

Things I am Going to Think About On Vacation

Like others, I try to clean off my desk before my summer vacation. This year it is particularly difficult because there seems to be several unresolved issues. I will mull them over and hopefully my subconscious will have more success than my consciousness in working through the issues.

There has been a key axis in the capital markets since late last year. One side of the axis is the European debt crisis and the other side is the strength of the world's largest economy. This axis remains in effect, even though the major currencies have reversed directions. What has changed is the news stream and how investors interpret the news stream.

It is as if some sort of tectonic shift took place late May to early June. The news stream from Europe become decidedly less negative and the US news stream took a clear turn for the worse. What I will be trying to get my head around is whether this shift is real and sustainable or merely a short-term largely corrective (counter-trend) development.

Europe

Is the European debt crisis over? With Spain's bond maturity toward the end of July (which appears to have already been funded), the periphery of Europe has largely met this year's funding needs. The auctions, in particular the recent Greek bill sale and Spanish bond sales have been absorbed smoother than expected. This signals the ending of the sovereign liquidity crisis, but this may simply mark a new phase of the crisis.

The release of the stress test results next week will bring the focus back to the other dimension of the crisis, European banks themselves. Some will have to raise more capital. Many have to roll-over their own bonds. This will be taking place while European banks have more bad assets to recognize than US banks, according to IMF estimates.

The mechanisms European officials have created in response to the crisis address the sovereign's potential needs, like the 440 bln euro European Financial Stability Facility. The ECB has provided extraordinary liquidity to European banks, but that is being unwound. It has purchased almost €60 billion of peripheral sovereign bonds over the past two months. It did purchase about the same amount of covered bonds from the banks, but it does little to address the impaired balance sheets as covered bonds are the one asset that has never been defaulted upon.

The political rhetoric has exaggerated the austerity in the euro zone in order to appease nervous investors. However, outside of the periphery, there is really nothing this year and a little more next year. The more substantial cuts are planned for 2012 and beyond.

Hurtful Price Action

Yet, Europe's growth prospects remain worrisome. The ECB and the IMF forecast 1% growth in the euro zone this year. The meager growth means that the output gap is likely to widen. This means that the debt/GDP ratios will not stabilize and deflationary forces may strengthen.

This in turn further underscores why the recent price action in the capital markets complicates rather than helps the euro zone. Short-term interest rates are rising in absolute terms and relative to US rates. The shifting interest rate differential has added an extra dimension to the euro's recovery.

If there has been one thing that has tracked the euro-dollar exchange rate, it has been the two-year swap rate between the US and Germany. The last significant low was on November 23rd 2009 when it was around 62 bp in Germany's favor. The euro's high for 2009 was recorded two days later. The swap rate trended higher in the US favor reaching 33 bp—an almost 100 bp swing—on May 27th. The euro bottomed two weeks later on June 7th.

It has been moving back in Germany's favor and now one is again paid to swap out of dollars and into euros. It now stands at around 20 bp in Germany's favor-- a 50 bp swing in a little more than a month.

The rise in money market rates and interest rates in general in the euro zone, coupled with a 3.5% appreciation of the euro on a trade-weighted basis is tantamount to a snugging of monetary policy. It is a retardant at precisely the moment in time when the region could use an accelerant.



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Falling Off a Cliff

If the European debt crisis did not end on a dime, did the US economic recovery? The US economy appeared to have been expanding at an above trend pace in Q4 '09 and Q1 '10, but the data stream began disappointing in May and soured further in June. Reports in recent days warn that the pattern has continued into early July.

It had looked like Q2 GDP would be slightly better than Q1's 2.7% annualized pace. However, recent data suggests otherwise. Forecasting quarterly GDP with precision may be less useful than understanding what is happening to the economy more broadly.

The economic narratives can be broken down into three main categories. The first is attributing the weakness in the US economy to exogenous variables, like the European debt crisis and the consequential disruption to the capital markets and the risk appetites on the part of businesses. This explanation would generate a hypothesis that as the European debt crisis ebbs, the markets, investors and businesses can return to status quo ante.

The remaining two explanatory models emphasize domestic factors to understand what is happening to the US economy. What they share in common is the recognition that there are both structural and cyclical forces at work. Where they differ is the weight they attribute to those forces.

Deus Ex Machina

The first would emphasize the maturation of the business cycle, where the government's fiscal stimulus has largely run its course (and even that was mitigated in Q1 '10 by cuts on the state and local government level) and the biggest boost from the inventory cycle is also behind us. The cyclical recovery ran into the structural constraints and now the economy is finding a new equilibrium.

The second would emphasize those structural constraints. Without above trend growth, unemployment will be exceptionally sticky. Without an improving labor market, consumption will remain poor. Consumption is the deus ex machina; in its absence, things grind to a halt.

Foreign demand might be able to replace flagging domestic demand in relatively small countries like Greece and Portugal, but it will not be sufficient for the US. Indeed the net export function looks like it will depress Q2 GDP by as much as 0.75%-1.0%, more than twice its drag in Q1.

US fiscal policy is about to shift in a significant way. Even if Congress manages to pass a bill to extend jobless benefits, the fact of the matter is that the large (nearly \$800 billion) fiscal stimulus will not be repeated next year. This alone will see the deficit as a percentage of GDP fall among the sharpest in the G7 next year. What now seems to be the likely outcome of the November Congressional elections may reinforce the idea that fiscal policy is off the table.

With the US approaching deflationary conditions, pressure may mount on monetary policy. Although the Fed funds target remains in a 0-0.25% range and there is practically no chance of a hike for at least a few more quarters, the Fed's balance sheet, which is the most fundamental way it can manage monetary policy, has not really grown since late 2008/early 2009.

Treasury yields are low. At first the decline seemed to be fueled by their appeal as safe havens. The decline in yields was dollar positive. Now, however, the decline in yields seems to reflect investor anxiety about US stagnation and is clearly less dollar supportive. Mortgage rates are near record lows. The spread between Treasury yields and mortgage rates are near record lows. It is not clear then what a new round of asset (Treasury and/or mortgage-backed securities) would accomplish.

The more benign scenarios can largely take care of themselves. The darker scenarios are very dark. The potency of a threat is a function of its credibility and its capability. There is nearly universal recognition that the capability (of renewed economic contraction and deflation) is grave, but what needs to be better assessed is the credibility or what is the most realistic base case.

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