FINANCIAL MARKETS TODAY

FMT
North American
Edition

IDEAglobal
the essence of market intelligence

Shandi J. Modi Michael Gallagher

Friday 23rd July 2010

IN TODAY'S EDITION (see page 3)

- UK: ECONOMY EXHIBITS STRATOSPHERIC GDP GROWTH IN Q2
- GERMANY: JULY IFO INDEX SOARS TO A 3-YEAR HIGH

Daily Sections

- LATEST NEWS AND RUMOURS
- MONEY AND BOND MARKET STRATEGY
- SHORT-TERM FOREX VIEW

LATEST NEWS AND RUMORS

▪ **ECB member Gonzalez-Paramo** said the bank stress tests (to be unveiled at 1600GMT) include 'very unlikely scenarios' and are as demanding, if not more so, than the ones carried out in the US. -Bloomberg

▪ **The German Ifo** business climate headline indicator comes in at a much stronger than expected 106.2 in Jul, vs 101.8 in Jun, and flies in the face of consensus expectations of a fall to 101.6 . The underlying current conditions and economic expectations sub-indices also surge, to 106.8 (from 101.2 in Jun) and 105.5 (from 102.5 in Jun), respectively.

▪ **Ifo's Abberger** cautions there are signs however that the economy could be more subdued in H2.

▪ **Ifo's Abberger** says improvement coming from all sectors, including industry, construction and trade - Rtrs

▪ **Bunds have slipped** about 20 ticks so far on the much-higher-than-expected IFO survey (at 106.2, well above the top of the range of forecasts).

▪ **German daily FAZ** reports that all of Germany'**s** Landesbanks have reportedly passed the stress tests. The paper notes that capital injections and government guarantees from the country's SoFFin fund have been sufficient enough for the banks to pass.

▪ **French household consumption** of manufactured goods falls a whopping 1.4% m/m in Jun, after rising by a downwardly revised 0.6% m/m in May (prev 0.7%).

▪ At least 5 of the 6 **Greek banks** being stress-tested will pass, according to the WSJ yesterday.

▪ Several **Spanish savings banks** (Cajas) that have participated in mergers and received money from the government's rescue fund may fail the bank stress tests — El Pais newspaper, cited by Bloomberg.

▪ **Cable continues its surge higher** and briefly traded above 1.5400, a one-week high. Multi-session seen targeting last weeks three-month high at 1.5470 ahead of key resistance at 1.5560/65 its 200-day ma and 1.5660/65 its 100-week ma.

▪ **UK Q2 GDP** turns out at a shockingly strong 1.1% q/q, far exceeding our expectations of an acceleration to 0.6% from 0.3% q/q in Q1. The surprise to us comes mostly from the strength of services output which rises 0.9% q/q (after 0.3% q/q in Q1), and a whopping 6.6% q/q advance in construction output (more than reversing the 1.7% q/q drop in Q1). Industrial production comes in as expected at 1% q/q.

▪ **GBP jumps across the board** after a much stronger than expected preliminary Q2 GDP reading of 1.1% q/q vs market expectations for 0.6% print. Cable trades to 1-week highs at 1.5385/90 while EUR/GBP seen less dramatic falling to around 0.8415 with EUR supported by the firm Ifo reading earlier.

▪ **The British Bankers Association** reports 34.8k in home loans in June, below the previous 36.4 and below consensus of 37k.

▪ **The Sep Gilt** has fallen about a quarter point after UK Q2 GDP, at 1.1% q/q, came out almost double expectations.

▪ **National Policy minister Arai** says that one can't be complacent about bonds given the fiscal state. He warns that abrupt sotck drop and yen rise could hurt the economy and says he is closely monitoring currency moves. Says that the Yen is strong because of risk aversion. Notes that funds may be moving to bonds from stocks and lowering yields. Fin Min Noda says he will give budget guidelines as early as today. Separately, Parliamentary secretary Tsumura says that the Yen's level against other currencies has been too high recently.

▪ **Japan's ruling DPJ** called on the government to keep debt issuance in the fiscal year from next April at or below this year's levels and urged them to cut waste. In an outline of the budget for 2011/12, the government said it aimed to limit spending, excluding debt servicing costs, at around JPY 71trn, roughly the same level as 2010.

▪ **Australia's import price index** rose 1.9% q/q (prev 0.3% q/q), higher than expected while the **export price index** rose 16.1% q/q (3.8% q/q prev) compared to expectations for a rose of 13.5% q/q in the second qtr.

▪ **US Trsy Sec Geithner** said that he sees "basic confidence" in the U.S. economy even though credit is "still quite tight" for some borrowers. Geithner said one of the strengths of the panel, is that it will have authority to examine non-bank financial firms. Geithner said tax cuts enacted under the Bush administration for "the most fortunate 2-3% of Americans" should expire on schedule at the end of this year. "That will help us begin the process of making a contribution to bringing down our long-term deficits," he said.

▪ The **US House** voted in favour of restoring emergency unemployment benefits for 2.5mln unemployed, sending the measure to President Obama.

▪ **Democratic leaders in the House of Representative**s said on Thursday they will wait until at least September before taking any action on legislation to force China to revalue its currency.

▪ **Fed Chairman Bernanke** says unemployment is the most important problem right now. Most modelling exercises suggest fiscal policies created 1-3 million jobs. Hears often from businesses about uncertainty delaying investment but can't

(continued next page)

WORLD FUNDAMENTALS

GMT	FRI 23 JUL 10	FOR	IDEA	MKT	RANGE	LAST
06:45	FR CONS MAN GDS M/M	JUN	-1.4A	0.2	-1.8/1.2	0.6%R
08:00	DE IFO	JUL	106.2A	101.6	100.5/102.5	101.8
08:30	UK GDP Q/Q 1ST	Q2	1.1A	0.6	0.1/0.8	0.3%
08:30	UK GDP Y/Y 1ST	Q2	1.6A	1.1	0.6/1.3	-0.2%
11:00	CA CPI M/M	JUN	-0.1	-0.2	-0.2/0.1	0.3%
11:00	CA CPI Y/Y	JUN	0.9	0.9	0.8/1.1	1.4%
11:00	CA CPI CORE M/M	JUN	0.1	0.1	-0.2/0.2	0.3%
11:00	CA CPI CORE Y/Y	JUN	1.9	1.9	1.6/1.9	1.8%

EVENTS:

01:30	AU	IMPORT & EXPORT PRICE INDEX, Q2
06:45	FR	INSEE QUARTERLY INDUSTRY SURVEY PUBLISHED, Q2
08:30	UK	BBA PUBLISHES MAJOR BANKS' MORTGAGE APPROVALS DATA, JUN
08:30	UK	ONS INDEX OF SERVICES PUBLISHED, MAY
10:00	EU	ECB'S TUMPEL-GUGERELL SPEAKS @ EUROPEAN ECON & FIN CENTRE
13:00	BE	BELGIAN LEADING INDICATOR PUBLISHED, JUL
	EU	EU BANK STRESS TESTS SET FOR RELEASE
	EU	ECB'S GONZALEZ-PARAMO SPEAKS ON LESSONS FROM THE CRISIS

	New York	London	Singapore
tel:	+212 835 1300	+207 664 0200	+65 6332 0700
fax	+212 835 1301	+207 664 0201	+65 6332 0701

quantify it. Fed could reintroduce some special lending programs in unlikely case of spillover from Europe debt crisis. 'Unusually uncertain' comment was based on latest Fed survey of its members, majority of whom said conditions were more uncertain than normal

- **US House Speaker Nancy Pelosi** still backs extending Bush tax cuts for middle class only. Tax cuts for rich boosted deficit and did not create jobs.
- **Fed custody holdings** as of 21/07/10. The total increased by $18.1 billion, with Treasuries rising by $13.8 billion and agencies adding $4.3 billion. The 4 week avg increased to $13 billion from $9.5 billion and the 3 month average fell to $6.3 from $6.6 billion.

MONEY AND BOND MARKET STRATEGY

US: As another string of strong company earnings/forecasts came out and as market confidence was boosted by some constructive data in Europe, stocks rebounded sharply. This sapped Treasuries of the gains they accrued on Wednesday and with some moderate steepening of the curve. Jobless claims rebounded a bit more than expected and Existing Home Sales fell a bit less than consensus forecast, but continuing claims dropped and m/m home prices rose. The Treasury announced sizes of 2yrs, 5yrs and 7yrs to be auctioned next week at levels still very near record low yields and with the Street very uncertain about whether the pickup in risk appetite can sustain or not. With no economic releases scheduled on Friday, focus is squarely on the market reaction to the stress tests in Europe and earnings including McDonalds, Ford, McGraw Hill and Verizon. The House voted for extension of jobless benefits through November, including retroactive payments to 2.5mn jobless whose benefits had run out, injecting a noteworthy $34bn over the next six months into consumers who are highly likely to spend the money as it is received. Given the "unusual uncertainty" Bernanke has told congress he has about the outlook, given the polls showing voters feel job creation trumps deficit reduction and given the general climate of caution and hesitation to invest and hire in the business community (especially small business), the current conditions could be more conducive to getting some additional fiscal action such as on the proposed $30bn legislation to boost small business hiring. The technical picture on Sept 10yrs is showing loss of momentum, still allowing room for spike to 12327 then 12409 but then sees a likely stall and reversal. Below 12229/12227 should test 12216 and break here aims for 12114.

GERMANY/EURIBOR: The **Sep Bund** has been pressed to below the bottom of its 128.50-129.50 range by today's huge upward surprise in the IFO survey. The latter jumped by more than 4 points to well above the top of the range of forecasts, and takes the index to three-year highs. This underscores the strength still being shown by the German industrial sector, although we wouldn't expect it to translate into a particularly good overall Eurozone economic outlook over the coming year or so. Now more important will be the end-of-day (1600GMT) publication of the Eurozone bank stress test results. As widely signalled, these tests should show the vast majority of major institutions passing, albeit under a limited sovereign risk scenario (i.e. no default). Nevertheless, we believe confirmation of this, as well as the associated improvement in transparency from the details published (the extent of which is still uncertain though), will alleviate uncertainty about the banking sector as well as risk aversion. The **Sep Bund** could then sink towards 127.10/127.50 support. Euribor is a mixed bag, but could actually benefit, on balance, from a reduction in perceived counterparty risk.

In terms of more broad market developments, the **10yr T-note/Bund yield spread** is near its recent 2010 low of 24bps — which keeps the focus of speculation on an eventual return to parity, even though we would find that at odds with the medium-term fundamentals. The 2yr German yield (around 0.70%) continued coming back down to more levels more appropriate to steady ECB policy, and the **2/10yr curve** is already testing above 193bps resistance. We would not be in the least surprised to see the latter rebound back to 205bps, multi-day. **Sep '11 Euribor** broke yesterday above 98.77 resistance to three-week highs over 98.80. It would next faces some resistance at 98.85 and more significantly, at 98.90, but this, at least, should cap the upside.

INTRA-EUROZONE: The **10yr Spanish/German spread** is still testing its 21st June swing low of 170bps, without either a clear break or rejection. Then the spread finds itself at the bottom of its summer range extending up to 220bps. Nevertheless, if the bank stress test publication serves to increase risk appetite, the peripheral markets could outperform a bit.

UK: The **10yr Gilt/Bund yield spread** looks increasingly poised for a break below 70bps support, and it's possible that this could happen along with a Bund sell-off following the stress tests. Outright, the **Sep Gilt** — which currently lacks direction in its 120.50-121.50 range — could be vulnerable, though. **Sep '11 S-Stg** has at the same time been gingerly attaining new record highs. However, both are pulling back after the UK Q2 GDP report, at +1.1% q/q, just came in at almost double expectations.

JAPAN: Better than expected data releases in the US, UK and Europe coupled with improved earnings reports in the US, saw risk appetite spill over into the Asian session. The Nikkei average was up 2.3% on Friday, which saw the 10yr future back down below the 141.70 level. Improved risk sentiment heading into next week should see the 10yr future back down towards 141.20. With yields across the curve being fairly depressed at the moment, any sustained bout of risk appetite will see the curve bear steepen as the 2s/10s spread widens to around 98bps from 93bps currently. Next week sees a host of data out of Japan. Retail trade for June is expected to come in 3.3% y/y, while the June jobless rate is seen to be unchanged at 5.2%. Overall household spending in June is expected to have been weak, while June core CPI is likely to have edged marginally higher to -1.1% y/y. Weaker than expected data will only add to prolonged deflationary fears, and will continue to weigh on JGB yields on a multi-week basis.

SHORT-TERM FX VIEW

Thursday's market developments were all pretty much as expected with economic developments more mixed. We expected the EURUSD to breach 1.29 and it did so. More broadly our expectations for a broad based risk on rally was more than repaid with AUDUSD breaching 0.89 as we anticipated. Moreover we expected CAD underperformance based on some weaker than expected consensus CAD retail data and mixed USD economic data. CAD retail sales were weak. USD data was definitely mixed as with our bias for bullish flavour to the data broadly met. But as we noted yesterday (elaborated in yesterday's FX Comment) in the current climate it does not really matter whether USD data is weak or strong, the USD could weaken on both scenarios. Hence our long AUDCAD rallied to as high as 0.9280. USD data did not show the better than expected labour market picture. Since this is virtually the first initial claims number that has gone against our expectations this year we would put this down to the impact of auto shut downs finally having a belated impact. With the lagging nature of the labour market we expected it to start deteriorating due to fundamentals over the coming weeks, if this is compounded by auto shutdowns being back weighted then it could push initial claims near 500k over the coming weeks. USD LEI was better than consensus as we anticipated but USD Existing home sales confounded our bearish bias. Overnight the FX markets appear to have woken up when El Pais reported a Spanish Caja had failed the stress test. This pushed EURUSD briefly lower but our expectations for a firmer than expected IFO was more than met and it helped push EURUSD above 1.2930. We have been highlighting for quite some considerable time how the market was underestimating the performance of Germany and its impact on its neighbours. Other second tier European data, which never has much FX impact, did not meet our expectations (admittedly based on World Cup related issues) with Italian Consumer Confidence showing little impact from their dismal World Cup showing! But perhaps they were just putting on a brave face as consumer spending in Italy declined as it did in France (due to a late start to summer sales). The stronger IFO helped underline the risk on/decoupling themes we have been highlighting for sometime. It also helped boost EURGBP ahead of the UK GDP number. UK GDP came in much stronger than consensus as for once the ONS did not 'low-ball' their first estimate as we anticipated. It appears to have been fairly broad based with even construction making a surprisingly strong contribution. This serves to illustrate that growth is the best way to reduce the deficit. Since then the new coalition government's policies (emergency budget only introduced in late June) have seen a deterioration in the economic outlook. It also suggests less of the recent upside surprises in the public finances are structural. It had limited initial impact on EURGBP.

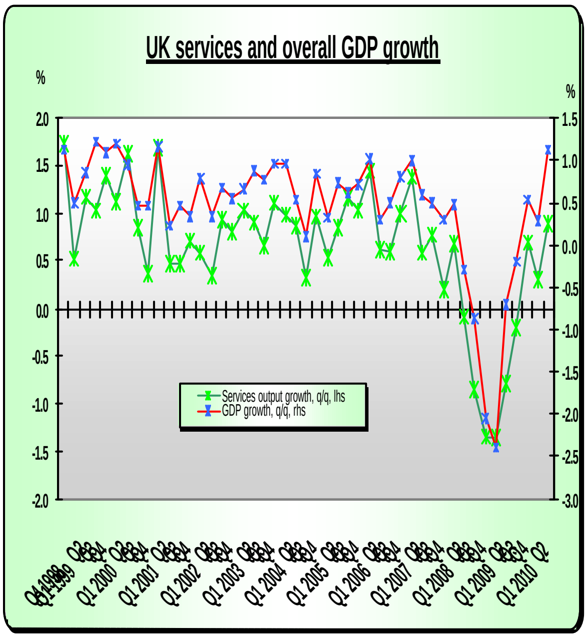
Over the next couple of hours the only release of note is CAD CPI. Here we expect a downside surprise to help our long AUDCAD trade make even more gains. With sentiment towards the EUR clearly improving after all the good data and showing no signs of wearing off we think this will provide a good back drop for the main release of the day; the results of the bank stress tests. Clearly the EUR bears are already out in force trying to generate negative headlines about the stress test results that whatever they show it will be bad for the EUR. Although IMM data suggest speculators are short, large hedge funds such as GLG are on the media and still appear very EUR bearish. This justifies our reading of recent price action as being driven by them as they try to move the EUR down. Hence the initial reaction to the stress tests may well be that the EUR bears start to sell aggressively to try to convince the markets the tests are indeed EUR negative. However the price action on the equity side of the banks should tell the real story. Moreover longer-term investors fundamental investors are likely to take a more balanced view of the stress test results. Hence we think the longer-term reaction of the markets is likely to be unambiguously EUR positive. As such we think the longer-term bullish EUR trend will remain intact. Hence while we see near term downside risks as EUR bears try to generate a sell off in the EUR, longer term we see EUR heading above $1.30. More recently even an ex-IMF managing director has commented that the European banks have less of the toxic debt than their US counterparts. We see this being generally risk positive for the wider market with riskier currencies outperforming the most. Hence we expect AUDCAD to make further gains with a breach of 0.93 targeted as RBA monetary policy was explicitly tied to the results of the tests. ZAR could be another strong outperformer. USDJPY is likely to rise while EURGBP should also head higher and our target of an eventual move towards 0.85 remains in place. GDP news reflects the achievements of the last government and as such is old news. Hence the boost to GBP is likely to be fleeting since the most recent comments by BoE chief Economist Spencer Dale is that the UK faces a low growth, low inflation and high unemployment outlook. This will increasingly weigh on GBP.

IN TODAY'S EDITION

UK: ECONOMY EXHIBITS STRATOSPHERIC GDP GROWTH IN Q2

The UK Q2 GDP growth rate turns out at a shockingly strong 1.1% q/q, far exceeding our expectation of an acceleration to 0.6% q/q, from 0.3% q/q in Q1. The surprise to us comes mostly from the strength of services output, which rises 0.9% q/q, in contrast to our 0.5% q/q expectation (after 0.3% q/q in Q1), and the whopping 6.6% q/q advance in construction output that more than reverses the –1.7% q/q plunge in Q1. Industrial production comes in as expected at 1% q/q. So, this GDP outturn far exceeds even the NIESR's 0.7% q/q prediction and pushes the y/y rate up to 1.6% from –0.2% y/y in Q1, **marking the first annual increase in GDP since Q2 2008.** The bias on GBP should remain to the upside, whilst Gilts should stay on the back foot.

So the Q2 growth acceleration suggests that on an annualised basis, the economy grew above trend, although the level of GDP still remains some 4.7% below the peak reached in Q1 2008. **Some of the increase would also reflect some upside correction, after a bad-weather-distorted growth slowdown in Q1.** It would seem that the strength of activity seen in previous services sector surveys are just beginning to feed through to the official hard data with a lag. This is the more so given that the services sector surveys for Q2 have generally shown activity to have expanded at a slower rate on average, than in Q1**. Additionally it is evident that a more buoyant distributive trades sector, not normally encapsulated in the services sector surveys, has assisted the strength of Q2 services output**.



This latest GDP number thus supports the view that 2010 GDP growth could actually turn out better than the 1.2% growth rate we have pencilled in (perhaps in the 1.5% ballpark), although much depends on the extent of the slowdown likely to be seen in H2 2010. The latest figures are even slightly higher than the BoE's latest central case y/y GDP projection for Q2, **and so raise questions about how much longer the BoE MPC will be prepared to wait before beginning the process of normalising interest rates.** This is especially given another MPC member's (Spencer Dale) recent remarks about the prospect of CPI inflation overshooting its target right through to end-2011, as well as its likely impact on pipeline cost pressures and public inflation expectations.

But the growth headwinds remain (some acknowledged also by Dale), in the guise of financial market tensions, the likely effects of fiscal austerity measures, prospects of a large wave of public sector redundancies, potentially slower demand growth in overseas markets and ongoing bank and household balance sheet restructuring, all of which should limit the upside on future growth. But to the extent that these latest figures are reflecting the true state of the economy, further (albeit slower) growth in the quarters ahead should help to improve fiscal revenues as well as reduce the size of the budget deficit, going forward. **Recall also that the BoE MPC believes that the implications of the Jun 22 emergency Budget for growth and inflation would depend on the response of the private sector**. For now though, Cable bulls should remain euphoric, with scope for further gains towards 1.5485 in the n/t. And the risk of the BoE MPC starting its monetary policy normalisation process from extraordinarily low interest rates, before end-Q1 2011, has risen slightly.

GERMANY: JULY IFO INDEX SOARS TO A 3-YEAR HIGH

The **German Ifo business climate headline indicator** comes in at a much stronger than expected 106.2 in Jul, vs 101.8 in Jun, and flies in the face of consensus expectations of a fall to 101.6 (we predicted an increase to 102). Not surprisingly EURUSD has reacted positively and we would expect Bunds to remain on the back foot. The underlying current conditions and economic expectations sub-indices in the survey also surge, to 106.8 (from 101.2 in Jun) and 105.5 (from 102.5 in Jun), respectively. This latest development takes the headline Ifo index to its highest print since July 2007 and reaffirms the view that the German economy continues to be the strong locomotive driving the Eurozone economic recovery.

The strength of the Ifo headline indicator and its sub-indices chime with the direction of the current conditions sub-indices contained in the latest Eurozone Sentix and German ZEW sentiment surveys. And they suggest not only are current business conditions thriving for the largest Eurozone economy, but that the immediate future looks reasonably bright, although there are signs that the latter months of H2 on balance will likely show a more subdued rate of growth compared with H1. Admittedly, the strength of the Ifo survey has been supported by Germany's good run at the recent World Cup tournament, as well as decent summer weather that has boosted the drinks sector, with Ifo economist Abberger stating that the improvement has been generally broad-based across sectors. So it would seem that buoyant business conditions are being driven not only by exports but also by some improvement in domestic demand (construction and retail trade also improving), although it is questionable how sustainable the pick-up in domestic demand will be. This is especially given fiscal austerity measures, concerns about future job prospects, and circumspect bank lending attitudes. For now though the latest Ifo survey, which shows the headline indicator soaring further above its 96.1 l-r average, **should be seen as supportive for a respectable Q3 GDP growth figure for Germany even if it does turn out to be softer than in Q2.** EURUSD bulls should remain euphoric