



Global Economy Report

June 2013



Global Economy Report

The Global Economy Report is prepared in cooperation by the Macroeconomic Research Division of Banca Aletti and the Global Governance Programme of the Robert Schuman Center for Advanced Studies of the European University Institute.

The objective of the Report is to provide an analysis of the current and expected macroeconomic and financial conditions at the global level, with also a focus on key economic areas such as Europe, the USA and ASIA.

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EXECUTIVE SUMMARY

- ❖ The recent macroeconomic data question the extent and perspectives of the global recovery. The slowdown in China and India, the continuous troubles in the euro area, and the worries that the mild recovery in the USA could reduce the expansionary stance of the FED's monetary policy are all increasing the downside risks.
- ❖ The IMF also corrected its global growth forecast for 2013 downwards, at 3.3%, due to substantial stagnation among major economies (1.2%) and expected reduced growth in emerging markets (5.3%). In 2014 growth, increasing by a confirmed 4%, will be still mostly due to emerging markets (5.7%), but will also have a positive impulse from major economies (2.2%).



EXECUTIVE SUMMARY

❖ The improvement of the Chinese economy is less intense than expected, with industrial production and retail sales that remain close to end of 2012 lows. Qualitative indicators have further weakened in May. The second quarter of 2013 could therefore witness another slowdown in growth (our estimate is 7.5%), while growth for the entire year could be 7.8%, lower than the 8% originally estimated. Data for May confirm that inflation is also following a weaker trend than expected, but it is unlikely that monetary policy will be more expansive, due to persistent risks on housing prices.

❖ In Japan, the macroeconomic scenario is improving. Growth in the first quarter was revised to 4.1%, higher than the 3.5% initially estimated. The expansionary impulse will persist throughout the year, tending to intensify, thanks to the extraordinary support of economic policies, guaranteeing a 1.9% increase in average yearly growth. For 2014 we forecast a further positive adjustment, reaching about 2.0%.



EXECUTIVE SUMMARY

❖ In the USA, after a stronger than expected Q1, the last data were mixed, incorporating the impact of the Sequester and confirming our forecasts of a weaker central part of the year. Overall, the growth forecasts are at 1.8% for 2013 and at 2.7% for 2014. The unemployment rate is expected to be at 7.3% at the end of 2013 and 6.7% at the end of 2014, remaining well above NAIRU. The principal risks lie in fiscal policy and a possibly lower than expected global growth.

❖ We expect inflation below 2% for the whole forecasting period, thanks to the output gap accumulated during the Great Recession and these three and a half years of weak recovery. In detail, the growth in average headline CPI will be equal to 1.5% in 2013 and to 1.6% in 2014, in average core CPI to 1.8% in 2013 and 2014.

❖ In a recent speech, Bernanke and Rosengren suggested how the Fed could start to reduce its monthly asset acquisitions earlier than expected. We expect, however, a reduction from the current rate of 85 bln USD only between September and October, when the recovery will be stronger. A definite stop in acquisitions could arrive around mid 2014.

❖ In this report, we present a special focus on the US economy.



EXECUTIVE SUMMARY

- ❖ In Q1 2013, the aggregate income in the Eurozone diminished for the sixth quarter in a row (-0.2%). The average growth estimate for the Eurozone for 2013 was cut to -0.8%, and that for 2014 to +0.9%. The risks on growth are on the downside.
- ❖ In terms of the largest Eurozone countries, GDP decreased in France (-0.2%) and Italy (-0.6%), while it increased only slightly in Germany (+0.1%). The May reading of qualitative indicators confirms a widespread weakness and projects the persistence of recessive conditions also in Q2. The greatest element of concern regards the impressive worsening of economic climate in Germany, where all components of the PMI surveys fluctuate on the limit between expansion and recession. The estimates for average annual GDP in 2013 are at -0.5% for France, -1.8% for Italy, +0.1% for Germany, all below consensus. In 2014, the three major economies of the Union will return to simultaneous growth, yet still dishomogeneously.
- ❖ Inflation continues to slowdown, with the general index at 1.2% in April (lowest since February 2010) and the core index at 1.0% (lowest since February 2011), before a modest positive adjustment in May. The current correction of raw materials' international prices, the lower than expected economic levels and the noticeable downturn in qualitative price surveys, caused a downward correction on inflation estimates, to 1.4% in 2013 and 1.3% in 2014.



EXECUTIVE SUMMARY

- ❖ After the recession at the end of 2011/beginning of 2012, the UK economy remains on stable levels of activity, once eliminated the impact of the Queen's Diamond Jubilee and of the Olympic Games. The job market is performing relatively well compared to growth. On the export front, the devaluation of the pound has not given the desired effects and we do not expect a strong contribution from Net Trade for the coming quarters. Our forecasts for real growth are at 0.8% in 2013 and 0.1% for 2014.
- ❖ We expect a fall in CPI modestly below target in Spring 2014, with the low labour productivity and the pound devaluation inflating input prices. We expect a headline average CPI at 2.6% in 2013 and at 2.5% in 2014.
- ❖ The Bank of England is responding aggressively to the modest growth signals of domestic demand. The programme of asset acquisition is on hold since November as the MPC is waiting to see if recovery signs are sustainable. Doubts on its efficacy, do not exclude a renewal, but it remains unlikely. We expect instead different monetary accommodation measures, under the Carney lead from July, probably a guidance on interest rates linked to specific economic targets like the Fed, guaranteeing blocked rates for two years. The official rates will stay constant at least until mid 2015.



EXECUTIVE SUMMARY GENERAL

	2009	2010	2011	2012	2013E	2014E
GDP (%YOY)						
US	-3.1	2.4	1.8	2.2	1.8	2.7
EUROZONE	-4.4	2.0	1.4	-0.5	-0.8	0.9
GERMANY	-5.1	4.2	3.0	0.7	0.1	1.4
FRANCE	-3.1	1.7	2.0	0.0	-0.5	0.8
ITALY	-5.5	1.8	0.4	-2.4	-1.8	0.4
JAPAN	-5.5	4.7	-0.6	2.0	2.1	2.0
BRASIL	-0.3	7.6	2.8	0.9	3.0	3.5
RUSSIA	-7.8	4.3	4.3	3.4	2.8	3.5
INDIA	6.4	8.9	7.5	5.1	5.1	6.0
CHINA	9.2	10.4	9.3	7.8	7.8	7.8
AUSTRALIA	1.4	2.6	1.4	3.6	2.6	3.0
COREA	0.3	6.3	3.6	2.0	2.8	3.8
INFLATION (%YOY)						
US	-0.4	1.6	3.2	2.1	1.5	1.6
EUROZONE	0.3	1.6	2.7	2.5	1.4	1.3
GERMANY	0.2	1.2	2.5	2.1	1.7	1.8
FRANCE	0.1	1.7	2.3	2.2	1.2	1.6
ITALY	0.8	1.6	2.9	3.3	1.7	1.6
JAPAN	-1.3	-0.7	-0.3	0.0	0.1	2.2
BRASIL	4.9	5.0	6.6	5.4	6.1	5.7
RUSSIA	11.7	6.9	8.5	5.1	6.4	5.6
INDIA	10.8	12.1	8.9	9.3	9.1	7.8
CHINA	-0.7	3.3	5.4	2.7	3.0	3.5
AUSTRALIA	1.8	2.9	3.3	1.8	2.5	2.5
KOREA	2.8	3.0	4.0	2.2	2.4	2.9

Banca Aletti Forecast

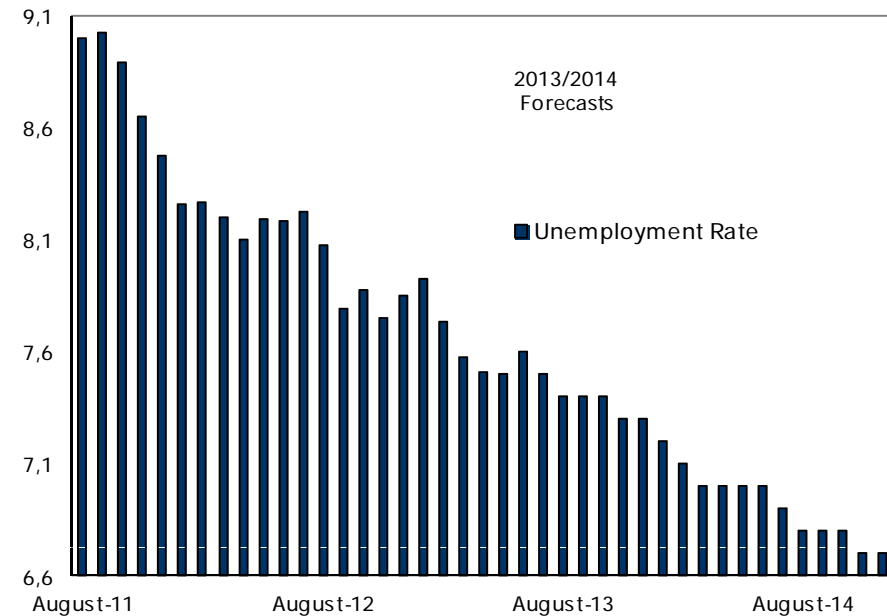
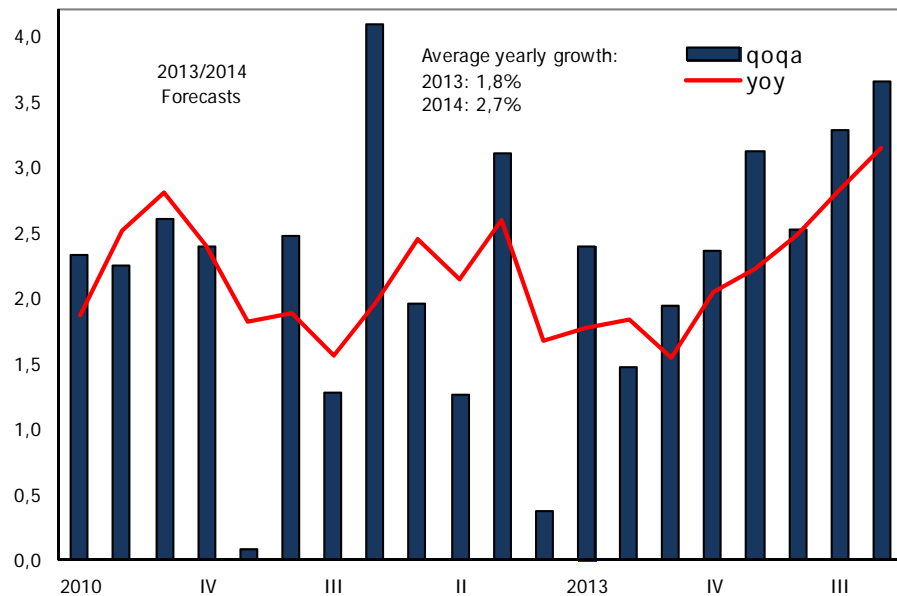
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FOCUS ON THE USA



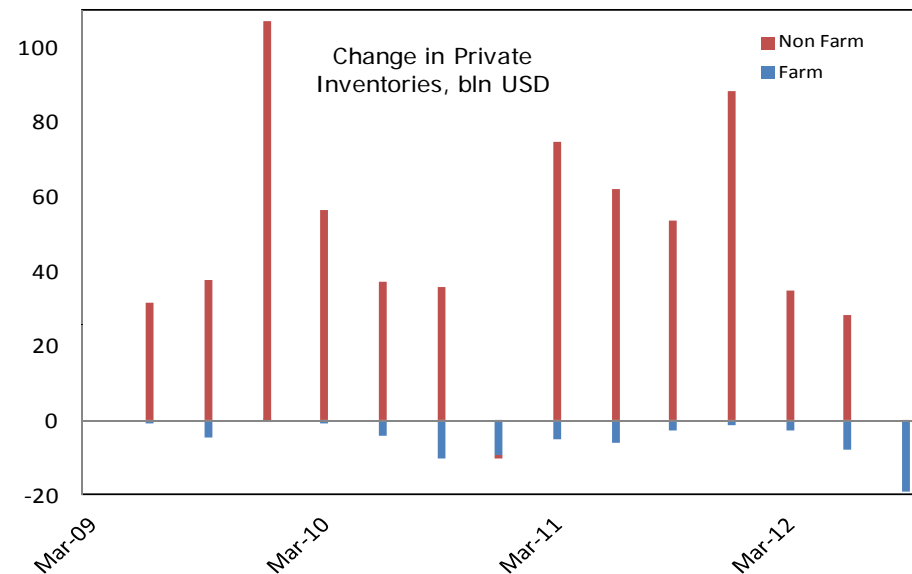
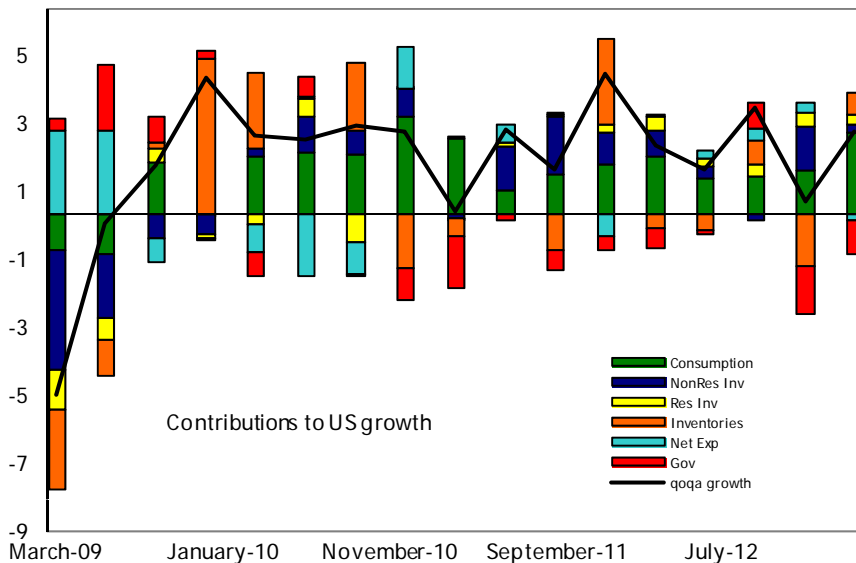
GDP GROWTH

After a stronger than expected Q1, the latest data have been mixed, confirming our forecasts for a weaker central part of the year, due to the impact of the Sequester and the Fiscal Tightening we are generally experiencing since the beginning of this year. Thanks to growth in Equities and real estate Assets prices and to the modest variation in households' total debt in the latest quarters, households' net wealth is almost back at its pre-crisis level. The adjustment process in households' balance is well underway, but not yet complete.



GDP GROWTH

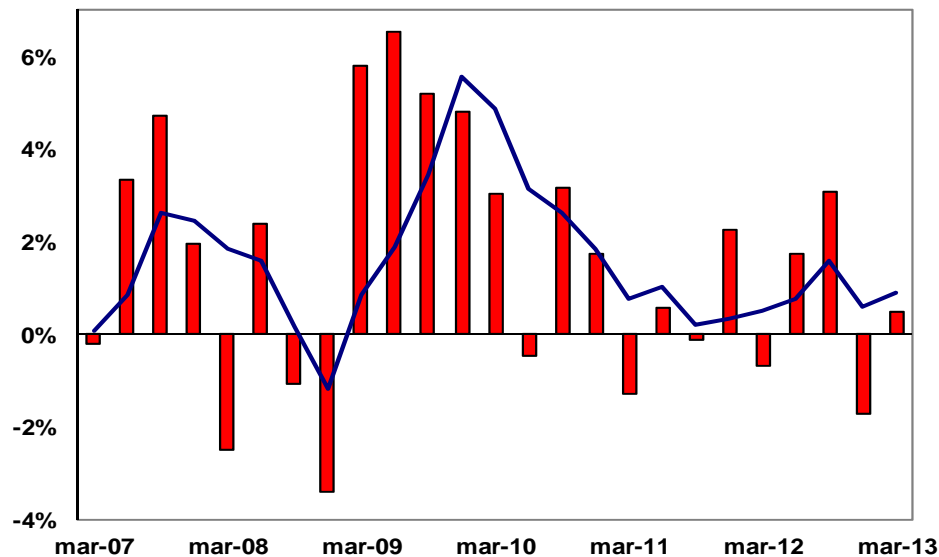
In Q2 we are also experiencing a slowdown in industrial activity due to lower restocking needs after Q1 accumulation. However, the reduced fiscal uncertainty and the improvement in investment intentions gives hope for investments growth in the coming quarters. At the same time, the real estate market recovery continues. So Q2 should be much weaker than Q1 (around 1.5% qoqa). The unemployment rate will decrease further, but we are still well above NAIRU. Overall, our forecasts for average USA GDP growth are at 1.8% for 2013 and at 2.7% for 2014. The main risks are on the downside and lie in fiscal policy and a possibly lower than expected global growth.



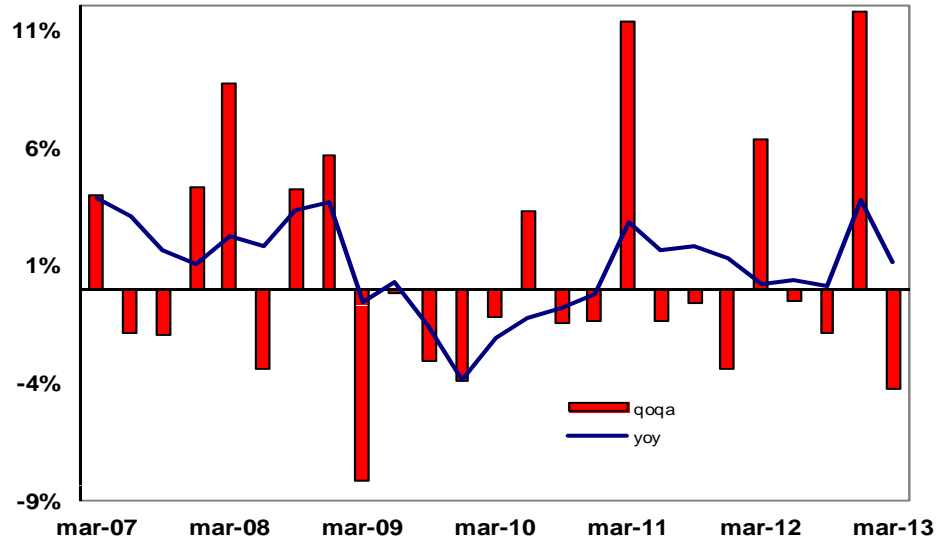
NONFARM SECTOR PRODUCTIVITY

Nonfarm Productivity estimates have been lowered to 0.5% in Q1 2013 (from a previously reported 0.6% qoqa growth). A surprise comes from the strong decrease in unit labour cost, down by 4.3% against the expected +0.5%. This drop is extraordinary. The BLS justifies this correction mostly with the 3.8% decrease in hourly wages. This is probably a payback after the strong increase in hourly compensation registered in Q4 2012, due to bonus and dividend anticipation to avoid tax increases in 2013. Although unit labour cost is one of the best measures of wage inflation, this series is more volatile than other measures of wage inflation that indicate a stable pressure at the moment. Thus, we believe there isn't downward pressure on wage inflation.

Output per Hour Nonfarm Sector sa

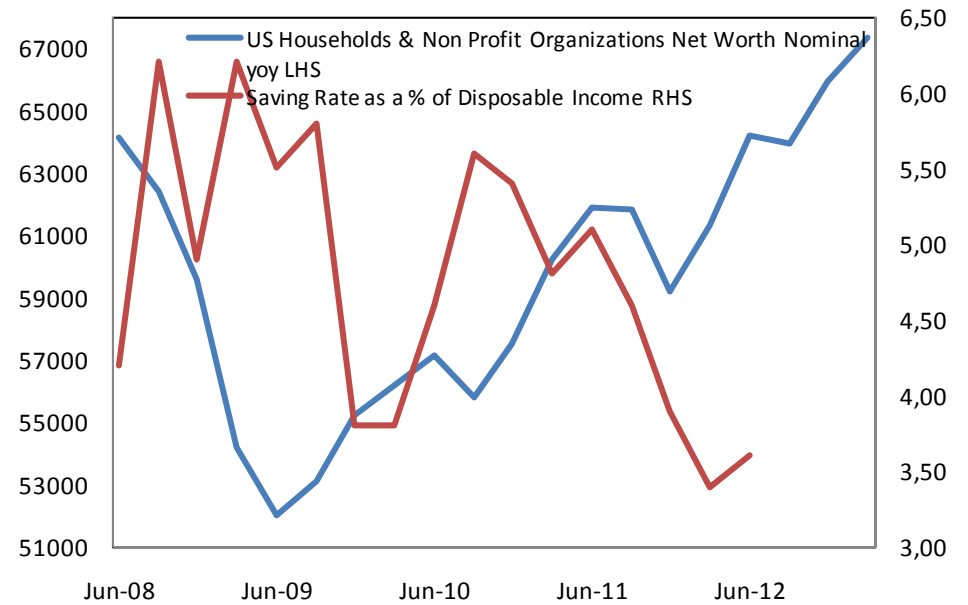
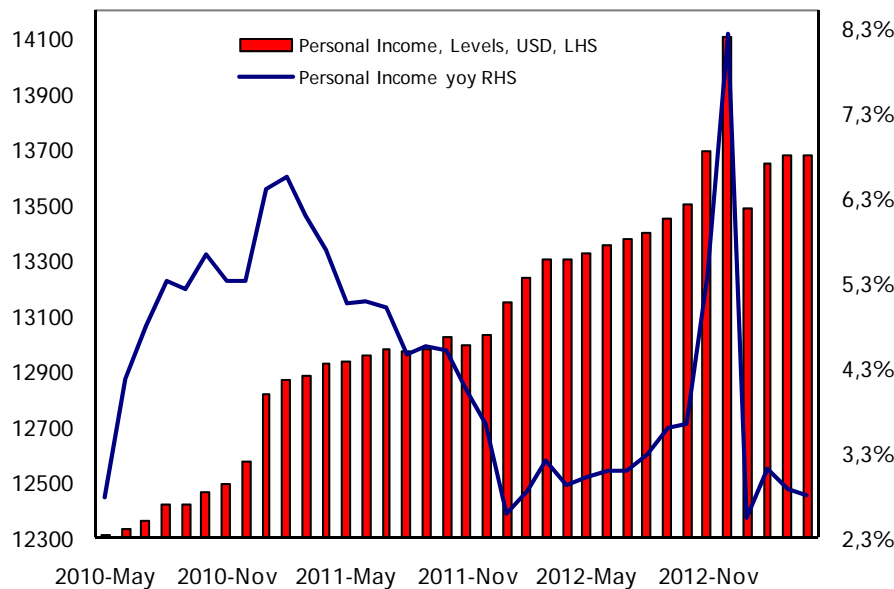


ULC Nonfarm Sector sa



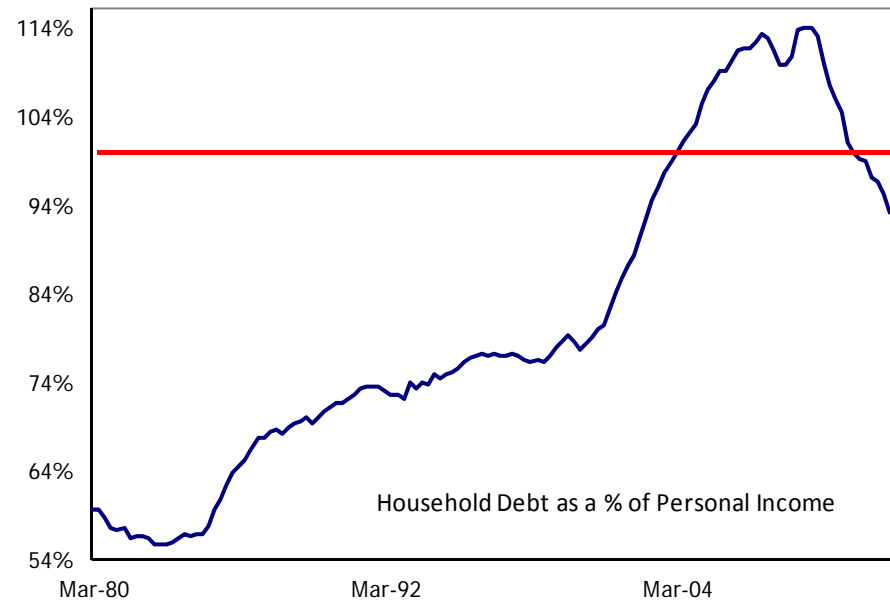
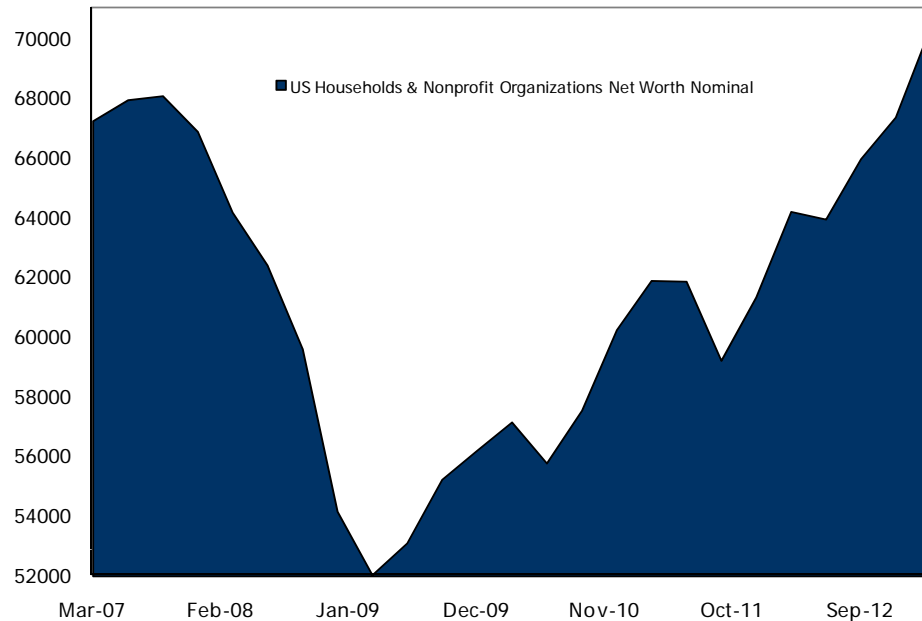
INCOME SLOWDOWN: SEQUESTER IMPACT

US Personal Income was flat in April, the first slowdown since May 2012. In April the wage dynamics is flat mom after +0.2% mom in March, stronger than implied by weekly earnings (-0.2% mom in April). The decrease in hourly earnings is due to a shorter working week, from 33.8 to 33.7, while hourly earnings are up 0.1% mom. The savings rate is at 2.5%, same as in April, with the March figure trimmed down from 2.7% originally estimated. This represents a modest rise from 2.1% in January when consumers tapped into their savings to maintain the same level of consumption despite the Fiscal Tightening which had led to a reduction of net salary for workers, with the end of the Payrolls Tax Holiday. This means that this trend will continue in the coming months and private consumption is expected to continue to slow down in the short run and the saving rate should rise again.



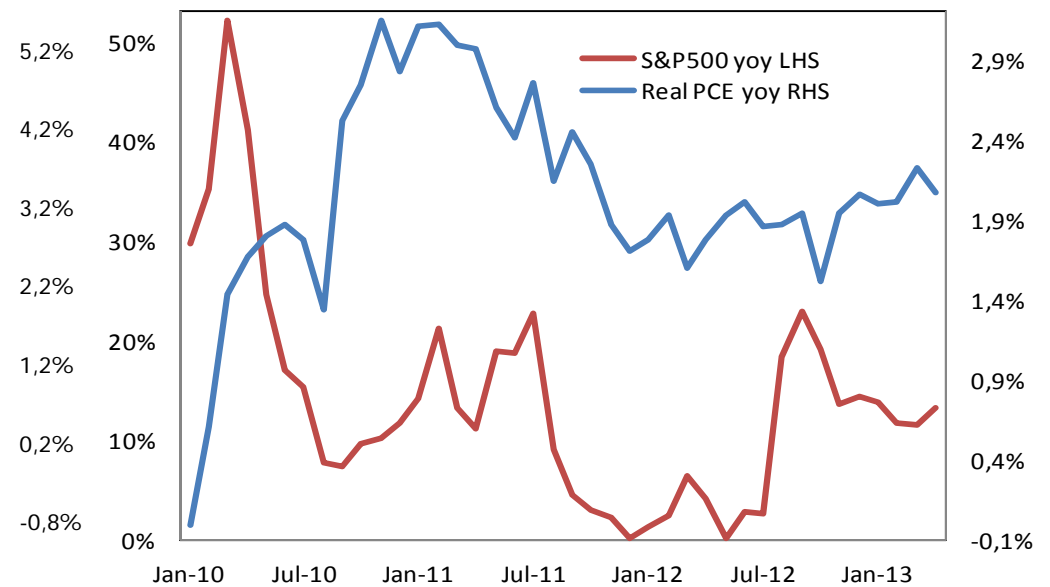
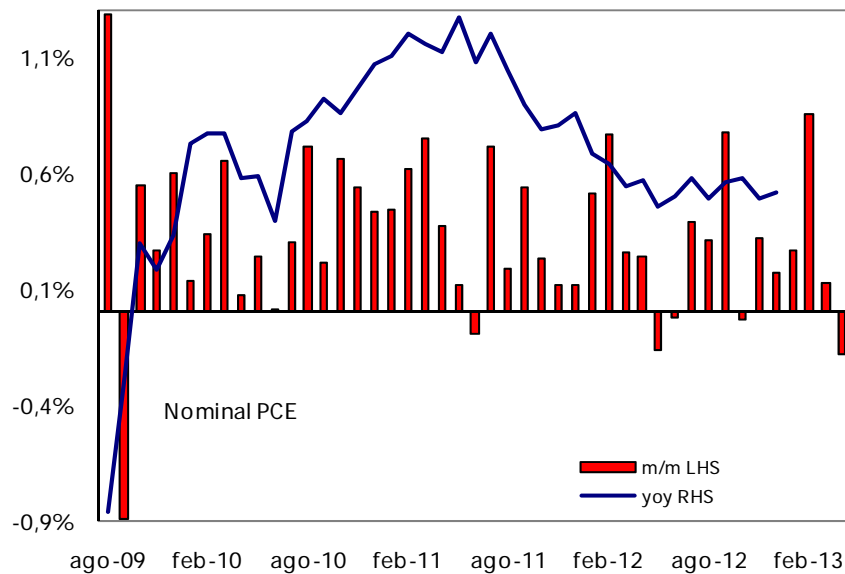
FLOW OF FUNDS: INCREASE IN WEALTH

The Fed Flow of Funds for Q1 2013 shows a 3 trl USD increase in Households' net wealth, which reaches a new peak, 70.349 trl USD. The increase was mostly determined by an increase in financial wealth, with the value of Equity and Mutual Funds withheld by US households up by 1.5 trl USD, while real estate Assets grew by 784 bln USD. The real estate sector is therefore contributing constantly to growth, through an increase in households' wealth that sustains aggregate demand, partly compensating the effect of Fiscal Tightening. This, coupled with the stock market rise, will further propel households' wealth in Q2. The data also show a continuous decrease in households' debt, with a -0.6% yoy change in Q1. In particular, mortgage debt decreased by 2.3% yoy, in line with 2012 decrease. Instead, consumer credit grew by 5.7% yoy, a slightly lower increase than in 2012.



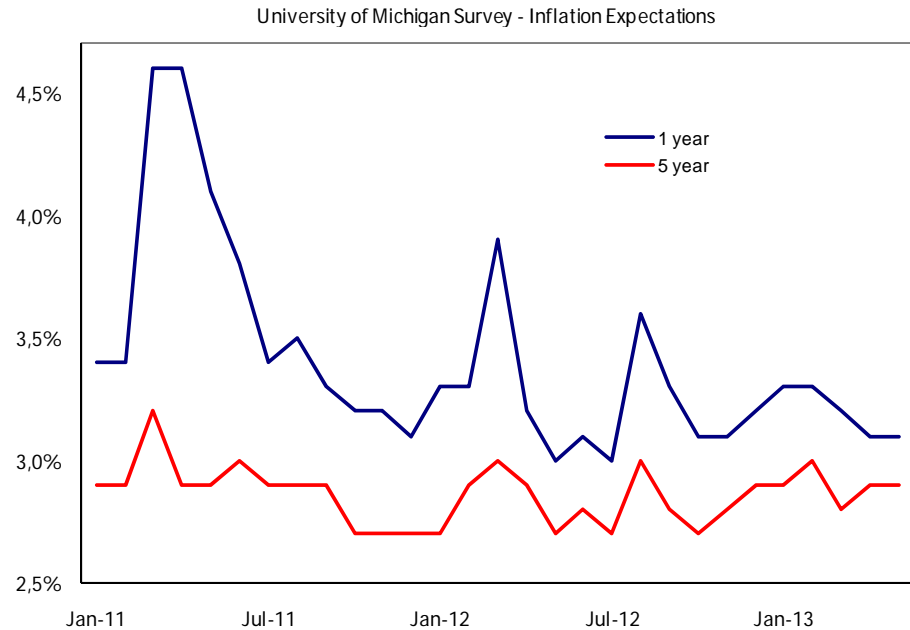
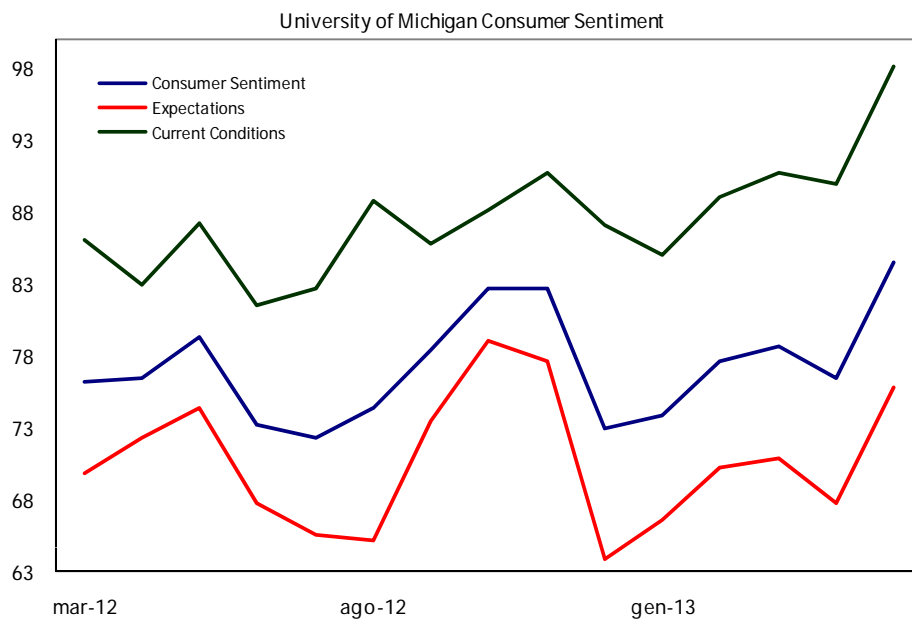
Q2 SLOWDOWN IN CONSUMPTION

As to the dynamics of personal spending, the April data registered lower growth than we expected, -0.2% mom, in nominal terms. The March data was at the same time revised to 0.1% mom from 0.2% mom originally reported. Only non durable goods component is decreasing (-1.15% mom), while durable goods consumption is rising (0.369% mom) and so is consumption of services (0.060% mom). Consumption of service in nominal terms was sustained by bad weather conditions in April, which pushed Utilities Consumption. In real terms, spending registered a stronger growth, 0.1% mom from 0.2% mom in March, with the deflator of PCE headline falling by 0.3% mom, in line with what implied by April CPI. Thus, April real consumption opens Q2 1.5% annualized higher than Q1 average, carrying a weak momentum in Q2. On this basis, we expect real consumption growth in Q2 between 2% e 2.5% qoqa, well below the 3.4% of Q1, with a Q2 GDP that should be around 1.5% (qoqa).



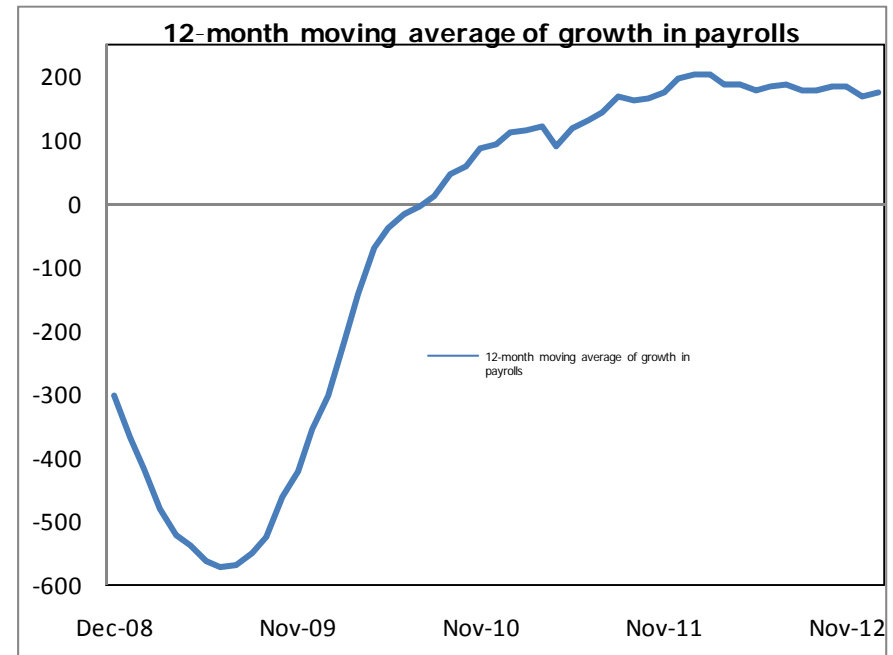
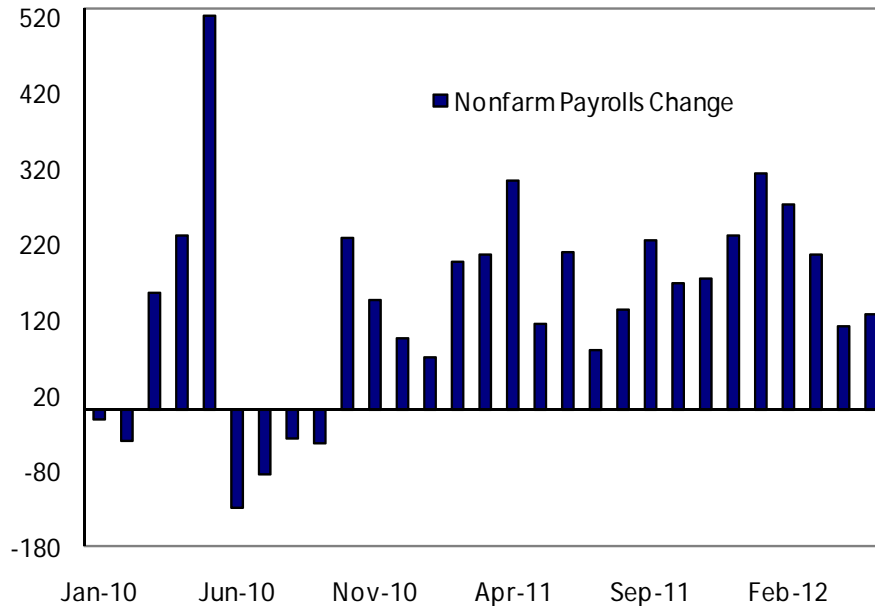
CONSUMER CONFIDENCE, UMICH

The University of Michigan Consumer Sentiment was revised upwards with the final May data, at 84.5, the highest since July 2007. The improvement is driven by high income families, while confidence in middle and low income families started improving later, at the end of May. Indeed, with less coverage on the Sequester and fiscal issues, the mix of economic news perceived by consumers was more favourable in May than in the past 10 years. For the first time in the past five years, more consumers reported an improvement in their personal finances than those who didn't, with increases in income seen as the main reason for this growth. Thus, we see the highest propensity to invest in durable goods since mid 2007 and the highest since mid 2005 for vehicles. This suggests growth in consumption in the medium term.



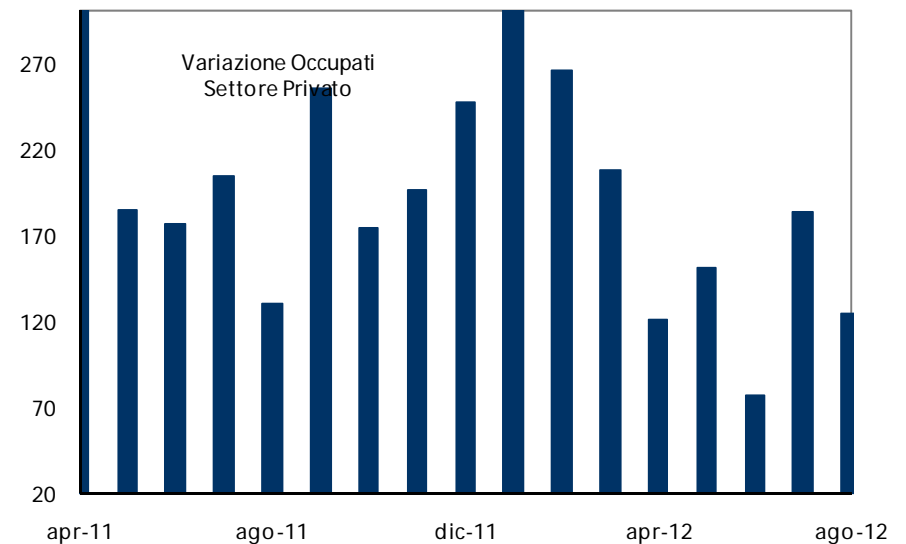
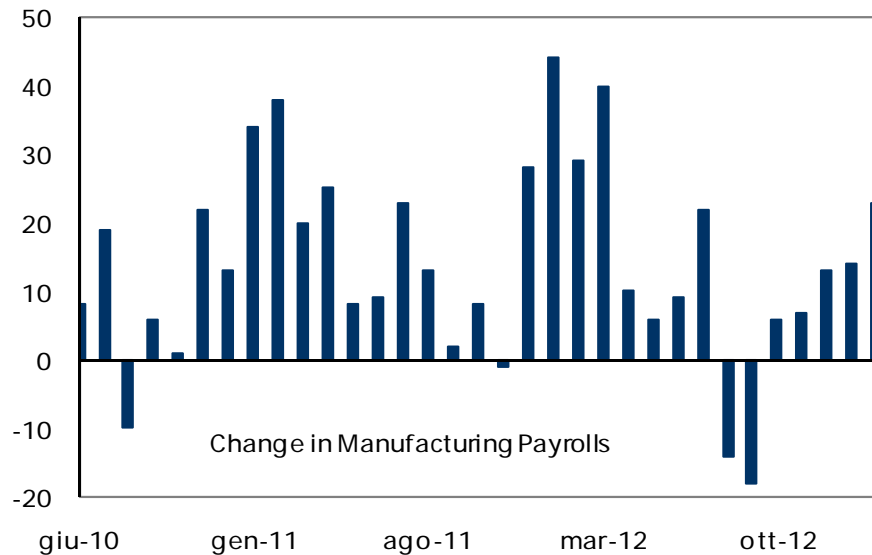
JOB MARKET, NEWLY EMPLOYED

The May Employment Report indicated the creation of 175K new jobs in the month, higher than we expected (154K). This figure was partly compensated by net negative revision for the prior two months data. The data is certainly positive, indicating a growth in the job market, but non fully convincing. In fact, the average new jobs created in the past three months is 155K, slowing down from the past six months average (194K).



JOB MARKET, BY SECTOR

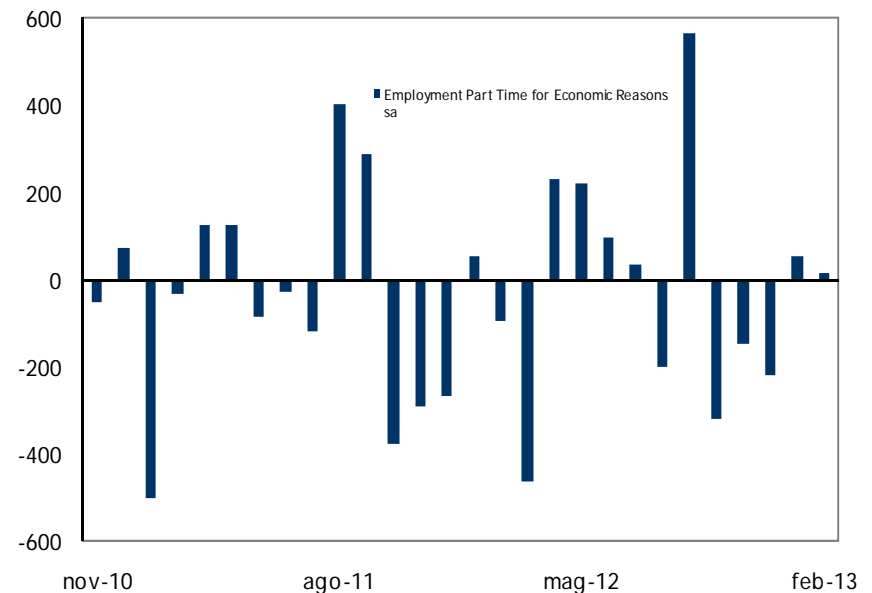
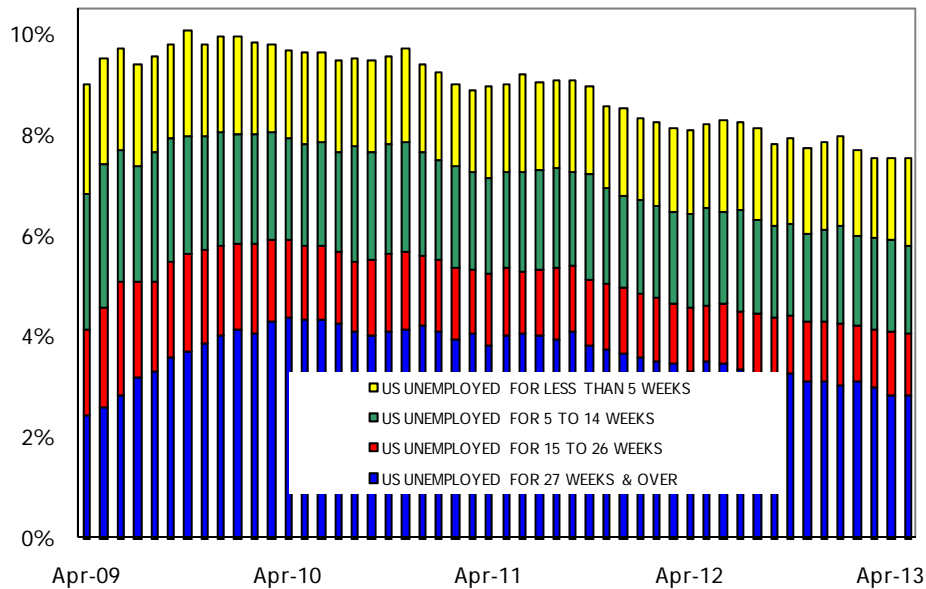
The Manufacturing sector lost 8K jobs in May. This backdrop had been anticipated by regional indicators of manufacturing surveys and by the national ISM, that highlighted the weakness in this sector after the strength displayed in the first part of the year, thanks to restocking needs. The Government sector lost 3K jobs. In particular, federal employees, net of postal service, dropped by 14K. That's a higher than 10K loss for the third month in a row, suggesting an impact from the Sequester. On the other hand, the public sector at the Local level registered an increase of 13K employees. Private sector saw 178K new jobs. Worth mentioning, the strength of Professional and Business Services (+57K) and Leisure and Hospitality (+43K). Among Professional e Business Services, Temporary Help registered a good increase (+26K).



JOB MARKET, HOUSEHOLD SURVEY AND INCOME

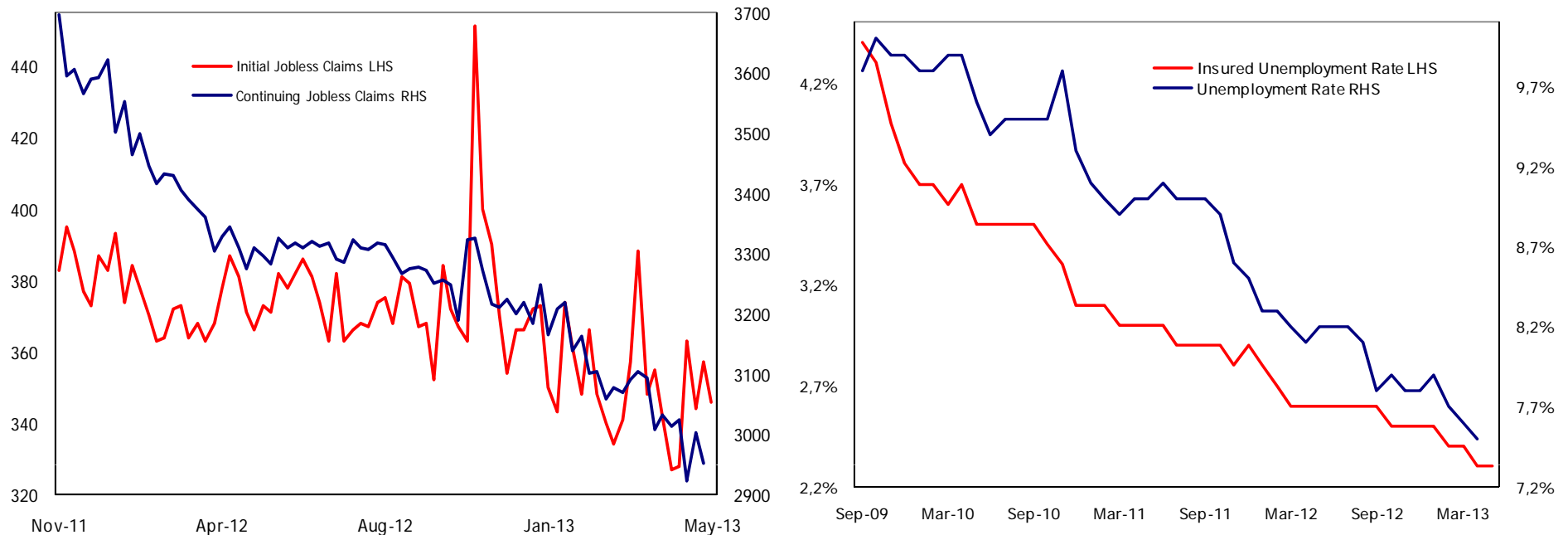
The Household Survey signals unemployment rate rising slightly to 7.55%. This is however a good news because the participation rate rose from its all time low in April (at 63.3% from 63.4%), with households' higher confidence to find a new job. Another positive signal in job market confidence comes from the number of people who spontaneously quit their job (so called Job Leaves), up to 944K from 864K. From the Consumer Confidence Survey published by the Conference Board, we gather a net improvement in current job market perceptions and indeed the Household Survey recorded a 319K increase in Civilian Employment. The rate of UnderEmployment (Unemployment Rate + Marginally attached workers + Part-time for economic reasons) fell to 13.8% from 13.9%. In particular, people working Part Time for Economic Reasons are down to 28.5% from 28.7%. Average Hourly Earnings overall remained flat, while Average Weekly Hours are flat at 34.5.

Unemployment Rate



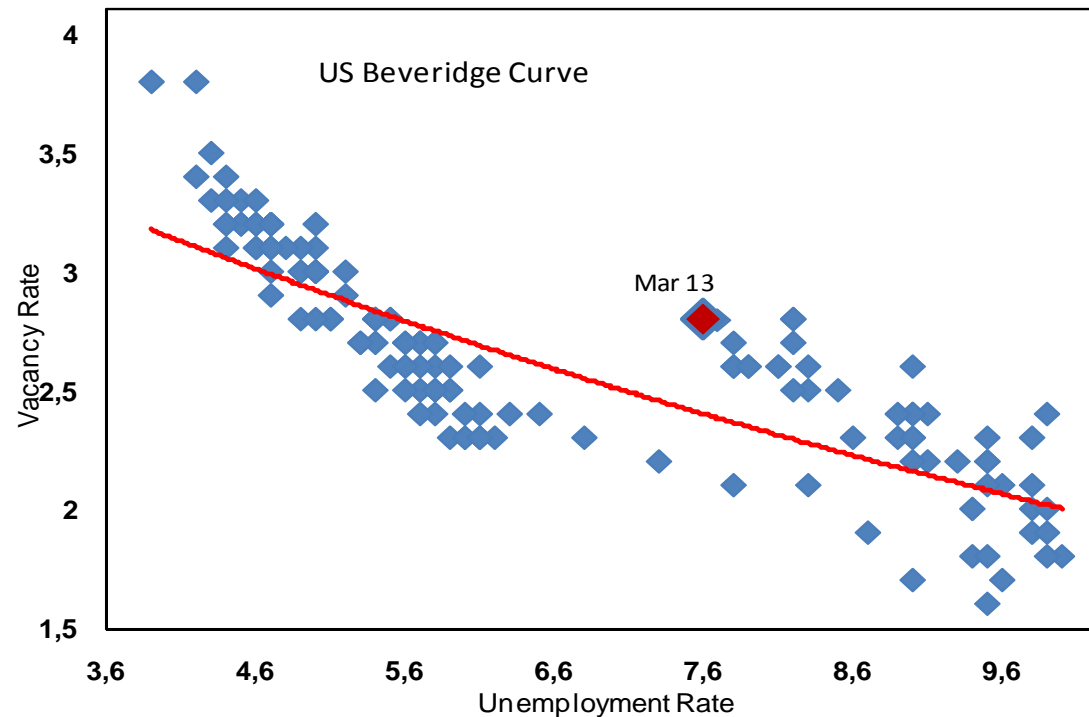
JOB MARKET, JOBLESS CLAIMS

Initial Jobless Claims dropped to 346K for the week ended June 1, an 11K decrease from the prior week, which recorded 357K claims (revised from 354K originally estimated). The 4-week moving average is at 352K, with a 4K increase vs. previous week. It's the fourth week in a row with an accelerating 4-week moving average. The Labour Department hasn't mentioned any anomaly in data on a state level, nor needed to estimate any state's data, thus suggesting a clean report. On the other hand, for the week ending May 25, Continuing Claims fell by 52K to 2952k, with previous week's data revised to 3004K from 2986K originally detected.



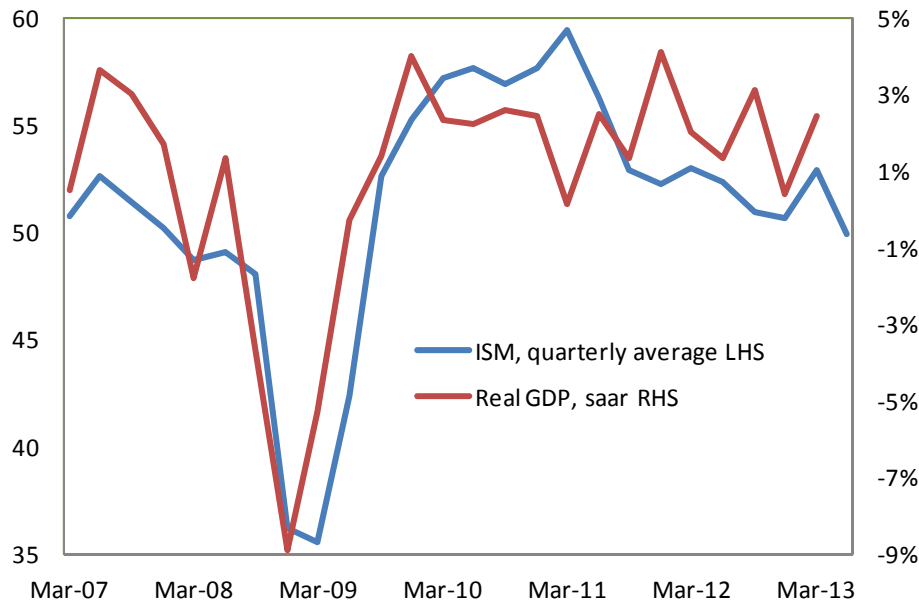
BEVERIDGE CURVE

The Beveridge Curve represents the relation between unemployment rate and Job Vacancy Rate (number of vacant jobs as % of total labour force), from JOLTS data published by the BLS. The outliers represent inefficiency of the labour market and a mismatch between unemployed and available jobs (per *skills* or location). During recessions we are usually under the curve on the right hand side, with high unemployment and few vacancies, while during expansions there are a lot of vacancies and low unemployment (above the curve on the left side). Hence, this chart suggests we are still in an uncertain situation, with the unemployment rate at historically high value, but the vacancy rate higher than during recessions.



MANUFACTURING BUSINESS CONFIDENCE

Manufacturing ISM decreased to 49.0 from 50.7 in April, in line with our expectations. This is the first time the survey dips into contractionary area since November 2012 and the minimum since June 2009, the last month of the Great Recession. The index is decreasing for the third month in a row, in line with a slowdown in the economy after a stronger than expected beginning of the year. The April and May average value for Manufacturing ISM is 49.9, in line with our GDP growth estimate in Q2, currently between 1.5% and 2.0% qoq. The drop in manufacturing ISM under 50 in May didn't come as a surprise after the weak performance of almost all regional surveys in the month. The biggest surprise came from the Chicago PMI, with its net consolidation.

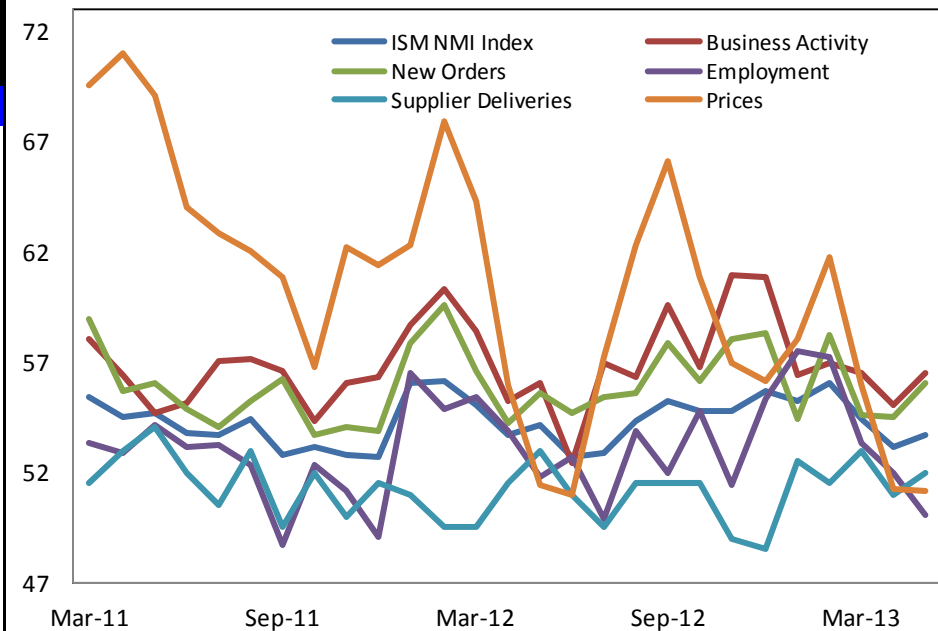


	ISM Man	New	Prod-	Employ-Delivery	Invent-	Prices	
Month	Index	Orders	uction	ment	Time	ories	
Weights	100%	20%	20%	20%	20%	20%	
May-12	52,5	57,2	54,1	55,9	49,2	46,0	47,5
Jun-12	50,2	49,6	52,4	55,7	49,5	44,0	37,0
Jul-12	50,5	47,5	53,3	53,2	49,7	49,0	39,5
Aug-12	50,7	48,9	48,9	52,6	50,2	53,0	54,0
Sep-12	51,6	51,7	51,4	53,7	50,5	50,5	58,0
Oct-12	51,7	52,8	53,3	52,3	49,9	50,0	55,0
Nov-12	49,9	51,1	53,1	50,1	50,1	45,0	52,5
Dec-12	50,2	49,7	52,6	51,9	53,7	43,0	55,5
Jan-13	53,1	53,3	53,6	54,0	53,6	51,0	56,5
Feb-13	54,2	57,8	57,6	52,6	51,4	51,5	61,5
Mar-13	51,3	51,4	52,2	54,2	49,4	49,5	54,5
Apr-13	50,7	52,3	53,5	50,2	50,9	46,5	50,0
May-13	49,0	48,8	48,6	50,1	48,7	49,0	49,5

NON MANUFACTURING BUSINESS CONFIDENCE

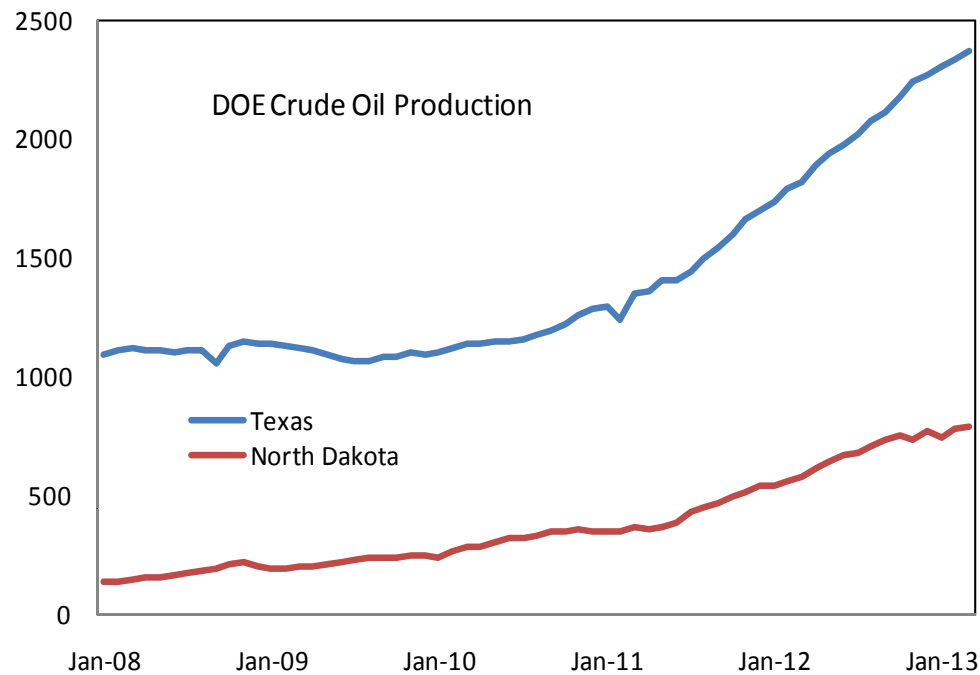
The Non Manufacturing ISM index grew in May by 0.6 points to 53.7. The details of the index are mixed. On the positive side, the new orders index, an indicator of future activity, grew by 1.5 points to 56.0, while the activity index increased to 56.5 from 55.0. However, New Export Orders decreased by 3.5 points in May, as global demand continues to shrink. The employment rate fell from 52.0 in April to 50.1 in May, reflecting weakness in the Non Manufacturing job market. Overall, this report is positive, with the headline index increasing after two months of contraction.

Mese	ISM NMI Index	Business Activity	New Orders	Employment	Supplier Deliveries	Prices
Pesi->	100%	25%	25%	25%	25%	
giu-12	52,7	52,4	54,7	52,7	51,0	51,0
lug-12	52,9	56,9	55,4	49,9	49,5	57,2
ago-12	54,3	56,3	55,6	53,9	51,5	62,3
set-12	55,2	59,6	57,8	52,0	51,5	66,1
ott-12	54,8	56,8	56,1	54,8	51,5	60,8
nov-12	54,8	60,9	58,0	51,4	49,0	56,9
dic-12	55,7	60,8	58,3	55,3	48,5	56,1
gen-13	55,2	56,4	54,4	57,5	52,5	58,0
feb-13	56,0	56,9	58,2	57,2	51,5	61,7
mar-13	54,4	56,5	54,6	53,3	53,0	55,9
apr-13	53,1	55,0	54,5	52,0	51,0	51,2
mag-13	53,7	56,5	56,0	50,1	52,0	51,1



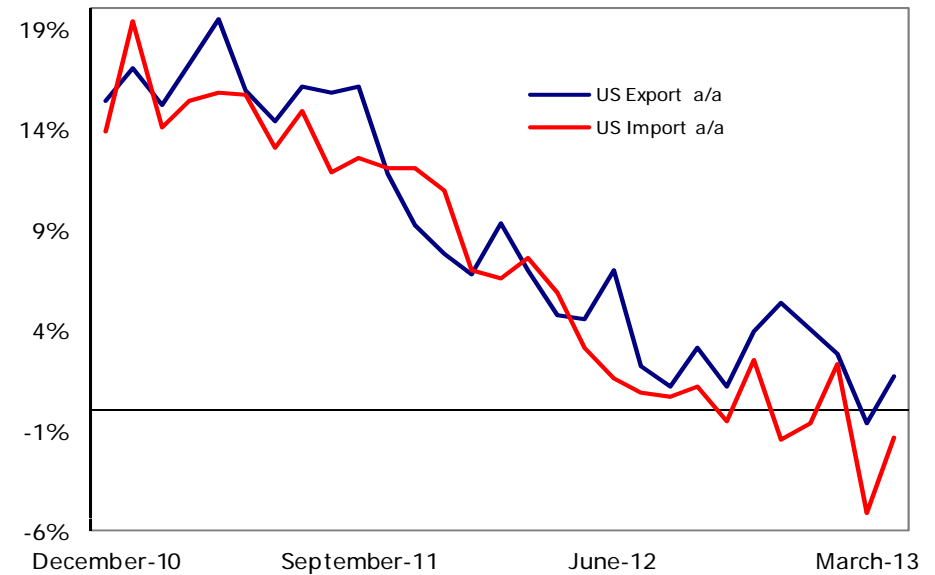
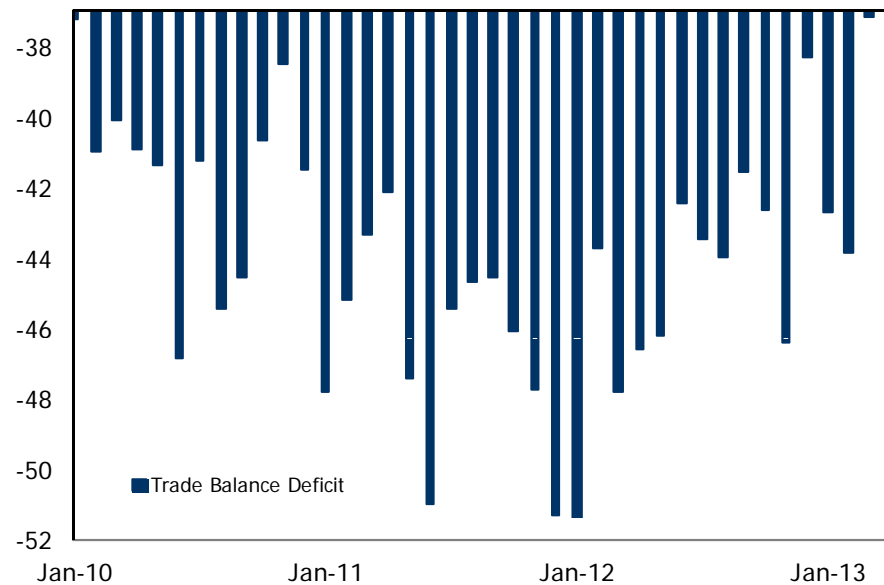
ENERGY SECTOR

The energy sector will continue to give a positive contribution to growth and employment in the coming quarters, thanks to exploitation of Shale Oil and Shale Gas.



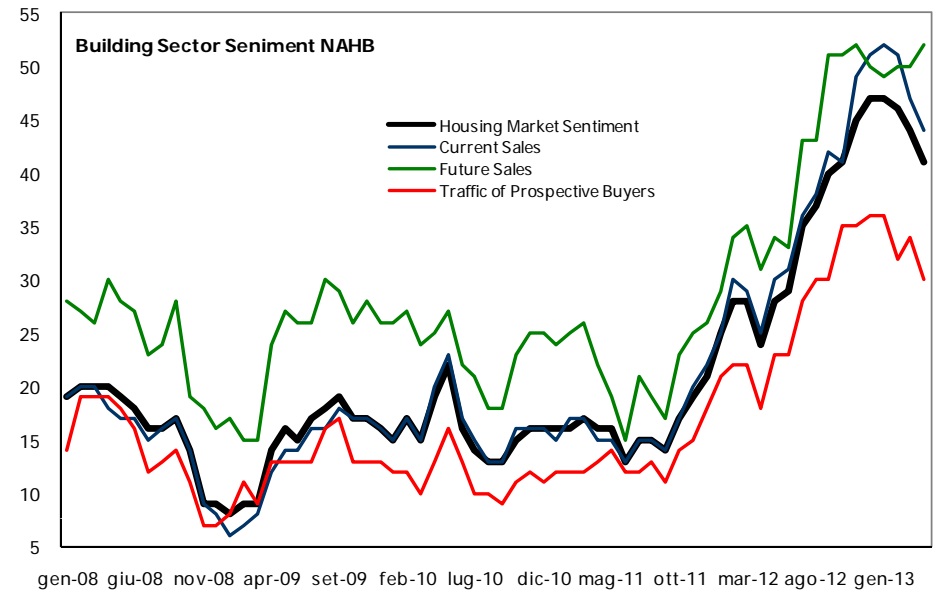
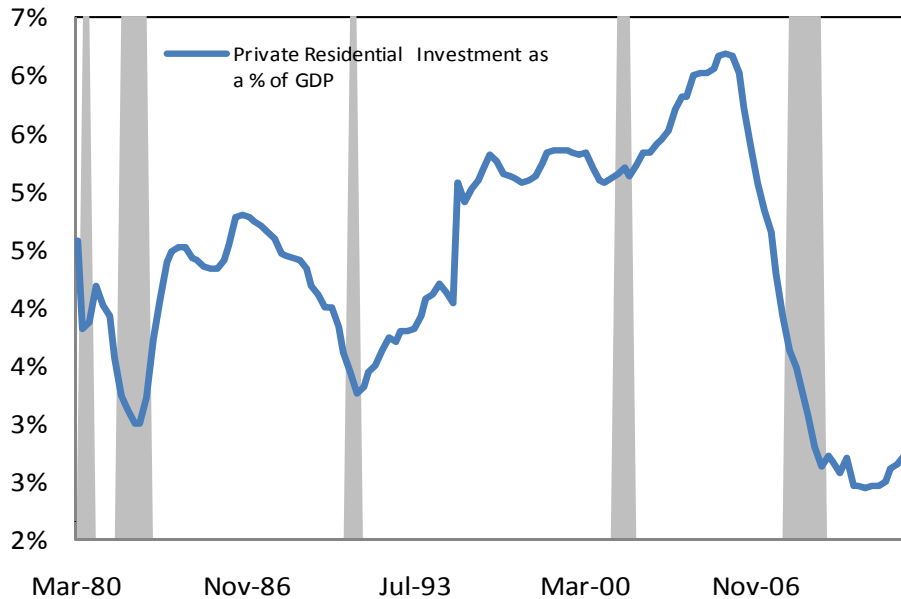
TRADE BALANCE

The US Trade balance in April shows a widening in trade deficit to -40.294 bln from -37.132 bln in March (from -38.8 bln originally measured), due to growth in exports lower than that of imports. Also in real terms there has been a larger deficit, at -47.563 bln from the revised 44.642 bln USD in March. Thus trade data for April is modestly increasing compared to Q1 average (0.195 bln USD wider), confirming our forecasts for Q2 neutral contribution to growth from Net Trade.



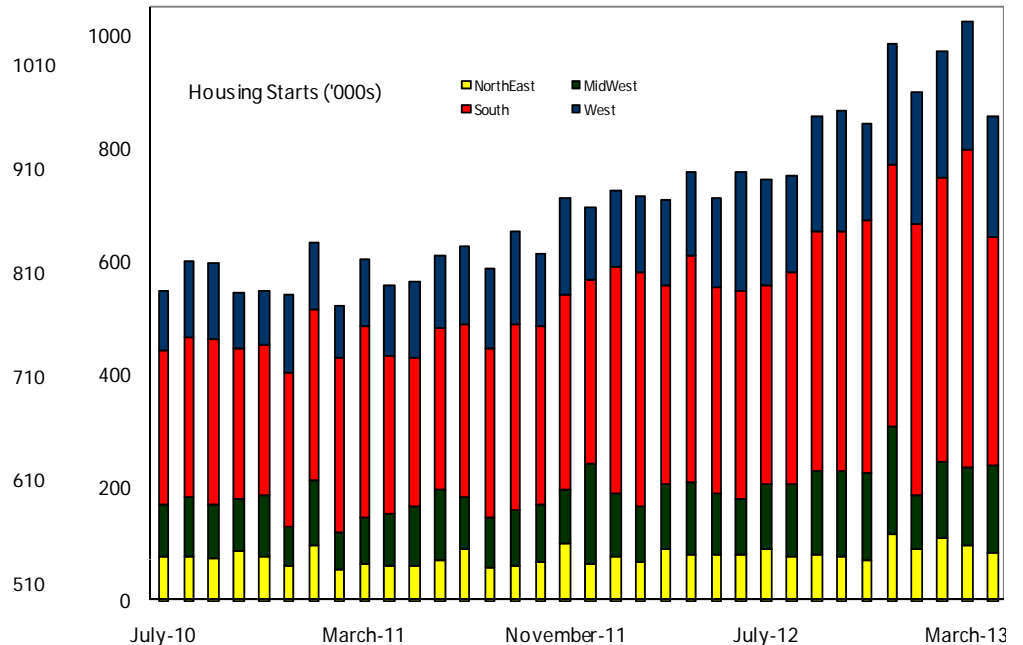
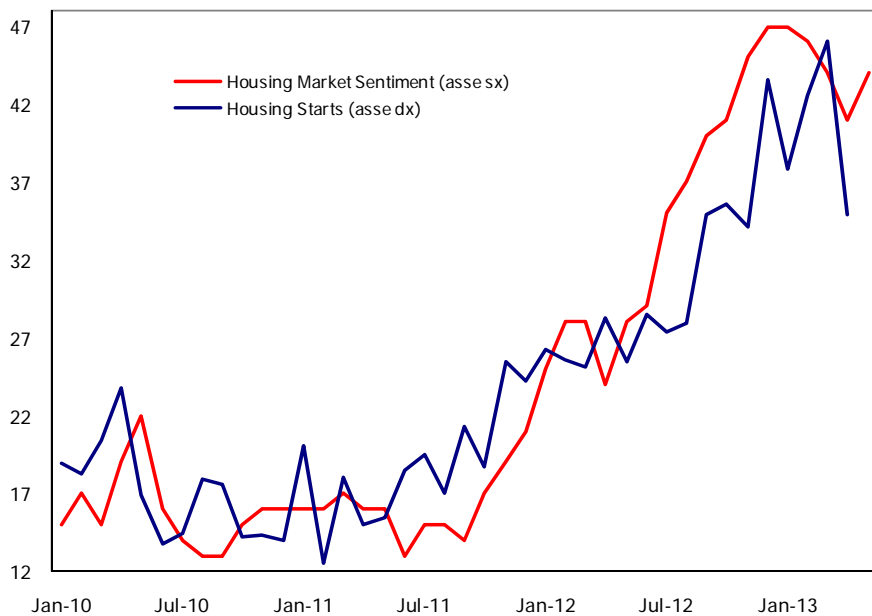
HOUSING RECOVERY CONTINUES

The recovery in Real estate is consolidating and expanding. We expect a positive contribution to growth from Residential Investments also in 2013, as anticipated by builder confidence published by the NAHB, which remains high despite the correction experienced at the beginning of the year.



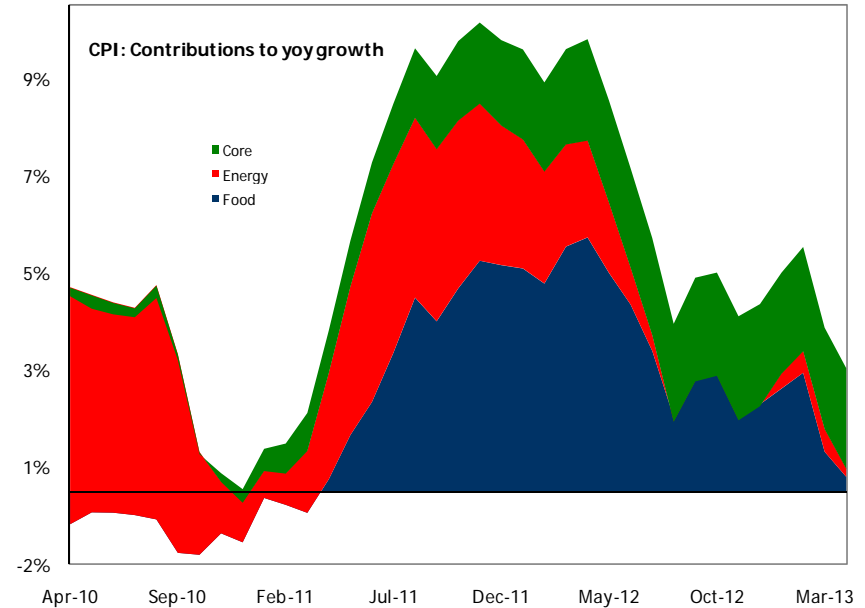
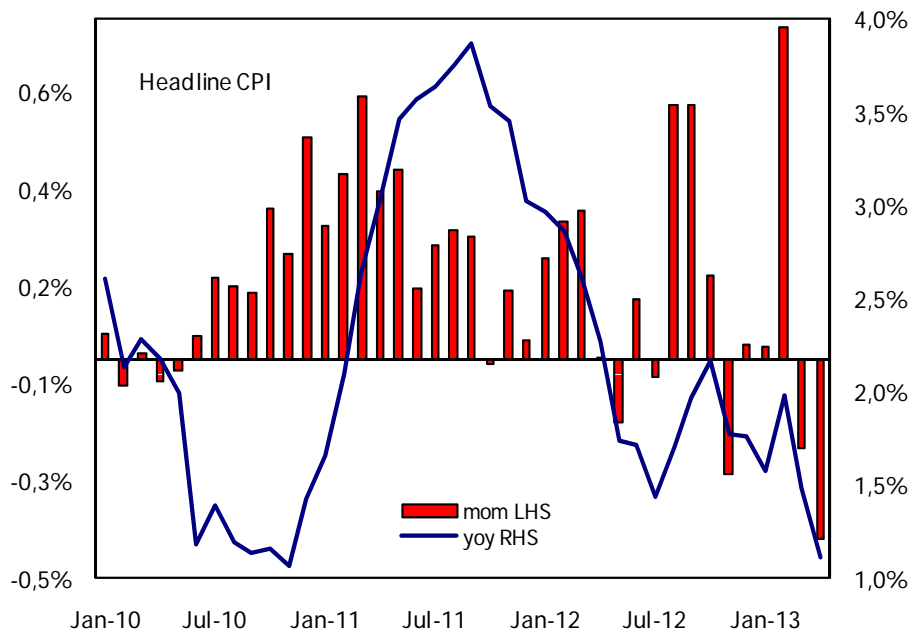
HOUSING STARTS STILL STRONG

In April Building Permits surprisingly increased by 14.3% mom. The strong growth in Permits Demand is mainly concentrated in the multi-family segment, that in April grew by 37.5% mom after the March fall (-17.3% mom). The jump in April Building Permits anticipates a probable rebound in May Housing Starts (usually there's a ½ months lag between the two series). Also, NAHB builder confidence bounced back to 44 in May from 41 in April. In particular, Sentiment on current sales of single family homes improved. This signals a probable increase in Housing Starts in May as well. Also, builder confidence for sales perspectives in the next six months grew further in May, suggesting a positive outlook for the future as well.



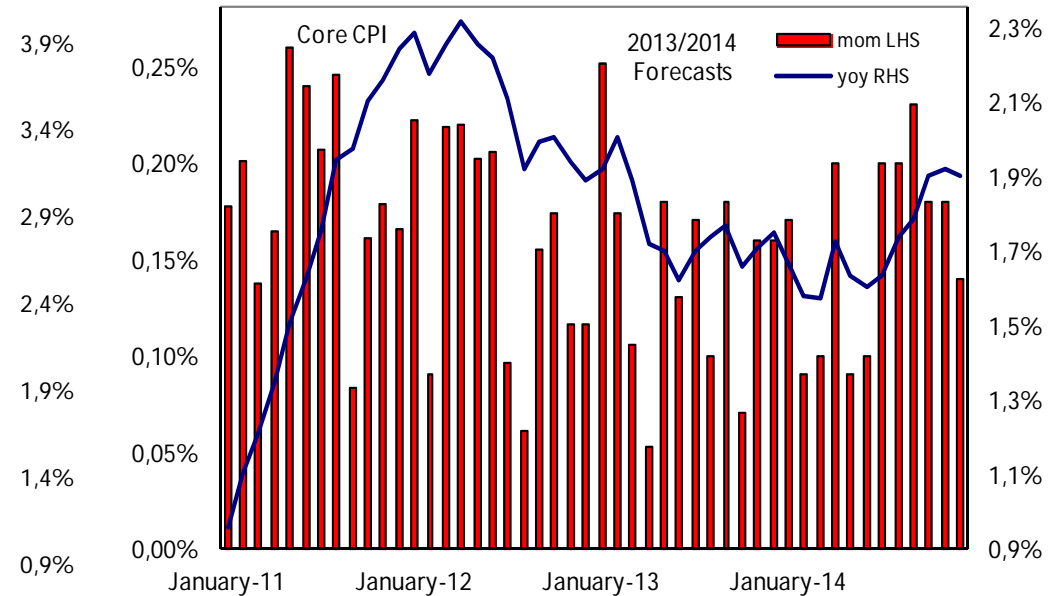
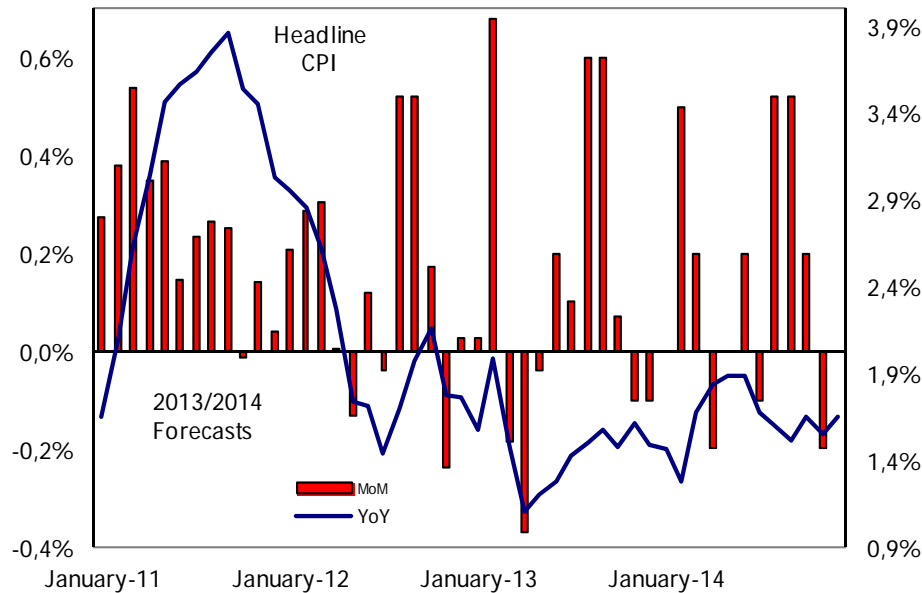
CONSUMER PRICES

Headline CPI decreased by 0.4% mom in April after a smaller decline in March (-0.2% mom), triggered principally by the Energy component, which decreased by 4.3% mom. On the other hand, the Food component registered a 0.2% mom growth. The Core index, CPI less Food and Energy, registered a 0.1% growth mom, the same as in March. This confirms what seen in import prices and in PPI in April. In yoy terms, Headline CPI recorded a marked slowdown, to 1.1% yoy from 1.5% in March, which represents the lowest trend growth rate since October 2009. Core CPI is slowing down as well, to 1.7% yoy from 1.9% in March, marking its minimum since June 2011.



INFLATION

Overall, we expect inflation to stay below 2% for the whole forecasting horizon, thanks to the output gap accumulated during the Great Recession and these three and a half years of weak recovery. There is a downside risk to our forecast, if the commodities correction due to the global slowdown continues. Core CPI growth will be driven by Shelter Costs. Overall, our forecasts are: average Headline CPI at 1.5% in 2013 and at 1.6% in 2014, average core CPI at 1.8% in 2013 and 2014.



MONETARY POLICY, BEIGE BOOK AND ROSENGREN

- The Fed's **Beige Book**, prepared with information available until May 24, describes US economic activity growing modestly. The housing sector supported growth, with smaller improvements in the manufacturing sector, bank loans and transportation. Although employers continue to have a hard time finding skilled workers, many have intentions of hiring. Overall, therefore, the report is consistent with the data we've seen so far in Q2.
- Reports on manufacturing activity were overall positive, with growth in Boston, Cleveland, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas e San Francisco Districts. Instead, short term outlook weakened in New York and in the Philadelphia district, which refer a decline in orders. Consumption grew moderately. Stock levels are reported at generally desired levels in New York and Chicago, in line with our forecasts that the reduced restocking needs will contribute to a lower growth in Q2.
- Bank credit grew modestly compared to the April Beige Book. Part of this growth was stimulated by strength of the residential sector. Hirings are signalled on the rise in several districts. This is in line with our idea that unemployment is still high due to a lack of skilled labour. The districts of Richmond and Atlanta talk of job furloughs in Federal offices. Pressure on wages is moderate.



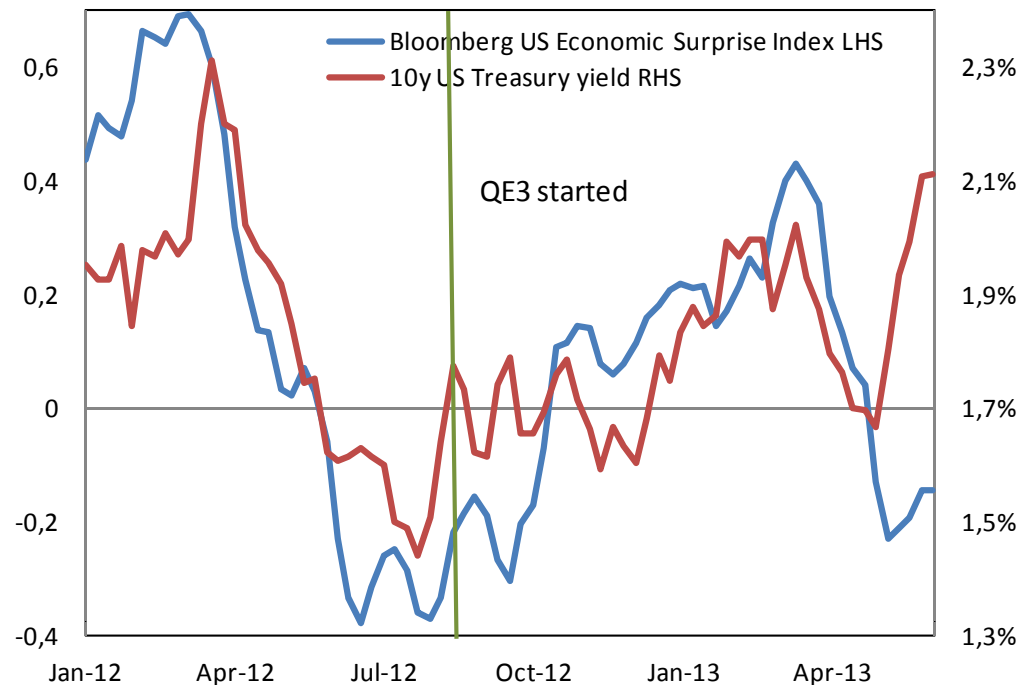
MONETARY POLICY, BEIGE BOOK AND ROSENGREN

- In a recent speech, **Rosengren**, President of the Boston Fed, contributed to building expectations about a near tapering in Fed's asset purchases program. He made a distinction between conditions necessary for a complete stop to the purchases and those who simply justify a tapering of the program;
- Rosengren clarified how the conditions to completely halt the purchases completely are quite strong, highlighting how the Fed should carry on with its programme until there will be a more substantial improvement in the labour market and economic recovery will be self sustaining. On the other hand, Rosengren also stressed how the conditions for a slight slowing down of purchases over a longer time span could be more stimulating than a higher pace of purchases for a shorter period. This argument, coming from a dovish member, seems to communicate tapering as a real possibility, while reassuring financial markets that the extraordinary level of monetary accomodation will stay in place.



MONETARY POLICY, TAPERING QE3

After Bernanke's Testimony at the JEC and comments by Boston Fed's President Rosengren, markets started discounting the likely tapering in the pace of the Fed's asset purchases. Bloomberg's Economic Surprise Index has historically been positively correlated to the performance of the 10y Treasury yield, but after this Testimony (22 May) the two series started to diverge.



MOTIVATIONS FOR QE3 REDUCTION

- **Stronger confidence in the macroeconomic outlook**, thanks to the reduction in both fiscal uncertainty in the US and in the extent of the Eurozone crisis, despite remaining concerns about Chinese and other emerging economies growth and the ongoing debate on fiscal policy in the US. If, indeed, growth accelerates at the end of the year, then long term rates will increase with a further selloff of long term Treasuries;
- **Labour productivity consistently low**: in the past years the improvement in the labour market has been relatively strong, compared to the weak growth registered over the same period, thereby leading to a reduction of labour productivity. If the Fed thinks that labour productivity will remain low, the growth needed to bring increases in employment of at least 200K per month is lower than previously estimated. Thus, with relatively low growth, in this case long term rates should not grow significantly;
- **Cost of QE3**: Bernanke highlighted an increase in risk appetite in certain asset classes which could become problematic. Therefore, the change in rhetoric by the Fed could reflect higher concerns on the costs of asset acquisitions. For example: the recent rise in mortgage rates might suggest that "*irrational exuberance*" has contributed to the rally in Real estate market. Also in this case, long term rates should not grow significantly;



MOTIVATIONS FOR QE3 REDUCTION

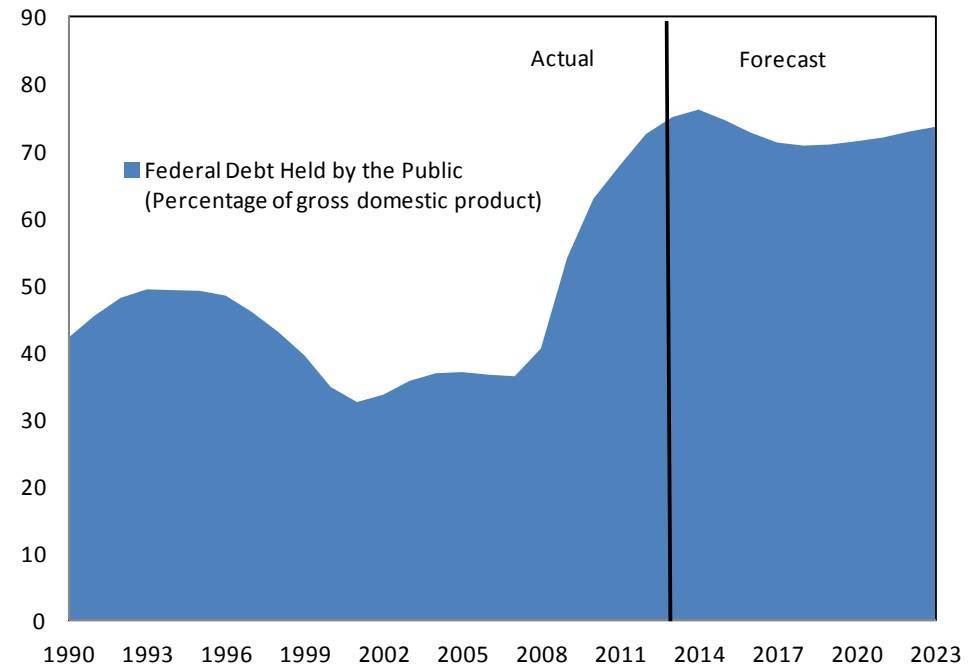
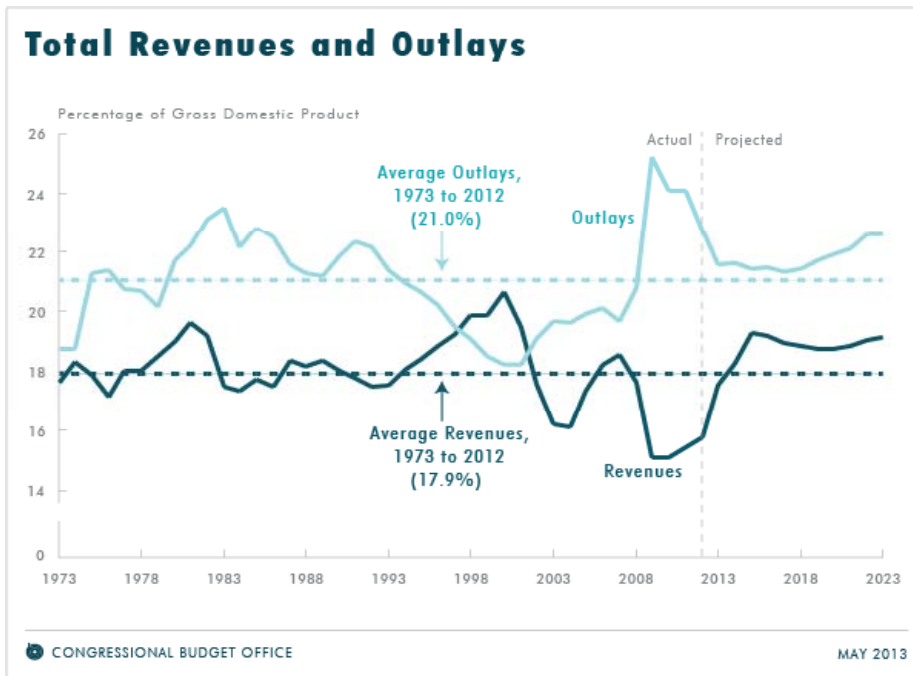
- **Drop in Participation Rate and Exit Strategy:** Unemployment rate is decreasing faster than expected by many members of the FOMC. Therefore, some members would like to start reducing purchases, as the threshold to raise FF is approaching (unemployment rate at 6.5%) quicker than expected. Also in this case, long term rates should not grow significantly;
- **Bernanke's intention to prepare the Exit Strategy:** Bernanke would at least start the Exit Strategy before the end of his mandate in February 2014. Also in this case, long term rates shouldn't grow significantly.

In any case, if US potential growth has been reduced after the Great Recession (as we believe), long term rates could not increase strongly, following the Japanese example in the past 20 years.



FISCAL POLICY: NEW CBO FORECASTS

On May 14 CBO strongly cut its budget deficit forecast for FY 2012 (by around 200 bln), to 642 bln USD (4% of GDP) from 5.3% in February, quite off the 10.1% peak in 2009. Reasons for the cut include: improvement of the economy, tax raises since January 1, Sequester (public spending cuts) and good dividend payouts from Fannie and Freddie on the Treasury's share, thanks to the housing recovery. The deficit should reach 2.1% in 2015 and then grow to 3.5% in 2023 due to growing costs associated to aging population, growing health costs, increasing federal subsidies for health insurance and increasing interests on debt. With these deficit forecasts, Federal debt will remain over 70% of GDP, while in the past 40 years it averaged 39% (at the end of 2007 it was 36%). Under current legislation, it should reach 71% in 2018 and then grow again to 74% in 2018 and keep increasing in the following years.



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