



Everything's up ?

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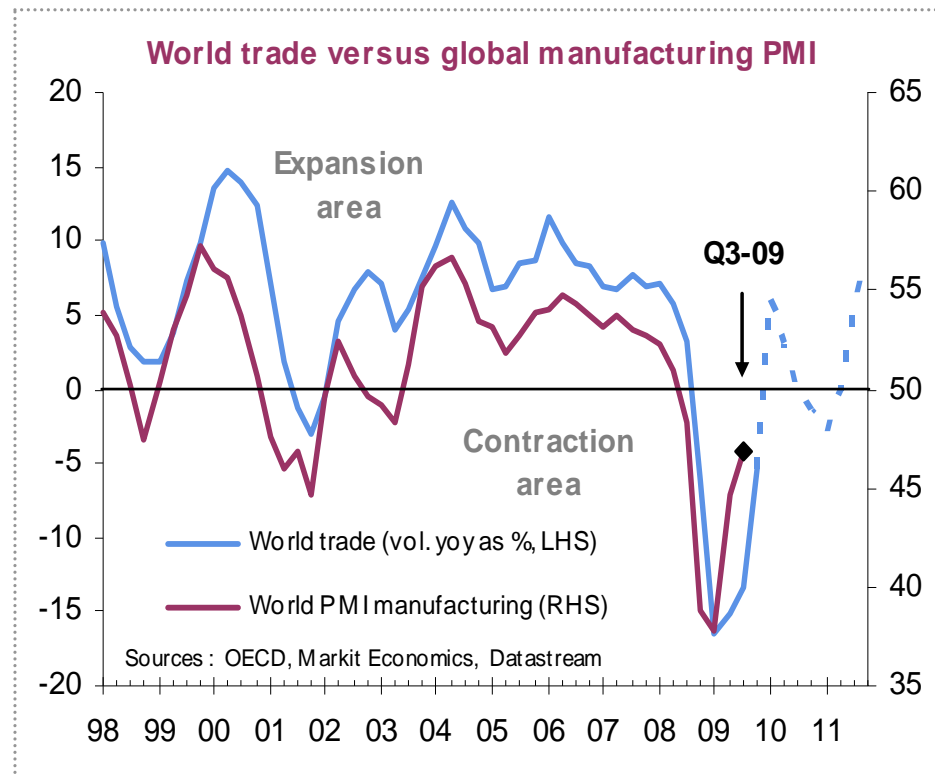
Everything's up ?

- Growth is back but for how long ? 2010 lures bleak
- Structural impact of the crisis, long run implications
- Money supply and inflation: the missing link
- Anchoring fiscal expectations: implication for the yield curve
- A cross asset analysis for the next quarter: everything's up ?

Global recovery under way...



- Global recovery under way
Broad based
- Macro factors
 - **Inventory** building.
 - Stabilization in **residential investment**.
 - Disinflation and **purchasing power** helped consumer spending to edge down and not collapse.
 - **Fiscal Stimulus** reaching their peak.
- **Don't dwell on it yet !**



But long term issues remain unsettled



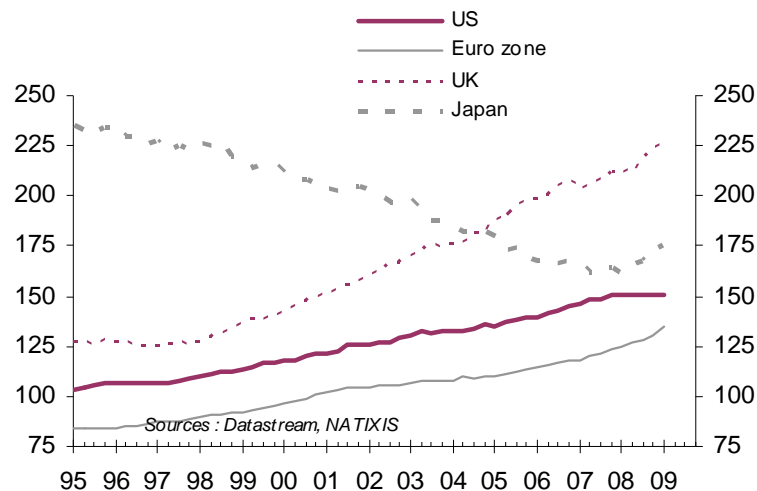
- Dealing with the demand shock

The cure worst than the disease ?

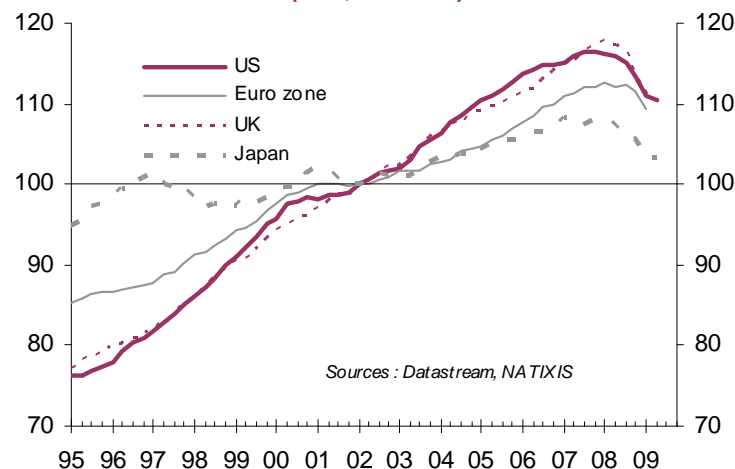
- The aftermaths of the crisis

- **De-leveraging** is a long process
- **Decoupling and emerging countries growth:** much ado about a little thing
- **Lower potential Growth.**
- **Fiscal situations** have worsened dramatically: long run impact on GDP growth (**capital** accumulation, long term **yields...**)
- **Monetization** of public debt: is **asset price inflation** the major threat ?

Private sector: debt (% GDP)



Private Domestic Demand (real, 100:2002)



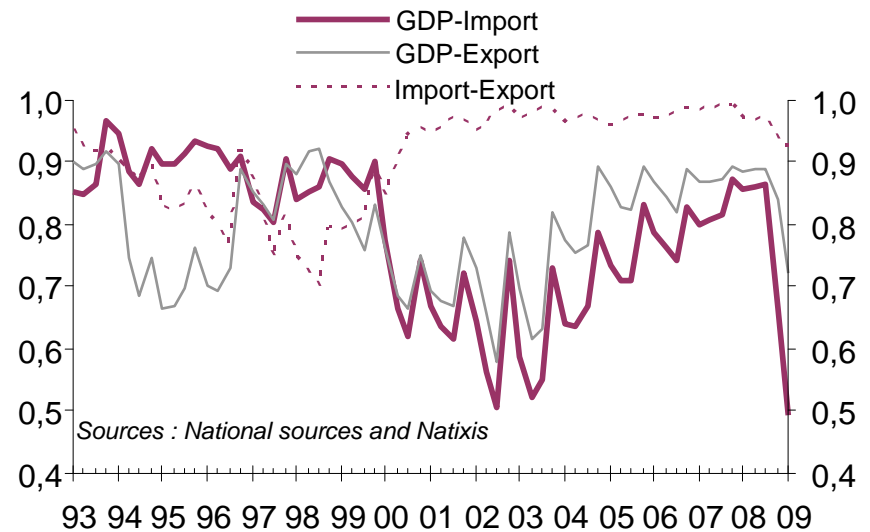
Can China save the world ? Unlikely

■ 2009/10 growth based on

1. **stimulus plan** (infrastructures and reconstruction) ; **credit growth** (real estate and cars)

2. Econometrics shows that Chinese **imports elasticity** to domestic demand is very low (<1%) in comparison to that of foreign demand (**2.4%**). This is due to the substantial content in imports of Chinese exports. **Imports do not depend on fluctuations in Chinese growth but rather on growth of China's largest exports markets.**

Correlation GDP-Import-Export

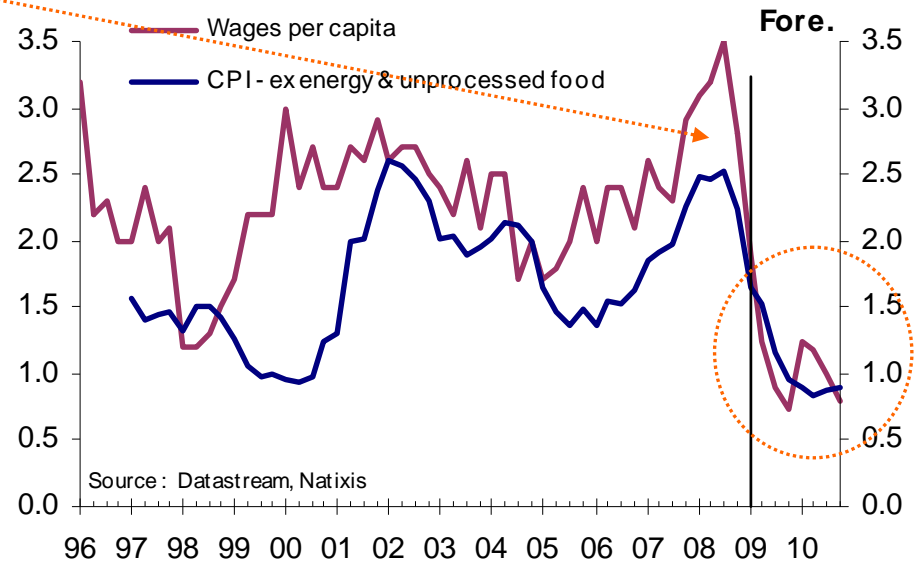


$$import = c_1 GDP_c + c_2 GDP_f + c_3 Effectif + c_4 Comp + c_5 imports(-1) + C$$

The end of disinflation will harm consumers

- The end of disinflation
 - Disinflation lifted temporarily the **purchasing power** of households
- Diverging trends
 - **Nominal wages** under a strong downward pressure...

EMU: wages per capita versus core CPI (YoY as %)

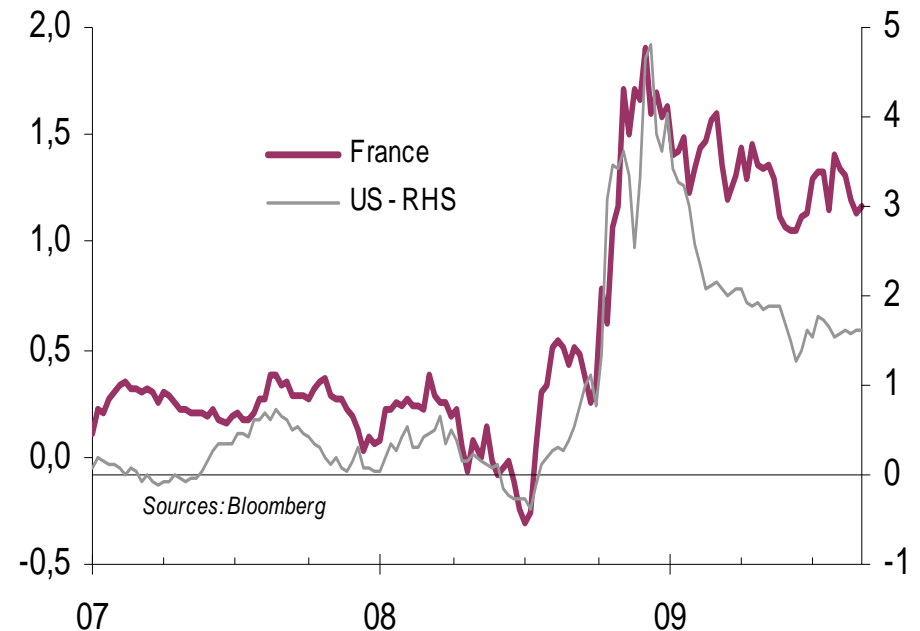


Reflation / deflation... balanced risks ?



- I/L swap curves reflect a dual scenario
- Short/Medium run views
 - **Deflationary** pressure remain in the **short run** – huge output gaps
 - **Long term inflation** might be spurred by excess money supply, capacity utilization rate, renewed bull market for commodity prices...

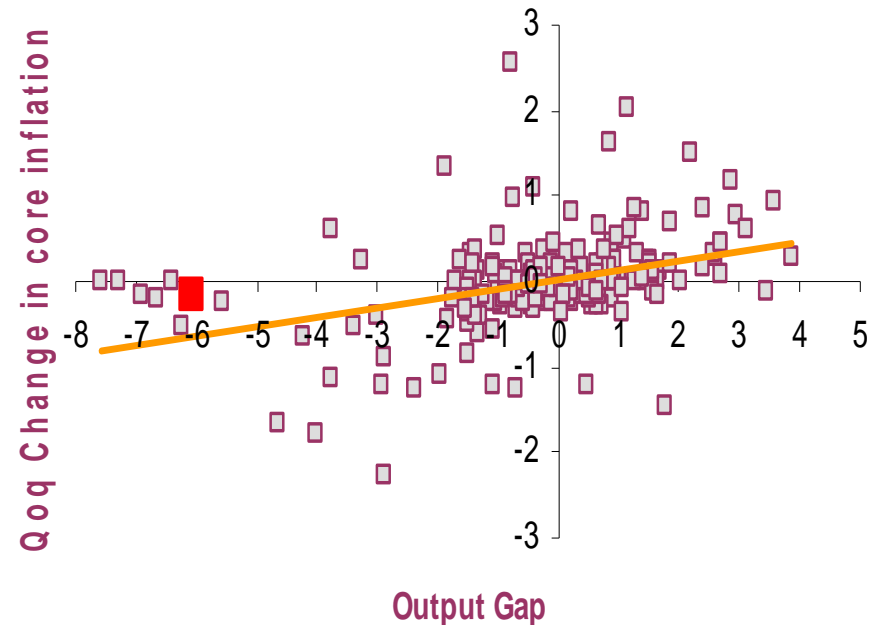
I/L swap yield curves (10/2-year)



The “real” side of inflation

- Baring specific shocks (oil), inflation is driven by strain on the supply side
- Huge output gaps
 - Suggest that deflationary pressure will prevail (US =>)
 - Upward revision in **output gap** (lower potential GDP is a risk for the medium run) – CF. 2002 US experience and the first “modern” debate on deflation risk and **helicopter money**.

Output gap and change in core inflation



The long way up... ==>

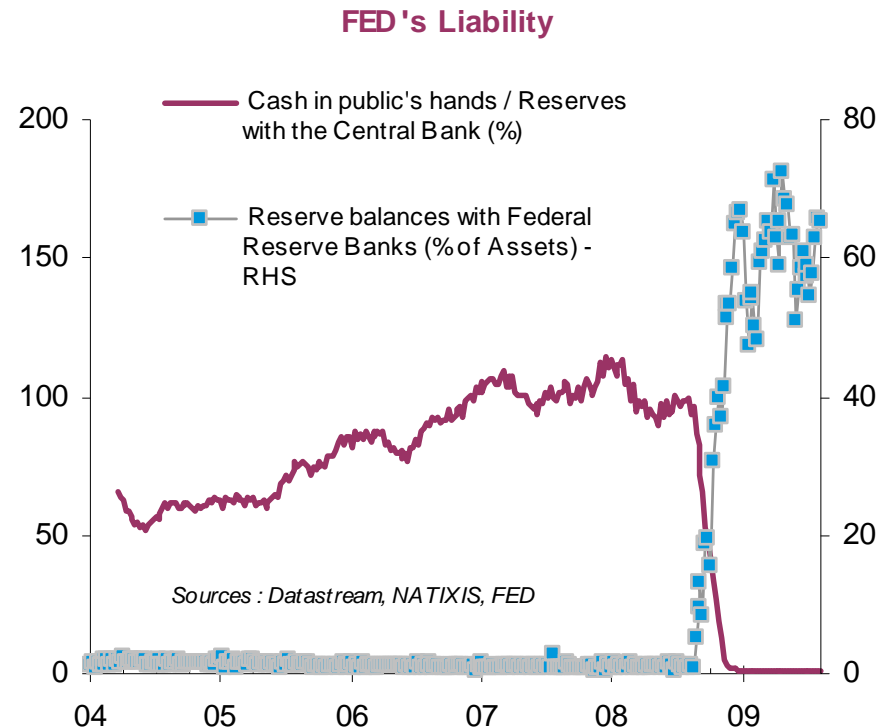
The “money” side of inflation

- What is money ? Fiat money

Helicopter and fiat money. Broad Money supply or central banks' balance sheets?

- Quantitative easing and Central Banks' balance sheets

- Quantitative easing provides **excess reserves to the banking system**, not to main street (cf. notes and coins).
- Inflation risk and the **credit channel**: senior loan surveys not really optimistic..
- One can't “**build**” inflation that easily

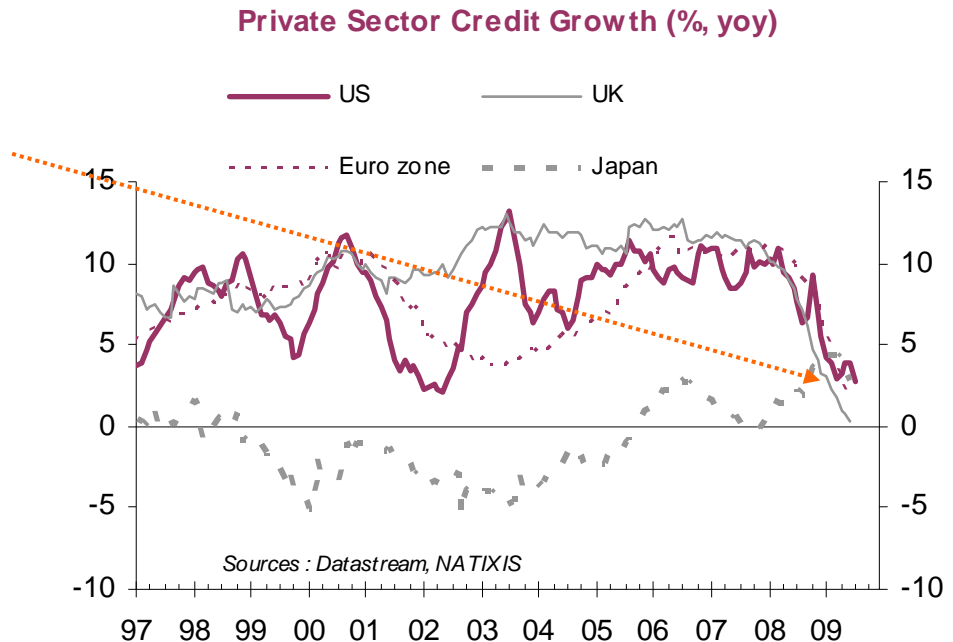


Tracking the monetary transmission channels

- Mishkin typology

- 4 channels:

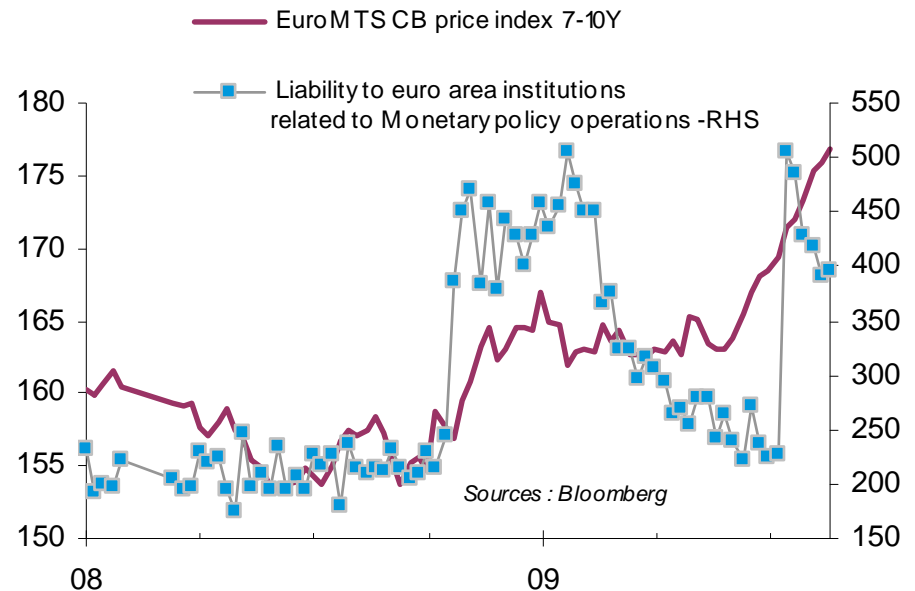
- **Credit** channel: private deleveraging (Ricardo ?) takes time. Credit is also a matter of demand !
- **Exchange rate** channel: volume elasticity much higher than price elasticity. Non cooperative game !
- **Wealth** channel: where is the next bubble ? Stock prices ? Commodity prices tax=> side effects
- **Balance Sheets**: lower business's net worth=> adverse selection and decrease / caution in lending (cf. Senior loan surveys)



Excessive transformation : A new “super macro SIV” ?

- “Enhanced Credit Support”
ECB arsenal: **Fixed rate full allotment**, expansion of collateral, long term liquidity position and **covered bond purchases** (market liquidity)...
- Bank support through maturity transformation
 - Credit Multiplier broken.
 - **Maturity transformation** : not through credit growth (post S&L strategy) but using an “unlimited access” to liquidity and being long Fixed income assets.

ECB QE and Covered bonds Market



Exit strategies: caught in a trap ?



- I can't walk out ?

Central banks dilemma: targeting CPI or asset prices ?

- Suspicious mind

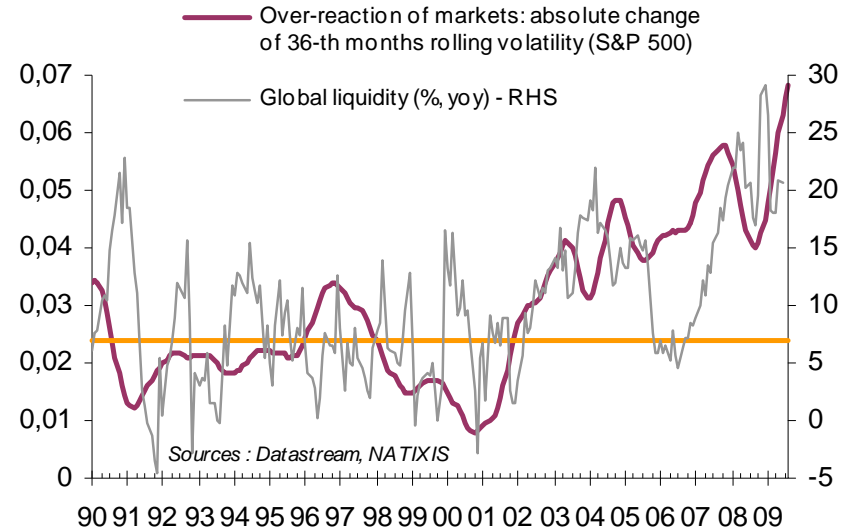
- **Killing growth or spurring inflation**

arbitrage: is this really what is at stake ?
Exit can be smooth ?

- **Public / mortgage debt monetization. Unavoidable ?** Spike in sovereign bond yields vs. **excess liquidity risk**: what if Central bank remains the “**investor in last resort**” (FED, ECB).

- **“FOR THE TIME BEING CB LIQUIDITY IS LIKELY TO REMAIN ABUNDANT” JC Trichet Sept 4th 2009...**

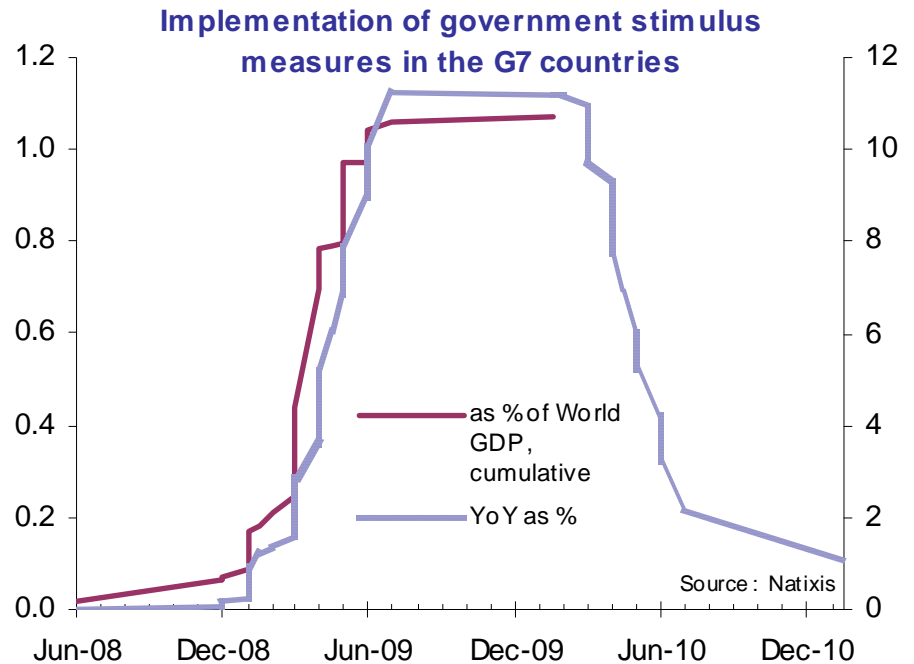
An indicator of bubbles intensity



Fiscal deficit: beyond the demand shock

- Full implementation of fiscal plans
 - Disinflation lifted temporarily the **purchasing power** of households

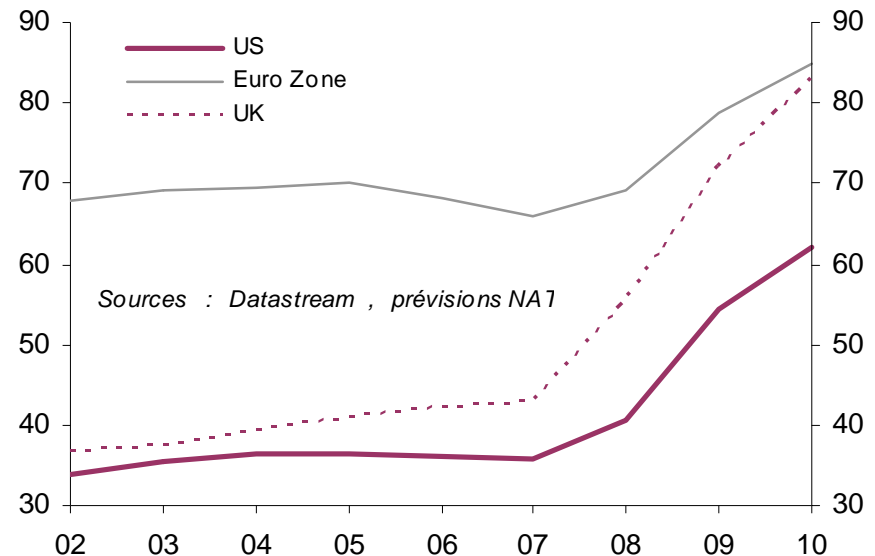
- Waning of impact
 - **New plan** unlikely
 - **Long run implications**



Fiscal deficits and supply: strong impact ?

- A new paradigm for fiscal policy
Beyond the demand shock: bringing back **fiscal credibility**
- Anchoring fiscal expectations
 - A limited **degree of freedom**: higher taxes ? Lower spending ?
Implication on future growth
 - paths...**Credit risk** : is government debt really a risk free asset ?
Towards negative asset swap margins ?
 - Implication for **Intra EMU** spreads, **swap** spreads...

Public Debts as a share of GDP

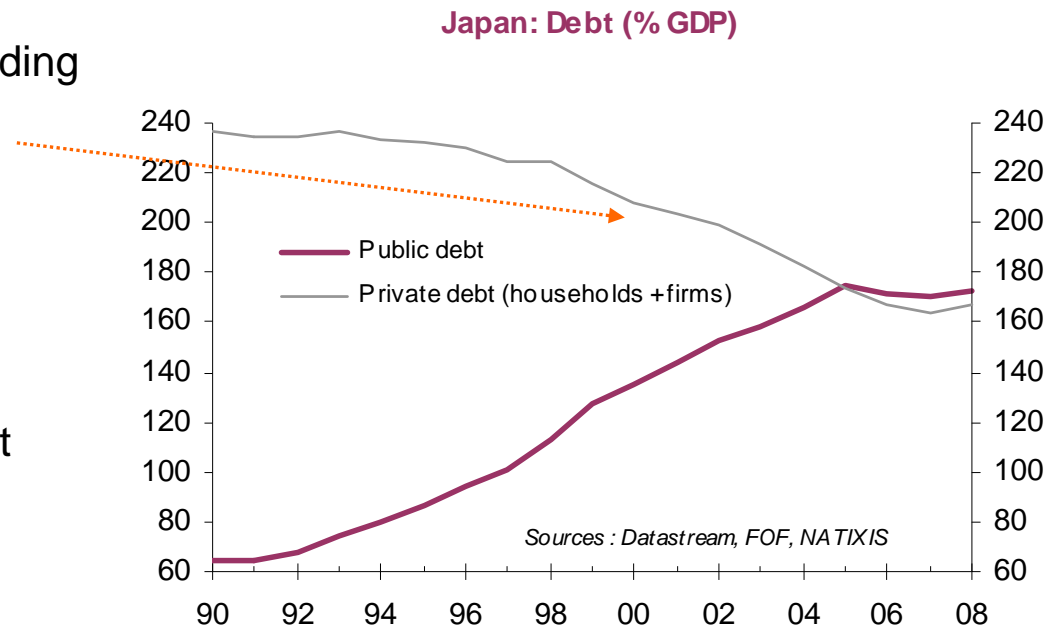


Fiscal deficits impact on sovereign yields

- Anchoring fiscal expectations

- **Ricardian equivalence:** What matters is the government spending as a whole (impact on total and private saving), not the way it is financed (neutrality).

- Supply and **preferences for specific maturities** : “preferred habitat”. The market for different maturities is segmented. Any arbitrage might imply a **term premium**.



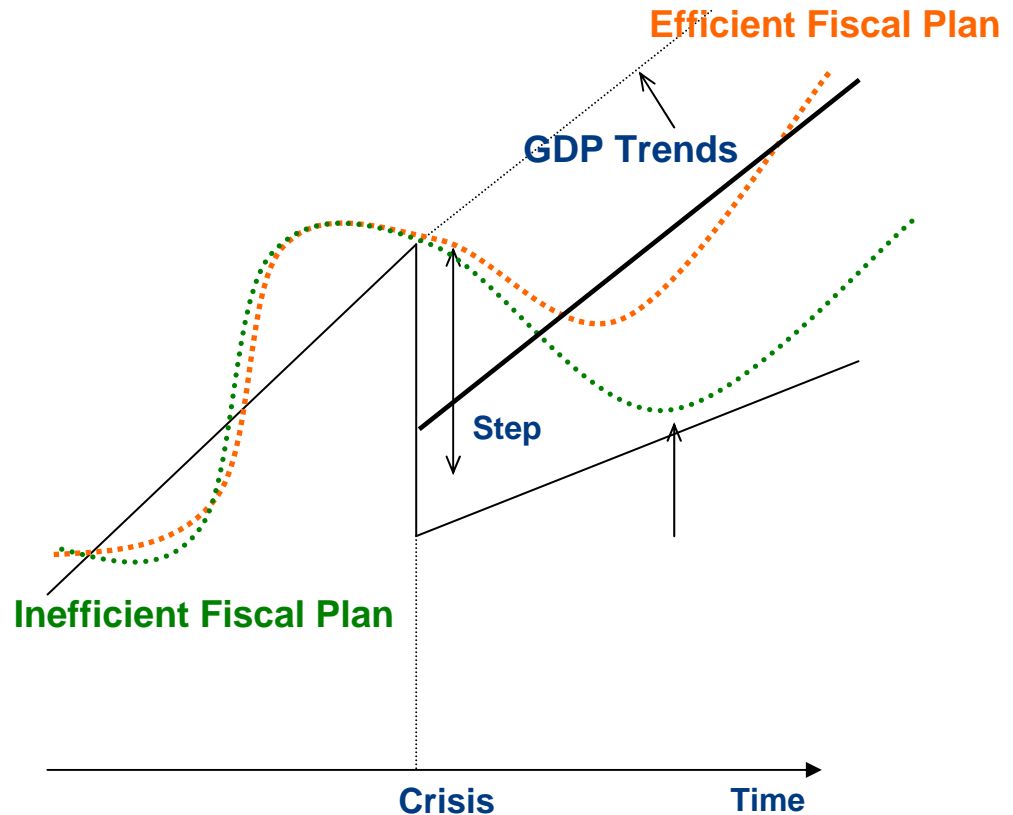
A gradual deterioration of Potential GDP

- Potential GDP will drift downward

Historically, potential converges towards real GDP

- Reading the data

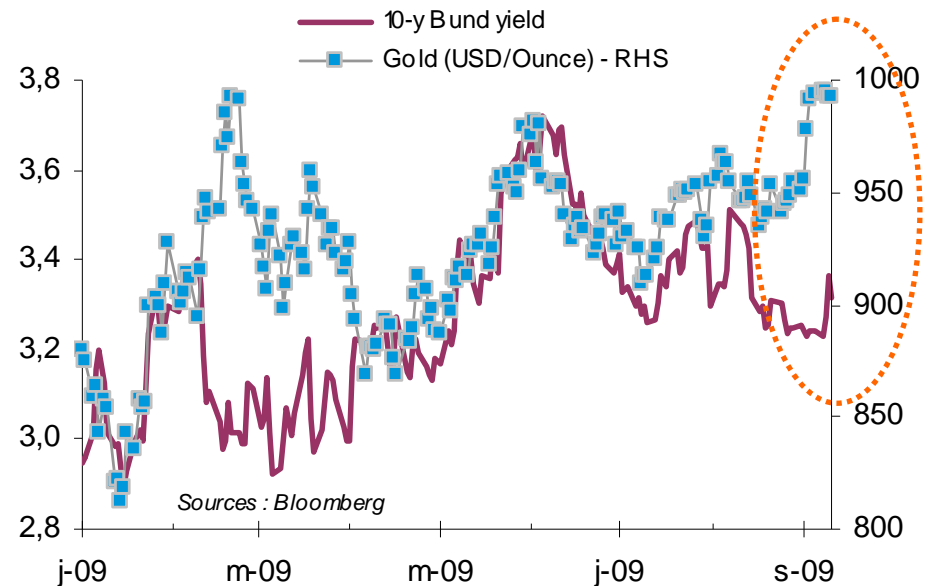
- **All fiscal policies** (and stimulus packages) **are not equals** !
Long/short run efficiency of fiscal implementations
 - **Potential output revised downward**: capacity destruction, lower job participation rate...
 - Implication for the assessment of **output gap** and inflationary pressures



Ex ante analysis of long term yields (1)

- **Conflicting forces**
 - **Monetary policy** (Taylor rule)
 - Huge fiscal deficits => **supply**
 - **Global liquidity** : soaring once again ! **Conundrum is back !**
 - **Inflation** threat : What B/Es say ? Information from nominal swap forwards ? = lower real growth 5x5x.

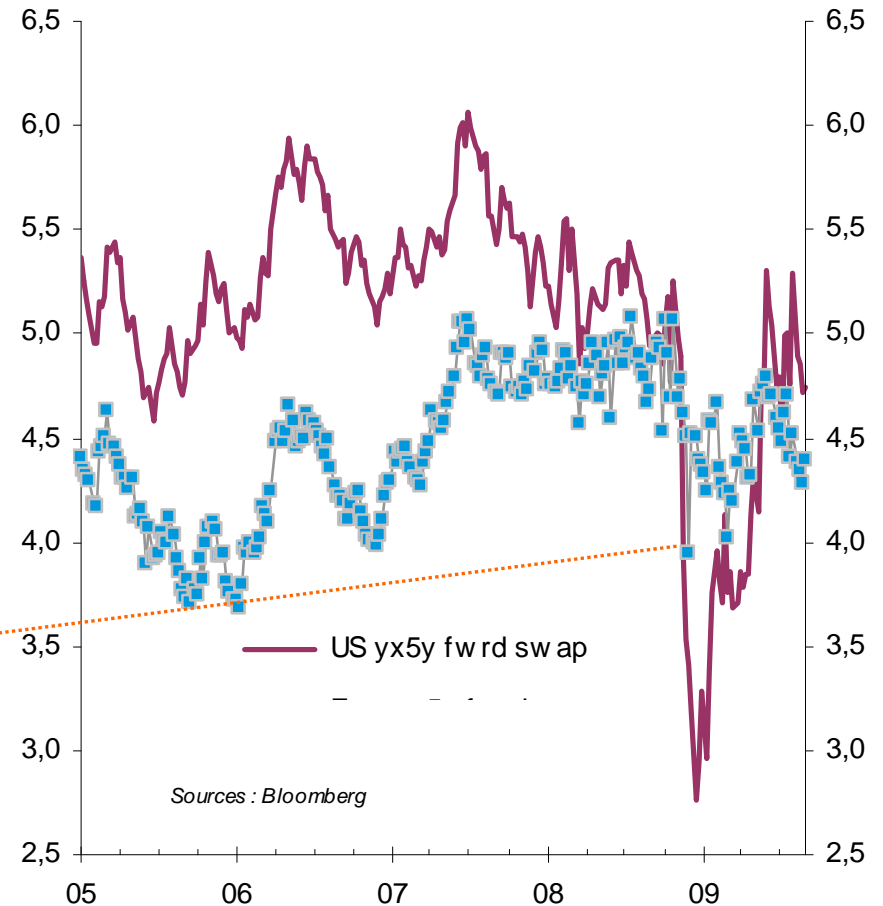
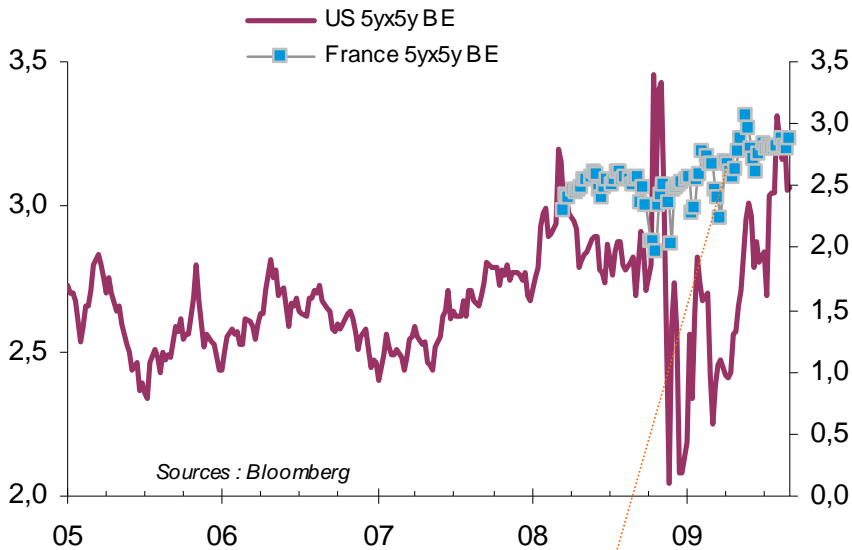
Inflation risk premium : a message from gold ?



Ex ante analysis of long term yields (2)

5y5y forward swaps

5y5y B/E inflation rates

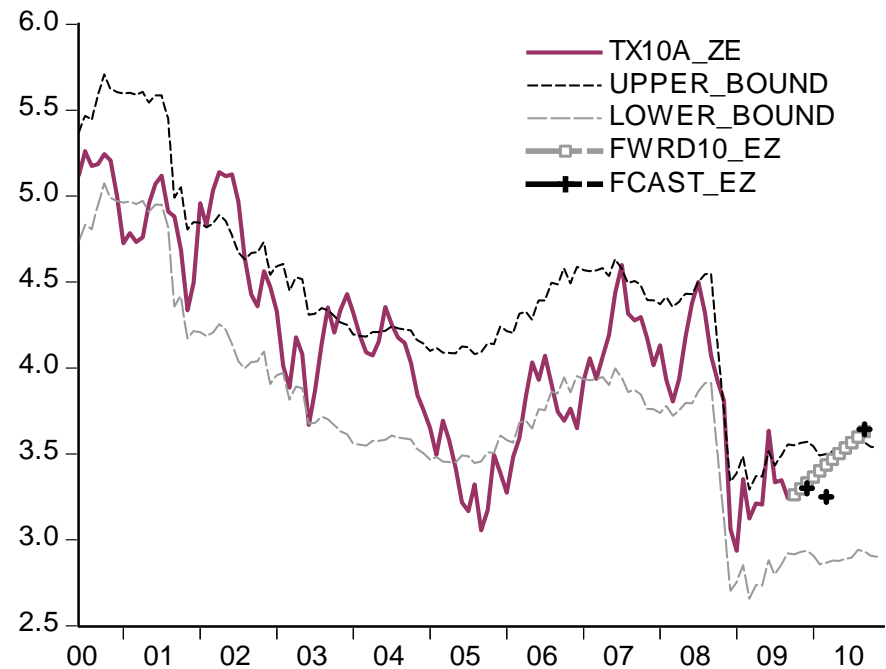


Lower real growth ahead ?

A tentative quantification of long rates

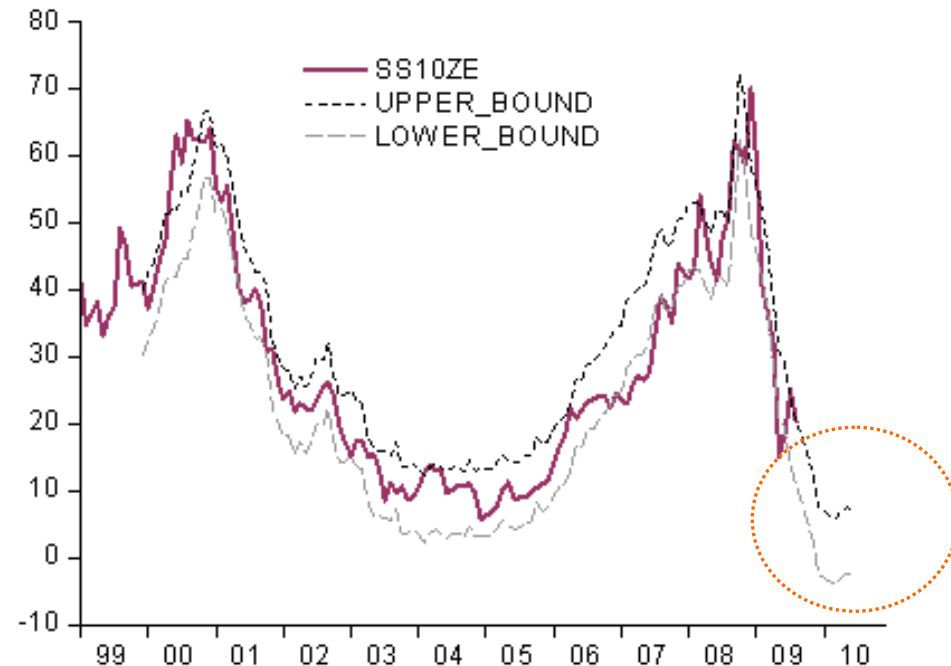


- **Model based analysis**
Don't over estimate the supply !
- **It all depends on liquidity**
 - **Global liquidity** : 1 months of reserve accumulation by China = Total QE program of the ECB !
 - Monetary policy expectations : **no hurry**
 - Supply
 - Repo rates



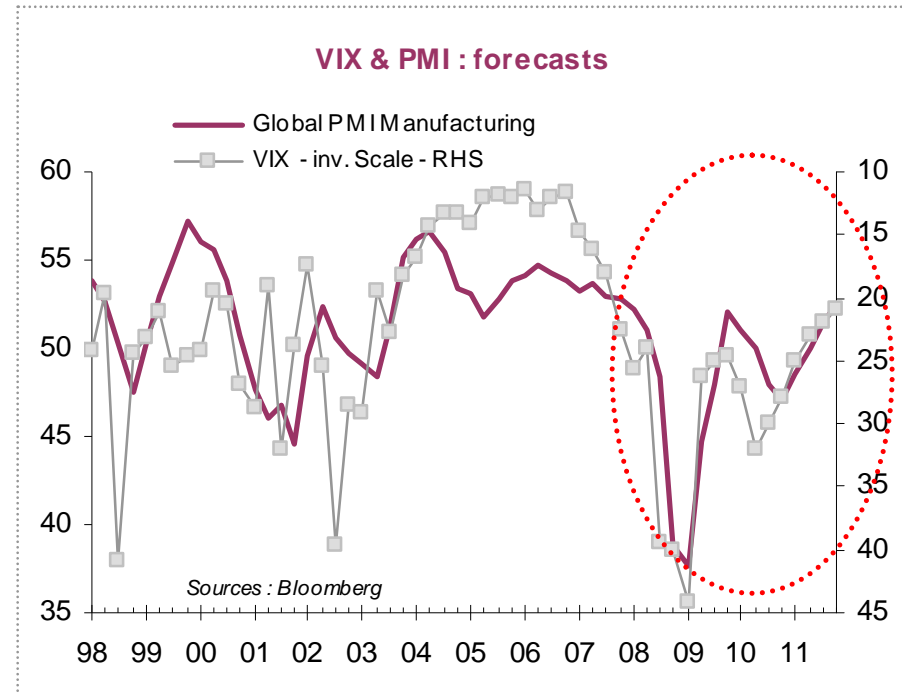
A tentative quantification on swap spreads

- **Tighter !**
Don't over estimate the supply !
- **It all depends on liquidity**
 - **Global liquidity** : 1 months of reserve accumulation by China = Total QE program of the ECB !
 - Monetary policy expectation : no hurry
 - Implication for **Intra EMU spreads**: **beyond directionality=> credit risk.**



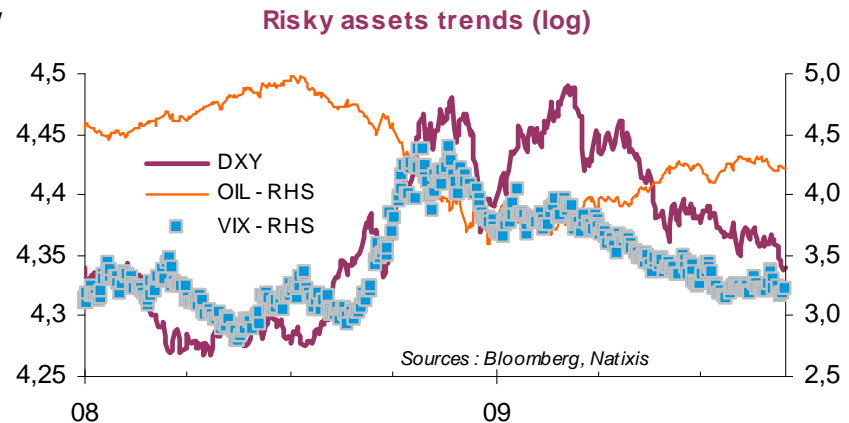
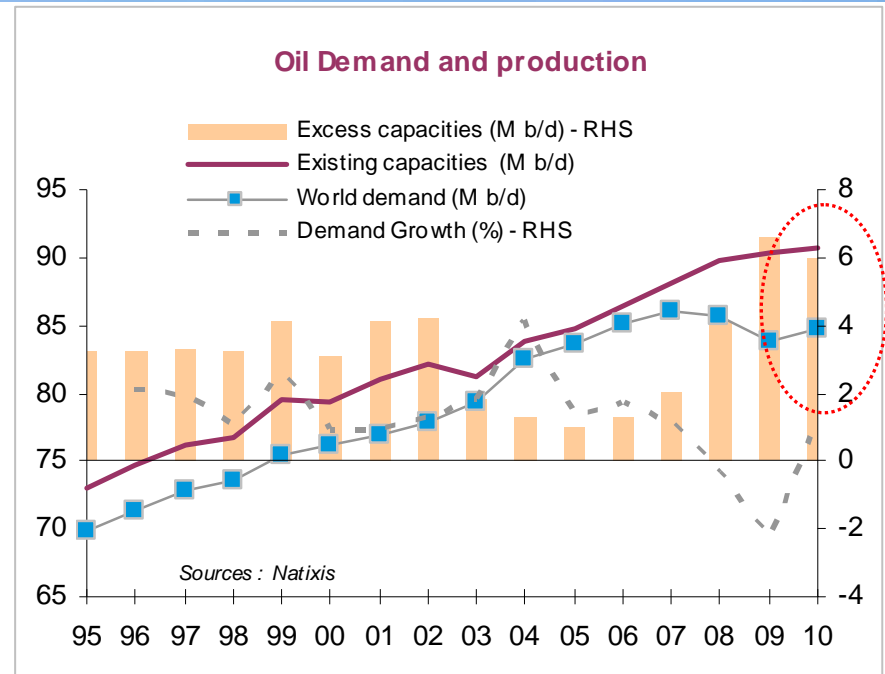
Implication for a cross asset analysis

- Risk aversion continue to drive the swings
W recovery means significant swing in Vix
- Crossroads
 - **Correlations** : correlation breakdown as early signals ?
 - Implication for **Intra EMU spreads**



Oil : driven by fundamentals ?

- Oil / commodity prices driven by false hopes ?
Beyond stock rebuilding
- Supply / Demand
 - Historical high for **excess capacities**
 - A collateral damage of the new liquidity conundrum?

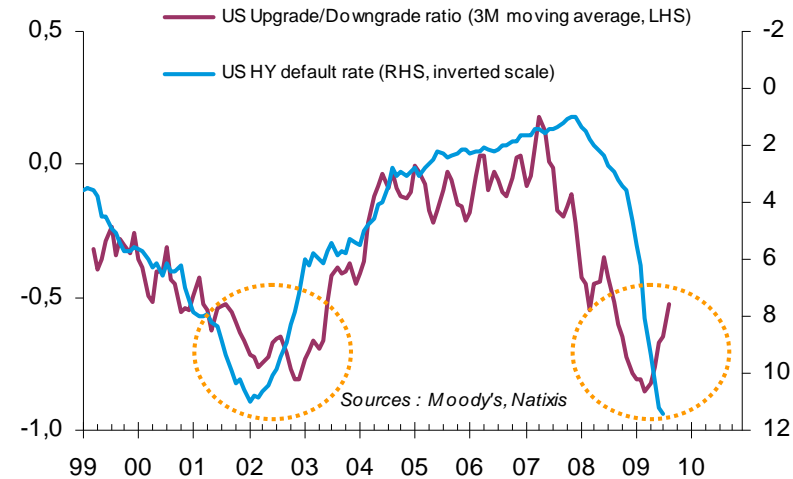


Credit market: a new cyclical pattern ?

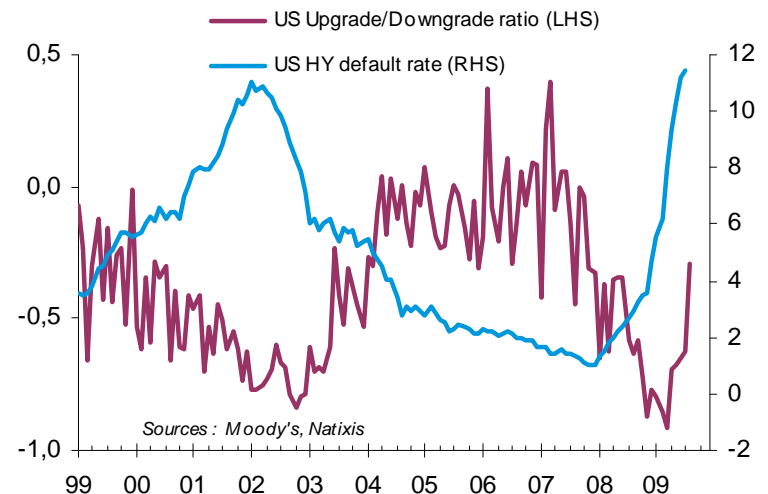


- **Credit market**
Spreads back to (or even below) fair value amid a sharp rally in risky assets
- **Burn after the reading**
 - **Default upturn drives spreads historically**

US HY default rate vs Upgrade/Downgrade ratio

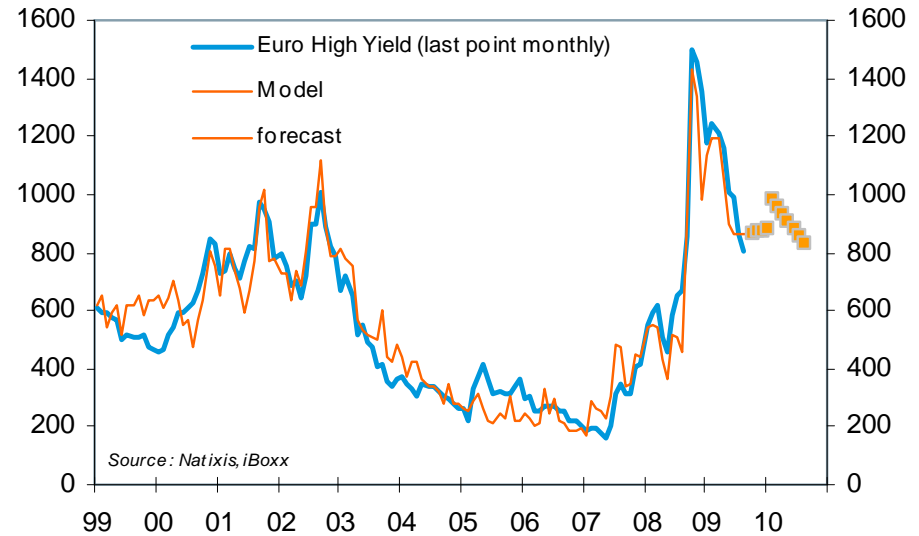


US HY default rate vs Upgrade/Downgrade ratio



Credit market: further tightening ahead ?

- Macro model driven models
Flirting with fair value
- What about excess liquidity ?



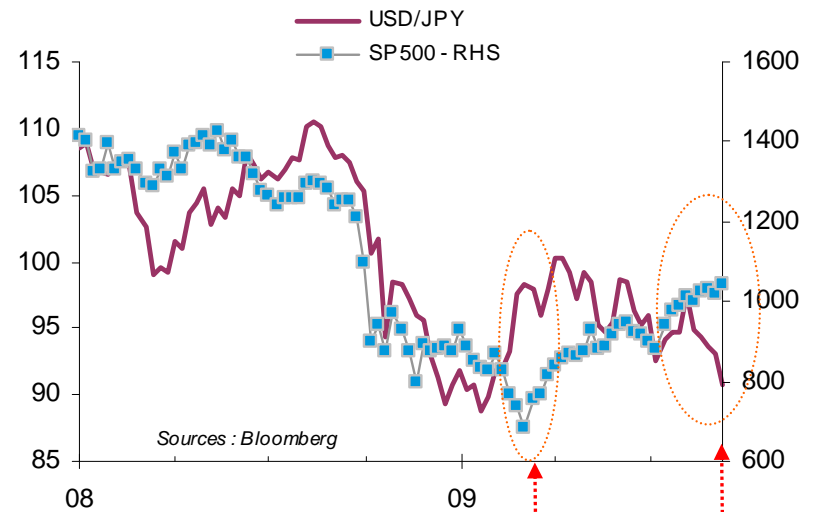
€HIGH YIELD

	01-Sep-09		Forecasts		
	Observed	Equilibrium	3M	6M	12M
Explanatory variables in model					
Default rate HY	11,5	-	12,4	10,7	9,5
Equity Implied Volatility (VIX)	29	-	25	32	27
Spreads (ASW, bp)					
BB	571	689	624	733	602
B	931	873	788	931	782
CCC	1350	1766	1571	1897	1549
High Yield	807	940	869	986	825

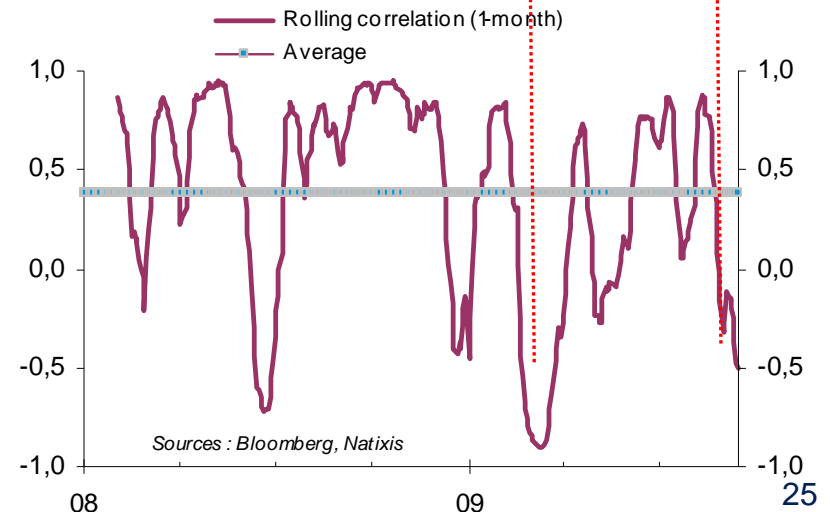
Equity market : best bull market ever: a pause ?

- Tentative analysis of previous correlation breaks
 - **March 09** : early rebound in USD/JPY
 - **September 09**: USD/JPY near 90...
 - **DIVERGENCE** also noticeable technically...

Macro crosse trades early signs ?



Correlation breakdown as an early signal ?



Equity market driven by valuations, earnings and liquidity

- A simple thought on equity

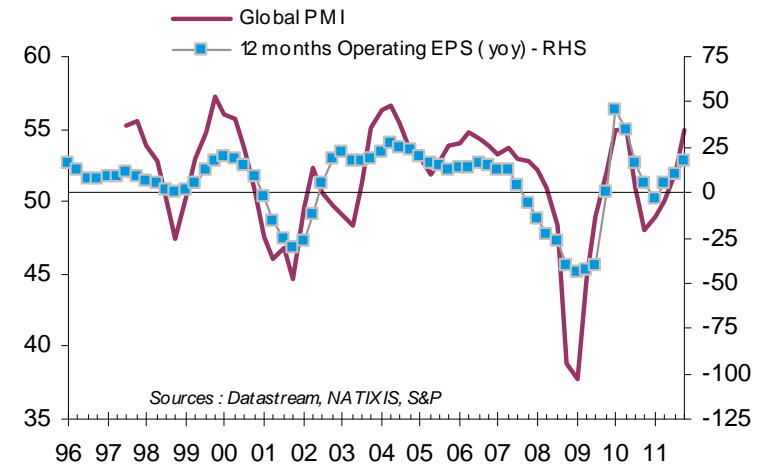
Is the expected 25 yoy growth in EPS macro compatible ?

- Valuing the market

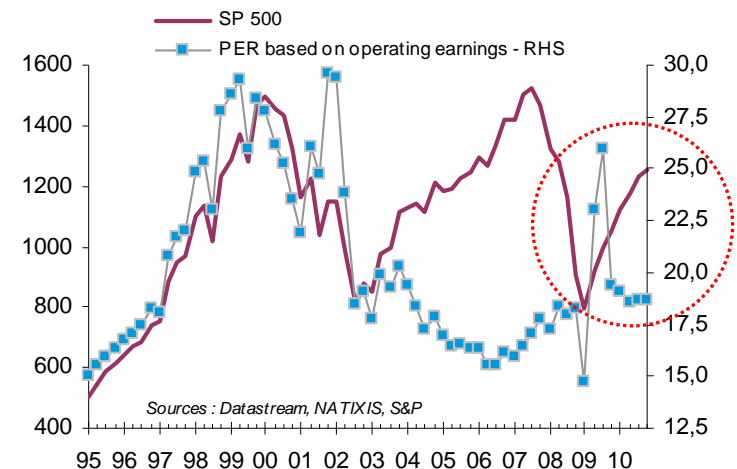
- **EPS:** tracking the economic W cycle and forecasting the EPS level 12-months forward.

- **Reconciling end of 2010 S&P 500 level with EPS growth and a fair level for PER.**

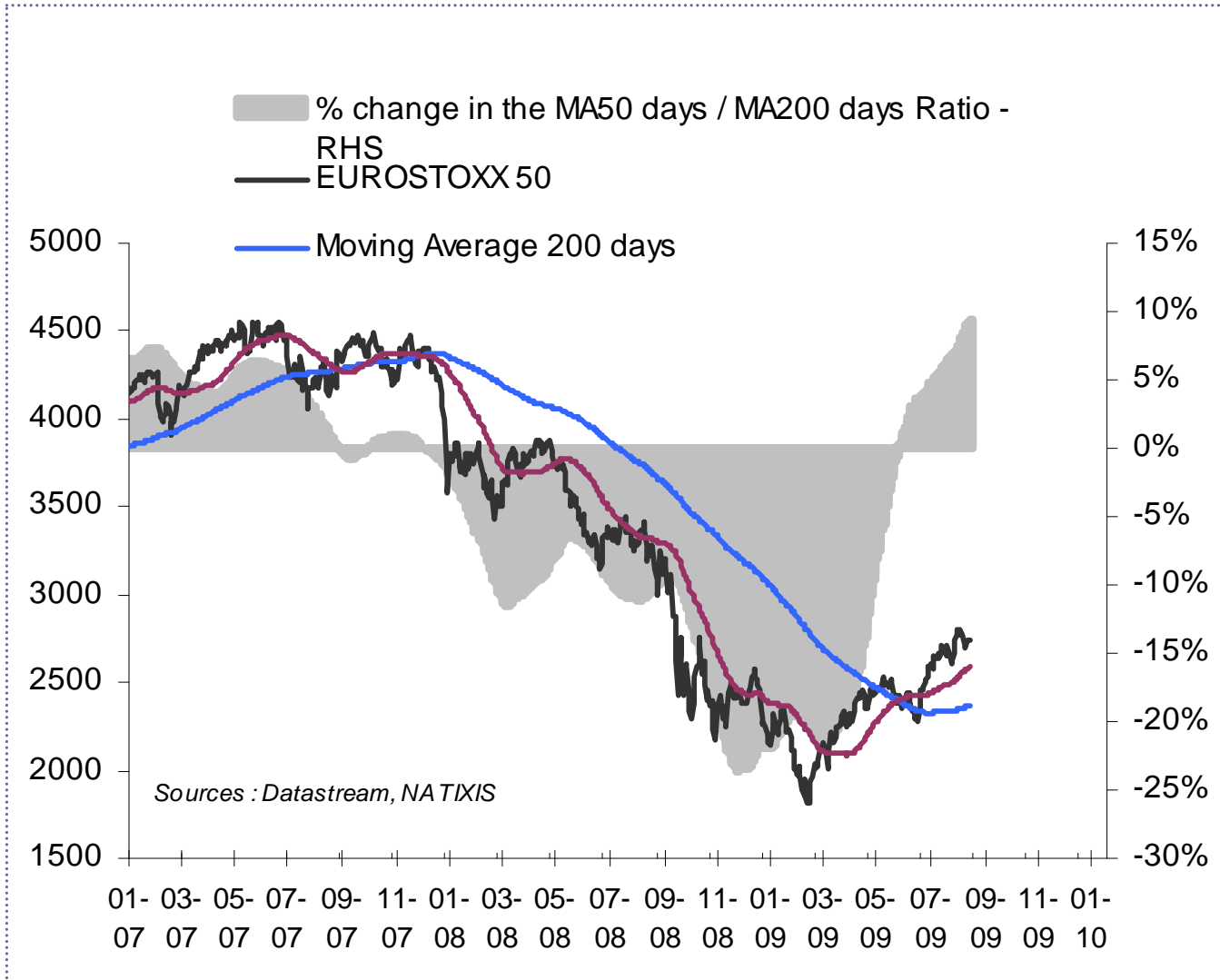
World growth assessment and Operating EPS growth



SP500 forecast



Stock markets: LR momentum still bullish



Main forecasts



	GDP (YoY)			Inflation (YoY)			Fiscal balance (% of GDP)		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
United States***	0,4	-2,6	1,3	3,8	-0,6	1,1	-3,1	-11,0	-9,8
Japan	-0,6	-6,3	1,1	-0,6	0,2	0,1	-8,0	-8,9	-9,9
Euro Zone	0,6	-4,0	0,1	3,3	0,3	0,9	-1,9	-5,6	-6,6
<i>Germany</i>	1,0	-4,9	0,6	2,8	0,3	0,8	-0,1	-4,6	-5,9
<i>France</i>	0,3	-2,2	0,5	3,2	0,0	0,6	-3,4	-7,0	-7,5
<i>Italy</i>	-1,0	-5,2	-0,4	3,5	0,8	1,2	-2,7	-4,9	-5,2
<i>Spain</i>	0,9	-3,9	-0,9	4,1	-0,2	0,9	-3,8	-8,1	-9,3
United Kingdom	0,7	-4,0	0,9	3,6	2,0	1,9	-7,1	-12,6	-12,7
Eastern Europe *	4,2	-4,9	-0,4	6,2	3,3	2,4	-3,2	-6,0	-6,9
Russia	5,6	-8,8	0,4	13,3	12,2	9,9	4,6	-11,2	-7,8
Latin-America	4,1	-1,9	2,3	8,2	6,6	6,1	-0,3	-2,8	-1,9
Asia excluding China and Japan**	4,2	1,7	4,3	7,7	1,3	3,3	-2,9	-6,1	-5,1
China	9,1	8,1	9,6	5,9	-0,5	3,0	-0,4	-4,0	-4,5
World GDP	1,6	-2,5	1,6	4,1	1,2	2,0	-	-	-
World GDP (PPP)	2,8	-1,3	2,5	-	-	-	-	-	-

* Poland, Hungary, Czech Republic, Slovak Republic, Slovenia, Estonia, Latvia, Lithuania, Bulgaria, Romania

** Korea, Thailand, Malaysia, Singapore, Hong-Kong, Indonesia, Philippines, India, Taiwan, Vietnam

***Public deficit excluding capital operations