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# Global Radar Screen

*Friday, May 6, 2011*

| DE Tactical and Strategic U.S. and Global Fixed Income Prospects: May 6, 2011 | | | |
|---|---|---|---|
| **Country/Region** | **Tactical** | **Strategic** | **Comments** |
| ***United States*** | | | |
| **Fed—Fed Funds** | *Stable* | *Higher* | First ever press conference more historic than newsworthy. But no QE3 likely now |
| **2-yr. Treas.** | *Neutral* | *Higher* | April jobs support decent Q2 bounceback. Commodities are saying something else. |
| **10-yr. Treas.** | *Neutral* | *Higher* | Replay of 2010? Core inflation still below 1% and inflation expectations have retreated |
| **Eurozone** | | | |
| **ECB—Refi Rate** | *Higher* | *Higher* | Save for factory sector, the real economy is still soft, especially around the periphery. Banking sector and continuing sovereign debt problems remain clear. |
| **Bund (10-year)** | *Neutral* | *Higher* | Despite ECB worries to the contrary, sizeable output gap, exacerbated by increasing fiscal tightening, suggest no domestic inflation risk, especially given fragile banking system and inter-related still soft monetary data. |
| **United Kingdom** | | | |
| **BoE—Bank Rate** | *Stable* | *Higher* | Substantial easing in place, but lending backdrop still weak. MPC splits about inflation risks are growing. Rate hike possible but not in the near-term. |
| **Gilts (10-year)** | *Neutral* | *Higher* | Economy has lost momentum as fiscal tightening starting to come through, with consumer the key downside risk. |
| ***Japan*** | | | |
| **BOJ—Call rate** | *Stable* | *Stable* | The earthquake will keep the liquidity spigot wide open. |
| **JGB (10-yr.)** | *Neutral* | *Higher* | Outlook is uncertain, but huge looming supply, exacerbated by quake rebuilding costs. |
| Tactical or "Short-Term"- 2 weeks to 2 months; Strategic or "Longer-Run" - 6 mos. to a year or more. Bold shading denotes change in view | | | |

## Overview—U.S. Economy 1, Commodities 0

The big slump in commodity prices this week and the talk of the end of the "risk trade" hinted at a potential slowdown in global growth. With gasoline prices approaching $4 per gallon, many investors worried about an approaching tipping point for the US economy. This notion was supported most recently by the big backup in weekly UI claims which contributed to the drop in commodity and equity prices last Thursday. While Friday's employment was reassuring, the backup in the unemployment rate to 9.0% helped bond prices only give up a little ground. The implied bounceback in Q2 GDP growth may be no better than 3% so GDP growth may very well fall short of the 3 ¼% forecast that the Fed has penciled in for all of 2011. Furthermore, wage inflation remains stuck at just under 2%. If wage costs are two-thirds of business costs, there is a limit to how much underlying inflation can accelerate until wage inflation accelerates, a view shared by the majority at the FOMC. As a result, the report puts the exit sign no closer in view and some must still wonder if this is a replay of 2010 when the Fed had to exit the exit strategy in the latter half of the year. We still think that won't happen now that core inflation is started to grind higher but it is hard to imagine a formal Fed rate hike before early 2012 at the earliest.

- **U.S.**: Investors will not get much guidance from the indicator flow this week. A modest to moderate gain in retail sales and energy-dominated increases in wholesale and retail inflation will continue the status-quo. The fact that year-ago change in headline CPI inflation will cross 3% may draw some attention from investors and generate some pushback from the hawks at the FOMC, three of whom speak this week.
- **Eurozone:** Investors are ready for a clear rebound in Q1 GDP growth, although partly a result of poor weather in Q1 and a rebound in construction. But the report will not shed much light on the extent that consumer spending growth is lagging. The ECB bulletin may give insight on the reasons for the less hawkish thinking inherent in the press conference.
- **United Kingdom**: More insight may be forthcoming from the inflation report this week to see how much the slower economic backdrop pares back the inflation forecast. How much will the report cover up the clear divisions within the MPC is the real question. Consumer updates from the BRC sales survey and consumer confidence, will be the key figures, given the shakiness seen recently in this sector.
- **Japan:** A fuller sense of the post-crisis policy response maybe found in the upcoming BOJ policy minutes this week. The business conditions indexes and bank lending will give a clearer sense of how bad the post-quake situation is, while the balance of payments data will show the impacts on service sector trade.
- **Emerging Markets/Regions**: Four major central banks meet this week. In **Poland**, policy rates will remain on hold despite the pickup in inflation, as output growth is slowing, unemployment is high, and the external outlook is uncertain. **Bank Indonesia** will most likely leave policy on hold, although a further tightening will be needed going forward. The **Bank of Korea** remains at war with inflation, making another rate hike highly likely at this point. The **South African Reserve Bank** will leave policy rates on hold. Inflation remains within the target bad, despite the global commodity price rise, and domestic demand growth remains subdued.

## Specific Regional Themes

- **U.S.: Still Muddling Along**

  Despite the worst fears of the commodities markets, the employment report pointed to an economy that was at least muddling along with decent job gains and a near 3% GDP growth profile. Interest rates, particularly on the long end remain low suggesting that the road to 4% 10-year yields we analysts have been worried about may start at 3%.

  Investors will not get much guidance from the indicator flow this week. A modest to moderate gain in retail sales and energy-dominated increases in wholesale and retail inflation will continue the status-quo. A moderate gain in **retail sales** (Th) will be boosted again by gasoline store sales (DE: +0.4%; consensus +0.6%). Retailers have reported good-sized April increases but express some wariness about the impact of higher oil prices. An eventual drop in gas price from the recent $20 drop in oil prices would be most welcome at this juncture. A fall in gas price would support **consumer sentiment** (Fri) but that may not happen for three to six weeks because of the lags between crude prices and prices at the pump. So both DE and the consensus look for little change in May sentiment from its 69.8 reading in April.

  The April **PPI** (Th) and **CPI** (Fri) should be a replay of the March figures, with outsized gains in headline inflation (although smaller than in March) and subdued core rate gains. (PPI: DE: +0.5%, consensus +0.6%; core PPI: +0.2%. CPI +0.4 headline; +0.2% core). The fact that year-ago change in headline CPI inflation will cross 3% may draw some attention from investors and generate some pushback from the hawks at the FOMC.

  A more robust rebound in imports (Wed) means a widening in the **trade gap** (DE: +47.2B; consensus 47.0B) from February $45.8B reading. **Business inventories** should rise sharply in March (DE: +0.7%.; consensus +0.9%), which a bit faster than assumed in the initial Q1 GDP estimate.

  Only six Fed speakers hit the tape this week, headed by a systemic-risk related Congressional testimony by **Bernanke** (Th. The outlook talks will be dominated by the hawks: **Lacker** (voter 2012, Tu), **Plosser** (voter 0211, Tu), and **Kocherlakota** (voter 2011, Wed). Centrist **Lockhart** (voter 2012, Wed) gives an outlook talk, while centrist **Duke** (always votes, Tu) speaks on community development.

- **Eurozone: Q1 GDP On the Cards**

  Very clearly, the main economic interest will be the preliminary **Q1 GDP** report due on Friday, with the Eurozone estimate emerging alongside or hours after many national updates including the upbeat economies of France and Germany. A clear pick-up in growth is widely seen (Consensus: 0.6% Q/Q; DE: 0.5%); albeit partly a result of a bounce-back in construction activity after poor weather hurt activity in the previous quarter. This effect may be particularly evident in Germany. There is little break-down with this initial release, although markets will be able to gauge the extent to which geographical divides may be intensifying in the manner that surveys numbers have been pointing to of late.

  Otherwise, markets may be sensitive to any signs regarding the extent to which consumer spending may be lagging. Insights in to the GDP backdrop may be forthcoming in Italy (Consensus & DE: 0.8% M/M) and France (Consensus: 0.4% M/M; DE 0.3%) on Tuesday when March **industrial production** numbers are released.

  Finally, the **ECB Bulletin** (Thu) may be looked at a little more deeply to see if its gives any deeper understanding of the less hawkish thinking of the central bank hinted at after last Thursday's press conference.

- **United Kingdom: More Insight Into BoE**

  After an unchanged policy decision was delivered last week, the **BoE** will give more insight into its thinking in the updated **Inflation Report** due on Wednesday. The last Report (in February) had seemingly given the go-ahead for a rate hike in ensuing months by suggesting that the inflation target would only be met if some small amount of hiking was initiated. However, the weaker real economy backdrop may have been enough to pare back projected inflation, albeit still leaving it very uncertain as to when (rather than if) the updated report would point to the first rate hike occurring. The question will be the extent to which the May Report tries to cover up the clear divisions within the MPC (over inputs such as sterling), something that its predecessor failed to do.

  Otherwise the week will be important for ever-more vital consumer updates, including the **BRC sales survey** (Tue) and **household confidence** numbers (Wed). Official figures on activity will also be watched, possibly more closely so. Indeed, **manufacturing production** data (Thu) will be examined for any sign of the slippage in growth suggested by surveys (Consensus: 0.3% M/M; DE 0.4% M/M) while **construction output** numbers (Fri) will be checked to see if they are consistent with the downbeat message seen in Q1 GDP figures.

- **Other Europe: Norges Rate Hike Threat**

  In **Sweden**, **industrial production/orders** data (Tue) should show continued clear momentum in the factory sector, echoing the message of surveys. Admittedly, given the weakness of latter regarding consumer activity, this may be giving a false impression of the overall strength of the economy, something that the Riksbank may be very well deliberating. However, the central bank will not be paying too much attention to the **CPI** backdrop, where an update arrives on Thursday. Underlying

inflation is well below that envisaged by the Riksbank albeit with the headline rate above.

In **Norway**, markets will be looking to see if the **Norges Bank** delivers on its recent rate hike threat at the **Board meeting** on Thursday. Weaker consumer signs and **CPI** inflation figures (an update for the latter is due on Tuesday) may argue for the Norges bank deferring any such decision until its June meeting.

In **Switzerland**, **CPI** numbers are also due on Tuesday, with some further small uptick likely in the Y/Y headline rate. **Consumer confidence** figures (Tue) are also due, the question being whether the clear rise seen in recent quarters continues or not.

- **Oceania: Aussie Budget Due**

In **Australia**, the week begins with updates on **trade** and the **NAB Business survey**, both due on Tuesday, where the question will be the extent to which the latter recovers after some easing back last month. However, the spotlight will most likely be on the **Federal Budget** announcement (also Tue), where Treasurer Swan is expected to announce a number of savings in the coming year. The week is then wrapped up with the **labor force survey** on Thursday.

The week is relatively quite in **New Zealand** in terms of economic data, with the only update of note coming in the form of the **Performance of Manufacturing Index** (Thu). (Andrew Wroblewski/Samuel Sidenbladh)

- **Japan: BOJ Minutes**

After the quiet Golden Week, the week ahead brings a collection of secondary economic indicators, but the March and April readings on tap will nevertheless be scanned for the effects of the Great East Japan Earthquake. First, off will be the Monday release of **BOJ Policy Board Minutes** from the April 6-7 meeting, which will give a fuller sense of the BOJ's earliest considered analysis of the post-disaster situation, and of the range of policy responses proposed under different possible contingencies. Wednesday will feature the March round of **Business Conditions Composite Indexes**, giving a sense of the diffusion across the economy of early shocks from the disasters, while Thursday will bring April **bank lending** figures, where heavy flows to stricken companies may affect the overall totals to a degree that would be informative, and March **balance of payments** data, where disaster impacts on service-sector trade will be the focus of interest. (Pierre Ellis)

- **Emerging Markets: Central Bank Watch**

Four central banks meet this week. In **Poland**, rates will *remain on hold* at 4.0% despite a sharp upward surprise to consumer prices in March. That development had prompted speculation about a May rate hike, but with high unemployment, decelerating output growth, and fresh uncertainties on the external front, the Council will likely come to the conclusion that another increase is not yet warranted. Under the Bank's assumptions, accelerating inflation was already in the cards during the early part of the year, but moderating thereafter, and that broad profile is still intact especially if upward commodity price pressures do in fact continue to ease in coming months. Another supporting factor for a hold is the fall-back in CPI inflation expectations recorded in the Bank's April survey, suggesting that cost-push shocks are not yet feeding into adverse second-round impacts within the economy. (Andrew Husby)

In **Asia**, **Bank Indonesia** is meeting on Thursday. Over the last few months, consumer price inflation has been falling back from the highs seen at the beginning of the year, easing the pressure on the central bank to follow up February's surprise rate hike with more policy tightening in the near term. Admittedly, rising global commodity and oil prices is clearly a concern to Bank Indonesia, but it has signaled that it is willing to meet some of this increase in tradables price pressures by allowing the currency to appreciate. Moreover, the latest set of national accounts data showed some further, and broadly based, moderation in economic growth in Q1, meaning that concerns about demand-pull inflation will have eased somewhat. Hence, the central bank will most likely *leave policy on hold* once more this month, even though further tightening will be necessary going forward.

The **Bank of Korea**, meanwhile, is meeting on Friday. The BoK left rates unchanged at its previous (April) meeting, but stepped up its hawkish language in the accompanying statement, noting that monetary policy would now be conducted with a "greater emphasis" on ensuring the basis of price stability is firmly anchored. Admittedly, consumer price inflation fell back in April, but remains not only elevated, but also still outside the central bank's target-zone and the government is still 'at war' with inflation. Hence, a *rate hike is highly likely* at this month's meeting, continuing the pattern of rate hikes every other meeting seen since the beginning of the year.

Elsewhere, the **South African Reserve Bank** is announcing the outcome of its policy deliberations on Thursday. The South African economy is still recovering from the recession seen in 2009, albeit less clearly so than in Asia, and with the main strength coming from commodity exports. Indeed, domestic demand is still subdued, but has shown signs of improving. Moreover, consumer price inflation is clearly within the SARB's target range of 3-6%, and with the central bank's forecast still keeping it there for the next two years. However, with commodity and food prices rising globally, new upside risks might be emerging to the forecast, but the SARB will most likely still *leave interest rates on hold* once more at this meeting. (Samuel Sidenbladh)