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The Morning Briefing

North American Edition
Thursday, May 12, 2011
6:30 am (EDT), 11:30 am (BST)
Allen Sinai, Chief Global Economist

GLOBE AT A GLANCE – Andrew Wroblewski, London / Pierre Ellis, New York

Equities: All lower. Japanese equity markets closed lower. Other Asian markets were mostly lower, too. European bourses fell almost immediately after opening and, after a very brief recovery, fell further in later morning trade, led lower by commodity stocks.

Bonds: Higher. JGB prices rose modestly across nearly all maturities. European bond prices, meanwhile, also rose across nearly all maturities, with the yield curve steepening slightly on the short to medium term-end.

Currencies: Stronger yen. The dollar fell against the yen through both the Asian and morning European sessions, moving marginally lower to around ¥/$ 80.83. Against the euro, the US currency rose marginally, trading marginally higher to near $/€ 1.415.

Eurozone: Output sees unexpected setback. Coming in below expectations more clearly this time around, industrial production actually decreased by 0.2% M/M in March.

United Kingdom: Modest rise in manufacturing. Surprising slightly to the downside, March manufacturing output rose by 0.2% in M/M terms, up from a flat February reading.

Sweden: Higher inflation. Largely matching expectations, April headline CPI inflation rose by a further 0.4 percentage point to 3.3% Y/Y, a fresh cycle-high.

Japan: Monetary dynamics improve. Matching expectations, growth in M2 money rose 0.1 percentage point to 2.7% Y/Y in April.

India: Industrial output growth picks up. Surprising clearly to the upside, March industrial output growth jumped 3.6 percentage points to 7.3% Y/Y.

Indonesia: Policy held. As expected by almost everyone, Bank Indonesia kept interest rates unchanged (at 6.75%) at its meeting in May.

Australia: Labor market jolt. Contrary to expectations of a further rise, employment fell sharply in April, dropping 22 100.

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

Treasuries jumped Wednesday, reversing their Tuesday losses, with the two-year yield falling four basis points and the ten-year yield down five. The market declined modestly overnight, but reversed that loss by midday, and took a near vertical step upwards soon after, reaching the daily high by 14:00 and essentially holding it through the close. The immediate prompt to the price jump was seen being safe-haven flows tied to a plunge in oil and stock prices triggered by an unexpected large weekly jump in petroleum and product inventories, with a follow-through push to the market on the report of decent results for the ten-year auction. Important data of the day were limited to the March international trade report, which had little impact.

The March **trade deficit** widened by a more-than-generally expected $2.7 billion (Consensus: widen $1.2 billion; Decision Economics: widen $2.4 billion) from a February deficit revised to be $0.3 billion narrower.

Those results are broadly in line with the assumptions built into the standing first-quarter GDP result, so there is no indication of any significant revision coming from this source.

The overall deficit widening reflected a 6.1% gain in goods exports and a 5.7% rise in goods imports, but much of the import growth reflected petroleum—without that, goods imports grew about 2.9%. Export growth, meanwhile, was solid across the board.

Most of the rise in petroleum imports was accounted for by physical volume—obviously, adding to the dollar import total, but also giving evidence that real economic activity was strong. Resilience of demand in the face of big price increases is a sign of domestic strength—for as long as it lasts.

All Fed observers will regard these numbers as fundamentally solid—mainly because export growth is counted on by everyone to bolster GDP growth to some degree. Doves will probably be troubled by the "tax" impact hinted at by the strength of petroleum imports, while hawks will likely see that as a sign that demand growth has solid momentum.

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For the hawks, there is a stronger argument for tightening in every bit of evidence that the economy is developing strength independent of Fed policy-juicing—and export growth is purely that. Doves may be slightly more at ease about the state of the economy, but certainly no balances are tipping.

DAILY CALENDAR

Today brings April retail sales and producer price index data, as well as the weekly unemployment insurance report and a speech by Philadelphia Fed President Plosser, all at 8:30 EDT/12:30 GMT, plus Congressional testimony by Chairman Bernanke and March business inventories results, both at 10:00 EDT/14:00 GMT.

The **retail sales** report is probably the most fundamentally important one of the week, giving the first clue on whether broad consumer spending has continued reasonably healthy into the second quarter—not a small issue, given the threat which higher gasoline prices are generally thought to pose to household budgets, and the impact already visible in consumer sentiment numbers. Perceived vulnerability on that score is a bit of a defining issue between Fed hawks and doves.

Actual behavior in stores does not seem to have been affected too much so far, with April-month reports from big chains having a very healthy tone, on the heels of a very decent March. The issues today will be the translation of the store results into seasonally adjusted form—which can change the message in either direction—and the strength of spending in merchandise categories not well reflected in the chain store numbers.

Forecasts today are reasonably upbeat, pointing to a moderately firm rise in the ex-autos figure (Consensus: +0.6%; Decision Economics: +0.5%), with the overall total tracking closely to it, because light-vehicle sales were steady in the month. Such results, in isolation, would not jar second-quarter GDP forecasts. But, as always, there is the possibility of big revisions to prior-month results, which not only could change the first-quarter consumer picture noticeably, but also shift the trajectory into the second quarter enough to affect GDP-growth thinking for the rest of the year.

The headline **producer price index** is expected to rise quite uncomfortably again (Consensus: +0.6%; Decision Economics: +0.5%), mainly because of another big jump in petroleum-related prices, while the "core," ex-food-and-energy, index is seen rising more moderately (Consensus and Decision Economics: +0.2%).

The issue with the PPI results nowadays is the ability of managers to increase prices—something which they will always do to the degree that the state of demand lets them get away with. They have a bit more push in that direction now from rising materials costs, and the success that they have will give the Fed a hint as to how much upward flexibility price-setters throughout the economy are perceiving. Results close to expectations would not be troubling.

The **initial claims** figure today will cover the third of four weeks in payroll-May—giving, together with earlier results, a fair sense of the overall monthly flow, and of the total volume of layoffs to be reflected in the net payroll employment change for the month.

Of course, a major question as to the health of the layoff trend was raised by the big unexpected rise in initial claims reported last week. Various special factors were said to have been operating in that number, but enough high figures have been reported in recent weeks to hint that the underlying flow of new claims has risen.

That does not preclude payroll numbers from continuing to be healthy, as long as—crudely—new hiring increases at least as much as layoffs do. A bit of that sort of offset seems to have occurred in the April payroll numbers—but the rise in initial claims in that month from March was smaller than what seems to be shaping up in May compared to April.

In any case, forecasts today point to a significant drop in claims (Consensus: -46,000, to 428,000; Decision Economics: -54,000). Those sorts of results would still leave the weekly total quite high in comparison to numbers commonplace only two months ago. It may be that a return to that lower range will be brought about by a bigger-than-predicted drop today—or it may be that the new level of claims is the new normal, and payroll forecasts would be adjusted accordingly.

Plosser, currently voting on the FOMC, will discuss the economic outlook at a conference of the New Jersey Bankers Association in Florida. .He is one of the most thoroughgoing hawks on the FOMC, coming from the University of Chicago monetarist tradition—and might be the first Committee member to dissent formally if a removal of policy accommodation is not initiated soon after the completion of QE2. Surely, that hawkish view will permeate the talk today—though there will probably be no actual talk of dissenting so early in the game.

Bernanke will appear, with his counterparts from the other main financial regulatory agencies, at a Senate Banking Committee hearing on "Oversight of Dodd-Frank Implementation: Monitoring Systemic Risk and Promoting Financial Stability." Monetary policy should not be a significant topic of discussion—though Senators may inquire about the potential for the current Fed rate and liquidity stance to promote destabilizing speculation.

The **business inventories** data, finally, will be important as a technical input to the coming first-quarter GDP revision. Forecasts today are close to the figures plugged in as assumptions in the first-round GDP numbers (Consensus and Decision Economics: +0.9%), so in-line results would force little or no revision. As always, higher-than-expected numbers would push up on GDP, and lower-than-expected ones push downward.

CANADA – Andrew Husby, New York

(Wednesday) Mixed trade data. The merchandise trade balance recorded a surplus of C$ 0.6 billion in March, slightly wider than an upwardly-revised 0.4 surplus the month prior. All major categories of exports except for agriculture rose in March in nominal terms, with the largest sectors (energy, industrial goods, and machinery) all seeing solid gains after stumbling the month prior. Energy exports rose 5.0%, and total exports rose 3.5% m/m. Imports rose 2.8% on a rebound in automotive products, industrial goods, and machinery and equipment. However, in constant-dollar terms, the trade deficit widened by $0.5 billion during the month, as import volume growth outpaced exports (3.2% vs. 2.5%), leaving the full Q1 deficit about $1.4 billion wider than Q4. That will leave net exports as a modest drag on growth in Q1, after a strong positive contribution in the final quarter of 2010.

WESTERN EUROPE – Andrew Wroblewski, London

EUROZONE – Output sees unexpected setback. Coming in below expectations more clearly this time around, industrial production actually decreased by 0.2% M/M in March, down very clearly from the upwardly revised gain of 0.6% seen in February (the net impact of revisions was slightly negative, however). The sector break-down showed mixed developments in March, with a drop back in energy, and more weakness in regard to consumer goods production, this time around more acutely on the non-durable side. Regardless, base effects helped push the Y/Y growth rate down clearly to 5.3%, a 13-month low.

Notably, the fall in output is the first in six months and perhaps not too much should be read into the weak March reading. Admittedly, calendar distortions (eg the later Easter) may have acted to boost March numbers. Regardless, the more recent trend in industrial output still runs short of the still upbeat assessment provided by manufacturing survey numbers, a development that further questions the accuracy of surveys in calibrating the extent of any recovery. Indeed, output growth in Q1 slowed clearly to around 1% Q/Q, a result that may temper expectations for the Eurozone GDP results due on Friday, albeit with the anticipated pick-up in activity predicated on a weather-induced rebound in construction.

Otherwise, the production data continues to highlight signs of the relative weakness in the peripheral countries but with up-to-date details only enough to suggest that developments are getting appreciably worse in Greece and Ireland. Regardless, the problems facing the peripheral countries are not so much in their manufacturing sectors which have managed to show some resilience underpinned by the global economy. Instead their problems are closer to home as highlighted by the steeper drops they are reporting in areas such as retail sales.

ECB – Little new from the ECB. As usual, and as expected, the editorial of the ECB's (May) Monthly Bulletin repeated the themes highlighted at last week's post-Council-meeting press-briefing by President Trichet. The editorial reiterated that the April adjustment of the very accommodative monetary policy was warranted in the light of upside risks to price stability and that the underlying pace of monetary expansion was still moderate. In addition, the editorial repeated that continued upside inflation risks alongside a reminder that rates are low and that the current stance is accommodative. Indeed, a further hiking is implicit by the ECB using language regarding the need to monitor developments very closely, terminology that in previous cycles has been used to hint at a rate hike two months hence.

It was worth noting the divergence in the assessment of monetary matters between the editorial and the section of the Bulletin discussing monetary matters was less evident this time around, albeit with the Bulletin underscoring the still historically weak growth rates of broad money at the present and with no detailing of the suggestion that that there is ample liquidity in the Eurozone.

Of some note, in the new Bulletin, the ECB updated its survey of professional forecasters, with the main interest being the longer-term inflation projection, ie five years ahead. This came in with a mean of 1.96%, up only very slightly from the previous survey three months ago (1.95%) and with an unchanged reading of 2.0% for the (less volatile) median outcome. As notably the estimated probability of longer-term inflation standing at or above 2% edged further up (to 50%), ie up additionally from an outcome in February (48%). Nearer-term inflation forecasts were revised more clearly higher to 2.5% for this year and to 1.9% for next, the former up 0.6 percentage point and the later up by only 0.1 point, all reflecting higher commodity price assumptions.

FRANCE – Inflation little changed. Largely echoing expectations this time around, headline CPI inflation rose by 0.1 percentage point to 2.1% Y/Y in April, still the highest since October 2008. In M/M terms, prices rose by 0.3%, a rise in clothing and energy costs tempered by a fall in fresh food (2.9%).

The Y/Y breakdown showed the rise was largely a result of a swing in clothing price inflation. As a result, the seasonally adjusted core inflation (excluding fresh food, energy and taxes effects) bounced a further 0.4 percentage

point to 1.1% Y/Y, the latter possibly suffering from calendar distortions related to the late Easter this year. Meanwhile, EU-Harmonized inflation remained at 2.2% Y/Y, still a two-and-a-half-year high.

SPAIN – Core rate higher. Matching flash data, final figures saw EU-Harmonized CPI inflation rising 0.2 percentage point to 3.5% Y/Y, the highest since October 2008. Headline national Y/Y CPI inflation rose similarly, but to 3.8%. More notably, core inflation (excluding energy and fresh foods) increased sharply from 1.7% Y/Y to 2.1%, the latter having been the highest since December 2008.

OTHER WESTERN EUROPE

UNITED KINGDOM – Modest rise in manufacturing. Surprising slightly to the downside, March manufacturing output rose by 0.2% in M/M terms, up from a flat February reading, having risen by 0.9% in January. However, a still sturdy tone was evident in the three-month rate of growth (favored by statisticians), remaining at 1.1%, implying a similar Q1 Q/Q growth rate to that seen in the final quarter of last year.

However, the Y/Y growth rate was clearly lower, slipping from 4.9% to a 13-month low of 2.7%. Overall industrial production, meanwhile, rose by 0.3%, eroding only some of the marked (1.2%) February slump, as only modest recoveries were seen in oil and utility production.

Even so, the data imply a possible downward revision to Q1 GDP growth, albeit a minimal one. A better understanding of likely revisions to Q1 national account numbers will come on Friday with the release of March construction numbers, data which will help corroborate (or not) the extent to which this sector did undermine activity last quarter.

Regardless, the industrial data must be regarded as disappointing, where current annual growth rates are below those of most of mainland Europe, despite the supposed competitive boost to the UK from the weakness in the pound. It is notable that factory sector survey data have started to echo signs of slowing, something that in the UK will be accentuated by the cutbacks in car production from April onwards caused by supply constraints in Japan. In addition, output last month will surely be hit by the additional public holidays, with these March data showing no sign that companies ramped up output in advance to compensate.

SWEDEN – Higher inflation. Largely matching expectations, April headline CPI inflation rose by a further 0.4 percentage point to 3.3% Y/Y, a fresh cycle-high (actually the highest in 30 months). Prices increased 0.4% in M/M terms last month, a result of a broad-based rise, but mainly an additional rebound in clothing costs. The long-standing core measure (CPIX, which excludes mortgage costs and taxes) also rose 0.4 percentage point, but to 1.4% Y/Y. Meanwhile, the underlying measure (CPIF) which the Riksbank puts more emphasis on (and which holds mortgage interest expenditure constant) rose 0.3 percentage point to 1.8%.

The April CPI and CPIF readings are in line with those envisaged in the updated projection provided by the Riksbank in its Monetary Policy Update published in April. Seemingly, for all the strength in output, the Riksbank is wary about hiking too fast for fear that the direct impact on mortgage rates will not only serve to push up headline inflation but in turn also household inflation expectations. However, perhaps a further reservation should come from the damage that rising prices are having to spending power, something implicit in the clear weakening in retail sales so far this year (NB a development not unique to Sweden in recent months).

CENTRAL EUROPE, RUSSIA AND TURKEY – Andrew Husby, New York

POLAND (Wednesday) – Surprise rate hike. In a surprising move, particularly after recent comments by central bank officials suggested a rate hike was unlikely in May, the NBP raised the base rate by 25 bp, to 4.25%. *Governor Belka indicated that the move suggested a "quicker" tightening schedule than earlier foreseen, but likely not the total scope, meaning that at least one, perhaps two more 25 bp hikes are due this year. Given the apparent desire to front-load the tightening cycle – while recognizing that communications from central bank officials have been less-than-clear in recent months – another hike in June appears in the cards.*

The potential for firmer price pressures drove the decision, as did recently-observed "broad-based" price increases – as the accompanying statement indicated that "in the medium term, continuing economic recovery in Poland together with further employment growth may gradually increase the wage pressure, and, in consequence, may cause stronger inflationary pressure to persist." The bank expects CPI inflation to run at a "heightened" level in coming months, and it sees the stronger zloty as not having had the expected dampening effect on prices.

JAPAN – Andrew Wroblewski, London

Monetary dynamics improve. Matching expectations, growth in M2 money rose 0.1 percentage point to 2.7% Y/Y in April, up further from readings around the turn of the year that were the softest since March 2009. This higher reading was accompanied by a higher reading in regard to the growth of the broader measure (M3), at 2.1%.

Elsewhere, bank lending growth remained clearly negative in April, but with the pace of decline easing clearly to -1.0% Y/Y.

Smaller external surplus. Surprising few, the (unadjusted) current account saw a smaller surplus of ¥ 1 679.1 bln in March, down from the ¥ 2 556.4 bln outcome in the same month of 2010. In seasonally adjusted terms, the current account surplus also deteriorated but to ¥ 752.7 bln from ¥ 1 218.8 bln in February.

ASIA – Chang Liu, London

INDIA – Industrial output growth picks up. Surprising clearly to the upside, March industrial output growth jumped 3.6 percentage points to 7.3% Y/Y, now a five-month high. The result was mostly due to a clear pick up in manufacturing output growth, to 7.9% Y/Y from 3.6% in February, alongside a moderate recovery in electricity output (7.2% from 6.7%). However, mining output growth fell back by 0.8 percentage point in the month to 0.2% from February.

INDONESIA – Policy held. As expected by almost everyone, Bank Indonesia kept interest rates unchanged (at 6.75%) at its meeting in May, following decisions to hold policy in both April and March, and with the last hike coming in February.

The latest decision was likely due to a combination of weaker economic growth (6.5% Y/Y in Q1from 6.9% in Q4 of 2010) alongside falling consumer price inflation (6.2% Y/Y in April from 6.7% in March).It is important to note, however, that core inflation actually rose to 4.6% in April from 4.5% and thus, while there may not be any policy changes next month, the possibility of a rate hike soon after is still very real.

SOUTH KOREA – Household lending growth rises. April data showed household lending rising by 6.1% Y/Y, up from the 5.9% seen in the previous month and the largest gain in 20 months. Moreover, mortgage lending also picked up 0.2 percentage point to 8.4% Y/Y from March, reaching a one-year high. As a result, mortgage lending as a percent of overall number of households rose by 0.2 percentage point to 67.1%, a fresh record-high. Meanwhile, lending to companies also picked up clearly to 4.0% from 3.0% in February, a 17-month high and with increases seen in lending to both large firms and SMEs.

Money supply data, however, showed the broadest measure (LF, formerly M3) increasing by 4.7% Y/Y, down from 5.2% in February and now the fourth successive fall in the growth rate.

THAILAND – Consumers sentiment slips further. The latest data from the University of the Thai Chamber of Commerce showed consumer confidence to have fallen by 0.2 point to 76.9 in April, a third successive fall from 81.5 in January and now hitting a five-month low. The breakdown revealed the latest decrease to be the result of a fall in the current conditions index (63.4 from 64.6 in March), likely dragged down by rising consumer price inflation (which hit a 15-month high in April), being only partially offset by a slight recovery in the expectations measure (84.6 from 84.3). Economic conditions, meanwhile, slipped 0.5 percentage point to 70.5 in April from the preceding month.

OCEANIA – Andrew Wroblewski, London

AUSTRALIA – Labor market jolt. Contrary to expectations of a further rise, employment fell sharply in April, dropping 22 100, the second fall in three months and the steepest decline since August 2009. Moreover, the fall was very much predicated around a slump in full-time working of 49 100, the weakest reading since early-2009. As a consequence, employment growth actually slowed sharply, dropping by 0.5 percentage point to 2.4%. Admittedly, partly a result of resilient part-time working and a drop in the participation rate of 0.2 percentage points to 65.6%, the seasonally adjusted unemployment rate was unchanged at 4.9% in April.

The latest set of labor force data provide more of a similar message to the thrust of data seen so far this year, at least save for the March numbers, suggesting a trend softening that cannot be attributed purely to the adverse weather damage seen of late. Moreover, the weaker tone in the report is backed up the unexpected weakness in the latest batch of retail sales numbers, possibly a sign that the softer labor market is taking its toll. Even so, the RBA will be mindful of the fact that the jobless rate remains so low and that Y/Y employment growth is still well above the long-term average.

As a result, the RBA is unlikely to be altering the more hawkish view stressed at the meeting earlier this month and further highlighted in its Statement on Monetary (SMP) policy last week, where a rate hike threat was clearer. Nevertheless, the thrust of recent data do suggest that the RBA has grounds for more circumspection and is unlikely to exercise its tightening bias in the next month or so, instead awaiting more data and the benefit of its next forecast cycle with an updated SMP in August.

NEW ZEALAND – Manufacturing sector picks up. The Performance of Manufacturing Index increased 1.3 points to 51.5 in April unwinding around half of he drop seen in the previous month, the latter having been the lowest

reading in six-months. The breakdown showed the recovery was not broad-based, with weakness in employment more manifest.