



- Strong U.S. payrolls jolt Treasuries, boost stocks
- U.S. labor market report – broad-based improvement
- Global PMIs—China to the rescue
- ECB pauses amidst continued low inflation
- Renminbi in focus
- Bitcoin update

**1. Strong U.S. payrolls jolt Treasuries, boost stocks:** Yesterday's ADP [report](#) and today's strong June figures (see below) propelled the Dow to a fresh record and added over 10bp to 10yr cash bond yields. The jump in forward rates has been more pronounced at longer maturities, steepening the yield curve slightly (Chart 1.1). This suggests a bit more optimism on growth prospects, but no significant change to the expected timing of Fed exit—the probability of a June 2015 rate hike as reflected in Fed funds futures is little changed from last week's levels. [Remarks](#) from Fed Chairman Yellen yesterday—which suggest that concerns about financial stability are not at a level that would prompt policymakers to bring rate hikes forward—have likely played into this view.

Rising hopes for stronger U.S. growth, coupled with reassurance that U.S. rates aren't likely to rise much faster than expected, have been good for risk trades. European equities have done even better than the U.S., while peripheral Euro Area bond spreads have narrowed, as have EM sovereign and corporate bond spreads.

The U.S. dollar has also gotten a lift from the strong jobs report, but the euro/dollar exchange rate remains well within the \$1.35-\$1.40 range that has prevailed for most of this year. The strength of the euro, despite the sharply widening gap between U.S. and Euro Area forward rates (e.g., the differential between German and U.S. 2yr forward rates—Chart 1.2), is likely to remain a source of concern for the ECB.

New post-jobs report highs for mature market equities continue a global liquidity-driven risk-on run, with recent economic data (including global PMIs—see below) boosting hopes for the recovery. The strength in sterling (up over 3.5%ytd on growing expectations of a BoE rate hike) is another reflection of this optimism. But will equity market returns live up to these expectations in the second half of 2014?

Chart 1.3 shows a fairly standard calculation of expected equity returns vis-à-vis year-to-date performance of selected mature markets and BRICs. Expected returns are calculated as the sum of the real equity risk premium, current real 10 year yields and latest CPI print. The real equity risk premium is the sum of the earnings growth (IIF GDP growth forecast) and the dividend yield for each index less the real bond yield.

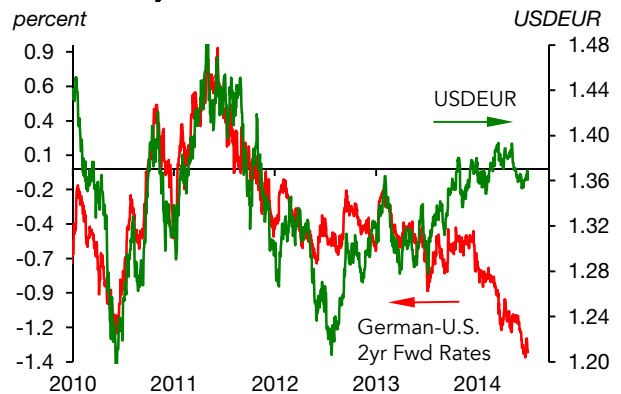
Broadly, equity markets in the U.S., Europe and India (helped by market-friendly elections) have delivered results at or above these calculations, while the Nikkei and remaining BRICs have notably underperformed. From an investment perspective, a key question is whether some catch-up from the under performers will be seen in H2 .

**1.1 U.S. One-Year Forward Yield Curve (10yr-2yr)**



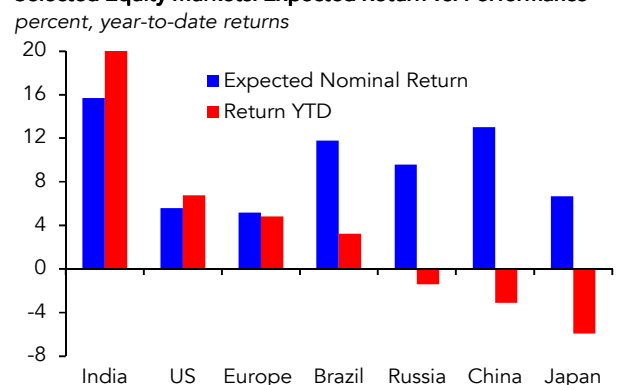
Source: Bloomberg, IIF calculations

**1.2 German-U.S. 2yr Forward Rates and USDEUR**



Source: Bloomberg, IIF calculations

**1.3 Selected Equity Markets: Expected Return vs. Performance**



Source: Bloomberg, IIF calculations.

**U.S. labor market report – broad-based improvement**

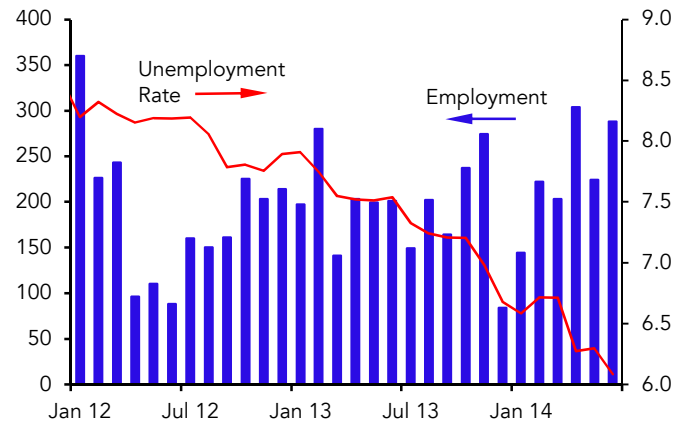
**2. U.S. labor market report – broad-based improvement:** After last week’s disappointing Q1 GDP release, Thursday’s labor market data sent a strong positive signal. Employment gains were greater than expected in Q2, with June printing 288k and the prior two months revised up by a cumulative 29k. The unemployment rate declined two ticks to 6.1% in June, while the labor force participation rate held steady (Chart 2.1). Employment gains were broad-based, with the diffusion index for industries with job growth climbing to 64.8 (up from 58.7 a year ago, with 50 = neutral). 2014Q2 also saw solid gains in total wages (proxy for income) and total hours worked (rough proxy for output), supporting the notion of a rebound in growth in the quarter just ended. Over the past four quarters, U.S. real GDP grew by only about 1½%, while job gains averaged a solid 208k, implying very weak productivity growth. Today’s data reaffirm that labor market slack is being absorbed at a rapid clip, which should support gains in wages and pave the way for further steps towards Fed exit. We maintain our Fed call for a first rate hike in June 2015, with the federal funds rate ending the year at 1%, but we remain concerned that markets will start to anticipate an earlier and steeper exit than currently priced in, possibly triggering an abrupt rise in bond yields.

**3. Global PMIs—China to the rescue:** The June round of [Manufacturing PMIs](#) brought overall welcome news with our weighted global average rising to 52.4 (up from 52.2). Of particular note, the emerging market aggregate rose back above the 50-mark for the first time in four months. However, this was solely driven by an increase in the China HSBC PMI to 50.7 (above 50 for the first time this year), in line with our forecast of stronger growth after a weak Q1. Results across other EMs were rather disappointing, with the index falling below 50 (Chart 3.1), primarily driven by weakness in Emerging Europe. Turkey’s fall to a three-year low of 48.8 stands out in particular, but the declines in Poland, Hungary and the Czech Republic are also of note, possibly signaling increased concerns about the lingering situation in Ukraine (even though the Russian PMI recovered slightly to 49.1). Other EMs registering declines in PMI in June included Brazil (48.7), Mexico (51.8) and South Korea (48.4).

The G3 aggregate remained strong in June. Japan’s level rebounded to 51.5, providing some hope that the post-VAT hike slump may be short-lived (Chart 3.2). Sentiment in the U.S. remained strong, lending support for our view that growth will pick-up after a disappointing [first half](#). The slight decline in the Euro Area PMI was confirmed but probably more interesting are the intra-regional divergences, in particular between buoyant Spain (54.6) and deflating France (48.2)—a sharp contrast to the respective fortunes of these countries in the World Cup over the past two weeks.

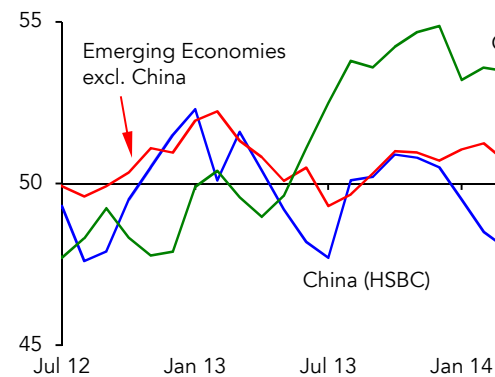
**4. ECB pauses amidst continued low inflation:** Following last month’s major announcements, and with flash June HICP inflation remaining unchanged at 0.5%oya (Chart 4.1), the ECB delivered no new initiatives at today’s meeting. Core inflation edged up by 0.1pp to 0.8% due to higher services prices, but the decline in import prices—not least reflecting the strong euro — as well as the remaining large slack in the economy (the

**2.1 U.S. Nonfarm Payroll Employment and Unemployment Rate**  
thousand, change from previous month      percent of labor force



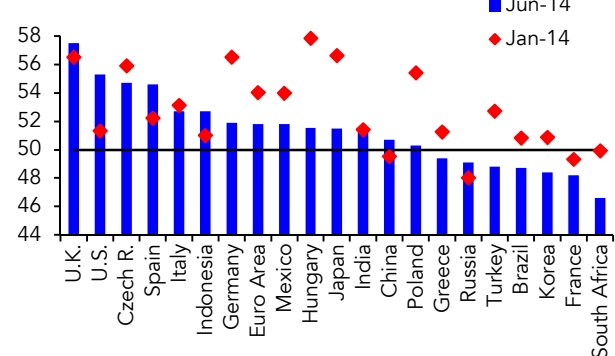
Source: Bureau of Labor Statistics

**3.1 Manufacturing PMI**  
index, 50=breakeven



Source: Bloomberg, Datastream, Markit Economics, IIF Calculations.

**3.2 Manufacturing PMI: Jan. 2014 vs. Jun. 2014**  
index, 50=breakeven



Source: Bloomberg, Datastream, Markit Economics.

**Renminbi in focus**

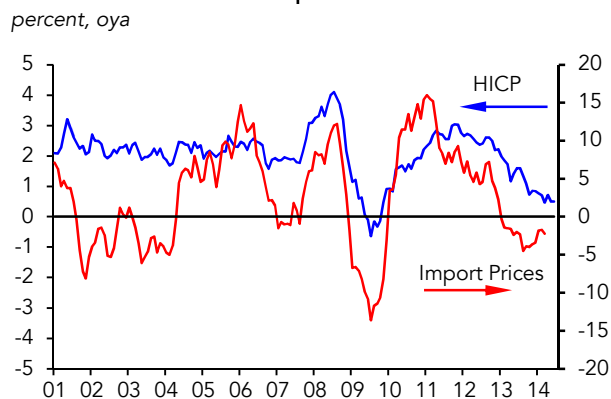
unemployment rate was unchanged in May at 11.6%, just 0.4pp lower than a year ago) is still exerting downward pressures on inflation. Also, bank lending continued to decline on both a sequential and annual basis in May, albeit at a slower pace. However, in his press conference ECB president Draghi conveyed confidence that the TLTROs announced last month (and available in eight tenders from September of this year until June 2016) will have a significant impact on both growth and inflation. He presented more technical information about the TLTROs and gave the impression that the funds would be very attractive to banks. Overall, the ECB has managed to significantly lower expectations regarding the future policy interest rate path over the past couple of months, and in particular since May (Chart 4.2).

**5. Renminbi in focus:** With Chinese equities (-1.5%ytd) underperforming both developed and emerging markets (+5.5-6% ytd), prospects for Chinese growth continue to be closely scrutinized (see our new research note, "[China: Targeted Policy Easing Supporting the Economy](#)"). Against this backdrop, this week's upturns in the June manufacturing (see above) and [services](#) PMI have sent encouraging signals. A weaker renminbi has also helped: the mid-March RMB band widening, together with steps to engineer a sharp depreciation in the RMB in late February and March have helped discouraged carry trade inflows. For example, Chinese bond mutual funds saw net outflows of \$1.2 billion in February-March—triple the pace of the previous two months. This has contributed to a substantial moderation in net purchases of foreign exchange by the central bank and financial institutions in recent months (Chart 5.1). Overall, the RMB weakened 3% between February and early June, helping support the export sector (Chart 5.2).

The Chinese government also continues to take gradual steps to support the international use of the renminbi, including the use of RMB to invoice and settle foreign trade, development of offshore RMB centers and hubs, support for dim-sum bond markets and reducing restrictions on access to China's capital markets for foreign investors. This week's [agreement](#) between China and South Korea introducing direct trading between the won and the yuan in Seoul is the latest in a series of such steps. Approved South Korean institutional investors will be able to invest up to RMB80 billion (\$13 billion) in Chinese equities—a similar quota to those given earlier to Britain and France.

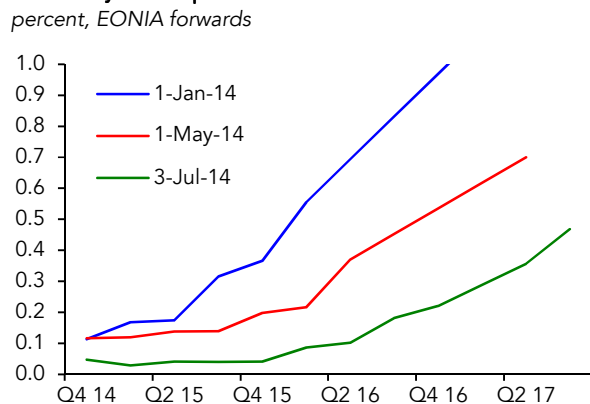
**6. Bitcoin update.** The world's most prominent cryptocurrency has continued its wild ride in recent months (see our January CMM feature—"[Bitcoin—Tulip Mania or Revolution?](#)"). On February 25, bitcoin experienced a significant setback after Tokyo-based Mt. Gox,—once the world's largest bitcoin exchange—shut down. Mt. Gox announced that it had lost ap-

**4.1 Euro Area - Consumer and Import Prices**



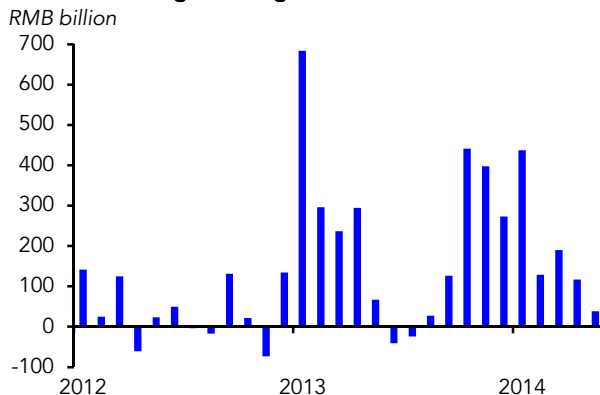
Source: Datastream.

**4.2 ECB Policy Rate Expectations**



Source: Bloomberg.

**5.1 China: Net Foreign Exchange Purchases**



Source: PBOC

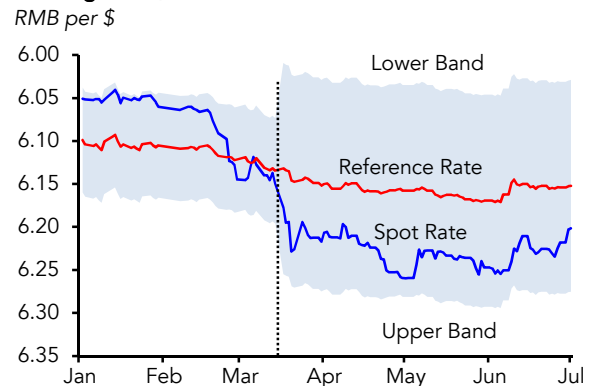
## Bitcoin update

proximately 850,000 bitcoins—a market value close to \$500 million and 7% of the total projected global supply—in a hacking attack. Since then the company's CEO revealed that he has "rediscovered" 200,000 bitcoins; a police investigation is still under way in Japan to determine the reasons for the disappearance and the exact number of bitcoins that vanished. In March Bitcoin faced additional setbacks when the Japanese government announced that it was not a currency and prohibited commercial banks from providing it to customers.

However, bitcoin has proven resilient, rebounding from an intraday low of \$340 on April 11 to \$658 on July 1 (Chart 6.1), propelled by several positive developments. Last month, California—home to an estimated 40% of all bitcoin-related jobs in the U.S.—passed a law that legalizes the use of bitcoin in transactions. In addition, a growing number of businesses have announced that they are now accepting bitcoin, including Expedia, one of the world's largest online travel companies (initially for hotel bookings only), and Newegg, a \$2.8 billion online computer hardware and software company. Moreover, a number of industry analysts maintain that the recent U.S. government auction of the virtual currency seized from the Silk Road (an online black market) was in fact a legitimizing activity.

With an estimated 60,000 online retailers worldwide now accepting the virtual currency, bitcoin is arguably moving closer to acceptance as a general-purpose currency. Apple Inc. also gave a big boost to the currency's legitimacy when it recently approved the return of bitcoin-related apps to its App Store—allowing users to send and receive bitcoin from their iPhone or iPad. Further steps towards greater acceptance were taken when Yahoo and Google added bitcoin's conversion price to their financial tools. Nevertheless, it remains to be seen whether these recent developments will have a material positive impact on bitcoin's adoption rate over the long-term and—more importantly—how national and international regulation, as well as tax treatment, will influence its legitimacy and functionality going forward.

### 5.2 Exchange Rate, 2014



Source: PBOC, Bloomberg.

### 6.1 Bitcoin Prices on Major Exchanges (Daily Highs)



Source: Bitcoincharts.com.

**GEM Teleconference “Where is the global economy heading in 2014H2?”**

We will be discussing the implications of the weak 2014H1 growth outcomes and the macroeconomic implications of a potential reversal of risk appetite on emerging markets (“**What could a Taper Tantrum 2.0 look like?**”), drawing on our July **Global Economic Monitor**, to be released on Wednesday, July 9. The **conference call** will take place on Thursday, **July 10 at 9:00 am U.S. Eastern Daylight Time** (2:00 pm London/3:00 pm Frankfurt/9:00 pm Beijing/10:00pm Tokyo). During the call Charles Collyns and Felix Huefner will present the main themes of the GEM and take questions from participants.

To connect yourself to the call dial: **Toll/International: 1-(817) 382-4538 or U.S. and Canada toll free: 1-(855) 596-0279**. You will be connected to an automated operator who will ask you for the title and the passcode for the call, as well as your name and affiliation. Title: July GEM call and passcode: **70822840**. You will then be connected to the call.

If you would like to participate in this teleconference, please send an email to Litia Shaw at [lshaw@iif.com](mailto:lshaw@iif.com) as soon as possible. The publication will be sent to all registrants prior to the call. The teleconference will be recorded and made available for replay to IIF members after the call. Let us know if you have any questions.

**What to Watch For Next Week:**

Monday: Germany IP (May)

Tuesday: U.K. IP, Japan Economy Watcher Survey, Brazil CPI (June)

Wednesday: U.S. FOMC Minutes, China and Mexico CPI

Thursday: Monetary Policy Meetings (Indonesia, Korea, Malaysia, Peru, UK), France and Italy IP (May)

Friday: Mexico Monetary Policy Meeting, India and Mexico IP

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