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The DE Global Markets Weekly

September 7, 2012

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No Need for Greenspan's Flippy the Coin for this FOMC

The closely watched ISM and jobs reports in the U.S. were weak and disappointing, leaving some analysts worried about potential recession in exports which could pull down a slow-growing expansion to a virtual crawl by late this year. The DE view is that is a very real risk but growth should remain in the 2 ½% to 2 ¾% range for the remainder of 2012, as slower export demand will be offset by a rising contribution from housing.

Even so, the disappointing statistics have increased the chance that the Fed will do something to expand the balance sheet in addition to extending the low for long language or cutting the interest paid on excess reserves. But this is not a slam dunk for Bernanke, who has to worry about not only preserving the sluggish expansion but also keeping the Fed out of political hot water. With contender Romney saying that he will fire Bernanke during his first day of office, Bernanke should be careful not to do too much in the next few months unless he has a really good reason.

In DE's view the events of the past weeks are sobering enough to get the Fed to act aggressively, as they too may be worried about an export recession in the U.S. But the Fed, like DE, may be unwilling to hang their collective hats on just a few observations from two indicators. DE understands the graveyard of business economists is filled with members who have cried wolf based on just "one number."

- **U.S.**: The ton of data available this week will be mixed. A decent gain in **retail sales** will be paired with a lousy **IP** reading. Headline **inflation** will be high but subtracting energy, the **core rate** will be moderate. They will have little bearing on what we think will be an **FOMC decision** to ease credit.
- **Eurozone:** The ECB follows DE expectations and promised large bond purchases to support nations who ask them and agree to the condtions laid out for support. The ECB is effectively waiting for the **German court ruling** this week which should at least allow the ECB program to proceed. The **Dutch election,** also this week may show that no stable government emerges, caught between its traditional support of the German hard-line and the tough economic times from its own austerity. **IP** updates will be soft while **core HICP** inflation remains low.
- **UK:** The MPC took no action as expected last week. The upcoming **labor market** reports will be mixed. However, what strength there is in the labor market will be modified by the soft *earnings number*, suggesting implied spending gains will be modest. A more downbeat housing report from the **RICS** is coming but **construction output** will be more promising. Still the lift from the **Olympics** will make interpretation difficult.
- **Japan:** The last patch of data hit the tape before the BOJ meets next week. None should have much impact on the upcoming decision. A minimal revision to the 0.3% initial gain in **Q2 GDP** is followed by a steady August **credit flow** close to July's 0.7% gain. **Core machinery orders** will show a modest increase in July, while **tertiary activity** should strengthen.
- **Central bank roundup:** Central bank in **New Zealand** on hold. The statement in July showed that the RBNZ was relaxed about the inflation outlook and revealed signs that the Bank may be increasingly concerned about the strength of the exchange rate, thus further hinting at an extended policy pause.
- **Emerging Markets/Regions:** Four central banks meet this week. **Korea** will likely cut rates as signs of economic deterioration intensify, while **Indonesia**, the **Philippines**, and **Russia** keep rates on hold. Domestic economies in the latter three are performing better, keeping policymakers on the sidelines.

Focus: Is an Export-led Recession Coming to the U.S.?

The troubling ISM (and jobs) reports. The firming up of various economic reports, such as home prices, within the construct of a very soft expansion, has been touted as major reason by some analysts to discount the chances of FOMC action this month. The most recent ISM report on manufacturing and to a lesser extent the jobs report, which are perhaps the two most closely watched economic reports, threw spanners into that kind of thinking. While some of our readers will not believe this, we drafted this note before the jobs report, which unfortunately supported the adverse implications of the ISM report.

But troubles not so much in ISM orders and inventories. Some analysts pointed to the overall ISM index remaining below 50 for the third consecutive month. But this in itself is historically a sign of very slow GDP growth but no recession. Of more concern is that the gap between orders and inventories suggests that the overall index could plunge below 45, a level which has been associated with recessions in the past. However, this relationship started to break down in the last 10 years. Declines in the orders-inventories gap to 47 in 2005 and 46 in 2006 did not precede recessions. And a collapse to 45 in 2010 and 2011 saw GDP growth slow to 2% but no recession. So the latest plunge in 2012 should be steeply discounted.

The problem is in export orders. The ISM export orders component has fallen 10 points since early 2012, the steepest drop on record, save the 2007-09 Great Recession. Declines of this magnitude have always been associated with export declines of at least 8%. This suggests huge drop in exports (which are only available through June, not August) very soon.

Which makes far too much sense. Analysts have been waiting for this to happen, as Europe has doubled-dipped and the expansion in EM, most notably China and Brazil has really cooled off. And many companies also reported a major drop in order books overseas at mid-year.

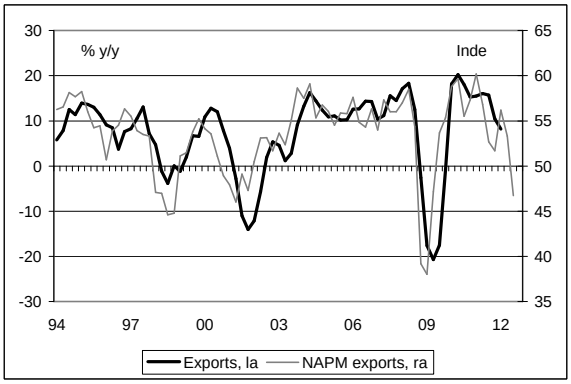
Could this take down the U.S. economy? Unfortuantely, the historical answer is yes. With the exception of the Asian crisis of 1997-98, declines in the ISM export orders have always been associated with either barely positive growth (the 2001 recession) or a deep recession in 2007-09.

But don't hang your recession hat on just two episodes. DE understands the graveyard of business economists is filled with members who have cried wolf based on just one variable. And the variable in question this time is ISM exports, which exists only back to 1987 or over three business cycles. It was right about the last two, missed the (mild) 1991 recession, and predicted a recession in 1997 when did not enfold. That is why we look at a host of indicators, which suggest that growth should be very sluggish but the economy should avoid recession.

A way out-a handoff from exports to housing to avoid a recession? DE Baseline view is that growth will remain very sluggish, with a handoff from a slower export sector giving way to better housing performance. In the past year, exports have added about 0.5 percentage point to GDP growth while housing may added another 0.25 percent. If the housing contribution were to increase towards 1 percentage point (well within historical parameters) and the export contribution faded to just under zero, then overall GDP growth would remain relatively unaffected at our Baseline of 2% plus.

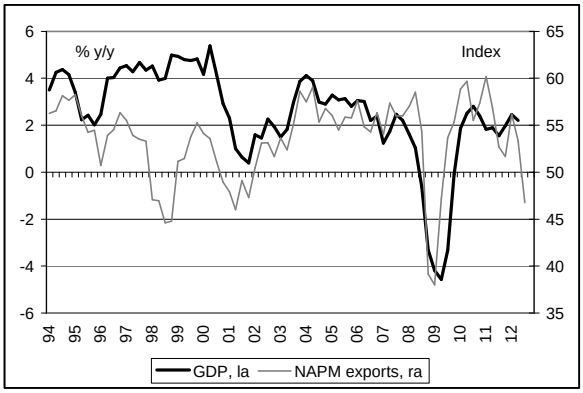
(M. Cary Leahey)

Chart 1: ISM Implies a Coming Export Collapse
(Percent change year-ago and index)



Sources: Commerce Dept., ISM, and Decision Economics, Inc.

Chart 2: …Which May Take Down the Whole Economy!
(Percent change year-ago and index)



Sources: Commerce Dept., ISM, and DE, Inc.

United States

After Jobs and ISM, No Need to Use Greenspan's Flippy the Coin

Indicator wrap-up. The combination of the weak jobs report and the disappointing ISM report point to potentially much slower growth from a potential export recession, as discussed in more detail in the *Focus* article. Manufacturing sector was especially weak in the employment report, with a 0.7% decline in the hours index, after three months of solid gains. The factory sector may finally be hit as the collapse in export demand, as seen in the ISM survey since early 2012. We have not seen this is the actual trade data, which is only available until June, about the time firms started reporting a big drop in export order books. The DE view is still that slower growth in the export sector will be offset by a further pickup in the housing sector, keeping overall GDP growth at 2% plus.

FOMC decision factors some balance sheet expansion (Thursday). The Jackson Hole speech gave no strong hints about the timing of new policy measures to support the economy. But since then, the implied export recession suggested in the latest ISM and jobs reports makes DE lean more towards some form of balance sheet expansion at the September FOMC meeting. This is not an easy call and the Fed may decide to wait until after the election to actually do something beyond extending the low for long language this month. An extension of the low for long action is likely to bring on *another dissent* with the lone voting hawk Lacker, who might effectively dissent twice if the balance sheet is expanded.

Trade balance: How bad (Tuesday)? The jobs report came late in the month so that the upcoming week is unusually busy. The first report is the **trade balance**. Both DE and Consensus look for a mild increase in the gap from $42.9B in June to $44.1B in July. DE continues to worry that there will be much larger slide in the trade gap in line with the collapse seen in ISM export orders.

Energy boost to inflation in August (Thursday/Friday). A jump in energy prices will contribute to higher **PPI** (Thursday and **CPI** (Friday) headline readings. A headline jump in the PPI (DE: +0.7%; Consensus: +1.0%) masks an OK core of 0.2%. Ditto for the CPI where a large headline gain (DE: +0.4%; Consensus: +0.5%) covers a core increase of 0.2%.

Decent retail sales for August (Friday). The weekly evidence on chain store sales and an moderate increase in vehicle sales suggests a decent gain in **retail sales** last month (DE: +1.0%; Consensus: +0.7%)

A tough month for industrial activity (Friday). The sharp 0.7% drop in the manufacturing hours worked index points to a large drop in **industrial production** in August.

Steady consumer sentiment (Friday). While both DE and the Consensus expect stable **consumer sentiment** readings, the risk is that the weak jobs report could pull down the preliminary reading of 74.1 slightly.

Mild inventory cycle underway (Friday)? After a small 0.1% gain in June, **business inventories** may rise a faster but still-moderate 0.3% according to DE and the Consensus. We worry that an *inventory cycle* may be underway as export demand slipped last summer, leading to higher inventories than desired in Q3 and a correction in Q4.

Fedspeak: Quiet except for the shouting at the FOMC. No speeches are planned for this week, with the two day meeting interrupting travel plans (by design?).

DE Forecasts:

- **Real GDP:** A sluggish, but still sustainable, expansion, with real GDP growth about 2 ¼% in 2012, lower than DE's early-year GDP growth estimate of 2 ½%. Growth is expected at about 2% in 2013; fiscal restraint a factor.
- **Inflation:** Headline CPI inflation fades from over 3% last year to nearly 2% in 2012, and averages between 1 ¾% to 2 ¼% in 2013.
- **Fed:** The Jackson Hole speech gave no strong hints about the timing of new policy measures. But since then, the implied export recession suggested in the latest ISM and jobs report makes DE lean towards some form of balance sheet expansion at the September FOMC meeting. This is not an easy call and the Fed may decide to wait until after the election to actually do something beyond extending the low for long policy rate language.

(M. Cary Leahey)

Canada

Housing and trade updates.

The week ahead: Housing and trade data to show key domestic and external updates.

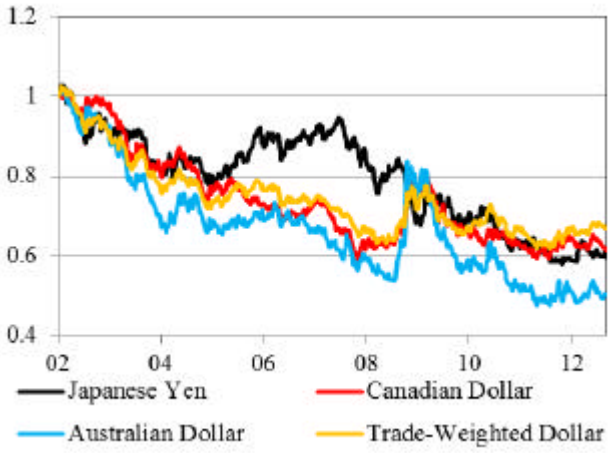
Housing starts (Tuesday, 8:15 a.m.) will be watched to see if the pace of activity declines in the wake of tighter mortgage lending restrictions. Housing starts had reached an annualized pace of 252,100 in April before moving down to the 208,500 units seen July. Forecasts call for a print greater than what seems sustainable on population demographics alone—likely closer to 180,000—with Consensus predicting 200,500 units and Decision Economics forecasting 210,000 units.

Imternational trade (Tuesday, 8:30 a.m.) will provide an update on global demand. Forecasts call for a narrowing of the C$1.8 billion deficit seen in June (Consensus: -C$1.3 billion; Decision Economics: -C$0.5 billion) as a strong Canadian dollar—or loonie—and weak Eurozone demand outweigh the lift from increasing oil prices.

Rising commodity (particularly oil) prices have been a popular scapegoat for Canadian exporting struggles as critics suggest that commodities boost the loonie to the point where Canadian manufacturers cannot compete.

Bank of Canada Governor Mark Carney debunked that myth in a Friday speech. While rising commodity prices do tend to prop up the loonie, they only account for about half of the currency appreciation in the past decade.

Chart 3
Major Currencies Versus U.S. Dollar (2002=1)



Sources: Bloomberg and Decision Economics, Inc.

As Chart 3 shows, the U.S. dollar has declined against many currencies in the past ten years, and Canada has, in fact, fared better than Japan and Australia. Japan is not a net exporter of natural resources, while Australia (like Canada) is. As 70% of Canadian exports go to the U.S., the loonie is boosted as a result. The multi-lateral depreciation of the USD is responsible for about 40% of the appreciation in the exchange rate. The remaining 10% is mainly the result of investors choosing the loonie as a safe haven bid.

Capacity Utilization (Thursday, 8:30 a.m.) is an inflation indicator, measuring the slack in the economy. Forecasts are mixed with Consensus predicting a slight increase in utilization from the 80.7% seen in Q1, while DE is calling for an ease. (Consensus 81.2%; Decision Economics: 80.5%).

The Survey of Manufacturing (Friday, 8:30 a.m.), as always, will show the pace and mix of activity in the manufacturing sector. Forecasts call for a moderate gain in shipments (Consensus and Decision Economics: +0.5% m/m).

DE Forecasts:

- **Real GDP:** The BoC is forecasting 2.1% growth for the year; the DE forecast is for an inline 1.9% to 2.2% gain. Risks tilt towards the downside on effects from the recession in Europe and a weak U.S. recovery.
- **Inflation:** Price inflation will be under the 2% y/y target for the next few months, before returning to the midpoint of the 1%-to-3% target range during 2013. Core inflation should run close to 2% over the next year.
- **Bank of Canada:** Policy on hold at least until 2013. The BoC likely will not tighten before the Eurozone stabilizes and U.S. economic data show more consistent firmness.

(Melissa Pumphrey)

Eurozone

Leading the (Peripheral) Horses to Water

Unlimited ECB Buying! The ECB bond purchase plan which has been christened **Outright Monetary Transactions** by the Central Bank, by providing a backstop with the promise of potentially unlimited buying of bonds is very much and obviously a key development. *Overt Bundesbank resistance is unfortunate, but not that problematic* as the German Government seems willing to let Draghi have his way for the time being. Even so, *the bond purchase plan is merely a more effective sticking plaster* for the Eurozone's wounds than hitherto, thereby buying more time. The fall in yields in peripheral countries (if sustained) merely tempers the headwinds their economies are facing rather than removes them, with questions about fiscal sustainability still very valid amidst on-going recessionary backdrop and outlook.

In addition, *the ECB has now passed the buck back to Eurozone governments.* The problem here of course is that while the ECB may have created a well from which peripheral countries may need to drink, as the adage goes, merely leading a horse to water does mean it will drink. Indeed, as the ECB has reiterated that any EFSF/ESM bond purchases, let alone any ensuing complementary support from the ECB in the secondary markets, will need the governments of any bond markets in question to request such action. The question is the extent to which the likes of Italy and Spain will feel requesting such a bail-out is a political (and possibly economic) hurdle too far.

Government Prevarication? In this regard the conditions attached to any such a fresh bail-out remain unclear, e.g. nothing more than sticking to the budget targets it already has in place or more onerous measures including politically toxic external supervision. *The risk therefore is that the long-standing ability of Eurozone governments to prevaricate may mean that it takes considerable time before any prospective bail-out country is made aware of the conditions that will be attached*, with markets showing fresh frustration as a result. In this regard, while noting its preference for IMF involvement, it is notable that the ECB is not making any such a political decision any harder by enforcing its own conditions. *Regardless, the likelihood is that the growing financial strains in Spain overall and increasingly in its regions will force the country into a bail-out in the next month or two*.

The Week Ahead: German ESM Ruling. Perhaps one reason why the ECB found it hard to bring full clarity about possible purchases was the fact that the legality of the ESM has still to be ruled on in Germany. This Wednesday the **German Constitutional Court** (GCC) rules on both the ESM and the Fiscal Compact, albeit with the verdict on the former the far more eagerly awaited as the issue of no-bail-outs and interference with German budgetary autonomy is scrutinized. Notably, the GCC has never blocked any ratification of any EU related matter, but the risk is that the GCC could ask for more time by offering only a preliminary verdict, with the worry being that financial markets may fail to realize that such interim judgments are quite common in German procedural law.

Dutch General Election. A further obstacle to the reforms that the EU is trying to ram through may come in the Netherlands. An early **General Election** has been called for this Thursday with the clear risk that no stable government emerges or at least one that is torn between anti-European zeal and resistance to more austerity.

Don't Forget the Data! Of clear note, and amidst the gloom that persuaded the OECD last week to predict Germany may see a contraction in the second half of this year, German industrial production has been holding up well, confounding survey messages, albeit with signs in the likes of the labor market that things have taken a turn for the worse. Better industrial output signs into early-Q3 have also been seen in the Netherlands with even Spain seeing less sizable falls in output. *How Eurozone-wide this development may be is unclear* but further clues in this regard will appear in the coming week. Indeed, **Industrial Output** numbers in France (Consensus: -0.6% M/M; DE: -0.3%) on Monday and in Italy on Wednesday (Consensus: -0.5% M/M; DE: unch) are expected to be soft(er), but even if so, the overall **Eurozone Industrial Output** (Wed) may see little further erosion (Consensus: -0.2% M/M; DE: unch).

Low Core Inflation. Otherwise the coming week sees various CPI updates culminating on Friday with **Final Eurozone HICP** data. The latter should confirm a clear spike higher in August but the breakdown should confirm the adverse impact of higher energy prices: the core rate may even have fallen from the 1.7% Y.Y pace of the previous month.

DE Forecasts:

- **Real GDP:** Recession continues, with the uncertainty being both the geographical breadth, depth, and length of the contraction. DE sees GDP falling, on average, by a weaker than Consensus 0.5% in 2012, with an increasing chance of activity continuing to fall in the second half of the year. Only an anemic sub-Consensus 0.2% rise is seen in 2013. Downside risks very much evident.
- **Inflation:** Headline HICP inflation has been above the 2% target since the end of 2010, largely due to food and particularly energy prices. Despite high oil prices, DE sees the rate falling from just over 2% this year towards 1% in 2013, hinting at emerging deflation risks.
- **ECB:** The ECB is likely to cut its refi rate by a further 25 bps yet this year, with more unconventional central bank measures also in the offing. The ECB program is the first of what may be many such coming steps. (Andrew Wroblewski)

United Kingdom

Crucial Labor Market Update

The Week Ahead: A Turn for the Worse in the Labor Market? There have been signs from various surveys that the labor market may be taking a turn for the worse, belatedly echoing the weakness in GDP numbers seen up until now. Admittedly, the adverse messages from these surveys have not worsened of late, with even some slightly less downbeat signs emerging, with July production data and *the fillip from the Olympics likely to mean current quarter UK GDP bounce s back clearly*. However, the underlying picture remains very uncertain, especially amidst the very marked month-to-month volatility seen in these surveys.

Indeed, this noisy survey backdrop makes the August **Labor Market** report (Wed) all the more important as a clearer gauge of the true temperature that the economy may running at. Admittedly**, Claimant Count** unemployment (Consensus: unch; DE: 7 000) has already been on the rise of late, albeit with a fresh fall seen last time around, the question being the extent to which factors such as the Olympics may have played a part in that fresh drop. Indeed, a better labor market backdrop was also seen last time around in the alternatively-sourced and broader ILO measure of unemployment. This saw a fourth successive drop, enough to trim the jobless rate on this basis to 8.0%. On a further more upbeat note, the rate of redundancies fell, while vacancies rose slightly further. Hours worked, however, fell slightly but employment numbers rose further. Notably, however, *what work there was is still dominated by (possibly far from voluntary) part-time working and self-employment*. A more specific labor market survey arrives on Monday.

DE View: To date, officially-produced numbers have offered clearly more reassuring messages regarding the labor market suggesting an unexpected resilience that seemingly provides a further rebuff to the notion that the UK economy is actually in recession. However, this relative strength is seemingly coming at a price at least for households. **Average Earnings** are still running at a pace well below CPI inflation. More worryingly, average earnings growth may still be too high given the very clear weakness in productivity that the combination of soft GDP and rising employment is painting. Further softness in Average Earnings is expected in the July update due on Wednesday (Consensus: 1.5% Y/Y; DE: 1.4%).

BoE Insight: *Any signs of a weaker jobs backdrop* will be read with mixed feelings by the BoE. While such a development may corroborate the softer survey numbers and GDP fall seen of late, at least it *may help temper the clear productivity weakness that the BoE is understandably so concerned about.*

The central bank is seemingly waiting until around November by when it may have a clear view on how successful the recently-launched Funding for Lending Scheme may prove to be, with it possibly the case that the MPC meeting that ended last Thursday may have seen the results of the first month of scheme.

Housing Market Faltering? House price updates of late have been mixed of late, albeit with clear softness apparent. Overall construction sector surveys, however, have been softening although official **Construction Output** numbers for July (Fri) may be decidedly better, a distortion that dogged Q2 numbers unwind. As for the house prices, they still seem to be above their-long term averages, this being one factor that may be (at least) accentuating banks unwillingness to lend without prospective buyers providing sizeable deposits.

Regardless a broader picture of the housing market arrives on Tuesday via the (August) **Royal Institute of Chartered Surveyors (RICS) House Price Surve**y. Notably this has highlighted a more downbeat picture for the sector, with more surveyors (realtors) reporting falling rather than rising prices and with the index of buyer enquiries remaining in negative territory. In addition, actual housing sales slipped a little further in July, while the supply of housing (in the form of unsold stock on surveyors' books) recovered a little. As a result, the closely watched sales to stock ratio (often seen as an indicator of future prices) fell afresh.

DE Forecasts:

- **Real GDP:** Official data suggest that the UK is in recession, but the data have been hit by an array of distortions, especially the marked Q2 slump. Even so, underlying GDP growth is no better than flat, with a clearly negative outcome likely for 2012. Hope is for something approaching 1% in 2013.
- **Inflation:** Headline CPI is proving stubborn, partly a result of energy prices, but an improving trend is now unfolding, seeing a fall from around 2½% this year to clearly under the 2% target in 2013.
- **BoE:** Bank Rate on hold until 2014, but with a fresh cut in coming months now a possibility. As for unconventional policy, further enlargement of asset purchases now less likely in coming months with the BoE instead to rely on additional policy tools that more directly address bank lending weakness.

(Andrew Wroblewski)

Other Europe

Sweden: Justifying the Riksbank Rate Cut

The week ahead: It will be interesting to see if the arguments made by the Riksbank behind its surprise decision to ease policy last Thursday are supported by upcoming data. Certainly, the low inflation backdrop that the Riksbank pointed to will be corroborated by **Consumer Price numbers** on Thursday, while the higher than expected productivity picture may be further underlined by the **Labor Market** figures the same day. However, the weakening in the economy ahead that was implicit in Riksbank thinking may not be readily supported by July **Industrial Production** figures (Mon). Indeed, even if a M/M fall does occur, this will be seen only as correction to clear bounce in activity that late-Q2 data pointed to regarding the industrial sector, numbers that also have run counter to the very soggy business sector survey readings seen of late.

DE Forecasts:

- **Real GDP:** The economy recovered very strongly in the first half of this year but less encouraging signs are emerging of late. Decent real GDP growth of less than 2% likely on average this year, giving way to above 1% in 2013.
- **Inflation:** Headline and underlying CPI rate likely to remain below the 2% target until late 2013.
- **Riksbank:** After the recent surprise easing, policy likely to be on hold until mid-2013.

Norway: Inflation Undershooting

The week ahead: Consumer Price numbers (Mon) provide the main domestic focus in the coming week, aside of course from the continued interest in any further comments from the Norges Bank regarding its desire to cap the exchange rate that. *There is continued (and justified) criticism in this exchange rate focus as it is resulting in domestic monetary conditions which risk stoking bubbles and even damage to competitiveness from rising wages*. Even so, the fact that inflation remains so soft, below expectations and below targets is giving the Norges Bank rationale for its policy preferences. August CPI numbers will not change this backdrop, especially as the more closely-watched underlying rate (currently 1.3%) is likely to remain so far short of the 2% target.

DE Forecasts:

- **Real GDP:** GDP growth of just under 3% seen this year but slower next.
- **Inflation:** Headline and underlying CPI rate likely to approach 2% target by late 2013.
- **Norges Bank:** Norges Bank on hold until at least next year.

Switzerland: SNB Currency Focus to Continue

The week ahead: At least domestically, the **SNB Quarterly Assessment** on Thursday will concentrate minds somewhat. Not that anything new is on the cards, with the SNB very much going to adhere to its near-zero interest rate policy as complement to its goal of capping the franc against the euro. Admittedly the costs of the exchange rate goal is rising every month, at least in terms of the huge rise in FX reserves that has occurred in the last few months (to over 70% of Swiss GDP), albeit with the rate of rise tempering in August. Regardless, the somewhat softer Q2 GDP backdrop is only likely to have reinforced the SNB mindset that the Swiss export sector is under threat from the very strong franc, thereby meaning that the central bank will continue to cap the currency at 1.20 to the euro.

Very probably, despite research from the World Economic Forum that suggest Switzerland remains the most competitive economy is the world, *the SNB may point to the softness in exports as evidence of the detrimental impact of the strong currency*, albeit failing to note that the same strength in the franc is also supporting domestic spending power, thereby helping explain the strength in the domestic economy. But the SNB may also have to be more open about the policy dilemma it faces, perhaps being more open about (and even suggesting measures to address) the bubble in the likes of the residential sector that low interest rates are bringing. Regardless, the ability of the SNB to continue capping the currency will surely be getting all the harder as the resilience in the Swiss economy merely helps accentuate the already clear safe-haven status of the Swiss currency.

DE Forecasts:

- **Real GDP:** Recession, or even contraction, very much avoided, with GDP growth likely to exceed 1% this year. Pick-up to 1½% seen in 2013.
- **Inflation:** CPI inflation to remain negative into early 2013, still averaging little more than 1% next year.
- **SNB:** Rates on hold for at least another year: threat of continued intervention to hold down Swiss Franc still being made by SNB, but exchange may ultimately be allowed to rise in due course. (Andrew Wroblewski)

Oceania

Australia: Key Survey Updates

The week ahead: Recovery in the Housing Market. Following a very busy week in which a slowing in Q2 *GDP* growth dominated market attention, the coming week is instead filled with survey updates and housing market data. The latter arrive on Monday and Wednesday, beginning with the release of **Home Loan Approval** numbers (Mon) for July, which may see some rebound after the correction seen in the previous month. **Dwelling Starts** for the second quarter (Wed), meanwhile, will possibly see some recovery after clear falls in the two previous quarters, including the Q1 drop which was the steepest since Q3 2010.

Consumers More Upbeat? Survey updates kick off Tuesday in the form of **NAB Business Confidence** figures, where there could be more convergence between the business confidence and business conditions sub-indexes after the former jumped to a new cycle-high last time around while the latter fell to the second-lowest in its cycle. **Westpac Consumer Confidence** data (Wed) then completes the week on an upbeat note, with the index likely to see a slight bounce back following the fall in the previous month. Elsewhere, the only other notable release in the week is the **Quarterly Bulletin** by the **Reserve Bank of Australia** due on Thursday.

DE Forecasts:

- **Real GDP:** After the clear bounce back in Q1, GDP growth more than halved in the second quarter, albeit still largely in line with the RBA's latest (August) projections. Expectations for this year are now for growth to slow slightly further to around 3½% by year-end before possibly moderating further in 2013.
- **Inflation:** Headline CPI inflation moderated to the lowest rate since 1999 in Q2 (at 1.2%) and is now expected to see some pick up to the lower half of the RBA's target range of 2% to 3% by the end of 2012.
- **Reserve Bank of Australia:** Following two successive rate cuts by the RBA, which brought the Cash Rate down by a cumulative 75 bps in June, the Bank kept rates unchanged at its latest three meetings. *Further policy easing is still possible later this year, possibly as soon as October*, should downside risks to global economic growth increase, The latest Statement still suggests that a policy pause will be the most likely outcome in the near-term.

New Zealand: RBNZ on Hold

The week ahead: Stagnation in Manufacturing. After a relatively quiet week in which *Construction* data for Q2 may have been the focus of markets, the coming week has a number of interesting economic data releases/events in store. Specifically, a likely rebound in second quarter **Manufacturing Activity** kicks off the week on Monday, closely followed by another housing market update in the form of **QV House Prices** (Tue). Otherwise, survey updates dominate the data slate in the week, with the **Performance of Manufacturing Index** and **ANZ Consumer Confidence** numbers due on Thursday and Friday respectively, and where the former will likely continue to imply near-stagnation in manufacturing sector activity.

Extended Policy Pause. Nearly all of the attention in the coming week, however, will be focused on the **policy decision** by the **Reserve Bank of New Zealand (RBNZ)** on Thursday. There are, however, unlikely to be any surprises this month. The statement in July showed that the RBNZ was relaxed about the inflation outlook and revealed signs that the Bank may be increasingly concerned about the strength of the exchange rate, thus further hinting at an extended policy pause.

DE Forecasts:

- **Real GDP:** Real GDP growth in Q1 jumped to the fastest pace in five years following disappointing results in Q4, but with moderate growth of between 1½-to-2% still envisaged for 2012. Growth likely to slow somewhat in the next quarter before picking up again in the latter half of this year as the recovery in the earthquake-hit areas gains momentum.
- **Inflation:** Headline CPI inflation in Q2 fell to 1%, now the lowest since 1999 and hitting the bottom of the RBNZ's target range of 1% to 3%, but is expected to pick up towards the end of 2012 as the recovery speeds up. Still below 2% for most of 2012 and 2013.
- **Reserve Bank of New Zealand:** The RBNZ *will likely be on hold (at 2.5%) until at least 2013.*

(Chang Liu)

Japan

Final Data Before BOJ Meets

The Week Ahead: BOJ Policy Committee studies late-arriving data. This week closes out the collection of July economic data and brings financial-sector reports starting the August round—the final batch of numbers before the monthly BOJ meeting next week. None are usually of a pivotal nature, though the July **machinery orders** result (Wed) will be closely watched as a reading on the state of business confidence—at a time when domestic and global uncertainties could be weighing heavily enough on decision-makers to cause a damaging investment-spending decline. Among other arriving reports, **revised second-quarter GDP** numbers (Monday) could convey a new message, but are unlikely to; August **bank lending** results (Monday) will gauge monthly credit flow, probably showing it steady; and July **tertiary industry** activity data (Wednesday), likely neutral for the month, will give the first broad trend indication on service-sector GDP in the new quarter.

DE View: Very strong first-quarter GDP growth was heavily driven by unsustainable strength in consumer spending, and a slowdown there cooled growth in the second quarter. A dwindling in auto-purchase subsidy funds will further restrain consumers in the third quarter, but broader-based earthquake/tsunami reconstruction activity will help support the overall economic expansion in a subdued—but still above-trend—range, probably through year end. Eventually, a reviving global economy will kick in to support longer-term growth in the 1% to 1.5% annual zone. However, risks of an intervening period of weakness—and of a monetary policy response—continue high.

Minimal GDP revision (Monday). Revised second-quarter real GDP should be revised only slightly, if at all, from the preliminary estimate of a +0.3% simple growth rate. Corporate financial data point to a modest downward revision to the business investment result, but even slight net improvement in other categories would offset it. Business profitability results were good in the quarter, so future investment will not be impaired on that score—the outlook depends almost solely on confidence.

Steady credit flow (Monday). Year-on-year growth in bank loans outstanding will stick close to the +0.7% July figure—suggesting neither any throttling nor any acceleration in this critical type of credit flow. Banks are not impaired in their lending ability, but demand for credit remains spotty.

Investment growth continues, mutedly (Wednesday). July core machinery orders will likely show a modest increase, about 2.0%, extending the 5.6% June rise, but not yet reestablishing the very mild upward trend in place before the 14.8% drop in May. In the current environment, however, relative stability amounts to good news, and the prospect for strong further disaster-reconstruction spending sustains the outlook.

Tertiary industry activity holds its ground (Wednesday). Tertiary-industry activity—accounting for nearly two thirds of the supply-side breakdown of GDP—should level out this month, after expanding 1.0% over the course of the previous two. Trend growth is barely positive so far this year, but will benefit from strengthening activity in the disaster region, particularly in the construction sector.

DE Forecasts:

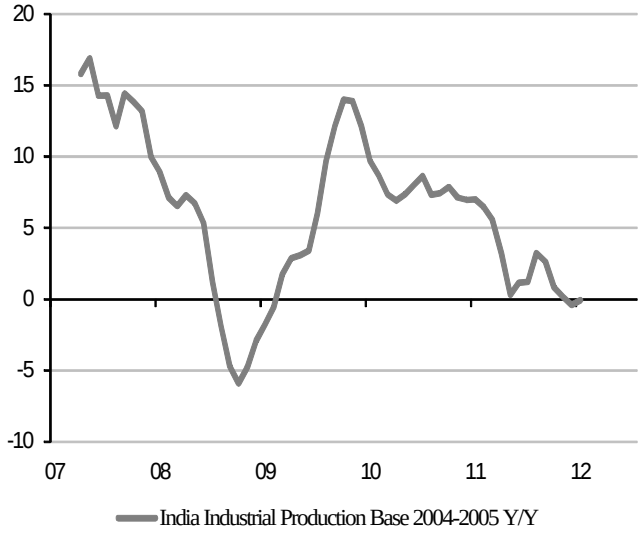
- **Real GDP:** Near-term growth is boosted by the long-delayed arrival of earthquake recovery and rebuilding funds, pushing the economy modestly above trend growth for a period—beyond which an improving global market should lift exports and sustain overall growth at potential, about 1.3%.
- **Inflation:** Inflation-targeting will force the BOJ, under its current management, or under newly installed management early next year, to take steps to prevent any extended deviation from a path towards 1% core inflation over the next three years. Current deflation worsening.
- **BOJ:** *BOJ policy rates will not be noticeably increased before 2014, if even by then.* The next move, September 18-19, should be to step up the size of the balance sheet. The more immediate issue is potential expansion of asset-purchase programs and the balance sheet—which current leadership will do only to the extent necessary to placate politicians, or if the economy or inflation disappoint. Longer-term interest rates will likely remain in the current range for another 6-9 months—though very recent levels are unsustainably low—beyond which an easing in global safe haven demand, and increasing market conviction that the BOJ is serious about pulling up inflation, will lift the ten-year JGB rate slowly towards 1% then 1¼%, and ultimately beyond.

(Pierre Ellis)

Emerging Markets

Week ahead: The most important data released this week are China and India's industrial production numbers. For the latter, there is no indication that the pace of output has strengthened, but the July monthly growth figure will probably be somewhat higher (+ 1.5% y/y) largely due to base effects. Regarding **China,** annual growth will remain relatively low (Consensus: + 9.2% y/y; Decision Economics: + 9.8% y/y). This is becoming one of the most important statistics to monitor, as the question of whether China's policy stimulus is working becomes essential to China's markets. A weaker-than-Consensus number will be disappointing, but it will not change much of the predominant vision that in the near-term, in which Chinese policymakers still have the resources and means to stabilize the economy, i.e., a weak industrial production number makes reserve-requirement reductions and lower interest rates more likely, sooner. A considerably stronger-than-Consensus result will have broad positive effects on equities. Positivity will particularly be noticed across Asia, as it can be implied that fiscal and monetary stimuli are beginning to bear fruit.

Chart 4
India Industrial Output (3 Month Average), Y/Y Pct. Chg.



Sources: Bloomberg and Decision Economics, Inc.

Central Bank Watch

Korea's central bank (PNB) is likely to cut rates this week, as signs of economic deceleration intensify, following meager second quarter growth and minimal expansion of industrial production in July. In the meantime, inflation has essentially collapsed, from over 4% y/y in late 2011, to barely over 1% in August. The Bank of Korea warns about a potential rebound of inflation, but with China's slowing taking a more alarming turn (not only in the eyes of Chinese policymakers but also from the perspective of many market participants), it is hard to see how the Bank of Korea can avoid reducing borrowing costs, at least until the important export sector shows signs of life, i.e., until China's cyclical bottom is found.

In the **Philippines**, the central bank has issued very clear indications that it intends to keep rates on hold in the near-term. Real GDP is growing at a rapid pace (5.9% y/y in the three months leading up to June) and, despite a deceleration of exports, strong domestic demand, including public sector investment, will likely keep the economy expanding in excess of 5% y/y during the second half of 2012. This is, in any event, what policy makers at the bank project. There are also some very public considerations of a potential need to increase rates in coming months if inflation, which picked up the pace in July-August, continues to accelerate.

Meanwhile, the Bank of **Indonesia** observes its economy going through a period of strong growth with moderate inflationary pressures. Policymakers are confident that the country's largely domestic-driven economy can withstand the current and foreseeable weakness in the export sector. In view of recent experience, this seems to be a reasonable expectation, particularly as efforts to stabilize China's economy—which will eventually help lift regional trade—are now more visible. The bottom line: no change in interest rates, for now.

Similarly, for the Bank of **Russia** the economy is operating at full capacity, while inflation remains well-behaved. The bank is, for now, discounting the risk that lower commodity prices and slower manufacturing production translate into an economy-wide downturn, and thus it is likely to hold interest rates steady this week.

DE Forecasts:

Despite external risks, EM economies continue to grow. Barring a full-fledged global crisis, a soft-landing scenario may ultimately best describe the path of real GDP across emerging markets in the near-term. Economic activity has slowed down significantly, particularly on the manufacturing side, but conditions are not recessionary.

Resilient consumer, easier credit… With few exceptions, consumer and investment spending remains well-supported, unemployment rates low; while borrowing costs have diminished.

…as inflation becomes a diminishing threat. Central Banks remain watchful of a potential re-acceleration of inflation, but for now caution leads them into either gradual easing or prolonged pauses following significant rate reductions. Across EM, rate increases appear likely to occur only as a result of exceptional domestic circumstances in

the months to come. A disinflation trend is gradually unfolding. The trend may intensify as a result of commodity prices' substantial declines.

Exports vulnerable to Eurozone crisis. EM Exports remain exposed, and are already growing very slowly; there is some financial risk arising out of the lingering European debt crisis, making markets sensitive to euro-zone development s the foreseeable future.

Growth likely to accelerate if Eurozone avoids "Lehman Moment." From current perspective, it is reasonable to expect that if a full-fledged financial crisis is avoided in Europe, EM would likely experience a moderate rebound later this year and into 2013, on the basis if easier money, stronger US demand, plus a bottoming and modest re-acceleration of growth in China.

As China goes, other EMs follow. Emerging markets will probably replicate, more or less closely depending of size, economic structure and location, China's near-term growth pattern: deceleration through the middle months of 2012, followed, later in the year and into next, by a moderate up-turn. Should the Asian giant slip into recession (or a recession-like stage, say 5%-to-6% growth), the pace of economic activity would be hurt significantly not just in manufacturing-oriented Asia but in commodity driven EMs, as commodity markets would be heavily impacted. There is a reasonable expectation that such Chinese-recession scenario will be avoided, especially now that a policy easing seems clearly underway.

(Francisco Larios)

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