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The Global Markets Weekly

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Euro-skeptics Rule After Sunday?

Investors are trying to deal with a prospect of a new Socialist regime in France, with the specter of confiscatory taxation and a return to increased deficit spending. The true differences between the two parties have been exaggerated and any of the division that Hollande may have with Germany may be helped by a rapid meeting between the new president and Merkel.

This will be there first meeting of the two leaders and if Germany is really prepared to keep the euro intact, they will need to consider changing policy in reaction to the new political realities. Investors sense some coming relaxation of the fiscal compact as well as some contemplation of a Eurobond, which is tantamount to some sharing of Eurozone wide fiscal responsibilities.

In any event, the ability of either candidate to change policy radically in France is constrained by the lack of parliamentary backing. The French parliament will be re-elected in mid-June and the presidential results so far suggest that the party in power may not have an impressive mandate. Still, the risk is that the elections will increase the profile of the euro-skeptic factions, putting greater pressure on Germany to either retreat to move forward.

- **U.S.**: Investors will be attuned to the question of the Fed's reaction to another soft jobs report, with a number of speakers mainly hawkish on tap. The data calendar is relatively light with an acceptable **PPI report** as well as a widening of the **trade gap** likely. Investors will take note if consumer sentiment swoons in reaction to the disappointing jobs data and the depressing news in Europe.
- **Eurozone:** In addition to the French election results above, signs of a buckling in **Germany** may be forthcoming in the IP. Even if the figures are strong in March, the Q1 average may be flat. Still, this may be weather related rather than Germany being dragged down by the periphery. National results from **France** and **Italy** will be mixed but the **Spanish** results should be so bad as to touch off renewed worries.
- **UK:** The **BoE** is unlikely to act at this week's meeting, although the upcoming inflation report (May 16) may open the dose of fresh stimulus. The BoE continues to put more weight on the more promising survey data rather than the official data that shows the economy in a mild downturn and some members are concerned about resilient inflation. Data flow includes some mixed **IP** updates but a mfg. bounce. The **PPI** data will be less worrisome.
- **Central bank roundup:** The **Norges Bank** should keep policy on hold, inline with projections, more upbeat activity data and still strong Krone keeping inflation at bay.
- **Japan:** This weeks **Q1 GDP report** should show growth probably accelerating to 0.5% in Q1 after a 0.2% drop in Q4. New reading on the **leading and coincident indicators** will present no worries. The April **bank lending** from the BOJ survey should show sustained lending growth. April money supply data should be close to 3% march pace, continuing the gradual accumulation of real-money spending power.
- **Emerging Markets/Regions:** Four central banks we follow meet this week. **South Korea** will keep rates unchanged, as policymakers are not ready to move despite slow growth and weakening export performance. **Poland** will continue its wait and see policy with concerns about sticky inflation despite worries about an output shock from the Eurozone. In **Indonesia**, another hold is looming, with growth robust and annual inflation having picked up to 4.5%, the middle of the target range. Rates will also be **unchanged** in **Malaysia**, with the economy in a sweet spot. IP data releases from **China** and **India** should have broad impact should they prove weaker than expected.

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Focus: US Budget Update: Will There Be a Romney (Ryan) Budget?

President proposes, Congress disposes. As expected, President Obama's budget has gone nowhere on Capitol Hill. Even in the Democratic Senate, the White House budget has been replaced by the 2010 Bowles-Simpson (BS) deficit reduction plan. The head of the Senate Budget committee Conrad (who served on the BS commission) has broken with tradition and is asking his members to base their own recommendations on a $4.3 trillion version of the BS plan. Conrad admitted his efforts will have no impact on short-term spending decisions: The Budget Control Act passed as part of the debt ceiling extension established discretionary spending limits for fiscal 2012 and fiscal 2013. Few observers think that Conrad's plan will even get through his committee much less to a full vote by the Senate.

Unlike the Senate, the House has been busy. The House has already pulled together its own budget resolution and is working hard to translate those recommendations into specific appropriations and other legislation. The budget, drafted by Representative Ryan (who also served on the BS commission and is a front-running candidate for Romney's VP nominee), is quite similar to the one he offered last year. When DE wrote about the Ryan plan last year, DE stated that it "would be the most sweeping change in the federal government in 50 years." It would lower the top corporate and individual tax rate to 25%, close numerous loopholes (details to come of course), and reduce the federal government outlay share of GDP from 24% to 16% by 2050. While Ryan would continue to privatize Medicare and turn Medicaid into a block grant program, he now offers older people the option of staying in Medicare, an omission which caused a firestorm last year.

Fighting over $19B in fiscal 2013. Even though spending limits were set last year, the House plans to cut discretionary spending another $19B. This proposal is a no-go, since the Senate Majority leader has vowed not to entertain any changes.

Marveling from afar. At the release of the Ryan budget, the putative Republican presidential candidate Romney called it "marvelous." Romney's own budget plan, outlined in March, is similar to Ryan's. Romney outlined a 20% cut in corporate and individual rates paid for by unspecified loophole closings and budget cuts. However, as one commentator noted that Romney might want to "marvel from afar." First, the details of Ryan's budget will become available as the various House committees work on appropriations and authorization legislation for the fiscal 2013 budget. Cutting discretionary spending another $19B will bring on howls of protest from both sides of the aisle. Second, and perhaps much more importantly, the campaign pressure may force Romney and maybe even Ryan to start listing precisely what loopholes they want to close. The four largest loopholes are pretty popular—employer-sponsored health insurance, the mortgage interest deduction, pensions/401ks/IRas, and capital gains.

Obama can't wait for details from Ryan—or better yet, Romney. Former Obama officials are already calling for Romney to submit a detailed budget plan to use as campaign fodder. So far, the Republicans have not fallen for the trap. But the demands of the campaign might call for more details than have yet been made public.

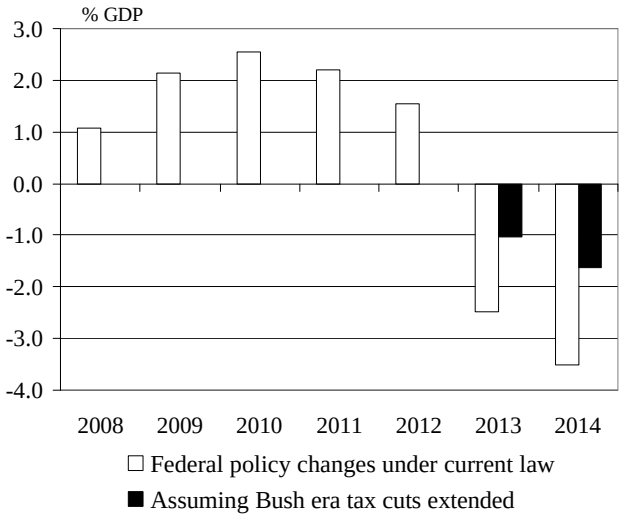
The looming fiscal cliff. The Federal government may hit the debt ceiling before the November election. This means that the "hair shirt" of the debt ceiling will complicate negotiations to deal with the potentially large swing in fiscal drag (white bars in chart) coming from the expiration of the mini-stimulus package ($182B), the Bush era tax cuts ($170B), and the budget cuts undertaken this year, including those under the automatic sequester ($68B). Bernanke called it a "massive fiscal cliff." Even if all of the Bush era tax cuts (including the AMT) are extended in 2013 (black bars in chart), the increase in fiscal drag could exceed 2% of GDP, historically very large, which many fear could cause very slow growth if not a mild recession.

Death or salvation at the fiscal cliff? But there is considerable room for bargaining. Even if Obama loses the election, he is still president on January 1, 2013. Obama wants to get rid of the automatic sequester, as do many conservative Republicans. Obama wants to extend the December 2011 stimulus while the Republicans want to extend the Bush era tax cuts for even high-income taxpayers. And, finally, both parties want tax reform and lower statutory rates for corporations. Imagine a scenario unfolding at year-end 2012 with (a) a reduced amount of fiscal drag, with the Fed implicitly ready to lean against the wind with QE3, (b) a $3 trillion plus grand budget compromise along the lines of the one that failed in August 2011, and (c) a joint call for meaningful tax reform. That outcome would be quite bullish for all dollar based assets. (M. Cary Leahey)

Table 1
Contractionary Fiscal Policy Actions,
(Billions of dollars, unless noted)

	2013
December 2011 stimulus	182
Bush era tax cuts expiring	170
High incomes above $250K	45
Health care/Medicare payroll tax	25
$1.2 trillion sequester	68
Total	445
%GDP	2.8

Chart 1
Fiscal Policy Is Turning Restrictive



Sources: BEA, CBO, JCT, and DE, Inc.

United States

How Soft is Soft?

The week ahead: The **employment report** capped a week of mixed evidence. While the closely watched **ISM** surprised on the upside with a healthy manufacturing reading, nonfarm payrolls rose a disappointing 115K. This is the second month of soft employment report as the recent hiring trend has slipped from 250K pace just three months ago to a pace of only 130K in the last two months. However, the latest weekly claims figure pointed to an improvement in the pace of hiring in May. So we think there is little reason to change the DE view of sub-par GDP growth, which is discussed briefly in a new section at the bottom of this page.

In a week with little data to chew on investors will be more attuned to Eurozone developments and on comments from Fed policymakers in the wake of another disappointing jobs report. The most important key reports are the trade gap, PPI, and consumer sentiment. Barring a major drop in sentiment, we will gather little new guidance on the near-term outlook.

Downside risk to consumer confidence. Most forecasters expect the early results for May consumer sentiment to hang near the 76.4 reading of April (DE: 76.0; consensus 76.4). The risk is that confidence could weaken in the face of another middling jobs report and the reports of the strains overseas.

A widening trade gap to hurt Q1 GDP. The **trade gap** surprisingly fell from $52.5B in January to $46.0B in February. The Commerce Department in calculating Q1 GDP assumed that the March estimate would be little changed from February. Both DE and the consensus expect a sharp widening (DE: $47.5B; consensus $49.9B. A wider trade gap could pull down Q1 GDP growth to 2.0%.

An acceptable PPI report. Another satisfactory **PPI** report seems to be in the cards with modest gains in the headline (DE: +0.1%; consensus) and core (DE and consensus: +0.2%).

Fedwatch: Doves gaining the upper hand? Another month of generally disappointing results increases the chances of further action by the Fed later this year. The key dove **Bernanke** is speaking on banking issues (Th) but investors await any comments on the macro outlook. The lone centrist, **Pianalto** (Wed, voter 2012), will be of interest. The hawks constitute the remaining speakers with **Lacker** (Mon, Tu, voter 2012), **Fisher** (Tu, voter 2014), **Kocherlakota** (Wed, Th, voter 2014), and **Plosser** (Th, voter 2014).

DE View on the Fed: While the recent data have been generally soft, we still expect subpar 2 ½% growth this year, high enough to keep QE3 on the table but unused. It is an open question if an intermediate policy action such as selling Treasuries to purchase mortgages is undertaken. DE still think that the Fed is keeping its powder dry to lean against the expansion faltering in the face of tighter fiscal policy at the end of 2012. A situation in which the White House and Congress acts "responsibly" by reducing the "massive" fiscal cliff and undertaking medium term fiscal consolidation could be rewarded by the Fed easing credit another notch.

DE Forecast & Investment Themes:

- **GDP:** A moderate, increasingly entrenched expansion is forecasted, with GDP growth of 2 ½% in 2012 and a bit less in 2013. Ongoing debt deleveraging and increasing fiscal consolidation efforts restrain growth.
- **Inflation:** Headline CPI inflation fades from 3.1% in 2011 to 2 ½ in both 2012 and 2102. Oil prices remain high, while core inflation continues to grind higher as the expansion continues.
- **Interest Rates:** A more entrenched expansion and stable above 2% inflation persuades the Fed to finally hike rates by mid-2013. Intermediate-term and longer-term Treasuries will front-run the eventual Fed move. But a safe-haven bid will refrain the backup in interest rates, with 10-year note unlikely to reach 3% before 2013.
- **Equities:** We remain strategically bullish while admitting the significant downside risks. Domestic **e**quity fundamentals remain supportive. Trailing EPS rises from $97 in 2011 to $105 in 2012 and to $113 in 2013. Assuming a conservative multiple of 13 implies a fair value estimate of 1350 for the S&P this year (about where it is now) and 1450-1475 for next year. Earnings so far in Q1 have been surprisingly strong with an 8% y/y pace likely. These estimates incorporate assumptions of positive but sub-par U.S. growth, a mild Eurozone recession, and a relatively "soft-landing" in EM nations.
- **Currency:** The underlying fundamentals suggest a weaker dollar, given the large current account gap. But growth differentials in the U.S. compared to other industrialized nations suggest some near-term support. Once the Eurozone recession has run its course this year, DE expects the trade-weight dollar to be down about 5% from its December 2011 average.

(M. Cary Leahey)

Canada

What A Difference A Day Makes!

The week ahead: Building permits (Mon., 8:30 a.m.) tends to be quite volatile but still is a leading indicator for the business cycle. **Housing starts** (Tues., 8:15 a.m.) will likely remain above the sustainable long-run pace as rising home prices and low interest rates fuel activity. **International trade** (Thurs., 8:30 a.m.) will likely show a small surplus as stronger commodity prices are somewhat offset by a stronger loonie. Expect export demand to remain muted until headwinds from Europe subside. The **net change in employment** and **unemployment rate** both arrive Friday (8:30 a.m.).

The net change in employment will be watched closely for either a continuation or reversal of momentum from the colossal March +82K print. Looking forward a monthly average of +25K would indicate moderate and sustainable progress towards full employment. A disappointing employment report would give the market additional evidence to think the BoC would continue to hold rates for the time being.

When will rates increase? In the April 17 meeting, the BoC hinted that "reduction of monetary stimulus" would likely become appropriate and therefore a tightening was modeled into the BoC economic projections. Since then, markets have been jittery. The table to the right shows the change in probabilities of the timing of interest rate hikes as implied by overnight indexed swaps on Monday, April 30th versus three days earlier.

Why the major move towards holding rates steady*?* Disappointing February monthly GDP (-0.2% m/m) stunned the markets as the rosy Canadian outlook was dampened. With the tame U.S. April unemployment report on Friday, May 4, the call for rates to remain unchanged grew even louder. Expect the market to keep overreacting to each major piece of economic news from Canada, the U.S. and Europe.

BoC projections are long-term. It is important to remember that the BoC projections are through 2014. Likely, the hawkish tone of the BoC was a hint to Canadian households to stop adding to household debt loads as debt servicing costs, of course, will rise with interest rates.

Table 1
Projected Policy Rate Probabilities Implied by OIS, from 4/30/2012

	5-Jun	17-Jul	5-Sep	23-Oct	4-Dec
unch	74.2	58.0	42.9	30.2	24.2
+25 bps	25.8	36.4	42.0	42.3	39.9
more than +25 bps	0.0	5.6	15.1	27.6	35.9

Table 2
Changes in Policy Rate Probabilities from 4/27/2012, bps

	5-Jun	17-Jul	5-Sep	23-Oct	4-Dec
unch	10.9	16.6	13.6	14.3	10.7
+25 bps	-10.9	-9.5	-2.6	4.7	5.6
more than +25 bps	0.0	-7.1	-11.0	-19.0	-16.3

Sources: Bloomberg and Decision Economics, Inc.

DE Forecast & Investment Themes:

- **GDP:** While the BoC is forecasting 2.4% growth for the year, the DE forecast is for a more modest 2% gain. Risks tilt towards the downside. Tensions in the Eurozone, both political and economic, are still significantly elevated and the recessions appears to be deeper and more persistent than initially expected. The U.S. recovery seems to be on softer footing of late. Domestic consumption and housing are expected to provide two-thirds of GDP growth this year, but rising household debt levels and an overheated housing market make the domestic backdrop quite fragile.
- **Inflation:** Prices are likely to remain close to the +2% y/y target for the year. Currently, the core and headline indices are both running slightly below at 1.9% y/y.
- **Interest Rates:** Policy rate on hold at least until late 2012. The BoC likely will not tighten before the Eurozone stabilizes and U.S. economic data shows more consistent firmness.
- **Currency:** The loonie is supported by relatively strong demand for Canadian commodities from emerging markets, and is considered a safe haven currency. So long as the emerging markets have a soft landing, expect the strength of the Canadian dollar to persist.

(Melissa Pumphrey)

Eurozone

ECB Confidence to be Tested Further

The week ahead: The ECB has made it clear that while weaker data seen over the last month has made for a more uncertain outlook, *the central bank wants (at least) another month's worth of data before making any fundamentally more negative assessment of the economic backdrop and outlook.* This view may be reiterated in a **speech by ECB President Draghi** on Tuesday. Regardless, the round of industrial production data due in the coming week now look all the more important, especially as these will help provide a better insight into the Q1 GDP results that the Eurozone economies will produce in the middle of the month.

DE view: The ECB is right not to be swayed overly by a month of worse-than expected survey data: these merely underline that recession continues without necessarily meaning that it has yet deepened. Even so, *the weaker survey numbers underscore that there is as yet no end in sight for the recession*, also possibly hinting that even in the vanguard economies, economic activity has taken a turn for the worse.

Is Germany buckling? Business survey data have been decidedly mixed of late with weak PMI readings moving further away from the continued above-par figures from Ifo. More notably, consumer sales figures have remained trendless, while the last week has seen *hints of a turn for the worse in the German labor market*. All of which should put more emphasis on the potential key **German industrial production** update due this Tuesday. Most likely the data will see a clear jump in overall production (Consensus: 0.7% M/M; DE: 1.5%), including both manufacturing and construction after weather-induced weakness in February. Even so, such a jump may leave the Q1 aggregate flat or even negative, implying that unless service sector activity picked up, German GDP may actually have suffered a further fall in Q1: DE currently envisaged a flat reading (data due May 15). Regardless, rather than a clear sign that Germany is being pulled down by weakness in the Eurozone periphery, any such GDP weakness may be more a result of weather distortion with the underlying German economy getting resilience from its relatively healthy banking sector, competitive exports and lack of fiscal tightening. However, *continued weakness in German GDP may help dilute the clear German-led resistance within the ECB Council to further easing*.

Mixed production readings elsewhere. French industrial production data may show a clear drop in numbers due on Thursday (Consensus: -0.3% M/M; DE: -1.3%), albeit only because (unlike Germany) they do not include the construction sector, with the weakness instead a result of a drop back in energy output after a cold February. **Italian industrial production** data (Thu) may show a modest rise (Consensus: unch M/M; DE: 0.5%), albeit not by enough to prevent a further sizable fall having occurred in Q1, the latter perhaps being a clear hint that GDP contracted further and clearly again last quarter. Finally, **Spanish industrial production** numbers (Mon) may show a less sizeable Y/Y drop, echoing the less downbeat retail sales figures seen of late. Such data would tend to echo the tone of the only modest 0.3% Q/Q drop seen in Spanish GDP last quarter, albeit with *the clear risk that the major downside risks facing Spain will only start to materialize from the current quarter*: DE expects a drop of around 1% Q/Q in Q2 Spanish GDP.

A change at the helm in France? Opinion polls strongly suggest that Sunday's second round of elections will see President Sarkozy lose to Socialist candidate Hollande. Much has been made of apparent differences in the policy agendas of the two, especially on the fiscal side. These differences have been exaggerated and any of the division that Hollande may have with Germany may be assuaged by what may be a rapid meeting between himself and Chancellor Merkel in the next week. Regardless, it must be underlined that *whoever wins the presidency this week-end, their effective ability to change policy radically may be very much constrained by a lack of parliamentary backing*. Next month (June 10 & 17) sees France re-elect its parliament; if the results of the first round of the presidential election are anything to go by, the electorate may not be willing to give whoever wins the presidency clear backing, especially with the risk being that the *parliamentary elections could see euro-skeptic parties get a higher profile.*

DE Forecast & Investment Themes:

- **GDP:** Recession continues, with the uncertainty being both the geographical breadth and length of the contraction. DE sees GDP falling on average by a below-consensus 0.6% in 2012, with activity stabilizing in the second half of the year, but with only an anemic sub-1% rise seen in 2013.
- **Inflation:** Headline HICP inflation has been above the 2% target since the end of 2010, largely due to food and particularly energy prices. DE sees the rate falling from 2.5% this year to 1.8% in 2013.
- **Interest Rates:** Main ECB rate likely to be cut by a further 50 bp in coming months, with more unconventional central bank measure also in the offing.
- **Currency:** Surprise resilience of the euro (against the dollar) seen persisting.

(Andrew Wroblewski)

United Kingdom

BoE on Hold – For Now!

The week ahead: Key BoE update awaited. Only a few months ago, UK money markets were clearly of the view that once the current program involving a further £ 50 bln of asset purchases was completed in May, the BoE would sanction a further enlargement at the key **MPC meeting** due to give its verdict this Thursday.

DE view: Now, however, the BoE is unlikely to do any more, at least at this particular juncture, although the next Inflation Report (May 16) may still leave open scope for more stimulus, as may the likelihood that any decision to freeze asset purchases this month will probably see clear dissents among the nine-strong committee.

The case for more stimulus. At first glance, the fact that the UK has moved back into recession would suggest that further stimulus may and should be on the cards, especially as the further drop in GDP seen in Q1 was very much in contrast to the recovery that had been implicit in BoE thinking for the early part of the year. In addition to which, it could be argued that more stimulus is needed to offset *the tightening in effective UK monetary conditions* that has arisen as a result of the rise in the (trade-weighted) level of sterling, alongside the rise in inter-bank rates (the latter now staring to feed through into mortgage rates).

The case against. However, while these two factors are likely to be part of the MPC discussion this week, the fact that they are still relatively small means that the issue of monetary conditions is unlikely to dominate policy thinking. Instead, *the MPC is likely to continue thinking that economic activity is stronger than the official GDP suggest*, a view clearly espoused by various BoE updates in the course of the last month. Admittedly, the BoE must be wary that any persistence of bad economic news may weigh on weak consumer and business confidence. Even so, the central bank (at least the majority on the MPC) has said it will be paying more attention to the relatively more upbeat survey data, well aware that the host of distortions, ranging from unusual weather, the leap year, and the additional holiday in Q2 may mean that official recorded GDP may be (artificially) depressed not just in Q1 but for the whole of the first half of the year. Indeed, there was actually a more hawkish tone at the last MPC meeting, in which the MPC majority asserted that with underlying activity recovering (ie excluding the likely distortions that may affect growth in the first half of the year), there was a greater chance than before that above-target inflation would persist into the medium term, whether because of elevated external price pressures, a rebuilding of margins or a rise in costs.

This worry about inflation resilience has been central to MPC member Posen's decision to reject further stimulus. *The question is the extent to which the inflation concerns some on the MPC have aired is merely a means to make markets more prepared for inaction this month* or, instead, is a genuine reflection of the changing views of the MPC. Most likely, it is the former.

Recent UK data unlikely to have altered MPC mindset. Admittedly, in the last week, manufacturing PMI data softened clearly. However, the latest result is still in line with the long-term average and also 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. Meanwhile, the services and construction PMIs remained strong, the latter result will have intensified BoE suspicions about the Q1 drop in GDP which was centered around the construction sector.

More notably, BoE numbers on underlying monetary dynamics showed slightly more reassuring messages in March data, figures that will clearly interest the likes of Governor King, who has often highlighted weakness in money growth. Indeed, the data showed a M/M bounce of 0.5% in underlying M4 growth, a result of which pulled the three-month annualized rate (possibly more closely watched by the BoE given the volatility in the numbers) back up to 6.4%, actually the highest since late-2007.

Better manufacturing numbers expected. This theme of data that will largely be acceptable to the MPC should continue in the holiday-shortened week ahead. **Industrial production** data (Thu) will be mixed, but should show a clear bounce on the manufacturing side (Consensus: 0.5% M/M; DE: 0.6%), otherwise, the already disappointing Q1 GDP may be due a downward revision. Meanwhile, **PPI** data (Fri) should show less worrisome price signals.

DE Forecast & Investment Themes:

- **GDP:** Official data suggest UK back in recession, but data has been hit by an array of distortions. Even so, underlying GDP growth is close to flat, with zero outcome likely for 2012. Hope is for something a little above 1% in 2013.
- **Inflation:** Headline CPI proving stubborn, partly a result of energy prices, but should still fall from around 2½% this year to under the BoE target of 2% in 2013.
- **Interest Rates:** Bank Rate on hold until 2014. As for unconventional policy, further enlargement of asset purchases possible later in the year, the latter helping to cap gilt yields.
- **Currency:** Tight fiscal and loose monetary policy provide mixed and directionless outlook for sterling, with the BoE likely to take note should the (trade-weighted) pound bounce materially further. (Andrew Wroblewski)

Other Europe

Sweden: How Clear a Bounce in GDP

The week ahead: The Riksbank has started to accept that the economy may not be as weak as it thought earlier in the year. Certainly, recent retail sales numbers point to a clear recovery having occurred, but survey data, while largely better, are more ambiguous about the extent of any recovery. This makes the key **industrial production** report (Thu) all the more important, with it likely that a decisive bounce may be seen after weather-distorted weakness in February. **CPI** data (Thu) is likely to remain soft, and in line with the projections made by the Riksbank back in February and will have negligible input into monetary policy thinking.

DE Forecast & Investment Themes:

- **GDP:** Economy recovering, but with feeble GDP growth of 0.5% likely on average this year, giving way to nearer 2% in 2013.
- **Inflation:** Headline and underlying CPI rate likely to remain below 2% target until late 2013.
- **Interest Rates:** Riksbank likely to be on hold until mid-2013, especially if Krona rallies afresh.

Norway: Norges Bank to Underline Policy Freeze

The week ahead: Having eased at its two last meetings, the 25 bp move in March having surprise many, the **Norges Bank** is very likely to keep policy on hold when it gives its next **verdict** on Thursday. This would be in line with the policy projections produced last time around as well as the more upbeat activity data seen of late and which Governor Olsen has pointed to in his most recent comments. As notably, the Norges Bank is unlikely to change its policy outlook, pointing to the still-strong Krone as a factor holding price pressures at bay. Underpinning the improved economic backdrop, **manufacturing** data (Tue) should show a clear M/M bounce in output. Meanwhile, **CPI** data (Thu) should confirm the absence of inflationary pressures, with the headline and core figures remaining in line with Norges Bank projections.

DE Forecast & Investment Themes:

- **GDP:** Mainland GDP growth of just under 2% seen both this year and next.
- **Inflation:** Headline and underlying CPI rate likely to approach 2% target by late 2013.
- **Interest Rates:** Norges Bank on hold until next year.

Switzerland: Economic Resilience Continuing?

The week ahead: Given the unexpectedly large drop in the PMI data released last week, markets may give a clearer airing to the Swiss economic data releases this week for any further sign that the clear resilience in the economy may be bucking. Admittedly, the sharp fall in the PMI data has not been corroborated by other alternatively sourced survey numbers. More such survey data appears this week, with **consumer confidence** figures on Tuesday likely to be less downbeat. Before then, on Monday, data should show a still clearly tight labor market with the **jobless rate** still just a notch above the recent cycle-low. The same day sees the next set of **CPI** numbers. These are likely to show further headline and core rate deflation but where the impact of the strong franc is clear: in March domestic good inflation was unchanged at zero Y/Y, while that for imported goods fell a little faster at -3.6%.

DE Forecast & Investment Themes:

- **GDP:** Recession, or even contraction, so far avoided, but with GDP growth still likely to undershoot 1% this year. Pick-up to 1.5% seen in 2013
- **Inflation:** CPI inflation to remain negative into early 2013, still averaging little more than 1% next year.
- **Interest Rates:** Rates on hold for at least another year: threat of fresh intervention to hold down Swiss Franc still being made by SNB.

(Andrew Wroblewski)

Oceania

Australia: Labor Market Data Awaited

The week ahead: Key updates awaited. Following the larger-than-expected policy easing by the RBA in the past week which came in response to weakening domestic demand and rising borrowing costs, the key question is whether or not the economy will show any signs of further weakening to warrant additional rate cuts incoming months. Clear hints of such action were provided in the latest RBA Statement on Monetary Policy. This obviously makes forthcoming data all the more of a focus for markets, with key numbers due this week. Survey updates arriving in the form of the **Performance of Construction Index** and **NAB business confidence** numbers start the week off on Monday, but with most of the attention likely be turned to an update on the consumer in the form of **retail sales** figures, which will receive more than usual notice this month as it includes an update on real sales figures for Q1. Expectations are for a largely similar gain compared to the previous quarter. **Visible trade** data for April (Tue) will also likely be closely watched for a possible recovery following the first back-to-back deficits seen in two years in March. However, even with the arrival of a slew of key data, the spotlight in the coming week will still fall on the **Labor Force Survey** for April (Thu), particularly as the RBA highlighted a possible deterioration in labor market conditions as a major risk to the domestic economy. Having weakened slightly since mid-2011, recent months have seen some stabilization in labor market conditions, a trend which should have continued through the last month.

DE Forecast & Investment Themes:

- **GDP:** Following disappointing results in Q4, GDP growth is still expected to pick up this year to around 2.75% Y/Y in the first half of year before then accelerating to 3.0% by year-end.
- **Inflation:** Having fallen to the lowest level since 1999 (of 1.6%) in Q1, headline CPI inflation is expected to drop further in the first half of the year to 1-1.5% before then picking up to around the mid-point of the RBA's target range of 2-3% by the end of 2012.
- **Interest Rates:** Given the hints from the latest (May) Statement on Monetary Policy, it seems further easing may be in store over coming months, with another 25 bp cut (to 3.50%) likely before the end of the year.

New Zealand: Survey Updates the Focus

The week ahead: PMI awaited. After a week of broadly downbeat data updates, the only positive note seems to be hints that a recovery may finally be picking up speed in the earthquake-devastated region of Canterbury. This was evident from a surge in building permits in the region in March, alongside a pick up in job numbers in Q1 which was partly responsible for bringing up the national participation rate to the highest level since Q4 2008. The **Performance of Manufacturing Index** and **QV House Prices** data both arriving Thursday will be watched for any further signs of improvement in a week otherwise relatively quiet in terms of economic data/events. Expectations are that the latest result will point to a continuation of the relatively solid expansion seen in the sector as implied by recent surveys.

DE Forecast & Investment Themes:

- **GDP:** A moderate expansion is expected in 2012 following a disappointing result in Q4, with GDP growth of 1½-2% envisaged and with growth picking up in the latter part of this year as the recovery in the earthquake-hit areas gains momentum.
- **Inflation:** Headline CPI is expected to ease further from the 1.6% seen in Q1 through the early part of the year, before picking up towards the end of 2012 as the recovery picks up, albeit remaining below 2% for most of 2012 and 2013.
- **Interest Rates:** The RBNZ will likely be on hold (at 2.50%) until at least 2013 as the New Zealand dollar remains elevated and after Q4 GDP came in below the Bank's forecasts.

(Chang Liu)

Japan

Checking Gauges

The week ahead: How much did the economy firm in the first quarter? Data in hand point to a moderate first-quarter GDP rebound, after the 0.2% decline in the fourth quarter, but the bigger issue is whether the normalization of growth will be sustained. No significant information came in the holiday-shuttered week just ended, and the week ahead promises little major news either—rather, it brings a handful of readings on the inner workings of the economy, to be read on a monitoring basis for any hints of malfunction.

DE view: GDP growth probably accelerated to a +0.5%. rate in the first quarter, with a good boost from consumer spending—some of it reflecting long-delayed disaster relief payments. Broader-based earthquake/tsunami reconstruction activity will help sustain growth in that above-trend range for a while, probably through year end, with a firming global growth picture gradually kicking in to support longer-term growth in the 1-1.5% annual range over coming years.

Composite indexes firmer in March. New readings of the **leading and coincident business conditions indexes** will spark no worries, with increases of 0.6% likely in the former and 1.2% in the latter.

Bank lending growth sustained. The latest BOJ Senior Lending Officers Survey pointed to some firming on the demand side of the market and some easing of conditions on the supply side—unambiguous, but very measured, good news on the flow of credit. April bank lending results should confirm that growth continued at least at the +0.8% year-on-year rate seen in March—the highest since October 2009.

Steady Monetary Growth. April money supply data will show M2 growth at a rate matching, or very close to, the +3.0% March pace—continuing the gradual accumulation of real-money spending power in a still modestly deflationary economy.

DE Forecast & Investment Themes:

- **GDP:** Near-term growth is boosted by the long-delayed arrival of earthquake recovery and rebuilding funds, pushing the economy modestly above trend growth for a period—beyond which an improving global market will lift exports and sustain overall growth at trend of about 1.3%
- **Inflation: I**nflation-targeting will force the BOJ, under its current management, or under newly installed management next year, to take steps to prevent any clear deviation from a path towards 1% core inflation over the next three years.
- **Interest Rates:** BOJ policy rates will not be noticeably increased before 2014, if by then. Longer-term rates will likely remain in the current range for 6-9 months, beyond which a fading in global safe haven demand, and increasing market conviction that the BOJ is serious about lifting inflation, will lift the ten-year JGP rate slowly towards 2.0%, and ultimately beyond.
- **Equities:** A strengthening domestic economy, the wholehearted focus of the government and the BOJ on weakening the yen, and low interest rates will create a favorable equity backdrop in coming years.
- **Currency:** Full-scale government and BOJ commitment to weakening the currency will eventually outweigh safe-haven flows as a determinant of the yen's level—promoting a significant decline.

(Pierre Ellis)

Emerging Markets

The week ahead: An abundance of price data on display from all regions of the EM world, showing by and large a continuation of the **benign inflation** trend in place—including, likely, some further disinflation in Brazil, and possibly in China.

GDP releases in Hong Kong and Indonesia (Q1-2012) are unlikely to be earth-shattering, with the former remaining one of the fastest growing economies in the region and the latter further slowing as the Chinese mainland cools.

Among the forthcoming **Industrial Production** figures, India's and China's have potentially broad impact should they prove to be weaker than anticipated. In China's case, consensus expectations are for stable year-on-year growth. DE's forecast is slightly below consensus. As regards India, the March figure may help clarify whether, as the RBI believes and PMI indices have recently suggested, industry is rebounding. Thus, from a market perspective, the result could—at least temporarily—tilt the balance of expectations, which have in recent weeks taken a clear turn for the worse, and pushed the Indian currency down.

Central Bank Watch

South Korea's central bank is likely to keep rates unchanged at 3.25%, as they have done since July of last year. There is no apparent reason for a tightening: inflation is low and diminishing (only 2.5% year-on-year in April, the lowest in two years), while economic activity is proceeding at a very modest pace, and remains under threat by a weak and weakening export performance. Thus, in principle policymakers should be closer to cutting rates than to increasing them. Yet they have not given any indication that they are ready to move, and in fact, as recently as last month, the stated view of the BoK's monetary policy committee was that there were signs of a moderate domestic-consumption acceleration, supported by employment gains, and that "the domestic economic growth rate [would] gradually return to its long-term trend going forward".

In **Poland**, the central bank will probably—despite some very public hesitations—keep interest rates on hold. At 3.9% year-on-year, inflation is significantly down from its cyclical peak, but still higher than the bank's ceiling (3.5%). Policymakers have expressed concern about the "stickiness" of inflation, with governor Belka stating that the possibility of a hike would be discussed in May. However, the economy is facing a growing adverse shock from the European recession, and the most recent statements by members of the Monetary Policy Council suggest an inclination to "wait-and-see", producing as well a justification for the prolonged above-target inflation as caused by supply-side factors outside the reach of near-term policy.

In **Indonesia**, another hold decision looms. A robust economy (growth in excess of 6% year-on-year, and probably accelerating), and possible increases in regulated fuel prices have translated into a full-stop to monetary policy easing by the central bank. Are they likely to reverse course and tighten? Not very soon—at least not in this week's meeting: the BI is clearly concerned about the potential for global conditions to hurt the economy; annual inflation has picked up a bit in the past three months, but at 4.5% it is right in the center of the central bank's target range (4.5% +/- 1 percentage point). Moreover, policymakers view a potential, fuel-price induced acceleration of inflation as likely temporary and possibly avoidable, as the government may not have to reduce subsidies anytime soon.

In **Malaysia**, Bank Negara will almost certainly keep rates unchanged (as it has done since June of last year). For now, and from the perspective of the central bank, the economy is in a sweet spot, with strong (but not exuberant) growth, inflation low and stable, and drops in food prices supportive of that trend. The latest policy pronouncement suggests that policymakers see risks to growth as the most significant at this point, stemming from apparent fragilities in the world economy, especially in Europe. Inflationary risks are described as present as well, but somewhat more hypothetical, such as the potential for financial speculation in commodity markets to lead to commodity-price acceleration once again.

DE Forecast & Investment Themes:

Soft landing materializing. A soft-landing scenario is gradually—but not yet fully—materializing across emerging markets. Economic activity has cooled, particularly on the manufacturing side, but conditions cannot be called recessionary even stretching the meaning of the term.

Stronger consumer, easier credit and prices… With few exceptions, consumer and investment spending remains well-supported, unemployment rates low; borrowing costs have diminished modestly as a disinflationary trend has taken hold.

…with possible inflation pickup on commodities. Central Banks remain watchful of a potential commodity-price induced re-acceleration of inflation, but for now caution leads them into either gradual easing or prolonged pauses following significant rate reductions. Across EM, rate increases appear likely to occur only as a result of exceptional domestic circumstances in the months to come.

Exports vulnerable to Eurozone crisis. EM Exports remain exposed, and are already growing slowly. There is some financial risk arising out of the lingering European debt crisis, making markets sensitive to euro-zone developments for the foreseeable future.

Growth likely to accelerate if Eurozone avoids "Lehman moment." From current perspective, it is reasonable to expect that if a full-fledged financial crisis is avoided in Europe, EM would likely experience a moderate rebound later this year and into 2013, on the basis if easier money, stronger US demand, plus a bottoming and modest re-acceleration of growth in China.

As China goes, other EMs follow. Emerging markets will probably replicate, more or less closely depending of size, economic structure and location, China's near-term growth pattern: further deceleration through the middle months of 2012, followed, later in the year and into next, by a moderate up-turn. Should the Asian giant slip into recession (or a recession-like stage, say 5%-to-6% growth), the pace of economic activity would be hurt significantly not just in manufacturing-oriented Asia but in commodity driven EMS there and elsewhere, as commodity markets would be heavily impacted. There is a reasonable expectation that such Chinese-recession scenario will be avoided, but Chinese policymakers' failure to shift towards easing creates some concern. (Francisco Larios)

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