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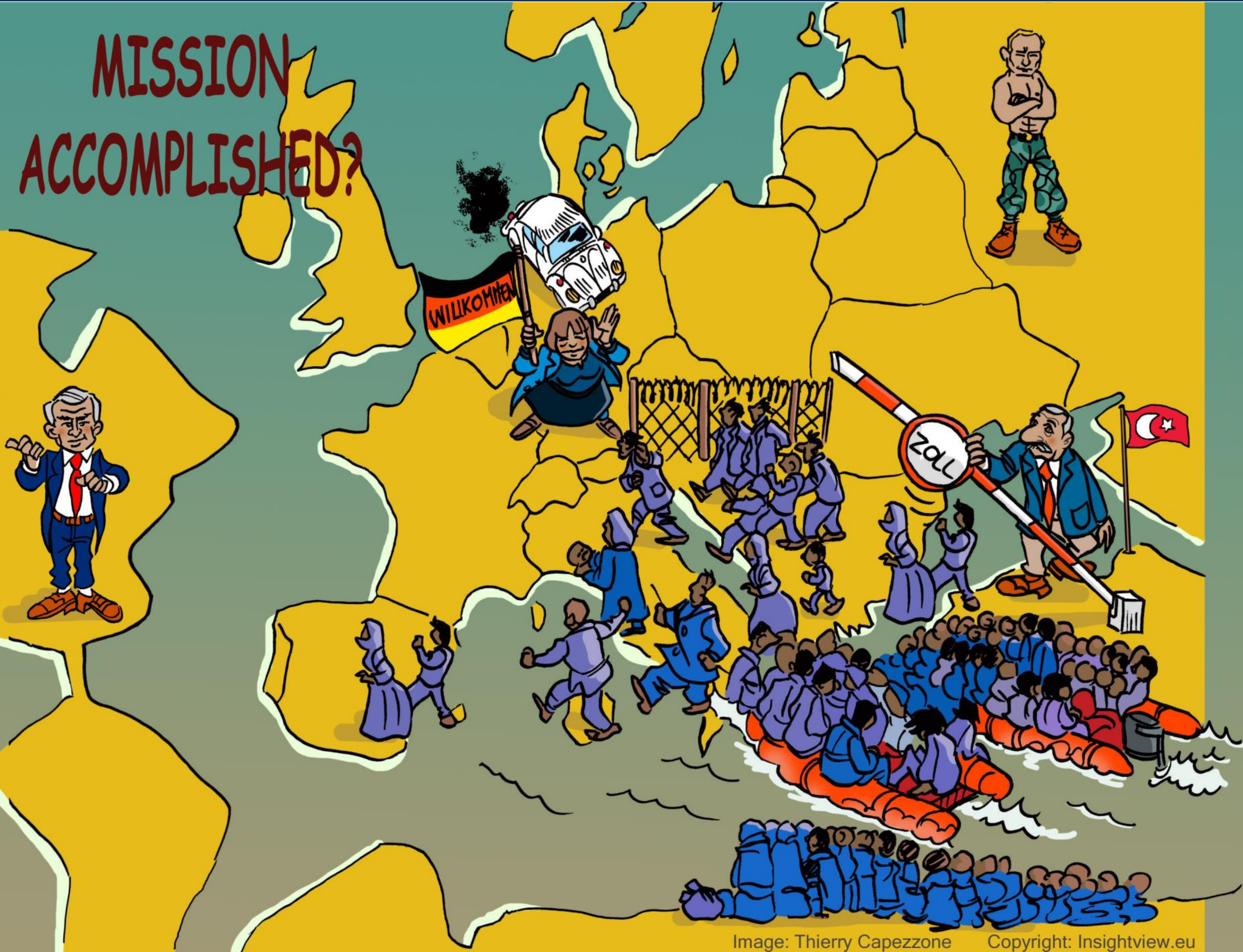
Insight Perspectives

Economic and political update



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Editor-in-chief – what the readers say

Global Economic and Political Update

Financial Market Update

This time around, spontaneous and high-handed Merkel risks alienating more than just her own party

The economic impact of the refugee crisis - and the unpredictable political outcome

Is Federal Reserve eagerness to avoid 1930-like mistakes creating more dangerous policy errors?

Charts
Previous Editions
PDF Menu

Insight Perspectives

Economic and political update

The Insight Perspectives newsletter is produced by Insightview.eu Ltd (Private Limited Company), Denmark, and is published on a monthly basis.

The editor-in-chief is Carsten B. Pedersen. If you are interested in subscribing to the newsletter, send your contact details to info@insightview.eu

The Insight Perspectives newsletter provides a summary of what happened in the month under review, plus articles about "special issues" in the global economy.

The newsletter attaches importance to identifying and analyzing current and future trends in the global economy, financial market and politics.

All articles will be linked to external sources and Insightview.eu, which includes more charts, maps, data and elaborating comments.

What readers say about Insightperspectives

Nina Smith, Professor, **Aarhus University**, School of Business and Social Sciences Departm. of Econ. and Business. Former chairman of the Danish Economic Councils.

"This is actually a very good newsletter if you want to get quickly informed about major economic issues all over the world"

Flemming A. Jørgensen, Vice President, **Danfoss** Group Treasury & Insurance

"Insightperspectives is a valuable supplement to the daily stream of information, received from banks and the various other providers of news and market analysis. It puts the issues discussed into context and provides a view on the long term implications, which can easily get lost in the daily flow of information"

Ole Damgaard-Nielsen, Managing Director, **Inter IKEA** Treasury

"Insightperspectives provides an easily understandable summary of the financially most important events, news and developments around the world."

Jesper Alsing, CEO, Value **Invest Asset Management S.A**.

"Insightperspectives brings an independent viewpoint on important economic, political and financial events. Thoughtful insights - I read regularly"

Peter Bundgaard, CEO, PM and founding partner of **BLS Capital Management**

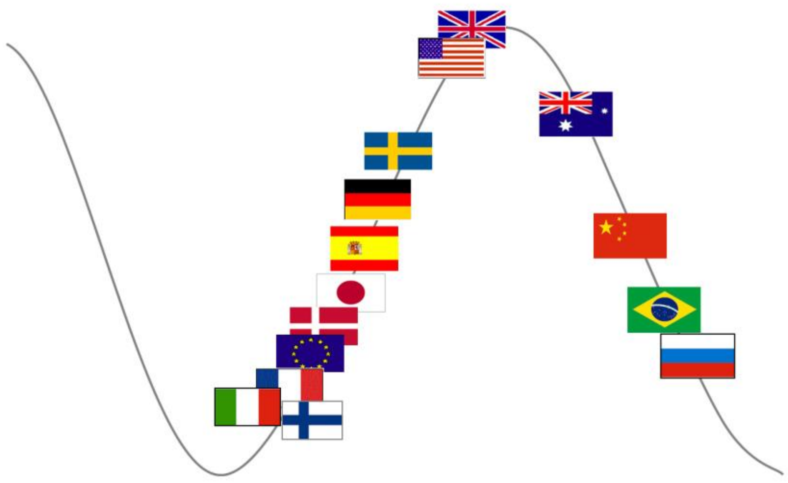
The editor of Insightperspectives is simply the best macroeconomist I have ever experienced. For more than a decade I have been a reader of his thoughtful analysis that comes with an edge. This is the only macroeconomic analysis you will need to be able to follow global trends that can make a difference in your own day-to-day decision-making, whether in business or investments.

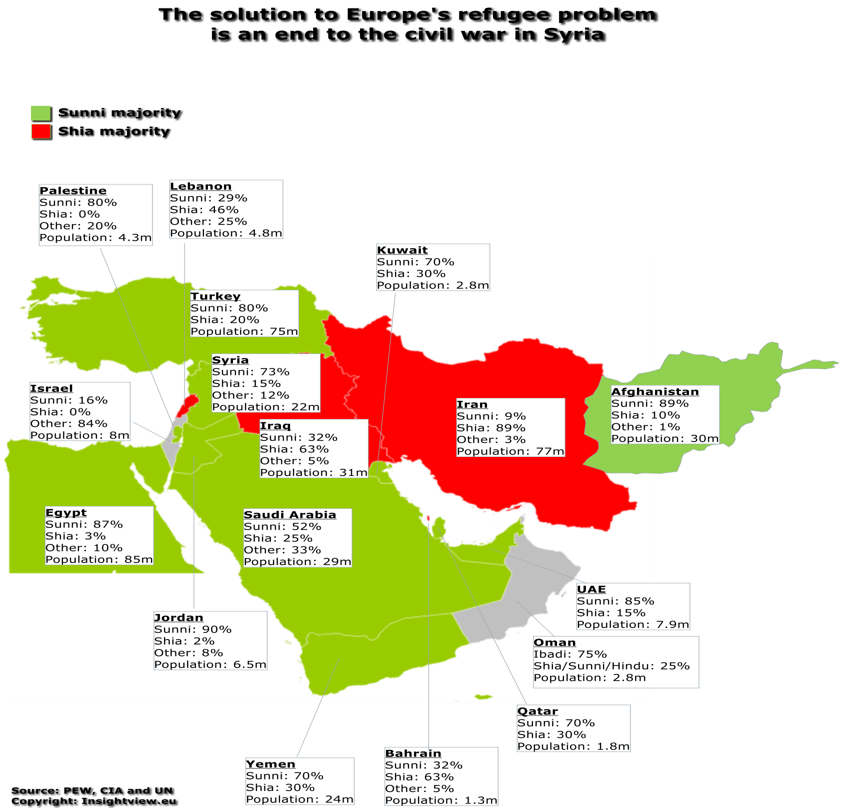
Global economic and political update

In September, the US Federal Reserve suddenly had second thoughts about raising policy rates due to external factors (China) and lower-than-expected inflation. Both arguments are somewhat interesting. First of all, the United States is a relatively closed economy. Secondly, many of today's deflationary forces can partly be blamed on excessive global monetary easing in the past, which was kickstarted by the United States in 2008 and reinforced by China's "mother-of-all-stimulus" in the same year. Since then, other developed countries have replicated Washington's monetary policy – read more in the article on page 24, Is Federal Reserve eagerness to avoid 1930-like mistakes creating more dangerous policy errors?

In Europe, the ruling Syriza-part gained victory in the national election in Greece, which should "ensure" that the agreed economic reforms are implemented. The financial market, however, does not really care as investors are preoccupied with far more serious problems after German chancellor Merkel autocratically opened the border to all Syrian refugees. This added significant pressure on other European countries and has now endangered not only the Schengen Agreement but the entire European Union – read the article, This time around, spontaneous and high-handed Merkel risks alienating more than just her own party, on page 17.

The Economic Cycle
click to enlarge





Hundred thousands, maybe millions, of refugees may now be planning to enter Europe. This could have serious ramifications when it comes to the economy and not least domestic politics. On the one hand, the influx of refugees is highly needed, at least from a macroeconomic point of view. Today, many European countries are exposed to a falling working-age population. This is particularly the case in Germany, Italy and Poland. The influx of refugees could prevent wages from soaring in Germany.

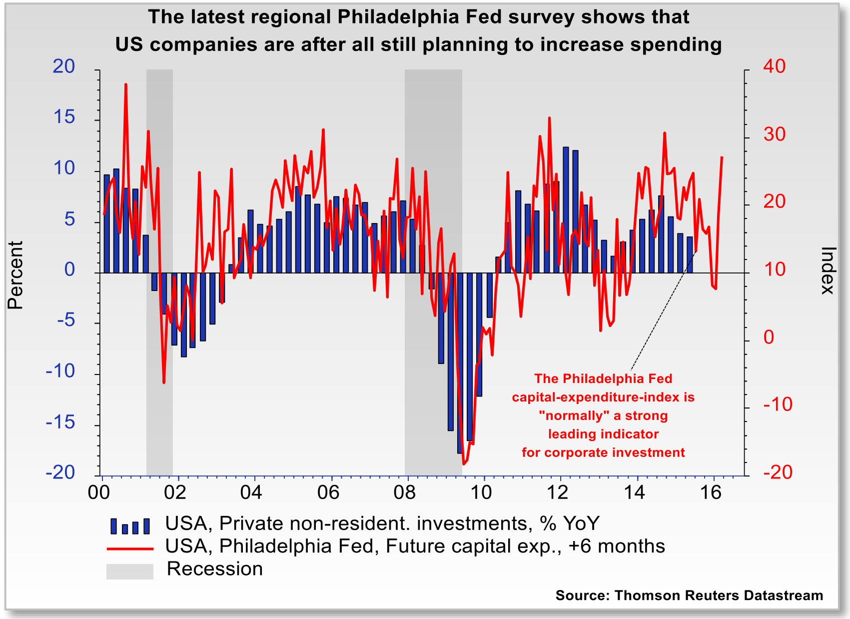
On the other hand, the refugee crisis may add more upward pressure on rents and conventional inflation in the short run. Furthermore, a huge number of migrants will reinforce pressure on many European countries to reform the welfare system. The question is therefore whether Europe's "native" voters will accept this? If this is not the case, the refugee crisis risks depleting Europe's political center in favour of the far left or right – read more in the article, The economic impact of the refugee crisis - and the unpredictable political outcome, on page 20.

Ironically, this is also why chancellor Merkel suddenly believes that a solution to the civil war in Syria is urgent. In this context, Mrs. Merkel believes the Russian president, Mr. Putin, should play a greater role. Even the Syrian president, Mr. Hassad, is now acceptable in Berlin. In Europe, this is Interesting times!

USA – Service sector shows growth but still significant weakness in manufacturing

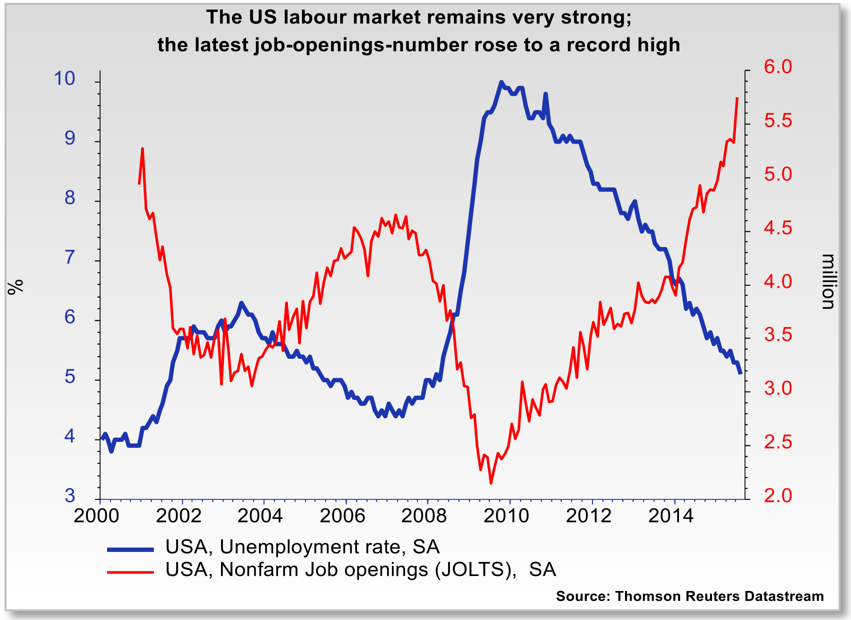
In the United States, the headline index in the regional manufacturing Philadelphia Fed survey fell sharply in September. The survey is highly linked to the national

ISM manufacturing survey. Weakness in the manufacturing sector was probably also the main reason behind the Federal Reserve's decision to postpone yet again the first rate hike since 2006.



Insightperspectives, however, believes the decision was highly peculiar, not least taking into account that sentiment in the service sector remains highly upbeat – read more in the article on page 24, Is Federal Reserve eagerness to avoid 1930-like mistakes creating more dangerous policy errors? In the second quarter, this was also reflected by the fact that the US economy expanded by 3.9% annualized.

Furthermore, the details in the manufacturing Philadelphia Fed survey show a less downbeat growth outlook. The six-month-outlook index stayed at an elevated level of 44.0, largely unchanged from 43.1 in August. The high level at this late stage of the business cycle is unusual. This shows that the current economic expansion may have one more growth leg. Far more importantly, the Philadelphia Fed capital-expenditure-index rose sharply to 27.2 from 18.4, which was the highest level since March 2014. This indicates that US companies are still planning to boost investment.



In the United States, the service sector, which accounts for 80% of the economy, is still expected to show strength although “external factors” will dent growth marginally. Private consumption is supported by a strong labour market – read the MarketWatch article, Job openings surge to new record of 5.75 million in July. This remains the case even though retail sales rose only 0.2% month-on-month in August. The headline number is denominated in current prices and is of course negatively impacted by deflationary pressure from falling energy prices. The same number in volume terms or constant prices continues to show solid growth as households benefit from falling inflation; this enables households to buy more goods and services.

Anyhow, Insightperspectives still expects US growth to slow from mid-2016 and beyond - with or without monetary tightening - as the boomerang generated by “front-loading future growth” in the past eight years will hit back with a vengeance - see the global economic growth forecast and the current business cycle. To see more about the global impact of aggressive monetary easing, read the article on page 24, Is Federal Reserve eagerness to avoid 1930-like mistakes creating more dangerous policy errors?

China – No growth panic, at least not yet

In China, there are no visible signs that the manufacturing sector is bouncing back. In August, industrial output rose only 6.1% year-on-year. In addition, urban investments rose "only" 10.9% year-on-year, which was the weakest rate of increase since 2000. In September, the preliminary Caixin manufacturing China PMI index fell to a record low of 47.0 from 47.3 in August. In addition, cargo handled by China railway fell in August at the fastest pace on record.

On the other hand, there are no signs of panic in the broader economy, at least not yet. This was also reflected by the fact that Chinese retail sales (current prices) rose 10.8% year-on-year, which was higher compared to 10.5% in July. In addition, house prices continue to increase supported by by falling property investment and a steady uptrend in secular demand due to urbanisation – read the Insightview article, China: Home prices supported by easing measures and secular forces.

Conversely, there are no visible signs that more monetary easing is feeding more decisively into broader credit expansion although Beijing has launched multiple easing measures. In a Chinese growth context, it is essential that construction activity bounces back as this will positively impact not least the "lower 50%" of the manufacturing sector (labour intensive). There are tentative signs that this "may" be in the pipeline, read the SCMP article, Land sales in China's first-tier cities heat up, although this is admittedly far too early to conclude.

Insightperspectives maintains the forecast outlined in the 2015 Outlook (January 2015) that Beijing will be "forced" to allow the yuan to depreciate to the range of 6.6 and 7.6 against the US dollar.

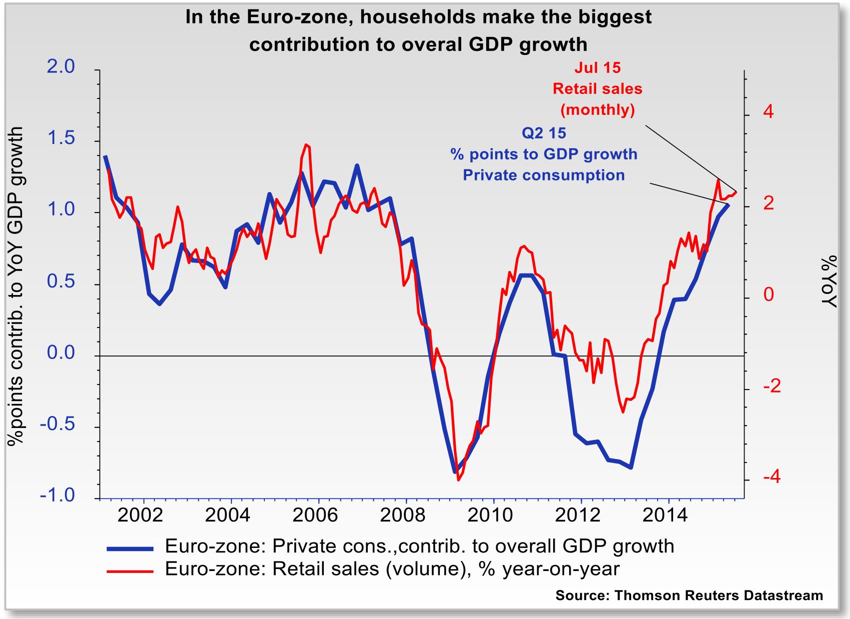
Euro-zone – Solid growth "in spite of" rather than "because of " the European Central Bank

In early September, the president of the European Central Bank underscored that he has no intentions of withdrawing an ultra-loose monetary policy anytime soon. In fact, Mr. Draghi stressed that the central bank may expand stimulus measures beyond September 2016 if the current turmoil in the financial market were to dent growth. In addition, the central bank increased the share of bonds the ECB can buy of each issue to 33% from 25%. A dovish central bank was probably not a major surprise; ECB president Draghi has indicated for some time that he will do whatever it takes to support the European economy and, not least, boost inflation.

Unfortunately, this also means that there is no significant pressure on elected policymakers in the national parliaments to improve fiscal balances or reform their economies. On September 22, this induced the credit rating agency Moody's to downgrade France's sovereign debt.

On the positive side, the fact that the ECB has still not succeeded in creating inflation continues to support growth. In the monetary union, retail sales continued to be on a solid upward trend in the third quarter –

read the Insightview article, Strong Euro-zone retail sales report indicates very strong Q3 GDP growth.



Furthermore, there are no signs that inflation will gain momentum anytime soon. Instead, the Euro-zone will continue to see low energy prices, or what this newsletter describes as “good deflation”. This was also reflected in the latest French consumer survey. In September, the leading consumer confidence index jumped to the highest level since 2007.

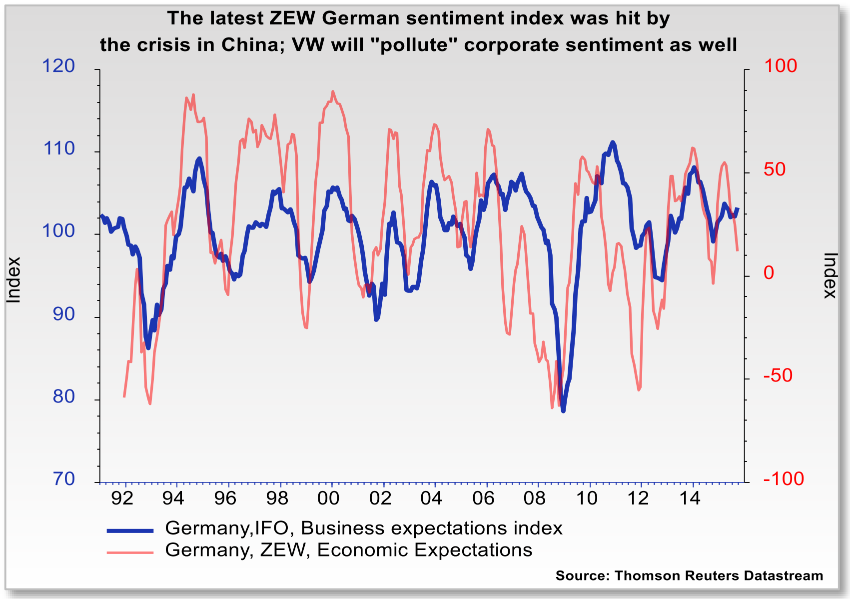
Looking forward, however, the unanswered question is what will be the impact of the current influx of refugees? Insightperspectives has tried to answer this in the article on page 20, The economic impact of the refugee crisis - and the unpredictable political outcome.

Germany – Mrs. Merkel is no longer able to profit from reforms made ten years ago

The German economy is at an important crossroad. Chancellor Merkel has yet again made one of her spontaneous decisions without the backing of her own political party, CDU. This has ramifications not only in Germany but all over Europe - read the article, This time around, spontaneous and high-handed Merkel risks alienating more than just her own party, on page 17.

Interestingly, the approval rating of Mrs. Merkel has been relatively high during her term in office, even if Germany’s strong economic performance today should be dedicated to the former SPD-chancellor Schröder’s economic reforms ten years ago. Instead, Mrs. Merkel has endangered many of Germany’s strong macroeconomic fundamentals. The chancellor allowed the European Central Bank to go “Italian” and Mrs. Merkel allowed the Greek crisis to bring the monetary union on the edge of collapse.

Unfortunately, Germany can no longer rely on credentials from the past, as the country is now exposed to multiple external shocks. Even before the influx of refugees became a crisis. In September, the ZEW investor sentiment index (expectations) fell sharply due to the economic crisis in China although corporate sentiment reflected by the IFO survey was relatively strong (conducted before the VW-emission case and the refugee crisis intensified). Last week, however, it became known that Volkswagen is cheating. Furthermore, there are signs that the refugee crisis is creating uncertainty (and chaos), which risks to derail the current positive trend in consumer sentiment.



In a "perfect world", the influx of refugees was supposed to be positive for a German economy significantly short of labour; but instead this development risks destabilising the political situation. More importantly, chancellor Merkel has no game plan and her migrant policy may not have the support of the majority of German voters, according to a poll published last week. Read the article, The economic impact of the refugee crisis - and the unpredictable political outcome, on page 20.

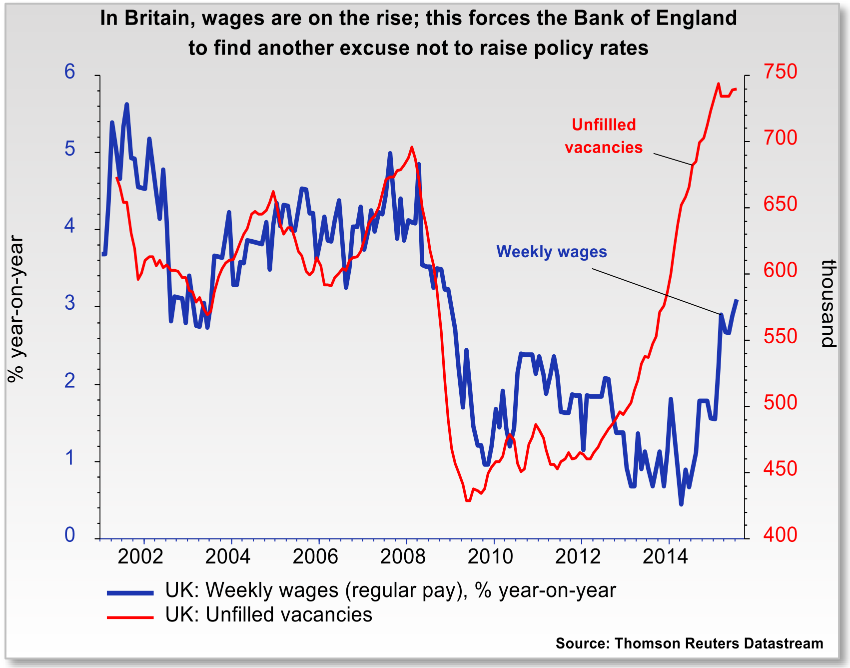
Britain - Wage inflation jumps to highest level in eight years

The British economy is assessed by this newsletter to be "late in the business cycle". The labour market is strong and unemployment is low. In August, the unemployment rate fell to 5.5% from 5.6% in the previous month, which is far below the initial threshold introduced by the incumbent governor of the Bank of England, Mr. Carney, to trigger the first rate hike. Contemporary central bankers, however, are "flexible". This is also why the Bank of England is still only talking about rather than raising policy rates.

The question is for how long Mr. Carney can wait? In August, weekly wages rose 2.9% year-on-year, which was the fastest rate of increase in the last six years. The latter is actually good news for households' real purchasing power as consumer price inflation is low due to imported deflation. On the other hand, Britain's productivity trend is very weak. Indeed, the country is experiencing a classic boom-bust cycle, which is predominantly sponsored by an easy monetary policy. This was also visible in the latest GDP report, which showed that private consumption was yet again the main growth driver in the second quarter.

The fact that the corporate sector is reluctant to boost spending should probably not be a major surprise as the monetary policy approach pursued by most central banks in the developed countries in the last eight years has been front-loading future growth - read more in the article on page 24, Is Federal Reserve eagerness to avoid 1930-like mistakes creating more dangerous policy errors? This and the fact that public sector debt continues to increase is of course not animating the corporate sector to boost investments. Uncertainty about the future is still high; furthermore, Britain is running a twin-deficit.

Neverthess, the short-term growth outlook for the British economy remains bright , at least in 2015. But economic growth may slow again in 2016 - with or without a rate hike – as the British economy will prove extremely vulnerable (see Insightperspectives' global forecast). Furthermore, the political situation is certainly not moving in the favour of Prime Minister Cameron after the European refugee crisis appears to have changed the political landscape.



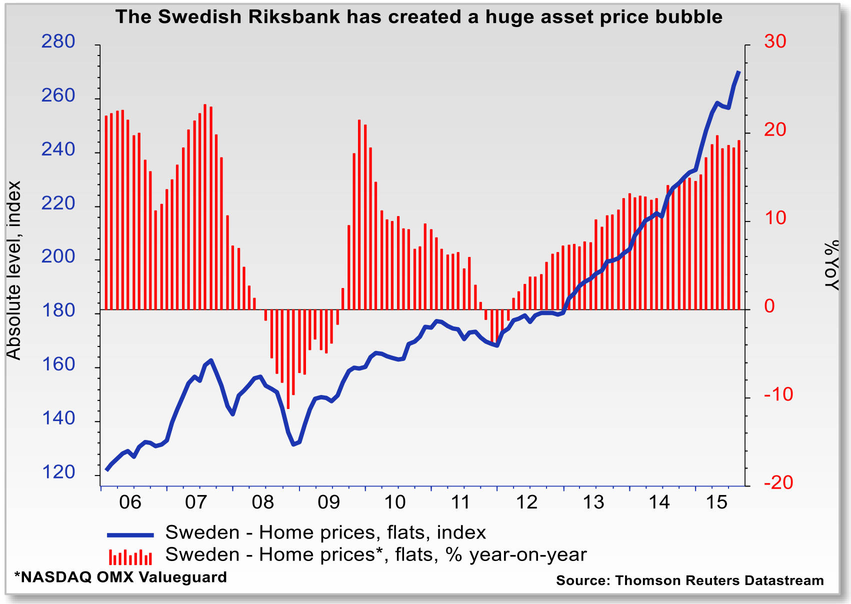
Nigel Farage surely sees the refugee crisis as a welcome opportunity to regain momentum for UKIP ahead of the EU referendum – read the Express article, Refugee crisis shows why we need out of EU, says Nigel Farage as he launches No campaign. In early September, a poll showed that a majority of 51% of the British voters want to leave the European Union, according to the DailyMail.

Sweden – Riksbank sponsors dangerous rally in house prices

The Syrian tragedy, which has led to the biggest refugee crisis since World War II, will challenge economic policy in many European countries and in Sweden in particular - read the article, This time around, spontaneous and high-handed Merkel risks alienating more than just her own party, on page 20. At present, the country sees an unprecedented influx of refugees as they prefer Sweden compared to many other European countries.

This, however, happens at the same time as property prices are soaring. In August, Swedish apartment prices jumped by 2.6% month-on-month to a record high. This was up 15.3% year-on-year, according to Nasdaq OMX Valueguard-KTH Housing report. In Sweden, house prices are increasing everywhere, which is probably no major surprise at the same time as the Riksbank pursues a policy of quantitative easing (money-printing). This is the case even though the Swedish economy is growing at the fastest rate since the third quarter of 2011 (3.3% year-on-year).

Indeed, the Riksbank has abstained from raising policy rates. In September, the governor of the Swedish central bank tried to excuse its inaction by criticizing the elected politicians - read the FT-article, Riksbank Stefan Ingves sees flaws in crisis-busting tools. Mr Ingves said "the Riksbank's task was to deal with inflation while others needed to deal with our dysfunctional housing market", according to the Financial Times.

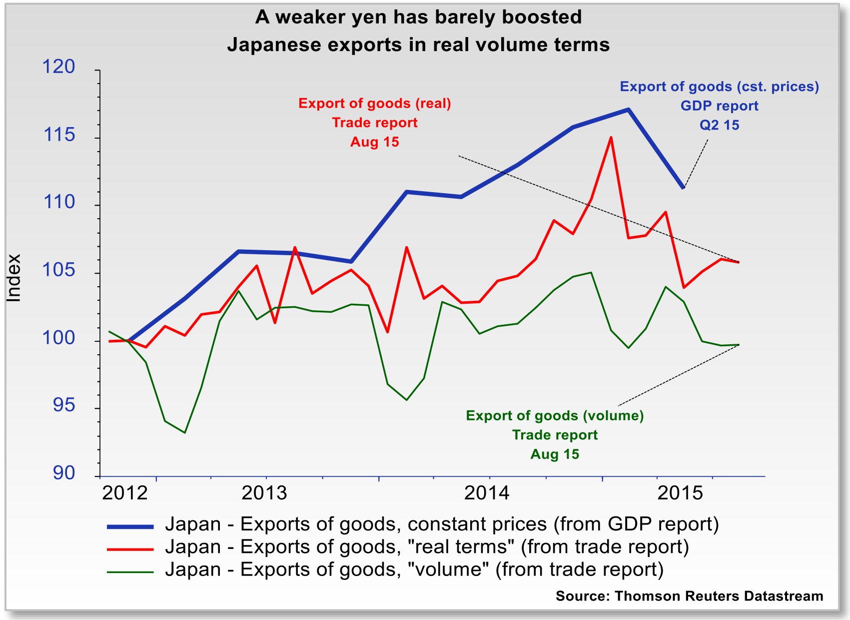


This is indeed one of monetary decision-makers biggest policy mistakes. The same argument has been made by ECB president Draghi, who argues that ultra-loose monetary policy needs to be followed up by economic reforms although he is very well aware that important member countries such as Italy and France have no intentions (or support in their parliaments) to deliver, at least not as quickly as needed. Furthermore, why should they launch sweeping economic reforms when the ECB's monetary policy (painkillers) is not animating elected policymakers to behave prudently?

Until recently, this newsletter has been biased towards buying the Swedish crown; Insightperspectives still assesses the crown to be cheap, at least based on the current macroeconomic fundamentals. But there is no doubt that Swedish policymakers are slowly creating the foundation for a boom-bust economy, which makes the long-term outlook for the crown highly uncertain!

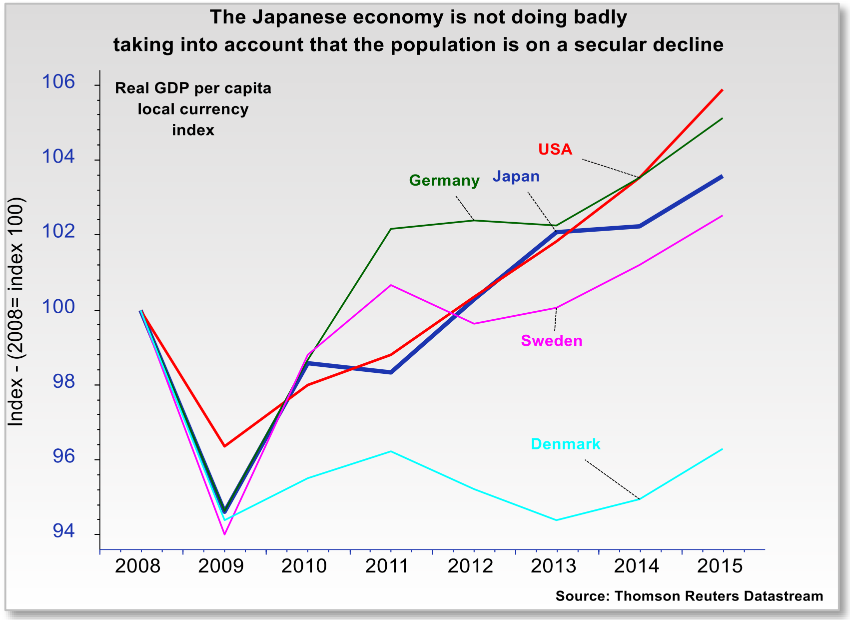
Japan – Response to downgrade of sovereign debt rating may be new fiscal stimulus package

In Japan, the export sector continues to disappoint even though the yen is at the lowest level in real terms since the 1980s. In August, exports rose only 3.1% year-on-year in value terms while imports fell 3.1% year-on-year. On the other hand, exports in real terms fell 0.2% month-on-month and were up only 0.8% year-on-year. In fact, exports in real terms have increased only 5.5% since Prime Minister Abe ordered the Bank of Japan to raise the level of monetary expansion to "nuclear" in early 2013. Instead, Japanese companies have booked a windfall profit from a weaker yen. Indeed, Japanese exporters have no reasons to boost export volumes dramatically due to shortage of labour. This has of course also boosted corporate profit and the performance of the Japanese stock market, which has been highly linked to the yen.



Conversely, Abenomics, the nickname of Prime Minister Abe’s highly controversial economic policy, has failed to confront Japan’s fiscal debt problem. In September, Japan's credit rating was downgraded by

S&P. Abenomics is surely exposed to headwind, which is not least the case as other countries around the world are copying Japan's beggar-thy-neighbour-policy. These problems could be reinforced if Beijing is "forced" to follow the same path (QE) - read more in the article on page 24, Is Federal Reserve eagerness to avoid 1930-like mistakes creating more dangerous policy errors?

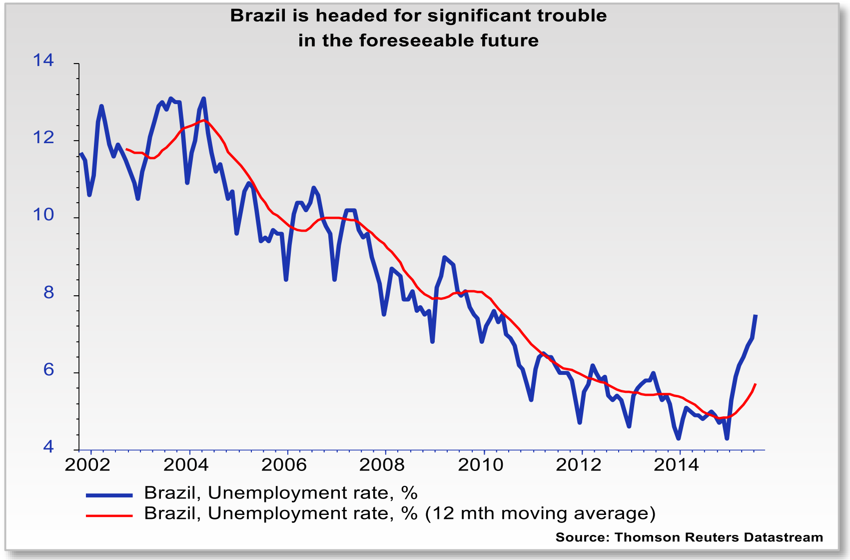


Perverserly, this is why Tokyo is now considering launching yet another fiscal stimulus program rather than more (useless) monetary easing. Last week, Mr. Abe vowed to boost GDP by 22% until 2020. If successful, this would create annual nominal GDP growth of 4%, which would be the first time since the 1980s. Do not count on Mr. Abe's forecast. Such a cocktail (fiscal easing and no more monetary easing) could trigger yen buying, at least from a macroeconomic point of view. This is not without risks as the current level of the fundamentally undervalued yen is highly dependent on more monetary easing, which is also the case when it comes to the Japanese stock market.

Brazil – Economy moves into a vicous circle

In Brazil, the economy urgently needs lower policy rates as the economy is moving deeper into recession (benchmark policy rate, Selic, stands currently at 14.25%). In July, industrial production fell 1.5% month-on-month, which was a huge 8.9% decline compared to one year ago. The decline was broad-based; capital goods production fell 28% year-on-year while consumer goods production fell in the range of 10% to 15% (non-durable and durable).

Brazil is in a very difficult situation, albeit the crisis is man-made. The economy contracted by 1.9% year-on-year in the second quarter (the economy is now in recession). The industrial production figures combined with many other reports show that the economy will contract even more in the second half of 2015.



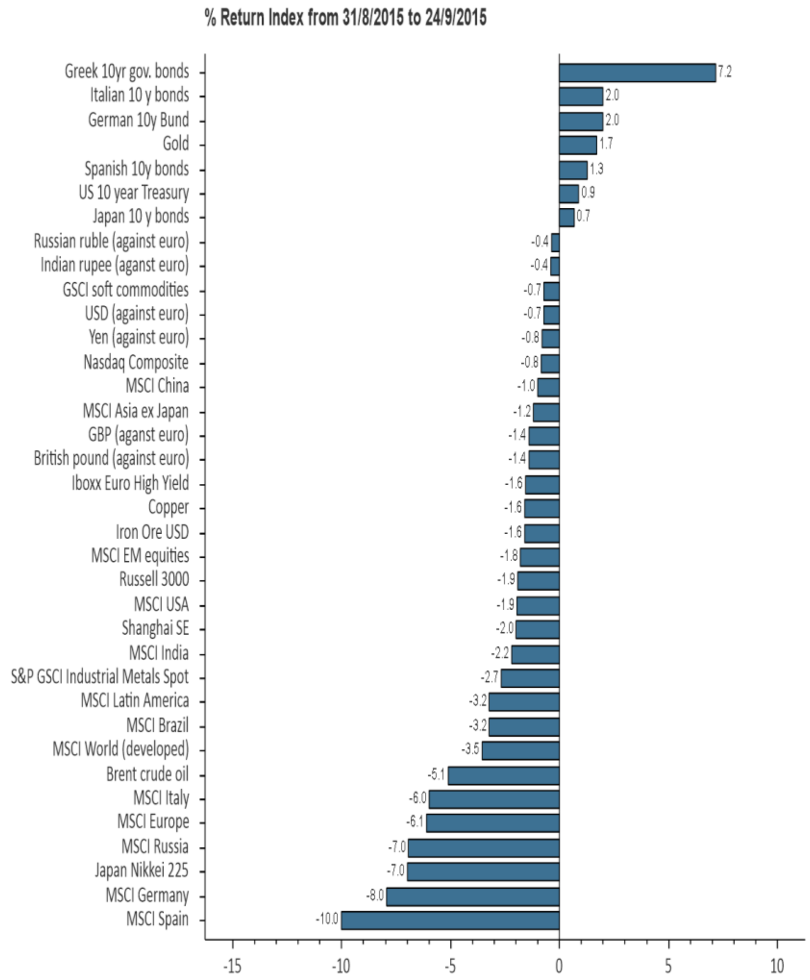
Unfortunately, this does not make leeway for the central bank to cut policy rates as the government is no longer able to post a primary fiscal surplus. This will also make it difficult to rein in inflation expectations (annual consumer price inflation is 9.5%). The currency, the real, has plummeted in spite of higher policy rates, which creates a vicious cycle of more inflation expectations.Brazil is indeed a ticking bomb! The Brazilian economy and political system seem to be collapsing. The Petrobas corruption case is getting closer to president Dilma Rousseff (the president is a former chairman of Petrobas). In August, former president Lula's chief-of-staff was arrested. Furthermore, consumer confidence has declined to an all-time low (Brazil is a highly consumer-led economy) and exports have plunged due to falling global demand and commodity prices.

Front page – Table of Contents

Financial Market Update

In September, the US Federal Reserve regretted once again that it even considered raising policy rates. This time, the excuse was "external factors" and falling inflation pressure - read more in the article on page 24, Is Federal Reserve eagerness to avoid 1930-like mistakes creating more dangerous policy errors? Before the meeting, representatives from Wall Street and not to forget the head of the IMF, a former French finance minister, warned that tightening at this stage could result in falling stock market prices.

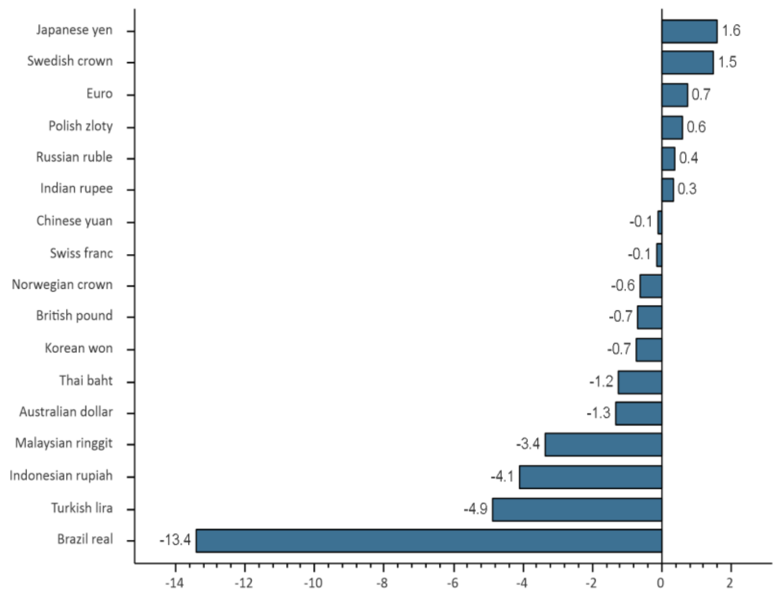
The Federal Reserve did not raise policy rates. Since then, however, stock market prices have declined relatively sharply around the world. The MSCI Developed World index fell 3.5% in local currency (last prices: September 24); the MSCI Europe index ended down 6.1% while the MSCI USA index fell 1.9%. This comes after a steep decline in stock market prices in August. In Europe, Germany was hit particularly hard after it became known that Volkswagen used software to trick US regulators. The global bond market benefited little from turmoil in the stock market as interest rates are already close to a historically low level, not least in the developed countries.



Source: Thomson Reuters Datastream

In the foreign exchange market, the Norwegian crown fell 0.6% against the US dollar after the Norwegian central bank cut policy rates by 0.25 percentage points to 0.75%. The Swedish crown rose 1.5% and was supported by the Riksbank which said the economy was doing well. Later, however, the central bank partly regretted because being too positive means that the currency strengthens too much. It is surely not easy to manipulate the foreign exchange market!

% Return Index vs USD from 31/8/2015 to 24/09/2015



Source: Thomson Reuters Datastream

The Brazilian real was yet again among the worst performing currencies. In September, the currency fell 13.4% against the US dollar having declined 3.7% in August. The Malaysian ringgit also continued to weaken falling 3.4% in September, having declined by 9.9% in August (Malaysia's Prime Minister appears to be deeply involved in corruption scandal).

Front page – Table of Contents

Refugee Crisis in Europe

This time around, spontaneous and high-handed Merkel risks alienating more than just her own party

This is an updated article pre-published on September 10, 2015

In the current situation with the world short of "control rods to stabilize the nuclear reactor", the European Union is needed more than ever before. Unfortunately, the fact that all the adverse effects of policy errors committed in the past appear to be emerging at the same time may have created irreparable cracks in the European Union.

This is the case as first of all, the developed world is slowly realizing that a policy of ultra-loose monetary policy has been no panacea for creating self-propelled growth. Instead, this has triggered a domino effect of competitive devaluations around the world – read the article, Is Federal Reserve eagerness to avoid 1930-like mistakes creating more dangerous policy errors? Since 2008, after Lehman went down the drain, the developed countries have pursued a policy of financial repression (money printing). In early 2015, the European Central Bank joined this policy approach as well - read more in the text box, The EU has changed beyond all recognition.

The second policy mistake: "You are either with us, or against us"

The second policy error made also by many EU member states together with the United States was how the fight against terror was mishandled, not least when it comes to the Middle East. This started with the invasion of Iraq in 2003 after "justified" military intervention in Afghanistan triggered by the terror attack in the United States on September 11, 2001. This has not only created the foundation for a new and far more brutal terror organization, Islamic State of Iraq and the Levant. This has also unleashed political and social turmoil in other Middle East countries.

Ironically, the West did exactly what many experts warned not to do, namely stirring up a hornets' nest. Today, democracy is surely no longer on the agenda in the Middle East, although this was somewhat naively part of former president Bush' war targets; even president Obama advocated democracy during a visit to Cairo University in 2009. Instead, these "well-meaning" efforts triggered the fall of Egypt's president Mubarak, who was, perversely, replaced by another dictator, president Abdel Fattah el-Sisi - read also the September 2013 edition of Insightperspectives, "Unwanted" military intervention in Syria seems imminent after failure in Egypt.

The EU has changed beyond all recognition

There is no doubt that the European Union has changed beyond all recognition, which has been the consequence of external shocks such as the global economic crisis and lately the refugee crisis. The change in ECB's monetary strategy has been highly unusual.

Since the appointment of an Italian president, Mr. Draghi, the European Central Bank has become a bank based more on "Italian values" rather than values from the Bundesbank. In Germany and many northern member countries, this has raised eyebrows (read the February edition of Insightperspectives, The ECB is no longer German – this is a bad omen).

The ECB president is indeed doing nothing to hide that he does not intend to be "German". In September, Mr. Draghi said that he considers raising the level of money printing. Granted, this will help the European economy, not least exporters, as such a policy approach will add further downward pressure on the euro.

This could be reinforced if the US Federal Reserve finally decides to raise policy rates. Unfortunately, this will also be a slap in the face of policymakers in Beijing, who cannot sit tight if the ECB intensifies the global currency war.

The West laid the foundation for the biggest refugee crisis in Europe since World War II by having ignored the Syrian crisis in the last few years. In September, this has been visible on highways and train stations as far away as Denmark. The civil war in Syria has also provided an opportune but dangerous moment for political mavericks such as Turkish president Erdogan to crack down on Kurdistan Workers' Party (PKK) in Turkey and the Northern part of Syria - read the FT article, Turkey opens criminal inquiry on Kurdish political leader.

Indeed, the Middle East has changed from a ticking bomb to a permanent fire. Policymakers in the capitals of Europe and in Washington are beginning to realize that they may have supported movements in the Middle East, which are now seen as our biggest future security threat. This is probably also why Washington, Berlin and Brussels only half-heartedly oppose Russia's increasing military involvement in Syria to support the regime of president Assad.

The refugee crisis may trigger profound political changes in the European Union

Unfortunately, the refugee crisis has yet again exposed the vulnerability of the European Union. This is a pity, as the EU is a necessity for long-term prosperity. Ironically, this comes only a few months after the latest Greek crisis was "solved" - yet again! Granted, the refugee crisis may boost European growth in the short run as authorities will have to accommodate hundred thousands of refugees, not least in Germany. Furthermore, the influx of Syrians may even help Germany mitigate the impact of a secular decline in its population (read more in the article, The economic impact of the refugee crisis - and the unpredictable political outcome, on page 22).

Image: Insightview
Bundeskanzleramt, Berlin

The refugee crisis, however, may also trigger a radical change in the political landscape beyond imagination.

First of all, this is visible in Britain, where Nigel Farage sees the refugee crisis as a welcome opportunity to regain momentum for UKIP ahead of Britain's EU referendum – read the Express article, Refugee crisis shows why we need out of EU, says Nigel Farage as he launches No campaign. In September, a poll showed that a majority of 51% of the British voters want to leave the European Union, according to the Daily Mail. Brexit would be bad news for the European Union, at least from this newsletter's "market liberalist" point of view. Brexit would mean that there would be no counterweight to a European Union that is increasingly going "Italian".

"Kaiser Merkel" or "spontaneous Merkel"

Mrs. Merkel has probably made the biggest cracks in the European Union. Many within the chancellor's own political party, CDU, and its sister-party, CSU, in particular, raised eyebrows after she virtually "invited" all Syrian refugees to Germany by dropping EU visa rules. In other European countries, this has also made many political leaders annoyed, as Mrs. Merkel decided to change the rules without consulting them. Ultimately, this may end up with a "de facto cancellation" of the Schengen Agreement, which would clearly be bad news for the European Union (Berlin was forced to close the border to Austria only a few days later).

This is not the first time that Mrs. Merkel's spontaneous decision-making has had significant implications beyond Germany's borders. Today, Germany and many other European countries are still licking their wounds after the chancellor abandoned nuclear energy shortly after the nuclear accident in Japan in March 2011; this was a decision which increased the use of coal and propelled carbon emission – read also the Insightperspective article from 2013, Is shale gas undermining EU energy policy?


DIE WELT

PANORAMA FLÜCHTLINGE

München überfordert – SPD-Frau fängt an zu weinen

In the last few weeks, Mrs. Merkel may have acted "politically correct" by allowing all Syrian refugees to enter Germany (whoever decides what is politically correct?). On the other hand, the chancellor also showed that Europe has become a union without rules, at least until she decides to change the rules. Mrs. Merkel's high-handed style, however, risks refueling fears in many member states that Berlin rules and nobody else. Ironically, this perception is precisely what Germany has tried to avoid in the last five decades. Unfortunately, this “German approach” may unleash serious anti-EU forces not only in Britain but also in many other countries of the European Union. This is also why the refugee crisis has placed the EU even closer to a critical crossroad, where many national parliaments may be forced by their voters to take a more hostile stance towards Brussels (or Berlin).

This is a bad omen for political stability in Europe; the European Union is needed. The union, however, has become a structural mess, which is a recipe for permanent crisis, where the national elected politicians are no longer in control. This time, Mrs. Merkel may have committed hubris!

Read more about the political divide in Europe in another article published by Insightview in January 2015, The divide between the political establishment and voters spells trouble.

Front page – Table of Contents

EU-Germany

The economic impact of the refugee crisis - and the unpredictable political outcome

The refugee crisis will have profound consequences on the European economy, not least in Germany. At first glance, this should be to the benefit of the economy. This, however, requires that the refugees are successfully integrated in society. Such an outcome "appears" possible based on the current sentiment of compassion after the tragic picture of the drowned Syrian boy was published.

On the other hand, successful integration requires a faster implementation of economic reforms in many European countries; alternatively, the influx of refugees risks reinforcing existing unemployment and social problems. Indeed, this requires far more than just a few lines of compassion on Twitter or Facebook. The majority of the same people who are now part of the well-meaning "willkommen-wave" in Germany and other countries may in fact soon be exposed to the costs of the refugee crisis.

A successful integration of refugees in the labour market also requires a radical change of the labour market in many European countries, unless of course refugees are supposed to be treated as “second-class” workers. This will add downward pressure on wages, which may ultimately speed up pressure on the welfare system. The refugee crisis is an external shock, which requires radical measures or at least a clear political strategy. Read also: Lebanon: Economic and Social Impact of the Syrian Conflict, UN report from 2013.

This means that compassion could soon be replaced by dissatisfaction. Indeed, many of the well-meaning people who are today expressing support to the refugees may be the first to throw stones (read the Focus.de article, Pegida-Demo in Dresden - 5000 Menschen auf der Straße: Bachmann kündigt Parteigründung an).

Even chancellor Merkel has discovered that compassion has a limit after Berlin was forced to close the border to Austria only a few days after the Chancellor dropped EU rules to allow in Syrian refugees - read the article on page 17, This time around, spontaneous and high-handed Merkel risks alienating more than just her own party.

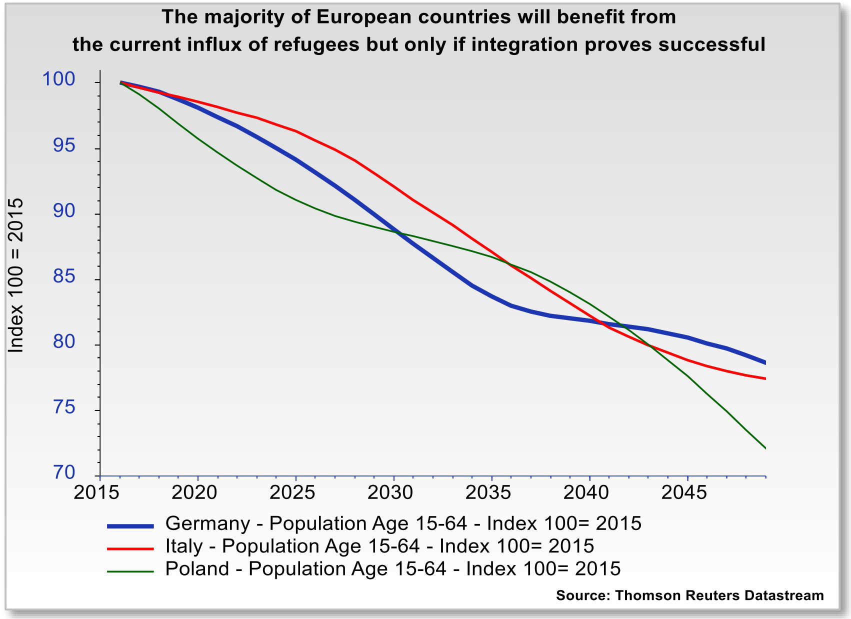

DIE WELT

PANORAMA FLÜCHTLINGE

München überfordert – SPD-Frau fängt an zu weinen

Refugees could solve labour shortage problem

In Europe, however, the corporate sector (and the stock market) should be thrilled by the influx of refugees, at least as long as compassion prevails. Many CEOs and this newsletter (read the November 2013 edition of Insightperspectives) have for years warned about future demographic problems due to an ageing and in some countries falling population.



In the coming twelve months, Germany is expected to receive more refugees than the number of people born in the same period. This is also why the refugee crisis is not necessarily inconvenient for Germany, surely not in a period when the country is exposed to labour shortage and therefore emerging wage inflation. The risk of higher wage inflation could disappear if thousands of well-educated Syrians are granted a residence permit (conversely, Germany's gain could end up as a permanent brain drain for Syria). In a corporate perspective, this should help boost corporate profit.

Are "native" Germans willing to pay the price?

The above-mentioned elements also explain why there is possibility that, further down the road, ordinary Germans may respond more adversely to the current influx of refugees. At this stage of the German business cycle, "native" wage-earners were supposed to benefit from the strongest labour market since the 1980s, having paid the price of the labour market reform (Hartz IV) introduced more than a decade ago.


Wirtschafts Woche

Mietpreisbremse wirkungslos

Die Preisspirale am Wohnungsmarkt bleibt ungebremst

Furthermore, "native" wage-earners may have to pay an even higher price as it appears they have to get used to another decade of the hated solidarity tax launched after Germany reunification - read the article from NTV.de, Länder fordern mehr Hilfe vom Bund - Schäuble plant Sparpaket. This weekend, the German finance minister, Mr. Schäuble, cancelled planned tax cuts.

In addition, the influx of refugees will exacerbate a shortage of housing in Germany, not least if Berlin grants hundred thousands of refugees permission to stay permanently. This will add upward pressure on rents although the "miet-bremse" is supposed to put a lid on housing inflation (existing apartments only). Granted, Berlin could decide to apply the miet-bremse to new housing supply as well, which is clearly not impossible as Mrs. Merkel is constantly moving further to the left. This, however, risks creating even more housing shortage as such a policy approach will not animate more supply.

The final outcome

In Germany, there is probably a limit to how much further left Mrs. Merkel can move; the far left is having second thoughts as well – read the Süddeutsche Zeitung article, Die linke Angst vor dem Fremden. Indeed, there is a significant risk that the current refugee crisis could radicalise the political environment in Germany and other European countries unless the European Union, the United States, Turkey together with Russia find a solution to the Syrian crisis.This is far more important than the refugee crisis in Europe. Alternatively, Europe's political centre could be empty very soon as the refugee crisis is splitting public opinion.

There is no doubt that chancellor Merkel has contributed to this by taking what appears to be a “politically correct” decision - read the article, This time around, spontaneous and high-handed Merkel risks alienating more than just her own party! Europe needs political leaders who are using both heart and brain. Unfortunately, Europe is short of that, which spells trouble!

Front page – Table of Contents

USA

Is Federal Reserve eagerness to avoid 1930-like mistakes creating more dangerous policy errors?

Last week, the US Federal Reserve did it again! The central bank postponed a long overdue but tiny 0.25 percentage point increase in policy rates due to “external factors” and “lower inflation”. This was the case even though, for some time, the Chairman of the Board of Governors, Mrs. Yellen, has prepared the financial market for such a decision. The Federal Reserve’s short-termism looks increasingly like a “Twitter-approach” based on the latest news headlines, although changes in monetary policy will not have an impact before twelve to eighteen months later.

Ironically, this could seriously undermine the already low credibility of the central bank, which could spill over to a global economy screaming for global leadership and coordination. This shows that monetary policymakers have little understanding of how the global economy is working. Granted, these are harsh words as monetary policymakers at the Federal Reserve and other central banks in the developed world are supposed to be the top-of-the-pop when it comes to central banking. On the other hand, this harsh assessment is shared by more well-known “authorities” than this newsletter. In September, the Bank for International Settlements reiterated yet again that monetary tightening in the United States is long overdue – read the latest quarterly report from BIS. The problem is that clones of Mrs. Yellen and former Federal Reserve chairman Bernanke are now in charge of the majority of central banks in the developed world. This means that policy errors at the Federal Reserve will have ramifications beyond the United States as these mistakes will be replicated worldwide.

Granted, it was not a major surprise in the financial market that the US Federal Reserve abstained from hiking rates on September 17, although this newsletter has believed for some time that stronger economic data would convince the central bank to act. The big surprise, however, was the fact that the main excuse for doing nothing, besides a lower inflation forecast, was external factors, or more precisely China.

This is somewhat bizarre, as the United States is a relatively closed economy (exports of goods and services account for 13% of GDP). Granted, a far bigger share of S&P500 companies' profit comes from overseas; but the Federal Reserve is not supposed to base monetary policy on the level of the stock market, although it sometimes feels like this is the case.

Why is the Federal Reserve nervous?

In late 2008, the Federal Reserve prudently launched the first wave of monetary stimulus, which was urgently needed to help a dysfunctional financial system after the abrupt collapse of Lehman Brothers, an investment bank. In addition, monetary expansion was also needed to eliminate associated deflationary expectations" caused by an abrupt collapse of confidence in the financial market. Initially, these measures were correctly described as "temporary" by the Federal Reserve; the problem is that since then these measures have proved to be permanent. In addition, the monetary stimulus approach was soon raised to an even higher level, which ultimately led to money-printing.

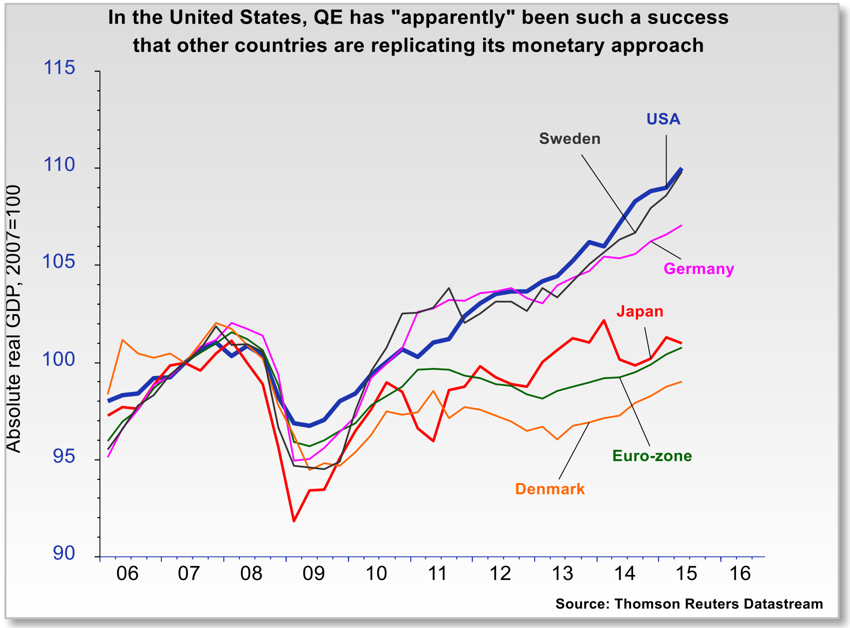
Surprisingly, seven years later the US economy is still not back to normal, at least not according to the Federal Reserve. This, however, is a highly peculiar assessment as the economy is growing by approximately 2.5% year-on-year (in the second quarter growth was 3.7% annualised). In addition, the absolute economic activity level is ten percent higher compared to the peak in early 2008. Moreover, the unenemployment rate has declined significantly although partly helped by adverse demographics.

So why is the Federal Reserve nervous? Are there any reasons to be nervous about a measly 0.25 percentage point increase in policy rates? It may surprise the readers that the answer is "yes - maybe"! This, however, is the consequence of having waited for too long. Earlier this month, the first Danish astronaut in space came back from the International Space Station having been in weightless condition for only ten days. Immediately, he was able to stand on his own two feet. This is in sharp contrast to astronauts having stayed on ISS for six months or longer. They are of course exposed to the risk of fracture.

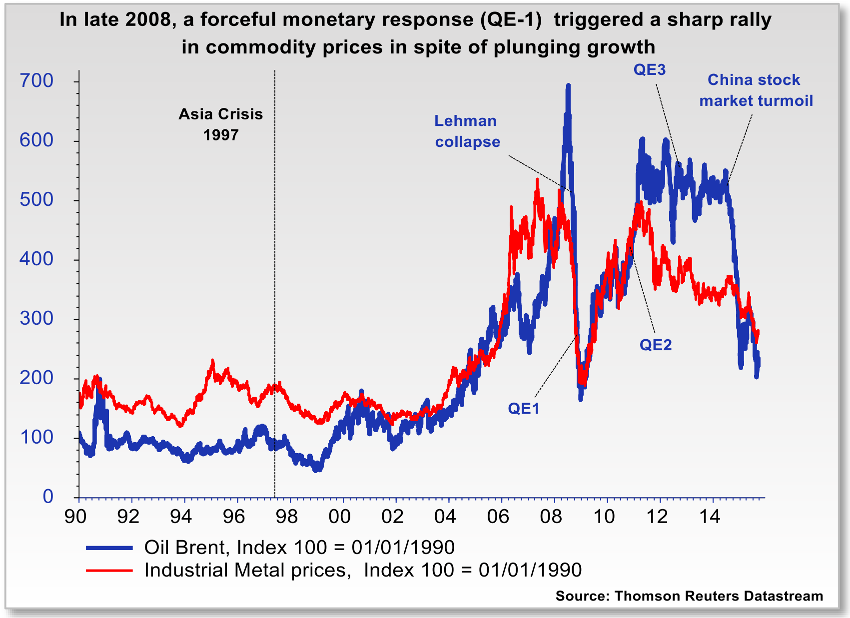
The same applies to the US economy and other economies having relied on money-printing. They are simply getting used to a comfortable "weightless condition". So yes, there is indeed a risk when trying to "normalise" monetary policy. This risk, however, will only get bigger if one postpones coming back to the "real world" and surely if these countries have not used the time in space to exercise (translated: reform the economy or heal fiscal imbalances).

The wrong response to good deflation

The Federal Reserve's second argument for postponing a rise in policy rates was a lower inflation forecast. Insightperspectives agrees that inflation will remain absent in the foreseeable future – read the Insightview article, US inflation is absent due to a third wave of deflationary pressure. When it comes to deflation, however, there is a significant risk that the Federal Reserve and other central banks are waging the wrong war. First of all, many of today's deflationary forces have been created by excessive monetary policies in the past; this has created the foundation for excess capacity, which is the case not least in China.

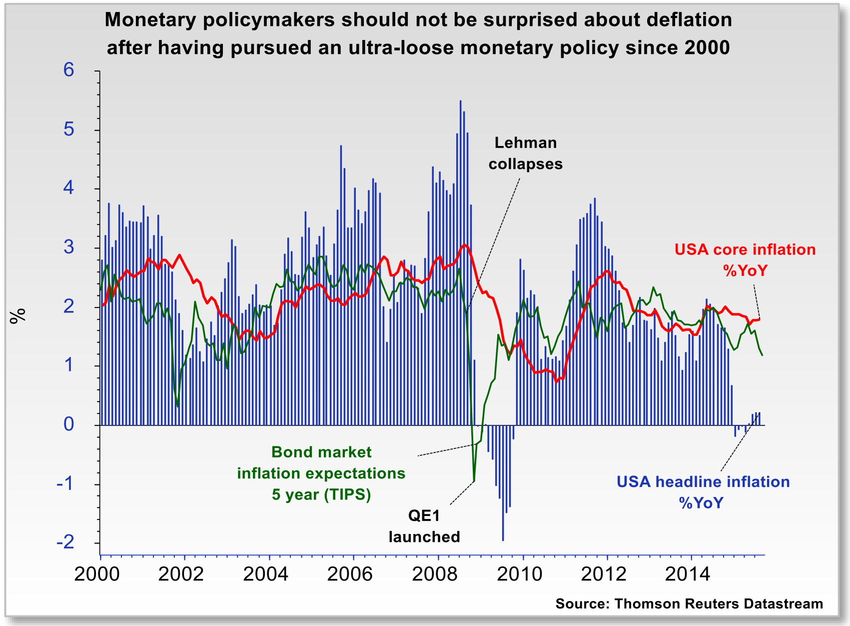


One of the most perverse consequences of excessive monetary stimulus was the fact that this created a strong rally in commodity prices from January 2009 to mid-2011 even though the global economy was going down the drain. Aggressive monetary stimulus in the developed countries and China by late 2008 reversed deflationary expectations into sharply higher inflation expectations. The commodity market was yet again seen as an "inflation hedge" and consequently boosted inflation in a time of increasing unemployment and falling wages. In this period, the aggressive monetary approach made a significant inroad into households' real purchasing power in the developed countries – read the article, The oil price war is just one market disturbance partly caused by the central banks, in the 2015 January edition of Insightperspectives.



Interestingly, at that time the boost to headline inflation was ignored by the central banks in the developed world. Instead, they said that the main focus should be on core inflation, which was much lower. Ironically, today core inflation in the United States is close to the same level as in 2010-2011; but the very same central banks now focus on headline inflation which is close to zero or negative. This form of inconsistency is clearly not boosting the credibility of the Federal Reserve and other central banks.

Another issue when it comes to deflationary pressure is the split into good or bad deflation. The Federal Reserve and other central banks in the developed world need to understand the dynamics of prices far better. Alternatively, they risk fighting "good deflation". Today, deflation is most often described as "bad" for the economy due to former Federal Reserve chairman Bernanke's studies of the 1930s. The fact, however, is that the world is most often exposed to good deflation caused by productivity gains based on a wave of innovations. Indeed, today the benefit of not least software innovation is probably even underestimated by macroeconomic statistics. But there is no reason why stronger productivity gains from software and other innovations should lead for instance to higher property prices, which is the case if monetary policymakers continue to see “good deflation” as bad. This keeps monetary policy loose for too long, which leads to asset price inflation and ultimately to overcapacity – read more about why monetary policy mistakes made in 1920s might have led to the economic disaster in the 1930s in the article, The good, the bad and the ugly, Insightperspectives, January 2015.



China is forced to join the global currency war

In a global perspective and for the sack of the United States, it is therefore essential that US monetary policy “comes back to earth” now rather than later. The problem is that the monetary approach “appears to have worked” and is therefore being replicated in other developed countries. The fact, however, is that the approach has of course not produced growth out of nowhere. This has “front-loaded” future growth by lowering interest rates to zero or shifted growth from another country to the United States due to competitive devaluation.

Seven years ago, Britain followed the Federal Reserve immediately. Furthermore, the Bank of England intends to stay “out in space” for a little longer as well, even though the economy is screaming for a rate hike. Even in Sweden, one of the best performing economies in the world since the global crisis erupted, the Riksbank has failed to exit money-printing due to “outer space” excuses. But other countries now want the same “benefits”. In early 2013, the Bank of Japan even raised its money-printing program to “nuclear”. The European Central Bank only started this policy approach in early 2015 (the “associated” members such as Denmark have been “forced” to follow as well). The fact is that this has become a full-blown “global currency war” similar to what was seen in the 1930s.

This beggar-thy-neighbour-policy in the developed countries has added significant pressure on China. The real exchange rate of the yuan has increased sharply and is considered by this newsletter to be overvalued. This is the case not least if one takes into account that China is exposed to excessive overcapacity in many sectors of the economy. Therefore, it is no surprise that Beijing is now considering whether it should join the global currency war more aggressively, having devalued the yuan against the US dollar by a few percentage points in early August.

This will be the case not least if the "lower 50%" of China's manufacturing sector in particular does not soon show visible signs of having hit rock bottom. This will "force" Beijing to allow the yuan to decline more sharply against other currencies. In the last few weeks, these are also worries highly reflected by sharply falling emerging market currencies. The financial market is surely pushing Beijing in that direction as the country continues to see significant capital outflow. The European Central Bank may help a reluctant Beijing to devalue more aggressively after Mr. Draghi, the president of ECB, said on September 3 that the central bank may expand its monetary stimulus measures beyond September 2016.

The developed world has lost moral leadership

It worries this newsletter that the developed world has not only lost moral leadership when it comes to foreign policy. The developed world cannot escape the fact that it is also partly to blame for the ongoing refugee crisis – read the article, This time around, spontaneous and high-handed Merkel risks alienating more than just her own party.

The double-standard, however, is also highly visible when it comes to monetary policy. In many ways, the developed world is doing exactly the opposite of what it adviced Asian countries to do during the Asian Crisis in the 1990s (reforms, fiscal discipline and not using devaluation as a growth tool). In many developed countries, this has, of course, not passed by unnoticed – read the FT-article by Malaysia's former Prime Minister Mahathir, West needs to go back to capitalist basics (2012).

If the US Federal Reserve does not succeed in beginning to normalise monetary policy in spite of a relatively healthy growth outlook in the coming twelve months, there is a significant risk that the United States and the Euro-zone in particular will end up like Japan.

The US economy is able to stand on its own two feet - read the Insightview article, Weak headline Philadelphia Fed index but very strong details. The problem is that the Federal Reserve and other developed countries no longer believe in market forces. In the developed world, the economy has become reliant on anti-depressants. A classic "business cycle" is no longer accepted. Instead, monetary policymakers try to flatten the cycle. This is a bad omen for long-term growth, not least if central banks seriously believe that "new" growth could be created by money-printing, although this is only possible based on innovation, productivity gains or population growth. Since the global crisis erupted, Ireland, Portugal and Spain have proved the latter.

Today, monetary policy in the developed world is creating many new imbalances. Even risk-averse investors are forced further out on the ice (risk curve) without being paid additional expected returns. Pension funds are forced to invest an increasing share of capital in the stock market or illiquid alternative investments. Furthermore, an ultra-loose monetary policy is front-loading future growth, thereby artificially boosting corporate earnings. This also supports the stock market and is reinforced by the fact that many companies see more benefit in buying back their own shares due to zero interest rates. This is also why nobody should be surprised that just rumours of a minor change in monetary policy rocks the boat. Ultra-loose monetary policy has made the situation crowded far out on the risk curve with investors who are supposed to have lower risk.

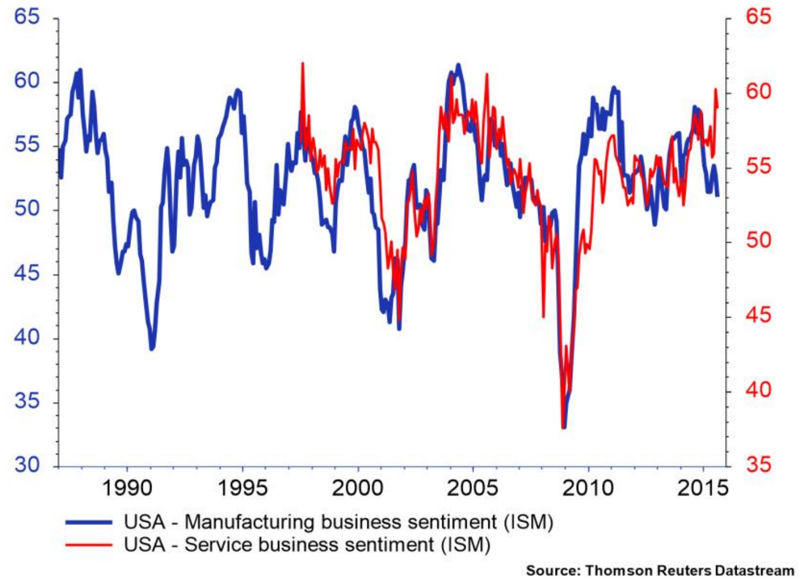
The most striking point is that everybody knows the "Emperor is wearing nothing". The central banks in the developed world, however, believe that they are not able to identify asset price bubbles, which means that they are not willing to prevent them from happening. On the other hand, the top-of-the-pop in central banking has no problems in identifying when a bubble busts and, of course, respond to this with more monetary easing! This is highly bizarre, but also explains why the world remains exposed to multiple waves of deflationary forces – read the BIS Working Papers No. 186, Deflation in a historical perspective! For the remaining few prudent central bankers, this is a harbinger of more bad news in the future (read the Indian Express article, RBI Governor Raghuram Rajan warns of 1930s Depression problems for global economy).

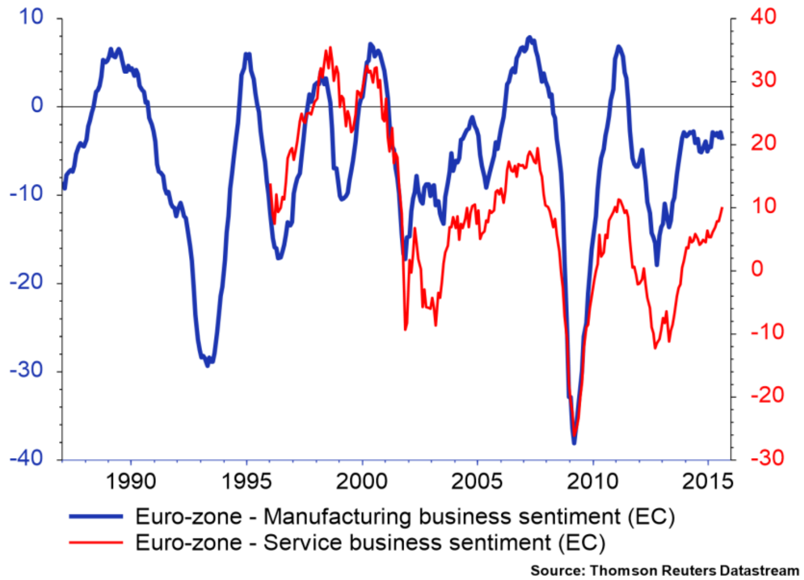
Front page – Table of Contents

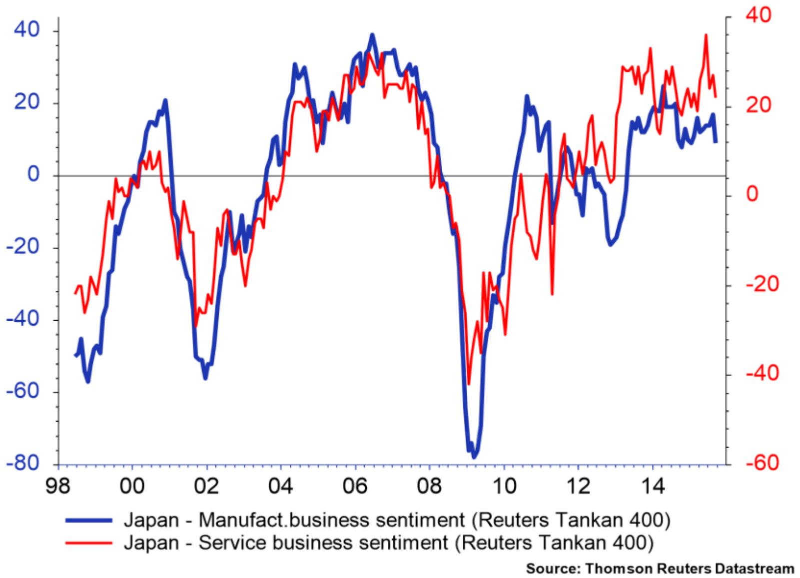
Charts

All charts are updated on September 24, 2015

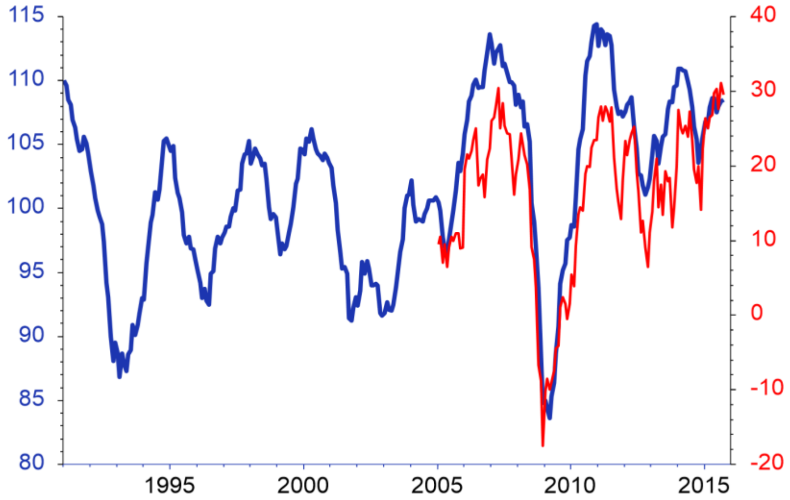
Business Sentiment





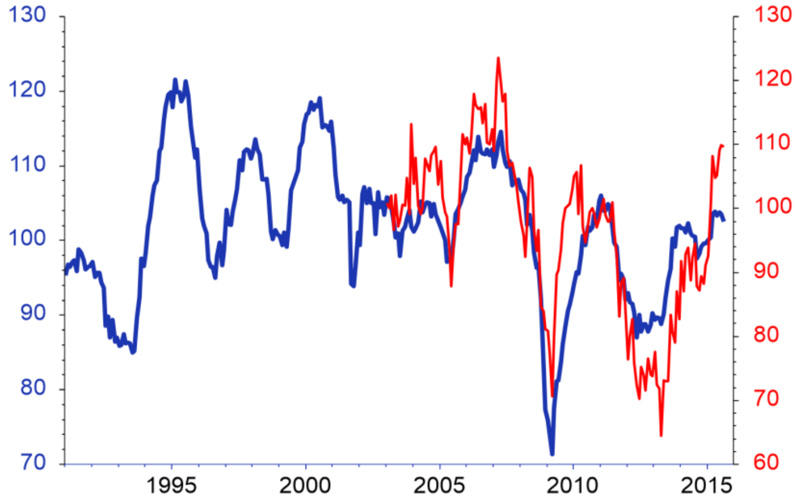


Business Sentiment (continued)



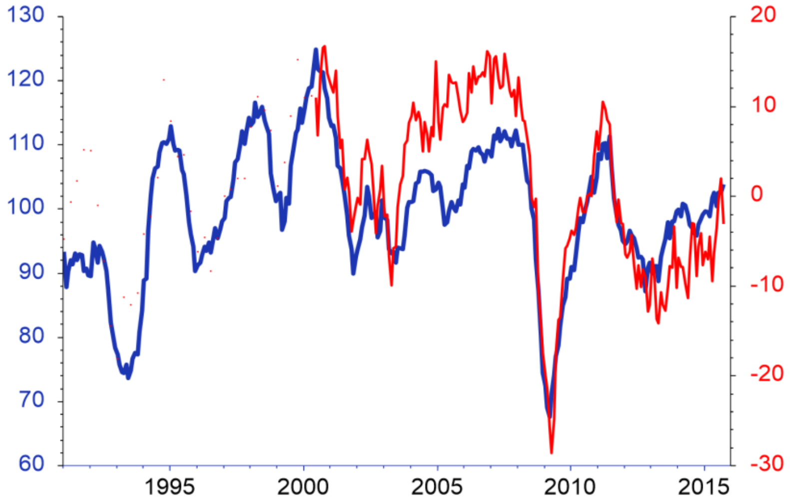
Germany - Manufacturing business sentiment (IFO)
Germany - Service business sentiment (IFO)

Source: Thomson Reuters Datastream



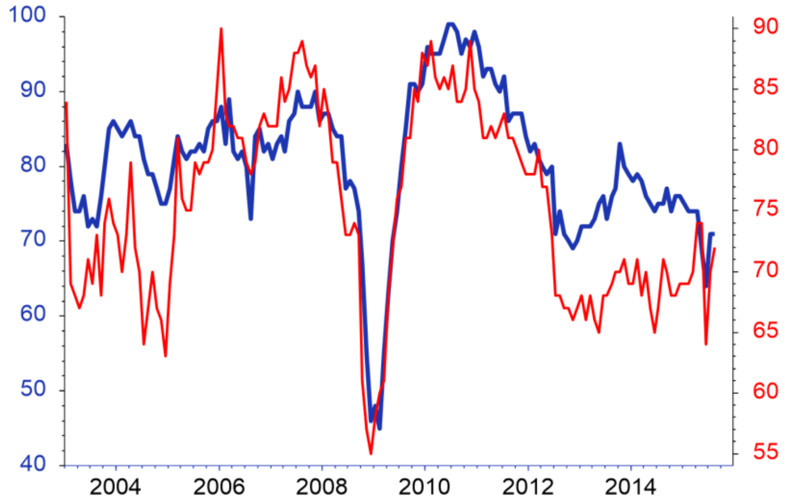
Italy - Manufacturing business sentiment (Istat)
Italy - Service business sentiment (Istat)

Source: Thomson Reuters Datastream



France - Manufacturing business sentiment (INSEE)
France - Service business sentiment (INSEE)

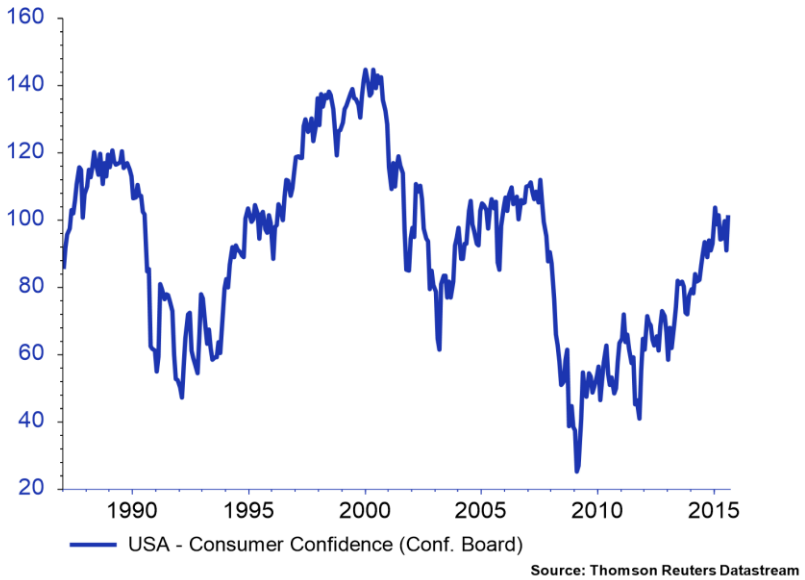
Source: Thomson Reuters Datastream

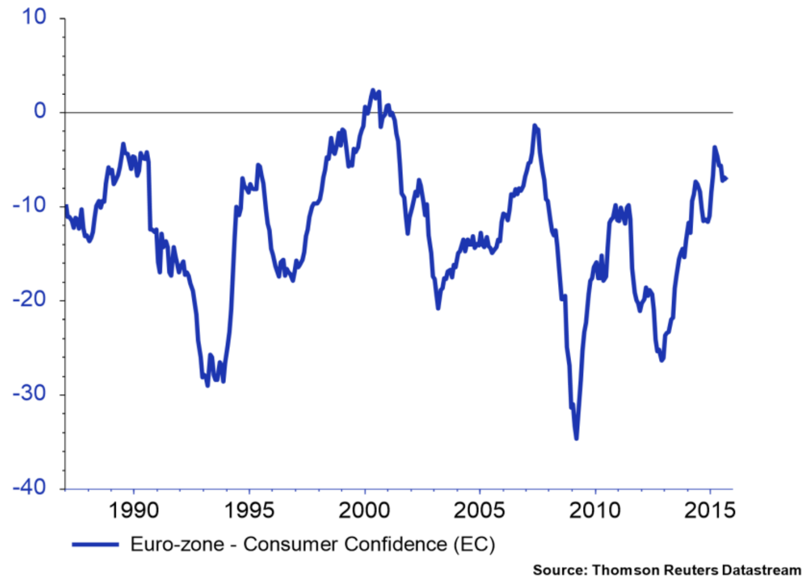


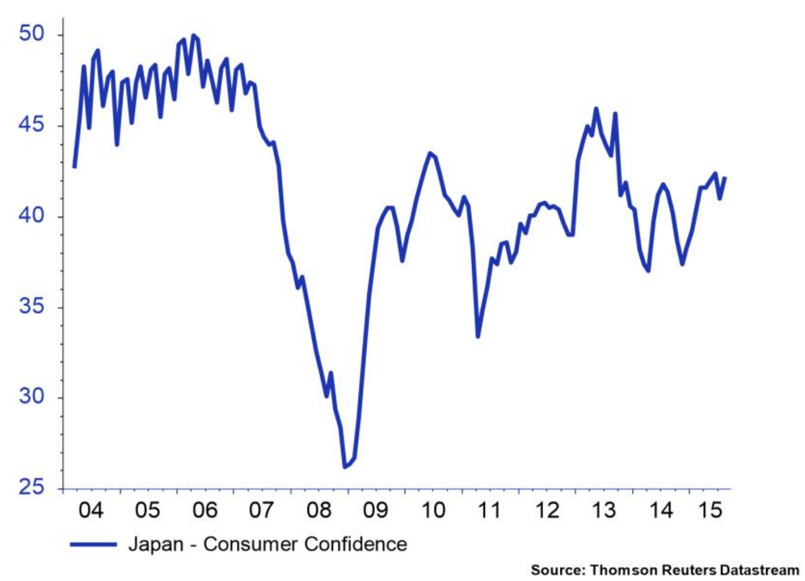
South Korea - Manufacturing business sentiment (BoK)
South Korea - Non-manufacturing business sentiment (BoK)

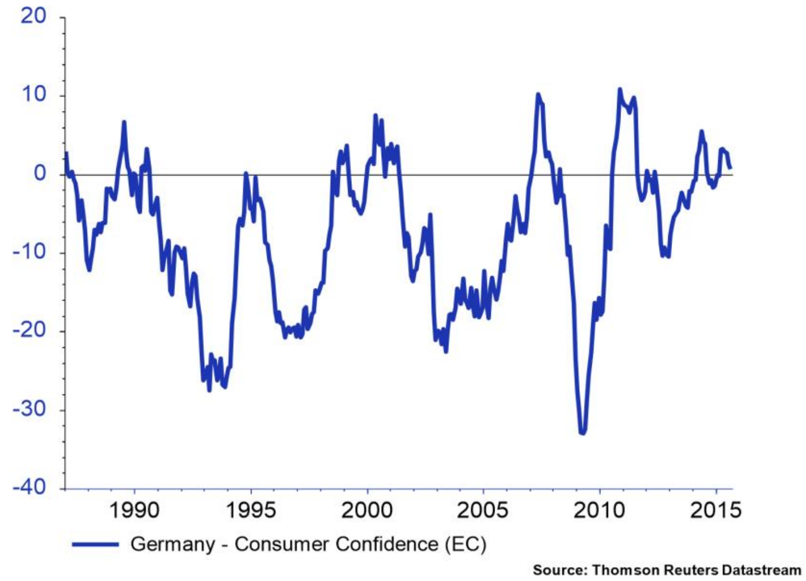
Source: Thomson Reuters Datastream

Consumer Confidence

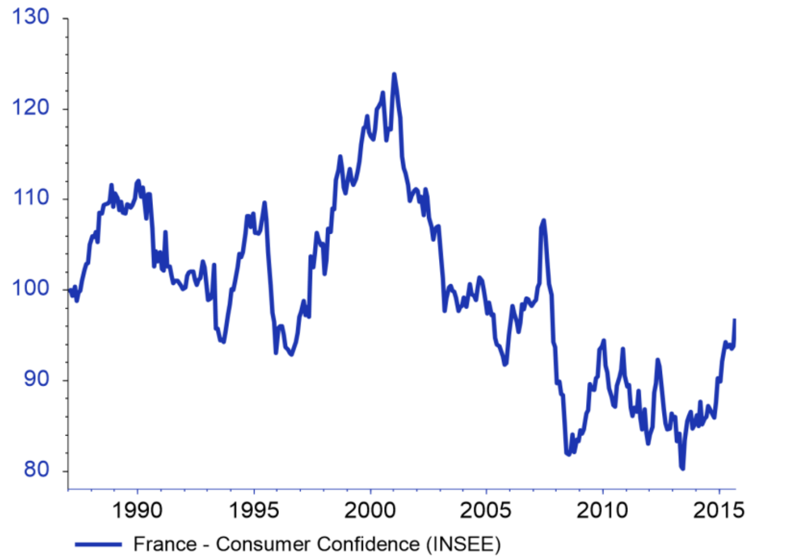








Consumer Confidence (continued)



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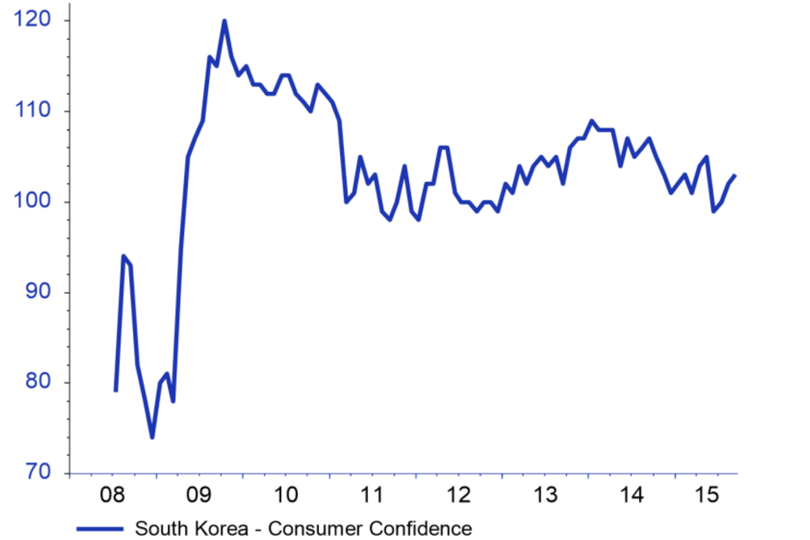

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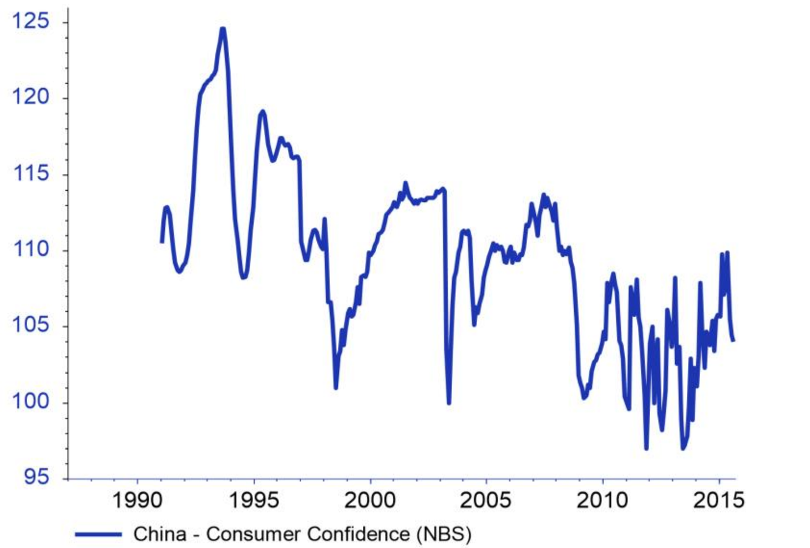

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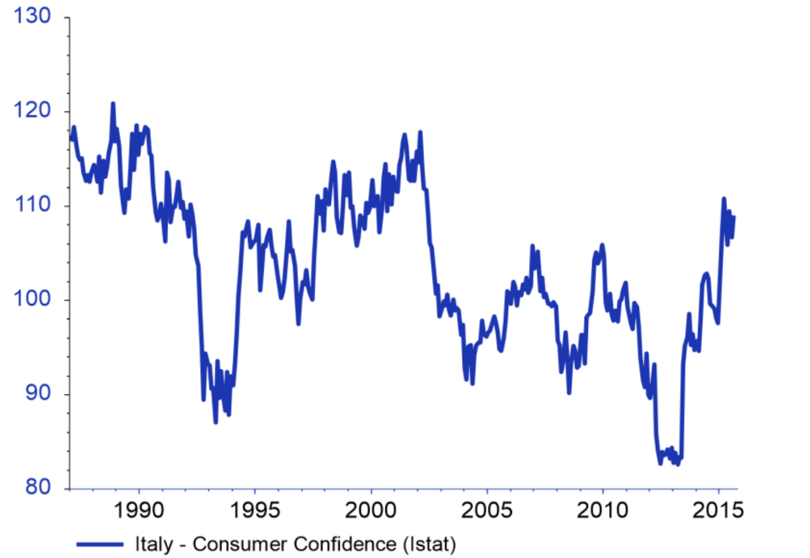

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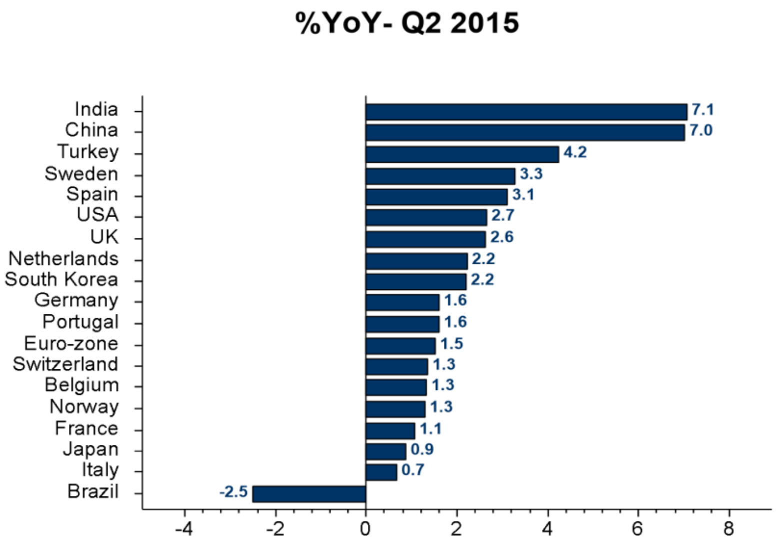
Real GDP growth



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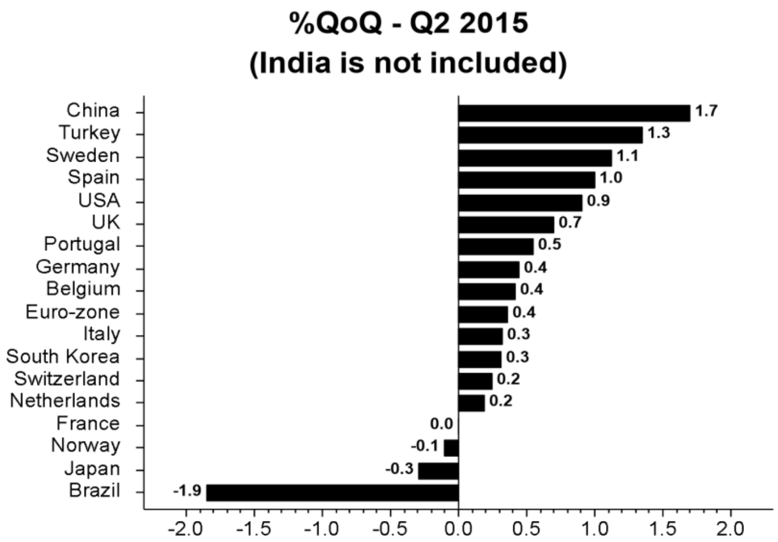

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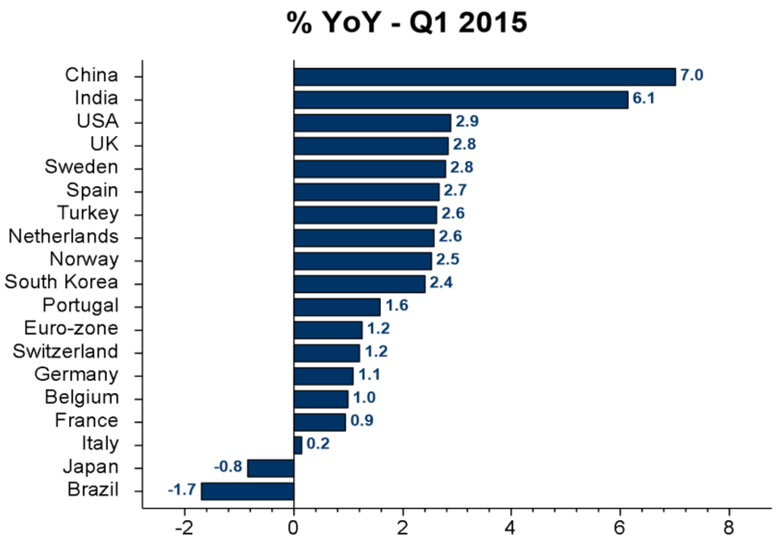

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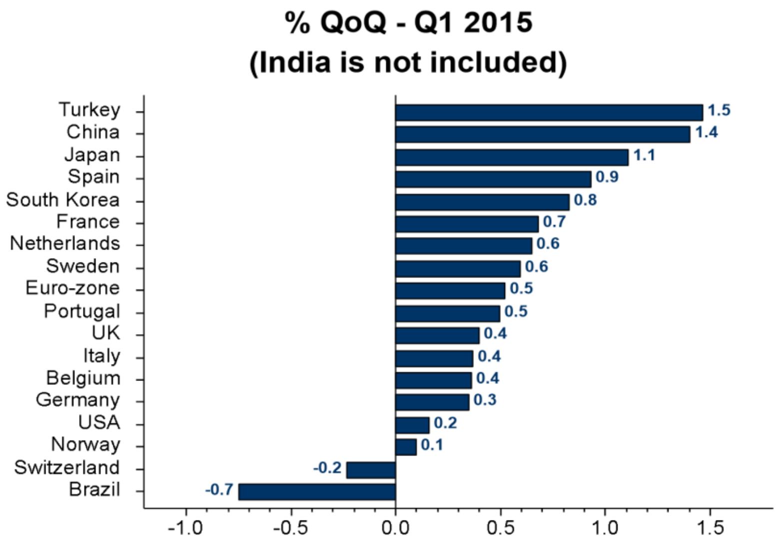

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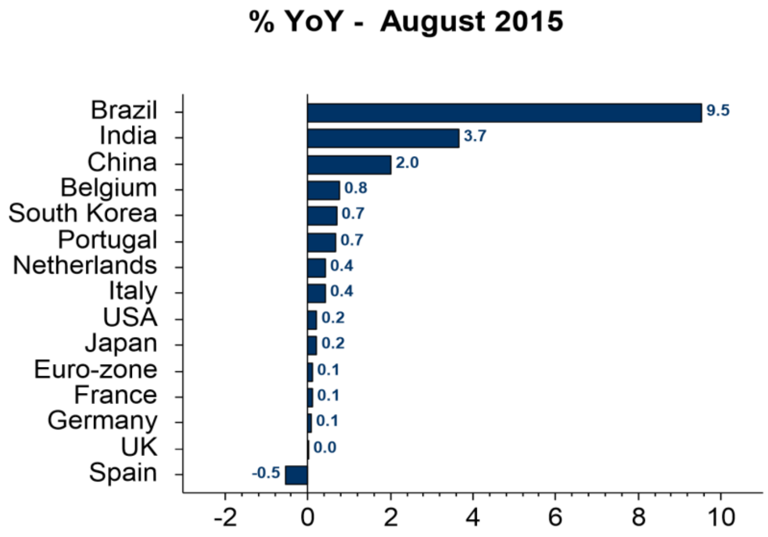
Consumer price inflation



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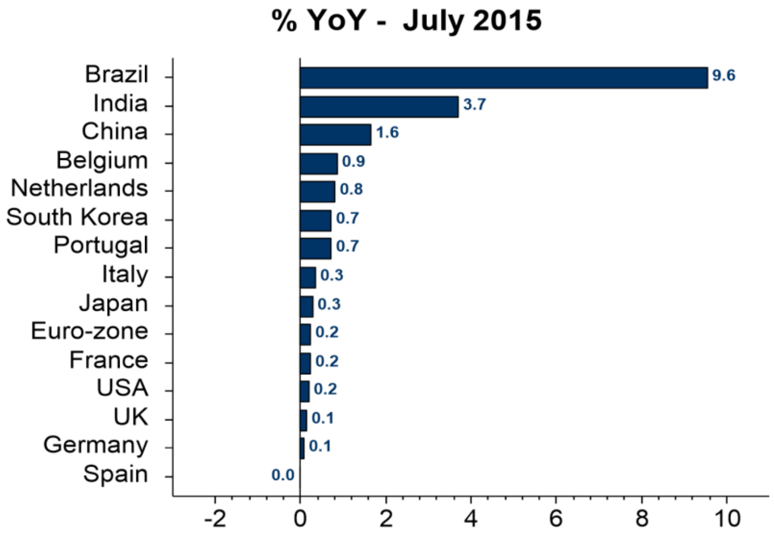

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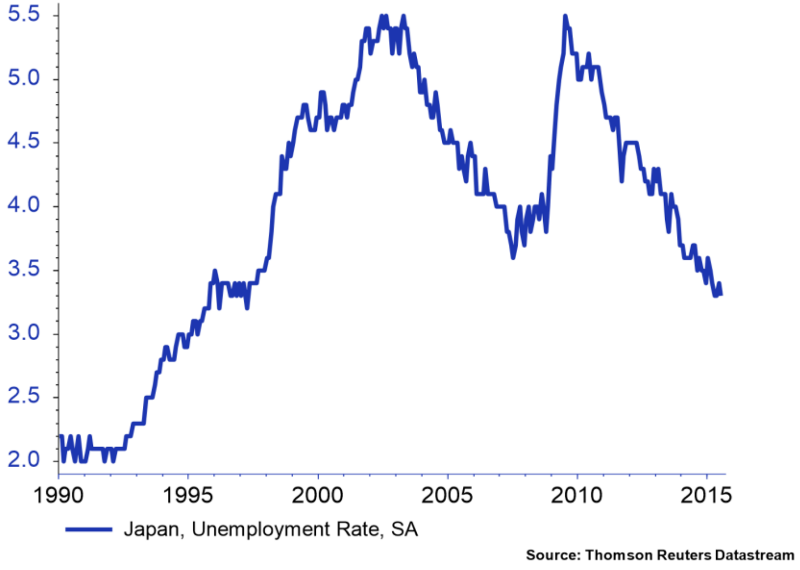
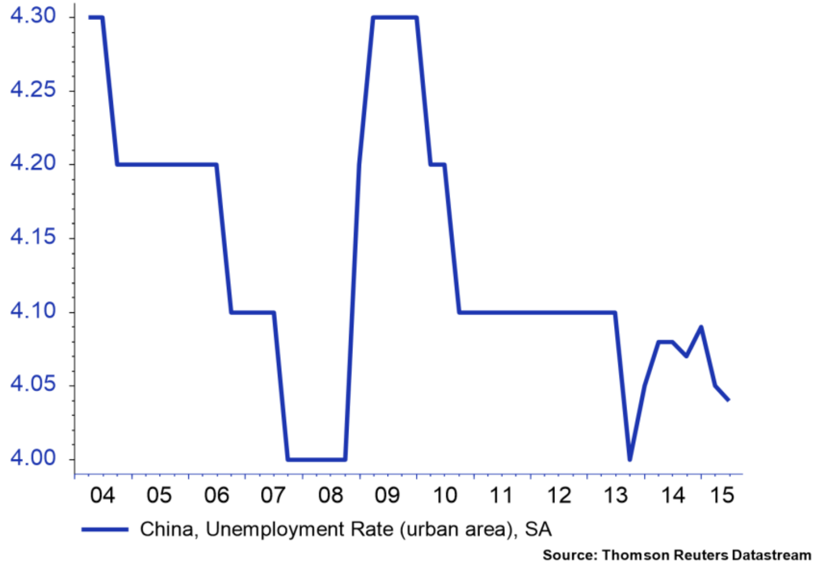
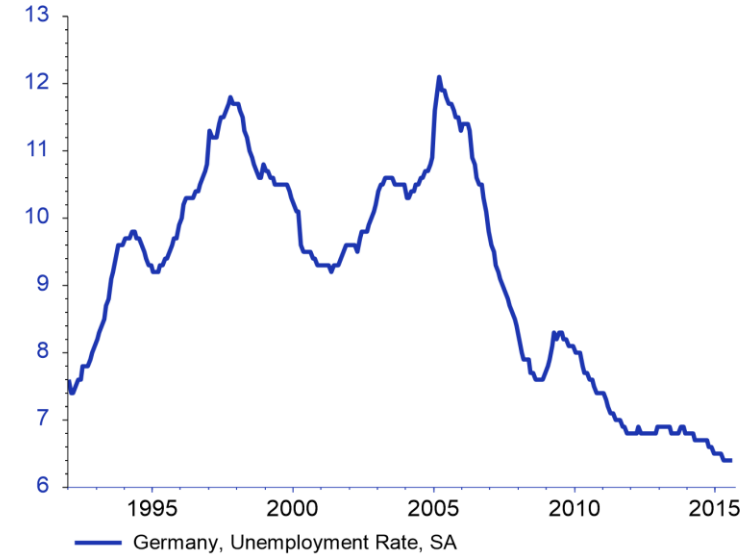
Unemployment





Unemployment (continued)



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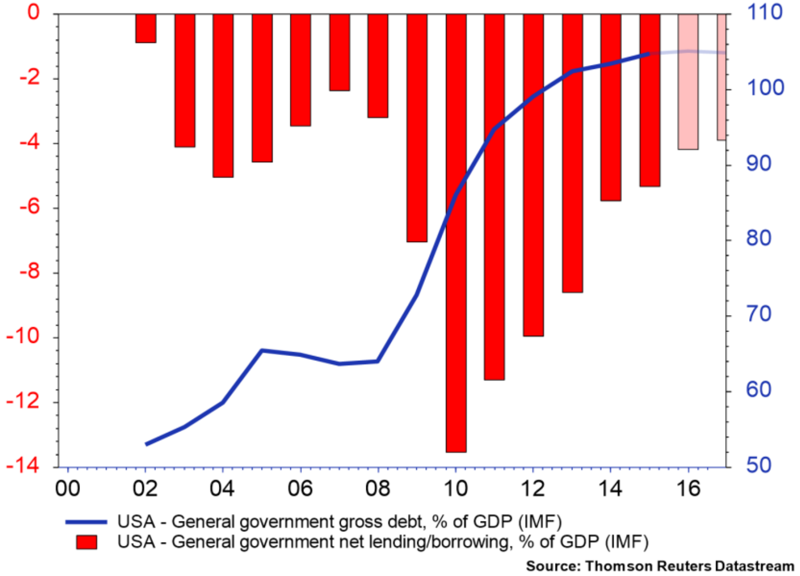
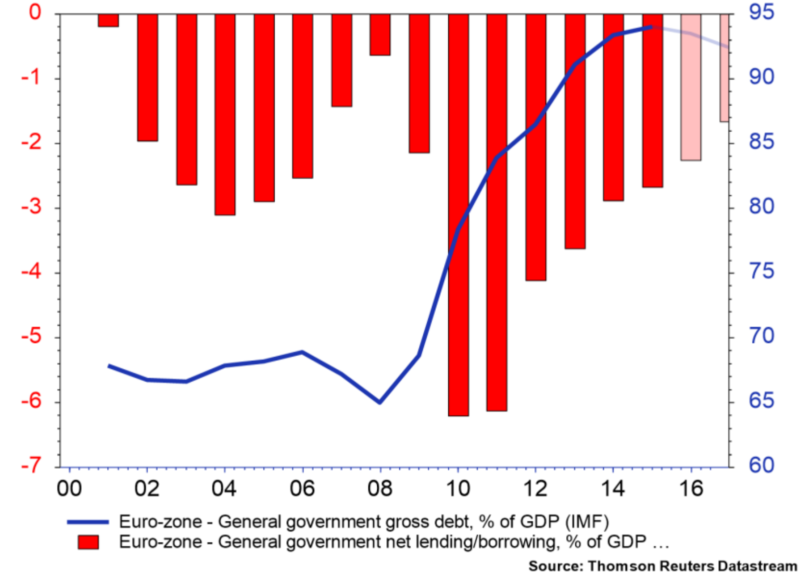
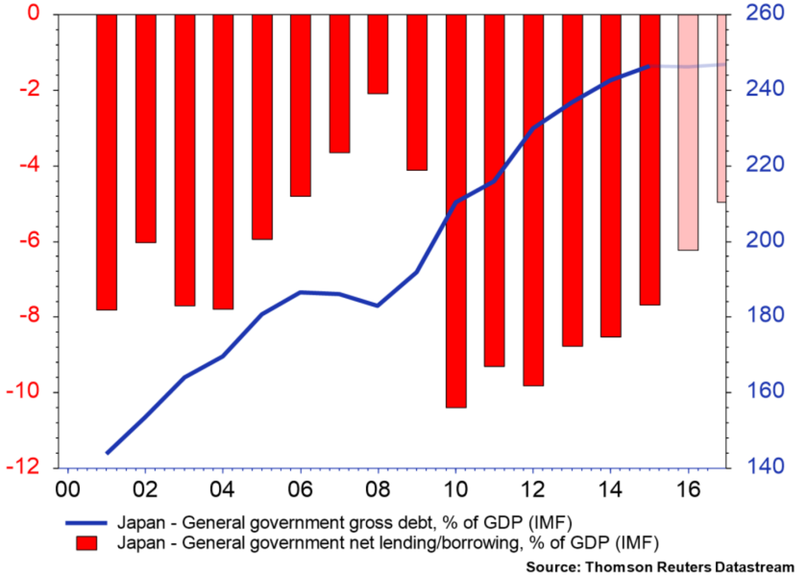
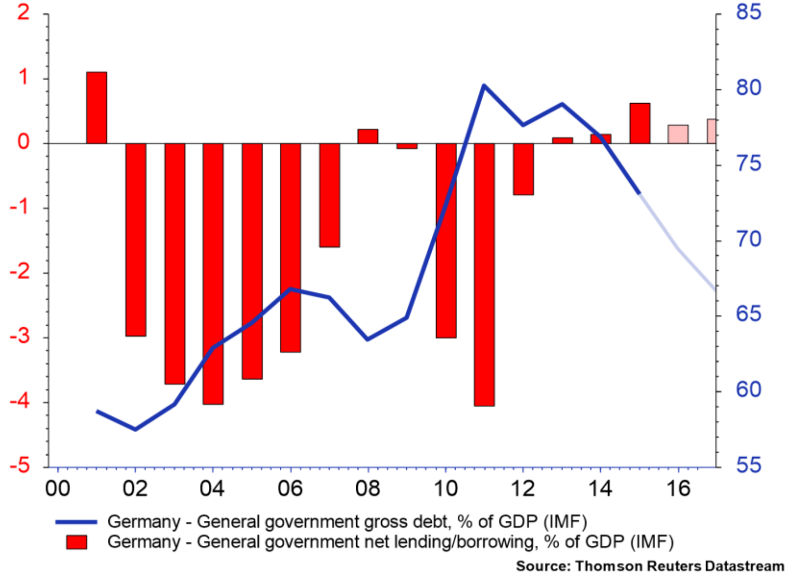
Public Sector Balances

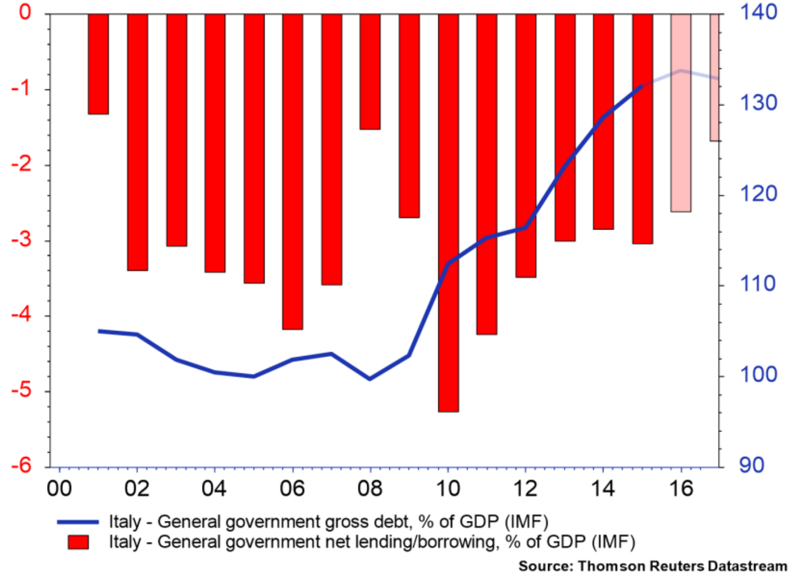


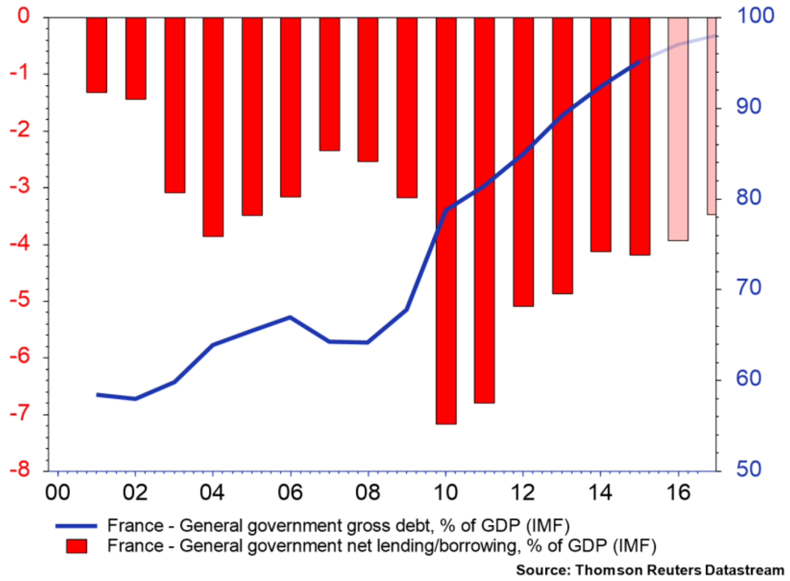


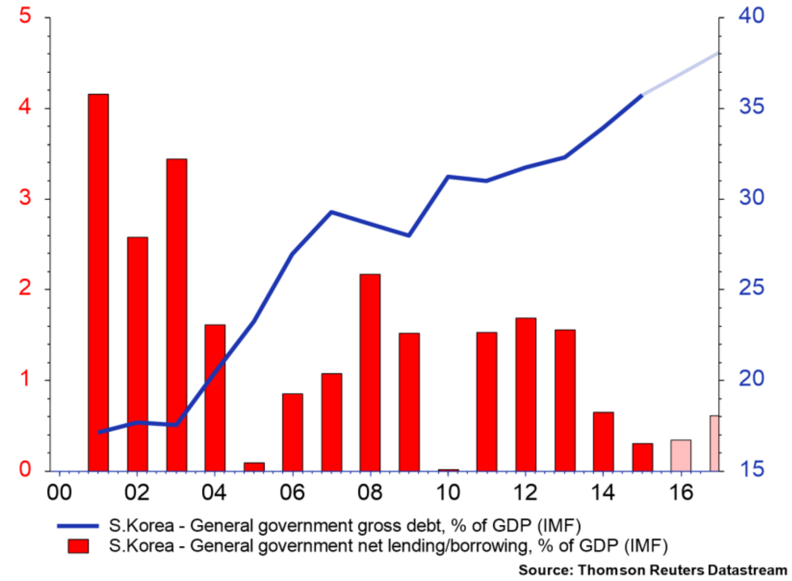


Public Sector Balances (continued)

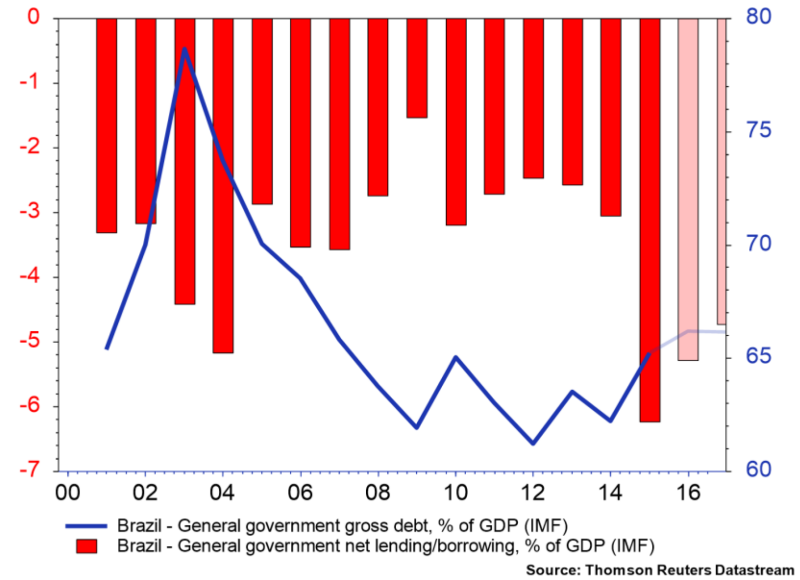


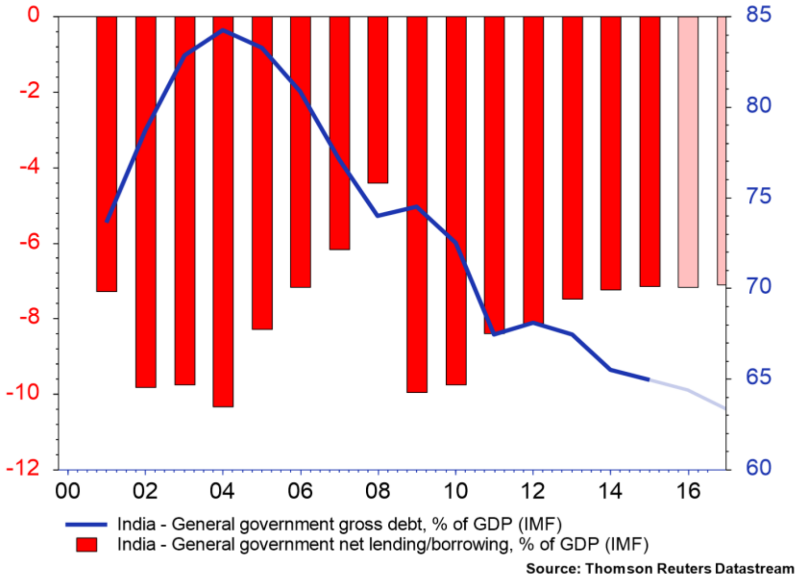




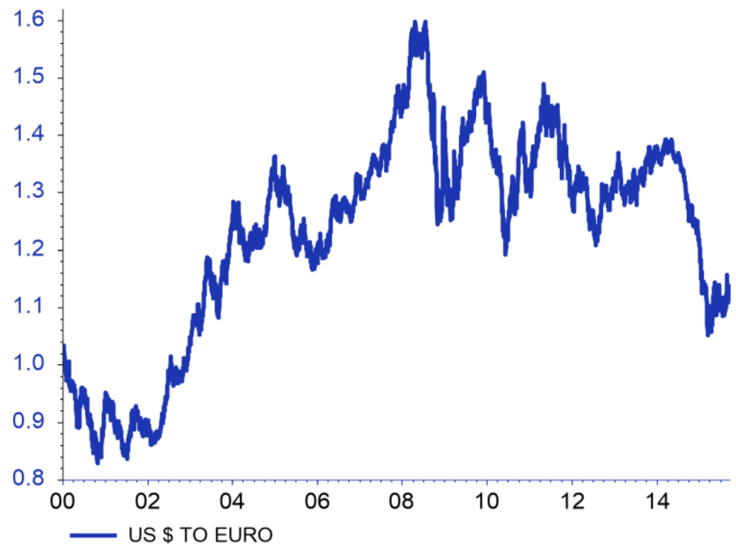


Public Sector Balances (continued)





Foreign Exchange Market



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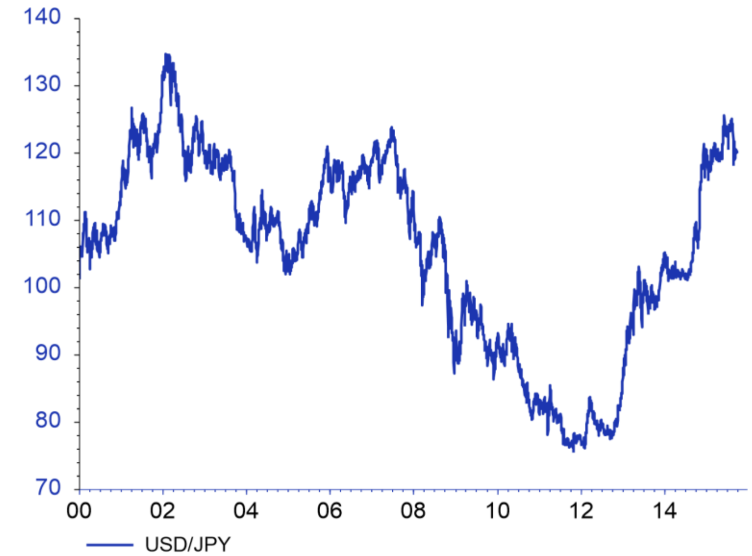

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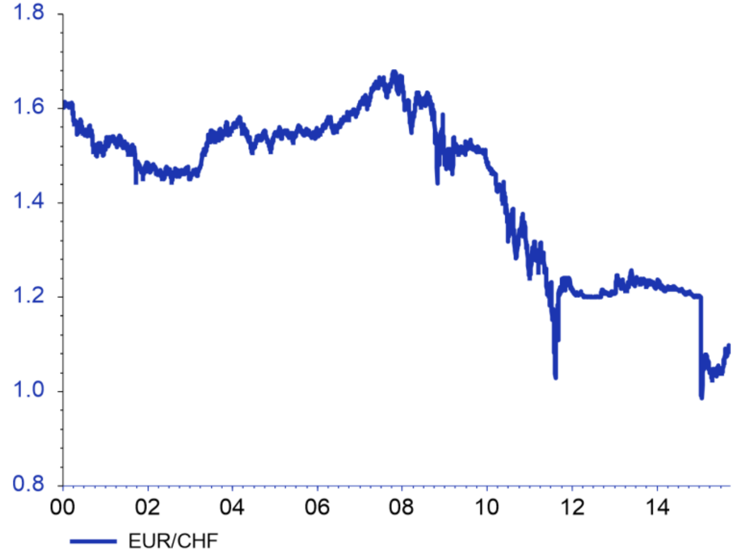

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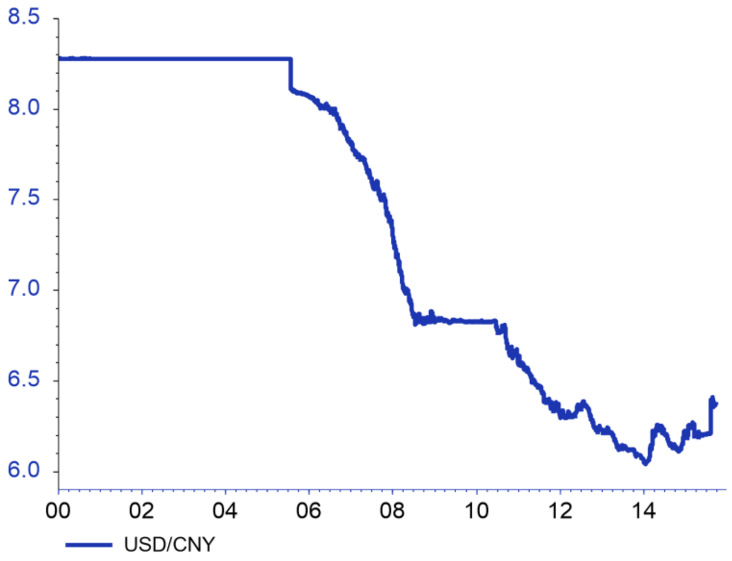
Foreign Exchange Market (continued)



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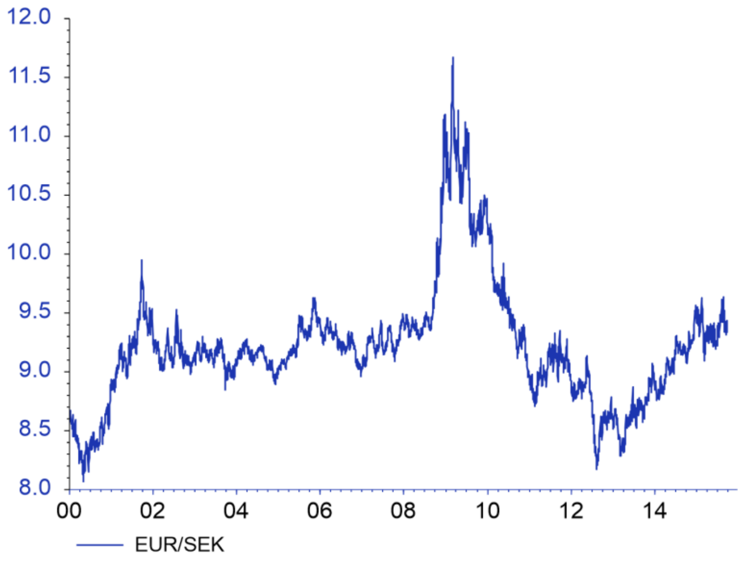

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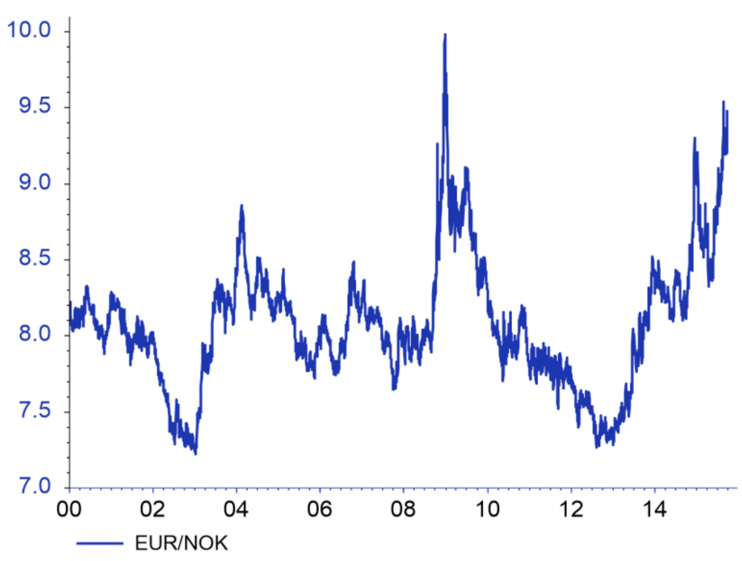

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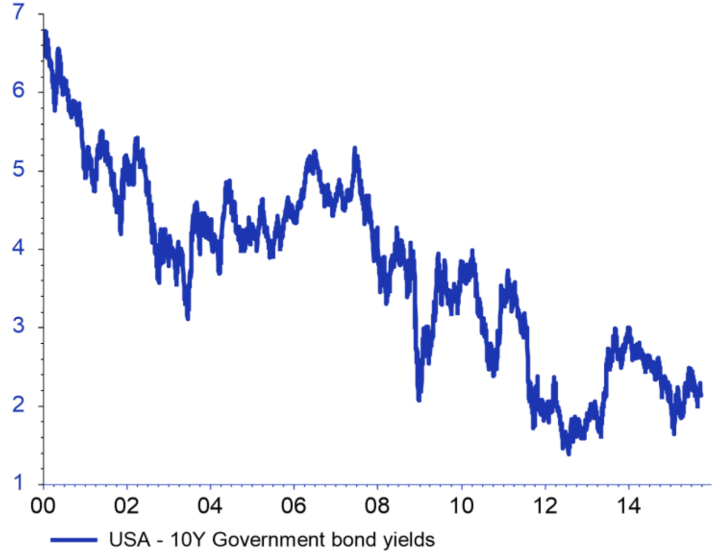
Government Bond Yields



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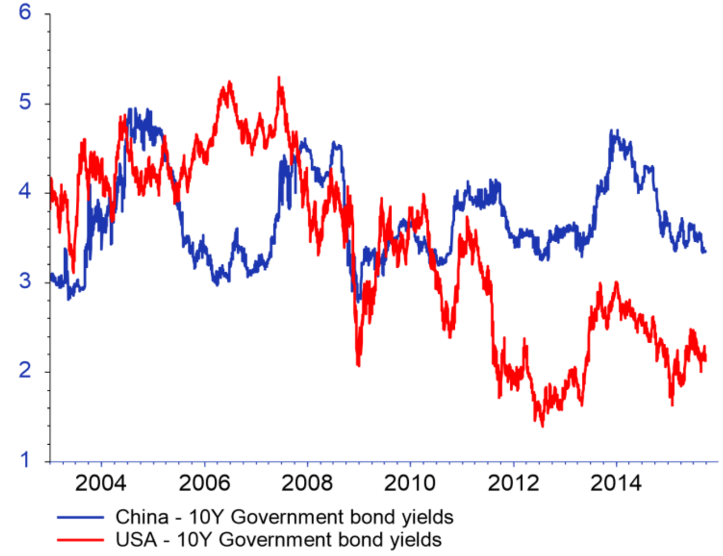

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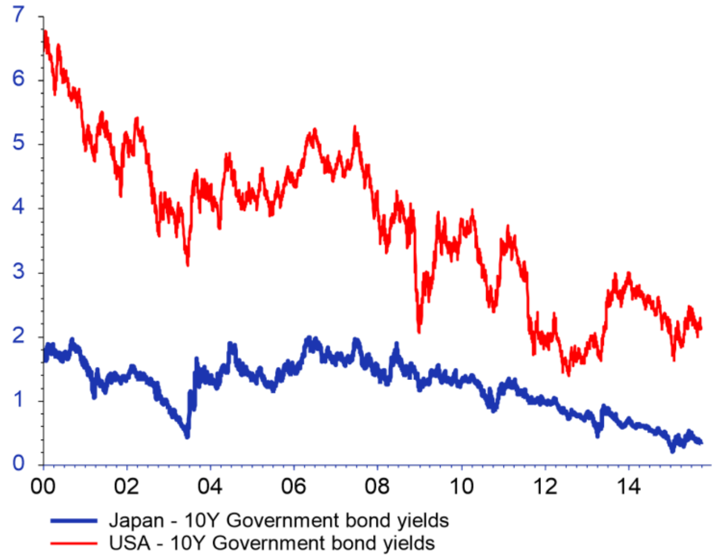

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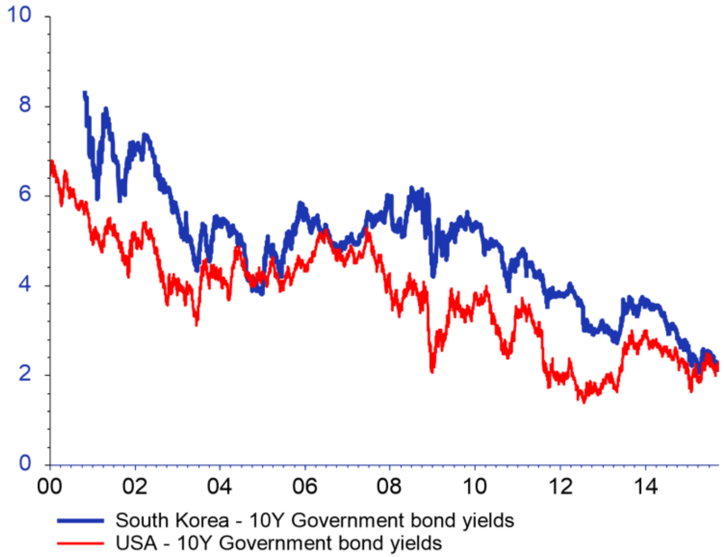

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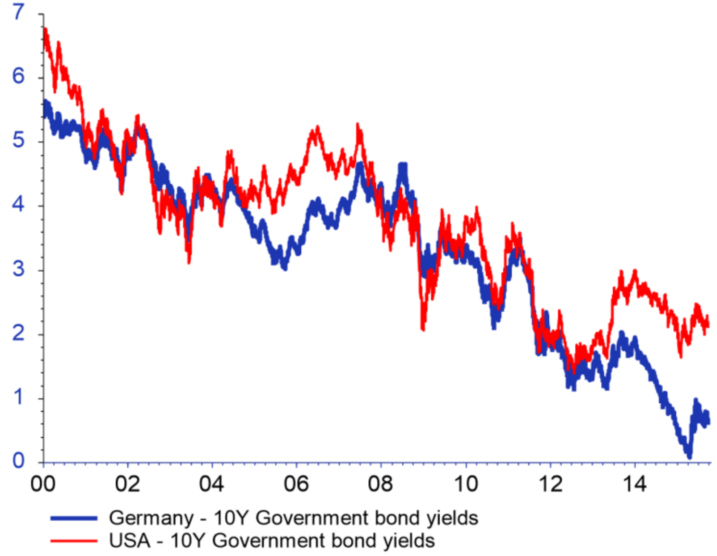
Government Bond Yields (continued)



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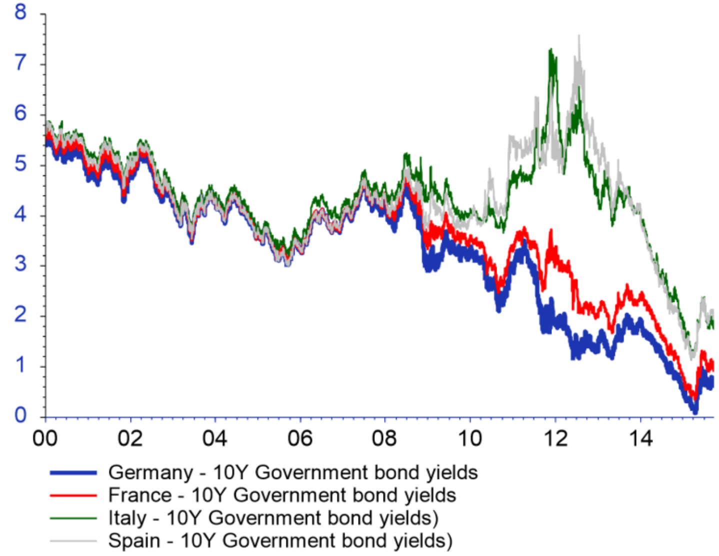

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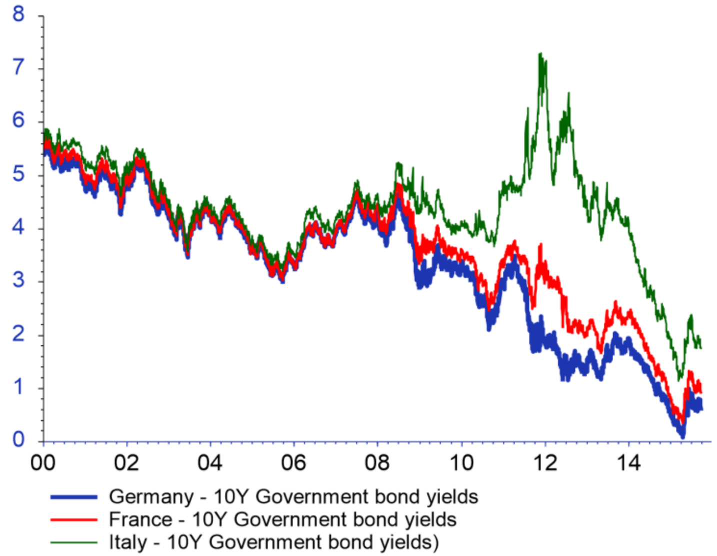

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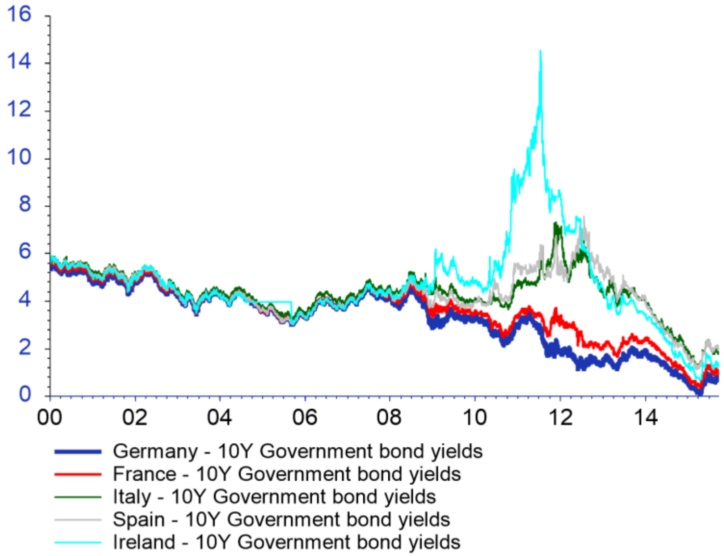

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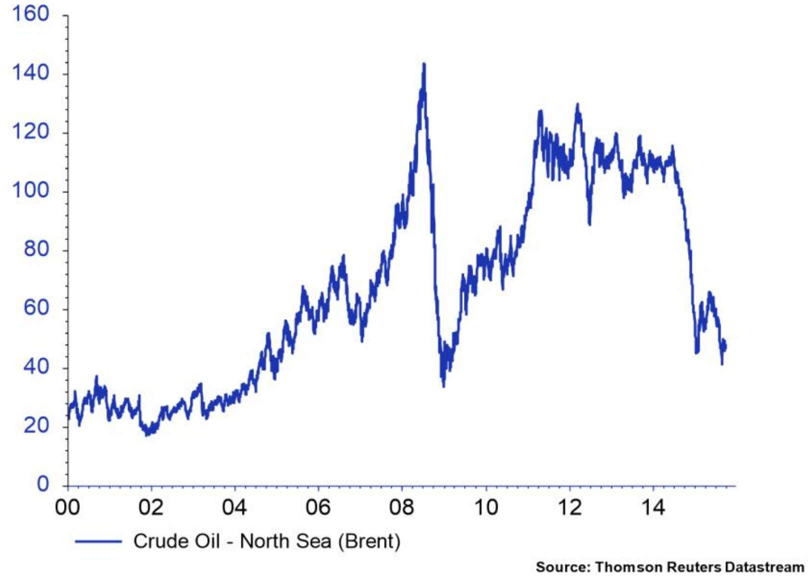
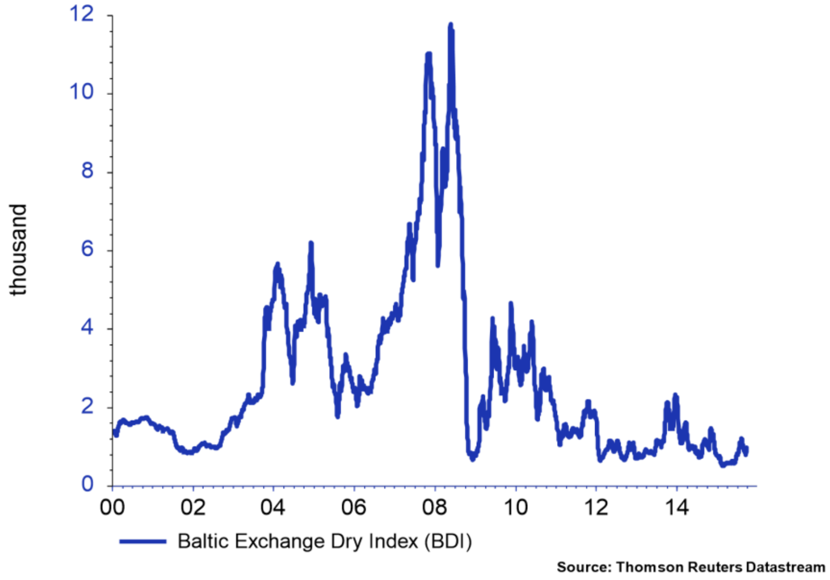
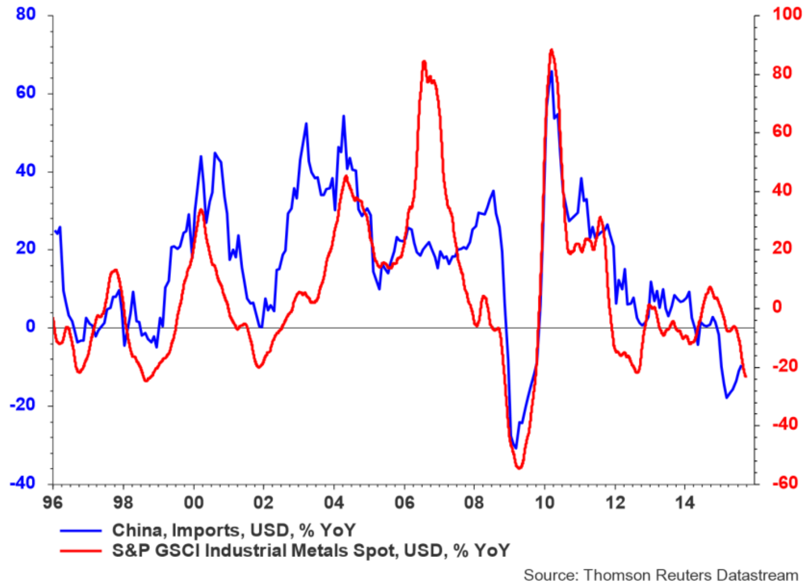
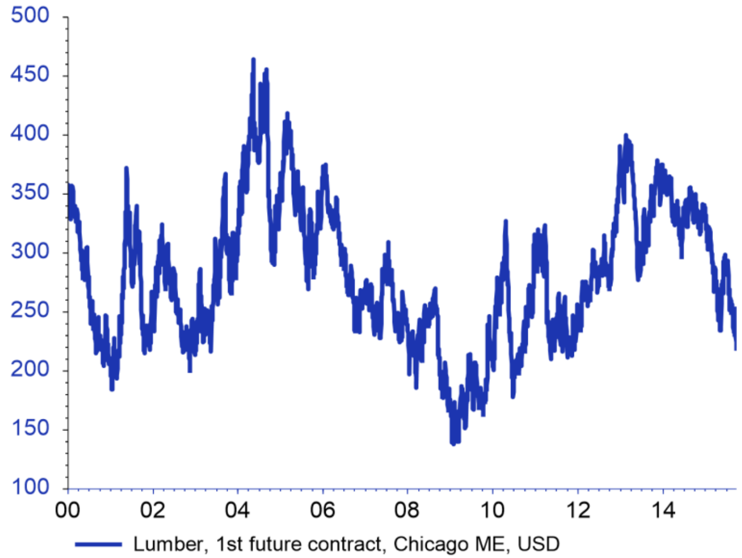
Commodity Markets







Commodity Markets (continued)



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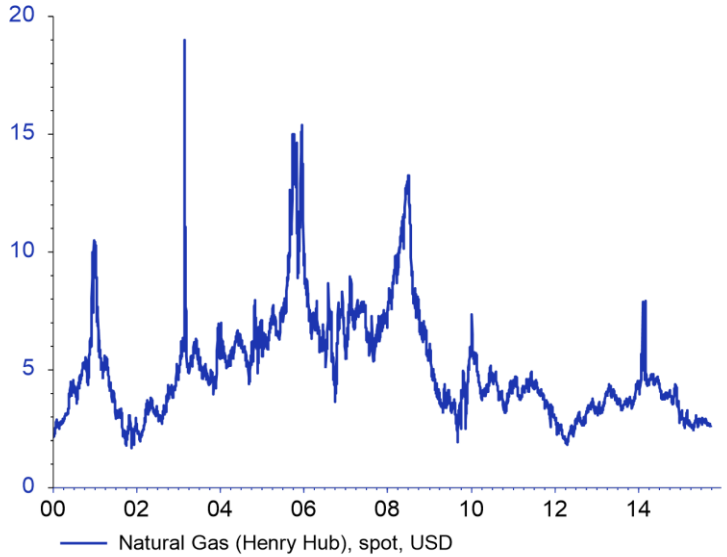

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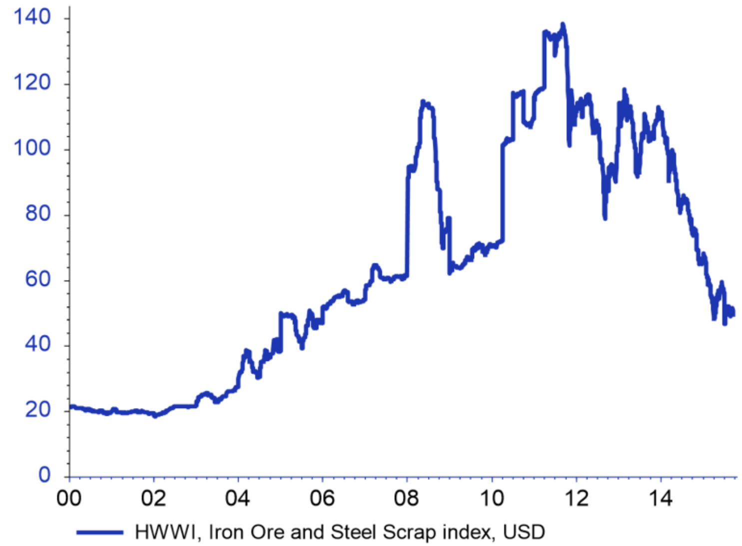

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Commodity Markets (continued)

Equity Markets

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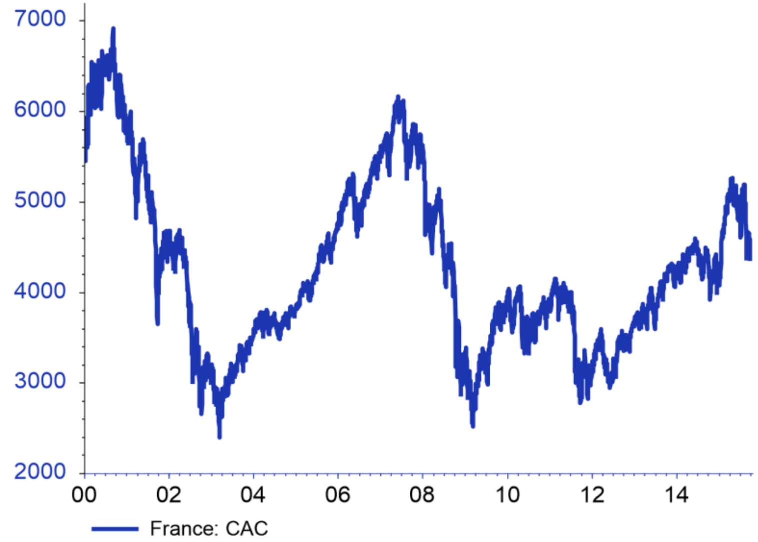

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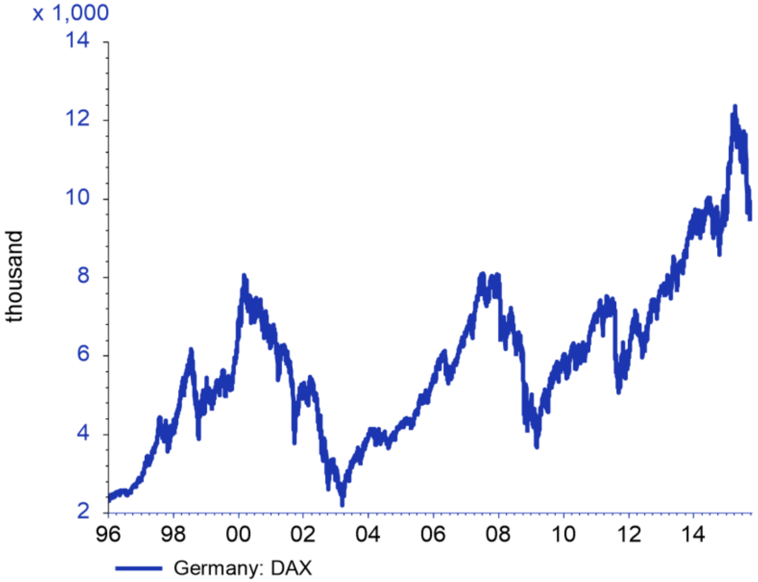

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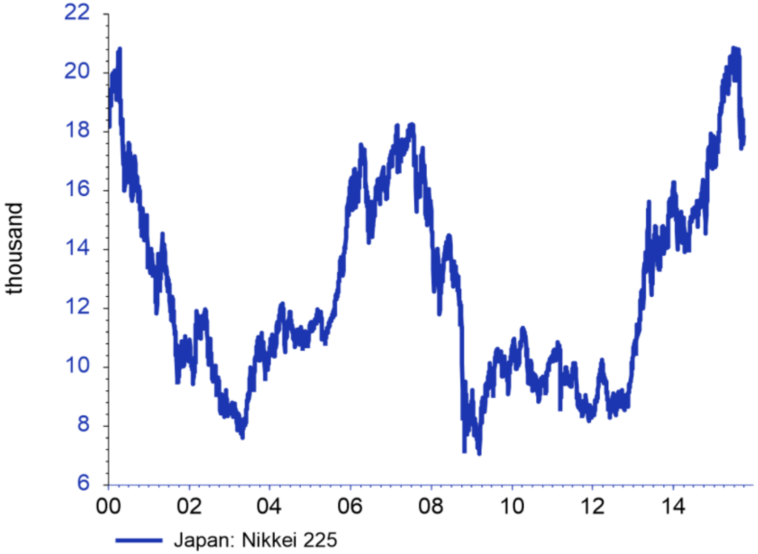

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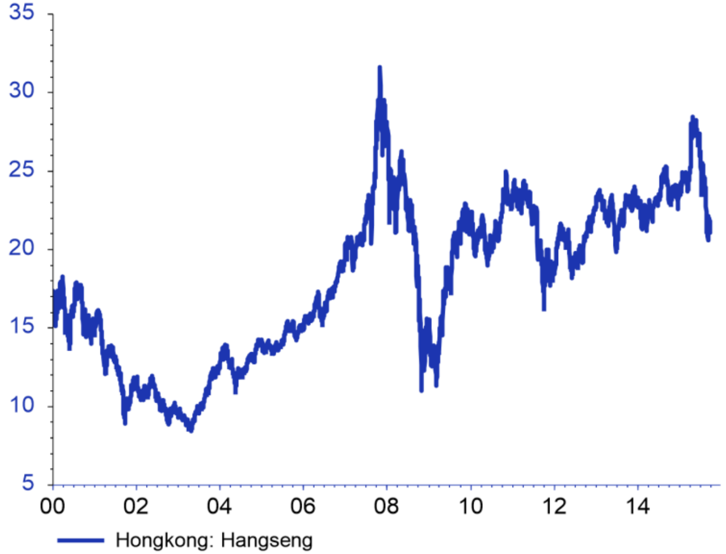
Equity Markets (continued)



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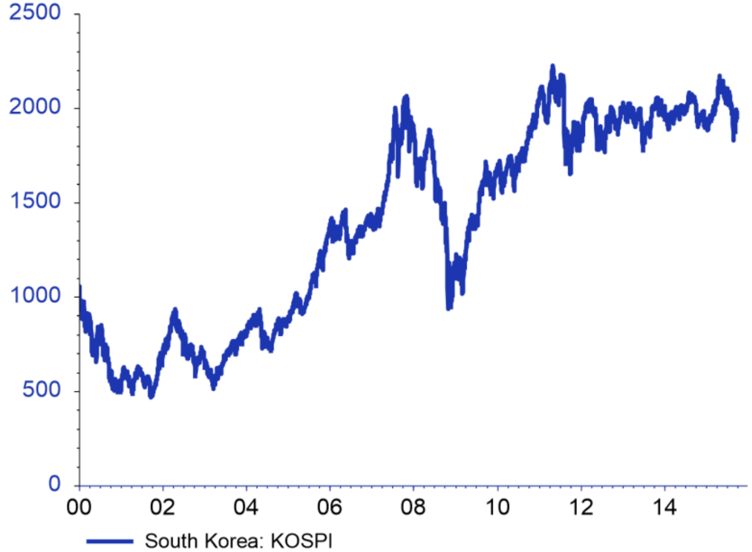

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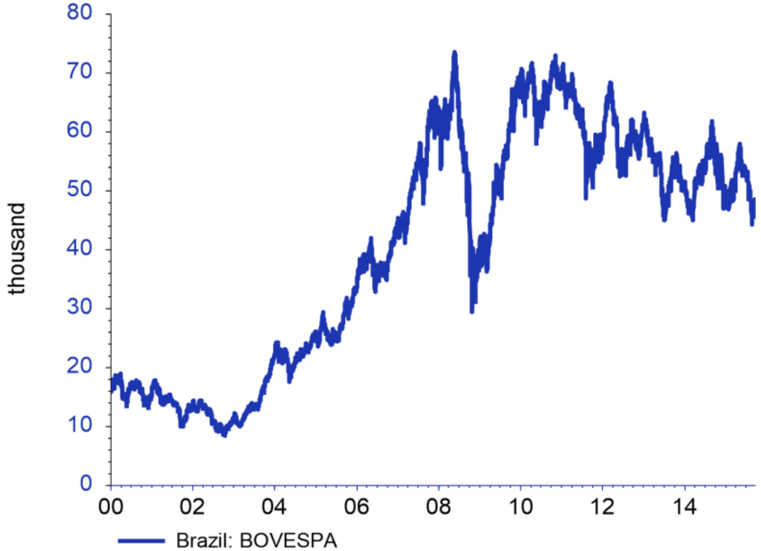

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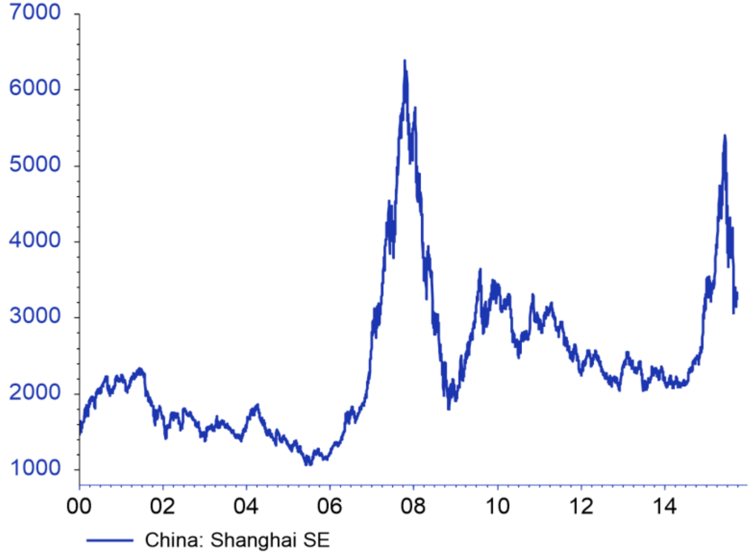

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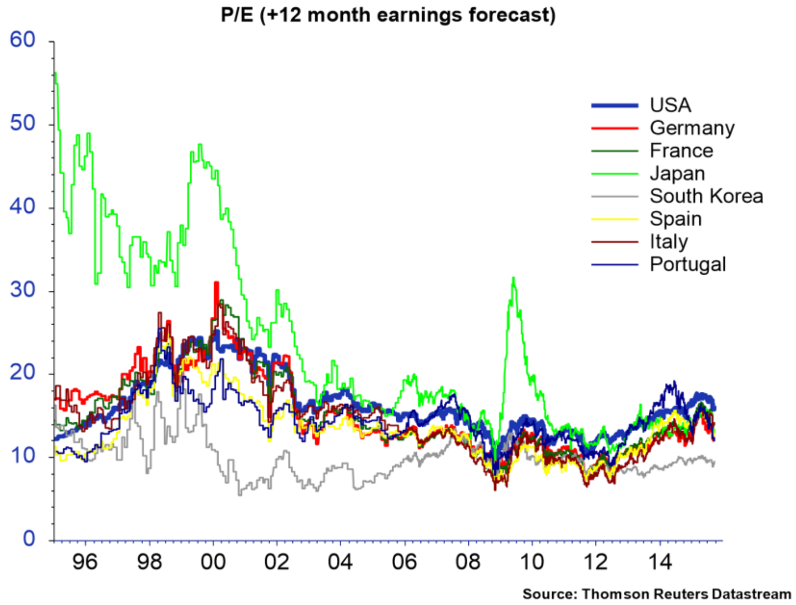
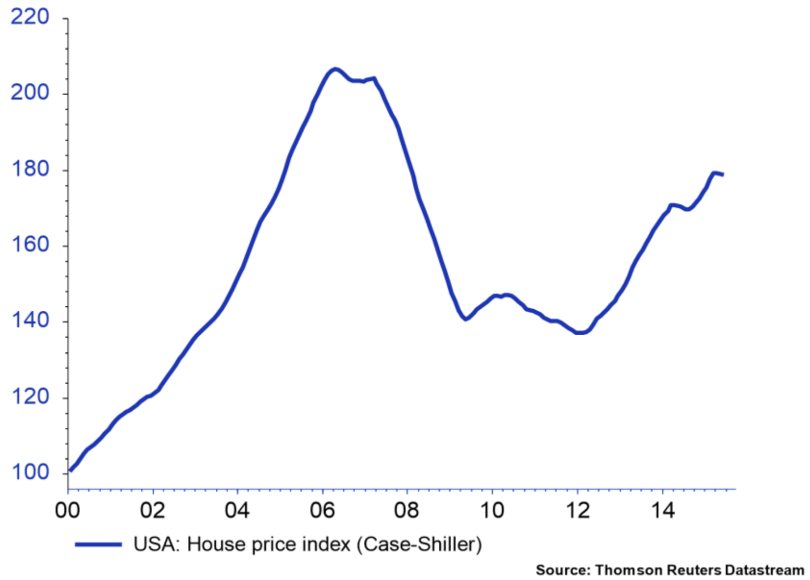
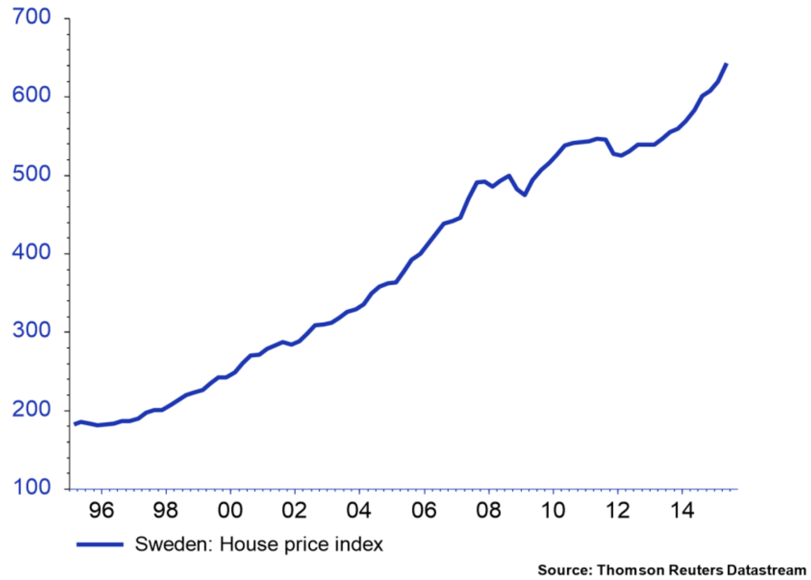
Equity Markets (continued)

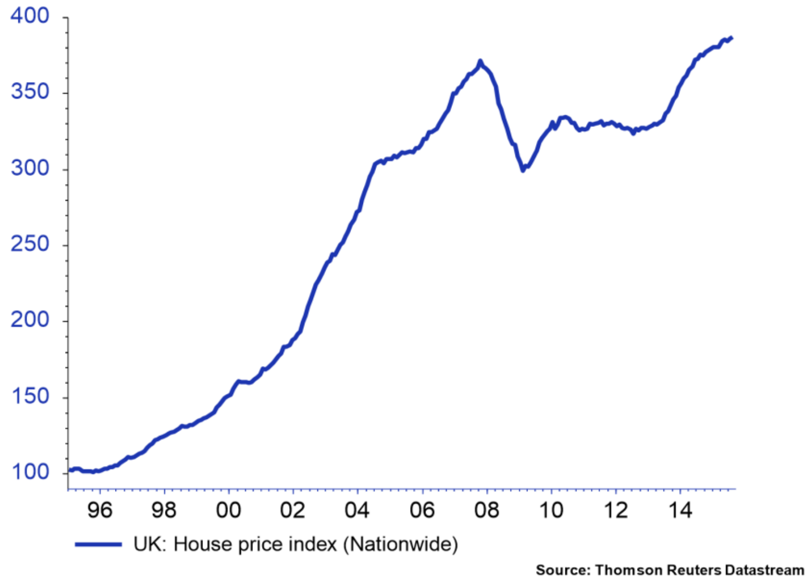
Equity Markets - Valuation

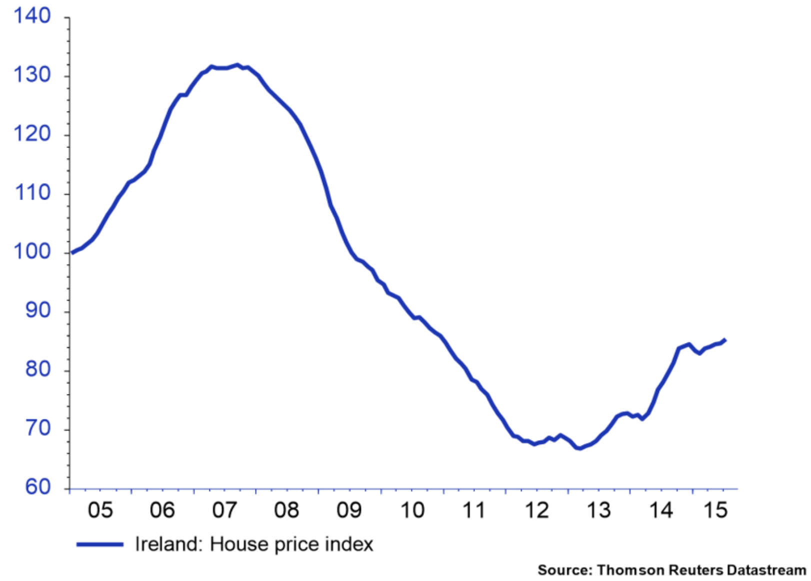


Home Prices

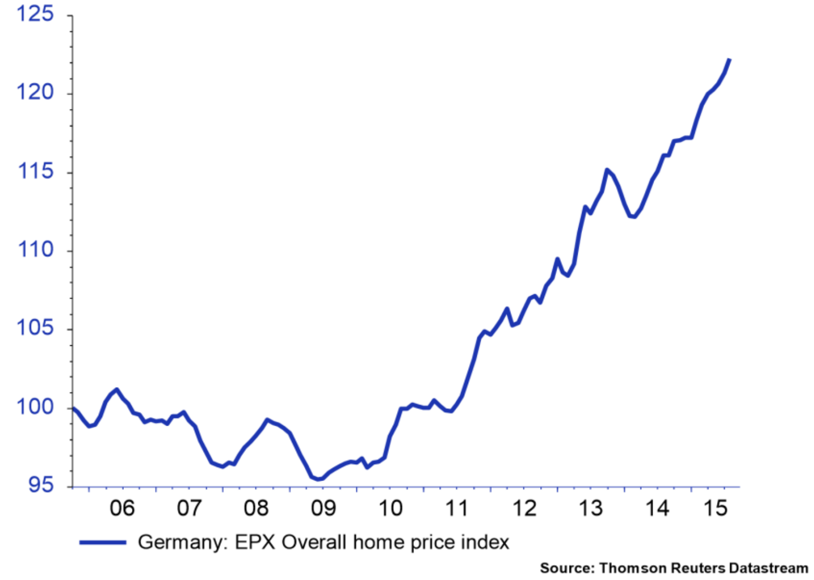

220
200
180
160
140
120
100
00 02 04 06 08 10 12 14
USA: House price index (Case-Shiller)
Source: Thomson Reuters Datastream

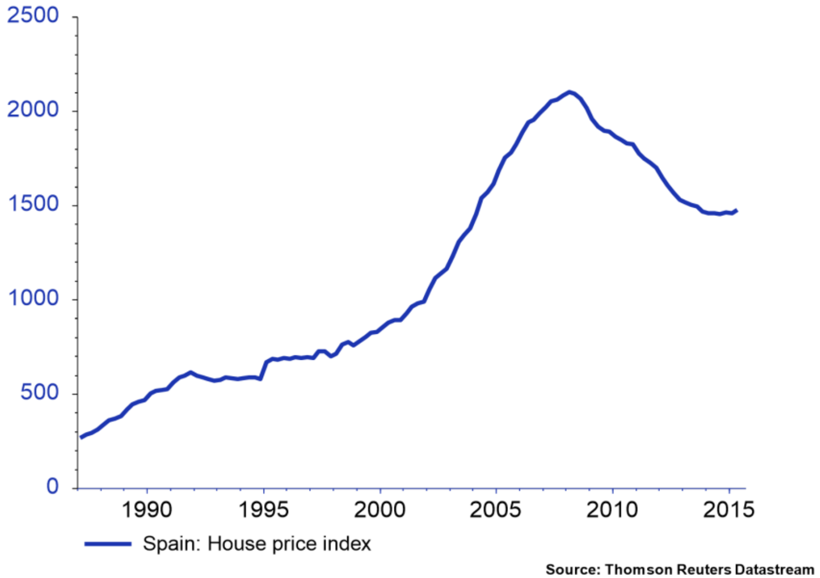

700
600
500
400
300
200
100
96 98 00 02 04 06 08 10 12 14
Sweden: House price index
Source: Thomson Reuters Datastream


400
350
300
250
200
150
100
96 98 00 02 04 06 08 10 12 14
UK: House price index (Nationwide)
Source: Thomson Reuters Datastream

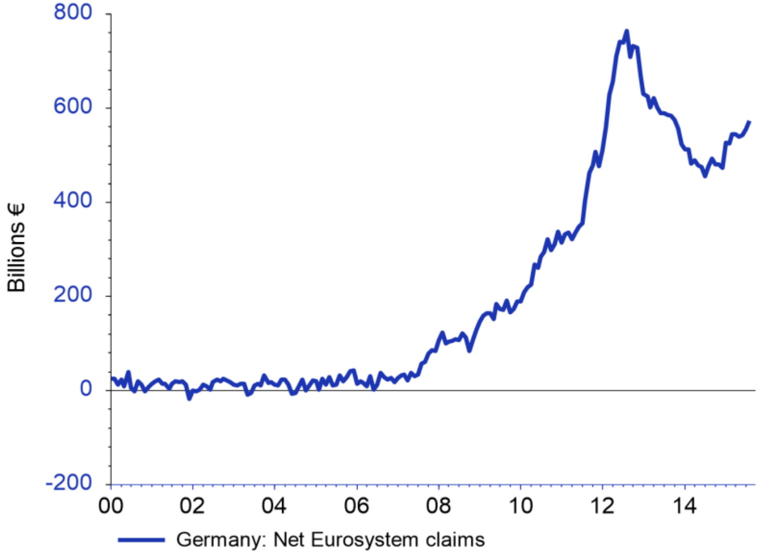

140
130
120
110
100
90
80
70
60
05 06 07 08 09 10 11 12 13 14 15
Ireland: House price index
Source: Thomson Reuters Datastream

Home Prices (continued)





Euro-zone Crisis



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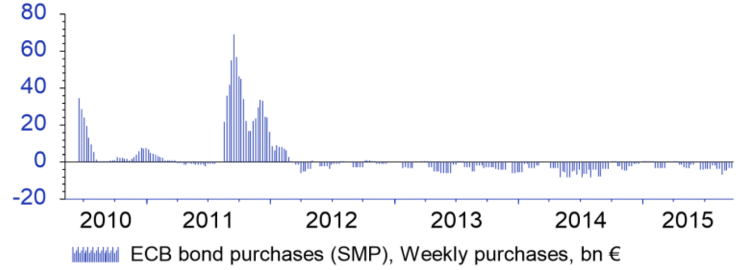

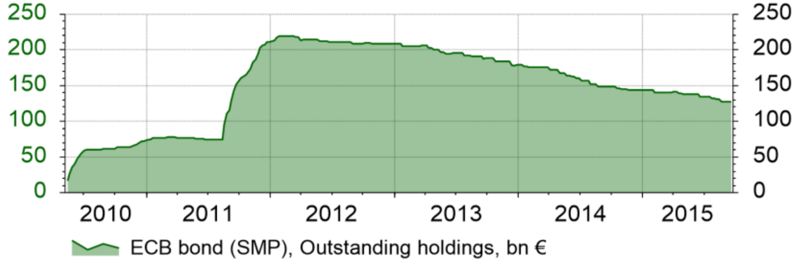

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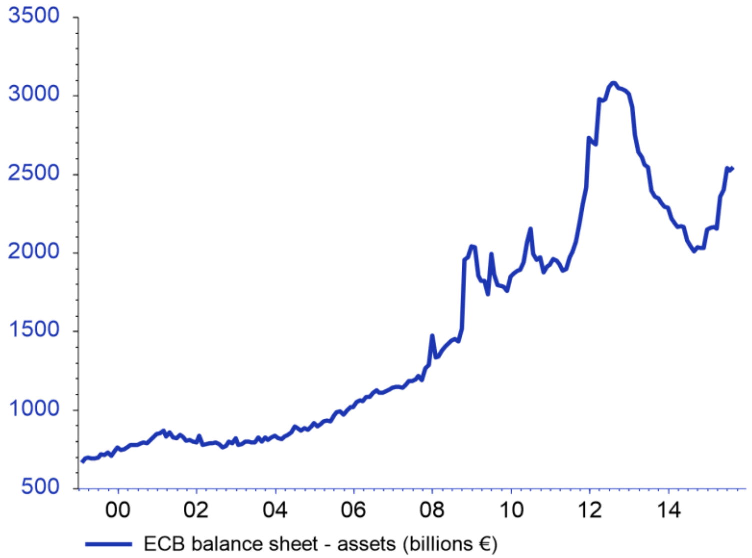

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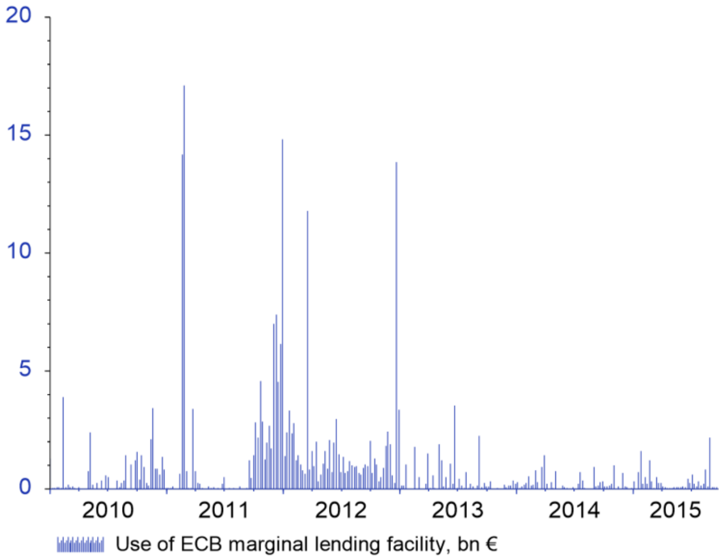

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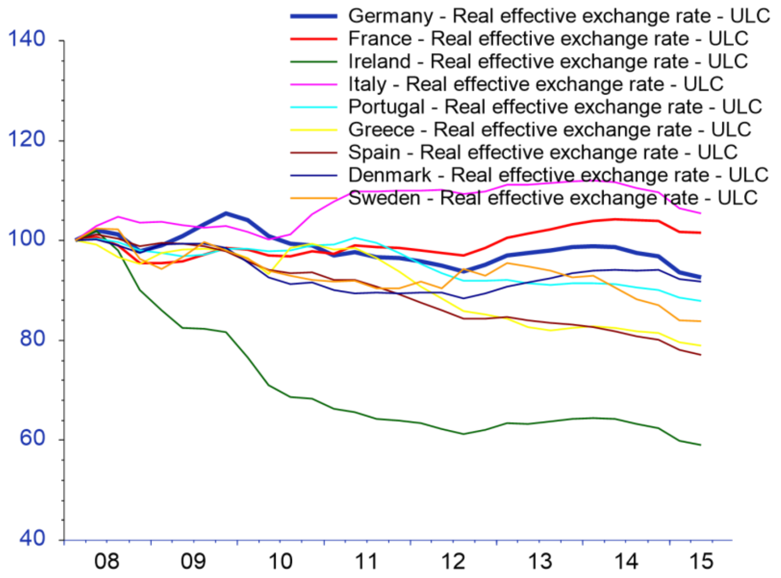
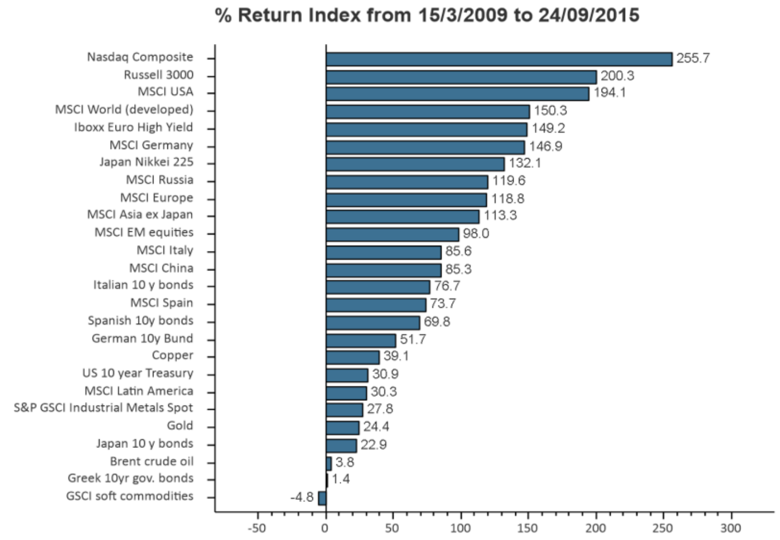
Labour costs



Source: Thomson Reuters Datastream

Performance of Asset types (local currency) – last update: September 24, 2015



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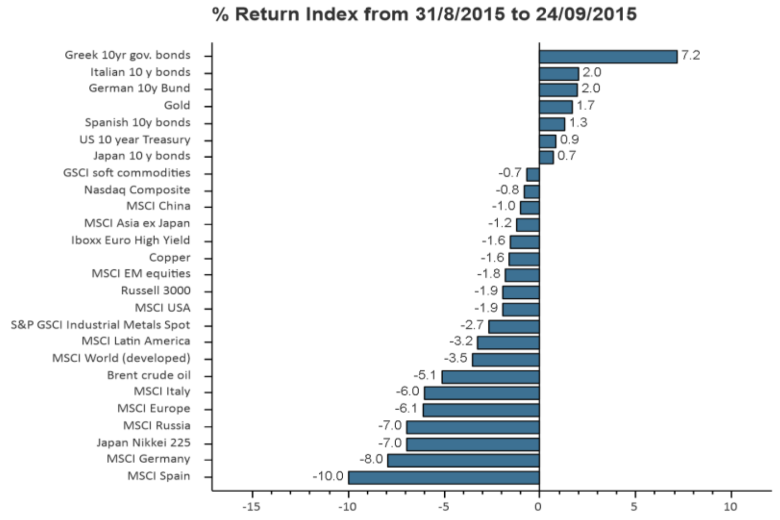

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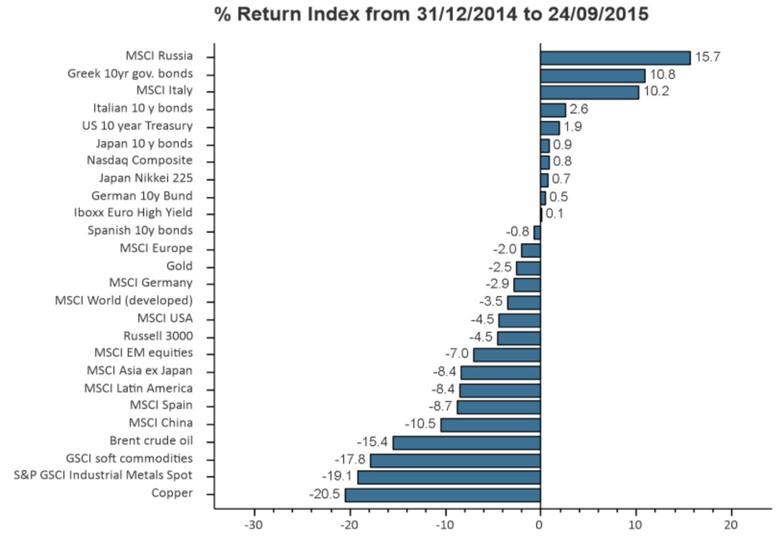

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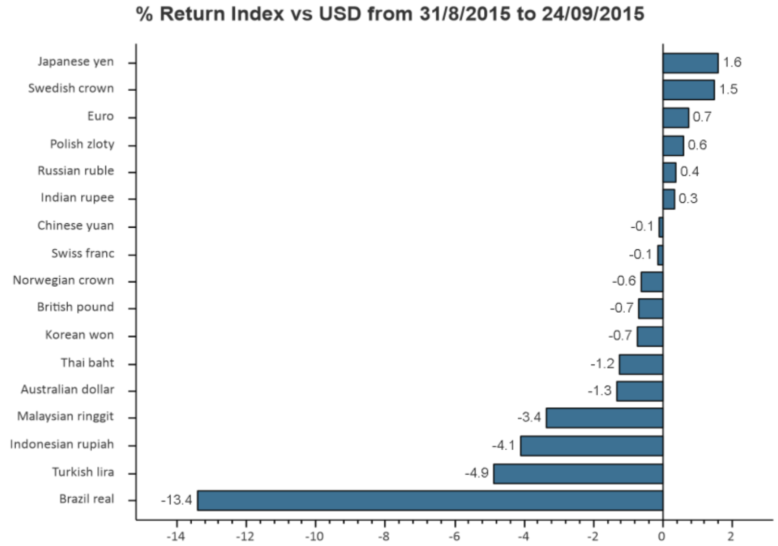

Source: Thomson Reuters Datastream

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