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The Morning Briefing

North American Edition
Wednesday, April 27, 2011
6:30 am (EDT), 11:30 am (BST)
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GLOBE AT A GLANCE – Andrew Wroblewski, London / Pierre Ellis, New York

Equities: Europe higher, Asia mixed. Japanese equity markets closed higher. Other Asian markets were mixed, however. European bourses fell briefly shortly after opening, before recovering and rallying for the remainder of morning trade.

Bonds: Europe lower, Japan higher. JGB prices rose across nearly all maturities. European bond prices, however, fell across all maturities, with the yield curve steepening on the short to medium-term end.

Currencies: Stronger dollar. The dollar rose against the yen through both the Asian and morning European sessions, trading up to around ¥/$ 82.15. Against the euro, the US currency traded mostly sideways, moving marginally higher to near $/€ 1.467.

Eurozone: Fresh credit supply restrictions. The latest (April 2011) ECB bank lending survey suggests that Eurozone banks generally tightened their credit standards.

Germany: Easter effect pushes inflation higher? According to data from five of the six laender used to compute the preliminary estimate, April CPI inflation is likely to have increased by 0.3-0.4 percentage points from the 2.1% Y/Y rate seen in the previous month.

United Kingdom: Modest recovery in GDP. Real GDP increased by 0.5% in Q/Q terms in Q1, in line with consensus thinking, it also being an exact reversal of the (unrevised) 0.5% contraction seen in the previous quarter.

Japan: Sales slump. Retail sales slumped 8.5% Y/Y in March.

South Korea: Still strong growth. Roughly in line with expectations, advance national accounts data saw a clear gain in Q/Q terms, with the economy expanding by 1.4% in Q1.

Australia: Inflation rises. Coming in above expectations this time around, Q1 consumer price inflation surged by 0.6 percentage point to 3.3% Y/Y from Q4 2010, the highest since December 2008.

U.S. ECONOMIC AND CREDIT MARKET OUTLOOK – Pierre Ellis, New York

Treasuries were solidly higher Tuesday, with the two-year yield falling three basis points and the ten-year yield down six. The market traded quite narrowly overnight, and opened absolutely flat, but quickly entered on a steep, virtually one-way, climb through the day—finishing at the highs. The only theme noted was ongoing short-covering, against the backdrop of a lack of reasonable alternatives to investment in Treasuries. Stocks had a strong day, giving no encouragement to bonds, but data releases were not unfriendly.

The February **Case-Shiller House Price Index** met expectations, falling 3.3% year-on-year (Consensus: -3.3%; Decision Economics: -3.7%). This worsened from the 3.1% year-on-year result in January, but less severely than January had worsened from December (-2.4%).

Seasonally adjusted numbers showed a 0.2% decline in February from January—tapering back from the 0.3% month-on-month decline seen in January, and continuing a progressive slowing in monthly declines since the -1.0% readings seen in both September and October. That trend could represent an indication that supply and demand in the existing-home market are coming into balance—though most observers will, obviously, be quite tentative in such a conclusion.

Performances in individual cities are varying considerably from month to month, and in comparison to other cities in any month. That has been the case for about two years now, as the national month-to-month price trend has oscillated around the zero mark.

For the moment, the national movement is back up towards zero—though with some cities still drifting downward. Probably, the undulating national-level trend—as opposed to the relentless decline that prevailed for the two years into early 2009—is signaling that there is no necessity for a further quantum decline in the house-price level, but there remains plenty of room for regional variation.

Of course, stabilization in the national price level would be threatened by any sharp rise in mortgage interest rates, or by a labor-market reversal. So far, no serious effects of the recent step up in rates have been evident in the new-home sales or pending existing-home sales numbers—but it is very early days for that.

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Fed doves would see the potential for a vicious cycle in any abrupt rate or employment shock to housing, with weakening house prices threatening both consumer spending and the flow of mortgage credit, further threatening employment and house prices. Surely, that will promote serious FOMC caution as QE2 winds up—just to make sure that PIMCO does not turn out to be right.

The April **Conference Board Consumer Confidence Index** rose a modestly firmish 1.6 points (Consensus: +1.1 points; Decision Economics: +1.6 points) from a prior-month level revised up by 0.4 point. Of course, this gain only minimally offset the 8.2-point drop suffered last month.

The present situation index lead the gain, with a 2.1-point rise—and, critically, that gain was centered in the employment reading, which showed a clear net improvement, not only from last month but from any month in more than a year.

Notably, the overall present-situation index had actually risen 3.7 points last month, with the employment reading showing a very minor dent—which was much more than reversed this month.

The expectations index, which had dropped 16.2 points last month, improved just a bit this time, with a 1.3-point gain—but there, the 6-month employment outlook faded somewhat. Meanwhile, however, the longer-term income outlook improved, though not by as much as it had deteriorated last time.

It is difficult to read any clear signature of gasoline prices in the March confidence plunge—other than perhaps in a diffuse sense of foreboding about the future. It is also hard to imagine that there was any positive impact in April.

Of course, other big-picture negatives imposed themselves in the March timeframe, and it may also be the case that higher gasoline prices are only now being perceived as a permanent part of the landscape. So far, consumer spending shows no evident hit—unless there would have been even firmer results without the gasoline factor.

That sort of risk will be of greater concern to the committed doves at the Fed than to the hawks—who will want to see direct evidence on the spending front before giving the problem any significant weight.

In any case, the hawkish mindset will see no reason for newly stimulative policy action in response to the "supply shock" which the oil-price runup represents for the U.S. economy—and the ultra-hard-money crowd might see reason for a bit less accommodation, since supply has effectively fallen relative to demand.

DAILY CALENDAR

Today brings March durable goods orders, at 8:30 EDT/12:30 GMT, the new FOMC policy statement, at 12:30 EDT/16:30 GMT, and Chairman Bernanke's press conference, including the release of new FOMC central tendency forecasts, at 14:15 EDT/ 18:15 GMT.

Durable goods orders are generally expected to show a fair-sized increase (Consensus: +2.0%; Decision Economics: +1.5%), largely because of a jump in the number of reported Boeing commercial aircraft orders. However, that sort of flow-through is never absolutely assured—and the outlook for orders in other categories is fairly uncertain, as always.

Still the general trend in manufacturing activity has been healthy, and the ISM new orders index bubbled up considerably in the first quarter--hinting at a broadening out of demand. Durables orders excluding transportation equipment—a total stripped of the volatile aircraft and motor vehicles categories—settled back into an idling pattern in January and February, after a huge November-December run-up, and are due to resume their growth.

The nondefense capital goods, excluding aircraft, total will be of even more interest than usual, since there have been some very recent hints of faltering growth there—and in the closely associated business-equipment investment item in the GDP numbers. Concerns are that Middle East disruptions, associated oil price increases, and even uncertainties about China's outlook, given policy adjustments there, may be shaking business confidence and promoting hesitation. Obviously, a strong performance today would ease those worries.

The **FOMC** is generally expected to leave interest-rate and QE2 policy unaltered—including the "extended period" commitment—while downgrading the economic outlook somewhat, in the formal statement and in the numerical forecasts that Bernanke will release.

The numerical report will be read for the implied adjustment path of the economy—surely with much interest in the issue of whether the growth slowdown apparently playing out now is seen as being transitory or as having a more permanent effect. Another important issue will be the impact of the big recent commodity price increases on trend inflation—whether it is seen as transitory or permanent.

Bernanke, of course, could face questions on any front--and presumably much more focused, and perhaps unsparing, ones than most he encounters at his Congressional testimonies or VIP gatherings. Still, he has always seemed quite imperturbable, and certainly up to the challenge of fending off any queries he does not want to answer.

One very interesting issue will be whether Bernanke gives any more precise sense of the distribution of opinions among the FOMC participants than the Minutes do. The number of meeting participants publically expressing hawkish opinions, or drifting in that direction, is gradually expanding--so that the group of participants who have strong policy views is increasingly polarized, and not necessarily too weighted in favor of dovishness. The uncommitted middle has always seemed to be in Bernanke's pocket, but ultimately he may not feel totally comfortable in dictating to those players.

Obviously, the future of QE2 will be a topic of interest, as would be any consideration--academically hypothetical, of course--of different modes of unwinding it. Bernanke has made a point of equating large-scale Treasury purchases with incremental interest rate cuts, in terms of stimulative impacts on the economy, and different paths for policy normalization, of rates and the balance sheet, might offer some theoretical advantages.

WESTERN EUROPE – Andrew Wroblewski, London

EUROZONE – Fresh credit supply restrictions. The latest (April 2011) ECB bank lending survey, which relates to changes during the Q1 2011 and to expectations of changes in the current quarter, suggests that Eurozone banks generally tightened their credit standards, albeit moderately, on loans to both non-financial corporations (NFCs) and households. Looking ahead, Eurozone banks expect a further moderate tightening of credit standards for both NFCs and households.

Of some note, the slight overall tightening of their credit standards on loans to NFCs was the reverse of the case in the preceding quarter. Moreover, and in contrast to the previous survey round, this move was mainly driven by banks' credit supply-side considerations related to access to market financing and by their liquidity positions. Other factors that contributed to the moderate tightening were perceptions about risks and the overall economic situation. These other factors stayed broadly unchanged compared with the previous survey round.

Regarding credit to households, Eurozone banks also reported a tightening of credit standards on loans to households for house purchase and on consumer credit. Banks cited an increased cost of funding and balance sheet constraints to explain the moderate increase in the tightening of credit standards. However, in contrast with NFCs, the general perception of risks (linked to the overall economic situation, housing market developments or creditworthiness of borrowers) appears to have also played a role in explaining the tightening of credit standards on loans to households.

As for the demand side, Eurozone banks reported a notable increase in the demand for loans by NFCs mainly driven by a pick-up in financing needs for fixed investment and inventories/working capital. In contrast, banks saw a decline in the demand for loans from households.

Comment: *These are somewhat troubling results, which may see talk of a credit crunch resurface given the clear manner in which supply restrictions are re-emerging just as demand (at least for companies) strengthens. Admittedly, demand is not strengthening in a uniform manner, with the weakness in household loan demand merely another testament of the continuing problems facing the consumer side of the Eurozone. Regardless, the survey merely provides fresh evidence of the fragility of the Eurozone banking sector, with the main detail lacking being whether the tightening in bank credit standards is a Eurozone-wide phenomenon or a result of greater divergences across countries(in which credit tightening is most clear in the peripheral countries). With it more likely being the latter, given the easier credit conditions reported by Germany, the Eurozone bank lending survey merely highlights the growing economic problems facing peripheral countries over and beyond the market-induced strains they are suffering.*

Orders grow further. Undershooting expectations once again, industrial orders for February nevertheless rose further, albeit with the 0.9% M/M being modest in a run of five successive increases, including the 1.2% rise of the preceding month. The breakdown, however, revealed that the February rise was more broad-based than in previous months. Even so, the overall Y/Y rate of growth slipped slightly to 21.3%.

GERMANY – Easter effect pushes inflation higher? According to data from five of the six laender used to compute the preliminary estimate, April CPI inflation is likely to have increased by 0.3-0.4 percentage points from the 2.1% Y/Y rate seen in the previous month. Such a result would be in line or just ahead of most expectations. The actual preliminary numbers should be formally released later today and are likely to show roughly a 0.2%-0.3% M/M rise, largely a result of higher energy and fuel costs alongside a rise in some service charges, including package holidays. Indeed, these latter factors were behind the rise in the Y/Y rate, a development that was probably due to the impact of the late Easter this year.

Consumer confidence eases further. The GfK measure of the consumer confidence outlook for May decreased 0.2 points to 5.7, thereby easing back further from a March outcome that was the highest in well over three years.

FRANCE – Consumer confidence flat. Matching expectations, the synthetic INSEE-computed consumer sentiment headline index remained at 83 in April, still a 22-month low. The latest figure reflected largely mixed developments among the main components, albeit very much including a correction back in inflation expectations.

ITALY – Consumer sentiment falls further. Undershooting expectations once again, the April consumer confidence index, as measured by ISAE, dropped 1.4 points to 103.7, a 25-month low and more. The drop this month came in the expectations component with the assessment of the overall current economy recovering some of the decline seen in March.

OTHER WESTERN EUROPE

UNITED KINGDOM – Modest recovery in GDP. Real GDP increased by 0.5% in Q/Q terms in Q1, in line with consensus thinking, it also being an exact reversal of the (unrevised) 0.5% contraction seen in the previous quarter. As a result, the Y/Y rate recovered 0.3 percentage points to 1.8%.

Comment: *Very clearly, the economy last quarter recovered from the poor weather that beset activity at the end of Q4. However, the limited break-down (purely on the output side in this preliminary release) suggest that the recovery was limited to services, which grew by 0.9% Q/Q after a 0.6% Q4 fall. Manufacturing continued to grow robustly (up 1.1%). As was largely expected, the economy last quarter was undermined by a further plunge in construction of 4.7%, enough to knock 0.3 percentage points of GDP growth, ie three times the Q4 impact, alongside some unwinding of the energy sector surge seen in late-Q4.*

Given the distortions that have affected GDP data of late, is probably best to view output as having been flat over the last two quarters. To what extent, this underlying weakness can be seen as a pay-back for strength in Q2 and Q3, when the economy clearly bounced back from the last weather distortion that hit in Q1 of last year is unclear. Regardless, the economy is clearly displaying a sector divergence. The more domestically sensitive construction and services sector is seemingly succumbing to the impact of consumer retrenchment and fiscal tightening (including a diminution of the fiscal boost seen ahead of last year's general election). Very clearly, according to the national account data and at least some surveys) construction is being hit the hardest, with the extent to which the bounce-back in services in the early part of this year will be durable being very hard to discern at this juncture. Even so, one worrying note is that the direct impact of the fiscal tightening is still modest given the bounce-back in government output.

In contrast, manufacturing remains strong, albeit hardly wildly so at 1.1%, ie a pace of growth well below that seen in the factory sectors of many other countries, (despite the alleged competitive advantage of the weak pound). The strength in this externally-sensitive sector obviously is consistent with the BoE aspiration of shift towards a more export led economy, albeit with the BoE clearly not anticipating that the domestic side of the economy would have softened so clearly and so rapidly of late.

Indeed, the BoE was anticipating growth last quarter in line with the 0.8% Q/Q of the Government's Budget Office, at least in its last (February) Inflation Report. However, more recent BoE thinking has acknowledged the weaker economic backdrop confirmed by this Q1 GDP report, most notably in the more cautious tone in the April MPC minutes. These minutes highlighted the continued merit in waiting to see how various factors evolve before adjusting policy. In this regard, further distortions will beset data in the current quarter, not least the added public holidays. Indeed, the last time the UK had an extra bank holiday in 2002), some computations suggest that knocked some 1% of nominal output.

With this in mind, the BoE face not only a weaker backdrop than its has been envisaging, but also a more uncertain one, something that surely will keep interest rates on hold for some months yet. As for fiscal policy, Chancellor Osborne has already confirmed that he will not alter course regarding proposed budget cuts. However, politically, he will face more flak, with financial markets also likely to be more suspicious, the latter aware that credible fiscal tightening needs a growing economy in order to be convincing.

Mortgage approvals stay weak. According to the British Bankers' Association (BBA), net mortgage lending in February was £ 0.8 bln, down from the previous month and more clearly below the recent trend. However, there were continued downbeat signs regarding house purchase mortgage loan approvals, which rose only modestly in March.

Continued recovery in services. The index of services rose by 1.5% Y/Y in February, a slowing from the pace set in the previous month. Even so, it is also noteworthy that the actual M/M outcome for February was 0.6%, half the rise from that seen in January.

CENTRAL EUROPE, RUSSIA AND TURKEY – Chang Liu, London

POLAND – Retail sales growth falls. Undershooting expectations, March nominal retail sales growth slipped 2.8 percentage points to 9.4% Y/Y from the February reading which was the highest since July 2008. The breakdown showed the latest drop to be led by fall backs in sales of household goods (4.7% from 32.2% in February), pharmaceuticals (16.8% from 32.2%) and an outright drop for food (-3.5%).

Higher unemployment. Largely in line with expectations, the March (unadjusted) unemployment rate was 13.1%, up 0.1 percentage point from the 13.0% outcome in the same month of 2010. The level of unemployment, meanwhile, rose 2.8% Y/Y to 2.1 mln.

JAPAN – Andrew Wroblewski, London

Sales slump. Retail sales slumped 8.5% Y/Y in March, the second largest fall on record as the impact of the earthquake hit spending. Indeed, sales fell 7.8% in M/M terms.

ASIA – Samuel Sidenbladh, London

PHILIPPINES – Still strong import growth. February data showed imports growing by 20.1% Y/Y, a slip from January's 23.7% and a seven-month low but still coming in clearly above the long-term average. The breakdown, however, showed import growth of electronics (accounting for over 30% of the total) plunging from 37.6% to 5.3%, a drop only partially offset by rising mineral fuel growth. Together with the already published export data, the trade balance was in deficit to the tune of $ 823 mln in February, a deterioration of $ 490 mln on the same month of 2010.

SOUTH KOREA – Still strong growth. Roughly in line with expectations, advance national accounts data saw a clear gain in Q/Q terms, with the economy expanding by 1.4% in Q1, a much clearer gain than in Q4 (0.5%) and the fastest in three quarters. However on a Y/Y basis, economic growth continued to slow, slipping from 4.7% to a 1½-year low of 4.2%. Even so, the latest outcome was still in line with the long-term average.

Nevertheless, the output side breakdown, showed the manufacturing and construction sectors behind much of the headline gain, albeit with construction output falling outright once more and at nearly twice the pace seen in Q4 (-3.2% Q/Q vs -6.1%). Services output growth, meanwhile, strengthened by 0.2 percentage point to 1.3%, the highest in exactly one year.

Meanwhile, the expenditure breakdown provided some mixed messages. On an upbeat note, private consumption expenditure strengthened in Q1, albeit only moderately so (0.5% Q/Q), but with a surge in government spending; the largest (at 1.8%) in exactly one year. However, providing a more muted message, capex fell for a second straight quarter and with the drop being the largest (4.3%) since Q4 2008 due to construction investment plunging (although facilities investment was down as well, but less clearly so). More than offsetting the impact of the capex drop, however, net trade once more provided a boost to headline growth, to the tune of 1.2 percentage points, as export growth expanded at a more rapid clip than the impart counterpart.

As is always the case with the advance GDP data, it should be remembered that it encapsulates mostly January/February data, meaning that the numbers are prone to revisions as March figures become available. Nevertheless, the rebound in Q/Q growth will have heartened the Government and Bank of Korea. Indeed the slight recovery in consumer spending in Q1 suggests that the ongoing policy tightening is currently not hampering consumer expenditure, although the steep drop in capex will have been noted. Admittedly it remains to be seen to what extent the drop in construction is a seasonal development, with a rebound then following in the current quarter, and this development is unlikely to have any major impact on central bank thinking in the current quarter.

Hence, with exports holding up and Y/Y growth in line with the long-term trend, there is little to suggest that the Government and central bank will take its eyes off the currently worrisome inflation backdrop. Thus, given the strength of the economy , and the pattern that has developed over the last few months, the BoK is probably prepared to tighten policy by another 25 bp as soon as next month as a further step in the Government's 'war against inflation'.

Mixed business confidence. The business confidence gauge compiled by the Federation of Korean Industries fell by a seasonally adjusted 1.5 points to 96.9 for May, a second straight drop and the lowest in over two years. However, the unadjusted gauge was up from 99.3 to 104.3, albeit only offsetting some of the drop seen in the survey for April. Moreover, the headline gain belied a mixed breakdown, with stronger domestic and export confidence being tempered by cash-flow and employment concerns.

Meanwhile, the seasonally adjusted BoK survey of manufacturing-sector expectations for May showed no change, with the index stuck at 95, a seventh straight below-100 reading. In contrast, the unadjusted index saw a gain of five points to 100, the first three-digit reading since February, with the gain being broad-based. Services confidence also saw some mixed developments with the seasonally adjusted gauge falling one point to 83, but with the unadjusted index up from 83 to 89. As to the actual outcome for April, both the manufacturing and services sectors exceeded

expectations on and unadjusted basis, but with the seasonally adjusted gauged undershooting the predictions made in the previous survey

TAIWAN – Leading index up. Data for March showed the leading index rising to 126.9, a third straight 0.2% M/M gain. Meanwhile, the coincident index was up by 1.1% (to 137.3) in March, almost as strong a gain as that seen in the preceding month (1.2%).

OCEANIA – Chang Liu, London

AUSTRALIA – Inflation rises. Coming in above expectations this time around, Q1 consumer price inflation surged by 0.6 percentage point to 3.3% Y/Y from Q4 2010, the highest since December 2008. In Q/Q terms, prices rose 1.6%, the largest gain in almost five years, driven by increases in the cost of education (5.7%), healthcare (3.9%) and food (2.9%).

The Y/Y breakdown, meanwhile, showed the latest outcome to be the result of increasing price pressures from food (4.3% from 2.5% in Q4 2010), transport (3.0% from 1.7%) and less negative clothing (-1.3% from -4.8%) costs, which were tempered by moderate falls in inflation for healthcare (4.1% from 5.0%), housing (4.8% from 5.0%) and alcohol & tobacco (11.2% from 11.4%).

Despite now being above the RBA's target range of 2-3%, the latest surge in consumer price inflation will clearly have been affected by the hurricane and flooding in Q1. Regarding this, the RBA already stated, in the minutes of its April meeting, that it would look through higher inflation stemming from these natural disasters. Furthermore, it is notable that the RBA's two preferred measures of inflation, the weighted median (unchanged at 2.2% Y/Y) and trimmed mean (2.3% from 2.2%), remained below the Bank's medium-term forecast of 2.5% at the end of 2011. Hence, while these latest results will do little to alter the central bank's decision to hold policy at its next meeting on 3 May, they do suggest that the RBA may feel compelled to resume its tightening cycle sooner rather than later, with more hints possibly in next month's statement on monetary policy.

NEW ZEALAND – Business confidence rebounds. The National Bank of New Zealand business confidence measure rose to 14.2 in April, following a -8.2 reading in March which was clearly distorted by the late-February earthquake in Christchurch. The breakdown showed the post-earthquake rebound in confidence to be fairly broad based, with a recovery in activity outlook (29.5 from 14.7 in February), inflation expectations (3.04 from 2.97) and a slight moderation in pricing intentions (27.8 from 29.4) notable.

It is notable that, despite the clearly bounce-back this month, confidence remains clearly below pre-earthquake levels (14.2 vs. 34.5 in February). Thus, it is likely we will see further increases in the next few months.