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The Morning Briefing

North American Edition
Tuesday, May 1, 2012
6:30 am (EDT), 11:30 am (BST)
Allen Sinai, Chief Global Economist

GLOBE AT A GLANCE – Andrew Wroblewski, London / Pierre Ellis, New York

Equities: Europe slightly lower, Asia mixed. Japanese equity markets fell clearly. Other major Asian markets were mixed, however, albeit with trading thin as many markets were closed for a public holiday. European bourses opened lower and then seesawed through the remainder of morning trade.

Bonds: Europe mixed, Japan higher. JGB prices rose across nearly all maturities, with the yield curve steepening on the long-term end. European bond prices saw continued divergences, however, with German and Italian markets higher, but Greek, Portuguese and Spanish markets falling.

Currencies: Little changed. The dollar fell against the yen during Asian hours, but then recovered the ground lost in the morning European session, trading around ¥/$ 79.91. Against the euro, the US currency saw broadly similar developments, moving little changed near $/€ 1.325.

United Kingdom: Manufacturing stutters as exports soften clearly. Coming in below expectations this time around, the headline manufacturing PMI for April dropped afresh.

China: Faster expansion in manufacturing. The semi-official (NBS and CFLP compiled) manufacturing PMI showed a modest 0.2 point increase in the headline index to 53.3 in April.

Australia: Rates cut, scope for further easing? Confounding market expectations of a 25 bp rate cut, the RBA decided to reduce the Cash Rate by 50 bp at its meeting in May.

U.S. ECONOMIC AND CREDIT MARKET OUTLOOK – Pierre Ellis, New York

Long Treasuries were modestly firmer Monday, with the ten-year yield slipping two basis points while the two-year yield held steady. All of the gain was achieved in overnight trading, with prices moving within a very tight range through the U.S. day. Activity was light, and no strong themes were evident. Reaction to new economic data was minimal.

Personal **income and consumption** results were broadly in line, though a somewhat firmer than expected +0.4% income result (Consensus and Decision Economics: +0.3%) did incorporate a better result for wage and salary income than might have been expected on the basis of the payroll employment data—a bit of good news for the sustainability of consumer spending.

A devastating 6.0-point drop in the headline **Chicago Purchasing Managers' Survey** index (Consensus: -1.7 points; Decision Economics: -0.4 point), meanwhile, was all but ignored—probably because sharp, purely local, swings in these numbers, often reversed the following month, are fairly common. However, any significant weakness in the ISM today would have more credibility for the fact that it was preceded by weakish indications from all the main regional reports.

DAILY CALENDAR

Scheduled today are the weekly store sales reports from ICSC/Goldman Sachs and Redbook Research, at 7:45 EDT/11:45 GMT and 8:45 EDT/12:45 GMT respectively, a speech by Minneapolis Fed President Kocherlakota, at 9:30 EDT/13:30 GMT, the April ISM Survey and March construction spending, both at 10:00 EDT/14:00 GMT, as well as speeches by San Francisco Fed President Williams, at 11:00 EDT/15:00 GMT, Chicago Fed President Evans and Atlanta Fed President Lockhart, appearing together at 12:30 EDT/16:30 GMT, and Philadelphia Fed President Plosser, at 15:00 EDT/19:00 GMT. April light vehicle sales reports from manufacturers will be appearing through the day.

The most closely watched data release of the day will be the ISM survey, which should bring some clarity to a manufacturing situation rendered very uncertain by the March employment report and by the quite choppy April regional purchasing manager surveys received so far. Other economic data reports will be of interest only if they surprise—and then might be of extreme interest.

Among the Fed speakers today—kicking off the normal post-FOMC roundtable of alternate opinions and forecasts—the only one not locked into a strong hawkish or dovish view, and also a pivotal voter on the FOMC, is Atlanta Fed President Lockhart.

Odds are, his acquiescence, along with that of companion middle-of-the-road voter Cleveland Fed President Pianalto, would be necessary in order for the Committee to take any new policy step—since enthusiastic doves among the voters, who have a majority, would probably hesitate to act without some semblance of a broader consensus.

The headline **ISM index** is expected, at least among pre-Chicago-survey forecasts, to hold roughly steady (Consensus: -0.4 point, to 53.0; Decision Economics: +0.6 point)—a result that would imply that the widely scattered, but generally weaker, results from the regional surveys reflected strictly local conditions, or idiosyncrasies of the individual surveys.

Of course, the weakness in the regional numbers might, in fact, have reflected a national slowdown, and clear evidence of that today would add to the reasonably widespread concern that the economy will slow this year—just as it did after fast starts in each of the last two years. That concern was only heightened by the surprising, and perhaps unwanted, acceleration in first-quarter inventory growth.

Of course, a strong reading today, on top of the inventory buildup, would hint that manufacturers are getting considerably bulled-up about the outlook. That would be a genuine surprise to markets.

Regarding the other indicators, the **store sales reports**, this time covering the final April week, will be watched for continuation of the same broadly in-line performance—which is a bit less firm than the March trend, because the Easter shift is currently depressing sales comparisons. In the background is the issue of the resilience—so far—of discretionary spending, even in the face of high gasoline prices. If sales weaken significantly today, confidence in that resilience would weaken too—encouraging the camp expecting a general economic slowdown.

Construction spending numbers are seen showing a fairly lackluster month (Consensus: +0.5%; Decision Economics: unch)—a result that would shake no views on the broad economic outlook. The special interest in the report reflects the important role of these numbers in underlying two dramatic moves within the Friday GDP report—the jump in residential investment (+19.1%) and the drop in non-residential structures investment (-12.0%).

There is always some potential for significant multi-month revisions in the monthly construction numbers (annual revisions will come too, in a few months), and those might combine with a surprising, or not too surprising, result for the new number to point to a significant GDP revision—one that might affect the interpretation of the quarterly result.

Light vehicle sales are seen rising very modestly from the 14.3-million March total (Consensus: 14.4 million; Decision Economics: 14.5 million). However forecast misses of 0.5 million are not too uncommon in these numbers—and a surprise of that magnitude would strongly impact thinking about consumer willingness to make big-ticket purchases. Obviously, a strong-side result would ease worries about consumer leadership of the economy in this treacherous period, while a weak-side result would play to the worries of the slowdown camp.

Lockhart will be appearing, with ultra-dove **Evans** in a discussion of "The Limits of Monetary Policy in an Interconnected World" at the annual Milken Institute conference. This clearly presents him with an opportunity to give his take on the developing state of the economy—and to hint whether he is beginning to tip, ever so slightly, in the direction of seeing benefits from more easing beginning to outweigh costs. Odds are, he would want to see the next employment report before even hinting at such a thing, but surprises do happen.

CANADA – Melissa Pumphrey, New York

(Monday) Monthly GDP down on manufacturing and mining declines. Gross domestic product unexpectedly contracted by 0.2% m/m (Consensus and Decision Economics: +0.2%) to C$1.28 trillion. Manufacturing fell 1.2% for the month on lower durable and non-durable goods production. Mining activity posted a 1.6% drop as weak foreign demand for potash and safety concerns in nickel mines led to temporary closings. Utilities declined 1.9% as mild weather resulted in lower demand for electricity and natural gas.

Retail trade fell 0.4% m/m as auto sales moderated after a record January. Wholesale trade (+1.5% m/m) and construction (+0.5% m/m) mitigated the declines. Real estate broker activity rose 1.1% m/m, while public sector output was flat.

The details of the data lend support to BoC projections that consumption and housing will fuel growth, while trade and the public sector will contribute little. The Bank of Canada is forecasting 2.4% growth this year, but a strong pickup in activity will be necessary as annualized growth so far is running at -0.6%. Markets have become jittery recently as BoC governor Mark Carney has hinted at forthcoming rate increases, but this soft data should table the tightening talk for now.

(Monday) Low crude, high gasoline drive March industrial price indices. The raw materials price index (RMPI) posted a 1.6% m/m decline for February (Consensus: +0.3%; Decision Economics: +1.5%). The drop was primarily due to crude petroleum prices falling 3.8% for the month—the fourth consecutive decline. The RMPI fell 5.6% y/y, while the RMPI ex mineral fuels (which includes petroleum) increased 0.3% m/m. The industrial product price index

(IPPI) increased 0.2% m/m (Consensus: unch; Decision Economics: +0.3%), the third consecutive gain for the index, mostly due to higher coal and petroleum product prices. Gasoline prices rose 4.7% m/m and softwood lumber increased 1.3% m/m. The IPPI has increased 0.9% y/y, but still remains below its 2011 peak.

Gasoline product prices in the IPPI are more closely tied to Brent and West Texas Intermediate (WTI) crude oil which rose throughout March. However, the crude petroleum prices in the RMPI are closer to Western Canada Select (WCS), which has been selling at an increasingly large discount to both Brent and WTI over the past few months. Manufacturers should be breathing easier on widening margins as year-over-year changes in the IPPI exceeded those of the RMPI for the second consecutive month.

WESTERN EUROPE – Andrew Wroblewski, London

UNITED KINGDOM – Manufacturing stutters as exports soften clearly. Coming in below expectations this time around, the headline manufacturing PMI for April dropped afresh, losing 1.4 points to 50.5, the softest reading since the end of last year. The drop was mainly a result of a softening in orders, in particular on the export side, supposedly the steepest fall in the latter since May 2009. Cost pressures lessened but prices charged hit the highest in seven months.

The drop this time has to be put into perspective of the month-to-month swings seen so far this year, all still delivering above-par readings. Indeed, despite the softening in the April reading, the outcome is still in line with the long-term average. In addition, the softer reading in these PMI numbers are at odds with other alternatively-sourced survey data such as those from the CBI, which paint a much more upbeat picture of UK manufacturing in which the broad-based improvement in orders seen so far this year remained very much intact in April.

Even so, these numbers will be keenly examined by the BoE: after all, the MPC has been keen to play down weakness in official data, including the further fall in Q1 GDP, by suggesting that the economy is actually doing better given the relatively upbeat message from survey data. Therefore, these PMI numbers will give it food for thought.

However, it is still unlikely that even if other survey data due in the next week falters that the BoE would sanction further asset purchases at the MPC meeting on May 10, probably preferring at least another month of numbers to get a better handle on the state of the real economy as well as being more wary about the inflation backdrop, the latter worry only likely to have been stoked by these PMI numbers.

JAPAN – Andrew Wroblewski, London

Vehicle sales growing strongly. April data saw an eighth successive positive reading in regard to vehicle sales. Indeed, sales rose by 92.0%, up clearly from the 78.2% rise of the previous month. Subsidies and base effects help explain the strength.

ASIA – Chang Liu, London

CHINA – Faster expansion in manufacturing. The semi-official (Federation of Logistics and Purchasing and the National Bureau of Statistics-compiled) manufacturing PMI showed a modest 0.2 point increase in the headline index to 53.3 in April, a fifth straight increase and now the highest reading in a year. This was a reflection of faster expansion in output and stable growth in employment, outweighing fairly broad based deterioration across other components.

Commenting on these results, an NBS economist noted that the slow but continued growth in the headline index, alongside a modest slowing in the new orders component, suggests that the economy is stabilizing, but with some uncertainty still remaining.

INDIA – Exports fall. Data for March showed exports falling by 5.7% Y/Y, more than unwinding the 4.3% gain seen in the previous month, albeit the first negative reading in the cycle. Import growth, however, actually picked up slightly to 24.3% Y/Y from 20.6% in the preceding month, boosted by a jump in non-oil import growth, outweighing the slowing for oil imports. The trade balance, meanwhile, showed a deficit of $ 13.91 bln.

INDONESIA – Consumer price inflation rises. Coming in slightly above expectations this time around, consumer price inflation rose to 4.50% Y/Y in April from 3.97% in March, a second successive rise and now a seven-month high. The latest increase was a reflection of a clear rise in price pressures for food (6.72% from 4.56%), outweighing falls for clothing (7.17% from 8.47%).

However, and notably, core inflation (which excludes food, energy and administrative prices) actually slowed slightly to 4.24% Y/Y last month from 4.25% in March, now a new cycle-low.

SOUTH KOREA – Further fall in price pressures. Confounding market expectations of a rise, consumer price inflation actually fell by 0.1 percentage point to 2.5% Y/Y in April, a 21-month low and now below the BoK's target ceiling of 4% for a fourth straight month. The latest decline reflected clear drops in price pressures for clothing (4.4%

from 5.0%) and health (1.0% from 2.3%), outweighing an increase for food (5.4% from 4.9%). On a M/M basis, prices were actually flat. Elsewhere, and notably, the core rate fell by 0.1 percentage point to 1.8% Y/Y last month, now a fresh cycle-low.

Exports fall. Data for April showed exports falling by 4.7% Y/Y, a third fall in four months but still unable to unwind much of the 20.6% surge seen in February. Imports, meanwhile, fell by 0.2% Y/Y following a 1.4% fall in March. The trade surplus, as a result, narrowed clearly to $ 2 153 mln from $ 4 348 mln in the same month of 2011.

THAILAND – Price pressures fall. April consumer price inflation fell to 2.47% Y/Y from 3.45% in the previous month, a fourth drop in the past five months and now the lowest in more than two years. Meanwhile, in M/M terms, prices rose by 0.42%.

The Y/Y breakdown revealed the latest rise in price pressures to be a reflection of a sharp drop in food inflation (4.51% from 7.07%), alongside moderate falls for non-food (1.18% from 1.23%) and raw food & energy (3.33% from 5.16%) inflation. As a result, core inflation (which excludes fresh food and fuel prices) showed a less marked fall last month to 2.13% Y/Y from 2.77%, a new cycle-low.

OCEANIA – Chang Liu, London

AUSTRALIA – Rates cut, scope for further easing? Confounding market expectations of a 25 bp rate cut, the RBA decided to reduce the Cash Rate by 50 bp at its meeting in May, ending a run of three straight decisions to hold policy, but all following the two successive 25 bp rate cuts at the end of 2011.

The statement by Governor Stevens following this meeting showed some notable changes. However, beginning with a largely unchanged assessment of the global economy, the RBA once again noted that growth was likely to continue at a below-trend pace this year but with no sign of a deep downturn occurring. Specifically, while conditions in Europe remains very difficult, the US is showing a continued moderate expansion and the Chinese economy is still expected to remain at a more measured and sustainable pace of growth going forward.

In terms of the domestic economy, the RBA noted slower-than-expected output growth over the past year despite the fastest domestic demand growth in four years, dragged down by effects of the high exchange rate and various temporary factors. Diverging performances between sectors were also noted again, with considerable structural changes occurring in the economy once again emphasized, while labor market conditions were seen has having steadied in recent months. In regard to inflation, the RBA noted that recent data showed CPI inflation had been lower than expected, with the underlying rate shown to have been just over 2% over the past year while the headline measure fell to around 1½% in the last quarter from 3½% previously. Both rates are still expected to remain in the 2-3% range going forward.

However, new this month, the Bank devoted nearly two paragraphs to the topic of funding and borrowing costs in the economy. Observing a general improvement in financial market sentiment, the Board noted that, while funding costs have declined in recent months, they remain higher relative to benchmark rates than in mid-2011. This has, in turn, led to some increase in borrowing costs as lenders passed on their higher costs of funding (albeit still being close to their medium-term averages). However, the Board also emphasized that market sentiment remains skittish due to sovereign debt and banking sector problems in Europe and that these remain a potential source of adverse shocks going forward.

Overall it seems the latest rate cut was, unsurprisingly, motivated by the Board's view that evidence in recent months showed both slower-than-expected growth and inflation, hence providing both rationale and scope for a further easing in monetary policy to support demand. In justifying the size of the latest reduction in rates, the Bank highlighted its desire for financial conditions to be easier now than those in December 2011, and a reduction of 50 bp was seen as necessary to achieve the appropriate level of borrowing rates in the economy. The latter point concerns the fact that the largest banks in the nation had failed to fully pass on the 25 bp CR cut in December to borrowers due to rising funding costs, and with the latest reduction in rates also likely to be only partially passed on to borrowers.

Thus, going forward, recent price data seems to show scope for further policy easing if needed, albeit with any such decision likely to be depend on both on economic data and developments in borrowing costs in the economy. Insights into any possible further easing may be found from updated growth and inflation projections arriving with the quarterly Statement on Monetary Policy due to be released Friday.

Deeper contraction in manufacturing. The April Performance of Manufacturing Index fell clearly by 5.6 points to 43.9, now implying deeper contraction in the sector and the second-lowest outcome in the cycle. The breakdown revealed a sharp swing into contraction for production, alongside steeper contraction in new orders and employment.

House prices fall further. According to the Australian Bureau of Statistics, house prices fell by 1.1% Q/Q in Q1, accentuating the 0.7% fall in Q4 and now a fifth-straight negative reading. Meanwhile, on a Y/Y basis, house prices dropped by 4.5%, following a same-sized drop as in Q4.

NEW ZEALAND – Labor cost growth slows. According to the Quarterly Labor Cost Index, Q1 labor costs rose by 0.5% Q/Q for ordinary-time wage rates, down slightly from the 0.6% gain seen in Q4 albeit still the joint second-highest pace in the cycle. Y/Y wage cost growth, meanwhile, was unchanged at 2.0% for a third straight quarter, as a rise in private sector wage growth offset the slowing in the public sector.