Weekly Insights on Markets and the Economy

THE U.S. ECONOMY

Annual % change in quarter, unless noted otherwise	2015		
	Q2	Q3	Q4
Real GDO[1]	2.3	**4.9**	**4.5**
Gross Domestic Product	3.9	**3.8**	**4.0**
Memo: Current tracking[2]		*1.5*	
Final sales	3.9	**4.6**	**4.2**
Consumption	3.6	**3.8**	**3.4**
Inventory ch ($ bn ar)	113.5	**83.4**	**77.9**
Nonfarm ($ bn ar)	111.0	**82.0**	**76.5**
Farm ($ bn ar)	4.1	**3.0**	**3.0**
Memo: Ex. government	3.4	**4.4**	**4.7**
Gross Domestic Income	0.7	**6.1**	**5.1**
Aggregate hours worked	1.0	**2.7**	**2.3**
Nonfarm payrolls	1.7	**1.7**	**1.7**
Ave mnth ch (thousands)	231	**167**	**233**
Industrial production	-2.6	**2.3**	**2.9**
Manufacturing output	1.2	**2.2**	**2.6**
Unemployment (% at end)	5.3	**5.1**	**5.1**
Chain PCE prices (% oya[3])	0.3	**-0.9**	**-0.1**
Food (% oya[3])	1.0	**0.5**	**0.1**
Energy (% oya[3])	-15.9	**-26.3**	**-15.1**
Ex. food & energy (% oya[3])	1.3	**1.3**	**1.3**
CPI (% oya[3])	0.2	**-0.9**	**0.2**
Ex. food & energy (% oya[3])	1.8	**1.8**	**1.8**
Petroleum (WTI, $ per barrel)	59.9	**45**	**45**

THE FED AND THE MARKETS

Percent, unless noted otherwise	Now	2015
	(10/09)	10/28[4]
Fed funds target	0-¼	**0- ¼**
3-month OIS[5]	0.17	
3-m euro $ fut contract[5]	0.39	
2-yr Treasury note	0.64	**0.78**
5-yr Treasury note	1.52	**1.62**
10-yr Treasury note	2.09	**2.34**
Inflation buffer	1.56	**1.93**
10-year TIPS	0.53	**0.41**
5-year TIPS	0.15	**-0.91**
5x5 TIPS[6]	0.91	**1.75**
JPM high grade	4.05	**4.24**
Spread[7] (bp)	196	**190**
JPM high-yield	8.99	**9.14**
Spread[7] (bp)	690	**680**
U.S. dollar / euro	1.14	**1.15**
Yen / U.S. dollar	120	**120**
		12/31
Wilshire 5000	21,158	**24,231**
Price/earnings[8]	12.2	**13.5**
S&P 500	2,015	**2,279**

Notes: forecasts are bolded; "bn" refers to billion, "ar" is annual rate, "oya" is the change from a year ago, "ave mnth ch" is the average monthly change, "TIPS" refers to Treasury Inflation Protected Securities, and "bp" is basis points. [1] Gross Domestic Output (GDO) represents the average of real GDP and real GDI growth. [2] Implication of the latest data. [3] Percent change from 12 months earlier at quarter end. [4] Second day of next FOMC meeting. [5] Three-month Overnight Index Swap rate; 3-month December eurodollar futures contract. [6] Forward 5-year Treasury yield, five years into the future. [7] Selected yield less 10-year Treasury yield. [8] Versus 2-year forward after-tax earnings. The price/earnings ratio has averaged 14.0 at cycle peaks, excluding the unprecedented 1990's multiples.
Sources: U.S. Department of Commerce; U.S. Department of Labor; Federal Reserve Board.

LAST WEEK

- Minutes of the September 16-17 FOMC meeting made it hard to understand why Fed officials continue to say that they plan to raise rates before the end of the year. But public remarks since that meeting, which recognize that the labor market will continue to recover as long as job growth exceeds 100,000 to 125,000 monthly, continued to keep the idea alive.
- Jobless claims continue to indicate that the recovery remains well entrenched and unfazed by fears about economic activity abroad, or that the latest estimate that Q3 GDP growth may be as slow as 1.5 percent is at all an accurate reflection of true economic activity.

THIS WEEK

- September retail sales and CPI (and jobless claims) are the highlight of the week's economic calendar.

REALITY CHECK: CONSUMERS ARE SPENDING THEIR WINDFALL AT THE "PUMP"

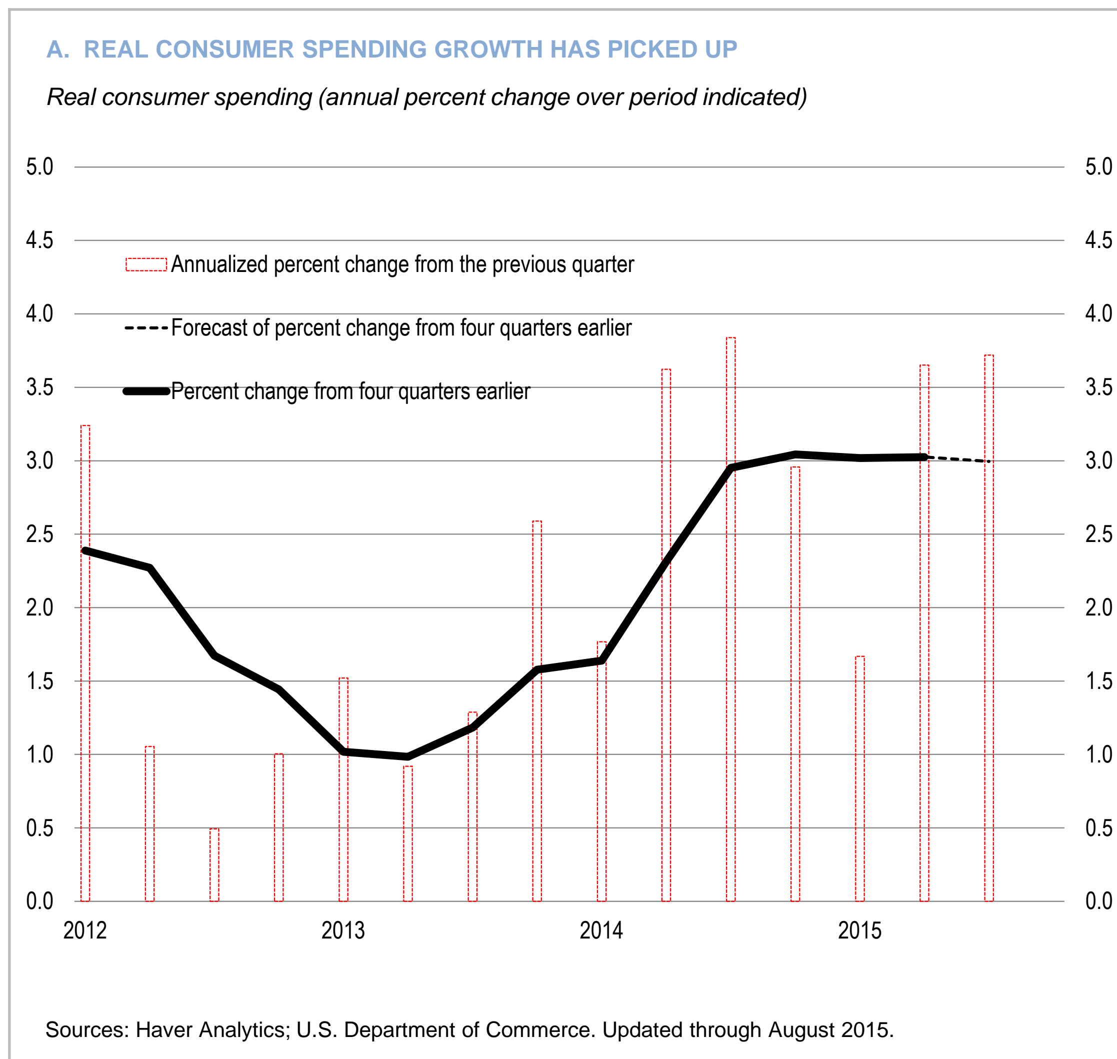
ECONOMIC FOCUS: "DOLARIZATION" REFLECTS ECONOMIC MIRACLES, NOT GLOBAL FRAGILITIES

- Commentary has swung from "Who Shrank the Super Power" to worries about the "Dominant and Dangerous" role of the dollar in the world economy.
- Such commentary misses the big points, that the dollars international investors are (voluntarily) accumulating are a side effect of a profoundly favorable economic renaissance around the world. It symbolizes a development that is promoting a more stable and more prosperous global economy, and is not eroding the stability of the global financial infrastructure.

REALITY CHECK: CONSUMERS ARE SPENDING THEIR WINDFALL AT THE "PUMP"

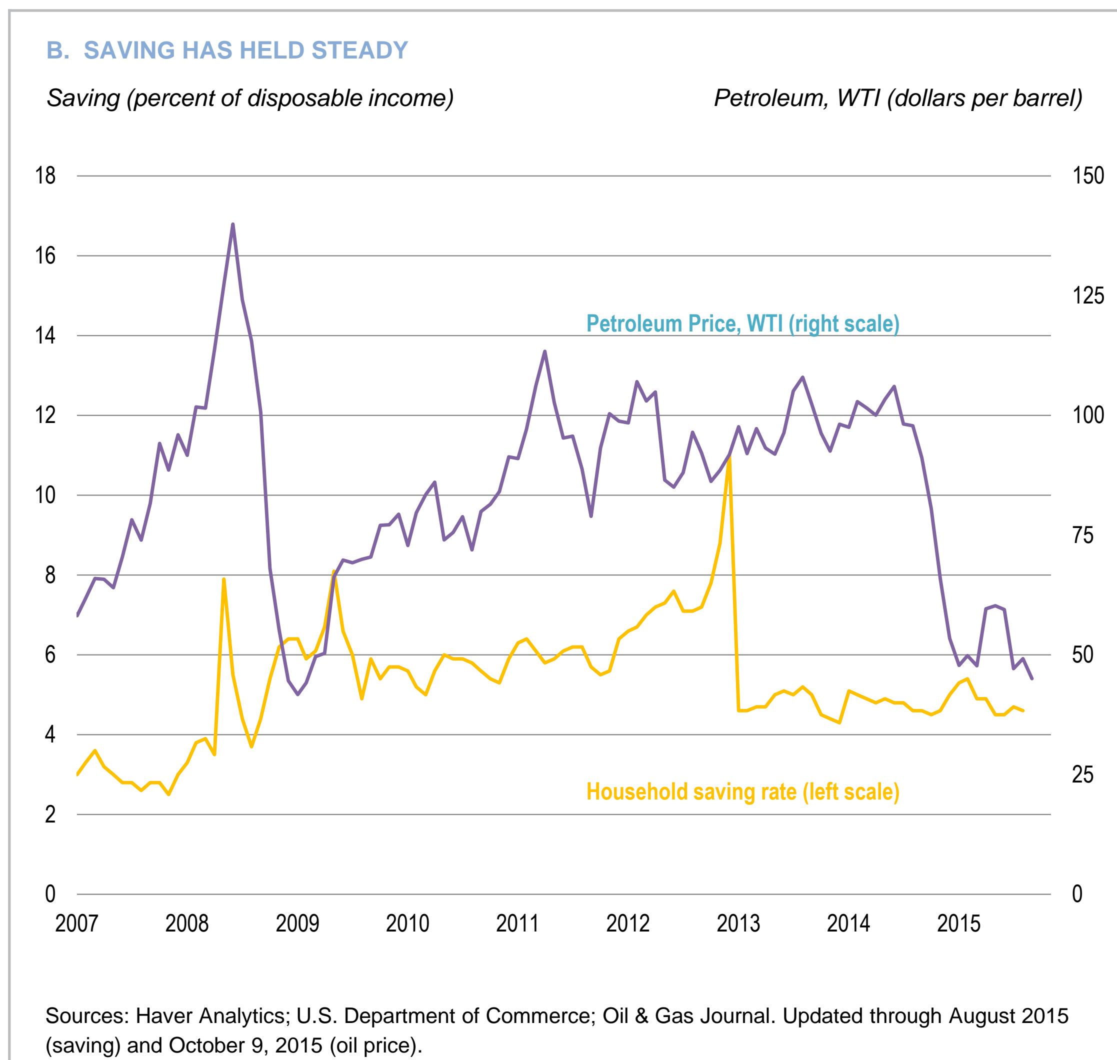
When petroleum prices began to tumble a year ago, bringing the pump price of gasoline and other household fuel prices down with it, observers wondered how the consumer would respond. If households boosted saving and paid down debt, economic activity would benefit less than if consumers spent their windfall on other goods and services. In that case, new business and consumer spending freed up by lowered outlays for energy would counterbalance any economic drags associated with cutbacks in drilling activity and petroleum-related capital spending.

Two perspectives indicate that consumers have responded by redirecting their spending to other areas. One is the actual behavior of real spending. Figure A indicates that real consumer spending has accelerated to about a 3 percent annualized



rate of growth over the past year. That is up from a slow point in 2013 of about 1.5 percent annualized.

The behavior of the saving rate offers more evidence that households have used their windfall for consumption. Figure B indicates that household saving has fallen back to the low levels reached prior to the drop in oil prices. This implies that households have not used the spare cash freed up by reduced energy bills to pay down debt or to boost saving. Instead, they must have shifted spending to other areas, otherwise the lowered nominal spending for energy would have cut consumption outlays and raised saving. Retail sales trends have been soft but outlays for consumer services (travel) have been solid. That accounts for the strength in consumer credit too.



Sources: Haver Analytics; U.S. Department of Commerce; Oil & Gas Journal. Updated through August 2015 (saving) and October 9, 2015 (oil price).

ECONOMIC FOCUS: “DOLLARIZATION” REFLECTS ECONOMIC MIRACLES NOT GLOBAL FRAGILITIES

ECONOMIC FOCUS SUMMARY

- **Worries about the shrinking super power have given way to worries about the growing primacy of the dollar, with international holdings of dollars quadrupling over the last 15 years to $24 trillion.**
- **Nonetheless, the accumulation of dollar assets by international investors is a side effect of profoundly favorable forces that are spreading prosperity and raising living standards.**
- **For that reason, the “dollarization” of the global financial system, a result of voluntary decisions by under-developed countries to link to the global economy, is not making the global financial system unstable. Instead, it is promoting global stability.**

WORRIES ABOUT THE GROWING PRIMACY OF THE DOLLAR IN THE GLOBAL ECONOMY ARE FAR OFF BASE …

Historians have a fascination with empires, their rise and their fall. And very often that template is used to describe the prospects for the U.S. economy in the evolving global community, with its GDP, which comprises 25 percent of the world's GDP expected to shrink in time back towards the footprint of its population, roughly 4 percent of the world's 7.3 billion people, as poor developing economies advance. The fact is that the U.S. is no empire. It isn't a colonial power and it has no aspiration to be one. It is an open and democratic system, like most other advanced economies. It has deeply embedded checks and balances that to keep it resilient. Its economy stumbles, as it has on 47 different occasions since the Declaration of Independence was signed in 1776. But difficult economic times don't lead to upheaval and revolution, underscoring its dynamism. So, the speculation about the imagined diminished influence of the U.S. economic system is more about superficial things than it is about substance.

In fact, it seems we can't quite make up our minds about what lies in store for the U.S. In the dark days of the financial crisis we heard a lot about the shrinking super power ("Who Shrank the Super Power? Waving Goodbye to Hegemony", *New York Times Magazine*, January 27, 2008). Now, with the economy rebounding from the recession more successfully than others, some are complaining that, while America's economic supremacy may be fading, the primacy of the dollar in the global financial and monetary system "has brittle foundations" and is making the system it underpins unstable ("Dominant and Dangerous," a special report on the dollar's role in the world economy, *The Economist*, October 3-9, 2015).

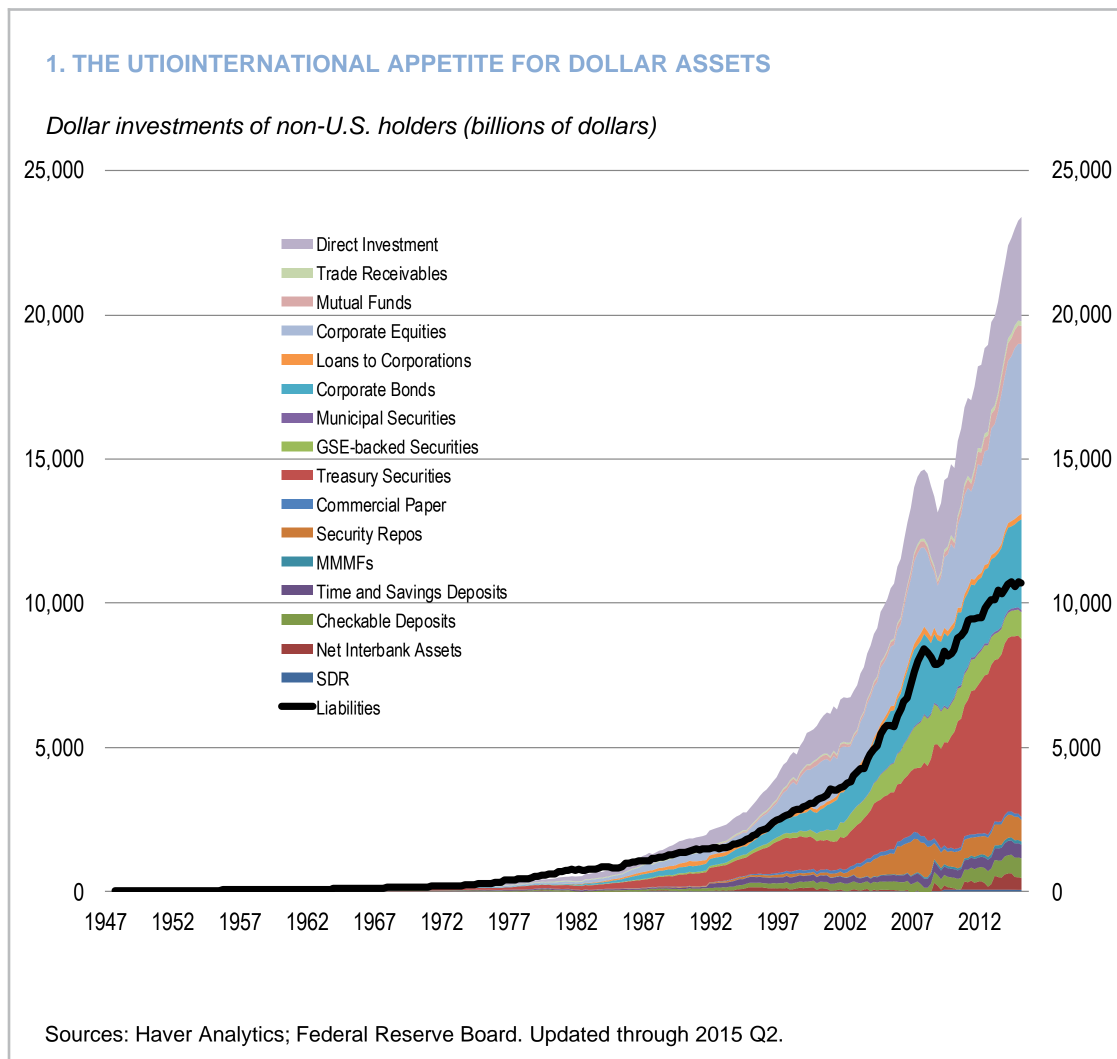
What is the concern? International investors are accumulating dollars at an eye-popping rate. International investors now hold $24 trillion of dollar assets, according to the Federal Reserve's Financial Accounts of the United States (Figure 1, page 7). That's more than quadruple the level of such holdings at the beginning of this millennium and is expanding more rapidly than dollar-denominated borrowings by the rest of the world. Because much of the accumulation of dollars is held by central banks of developing economies, naturally much of this buildup has been centered in the official holdings of dollars (international

reserves), as tallied by the International Monetary Fund (Figure 2, page 8). And it is the reason why official holdings of U.S. Treasury securities now comprise almost half of all outstanding U.S. Treasury obligations (Figure 3, page 10).

One worry about the growing dollarization of the global economy is that emerging markets are having to endure volatile capital flows associated with fears about what will happen when the Federal Reserve (soon) begins to normalize its policy rates. The withdrawal of capital from those markets batters currencies and share prices. That worry is a bit peculiar, because, in theory, flexible exchange rates allow countries to insulate themselves from monetary actions by the Federal Reserve that might not be appropriate for them. If countries choose to peg their currency to the

1. THE UTIOINTERNATIONAL APPETITE FOR DOLLAR ASSETS

Dollar investments of non-U.S. holders (billions of dollars)

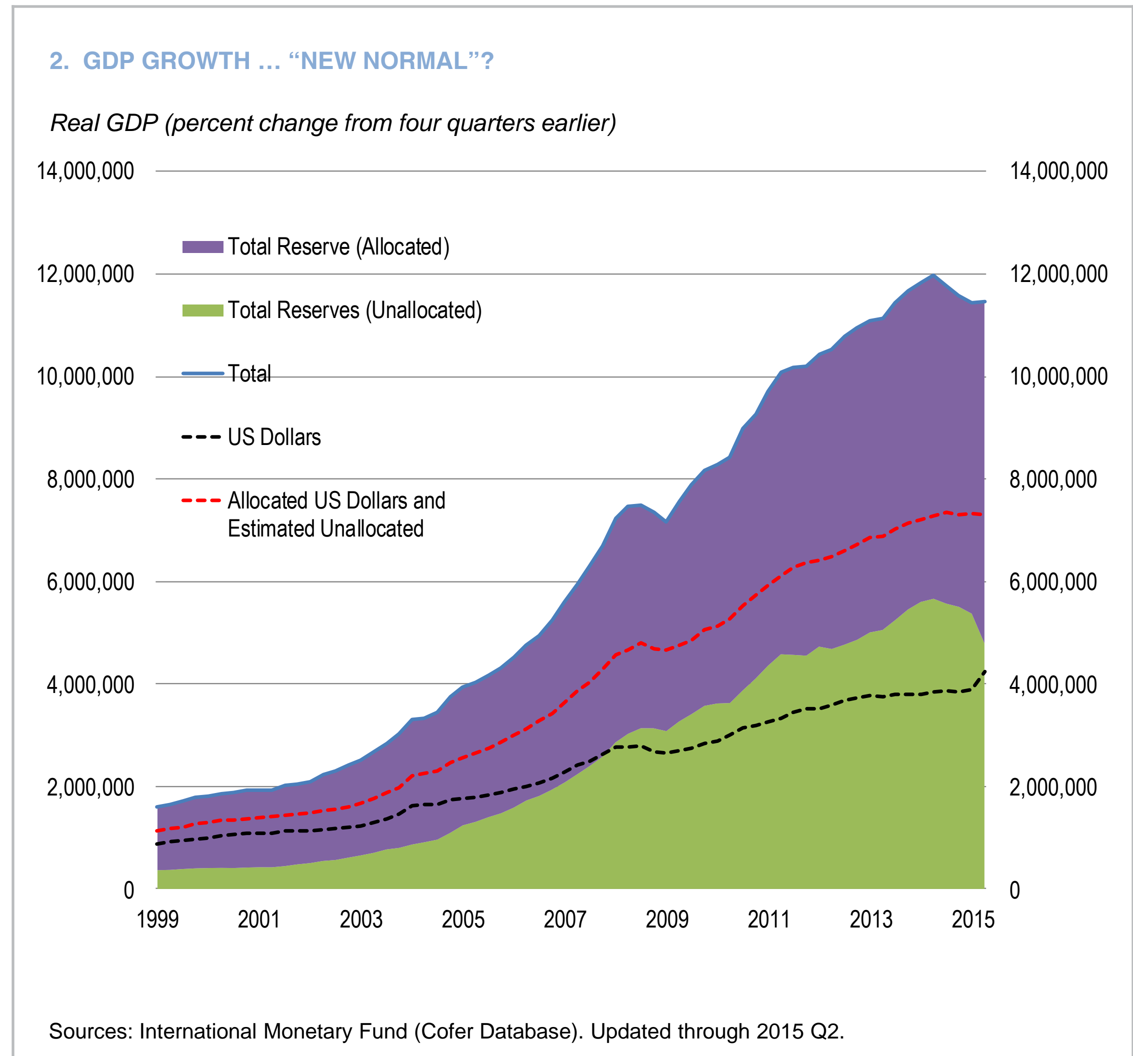


Sources: Haver Analytics; Federal Reserve Board. Updated through 2015 Q2.

dollar, they are doing so because the economic benefits of a stable currency—the diminished uncertainty about currency swings that appeals to international businesses—outweigh the challenges posed by being exposed to Federal Reserve's policy actions.

And, in any case, countries like China that choose to stabilize currency levels relative to the U.S. dollar have ample alternatives to counteract any drags that would result when the interest rate policies of the People's Bank of China are required to match those of the Federal Reserve in order to maintain a stable currency level.

And, the longer-run health of the emerging economies is best served if the Federal Reserve is



Sources: International Monetary Fund (Cofer Database). Updated through 2015 Q2.

successful in meeting its congressional mandates of maximum employment and stable inflation. To delay action for fear of triggering a capital outflow from emerging markets only to move hastily later would prove to be more disruptive for emerging economies than one that moved gradually and in an orderly manner.

In other words, foreign exchange markets are safety valves, if they are allowed to adjust freely. China knows this story well, because by keeping its currency pegged to the dollar as others apply new monetary stimulus that drove their currencies down, her loose peg to the dollar couples her monetary policies to the Fed's.

A second worry is that there is no formal backstop for the offshore dollar system and that, with the U.S. Congress growing wary of the Federal Reserve's emergency lending, it's hands may be tied politically in future financial crisis. In the last crisis, the Fed stepped in as lender of last resort by providing $1 trillion of dollar liquidity to foreign banks and central banks through the swap arrangements. Some observers wonder how long countries will be willing to tie their financial systems to America's "fractious and dysfunctional" politics.

The worry that America's politics is turning inward likely confuses the political reaction to the shrinking share of income earned by labor and widening income distribution—an issue that will dominate the coming presidential race—as a sign that the public wants to disengage from the global industrial revolution, which they know is a new reality. And it is highly doubtful that, in the face of a new unexpected crisis, Congress would refuse to allow the Federal Reserve to take action.

And a third worry is that the U.S. will use its financial clout as a political tool. This worry seems unfounded, because in an increasingly interconnected global and financial economy, nothing would be more damaging to the U.S. economy than policies that undermined investor confidence. In other words, the prospect of international capital flight is a powerful check and balance on political instincts.

In fact, the worry about the expanding presence of U.S. dollar assets abroad is a distraction from the

3. HOLDERS OF TREASURY SECURITIES OUTSTANDING

Holders of U.S. Treasury obligations (billions of dollars unless noted otherwise)

	2007	2008	2009	2010	2011	2012	2013	2014	2015[1]
All publicly-held Treasury debt	5,159	6,396	7,838	9,420	10,478	11,611	12,380	13,055	13,167
Savings Bonds	196	194	191	188	185	183	179	176	174
Bills	1,000	1,861	1,788	1,769	1,519	1,626	1,591	1,457	1,393
Other	3,903	4,283	5,803	7,405	8,724	9,760	10,559	11,363	11,411
Bills	1,000	1,861	1,788	1,769	1,519	1,626	1,591	1,457	1,438
Notes	2,487	2,792	4,179	5,568	6,599	7,321	7,875	8,221	8,327
Bonds	558	592	715	888	1,060	1,237	1,408	1,576	1,663
TIPS	471	530	568	616	739	849	973	1,078	1,102
FRNs	0	0	0	0	0	0	0	164	261
FFB	0	0	0	0	0	0	0	0	0
Nonmarketable	620	595	561	549	531	548	509	528	344
International holders (private and official)	2,353	3,077	3,685	4,436	5,004	5,574	5,793	6,156	6,077
% of all Treasury debt	45.6%	48.1%	47.0%	47.1%	47.8%	48.0%	46.8%	47.2%	46.2%
Memo:									
Cumulative trade deficit with the U	-5,386	-6,095	-6,478	-6,973	-7,522	-8,058	-8,537	-9,045	-9,400
% held in Treasuries	43.7%	50.5%	56.9%	63.6%	66.5%	69.2%	67.9%	68.1%	64.6%
Australia	10	10	16	15	22	27	34	35	31
Belgium	13	16	17	33	135	139	257	335	155
Luxembourg	70	97	88	86	148	155	135	172	185
Brazil	130	127	169	186	227	253	245	256	257
Canada	19	8	53	75	45	66	56	69	69
Caribbean	116	198	128	168	227	268	294	272	325
China	478	727	895	1,160	1,152	1,220	1,270	1,244	1,241
Memo:									
Cumulative trade deficit with the U	-1,600	-1,868	-2,095	-2,368	-2,663	-2,978	-3,297	-3,640	-3,842
% held in Treasuries	29.9%	38.9%	42.7%	49.0%	43.3%	41.0%	38.5%	34.2%	32.3%
Egypt	10	17	19	26	4	1	4	5	5
France	10	17	31	15	45	51	54	79	49
Germany	42	56	48	61	61	63	67	73	80
Hong Kong	51	77	149	134	122	142	159	173	182
India	15	29	33	41	44	60	69	83	116
Ireland	19	54	44	46	95	103	180	202	217
Israel	6	19	14	21	19	24	24	25	16
Italy	15	16	21	24	23	27	30	32	32
Japan	581	626	766	882	1,058	1,111	1,182	1,231	1,198
Korea	39	31	40	36	47	48	54	68	74
Norway	26	23	12	20	57	75	87	82	67
Mexico	34	35	37	34	29	61	65	85	86
Netherlands	15	15	20	23	22	32	37	36	39
OPEC	138	186	201	212	261	262	238	286	298
Philippines	10	12	12	20	33	37	40	41	41
Poland	13	4	23	26	29	32	31	28	30
Russia	33	116	142	151	150	162	139	86	82
Singapore	40	41	39	73	75	99	86	110	114
Spain	9	4	14	8	24	27	23	28	31
Sweden	14	13	15	17	29	28	34	40	41
Switzerland	39	62	90	107	142	195	177	190	218
Taiwan	38	72	117	155	177	195	182	174	169
Thailand	27	32	33	52	52	54	52	33	33
Turkey	26	30	28	29	32	58	52	77	75
United Kingdom	158	131	180	270	114	133	164	189	213
All other	155	163	151	193	215	214	192	190	186
Memo: Official holdings	1,641	2,138	2,700	3,189	3,621	4,033	4,055	4,113	4,117
Bills	196	458	528	462	357	373	398	335	359
Notes and bonds	1,445	1,680	2,172	2,727	3,263	3,660	3,656	3,778	3,758
Domestic investors	2,806	3,319	4,153	4,984	5,473	6,038	6,587	6,899	7,090
US households	202	184	853	1,123	717	943	957	697	640
Nonfinancial businesses	98	82	89	96	92	92	97	95	98
State and local municipalities	649	601	587	596	561	610	600	637	642
Federal Reserve	741	476	777	1,021	1,663	1,666	2,209	2,461	2,461
Depository Institutions	123	102	197	300	253	340	304	297	299
Property Casualty Companies	71	66	89	92	96	90	96	102	102
Life Insurance Companies	71	106	133	157	175	181	169	183	191

Sources: Haver Analytics; Federal Reserve Board; U.S. Treasury. Updated through 2015 Q2.

profoundly favorable underlying factors that are behind the rapid expansion of dollar holdings, the voluntary decision by under-developed countries to link to the global economy, speed up their economic development, and raise their living standards.

<u>… BECAUSE WHAT'S DRIVING IT IS SPAWNING PROFOUND ECONOMIC BENEFITS …</u>

Countries that embark on an ambitious development program by first giving international businesses access to their abundant labor pool naturally will tend to run a trade surplus with the global community. Over time, as living standards rise and their domestic consumption rises, these surpluses will fall. A country that runs a trade surplus with the U.S. , for example, will experience a greater capital inflow than capital outflow and will accumulate dollars. It could sell its dollar holdings but that would drive its currency up, undermining its appeal to international businesses. So, if a country aims to promote a stable currency to aid its development agenda, it will willingly hold the dollars that it is generating in trade with the U.S. It may invest its surplus dollar holdings in many forms, including U.S. Treasury securities.

So, the expansion in dollar holdings by international investors (Figure 1, page 7) and accumulation of dollars in international reserve holdings—held by governmental bodies—mirrors their trade surpluses that arise from rapid economic development. They are accumulating dollars, not because they are lured by the attractive yields on dollar assets, but because they are committed to ambitious development agenda.

Viewed broadly, the dollarization of the global economy is a side effect of rapid gains in living standards in the emerging economies. Dollarization is a reflection of economic miracles. If the driving forces that are fueling the rapid expansion of holdings of dollar assets by international investors are bringing greater prosperity to vast impoverished regions of the world, surely that promotes greater geopolitical stability as well. For that reason, the "brittle foundation" characterization of the dollar's role in the global financial system seems inappropriate.

… BECAUSE IT REPLICATES THE SUCCESSFUL BRETTON WOODS SYSTEM …

The *Economist Magazine* special report sees warnings in the collapse of the post-war Bretton Woods system of fixed exchange rates in the 1970's as an example of how a system anchored to the dollar can lead to trouble. That system was replaced by floating exchange rates and mobile capital.

The Bretton Woods System was set up in the aftermath of World War II to help war-ravaged economies recover. Currencies were fixed to the dollar at levels that promoted strong export growth and economic recovery. Persistent trade surpluses with the U.S. meant that Europeans were accumulating ever-expanding holdings of dollars. With much of the war damage repaired and countries increasingly unwilling to accumulate dollars, the Bretton Woods system was abandoned. In the 1970's but not before it had accomplished what it was set up to do.

… BECAUSE IT'S VOLUNTARY, NOT IMPOSED BY THE U.S. …

Today's currency pegs maintained by developing countries, particularly in the case of China, mimic the spirit of the Bretton Woods System (some academics refer to these systems as Bretton Woods II). But those who maintain fixed currency pegs today do so voluntarily to promote their development agenda. The U.S. does not force anyone to link their currencies to the dollar.

… AND BECAUSE IT' IS A BURDEN FOR THE U.S. TOO, IN THE SHORT RUN

Of course, we in the advanced economies should cheer the rapid development that is taking place in the emerging countries—what is the main driver of the dollarization of the global financial system—for the future economic opportunities that it will offer, for the geopolitical stability it promises when economic prosperity is shared more broadly, and for the increased global competition it will promote.

But it is often forgotten that imbalanced trade places a burden on the developed economies as well. The rapid accumulation of dollar assets by international investors often is portrayed as a one-way windfall for the United States and for Europe.

That perspective almost certainly is too narrow for several reasons. For one, enlarged trade imbalances between developing and developed economies imply that developing countries are unable to spend and invest their surpluses quickly enough and so are forced to save the capital (dollars and euros) they are accumulating as a result of chronic trade surpluses. That contributes to an elevated level of global saving—or, conversely, shortfall of aggregate global demand—that complicates the economic challenges for economies that are recovering from recessions.

And the reconfiguration of manufacturing operations around the world as operations shift to developing economies is disruptive, even as expanding trade with developing economies brings new job opportunities in other areas. Those who are displaced may be quite visible while those who are benefiting from new opportunities as a result of increased global trade likely are less visible.

P.S. THE OUTSIZED FOOTPRINT OF U.S. FINANCIAL PROWESS EVENS AS ITS GDP SHARE SHRINGS IS A REFLECTION OF WEALTH NOT GDP

The U.S. economy's footprint in global economy would be expected to recede naturally as the ongoing development in emerging economies advances. So, as a result, the *Economist Magazine* article finds it to be troublesome that America's clout is increasing in global finance. For example, Wall Street's investment banks comprise 50 percent of global finance, according to the magazine. About 55 percent of the world's assets under management are run by American fund managers. And global capital flows appear to move in harmony with a measure of the volatility in America's stock markets.

It should come as no surprise that this would be the case, because financial activities would be expected to be correlated with the wealth of nations, not the size of a country's GDP footprint. The relative hare of U.S. GDP may over time fall back more in line with the relative size of its population (4 percent of the global population), but it is a wealthy nation and naturally that will be reflected in the outsized footprint of its financial system.

CONCLUSION

The spread of dollar assets around the world is not a sign that the global economy is becoming dangerously anchored to the U.S., resting on increasingly brittle foundations. It is an indication that economic prosperity is beginning to spread to impoverished nations. The world would not be more stable or safer if this were not occurring. Surely a persistence of the status quo of the last century would lead to a more imbalanced and dangerous global system. Whatever vulnerabilities those who fear the dollarization of the global economy imagine, surely the benefits of wider gains in prosperity outweigh any imagined costs.

CONTACT:
James E. Glassman
Telephone: (212) 270-0778
jglassman@chase.com

© 2015 JPMorgan Chase & Co. All rights reserved. Chase, JPMorgan and JPMorgan Chase are marketing names for certain businesses of JPMorgan Chase & Co. and its subsidiaries worldwide (collectively, "JPMC"). The material contained herein is intended as a general market commentary. To the extent indices have been used in this commentary, please note that it is not possible to invest directly in an index. Opinions expressed herein are those of James Glassman and may differ from those of other J.P. Morgan employees and affiliates. This information in no way constitutes J.P. Morgan research and should not be treated as such. Further, the views expressed herein may differ from that contained in J.P. Morgan research reports. The above summary/prices/quotes/statistics have been obtained from sources deemed to be reliable, but we do not guarantee their accuracy or completeness.