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The Global Markets Weekly

September 23, 2011

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Will the ECB Blink and Cut Rates Now?

Troubled European markets are looking for some support from policy-makers, wary that those same policy-makers, whether they be Eurozone governments or even the ECB may not be grasping the scale of the downside risks that may be amassing. Admittedly, the coming week may see Germany take the next step to validating the more flexible EFSF whose resources could be used to stabilize markets and help address the recapitalization of EU banks, something that the likes of the IMF has been crying out for.

However, other governments still seem to lack any urgency to get the 440B euro fund up and running. As a result, the ECB will have to remain the main support to markets via its government bond buying, however distasteful this may be to the German element within the central bank. Indeed, the ECB must be feeling it needs to do more and possibly very soon. Notably, over and beyond the clear strains in financial markets, the weakness in recent survey numbers provides an even more fundamentally economic rationale for ECB action.

As a result, a rate cut at, if not before, the October 6 Council meeting is now a distinct possibility, possibly with the emphasis on getting the current (0.75%) deposit rate down as a means to help unlock the hoarding of cash which has resulted in the marked rise of deposits at the ECB of late. In addition, and perhaps more notable may be the unveiling of fresh banking sector liquidity provisions, very much more on a longer-term basis.

- **U.S.:** The focus returns to economic indicators, with durable goods orders and personal spending expected to show ongoing growth in August, but not as strong as July. Still, the numbers should keep the Q3 real GDP growth track above 2%. Meanwhile, housing data will be soggy at best, and consumer sentiment surveys should continue to register distaste with Washington and joblessness. All this may take a back seat to policy developments, if the government actually shuts down.
- **Eurozone:** Market and political events may continue to take center-stage, with hopes that the ECB may be pushed into more action sooner than later. Concerns about a Greek default will probably continue, although should the scheduled return of auditors to Athens in coming days result in the release of the next tranche of the existing bail-out, general thinking may be that any such default may be months away rather than in the very near-term. Otherwise, German Ifo numbers and the EU Commission figures are unlikely to offer anything new by merely underlining the mounting downside real economy risks already apparent.
- **United Kingdom:** Monetary and credit conditions data are likely to be key ingredients into any BoE decision to restart asset purchases. Otherwise, the week has updates on the consumer with the CBI trades survey providing insights into retailing while sentiment data may reveal the extent to which households are succumbing to the plethora of bad news now emerging.
- **Japan:** Labor-market results will give a sense of business sector confidence in the growth trend and a broad-brush indication on the health of a key consumer-spending fundamental. The industrial production report will be of most interest for the production-plan survey, and what it suggests about the immediate trend. Housing starts, after a striking flurry of activity in July due to tsunami reconstruction, probably reversed a bit in August—but strong-side results should be the norm for a while.
- **Emerging Markets/Regions**: Manufacturing output data from Korea, Singapore, and Thailand, should show pickups in year-over-year growth. Over in Europe, the trade gap likely narrowed in Turkey, while Hungary unemployment held steady.

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Fed Bites Dog

Data/event recap: The **FOMC** delivered a baby-step stimulus effort this week to keep the rocky recovery going. The Fed will swap $400B in short-term Treasuries (3-years or less) for $400B in long-term Treasuries (6 to 30 years) in order to hold down already record-low interest rates. The overall size of the balance sheet, however, is maintained and with core inflation pushing back towards 2%, the bar is set high for QE3. In addition, the Fed did a **double twist**, as they decided to reinvest proceeds of maturing treasuries into agency and MBS securities. Expectations are that the Fed's latest efforts will have a very modest impact on the economy, helping to keep mortgage rates low and fueling a refinancing boom that will put some extra cash into households' wallets. The market sell-off after the announcement, however, points to the perceived irrelevance of monetary policy with the Eurozone on the brink of a sovereign debt default. Nevertheless, the Fed is likely to go down fighting by doing whatever it can to fulfill its dual-mandate, even if it means working only at the margins.

But what really grabbed investors attention, particularly in the global equity turmoil, was the emphasis put by the Fed on the **downside risks** which were partly attributable to "strains in global financial markets." We already knew all that but when the Fed says it, it makes news.

The light data week focused on **housing,** where indicators confirmed the widely held believe of a flat housing market with little upside potential. Home builders remain deeply pessimistic about demand prospects, and are keeping new construction to minimal levels so as not to disrupt an already precarious supply/demand imbalance. Some of the downside surprise in August housing starts, however, was likely weather-related, and the relatively buoyant permits number suggests no further cutbacks in construction in the offing. It might be tempting to read the upside surprise in August existing home sales as a sign of firming demand, but caution should be taken. According to NAR, investors accounted for 22% of sales, compared to 18% in July, meaning that 74% of the monthly gain is attributable to investors picking up distressed properties. Still, this is a positive development since a reduction in inventories is necessary for a rebound in housing. But we are still a long way off from that day.

Not another government shutdown! The possibility of another government shutdown materialized this week. As usual, Congress has to craft a continuing resolution (CR) to fund the normal operations of governments, since none of the regular appropriations bills have passed. Added to this CR is spending for disaster relief. After a close vote and more than one try, the House passed a CR with $4B in disaster aid and decided to adjourn to October 3 just as the new fiscal year begins. The Senate wants more money for disaster spending and well as other programs and rejected the House version. Unless the House decides to return next week, the government could shutdown on Friday September 30.

The week ahead: Still on a 2% Q3 GDP Track With the FOMC meeting behind us, the focus returns to economic indicators this week. July was a satisfying month for consumer and business spending, but the real test for the near-term outlook will be performance in August and September.

Personal consumption (DE: +0.3%; Consensus: +0.2%) and **durable goods orders** (DE and Consensus: -1.0%) for August are a comedown from July. But the Q3 growth track shouldn't be shaken too dramatically from its 2%+ perch. Core PCE inflation should track a modest monthly pace of +0.2% (DE and Consensus), translating into a +1.7% year-over-year pace – rising but not alarming so.

Readings on **pending home sales** (DE: unchanged; Consensus -1.0%) and **new home sales** (DE: 286K; Consensus: 295K) for August and the **S&P/Case-Shiller home price index** (DE and Consensus: -4.7% y/y) will add to the bleak assessment from this week's indicators. Record-low mortgage rates are causing a refinancing boom, but sales remain flat thanks to tight credit and weak jobs, and stagnant income. No housing market recovery is sight.

Consumers are angry and frustrated about a host of problems surrounding Washington and the labor market. But the plunge in major sentiment indices that began over the summer is likely behind us. The **Conference board index** likely edged up (DE: 47.8; Consensus: 47.0), while the **Reuters/University of Michigan index** held onto modest early-month gains (DE: 58.0; Consensus: 57.8).

Several Fed speakers are on tap this week. Hawks (and recent dissenters) **Plosser** and **Kocherlakota** (both voters 2011) speak on Monday and Thursday. Ultra-dove **Rosengren** (voter 2013) delivers two speeches at the Swedbank on Wednesday and Thursday. **Bullard** (voter 2013) speaks on Monday and Friday, while **Raskin** speaks on Monday. (Paul Edelstein/M. Cary Leahey)

OLD NEWS BUT GOOD NEWS

Recap – Consumer Spending Remains Weak

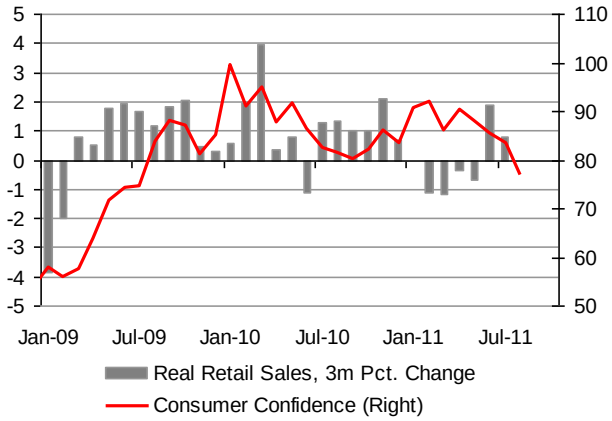
Retail sales fell 0.6% in July, and fell 0.8% in constant-dollar terms, largely a result of lower vehicle sales. In volume terms, sales are still above their Q2 average, but have gone nowhere since late-2010. Growth in the second half will require some contribution from consumers as export performance suffers, and inventory accumulation is unlikely to proceed at H1 rates.

The Week Ahead – Monthly GDP: Old News But Good News?

Attention this week turns to **monthly GDP** data (Fri) for July, but only from a purely technical perspective for Q3 GDP implications, as market expectations have moved quite a bit since then with respect to the outlook. Expectations call for a 0.3% m/m print, a result that would, discounting recent financial market ructions, keep up hopes for 2% growth in Q3. The risk to this week's print is more likely to the upside, but even a gain of 0.4-0.5% would be looked through, as it would reflect mainly a surge in manufacturing activity after production disruptions in the vehicle and energy sectors in recent months.

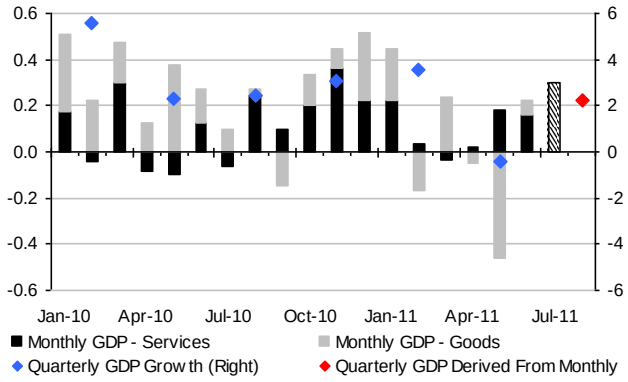
A clearer indication of underlying momentum may come from the service sector component. On that metric, conditions remain reasonably stable (see chart), but only "just." Wholesale sales were a clear positive during the month, and retail trade a clear negative. Two of the largest and less observable components, the finance and real estate sectors, are showing softer growth. That is in some ways welcome news, given froth in some housing markets. The risk is that turns into unwelcome news if global prospects deteriorate significantly – which would leave consumers out over their skis with high debt loads.

Sluggish Retail Spending, Confidence Dips



Source: Statistics Canada, OECD, and Decision Economics

Even A More Optimistic Rebound from Disruptions Implies Modest Growth in Q3
(Contribution to Pct. M/M and Pct. Annualized)



Source: Statistics Canada, and Decision Economics.

The chart to the right shows an implied Q3 result derived from a 0.3% gain in July, and a reasonably optimistic penciling-in of 0.2% growth in August and September. While the averaged monthly numbers do not track the quarterly national accounts figures exactly, they are typically within 0.5% at an annual rate (with the last two quarters missing by less than 0.2%).

Other data this week include the **raw materials and industrial product price indices** (Thu). Both should show continued moderation in a year-ago comparison, supporting an outlook that includes subdued price pressures. (Andrew Husby)

Eurozone

Already In Recession?

Data/event recap: The last week has been another with clear swings in bond and stock prices, albeit with net falls the clear theme. Once again, little of this was due to data. Instead, warnings from the IMF, alongside worries about an imminent Greek default continued amidst on-going negotiations between Athens and those considering lending Greece more cash, culminating with the promise of even more austerity from Greece. But **sovereign debt worries** were evident elsewhere in the Eurozone, albeit only partly accentuated by a further downgrade of Italian debt and a belated admission by the Italian government that its growth projections had been too upbeat. Meanwhile, banking sector frailties intensified again, something that may very well have played a role in the European Systemic Risk Board, a new body comprising EU central bankers and supervisors and chaired by the ECB, warning on Wednesday that risks to the stability of the EU financial system have increased considerably in the last few months.

As for data, the September **flash PMIs** suggest that the Eurozone economy is at best stagnating and possibly suffering a contraction, with risk of the latter intensifying into the coming quarter. Moreover, the weakness is across the whole of the Eurozone, albeit more markedly in the periphery, with softness in business surveys being echoed by an erosion in consumer sentiment. These numbers will be causing added reverberations at the ECB. Not only do they suggest that the downside risks to real activity that the ECB belatedly recognized at its Council meeting earlier this month may be increasing, they also suggest these risks may now actually be materializing even in what were previously vanguard economies like Germany.

The week ahead: **ECB Policy Move: Sooner Rather Than Later?** While economic data may start to take on a higher profile, market and political events may continue to take center-stage, with markets hoping that the ECB may be pushed into more action sooner than later. Concerns about a Greek default will probably continue, although should the scheduled return of auditors to Athens in coming days result in the release of the next tranche of the existing bail-out, general thinking may be that any such default may be months away rather than in the very near-term. Regardless, markets will be keen to see that the **EFSF gets full parliamentary approval** sooner rather than later, possibly aware that its resources may need to be directed to recapitalizing troubled banks rather than taking over the government bond buying role that the ECB is now pursing (still to the consternation of Germany). In this regard, it seems highly likely that the German parliament will give its approval (Thu), the question being the extent to which the German vote sees further splits appear within Chancellor Merkel's collation that may unnerve markets further. Markets will also be tested with key bond auctions due in Italy on Tuesday and Thursday.

The data slate this week is large, although the array of survey data such as the **German Ifo** numbers on Monday (Consensus: 106.5; DE: 107.0) and the EU Commission figures (Thu) are unlikely to offer anything new by merely underlining the mounting downside real economy risks already apparent. The question is whether **CPI updates**, such as those from Germany (Wed) and then the Eurozone HICP flash (Fri), start to echo more clearly the easing in price pressures evident in those surveys (Consensus & DE: 2.5% Y/Y). Perhaps the most important release comes on Tuesday with the **ECB monetary update**, especially given that that the still-soft M3 (Consensus: 1.9% Y/Y; DE: 1.5%) and **private sector lending growth numbers** have for some time very much flagged the banking sector fragility that stock markets have more recently focused on. (Andrew Wroblewski)

United Kingdom

Key Credit Updates Awaited

Data/event recap: The UK has seen a quiet week, albeit again buffeted by events in the nearby Eurozone as well as in the USA. Speculation that the **BoE may re-start asset purchases** was fanned somewhat both by signs of banking sector fragility and by minutes to this month's MPC meeting, in which most of the committee members thought that it was increasingly probable that further asset purchases would become warranted at some point. Indeed, for some members, a continuation of the conditions seen over the past month would probably be sufficient to justify an expansion of the asset purchase programme at a subsequent meeting. Very clearly, the **MPC is shifting towards fresh stimulus** and one that would be based around resumed asset purchases rather than any alternative form of unconventional policy easing. The question is whether the MPC will wish to wait for the November Inflation Report before resuming asset purchases or resume after its next meeting on October 6.

Data wise, the most notable release was **public sector borrowing data**, which saw the budget move into a clearly larger deficit, actually a record for any August month. Even so, the data offered mixed messages. The good news is the marked downward revisions not just to recent months but for the last FY. However, when the Chancellor presents updated fiscal projections (on November 29) he may have to acknowledge that (due to a reassessment of spare capacity in the UK economy) the structural budget gap may be higher than previously thought, thereby canceling out the potential fiscal scope that these borrowing revisions may otherwise have created. With this in mind, the Government may prefer that any fresh stimulus that the economy needs in the near-term comes from the monetary side and not the fiscal, albeit with pressure (from the likes of the IMF) more of the view that, should the economy weaken further, some budget consolidation may need to be delayed.

The week ahead: Monetary and credit conditions data due on Thursday may be digested eagerly by markets as such numbers are likely to be key ingredients into any BoE decision to restart asset purchases. Broad money supply and lending numbers may show continued softness, as may BoE data on consumer lending, including mortgage applications. However, the key release may be next BoE credit conditions survey, the early findings from which may already be causing worries within the central bank. Otherwise, the week has updates on the consumer with the **CBI trades survey** (Tue) providing insights into retailing while **sentiment data** (Fri) may reveal the extent to which households are succumbing to the plethora of bad news now emerging. (Andrew Wroblewski)

Other Europe

Sweden: Eyes on the Eurozone

Data/event recap: Eyes were focused on the Eurozone, meaning that Swedish markets paid little attention to the Riksbank Board minutes, albeit an update that underscored the extent to which considerable uncertainty over economic developments dominated policy-thinking, all of which implied that the projected repo rate path may need to be revised in the period ahead.

The week ahead: An array of data is due in the coming week, perhaps the most important being the **producer and consumer surveys** (Wed) although the **household lending** (Tue) and **retail sales** (Thu) figures may be important for the Riksbank.

Norway: Norges Bank in Neutral

Data/event recap: Norway saw a more **clear-cut change in central bank thinking**. In line with overwhelming expectations, the Norges Bank kept its key policy rate at 2.25% after its latest Board meeting, thereby matching the decisions made in June and August. However, its updated analysis now very much hints that the Norges Bank is in neutral, pointing to (apparently equally likely) circumstances in which the key rate could be raised or reduced. This is likely to be more formally detailed with new economic and policy projections at the next policy meeting in October.

The week ahead: Important data awaits in coming days, with a somewhat weaker profile evident of late in regard to **retail sales** (Thu) while strong **private credit numbers** (Fri) are probably still perturbing the Norges Bank.

Switzerland: FX still the focus

Data/event recap: Nothing of note emerged in Switzerland, save for much stronger (August) **money supply** numbers which clearly saw the initial impact of SNB efforts designed to curb the Swiss franc.

The week ahead: There is little data of note save for the **KOF survey** (Fri). (Andrew Wroblewski)

Oceania

Australia: RBA Reveals Nothing New

Data/event recap: The past week began with the **Reserve Bank of Australia minutes** of its 6 September policy meeting, which showed continued neutral tones and provided little further insight beyond the comments made by Governor Stevens following the actual meeting. The remainder of the week saw the arrival of the **Westpac and Conference Board Leading Indexes**, with the former seeing an increase to a fresh cycle-high but the latter falling to the lowest since March.

The week ahead: It was a relatively quiet week in terms of economic data, beginning with **HIA new home sales** data on Wednesday. The only other data of note are **private sector credit numbers** (Fri), which is generally expected to remain stable from the previous month.

New Zealand: Downside GDP Shock

Data/event recap: The week started with the **Performance of Services Index**, which saw a further decline, but still remained above 50 for a twenty-first successive month. The week also saw a widening in the current account deficit for Q2. However, all of the focus was on Q2 GDP figures. These surprised clearly to the downside, showing near stagnation in the economy which, along with bearish comments from Governor Bollard, led to a fall in interest rate expectations.

The week ahead: The week starts with **visible trade data** on Monday. Meanwhile, the remainder of the data next week will be concentrated on Friday, which sees the arrival of **building permits**, NBNZ **business confidence** and **M3 money supply** figures. (Andrew Wroblewski)

Japan

Updates to the Post-Quake Growth Trend

Data/event recap: The week just ended was shortened by Monday and Friday holidays, so that, in particular, the full effects of the sharp Western-market movements as the weekend approached could not be fully reflected in Japan's markets. Over the week ended Thursday, Japan's equities generally tracked the small net decline in U.S. and European markets over their Wednesday-end weeks, while the JGB market was much more stolid, in yield terms, than the Western counterparts, showing a one basis-point decline as against their 10+ basis point drops.

Important economic data of the week were limited to the August **merchandise trade report**, which showed significantly less export growth than expected, some 2.8% year-on-year, as against 8.0% looked for, but also much stronger import growth, +19.2%, as against +14.2%. The combination, while giving some encouragement on the strength of domestic demand, could only heighten concerns about the external threat facing Japan's economy.

The coming week: Policymakers continued their verbal assaults against that risk, with PM Noda, notably, proposing to step up subsidies to companies that build domestic plants, rather than locating them abroad, in the face of the strengthened yen. New Finance Minister Azumi, meanwhile, promised "bold" currency-market action, if it proves necessary, and BOJ Board Member Shirai promised that the Bank would respond "immediately," if "the risk increases that the expected economic recovery scenario collapses."

The week ahead brings the major round of August economic indicators—critical information, as markets and the BOJ assess the growth trend being established as the rebound from the March disasters nears completion. The first key reading arrives Thursday, in the **retail sales report**, which will combine with the **family income and expenditure survey**, due Friday, to reveal the degree of household-sector participation in the post-disaster rebound. So far it has been relatively encouraging.

Friday also brings the **labor market survey** results, the preliminary look at **industrial production**, and the **housing starts** total—all important supply-side indicators. The labor-market results will be looked to for a sense of business sector confidence in the growth trend, as well as for a broad-brush indication on the health of a key consumer-spending fundamental, while the industrial production report, barring a big surprise relative to the medium-sized August increase generally expected, will be of most interest for the production-plan survey, and what it suggests about the immediate trend. Housing starts, for their part, showed a striking flurry of activity in July, surely due to tsunami reconstruction, and a bit of a reversal probably occurred in August—but strong-side results should be the norm for a while. (Pierre Ellis)

Recap: Rate held in Hungary, perceptions of risks more acute than in 2010. In line with expectations, Hungary's central bank left its benchmark rate on hold at 6.0%, explicitly adopting a "wait-and-see" stance for policy. In response to the falling forint, at least one policymaker voted for a rate hike, but was outvoted by an "overwhelming majority" according to post-meeting comments by Governor Simor.

The economic outlook given in the bank's statement was downright gloomy, with the Council seeing subdued growth(+1.6% y/y in 2011, +1.5% in 2012) over the next two years amid ongoing household balance sheet adjustments, an "uncertain" business climate, and "prolonged problems" in the European banking sector. The bank expects output to stay below potential through at least 2012.

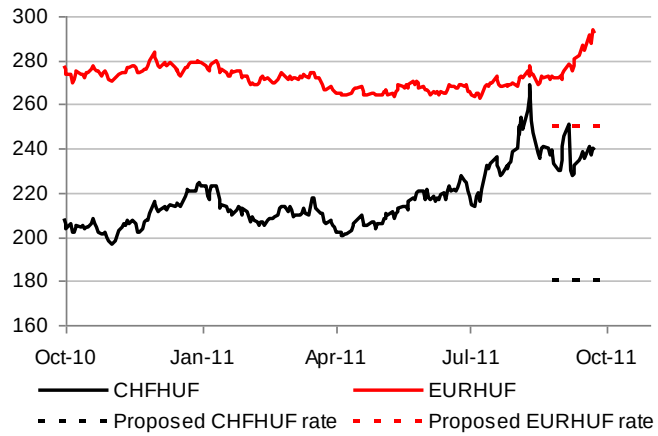
Recognizing a key development in the past week, the statement highlighted banking sector uncertainties stemming from the government's newly introduced plan to allow households to repay foreign currency debt at below-market rates (see chart at right). About two-thirds of mortgage debt is denominated in Swiss francs. The central bank expects about 20% of about $25 billion in FX loans to be repaid early under the plan.

Whether the plan ends up being of significant benefit to households in the long-term is debatable. Financial intermediaries will be weighing lending against heightened policy uncertainties, dampening already weak domestic demand growth.

Encouragingly from the perspective of supporting the currency, Governor Simor indicated that the central bank would make available its foreign currency reserves to domestic banks should they require it to cover early repayment of FX loans. While the need to hike aggressively in defense of the forint is perhaps lessened, it cannot be ruled out in a scenario where global financial market vulnerabilities become more acute.

As for inflation, the bank expects tax measures to prolong the convergence of inflation to target, now seen reaching the 3.0% target by the first half of 2013 (from the upside), previously the end of 2012. (Andrew Husby)

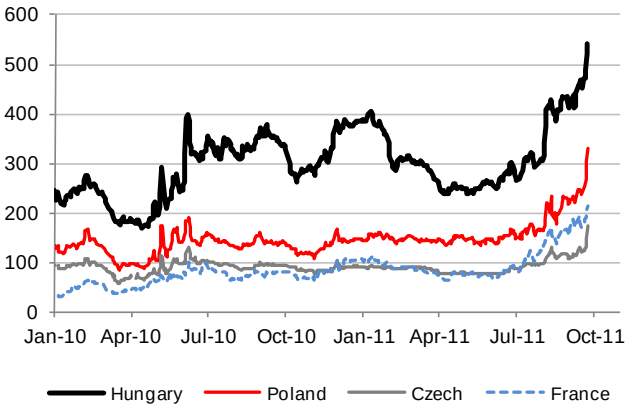
Mortgage Plan May Help Households, Hurts Banks



Source: Bloomberg and Decision Economics

But Heightened Risk Perceptions Run Far Deeper Than the Country-Specific Issues

5yr CDS Spreads (bps)



Source: Bloomberg and Decision Economics

Central Bank Watch:

No major EM central bank we follow meets this week. (Francisco Larios/Andrew Husby)

Focus on Eurozone Risks

Is Manufacturing Going Into Recession? The September flash PMIs released last Thursday suggest that the Eurozone economy is at best stagnating and possibly suffering a contraction, with risk of the latter intensifying into the coming quarter. Moreover, the weakness is across the whole of the Eurozone, albeit more markedly in the periphery. Indeed, the PMI numbers suggest that output growth slowed to near-stagnation in both Germany and France, both countries showing the weakest rates of expansion since their recoveries began over two years ago. The rest of the Eurozone, meanwhile, contracted for the fourth successive month, with the rate of decline accelerating to the fastest since July 2009. Unsurprisingly, the PMI numbers highlight that this weakness is taking an increasing toll on price pressures.

Specifically, and largely matching expectations, the manufacturing PMI dropped 0.6 point to a 25-month low of 48.4, the sixth fall in the last seven months, a period in which the index has tumbled over 10 points (admittedly, from the 11-year high seen in February). Notably, the headline figure fell back further below the long-term average, but with yet more ominous signs offered by the survey break-down. Indeed, the ratio of manufacturing new orders to inventories, which acts as a guide to near-term output developments, fell for a seventh month in a row (albeit still the lowest since April 2009), seemingly as stocks of finished goods reacted to disappointing sales and orders. Meanwhile, the flash services PMI very much undershot expectations this time around, slumping 2.4 points to 49.1, the largest of what is a now run of six successive declines, with the latest reading being the first sub-50 and the lowest in 25 months. More negatively, expectations within the sector saw sizable erosion.

With Consumer Spending Growth Already Weak? These numbers, especially as they are being echoed by an erosion in consumer sentiment, will be causing added reverberations within the already-stunned ECB. Not only do they suggest that the downside risks to real activity that the ECB belatedly recognized at its meeting earlier this month may be increasing, they also suggest these risks may now actually be materializing even in what were previously vanguard economies like Germany. Indeed, the ECB will surely be asking to what extent financial market turbulence may be exacerbating downward pressure on activity via the damage that may be ensuing to the monetary policy transmission mechanism. In this regard, the ECB may already be on much greater alert. The European Systemic Risk Board ESRB, a new body comprising EU central bankers and supervisors and chaired by the ECB, warned on Wednesday that risks to the stability of the EU financial system have increased considerably in the last few months. Key risks stem from potential further adverse feedback effects between sovereign risks, funding vulnerabilities within the EU banking sector, and a weakening of growth outlooks both at global and EU levels.

Policy Responses: Recapitalize Banks, Pump Up Liquidity and Cut Rates? Very clearly, the ESRB is echoing calls from the likes of the IMF for the EU to recapitalize its banks, something that the ECB would surely favor. But the ECB must be feeling it needs to do more and possibly very soon. Notably, over and beyond the clear strains in financial markets, the weakness in these PMI numbers provides an even more fundamentally economic rationale for ECB action. Indeed, as the accompanying chary highlights, these PMI readings are now at levels historically associated with ECB cutting rates, while the softening in price pressures is something that may also be sapping further the inflation hawkishness of the ECB. As a result, a rate cut at the October 6 Council meeting is now a distinct possibility, possibly with the emphasis on getting the current (0.75%) deposit rate down as a means to help unlock the hoarding of cash which has resulted in the marked rise of deposits at the ECB of late. In addition, and perhaps more notable may be the unveiling of fresh banking sector liquidity provisions, very much more on a longer-term basis. (Andrew Wroblewski)

