

September 12, 2010

Growth and Inflation

Global growth has slowed, but economic activity in China and India continues to support the global expansion. The OECD recently indicated that the economic recovery was proving slower than projected, and recommended that policy makers extend or bolster stimulus programs. GDP in the OECD was expected to rise 1.5% in the second half of 2010 compared to a prior forecast of 1.7% and 3.0% in the first half of 2010. Economic data shows firm output in India and China, highlighting the fact that the emerging world continues to outperform the developed world. European growth has surprised to the upside in recent months, but consumer spending is sluggish and the banking system is fragile. Austerity measures are still providing a headwind to growth. The U.S. economy has seen strength relative to downbeat expectations in recent weeks, but the back to school shopping season was lackluster and car sales remain depressed. The political environment is still weighing on the desire of businesses to expand.

Inflationary pressures are tame in the developed world, but are present in the emerging world. High commodity costs provide an upside inflation risk, but are offset by spare capacity in the OECD. Inflation measures have stopped rising in India, but are still extremely elevated. China's CPI is also gaining, but is being lifted by food inflation. Rising wages in China and tight supplies of cotton, coffee, sugar, corn, and copper are boosting inflationary pressures. However, monetary policy can do little to deal with these supply shocks. Recent inflation measures have been tame in Europe, and U.S. CPI is forecast to be benign for August. High unemployment, on going de-leveraging, and excess inventory in real estate sector are capping U.S. inflation.

Money Markets

The U.S. treasury market is expected to work sideways, but the decline in yield is showing loss of momentum. The market has seen

stronger than expected economic numbers in September, cooling the rally. The market continues to show sensitivity to the level of economic surprises, as the better than expected results have weighed on treasury prices. Moreover, the Chinese stock market has worked higher and recent Chinese economic data argues for a continued global economic expansion. Outside of economic trends, there has been a pick up in corporate supply. \$40 bln in new corporate paper was sold in the first full week of September, and some market watchers believe \$100 bln in corporate paper could hit the market during the month. At the same time, Moody's has projected a sharp decline in the U.S. and European speculative default rates. They are expected to fall to 2.9% and 2.3% respectively by December. The global default rate is expected to hit 2% in 2011. Junk issuance has also been strong, and is creating competition to treasuries. However, the U.S. economy remains weak, and there is little confidence in the expansion. Bank lending has been anemic and suggests poor credit demand and limited growth prospects. Investors continue to buy bonds aggressive with weekly mutual fund numbers showing dramatic inflows. Custodial holdings at the Fed have accelerated in recent weeks. Foreign official accounts remain aggressive buyers, while U.S. banks have been heavy purchasers since late June with their holdings of treasuries and agencies up approximately \$100 bln. The Fed is also continuing with its purchase program as it tries to keep its balance sheet from shrinking. Although the Fed's buying has been less aggressive than the operations in 2009 and the opening round of purchases in early August 2010, its presence keeps sellers off balance.

Foreign Exchange

The dollar is likely to trade choppy. The FX market seems caught between trading interest rate and growth differential and general risk taking linked to the outlook for a sustained global recovery. The lack of direction is seen the **euro's** sideways price action in recent weeks. Changes in the S&P 500 have

explained about 41% of the variation in the euro since mid July. In recent weeks, the U.S. economy has seen a flurry of stronger than expected numbers, while Europe's ability to post an economic surprise has been steady. The IMF's praise for the Greek Austerity plan, and disbursement of E3.3 bln to Greece should help lift the euro and may bring money back into the debt of PIIGS. The **sterling** is likely to find pressure from signs of weakening domestic demand and the headwinds of austerity measures. PMI numbers fell short of expectations, and like the U.S. there is limited confidence in the government's ability to generate growth. The **yen** is overbought, but has been underpinned by Chinese reserve diversification. China has been an aggressive buyer of JGBs in recent months. The market will be focused on the September 14th election, and there is some feeling a change in government could shift FX policy and weaken the yen, which is a headwind to corporate profits. The bankruptcy of Incubator Bank, which specialized in lending to small business, highlights downside risks to the economy. The Nikkei is also off 12.4% y-t-d and has dramatically underperformed the S&P 500 and most European indices. The **Canadian dollar** is likely to be supported by the BOC's willingness to raise rates and its confidence in the economic outlook. Commodity prices have been firm, the Ivey PMI displayed strength, and the BOC is projecting healthy consumer spending. The Canadian dollar will remain an alternative to the euro, dollar, and yen as a reserve currency. The one possible negative would be increased interest in the debt of PIIGS. The **Australian dollar** faces cross currents. On the bullish front, the Chinese economy is moving forward and supportive to export growth. The labor market remains healthy, and commodity prices have been firm with the CRB Raw Industrial price index rising sharply since mid July. On the bearish front, the AUD/USD is approaching stiff resistance in 0.95 to 0.97 area, there is momentum for the mining tax, and PMI numbers point to lackluster growth. There appears to be a divergence between the labor market and PMI

numbers. Continued weakness in PMI numbers will cap the Australian dollar's gains.

Equities

Equity indices are likely to fluctuate in a trading range with a mild upside bias. The market will be supported by cheap valuation and under investment by retail and institutional investors. However, the upside will be limited by a dim view of profit growth and concerns over supply. Stocks remain attractive relative to alternative assets. Cash flow is strong, dividend payments are attractive, and companies are managing the macro environment successfully. The trade has seen a flurry of M&A in recent weeks confirming stocks are cheap. Bristol Myer's purchase of Zymogenetics, and 3G Capital's acquisition of Burger King provide examples. There are also rumors of consolidation in the financial sector with Capital One thought to be in play. Furthermore, Altria announced a 10% hike in its dividend boosting its yield to 4.67% despite a sharp rally on announcement day. Equity mutual fund flows from the ICI display a continued pace of redemption and persistent purchase of fixed income products. In recent months, selling has even occurred during periods of strength. An event which is unusual as retail investors tends to chase the trend in share prices. The lack of interest is a bullish contrary indicator. Even though companies have been slow to lower profit guidance, the anemic growth environment has created headwinds to profit growth. Buyers are cautious and reluctant to pay up for shares. Texas Instruments and National Semiconductor indicated consumer electronics demand was weak, and provided guidance which could not generate buying despite already depressed prices and valuation. However, Asian trade press suggests that notebook demand may be ripe to pick up in Q4. The business sector appears to be the biggest driver of IT spending. Investors will be nervous about the close of the quarter given soft consumer spending and lack of confidence in the ability of politicians to generate growth into 2011. The inventory cycle is becoming less supportive to

profit growth. A potential wave of European bank capital raising is also bearish. Deutsche Bank is expected to offer \$12 bln in shares to the market in order to purchase Postbank. Additionally, the Basel panel wants banks to double capital over the next eight years and the ruling could lead to a step up in issuance. At face value the 6% Tier One capital ratio should not be a problem for U.S. banks.

Commodities

Commodity prices will be sensitive to the pace of global growth, focused on weather, and driven by specific market issues. The recent rally in equity prices and healthy economic data points out of China will help to support prices. Although the Bank of Canada raised interest rates and India is likely to tighten monetary policy, easy monetary policy in Europe and the U.S. is keeping investors interested in commodity investments. The opportunity cost of holding commodities is still low. Grain prices will be sensitive to the North American harvest, while Coffee will focus on weather in Brazil and Vietnam. Sugar will also be sensitive to weather and the ability of Brazilian ports to load ships. In the last 30 days, sugar, corn and silver have been the strongest performers. Natural gas, cocoa, and aluminum have lagged.

Crude oil prices will be driven by demand. In the U.S., supply is ample, and signs of firming distillate demand are the most bullish dynamic for the market. For the week ending September 3rd, there was a 24.0 day supply of gasoline compared to 22.4 a year ago. Furthermore, gasoline stocks have built in a period where they normally decline. Gasoline demand has been firm, but should decline seasonally in the coming weeks, and leaves the market vulnerable to an imbalance between supply and demand. The 4-week average of gasoline demand was 9.371 mbd up 1.1% from last year. Distillate supplies have built seasonally, and supply levels are comfortable. For the period ending September 3rd, there was a 46.1 day supply of distillate in storage.

Seasonally, stocks should be cresting and will start to be drawn as heating demand surfaces. After a lull in late July early August, demand has improved. The 4-week average of distillate demand was 3.79 mbd up 9.4% y/y. The WTI 3:2:1 crack spread has firmed sharply from mid August with the rise in distillate demand. Looking to Asia, China boosted oil imports in August. Net imports of oil products doubled to 3.675 mln barrels. Likewise, net imports of crude oil imports rose 10% m/m to 154.87 mln barrels. There is some speculation that the oil went into storage, as a number of refineries were closed for maintenance. Oilchem.net reported refinery operating rates have risen in September implying a reopening. Singapore product inventories have risen the past two weeks and remain at elevated levels. Asian 3:2:1 cracks spreads are on the lower end of the 52 week range and display weak demand. In Europe, inventory levels and crack spreads look uneventful.

Natural gas inventories are comfortable, and demand shocks are likely to drive prices. As of the week ending September 3rd, there was 3.164 Bcf in storage. Injections are likely through late October and will keep supplies building. However, supplies are less burdensome relative to a year ago down 6.4%. Supplies are also 5.5% above the five year average, but have slowed relative to average in recent weeks. On the demand front, weather has turned cooler, and cut power demand in the period ending September 3rd. The 8 to 14 day forecast has temps forecast above normal for the middle U.S. up into the northeastern coast. This may help prices at the margin. Industrial demand eased in the last measuring period, and the EIA expects gas demand to be flat in 2011 from 2010.

Copper prices will be a function of global growth. Supplies appear to be tightening in the short term. Recent industrial figures from China and India exceeded estimate, and manufacturing PMI numbers in the U.S. and Europe have been firm pointing to sustained copper demand. Furthermore, China's copper

and product imports increased 11% m/m and 16% y/y in August to 379,527 mts. LME copper inventories continue to trend lower and have steadily declined since February. Likewise, Shanghai copper stocks fell 7,892 mts in the last period to 98,025 mts, which is a seven month low. Recent statements from Codelco suggest production will be relatively stable compared to last year, but the company noted that supply faces a challenging outlook. It projected similar production levels this year as compared to last year. First half copper output was 799,000 mts compared to 783,000 mts a year ago. Codelco saw demand above the historical trend due to emerging market growth. Big picture, high prices seem to be boosting production. Codelco indicated it had increased capital spending to lift output, and it is hoping to increase production to 2,000,000 mts by 2010. The company called demand auspicious. Freeport McMoran recently said that its Peruvian unit was studying a large scale expansion, and new reserves may help to double production at its Cerro Verde mine. Chinaclo said it is waiting to build its Toromocho mine and wants to start production in 2013, but Peru has delayed action by changing environmental rules. Barrick gold said that it will boost copper production with gold production. A near record price over \$3.50 lb seems to be the main negative.

Gold prices may be vulnerable to a set back on slower investment flow. Non-commercial long positions are elevated, and open interest has started to flatten with prices flirting with the June high of \$1270. Likewise, gold ETF holdings in GLD and IAU have failed to rise above the summer high and have been flat in recent weeks. Equities have found a firmer tone in recent weeks, but confidence is fragile. Investors are uneasy over profit growth and Deutsche Bank is set to sell shares. Basel rules have the trade focused on the poor capitalization of European banks. Interest rates remain low in major economies and are presenting little competition to holding gold. In the physical market, data points are mixed to bearish. Italy's Q2 gold jewelry sales fell

23.5% y/y, and the VM group predicted that gold jewelry consumption would fall 15% in 2010. Retailer buyers in India were said to be delaying purchases. The IMF did sell 10 tones of gold to the central bank of Bangladesh. On the supply side, Barrick Gold indicated it was boosting production from existing mines, and was focused on organic growth

Soybean prices will focus on the U.S. harvest and demand trends. The USDA's September report was disappointing to the market. Global ending stocks were cut slightly to 63.61 mts. However, the decline was led by a reduction in Brazil and Argentina. China's ending stocks were revised upward. U.S. ending stocks were reduced only 0.29 mmts and production was raised about 1.5 mmts. The U.S. soybean yield was boosted 0.7 bushels per acre to 44.7 bushels per acre. The U.S. stocks to use ratio was cut 0.5% to 10.6%, but still more than double last year's level of 4.5%. Crop conditions have shown deterioration in recent weeks with 64% of the crop in good to excellent condition. The trend in crop conditions does not seem consistent with the bump in yield. In June, the good to excellent reading was 75%. Export commitments remain strong and at a record 654 mln bushels. Export sales have eased recently from a brisk pace in August, but not enough to disrupt the favorable trend. However, the outlook for strong demand is part of the market's current price structure. The market may need to see proof of Chinese interest to keep going higher.

Corn prices will be sensitive to crop developments and demand trends. The USDA's September crop report suggests tightening supplies and was bullish. World ending stocks were cut to 135.56 mts from 139.2 mmts in August. Production was reduced slightly more than 5.5 mmts due to a drop in the U.S. crop size. The U.S. corn yield was reduced more than expected to 162.5 bushels per acre. The yield level will remain a concern as the harvest approaches. The U.S. stocks to use ratio is a very low 8.3% down from 9.7% in August. A year ago, the stocks to use ratio was 10.3%.

Crop ratings have eased in recent weeks falling to 69% good to excellent from a peak over 75%. On the demand front, corn export sales have decreased from a hot pace in August, but remain at levels which will support the market. There has been some cancellation of Chinese corn purchases and the rise in price may provide some limit. The most negative factor for the market may rest in the heavy fund long. The noncommercial trader is long 510,440 futures and options contracts and short 95,540 contracts. The net long rose 39,804 contract in the last period and the funds are five times more long than short. Funds will not be under pressure to sell until there is more clarity on the production and success of the fall harvest.

Wheat prices will remain sensitive to demand, the Canadian harvest, and crop developments in the FSU. The crop report is unlikely to support another leg higher in prices. The USDA cut its global production outlook by 2.73 mmts to 643 mmts, but raised its global ending stock number by 3.03 mmts to 177.79 mmts. Ending stocks are down from last year, but elevated and argue against a major gain in prices. Production has been cut 29 mmts since May. The Canadian crop was lifted by 2.0 mmts to 22.5, while the EU crop was reduced about 2.4 mmts to 135.13 mmts. The Russian crop was cut 2.5 mmts to 42.5 mmts. Domestically, the U.S. production was left unchanged, but ending stocks were reduced 50 mln bushels due to exports. The stocks to use ratio was 37.0% which compares to a high 48.2% last year and a low of 13.2% in 2007/2008. Beyond the crop report, US wheat export sales have been surging and are at levels last seen in 2007. Continued strength in export sales is needed to underpin the market. There are risks that the Canadian crop will see a wet fall and delayed harvest and yields. The trade will also be focused on winter wheat developments in Russia. Reports from the Institute of Agricultural studies indicated that Russia's winter wheat plantings in the Volga region would fall 50% from last year, but

plantings in the southern portions of Russia would rise and help offset the weakness.

Cotton prices will be sensitive to demand and harvest activity. The USDA's September report painted a picture of strong demand. U.S. 2010/2011 production was revised up 0.31 mln bales to 18.84 mln bales due to both planted area and higher yields. However, usage due to both exports and consumption was revised higher by 0.70 mln bales pushing ending stocks down to 2.7 mln bales (3.12 mln bales were forecast). Ending stocks are extremely tight. Supply/demand is also tight globally. The USDA revised global ending stocks by 0.17 mln bales to 45.44 mln bales with Chinese stocks cut to 16.01 mln bales from 16.76 mln bales in August. China's production was reduced 0.5 mln bales to 32.5 mln bales and ending stocks were also pushed lower. The USDA left India's production unchanged, but cut exports and imports. Indian ending stocks were revised higher to 7.67 mln bales from 6.59 mln bales in August. Outside of the USDA report, US export sales have eased in recent weeks, but remain brisk relative to a year ago with the four week average up 87.1% y/y. A Chinese new service said that the Chinese cotton crop is in worse condition this year than last due to adverse weather. The statements set the stage for strong import demand. U.S. consumer spending in the back to school period was weak and hot weather has delayed some apparel sales. Retailers are likely to raise the price of cotton items next year. In a recent CNN story, the president of the California Fashion Association said that the price of a cotton T-shirt could rise \$2 from the current level of \$12.

Hog prices will be driven by demand. Supply is expected to increase, but the gain is likely to be below seasonal norms. The expected increase in supply and outlook for demand has caused October and November futures to trade at a substantial discount to the spot market. In fact, the discount is helping to support the futures market as the trade is ahead of data flows. Hog slaughter for the week ending

September 11th was off 6.5% from a year ago. Hog carcass weights are 1 lb below a year ago and when combined with slow slaughter levels suggest producers are current with their inventory. On the demand front, pork cut out has eased in recent days, but prices remain elevated. The market is in a lull before holiday demand starts to pick up for Thanksgiving and Christmas. This will leave the trade look at pace of exports for direction.

Like hogs, **cattle** prices will be driven by demand. Placement patterns suggest supplies should increase in the coming weeks, but feedlots are extremely current and supply is manageable. Supply will be seasonally light and price supportive, but at current prices demand will have to remain firm. Demand has eased from its hot pace, as Labor Day needs were met. Cooler weather should help support demand into the winter. The export market is the swing factor. Beef exports have been hot. Export sales for beef are up 13.5% y/y in the last four weeks. Moreover, hide exports are up 50% y/y over the past four weeks. The hide and offal value is playing an important role in lifting prices and supported by the quick pace of hide exports. As of the week ending September 10th, the hide and offal value was \$11.01 compared to \$9.44 last year. On a side note, tightening corn supplies and further price gains in corn could pull cattle and hogs forward and lift 2011 prices relative to October and December futures.

Sugar remains in tight supply, and sensitive to ship loadings out of Brazil. The board is in steep backwardation highlighting the shortage of supply and the outlook for balance in late 2011 and 2012. Reports from the Santos Port in Sao Paulo suggest that ships are waiting a record 29 days before being loaded. The previous record was 20 days in October 2009. At last count, 104 ships were waiting in port compared to 72 a year ago. A few weeks back, there was an expectation that the bottle neck would be reduced. Furthermore, the Brazilian Agriculture Department cut its production forecast by 0.5 mts to 38.2 mts. In India, the

monsoon has been helpful for production, but rains risk delaying crushing in India's the Maharashtra region, which is the country's largest producer. Despite the production delay, the Indian Farm Minister Pawar said that output would rise 17% to 22 mts. Supply was expected to match demand and cool Indian sugar imports. On September 1st, the Indian Sugar Mills Association said that India could produce 25.8 mts of sugar in the crop year starting October 1st. Looking at Russia, Producer's Union lowered its Russian beet sugar forecast to 3.0 mts to 3.1 mts tons of production down from a prior estimate of 3.2 to 3.5 mts. Demand is strong. Pakistan is expected to buy 500,000 tons in December, and the press release highlighted the need to meet shortage. Recent wire reports also suggested a pick up in wholesale and retail purchases in India. CFTC data shows large funds (non-commercial reporting positions) a massive net long of 147,501 contracts. There were 160,235 long futures and options contracts, and just 12,737 short futures and options contracts.

Coffee supplies remain tight and the market is sensitive to weather conditions, and the need to ration demand. Wet weather in Vietnam and Indonesia has cut the outlook for production by delaying harvest. Furthermore, there are expectations that the Vietnamese government will move to put 500,000 mts of coffee in storage. In Brazil, Conab raised its 2010/2011 coffee forecast by 200,000 bags to 47.2 mln bags. Production is up from 39.5 mln bags last year, but well below prior industry forecasts in the 50 to 55 mln bag range. Yields have been hurt by weather, and Conab indicated that farmers were not likely to expand plantings next year. Farmers were reportedly using high prices to pay down debt. Dry weather patterns, due to La Nina, are threatening the 2011/2012 crop, which will be reduced due to the biennial cycle. Outside of major producing areas, the Uganda Coffee Development Authority is projecting September exports to decline 9.8% m/m to 196,000 bags. NY stock levels are extremely tight at

2,011,042 mln bags, but the decline in inventory has moderated in recent weeks and suggests tightness may be abating, however, weather conditions in both Brazil and Vietnam and worries over the tree cycle in Brazil are keeping a risk premium in the market. On the demand side, prices are finding upward pressure. Green Mountain is joining the parade of roasters and wholesales boosting prices. The price of its K-Cup and Keurig products is expected to rise 10-15% October 11th. Despite higher prices by its supply SJ Smuckers, Dunkin Donuts has not raised prices, and Starbucks said it always reviews pricing. Starbucks is also setting expansion plans into the Baltic States. It appears another round of retail price hikes may be needed to ration demand.

Cocoa prices have been pressured by higher than expected supplies. In the week ending August 29th, farmers from the Ivory Coast Delivered 8,266 mts of cocoa to ports in Abidjan and San Pedro. Deliveries were double last year's level. Additionally, exports rose 77% y/y in July. Political tensions in the Ivory Coast also appear to have receded, as the President signed the voter list. It appears the election is set for October 31st. Additionally,

Cocoa production from Nigeria is expected to rise 10% in the new crop year due to improved plants and better farm management. Output is forecast at 335,000 mts. A farm association in the country indicated that new trees planted between 2005 and 2007 are starting to bear fruit, and farmers have received extensive training. However, heavy rains have delayed the harvest in Indonesia and created slower exports in August. August exports declined 21% m/m to 36,168 mts. Technically speaking, the LIFFE is set to provide a CFTC like report on commodity ownership. A trial period will start September 28th and all positions over 100 lots will be reported. The announcement may ease worries over a squeeze. The spread between London and NY cocoa futures has declined sharply in recent weeks implying that the squeeze in London is abating. The basis, however, remains elevated and appears supportive to futures. CFTC data shows large funds turning short cocoa in the last period. The non-commercial reportable position displayed a net short of 8,709 futures and options contracts. The net short expanded 3,511 contracts. Open interest has risen on the price decline highlighting a pick up in fund shorts.

North America

***U.S.** growth is slow. Although recent economic data has tended to show stronger than expected activity, conditions are still soft. Back to school spending was weak, auto sales are historically depressed, and businesses are cautious. The threat of higher taxes and tough regulation has impeded growth. Inflation is tracking sideways at low levels. Monetary policy is impotent, but will remain on hold into 2011. The **Canadian economy** is expanding, and the BOC had enough confidence in growth to continue its path of normalizing rates. The BOC expects solid consumption and business expansion to rise strongly. However, the BOC also indicated that it expected the recovery to be more gradual than in July. The Ivey survey displayed vibrant manufacturing activity, but the housing market is tame and trade data suggests slower growth abroad is creating a headwind to exports. The BOC is signaling it will continue to normalize interest rates carefully. Key economic indicators:*

U.S.:

- August Manufacturing ISM rose 0.8 to 56.3 (52.8 expected) – the gain was surprising. Production gained 2.9 to 59.9, new orders fell 0.4 to 53.1, employment jumped 1.8 to 60.4, and prices rose 4.0 to 61.5. Manufacturing activity is firm.
- August Non-Manufacturing ISM fell 2.8 to 51.5. Employment declined 2.7 to 48.2, new orders decreased 4.3 from 52.4, and backlog eased 1.5 to 50.5. Prices rose 7.6 to 60.3.

- August Private Payrolls rose 67,000 (40,000 expected). The net revision was +123,000. Construction jobs increased 19,000 and healthcare and education jobs surged 45,000. Manufacturing jobs fell 27,000 pressured by the unwinding the GM effect from July. Retail employment eased 5,000, financial jobs dipped 4,000, and trade and transportation employment decreased 9,000. Census workers continue to drop off of payrolls. The August Unemployment Rate was up 0.1% to 9.6% (in line) and remains elevated.
- August Chain Store Sales rose 3.2% (3.0% expected). Spending was slightly ahead of estimate, but hurt by weather and on going caution in the consumer sector.

Canada:

- August Employment rose 35,800 (30,000 forecast). Full time employment rose 79,900, while part time employment fell 44,100. Employment gains were centered in the education and professional categories. Management, information, and finance fell. In the good sector construction rose 12,000, but manufacturing declined 25,600. The guts did not look as impressive as the headline.
- August Unemployment Rate rose 0.1% to 8.1% (8.0% expected). The rate shows some signs of stability in recent months and is consistent with the weakness in core employment categories.
- August Ivey PMI rose 11.9 to 65.9 (55.5 expected). Employment was off 0.4 to 51.6, deliveries surged 8.5 to 47.5, and prices rose 4.8 to 60.8. The index is at a new cycle high, but below peaks seen in 2006 and 2008.
- August Housing starts fell 3.0% m/m to 183,300 (185,000 expected). Starts have declined 4 straight months, and remain below pre-crisis levels.
- July export volume fell 0.6% m/m, while import volumes rose 1.4%. Export growth shows signs of stalling, but import growth continues to rise and point to robust domestic demand.

Europe

*The **Eurozone** economy is expanding led by the business sector and strength in Germany and France. Consumer spending is lackluster, and austerity measures continue to weigh on growth. Inflation is tame, and the ECB will be keep rates steady into 2011. The potential need for banks to raise capital and on going balance sheet repair will prevent the ECB from tightening monetary policy. The **U.K.** economy appears on softer footing given PMI data and the weaker demand for housing. The labor market, however, has to this point shown recovery. Inflation is above target but expected to ease. The BOE will keep rates unchanged into 2011 as its watches the adverse impact of austerity measures on growth.*

Eurozone:

- August Manufacturing PMI rose 0.1 to 55.1. Germany, France, and Austria posted the quickest growth. Details from the press release indicate job creation continued in Germany, the Netherlands, and Austria. New export orders rose for the 13th straight month. However, the rate of increase eased for the 5th consecutive month. All of the nations covered reported higher levels of new export orders, including a slight rise in Greece for the first time since last September. Production and new orders are expanding at a slower rate. Input inflation eased, and there was modest pass through of higher costs.
- August Service PMI rose 0.3 to 55.9 (55.6 expected). There was a solid gain in new business, which hit a four month high. Business activity was firm, but driven mainly by France and Germany. Activity fell slightly in Spain. Employment expanded for the 4th month. Germany, France, and Italy reported higher employment levels. Backlog rose for the 7th month. Input inflation rose sharply to a 22 month high. Costs have risen 9 straight months. Average service

charge fell for the 22nd month due to strong competition. The data suggests major margin squeeze.

- August Bank of France Business Sentiment was flat at 101 (in line). The trend is sideways to lower in recent months. Service sentiment fell 1 to 95 and is also trending flat to lower in recent months. The production outlook fell 5 to 1 and has a weaker tone. Order level rose 1 to 8 and choppy. Utilization fell to 74.5% from 76.3% -- it is easing
- July French imports rose 3.0% m/m and the trend continues higher with 2 months of sharp back-to-back gains. Exports rose 1.9% m/m and continued to rise following a 10.6% surge in June.
- July German exports fell 1.5% m/m (flat expected), but the trend is still positive. July German Imports declined 2.2% m/m (+0.1% expected) and have turned weaker over the past few months.
- July EZ Retail Sales rose 0.1% m/m (0.2% expected). The level of sales is flat and suggests little improvement or strength in consumer spending across Europe.
- August Spanish Consumer Confidence rose 1.3 to 74.9. Confidence has weathered the fiscal storm and rebounded from the low of 65.1 in May. Employment rose 2.9 to 44.5. The trend is higher. Household situation also improved.
- July Belgium Unemployment Rate rose 0.3% to 8.9% and continues to trend higher. It suggests on going labor market deterioration.
- August Irish Live Register rose 2,500. The level of increase remains high to most of the 2000's. The August Unemployment Rate rose 0.1% to 13.8% and has turned higher since a low in April at 13.0%.
- August German Unemployment fell 17,000 (-20,000 forecast). The Unemployment Rate was unchanged at 7.6%. Wires suggest that export and investment spending are leading to job growth. Unemployment changes are consistent with the 2007/2008 level and point to a moderate recovery, while the unemployment rate continues to decline.
- August Final German CPI rose 0.1% m/m (flat expected). The year over year rate rose 1.0%. Inflation is contained.
- August Dutch CPI rose 1.5% y/y (1.5% expected). Inflation is tame.
- Ireland CPI rose 0.2% y/y. Growth is turning positive, but remains low. Base effects are lifting the number.

U.K.:

- Manufacturing PMI fell 3.0 to 54.3 (57.0 expected). It stands at a 9 month low and is clearly rolling over. Output rose at its slowest rate since September, new orders eased sharply, employment had a softer tone, but backlog fell and helped to support output. Summary statements suggest output will slow in the coming months as the new orders to inventory ratio declined to a 17 month low. Employment had a softer tone. There was a notable increase in average purchase price was reported. Supply chain prices were lifted by an increased raw material demand and low stocks at suppliers.
- UK Service PMI fell 1.8 to 51.3. (52.9 expected). Employment fell sharply, backlog declined for the 35th straight month, and sales increased at the slowest pace in 14 months. Activity has been slow to trend since February. Input costs continue to rise with the rate accelerating to a 3 month high. Higher salaries and rising utility bills were blamed. Efforts to pass on higher costs were thwarted by competitive pressures and the need for discounting to generate sales.
- CIPS Construction PMI fell 2.0 to 52.1. There was a sharp slowdown in residential construction.
- July Exports x-oil declined 0.7% m/m pausing after strength in May and June. Imports ex-oil rose 2.1% m/m. The trend has been choppy, but firm. A record visible trade deficit was recorded at \$8.667 bln.

- July IP rose 0.3% m/m (in line). The trend is uneven, and the index level is below the March peak. Manufacturing activity is grinding higher, while mining has been a drag on the index.
- Halifax Home Prices rose 0.2% m/m (-0.5% expected). The index has been flat to lower in recent months. The price to earnings ratio fell 0.01 to 4.73. The trend is higher, however.
- July Mortgage Approvals were 48,700 (46,500 expected) and have been flat to lower since late 2009. There is a clear slowdown in housing demand.
- August BRC Like for Like Retail Sales rose 1.0% y/y up from 0.5% in July. Total sales increased 2.8% y/y compared to a 2.2% y/y increase in August 2009. Food sales growth slowed a little. Clothing and footwear sales strengthened, helped by new autumn/winter items and back-to-school. Homewares edged up but sales were still often deal-driven, with big-ticket items affected by consumer uncertainty over job cuts and income prospects. Non-food non-store sales (internet, mail-order and phone sales) picked up in August and were 17.8% higher than a year ago, but this was against an exceptionally weak 8% gain in August 2009.

Asia

*Asian economies are expanding, but data points are mixed regionally and in some cases within countries. Downside risks remain given the headwind from slower growth in the OECD and a drift toward tighter monetary policy in the region. **China's** economy continues to expand helped by firm bank lending. The government is working to shift stimulus to inner areas and domestic industries to balance potential risks to the export market due to lower consumer spending in the U.S. and EU. The manufacturing PMI survey has lost momentum in recent months, but service PMI numbers are healthy and August retail sales and industrial output were consistent with healthy growth. Food prices are lifting CPI and creating an inflation problem. Higher wages are also working through the country. Inflation is expected to peak in the coming months and moderate into year end. The PBOC will be biased toward tightening policy. There are some calls for a rise in deposit rates to cool excesses in the property market. **Japan's** economy has softer footing with the strong yen curbing exports and domestic demand sluggish. Deflation lingers. The BOJ will be working to combat deflation, although rates have found a floor near zero. **Australia's** growth is uneven. PMI numbers point to sluggish growth, but healthy economic activity in China and a vibrant labor market point to continued expansion. The new government and potential for a mining tax could create a headwind to growth. Inflation is tame, and the RBA sees rates near normalized levels. Rates are expected to be kept steady into year end. **Korea's** economy is expanding at a slower rate and business surveys show loss of momentum. The BOK's reluctance to raise rates is consistent with the weaker tone in business survey results. Inflation is contained, although the BOK is fearful of a future increase. The BOK will be biased toward raising rates, but action will be careful. **India's** growth is vibrant and bottle necks are lifting inflationary pressures. Industrial production and PMI data point to a strong expansion. Inflation remains elevated. The RBI will raise rates 25 bps at its September meeting. Key economic indicators*

Australia:

- AIG Manufacturing PMI fell 2.7 to 51.7. Production declined 5.8 to 51.5. The series is uneven, but this data is consistent with slowing. New orders decreased 6.1 to 50.6 – lowest since December (48.6). Employment rose 3.6 to 51.3 in line with trend. Input prices fell 1.0 to 71.0 but remain elevated.
- AIG Service Index rose 0.9 to 47.5 and has been below 50 most of the year. It does not suggest strong growth. New orders rose 0.9 to 47.0, sales increased 7.4 to 51.8, rebounding nicely after 3 months of depressed levels. Employment fell 3.4 to 47.0, wages declined 0.1 to 62.9 and

remain elevated. Input prices eased 1.3 to 54.9 and showed cooling. Selling prices dipped 0.9 to 46.6.

- July Exports fell 4.5% m/m and Imports rose 1.6% m/m. Pace of exports slowed after robust activity in the spring and summer. The import growth trend is firm.
- August Employment rose 30,900 (25,000 expected). Full time employment rose 53,100, while part time employment fell 22,100. The trend suggests healthy job creation.
- August Unemployment rate fell 0.2% to 5.1% (5.2% expected). The rate is grinding lower and at 2006 levels.

China:

- Manufacturing PMI rose 0.5 to 51.7 (51.5 forecast). Table from the NBS and Federation of Logistics and Purchasing showed output up 0.4 to 53.1 but the trend is still toward slower expansion. New orders rose 2.1 to 53.1 and a rebound may be brewing. Employment fell 0.5 to 51.7. The trend is weak and suggests modest hiring. Input prices rose 11.1 to 60.5 and are firm.
- August China Non-manufacturing PMI was flat at 60.1. It has been moving sideways in recent months. The HSBC Service PMI rose 1.3 to 57.6 and noted service employment rose further with the rate of growth at a 3 month high. Backlog fell and survey responders saying that they had sufficient resources to fill workloads. Expect business activity to be higher in 12 months. The composite PMI said that input prices measure rose markedly in August, pointing to a substantial rise in costs following a decline in July. Private sector charges were raised for the first time in 3 months, although the rate of inflation was only modest.
- August Vehicle Sales rose 16.1% to 1.3 mlu. The Auto Industry Association said that sales might rise to 16 mlu this year up from a previous estimate of 15 mlu.
- Vanke reported August sales surged 149% y/y to CNY 12 bln, suggesting a hot property market.
- August Hong Kong Home sales rose 23% to a 3 year high. By volume, 14,699 units were sold up from 12,957 in July.
- August New Yuan Loans were 545.2 bln (500 bln expected). Loan growth is robust and supportive of continued economic expansion.
- August Retail Sales rose 18.4% y/y (18.0% expected). Sales growth remains vibrant. Household electronics, furniture, autos, and communication appliances continued to show strength.
- August Industrial Production rose 13.9% y/y (13.0% expected). Production has moderated from the peak, but remains healthy. Electricity output remained hot on sequential basis. Steel and cement production displayed small sequential gains. Motor vehicle output eased from trend. The data was less strong on a month over month basis.
- August CPI rose 3.5% y/y (in line) and continues to work higher. Inflation is below the peaks seen in 2004 and 2008. The uptrend is showing loss of momentum, and being helped by base effects. Food inflation jumped and lifted the index but most components show tame inflation, and housing inflation decelerated. CPI rose 0.2% m/m.

India:

- August Manufacturing PMI fell 0.4 to 57.2. New orders rose at a substantial pace, while export orders slowed, but remained above averaged. Production expanded in line with July, and there was a marginal reduction in the pace of hiring. Backlog continued to build. Power glitches and parts shortages lifted backlog. Input price inflation expanded for the 17th straight period driven by higher raw material prices. Charges also rose, although the extent of the increase was limited by strong competition.

- August Service PMI fell 2.4 to 59.3. All six sectors covered reported rising new business. Output was strong, backlog rose, and employment increased. There was a marked gain in input costs due to purchase costs and wages. Output prices also increased.
- July Exports rose 13.2% y/y, while Imports increased 34.3% y/y. Export growth has slowed dramatically, but to a growth rate seen during much of the middle 2000's. Sequentially, export growth has been weak the past 4 months. Import growth is consistent with robust domestic demand. Non-oil imports rose 49.6% y/y. sequentially, non-oil imports are rising.
- August Local Car sales were 160,794 and continue to rise. Vehicle demand remains robust and at record levels.
- August 28th Primary Articles WPI rose 15.4% y/y. Inflation is topping and likely to ease lower. However, WPI is also very elevated.

Japan:

- August Economy Watchers survey Current fell 4.7 to 45.1 (49.9 expected). Outlook plunged 6.6 to 40.0 (46.4 expected). The yen's strength is probably hurting the outlook and the index is topping. Households and business categories show weakness. Employment fell 4.2 and has been down 2 straight months.
- August Tokyo Office Vacancies rose .07% to 9.17%, continuing to inch higher.
- Q3 BSI Large All Industry Index rose 3.1 to 7.1 showing strength. However, the outlook for Q4 was depressed at 0.1 and the view for Q1 2010 was 3.9.
- August Vehicle sales rose 46.7% y/y. There was a sharp recovery in the growth rate.

Korea:

- September Business Survey fell 0.6 to 102.5. The index hit has been trending lower since peaking in March at 114.3.
- September BOK Manufacturing Sentiment fell 8 to 101 and shows a weakening trend in activity. The non-manufacturing PMI dipped 7 to 84 and shows weakness too. The Korean economy is decelerating.
- August Manufacturing PMI fell 2.3 to 50.9. The rate of new orders slowed to the slowest pace since May. Export business eased, while output grew slightly reflecting slower new orders. Employment expanded, but at the slowest pace in 10 months. Input price inflation was the lowest in 8 months and unchanged from July
- August CPI rose 0.3% m/m (0.4% expected) and rose 2.6% y/y. Core inflation is up 1.8% y/y and contained. The government is expected to boost power and gas prices in August and September.
- August Bank lending to Households rose KRW 0.97 trln, while lending to companies gained KRW 0.5trln. Bank lending was anemic and mortgage lending contracted consistent with slower growth and the BOK's decision to leave rates unchanged.
- August PPI rose 3.1% y/y and has decelerated in recent months.
- South Korea's home prices will continue to fall after declining about 10% in areas around Seoul this year – Moody's.

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