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THE WEEKLY VIEW

Draghi: "Central Banks Cannot Replace Governments" Instead They are Buying Time

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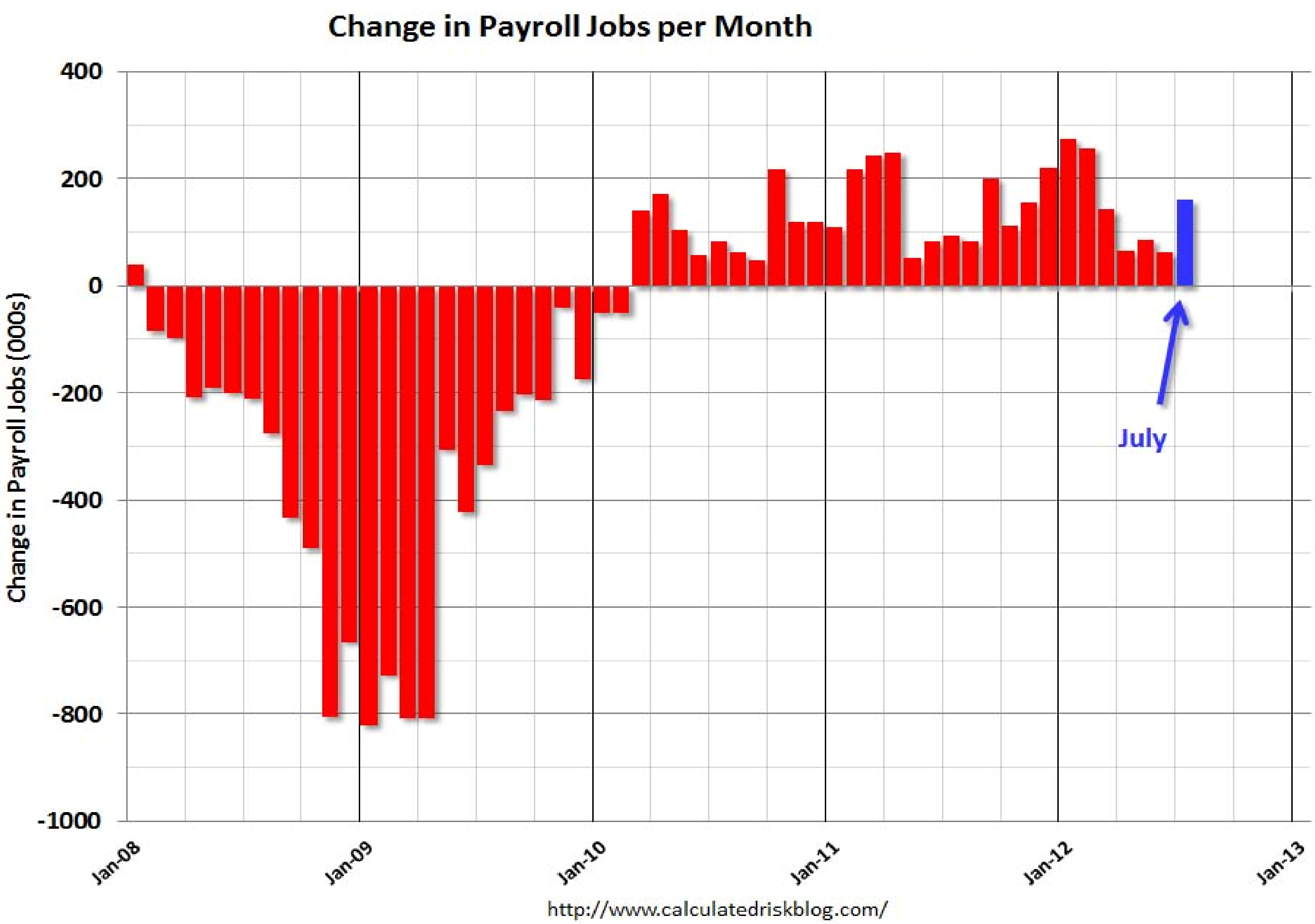
- The Federal Reserve and European Central Bank (ECB) disappointed markets last week by not announcing further monetary stimulus following their scheduled meetings. The Fed reiterated it "will provide additional accommodation as needed," implying that economic and financial conditions would have to worsen further to get them to act. Expectations were greater for the ECB to resume sovereign bond purchases of financially-stressed governments, especially in light of President Mario Draghi's high-profile statement "to do whatever it takes to preserve the euro" from the previous week. In his press conference last Thursday after the ECB left monetary policy unchanged, **Draghi clarified that any bond buying would be conditional**: "First of all governments need to go to the EFSF; the ECB cannot replace governments." The requirement that default-prone countries essentially 'fill out a credit application' for the EFSF*, indicates a policy in which a member nation that is not meeting its financial obligations (defined by the EFSF/ESM) and will not submit to structural reform, does not belong in the Eurozone. The ECB appears to believe the euro's long-term success is dependent upon enforcing this policy. (*The European Financial Stability Fund [EFSF] is expected to transition into the European Stability Mechanism [ESM] — a permanent bailout fund with explicit ECB banking supervision — upon potential constitutional authorization in September.)
- Unfortunately, the risk of Draghi's conditionality is that conditions won't be met. Fears of this risk were evident early last week when Spanish and (to a lesser extent) Italian bond yields threatened to rise above levels that would make their governments insolvent and require bailouts to prevent both default and systematic contagion among major creditors, especially European banks. Spain now must decide whether to seek EFSF/ESM support; we think they will, with the ECB wielding a 'big stick' in one hand and an enticing 'carrot' of unlimited bond buying (of shorter maturities) in the other. Thus Spanish voters must weigh the perceived loss of sovereignty — like the Portuguese, Irish and Greeks before them — against the costs of living with the potential for more economic and financial mismanagement. Of course the wisdom of EFSF/ESM (and ultimately ECB) oversight could prove no better than Spain's, particularly if further austerity is imposed, which drives them deeper into recession. However, this is precisely the decision the ECB wants Spain to make. By forcing agreement, either way, the rest of the Eurozone can move on with or without Spain. **Spanish 10-year bond yields remain under 7% and the euro has held above 1.19 per US dollar, a major technical support level, both of which we interpret as market perception that Spain will acquiesce.**
- The ECB's choice to avoid decisions that it believes properly reside with elected officials appears to echo the Fed's view that institutional credibility and independence are best maintained by deferring to voters when the macroeconomic and monetary environment is seen to be stable. We therefore see the framework for the current trading range in stocks as one where stressed markets at the lower end of the range create the policy response that caps the lows, and yet more stable markets cause central banks to push responsibility back to politicians who can't agree on longer term

action. There is considerable overlap and debate over where monetary and fiscal responsibilities lie regarding growth, employment, and price levels, but under present circumstances of extraordinary monetary accommodation, monetary policymakers' desire to push back on fiscal authorities is understandable. We expect stocks to be range-bound through the summer.

- US employment increased by 163,000 in July, much better than the prior three months (see Weekly Chart) and above consensus expectations for just 100,000. Furthermore, aggregate payrolls — a broad measure of employment health that combines hours worked with hourly earnings — continued to rise and is 3.8% above year-ago levels, comfortably ahead of 1.7% consumer price inflation. This suggests that consumer demand can be maintained amid ongoing household deleveraging and that recession remains unlikely. The US non-manufacturing purchasing managers' index underscored the relative health of the service sector (close to 80% of GDP) by increasing half a point in July to 52.6, signaling ongoing expansion of business activity. In contrast, however, the US manufacturing PMI remained slightly below 50 indicating modest contraction, reflecting continued weakness abroad where global manufacturing and service PMIs are, for the most part, in decline. **Given the better than expected gains in employment and continuing expansion in the service sector, we continue to assign below 50% odds of a synchronized global recession, with the US posting 'new normal' GDP growth of 1% to 2%.**

THE WEEKLY CHART: JOB GROWTH AVERAGING AROUND 100,000 SINCE 2009



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