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# *The Morning Briefing*

North American Edition
Wednesday, July 23, 2008
6:30 am (EDT), 11:30 am (BST)
Allen Sinai, Chief Global Economist

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

**Equities: All higher.** Japanese stock markets closed higher, as concerns about high oil prices eased. Other Asian bourses also closed with strong gains save for Shanghai, helped by the banking and airline industry. European equity markets opened strongly higher, led by the financial sector.

**Bonds: All down.** Japanese government bonds were lower across the curve. Likewise, European benchmark bonds fell across nearly all maturities.

**Currencies: Stronger dollar**. The dollar rose against the yen in European trade, towards ¥/$ 107.80, having seen little net change in Asian hours. Similarly, against the euro, the US currency saw little net change in Asian hours and rose sharply in early European trade towards $/€ 1.573.

**Eurozone: Orders slump back.** Coming in very much lower than most expectations, industrial orders slumped by 3.5% M/M in May, a downside surprise accentuated somewhat by negative revisions to previous months.

**France: Household spending falls again.** Showing a drop largely as expected, consumer spending on manufactured goods fell by 0.4% M/M in June.

**United Kingdom: Rate hike threat clear.** Surprising some, the minutes from the July 9-10 BoE MPC meeting showed the committee to have been split in regard to the decision to keep rates on hold this month.

**United Kingdom: Softer activity, but price pressures remain.** The CBI Industrial Trends survey for July showed clearly higher pricing intentions, but with a weaker real activity backdrop.

**Malaysia: Energy-induced surge in CPI inflation.** Overshooting expectations, consumer price inflation jumped from 3.8% Y/Y in May to 7.7% in June, the highest in over 12 years.

**Taiwan: Weaker export order.** Undershooting expectations, export orders growth slowed from 14.5% Y/y in May to 9.3% in June, the lowest since February 2007, a month that was distorted by calendar effects.

**Australia: Consumer price inflation rises.** Coming in slightly higher-than-expected, consumer prices rose by 1.5% Q/Q in Q2, pushing up Y/Y inflation from 4.2% to 4.5%, a seven-year high.

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

**Treasuries fell back Tuesday, with the two-year yield rising about twelve basis points and the ten-year yield up a bit more than five and a half.** Prices opened firmly, but fell off on characteristically hawkish remarks from Philadelphia Fed President Plosser and were further pressured by a mid-morning drop in oil prices and a strong late rally in stocks.

**Plosser** used the words "sooner rather than later" with reference to prospective interest rate increases twice in his formal speech text—suggesting that he wanted it to be noticed.

However, the usage was clearly prospective in both instances, and was accompanied both times by a phrase of the nature of "the exact timing depends on how the economy evolves."

Plosser noted that his 2008 GDP-growth forecast of about 1.7% "is near the upper end of the range of FOMC participants' projections." Of course, at this point, differences regarding 2008 growth are driven by differences regarding performance in the second half of the year—essentially coming down to differences about a post-rebate consumer fade and about the potential for other spending categories to firm up, either naturally or because of the Fed's rate cuts.

Plosser sees the second half as "sluggish," and thinks "the road to recovery is likely to be a bumpy one," but remains focused on the "current very accommodative stance of monetary policy," and the necessity to take account of the lags in its effect. Part of his relative comfort may reflect the fact that the Philadelphia District, as he noted in response to a question, has not suffered a housing bubble and crash of any great consequence, and seems to be in reasonable general economic shape.

True to form, Plosser expressed great concern about inflationary expectations—in particular, about the possibility that a sustained increase in energy prices might lead to an unhinging of inflationary expectations even if core inflation remains largely unaffected.

As a onetime Milton Friedman student, he was careful to note that "Monetary policy cannot control changes in the relative price of a key commodity, like oil or food. But it can help ensure that a relative price increase doesn't turn into a rise in overall inflation."

However, Plosser worries that confidence in the Fed's willingness to do this can falter: "I don't believe we can be sanguine that the behavior of core inflation will keep the public's inflation expectations well-anchored in the face of persistently high headline inflation. To keep inflation expectations anchored means that monetary policymakers will have to back up their words with action."

The hint here is that the Fed might need to go a bit overboard in tightening—raising rates beyond the level it judges, independently, would keep overall demand and supply in a non-inflationary balance over the longer term—in order to prevent "persistently high headline inflation" from pushing inflationary expectations higher, even if those expectations would ultimately prove unsustainable.

Of course, Plosser's worries on that score would be greater at times, like now, when policy seems to him to be at a manifestly "accommodative" setting. As of today, he believes that policy has "appropriately ensured that monetary policy is consistent with market forces that will bring economic growth back toward its long-term trend over the next year," but the question will be when he judges progress toward that goal as being sufficient to warrant removing some of the accommodation.

One criterion for him might be whether the economy proves to be less "bumpy" than he expects, or whether the down-bumps seem to be met with increasingly reliable resilience—hinting that underlying tendency towards recovery is firming.

If inflationary expectations worsen, Plosser's judgment would probably be reached more quickly—on principle, and because there would be a hint that economic weakness is not proving so severe as to make people confident that price increases will not stick. Odds are, he would not be too alone in making such a judgment.

## DAILY CALENDAR

Today brings speeches from Fed Governor Mishkin, at 9:00 EDT/13:00 GMT, and Vice-Chairman Kohn, at 11:15 EDT/15:15 GMT, as well as the release of a new FOMC Beige Book, at 14:00 EDT/18:00 GMT.

**Mishkin** and **Kohn** both participate in the Bank of Canada's Economic Conference—an annual invitation-only session, this year focusing on "International Experience with the Conduct of Monetary Policy under Inflation Targeting."

Inflation targeting is a subject dear to the hearts of both the Bank of Canada and Mishkin, and he has been a regular at the Bank's many seminars and conferences on the topic. Today he makes a keynote address—though no formal title is listed on either the conference agenda or the Fed's web site.

Kohn, for his part, participates in a panel discussion of a paper titled "Trends in Monetary Policy Transparency" to be presented by Cambridge scholar Petra Geraats. With Kohn will be speakers from the Bank of Japan, the Czech National Bank, and Norges Bank.

Mishkin leaves the Fed at the end of August, but apparently will participate in the FOMC meeting that month. Of course, the main interest in comments from both him and Kohn will be in respect to personal spins on the tradeoff between downside financial-economic risks and upside inflation-expectations risks.

It is as doubtful that either will seem as near trigger-finger ready to tighten as Plosser did yesterday—though the degree of counter-balancing downside concern they exude, or not, will be important. Interest is only heightened by above-the-fold Tuesday FT article hinting that Bernanke's Humphrey Hawkins comments were more hawkish than they seemed.

The **Beige Book** has not seemed to bring much news or carry much weight lately, but any clear message of economic weakness might grab market attention. Surprising strength, of course, would be very newsworthy.

## CANADA – David Kalita, New York

**(Tuesday) Gasoline prices boost retail sales.** Retail sales rose by 0.4% m/m in May after a 0.6% gain in April. Excluding motor vehicles, sales rose 0.4% after a 1.2% jump the month prior. Of the C$144 million gain in sales between April and May, C$109 million came from gasoline, the result of higher prices (+8.8% in May). In real terms, retail sales only increased 0.1% in May.

## WESTERN EUROPE – Andrew Wroblewski, London

**EUROZONE – Orders slump back.** Coming in very much lower than most expectations, industrial orders slumped by 3.5% M/M in May, a downside surprise accentuated somewhat by negative revisions to previous months worth a cumulative 0.6 percentage point (orders rose by 2.0% in April). As a result, the Y/Y rate was -4.4%. This was a marked contrast to the 12.3% surge posted in April, and was the softest reading in exactly three years, albeit with the early Easter and ensuing calendar anomalies probably the cause of the volatility seen in M/M and Y/Y recent numbers. Nevertheless, orders in April/May were down some 0.4% from the Q1 average, a quarter when orders fell 0.3%.

**FRANCE – Household spending falls again.** Showing a drop largely as expected, particularly given the net 0.3 percentage point downward revision to previous months, consumer spending on manufactured goods fell by 0.4% M/M in June. The drop offset some of the 1.7% bounce seen in May. The latest fall was mainly due to a sharp correction in car sales. In Y/Y terms, household consumption growth slowed sharply to 1.0%, albeit remaining above the cycle-low of 0.2% set in April.

**Comment:** *This latest fall in spending may be nothing more than a continuation of the sharp month-to-month volatility in the data. However, a weaker trend does seem to be emerging. Indeed, the June fall was the third drop in the last four months of data, during which a cumulative fall of 0.5% occurred. Admittedly, on a less downbeat note, the data still left spending in Q2 flat in Q/Q terms, little different from the 0.1% gain posted through Q1 or the 0.2% rise seen in Q4 last year.*

*But, all these outcomes are well below the very strong growth rates seen in the quarters prior to the final quarter of last year, adding to the weight of evidence that consumer spending has faltered of late. This conclusion is less evident in national account data, where consumer spending only began to slow in the first quarter of this year. But the latest monthly data certainly suggest that this Q1 weakness continued into last quarter, undermining both Q2 GDP growth (data due Aug 14) as well as setting a poor base for growth in the current quarter.*

**ITALY – Retail sales recover.** Retail sales (nominal) rose by 0.5% Y/Y in May, a contrast to the 2.3% plunge seen in April and the 1.0% slide posted in March. However, the recovery in May was mainly on the food side, very probably supported by higher prices rather than sales volumes. Calendar effects also probably lay behind some of the swings seen in recent months. In seasonally adjusted terms, retail sales rose by 0.2% M/M.

**OTHER WESTERN EUROPE**

**UNITED KINGDOM – Rate hike threat clear.** Surprising some, the minutes from the July 9-10 BoE MPC meeting showed the committee to have been split in regard to the decision to keep rates on hold this month. As was widely expected, arch-dove Blanchflower wanted a rate cut, but his hawkish colleague Besley called for rate hike at that juncture, leaving the rest of the nine strong committee carrying the day.

However, it was clear that the rate hike discussion was the major preoccupation of the committee. Indeed, the minutes noted that the Committee could, by raising Bank Rate this month, send a strong signal that it remained determined to bring inflation back to target in the medium-term. But it did accept that there were also a number of arguments for maintaining Bank Rate at 5.0% this month. The upside news on inflation during the month came alongside more downside news on economic activity during the month too, so it was possible that a higher level of Bank Rate would not be needed in order to generate more spare capacity. An increase in Bank Rate in the current circumstances, when confidence was low and the financial sector fragile, could impart a downward momentum to the economy that risked a significant undershoot of inflation in the medium term. Therefore, keeping Bank Rate at 5.0% when the economy was slowing was arguably already sending a strong signal of the MPC's commitment to reducing inflation. Moreover, a rate change this month would be a surprise at a time when credit and other financial markets remained fragile, and any change in rates would be better communicated alongside the Bank's August Inflation Report.

For all members of the Committee, the decision was a difficult one and a range of views about the weights to place on different arguments was evident, albeit with all members agreeing that the path of inflation in the near term would be higher and the slowdown in activity more pronounced than previously thought. However, most members judged that the risks to inflation in the medium term were most likely to be balanced by maintaining Bank Rate at 5.0% this month.

**Comment:** *The minutes clearly emphasize that the MPC now has clearer, collective tightening bias and one that could be exercised as soon as next month, with the more hawkish tone probably a reflection of the impact that the strong June CPI data had on BoE thinking. Seemingly the BoE were not impressed by soft survey data of late including their own Agents Survey (released alongside the minutes), which showed a further marked deterioration in the labor market backdrop and even more of an easing in capacity constraints. The question is whether such data (as well as the softer global indicators seen of late) will convince the committee in its Inflation Report analysis that sufficient spare capacity is, indeed, likely to emerge to offset the higher inflation pressures it perceives. A (very probably one-off) rate hike next month is certainly a clear possibility, but (most likely) even deeper worries about the real economy may serve to keep policy on hold for some months yet.*

**Mortgage approvals weakness deepens.** According to the British Bankers' Association (BBA), gross mortgage lending growth in June fell to £ 3.8 bln from (an upwardly revised) £ 4.5 bln in the previous month, the former more than £ 1 bln below the recent average. Moreover, mortgage loan approval numbers fell further, particularly those for house purchase, with the Y/Y rate of growth turning even more negative to minus 66.9%. But the BBA also noted that credit card lending had weakened as had overall consumer borrowing.

*The clearly weaker BBA mortgage approvals data (at least outside of re-mortgaging) certainly shows the growing impact of tighter credit conditions and economic pressures on households and financial institutions. The data point to a marked fall in the more closely-watched mortgage approval data for June that the BoE will provide out next Tuesday (probably to around a new record-low of below 40 000).*

**Softer activity, but price pressures remain.** The CBI Industrial Trends survey for July showed clearly higher pricing intentions, with the average domestic price balance rising six points to a fresh cycle-high of 34 and therefore even more markedly above its long-term average value of around -4.

The rest of the survey, dealing with the real economy was much more downbeat, however. Indeed, total orders dropped to -8, largely reversing the surprise improvement seen in June. This was partly a reflection of the fact that export orders deteriorated slightly (down two points to -7), but more indicative of weaker domestic demand. Both orders indexes, however, remained clearly above their long-term average values. However, the balance of respondents anticipating higher production fell precipitously, slumping nine points to a five-year low of -7, possibly a result of an involuntary build-up in inventories that the survey also hinted at.

The survey also contained several questions polled only quarterly, including two on business capex plans, which were both clearly softer. However, the survey implied no further fall in capacity utilization, with the balance of firms reporting they were working below their capacity actually falling two points to 55 (still largely in line with the long-term trend). These quarterly results also reported domestic and export price pressures at the highest since 1995. On the still sobering side, the survey showed another fall in business optimism, to -40, a seven-year low.

**CENTRAL EUROPE, RUSSIA AND TURKEY** – David Kalita, New York

**POLAND (Tuesday) – Rising core consumer price pressures.** June data saw core consumer price inflation rising from 3.2% Y/Y to 3.4%, the highest since April 2002, on the back of a 0.3% M/M gain.

**ASIA** – Samuel Sidenbladh, London

**MALAYSIA – Energy-induced surge in CPI inflation.** Overshooting expectations, consumer price inflation jumped from 3.8% Y/Y in May to 7.7% in June, the highest in over 12 years. The surge in price pressures was clearly due to a 18.7 percentage points jump in transport price inflation (to 19.6% Y/Y) caused by a 41% cut in fuel subsidies seen in that month. However, food price inflation was up clearly as well, rising from 8.2% Y/Y to 10.0%, alongside marginal increases in household, education and miscellaneous price pressures.

*The stronger than expected jump in headline CPI inflation will most likely push the Bank Negara Malaysia into hiking rates at its policy meeting on Friday. That policy would have to be tightened following the fuel-subsidies cut was widely expected, the only question was whether the Bank would pull the trigger now or later in the year. Moreover, a hike now would most likely not be a one-off, but rather the first in a series of hikes, in order to try to anchor inflation expectations and avoid too much of a pass-though from fuel prices into other components of the CP. Indeed last time inflation was above 6% interest rates were much higher (the pre-cursor to the current policy rate – the three-month intervention rate – stood at 11.0%).*

**SINGAPORE – Stable consumer price pressures.** Contrary to expectations of a clear pick-up, consumer price inflation was stable at the 26-year high of 7.5% Y/Y for a second successive month in June. The unchanged headline reading came on the back of a 0.3% M/M decline, driven by clear falls in clothing and housing costs. The Y/Y breakdown, meanwhile, was somewhat mixed. Food price inflation rose to a four-month high of 1.5% Y/Y (from 1.2%), alongside rising clothing and housing price pressures. However, all other components of the index (most notable transport) saw price inflation easing back.

*The Monetary Authority of Singapore has hinted that it may revise (upward) its forecast for consumer price inflation in 2008.*

**TAIWAN – Weaker export orders…** Undershooting expectations, export orders growth slowed from 14.5% Y/Y in May to 9.3% in June, the lowest since February 2007, a month that was distorted by calendar effects. On a sector basis, both electronics and telecoms orders growth (accounting for nearly 50% of total orders) slowed – the former hitting a 13-month low and the latter posting the lowest reading since March – but with other components down as well. However, there was a pick-up in basic metals and chemicals orders growth. In geographical terms, meanwhile, export orders to the US fell by 2.2% Y/Y, the first negative reading since March 2003, and with orders growth to Europe, and most of Asia down as well. The one notable exception to the broad-based slowdown was (once gain) China, which saw order growth rising to a three-month high of 17.7% Y/Y (up from 15.3%).

*The June orders data left export orders growth in Q2 down 2.6 percentage points on the Q1 reading (at 13.1% Y/Y) to a one year low. Crucially, this is in contrast, to a slight strengthening in export growth in the last quarter, and suggests that the latter may have been due more to rising prices, rather than volumes. Indeed, the weaker output reading for Q2 (see below) is pointing in that direction. Moreover, the data highlight that China remains a bulwark against a more marked slowdown in orders. But given the weaker economic data seen last week, the question remains for how long this will be the case. Regardless, coupled with the available domestic data, the output and orders figures suggest that economic growth slowed further in Q2.*

**…and slower output growth.** Industrial production growth slowed from 5.6% Y/Y in May to 5.1% in June, the lowest reading since April 2007 and contrary to expectation of a pick-up. The breakdown revealed a broad-based slowdown, with manufacturing output growth slipping from 6.2% Y/Y to 5.9%, while the utilities and construction sector contracted at a faster pace than in May. Mining sector growth was down as well, falling from 35.5% Y/Y to 4.0%. *In quarterly terms, output growth fell from a two-year high of 12.0% Y/Y in Q1 to 6.8%, the lowest in exactly one year.*

**OCEANIA –** Samuel Sidenbladh, London

**AUSTRALIA – Consumer price inflation rises.** Coming in slightly higher-than-expected, consumer prices rose by 1.5% Q/Q in Q2, pushing up Y/Y inflation from 4.2% to 4.5%, a seven-year high. The pick-up in the headline index was driven by rising financial services, clothing and transportation. Of some note, food price pressures eased from 5.7% Y/Y to 3.9%.

*The headline reading was also above the latest (May) forecast from the Reserve Bank of Australia. However, over the last few weeks, the Bank had already flagged that it was exacting a stronger-than-forecast outcome. Indeed, the more detailed breakdown of the CPI showed that the headline pick-up was entirely driven by tradables inflation, with the non-tradables component – which more closely reflects domestic demand pressures – seeing price pressures falling from 3.3% to 2.9%, just within the RBA's target range of 2-3%.*

*However, the RBA's preferred core measures – the trimmed mean and weighted median – were both up, the former rising by 0.2 percentage point to 4.3% Y/Y and the latter from 4.4% to 4.5% (averaging 1.2% Q/Q). Admittedly, the increase in core pressures was more or less in line with expectations. Therefore, the Q2 CPI data is unlikely to shift near-term policy. Inflation remains a problem, but the RBA has already hinted that it expects inflation to moderate over the medium-term as the domestic economy deteriorates, and hence, it is prepared to look through the current energy-induced hump in inflation, as long as data continue to point to a clear slowdown in domestic economic activity.*

*To be sure, there are upside risks to the growth and inflation outlook, posed mainly by the improving terms of trade and its expected positive impact on domestic seining. As such, the RBA is likely to keep policy on hold for the foreseeable future, closely examining the data developments over the coming months, but with an important clue to RBA's thinking being the quarterly Monetary Policy Statement due on 11 August, with its updated growth and inflation forecasts.*

**Skilled vacancies fall.** Data from the department of Employment and Workplace Relations showed skilled vacancies falling by a sensually adjusted 3.7% M/M in July, building on the 4.9% fall in June and brining Y/Y growth down from -4.2% to -8.2%. In trend terms, the index was down as well, falling by 0.5% M/M and 6.0% Y/Y (-0.5% and -3.4% respectively in the previous month.

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

**MEXICO (Tuesday) – Retail sales rise.** May retail sales increased 3.4% Y/Y, in line with expectations, following a 7.3% rise in April.