

August 1, 2010

## Growth and Inflation

The global economy is on softer footing, but continues to expand. Chinese growth has downshifted, but the markets have become more comfortable with a soft landing scenario with the Chinese CSI 300 firming. European business sentiment indicators point to further growth, and credit conditions have stabilized. Austerity measures and sluggish consumer spending are creating a headwind to growth. The U.S. economy continues to be hurt by the political and regulatory environment which is hostile to business. The threat of higher marginal tax rates and uncertainty over dividend and capital gains tax rates are freezing small business creation. However, regional PMI surveys are still displaying growth, and chain store sales have inched to a new cycle high.

Inflationary pressures are limited. Inflation is capped in the U.S. as the labor force is under utilized and recent government data displayed 18.9 mln vacant homes in the U.S. suggesting limited appreciation for home prices. Colgate and Kellogg reported weaker than expected profits suggesting limited pricing power for brand name products. In Europe, German CPI figures showed a flat trend in inflation and the flash PMI reported suggested easier input costs and stable output prices. The U.K. housing market shows signs of softer pricing, while higher taxes are leaning against consumption. In Asia, inflation is strong in India. The RBI noted industry was bumping up against capacity constraints, but monetary policy is being tightened and crop conditions are expected to check food price inflation. Weekly primary articles WPI shows inflation peaking, but on base factors. China is cutting drug prices by as much as 50% on some items, and the property market continues to show signs of cooling with the government intent on preventing a bubble. The head of Macroeconomic research at the NDRC indicated that China faces deflationary pressures in the second half of 2010. Recent wage hikes appear to be the greatest inflationary threat to the Chinese economy. The impact of higher

wages will be working through the economy in the coming months. Q2 CPI was less than expected in Australia, and Japan continues to fight off deflation.

## Money Markets

U.S. treasury yields are expected to work sideways, but yields will be sensitive to the strength of PMI numbers at the start of August. The market faces a number of cross currents. On one hand, low inflation, high unemployment, and a weak housing market are supporting treasury prices. On the other hand, valuation is poor and treasury yields are uncompetitive with corporate debt and equities. There are few signs of inflation. Pizza Hut recent announced price cuts for its average pizza from \$21 to \$12, and residential real estate activity remains depressed. CB Richard Ellis noted that commercial leasing rates were bottoming out in most major U.S. cities, but forecast high vacancy rates in office, retail, and industry properties into 2011. Excess capacity in the real estate, labor, and product markets is capping inflation. The core inflation rate is rising 0.9% y/y, which is helping to pressure nominal yields, although real yields are negative within three years on the curve. Economic growth remains anemic. The housing market shows little sign of recovery, employment growth is sluggish, and PMI numbers show loss of economic momentum. The large gain in Q2 inventories hints that the inventory cycle will play less of a roll in lifting growth. Q2 GDP numbers indicate an abnormally slow economic recovery, and imply the regulatory and tax backdrop facing the economy is stifling growth. Valuation is poor. Outside of Japan and Europe, major central banks are raising rates and make the U.S. market look less competitive. The U.S. 2 year yield is comfortably under the German 2 year yield, while the spread between the Moody's Baa Corporate and U.S. 10 year has widened 60 bps since late April to over 300 bps. The spread is historically wide and in the 12th percentile going back to 1989. The spread is large despite a record amount of cash on corporate balance sheets and excellent cash

flow management. Additionally, a number of major blue chip equities carry dividends at or above the 10 year yield. Investors can get paid more than treasury yields with an option of growth. The U.S. fiscal situation also remains in crisis, and credit could become a bear issue for the treasury market at quickly.

### Foreign Exchange

The foreign exchange market will be driven by growth and interest rate differential with the trade more sensitive to individual country fundamentals. The **euro** is being supported by stronger than expected economic activity. Surveys of business activity have been buoyant, while 3 month Euro LIBOR and the 2 year yield have risen significantly above their dollar counter parts. Fiscal austerity measures should create a headwind to growth, but the impact has so far been limited and Europe is well ahead of the U.S. in getting its fiscal house in order. The **sterling** is being supported by surprising strength in consumer spending, and favorable trends in employment, however, a slower housing market and uncertainty over higher taxes and financial regulation are potential negatives. Better than expected Q2 GDP growth will support the sterling until there are clearer signs of an economic slowdown. The **yen** will be pressured by on going deflation and recent comments from government officials pointing to the possibility of intervention. Export growth is strong on a year over year basis, but has shown sequential weakness prompting concern from government officials. The slower pace of Chinese growth could also be a drag on the yen. The Japanese economy continues to expand slowly given the level of the PMI and the overall trend in household spending. Low interest rates in Europe and the U.S. continue to support the yen. The most bearish dynamic facing the yen has been the pick up in foreign bond purchases over the last six weeks. There has been a notable outflow of cash into overseas markets and Japanese investors show signs of looking for return. The **Canadian dollar** will be helped by firm commodity prices, a healthy

banking system, and the movement of the BOC to lift rates over time. The Canadian dollar remains an alternative reserve, but may be hurt somewhat by weak growth in the U.S. The **Australian** dollar will remain supported by interest rate differential, but the upside will be capped by the outlook for a prolonged pause in monetary tightening. The differential is unlikely to expand. Q2 CPI was lower than expected and contained and will give the RBA time to watch the expansion to develop. The Q2 NAB survey suggests further growth, but does not point to an overheating economy. Additionally, the slowdown in the Chinese manufacturing PMI is likely to reduce investor interest in the Australian dollar.

### Equities

Equity prices are expected to work sideways supported by valuation, but pressured by lack faith in the global expansion and profit outlook. Stocks are cheap by a number of measures. In the financial sector, major U.S. banks are trading at a low price to tangible book value. Price to tangible book ratios are about half pre-crisis levels. Citigroup, for example, is trading below tangible book value. PE ratios are depressed in the healthcare and energy sectors. The XOJ is priced at 10.5 times earnings and 1.4 times book value. Dividend yields on stocks like Pepsi, Intel, First Energy, Proctor and Gamble, and Verizon are competitive with or above the 10 year treasury yield. Overall, the earnings yield on the S&P 500 remains historically elevated to the 10 year treasury and the Baa Corporate. However, growth prospects are downbeat. The threat of higher taxes on capital and a difficult regulatory landscape are dampening the outlook for profit growth. Financial regulation is strangling expansion in the financial sector. Visa recently warned that it could be charged with anti-trust violations by the DOJ despite the recently passed Durbin amendment which regulates fees on credit and debt card usage. Regional PMI numbers show loss of momentum, and consumer names Kellogg and Colgate noted competitive pressures were

pressuring margins. In recent earnings reports, steel companies noted a slow down in Q3 volumes, while homebuilders pointed to little recovery in demand. Technology stocks have failed to sustain a rally despite generally solid results.

### Commodities

Commodity prices will be sensitive to the pace of economic growth, and displayed a strong correlation to equity prices during July. However, weather conditions will drive the grain markets and tight supplies of cotton, sugar, and coffee will impact investor interest. It is difficult to quantify, but the commodity trade will also be sensitive to the effects of financial regulation as the ruling making process gets underway. Disclosure, red tape, and registration issues threaten investment flow, hedger interest, and market liquidity.

The **crude oil** market appears in balance. Prices will likely be driven by outside markets (the dollar and equities), and the outlook for global economic growth. The trade will also watch weather as the hurricane season approaches peak activity. As of the week ending July 23<sup>rd</sup>, there was a 23.4 day supply of crude oil available in the U.S. unchanged from a year ago. There was a counter seasonal build in crude stocks in mid July, but it will take more than one week of strength to break the market. Product supplies are adequate. There was a 23.6 day supply of gasoline (23.2 a year ago) and a 46.4 day supply of distillate (49.3 a year ago). Gasoline demand is firm. The four week average of gasoline demand was 9.339 mbd compared to 9.205 a year ago. Gasoline demand should start to taper off in the coming weeks as the vacation season ends. Distillate demand has declined in recent weeks, but remains above a year ago (3.608 mbd v. 3.300 mbd). Looking to Asia, product stocks are historically elevated in Singapore and show no sign of shortage. Chinese commercial oil stockpiles also rose 4.7% in June and hit their highest level of the year. There were 211.1 mln barrels in reserve. However, diesel

inventories fell 5.6%, and gasoline stocks rose 1.6%. A government official recently indicated that net exports of gasoline and diesel would rise in the coming months as domestic refining capacity expansion outpaces demand gains. China is also talking about increased energy efficiency. The idea of Chinese energy efficiency prompted JP Morgan to cut its 2010 and 2011 oil price forecast.

**Natural gas** prices will be driven by demand. Supply remains adequate, although is small than a year ago. As of July 23<sup>rd</sup>, there was 2,919 bcf in storage and the current trend will leave supplies comfortable into the withdrawal season. Store levels were 8.9% above the five year average and 3.1% below a year ago. The Baker Hughes rig count was 972 in the week ending July 30<sup>th</sup> down 10 rigs from the week prior. The rig count is rising slowly and supportive to the boost in supply. Weather related demand has been strong. In the week ending July 22<sup>nd</sup>, temps were 3.4 degrees above normal and 5.3 degrees hotter than last year. The 8 to 14 day forecast is projecting above normal heat through most of the eastern half of the country and if realized should support cooling demand. Demand trends have been supportive. According to BENTEK, nature gas consumption in the electric power and industrial sectors has exceeded year ago levels by 20.5% and 7.8% respectively. Industrial production growth continues to accelerate relative to a year ago, although regional PMI numbers paint a picture of slowing manufacturing activity.

**Copper** prices firmed in late July on ideas of a soft landing in China, an ongoing decline in inventories, and bullish comments from Freeport on demand. LME inventories have steadily declined since late February and stood at 413,500 tones in late July. Although the level of inventory is elevated to the last five years, the trend has been price supportive. Likewise, copper inventories in Shanghai fell 9,415 mts to 104,507 in late July and hit a six month low. Barclays recently indicated it saw a 386,000 tone deficit noting that supply would

rise 532,000 tones, but demand would increase 800,000 tones. Xstrata reported that its H1 copper output fell 3% y/y. Freeport, however, was projecting a pick up in output in H2 and reported that cash costs were \$.97/lb which is supportive to further output. Surprising, the market discounted statements by U.S. Steel, Arcelormittal, and Allegheny who suggested a slowdown in steel demand due to seasonal weakness in Europe and reduced Chinese demand. Steel companies, however, were upbeat on the outlook for Q4. Steel prices have stabilized in recent days and Vale said it saw no sign of industrial production growth slowing. More importantly, Freeport noted its order book was filling more strongly than it had seen in some time. Freeport said copper demand from the U.S., Northern Europe, and to some extent Korea and Japan was the best in some time. Lastly, the Chinese CSI 300 has worked over psychological resistance at 2800. Copper futures have been strongly correlated to Chinese shares in recent months, although the recent copper rally has been outsized relative to stock market strength.

**Gold** prices have been pressured by liquidation, but it is difficult to get a hold on the market's short term drivers. Inflation remains capped and central banks outside of the U.S., Japan, and Europe are raising rates. However, low treasury yields and soggy year to date equity returns are supportive to demand. The political backdrop remains positive as the regulatory and tax environment in the U.S. is creating uncertainty and there is lack of confidence in government policy. The European credit crisis has eased, and helped to cap gold, but the impact may have run its course. The recent sell off from mid June saw gold holdings by the SPDR Trust fall 33 tonnes from their all time. Open interest has also declined sharply in recent weeks, although CFTC data still displays a lopsided fund long. Looking at physical news, India's gold imports were reported up 7.8% year to date through July at 171.6 tonnes. Festival buying was said to be supportive to demand. The Indian market could also see better buying as the

monsoon leads to higher rural incomes. Barrick said it saw modestly lower output in H2, but indicated the outlook for pricing was positive.

**Soybean** prices will be driven by spill over from wheat market, weather, and demand trends. The rally in wheat on the expected shortfall in FSU grain production has set a positive tone for the bean market and kept sellers cautious. The market is still in the process of pricing surprise shrinkage in global grain stocks. Barring a dry period, North American production should provide a cap to prices. Weather conditions are favorable for output as wet and hot weather is forecast for August. Crop conditions, as rated by the USDA, have maintained healthy levels, although the good to excellent reading is down from the spring. Demand may be the biggest driver as industry chatter suggests that both domestic and foreign end users are poorly covered. Soybean export sales have surged in recent weeks and point to vibrant demand. In its conference call, Bunge recently reported margin erosion due to increased Chinese demand for soybeans and lower than expected South American sales. It expected a more balanced supply and picture given the size of the South American crop. This idea may confirm the trade is short bought. On a bullish side note, Eral Maggi Scheffer, Brazil's biggest soybean grower, said it was scaling back plans to boost output next year due to FX trends hurting export profits and pot-holed roads increasing shipping costs.

**Corn** prices will be sensitive to the price of wheat, weather, and Chinese demand. Corn remains pulled higher by the wheat rally and the market's worry about the level of global grain stocks. The 8 to 14 day forecast has above normal temps through much of North American growing areas, but the pattern is also expected to bring above normal rain fall. The combination should be supportive to production. U.S. crop conditions are favorable with 72% of the crop in good to excellent conditions. On the demand front, the NDRC

recently said that corn imports would help to dampen soaring domestic prices. June corn imports by China were 64,500 tonnes and a level 12 times more than May. [www.chinaKnowledge.com](http://www.chinaKnowledge.com) recently reported that the China would see annual imports of 3 mmts and could import 15 mmts by 2015. It noted that production has been hurt by adverse climate conditions and environment deterioration, while livestock demand was increasing to match meat consumption. The report underscored the threat that China may no longer be self-sufficient in producing corn. U.S. export sales are firm, but there is nothing in the recent data which shows a major change in demand patterns.

**Wheat** prices will be driven by weather patterns in the FSU, Canada, Australia, and Argentine into the August 12<sup>th</sup> crop report. The U.S. crop appears healthy, but is not a factor in trade. Weather conditions are causing the trade to drastically revise down its outlook for global production, and a risk premium is likely to remain in the market, lifting prices, until crop uncertainty fades. Drying weather continues to cause a major reduction to the outlook for FSU production. The Russian Grain Union recently cut its forecast for 2010 grain production to 75 to 78 mmt down from an earlier estimate of 81-85 mmt. More severe, SovEcon forecast grain production at 70 to 75 mmts. Domestic consumption is expected around 71 to 72 mmts suggesting Russian exports could be limited. In fact, in recent days there has been growing acceptance of the idea that Russia will cut off wheat exports. Looking to Canada, scouting reports indicate that the Canadian wheat crop is experiencing late development due to excessive rains and could be vulnerable to frost. Dry conditions are reported in Western Australia and Argentina, and are trimming production estimates in these regions. The market may have a better feel for crop size after the USDA's August 12<sup>th</sup> report. There is currently a feeling in the market that the USDA's 2010/2011 corn and wheat exports are understated by 150 mln bushels and 250 mln bushels respectively

**Cotton** prices will be driven inventory levels and crop prospects. Prices have firmed sharply on the back of reduced cotton stocks. ICE cotton inventories have plunged over the last month falling from a high of 1,080,657 bales on June 2<sup>nd</sup> to 47,571 bales on July 29<sup>th</sup>. Stocks are at their lowest level since late 2004. The drop in supplies is coming in the face of news that China might be increasing imports in July and August. May and June Chinese imports were 200,000 mts and 177,213 mts respectively, but expected to rise into the 250,000 to 300,000 mt level in July and August. Current tight supplies are tempered somewhat by expectations for a large U.S. and Indian crop, but the improved supply picture is offset by news that tight conditions in China have forced the government to sell reserves. The U.S. crop appears to be progressing well as 68% of the crop was in good or excellent condition for the week ending July 25<sup>th</sup>. However, there has been some concern over dry conditions in the Delta, and the 8 to 14 day forecast has dry weather forecast for the Texas region. Current crop rating conditions are the best since 2004. India's Cotton Advisory Board revised up its outlook for production by 300,000 bales to 29.5 mln bales. Monsoon rains seem favorable for production. However, the Advisory Board also lifted its export estimate by 300,000 bales to 8.3 mln bales. The export increase highlights the quick pace of demand. The Chinese government recently announced it would sell inventory to cool prices. The sales price was reported at \$1.10/lb compared to local market prices of \$1.20/lb. Both price levels are high compared to the ICE board. China is also raising margins on the Zhengzhou exchange to limit speculation. Margin rates are expected to rise from 7% to 35%. Recent wire reports also suggest that China's cotton output could be lifted by improved yields. Prices on the ICE are backward reflecting the current tight supplies and expected increase in supply after the U.S. harvest. Lastly, the market will be sensitive to back to school apparel demand in the U.S. over the next few weeks. Healthy sales will provide a bullish shock to the market.

**Hog** supplies will be increasing seasonally, but the current supply situation is price supportive. Hog slaughter and production numbers are down. Since June 1<sup>st</sup>, slaughter is 4.3% below a year ago and about 1.5% less the suggested by the June hogs and pigs report. In the week ending July 30 pork production was 392.2 mln lbs down 6.6% y/y. However, there has been some increase in hog weights despite the hotter than normal summer. The weight gain hints that producers may be less current than slaughter numbers suggest and will also help to support production. Cold storage numbers are bullish for the market and suggest tightening supplies. Pork in storage fell 8% m/m and 29% y/y in June. The tight supplies are reflected the in cut out value which is slightly below this year's high and at the upper end of the five year range. Another factor which is supportive for the market is the increased certification of poultry plants which can export into Russia. A pick up in chicken exports to Russia will reduce competitive supplies. Hog futures are expecting lower prices into the winter. The CME spot index was priced at \$82.95 on July 30<sup>th</sup> compared to October and December hogs which were priced at \$79.02 and \$75.40 respectively.

**The Cattle** market faces heavy cross currents. On the supply front, the herd size continues to decline. As of July 1<sup>st</sup>, there were 100.8 mln head in the U.S. down 1% from a year ago. The cattle inventory has continued its decline from the mid 1990's. The inventory data provides a supportive backdrop to the market. Near term, however, supplies are expected to pick up into the fall. Supplies will be tight on a seasonal basis, and feed yards are current, but animal numbers will increase providing a headwind to higher prices. The current nature of feed yards is highlighted by the average steer weight for the week ending July 30<sup>th</sup>. Weights were 1,272 lbs compares to 1,288 lbs a year ago. Cold storage numbers suggest tightening supplies. Frozen beef supplies rose 3.5% m/m, but were down 13.7% y/y. The trend in frozen beef supplies is lower. The export market remains strong. Weekly beef

export sales are up 42.1% y/y over the past four weeks and up 25.9% year to date. South Korea, Russia, and Japan have been large imports of beef this year. Although export demand is firm, domestic demand is likely to be soft as summer heat and vacation season cut down on demand. Boxed beef prices have eased in recent weeks, and the technical set up argues for further declines before a seasonal pick up in the fall. Cattle futures are priced in contango and reflect the outlook for tightening supplies in the fall and the expected lift in demand. As of July 30<sup>th</sup>, the six state Fed cattle price was \$94.95 compared to December 2010 and April 2011 futures which were priced at \$96.22 and \$99.40 respectively.

**Sugar** prices will remain sensitive to the flow of supply out of Brazil. The market is being pushed higher by transportation snags in Brazil where a record 115 vessels were waiting to be loaded at six main ports. Physical demand has been strong, and news that the Philippines would move to import 100,000 mts at the turn of July/August has helped to lift the market. Down the road, rains suggest the Indian crop will be abundant. Datagro recently projected a 14% rise in the current Brazilian crop to 37.5 mmts. Brazil's Agricultural Ministry said that raw and white sugar prices would fall over the next two years. White sugar was expected to drop to \$490 a ton in 2011 from the current price of \$540 ton. Furthermore, Sucden recently reported that it saw improved Chinese sugar output. Next year's crop was seen at 12.0 to 12.5 mmts up from 10.7. The sugar market is significantly backward reflecting the current tightness and expected increase in output. October 2010 is trading at nearly a 1 cent premium the March 2011. The spread has risen more than 2 cents from its early June low. Weakness in the spread may be an indicator of a trend change in the market and a looser supply/demand balance.

**Coffee** prices will be driven by the trend in farmer selling and the outlook for fresh supply. The supply/demand balance appears tight. ICE coffee stock levels continue to grind lower and

flirt with levels last seen in 2002. At the same time, F.O. Licht recently cut its global coffee production outlook by 2.2% to 124.2 mln bags due to adverse weather conditions. Output estimates for Vietnam and Indonesia were reduced 1.7% and 8.2% to 17.1 mln bags and 9.05 mln bags respectively. Further, Brazil's Robusta production was reduced 5% to 11.8 mln bags. Highlighting the tight picture, the ICO said the market would remain tight in the near to medium term after meeting with Brazilian government officials on July 30<sup>th</sup>. Demand is strong. Green Mountain Coffee reported robust sales. It shipped 72 percent more K-Cup portion packs and nearly doubled its shipments of Keurig brewing systems. Green Mountain projected FY 2011 sales growth of 44% to 50%. University of Sao Paulo's Cepea Research Unit said that Brazilian farmers will be willing to sell their April to September harvest for BRL 300 to BRL (\$170 to \$176 a bag), and demand was expected to absorb supply. Some quotes have farmers selling as high as BRL 400 a bag. The one negative facing the market is a likely hike in retail prices, as wholesalers and processors pass on higher prices. The Brazilian Coffee

Industry is expecting a 15% price hike at Brazilian outlets.

**Cocoa** remains supported by a tight balance between supply and demand. Chocolate producer Barry Callebaut recently said that prices would not fall any time soon because demand is rising and supply is stable. Hershey indicated growth in U.S. core brand volumes. Further, ABN put out a report indicating that the cocoa market faces a looming and structural deficit between supply and demand. The London market was seen in shortage by 200,000 mts. Conditions for the New York market were seen less tight due to the supply of Indonesian beans. Furthermore, Macquarie recently indicated that the market would be in deficit by 95,000 mts in the crop year ending September 30<sup>th</sup>. The London market continues to be the focus of excessive hedge fund activity and the potential for distorted pricing, although Liffe cocoa stocks have increased in recent weeks. A push for the disclosure of speculative positions remains present in the industry. The London/New York spread has narrowed dramatically in recent weeks, but remains historically elevated.

### North America

*As displayed in Q2 GDP, the **U.S. economy** is expanding at a slow rate, and the post recession recovery is historically muted. The regulatory and tax backdrop is inhibiting business expansion and making consumers uneasy. Housing continues to suffer payback from the tax credit, and commercial real estate is slow to recover. The impact of the inventory cycle is becoming less positive for growth, and the outlook for consumer spending will be shaped by back to school spending. Inflation is contained. The Fed is far from lifting rates. The **Canadian economy** is expanding at a healthy rate helped by elevated commodity prices and a solid banking system. Inflation is contained, and the BOC is in the process of normalizing rates. The BOC will likely raise rates again by year end if a soft landing emerges in China and the U.S. economy can avoid a double dip recession. Key economic indicators:*

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

- July NAHB survey fell 2 to 14 (16 expected). Builders said the pause in sales post the tax credit is longer than anticipated. Buyer traffic fell 3 to 10, sales declined 2 to 15, and present time decreased 1 to 21.
- June Housing starts fell 549,000 (577,000 expected). Single family starts declined 0.7% and could not recover from May's sharp drop. Multi-family starts plunged 21.5% and weakened after a rebound in May.

- June New home Sales rose 23.6% to 330,000 (310,000 expected). New home inventories were historically low at 210,000 and the median price fell 0.6% y/y. Foreclosure activity and heavy existing supply are weighing on new construction.
- June Existing Home Sales fell 5.1% (-9.9% expected). The median price rose 1.0% y/y to \$183,700. Median prices have shown sequential strength in recent months. The National Association of Realtors said June sales still reflected tax credit impact with some sales not closed due to delays, which will show up in the next two months.
- June Durable Good Orders fell 1.0% (+1.0% expected). Orders declined 0.6% excluding transportation. Non-defense capital good orders excluding air rose 0.6% and continue to show expansion. Manufacturing activity has a softer tone, but continues to expand.
- Q2 GDP rose 2.4% (2.6% expected). Investment spending paced the gain, and growth was limited by a sharp widening in the trade deficit. Inventories rose \$75.7 bln and suggest the economy could find a softer tone in Q3.

### **Canada:**

- June CPI fell 0.1% m/m (in line). Core inflation rose 1.7% y/y and is contained.
- May Retail Sales fell 0.2% m/m (+0.4% expected). Auto, building materials, and gasoline weighed on sales. Clothing, jewelry, and food sales were strong. The year over year sales growth rate of 5.2% suggests healthy conditions.

### **Europe**

*The Eurozone economy is slowly expanding with uneven growth. Business surveys are showing surprising strength, but consumer spending is lackluster. Austerity measures are creating a headwind to growth, but have failed to derail the expansion. The credit markets show signs of healing, and bank stress test results had a benign impact on capital market pricing. Inflation is contained and the ECB will keep rates unchanged well into 2011. The **U.K.** economy is expanding, and Q2 GDP showed surprising strength. The outlook is mixed. Consumer spending has held up better than expected, but housing activity and pricing is slowing. Industrial activity is firm. Austerity measures provide the greatest downside risk to growth. Inflation is benign. The BOE is likely to keep monetary policy unchanged into 2011. Key economic indicators:*

### **Eurozone:**

- July EZ Flash PMI Composite rose 0.7 to 56.7 (55.5 expected). Output growth picked up in both the manufacturing and non-manufacturing sectors. Manufacturing is leading the upturn. Employment rose and new orders increased. Input price inflation slowed and prices charged were generally unchanged for the fourth month.
- German IFO Business Climate Index rose 4.4 to 106.2 (101.5 expected). Current Assessment jumped 5.7 to 106.8 (101.8 forecast) and Expectations increased 3.1 to 105.5 (101.6 expected). The Climate index is back at pre-crisis levels and suggests a solid expansion.
- July French Business Confidence rose 3 to 98 (94 expected). Inventories fell 6 to -2, order book rose 5 to -30 (trending higher), and own production outlook declined 2 to -9 (rolling over).
- July French Construction Confidence rose 2 to 94 and is flat to higher in recent months.
- July French Service Confidence was flat at 98 and has been flat to lower since April. The improvement from the winter and spring has stalled. Recent labor trends fell 1 to 4, but are on a higher trajectory. Future labor trends rose 2 to 2 and continue higher. Expected prices fell 4 to -9 and the trend is down, but past prices rose 2 to -6 and have been rising.
- July Finish Business Confidence fell 2 to 3. The trend continues to stall and show a softer tone.

- July Italian Business Confidence rose 2.2 to 98.3 (96.4 expected). It is trending higher and back at pre-crisis levels. Foreign and domestic orders were firm.
- July French Retail Confidence fell 2 to 100 and has eased since peaking in April. It is consistent with anemic consumer spending.
- June French Consumer Spending fell 1.4% m/m (+0.3% expected). Spending on cars was flat, but household goods and textiles fell 3.6% and 5.0% respectively. The sequential trend is choppy.
- June German Real Retail Sales fell 0.9% m/m (-0.2% forecast), but show firmness over the past 3 months and improved demand. In nominal terms, vehicle sales and clothing sales were strong, and IT and furniture sales were weak.
- June Portuguese Retail Sales fell 1.1% m/m. Sales have been down sharply 3 straight months.
- July German Gfk Consumer Confidence rose 0.4 to 3.9. 3.5 expected. However, the index is stable over the past year and does not point to a major rebound in economic activity.
- July Dutch Consumer Confidence rose 4 to -14, but is still lower than January's reading of -10. Large purchases rose 1 to -14, but have trended downward. Economic climate rose 10 to -19 but is not much different from January.
- July Finish Consumer Confidence rose 0.4 to 19.1. The index continues to rise and is flirting with the 2007 peak – a positive sign for growth.
- July German Unemployment fell 20,000 (in line). The drop in unemployment is in the range seen between mid 2005 and early 2008. The Unemployment Rate fell 0.1% to 7.6% (as expected). It is closing in on the November 2008 low.
- June EZ Unemployment Rate was unchanged at 10.0%. It shows signs of cresting.
- July EZ CPI rose 1.7% y/y in line. It is creeping higher but slightly below the 2004 to 2007 range.
- June M3 rose 0.2% y/y (-0.1% expected) and may be bottoming. Lending to households rose 2.8% y/y, while non-financial lending contracted 1.9% y/y.

### U.K.:

- June Major Bank Mortgage Approvals fell 3,000 to 48,000 (52,000 expected). The trend is flat this year, but down from December's reading of 58,000.
- July CBI Manufacturing Total Orders rose 7 to -16 (-24 expected). Overseas demand was buoyant with a balance of +18. Output was also lifted by the inventory cycle.
- July CBI Distributive Sales rose 38 to 33 (3 expected). The index shows a recovery back to levels last seen in 2007. The strongest growth areas were grocers, clothing and footwear, and leather. Annual summer discounts, the World Cup, and warm weather drove sales. 45% expected higher sales in August. On motor vehicles, the volume of sales was lower than a year ago with a balance of -17%. Volume of sales is expected to be lower in August at -23%.
- June Retail Sales rose 0.7% m/m (in line). There was broad strength in spending.
- July Nationwide Home Prices fell 0.5% m/m (-0.3% expected). The year over year rate is decelerating at +6.6%. Home prices look to have peaked and are rolling over.
- Q2 GDP rose 1.1% (0.6% expected). Construction, service and finance industries performed strongly and GDP growth suggests a solidifying recovery.

### Asia

*The Asian economy is expanding, but Chinese growth has decelerated. The **Chinese** economy appears to be poised for a soft landing given the recent stock market rally, but the manufacturing*

*PMI continues to show deceleration in the pace of growth. Inflationary pressures are present, but show signs of easing. The PBOC is likely to keep rates steady over the next few quarters. **India's** growth is strong, and the RBI is talking about capacity constraints. Inflation is peaking due to base affects, but remains elevated and will drive further rate hikes. The **Korean** economy is strong given the BOK's survey of business activity. Inflation is contained, but the BOK is working to normalize rates. The BOK will be biased toward raising rates, but sensitive to the pace of global economic growth. The **Australian** economy continues to expand, but will find downside risk from the loss of momentum in China. Inflation is contained, and the RBA is likely to keep rates unchanged at last through the fall. **Japan** is expanding slowly. Consumer spending is better but still muted, and exports show signs of weakening momentum. Deflation persists. The BOJ is far from raising rates. Key economic indicators:*

### **Australia:**

- Q2 CPI rose 0.6% (1.0% expected) and 3.1% y/y. Inflation looks contained. A 0.1% drop in service prices pressured the index.
- May LEI rose 0.3% m/m and continues to show expansion.
- Q2 NAB Survey showed business conditions falling 2 to 6. However, the September outlook was 12. Employment and order trends are favorable for growth.

### **China:**

- July Manufacturing PMI fell 0.9 to 51.2. (51.4 expected). All components but employment fell from June. The economy is on softer footing. The service sector will find greater attention as the government moves to cut excess capacity and boost energy efficiency.
- In its July report, the PBOC expected the slowdown in growth to stabilize and the economy to avoid slump in H2 2010. The PBOC said: 1) the current slowdown was a function of base factors and macro controls. 2) The proportion of trade to the US, Japan, and Europe has fallen as trade flows are being diversified. 3) Demand from EM can compensate for declines in exports to developed nations. 4) EZ debt crisis not likely to have a large impact. 5) A Flexible yuan will help improve effectiveness of monetary policy

### **India:**

- RBI raised its GDP growth for year end March 0.5% to 8.5%. Stronger industrial output and favorable service sector trends were noted. Inflation was projected at 9.4%. Further, the RBI stated: 1) The auto industry was facing capacity constraints, and constraints were being reached in a wide range of sector. 2) Domestic demand continued to accelerate. 3) The recovery has consolidated and is becoming broad based. 4) Monetary policy was not consistent with economic situation and it would not give inflation an upward bias. 4) Inflation expectations were elevated.
- July 17 Primary Metal WPI rose 14.5% y/y and shows signs of cresting. Base affects are slowing inflation.
- June infrastructure growth in six industries shows sequential weakness across the board, but the year over year growth rates are positive. The year over year growth rates are slowing. Cement output has been down four of the past five months.

### **Japan:**

- July PMI fell 1.1 to 52.8. Softer, but consistent with the one year range. The report displayed a slow rise in output and new orders, expanding employment for a fourth month, and discounting on sales prices. New business was at its slowest rate since March and there was some unease over the economic landscape.
- June Jobs to Application ratio rose 0.2 to 0.52 (0.50 forecast). The ratio continues to inch higher. Sequentially, job offers rose 2.7%, while new applications fell 0.2%. The trend in offers is favorable for employment.

- June Unemployment Rate rose 0.1% to 5.3% (5.2% expected). The rate is ticking back up, and suggests a loss of momentum in labor demand. The labor force rose 90,000, while unemployment gained 70,000. It was the first rise in the labor force in two months. Employed rose 40,000 breaking two months of sharp declines.
- June Household Spending rose 0.5% y/y (-0.9% expected). The year over year rate is consistent with levels last seen in 2007. Spending rose 2.9% m/m and the sequential gain has been solid three of the past four months.
- June Housing Starts rose 0.6% y/y (1.8% expected). Sequentially, starts rose 1.7% and recovered from two months of weakness. Total starts have eased lower for the year.
- June National CPI fell 0.7% y/y (in line). Core CPI fell 1.5% y/y (-1.6% expected). The economy is still struggling with deflation. However, the pace of decrease is slowing. Sequentially, the rate was unchanged after two months of contraction. Food prices rose, but household goods, clothing, and transportation and communication prices declined sequentially.
- July BOJ July Senior Loan Officers Survey stated loans from firms fell 7 to -17. Household credit demand declined 2 to -2, but is trending better. Demand for loans over the next three months was up 3 to -2, and shows no major improvement in lending activity.
- June Exports rose 27.7% y/y (23.5% expected), while Imports jumped 26.1% y/y (24.7% expected). Although exports were strong on a year over year basis, they fell 0.4% m/m and have seen a softer sequential tone. Sequential import growth is firmer.

### **South Korea:**

- August BOK Manufacturing Survey rose 1 to 109, while the Non-Manufacturing Survey rose 2 to 91. Both surveys show on going strength in the recovery.
- June Industrial Production rose 1.4% m/m (0.9% expected). Production is up 16.9% y/y. The sequential trend points to healthy output. The year over year rate is slowing on base issues. Capacity use was 83.9% up from 82.8% and was 79.6% at the start of the year for comparison.
- June Service Output rose 4.4% y/y. The pace of growth has slowed, but remains positive.
- June Consumption Good Sales rose 3.8% y/y showing a stronger trend. Durable sales contracted, but semi-durable sales were strong up 10%. Consumption trends are consistent with a healthy expansion.

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