Bloomberg BRIEF

Economics

NEWS & COMMENTARY

08.19.10
THURSDAY

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6 - German Bond Yield Drops Below 3%
7 - U.S. Credit Costs Outpace Spain's
8 - Australian Dollar May Extend Gains
9 - Ringgit Hits 13-Year High as GDP Rises
10 - U.K. Retail Sales Up Most in 5 Months

DATA REPORTS *(NEW YORK TIME)*

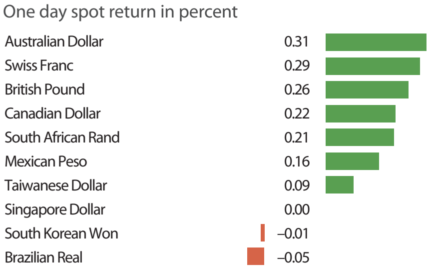
TIME	EVENT	SURVEY	PRIOR
0:30	JN All Industry Index (MoM)	-0.30%	0.20%
2:00	GE Producer Prices (MoM)	0.10%	0.60%
4:30	UK Retail Sales Ex Auto Fuel	0.20%	1.00%
4:30	UK M4 Money Supply (YoY)	2.00%	3.00%
5:00	SZ Credit Suisse ZEW Survey	-	2.2
8:30	CA Leading Indicators MoM	0.70%	1.00%
8:30	US Initial Jobless Claims	478K	484K
8:30	US Continuing Claims	4500K	4452K
10:00	US Philadelphia Fed.	7.2	5.1
10:00	US Leading Indicators	0.10%	-0.20%

ECONOMIC-EVENTS CALENDAR

DATE	TIME	
8/19	0:00	TH Thai Industrial Sentiment Index
8/19	6:45	HU Hungary Publishes July Budget Data
8/19	TBA	PO Bank of Portugal Statistical Bulletin
8/19	10:30	CA Bank of Canada Quarterly Review
8/19	12:30	US Fed's Bullard Speaks on U.S. Economy
8/19	TBA	US Gap Inc Second-Quarter Earnings
8/19	TBA	US Hewlett-Packard 2Q Earnings
8/19	TBA	US Staples Second-Quarter Earnings
8/19	TBA	US Aeropostale Inc. 2Q Earnings

TOP CURRENCY PERFORMERS

One day spot return in percent



Leading Economic Indicators; Bullard to Speak

FIRST WORD DAYBOOK:
Beth Mellor

■ **WHAT TO WATCH: Index of U.S. leading indicators** probably climbed in July for second time in four months. Economists forecast a gain of 0.1 percent. 10 a.m. **Fed's Bullard** speaks on U.S. economy; he may reiterate his view the Fed needs to take additional steps to boost growth. 11:30 a.m. **Hewlett-Packard hired Spencer Stuart** to handle search for a new CEO to replace **Mark Hurd**.

■ **MARKETS: U.S. 10-year Treasury yields** climbed from near a 17-month low. **Malaysia's ringgit climbed** to a 13-year high. **Cocoa may extend declines** to a nine-month low in the coming weeks, technical analysis by Commerzbank AG shows. **Russia sold** the smallest amount of 2014 ruble bonds in more than two months yesterday.

■ **ECONOMY: Farm Export Sales**, 8:30 a.m; **Initial Jobless Claim**s, 8:30 a.m., weekly Aug. 14, estimate 478,000. **Philadelphia Fed Index,** 10 a.m., Aug., estimate 7.2.

■ **COMPANIES: MasterCard agrees to buy** U.K.'s DataCash for 333 million pounds ($517 million). **Pactiv's $6 billion acquisition** by Reynolds Group may result in downgrades of both companies, Moody's says. **BHP Billiton** had biggest two-day drop in more than two months in Sydney on concern it may overpay for Potash.

■ **GOVERNMENT: Congressional Budget Office** to release updated 2010 budget and economic outlook. 11 a.m. **Secretary of State Hillary Clinton** to address UN General Assembly on Pakistan.

BIG PICTURE JOSEPH BRUSUELAS, BLOOMBERG ECONOMIST

Fed Set to Fight Expectations Deflation May Grow

Signs are pointing toward an increase in expectations that inflation will decline, presenting a challenge to a **Federal Reserve** that is eager to avoid such perceptions.

U.S. inflation expectations, based on 10-year break-evens, have fallen 72 basis points over the past six months to 1.6 percent from 2.32 percent. This leaves the Fed in the difficult position of having to rely on its bully pulpit to keep expectations anchored and to prevent an outbreak of deflation.

This trend is probably because of a decline in the core consumer price index to 0.9 percent. While the probability of an outright slide into deflation remains small, it can't be entirely discounted given the economic slack and elevated rate of unemployment. The output gap in the economy and the unemployment rate, according to the **Congressional Budget Office**, are likely to remain challenges for the foreseeable future.

Later today, **St. Louis Fed** President **James Bullard** will present his outlook on the U.S. economy, in which he is expected to reiter-

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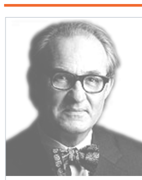

KEENE'S CORNER

David Kelly, chief market strategist at JPMorgan, on how to revive consumer spending in the U.S.

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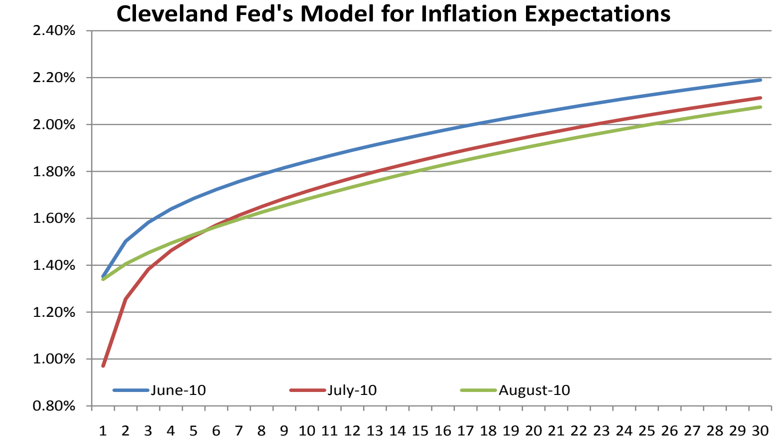
BIG PICTURE JOSEPH BRUSUELAS

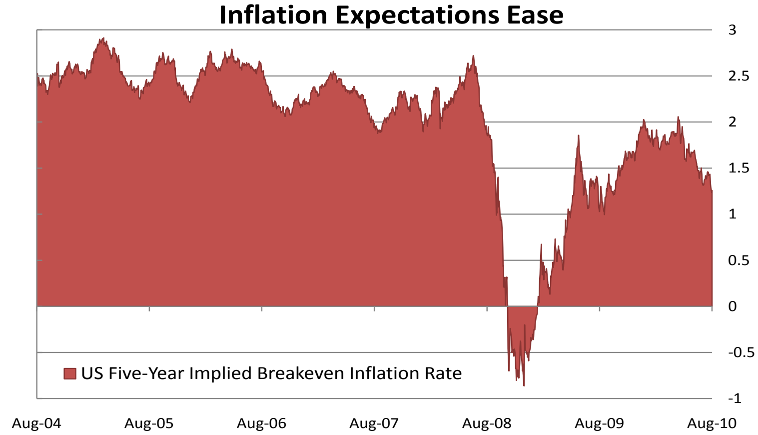
continued from page 1

Cleveland Fed's Model for Inflation Expectations



Source: Federal Reserve Bank of Cleveland, Bloomberg

Inflation Expectations Ease



Source: Bloomberg **USGGE05 INDEX <GO>**

ate his view that the Fed may need to take additional steps to support the economy. Given the soft economy and the probability that core prices will slide further later this year, the Fed will need to actively shape expectations.

Individual expectations about inflation influence spending decisions. Choices like whether to purchase a home or a car and how to allocate investments between equities and fixed-income instruments are affected. Moreover, smaller decisions like how much sugar, flour or other non-perishable food items based on prices in the future affect consumption and growth.

Bullard's recent assertion that the Fed may engage in another round of quantitative easing to prevent a potential bout of deflation foreshadowed the Fed's move to reinvest the proceeds of maturing assets into Treasuries.

Once deflation takes hold it can be destabilizing. It encourages consumers to hold off on purchases until prices have bottomed. Deflation not only discourages consumption, it depresses investment and causes the real value of household debt to increase, which can lead to a negative feedback loop on spending as individuals reduce debt levels.

One example of deflation is the housing market. Historically low mortgage rates — the rate for a 30-year mortgage was 4.53 percent yesterday afternoon — have provided little incentive to buy. This is why the Fed has taken the extraordinary steps of purchasing $1.45 trillion in mortgage-backed securities and agency debt over the past two years.

Typically, if the Fed errs on the side of "risk management" and keeps policy loose it runs the chance of stoking inflation. However, due to the slack in the economy, the Fed is trying to ward off deflation.

Yet the attempt by the Fed to communicate its intentions has not assuaged investors that its policies will prevent a slide into deflation. Since the recent change in policy by the central bank — to stabilize its balance sheet — inflation expectations have increased.

The inflation expectations seen in the 10-year break-evens are buttressed by other data. The Fed's preferred metric of inflation expectations, the five-year, five-year forward, has declined 30 basis points from 2.431 to 2.128 percent since the Aug. 10 **Federal Open Market Committee** meeting.

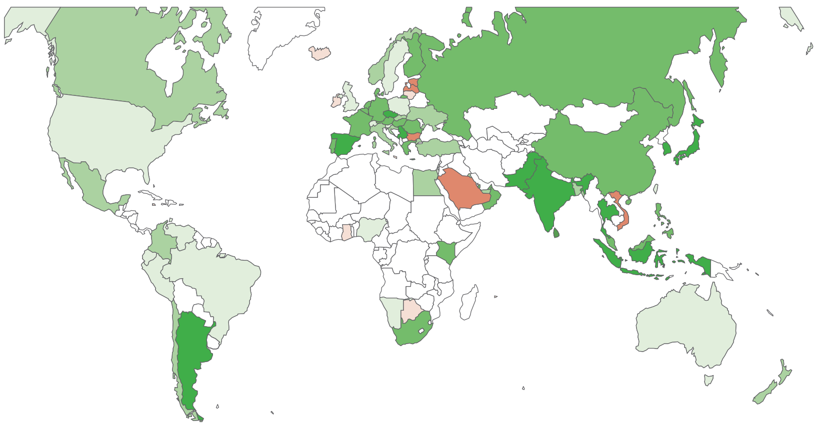
The five-year implied break-even inflation rate, often used to gauge inflation expectations, has fallen 17 basis points to 1.25 since the meeting. A move below 1 percent in this metric would unnerve investors and get the Fed's attention.

Yet another alternative measure of inflation expectations put forward by the **Cleveland Fed** uses real and nominal interest rates to describe how short-term interest rates and inflation move over time is slightly more encouraging. This model shows that expectations on near-term inflation have recovered since falling in July, but are modestly lower over the long term. At a one-year time horizon, expectations have improved 37 basis points to 1.34 percent. At a two-year horizon, expectations increased 15 basis points to 1.41 percent and remain essentially unchanged five years out.

The Fed has some work to do to convince investors that it possesses the tools, the intent and the will to prevent disinflation from turning to deflation. Expect Bullard to make a strong case later today that, if necessary, the committee will continue to monetize debt — specifically by purchasing Treasuries — to prevent exactly that.

OVERNIGHT BY BLOOMBERG NEWS

Global Equity Performance



EUROPE

■ **U.K. retail sales (excluding auto fuel) surged** 0.5 percent month-over-month in July, above expectations of 0.2 percent. The June reading was revised up to 1.1 percent from 1 percent. The year-over-year rate fell to 2.4 percent from 3 percent in June.

■ **The total orders component** of the August survey of U.K. manufacturers from the CIBC improved to minus-14 from minus-16 in July.

■ **Public-sector net borrowing in the U.K. totaled 3.2 billion pounds** in July versus 13.9 billion pounds in June. That compares with net borrowing of 6.6 billion pounds in July 2009.

■ **The first July reading of U.K. M4 money supply growth showed a 0.4 percent month-over-month increase**, and 2.3 percent year-over-year gain versus 3.1 percent in June.

■ **In July, major bank mortgage approvals in the U.K. dropped** to 47,000 from 48,000 in June and 53,000 in July 2009.

■ **German producer prices jumped** 0.5 percent month-over-month in July, above expectations of 0.1 percent. The year-over-year rate rose to 3.7 percent from 1.7 percent in June.

ASIA

■ **Japanese department-store sales declined** 1.4 percent year-over-year in July versus a 6 percent decline in June.

■ **Japanese investors bought** 2.18 trillion yen worth of foreign bonds in the week ended August 13, a record.

■ **The final July reading for machine tool orders in Japan rose** 144.9 percent year-over-year compared with an initial reading of 144.8 percent and June's 139.5 percent.

■ **Wholesale prices of primary articles in India rose** 14.9 percent year-over-year in the week ended Aug. 7.

■ **Average weekly wages in Australia rose** 0.8 percent quarter-over-quarter in May, below market expectations of 1.2 percent. Year-over-year it fell to 5.2 percent in May from 5.8 percent in February.

WASHINGTON WATCH BY BLOOMBERG NEWS

More SEC Lawsuits Seen

The **Securities and Exchange Commission**'s fraud case against New Jersey may presage a wave of lawsuits seeking to crack down on misdeeds by public officials who raise money in the $2.8 trillion municipal bond market. New Jersey settled claims it didn't disclose to investors that it had failed to put enough cash into its two biggest pension plans when it sold $26 billion of bonds from 2001 to 2007. It is the first SEC fraud case against a state and follows the creation of a unit set up this year to focus on municipal securities and pension funds. "They will be looking for other cases," said **James Doty**, a former SEC general counsel who's now with Baker Botts in Washington.

Obama Finishes Tour

President **Barack Obama** showcased an Ohio family that he said benefited from his economic policies as he wrapped up a cross-country trip pushing the message he will carry into the November congressional elections. Obama told a town hall-style event hat the U.S. is recovering from recession. "We stabilized the economy," Obama said "We've made progress, but let's face it, the progress hasn't been fast enough."

Medicare Premiums Rise

Monthly costs of Medicare prescription drug plans will rise an average of $1 to $30 next year for the elderly and disabled, the government said. Lower-than-expected cost increases and greater use of generic drugs by the 27 million beneficiaries helped keep the increase modest, **Paul Spitalnic**, an actuary for Medicare, said. Premiums have gone up every year since Medicare's drug benefit program, called Part D, began in 2006.

NEWSMAKERS

BY BLOOMBERG NEWS

Stanley Druckenmiller, chief investment officer of **Duquesne Capital Management**, is quitting the business after three decades, telling investors he's worn down by the stress of trying to maintain one of the best trading records in the industry while managing an "enormous amount of capital."

Peng Wensheng has been hired by **China International Capital Corp.** from Barclays as head of China research to replace **Ha Jiming**. Ha is joining **Goldman Sachs**.

Steve Barrow, head of G-10 currency research at **Standard Bank**, said investors should sell the euro against the Canadian dollar, predicting it will weaken initially to C$1.307 followed by C$1.297.

Andrew Roberts, head of European rates strategy at **Royal Bank of Scotland,** is advising investors to sell so-called peripheral euro-region bonds against benchmark German bunds as optimism stemming from tests on the region's banks fades. He said the stress tests were "irrelevant."

Christian Gattiker, head of research at **Bank Julius Baer**, said a "bubble" in government bonds is yet to peak because investors no longer trust the equities market.

Takafumi Yamawaki, chief rates strategist at **JPMorgan** in Tokyo, said Japan's 10-year bond yields are likely to fall below 0.9 percent by the end of this month, citing trading patterns. That would be a seven-year low.

Takehito Yoshino, chief fund manager at **Mizuho Trust & Banking**, said Japan's 20- and 30-year bond yields, near the lowest levels since 2003, may surge as demand among life insurers peaks.

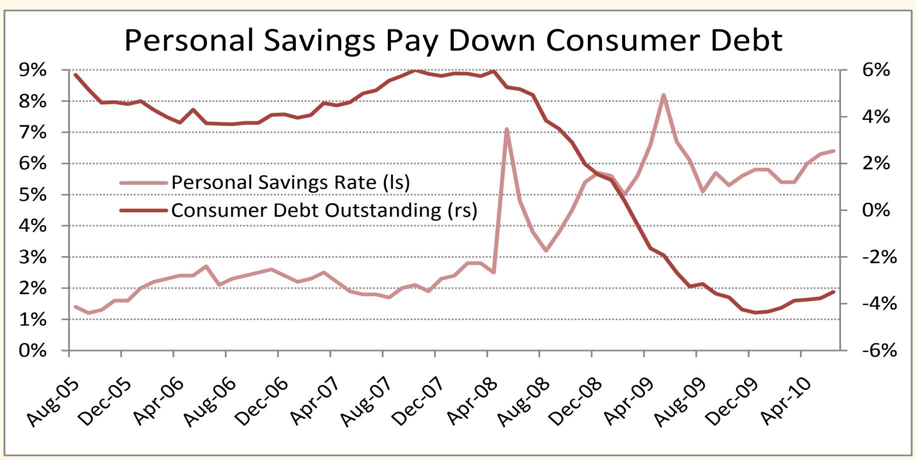
Paul McCulley, a managing director at **Pimco**, said the Bush tax cuts should be extended except for the top two brackets "or else the double-dip-recession risk will go up dramatically."

FACE OFF

Guy Verberne of **ABN Amro Bank** expects the Philadelphia Fed's top-line estimate of general business activity, published at 10 a.m., to rise to 10 from 5.1.

Ray Stone of **Stone and McCarthy** is forecasting a decline to minus 6. A Bloomberg survey of economists has the median forecast at 7.2.

Inside the Numbers *Michael McDonough, Bloomberg Economist*



The U.S. **Bureau of Economic Analysis** may be overstating the personal savings rate. That's because the agency's calculations include debt and mortgage payments as savings.

It's widely known that since the onset of the Great Recession the personal savings rate has risen sharply as households hunkered down for an uncertain future. Less understood is that this increase in savings does not necessarily mean savings accounts are growing.

Personal savings are calculated by subtracting personal outlays from disposable income. Debt payments, including those aimed at paying off credit cards and mortgage interest, are not included in personal outlays, which means the payments show up as savings in BEA calculations.

So in one respect these are faux savings because they don't really remain with the individual. This implies that the official statistic is exaggerated, suggesting that consumers may have less purchasing power than the savings rate alone indicates.

Part of what is being counted as savings is in fact helping bring down the level of outstanding consumer debt (excluding mortgages), which has declined by $164 billion since peaking in August 2008. The personal savings rate rose to 6.4 percent in June after averaging just 2.2 percent in 2006 and 2007 (see chart).

While it's difficult to assess definitively what percentage of savings is going toward deleveraging, a back-of-the-envelope calculation shows that about 40 percent of what is being counted as savings may actually be going toward paying down debt.

This implies that the savings rate may be acting more as a proxy for deleveraging rather than as true savings.

BLOOMBERG NEWS OF NOTE

No Fear of German Inflation as Yield Drops Below 3%

Angela Merkel's government is giving Germany something not achieved during the Kaisers, two World Wars or the development of the modern bond market: An interest rate of less than 3 percent on money borrowed for 30 years.

With the world economy suffering the aftershocks from last year's recession, Germany's 30-year bond yield has dropped to a record low of 2.96 percent. German consumer prices will rise just 0.9 percent this year, the International Monetary Fund says, less than half the average since 1980. In the U.S., Pacific Investment Management Co. says there's a 25 percent chance of a sustained period of falling prices, and the two-year Treasury note yield has also declined to a record low.

"The risk of deflation is much more real than the risk of inflation," said Christoph Kind, head of asset allocation at Frankfurt-Trust, which manages about $20 billion. "The move in yields is a clear reflection that we are moving toward a deflationary environment. Nobody would be buying if there was a risk of inflation picking up."

Memories of the hyperinflation that destroyed Germany's economy in 1923 have set the blueprint for central banking since World War II. Today, bond values suggest that deflation is a much greater threat to economic stability.

Central banks around the world are weighing whether to introduce more stimulus measures to a global economy that may be sliding back into recession. While the Federal Reserve on Aug. 10 extended its bond purchase program to shore up the U.S. economy, the European Central Bank shows little appetite to risk stoking inflation by loosening policy.

As central bankers debate, bond yields keep sliding. The yield on the two-year U.S. Treasury fell to 0.48 percent on Aug. 17 and the yield on the Japanese 10-year security is close to the lowest since 2003. U.S. consumer prices excluding energy and food held at a 44-year low of 0.9 percent in June.

"I do not think the deflation and double-dip is the baseline scenario, but I think it's the risk scenario," Pimco Chief Executive Officer Mohamed A. El-Erian said on Aug. 5.

The German 30-year yield rose 3 basis points to 3.005 percent as of 11:24 a.m. in Frankfurt today. The return on 10-year Japanese debt was at 0.925 percent.

The inflation-fighting tradition pioneered by Germany's Bundesbank, after the hyperinflation of the 1920s undermined confidence in the Weimar Republic, has left central banks unaccustomed to worrying about declining prices.

"Fighting inflation is the old Bundesbank mentality and part of the DNA of German bankers," said Fredrik Erixon, director of the European Centre for International Political Economy in Brussels. "This has spread to a lot of other central banks in the past 20 years."

By the end of 1923, prices were doubling every 49 hours and one dollar was worth more than a trillion marks. The experience paved the way for Adolf Hitler's rise to power.

When the Allies and German politicians started to rebuild the war-ravaged economy in the 1950s, the Bundesbank's inflation-fighting zeal helped cement an economic boom that established the nation's currency as a global benchmark.

The hyperinflation of the last century casts a long shadow. Thomas Hoenig, president of the Fed bank in Kansas City, Missouri, keeps a framed bill from Weimar-era Germany on a wall near his office, and has opposed the near-zero rate policy that he says could fuel asset bubbles.

— by John Fraher

BOJ to Assess Yen

The Bank of Japan is still assessing the economic effect of the yen's rise to a 15-year high, according to three people familiar with the matter, as speculation mounts that it will consider easing monetary policy.

Data released since the central bank kept policy unchanged on Aug. 9-10 don't suggest that economic conditions have suddenly deteriorated, one of the people said on condition of anonymity. Figures this week showed economic growth slowed in the second quarter.

The yen fell today after a Sankei newspaper report fueled expectations the bank will expand a 20 trillion yen ($230 billion) credit program as soon as this week to lower short-term interest rates and weaken the currency. Trade Minister Masayuki Naoshima said today that the yen is too strong against the dollar and should drop about 6 percent to help exporters.

— by Masahiro Hidaka

Norges Bank

The man tipped as Norway's next central bank head may steer monetary policy toward preserving a stable krone and slow the pace of interest-rate increases, economists at First Securities ASA and DnB NOR ASA said.

Incumbent Svein Gjedrem, who will end his second and final six-year term on Dec. 31, may be succeeded by Oeystein Olsen, head of the nation's statistics agency, according to economists contacted by Bloomberg and local press reports. The Finance Ministry will formally advertise the post on its website today.

"Oeystein Olsen is the one in the lead," Harald Magnus Andreassen, chief economist at First Securities, said in a telephone interview from Oslo. "As governor, Olsen might put more emphasis on the stability of the exchange rate than Gjedrem. In that sense it could even lead to lower rates in Norway as long as interest rates are so low abroad."

— by Josiane Kremer

COMMENTARY DAVID G. BLANCHFLOWER, BLOOMBERG COLUMNIST

Tax Cuts Are Only Way to Economic Growth

Unless we act fast, a plunge into depression is a growing risk in both the U.S. and the U.K.

Quantitative easing will probably have to be started again this year in both countries. The so-called Bush tax cuts, which are scheduled to expire at the end of the year, should be extended as soon as possible.

In the U.K., the draconian public-spending cuts alongside the increase in the value-added tax planned for the end of the year should both be scrapped. Now is the time to cut taxes, not increase them. Payroll tax holidays are the way to go.

U.S. unemployment remains worryingly high at 9.5 percent and initial jobless claims are up again. Banks are still not lending, especially to small businesses and even though mortgage rates are at historic lows, house prices show no signs of recovering. Consumer confidence is down and spending is slowing.

The recently announced trade figures were ghastly. U.S. exports in June were $150.5 billion compared with $200.3 billion of imports, which resulted in a goods-and-services deficit of $49.9 billion, up from $42 billion in May.

Talk of exit strategies for the **Federal Reserve** that we heard earlier in the year has now disappeared; the **Federal Open Market Committee** at its meeting last week confirmed that the recovery was slowing and downgraded its growth outlook.

The announcement that the Fed will recycle the proceeds of maturing mortgage-backed securities into new purchases of long- dated Treasuries is welcome. But banks aren't lending and firms need incentives to hire, so the Fed move isn't enough, especially since quantitative easing will take time to work.

It's time for tax cuts, which have the added advantage that they work quickly. Firms respond to incentives.

The **American Enterprise Institute**'s suggestion that there should be a payroll tax holiday is a good one as it would boost household disposable income while encouraging firms to retain workers on payrolls.

The AEI estimates that if the payroll tax (of which households pay half directly) were suspended — say, for a year or 18 months — households would experience an immediate 3.5 percent increase in disposable income they could employ to sustain consumption and pay down debts.

And it would give an incentive to hire. This would inject an additional $625 billion a year and would jumpstart the economy.

But the likelihood of this happening any time soon is slight, so in the meantime it makes no sense to repeal the Bush tax cuts, which would lower the amount of stimulus. It would be better to reform them to maximize their job-creating impact. But we need a lot more stimulus right now, not less.

And then there is the U.K. where the coalition government is planning on public-spending cuts of as much as 40 percent in some government departments' budgets and a loss of about 600,000 public-sector jobs alongside big tax increases, including raising the VAT from 17.5 percent to 20 percent in January.

Cutting public spending and raising taxes at this point in the cycle is inevitably going to lower economic growth and raise the number of jobless.

It's that simple. Recent evidence of this comes from Greece, which implemented its own austerity package: Gross domestic product shrank 1.5 percent in the second quarter, unemployment rose to 12.5 percent, and 10-year Greek government bond yields are still high at 10.7 percent. The picture is similar in Ireland.

It hasn't helped that members of the Liberal Democrat-Conservative coalition have been talking the economy down. Last week, U.K. Energy Secretary **Chris Huhne** said in a speech that the U.K. economy was "bankrupt" and "shattered," which it clearly is not. Economic Secretary to the Treasury **Justine Greening** described it as a "basket case" during a budget debate. The danger is that the coalition government's misguided policies will push the economy back into a recession.

Consumer and business confidence in the U.K. both started to plunge, coincident with the formation of the new coalition government in May. Of particular concern, in the most recent nationwide survey, is the plunge in the expectations index — which dropped to 76 in July from 89 a month earlier — to its lowest level since April 2009. The index has fallen 31 points since April.

A European Union survey has also shown that people in the U.K. increasingly expect unemployment to rise during the next 12 months.

This will inevitably hit spending. The coalition government should scrap the austerity budget and its planned tax increases and start cutting taxes.

This can be done best by reductions in National Insurance contributions, which are a tax on jobs. For 2010-2011, the Treasury projects this levy will raise 99 billion pounds. Employees pay 11 percent on weekly incomes of between 110 pounds and 884 pounds.

The contribution rate should be cut to a flat 5 percent in a two-year holiday for all income groups immediately. This would encourage individuals to spend more, and companies would boost hiring because of the lower price of labor.

This measure would revive economic growth and probably reduce the size of the budget deficit in the long run as it would increase government revenue. It's time for tax cuts, not tax increases.

(David G. Blanchflower, a former member of the Bank of England's Monetary Policy Committee, is professor of economics at Dartmouth College and the University of Stirling.)

GIUEST COLUMNIST ANDY XIE

China Swallows Obama Stimulus Meant for U.S. Economy

The global economy is like fried ice cream: If you don't act fast, it turns into a mess.

American pundits, Nobel laureates included, are predicting Japanese-style deflation for the U.S. and Europe. They are urging the Federal Reserve to pursue another round of quantitative easing to stop the onset of an Ice Age for Western economies. The Fed didn't oblige at its last meeting, but threw a bone to the deflation crowd promising not to pull money out of its previous round of asset purchases to boost a recovery.

On the other side of the world, consumer prices are surging. Emerging markets as a whole now have an inflation rate of more than five percent. India is registering price increases of more than 13 percent. China's are more than three percent.

Much of the "heat" comes from the property market. Million-dollar flats in Mumbai have panoramic views of the city's slums. Hong Kong's real-estate prices have almost reclaimed their 1997 peak, though the economy has barely grown since then in per-capita terms. Moscow is somehow always near the top of the list of the world's most expensive cities.

The emerging markets are on fire. Deflation prophets in the West are in for a rude awakening. Eastern fire will turn Western ice into a mess, and 2012 looks like it will be the year of melting. The fuel for the fire is coming from deflation-fighting stimulus programs, such as that of U.S. President Barack Obama.

Stimulus is prescribed as a panacea for recession. In today's global economy, it isn't effective in the best of circumstances and is outright wrong for what ails the West now.

Trade and foreign direct investment total half of global gross domestic product. Multinational corporations drive both. They shop around the world for the lowest-cost production centers and ship goods to wherever the demand is. Demand and supply are dislocated. So when a government introduces stimulus, the initial increase in demand doesn't necessarily boost local supply. More importantly, if multinationals decide to invest somewhere else, there wouldn't be an increase in jobs to sustain the growth in demand beyond the stimulus.

Just as water flows down, stimulus affects low-cost economies more, wherever it is initiated. As the West pours money into the global economy through large fiscal deficits or central banks expanding balance sheets, the emerging economies are drowning in excess liquidity.

Deflation prophets in the West are in for a rude awakening. Eastern fire will turn Western ice into a mess, and 2012 looks like it will be the year of the melting.

How will this all end? Ideally, before inflation takes hold in the U.S. and Europe, the costs in emerging economies will rise enough for multinationals to invest and hire in the West again. I wouldn't count on that. The average wage in the developed economies is 10 times that in emerging markets. There are five people in the latter for one in the former.

A more likely scenario is that the West will have to stop stimulus programs when inflation spreads to it from the emerging economies. The most immediate channel is through rising commodity prices. The prices of imported consumer goods will rise with increasing labor costs in emerging economies. China's nominal GDP is growing at about 20 percent per year. The odds are that its labor costs will surge as its worker shortage bites.

Lastly, labor in the West will demand wage increases to compensate for current and future inflation. One may argue that high unemployment rates will keep wages in check. Think again. In the 1970s, the U.S. suffered a wage-price surge even with high unemployment because workers saw through the Fed's "growth first and inflation be damned" intention.

In 2012, the Fed will run out of excuses not to raise interest rates. As the excess liquidity in the global economy will be gigantic by then, the tightening will probably trigger a global crisis as asset bubbles burst.

What really ails the West is declining competitiveness. Globalization is pitting the Wangs in China or Gandhis in India against the Smiths in the U.S. or Gonzalezes in Spain.

Multinational corporations decide on whom to hire. The Wangs and the Gandhis are willing to accept low wages to accumulate wealth. The Smiths and the Gonzalezes have wealth and won't accept Third World wages. When their governments give them money to spend, their demand just makes the Wangs and the Gandhis richer and themselves poorer with rising national debt.

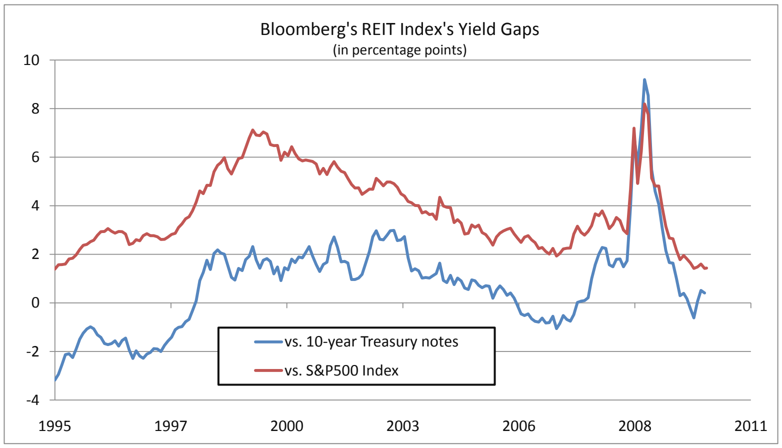
The West must wait for the Wangs and the Gandhis to become rich enough so that they demand Western wages and spend like the Smiths and Gonzalezes.

It is a long and painful process for the West. And there is no way around it.

(Andy Xie is an independent economist based in Shanghai and was formerly Morgan Stanley's chief economist for the Asia-Pacific region.)

CHART OF THE DAY

‘REITs Have Run Their Course’ as Yield Gaps Close



Real-estate investment trusts are losing appeal as a haven for U.S. investors seeking refuge from falling yields.

As the Chart of the Day shows, the gap between the dividend yields on a Bloomberg index of REITs and the **Standard & Poor’s 500 Index** is the smallest since 1995. The spread narrowed to 1.3 percentage points earlier this month from a high of 9.7 points in November 2008.

The spread between yields on the Bloomberg index and 10- year Treasury notes, which the chart also depicts, shrank even more. This gap averaged just 0.1 point this year after peaking at 10.6 points in March 2009, when the most recent bear market in stocks hit bottom.

"REITs have run their course and are relatively expensive," **Jack Ablin**, chief investment officer at **Harris Private Bank**, wrote this week in a report. Bloomberg’s index of 111 REITs soared 145 percent from its March 2009 low through Tuesday, trouncing the S&P 500’s 60 percent gain in the same period.

Oil and gas partnerships, utilities and telephone companies, and the largest drugmakers are better choices for yield-driven investors, **Doug Sandler**, chief equity officer at **RiverFront Investment Group**, wrote in another report.

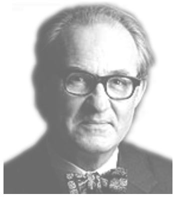
Sandler also recommended “higher dividend growth stocks,” yielding at least 3 percent and having a decade-long history of 10 percent-plus payout increases annually. He mentioned **Altria Group Inc.**, **Chevron Corp.**, **Lockheed Martin Corp.** and **Mattel Inc.**, along with the **PowerShares Dividend Achievers Portfolio** and **Vanguard Dividend Appreciation** exchange-traded funds.

— David Wilson

MARKET INDICATORS

BOND MARKET	10-YEAR YIELD	1-DAY CHANGE IN BP	YTD CHANGE IN BP
U.S.	2.67%	3.6	–116.9
Euro-Area	2.38%	5.7	–101.1
Germany	2.38%	2.9	–101.1
France	2.67%	3.1	–92.7
U.K.	3.05%	2.3	–96.5
Switzerland	1.16%	0.0	–74.4
Norway	3.20%	–5.6	–94.5
Sweden	2.44%	6.7	–84.9
Turkey	8.82%	0.0	–201.0
S. Africa	7.97%	2.0	–119.6
Canada	2.94%	–2.6	–67.3
Brazil			
Mexico	6.16%	–6.3	–184.2
Australia	4.92%	–1.1	–72.4
New Zealand	5.19%	–3.4	–61.9
Japan	0.94%	1.6	–35.5
Hong Kong	2.02%	3.2	–56.2
Singapore	1.90%	1.0	–76.0
CURRENCY MARKET	**LAST VS. USD**	**1-DAY% CHANGE**	**YTD% CHANGE**
Euro	1.2835	–0.14%	–10.38%
Japanese Yen	85.5500	0.11%	–8.03%
British Pound	1.5633	0.25%	–3.32%
Swiss Franc	1.0392	–0.32%	0.39%
Canadian Dollar	1.0274	–0.21%	–2.45%
Australian Dollar	0.9010	0.30%	0.37%
New Zealand Dollar	0.7125	–0.27%	–1.43%
Danish Krone	5.8050	0.15%	11.70%
Norwegian Krone	6.1633	0.04%	6.38%

CURRENCY MARKET	LAST VS. USD	1-DAY% CHANGE	YTD% CHANGE
Swedish Krona	7.3584	0.20%	2.76%
Czech Koruna	19.3201	0.23%	4.63%
Hungarian Forint	216.0000	0.14%	14.29%
Polish Zloty	3.0705	0.20%	7.25%
Russia Ruble	30.4475	0.10%	1.37%
S. Africa Rand	7.2588	–0.21%	–1.88%
Turkish Lira (000)	1501925.0000	–0.02%	0.05%
Brazil Real	1.7531	–0.07%	0.49%
Mexican Peso	12.6098	–0.17%	–3.68%
Chinese Renminbi	6.7908	–0.02%	–0.53%
Hong Kong Dollar	7.7707	0.01%	0.21%
Indian Rupee	46.5750	–0.15%	0.11%
Indonesian Rupiah	8964.0000	–0.06%	–4.68%
Singapore Dollar	1.3517	–0.02%	–3.79%
S. Korea Won	1172.7000	–0.16%	0.75%
Taiwan Dollar	15.0800	0.40%	5.46%
COMMODITY MARKET	**LAST VALUE**	**1-DAY CHANGE**	**1-DAY% CHANGE**
Crude Oil (Brent)	77.02	0.55	0.72%
Gasoline (NYM)	196.12	0.80	0.41%
Natural Gas (NYM)	4.24	–0.03	–0.66%
Gold (CMX)	1229.70	3.10	0.25%
Silver (CMX)	18.40	–0.20	–1.05%
Copper (LME)	7480.00	90.00	1.22%
Aluminum (LME)	2123.00	18.00	0.86%
UBS-Bloomberg Cmdty	1119.33	7.64	0.69%
Goldman Sachs Cmdty	517.39	3.42	0.67%
CRB Index	269.90	–0.29	–0.11%
Baltic Dry Index	2558.00	43.00	1.71%



KEENE'S CORNER

Ken Prewitt and Keith McCullough talk to **David Kelly**, chief market strategist at **JPMorgan**, about the state of the U.S. consumer. Tom Keene is on vacation.

Q: What's the market saying to you?

A: I don't think there's any fundamental belief that the economy is turning a corner.

Q: When you look at the quantitative ease last week and the reaction, does anything jump out?

A: The problem is that when you have inflation at close to zero and interest rates at close to zero, monetary policy doesn't work, period. What this economy needs are people in the private sector deciding to buy cars, buy houses, invest in new businesses, hire people. It's that psychological spark that's missing, and there's nothing that monetary policy can do to really change that. The problem is then if the Federal Reserve says, "We realize we've got a greater problem, so we're going to do something," but people don't really trust the cure, you have a negative market reaction.

Q: What's the state of retailing?

A: It's still pretty soft. Consumers are being careful about how they spend money and they're busy refinancing mortgages and increasing savings. That's making it a tough retail environment, but it does give us promise for the future. Consumers are in much better financial shape now than they were three or four years ago.

Q: So you have the government telling you to take on leverage, buy a car, get a house, the whole shebang. Then you have consumers saying, "I'm not that dumb." And growth is going to slow as a result?

A: Part of the problem is that if the Federal Reserve tells people it's worried, that undermines confidence. People aren't illogical about this. The problem is that at this stage, excessive spending is a public virtue and a private vice. What you really want is for everybody else to go out and spend lots of money and bail you out, rather than you yourself spending more money. I think the key thing is if you look at the level of housing starts, you look at the level of vehicle sales, we've got nowhere to go but up.

Q: What about government debt?

A: I have a real problem with the government accumulating a lot of debt in the long run. But in the short run, what you need more than anything else to deal with the debt problem is growth. There's nothing the government can do in the form of cutting spending or raising taxes that would be as effective as engineering economic growth of six, seven or eight percent. If we can get back to full employment fast, that'll do more for our debt problem than anything else.

Q: So getting people confident would be a better message out of Washington?

A: Absolutely. I think what you need to do short term is be as generous as possible in terms of extending the Bush tax cuts to keep money in the economy. Then in the long run, look at issues like the retirement age, how low you can push the unemployment rate, the growth of entitlement spending. The long-term debt problem needs long-term solutions. The short-term macroeconomic problem needs a generous government that will help the private sector get going.

Q: Does this hold back the market?

A: It's holding back the stock market to some extent. The average individual investor has thrown in the towel. More money has gone into bond funds in the last two years than went into stock funds at the height of the tech bubble. People absolutely loathe stocks. There are professionals trading money back and forth, but there's no real inflow coming in from retail investors. If you look at the gap between the earnings yield on stocks today and the yield on Baa corporate bonds, it's wider than it's been at any time since Jimmy Carter was president.

Q: At what point are people willing to accept more risk?

A: When they have more confidence. When people are fearful, their time horizons narrow. When they get more confident, they begin to think, "Where am I going to be in five, 10, or 15 years?"

This interview was condensed and edited.

This morning:
Guest host Dave Wilson; Jim Paulsen of Wells Capital Management on U.S. jobs and equities; Ray Stone of Stone MCarthy on jobs, housing and the consumer; Howard Davidowitz of Davidowitz and Associates on back-to-school retail.

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CORRECTION: A Page 1 article in yesterday's issue inaccurately stated the rate of increase in U.S. industrial production for the month of July. It was 1 percent, not 10 percent.

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