

December 31, 2011

## Growth and Inflation

The global economy is expanding at a slow rate, but macro policy measures are turning to support growth in Asia. The lagged impact of monetary policy brightens the outlook for global growth in the second half of 2012. The U.S. economy continues to show relative strength to Europe and Asia, but the Germany economy has been slow to buckle under the weight of the EZ crisis. A warm winter in the U.S. has lowered heating costs and lifted construction, which should help to raise disposable income. Purchasing managers data released in early January will provide the next comprehensive view of global growth. Early manufacturing PMI releases for Japan and China implied growth continued to struggle in Asia during December.

Inflationary pressures have moderated. Slower global growth, austerity measures in Europe and flat to lower commodity prices have pressured inflation. The U.S. 10 year TIPS break-even has dipped under 2.00% in recent days and implies a benign inflation outlook. In Asia, the growth rate of wholesale prices has plunged in India and Chinese real estate prices are under pressure. Highlighting falling inflation expectations in China, a PBOC survey indicated that 36.8% of households expected prices to rise in the coming quarter compared to 50% the quarter prior. Additionally, the Markit Chinese PMI indicated that manufacturers were discounting. Headline inflation in Asia should show an easier trend in Q1 2012. In the U.S., the holiday season saw discounting, and warm weather will weigh on apparel pricing. In Germany, the December flash CPI was up 2.4% y/y, showing signs of cresting. Inflation is also likely to fall in the U.K. due to base effects.

## Money Markets

The U.S. Treasury market will be sensitive to asset allocation shifts (portfolio re-balancing), the EZ sovereign crisis, and the trend in global economic growth. Valuation is poor with the real 10 year yield below zero based on the core

inflation rate and nominal yields flirting with 2.00%. Treasury bonds posted a 30%+ return in 2011, outpacing major asset classes. Without financial or geopolitical crisis, treasury price appreciation potential seems limited and when coupled with a large 2011 return could cause investors to pare treasury holdings in favor of risk assets. One sign of poor value may rest in the recent liquidation of custodial treasury holdings at the Fed. Holdings have declined about \$50 bln in December. However, without clear resolution of the EZ crisis, investors will remain warm to treasuries. Politicians in Europe have yet to prove they have implemented a policy of stabilization, and many in the trade see the risk that Greece will have to leave the EZ in 2012. The ECB has had some success lowering the yield of short term debt in Spain and Italy, but 10 year yields need to drop meaningfully to hurt treasury demand. Strength in the U.S. economy has had limited impact on treasury pricing. Initial unemployment claims have been persistently below 400,000, but have yet to spark selling. Likewise, holiday sales results were firm and there are reports of extremely heavy traffic at Disney's Orlando theme parks. The market seems more focused on weaker Asian and European growth than improved U.S. growth prospects. A turn around in Chinese share prices, a dynamic which could signal improved Asian growth, may be a factor which leads to lower treasury prices. Likewise, a clear acceleration in growth as highlighted by rising global PMI indices would probably hurt treasury prices.

## Foreign Exchange

The FX market will be looking to see if dollar demand eases in the New Year and focused on relative growth differential. In early January, banks may be more willing to lend dollars as year-end window dressing abates and the ECB shows greater willingness to provide liquidity. Furthermore, central banks in India and China could ease monetary policy and lower risk aversion. Entering 2012, the U.S. economy has been displaying relative strength to other economies to the dollar's benefit.

The **euro** will be pressured by an expansion of the ECB's balance sheet, but also be sensitive to the health of the EZ economy and strength of monetary union. The ECB's willingness to expand its balance sheet via the provision of 3 year repos will dramatically raise the amount of euros in the system. Further, the ECB is likely to cut interest rates another 25 bps in first quarter of 2012, and there is a growing expectation that another long term repo operation could be implemented (say a 5 year repo). European growth remains poor in the peripheral, but the IFO suggests the Germany economy is slow to deteriorate. The financial stability of the EZ is fragile, and Merkel and Sarkozy are expected to meet January 9<sup>th</sup> to discuss fiscal and economic union. The sovereign crisis is not resolved and the euro is flirting with an important technical level at 1.2867 - the January 2011 low. Credit rating downgrades risk hurting confidence in the ability of governments to prevent crisis and are possible in Q1 2012. The **sterling** will be sensitive to economic trends and diversification demand. CBI sales data suggested a lift in consumer spending and painted a stronger picture of growth, but the housing and manufacturing sectors are still weak. The BOE is open to additional monetary ease if inflation falls. The sterling sharply outpaced the euro in the second half of 2011, and investors have shown a strong appetite for gilts with 10 year yields recently trading below 2.00%. Signs of stability in the EZ and low gilt yields would leave the sterling vulnerable to weakness. The **Swiss franc** is likely to be pressured by poor economic growth and the desire of the SNB to check its strength. The economy is not performing well under the weight of a high franc. Real exports contracted 6.8% in November, and growth rate has decelerated sharply in recent months. Likewise, the UBS Consumption index fell 0.9 to 0.81 in November. It is just above recession levels seen in 2003 and 2009. The **Canadian dollar** will be sensitive to commodity prices, the pace of growth, and diversification flows. If the CRB index breaches the 290 level, the Canadian

dollar could find selling on the idea of weak commodity demand and pricing. However, the potential for monetary ease by the RBI and PBOC could bolster the outlook for commodity demand in the second half of January and provide spill over support to commodities and the Canadian dollar. Domestic growth is not at a level which seems to argue for a major currency move in either direction. However, the Canadian dollar remains an alternative to the euro and U.S. dollar as investors look to diversify holdings. The **Australian dollar** is expected to be sensitive to the outlook for growth, stock market direction in Asia, and the outlook for rate cuts by the RBA. Chinese and Indian shares have pointed to weak economic growth and sluggish commodity demand. However, monetary ease in China and India is likely in late January and could bolster the outlook for a soft landing. Domestic economic activity is mixed to weak, and the RBA is likely to keep cutting rates which is likely to cap the Australian dollar on brisk rallies. Over the last six months, there has been an 86% correlation between the CRB Index and the Australian dollar. The **yen** continues to trade range bound pressured by weak growth and the BOJ's desires to cap gains. However, lack of attractive interest rates in the U.S. and Europe are providing support. Further weakness in Asia outside of Japan is providing an incentive for Japanese investors to keep money home.

### Equities

U.S. stocks will be driven by asset allocation and the outlook for profit growth in the New Year. The S&P 500 turned in a flattish performance in 2012, badly lagging treasury bonds. However, U.S. shares outpaced much of the emerging world, European shares, and the CRB Index. U.S. shares could find some buying on portfolio rebalancing out of treasuries into stocks, and some investors see high dividend paying multi-nations as a safe haven. Profit expectations have been easing in recent weeks, but still leave the market looking cheap compared to treasuries and history. The S&P 500 is expected to earn about

\$102.50/share over the next year and is trading about 12.3 times earnings. The expected earnings yield is 8.1% compared to a 10 year treasury yield near 2.0%. Internationally, the DAX has a dividend yield of 4.1%, which is about 2.0% above the yield on the 10 year Bund yield. The outlook for profit growth will be better shaped on the release of Q4 2011 profits and Q1 2012 guidance. Alcoa is historically seen as the firm kicking off the earnings season. It is forecast to release numbers January 9<sup>th</sup>. The trade will be monitoring the technology sector for signs of underlying demand and the fading impact of flooding in Thailand. Industrial shares will be watched for indications that the slowdown in Asian and European growth is undercutting profits. Expectations for bank shares will be depressed due to the regulatory and trading environment. If implemented in late January, looser macro policy measures in India and China could raise investor interest in equities on hopes for a growth revival. Technically, traders could view the ability of the S&P 500 to hold or fail at 1292 as being pivotal to price direction in Q1 2012.

### Commodities

Commodity prices will be sensitive to the growth outlook, geopolitics, and weather. The slower growth trajectory has undercut inflation expectations and demand, but prices could stabilize if macro policy loosens in Asia and translates into firmer growth. Social unrest and Iran's quest for power are present in the Middle East to the benefit of oil and gold prices. Dry weather conditions in South America threaten crop production. In 2011, the CRB saw eight of its nineteen sectors up led by RBOB gasoline (27%), OJ (18%), and live cattle (16.3%). Natural gas (-45%), cocoa (-35%), and wheat (-25.7%) lagged. Looking at individual markets:

The **oil** market will be sensitive to tensions in the Middle East and the trend in demand. Geopolitical factors appear price positive. Iran continues to saber rattle around the Strait of

Hormuz, and tensions in Syria and Iraq are present. Demonstrations in Syria continue with the killing of protesters and reformers making news. The withdrawal of U.S. troops seems to have raised the level of violence in Iraq. On a bearish note, Libya's oil production has picked up and is reportedly at slightly more than 1 mbd. The National Oil Corporation said that production was expected to reach 1.6 mbd, pre-civil war levels, by mid 2012. Weak growth patterns in Asia and Europe put firm demand estimates at risk. Product inventories in Singapore are at the lower end of the three year range and point to tight supplies, but the decline is probably driven very low crack margins. The Minas 3:2:1 crack is barely positive and at a multi-year low implying weak demand. On a more positive note, Platt's reported that Chinese oil demand was up 2.6% y/y in November to 9.54 mbd. Platt's suggested that diesel shortages remained present. In the U.S., product demand trends are mixed. Gasoline demand continues to show weakness and was off 5.62% y/y in the four weeks to December 23<sup>rd</sup>. Gasoline demand has been persistently weak suggesting that prices are too high and rationing usage. In contrast, distillate demand is strong and was up 3.88% y/y in the four weeks to December 23<sup>rd</sup>. Growth is solid given warm weather patterns. On the supply front, crude oil inventories are following normal seasonal patterns, and likely to increase through Q1 2012. U.S. domestic production remains strong to a year ago, and imports are near year ago levels. Gasoline stocks are building and slightly high to the five year range. The days supply is ample at 24.9 days compared to 23.1 a year ago. Distillate supplies are on the mid to lower end of the five year range, and likely to move sideways to lower in the coming weeks on a seasonal basis. The days supply was 34.9 compared to 41.6 a year ago.

**Natural gas** prices will be sensitive to weather. A mild December has left supplies more than ample. As of December 23<sup>rd</sup>, there was 3,548 bcf in storage up 9.1% y/y and 13.7% ahead of the 5-year average. Storage

is outside the 5 year range and falling slowly compared to normal. The NOAA 8 to 14 day temperature forecast had above normal temps through much of the Midwest up into the Northeast into January 14th. Temps are likely to be a drag on prices. Rig count levels remain strong and production is on the mind of producers. Through the week ending December 21<sup>st</sup>, gross production was up 6.6% y/y, while U.S. consumption was off 14.5% y/y paced by a decline in residential and commercial usage. Industrial usage has slowed relative to last year, which is also a negative. Weaker global growth may be cooling industrial output and offsetting cheap prices. However, it will take a few more weeks of poor usage to prove a trend.

**Gold** prices have been pressured by liquidation, but the lead futures contract has found support around the September low in the \$1540 area. Gold faces mixed cross currents. Slower economic growth in Asia and Europe are a negative for demand growth, but low interest rates and political uncertainty are supportive. The weak Indian rupee has been a headwind to demand and highlights the potential adverse impact of softer growth on consumption. The U.S. Mint recently indicated that it would have sufficient supplies and did not anticipate having to allocate initial coin releases. Gold Eagle sales in December were said to be tracking 20% below the monthly average. ETF gold holdings were 75.78 mln oz at writing and off the recent peak of 76.9 mln oz in the mid December. The reduction has been limited given the recent price decline. The ECB is expanding its balance sheet which is an inflationary dynamic, but the action is also lending support to the dollar which detracts from gold demand. The ECB's 3-year repo operation has lowered refinance risk and brought down short term interest rates in the peripheral of the EZ, but long rates are still high and the sovereign crisis is not resolved. The potential for downgrades to EZ sovereign credit ratings and the possibility of Greece leaving the EZ could cause investors to remain interested in gold. Ultra low U.S. treasury yields and concerns of a collapse in

Chinese real estate are additional reasons for gold to find support.

**Copper** prices will be sensitive to economic growth. The current supply/demand picture remains tight, but should loosen as it appears that Freeport's Grasberg mine will ramp up to full production by January 20<sup>th</sup> post strike. LME stocks have continued to trend lower in recent weeks and highlight tight supplies. At writing, LME inventories stood at at 370,400 mts. Inventories in Shanghai rose 10,936 mts in the last period to 93,219 mts, but stocks are still near the lower end of the two year range. Slower real estate activity in China and India put demand growth at risk. The U.S. housing market has shown signs of firming, but remains historically depressed and is unlikely to carry the copper market higher at this juncture. The direction of the global PMI in early January and Asian equity markets could set the tone for copper. Over the past six months, there has been an 89% correlation between the Chinese CSI 300 and the price of front month copper.

**Corn and soybean** prices will be sensitive to South American weather and demand patterns. The market continues to develop a risk premium as Argentina has been dry, and about 19% of the crop still needs to be planted according to the Buenos Aires exchange. The USDA's weekly weather and crop bulletin highlighted dry conditions in Southern Brazil and Argentine, and indicated early plantings in Parana have left crops susceptible to warm and dry conditions. As a result of dry weather, analysts are cutting their production forecast for the American soybean and corn crops. On the demand front, it should be noted that barriers to ethanol imports will be reduced in the New Year, but ethanol production in Brazil is struggling to keep up with domestic demand. Export sales for corn and soybeans are lackluster down 23.7% y/y and 3.6% y/y respectively over the past four weeks. Technical traders will be watching the ability of March corn to move over \$6.50. March

soybeans have major resistance substantially higher around \$13.00.

**Wheat** prices will be driven by the price of corn and grown conditions in the Ukraine and U.S. Plains. The dry conditions in the Ukraine are leading to a reduction in the production outlook. The U.S. Plains are expected to see normal to below normal precipitation and above normal temps. The forecast does not appear ripe to shake the production outlook for U.S. winter wheat at this time. U.S. export sales are off 42.2% y/y over the past four weeks. Demand is not strong enough to generate a bid. Technicians are likely to watch \$6.32 and \$7.00 in the Chicago March contract for price direction.

**Cotton** prices will be sensitive to demand and the outlook for overseas production. U.S. holiday sales appeared solid and Nike recently reported strong sales and orders, which is a plus for the consumption picture. Other data points are mixed. Chinese cotton yarn imports fell 11.8% y/y in November and have been consistently weak in 2011. In contrast, uncombed Chinese cotton imports were strong both sequentially and year over year in November at 378,124 mts. Thailand's cotton imports were reported to be down 42% y/y in November hurt by flooding. Recently, India's Business Line has reported a pick up in cotton purchases by mills and exporters suggesting improved demand for Indian cotton. U.S. export sales, which are down 84.7% y/y over the past four weeks, point to lackluster demand. On the supply side, the USDA cut its outlook for Indian production. Output was reduced by 750,000 bales to 33.50 mln bales. The USDA's production outlook comes on the back of reports that farmer sales in India were down 25% from year earlier between October 1<sup>st</sup> and December 25<sup>th</sup>. A slow harvest was blamed. There is also market chatter suggesting that plantings in China could be down in 2012. Area could fall 20%, but the USDA has been cautious about such a sharp drop in actual plantings. ICE stockpiles are lean at 39,394 bales.

**Cattle** prices will be driven by demand. Supplies are poised to expand into February, but producers are current. Slaughter was 539,000 head in the last week off 4.9% y/y, while steer dressed weights are 6 lbs below last year. Thus, even though supplies are likely to increase seasonally, supply looks manageable. Higher corn prices could put some pressure on producers to move cattle to market, but more strength in corn is probably needed to shift behavior. Looking at demand boxed beef prices are flirting with record highs. Demand could downshift post the holiday period, although lower than expected heating costs may help to lift disposable income and help consumption at the margin. Packer margins are narrow and not supportive to aggressive buying. Export sales of beef have remained firm in recent weeks up 9.7% y/y in the past four weeks, but hide sales were down 0.8% y/y in the past four weeks. Foreign demand continues to be a key driver of price.

Like cattle, demand should be a key factor driving **hog** prices. The supply picture is mixed. Seasonally, supplies tend to fall in the first quarter, but numbers should be ahead of last year. The market is looking for a cut back in supply and healthy demand as the February (about \$2.50) and April (nearly \$6.00) contracts are trading at a premium to the spot CME index. The December hogs and pigs report showed the herd up 1.5% y/y. Market hogs rose 1.7%, while the breeding herd increased 0.4% y/y. The composition of the market data suggests slaughter will pick up relative to last year in the coming weeks and rise slightly more than 2.0% y/y in Q1 2012. Q2 2012 slaughter is likely to be just below 2.5% y/y. Hog slaughter for the week ending December 31<sup>st</sup> was estimated at 1.967 mln head up 2.2% y/y. Iowa weights are up about 1.4 lbs from a year ago.

The **coffee** market will focus on the outlook for Brazilian production, while eyeing more bearish dynamics in Vietnam. The Brazilian government is expected to forecast its

assessment on January 10<sup>th</sup>. Expectations for the Brazilian crop have been reduced due to dry weather. Ipanema Coffee, one of the largest producers in Brazil, warned that dry conditions would hurt production. The 2012 crop was expected to be under 53 mln bags and below the 54 mln bags produced in 2010 during a similar cycle year. Likewise, a research group from the University of Sao Paulo projected output between 45 mln and 50 mln bags in 2012 blaming frost and dry conditions for weak production. Outside of Brazil, talk of coffee rust highlights on going production troubles in Colombia, but Peru noted an 18% increase in production to 6.2 mln bags. ICE coffee warehouse stocks have been creeping higher since December 7<sup>th</sup> and suggest some loosening of supply. In Vietnam, farmers have reportedly eased up on selling. However, the General Statistics Office is looking for calendar year 2011 sales of 1.25 mmts up 2.7% y/y. An analyst from the CoffeeNetwork recently indicated that Vietnam could see record production in 2011/2012, while Macquarie indicated that Robusta could see a 2.5 mln bag surplus. CFTC shows large fund positions near balance. The technical condition of the NY March contract could brighten if prices move over \$2.40.

The **sugar** supply/demand balance seems to be loosening, but poor production in Brazil and the potential for U.S. ethanol imports are

positives below the surface. India looks set to export sugar. The Food Secretary indicated that production may be 24.6 mmts in the new crop year compared to estimated consumption of 22.5 mmts. Pakistan reportedly may allow millers to export 500,000 mts after April. A spokesman for the Pakistan Millers Association indicated a potential 1.2 mmts surplus in the 2011/2012 crop year. Production was expected to exceed usage by 600,000 mts and come on top of another 600,000 mt in storage. Indonesia has set a quota of 2.1 mmts of imports in 2012 down from 2.4 mmts last year and purchases of 2.06 mmts in 2011. The Ag Ministry is looking for Indonesia's domestic output at 2.70 mmts in the coming year compared to 2.23 mmts the year prior. On a more bullish note, the law change in the U.S. to allow ethanol imports could be supportive to sugar, but weak Brazilian sugar production has created a deficit in the Brazilian ethanol market. In fact, there are some looking for Brazil to import U.S. ethanol. Reuters reported that Brazil's ethanol production was 25% less than potential demand and down 17% y/y in the current harvest season. Sugar production in Brazil's Center South was estimated at a 24 year low by the CTC research center. Technicians will be watching the ability of the NY March contract to work above 24 cents as an indicator of strength.

### North America

*The **U.S.** economy continues to expand at a modest pace. A mild December will help lift disposable incomes by reducing heating costs and raising construction activity. Regional PMI numbers show a slow expansion in manufacturing sector, while holiday sales looked solid with the ICSC expecting December sales to rise 3.5% y/y off an elevated base. The labor market shows signs of strengthening given a persistent level of initial unemployment claims below 400,000 and housing has found a firmer tone. Inflation looks tame and the headline rate is expected to moderate into early 2012. Fed policy is on hold, but officials will be open to monetary ease until the unemployment rate moves closer to 7.0%. The **Canadian** economy has a slower trajectory of growth given the trend in monthly GDP and labor data. Weaker economic growth in Asia and Europe coupled with a softening of commodity prices has generated a headwind to growth. However, recent retail sales data was firm and suggests the economy is far from recession. Headline inflation should be cresting and the BOC is likely to keep policy steady in the medium term. Key economic indicators:*

### U.S.:

- November Durable Good Orders jumped 3.8% m/m [2.2% expected] and were revised up to flat from -0.7% in October. Non-defense capital good orders ex-air fell 1.2% [+1.0% expected], but were revised up to -0.9% from -1.8%. Aircraft orders rose 73.3%. Details showed strength in primary metals and weakness in computers and electronics. Overall, the data is pointing to flat growth.
- December NAHB Survey rose 2 to 21 [20 expected]. Housing is stable given the range of the index.
- November Housing Starts rose 9.3% m/m to 685,000 units [635,000 forecast]. Single family starts rose 2.3%, but multi-family starts surged 25.3%. There is a significant recovery in multi-family unit construction, which is likely linked to the rental market. Single family starts are down 1.5% y/y.
- November Existing Home Sales rose 4.0% m/m to 4.42 mlu. There was a major revision to the series which shows a slight climb in sales over the past few months. Overall, conditions remain depressed. Home prices were down 3.5% y/y and the supply of homes has dropped to 7.0 months suggesting less inventory overhang.
- November Pending Home Sales rose 7.3% m/m [1.5% forecast]. Sales have rebounded in recent months and point to improved demand.

### Canada:

- October GDP rose 2.7% y/y and has downshifted from the 2010 peak.
- October Retail Sales rose 1.0% m/m [0.5% expected]. Auto, furniture, and electronics displayed strength. Consumer spending is up 4.4% y/y and appears firm.
- October Home Price Index was flat sequentially and up 7.0% y/y. Home price inflation shows signs of accelerating after a pause.
- November CPI rose 0.1% m/m [in line] and 2.9% y/y [2.2% forecast]. Core inflation was flat up 2.1% y/y [2.2% projected], but is at the top end of the five year range.

### Europe

*The **EZ** economy is contracting, but growth in Germany is slow to fall and displays relative strength. Austerity measures and budget concerns continue to weigh on growth in southern Europe highlighted by the deterioration in Italian business confidence. Inflation shows signs of peaking. The ECB will be biased toward additional monetary policy accommodation. A 25 bp rate cut in Q1 and additional measures to provide liquidity to banks are likely. Although there are signs that consumer demand popped in December, the **U.K.** economy is growing at a weak rate. The labor market is soft, while housing remains depressed from a historical perspective. Manufacturing activity has been hurt by weaker overseas growth. Inflation remains sticky and high, but should fall in 2012. The BOE will be biased toward expanding its asset purchase program, but an actual expansion will likely come on a clear decline in the inflation rate and below trend growth. Key economic indicators:*

### Eurozone:

- The December German IFO rose 0.6 to 107.2 [106.0 expected]. Current assessment was flat at 116.7 [116.0 forecast], while Expectations were up 1.1 to 98.4 [97.0 forecast]. The survey has stabilized in recent months and suggests deterioration may be stopping. Detail: 1) Manufacturing was flat at 8.6, but the trend is down. 2) Construction rose 2.6 to -6.6, and has firmed in recent months. 4) Retail rose 4.5 to 5.8 and has bounced compared to the August to November period.
- December Belgium Business Confidence rose 1.6 to -10.6 [-12.5 forecast]. Confidence shows early signs stability.
- Italian Business Confidence fell 1.9 to 92.5 [93.7 forecast]. Confidence is deteriorating with orders and production falling.
- December EZ Consumer Confidence fell 0.8 to -21.2 [-21.0 forecast] and is working lower.
- December Dutch Consumer Confidence fell 5 to -37, and is at a cycle low.

- January German GfK Consumer Confidence was flat at 5.6 [5.5 forecast]. Confidence is trending sideways.
- November Finish Unemployment fell 0.8% to a three year low of 6.2%. Labor demand appears solid.
- November Irish Retail Sales rose 1.6% m/m and contracted 0.8% y/y. The volume of sales has rebounded compared to recent months and holds out hope for improved consumer demand.
- November Spanish Retail Sales contracted 7.2% y/y and highlight weak consumer demand.
- November EZ M3 rose 2.0% y/y [2.5% expected] and points to poor growth with little inflationary pressures.
- Flash German CPI rose 0.7% m/m [0.8% expected] and 2.1% y/y [2.2% expected]. Inflation looks contained. Details from the state data showed a sharp jump in leisure and entertainment prices and weakness in apparel.

### U.K.:

- November Nationwide Consumer Confidence rose 4 to 40 [36 forecast]. The number is bouncing from a record low.
- December CBI Reported Sales surged 28 to 9 [-12 forecast]. There appears to be a surprising bounce in consumer demand. Sales for the time of the year rose 23 to -16 rebounding from extreme weakness between July and November.
- November BBA Home Purchase Loans were 34,738 [35,400 expected]. Activity remains sluggish, but off the late 2010/early 2011 lows.

## Asia

*Asian growth remains weak to trend and there are few signs of improvement. **China's** HSBC/Markit manufacturing PMI argues for contracting growth and it appears the weaker export market is weighing on growth. News from the real estate sector points to a material slowdown in activity. The consumer sector continues to show strength, but the outlook will be reassessed after consumer demand is measured over the Chinese New Year. Inflation has peaked and should work lower in the coming months. The PBOC is set to loosen monetary policy. A reserve ratio cut is expected around the Lunar New Year January 23<sup>rd</sup>. **India's** economy is on soft footing. Manufacturing activity has declined sharply, and State Bank of India recently indicated a material reduction in home loans due to weaker home sales in top tier cities. The positive may rest in reports that home sales are still strong in second and third tier cities. Finance Minister Mukherjee is looking for 7.75% growth in 2012 and inflation between 6% and 7%. Inflation has peaked and should trend lower. The RBI is likely to cut rates 25 bps January 24<sup>th</sup>. The **South Korean** economy is showing slower growth. Business confidence indicators are soft and industrial production is decelerating. Weaker growth in Asia and Europe is weighing on the export sector. Inflation has yet to hit a level which makes the BOK comfortable and remains elevated. BOK Governor Kim indicated that supply side inflationary pressures would weaken in 2012, but inflation expectations remained high. The BOK will keep policy steady as it balances weaker than expected growth and above target inflation. **Australia's** growth is soft pressured by the slowdown in India, China, and Europe. Weaker commodity prices are a drag on growth, and domestic demand is unexciting. Leading indicators of growth provide a mixed picture. Inflation is tame, and the RBA will continue to cut rates in the coming months. A 25 bp rate cut is expected February 7<sup>th</sup>. **Japan's** economy is growing at a poor rate. Business surveys show lackluster activity, consumer spending set back at last reading, and the trade sector is being hurt by the yen's strength and weak overseas demand. Deflation remains a problem, and the BOJ will remain biased toward monetary policy accommodation. Key economic indicators:*

### Australia:

- October Westpac LEI rose 0.1% m/m. The index level of 282.2 shows the growth outlook flat since August.
- October Conference Board LEI rose 0.6% to 125.3. The index argues for continued growth.
- November Private Sector Credit rose 3.5% y/y [3.6% expected] and is depressed suggesting weak growth and limited inflation.

### **China:**

- December Markit PMI rose 1.0 to 48.7. Detail: 1) Production decreased marginally. 2) New Orders fell hurt by muted demand. 3) Inventories rose due to weaker than expected sales. 4) Input costs fell due to lower raw material prices and prices charged fell with discounting noted. 5) Employment levels fell marginally.
- November New Home Prices fell in 49 cities compared to 33 cities in October. Prices rose in only 5 of the 70 cities monitored.
- November Hong Kong Residential Mortgage data showed loans down 8.0% m/m – the sequential trend remains very weak. Gross new loans were 10,564 compared to 24,048 six months ago.
- The PBOC's quarterly survey indicated that the proportion of households looking to buy property down 0.3% to 13.9%, which is near a survey low. Moreover, the loan demand index fell 3% to 79.9% and Business Confidence fell 1.8% to 68.4%

### **India:**

- December 17 Primary Article WPI rose 2.70% y/y, and is down sharply in recent weeks. Inflation is rising at the lower end of the historical range. Basing effects could provide pressure through Q1 2012.

### **Japan:**

- December Manufacturing PMI rose 1.1 to 50.2 and continues to show sluggish growth. Detail: 1) Output declined at a marginal pace. 2) New order volume fell for a fourth straight month. 3) Employment rose at its fastest pace in nine months. 4) Backlog fell. 5) Input costs rose, but there was a marginal decline in output costs.
- December Small Business Confidence fell 0.2 to 45.6. Growth has a soft tone post the earthquake recovery.
- November Industrial Production plunged 2.6% m/m [-0.8% expected]. The index is flat to lower since June and points to weak growth.
- November Exports contracted 4.5% y/y, while Imports rose 11.4% y/y [8.3% forecast]. The volume of export shows weakness sequentially with the index the lowest since May. Import volumes are at the higher end of the year range, but slightly lower than the August peak.
- November Household Spending contracted 3.2% y/y [-1.2% forecast] and 1.3% m/m. After a period of sequential strength, spending fell and argues for a loss in consumer demand.
- November Unemployment Rate was flat at 4.5% [in line]. Employment rose a slim 30,000, while unemployment jumped 40,000.
- November CPI contracted 0.5% y/y [-0.4% forecast]. Core CPI fell 1.1% y/y [in line]. The economy appears to be battling another round of deflation given the trend in the core inflation rate.

### **South Korea:**

- December Consumer Confidence fell 4 to 99. Unease over the death of Kim Jong Il may have hurt confidence. Employment declined 9 to 82 and consumer spending plans eased 2 to 107. Both are soft to trend.
- January Business Confidence fell 3.1 to 96.2. The index is mid range compared to the past six months.
- January BOK Manufacturing Confidence declined 4 to 85 and is on the lower end of the six month range. Non-manufacturing Confidence fell 1 to 83 and is near the lower end of the six month range.



- November Industrial Production contracted 0.4% m/m [+0.4% forecast], but expanded 5.6% y/y. sequentially production has contracted four out of the past five months.
- November LEI rose 0.2%, but the index has been flat since June and suggests slow growth.
- November Service Output rose 2.6% y/y and shows slow growth.
- December CPI rose 0.4% m/m [+0.2% expected] and 4.2% y/y [4.0% forecast]. Core inflation rose 3.6% y/y and is rising.

**Note:** This report has been prepared by Hadrian Partners, Ltd. ["Hadrian"] identified herein. This report is for distribution only under such circumstances as may be permitted by applicable law. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. The report is published for informational purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. The securities described herein may not be eligible for sale in all jurisdictions or to certain categories of investors. The report is based on information obtained from sources believed to be reliable but is not guaranteed as being accurate, nor is it a complete statement or summary of the securities, markets or developments referred to in the report. The report should not be regarded by recipients as a substitute for the exercise of their own judgment. Any opinions expressed in this report are subject to change without notice and Hadrian is not under any obligation to update or keep current the information contained herein. Hadrian and/or its directors, officers and employees may have or have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent in the relevant securities or related financial instruments discussed in this report. Furthermore, Hadrian may have or have had a relationship with or may provide or have provided financial services to the relevant companies. Employees of Hadrian may serve or have served as officers or directors of the relevant companies.

Options, derivative products and futures are not suitable for all investors, and trading in these instruments is considered risky. Past performance is not necessarily indicative of future results. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related instrument mentioned in this report. Clients wishing to effect transactions should contact their local financial services representative. Hadrian accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this report.

**Additional information will be made available upon request.**

No part of this report may be reproduced or distributed in any manner without the permission of Hadrian. Hadrian specifically prohibits the re-distribution of this report, via the Internet or otherwise, and accepts no liability whatsoever for the actions of third parties in this respect.