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Global Radar Screen

Friday, June 17, 2011

DE Tactical and Strategic U.S. and Global Fixed Income Prospects: June 17, 2011			
Country/Region	**Tactical**	**Strategic**	**Comments**
United States			
Fed—Fed Funds	*Stable*	*Higher*	Soggy data/complicated/lengthy exit strategy push first policy hike off even further.
2-yr. Treas.	*Neutral*	*Higher*	Bernanke discounts QE3 but investors think otherwise.
10-yr. Treas.	*Neutral*	*Higher*	Hanging around 3%, which looks pretty good if the U.S. becomes Japan.
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 hikes unlikely 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— Beam Me Up Scotty

Investors were relieved to learn of reports that policymakers in Europe finally agreed that private sector participation in the next Greek bailout would be limited to a voluntary rollover of existing debts. Germany had been pushing for private investors to accept some losses on their holdings, but were persuaded by the French govt and the ECB that this could lead to a default and another "Lehman moment." The deadline for this new deal has been pushed off to the July 11 finance ministers meeting rather than the one that begins this Sunday. Even so, markets will look to see if this weekend's meeting provides more breathing room to Greece by the country being granted the next tranche from its current rescue package. Still, this new package sounds to us like kicking the can down the road, with the ultimate destination a default by Greece, although not necessarily this year. In the meantime, it can be argued that the Greek debt crisis is no longer in the hands of Eurozone policy-makers, instead lying more with Greece, whose govt. appears to be losing control. We worry that we will end up with a potentially catastrophic default in Greece without having instituted the economic reforms that were asked for in the first place in order for them to get help last year.

- U.S.: With relatively light data on tap, the focus will be clearly on the FOMC decision and press conference. Investors expect few surprises, with the Fed admitting that the economy is underperforming, that QE2 has ended, and that rates will stay low for long. During the press conference, Bernanke is likely to indicate once again that the economic and political tradeoffs do not favor QE3. With a broad-based acceleration in core inflation underway, the bar for QE3 is quite high unlike this time last year when core inflation was still falling. It would take GDP growth of 1 ½% or less to make QE3 a possibility. The earliest the Fed could come to that conclusion would be the Jackson Hole annual confab in late August.
- Eurozone: Amidst the discussion of the Greek bailout, further indications of economic softness will increase inventor nervousness. Most important will be the flash PMI data, whose mfg sector eroded noticeably last month. The services PMI was upbeat last month but contained considerable regional disparities. The German IFO figures will be more upbeat, however.
- United Kingdom: Various survey evidence will take a back seat to the MPC minutes, mainly to see to what extent the new recruit Broadbent highlights his policy preferences. The CBI mfg. survey will be checked for corroboration of softer signs elsewhere, while the distributive trade survey will update the consumer sector, which has been shaky.
- Japan: With both the BOJ and the Govt. concluding that the economy is recovering, BOJ policy has left on hold last week, but the BOJ introduced a relatively modest new lending program. The data calendar is sparse but includes the merchandise trade report which will give some insight on the industrial rebound from the March disaster. This reading will have some bearing on how much the recent weakness in US mfg. is attributable to the disruption to the supply chain from Japan.
- Emerging Markets/Regions: Three major central banks meet this week, as Turkey Hungary and the Czech Republic will all maintain unchanged policy rates. In **Turkey**, we expect the unusual policy of tighter reserve requirements and rate cuts (to hold down inflation but weaken the lira to ease the sizeable current account deficit) will eventually change towards a diet of rate hikes as domestic demand growth remains strong. That change may be hinted at but not made at this meeting. With subdued core inflation, a strong currency, rates will stay on hold in the **Czech Republic**, despite strong economic activity. In Hungary**,** the early-2011 tightening cycle is deemed sufficient to keep inflation in check. Policymakers have an easing bias given the more dovish membership now.

Specific Regional Themes

- **U.S. QE2 RIP?**

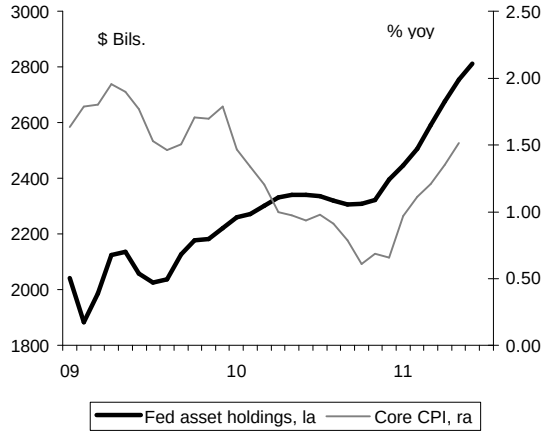
  With relatively light data on tap, the focus will be clearly on the FOMC decision and press conference (Wed). Investors expect few surprises, with the Fed admitting that the economy is underperforming, that QE2 has ended, and that rates will stay low for long. During the press conference, Bernanke is likely to indicate once again that the economic and political tradeoffs do not favor QE3. Bernanke will also discuss a downwardly revised GDP forecast in the 2 ½% to 3% range for 2011.

  With a broad-based acceleration in core inflation underway, the bar for QE3 is quite high. Remember in the summer of 2010 when QE2 was contemplated, the core inflation rate was still falling (Chart 1). As a result, it would take GDP growth of 1 ½% or less to make QE3 a possibility. The earliest the Fed could come to that conclusion would be the *Jackson Hole annual confab* in late August.

  Home sales report and durable goods are the key reports this week. Given the drop in pending home sales in April, a large drop in **existing home sales** (Tu) is expected in May (DE: 4.97M, -6.9%; consensus 4.80M, -5.0%). **New home sales** (Th) should be relatively flat relative to 323K pace of April (DE: 341K; consensus 310K). A rebound in aircraft could boost **durable goods orders** (Fri) in May (DE: +2.0%; consensus +1.6%). The gains in other sectors will be more tentative. The second revision to **Q2 GDP** should be 1.9% close to the 1.8% earlier estimate.

  The Fed's informal blackout period limits the Fed speakers to just one: welcoming remarks by Chicago Fed president **Evans** (voter 2011) at a state fiscal conference.

Chart 1: High QE3 Bar: Inflation Rising Now



- **Eurozone: Peripheral Worries Still the Focus**

  With domestic political problems having surfaced with a vengeance in Greece, the details and timing of a further Greek bail-out look almost irrelevant. Indeed, it could be argued that the Greek debt crisis is no longer in the hands of Eurozone policy-makers, instead lying purely with Greece, whose government is losing control.

  Regardless, the deadline for a deal has been deferred to the **meeting of Eurozone finance ministers** on July 11 rather than the one that starts on Sunday. Even so, markets will look to see if this latter meeting provides more breathing room to Greece by the country being granted the fifth tranche from its current rescue package. The finance ministers will also discuss further the nature of any private sector involvement, albeit only with a view to taking any decisions at the July 11 Eurogroup meeting.

  Meanwhile, amidst all these discussion about a Greek bail-out, economic data could make markets even more nervous if further signs of a softening economy emerge. In this regard, perhaps the greatest heed will be paid to the **flash PMI** data (Thu). The **manufacturing** survey eroded clearly last time around, with any fresh slippage (Consensus: 53.8; DE: 54.0) possibly being viewed as evidence of weaker global momentum given the clear and on-going reliance on exports behind Eurozone growth. NB:

  German Ifo data on Friday (Consensus: 113.5; DE: 113.7) and **German ZEW numbers** (Tue) will give alternatively-sourced survey insights, albeit with a very much German (and therefore relatively more upbeat) perspective.

  Meanwhile, the **services PMI** was less upbeat once again in May, but still revealed signs of wider geographical disparities, with clear weakness around the peripheral economies: more such evidence may be forthcoming (Consensus: 55.5; DE: 55.3).

  Perhaps as much interest should be in the flash **Eurozone consumer confidence** reading (Wed) to see if the slight recovery in May persists or not.

- **United Kingdom: More MPC Insight**

  Economic data is thin on the ground in the coming week, with the main interest coming from survey updates provided by the **CBI**. In this regard, the **manufacturing survey** numbers (Tue) will be watched for any corroboration of the softer factory sector signals evident elsewhere. The **distributive trades survey** (Thu) will give an update on the consumer, as will **British Banking Association lending** data (also Thu).

  Instead, the focus will be on the **minutes of this month's BoE MPC meeting** (Wed), mainly to see to what extent new recruit Ben Broadbent highlights his policy preferences.

- **Other Europe: Norges Bank Decision Due**

  In **Sweden**, the week ahead sees key data on Wednesday. These involve an update on both **business and consumer confidence** as well as the

latest **labor market** dynamics, the latter likely to remain upbeat.

In **Norway**, Wednesday is also the key day, bringing updated **labor market** numbers. However, the focus will be the **Norges Bank Board decision**. Having hiked in May, no further rate rise is seen at this juncture, but with the interest being in any change to the policy outlook. In this regard, it will be interesting to see what reaction recent weak consumer data has on Norges bank thinking.

Switzerland has no data of any note but the week does see (Tue) a keynote **speech by SNB President Hildebrand**.

- **Oceania: RBA Minutes**

  In **Australia**, the week is relatively quiet in terms of economic data. All of the attention will likely be focused on the **Reserve Bank of Australia minutes** of its 7 June policy meeting due Tuesday, although it is unlikely to provide any additional insights beyond the information already released in the statement by Governor Stevens following the meeting. Elsewhere, the week also sees the arrival of the **Westpac** (Wed) and **Conference Board** (Thu) **leading indexes**.

  In **New Zealand**, the week begins with the **Performance of Services Index** and Q1 **manufacturing activity** updates on Monday. Some attention will also be paid to **current account** numbers for Q1 (Wed), which is expected to see some recovery after the slump in the previous quarter. (Andrew Wroblewski/Samuel Sidenbladh)

- **Japan:**

  The Bank of Japan and the Kan government agreed last week that the economy is improving, with the BOJ's monthly "Statement on Monetary Policy" formally declaring that activity "is showing some signs of picking up," and Economic and Fiscal Policy Minister Yosano saying that the central bank view is "more or less in line" with government thinking. Accordingly, the BOJ Monetary Policy Board chose to leave the main policy levers unchanged at its regular meeting, though it did institute a new relatively modest lending program to stimulate equity investments and asset-based lending, particularly in smaller-scale transactions.

  Data flow is sparse next week, though the schedule does include the very important May **merchandise trade** data report (Mon), where the behavior of exports will give a key bottom-line reading on industrial recovery from the March disaster—a reading that will have some bearing on the interpretation of recent manufacturing weakness in the U.S., where supply-chain crimps are thought to have played a role. Other releases of the week are limited to the April **all-industry activity** report (Apr), giving a slight further fleshing-out of the picture of stabilization and nascent recovery already painted by the earlier industrial production and tertiary industry activity releases, and the May **corporate services price index** (Fri), watched for broad consistency with the trend towards easing deflation seen in consumer price numbers. (Pierre Ellis)

- **Emerging Markets: Central Bank Watch**

  This week brings a trio of central bank meetings in Eastern Europe, as Turkey, Hungary, and the Czech Republic will all maintain unchanged policy rates. The situation is slightly more complicated in **Turkey**, where the central bank is trying to tackle a widening current account deficit and elevated inflation pressures through higher bank reserve requirements and rate cuts – the latter half of the unorthodox policy combination with the intent of weakening the lira, easing the sizeable current account imbalance. However, evidence suggests these steps may have to be ultimately abandoned later this year in favor of traditional rate hikes, as consumer loan data continue to show little progress in terms of stemming a strong rebound in domestic demand, while the current account gap continues to widen. So, no change in rates this week, but attention will be on further reserve ratio increases, or language that suggests an eventual shift in policy.

  In the **Czech Republic**, another hold at 0.75% is on tap, as subdued core inflation and a strong koruna continue suggest that a rate hike would only come late in 2011 at the earliest, despite signs of an ongoing recovery in economic activity. However, that recovery is not being led by consumer demand, but instead external demand and investment, leaving the majority of policy makers comfortable with keeping rates on hold for at least the next few meetings. Finally in **Hungary**, rates will likely remain on hold for quite some time with a slight easing bias, as the late-2010/early-2011 tightening cycle is being deemed by the Monetary Council as sufficient to keep inflation pressures in check for now. The Council is operating with a more dovish composition, and will lean toward an eventual cut in rates if conditions allow. If incoming data in coming months suggest that global growth does appear to be proceeding at a slower-than-expected pace, and domestic demand continues to be sluggish, a cut later this year would be in the cards. But for now, ongoing uncertainty about potential upside surprises to growth and inflation makes a protracted hold the much more likely scenario. (Andrew Husby)