



## Daily Notes on the **Global Economy**

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### The Dotcom Bunds

From time to time in our career, we have seen markets buy heavily into propositions that seem too good to be true and that often prove to be untrue. Of course, speculators and traders can make a lot of profits along the way as these bubbles grow, but the ultimate deflation of prices when they burst causes more pain than the profits previously generated, and it may threaten institutions.

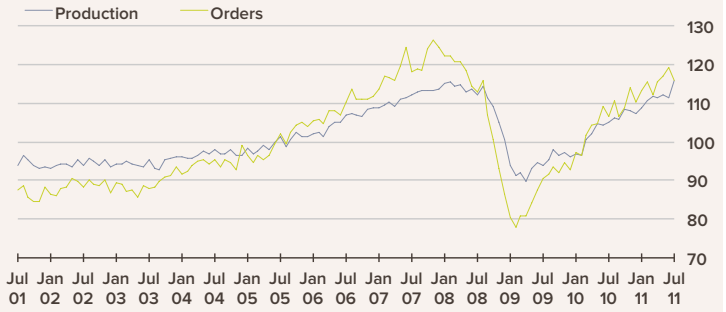
For instance, you do not have to be that long in the tooth to recall how individuals flocked into dotcom stocks at the turn of the century, buying shares of companies that had no profits—sometimes not even any income—and no clear path to profitability. The myth that supported this behavior was that an irresistible shift in the way the world worked was occurring, and that you could not risk missing the opportunities these companies presented: The profits and income would come, it was argued. You just had to believe the myth and ride the wave. In the end, the myth turned out to be just that, even though the world *did* change massively with the internet revolution. It just managed to do so without most of the dotcom companies that were imagined to be a part of it.

**The big myth in the markets today is the one that says Germany is “safe” from any institutional failures that will be generated by the sovereign debt blow-up in Euroland.** That myth has induced investors to bid the yield on ten-year Bunds down to 1.8% yesterday from 3.1% in the first quarter of last year, just before the Greek sovereign crisis broke. For the record, the standard metric for headline “inflation” in Germany has more than doubled, from 1.1% in March 2010 to 2.3% last month, and core CPI increases have accelerated from 0.8% year-over-year to 1.3%. So real yields have declined from 2% to minus 0.5% using headline CPI as a deflator. **There has to be a reason investors are willing to buy ten-year Bunds at negative real interest rates... just as there was a reason investors were willing to buy dotcom stocks with no dividend return.** We suggest that it is the myth of safety that has created a bubble in Bund prices.

**We have no reason to think that German sovereign bonds are going to be any safer than French, Spanish, Italian or even Greek bonds when the sovereign debt sell-off in Euroland runs out of control.**

Germany is perceived to be in the strongest fiscal position of all Euroland governments. That may be true, relatively speaking, but Germany’s public sector debt was 83% of GDP at the end of last year, and its fiscal deficit was 3.3% of GDP. That is not good... and it may not last. No one can predict the impact of a Euroland bond meltdown on Germany’s huge multinational banking groups. **Who says that German banks, just because they are big, and just because they are domiciled in Euroland’s largest and most stable economy, are safe?** Our bet is that bank losses in Germany would send these big institutions running to the government for recapitalization... dare we say, just as happened in Ireland? We fear that knock will be big enough to require substantial new deficit financing by Berlin, bumping up the national debt ratio even faster... again, as happened in Ireland. *Note that when Bund yields start to rise, losses at Germany’s banks—as well as those at all other Euroland banks—will soar.* Everyone holds Bunds in size these days, eh?

### Germany: Industrial Production And Orders, Index 2005=100



Of course, Germany also seems to be the end of the line for covering the bad bonds of other nations. As long as the EMU governments insist on dealing with the sovereign debt problem of one country by tapping the resources of other governments, the pool of tappable countries will continue to decline as the number of governments in distress grows. Demands on Germany’s savers to bail out the rest of Euroland will rise, just when the demand to refinance German banks with public sector borrowing peaks.

If we are right, and if “safe” Bunds prove to be unsafe, a massive collapse of German bond prices is inevitable as more people—more than just us—start to doubt the myth of the safe-haven Bund. As doubt replaces wishful thinking, irrational exuberance will be replaced by precautionary selling. *We believe that a big sell-off in Bunds will be the catalyst of the ultimate crash of the Euroland financial system. When you see Bund yields start to rise—and we say you will—that will be the sign that the end is near. Bonds back the banking and monetary system, and the failure of all bonds must mean the failure of all banks.*

Where will the money go, you may wonder? Cash is the alternative to bonds and bank deposits. Gold bugs may disagree, but there ain’t enough gold around, whereas there is plenty of paper. That is what Keynes would tell us to expect—Euroland is about to fall into his liquidity trap. When everyone wants to hold only money—in Swiss or North American banks, or hard cash—and not bonds, central banks can no longer influence the economy. They are forced to be the

### Yields On 10-Year Government Bonds @ 10:00 GMT

	Coupon	Maturity	Yield (%)	Prev. (%)	Chge (b.p.)	Δ vs U.S.	Prev. Δ vs U.S.
United States	2.125%	8/21	2.019	1.977	+4		
Japan	1.200%	6/21	0.969	0.955	+1	-105	-102
Germany	3.250%	7/21	1.865	1.854	+1	-15	-12
United Kingdom	3.750%	9/20	2.335	2.342	-1	32	36
France	3.250%	10/21	2.671	2.684	-1	65	71
Canada	3.250%	6/21	2.235	2.300	-6	22	32
Australia	5.750%	5/21	4.331	4.211	+12	231	223

Note: All yields converted to a comparable semi-annual basis. Data collected 10:00 GMT daily, from market sources believed to be reliable by High Frequency Economics. These data are market indications only, not quotes.

bond buyer of last resort, distributing cash to people through the banks. Then, the only option left is fiscal policy, which will need a really big rethink in Euroland. Austerity buffs may have a long-term case, but the cost of deflating an already deflated economy is higher than the cost of incremental deficit spending, even now.

### Passage To Marseille

Finance ministers and central bankers from the G-7 and other affinity groups are going to meet in Marseille this Friday and Saturday. They are tasked with saving the world from the Euroland sovereign debt crisis and the financial meltdown that it will cause. Do not worry... the G-7 ministers and bankers do not have any chance of saving the world from anything. Fiscal policy remains babelized amongst the group, and the national governments are focused on austerity rather than stimulus. *That is not what the G-7 economies need.* Central bankers are tapped out. At best, they can confab on strategies to keep a failed banking system the size of Euroland's liquid and polish up their bullet points for governments on how to use deficit financing to recapitalize banks without losing money. TARP architects Bernanke and Geithner may be offering seminars on this during those long walks on the beach that photo-ops are made of. Of course, Euroland governments and the ECB are constitutionally prohibited from doing the right thing.

*We have no hope that anything good or important will come from these meetings. We may see some "resolve" to do whatever has to be done, but we already got that from the last dozen communiqués.*

### Euro Zone

There were no economic releases this morning. Revised figures published yesterday confirm that **GDP** grew only 0.2% in the second quarter, slowing from 0.8% in the first. The year-over-year rate of increase is now reported at 1.6% instead of 1.7% in the flash estimate, mainly because of revisions to historical levels. Details of the composition of demand, available for the first time in this release, show **household spending** contracted 0.2% in Q2 after a 0.2% rise in Q1. Public sector spending also declined by 0.2% in Q2, after a 0.4% rise in the first quarter. **Fixed investment**, which had jumped by 1.8% in the first quarter, rose 0.2% in the second quarter, a sharp slowdown. Were it not for an increase in **net exports** and some **inventory accumulation**, GDP would have been flat or declined last quarter. *Almost certainly, the headline figure will be marked down in the next revision.* GDP data for Greece and Ireland have not been included in these preliminary estimates. We already know that Greece's GDP was 6.8% lower than a year ago in the second quarter. We figure that means the economy contracted by 2.7% from Q1. Fiscal austerity weighs heavily on economic growth prospects for both Greece and Ireland. *Prospects for the third quarter and beyond are not good. Monetary conditions are tight. Fiscal austerity is being implemented everywhere. Real incomes are declining. Net exports are disintegrating.*

The ECB yesterday allocated €115.41 in **seven-day repo agreements** to 126 banks, all at its 1.5% minimum bid rate. True to recent form, the ECB accepted every tender received. Last week, the ECB received and filled bids for €121.67 billion from 135 banks. It is good news that fewer banks came to the ECB for funding at the repo window, but we are still seeing an elevated number of bidders that cannot fund their reserve requirements less expensively on the interbank market. *The freezing up of the interbank market is a critical red flag that risks of institutional failure are seen as high.* On the flip side, the ECB attracted offers from 98 banks to place €173 billion in **seven-day deposits** at yields ranging up to 1.05%. The ECB accepted €129 billion of these offers, exactly enough to sterilize the monetary impact of its bond purchases from the secondary market last week. The rate the ECB had to pay to sterilize its bond purchases dropped from 1.14% at the margin last week. This is a good thing. *When the ECB has to pay more for*

### A Quick Look at Upcoming Events

	Wednesday	Thursday
<b>Japan</b>	<b>BoJ Board Meeting</b> LEI (7p)	<b>Bank Lending (8)</b> Business Failures (8) Current Account (7) Machinery Orders (7) BoJ Monthly Report
<b>Australia</b>	<b>GDP (Q2)</b> Governor Stevens Speaks	<b>Employment (8)</b>
<b>Euro Zone</b>	Nothing	<b>ECB Council Meeting</b>
<b>Germany</b>	<b>Industrial Production (7)</b>	Labor Costs (Q2) <b>TRADE (7)</b>
<b>France</b>	Nothing	Payrolls (Q2r) BdF Bus Sentiment (8) <b>TRADE (7)</b>
<b>United Kingdom</b>	BRC Shop Prices (8) <b>Industrial Production (7)</b> MPC Meeting Begins	<b>MPC Meeting Ends</b>
<b>Canada</b>	<b>BoC Rate Decision</b> Ivey Index (8)	<b>TRADE (7)</b> Building Permits (7) New Housing Prices (7)
<b>United States</b>	Fed Beige Book Weekly Redbook Sales Weekly MBA Mortgages	<b>TRADE (7)</b> Consumer Credit (7) <b>Weekly Initial Claims</b> <b>Bernanke Speaks</b>
<b>China</b>	Nothing	Nothing

Underscore=Already released    Italics=Estimated release date

### Further Down The Road...

September 9 - 10	G-7 FinMins And Bankers Meet In Marseille
September 15 - 16	EU FinMins Meet In Poland
September 20 - 21	United States—FOMC Meeting
September 23	G-20 FinMins & Central Bankers Meet In Washington
September 23 - 25	IMF Annual Meetings in Washington
October 4	Australia—RBA Board Meeting
October 5 - 6	United Kingdom—MPC Meeting
October 6	Euro Zone—ECB Council Meeting
October 6 - 7	Japan—BoJ Board Meeting
October 25	Canada—BoC Interest Rate Decision
November 3 - 4	G-20 Summit In Cannes

*deposits to sterilize its bond market interventions than it charges to lend reserves at the repo window, it will have to raise the repo rate to prevent an unstable situation.* Otherwise, banks will just load up on repos and lend back to the ECB at a guaranteed positive spread... that's good business! Meanwhile, there were no bidders for dollars at the ECB's weekly offering of funds at 1.1%. That is good news, anyway.

To correct an error in our *Weekly Notes*, the ECB did buy bonds last week—it reported on Monday that it settled €13.3 billion in purchases. This is up from €6.5 billion the previous week. *We find it troubling that yields on PIIGS bonds jumped despite this intervention. Our skepticism about the sustainability of the ECB's bond support efforts goes up when we see this happen. We suspect the bond market is bigger than the ECB's appetite for intervention.* Time will tell.

Tomorrow, the ECB Council will meet. *We believe that it cannot cut rates despite slowing prices and a faltering economy.* Cutting rates now would bring the repo rate and the rate the ECB pays for seven-day deposits even closer together. *When that spread vanishes, the ECB will have to stop buying bonds or raise the repo rate.* That will be the day before the world ends.

### Germany

FSO and Buba reported this morning that **industrial production** exploded in July, jumping 4% from June after adjustment for seasonal

### United Kingdom: Industrial Production Index



factors. *Nobody in their right mind should believe that this actually happened.* The details show a 15.4% surge in production of consumer durables last month, more than reversing a 6.3% decline in June. Overall, industrial output declined 1% in June, which puts the two-month moving average rate at a more credible but still elevated 1.5%. If you believe these figures, production was 10.1% higher than a year ago in July—accelerating from 6.6% in June—and has finally regained its pre-downturn level. *Suffice it to say that we expect a big downward revision to this result, which is not corroborated by any other economic indicator or survey result. This headline stinks of a mis-applied seasonal correction. Remember, too, that July and August are summer vacation months, and the data for this period tend to be more volatile than for other months.* Apparently, the Economics Ministry is advising that a shift in the timing of school holidays this year biased the July result. We have not seen this note, nor do we understand why the timing of school holidays should affect industrial output. *We will work on that.* If this assessment is accurate, then a snap back down of production in August should be expected.

Indeed, Buba and FSO reported yesterday that **manufacturing orders** fell 2.8% in July, driven by a sharp decline in orders for capital goods. *This result is more in line with the sharp declines we have seen in the IFO and ZEW indexes, and the recent trend in exports.* Orders were 8.7% higher than a year ago, but that is a very low base for comparison. They are still 8.1% lower than when this economic downturn began in 2008. In June, orders jumped 1.8% on the month, and strong increases of 1.5% and 2.9% were reported for May and April respectively. *We think it will be all downhill from here, as tight money, reduced public spending, falling exports and declining real incomes erode aggregate demand.*

Press reports this morning indicate that the Federal Constitutional Court rejected arguments that Germany's participation in the bail-out packages of other EMU government violate the constitution. *Some people were worried about this.*

Tomorrow, we will see second quarter data on labor costs and the merchandise trade report for July. *We estimate the trade surplus declined to €9.4 billion from €12.7 billion in June and €13.5 billion a year ago. If so, the current account surplus should be down to €5.4 billion, compared to €11.9 billion in June and €10.4 billion last year.* Our figures suggest that the trend in net exports is subtracting from GDP growth. Labor costs were last reported up 2.8% over year-ago levels, a pace consistent with a 1.5%-or-lower year-over-year inflation rate as long as productivity increases at a normal pace.

### Japan

The Cabinet Office today said that its composite **index of leading economic indicators** rose to 106 in July from 103.3 in June. Normally, levels of this index above 100 foreshadow economic expansion. *We doubt this tells us anything useful about the economy right now.* What Japan is experiencing in the wake of the March 11 disasters is a

super-cyclical depression, not a business cycle downturn. The LEI is calibrated to indicate only changes in cyclical position, which are not the most important thing right now. *Growth, in this case especially, is no assurance of a return to prosperity.*

The **BoJ Board announced no changes to monetary conditions** at the end of its two-day meeting last night. This was expected. Speaking to reporters after the meeting, Governor Shirakawa pointed out that the Bank had taken bold action at its last meeting, in August, increasing its direct lending facilities. The Governor also fielded several questions about the Swiss National Bank's aggressive intervention to cheapen its overvalued currency. No hint of imminent BoJ action was given by Shirakawa-san.

Tonight, we will see August data on bank lending and business failures, along with July reports on the current account balance and machinery orders. Also tonight, the BoJ will publish its latest *Monthly Report*. *Based on partial data published last night, it looks as though bank lending fell again last month. We estimate a decline of 1.1% year-over-year after a 0.6% 12-month drop in July. The unadjusted current account surplus should come in around ¥1.2 trillion, narrower than ¥1.7 trillion a year ago. We estimate machinery orders will print 15.4% higher than last year but still 26.4% lower than their peak before in this latest economic downturn began in 2008.*

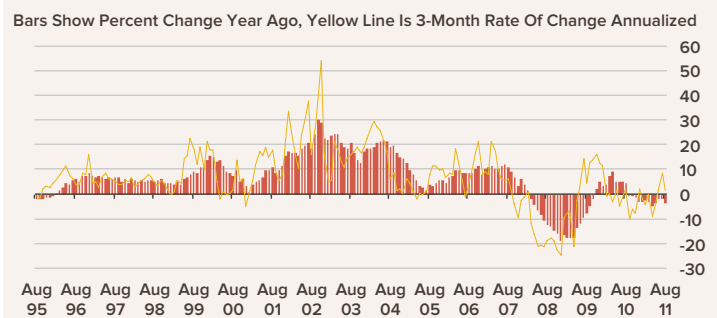
### United Kingdom

NatStats reported this morning that seasonally adjusted **industrial production** in July was down 0.2% on the month and 0.7% lower than a year ago. In June, production was 0.3% lower than a year ago after no growth at all on the month. Manufacturing fared better, but still not well. Production was up 0.1% in July and 1.9% higher than a year ago. Both indexes are depressed, with industrial output still 12% lower than its pre-downturn peak and manufacturing production depressed by 9.3% from its February 2008 high. These results were close to what the City expected and so did not move the markets.

Also this morning, the British Retail Consortium reported that its **shop price index** was 2.7% higher than a year ago in August. *This index is not reliable as a harbinger of the latest CPI trends.* Most things consumers spend money on—and therefore, most of the items in the official CPI, which is what policy makers care about—are not sold in shops. The proper use of this index is to deflate the nominal estimate of shop sales increases reported in the BRC's **Retail Monitor**. BRC reported yesterday that overall sales at the shops it surveys were just 1.5% higher than a year ago in August. So the two studies together point to a 1.2% year-over-year decline in retail sales volumes when NatStats' official index is published next Thursday.

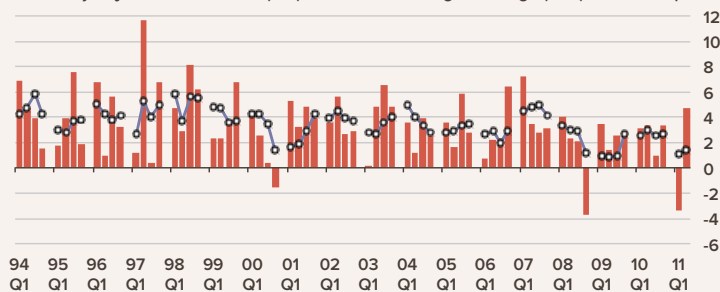
The **Halifax house price index** fell 1.2% August, according to this morning's report, leaving it 2.6% lower than a year ago over the three months ended August. The July index was revised lower to show a 0.2% increase for the month instead of 0.3%. Over the three months ended July, it was 2.6% lower than a year ago. *Sagging house*

### United Kingdom: Halifax House Price Index



**Australia: GDP**

Seasonally Adjusted Annual Rate (Bar) and Percent Change Year Ago (Line) To 2011 Q2p



prices undermine the balance sheet of the banking system. They also depress consumer wealth and discourage retail spending. Of course, falling prices restrain all activity in the housing market itself. This renewed decline in house prices is bad news no matter how you think about it.

SMMT, the auto dealers' association, yesterday reported 59,346 **car sales** in August. This is 7.3% more than a year ago, but August is the teeniest month of the year for car sales, and these data are not seasonally adjusted. So *who really cares?* Sales were 7.3% higher than a year ago but year-to-date sales were 6.1% lower than in the same period last year. *That is the figure to watch.*

The BoE's Monetary Policy Committee began a two-day meeting this morning that will end tomorrow with a decision on monetary conditions. *Our take on the MPC is that it is more likely to renew QE with a new round of asset purchases than to contemplate hiking interest rates. Its most likely course, however, is to hold all monetary conditions unchanged until its November meeting, when it will have another Inflation Report to explain a sea change in monetary conditions or recourse to QE. Until then, we expect the MPC to hold interest rates and monetary conditions unchanged, keeping a rate cut on reserve in case the Euroland banking system goes bust sometime soon.*

**France**

There have been no economic releases so far this week. Tomorrow will bring revised estimates of payroll employment for the second quarter, the BdF's index of consumer sentiment and the merchandise trade report for July. *We estimate further decay in the trade balance, to a deficit of €5.8 billion compared to a €4.1 billion gap a year ago. Initial estimates showed payrolls were up only 0.4% in the second quarter and 1.3% year-over-year. A revision to these initial estimates is unusual.*

**Australia**

ABS reported last night that **GDP** rose 1.2% in the second quarter and was 1.4% higher than a year ago. The first quarter estimate was revised up to show a 0.9% decline instead of 1.2%, but the year-over-year rate of increase was left unchanged at 1%. Net exports added half a percentage point to the headline growth rate. Consumers' expenditures were little better than flat for the quarter, but investment spending increased by 2% after a 4.1% rise in Q1. Inventories increased in the quarter, too. *These are weak indications of domestic demand, supported by strong growth in the export-oriented resource production sector.*

**The RBA Board left interest rates and monetary conditions unchanged at its meeting yesterday.** This result was widely expected. Reading the statement that followed the meeting, it is clear that the Board is worried about a deterioration in global financial and economic conditions curbing demand for Ozzie exports. It almost seems as if the Board is preparing us for a rate cut, should one be needed

to offset the consequences of a European financial crisis. "Most financial indicators suggest that monetary policy has been exerting a degree of restraint. Credit growth has declined over recent months and is very subdued by historical standards, even with evidence of greater willingness to lend. Most asset prices, including housing prices, have also softened. The exchange rate is high. Each of these variables is affected by other factors as well, but together they point to financial conditions being tighter than normal."

RBA Governor Stevens, speaking in Perth last night, suggested that steady interest rates are the most prudent course in uncertain times. Australia's economy continues to grow steadily, backed by solid public finances and a secure banking system, he pointed out. *The market took his speech as a commitment to keep rates steady despite the recent uptick in key inflation measures, at least until the Euroland debt crisis takes a turn for the better. We think the RBA will cut rates if Euroland's woes take a turn for the worse.*

Yesterday, the **current account balance** was reported in deficit by only A\$7.4 billion in the second quarter, less than the whopping A\$11.1 billion gap in Q1, although wider than the A\$4.5 billion deficit a year ago. It looks as though net exports will add to second quarter GDP growth in today's release. ABS also reported 49,813 **mortgage approvals** in July, 1% more than in June and 5.4% more than a year ago. In June, approvals were up 6% year-over-year on a 0.6% rise for the month. If you look at the levels, approvals are well off their 2007 peak and are still declining overall, despite an uptick in the last few monthly reports. *It will be a long time at this rate before mortgage lending recovers by enough to trigger alarm bells.*

Tonight, ABS will release the employment report for August. *We estimate the jobless rate declined to 5% from 5.1% in July, with a reduction of about 12,000 in the number of unemployed persons.*

**Canada**

No economic reports were published yesterday.

The BoC will announce its decision on interest rates and monetary conditions today at 09:00 EDT. We do not expect a change, and neither does anyone else despite weaker economic results than the Bank had been projecting. *Like the RBA Board, we think the BoC would be inclined to cut rates on the basis of the macroeconomic data, but will keep any artillery it has available on reserve in case a banking sector tsunami comes its way from Euroland.* Also today, the Ivey School will publish its index of purchasing managers' sentiment for August, a report that we do not follow. Tomorrow, look for the merchandise trade report for July and StatsCan's latest figures—also for July—on building permit issuance and new housing prices. *We fear that the trade balance will turn out to be a deficit of C\$2.22 billion or so, wider than both C\$1.6 billion in June and €2.18 billion a year ago. Yes, we agree with the BoC that the strength of the loonie is an important headwind for the economy. We figure building permits will print 4.8% lower than a year ago, and house prices will turn out a mere 2.7% higher than last year... hardly a bubble.*

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September 7, 2011 at 7:25 EDT  
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