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Global Radar Screen

Friday, June 3, 2011

DE Tactical and Strategic U.S. and Global Fixed Income Prospects: June 3, 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*	Pushed thru 3% as investors sense a double-dip
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—US Air-Pocket or Something Worse?

The string of weak US economic statistics was capped this week by the big drop in the ISM index and the major slowdown in employment growth. It is abundantly apparent that the US hit an air pocket last month, brought on by more cautious behavior by households and firms in reaction to the lagged effects of higher food and oil prices and the supply-chain effects of the disaster in Japan. Many worry is that this is the sign of something worse like a double dip. Furthermore, there is not much left in the policymaking arsenal to fight it. Another Keynesian style stimulus program seems impossible in the current political environment. Adoption of QE3 would be a tough sell as well. There is considerable criticism within the Fed which would become very public with multiple vocal dissents. There has been considerable criticism outside the Fed regarding QE2 and undertaking a new program could threaten the Fed's cherished independence. However, not all of the US figures have been bad. The service sector survey rebounded in May and consumer spending, while sluggish, has shown no appreciable change in recent weeks. Japan is starting to rebuild, which should help business confidence and export orders. And oil prices had moved down from their highs which is freeing up a little consumer spending. We need to remind ourselves that the US economy is doing relatively well after Wall Street's near-death experience of 2008 and that showdowns are to be expected, even in slow expansions. We remember that investors worried about a double dip in 2003, two years into the expansion, although that slower growth episode was not accompanied by high and rising oil prices (Chart 1).

- U.S.: The data flow is relatively light this week so that investors will be focused on the reaction of policymakers to the disappointing May data. We suspect that the most Fed officials will discount the May figures as more of a one-off event than the start of a double dip. The question of QE3, which many investors had taken off the table, is now back. But the bar for QE3 is very high, something Bernanke (who is speaking this week) admitted in February. He understands that with core inflation starting to rise, the political and economic tradeoffs are no longer favorable for more policy action.
- Eurozone: The ECB will indicate its inclination to hike rates in July, even though the macro backdrop of softer growth, weak monetary data, and still fragile banking sector suggest otherwise. Updates on the Greek bail-out will be watched in addition to the national IP figures to see how much they reflect the softness in mfg. surveys and the Eurozone retail sales update given the weakness in the month before. The Q1 GDP update will provide the first expenditure breakdown.
- United Kingdom: The BoE meeting is a non-event, as investors defer any rate hike to much later in the year, a view supported by the expected large drop in IP and potential large drop in construction output. Softer PPI numbers will underpin the notion of a BoE on hold for some time. The BRC retail survey and inflation expectations survey are also on tap.
- Japan: Data this week such as the tertiary industry and the coincident indicator reports will help understanding better the bottoming process in place after the disaster. The money supply/lending figures will give some clue to post-quake credit flows while the BOP figures will cover repatriation flows. Revised Q1 GDP will give a notion of demand changes in response to the disaster.
- Emerging Markets/Regions: Four major central banks meet this week. In Poland a 25 bps hike is likely given the bank's new willingness to move early and surprise markets. A 25 bps hike is likely in Brazil, although the central bank is getting closer to a pause. Policy should be on hold in Indonesia after the surprise hike in Feb, given the moderation in inflation and domestic demand growth. The decision in Korea will be finely balanced, given the jump in inflation even though the recovery took a turn for the worse.

Specific Regional Themes

- **U.S.: Hand-Wringing Time**

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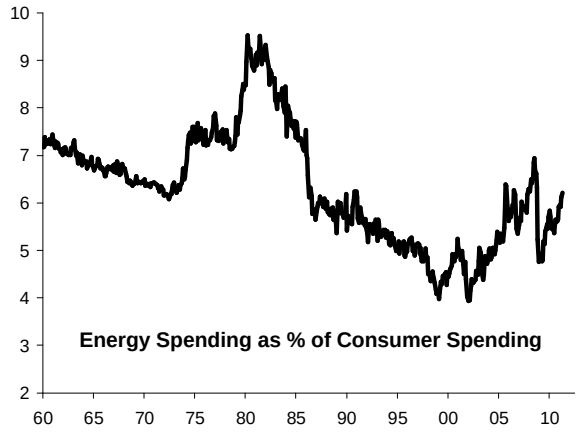
The only indicator of note is **trade balance**. After a nearly $3B deterioration in March to $48.2B, DE looks for some retracement to $47.1B, while the consensus looks for a further widening. There will special interest in the pattern of trade with Japan in the aftermath of the quake.

The Fed speaking tour resumes with obvious investor interest in how much the Fed speakers discount the recent soft news and the possible need for QE3, with the full range of views covered. **Bernanke** speaks on Tuesday. Hawks **Plosser** (voter 2011, Mon & Th) and **Fisher** (voter 2011, Mon), with **Hoenig** (voter 2013, Wed). The doves get their say with **Dudley** (always votes, Tu) and **Yellen** (always votes, Th). Moderate **Lockhart** (voter 2012) opines Tuesday. The **Beige Book** (Wed) will surely confirm the weaker tone of the recent economic statistics.

Chart 1: High Oil Prices the Real Risk



- **Eurozone: ECB Awaited**

The **ECB** has been clearly advertising that it believes official rates need to move higher. It is unlikely to hike as soon as the **Council meeting** this Thursday, but will very likely point to a move in July by once again opting to use rate-hike flagging rhetoric such as the need for 'strong vigilance'. It will be interesting how the likely hike will be justified amidst signs of softer growth, fresh weakness on the monetary side and the on-going travails of the peripheral countries, with both of the latter linked to the still fragile banking sector. However, recognition of the weak banking sector will be recognized by the probable extension (at least for a further three months) by the ECB of unlimited funding to Eurozone banks.

Over and beyond and progress made in regard to Greek bail-outs, economic data will be watched as well, with the question being the extent to which the array of national **industrial production** numbers, including German figures on Wednesday (Consensus: 0.1% M/M; DE: 0.3%), start to echo the softer manufacturing survey numbers. Eurozone **retail sales** data (Tue) may come in to sharper focus, especially after the very weak reading last time around (Consensus: 0.3% M/M; DE: 0.4 %). There is also an update for Q1 **Eurozone GDP**, data that will provide the first break-down for the numbers.

- **United Kingdom: Big Fall in Output Due**

The **BoE-MPC meeting** (Thu) looks like being a non-event this month, with markets still deferring any initial rate rise until much later in the year. Moreover, this viewpoint may be encouraged only further should **industrial production** data show a very large fall in an April update due Friday (Consensus: 0.1% M/M; DE: -1.7%). **Construction output** data (Fri) may be affected similarly. However, while chiming with less upbeat survey data of late, such weakness will be more a result of holiday distortions related to the recent royal wedding than anything more fundamental, with a bounce-back due in ensuing months.

Even so, softer **PPI** numbers, including a fall on the input side and a softer core output reading (Consensus and DE: 0.3% M/M) will only help to underpin thinking that the BoE will be on hold for some time yet. Otherwise, survey data will be watched closely, the most notable being the **BRC retail survey** on Tuesday given the on-going worries about the UK consumer backdrop. There is also the latest **inflation expectations survey** produced by the BoE (Thu).

- **Other Europe: Data Flow**

In **Sweden**, important data arrives in the form of the **industrial production and orders** update (Fri), numbers which have remained very upbeat of late. There is also an array of **Riksbank speakers**, including comments from Governor Ingves on Monday and Wednesday.

Norway also has an **industrial production** update (Wed), albeit where the backdrop of late has been very soft. **CPI** numbers are also due (Fri), with the last (still soft) batch of data being in line with Norges bank thinking.

Switzerland too sees **CPI** numbers (Tue), where more soft data is envisaged. However, recent data very much underscore the impact of the strong franc on prices with domestic goods inflation running at 0.5% Y/Y, while that for foreign goods fell 0.5%. As

a result, the current inflation picture may not be enough to deter the SNB from hinting at higher official rates at the upcoming quarterly assessment on June 16.

- **Oceania: Continued Policy Pause**

  In **Australia**, the week sees a number of survey updates, including the **Performance of Construction Index** (Mon) and the **Westpac consumer survey** (Wed). But most of the attention will be focused on the **policy decision** from the **Reserve Bank of Australia** on Tuesday, where the Bank is generally expected to extend its recent policy pause, at least until the next release of the Statement of Monetary Policy in August. Wednesday also sees the arrival of **home-loan approval** numbers, before **labor force statistics** wraps up the week on Thursday.

  In **New Zealand**, the only event of note is the **Reserve Bank of New Zealand policy decision** on Thursday, where rates are expected to remain unchanged not just this time around but for the near future. (Andrew Wroblewski/Samuel Sidenbladh)

- **Japan: Revised Q1 GDP**

  The marquee economic report of the coming week should be the revised first-quarter **GDP** data (Thu), giving a more refined picture of demand-side contributions to the quarter-on-quarter decline in output—though with odds favoring little change to the overall figure.

  Other, fresher, data of the week will contribute a bit to understanding of what may be a bottoming process after the March disaster-shock, with the April **coincident indicator** reading (Tue) giving a broad-brush look, and the April **tertiary-industry activity** report (Fri) laying out the performance of a number of important non-manufacturing sectors—where the supply-chain crimps caused by the earthquake/tsunami may be less critical than the electric-power problems.

  Probably less closely watched will be May **money supply** and **bank-lending** numbers (Wed) and April **balance of payments** results (Wed)—though the lending figures may give some clue on credit flows to disaster-affected users, and the BOP data could shed light on the role of repatriation flows in strengthening the yen. (Pierre Ellis)

- **Emerging Markets: Central Bank Watch**

  Four major central banks meet this week. In **Poland**, the central bank wrong-footed markets in May by hiking rates 25bps, to 4.25%, after having expressed signs of being relatively comfortable with a hold. The measure was an attempt to head off second-round effects of higher food and energy prices on wage-setting, in effect bringing forward rate hikes already scheduled for this year. Recent data have been characterized by higher inflation expectations, firmer inflation (+4.5% y/y, target is 2.5% +/- 100 bps) and wages, with the only soft spot being a modest deceleration in industrial output. Markets are pricing in at least two more 25 bps hikes this year, a reasonable magnitude, the question being the timing. Taking the bank's new willingness to move earlier and often at face value, a *25 bps rate hike should be the expectation this week.* The caveat – given the NBP's tendency to surprise markets, a hold is certainly not out of the question if they place greater emphasis on global question marks, and softer domestic production readings.

  In **Brazil,** rate hikes are still on the horizon, albeit at a more gradual pace and edging nearer to a pause, with *25 bps still likely this week* but dependent on the data flow thereafter. Hiking by less has been expected for some time, appropriate given the observed slowdown in domestic data, notably industrial output, while acknowledging still elevated inflation, which is edging above the upper end of the bank's 4.5% +/- 200 bps tolerance range. Inflation should begin to decline in coming months, helped by easing in commodity prices, reinforcing the gradual tightening strategy as the central bank assesses the impact of earlier tightening moves. (Andrew Husby)

  In **Asia**, **Bank Indonesia** is meeting on Thursday and is once more likely *to keep policy on hold*. Indeed, although the BI took markets by surprise by beginning to hike interest rates in February, it has seen no reason to following up that initial hike with any further policy tightening. Admittedly, consumer price inflation has fallen back clearly over the last few months from the peak at the beginning of the year. Indeed, it is the latter development that will also the central bank to stand back once more, alongside the further, slight moderation in domestic demand growth in Q1.

  The following day the **Bank of Korea** is meeting. The BoK confounded expectation of a further hike last month, meaning that the last rate hike took place as far back as March. Since, then, consumer price inflation has jumped, and although having seen a marginal moderation in the latest set of data, it remains above the central bank's tolerance band and core inflation has risen further. On the flip side, the real economy data took a turn for the worse in data released last week, meaning that the decision will be *very finely balanced*. (Samuel Sidenbladh)