

## June 2008: The beginning of the end or the end of the beginning?

### Market pessimism increased in June

News about the economy and from the markets further darkened the increasingly gloomy sentiment in June. The price of crude oil rose to new record high levels as tensions unexpectedly mounted in the Middle East. Confidence in the U.S. economy's resilience is also crumbling. Unemployment is rising at a growing rate and the high prices of food and energy is eating into consumption. Fear of inflation has also struck the central banks, and the concern about the direction of monetary policy is a new uncertainty factor. The situation is not helping banks, which are already in a difficult position, and fears that banks will suffer further losses have multiplied.

The global equity markets declined abruptly in June, falling by around 10 percent. On many markets, equity values fell below the March lows due to earnings fears. Indeed, the risk factors currently favor a clear underweighting of the equity markets. The fixed income markets also performed poorly in June. Long rates continued to rise as the central banks took a stricter stance on inflationary dangers.

### Will the European Central Bank drive the euro zone into recession?

The ECB seems to have reached the conclusion that inflation acceleration is a long-term structural problem. This is to say that the rise in the price of food and energy may lead to an accelerating rise in salaries. Therefore, the only way to tackle inflation is by driving the euro zone economy into recession. It appears that the ECB is also prepared to accept the risks arising from the sacrifice: the recovery of banks in the euro zone will be delayed, the likelihood of payment defaults will increase quickly, and tightening monetary policy will impair the situation of countries in the Mediterranean region, in particular. The possible raising of the refinancing rate has been met with astonishment on the fixed income markets, as the ECB's monetary policy has little or no impact on the pricing of raw materials on the global market.

The threat of tightening monetary policy is weakening the financial outlook, which is already slightly shaky, and adds to the uncertainty regarding the direction of interest rates. As uncertainty increases, investors demand higher compensation for risk taking in different asset classes, although at the moment the markets are devoid of risk takers.

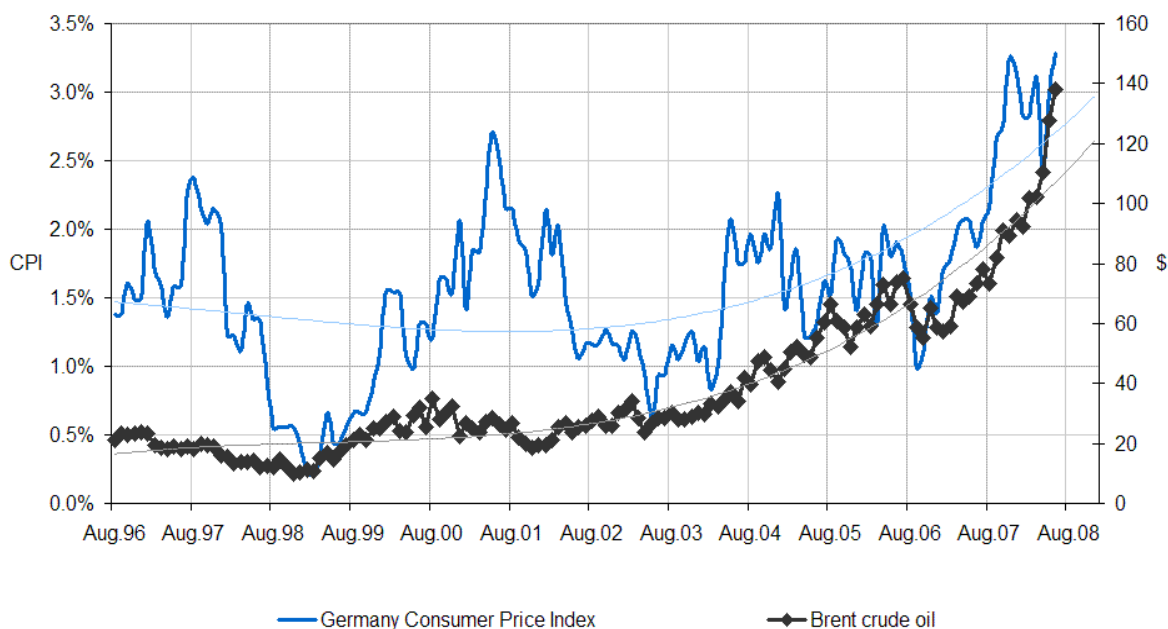
### Outlook for the rest of the year

In the fixed income markets, the ECB is expected to raise its refinancing rate up to 4.5 percent by the end of the year. If the ECB's interest rate hikes were more moderate, the market reaction would probably be cautiously positive. Expectations that the Fed will tighten monetary policy have reduced somewhat, but the markets anticipate that the federal funds rate will rise to 2.25 percent by the end of the year.

Corporate earnings growth looks more challenging than before under pressure from mounting costs and financing expenses. However, share prices have fallen significantly and rapid upward movements may also take place without any specific reason. Markets will probably have to wait some time for better news. Conditions that allow a sustained rise in equity prices will only be created once the weakening earnings trend eventually reaches a turning point.

A fall in the price of raw materials would ease the situation of companies and consumers, as well as the operations of the central banks. However, inflation is expected to accelerate in the coming months, and the prices of many raw materials are at the mercy of the increasingly unpredictable weather conditions. Although the price level of crude oil is, from many points of view, higher than the demand would suggest, the oil price rise has been alarmingly strong. The weakening dollar is accelerating the oil price rise, as oil-exporting countries want to maintain the level of their export income. In many emerging economies, demand for raw materials is also fuelled by negative real interest rates and subsidies.

Figure: The rising price of crude oil has accelerated inflation in Germany and has forced the European Central Bank to consider tightening monetary policy



Data: Reuters

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