Thursday, June 14, 2007

KBC Banking & Insurance

Sunrise Market Commentary

From KBC Market Research Desk - More research on www.kbc.be/dealingroom

- US Treasuries looking for a bottom, but inflation data still hurdle to take
- France considers to raise its VAT by 5%
- Yuan in the spotlight, but yen fades
- A trading day with two faces

Global overview

S&P	↗
Eurostoxx50	↗
Nikkei	↗
Oil	↗
CRB	↗
Gold	↗
2 yr US	→
10 yr US	↘
2 yr EMU	↘
10 yr EMU	→
EUR/USD	→
USD/JPY	↗
EUR/GBP	→

A trading day with two faces

With or without economic data, the least one can say is that price action on global markets was quite remarkable of late and this was also the case yesterday.

Yesterday morning in Europe, bonds again sold off in quite an aggressive way and that left its traces on other markets, in the first place on the stock markets, even if the damage for equities was contained, given the sharp swings on interest rate markets. However, the most remarkable reaction followed the publication of the US import prices and retail sales. Both came out much better than expected. In the current environment, one would have expected a new massacre on the bond markets (with spill-over effects to other markets), but the opposite was the case and yields fell (cf. bond section).

So, later in the session, all other markets changed course too. Especially stocks again showed quite some resilience and strongly rebounded more than recouping Tuesday’s losses. So, there is a good reason to say that, despite the higher interest rates, the appetite to invest in riskier asset classes is still there. This for example is also confirmed by the limited losses on the emerging markets’ currencies. The carry trade story may have lost some prettiness due to higher interest rates, but it obviously didn’t surrender yet.

On the currency markets, the dollar gave back some gains against the single currency, but forced a technical break higher against the yen. So, most important yen cross rates are now back close to the recent highs (low in the yen). Another indication that the carry trade theme is still alive.

In the commodity markets, Brent oil is back at the USD 70 dollar barrel mark. Oil prices, of course, are highly influenced by specific demand and supply factors (US inventories data yesterday), but looking at the stock markets yesterday, also here the resilience of the riskier markets to higher oil price is remarkable.

Quote of the day: “China’s currency is under-valued’, the US Treasury ‘FX report’, declining to name Chine as a currency manipulator.

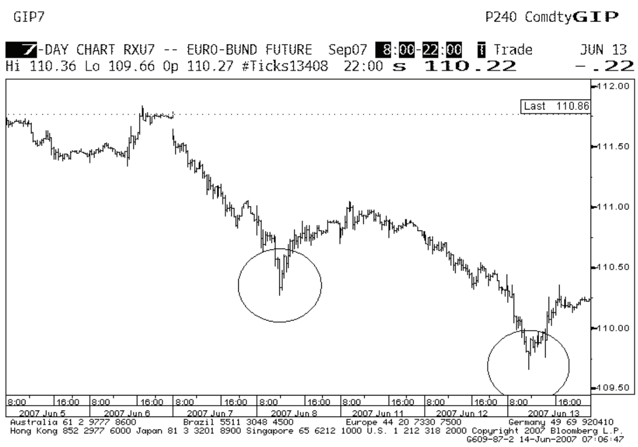
Markets: Fixed Income

	US yield	-1d
2	5.0813	-0.0041
5	5.141	-0.0472
10	5.2084	-0.0717
30	5.2822	-0.0980

	DE yield	-1d
2	4.4770	-0.0410
5	4.5710	-0.0100
10	4.6270	-0.0030
30	4.7800	-0.0020

On Wednesday, global bond markets once more had a nervous wild session, reminiscent to what we saw last Friday. Bonds crashed sharply lower during the European session, but recovered during the US session, as stronger-than-expected US retail sales and higher-than-expected US import prices failed to sustain the sell-off. As a consequence, a corrective profit taking buying wave in the overextended market occurred, pushing bonds higher and suggesting that the market is exhausted and looking for a bottom. While the intra-day movements of Bunds and Treasuries were basically the same, the ultimate daily result differed, partly because of the different opening hours. So, US yields fell by 1.6 to 12.3 basis points, the curve flattening, while in EMU, yields rose by 0.9 to 3.5 basis points, steepening the curve in a bearish fashion.

Intra-day, the Bund opened slightly lower, but the inability to move higher gave way to more selling that escalated and turned into a rout, pushing the Bund to new lows (109.66), slightly before noon. Bonds were moderately higher going to the US data releases. These were bond-unfriendly (cf. above and news section) and Treasuries spiked lower, but the move stalled at the intra-day lows and the lack of follow through selling convinced traders that a correction was at hand, due to huge oversold character of the market. Bonds jumped higher, the longer end leading, as it was the longer end that had been hit the worst in recent sessions. After the initial jump higher, there was more buying and prices steadily rose till about 17.00 CET when sideways trading kicked in. Comments of Dallas Fed Fisher had little impact and the same was true for the Beige Book. The latter showed an economy that is continuing to expand, at the margin maybe somewhat better than painted in the April report.



Bund (7 sessions): Second intra-day resurrection, both during US sessions, suggesting that the market is looking for a bottom.

US Treasuries looking for a bottom, but inflation data still hurdle to take

R2	105 04	-1d
R1	104 18	
T-Bond	**104 10/32**	5/16
S1	104 06+	
S2	103 20+	

Technicals Sep T note future:

The MT technical picture of the Sep-Note future is bearish. A massive double top formation with neckline at 106-06+ is visible on continuation chart with targets at 103-03/102-27+. A move above 106-12/06+ (prev. contract low on daily and continuation charts) would be a positive signal suggesting that the sell-off is over for now. However, a drop below 104-01 (2006 low), currently not confirmed, would only color the picture deeper black. Shorts might consider some profit taking when STMA at 104-18 is broken (closing basis), while a move above 105-15+ (MTMA) would be more relevant.

Support stands at 104-06++ (S1, today low), at 104-00+ (S2, Bollinger bottom), at 103-20+ (S3, sell-off low) and at 103-03/102-27 (S4, targets double top).

Resistance stands at 104-13+ (R1, yesterday high), at 104-18 (R2, STMA), at 105-02 (R2, Friday high), at 105-15+ (R3, MTMA), at 105-29+ (R3, last Thursday high) and at 106-06+/12 (R4, Neckline double top).

The contract is in oversold territory.

Today, the calendar contains the May PPI, the weekly initial claims and the Q1 mortgage delinquencies. There are no Fed appearances of which we are aware.

In the current very nervous market, the inflation data are of utmost importance for trading. Yesterday, the import price inflation was way above expectations, but it is PPI and especially CPI (to be released tomorrow) that really counts.

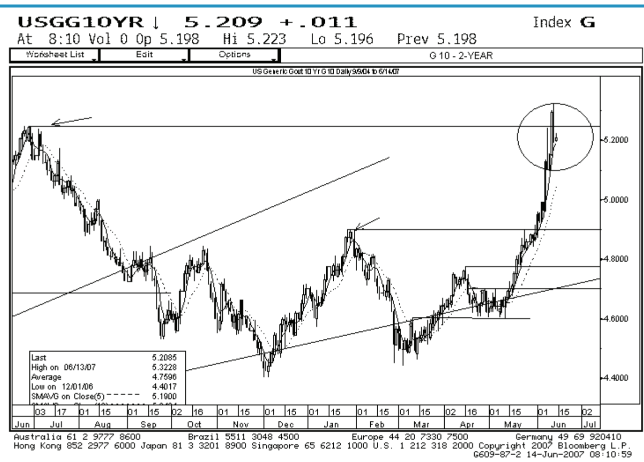
The market expects headline PPI to be up 0.6% M/M (3.6% Y/Y) and core to increase by 0.2% M/M (1.5% Y/Y), following a flat figure in April and March. In the good Fed tradition, it is the core measure that will get the attention. Following two reports that probably understated the trend of core PPI, the market counts on some modest rebound and we see no reasons to distance ourselves from that prospect. The drop in passenger cars and light trucks prices in April should not be sustained and also the drop in drug prices in April looks difficult to duplicate in May. Regarding the headline figure, there is much uncertainty. Energy prices should be higher again, but probably not to the extent of previous months and also food prices, sharply up in recently, probably rose further but at a slower pace.

Initial Claims (312K) were probably little changed last week. The Q1 mortgage delinquencies are no market mover, but with concerns about the sub-prime market still bubbling beneath the surface, one shouldn't completely lose the release out of sight.

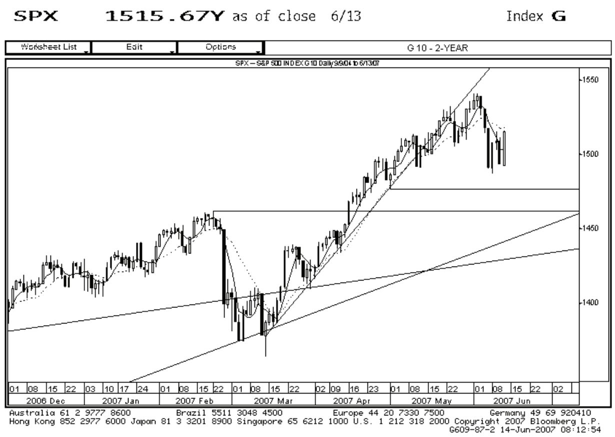
Regarding trading, yesterday the market couldn't sustain the sell-off after strong economic data and even rebounded sharply from intra-day lows. The longer end, hit the hardest recently, led the movement reversing a part of the previous curve steepening. Just like last Friday, the price movement offers the possibility that the downside is exhausted for now and a consolidation/correction may be at hand. The market is indeed hugely oversold. There are some other technical indications that suggest such an outcome. The 104-01 major low on the continuation chart has not been broken on a closing basis and a similar thing is visible in the 10-year yield chart where the eye-catching 5.25% still holds on a closing basis.

So while the technical point to some consolidation/correction in a short-term perspective, the eco data, especially inflation may still postpone such a development. Indeed, as the recent movements were essentially rises in real yields, disconcerting inflation data, not our favourite scenario though, may lead to a final (?) selling wave. So if today's PPI and tomorrow's CPI come out benign (consensus), the current sell-off phase may be over. A close above the STMA (104-18 today Sep future) would be an indication that the worst is over for now, but a move above 105-15+ (MTMA) is needed to give more comfort.

Longer-term, the direction is still for higher yields.



10 year yield: move above 5.25%, not sustained for now. Scope for correction if inflation data don't surprise on upside.



S&P: Nice rebound makes re-run to highs again a possibility, but today's price action crucial.

R2	111.05	-1d
R1	110.5	
BUND	**110.22**	-0.2200
S1	110.08	
S2	109.66	

Technicals September Bund future

The technical picture of the Bund is bearish. A break above 111.05 would be a first signal that some improvement is at hand.

Intra-day, **support** comes in at 110.08/02 (daily channel bottom/daily Bollinger bottom), at 109.67/66 (October 2002 low on the continuation charts/new contract low).

On the topside, **resistance** stands at 110.36 (yesterday's high), 110.50 (STMA), at 111.05 (previous reaction high), at 111.28/34 (MTMA/previous reaction low), at 111.65 (previous reaction high), at 111.84 (previous reaction high) and at 111.86 (daily channel top).

The Bund contract is in oversold territory.

France considers to raise its VAT by 5%

Today, the euro zone calendar contains the May inflation data and labour costs for the first quarter. Euro zone inflation is expected to confirm the flash CPI at 1.9% Y/Y unchanged from the previous two months and equal to the core CPI. As such, euro zone inflation remains below the 2% level for the ninth month running. Over the summer, inflation may still fall somewhat further below 2% due to the favourable oil-related base effect. But from September on, inflation will move back up and that's why the ECB doesn't take much comfort from the recent more favourable inflation data. **The latest inflation projections showed inflation coming out at 2% in both 2007 and 2008, slightly above the ECB definition for price stability. Yesterday, there were some comments of government officials, which suggested that France is considering raising the VAT by 5 percentage points to 24.6% in 2008. Such an increase may have some upward impact on the French and euro zone inflation data, which may put the risks on the upside to these projections.** In this context, labour costs also need to be closely monitored, as the emerging capacity constraints may give way to higher wage demands.

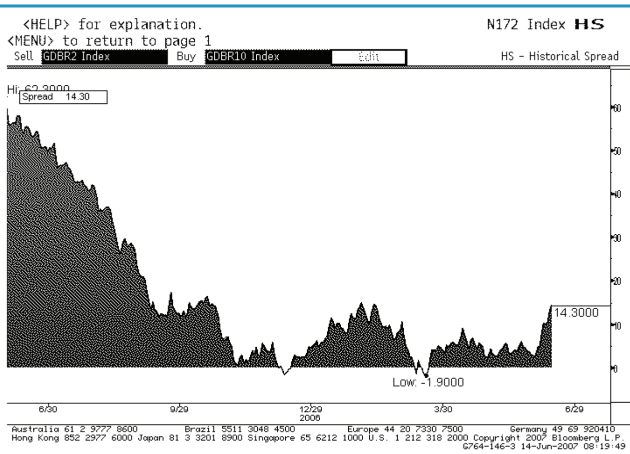
On the ECB front, several ECB governing council members spoke out hawkish yesterday with Garganas saying that the inflation risks are 'clearly on the upside'. Today, ECB's Quaden and Weber will speak, while the ECB monthly bulletin will also be published. The latter usually repeats the introductory statement of last week, but may also include some interesting articles that may provide some further insight in the current monetary policy. Outside the euro zone, the Swiss central bank is widely expected to raise rates from 2.25% to 2.50% and to signal more interest rate hikes to come to ensure price stability and cap the weakening of the Swiss franc.

On the supply front, Italy will tap its 5- and 30-year BTPs for a total amount of EUR 4 B. In line with yesterday's rather strong demand for the new German Schatz, demand should be rather well supported for the BTP auctions too.

Regarding trading, the bear re-steepening of the European yield curve continued yesterday, even while bonds recouped most of the morning losses intraday. This even happened despite stronger than expected US retail sales, which may suggest that the sell-off has become exhausted. The spread between 2- and 10-year yields is now also nearing the top of the sideways range between 0 and 15 basis points, which had been in place since September last year. This along with the oversold conditions and the completion of the inverted head and shoulder formation may lead to some consolidation in yields. **We however continue to trade from a bearish point of view, but prefer a sell on up-ticks approach towards the topside of the downtrend channel at 111.86**

In the UK, Gilts tracked European bonds lower yesterday. **Overnight, the RICS house price balance weakened further in May to 23.9% from 28.5% in April.** According to the RICS, 'affordability conditions are set to worsen across the board and will herald a cooling market. The full impact of rising rates is yet to be felt'.

Today, the retail sales will take centre stage. A slowdown in domestic demand will be needed to prevent the Bank of England from raising rates further.



Spread between 2 and 10 year yields testing the top of the sideways range.

Bund recoups morning losses despite better than expected US data. Is a bottom in place for now?

Currencies: Yuan in the spotlight, but yen fades

R2	1.3375	-1d
R1	1.3333	
EUR/USD	**1.3307**	-0.0003
S1	1.3288	
S2	1.3254	

On Wednesday, the **EUR/USD** pair tried to move lower still. New correction lows were set at the 1.3270 zone; This indicates that pressure is still there to push this pair lower. Ever since the break of 1.3367 support, the technical picture also collaborates with the downward bias. The market sees the US economic recovery and fast rising yields as a supportive factor for the USD. Yesterday though, yields didn't move that way, indicating it may be time for a correction over there. That could cool things down in EUR/USD too.

The **retail sales** showed strong growth, as the headline popped up 1.4% M/M, wiping out the 0.1% decline of April. It was stringer than expected and underscores the USD supportive atmosphere, although the actual reaction was muted. At the same time, import prices also showed upward price pressure, rising 0.9% M/M.

The **Fed Beige Book** in the evening essentially confirmed the prevailing sentiment, but also nothing more than that. The anecdotal evidence showed the expansion continued, with even some regions expanding stronger. Overall wage pressures hadn't increased though and there was no indication of an increase in overall price pressures. This report had no meaningful impact on FX.

We still feel the market is caught dollar short, as it underestimated the potential depth of the present dollar recovery. For us, the prevailing sentiment is one of **buying USD on dips**.

Today, the **PPI** will be looked at, but some caution will be built in for tomorrows' CPI report.

Technicals EUR/USD

Supports stands at 1.3264 (13 Jun low) and at 1.3234 (16 Mar low).

Resistance is seen at 1.3326 (8 Jun low), at 1.3333 (11 Jun low) and at 1.3375 (12 Jun high).

EUR/USD ('07): ongoing correction

R2	123.13	-1d
R1	122.87	
USD/JPY	**122.81**	0.6400
S1	122.49	
S2	122.2	

USD/JPY rose further yesterday, putting the multi year highs at 122.20 to a serious test and this area succumbed to the pounding USD revival story, as the yen is still being sold off as a cheap funding currency.

Yesterday, the US Treasury presented its semi-annual **FX report.** It again refrained from naming China as a currency manipulator but it did take a step forward from last time around as now the yuan was labelled as **'under-valued'**. Also a **legislative bill** was proposed by a bi-partisan group of Senators, aimed at pushing China to let the yuan appreciate faster. The bill would propose a Treasury report not finding out whether a currency was 'manipulated' but just whether it is 'fundamentally misaligned'. Then actions could be taken to remedy this, potentially through Fed interventions.

Apparently these signs of unhappiness from within the US administration/senate are regarded as limited to the yuan situation. USD/CNY indeed set a new low this morning, as this pressure is translated into rates. We however had felt some caution was needed for a potential contamination for USD/Asia and more specifically for USD/JPY. This pair was testing the multi year highs at the time of release, but was unfazed by the limited comments… There is no contamination to fear at all. **The USD/JPY year highs were broken and the US currency built out gains to the 122.80 zone.**

Only a real breakthrough in USD/CNY apparently can kick-start USD/JPY. For now, the market bravely holds open to its carry trade idea of selling the low yielding yen and buying the dollar. Of course the yield spread has only increased between the US and Japan of late as US yields have been skyrocketing lately. This confirms this is still after all a **buy-USD-on-dip environment**. At the same time, the BoJ will publish its rate decision tomorrow morning, but no change is expected and this prospect is comforting to carry traders.

Technicals USD/JPY

The pair broke, through the multi year highs!

Support is seen at 122.49 (today low), at 122.20 (previous year high) and at 121.86 (8 Jun high).

Resistance is seen at 122.87 (13 Dec 2002 high), at 122.97 (3month channel top) and at 123.54 (9 Dec 2002 high).

USD/JPY ('07): breaking to new highs

R2	0.6781	-1d
R1	0.6769	
EUR/GBP	**0.6750**	0.0008
S1	0.6727	
S2	0.6700	

EUR/GBP rose slightly yesterday, as data couldn't hold on the sterling positive momentum. Yesterday, the labour market report showed only subdued wage growth, indicating little inflationary pressures form that angle. This morning the RICS house price balance showed a dip to 23.9 from 28.9. This easing shows that the consecutive BoE rate hikes are having an impact. Such indicators all point to the fact that the BoE should not necessarily be in a hurry to hike rates for now. The CPI also fell back more than expected this week.

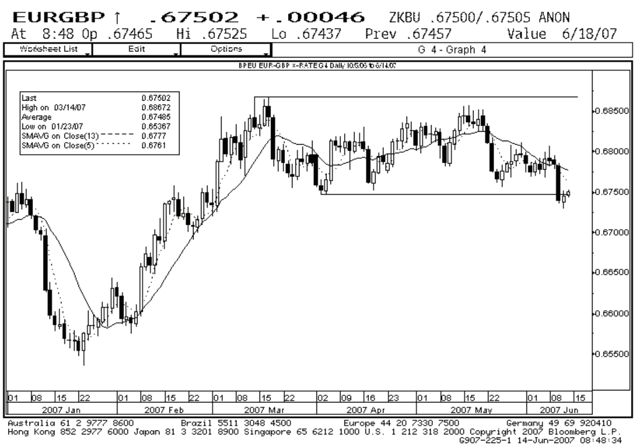
This is not the kind of momentum data-wise that we would see fitting well with more downside for EUR/GBP. This was however our stance, so some caution could be needed even while the EUR/GBP pair hasn't risen on all these data. Still it may have taken away the downward scope short-term. **The technical picture is still showing the pair is testing the boundary lows at the 0.6750 zone…** Today's UK retail sales will be watched closely.

Technicals EUR/GBP

The pair is oversold, trying to break the range lows.

Support is seen at 0.6727 (2 Mar low), at 0.6719 (26 Feb low) and at 0.6700 (22 Feb low).

Resistance is seen at 0.6769 (29 May breakdown) and at 0.6788 (12 Jun high).



EUR/GBP (2007): test is taking too long

News:

US: Strength retail sales surprises

The **May retail sales** showed strong broadly based growth. Headline sales rose by 1.4% M/M following a 0.1% M/M fall in April, while sales excluding cars rose by 1.3% M/M following a 0.1% M/M gain in April. The outcome exceeded expectations for a 0.6% M/M and 0.7% M/M increase. The strength spread across a high number of sectors. Car sales jumped 1.8% M/M despite unit car sales showing a decline, electronics were up 1.3% M/M, building materials increased by 2.1% M/M, gasoline sales 3.8% M/M, but also sporting goods, general merchandise and department sales all rose by 1% M/M or more. **The strong retail sales are another encouraging signal for the US economy that seems to be recovering sharply from Q1 weakness, underpinned by decent consumption growth.** Some of the strength though is a payback for April weakness. So, it might be better to look to the April/may figures as a whole, but even than they should be welcomed with a sign of relief.

Import prices jumped 0.9% M/M and 1.1% Y/Y higher in May, following a 1.4% M/M and 2.1% Y/Y gain in April. The market was looking for a more subdued 0.3% M/M increase. Import prices, excluding petroleum, were up by 0.5% M/M and 2.8% Y/Y. The higher petroleum prices point to an upside risk for headline PPI that will be released today.

Other: Subdued earnings growth continues

In the UK, the **labour market report** showed jobless claims falling 9.3K in May, the 10^{th} decline in 12 months. The number of people in employment for the three months ending in April was however also down 10K over the quarter, but still up 87K over the year. The decline in employment over the quarter is a bit puzzling after five consecutive quarters of firm output growth. Nevertheless, also earnings growth remains rather subdued; as average earnings growth excluding bonuses was unchanged at 3.6% and including bonuses even fell to 4% from 4.4% in the three months through April. **From the labour market, there is still no sign that strong growth and elevated inflation levels may lead to significant higher wage agreements.**

Calendar:

Thursday, 14 June		Consensus	Previous
US			
14:30	**Producer Price Index (May) M/M Y/Y**	**0.6% / 3.6%**	**0.7% / 3.2%**
14:30	PPI Ex Food & Energy (May) M/M Y/Y	0.2% / 1.5%	0.0% / 1.5%
14:30	Initial Jobless Claims (Jun 09)	312K	309K
14:30	Continuing Claims (Jun 02)	2503K	2535K
16:30	Mortgage delinquencies (Q1)		4.95%
UK			
01:01	RICS House Price Balance (May)	A 23.9%	28.9%
10:30	**Retail Sales (May) M/M Y/Y**	**0.3% / 3.8%**	**-0.1% / 4.2%**
EMU			
11:00	HICP (May) M/M Y/Y	0.3% / 1.9%	0.6% / 1.9%
11:00	Labour Costs (Q1) Y/Y	2.5%	2.4%
11:00	HICP – Core (May) Y/y	1.9%	1.9%
Germany			
08:00	CPI – EU Harmonised (May F) M/M Y/y	0.2% / 2.0%	0.2% / 2.0%
France			
08:45	Non-Farm Payrolls (Q1 F) Q/Q	0.6%	0.6%
08:30	Bank of France Bus. Sentiment (May)	109	108
Switzerland			
09:30	**SNB rate decision**	**2.50%**	**2.25%**
Events			
06:00	BoJ Monetary Policy Meeting		
10.00	ECB Quaden delivers Belgian economic report		
10:00	**ECB Monthly Report (Jun)**		
10:30	Bank of England inflation attitudes survey		
14:00	US Paulson delivers remarks in New York on National Security		
14:30	Fed holds Washington Hearing on Mortgage Regulations		
21:40	**ECB's Weber on Germany's economic prospects and European monetary policy**		
Italy	**BTP Auctions 4% Apr12 and 4% Feb37**		

10-year	td	- 1d	
US	5.21	-0.07	
DE	4.63	0.00	
BE	4.69	-0.01	
UK	5.47	0.02	
JP	1.98	-0.02	

2 -year	td	- 1d
US	5.08	0.00
DE	4.48	-0.04
BE	4.49	-0.02
UK (3yr)	5.81	0.00
JP	1.23	0.00

STOCKS		- 1d
DOW	13481.95	186.86
NASDAQ	2582.31	32.54
NIKKEI	17842.29	109.52
DAX	7678.26	-27.84
DJ euro-50	4401.68	18.66

IRS	EUR	USD (3M)	GBP
3y	4.765	5.559	6.262
5y	4.813	5.651	6.185
10y	4.909	5.809	5.896

Eonia	4.08	0.29
Euribor-1	4.11	0.00
Euribor-3	4.15	0.00
Euribor-6	4.28	0.01

3-m f.	1st	- 1d	2nd
euro	95.845	0.00	95.645
dollar	94.640	0.00	94.630
sterling	94.140	0.01	93.920

Currencies		- 1d
EUR/USD	1.3307	-0.0003
USD/JPY	122.81	0.64
GBP/USD	1.9715	-0.0025
AUD/USD	0.8384	-0.0027
USD/CAD	1.0674	0.0009

Currencies		- 1d
EUR/JPY	163.39	0.80
EUR/GBP	0.6749	0.0008
EUR/CHF	1.656	0.0010
EUR/SEK	9.392	-0.02
EUR/NOK	8.0925	-0.03

Commodities	CRB	GOLD	BRENT
	311.68	650.75	70.08
- 1d	1.97	3.35	1.50

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