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WEEKLY ECONOMIC AND MONETARY REPORT

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Today's US payrolls data – which showed zero job creation last month - will do nothing to improve the mood of the markets. A 'double-dip' recession isn't inevitable (though the influential US economist, Nouriel Roubini, put the chance of one at 60% this week), but there are growing signs of systemic stress.

It is dangerous to read too much into what is still mostly anecdotal evidence. But a couple of news stories this week are indicative of a new level of concern:

- The first (flagged by the respected *FT* columnist, Gillian Tett) is the message being put out by the CDS market. There are, she said, now 70 US corporates for whom CDS cover is cheaper than it is for the US sovereign; a couple of years ago, there were none.
- The second concerns foreign government-owned deposits at the US Fed. According to the St Louis Fed, "official foreign accounts" with the Fed are now at an all-time record – which commentators are suggesting is indicative of a pervasive loss of confidence in European banks (see below, for Lagarde's speech at Jackson Hole).

Plus, there is certainly evidence of a global slowdown.

Earlier this week, JP MorganChase published its global Purchasing Managers Index for August. Although, at 50.1, the PMI is still showing some growth, it was down from 50.7 in July. Moreover, around the world national PMIs are falling – and many now indicate contraction. For instance, it was reported this week:

- that the US manufacturing PMI for August fell from 50.9 to 50.6 (with the Chicago Fed's PMI also falling, from 58.8 to 56.5);

- that the eurozone's composite PMI fell from 50.4 to 49.0 (with Germany falling from 52.0 to 50.9, and with France, Spain, Greece and Ireland all below 50);
- that the UK's manufacturing PMI also fell sharply, to 49.4;
- that Japan's PMI is now at a three year low; and
- that China, South Korea and Taiwan all have PMIs below 50 (ie that their economies contracted in the latest month).

Not good news – and pressure is growing for some sort of policy response.

I JACKSON HOLE MEETING

As we suggested last week, despite all the earlier expectations, Bernanke was not the star of the Kansas City Fed's annual jamboree; that honour went to the new MD of the IMF, Christine Lagarde.

That said, Bernanke's speech was important. The main point he made was that ultimate responsibility for economic policy rests with politicians – not with the central banks. That applies as much in the eurozone as it does in the US. In the latter case, he said, the Fed will do what it can (and it has many tools at its disposal, including the possibility of more QE), but "the country would be well-served by a better process for making fiscal decisions". He also urged Washington to come up with "good, proactive housing policies", and said that the Fed had "marked down its outlook for the likely pace of growth" – which most observers took as a coded hint that the Fed would support more fiscal stimulus in the very short term, provided it was matched by a plausible programme for medium-term consolidation.

That was pretty much as expected. What was not expected was Lagarde's attack on the European banks – which suggests that those who had assumed that (as a former finance minister in France) she would be a patsy for the Europeans will be mistaken.

What she said (which is consistent with the work that the IMF's staff has been doing for some time) is that the weakest European banks are in "urgent" need of recapitalisation. In principle, she added, this should be done through the private sector. But, if that is not possible, the public sector should step in. As she put it, one option would be to mobilise the EFSF or other Europe-wide funding.

That wasn't all she said. She also called on central banks to keep monetary policy "highly accommodative", and she urged the US to do something to stop the downward spiral of US house prices. But the proposal to use public funds to recapitalise European banks was the most contentious – and it was immediately attacked as "plain wrong" by Trichet. His fear is that proposals such as this have the potential to create panic in what is obviously a very sensitive market. That said, the *WSJ* insisted that "Mrs Lagarde understands the problem better than her former peers", and the *FT* praised her for telling the "ugly truth" – ie that EU banks are in worse shape than the recent stress tests would suggest.

One other intervention at Jackson Hole is worth noting: World Bank President Bob Zoellick warned that events in the Autumn "could trigger market challenges beyond the three small countries" of the eurozone (Greece, Ireland and Portugal). As he put it, "we have a very serious issue" – and we must accept that the Fed will be constrained in the help it can offer, given that 2012 is an election year.

II EUROZONE CRISIS

Lagarde's comments at Jackson Hole are a pretty good indicator that she doesn't think the eurozone's problems are going to go away – and, indeed, the news this week has not been very encouraging.

In particular, there are reports today that the IMF/ECB/Commission "troika" has suspended its fact-finding mission to Athens for at least 12 days, because it can find no evidence that the Greek government is meeting its targets on cost-cutting or asset sales.

Plus, Greece's own (independent) budget office has said that the country's "debt dynamics" are "veering out of control". The situation is hardly likely to be helped by a strike of cafes and restaurant owners over an increase in VAT.

In addition:

- Greece is said still to be negotiating with Finland and other eurozone states on collateral arrangements for its latest bail-out;
- German Chancellor Merkel is locked in a row with members of her own coalition and with the Bundestag more generally about approval of an expanded EFSF (it seems that the only way she will win is to promise the Bundestag a much bigger say over any future aid package); and
- there are serious signs of "reform fatigue" – particularly in Italy and Spain, where there has been significant back-tracking on austerity this week.

Plus, of course, there is the renewed concern about European banks, prompted by Lagarde's speech – as well as by the IASB, which released a report this week attacking the inconsistent approaches that big European banks have taken with regard to writing down their Greek exposure. According to the IASB, writedowns go from 53% at HSBC and 51% at Commerzbank to 23% at BNP, 22% at SocGen, and just 21% at Dexia, Deutsche and CNP (a big French insurer).

The IMF has also been floating a draft of its forthcoming *Global Financial Stability Report*, in which it claims that (using CDS prices to value debt) banks in Ireland, Greece, Portugal, Italy, Spain and Belgium would take a €200 billion hit to their core capital. It is this that clearly underpinned Lagarde's comments at Jackson Hole.

III RECENT ECONOMIC AND MARKET DEVELOPMENTS

A **THE US**: Today's jobs data (the first significant economic release for August) was even worse than expected – and it is bound to reinforce fears that the US is sliding back into recession.

The market expected a net gain of around 100,000 in non-farm payrolls – itself far less than the 190,000 required to make a dent in the unemployment rate. In fact, the economy added no net jobs. Even though the unemployment rate (calculated separately) was unchanged at 9.1%, that was devastating. The only significant area of jobs growth was health care (up 30,000); in contrast, manufacturing cut 3,000 and the entire private sector added just 17,000 – the fewest since February 2010. (That compares with a gain of 91,000 private sector jobs reported by ADP yesterday – which itself was considered disappointing.) Moreover, July's payroll increase was revised down to just 85,000.

There can be no positive spin on this; it is bad news. But it was not the only bad news this week. In addition to the weak PMI data (discussed above), it was also reported:

- that the Conference Board's consumer confidence index fell last month from 59.2 to 44.5;
- that the Case-Shiller 20-city house price index was down 4.5% year-on-year in June; and
- that the NAR's index of pending home sales fell 1.3% in July.

There was some more encouraging news, however. Personal incomes, for instance, rose 0.3% in July, while consumption rebounded 0.8% - pushing the savings rate down from 5.5% to 5.0%. And automobile sales appear to have bounced back. Moreover, the White House has just released a new forecast, predicting that the 2011 budget deficit will be lower than expected – around US $1.32 trillion, down from an estimate of US

$1.65 trillion in February. Nevertheless, that is still 8.8% of GDP. (In contrast, Greece's primary deficit is expected to be only 3.5%.)

The result seems to be that the FOMC is paralysed. According to the minutes of its August 9 meeting (released on Tuesday), some Governors wanted bolder moves – including consideration of more QE – while three (presumably, inflation 'hawks') opposed the decision to specify that interest rates will stay low through 2013.

From the Administration's point of view, the key now is clearly jobs. Obama is apparently to outline a new jobs plan to Congress next week – and it is clearly no coincidence that he has chosen a distinguished labour economist, Alan Krueger, to replace Austen Goolsbee as head of the Council of Economic Advisers. Krueger (50) has spent his entire career at Princeton, except for a spell as chief economist at the Treasury.

As for the impact of all this on the markets, the effect has been mixed. Through Wednesday, the DJIA was up 330 points (2.9%), the S&P500 was up 42 points (3.6%) and the Nasdaq Composite was up 99 points (4%). Since then, however, there has been a sharp sell-off – which accelerated after release of the employment data. Over the last two days, the Dow has lost around 300 points, the S&P has dropped 34 points and Nasdaq is off 67 points.

At the same time, however, Treasury yields have continued to ease. The benchmark 10-year Note, for instance, has fallen from 2.18% to just 2.05% - reflecting the absence of any serious investment alternative to the dollar.

For the future, it is worth noting that short-selling interest in the S&P is now at its highest level since November – not least because of concern that more banks may be sucked into the mortgage scandals that have engulfed BofA (see below).

B **EUROPE**: Things aren't any better in Europe. Indeed, the EU's Economic Sentiment Index fell sharply last month, from 103.0 to 98.3 – the sixth straight drop. It is now at its lowest level since May 2010. More important, perhaps, unemployment is rising. Within the eurozone, it was up 61,000 in July, to 15.7 million – or 10% seasonally- adjusted. In Spain, it is now 21.2%; in Ireland, it is 14.5%. Even in France, it is 9.9%.

Plus, inflation is picking up. Within the eurozone, producer prices rose 6.1% year-on-year in July, or 0.5% month-on-month. Although that was largely explained by a sharp jump in energy prices, it constrains what the ECB can do – even if it were minded to (and there is little evidence that Trichet is inclined to change policy, though he does step down in two months).

Not surprisingly, the result has been backsliding as far as commitments to austerity are concerned. We have already noted that the 'troika' has quit its evaluation of Greece's programme, saying it will return in 12 days to see if the government is serious. The Spanish government is also balking at introduction of a promised wealth tax. Most significantly, Berlusconi has succumbed to enormous pressure from within his coalition and from Italian business, and has essentially eviscerated the austerity proposal he himself introduced a couple of weeks ago. Notionally, it still cuts the deficit by €45 billion. Now, however, that is to be achieved largely by eliminating tax evasion (a hopeless task): Berlusconi has dropped the proposals for a 5-10% wealth tax and an increase in VAT, and has scaled down cuts in grants to local authorities.

Just about the only country that is living up to its commitments is Portugal – where the government is introducing a new 'solidarity tax' on high earners, and where the deficit will be close to zero in three years. It will be interesting to see if the markets give Lisbon credit for the sacrifices it is making.

As for the UK, the situation is at least as bleak as in the eurozone – perhaps bleaker. This week, for example, it was reported:

- that house prices are starting to fall again – by 0.6% last month (according to the Nationwide) or by 0.1% (Hometrack);
- that consumer confidence is down again, with the GfK/NOP index falling from -30 to -31 in August; and
- that export orders are now at their lowest level since June 2009.

The CBI's quarterly Service Sector Survey also reported this week that business activity slumped in August to the lowest level since November 2009.

C **JAPAN**: To some surprise, former Finance Minister Yoshihiko Noda (54) has emerged as Japan's new PM – beating the Trade Minister, Banri Kaeda, 215/177 in a run-off vote. He is Japan's sixth PM in the last five years – which does not bode well. That said, he is competent and experienced, and by nature conciliatory. Like many of his predecessors, he is a graduate of Waseda University – as well as of the Matsushita Institute of Government and Management.

A couple of points are worth making abut the election:

- First, the popular favourite, Foreign Minister Seiji Maehara, was defeated in the first round. He may well end up as DPJ Party Chairman.
- Second, the big loser in the poll was the party's "fixer", Ichiro Ozawa – who backed Kaeda. He is expected to step down as DPJ Chairman.

The new Finance Minister is Jun Azumi (49), another Waseda graduate, who has been involved with post-earthquake reconstruction in the NorthEast. Unusually for a Japanese politician, he is a former journalist.

The new team will have its work cut out on the economy. It was reported this week that industrial output rose 0.6% in July – the fourth straight increase. However, that was less than half what was expected – suggesting that manufacturers have now almost caught

up with the impact of March 9. Moreover, the PMI is at a three-month low, and auto sales were down 26% year-on-year in August.

D **CHINA**: According to an article published this week by PM Wen Jiabao, inflation remains Beijing's top priority – and, indeed, the PBoC tightened policy again on Monday, for the first time in two months.

Perhaps more interesting is an initiative by the French Presidency of the G20 to put the potential internationalization of the renminbi on the agenda for the November Summit meeting. The specific proposal would be to broaden the basket of currencies that make up the SDR to include the renminbi – a step that would entail liberalisation of RMB trading and greater transparency. It is not clear if this initiative has the support of the Chinese authorities.

IV FOREIGN EXCHANGE MARKET DEVELOPMENTS

Gold is up again – a good indicator of the nervousness that has gripped the market this week. Last week, it fell 4%, to close at US $1,770/oz. This week, it has risen 6%, and is currently trading at US $1,875.50. It is significant that it has risen almost US $50 since the disappointing US employment data was released – a reflection of concern that the Fed may yet introduce a new QE programme.

The corollary of gold's rise is usually a stronger Swiss franc – and, indeed, that has also been the case this week. The failure of the SNB to intervene on Wednesday, coupled with stronger than expected Swiss GDP data yesterday (the second quarter growth rate was 2.3%), gave the green light to traders to buy the franc. As a result, it has strengthened 3.7% against the dollar, from SF 0.811/US $ to SF 0.781, and 4.0% against the euro, from SF 1.164/€ to SF1.118. The markets appear confident that the SNB is reconciled to a stronger franc.

On the other key crosses, the dollar has been fairly steady:

- US $/euro: Last week, the euro eased 0.4% to US $1.436/€. This week, it strengthened initially to US $1.453, before easing steadily to US $1.422 at the present time. Week-on-week, that means, the dollar is up just 1%.
- Yen/US $: The BoJ has been keen to rein in the yen, which closed last week at Y76.9/US $. It has, however, had very little success. Indeed, the dollar is currently trading virtually unchanged at Y76.8.
- US $/sterling: The pound weakened last week from US $1.657/GBP to US $1.623. It hit a high of US $1.64 on Monday, but since then it has fallen back again, and it is currently trading almost unchanged at US $1.621.

Against the so-called commodity currencies, the dollar has weakened slightly. It has eased 1.4% against the Australian dollar, to A$0.937/US $ (the third weekly gain for the Aussie), and by 0.8% against the Canadian dollar, to C$0.981/US $.

Next week, the key event is likely to be the BoJ's two-day Council meeting. There has been speculation that the Bank will intervene directly to drive the yen lower.

V OIL

Last week, the price of front-month WTI rose US $3.11 a barrel to close at US $86.37, while October Brent rose US $2.74 to close at US $111.36 – leaving the spread in favour of Brent at almost US $26 a barrel.

This week, prices of both marker crudes initially rose sharply – with WTI closing yesterday at US $88.93 a barrel and Brent at US $114.29. The main reasons behind the price rise appear to have been:

- A sharp drop in stocks at Cushing, OK – off 600,000 barrels in the latest week, to their lowest level since November 2010. (That said, total US crude

stocks rose 5.28 million in the latest week – suggesting that there is potential oversupply on the East Coast.)

- A growing feeling that it may take years, not months, to bring Libya back on stream as a major producer.
- The threat of sanctions against Syria. Even though Syria only exports 150,000 b/d, it seems this is enough to tilt the balance in the Brent market.

However, today's poor US employment data has turned the market around. So far today, WTI is down US$1.91 a barrel, at US $87.02, while Brent is off US $1.19, at US $113.10. Quite reasonably, the markets are now factoring in a higher chance of global recession .

VI BANKING

A EUROPE: It has been a busy week for European banks – and there seems to be a consensus (at least, outside the ECB) that Lagarde was right to warn about inadequate capital. Indeed, Morgan Stanley came up with its own estimate – insisting that eurozone banks alone need €80 billion by year-end. Its proposal is a temporary bank liquidity guarantee programme, organised through the ECB, which would make up for any private sector shortfall.

The other big news was, of course, the "friendly merger" in Greece, between Alpha Bank and Eurobank EFG – with Qatari interests (the Paramount fund) backing Alpha and with Saudi Arabian interests (reluctantly) backing Eurobank. On balance, this deal has got a good press outside Greece. In the *FT*, for instance, it was described as "the first piece of good news for the Greek economy in a year" – and it was particularly welcome given the increasingly evident plight of other Greek banks (notably Piraeus Bank). That said, there was some surprise at the substantial premium Eurobank appeared to be paying. The deal was described as far more advantageous to Alpha than the merger with NBG that was vetoed earlier in the year.

Finally, the UK is gearing up for release of the report of the Independent Commission on Banking (the Vickers Commission), which is due on September 12. It is expected that this will recommend the "ring-fencing" of the retail activities of UK banks, so that their viability is not compromised by so-called "casino" business on the investment banking side. Most UK economists support this in principle, but the devil is in the detail:

- how will "casino" activities be defined?
- will there really be two completely separate pools of capital? and, most important,
- how quickly will the new proposals be implemented (the Coalition government may well delay implementation until after the next election)?

B **<u>THE US</u>**: It was reported today that the Federal Housing Finance Agency is to sue BofA, JP Morgan, Goldman Sachs, Deutsche Bank and several others for their alleged failure to perform due diligence on the mortgages (often credit-impaired) that they subsequently packaged up and sold to investors.

This is not a new problem for the banks. The FHFA had already filed a suit against UBS, and 50 state attorneys-general are trying to agree a civil settlement. AIG has also filed suit against BofA. It is, however, important – and it is another reason that not all investors share Warren Buffett's enthusiasm for BofA stock.

VII NEXT WEEK

It is the Labor Day weekend in <u>the US</u> – which means a lighter than usual economic calendar. The key releases that will come out next week are:

- the trade deficit for July, expected to be around US $47 billion;
- the Fed's "Beige Book" survey of economic activity; and
- the ISM services index for August.

In addition, Obama addresses Congress on Thursday, and is expected to propose a new "jobs plan".

In Europe, the main releases next week include:

- the eurozone services PMI;
- German factory orders for July; and
- German industrial production, also for July.

The ECB's Council meets on Thursday, while it is expected that Germany's Constitutional Court will rule on the legality of EMU bailouts on Wednesday. (it would be a sensation if the Court – which is highly political – did not find a way to rule that the bailouts are permissible.)

In Japan, the BoJ holds a two-day meeting which could lead to direct action to hold down the soaring yen.

Regards,
GISE