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DE Global Markets Weekly

April 17, 2014

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FOMC Reaction Function

The concept of a fed "reaction function" has been prominent lately, both in a conspicuous mention in the latest FOMC Minutes and , second, as the central subject in the manifesto for Chairwoman Yellen's term represented by her Economic Club of New York speech.

Yellen avoided use of the technical phrase, but her discussion of the policy ideal of a well-understood relationship between data results and FOMC responses corresponded exactly to the mathematical concept—dear to Fed PhDs—of fixed relationship between any set of values of input variables and a unique output value.

She emphasized that a relationship well understood by the public—allowing the policy response to unforeseen shocks to the economy to be properly anticipated—would impart an "automatic stabilizer" property to the economic system.

Problem is, disagreement still exists within the FOMC as to the current values of the input variables, a topic which Yellen discussed extensively, and which did seem to be evident in the Minutes. At one point in the March meeting, "a number" of officials expressed concern that the "overall upward shift" in the federal funds rate dot-scatter chart "could be misconstrued as indicating a move by the Committee to a less accommodative reaction function," but "a number" of others responded that, effectively, the first group failed to perceive a change in an input variable, pointing out that the dot-shift "was arguably warranted by the improvement in participant's outlooks for the labor market…"

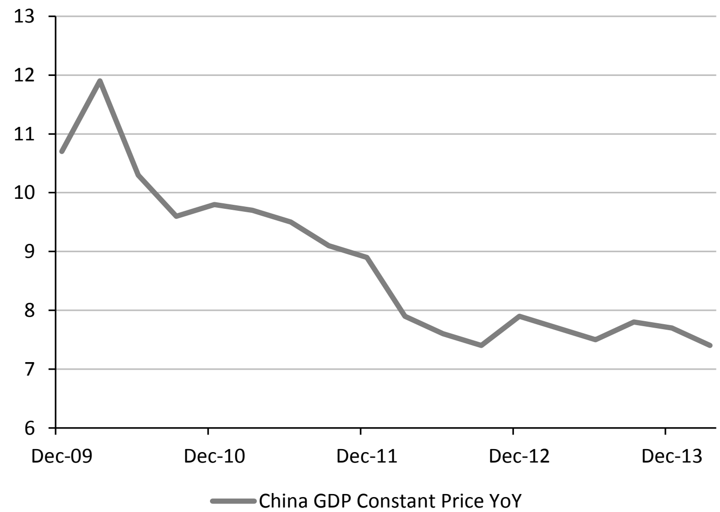
- **U.S.:** There is little high impact economic data this week. Instead, **company earnings reports** will be the market-movers, at least in terms of scheduled data, with 159 S&P 500 companies reporting.
- **Eurozone:** There may be even keener interest in the array of survey numbers due, as markets assess whether the Eurozone real economy may actually be developing a little added momentum. In particular, April **PMI Flashes** (Wed) will be examined all the more acutely.
- **UK**: Amidst what seems to be growing market concern about rising house prices, mortgage approval data from the **British Bankers' Association** (Fri) may be the most important data release this week.
- **Japan:** Work on the BOJ's semiannual *Outlook* report, due April 30, continues apace, and key data releases this week—the **merchandise trade balance** (Mon), and the **CPI** (Fri), might still impact thinking on the current motion in the economy, and on the outlook.
- **Emerging Markets/Regions:** In **China**, the only item of significance the **HSBC PMI,** expected to stay below the 50 mark, but moving slightly towards it. For **Korea**, Q1 real **GDP** arrives. The (reasonable) expectation is for a high annual rate of expansion **(Consensus: 3.8% Y/Y; DE: 3.9% Y/Y).** In **Mexico**, **Banco de Mexico meets**. The almost certain decision is to keep interest rates at present levels. In **Turkey**, the **TCB meets** (Thu) to decide on interest rates. Consensus expects a hold decision. That is not an unreasonable expectation based on fundamentals. However, there have been strong indications that the odds of a rate cut are high (40%-to-50%).

Focus on China's GDP: Weakening

Q1 Real GDP was announced overnight at 7.4% Y/Y. This is just above Consensus (7.3% Y/Y) and slightly above DE's estimate (7.1% Y/Y). The figure marks an unsurprising deceleration from Q4's result (7.7% Y/Y) but *it clearly describes a relatively stable path, not—on the surface—an alarming further downturn of real GDP growth.*

End of story? Probably not. The seasonally-adjusted series describes a sharper deceleration: annualized growth would have slowed from 9.5% in Q3-2013, to 7% in Q4-2013, to only 5.7% in Q1-2014. But the series (which has a short published history) is of doubtful quality: it seems to slow consistently in the first quarter of the year, despite the presumed seasonal adjustment.

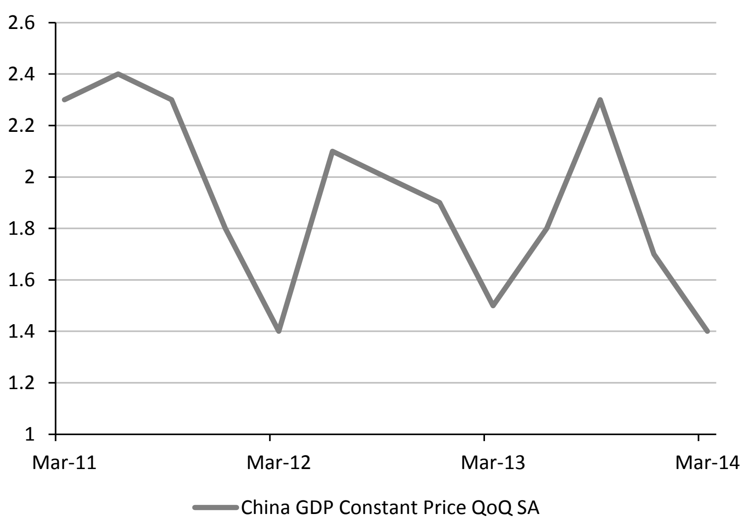
Chart 1
China: Real GDP
(Pct. Chg. Y/Y; NSA)



Source: Bloomberg, Decision Economics, Inc.

Still, a look at the high-frequency series released alongside real GDP (retail sales, fixed capital formation, industrial production) suggests that as of the end of the quarter the Chinese economy continued to decelerate, and failed to reflect any impact from the announced (limited) fiscal stimulus.

Chart 2
China: Real GDP
(Pct. Chg. Q/Q; SA)



Source: Bloomberg, Decision Economics, Inc.

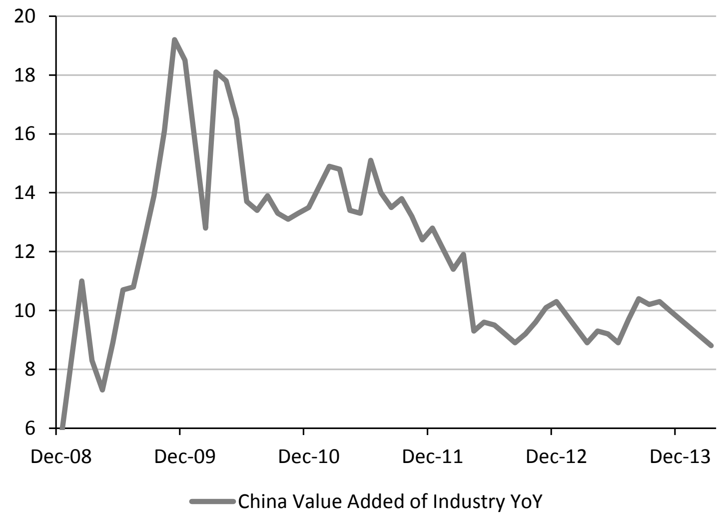
Urban fixed capital formation, for example, expanded 17.9% Y/Y during the first two months of the quarter, and 17.2% Y/Y in March, near the lowest pace of annual expansion for any month in close to a decade. Interestingly, despite the official rhetoric, public-sector investment decelerated marginally, from 14.8% Y/Y in Q4 to 14.5% Y/Y in Q1, private sector investment, whose share has increased from less than 50% a decade ago to almost two thirds of the total as of now, decelerated as well, a bit more markedly, from 19.8% Y/Y in Q4 to 19% in Q1 (it expanded 21.9% Y/Y in Q3).

Meanwhile, industrial production slowed a bit further, to 8.8% Y/Y, and retail sales, once adjusted for inflation, decelerated to 11% Y/Y, the lowest such rate since early 2012.

It must be said that none of these numbers represents a dramatic weakening. However, they are evidence of waning momentum and suggest that stimulus policies are either falling short on impact or short on implementation. This is especially important against the background of a tight monetary environment.

The bottom line: unless (a) exports accelerate significantly, and/or (b) additional government spending manages to lift domestic demand, current dynamics point to further deceleration during the second quarter, moving the rate of growth closer to the 7% mark.

Chart 3
China: Industrial Production
(Pct. Chg. Y/Y)



Source: Bloomberg, Decision Economics, Inc.

From the standpoint of policy, the data just released will probably not be enough to overcome the government's reluctance to more substantial fiscal and more orthodox monetary stimulus. But the odds of some relaxation of credit are growing, and the intensity with which spending plans are implemented will tend to increase. As for the renmimbi, current conditions favor additional but (given the central bank's philosophy) modest depreciation.

(Francisco Larios)

United States

Key March Data

Major Indicator/Event Wrap-up: The March employment report was solid on a number of dimensions (including a nonfarm payrolls gain of 192,000, and a jump in Household Survey employment of 462,000), very much supporting DE's view that the economy will rebound solidly in the 2nd quarter after inventory effects and weather held down 1st quarter performance.

The Federal Reserve altered its forward guidance in March, emphasizing that a qualitative set of labor market, inflation, and financial market factors will ultimately determine policy. Mid-2015 could bring an initial rate hike, assuming continued progress in the labor market and a pickup in price and wage inflation. Low observed inflation creates lingering doubt about just how transitory it is.

Consumer and business fundamentals are firmer than in recent years. The housing market is still adjusting to a mid-2013 step-up in long-term rates, but spring data will need to show an uptick. Consumer spending has been a strong point in recent quarters, and should be supported by ongoing job and income gains. A newer tail risk to the U.S. economy is financial market and economic slowdown in key emerging market economies, and general geopolitical frictions. Direct economic impacts will likely be minimal, but higher uncertainty has its costs.

Week Ahead—Light on Economic Data, Heavy on Company Earnings: There is little in terms of high impact economic data this week—existing home sales (Tue) and new home sales (Wed) for March will begin to illuminate the spring housing market situation, while durable goods orders (Thu) will update business confidence and spending plans. Instead, company earnings reports will be the market-movers, at least in terms of scheduled data events, with 159 S&P 500 companies on deck. Earnings estimates were slashed as adverse weather brought company profit warnings. This week will bring anecdotal evidence about how severe those effects were, and whether more than weather is impacting profitability.

Home sales data will be more important as the spring months pass, as transactions ex-weather will reveal the state of the housing market after a rate-rise hangover. Some at the Fed worry the impact of the earlier mortgage rate rise is more adverse than expected, but the market will adjust well if labor market fundamentals continue to improve. Higher prices and higher rates have pushed affordability to post-recession lows, according to the National Association of Realtors affordability composite index.

March **existing home sales** (Tue) data will still reflect poor February weather, as data capture contract closings, not signings—activity begun as long as nearly two months prior. That explains why forecasts for March remain depressed **(Consensus: -1.1% to 4.55 million; DE: unch)** even as the worst of the weather abated.

New home sales, however, are defined as occurring when a deposit is taken or a sales agreement signed, and are thus a better reflection of current activity. The drawback is that sampling variability and sample size mean that there is a wide confidence interval around the actual release—of +/-18% in the February release. Several months are needed to reveal “true” activity. Revisions can also be large. Here, expectations center on a slight uptick **(Consensus: +3.4%; DE: +4.5%)**, reflecting the spring thaw.

Finally, **durable goods** orders will reflect strength in aircraft orders, with mixed moves elsewhere. The total is expected to rise modestly **(Consensus: +2.0%; DE: +1.5%)**. Non-defense capital goods, ex-aircraft, a key GDP indicator, fell 1.3% in February after December -1.6% and January +0.8%, leaving the Y/Y rate at a very sluggish 2.1%. Weak business investment demand is not encouraging, but the strength in consumer durables opens up the prospect of stronger future investment.

DE Forecasts:

- **Economy:** A relatively sluggish, but sustainable and entrenched expansion that shows signs of accelerating above recent trends. This year, growth will be faster than the 2.5% Q4/Q4 posted in 2013—so long as Emerging Market slowdown or financial market contagion do not significantly impact U.S. shores.

- **Inflation:** Headline 2013 CPI inflation slowed from the 2.1% seen in 2012, coming in at 1.5%. This year and beyond, higher inflation should be more likely as Fed easy money takes full hold.

- **Fed:** The Fed QE "Open-Ended" policy is still aggressively accommodative, with a commitment to keep easing until the economy and labor market get satisfactorily, and sustainably, better. The move—even with gradual tapering and a likely cessation this year—offers the best chance of a policy-driven recovery thus far. The overall philosophy shift was hugely significant and could still help take real GDP growth to 3% or higher in 2014, depending on the effectiveness, and on lags between the turn toward ease and its impacts on the economy.

(Andrew Husby)

Canada

Growth Recovering After Harsh Weather

Week Ahead: Wholesale Trade and Retail Trade.

Last week saw the release of the survey of manufacturing, a Bank of Canada rate decision, and the CPI release. February manufacturing sales increased a higher-than-expected 1.4% M/M. D.E. had been expecting an increase of 1.2% while the consensus had predicted an increase of 1.0%. The increase represents an acceleration over a revised growth of 0.8% M/M during January. December manufacturing sales were hurt by a very harsh winter that hindered much of the economy. After manufacturing sales, the Bank of Canada surprised no one when they chose to issue a hold on all rates. The interest rate has not changed since 2010. Finally, the CPI rose faster in February thanks to higher energy prices. The acceleration was right in line with the estimate from D.E. at 1.5% Y/Y. Despite recent strengths in inflation, it is unlikely that inflation will reach the 2.0% Y/Y goal any time soon.

First up during the week on Tuesday is **wholesale trade**. Wholesale trade has had the same story as much of the economy. Extremely harsh weather during December slowed the economy; wholesale trade was no different. After rebounding to increase 0.8% M/M in January after a decrease of 1.3% during December, a slight deceleration is expected during February (**DE: 0.6%; Consensus: 0.7%**). Many parts of the economy saw dramatic rebounds in January only to be followed by slight decelerations the following month.

Then, on Wednesday, **retail trade** results for February will be announced. Similar to wholesale trade, it is expected that after the big bounce back during January a slower increase in February representing moderated growth is most likely. Retail trade rebounded from -1.9% M/M during the slow December to grow 1.3% in January (Ex-autos: -1.5% during December, 1.0% during January). Gas prices should drive the slower growth during February (**DE: 0.5%; Consensus: 0.4%**). After the economy gains some distance from the problematic winter, growth should, leveling off at about 2.2% for the year.

DE Forecasts:

- **Economy:** Q4 growth clocked in at 2.9% Q/Q (SAAR), higher than the BoC's estimate of 2.5%. DE estimates that Canada will continue to expand as the housing market cools and as risks continue to tilt towards the downside on effects from the recession in Europe (now showing hints of recovery), slowdown in China, and fiscal headwinds in the U.S. The focus of growth will continue to shift away from domestic sources such as residential investment, construction, and consumer spending to exports and business investments.

- **Inflation:** Core inflation will be under the 2% Y/Y target through 2014, before returning to the midpoint of the 1%-to-3% target range towards the middle of 2015 (previously thought to be early-2015). The timeframe to reach target mark has been extended due to the continued softness in the economy. The BoC altered in its January Monetary Policy Report that total and core CPI will not hit the 2% mark till Q4 2015, unchanged from its October MPR.

- **Bank of Canada:** Persistently soft inflation continues to loom over the heads' of policymakers at the BoC and their concerns were evident in the February statement. Despite their concerns however, the Bank has maintained its forecast for when inflation will reach the 2% target mark signaling that they believe the output gap will be gradually eliminated over the next two years. Also per the central bank, the global economy is projected to accelerate, setting a favorable scenario for Canadian exports and for business investments. Thus, it seems unlikely that the Bank will lower the overnight rate and instead will make upward moves as the economy and inflation show positive signs. DE predicts that the Bank will hold rates through 2014 and even early-2015, consistent with the BoC's inflation projection.

(Ethan Ward)

Eurozone

Key Survey Updates Remain Solid?

Week Ahead: Despite a focus seemingly on the price backdrop, the improving real economy picture is garnering more attention, this perhaps being one reason why the euro has been relatively impervious to ECB easing speculation. As a result, there may be even keener interest regarding the array of survey numbers due this week as markets try and assess whether the Eurozone real economy may actually be developing a little added momentum. In particular, the April **PMI Flashes** due on Wednesday will be examined all the more acutely, especially given the better signs seen in the last few months, the latter enough to have garnered ECB acknowledgement.

Coming in slightly softer than expected, the March aggregated flash PMI edged down from a 32-month high. Regardless, those numbers (at least according to the compliers of the survey) suggested an on-going economic recovery, continuing the longest streak of growth in the Eurozone economy since the first half of 2011, with better signs geographically given the markedly better readings from hitherto-weak France. Clearly, they suggested that the Eurozone as a whole is continuing to grow in the current quarter, albeit being more equivocal as to whether added momentum has developed.

Further PMI Solidity Envisaged. It is unsurprising therefore that another solid reading is largely anticipated for the April **PMI Manufacturing** figure, with some bounce anticipated **(Consensus: 53.1; DE: 53.5)**, alongside a possible new cycle-high for the **Services PMI** counterpart **(Consensus: 52.5; DE: 52.7)**. In this regard, it will be interesting if the **German Ifo** survey data on Thursday consolidates any further **(Consensus: 110.5; DE: 111.0)**. Regardless, and more likely than not, these surveys are only likely to reinforce the view that the Eurozone economy is on a better recovery footing, as may (flash) **Consumer Sentiment** data due on Tuesday, the latter also underscoring that Eurozone households are far from developing any deflation psyche. Moreover, and boosted by mild weather, February **Construction Output** data (Tue) may point to some upside risks as far as Q1 GDP growth is concerned.

ECB Awaiting Wide Range of Data. Indeed, given the most recent signs that the real economy may be gaining momentum, while the nascent recovery in private sector credit growth suggests that the monetary policy transmission mechanism may be in a better state of repair, the arguments in favor of further ECB action purely on account of low inflation are not that convincing at this juncture. The last set of data to highlight the improving economy were March car registrations, the pick-up in which over the last few months is hardly indicative of discretionary spending softening, the very opposite.

Even so, over and beyond the PMI flashes, the ECB will be looking at several other key indicators in coming weeks regarding activity, including money supply data (April 29) and the bank lending survey (April 30), the last of which hinted at the improvement in credit growth official data have just started to corroborate.

Easter Distortion? Regardless, the ECB has highlighted that calendar effects (ie the timing of Easter) may have tempered March inflation, April HICP data (April 30) may bounce back sharply (DE sees a rebound to around 1% Y/Y).

DE View: If inflation fails to bounce in this manner, the ECB will feel it has to take (or at least flag) some action at the May 8 Council meeting. Particularly, given the lack of any clear plan in terms of QE, a token cut in the refi rate would be the most likely, with a move to negative discount rate more of a possibility.

More likely, the ECB would wish to wait for the full thrust of data through the coming month in order to ascertain the extent to which the Eurozone real economy may be picking up: Q1 GDP data (May 15) may show a clear and above-consensus improvement with a 0.5% Q/Q increase a distinct possibility, an outcome that would force the ECB to revise its growth projections up (further) at the same time as paring back its near-term, inflation outlook.

DE Forecasts:

- **Economy:** Recovery continues but no room for complacency. However, DE sees GDP seeing continued modest growth similar, if not better, than the solid Q4 reading. This may help lead to a 1.3% outcome for 2014 and a little faster in 2015. Downside risks becoming less evident, as low inflation boosts spending power.

- **Inflation:** Headline HICP inflation has fallen even more clearly below the 2% target. Partly due to base effects, warm weather and lower oil prices, DE sees the rate being volatile in coming months and averaging just around 1% through 2014 but rising back into 2015, so that next year sees an average rate of 1.5%.

- **ECB:** It is still a possibility that the ECB will cut its key rate yet further in the next few months if clearer deflation risks force the issue, the latter possibly a reflection of an even firmer euro. More likely, however, continued better/steady real economy data will not necessitate such action, but measures to boost lending (ie FLS-type moves) may nevertheless still be forthcoming.

(Andrew Wroblewski)

United Kingdom

BoE Unmoved

Week Ahead: Surprising few, the **minutes to the April 9-10 BoE MPC meeting** due on Wednesday are unlikely to show the committee to be alarmed by recent data. Admittedly, data since that meeting has shown a further fall in inflation and in the jobless rate. Indeed, and providing a much more robust picture of the labor market, the jobless rate fell from 7.2% to 6.9% in the three months to March, thereby hitting the lowest since late-2008. This means that the jobless rate has dropped below the hitherto very-sensitive 7% mark, the level at which the BoE once pledged it would start to undertake discussions of future monetary tightening. However, this forward guidance has already been replaced with a more qualitative guidance, encompassing other measures of labor market pressures, but which implies that more robust debate amongst policy makers is likely here-on.

DE View: While markets may be perturbed by this surprisingly large drop in unemployment, the thrust of data still shows signs of ample labor market slack. The amount of persons wanting a job, but not considered to be part of the active labor force, rose further and at 2.3 mln is higher than the official jobless count of 2.2 mln. In addition, the data still showed that there are many (1.4 mln) who are working part-time only because they could not find full-time work.

These are issues that the BoE will debate, but with the key consideration being that the MPC will not be that surprised by these figures given that the February Inflation Report suggested such a drop would occur in Q1 2014.

Solid Sales Continues. It is less clear what the impact of recent warm and very wet weather may have had on spending, particularly at the consumer level. The most recent retailing surveys have been mixed despite upbeat consumer confidence numbers. Even so, a correction back in **Retail Sales** is expected in the March update due on Friday **(Consensus: -0.4% M/M; DE: -0.5%)**, but with another very solid reading for the whole of Q1 still the result.

Fiscal Side Improving? Public sector finance data seem on track to meet recently updated and downwardly revised Government estimates but a high degree of uncertainty remains, not least as a result of the clear propensity to data being revised. Regardless, another improvement is expected in the March **Public Borrowing** numbers due on Wednesday **(Consensus & DE: £ 8.5 bln)**, these data being for the last month of the fiscal year.

Mortgage Approval Update. Amidst what seems to be growing market concern about rising house prices is the fact those same markets may have overlooked the fact the BoE has already acted to address housing market strength via its recent modification of the FLS. Indeed, at the end of last November, BoE announced a decision to modify the Funding for Lending Scheme so as to remove incentives for household lending. This move was not particularly high-profile but may prove to be a very important development. Indeed, the FLS was very effective in resuscitating the housing market almost as soon as it was introduced in August 2012. Mortgage approvals jumped straightaway and have continued to rise since, at least until February numbers appeared (showing a large M/M fall).

DE View: This is important as the FLS modification actually only took effect at the end of January, meaning only in subsequent months would any impact appear. Admittedly, there was little sign from the recent BoE Credit Conditions survey that the recently watered-down Funding for Lending Scheme is tempering mortgage demand or supply. But approval data should be watched with ever closer scrutiny in coming months to see if the potential risks from imbalances in the housing market may already have been addressed by the BoE.

In this regard, the March batch of BoE mortgage approval data is due on May 1, with an insight available ahead from the consumer lending data published by the **British Bankers' Association** next Friday.

DE Forecasts:

- **Economy:** A clearly improving trend has emerged, but with little sign that any further acceleration is on the cards from the pace set in the last two to three quarters. As a result, a GDP growth rate around 2-¾% for 2014 is expected and nearer 2% in 2015.
- **Inflation:** Headline CPI has fallen back clearly, actually below the target for the first time in four years. Unlikely to move any lower through 2014, with volatility expected in the next 2-3 months.
- **BoE:** Bank Rate on hold until probably after mid-2015. Indeed, recent modification of FLS may already be having some impact on housing market. BoE also likely to use macro-prudential measures ahead of any hike in rates.

(Andrew Wroblewski)

Other Europe

Sweden: Stronger Productivity

Week Ahead: The Riksbank is clearly concerned about the undershoot of both its inflation projection and its inflation target, albeit not making much of the fact that real activity is growing well above what it has been anticipating; the 3.1% Y/Y rate seen of Q4 GDP was some two percentage points above what the central bank had expected. Amidst this divergence between the inflation and growth performance, the **Labor Market** is actually very much on target, something that may be underlined by the update due on Tuesday. Last time around, the seasonally adjusted jobless number fell back 0.1 percentage points to 8.1%, an outcome still consistent with a flat trend and lonely a little above the Riksbank forecast of an average 7.9% rate for 2014. More notably, however, actual employment continued to move higher, but still not enough to have prevented the Riksbank raising its productivity projection much higher to 1.9% for this year.

That productivity issue may be something that the **Minutes to the April 8 Riksbank** Board meeting minutes may explore (Thu). Otherwise those minutes may act more light into the decision to of the Board to adjust its projected rate path downward, largely a result of envisaging greater chance that the repo rate may need to be cut further in the near-term.

DE Forecasts:

- **Economy:** After moderate real GDP growth of 1.5% in 2013, continued volatility is possible into this year. Even so, more solid growth is emerging with something near 3% envisaged for 2014 but slowing slightly in 2015.
- **Inflation:** Headline and underlying CPI rate likely to remain well below the 2% target until late-2014, but unlikely to precipitate further Riksbank moves.
- **Riksbank:** After the rate cut in late-2013, monetary policy will be on hold until the rate hike cycle starts perhaps as soon as late-2014, despite Riksbank worries regarding soft inflation

Norway: Improving Credit Demand?

Week Ahead: The sole item of interest this week is the Q1 **Norges Bank's Survey of Bank Lending**. Last time around (ie in January), banks reported somewhat lower household credit demand. Overall credit standards for households were reported to have eased slightly and contacts expect approximately unchanged credit standards and somewhat lower credit demand in 2014 Q1. Banks report approximately unchanged corporate credit demand in Q4. This time around some improvement may be evident, something that chimes with the better tone regarding the housing market that seems to be re-emerging.

DE Forecasts:

- **Economy:** GDP growth of near 2% last year but somewhat higher in 2014 and 2015 as momentum is building.
- **Inflation:** Headline and underlying CPI rate have picked up, with the latter having moved back toward the 2.5% target. Further gains possible through the rest of the year.
- **Norges Bank:** The Norges Bank may start the rate hike process as early as the second half of 2014 despite it signaling otherwise once again at its latest meeting.

Switzerland: Strong Money Growth

Week Ahead: Recent real economy numbers have continued to point to a solid economic backdrop, suggesting no let-up to the above-trend GDP growth rates seen in recent years. Moreover, even on the monetary side, data is holding up, as **Money Supply** figures (Tue) may highlight.

DE Forecasts:

- **Economy:** Recession never an issue, with GDP growth of around 2% in 2013 likely to be repeated for both 2014 and 2015, actually above trend-results.
- **Inflation:** CPI inflation no longer negative, likely to average around 1% next year.
- **SNB:** Rates on hold for some time but perhaps less prolonged than markets suggest: threat of continued intervention to hold down Swiss franc still being made by the SNB, but exchange rate issue may soon be overtaken by concerns of a real estate bubble.

(Andrew Wroblewski)

Oceania

Australia: CPI Spikes?

Week Ahead: Coming on the heels of a moderately busy week in which the release of the Reserve Bank of Australia (RBA) Minutes, where little new was offered beyond that already provided in the Governor's Statement after the actual meeting, stole nearly all of market attention. The coming week, shortened by the Easter holidays, is comparatively quiet. Despite the general calmness, however, next week actually has key **CPI Inflation** data for the first quarter arriving on Wednesday, a release that will be very closely watched by both markets and the RBA alike. Regarding the latter, the Bank is largely expecting price pressures to pick up further through the first half of the year, possibly exceeding the ceiling of its target range (at 3%) around mid-year. However, pressures are still largely expected to remain contained going forward, helped by weak wage pressures (as a result of a still-subdued labor market) and the recent appreciation of the AUD. That being said, however, inflation may well surprise to the upside of RBA expectations, having broken the 3% threshold already last quarter. Further ahead, inflation should moderate afresh through the second-half of the year.

Elsewhere, the only other notable release of the week is the **Leading Index** compiled by the **Conference Board** arriving on Tuesday. Most likely, the gauge will show a further, albeit again relatively modest, improvement.

DE Forecasts:

- **Economy:** Real GDP growth bounced to 2.8% Y/Y in Q4 from 2.4% in the third quarter, hitting a joint five-quarter high. Looking forward, a similar pace is largely expected through the first quarter, with growth averaging around 2.8% through 2014 and likely even higher in 2015.

- **Inflation:** Q4 CPI inflation swung to a cycle-high of 2.7% Y/Y from a five quarter low of 2.2% in the third quarter. The outlook for Q1 sees price pressures moving higher to over 3% by mid-year. The second half of 2014 sees price pressures returning to within the upper half of the RBA target range of 2%-to-3%, albeit averaging 2.7% for the full year. Looking further ahead, an outcome near 3% or slightly higher is likely for 2015.

- **Reserve Bank of Australia:** The RBA kept rates unchanged at its meeting in April after similar decisions in the six previous meetings; albeit with rate reductions over the last 27 months having reduced the Cash Rate by a cumulative 225 bp. Moreover, the latest Statement by Governor Stevens reaffirmed the Bank's comfort with its recently-implemented neutral policy stance as past rate cuts and the recent depreciation of AUD provided reasonable prospects for activity outside the resources sector to pick up over time. However, and notably, the Bank has clearly begun trying to draw attention away from currency developments in recent weeks—with some speculating that the recent improvement in labor market conditions could mean that currency strength is no longer a major concern for the Bank.

New Zealand: RBNZ Continues Its Hiking Cycle

Week Ahead: Following a week where the release of CPI data for the first quarter, which surprised clearly to the downside and showed price pressures still being very well contained, dominated market attention, the coming week—shortened by Easter holidays—is instead very quiet. However, in a week nearly completely devoid of any relevant economic data releases, next week actually sees the third **Reserve Bank of New Zealand (RBNZ) policy meeting** of the year. This should receive a significant amount of attention, especially after the Bank initiated its hiking cycle last month and outlined an aggressive hiking cycle that would take the Overnight Cash Rate (OCR) to over 4% by 2015.

The recently-released soft inflation figures for Q1 have led some analysts to question whether the timing and scale of these flagged hikes would be adjusted. Indeed, should subdued inflation prove to be sustained and cause a shift in the inflation outlook profile, the RBNZ could very well adjust the precise timing of their hiking moves—especially as these were never meant to be set in stone to begin with. Most likely, however, with only one observation of moderately weaker-than-expected inflation data to work with, the Bank will not be too alarmed. As a result, a 25 bp rate hike is still the most likely outcome at its upcoming meeting next Thursday—albeit with developments between now and the next release of the RBNZ Monetary Policy Statement (on 12 June) very possibly changing the Bank’s view somewhat.

DE Forecasts:

- **Economy:** GDP growth remained solid at 3.1% through the fourth quarter after jumping to 3.3% Y/Y in Q3, the latter being the highest in over six years. Looking forward, however, growth may slow slightly in coming quarters, averaging around 3% through this year. Further ahead, growth may pick-up even further to near 3-½% through 2015.

- **Inflation:** Headline CPI inflation in Q4 moderated afresh and to 1.5% Y/Y from 1.6% in the previous quarter, albeit still the second-highest outcome in nine quarters and also being only the third reading within the RBNZ’s target range of 1%-to-3% in six quarters. Going forward, inflation is expected to rise afresh towards the 2% boundary in the coming quarters, but not reaching that level until year-end. In annual terms, inflation is seen averaging near (or just below) 2.0% through this year before rising to near 2-½% over 2015.

- **Reserve Bank of New Zealand:** The RBNZ kicked off its hiking cycle as expected in March with a 25 bp increase in the OCR. More surprising was the hawkish rhetoric and policy guidance showing rates rising to 4% by year-end and exceeding 4.25% by Q1 2015 before finally hitting its “new neutral” level at 4.5% by mid-year. The specific scale and speed of any future moves, however, will still be largely dependent on developments both on the data front and possible volatility in the NZD.

(Chang Liu)

Japan

Trade Disappointment?

DE View: After the short 2012 recession, the economy grew strongly in the first half of 2013. But, third-quarter growth slowed, and the fourth quarter, contrary to expectations, did no better. Results in both quarters highlighted the damaging role of too-weak exports and too-strong imports.

Fourth-quarter numbers did, importantly, show some improvement in private-sector domestic demand, giving a modestly positive signal on sentiment. Now, the focus is on the pulling-forward of consumer spending and home-buying prompted by the approach of April 1 consumption tax increase—and on the severity of the payback drop currently underway. Early data point to a strong first-quarter upswing, with a hint that growth may be broader, and less subject to a second-quarter payback, than tax anticipation alone would imply.

China-economy and island-confrontation concerns are serious, and exports continue quite restrained. On the domestic front, the issue is follow-through on the wave of enthusiasm prompted by PM Abe's election victories and the sharp change in Bank of Japan policy. Measures of business confidence have improved, notably in sectors benefited by the yen decline. Still, domestic investment plans generally remain conservative—but there are hints of increasing liveliness.

Week Ahead: Work on the Bank of Japan's semiannual *Outlook* report, due April 30, continues apace, and key data releases this week—the March **merchandise trade balance** (Monday), and the **CPI** (Friday), covering April for the Tokyo index and March for the national one—might still impact thinking on the current motion in the economy, and on the outlook.

Merchandise trade data (Monday) have shown a clear impact of the yen decline in lifting the nominal value of import and exports, but no very conspicuous effect in limiting real imports or, especially, in expanding real exports. After moderately strong quarterly growth in the first half of last year, real exports settled into a choppy path of little more than net sideways motion that has persisted since.

Some of the sluggishness of real exports reflects economic weakness abroad, and perhaps the drop in the yen has helped prevent a bigger real deterioration. However, expectations of solidly stronger export growth are key to Abe Government and BOJ projections that the economy will resume healthy growth following the near-certain GDP contraction in the second quarter.

Forecasts this month do not give much encouragement, looking for a sharp expansion in the deficit from the ¥356.9 billion recorded in March 2013 **(Consensus: -¥1085.9 billion; Decision Economics: -¥1135.0 billion).** Export growth is seen slowing a bit from the +9.7% average year-on-year rate seen in January and **February (Consensus: +6.2%; Decision Economics: +7.6%),** while import growth changes relatively little from a +17.1% average **(Consensus: +15.9%; Decision Economics: +18.9%).**

March national **Consumer Price Index** (Friday) forecasts point to a modest pickup from the +1.5% year-on-year February reading for the overall figure **(Consensus and Decision Economics: +1.6%)** and to an ex-fresh-foods, "core," result similarly close to the +1.3% February number **(Consensus and Decision Economics: +1.4%).** The latter estimates would conform to Bank of Japan projections for little change in the “core” number, so in-line results should cause no market shock.

There will be unusual interest in the Tokyo results this time—since, covering April, they will reflect the first impacts of the consumption-tax increase. Forecasts for the core figure show a sharp acceleration from the +1.0% year-on-year March result **(Consensus and Decision Economics: +2.8%)** which carries over to a full-index pickup from the +1.3% year-on-year seen in March **(Consensus: +3.1%; Decision Economics: +3.0%).**

The expected accelerations in the Tokyo results closely match Governor Kuroda’s estimate that the consumption-tax increase would add about 1.7 points to the April year-on-year figures—so in-line numbers should cause no disruption.

However, there is much talk of companies pushing through outright product-price increases under the cover of the tax change—and stronger-than-expected Tokyo results would certainly fuel suspicions that such a thing is happening.

Presumably, companies would attempt outright price increases only if they were reasonably confident that demand strength would be adequate to support them. Some, or many, might be wrong in that confidence—but a broad pattern of increases would at least hint that optimism is growing.

DE Forecasts:

- **Economy:** Sharply expansionary macro policies from the Bank of Japan have revived domestic-demand growth somewhat, but. strong trade-sector headwinds developed last year, and now the economy faces an artificial boost and sag because of accelerated buying ahead of the April 1 consumption tax increase. Prospects for fundamental reform, and for a solid and sustained confidence-led expansion seem to have been strengthened by the decisive election victories of the business-friendly Abe Government. However, worries about too-slow progress are growing. DE looks for late-year strength to pull 2014 GDP up near 2%.

- **Inflation:** Aggressive inflation targeting, and implicit currency management, drove the BOJ to take even stronger steps than expected to reflate demand and prices. Still, chances of the Central Bank meeting its inflation target on time are fairly low. The developing issue is whether fear of missing the deadline will prompt any new stimulus, or simply an extension of the existing quite-aggressive plan.

- **BOJ:** The Kuroda Policy Board has made drastic changes to the Bank’s modus operandi—shifting to a Fed-like open-ended policy of buying large quantities of long-maturity bonds with newly printed money. Policy interest rates have been removed from the discussion for now, and there will be no thought of bringing them back before 2015.

- **Markets:** Though bond market developments have occasionally challenged the BOJ’s duration-removing policy, longer-term interest rates should stay contained for many months. Eventually, lessening global safe-haven demand, and increasing market conviction that the BOJ is succeeding in pulling up inflation, will lift the ten-year JGB rate beyond 1%. Given whole-hearted policymaker commitment to yen depreciation, further decline is in the cards, with levels in the ¥110 to ¥115 range in sight.

(Pierre Ellis)

Emerging Markets

China

Week Ahead: A very light data week, following release of GDP and other key indicators. The only item of significance on the calendar is the privately-produced HSBC PMI, (reasonably) expected to stay below the 50 mark, but moving slightly towards it.

DE Forecasts:

- **Economy:** Real GDP growth in the neighborhood of 7.2% (perhaps a little above, perhaps a little below) represents China's current and near-term reality, with the possibility of a step up into the 7.5%-8% range in the quarters ahead, depending largely on external conditions. The medium-term outlook remains unchanged: there may be some improvement in China's real GDP growth, but not much; it may last a few months or quarters, rather than a few years; and, a renewed deceleration of growth to lower plateaus remains a very distinct possibility as part of China's future growth profile.

- **Inflation**: CPI inflation appears to be under control for now, likely to stay well below the 3.5% mark on average. Should that be the case, it would represent undershooting of the PBOC's inflation expectation (3.5%). Therefore, monetary policy actions are probably not going to be driven in the foreseeable future by good-price inflationary pressures. Still, steps to tighten monetary policy cannot be ruled out during the next few months to the extent that the central bank remains focused on restraining the so-called shadow banking, outside of the traditional banking mechanisms that have channeled credit in the past.

- **Policy:** It is highly unlikely that the new leaders will permit a sudden and sharp deceleration of growth, which is improbable to the extent that as the global economy bounces back, even if moderately, Chinese exports should improve. At the same time, there seems to be still very little appetite for a substantial fiscal and monetary stimulus, above and beyond the measures already taken. .

India

Week Ahead: Only the 8-industry index, which represents roughly 40% of the industrial production index but it has been a very poor indicator of it in recent months. Last month's surge, for example, was accompanied by a surprisingly sharp drop of industrial production. Nonetheless, a poor 8-industry result would be a clear negative from the fundamental standpoint. Market interpretation could, however, be tempered by the marginal increase of the probability of monetary easing.

DE Forecasts:

- **Economy:** Early signs of stabilization point towards a very modest improvement of real GDP growth over the next 12 months, towards the 5.5%-to-6.0% range.

- **Inflation:** Both, WPI and CPI annual inflation dropped suddenly in December, putting the series potentially on a lower path for the next few months.

- **Policy:** The RBI has, in principle, hardened its hawkish stance by setting a seemingly more difficult target for its policies (reducing CPI inflation), but this switch, and the tough rhetoric, are clearly bounded by the reality of a very weak economy, and the bank has left itself some escape options. A *hold* decision in the next meeting would be coherent, for example, with stable-to-lower WPI and CPI inflation (quite possible, but uncertain), still-soft industry data (likely), and a calmer currency market (uncertain).

Korea

Week Ahead: Q1 real GDP on the calendar. The (reasonable) expectation is for a high annual rate of expansion (Consensus: 3.8% Y/Y; DE: 3.9% Y/Y). Medium term concerns remain, including the growth performance of China, South Korea's key trade partner, but near-term conditions suggest strong momentum should keep growth in the 3.5%-to-4% mark over the next couple of quarters.

DE Forecasts:

- **Economy:** The evidence is beginning to point more clearly toward at least a few quarters of faster growth, especially if external conditions improve. Encouragingly, the labor market remained solid throughout the soft real GDP patch last year. But there are still some risks to the improved outlook, both external (China, the U.S.) and domestic (will private consumption stay on track?).

- **Inflation:** Non-existent for the foreseeable future.

- **Policy:** From DE's perspective, the net sum of the foreseeable factors over the next few quarters makes the likelihood of a stable interest policy very high, admitting for yet one or two further rate cuts on won strength. The latest policy pronouncement by the Bank of Korea tilts only very subtly in the direction of a potential further easing. The bank seems inclined to keep rates where they are for a few months (although a last 25 basis point cut cannot be ruled out) and would then, possibly early in 2015, start a gradual normalization of nominal rates.

Mexico

Week Ahead: Banco de Mexico meets to decide on monetary policy. The almost certain decision is to keep interest rates at present levels: growth is weak but improving, and the outlook has brightened as the U.S. expansion seems firmer; inflation has dropped well below the 4% ceiling, and appears likely to move further down in the near term.

DE Forecasts:

- **Economy:** Modest growth will likely continue in the foreseeable future, subject to the risks that affect the U.S. economy. DE's estimate for 2014 real GDP growth: 3.0%.

- **Inflation:** Likely (comfortably) below 4% for the foreseeable future.

- **Policy:** Banco de México is comfortable with the current inflation situation and the outlook, and more willing to support growth (depressed largely on account of very tight fiscal policy since the ascent of the Peña-Nieto government).

Brazil

Week Ahead: The key release is March's current account balance (Friday). Consensus (-$8.2 billion) and DE (-$7.7 billion) expect a modest increase of the shortfall over last year. From DE's perspective, the current account is on a path that should lead to stabilization in the months ahead, with some shrinking a distinct possibility in the second half of the year and an annual result slightly below last year's.

DE Forecasts:

- **Economy:** Economic activity is beginning a mild recovery, driven by internal demand. Current DE estimate for 2013: 2.3%; growth would pick up to around 3% in 2014, on present trends.
- **Inflation:** Annual inflation is now significantly below the 6.5% upper limit set by the monetary council (Copom). The IPCA-CPI is likely to remain within the range, but above the center of the target (4.5%) during the remainder of 2013.
- **Policy:** DE's research suggests that the central bank may have some additional room to tighten, perhaps 50-100 basis points, without severely jeopardizing growth (assuming the global economic recovery continues). New data will probably decide the matter.

Turkey

Week Ahead: The Turkish central bank (TCB) meets to decide on interest rates (Thursday). Consensus expects a hold decision. That is not an unreasonable expectation based on fundamentals. However, there have been strong indications that the odds of a rate cut are high (40%-to-50%). The bank tightened rather abruptly at the end of January, in a move that was at least partly predicated on the need to adjust to worsening domestic and global risks. Those risks, the government now argues, have been reduced by the outcome of the election, as demonstrated by the appreciation of the lira since then. Political pressure by the Erdogan administration—which is moving to exert greater control over bank policy-- is apparently strong enough to have Governor Erdem Basci state that although the central bank will not hold an "*extraordinary meeting at the moment*," to reduce rates, "*one shouldn't expect too big a rate decline*", obviously pointing to a partial undoing of January's tightening, as early as this week's meeting. Moreover, the Governor has recently emphasized that inflation, which has risen in the past few months, is near its peak and will fall sharply during the second half.

DE Forecasts:

- **Economy:** Domestic demand likely to be hurt by political turmoil and the sharp interest rate increase put into effect by the Turkish Central Bank. DE's estimate for this year has been cut to around 2.5%, with considerable downside risk.

- **Inflation:** Annual CPI peaked in July at 8.9% Y/Y and decelerated to 7.7% Y/Y in October. It is increasingly doubtful that the TCB's new year-end forecast (upped from 6.2% Y/Y to 6.8% Y/Y) materializes. Our current estimate: 7.4% Y/Y.

- **Policy:** The Turkish Central Bank surprised skeptical markets and pushed policy interest rates sharply higher in early 2014. The bank made the following adjustments: it increased the overnight lending rate from 7.75% to 12% (425 basis points), the overnight borrowing rate from 3.5% to 8% (450 basis points), and the repo rate from 4.5% to 10% (550 basis points)--a very large shift upward of the TCB's interest rate corridor. Multi-percentage-point adjustments of interest rates are not unprecedented in Turkey's recent history, but this year's tightening clearly exceeds the one implemented in 2011 and surpasses even the most adventurous predictions, which saw the TCB hiking by around 200 basis points. In that sense, the bank has made an extraordinary effort to come to terms with the markets, and the Erdogan government has chosen to stand aside and let the bank make a move that it opposed, but with little conviction, almost ritually. All of which is evidence that policymakers viewed the situation as rapidly escaping their control, and heading towards a crisis. Will it work for Turkey? So far, policymakers can claim success. But rate increases may be of questionable efficacy to stop capital flight when the source is a collapse of confidence, and continuing political conflicts could bring back instability in the lira's market.

(Francisco Larios)

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