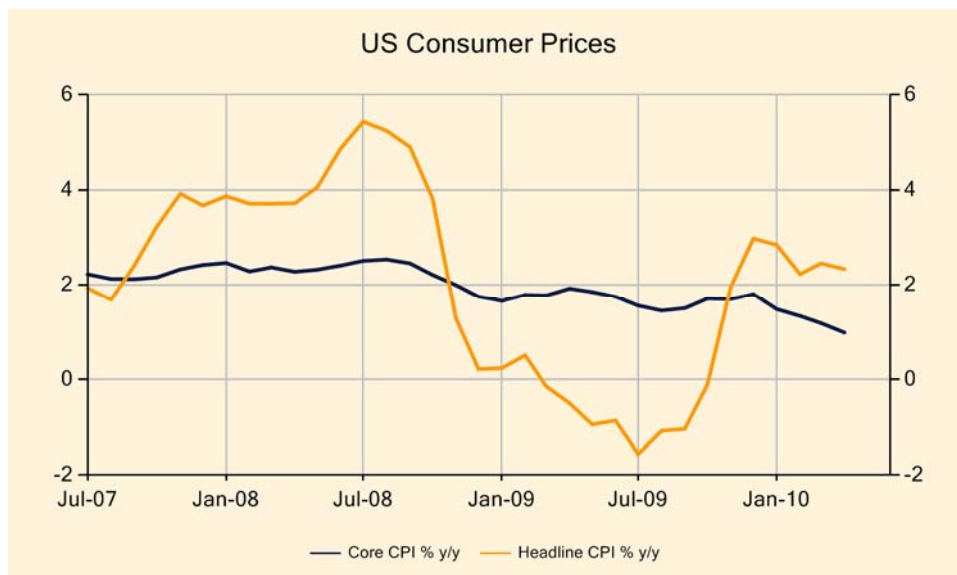


## THE WEEK AHEAD

Last week ended with the big questions about the sustainability of the global recovery still left largely unanswered. US retail sales fell unexpectedly in May by 1.2% m/m, but with consumer confidence stronger than expected, uncertainty about the US economy remains. All the more so as the data released elsewhere also sent conflicting messages, with German manufacturing and industrial orders strong while UK production surprisingly fell. Chinese data was also mixed with retail sales and inflation firm while production was weaker than expected. These contrasting outcomes are keeping markets on edge, although they no longer seem to be regarded as uniformly USD bullish. News out of the eurozone regarding indebtedness issues is also being treated more equivocally, which is also an improvement on the recent past.

In the coming week the data flow is relatively limited, with policy developments probably of greater concern. Even so US CPI data on Thursday will be closely watched given the recent softness of the core rate which fell to 0.9% in April. Any further weakness here will dampen Fed rate tightening expectations, especially after Fed Chairman Bernanke expressed some concern about the pace of the recovery last week. In theory this should be USD negative, but it also contains a double-edged risk as it could also inspire a resumption of global risk aversion. The EUR attempted to rally last week, assisted by ECB President Trichet's confirmation that the ECB will continue to buy eurozone bonds. However, he also dampened expectations of ECB intervention in the FX markets, which leaves the EUR's risks still tilted lower as we doubt the concerns over debt sustainability have been resolved. Austerity measures across much of Europe are being welcomed for now, but these could turn less helpful as the economic price becomes more obvious in coming months. In the coming weeks as well the eurozone faces considerable sovereign and bank refunding pressures, which are more than likely to result in some disappointments on the way. In the coming week Ireland, France and Spain are due to issue debt and any slip up could quickly result in pressure returning on the single currency. Against this background eurozone sentiment surveys as well as the German ZEW index will probably be of secondary interest.



Another policy concern over the coming week is in the UK, where the newly formed Office of Budget Responsibility (OBR) is due to publish its assessment of the UK's fiscal position ahead of the June 22 budget. It may well be that the budget deficit looks slightly better than expected as recent monthly outturns have been slightly smaller than first thought. However, with the OBR also examining the size of off-balance sheet liabilities their incorporation into the national debt creates the potential for a negative surprise. For GBP the question is looming about the impact of severe

austerity measures on growth, and by extension on the path of monetary policy. Should the government seek to rein in the deficit too quickly (as Japan did in the 1990's) then the Bank of England may end up maintaining QE for sometime longer. UK data this week includes a variety of house price indices, labour market data, retail sales and public finance data.

Finally, the SNB and the BoJ will also be in the limelight. The SNB's quarterly monetary policy assessment will be of particular interest with regard to the SNB's attitude to ongoing CHF strength. Unprecedented amounts of FX intervention in May have so far only succeeded in limiting the CHF's rise, not preventing it, which may undermine the SNB's broader mission to keep downward pressure on prices by injecting CHF into the market. Conflicting priorities make the SNB's attempted control of the exchange rate harder to sustain. With regard to Japan, while the BoJ meets in the coming week to set monetary policy, it is the new government's plan for the public finances which is likely to garner most attention following new PM's warning that Japan risks a default if it does not get its fiscal house in order. A plan is intended to be agreed by June 22<sup>nd</sup> and presented at the upcoming G20 meeting later in the month. A credible plan would go some way to boosting confidence and help improve broader market sentiment.

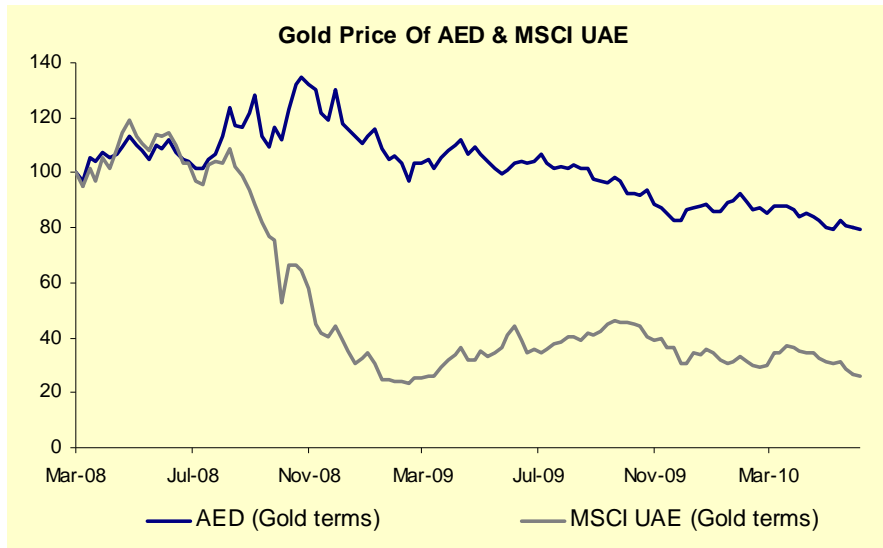
In Emerging Markets, the last week as been dominated by survey-beating inflation data out of China, very robust Indian IP and another 75bps rate hike in Brazil, further disinflation in Egypt, upgrades to the region's GDP outlook by the World Bank and downgrades to UAE bank outlooks by Moody's, including HSBC ME. Looking ahead, we get India's inflation data this week and likely 'no change' decisions on interest rates in Egypt and Turkey. Kuwait's council debates the budget.

China's data provided compelling evidence that growth in Asia remains robust and supportive of strong export revenue growth over 2010/11 in the GCC and wider MENA region. Consumer price inflation was moderately higher than the anticipated 3.0%/y figure for May but core inflation remains well behaved and we continue to believe that the PBOC is unlikely to raise interest rates or revalue anytime soon. Where rates are likely to rise is in India. This week we get the May WPI release. The market is expecting no change (9.6%/y) and the RBI sits on negative real interest rates at a time when risk aversion in global markets is penalizing markets attached to high budget and external deficits. The RBI is widely expected to raise rates at its next meeting on 27 July. Key to whether the RBI raises rates in between meetings will be the combination of risk aversion in markets and the rate of inflation. The former makes it less likely the RBI will hike while the latter the opposite. Either way, the policy making environment for the RBI has become delicately balanced. Either way, the policy making environment for the RBI has become delicately balanced. Inflation is out on 14<sup>th</sup> June.

Closer to the Gulf, the CBE faces a similar environment to the RBI, although with confirmation that headline inflation is receding. Core inflation remains resilient, but comfortable, at 6.7%/y and the headline rate fell from 11.4%/y in April to 10.5%/y in May. The CBE is making its decision at a time when Egypt's capital markets have been hit disproportionately hard – compared with MENA peers – and USDEGP has risen by almost 3% qtd. Clearly the pound's recent fall will be an important input into the CBE's decision on whether to raise rates. We expect no change from the CBE with a statement that places growth concerns above inflation. We noted in *MENA Weekly Risks & Opportunities* (24 May 2010) that Egypt is vulnerable to risk aversion, but short EUR long EGP remains an attractive carry pairing. We retain that position.

Despite the activities of Moody's, sentiment is riding high in the UAE on World Bank forecasts which expect robust recovery in the MENA region. Real GDP growth in the GCC was calculated at 0.2% in 2009 and the Bank expects regional activity to return to trend 4-4.5% in 2011/12. Non-GCC MENA is expected to put in a slightly faster rate over the next 18 months, primarily due to sustained 5-6% growth in Egypt. The Bank sees three downside risks to its outlook; first deeper European distress; two, lower oil prices would follow from the first spreading globally; and three, a slowdown in reforms (particularly budgetary in the non-oil exporting countries).

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