

July 18, 2010

## Growth and Inflation

The global economic expansion has a significantly softer tone, but growth continues. Emerging economies are the primary driver of output. Globally, PMI indices are showing expansion, but the pace of gain has moderated. The June JP Morgan All Industry Activity Index fell to a four month low of 55.4, confirming a deceleration in economic activity. An oppressive regulatory backdrop is creating a headwind to economic growth in the U.S., while Chinese officials are working to create a soft landing and adverse fall out from rising labor costs and a potential real estate bubble. The European trade sector is healthy, but domestic demand is anemic. The IMF recently raised its 2010 World economic growth forecast by 0.5% to 4.50%, but left its 2011 projection unchanged at 4.25%. The IMF stated risks to the recovery had increased sharply due to financial market turbulence and policy reforms.

Inflationary pressures remain capped in the developed world, but linger in emerging Asia. U.S. and EZ consumer price indices show no threat of inflation, and Japan continues to fight deflation. The low level of inflation is reflected in the decline in the 10 year TIPS break-even which has fallen from nearly 250 bps in early January 2010 to a recent low of 172 bps. The TIPS break-even is comfortably below the levels seen between 2004 and early 2008. The one exception to tame inflation in the OECD may rest in Canada, where the recent BOC survey of business showed a pick up in both input and output price pressures. Recent rate hikes by the BOK and RBI indicate authorities recognize inflation risks in Korea and India. Chinese real estate prices show signs of moderating, but a sustained period of relaxation in home prices will be needed to cool inflation fears. Rising wages threaten to create a wage price spiral and lift prices despite the fact that June CPI rose a less than expected 2.9% y/y and the CPI index has shown sequential weakness in recent months.

## Money Markets

U.S. treasury yields are expected to work sideways. The market is being supported by low inflation in the OECD, slack in the U.S. labor market, and weakening economic growth. Prices have benefited from an extended period of economic numbers falling short of expectations. In fact, negative surprises on growth numbers are at their highest level since 2008 and highlight recession risk. Recent weakness in housing data, poor employment growth and the drop in the Philly and Empire surveys highlight deteriorating economic activity. Furthermore, the market is being lifted by from slowing Chinese growth and a weak Chinese stock market. During 2010, the 10 year treasury yield has been highly correlated to the trend in economic surprises and the direction of the Chinese CSI 300. The downside to the market rests in low yields and questionable valuation. The market has seen an influx of investment flows due to stress in Europe. A recent report in the Nikkei indicated that Japanese investors were heavy sellers of PIIGS debt this year and strong buyers of treasuries. Likewise, a large U.S. bond fund reportedly cut its weighing in European bonds and bought treasuries. If Europe remains stable post bank stress tests, money may filter back in to PIIGS at the expense of treasuries. Domestically, treasuries are rich to equities given flat to negative real yields at the front end of the yield curve. Additionally, there is some speculation that the Obama Administration will move to block the sunset of the dividend and capital gains provisions of the Bush tax cuts. If true, lower dividend tax rates should work to under cut treasury demand at the margin. There are also a host of REITs, energy funds, and blue chip common stocks which yield at or above the 10 year treasury yield. Any sign of improved growth should create a sell off given historically low yield levels.

## Foreign Exchange

The dollar should trade mixed. The **euro** has benefited from an improved growth and interest rate differential, but bank stress tests provide an obstacle to a further rally. Stress

test results are due July 23<sup>rd</sup>. Conventional wisdom holds a majority of banks will pass, but there will be scattered capital raising. The euro is benefiting from the end of heavy liquidation. Japanese investors and a well known U.S. bond fund both rotated holdings out of European bonds to U.S. treasuries exemplifying the march of money out of the Eurozone. With the process complete and financial market conditions stabilizing, the euro has lifted. Further, fiscal austerity measures in Europe have boosted confidence, while the U.S. economy continues to struggle and has slowed dramatically in recent weeks. Expectations for a Fed rate hike have been pushed well into 2011 due to weak economic conditions and lack of faith in political leadership. The **sterling** faces crosscurrents. The U.K. labor market has shown strength, and PMI numbers are consistent with on going expansion, but consumer spending is cautious, housing has slowed, and government austerity measures threaten growth. JP Morgan reportedly paid stg 328 mln in bonus taxes. This type of payment is likely to chase money out of the country. Moreover, the tax raised about half as much as planned highlighting the aversion of business to policies which tax capital. The **Australian** and **Canadian** dollars are being hurt by signs of a global slowdown. Commodity demand appears to be easing in China with talk of falling steel prices and restrictions on real estate activity. The Australian economy shows loss of momentum. The service and construction PMIs were below 50 in June, and the manufacturing PMI slipped with a material set back in production, new orders, and employment. The RBA is unlikely to raise rates in the near term. In contrast, the BOC is expected to raise rates 25 bps July 20<sup>th</sup>. The BOC's business survey displayed expectations for robust revenue growth and hiring. Firms were also expecting prices to rise at a quicker pace. Further, the BOC's lending survey shows banks ready to extend credit. A slowdown in commodity demand is a downside risk to the Canadian dollar. Technically, the U.S. dollar is basing against the Canadian dollar hinting at trend reversal and dollar rally.

Relative to Australia, the expected narrowing of the Canadian/Australian interest rate differential and firmer Canadian growth could help the Canadian dollar outpace the Australian dollar. The **yen** continues to trade firm helped by low global interest rates, which are helping to keep JGB yields attractive. Moreover, Chinese accounts were reportedly a large buyer of yen bonds. Heavy capital inflow and the willingness of the Chinese to park reserve money in yen asset have raised the profile of the yen as a reserve currency. Japanese banks have also been boosting capital which may be supporting repatriation and lack of capital outflow. On the downside, the Japanese economy remains on weak footing and deflation persists. Both economic dynamics argue for a weaker yen.

### Equities

Equity prices are expected to work sideways supported by attractive valuation, but the trade will debate a value trap. Looking at value, the BKX is trading below book value as the regulatory backdrop has the trade pricing little growth in the banking sector. Although banks are cheap, lending activity is lackluster and regulation is cutting the earnings outlook. Bank of America recently said the Durbin Amendment would cut revenues by \$1.8 to \$2.3 bln and could lead to a \$10 bln charge. Likewise, Citigroup said the amendment would have a pre-tax impact of \$550 to \$800 mln in the second half of 2010. Drug shares, basis the DRG, are priced at 9.7 times earnings and carry a dividend yield of 383 bps. Given demographics and a yield 80+ bps over the 10 year treasury, the sector looks attractive, but is likely pressured by the uncertain impact of newly enacted healthcare legislation. The market remains uneasy over energy legislation too. There is a growing chorus of analysts who are noting that 40% of the S&P 500 faces the headwind of increased government intrusion or regulation. Further examples of cheap valuation rest in Intel and Target. Intel recently posted record profit results and gave a rosy forecast, but is priced at a historically

depressed 10.2 times earnings. Likewise, Target is priced at 12.7 times earnings seeing valuation only lower in 2008 and 1990. Tax increases linked to healthcare and fear over the expiration of the Bush tax cuts are pressuring valuation in the retail sector. The market is getting comfortable with a high structural level of unemployment. The equity market may struggle until the mid term elections. The market may try to force change toward a government which is friendlier toward capital.

### Commodities

Commodity prices will be sensitive to the pace of economic growth, and individual market fundamentals. Despite signs of slower economic growth, investor interest in commodities remains strong. Barclays Capital noted that commodity assets under management rose \$1.4 bln in June to \$292 bln. There were \$2.1 bln in fresh inflows. ETFs received \$1.6 bln of the new money with investors focused on metals. During Q2, \$15.4 bln flowed into the commodity asset class compared \$11.3 bln in Q1. A sustained downshift in economic growth through Q3 would likely weigh on investor demand. Gold has started to see long liquidation hinting investors may be turning cool on commodities due to softer growth. The recent rise in wheat prices on the back of a Russian drought, strength of sugar prices on transportation glitches, and firm coffee prices due to tight supplies and healthy demand will influence price direction beyond fund flow and broad economic trends.

The **crude oil** market is well supplied, and there are signs demand is slipping. Macro economic numbers show slower economic growth given the trend in global manufacturing PMIs, while there are stories that China is reducing refining runs. Chinese refining did rise 11% y/y in June, but the gain was the slowest in 10 months. More importantly, C1 energy reported that Chinese refining activity would ease in July due to weaker margins. Product stockpiles in Singapore hit an eight week high

in the period end July 14<sup>th</sup>, and remain extremely elevated on a historical basis. The U.S. market has ample supplies. In the period ending July 9<sup>th</sup>, the days supply of gasoline was 23.7 verses 23.5 a year ago, and there has been a counter seasonal build in gasoline stocks in recent weeks. However, demand has been solid. In the last reporting period to July 9<sup>th</sup>, the 4-week average of gasoline demand was 9.308 mbd compared to 9.144 mbd a year ago. Distillate supplies are ample. There was a 43.9 day supply compared to an extreme 48.6 day supply a year ago. Stocks are building in a normal fashion. The 4-week average of distillate demand is elevated. It was 3.70 mbd verses 3.28 mbd a year ago. However, demand has eased over the past four weeks, slowing loss of momentum in demand. Looking at Europe, PJK fuel oil inventories are elevated and inconsistent with shortage, while gasoline stocks have been trending higher in recent weeks and the market looks to have more than adequate supply.

**Natural gas** prices will be pressured by adequate supplies, but mildly helped by the forecast for above normal temps in much of the middle to eastern half of the U.S. Natural gas supplies are ample. As of July 9<sup>th</sup>, there was 2.840 Bcf in storage. Storage levels were 1.1% below last year and 10.7% over the 5 year average. Domestic production is strong. In its most recent reporting period, BENTEK noted that product was averaging 61 Bcf per day up 2.4% y/y, while the EIA projected July production up 3.2% y/y to an average of 61.5 Bcf per day. Given signs of slower economic growth, the increase in production is capping prices. Weather should help boost usage and provide marginal support given economic and supply trends.

**Copper** prices face mixed cross currents. Signs of slower global growth are capping the market's upside. Auto sales, construction, and industrial activity have a softer tone. Recently, Asian steel makers cut prices and June copper imports by China were soft. Baosteel cut prices for some steel products by CNY 300 a tone and

said that auto sheet demand was expected to slow from first half. Similarly, China Steel cut prices 4% for September. Chinese June copper imports fell 17% m/m and have declined three straight months. At the same time, copper production in China hit a record in June rising 26% to 422,000 mts. Although some of the increase in Chinese production is reducing the need for imports, it may signal oversupply given economic conditions. On a more positive note, LME copper stocks have been falling, although they remain relatively high compared to recent years. Stocks in Shanghai have fallen from their high, but are also elevated at 120,238 tons. Bigger picture, Codelco's CEO recently said that higher costs and lower ore grades will slow supply from coming onto the market. Concerns over future supply may help to provide support on breaks, as buyers look beyond the current economic slowdown and face low financing costs.

**Gold** prices have broken down technically. There are rumors of a large fund being hit with redemption and liquidating. Further, there has been speculation that traders who are short euros and long gold may be unwinding positions. Although European bank stress test results are set for July 23<sup>rd</sup>, PIIGS have successfully auctioned debt and calm has returned to the European credit markets. CFTC data has shown some spec liquidation in gold and there has been heavy ETF buying in recent months without a major rise in price. Gold ETF accumulation has slowed. Low inflation and weak economic growth may be reducing gold demand. Rate hikes by the BOK and RBI may also be dimming demand for gold, but global interest rates remain extremely low both in nominal and real terms. In the spot market, there have been reports of selling by jewelers and some de-stocking. The Indian Bullion Market Association said that Indian gold imports may fall 36% this year due to higher prices and volatility.

**Soybean** prices will be driven by the outlook for crop production, Chinese demand, and spill

over from the wheat market. At writing, blooming of soybeans in 18 states was at 40% of the crop which was ahead of last year's pace of 22% and the five year average of 37%. However, there are worries that Midwest beans received too much rain, are waterlogged, and will see poor yields. This worry is balanced by the outlook for hot weather which could "dry" beans. The market may find a risk premium on the yield issue, which will be closer to settled after the August crop report. Chinese demand remains firm, but the National Grain and Oils Information Center noted that imports in 2010/2011 would be down 2% to 48 mmts compared to 49 mmts this year. Chinese imports in June were 6.2 mmts – a record. First half imports were 25.8 mmts and tracking ahead of the National Grains and Oils Information Center's forecast and the USDA's estimate as of July. Net export sales have tracked strongly in recent weeks and suggest the trend of strong demand in June has continued into July. Fears of a short wheat crop in the FSU will provide spill over support as the market fears wheat will steal corn acres and corn will steal bean acres.

**Corn** prices will be sensitive to growing conditions, the price of wheat, and Chinese demand. Growing conditions are favorable. Corn silkings in 18 major states were 38% as of July 11<sup>th</sup> compared to 15% a year ago and a five year average of 26%. Weather is expected to be hot across the Corn Belt over the next 8 to 14 days, but subsoil moisture is adequate and precipitation is expected to be near normal. It will take a persistent lack of rain over the next few weeks to damage crop prospects. However, the decline in the outlook for global wheat supplies is lifting wheat prices and may elevate corn prices as the market needs to maintain acres. Chinese demand is expected to remain strong. Merrill Lynch recently put out a report suggesting Chinese corn imports of 2.3 mmts in 2010. Demand was expected to rise 3.4% and Chinese planted area was forecast off 1.5%. That said China's National Grain & Oils Information Center left its 2010 corn production forecast unchanged at 168

mmts. Corn export sales did fall 11.2 y/y over the past four weeks. Export sales are still firm, but not quick compared to the historical trend. One negative for the market rests in news that Congress will work to cut the ethanol subsidy by 9 cents to 36 cents a gallon.

**Wheat** supplies are tightening and prices will be sensitive to weather conditions in the FSU. Dry weather has caused a major downward revision to the FSU crop. The Russian Ag Ministry recently said the total grain crop harvest could be below 85 mts compared to 97 mts a year ago. The Ministry noted that 9.6 mln hectares of planted area has been ruined by drought. Russia's Grain Producers Union indicated that the harvest could be as low as 77 mts. In its July 9<sup>th</sup> report, the USDA cut global wheat inventories by 3.5% to 187.1 mmts. Russian production was reduced 4.5 mmts to 53.0 mmts. The USDA's Russian production figure is likely to come down further in the coming months given weather patterns and comments from the Russian government. Canada, which has also suffered weather adversity, saw its crop estimate cut 4.0 mmts to 20.5 mmts. In contrast, U.S. wheat production was revised up 7.2% to 60.30 mmts. However, ending stocks were revised down 5.8% to 157.3 mmts due to an expected increase in exports. The USDA raised its export forecast 11.1% to 27.22 mmts most likely due to events in the FSU and Canada. Weekly export sales are up 21.7% y/y over the past four weeks and point to better demand. The total spec position was still short in the Chicago wheat contract through July 13<sup>th</sup>. Given price action and fear over supply, specs are likely to cover in the coming weeks, and provide price support.

**Cotton** prices have found pressure as the supply/demand picture has loosened. The USDA's July 9<sup>th</sup> report displayed a pick up in supply. 2011 global ending stocks were revised up 0.6% to 49.91 mln bales, while production was lifted 1.5% to 116.02 mln bales. Looking at the U.S, ending stocks were lifted 25% to 3.50 mln bales, and production

was increased 9.6% to 18.30 mln bales. Favorable growing conditions and soil moisture were responsible for the improved production outlook. Crop ratings are very positive for U.S. production. However, heavy rains are threatening the Chinese cotton crop in the Jiangxi and Anhui provinces. The USDA kept its China outlook for production and ending stocks unchanged in the July 9<sup>th</sup> report. On top of an improved supply outlook, Cotlook recently reported that textile mills had secured ample supplies for their Q3 production needs. Yarn inventories are reported to be rising in China. Weekly upland cotton export sales were 167,000 bales in the week ending July 8<sup>th</sup>. Sales have been down 3.4% y/y over the past four weeks, but it will take a few more weeks of sales below 280,000 bales to confirm weaker demand. Signs of slower consumer activity in the U.S., and move by the Chinese government to dampen the economy could also undercut apparel demand and weigh on cotton. However, the idea of slow growth has blanketed the market in recent weeks.

**Hog** prices should be pressured by an expected seasonal increase in supply, but numbers are down from a year ago, and hot weather will pressure on weights helping to cap production. As a result, there will be a slow trend higher in production seasonally, but production will be seasonally small. On the demand front, the export market is strong. Pork exports were up 18.2% y/y in May. The recent strength of the euro will help boost U.S. pork exports. Pork exports were robust across most importing countries with the exception of Russia and Taiwan. Although cheaper than beef, retail pork prices have risen up 6 cents from May to \$3.10/lb in June. Prices are up 5% from last year. In contrast, poultry prices are down 3% from a year ago. Futures are priced consistent with current tightness and an expected pick up in supply during the fall. The spot hog index was priced at \$78.12 on July 16<sup>th</sup> compared to prices of \$81.70 for August hogs and \$75.70 for October hogs.

**Cattle** prices face mixed cross current. Feed yards are very current, and supplies are expected to remain below year ago levels through August, but supplies will rise into the fall. Highlighting manageable supplies, cattle weights are light. In the week to July 16<sup>th</sup>, USDA steer weights were 1,266 lbs and 17 lbs below a year ago. Light weights will weigh on production. On the demand side, the export market is strong. Beef and veal exports were up 27% y/y in May. South Korea, Vietnam, and Japan paced the gain. Retail prices could create a headwind to stronger cattle prices. In June, beef prices averaged \$4.08/lb which is 3 cents below the record high in September 2008. Given a high unemployment rate, the high retail price will encourage substitution to cheaper pork and chicken. Tight supplies and export demand have kept boxed beef prices flat in recent weeks, but the trend has been down since mid May. Boxed beef prices were expected to trade firm in the week starting July 18<sup>th</sup>. The market will need to see a pick up in boxed beef prices to sustain current price levels.

**Sugar** has seen near term price support as logistical problems in Brazil have prevented exports, and demand is high in front of Ramadan. Pakistan and Thailand have been reported buyers. Tight supplies are confirmed by comments from F.O. Licht, which said global inventories would be 119 days in the crop year end September down from 139 days in 2009 and 170 days in 2008. The NY sugar market is backward confirming current tightness and an expected pick up in supply. The market should loosen as Brazilian port congestion unwinds, and supplies increase. The International Sugar Organization said that a record Brazilian crop and increased output in India would put pressure on prices. Brazil was expected to produce 41 mmts in 2010/2011 up from 36 mmt in the current season. India was forecast to produce 26 mmts and export 500,000 mts. India's farm ministry reported that Indian farmers planted 4.74 mln hectares as of July 15<sup>th</sup>. This compares to 4.18 mln a year ago. The ISO expected Chinese sugar

production to surge 20% to 15 mmts, but China was still expected to import 2 mmts. The ISO projects that the sugar market will have a surplus of 2.5 mmts in 2010/2011 on production of 172 to 173 mmts. On a side note, there are reports that excessive rains have cut Indonesian production. The crop was forecast at 2.7 mmts up from 2.4 mmts last year. The Indonesian industry spokesman noted that Indonesia's sugar imports would total 2.2 mmts this year compared to 2.0 mmts last year. Imports were expected to rise 10% a year over the next five years due to the needs of the food and beverage industries. Large funds remain extremely long sugar. As of July 13, large funds were net long 187,993 futures and options contracts with 129,717 longs and 15,620 shorts. However the total net long, including small spec traders, was not excessive and near the bottom of the 3 year range.

**Coffee** supplies are tight and supporting prices, while demand appears firm. ICE inventories have fallen to 2.150 mln bags and are back to levels last seen in 2000. Likewise, the Green Coffee Association reported inventories down 69,719 bags to 4.498 mln bags in June. Green coffee inventories are also at 2000 levels. Besides tight inventories, precipitation patterns have hurt flowering in Minas Gerais. The chief economist for Cooperaiso (cooperative), which represents 6,000 growers in the region, cut his estimate for production to 3.1 mln bags down from 3.3 mln bags. In addition to a downward revision to Brazilian output, the Colombian grower's association noted that output during the first six months of 2010 was 4.04 mln bags down from 4.24 mln a year ago. Coffee demand remains strong. Starbucks CEO recently indicated that customer traffic rose in the June quarter. The increase was the second straight after three years of decline. He also indicated that U.S. and European sales have not been hurt by recent economic turbulence. On July 8<sup>th</sup>, the ICO said that global production could rise as much as 12% to 133 mln and 135 mln bags. Brazilian production was expected at 50 mln bags up from 39.5 mln bags, while

Columbia was projected to produce 10 to 11 mln bags up from 9 mln bags. In Asia, Vietnam's production for 2010/2011 was forecast flat at 18 mln bags. One downside risk to price is the build in speculative long positions. CFTC data shows the net spec long in NY coffee at 44,821 contracts and working toward the higher end of the five year range. The spec long is the largest since the September 2007 to March 2008 period.

**Cocoa** demand appears firm. The Q2 North American grind rose 12.1% y/y to 117,657 mts. The gain follows a 16.2% y/y increase in Q1 (116,122 mts). Likewise, the Q2 European grind rose 13% y/y to 328,704 mts. The increase was the biggest gain since Q3 2000. In recent statements, Barry Callebaut said that global demand for chocolate would move into positive territory in the second half of 2010 and noted growth in emerging markets. The ICO recently forecast a 2% to 3% rise in global consumption. On the speculative side, the FT reported that hedge fund Armajaro took delivery of 240,100 mts of cocoa from the Liffe exchange. The delivery was the largest since

1996 and estimated at 7% of global production. Active speculative interest in the market caused a group of European cocoa trading companies to write a letter for publication in the U.K. Independent. The letter said there was clear manipulation in the London cocoa market. They complained the market lacked transparency and control. They threatened to pull out of the London market. The group has met with Liffe officials, and wants publication of data on speculative interest similar to that of the ICE exchange. The front month spread between London and NY Cocoa is historically high and well above the range seen between 2005 and mid 2009 giving credibility to the commercial trade's complaint. On the supply front, recent data from the Ivory Coast showed deliveries to the ports of Abidjan and San Pedro at 1.059 mmts tons through July 4<sup>th</sup>. For the current season, deliveries are running about even with last year. However, rains were reported to be slowing production on July 7<sup>th</sup>, and helped to marginally increase prices. The ICO expected 2011 production at 1.3 mmts and noted higher prices were lifting investment and plantings.

### North America

*The **U.S. economy** is on softer footing. Regional PMI surveys have eased, mortgage applications have slumped, and consumer spending has downshifted. The adverse regulatory environment coupled with uncertainty over tax rates in 2011 has frozen entrepreneurial spirit and business expansion. Inflation is tame. The Fed revised down its 2010 and 2011 growth and inflation forecasts at the June FOMC meeting. A rate hike is unlikely until well into 2011. Talk of a new round of QE is exaggerated. The **Canadian economy** shows healthy expansion with the BOC's business and loan officers' surveys showing healthy economic conditions. The labor market is near normalizing and housing is on firm footing. Inflationary pressures are building. The BOC's survey on prices showed elevated expectations for both input costs and selling prices. The BOC is likely to raise rates 25 bps on June 20<sup>th</sup>. Key economic indicators:*

#### **U.S.:**

- June ISM manufacturing fell 3.5 to 56.2 (59.5 expected). 13 of 18 industries reported growth. New orders, production, and employment declined. The period of commitment to capital spending expanded 6 days to 112 days and suggests a cautious attitude toward expansion.
- June ISM Non-manufacturing PMI fell 1.6 to 53.8 (55.0 expected). 15 industries reported expansion, while 2 industries reported contraction.
- June Nonfarm Payrolls fell 125,000 (-130,000 expected). There were 83,000 private sector jobs created. Laid off census workers accounted for the decline in jobs, but job creation remains weak.
- June Unemployment fell 0.2% to 9.5% (9.8% expected). The drop in the unemployment rate was a function of a sharp contraction in the labor force.

- May Pending home sales fell 30% m/m hurt by the impact of the expiration of the tax homebuyer's credit.
- June Retail Sales fell 0.5% (0.3% expected). Vehicles and parts declined 2.3% and dropped for a second month. Furniture fell 1.1% and has declined 3 straight months. Electronics rose 1.3% and put together 2 months of strength. Eating and Drinking rose 0.2% and has been flat in recent months.

### **Canada:**

- June Ivey PMI fell 3.8 to 58.9 (63.4 expected). The index suggests healthy growth, but is below the peaks seen during the pre-crisis period. Employment fell 4.5 to 53.6, supplier deliveries dropped 0.7 to 43.5, and prices eased 0.9 to 58.3.
- June employment rose 93,200 (20,000 expected). Full time jobs gained 48,900, while part time jobs increased 44,200. Employment growth is vibrant.
- June Unemployment Rate fell 0.2% to 7.9% (8.1% expected) and trending lower.
- June Housing Starts were 189,300 (190,300 expected). Starts have eased from the recent peak of 210,800, and remain below the levels seen between 2004 and early 2008. Housing is recovering slowly.
- May Manufacturing Sales rose 0.4% m/m and 16.5% y/y displaying strength. Inventories fell 0.7% m/m and were off 6.8% y/y. New order growth was strong up 2.5% m/m and 33.8% y/y. The manufacturing sector is expanding at a healthy rate.
- May Vehicle Sale rose 0.2% m/m (0% forecast). Truck and bus activity paced the gain. Activity is choppy and there is lack of clarity on strength.
- May Exports rose 5.2% m/m and 21.3% y/y showing strength. Imports were also strong gaining 5.8% m/m and 17.6% y/y. The trade sector is supportive to growth.
- Q2 BOC Business Outlook Future Sales Index fell 19 to 25.0 (35.5 projected). Businesses are generally upbeat about the outlook, but optimism has eased.
- Q2 BOC Senior Loan Office Survey fell 6.1 to -24.8. Credit condition show signs of loosening to pre-crisis levels. The index last hit current readings in 2005.

### **Europe**

*The Eurozone economy is expanding, but growth is uneven. Consumer spending remains anemic, but employment trends show improvement and the trade sector is strong. Manufacturing surveys of business conditions are consistent with expansion, but austerity measures do create a headwind to growth. Credit markets are healing, but risks remain as PIIGS need to roll over debt. The recent Greek T-bill auction was successful but the yield was high at 4.55%, and ECB repo operations are experiencing brisk volumes creating uncertainty over the health of bank balance sheets. Inflation is tame. The ECB will keep rates unchanged and accommodate the financial system. Stress test results will help to shape the longer term outlook for monetary policy, but for now a rate hike is unlikely until 2011. The **U.K.** economy is giving off mixed signals. Housing is slow, consumer demand has softened, and the manufacturing PMI expanded, but the color on growth was mixed with the trade sector easier. Employment growth looks firm, but the JP Morgan bank tax is a reminder that there are headwinds to job creation. Inflation is higher than desired, but unlikely to accelerate. There has been some talk of a BOE rate hike, but no action is likely before 2011. Key economic indicators:*

### **Eurozone:**

- June EZ Manufacturing PMI was 55.6 (as expected). Employment rose for the 2<sup>nd</sup> straight month led by Austria, Germany, and the Netherlands. Manufacturing production, new orders, and new export orders all rose for the 11<sup>th</sup> successive month. The new orders-to-inventory ratio remained

below recent peaks and suggests that output growth may weaken from the strong rate seen during the first half of the year.

- June EZ Service PMI fell 0.7 to 55.5. Activity expanded for the 10<sup>th</sup> straight month. Employment rose modestly, but at the fastest pace since June 2008 with strength in France and Germany. Business activity rose across all national service sectors, but new order growth slowed. Weak domestic conditions were blamed for the slowdown. Average input prices increased for the 7<sup>th</sup> straight months, while output prices declined for the 12<sup>th</sup> straight month.
- June Bank of France Sentiment fell 1 to 100 (100 forecast). The index has moved flat to lower this year. Service sentiment was unchanged at 97 and is trending flat to higher. Production outlook rose 1 to 7 and has moved sideways in recent months. Order level rose 1 to 8, moving sideways this year. Capacity utilization was 76.7% and is creeping higher.
- May German Imports rose 14.8% m/m (3.5% expected). Exports rose 9.2% m/m (4.0% expected). Trade rebounded from weakness in April and is positive for growth.
- May EZ Retail Sales rose 0.2% m/m (0.3% expected). The series has been tracking flat to lower since December. Consumer demand is lackluster.
- June French BOF Retail Sales fell 1.0% m/m. Food fell 2.3%, clothing fell 8.6%, furniture declined 7.8%, appliances declined 1.1% and electronics dropped 2.8%. DIY rose 3.3%, hardware gained 15.8%, and cars rose 2.9%.
- Carrefour noted that sales in Q2 were up 2.7%, but off 2.9% in Europe excluding France.
- June Spanish Unemployment fell 83,800 not seasonally adjusted (-65,000 forecast). The labor market shows signs of improvement.
- May Italian Unemployment rate fell 0.2% to 8.7% (9.0% expected) showing signs of cresting.
- June EZ CPI was flat m/m and up 1.4% y/y. Inflation is tame and remains below pre-crisis level and the 2000 to 2008 period.

### **U.K.:**

- June Manufacturing PMI fell 0.5 to 57.5 (in line), but is elevated and supportive of growth. Manufacturing employment increased for a third month and at the fastest pace in 15 years. New orders increased for the 12<sup>th</sup> straight month, as manufacturers benefited from successful promotional campaigns and stock rebuilding. Anecdotal evidence suggested that domestic demand remained solid. In contrast, growth in new export orders – a key support to the recovery in recent months – downshifted markedly.
- The June Service PMI fell 1.0 to 54.4 and has declined 3 of the past 4 months. Selling prices rose with firms having an easier time passing on costs, but competitive pressures are restraining inflation. Details showed a major drop in sentiment - the largest in survey history. Fears of recession were reported.
- June PMI Construction fell 0.1 to 58.4 (58.5 forecast). All of the 3 construction sub-sectors gained. Employment was unchanged with efforts to expand offset by cost cutting in some companies. There was concern over the adverse impact of a higher VAT and public spending cuts.
- June Halifax Home prices fell 0.6% m/m (+0.2% forecast). Home prices have declined 3 straight months. The price to earnings ratio was unchanged at 4.72 and has been flat to lower this year.
- June New Car registrations rose 10.8% y/y. The pace of gain is decelerating
- June BRC Same Store Sales rose 1.2% y/y. The pace of growth is slow over the past few months. Sales were stronger in the second half of the month. Food sales growth was about the same as in May, thanks to the hot weather and World Cup. Clothing and footwear sales growth slowed, as many people had already bought in May. TVs benefited from football and outdoor DIY

and leisure improved on weather, but at the expense of indoor home wares. Non-food non-store sales (internet, mail-order and phone sales) in June were up 17.3%y/y, but down 21.9% from May. June's gain was against a similar increase in June 2009, while May's gain was against a weak May 2009.

- June CPI rose 0.1% m/m (flat expected). CPI rose 3.2% y/y (3.1% expected). Inflation is on the high side of the BOE's desire, but expected to be contained.
- June RICs fell 13% to 9% (20% expected). The index is trending lower after peaking in late 2009. It stands at an 11 month low. Number of homes sold was flat at 17 and stocks of homes on books rose 5 to 67. The supply of homes is outstripping demand. The sales to stock ratio fell to 25, which is the lowest in a year.
- June Claimant Count fell 20,800 (-20,000 projected). The drop is stronger than pre-crisis levels. Labor market looks healthy.
- June Claimant Count Rate was down 0.1% to 4.5% (4.6% expected). The rate looks to be finding a steady decline.
- May Weekly Earnings rose 2.7% y/y (3.0% expected). Wage growth is soft.
- May ILO Unemployment rate was down 0.1% at 7.8% (7.9% expected). The rate is cresting.
- May export volumes were flat, while import volumes gained 2.7%. The export volume index has worked sideways this year, but dampened by oil. Ex-oil and erratics the trend is more favorable for growth. Import volumes have crept higher and the trend is stronger ex-oil.

### Asia

*The Asian economy continues to grow, but the pace of activity has slowed materially. **Chinese** economic numbers show deceleration and the government appears comfortable with the slowdown. A number of investment houses have cut their GDP growth forecasts and pared back their outlooks for a PBOC rate hike. Inflationary pressures are present, but June CPI was tame. **India's** growth is vibrant, and inflationary pressures are high. The RBI will hike rates opportunistically to check inflation. The **Korean** economy is strong and inflationary pressures are present. The BOK said inflation would likely intensify in the coming months and the economy would register solid growth in the coming months helped by exports, consumption and investment. More rate hikes are likely. The **Australian** economy is expanding, but the underlying strength of the recovery is questionable given PMI data. The labor market appears strong and trade data has yet to reflect a material adverse impact from the Chinese slowdown. The RBA is likely to keep rates steady. The **Japanese** economy is sluggish, and continues to face deflation. The BOJ has lifted its economic outlook, but a rate hike looks unlikely in the foreseeable future. Key economic indicators:*

#### **Australia:**

- June Manufacturing PMI fell 3.4 to 52.9. New orders, employment, and production slumped. There is loss of momentum, but expansion.
- June Service PMI rose 1.3 to 48.6, but has been below 50 for 5 of the past 6 months. Employment rose 3.5 to 51.8, sales gained 5.9 to 49.4, and new orders fell 1.8 to 46.1. The data suggests a fragile recovery.
- June Construction Index fell 6.8 to 46.4 and is below 50 for the first time since December. Details showed weakness in employment and new orders. House (43.8 v. 57.7) and apartment (44.0 v. 42.0) indices were weak, but commercial (51.8 v. 50.5) and engineering (52.9 v. 42.5) firm.

- June Employment rose 45,900 (15,000 expected). Full time employment rose 27,500 and part time employment increased 18,400. Labor market conditions are healthy and consistent with a solid economic expansion.
- June Unemployment Rate fell 0.1% to 5.1% (5.2% expected) and continues to decline.
- June NAB Business Conditions rose 2 to 8. Confidence fell 1 to 4.0. Employment dropped 1 to 6, but was in line with the recent range, while forward orders rose 7 to 6 and were firm to trend.

### **China:**

- June PMI Manufacturing fell 1.8 to 52.1 (53.2 expected). Output declined 2.4 to 55.8, new orders dipped 2.7 to 52.1, export orders decreased 2.1 to 51.7, input prices fell 7.6 to 51.3, and employment declined 1.5 to 50.6. The inflation slowdown was notable.
- June Non-manufacturing PMI fell 0.3 to 62.7 and remains firm.
- June Passenger Car sales rose 19% y/y to 1.04 mln – China Association of Automobile Manufactures. Inventories are rising. Days supply was 55 in June compared to 41 in February.
- June NDRC Housing Prices rose 11.4 y/y showing slight deceleration. Sequentially, prices fell 0.1%. New residential was flat and resale down 0.3%.
- June Property Climate Index fell 0.01 to 105.06 and continues to work lower. Floor space under construction rose sequentially, but decelerated on a year over year rate. Sales of commercial residence rose sequentially, but decelerated on a year over year basis.
- June New CNY Loans were 603.4 bln (600.0 bln projected). Loan growth has slowed, but is healthy.
- June Exports rose 43.9% (38.0% expected). Imports expanded 34.1% (35.4% projected). Oil demand rose sharply sequentially and the refined trade deficit widened. Soybean imports were huge and copper import volumes soft. Exports to the U.S. and Europe rose sequentially.
- June Tax Receipts Rose 14.7% y/y, while spending increased 26.8% y/y. There has been an obvious slowdown in the growth of tax revenues.
- Q2 GDP rose 10.3% (10.5% forecast). The government says it wants slower growth to stop overheating and highlighted growth was within the range of the 10 year average.
- May LEI rose 0.8 to 145.8, showing a steady uptrend. May Coincident indicators rose 0.9 to 184.6 and continue to work higher. The Conference Board said that growth was less robust, but solid. They also said there was evidence that the expansion was cooling.
- June CPI rose 2.9% (3.3% projected). The uptrend is cresting. The sequential change was -0.6% and CPI has declined 3 of the last 4 months suggesting deflation. Year over year data shows clothing off 1.0% and transport and communication down 0.3%. Food and housing were both up 5.0%.
- June Retail Sales rose 19.3% y/y (18.8% forecast). Sales show signs of cresting, but base effects are going to get tougher. Electronics and autos showed deceleration, but furniture and jewelry were strong.
- June Industrial Production rose 13.7% y/y (15.1% expected). Production growth is easing pressured by the base effect and government actions to slow growth. The NBS representative said that 2/3rds of the decline was a function of base effect with last year. Moderation also reflects slowdown in the pace of production in six energy consuming industries following government's move to reduce energy usage and pollution.
- June FDI rose 39.6% y/y (15.8% projected). Given wage issues and talk of protectionism, the gain is surprising. Growth is strong and near the top end of the historical range. The base will get tougher, however.

### **India:**

- June Manufacturing PMI fell 1.7 to 57.3 and has expanded 15 straight months. Details showed work loads increasing and backlog accumulating at a quick pace. Payrolls did not expand during

the survey period with 96% of companies keeping staffing unchanged. Inflationary pressures moderated.

- June Service PMI rose 3.8 to 64.0 hitting a 2 year high. Incoming business increased sharply and companies were adding to staff.
- May Exports rose 35.1% y/y, while imports increased 38.5% y/y. Growth rates are decelerating on base effects. Non-oil imports increased 32.3% y/y. The level of non-oil imports has eased over the past 2 months. Export levels have also set back.
- May Industrial Production rose 11.5% (16.2% projected). Base effects are causing the growth rate to ease. Activity is still elevated.
- June Local Car Sales were 141,184. Sales have drifted lower in recent months but remain strong.
- Primary Articles WPI (July 3rd period) rose 16.25% y/y and remains elevated.

### **Japan:**

- June Manufacturing PMI fell 0.8 to 53.9. It eased from the recent high, but is on the upper end of the recent range.
- June Service PMI fell 0.4 to 47.1, hitting a 4 month low. A modest reduction in staffing levels was reported, while backlog declined significantly. Output prices eased and discounting continued.
- June Small Business Confidence was up 0.7 to 47.4. The July forecast was up 0.5 to 47.9. Manufacturing rose 1.9 to 49.3, while non-manufacturing gained 0.1 to 45.8.
- June Economy Watchers Survey fell 0.2 to 47.5. The Outlook Index declined 0.4 to 48.3. Households were flat at 46.2 and business fell 1.8 to 47.3. Employment rose 1.5 to 56.3.
- June Consumer Confidence rose 0.9 to 43.6. The trend is higher. Employment rose 1.3 to 41.1 and is working higher. The willingness to buy durable goods rose 0.3 to 47.2 and is drifting upward.
- May Household Spending fell 0.7% y/y (+0.3% expected). However, sequentially spending rose 0.7%. The series has been very choppy and flat to lower. There is no kick to consumer spending.
- May Jobless Rate rose 0.1% to 5.2% (5.1% forecast). The unemployment rate is showing signs of rising after hitting a low of 4.9% in January/February. Work force participation has risen from February when it hit a low of 58.9% versus May's reading of 60.1%. Employed fell 240,000 and the number has declined 4 straight months. Unemployment rose 10,000 and has risen 3 straight months.
- May Jobs to Application Rate rose 0.2 to 0.50 (0.49 expected) and continues to creep higher suggesting mild labor market recovery. New applications rose 4.3% m/m, while new job offers rose 3.5%.
- May Housing Starts fell 4.6% y/y (5.0% expected). Sequentially, starts have been down sharply 3 of the past 4 months and numbers have trended lower in since December/January.
- May Construction orders rose 9.2% y/y. The level of activity has been very choppy.

### **South Korea:**

- June Manufacturing PMI fell 1.3 to 53.3 posting its weakest reading since December 2009. Strong new orders, however, supported output. Production fell for a 2<sup>nd</sup> straight month. Input costs increased further in June, but at a slower rate. Rising input costs were driven by rising raw material prices and unfavorable exchange rate variations. Output prices increased for the 6<sup>th</sup> successive month and at the fastest pace since November 2008. Employment increased during June and hiring trends are above the long term average.
- June CPI fell 0.2% m/m (+0.2% expected). Core CPI rose 1.7% y/y. Food prices declined 1.6% m/m and pressured the index. Furnishings and recreation and culture prices fell, but miscellaneous goods and services rose. Inflation is tame.
- June Bank Lending to Companies fell KRW1.94 trln, while Lending to Households rose KRW2.48 trln. Business borrowing appears sluggish, but housing borrowing has firmed.



- June Unemployment rose 0.3% to 3.5%. The number rebounded from May's low of 3.2% and the series has shown some volatility recently. Employed periods fell 26,000, while unemployment rose 85,000. Employment eased after posting sharp gains between March and May. Unemployment rebounded after showing solid declines between February and May.
- June Department Store Sales rose 11.3% y/y, while Discount Sales increased 6.0% y/y. Both series displayed improved growth. Department store sales growth is at the upper end of the historical range.

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