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Global Radar Screen

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DE Tactical and Strategic U.S. and Global Fixed Income Prospects: August 12, 2011			
Country/Region	**Tactical**	**Strategic**	**Comments**
United States			
Fed—Fed Funds	*Stable*	*Higher*	Fed takes the no-hike pledge to mid-2013 but could break it at any time (we hope).
2-yr. Treas.	*Neutral*	*Higher*	The end is coming and the Fed will never tighten!!!!!
10-yr. Treas.	*Neutral*	*Higher*	Ditto and US is Japan.
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*	*Stable*	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—2011=2008?

The burning question is whether 2011 is 2008 again. In short, no. In 2007-2009, we experienced a once in 75 year credit and economic contraction following 25 years of leverage, financial innovation (credit derivatives), and greed. So stocks went down hard and markets froze. In 2011, we are seeing a more "typical" equity correction with little seizing up in the markets. Investors are cutting their equity exposure for at least three reasons. First, the US (and to a lesser extent European) policymaking appears dysfunctional. Second, budget tightening around the globe means slower earnings growth and hence lower equity prices. Third (and perhaps most importantly), all this, including the debt downgrade, followed a series of poor economic reports. The disappointing economic evidence was the lagged response to the earlier jump in oil prices and the disruptions from the Japanese supply chain. But not all of the important numbers recently have been bad, hence the extreme volatility in equities. The US jobs report was soft but OK, weekly claims fell to their lowest since April, and retail sales showed some actual pickup in July. Forecasters may be finally ready to lift their current quarter GDP forecasts after six months of intra-quarter downgrades. No one will do so soon after the miserable consumer sentiment reading Friday. We think there will not be double dip and hence 2011 will be more like 1983-84 than 2007-08 (Chart 1). The stock market has fallen significantly (more than 10%) 16 times since 1946, even though the recession has unfolded only 10 times. That said, the worry of course, it might not take much more to tip a slow growing economy into recession in the US. Our biggest worry is that the hardened positions among Congress and the White House will prevent fiscal policy from becoming sharply contractionary next year from the loss of the one-year payroll tax holiday, investment incentives, and UI benefits. This swing in policy could be the straw that breaks the camel's back.

- **U.S.:** The most recent numbers have been constructive for the economic outlook, but the sentiment number is troubling. We expect a modest follow-through this week as the activity reports will be subdued and core inflation steady but moderate. Investors will be looking Jackson Hole later this month for further guidance on the Fed's interest rate pledge.
- **Eurozone:** The update on ECB bond buying will be the focus but hard to interpret. A modest figure may be due to half hearted interest by the ECB rather than reduced funding pressures. A large number (above the € 74B already on ECB books) might be unsustainable. The Q2 GDP figures will not be dismissed as they are expected to be soft.
- **United Kingdom:** The MPC policy minutes will indicate fewer dissents with no members advocating tighter policy now. The next CPI figures will be acceptable but after that utility increases will push the yoy rate much higher. The weakness in the upcoming labor market figures will underscore the soft retail sales readings to come later in the week.
- **Japan:** The Q2 GDP figures will obscure the effects of the late spring recovery about the disaster. However, useful information may come regarding the recovery in real exports and well as the state of business stockbuilding. Merchandise trade and tertiary activity reports will complete the light calendar.
- **Emerging Markets/Regions:** No major EM central banks meet this week. In China, after recent data releases, it still seems reasonable to expect a pause in interest rate hikes in the near-term, without (yet) removing or relaxing the lending ceilings imposed on the state-owned banking system, but while pushing for (hard to attain) changes in the distribution of loans in favor of credit-starved small firms.

Specific Regional Themes

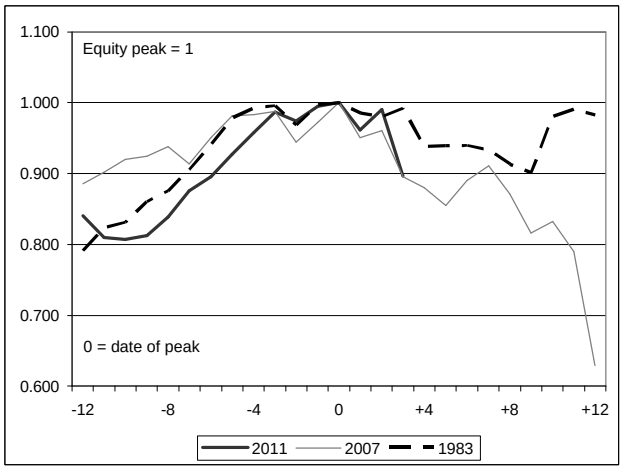
- **U.S.: After the Fed Pledge**

In an exceptionally flat-footed move, the **FOMC** decided to redefine the extended period to mean no rate hikes until mid-2013. This small change brought on 3 dissents, the first time since 1992. This made 2-year traders happy, while bonds and stocks fell on the news. The strong rally late in the day may be due to a rethinking of the final line of the statement in which the Fed reworded (again) to indicate their willingness to use their "tools" as "appropriate" based on "incoming information" suggested that they could consider QE3 at a later date.

The most recent numbers have been constructive for the economic outlook. We expect a modest follow-through this week as the activity reports will be subdued and core inflation steady but moderate. First out of the box will be **empire state mfg. survey** (Mon) which should be steady in August after the July rebound. The **Philly Fed survey** (Th) should also show a little improvement. These two report will be much more important than the **IP report** (Tu) for July which will show a moderate increase (DE and consensus +0.4%).

Housing will continue to bounce along bottom, with **housing starts** (Tu) (DE: 0.641K; consensus 600K) and **existing home sales** (Th) (DE: 4842K; consensus 4900K).

Chart 1: Will 2011 Be 2007-08 or 1983-84?



Inflation reports will be mixed with some residual impacts on the headline CPI from past increases in commodity prices. The **CPI** (Th) will be rise moderately (DE: +0.4%; consensus +0.2%), the core will be steady at 0.2%. (However, 0.2% rate is not friendly as it at already at the 2% Fed tolerance). The **PPI** is unlikely to show impacts from higher commodity prices (DE: and consensus +0.1%; core +0.2%).

Fed officials are basically on vacation with only a few hitting the road before the Jackson Hole confab. Dovish New York Fed President **Dudley** (always votes) speaks Thursday and Friday on a regional tour. Dissenting hawk Philly Fed president Fisher speaks Wednesday. Moderate Atlanta Fed **Lockhart** (voter 2012) speaks on Monday (Pierre Ellis)

- **Eurozone: ECB Bond Buying Assessed**

Key Q2 GDP numbers are due this week, but the figures may take a backseat (as far as markets are concerned) to the **ECB notification** of the scale of its recently-resumed **bond buying** (Mon). Such data will not reveal the country of origin of the debt bought. Moreover, it is unclear whether markets would regard what may be considered a large amount of buying (over and beyond the € 74 bln already no ECB books) as positive or negative. A smaller numbers may be interpreted as showing the ECB being half-hearted in its actions, while a large number could unnerve markets that the ECB may not be able to maintain such a pace.

Regardless, the **GDP data** for the Eurozone as well as key countries such as Germany (all Tue) will not be dismissed, especially as they may reveal a much softer growth rate for the Eurozone, something made all the more likely in light of the softer French national account numbers released of late.

There is also **final HICP** data, numbers that should confirm a fall in headline inflation last month as well as a softer core number

- **United Kingdom: MPC Divides Seen**

There is plenty of important data in the coming week. **CPI numbers** (Tue) may be the calm before the storm as only from the data due in the next month will much-flagged utility price rises push the Y/Y rate appreciably higher. In the interim, these next CPI data should see the Y/Y rate little changed (Consensus: 4.3% Y/Y; DE: 4.1%).

Wednesday sees the **labor market update** where more widespread weakness may be evident, ie not just in the unemployment figures, but also in employment too. **Average earnings** growth should remain soft, still consistent with a squeeze on spending (Consensus: 2.3% Y/Y; DE: 2.2% Y/Y). **Retail sales** figures (Thu) should highlight this squeeze with fresh weakness possible (Consensus: 0.3% M/M; DE: -0.3%), while **public borrowing** numbers may highlight a lack of improvement in the budget deficit (Consensus: £ 2.4 bln; DE: £ 4.0 bln).

Meanwhile, the **minutes to the August MPC meeting** due this Wednesday should confirm that the latest stable policy decision is likely to have involved fewer dissents than of late, with it likely that no members continued to advocate tighter policy. This is implied from the tone of the latest BoE Inflation Report.

- **Other Europe: SNB Action About the Franc?**

In **Sweden,** there is little for markets to chew over data-wise, with only **industrial production** numbers due on Monday.

Norway and **Switzerland** have no data scheduled, although markets in the latter will be looking to see if the SNB takes any further action to curb the Swiss franc strength.

- **Oceania: RBA Policy Minutes**

  In **Australia**, the week begins with the **Reserve Bank of Australia minutes** of its 2 August policy meeting (Tue), which is unlikely to provide any additional insights beyond the information already released in the statement by Governor Stevens following the meeting. Q2 **labor cost** data follows on Wednesday, before **average weekly wages** numbers wrap up the week on Thursday.

  In **New Zealand**, the week is relatively quiet in terms of economic data. The week starts with the **Performance of Services Index** on Monday, before Q2 **PPI** data completes the week on Wednesday (Andrew Wroblewski)

- **Japan: Misleading Q2 GDP?**

  This week brings few economic indicators, but important ones, with the preliminary estimate of second-quarter GDP appearing Monday, July merchandise trade data Thursday, and June all-industry activity numbers Friday. **GDP** results will compare economic activity in the immediate aftermath of the March earthquake/tsunami with activity just before, making for a difficult comparison—or at least one obscuring the strength of the late-spring recovery. Apart from the raw overall growth figure, particularly interesting information in the report will be the clues on the post-disaster state of inventories, and on the real magnitudes underlying the relatively mild recovery that has taken place in nominal exports. Both factors could influence third-quarter growth estimates.

  Merchandise trade data, meanwhile, will track the nominal export performance into July—just about to the point where effects of western financial market turmoil might begin to be visible.

  All-industry activity detail will fill out the picture of second-quarter growth by industrial sector—displaying any significant differences in post-disaster performance. (Pierre Ellis)

- **Emerging Markets: Central Bank Watch:** No Major meetings this week.

  China: New data means new policy? Inflation is still too visible a threat for the central bank to change course drastically, but not enough to keep the current policy stance without nuances as the tightening medicine works its way through the system, the global economy slows and global risks mount. Thus, after this data release it still seems reasonable to expect a pause in interest rate hikes in the near-term, without (yet) removing or relaxing the lending ceilings imposed on the state-owned banking system, but while pushing for (hard to attain) changes in the distribution of loans in favor of credit-starved small firms. (Francisco Larios)