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Growth and Inflation

Global growth has slowed and appears to lack a catalyst for meaningful strength. U.S. fiscal and regulatory policy is hampering output, while China is balancing its desire to prevent a property bubble with infrastructure spending in the central and western regions of the country. Japan's economy faces the headwind of a strong yen and deflation, while Europe is working through fiscal austerity. Growth in German and France is stronger than Spain, Portugal, Greece, and Ireland creating an uneven Eurozone economy.

Inflationary pressures are limited in the OECD. Slow growth and excess capacity are holding back price gains and muting demand. Real estate markets in the U.K. and U.S. remain depressed and are helping to check inflation by limiting wealth effects. Surprisingly, the USDA lowered its 2010 food inflation forecast by 1.0%, expecting prices to rise 0.5% to 1.0% this year. The downward revision comes despite obviously higher prices for pork, beef, and coffee. Inflationary pressures are present in the emerging world, especially India and China. Strong income growth is helping to underpin demand, and poor infrastructure is contributing to bottlenecks in India. Rising wages in China and India are also working through the economy helping to put a floor on inflation by raising cost structures and stoking consumer demand.

Money Markets

The U.S. treasury market is showing sign of tiring as prices have not been able to show upside follow through despite weak housing numbers and a surprise decline in core durable good orders. Likewise, the market lost its bid in front of what is expected to be weak August PMIs, and a soft August employment report. Valuation is poor with yields at unattractive levels relative to corporate debt and equities, but lack of forward momentum in the economy and extremely low inflation are providing support. In recent months, yields have been under pressure and strongly correlated to the

trend in economic surprises. Economic numbers have persistently fallen short of trade expectations, and economists have been slow to lower growth forecasts. For example, the trade is still expecting August private sector payroll growth despite the fact that unemployment claims flirted with 500,000 during the payroll survey week. The Philly Fed employment index also points to a contraction in private sector payrolls. Treasury prices are unlikely to form a major top until there are signs the real estate market has healed and labor demand has increased. Furthermore, retail investors and banks are large treasury buyers. Inflows have been steady as ideas of a prolonged period of easy monetary policy and low short term rates have boosted demand. Recently, press reports highlighted that between January 2008 and July 2010 bond funds received \$559 bln in fresh cash. At the same time, equity funds experienced a net outflow of \$232 bln. Through late August, the trend showed no signs of stopping. On the institutional front, the Fed's H8 data showed commercial banks had increased treasury holdings by nearly \$100 bln since June 6th. Complementing the retail and bank bid, custodial accounts have been strong buyers in the last four weeks purchasing nearly \$60 bln in treasuries. The Fed also continues to reinvest proceeds from maturing MBS and agency debt holdings into treasuries in order to keep its balance sheet at approximately \$2.05 trln. The upside risk to yields rests in unattractive valuation and the heavy inflow of money into the market being a contrary indicator. One well known survey indicated that portfolio managers were historically long to benchmark and there is market chatter suggesting a well known West Coast fund is starting to lighten up on treasury holdings.

Foreign Exchange

The dollar is likely to trade choppy. In recent sessions, the dollar has been trapped by reacting to growth differential and the "risk" trade. At this juncture, it is unclear which driver is winning out. The **euro** is benefiting from signs of relatively strong growth. The

flash EZ composite PMI and August German IFO survey displayed strength relative to U.S. housing numbers and the recent trend in durable goods orders. Likewise, dollar 3 month LIBOR rates have declined sharply in recent weeks falling under 30 bps and are hurting the dollar's yield. Based on the Euribor/Dollar LIBOR spread, the EUR has about a 60 bp yield advantage. However, the ECB is unlikely to raise rates and the 30 year German 10 year is hitting historically low yield levels making the U.S. 30 year yield more attractive. The **sterling** faces pressure from a weak housing market and a difficult regulatory and tax environment. However, retail sales have held up better than expected and manufacturing activity appears steady/firm. The BOE is in little hurry to raise rates and it will likely take strong employment numbers to support the sterling on a longer term basis. The **Australian** dollar continues to find support on interest rate differential, but the RBA will be on hold which mutes some of the favorable impact. Furthermore, the Australian economy seems on softer footing and the political backdrop is uncertain. Neither PM Gillard nor her Conservative opponent Abbott has been able to form a government. There is fear the need to find a coalition members could lead to a pushing forward of the mining tax. The fate of the tax could be a major driver of the AUD's direction. The **Canadian dollar** is being hurt by signs of slower economic growth, choppy commodity prices, and disappointing profit numbers from Bank of Montreal. The strength of the banking system and the outlook for further BOC rate hikes were seen as reason to own the Canadian dollar, but these factors are being rethought after disappointing numbers from BMO. Despite historically high foreign bond purchases by Japanese investors, the **yen** remains strong. It appears that low global interest rates are supporting the yen, and the yen has found interest as a reserve currency as China diversifies its assets. Japanese trade data is consistent with economic strength and may be helping to support the yen. However, deflationary factors and the threat of intervention will provide a cap. The

government looks closer to intervening to pressure the yen.

Equities

Equity indices are likely to fluctuate in a trading range. Valuation remains attractive, but the market lacks a catalyst to work higher due to the outlook for poor profit growth. Relatively cheap valuation is consistent with the recent burst in M&A activity. The bidding war for 3PAR between Dell and H-P and Intel's purchase of McAfee imply stocks are inexpensive and indices should be higher. There have also been a pick up in buyback announcements in the retail sector. Gap Stores (\$750 mln), Nordstrom (\$500 mln) and Dillard's (\$250 mln) have recently announced buybacks. In the technology sector, Intuit and Marvel announced repurchases of \$2 bln and \$750 mln respectively. The lack of sell off in Intel after it lowered revenue and gross margin guidance on August 27th highlights the market has discounted a heavy dose of bearish news. Earnings yields remain very high indicative of expectations for weak profit growth. Fear over higher taxes and sluggish economic growth are discouraging investment flow and working to cap prices. The most recent AAI poll showed an extremely level of pessimism with the bull index at 21%. This level of bearish sentiment is usually price supportive.

Commodities

Commodity prices will be driven by a mixture of supply and demand factors. The pace of global growth will drive prices, but the impact of weather on cotton, coffee, and grain markets will also drive trade. With two trading days left in the month of August, the CRB had posted mixed results with 11 of 19 commodities higher. Coffee and cotton were the strong markets, while cocoa and natural gas lagged. Wire stories indicate investor interest in commodities remains strong.

Crude oil prices will be sensitive to demand trends, which look soft. The market appears

well supplied. Reports suggest that Chinese demand is decelerating. China's Petroleum and Chemicals Industry projected August demand up 5.6% y/y to 8.6 mbd, but this pace is below the 15% y/y gain in Q2 and 22% y/y increase in H1 2010. Asian crack spreads are soft confirming slackening demand. Product stocks in Singapore have eased in recent weeks but remain historically elevated. In the U.S, crude oil inventories have shown counter seasonal strength moving flat to higher instead of declining. The days supply of crude is comfortable at 23.6 compared to 23.8 last year. Distillate supplies continue to build in line with the seasonal norms, but supplies are bloated. There was a 49.7 day supply compared to 48.1 days a year ago. Demand has firmed in recent weeks, but the sequential trend has been downward in recent months. The 4-week average of distillate demand is 3.542 mbd compared to 3.376 mbd last year. Gasoline supplies are showing a counter season build, and could be working toward burdensome levels due to strong imports. There was a 24.0 day supply of gasoline in the latest reporting period compared to 22.8 a year ago. Gasoline demand has improved with the 4-week average standing at 9.387 mbd versus 9.115 mbd last year. In Europe, PJK inventory numbers point to comfortable gasoline and fuel oil stocks, and the 3:2:1 Brent/Northwest Europe crack price is depressed trading at levels last seen in February.

Natural gas prices will be driven by industrial demand, as cooling demand will begin to tail off in the coming weeks. Storage levels are ample, but less burdensome than a year ago. As of the week ending August 20th, there were 3,052 Bcf in storage. Store levels were 6.1% below a year ago, but 6.2% ahead of the five year average. The trend in storage injection has slowed relative to average, but is set to be comfortable going into the heating season. The Baker Hughes rig count has been flat to higher in recent months and not consistent with a major pick up in production. The rig count was 973 in the week ending August 27th compared to 699 last year. Consumption data from

BENTEK showed electrical power consumption from natural gas falling 10%, and industrial usage down 3% in the latest measuring week. However, numbers are still up 8% and 1% for the year. The data is a reflection of cooler weather and slower economic activity. The 8 to 14 day weather outlook has above normal temps for much of the southern half of the U.S. extending from New Mexico to the Atlantic south of Nebraska, central Illinois and Pennsylvania. Hurricane activity is an upside risk to prices, but so far storm activity has been inactive in the Gulf of Mexico going into the peak season.

Copper prices will be sensitive to the trend in global growth. Comments from an industrial conference on August 31st may help to set the tone for the market. Companies, such as ITW, Emerson Electric, and United Technologies are presenting and are leveraged to global growth, providing a proxy for copper usage. Further, PMI numbers at the start of September will shed light on the pace of global growth. Industrial demand appears on softer footing given the recent trend in global PMIs. Goldman Sachs recently cut its price outlook for steel due to weakening demand highlighting downside risk to copper. Additionally, housing activity in the U.S. remains historically depressed, and China continues to dampen its housing market to prevent a bubble. On the supply front, LME copper stocks continue to drift lower and suggest tightening supplies. Shanghai copper stocks have been stable. Peru's July copper output rose 6% helping to loosen supplies, but BHP said that physical demand for copper is still high and consumers are looking to replenish copper inventories. .

Gold is being supported by financial flows and healthy physical demand. Low interest rates in Europe and the U.S. continue to present little opportunity cost in holding gold and investors remain uneasy over equity markets. The low level of rates is highlighted by the German 30 year yield falling below 275 bps, while the S&P 500, CAC 40 and Nikkei are off 4.5%, 10.9%, and 14.5% year to date. Highlighting strong

investment flow, CFTC data showed reporting non-commercial players a net long 245,456 futures and options contracts. There were 270,100 longs and just 24,644 shorts. The net long position rose 18,492 contracts in the period ending August 24th. Furthermore, the World Gold Council reported that investors bought 291.3 mmts of gold in ETFs in Q2. Purchases were the second highest for a quarter on record. Indian demand is strong and the pending festival season will help to solidify demand. The festival season starts in September and market watchers believe demand will peak on Diwali November 5th. The national Spot Exchange in India projected a pick up in Indian purchase to 600 to 625 tons compared to 480 to 485 tons a year ago. Indian consumers were said to be buying and not selling gold and second half gold demand was expected to be up 25% from a year ago. Likewise, the World Gold Council said that Indian bullion demand nearly doubled from a year ago due to investment flow and rising incomes leading to jewelry purchases. The World Gold Council also expected demand for gold to accelerate in China. Gold demand in China rose 26% y/y to 111.7 tons in Q2. One offset may be what appears to be a continual pick up Chinese output. China's gold output rose 5.9% y/y to 127.3 mts y-t-d into May. GFMS is projecting gold to reach \$1,300 an oz.

Soybean prices will be driven by demand and the outlook for yields. The crop rating has deteriorated in recent weeks with the good and excellent categories falling from 75% in early June to 64% in late August. The rating is high relative to recent years, but the trend and weather patterns have made the trade nervous about the prospects for production. There is concern that dry weather has slowed pod development in sections of the Midwest. Looking to demand, export sales surged in mid August and the 4-week average remains elevated relative to recent years. However, in recent sessions there has been talk of farmer selling with the start of the Delta harvest. The Gulf basis has softened, which may act to cap the market.

Corn prices will be sensitive to the outlook for yield per acre, and the pace of demand. There is growing skepticism over USDA's yield forecast as reports from the country are mixed, and weather is uneven. The market is likely to maintain a risk premium until more is known about the crop size. Crop condition numbers have eased sharply since mid June, but levels still seem favorable for production relative to history. 70% of the crop was in good to excellent condition at writing. On the demand front, export sales numbers are brisk and at the upper end of the five year range. Recent press coverage from China suggests that corn production will rise 4.8% this year to 165 mmts due to increased planting and favorable weather. The data seems to imply Chinese corn demand will be controlled. None-the-less, still high wheat prices and export sales are supportive to prices and suggest global demand is healthy.

Wheat prices will be driven by demand trends and the fate of the Canadian harvest with the market adjusting to the shortage in the FSU crop. The USDA cut its Russian wheat production estimate by 9% from the mid August report to 41 mmts (61.7 mmts a year ago). The Canadian harvest is expected to be late this year due to delayed plantings. A strong La Nina pattern is in place and has only been present once in September since 1955. In September of 1955, Canadian harvest weather was wetter than normal and saw heavy snow accumulations. Moderate La Nina years have a tendency to be wet, but not snowy. In any case, the current weather pattern could cause a reduction in crop yield, further tightening supplies and reducing the crop of an exporter. U.S. wheat export sales have been running at a blistering pace relative to last year as buyers are looking to secure supply. Egypt, which usually buys Black Sea wheat has been purchasing Canadian and European wheat, and may be forced into the U.S. market, keeping the export sales trend hot.

Cotton supplies remain tight and demand firm. The biggest negative may rest in concerns over the health of global economic growth and what appears to be a lackluster back to school season for U.S. retailers. ICE certified stock level have flattened after plunging in recent months, but remain historically tight at 18,690 bales. More broadly, cotton in public storage totaled 2,047,000 bales at the end of July compared to 3,477,000 bales in June and 5,615,000 bales a year ago. The U.S. crop is progressing and current trends will act to cap prices. In the last reporting period, bolls were setting on 94 percent of acreage up 5% from a year ago and 4% ahead of the 5 year average. Nationwide, bolls opened on 7% crop leaving progress 21% complete, which is 9% ahead of last year and 5% above the 5-year average. Recent reports out of India suggest a record crop at 32.5 mln bales, but flooding in Pakistan puts the Pakistani crop at risk. Demand remains strong. Cotlook recent projected that global cotton consumption would rise 3.1% in the new crop year, and the market would be in deficit of 756,000 tons. Purchases from China and India were expected to drive the shortage. Spot cotton prices in India are firm, and demand for government auctions in China has been strong. U.S. fiber consumption has been brisk, but high prices are generating some substitution away from cotton. U.S. textile mill data showed July consumption of all fibers up 2.3% m/m and 9.7% y/y. However, cotton usage was less vibrant up 1.1% m/m, but down 3.4% y/y.

Hog prices will be driven by the ability of the market to sustain record high pork cut out values. Supplies will be increasing seasonally, but the futures market is already pricing the jump in supply with lead futures trading at an approximate \$10 discount to cash. Supplies remain tight with cold storage numbers down 27% from a year ago, and slaughter numbers since June 1st tracking about 2% less than implied by the hogs and pigs report. Furthermore, slaughter is running below year ago levels, and weights are running about in line with last year suggesting that producers

are current. Thus, even though slaughter numbers are likely to increase, supplies are likely to be seasonally tight and manageable for producers. High prices are the major obstacles to a rally. The export market will have to remain robust, and U.S. consumer interest in pork will have to overcome the likelihood that groceries will be raising prices to offset unusually elevated cut out levels.

Cattle prices will be driven by the ability of the market to absorb high prices post the Labor Day Holiday. Exports have been strong, and meat bookings for Labor Day helped to support prices. However, there could be a pause in demand working into the middle of September before cooler weather helps to underpin beef consumption. Boxed beef prices finished the week of August 28th at \$164.30 compared to \$143.71 last year and \$159.42 the week prior. Furthermore, the hide and offal value was \$10.81 for the week ending August 28th down 5 cents from the week prior but up from \$9.45 last year. The elevated level of the hide and offal is helping to lift packer margins. Supplies are set to rise seasonally, but packers are current. Weights are about 10 pounds below a year ago, and strong exports and high beef prices have made it easy to market cattle as packers have held profitability.

Sugar prices are being supported by tight supplies and disappointment over a near term pick up in production. In the wake of drier than expected weather in Brazil, Unica lowered its forecast for Brazilian sugar production. Production is now projected at 33.7 mmmts down from the March forecast of 34.1 mmmts. Unica also warned that dry weather could hurt next year's sugar crop, and it could cut its forecast for production again. The extreme level of dryness is highlighted by the government of Sao Paulo banning the burning of sugar cane. Dry weather was expected to persist until mid September. Likewise, wet weather in Australia is slowing the sugar harvest. The harvest is 40% completed compared to 50% a year ago. On going wetness could start to cut production levels.

Australia's weather service is projecting wet weather into year end due to the La Nina pattern. Additionally, the Ukraine has cut its projected sugar harvest by 9% to 2 mt. However, fears over tightness are being reduced by the signs that port congestion in Brazil is starting to be unwound. The backlog of ships has fallen to 112 from 125 on August 10th. A year ago, there were 60 ships waiting to be loaded. Bigger picture, the International Sugar Organization is projecting a surplus of 3.2 mmts in 2010/2010 and a reversal of this year's shortage of 4.9 mmts. The futures curve is structured in backwardation consistent with near term tightness and a pick up in supply next year.

Coffee supplies remain tight, and the market will be sensitive to weather patterns in Brazil. High prices have the trade looking for farmer selling, but more signs of availability are needed to cap prices. NY coffee inventory levels continue to trend lower and suggest shortage. As of August 26th, there were 2.016 mln bags in storage. Inventory levels remain at 2002 levels at the same time coffee consumption is stronger. In Brazil, worries about dry weather and hotter than expected weather have injected a risk premium into the market. Weather patterns have the trade seriously thinking about a reduction in supply. Likewise, Columbia's grower's association projected production at 10 mln bags compared to an earlier forecast of 10 to 10.5 mln bags, while the Kenyan trade group indicated that poor weather would cut the 2009/2010 crop by 31% to 40,000 MTS. Highlighting worries over tight supply, Nestle announced it would double

its direct purchase of coffee from farmers for its Nescafe brand in order to booster supply and quality. It will also be distributing coffee plantlets to farmers and training farmers. On the demand side, retail prices are rising. J.M. Smuckers and Kraft have increased the retail price of coffee 9% to 10% in recent weeks. Large funds remain long coffee by over a 5 to 1 margin with a net futures and options long of 58,132 contracts. However, large funds had liquidated 7,133 contracts in the period ending August 24th.

Cocoa prices have found pressure on expectations for a pick up in supply. In recent days, the International Cocoa Organization painted a tight picture for the market. A deficit of 72,000 tons for the current crop year was projected. The deficit number was widened from 69,000 tons. A higher grinding forecast led to tighter conditions. However, much of the focus in the market has been centered on Armajaro and its previously established long position. Weather conditions have improved in the Ivory Coast, and caused the outlook for supply to increase. Furthermore, European stocks of cocoa have tripled due to supply from the Ivory Coast, Ghana, Ecuador, and Nigeria passing grading. Likewise, Ghana's 2009/2010 harvest is expected to be healthy at 650,000 mts, and 2010/2011 production is expected to increase into the 700,000 to 750,000 mts range. Cash prices have weakened and futures have dropped even more in recent weeks with the basis between Ghana Grade 1 and NY cocoa at a multi-year high.

North America

*The **U.S. economy** is in a slow growth pattern with Q2 GDP rising 1.6%, and the housing market historically depressed. So far, back to school spending has been disappointing and the economy lacks a growth driver. The consumer does not want to take on debt, and government policy is creating lack of confidence and freezing business expansion. Inflation is contained. The Fed will continue with its policy of targeting its balance sheet size at approximately \$2 trln, but the headwinds facing the economy cannot be fixed via monetary policy. The **Canadian economy** is expanding, but recently released manufacturing and retail data suggest the pace of growth is softer. Inflation is tame. The BOC will be looking to normalize rates, but will be sensitive to the*

direction of global growth in implementing any changes. Another 25 bp rate hike is possible by year end. Key economic indicators:

U.S.:

- August NAHB survey dropped 1 to 13 (15 expected). Future sales fell 3 to 18, prospective buyers were unchanged at 10, and present sales declined 1 to 13.
- July housing starts rose 1.7% to 546,000 units (560,000 expected). June was revised down 12,000 to 549,000 units. Single family housing starts fell 1.2%, and have declined four straight months. Multi-family starts tumbled 8.0% after posting strength in June. Multi-family starts have displayed relative strength.
- July Existing Home Sales fell 27.2% to 3.83 mlu (4.65 mlu expected). Single family sales declined 27.1%, while condos tumbled 28.1%. Inventories are elevated with a 12.5 month supply on the market. The median home price rose 0.7% y/y. Sales are massively depressed compared to the long term trend.
- July New Home Sales fell 12.4% to 276,000 (330,000 forecast). Home sales are at a record low, but inventories are lean.
- July Durable good orders rose 0.3% (3.0% expected) and declined 3.8% ex-transport (0.5% forecast). However, June was revised to -0.1% from -1.0%. Non-defense capital good orders excluding aircraft fell 8.0% posting a major drop. Defense orders fell 2.2%, computer and electronics declined 2.4% for a second straight month, and vehicle and parts rose 5.3% likely due to GM keeping its plants open in July. Private aircraft rose 75.9%

Canada:

- June Manufacturing Sales rose 0.1% m/m (-0.5% forecast) and 12.7% y/y. Inventory levels are lean with the inventory to sales ratio at 1.31 compared to 1.58 a year ago.
- July LEI rose 0.4% m/m (0.6% expected) suggesting on going growth.
- July CPI rose 0.5% m/m (0.6% forecast). CPI was lifted by energy, alcohol, and tobacco price hikes. Clothing and footwear fell 0.9%. Inflation is tame.
- June Retail Sales rose 0.1% (0.4% expected). Details were consistent with strength as motor vehicles rose 2.1%, furniture increased 2.3%, building materials jumped 0.5%, and electronics increased 5.1%. Clothing contracted 1.1%, food dipped 0.1%, and gasoline stations fell 2.7%.

Europe

*The **Eurozone** economy is holding up better than expected given the flash composite PMI and German IFO survey. Relative strength in Germany and France is balancing the headwinds of austerity in Spain, Greece, Portugal, and Ireland. Inflation is contained. The ECB will keep rates steady into 2011, and continue to watch the pace of healing in the banking sector. The **U.K.** economy is throwing off mixed signals. Housing is slowing, but consumer spending is holding up ahead of forecast outside the auto sector. The economy continues to face headwinds from tax and regulatory policy. Inflation is above the BOE's desired level, but expected to moderate. The BOE will keep rates unchanged into 2011. Key economic indicators:*

Eurozone:

- EZ August Flash PMI fell 0.6 to 56.1 (56.3 expected). Manufacturing fell 1.7 to 55.0, while services rose 0.2 to 56.6. Manufacturers saw a faster increase in new orders, while service providers saw a slight pick up in the rate of new business. Job creation continued, but at a slower rate than July. There was an easing in manufacturing input costs, but service sector costs rose at the fastest rate since October 2008. Output prices rose negligibly with higher factory prices offsetting a drop in service prices.

- August German IFO rose 0.5 to 106.7 (105.7 forecast). Assessment rose 1.4 to 108.2 (107.5 forecast). Expectations fell 0.3 to 105.2 (104.3 forecast). Diffusion index by sector showed total industry up 1.0 to 12.6, manufacturing up 1.7 to 20.1, construction down 4.7 to -18.6, and retail up 5.3 to 9.1. The strength in retail stands out and is an offset to weakness in construction.
- July Dutch Unemployment was unchanged at 5.5%. The rate is cresting.
- July Finish Unemployment fell 1.3% to 7.5% (7.6% expected), showing better labor demand.
- August Dutch Consumer Confidence rose 3 to -11. The trend is net flat since late last year, but improving from the 2009 low. Large purchases and willingness to buy rose.
- June EZ New Orders rose 2.5% m/m (1.5% expected). The trend in orders is higher and suggests on going economic expansion.
- July Irish New Vehicle Sales were 8,648 compared to 6,009 a year ago and 20,262 in July 2008.
- German Gfk Consumer Confidence rose 0.2 to 4.1 (4.0 forecast).
- Italian Consumer Confidence fell 1.5 to 104.1 (105.3 forecast).
- Dutch Producer Confidence rose 2.8 to 0.4 (-2.6 expected) implying better than expected growth.
- July EZ M3 rose 0.2% y/y (0.3% forecast). Household lending rose 2.8% y/y unchanged from June. Non-financial lending contracted 1.3% y/y compared to -1.6% in June. M3 growth is sluggish and has been near unchanged since late 2009.

U.K.:

- July Retail Sales rose 1.1% m/m (0.3% expected) displaying surprising strength. Sales were up sharply in non-food (+1.8%) and other stores (6.1%). Clothing rose 0.9%, food fell 1.0% and auto fuel increased 1.1%.
- UK CBI Distributive trades August Sales volume rose 2 to 35 (18 forecast). Expected sales fell 6 to 39. Sales volumes hit their highest level since April 2007. Clothing, grocers, durable household goods, footwear & leather, and hardware & DIY were the best performing sectors. Better weather at the beginning of August, summer sales, and summer holidays helped drive sales. The numbers employed in the retail sector were broadly unchanged for the first time since February 2004. Price inflation accelerated. 66% of firms aid ASP rose relative to a year ago. Retailers are also increasing investment. Vehicle sales fell on the year for the third straight month.
- July Major Mortgage Bank approvals fell 1,000 to 47,000. The trend has been flat to lower this year. Stagnate to soft housing conditions are present.
- August CBI Manufacturing Orders rose 2 to -14 (as expected), showing improvement relative to trend. Export orders surged 11 to -1, finished stock fell 2 to 1, and volume of output rose 4 to 10.0. The output volume number is consistent with expansion. Average selling price was up 6 to 11 and about mid range.
- July CPI contracted 0.2% m/m (in line). Core CPI rose 2.6% y/y (3.0% forecast). There was across the board weakness in CPI on a sequential basis. Seasonal food (-0.3%), energy (-0.2%), housing/water (-0.3%), and education/health (-0.3%) all declined. Core CPI looks to be peaking.

Asia

*Asian economies are expanding, but the pace is moderate and finding downside risks. **China** continues to battle a property bubble and work to reduce excess capacity in the industrial sector. Furthermore, the slow pace of U.S. growth is a headwind to exports. However, China is working to develop domestic industries such as pharmacy, and looks set to boost infrastructure spending in the central and western sections of the country. Inflation, outside the housing sector, is rising and press reports suggest it may be near double the stated rate at 6.0%. The PBOC will leave rates unchanged and policy makers will micro-manage industry to cap inflation. **Japan's** economy is*

growing slowly and being restrained by a strong yen. Recent consumer spending data was mixed, exports and imports display on going growth, and the labor market is showing very modest improvement. Deflation remains solidly in place, and the BOJ will be biased toward battling deflation but has few tools available. **Australia's** economy has softer footing, pressured by slower global growth and a weaker tone in industrial commodity prices. Housing appears to have slowed, but the labor market has yet to show material weakness. Inflation is tame, and the RBA will keep rates steady in the coming months. **Korea's** economy is expanding, but faces risk of slower growth due to a potential weakening in the export market. Consumer spending looks healthy. The BOK is talking about normalizing rates and cutting off an expected rise in inflation, but will move slowly given uncertainty over the pace of global growth. **India** continues to expand. Strong gold demand highlights healthy income growth. Inflation remains high and troubling. The RBI will continue to raise rates in the coming months. Key economic indicators

Australia:

- August DEWR Skilled labor Vacancies fell 0.3% m/m. It is too early to expect a major weakening in the labor market.
- June Conference Board LEI rose 0.1%. A slow rise continues.
- Q2 Private Capital Spending fell 4.0% (+2.0% expected) showing two quarters of contraction.
- Q2 Housing Affordability fell 10.5 to 108.3. Affordability is sliding and will create a headwind to home sales.

China:

- June LEI rose 0.8% and continues to grind higher, suggesting further economic strength.
- August Market News Business Sentiment Index fell to 62.16 from 64.94 in July and 56.80 last year. The trend is firm. New orders were 61.16 v. 67.68, need to hire was 58.74 v. 57.19, and production was 60.33 v. 63.95. Outlook numbers were constructive for growth.

India:

- Primary Article's WPI rose 14.75% y/y in the week ending August 14th. It continues to show signs of a top, but remains elevated.

Japan:

- July National Department Store Sales fell 1.4% y/y. The contraction is actually slowing and shows improved spending. The growth rate may be negative, but it is consistent with much of the 2000 to 2004 period. However, it is below the late 2005 to 2007 period.
- July Unemployment fell 0.1% to 5.2% (5.3% expected). Employed rose 210,000, while unemployed declined 60,000. Better trend in employed over the past two months. The recovery is fragile.
- July Jobs to Application Ratio was up 0.1 to 0.53 (in line) – the trend is gradually higher suggesting mild improvement in labor market conditions. By comparison, the ratio peaked at 1.08 in July 2006. Job offers rose 1.3% m/m, while applications fell 0.5% m/m.
- July Household Spending rose 1.1% y/y (1.5% forecast). Sequentially spending fell 0.4% breaking three months of gains. The trend is mildly positive in that the growth rate is back at 2007 levels and favorable base effects are fading.
- July CPI contracted 0.9% y/y (in line). Core CPI declined 1.5% y/y (in line). Core inflation is stabilizing on a year over year basis, but is still negative suggesting active deflation. Sequentially, total and core CPI declined 0.3% and 0.1% respectively. Food, household goods, clothing, medical care, and transport/communication contracted.

Korea:



- July Department Store Sales rose 10.1% y/y, while Discount Store Sales increased 8.2% y/y. Sales growth looks to be reaccelerating.
- August Consumer Confidence fell 2 to 110. It is trending flat to slightly lower in recent months. Employment rose 1 to 108, while spending plans were flat at 112. Income fell 1 to 101 and has been flat to lower in recent months.

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