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Viewpoints

FROM THE OFFICE OF THE CHAIRMAN

A MESSY START TO JULY.

Just when it seemed things were shifting back to the optimists' camp, Friday's news about the state of the world threw another spanner in the works. In addition to a very disappointing US nonfarm payrolls report, Italy came into the spotlight in the European crisis. Subsequently, the earliest of the June data releases from China look somewhat of a mixed bunch too. China's CPI came in at the high end of expectations and there was a notable rise in the trade surplus due to soft imports.

On Friday morning in my customary weekly voicemail, I said that of the four apparent marginal drivers of the world economic "mood", three appeared to have taken a turn for the better: the post-tsunami recovery in Japan, signs of an end to the soft patch in the US, and growing hopes that China's soft landing has arrived. All of this was reflected in our July *Monthly Insights* where we outlined our expectations for the second half of the year. Sometimes a day seems like a very long period of time. At least the one area that seemed a continued problem, the European Monetary Union (EMU), stayed the same!

JAPAN'S RECOVERY.

Japan's post-tsunami recovery appears to be firmly on track. The quarterly BOJ Tankan survey released last week was suggestive of a V-shaped recovery, consistent with almost all recent data. This week, the BOJ will probably raise their assessment of the cyclical economic outlook. Whether any of this will translate into anything more substantial beyond this autumn remains highly uncertain. There remains quite a debate between two groups of observers. The majority continue to see a poor future for Japan given its major structural challenges. The minority (adjusting for Japan's weak demographics) see a country that can sustain, and perhaps even grow, high living standards and that may offer some lessons to guide the US and parts of Europe.

US AND ITS IRRITATING MONTHLY PAYROLLS.

I lose count of the number of times I've experienced nonfarm payroll Fridays like the one we just had. I vaguely remember back in the late 1980s that a specialist US bond trader lost a significant amount of its capital betting on a payroll number that turned out to be very different than they expected. I also recall that some months later, subsequent revisions showed that the actual number had been closer to the trader's original expectation. That lesson taught me to never get too carried away about the whole topic of nonfarm payroll Fridays. In the past couple of years, we have supposedly had the benefit of the ADP report the day before the payrolls announcement. This report, it seems, was intended to help everyone and take the heat out of the Friday release. Well, yet again, that didn't work last week. The ADP number doubled expectations, but payrolls were significantly disappointing. I was asked about my own expectations for the payrolls release a few minutes beforehand, and I answered that it would be significantly different from expectations. I didn't necessarily mean in the way it appeared! Coming at the end of a week which started with a much better-than-expected ISM manufacturing report, it has left the debate about the US recovery wide open. Is the US stuck with a very weak 1-2 pct recovery for some time, or is the payroll data inaccurate once again? Or, is the US stuck with a strong profit-growth, but weak job-growth, recovery?

I had been pretty strongly in the camp that the US recovery had only temporarily stalled during the past couple of months, and that higher food and energy prices, along with the disruption of the Japanese supply chain, were responsible for the softer data. But if Japan is witnessing a bounce back, it should be seen elsewhere too. I can't see why the US can't create jobs if the economy is improving.

Following Friday's data, I guess we now watch weekly job claims even more closely than usual and wait until the August release of the July report to see whether the apparent grim employment situation is realistic or not.

Meanwhile the President and Congress appear locked in a pretty fierce battle to come up with a budget deal before the supposed debt ceiling limit is reached. No doubt we will experience some further drama here.

CHINESE DATA.

China released their monthly consumer and producer price inflation readings this weekend. Both figures were at the high end of expectations, with CPI coming in at 6.4 pct. High food prices appear to be responsible for this figure. According to Yu Song, the GS Beijing-based economist, there are signs of moderation in the non-food elements. The debate will now focus on whether the June reading is the peak or not, and it will be fascinating to hear the local policymakers' tone this coming week. The PBOC Governor Zhou highlighted base effects as responsible for such a high CPI figure. The coming reversal of such forces is why so many expect CPI to ease in the coming months towards 4.5 pct.

In my judgement, the near-term trend of Chinese CPI is extremely important for the second half of the year. It will determine the stance of PBOC policymakers as to whether they can stop tightening. Given that the challenges facing the US, Europe and others will likely impact Chinese exports, lessening inflation would allow domestic demand to help the Chinese economy adjust to the post-crisis world. At the same time, it would help the rest of us through increased Chinese imports.

On this score, the June trade data is not a great reading for the optimists, unless you conclude that the soft import data is temporary. The monthly trade surplus bounced back to $22.3bn in June, a surplus I think higher than the rest of the year to date. Both exports and imports were softer than expected, with imports especially disappointing. The release will muddy the waters also in terms of politics, as it will prove convenient to those who like to blame China for all their problems. According to the Reuters report of the data, the rolling 12-month surplus is $173.4bn, which is less than 3 pct of GDP. This figure is still supportive of those of us who believe the trade balance has entered a new, lower era. It will be the headline that garners the attention though.

In coming days there will be further important China data releases including the latest monetary data.

EMU PROBLEMS GETTING BIGGER.

While many took heart from the Greek parliament's decision to support further austerity measures a couple of weeks ago, in my mind, last week was more concerning. The big downgrade of Portugal demonstrated that this crisis stretches way beyond just Greece. While I can't get excited about the downgrade itself, the realization that it is not just Greece that is challenged might have been a bit forgotten. In this light, and of much greater concern, was the troubling week (especially Friday) that Italian bond spreads experienced. With worries about the forthcoming bank stress tests, and doubts about the cohesiveness of Italian fiscal tightening measures, Italy has entered the spotlight for the first time since this crisis erupted early in 2010. It is possible that last week's market pricing was actually a by-product of investors selling Italy to hedge their exposures in other troubled EMU countries. Even if this is true, a few more days like Friday and the whole EMU crisis will have risen to a more troubling level. I have found it reasonably easy to not get too worried about the debt dynamics of Ireland, Portugal or Greece—but Italy is a different topic. While Brazil overtook Italy to become the world's seventh largest economy last year, Italy is still a big economy. At 120 pct of GDP, Italy's debt is equivalent to around 25 pct of the Euro Area GDP. Neither the Euro Area nor possibly the rest of the world can afford a full-blown Italian bond market crisis.

In addition to the modest specifics of Italy that seemed to be worrying markets last week, the broader concern is that we are still waiting for some sort of true leadership out of Europe to help us get ahead of this crisis. With the onset of the long summer holidays, however, it may not be forthcoming. I hope this is not the case.

Ah well, at least the English Premier League is back in another 5 weeks.

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Viewpoints are also available on our website.

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