

Market View

10 October 2008

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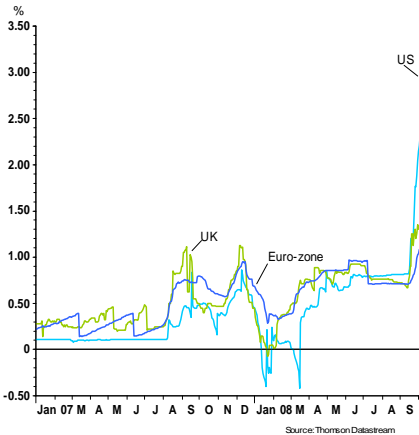
Economic & Market Trends

A global recession is still likely in 2009 but the policy response is shifting into top gear, which should lower the risk of an even worse economic outlook (and yes, there is a worse outlook). In a co-ordinated move, seven central banks cut rates on Wednesday (six by 50bps, China by 27bps). The move is arguably a little late and the cuts could safely have been larger, but the move does show that central banks can work together, and is clearly fully justified - the risk of inflation staying permanently high is fading fast. We are also hopeful that over the next few days (after G7 weekend meetings in Washington) a major fiscal easing will be announced; increased public spending lower indirect taxes, to help reduce the pain on the economy. There are constraints on fiscal easing (such as the Euro-zone Stability Pact) but these need to be abandoned for now - albeit with the explicit intent of re-introducing the constraints when the economy improves. But, regardless of what happens now on the policy side, the financial crisis will inflict serious damage. Rate cuts do not change our view that the world economy will suffer a global recession in 2009 - typically defined as world GDP growth slowing to around 3% pa, after 5% in 2006-07, and a likely 4% in 2008. Nevertheless, rate cuts and likely fiscal easing to come, together with the additional government measures to inject capital into bank systems and the stepped-up liquidity support for the money/commercial paper markets, does make us more confident that the risk of an even worse outlook - a 1930s-type depression - has been reduced.

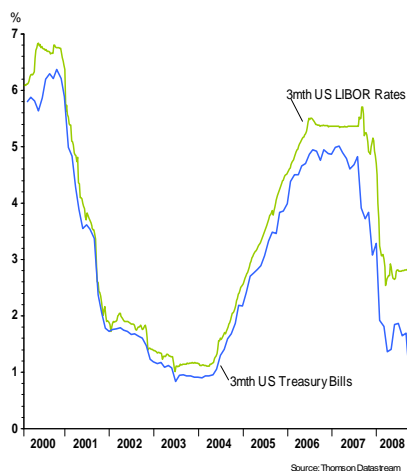
It will take time, but the measures needed to unblock the money and credit markets are finally falling into place. Given Thursday's late carnage in the US equity market (which was maybe not helped by the lifting of the short selling ban), the policy initiatives are clearly coming too slowly and/or are not enough for most investors. Nevertheless, amongst the phelora of new initiatives there are several stand-outs which target the core of the problem - the lack of trust between banks. Guarantees on bank deposits (Germany, Denmark, Ireland, and others), and the lifting of bank deposit insurance (the US, UK, and others) should reduce the risk of more bank runs. UK and Spain moves to re-capitalise banks by direct capital injections, with the US likely to follow soon (they can do this under TARP terms), are also almost always the most effective way of ending a financial crisis. Finally, the Fed has introduced yet another new liquidity funding facility to buy 3-month debt from banks and non-financial companies in the commercial paper market - which means the Fed (for the first time) will be lending directly to companies. Lower official

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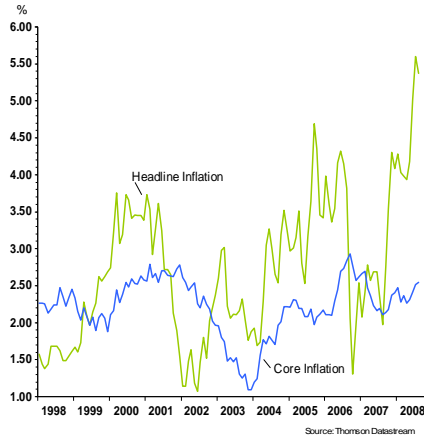
LIBOR RATES: STILL SKY-HIGH RELATIVE TO OFFICIAL POLICY RATES



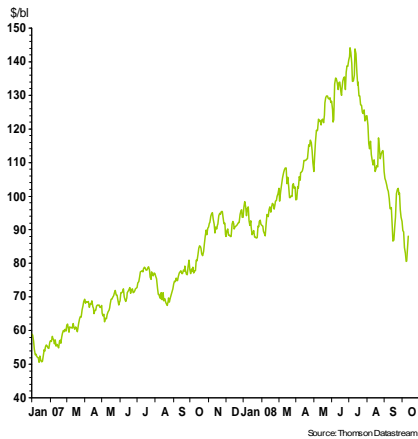
THE "TED" SPREAD: STILL SHOWING THAT MARKET PRESSURES ARE EXTREME



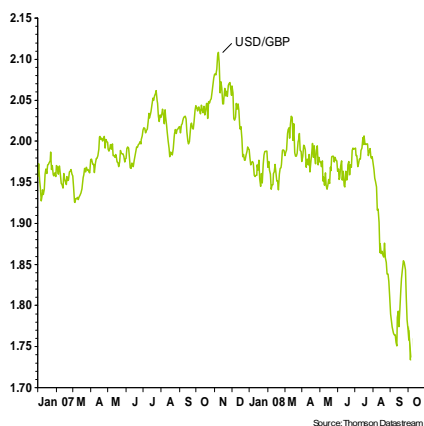
US INFLATION: HEADLINE SET TO SLOW SHARPLY AND CONVERGE ON CORE



OIL PRICES: SET TO STAY LOWER GIVEN THE GLOBAL RECESSION ON THE WAY



STERLING AGAINST THE USD: SET TO DROP FURTHER AS UK RATES FALL FAR



policy rates should also help in the end. Many business loans are linked to central bank rates, variable rate mortgages as well. In addition, lower official rates should steepen the bond yield curve, which will support banks. Yields across all durations should fall but shorter duration yields should fall the most.

Central banks in the US, Europe, and elsewhere, are not finished - rates will fall further. If the stresses in money/credit markets, and the equity markets, remain extreme, more co-ordinated rate cuts are likely soon. But deteriorating economic data will also still bring more rate cuts, anyway - if the markets stabilise, at upcoming regular meetings. In the US, the Fed is expected to cut rates by another 50bps (down to 1.0%) by year end, and for now we assume that the next cut will come at the December meeting rather than the upcoming October 29th FOMC. Next week, the financial crisis will likely still dominate but if any US data does return to being higher profile it will be September retail sales and September consumer prices (Wednesday). Headline inflation should continue its move down, given lower energy prices, and by mid-2009 should be close to US core inflation (which is currently around three percentage points lower, *see chart*). September retail sales should confirm that US real consumer spending fell in Q3 as a whole, which would be the first quarterly drop since Q4 1991. Our US economic forecast now includes real GDP growth declines in Q3 and Q4 2008, in Q1 2009 as well, then followed by a prolonged bottoming out with significant improvement in the economy having to wait until 2010. In the UK, we expect the BoE to cut rates by 50bps at its next two meetings (early November, early December) - so down to 3.5% by year end (4.5% now), which should bring more sterling weakness (*see chart*). Rates will also fall further in the Euro-zone.

Emerging markets will be impacted by a global recession but the big countries, especially in Asia and Latin America, have a lot of resilience and will bounce back more quickly than elsewhere - opportunities for the long term are opening up. Supporting economic growth is now the top macro-economic priority and the rate cuts in China have been supplemented by rate reductions in Taiwan, Korea, and Hong Kong, an easing in Singapore (a move to a “neutral” FX rate stance), and bank reserve requirement cuts in Indonesia (even though rates were increased), and India (where we now also expect rates to stay on hold at the end October (24th) RBI meeting). Global recession will impact some countries worse than others. Most Asian countries, as well as Brazil, Russia, and Nigeria, come out as relatively low risk in analyses of emerging market fragilities. Asia scores badly on its openness to foreign trade (exports as a % GDP) but scores well on other dimensions of risk: Factors such as the growth in domestic credit; the level and rate of change of the loans to deposits ratio in the banking system; the external trade balance as a percentage of GDP; domestic and external debt as a percentage of GDP; and the level of foreign reserves. The countries this analysis typically throws up as being vulnerable to “hard-landings” are the smaller ones in Emerging Europe - the Baltic states, Hungary, Kazakhstan, Iceland (in crisis already). In Latin America, Colombia usually comes out as most vulnerable. The Middle East comes out as generally low risk, whilst in Asia, Vietnam and Korea are the most exposed.

Economic & Market Calendar

Prepared on 10 October 2008

		Next Week: Oct 13 – Oct 17		Last Week: Oct 06 – Oct 10		
		Expected	Previous	Actual	Previous	
Mon	UK	Sep PPI input y/y	--	26.0%		
		PPI output y/y	8.8%	9.7%		
Tues	US	Oct 12 th ABC consumer conf.	--	-43		
	Japan	Sep Consumer conf.	--	30.5		
	Euro-zone	Oct ZEW survey	--	-40.9		
		Aug Industrial production	1.1%	-0.3%		
	Germany	Oct ZEW survey	-50.0	-41.1		
	France	Sep CPI	0.2%	0.0%		
	UK	Sep CPI y/y	5.0%	4.7%		
		Retail prices y/y	--	217.2		
	RICS house price balance	-85.0%	-81.0%			
	BRC retail sales monitor					
Wed	US	<i>Fed's Bernanke, Bullard, Rosengren, Yellen, to speak</i>				
		<i>Fed's Beige Book</i>				
		Oct Empire Manufacturing	-10.0	-7.4		
		Sep PPI	-0.4%	-0.9%		
		Core PPI	0.2%	0.2%		
		Advance retail sales	-0.6%	-0.3%		
		Retail sales less autos	-0.1%	-0.7%		
		Aug Business inventories	0.4%	1.1%		
	Japan	Aug Industrial production	--	-3.5%		
	Euro-zone	Sep CPI y/y, f	3.6%	3.8%		
		Core CPI y/y, f	--	1.9%		
	Germany	Sep CPI y/y	2.9%	2.9%		
	UK	Sep Jobless claims	35.0K	32.5K		
	Australia	Aug Ave. earnings 3m/y/y	3.7%	3.7%		
		Aug ILO unemployment rate	5.6%	5.5%		
		Aug Westpac leading index	--	0.2%		
	Thurs	US	<i>Fed's Bullard to speak</i>			
		Oct 11 th Initial jobless claims	--	478K		
		Oct 4 th Continuing claims	--	3659K		
		Oct Philadelphia Fed	-9.4	3.8		
		NAHB housing market	17	18		
		Sep Industrial production	-0.9%	-1.1%		
		Capacity utilization	78.0%	78.7%		
		CPI y/y	5.1%	5.4%		
		Core CPI y/y	2.5%	2.5%		
		Aug Total net TIC flows	--	-\$74.8B		
US		<i>Speeches by Fed's Stern, Rosengren</i>				
		Oct 4 th Initial jobless claims		478K	498K	
	Sep 27 th Continuing claims		3659K	3603K		
	Aug Wholesale inventories		0.8%	1.5%		
Japan	Aug Machine orders		-20.77%	-13.9%		
UK	Sep HBOS house prices		-1.3%	-1.8%		
	Aug Trade balance		£4.74B	-£4.76B		
Fri	US	<i>Fed's Bullard, Evans to speak</i>				
		Oct U. of Michigan conf.	66.0	70.3		
		Sep Housing starts	880K	895K		
		Building permits	840K	857K		
Japan	Aug Tertiary industry index	-0.9%	1.2%			
US	Expected/Actual					
	Aug Trade balance			-\$59.0B	-62.2B	
	Sep Import prices			12.2%	16.0%	
Japan	Sep BOJ meeting minutes					

Previous data are for the preceding period unless otherwise indicated
 Data are % change on previous period unless otherwise indicated
 p – preliminary data, f – final data, saar – seasonally adjusted annualised rate
 GMT – Greenwich Mean Time / Universal Standard Time

Date of next meeting of...
 Fed Board 29 Oct/16 Dec
 BoE MPC 06 Nov/04 Dec
 ECB Council 06 Nov/04 Dec

3–12 Month Outlook

<i>FX Outlook</i>	Spot	1 mth	3 mths	12 mths
USD 3-mth rates (%)	4.8	3.3	2.5	1.5
EUR 3-mth rates (%)	5.3	5.0	4.7	3.1
GBP 3-mth rates (%)	6.3	5.7	4.7	3.0
USD 10-yr bond yield (%)	3.8	3.6	3.6	3.8
EUR/USD	1.36	1.42	1.46	1.34
USD/JPY	99	102	107	111
EUR/JPY	135	145	156	149
GBP/USD	1.69	1.71	1.78	1.62
EUR/GBP	0.81	0.83	0.829	0.83
USD/CHF	1.12	1.10	1.08	1.19
AUD/USD	0.65	0.70	0.82	0.76

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