

# Pivot Points for 2013 in the Era of Dissonance

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# 2012's Themes are Old News

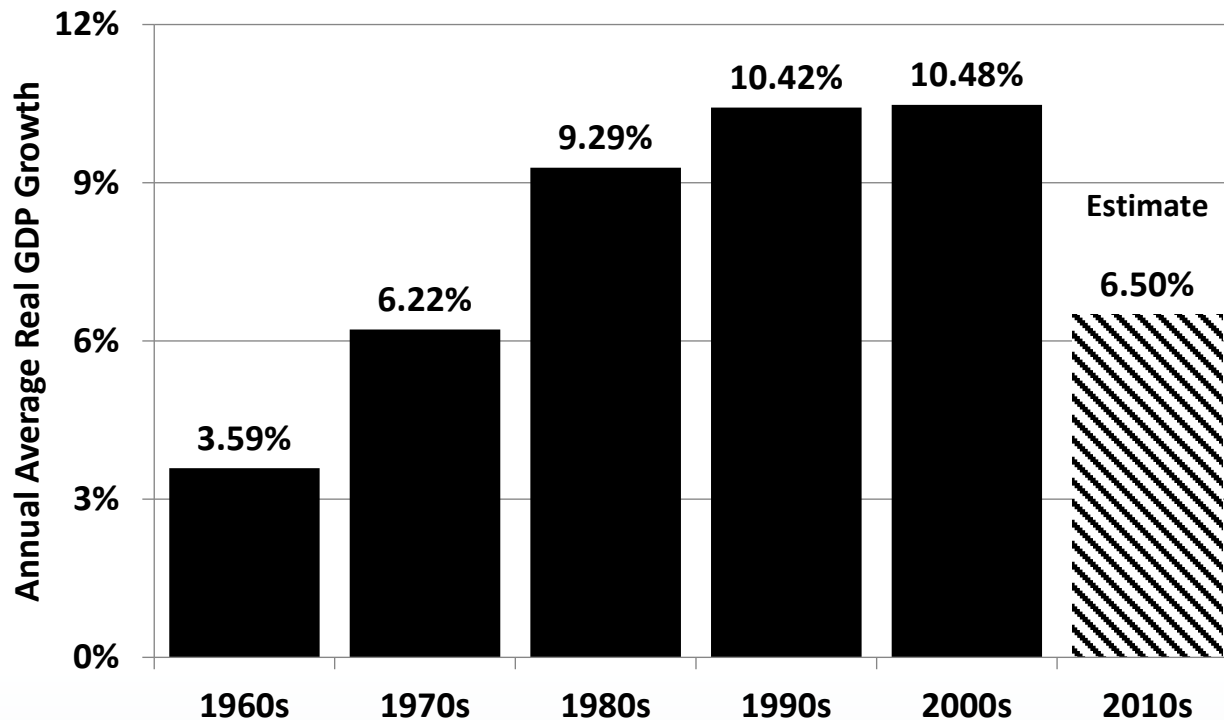
- **China's growth deceleration has ended**
- **European debt crisis will make some headlines but the danger of implosion has passed**
- **US avoided the worst of the fiscal cliff and will get by the debt ceiling, too (very messy, though)**
- **2013 is about Looking Forward to New Challenges, New Opportunities**

# Themes for 2013

- **Market participants potentially start to embrace increased risk-taking in search of higher returns – bad for flight to quality exposures.**
- **Improved investor confidence highlights unintended consequences of Quantitative Easing by US, UK, Europe, and Japan – potential for emerging market currencies**
- **Metals markets may be conflicted, as gold loses support from the fear factor while copper benefits from an improved global economic outlook.**
- **Climate volatility may keep Agricultural markets on edge.**

# China stabilizing in the 7% real GDP growth area for now, drifting down later in the decade

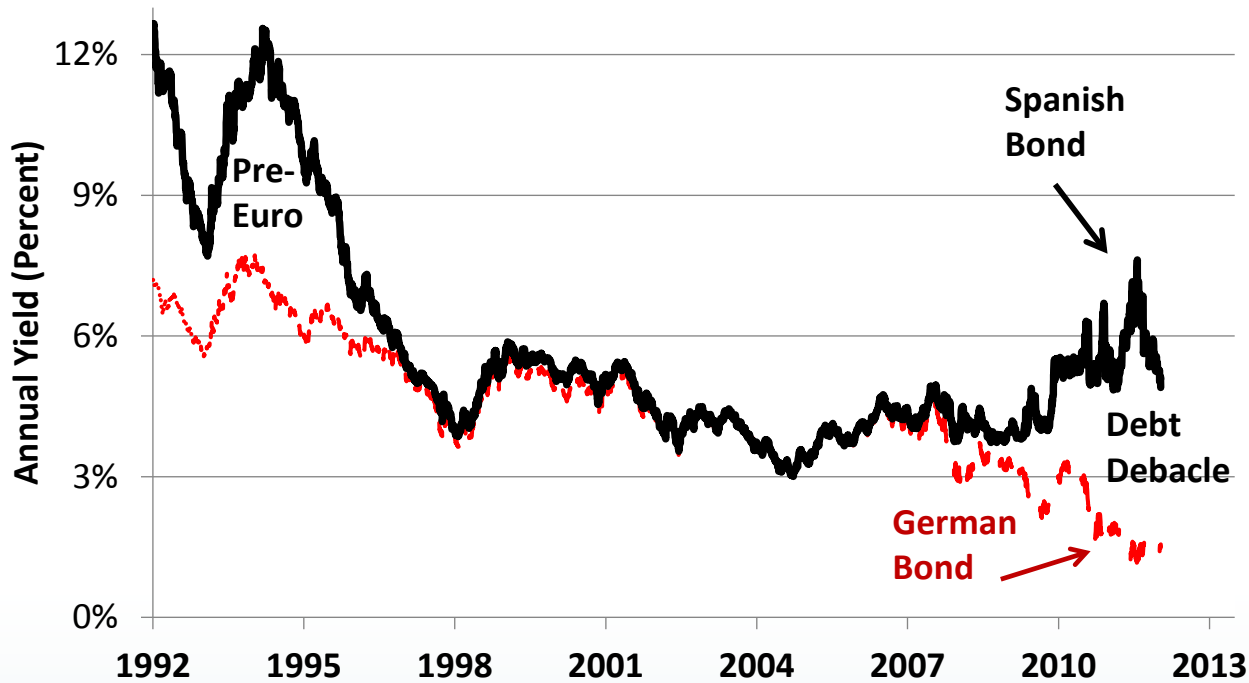
## China: Real GDP Growth Rates by Decade



Source: World Bank Real GDP Index from the Bloomberg Professional (WRGDCHIN). Estimates by CME Economics Research.

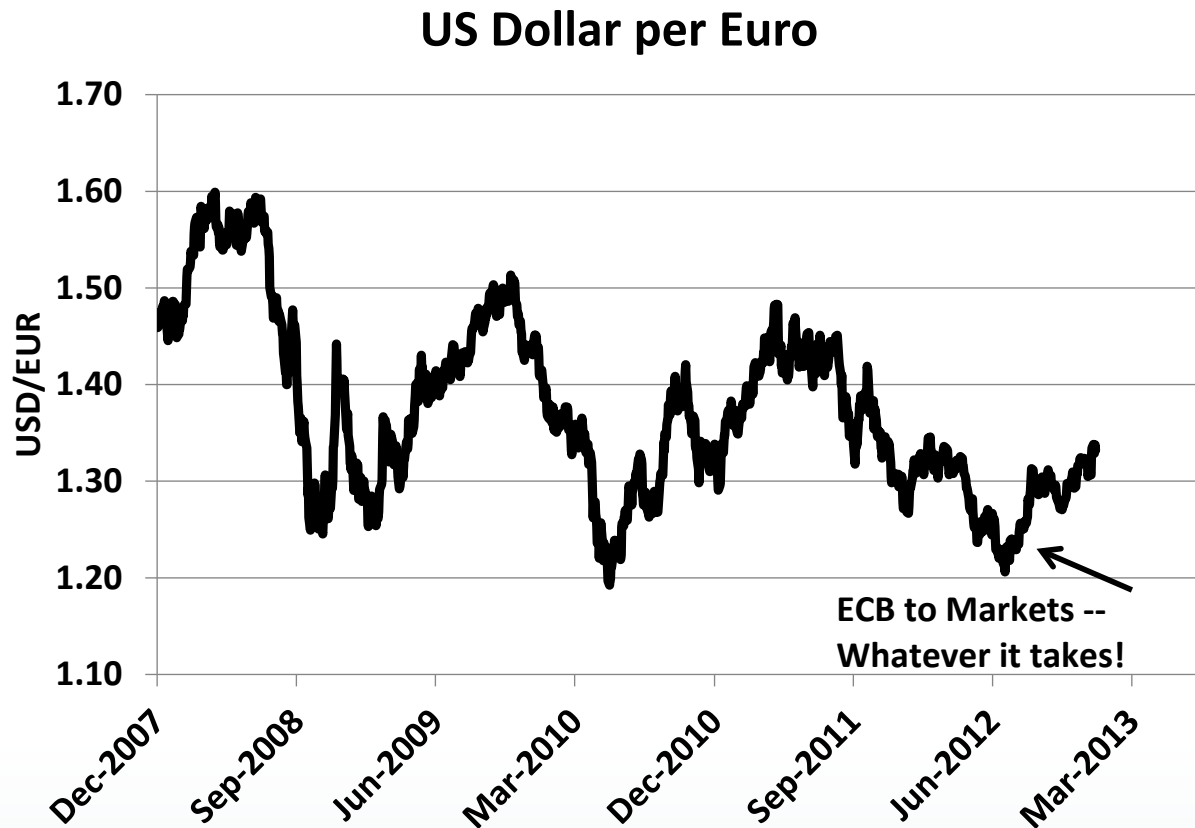
# European Bond Markets In Recovery

## Spain and Germany: 10-Year Government Bond Yields



Source: Bloomberg Professional (GDBR10 and GSPG10YR)

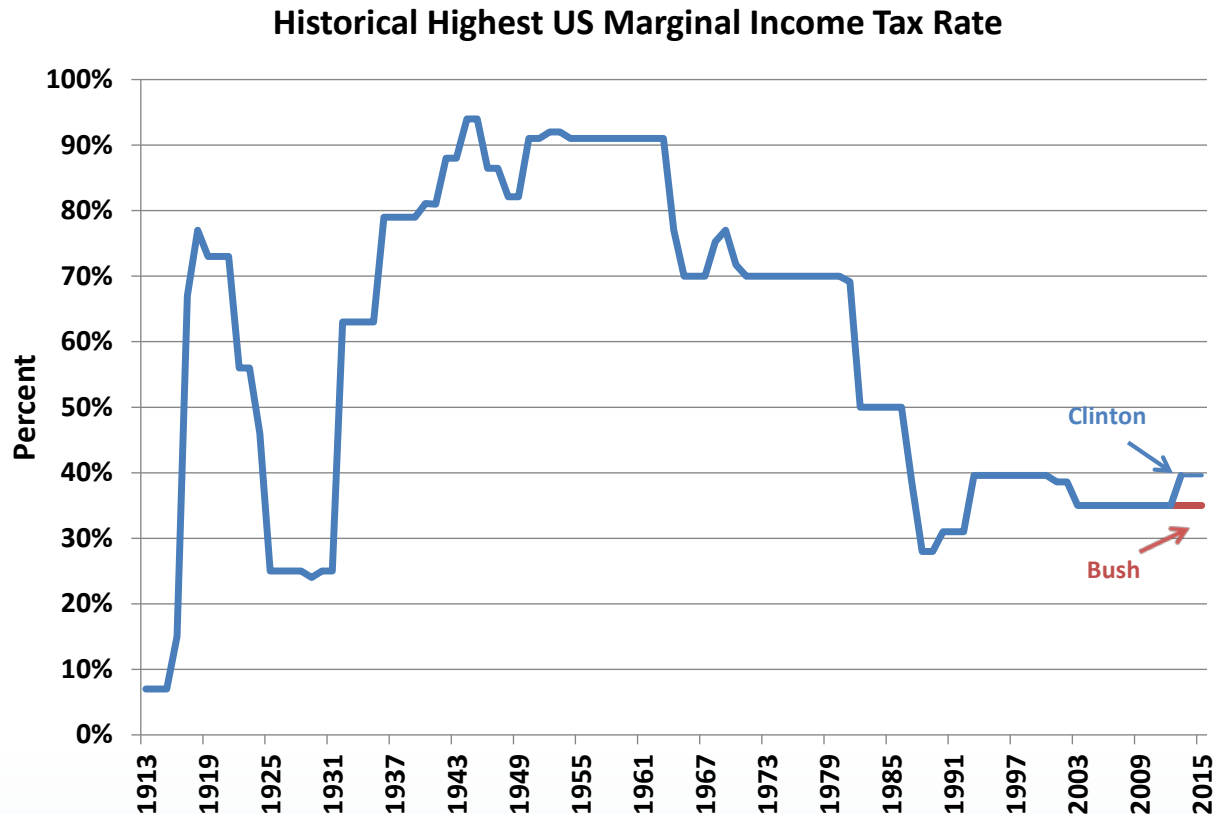
# Euro Has Recovered from Worst of Break-up Fears



Source: Bloomberg Professional (EUR)



# US Tax Rate Uncertainty Resolved (for now)

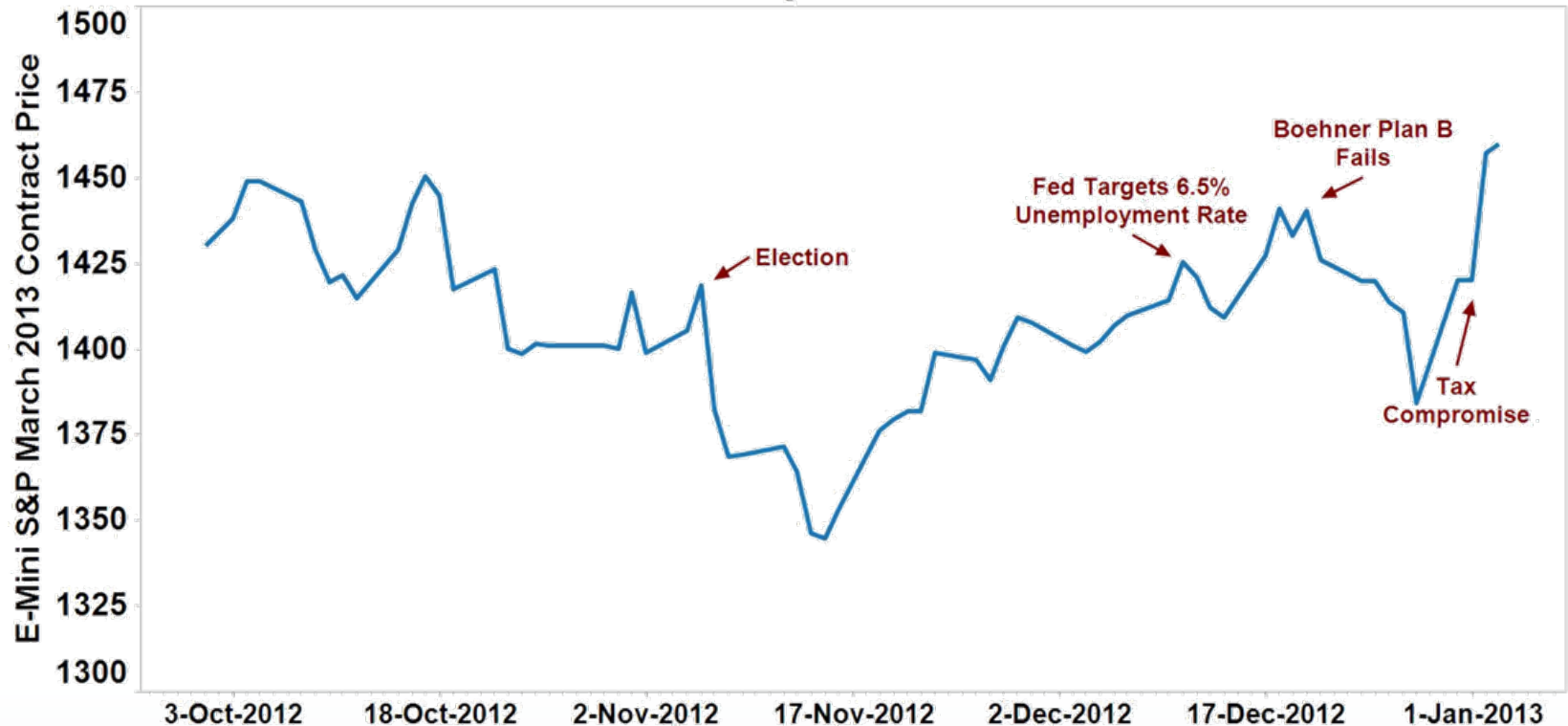


Source: Tax Policy Center, Urban Institute and Brookings Institute

\*Note: Income Bracket applied to Highest Tax Rate has changed over time

# US Fiscal Cliff Avoided – Stocks Rally

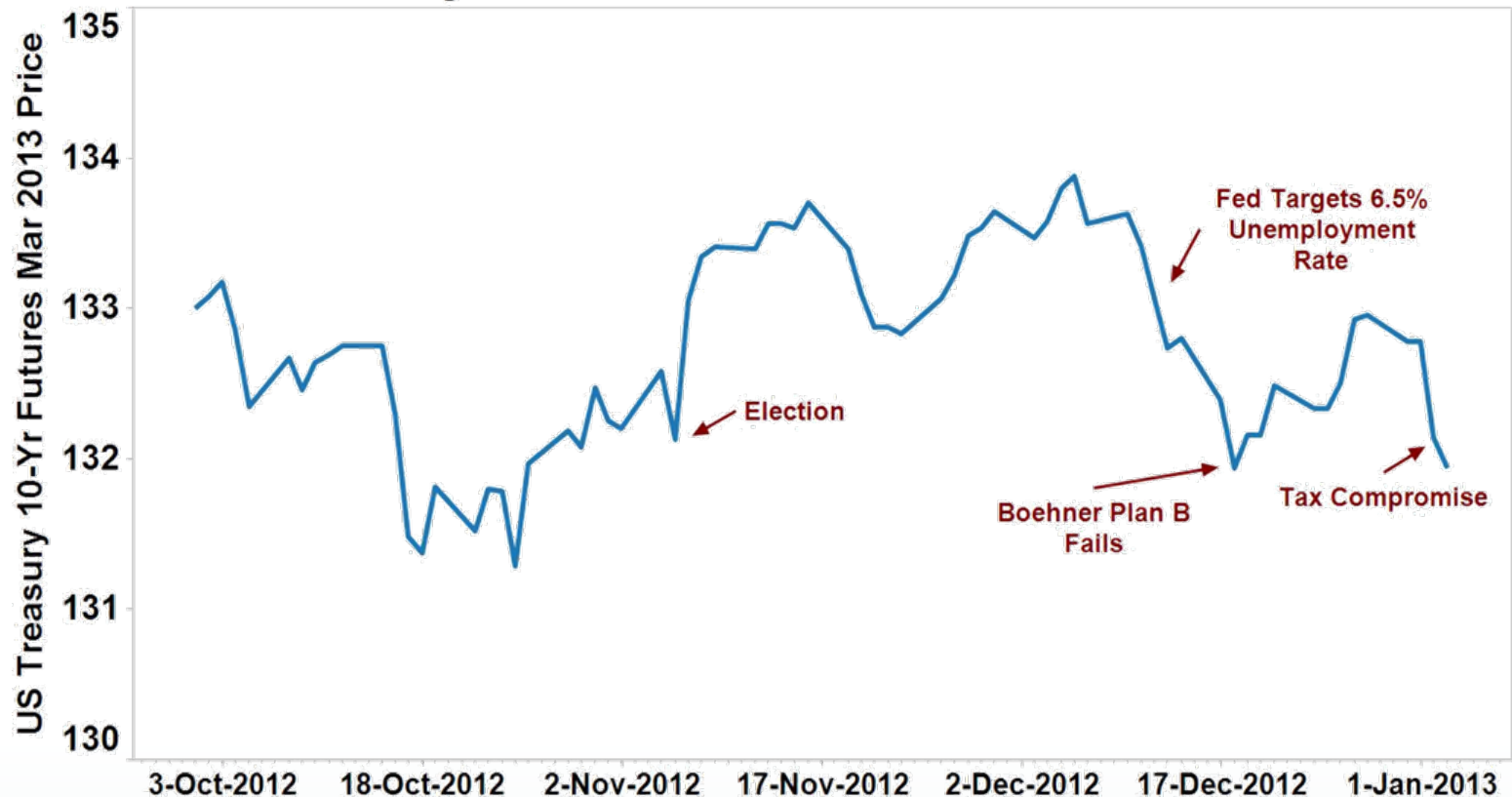
## US Stocks Rally with Tax Deal



Source: ESH3 Data from Bloomberg Professional

# US Fiscal Cliff Avoided – Bond Prices Fall

## Treasury Note Prices Decline on Tax Deal



Source: TYH3 Data from Bloomberg Professional

# Current Economic Conditions in the United States

**The US economy has reeled off 14 straight quarters of real GDP growth since Q3 2009 averaging about 2.2% growth per annum.**

**The unemployment rate has fallen from its peak of 10% to below 8%, as 1.84 million net new jobs were created in 2012.**

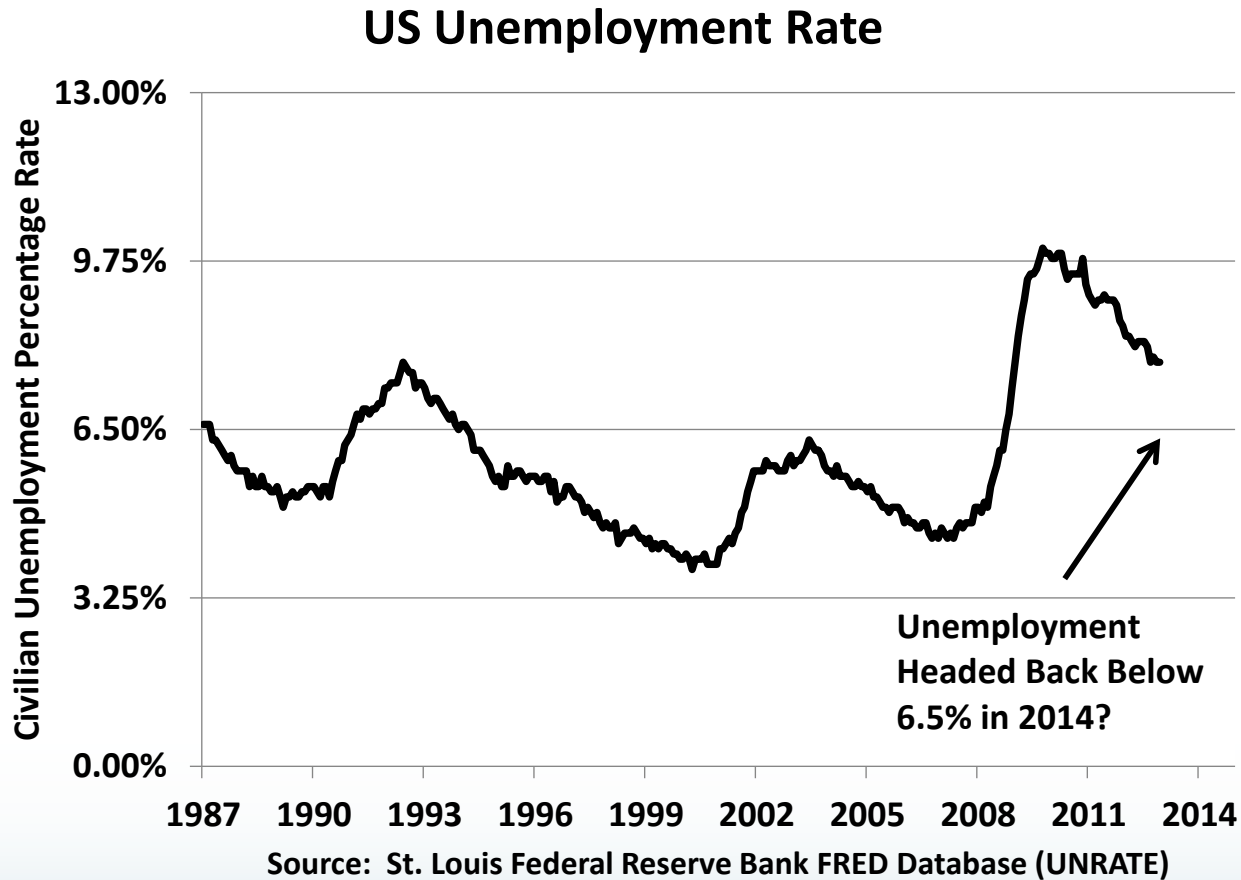
**US large corporations are flush with very large cash holdings,.**

**The US banking sector has recapitalized itself since 2008 and is now comfortably profitable.**

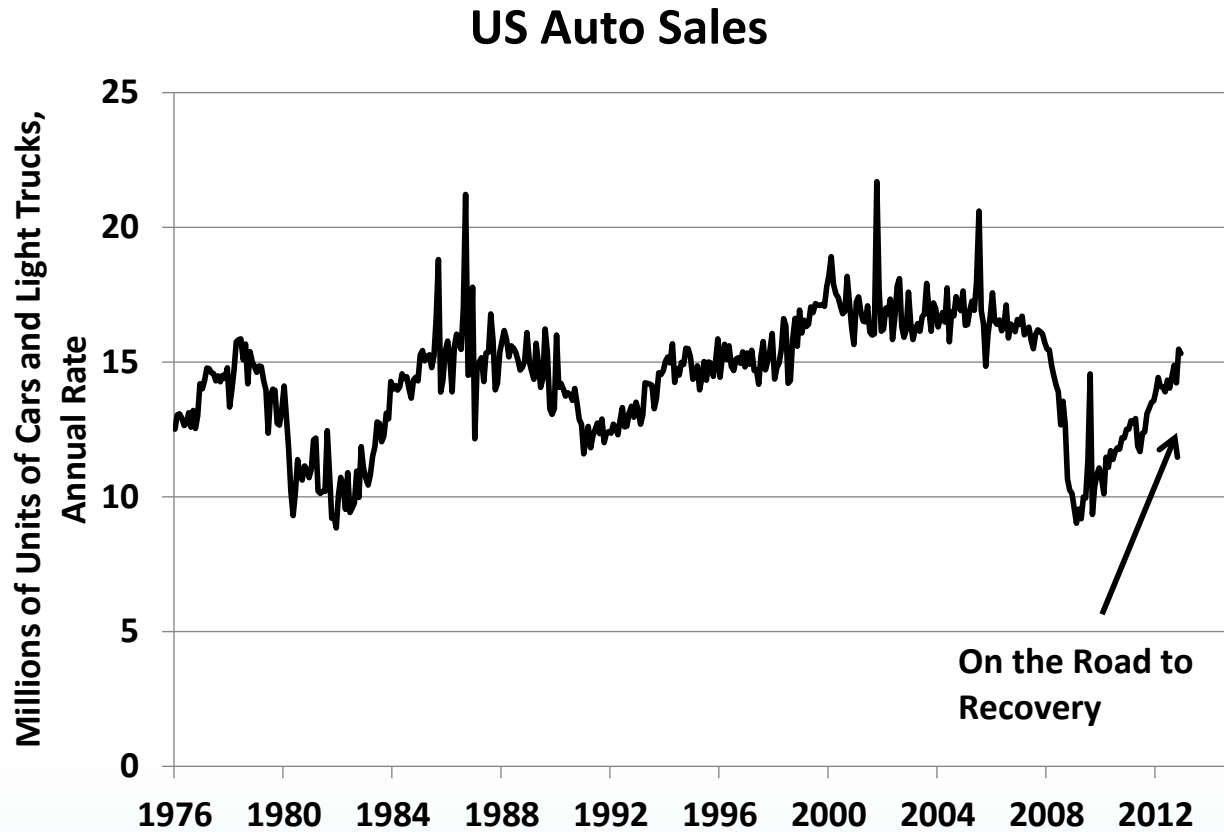
**Auto sales are booming**

**Housing is finally entered a recovery phase in 2012**

# US Labor Market Improving Slowly

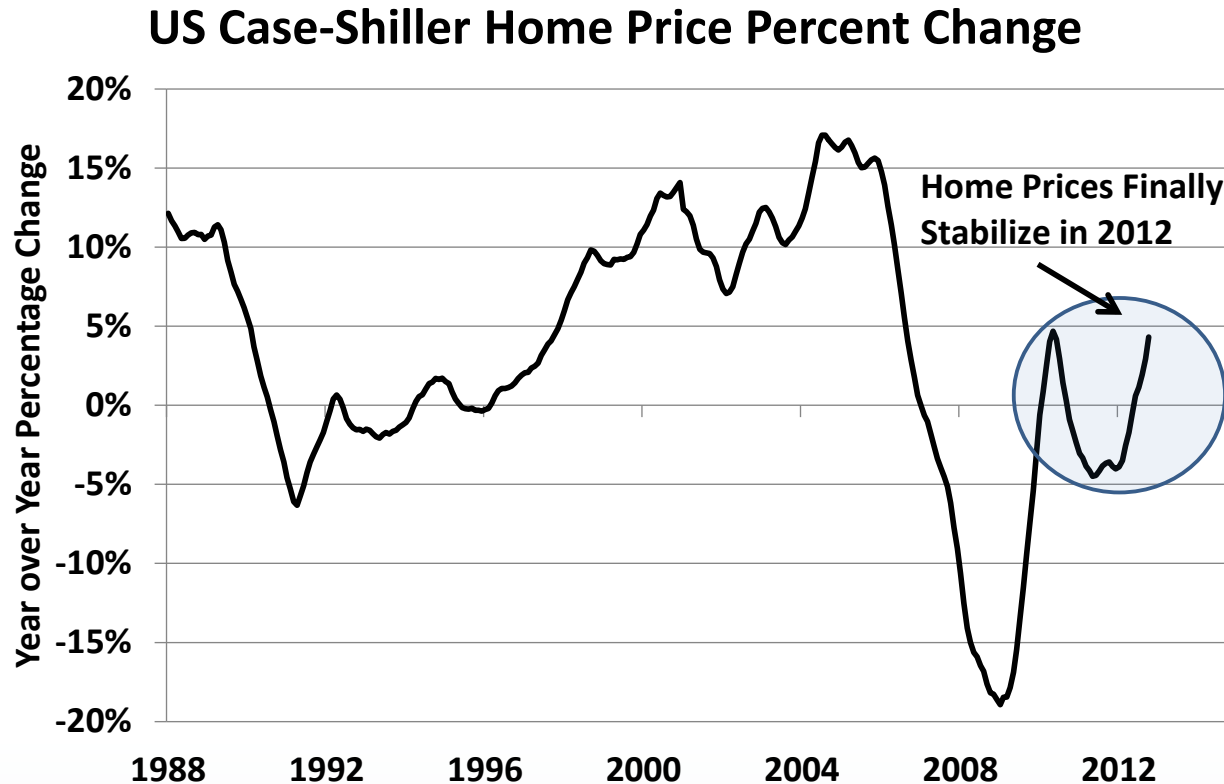


# US Auto Sales Are Back to 15 Million Units per Year



Source: Federal Reserve Bank of St. Louis FRED Database (ALTSALES)

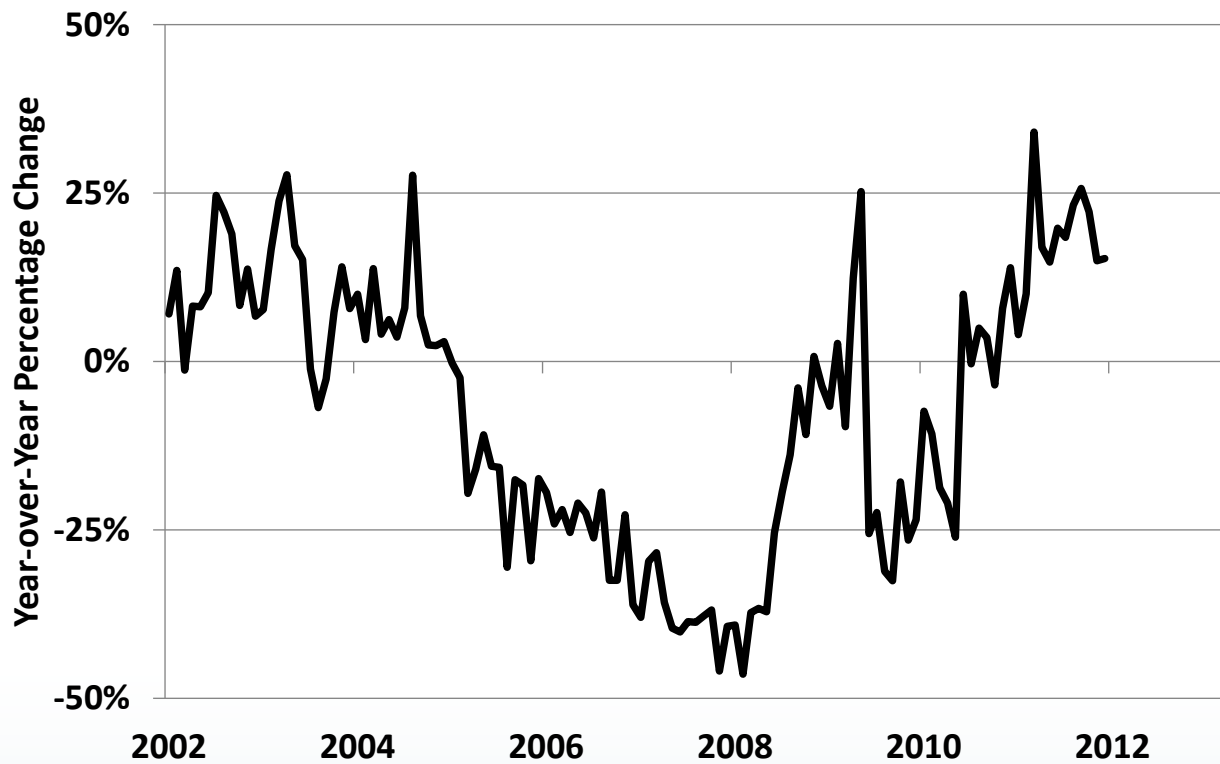
# US Home Prices Finally Stabilized ....



Source: Case-Shiller index from the St. Louis Federal Reserve Bank FRED Database (SPCS10RSA , SPCS20RSA)

# Leading to a Recovery in Single-Family New Home Sales ...

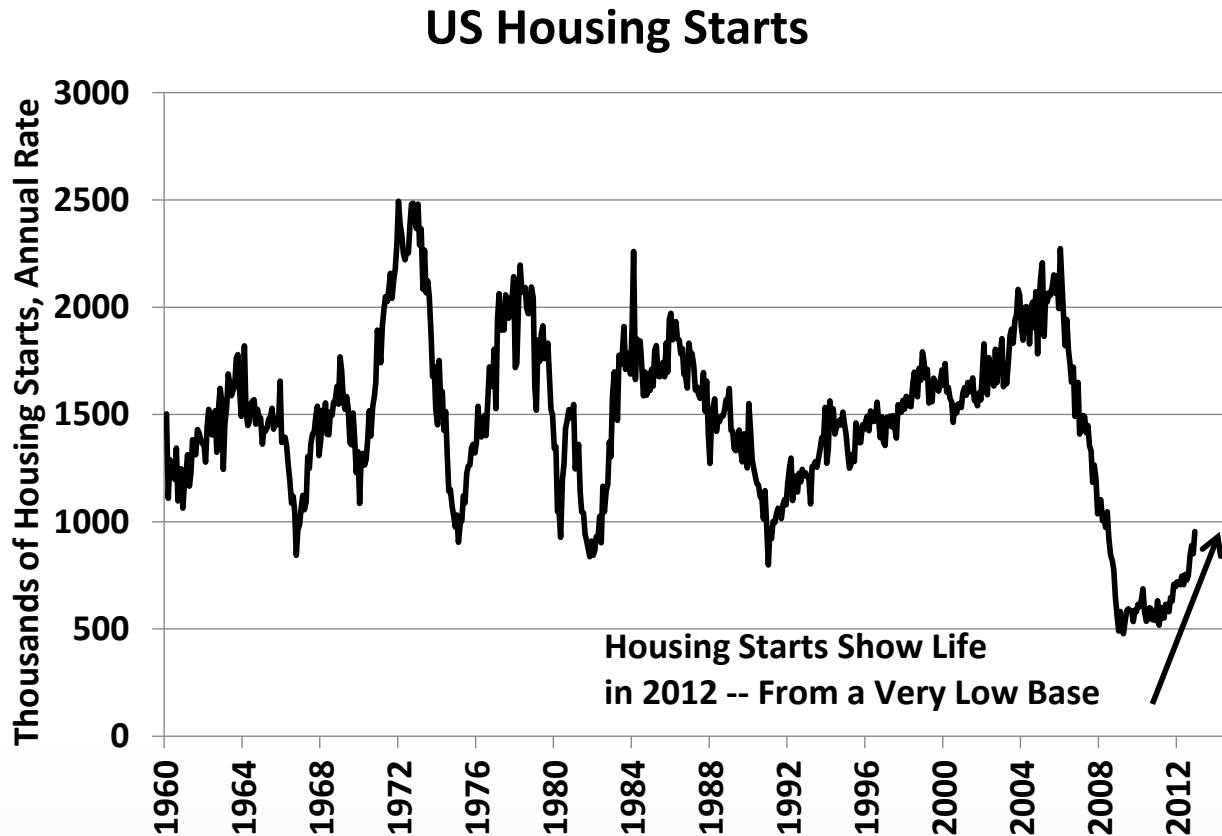
## New Single-Family Home Sales in US



Source: St. Louis Federal Reserve "Fred" Database (HSN1F)



# And a Rebound in Housing Starts from a Very Low Base

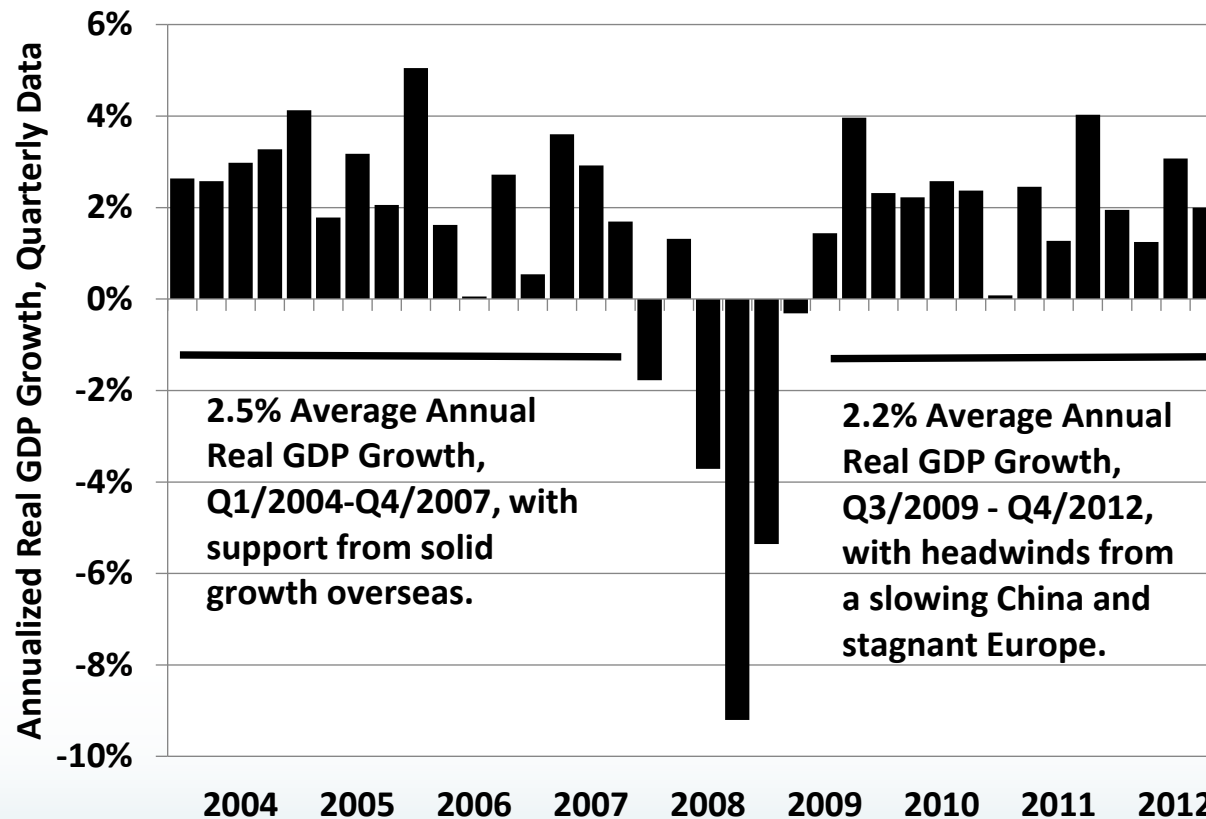


Housing Starts Show Life  
in 2012 -- From a Very Low Base

Source: Federal Reserve Bank of St. Louis FRED Database (HOUST)

# US Real GDP Growth in the last 14 quarters has been comparable to pre-crisis growth.

## US Real GDP Growth by Quarter



# 2013 -- Back to the Quantitative Easing Debate

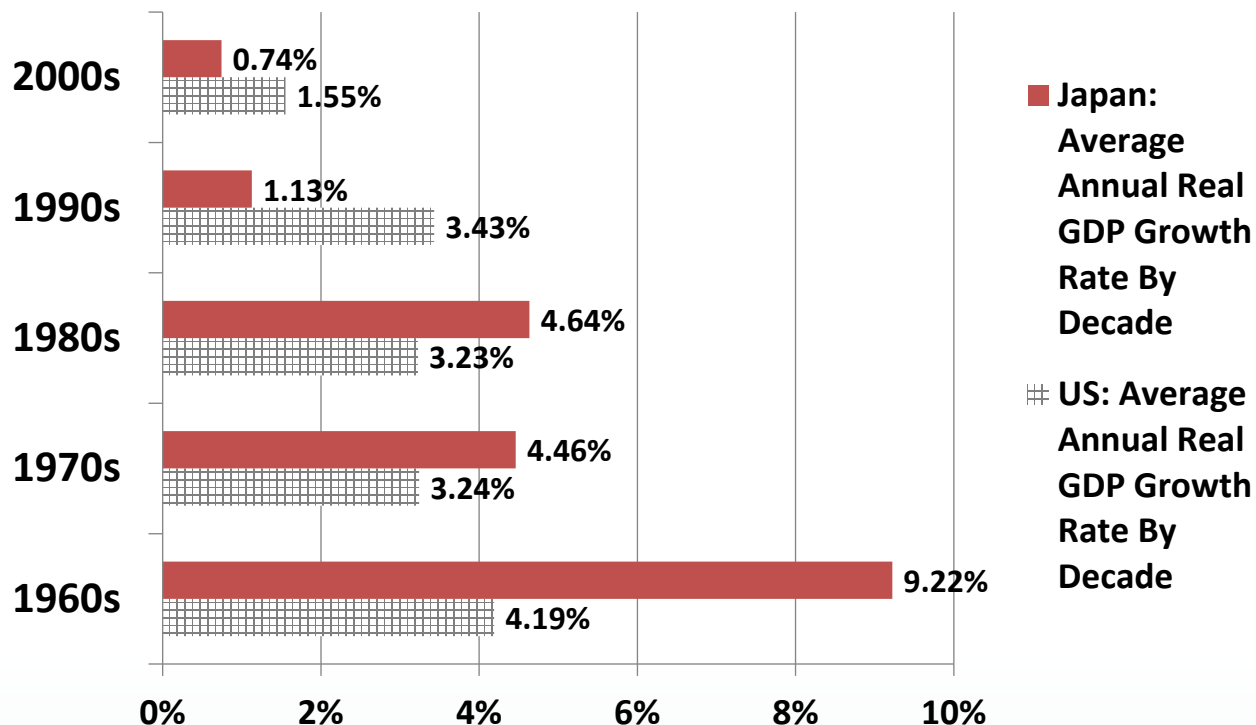
## Evaluating Why QE Did Not Help Create Jobs:

**“Essential concepts necessary to consider when evaluating the efficacy of quantitative easing,”**  
*Review of Financial Economics*, 2013, (Bluford H. Putnam)

**Unintended Consequences of QE: “Ultra easy monetary policy and the law of unintended consequences,”** Federal Reserve Bank of Dallas Globalization and Monetary Policy Institute, 2012, Working Paper no. 126 (William R. White).

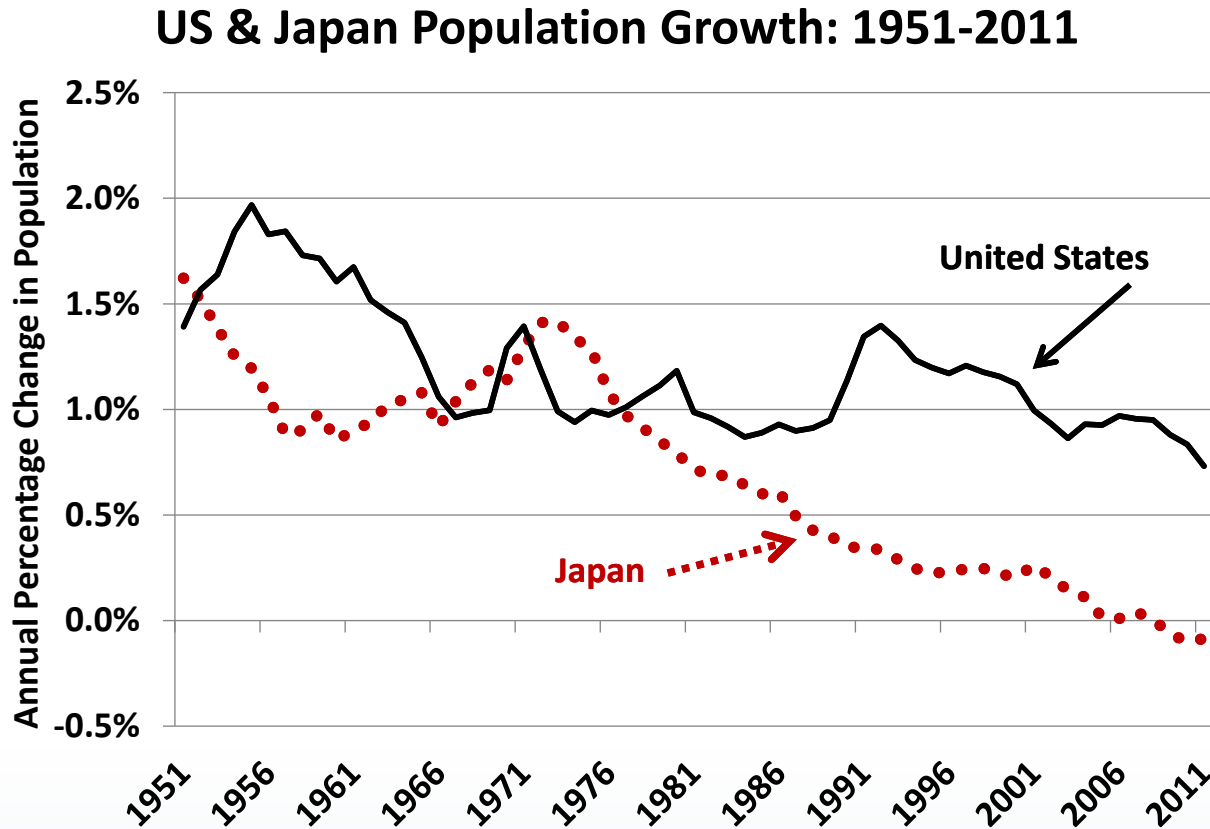
# US & Japan are the Two Countries Most Concerned about Raising Economic Growth

## US and Japan Real GDP Growth by Decade



Source: World Bank Real GDP Data provided through the Bloomberg Professional

# Japan's Population Growth Rate Peaked in 1971, the US in 1991



Source: US Census Bureau: International Database

# Population Pyramids

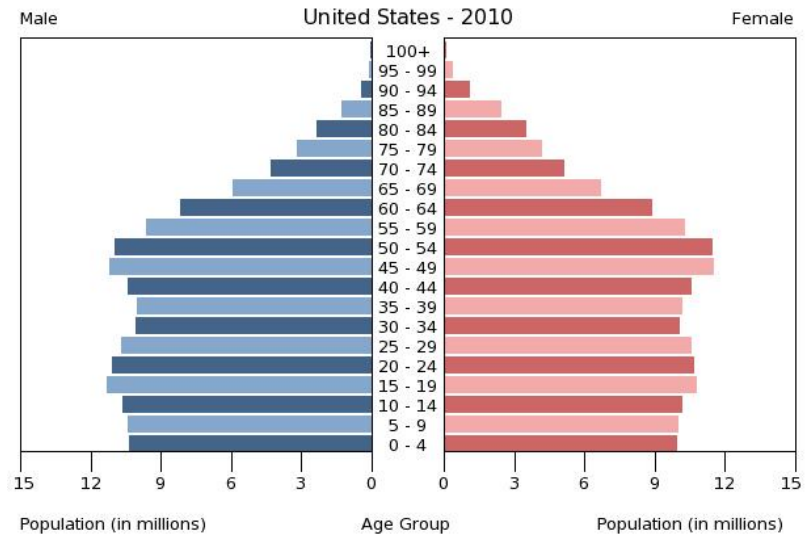
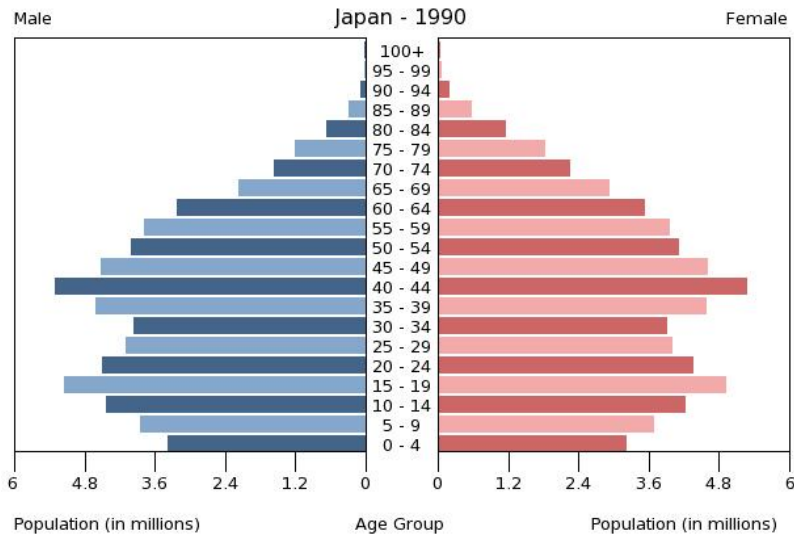
**The next charts represent a country's age profile in 5 year segments, with the children at the base, the working age population in the middle, and the retirees at the top. Men are in blue on the left, and women in red on the right.**

**Source: US Census Bureau: International Database.**

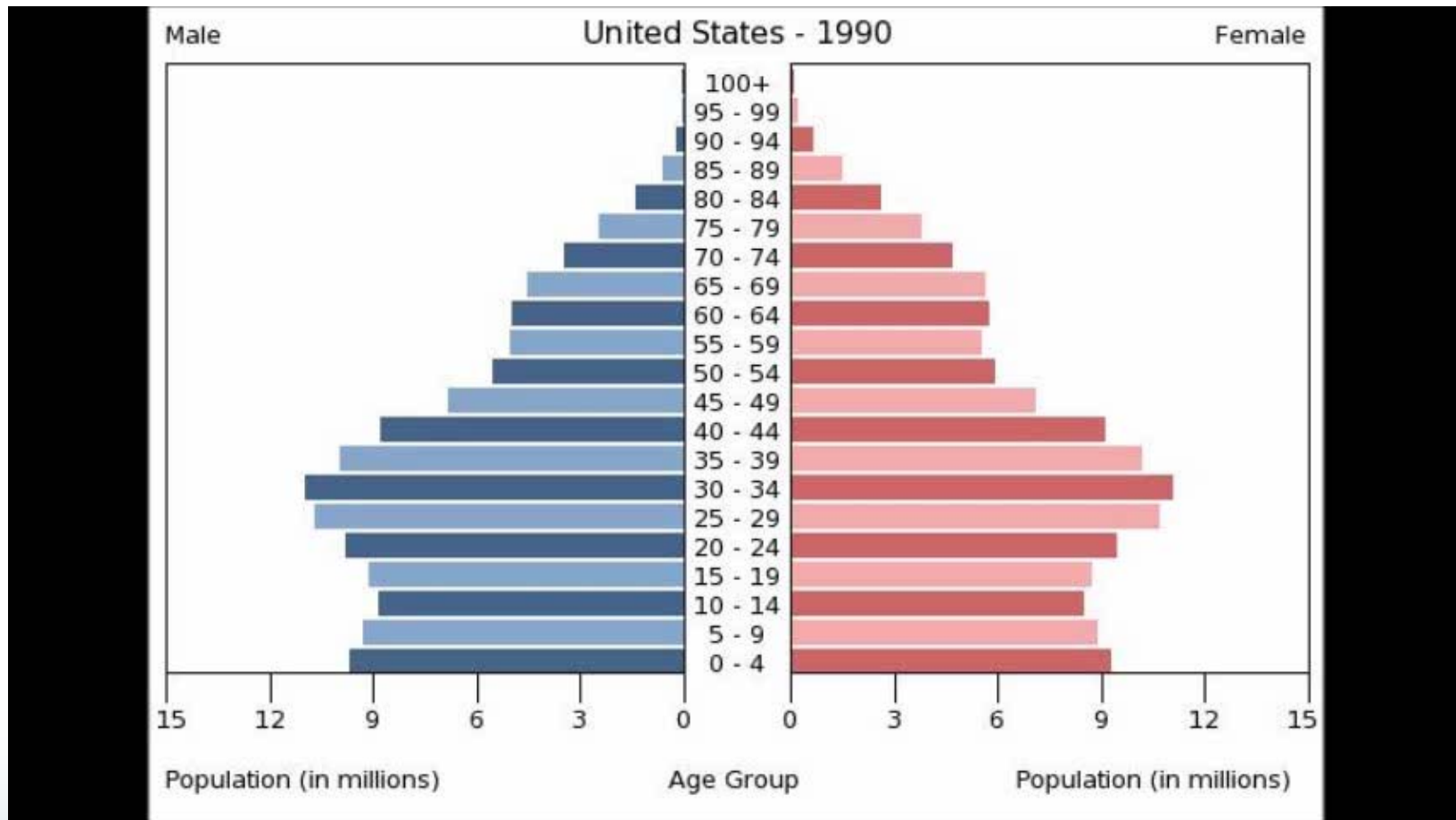
# Population Pyramids:

## Japan

## United States



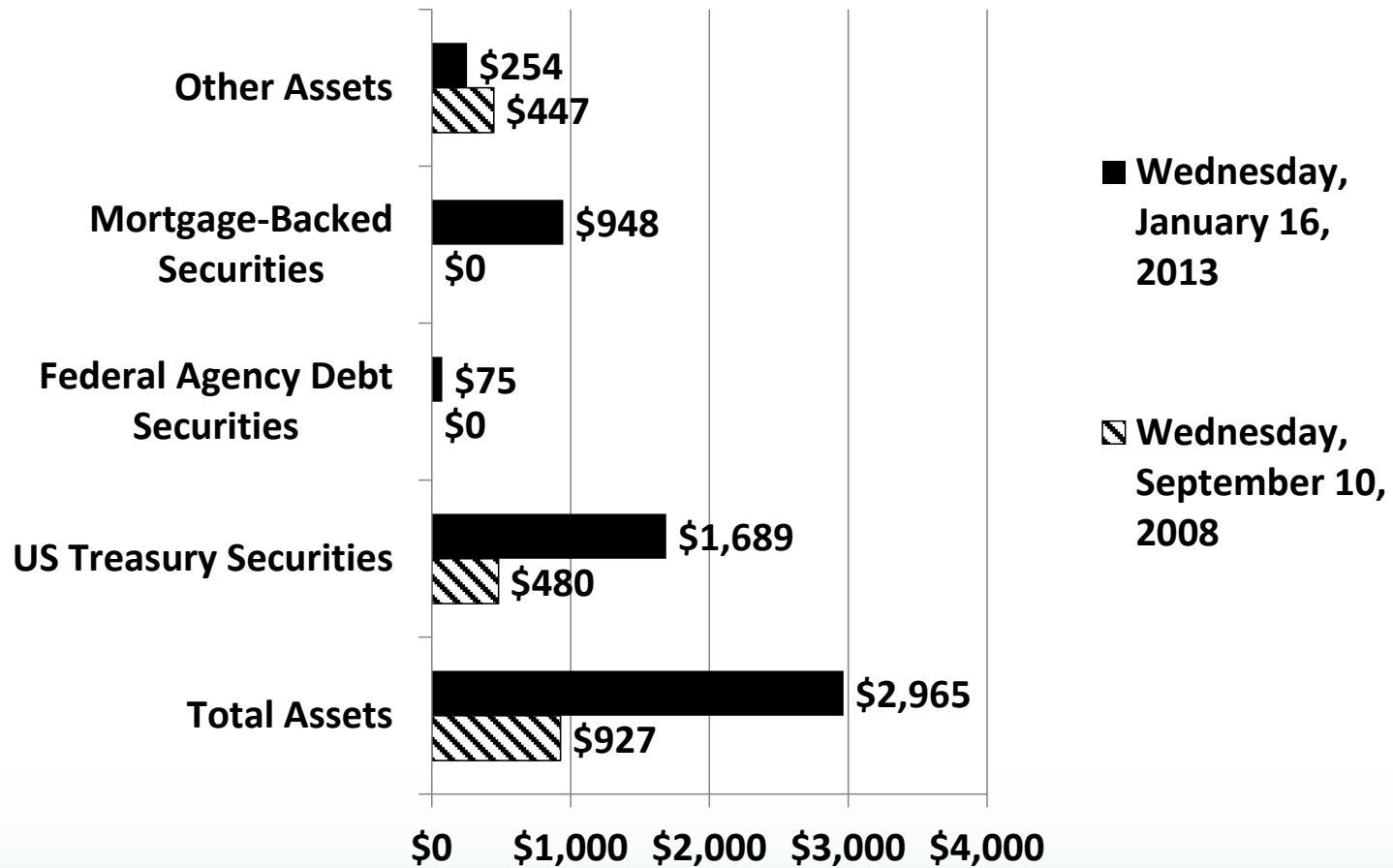
# Aging of US Population from 1990 through 2022





# US Federal Balance Sheet Expansion

## Assets of the US Federal Reserve (\$Billions)



Source: Federal Reserve Release H.4.1, Table 8.



# US 10-Year Treasury Inflation-Adjusted Yields

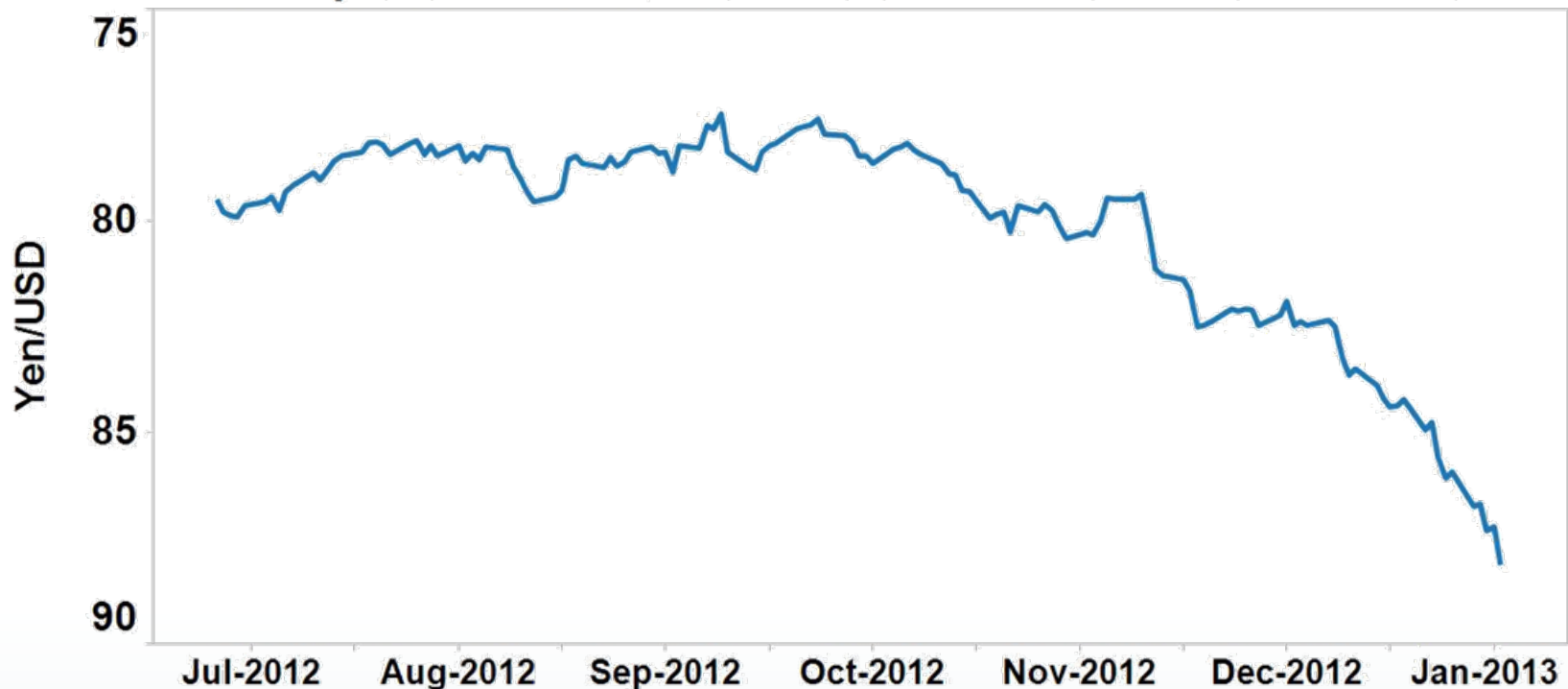
How Low Can Inflation-Adjusted  
10-Year Treasury Bond Yields Go?



Source: Data from the Bloomberg Professional.

# Japan Embarks on Currency Depreciation Policy and Expanded Quantitative Easing

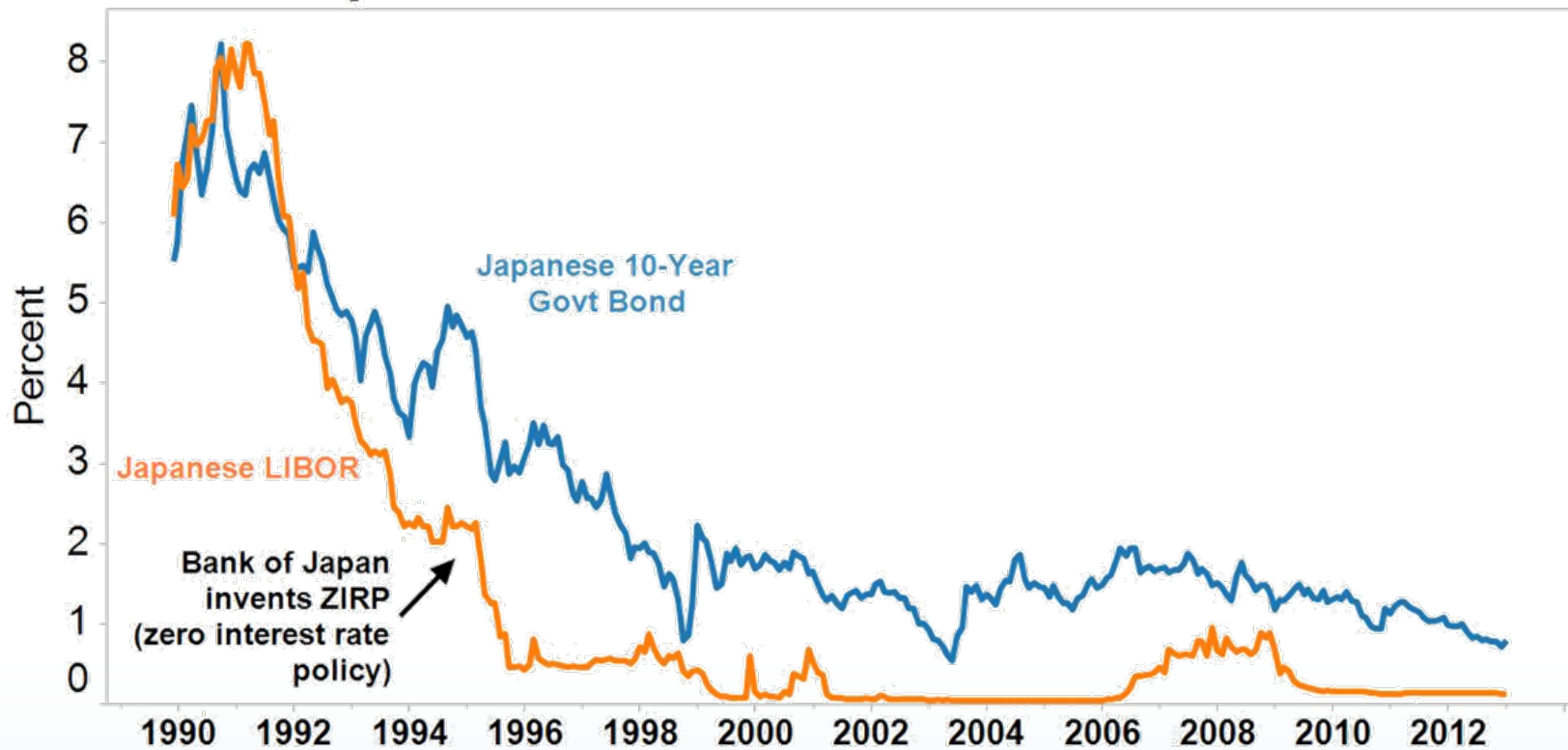
If the Bank of Japan Successfully Weakens the Yen,  
Will the Japanese Government Bond Market be Destabilized?



Source: JPY Data from Bloomberg Professional

# Japan Embarks on Currency Depreciation Policy and Expanded Quantitative Easing

## Japanese LIBOR and 10-Year Bond



Source: JY0001M and GJGB10 Data from Bloomberg Professional

# Emerging FX in ZIRP World

**The central banks in the US, UK, Euro-Zone, and Japan are all committed to extended periods of near-zero short-term interest rate policies (ZIRP).**

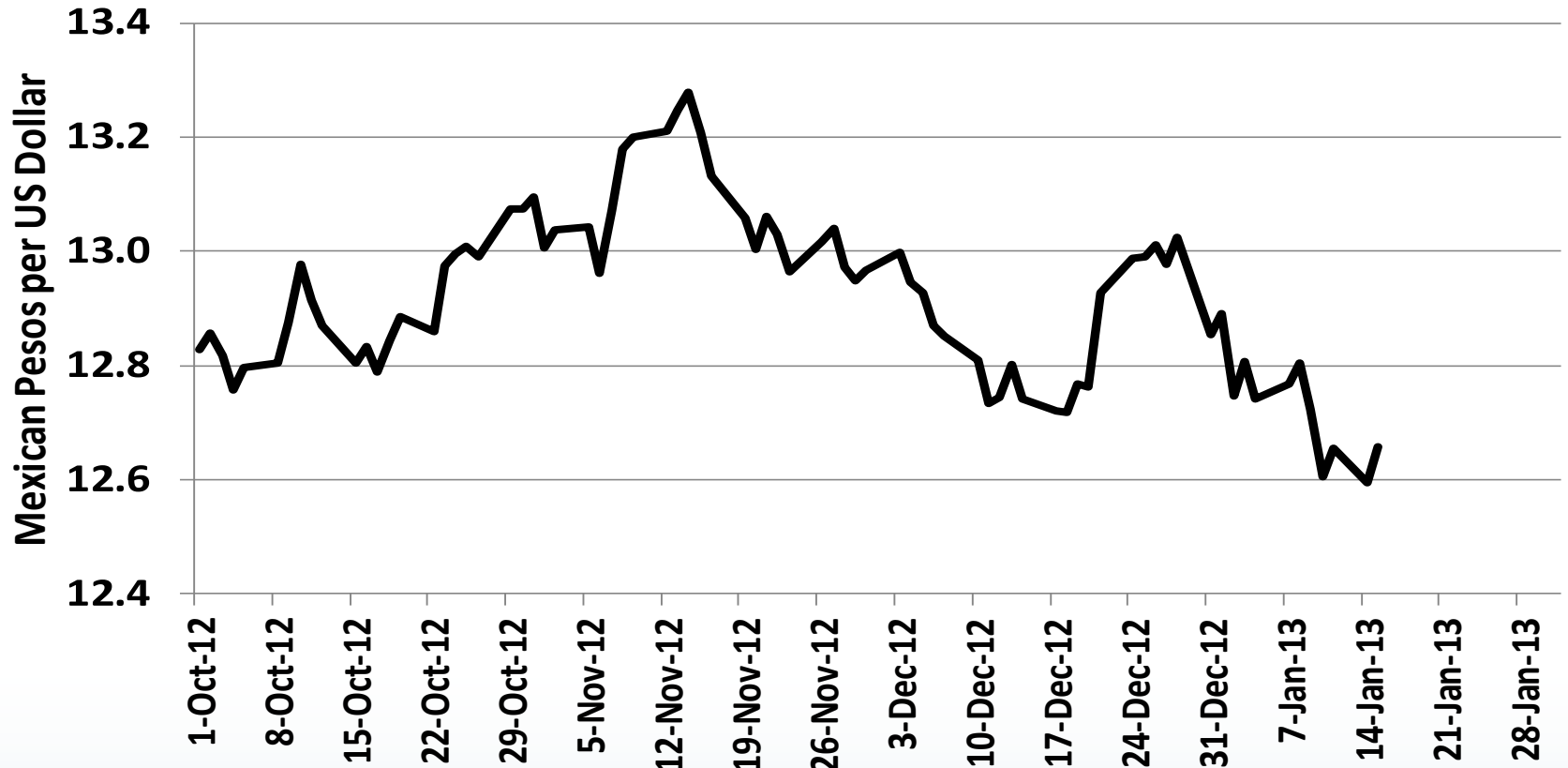
**The mature commodity producing countries, such as Australia, and the emerging market nations, from Mexico and Brazil in Latin America to India to China are likely to maintain interest rates between 3% and 6% (or more) above those in the US, UK, Euro-Zone, and Japan.**

**This makes investments in the currency carry trade very attractive, even relative to the substantial risks. However, when market fears (i.e., Europe debt crisis, China slowdown, US fiscal cliff, etc.) dominate, risk-off trading will close these positions down. These carry positions will get reestablished as global market fears calm.**

<p><b>Emerging Market Country Short- term Interest Rate</b></p>		<p><b>US Federal Funds Rate</b></p>
	<p><b>Joint Interest Rate &amp; Exchange Rate Market Volatility</b></p>	
<p><b>Spot FX/USD Rate</b></p>		<p><b>Futures FX/USD Rate</b></p>

# Mexican Peso Traded US Fiscal Cliff Debate

Mexican Peso Sold Off on Election Fears of US Fiscal Cliff -- Then Rallied with the Tax Deal

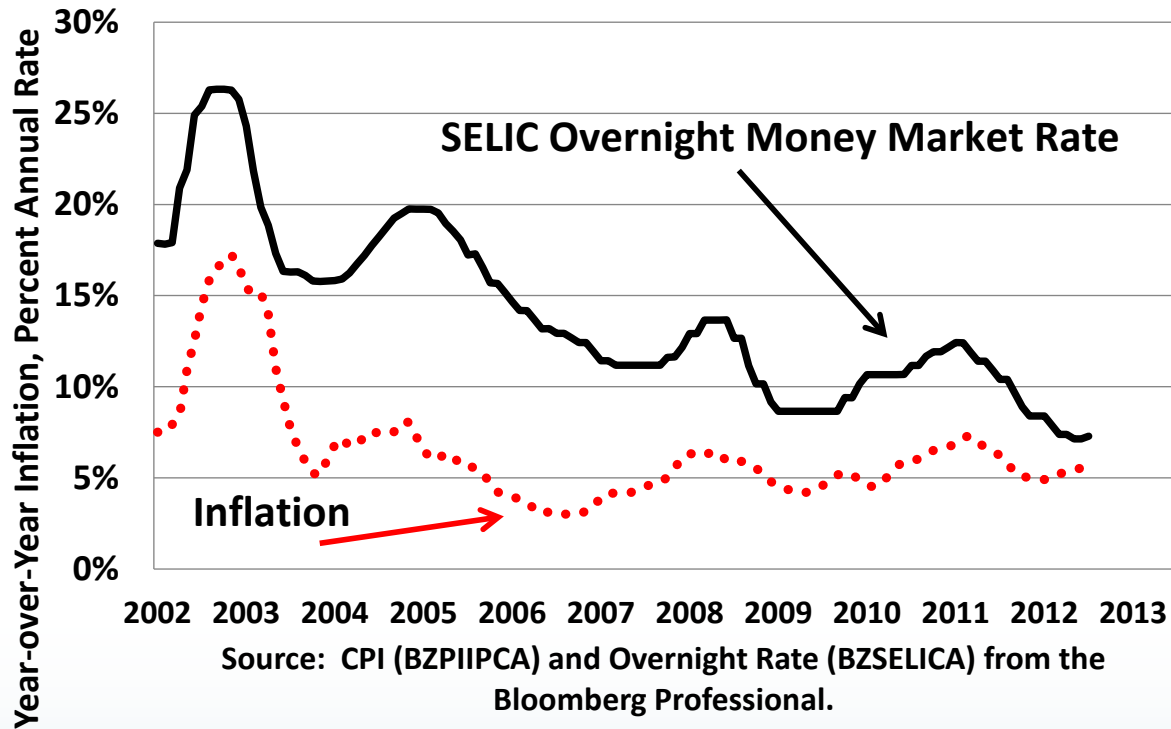


Source: Bloomberg Professional (MXN)



# Brazil Narrowing Rate Spread Over Inflation

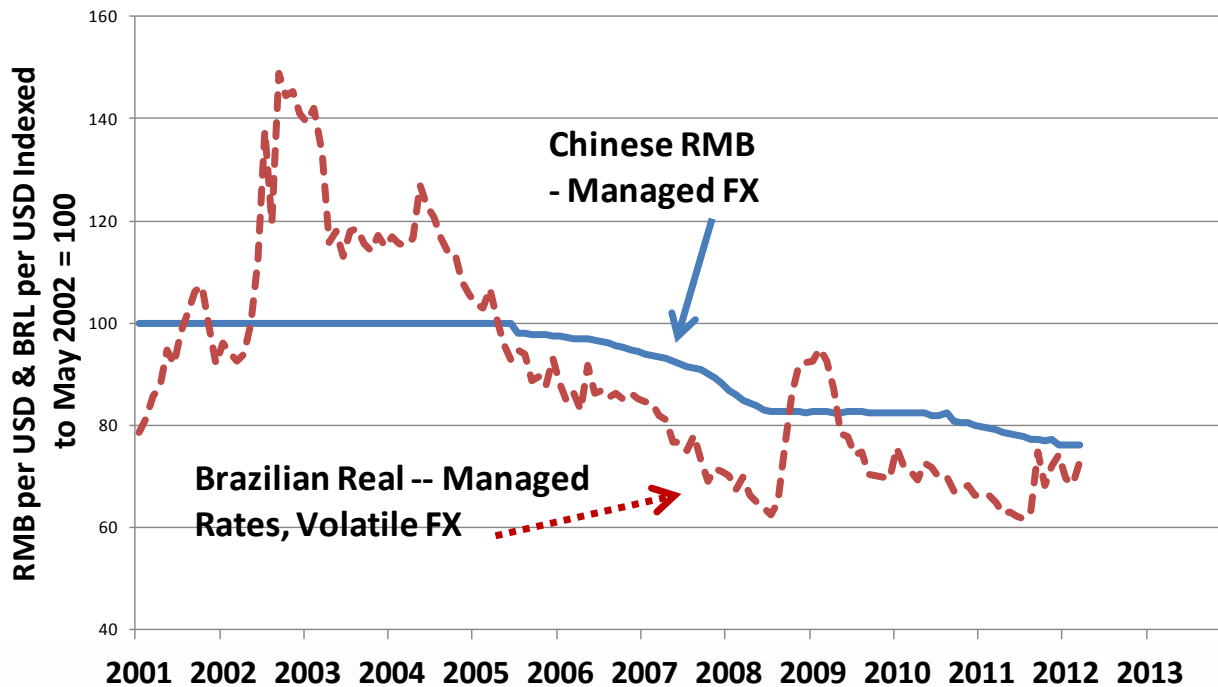
## Brazil: Inflation versus Overnight Rates





# China & Brazil Exchange Rate Paths

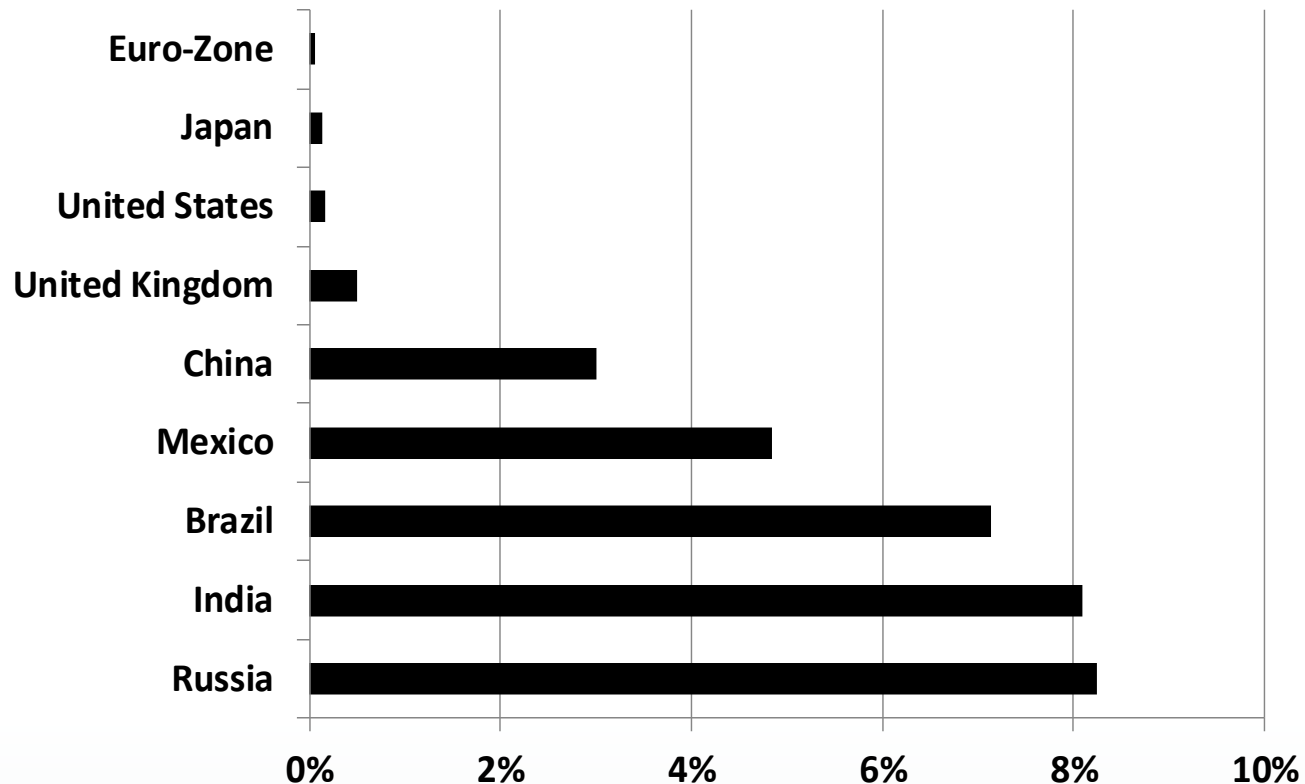
Comparing Paths of the Renminbi and the Real  
(Falling line indicates strength versus the US Dollar)



Source: Brazilian Real (BRL) and Chinese Renminbi (RMB)  
from the Bloomberg Professional.

# Rate Comparisons: Why Yield-Seekers may consider the FX Carry Trade in Risk-On Markets

Short-Term Interest Rates



Source: Bloomberg Professional  
(Most liquid overnight rates to 1-month interbank rates)

# Gold

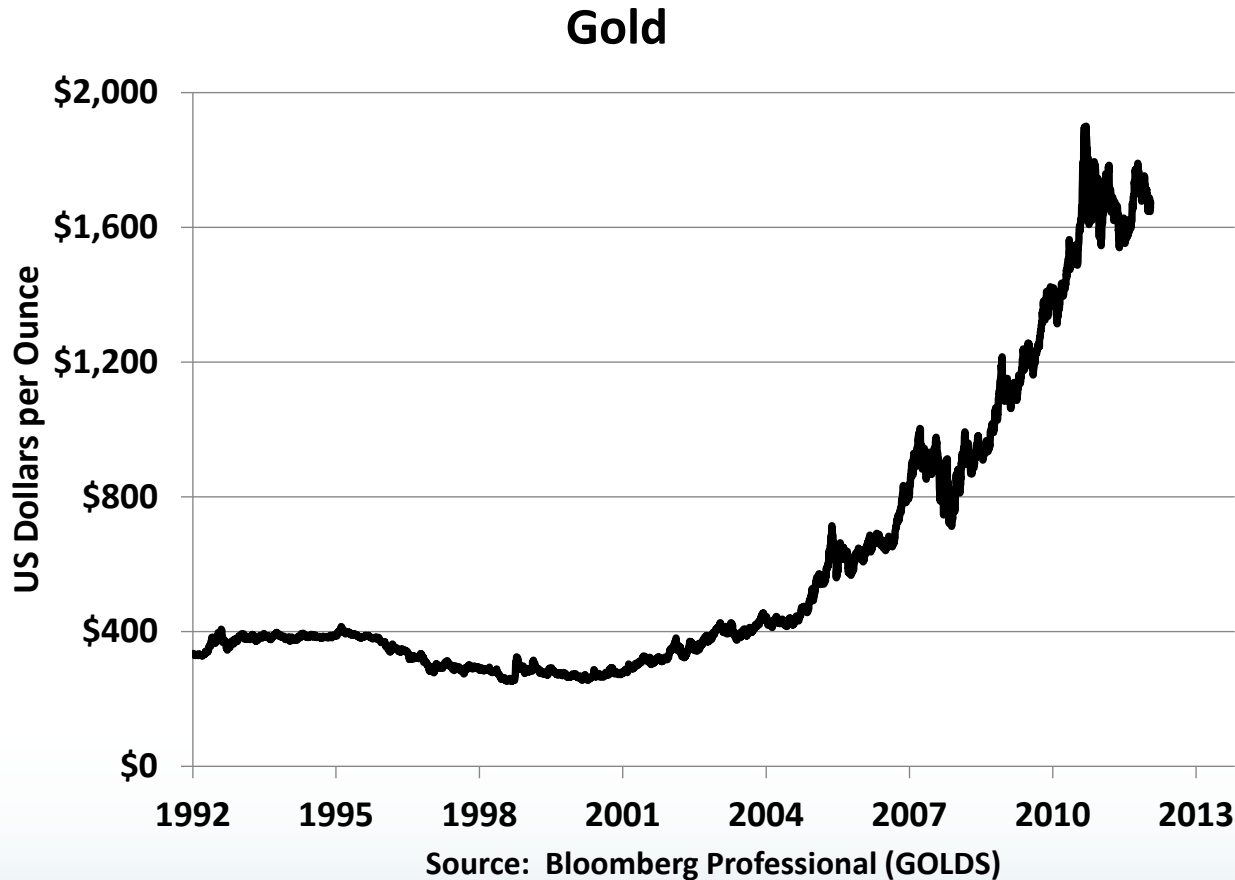
**Gold benefits from zero rates, which are here for another year in the US, UK, Europe, and Japan.**

**Gold benefits from stronger demand if China and India show solid growth. Both countries should do a little better in 2013 than in 2012. But India is raising taxes on gold imports.**

**Gold benefits from investor fears, which are dissipating.**

**The question for investors is how much demand comes out of the market as fears recede?**

# Gold Price Has Hit Choppy Waters Above \$1600/ounce



## Copper

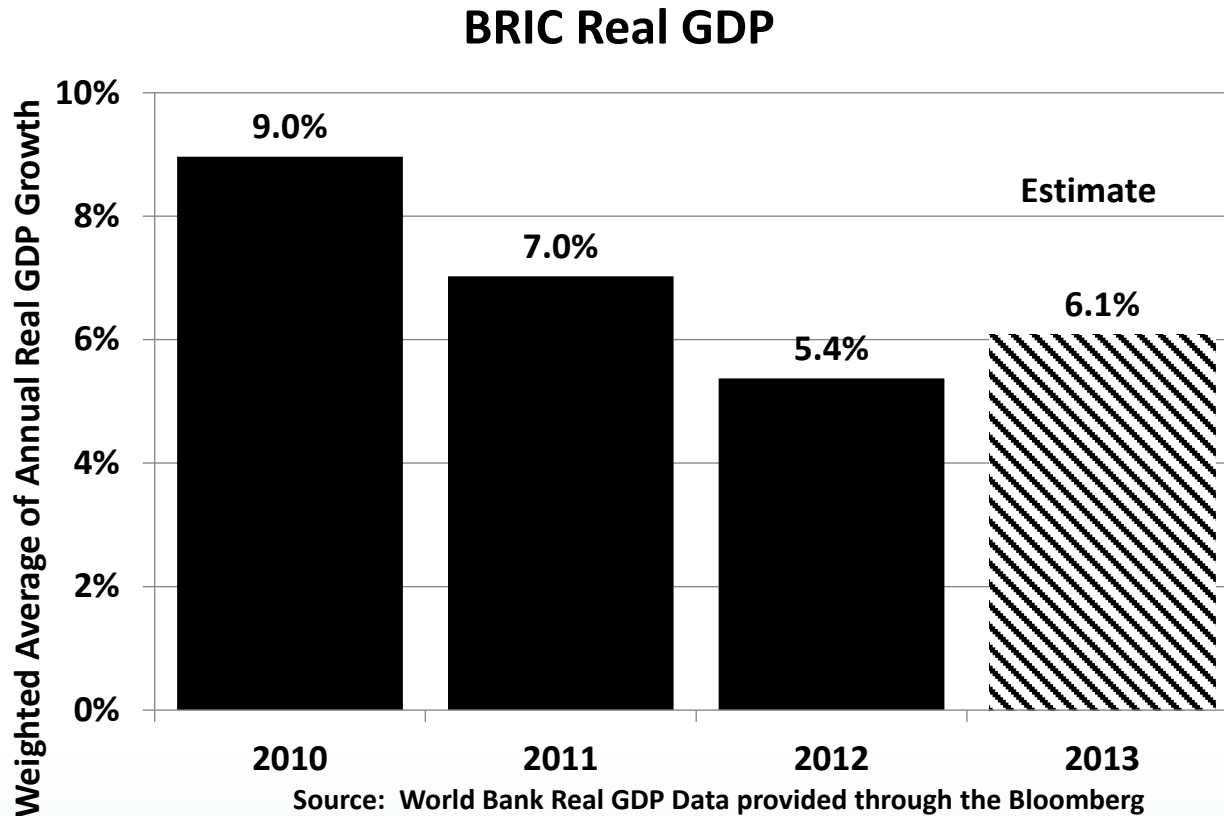
**Copper demand stems from infrastructure building.**

**China is critical. China slowed infrastructure spending plans in 2011 and 2012, but there are signs that China will start spending again to get the economy moving faster 2013.**

**India is a big buyer of gold jewelry. India's economic growth slowed in 2012, but may rebound modestly in 2013.**

**Copper is likely to be very volatile, with potential support if a more optimistic global economic outlook gains credence.**

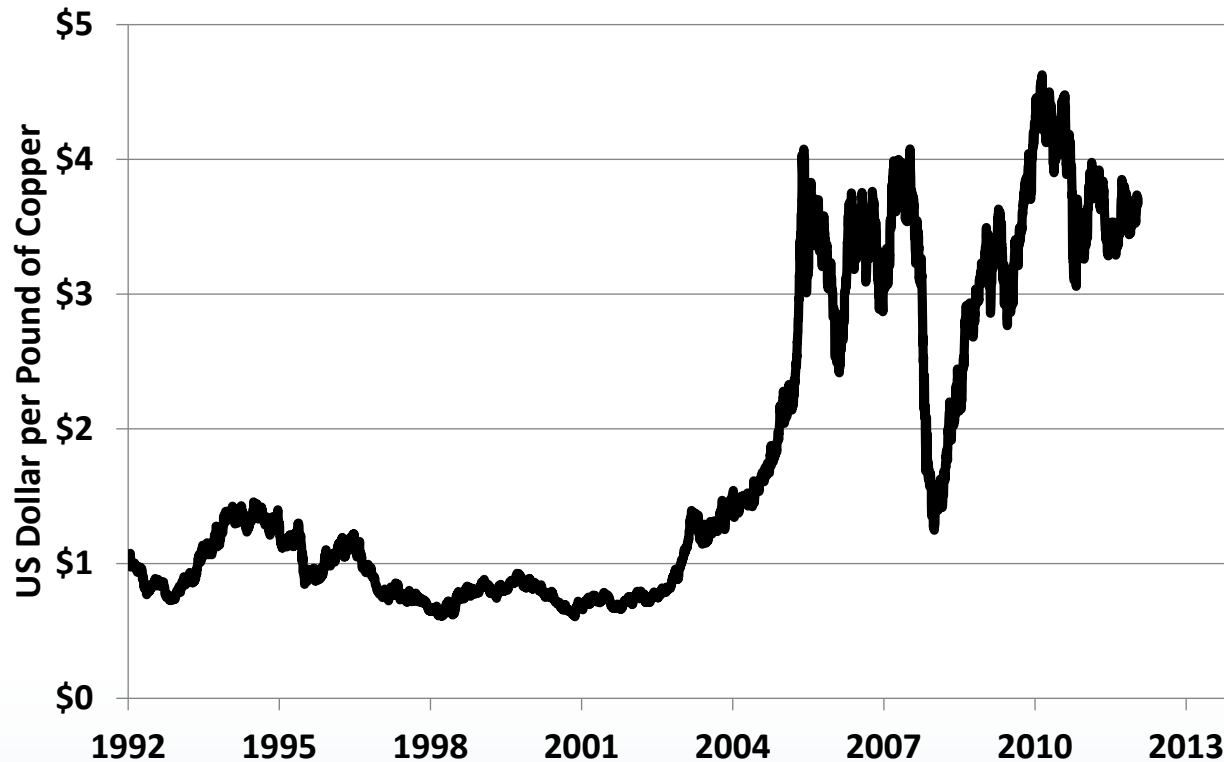
# BRIC Economies may Improve in 2013, led by China and Brazil



Source: World Bank Real GDP Data provided through the Bloomberg Professional. Q4/2012 and 2013 estimated by CME Economics Research.

# Copper Has Become a Risk-On, Emerging Market Growth Story

COMEX Copper Nearby Contract Futures Price



Source: Bloomberg Professional (HG1 <Comdty>)

# Energy Market Potential Surprises for 2013

**US economic growth dividend for increased oil/gas supply**

**More infrastructure progress in the US than market participants appreciate**

**Possibly less geo-political fears**

**Syria and Egypt do not have oil**

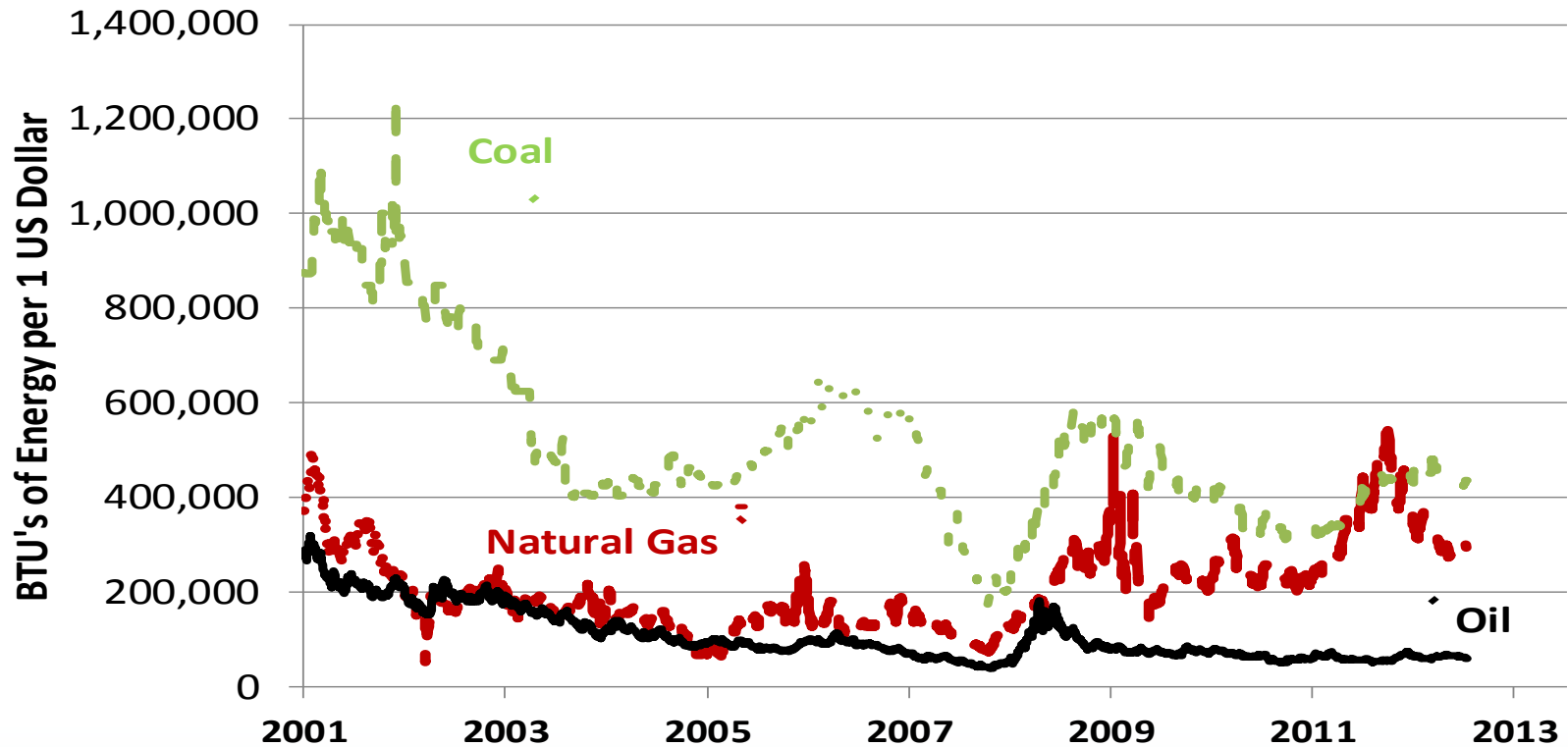
**Iran tensions appear to be lessening**

**Market participants may shift from demand focus to supply focus which has possible implications for a narrower Brent-WTI spread and a narrower WTI-Natural gas spread.**



# Natural gas offers a low cost per BTU

## BTU's per US\$1 by US Energy Source



Source: Bloomberg Professional for prices (USCRWTIC, NGUSHHUB, UNYMM1),  
CME Economics Research for BTU conversion.

# Weather Volatility

**Weather volatility can easily disturb agricultural markets**

**Q1/2013 already has seen:**

**Frigid Temperatures in Russia and China**

**Extreme Heat in Australia and New Zealand**

**Continuation of US Midwest Drought  
(although there is some snow cover now)**

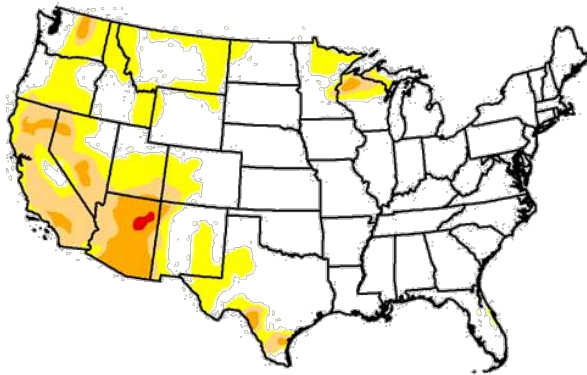
## US Drought Monitor Charts -- Source

**The U.S. Drought Monitor is produced in partnership between the National Drought Mitigation Center at the University of Nebraska-Lincoln, the United States Department of Agriculture, and the National Oceanic and Atmospheric Administration.**

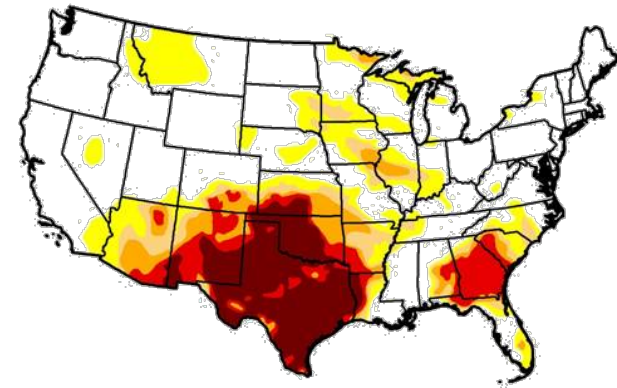
**<http://droughtmonitor.unl.edu/>**

# The Texas Drought emerged over time in 2010-2011

2009 Q4

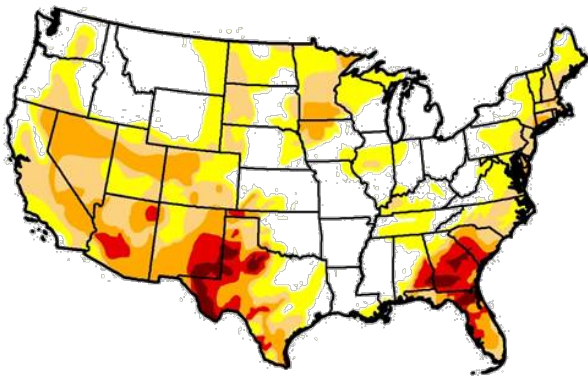


2011 Q3

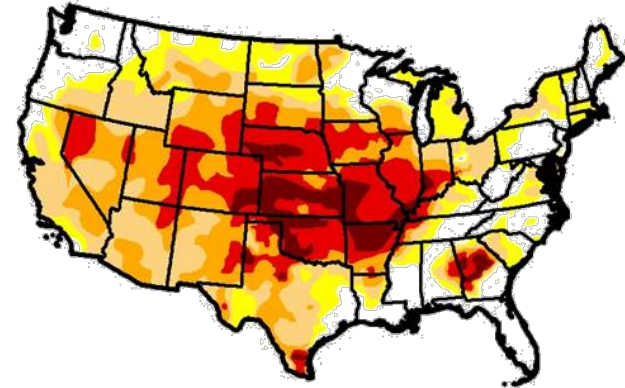


# In 2012, the US Midwest Drought Emerged Very Quickly

2012 Q2



2012 Q3



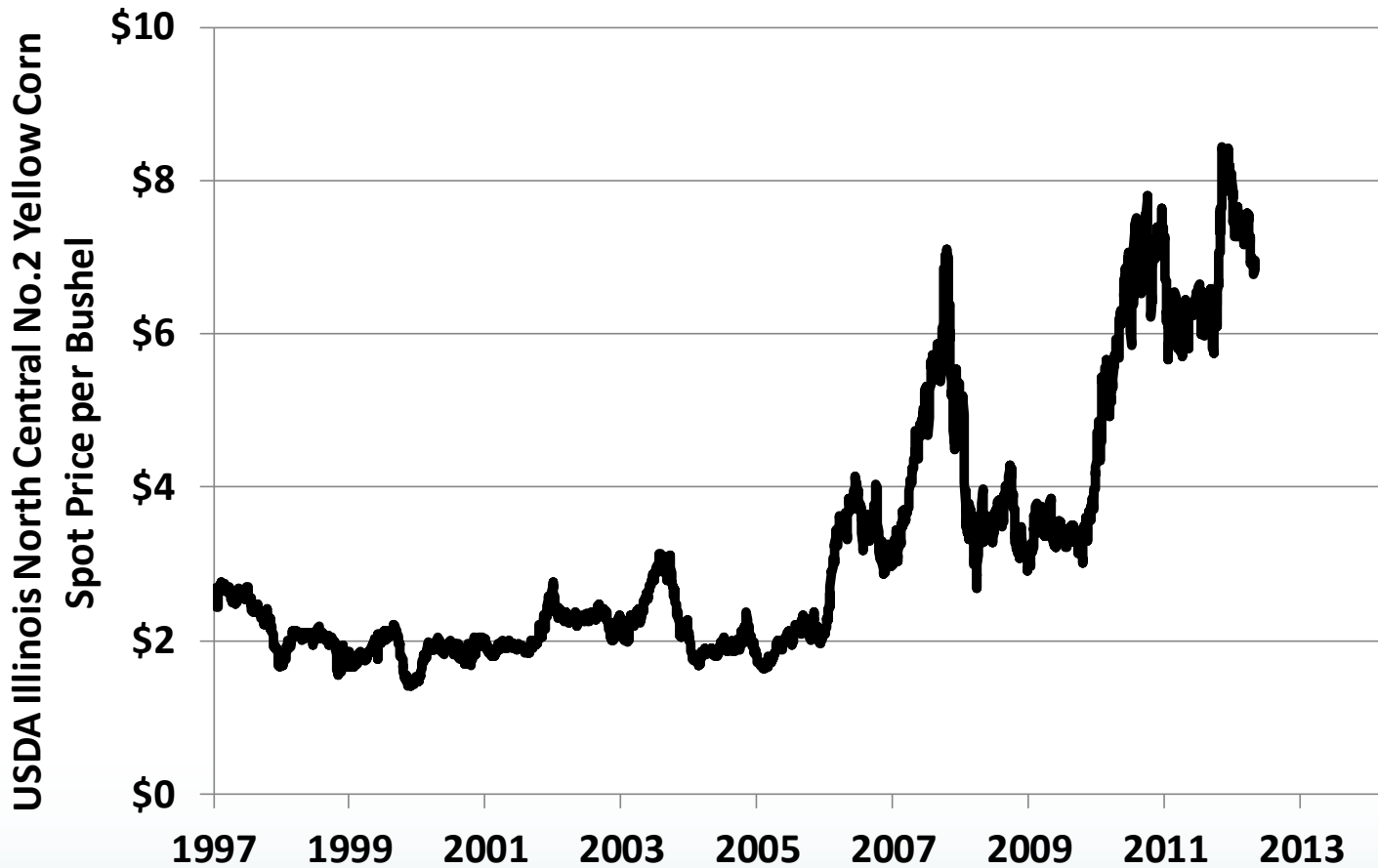
# Weather Volatility: US Drought Update

2009 Q4



# Corn and the Drought

## Corn Spot Price



Source: Bloomberg Professional (CORNILNC)



# Pivot Points for 2013: Politics & Weather

- **US Spending and Debt Ceiling Debates (February-April, and possibly beyond)**
- **Formation of New Coalition Government in Italy (February-March)**
- **Development of Midwest US Drought (Spring-Summer)**
- **German Elections (September 2013) – Merkel will probably need a new coalition partner**



# Economic Points to Watch

**US Unemployment Rate Dips Below 7%**

**China reports Real GDP Growth above 7% in 2013 for two quarters in a row, along with supporting export data**

**Brazil reports Real GDP Growth the first half of the 2013 increasing into the 3%-4% range**

# Confirming Signs We May Be Entering a “Risk-On” Market Environment?

## •FX:

- Yen/\$ cross 100
- Brazilian Real cross 2.00 (BRL per USD)

## •Bonds

- JGB 10-Year Yields cross 1%
- US 10-Year Treasury Yields cross 2%
- Spanish 10-Year Bond Yields remain close or under 5%