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The Financial Crisis, Act III...and Epilogue?

OCTOBER 2013

Summary

New round of central bank liquidity injections worldwide

- The U.S. economy can't do without Fed support
- The euro area is out of recession, but bank sector and sovereign issues remain
- The Fed, BoJ, BoE and ECB continue to nurse ailing economies

Continued low interest rates are not enough to dispel emerging risks

- The momentum driving global trade has been undermined for the foreseeable future
- China can no longer act as the global engine of growth
- Foreign exchange rate adjustments appear inevitable

Is inflation, end-point of the financial crisis, around the corner?

- New round of liquidity injections, currency crises, geopolitical tension, labor unrest...
- ... Inflation remains the most likely scenario, but the path ahead is unclear

New Round of Liquidity Injections Worldwide

U.S.: Our Assessment in Mid-June, and Where We Are at Mid-September

American Economy, After the Fed... the Fed

SOME GOOD NEWS...

- The growth holds up with the fiscal cliff,
- The real estate market's recovery is unquestionable,
- The households wealth is peaking at an historical high while the debt interest burden is at its lowest level,
- The unemployment rate declines, the consumer confidence goes back up,
- Companies are overflowing with cash,
- Shale gas is boosting competitiveness...
- ... when the real exchange rate of the US dollar is at a historic low point.

...SOME NOT-SO-GOOD

- The real GDP growth remains below 3%, the industrial production hasn't returned to its pre-crisis level,
- Job creation doesn't exceed 190K/month since January, unemployment duration remains close to its record,
- Labor participation rate is plummeting
- The mortgage market doesn't get going again, credit growth withers,
- Growth productivity is below 0,5% per year.

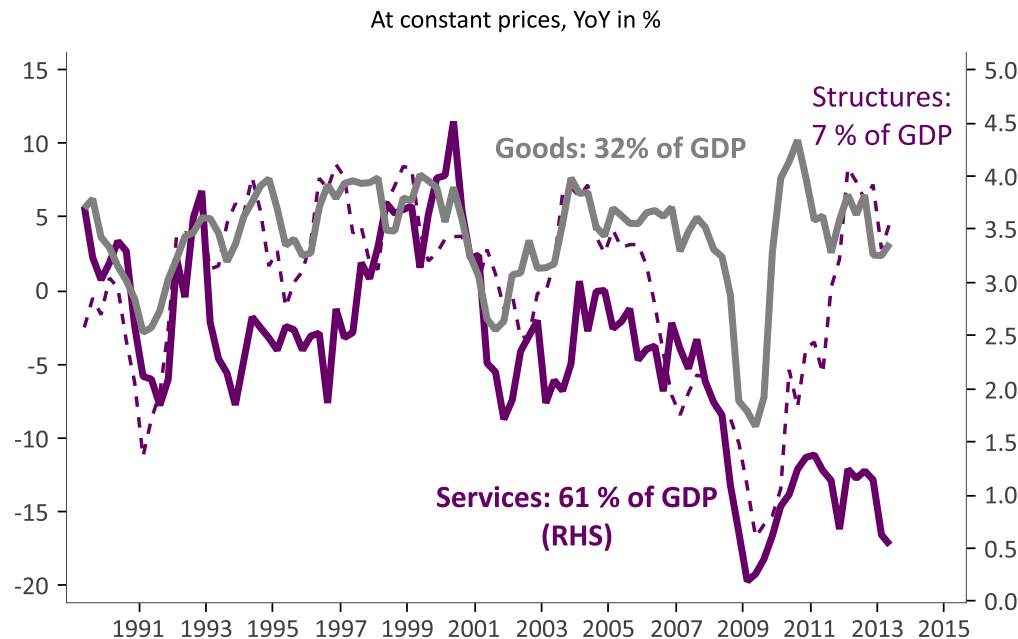
WHERE WE ARE at mid- September

- Q2 GDP = 1.6% y/y, up from 1.3%
- Jobs: 148,000/m between June and August
- 63.2% in August, lowest since July '78
- New starts down 25% r.a. since May
- Drop of 0.5% y/y in Q2

No Real Recovery Until Service Activity Returns to Normal

The real estate and financial crises have undermined the momentum driving services growth. The service sector accounted for more than 2 points of annual GDP growth through 2000 and virtually all of the job creation.

American GDP Growth by Sector



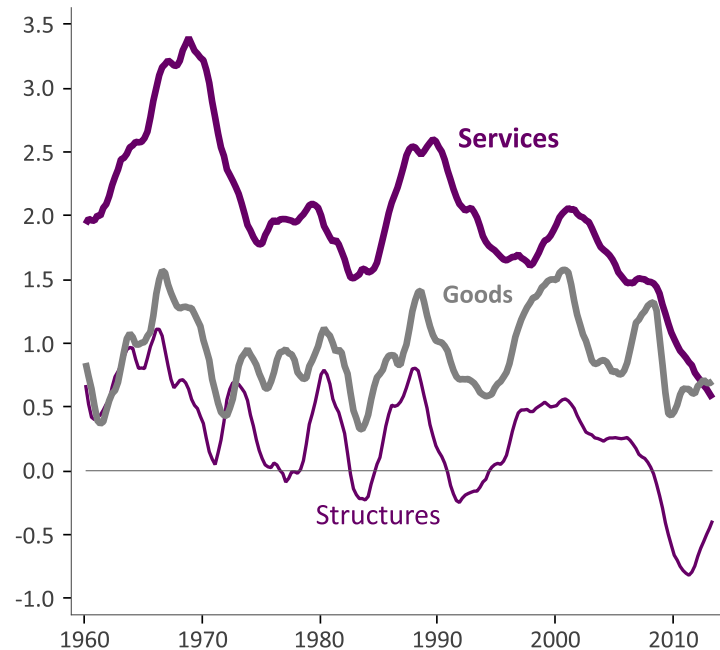
Sources: RichesFlores Research, Macrobond

The Industrial “Renaissance” Won’t Fill the Void Left by the Service Sector’s Decline in the Short Term

With 12 million jobs, compared with 95 million in the service sector, industry cannot make up for the jobs lost in private sector service activities.

Contribution to GDP Annual Growth

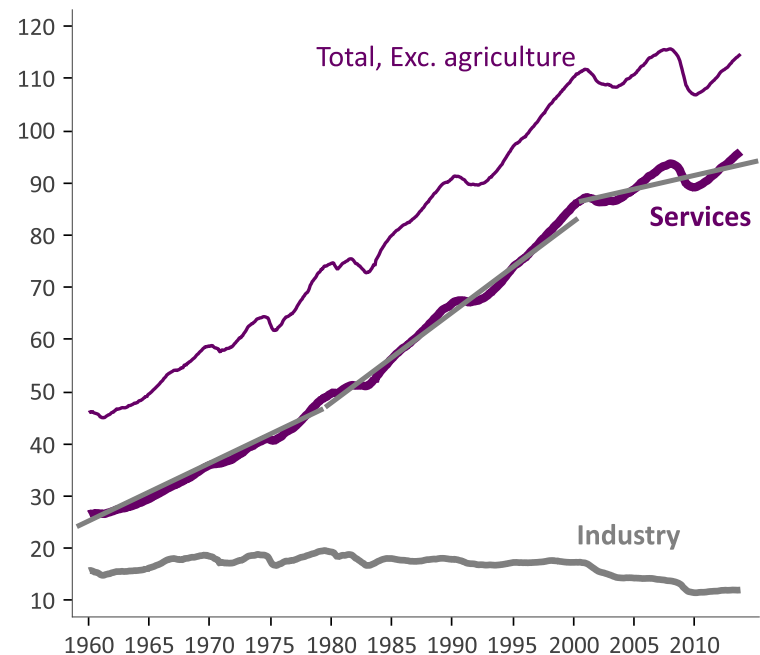
At constant prices, 5-year based, in annual growth points



Sources: RichesFlores Research, Macrobond

Employment in Private Services and Industry

Payrolls, in millions



Sources: RichesFlores Research, Macrobond

The Pitfalls Bernanke Must Avoid

Wealth without “wealth effects”

U.S. household wealth has climbed to historical heights, but can no longer generate significant wealth effects because there is not enough room to further lower savings rates.

Lower cost of debt without debt reduction

The interest charges on household debt have plummeted. Debt is now more bearable, but outstanding debt levels remain high, so households have little borrowing capacity.

Lower unemployment rate, but underemployment

If workforce participation were where it was in 2009, the unemployment rate would currently be over 11% for the overall population and 20% for ages 16 to 24.

Profits without productivity gains

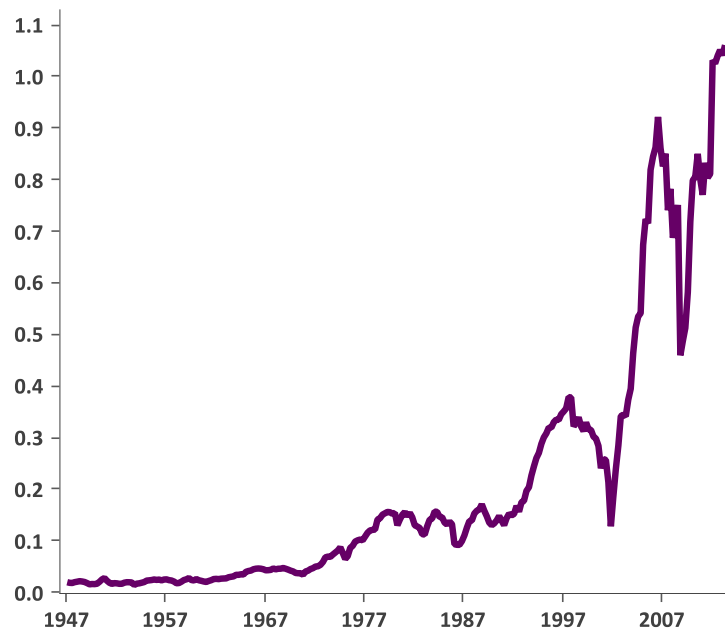
Companies are awash in cash, but profit growth has been nearly stagnant for the past two years owing to a lack of productivity gains. Investment and employment prospects look grim as a result.

The Pitfalls the Fed Must Avoid

Profits Without Productivity

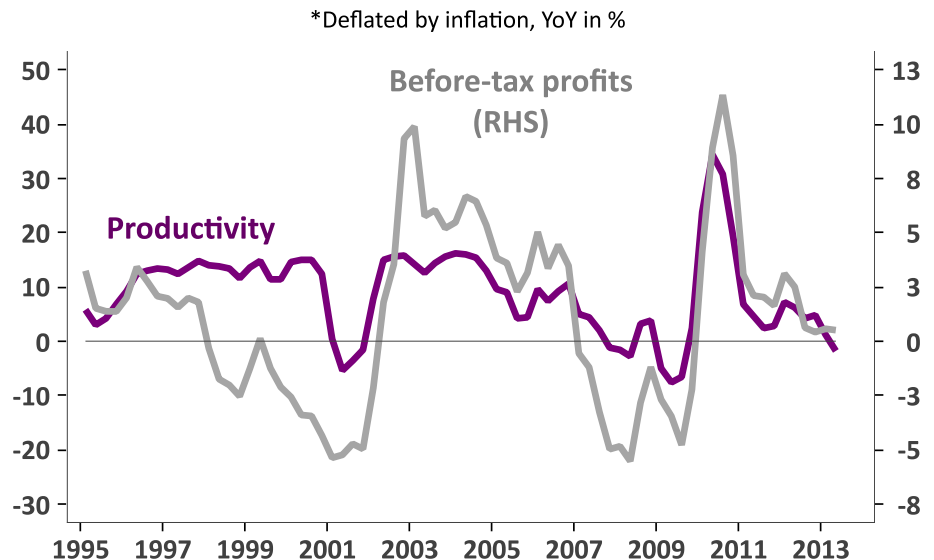
Jobs and investment rely on earnings momentum rather than the level of earnings.
For now, weak productivity gains are hampering profit growth.

**After-Tax Profits of Domestic Non-Financial
Corporate Business, USD Trn**



Sources: RichesFlores Research, Macrobond

**Productivity per capita and real profits in the United-
States**

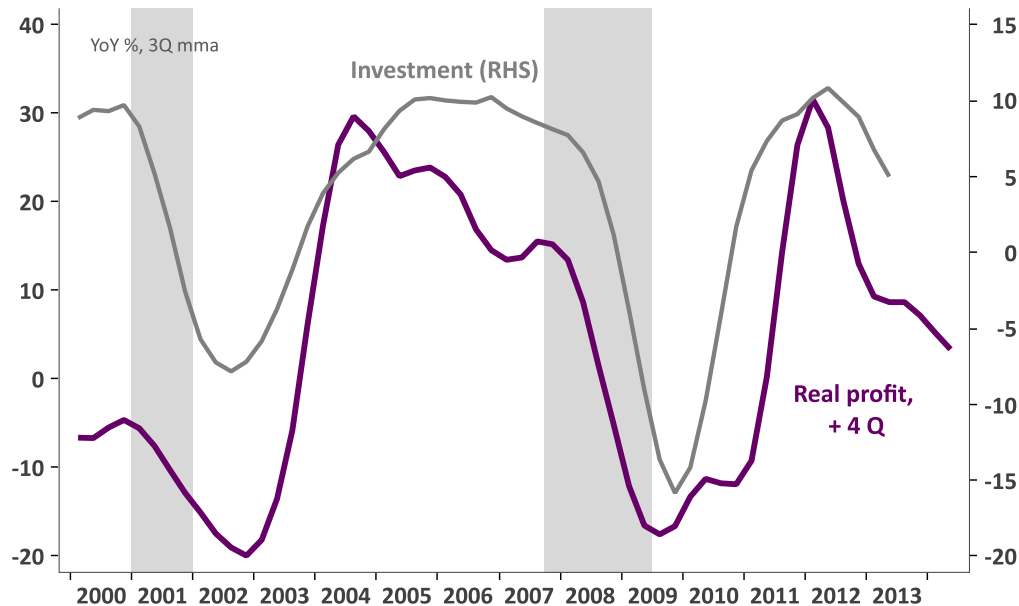


Sources: RichesFlores Research, Macrobond

With Productivity Gains Plummeting, Investment and Job Growth Are Likely to Dry Up

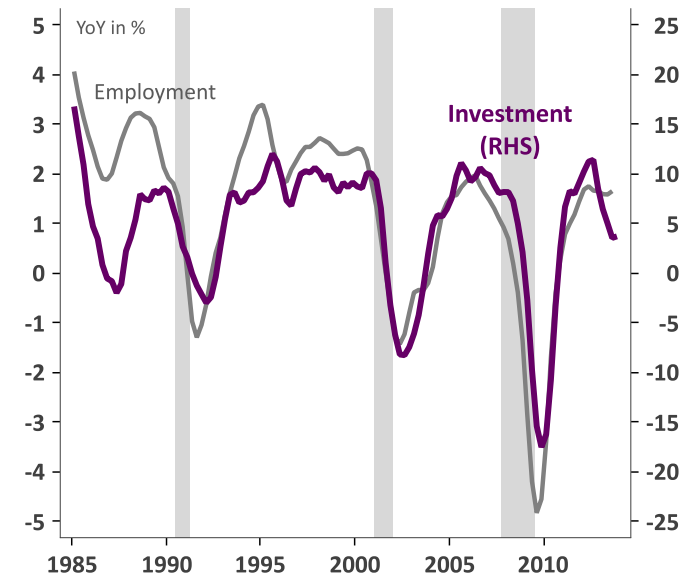
Strong profits have led a number of economists to predict renewed investment. But such a scenario is unlikely today judging by the decline in productivity gains. Employment prospects are suffering as a result.

Real Profits and Corporate Investment Growth



Sources: RichesFlores Research, Macrobond

Non-Residential Investment and Payroll Employment, YoY in %



Sources: RichesFlores Research, Macrobond

The Question Is Not Why the Fed Didn't Act on 18 September, But Why It Went Off Track in May

There are several possible answers to this question

- It wanted to reduce the risk of bubbles stemming from the serious asset allocation imbalances caused by QE
- It needed to ease disagreement among Fed board members
- It wanted to pave the way for Ben Bernanke's succession
- There was concern to see how growth would respond to a rate rise and a steepening of the yield curve

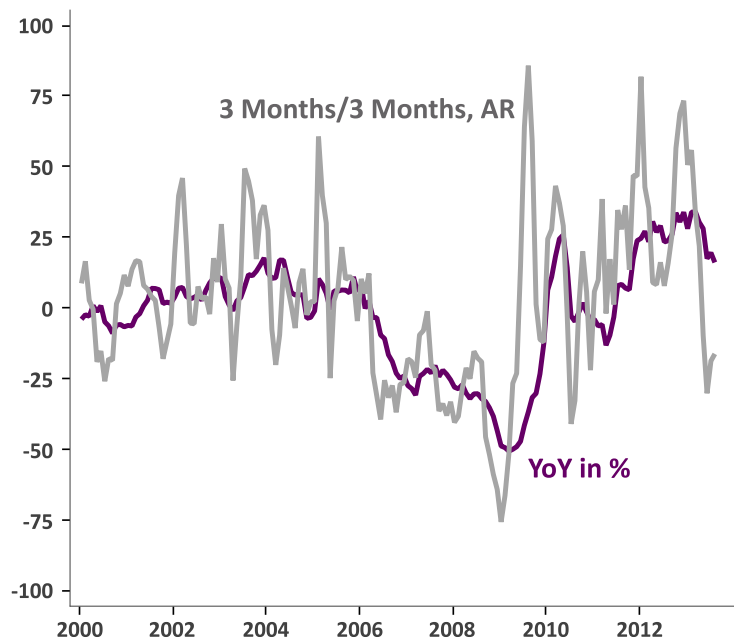
Financial and real estate market reaction prevented the Fed from pursuing this course of action

- LT yields rose too quickly
- Higher interest rates had a severe impact on real estate
- The rest of the world was hit, too (emerging and euro area sovereign markets)
- Failing to halt the expectations that were forming would have been a major risk

Higher Interest Rates Had a Severe Impact on Real Estate

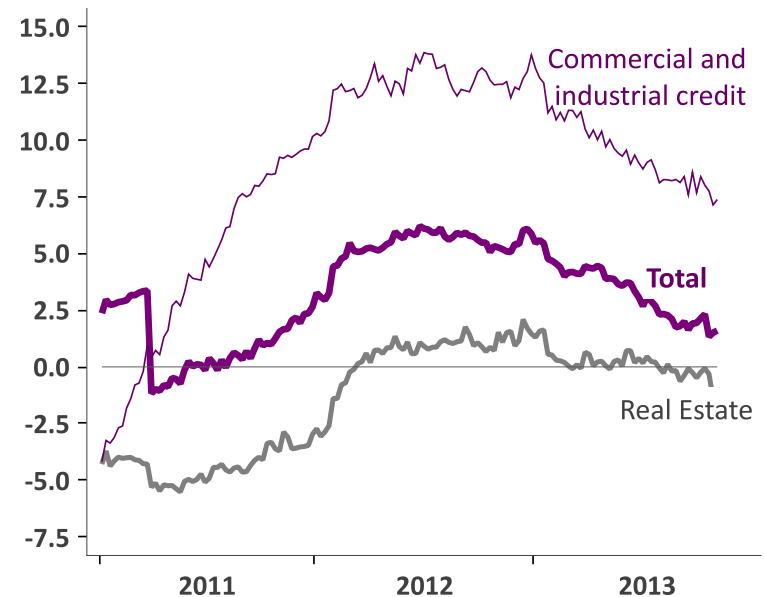
Higher mortgage rates could have triggered a wave of buying if the situation had cleared up. However, market trends show that demand is still extremely sensitive to the cost of credit.

Housing Starts, 3MMA in %



Sources: RichesFlores Research, Macrobond

Commercial Bank Credit to Private Sector, YoY in %



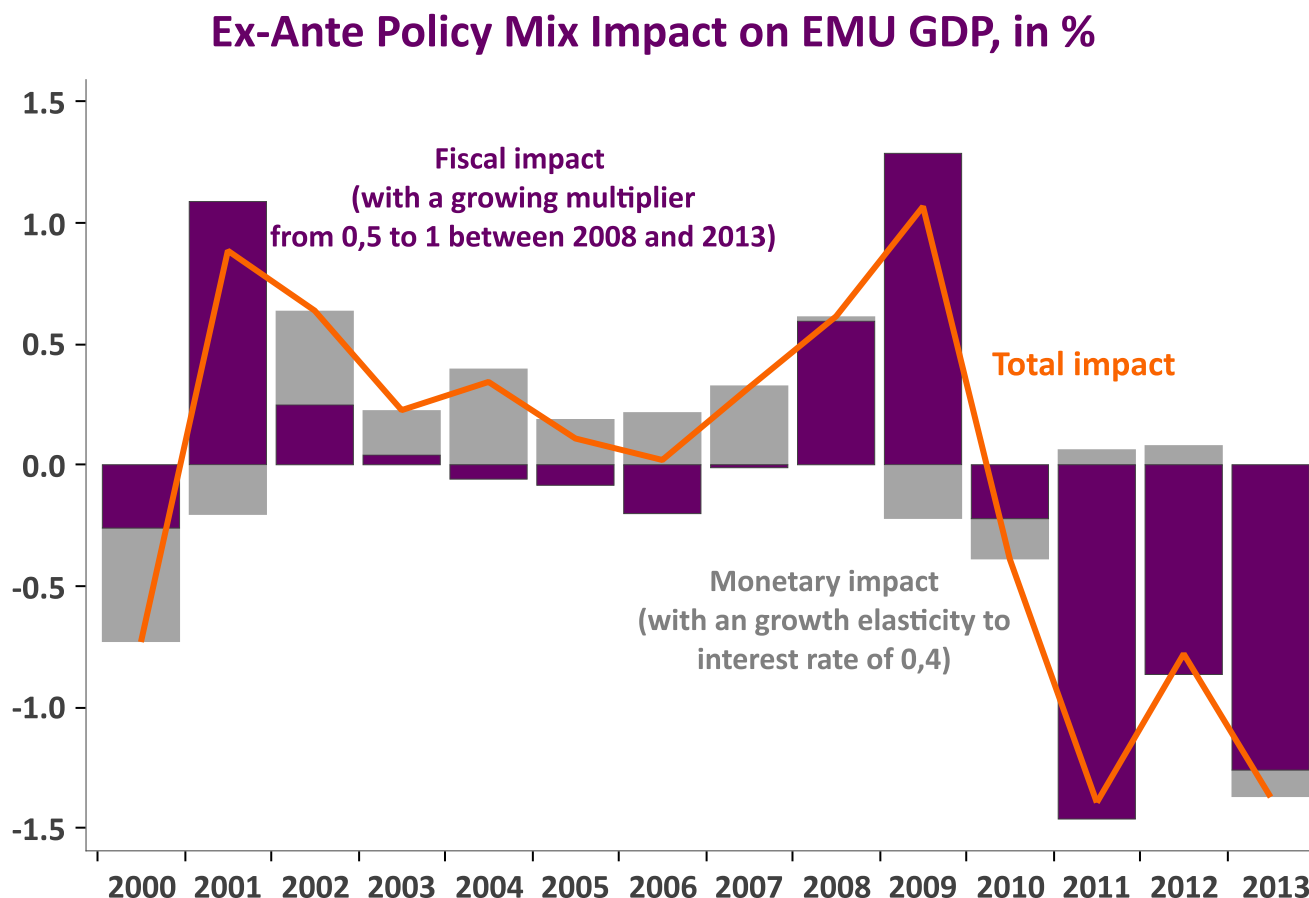
Sources: RichesFlores Research, Macrobond

Europe Puts Troublesome Issues Behind It, For the Time Being

- **The end of indiscriminate austerity policies and the German vote in favor of monetary union have changed the game for the near term**
 - Renewed consumer confidence has halted the downward slide in consumption
 - Making up lost ground as recession comes to an end will reignite intra-regional trade and spur growth in the quarters ahead
 - Merkel's victory gives her a mandate to forge ahead pragmatically, which is the only viable strategy
- **But the euro area's fundamental problems remain unresolved**
 - Dwindling growth potential
 - Economic policy coordination
 - Banking sector clean-up, public financing questions, etc.

Growth prospects remain tenuous, there is a real risk of lingering effects from the sovereign crisis, work on bank balance sheets is unfinished, and so on.

The End of Austerity Policies Brings to a Close Three Years of Extreme Budgetary Restrictions



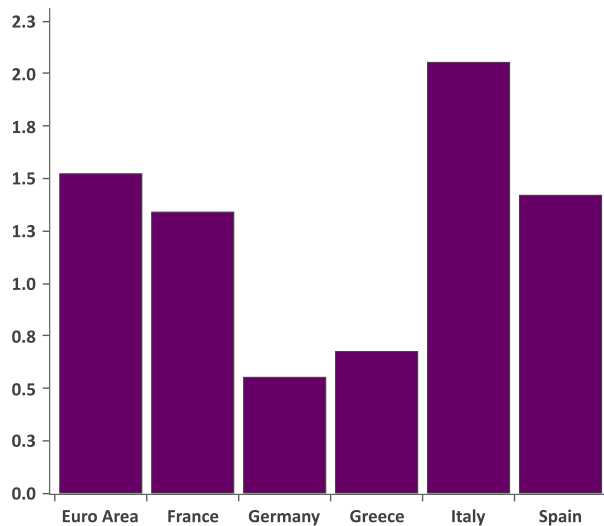
Sources: RichesFlores Research, Macrobond

Consumer Confidence Is Picking Up

Consumer confidence has steadily improved as austerity policies have tapered off. The consumption outlook has benefited across the board.

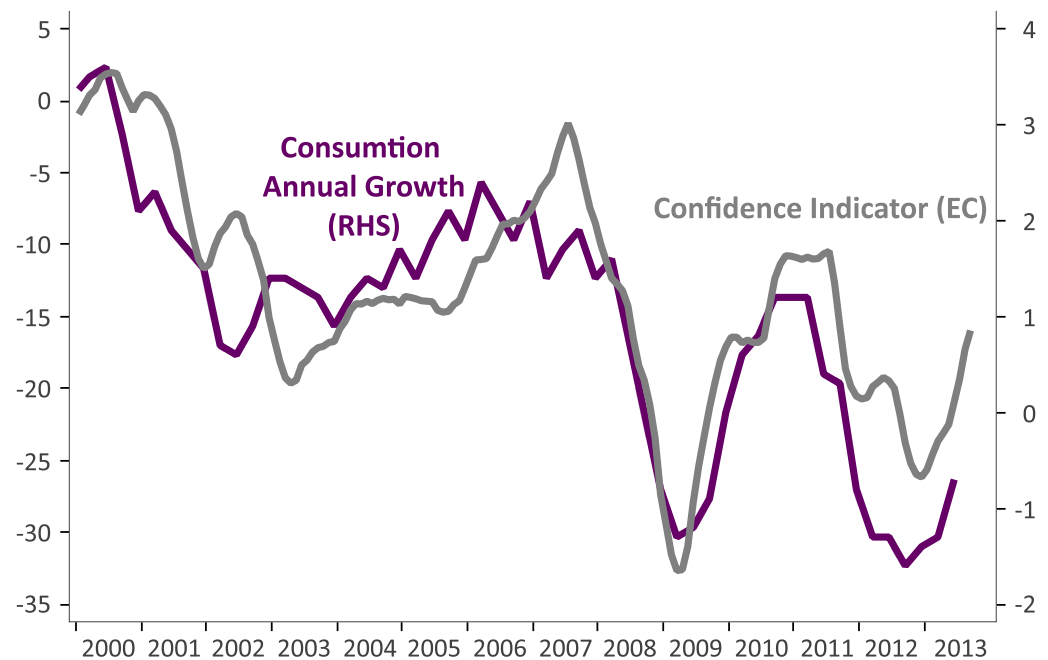
12-Month Change in Consumer Confidence

September 2013



Sources: RichesFlores Research, Macrobond

Consumer Confidence and Consumption in the Euro Area

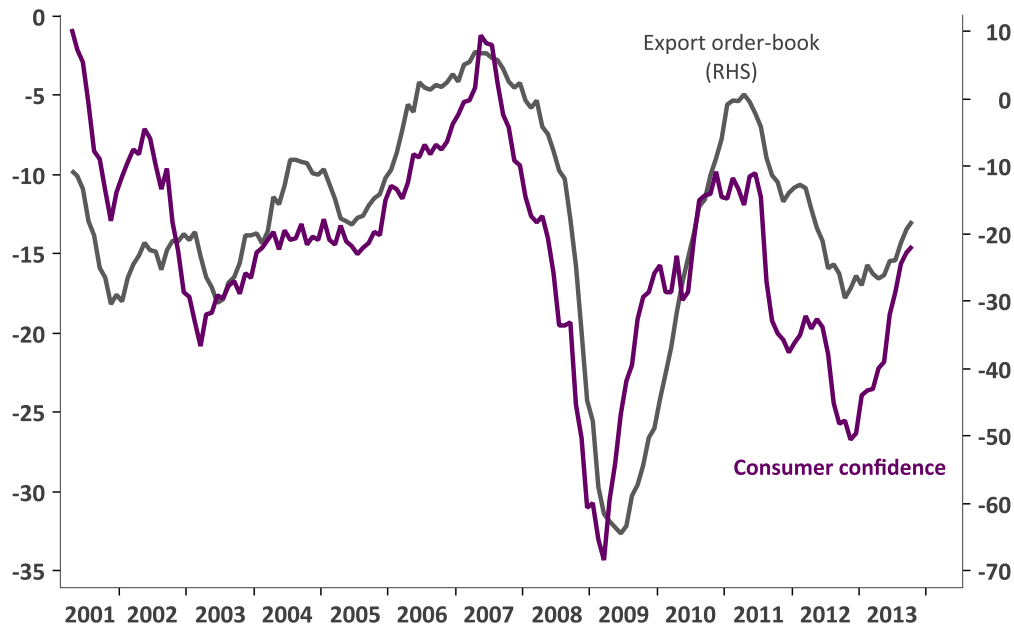


Sources: RichesFlores Research, Macrobond

The Scenario No One Expected: a Domestic-driven Recovery

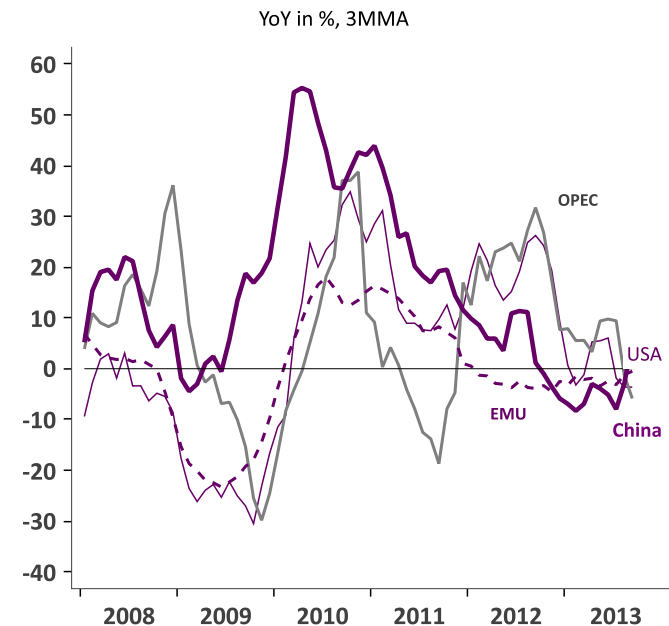
With export activity at a standstill, improving domestic prospects are the only rays of sunshine for the euro area economy.

Consumer Confidence Indicator and Export Order-Book



Sources: RichesFlores Research, Macrobond

German Exports Growth



Sources: RichesFlores Research, Macrobond

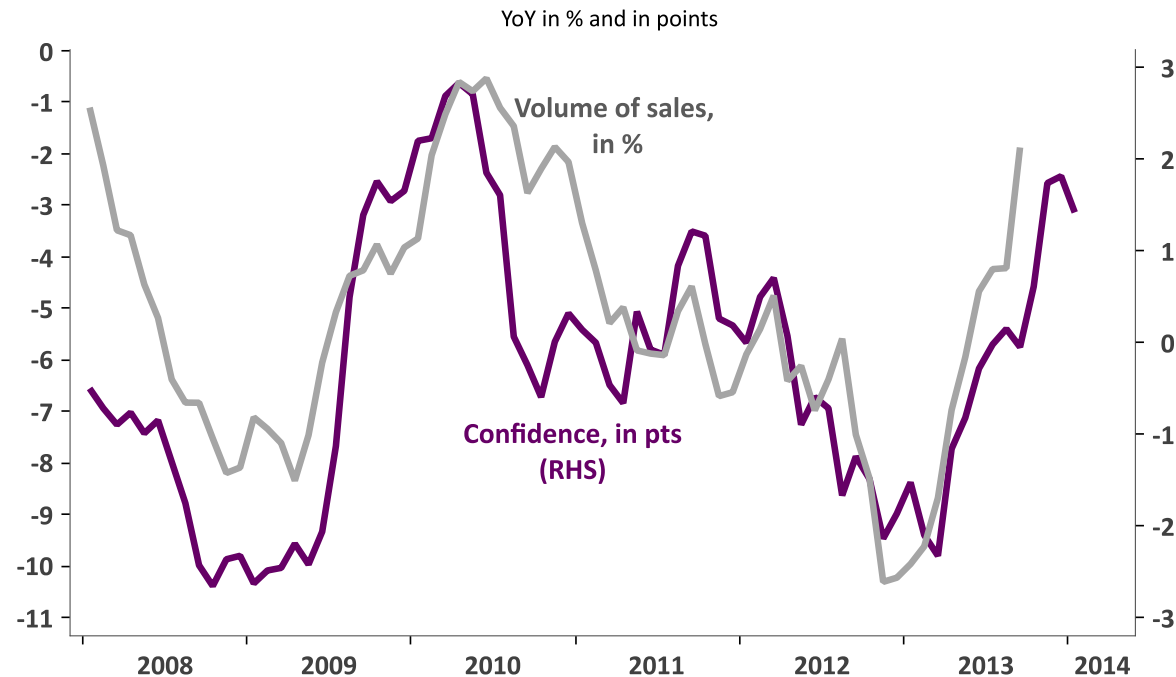
Catch-up Effects: the Bright Spots in a Lackluster Recovery

- **As with the end of any recession, the catch-up effects harbor some nice surprises, such as:**
 - Consumption in Spain => extreme risk reduced
 - Vehicle sales => sector rebound outside of Germany
 - French corporate margins stabilizing => better investment outlook
- **These effects will strengthen confidence in the coming months**
 - Consensus estimates likely to be revised upward

Spain: Domestic Demand Bounces Back

Improved consumer confidence is bolstering demand and lifting the country out of recession. Sovereign risk is diminishing as a result.

Consumer Confidence and Retail Sales Growth

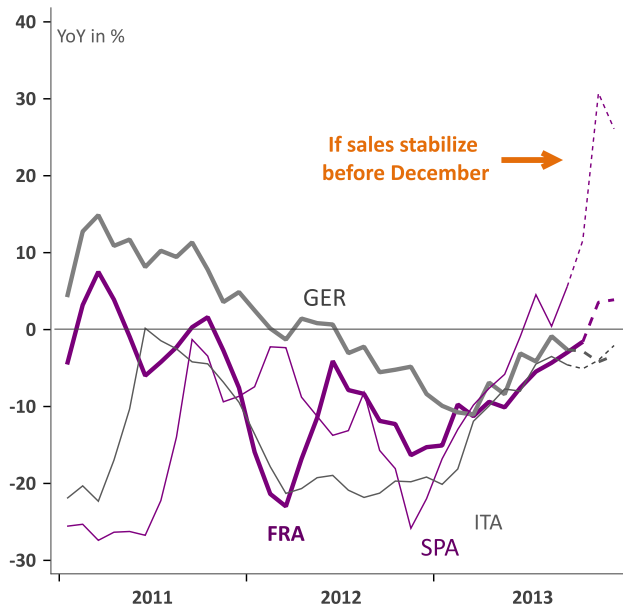


Sources: RichesFlores Research, Macrobond

Automobiles: Slingshot

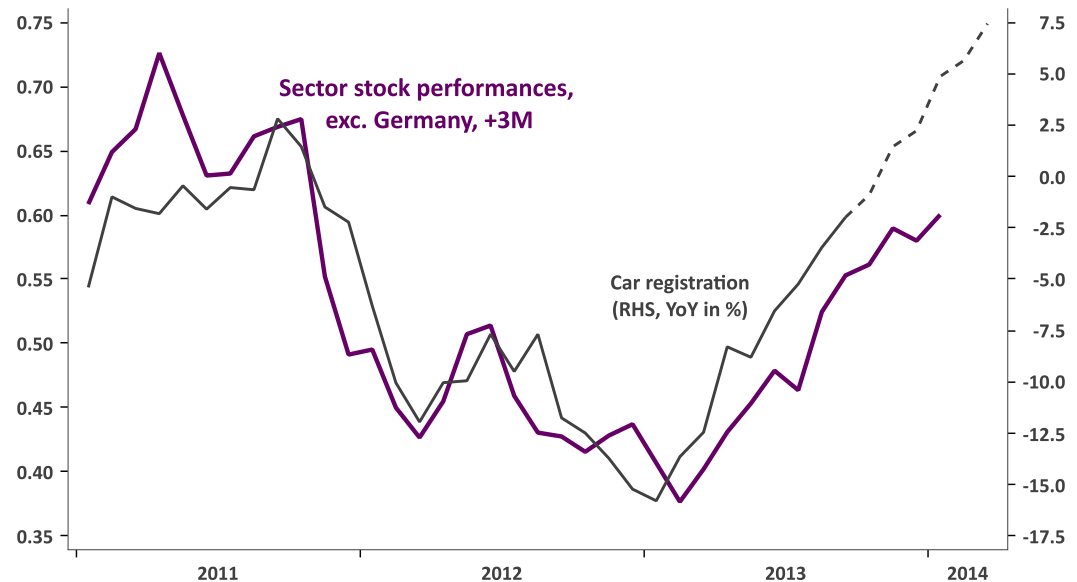
The stabilization of car registrations alone provided a clear improvement in profit outlooks for this key European sector .

Car Registrations Growth



Sources: RichesFlores Research, Macrobond

Relative Performance to Euro Stoxx 600 of the Automotive Industry, Exc. Germany, and Car Registrations Annual Growth



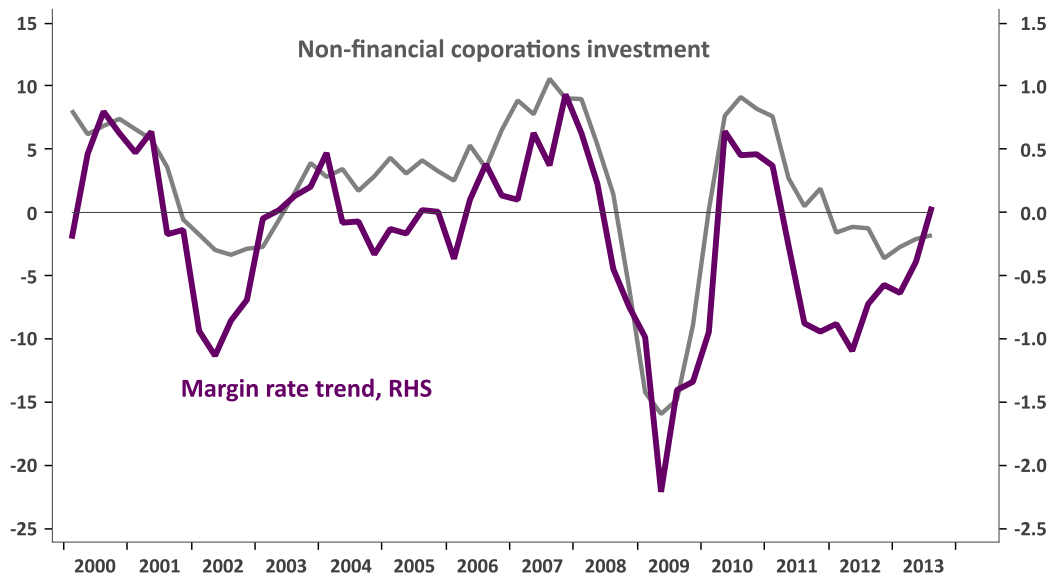
Sources: RichesFlores Research, Macrobond

France: Investment Prospects Looking Up...

The improvement in private sector profit margins is an encouraging sign for investment and employment.

Margin Rate Trend and Productive Investment

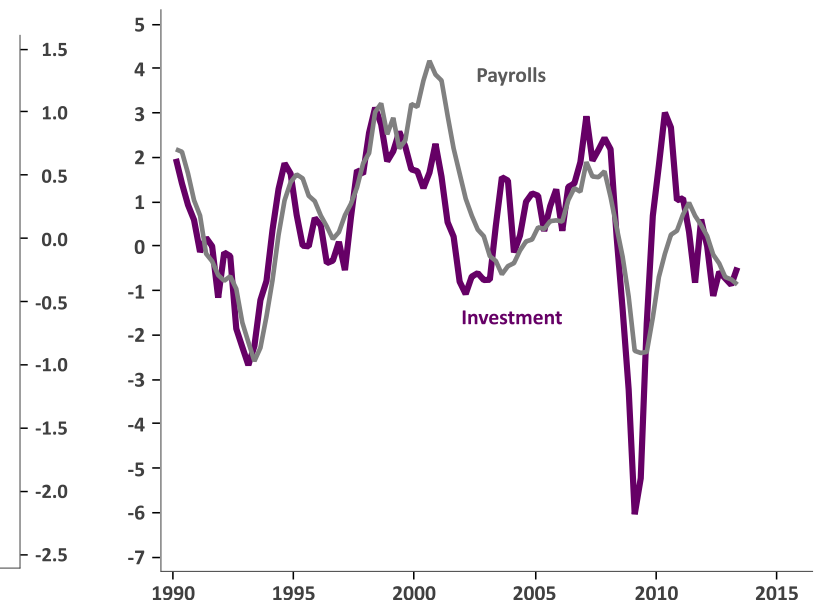
YoY in points for the margin rate and in % for investment, constant price



Sources: RichesFlores Research, Macrobond

Investment and Employment in France

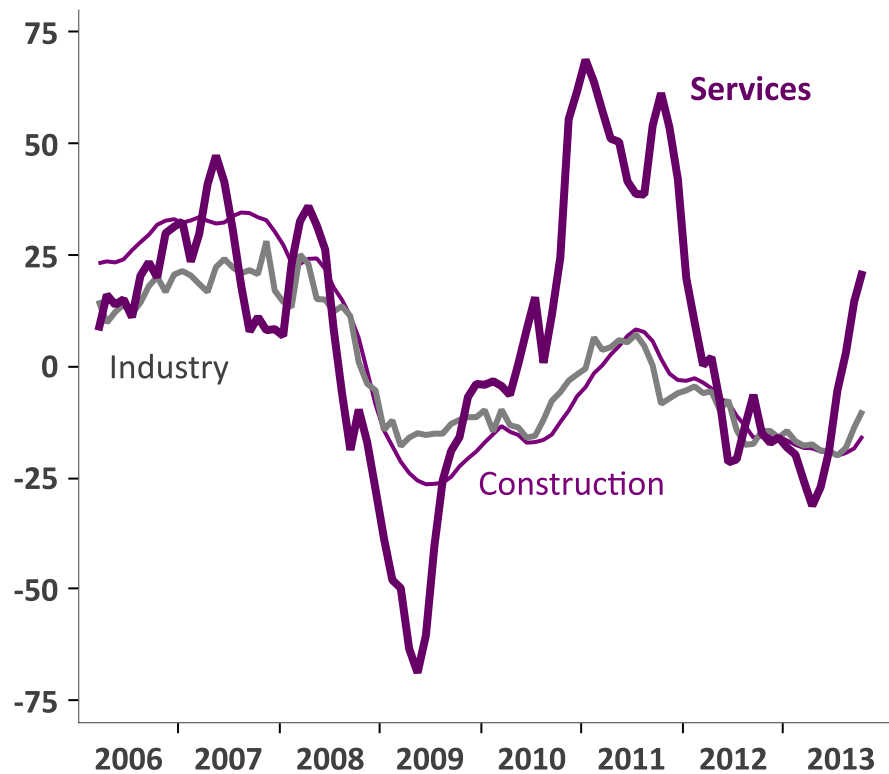
Non-Financial Corporations, volumes in YoY in %



Sources: RichesFlores Research, Macrobond

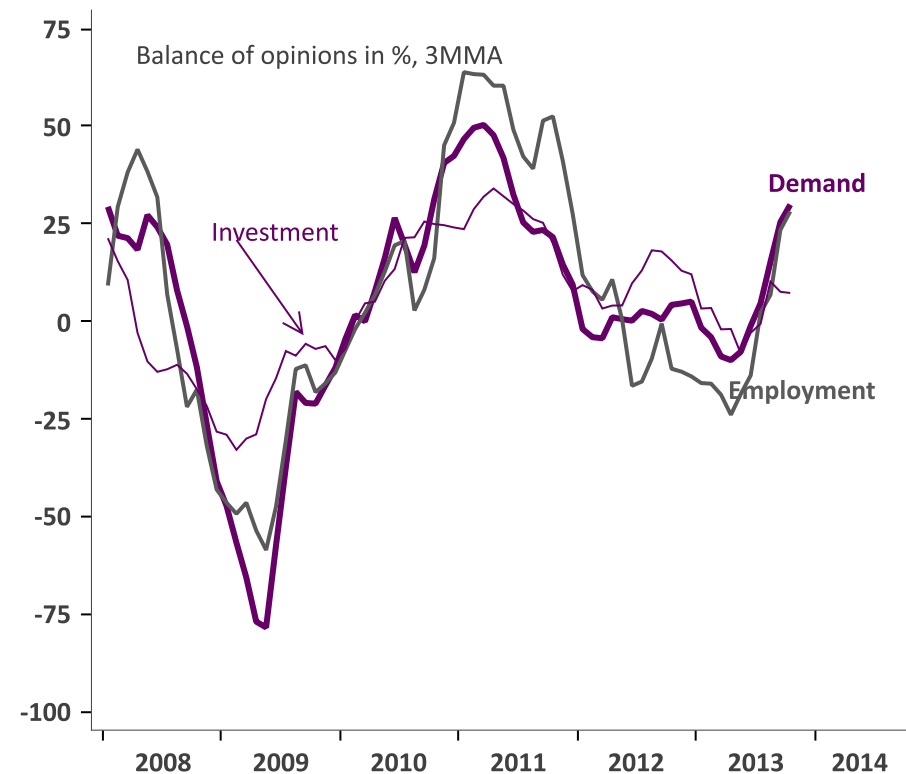
... Leading to a Broadly Sunnier Jobs Outlook

Expectations of the Employment in France by sector



Sources: RichesFlores Research, Macrobond

Expectations of temporary employment agencies



Sources: RichesFlores Research, Macrobond

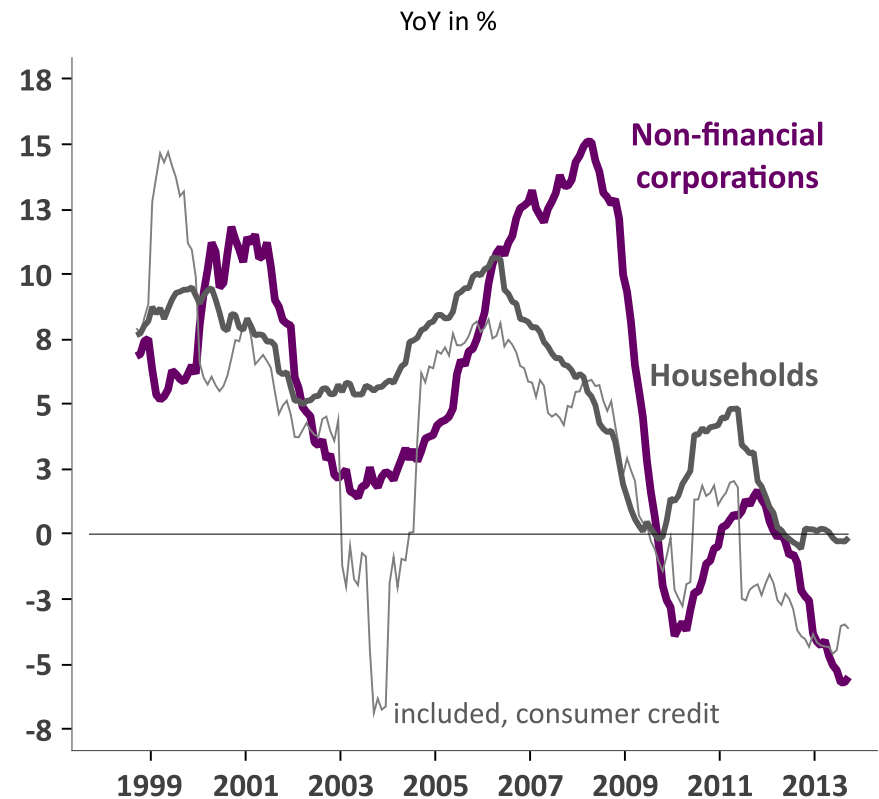
German Elections: Popular Support for the Euro

- Germans voted overwhelmingly to remain in the single currency
- Merkel's success shows that voters approve of her strategy, which boils down to a cohesive Europe
- Following some woeful initial missteps in handling the euro crisis, Merkel is expected to stick with the pragmatic approach...
- ...vital to preserving the euro area, upon which Germany will increasingly rely in the future

Banks: More Needs To Be Done

- Bank balance sheets need more work
- Market sentiment is improving and demand is rising, but euro area lending trends are still a source of concern
- Is the ECB headed for another LTRO?

EMU: Credit to Private Sector



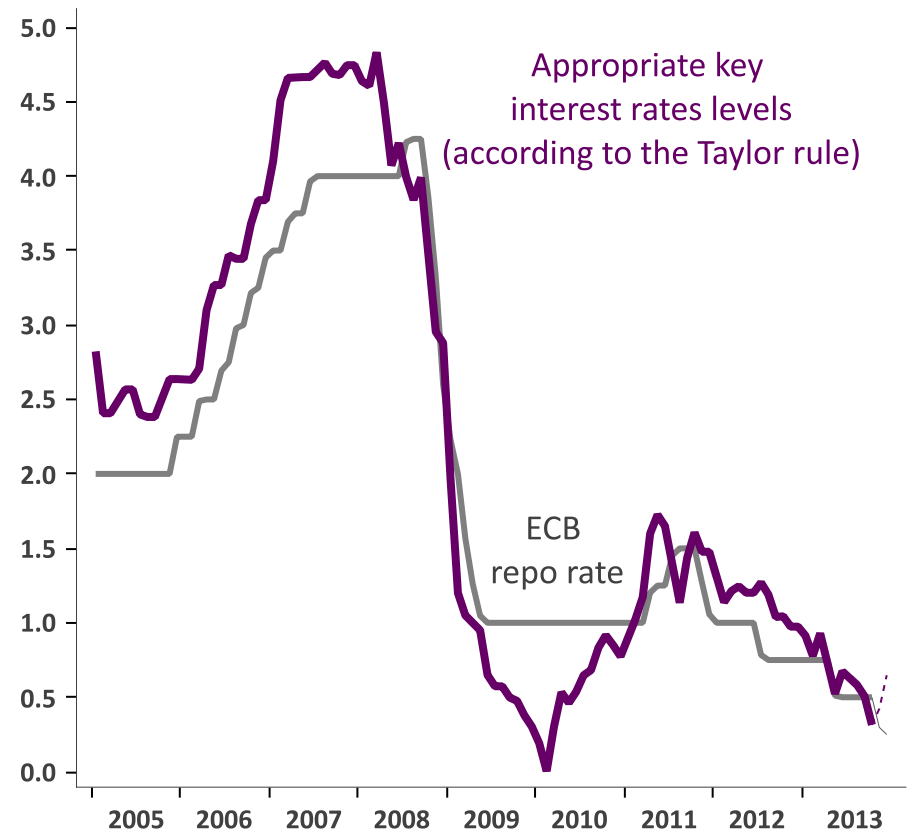
Sources: RichesFlores Research, Macrobond

The ECB Will Have To Do More

- Banks' soundness is still up in the air
- Governments' tenuous situation is forcing them to stick with restrictive policies
- OMTs are a stopgap measure and are no longer a practical way to manage the sovereign crisis
- ECB policy cannot be described as accommodative, even though it is supposed to be
- Significant euro appreciation is a risk

The most likely scenario is a LTRO in late 2013/early 2014 in the amount of €250-500 billion

The ECB policy can't be seen as accomodating

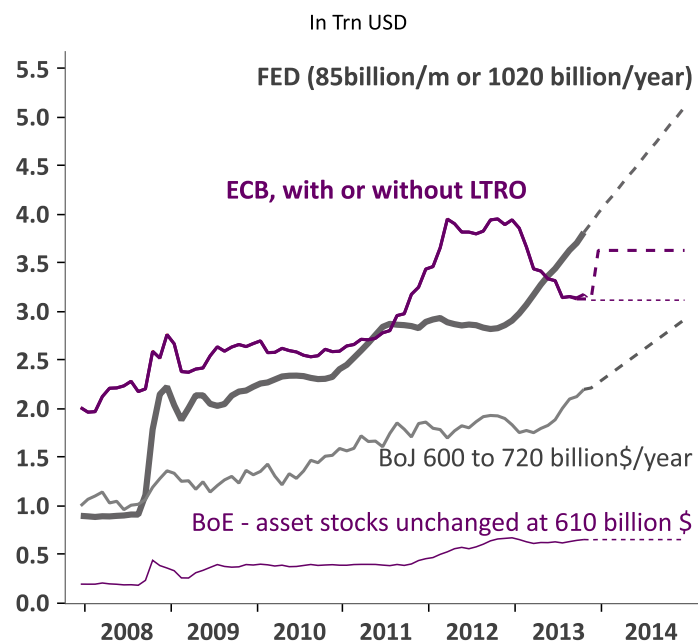


Sources: RichesFlores Research, Macrobond

With Or Without an ECB LTRO, the “Big Four” Balance Sheet Will Again Expand Exceptionally in 2014

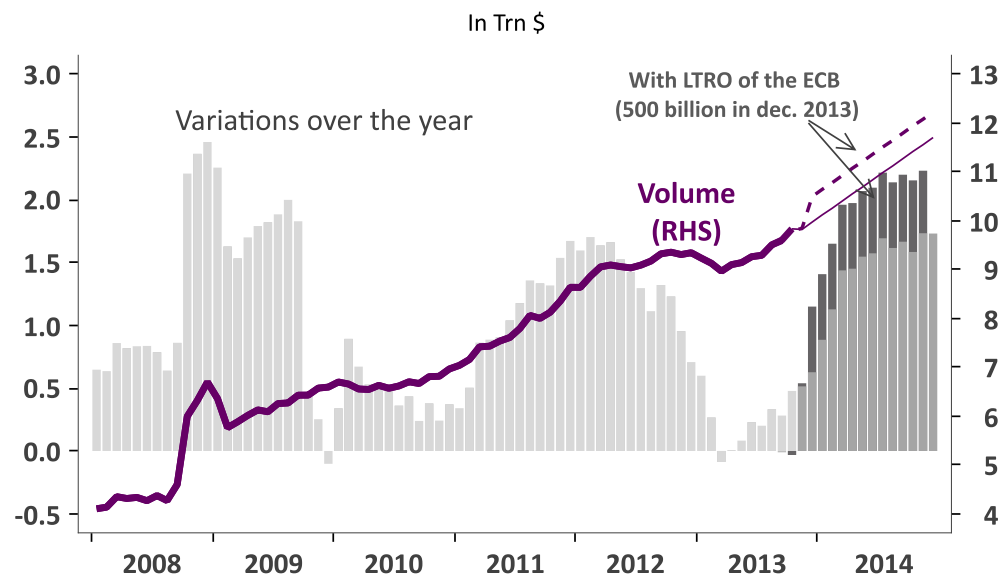
The lack of coordination among CBs has hampered the effectiveness of Fed initiatives. After a pause this year, we expect to see another strong expansion of the big four central banks’ aggregate balance sheet in 2014.

Main Central Banks Balance-Sheets



Sources: RichesFlores Research, Macrobond

Balance Sheet of the Four* Main Developed Country Central Banks



Sources: RichesFlores Research, Macrobond * Fed, ECB, BoJ, BoE

A Bond Market Crash Is Not On The Cards... But Investors Are Growing Wary

Fed asset purchases will not decline until spring at the earliest

- U.S. long yields will be back in the range of 2.30-2.50% by year's end
- With the Treasury Bond market drying up, the search for returns is supporting asset prices
 - European equities
 - Assets that protect against future inflation
 - A doubly negative combination for the greenback (hyper-abundance of dollars and expectations of LT inflation)

Europe is in a good position to benefit from the prolonged Fed policy status quo

- The end of recession and a new ECB LTRO are speeding up the decline of extreme risk
- German voters have backed the euro
- The bright spots of the recovery are channeling investment to neglected sectors

But wariness over prolonged unconventional policies is making markets more sensitive and more demanding in terms of results

- Safe havens are still going strong: Swiss franc, gold

Emerging Markets: Transitions and Structural Inadequacies

Keeping Interest Rates Low Is Not Enough To Dispel Emerging Risk

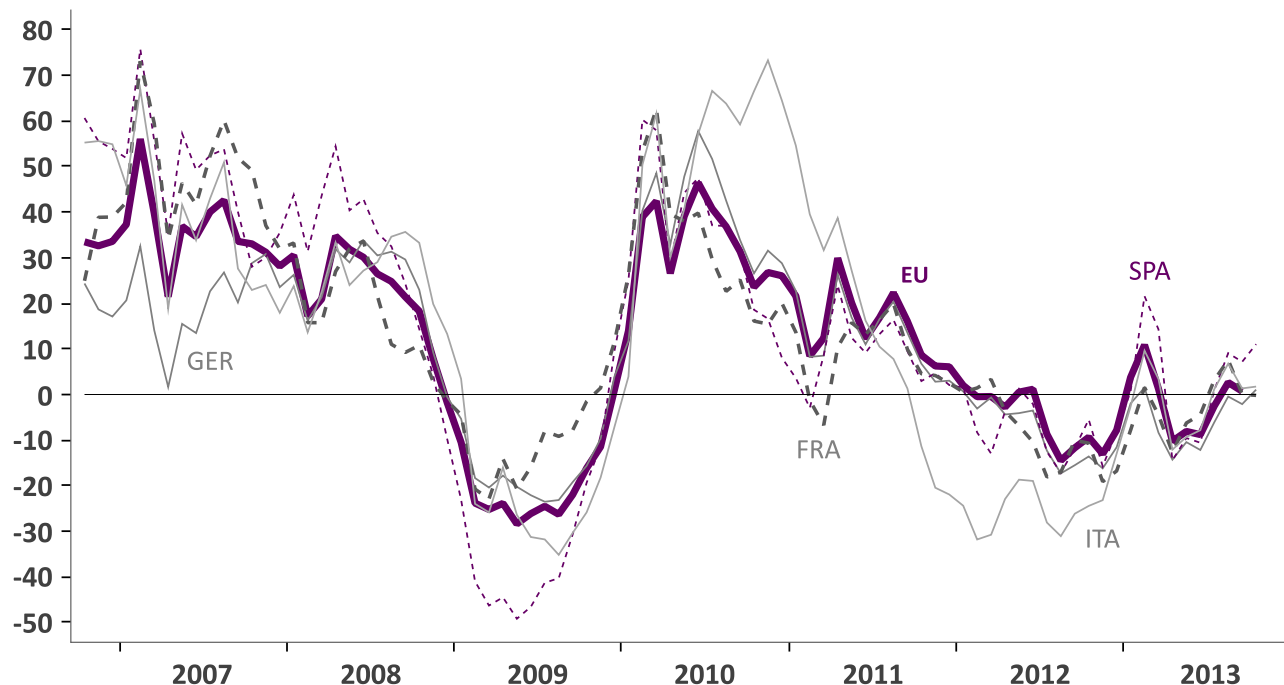
An extended period of challenging conditions have put emerging countries' structural shortcomings back in the spotlight

- Improvement in Europe is a real breath of fresh air, but not enough to return growth to past levels
- The effects of China's transition are taking vital support away from other emerging countries trying to sustain their progress
- Many countries will find it hard to avoid sizeable monetary adjustments (interest and exchange rates)

The End of the Euro Area Recession Offers Emerging Countries Some Relief, However Modest

The end of the euro zone recession is likely to fuel trade over the coming months. But Europe is not the only one to blame...

Annual Growth of Chinese Exports to EU, in %

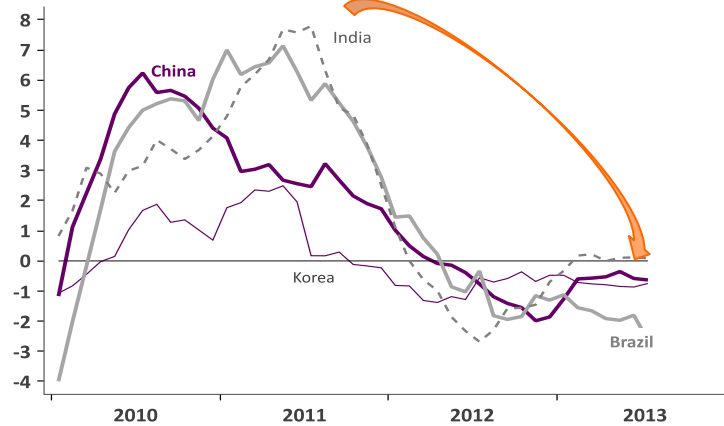


Sources: RichesFlores Research, Macrobond

Sluggish World Trade

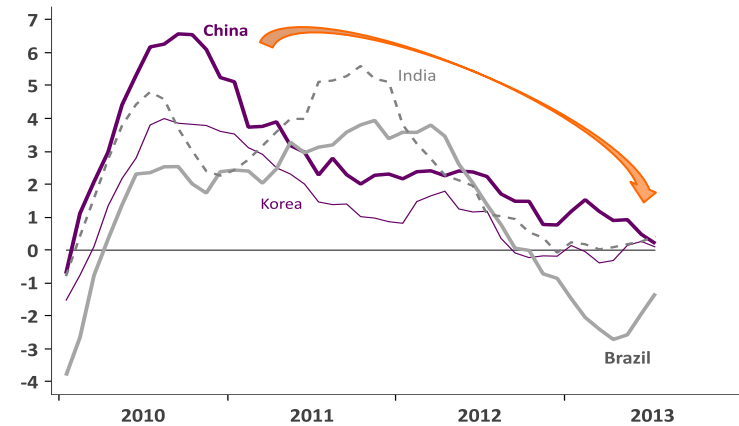
Contribution of sales by destination to the annual export growth of each country

Exports to Euro Area



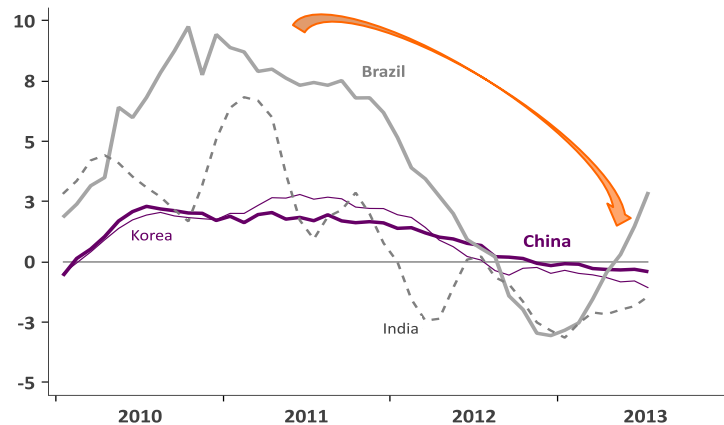
Sources: RichesFlores Research, Macrobond

Exports to United-States



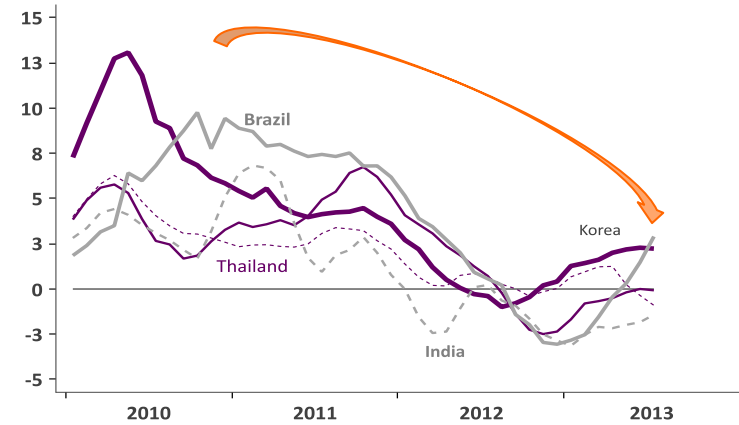
Sources: RichesFlores Research, Macrobond

Exports to Japan



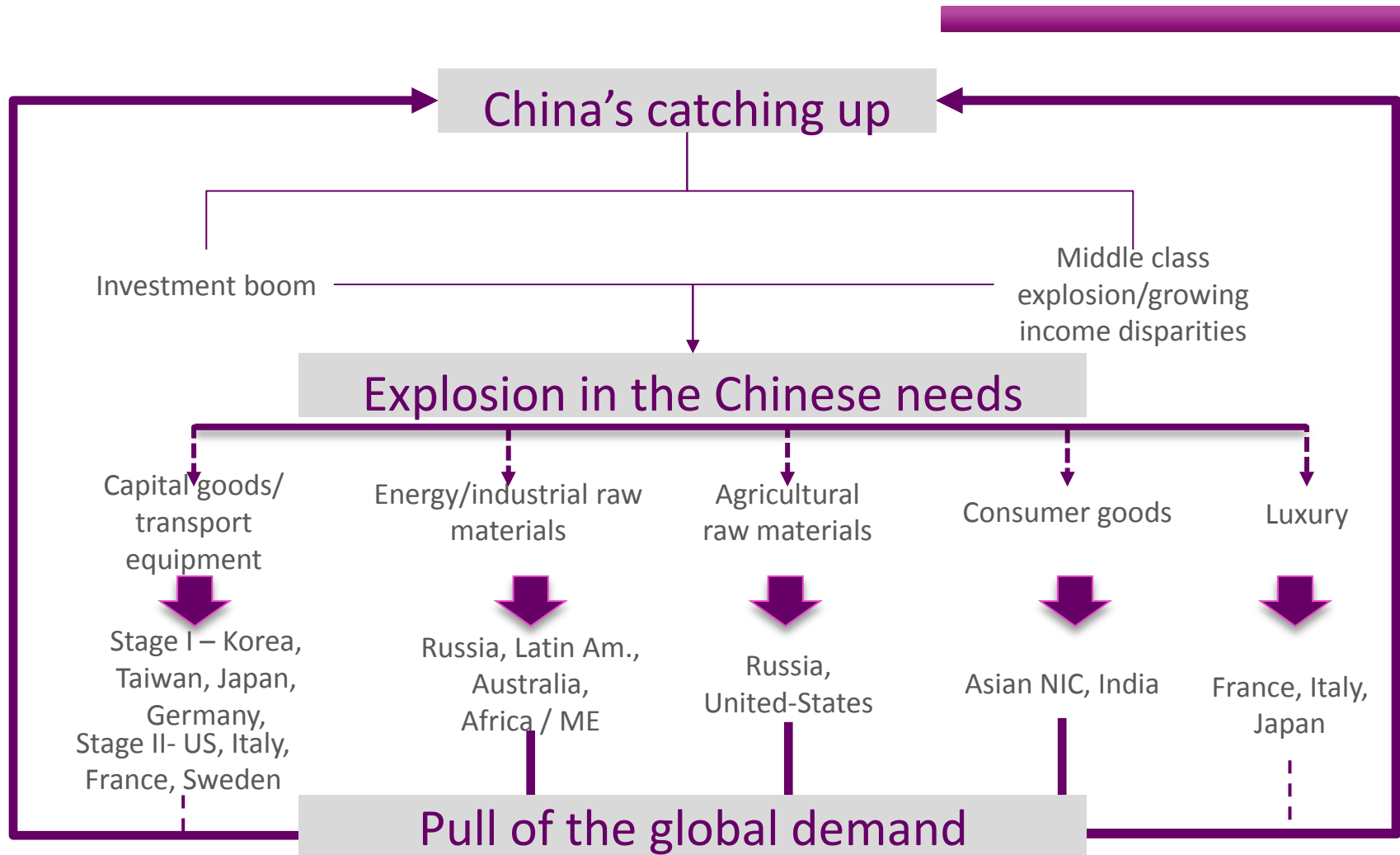
Sources: RichesFlores Research, Macrobond

Exports to China



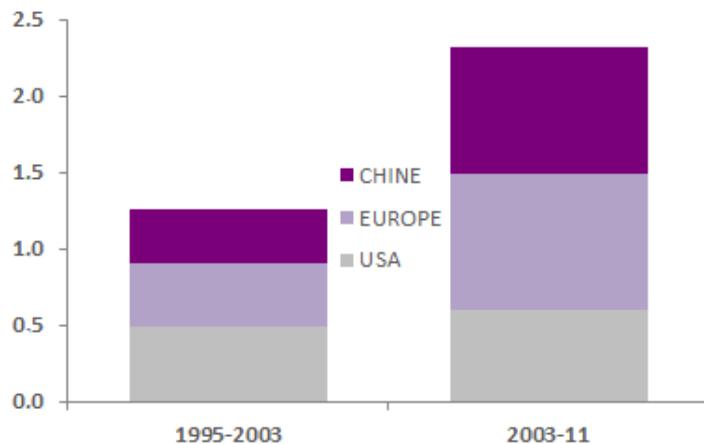
Sources: RichesFlores Research, Macrobond

China: Principal Driver of Emerging Market Development During the 2000s



The 2000s: Ramp-up of China and Trade Among Emerging Markets

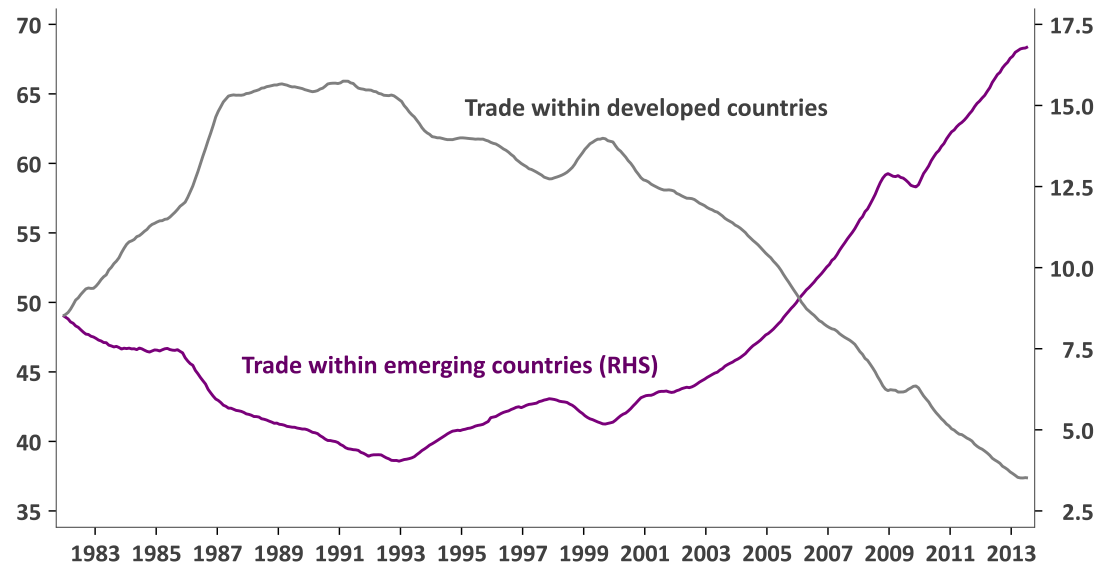
Contributions of Exports to Different Markets to EM GDP Growth



Source : RichesFlores Research

Evolution of the exports share

In % of global exports, in \$, 12MMA



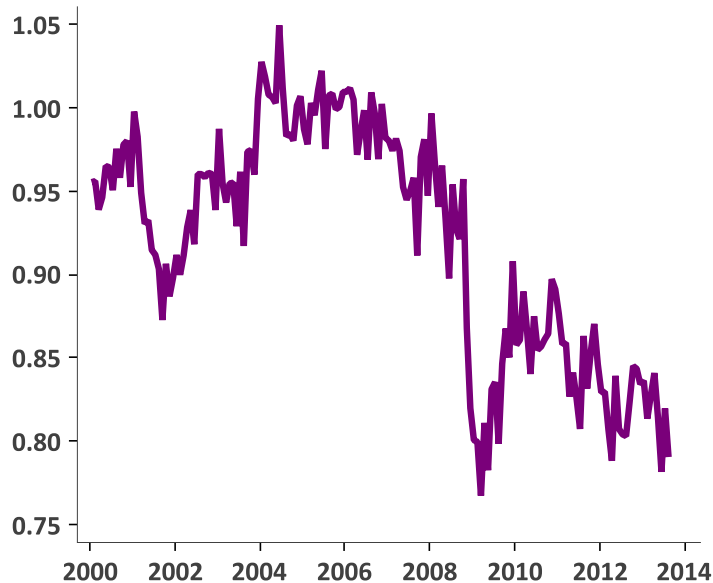
Sources: RichesFlores Research, FMI, Macrobond

China No Longer Has the Means To Be the World's Growth Driver

The Chinese economy's transition is sharply reducing the role that imports play in its growth, which is also attributable to a growing service sector, increasing specialization and the development of higher value added local production.

Import Content of the Production - Emerging Asia

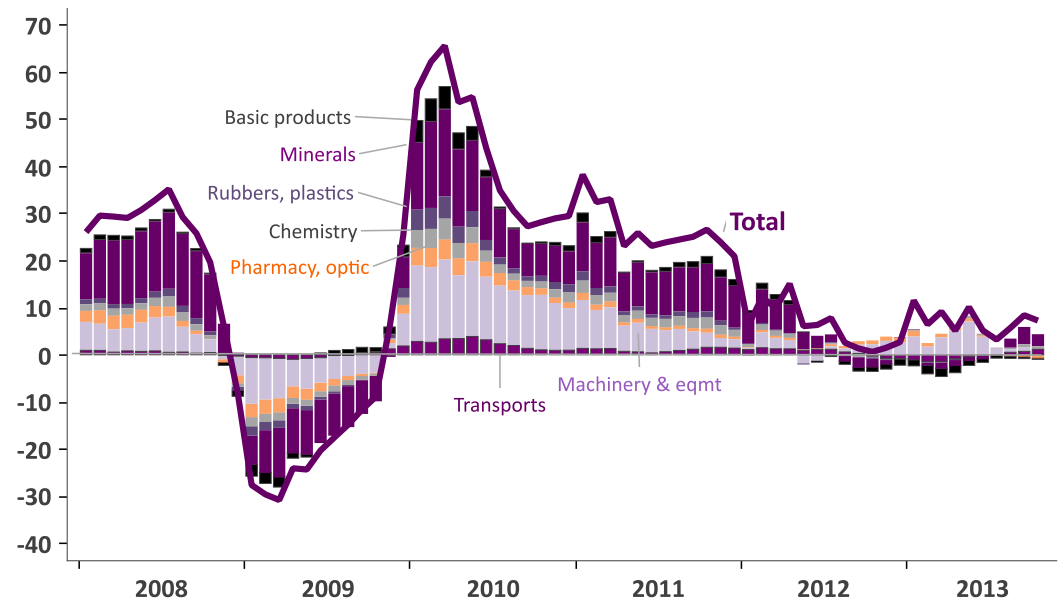
Volume of importations/industrial production, 2000=100



Sources: RichesFlores Research, CPB, Macrobond

Contributions to the Annual Growth of Chineses Imports

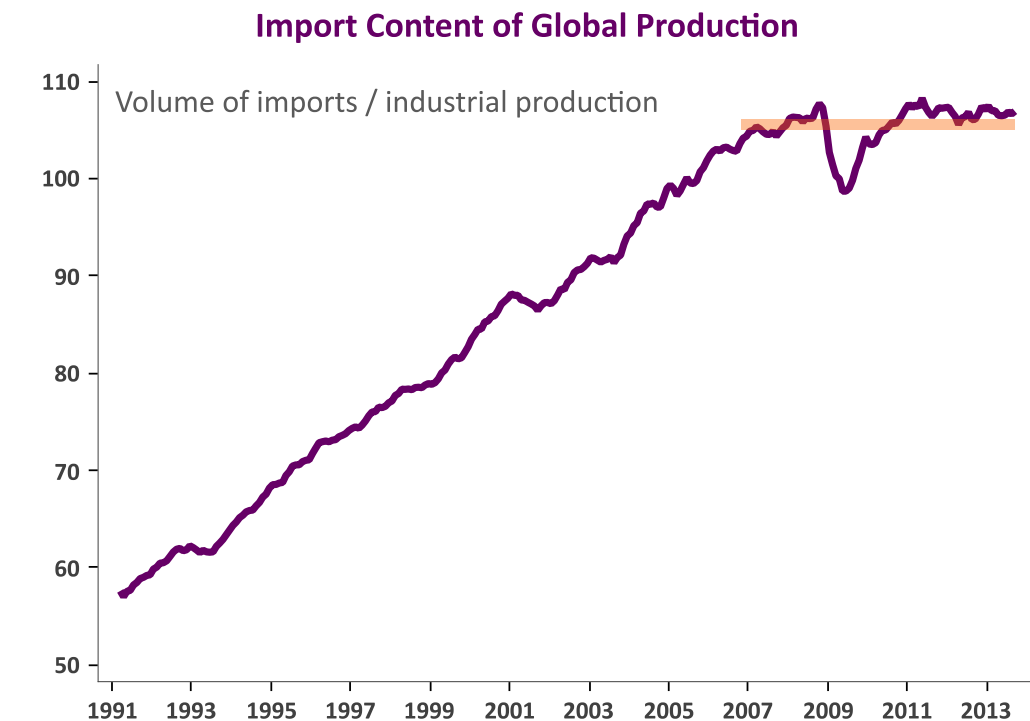
Moving Average 3 Months, current prices, pts of %



Sources: RichesFlores Research, Macrobond

The Momentum Behind World Growth Has Been Structurally Diminished

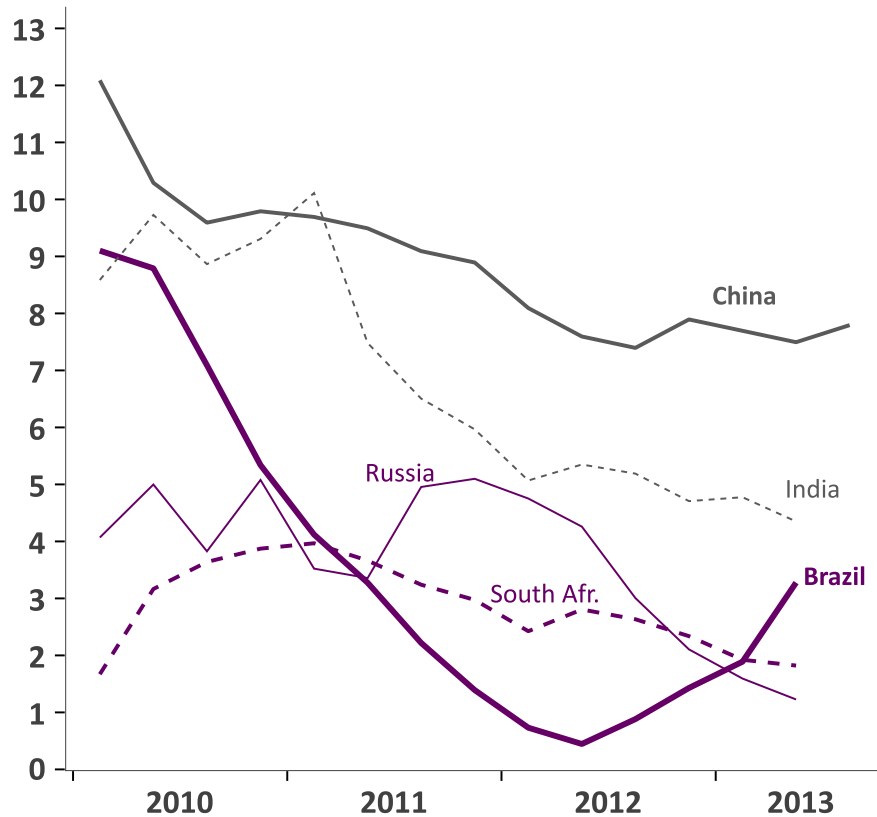
The realignment of current account balances and China's transition have halted the rise in the import content of world growth since 2008. World trade now appears incapable of resuming its role as an engine of growth.



Sources: RichesFlores Research, Macrobond

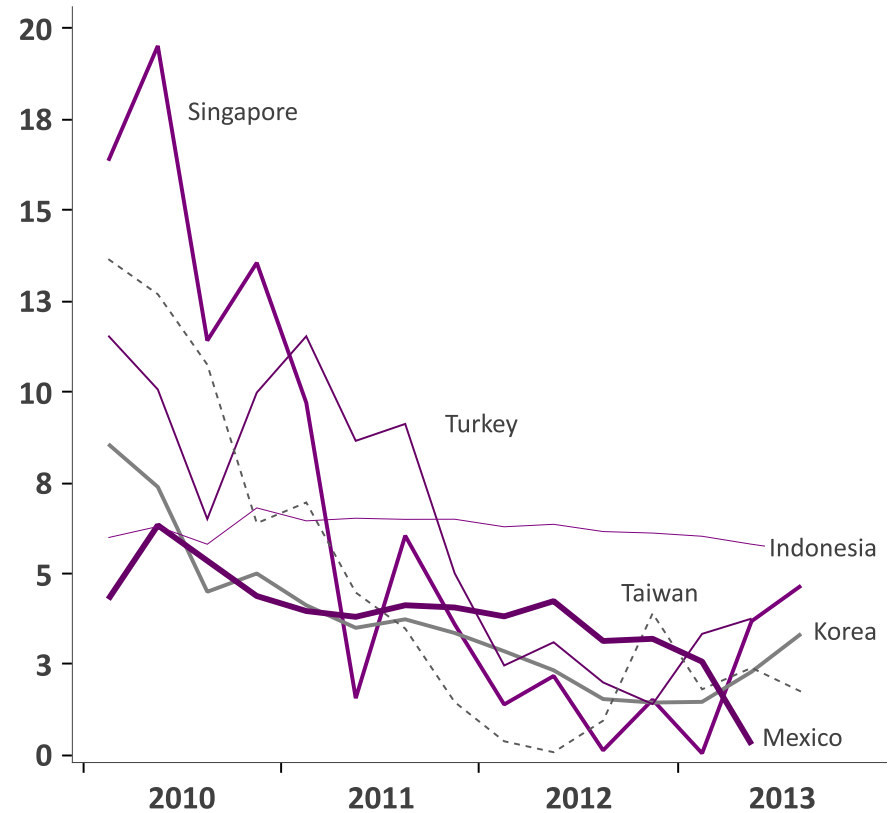
... Emerging Countries Are Paying the Price

Real GDP Growth, YoY in %



Sources: RichesFlores Research, Macrobond

Real GDP Growth, YoY in %



Sources: RichesFlores Research, Macrobond

Two Diametrically Opposed Camps

Manufacturing exporters

Sources of difficulty

- Slowing world demand
- Intense international competition

Characteristics

- High investment rate
- Weak inflation
- Current account surplus or small deficit

Key risks

- **Persistently weak growth / deflation**

Other emerging countries

- Slowing world demand

- Under-investment
- High inflation
- Current account deficit

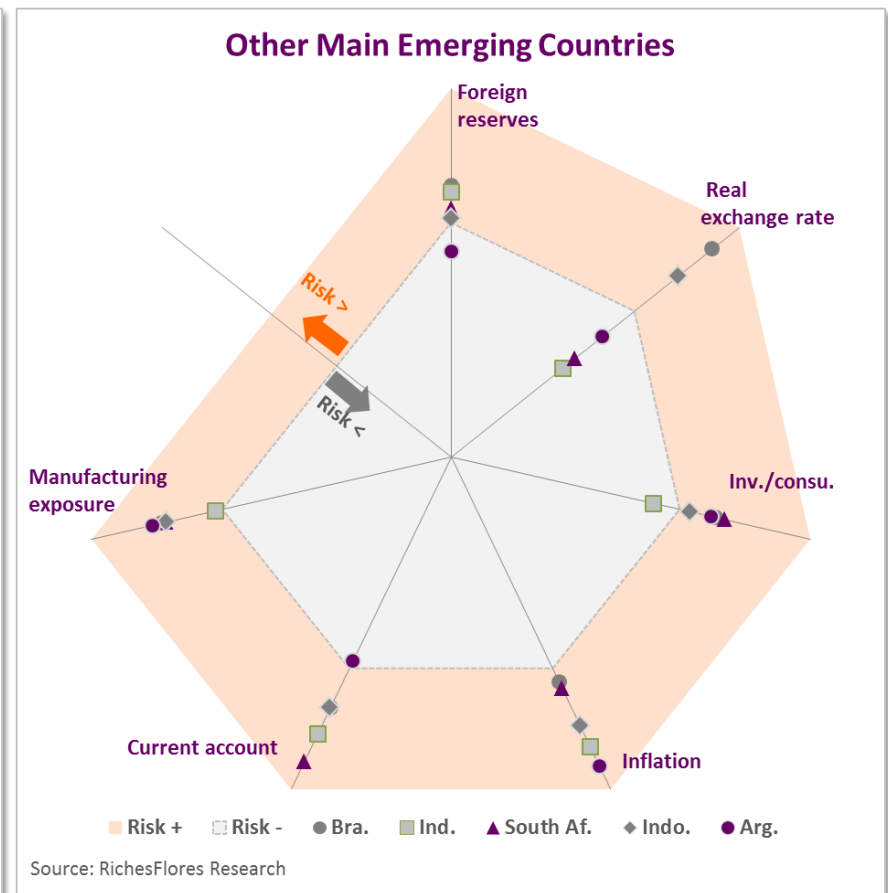
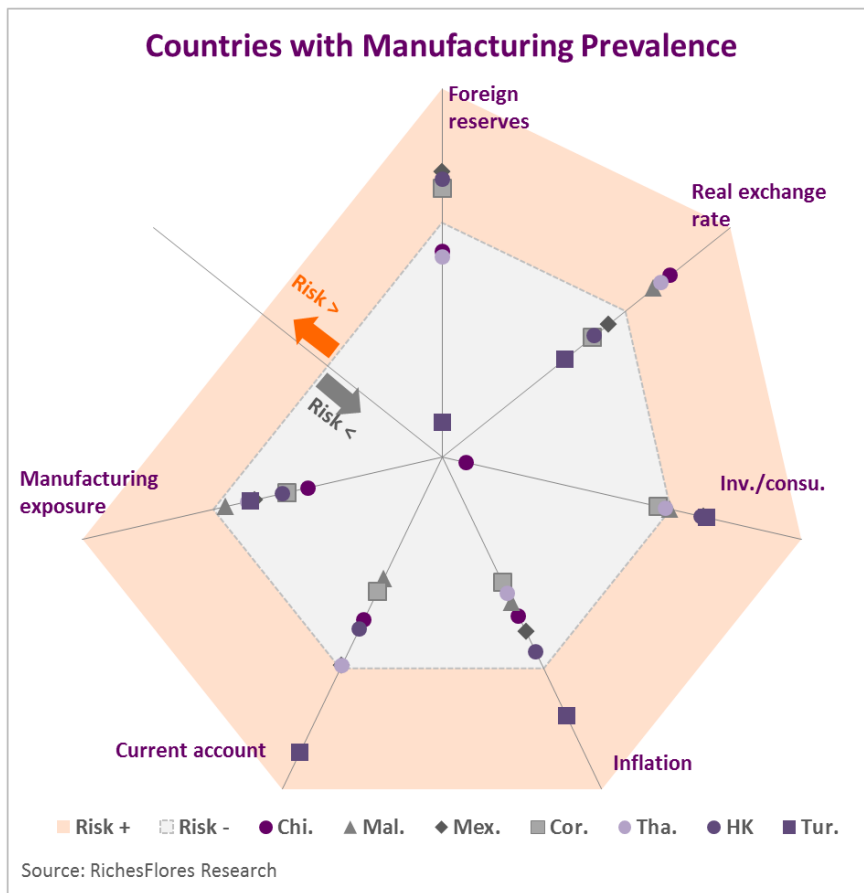
- **Currency crisis, inflation, interest rate spike, social unrest**

Manufactured Goods in Total Exports and Inflation -
Deviation From the Average, in % pts



Sources: RichesFlores Research

Diagram of Key Emerging Market Risks



Nda. Position relative to the sample, indicators are normalized (the sum of the coefficients is zero).

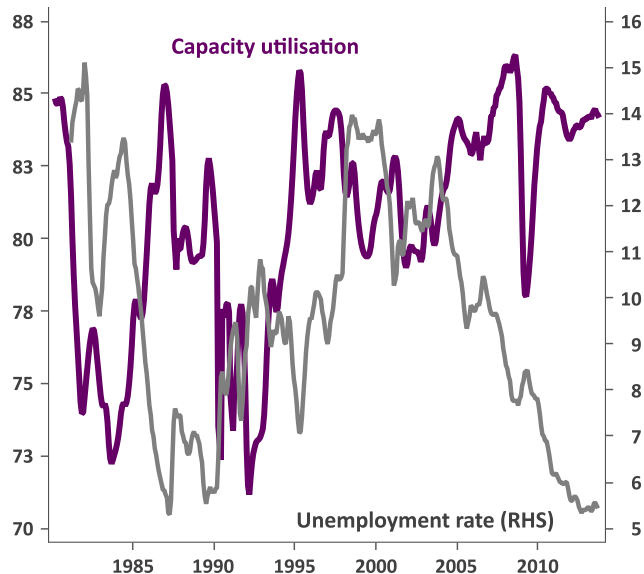
Coefficients are calculated using the following indicators: manufacturing exports as a share of total exports in 2012; current account balance as a % of GDP in Q1 2013 ; annual inflation in August 2013; ratio of domestic consumption to investment per capita (shows a country's ability to meet its own demand); spread between the real effective exchange rate in Q2 2013 and its pre-crisis average (2003-2008); foreign currency reserves as a % of GDP in Q2 2013.

Case Study: Brazil

Overheating Without Growth

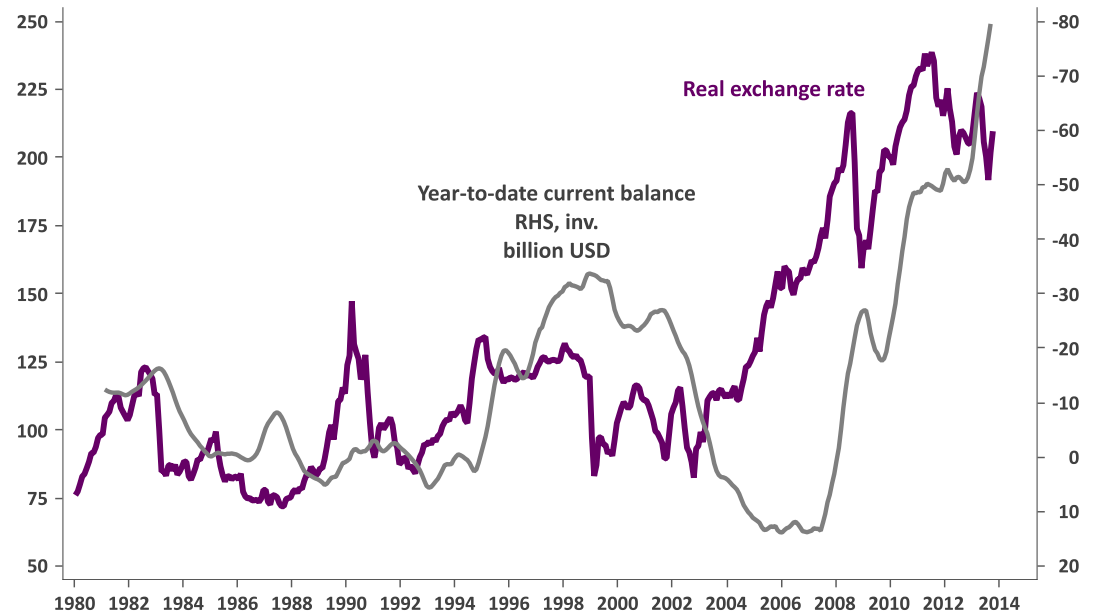
The lack of adequate structural progress on the investment and education front is depleting the country's growth potential. Rising inflation is aggravating currency appreciation, which is already being driven by capital inflows. An exchange rate adjustment now looks unavoidable.

Unemployment Rate and Capacity Utilisation,
in %



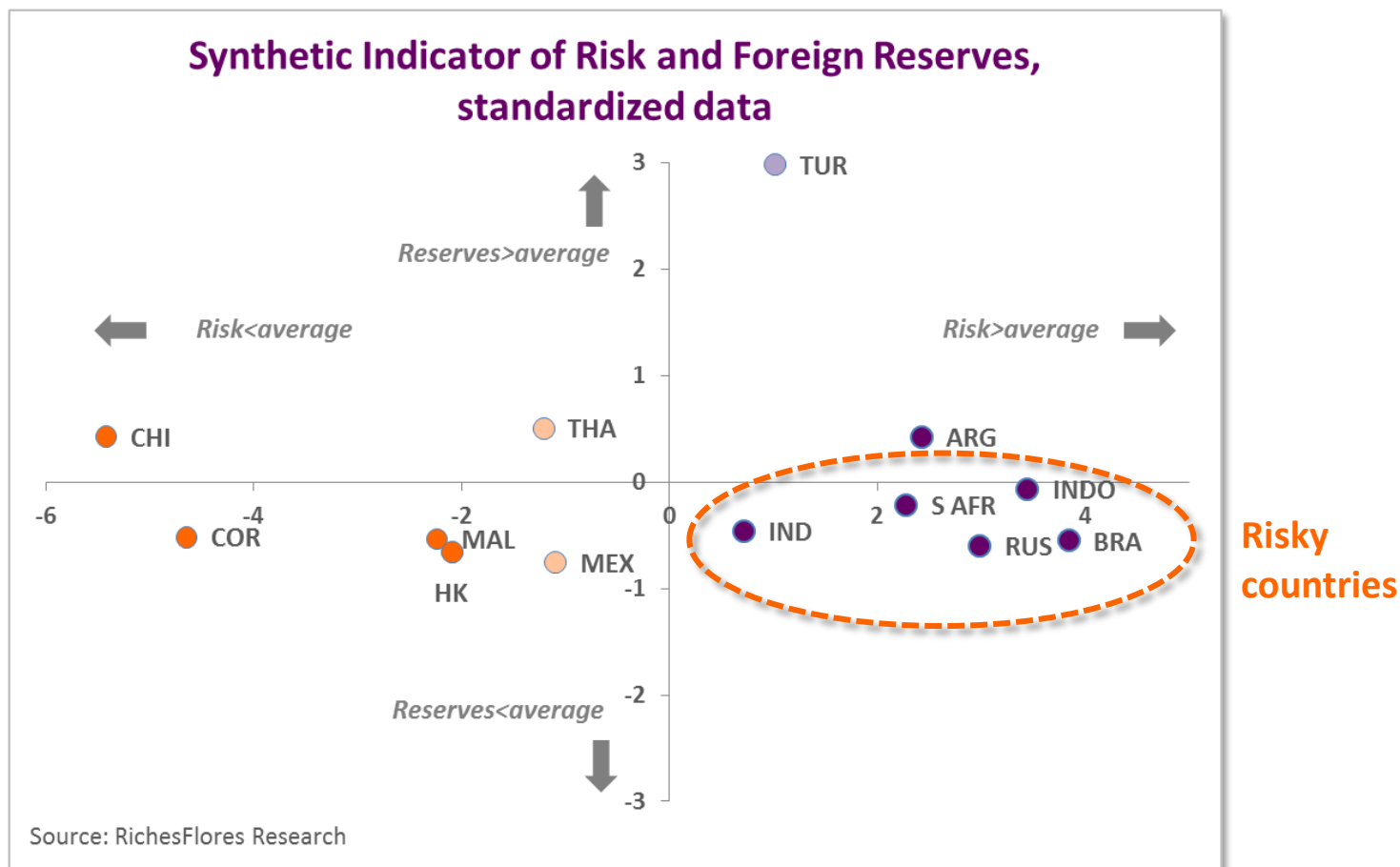
Sources: RichesFlores Research, Macrobond

Brazil: Real Exchange Rate and Current Balance



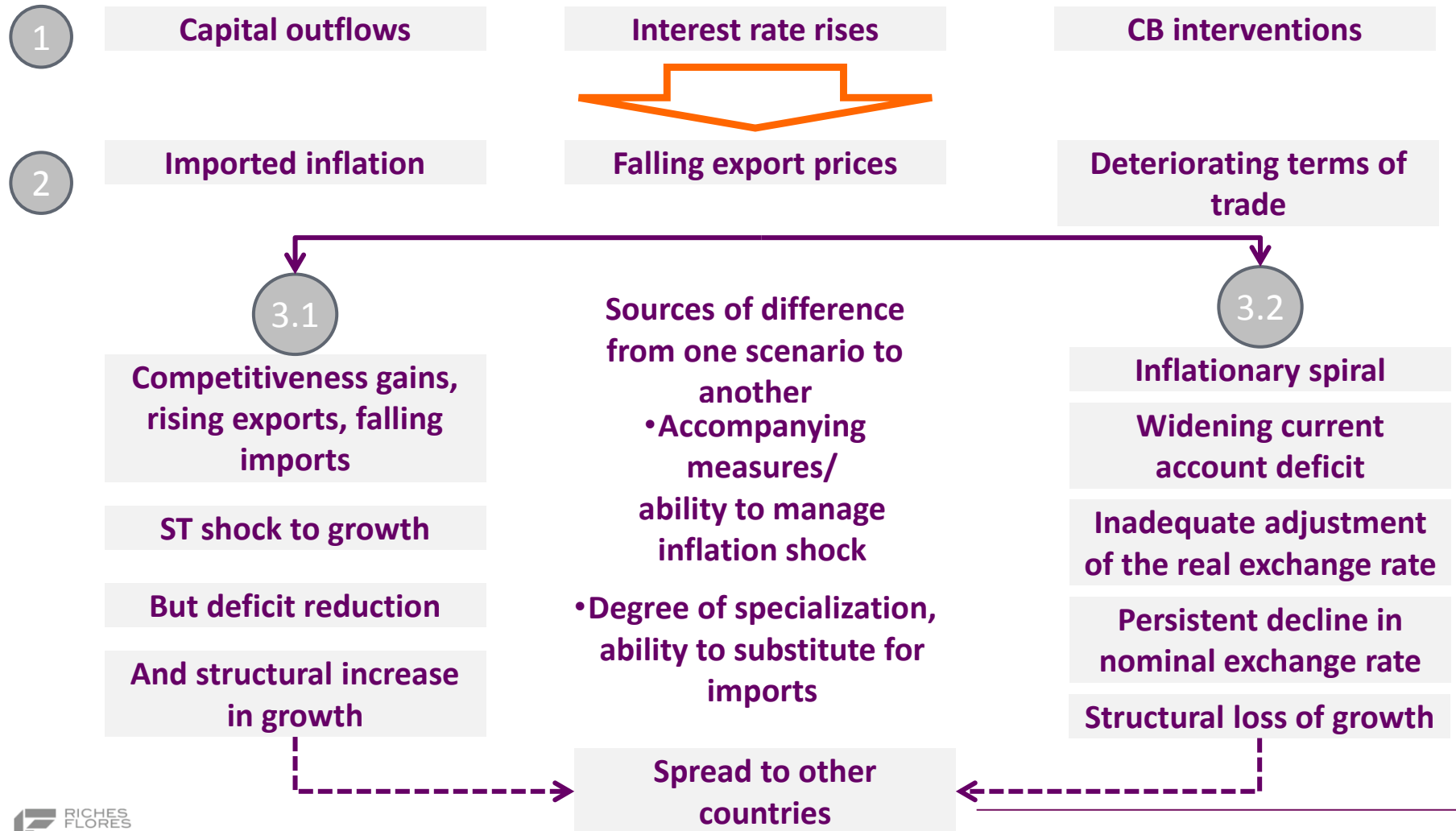
Sources: RichesFlores Research, Macrobond

The Four Non-China BRICS Together Pose the Biggest Risk*



* According to the indicators on page 34

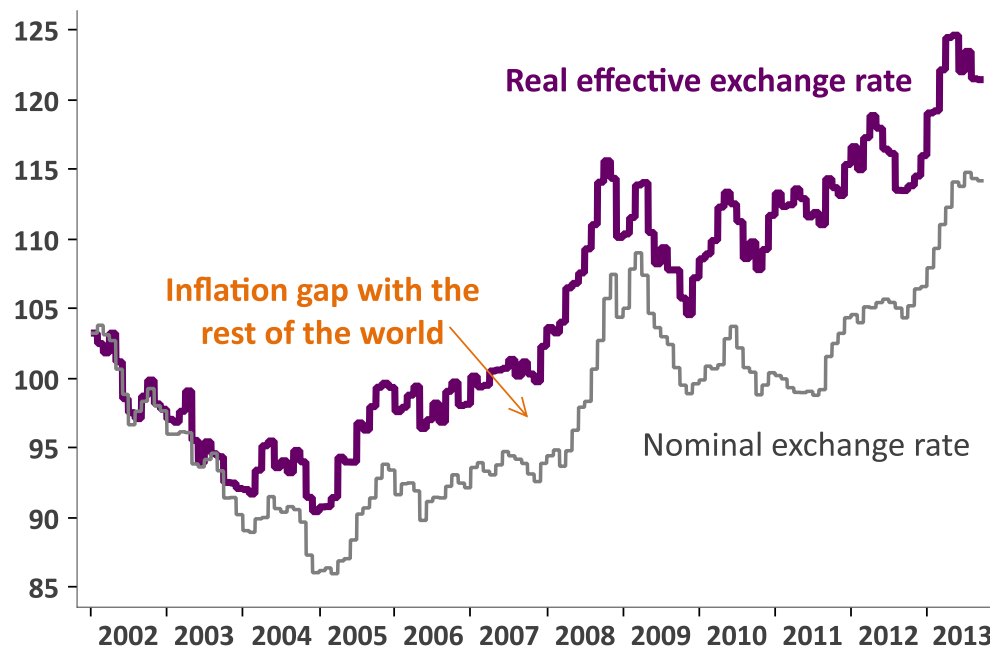
Typical Stages of a Currency Crisis



How Long Can China Hold Out?

The yuan's appreciation is limiting price increases on imported goods (notably energy and agricultural products) but is also a growing drag on Chinese competitiveness, a phenomenon that will only worsen if other currencies depreciate.

Chinese Exchange Rate, 2002=100

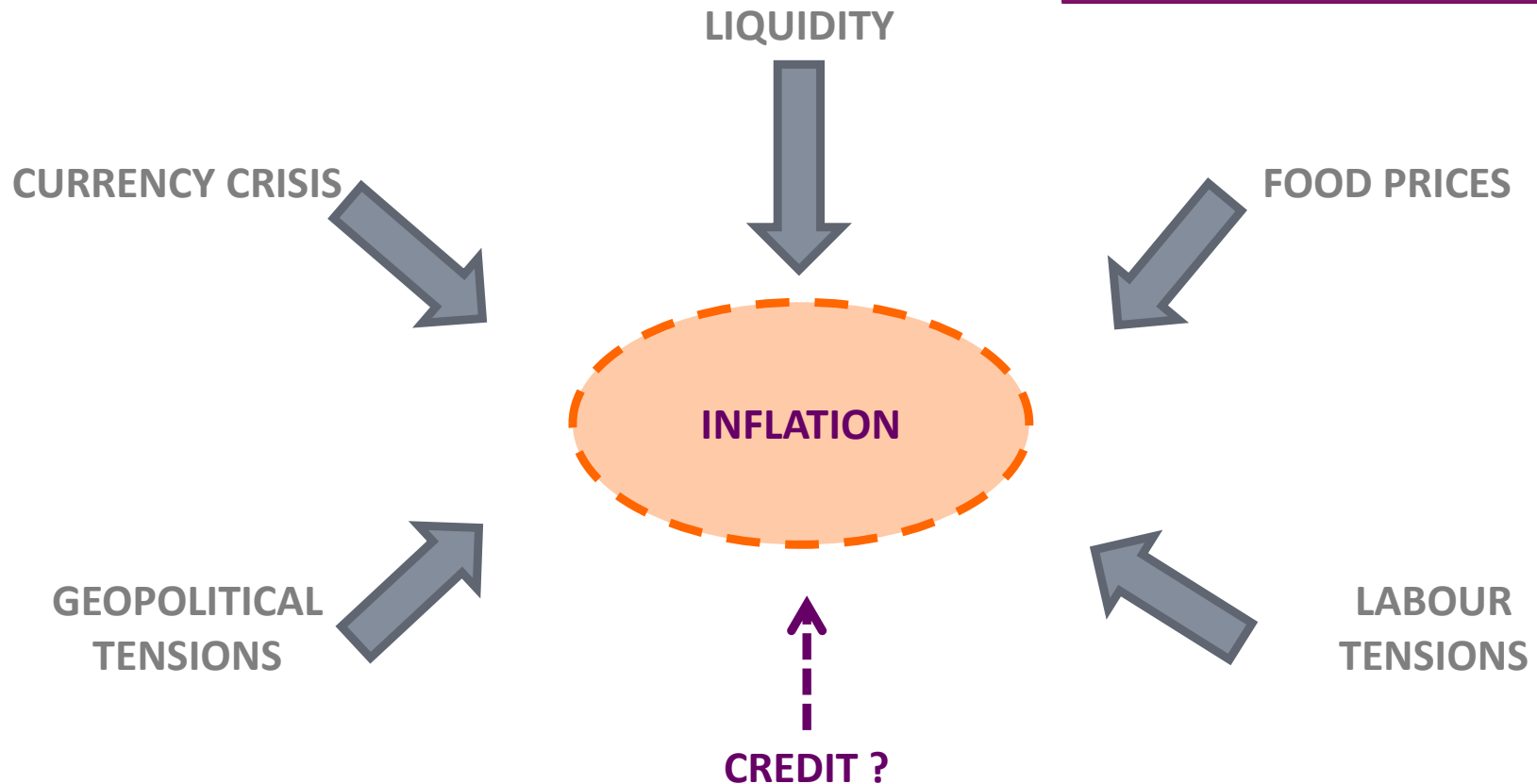


Sources: RichesFlores Research, Macrobond

After Five Years of Crisis, an Epilogue?

Inflation: the Question Isn't "If" But "When"

Nearly All the Ingredients Are There



Renewed lending growth is the missing link. Can it be far behind? The answer lies with the U.S. economy.

Conclusions: a Highly Unstable Environment

- **Markets increasingly wary of central bank policies**
 - Interest rates remain low, but the risk of a poorly timed lurch is increasing
- **Recurring currency market tensions**
 - The U.S. dollar has been structurally weakened
 - An emerging currency crisis is a serious risk
 - Chinese currency policy needs to change direction
- **There is a real risk of another slump in world growth**
- **The inflationary scenario is the most likely, but its timing and the channel by which it arrives are still unknown**

Scenario Key Figures

Global Scenario - October 2013

	2012	2013		2014	
Real GDP growth, in %		oct-13	juin-13	oct-13	juin-13
WORLD*	3.1%	2.6%	2.9%	2.7%	3.3%
USA	2.8%	1.4%	1.7%	1.7%	2.2%
EMU	-0.6%	-0.4%	-0.6%	0.9%	0.6%
- Ger	0.9%	0.4%	0.2%	1.5%	1.4%
- Fr	0,0%	0.3%	-0.3%	0.8%	0.5%
- It	-2,4%	-1.8%	-1.7%	0.2%	0.0%
- Spa	-1.6%	-1.4%	-1.6%	0.5%	0.0%
JAPAN	2.0%	1.9%	1.6%	1.3%	1.2%
CHINA	7.8%	7.3%	7.3%	7.0%	7.0%
BRAZIL	0.9%	2.9%	2.8%	2.5%	3.0%

*At 2010 PPP exchange rates

Source: RichesFlores Research

Financial Framework

	End of 2012	End of 2013	End of 2014
Fed Funds	0.25	0.25	0.25
Repo EBC	0.75	0.50	0.50
10YR T-Bonds	1.70	2.50	3.50
10 YR Bunds	1.50	2.00	2.25
EURUSD	1.32	1.35	1.40
Oil (Brent/b)	111	100	130

Source: RichesFlores Research

Sources, Available at www.richesflores.com

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- Véronique Riches-Flores, contact@richesflores.com



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- Economic and financial research provider
- www.richesflores.com
- Contact: veronique@richesflores.com