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LATEST NEWS AND RUMORS

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

Bernanke said on Thurs that in short term, should maintain a reasonable degree of fiscal stimulus; longer term need to take steps on controlling deficits. Labor market situation 'unsatisfactory.' Repeats options for Fed going forward would include reducing interest on reserves, buying more securities if conditions warrant. Said our baseline scenario is as effects of financial crisis pass, moderate growth in economy will be seen. Adds European situation is improving, confidence coming back. Although some US data has been disappointing, Fed has no basis to radically change its outlook.

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

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

US June Conference Board leading economic indicators report revealed an overall decrease of -0.2% m/m, versus the revised +0.5 m/m reading seen in May (prev. +0.4% m/m), above market expectations for a -0.3% m/m decrease. Despite this decrease gains were posted in 5 of 10 measured categories. Overall, the greatest sources of weakness came via average workweek, pace of deliveries, stock prices and initial jobless claims. Meanwhile, improved readings were seen from interest rate spread, money supply, consumer expectations, building permits and consumer goods orders, alongside an unchanged reading from capital goods orders. IDEA: Alongside the decrease seen in the headline measure, we continue to expect further GDP gains in 2Q10, though likely to see some deceleration to around 2.8% following the broader sense of weakness seen in recent data.

US Initial jobless claims for the week ending 17 July increased +37k to 464k, versus the revised 427k reading seen in the week prior (prev. 429k), above market expectations for an increase to 445k. The 4-week average was reported at 456.0k, versus the revised 454.8k seen in the previous week (prev. 455.3k).

US June NAR existing home sales report revealed an overall decrease of -5.1% m/m (to a SAAR of 5.37mln), versus the unrevised -2.2% m/m decrease (SAAR of 5.66mln) seen in May. This comes in above market expectations for a decrease to SAAR 5.10mln (-9.9% m/m). Meanwhile, inventories increased +2.5% to 3.992mln (8.9 months' supply), while the median price managed to post a +5.2% m/m increase to $183.7k (+2.7% y/y).

Housing price index for May rose 0.5% vs. expectation of -0.3%. April was revised higher to 0.9% from 0.8%.

NY Fed Pres Dudley(voter) says road to US economic recovery "a bit bumpy" as relatively weak consumer spending, ongoing financial market problems weighing on recovery. Economic growth "far less robust" than Fed would like. Sees only "slight risk" of a double-dip recession and US economic growth may be a bit less in Q3 than in 1H'10. Improving domestic, foreign demand should continue to drive us manufacturing output. Adds June payroll numbers tell story of sluggish jobs recovery.

The Treasury has announced the sale of **2Yr notes ($38.0bln** on Tuesday, 27 July), 5Yr notes ($37.0bln on Wednesday, 28 July) and 7Yr notes ($29.0bln on Thursday 29 July) with settlement on Mondat, 2 August. These estimates are roughly in line with expectations with the 5Yr coming in around $1.0bln more than some estimates.

continued next page

WORLD FUNDAMENTALS

GMT	FRI 23 JUL 10	FOR	IDEA	MKT	RANGE	LAST
06:45	FR CONS MAN GDS M/M	JUN	1.2	0.2	-1.8/1.2	0.7%
08:00	DE IFO	JUL	102.0	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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Canada's Monetary Policy Report: BOC worried about European debt crisis and uneven global recovery making outlook highly uncertain. It revised its GDP forecasts lower for the next few quarters: Q2 to 3% from 3.8%; Q3 to 2.8% from 3.5%; Q4 to 3.2% from 3.5%; Q1 2001 to 3% from 3.3%; and the rest of quarters will be higher than previously forecasted. Inflation will remain mild and BOC expects the loonie to weaken; thus, helping its export growth in 2010 and 2011.

BOC Carney says he doesn't expect Canadian households to increase savings; believes in the quality of Statistics Canada, despite the changes it is making, but will look at the integrity of the proposed changes; doesn't believe in double dip for the US; BOC is not preordained in interest rate moves.

Canadian retail sales down -0.2% in May m/m vs. expectation of +0.4%. April was revised lower to -2.2% from -2%. Less autos, sales declined -0.1% m/m. compared to expectation of +0.5%. April was revised lower to -1.4% from -1.2%. The big decline came from building material and garden equipment and supplies dealers, which fell 4.1%. Gasoline stations sales were down 2.3%, as prices fell at the pump. Sales at motor vehicle and parts dealers decreased 0.5% in May. The largest percentage increase came from clothing and clothing accessories stores (+2.6%).

EIA report revealed U.S. weekly natgas stocks up 51 bcf, versus forecast of 53 bcf build. Natgas producing region up 6 bcf in latest week while consuming region east up 41 bcf, west up 4 bcf.

Crude closed the day up $2.74 that is 3.58% higher to settle at $79.30 a barrel as some of the upbeat corporate earnings reports brought optimism to the investors on higher demand for crude.

Eurozone industrial orders jumped by 3.8% m/m in May, following a downwardly-revised 0.6% gain the previous month and confounding expectations of a slight decline. The y/y rate rises to 22.7% from 21.9%. IDEA: While this is somewhat dated data, even today's PMIs corroborate unexpectedly healthy economic prospects in the Eurozone.

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 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 and in contrast to the market expectation of a fall to 55.0. As such the composite PMI rises, to 56.7 from 56.0 in Jun, vs the market consensus for a fall to 55.5.

Preliminary German manufacturing and services sector PMIs for Jul turn out at 61.2 and 57.3 respectively, up from 58.4 and 54.8 respectively in Jun and far exceeding market expectations. German composite PMI thus rises to 59.3 from 56.7 in Jun. French flash manufacturing PMI falls to 53.7 from 54.8 in June whilst flash services PMI is up at 61.3 from 60.8 in Jun, taking its composite PMI up to 59.9 from 59.6.

The French INSEE survey on industrial business confidence for Jul shows an increase in its headline sentiment indicator to 98 from an upwardly revised 96 in Jun (prev 95), and contrary to market expectations for a fall to 94. **Consumer confidence** on the other hand remains at a low ebb, with the headline household sentiment indicator holding steady at -39, same as in Jun, but still in contrast with the market prediction of a deterioration to -40.

EU Monetary Affairs Commissioner Rehn says the EU has the means to fix any problems found in the stress tests, although the banks in need of capital should seek market funding before national rescue funds. -Bbg

According to Reuters sources the **European stress test results** may be published earlier than 16:00GMT on Friday, but no final decision yet.

European banks may provide breakdowns of their sovereign bond exposure when they release the stress test results, according to the CEBS. -Bloomberg.

The **IMF's European Dept** published a report on the Eurozone after talks with the EC and ECB. It said the current drive to cut government debt and spending in the region could reduce the economic growth in the coming years. It also said the euro's heavy slump since the start of the year had reduced it to roughly the right level, while record low 1% ECB interest rates should be kept in place to aid the recovery. The EZ was also at risk of suffering a credit crunch, with high-debt countries such as Greece, Italy, Portugal and Spain most in danger due the amount of people employed by SMEs, who may struggle to borrow.

UK Jun retail sales of 0.7% m/m exceeds the market consensus of 0.5% m/m but is not as strong as our own above-consensus prediction of 1% m/m. Nevertheless the strength of Jun sales is given additional teeth by the upward revision to the May figure to 0.8% m/m, from 0.6% previously recorded. The Jun y/y rate eases however to 1.3% from 1.7% y/y in May, due mostly to base effects. Ex-auto fuel, underlying retail sales growth is stronger, rising by 1.0% m/m.

UK BoE Chief economist Spencer Dale says the UK economy faces a triple whammy of higher inflation, lower growth and rising unemployment. He says living standards over the next few years will rise only "minimally". In an interview with the Independent newspaper, he said he did not expect inflation to return to its 2% official target before the end of next year, partly because of the hike in VAT. Although he acknowledged that the emergency Budget had done much to avoid the risk of a UK sovereign debt crisis and a rise in interest rates, he also acknowledged that the Budget would mean lower growth.

The **Swiss SNB's monthly report** revealed that their euro reserves more than doubled to a fresh record level in the second quarter owing to its heavy scale of interventions. SNB euro holdings soared to EUR 120.5bn from 56.4bn in the first quarter, taking the euro's share in the SNB's currency reserves to 70.5%. USD holdings rose to $45bn from $26.1bn, making up 21.5% of reserve assets.

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: Overnight losses in US equities saw risk aversion continue in the Asian session. The Nikkei average was down 0.6%, and is currently around 1.4% above its recent low of 9076 touched towards the end of November 2009. The 10yr JGB future rallied as a result and managed to touch an intra-day high of 142.08, its highest level since August 2003. However earlier gains were pared as it edged back below 141.90. For the cash bonds, apart from the 2yr yield which rose, the rest of the yields were seen to fall. Data out of Japan which saw the all industry activity index come in better than expected, rising 0.2% m/m in May, was largely ignored. The markets will now be focusing on the results of the bank stress tests in Europe. The focus thereafter will likely shift back to growth prospects for Europe and the US. There is very little room for JGB yields to head significantly lower, especially at the front end of the curve, and hence any increased appetite for JGBs will be directed at the long end. The 20yr yield can be seen at 1.750% should risk aversion persist next week.

SHORT-TERM FX VIEW

Risk sentiment reversed on Thursday as investors turned their attention to stronger data and earnings. Overnight, there were above consensus European manufacturing and services numbers, along with improved UK retail sales figures. Healthier Q2 earnings reported by several US companies, and better than expected US existing home sales (-5.1% vs. -9.9% expected in July) helped continue the positive momentum. All risky financial assets rallied. Equities were up all day and finished about +2%. Treasuries bear steepened with 2/10 spread at 236 bps. Both crude and gold each gained about $3. The majors were higher against the USD and the JPY. EURJPY and EURUSD added about one big figure each, settling near 112 and 1.29 respectively. USDJPY was lower overnight on the continuation of the risk aversion theme experienced on Wednesday, after Bernanke's testimony, but headed higher after the release of the European data. USDJPY settled around the 87 handle, same level it was on Wednesday afternoon NY time.

These are volatile markets as pricing makes 180 degree turns abruptly within one or two days. As everyone waits anxiously for the EU stress tests, we feel that the market has already priced in a favorable result for Europe, since European officials have been commenting confidently about their preliminary findings. Therefore, we feel the risk for EURUSD is to the downside. If the results do not satisfy the investing public, be it that there were too many banks that failed or the tests weren't severe enough, euro should sell off. If the results please the markets, traders would have expected that and would turn their focus to the strength of the European economy going forward. Regardless of the European PMI releases on Thursday morning, we feel that the austerity measures will weigh on the growth prospects of Europe, which will be negative for the euro. If the test shows most European banks are in solid shape, expect a knee-jerk pop in the euro. We would sell into that rally. Short EURUSD and EURJPY after the results are released. Also, stay short GBPJPY.

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EUROZONE: JULY PMI SURVEYS POINT TO STRONGER GERMAN IFO

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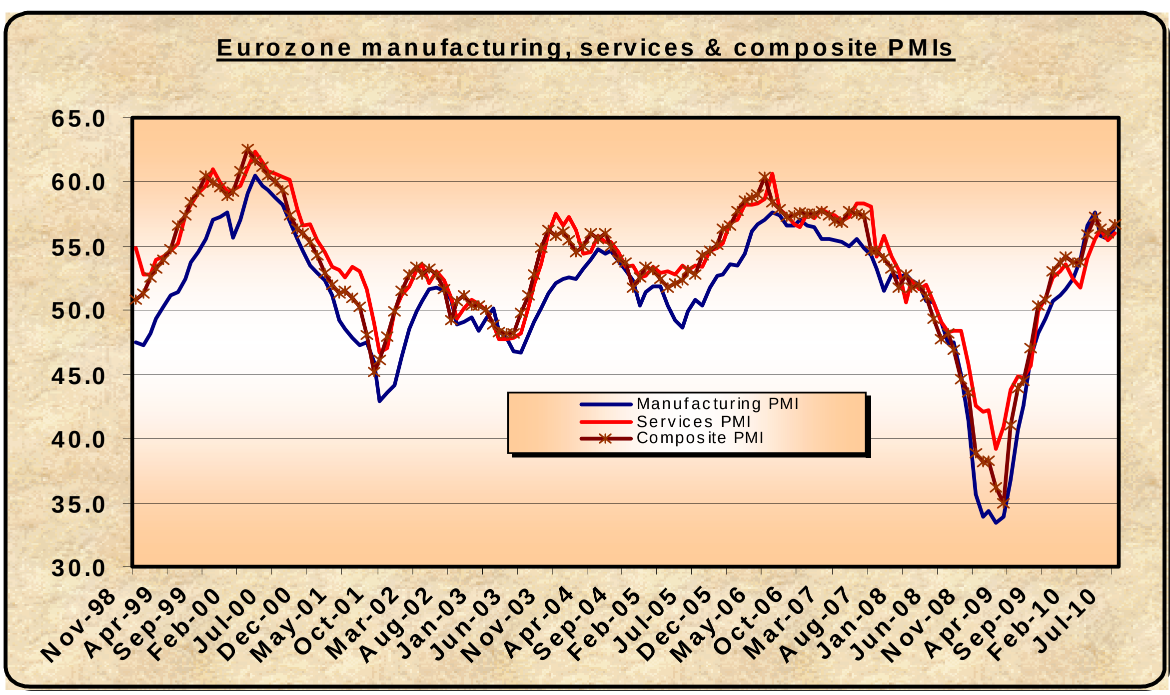
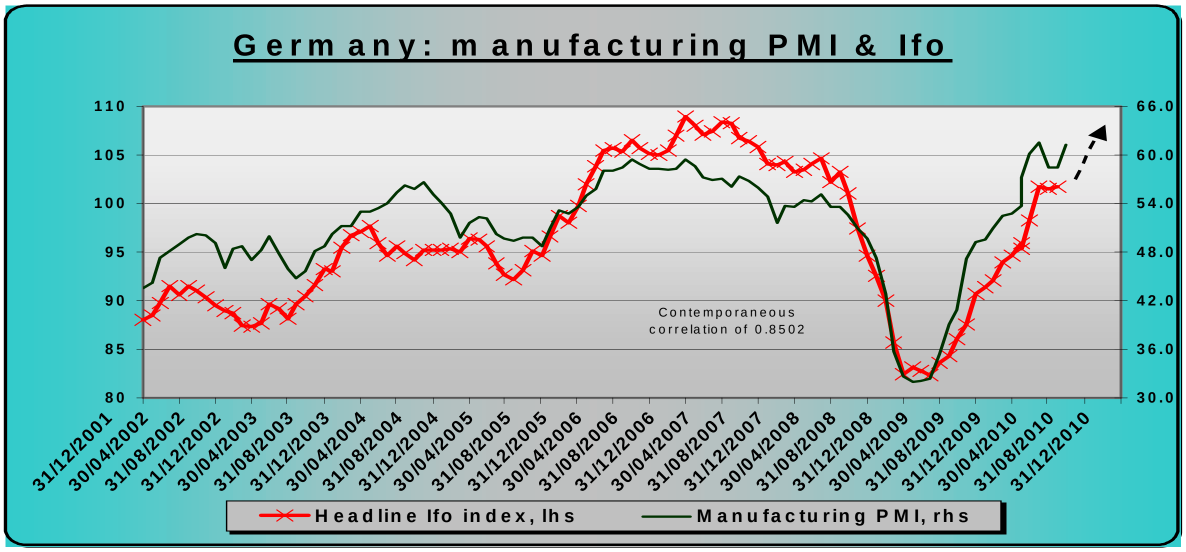
The increases in the Eurozone sectoral PMIs are consistent with recent evidence of the strengths seen in the Eurozone Sentix and German ZEW current conditions sub-indices for Jul. **And we note that stronger advances in Germany have driven the surge in Eurozone activity** for the most part. What's also 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)*