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CAPITAL DAILY

Global economic and market analysis from Capital Economics

Too soon to look to China to rescue the world

- ***China's investment stimulus is proving to be a mirage***
- ***Government bond yields still have further to fall***
- ***Gold's safe haven status takes another knock***

Key market themes

There have been at least three striking developments in the markets in the last two weeks. None has come as a surprise to us, although they have arrived even more quickly than we had anticipated.

The first is the slump in **equity** prices. This has already taken the major indices very close to or even through the new lows we were expecting to see by mid-year (including 650 for the US S&P and 3,500 for the UK FTSE). Given the lack of any obvious catalyst for recovery in the near future, these targets should not be seen as floors. Indeed, it says a lot about the mood in the markets that they have given such a lukewarm response to the latest raft of stimulus measures and financial packages being adopted in the US and the UK.

The markets (both **equities** and **commodities**) actually found more to cheer in hopes of a fresh stimulus package in **China**. Admittedly, official actions may be more effective in what is still largely a command economy. But in the event, China's investment stimulus (at least the government-funded part) is turning out to be something of a mirage. As we discuss in our latest *Asian Economics Weekly*, China's 2009 budget does not provide for any boost from accelerated government spending. What stimulus there is from a rising budget deficit is entirely due to slower growth in tax revenues.

How do we square this with the perception that China's government is doing a great deal more, notably with its RMB4trn stimulus package? At face value, this package is equivalent to around 12% of 2009 GDP. But we continue to have many reservations. For a start, the package is spread over a little more than two years, bringing this year's portion down to 5½% of GDP. In addition, only a small part is funded by the central government – approximately 1½% of GDP. The central government is hoping that the broader state sector – banks, SOEs, local governments – will fund the rest. For this reason the headline RMB4trn is best thought of as an aspirational rather than a budgeted target.

Most importantly, it remains unclear how much is new spending that would not have happened anyway. The government's data on capital expenditure are opaque, but it is worth noting that total government spending on "economic construction" usually amounts to around 5% of GDP. If this is the relevant benchmark, the fiscal package amounts to little more than a rebranding of existing spending commitments.

The second striking market development is the recent decline in **government bond yields**, led by **UK gilts**. Again we were a little surprised by the speed of the move, but not at all by the direction. (See recent *Dailies* and our *Global Markets Focus*, "What does QE mean for

KEY DATA AND EVENTS

				GMT	Previous	Median	CE Forecasts
Sun 8th	Jpn	Current Account (Jan)	Seas. Adj.	23.50	+¥499bn	+¥420bn	+¥300bn
	Jpn	Trade Balance – BOP Basis (Jan)		23.50	-¥198bn	-¥812bn	-¥900bn
	Jpn	M2 Money Supply (Feb)		23.50	(+1.9%)	(+1.9%)	(+1.9%)
Mon 9th	Gre	CPI (Feb)	EU Harm.	-	-0.5%(+2.0%)		-1.5%(+1.5%)
	Jpn	Eco Watcher's Survey (Feb)	Current	05.00	17.1	17.3	18.0
	Jpn	Eco Watcher's Survey (Feb)	Outlook	05.00	22.1	-	22.0
	Twn	Exports (Feb)		08.00	(-44.1%)	(-26.2%)	-
	Twn	Imports (Feb)		08.00	(-56.5%)	(-37.3%)	-
	Twn	Trade Balance (Feb)		08.00	+$3.4bn	+$2.6bn	-
	SV	GDP (Q4)	q/q(y/y)	09.30	(+3.8%)	-	-

m/m(y/y) unless otherwise stated; p = provisional estimate government bonds?", 4th March.) To recap, regardless of exactly how quantitative easing (QE) is implemented we think that the wider economic and financial environment means that yields have further to fall. But as last week's rally in the gilt market has shown, central bank purchases of government bonds will certainly help the process along. We continue to expect **10-year government yields** to bottom out at around 2.0% in the US (currently 2.8%), 2.25% in the euro-zone (2.9%) and 2.5% in the UK (3.1%).

Finally, a few words about **gold**. Our sceptical views are well-established. (See for example *Capital Daily*, "A cautionary note on gold", 24th February.) At this stage we would just add that gold's lacklustre performance after briefly topping $1000/oz does little to bolster its appeal as a safe haven or hedge against inflation. After all, this was a period when equities fell to new lows and the adoption of QE in the UK might have been expected to increase fears of a surge in inflation. Safe haven status lies in the eyes of the beholder, but investors seem far from convinced. (**Julian Jessop**)

What to watch for this week: US

No major data releases or events today. The markets will be focused on the release of February's **retail sales** figures (Thursday) to assess whether the rebound in January was just a blip in the downward trend (likely) or the start of a miraculous turnaround (very unlikely).

Admittedly, the Fed said in its March Beige Book that "many Districts noted some improvement [in retail sales] in January and February compared with a dismal holiday spending season". And the Redbook and ICSC weekly sales figures both picked up in February, albeit from very low levels.

However, we find it hard to believe that retail sales are undergoing a meaningful improvement at a time when employment, equity prices and house prices are all plunging. And it is notable that large retailers, such as Home Depot and Costco, have recently announced poor earnings. Finally, if the University of Michigan's measure of **consumer confidence** were to fall further in March (data released on Friday), this would increase the likelihood of a renewed slump in retail sales in the coming months. (**Paul Dales**)

Euro-zone

No major data releases or events today. This week's key data all come on Thursday. The **euro-zone PPI** data are likely to show that annual factory gate price inflation turned negative in January. **Italy's Q4 GDP** breakdown should confirm that the country is experiencing one of the deepest economic downturns in the region. Finally, **German industrial production** probably continued to decline in January, although not as rapidly as at the end of last year. (**Ben May**)

UK

No major data releases or events today. This week's key data all come on Tuesday, covering the retail sector, external trade and industrial production. High street spending started the year surprisingly well. The **BRC**'s measure of annual growth of like-for-like sales values rose from -3.3% to +1.1% in January. However, this was driven in large part by a strong performance during the clearance sales at the start of the month. Spending growth weakened again as the month progressed. Accordingly, we expect February's growth rate to fall back into negative territory.

The immediate outlook for **exports** remains pretty dire. The CBI's export orders balance has continued to freefall and the recent modest improvement in the CIPS/Markit measure was wiped out in February. Goods and services export volumes fell by 5.5% in the three months to December and an even sharper rate of contraction looks likely in January.

The one consolation so far has been that *imports* are falling at an even faster rate, allowing net trade to make a positive contribution to quarterly GDP growth in Q4. Weakening domestic demand should ensure this continues. That said, both the trade in goods deficit and the overall trade in goods and services deficit narrowed particularly sharply in December. We have pencilled in a slight widening in both in January, reflecting the usual volatility of these numbers.

The **industrial production** data are likely to confirm that the manufacturing recession is destined to be at least as severe as that in the early 1980s. In particular, the CBI survey's output balance deteriorated from -35 to -48, indicating that respondents believed that the pace of output decline sped up in January. We have therefore pencilled in a further 1.4% monthly decline for industrial production, leaving output 10.2% lower y/y. Manufacturing output is liable to suffer more than industrial production as the latter also includes resilient sectors such as utilities. Our best estimate is a monthly fall of 1.6%, taking the annual fall in output to a monstrous 11.8%. (**Vicky Redwood**)

Asia-Pacific

We have long been talking of February as the month in which – due to the timing of Chinese New Year – deflation would arrive in **China**. On Tuesday we will find out. We think that consumer prices fell by 1.9% y/y, with both the food and non-food components posting declines.

Meanwhile, the Chinese media are reporting that the February trade data will be even worse, at least for exports, than those for January. If the 21st Century Business Herald, a Chinese newspaper, is right, both exports and imports fell by more than 20%. One impact would be to shred the trade surplus – it reached $39bn in January, but a contraction on that scale would reduce it to around $7bn.

Finally, the statistics bureau should release combined January and February figures for industrial production and retail sales on Thursday. We are forecasting a small increase in the former, but will be more interested in the performance of retail sales. These have held up well so far as the rest of the economy has slowed. But slowing tax receipts suggest that consumption spending may be starting to slip. (**Mark Williams**)

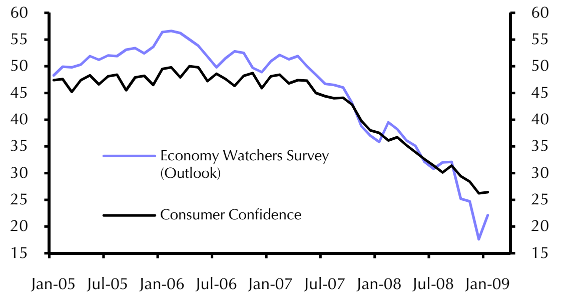
There are a number of second string data releases from Japan this week, although all could be interesting. There is already plenty of speculation that the 3.3% q/q decline in **Japanese GDP** originally reported for the fourth quarter will be revised down in the second release on Thursday morning (Tokyo time). This speculation follows the publication of the Ministry of Finance's detailed survey of capital spending, which showed a worse than expected decline of 17.3% y/y.

However, the MoF survey has been reporting larger falls than the equivalent GDP series for a while now, so it should not be taken for granted that the latter will be revised down. What's more, there is always a chance that other components of the GDP report could be revised up as well as down. The upshot is that, while the risks probably are on the downside, we don't have enough new information to forecast a major revision to the Q4 GDP data in either direction.

In any event, the latest monthly data will tell us more about the current quarter and beyond. We already know that the January **balance of payments** (released today) will show a large trade deficit, based on the preliminary customs data. However, the Bank of Japan will publish new figures on export and import volumes, which are more relevant to the trade components of GDP. The collapse in exports will make another large negative contribution to Japan's GDP in the first quarter. But imports have also started to drop back, which means that the overall drag from net trade should still be smaller than it was in the final quarter of last year. (See our *Asian Economics Update*, "A tiny silver lining in Japan's trade data", 25th February.)

This week also sees the publication of two surveys of sentiment in February – the **Economy Watchers Survey** (Monday) and **consumer confidence** (Friday). Both have recently shown signs of stabilising, albeit at very low levels. (See Chart 1.) We are hopeful of a further modest pick-up in February, partly reflecting the boost to real incomes from lower energy prices.

CHART 1: JAPAN EWS & CONSUMER CONFIDENCE



Source – Thomson Datastream

We would give the results of these relatively timely surveys more weight than the index of leading indicators for January (Tuesday), which is simply a composite of numbers that have already been released. (**Julian Jessop**)

Elsewhere, the **Bank of Korea** announces its latest rate decision on Thursday. The benchmark rate has already been cut aggressively (by 325bp since October) to a record low of 2.0%. But with domestic demand extremely weak and exports continuing to plunge, further cuts look inevitable. In the statement that accompanied last month's 50bp cut, the central bank emphasised that it would do "what is needed to improve liquidity conditions and to ward off the risk of a severe slowdown." We therefore think that the Bank will cut by another 50bp this week would not be surprised to see the key rate fall all the way to zero (or thereabouts) by mid-2009. Thereafter, the focus should shift to quantitative easing, a possibility that was flagged up by Governor Lee last month. (**Tehmina Khan**)

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