

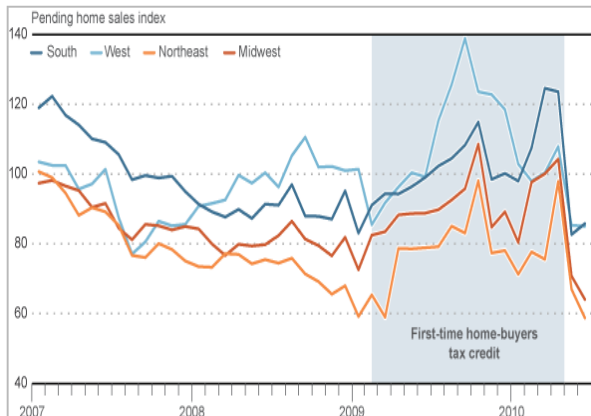
INSIDE DEBT

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Tuesday, August 3, 2010

CHART OF THE DAY

U.S. pending home sales by region



Pending sales of previously owned homes fell to a record low in June as contracts fell in three of the four regions.

TODAY'S TOP NEWS

- Fed to consider symbolic shift as economy wavers
- U.S. bill sale well bid, interbank dlr rate falls
- Consumer, housing data fan recovery worries
- Geithner: U.S. unemployment could rise - ABC
- FDIC seeks CMBS underwriters
- Australia central bank holds rates, may pause awhile
- July U.S. auto sales up; Ford, GM in focus
- Banks rush to park cash at ECB, reduce liquidity intake

ECON WATCH

FOR WEDNESDAY AUGUST 4

| ET | Indicators | Unit | Reuters | Prior |
|-------|--|------|---------|--------|
| 3:43 | IT Markit/ADACI serv PMI | ind | 52.0 | 51.5 |
| 3:48 | FR Markit/CDAF serv PMI | ind | 61.3 | 61.3 |
| 3:53 | DE Markit services PMI | ind | 57.3 | 57.3 |
| 3:58 | EZ Markit serv PMI | ind | 56.0 | 56.0 |
| 3:58 | EZ Markit-composite PMI | ind | 56.7 | 56.7 |
| 4:28 | GB Markit/CIPS Svcs PMI | ind | 54.4 | 54.4 |
| 5:00 | EZ Retail sales mm | % | 0.1 | 0.2 |
| 5:00 | EZ Retail sales yy | % | 0.1 | 0.3 |
| 7:00 | US Mortgage index | ind | - | 720.6 |
| 7:00 | US Refinancing index | ind | - | 3918.1 |
| 7:30 | US Challenger layoffs | ind | - | 39,358 |
| 8:15 | US ADP Nat Employment | k | 40 | 13 |
| 10:00 | US ISM non-mfg | ind | 53.0 | 53.8 |
| 10:00 | US ISM N-mfg bus act | ind | 57.0 | 58.1 |
| - | GB BoE Starts 2-day Monetary Policy Meet | | | |

MARKETS TODAY

TODAY'S TOP STORY: U.S. Federal Reserve officials will consider a modest but symbolically important change in the management of its massive securities portfolio when they meet next week, amid signs the economy may be losing momentum, the Wall Street Journal reported.
For more please click here

TREASURIES: U.S. Treasury debt prices rose, pushing the two-year yield to an all-time low after a Wall Street Journal report underscored the belief the Federal Reserve would buy more bonds to prop up the economy.

- 2-yr notes gained 2/32 yielding 0.54 pct from 0.57 pct. The 2-yr note yield dipped as low as 0.53 pct, marking a new record.
- 10-yr Treasury notes rose 17/32 to yield 2.91 pct, down from 2.97 pct.
- The spread between the yield on 2-yr notes and 10-year notes flattened to 237 bps from 240 bps. The gap between yields on the 10-yr note and the 30-yr bond pushed out to 113 bps, marking a new record-wide level.

FOREX: The U.S. dollar fell near a four month low against a basket of currencies after the Fed is reportedly considering buying more debt to pull down market rates, making the dollar potentially less attractive.

- The dollar index fell to 0.43 pct to 80.592, lowest since April 16.
- The yen strengthened against dollar after the 2-yr U.S Treasury yield advantage over the same maturity Japanese government bond narrowed to lowest since January 2009.

CORPORATES: U.S. corporate bond spreads edged tighter, extending the past four weeks' improving trend as robust demand for a spate of new debt sales bolstered sentiment.

- The CDX.IG-14 index widened by about 1 bps to 100 bps.
- MetLife launched a \$3.0 bln four-part debt sale.
- Public Service Electric and Gas sold \$250 mln of secured medium-term notes. Corning sold \$700 mln of notes in two parts. The size of the deal was increased from an originally planned \$600 mln.

STOCKS: U.S. stocks slipped as Dow component Procter & Gamble Co.'s lackluster results, coupled with weaker-than-estimated data on consumer spending and housing, prompted investors to exercise caution a day after the market's 2 percent rally.

- Dow fell 0.36 pct to 10,636.31, S&P was down 0.48 pct at 1,120.42 and Nasdaq lost 0.52 pct to 2,283.52.
- P&G fell 3.42 pct while Pfizer jumped 5.56 pct.
- Dow Chemical slid 9.99 pct, Archer Daniels Midland rose 0.60 pct.
- U.S. listed shares of RIM slipped 2.54 pct.
- The S&P Consumer Discretionary Sector fell 1.34 pct while the S&P Retail index lost 1.91 pct. S&P financials fell 1.12 pct.

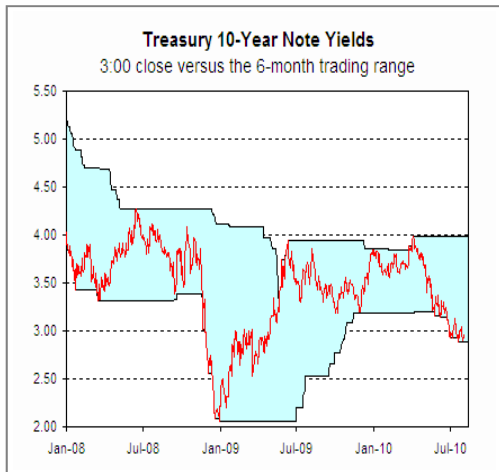
C & E: U.S. crude oil rose to settle at a three-month high above \$82 a barrel, up a fourth straight session as the dollar weakened broadly and offset disappointing economic data.

- U.S. crude oil climbed 1.32 pct to \$82.41 per barrel.
- Gold advanced 0.41 pct to \$1,186.1 an ounce.
- Reuters-Jefferies index shed 0.08 pct to 276.63.

- For MARKET SNAPSHOT click here
- For NEXT UP click here
- For DEEP DIVE click here



MARKET SNAPSHOT as of 3:00 pm EST



TREASURIES <5> <500>

| | BID | ASK | YIELD | CHANGE |
|-----------|---------|---------|-------|--------|
| 1-Mo Bill | 0.150 | 0.12 | 0.152 | 0.002 |
| 3-Mo Bill | 0.155 | 0.145 | 0.157 | 0.012 |
| 6-Mo Bill | 0.195 | 0.185 | 0.198 | -0.004 |
| 1-Year | 0.255 | 0.250 | 0.259 | -0.014 |
| 2-Year | 100.164 | 100.195 | 0.543 | 0.055 |
| 3-Year | 100.617 | 100.648 | 0.788 | 0.160 |
| 5-Year | 100.945 | 100.992 | 1.553 | 0.414 |
| 7-Year | 100.656 | 100.703 | 2.273 | 0.523 |
| 10-Year | 104.969 | 105.016 | 2.912 | 0.430 |
| 30-Year | 105.688 | 105.750 | 4.044 | 0.375 |

EQUITIES

| | INDEX | CHANGE |
|---------|----------|--------|
| DJIA | 10641.15 | -33.23 |
| NASDAQ | 2285.62 | -9.74 |
| S&P 500 | 1120.96 | -4.90 |

OIL

| | PRICE | CHANGE |
|-------|-------|--------|
| NYMEX | 82.5 | 1.1 |
| BRENT | 82.6 | 1.8 |

EURODOLLAR FUTURES

| | CLOSE | CHANGE |
|--------|--------|--------|
| Aug-10 | 99.605 | 0.010 |
| Sep-10 | 99.615 | 0.020 |
| Dec-10 | 99.580 | 0.015 |
| Mar-11 | 99.515 | 0.020 |

REPURCHASE AGREEMENTS

| G/C | | MORTGAGE REPOS | |
|--------------|-------|----------------------------|-------|
| O/N | 0.320 | O/N | 0.300 |
| 2-Week | 0.290 | 2-Week | 0.300 |
| 1-Month | 0.290 | 1-Month | 0.300 |
| 3-Month | 0.310 | 3-Month | 0.310 |
| AGENCY REPOS | | i-REPO SM INDEX | |
| O/N | 0.300 | 10:00 AM | 0.240 |
| 2-Week | 0.300 | 3:00 PM | 0.238 |
| 1-Month | 0.300 | | |
| 3-Month | 0.310 | | |

IR SWAPS <19901>

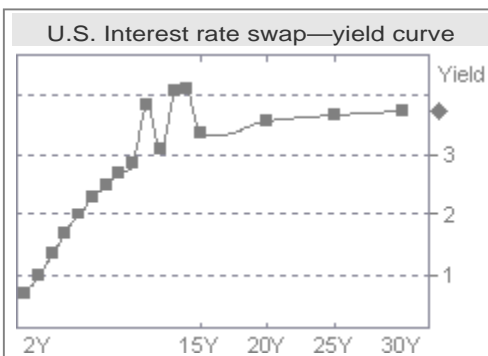
| | SPREAD | | RATE | |
|---------|--------|--------|------|------|
| 2-Year | 14.50 | 18.50 | 0.68 | 0.71 |
| 3-Year | 21.50 | 25.50 | 1.00 | 1.03 |
| 5-Year | 14.25 | 18.25 | 1.69 | 1.71 |
| 7-Year | 2.00 | 6.00 | 2.29 | 2.30 |
| 10-Year | -5.75 | -1.75 | 2.86 | 2.86 |
| 30-Year | -33.25 | -29.25 | 3.71 | 3.70 |

FUTURES

| | PRICE | CHANGE |
|------------|--------|--------|
| CBOT 5 yr | 120.09 | 0.47 |
| CBOT 10 yr | 123.23 | 0.03 |
| CBOT 30 yr | 128.00 | -0.13 |

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

| | BID | ASK | BID | ASK |
|----------|-------|-------|-------|-------|
| O/N | 0.210 | 0.240 | - | - |
| 1-Month | 0.300 | 0.400 | 0.173 | 0.183 |
| 3-Month | 0.400 | 0.600 | 0.171 | 0.181 |
| 6-Month | 0.550 | 0.700 | 0.174 | 0.184 |
| 12-Month | 0.900 | 1.200 | 0.214 | 0.224 |



CURRENCIES

| | BID | ASK |
|-------------|---------|---------|
| Euro | 1.3232 | 1.3234 |
| Sterling | 1.5944 | 1.5950 |
| JP Yen | 85.81 | 85.84 |
| Swiss Franc | 1.0387 | 1.0390 |
| Can Dollar | 1.0234 | 1.0238 |
| Mexico | 12.5985 | 12.6046 |

FED FUNDS NYFRSM - 10AM

| | | | |
|------|--------|----|--------|
| Open | 0.2200 | 1m | 0.2944 |
| High | 0.2500 | 3m | 0.4363 |
| Low | 0.1400 | | |

ACTIVE FANNIE MAE AGENCIES

| TERM | COUPN | MATURITY | YIELD-SPREAD | | YIELD |
|---------|-------|------------|--------------|----|-------|
| 2-Year | 1.125 | 30/07/2012 | 14 | 13 | 0.67 |
| 3-Year | 1.625 | 15/04/2013 | 6 | 5 | 0.84 |
| 5-Year | 2.375 | 28/07/2015 | - | 20 | - |
| 7-Year | 5.125 | 18/10/2016 | -1 | - | 2.26 |
| 10-Year | - | - | - | - | 4.55 |
| 30-Year | 6.625 | 15/11/2030 | 28 | - | 4.32 |

ACTIVE FREDDIE MAC AGENCIES

| TERM | COUPN | MATURITY | YIELD-SPREAD | | YIELD |
|---------|-------|------------|--------------|------|-------|
| 2-Year | 1.125 | 27/07/2012 | 14.5 | 13.5 | 0.68 |
| 3-Year | 1.25 | 20/08/2013 | 18.5 | 18 | 0.97 |
| 5-Year | 2.875 | 09/02/2015 | 3 | 2 | 1.58 |
| 7-Year | 5.25 | 15/09/2016 | -6 | - | 2.21 |
| 10-Year | 3.75 | 27/03/2019 | 4 | - | 2.95 |
| 30-Year | 6.25 | 15/07/2032 | 36 | 33 | 4.4 |

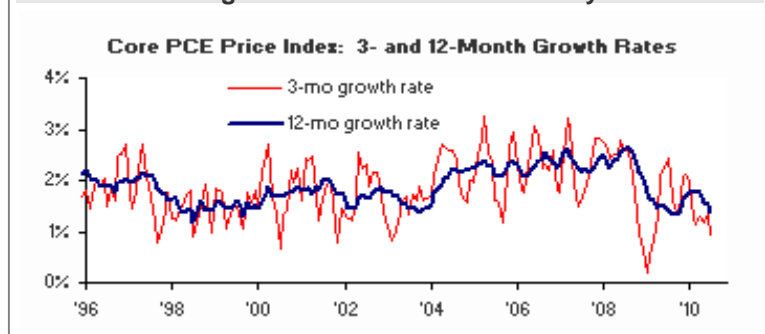
Active MBS 15YR

| | CPN | BID | ASK | YIELD |
|-------|-----|----------|----------|-------|
| FNMA | 4.0 | 104.2010 | 104.2050 | 2.423 |
| FHLMC | 4.0 | 104.2000 | 104.2000 | 2.378 |

Active MBS 30YR

| | CPN | BID | ASK | YIELD |
|-------|-----|----------|----------|-------|
| FNMA | 4.5 | 104.1560 | 104.1620 | 2.682 |
| FHLMC | 4.5 | 104.1170 | 104.1230 | 2.647 |
| GNMA | 4.5 | 105.1660 | 105.1720 | 2.971 |

Wrightson ICAPSM Chart of the Day



TODAY'S TOP NEWS

Fed to consider symbolic shift as economy wavers-WSJ

U.S. Federal Reserve officials will consider a modest but symbolically important change in the management of its massive securities portfolio when they meet next week, amid signs the economy may be losing momentum, the Wall Street Journal reported.

Any change only four months after the central bank ended a massive bond-buying program would signal deepening concern about the U.S. economic outlook, the newspaper said in the report on its website.

Fed officials meeting on Aug. 10 will consider whether to use cash the Fed receives when its mortgage-bond holdings mature to buy new mortgage or Treasury bonds, instead of allowing its portfolio to shrink gradually, as it is expected to do in the months ahead, the report said, without citing sources.

The central bank's \$2.3 trillion portfolio has nearly tripled in size since 2007. Buying new bonds with cash from maturing bonds would show the public and markets that the Fed is seeking ways to support economic growth, the report said. It could also be a compromise that rival factions at the Fed support, as officials differ about whether and how to address a subpar recovery.

Consumer, housing data fan recovery worries

U.S. consumer spending and incomes were flat in June while home purchase contracts tumbled to a record low, implying an anemic economic recovery for the remainder of this year.

The reports showed the recovery assumed a decisively sluggish tone in the last month of the second quarter, setting up the July-September period for a lackluster performance just as lawmakers hit the hustings before November elections.

Analysts said there was now a greater risk that the April-June quarter's already soft 2.4 percent growth pace could be revised down.

Spending had edged up 0.1 percent in May, the Commerce Department said, and analysts expected another rise in June.

A separate report from the National Association of Realtors showed the group's Pending Home Sales Index dropped 2.6 percent to a historic low of 75.7.

The Commerce Department also reported that new orders received by U.S. factories dropped 1.2 percent in June.

Personal income was flat after increasing 0.3 percent in May. It was the first time since September that incomes had not risen. Real disposable income increased 0.2 percent after rising 0.4 percent the prior month. The saving rate was 6.4 percent, the highest since June last year.

FDIC seeks CMBS underwriters

The FDIC is seeking proposals from Wall Street dealers to help issue commercial mortgage-backed securities with loans saddling failed bank balance sheets, according to an FDIC document.

Dealers have until Aug. 20 to submit their plans under the FDIC's request for proposal, a copy of which was obtained by Reuters. An FDIC spokesman declined to comment.

Federally backed issuance would be the newest development in the \$700 billion CMBS market, which has been crawling back from the financial crisis since December. While likely lacking the yield of a traditional CMBS, FDIC bonds could fill a void in a market shrinking due to lack of new issuance.

Separately, The NY Fed said it plans to conduct small reverse repurchases tomorrow with agency MBS for the first time. Reverse repos is a tool for the U.S. central bank to reduce the \$1 trillion excess reserve in the banking system.

U.S. bill sale well bid, interbank dlr rate falls

A U.S. auction of four-week bills was well bid, in line with recent bill auctions, as benchmark interbank dollar funding costs fell to a 2-1/2-month low on the possibility the Federal Reserve could become more accommodative.

The two-year U.S. swaps spread fell to around 16 basis points, its lowest since late April. Bond markets were already anticipating that the Fed would keep borrowing costs near record lows after Bernanke said yesterday that the economy has yet to recover fully and monetary policy must remain accommodative.

The Libor for three-month dollars fixed at 0.43469 percent, down one basis point from 0.44469 percent yesterday.

Its spread over the three-month OIS rate was unchanged at 26 bps, the smallest gap since May 20.

In euro money markets, three-month euro Libor fixed unchanged at 0.83156 percent while the equivalent Euribor rate inched up to 0.899 percent, matching its highest in a year set last week. The benchmark Euribor rate has risen around 11 basis points since the ECB withdrew a month ago a huge chunk of emergency cash it provided to banks in 2009.

Geithner: U.S. unemployment could rise - ABC

Treasury Secretary Timothy Geithner said the U.S. unemployment rate could rise for two months before it drops, potentially deepening Democrats' problems in the November congressional elections.

"It's possible you're going to have a couple of months where it goes up," Geithner said on ABC's "Good Morning America" interview broadcast and taped a day earlier.

"But what we expect to see ... is an economy that's gradually healing. Of course we want to do what we can to reinforce that process because it's not growing back as quickly as we'd like."

The economy has added jobs in five of the past six months, which may entice some discouraged workers to resume looking, although private sector hiring remains weak.

Although the Fed is widely expected to keep its benchmark short-term interest rate unchanged near zero, officials may talk over what more steps might be needed to give the recovery an extra jolt.

Meanwhile, Harvard University law professor Elizabeth Warren would be a very effective leader of the new U.S. consumer financial agency but no decision has been made yet about the post, U.S. Treasury Secretary Timothy Geithner said.

Australia central bank holds rates, may pause awhile

Australia's central bank held interest rates steady for a third straight month, and moderating inflation at home combined with uncertainty abroad could allow it to pause for some time to come.

Interbank futures held steady as investors wagered the RBA could keep its cash rate at 4.5 percent into next year.

A surprisingly benign reading for inflation in the second quarter gave the central bank room to skip a further hike this month. Underlying inflation moderated to a three-year low of 2.7 percent last quarter, putting it back in the central bank's 2 to 3 percent target range.

In a brief statement, RBA Governor Glenn Stevens said inflation was likely to stay in the upper half of that target band through to the middle of next year.

Markets are pricing in virtually no chance of a rise in either September or October, and only around a one-in-five probability of a hike to 4.75 percent by Christmas. Swap rates imply just 15 basis points of tightening for the next 12 months.



TODAY'S TOP NEWS

July U.S. auto sales up; Ford, GM in focus

Top U.S. automakers General Motors and Ford Motor reported an increase of 5 percent in July sales from a year earlier, results they said pointed to a slow but steady turnaround for the battered sector in the third quarter.

The sales increase for Ford was lower than some of the more bullish analysts had forecast and the automaker's shares dropped as much as 2.9 percent.

July sales for Hyundai Motor rose 19 percent while sales for its affiliate Kia were up almost 21 percent. Nissan Motor posted a sales rise of almost 15 percent.

The stronger auto sales for July came as indicators for U.S. consumer spending and incomes for June were flat, data economists said pointed toward a still-anemic recovery.

GM's IPO is expected to reduce the U.S. government's GM ownership stake of 61 percent. GM said it was keeping its forecast for full-year industry wide U.S. sales unchanged at 11.5 million to 12 million vehicles at the start of the second half. Ford's sales were boosted by a nearly 40 percent gain for F-Series pickup trucks and early sales of the Fiesta.

Banks rush to park cash at ECB, reduce liquidity intake

Euro zone banks scaled down their intake of ECB loans, and rushed to earn the extra sliver of interest they get for helping the ECB counterbalance its controversial government bond buys.

The ECB comfortably attracted the 60.5 billion euros in one-week deposits it needed to offset the bond purchases it has made since May.

To achieve its goal it had to pay banks an average interest rate of 0.45 percent, well below the 0.55 percent it paid last week. A total of 93 banks were willing to offload more than 115 billion euros, almost double the intended target. Overall, banks may be beginning to scale back their dependency on ECB liquidity.

They took 154.844 billion euros worth of week-long loans from the ECB, compared to 190 billion last week. The picture was not quite clear-cut, however. Excess liquidity is currently less than half of what it was before banks paid back almost half a trillion euros worth of one-year loans at the start of July.

NEXT UP

Could U.S. cut 30-year auction size? Some say yes

The Treasury Department has said it wants to move buyers of U.S. debt into longer-dated securities but uncomfortably strong demand for very short-term paper could make that task more difficult.

Recent changes to rules governing money-market funds have forced more investors into short-dated Treasuries, such as two-month and three-month bills. Rates are so low in the very front end that the Treasury may have to increase its bill issuance.

The Treasury's task is to subdue any wild moves in yields and make sure the U.S. government's cost of borrowing stays within reasonable limits over time. The best way to do that is to lock in more low rates on long-term securities, such as the 30-year bond. That mission has grown ever more crucial as the U.S. deficit has expanded in recent years. But at the moment, market demand is pulling the Treasury department in the opposite direction of its stated goal, away from longer-dated issuance into short-term securities. Meanwhile, the 30-year bond yield has risen much more quickly than the 10-year yield due to uncertainty about the U.S. economy's future health.

Treasury expects to issue a total of \$350 billion in U.S. debt in

Japan concerns grow as yen rises to 8-month high

Japan's finance minister sidestepped questions about intervention to curb yen strength and said markets should determine exchange rates, prompting the currency to rise to an eight-month high against the dollar.

The rise in the yen is raising alarm bells among Japanese policymakers who worry about its impact on deflation and the country's vital exports just as the U.S. and Chinese economies show signs of slowing down.

Naoto Kan said it may be necessary to consider new stimulus steps for the economy given the uncertain outlook, while a Bank of Japan policymaker said he was watching the yen closely. The yen's rise has raised market speculation of renewed government pressure on the BOJ to relax its already ultra-loose policy to take the edge off the currency's appeal.

Concerns that the global economy is faltering just as it has emerged from the worst downturn in decades is causing alarm among policymakers globally.

Swiss inflation slows, SNB not seen hiking soon

Swiss inflation unexpectedly slowed in July as shops slashed prices in sales and the strong Swiss franc reduced the costs of imported goods, sending the franc lower against the euro.

The CPI for July rose only 0.4 percent compared to a year earlier was 0.7 percent lower versus the previous month, the Federal Statistics Office said. Core inflation was 0.1 percent year-on-year. In June, the SNB ended its pledge to keep a lid on the Swiss franc, saying deflation risks had disappeared for the time being, prompting a rally in the currency. The central bank's interest rate target remains at rock-bottom and economists are divided as to when the bank may tighten policy.

Separately, Spain's registered jobless total fell for the fourth straight month in July by 1.85 percent from June, the Labor Ministry said, as the busy tourist season provided a boost to employment. Spanish registered jobless fell by 20,794 workers in July from June though was up 10.3 percent from the same month last year, the government data showed. The number of jobless in July stood at 3.91 million from 3.98 million in June.

the third quarter. Consensus on Wall Street has the Treasury announcing the auction sizes of \$33 billion in three-year notes, \$24 billion in 10-year notes and \$16 billion 30-year bonds.

U.S. Treasury investors most bullish since Feb -poll

Investors are the most bullish on U.S. Treasuries since February on worries over a double-dip recession and bets that the Federal Reserve will not raise rates until late 2011, a poll released on Tuesday showed.

The share of investors who said they are "long," or owning more Treasuries than their portfolio benchmarks, jumped to 21 percent on Monday from 15 percent last week, J.P. Morgan Securities said.

This level of investor bullishness on Treasuries was the highest since Feb. 22, the firm said. The scramble for U.S. government debt has pushed the two-year note yield to a series of record lows in recent days. Early Tuesday, the two-year yield touched an new low of 0.526 percent, according to Reuters data.

Those investors who said they have a "short" stance, or are holding less Treasuries than their portfolio benchmarks, fell to 12 percent from 16 percent a week ago.



DEEP DIVE Commentary and Analysis

FED FOCUS

Conviction grows at Fed on need for more easing

By Pedro da Costa and Mark Felsenthal
Federal Reserve officials are increasingly worried about the U.S. economy's health, making it likely the U.S. central bank will soon take further steps to try to lower borrowing costs.

The Fed's policy-setting panel meets next week, and while that may be too early for any concrete steps, it might offer a good place to plant the first seeds of a directional shift -- away from any exit strategy and towards further easing.

The Fed, which has already said it is weighing its options, may choose to signal this change by taking small steps at first. It could do that by starting to reinvest the proceeds from mortgage-backed bonds in its portfolio as they mature, or by lowering the interest it pays on bank reserves.

Officials are well aware that such moves would have only a marginal effect on borrowing conditions. Their intent would simply be to lay the groundwork for further moves if the economy remains moribund. Those easing steps would likely center on additional purchases of U.S. Treasury bonds.

To combat the financial crisis and deep recession, the Fed bought more than \$1.1 trillion in mortgage securities and \$300 billion in longer-term Treasuries.

The central bank already has an overwhelming presence in the mortgage market, so buying more Treasuries has become the most likely avenue for any further substantial easing that might take place.

JOBS REPORT MAY HOLD KEY

Fed Chairman Ben Bernanke and St. Louis Federal Reserve Bank President James Bullard were only the latest in a string of top officials to flag their uneasiness about the outlook.

Bullard was most explicit, citing a growing danger of deflation during a conference call with reporters last week and saying the Fed should be prepared to resume asset purchases if conditions worsen.

Bernanke was less specific in a speech on Monday. But while he offered few new clues on the immediate outlook for policy and said he expected the economy to continue growing, he did warn the recovery was not yet firing on all cylinders.

"We need to make sure that monetary policy continues to provide the support the economy needs until we begin to see growth, sustained growth and particularly growth in jobs," the Fed chief said.

Many economists believe the United States will face a prolonged period of sub-par growth, even if it avoids a double-dip recession, as the effects of a heavy cocktail of government spending and steep interest rate cuts fade.

A struggling labor market, marked by employers' heightened reluctance to hire, is the most painful reflection of this fragility. Data on Friday that is expected to show a second straight month of net declines in employment could seal the deal for Fed policymakers, particularly if it is unequivocally weak.

Economists are looking for a loss of 65,000 jobs as temporary workers hired by the government to conduct the decennial census are let go. The private sector is expected to have added only 90,000 new jobs -- not enough to keep unemployment from rising.

The latest tally of U.S. gross domestic product, the broadest measure of economic activity, offered plenty of reason for concern. The headline number itself showed a sharp retrenchment in the pace of growth, to a 2.4 percent annual rate in the second quarter from 3.7 percent in the first.

But the composition of growth was also troublesome, with the pace of growth in consumer spending moderating and invento-

ries still on the rise. Given the lack of sustained private demand, firmer inventories could mean a further slowdown in production in the months ahead.

Omens of such an outcome were already evident in the Institute for Supply Management's manufacturing survey for July. It showed the sector's expansion slowing to its weakest level in a year and a worrisome drop in new orders.

"If the stimulus package was a box of doughnuts dumped on the economy, we only have one or two doughnuts left in the box," said Jack Ablin, chief investment officer at Harris Private Bank in Chicago.

Unfortunately for the Fed, which gathers on Tuesday, its own stash of doughnuts is looking rather depleted as well.

COLUMN-Problem is low demand, not uncertainty

By Jim Saft

Apparently, the U.S. economy is being held back by massive uncertainty over new regulation, future taxation and the deficit and how it will be handled, a state so frightening and confusing that investors won't invest, businesses won't hire and nervous consumers have taken to their beds.

That, at least, is the account of Dallas Federal Reserve President Richard Fisher, who in a speech last week blamed fear of the arbitrary exercise of power by those in government for slowing the economy and putting those who make, employ and spend in a "defensive crouch."

"For some time now in internal discussions with my colleagues at the Fed, I have ascribed the economy's slow growth pathology to what I call 'random refereeing' -- the current predilection of government to rewrite the rules in the middle of the game of recovery," Fisher told business leaders in San Antonio.

"Businesses and consumers are being confronted with so many potential changes in the taxes and regulations that govern their behavior that they are uncertain about how to proceed downfield. Awaiting clearer signals from the referees that are the nation's fiscal authorities and regulators, they have gone into a defensive crouch."

Saying that businesses and consumers aren't spending and investing because they are worried about uncertain new regulations and taxes is like saying a man standing on the side of the road next to his wrecked car has stopped driving because his insurance premium is about to go up.

Sure, it's a factor but it is not the main cause.

Let me offer a simpler explanation: The United States is suffering from a shortage of final demand, the lack of which carries much more weight in economic decisions than concerns about how the new consumer financial protection rules will be carried out.

Banks aren't refraining from lending because they are worried about coming regulation, they are refraining from lending because more clients are refraining from borrowing. Borrowers, in turn, don't want to invest because they see less potential for the demand that will make those investments profitable.

Fisher, who in the past has talked a great deal of sense about banking regulation and who is a fearsome and principled hawk and defender of the Fed's independence, says a regular survey of business contacts he makes before Fed meetings reveals that they are "distressed" about the lack of direction from Washington and are hunkering down, doubtless as a prelude to taking their ball and going home.

Well, I do a poll of fifth graders periodically and they report, emphatically, that homework is interfering with their education and that they want lemonade to come out of the water fountains.

I mean seriously, when did business leaders ever welcome new regulation or heap praise upon Washington?

DEEP DIVE Commentary and Analysis

POLICY, POLICY WHO HAS THE POLICY

The distressing thing about this line of thinking, which is not contained by any means to the Dallas Fed, is that it absolves the central bank from responsibility from acting to stimulate a flagging economy. After all, you can buy up all the bonds you like but that won't make regulations less onerous or politicians less capricious.

Interestingly, James Bullard of the St Louis Federal Reserve also talked about how regulatory clarity was needed in a recent television interview, and it is true that the Fed, with its expanded role in financial regulation, must act quickly to make clear how they will use their new powers. Bullard also raised the possibility that more quantitative easing will be needed to fight deflation.

Fisher's view, though, seems to be that the fear of regulation and uncertainty actually trumps the power of monetary policy.

"If this is so, no amount of further monetary policy accommodation can offset the retarding effect of heightened uncertainty over the fiscal and regulatory direction of the country ... Indeed, one could posit that further monetary accommodation might make the situation worse if private-sector operators were to con-

clude that the Federal Reserve has become politically pliable and is prone to substituting such accommodation for fiscal discipline."

Fisher is off base on regulation, but he has raised a painful truth about politics and monetary policy after the crisis. The Federal Reserve, with cause and in exigency, trampled on the rights of Congress by picking winners and losers through its policy. After all, builders not bakers were helped when the Fed was buying up mortgage bonds. This leaves them open to attacks and doubts if, as I expect, they need to do more quantitative easing. It would be great, then, if all the United States needed was clarity about policy, but that will not be nearly enough. What will be needed -- more quantitative easing -- will be highly contentious, risky and a political live hand grenade.

(James Saft is a Reuters columnist. The opinions expressed are his own. At the time of publication James Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund.)

INSIDE DEBT is produced by Reuters in partnership with ICAP.

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