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CURRENCIES & MORE
OUR INSIGHT INTO THE WORLD'S LARGEST MARKET

Pound: The third round of Brexit talks ended again in a stalemate, indicating no progress at all
Euro: Harmonized inflation at 1.8 percent could make it difficult for Draghi to defend extending QE
Dollar: The Fed's Labor Market Condition Index is in contrast to the superficially solid NFP

Pound: No Progress on Brexit talks
In a tense press conference, after the third round of Brexit talks in Brussels, the E.U. Chief Negotiator Michel Barnier was scathing about the U.K.'s approach to the financial settlement, jurisdiction over citizens' right and access to the single market.

The Clock is Ticking Down, David Davis was told

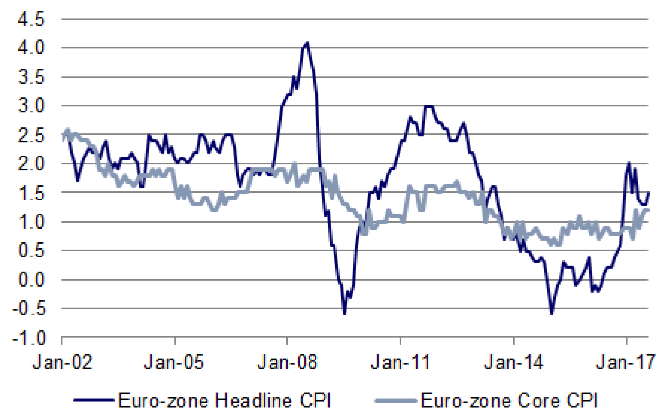
Source: The National

Barnier said there has been "no decisive progress" on the key issues with the U.K., putting him at odds with Davis. The E.U. side was left "flabbergasted" after their British counterpart launched a legal deconstruction of the Brexit bill. According to E.U. sources, British negotiators spent many hours launching a painstaking, line-by-line rebuttal of the E.U.'s demand for the divorce settlement, to the barely concealed fury of E.U. negotiators. "How can we build trust and start discussing the future relationship?", Barnier rhetorically asked. Barnier also gave a stark warning that the single market would not be undermined by Brexit, saying that it was impossible for an individual country to shape the market's regulation from the outside. "The U.K. wants to take back control, wants to adopt its own stand and regulations – but it also want to have these standards recognized automatically in the E.U.", he concluded. "That is what U.K. is asking for. This is simply impossible. You cannot be outside the single market and shape its legal order", Barnier pointed out. At the same time, Davis expressed frustration at the E.U.'s stance of financial matters, and its refusal to allow further discussions on the future relationship between the two sides.

Conclusion: The gridlock remains on Brexit talks.

Euro: Solid but not Optimal Inflation
Headline CPI increased by 1.5% in August year-on-year, from 1.3% in July, whereas core CPI remained at 1.2%. Data released one day ago from Germany and Spain showed that inflation picked up a touch more than expected; 1.8 percent in Germany and 1.6 percent in Spain, both a tenth of a percent higher than in the previous month. More importantly, Harmonized Consumer Price Inflation – the ECB's main inflation gauge – now stands at 1.8 percent, not far from the ECB's 2-percent inflation target. HICP increased from 1.4 percent in May, to 1.5 percent in June and July, to 1.8 percent as of August, which we think is a reason to expect core inflation to pick up a little in the months ahead. The data suggest that the ECB's strong policy support is becoming less necessary. Given the development in consumer prices, it will be interesting to hear ECB President Mario Draghi's response to questions regarding the appreciation of €/$, at his upcoming press conference on 7 September.

Euro-zone headline and core CPI in the past 15 years



Source: Bloomberg Finance L.P., Julius Bär

Conclusion: Rising consumer prices do not justify the ECB continuing QE for an extended period of time.

QUICK NEWS HEADLINES (time in CEST)

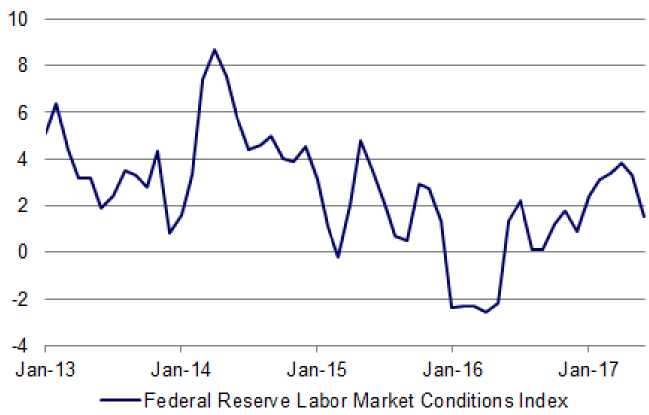
The following five headlines might have an impact on currency markets today:

- Japan: Capital spending rose 1½% in Q2 y/y, much less than the 7.9% expected.
- South Korea: The trade surplus for August came at $ 7.0 billion, more than the $ 6.2 billion expected, GDP rose 2.7% in Q2, in line with expectations.
- Sweden: The Manufacturing PMI for August is expected at 60½ (08:30).
- Brazil: GDP is expected unchanged in Q2 y/y (14:00).

Dollar: Labor Report Solid, or only Superficially Solid?

Wednesday's ADP Employment Change – as a prelude for today's NFP – came in well at 237'000 (see yesterday's edition) and suggests a solid print this afternoon. We always argued that FX markets are somewhat narrow-minded looking only at the NFP and the U-3 unemployment rate. The widely monitored U-3 unemployment rate, which measures only unemployed workers (but does not include discouraged workers, persons marginally attached to the labor force or part-time workers seeking a full-time job) is expected at 4.3 percent, the lowest since March 2001. The "real" unemployment rate (U-6), which includes those mentioned above, stands at 8.4 percent. Furthermore, the Fed's Labor Market Conditions Index, which is derived from 19 sub-categories of the labor market does not paint such a rosy picture. The LMCI has declined in recent months and is below the averages of the years 2013 to 2015 (see chart below). The broader LMCI includes variables such as the labor force participation rate, hiring rates, or jobs hard to fill (see the full list of the components in the body text of this email). This likely explains that wage pressure in the U.S. is not really materializing. The increase of hourly earnings currently stands exactly at the same level as it was a year ago. Additionally, the employment cost index has not changed over the past four quarters.

The Fed's LMCI since 2013



Source: Bloomberg Finance L.P., Julius Bär

Conclusion: The broader LMCI offers a different picture compared to the NFP and headline unemployment rate.

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