



Hadrian Brief

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Growth and Inflation

The global economic expansion is moving forward at a slow pace. **U.S.** consumer spending has eased, and housing demand has plunged post the expiration of the homebuyer's tax credit. Commercial real estate activity remains depressed with a real recovery unlikely until 2011. However, manufacturing activity continues to expand, and auto makers are expected to keep plants open during the usual summer shut down period. **European** growth is mixed with still sluggish consumer spending and fiscal austerity balanced by continued strength in the manufacturing and trade sectors. Credit stress in European presents a downside risk to global growth. In **Asia**, the economic expansion continues, but China is clamping down on real estate activity and is removing export tax rebates. China is trying to stoke domestic demand outside of the real estate sector. Outside of China, growth prospects remain positive, although the picture is less vibrant.

Inflationary pressures are limited in the OECD, but emerging Asia faces the rise of higher inflation. Eurozone, Canadian, U.S., and Japanese consumer price indices are showing historically depressed year over year growth rates. Ample slack in the labor and product market remains present and government related austerity measures are dampening domestic demand. Further, loan growth is depressed and fails to provide the building blocks for an inflation outbreak. In Asia, Chinese lending growth has slowed but remains strong. At the same time, wages are finding upward pressures. However, some businesses are looking to shift production to the interior of China in order to halt a wage-price spiral. Real estate prices are also finding pressure. China is also creating a flexible mechanism for yuan trading, which should allow monetary policy to be more effective in reducing inflation. In India, WPI remains elevated and points to extreme inflation risk. Fuel prices are being deregulated and as a result gasoline and diesel prices are set to rise. Indian inflation is likely to be balanced by further RBI rate hikes, and

favorable monsoon rains, which boost crop production.

Money Markets

Treasury yields are expected to work sideways, but prices will be sensitive to the flow of early July economic data and the health of the European banking system. In recent weeks, the 10 year treasury yield has declined on signs of slower growth. Economic indicators have consistently surprised on the downside and correlated to higher treasury prices. Chain store sales have slumped and housing activity has plunged. KB Home, Toll Brothers, and Lennar each reported weaker traffic and confirmed the sharp decline in the MBA purchase index since late April. Additionally, labor demand is sluggish as unemployment claims have been elevated and regional purchasing managers' employment indices have shown weakness. Fall out from the oil spill in the Gulf of Mexico has also shaken confidence of Coastal economies. The growth picture will be shaped by global PMI and employment figures in early July. Beyond economic numbers, the House-Senate compromise on financial regulation has lifted some uncertainty from the banking sector, but the regulatory backdrop remains a headwind to economic growth. Bank shares have stabilized, but a move in the BKX over 51 is needed to pressure treasury prices. Still sluggish bank lending and lingering credit worries are pressuring yields. Internationally, the need for the ECB to extend credit on the expiration of the E443 bln Long Term Repo Operation (LTRO) on July 1st will shed light on the health of the banking system. The ECB will make plenty of liquidity available, but the amount of roll over and impact on deposit rates will signal the health of the system. If liquidity needs are dramatically reduce, and deposit rates benign, safe haven flows will likely fade. At writing, the EZ 2 year note was yielding 10 bps below 3 month euro LIBOR. Higher 2 year rates in Europe would quickly spill over into the U.S. treasury market. Also of interest, Fed custody data has shown foreign entities cutting down on treasury holdings and boosting agency

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holdings in recent weeks. The portfolio shift may be yield enhancement and signals healthy private sector demand for treasuries, but also hints that treasuries may be overpriced. Technically, the 3.00% yield remains pivotal to the 10 year, and market direction.

Foreign Exchange

The dollar is expected to trade mixed, but nervousness over a possible attack on Iranian nuclear facilities by Israel could create a temporary safe haven bid. The **euro** has found firmer footing. U.S. growth expectations have been notched down given soft labor market data and weakness in the consumer and housing sectors. In contrast, Eurozone economic growth has held up better than expected. Flash EZ PMIs were firm to expectations and consistent with an on going economic expansion. Further, there are signs that German auto makers are adding shifts and workers to meet robust production schedules. On the fiscal front, European governments have moved swiftly and effectively in trimming deficits. At the same time, the U.S. Congress is talking about using procedural measures to avoid crafting a budget, and the Congressional leadership is trying to work through another stimulus plan. There could easily be a loss of confidence in the U.S. budget process. Recently, a PBOC official said the euro would see short term weakness, but was favorable toward the euro medium and long term. China's trade flow with Europe is larger than the trade flow with the U.S. which suggests that yuan flexibility and a stronger yuan may in fact weigh on the euro relative to the dollar. The euro's direction will be greatly contingent on the details of maturity of the ECB's 1 year LTRO. Smooth money market conditions post the event will cool fears over the European banking system and lift the euro. The **sterling** is being lifted by the successful reception to the budget and austerity measures. Rating agencies have provided a vote of confidence, and it looks like the U.K. will maintain its AAA rating. However, growth prospects are not strong despite labor market health. Housing

has lost momentum from last year, and consumer spending has eased in recent months. A higher VAT also dampens the longer term spending picture. Manufacturing activity has also slowed. The **Australian dollar** will be lifted by the change in leadership. New PM Gillard suggests the government will back down from the mining tax -- a development, which will boost the outlook for economic growth. Further, the move by China to embrace a more flexible currency policy will lift the outlook for a stronger yuan, increased commodity demand, and an increase in Australian imports by the Chinese. However, the domestic economy has shown a softer tone with auto sales finding an easier pace and housing demand losing some momentum. The interest rate differential is favorable for the Australian dollar, but the RBA is unlikely to tighten policy in the medium term. The **Canadian dollar** continues to benefit from a pick up in reserve currency status. The Russian central bank recently said it could add Canadian dollars to its reserve holdings. Russia is out spoken, but investor confidence in the Canadian fiscal situation and banking system is helping investment inflow. Canada has come out against a global bank tax. In contrast, President Obama is favoring a bank tax of 15 bps on liabilities. The **Swiss franc** is likely to benefit from ideas that the SNB is finished trying to support the euro, and more confident in the growth outlook. The SNB recent said that deflationary risks had largely disappeared. In its quarterly survey, the SNB revised up its growth outlook and said industry is looking to the immediate future with confidence. The outlook for employment growth has also improved. The **yen** remains supported by low interest rates in the U.S and Europe, but pressured by the BOJ's on going concern about deflation. The market is looking for the Tankan survey to show its first increase in capital spending since 2007. Signs of quicker growth will benefit the yen. Likewise, ideas of a strong Chinese yuan may help to lift the yen as Asian economies may be less compelled to pressure their currencies for export competitiveness.

Equities

Equity prices are expected to work sideways to higher, but geopolitical tensions are a risk to higher prices, and the trade will be sensitive to corporate guidance in the early days of July. Recent profit reports from FedEx, Bed Bath and Beyond, Carnival, Best Buy, Lennar, and KB Home have caused the trade to revise down the outlook for profit growth. However, the Oracle and Jabil Circuit displayed strength and suggest that the technology sector is buoyant. Given the sell off since late April, the market is pricing a slowdown in profit growth. Lack of negative profit warnings in early July will likely to lead to short covering into the release of actual Q2 profit numbers in mid July. Equity valuation is attractive. Based on current profit expectations, the earnings yield on the S&P 500 is projected at an unusually high 7.00% at year end 2011. Given a 10 year yield less than 3.20%, stocks look historically cheap to treasuries. The spread between the expected earnings yield and the 10 year treasury is at levels last seen in the late 1970's. Stocks also look attractive to corporate debt and cash. As a result, any sign that earnings expectations can be realized will support stock prices. Even though valuation is attractive, the political backdrop remains a headwind to higher prices. The threat of an Israeli attack on Iran exists, and President Obama is pushing for a 15 bp tax on bank liabilities. The likely passage of a financial regulation bill around July 4th will likely hinder economic growth and create pressure on bank earnings. Earnings for JP Morgan, for example, have been cut in recent weeks in anticipation of the legislation becoming law.

Commodities

Commodity prices will be sensitive to the pace of economic growth, weather, and geopolitics. Growth expectations have been reduced in recent weeks given the softness in consumer spending, and concerns over the U.S. and Chinese real estate markets. However, industrial activity continues to move forward.

Positive growth is needed to keep investors interested in owning the commodity asset class. Crop conditions are favorable for grain and oil seed production. The cotton crop is at more risk, but is currently healthy. Hurricane activity will influence the price of energy. The hurricane season is expected to be active, but so far a major threat has not surfaced. Geopolitical factors are supportive as ideas of a strike on Iranian nuclear facilities by Israel and lack of confidence in U.S. fiscal policy are positive for gold and commodities in general.

The **crude oil** market appears comfortably supplied and will be driven by the outlook for global demand and the flow of investment dollars. Signs that Israel may be preparing to bomb Iranian nuclear facilities could also support prices on fears of supply disruption. Press reports suggest Israel has prepared for an attack and were given credibility by Italian PM Berlusconi who hinted at Israeli action at the G-20 meeting. U.S. crude oil inventories have risen counter seasonally in recent weeks. There was a 24.1 day supply of crude oil in the period ending June 19th (23.9 last year). On the product size, demand has been mixed to strong. Diesel demand has eased in recent weeks, but the 4-week average is up 12.8% y/y at 3.891 bd. The days supply of diesel is still high at 40.4 but below last year's level of 44.1. The 4-week average of gasoline demand was up 0.8% y/y at 9.237 mbd. The days supply of gasoline was 23.6 compared to 22.8 a year ago. 3:2:1 crack spreads display weaker demand in Asia and Europe, and steady demand in the U.S. As of June 25th, the WTI 3:2:1 crack spread was firm at \$8.24. In contrast, the Minas 3:2:1 had plunged to \$5.33 and reached levels last seen in January. The Brent 3:2:1 was \$7.83 and at the lower end of its recent range. In Asia, India has decided to move to a market system for gasoline and diesel. This will limit the losses at state run refiners, but should cut consumption at the margin. Gasoline prices were expected to rise about 3.5 rupees per liter. Additionally, product inventories in Singapore rose 5.5% w/w in the period ending June 23rd. The rise in inventories

is consistent with the set back in crack spreads. On a side note, the IEA reported that global oil refining capacity would rise 9 mbd through 2015 with China set to build out 3.3 mbd of capacity. China Petroleum and Chemical also announced plans to double storage at its Maoming site to 4 mmts.

Natural gas supplies are comfortable. Hurricane activity and cooling demand will likely drive prices day to day. As of June 18th, there were 2,624 Bcf in storage. Storage was down 0.5% from a year ago, but 13.3% above the 5 year average. The decline relative to a year ago is a mild plus. Weather has been hot to the benefit of cooling demand. In the latest reporting week, BENTEK Energy Services indicated a 12% rise in natural gas demand for electric power. The 8 to 14 day forecast has temperatures in the upper Midwest and northern Atlantic region above normal. Bigger picture, the EIA reported that residential natural gas usage declined 22% over the past 19 years. Consumption fell 16 of 19 years and was driven by appliance efficiency, improved housing construction, and population shifts toward warmer weather. Higher natural gas prices were also noted. On the industrial front, the manufacturing sector continues to expand, but the pace of expansion is slow. The slow growth environment is likely to deter a strong gain in prices. Looking at hurricanes, the market will be on guard for storms which shut in supply. At writing, the outlook was calm with tropic Storm Alex expected to rotate into Mexico and miss Gulf production. The Baker Hughes rig count was 958 for the week ending June 25th. The trend has been flat in recent weeks, but well above last year's level of 687.

Copper prices possess a favorable technical set up. The daily bar chart pattern resembles a bottom, while large funds had a very small net long of 1,548 futures and options contracts as of June 22nd. There is plenty of room for fund buying to enter the market. On the fundamental front, the comments from the International Copper Study Group have been supportive big picture. The Group noted March

demand at 1.70 mln tons and output at 1.59 mln tons. Although output was up 2.0% in Chile, output was down 9% in Peru, the U.S., and Indonesia. In a recent presentation to analysts, Freeport noted that it was very difficult to find new sources of copper supply and the noted the market was constrained. Freeport expected to see its supply inch higher over the next few years. Sales were currently projected at 3.84 bln pounds, and forecast to rise to 3.98 bln pounds (+3.6% y/y) and 4.00 bln pounds (0.5% y/y) in 2011 and 2012 respectively. Stock levels continue to inch lower on the LME, and canceled warrant levels were elevated at 30,975 on June 25th. Furthermore, Shanghai stocks have eased lower in recent weeks. Ideas of a flexible yuan and speculation of yuan appreciation have boosted bullish psychology toward the market, although Chinese real estate activity continues to be on a slowing trajectory and both U.S. commercial and residential real estate markets are depressed with new home sales hitting a record low in May and the May Architectural billing ratio remaining below 50.0.

Gold continues to see strong investment demand helped by low interest rates, unease over events in the Middle East, and lack of confidence in financial assets and government policy. Flows in the SPDR Gold ETF have been very strong in recent weeks. As of June 25th, the fund held 1,316.18 mts of gold and had seen a steady acquisition compared to the prior days. Highlighting the uptrend in gold holdings, the 30 day average was 3% lower at 1277.53. Furthermore, CFTC data showed large funds net long 274,202 futures and options contracts. There were 297,375 longs and just 23,173 shorts. The Chairman of the Shanghai Gold Exchange noted that Chinese investors were buying gold after the government introduced steps to curb the real estate market. Barclays Capital is looking to expand its gold storage capacity, while Oscasa is planning to open a 165,000 square foot vault in New York in the coming months to store gold. Press reports hinting that Israel may be staging to attack Iranian nuclear facilities, along with on going

instability in Afghanistan have subtly helped the bid. Furthermore, the U.S. Congress may be trying to avoid making a budget. Investors are losing confidence in U.S. political leadership with ratings on Congress and President Obama at lows. U.S. treasury yields below 2.00% through five years and Eurozone yields below 1.50% through five years create little opportunity cost for holding gold. At the same time, major equity markets in the U.S, Asia, and Europe are lower year to date. Depressed inflation has not deterred demand. The 10 year TIPS break even has been below 2.00% since mid May and inflation rates in the OECD are low.

Soybean prices will be driven by North American weather and Chinese demand. Growing conditions are neutral to bearish for soybeans. Weather may have been a shade too wet recently, as the percentage of soybeans rated good to excellent fell 4% to 69% in the period ending June 20th. Despite the decline in rating, the number was slightly ahead of the five year average of 67%. Given the seasonal up in temperatures and adequate soil moisture, the outlook for production remains strong and a cap to prices. One positive note for the market rests in reports that India's soybean acres may fall 5% to 7% this year on switching to cotton and sugar crops. Looking to demand, researchers at grain.gov.cn (China National Grains & Oils Information Center) said that Chinese demand for soybeans would fall to 3.5 to 4.0 mmts in August down from 5.0 mmts in July due to excessive arrivals. The statements are consistent with recent reports of full ports and a bloated pipeline. Export sales have declined 42.8% y/y over the past four weeks and suggest a slowdown in demand. It has been reported that China's rapeseed output will fall 15% short of estimate to the benefit of soybean demand.

Corn prices will be driven by weather and Chinese demand. Growing conditions are favorable and price bearish. Through June 20th, 75% of the U.S. corn crop was rated good or

excellent up 5% from the 5 year average. There is ample soil moisture and planting was timely. The prospect for record yield is good. On the demand front, the Chinese crop is uncertain and there are expectations that output will fall short of forecast because of dry weather in central and northeastern growing areas. The U.S. Grains Council president Dorr is on record saying that China may buy more than 1 mln tons of corn this year. China's National Grain and Oils Information Center said that imported corn from the U.S. was priced 130 to 150 yuan a ton cheaper than local supply. The pace of corn export sales is healthy. Sales are up 20.8% y/y over the past four weeks.

Wheat prices will be driven by weather conditions in Canada and Europe. Canada continues to face wet conditions which will keep production expectations downbeat. The Canadian Wheat Board said that rain had prevented seeding and noted poor weather was likely to change its planting estimates. Likewise, dry weather has been present in European growing areas, while weather conditions in the Black Sea region has been adverse for production. Highlighting the outlook for reduced output, Rabobank recently projected global output for 2011 at 660 mmts compared to the USDA's June 10th forecast of 668.5 mmts. In contrast, wheat conditions in the U.S. are neutral to bearish. The winter wheat harvest was 17% completed through June 20th which is 2% ahead of last year, but 6% below the 5 year average. 84% of spring wheat was rated good or excellent compared to 77% last year. U.S. export sales have been robust and supportive. Over the past four weeks, total sales are up 62.3% y/y, but will need to continue higher to match the sales level seen in the summer and early fall of 2009.

Cotton prices will be driven on the outlook for a tightening of the supply/demand balance. Cotlook recent indicated demand would exceed supply by 385,000 mts in 2010/2011 raising its

deficit forecast from 224,000 mts. Stronger demand in Brazil and Turkey and a reduction in Turkish supply were blamed for the reduction. International factors are mixed. India is boosting cotton plantings. 2.62 mln hectares are expected to be sowed compared to 1.48 mln last year. India's cotton association is looking for production in the year ending September 30th to be 30.55 mln bales up from 29.75 mln bales last year. Weather conditions also appear favorable for production given the current monsoon pattern. In China, demand remains strong and cotton in short supply as the government has raised the import quota by 1 mmts, and been aggressive with the sale of its stocks. There is talk that large textile mills in China's Anhui Province were one and a half months short on supply. In Pakistan some mills are reportedly shut due to shortage. Looking to the U.S., 62% of cotton was in good to excellent condition down from a peak of 66% on June 6th, but well above a year ago (44%). U.S. demand is strong. U.S. mill consumption rose 2.9% m/m and 7.6% y/y in May. However, export sales have eased in recent weeks. Sales are off 10.2% y/y over the past four weeks.

Hog prices are likely to be supported by tight supplies. The June hogs and pigs report was not a major surprise, but showed inventory down 3.7% y/y (-3.0% expected). The breeding herd contracted 3.0% (-3.5% forecast). The USDA reported that producers were paying down debt instead of expanding production. The report suggests supplies should be relatively tight. However, pigs per litter and farrowing numbers were a bit higher than expected and may pressure February 2011 hogs. Further, cold storage numbers displayed a sharp drop in supplies. Pork supplies were off 7.3% m/m and 23.3% y/y. Seasonally, hog numbers should start to rise which will provide a headwind to higher prices, but the tight supply of pork in cold storage and continued decline in inventory will provide balance. Further, Russia has ended its U.S. chicken import ban. Russia is the top buyer of U.S. chicken and the action should raise

poultry prices to the benefit of hog prices. The Russian import ban had caused a swelling in chicken in cold storage. In May, chicken in cold storage was up 9.0% y/y. Domestic demand is likely to be lackluster, and will put pressure on foreign buying to lift prices. The recent softening of the dollar against the euro has helped the market. Likewise, an adjustment in the value of the yuan will make pork more attractive to Chinese consumers. The pork cut out has been under pressure in recent weeks, but remains elevated.

Cattle prices will be driven by demand, but find help from a reduced supply of competing meats. Hog supplies look lower given the results of the hogs and pigs report and falling frozen pork inventories. Chicken supply should also decline given Russia has lifted its poultry import ban. Cattle supplies are set to rise seasonally through the summer, but will be relatively tight compared to history given herd size. Feedlots are current. Steer carcass weights are seven pounds below last year. Additionally, cold storage numbers showed frozen beef inventory down 1.5% m/m and off 12.9% y/y. Domestic demand is likely to be lackluster as consumer spending has softened and unemployment remains high. Summer heat will also create weakness in demand outside of grilling items.

Sugar prices will be driven by the outlook for demand, as the market is expected to work toward surplus into 2011. Demand has been strong in recent weeks. Indian buying has been lifted by soft drink makers and the marriage season. India delayed the import duty on refined sugar. The action suggests that supplies are tight enough to support prices. The Indian government does not appear ready to lift the domestic price. Additionally, Pakistan recently bid for 175,000 tons of refined sugar. It is planning on importing 1.2 mln tons of sugar to meet domestic demand and cap prices. On the supply front, Brazil crop is large, but has been priced by the trade. India is set to lift production. The Indian farm ministry said that Indian farmers planted 4.73

mln hectares of sugar this year compared to 4.52 mln hectares a year ago. The monsoon is favorable for production. The market continues to look for Indian production to be in the 23 to 25 mmt area. The most bullish supply dynamic rests in Thailand, where sugar output may be down 13% in the coming crop year on adverse weather. The Thai government is looking to reallocate sugar to the domestic market from the export sector to ease shortage. Technically, large funds remain a major long in the market and could mute the ability of the market to continue higher.

Coffee is being supported by tight supplies. New York inventories were 2.246 mln bags as of June 23rd and continue to trend lower. Stock levels are approaching the 2002 low of 2.169 mln bags. The trade is also looking at reports of tight inventory in Brazil. Given the health Brazilian harvest, the outlook has caught the trade by surprise and suggests huge demand. Brazilian Broker Terra Futuros said inventories could hit 1.75 mln bags in September and then fall to 800,000 bags in March 2011. Current inventories were 2.2 mln bags. The market remains uneasy about production in Central America and Mexican exports for 2009/2010

are expected to fall 10% y/y due to cold weather cutting production. Looking to Vietnam, exports are sluggish as farmers appear to be holding beans. The January to June export total is tracking down 12% y/y. There is also focus on adverse weather. Rains in Dak Lak and Gia Lai are 30% below normal and could curb production. The most bearish dynamic is the pure surge in prices and a report from the International Coffee Association suggesting that roasters will soon raise retail prices by 10%.

Cocoa prices remain supported by unease over supply and the pace of demand. Heavy rains in the Ivory Coast have created fear of decreased yield. Likewise, strong rain fall in Nigeria has lifted the outlook for black pod disease. Deliveries to Ivory Coast ports are at last report running at 1.025 mln tons compared to 1.040 mln a year ago. Despite tight current conditions and crop fears, both Fortis and Macquarie are looking for the market to work into surplus in 2010/2011. There are expectations that demand will remain strong and food companies will lift inventories. Nestle recently indicated it was going to expand its business instead of buying back shares.

North America

*The **U.S. economy** has slowed given housing and consumer data. Manufacturing output is continuing, but the regulatory and political environment is a risk to growth. Inflation is tame. Monetary policy is on hold into 2011. The **Canadian economy** is expanding. LEI points to growth, commodity prices are elevated, and the banking sector looks healthy. Inflation is benign. The BOC will look to raise rates again in the fall if European credit risk settles and the slowdown in U.S. growth stabilizes. Key economic indicators:*

U.S.:

- May CPI fell 0.2% (in line). Core CPI rose 0.1% (as expected). Food and beverage prices were unchanged, while housing was flat. OER was flat, but lodging away from home rose 2.5% and has been much firmer in recent months. Other items of noted: apparel and upkeep rose 0.2%, new and used car prices gained 0.2%, fuel fell 5%, tobacco rose 1.3% and medical care increased 0.1%. Medical inflation has been tame in recent months.
- April Moody's Commercial Property Price index rose 1.7% m/m. Prices are 41.1% below the October 2007 peak, but up 4.7% from the October 2009 low. Transaction volume was reported to be low and inconsistent with a bottom in activity. There were 114 re-sales worth \$800 mln compared to 127 repeat sales in March.
- May Architectural Billing index fell 2.7 to 45.8. Activity remains weak. At this level, it is unlikely commercial construction activity will improve until 2011.

- May FW Dodge index rose 3 to 86.0. The index remains depressed. The trend in non-building activity has slowed, and may hint that the impact of stimulus money on roads is fading.
- June NAHB Survey fell 5 to 22 in line with the drop in the homebuilding stocks. Present time fell 6 to 17, next six months dropped 4 to 27 and traffic declined 2 to 14. It is clear the homebuyer's tax credit pulled business forward.
- May Housing starts fell 5.9% to 593,000 units (648,000 expected). The expiration of the tax credit pressured starts and created payback.
- May Existing Home Sales Existing declined 2.2% m/m (6.0% expected). Sales were pressured by the end of the tax credit, but the full impact is likely to occur in June. Sales activity is sluggish.
- May New Home Sales fell 33% to a record low 300,000 units (410,000 expected). The expiration of the tax credit pressured sales. Inventories were lean and also historically low.
- Durable good orders fell 1.1% (-1.4% expected). Ex-transport orders rose 0.9% (1.0% expected). Non-defense capital good orders ex-aircraft rose 2.1% and have worked sideways to higher in recent months in a choppy trend.

Canada:

- May CPI rose 0.3% m/m (0.2% expected). CPI is up 1.4% y/y. Clothing and healthcare costs were weak, but shelter was firm. Inflation is tame.
- April Retail Sales fell 2.0% (-0.4% forecast). Autos fell 4.8% and weighed on spending, but there was broad weakness with building material, food, clothing, and general merchandise down. Electronics were the bright spot up 0.6%
- May Leading Indicators rose 0.2% m/m (0.3% expected). The index was up 11.9% y/y and points to growth.

Europe

The Eurozone economy is expanding helped by strength in the trade sector. Indicators of business activity are firm, but domestic demand is anemic, credit stress lingers, the banking system is fragile, and austerity measures are capping growth. Inflation is contained. The ECB will keep rates low well into 2011 and will work to support liquidity and stability in the banking system. The U.K. economy is on softer footing given the recent trend in retail sales and industrial output. Budget cuts and tax hikes will create a headwind to growth. Housing activity is stable but soft compared to last year. In contrast, the labor market is surprisingly strong with the claimant count better than pre-crisis levels. Inflation is elevated compared to the BOE's desire and pace of growth, but the MPC will keep rates unchanged into 2011. Key economic indicators:

Eurozone:

- June EZ Flash PMI Composite fell 0.4 to 56.0 (55.8 expected). Manufacturing declined 0.2 to 55.6 (55.3 projected), while service fell 0.8 to 55.4 (55.9 forecast). Details included: New orders fell for a second straight month and slowed in both manufacturing and services, easing to 6 and 4 month lows respectively. The finished goods inventory ratio rose slightly from May's 11 month low, but pointed toward weaker output growth. The employment index hit a 2 year high lifted by marginal increases in both manufacturing and services. Prices charged by manufactures continue to rise, but at a pace well below pre-recession levels. Prices charged in the service sector fell again due to weak demand, especially in the consumer sector.
- June French Business Confidence fell 2 to 95.0 (96.0 expected). The index shows signs of cresting. Order book fell 4 to -36, own production outlook declined 10 to -7, and overall production outlook slipped 1 to -4.
- June French Building Confidence was unchanged at 93. Trend is flat to higher. Expected activity and turnover were stronger showing improvement.

- June French Service Confidence index fell 1 to 98 and shows slower activity. The General outlook index was flat at -8, expected demand declined 4 to -1, recent labor trends rose 2 to 1, and future labor trends sank 5 to -4. Lastly, recent investment trends fell 1 to -1 and is still elevated
- June Italian Business Confidence fell 1.0 to 104.4 (105.0 expected). The index continues to work lower from the December peak of 113.6.
- INSEE says that French GDP will rise 0.5% in Q2 and 0.4% in both Q3 and Q4.
- July German GFK Consumer Confidence was unchanged at 3.5 (3.3 expected). The trend is steady. Willingness to buy was strong through June. Willingness to save was down sharply.
- May French Consumer Spending rose 0.7% (0.4% expected). Sales have risen nicely over the past three months, but the overall trend is choppy. Household appliances and equipment rose sharply helped by TV purchases for the World Cup. Auto and clothing purchases were soft.
- April Italian Retail Sales fell 0.3% (-0.1% expected). The trend is choppy and the index level is flat over the past six months showing little growth.
- May Spanish Cement Production fell 7.2% y/y, but sequentially production was firmer. The year over year pace of production decline is slowing, but likely a function of the base effects.

U.K.:

- May Retail Sales ex-fuel rose 0.5% m/m (0.1% forecast). Sales have chopped in recent months but are moving higher. Clothing and other store sales fell 1.3% and 0.8% respectively. Household goods and non-store retailing were strong up 1.7% and 1.8% respectively.
- June CBI Distributive Trade Volume rose 13 to -5, reversing a sharp drop in May. None-the-less, volume declined for a second straight month. June motor trade fell sharply after a bounce in May and the trend is poor. Expected sales rose 26 to 11. Sales were expected to rise in July due to the World Cup. Here is some color on sales: "The decline in sales was led by footwear & leather, which saw a sharp fall in sales after 11 of solid growth, followed by hardware, china and DIY. "
- June CBI Industrial Orders fell 5 to -23 (-15 expected). Exports were a bit weaker compared to May at -2. Output was down 2 to 15, and inflation pressures remained, but have eased. Stocks were adequate at a net of 11, but below the longer-term trend. The CBI said: "Although demand for UK-made goods has weakened a little this month, the manufacturing sector remains on a path of recovery, with conditions much improved on just a few months ago. UK exports continue to be boosted by the weak pound and strengthening world trade, firms still expect a healthy rise in production in the coming months and inflationary pressures look to be easing a little."
- May Jobless Claims fell 30,900 (-20,000 expected). The change in claims shows strong labor market conditions with the pace of drop more than most of the 2000 to 2007 period (during the expansion).
- April Average weekly earnings rose 4.2%. Wage growth is accelerating consistent with stronger labor market conditions.
- May Rightmove House Prices rose 0.3% m/m and 5.0% y/y. Rightmove stated there was evidence to suggest the housing market recovery was struggling to maintain momentum. However, the index level continued to work higher
- May BBA Loans for Home Purchase were 36,709 (36,000 expected). The number of loans for purchase has been flat to higher since January. Re-mortgage was 21,229 and has been flat since January.
- May RICS rose 3% to 22% hitting the highest rate since January 2010. The sales to stocks ratio fell 1 to 27. The housing market shows stability in recent months

Asia

*The Asian economy continues to grow, but the pace of activity has slowed given developments in the Chinese real estate sector and recent data points out of Australia. **China** is working to cool its real estate market and limit excess capacity in select industrial sectors. However, output and consumer spending appear to be healthy and supportive to growth. Inflationary pressures remain significant given the potential for a wage-price spiral. The PBOC will work to cool inflationary pressures given more flexible FX policy and liquidity measures. **India's** economy is expanding, but inflationary risks are high. The RBI will move to tighten monetary policy in the coming months. In fact, a rate hike is possible at any time. **Australia's** growth rate has slowed given trends in consumer spending and housing. Growth is still positive helped by spill over from India and China. Inflation is not a problem. The RBA will think about raising rates later this year. **Korea's** economy continues to expand and inflation is tame. The BOK will be biased toward rate hikes, but is in no hurry to act. **Japan** is expanding slowly, but capital spending is expected to expand. Deflation persists. The BOJ is far from raising rates. Key economic indicators:*

Australia:

- May Vehicle Sales fell 3.2% m/m. The number of vehicles sold has been flat over the past six months and demand has a softer tone.

China:

- PBOC Survey:
 - Enterprise Confidence index fell 0.5 to 83.9. Companies were cautiously optimistic on market demand and profitability. European credit stress and government tightening measures likely created the caution.
 - A record number of urban households thought home prices were at unacceptable levels, while the percent of Chinese ready to buy property over the next 3 months fell to 15.5% -- second straight quarterly decline.
 - Financial institutions indicated demand for home mortgages dropped 6.4 to an index level of 58.8 confirming slowing mortgage demand.
 - Satisfaction with consumer prices fell to a record low 21.7%. The number of survey takers that thought inflation was too high hit a 10 year high.
 - Loan demand fell 2.2 to 66.9 which is consistent with the recent range.
- May Hong Kong Unemployment rate rose 0.2% to 4.6% and shows very early signs of bottoming.
- China International Capital said China could see the loss of millions of temporary jobs with the completion of projects under the government's stimulus plan. Pay hikes and minimum wage gains could prompt more cautious hiring.
- The NDRC calculates stimulus brought 5.6 mln long term jobs and 50 mln temporary jobs. The supply of labor in 2011 could rise by 39 mln with 7.58 mln collage graduates, 6 to 7 mln surplus laborers moving from rural areas to the cities and 25 mln temp workers losing their jobs. Further, China may only create 8 mln jobs if growth slows to 7.5%.

India:

- June 12th Primary Articles WPI rose 17.6% y/y. Inflation remains extremely elevated.

Japan:

- May Nationwide Department Store sales fell 2.1% y/y. The rate of decline continues to slow, but activity is sluggish.
- May Exports rose 32.1% y/y (36.5% expected), while Imports increased 33.4% y/y (34.2% expected). In real terms, the index level for exports gained 1.0% m/m, while imports surged 7.6% m/m, pointing to on going growth.
- May Corporate Service Prices fell 0.8% y/y. Deflation is slow to end.

- May National CPI fell 0.9% y/y (-1.1% expected). Core CPI declined 1.6% y/y in line. Deflation remains in place. The sequential change was -0.1%. Food, housing, household goods, and medical care fell. Clothing rose, as did transportation and communication.

South Korea:

- May Department Store Sales rose 8.0%, while May Discount Store Sales rose 2.3%. Discount store sales have been choppy, but higher in recent months. Sports and clothes posted the strongest year over year gains.
- June Consumer Confidence rose 1.0 to 112.0. The trend has been flat in recent months. Employment rose 3 to 105 and is trending higher. Spending increased 2 to 103 but is in the recent range.

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