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## GLOBE AT A GLANCE – Andrew Wroblewski, London / Pierre Ellis, New York

**Equities: Mainly lower.** Taking a cue from Wall Street, Japanese stock markets closed sharply lower. Other Asian bourses were also lower, pulled down by woes about global recession. In contrast, European equity markets rose in the morning session, recovering from an initial sell-off.

**Bonds: Little net change.** Japanese government bonds rose across the curve. European benchmark bonds also rose throughout all maturities.

**Currencies: Stronger yen.** The dollar was volatile against the yen through Asian and European activity trading around ¥/\$ 93.18. Against the euro, the US currency saw little net change in Asian hours but fell in European trade towards \$/€1.263.

**Eurozone: Much softer PPI inflation.** Undershooting expectations this time around, producer price inflation fell 1.6 percentage points to a six-month low of 6.3% Y/Y.

**Switzerland: Marked fall in headline inflation.** Very much undershooting expectations, consumer price inflation fell sharply in November, falling 1.1 percentage points to 1.5% Y/Y.

**Japan: Policy stable.** As largely expected, the BoJ policy board kept the target for the unsecured overnight call rate at 0.3% after a previously unscheduled meeting.

**South Korea: Growth revised down.** Revised national accounts data showed GDP growing by 0.5% Q/Q in Q3, a 0.1 percentage point downward revision on the advance estimate and the lowest reading in exactly four years.

**Australia: Rates slashed yet again.** Surprising markets by the size of the cut, the Reserve Bank of Australia reduced its benchmark cash rate by 100 bp to 4.25% – the lowest since 2001 – following its December meeting.

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## U.S. ECONOMIC AND CREDIT MARKET OUTLOOK – Pierre Ellis, New York

**Treasuries surged Monday, cutting the two-year yield by about eight basis points and the ten-year yield by about nineteen.** The market gained solidly overnight, on severe weakness in overseas stock markets, rose a bit further as data came in weaker than expected, and as U.S. equities carried on the global weakness, and leapt in the afternoon, when Chairman Bernanke mentioned, as a policy option, the possibility of heavy Fed buying of Treasuries. Prices fell back a bit in late trading, but declines were limited by a late severe selloff in stocks.

The headline November **ISM index** fell a greater-than-generally-expected 2.7 points (Consensus: -1.4 points; Decision Economics: -2.4 points) to 36.2.

Notably, orders fell even more severely than the headline, with a 4.3-point drop to 27.9. Demand for manufactured goods is apparently in near free-fall.

Meanwhile, production (-2.6 points to 31.5) and employment (-0.4 point to 34.2) declined comparatively slightly—a shock-absorbing effect if demand picks back up, but, more likely under current circumstances, a postponement of the inevitable that will force abrupt adjustment if demand does not revive.

The prices paid index, meanwhile, took yet another sharp step down, falling 11.5 points to 25.5. This does largely reflect the great downward flexibility in energy

and materials prices—but also reinforces the broader picture of unusually, and unexpectedly, rapid disinflation.

For the Fed, the data emphasize yet again the sharper-than-expected decline in the economy—and the uncertainty as to where the bottom will be—and serve as another prod to concerns about the "tail risk" of outright deflation.

**Bernanke's** text reviewed the Fed's response to the financial crisis, and—of more immediately concrete interest—discussed the condition of the economy and potential further steps by the Fed.

The description of the economy seems essentially neutral with respect to the issue of whether downside surprises have outrun even the view underlying the easing bias clear in the last FOMC statement. But, Bernanke considers potential further policy steps with a specificity that suggests that the Fed, at a minimum, strongly suspects they will be needed.

His discussion of policy options is conducted in the framework of a "three aspects" breakdown that he lays out in his review of what the Fed has done so far. The first of these aspects is conventional monetary easing, meaning interest-rate cuts, the second is the provision of liquidity to the private sector, as "by lending cash or its equivalent secured with relatively illiquid assets" even in overseas dollar markets, and the third has been the Fed's efforts to "use all our available tools to

promote financial stability,” as by stabilizing systemically important financial institutions.

The Chairman seems to regard the last of the aspects, promoting financial stability, as being well in hand, given the passage of the TARP—or in the now-preferred usage, the EESA—and the high state of vigilance, and availability of funds, among global central banks and governments. As in previous discussions, the Lehman collapse is portrayed as regrettable, but unavoidable given the laws in place at the time.

Bernanke’s consideration of possible future actions on the “conventional” front, meanwhile, is perfunctory, suggesting that “aspect” has about run its course, and he slides easily—and probably significantly—into discussion of the “liquidity” aspect: “Although conventional interest rate policy is constrained by the fact that nominal interest rates cannot fall below zero, the second arrow in the Federal Reserve’s quiver—the provision of liquidity—remains effective.”

The hint is that further rate cuts are seen as a given—to whatever bottom the Fed thinks is safe with respect to the preservation of a functioning money market, including money market mutual funds.

Bernanke goes on to lay out two potential thrusts of liquidity-related action:

“First, the Fed could purchase longer-term Treasury or agency securities on the open market in substantial quantities. This approach might influence the yields on these securities, thus helping to spur aggregate demand....Second, the Federal Reserve can provide backstop liquidity not only to financial institutions but also directly to certain financial markets, as we have recently done for the commercial paper market. Such programs are promising because they sidestep banks and primary dealers to provide liquidity directly to borrowers or investors in key credit markets.”

This level of specificity about possible future policy actions is, of course, extraordinary for comments from a central banker, but is as far as Bernanke goes. However, there can be speculation about where the Fed might go, and what the effects might be.

The option of buying securities out the Treasury yield curve in an attempt to reduce longer-term yields was conceived in the context of the Japanese and early 2000s U.S. episodes, where a zero nominal overnight rate was seen as constraining the central bank’s power to influence longer-term rates—and thus to “spur aggregate demand.”

However, there may be only limited potential for that course of action to help in the present situation—where the problem is not one of too-high Treasury rates, but, rather, of excessive spreads, or even outright credit availability, for private-sector borrowers.

Purchases of agency securities, in contrast, work directly to reduce spreads—and Bernanke sees it as

“encouraging” that the recent \$600 billion initiative in that direction “was met by a fall in mortgage rates.”

The second aspect of liquidity-related policies, initiatives that “sidestep banks and primary dealers to provide liquidity directly to borrowers and investors in key credit markets,” might also work to reduce spreads and increase credit availability. As an example of such an effort, Bernanke points to the new plans to fund holdings of asset-backed securities—where the intention is clearly to reduce spreads, including the infinite spreads represented by current private-sector inability to issue the securities.

The question that must be asked is whether renewed availability of credit, or lowered costs, would work to significantly stimulate the economy any time soon, given what seems to be a great unwillingness to spend—let alone to borrow in order to spend. The interruption in credit flow caused by the crunch of the last year may have done enough damage to the economy, and to the outlook, to quash consumer willingness to spend and business willingness to invest to a degree beyond correction by lower cost of borrowing—with passage of time the only potential cure.

However, new Fed initiatives along the lines laid out by Bernanke might work to soften the downturn a bit—particularly if they can be targeted, perhaps with help from the TARP, at the high-yield and other sectors where rollover risk is looming as a major threat.

## DAILY CALENDAR

Today brings the weekly store sales reports from ICSC/Goldman Sachs and Redbook Research, at 7:45 EST/12:45 GMT and 8:55 EST/13:55 GMT respectively, a speech from Philadelphia Fed President Plosser, at 12:30 EST/17:30 GMT, and November light vehicle sales reports from manufacturers, appearing through the day.

**Store sales reports** today will cover the fourth and final retail-November week—extending through Saturday of Thanksgiving weekend.

Gelling of thought about the November sales month will probably wait until the broad group of reports from monthly reporting chains arrives Thursday—with the main interest today being in commentary on “Black Friday” sales.

Press accounts suggest that Friday activity was unexpectedly strong, driven by extraordinary one-day or limited-quantity discounts, and that Saturday saw a near evaporation. Reports today will fold Friday and Saturday activity into a weekly total—so that a sense can be obtained of whether the full week came in above targets.

In-line results would hint that Saturday weakness was great enough to offset much of whatever upside surprise occurred—and there would be no suggestion that full-season sales will be above expectations.

Above-plan results might be read a bit more optimistically, but suspicions that sales later in the season had been cannibalized by the early burst of activity would surely linger until proven unfounded by later reports.

**Plosser**, who will rotate out of FOMC voting status in January, discusses the economic outlook at the annual University of Rochester business school forecast conference—continuing in a role that he had for years before joining the Fed.

Though Plosser's views may not have any great direct weight in the December FOMC decision, he does belong to the more-technical element of the Committee's hawkish wing and could give a sense of how that bloc—which will be represented among voters next year by Richmond Fed President Lacker—conceives of the Fed's exit strategy from the current all-out accommodative stance.

Even the FOMC mainstream is surely convinced that the return to policy normalcy must be much quicker than the “measured tightening” path of the Greenspan Fed, but there is probably less agreement on exactly how fast, and on what development should trigger the start of the move. Probably, the Plosser/Lacker school will represent the extreme view on quickness and sooness.

**Light-vehicle sales** are expected to at best hold steady at the 10.6-million October rate (Consensus: 10.4 million; Decision Economics: 10.6 million).

The absence of any significant rebound, after the near-2-million unit plunge in the sales rate from September to October, would confirm that the drop was not a fluke—presumably reflecting a profound deterioration in consumer financial confidence

**WESTERN EUROPE** – Andrew Wroblewski, London

**EUROZONE – Much softer PPI inflation.** Undershooting expectations this time around, producer price inflation fell 1.6 percentage points to a six-month low of 6.3% Y/Y in October. Perhaps more notably, the core rate (excluding energy prices) also eased once again by another 0.2 percentage points to 3.8% Y/Y, further away from a July reading that was the highest since 1995. In M/M terms, headline producer prices fell by 0.8% M/M, again very much energy-led, but with some softening in consumer goods.

**OTHER WESTERN EUROPE**

**UNITED KINGDOM – Construction PMI falls to fresh record-low.** Undershooting expectations once again, the construction PMI decreased by 3.3 points to 31.8 in November; a fresh record-low.

**SWITZERLAND – Marked fall in headline inflation.** Very much undershooting expectations, consumer price inflation fell sharply in November, falling 1.1 percentage points to 1.5% Y/Y and therefore back to the SNB target of 2% for the first time in a

year. The drop in the Y/Y rate was the largest since 1993.

Prices fell by 0.7% M/M in November, led lower by a fall in food and alcohol prices, but mainly by a slump in energy costs (petroleum prices fell by 13.6%). However, prices otherwise, inched higher last month. Nevertheless, the underlying inflation measure that excludes food, drink and seasonal produce slipped 0.1 percentage point to 1.5%, while, the measure that also excludes administrative prices remained at 1.8%.

**Comment:** *Headline CPI inflation is now even further below the 2.69% average anticipated by the SNB for the current quarter in its quarterly assessment made in mid-September, with a further weakening surely in the pipeline given the additional drop in food and fuel prices coming through. Even given the lack of any clear sign of a further fall in core rates, this backdrop will surely make the SNB feel (even) more comfortable with the significant easing in policy it has presided over of late, although the rate cuts are more designed to address downside risks to the economy.*

*In this regard, the SNB may be more alarmed that the most recent Swiss survey data has now weakened sharply, to a degree that the likes of the PMI numbers are echoing the weakness seen elsewhere in Europe, rather than retaining their previous resilience. With this in mind, even if the Q3 GDP data (due Thursday) continue to show an economy growing, the SNB is still likely to point to 2009 being a year when GDP may contract. Indeed, this may be the theme that the SNB will project at the next Board assessment on December 11.*

**JAPAN** – Andrew Wroblewski, London

**Policy stable.** As largely expected, the BoJ policy board kept the target for the unsecured overnight call rate at 0.3% after a previously unscheduled meeting. The decision was arrived at unanimously.

The meeting did agree a new set of funding measures which the BoJ introduced in order to help commercial bank lending to firms but also boost money market liquidity. Explaining the measures, BoJ Governor Shirakawa went on to note that as for future policy-making, he still had the same view that any further lowering the (policy) interest rate amid already-low rates would hinder smooth functions of the money market.

**ASIA** – Samuel Sidenbladh London

**SOUTH KOREA – Growth revised down.** Revised national accounts data showed GDP growing by 0.5% Q/Q in Q3, a 0.1 percentage point downward revision on the advance estimate and the lowest reading in exactly four years. In Y/Y terms, growth was revised down as well, from 3.9% to 3.8%, now a whole percentage point below the Q2 outcome and the weakest since Q2 2005.

The revisions to the expenditure breakdown showed a slight upward revision to government expenditure, while the dismal private consumption expenditure reading was unrevised at 0.1% (-0.2% in Q2), the second lowest outcome in four years. There were, however revisions to both capex and trade data, the former now growing by 0.7% Q/Q (was 1.1%) – as both construction and facilities growth was revised down – while exports fell more clearly than previously estimated (-1.2% vs -0.8%).

On the output side, the revisions were broad-based, with an upward revision to the agricultural sector more than offset by downward revisions in the secondary sector.

*The revised data did little to lift the spirits; on the contrary, they only underscored the continued dismal domestic demand back-drop and the weakening export sector. As such they will provide little comfort for the Government or the Bank of Korea. Moreover more up-to-date data suggests that the weakness seen in Q3 has not only carried over into the current quarter, but has also worsened, with export growth in Asia seemingly having fallen off a cliff in October and with little sign of any improvement in the domestic outlook.*

#### **OCEANIA – Samuel Sidenbladh London**

**AUSTRALIA – Rates slashed yet again.** Surprising markets by the size of the cut, the Reserve Bank of Australia reduced its benchmark cash rate by 100 bp to 4.25% – the lowest since 2001 – following its December meeting. Rates have now been cut by a cumulative 300 bp since September.

In the accompanying statement, the RBA noted that although recent central bank and government action had begun to have a positive effect on the financial market, sentiment remained fragile. Moreover, the Bank still expected below-trend global growth in 2009, and easing price pressures globally. Domestically, the central bank acknowledged that recent data was pointing to a significant moderation in domestic demand, led by very cautious consumers and businesses. As a result, domestic consumer price inflation was expected to start easing soon.

Moreover, the RBA Board highlighted that with the latest cut, monetary policy was now expansionary and that interest rates were now at its previous cyclical low-point. Moreover, the Bank pointed out that there had now been a major easing in monetary policy and that, coupled with the fiscal stimulus already announced and the fall in the exchange rate, there was a significant policy stimulus in place to support demand over the coming years.

*Although the RBA left the final paragraph of the statement unchanged, ie, suggesting it would continue to monitor developments and make adjustments as needed, the RBA seemed to indicate that markets should not take further large rate-cuts as a given, highlighting that rates are now at the same cycle-low of the previous down-turn, that policy is now expansionary and that the fiscal stimulus will also aid the economy. However, this should not be interpreted as a sign that the RBA considers the easing cycle to be over, but rather that the Bank will continue to monitor data developments and act accordingly.*

**AUSTRALIA – Retail sales trend stable.** Data for October showed the (nominal) retail sales trend rising by 0.2% M/M, the same pace as preceding two months but above expectations. Falling household goods, apparel and restaurant retailing sales were more than offset by continued strong (0.6% M/M) food sales and clear gain in other retailing (0.8). On a seasonally adjusted basis, sales were up by 0.7% M/M following a revised 1.0% drop in September.

*The new methodology has turned the seasonally adjusted series more volatile than previously, and the Australian Bureau of Statistics strongly discourages its use for analytical purposes, instead highlighting the trend series. Hence, the retail sales release is proving less useful in judging domestic demand developments. This weakness has been acknowledged by the ABS, and the old methodology will be re-introduced for the November survey (but data will not be presented using this method until 2009).*

**Current account deficit narrows.** Balance of payments data showed the current account deficit narrowing to A\$ 9.7 bln in Q3 – the smallest deficit since Q3 2003 – from A\$ 14.0 bln. The Q3 reading was the third improvement better than expected, with the goods balance swinging from a deficit into surplus while the income deficit narrowed. The services surplus, meanwhile, shrank slightly.

#### **LATIN AMERICA – Andrew Husby, New York**

**BRAZIL (Monday) – Trade surplus widens.** Brazil's Trade Ministry reported a larger than expected trade surplus in November, coming in at \$1,613 million, up from last month's \$1,207 million. One year ago the trade surplus was \$2,027 million. Exports grew 5.0% y/y to \$14.8 billion (the slowest pace in eight months). *However, the most striking development, and perhaps the most informative of the impact of currency depreciation and global crisis, was the abrupt reduction of the pace of imports from over 40% year-on-year in October to 9.3% year-on-year in November.*