Summary

In the past week, the law of unintended consequences struck again in the HIDCs (Heavily Indebted Developed Countries) as the decision to involve depositors in Cyprus' financial bail out threw light on the most important of Europe's many vulnerabilities, namely the undercapitalisation of Europe's banks. Europe's politicians are loath to recapitalise banks for political reasons, but this now leaves banks vulnerable to speculative attack.

Global

Global sentiment was dominated by events in the HIDCs, notably weaker US data, the Cyprus banking crisis, and uncertainty surrounding the political situation in Italy. After a quarter of stronger US data, the past week saw disappointing data releases. We think this is important because the recent rally in the US stock market will be difficult to sustain unless the data continues to surprise on the upside. Specifically, US consumer confidence disappointed at 59.7 for March versus a forecast of 67.5, the Richmond Fed index came in at +3 versus +6 expected and new home sales dropped 4.6% mom in February versus a forecast drop of 3.9%. Initial claims for unemployment benefits also ticked higher. New York Fed President Bill Dudley reiterated the core view at the Fed that accommodative policies will continue. US stocks were flat on the week, but ended on a softer note. The US treasury market took a more directional view, rallying to take the 10-year yield from 1.92% to 1.84%. The Cyprus banking crisis brought to the market's attention the deep vulnerabilities in the European banking system. Unlike the US, Europe didn't recapitalise its banks in 2008/2009. Some estimates put the recapitalisation requirement as high as 10% of European GDP. While Cyprus itself is largely unimportant in the broader global context, banks in Europe are now vulnerable in ways they were not before the Cyprus bail-in of depositors. For example, a concerted effort to short bank stocks could force vulnerable banks into de-leveraging, thus crystalising losses, further eroding their equity, and finally force a recapitalisation from governments, which, as is well known, are ill-positioned to put up the money. Weak German IFO data, Fitch's decision to place the UK on ratings watch negative, and a poor Italian bond auction did not aid sentiment about Europe. EURUSD dropped below 1.28 (-1% on the week). At the time of writing, it has still not been possible to form a government in Italy. The largest Emerging Markets countries agreed to work more closely together at the BRICS summit, a trend we believe will continue over the coming years as economic power continues to shift to Emerging Markets. Against this backdrop, the performance of Emerging Markets was relatively non-descript. Emerging Market stocks rallied 1.1%, while Emerging Markets fixed income was broadly flat. Emerging Markets currencies gave up 0.2% over the past week, US Dollar sovereign bonds the same, while corporate bonds rallied a modest 0.1%.

Latin America

In Latin America, tomorrow's deadline for **Argentina** to submit a proposal on how to resolve the conflict with holdout investors is likely to be a focus of the market. In **Colombia**, the current account deficit widened marginally to 3.1% of GDP for 2012 as a whole compared to 2011's 2.9% of GDP deficit. The central bank cut policy interest rates by 50bps to 3.25% versus 25bps expected, thus following **Mexico's** recent decision to cut rates. In **Venezuela**, the government launched a new FX auction system by selling USD 200m at a FX rate deemed to have been far weaker than the official exchange rate, though it remains to be seen if this was intentional or a result of teething problems under the new system. **Brazil's** producer price index (IGP-M) gained 0.21% mom in March, which was an improvement from the previous print. Growth in bank lending accelerated slightly from 16.4% yoy in January to 16.8% yoy in February. The Central Bank of Brazil sold USD 1bn via FX swaps at 2.02% in order to contain BRL depreciation. **Mexico's** monthly GDP economic growth indicator ticked up to 3.2% yoy growth versus 2.6% expected and 1.42% previously, while the current account produced a strong surplus of USD46m versus an expected deficit of USD 1.2bn. Unemployment dropped sharply to 4.85% versus 5.27% expected. Inflation rose to 0.52%.

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Asia

The **Czech** central bank left rates unchanged at 0.05%, and increased the rhetoric about weakening the currency in the face of continuing strong inflows. **Hungarian** unemployment rose to 11.6% from 11.2% previously, but the increase was lower than expected (11.7%). The central bank cut interest rates by 25bps to 5% in line with expectations. Poland's retail sales declined 2.6% mom versus 1.3% expected as the economy continues to go through a regular business cycle contraction. **Russia** and **China** reached a breakthrough in energy cooperation, when they signed a Memorandum of Understanding pertaining to Russian gas supplies to China. S&P, the ratings agency, upgraded **Turkey's** long-term foreign currency rating one notch to BB+, while the central bank left policy rates unchanged at 5.5%. There were no hikes in the reserve ratio contrary to market expectations as the central bank opted instead to cut the upper band for the short term funding rate by 100bps to 7.5%. The central bank of Russia announced that the next policy meeting will take place on 2nd April. Israel kept rates unchanged at 1.75% as expected. Both the fiscal balance and the trade balance improved in **South Africa**. **Kenya's** Supreme Court ordered a recount in 22 of 291 constituencies following the recent election.

Eastern Europe, Africa, and Middle East

China's banking regulator introduced new rules to regulate wealth management products. Industrial profits were roughly stable at a rate of 17.2% yoy in January to February compared to a rate of 17.3% yoy in December. Retail and diesel prices were cut by 3.3% and 3.5%, respectively. In **South Korea**, the government revised the growth forecast from 3.0% to 2.3% and unveiled a plan for a new fiscal stimulus. There is plenty of room for stimulus as the budget targets a surplus of 2.2% GDP. **Philippines** sovereign rating was increased to investment grade (BBB- from BB+). Imports declined 8% yoy and exports fell 2.7% yoy in January, thus improving the trade balance. **Singapore's** March CPI was 4.9% yoy versus 4.1% expected and 3.6% previously. One-off increases in transport prices and food and travel costs associated with the Chinese New Year largely accounted for the increase in prices. **Taiwanese** industrial production was softer than expected at -11.5% yoy in March versus -9.3% expected. The softness was largely a correction following a very strong previous number (+19.1% yoy). **Hong Kong's** trade numbers softened in February.

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