

GLOBAL MARKET OUTLOOK: SEPTEMBER 2010

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Executive Summary

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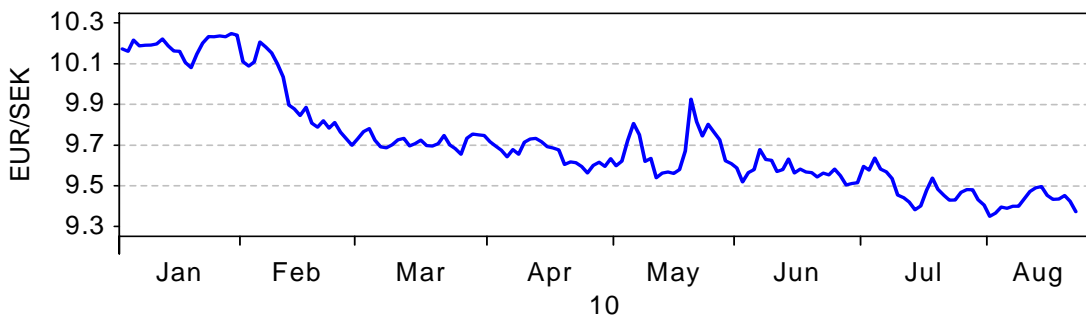
- The big unresolved issue at the moment is whether the US economy is on the brink of returning to recession. **If it is and the spectre of another significant global downturn looms, developed market equities could fall a further 15-20% and long-term Treasury bond yields could touch 2.0%.** Under this scenario, a G7-coordinated quantitative easing would be inevitable, but with limited impact in our view.

- We still think the US economy is going through a 'soft patch' and will avoid a double-dip. **If we are correct then stock prices will in time stabilise, but the market is likely to remain volatile in the short-term.**

- In theory, monetary policy could produce real effects if it could transform pessimistic expectations about the future. But with so much support already failing to lift the caution, it is hard to see what more could be done on sufficient scale to provide a real and substantial positive change in beliefs. **Even the Fed's legendary printing press is unlikely to work as inflation has never been shown to produce real growth.**

- It is time to recognise the limitations of monetary policy. It can only do so much, and has already done all it can on this occasion. **The faltering recovery in financial and commodity markets in recent months suggests investors are beginning to realise there is no magic monetary solution, only a tough slog ahead.**

Euro/Krona Exchange Rate



Source: Reuters EcoWin

- With the economic rebound likely to be marginal and patchy, official interest rates should stay low for a prolonged period. **This should in turn boost foreign-exchange carry-trade favourites such as commodities-linked currencies, while Scandinavian units may provide shelter for those taking a more negative view on the Eurozone outlook.**

- The Federal Reserve's recent decision to re-invest proceeds of maturing mortgage bonds into US Treasuries could potentially help push benchmark 10-year yields through the December 2008 lows around 2.04% over the next six months, especially if the American economy continues to stutter along with little sign of renewed vigour. **The Fed's move, announced after its policy meeting in August will be an extra fillip to a structural shift in investor preferences away from risk and toward more predictable returns witnessed since the financial crisis began.** Under this scenario, Bund yields would also continue to fall, with 'peripheral' Eurozone spreads widening further.

- The latest provisional surveys of Euroland purchasing managers for August have only underscored the divide between the robust centre and the struggling edges; Germany and France are doing pretty well but there are no signs that austerity is bringing with it a rapid growth in competitiveness for the hindmost. This is the problem: **Europe cannot support its banks, honour all its debts, increase competitiveness of the weak and hold on to a common currency all at the same time, and the market knows it.**

continued overleaf

World Economy:

The big unresolved issue at the moment is whether the US economy is on the brink of another episode of recession. ***If it is and the spectre of a global recession looms, developed market equities could fall another 15-20% and long-term Treasury bond yields could touch 2.0%.*** Under this scenario, a G7-coordinated quantitative easing would be inevitable, but with limited impact in our view. Many believe the US economic engine is about to stall and another recession is inevitable, but a good number do not. In our opinion the chances of a double-dip recession remain quite small, which supports our view that the recent stock market weakness is reflective of a mid-course slowdown rather than another significant downturn. The way we see it no one should be surprised by weak US economic news. The sharp retreat in stock prices since April has been the market's way of discounting this soft spot in global growth. Naturally, the incoming economic data should be weak. ***Nevertheless, stock markets don't discount the same bad economic news twice, and if we are correct that the world economy has only hit a soft patch rather than renewed recession, stock prices should stabilise in the not too distant future.*** Consumers are frightened and there has been an upward blip in the household savings rate, which translates into a downward blip in consumer spending. The overall economy has slowed as a result. The big offset to weaker consumption is the corporate sector, which is doing fine with rising profit margins, low borrowing costs and healthy balance sheets. The capital spending recovery remains very much on track and looks pretty robust. These cross currents could mean a prolonged stalemate for equities. On the one hand, trepidation on overall growth will remain so long as jobs growth is sluggish and consumers are frightened, making any quick and significant breakthrough in the US stock market hard to come by. On the other hand, good corporate profits and extraordinarily low interest rates imply that stocks are already inexpensive, a factor that should keep equity buyers in the marketplace. What could break this stalemate, or more succinctly, what could be the catalyst that gets the equity process out of this despondency? We believe the soft spot is concentrated in the consumer sector, and that any positive catalyst has to come from there.

- ***jury out on US economy***

World GDP Forecasts

%	2008	2009	2010 (f)	2011 (f)
World	3.0	-0.6	4.0	3.3
US	1.2	-2.4	3.0	2.0
Japan	-0.7	-5.2	1.8	2.0
China	9.0	8.7	10.5	10.2
Eurozone	0.7	-4.1	1.6	1.3
UK	0.7	-4.9	1.5	1.7
Ireland	-3.5	-7.6	1.2	2.7

There is no question that employment growth has been disappointing, which has created many concerns over the sustainability of the US economic recovery. Obviously, any good news on non-farm payroll growth would be a pleasant surprise that could send stock prices higher. There are several key points to keep in mind as regards the US labour market. Job growth typically follows corporate profits and economic recovery with variable lags. In the last recession, it was not until 2003 that job creation started to pick up. Similarly, after the 1990 recession, job growth did not pick up until 1992. Therefore, it is too early to conclude that job growth will remain anaemic going forward. We all know that firms are profit maximisers and profit growth is the foundation for job growth. ***Private-sector job creation follows profit-per-employee hours worked closely.*** The latter is a proxy for marginal profits of labour force, or productivity. In theory, in order for firms to maximise overall profits, they must hire people until the marginal profit of the last employee falls to zero. Otherwise, companies have left money on the table. In practice, companies may hold back hiring temporarily because of economic uncertainties, and they have to balance their profit motives and the need for business stability. However, in the end, private companies are here to make a profit. So long as marginal profit per worker remains positive (or even stays high, as is presently the case), firms will be induced to hire more people. Otherwise, companies are not maximising profits. ***We suspect we are on the cusp of a job-creation cycle, judging by the very recent trend of profit-per-employee hours worked and by the rollover of labour productivity growth.*** Firms may be induced by fat profits to add more workers and therefore, start to bid down marginal profit per worker. Of course, firms could continue to hold back hiring because of the uncertain macro-economic outlook. In this case, the labour market could remain sluggish for a while, prolonging the uncertainty surrounding the economy. If economic recovery sputters, profits would evaporate and firms will not hire. In this case, the stock market would sniff it out and equity prices would fall hard.

- ***job creation remains the problem***

Official Interest-Rate/Monetary Policy Outlook:

Expectations about income, asset prices, interest rates and risk are central to pricing of all real and financial assets, as well as the spending decisions made by households and firms. Whether termed animal spirits, sentiment or optimism, expectations determine asset prices and growth. Central bankers, policymakers and the financial services industry have spent the past two years trying to rebuild the essentials of the pre-2007 credit and commercial system — minus the more egregious components. Get credit growing. Restart securitisation (minus the liar loans). Incentivise new borrowing and investment (minus reckless projects). However, that system rested on a set of beliefs about risk and returns that has been comprehensively shattered after it was proved false by the worst financial trauma in three generations. It cannot easily be recreated until the passage of time encourages a gradual forgetting. **For now, caution about the outlook dominates cheap money and liquidity, rendering monetary policy temporarily impotent.** By cutting interest rates to zero and supplying unlimited liquidity to the banking system and other parts of the financial markets, central banks have limited explicit defaults and socialised the maturity risk in banks' loan books. Unconventional policies have averted Armageddon in the banking system and a worldwide depression. But **monetary policy cannot do more to restart growth. It cannot stimulate credit to the real economy. And it cannot put back the securitisation structures that fed much of the credit demand over the last two decades.**

• *cheap credit not the answer*

Official Interest Rates 2010/2011

	Current	End Sep (f)	End Dec (f)	End Mar (f)	End June (f)
US	0.25	0.25	0.25	0.25	0.50
Eurozone	1.00	1.00	1.00	1.00	1.00
Japan	0.10	0.10	0.10	0.10	0.10
UK	0.50	0.50	0.50	0.75	1.00
Canada	0.75	1.00	1.00	1.25	1.50
Sweden	0.50	0.75	1.00	1.25	1.50
Norway	2.00	2.00	2.25	2.50	2.75
Switzerland	0.25	0.25	0.25	0.50	0.75
Australia	4.50	4.50	4.75	5.00	5.00
New Zealand	3.00	3.25	3.50	3.75	4.00
China	5.31	5.31	5.58	5.85	6.12

In a Federal Reserve working paper on “*Money, Reserves and the Transmission of Monetary Policy: Does the Money Multiplier Exist?*” economists Seth Carpenter and Selva Demiralp observe that: “*Since 2008, the Federal Reserve has supplied an enormous quantity of reserve balances relative to historical levels as a result of a set of non-traditional policy actions. These actions were taken to stabilise short-term funding markets and to provide additional monetary policy stimulus at a time when the federal funds rate was at its effective lower bound. The question arises whether or not this unprecedented rise in reserve balances ought to lead to a sharp rise in money and lending. The results in this paper suggest that the quantity of reserve balances itself is not likely to trigger a rapid increase in lending. To be sure, the low level of interest rates could stimulate demand for loans and lead to increased lending, but the narrow textbook money multiplier (linking bank reserves to lending) does not appear to be a useful means of assessing the implications of monetary policy for future money growth or bank lending.*” **With rates now at zero, monetary policy can do no more. Adding more reserves does not stimulate lending.** The paper's findings chime with the Bank of England's struggle to explain how its vaunted quantitative easing (QE) programme works. The Bank is still unable to say how the effects of QE are transmitted to the real economy. It has struggled to identify any concrete benefits at all, beyond a rather nebulous improvement in asset prices. Manipulating the yield curve through low rates and QE can shuffle money around the financial system, redistributing income and wealth from creditors to debtors, and help banks and hedge funds make money by playing maturity transformation (whether in fixed-income markets, currencies or commodities). What it cannot do is rebuild the expectations (about creditworthiness, risk and return) on which interactions between the financial sector and the rest of the economy depend. **There has been no discernible real-economy impact from QE programmes so far. There is no reason to expect expanding central-bank balance sheets another few hundred billion dollars would be more successful stimulating economic growth. Key financial institutions have been calling for an expansion of QE. But that is hardly surprising. So far they have been the only ones to show any benefit.**

• *liquidity but not loans*

Currencies:

Financial markets may be ready to factor in a global economic scenario that essentially has as its core theme recovery rather than recession, but the rebound is likely to be marginal and patchy. That **means interest rates are likely to stay low, helping carry-trade favourites such as commodities-linked currencies, while Scandinavian units may provide shelter for those taking a more negative view on the Eurozone outlook.** Several international organisations have suggested that recent economic growth has passed its peak, but they still put little emphasis on any double dip. The Federal Reserve now envisages a more modest pace of recovery, and the IMF sees continuing economic recovery despite some slowing. The OECD is more dovish, describing growth as having peaked and saying its leading US indicator has turned negative. But the Fed, perhaps the most proactive of central banks, isn't standing idly by, moving at its August policy meeting to shore up its balance sheet to support the economy. That has pushed down US bond yields and suggests we are seeing a rush for safety, but it is notable that no such signals are coming out of the Dow Jones industrial average, which is roughly in the middle of its range so far this year and in no way indicates a rush for the exit. All in all, for foreign-exchange markets it looks like the core balance to positioning will be much harder to shake off, based as it is on ultra low rates staying for the long-term. This will leave the Aussie and Kiwi at the top of performance tables as they remain the definitive carry trades on offer, while for those more inclined to take a gamble, Scandinavia may offer some shelter from any Eurozone problems.

- **carry-trade favourites to remain in place**

Spot Exchange Rates 2010/2011

	Current	End Sept (f)	End Dec (f)	End Mar (f)	End June (f)
€/GBP	0.8205	0.8150	0.8000	0.7800	0.7500
€/\$	1.27	1.24	1.18	1.16	1.15
€/Yen	107	106	103	100	100
\$/Yen	85	85	87	86	87
GBP/\$	1.54	1.52	1.48	1.49	1.53

The Swedish and Norwegian economies look strong compared with their Eurozone peers, and are not burdened by the same fiscal constraints. Initial tightening cycles are underway, and Sweden is expected to end the year with rates at 1.00%, while Norway's rates are already at 2.00% with hikes priced in further down the curve. Canada is another firm favourite, underpinned by commodity prices and the ever-present bids for Canadian companies — BHP's \$39bn for Potash Corp. the latest headline grabber, underscoring the very favourable balance of payments backdrop for the Canadian dollar. Long-term portfolio inflows have been soaring, running at a record annual pace of C\$120bn. Oil revenues also underpin Canada as they do Norway. Furthermore, Canada's relatively sound monetary and fiscal policies will allure global bond investors. C\$51bn of foreign capital has flowed into Canadian bonds in the first half of 2010. More interest rate increases by the Bank of Canada will attract flows into money market instruments. With near zero rates in the major developed economies, investors will be able to earn a yield on their idle cash in Canada. Central banks will look to the Canadian dollar to diversify their foreign-exchange reserves. The four major currencies — dollar, euro, sterling and yen — account for the vast majority of reserve holdings. However, there has been a sharp spike in holdings of "other currencies" to 3.6% of total reserves. **A 1% shift in global reserves amounts to about \$85bn, a portion of which will find its way into the Canadian dollar.** With US interest rates so low, the dollar looks a favourable play to fund commodity currency longs, as there is greater liquidity on offer and also the potential for more US easing in the pipeline, or at least the maintenance of already high stimulus. **Alternatively, the euro looks a good choice to fund Swedish or Norwegian crown longs with the potential for unsustainable sovereign debt levels and widening 'peripheral' bond market spreads to further undermine the single currency and so bolster what is currently a marginal return.** Good value to sell strength in EUR/NOK is tied to the 200-day moving average at 8.0809, and it is worth noting that only the briefest trade has been seen above 8.10 in nearly three months. Stronger EUR/SEK resistance offering value for top-pickers is currently seen around 9.65/9.70, with the Swedish currency having appreciated strongly versus the euro since the start of 2010.

- **Canadian dollar another firm favourite**

Equities:

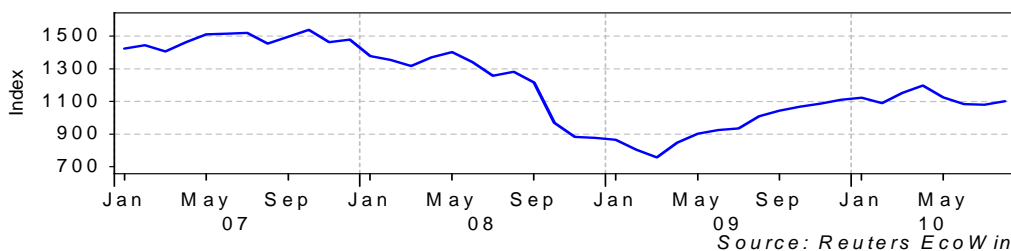
With equities stuck in a range and long-term investors sidelined by high volatility, alternative trading strategies are set to make gains as long as the market zigzags. Cross-asset correlations, index trackers, technical analysis and algorithmic programmes are drawing more interest on trading desks and from hedge funds that are playing short-term moves until the economic picture comes into sharper focus. **The bottom line is that the market is range-bound but not dull. If you're creative enough, it offers good opportunities to play strategies such as correlations between asset classes.** Since early May, the S&P 500 and Euro STOXX 50 indices have been bobbing in a range about 12-15% wide, staging brisk rallies quickly followed by sharp retreats that have left traditional investors feeling dizzy. The usual long-only strategy relying on sector picks has not been good enough for antsy hedge funds and traders, as virtually all sectors have been range-bound since April. Traders have instead turned to correlation strategies, such as the one between the euro and European stocks, to get their 'buy' and 'sell' signals. Stocks and the euro have been moving hand in hand, and the euro has clearly been calling the shots. When you know that, you see where stocks are heading. **The euro, which has had a daily correlation of +0.9 on a rolling 25-day average with the Euro STOXX 50 index for most of August, has been a key barometer for foreign investors trading Euroland stocks since the region's debt crisis.** A perfect positive correlation of 1 implies that two assets are moving in lockstep.

- **tactic plays flourish**

The correlation has been even stronger with the volatile banking stock index, reaching +0.98 in early May. **Investors buying shares of Commerzbank, Societe Generale and Santander right when the euro started to bounce back in early June and selling them when the currency broke out of its uptrend channel on August 10, ignoring the strong quarterly results the three banks had just posted, made gains ranging between 32% and 55%.** Another strong correlation that has been on the radar screens is the one between individual stocks and equity indices. While this correlation remains very high as market players are reluctant to bet on particular names, investors have been increasingly putting money into Exchange Traded Funds (ETFs). European ETFs, a fast-growing market dominated by funds from Deutsche Bank, BlackRock's iShares and Societe Generale's Lyxor, replicate indices performances, giving investors exposure to the underlying assets but at a lower cost and with more short-term flexibility. As uncertainty increases, people are less brave about committing heavily to individual stocks, and as such there is some safety in trading the indices. **Strong appetite for index trackers will likely continue, at least until a clear picture of the economy's direction emerges.**

- **turning to index trackers**

S & P 500 Index



Investors have also turned to technical analysis while dropping traditional valuation tools such as price-to-earnings ratios because of the lack of visibility on the denominator. Charts on the S&P 500 and Euro STOXX 50 show investors have been keen to book gains when the indices flirt with key resistance levels and buy when they fall toward support levels, using Fibonacci retracements and moving averages as fences. In time of uncertainties, the number of people turning to charts and Fibonacci levels increases a lot and, in a way, it becomes a self-fulfilling prophecy that even the most sceptical investors can't ignore. Some hedge funds and trading desks at big investment banks have also turned to algorithmic and high-frequency programmes, which seek big gains from even a small price movement because of the speed at which they trade and the high volumes involved. Most of these programmes, which now represent a big chunk of trading volumes on US and European bourses, thrive when stocks are range-bound because they are market neutral. A trading range is the preferred playground for high volume players, and it's rather easy to catch non-professionals off guard and make a profit. **In our view trading ranges are likely to prevail until markets get a handle on US and European GDP growth prospects for 2011. And given the current macro-economic outlook, the establishment of a new strong trend in either direction is unlikely to be around the corner any time soon.**

- **technical analysis also closely watched**

Bonds:

The Federal Reserve's recent decision to re-invest proceeds of maturing mortgage bonds into US Treasuries could potentially help push benchmark 10-year yields through the December 2008 lows around 2.04% over the next six months. The Fed's move, announced after its policy meeting in August will be an extra fillip to a structural shift in investor preferences away from risk and toward more predictable returns witnessed since the financial crisis began. This shift has been a boon to bond markets. Now the Fed will join the buyers as it looks to rebalance its portfolio, leading to more curve flattening and lower 10-year yields. Before the financial crisis Fed Chairman Ben Bernanke said the "*global savings glut*" explained why bond yields had failed to react in their usual manner to the Fed's tightening cycle that began in 2004. Back then it was foreign-exchange reserves managers who were less price sensitive and were the big buyers of Treasuries as they looked for liquid and safe investments to park their dollars. Now a new class of buyers who are equally insensitive to price are going into the safety of the bond market. **Retail investors especially are shying away from equities to the safety and predictable returns on offer in bonds.** Net new cash flow into stock mutual funds in the first half of 2010 were a mere \$9bn, compared with \$137bn for taxable bond mutual funds, according to Investment Company Institute data. The appetite for risk has diminished considerably as concerns remain over high unemployment, the lower availability of credit and a need not to be excessively leveraged. But the key factor is the dramatic reduction in US households' net wealth. According to the Fed's flow of funds data, net wealth has fallen \$11.3 trillion since the peak in the second quarter of 2007 despite a recovery of \$6.3 trillion from the trough in the first quarter of 2009. The biggest concern over the last 10 years has been this reduction in net wealth combined with the extreme volatility that households have had to endure. Between 1980 and 2000, households believed the equity and housing markets only went up and that events such as the 1987 crash or Asian financial crisis were opportunities to buy on dips. The bursting of the TMT bubble and subsequently the housing bubble have shattered these perceptions and households seem unwilling to stomach the wild swings in their net worth. **With the Fed looking to keep rates low for an "extended period" households seeking safe and predictable returns are choosing to extend their duration to pick-up that extra return.** Banks, too, are looking for this yield. According to Fed data, commercial bank holdings of US government securities rose \$57.4bn between January and May after a \$168bn increase in all of 2009.

- **US 10-year yield could fall to 2.00%**

2010/2011 Native Global Bond Yield Forecasts %

	Current	End Sept (f)	End Dec (f)	End Mar (f)	End June (f)
US					
2 Year Treasury	0.49	0.65	1.05	1.55	2.05
5 Year Treasury	1.33	1.55	1.85	2.25	2.65
10 Year Treasury	2.49	2.70	2.95	3.25	3.55
30 Year Treasury	3.55	3.75	3.95	4.20	4.50
Germany					
2 Year Bund	0.59	0.80	1.10	1.45	1.80
5 Year Bund	1.24	1.45	1.70	2.00	2.30
10 Year Bund	2.16	2.40	2.60	2.85	3.10
30 Year Bund	2.74	3.05	3.25	3.50	3.75
UK					
2 Year Gilt	0.61	0.85	1.20	1.60	2.00
5 Year Gilt	1.59	1.90	2.20	2.55	2.90
10 Year Gilt	2.85	3.15	3.40	3.70	4.00
30 Year Gilt	3.82	4.20	4.45	4.75	5.05

The regulatory desire for banks to de-risk, de-leverage and build capital cushions will only help to promote further buying from the financial sector. The Fed will, from a monetary perspective, be in the market to purchase some \$20bn of Treasuries each month as it looks to hold the size of its balance sheet at \$2.054 trillion. Given that the Fed downgraded its outlook for growth saying "*the pace of economic recovery is likely to be more modest in the near-term than had been anticipated*" there is a strong potential that the Fed may have to adopt more active quantitative easing (QE) and buy more Treasuries. Major central banks have already gone the way of Japan in adopting interest rates to near zero and QE and financial markets look to be mimicking the Japanese bond markets in pushing yields ever lower. **A flatter yield curve is likely and a move to 2.04% or below cannot entirely be ruled out although it is not our base view at this juncture.**

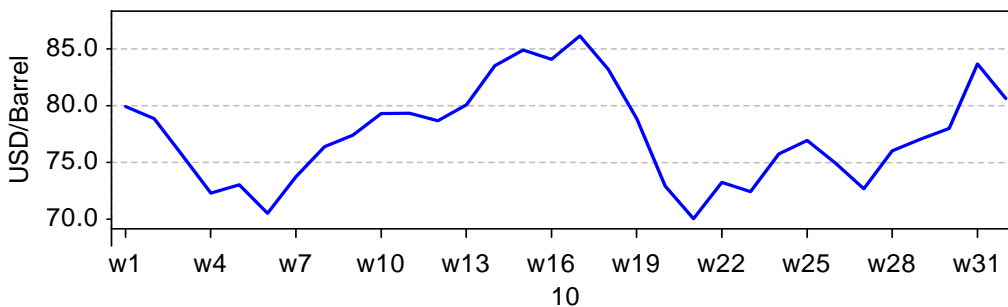
- **de-risk, de-leverage**

Oil:

Traders and investors don't anticipate the oil market tightening before the second half of 2011, as high stocks of crude and refined products ensure it remains well supplied for at least the next nine months, according to an analysis of forward price movements. Forward prices are not an accurate predictor of the level of future prompt prices. But the changing shape of the curve can convey useful information about the expected timing of shifts in the supply-demand inventory balance, as well as the weight of buying and selling interest dealers are seeing in the market. **The relative weakness of prices in H2 2010 and H1 2011, compared with prices in the remainder of next year and 2012, suggests most traders and investors now expect the stock overhang to linger through the northern hemisphere Winter and not disappear until the Summer 2011 driving season at the earliest.** Prices along the length of the curve have fallen since the start of the year, as strong production growth and high refining runs have dominated a recovery in demand. But the steepest losses are concentrated nearby in H2 2010 and H1 2011. Light sweet oil futures for December 2010 have fallen \$8.30 (9.6%) since the start of the year, while June 2011 futures are off \$6.70 (7.7%). In contrast, prices for the balance of 2011 and 2012 have held up better. Futures for December 2011 are down \$6.20 (7.0%) and for December 2012 are down \$6.00 (6.7%). Some of the weakness in H2 2010 and H1 2011 is simply due to time decay. As they draw closer to expiry these futures contracts lose some of their pure option value as financial instruments and enter the prompt widow where the threat of delivery (and associated costs of financing and storage) looms. The contango (or backwardation) is always steepest nearby. Futures contracts in H2 2011 and 2012 are not yet subject to the downward pressure from high inventory levels. **But H2 2011 and 2012 futures are also the best performing contracts along the whole curve and have held up better than longer-dated contracts for 2013-2015.** For example, December 2012 futures are down 6.7% but December 2014 futures have fallen 8.4%. Far forward prices have moved down almost in line with the spot market. The relative strength of futures in the H2 2011-2012 window suggests it is not solely due to the passing of time. Instead traders and investors seem to have pushed back their hope for a tighter supply-demand balance into this time frame. Price movements reveal strong buying interest from hedge funds and other investors in this part of the curve. December contracts for both 2011 and 2012, which are popular with investors because they offer the greatest concentration of liquidity, are trading at a small but significant premium over nearby futures.

- **no cyclical recovery seen until H2 2011**

World Oil: Europe Brent Spot Price Close, \$



Source: Reuters EcoWin

While investors still expect "cyclical" tightening in the latter half of next year, fears about a more sustained "structural" shortfall in crude supply have vanished. The forward price curve beyond 2012 is now flatter than before. Prices for 2013-2015 no longer escalate as much as they did at the start of the year. Back in January, December 2015 futures were trading at a premium of \$5.40 over December 2012, a compound annual increase of 2.0%. The premium has now halved to \$2.70, a compound annual increase of 1.0%. The market is no longer anticipating strong upward movement in oil prices in the medium-term. Or dealers are running into too much selling interest at the higher numbers, which amounts to the same thing, as the market is very thin on these far forward dates, and prices are largely driven by the book-management needs of the large dealing firms. The relative reduction in far forward prices (2013-2015) may reflect increased concern about deflation (a cut in the expected inflation rate over the period). But it is also consistent with the International Energy Agency's revised forecast for the oil market to remain comfortably supplied until at least the middle of the decade, which pushed back structural shortages until at least 2016. **On net, traders and investors seem to be expecting a normal cyclical tightening of the supply-demand balance over the Summer of 2011 and into 2012. But there is no longer much fear about a structural shortage until after 2015, as the cushion of spare capacity inherited from the recession and strong supply growth, are expected to prove sufficient to meet increases in demand.**

- **no structural tightness foreseen**

EU Policy:

Europe's long Summer holiday still has a few days to run but this year's re-entry will bring with it evidence that very little progress has been made on the issues that threaten to rend the currency union and upend the global economy. Despite waving the stress-test magic wand over its banks in late July the same problems continue to grow unchecked: a Eurozone '*periphery*' that can't compete, may not be able to pay its debts and so may bring down with them the very banks that have been pronounced healthy. While the German economy is growing at a rate not seen since the Berlin Wall came down, things are a good bit worse in Ireland, Portugal, Spain, Italy and especially Greece, all of which face some combination of an austerity-induced recession and debts public and private which threaten their banking systems, local governments and Treasuries. **Investors have looked at this on the one hand and on the other a \$1 trillion bailout, a pliant International Monetary Fund and the results of the stress tests and have voted with their feet:** average spreads between German and '*peripheral*' country bonds are back in territory last seen in June and heading north. Ten-year Greek bonds now yield 945bps more than German issues, or about where they were in May when we were all debating the chances of the euro surviving in its current form.

- **holiday coming to a painful end**

Irish government bonds too have performed alarmingly as austerity without debt rescheduling does what austerity without debt rescheduling does: kills growth and kills the prices of assets the debts are secured upon, leaving the country less able to service its debts and more likely to default, though we don't see it coming to this in Ireland's case. Defaults are like sneezes; some are polite and soft and some splatter everyone in the room. A number of interlocking stories show that, while European central bankers are talking a firm game about upgrading economic growth forecasts on the back of German exports, their actions show continued very strong concern. First came the news on Monday, August 23, that Anglo Irish Bank had transferred a new batch of impaired loans to the state-run bad bank National Asset Management Agency (NAMA) at just 38.1% of their face value, a price lower than the last transfer and one that, while it may prove optimistic, even at this level implies a weakening asset market and a growing and perhaps ultimately un-meetable bill for the Irish government. **Remember, the more money Ireland needs from the centre, the less there is available to meet the growing needs of Greece and Spain.** Shortly after came news that the European Central Bank last week bought €338bn of bonds, the most since early July. This followed closely on talk, unsubstantiated, last week among bond market participants that the ECB had bought up to €60bn of Irish bonds as investors lost confidence in Ireland and sold. And finally this culminated in Standard & Poor's downgrading its credit ratings on Ireland by one notch to AA-minus and assigning the country a negative outlook.

- **Ireland looking vulnerable**

All of this put dovish comments by Axel Weber, Bundesbank President and a hawk's hawk, in perspective. Weber told Bloomberg Television on Friday, August 20 that it was "*wise*" to extend unlimited lending to banks through the volatile end of year period, effectively moving the conversation about exiting some of its support of the market and of banks back to 2011. That was not far from market consensus, but coming out of Weber's usually tough-talking mouth unexpectedly on a Friday in Summer suggests that things in the banking system in Germany are not stable and will require continued support. Spain too is a huge source of concern: as of June its banks have borrowed €126bn from the ECB, up nearly half from May, money they need because many are shut out of interbank funding markets and have amassed huge portfolios of real estate which they hope will somehow rise rather than fall in value. The latest provisional surveys of purchasing managers for August only underscored the divide between the robust centre and the struggling edges; Germany and France are doing pretty well but there are no signs that austerity is bringing with it a rapid growth in competitiveness for the hindmost. This is the problem: **Europe cannot support its banks, honour all its debts, increase competitiveness of the weak and hold on to a common currency all at the same time.** This is not a problem market confidence can solve, even if market confidence can be generated. Like the US, Europe has decided that the banks won't be allowed to fail and has reasoned outward from there, a debts over people, or taxpayers if you like, strategy.

- **ECB not rushing to the exit door**

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