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The DE Global Markets Weekly

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No Golden Dawn for Investors Yet

We discovered this week that the election of more near-term importance to investor thinking was in Greece not France, even though the French election results may be the more important longer-term. DE increasingly thinks that a fresh election is likely in Greece, which will usher in a new coalition opposed not only to additional measures that are needed to meet austerity targets but would roll back existing ones. This is anathema to the rest of the Eurozone, which seemingly makes a Greek exit from the euro club increasingly likely this summer. But this would be a "managed exit" in an effort to reduce the chances of the "Greek moment" becoming the next "Lehman moment."

The events of the last week support DE's suggestion that a Hollande victory might help Germany ease its austerity above all pledge more rapidly. Policymakers signaled that they could accept an inflation rate as high as 3%, well above the 2% Eurozone average as well as a faster pace of wage gains. This would not only help boost German growth which is currently stagnant but would also reduce how much the hard-pressed peripheral nations would have to internally devalue in order to become more competitive with Germany. In addition, Brussels suggested its willingness to stretch out the 3% deficit target from 2013 to 2014.

While these are important step, they will make little difference to the short-run economic situation even though they assuage investors. Right now, the periphery needs more money, particularly to bail out the Spanish banks. The money has to come from somewhere, ranging from the rich nations in the EU to the members of the IMF. Fiscal transfers are a way of life in the U.S., why not within the Eurozone, some argue.

- **U.S.**: A busy midmonth calendar awaits investors lead by a possible modest gain in **retail sales**, a decent gain in **IP**, a modest bounce in **housing starts**, and a modest gain in the **CPI**. The closely watched **Fed regional PMIs** are expected to rebound modestly after the big drop in April. Still, all this is unlikely to change the consensus view that Q2 will be at best not much faster than the 2.3% pace of Q1.

- **Eurozone: Major bond auctions** this week may exaggerate the market reaction to unfolding developments. The **EU** may agree to stretch out the 3% deficit targets this week, as discussed above. **Merkel meets with Hollande** for the first time this week and are sure to show some unity regarding Greece. The **Q1 GDP** data may show a slightly larger contraction than Q4 but this may be distorted by the weather as the upcoming March **IP** figures may show a rebound. **Car registrations** and the **ZEW** survey may support the notion that the weak Eurozone may be on a firmer footing into Q2. Finally, the **HICP** data will confirm the drop in the headline rate to 2.6%.

- **UK:** The upcoming **BoE Inflation Report** will hint that asset purchases may resume, albeit also hinting that the MPC was split on the issue. The **labor market report** this week may be weak after some mixed messages. In particular, the **average earnings** data may be even weaker, implying more erosion in household purchasing power.

- **Japan:** This weeks **Q1 GDP report** should show growth probably accelerating to 0.8% in Q1 thanks to a good boost from household spending after a 0.2% drop in Q4. **Domestic goods prices** will temporarily dip back into deflation. **Tertiary activity** may decline, while **machinery orders** will drop sharply in March after huge gains earlier in the year. A steady uptrend in capex seems underway.

- **Emerging Markets/Regions:** With no central banks we follow on tap, data flow will be watched. Price gains in **India** will show easing. **Hungary** and **Czech Republic** GDP will see declines from spillover effects form the Eurozone, while **Russia** GDP shows commodity-based strength. Low interest rates and inflation bolster growth in **Mexico.**

Focus: Greece, Reverberations and Ongoing Risks

Greece's continued membership in the Eurozone is looking increasingly at risk. The general election in Greece on May 6 failed to deliver a stable government, ie at least one that had a working parliamentary majority, with the clear impression that the Greek electorate gave a resounding rejection to the austerity measures being demanded of the country as part of its bail-out conditions.

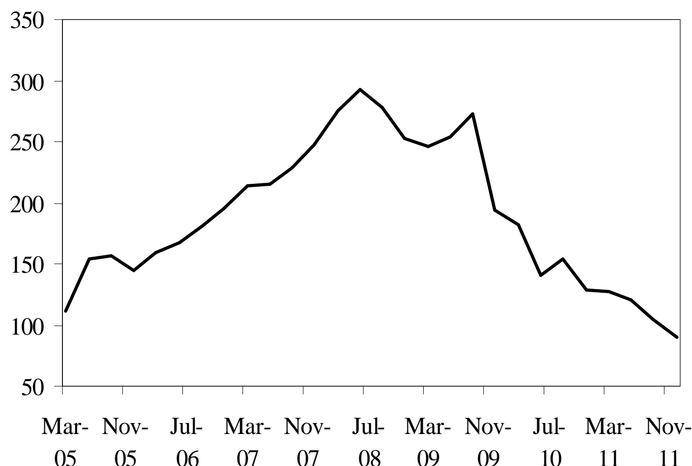
Fresh Elections: A Referendum on the Euro. However, the EU and IMF have made it clear that unless the bail-out conditions are adhered to, further bail-out funds will not be forthcoming, raising the stakes that Greece may be forced into a default in the next few months alongside a likely exit from the euro. Admittedly there are other possibilities. At this juncture, *Greece is unlikely to cobble together any stable coalition*, implying that fresh elections may be needed, with a date of June 17 already circulating. A different result is possible. Notably, while mustering only some 32% of the vote, the two pro-austerity parties (New Democracy and PASOK) actually came close to winning a parliamentary majority: their thinking may very well be that they could win more seats next time around, especially if they were to turn the election into an effective referendum on Greece staying in the euro, aware that opinion polls suggest that the Greek electorate still largely backs membership.

EU Patience Running Out? Such an election swing could very well win Greece more time. However, the risk is still that any such a victory for these two parties would not quell the demands within the country for a bail-out renegotiation and an easing in austerity. Regardless, *the rest of the Eurozone (and especially the IMF) may be losing whatever patience they have left with Greece* and may say that enough is enough, deciding that Greece has shown itself unwilling to reform rather than merely being unable to do so. In addition, Greece may decide it too may fare better outside the Eurozone.

The Risks to Greece. While the implied default and curtailment of bail-out funds would rob Greece of any external financing, the fact that the country is close to running a primary budget balance would mean that the ensuing domestic fiscal jerk may not be too severe on the economy. Admittedly, *the clear risk for Greece would be the damage to the banking system from a default/euro-exit*. There is another risk in the extent to which any boost to competitiveness stemming from the re-introduction of a (markedly devalued) drachma would be frittered away into higher prices.

The Risks to the Eurozone. At first glance, it would seem that the Eurozone could withstand a Greek exit, undoubtedly much better to that perhaps two years ago (when Greece won its first bail-out). As Chart 1 shows, exposure by European banks to Greece has fallen back markedly of late, with these figures (ending in Q4 last year) failing to take account of the debt swap achieved in February when banks will have reduced their exposure further. However, and unfortunately, **other risks have arisen in the last few years**, most notably the money that Greece owes the rest of the Eurozone mainly in the form of the € 107 bln liabilities (as of February) the country has in its TARGET2 account (ie the intra-Eurozone clearing system run by the ECB), a result partly a repercussion of the fact that the country is still running a current account shortfall of close to 9% of GDP. In addition the ECB holds some €50 bln in Greek bonds. Should Greece leave the euro, the taxpayers of each of the Eurozone countries would have to make good any losses incurred by the Euro-system in proportion to their relative size – thereby meaning further liabilities for already stretched peripheral countries.

Chart 1
Eurozone Bank Exposure to Greece Down Sharply, €bln



Source: BIS

Admittedly, the circa-€ 120 bln that emerges from unused Greek bail-out funds could be used to plug this hole. However, it would mean that *there is no effective top-up to the bail-out funds* that may (increasingly) be needed elsewhere in the Eurozone given the clear risks of some domino effect on other peripheral countries from a Greek euro exit (see Chart 2). At this juncture, some effective €500 bln is available but only half that may be accessible in the next few months as the much heralded ESM is not due to come into existence until July – at the earliest.

ECB Back in the Spotlight? As a result, should the financial market repercussions from a potential Greek exit prove hard to control, then the economic damage may be equally insidious. If so, then *the threat is that the so-far mild, but continuing, Eurozone recession could turn far more severe,* potentially mimicking the near-5% collapse in GDP seen in 2009. Surely, the ECB would then respond, albeit more on the unconventional side, by providing more liquidity and/or

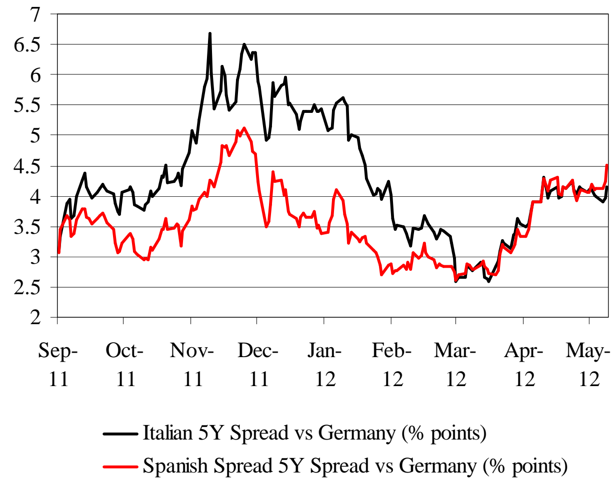
resuming government bond purchases. Most likely this will be the case, but the ECB Council may have to overcome Bundesbank resistance first.

Overcoming Bundesbank Resistance. The German central bank is clearly uncomfortable with the stance of ECB policy, even this week noting that Germany is subject to a very expansionary monetary policy which needs to be offset elsewhere. This seems hard to square with signs that the German labor market may be taking a turn for the worse and where German Q1 GDP data (due Tue) may fail to show any recovery from the drop of the previous quarter. Even so, the Bundesbank is clearly uncomfortable with the inflows coming into Germany and which are evident in the huge rise in the German TARGET2 balance (see lower chart), these actually being a mirror-image of the TARGET2 shortfalls in peripheral countries and are being driven by capital flight. The clear Bundesbank worry is that these inflows (at over €500 bln, they are worth over 20% of German GDP) may ferment financial instability problems for Germany in due course, maybe not in terms of formal consumer price inflation but in asset bubbles.

More likely than not, should it need to in coming months, the ECB will overcome these German reservations regarding more unconventional easing. Indeed, while only a month ago, the ECB was contemplating an exit strategy from its current monetary stance, it may have to come up with an entirely different 'exit' strategy if the worse comes to worst as far as Greece is concerned.

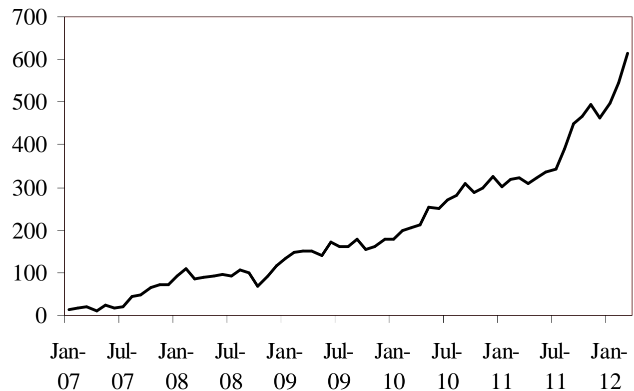
(Andrew Wroblewski)

Chart 2
Eurozone: Periphery Strains Returning



Source: Bloomberg

Chart 3
Germany: Soaring Bundesbank TARGET2
Net Position, €bln



Source: Bundesbank

United States

A Firmer Tone?

The week ahead: U.S. equity markets edged lower while the bond market extended its gains as the evidence of the past week kept the risk-on trade on the backburner. While investors are concerned that Q2 GDP will not match the 2.3% pace of the Q1, the weekly claims figures suggested some pickup in hiring in May relative to the disappointing 130K pace of March/April. The consumer sentiment figure was the highest in four years but still well below 80, the level that usually signifies an "acceptable" expansion. The PPI had just enough inflation in it to suggest that the doves and hawks at the FOMC were not prepared to change their minds.

A busy midmonth calendar awaits investors led by a possible modest gain in retail sales, a decent gain in IP, a modest bounce in housing starts, and a modest gain in the CPI. The closely watched Fed regional PMIs are expected to rebound modestly after the big drop in April. Still, all this is unlikely to change the view that Q2 will be at best not much faster than the 2.3% pace of Q1.

Retail sales, stronger than it looks (Tuesday). After a solid 0.8% increase in March that surprised investors**, retail sales** is expected to rise modestly (DE: +0.1%; consensus: +0.2%). However, this month, falling gasoline prices are holding back underlying household spending. Excluding autos and gas, spending may advance a more moderate 0.4%. Consumer spending is still expected to advance at a 2.5% pace this year, not bad bit well below the historical average of 3% plus.

Bounce in regional manufacturing (Monday/Thursday). Both regional Fed manufacturing surveys we follow are expected to show a nice rebound after large drops in April. After a 13 point drop in April to 6.6, the **Empire State index** will modestly rebound (DE: 10.8; consensus: 9.0). The **Philly Fed** should rebound from 8.5 in April (DE: 9.6; consensus: 10.0).

Moderate gain in industrial output (Wednesday). The strength in the factory sector in an otherwise ho-hum jobs report suggests a moderate gain in **industrial production**. (DE: +0.4%; consensus: +0.5%). But this relationship suggests a much stronger result in March than the actual unchanged result.

Business inventories remain strong (Tuesday). The assumed gain in March **business inventories** inherent in the first Q1 GDP estimate is a gain of 0.7%, a bit faster than the 0.6% gain in February. DE expects an increase of 0.7% while the consensus opts for a smaller gain of 0.5%. A gain of 0.5% might drag the revised estimate of GDP closer to 2.0%.

Lower oil prices drag down measured inflation (Tuesday). A decline in energy prices, most notably gasoline, should mean a decline in headline inflation from 0.3% in March to 0.1% in April (both DE and consensus). The **core rate** should remain well behaved at 0.2%.

Fedwatch: FOMC minutes and only two speakers. The minutes of the April 24-25 meeting may provide some color regarding the increased (numerical) hawkishness of members who presented their policy path forecasts. Only two speakers hit the tape. Centrist **Duke** (Tu, always votes) and policy maverick **Bullard** (Wed, Th, votes 2013). Even though her appointment ended earlier this year, Duke continues to serve at the Board that is short-staffed already with two open positions. The two Obama nominees successfully navigated the Senate finance committee but await a full vote by the Senate. A senatorial hold threatens to scuttle their candidacies, a victim of election year politics similar to what happened in the Bush Republican nominees in 2008.

DE Forecast:

- **GDP:** A moderate, increasingly entrenched expansion is forecasted, with real GDP growth in a range of 2 ½% to 3% 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 2013. Oil prices remain high, while core inflation continues to grind higher as the expansion continues.
- **Central bank view:** While the odds of QE3 have gone up in reaction to some disappointing economic news, DE's view of a more entrenched expansion accompanied by relatively steady if not high core inflation means little chance of QE3 this year. It is an open question if an intermediate policy action such as selling Treasuries to purchase mortgages is undertaken. DE expects the Fed to finally hike rates by mid-2013. The Fed's pledge of "low for long" (until the end of 2014) does not mean unchanged. 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.

(M. Cary Leahey)

Canada

Labor market jumps forward but rates to stay put on calm prices, slow growth.

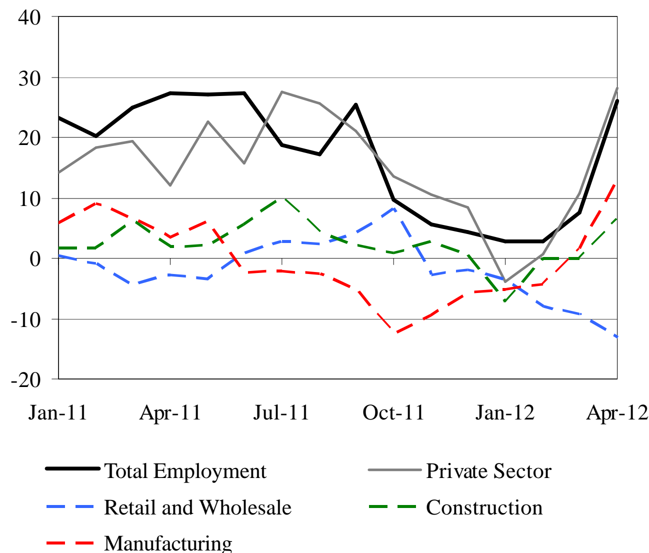
The week ahead: Manufacturing and wholesale data to show continued inventory building (Wednesday/Thursday). The Survey of Manufacturing and wholesale trade will be of technical interest for both Q1 and Q2 GDP calculations. Both manufacturing and wholesale inventories have been strong in January and February, and further significant inventory building in March would bolster growth in Q1 at the expense of Q2. This data comes on the heels of the March C$350 million trade surplus which also impacts GDP. While the trade surplus declined in Q1 relative to 2011:Q4, the surplus gained in monthly terms.

Prices to remain below target (Friday)… April consumer price index (CPI) data will likely show that both the core index and headline index are below the 2 percent inflation target. The CPI will be scrutinized over the next few months as a barometer for the timing of interest rake hikes.

…leaving the BoC on the sidelines… At 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, the market have been on edge—overreacting to each new indicator in terms of pricing in the timing of interest rate changes.

…despite another strong employment report. The April employment report which arrived Friday showed a strong continuation labor market improvement. Canada added 58,000 jobs in April with gains concentrated in private sector and full-time employment. In year-over-year terms, employment in the goods sector has expanded by 2.4% while service sector employment has only grown by 0.9%. These trends are particularly pronounced when retail employment is compared with manufacturing and construction employment.

Chart 4
Recent Employment Improvement Concentrated in Goods Sector, 6 month average net change in thousands



Source: Statistics Canada

Employment gains reach historic highs. Combining the +58K in April with the +82K figure for net change in employment in March, Canada has not added as many jobs in a two-month span since 1981. Looking forward a monthly average of +25K would indicate moderate and sustainable progress towards full employment. The chart at right shows both the total employment as well as private sector six month average changes in the +25K range.

But uncertain external conditions dominate the landscape. With this recent data hitting all the right notes in terms of lasting and meaningful improvement in the labor market, speculation continues on the timing of any monetary policy changes. However, inflation remains subdued and global headwinds have picked up velocity of late—suggesting a hold for now.

DE Forecast:

- **Real 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 on tensions in Europe. 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.
- **Central Bank:** Policy rate on hold at least until late 2012—even with the recent improvements in the labor market. The BoC likely will not tighten before the Eurozone stabilizes and U.S. economic data shows more consistent firmness. (Melissa Pumphrey)

(Melissa Pumphrey)

Eurozone

How Large a Further Drop in GDP?

The week ahead: A wide array of developments, including data updates, will continue to drive if not weigh on markets in the coming week, not least the (political) **situation in Greece** and the **general fiscal situation** through the rest of the Eurozone. Market moves may be exaggerated by the fact that series of major **bond auctions** are due, including ones in Italy (Mon), France (Wed) and Spain (Thu).

EU finance ministers meet. As for **Greece** (see Focus), the main interest will be whether any move is made to forming a government or whether a fresh election will be more likely. Either way, the clear message from Greek political parties will be demands for an easing in the austerity that is being foisted on it, let alone the *additional budget cuts that now increasingly seem to be needed if current fiscal targets are to be met*. This is anathema to the rest of the Eurozone, with the fact that Greece's future in the Eurozone lies in its own hands being underlined very clearly in any conclusions that may be forthcoming from the **meeting of Eurozone finance ministers on Monday** and then the meeting with their EU counterparts on Tuesday.

However, this finance ministers' meeting may be more willing *to discuss an easing in fiscal targets for the rest of the Eurozone*, offering a further year (beyond the currently mandated 2013) for countries to meet the 3% budget deficit targets. For some countries this may have strings attached, eg in *Spain, it is clear that the EU want speedier action regarding, and an independent audit of, the country's banking secto*r.

Merkel meets Hollande! Fiscal policy will also be the key topic when German **Chancellor Merkel at last meets with new French President Hollande** (tentatively set for Tuesday). Already, Chancellor Merkel has sounded more diplomatic, trying to play down any differences with the new French leadership. Certainly they will show unity on the Greek situation. In addition, Chancellor Merkel will continue the more growth orientated rhetoric seen of late from her. This is not just because she wishes to avoid any spat with France, but is as much a realization that her hitherto focus on austerity is unpopular even in Germany, losing the Chancellor and her party key regional elections of late (the next of which is due on May 13). Indeed, Chancellor Merkel may not only now have to appease the Socialists in France, but also the Socialists in Germany (with their similar more growth-orientated agenda), as she may have to work much more closely with them, eg needing their support for key upcoming legislation.

Economy still contracting. The Eurozone recession is continuing and a clear reminder is likely to come in **Q1 GDP numbers** on Tuesday. Indeed, Eurozone GDP may contract a little more than the 0.3% fall of the previous quarter (Consensus: -0.2% Q/Q; DE: -0.4%), thereby actually undershooting the more gloomy projections made by the EU Commission. This may involve disparate results among the various Eurozone countries, including a lack of a recovery in Germany (Consensus: 0.0% Q/Q; DE: unch), a return to contraction in France (Consensus: unch Q/Q; DE: -0.3%) and a continued, relatively steeper fall in Italy (Consensus and DE: -0.7% Q/Q). As much focus may be on the other economies, not just the other peripherals, but even the likes of the Netherlands which actually went into recession ahead of many other countries.

However, a slightly steeper GDP decline in Q1 than in the previous quarter does not mean that the recession has actually got worse, instead the possible greater weakness being more result of poor weather in February that hit both manufacturing and particularly construction, albeit boosting the energy sector. Indeed, the Eurozone economy may have ended the quarter on a firmer footing at least as far as Eurozone industrial production is concerned – March numbers arrive on Monday (Consensus: 0.6% M/M; DE: 0.5%). Regardless, the clear signs are that recession is continuing into the current quarter. This is likely to be the message from the May **ZEW survey** in Germany due on Tuesday as well as **Eurozone car registration figures** (Wed).

Inflation update. Final **HICP** data (Wed) should confirm a small drop in the headline rate to 2.6%, possibly also revealing an edging back in the core figure too. In addition hints of an easing in pipeline price pressures may come in softer German **WPI** and **PPI** readings on Monday and Friday respectively.

DE Forecast:

- **Real 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. Downside risks building, especially if Greece defaults.
- **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.
- **Central bank view:** 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. German resistance to current policy measures may be diminishing.

(Andrew Wroblewski)

United Kingdom

BoE Stimulus, Ended or Paused?

The week ahead: Clearer insight into BoE thinking? All eyes will be on the **BoE Inflation Report** and the accompanying press conference this Wednesday as markets try and get a clearer reason why the BoE failed to extend its asset purchase program any further at the MPC meeting last Thursday.

The *latest MPC decision was hardly a surprise*, although a little troubling given that the MPC gave no reason for its inaction, a clear contrast to the last time asset purchases were put on hold (February 2010) when the BoE then clearly underlined that additional purchases could be made should economic circumstances warrant it.

DE view: More likely than not, the Inflation Report will hint that asset purchases may resume, albeit also hinting that *the MPC was split on the issue*, these divides possibly being the reason why the central bank failed to explain its inaction last Thursday (NB the vote back in February 2010 was unanimous, possibly helping explain why a statement was then readily forthcoming. The extent of any split will not be clear until the minutes of the meeting are released on May 23, although the *Inflation Report may offer clues, possibly noting in the Overview a wider range of views among committee members regarding inflation risks.*

Scope for more stimulus? More likely than not, scope for further asset purchases may be explicitly evident in Inflation Report itself, via a further undershoot of the 2% CPI inflation target. This is likely to reflect the impact of the stronger level of sterling, tighter financial conditions as well as the undershoot in activity so far this year (the latter meaning that GDP projections will be pared back). However, the risk is that the clearer worry regarding inflation resilience may have worked its way into BoE thinking, meaning that the Inflation Report central forecast may not show inflation below target two years hence. But even if this were to be the case, *there may still be more implicit scope for further asset purchases in the Inflation Report* projections as (has been the case for some time now) there will be no formal quantification of the size and likelihood of the downside risks emanating from the Eurozone, the BoE believing it impossible to estimate the most extreme outcomes. Indeed, this point may be underlined by Governor King to highlight that the BoE would be able and willing to respond should Eurozone risks materialize. Moreover, he may highlight that the BoE could revise asset purchases at any juncture, with it far from it being the case that the BoE is tied to changing policy only in the months in which Inflation Reports are published.

Why the reservations? Therefore the BoE is likely to imply that at this juncture further action could very well be forthcoming. However, and especially if there is scope highlighted for further monetary stimulus, it will be interesting to see why the BoE did not use at this juncture. Most likely , this may be a result of the inflation worries that have emerged in recent months, something that may have been fanned by the latest PPI data which the MPC meeting would have had access to. However, it may also be the case (at least for some MPC members) that there may be growing questions about what asset purchase are actually doing:, are they are having any impact at all or even that they are counterproductive as they may be pushing up inflation.

Labor market update key. Regardless, the data due this week will largely be important in shaping both market and central bank thinking. **Visible trade data** for March (Tue) may not have much impact, although it will be interesting to see if the fall back in exports (of 3.4% M/M), seen in February is reversed. This is highly likely given that the February numbers may be anomalous given the impact of poor weather during the month.

Instead, the greater focus may be on the **labor market report** (Wed). Recent reports have been mixed, albeit echoing somewhat the less downbeat messages in labor market survey data seen of late. However, the more up-to-date claimant count numbers which (notably) show a continued rise do urge caution in assessing the labor market backdrop, possibly being an indication that perhaps the more lagging ILO data improvement is a result of mild weather seen in late 2011 and January this year rather than any underlying turn for the better. Indeed, a further clear rise may be on the cards in these upcoming numbers (Consensus: 5 000; DE: 7 500), especially given the impact of poor weather during April

Regardless, what work is being garnered is still being remunerated softly and still clearly below what is now falling consumer or retail price inflation rates. Indeed, the likely even weaker **average earnings data** (Consensus: 1.1% Y/Y; DE: 0.9%), in tandem with increased signs that what work there is far from full-time (self-employment remains near an all-time high), actually implies even more erosion may be occurring in regard to household spending power.

DE Forecast:

- **Real GDP:** Official data suggest U.K. 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.
- **Central bank view:** 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. (Andrew Wroblewski)

Other Europe

Sweden: Riksbank Diversifies

The week ahead: More from the Riksbank. It will be interesting to see if the **Riksbank** gives any further insight into its **new bond portfolio**, evidently designed to ensure that the required systems, agreements and knowledge are in place if it becomes necessary to rapidly take extraordinary measures in the future. So far the Riksbank has said it will create a fund worth SEK 10 bln, most likely being built gradually through to the end of the year. Otherwise, there is no data of any note in the current week.

DE Forecast:

- **Real 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.
- **Central bank view:** Riksbank likely to be on hold until mid-2013, especially if Krona rallies afresh.

Norway: More Risks for the Norges Bank to Consider

The week ahead: Credit Figures to remain strong? In keeping its policy rate on hold last week, the Norges Bank was nevertheless more open about the signs that activity in the Norwegian economy is slightly higher than it had expected, something it corroborated by pointing to the results of its regional network reports. While of course downside risk elsewhere abound, there were clearer hints of the *potential policy dilemma the Norges Bank is facing*, with a further acknowledgment that low interest rates over a long period may lead to considerable risk taking and excessive debt accumulation among households and firms, this risk is already evident in the still rising growth rate for **private credit**. The next update arrives on Monday, with it notable that the last set of numbers (February) were already the highest in almost three years at 7.0% Y/Y.

DE Forecast:

- **Real 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.
- **Central bank view:** Norges Bank on hold until at least next year.

Switzerland: Franc Fixation Continues

The week ahead: SNB update due. Recently-appointed **SNB President Jordan** will give a keynote address on Monday. He is unlikely to depart from the clear central bank script used of late, namely that the SNB will do its utmost to cap the Franc. Markets are unlikely to be impressed, fully aware that *the Swiss Franc will not lose its safe haven status should Eurozone turmoil intensify further*.

DE Forecast:

- **Real 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.
- **Central bank view:** 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: RBA Still the Focus

The week ahead: Budget surplus planned. The key event in the past week was the announcement of the Budget for fiscal year 2012/13, which revealed the Government keeping its promise to return the budget to a surplus this year. Given that the deficit forecast for the current fiscal year (ending in June) was also revised higher, the return to surplus would likely entail the largest fiscal contraction in over 40 years in the nation or around 3% of GDP. This would be about equal to the Government's forecast for growth in each of the next two years. Commenting on this, Treasurer Swan said the move would provide a buffer against the uncertain global economic outlook and clearly shifted the burden of supporting growth to the RBA by saying that it would also "allow monetary policy to respond to economic developments as appropriate". However, while traders' speculation of a rate cut as soon as the RBA's next meeting in June spiked to near-certain following the budget announcement, these then fell back clearly after the release of labor market data last week showing the unemployment rate falling to the joint-lowest since 2008.

Minutes likely to reveal little new. With the latest speculation on the RBA upcoming decision, the release of the **minutes** to the **RBA policy decision meeting** on 1 May arriving this Tuesday will likely garner more attention than usual, but is still unlikely to provide many new insights into RBA thinking beyond the information already released in the statement by Governor Steven following the meeting and the subsequent release of the May Statement on Monetary Policy. **Labor cost** updates in the form of the **Labor Cost Index** (Wed) and **average weekly wage** (Thu) figures for Q1 may also be of some interest, albeit with both measures expected to see some easing back in growth from the previous quarter.

The remainder of the week sees data on **home loan approvals** on Monday and **Westpac consumer confidence** figures on Wednesday, where the former is likely to see a third-straight but less steep drop compare to the previous month.

DE Forecast:

- **Real GDP:** Following disappointing results in Q4, GDP growth is still expected to pick up this year to around 2.75% in the first half of the 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 this year to 1% to 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.
- **Central bank view:** Given the hints from the latest (May) Statement on Monetary Policy that the Bank had scope for further policy easing, and the subsequent announcement of the 2012/13 budget, the probability of at least another 25 bp cut (to 3.50%) before the end of the year has increased significantly, albeit with an August rate cut still seen as being more likely than June.

New Zealand: Updates on the Consumer Awaited

The week ahead: Retail sales the focus? Following a relatively quiet week in which the only notable economic data release revealed a clear swing back into contraction for the nation's manufacturing sector, the coming week offers key updates on the consumer in the form of Q1 **retail sales** data (Mon) and **ANZ consumer confidence** numbers (Thu). The former will be closely watched and is expected to see some correction following two consecutive quarterly increases which were the largest since 2006. Elsewhere, **producer price inflation** data for the first quarter arrives on Thursday, which is expected to reveal a further easing in price pressures after the modest increase seen in Q1, before the **Performance of Services Index**, which will likely continue to imply solid expansion in the sector, completes the week (Mon).

DE Forecast:

- **Real GDP:** A moderate expansion is expected in 2012 following a disappointing result in Q4, with GDP growth of 1½% to 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 speeds up, albeit remaining below 2% for most of 2012 and 2013.
- **Central bank view:** 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

GDP, and Hints on the Outlook

The week ahead: How lasting will first-quarter strength be? Data in hand point to a solid 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. Last week saw some mildly favorable news in a decent first-quarter performance for balance of payments services trade, perhaps signaling a better trend, and in good March composite business conditions index readings. This week brings the first official estimate of first-quarter **GDP** growth, plus a few March indicators filling in quarter-end detail that might hint at the near term outlook. Most important among the latter will be **machinery orders**, a direct indicator of near-term demand, and also an important spot check on business confidence.

DE view: GDP growth probably accelerated to a +0.8% rate in the first quarter, with a good boost from consumer spending—some of it reflecting long-delayed disaster relief payments—and little, if any drag from international trade. Broader-based earthquake/tsunami reconstruction activity will help sustain growth in a more subdued—but still above-trend—range for awhile, probably through year end, with a firming global growth picture gradually kicking in to support longer-term growth in the 1% to 1.5% annual zone over coming years.

Domestic corporate goods prices slip back into deflation (Mon). Year-ago factors are falling out of price comparisons big-time this month, with the March domestic corporate goods price index to swing to a 0.2% year-on-year decline from a 0.6% rise in February. This will not be regarded as a lasting shift, since developments in coming months will be compared with much weaker year-ago moves; continuation of recent trends will lift the year-on-year figures back up before long.

Tertiary industry activity fades a bit further (Wed). March tertiary industry activity likely declined 0.3%, keeping the full quarter roughly flat with the fourth-quarter level—surely a temporary stall, after the accelerated rebound from the post-tsunami crash.

Machinery orders consolidate (Wed). March core orders should fall 1.5%, after posting increases of 4.8% in February and 3.4% in January. That sort of decline, or even a moderately worse one, would preserve a slow, but reasonably steady, uptrend in place since early 2009—an indication of sturdy business confidence, given the severe—and unavoidable—shocks Japan has suffered over recent years.

GDP rebounds strongly (Thu). GDP grew about 0.8% in the first quarter, or 3%+ at an annualized rate—a powerful rebound from the 0.2% decline suffered in the fourth quarter. Consumer spending looks exceptionally strong, and foreign-sector developments might even boost growth slightly, rather than dragging on it severely, as in the fourth quarter.

DE Forecast:

Real 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 extended deviation from a path towards 1% core inflation over the next three years.

Central Bank: 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 pushing up inflation, will lift the ten-year JGP rate slowly towards 2.0%, and ultimately beyond.

(Pierre Ellis)

Emerging Markets

Week ahead: a relatively light high-frequency data week, with a few GDP releases and no central bank meeting of any consequence.

Price gains in India to show easing. Price data on India expected to show continuing and moderate disinflation (DE's estimate: 6.7% year-on-year), but an adverse result would increase the already significant risk of a heightened focus on inflation control at a time when the pace of economic activity continues to slow.

Hungary and Czech Republic GDP will reflect spillover effects from Eurozone… Hungary and Czech Republic, two small open manufacturing-oriented economies in the eastern edges of developed Europe probably saw their GDPs either fall during the first quarter (Hungary: -0.2% year-on-year), or barely grow (Czech Republic: 0.4% year-on-year), with conditions more likely to worsen than to improve in the foreseeable future owing to their large export dependence on the Eurozone.

…while Russia GDP shows commodity-based strength…The contrast with commodity-dependent Russia is notable. There are only feeble indications (a slowing of imports at the end of the first quarter, some slowing of industry in March following a spike in February) that Russia's recovery may have suffered from the deterioration of Europe's economic performance. At present, our expectation is for real GDP growth upwards of 4% during the first three months of 2012. And while Russia cannot be isolated from the Eurozone's recession and all related risks, it appears, at this stage of the cycle, to be less vulnerable than the smaller central European counterparts. In part this is because commodities still have support from EM demand.

…and low interest rates and inflation in Mexico bolster growth. Another economy bucking the global cooling trend is Mexico, whose economy has been strengthening during the past few quarters—a notably different trajectory than most other EMs. Mexican real GDP growth was probably strong in the first quarter (DE's estimate: 4.4% year-on-year). Part of the reason is domestic: within-target, low inflation has allowed Banco de Mexico to keep rates at historically low levels (with some hints that they may even be cut this year), boosting consumption and investment. Domestic investment is also supported by the recovery of employment in the U.S., which tends to lead to increasing worker remittances into Mexico, and by the (this time) benign impact of the U.S. manufacturing improvement on Mexico's industry.

Central Bank Watch: No scheduled policy meetings this week.

DE Forecast:

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 central banks watchful of 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 development s 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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