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Viewpoints

FROM THE OFFICE OF THE CHAIRMAN

What Now After the G20?

At the September annual IMF meetings, the UK Chancellor stated that European policymakers had 6 weeks to save the future of the Euro Area and, by implication, to stop the risks of negative contagion to the rest of the world. His 6 weeks tied in with the long-planned G20 meeting, which just happened last week. It is now over and, according to most reports, the world has not been saved.

Following Osborne's comments at the IMF meetings, it seemed to me that Europe's policymakers had essentially bought 6 weeks to offer hope that they could finally deliver a solution to their complex problems. In turn, I believed that financial markets around the world would do better leading up to the meeting as: (1) expectations for a solution would rise, and (2) I thought we would get fresh evidence that the US economy was performing better than negative expectations and that markets would become more comfortable with a so-called soft landing in China.

Well, global equity markets (not peripheral European bond markets) have done considerably better during this period, with S&P futures actually rising back to the level they broke down through at the start of August. Indeed, this has been helped by better news in both China and the US. And, until early last week, some signs that European policymakers were coming to grips with the scale of their challenge.

So what happens now?

The G20 Meeting.

The G20 meeting was overshadowed by the remarkable political events in Greece, which I don't need to go over given the widespread coverage on the topic. From what I can tell, late Saturday afternoon European time when I was writing this, it looks as though there is some semblance of a Greek government, but there has not been any strong statement of endorsement by likely coalition members for the European rescue package that had been agreed to the week before last. What is especially important is that Greek's Euro Area allies, especially Germany, appear to be making it very clear, "Take it as agreed, or there will be no more money."

If it weren't for the rather delicate matter of Italy – which I will address further below – my initial reaction to this latest twist was that it was good, as it suggested the end of this very Greek tragedy was closer. Perhaps a larger Greek default is around the corner, but given how much has been expected and discounted, is that such a bad thing now? (2-year yields rose above 100 pct late last week for example).

The G20 statement was important for three other reasons.

First, after lots of encouragement, Italy "invited" an IMF quarterly inspection of its economic policy plans, which is quite an extraordinary move and, in many ways, to be welcomed. However, with more and more observers calling for a change of Italian government, this now seems a separate dynamic away from the Greek issue. With Italy being the 3rd largest economy in the Euro Area, and with debt around 120 pct of that large GDP, its turmoil is much more significant than the situation in Greece.

I have always believed that the world could cope with a sizeable Greek default since it is such a small economy. That said, persistent problems in Italy are a different matter. In the coming days, lower Italian bond yields will be absolutely vital for calming down fears of fresh contagion.

Growing Role for the RMB?

The second important aspect of the G20 statement that caught my eye had nothing to do with the European mess, but the role of the CNY and SDR. There had been some suggestions that, under the French chairing, tentative agreement had been reached to announce a specific target date, 2015, for the participation of the CNY in the SDR basket. If this would have been announced clearly in the statement, then it would have implied an acknowledgement of a clear path toward effective convertibility of the CNY into a major currency. This would have had profound consequences for Chinese capital markets and investors.

As it happens, and typical of the odd way the G20 seems to be developing, the statement didn't go this far. Instead, they stated that further analysis would be undertaken, but with the possibility that the SDR basket would be redefined in 2015, or possibly before. It is unclear as to why this was stated in this manner, but probably to gloss over some divisions amongst key participants. It would be my hunch that France would have been pushing for a definitive date, China would be ok with that, but not with a public commitment to a precise date for convertibility, and the US would not support any statement without such a plan.

Given the way I think about the world, this aspect of the G20 statement is at least as interesting as anything about Europe. Given China's importance to the world, it is probably more critical. I shall be trying to pursue more about this aspect of the communiqué in coming days.

The third part that was interesting also related to the topic of currencies. There was no mention about Japan's huge FX intervention earlier in the week (therefore no resistance to repeating it?), while at the same time, some blessing of changes to the Russian Ruble regime, and also encouragement for further flexibility, i.e., appreciation of the RMB.

A New Style at the ECB?

In a rather refreshing development, the ECB surprised the markets Thursday by announcing a 25 bps cut. Being Mario Draghi's debut, most believed such a step was highly unlikely given his nationality and perceived hawkishness. Mario delivered, and did a good job of suggesting it was entirely consistent with the ECB's view of inflation being likely to decline in the future. Hats off to the new President for taking this step, although given the gravity of the latest Euro Area economic data, it was the least they could do. As I had mentioned to many colleagues in the days before, the latest PMI's were so weak in Europe, a cut was more than justified on the ECB's own reaction path of recent years.

Against this welcome move, Draghi gave no sign that, under his leadership, the ECB would be rushing to more generous or aggressive support of secondary financial markets. Some have noted this as a disappointment. Just as for his predecessor, he might have no choice given the sensitivity of contagion issues.

So What to Focus on Next?

It would be nice to say that we can move on from Greece, Italy and Europe, but alas not yet. While the political stability of those two countries, or lack of, will dominate in coming days, there are more and more encouraging signs in two other places that really matter for us all.

This coming week will be a major week for Chinese data, including the CPI consumer price data, which is widely expected to drop to 5.5/5.6 pct. This would be comforting to those expecting a "soft landing". The better tone of the Chinese rate and equity markets presumably reflect expectations of this, as well as signals from policymakers that policy is moving away from its hawkish tone.

In the US, last week's data did not positively surprise as much as previous weeks, but it continued to be better than many expected. And, with ISM and payrolls out of the way, focus will probably shift towards policy issues for the balance of the month, both with respect to measures to help the housing market, and of course, budgetary discipline. Both are potential sources to further boost investor sentiment.

It will be fascinating to see how the S&P futures trade early next week. Despite all the poor news in Europe, we are trading at the higher levels since the Summer breakdown. And, if we could retest the 1280 area and progress from there, a lot of bears would be struggling. On the other hand, if we breakdown again this week, it will give food for thought to the bulls also.

And the Yen.

According to many reports, last week the Japanese monetary authorities undertook significant FX intervention to reverse fresh Yen strength. Not only was the reported size close to Japan's year-to-date current account surplus, the fact that it was executed ahead of the G20 meeting suggests a degree of importance that I think market participants should respect. From what I can see, if the Yen reverses above Y80 in coming days, then once again, it will be worth exploring the idea of a major trend change. Given the ongoing evidence in the US, I am in the camp that the notion of "Japanisation" of the US doesn't look correct to me.

Away from all of this, I can't end without commenting on the weekend's celebrations of the 25th anniversary of Sir Alex Ferguson as Manchester United manager. Not only is this a remarkable achievement, but his ability to adjust to the changing demands through time is a remarkable example of what managers and leaders are supposed to strive towards. There are surely powerful lessons to many others to take heed from. (It is also a rather nice way of getting over that incredible result against the noisy neighbours too!) Good luck.

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