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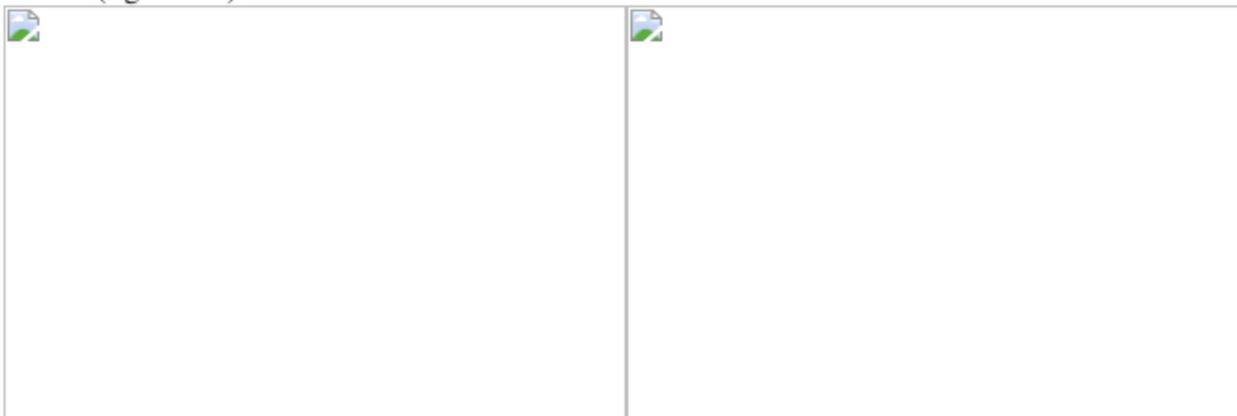
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February 23, 2013

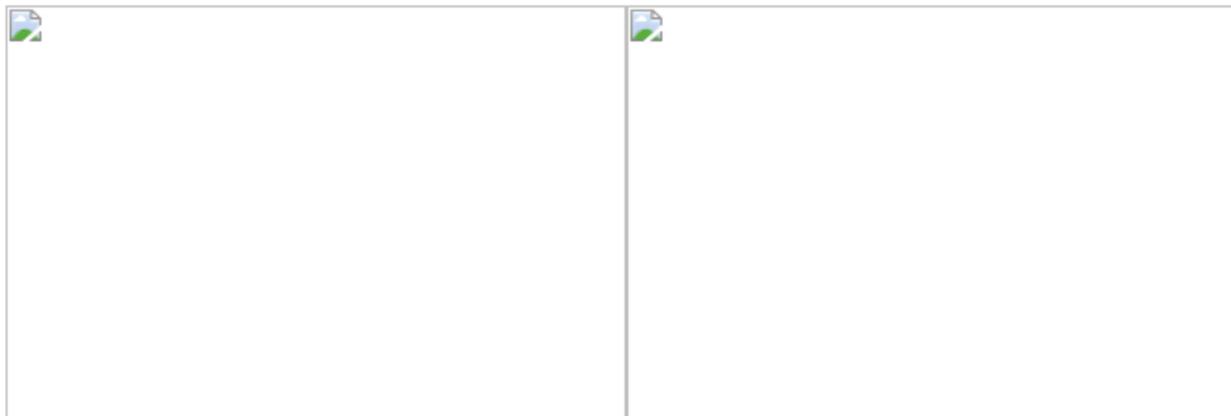
## Stabilizing at healthy levels

**Global growth stabilizing at a healthy level.** After five straight months of impressive monthly gains, the global manufacturing surveys are taking a breather: the February manufacturing PMI was flat in Europe and a touch lower in the US. We had expected a downtick in the U.S. surveys (January 29<sup>th</sup> Macro Skinny) as higher taxes and the impending budget sequestration temper business sentiment. So this weakness is nothing to get worried about. The European manufacturing survey was disappointingly flat, but the silver lining here is the improvement in both France and Germany (the Euro-area average was probably dragged down by Italy, perhaps in response to heightened election uncertainty). The bigger surprise was the collapse in Europe's services PMI. It does admittedly imply a more protracted recovery, but one should not dismiss the impressive progress seen in manufacturing activity in recent months, which tends to be a more reliable forward-looking measure of growth. Taken together, European growth is still on track to improve from a run rate of -2% late last year towards 1% at the end of this year. It is an improvement, even if it's well below the pre-crisis trend of roughly 2%. Pending the February manufacturing surveys from the emerging markets, our best guess is for a global PMI index consistent with decent, 3.5% global GDP growth in the first quarter (left chart). The improvement in the global PMI from prior months is already showing up in the hard data. Global car sales, for example, have picked up sharply in recent months (right chart).

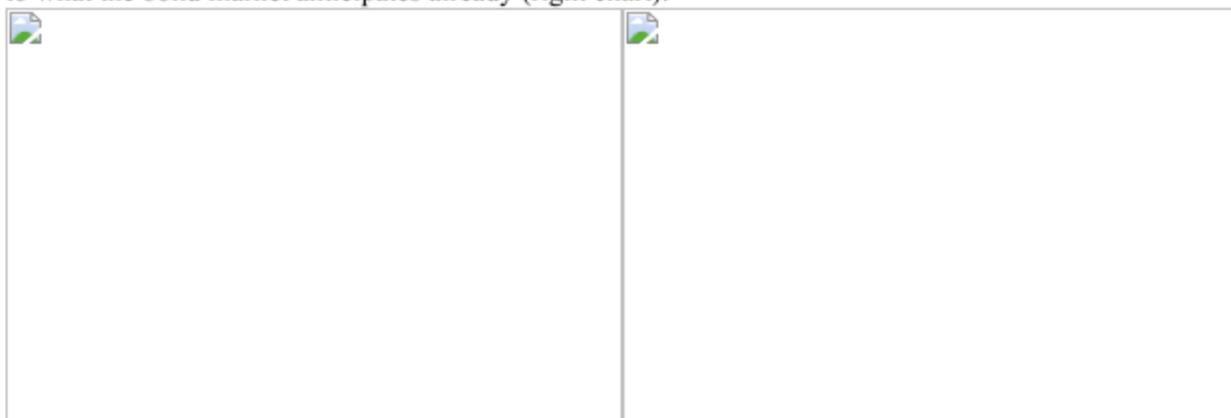


**US: focus on the other side of the valley.** In the US there are early signs of the well-anticipated fiscal drag “finally” kicking in. Our view here hasn't changed – it's a temporary drag masking a faster growing private sector, which is why we're still looking for growth acceleration later in the year. For now, though, economic data will be noisy. On the **consumer** side, the January retail sales held up, but the hit to consumers from higher taxes (as well as gasoline prices) seem likely to appear in the February-March numbers. On the **corporate** side, the national ISM/PMI surveys across both

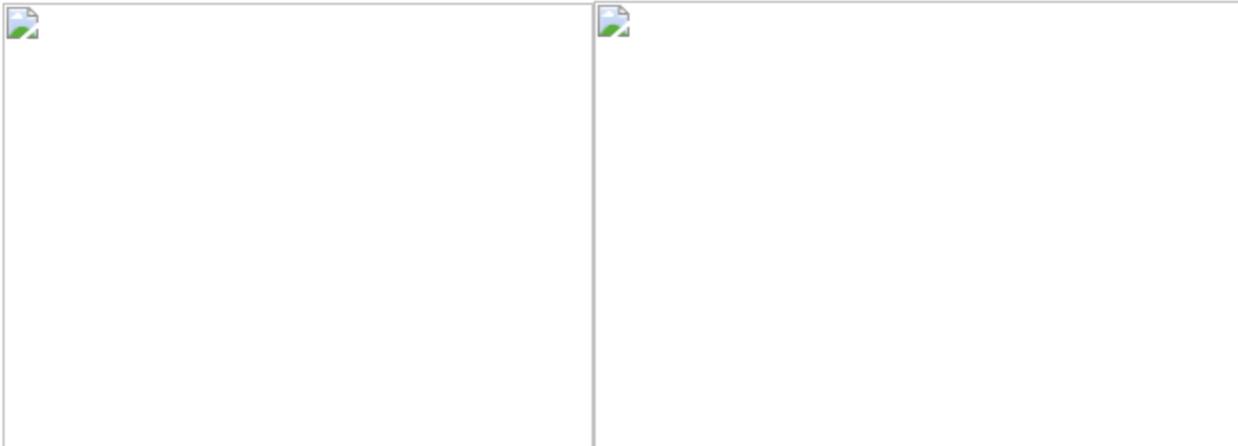
services and manufacturing businesses continue to paint a solid picture for both production and capex plans (left chart). A modest tentative drag from fiscal tightening is likely, and based on the regional Fed surveys, most of it will likely be concentrated in sequester-sensitive states.<sup>1</sup> **Housing** data may wobble<sup>2</sup>, too, but the fundamentals – of growing demand and shrinking supply (right chart) – support our view that sales activity, construction, and prices will continue to head higher. We would heavily discount any possible weakness in housing stemming from the drama in Washington regarding the sequestration (ongoing), the budget deal (next month), and the debt ceiling (in May).



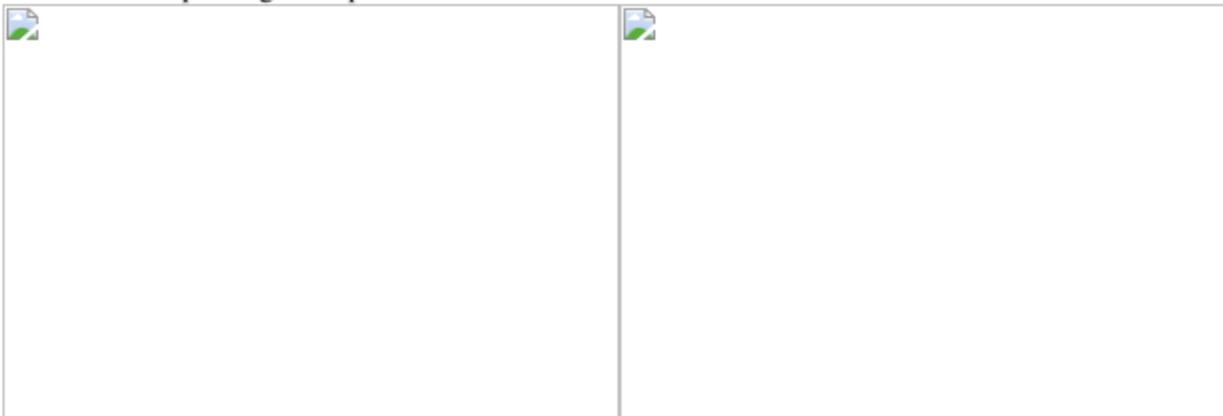
**Fed: expect more communication hiccups.** The equity market did not like the January FOMC minutes earlier this week, which revealed that several participants suggested the Fed should “vary the pace of asset purchases...in response to changes in the economic outlook or as its evaluation of the efficacy and costs of such purchases evolved “. But this is not new; the Fed already put to rest notion of “QEternity” in the minutes to the previous FOMC meeting (January 19th Macro Skinny). Rightly so, the bond market didn’t budge this week, particularly when yields had already corrected upward quite a bit in prior months. More confusion from the Fed is unavoidable, but in our view the FOMC is unlikely to announce any material change to its Large-Scale Asset Purchases (LSAP) program over the next 3-6 months; the tax hikes and the sequester implementation will keep the labor market weak enough to keep the FOMC hawks at bay. That being said, we continue to assign a high likelihood that asset purchases end or are reduced by the end of the year. Even then, it is extremely unlikely that bond yields will snap up violently. Assuming conservatively that the Fed starts tightening in mid-2015, our Treasury valuation model<sup>3</sup> suggests that ending LSAP by year-end would lead to around a 35bp sell off – similar to what the bond market anticipates already (right chart).



**More ECB/BOJ easing likely.** Outside the US, monetary policy will likely ease further in two key economies. **Japan:** the G7 group signaled that competitive devaluation is legitimate provided it is implemented using domestic policy easing, as opposed to pushing for a weaker currency vis-à-vis foreign asset purchases. If Prime Minister Abe wants to show he can “walk the talk”, without buying foreign bonds, the BoJ needs to seriously consider a Fed-style “twist” to its asset purchases program – shifting aggressively from short-maturities to much longer maturities. It is quite striking that in duration terms (measured in “10-yr equivalent” securities), the BoJ hasn’t been buying much, certainly when compared to the Fed (left chart). **Europe:** the ECB will likely realize that monetary policy in the Euro-area is getting too tight, particularly when compared to the rest of the G10.<sup>4</sup> The strength of the Euro against the US dollar, the Sterling and the Yen indeed shows that the ECB is not easing enough on a global scale. But more fundamentally, loan rates in the periphery are still too high relative to Germany (right chart). More conventional easing (by lowering the ECB rate to 0.25%) would be a good start, but what Europe really needs is aggressive quantitative easing of the type that the Fed and the Bank of England delivered. The ECB does not appear ready to deliver a full-blown QE, but we may get there if the weakness in bank lending markets persists. This should help weaken the Euro and regulate the pace of private sector deleveraging.



**The wall of global liquidity heads for emerging markets.** Since growth in developed markets (DM) is still held back by debt deleveraging this year, emerging markets (EM) are going to drive global growth. That's because EM borrowing rates fell throughout last year, and now that global risk aversion has normalized too, the conditions for EM domestic demand re-acceleration are ripe. EM is already running at close to full capacity, yet the scope for a spike in EM inflation this year is limited. Growth is not the sole investment proposition EM has to offer; it's carry as well. EM-DM rate differentials have been quite high since 2009 (right chart), but what makes this theme particularly appealing right now is the scope for EM currency appreciation in a depressed currency volatility environment. Until not so long ago, emerging markets flourished at the start of each global liquidity cycle and popped when the Fed and other major central banks started to tighten monetary conditions. The tsunami of EM currency and debt crises in the 1990s is still echoing, particularly when put in the context of today's ferocious global liquidity glut. But in the 1990s, emerging markets were overfed with liquidity because EM currencies were fixed at "cheap" rates, and consequently overbought in the following years. Today, most EM currencies are allowed to appreciate, and hence, regulates the flow of hot money. It's not a surprise then that the Fed's tightening cycle of 2004-2006 didn't cause any pain in EM (on the contrary – it was the developed world that popped as global liquidity was withdrawn). Bottom line: EM offers interesting opportunities both in yield and in growth investments, yet it is a lot more resilient to sharp swings in capital flows.



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[1] We saw a similar effect in advance of the fiscal cliff (October 26th Macro Skinny), where the Richmond Fed survey – which covers the states that are most exposed to sequestration – collapsed while the Kansas City Fed and the national Markit PMI were more robust.

[2] Some recent measures of housing activity paused, but we see little reason for concern. Housing starts in January slowed month-on-month, but this was from a high rate of increase in December, and the weakness was entirely in the multifamily sector. The National Association of Homebuilders housing market index declined 1 point (to 46), but this index has steadily increased for more than a year (and is still near the highest levels since 2006).

[3] Our model was based on a regression of 10-year Treasury yields on: a constant, long-term inflation expectations, and 3-year Treasury yields (the three year rate replaces the commonly-used policy rate variable; the latter became a biased estimator of the Fed's optimal policy rule over the past several years. The Fed's forward looking guidance on the zero policy rate from late '11 till late '12 meant that the three year rate effectively became the new policy rate). We used the regression coefficients to compute the fair value (excluding QE) 10-year Treasury yield in the fourth quarter of 2013 assuming inflation expectations remain constant at current levels, but the 1-year-ahead, 3-year Treasury yield increases in a way that is consistent with our view on the future path of the federal funds rate. Our estimates showed the 10-year yield would increase by 35bps from current levels if the Fed stops its asset purchase program at the end of the year.

[4] True, the ECB has expanded its balance sheet, but that was a "credit easing" policy to avoid a melt-down scenario. Like the UK and the US in 2010, monetary policy is too tight in the Euro-area (outside Germany, that is) so more standard QE expansion is needed. They don't seem to be keen on going this way now, but Draghi's recent comment that the Euro is important for "growth and price stability" is very unusual (he put growth and price in the same sentence!).

#### Acronyms:

BoJ – Bank of Japan  
DM – Developed Markets  
ECB – European Central Bank  
EM – Emerging Markets  
FOMC – Federal Open Market Committee  
FRB – Federal Reserve Board  
IMF – International Monetary Fund  
ISM – Institute for Supply Management  
NAR – National Association of Realtors  
PMI – Purchasing Managers Index  
PPP – Purchasing Power Parity  
QE – Quantitative Easing

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