

Global Snapshots

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Wildcards in the Leverage Racep.2

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Turkey Wants to Stand on Its Own Two Feetp.4

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Changing Dynamics in the Indian Bond Marketp.5

- Since early 2009, signs of recovery have pushed bond yields higher across the globe. When it comes to India, however, this market stands apart with one of the fastest jumps in bond yields, both at the global level and within local debt markets in Emerging Asia. Looking ahead, we expect India's 10-year G-secs to trade in a range of 7.0% to 7.5% in coming months with the RBI reluctant to see yields move up too quickly, while traders remain concerned by fundamentals. As recovery takes root, however, we see the exit from this range on the upside.

Philippines: Resiliency is Not Enoughp.6

- Powerful waves of economic and political turmoil have hardly allowed smooth sailing in the Philippines. Yet, despite the global financial crisis, the Philippine economy has remained somewhat insulated due to its diversified structure. On the political front, while there is still considerable uncertainty regarding the 2010 presidential elections, there appears to be little risk of massive fiscal slippage or unexpected backsliding on market-friendly reforms.

ECB Exit Hampered by Eurozone Divergencep.7

- Amid encouraging signs of economic recovery, monetary authorities across the globe are caught in a real dilemma: when and how to shift their policy towards “normalization” without tipping their respective economies back into recession. The ECB is no exception, but its task is further complicated by the heterogeneity of the Eurozone economies. Activity, the pace of recovery, and output gaps diverge strongly among the Eurozone Member States, which could ultimately generate highly contrasting inflation profiles. Moreover, the banking systems of the individual economies are in very different states of repair. These diverging trends are likely to become gradually less pronounced, but could still present a real headache for the ECB and force a slow pace of monetary policy normalization.

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Wildcards in the Leverage Race

The Q2 Flow of Funds (FoF) report shed new light on the ongoing balance sheet adjustments in the US economy. As expected, deleveraging among households and the financial sector continued, while the public sector further boosted debt to fund the stimulus measures aimed at buffering the impact of private sector deleveraging on economic growth. When we last wrote about the "Leverage Race" on these pages (*cf. Global Snapshots of June 18, 2009*), we correctly noted that there would be no lack of willing domestic buyers for the flood of new Treasury issuance. What we had not anticipated was just how low Treasury yields would remain. In this Snapshot we focus on two wildcards in the leverage race. (1) How much will US households save? (2) When will Treasury yields start to rise? The views on these two key questions explain much of the difference between the bears and the bulls on the US economy. Our own growth forecast of 1.9% for the US in 2010 is at the lower end of consensus, with the median at 2.4%, a high of 4.0% and a low of 0.7%.

The Anatomy of US Savers

For the first time since Q1.07, the net worth of US households increased in Q2.09, rising almost USD 2trln. As seen from the table below, the bulk of these gains came from the asset side, and notably from equities. The gains on real estate, although more modest, are perhaps the more encouraging. Coupled with recent housing market indicators, this adds further evidence that the worst of the housing storm has indeed passed. Based on preliminary data for Q3, we estimate total asset gains of similar magnitude in Q3. With respect to liabilities, there was a slight reduction in household debt, and we anticipate another drop in Q3.

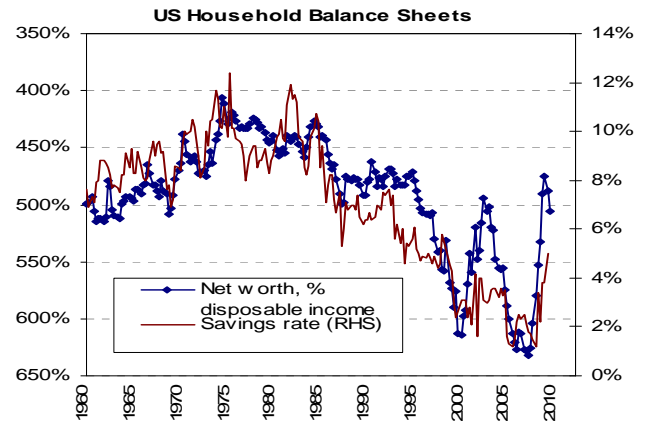
US - Balance Sheets of Households and Nonprofit Organizations (USD bn)					
	2006	2007	Q4.08	Q1.09	Q2.09
Assets	76,749	78,229	67,134	65,244	67,208
Selected items					
Real Estate	24,260	22,880	20,398	19,869	20,026
Equities	9,488	9,453	5,879	5,150	6,266
Liabilities	13,414	14,318	14,217	14,103	14,068
Household net worth					
% disp. income	639	614	490	475	487

Source: Federal Reserve, Flow of Funds.

The key variable from household balance sheets for economic forecasters is the net worth to disposable income ratio. As seen from the chart below, this variable is closely correlated to the savings ratio; as net worth as a percentage of disposable income declines, US households tend to save more of their income and thus spend less. The current recession has seen a sharp increase in the savings ratio from below 1% to around 4.5% at present. This is the result of both "voluntary" cuts in spending, driven by the sharp loss of wealth and "involuntary" spending cuts resulting from the credit crunch, with some borrowers forced to foreclose.

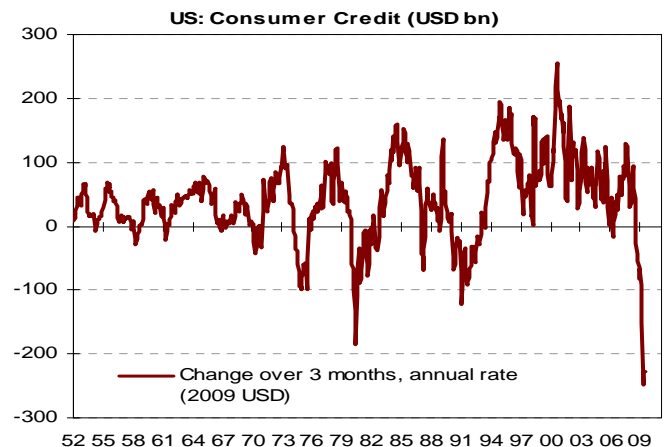
Both elements merit attention. On the wealth side, it is important to recognize that equities are primarily held by the richest US households, whereas around two-thirds of households own their homes. In determining savings behavior,

the latter is more important and net worth excluding equities correlates more strongly to the savings ratio. It should be noted, however, that even households that do not own equities often look to equity market movements as a metric on the health of the economy and thus the security of jobs. In this context, the recent gains in net worth are encouraging, but even if subsequent quarters seen firm gains, a return to pre-crisis levels of net worth is clearly not on the cards any time soon.



Source: Datatstream and own forecasts for Q3

On the credit crunch, we note with encouragement the improvement in conditions since the peak in turmoil last autumn. Nonetheless, conditions remain tight and only households with high FICO scores are able to secure credit. Moreover, the most recent data show that consumer credit continued to collapse in July and August at a pace not seen since WWII. Against this backdrop, the ongoing thaw in credit channels is set to prove slow. Consequently, foreclosures will remain at elevated levels resulting in additional "involuntary" saving.



Summing up these points, we expect net worth to return to around 525% in 2010. This is consistent with a savings ratio around the 5.5% mark, and our central scenario assumes a gradual adjustment to this level by the end of 2010. Short-term forecasts on savings, however, are subject to significant uncertainty. If US households decide to pause, holding the savings ratio at 4.5% instead of continuing our projected adjustment to 5.5%, this alone would add 0.6pp to our growth

forecast for 2010. Conversely, more frugal behavior, quickly returning the savings ratio to its long-term average of 6.75% would trim our 2010 outlook to just 1.2% all else being equal.

A Rebalancing of the US Domestic Sector Balance Sheet

In H2.08 and H1.09, Treasury issuance reached its highest level since WWII (13.2% of GDP, USD 1.9 trln). There has been much debate on whether the rest of the world had the capacity to absorb this issuance without a sharp rise in Treasury yields. The main fear was that foreign investors would forsake US public assets. In fact, international investors no longer absorb the bulk of US government bond issuance. In Q2.09, they acquired only 21% of new Treasuries (vs. 48% in Q1). But the Fed took over, with its Treasury purchase program absorbing 34% of issuance in Q2 (vs. 6% in Q1). However, with the end of Fed’s purchases approaching – by mid-September the Fed had already bought USD 285bn of Treasuries (out of 300bn) – the question of who’s going to buy Treasuries is back at center stage. The amount of savings and their asset allocation are key to answering this question.

On the domestic front, households purchased more than 40% of new Treasury issues in H1.09, compared to an average of around 10% over the past 25 years! This is the result both of higher savings and of a clear strategy to allocate more to safer assets as many households are still licking their wounds from the subprime crisis. Looking ahead, we expect US households to revert their Treasury allocation to at least the long-term average of 2.4%. Commercial banks have only just started to return to government paper. Over the past decade, banks slashed their exposure to Treasuries in the hunt for yield. A more conservative asset allocation for bank assets, however, is clearly in the pipeline and will be further encouraged by regulation.

	Total Assets (USD bn)	Treasuries (% of total assets)		Potential* purchases of Treas. (USD bn)
	Q2.09	1985-2009	H1.09	
Households	42,361	2.4%	1.4%	426
Commercial Banks	14,200	4.6%	0.9%	538
Insurance Comp.	5,869	5.6%	2.7%	167
Total	62,430	-	-	1,131

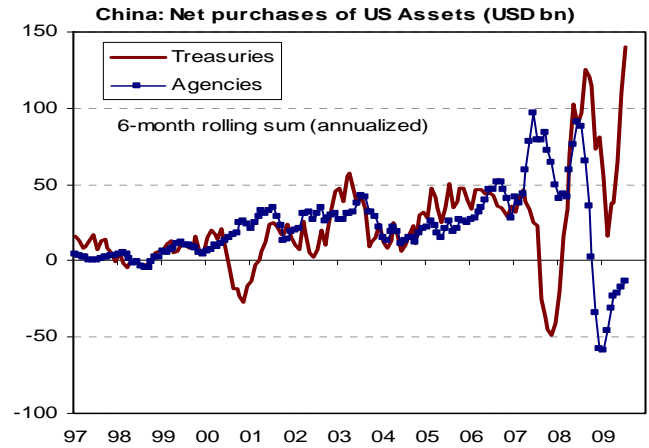
*Potential purchases: purchases that would "normalize" balance sheets (i.e. that would bring the allocation back to its 25-year average).

Source: Flow of Funds (Fed) and own calculations.

All else equal, we estimate that the “normalization” of the asset allocation among US households and commercial banks alone could generate additional demand for Treasuries of USD 1.1 trln (cf. table). Making a similar calculation for the rest of the domestic financial sector, we add around USD 200bn to the number. Note that the deleveraging process may even encourage, over time, domestic agents to hold more Treasuries than they did on average in the past.

On the external front, it is noteworthy that foreign central banks have renewed their appetites for US Treasuries. The case of China is the most telling. China has massively sold Agency securities since Lehman’s collapse, but in place has bought a record amount of Treasuries (cf. graph). No doubt that the Chinese authorities will do the necessary to avoid a collapse of

the USD. Indeed, from a strategic standpoint, they will very likely prefer to wait for a moment of dollar strength before reducing their USD holdings. Against this backdrop, the recent weakness of the greenback should encourage China to buy more Treasuries, not less!



How long will the “bond bubble” last?

As outlined above, we see little risk of Treasury demand drying up in the short term, and consequently little risk of a sharp rise in Treasury yields. This is all the more the case given our outlook for a bumpy recovery. Longer term, the household savings rate will stabilize and domestic agents will consider that they hold “enough” Treasuries. Moreover, foreign central banks will inevitably tend to diversify their reserves away from the US dollar. In such an environment, Treasuries would have to post higher yields to attract investors, particularly as inflationary pressures start to rise once a sustainable recovery takes root. In addition, keep in mind that for foreigners the dollar plays an equally important role in the investment decision and may end up carrying part of the adjustment burden. At this stage, however, we simply doubt that this “medium term” will occur in 2010.

Didier Borowski / Michala Marcussen

Turkey Wants to Stand on Its Own Two Feet

It has been a very busy couple of weeks for Turkish investors with multiple market-moving events to digest in the run-up to the annual meetings of the IMF in Istanbul. Most of the recent events have been positive, and rising Turkish asset prices reflect this. The sole exception to the good newsflow comes in the form of the IMF, where hopes for a new Standby Agreement have faded. With the IMF annual meetings scheduled to open next week, we review the key events.

CBRT continues to exceed market expectations

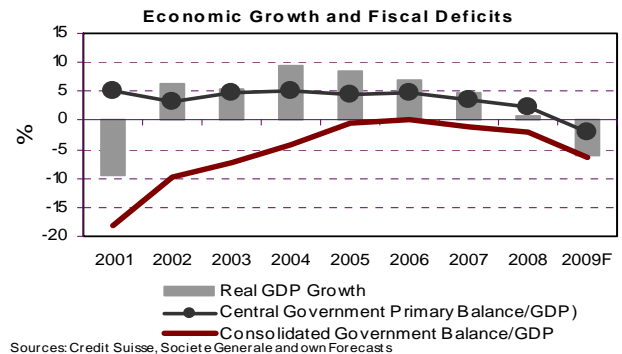
The Central Bank of Turkey (CBRT) cut rates last week by 50bp to 7.25%. Since initiating its easing cycle in November 2008 the CBRT has now cut rates by 950bp, more than any other central bank in the world. With inflation at 5.3% y/y, real rates in Turkey are now below 2%. This is very low by historical comparison, but the statement accompanying last week's rate cut nevertheless indicates a continuing bias to ease. We have been slightly more constructive than the market, which currently looks for policy rates to bottom at 7.0%. As the CBRT has consistently surprised markets during this cycle by cutting more and faster than expected, it is not inconceivable that the CBRT may lower its policy rate all the way to 6.0%. The lira's strength and global risk appetite both provide flexibility to the CBRT.

Irrespective of where interest rates bottom in this cycle, a quick turnaround towards a tightening bias is unlikely. Turkey's economy will contract by around 6% in 2009, and while the first half of this year almost certainly represents the bottom for growth, economic recovery will come slowly and with bumps. In other words, don't look for rate hikes before mid-2010. When Turkish growth begins moving back towards trend (near 5% per year) and rate hikes do occur, they are likely to come faster and in larger increments than for most other central banks. Still, while neutral interest rates will be substantially higher than the current sub-2% level, we do not anticipate the policy rate returning to its November 2008 level of 16.75%.

New fiscal program is credible, but not impressive...

Turkey's Medium Term Economic Program announced last week envisions fiscal deficits declining from -6.5% of GDP in 2009 to -3.0% in 2012. The government projects that Turkey's primary fiscal balance will return to surplus during 2011. The government makes these assumptions against projected GDP Growth of -6% in 2009 and +3.5% in 2010, with a return to the +5% potential growth rate only in 2012. Inflation is seen as relatively stable around 5% y/y during the next three years. This long-awaited multi-year framework does not contain much detail regarding possible spending cuts; nor does it indicate where tax revenues might be increased. In fact, Economy Minister Babacan specifically ruled out hiking the VAT or raising corporate income taxes as part of the fiscal consolidation effort. More details will be made available as the government rolls out plans for the 2010 budget in the next few days and weeks, but the biggest missing piece of the medium-term plan is the lack of a "Fiscal Rule" which would require this and future governments to reduce public deficits and debt whenever certain thresholds are breached. The Turkish government has long spoken of the need for a Fiscal Rule, and Babacan last week said that work on this continues – with an

announcement possible in early 2010 and implementation in 2011. But given that this Fiscal Rule has been discussed and rumored for years, it's hard to put much stock into this prospect.



Despite some misgivings about the three-year program's economic assumptions and the lack of detail about future spending cuts and revenue increases, at least there is now a plan with clear macro benchmarks. In and of itself, this is positive. Unsurprisingly, the IMF quickly welcomed Turkey's new three-year plan as a good start towards "gradually reversing the deterioration in the country's public finances." The IMF statement does not, however, signal any agreement on a formal program with the Fund. IMF chief Dominique Strauss-Kahn said last weekend that Turkey does not need IMF loans, a very public acknowledgement that Prime Minister Erdogan prefers to keep the IMF on hold. The absence of a formal lending program deprives Turkey of an important reform anchor, but it clearly provides the government with greater policy flexibility. Erdogan reportedly told associates last week that "(Turkey) is trying to stand on its own two feet and we do not want a (IMF) walking stick anymore." Still, the government's new 3-year plan makes it easier for Turkey and the IMF to agree on a program if conditions dictate. But given the recent market environment in which Turkey has experienced no trouble funding itself, the country's political decision-makers seem content to keep the IMF at arm's length.

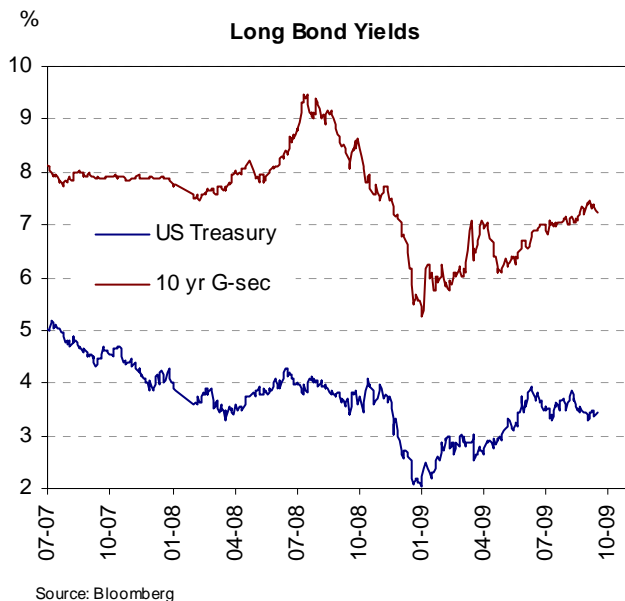
...but sovereign ratings may finally move higher

Despite the fading prospects for an IMF program, the rating agencies have turned more positive on Turkey. Last Friday, Moody's raised to positive from stable the outlook on Turkey's Ba3 rating. One day earlier, S+P raised its outlook to stable from negative on Turkey's BB- rating. Turkey's ratings have been frozen in time for the past 4-5 years even as markets have clearly priced the country's improved creditworthiness. Turkey's hard currency bonds trade substantially tight to comparably rated sovereigns such as Venezuela, Gabon and Serbia. Turkey sovereign trades more or less in line with other favored BB- sovereigns such as Indonesia and Philippines, but the latter have been upgraded several times in the last few years. Given the generalized improvement in Turkey's credit metrics during this decade, an upgrade by at least one or two of the main rating agencies seems probable over the next 12 months unless there is another significant deterioration in the world economy and global credit markets.

Blaise Antin

Changing Dynamics in the Indian Bond Market

Since early 2009, signs of recovery have pushed bond yields higher across the globe. When it comes to India, however, this market stands apart with one of the fastest jumps in bond yields, both at the global level and within local debt markets in Emerging Asia. Looking ahead, we expect India's 10-year G-secs to trade in a range of 7.0% to 7.5% in coming months with the RBI reluctant to see yields move up too quickly, while traders remain concerned by fundamentals. As recovery takes root, however, we see the exit from this range on the upside.



The Three Bears...

The 10-year G-sec yield has soared from below 5% in late December 2008 to around 7.0% today driven by three factors.

1. Recovery: Recent indicators of investment activity and consumption demand have ignited hopes of sustainable economic recovery. Indeed, we have recently revised up our growth forecast for India to 6.2% in 2009 (from 5.7%) and 6.9% in 2010 (from 6.2%), but see a bumpy global backdrop.

2. Rate hike expectations: The divergence between consumer and wholesale price inflation has been striking, with WPI close to nil (+0.12% y/y) and CPI in double digits (11.9% y/y). The current difference between the two indices is largely due to the higher weighting of food prices in CPI. Lower than expected rainfall during the monsoon season is constraining agricultural production and putting upward pressure on food prices. Looking ahead, we expect to see the WPI track higher hitting 3.0% y/y by year-end. Coupled with the economic recovery, the markets have already started factoring in early withdrawal of monetary accommodation.

3. A surge in issuance: The fiscal stimulus measures announced to buffer the economic downturn have further eroded public finances and the weak monsoon is stoking fears of even more stimulus, an even larger deficit and even more

issuance. The central government deficit is officially forecast to increase to 6.8% of GDP in FY10, up from 6.2% in FY09. Street estimates – including our own – are closer to the 8% mark. The huge deficit has, in turn, led to a surge in issuance. With central government auctions averaging from USD 2.5-3.1bn per week, market appetite for G-secs has been severely tested.

Who Will Buy G-secs?

Banks are the main investors for government securities. This is strongly tied to current regulations. Under the Statutory Liquidity Ratio, banks must hold a minimum of 24% of liabilities in government and other approved securities. Currently, these holdings are around 28-29%. The key point is, however, that banks have reached the maximum limit of their G-sec holdings which are to be accounted as held-to-maturity (HTM). Only bonds representing 25% of deposits can be kept in HTM. Beyond this amount, banks must mark-to-market their holdings, recognize and make provisions for any losses incurred. Consequently, banks are reluctant to significantly increase holdings from current levels as this would entail taking on interest rate risk.

One solution to ensure sufficient demand for new government issues is for the RBI to increase both the SLR and the HTM limits. The RBI could also use open market operations (OMO) to stem a sharp rise in bond yields. Coupled with reassurance from the RBI that policy tightening will be gradual, large purchases via OMO have proved a key support factor for bond yields in recent weeks. Clearly, the RBI was uncomfortable seeing long bond yields trading around 7.5% in early September.

...and Goldilocks

Looking ahead, the challenge for the RBI is to manage policy tightening to stem inflation risks but without sharply damaging the economic recovery. In our opinion, the RBI will only initiate withdrawal of monetary easing gradually given a still frail global economy. We expect the first 25bp rate hike to come in Q1.10 and see an additional +25bp rate hike in Q2.10, bring the repo rate to 5.25%. Like other central banks, however, the RBI will also be tightening other policy variables. In our opinion, the CRR (cash reserve ratio, i.e. the proportion of deposits which Indian banks must hold as cash with the RBI) could be tightened before the end of this year.

Considering these factors, we expect the 10-year G-sec to trade back to the higher end of the 7.0% to 7.5% range over the coming months. The recent volatility in G-secs reflects the uncertainty of the “three bears” lurking on the horizon. Ultimately, we expect the long bond yields to exit the recent trading range on the upside.

Nidhi Chawla

Philippines: Resiliency is not enough

Powerful waves of economic and political turmoil have hardly allowed smooth sailing in the Philippines. Yet, despite the global financial crisis, the Philippine economy has remained somewhat insulated due to its diversified structure. On the political front, while there is still considerable uncertainty regarding the 2010 presidential elections, there appears to be little risk of massive fiscal slippage or unexpected backsliding on market-friendly reforms.

A Resilient but Puzzling Macro Story

Economic growth has already recovered following a very painful first quarter. While export growth will remain in negative territory for some time, it has little impact on the overall contribution of net exports to growth as imports have also collapsed, reflecting the nature of processing trade in the electronics industry. Domestic consumption has moderated in the first half of the year, but this should prove to be temporary. Inflation has sharply come down, despite still strong (but moderating) credit and money growth. We expect the current output gap will also keep inflationary pressures limited. Under a risk scenario of much higher food prices, driven by potentially adverse weather conditions and higher global energy prices, inflation may come back; but, regardless, there is little risk that the central bank will be the first to hike rates in the region. Compared to other Asian countries, the sudden surge of capital flows is much less problematic for the Bangko Sentral ng Pilipinas (BSP). There is no untenable pressure on asset prices and the capital account inflows remain manageable. Even though, BSP will likely continue intervening to keep the PHP within its comfort zone, this should prove sustainable.

The current account balance remains very comfortable and external debt well under control. Workers' remittances have been much stronger than anticipated. The latest monthly data shows growth above 9% y/y, even from an already high base. Although officials have given many reasons why remittance growth remains robust, we think there are other important factors that should be considered as well. Of course, Filipino workers' remittances enjoy a diverse geographical base and are generally less exposed to cyclical positions overseas than other emerging markets, especially Latin America (i.e., overall much less exposed to US risk). And yes, the Philippines deployment rate remains very strong, not only to the Gulf Countries, but also to other Asian countries.

Still, we are convinced that other factors are playing an important role. With much lower fees from local banks and improved accounting practices, more workers' remittances are being channeled through the formal banking sector. Thus, the overall benefit to the economy seems to be a bit overestimated. Also, this resilience has been largely driven by one-off factors, with overseas Filipinos repatriating money during the financial crisis due to a sudden loss of confidence in international banks. To this extent; the Philippines ironically became a domestic safe heaven. Overall, while we see no reason for workers' remittances to collapse in the coming quarters, y/y growth may not continue to accelerate even as the global economy

recovers. The risk is that investors have taken robust remittances for granted, future expectations are set too high.

ROPs spreads are now back to roughly pre-crisis levels. Once again, local banks and financial institutions have been massively buying Philippines external debt, reflecting the strong domestic dollar liquidity. While spreads may widen again ahead of the elections, Philippines external debt is likely to remain much less correlated with global risk appetite than other emerging markets, chiefly owing to its ownership structure.

Little Risk of Fiscal Slippage Ahead of the Elections

Like most countries throughout the world, the Philippines fiscal deficit has increased. It may reach 4% of GDP in 2009. Many investors have recently expressed concerns that the pre-election period may lead to much stronger spending growth, even as revenues would continue to contract. Indeed, revenues will remain weak in coming months as many well-needed tax reforms are put on hold ahead of the elections. Still, a surge in spending is unlikely. Ironically enough, the opposite may be true. Fiscal institutions have taken some policy measures to avoid any new infrastructure projects ahead of the elections. Overall, the fiscal deficit is likely narrow in 2010, driven by a recovering economy and lower spending growth. Moreover, funding the deficit remains very well managed, with rising local currency funding (potentially reaching 60% of total funding by 2010) as domestic liquidity is ample and external funding conditions remain very favorable. This is a sea-change compared to few years ago when, at that time, the Philippines had to rely chiefly on huge and costly external debt issuance.

The key uncertainty is the election. It is too early to predict the outcome but, so far, the outlook seems comforting. Senator Aquino ("Noy Noy") appears to be very well positioned in the polls, which would be very positive. While former President Estrada ("Erap") may be playing the role of the king maker, he is not currently in a position to be a legitimate contender as he is under a severe smear campaign, having been accused of ordering the murder of Salvador "Bubby" Dacer and currently charged in corruption cases related to PLDT. No candidate has put in place an economic agenda yet. Still, while we do not expect the type of euphoria comparable with SBY's reelection in Indonesia, we think that the worst should be avoided.

Hopefully, the presidential election will be an opportunity for the Philippines to reinvent itself. Even though recent economic policies have been sound and cautious, the big picture remains clouded by the fact that there is no clear medium-term agenda. The Philippines is missing a credible long-term development model. Relying on workers' remittances and niche export markets is not sufficient and might ultimately prove counterproductive. A broad-based tax reform is needed to unleash infrastructure investment and attract FDI in the resources sector. This will be the real challenge for the upcoming administration.

Jean-Charles Sambor

ECB Exit Hampered by Eurozone Divergence

Amid encouraging signs of economic recovery, monetary authorities across the globe are caught in a real dilemma: when and how to shift their policy towards “normalization” without tipping their respective economies back into recession. The ECB is no exception, but its task is further complicated by the heterogeneity of the Eurozone economies. Activity, the pace of recovery, and output gaps diverge strongly among the Eurozone Member States, which could ultimately generate highly contrasting inflation profiles. Moreover, the banking systems of the individual economies are in very different states of repair. These diverging trends are likely to become gradually less pronounced, but could still present a real headache for the ECB and force a slow pace of monetary policy normalization.

Eurozone Divergence

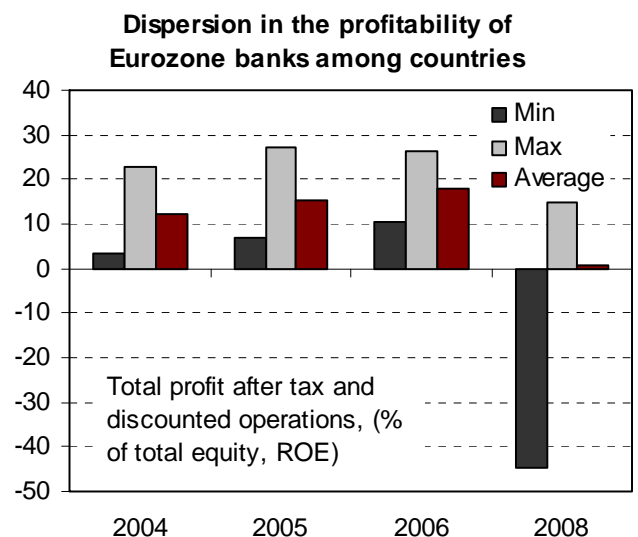
In Q2.09, Germany and France technically emerged from recession, whereas Spain and Italy saw growth fall for a 5th consecutive quarter. Recent surveys suggest this diverging trend is likely to continue in upcoming months. In line with sales, a divergence in prices is becoming increasingly apparent; in particular the difference in underlying inflation (excluding food and energy) has intensified over recent months. This is partly due to temporary factors such as the upturn in the automotive sector (as a result of the cash for clunkers program) and the huge inventory correction. However, the crisis appears to have weakened the Eurozone countries to a varying extent, reflecting their structural differences.

- **The real estate sector and net household debt.** In some countries (Germany, Italy, etc.), the real estate sector was not overbought. In Spain and in Ireland, the real estate bubble burst, leaving households – heavily in debt and paying down mostly variable-rate mortgages – in an even more fragile financial situation.
- **Vulnerability to international trade.** Since 2000, Germany has snapped market share from other Eurozone countries, thanks to astute sector and geographical positioning, as well as a strategy of keeping wages in check. Germany had become heavily reliant on exports and suffered the most from the plunge in international trade. But today, it stands to gain the most from the turnaround as well as from its exposure to Asia (45% of exports from the Eurozone to China stem from Germany).
- **State of public finance spending.** The Stability Pact cannot be credited with much effectiveness, and even before the crisis public sector debt between Member States diverged greatly. In Italy, high public debt (106% of GDP in 2008) had left very little flexibility for policy stimulus, whereas France (68%), Germany (66%) and especially Spain (40%) have been able to bolster economic activity thanks to substantial stimulus plans.
- **Structure of the labor market.** The adjustment in the unemployment rate varied greatly by country, based partly on the degree of flexibility embedded in each country’s labor market structure. In Spain, the high proportion of

temporary work accounted for a significant increase in the unemployment rate (from 8% to 18%) and weakened the financial situation of households at the same time. In Germany, use of temporary layoffs (part-time work) strongly limited job losses.

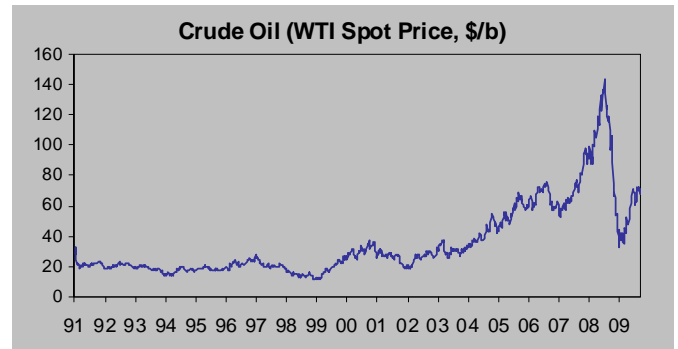
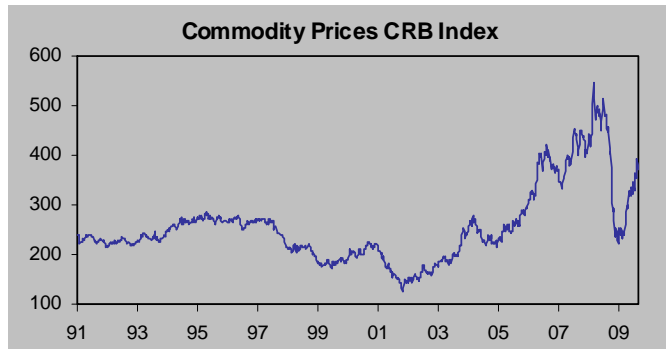
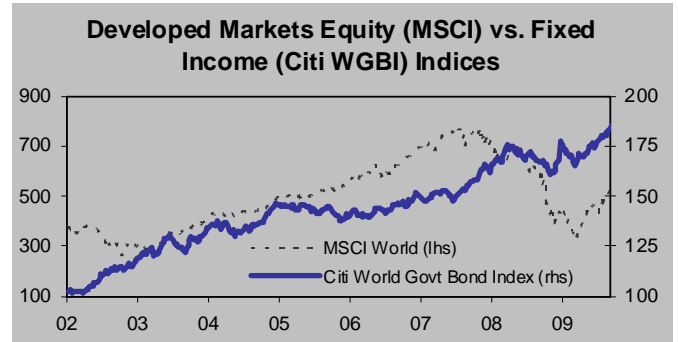
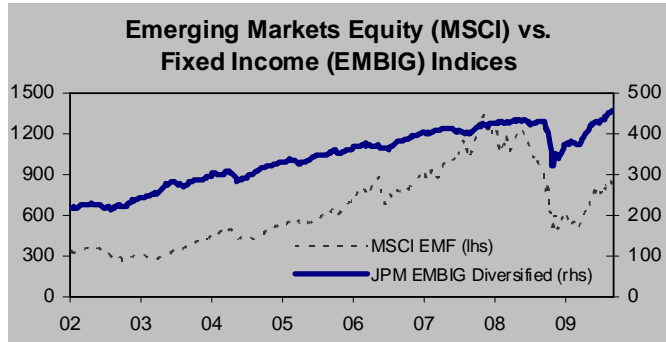
The ECB Faced with Diverging Reactions

The two-tiered pace of economic recovery among the Member States of the EU has complicated the ECB’s task. The ECB will need to “normalize” its monetary policy – in particular, formulate an exit strategy from its recent unconventional policies, which in itself is not simple. And, the ECB will have to accomplish this faced with the significant economic differences among the Eurozone countries. However, the most difficult task at hand for the ECB could well be the heterogeneity of the banking systems within the Eurozone. The latest Stability Review by the ECB mentions the gap in profitability (cf. chart below) which is likely to widen owing to the deterioration in the financial situation of households.



In the short term, the divergence among the Eurozone countries is likely to continue, with close to zero growth in Spain and Italy in 2010, and growth of over 1% in Germany and France. However, this cyclical divergence is set to fade gradually. The labor markets in Germany and France stand to worsen in late 2009 and in 2010; whereas public sector spending cannot continue to underpin economic growth indefinitely (Spain is already considering spending cuts). All the Member States stand to gain from the turnaround in international trade in the long term and no doubt the ECB will “normalize” its monetary policy. However, the ECB will have use caution and move progressively in light of the heterogeneity of the Eurozone economies. In the long term, the ECB will also have bear in mind their ongoing structural differences (e.g. the real estate sector), so as to not create new bubbles in some countries.

Clémentine Gallès



Select Global Exchange Rates As of September 23, 2009

	F/X Rate	% Ch. WoW	% Ch. YTD	Year End			
				2008	2007	2006	2005
		Local Currency Appreciation/Depreciation					
USD/EUR	1.48	0.8%	6.2%	1.39	1.47	1.32	1.18
USD/GBP	1.64	-0.3%	12.5%	1.46	2.01	1.96	1.72
GBP/EUR	0.90	-1.1%	5.9%	0.95	0.73	0.67	0.69
JPY/USD	91.29	-1.0%	-0.7%	90.64	112.04	119.16	117.75
JPY/EUR	135.0	-1.7%	-6.5%	126.1	164.9	156.9	139.5
CHF/USD	1.02	1.2%	4.3%	1.07	1.12	1.22	1.31
CHF/EUR	1.51	0.5%	-1.8%	1.49	1.65	1.61	1.56
Asia Pacific							
CNY/USD	6.83	0.0%	-0.1%	6.82	7.29	7.80	8.07
IDR/USD	9700	0.2%	12.4%	10900	9393	8994	9830
KRW/USD	1207	-0.1%	4.6%	1262	936	930	1010
PHP/USD	47.45	1.3%	0.2%	47.55	41.28	49.01	53.09
TWD/USD	32.40	0.1%	1.1%	32.76	32.43	32.59	32.83
THB/USD	33.68	0.1%	3.1%	34.72	29.50	36.10	41.03
INR/USD	48.02	0.4%	1.2%	48.58	39.41	44.11	45.05
Latin America							
ARP/USD	3.84	-0.3%	-10.1%	3.45	3.15	3.07	3.03
BRL/USD	1.79	0.4%	30.1%	2.33	1.78	2.14	2.34
CLP/USD	539.4	1.1%	18.2%	637.3	498.0	532.3	512.0
COP/USD	1915	2.1%	17.4%	2249	2017	2240	2287
MXN/USD	13.25	-0.5%	4.4%	13.83	10.92	10.80	10.63
VEB/USD	2.15	0.0%	0.0%	2.15	2.15	3.34	2.15
EMEA							
CZK/EUR	25.24	0.0%	6.5%	26.88	26.63	27.49	29.09
HUF/EUR	271.3	-0.5%	-1.7%	266.7	253.7	251.8	252.7
PLN/EUR	4.19	-1.3%	-0.9%	4.15	3.59	3.83	3.85
RUB/USD	29.98	2.0%	1.9%	30.54	24.54	26.33	28.74
ZAR/USD	7.43	-1.5%	25.1%	9.30	6.86	7.04	6.33
TRY/USD	1.48	-0.6%	4.0%	1.54	1.17	1.42	1.35

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