Thoughts on the Data in the Week Ahead and the Foreign Exchange Market

Economic data has been of tertiary concern to the market recently, overwhelmed by the drama in Europe. Given that the drama may die down, with new governments in Greece and Italy, the economic data may become somewhat more important.

U.S.

The US production and consumption data are likely to confirm that the economic momentum from Q3 is carrying over into early Q4. Manufacturing remains a bright spot of the economy. And mining and drilling is also doing well. On the other hand, weakness in real earnings, consumer surveys and chain store sales suggest more moderate increases in retail sales. Consumption in general is unlikely to contribute as much to GDP in Q4 as it did in Q3 (1.7 percentage points, or a little more than 2/3 of the 2.5% growth).

Recognizing the contrasting signals between sentiment indicators and real sector data, the value we assigned to the latter over the former allowed us to anticipate economic improvement recent months. The NY Empire State survey and the Philadelphia Fed survey's are for the month of November and will likely show that sentiment is correcting toward reality, though it cannot be too surprising given recent volatility if the path is not smooth. At the same time, weekly initial jobless claims have fallen in early November to their lowest level since April as is the smoothed four-week average.

The US also reports both producer and consumer prices. **The inflation picture remains benign.** Producer prices have stabilized after the 0.8% rise in September and base effects will allow the year-over-year rate to moderate. Headline, consumer price increases may have peaked. The year-over-year rate has climbed steadily, without falling, since last November's 1.1% increase. It stood at 3.9% in September, but likely slipped in October. The core rate has risen steadily since last October's 0.6% year-over-year pace. It may have ticked up to 2%.
Inflation is remains significantly higher than it was a year ago when the Fed announced a $600 bln Treasury purchase program. **We suspect a renewed threat of deflation is one of the most powerful triggers of a balance-sheet response by the Federal Reserve.**

Flows

The US Treasury will also report the TIC data. **When trying to understand the failure of the dollar to have performed better during the escalation of the European debt crisis, a largely unexpected ECB rate cut a dramatic reduction of the interest rate differential between the US and Germany, the drying up of portfolio capital exports to the US should be part of any explanation.**

Long-term (excludes bills) portfolio capital inflows averaged about $66.1 bln a month last year. Over the last 12-months, the average has slipped to about $39.9 bln and over the last six months, they have averaged $24.3 bln. In the three-months through August, the average slowed further to $23.7 bln.

Even this calculus exaggerates the private sector capital inflows into the US. Foreign central bank holdings of US bonds account for a full half of the inflows the TIC data has captured. Moreover revisions in the past have been from the private sector to official accounts.

The TIC data could be exceptionally weak in September, even though we know the dollar was relatively strong. Recall that in September, the euro depreciated almost 7% and sterling 4% against the dollar. The Swiss franc depreciated by 11%. The Canadian dollar fell 7%. The greenback eked out a small gain against the Japanese yen and appreciated against all the emerging market currencies as well.

September saw many foreign central banks intervene in the foreign exchange market to slow their currencies declines. This required selling of reserves and purchasing local currencies. The Federal Reserve's custody holdings for foreign central banks fell roughly $50 bln in the month of September. Although the TIC data and the Fed's custody holdings report do not necessarily capture the same flows, there appears to be a significant overlap.
More recently, foreign central banks appear to have taken advantage of the stronger currencies to rebuild reserves. It is not public information which countries patronize the Fed's custodial services; however, there was a significant jump in custody holdings following the BOJ's estimated $100 bln of intervention on October 31. On a weekly average basis, the rise in custody holdings over the past two weeks has nearly recouped the amount drawn down in Sept-Oct period.

Japan

There are some reports suggesting that the BOJ has continued to intervene in the foreign exchange market covertly. While possible, it seems that the odds of success are a priori slim. Covert intervention loses its signaling ability and cannot hope to succeed where large overt intervention failed. Arguments that political considerations may have forced Japan to go "underground" seem weak in light of the widespread talk and the fact that Japan's intervention that took place within days of the G20 meeting was unprecedented in terms of scale.

When considering why the yen is so resilient in the face of its economic problems and the further expansion of the BOJ's quantitative easing, various and mostly abstract answers have been provided. **Yen appreciation is a function of Japan's inability to recycle its surpluses.** The key surplus is not to be found in the trade surplus, but in its surplus on the investment income account, including licensing fees, royalties, dividends and coupon payments.

In the Jan-Sept period, Japan imported about JPY10.4 trillion of such capital. Japanese investors exported about JPY7.1 trillion over the same period. However, that is swamped by foreign purchases of about JPY16 trillion (including bills) at the same time.

The yen has appreciated because Japan has not been able to offset the two key sources of demand. First, Japanese investors are repatriating an average of about JPY1.16 trillion yen a month from earnings stream of its foreign investments, Second, foreign investors have also been substantial buyers of Japanese assets, particularly bills. Functionally BOJ intervention acts to recycle the inflows when the private sector is unwilling or unable to perform the task.

The weekly portfolio flow data will be interesting. Japanese investors were buyers of foreign stocks and bonds in the last three weeks of October, but following the BOJ's intervention, they seem to have taken advantage of the stronger yen to repatriate funds at a more attractive foreign exchange rate. Part of the factors that may have undermined the effectiveness of BOJ intervention is that Japanese investors repatriating overseas investment absorbed a full quarter of the intervention.

UK

British inflation is near a peak. Although its firmness did not prevent the Bank of England to resume gilt purchases last month, a decline in inflation is will increase the likelihood that the gilt purchase plan is extended when the current program is completed by February 2012.

Ironically, since the BOE announced the resumption of the gilt purchases, sterling has been the second best performing G10 currency, appreciating 4% against the US dollar, behind the 5.4% advance of the Australian dollar (and that was scored despite an RBA rate cut).

Foreign investors have been significant buyers of gilts in recent months. In September, BOE data indicates foreign investors bought a net GBP12 bln of gilts, the highest monthly figure since June 2010. In the past month, 10-year gilts have been the best performing G10 bond.

Soft UK retail sales and employment reports will underscore the fragility of the British economy. The continued weakness in turn will make the government's fiscal objectives even more difficult to achieve. Yet the apparent new found safe haven status of UK gilts may blunt the impact on sterling. Yet, is the euro zone tensions ebb, sterling may underperform the euro.

Euro Zone

The euro zone reports both growth and inflation figures but neither is likely to be surprising or market moving. The euro zone region may have managed to match Q2 growth of 0.2%, but the various reports suggest the economy finished the quarter with poor momentum and the region as a whole appears to be contracting in Q4.

Euro zone inflation is set to ease as well even if proves sticks in the October release with the headline at 3% and the core rate at 1.6%. The ECB's new staff forecasts to be published next month will likely also point to downward revisions in the trajectory of growth and prices. After the surprise but justified rate cut last month, the ECB is likely to cut rates again in December.

Indicative market prices suggest little chance that the Draghi-led ECB will cut the key repo rate below the 1.0% floor established by the Trichet's ECB. Yet we suspect this question will be ultimately settled by the facts on the ground, such as the extent of fiscal austerity and the depth and duration of the economic downturn, rather than precedent.
There is a large supply of sovereign paper the euro zone to hit the market in the days ahead. Around 20 bln euros of bonds and a little less of bills are likely to be brought to market. **There is substantially more issuance than**

redemptions in the week ahead and this means that a well received auction may be more euro positive than would otherwise be the case.

Monday's small Italian 5-year offer is a bit of a dress rehearsal for Thursday's bond auction. However, the recent sell-off will serve as a bit of a concession and the stabilized political situation in Italy and Greece may allow not only Italy, but Spain and France to raise the necessary funds. It should not be surprising if the German auction do not draw a strong bid-cover in such an environment.

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