

## EXECUTIVE SUMMARY

October 29, 2010

## Are Those Who Make History Condemned to Repeat It?

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## Cautious Pessimism

**The crisis and policy responses reveal that the world is badly organized and run, and will take ages to fix:** There are no silver bullets for global balance sheet and structural problems. The non-system of DM free and EM dirty FX floats is only starting to be addressed. Plus, there are high geo- and local political hurdles to global structural reform and coordination, even given that the West retains policy capacity and credibility. In particular, EM countries are unwilling to float their currencies or unable to lead global rebalancing, lest growth rates slow and/or unsustainable imbalances shift from the West back to EM. Add to that uncertainty about the U.S. mid-terms elections and gubernatorials; the scope, scale and success of QE2; the U.S. insistence on monetary easing against EM resistance to FX realignment; and lurking threats of FX/trade friction despite G20 rhetoric. We still reckon that QE2 or apparently improved global coordination will offer a reprieve against a double dip or a full-blown currency/trade war. But the key issue is that nowhere does local politics point to faster balance sheet repair, structural reform, or global coordination. It's small wonder the policy, macro, and market signals are mixed, switching staccato among green, amber and red.

**Cautious pessimism is our way of navigating global uncertainty and second/third best policies and politics.** We remain relatively risk-averse, though we're willing to tactically exploit temporary de-escalations of risk—but only with strategic caution. Capital controls and decelerating leveraged dollar-funded carry trades may slow dollar depreciation, but not prevent it. Getting the policy mix, macro views and market strategy right for the monumental trade-offs between inflation/deflation, deleveraging/monetary easing, reflation/fiscal consolidation, global rebalancing/FX-realignment, and structural reform/protectionism is critical. The chances that our dear leaders get this all right quickly may be higher than they seem. But they are pretty low, all in all.

- **Commodities: Tactical overweight EM-growth-gear metals, weather-constrained softs, grains.**
  - **Gold: Tactical underweight.** The putative currency debasement of QE2 is running its course, as USD depreciation slows and general QE2 across rich countries recedes for now.
- **G10 Currencies: Expect slowing USD depreciation.** A shift in dollar rhetoric in the face of easing monetary policy is discouraging further building of USD shorts and leveraged carry trades for now. We therefore believe it makes sense to cautiously (keeping tight stop losses) re-enter EUR shorts against currencies with stronger fundamentals (CHF, SEK and AUD). But real-money portfolio rebalancing away from the United States and the rest of G3 to EM will continue in the longer term. And EM FX fixing/dirty floating will continue to displace appreciation pressure to floating major currencies.
- **G10 Rates: Curves steepening,** due to upside data surprises (ex-US), uncertainty about size and scale of QE2 in the U.S., and rising market-implied inflation expectations, will give way to flattening as data roll over and QE2 limitations take hold.
- **EM FX/Fixed Income:** In the current environment of capital controls and interventions and diverging business cycles, we like the following relative value trades in EM FX: *short BRL/PEN, short ZAR/INR, long PLN/HUF and short USD/RUB.*
- **Credit: Tactically overweight EM credit and short-maturity high-yield;** within DM continue to overweight high-grade vs. high-yield and U.S. vs. EZ corporates. EM and U.S. credit will benefit from QE and a weaker USD (to which most EM is pegged/managed) relative to EZ credit constrained by a macho ECB and sovereign debt problems.
- **Equity: We remain relatively bearish about equity relative to bonds.** Given the potential for risk-on, we are now neutral Developed Equity relative to Emerging Markets. However, we still maintain a quality bias in our recommendations.
- **Financial institutions: Remain Overweight credit against equity** and tactically neutral across the non-equity capital structure as QE forces cash investors down the capital structure. Underweight subordinated risk via CDS where the sub-senior spread approaches 2-year lows and overweight retail risk to investment banks in the line of fire of regulatory reform.

## Necessary but Insufficient Policy Responses for “Interesting Times”

By Arnab Das

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The key themes of our interesting times, as per the Chinese curse, warrant concern rather than **bullishness**, as per the on-again, off-again view of the commentariat. NB: In the double-talk of politics, local and global, the policy-speak monikers often oppose the problems being targeted, reflecting their intractability.

- **The G20: Global (Un)Coordination Problem?**
- **QE2: Opening the sluice gates for a liquidity—i.e., insolvency—trap?**
- **U.S. Mid-Terms: Is three a crowd—or, a Mexican Stand-off?**
- **EZ Does It! Fiscal adjustment and governance reforms remain challenging**

### I. The G20 and Uncoordinated Global Policies: Reasonable People Agree to Disagree

The non-system persists of EM dirty—in some cases, filthy—floats and DM free floats, posing a major **global coordination problem and zero-sum thinking**. This is ultimately a problem of disjointed, even opposing domestic and global goals, constraints, and tools. We’re glad the G20 is taking steps forward, but we must also be responsible and realistic: The central, immediate issues are being sidestepped. FX realignment is the bullet being dodged, with a view to targeting current accounts and raising influence on the world stage for the BRICs. FX regimes and levels are not the core problem, merely the mechanism by which the problem is propagated or adjusted. Current and trade accounts are the heart of the matter as after all, a trade surplus adds to the exporting country’s output; the deficit on the other side of the coin subtracts from importer’s growth:

$$Y = C + I + G + X - M$$

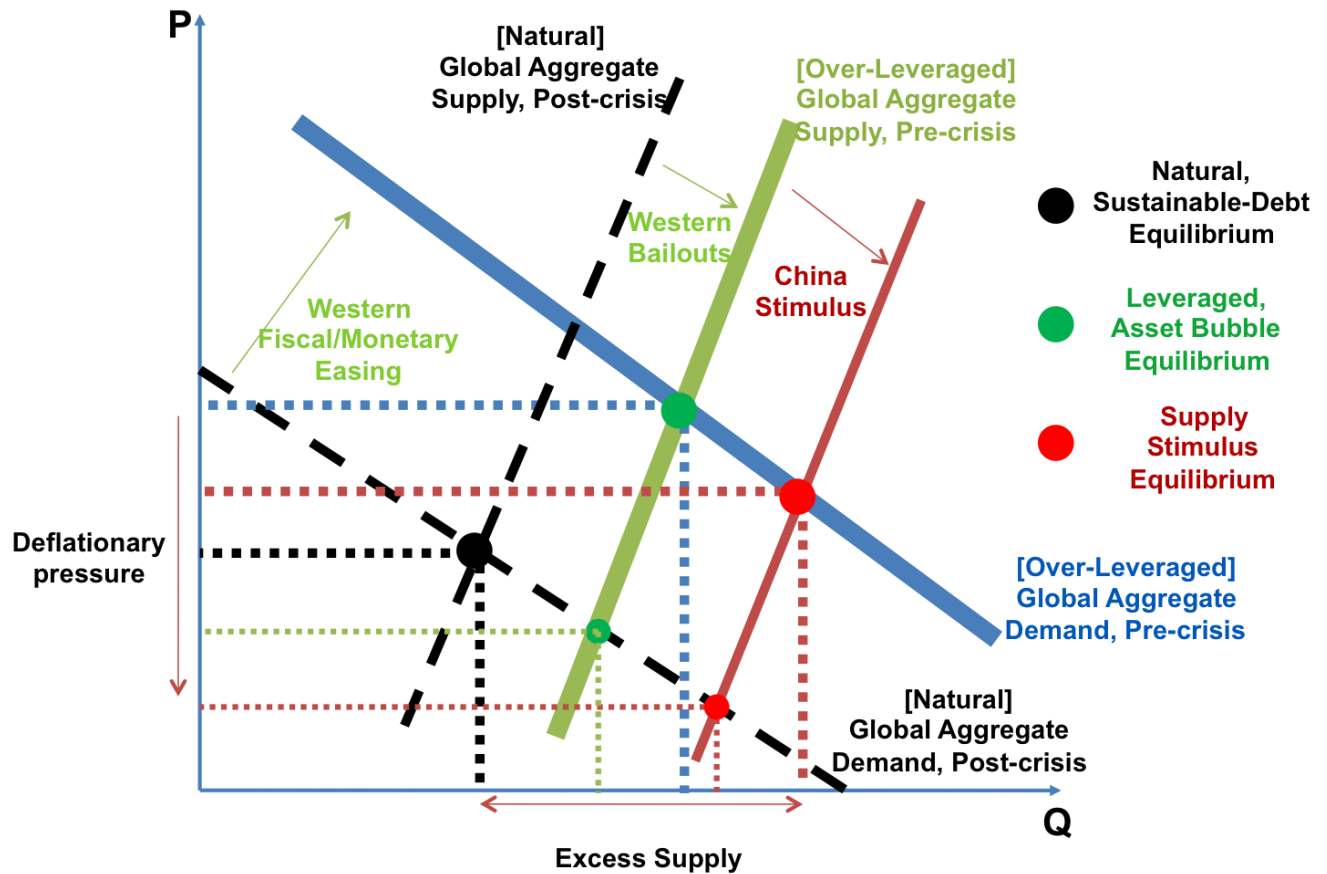
And assuming our world remains open for trade and investment but remains a closed system, [net trade \(that is, + X – M\) is a zero sum game](#) (Y is domestic output; C, consumption; I, investment; G, government spending; X, exports; and M, imports). If we do close the world down for business, however, it will be a negative-sum game, as falling X and M take down Y...

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Figure 1: General Disequilibrium in an Off-Balance World—Picturing the Ps & Qs (Stylized Aggregate Demand/Supply)

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Source: RGE

**A negative sum game on Bail-Out Planet Ponzi: A practical application of general disequilibrium theory.** The macroeconomic reality is that we find ourselves in a world of inadequate demand and excess supply compounded by excessive debt, and aggravated by surplus countries’ desire to maintain export-led growth while the deficit countries try to switch to exports. How on earth can every country expect to grow through exports, until we open up the trade routes to Mars? The chart above is a stylized rendition of the global disequilibrium: The Natural, Sustainable-Debt Equilibrium—where we would have been, but for the build-up of the leveraged asset bubble that burst, and probably where we should be; the pre-crash Leveraged, Asset-Bubble Equilibrium; and the post-crash policy-induced reflation by

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the West which is trying to consumption-smooth its way back to sustainable growth; and a globally-deflationary Supply-Stimulus Equilibrium, led by China's investment spree.

**As a direct result of the crisis, the global aggregate demand curve shifted down and in because consumers lost wealth, income, jobs and access to credit.** The extreme collapse forced unique monetary and fiscal policy seeking to restore demand as much and as fast as possible. As a direct result of the initial policy response—with bailouts galore—the global aggregate supply curve remained essentially unchanged (following an aggressive inventory cycle). The United States eschewed its capitalist roots and general belief in creative destruction for what might become “destructive preservation”, bailing out everything in trouble from banks to insurers to credit card firms to car leasing companies to auto assemblers, and of course households via Fannie, Freddie etc. All were too big, strategic, systemic, interconnected to fail, lest it, in concert with the collapsing financial system put the American way of life at greater risk. Given the speed and extent of the Global Crash, as well as the history of the Great Depression, the last of a series of deflations and multi-year depressions following the serial financial crises of the 1800s, this policy response was probably the only politically acceptable answer. It's quite clear that without the bailouts, we would experience a Global Depression of destructive destruction.

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**Surplus countries' response to the buyer's strike unleashed by the leveraged asset bubble collapse was to maintain or in China's case add to aggregate supply via an investment- and infrastructure-spending spree.** Aggregate supply first stabilized and then moved out thanks to policy, even as aggregate demand moved in. For example, Germany joined the deficit countries in bank and auto assembler bailouts. China's fiscal stimulus of 25% of GDP, the largest in world history, took the form primarily of credit creation running at an annual 35-40% during 2009-10. The 5% of GDP collapse in Chinese exports was almost completely offset by a 5% of GDP surge in gross domestic investment, restoring real GDP growth almost back to its heady 12% pre-crisis rate, and cementing the consensus view that China would continue to barrel ahead no matter what happened to the global economy.

But the grim reality is that surplus country policy responses would export deflation to client states; dire demographics and current structure of activity leave them no other choice —as articulated within their respective national contexts by Germany's finance ministers and China's Premier and President. So, global activity tends to gravitate to a lower price level with ambiguous implications for the level and distribution of output, to restore equilibrium.

**No government accountable to domestic constituents wants to be global “Swing Consumer” in a world of excess supply and inadequate demand, because that role implies highly volatile activity and employment.** OPEC's stabilizing of oil prices, famously and fortuitously benefits from the Saudi role as the “Swing Producer.” As the world's largest reservoir, supplier and deployer of spare capacity in oil with an exceptionally low lifting cost, Saudi Arabia can uniquely afford to vary output in response to shifts in

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global demand, enabling the cartel manage both the price and quantity of oil. The main locomotive for global growth has long been the indefatigable U.S. consumer, whose insatiable appetites have held up not only U.S. activity, employment, income flows, and stocks of wealth and debt, but all those across our planet. Now, even the United States no longer wants to be the consumer/importer of first, last and only resort. Imports are now directly subtracting from activity and job creation, as per recent quarterly GDP reports, as the role of net trade has flipped from a source of recovery to a headwind.

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**Who will step into the breach, now that the U.S. shopper is down and out? The short answer: No One.**

The decouplers continue to insist it doesn't matter, but the facts are that U.S. growth is converging over time to the anemic, stall-speed rate of final sales growth. All that has stood in the way is the largesse of the U.S. tax payer with apparently unlimited ability to issue Treasury bonds and Fed fiat money to sustain aggregate demand. Without a swing consumer, the excess supply will impose some dis- or even deflationary pressure somewhere. That's why we're on the cusp of some QE, yield curve-flattening, dollar-depreciating policy, which would export inflationary pressure to the dollar-peggers, rather than import the deflationary pressure of the augmented supply curve established by bailouts and surplus-country investment stimulus (particularly China).

**Stepping back, then, it appears there's a battle raging over market share,** except for those few relatively balanced economies sitting on the sidelines. These economies happen to be the relatively large, relatively closed EM economies of Brazil, India, Indonesia, and arguably Turkey, Poland and South Africa. In contrast, the large, rich deficit economies need to rebalance from consumption to investment and net trade. In direct consumption, the surplus economies and the world's one large, open economy—China—need to rebalance from net trade and investment to consumption. The people have yet to fully share in the spoils of growth in the People's Republic, partly because the People's Currency is being held below equilibrium, in order to boost net trade, investment, corporate profitability, and hence keep activity and employment above their natural equilibrium. And similarly, labor income needs to rise in surplus Germany and Japan to contribute to EZ and global rebalancing.

The Fed is the only credible dual-mandate central bank; alone explicitly charged with trying to manage both prices and quantities and full employment consistent with non-accelerating inflation (together with a third leg of its formal, legal third mandate, moderate long-term interest rates). Caveats to note: Chindia's central banks behave in something close to this manner – but of course no sane observer really believes them to be independent or orthodox. Many other DM and EM CBs have operated in a similar way as a result of the Global Crash, proving that central bank Independence is just a convenient fiction as reflected in surging intervention by the recently freed central banks of Brazil, Japan and Switzerland.

But as long as the Fed is the global money issuer and the United States remains the largest economy with the largest stock of wealth, the Fed can do whatever it takes to bring the inflation rate or price level

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back up and thereby raise employment prospects. Of course any central bank can increase base money, but only an issuer of global money can reflate its economy and inflate those of other countries that peg to the dollar. This message came across loud and clear in the months between Fed Chairman's Jackson Hole speech and the Treasury Secretary's appearance at the G20. So loud and clear is the coordination problem that the signatory of the dollar bill no longer has to adopt a turncoat, Texan swagger and utter that (in)famously theatrical but incredibly succinct aphorism: Our currency, your problem. Four decades later, how much has changed, and yet how much remains the same. Thus, it fell to the finance minister of Brazil to call time on the global currency war and boycott the G20. The clarion call was taken up by China, the largest net creditor to the United States, which objects to the inflationary monetary policy of the Fed, yet continues to dollar-peg.

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The U.S. external position has deteriorated significantly, such that it is now the world's largest net debtor in absolute terms, threatening to undermine the exorbitant privilege of reserve currency dominion. This gives U.S. residents the option to hold assets in any currency but creates strong demand for dollar liabilities. U.S. net external debt is still a relatively modest 25% of GDP—much less than many EM countries or EZ PIGS when they face the come-uppance of their Ponzi scheme external debt dynamics. But U.S. household net wealth is still over 350% of GDP. U.S. liabilities are overwhelmingly in dollars and the assets in a mix of dollars and other currencies. So as long as the dollar remains *primus inter pares* and national net worth remains positive, net external debt is not a binding constraint. And as long as the United States remains the largest economy and richest country, the dollar-pegging of those who would seek to grow through net trade is likely to continue. And if the preferences of would-be exporters change, of course, their currencies are likely to revalue either through inflationary pegging, or deflationary revaluation. Just ask Germany or Japan to recount their experience in the closing decades of Bretton Woods, and Japan since.

Thus a Hobson's choice is foisted on the dollar bloc. Dollar-pegging is in today's world a domestic policy choice and is a source of much confusion particularly in the EZ and China, which have a love-hate relationship with the dollar and the United States. Over 75% of currency trades—including those involving other major reserve currencies are with the dollar cross. The exorbitant privilege arises no longer from the insistence of the United States on the use of dollars, but the preference of economic agents and other countries. This in turn reflects the scale of the U.S. economy, and the credibility of its institutions of state and of property rights.

France, (with whom bilateral U.S. relations have been in decline ever since the Marquis de Lafayette with a local peak around Alexis de Tocqueville), as part of its agenda for its upcoming stewardship of the G20, hopes to dislodge the dollar from its reserve currency pinnacle, perhaps by global coordination and even Treaty. China has expressed some sympathy by proposing an SDR FX reserve basket despite wanting to maintain high export growth and continuing to dollar-peg, even as it decries U.S. money-printing. If they succeed, the United States will eventually have to learn to live within its means, because

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dollar-peggers will have some alternative basket of currencies with which to keep their exchange rates under control. No bad thing, and about time—this should happen anyway and be led by U.S. domestic policy rather than a shift in the role of the dollar.

But inducing the United States to consume less would still leave the problem of excess supply and inadequate demand unsolved. This conundrum is the schizophrenia of the global response to U.S. profligacy: It should be reined in, but without reducing aggregate demand. It's hard to see how to solve this equation, which is already in disequilibrium. Furthermore, this is not a problem that cries out for either an international monetary regime shift or is amenable to a quick monetary policy fix. Rather, it is a structural problem—the absence of a swing consumer in the context of excess aggregate supply. This problem can only be solved by allowing supply and demand to equilibrate, via reform and rebalancing. This is not to say that there shouldn't be policy-led consumption smoothing. However, policies are pointing in opposite directions, as depicted in the stylized aggregate supply/demand map above, retarding rather than facilitating global rebalancing, and aggravating the currency and trade tensions.

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**The G20 Finance Ministers have put a reasonably good face on a bad situation,** notwithstanding an effective Brazilian boycott. Summitry has de-escalated the rhetoric of currency war ahead of the November Leaders' Summit and the focus is shifting from FX levels to current account caps. In a roundabout way, this is more direct; whereas exchange rates are putative control variables given relative monetary and fiscal policies, current account balances are outcomes—allowing more of an out for both deficit and surplus countries. And of course there's no surety about who's on the other side of any major current account surplus, if overall balances are being limited, rather than bilateral adjustments being assisted through bilateral cross exchange rates.

**There can of course be no such thing as a swing consumer, not at the best of times, and certainly not now in bad times: There's no spare demand in a world of excessive debt and deleveraging,** only spare capacity. The question then becomes, who can generate enough increase in demand to offset the deceleration in demand arising from the retrenchment of net-debtor/deficit countries. This is the age-old rebalancing problem, one that was not solved by the Bretton Woods Treaty, because the then surplus/creditor Yankees rejected the British/Keynesian proposal that current accounts be directly rebalanced. Now, the shoe is on the other foot, and the United States is pushing for current account constraints. In a way this will help, since it will limit the growth of the savings-investment balances around the world.

So far so good, but the story is far from over. The current account caps and planned IMF reforms are major steps in the direction of better coordinated global macroeconomic management and a

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structurally sounder, system. But these are major steps on a very long march indeed, and it is not at all clear that the devil in the details and implementation is in retreat. And in the meanwhile, the savings/investment trends are pointing in the opposite direction from the current account caps, again as reflected in widening global disequilibrium.

**Imbalances—is this where all the growth has gone?** Reserve accumulation in Q3 is running at *nine* times the rate of Q2, with two-thirds of it concentrated in China's nearly US\$200 billion of reserve growth, a record for a reserve-busting country. So, even if the finance ministers have paved the way for important progress in their dear leaders' Seoul summitry, more soul-searching is called for. One angle to consider is that if capital flows dominate trade and current accounts (services and income flows), even if current accounts have been capped, there will still be enormous reserve accumulation to the extent that exchange rates are not allowed to move. This is after all the character of the non-system that perturbs us so much. Eventually the capital inflows would boost the domestic investment rate in the recipient countries, and reduce the current account balance. However, things might go further awry in the meantime. In a large, open economy, like China, where net trade and investment already loom so large, capital inflows especially if held at bay with sterilized intervention, could have a number of adverse short- and medium-term implications even if in the long run (after we're dead), balance would eventually be restored. But in the meantime, imbalances could increase or at not improve.

**IMF Reform: Another case of necessary but insufficient.** A major long-term positive, but won't do much for the here and now, and what is left unresolved speaks volumes at least commensurate with the important step forward. One view of the global macro imbalance aspect of the crisis is that EM countries, particularly in Asia, have self-insured because they don't want to run deficits that require them to return cap in hand to the IMF. In South Korea, the Asian Crisis is called the IMF crisis, by way of example. So the logic goes, give EM countries a seat at the top table and render them stakeholders as peers in the international system and they'll get it right.

**So it appears a new sort of G10 is being formed in the IMF's management:** the Big Four EMs, the BRICs; an EU/EZ quartet of the Germany, France, Italy, and the United Kingdom; Japan; and the indispensable nation, the United States. This would indeed be a major step forward. The chairs vs. shares debate about the IMF's structure and governance would be substantially improved, at least on the face of it. Benelux, for example, great believers in democracy, would probably cease to have a larger share of votes in the IMF than Chindia—the farcical reality that today, fewer than 20 million—even high-income, well-heeled—Europeans should have more weight in the world order than over 2 billion relatively poor Chindians, and even though their GDP weights or share of world trade, or any other metric, is far smaller..

**But wait a second! Or a generation?** Benelux has not yet agreed, and the redistribution of IMF quota shares has not been agreed either. Plus, the EZ will have three countries at the table, even though it will

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continue to have (we're told without qualification) a single currency. Any reassessment in Europe concludes that the share of the United States should be reduced, not of Europe. Any realistic assessment of relative growth rates and shares of activity clearly points to an increase for EM Asia at the expense of Western Europe and Japan. Any forward-looking assessment would include the combination of demographics and catch-up, assuming an open world economy (without which the exercise has no point—a bordered world doesn't need an IMF or global coordination after all), would only accentuate that shift, and within the BRICs towards Brazil and India, probably significantly less towards Russia, and relatively less for China.

**So the IMF reform suffers from three major problems even though it is a big step forward:** One, It is an important but incomplete step toward legitimacy. Two, the step forward will be whittled away by the inevitability of growth differentials and demographic destinies. And three, reserve accumulation isn't about self-insurance alone, or even in large part any more. It's about mercantilist FX policies to maintain high employment and growth, all the while subtracting from the growth of other countries in a world of excess supply and aggregate demand shortfall. Hence the potential value of current account caps.

**II. To QE2 or Not to QE2? Yes, absolutely necessary. But woefully insufficient**

**QE2 cannot do too much heavy lifting in the absolute, nor can it work as well as QE1 seemed to, as [we have discussed at length](#):** The financial effects have probably already been fully or even overpriced; and its economic benefits will probably last a couple of quarters with a marginal impact on both growth and inflation, limiting its longer term impact on expectations. QE1 benefitted from the far more powerful tailwinds associated with its timing. It came after the most intense moment of the crisis. It was far larger and more targeted at the direct source of the problem—MBS. The Fed had already put its own balance sheet and reputation to work to correct the market failures subsequent to Lehman's collapse, including rolling over commercial paper (CP) when the asset-backed market had gone out for lunch. The Treasury was engaged in saving critical counterparties in the financial system and the real economy including not just GMAC, but GM itself, as well as AIG. Asset prices, and the level and trajectory of public debt already reflect those emergency measures.

So, QE2 will lack the combination of fiscal stimulus, an aggressive inventory cycle, base effects, and the pull back from Armageddon in generating a positive feedback loop from markets to macro. It will also be heavily constrained by domestic and global doubts about its wisdom and efficacy. But of course, QE2 is necessary as anything less would be inconsistent with the Fed's dual mandate. In a world of excess supply in which creditor countries wish to keep growing by exporting, U.S. demand reflation is essential, pending the appearance of an alternative Swing Consumer of last resort.

The prospects are such that on domestic considerations alone, QE2 will have negligible effect on U.S. aggregate demand, and no discernible effect on global demand or inflation rates. Therefore, we may

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well need a QE3 and even QE4. It remains to be seen what the surplus/creditor country response would be. But the threat of untrammelled dollar depreciation from the mere mention of QE2 appears to have not only sent the signal that the U.S. can trash the dollar; but also that it is not eager to do so, as reflected in partial resurrection of the “strong dollar is in the national interest of the United States” mantra from its original co-author, current Secretary of the Treasury. Above all the U.S. is bringing a creditor country to the table of rebalancing via current account caps. Not as bad as it could be, but not great either...

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### III. All Politics is Local. Hence, a Congressional Ménage-a-Trois? A Gubernatorial Bustup?

**The U.S. mid-terms may well lead to a three-party Congress—from right to left, Tea, Republican, Democrat. A Mexican Stand-off is a distinct possibility.** One major strand of conventional wisdom has it that gridlock is good. A kind of political variant on the folk wisdom of the Hippocratic Oath—Congress and D.C. should do no harm. At the best of times, from the vantage point of Pennsylvania Ave, stewarding the Hill must look like herding cats. Great leadership of course implies great stewardship of natural advantages, political and economic, and the establishment of incentives to create new ones.

Well, we’re not in the camp that holds no news is good news. The United States needs to take action on a variety of fronts including fiscal consolidation in the medium run. There is no political process for ensuring this but there could be technical and technocratic discussion instigated say by the Government Accountability Office (it is so clearly not just about accounting, but about accountability, after all). Efforts to do so from the Congressional Budget Office and the White House itself seem to have no traction. Alternatively, permanent structural reform that would rebalance the economy away from consumption and non-tradables like housing, towards greater competitiveness. Perhaps tax reform to assist both of the above, which could be structured to include a federal VAT and/or energy tax including a [temporary but extended payroll tax cut](#) to shift fiscal incentives from capital investment to job creation for a period long enough to assist balance sheet repair.

**If all politics are local but the problems are state-, nation, and worldwide...just imagine the proliferation of (un-)coordination problems.** Such a burst of well-conceived, properly executed and politically finessed structural reform just isn’t going to happen. The Lame Duck that will begin next week may quack, waddle and hop a lot but is unlikely to get much done. So much so, that the Bush tax cuts may even expire if the Democrats and Republicans can’t see eye to eye over the tops of the Tea Party’s wigs and top hats. Things may have to go from bad to much worse to make that comprehensive reform happen; it may well take another crisis to secure political consensus. Things are more likely to worsen than improve, especially in the short run, but perhaps not by enough to make the political class in the United States or most other countries, grasp the nettle.

### IV. EZ Does It! Fiscal Adjustment and Governance Reform as Rebalancing Flashpoints

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**PIG Stall?** While the focus is on the expansion of the Fed balance sheet, the contraction of EZ balance sheets continues, as banks deleverage and excessively indebted sovereigns cut their budgets.

- Portugal is teetering on the verge of a political crisis thanks to focus on fiscal fixes. If the budget isn't passed, the government may step down as it has threatened, after negotiations broke down again this week. If so, an interim government with limited powers would have to step in until elections, which can't be held until May 2011. The budget is way off track, with a larger deficit so far this year than last. And the crux of the political problem is severe 2011 budget cuts, larger than Greece's.
- Greece is outperforming its fiscal targets, but the economy is taking a beating, and the 2009 deficit was again revised up. Tax revenue is consistently below target, in turn implying that further austerity measures might be required in 2011 as the economy contracts more than expected.
- Ireland's banking black hole continues to be a fiscal quagmire, with a trade-off taking shape between sovereign and bank credit quality. The government has doubled its austerity plans following a halving of its growth forecasts, which are still too optimistic in our estimation.

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Thus, a quick PIG round up suggests that scepticism about the quality and efficacy of the fiscal adjustment plan remains open. Spain continues to hold its head above water, but is still exposed to further challenges in its banking sector, wide open labor market, and lack of clarity about how lost public revenue and private construction activity will be replaced. And the EZ recovery remains at risk from dollar-depreciation/euro strength. Germany is motoring ahead, not least because of the strength of EM Asia/Chinese domestic absorption—but as we have shown above, this may not be a sustainable source of growth in the absence of equilibrium between rising global supply and weak global demand.

Against this backdrop, EZ/EU summitry is taking forward a tortuous reform process. On the table for now is permanent bailout mechanism, with moral hazard to be contained by a sovereign debt restructuring mechanism to bail-in private creditors and a 0.2% of GDP fine for repeat fiscal offenders. Automaticity hangs in the political balance with votes apparently required to stop the fines rather than impose them. The suspension of voting rights, as a probable bargaining chip, is probably off the table. So let's tot this up compared to the Maastricht and Stability and Growth Pact enforcement mechanisms. Back then, hard and fast rules, that didn't bind or stick: A 1% of GDP fine without automaticity and with political discretion, with no suspension of voting rights and no sovereign debt resolution mechanism, but with bail-outs explicitly ruled out. So looking forward through the thicket of Treaty reform, probably essential to get the bailout fund-cum-resolution mechanism past Germany's Constitutional Court, we are being asked to believe that substantially smaller, discretionary fines than the larger ones that didn't work, without suspension of voting rights, but along with debtor bail-outs and creditor bail-ins will encourage fiscal probity and external balance in EZ policymaking. We reserve our own judgement, leaving our readers to wonder whether the promised EZ nettle-grasping has delivered the right balance

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of carrots and sticks to over-borrowers and over-lenders...If there are systemic debt build-ups, will the EZ tip-toe towards the brink of financial crisis to impose a bail-in? It's worth noting that bail-ins so far have been officially executed only for non-systemic creditors in recent times.

And placing all this in the current QE2 juncture, unreasonable EUR and JPY strength is likely to persist against the USD. China is likely to continue dollar-pegging and EUR diversifying as well as JGB buying (via U.K. proxies). The relative strength of those two currencies will assist U.S. external adjustment, but are tantamount to further nails in the coffin of robust, sustained EZ and Japanese growth. Ultimately, then, the prospects of USD weakness/EUR-JPY strength are unsustainable. Eventually, EM currencies must rise against G3 currencies, either through inflation or preferably through faster and larger nominal appreciation, led by CNY.

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**In Summary: Macro and Market Maxims for These Interesting Times**

A Mexican stand-off may be judged to be tolerable, if the Fed can corral the markets and hold the fort. But the Fed's abilities to deal with the spate of [solvency and structural problems we face are limited](#). The Fed may help smooth consumption and refinancing of the excessive debt burden by helping to prevent us from going down for the count into a deflationary double dip. Such a recession would be very bad indeed, especially if it were a severe double dip as the absence of policy bullets and the political and fiscal constraints to a new round of bailouts might be insurmountable (see our scenario analysis in the [September 2010 CAM](#)). The best then that we can hope for is that the band aids hold despite barely staunching the world economic haemorrhage, while the patient heals itself through deleveraging after refusing the radical surgery called for by the global metastasis of a cancerously unbalanced global economy.

Against such a diagnosis of probable but tentative survival and no rapid or complete recovery, the best practice of medicine may be little else but to conserve resources, wealth, keeping powder dry, thus biding time for an eventual recovery. Meanwhile, the symptoms of improvement need to be carefully balanced against the those of deterioration; after all a flat-lining, gradual recovery is no bad thing after a cardiac arrest of the financial system that is the heart of the global economy. We insist not just on mixing our metaphors, but on remaining risk averse because we're clearly not in a secular bull market but a protracted period of uncertainty and volatility. Such interesting times call for careful husbandry rather than rolling the dice...

## Plant, Dig, Drill, Pray

By Shelley Goldberg

- What are the global policy implications for the commodity sector? In light of the recent G20 communiqué, the November Leaders' Summit, the imminent QE2 package, the November FMOCC meeting and U.S. midterm elections, the dynamic forces at play for commodities are many, at a time when price appreciation is occurring in an otherwise weak, growth-challenged global economy.
- For the sector to continue to perform well, policy must translate into a combination of long-term global growth, higher inflation and a weaker U.S. dollar. Such an outcome in its entirety is unlikely.
- Since Fed Chairman Ben Bernanke's speech at Jackson Hole, the U.S. dollar has fallen by approximately 6%, but commodity prices have risen by twice that. The positive impact on U.S. growth of QE2 could be stifled by the negative terms-of-trade effect and its impact on real disposable income that the ensuing heightened commodity prices entail.
- Policy will dictate the economic direction after the midterm elections, but we are fairly confident that, until then, commodity volatility traders should benefit.

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### Recommendations

We recommend an overweight to the agriculture sector, including softs and grains.

- From a seasonal/cyclical aspect, we anticipate ongoing weather-related spikes and supply constraints in an already low stocks-to-use ratio world.
- From a secular standpoint, EM nations are increasing consumption to fulfill a growing middle class demand for protein, of which grain is the primary input.
- Agriculture has become an energy commodity in its own right, as land is repurposed for biofuel-oriented commodities. We suggest longer-term investment opportunities that include seed and fertilizer producers, farm machinery and equipment and water/irrigation-related industries.

We also recommend industrial metals that serve construction— e.g. copper and iron ore—which could see a boost from added infrastructure stimulus.

- EM recovery is closer to a V than U shape, yet high current inventory numbers dictate questionable sustainability.
- Energy, currently in healthy supply, also has a less sustainable upside, in our view.
- The continued prospect for gold may be running its course and should be managed tactically.

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**Tilting of the Risk-On/Risk-Off Seesaw**

In the event that QE2 succeeds in weakening the U.S. dollar and flattening the yield curve, commodity prices should appreciate. Nevertheless, we expect limited upside from current levels as recent price rallies strengthen our view that the expected US\$600 billion QE2 package is largely priced in. We do not believe that QE2 will have a sustainable effect on commodity prices as supply and demand factors eventually bring prices back to fundamentals. Recent talks are more pessimistic in light of asset price appreciation as of late. Should the QE2 package be smaller than expected, commodity prices would likely fall.

QE2 may also signal a return of assets to riskier homes in search of higher returns. Commodities are frequently placed in a high-risk/high-return category, despite statistically proven arguments that commodities can lower the volatility of a broader asset portfolio. Yet, as a standalone investment, commodities may exhibit signs of sharp trend reversals and breakout patterns resulting from sudden and significant shifts in the supply/demand balance. Exposure to the sector through producer equities and debt comes with particular risks when new technologies and/or unproven reserves are factored in.

Note, the current 10-day volatilities, which have come off significantly from 2008-09 levels. By comparison, the volatilities of broader asset class indexes are typically much lower.

**Figure 1: Ten-Day Volatilities**

Commodity	10-Day Volatility		Index	10-Day Volatility
Natural Gas	37.00		GSCI	27.55
Crude	36.44		Lehman Aggregate	03.56
Heating Oil	35.83		S&P	13.01
Corn	34.12			
Wheat	29.30			
Soybeans	33.01			
Gold	19.93			
Silver	38.20			
Palladium	36.09			

Source: Bloomberg

The size of the QE2 package should dictate the sustainability of any resultant price rallies. For prices to stay elevated, QE2 has to succeed in a multitude of ways: repairing balance sheets, fulfilling persistent global demand for raw materials, tilting the supply/demand balance toward inventory reductions and

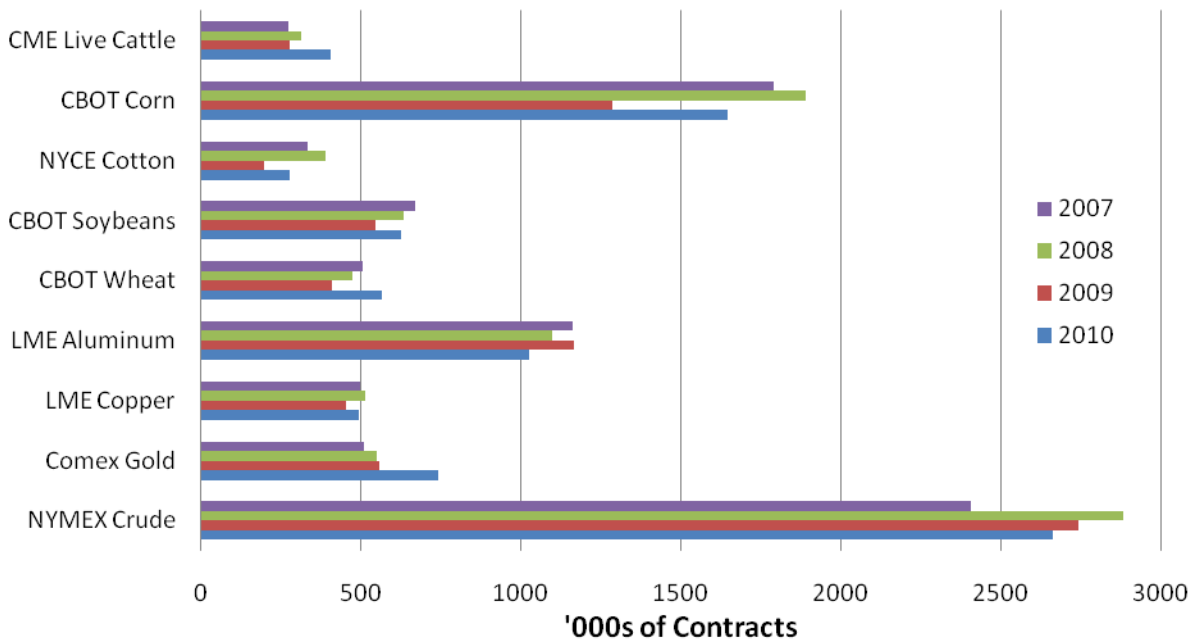
COMMODITIES

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backwardated markets. QE2 must shift commodities to a desired financial investment rather than simply a buy and store/return on yield play that results in an inventory build.

A growing interest in commodity investing is noted by average weekly annual open interest on listed futures and options commodity contracts. Note that 2009's woes disrupted the flow of volume (Figure 2), yet 2010 has surpassed 2009 and looks to continue along the growth trend, as noted by Figure 3. Lastly, note that these figures do not represent the OTC (over the counter) markets, a sizable and significant percentage of overall traded commodities, gold being a primary example.

Figure 2: Annual Average Open Interest (futures and options combined)



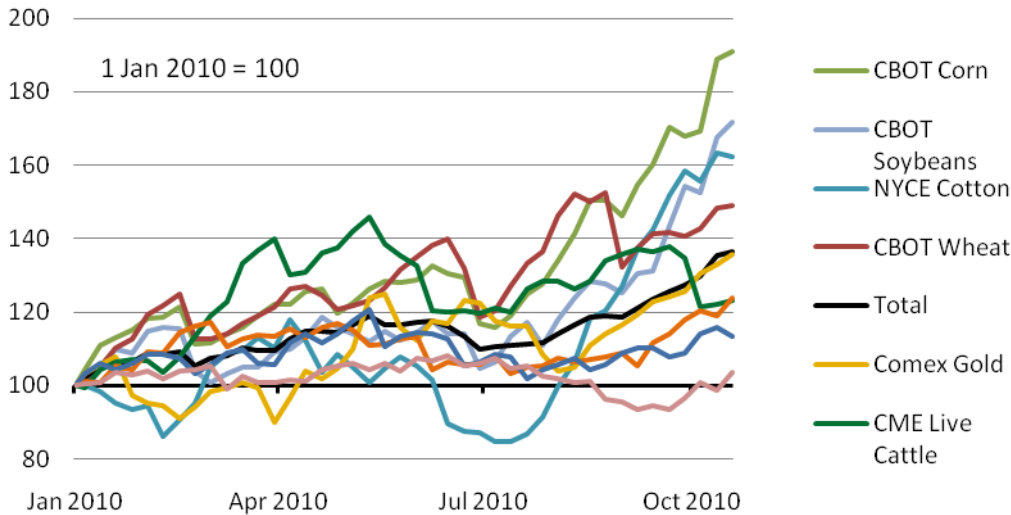
Source: Bloomberg

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Figure 3: Change in Open Interest 2010 (number of contracts, futures and options combined)



Source: Bloomberg

There are a number of new commodity exchange-traded funds (ETFs) being introduced to the markets, facilitating more investment in commodities. Additionally, an increasing number of large private and public funds now include commodities as an asset class or increasing existing allocations. QE2 may attract riskier assets, yet even with rising investor interest in commodities we do not anticipate hyperinflation or even core inflation as being likely outcomes on the basis of QE2.

**From South Korea to Seoul**

The G20 communiqué in South Korea dealt with increasing tension over the ongoing appreciation of a number of currencies against the U.S. dollar, coupled with government intervention as an offset to that risk. Key issues were addressed including current accounts, protectionism, exchange rate flexibility and capital controls. The Seoul summit’s theme will be “the G20’s Role in the Post-Crisis World,” yet nations outside the G20 must address similar concerns, albeit on a smaller scale. Yet, reaching a reasonable prognosis requires a country-by-country policy study as to which nations will continue along a competitive devaluation path versus those that will adopt free-floating currencies.

The currency war for commodity net importers has become a double-edged sword. Net importers benefit from lower commodities prices customarily priced in U.S. dollars. For example, globally traded crude oil is highly sensitive to dollar moves. In terms of global trade, 44.8% of all imports flow to nations outside of the U.S., Europe and Japan. Yet, commodity imports are only one factor. A strong local

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currency impairs exports, stifles tourism and fuels domestic inflation, harming both industry and households.

A net exporter nation with low GDP per capita would suffer most in this situation (e.g. China), yet since removing its peg to the U.S. dollar in June, the yuan has only appreciated by roughly 2.5%. So in essence, China has been exporting inflation while the U.S. has been exporting deflation. The weak dollar and cheap commodity prices was a 2008-09 windfall for China when its fiscal stimulus took the form of a large credit-led investment and infrastructure spending spree of over 20% of GDP, and additionally enabled China to stockpile at depressed commodity prices.

While nations that are largely self sufficient in a number of commodities would not reap the benefits of cheap resource imports (Canada, Australia, Brazil), they are still better off in the long run due to stronger balance sheets and stable governments. A net importer of commodities with high GDP per capita and capable of relying on domestic sources of growth should also fare better (Switzerland).

**From Washington (FOMC) to the State Level (Mid-Term Elections)**

While the FOMC rate decision in early November has a close-to-zero probability of hiked borrowing costs, the more pertinent issue is the looming November midterm elections. First, support is growing for fiscally conservative candidates, which could have a bullish impact on the dollar stemming from expectations of lower spending and printing. With the Republican (and even more so the Tea Party) vote finding stimulus unpopular, the credit markets could suffer post-initial QE2 easing. The result could put a strain on R&D, growth and development in the commodity sector, and jeopardize brownfield and greenfield projects in producer pipelines. This would be particularly evident in alternative energy, the subsector most demanding of investment by private equity and venture capital.

Additionally, a Republican vote may well endanger potential “green” tax benefits. In sum, it is not a function of which currencies are depreciating, but rather the speed of depreciation. The lack of a resolution of the mounting currency tensions has made it more likely that the Fed will pursue another round of asset purchases, weakening the dollar and driving up commodity prices. Such a move would encourage more trade wars coupled with beggar thy neighbor and mercantilist activity.

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## Please Sir, I Want Some More

By Natalia Gurushina

- Start very cautiously rebuilding EUR shorts vs. USD as we believe that the probability of another serious USD weakening remains low.
- Start re-entering into longs for European economies with strong fundamentals, such as Sweden and Switzerland (short EUR/SEK and short EUR/CHF). Keep tight stop-losses as the situation is likely to remain volatile.
- Maintain short EUR/AUD and short EUR/CAD—also with tight stop-losses.
- Buy volatility (VIX) at levels below 20% as “just in case” insurance.

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### Market Performance: Range-Bound Trading

EUR has been range bound against USD in the past month, which was part of our baseline scenario. The mad rush to rebuild EUR longs in anticipation of a second round of quantitative easing in the U.S. () appears to be over and most of the effects associated with the baseline program of Treasuries purchases (US\$600 billion spread over several months) are priced in. We have previously [mentioned several trades](#) that might benefit in the current environment. Among them, so far only one—long CAD/EUR—has been marginally unsuccessful, as CAD weakened by 0.8% against EUR in October. The long GBP/EUR recommendation was flat for the month as a whole, but started to turn our way in the second half of October. Long AUD/EUR also cautiously moved our way.

### Fundamental Outlook: Will the Fed Put in Enough Fuel to Fly the Helicopter?

As the November 2-3 FOMC meeting approaches—and the announcement of the Fed’s new UST purchase program—**speculation about the exact size and the mechanism of QE2 continues to dominate the market**. Our baseline scenario assumes a US\$600 billion program spread over a period of several months with the possibility of a second phase of QE2 if the Fed believes that the initial program has failed to meet expectations. In [Quantum\(s\) of Solace](#), we argued that the direct effect of the initial program on EUR/USD has been largely priced in by now. A QE program of this size is unlikely to result in further compression of U.S. real yields, whereas the Baa-UST spread is likely to tighten only marginally from its current 213 bps to 200 bps.

**If the impact of QE2 (at least the initial phase) has been largely priced in, what other factors could affect EUR/USD in the coming weeks?** Answering this question involves a recap of the key variables in RGE’s EUR/USD model. First, we look at the real rate differential between the U.S. and the eurozone as the measure of returns, using Germany’s real rates as a proxy for the eurozone. Second, we use the BarCap Baa-UST spread as a measure of global risk aversion. Third, we introduce a measure of intra-

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eurozone risks and use the differential between 1Y CDS in PIIGS and Germany as a measure. Finally, we also look at technical positioning—specifically at IMM speculative longs.

This framework points to the importance of **keeping an eye on German real rates**, as well as on U.S. TIPs (which are directly affected by QE). **Germany's 10Y real yields have recently started to creep higher** from the abnormally low levels in September and October. This move back closer to the 1% territory is unsurprising given that Germany's macroeconomic data flow still surprises on the upside from time to time. **In the near term, this development should be supportive of further marginal USD weakness.** In the longer term, it remains to be seen how high German real yields could go (given that the economy will cool from now on) and how successful the Fed would be in pushing 10Y TIP yields lower, given the already low starting point. That low level for U.S. real yields is what differentiates QE2 from QE1, and may limit the impact of QE2 on EUR/USD.

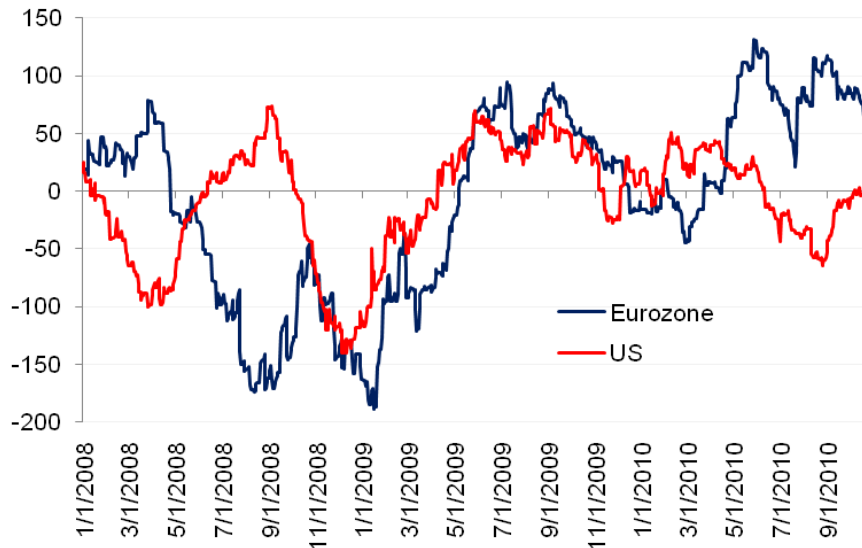
**What could force the ECB to adopt a less hawkish monetary policy stance?** One possibility is Germany's economy cooling faster than expected in 2011 (partially due to the impact of a stronger EUR). A likely return of deflationary pressures in Q1 -2011 and the need for additional fiscal austerity in the eurozone might also influence the ECB, but we do not count on this happening in the immediate future. In fact, the current level of economic activity in Germany is a reason why the ECB might think about a rate hike. Another factor is that the implementation of VAT hikes in several eurozone economies is likely to push up headline inflation, even if the core of the currency bloc inflation remains weak. All this should benefit EUR in the near term. However, Europe's macroeconomic outlook is likely to be gloomier over a six-month horizon. At the same time, recent macroeconomic news flow in the U.S. is slightly more positive (as a lot of negative expectations have been absorbed by the market eurozone).

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Figure 1: Economic Surprise Indexes in Eurozone and U.S. (Citibank)



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Source: Bloomberg

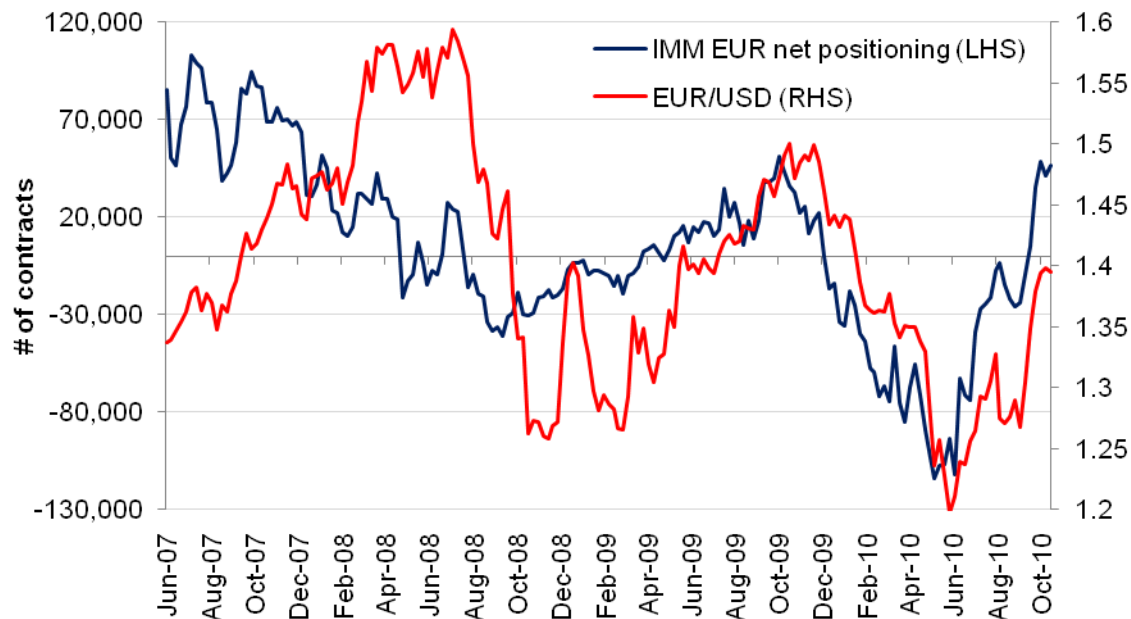
**Another key parameter to monitor is global sentiment**, measured in our model by the BarCap Baa-UST spread. Global sentiment's impact on EUR/USD was much more significant during the first round of QE than now, since it was accompanied by globally synchronized fiscal and monetary policy initiatives. A sustained upside for global risk sentiment is likely to remain very limited in the coming months as we enter a period of severe European and EM fiscal austerity and slower GDP growth globally. As such, **any USD weakness stemming from this particular factor is likely to be limited as well.**

**In addition, we point out that speculative EUR longs appear elevated**—we are now back at fall 2009 levels. Such extreme positioning might be unsustainable, especially if the market turns its attention to Europe and ominous macro news from that part of the world starts to sink in. So, this points to the possibility of USD correction around the time of the QE2 announcement.

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Figure 2: IMM Long EUR Speculative Positioning



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Source: Bloomberg

**The final element of our EUR/USD model is intra-eurozone risk**, which we measure by the differential between 1Y CDS spreads in PIIGS and Germany. There is a fundamental link between the currency and the credit in the case of the eurozone. Specifically, any EUR debt refinancing problems would entail an inflationary exit from the EMU with a massive drop in the real value of the debt via a sizeable EUR devaluation. Of course, if the real value of the debt is reduced via restructuring or its net present value via rescheduling, the currency's reaction is likely to be spread out over a longer period of time.

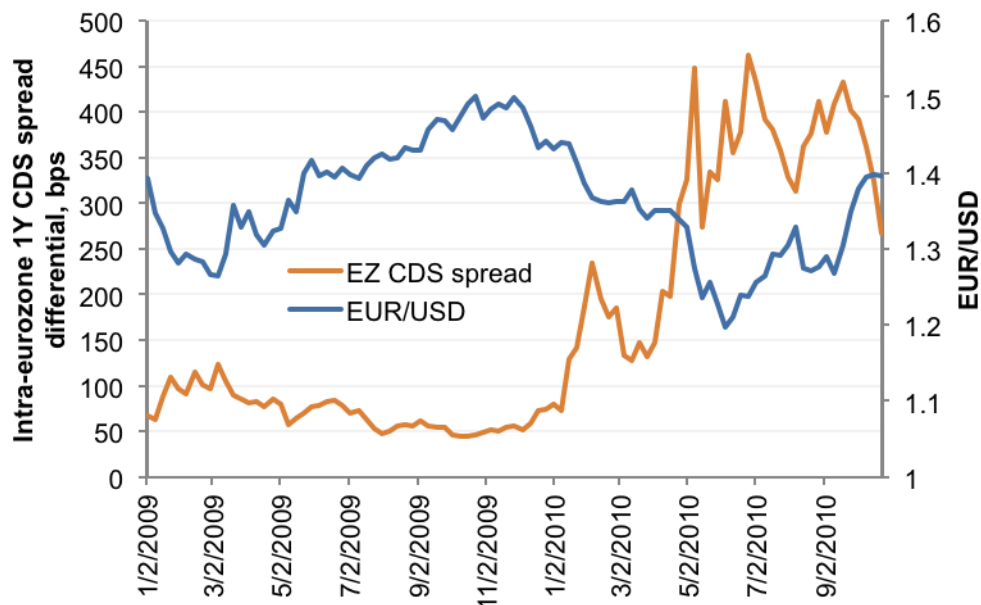
**The markets continue to disregard most of these risks.** This stance can perhaps be justified in the very near term (fingers crossed!), but is hardly prudent on even a slightly longer-term horizon. What do CDS spreads tell us? First of all, the intra-eurozone CDS spreads differential has tightened very sharply in the past month—from 425 bps to 264 bps, which effectively brings us to the levels seen in April this year. One can argue about the sustainability of the current EMU situation, but from the point of view of EUR/USD valuations, we once again say that there is limited **room for further spread tightening and further USD weakness**. Even if we assume that the market develops amnesia and forgets all that has occurred since early 2010, the best we can see is another 100 bps reduction in intra-eurozone CDS spreads in the next quarter or so. Within our model, this would translate into **an additional 3% USD weakness against EUR**. On the other hand, if more skeletons fall out of eurozone closets in the coming months (not an unreasonable assumption), the potential for the CDS spreads widening would be much greater. USD would stand to gain 6-6.3% against EUR if spreads return to August levels...

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Figure 3: EUR/USD and 1Y CDS Spreads Differential Between PIIGS and Germany



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Source: RGE, Bloomberg

To sum up our discussion so far, our estimates suggest that **the 1.39-1.40 range represents the fair value estimate for EUR/USD cross under RGE's QE2 baseline scenario.** The elevated level of speculative EUR longs points to a **possibility of a USD correction** to the lower end of the 1.33-1.38 range. What could change this outlook towards greater USD depreciation? The answer is a **larger-than-expected "shock and awe" QE2 package.** Such a package would bring a further rally in U.S. yields and tighter Baa-UST spreads, and would likely lead to further build-up in EUR longs. **Under this scenario—with a [20% probability](#)—the USD would weaken to 1.43-1.47 against EUR.**

**Of course, any such USD weakening would be unsustainable.** It would result in an even more significant reduction in the eurozone's GDP growth and might invite another wave of currency manipulation accusations against the U.S. Even though G20 countries promised to refrain from competitive devaluations at a recent South Korea meeting, we remain skeptical. The U.S. and South Korea's sneaky suggestion to target the size of the current account deficits—rather than the exchange rates—is unlikely to be implemented and any additional (and especially) sharp currency moves will be viewed with suspicion and disdain by the global community, and will probably cause a new wave of competitive devaluations.

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**Market Views and Recommendations: Get Out of the Trench, But Keep Your Helmet On**

- Start very cautiously rebuilding EUR shorts vs. USD as we believe there is a low probability of another serious USD weakening.
- Start re-entering into longs for Europe's economies with strong fundamentals, such as Sweden and Switzerland (short EUR/SEK and EUR/CHF). Keep tight stop-losses as the situation is likely to remain volatile.
- Maintain short EUR/AUD and short EUR/CAD—also with tight stop-losses.
- Buy volatility (VIX) at levels below 20% as “just in case” insurance.

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## Lest We Forget the Others

By Arun Motianey and Steve Reich

### Recommendations Summary:

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- **We hold that the large-scale asset-purchase (LSAP) program that the Fed is about to revive is already priced into government bond markets;** our expectations are for a US\$600 billion program of securities purchases.
- However, the scale of these purchases will not be sufficient for the Fed to achieve its objectives, which we believe are to drive down the nominal benchmark Treasury by another 40 bps and, more importantly, the benchmark TIPS by another 25-40 bps. Nervousness in the bond markets about the Fed's end-objectives will inject frequent selloffs, but in this case **investors should be adding duration carefully and tactically to their portfolios.**
- The data out of the UK is conflicting and the seesaw continues between those who see inflation pressures building—and so argue against coming out in favor of a Fed-style second round of quantitative easing (QE2)—and those who see these pressures as being temporary. **We expect a rally in the 10y gilts eventually, but for now we will hold our fire** and watch forthcoming data.
- Australian government bonds are facing their own dilemma; but unlike gilts, expectations of a rate hike are being rinsed out of the money markets. Not so fast, we say, since inflation readings on the non-tradable side are troubling. **Prepare for bear flattening of the curve.**
- Our attention turns to the EZ money markets, where the ECB's zealotry in expunging excess liquidity has impressed the markets rather more than it should. **We recommend wideners against the EONIA curve using Euribor forward contracts.**
- We also do a quick roundup of the EZ peripheral bond markets, where problems in Ireland are taking a backseat to renewed fears of default in **Greece** and, in line with our longstanding views, the generous financing package from the "troika" has **merely pushed back the likelihood of default to the point where funding ceases.** Meanwhile, Portugal, which had escaped the worst of the crisis in Q2, is now looking increasingly Hellenic.

### Recapping QE's Effects in U.S. Rates and Swaps

At the time of writing, the Fed's likely November 3 actions and implications are still being widely discussed. We explained in the Fixed Income section of [Quantum\(s\) of Solace](#) that much of our baseline scenario—which we pegged at a 60% probability—is already priced into the Treasury yield curve levels, slope and curvature. In fact, the market seems to be acting on a well-recognized sentiment: Buy on the

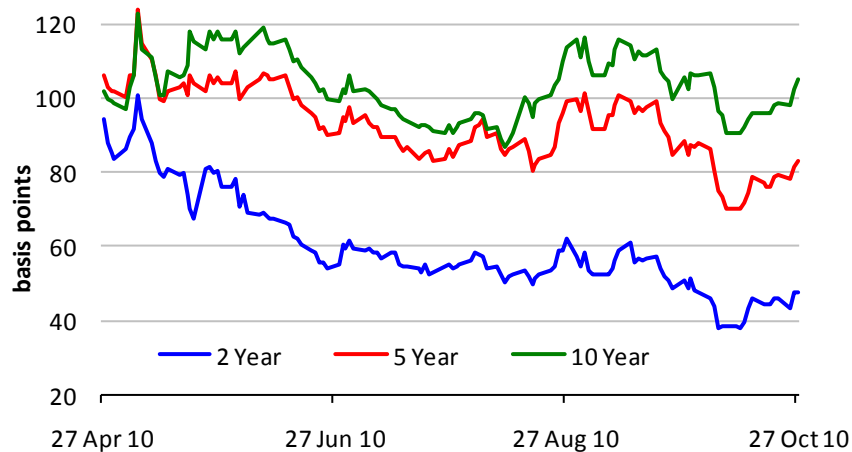
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rumor, sell on the hunch. And the hunch is the inchoate belief that the Fed may prove to be more conservative than previously assumed. Hence, the mild selloff currently underway is likely a reaction to even the sober optimism about QE that prevailed until recently. We can see that most clearly in the short-expiry U.S. swaption volatility. The downward drift in the long tails—specifically, the 5y and 10y swaps—ended a week ago and has in fact reversed (see Figure 1).

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**Figure 1: U.S. Swaption Volatility (3-month expiry)**



Source: Bloomberg

But these jitters, which have spread through cross-market channels to other developed government bond markets, are not unusual. The U.S. central bank signaled strongly that it is on the verge of reviving a LSAP program, and expectations frequently correct—or, more precisely, adjust—closer to implementation. Our [analysis](#) concluded that, in the absence of “shocks” emanating from outside the U.S. economy, a 10y Treasury yield of around 2.5%—and a 10y TIPS yield of around 35 bps—would fully discount a purchase program of US\$600 billion (our base case) that takes place over a relatively fixed time period.

We also went on to say that the Fed would find that response to be inadequate and would aim for something more effective. That may come in the form of additional purchases at the end of the initial period, or in converting to an open-ended program soon after initiating the LSAP, or a variant thereof (some of which we have discussed as our non-baseline scenarios), or some other unconventional policy target and instrument using conventional or unconventional means. Our conclusion was that monetary policy would stretch its sinews until it lowered nominal Treasuries by at least another 25-30 bps in the intermediate sector of the curve and pushed real yields down by a further 25-40 bps in the comparable segment of the TIPS curve.

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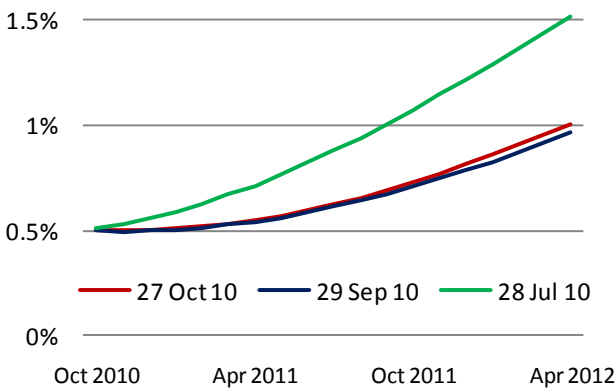
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Hence, regardless of the size of the initial purchase program, and the selloffs punctuated by rallies as the bond market tries to interpret the Fed’s designs, there would almost certainly be more to come. Unless the Fed loses control of its policy instruments—by, say, uprooting inflation expectations—we think it more likely than not it would continue on this course till it reached close to those levels. If it succeeded in doing so, it would also flatten the yield curve up to the 10y and possibly beyond. In these circumstances, swap spreads would start to narrow again, as they typically move directionally when central banks buy assets on a large scale. Such a view means that we recommend cautiously going long on the 10y bond on either of the curves.

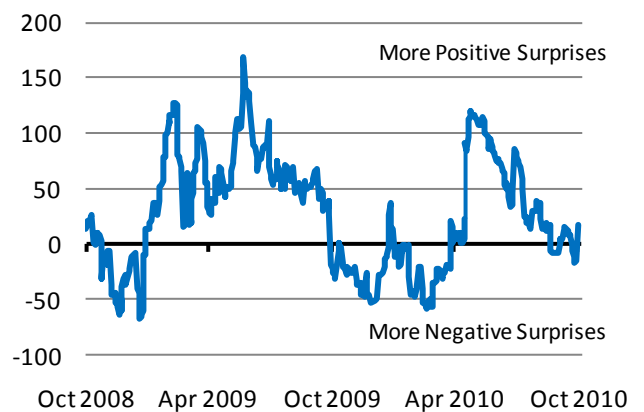
**UK Gilts: No Expansionary Contraction**

The UK money market curve flattened for much of October, as rate hikes started to be priced out and speculation took hold about QE by the Bank of England (BoE). The UK Base Rate curve implied by SONIA (the Sterling Overnight Index Swaps) till earlier this week moved down, signaling that a 25 bps hike in the policy rate was not likely until Q2 2012 (compare that to three 25 bps hikes in the same period as recently as July). But this changed abruptly on October 26, with better-than-expected activity figures for Q3. Now, rate expectations are back to where they were a month ago (Figure 2).

**Figure 2: UK Base Rates Implied by Swaps**



**Figure 3: Citigroup UK Economic Surprise Index**



Source Bloomberg and RGE calculations

Apart from the most recent Q3 GDP figures, the activity data surprise index we follow (Figure 3) has moved down (relative to expectations) since the middle of the year. Yet the stickiness of inflation does provoke dissent in the BoE’s Monetary Policy Committee. The government’s recent Spending Review was in line with expectations, but the absence of backsliding (in the form of additional back-loading of cuts) was met with approval by the rating agencies. The gilts market may not be impressed with government suggestions that this is an expansionary contraction, but with QE hopes for the near term

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now getting quickly washed out, we stay neutral on the gilts curve and will withhold our recommendation to go long on the 10y bond.

Much will depend on whether the spike in inflation from a weaker currency (and certainly from the recent hike in VAT) peters out. The 10y gilt at over 3% is taking its cue from the money markets, when actually it should be taking direction from the long-dated inflation swaps market, which shows little concern about inflation.

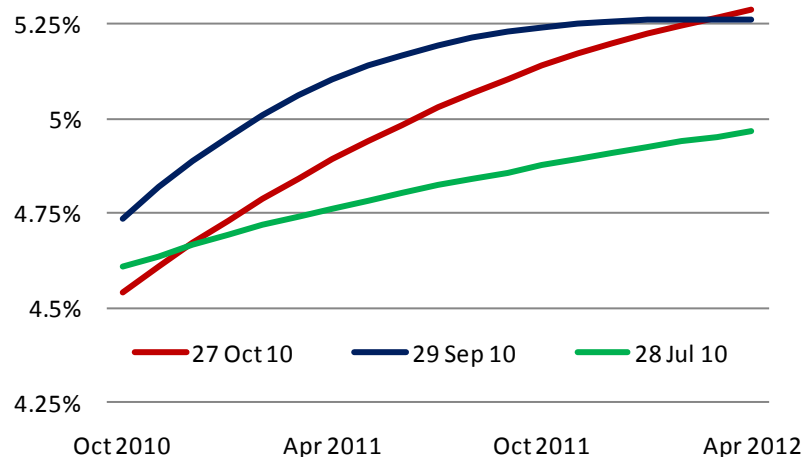
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### Australian Government Bonds: A Bear Approaches

Australia's policy rate trajectory implied by the overnight swap curve has changed shape in a way that makes it different from every other major developed country government bond market. Most have shifted down in a parallel fashion, implying a downgrading of expectations of rate hikes—some sharply (as in the case of the U.S.), others gently (as with Canada or Sweden).

Australia's rate expectations path has steepened relative to what it was as recently as a month ago (as Figure 4 shows). The money markets are now expecting less tightening over the course of the next year and then a shift to a somewhat more aggressive policy in 2012.

**Figure 4: Australia Policy Rate Implied by the Overnight Swap Curve**



Source Bloomberg

The strong employment data that came out in early October was brushed aside by the money markets as global considerations, i.e. Fed-led QE, the strengthening Australian dollar and larger flows from carry trades, not to mention the implications of that for future inflation readings drew investor attention. The Q3 CPI release came in a bit weaker than expected and will be more grist for the money market's mill. Unquestionably, this reduces the chances of a rate hike at the RBA's November Board meeting. But on

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closer examination, we see that weaker headline figures conceal a sharp rise in the price of non-tradables (1.1% q/q), now accelerating. The strong Australian dollar does not help here.

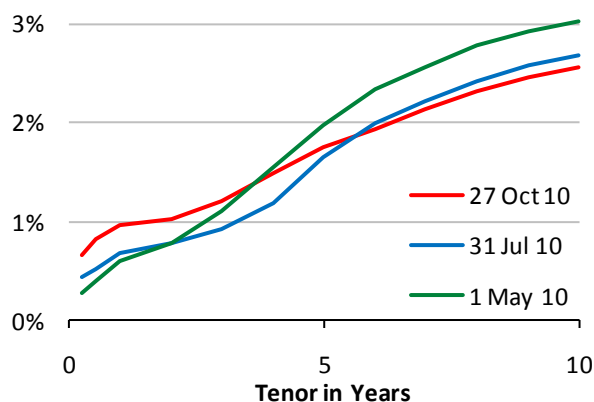
The ACGB 10y yields have backed up by almost 40 bps in less than two months. We would be inclined to go with signals from the longer-dated government bond market. The risk of a bear flattening of the Australian yield curve remains high.

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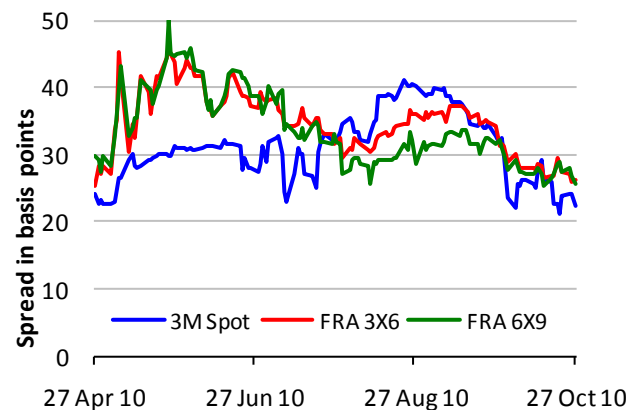
**European Money Markets: Carried Away**

Ninety-day Euribor fixings breached the 1% level for the first time since mid-2009 and, if the ECB's rhetoric is to be believed, could go even higher. The eurozone government benchmark yield curve has bear- and bull-flattened notably in the last three months (see Figure 5).

**Figure 5: Eurozone Govt. Benchmark Yield Curve Swaps**



**Figure 6: Forward Euribor Spread Over EONIA**



Source Bloomberg, RGE calculations

However, our concerns about the problems in the EZ periphery remain. Worries about Portugal's ability to appease the market's expectations for its public sector adjustment are moving to the forefront even as Ireland's have receded (in a relative sense). Meanwhile, Greece's discussions with the troika on a possible time extension of its own adjustment program are still underway and we expect Greece to share the limelight (with Portugal) in the coming weeks as the country's Finance Ministry must revise its 2006-09 deficit figures yet again, inevitably reviving fears of default. Much of the quick adjustment in Greece's public deficit figures came from picking the low-hanging fruit. It gets much tougher from now on.

Yields on both Portuguese and Greek sovereign debt have started to move up in the last week of October. Though the short end of the Greek yield curve (<2 y) is not reflecting expectations of an

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imminent default, the 3-5y sector of the yield curve is now moving up to levels not far from where they were in the trough of the financial crisis. It is this section of the curve that needs to be watched most closely.

We believe the money markets, especially in the forward contracts, are too tight against the EONIA swap (see Figure 6). If the ECB is forced into a retrenchment on its liquidity-removal plans, we would expect a rapid widening on the 3X6 and 6X3 forward contracts.

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## EMERGING MARKETS

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## We Are All in This Together

By Natalia Gurushina

**Recommendations Summary:**

- Maintain core longs in INR, IDR and CNY against G3 (regional aspect of EM divergence).
- Short ZAR/INR, long PLN/HUF, short BRL/PEN and short USD/RUB (inflation and business cycle diversification within EM, tighter capital controls in selected EM).
- Maintain long NTN-B (May'11) in Brazil, 2y-5y IRS steepener in the Czech Republic and 2-year cross-currency payer in Russia.
- Hold long Poland (Oct'20), Israel (Jan'20), Mexico (Bonos Jun'20) and South Africa (Sept'15) if you own them already, but we caution against aggressively adding to these positions as valuations in EM FI are being stretched.
- Take profits on selling 1-year protection in Ukraine.

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**Market Performance: Piggybacking on QE2**

More-correlated EM FX have followed the EUR/USD cross in the past month—appreciating vs.USD when it weakened against EUR and giving back most of the gains when the dollar strengthened. Our short USD/RUB recommendation largely followed the same pattern. Our short ZAR/INR recommendation gained 2.5% and we hope it will continue to perform well on the back of the diverging cycle and growth outlook in these two countries. It looks like the Czech 2y-5y IRS curve has finally started to move our way, steepening by 10 bps to 45 bps in the past few days. The Russian 2-year cross-currency swap payer has also taken a small step in the right direction. Our recommendation to be long on the NTN-B (May'11) bond in Brazil gained 0.92% and our recommendation to sell 1-year protection in Ukraine rallied by 39bps in October.

**Fundamental Outlook: Focus on Global Factors**

We start this month's discussion by looking at some key global developments that are likely to have **major implications for EM assets in the coming weeks: (1) FX interventions and so-called currency wars and (2) [another round of quantitative easing \(QE2\) in the U.S.](#)**

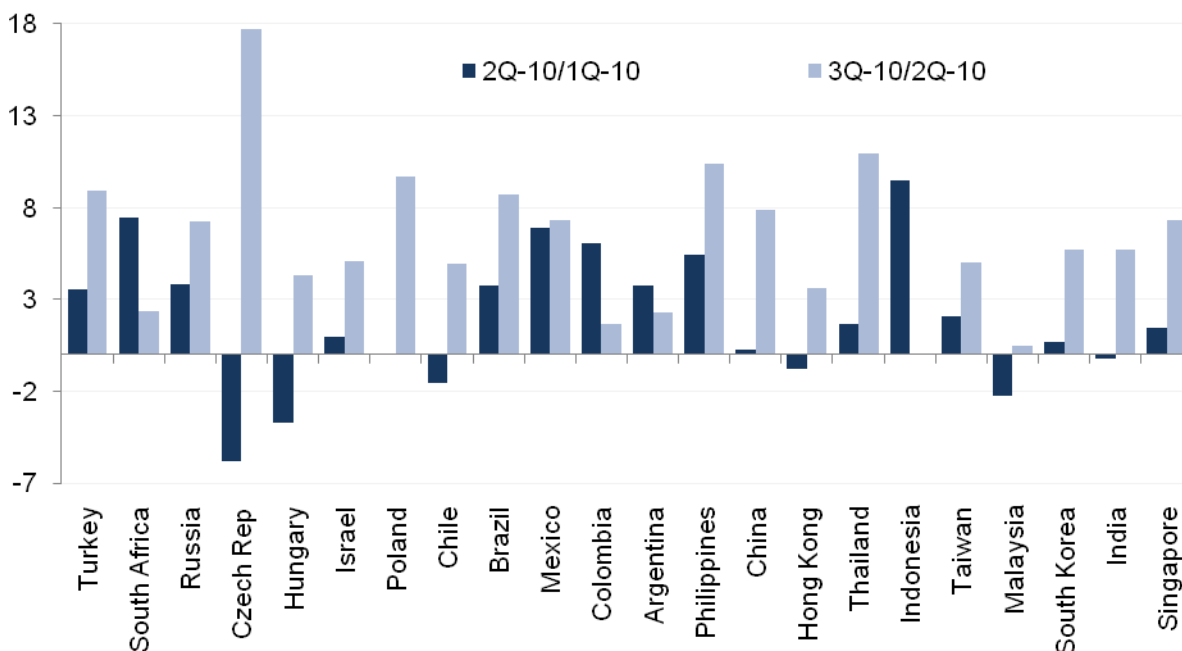
Some EM countries made it public, others remain silent, but it appears that almost all EM have **stepped up interventions in the past three to four months**. The evidence is out there—reserve accumulation accelerated significantly in Q3 vs. Q2—and the shift is especially noticeable in EMEA and EM Asia (the increase in reserves was also partly due to EUR's appreciation against the dollar, which raised the value of EUR assets in reserve portfolios). The only countries (Figure 1) that did not show greater reserve

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accumulation in Q3 2010 are those for which September data is not yet available (South Africa, Indonesia, Argentina and Colombia).

Figure 1: International Reserve Accumulation (Percentage Change Over Previous Quarter)



Source: RGE, Bloomberg

In this respect, it would be interesting to see whether the latest G20 meeting will have any lasting policy consequences. So far, we remain slightly skeptical. In its communiqué, G20 members stated that they would "move towards more market determined exchange rate systems" and "refrain from competitive devaluation of currencies." However, we will have to see how this will play out in practice—especially the proposed targeting of the current account balances as a percentage of GDP instead of the exchange rate. China was more enthusiastic about a shift away from the exchange rate than Brazil, Saudi Arabia, Germany and Japan. Still, we would be surprised if China agrees to the 4% current account balance target. In addition, we suspect that EM countries will be less inclined to allow further currency appreciation if global growth slows more than expected and QE2 results in a more sizeable USD depreciation against EUR.

**EM FX will likely feel the most impact of QE2** because of the asset class’s higher betas and stronger correlations to EUR/USD. In addition, global factors account for over 50% of the risk premium variation for all major EM currencies. Within this group, there are several currencies that stand to benefit the most from further USD weakness vs. EUR: TRY, RUB, SGD, ILS and INR. Even though we believe markets

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have largely priced in the impact of QE2, the baseline scenario leaves room for additional USD weakening against EUR, if (a) the QE2 package leads to an improvement in global sentiment (via a stronger-than-expected effect on USD growth, for example) or (b) the initial QE2 is followed by a stage two package that further compresses real yields in the U.S. Under these circumstances, we can see USD depreciating to 1.42-1.47 against EUR. The flipside of the coin, of course, is that the same currencies are likely to weaken the most against USD if (a) QE2 fails to meet expectations and (b) [USD experiences a sizeable correction against EUR](#) as positioning remains extremely stretched. One observation that we would like to make here is that, if EM central banks opt for ongoing reserve accumulation in the coming year, this would mitigate the impact of QE2 and ease any potential appreciation pressure on EM FX.

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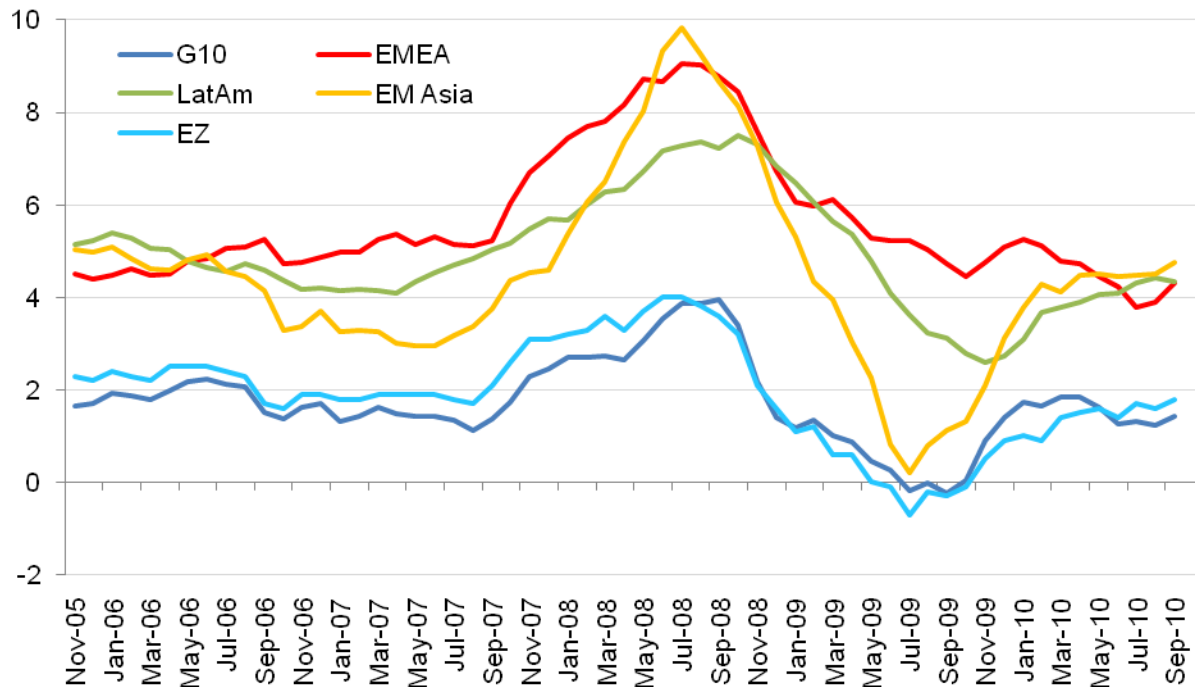
**As regards EM rates, we do not expect them to react much to QE2.** This is partly because the baseline scenario for QE2 has been priced in, but mostly because EM rates remain among the least [correlated](#) to other risky assets, including EUR/USD and UST. Given that there is some divergence within EM Fixed Income, there is a possibility that the second stage of QE2 (if it materializes) could lead to a limited 10-12 bps rally in those EM rates that are most highly correlated to the U.S. real yield curve, such as Indonesia. Further flattening of the U.S. nominal curve under this scenario is likely to cause yield curve bull-flattening (at least initially) in Mexico, India, Malaysia, Poland, South Africa and the Czech Republic. Still, we urge investors to pay closer attention to local fundamentals rather than QE2 in the case of EM rates, as the former are likely to have far more significant implications for local yields.

**In this respect, a potential increase in inflation pressures should be closely monitored.** Even though inflation pressures in EM remain largely contained for now, we have noticed some uptick in headline CPI numbers in most countries in the past two-to-three months. We caution that the wall of liquidity associated with QE2 may accentuate this trend. In EMEA, recent inflation trends in [Turkey](#) and [Russia](#) have been worrisome. In Turkey, rising headline inflation runs counter to the decidedly dovish stance of the Turkish central bank. We also monitor South Korea, Singapore and China in EM Asia, as well as Peru and Brazil, given that headline inflation picked up noticeably in the former and that inflation expectations continue to surprise on the upside in the latter.

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Figure 2: Headline CPI in Emerging Markets and G10 (% y/y)



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Source: RGE, Bloomberg

**Central bank reactions to larger liquidity inflows to EM on the back of QE2 may also affect the shape of local yield curves.** In particular, sterilized interventions may drive up EM short rates, leading to bear-flattening. This is likely to re-route inflows from inflationary increases in the money base to higher asset prices. In turn, this will support a credit and equity boom, but will also lead to further inflow barriers via higher taxes, etc.

**Market Views and Recommendations:**

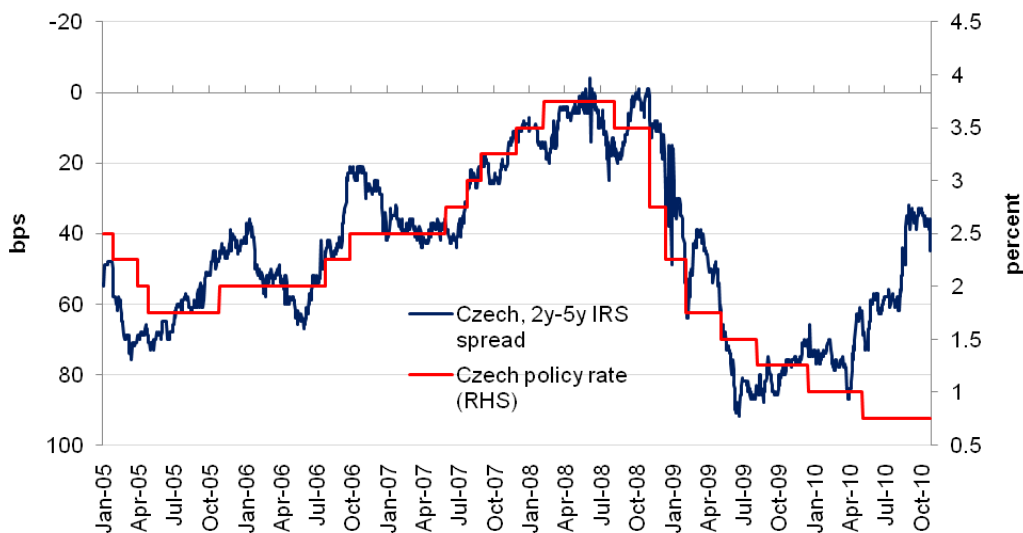
- We continue to emphasize the importance of global macro risks for EM assets,** especially as the U.S. gears up for QE2. The successful implementation of this program would provide a further boost to higher-beta/higher correlation EM FX (RUB, TRY, CLP, ZAR, and INR). However, the opposite would be true in the event of a USD correction. What we are seeing right now could be a shift in expectations regarding QE2, leading to greater volatility, especially in the EM FX space.
- We recommend playing the regional aspect of EM diversification** as Asia ex-Japan will continue to [stand out in the EM crowd on macro grounds](#). We express this fundamental view by maintaining core longs in INR, IDR and CNY against G3.

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3. **We also recommend playing the inflation and business cycle diversification within EM and see a high likelihood of further tightening of capital controls in selected EM.**
  - a. On the FX front, we like being short on ZAR/INR, long on PLN/HUF, short on BRL/PEN and short on USD/RUB. We realize that RUB’s high correlation to EUR/USD could affect this trade in the near term, causing greater volatility, but we argue that the Central Bank of Russia would have no choice but to allow [greater RUB appreciation](#) and higher policy rates to deal with rapidly rising inflation.
  - b. On the fixed income/rates front, we see [further bull-flattening of local curves and lower yields](#) on the long end in Poland (Oct’20), Israel (Jan’20), Mexico (Bonos Jun’20) and South Africa (Sept’15). As such, it still makes sense to hold one’s position on these bonds, but we caution that valuations are getting stretched. As such, we would not advise to add to these positions aggressively. We also believe that the recent weakness on the long end of Malaysia’s local curve (Nov’19) on the back of the 2011 budget announcement was most likely overdone. Malaysian bonds may be affected by risks including the short debt payment hump in Q2 2011 and lack of clarity about the private sources of financing of the government’s ambitious infrastructure program. However, recent price action was quite extreme, so this bond is becoming attractive. A key risk for the Israel curve flattening is a rise in inflation expectations on the back of house prices, which may result in another rate hike.
  - c. We also like long positions on Brazil’s NTN-B (May’11) inflation-linkers, 2y-5y IRS steepener in the Czech Republic and 2-year cross-currency payer in Russia.

Figure 3: 2y-5y IRS Curve (inverted) and Policy Rate in the Czech Republic



Source: RGE, Bloomberg

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4. **Last, we recommend taking profit on our recommendation to sell 1-year protection on Ukraine.** We opened this recommendation in May 2010 at 649 bps and now, at 411 bps, it is close to the original 400 bps target. We think that additional upside here might be limited, as macro imbalances in Ukraine remain significant. In addition, it appears the market has priced in most of the good news regarding the IMF deal and/or the improvement in relations with Russia.

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## What is Thy Bidding, Master?

By David Nowakowski

- Quantitative Easing (QE2) pushes investors out of cash and Treasuries into riskier bonds, equities and FX. The Fed's actions will work, but the sequel will be weaker than the original.
- The announcement effect has largely taken place. Investment Grade (IG) has priced in most of what we expect QE2 to justify, but can continue to tighten, while High Yield (HY) has moved more than it should.
- RGE recommends being neutral on IG, keeping HY exposure on the short-end of the credit curve, adding EM exposure and being long on U.S./short European credit.

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### Background: The Fed Applies Force

Can QE2 fix our current predicament, and will it once again have beneficial effects for credit? During the crisis of 2008-2009, the world's central banks were behind the curve, trying desperately to fix fraying money markets and frozen credit, mitigate counterparty risk and ensure interbank and cross-border liquidity. Eventually, thanks to a variety of programs and international coordination, in tandem with a massive central bank balance sheet and fiscal expansion, policymakers put Humpty-Dumpty back together again, buying time for recovery. As discussed during RGE's [conference call](#) and [accompanying document on Quantitative Easing](#), our analysis concludes that the upcoming unconventional monetary easing is unlikely to have the same strong effects, as liquidity is no longer the issue. Other, more appropriate supportive measures and coordination are missing, while structural and solvency problems remain unaddressed.

From a credit standpoint, monetary easing helps the asset class through the three "Is":

1. **Inflation.** Simply put, more money chasing the same goods should enable firms to raise the price level, making nominal debts smaller in real terms. A weaker dollar also helps firms with exports or foreign competition.
2. **Investment.** A lower cost of capital will encourage capital spending, real estate activity and other interest-rate-sensitive outlays, helping to grow the real economy. (Employment should benefit, but only indirectly).
3. **Inducement** of investors to take on more risk, by making the real rate less attractive on cash (and, for QE, Treasuries). Portfolios will also have less risk as the yield curve is pinned down, and thus should move out on the efficient frontier to credit, equity, etc. Banks benefiting from the gift of financial repression might decide to lend more as their net interest margin expands.

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So, will the macroeconomy, firms, builders, banks and investors all do the Emperor’s bidding? Or will they realize that he has no clothes? Unfortunately, we expect only minor economic effects from QE2 on inflation, investment and growth, while effects on risk appetite are largely priced into equities and Treasury yields. IG credit has slightly lagged these asset classes and RGE’s models suggest that IG spreads are too high. Spreads should react positively to QE2, but not in a major way. High Yield has probably overreacted; it typically moves about 2.4 bps for every 1 bps move in BBB-rated bonds, but while BBBs have tightened 20 bps since the Jackson Hole conference, HY has come in at nearly 100 bps—it has overshot, given our estimates of the impact of QE2. That said, the status quo of reinvesting MBS into Treasuries is clearly not enough, and reducing the chances of deflation is the right thing for the U.S. Central Bank to do.

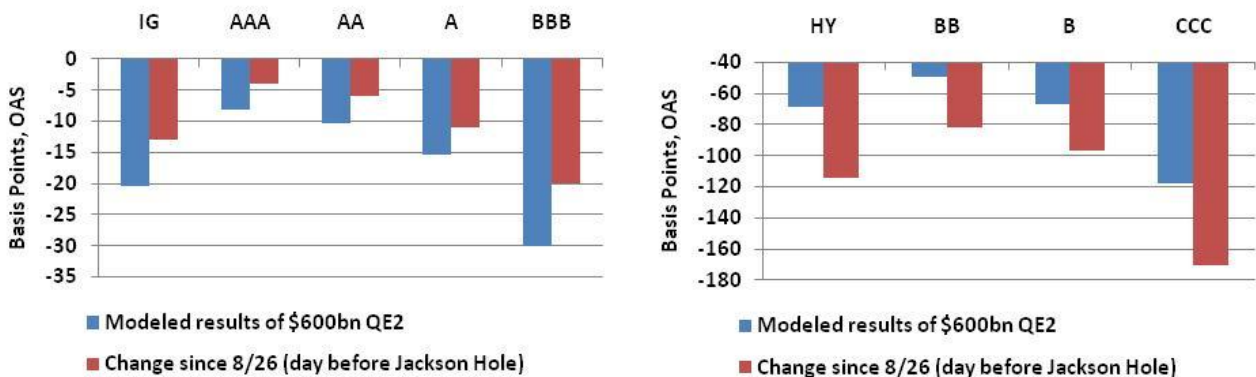
Specifically, under our three main scenarios, our models for BBB spreads give the following result:

**Scenario 1, US\$600 billion LSAP, open-ended (60% likelihood):** BBB spreads would tighten about 18-30 bps; i.e. this scenario seems to be mostly priced in, unless VIX drops well below 20 and growth effects are more than we expect.

**Scenario 2, US\$1.25 trillion LSAP (20% likelihood):** Equivalent to nearly 200 bps in rate cuts, this would have a powerful, 35-42 bps reduction in BBB spreads, likely bringing bond spreads back to April’s lows.

**Scenario 3, state contingent, US\$125 billion/month (20% likelihood):** Likely a disappointment; while our models do predict a slight reduction in spreads, the possibility that asset purchases would end early means that a sell-off could ensue. If other risky assets sold off, spreads could widen modestly then drift tighter as the Fed moves to purchase US\$600bn or more.

**Figure 1: RGE Models Show IG Should Be Tighter From QE, But HY Has Overreacted**



Source: Merrill Lynch, RGE

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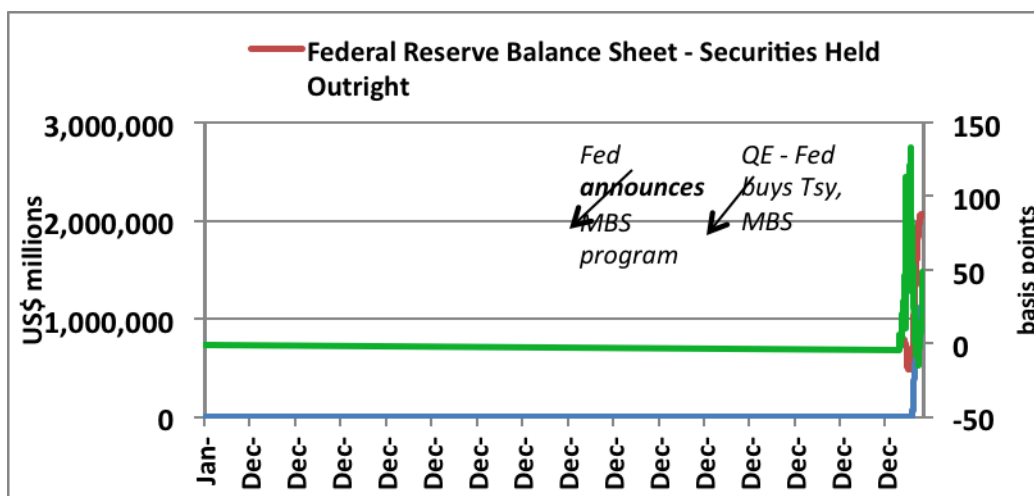
Why has HY moved so much more than IG? This is partly a reaction to the spike by other risky assets. RGE believes equities have moved too far as well. Path dependency is also a key factor; along with reducing the chances of deflation and a double-dip, QE may allow insolvent companies to extend loans or issue new bonds and temporarily postpone default. The steepening of credit curves suggest this is a possible explanation—a few extra coupons can cause a significant price change, even if longer-term default probability remains unchanged.

**How Will Borrowers React?**

While zero-yielding cash and puny real Treasury yields force investors to add risk to portfolios, borrowers are able to refinance at low rates and have been quick to take the opportunity this year. The effect of QE2 on mortgage rates will be much weaker than last year (**Figures 2-4**) and, in addition, loan volumes are still declining—low rates are unlikely to spur releveraging, though they may slow down deleveraging. This is discouraging for those hoping for more traction from MBS refis, but it means that par agency MBS will continue to outperform premium, high-in-coupon product, which has rebounded a bit but continues to suffer from refi fears and the risk of mass mods and put-backs.

On the other hand, it is important to acknowledge that changing the term structure does more than create an inter-temporal shift in saving and spending. Wealth and debt are not homogeneous across the population, and savers will continue to be punished as financial repression transfers money to banks and inflation reduces real purchasing power. This is the real cost of QE, along with the risks the Fed Chairman has mentioned in recent speeches.

**Figure 2: QE in 2009 lowered elevated spreads, but in 2010 spreads and yields are low already**



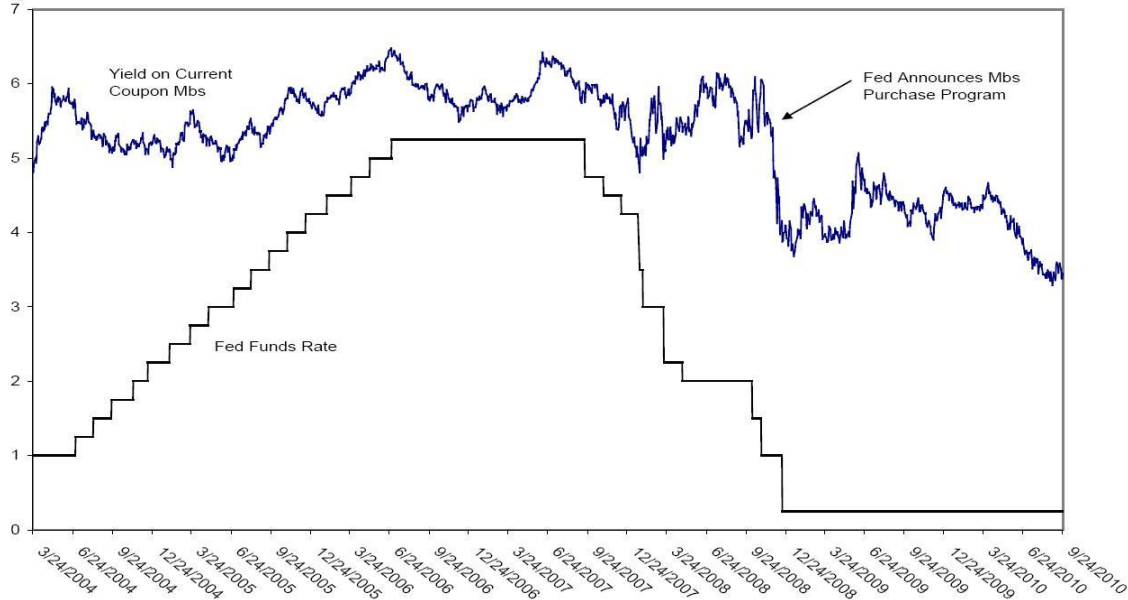
Source: Federal Reserve, Bloomberg

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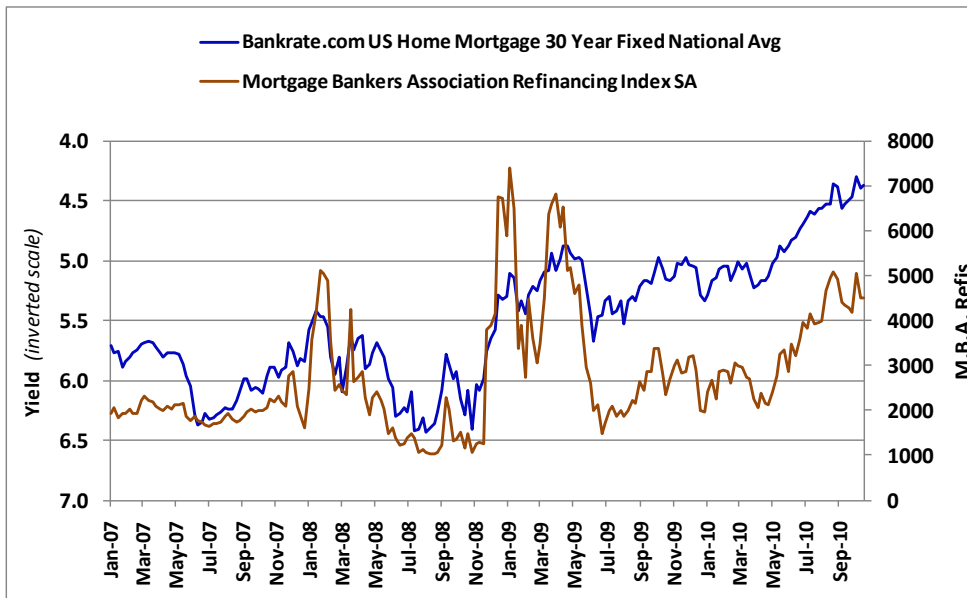
Figure 3: MBS Purchases Worked Where Conventional Policy Did Not



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Source: [Clarida](#) (Oct 2010)

Figure 4: QE2 Unlikely to Do Much More, and Refinancing Already Happened



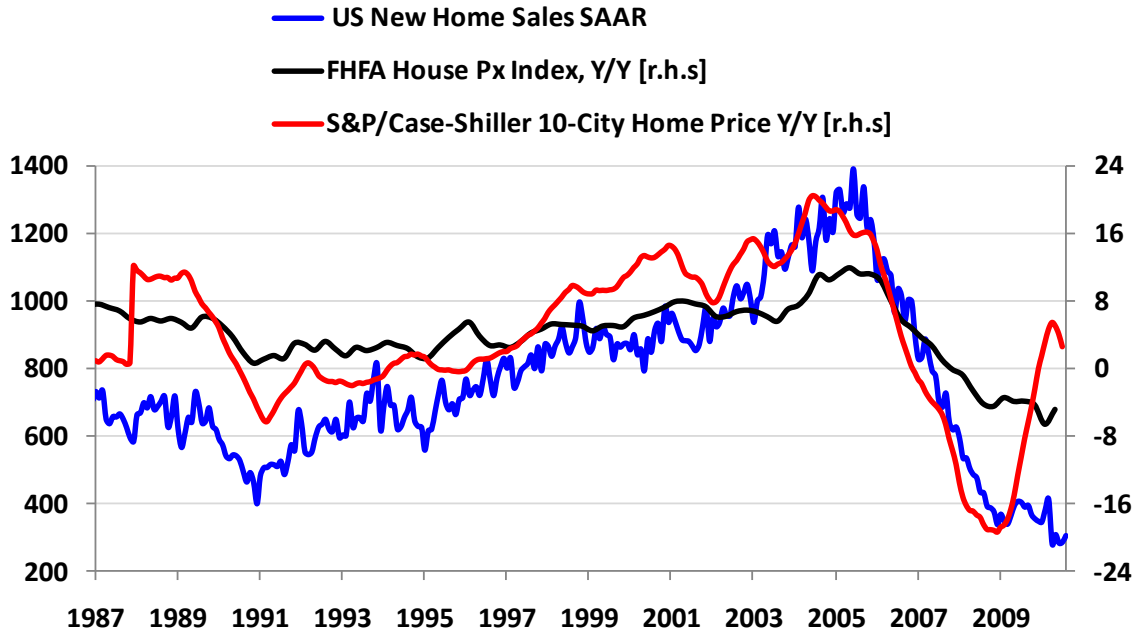
Source: *Bloomberg*

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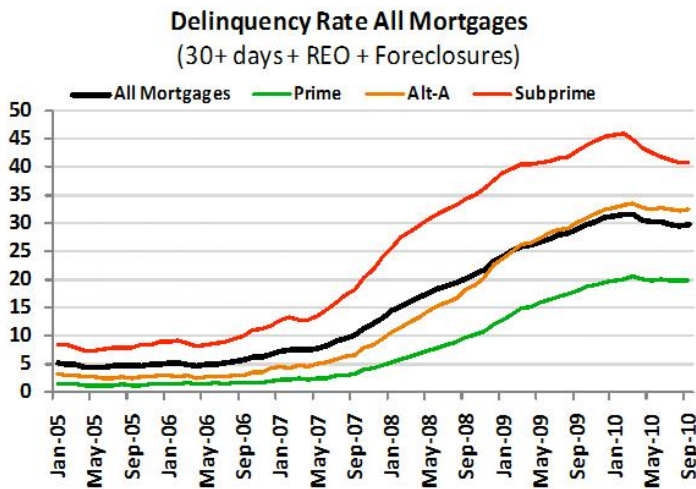
Figure 5: The Good News Is, We've Probably Hit Bottom



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Source: U.S. Census Bureau, FHFA, Case-Shiller, Bloomberg, RGE

Figure 6: The Real Problem Is Insolvency.



Source: Bloomberg, image copyright Looney Tunes

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## A New Hope?

QE1, QE2, QE3...like the massive monetary easing in 1990's Japan, preventing collapse and fighting deflation buys time, but does not deal with the critical issue of required deleveraging. [We can do this in an ugly fashion](#) through zombie companies and denial, leading to defaults and foreclosure. Or there is a more proactive approach which maximizes value and avoids bankruptcy through restructuring and debt-to-equity swaps ([Ford being](#) a prime example). So far, banks used the first window of opportunity to raise capital and reduce leverage, but other borrowers—including many highly leveraged corporates, homeowners with negative equity and European sovereigns and banks—just amended and extended, or simply pretended that the recovery would restore solvency. **Figure 5** confirms Calculated Risk's remark that "we're all subprime now" and the Eurozone and foreclosure crises should finally spur recognition of reality. It will not be easy, but it is the only way to a sustainable recovery.

Emerging Market countries and credits are much better positioned than U.S. and European corporates, and while some defaults are still possible in a downturn, spreads of nearly 300 bps for an asset class comprising 75% investment-grade entities are compelling. We recommend going long/overweight EM through JP Morgan's EMBIG and CEMBI indices at spreads of 273 bps and 317 bps, respectively.

## Market Views and Recommendations:

- **We stick with underweights/shorts in European Corporate Bonds and iTraxx Main and Financials (Snr and Sub).** These recommendations underperformed as risk appetite rebounded.
- **Overweight U.S. vs. Europe in Investment Grade.** HY and HY ex-Financials did well, led by U.S. HY's 77 bps surge in September.
- **Overweight in consumer staples, healthcare and technology** as relative safe havens, globally and across the credit spectrum.
- **Selling protection on 2-year HY CDS using CDX.NA.HY.S13 3-year continued its gains,** closing in on our 5% target return. The spread on this short-dated derivative has moved from 464 bps to 240 bps in four months, outperforming the 200 bps rally in 5Y HY CDS since July 1.
- **We add to our credit exposure with EM Sovereign and Corporate Exposure via EMBIG and CEMBI,** expecting QE2 to boost liquidity, reserves, commodities, EM growth and FX rates. For more details please see the [RGE EM Quarterly](#) and its [Credit section](#).
- **Go neutral credit relative to Treasuries,** based on lower upside for Treasuries ahead of QE2.
- **Retain short HY vs. long IG despite negative returns,** on eventual low-recovery defaults in HY. The CDX.HY and EM positions should be used to limit this "short risk" exposure.

## CREDIT

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**Agency MBS:** Premium coupons will continue to underperform pars due to refi programs, putbacks and other risks. Private label MBS may suffer slightly from documentation issues (junior first-loss pieces may benefit), but deep discounts on senior tranches will likely compensate for this risk, though liquidity will worsen.

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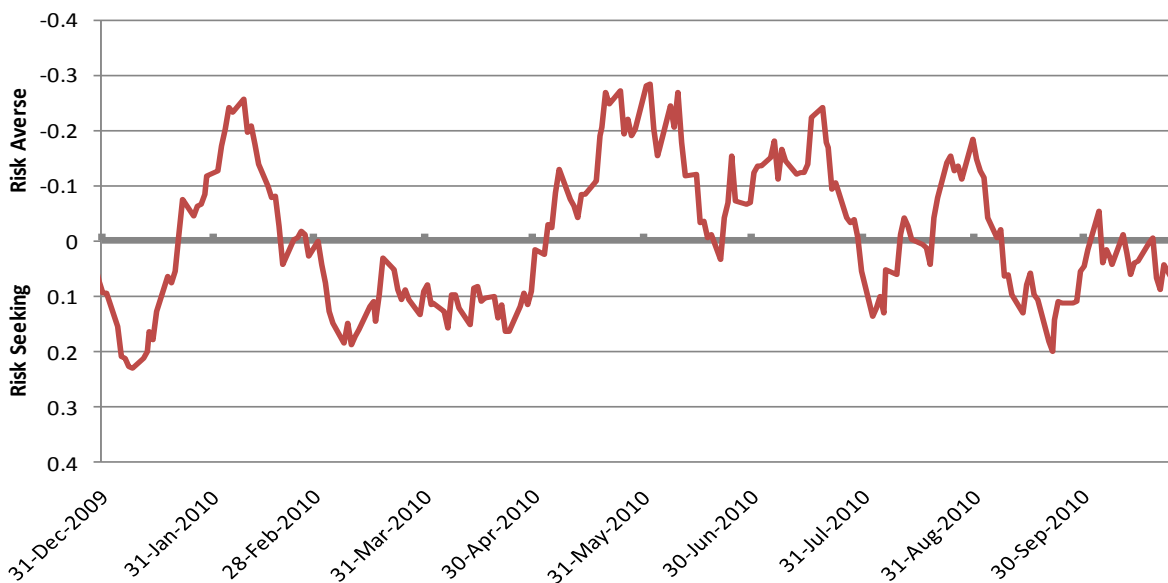
# Pushing on a String

By Gina Sanchez

## Market Update

- The Fed’s expected announcement of second round of Quantitative Easing (QE2) is the talk of the town. Much of the effect of quantitative easing already has taken place thanks to the pre-announcement pronouncements. However, , that has not necessarily translated into strong risk buying U.S. equity markets.
- The tentative rally did not strongly favour the riskiest assets as much as we expected. We are very skeptical that QE will significantly affect growth and we believe that QE2’s main results, dollar weakness and lower Treasury yields, helped ignite risk buying. In fact, we are already seeing doubts in equity markets that are giving back part of the anticipation rally.
- In addition, Treasury yields are already backing up, while the earnings season has a familiar pattern of top line earnings that beat reduced analyst estimates, while sales growth shows a more anemic picture. Mergers, acquisitions and share buybacks are helping to support equity markets, but we anticipate that a lot is still on hold as uncertainty mounts over midterm election results and subsequent policy change. In fact, Bernanke may want to accelerate his policies before Fed regime change results in a more hawkish FOMC.

Figure 1: Mild Risk Seeking Suggests Vulnerability in U.S. Equity Markets



Source: Factset

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## GLOBAL EQUITY

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**Summary and Recommendations**

- Risk reigniting efforts made policy makers have yet to create a strong risk rally; either because the markets are nervous or there even stronger efforts are required.
- We believe that the markets are nervous and therefore continue to recommend a quality bias in the portfolio with overweights in the U.S. vs. Europe. Within Europe, we like Germany, Switzerland and the UK versus Portugal, Italy, Ireland, Spain. In Emerging Markets, we like Brazil relative to the rest of Latin America and Turkey relative to Hungary.
- We hedge against this bias by taking a neutral stance in Emerging Markets versus Developed Markets as we don't want to be caught without exposure to a running Emerging Markets if risk reasserts itself.
- Mergers and Acquisitions, particularly in the Energy and Materials space continue to support these areas and as a result we are overweight these sectors along with Sweden, Finland and Norway. In Emerging Markets, we continue to like Asia on the Energy theme.

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**Developed Market Equity**

The rally that dominated October was primarily led by small cap companies as well as growth companies. On a country basis, it was led by some of the lowest quality countries including Greece and Portugal which led Europe to outperform as a region. M&A activity continued to push up Energy and Materials where we recommended overweights. However, Information Technology also performed well on the back of continued corporate spending and a recovery in capital spending. Following Europe, Asia ex-Japan also had a strong performance along with the U.S., which were separated by only basis points. Canada lagged moderately while Japan turned in a positive, but relatively poor performance.

Within Europe, Greece and Portugal lead the rally; however, Germany staged a good performance, a country that we continue to like on a relative basis. Greek Consumer Discretionary companies turned in very strong performance on relatively little company specific news. Other strong sectors include Financials where optimism that Greek banks would regain access to the international interbank markets drove bank shares higher. Among our recommended country overweights, Germany, Finland and Norway performed well on a relative basis. All were helped by rising prices in Energy, Materials and Industrials. The UK, Switzerland and Sweden performed positively on an absolute basis, but lagged on a relative basis as quality lagged generally in the rally. Of our underweight recommendations, only Ireland lagged, dragged down by the performance of its Financials sector.

**Emerging Market Equity**

Emerging Market equity posted a better month than Developed Market equity, but only by a small margin. The rally was led by Emerging Europe where Turkey—one of our recommended overweights—led the charge. Credit growth, a demographic tailwind and increasing ties to the Middle East are all factors that

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are helping to buoy Turkish stocks. Generally, we continue to be positive on this story. Asia performed well on a relative basis, in line with our recommendation; however, we have seen evidence of waning technology spending and Energy names in the Philippines, China, Indonesia and Thailand held up performance. Latin America, the Middle East and Africa lagged the universe, although both posted positive absolute performance. Within Latin America, Peru led the charge with Materials and Industrials posting a strong performance. Brazil turned out to be the only country that posted very poor performance in the Energy sector, weighing down the performance of the entire LatAm index. Most other sectors in Brazil performed very well including Healthcare, Utilities, Telecommunications and Financials. Mexico was a surprising performer posting strong returns in all sectors except Consumer Staples.

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**Outlook**

Looking ahead, we see several themes that support a risk rally but also note important risks to consider. Given the environment, a light touch on risk is probably the way to go. The main positive for Global Equities is the active mergers and acquisitions cycle currently underway in the Energy and Materials sector. Positioning in this environment will be tricky because short term rallies could be painful to long term positions that recognize risks policy makers are attempting to ignore. In our [Emerging Markets Quarterly](#), we have chosen to take a neutral stance in emerging market equities relative to developed market equities. We have seen evidence of strong flows into Emerging Markets. The much anticipated QE2 could push further flows out the risk curve. However, the tenuous nature of the rally also suggests that it could rapidly unravel. In fact, at the time of this publication, the markets were already starting to pull back on doubts of the size and scale of QE2.

While the G20 is trying to talk down the “currency war” the undercurrents suggest something different. For the most part, we expect range-bound trading because we think any sizeable U.S. dollar weakening is unsustainable. But that doesn’t mean we won’t see volatility as a result. In Europe, the crisis is all but forgotten, effectively kicked far enough down the road to no longer be a concern. And, in times like this, the cheapest will rally. We would recommend taking our Belgium and France underweights to neutral as country stock markets seem to have returned to stock fundamentals and away from spill-over themes. Hence, we anticipate that the markets no longer care that Belgium and France remain very exposed to the worst banking systems in Europe. Generally, we still feel that the U.S. will ultimately outperform Europe, and that quality will be the place to be as the currency conflict slowly comes into view over the next several months. Keeping an overweight in the strongest or most independent economies in Europe with an underweight to the periphery economies will likely be well worth it when the hangover from the rally arrives.

On a sector basis, we continue to like Energy and Materials on the strength of the M&A cycle and as a result also continue to like Norway, Finland and Sweden. However, we continue to hedge this position with the safety of strong cash flows in the form of dividends in the Telecommunications and Utilities

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sectors. We continue to like our overweight in Healthcare, however, valuations for consumer staples no longer support this overweight. Finally, we recommend upgrading Consumer Discretionary to neutral.

Figure 2: Developed Market Country Valuation, Book to Price vs. Return on Equity

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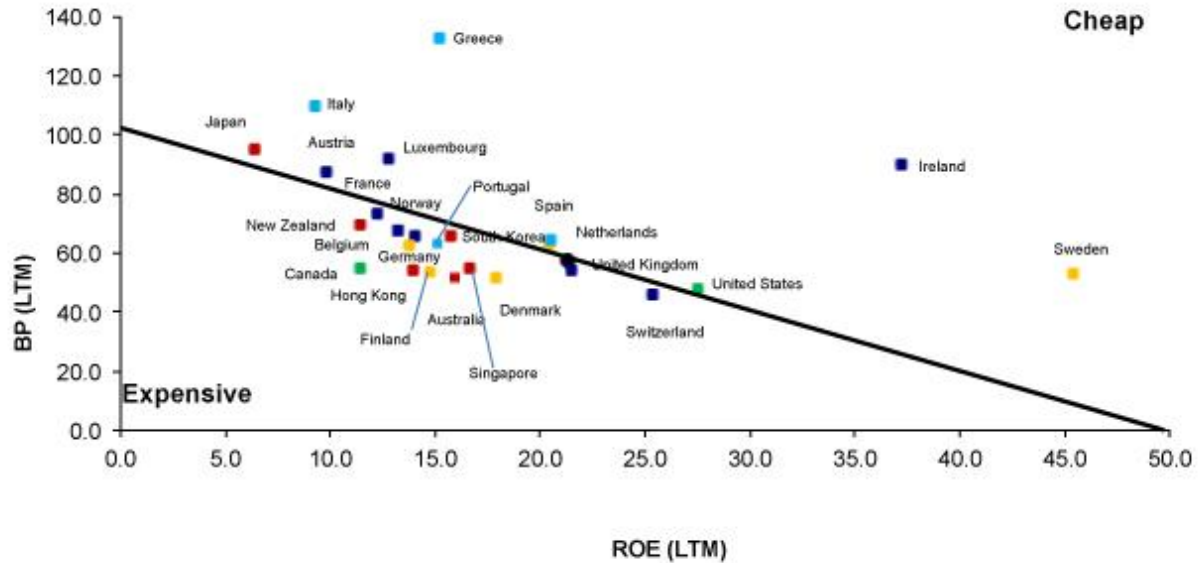
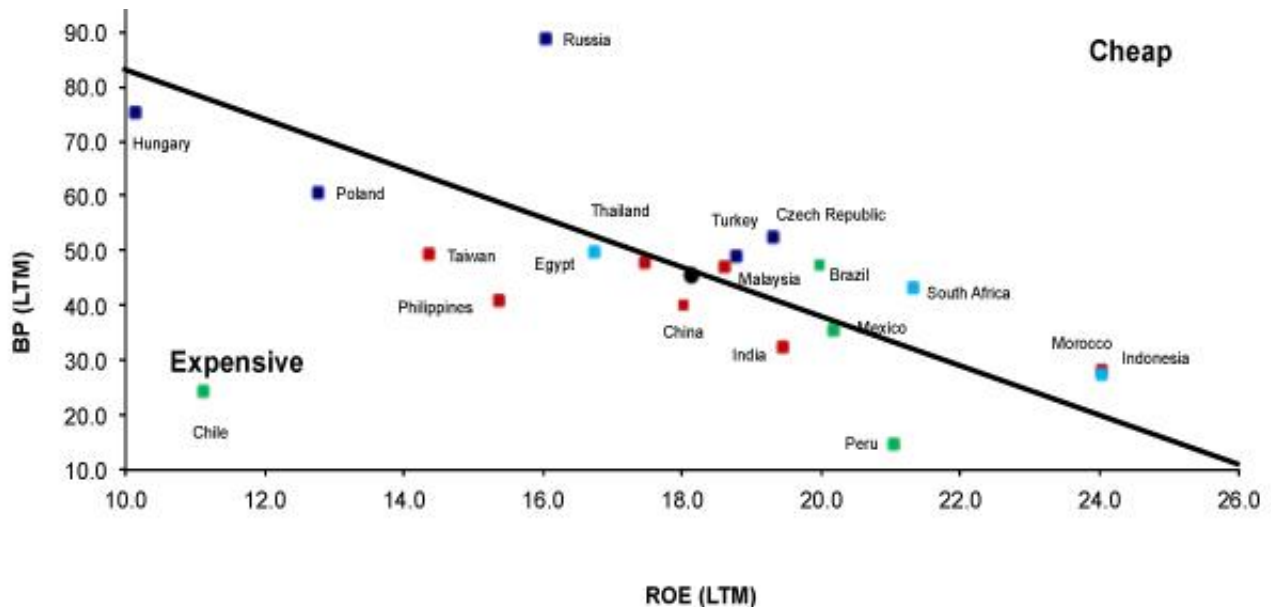


Figure 3: Emerging Market Country Valuation, Book to Price vs. Return on Equity



Source: Factset

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Figure 4: Developed Market Sector Valuation, Earnings Yield vs. 12 Month Forward Implied Growth

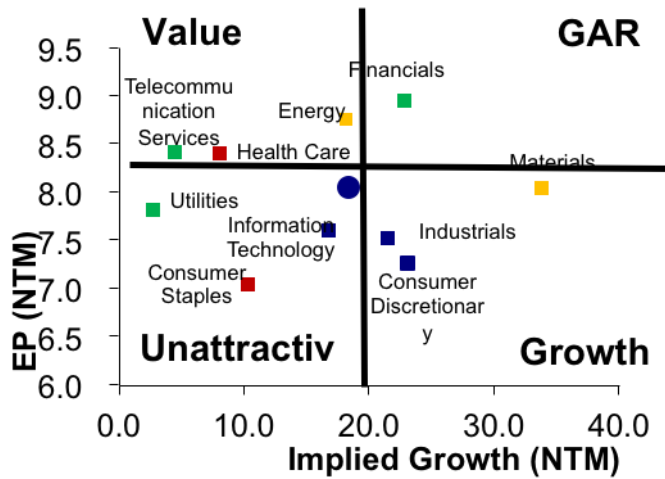
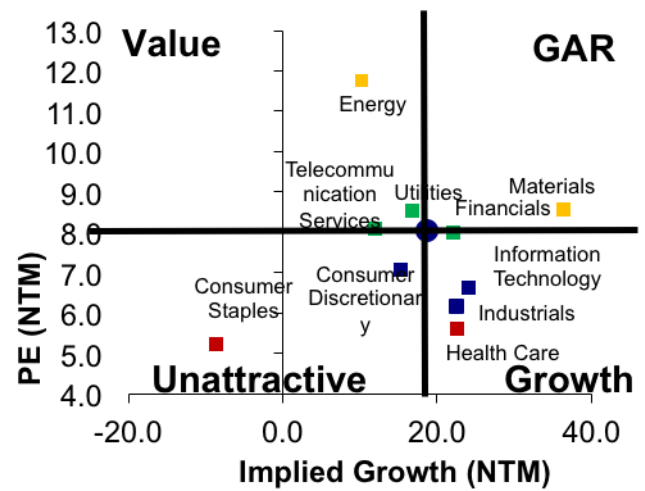


Figure 5: Emerging Market Sector Valuation, Earnings Yield vs. 12 Month Forward Implied Growth



Source: Factset

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**S&P Developed Broad Market Index**

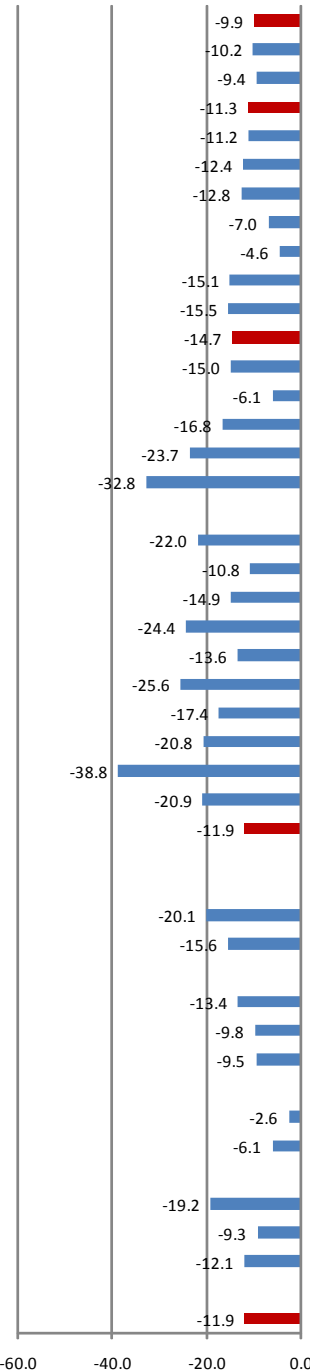
US\$ total returns, %  
Data as of: 25-Aug-2010

	Weight	YTD %	12m %	% off Previous Cycle High	Current RGE GDP 2010 Forecast	Change in Forecast
<b>North America</b>	53.3	-3.2	7.1	-9.9		
North America						
United States	48.2	-3.5	6.4	-10.2	2.6	0
Canada	5.1	-1.0	13.9	-9.4	3.2	-0.1
<b>Asia Pacific</b>	18.3	-2.5	0.8	-11.3		
Asia Pacific						
Japan	10.1	-1.2	-6.6	-11.2	1.5	-0.7
Australia	3.6	-10.8	4.6	-12.4	3.2	0
South Korea	2.2	0.7	14.5	-12.8	6.1	0
Hong Kong	1.5	4.8	19.7	-7.0	4.8	0
Singapore	0.8	4.3	21.3	-4.6	13.5	0
New Zealand	0.1	-9.8	0.3	-15.1	2.5	0
<b>Europe</b>	28.4	-11.2	-4.0	-15.5		
Europe						
Core Europe						
United Kingdom	9.4	-6.4	2.4	-14.7	1.1	0
France	4.0	-17.7	-11.4	-15.0	1.2	0
Switzerland	3.5	-3.1	4.2	-6.1	1.8	0
Germany	3.2	-12.3	-4.5	-16.8	3.2	1.3
Belgium	0.5	-8.9	-1.6	-23.7	1.3	0
Ireland	0.2	-20.9	-13.7	-32.8	0.2	0
Luxembourg	0.2	-20.6	-0.9	--	2	0
Austria	0.2	-12.4	-11.5	-22.0	1.3	0
Northern Europe						
Sweden	1.3	1.2	8.0	-10.8	2.9	0
Netherlands	1.2	-13.3	-2.4	-14.9	1.3	0
Finland	0.5	-9.7	-6.9	-24.4	1	0
Denmark	0.5	0.3	1.4	-13.6	1.3	0
Norway	0.4	-15.4	7.7	-25.6	1.5	0
Southern Europe						
Spain	1.6	-24.8	-20.3	-17.4	-0.5	0
Italy	1.4	-23.4	-20.5	-20.8	0.7	0
Greece	0.2	-40.2	-47.5	-38.8	-3.5	0
Portugal	0.2	-20.8	-14.1	-20.9	0.5	0
<b>Total</b>	100	-5.6	2.4	-11.9		

\* OECD Forecasts

Comdty Sensitive	Energy	9.5	-12.9	-2.2	-20.1
	Materials	7.8	-7.1	8.9	-15.6
Economic Pace Sensitive	Industrials	11.9	-1.7	6.8	-13.4
	Info. Tech.	11.9	-7.9	3.5	-9.8
	Cons. Discr.	10.7	0.1	9.8	-9.5
Stable Growth	Cons. Staples	9.7	0.5	11.1	-2.6
	Health Care	9.5	-7.0	2.3	-6.1
Interest Sensitive	Financials	20.8	-7.7	-7.6	-19.2
	Telecom Services	3.9	-1.6	8.0	-9.3
	Utilities	4.4	-6.1	-0.6	-12.1
<b>Total</b>		100	-5.6	2.4	-11.9

**% off Previous Cycle High, Annualized**



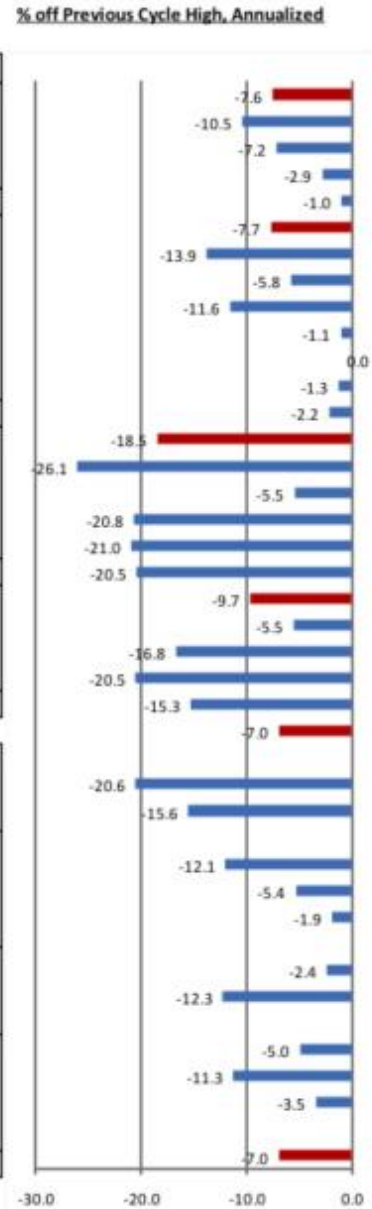
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S&P Emerging Markets Broad Market Index

US\$ total returns, %  
Data as of: 25-Aug-2010

	Weight	YTD %	12m %	% off Previous Cycle High	Current RGE GDP 2010 Forecast	Change in Forecast
<b>Latin America</b>	24.45	-2.7	22.9	-7.6		
Latin America						
Brazil	16.7	-7.3	20.9	-10.5	7	0
Mexico	4.3	-0.4	14.7	-7.2	4	0
Chile	2.7	25.4	54.3	-2.9	4.7	0
Peru	0.8	12.7	28.8	-1.0	7.8	1
<b>Emerging Asia Pa</b>	51.9	2.3	20.7	-7.7		
Emerging Asia						
China	18.6	-2.5	13.0	-13.9	9.8	-0.2
Taiwan	14.3	-3.8	19.0	-5.8	6.8	0
India	10.6	6.0	24.6	-11.6	8.6	0
Malaysia	3.2	21.2	33.1	-1.1	6.9	0
Indonesia	2.5	24.5	43.5	0.0	5.8	0
Thailand	1.9	27.4	46.7	-1.3	7	1.9
Philippines	0.8	24.2	37.8	-2.2	3.7	0
<b>Emerging Europe</b>	12.1	-1.8	18.8	-18.5		
Emerging Europe						
Russia	7.7	-2.4	25.1	-26.1	4.6	-0.1
Turkey	2.0	10.0	26.0	-5.5	5.8	0
Poland	1.5	-7.8	-0.9	-20.8	3	0
Hungary	0.4	-18.2	-9.3	-21.0	-0.3	0
Czech Republic	0.5	-1.8	-7.4	-20.5	1.6	0
<b>Middle East, Africa</b>	11.6	-1.0	10.8	-9.7		
Middle East, Africa						
South Africa	7.6	1.1	14.9	-5.5	3	0
Israel	2.8	-7.4	6.7	-16.8	3.5	0
Egypt	0.7	3.7	-1.7	-20.5	5.5	0
Morocco	0.5	0.9	-2.0	-15.3	5.2	0
<b>Total</b>	100	0.2	19.7	-7.0		
<b>Comdty Sensitive</b>						
Energy	13.2	-9.9	7.9	-20.6		
Materials	14.2	-2.7	20.7	-15.6		
<b>Economic Pace Sensitive</b>						
Industrials	7.7	5.3	21.2	-12.1		
Info. Tech.	12.1	-4.3	19.8	-5.4		
Cons. Discr.	6.7	7.8	34.9	-1.9		
<b>Stable Growth</b>						
Cons. Staples	7.1	10.8	39.5	-2.4		
Health Care	2.8	-0.6	17.0	-12.3		
<b>Interest Sensitive</b>						
Financials	24.0	2.6	22.5	-5.0		
Telecom Services	8.0	3.9	8.0	-11.3		
Utilities	4.1	2.6	17.6	-3.5		
<b>Total</b>	100	0.2	19.7	-7.0		



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<b>S&amp;P Developed Broad Market Index Model Portfolio</b>				<b>S&amp;P Emerging Markets Broad Market Index Model Portfolio</b>			
US\$ total returns, % Data as of: 25-Aug-2010				US\$ total returns, % Data as of: 25-Aug-2010			
		Index Weight	Reccomendation		Index Weight		Change
	<b>North America</b>	53.3	Overweight		<b>Latin America</b>	24.45	
North America	United States	48.2	Overweight	Latin America	Brazil	16.7	
	Canada	5.1			Mexico	4.3	Underweight
					Chile	2.7	
	<b>Asia Pacific</b>	18.3			Peru	0.8	
Asia Pacific	Japan	10.1	Neutral	Emerging Asia	<b>Emerging Asia Pacific</b>	51.9	Overweight ↑
	Australia	3.6			China	18.6	
	South Korea	2.2			Taiwan	14.3	
	Hong Kong	1.5			India	10.6	
	Singapore	0.8			Malaysia	3.2	
	New Zealand	0.1			Indonesia	2.5	
	<b>Europe</b>	28.4	Underweight		Thailand	1.9	
Core Europe	United Kingdom	9.4	Overweight		Philippines	0.8	
	France	4.0	Underweight	Emerging Europe	<b>Emerging Europe</b>	12.1	
	Switzerland	3.5	Overweight		Russia	7.7	Underweight
	Germany	3.2	Overweight		Turkey	2.0	Overweight
	Belgium	0.5	Underweight		Poland	1.5	
	Ireland	0.2			Hungary	0.4	Underweight
	Luxembourg	0.2			Czech Republic	0.5	Neutral ↑
	Austria	0.2			<b>Middle East and Africa</b>	11.6	
Sweden	1.3		South Africa		7.6		
Northern Europe	Netherlands	1.2		Israel	2.8		
	Finland	0.5		Egypt	0.7		
	Denmark	0.5		Morocco	0.5		
	Norway	0.4		<b>Total</b>	100		
Southern Europe	Spain	1.6	Underweight	Comdty Sensitive	Energy	13.2	
	Italy	1.4	Underweight		Materials	14.2	
	Greece	0.2	Underweight		Industrials	7.7	
	Portugal	0.2	Underweight		Info. Tech.	12.1	
	<b>Total</b>	100			Cons. Discr.	6.7	
Comdty Sensitive	Energy	9.5	Nuetral ↑	Economic Pace Sensitive	Cons. Staples	7.1	
	Materials	7.8	Neutral ↑		Health Care	2.8	
					Stable Growth	Financials	24.0
Economic Pace Sensitive	Industrials	11.9	Underweight	Telecom Services		8.0	
	Info. Tech.	11.9		Utilities		4.1	
	Cons. Discr.	10.7	Underweight	<b>Total</b>	100		
Stable Growth	Cons. Staples	9.7	Overweight	Interest Sensitive			
	Health Care	9.5	Overweight				
Interest Sensitive	Financials	20.8	Underweight				
	Telecom Services	3.9	Overweight				
	Utilities	4.4	Overweight				
	<b>Total</b>	100					

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## CORPORATE SECTOR: FINANCIAL INSTITUTIONS

October 29, 2010

## No Risk, No Reward

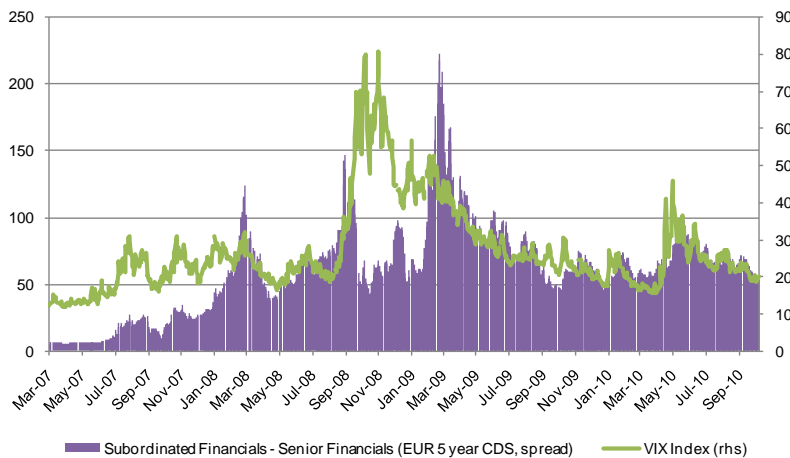
By Jennifer Kapila

## Recommendations Summary:

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- Investment decisions at the end of 2010 will require an uneasy balance between recognition that high beta financial assets have little room left to run and “forced” risk retention due to wider portfolio rebalancing. QE2 will have little impact on bank earnings and bank assets look fully priced, given the fiscal, credit and currency issues that abound.
- Most of the risks posed by headlines are surprising only in the degree and timing of reaction. The backwash from the U.S. real estate bubble has been suppressed by “extend and pretend” techniques and, until recently, over-shadowed by Eurozone sovereign risks. The extent of the willful negligence leading to this major system malfunction is indeed a surprise, but the renewed threat to solvency in the worst potential outcome, i.e. recognizing real estate loans at their current value, was not.
- Third quarter earnings may have finally convinced participants of the challenge of growing revenues and lingering pockets of vulnerability (i.e. investment banks and Spanish domestic), but this has been a core element of our view on the financial sector, both in the U.S. and Europe, since well before the inception of the Cross Asset Monthly. We retain a preference for banks with (relatively) stable earnings generation and out of regulatory harm’s way.

**Figure 1: A Rapid Decrease in Volatility to Low Levels Has Significantly Reduced the RV of Subordinated Risk**



Source: Bloomberg

## CORPORATE SECTOR: FINANCIAL INSTITUTIONS

October 29, 2010

**Summary Recommendations**

The disconcertingly unpredictable reaction to new issues and the re-emergence of old issues compels us to take a more neutral stance this month to pause and consider more selective recommendations.

- Overweight credit relative to equity. Macroeconomic obstacles to revenue growth, higher capital requirements and moral hazard still favor debt for the foreseeable future.
- Remain cautious on subordinated debt risk. Upside price appreciation is limited but moral hazard, attractive carry for long-term buyers and potential bail-in legislation imposing losses on senior unsecured are still supportive for select subordinated risk. We protect against downside risk and a rise in volatility by going long on senior financial risk and short on subordinated financial CDS risk.
- In light of continued volatility, both in terms of earnings and regulatory decisions, we still overweight large entities with significant retail or EM exposure relative to investment banking groups.
- We also continue to underweight exposure to smaller eurozone peripheral nations (such Portugal, Ireland and Greece), as fiscal and intra-EZ political tensions re-emerge and an expensive euro increases the austerity burden.

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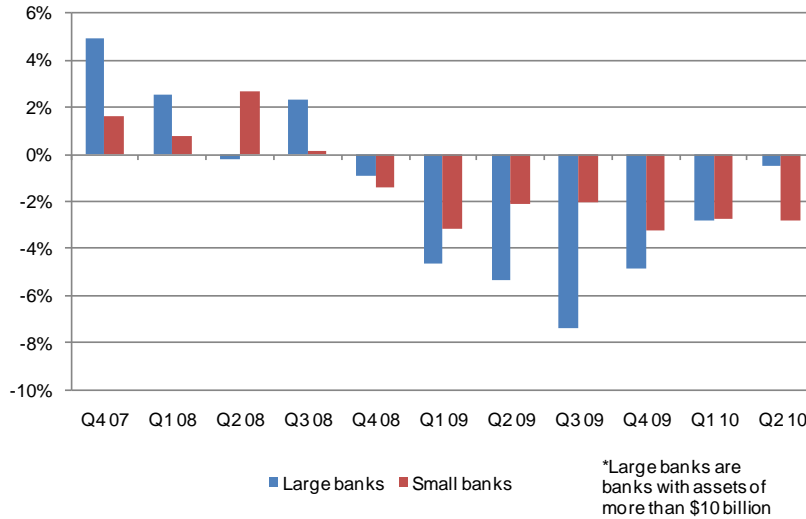
**QE2: As Much Use to Earnings and the Real Economy as the Trans-Atlantic Liner**

Unless banks significantly increase their lending activities, we fail to see much positive uplift in earnings on the back of QE2. While lending standards may have broadly eased, a closer look at the last [Senior Loan Officer Survey from July 2010](#) suggests this easing occurs on the margins—the majority of banks report unchanged standards—and is more prevalent among large banks than small banks. Where standards have eased, the greatest factor seems to be competitive pressure both from banks and non-bank lenders, potentially driving a renewed underpricing of risk tolerable only to larger banks and shadow banks. Individuals that have been unable to refinance thus far will find opportunities still limited, while the relative fundamentals of larger non-financial corporates favor ongoing disintermediation. That leaves SMEs as the potential target of any new lending gains. However, recent and further curve flattening could have a marginally negative effect on net interest margins (NIM) given already very low funding costs, and could penalize smaller institutions—which may be better suited to underwriting and managing SME loans—at the expense of larger competitors with more diverse (but volatile) revenue streams.

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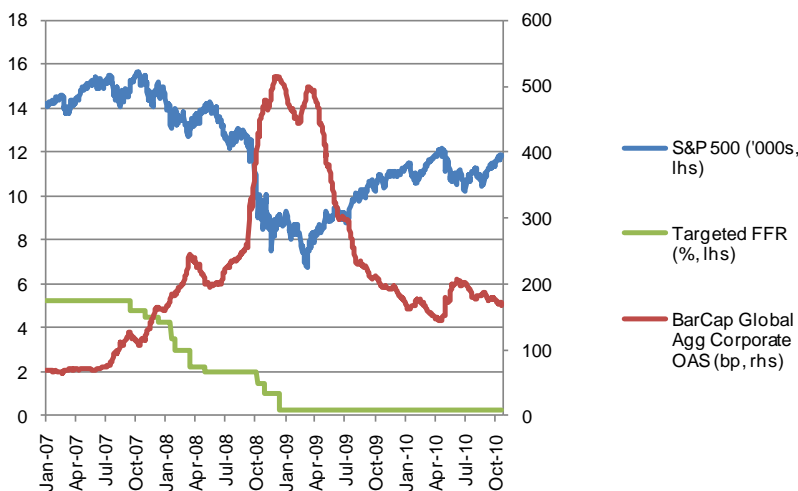
Figure 2: Small Bank Appetite for Commercial Lending Remains Limited (q/q change)



Source: FDIC (commercial and industrial loans)

The scope for asset reflation is limited as well, as assets trade at a significantly higher premium today than in Q1 2009, when the first round of QE was launched amid widespread market panic over deflation and economic contraction.

Figure 3: This Time Around, Rates are Low and Bonds and Equities Have Less Upside



Source: Bloomberg

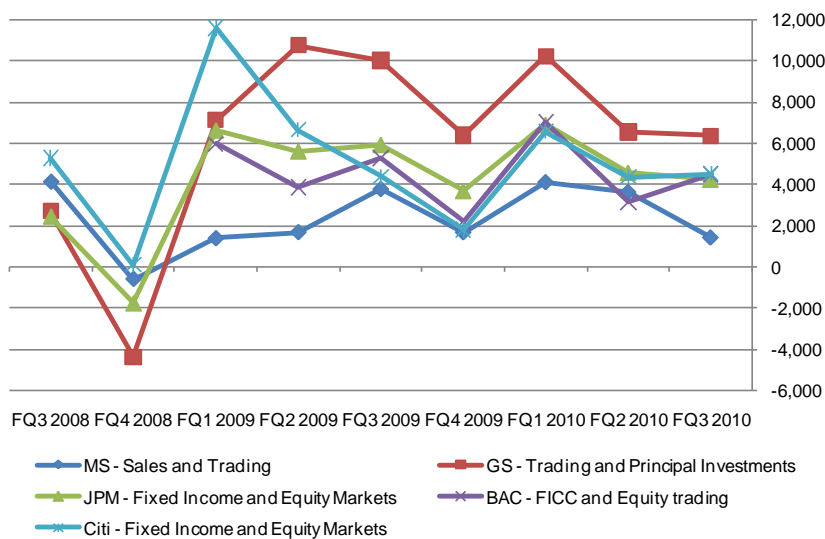
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Finally, there is a possibility that portfolio rebalancing and continued low rates could stimulate trading flows, origination and M&A activity. For most large entities, M&A is a relatively small proportion of total revenue generated and any realistic increase would likely only have a marginal effect on earnings. Third quarter earnings reports from U.S. and Swiss banks show that trading flows remain weak, despite sustained asset reflation in higher beta asset classes—equities, Tier 1 and high yield—so this is no surefire windfall.

Figure 4: Trading Revenue Direction Is Mixed at Best (USD millions)



Source: Bloomberg

As for origination, U.S. banks may have a competitive advantage outside of the domestic market with a weaker dollar, but benefits will accrue to the largest historical bookrunners. Continued deleveraging and spread tightening though could suppress incremental fee generation.

Regulation: The Iterations Continue, Discordant

Recently it appears that within developed markets, the eurozone is a kinder place to operate for a bank, as long as sovereign risk is off the table. The Dodd-Frank bill left implementation at the regulator’s discretion, with the resultant opportunity for significant lobbying to demand anodyne standards. The Volcker rule, however, has rendered U.S. banks more sensitive to protectionist EU legislation, while [the latest proposal from the FDIC on liquidation authority](#) demonstrates the ability of regulators operating in a single jurisdiction to move forward otherwise controversial dialogues.

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While credit rating agencies have opined upon the futility of this bridge bank structure, the notice effectively calls for all long-term unsecured creditors to be exposed to losses in the event of failures and repo counterparties will remain exposed to any value at risk of the underlying repo collateral. Mid-term U.S. elections however, could result in a Congress that seeks to block or amend certain elements of the bill.

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On the other side of the Atlantic, there is a notable difference in political will between “true” sovereigns and eurozone members. We witnessed the BIS make significant concessions vis-à-vis the implementation schedule of Basel III capital rules and the CEBS conduct a stress test with questionable assumptions, but Switzerland and to a lesser degree the U.K. are calling for more stringent capital standards. [The Commission of Experts appointed by the Swiss Federal Council issued a report](#) advising that Switzerland’s largest banks maintain a Tier 1 ratio of 19%, of which at least 10% would be composed of common equity. The council estimates a total capital requirement of CHF76 billion for both UBS and Credit Suisse, which compared with Q3 capital levels implies CHF10 billion and CHF12 billion of additional tangible common equity for UBS and CS, respectively, and CHF36 billion each of contingent equity issuance, which has met with limited success. Mandatory conversion, particularly at a high common equity trigger level of 7% (versus the 5% core Tier 1 ratio of Lloyds ECNs), and higher required ratios will certainly reduce the attributable profit to shareholders, which is already acutely susceptible to weaker and more volatile trading profits across capital markets-oriented groups. As the requirements are calibrated to market share and size, Swiss banks may need to shrink to become more competitive, or divest and thus become another regulator’s headache. Divestment may not be an entirely negative outcome for a tiny country like Switzerland.

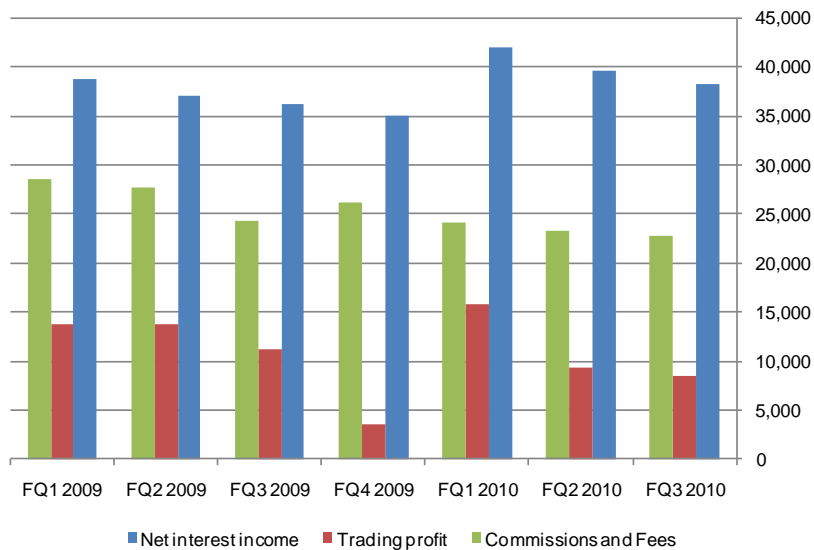
### Earnings: Banking on Provisions a Little Longer

We have [consistently warned](#) that growing top line revenue would be a key 2010 challenge for banks as efficiency gains and provision decreases are exhausted. This trend has become apparent to [mainstream media](#) as quarterly decreases emerge across interest-based, capital markets and fee-generating businesses.

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Figure 5: After Reflation, Rate Cuts and Accounting Changes, Revenues Can't Fight Gravity



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Source: Bloomberg (C, JPM, and BAC)

Note: The Q1 2010 boost in net interest income and margins across U.S. banks was due to consolidation of off-balance sheet vehicles.

The tightening of bid-offer spreads—a function both of greater risk appetite and a need to be more competitive to maintain current market share—constrains capital market earnings and renders them more susceptible to volatility, which may be poised to return given the rapid descent of VIX ahead of QE2 execution. On the other hand, political uncertainty and the continued presence of the state in financial sector dealings makes it difficult to value and stabilize the pricing of financial sector liabilities. With a relatively flat yield curve and stagnant creditworthiness in an anemic economy, the only reliable form of revenue is solid loan income or a decrease in expenses, most likely provisions as operating expenses were whittled down in preceding quarters. There is still some further room for provisions to fall, but the quantum is dwindling; in the case of JPMorgan, provisions have decreased more than 50% for two consecutive quarters. This necessarily means dividends must decline; with higher capital requirements and leaner pickings, simply maintaining decent ROEs will be a tough slog and we should expect restructuring and inorganic growth via acquisitions to pervade the financial sector.

### Performance

Within equities, EM financials again broadly outperformed DM financials, though not as strongly as last month due to corrections in Greece, Germany and Portugal. Within DM, Greek financials staged a major reversal as investors bought the renewed confidence in Greece ([successful debt issues and growing](#)

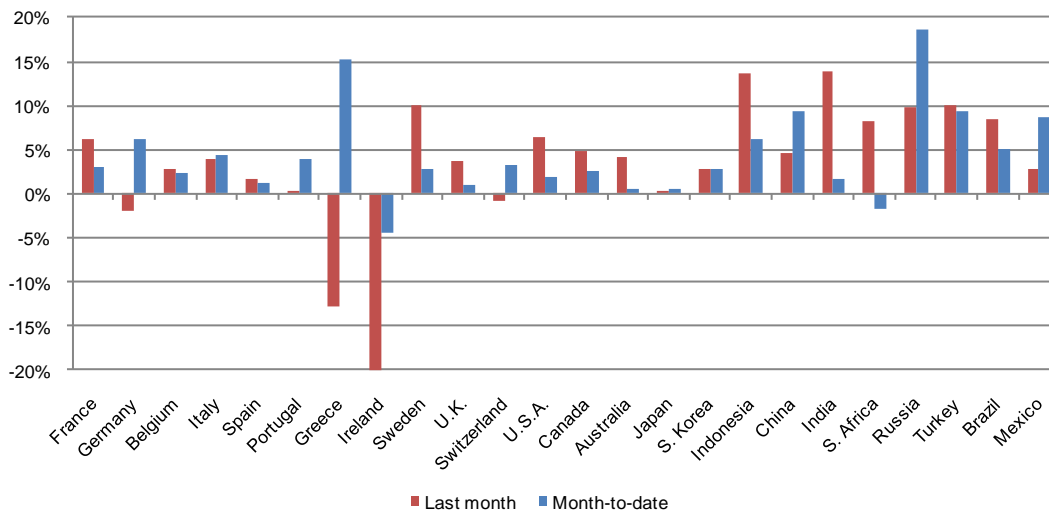
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[acceptance of Greek sovereign debt as collateral](#)). German financials, followed by Italian and Portuguese financials, outperformed, while Ireland followed by Spain and the true sovereigns—Japan, Australia, and UK—underperformed. The performance of our recommendations was inconsistent, driven by both risk appetite and headline risk, suggesting to us that idiosyncratic risk has taken centre stage as volatility has declined.

Figure 6: S&P Global BMI, Financial Equities, Total Return



Source: Factset

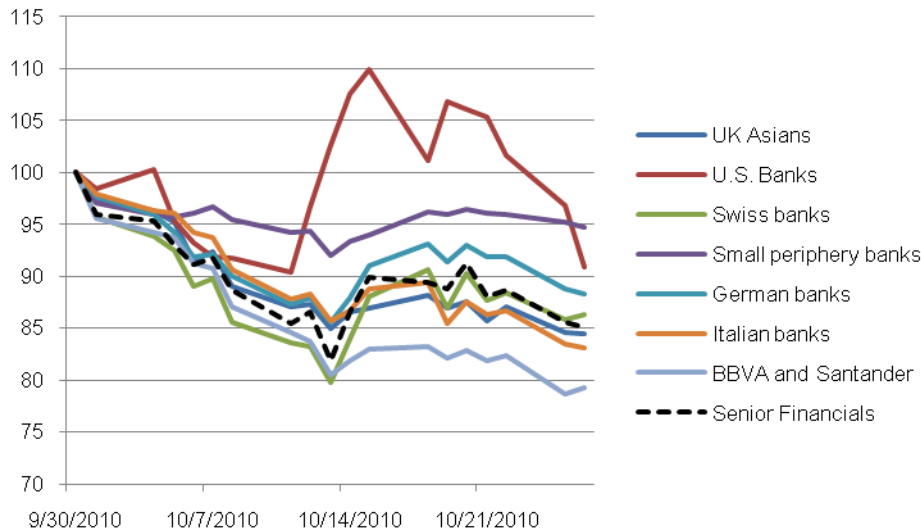
Our recommendations in credit have been fundamentally risk averse, effectively positioning for high impact tail events. As such, they have yielded highly mixed results. Within CDS and month-to-date, our preference for EM exposure—via UK Asian banks and large Spanish banks—relative to small periphery banks (Portuguese and Irish names) was a good call, but foreclosure issues rocked U.S. bank risk premia, particularly Bank of America. Over a longer time horizon (YTD), our in-class selections—strong and or true sovereigns and emerging market risk—have fared relatively well, but our capital structure positioning, favoring senior risk over subordinated debt, has fared quite poorly in the last several months.

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Figure 7: EM Exposure Still Commands a Risk Premium (5-yr CDS MTD performance, rebased)



Source: Bloomberg, RGE

On an index-weighted basis, the subordinated debt (Tier 1 and Lower Tier 2 in particular) spread performance may have a relatively small effect on a benchmark portfolio for cash investors, and we've been regularly more optimistic on such securities for blue-chip names and for long-term holders. However, senior spreads have remained stubbornly "sticky," particularly in the EUR space; senior spreads have remained relatively flat (B+150-160 bps) for three months while Lower Tier 2 and Tier 1 have tightened 40-50 bps and 150-200 bps, respectively.

That said, a look at the Merrill Lynch Global Broad Market Financials Index suggests that this sub-senior risk divergence is particularly concentrated in the EUR space and is less obvious in the USD space. The primary trend was a rotation away from U.S. issuers in favor of European or EM-exposed issuers, though yen-buyers prioritized duration over issuer nationality.

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