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Global Radar Screen

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DE Tactical and Strategic U.S. and Global Fixed Income Prospects: August 19, 2011			
Country/Region	**Tactical**	**Strategic**	**Comments**
United States			
Fed—Fed Funds	*Stable*	*Stable*	Fed takes the no-hike pledge to mid-2013 but could break it at any time (we hope).
2-yr. Treas.	*Neutral*	*Higher*	A lame Jackson Hole conference could continue the bull flattener.
10-yr. Treas.	*Neutral*	*Higher*	Ditto and US is Japan with sub 2% yields.
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—Solving the Growth/Debt/Policy Problem, Texas-Style

Disappointing economic updates in Europe and especially the US sent equities sharply lower and bonds sharply higher. Fixing the growth and debt problem simultaneously is an exam no policymaker wants to take. Passing the first part of the exam means flunking the second. Stimulative fiscal polices make the debt and the deficit worse. Cutting deficits slows growth. The logical solution is for governments to craft policies that blend efficient stimulus in the short run for medium term fiscal consolidation. Unfortunately, few policymakers are willing to try that in the US, while Europe may be more willing. The US, which undertook a large stimulus package in 2009, enjoyed at best mixed results. With unemployment high and growth very slow, the public and many politicians, especially those running for the Republican presidential nomination, have reversed the economic causality, arguing that deficit and debt cause unemployment not the other way around. And some take the (il)logic one step further and think stimulative policies can only cause inflation. If this were true, a move towards QE by the Fed, would be "almost treasonous." But we are not aware of a situation that sustained core inflation does not follow stronger growth, so Fed efforts to stimulate the economy, which are sure to be bandied about at Jackson Hole later this month, are understandable. Such efforts are unlikely to bear fruit. Three hawks already dissented over the relatively meaningless pledge to keep policy rates steady until mid-2013. A decision to expand the balance sheet substantially or even lower the IOER to zero would bring forth even more internal opposition, not to mention what would be said in the primary campaign. As long as job growth is even barely positive, the FOMC hawks are unwilling to fly back to Bernanke's nest and become doves.

- **U.S.:** Investors are probably expecting more from the Jackson Hole confab than can be delivered as the Fed is not ready to embark on QE3. So the bull flattener makes sense until the end of the month, when the first major economic report hits the tape. In a light data week, the king of the hill is durable goods, where a sizeable jump should reverse June's 2% drop.
- **Eurozone:** In a busy week, key updates are awaited. Of most interest will be the flash PMI, with fresh slippage after three months of erosion will give clear evidence of the eroding export picture. German Ifo and ZEW updates will also be useful and possibly more upbeat. The services PMI and Eurozone consumer confidence will also be of value, with some data hounds watching the M3 growth numbers for additional signs of softness.
- **United Kingdom:** There is not much in terms of data in the coming week, leaving perhaps more interest in otherwise in the revisions to Q2 GDP. A downward revision is certainly possible, but the main interest will be in the first insight into the expenditure break-down, particularly if there is further erosion in consumer spending.
- **Japan:** Only inflation updates are available this week. The CSPI cost index deflation has moderated but only in a very uneven way, bespeaking a very unsettled state of expectations. The CPI should show some very modest decline on the new conceptual basis, instead of the moderately firming trend shown in the old data
- **Emerging Markets/Regions:** Three major EM central banks meet this week. **Mexico**'s central bank is expected to keep rates on hold, given less worrisome inflation outlook and the global financial market turmoil. In **Turkey**, there is a slightly less than 50/50 chance of another rate cut following the surprise reduction at the last meeting. Finally, the central bank in **Hungary** will maintain an unchanged policy, as a more uncertain external environment is offset by a need to keep the currency supported.

Specific Regional Themes

- **U.S.: Will Jackson Hole Be a Bust?**

  In the current economic and political environment, it is hard to think that the Fed wants to jump boldly back into the QE fray. But investors are still expecting some miracle to come from Jackson Hole along the lines of last year, when QE2 was outlined. The chances are high that the confab will disappoint and make the bullish steepening trade a good bet. That trade makes sense until the 31st when the Chicago PMI arrives, the first number that could change investor's attitudes about how limp the economy is.

  In a light data week, the king of the hill is **durable goods** (Wed), where a sizeable jump (DE: +2.5%; consensus +2.3%) is expected, reversing June's similar-sized drop. Q2 GDP is likely to be revised down slightly (DE: and consensus +1.1%) from the published 1.3%. The downward revisions to GDP recently were one the reasons the equity market has performed so poorly. The recovery appears even more anemic than first estimate, when results using the income data were rolled in.

  The revised **consumer sentiment** report (Fri) may mean little since we already learned from the preliminary estimate of a large 9 point decline to recessionary levels.

  Speakers at Jackson Hole include **Bernanke** and **Trichet** (Fri) and the opportunity for all FOMC members to opine to the press, where many times the real action is. (M. Cary Leahey)

- **Eurozone: Key Surveys Awaited**

  Business survey readings this week will give insight into just how frail the Eurozone economy has become. In this regard, perhaps the greatest heed will be paid to the **flash PMI** data (Tue). The **manufacturing** survey eroded clearly for a third successive month last time around, with any fresh slippage possibly being viewed as evidence of even weaker global momentum (Consensus: 49.5; DE: 50.2), given the clear and on-going reliance on exports behind Eurozone growth. NB: **German Ifo** data on Wednesday and **German ZEW numbers** (also Tue) will give alternatively-sourced survey insights, albeit with a very much German (and therefore potentially relatively more upbeat) perspective.

  Meanwhile, the **services PMI** also suffered clearly last time around, revealing continued signs of geographical disparities: more such evidence may be forthcoming.

  Perhaps as much interest should be in the flash **Eurozone consumer confidence** reading (Tue), to see if the financial market turmoil is having any major spill-over effect.

  Otherwise and of some clear note, the ECB monetary update (Fri) may be important, especially given that that the still-soft **M3** growth numbers are very much a continued sign of banking sector fragility (Consensus: 2.2% Y/Y; DE: 2.0%).

- **United Kingdom: GDP Details**

  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%).

  GDP details. There is not much in terms of data in the coming week, leaving perhaps more interest in otherwise in the revisions to **Q2 GDP** (Fri). A downward revision is certainly possible, but the main interest will be in the first insight into the expenditure break-down, particularly if there is further erosion in consumer spending.

- **Other Europe: Data Mix**

  In **Sweden,** interest in economic data will be most acute on Thursday when **producer and consumer surveys** are released alongside an update on what has been a very firm **labor market**.

  Norway too has a key **labor market** update (Wed), albeit where recent data have been mixed. Perhaps more interest will be in the **Q2 GDP** numbers (Tue) with the likelihood being that the mainland numbers will see some clear slowing in growth.

  Switzerland has little data of note save for the **KOF survey** (Fri).

- **Oceania: Quiet Data Week**

  In **Australia**, the only data of note next week is arrival of the **Conference Board Leading Index** on Wednesday.

  New Zealand also sees a quiet week in terms of economic data, starting with **trade** data on Wednesday, before Q2 **retail sales** numbers wrap up the week on Thursday. (Andrew Wroblewski)

- **Japan: Inflation Updates**

  This week brings only inflation data, with the July corporate service price index arriving Wednesday and the July national consumer price index data due Friday. **CSPI** results are of background interest as a partial measure of cost-side developments, and the conformity that they are displaying with consumer-level price trends. Over the last year CSPI deflation has moderated, but in a very uneven way, with price declines accelerating a bit in some categories, and slowing, or reversing, in others, in a very wide scatter. That pattern bespeaks a very unsettled state of expectations—more so than policymakers would be comfortable with.

  The consumer-level trends, meanwhile, are subject to restatement this week, with new 2010-base **consumer price index** figures being rolled out on a historical basis along with the July results on Friday. A small

number of pre-released results, for very recent months, show core prices in very modest outright decline on the new basis, instead of the moderately firming trend shown on the old. (Pierre Ellis)

- **Emerging Markets: Central Bank Watch:**
  This week brings meetings of three central banks that we cover. **Mexico**'s central bank had been expected to *keep rates on hold* even before the recent financial market turmoil hit. Now, signs of downshifting growth in the all-important U.S. export market are bringing down the outlook for Mexico as well. Consumer price pressures have not been too worrisome for the central bank throughout the recovery amid weak domestic demand, and moderation in commodity prices is making that outlook even more favorable. With rate hikes pushed out well into 2012, the prospect of a cut should be on investors' minds if global conditions continue to deteriorate. However, that sort of a policy shift will not come this week.

  In **Turkey**, the central bank surprised markets last month with a 50 bps cut, a decision that markets rewarded by sending the lira to new lows. For months now, the central bank's "unorthodox" approach to policy setting (lower rates combined with higher reserve requirements) in order to tackle a sharp widening in the current account deficit and strong credit growth has left most analysts wrong-footed when anticipating the outcome of individual policy meetings. Elevated inflation, still-strong credit growth, and a still-widening current account deficit had been boosting expectations that abandoning those measures in favor of conventional rate hikes would have to occur. But now, the ratcheting-up of global growth concerns, financial market turmoil, and early signs of a slowing in domestic credit growth make the recent actions justifiable with the benefit of hindsight. The sticking point is the plunging lira, now down nearly 25% versus the euro since early December, and 10% from July highs. To that end, this week's decision is likely characterized by *slightly less than even odds of a rate cut*, a small chance of an adjustment to reserve requirements, and further indications of willingness to support the lira in the FX market.

  Finally, in **Hungary**, an *unchanged policy rate is in the cards*, as a more-uncertain external environment is offset by a need to keep the forint supported. Inflation has declined and the growth outlook is softening, but sizeable levels of foreign currency debt in the household sector, most notably Swiss franc denominated, make the central bank wary of putting further pressure on consumers' ability to service that debt in an already-weak domestic demand environment. The external sector has been a bright spot in Hungary's recovery, so signs of further deterioration on that front will put a rate cut on the table, but not just yet. (Andrew Husby)