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Global Radar Screen

Friday, August 5, 2011

DE Tactical and Strategic U.S. and Global Fixed Income Prospects: August 5, 2011			
Country/Region	**Tactical**	**Strategic**	**Comments**
United States			
Fed—Fed Funds	*Stable*	*Higher*	Bernanke indicates Fed could ease again but not soon. Policy tightening a long way off.
2-yr. Treas.	*Neutral*	*Higher*	Still weak jobs and global turmoil help the front end.
10-yr. Treas.	*Neutral*	*Higher*	Sustained sub 3% yields in play if no 2011H2 rebound.
Eurozone			
ECB—Refi Rate	*Stable*	*Stable*	Real economy softening, especially around the periphery and in regard to the consumer. Banking sector and widening sovereign debt problems even clearer, despite latest Eurozone efforts. ECB hiking to be punctuated: policy reversal possible.
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*	Earthquake aftermath and yen strength 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—Stabilization hopes?

As the week closed there was the bad, but not surprising, news of a Standard and Poors downgrade of U.S. sovereign debt, but there were also some positive developments that helped U.S. stocks stabilize, at least for the moment. July employment data surprised mildly to the strong side, joining a spotty, but growing, collection of data hinting that the economy may have been firming up a bit—or certainly not falling into a snowballing decline—on the eve of the latest market turmoil. Meanwhile hopes for an at least temporary calming of the European situation were sparked by Italian Prime Minister Berlusconi's late-Friday announcement of an acceleration both in austerity plans—bringing forward difficult measures originally set to begin only after 2013 elections—and in market reforms described by Finance Minister Tremonti as the "mother of all liberalizations." The adjustments were all-but-explicitly made in exchange for an agreement by the European Central Bank to include Italian bonds in its renewed program of emergency sovereign-bond purchases—with Berlusconi's coalition partner Umberto Bossi of the Northern League promising that the buying would start Monday. It remains to be seen just how willing the ECB is augment its collection of dubious paper with chunks of Italian debt, but hopes were raised for the availability of a bit of bridge financing until the Eurozone nations finish the process of writing—and ratifying—the legal documents necessary to implement the European Financial Stability Facility enhancements agreed at their July summit meeting.

- **U.S.:** The FOMC meets, and confronts a more tumultuous world than last time, with no straightforward policy remedies available. Hesitation may be the most likely course of action. The big data release of the week will be the July retail sales report, on Friday, telling whether the already fragile consumer spending situation gives hints of buckling.
- **Eurozone:** Financial markets will be focused on themselves as they grapple with intensified sovereign debt problems, stock market slumps and fresh signs of banking sector turmoil. Daily data from the ECB on matters such as deposits with the central bank will be watched, as will EONIA itself, as markets ponder the extent to which banks may be hoarding liquidity afresh. At least there are no major peripheral bond auctions that could act to focus concerns.
- **United Kingdom:** The quarterly BoE Inflation Report (Wed) may attract less attention than of late, simply because it already looks as of the MPC is going to keep policy on hold for some time and that this view will be merely corroborated by the updated growth and inflation projections. However, speculation that the BoE may be prepared to re-start asset purchases could easily be intensified if the key economic data events show more weakness. Most notable in this regard will be Tuesday's manufacturing production data
- **Japan:** Surely the main concern this week will be potential market turbulence, and particularly whatever possibility develops for further currency-market intervention. On the data front, meanwhile, interest will focus on several releases tracking important elements of recovery from the March disasters. Key among them will be the June **tertiary industry activity** numbers (Wed), covering a broad swath of the economy, and the June **machinery orders** report (Thu), an important confidence gauge..
- **Emerging Markets/Regions:** No major EM central banks meet this week. In **Turkey** we think monetary policy will likely have to take a different course eventually, despite the recent rate cut, with interest rate increases likely perhaps as early as the first few months of next year.

Specific Regional Themes

- **U.S.: FOMC confronts a changed world.**

  The feature event at the start of the week will be the Tuesday **FOMC meeting**, where policymakers will confront an economy more mixed and markets much more troubled than even six weeks ago. Whatever public adjustments are made to the policy stance—quite probably, little or none—will surely be the result of a vigorous behind-closed-doors discussion.

  Data flow begins Tuesday, with a **productivity and costs** report covering the second quarter, and including historical revisions reflecting the newly revised GDP data. Productivity looks to have deteriorated in the first half of this year—perhaps reflecting over-enthusiastic hiring in the early spring, and going some ways to explain the later hiring slowdown. Forecasts for the second quarter number are uniformly negative (Consensus: -0.8%; Decision Economics: -0.7%), and chances are the first quarter figure, after revision, will look very similar.

  Thursday will bring June **international trade** results, important in their own right, as an update on the developing import and export trends, and also as a potential factor in revisions to the second-quarter GDP numbers. Expectations are broadly in line with the assumption made in the GDP estimates (Consensus: -$48.0 billion; Decision Economics: -$49.9 billion), so an in-line result would cause little revision.

  The most important data release of the week will be the July **retail sales** report on Friday, giving the first broad look at the consumer spending trend heading into the third quarter. Household financial fundamentals have generally deteriorated in recent months, and concerns for the resilience of spending are growing. Forecasts for overall sales (Consensus and Decision Economics: +0.5%) and for the ex-autos total (Consensus: +0.2%; Decision Economics: +0.4%), are modestly upbeat.

  Last, and perhaps not least, will come the first August look at the **University of Michigan Consumer Sentiment Survey.** These numbers have been particularly gloomy in recent months—a dangerous state of affairs, given the new, and very concrete deterioration in stock prices. Forecasts look for no relief, even after a 7.7-point drop in the headline index last month, (Consensus: -0.8 point to 63.0; Decision Economics: -1.3 points).

  Fed officials will be scarce in the week—as they are obligated to be in the immediate proximity of an FOMC meeting—but there will be a Friday appearance by New York Fed President **Dudley**. He is among the most dovish Fed players, and will be more so, should the retail sales numbers come in weak. (Pierre Ellis)

- **Eurozone: Contagion Risks the Focus**

  The limited economic data in the next week may attract little attention, especially as there is little of great importance, particularly in the first few days. While hoping that some progress on bail-out funds may have been made in what could be a series of teleconferences by policy-makers over the week-end, financial markets will instead be focused on themselves as they grapple with the intensified sovereign debt problems, stock market slump and fresh signs of banking sector turmoil. Indeed, daily data from the ECB on matters such as deposits with the central bank will be watched as will EONIA itself as markets grapple with the extent to which banks may be hoarding liquidity afresh. Other ECB data will also be watched including hints on Monday regarding the extent to which the central bank has been buying government bonds again. At least there are no major peripheral bond auctions that could act to focus concerns. As for data, the more important numbers all arrive on Friday, with **French GDP figures** that are likely to reveal a distinct slowing in growth, a development that will be echoed in **Eurozone industrial production** numbers (Consensus: 0.1% M/M; DE: -0.5%).

- **United Kingdom: BoE insight awaited**

  The quarterly **BoE Inflation Report** (Wed) may attract less attention than of late, simply because it already looks as of the MPC is going to keep policy on hold for some time and that this view will be merely corroborated by the updated growth and inflation projections. Clearly, growth projections will be lowered, the question being whether the scale of any downward revision will be enough to intensify the admittedly-limited speculation that the BoE may be prepared to re-start asset purchases. However, the latter could easily be intensified if the key economic data events show more weakness. Most notable in this regard will be Tuesday's **manufacturing production** data, the question being whether this update echoes the clearly weaker tone seen in factory sector surveys of late (Consensus: 0.2% M/M; DE: 0.3%). **Construction output** data (Fri) will be important in this regard too, while the **BRC retail sales** and **RICS housing market** surveys on Tuesday will provide important insights into what are very much already-fragile parts of the economy.

- **Other Europe: CPI updates, Norges Bank meeting**

  In **Sweden**, the week sees on the **CPI** update (Thu), figures which have surprised on the downside of late. Indeed, the last CPI and CPIF readings were some 0.2 percentage points below those envisaged in the updated projection provided by the Riksbank in its Monetary Policy Update published early last month. **Norway** too has **CPI** data to digest (Wed), with recent outcomes for the headline and core also having undershot central bank expectations of late. There is also **retail sales** data (Fri), the question being whether the better tone seen in the last report can be continued or not. However, the focus will be the **Norges Bank meeting** (Wed), especially with markets keen to see if the clear near-term rate hike threat seen in June can be maintained. In **Switzerland**, market eyes will be on the FX markets to see if the SNB delivers any further

in its recent and high-profile threat to do whatever is needed to curb franc strength. Even so, there are **jobless data** (Mon) and **consumer confidence** numbers (Tue) due.

- **Oceania: Survey updates**
  In **Australia**, the week begins with **home loan approvals** numbers on Tuesday. A number of survey updates are also due, including the **NAB business confidence** (Tue) and the **Westpac consumer survey** (Wed) figures. Thursday then completes the week with the arrival of **household inflation expectations** data and the **labor force survey**, where conditions are generally expected to be stable. The week is relatively quiet in **New Zealand** in terms of economic data. Monday sees the arrivals of **QV house prices**, before the **Performance of Manufacturing Index** and **ANZ consumer confidence** numbers (both Thu) wrap up the week. (Andrew Wroblewski)

- **Japan: Wary markets**
  Surely the main concern this week will be potential market turbulence, and particularly whatever possibility develops for further currency-market intervention. On the data front, meanwhile, interest will focus on several releases tracking important elements of recovery from the March disasters. On Monday will come July **bank lending** results, largely opaque, but with any signs of firming an unambiguous positive, while Wednesday brings June **tertiary industry activity** numbers, reporting on progress in a very broad swath of the production-side economy. Thursday features the June **machinery orders** report, an important gauge of business confidence in an uncertain period, while Friday brings revised June **industrial production** numbers, with the risk of a significant restatement never totally absent. (Pierre Ellis)

- **Emerging Markets: Central Bank Watch:** No Major meetings this week.
  Turkey: Further Easing? Turkey's central bank cut their policy rate (the one-week repo) by 50 basis points, to 5.75 percent. This is the third interest rate reduction since December 2010, for a cumulative 125 basis points. A stark contrast with monetary policy elsewhere, the continued easing is part of a strategy that aims to deal with the most visible vulnerability in Turkey's economy, a very large current account deficit, by inducing a weaker Lira. In this framework, inflation has been seen as a problem of a distant second-order, although policymakers have raised bank reserve requirements to slow lending growth, both to prevent eventual overheating and bubbles and the concomitant risks to financial-sector health.

  Whether this approach can be called a success thus far is debatable: the Lira has, in effect weakened, but the current account deficit has not narrowed; inflation has moved up, but just slightly. Be that as it may, the most likely 12-month scenario for Turkey includes—barring a sudden collapse of activity—some monetary tightening, as the TCB's strategy is likely, on present trends, to reach a natural limit.

  Also important from the standpoint of central bank policymaking is that the data now show a reduction of the pace of consumer lending during the past five weeks, prominently in mortgage and car financing. All of this against the background of still-considerable slack in manufacturing: capacity utilization has continued to rise, but at a slower pace, and it remains well below the pre-crisis norm. And for the central bank—as mentioned in their post-meeting communiqué--against a background of increasing external risks that warranted their move to ease to-- in their words--"reduce the risk of a domestic recession that may be caused by the heightened problems in the global economy".

  Should those risks not materialize, however, the current trajectory of the Turkish economy, particularly given the boost of low borrowing costs, is likely to lead to a more significant rebound of inflation within a 12-month horizon, fueled by strong demand and by a weak lira (now close to a historic low).

  The bottom line is that the current policy has not aggravated the inflation problem, but has failed to remedy the risk posed by a widening external shortfall, and unless the trend changes abruptly on account of global forces, monetary policy will likely have to take a different course over the next few months, with interest rate increases likely perhaps as early as the first few months of next year. (Francisco Larios)