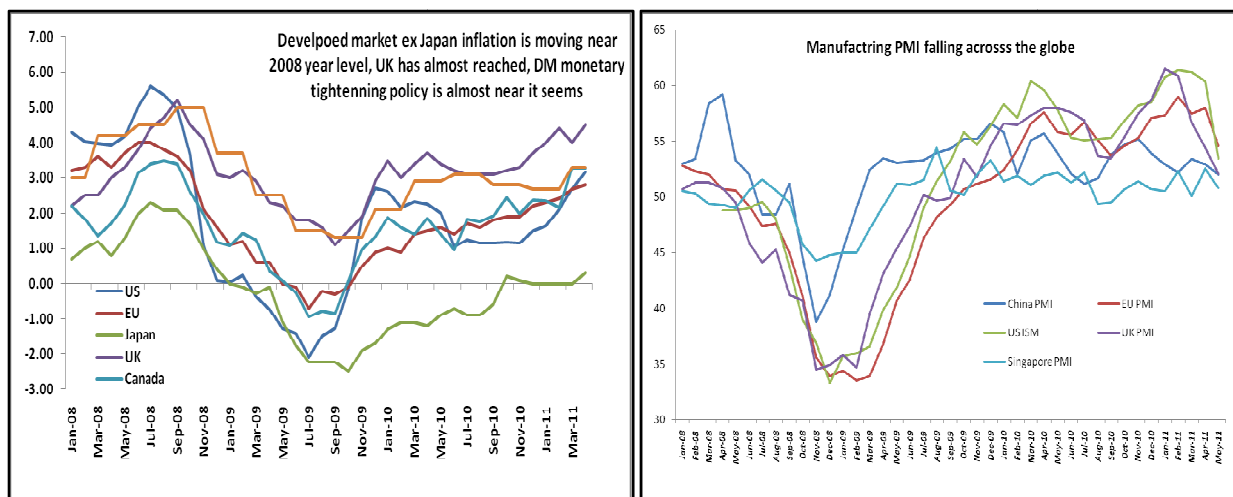


The starting of June was disappointing from economic data perspective. As per reports released on 1<sup>st</sup> June, Manufacturing PMI across Europe, US and Asia fell during May.

China known as the major consumer for metals and energy has seen manufacturing activity slowing down for second straight month in May. Chinese manufacturing PMI fell to 52.0 in May from 52.9 in April. It is evident that the world's second-biggest economy is slowing marginally but does not point to a sharp slowdown in its vast manufacturing sector. Chinese inflation is still above 5% which may prompt PBoC (People Bank of China) for further monetary tightening. China's economy has entered a tough period in June, with the drought crisis and power outages. Enduring high inflation pressures and uncertainties in external liquidity also add to the need to combat excessive price gains rather than maintain growth

In Europe, apart from public debt concern from Greece, Portugal, Ireland, Spain and Italy, slowing down of manufacturing activity has a reason for concern. The Inflation in the common area rose to 2.8% above the target rate set by the European central bank. The ECB which has more focus on price stability compared to Bank of England. Fuelled by a spike in energy costs as well as for raw materials, the ECB lifted its benchmark interest rate from 1% to 1.25% with a further quarter-point rise expected over the summer. Rise in rates along with public debt concern may further dampen the manufacturing growth in the common currency area. As per reading of May, EU Manufacturing PMI dropped to 54.6 from 58.0 in April. The fall in the index was the largest since November 2008.

Moving to UK, manufacturing PMI read at 52.1 in May, from a downwardly revised 54.4 in April. Growth in Manufacturing in the UK is the slowest pace in last 20 months. The UK is now witnessing a high level of inflation with CPI slightly below 5%. Inflation expectation are growing in the economy with rise in commodity prices, however the BoE is still very cautious on taking any step towards monetary tightening. UK GDP growth for 1<sup>st</sup> quarter is expected at 1.8% as per estimates.

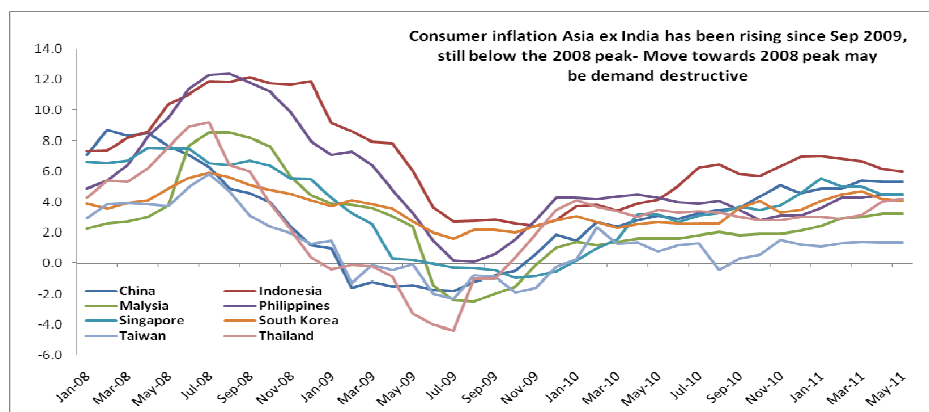


Source-Bloomberg, JRG analytics

In US, the US Institute for Supply Management's manufacturing index also came lower than the previous month, with a May reading of 53.5 compared April's reading of 60.4. Most of the developed market except Australia and Japan has a reading of 50 in their PMI till now, which shows expansion, otherwise contraction. As inflation is heading up, any monetary tightening may hinder expansion of manufacturing sector and may lead to further softening. We do not see any tightening policy further in US and UK for next 2-3 months, but sentiment may build up in the market as ECB set for rate hike in July meeting.

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In emerging Asia, most of the economies are witnessing higher inflation and now with manufacturing slowdown. Headline inflation in Asia ex Japan has been rising rapidly since the second half of 2010, reaching a 29-month high of 5.8% in March 2011. While food inflation has been driving headline inflation higher, core inflation pressures have also been elevated, tracking at a high of 3.9% in March 2011. The process of taming inflation will ultimately be damaging to growth. The results seem revealed now. As per recent data Purchasing Managers' Indices for India, Korea, Taiwan and Singapore all worsened.



Source-Bloomberg, JRG analytics

In India, the HSBC Markit PMI based on a survey of around 500 companies; fell to 57.5 in May from 58.0 in April. It was the lowest level since it hit 56.8 in January. The decline was less than those of developed market. South Korea manufacturing growth dropped to its slowest pace in six months, with HSBC's PMI falling to 51.2 from 51.7. Taiwan's had a similar drop with the HSBC PMI falling to 54.9 in May from 58.2 in April. In Singapore, the index dropped 1.7 points to 50.8 in May, from 52.5 in April. In Asia pacific, Australian AIG May PMI fell to 47.7, a contraction for 3<sup>rd</sup> Month. Nine out of the 12 manufacturing sub-sectors recorded declines in activity during the month, with the clothing and footwear sub-sector recording the steepest contraction, followed by the chemical, petroleum & coal products sub-sector.

Another critical factor need to be mentioned is the end of Quantitative easing by the Federal Reserve Bank, US which has been a major driver rise in global commodity prices. Last November, the Fed announced that they would buy an additional \$600 billion of long term treasuries (\$75 billion each month) pumping liquidity in the market and keeping the market rate of interest at lower levels. These purchases are scheduled to be completed by the end of June which will provide further clarity about the trend of markets.

### New market Buzz QE3, less likely in our view

Now the market is speculating QE 3<sup>rd</sup> is coming after string of weak economic data from the US. Speaking to a group of international bankers in Atlanta, Bernanke said the recovery in the US economy is "uneven" and "frustratingly slow". Bernanke said US interest rates would remain low for some time to come but the government's \$600bn (£365bn) "quantitative easing" (QE2) stimulus plan would run out this month as planned.

The US economic recovery has been temporary. The economy has been highly reliant on government stimulation, both fiscal and monetary. Not only is the fiscal stimulation now petering out, but as the acrimonious discussions in Washington indicate, fiscal policy is highly likely to become more restrictive from here on. Now QE2 is about to end as well. It is instructive that when QE1 ended in the spring of 2010, the market dropped 17% and the economy faltered. It was only with the announcement of QE2 that the market began to recover strongly and the economy perked up, although not by much. It is notable that with all of the massive stimulation, the economic recovery has been by far the weakest in the post-World War II period.

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After weak economic data around sectors, market expected fed may come with another round of quantitative easing named "Q3" However, a key consideration is that with the Fed balance sheet already having ballooned above \$2 trillion, any program that increases it even more makes it that much more difficult to exit when the time comes. In addition, any move to initiate QE3 is likely to meet substantial opposition in congress as well on the FOMC itself.

Fed's focus has been more on unemployment and risk of deflation when they come with QE 2<sup>nd</sup>. It drove up prices but failed to bring any significant changes in short term employment boost. The rebound in core inflation means that the risk of imminent deflation is much smaller than it was last year when QE2 was introduced. The rise in the annual rate of core PCE inflation hasn't been dramatic, from a low of 0.7% late last year to 1.0% in April. But looking at inflation over a shorter time horizon, the three-month annualized rate has climbed from just 0.2% at the time the Fed agreed to QE2 to 1.9% in April.

We believe no fresh QE may come into picture and it may halt US dollar's decline. However, any rise in rates in EU and hawkish stand by the BoE may put some downside pressure to US dollar.

The easing of growth in emerging countries as well as developed markets such as EU and UK suggest rise in interest in US dollar as "safe haven instrument".

From Indian perspective, the US dollar recovery globally may limit decline in USDINR. Apart from that with a weak current account, slowing manufacturing, fear of capital account inflow due to bearish stock market outlook (short term) may put pressure to Indian rupee. We believe downside in USDINR will be limited and up move till 46.00 is possible in the short term (2-3 months) frame, given QE 3<sup>rd</sup> is not implemented.

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