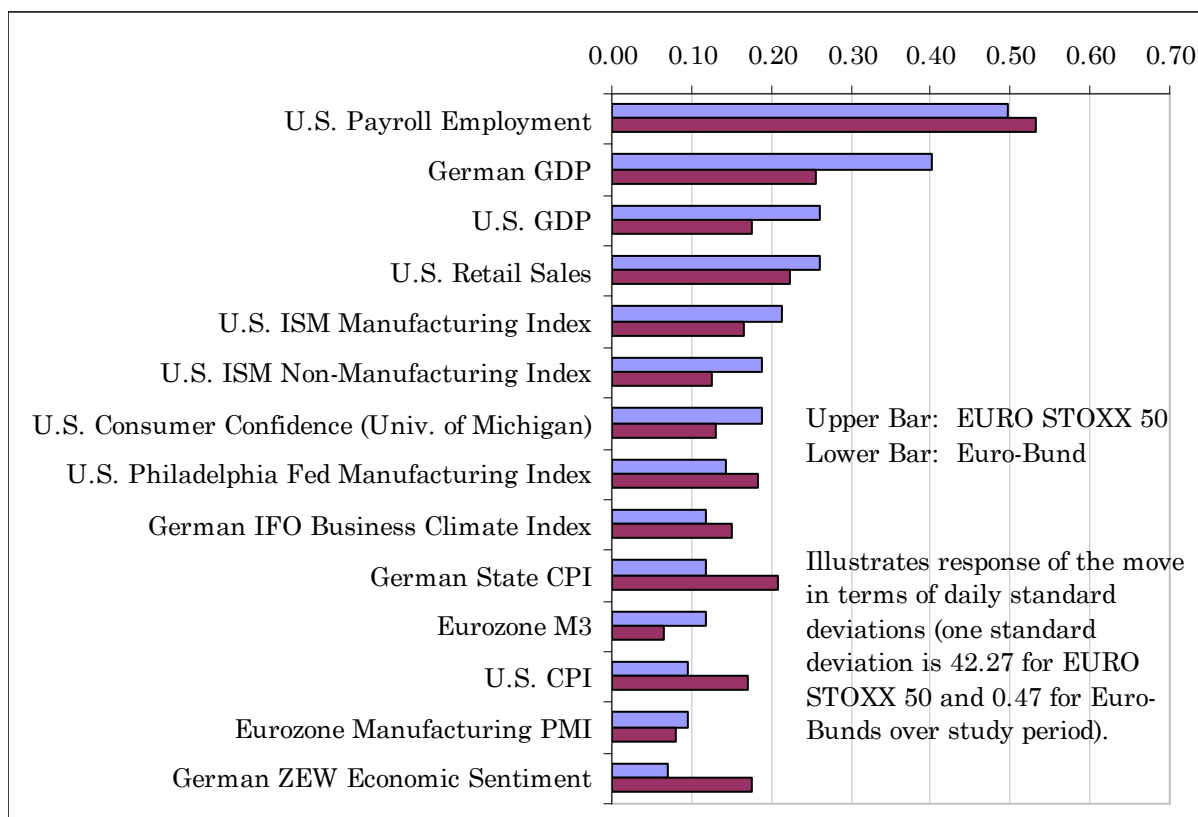
- ECB expects inflation near 1% over near-term and to remain moderate over policy-relevant horizon (1.2% 2010; 1.5% 2011)
- ECB says medium and long-term inflation expectations are “firmly anchored.”



# Economic Indicator Impact on Eurex EURO STOXX 50<sup>®</sup> and Euro-Bund Futures

US economic reports have substantial impact on European stock and bond markets (8 of 14) due to:

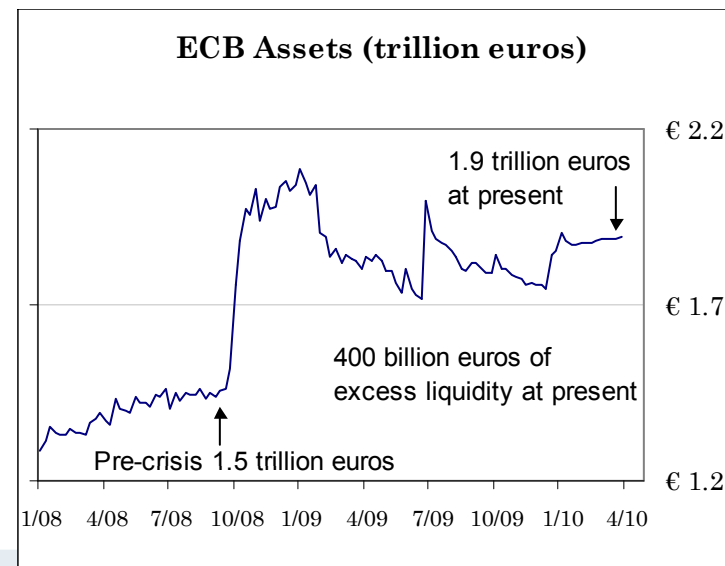
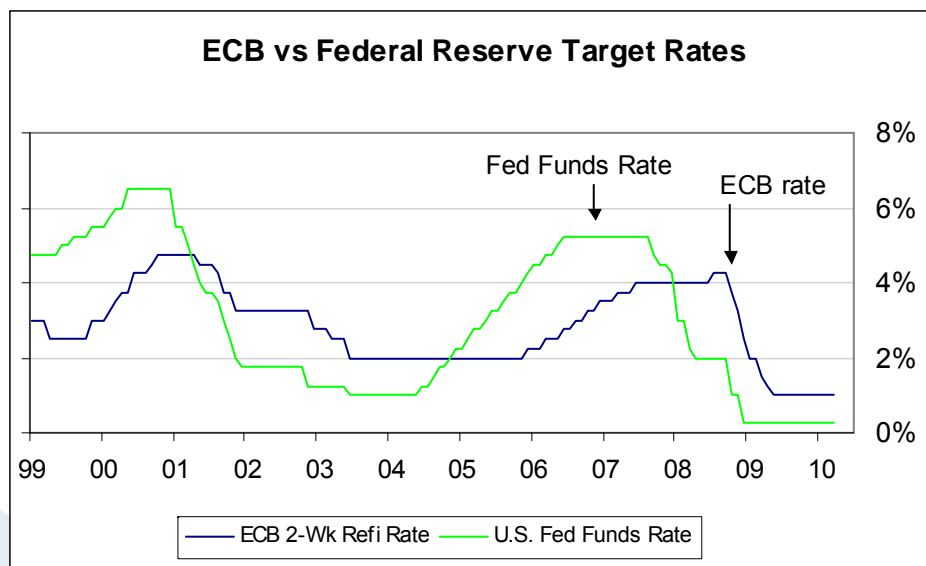
- Large U.S. influence on global and Eurozone business cycle
- ECB-Fed policy linkage
- Trader response



Indicators with largest impact on Euro-Bund market, according to Royal Bank of Scotland report, "What Moves the European Bond Market?, March 2007.

## European Central Bank (ECB)

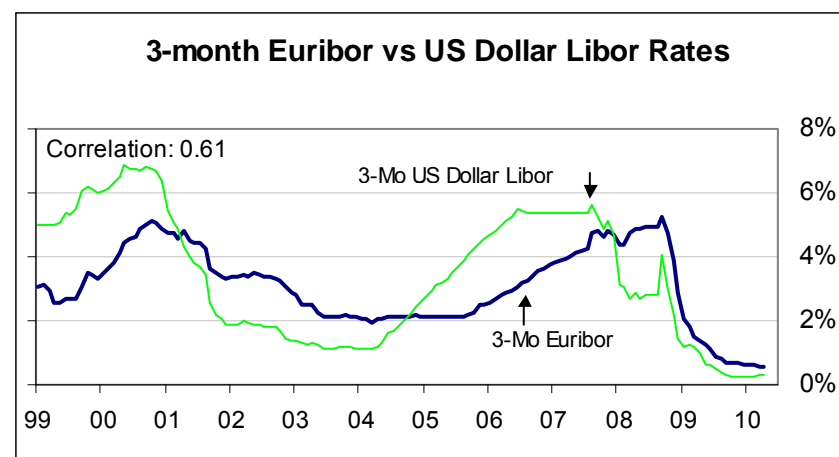
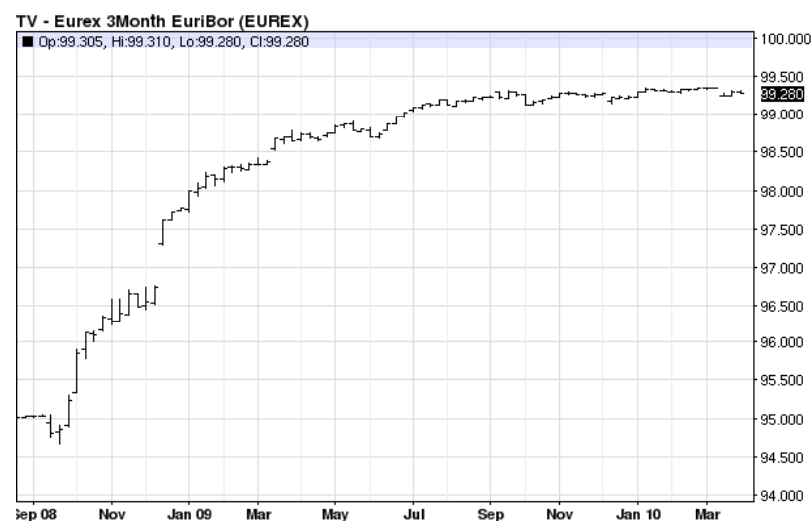
- Key target rates: 2-week refinancing rate (1.00% since May 2009), marginal lending facility rate (1.75%), deposit facility rate (0.25%)
- ECB has flooded banking system with reserves (e.g. €614 bln 12-mo bank lending in 2009), Eonia overnight rate 0.32%, only about 15 bp above U.S. federal funds rate (0.17%)
- ECB in March extended promise of unlimited liquidity until October 2010;
- Consensus is for refi hike of 25 bp by Q1-2011, 50 bp by Q2-2011, 75 bp by Q3-2011.
- ECB exit moves include dropping 6-mo and 12-mo operations, moving back to short-term operations. 60 bln euro covered bond purchase program ends in June 2010



## EUREX Three-Month EURIBOR Futures

- EURIBOR Futures prices rallied sharply on the financial crisis with ECB cutting 2-week refinancing rate by 325 basis points from 4.25% to 1.00%
- EURIBOR Futures prices have been flat since Sep-2009 with unchanged ECB policy.
- 3-month EURIBOR rate of 0.58% is currently 29 bp above the U.S. dollar Libor rate of 0.29%; a positive factor for euro.
- Correlation of 0.61 between eurozone and U.S. 3-month rates. U.S. 3-month rates have generally led eurozone rates in past decade due to U.S. leading the business cycle.

Eurex Three-Month EURIBOR Futures (weekly nearest)



## Three-Month EURIBOR Futures Strip Curve

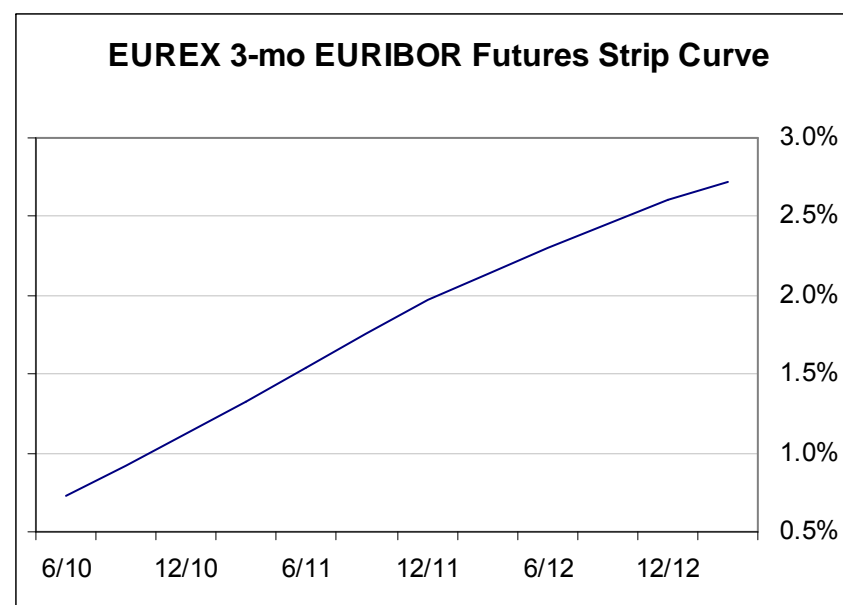
- Futures strip curve shows expected 3-month EURIBOR rate looking out into the future

- Curve shows that the market expects the 3-month EURIBOR rate to slowly rise from current level of about 0.58% as business cycle and monetary policy normalize:

**Dec-2010: 1.12% (+54 bp)**

**Dec-2011: 1.97% (+139 bp)**

**Dec-2012: 2.61% (+203 bp)**



# EUREX Euro-Bund Futures (10-year)

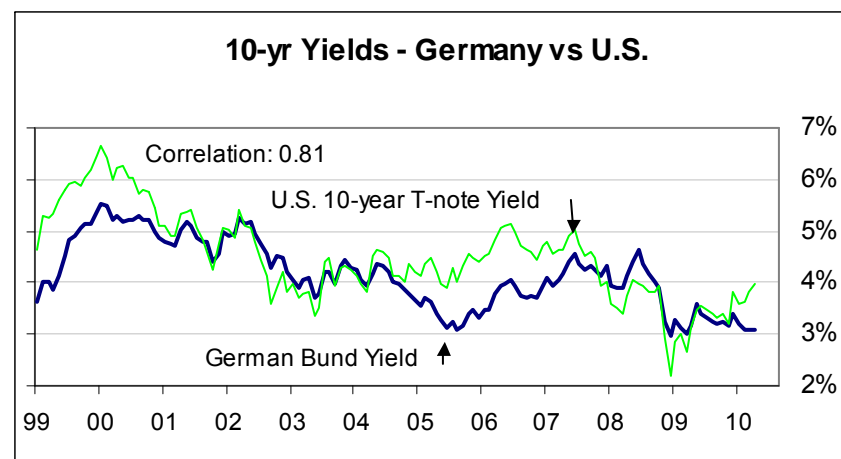
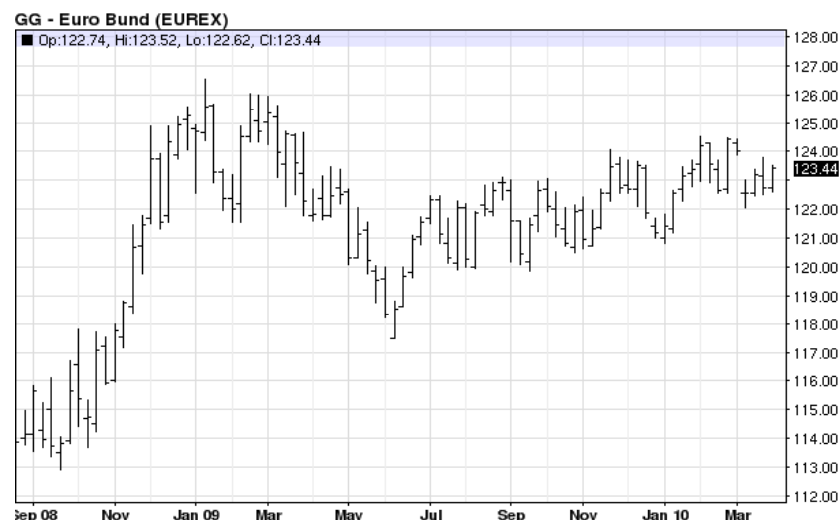
- Bund prices rallied from June-08 thru March-09 due to the global financial crisis and an easier monetary policy
- Bund prices have been relatively flat since September due to stable monetary policy and mild economic recovery
- Bund yield of 3.10% is currently 90 bp below U.S. 10-year T-note yield due to weaker eurozone economy, smaller bond issuance, and perceived lower inflation risks for Europe
- Chance of upward spikes in yields in coming months on positive economic data and/or inflation scares, which may force Fed and ECB into tightening

## Eurex Bund Trading Hours:

8:00-22:00 Central European Time (Germany)

2:00 AM – 4PM Eastern Time (NY)

Eurex Euro-Bund Futures (weekly nearest-futures)

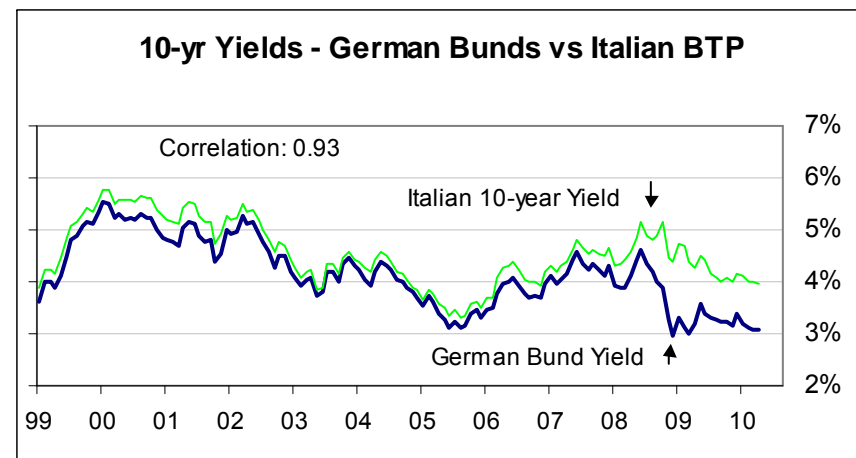
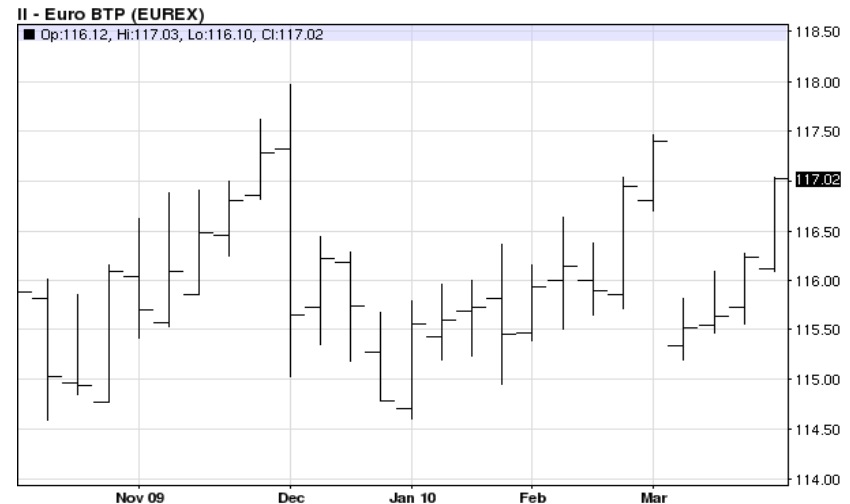


Current 10-yr yields: German 3.09%, US 3.99%

# EUREX Euro-BTP Italian Bond Futures (10-year)

Eurex Euro-BTP Italian Bond Futures (weekly nearest-futures)

- Italian 10-year yield of 3.95% is currently 86 bp above German yield of 3.09%. Current spread of 86 bp is above pre-crisis average near 25 bp but well below early-2009 peak of 157 bp.
- Yield premium caused by weaker Italian economy (negative GDP in 7 of last 9 quarters) and poor Italian fiscal situation.
- 2010 Italian budget deficit of 5.3% of GDP (vs 5.0% for Germany); 2010 Italian gov't debt 117% of GDP (vs 77% for Germany).
- Italian 5-year CDS price is 122 bp; more than triple German CDS of 32 bp.
- Italian debt ratings vary from 2-4 notches below AAA vs Germany AAA.

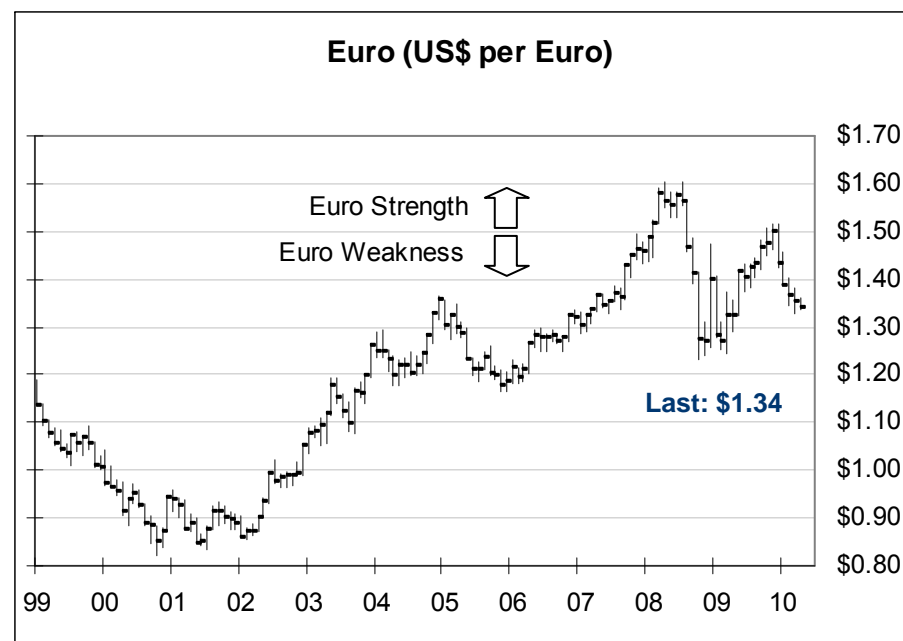


Current 10-yr yields: Germany 3.09%, Italy 3.95% (+86 bp)

# The Euro

## Euro Market Factors

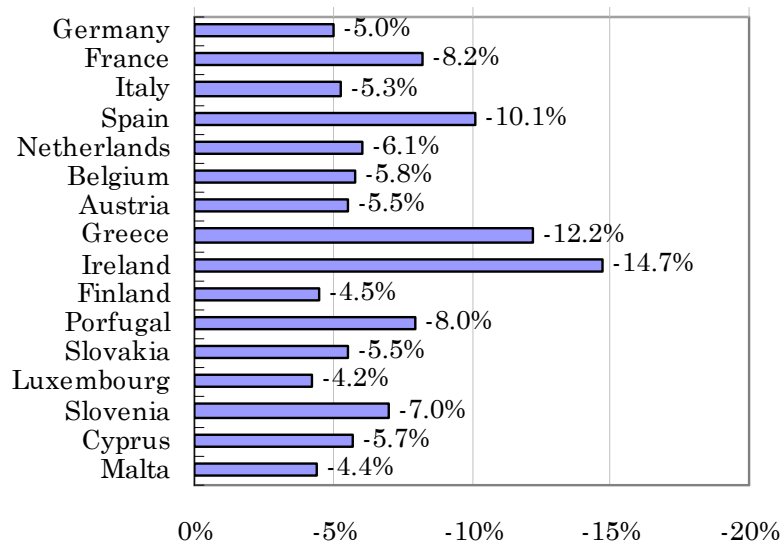
- Euro showed strength from 2006 to mid-2008 as dollar weakened on emerging US housing crisis.
- Euro fell during the late-2008 financial crisis as dollar rallied on safe-haven buying.
- Euro regained strength in 2009 due to reduced safe-haven demand for dollar liquidity and stronger euro interest rate differentials.
- Euro weakened in early 2010 due to Greek debt crisis and extension of easy ECB policy (liquidity guarantee in March extended until October).
- But euro still has benefits of higher interest rate differential (29 bp on 3-month, 99 bp on 10-year yield), trade surplus, and easier ECB liquidity exit.



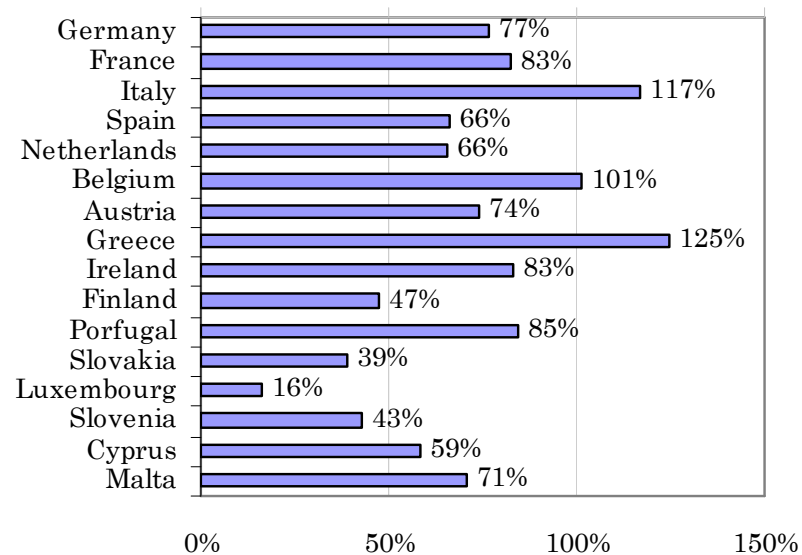
## Eurozone fiscal problems (Greece) hurt euro...

- Greek debt financing problems created eurozone crisis earlier this year; hurt euro
- EU and IMF promised credit facility for Greece if necessary, which placated the markets for the time being.
- No real risk of Greece or any other country exiting eurozone

**2010 Govt Budget Deficit at % GDP**



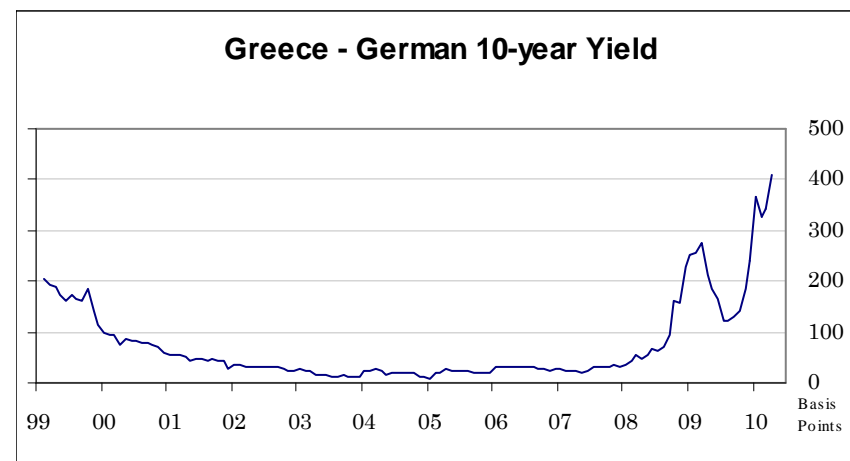
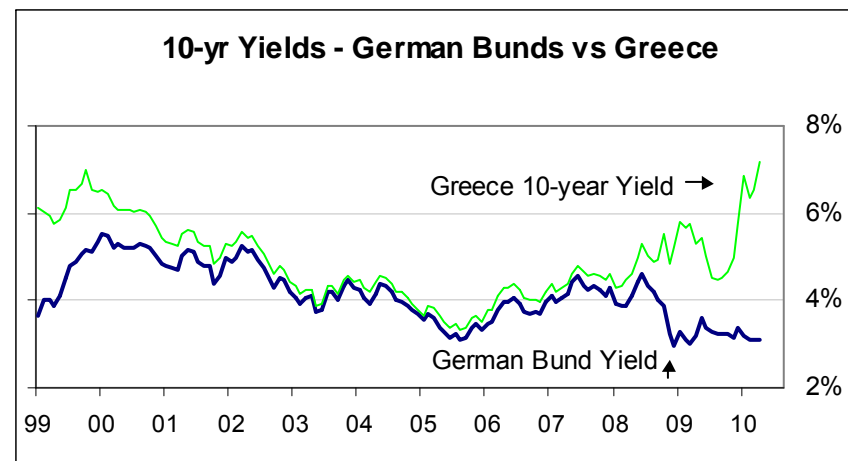
**2010 Government Debt at % GDP**



**Note: U.S. 2010 Budget Deficit 10.6% of GDP; Debt 94% of GDP**

## Greek Debt Problems Are on a Slow Burn

- Greece needs to raise €54 billion in bonds this year; €21 billion to cover bond redemptions just in April and May
- Greece may be balking at IMF terms; EU/IMF rescue facility is not binding on eurozone members and it is not clear when facility kicks in
- Greek bonds are still rated investment grade 6-7 notches below AAA, 3-4 notches above non-investment grade junk; more rating downgrades possible
- Credit default swap pricing (5-yr): 391 bp (vs 122 bp for Italy, 32 bp for Germany)
- Greek 10-year yield soared above 7%; yield spread to Germany is near 400 bp.



# Eurex EURO STOXX 50<sup>®</sup> Futures

- EURO STOXX 50 is up 72% from March-2009 low, but has retraced only 46% of June-07 to March-09 plunge
- Would take further 53% rally to reach June-2007 9-year high

## Bullish factors:

- Economic recovery is weak but gaining traction
- Extremely easy monetary policy; low interest rates
- EURO STOXX 600 earnings growth weathered the recession fairly well at -40% in 2008 and -2% in 2009; strong growth expected of +47% in 2010, +23% 2011
- Valuations have room on upside in coming years

## Bearish factors:

- Continued macroeconomic and financial system risks
- Valuations are no longer cheap

### Eurex Stock Index Trading Hours:

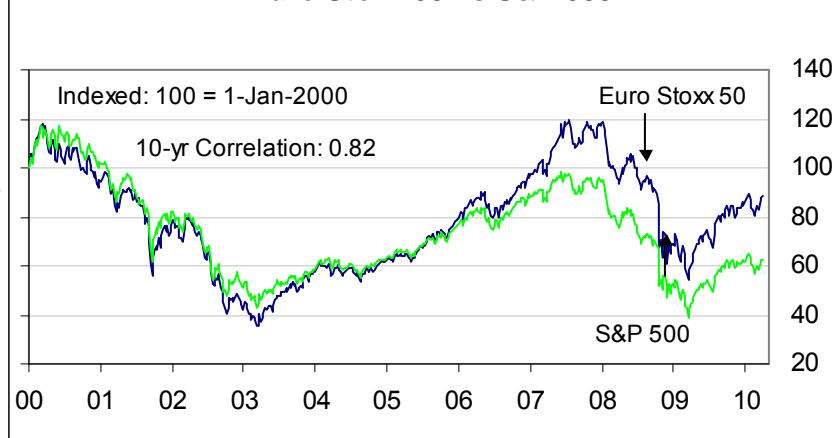
7:30-22:00 Central European Time (Germany)

1:30 AM – 4 PM Eastern Time (NY)

Eurex EURO STOXX 50 Futures (weekly nearest-futures)

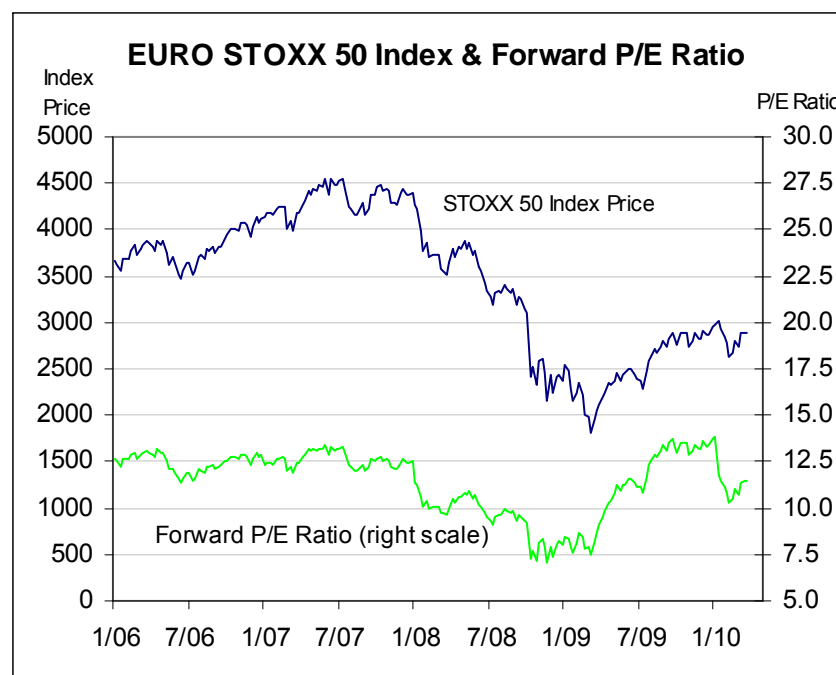


Euro Stoxx 50 vs S&P 500



## European Stock Index Valuation – Still Reasonable

- **Forward Price/Earnings (P/E) ratio, based on year-ahead forecasted earnings, hit a low of 7.25 in early-December 2008 during the financial crisis**
- **Forward P/E still reasonable near 11.5 even after upward rebound in stock prices**
- **Valuation is still below the 2006-07 average of about 12.5**
- **EURO STOXX 50 forward P/E of about 11.3 is well below the U.S. S&P 500's 15.1 (vs 5-yr avg of 15.3), indicating reasonably priced European stocks**



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