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Global Radar Screen

Friday, June 24, 2011

DE Tactical and Strategic U.S. and Global Fixed Income Prospects: June 24, 2011			
Country/Region	**Tactical**	**Strategic**	**Comments**
United States			
Fed—Fed Funds	*Stable*	*Higher*	Fed to market: we have done enough; but policy tightening a long way off.
2-yr. Treas.	*Neutral*	*Higher*	Bernanke discounts QE3 but reminds investors they have some tools left.
10-yr. Treas.	*Neutral*	*Higher*	Bubblicious: 3% yields look pretty good if the U.S. becomes Japan.
Eurozone			
ECB—Refi Rate	*Higher*	*Higher*	Real economy still far from upbeat, especially around the periphery and consumer sector. 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*	***Stable***	Substantial easing in place, but lending backdrop still weak. MPC splits about inflation risks are clear. BOE on hold for some time.
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—The Known Unknowns

Investors are weighed down by uncertainty, with perhaps the three biggest "known unknowns" oil prices, the Greek situation, and the U.S. debt limit. The decision by the IEA to release crude oil from government stockpiles may help offset the loss of Libyan oil production and promote lower oil prices, a plus for oil consuming nations and sagging global growth. Even with the recent drop in oil prices, the U.S. has sustained a jump in oil prices that has usually contributed to a recession. The Greek situation seems to stumble from crisis to crisis, complicated by the fact that solving the problem involves Greece, the EU, the ECB, and the IMF. In addition, the policymakers in the EU do not speak with one voice and many times seem out of tune with what the ECB and the IMF are saying as well. The hurdles facing the Greek bailout seem never ending: a Greek parliamentary vote on a new austerity plan by June 29, a Eurozone ministers meeting July 3 and a signoff by the IMF (date unspecified) before the next tranche of the existing bailout fund can be delivered before Greece runs out of money July 15. At the same time, a new bailout plan (with or without private sector involvement) needs to be pulled together this summer. And the U.S. has a sovereign debt crisis on its own, with the debt ceiling breach looming in early August. The news on this front has been poor. The initial optimism regarding the bipartisan talks run by US Vice President Biden has ended with the dramatic walk-outs by its two Republican members. The House Republicans say they cannot agree to a deal (and a successful vote on the debt ceiling) with any tax increases and the Democrats say there cannot be an agreement without some tax increases. We are at an impasse, which we think will be averted, as politicians find little benefit in agreeing with their opponents too early.

- **U.S.:** The calendar this week is moderate with the PMI updates the clear focus. The declines expected by both DE and the consensus would imply that the soft patch was not over but was at least slowing down. Mainly hawkish Fed speakers such as Hoenig, Fisher and Bullard may continue to draw the line in the sand regarding the need for QE3.
- **Eurozone:** Greece remains the focus this week and in coming weeks. Even if the Greek parliament approves the austerity package this week, investors may be very nervy about the Greece situation well into the following week-end when Eurozone finance ministers are set to meet (on July 3) to decide on whether fresh funds will be given to Greece to avoid a mid-month default. Regardless, economic data will be influential too, especially given signs from survey data that the Eurozone economy is slowing afresh, and possible clearly so. The EU survey evidence, however, may be less downbeat, however. The ECB monetary update may be important as well, given the fresh softening of M3 growth.
- **United Kingdom:** While some solace may be found in the upcoming PMI update, investors will be more interested in the various lending updates. In addition some softness in the labor productivity figures this week may be a key issue raised by the BoE members testifying, particularly given the hints of last week that further asset sales were being considered.
- **Japan:** Data flow this week is very rich, with the main round of May monthly indicators giving a near real-time update on recovery from the March disasters, and the second-quarter Tankan report offering a detailed look at the shock suffered by companies, and at the effect which it had on their outlooks and planning—giving a reality check on policymaker hopes for a quick recovery.
- **Emerging Markets/Regions:** While no central banks we follow meet this week, we review the situation in **Brazil**. The conditions are ripe for a policy pause. A sharp slowdown is not yet very likely, but the odds are increasing the longer the current policy stance is maintained, particularly given the rising dangers of a soft global economy from multiple sources, including Europe's debt problems, the anemic performance of the US economy and the *cooling* process underway in China.

Specific Regional Themes

- **U.S. The Manufacturing Update, Please!**

The calendar this week is moderate with the PMI updates the clear focus. The declines expected by both DE and the consensus would imply that the soft patch was not over but was at least slowing down. Nonetheless, we start the week with the **income and spending** figures for May, looking for a moderate gain in income (DE: +0.3%; consensus +0.4%) and relatively flat spending (DE: -0.1%; consensus +0.1%), held down by falling auto sales.

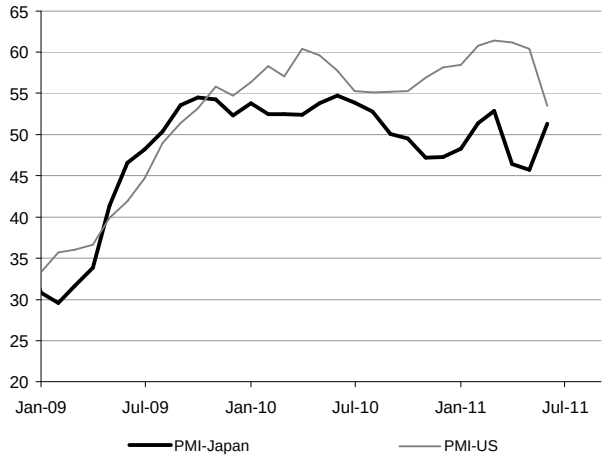
A further drop in the April **Case Shiller home prices** (Tu; DE -1.0%; consensus -0.2%. This would bring the yoy change from -3.5% to over 4%. Some bounceback is expected in **pending home sales** (Wed., DE: +4.0%; consensus +1.0%), after April's 11.6% drop.

Confidence updates start Tuesday with little change expected with the **Conference Board measure** (DE: 60.2; consensus 61.0). The final **sentiment** update (Fri) should be close to the 71.8 preliminary reading.

Further declines are expected in both the **Chicago** (Th) and **national PMIs** (Fri), despite the rebound in Japan's PMI last month (Chart 1). Investors are skeptical that signs of some improvement in the Japanese supply chain will stem the expected slide in June (Chicago: DE: 50.2; consensus 54.0) (National: DE: 50.2; consensus: 51.5).

Vehicle sales (Fri) should rebound (DE: 12.4M; consensus 12.0M) retracing about half of May's decline.

Chart 1: Some Help to US Mfg From Japan?



The Fed's talking head parade resumes starting with Minn Fed president **Kocherlakota** (voter 2011) on leverage (Mon). Outgoing KC president **Hoenig** (voter 2013) speaks on financial reform and should renew his call for breaking up large "too big to fail" financial institutions (also Mon). He also speaks on the outlook Thursday. The "one and only" Dallas Fed president **Fisher** (voter 2011) will continue to argue that the Fed has done enough, implicitly calling for an exit soon (Wed) Newcomer governor **Raskin** (always votes) speaks Thursday. She is unlikely to talk about macro matters beyond some generalities. St Louis president **Bullard** (voter 2013) may give an interesting take on QE2 and what it would take to agree to a QE3.

- **Eurozone: Greece Still the Focus**

The next obstacle facing **Greece** looms this week, with its **parliament** likely to **debate and** (Tu. or Wed) **vote** on the **austerity package** which the rest of the Eurozone want passed before any further bail-out is disbursed. Actually, it seems that Greece may be asked to make additional cuts over and beyond the € 28B package currently envisaged. The chances are that the package will be passed, but possibly in some diluted form and, more likely, without any sign of the kind of cross-party support for such austerity that may be needed to satisfy markets, the IMF and maybe other Eurozone countries.

As a result, even in the event of the package being passed next Tuesday, markets may be very nervy about the Greece situation well into the following week-end when **Eurozone finance ministers** are set to meet (on **July 3**) to decide on whether fresh funds will be given to Greece.

Regardless, economic data will be influential too, especially given signs from survey data that the Eurozone economy is slowing afresh, and possible clearly so. Updated **PMI numbers**, which signaled such a softening last week, are due this Friday. However, other alternatively-sourced **survey data from the EU Commission** (Wed) may tell a less downbeat message, albeit possibly corroborating clearer weakness among peripheral countries.

Even so, there may be more signs of consumer fragility on Thursday from **German retail sales** data (Consensus: 0.5% M/M; DE: unch) and **French household consumption** numbers (Consensus: 1.0% M/M; DE: 0.4%) while inflation signals may reveal on let-up:

German CPI data are due on Tuesday (Consensus & DE: 2.3% Y/Y), while the **Eurozone flash HICP** arrives no Thursday (Consensus: 2.8% Y/Y; DE: 2.7%).

Of some note, the ECB monetary update (Thu) may be important, especially given that the fresh softening in **M3** growth (Consensus: 2.1% Y/Y; DE: 2.2%) may be a further sign of banking sector fragility.

- **United Kingdom: Lending Updates Due**

Given the falls in it of late, markets will be very sensitive to the **manufacturing PMI** update on Friday, where some solace may be evident (Consensus: 52.3; DE: 52.5).

Otherwise, the week provides clear insights in to the lending backdrop in the UK, with an updated picture

on the supply-side coming from the **BoE credit conditions survey** (Thu). However, a picture of the demand side will also arrive via **BoE consumer lending data** as well as the monthly **broad money and lending** update (all Wed).

There are further insights in the **consumer** more generally from the **confidence** figures (Thu) as well as a picture of the **housing** market from Nationwide (also Thu).

The week also has **final Q1 GDP** data where a possible downward revision may occur. Perhaps more interest should be in the **services** sector and **productivity** numbers on Wednesday, with the recent softness in the latter a clear concern for the BoE.

Indeed, the latter may be a key issue raised when **BoE members testify** on Tuesday, something markets will be keen to listen to given the hints of fresh asset sales revealed in the last MPC minutes.

- **Other Europe: Manufacturing Updates**

  In **Sweden**, the week culminates on Friday with the **PMI** data, numbers that have suggested a clear slowing of late as far as manufacturing is concerned. A softening in **household lending** data has evident as well with an update for this series also due on Thursday, preceded by the key **retail sales** release which will reveal whether the better tone seen n the April figures continued or not.

  Household credit (Wed) and **retail sales** data also feature in **Norway** this week, albeit with the former having show more pronounced softness of late. **PMI** numbers finish the week on Friday.

  Switzerland sees the **KOF survey** (Fri), proceeded by the **PMI** numbers (Wed).

- **Oceania: Data Flow**

  In **Australia**, the week sees a number of housing market updates, including **HIA new home sales** (Fri) figures. Some attention may also be paid to **private sector credit** data due on Thursday.

  In **New Zealand**, the week begins with **trade** numbers on Monday. The remaining data next week is concentrated on Thursday, with the arrival of **NBNZ business confidence**, **building permits** and **M3 money supply** numbers due. (Andrew Wroblewski/Samuel Sidenbladh)

- **Japan: Rich Post-Crisis Updates**

  Data flow this week is very rich, with the main round of May monthly indicators giving a near real-time update on recovery from the March disasters, and the second-quarter **Tankan** report (Fri) offering a detailed look at the shock suffered by companies, and at the effect which it had on their outlooks and planning—giving a reality check on policymaker hopes for a quick recovery.

  The data calendar starts Tuesday with **retail sales** numbers, which, with **the family income and expenditure** data on Friday, will map out the consumer-sector recovery to date. Consumer spending is a critical area of uncertainty in the outlook, as income and sentiment shocks caused by the disasters impact what was already a shaky situation.

  On Wednesday will come the very closely watched **industrial production** report. Bullish production-plan forecasts have prompted optimism about a quick return to pre-crisis output levels, and those hopes will be confronted with actual May results, and with an updated round of the forecasts.

  Thursday brings the monthly **housing starts** release, watched now for early signs of rebuilding activity in the disaster zone, while Friday features, in addition to the **Tankan**, both the **labor market survey**, with its implicit message on the stability of the demand side there, and the **consumer price index**, where the sturdiness of the re-inflationary trend continues to be at issue. (Pierre Ellis)

- **Emerging Markets: Central Bank Watch: Brazil**

  This week brings no major central bank meetings that we cover.

  Brazil: A Soft Landing? The most recent statistics on Brazil's sales, inflation and the labor market describe an economy moving towards full employment just as the effects of a period of monetary tightening begin to surface. The evidence suggests that there is substantial quantitative and qualitative improvement in employment underway, which should be supportive of consumption growth at moderate rates in coming quarters. Interest sensitive sectors, however, face some headwinds as rates continue to move up.

  As for policy, the state of fundamentals seems conducive to a pause. From the central bank perspective, the question seems to be largely of message, as policymakers would need to take the risk of stopping the tightening process as annual inflation remains at or above the upper ceiling of the target range of 4.5%± 2 percentage points.

  And as they hesitate, the balance of risks is shifting away from inflation and in the direction of recession. A sharp slowdown is not yet very likely, but the odds are increasing the longer the current policy stance is maintained, particularly given the rising dangers of a soft global economy from multiple sources, including Europe's debt problems, the anemic performance of the US economy and the *cooling* process underway in China. This is not a favorable environment for equities, and in fact even the real is in some danger from a near-term perspective. (Francisco Larios)