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The Voice of Workplace Super

What is QEP and What Does it Mean:

Flat-lining Economies but the Devil Finds Work.....

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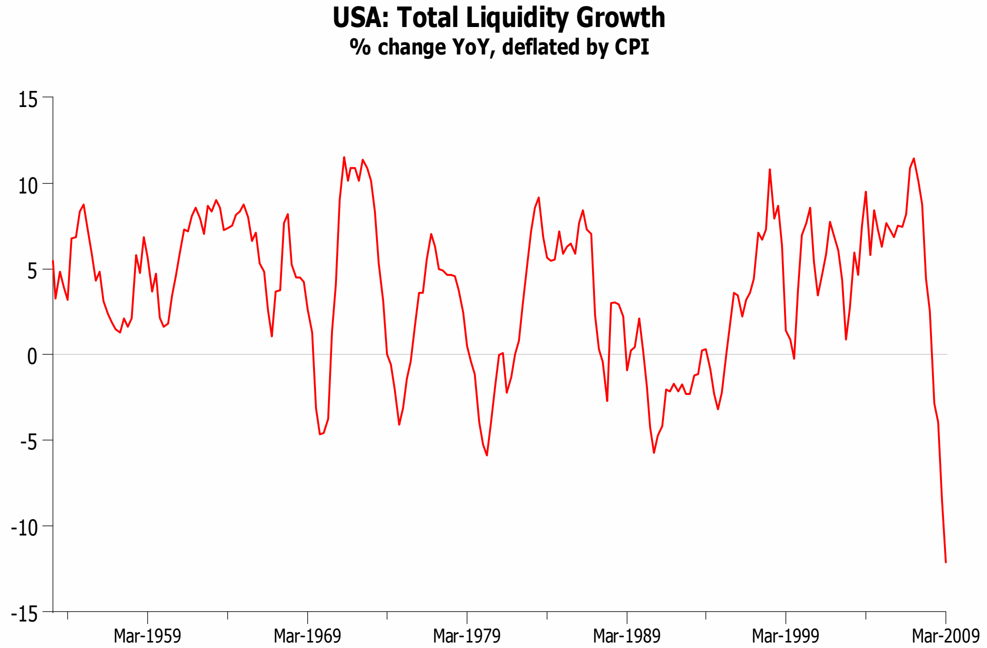
Data Cut-off 27th July 2009

USA: Record Contraction

- If we look at a 'wide definition' of 'liquidity' we find that last year's contraction in the US nominal 'money supply' was the worst and most rapid on record.
- This measure of money includes not just the liabilities of the commercial banks but the investment banks as well.
- Given this situation, it is not surprising that many central banks around the world have turned to 'extraordinary measures' in order to attempt a rescue. The most prominent of these have been the so-called Quantitative Easing Policies.



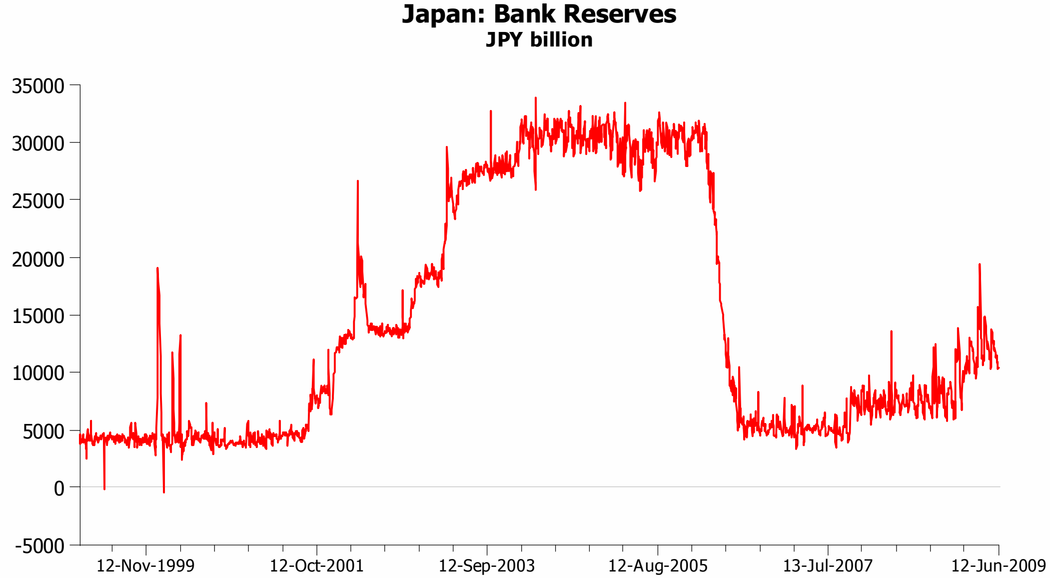
Source: CEIC

'ryoteki kinyu kanwa'

- The term Quantitative Easing is the direct translation of a phrase which entered into the Japanese press in the mid / late 1990s. Rumours suggest the phrase was originally coined by a Japanese-fluent Sudetenland German!
- It has no particular theoretical basis but it evidently sounded better than 'under-funding' or 'printing money'.
- We believe the phrase 'printing money' originated with the Bank of England's funding of Wellington's campaigns in the Peninsula – people received the product of a printing press in exchange for standing in a line and being shot at – hence some of people's knee-jerk concerns over the practise?
- However, in a de-leveraging complex modern banking system, the term printing money has little relevance.
- ***Crucially, the term QEP is not exact – it does not have a rigid format.***

Japan's Experience with QEP

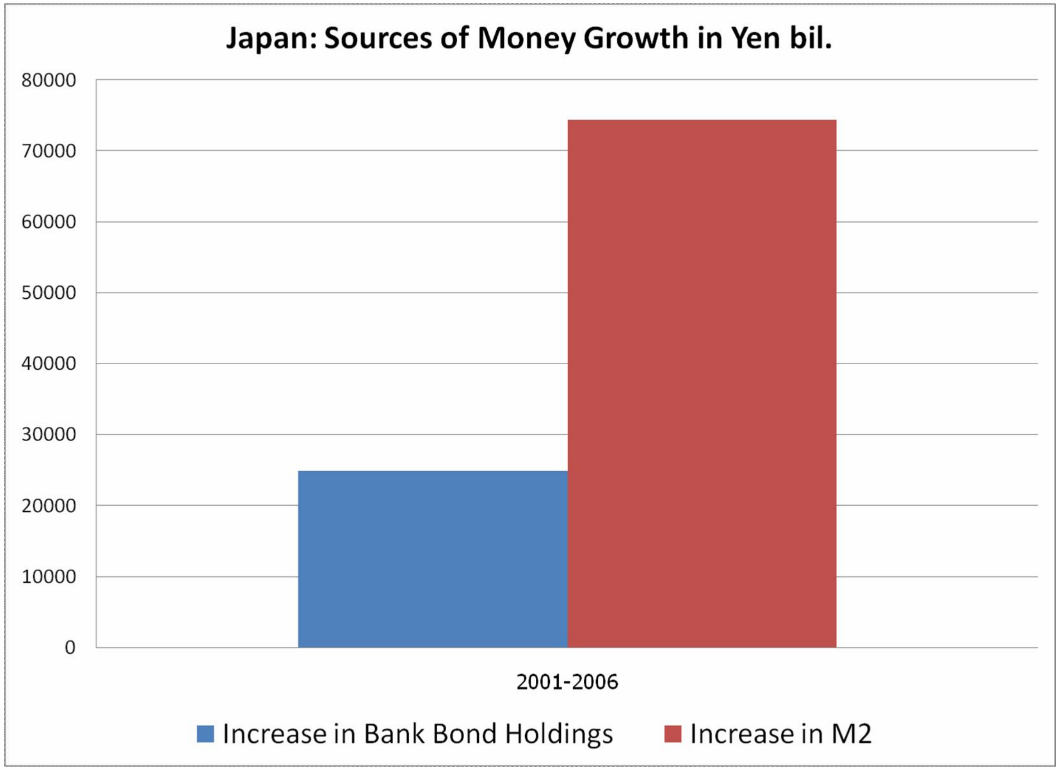
- When the Bank of Japan introduced its QEP in 2002, it was seen as something of a sleight of hand by the BoJ staffers.
- The commitment to force reserves into the banking system, which the banks then held as excess reserves, made no effective difference to the supply of liquidity to the banking system. Under the Zero Rate Policy the banks could borrow elastically whatever they wanted anyway....
- However, what the QEP did signal was that the BoJ could not raise short term interest rates without first abolishing the QEP.
- **The QEP was actually a price signal or 'commitment' not a quantity measure**.



Source: CEIC

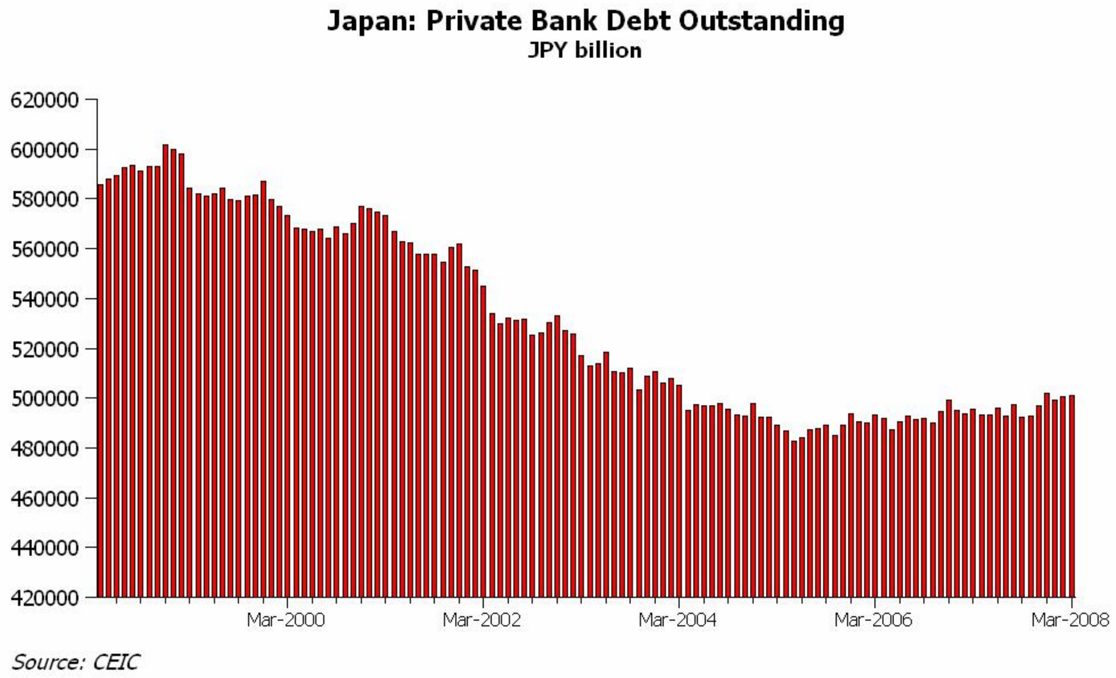
Japan: Monetising Bonds

- What the QEP did in reality was to anchor Japanese interest rates expectations at zero and this allowed Japan's banks to borrow from the BoJ and to profitably acquire Japanese Govt Bonds with the proceeds.
- As the BoJ and the commercial banks purchased JGBs, they not only funded the budget deficit and improved their own capital positions, they also created new liquidity in the economy.
- In fact, we estimate that the 'monetisation' provided around 30% of Japan's monetary growth in the 2001-2006 period.



Japan: Deleveraging Destroys Money

- However, we might argue that Japan did not monetise enough bonds, given that the acting of deleveraging the Zaitech and other speculative funds destroyed perhaps a third of Japan's money supply....
- This is one reason why Japan's monetisation did not lead to inflation (the other being weak capacity utilisation).



Japan: QEP In Reality

Combination of QEP and ZIRP leads to anchoring of short term rates at zero.

Banks ride JGB Curve

Banks acquire foreign assets

Depresses yen but boosts global liquidity growth

Improves bank profit & capital

Funds budget deficit

Creates Money

Govt gives money to weak parts of economy

Stable Money Suppy

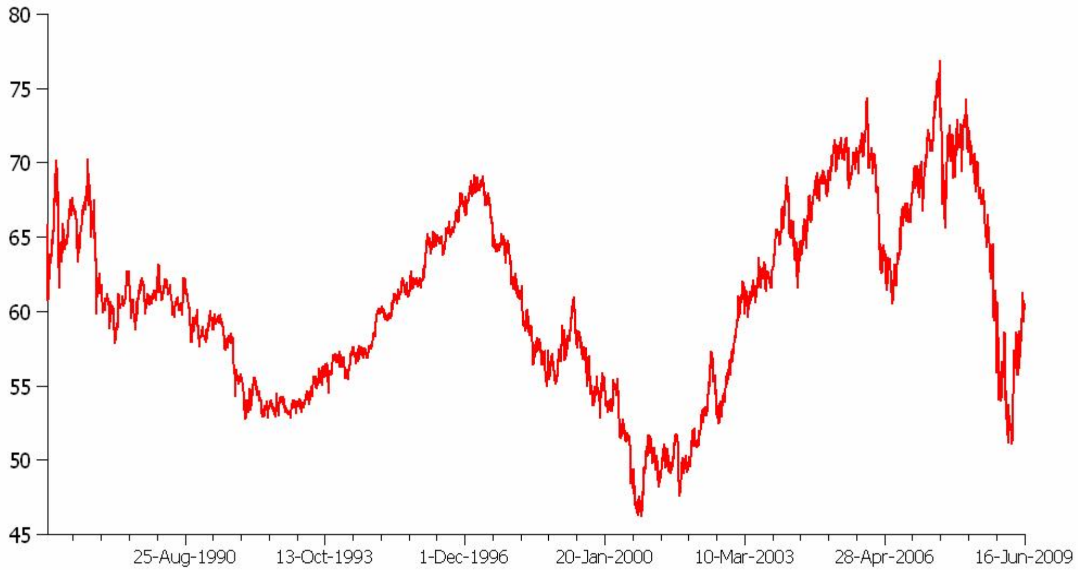
Companies repay Debt strengthen b/s but destroy cash

Destroys Money

Switzerland and NZ: Expensive Cows

- However, there are other versions of QEP. The ECB is buying private sector bonds in order to force yields down on long term corporate debt.
- The Swiss authorities have become concerned about the strength of the currency and its effect on the profitability of their tourism, manufacturing and agriculture sectors.
- The New Zealand authorities fear a crisis in their dairy sector following the previous speculative boom and impact of US dairy subsidies.
- Both central banks are promising unsterilized intervention in their currencies – in reality nothing more than competitive devaluations disguised under a QEP banner (exactly what we would do...).

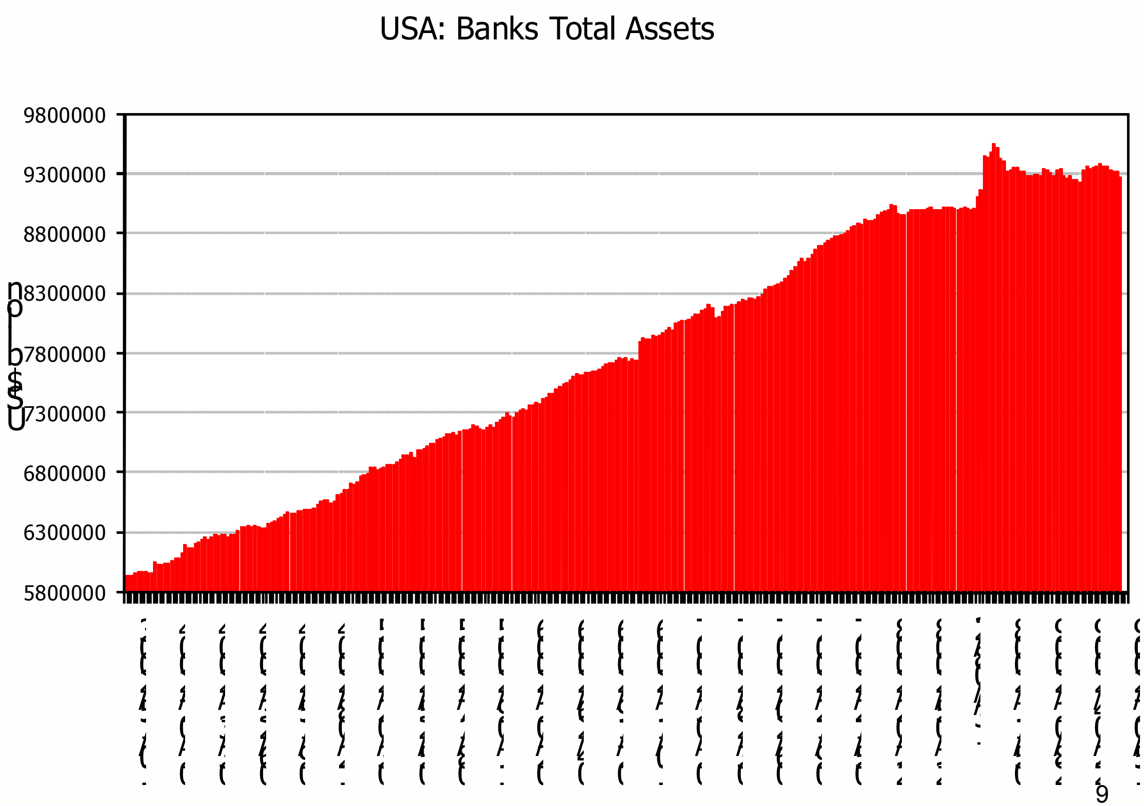
New Zealand: Trade Weighted Exchange Rate



Source: CEIC

USA: No Respite for Commercial Banks

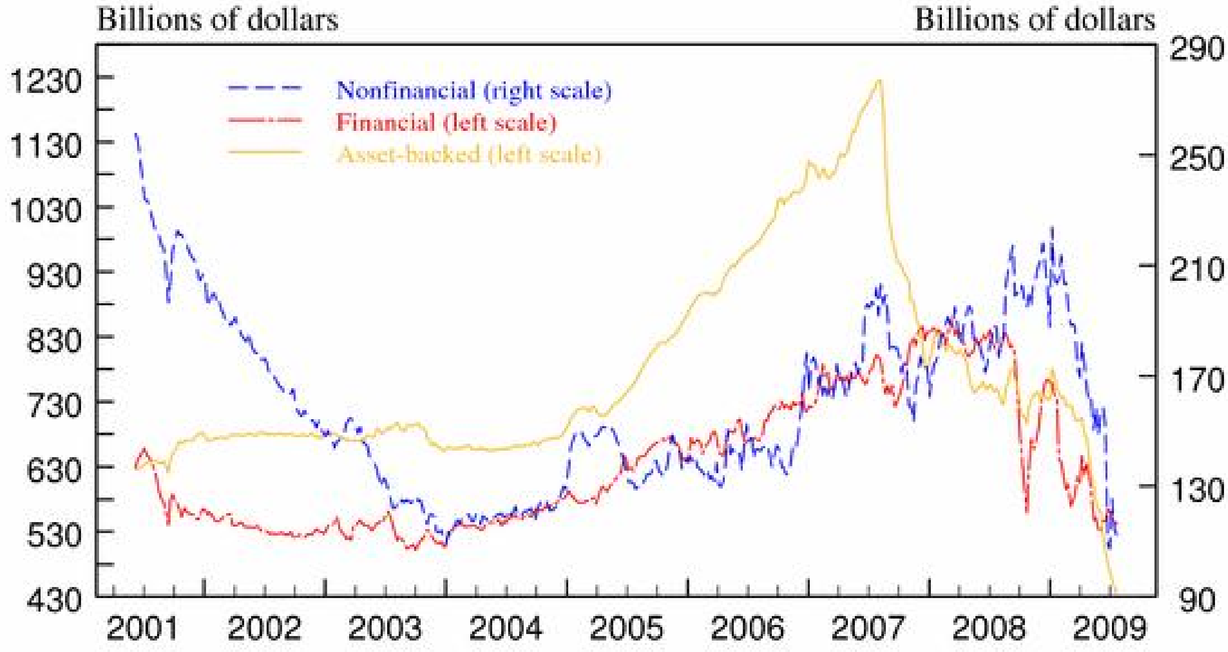
- Despite the Fed's use of a QEP, this year has so far seen no improvement in trends in the US commercial banks – they are still suffering from shrinking balance sheets.
- The US commercial banks are neither lending to the real economy *nor yet helping to fund the budget deficit on a consistent basis*.
- Judged by this yardstick, the US QEP has failed.



USA: Commercial Paper Wilts

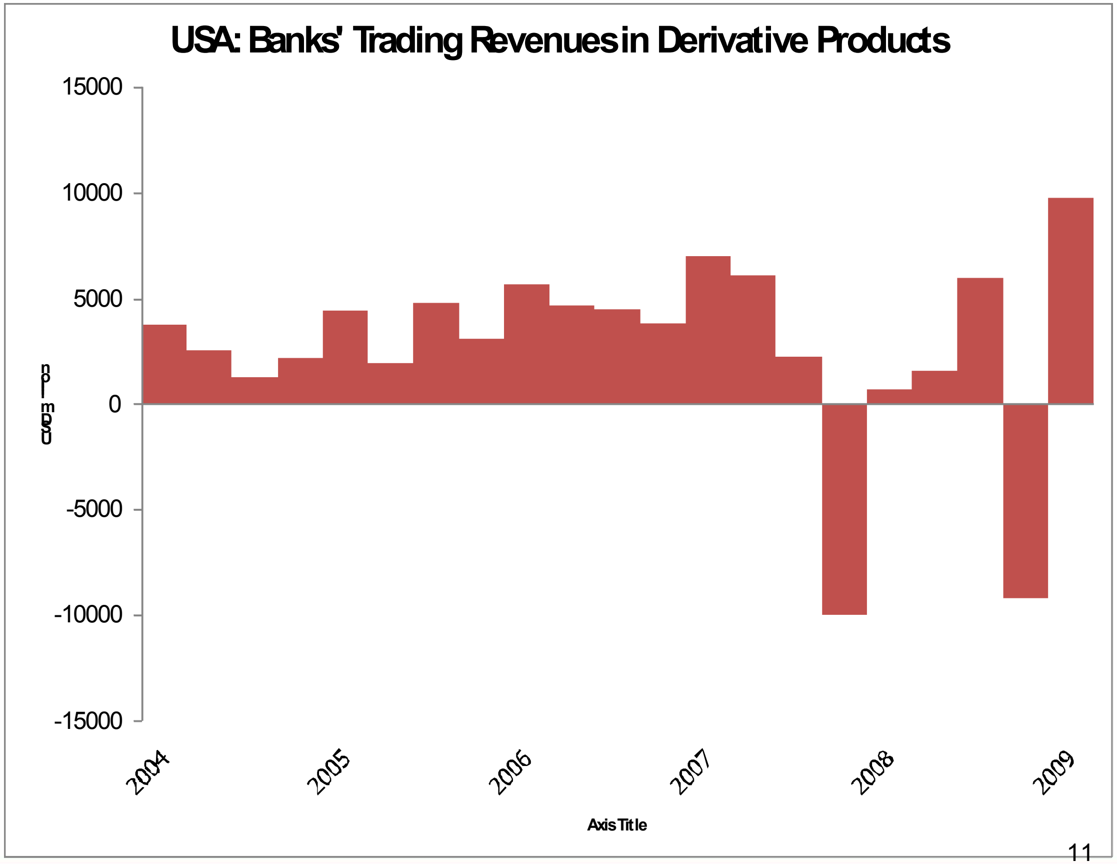
- One of the other targets of the US QEP was to revitalise the commercial paper markets.
- *This component of the policy also appears to have failed.*

CP Outstandings, seasonally adjusted
Weekly (Wednesday), seasonally adjusted



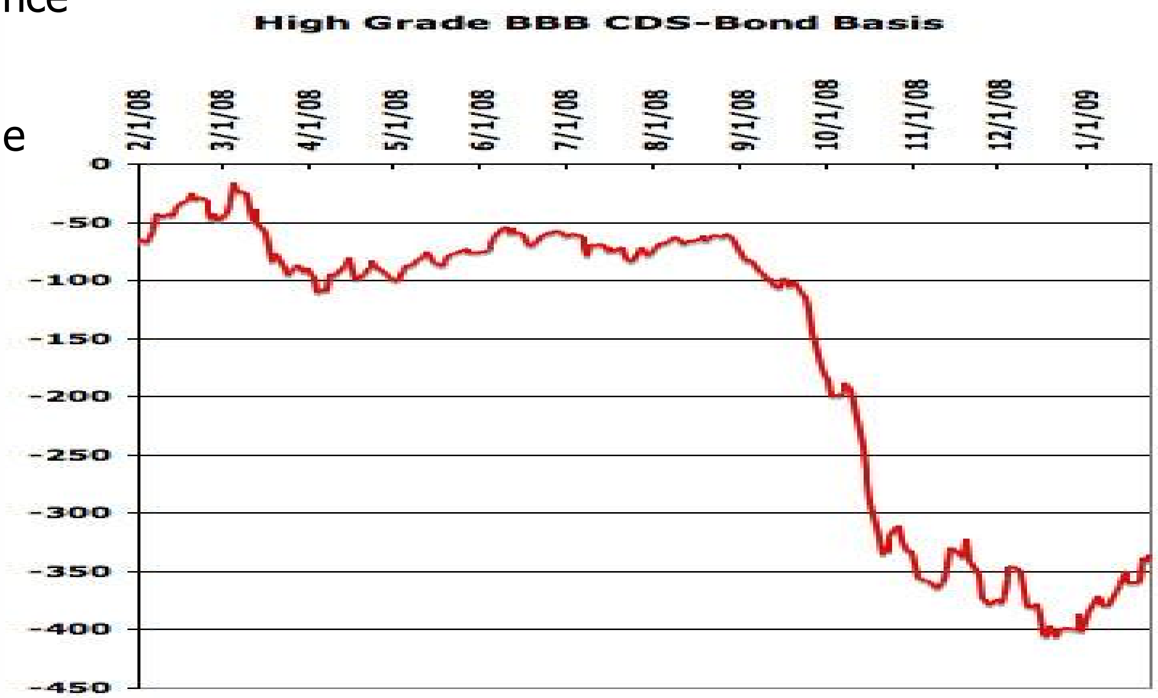
USA: The Boys are Back In Town…

- However, there is one area in which the US QEP has proved to be spectacularly effective.
- These institutions were able to borrow from the Fed at virtually zero cost under Section 13 of the FRB Act and it seems that they have put this money to work effectively – as their recent results have testified.
- We believe that the US investment banks began expanding rapidly in 2009H1 again and they may have even restarted a credit boom in the OTC derivatives markets.



USA: Arbitrage into Cash Markets

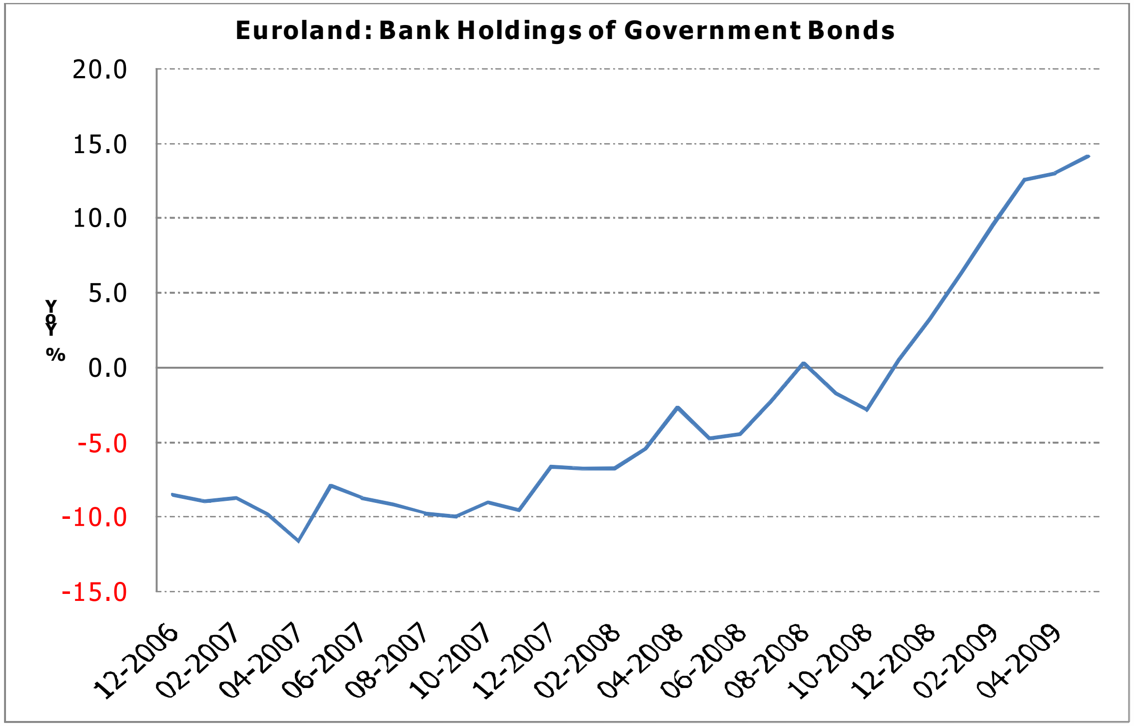
- In fact, the derivative markets became so active that funds returned to the cash markets.
- Hence, the investment banking boom implicitly reflated the cash markets and even allowed corporate bond issuance to recover.
- The corporate bond market became perhaps the 'only' credit channel operating in the economy.



Original source: JP Morgan, via CondeNast Portfolo.com

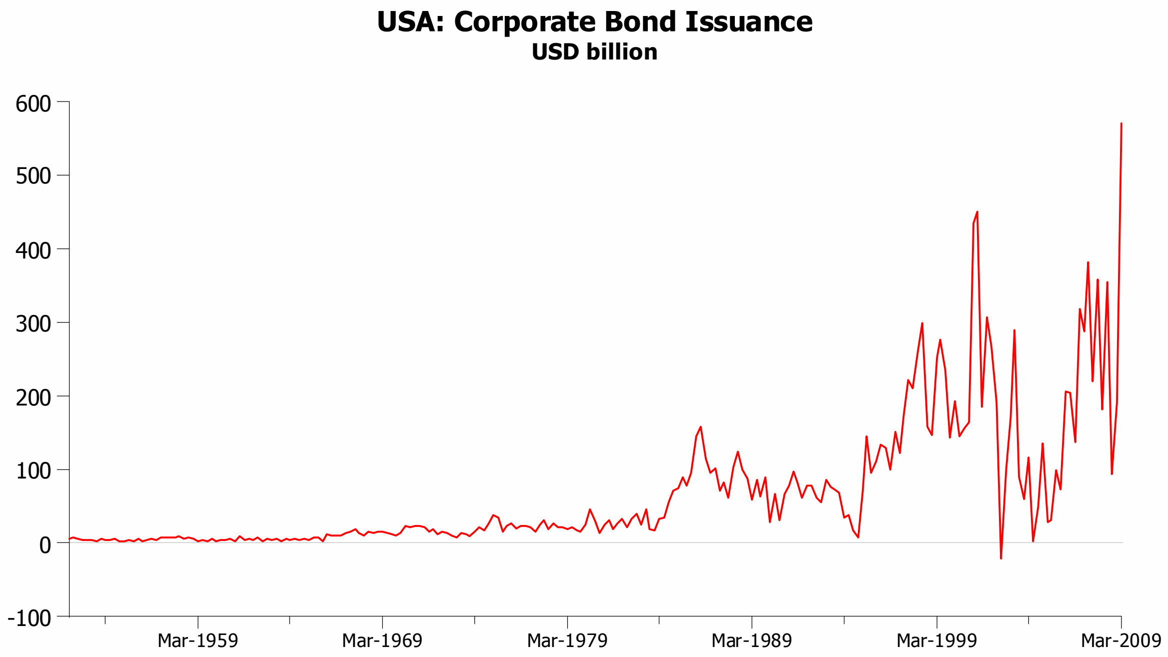
Europe: The Banks Return to Bonds

- In Europe, we have seen the commercial banks returning as enthusiastic buyers of domestic government bonds – a repeat of Japan's QEP 'success'?
- This action also created liquidity in the financial systems concerned.
- *We believe that it was these activities of the US investment banks coupled with the Euro Zone and to some extent the Japanese banks which caused a liquidity boom in global financial markets during 2009Q2.*



Global: Bond Issuance Improves

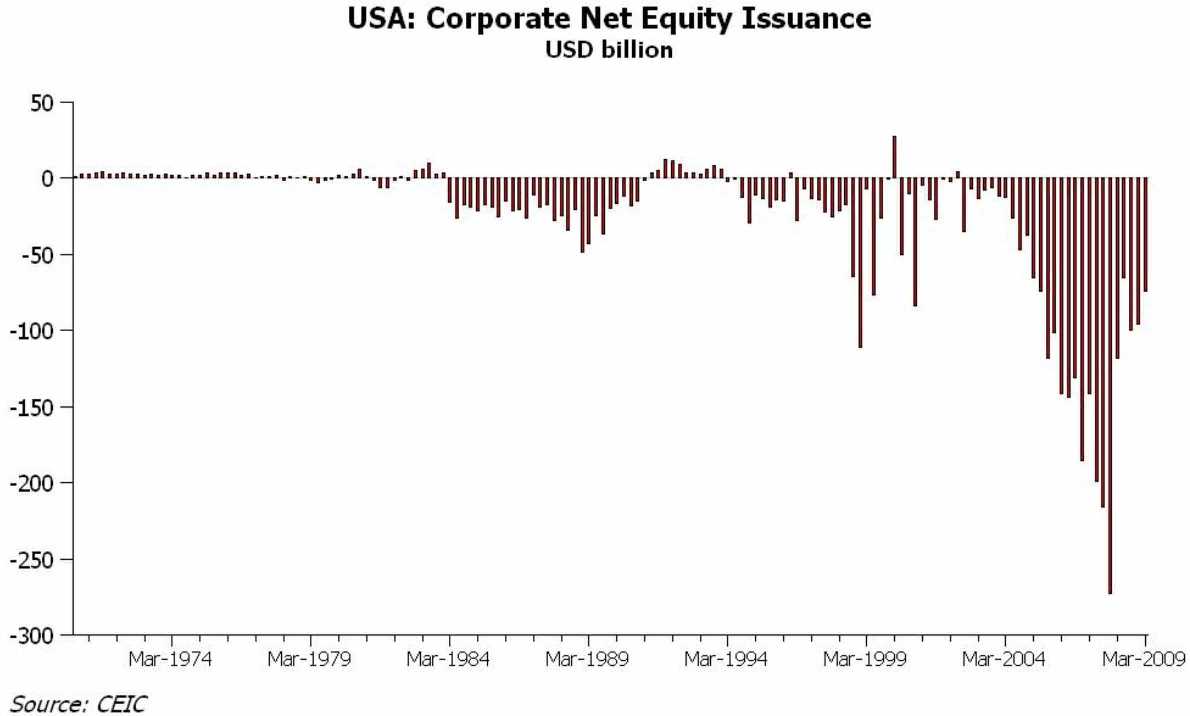
- In the US and Europe, the recovery in financial markets clearly allowed private sector bond issuance to improve – a useful if marginal benefit to the economy and to large cap companies in particular.



Source: CEIC

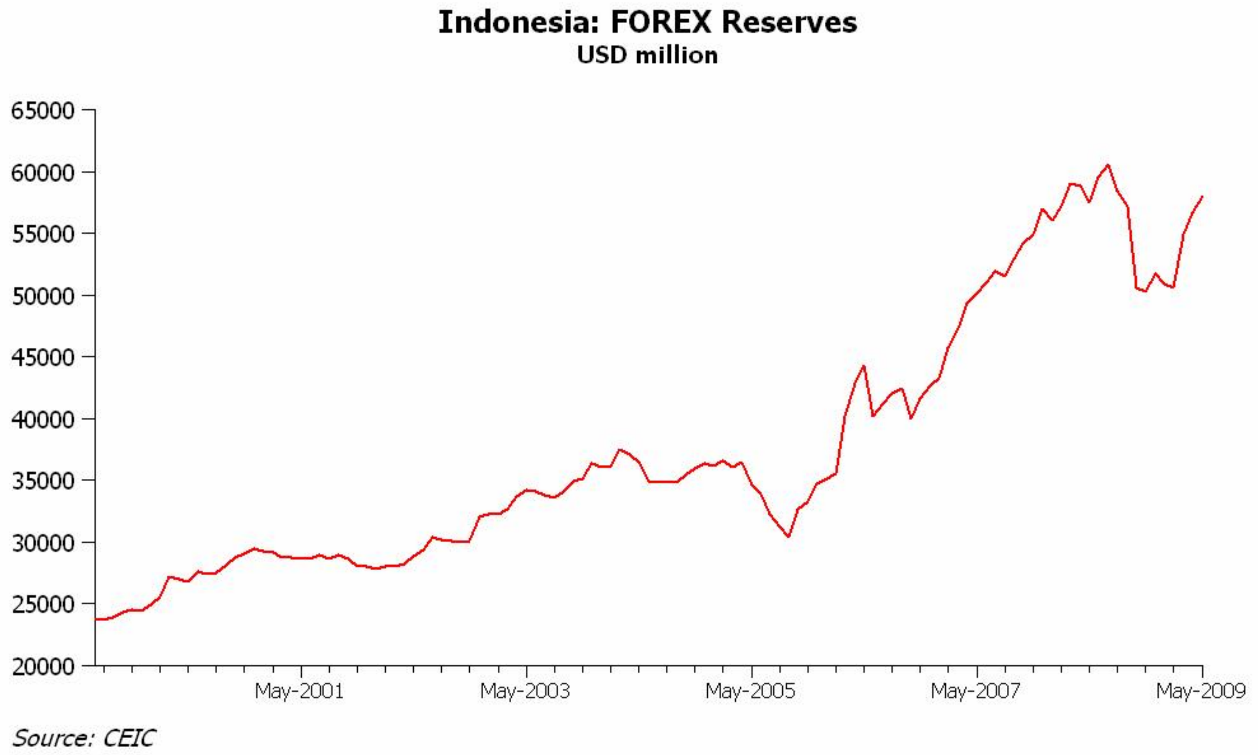
USA: Zaitech Returns Again?

- Having raised funds in the corporate bond markets, US companies used the proceeds to buy in yet more equity.
- Clearly this is good for equity prices – but perhaps not for the companies themselves.



Emerging Markets Gain

- But, in the Emerging Markets, the improvement in risk appetite was more significant in that it is boosted foreign reserves and hence domestic liquidity growth.
- The revival in global capital flows was a source of potential stimulus to the EM.



USA: Dealing With The Devil

- The Fed, however, is concerned about the growth in the derivative markets, the long term implications of creating another credit bubble and its own legal position vis-a-vis Section 13 of the FRB Act.
- Hence, it is now lending less to the investment banks but its situation is made even more complex by the government's large funding requirement which needs the FRB to remain accommodative.
- We expect the Fed to lend less but to buy more Treasuries going forward, a complex but probably less expansionary situation for global liquidity trends.

Federal Reserve Assets USD million

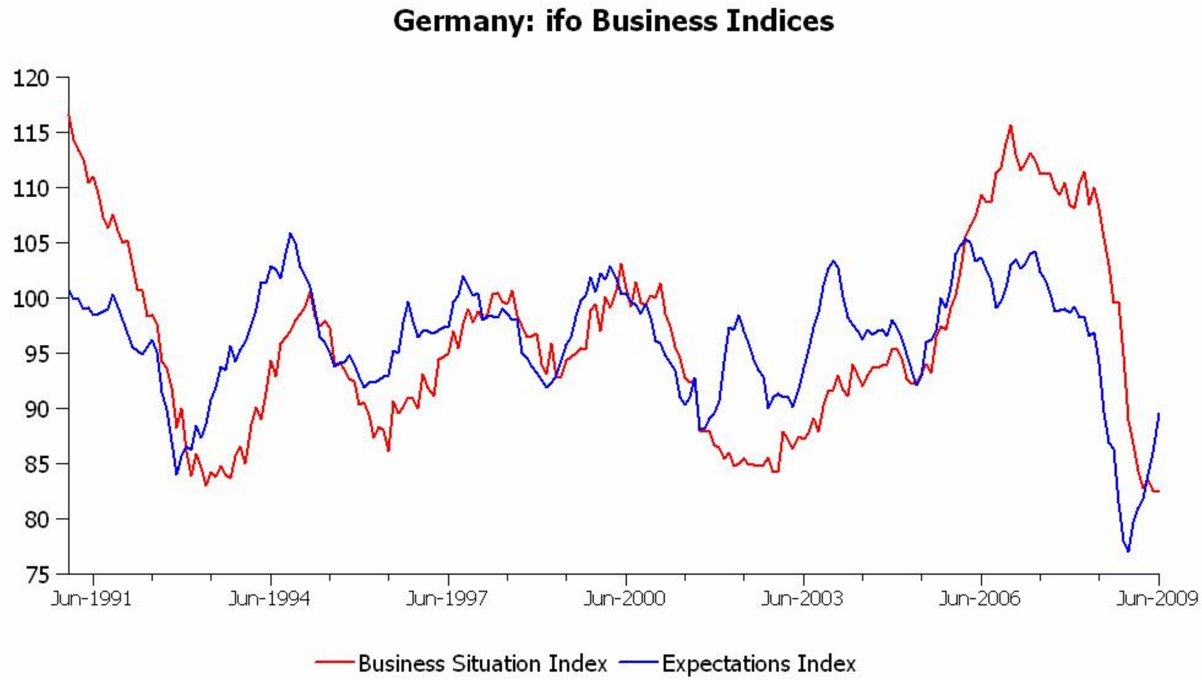
USA: Treasury Supply

- In fact, according to our calculations, the US Treasury is currently behind schedule with its bond auctions.
- A less generous FRB and rising Treasury supply do not bode well for financial liquidity trends going forward, although the FRB may be able to provide some support for bonds through the QEP.
- *Therefore, we suspect that markets will need to see concrete signs of an economic recovery to continue their rally.*

Source: CEIC

Global: A Triumph of Hope…

- Over recent weeks, financial markets have taken heart form a number of positive confidence surveys.
- However, we are struck by the growing dichotomy between expectations for a recovery and the current perceived reality of the situation.

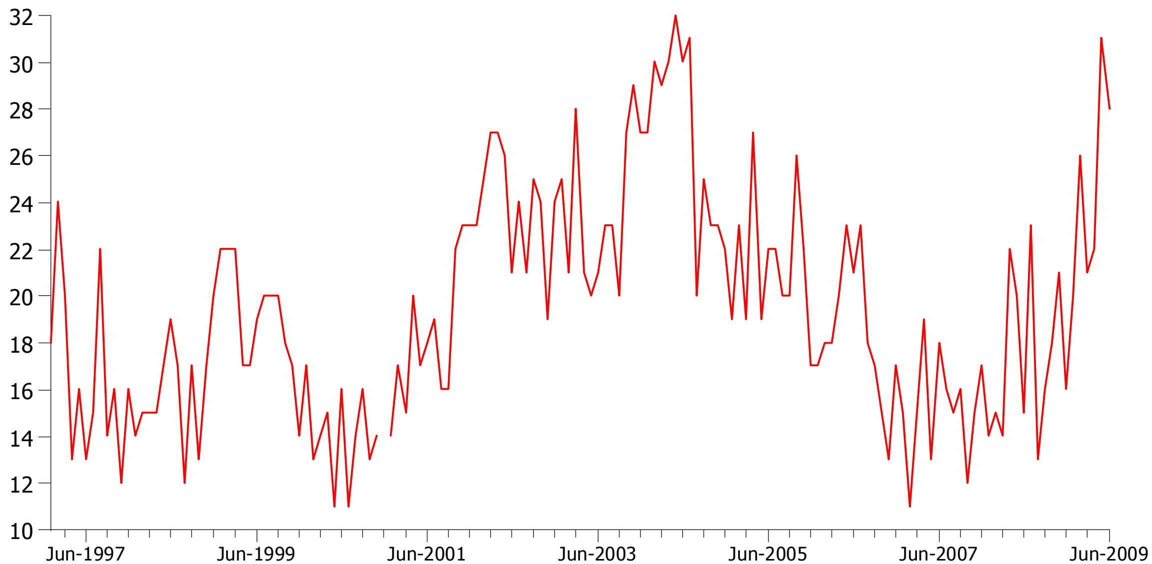


Source: CEIC

USA: A Manufacturing Recovery?

- There are signs of a limited rebuilding of inventories now occurring in parts of the US traded goods sector supply chain (particularly in the tech sector)

USA: ISM Inventory Index - # Reporting Too Low
index



Source: CEIC

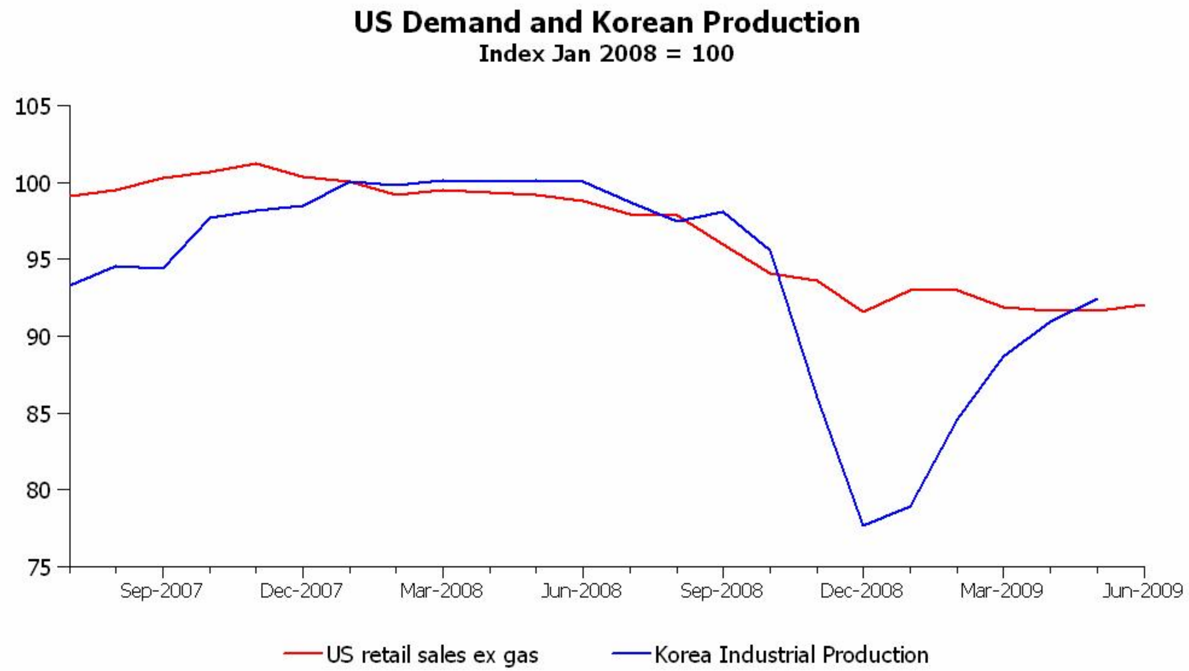
USA: Korea's Saviour

- However, we suspect that the main beneficiaries of any US stock-building will be foreign producers, since it was the latter were the counterparts to the de-stocking phase.

Source: CEIC

Global Production Re-Aligns

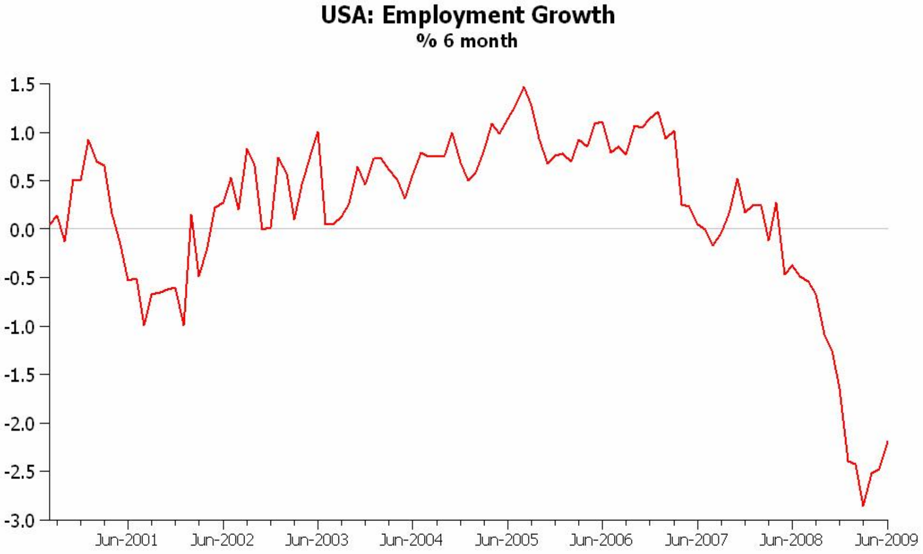
- In fact, there are now clear signs that following the reduction in inventories, production growth has re-converged on (weak) spending trends.
- Unfortunately, the trend in the latter is still weak but the adjustment in production from one level to another added 400 b.p. to Asian GDP.



Source: CEIC

USA: Non-Manufacturing Still Weak

- Meanwhile, the US non-manufacturing sector remains weak and employment trends remain absolutely weak.



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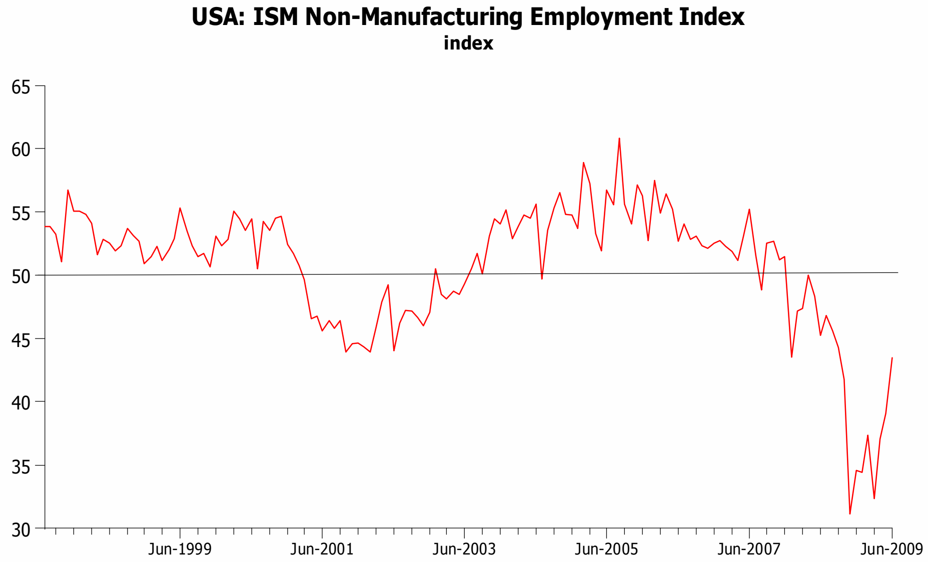


Source: CEIC

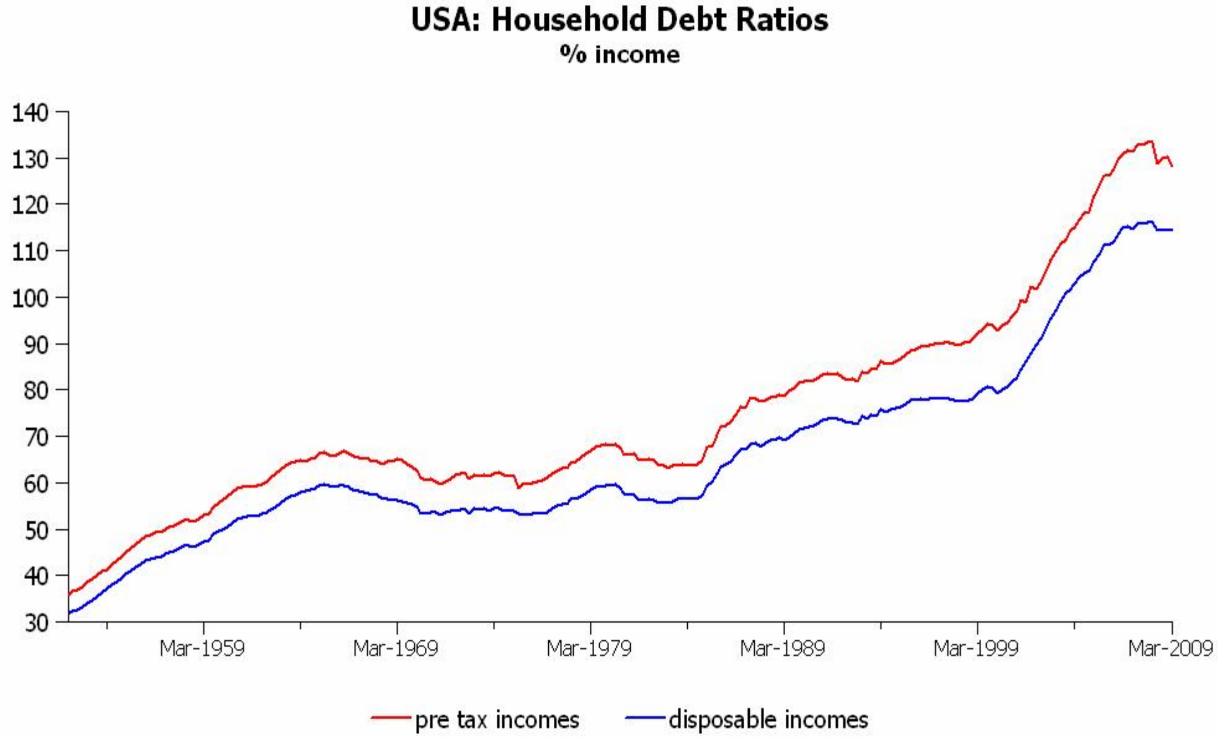
USA: Incomes Deflate

- In fact, US household incomes may now be deflating.

Source: CEIC

USA: Consumers Need to Save More

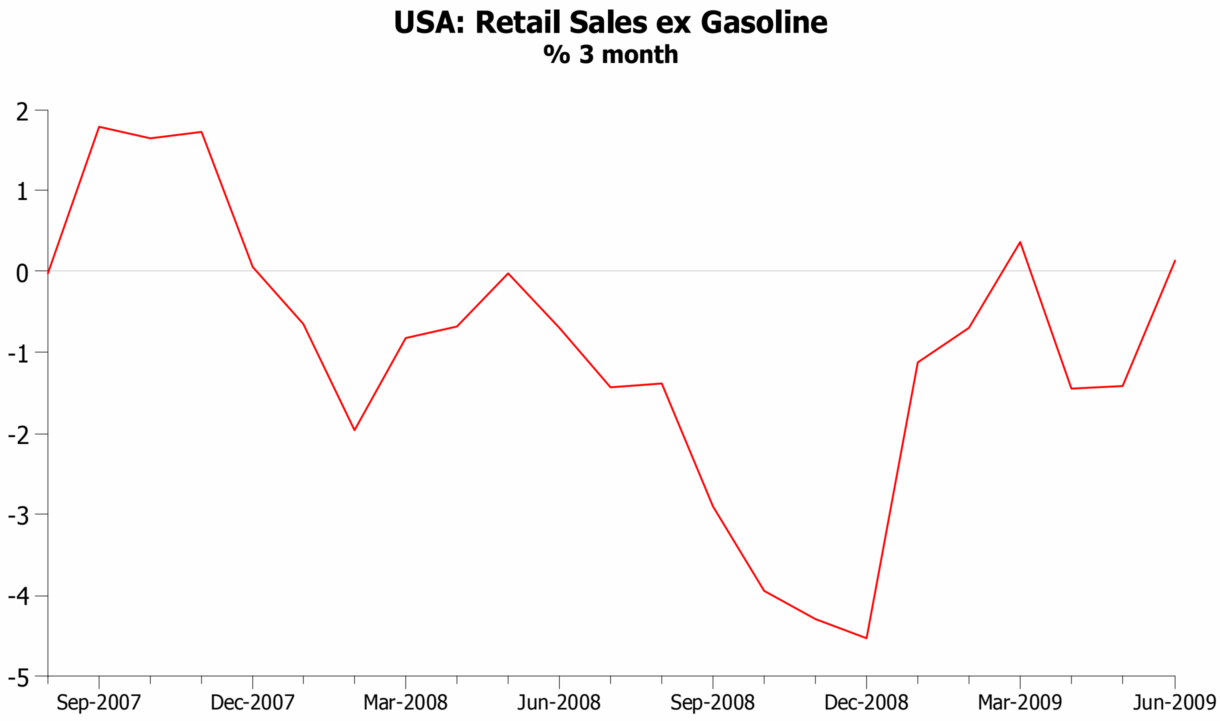
- Although US households have begun to repay some of their debts, they are not yet ‘saving’ at a fast enough pace to repair their balance sheets.
- Therefore, they must now try to save even harder even as incomes fall.



Source: CEIC

USA: Deflating Sales

- Consequently, we expect further falls in nominal spending over the next 12-18 months.

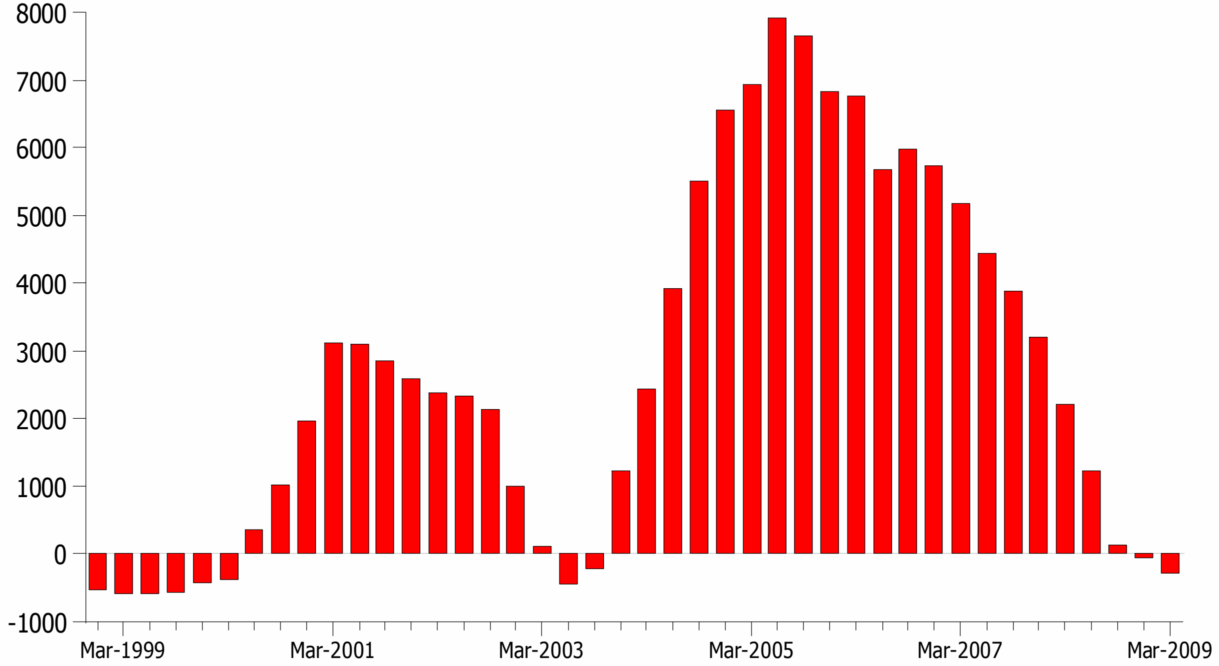


Source: CEIC

Japan: Fiscal Inaction

- In Japan, the authorities have not used fiscal policy for fear of incurring further large public debts which they are already encountering difficulties in financing.

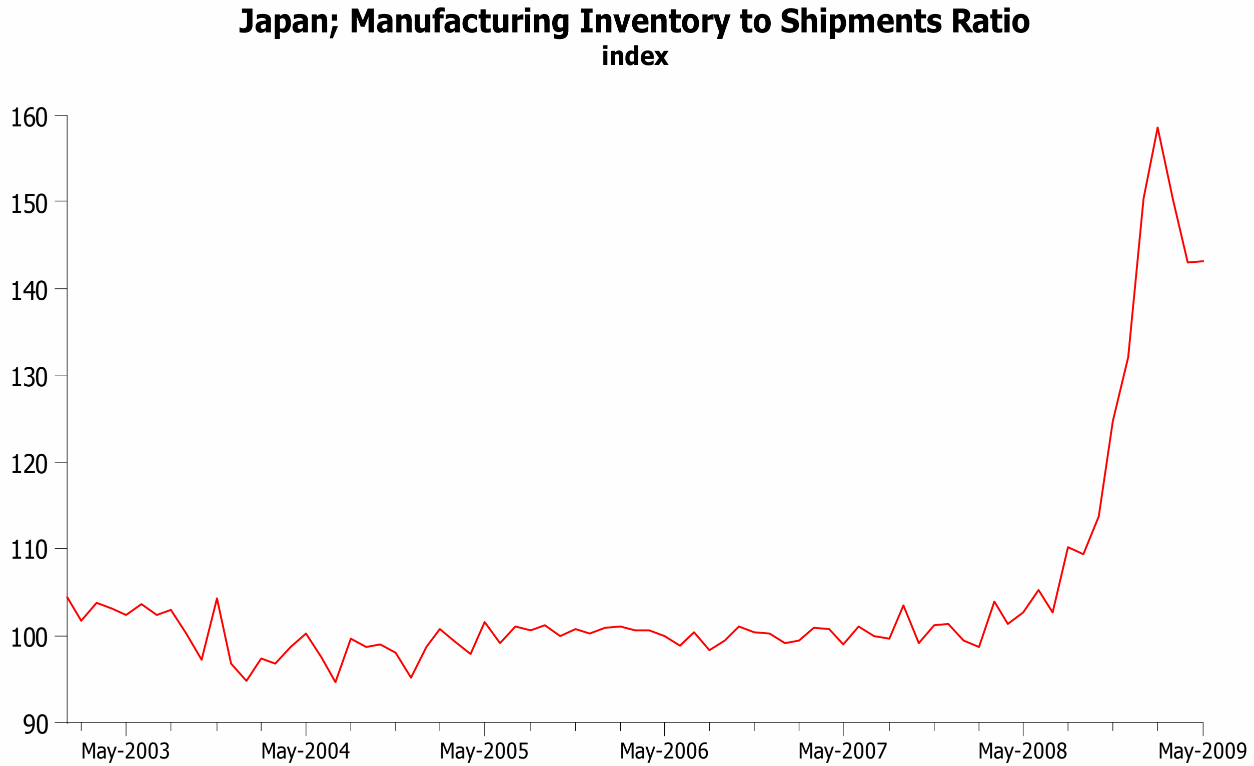
Japan: Household Sector Acquisitions of JGBs
JPY billion rolling 4Q sum



Source: CEIC

Japan: Manufacturing Bottoms

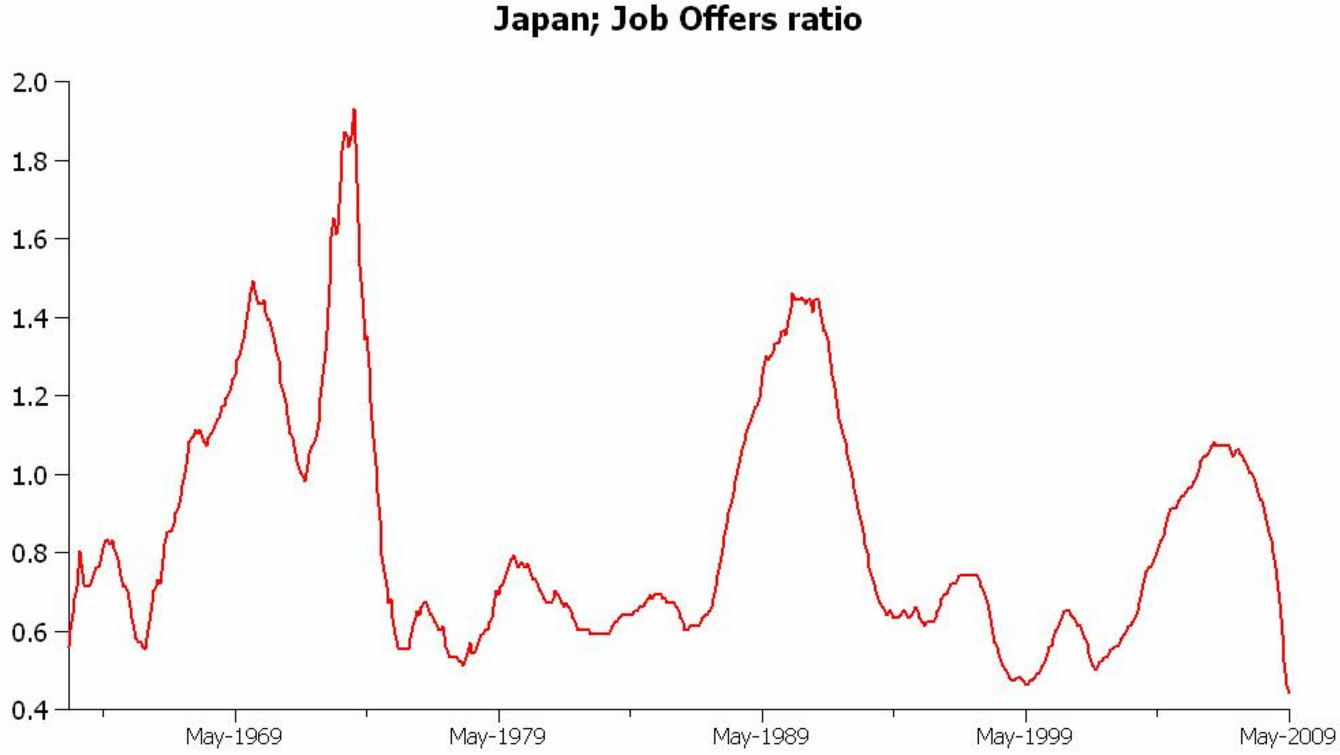
- Therefore, although there is some ‘good news’ beginning to appear in the manufacturing sector as the rate of decline slackens....



Source: CEIC

Japan: Domestic Economy Wilts

- ..the focus of the slowdown is now shifting into the domestic economy as weak corporate cash flow leads unemployment rates higher.

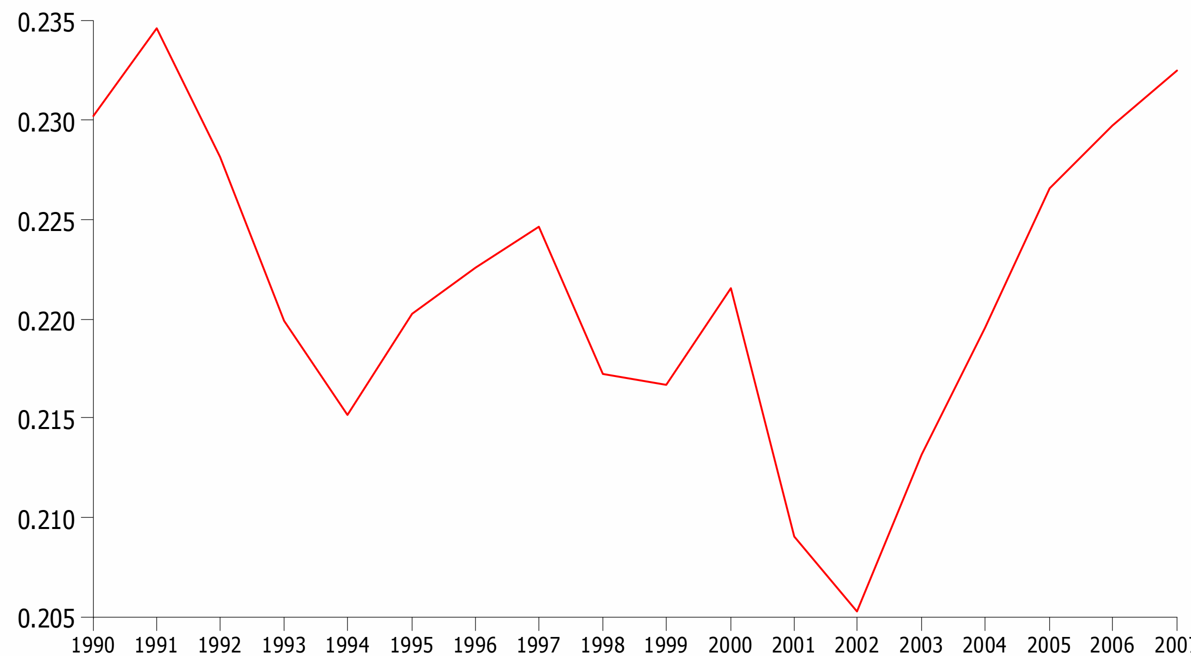


Source: CEIC

Japan: Restructuring Required

- In practice, we do not believe that Japan will be able to recover until it either restructures or receives a boost from a very weak yen.

Japan: Manufacturing Sector
% real GDP

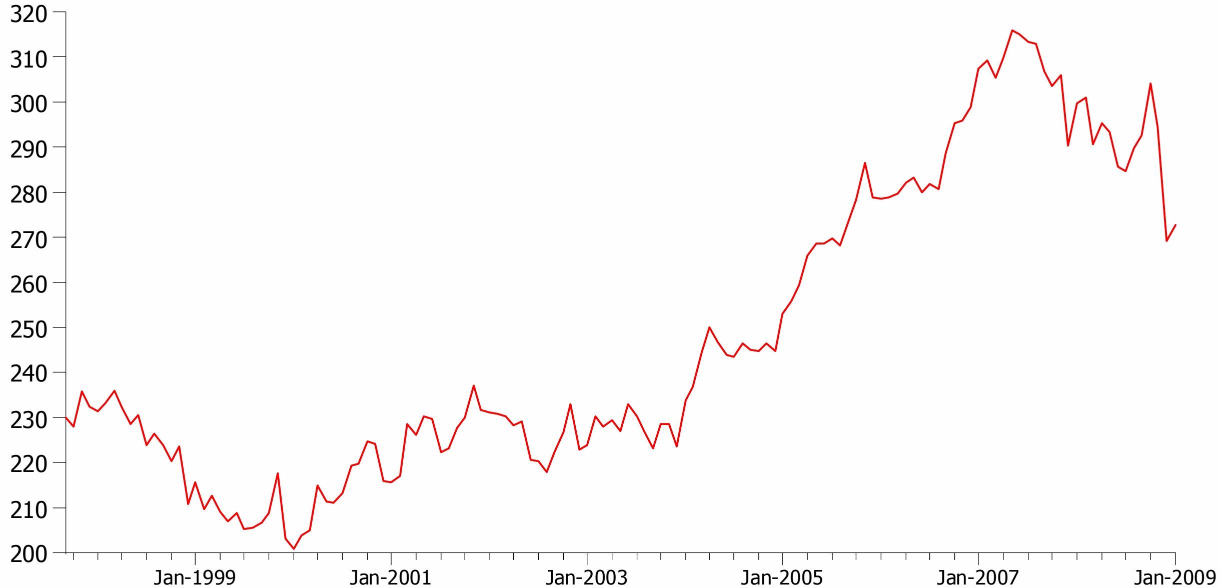


Source: CEIC

Euro Zone: The Banks are Insolvent

- The worst kept secret? Euro Zone banks have huge unmarketable positions in US structured finance that they cannot afford to sell.
- *These positions imply that the banks in reality have weak capital bases and a constant need to remit Euros in order to fund the positions.*

Euro Zone: Banks' Foreign Assets
% bank capital

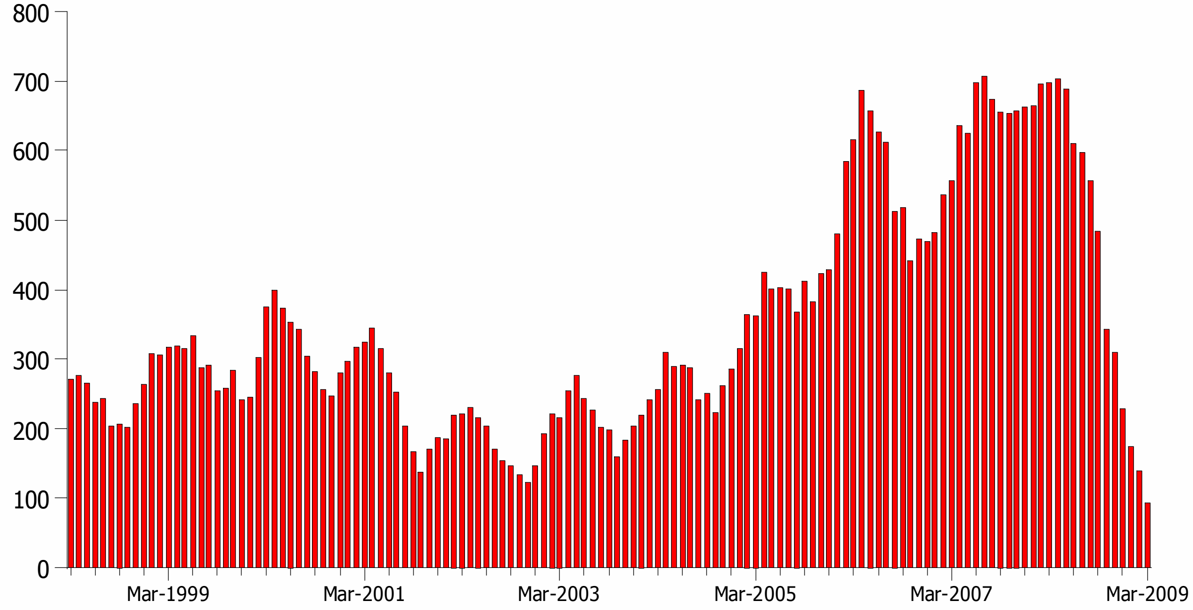


Source: CEIC

Euro Zone: Debt Deflation

- Although the Euro Zone banks can buy domestic government bonds (since these are zero-risk-weighted in their capital adequacy calculations), their weak capital positions prohibit them from lending to the European real economy.
- Hence, we have negative credit growth rates in the private sector.

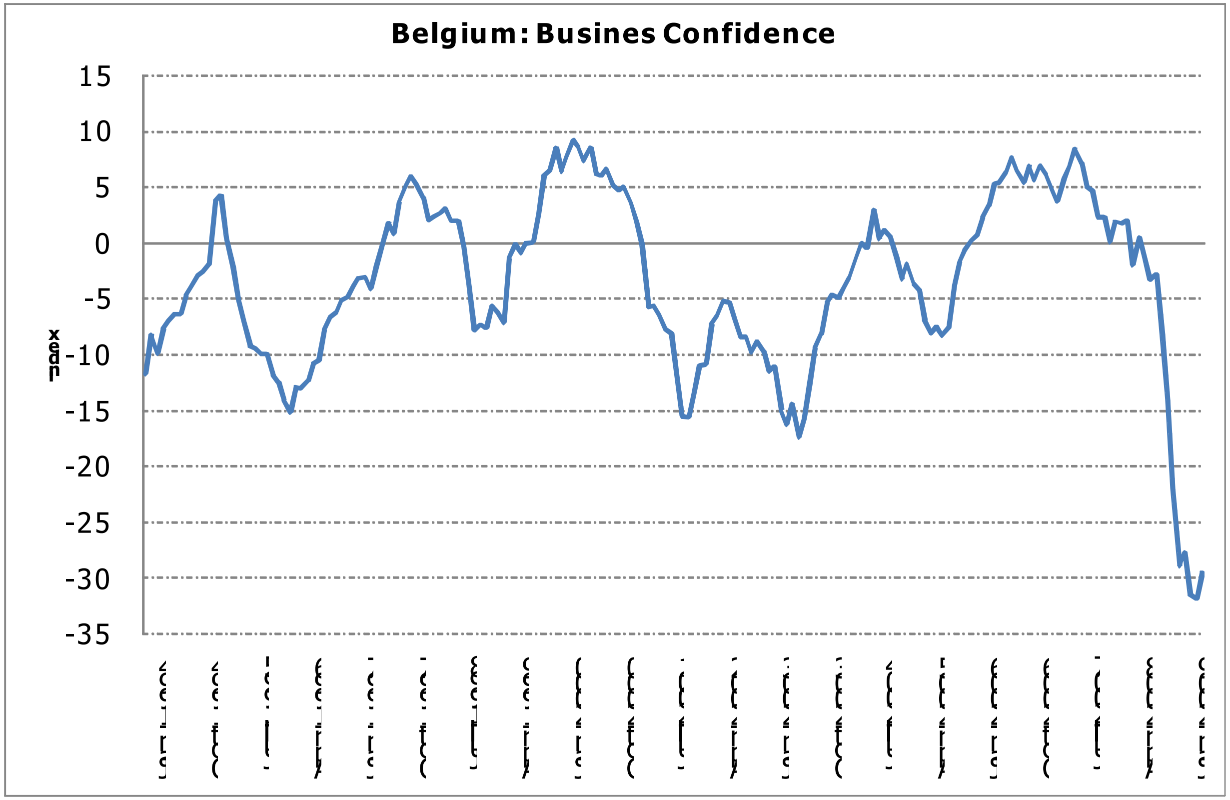
Euro Zone Bank Lending
EUR billion over 6 months



Source: CEIC

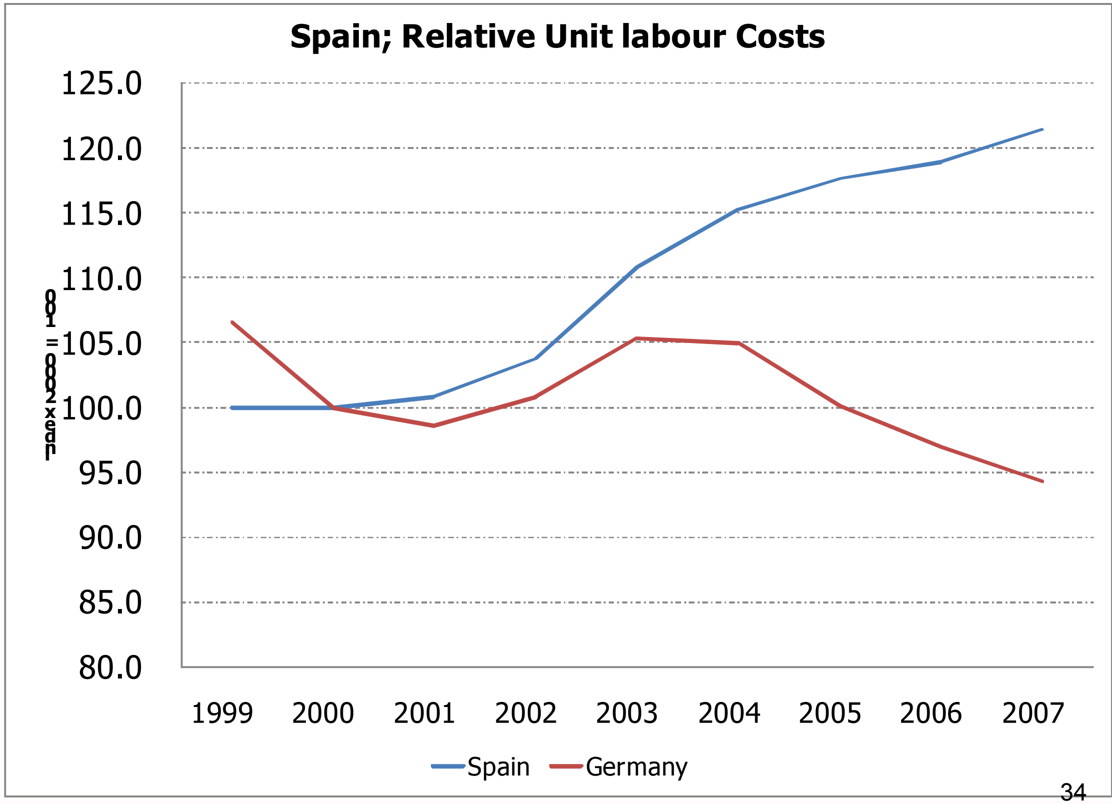
Euro Zone: Recovery?

- There has recently been signs of a *stabilisation in the rate of decline* in the Euro Zone real economies – but few signs of an improvement.



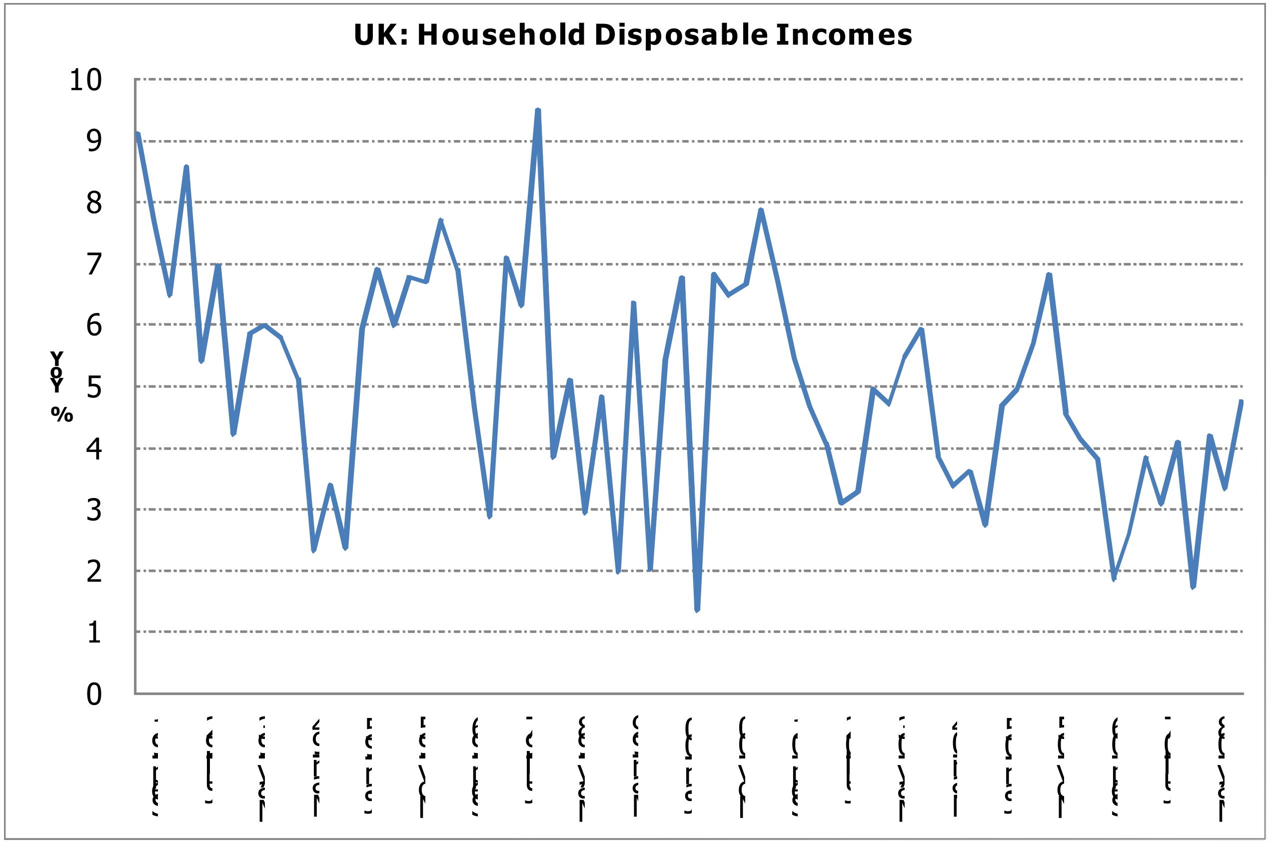
Euro Zone: Structural Imbalances Remain

- Moreover, the Euro Zone continues to possess intra regional competitiveness issues which are not improving – indeed Spain's situation is deteriorating further.
- *Ultimately, we envisage output gaps of >20% will be needed in the PIGS in order to generate the necessary deflation to restore their competitiveness.*
- *The only alternatives would be a 80cent EUR or a break up of EMU.*



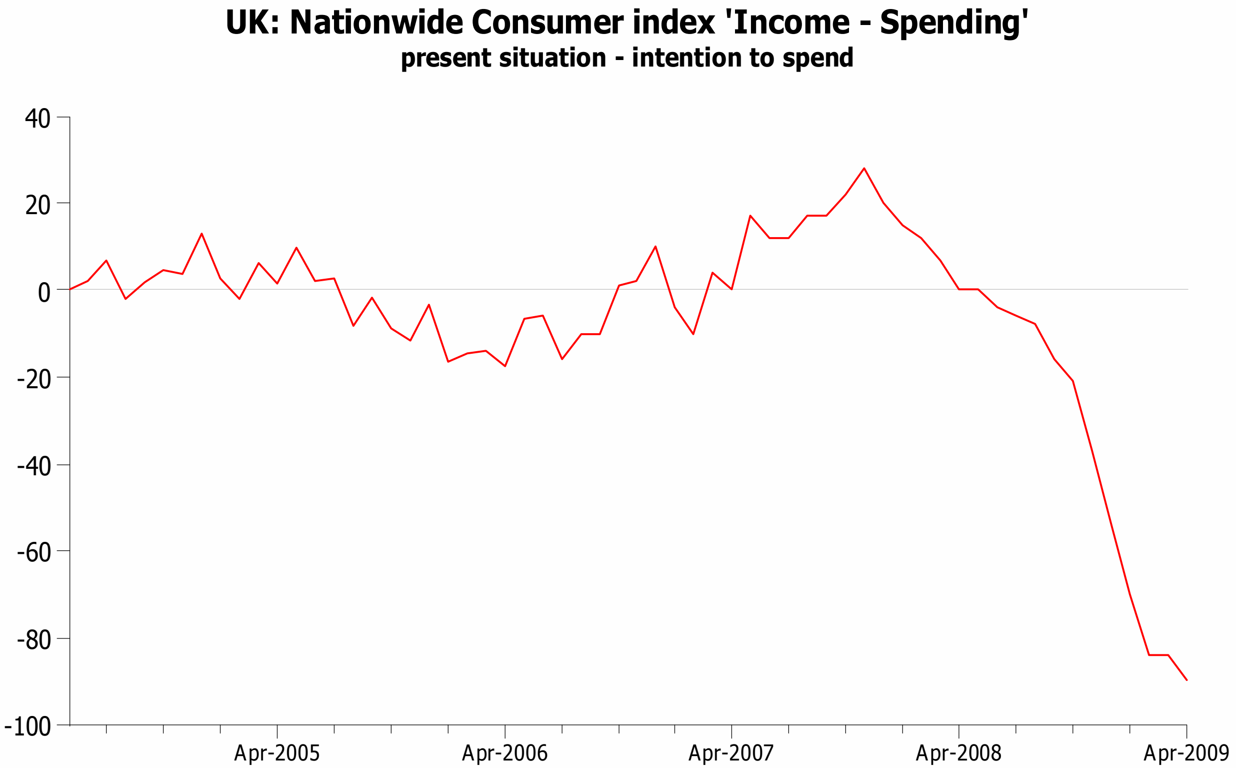
UK: Thank you Gordon

- As a result of a sharp cut in taxes and interest rates, UK disposable income growth has been very robust of late.



UK: Old Habits Die hard

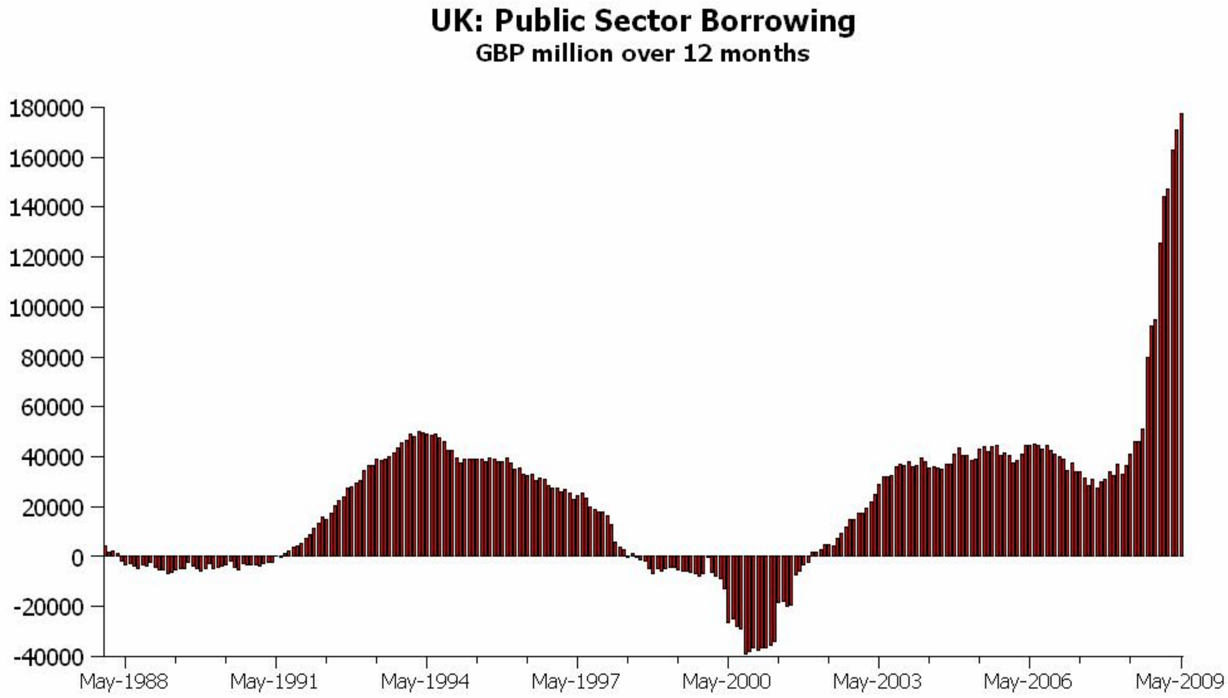
- Amazingly, UK households are continuing to dis-save and they are clearly not rebuilding their balance sheets.
- This is one reason that UK retail sales have remained robust.



Source: CEIC

UK: Fiscal Abandon

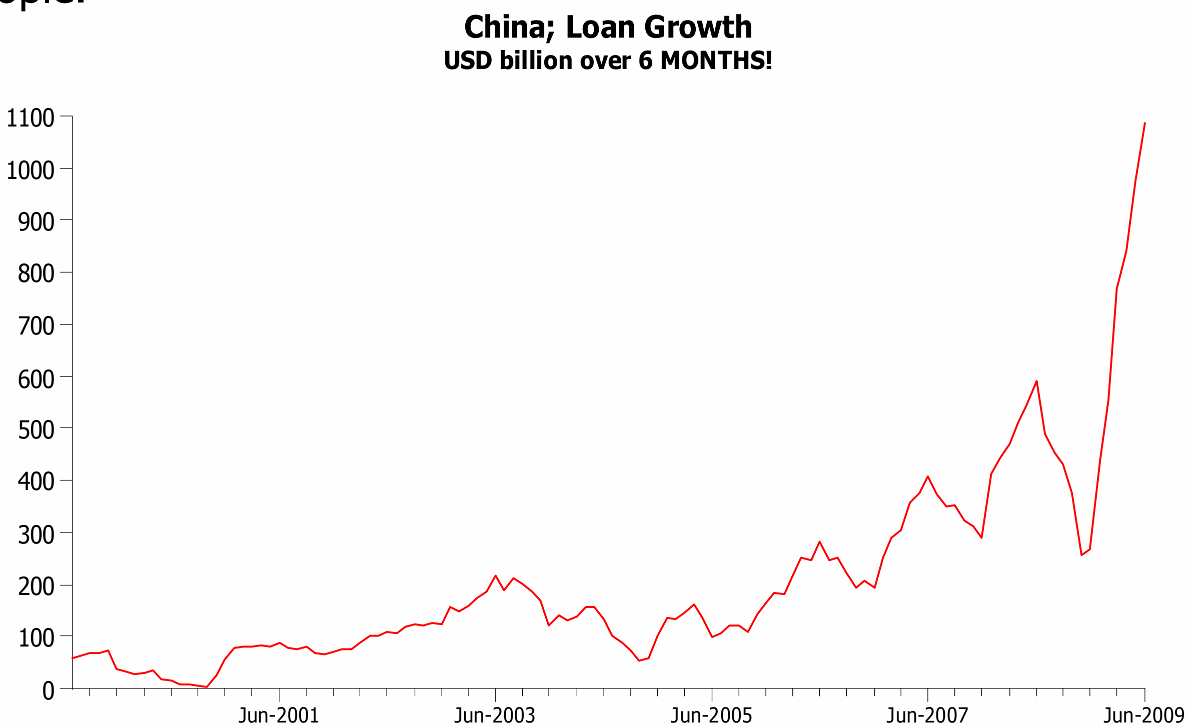
- But, in 2010 the UK must repair its balance sheets against a background of weak income growth.
- The true UK slump may not be until next year and it will be vicious when it comes.
- We suspect that the same may be true in Australia next year



Source: CEIC

China: Production Recovery

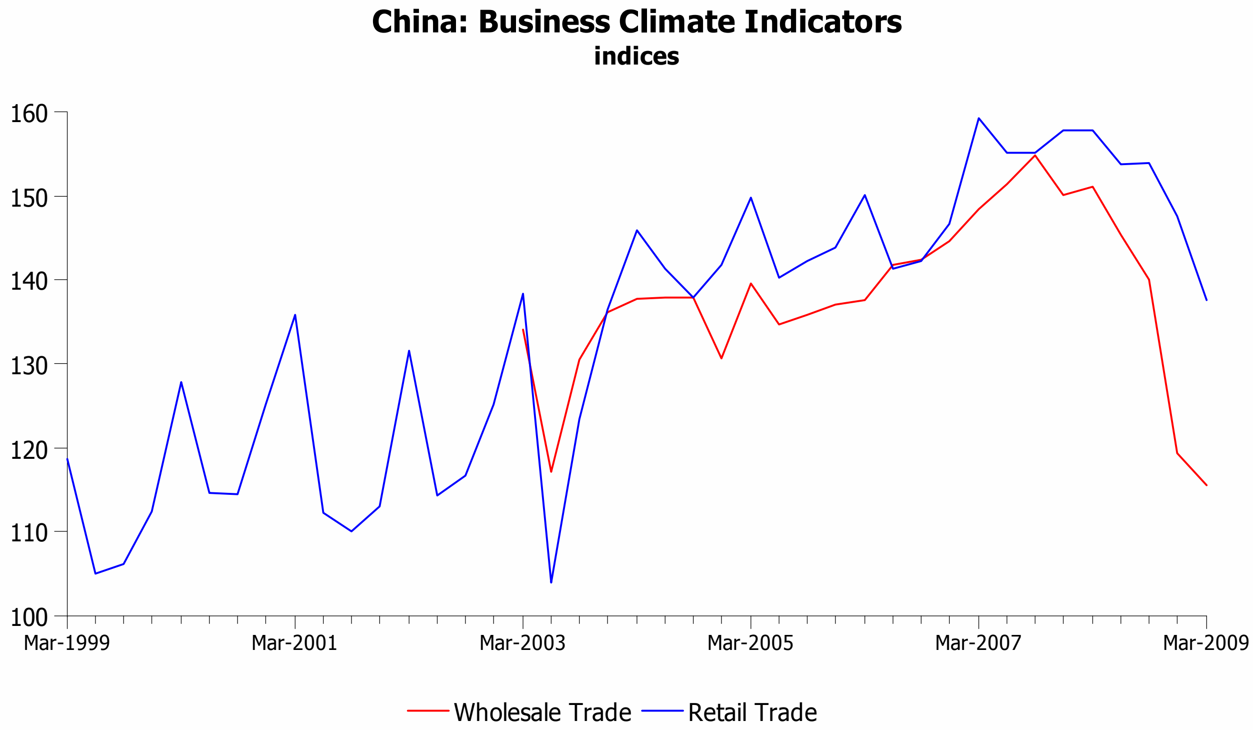
- China has provided nearly $1100 billion of new credit to its corporate sector over the last six months and ample government subsidies so that companies can continue to produce goods and more importantly employ people.
- In reality, China's government had to follow this path – the combination of rising unemployment and rising food prices would have forced political change had the government not acted.



Source: CEIC

China: Weak Demand

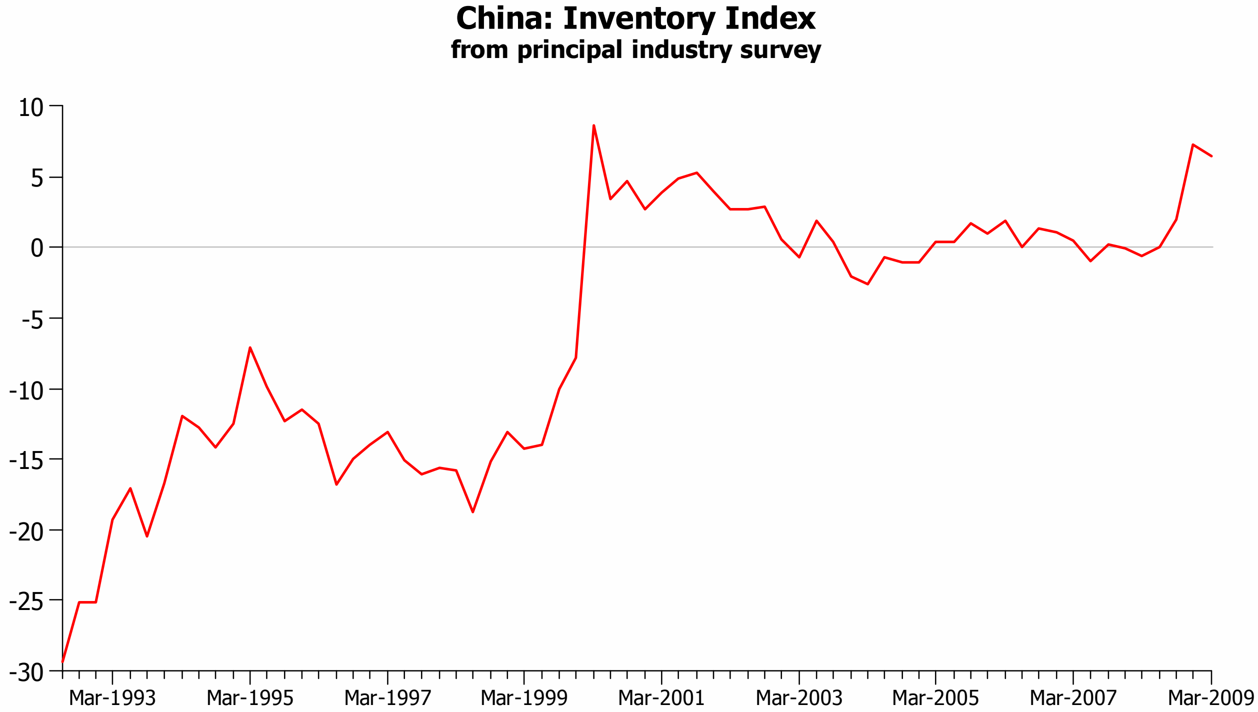
- However, there is no sign of a recovery in Chinese domestic demand.



Source: CEIC

China: Inventories Rise

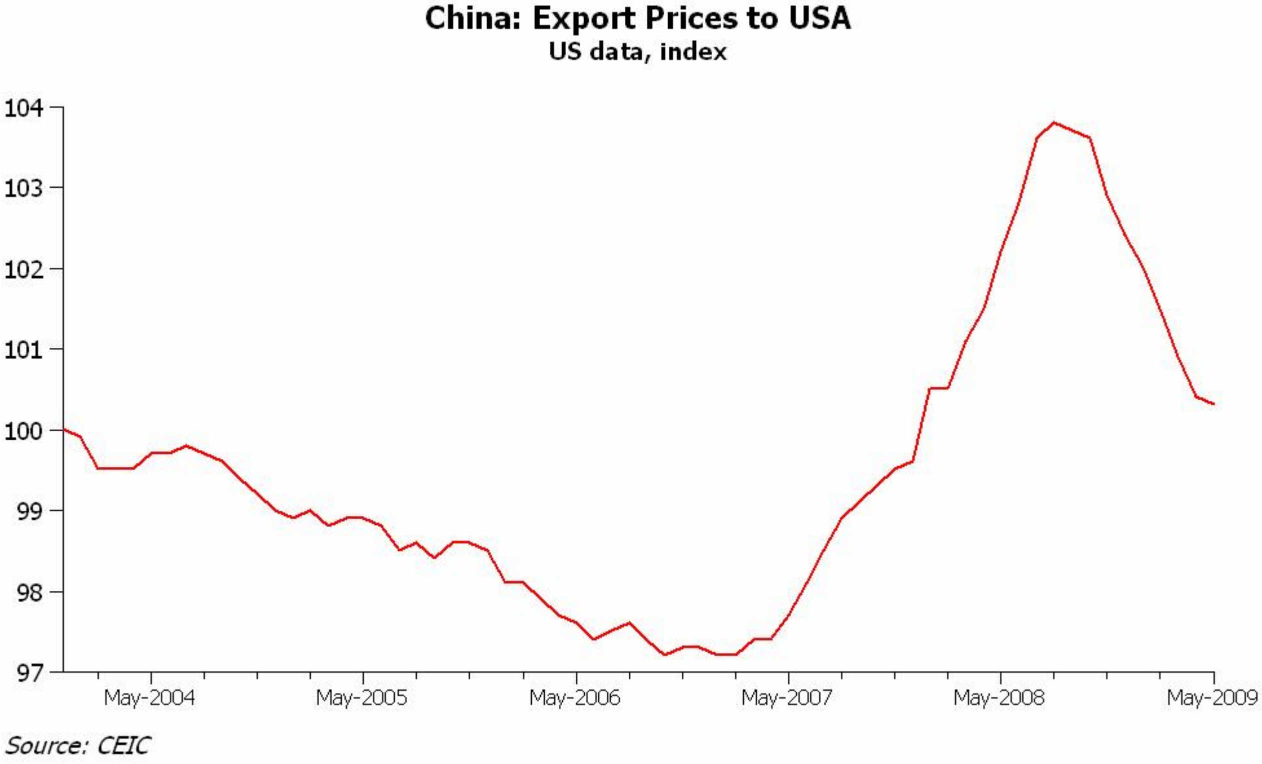
- Consequently, the production growth is simply feeding high inventories in both the input and output markets.
- Ultimately, this will be deflationary for the global economy.



Source: CEIC

China: Exporting Deflation

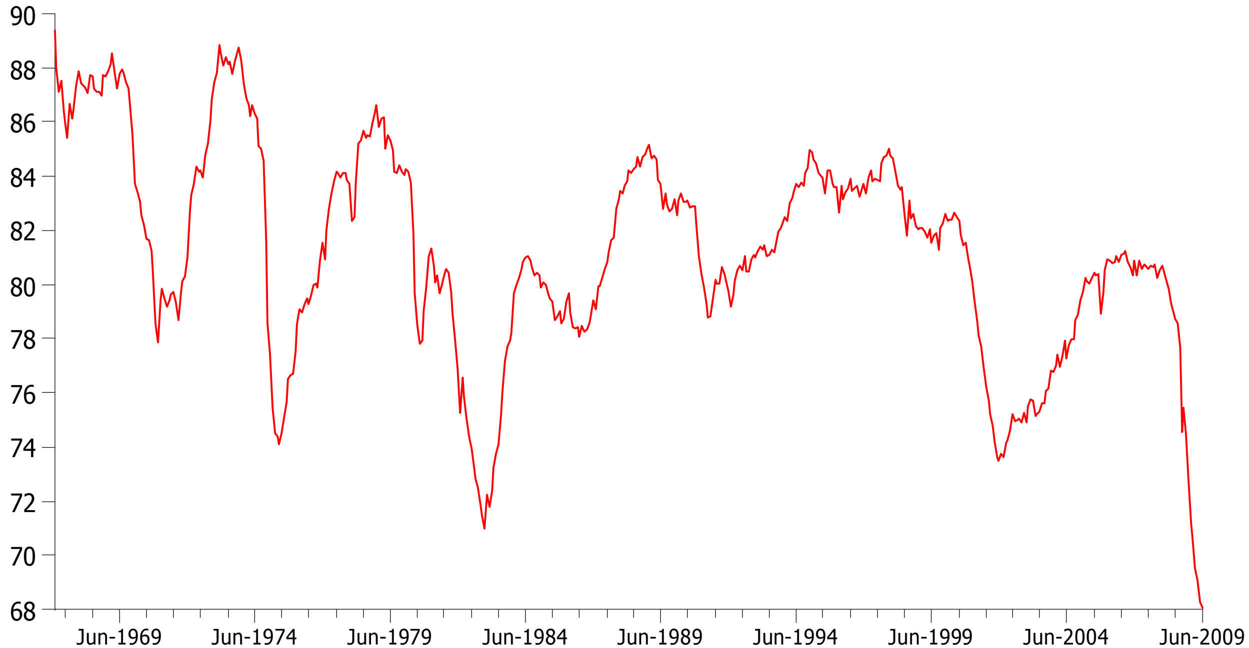
- Indeed, China is already exporting deflation



Global Deflation?

- With China exporting deflation, OECD wages tending to fall and global capacity utilisation extremely low, we see little fundamental threat from inflation in the next five years.

USA: Capacity Utilisation rate
% rate



Source: CEIC

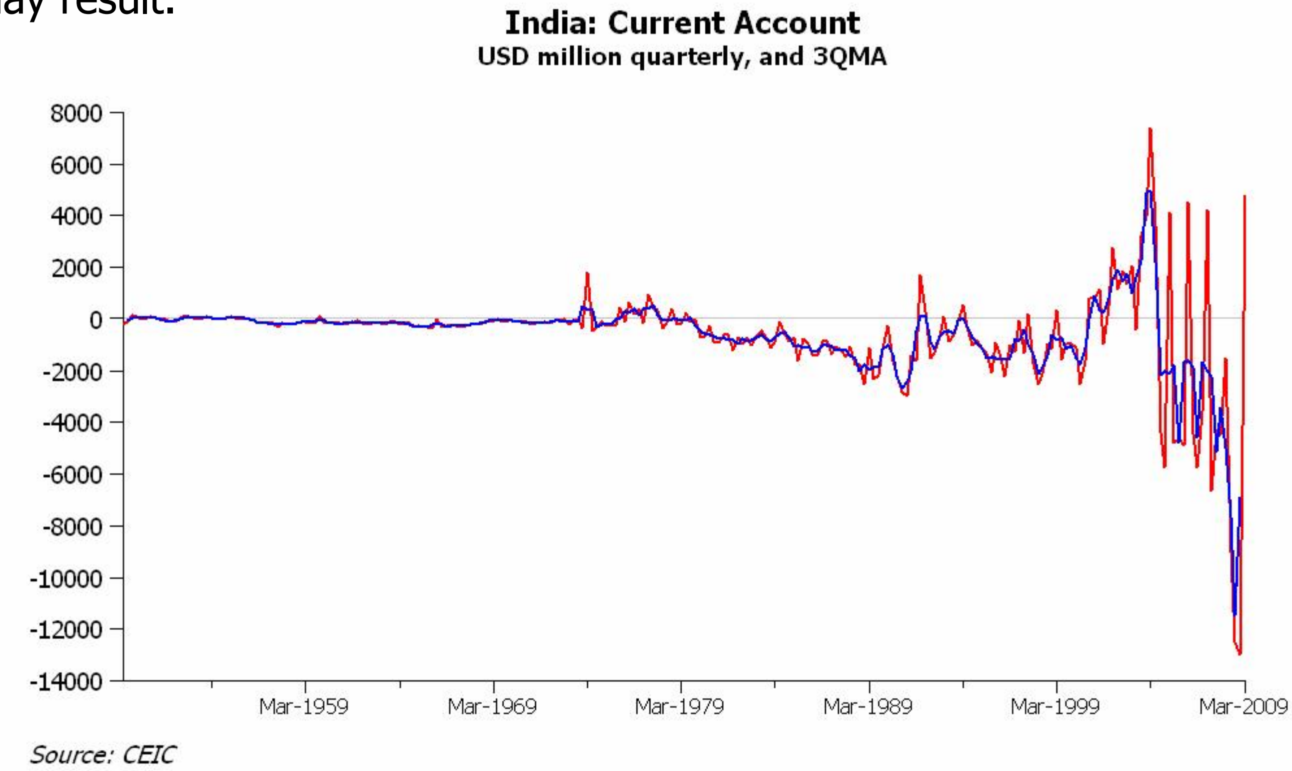
But Government A Threat to Inflation ?

- In practice, we suspect that the only source of inflation in the next year could be government sales taxes.
- As western governments attempt to repair their own balance sheets, they may resort to higher sales taxes which will add to recorded inflation (while being deflationary for growth and profits).

Source: CEIC

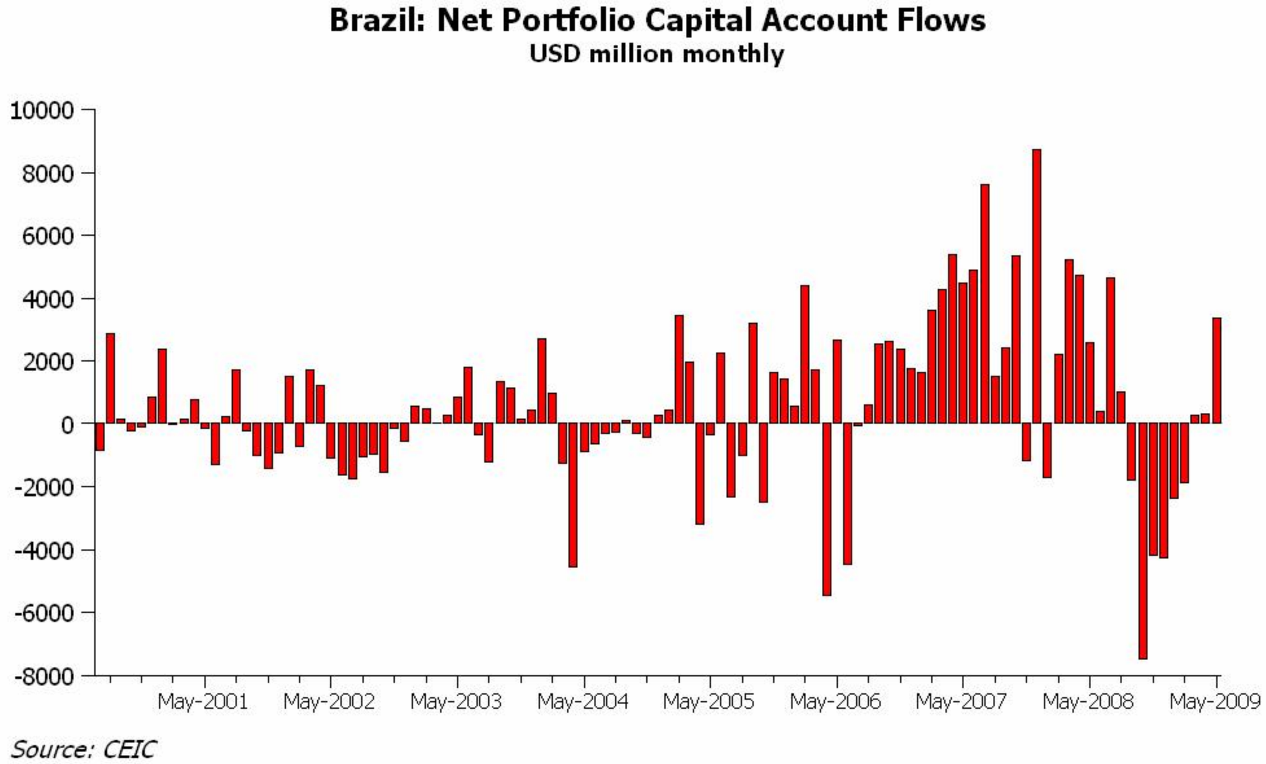
India: Overheating

- India is however an outlier – here the policy response has been too great and the country may be expanding too rapidly.
- We fear that a BoP crisis may result.



Brazil: Capital Returns

- Over recent months, global capital has returned to Brazil with a positive effect on BRL assets and liquidity conditions.

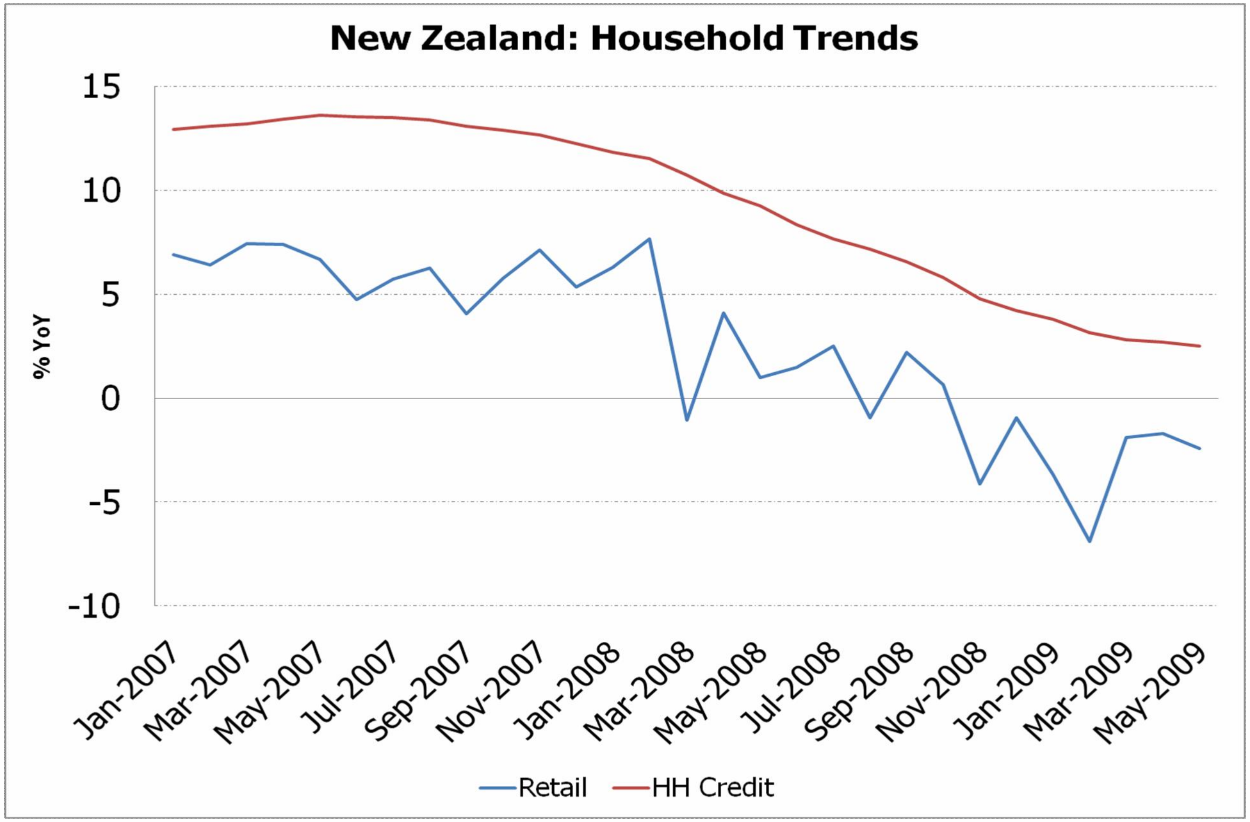


Korea: A Better Story

- Korea, however, is looking firmer. Capital is returning, inventories are down and production is rebounding.

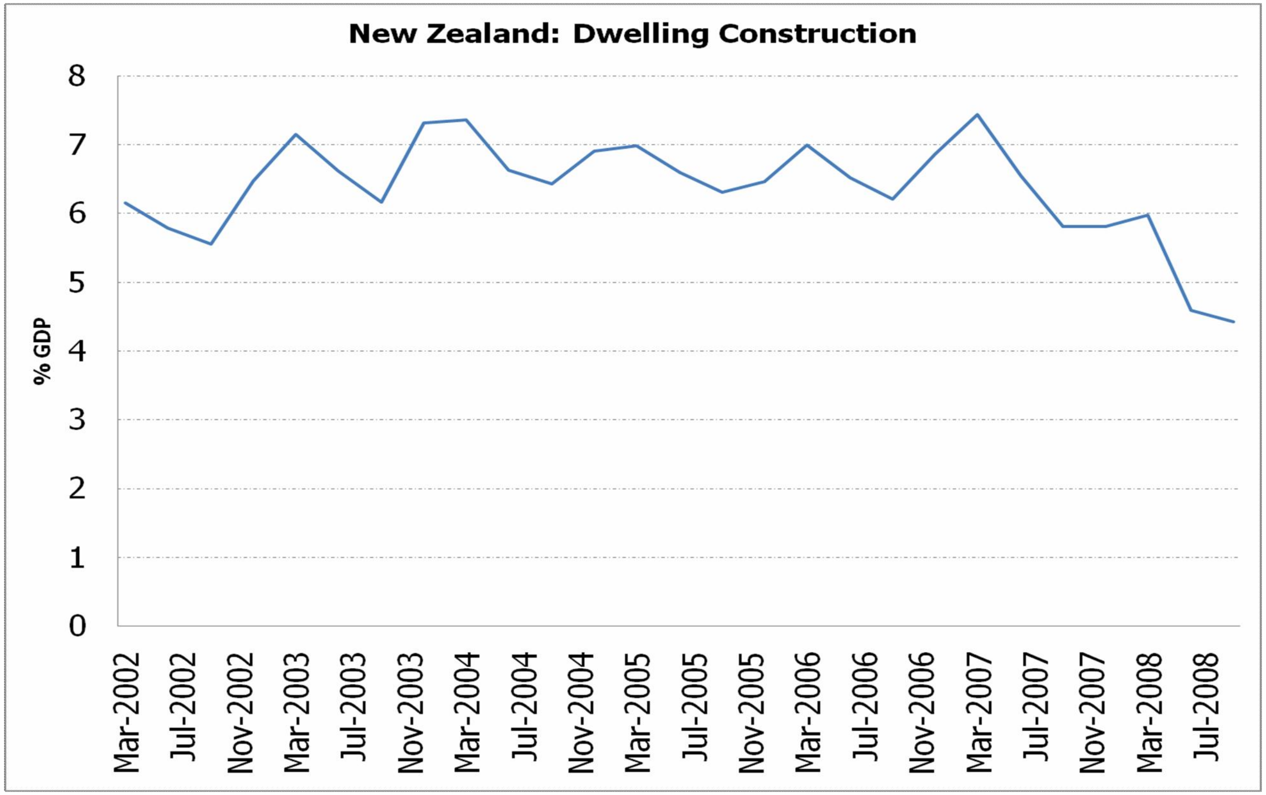
New Zealand: A Credit Crunch

- New Zealand's economy is clearly suffering a significant degree of credit supply weakness.
- This credit constraint has interacted with the cash flow negative situation within the private sector to cause a prolonged slowdown.



New Zealand: Rebalancing

- As the credit crunch continues, we expect the New Zealand economy to move away its housing / non-traded goods bias towards a more traded goods focused situation.
- The RBNZ may encourage this structural with an active currency policy.



Key Themes

- The US economy has completed the 'steep' part of its savings rate adjustment but the savings rate still needs to rise further. Against a background of weak income growth and a lack of fiscal offset, the recession may persist until late 2010 (admittedly with odd positive quarters within the period).
- In Japan, the manufacturing sector may have stabilised but domestic unemployment will ensure the recession continues. The government's response has been insignificant, although monetary conditions are now easier and the Yen carry trade may be returning.
- In Europe, the rate of decline in the core has stabilised (n.b. not the level of activity) and structural imbalances and flaws remain in the EUR.
- In the UK, the household and government sectors are still locked in a credit boom which we expect to end badly in 2010. Australia is also still 'wringing out' the last part of the previous credit boom.
- Some of the Asian Emerging markets have seen some improvement, although China's growth is subsidy driven and clearly unsustainable. Indeed, China may emerge as a substantial deflationary force in the global economy. India may be overheating.
- However, financial sector liquidity has been surging of late as a result of the activities of the US investment banks and European & Japanese commercial banks. However, we doubt that the monetary authorities are entirely comfortable with this situation and rising Treasury bond supply may yet lead to a reduction in the liquidity supply in financial markets.

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