Global Snapshots

A bi-monthly from Société Générale Asset Management

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Emerging Local Bonds Markets: Lessons from the Recent Past .... p. 2

- The emerging debt market frontier has shifted substantially during the past decade from globally traded, dollar-denominated bonds to locally traded, domestic currency-denominated bonds. The share of local bonds in the total annual EM bonds trading volume leapt from 22% in 1997 to 68% by Q3.07. EM local bonds markets, many of which delivered annualized double-digit returns over the past few years, have come under pressure with the reduction in global risk appetite. Uncertainty regarding the global outlook might continue to weigh on local yields. The good news is that EM macro fundamentals remain strong, and a disconnect is emerging between local bond prices and the underlying credit and FX risk. In a nutshell, EM local markets are starting to look cheap again. Investors will eventually notice and increase exposure to these markets - though probably not until the current global credit panic subsides.

The impact of a European Blue Card .... p. 3

- Next month's EU summit will take up plans for a “Blue Card” work permit that would allow foreign workers to fill highly skilled jobs in the European Union. While the "Blue Card" concept already has many detractors inside and outside Europe, reform is clearly needed to address the impending skills shortage in the European labour force -- especially given the EU's aging population and the relative dearth of European university graduates trained to work at high levels in healthcare, engineering, and information technology. In our view, while the Blue Card marks an important step in the right direction for Europe, but more needs to be done for the EU to attract talent. The creation of a European Blue Card also represents a potential raid on the labour markets of the poorest and smallest developing countries -- with predictable effects.

Has the Fed become hypermetropic? .... p. 4

- On November 14, the Fed announced that it was changing the content, time horizon and release schedule of its forecasts. This is a notable event in that the central bank is modifying a procedure that had been in place for almost 30 years! We review the procedural changes along with the new Fed forecasts and the medium-term outlook, and we consider their repercussions on monetary policy. Analysing the forecast, the neutral Fed Funds rate would appear to be about 4.25-4.50%. In other words, the Fed’s medium-term projections reveal that the 75bps in cuts in the Fed Funds rate since September have been appropriate, and that monetary policy is therefore not especially accommodating. Two conclusions can be drawn from this. If risks intensified, the Fed would not hesitate to ease monetary policy. From this point of view, an especially close watch must be kept on the jobs market. However, if the Fed’s growth forecasts prove overly “pessimistic”, inflationary pressures could quickly re-emerge.

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EM Local Bond Markets: Lessons from the Recent Past

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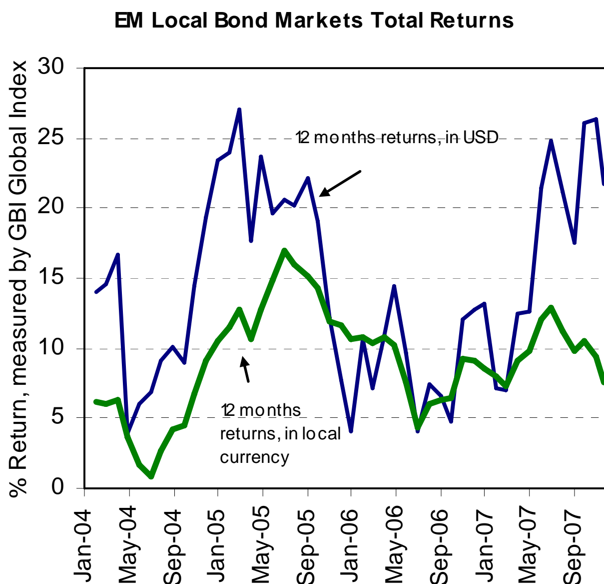
The Emerging Market (EM) debt frontier has shifted substantially during the past decade from globally traded, dollar-denominated bonds to locally traded, domestic currency-denominated bonds. The share of local bonds in the total annual EM bonds trading volume leaped from 22% in 1997 to 68% by the third quarter of 2007. The majority of these local bonds are government debt, but local bond issuance by emerging companies is also increasing.

The growth in EM local debt trading is partially explained by very attractive returns, especially when converted back into US dollars. From January 2004 through 3Q.07, the JP Morgan GBI Global Index – a benchmark for EM local sovereign bonds – posted an average annualized return of 14% in USD. Measured in local currency, the same index delivered 9%, indicating that approximately 1/3 of the good performance was due to the appreciation of EM currencies.

EM Local Bond Markets Total Returns



Source: JP Morgan Indexes

Taking lessons from history…

A closer look at the factors that drove past performance can provide some guidance for prospective returns. Consider first **local currency-denominated returns.** Since 2004, these have displayed a cyclical pattern, with periods of rising returns followed by declining returns, which last for about a year as seen from the chart above. Extrapolating this pattern, one might conclude that we are now in the middle of a declining returns phase with rising local yields, and that this phase may have another 6+ months to run.

In the first period (mid 2004 – mid 2005) of rising returns, the US economy stepped firmly out of recession and the Fed initiated very gradual policy tightening. A combination of healthy global activity and still quite loose policy stance in the US was particularly beneficial for EM local markets, for three reasons. First, the measured pace of policy tightening increased the perceived longevity of carry gains driven by interest rate differentials. Second, buoyant global markets gave a boost to EM exports, solidifying the view that their currencies were underappreciated. Third, led by stronger current accounts, the improvement in EM fundamentals strengthened the perception that convergence of local EM interest rates to G7 levels was about to gain momentum.

This boom in local EM bonds markets was interrupted in the middle of 2005. An important trigger of this turn was the renewed strength in the US dollar, with the US economy showing more underlying momentum than its G7 peers and with increasing risk of a faster pace of Fed tightening.

These fears were partially dissipated by the pause in rate hikes in the US, in mid-2006, which marked the beginning of another phase of rising returns in EM local markets. Ironically, until mid-2007, the US housing market woes were beneficial to EM local markets, because they significantly reduced the odds of further Fed policy tightening. This constructive sentiment dissipated in mid-2007, when the spillover from the subprime shakeout started to increase the risk of a recession in the US, and imposed a growing toll on risk appetite.

The US dollar plays an important role in these year-long trends in EM local markets' returns with the weakness or strength of the USD typically magnifying the underlying trend in local yields. For instance, USD weakness in mid-2004 to early 2005 increased investors' appetite for EM local bonds, driving down local yields, because it significantly increased the expected risk-adjusted return on long positions in EM currencies. More recently, the positive correlation between the US dollar and EM local yields has declined.

In the new phase initiated in Q3.07, the ongoing decline in the USD was not enough to entice investors' appetite for EM local bonds. Investors who maintained their allocations were rewarded: returns in USD have been quite attractive (as the chart shows), a consequence of the tumbling greenback. However, local yields widened during the summer and have not yet fully recovered - a feature that explains reduced returns in local currency.

…and looking to the future

Looking ahead, one might wonder what all this says about prospective returns. Our take is that demand for EM local bonds benefits from a combination of healthy global economic activity and contained inflationary risks. At this juncture, this constructive scenario requires a good dose of optimism, since it rests on three key factors being observed, simultaneously: (1) well anchored inflation expectations, despite rising energy and commodities prices; (2) soft economic activity in the US (but small recession risk); and (3) more evidence of global decoupling from the US economy.

At the moment, investors are uncertain regarding whether or not this benign environment will be observed in 2008. We believe that this uncertainty will continue to weigh on local yields. It could be the case that returns measured in local currency will drift even lower, before they return to their medium term average of 9% (in which case the attractiveness of this asset class start to depend more and more on further EM FX appreciation-driven returns in USD).

The good news is that EM fundamentals remain strong, and a disconnect is emerging between local bond prices and the underlying credit and FX risk. In a nutshell, EM local markets are starting to look cheap. Investors will eventually notice and increase exposure to these markets -- though probably not until the current global credit panic subsides.

Marcela Meirelles

The winners and losers from a European Blue Card

Next month's EU summit will take up plans for a “Blue Card” work permit that would allow foreign workers to fill highly skilled jobs in the European Union. In the past, the bulk of Europe's migrant workers have been of the unskilled variety -- in contrast to the US where a larger share of foreign workers are regarded as skilled or highly skilled. While the "Blue Card" concept already has many detractors inside and outside Europe, reform is clearly needed to address the impending skills shortage in the European labour force -- especially given the EU's aging population and the relative dearth of European university graduates trained to work at high levels in healthcare, engineering, and information technology.

In a nutshell, the Blue Card would grant renewable two-year work permits for skilled labourers from non-EU countries. To qualify, these workers would need to have an employment offer with a minimum one-year contract that pays at least three times the minimum wage and offers full benefits. As in the US where work permits (known as H1B visas) have long been available to foreign skilled workers, the sponsoring company would have to demonstrate that it could not find local workers to fill the positions. As currently envisioned, the Blue Card would be renewable, allow foreign workers to bring their families to live with them in the EU, and allow for internal migration (for purposes of employment) within the whole of the EU (i.e., all 27 countries). After five years of continuous employment inside the EU, Blue Card holders would automatically receive permanent residency in the country where they've settled. The option of eventual citizenship is not yet on the table, though such an outcome may eventually be incorporated.

The Blue Card is destined to become a reality

It is too soon to know whether the upcoming EU summit can finalise all Blue Card details since several countries have expressed concerns about losing sovereignty over immigration policy. But given the EU's ageing demographics and the acute need for skilled workers in coming years, the concept (in one form or another) seems destined to happen -- especially because the system requires only qualified majority support among the 27 EU Member States. In other words, while countries such as the UK can opt out, they cannot veto the entire program. In its current form, the plan calls for the admission of 20 million skilled workers from Asia, Africa and Latin America over the next two decades. These are big numbers, intended to reverse current global migration trends which show that most highly skilled workers from developing countries resettle outside the EU. According to the European Commission, immigrant workers classified as "highly skilled" make up 0.9% of the total EU workforce versus 3.5% in the US, 5.3% in Switzerland, 7.3% in Canada, and 9.9% in Australia.

In our view, while the Blue Card marks an important step in the right direction for Europe, there are other reasons why the best and the brightest from the developing world have settled outside the EU -- and why many of the most talented Europeans have themselves decamped to the US and elsewhere. For one, European salaries in fields such as information technology, healthcare and engineering are lower than in the US. In addition, many skilled foreign workers now active in the US (especially in the high-tech sector) first arrived as students to take advantage of the abundant research opportunities available in America's many resource-rich universities. In addition to the Blue Card program, then, EU countries must promote structural reforms that allow EU companies to offer more competitive pay and benefits, and Europe's higher education system also needs upgrading with an accompanying mandate to promote greater innovation and entrepreneurship. It remains to be seen whether the frequently disjointed EU can work cooperatively not just to implement the Blue Card system, but to push forward the other reforms required to ensure a more business-friendly environment that encourages greater allocation of risk capital.

The poorest emerging markets will export labour

There is a flip-side to every coin, and in this case it seems that the greater the success of Europe's Blue Card, the bigger the loss for emerging markets -- especially the smaller and poorer of these countries. While remittances from foreign workers are an increasingly important source of external financing for many emerging markets, we do not regard the export of highly skilled labour as the best path to sustainable economic development. During 2006, foreign workers in the EU sent home an all-time high of EUR 26bn through formal channels (note: informal remittances are also likely to have been quite substantial). Globally, remittances represent important wealth transfers that boost FX reserves and provided additional investment capital in developing countries such as Mexico, the Philippines, and Poland (to name just a few of the big beneficiaries). But if reforms such as Europe's planned Blue Card significantly alter the balance of immigration away from unskilled labour in favour of skilled labour, then there will inevitably be a growing skills shortage in the developing world -- especially if the EU makes good on its plans to import 20 million workers over 20 years.

At a meeting last month of senior government officials from 79 African, Caribbean and Pacific countries, several prominent policymakers warned of dire consequences from an accelerating brain drain in the developing world. To take but one example, while this decade's vastly improved investment outlook for Africa has encouraged small numbers of African expatriates to return home in search of rewarding work opportunities, a general brain-drain has continued with many Nigerians, Kenyans and even South Africans jumping at the first good opportunity to find steady and more lucrative employment overseas. The problem is most acute in the health sector where doctors and nurses stream abroad year after year in substantial numbers. Liberia's Health Minister recently said that the EU Blue Card plan could make it impossible to rebuild his country's healthcare system after years of civil war. But the problem of exporting highly-trained workers is felt in many sectors where skills are easily transferred and shortages in the rich countries are long-standing (e.g., engineering). South African Finance Minister Trevor Manuel, one of the most respected policymakers in the developing world, has described the export of skilled labourers as "a self reinforcing, deteriorating spiral."

The EU Blue Card designers have pledged to implement the new policy in a way that does not amount to raiding poor countries of their best, brightest, and most productive workers. But we are sceptical of such pledges when it comes time for actual implementation. The freer movement of labour (legal and otherwise) is a natural outgrowth of globalization. As the wealthy countries age and look for ways to maintain their standard of living, they have little choice but to import able and willing workers from lower income countries.

Blaise Antin, Michala Marcussen

Has the Fed become hypermetropic?

On November 14, the Fed announced that it was changing the content, time horizon and release schedule of its forecasts. This is a notable event in that the central bank is modifying a procedure that had been in place for almost 30 years! We review the changes below, along with the new Fed forecasts and medium-term outlook, and we consider their repercussions on monetary policy.

What are the main changes?

- **Release schedule:** The Fed will now release economic forecasts four times per year (instead of two). The forecasts will be published jointly with the minutes of the FOMC meeting during which they were discussed.
- **Time horizon of forecasts:** Three years instead of two.
- **Content:** Real GDP growth, unemployment rate, and both headline inflation and core inflation (i.e., ex-food and ex-energy). Previously, only the latter had been forecast.
- **Review and discussion of risks**: The risks surrounding the forecasts will be presented systematically.

All in all, the change aims to improve understanding of Fed strategy and to strengthen the credibility of monetary policy by providing greater transparency. In this context, the release on November 20 of the October 30-31 FOMC minutes was awaited even more eagerly than usual.

Weaker growth and inflation under control

In today's very tense macro-financial environment, the Fed's new projections have naturally attracted attention. A clear distinction should be made between its short-term forecasts (2008) and its forecasts for 2010.

The Fed has lowered its 2008 growth forecast range to 1.8%-2.5% (Q4/Q4). This is a major revision compared to June (cf. table). Several reasons have been put forth for this change: mortgage lending has tightened; housing has slowed more than expected; and oil prices have risen. Against this backdrop, the Fed is forecasting an increase in household savings and slower growth in household spending. However, net exports will provide some support.

2008 core inflation is expected to be slightly weaker than was the case back in June. However, in spite of the lowered growth forecast, **the unemployment rate forecast has only been raised slightly** and remains below the symbolic threshold of 5.0%. This is surprising and difficult to interpret. In the run-up to the presidential election campaign, it is possible that Fed members did not want to give Congress an argument in favour of more aggressive cuts in interest rates.

And, finally, regarding risks, the Fed stresses that they could push growth down and unemployment up. Financial market turbulence, tougher credit terms, and a possible drop in housing prices are factors that could pull down the economy. Against this backdrop, it is worth pointing out that FOMC members appear more confident than they were last June about inflation slowing down.

However, it is the first 2009-2010 growth forecasts that have attracted the most attention. The Fed forecasts GDP growth of about 2.5% for the period, versus the 3.0% annual average over the last 15 years. The Fed is thus revising downward the trend growth rate for the US economy.

Economic Projections of Federal Reserve Governors and Reserve Bank Presidents

%	2007	2008	2009	2010
Real GDP*	2.4 to 2.5	1.8 to 2.5	2.3 to 2.7	2.5 to 2.6
June projections	*2.25 to 2.5*	*2.5 to 2.75*	-	-
Unemployment rate	4.7 to 4.8	4.8 to 4.9	4.8 to 4.9	4.7 to 4.9
June projections	*4.5 to 4.75*	*about 4.75*	-	-
Inflation (PCE)*	2.9 to 3.0	1.8 to 2.1	1.7 to 2.0	1.6 to 1.9
Core inflation (PCE)*	1.8 to 1.9	1.7 to 1.9	1.7 to 1.9	1.6 to 1.9
June projections	*2.0 to 2.25*	*1.75 to 2.0*		

* Changes from the 4th quarter of the prior year to the 4th quarter of the indicated year.
Source: Federal Reserve

The implications for monetary policy

The Fed's cut in projected growth potential has important repercussions for monetary policy. For one, lower trend growth implicitly means a lower "neutral interest rate". Customarily, this rate is estimated on the basis of nominal GDP. With growth potential of about 2.5% and inflation expected between 1.6% and 1.9% until 2010 (versus an average of 2.1% over the last 15 years), the neutral Fed Funds rate would be about 4.25% to 4.50%. In other words, the Fed's medium-term projections reveal that the 75bps in cuts in the Fed Funds rate since September have been appropriate, and that current monetary policy is therefore not especially accommodating.

Two conclusions can be drawn from this. If risks intensify, the Fed would not hesitate to ease monetary policy. From this point of view, an especially close watch must be kept on the jobs market. However, if the Fed's growth forecasts end up being overly "pessimistic", inflationary pressures could very quickly re-emerge.

Does the Fed see better from far away than close-up?

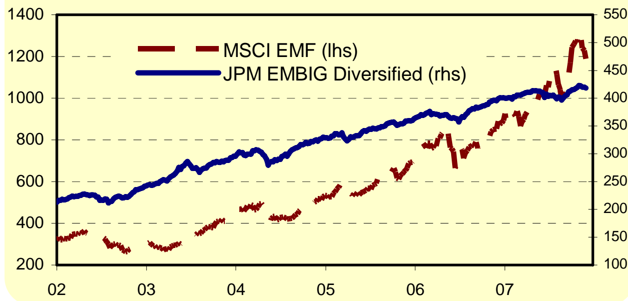
The risks that have been mentioned are more in the short term (2008) than the medium term (2009-2010). Does this mean that the Fed is more confident in its medium-term projections than in its short-term projections? Not necessarily!

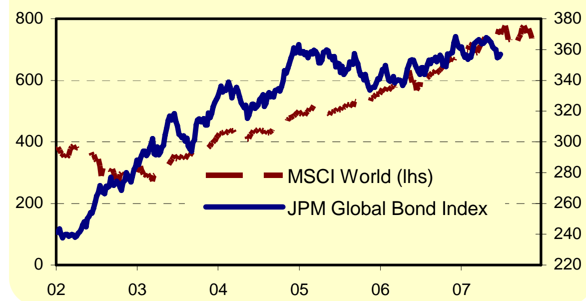
In very timely fashion, the Fed jointly released a study[1] that measures past errors in forecasting and underlines the uncertainty surrounding its projections. The authors note that, over the last 20 years, the Fed's forecasts have not been more accurate than those of the private sector. The message is clear: Fed projections are not written in stone. They are useful in indicating the underlying assumptions on which monetary policy decisions are based, but it will ultimately be up to financial markets to decide how well founded these projections are. On average, private sector "experts" make the same amount of mistakes as the Fed!

Didier Borowski

[1] "Gauging the uncertainty of the economic outlook from historical forecasting errors", David Reifschneider and Peter Tulip, Federal Reserve, Finance and Economics Discussions Series, 2007-60.

Market Data





Select Global Exchange Rates

As of November 28, 2007

	F/X Rate	% Ch. WoW	% Ch. YTD	Year End 2006	2005	2004	2003
USD/EUR	1.47	0.45%	-10.69%	1.32	1.18	1.36	1.26
USD/GBP	2.07	-0.38%	-5.07%	1.96	1.72	1.92	1.79
GBP/EUR	0.71	0.83%	-5.92%	0.67	0.69	0.71	0.71
JPY/USD	109.87	-1.13%	8.46%	119.16	117.75	102.63	107.22
JPY/EUR	162.02	-0.68%	-3.14%	156.93	139.48	139.10	135.00
CHF/USD	1.12	-0.96%	9.29%	1.22	1.31	1.14	1.24
CHF/EUR	1.65	-0.51%	-2.39%	1.61	1.56	1.55	1.56
Asia Pacific							
CNY/USD	7.39	0.35%	5.60%	7.80	8.07	8.28	8.28
IDR/USD	9418	-0.13%	-4.50%	8994	9830	9270	8420
KRW/USD	931	0.17%	-0.13%	930	1010	1035	1192
PHP/USD	42.88	0.87%	14.31%	49.01	53.09	56.23	55.54
TWD/USD	32.33	0.03%	0.80%	32.59	32.83	31.74	33.96
THB/USD	30.80	2.05%	17.21%	36.10	41.03	38.92	39.62
INR/USD	39.56	-0.68%	11.50%	44.11	45.05	43.46	45.62
Latin America							
ARP/USD	3.15	-0.28%	-2.57%	3.07	3.03	2.97	2.93
BRL/USD	1.80	-0.65%	18.72%	2.13	2.34	2.67	2.89
CLP/USD	510.65	0.29%	4.23%	532.25	512.00	555.75	592.75
COP/USD	2065.95	0.23%	8.41%	2240	2287	2355	2780
MXN/USD	10.93	0.61%	-1.23%	10.80	10.63	11.15	11.23
VEB/USD	2145	0.00%	0.00%	2145	2145	1918	1598
EMEA							
CZK/EUR	26.49	1.08%	3.74%	27.49	29.09	30.40	32.39
HUF/EUR	255.27	0.38%	-1.37%	251.77	252.65	245.22	262.90
PLN/EUR	3.65	1.11%	4.99%	3.83	3.85	4.08	4.70
RUB/USD	24.39	-0.20%	7.94%	26.33	28.74	27.72	29.24
ZAR/USD	6.88	-0.98%	2.25%	7.04	6.33	5.67	6.68
TRY/USD	1.19	1.70%	18.94%	1.42	1.35	1.34	1.41

Past issues

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