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- UK: PRELIMINARY Q2 GDP DATA AWAITED

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LATEST NEWS AND RUMORS

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 rise 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 favor of restoring emergency unemployment benefits for 2.5mln unemployed, sending the measure to President Obama.

Democratic leaders in the House of Representatives 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 modeling exercises suggest fiscal policies created 1-3 million jobs. Hears often from businesses about uncertainty delaying investment but can't 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.



WORLD FUNDAMENTALS

GMT	FRI 23 JUL 10	FOR	IDEA	MKT	RANGE	LAST
06:45	FR CONS MAN GDS M/M	JUN	1.2	0.2	-1.8/1.2	0.7%
08:00	DE IFO	JUL	102.01	101.6	100.5/102.5	101.8
08:30	UK GDP Q/Q 1ST	Q2	0.6	0.6	0.1/0.8	0.3%
08:30	UK GDP Y/Y 1ST	Q2	1.1	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

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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: Following an opening run-up towards the top of its 128.50-129.50 range following the Bernanke-driven Treasury gains late Wednesday, the Bund drifted back into the lower end of that range as equity markets rebounded. An unexpected increase in the Eurozone PMIs and a surprise jump in Eurozone industrial orders weighed, at the margin, on the downside. Friday's IFO should do the same, and show that the Eurozone economy (unlike the US) is performing surprisingly well — so far. The **10yr T-note/Bund yield spread** has dropped to a new 2010 low of 25bps — 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 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 above 98.77 resistance to three-week highs over 98.80. It next faces some resistance at 98.85 and more significantly, at 98.90, which should cap the upside.

Friday may now be a decisive day for the Eurozone FI market, depending on the bank stress results (and the uncertain timing of their release). 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, will alleviate uncertainty about the banking sector as well as risk aversion. The **Sep Bund** could then sink towards 127.50/128.00 support. Euribor is a mixed bag, but could actually benefit, on balance, from a reduction in perceived counterparty risk.

INTRA-EUROZONE: The **10yr Spanish/German spread** has rebounded just back above its 21st June swing low of 170bps, suggesting a false break. In that case the spread would find 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.

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. Some pull-back could be seen on Friday upon a robust UK Q2 GDP report, though the EU stress tests may later impart a positive impetus via Euribor.

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 1.8%, which saw the 10yr future back down below the 141.80 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

Asia saw strong gains in its equity markets with the benchmark NKY 225 rallying nearly 2%. Currency markets saw a mixed USD and weak JPY. The majors held on to overnight gains in the early part of the session and then moved lower with EUR/USD back below the 1.29 handle and GBP/USD holding at 1.5288 ahead of Q2 GDP data release. Q2 GDP is expected to post a 0.6% q/q (1.1% y/y) rise compared to 0.3% q/q (1.4% y/y) rise in the first quarter.

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GBP could move to target the 1.53 handle again if the data prints as expected or better. USD/JPY also moved below the 87 handle in the afternoon Tokyo session. The JPY erased much of Thursday's Asian gains as better earnings and Euro PMIs boosted risk appetite.

EUR trimmed early gains and moved to 1.287 despite better expectations for IFO following from Thursday's PMI. The Euro zone stress tests are due for release after the close of the Europe session but rumour has it they could be released ahead of time. Nevertheless, we would recommend going short EUR/USD and EUR/JPY. Optimism has begun wearing off and with most of the positive news already priced in, market participants could look to sell the EUR once again.

IN TODAY'S EDITION

EUROZONE: JULY PMI SURVEYS POINT TO STRONGER GERMAN IFO

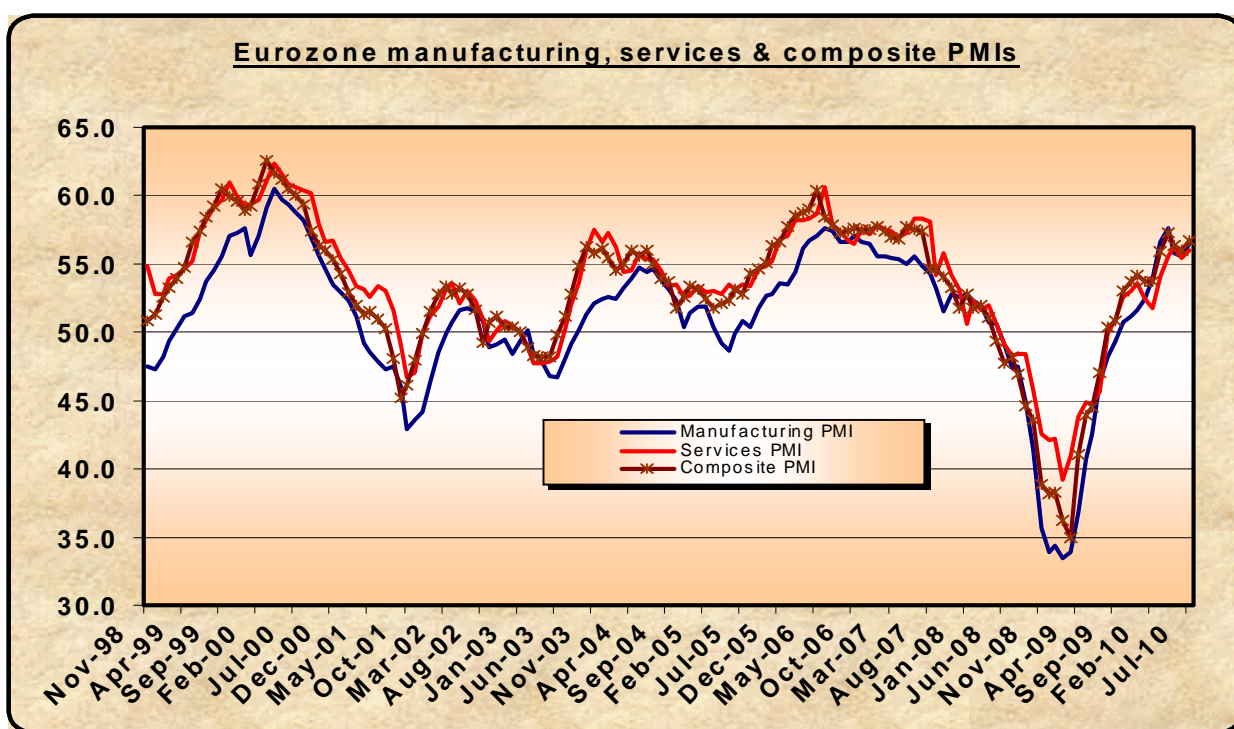
The July Eurozone sectoral PMI surveys turn out firmer than even our own above-consensus predictions for an acceleration in the rate of activity expansion. The flash Eurozone manufacturing sector PMI rises to 56.5 from 55.6 in Jun and in contrast to the market prediction of a fall to 55.2. The flash services PMI rises to 56.0 from 55.5 in Jun, compared to the market expectation of a fall to 55.0. As **such the composite PMI rises**, as we suspected it would, to 56.7 from 56.0 in Jun, vs the market consensus for a fall to 55.5. Markit, the compiler of the survey, attributes the strength in activity to the effect of the World Cup tournament, which is expected to be temporary.

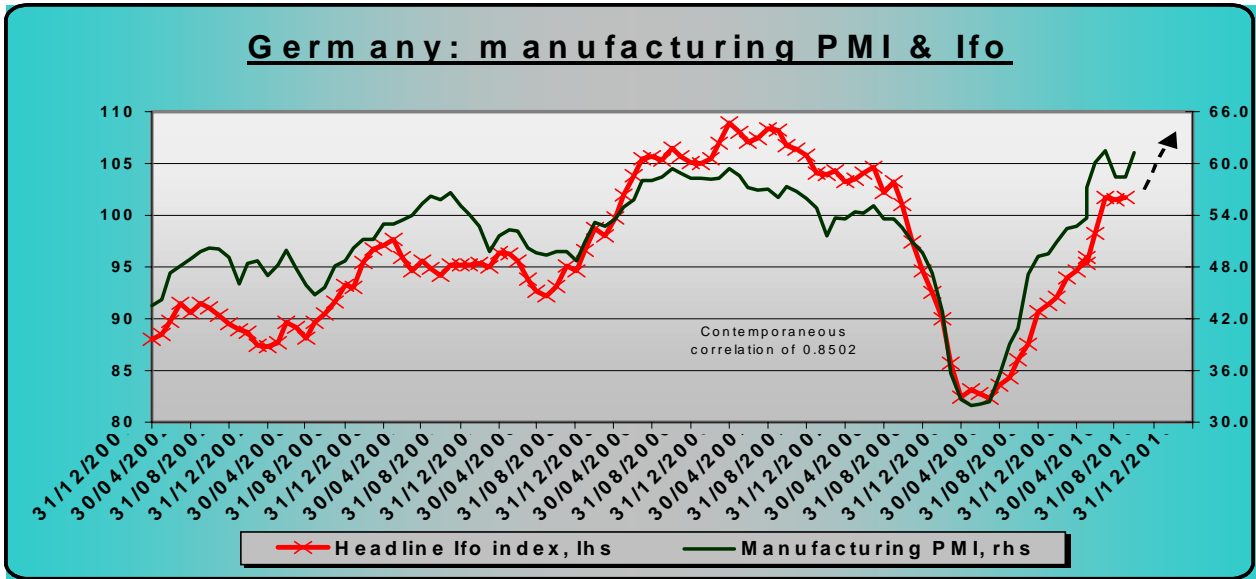
The increases in the Eurozone sectoral PMIs are consistent with recent evidence of the strengths seen in the Eurozone Sentix and German ZEW current conditions sub-indices for Jul. **And we note that stronger advances in Germany have driven the surge in Eurozone activity** for the most part. What's also interesting is that the Jul services PMI increase actually bucks the downward trend in the average stock market indices during the month, despite their 0.70 correlation. This suggests the world Cup influence, combined with some services firms benefiting directly from the strength of an expanding manufacturing sector, played an overwhelming role.

(see graph below)

But even with the resultant rise in the flash composite PMI to 56.7, this still doesn't detract from the fact that the start of Q3 is seeing overall Eurozone activity proceed on a more sedate footing than was witnessed at the beginning of Q2. **This adds to the view that Q3 GDP growth in the Eurozone will likely turn out softer than the rate expected to be recorded for Q2 (at least 0.6%-0.7 q/q).** This is the more so if the composite PMIs for Aug/Sep show an easing from here.

But for the more immediate term, **the latest manufacturing PMIs for both the Eurozone and Germany in particular, support our forecast of a stronger German headline Ifo business climate indicator for Jul**, when the latter survey is published on Friday. Indeed, based on the strength of the Eurozone Sentix and the German ZEW current conditions sub-indices, it was already looking as though a higher German Ifo business climate indicator would be recorded for Jul, (to 102.0 on our forecast), from 101.8 in Jun. The PMI surveys serve to underpin our expectation and we wouldn't be surprised to see an Ifo headline indicator for Jul that even exceeds our above-consensus prediction (market seeks a fall to 101.6). **In principle, this would be supportive for the EUR.** *(see graph next page)*





UK: PRELIMINARY Q2 GDP DATA AWAITED

The preliminary estimate of UK Q2 GDP is due Fri (08:30GMT), and we look for a 0.6% q/q rate, which translates to 1.1% y/y. This would mark an acceleration from the 0.3% q/q rate recorded for Q1 **and the annual rate would represent the first positive y/y increase since Q2 2008**, after registering a -0.2% y/y in Q1. The consensus prediction matches our expectation.

Our forecast for a 0.6% q/q rate of GDP growth is predicated on the fact that IP in the first two months of Q2 points towards industrial output growth of a marginally quicker pace than in Q1, of a around 1.1%. Atop that, survey evidence shows construction activity expanded at a faster rate in Q2, which should have translated into positive growth of this

component in Q2, after a 1.7% q/q plunge in Q1. **Regarding the services sector however, surveys to date actually reveal a slower rate of expansion on average in Q2, relative to Q1**, due in part to the effects on air traffic transportation and other related services of the Icelandic volcanic ash cloud at the beginning of Q2. But we think that the some of the distributive trades services, not normally included in the service sector surveys, would show a rebound and pick up some of the slack, allowing overall services sector growth to still accelerate, to 0.5% q/q, from a tepid 0.3% q/q rate in Q1. Besides, some of the strength of services activity in Q1, not encapsulated fully in the Q1 GDP stats, could well show some feed-through into Q2. The well-respected economics think-tank NIESR has predicted a 0.7% q/q GDP increase for Q2, as has about 30% of economic forecasters, so should 0.6% q/q materialise, the bias on GBP could actually be slightly lower, even though the central expectation is for 0.6%. GDP growth in 2010 remains on course to average out in the 1.1% - 1.2% ballpark. (see graph below)

