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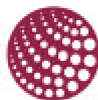

DECISION ECONOMICS, INC.
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The Global Markets Weekly

October 14, 2011

Banking on Eurozone Policy-Makers!

Markets reacted very clearly to the growing signs that political policy makers are waking up to the task confronting them. Notably, the **EU** has set itself a more exacting deadline of **October 23** when it will convene a **Summit** to agree a plan to address the Eurozone debt problems, aiming to provide a final decision on Greece's bail-out, enlarge its effective bail-out resources and recapitalise Eurozone banks. Perhaps, Greece could be the most contentious issue, with a German-led group of creditor countries pushing to revise the second €109 bln Greek bailout to include deeper haircuts for Greek bondholders.

Even so, risks remain, with difficult negotiations ahead, especially if EU leaders actually feel little commitment to the October 23 deadline, instead being of the view that they have until early November given that the initial promise from the likes of Germany and France was that a full plan would be provided by the G20 Summit on November 3-4. As for Greece, even if the EU decides it wishes to offer Greece short-term further funds, the IMF (which is clearly more circumspect about the willingness of Greece to stomach reforms) may highlight its reservations, something that may intensify market worries that the country is near default rather than a voluntary restructuring. As for the more powerful EFSF, the problem may be that the so-called insurance plan to leverage the EFSF, in which the up to 40% of a country's debt would be guaranteed by the Facility could find problems in that it may result in too few countries guaranteeing too many countries.

Finally, there are the differences over bank recapitalisation itself, with an accompanying problem being the extent to which banks themselves would respond to any demand for an increase in capital ratios by selling asset rather than raising new capital. From the government point-of-view, there are still clear differences over whether the cash they may need to commit to banks should come from national treasuries (the German option) or from the €440 bln European financial stability facility, with France preferring the latter option in order to see less potential damage to its own debt profile and possible debt rating. Notably, the ECB (for once) is siding with the German as it wants to ensure that EFSF resources can be directed entirely to taking over the government bond buying role that the central bank is still being pressured into undertaking.

- **U.S.: CPI and PPI** data should show a boost from higher energy prices, and a firm but moderate core. **Housing starts** were likely boosted a bit in September, but still very weak, while **existing home sales** likely fell. **Industrial Production** data should incorporate ongoing expansion in the manufacturing sector.
- **Eurozone:** Aside from the **G20 meeting**, surveys will be the data focus with most of the attention on the **ZEW survey**, German **Ifo data** and French **INSEE numbers** on Friday. Eurozone **consumer confidence** data should also be closely watched.
- **United Kingdom: CPI** data should show a fresh cycle-high for the headline figure. **Retail sales** numbers should continue the recent flat to softer trend. Given the weakness in the economy and the associated impact of fiscal consolidation measures, **public borrowing** data may get greater scrutiny than hitherto.
- **Japan:** Data releases are limited to the revised August **industrial production** report, with little change to earlier figures expected. The key policy event should be the **Bank of Japan Branch Managers Meeting**.
- **Emerging Markets/Regions**: The key data release this week is **China's third quarter GDP**. Consensus expectations are near 9.3% year-on-year. DE's own estimate is not too far from that mark but lower, at 9% year-on-year.

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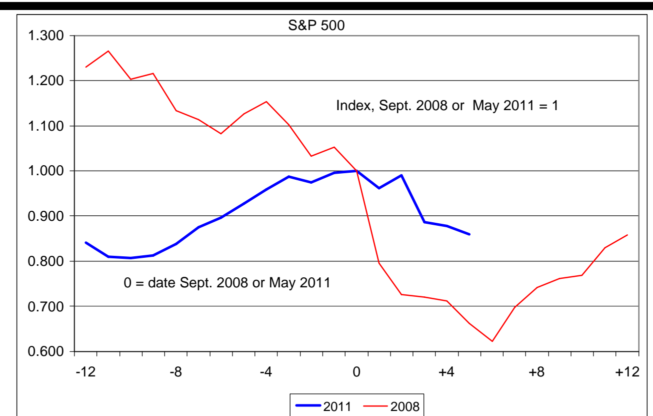
Focus: Is 2011 = 2008?

The Source of the Market Turmoil is Different

The slide in the equity market has investor worried that 2011 will be a replay of 2008. Chart 1 compares the performance of the S&P500 with the level of the index in May
2011 and September 2008 set to 1. The equity market had been sliding since late 2007 in anticipation of the US recession unfolding later in the year, whereas the US equity market was rising in the first half of 2011 in anticipation of a pickup in GDP and earnings growth. The Lehman moment of 2008 only exacerbated the long-standing equity decline.

The Lehman moment in September 2008 caused a funding crisis, as shown in Chart 2 which shows the change in basis points of the 3-month Libor. The change in Libor in 2011 has been very small in comparison, even though the CDS spreads on European financials have gapped (Chart 3), partly due to funding strains in the sovereign debt market.[1]

Chart 1. Different Equity profile in 2011



Source: S&P and Decision Economics, Inc.

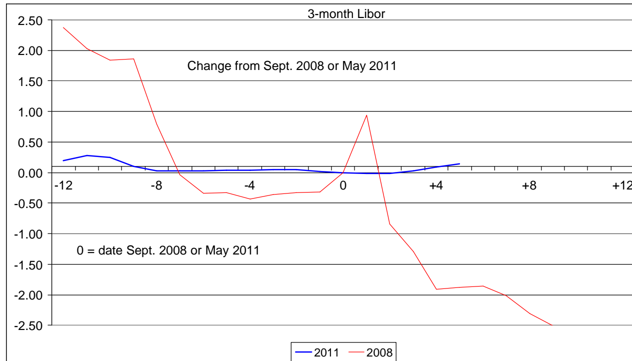
Rally in the Bond Market is Very Similar

The performance of the Treasury market has been markedly similar in both episodes (Chart 4). The 2008 experience suggests some backup in 2012, which makes sense if global growth stabilizes.

Foreign Exchange Behavior Also Much Different

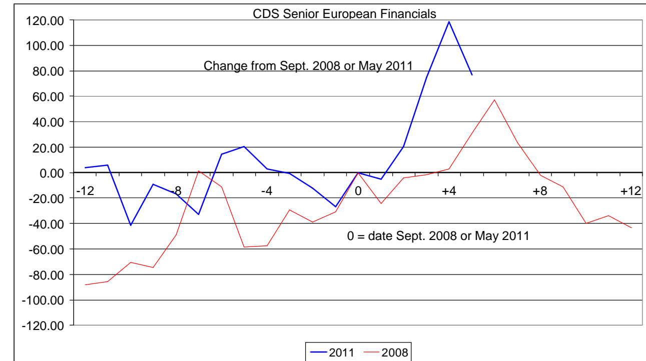
In 2008, the trade-weighted dollar had been rallying since spring and was boosted by Lehman's fall. In 2011, the dollar trend has been consistently down, with a little bounce unfolding since August. (M. Cary Leahey)

Chart 2: Funding Conditions Much Better



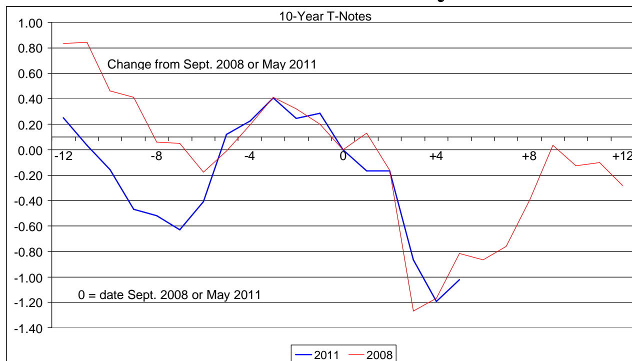
Source: Federal Reserve and Decision Economics.

Chart 3. Even Given Euro Financial Worries



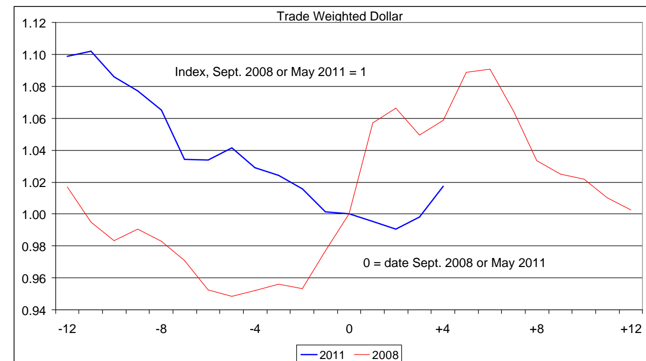
Source: Bloomberg Markets and Decision Economics, Inc.

Chart 4. Treasuries Pattern Very Similar



Source: Federal Reserve and Decision Economics, Inc.

Chart 5. Dollar Performance Much Different



Source: Federal Reserve and Decision Economics, Inc.

[1] See the charts on page 7 of the September 2011 *IMF Financial Stability Review*.

United States

Consumers Feel Lousy, Continue to Spend Anyway

Recap: An early-October read on the **Reuters/University of Michigan Consumer Sentiment** showed unexpected deterioration in both the outlook and current conditions. Inflation projections also backed off. This largely quashes the hint of revival given in September and paints a precarious picture of consumer behavior.

Nevertheless, **retail sales** jumped +1.1%, almost double the expected pace, on the heels of a relatively strong employment report. Autos (+3.6%) played a big part, as did furniture (+1.1%), gasoline (+1.2%), clothing (+1.3%), department stores (+1.1%), and restaurants (+1.2%). The main laggards were building materials (-0.1%) and grocery stores (-0.2%). Adjusting for inflation, retail sales likely grew around +0.7%, which if combined with the upward revision to August, should boost Q3 growth projections by a few tenths of a percentage point. The result should be to solidify near-term growth projections of 2-2.5%, depending on how much spending came out of inventories last quarter. No matter how bad consumers feel about jobs, government, and their personal finances, they continue to spend. And as long as consumers continue to spend, we will continue to believe that the weak economic recovery will endure.

The August **trade deficit** was flat, defying expectations of mild deterioration. Essentially, U.S. trade stagnated that month, with exports down a mere -0.1% and imports unchanged from July. Weakness was spread across consumer an industrial categories. Oil imports jumped 7% as a rebound in demand offset a decline in prices. The bright side is that strong export gains made in July were largely held onto, keeping the trade deficit narrow compared to the Q2 average. This will help boost Q3 GDP. But the export backdrop may have deteriorated more recently, and is now under threat from a European recession and a slowdown in emerging Asia.

The week ahead: The indicator spigot opens wide this week with data on inflation, housing, and manufacturing, as well as the Fed's latest Beige Book report.

September inflation was likely accelerated by higher gas prices in both the **CPI** (DE: +0.5%; Consensus +0.3%) and the **PPI** (DE: +0.5%; Consensus +0.3%). The up-tick in gas price in these series was partly the result of seasonal adjustment factors, which normally capture a much steeper decline after the summer driving months. Core inflation, meanwhile, should be tamer in the CPI (DE: +0.3%; Consensus +0.2%), but should be enough to push year-on-year rates above +2%.

Housing data for September should be generally bleak, though no more so than recent history. **Housing starts** likely rebounded after a weak August (DE: 605K; Consensus 595K). But builders are keeping inventories lean in the face of weak demand, so there is no genuine upside in the near-term forecast. **Existing home sales** likely declined -1.8% to 4.94M units based on pending home sales results for July and August.

Expectations for September **Industrial Production** are generally upbeat, though measured (DE: +0.3%; Consensus: +0.2%). Despite flashing warnings signs from regional and national manufacturing surveys, actual production (overall and in manufacturing) continues to grow, though at a somewhat slower pace than in 2010. Meanwhile, the **Empire State and Philadelphia Fed Manufacturing Indices** will give an early look at the sector in October. Both DE and Consensus expect the indices to stay negative, but move closer towards a neutral reading. This would support expectations of ongoing expansion at the national level, though regional and national indices have diverged on this point recently.

In addition to the data, we are treated to a flurry of Fed speeches. **Rosengren** and **Bernanke** address the Boston Fed's Conference on Tuesday. **Lacker** (Monday), **Lockhart** (Tuesday), **Pianalto** (Thursday), and **Yellen** (Friday) give Outlook speeches. **Tarullo** discusses "Unemployment, the Labor Market, and the Economy) on Thursday. **Evans** addresses the Michigan Council on Economic Education on Monday, while **Kocherlakota** speaks before the Harvard Club of Minnesota on Friday.

Finally, the Fed's latest **Beige Book report** will give insights into how regional business contacts, academics, and analysts are coloring committee members' views on the outlook. The report primarily covers the month of September, for which economic data have been firming after a weak summer.

(Paul Edelstein/Pierre Ellis)

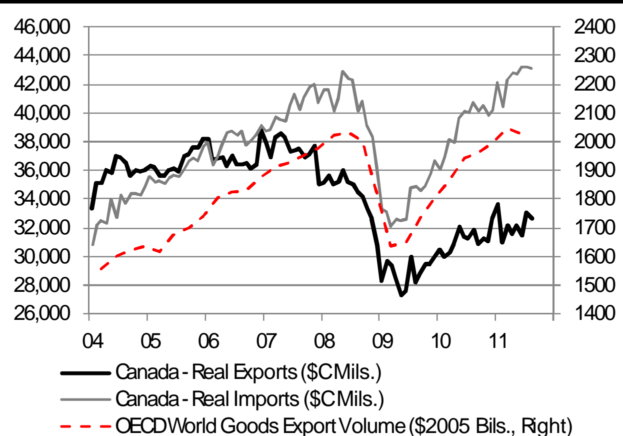
Canada

Upbeat Data Flow Last Week, But No Major Shift of Modest Growth Trend

Recap: Trade, housing starts, and manufacturing

Last week's data hinted at a less pessimistic outcome for Q3 growth performance, with housing starts, international trade, and manufacturing data all coming in firmer than anticipated. The trade deficit came in narrower than expected in August at $0.6 billion, compared to an August deficit revised narrower to $0.5 billion. Nominal exports rose 0.5% and imports 0.6%, though in constant-dollar terms, exports fell 1.2% and imports only 0.2%, suggesting a less positive message for Q3 net exports than the headline indicated. Barring a significant widening in the real trade deficit in September, net exports should post a positive contribution to Q3 GDP due to a sharp export jump in July.

Exports Hold At Higher Level…But What Now?



Source: Statistics Canada, Bloomberg

The chart to the left highlights a persistent problem facing the export sector. World trade (red dashed line) has effectively regained pre-crisis levels, but Canada's exports remain meaningfully short in real terms. Minimal exposure to emerging market growth, the strong CAD (which aided the strong rebound in imports), and sluggish productivity trends, suggest the outlook for net exports will remain soggy for a while. That may hold despite both the rebound from temporary factors (autos, energy) so-far witnessed and the perceived advantages of being a resource exporter at a time when emerging economies' appetite for those resources still appears to be on the rise.

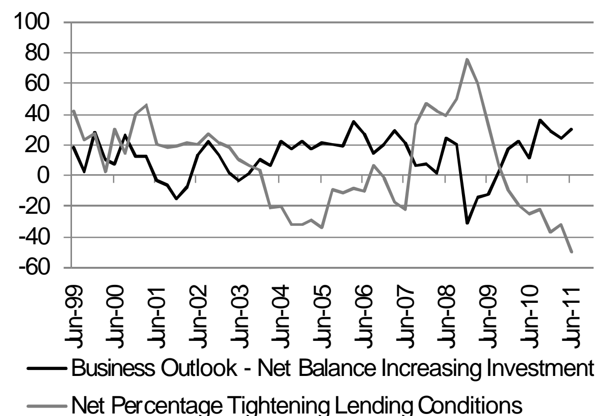
Housing starts came in firmer than expected in September, rising 7.3% to 205,900, entirely on multi-family units (+14.2% m/m to 118,000). Single-family starts fell 1.5% to 67,900. The August result was revised higher to 191,900 from 184,700, strengthening the underlying tone of recent data, and likely adding some support to the residential component of Q3 GDP. Residential building permits data suggest that starts may not hold that +200K pace moving forward, with August data showing a 10.4% decline there. Elsewhere, manufacturing data showed a 1.1% increase in constant-dollar shipments, but a third consecutive relatively flat print for inventories.

Ultimately, all three reports provided welcome news, diminishing, on their own, fears of a more-serious slowdown, but the activity data only cover the early part of the period of increasing financial market turmoil. September and October data have a clear potential to disappoint, leaving Q4 on a less certain footing, which explains why markets are still erring on the side of pricing in a potential rate cut in the months ahead.

The Week Ahead: Business and Lending Surveys, Consumer Prices

Monday brings the Bank of Canada Business Outlook and Senior Loan Officer Surveys (Mon) for the third quarter. The Business Outlook Survey will be watched for an update on businesses' perceptions of future sales growth, hiring plans, and investment intentions, as well as inflation expectations and capacity pressures. Direct policy implications will be muted, given persistent external concerns, but more color on the confidence front will be welcome. The Loan Officer Survey in Q2 showed the most significant easing of lending conditions on record, so attention will be on whether that measure moved closer to neutral in Q3. The consumer price index (Fri) should show stable-to-moderating CPI inflation, with upside price pressure not, for now, a significant concern for the Bank of Canada. The core rate should hold below 2.0%, while the headline rate may come down to 3.0% or just below, decelerating from a high of 3.7% in May. Finally, wholesale trade (Thu) should show another modest rise in sales, though attention should be paid to the inventory result, with weaker stock-building here, and in other sectors, a potential wild-card holding down growth in the third and fourth quarters.

Easy Access to Credit So Far



Source: Bank of Canada

Eurozone Production Sounder Than Thought

Recap: Data-wise there were some very interesting numbers. Coming in above that widely seen, albeit expectations made prior to the upside surprises provided by **Italian and French output** updates earlier in the week, **Eurozone industrial production** jumped by 1.2% M/M in August, thereby very much building on the 1.1% bounce of the previous month. Notably, there was also better news regarding output in the peripheral economies, Greece being the clear and continued exception. Regardless, it is unclear (especially given the weakness in manufacturing sentiment readings), how sustained this solidity in Eurozone production may be, the risk being that this increase in output merely adds to inventories, the unwinding of which will damage activity in this and coming quarters. Even so, these numbers certainly suggests that the Eurozone will have enjoyed a clearly stronger GDP performance last quarter than in the previous one. Indeed, spending side data corroborate a picture of a resilient Q3, as evident in more upbeat German export numbers.

There was also an update from the **ECB** via its (October) **Monthly Bulletin** in which the ECB chose to highlight its caution about potential pprivate sector involvement in regard to Greece. Otherwise, final data confirmed that **HICP inflation** jumped half a percentage point to a three-year high of 3.0% Y/Y in September. The breakdown released for the first time with this update showed that the sharp rise in inflation was based around a swing in clothing inflation, actually most of which was evident in Italy. As a result, rather than suggesting clear underlying price pressures, this further highlights on-going computational problems with the HICP data, particularly in regard to measuring clothing prices against a backdrop of swings in sales and price incentives.

The week ahead: Aside from anything that emerges from the week-end **G20 meeting** in France this week-end and any leak that may be forthcoming from governments ahead of the looming **October 23 Summit**, surveys will be the focus, at least in terms of data. First up, will be the **ZEW survey** (Tue), albeit with its results having lost much predictive power of late. More focus will be on the German **Ifo data** (Consensus: 106.3; DE: 105.5) and French **INSEE numbers** on Friday, although these will not reveal anything new about the most important rest-of-the-Eurozone. Eurozone **consumer confidence** data (Thu) should also be closely watched. For markets, and in lieu of the recent rating downgrade for the country, the **Spanish bond auction** on Thursday may be watched more closely than usual

(Andrew Wroblewski)

United Kingdom

Labor Market Softening Further?

Recap: The main measure of **unemployment** saw a further and actually much steeper increase of 114 000 in the three months to July, pulling the rate up to 8.1%, the quarterly increase being the largest in over two years. Indeed, the media focused clearly on the rise in the jobless total to a 17-year high of 2.57 mln. Meanwhile, employment showed a fresh decrease (of 0.6% in the quarter to July, albeit very much mostly a result of a drop in part-time working and that by retirees, with sector data for Q2 unsurprisingly still confirming a clear (and record) erosion in public sector employment. Regardless, what work is being garnered is still being remunerated softly and clearly below prevailing consumer or retail price inflation rates, with the latest (and actually weaker) **average earnings** numbers actually implying even more erosion may be occurring in regard to household spending power.

This erosion was possibly evident in the latest **British Retail Consortium sales** survey, where despite a pick-up in growth rates for last month, the numbers still implied that real sales have continued to fall clearly. Weakness was discernible still in the housing market as well. Indeed, the latest (September) **Royal Institute of Chartered Surveyors (RICS) house price survey** provided continued signs of softness regarding the housing market where the message is still one of falling prices and low(er) turnover.

Also on a downbeat note, **manufacturing output** dropped 0.3% M/M, the third successive fall after the clear rebound in May from the litany of distortions that dogged April numbers. Even so, base effects allowed the three-month rate of growth for manufacturing to recover, albeit assign to 0.5%. Perhaps of more note but little surprise, the latest weakness was broad-based. Otherwise, oil and utility production recovered materially in August, a result that meant that overall industrial production increased 0.2% in M/M terms after a 0.4% July drop. Such data suggest continued weakness may be seen in Q3 GDP. Last quarter, output was hit by several factors (such as the Japan earthquake and the royal wedding) which were officially estimated to have knocked GDP back by half a percentage point, thereby explaining the feeble 0.1% Q/Q outcome. These latest production data (actually showing overall industrial production in Jul/Aug up around 0.2% on the Q2 average) show no sign that the Q2 distortions are unwinding very much in favor a distinct pick-up in GDP in Q3, instead being consistent with the kind of weak readings that business survey updates are hinting at, albeit probably up clearly from the tepid Q2 outcome.

The week ahead: There are several important pieces of data in the coming week, starting off with the **CPI** data (Tue). A higher headline figure, indeed a fresh cycle-high, is on the cards (Consensus & DE: 4.9% Y/Y%) as recent utility prices increases come through, the question being whether the likely peak comes in this set of data or that for next month. **Retail sales** numbers (Thu) should continue the recent flat to softer trend (Consensus &; DE: unch M/M), albeit portraying a less downbeat message than overall consumer spending data have offered. Given the weakness in the economy and the associated impact of fiscal consolidation measures, which the Government is keen to adhere to, **public borrowing** data (Fri) may get greater scrutiny than hitherto. Recent borrowing data have brought mixed messages. Last month saw 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 be very happy that any fresh stimulus that the economy needs in the near-term has (already) 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. That spare capacity issue may be something that surfaces in the **BoE minutes** to this month's MPC meeting (Wed), albeit with markets concerned how large a majority was behind the decision to re-launch asset purchase and the extent to which the committee really belied this action will bolster activity.

(Andrew Wroblewski)

Other Europe

Sweden: Softer Data

Recap: Surprising to the downside, **industrial production** slumped 3.1% M/M in August, more than unwinding the 2.3% revised bounce of the previous month. Partly as a result, the Y/Y rate of growth softened clearly to 5.6% from 7.7% in July. On a further less reassuring note, **industrial orders** slipped by 0.5% M/M, also showing signs of the marked volatility seen in the output numbers and with a softer underlying ton evident. Meanwhile, September **headline CPI** eased to 3.3% Y/Y from 3.4%, exactly unwinding the rise of the previous month in which the overall figure hit the highest in almost three years. Notably, the long-standing core measure (CPIX, which excludes mortgage costs and taxes) slipped a notch to 1.3% Y/Y while the underlying measure (CPIF, which the Riksbank puts more emphasis on and which holds mortgage interest expenditure constant) slipped similarly but to 1.5%. The September CPI and CPIF readings remain some 0.2 percentage point below those envisaged in the updated projection provided by the Riksbank in its Monetary Policy Update published in July.

The week ahead: Aside from the usual array of **Riksbank speeches** due in the coming week, the focus will be on the **labor market** update on Thursday. Last time around, the (unadjusted) unemployment rate fell to 6.6% (August), some 0.6 percentage points below that of the same month in 2010, a much smaller Y/Y drop to that evident in previous readings. However, seasonally adjusted numbers confirmed an on-going drop in underlying joblessness (to a rate of 7.4%), albeit with the rate of decline slowing. On a more unambiguously less upbeat note, there was a further slowing also evident in terms of Y/Y employment growth.

Norway: Inflation Still Muted

Recap: **CPI** inflation increased by 0.3 percentage point to 1.6% Y/Y in September, albeit only unwinding the fall seen in the previous month and continuing the sharp swings seen in the last six months. On a M/M basis, prices jumped 0.9%, led by a seasonal surge in clothing costs alongside a rise in airfares and food prices. The Y/Y breakdown shows that the rise in CPI inflation came from a swing in food price inflation as well as transport costs, the latter probably related to airfares. As a result, the core rate, CPI-ATE (excluding taxes and electricity), moved back to 1.2% Y/Y from 0.8% in August, largely reversing the July drop. The data still leaves inflation, headline and core, below Norges Bank projections.

The week ahead: The **Norges Bank** is widely and justifiably seen keeping its key policy rate at 2.25% after its next Board meeting on Wednesday, thereby matching the decisions made in June, August and September. At the last meeting, however, the Norges Bank more clearly suggested that the key policy rate should be kept low for a longer period than expected in June, noting the turbulence and uncertainty abroad, combined with lower inflation and weaker prospects at home. Indeed, the updated analysis at that meeting very much hinted that the Norges Bank had move to a neutral footing, 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 with the **Monetary Policy Report** that will be released alongside the verdict this Wednesday.

Switzerland: Nothing Changing

Recap: There was no important data in the last week, with the remaining interest being the continued 'good behavior' of the Swiss exchange rate.

The week ahead: The week ahead is almost as barren, although **money supply** data (Fri) should garner more attention than usual to see if the impact of SNB intervention shows up any more clearly on the various monetary aggregates. **Visible trade** numbers (Thu) will get nothing but a cursory viewing.

(Andrew Wroblewski)

Oceania

Australia: Improved Survey Messages

Recap: The Westpac-compiled measure of **consumer confidence** index rose 0.4% M/M in October, accentuating the 8.1% bounce in the previous month, the later having been the fastest pace of growth since July 2010. The breakdown showed clear improvements across all components save for a modest correction back in the assessment of current conditions. On the company side, the **National Australia Bank measure of business confidence** bounced clearly last month, rising seven points to -2. Meanwhile, the business conditions index also rebounded, albeit rising five 2 points to 2, now being four points below its long-term average. The breakdown revealed the recovery to be the result of fairly broad based bounces among the various components.

On the housing front, a better tone was also evident: **total home loans** rose by1.2% M/M in August, extending the run of increases to five months including the upwardly revised July rise of 1.9%. Notably, the latest increase was much broader based that in July, including a clear gain in approvals for new home purchases.

Finally, and showing better signs than most expected, the seasonally adjusted **unemployment rate** eased 0.1 percentage point to 5.2% in September, hereby moving down from an August reading which had been the highest since November 2010. **Employment**, meanwhile, surprised clearly to the upside this time around, rising 20 400 following a little-revised drop of 10 500 in the previous month. This was a reflection of roughly-equal gains in both full-time and part-time employment. Elsewhere, the participation rate was (again) stable at 65.6% last month. These were certainly somewhat more reassuring numbers, albeit still leaving a degree of softness in regard to the recent trend in jobs growth.

The week ahead: The week ahead has some more survey data including the **NAB quarterly business** numbers on Thursday. There is also the **leading index** (Wed). More focus will be on the **RBA minutes** to the Board meeting earlier this month, especially with markets grappling whether the central bank might cut rates in the near future. However, the minutes may do little than reiterate the admittedly more dovish tones seen in the statement following the meeting.

New Zealand: Factory Sector Still Softening

Recap: The September **Performance of Manufacturing** Index fell by 1.9 points to 50.3, a fourth straight decline and now a six-month low. The breakdown revealed the latest fall to be a reflection of a weakening in production and orders offsetting and a swing into expansion for employment.

The week ahead: There is little of note in the coming week, with no key data scheduled.

(Chang Liu)

Japan

BOJ Branch Managers Meet

Recap: Economic data of the week gave somewhat mixed messages, with a disappointing result for August tertiary industry activity (-0.2%), set against a solid upside surprise in August machinery orders (+11.0% for the "core," ex-volatile orders measure) and another incremental firming in September bank lending (-0.3 year on year, versus -0.5% in August).

The tertiary industry result, following on a 0.3% decline last month, effectively showed recovery from the March disasters to have been stifled—at a level a full percentage point under the February pace. Industries included in the total account for almost two thirds of the production-side breakdown of the market economy, so the clear suggestion is that GDP growth could slow markedly, after the big quarter-on-quarter jump that will be registered, at least numerically, in the third quarter.

On the good news side, the machinery orders jump, reflecting strictly domestic demand, and the stabilizing loan balance both pointed to reasonably healthy business confidence—at a point when serious impacts from disaster-zone rebuilding are just beginning. That is a good omen for the general spending outlook, hinting that demand growth may yet lift the production side of the economy out of its funk.

There were no major policy developments in the week, though Finance Minister Azumi did suggest publicly that resolution of the Eurozone crisis would lessen upward pressure on the yen—perhaps an indication of less eagerness to attribute yen strength to market misalignment. Both the dollar and, particularly, the euro gained ground against the yen over the week, while Japan's stock and bond markets showed only muted co-movement with their sharply adjusting Western counterparts.

The week ahead: The week ahead is quiet in terms of scheduled indicators and events. Important data releases are limited to the revised August **industrial production** report (Mon), with little change to earlier figures expected, and all-industry activity results (Wed), that should mainly reflect the poor tertiary-industry performance already seen. The key policy event should be the **Bank of Japan Branch Managers Meeting** (Thu), bringing the Monetary Policy Board formal reports from the regions, and from foreign outposts, that will factor importantly into the upcoming, and policy-driving, semiannual Outlook for Economic Activity and Prices.

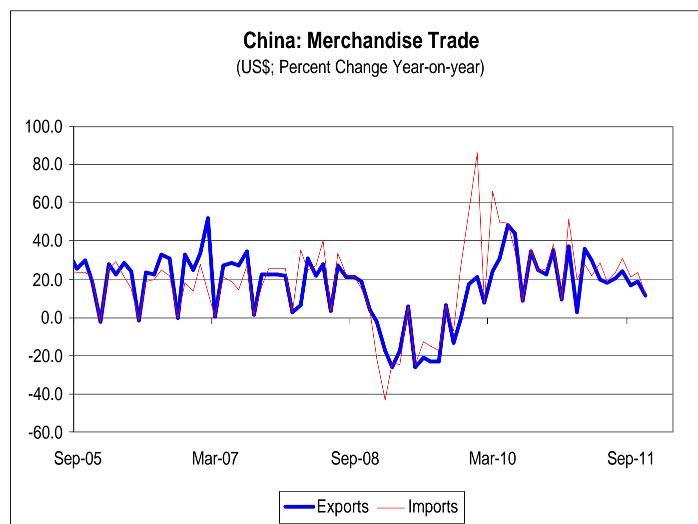
(Pierre Ellis)

Emerging Markets

Outlook. The global growth slowdown has clearly reached emerging market shores and substantially changed the balance of risks that guides policymaking. To be sure, a static snapshot of economic activity across EMs would show these countries as still-in-expansion-phase. Moreover, those which have decelerated most significantly (such as Brazil) continue to post rates of growth that are solid in their own historical context. It should also be noted that the slowdown is not uniform across and within regions as the EM term obviously groups economies of a broad diversity not just on account of growth history and potential but also risk.

The slowdown is perhaps most noticeable in the EM manufacturing sectors. From Brazil to China, and even still-booming Turkey, industrial production has slowed markedly in the past two quarters. This deceleration, along with a strengthening US dollar and market fears of a global recession, have brought commodity prices down from their recent peak, eroding the outlook for commodity-exporting nations in South America and elsewhere.

These adverse trends are unfolding in the midst and against the background of relatively high capacity utilization and, in a number of important cases (Brazil, for example) labor market conditions that approach full employment. As a result, central banks continue to exhibit some reluctance to ease policy in an aggressive manner. The turn towards easier money has begun, but lingering inflation-concerns (and still-high, although diminishing, annual inflation) induce caution among policymakers. Nonetheless, it is hard to see how—given EU and US trends—further easing can be avoided, to prevent the current situation from morphing into recessionary conditions. This latter outcome remains unlikely, unless a new global financial crisis takes place.



Recap: China Trade. Chinese September exports and imports seem to tell a clear story: sharply decelerating exports would suggest that external demand is weakening as the world economy slows; import deceleration would point to a cooling of domestic demand, watched nervously by investors weary of the consequences of a China slowdown on the global economy. Indeed, measured—as the Chinese government does—on an annual basis, export growth went from 24.4% year-on-year to 17% year-on-year. This is lower than the average of the past, but by no means weak. It is, in short, not far from "normal". Still, the underlying trend is, unsurprisingly, downward. Import figures could be described in similar terms: softer in September, but not the *softest* of the cycle, and still strong. Yet the lower annual growth figure is *consistent* with the *belief* that the Chinese economy is slowing. And this is the bottom line: the September trade figures are *consistent* with a *China cooling—world economy slowing* view of the world, but they yield precious little information on the intensity of those trends, both of which are clearly established in the data.

This Week's Data Releases: The key data release this week is China's third quarter GDP. Consensus expectations are near 9.3% year-on-year. DE's own estimate is not too far from that mark but lower, at 9% year-on-year. A drop to the 8.5% to 9% range would not be shocking from an analytical perspective, but could be unnerving to markets increasingly focused on recession risk. (Francisco Larios)

Central Bank Watch: This week brings wide geographic diversity in EM central banks, but some common factors. Much – perhaps too much – of the rate outlook in EM countries rests on perceptions of European officials' capacity to manage the relationship between the proverbial immovable object (debt and bank balance sheets) and an irresistible force (markets). **Brazil**'s central bank will continue with a series of moderate rate cuts in the face of slower global growth, with markets pricing in another 50 bps cut this week – taking the Selic rate to 11.5%. Expectations of deeper cuts have been pared back recently as optimism builds that some sort of resolution in Europe will keep more-serious financial market and recession risks at bay for now. That, plus elevated inflation will keep the bank wary of slashing rates all the way to the 9% level floated by some government officials as desirable sometime in 2012.

Central banks in the **Philippines** and **Thailand** face moderating inflation pressures, and a ratcheting down of the growth outlook on mostly external factors. Thailand is also facing damaging floods. Scope for a pre-emptive rate cut in both countries is very modest, but such a move appears increasingly possible. Indonesia's recent unexpected rate cut may be signaling regional peers follow suit, with 25 bps cuts possible for both Asian rate-setting bodies, but perhaps more likely in the Philippines. Finally, **Turkey**'s central bank is set to keep its benchmark rate on hold, keeping in place the – in hindsight prescient – cuts of late 2010 and 2011. The bank is accepting a near-term spike in inflation to keep growth supported, and to support further rebalancing of the current account deficit. Pronounced lira weakness, meanwhile, is now being addressed through FX intervention. Demonstrating a willingness to act will be important, given a relatively lower level of dollar reserves relative to regional peers. (Andrew Husby)