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Global Radar Screen

Friday, May 20, 2011

DE Tactical and Strategic U.S. and Global Fixed Income Prospects: May 20, 2011			
Country/Region	**Tactical**	**Strategic**	**Comments**
United States			
Fed—Fed Funds	*Stable*	*Higher*	Complicated and lengthy exit strategy pushes first policy hike off even further.
2-yr. Treas.	*Neutral*	*Higher*	Soggy Q2 rebound falling well short of Fed 3 1/4% forecast.
10-yr. Treas.	*Neutral*	*Higher*	But may be negated by rising core inflation, now approaching 1.5%, a flash point
Eurozone			
ECB—Refi Rate	*Higher*	*Higher*	Save for factory sector, the real economy far from upbeat, especially around the periphery. Banking sector/debt problems remain clear. ECB hiking to be punctuated.
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—Judgment Day Delayed

In the U.S., stocks and bonds are been in a holding pattern for the past two weeks, with the bond market holding on to its recent gains. The bond market in particular is trading that the judgment day on the Fed is later rather than sooner. First, the rebound in the Q2 seems pretty soggy, with few forecasters willing to pencil in more than 3% GDP growth after only 1.7% in Q1. Even the Fed thinks that the downside risks outweigh the upside risks to the outlook. Second, the FOMC minutes indicate policymakers are contemplating a complicated and lengthy exit sequence which starts with *stopping* QE2 in June and *freezing* the balance sheet over the summer. After that, at a time yet to be specified, passively *shrinking* the balance sheet, *draining* reserves to help set up the corridor system, *explaining* they are finally ready to hike rates by *altering* the "low for long" language, then (after *skipping* at least one FOMC meeting) *hiking* policy rates, and finally actively *selling* assets with the goal to getting to a mainly Treasuries portfolio within five years. While DE is carrying a below consensus GDP forecast of less than 3% for the remainder of 2011, a rising core inflation rate will persuade the Fed to hike rates sometime in 2012H1, which implies the passive reduction in the balance sheet may begin as early as late 2011. Some others do not expect a formal rate hike until 2013. All this suggests that interest rates could remain quite low, pinned down by a Fed in no hurry to start exiting as long as the recovery seems soggy. This complacency about low rates could change in a hurry, particularly if Washington policymakers cannot come up a debt ceiling extension this summer or more importantly, at least a rough outline of what they would do after the 2012 election to achieve a sufficient amount of medium term fiscal consolidation.

- **U.S.**: This may very well be another week when the indicator or Fed-speak provides little direction. And with little happening on the fiscal front in DC, we may have to wait until the jobs report June 3 (if then). This week, the durable goods report has the greatest potential to move the market, given the volatility in the series. A sizeable payback in April is expected after a strong March rebound. The seven Fed speakers this week run the gamut from ultra-hawk to ultra-dove.
- **Eurozone:** The key focus will be the survey data, which will be scanned for fresh signs of weakness, particularly in the peripheral nations. Of that the flash PMI will receive the most attention, with potential new weakness attributable to some slowing in global export growth. German survey and GDP figures will show broad-based gains, while the ECB money update will show a pattern of modest M3 growth.
- **United Kingdom**: Investors attention will gravitate to updates on the consumer, which has appeared fragile. The GDP expenditure data will indicate if consumer spending dropped in Q1. Consumer lending, the CBI update, and household confidence figures will become available. Investors will look for some improvement in the public borrowing figures.
- **Japan:** The major first post-quake indicators hit the tape. The merchandise trade report will reflect the full brunt of the factory damage, supply-chain crimps, and power shutdowns. The retail sales figures will be another important barometer of the worst disaster-related effects, while the CPI may indicate some anti-deflationary developments. Finally, BOJ governor Shirakawa will speak and watched for any evolution on his thinking about the post-quake outlook.
- **Emerging Markets/Regions**: Only two major central banks meet this week. In **Turkey**, policy will **remain on hold**, despite surging loan and domestic demand growth but tightening steps may be required by year-end. In **Mexico**, the overnight *rate will remain on hold* at 4.5% as an intact-yet-moderating growth profile is met with benign inflation pressures, bucking the need to embark on a tightening cycle in line with regional peers. And we look in more detail at the moderating **Mexican** recovery and the chances for a soft-landing in **India.**

Specific Regional Themes

- **U.S.: Soggy Status Quo**

  This may very well be another week when the indicator or Fed-speak provide little direction. And with little happening on the fiscal front in DC, we may have to wait until the jobs report June 3 (if then) to provide some new direction. This week, the **durable goods** report (Wed) has the greatest potential to move the market, given the volatility in the series. A sizeable payback in April is expected after a strong March rebound (DE: -2.0%; consensus -2.4%). **New home sales** (Tu) should be steady in April (DE: 311K; consensus 305K. Homebuilders have extremely low inventories and, when sales finally turn (and some worry this won't happen until 2013), those left standing will enjoy sharp gains in output and profits.

  The final **consumer sentiment** (Fri) for May should hold close to the preliminary reading (DE: 72.4; consensus: 72.5). **Longer-term inflation expectations** have settled down around 3.0% and the **short-term expectations** may eventually decline from its lofty 4.5% reading once gas prices start falling to reflect the drop in crude oil prices. A small upward revision (Th) to **GDP growth** (DE: 2.0%; consensus 2.2%) will be of little consequence but the April **spending** result (Fri) will give us a better bead on Q2 tracking (DE: +0.4%; consensus +0.5%).

  Only seven Fed speakers hit the tape this week but squeezed in over just three days. **Bullard** (voter 2013, Mon) starts the week, followed by **Rosengren** (voter 2013), **Duke** (always votes), **Hoenig** (voter 2013), Plosser (voter 2011), **Bullard** (him, again?) (all Tu), and Kocherlakota (voter 2011, Wed). The gamut ranges from ultra dovish to ultra-hawish so opinions may be all over the map.

- **Eurozone: More Surveys Awaited**

  In terms of economic data, surveys will be the clear focus for markets in the coming week, with the business surveys grabbing most attention. Most closely watched will be the **flash PMI** data (Mon). The **manufacturing** survey recovered somewhat last time around, with any fresh slippage (Consensus: 57.5; DE: 57.0) possibly being viewed as evidence of weaker global momentum given the clear and on-going reliance on exports behind Eurozone growth. **German Ifo** data on Tuesday (Consensus: & DE: 113.7) will give an alternatively-sourced survey insight, albeit with a very much German (and therefore relatively more upbeat) perspective. **EU Commission numbers** (Fri) will provide a further (and broader) source of survey updates. Meanwhile, the **services PMI** was less upbeat in April, but still revealed signs of wider geographical disparities, with clear weakness around the peripheral economies: more such evidence may be forthcoming (Consensus: 56.5; DE: 56.0).

  As for official data, the Q1 **final GDP** numbers in Germany (Consensus: & DE: 1.5% Q/Q) should show broad-based growth, while German **CPI** data (Fri) may reveal that some of the April rise in the headline rate was a reflection of calendar distortions (Consensus: 2.3% Y/Y; DE: 2.5%).

  The week ends on Friday with the ECB-compiled monetary update, where the pattern of modest pick-up in **M3 growth** may continue (Consensus: & DE: 2.4% Y/Y) albeit with private sector lending still showing clear fragility.

- **United Kingdom: Consumer Updates**

  Revised **Q1 GDP** data (Wed) is unlikely to alter the fragile growth backdrop highlighted by the preliminary release (Consensus: & DE: 0.5% Q/Q), albeit with perhaps more interest in the expenditure break-down offered for the first time with this update: the question being whether the Q4 contraction in consumer spending continued or not. Other consumer updates during the week will also be closely watched, including the **BBA consumer lending** figures (Wed) and survey data in the form of the **CBI distributive trades** figures (Tue) and a **household confidence** number (Fri). Otherwise, the week has **public borrowing** numbers (Tue), the question being the extent to which they suggest some improvement is occurring (Consensus & DE: £ 6.5B).

- **Other Europe: GDP Updates**

  In **Sweden**, the week culminates on Friday with what should be another very strong **GDP** reading (for Q1), the question being the extent to which recent softer consumer signals feature in the data. Certainly, the latter is evident in the recent drop in **consumer confidence** numbers, an update for which arrives on Thursday, alongside, **producer sentiment** gauges. A softening in **household lending** data is evident as well with an update for this series also due on Thursday. However, the week also has what should be another upbeat and strong **labor market** report, very clearly showing solid jobs growth (Wed).

  GDP data also feature on the data slate for **Norway** this week, arriving on Friday, albeit with a more modest outcome on the cards at least compared to Sweden. A **labor market** update (also likely to be mixed) is due on Thursday.

  Switzerland sees what should be another upbeat **money supply** update (Mon) but with the outcome of the **KOF survey** (Fri) far less clear given the extent to which recent data have surprise no the upside.

- **Oceania: Quiet Data Flow**

  Although there is little data of note in the coming week in Australia, what numbers there are may garner some attention, as both the **Q1 construction work** (Wed) and **private sector capital investment** (Thu) numbers will feed directly into the GDP figures due early next month.

  In **New Zealand**, meanwhile, the only data of note are **RBNZ's business inflation expectations** survey due Tuesday. (Andrew Wroblewski/Samuel Sidenbladh)

- **Japan: First Major Post-Quake Indicators**
  This week starts the cycle of major economic indicators for April, giving a first sense of the full impacts of the natural disasters on the level of activity. The situation may worsen further over coming months in terms of electricity shortages, but the passage of time will also allow for the development of production-side work-arounds and for some healing in consumer sentiment.

  Data flow begins Wednesday, with the **merchandise trade** report, where exports will reflect the full brunt of factory damage, supply-chain crimps, and power shutdowns over the six weeks following the disasters. That day also features an appearance by BOJ Governor **Shirakawa** at an economic forum in Tokyo, watched for any evolution of his thinking about the depth of the hit to the economy and the prospects for relatively quick recovery. Friday is the next big day, bringing both **CPI** results, where the issue will be the extent of any non-transitory counter-deflationary developments, and **retail sales** figures, another report showing what are likely to be the worst disaster-related effects. (Pierre Ellis)

- **Emerging Markets: Central Bank Watch**
  Two major central banks meet this week. In **Turkey**, the central bank's unorthodox measures–lowering rates and hiking reserve requirements–are having little visible impact on surging loan and domestic demand growth, suggesting that while officials will *remain on hold with respect to rate hikes through mid-year*, *more-conventional actions may ultimately be required by year end*. Weekly data still show no sign of a slowdown in lending growth, raising risks of building imbalances. The central bank still expects higher reserve requirements to have a lagged impact on lending, but does acknowledge that further actions may ultimately be warranted. The current account deficit continues to exhibit record widening, imports now above 2008 levels while exports remain below their 2008 highs. On the inflation front, year-on-year price growth continued to plumb fresh lows, but it should head markedly higher heading further into 2011 as food and energy prices remain elevated and favorable base effects fall away.

  In **Mexico**, the overnight *rate will remain on hold* at 4.5% as an intact-yet-moderating growth profile is met with benign inflation pressures, bucking the need to embark on a tightening cycle in line with regional peers. Peso strength and slack in the labor market are keeping a lid on core price pressures, which held around 3.2% y/y in April (the central bank maintains a 3% +/- 1% target range for inflation). In addition, policymakers expect both measures to remain within the target range through 2012, albeit with the headline measure testing the upper end of that range. Upside risks to that view from commodity prices or a more-rapid recovery in domestic demand and investment are still present, but the central bank is very likely to keep rates on hold through the end of 2011. (Andrew Husby)

Mexico: A Moderate Recovery Continues Mexican GDP has finally recovered back to pre-recession levels, and the economy enters the expansion phase on a solid footing, with some potential elements of an upside surprise in place (particularly as regards consumer spending) but with little of the dynamism that has been present in other emerging markets over the last year or so, and which has helped generate policy-altering inflationary pressures. In fact, given where inflation actually is in Mexico at the moment, the implication of the figures just released probably extends the horizon for Banco de Mexico's dovish stance: a rate increase this year appears unlikely.

Soft Landing in India? Two new data items push the Indian picture in a more constructive direction. The first is a rebound in industrial production growth, which had been hovering around 3.5% year-on-year during the past four months, and which accelerated to 7.3% year-on-year in March—despite a very strong comparison base. The second is a significant deceleration of food prices, a key source of India's recent inflation. Still, government rhetoric remains hawkish, warning about continuing inflation dangers.

Policymakers are acting on the Reserve Bank of India's concern that "demand [is] strong enough to allow significant pass-through of input price increases". While the bank expresses awareness of the "visible signs of moderating growth", they insist that current rates of inflation are unacceptable: bringing them down, therefore, even at the cost of some growth in the short-run, should take precedence.

Nonetheless, the easing of food price inflation, the prospect of further supply-side relief from growing agricultural output, plus the rebound of capital goods production, as well as the income gains in agriculture, provide a ray of light in an otherwise challenging environment for equities. If persistent, these signals would be indications of a soft economic landing, with activity escaping a major downturn under the burden of the RBI's open-ended tightening campaign, and the first glimmer of a monetary policy pause a few months down the road. (Francisco Larios)