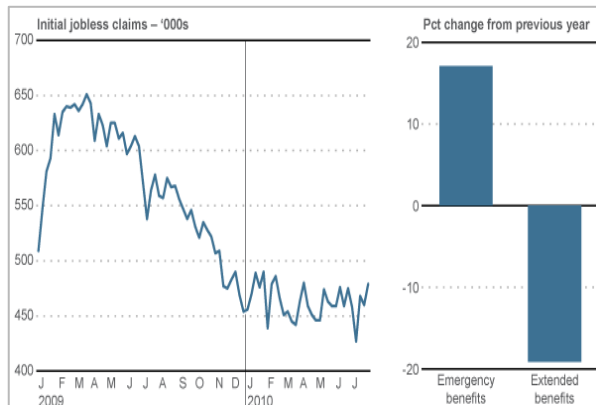


CHART OF THE DAY

U.S. initial jobless claims



U.S. initial claims for state unemployment benefits rose 19,000 to a seasonally adjusted 479,000, the Labor Department said. That compared to market expectations for a drop to 455,000.

TODAY'S TOP NEWS

- U.S. jobless claims rise, cast a pall on economy
- ECB Trichet: data strong but crisis battle not won yet
- U.S. CP market shrinks, dollar funding costs ease
- U.S. mortgage rates hit record lows - Freddie Mac
- Japan bank buying helping to push down U.S. yields
- Canada's Flaherty: C\$ rise "makes sense"
- Bank of England holds rates steady as expected

ECON WATCH

FOR FRIDAY AUGUST 6

| ET | Indicators | Unit | Reuters | Prior |
|-------|---------------------------|------|---------|-------|
| 4:30 | GB Industrial output mm | % | 0.2 | 0.7 |
| 4:30 | GB Manuf output mm | % | 0.4 | 0.3 |
| 4:30 | GB PPI Input prices mm | % | -0.5 | -0.2 |
| 4:30 | GB PPI output prices mm | % | 0.0 | -0.3 |
| 4:30 | GB PPI Core Output mm | % | 0.1 | -0.3 |
| 5:00 | IT GDP prelim qq | % | 0.4 | 0.4 |
| 6:00 | DE Industrial output mm | % | 0.7 | 2.6 |
| 7:00 | CA Employment change | k | 15.0 | 93.2 |
| 7:00 | CA Unemployment rate | % | 7.9 | 7.9 |
| 8:30 | US Non-farm payrolls | k | -65 | -125 |
| 8:30 | US Manufacturing Payrolls | k | 10 | 9 |
| 8:30 | US Private Payrolls | k | 90 | 83 |
| 8:30 | US Unemployment | % | 9.6 | 9.5 |
| 8:30 | US Avg hourly Earnings | % | 0.1 | -0.1 |
| 8:30 | US Average work week | hrs | 34.1 | 34.1 |
| 15:00 | US Consumer credit mm | bln | -5.00 | -9.15 |

MARKETS TODAY

TODAY'S TOP STORY: New U.S. claims for unemployment benefits unexpectedly rose last week to the highest level since early April, highlighting a weak labor market and the fragile economic recovery.

For more please click here

TREASURIES: U.S. Treasuries rose after an unexpected rise in weekly new jobless claims fueled worries about the labor market and bolstered the safe-haven appeal of government debt.

- 10-yr Treasury notes rose 14/32 to yield 2.91 pct, down from 2.96 pct, while 30-yr bonds were up half a point to yield 4.06 pct from 4.09 pct.
- 2-yr rose 3/32 to yield 0.53 pct, down from 0.57 pct on Wednesday.
- 5-yr Treasury notes were up 7/32 to yield 1.57 percent.
- 2-10's part of the yield flattened by about 1 bps to 238 bps.

FOREX: The dollar edged lower versus the euro, as investors avoided building large positions a day ahead of a U.S. payrolls report that markets hope will offer fresh insight on the state of the economy.

- Euro rose 0.31 pct to \$1.3193 after earlier rising as high as \$1.3234 but fell against the yen to 113.18 yen, down 0.33 pct.
- Against the yen, the dollar fell 0.59 pct to 85.80 yen, just over a yen off a 15-year low.
- Sterling was little changed at \$1.5892 after hitting a six-month high above \$1.59 this week.
- New Zealand dollar fell 0.75 percent to \$0.7286.
- The dollar index fell 0.18 pct to 80.744 not far from 3-month low of 80.46 hit on Tuesday.

CORPORATES: U.S. corporate bond spreads edged wider as the market absorbed a surge of new debt sales on track to exceed \$30 billion this week.

- The CDX.IG-14 index widened to 102 bps from 100 bps.
- Hess sold \$1.25 bln notes yielding 5.65 pct and Ferro sold \$250 mln notes yielding 7.87 pct.
- Volkswagen International Finance launched \$1 bln of 3-yr notes at a yield spread of 93 bps and 10-yr notes at a yield spread of 120 bps.
- However, the financial sector was the most actively traded segment of the investment grade corporate bond market.

STOCKS: U.S. stocks edged lower as an unexpected rise in initial jobless claims and unimpressive July retail sales dimmed optimism a day ahead of the monthly payrolls report.

- Dow fell 0.05 pct to 10,675.06, S&P lost 0.13 pct to 1,125.76 and Nasdaq slid 0.46 pct to 2,293.06.
- S&P retail index rose 0.57 pct following the retail sales report which was up by 2.9 pct but missed analysts expectation.

C & E: Oil prices slipped, as disappointing U.S. jobless claims and retail sales data fed doubts about the energy demand outlook the day after a government inventory report showed rising fuel stockpiles.

- U.S. crude oil fell 0.49 pct to 82.07 per barrel.
- Gold gained 0.12 pct to \$1,196.05 an ounce.
- Reuters-Jefferies index lost 0.47 pct to 277.67.

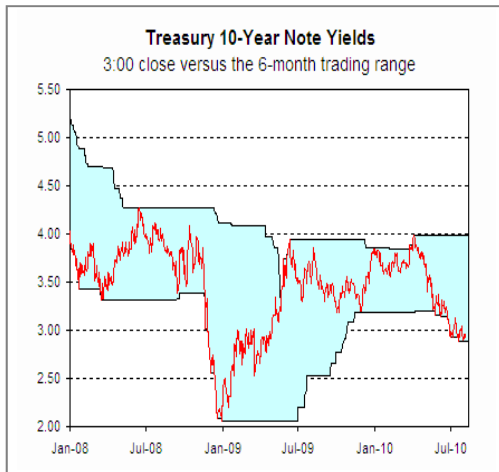
• For MARKET SNAPSHOT click here

• For NEXT UP click here

• For DEEP DIVE click here



MARKET SNAPSHOT as of 3:00 pm EST



TREASURIES <5> <500>

| | BID | ASK | YIELD | CHANGE |
|-----------|---------|---------|-------|--------|
| 1-Mo Bill | 0.150 | 0.12 | 0.152 | -0.011 |
| 3-Mo Bill | 0.145 | 0.135 | 0.147 | -0.004 |
| 6-Mo Bill | 0.185 | 0.180 | 0.188 | -0.006 |
| 1-Year | 0.250 | 0.230 | 0.254 | 0.000 |
| 2-Year | 100.156 | 100.188 | 0.546 | 0.055 |
| 3-Year | 100.555 | 100.586 | 0.809 | 0.086 |
| 5-Year | 100.805 | 100.844 | 1.582 | 0.152 |
| 7-Year | 100.531 | 100.578 | 2.292 | 0.227 |
| 10-Year | 104.891 | 104.953 | 2.921 | 0.313 |
| 30-Year | 105.266 | 105.328 | 4.068 | 0.281 |

EQUITIES

| | INDEX | CHANGE |
|---------|----------|--------|
| DJIA | 10661.21 | -19.22 |
| NASDAQ | 2294.09 | -9.48 |
| S&P 500 | 1124.38 | -2.74 |

OIL

| | PRICE | CHANGE |
|-------|-------|--------|
| NYMEX | 82.1 | -0.4 |
| BRENT | 81.6 | -0.6 |

EURODOLLAR FUTURES

| | CLOSE | CHANGE |
|--------|--------|--------|
| Aug-10 | 99.603 | -0.003 |
| Sep-10 | 99.600 | -0.005 |
| Dec-10 | 99.555 | 0.000 |
| Mar-11 | 99.495 | 0.020 |

FUTURES

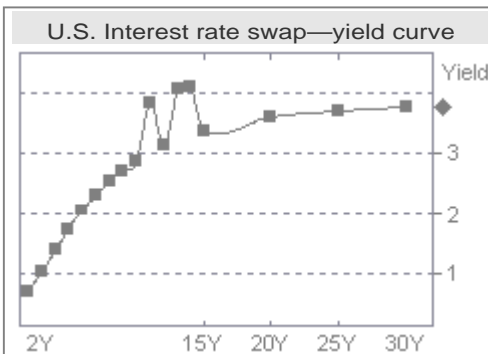
| | PRICE | CHANGE |
|------------|--------|--------|
| CBOT 5 yr | 120.00 | 0.21 |
| CBOT 10 yr | 123.23 | 0.03 |
| CBOT 30 yr | 128.00 | -0.13 |

REPURCHASE AGREEMENTS

| G/C | | MORTGAGE REPOS | |
|--------------|-------|----------------------------|-------|
| O/N | 0.300 | O/N | 0.300 |
| 2-Week | 0.290 | 2-Week | 0.300 |
| 1-Month | 0.290 | 1-Month | 0.300 |
| 3-Month | 0.300 | 3-Month | 0.310 |
| AGENCY REPOS | | i-REPO SM INDEX | |
| O/N | 0.300 | 10:00 AM | 0.240 |
| 2-Week | 0.290 | 3:00 PM | 0.243 |
| 1-Month | 0.300 | | |
| 3-Month | 0.300 | | |

IR SWAPS <19901>

| | SPREAD | | RATE | |
|---------|--------|--------|------|------|
| 2-Year | 16.00 | 20.00 | 0.70 | 0.73 |
| 3-Year | 22.25 | 26.25 | 1.03 | 1.05 |
| 5-Year | 16.25 | 20.25 | 1.74 | 1.76 |
| 7-Year | 4.25 | 8.25 | 2.33 | 2.34 |
| 10-Year | -3.25 | 0.75 | 2.90 | 2.89 |
| 30-Year | -31.00 | -27.00 | 3.76 | 3.74 |



CURRENCIES

| | BID | ASK |
|-------------|---------|---------|
| Euro | 1.3177 | 1.3180 |
| Sterling | 1.5880 | 1.5884 |
| JP Yen | 85.87 | 85.90 |
| Swiss Franc | 1.0472 | 1.0476 |
| Can Dollar | 1.0167 | 1.0172 |
| Mexico | 12.5637 | 12.5698 |

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

| | BID | ASK | BID | ASK |
|----------|-------|-------|-------|-------|
| O/N | 0.210 | 0.240 | - | - |
| 1-Month | 0.280 | 0.380 | 0.172 | 0.182 |
| 3-Month | 0.350 | 0.550 | 0.170 | 0.180 |
| 6-Month | 0.520 | 0.650 | 0.170 | 0.180 |
| 12-Month | 0.880 | 1.200 | 0.209 | 0.219 |

FED FUNDS

| | NYFR SM - 10AM |
|------|---------------------------|
| Open | 0.2100 1m 0.2900 |
| High | 0.2300 3m 0.4212 |
| Low | 0.1400 |

ACTIVE FANNIE MAE AGENCIES

| TERM | COUPN | MATURITY | YIELD-SPREAD | YIELD |
|---------|-------|------------|--------------|-------|
| 2-Year | 1.125 | 30/07/2012 | 15 - | 0.69 |
| 3-Year | 1.625 | 15/04/2013 | 9 - | 0.89 |
| 5-Year | 2.375 | 28/07/2015 | 21.5 21 | 1.79 |
| 7-Year | 5.125 | 18/10/2016 | 0 - | 2.29 |
| 10-Year | - | - | - - | 4.57 |
| 30-Year | 6.625 | 15/11/2030 | 29 26 | 4.36 |

ACTIVE FREDDIE MAC AGENCIES

| TERM | COUPN | MATURITY | YIELD-SPREAD | YIELD |
|---------|-------|------------|--------------|-------|
| 2-Year | 1.125 | 27/07/2012 | 16 14.5 | 0.7 |
| 3-Year | 1 | 23/09/2013 | 23 22 | 1.03 |
| 5-Year | 2.875 | 09/02/2015 | 3 2 | 1.61 |
| 7-Year | 5.25 | 15/09/2016 | - - | 2.24 |
| 10-Year | 3.75 | 27/03/2019 | 6 2 | 2.98 |
| 30-Year | 6.25 | 15/07/2032 | 33.5 30.5 | 4.4 |

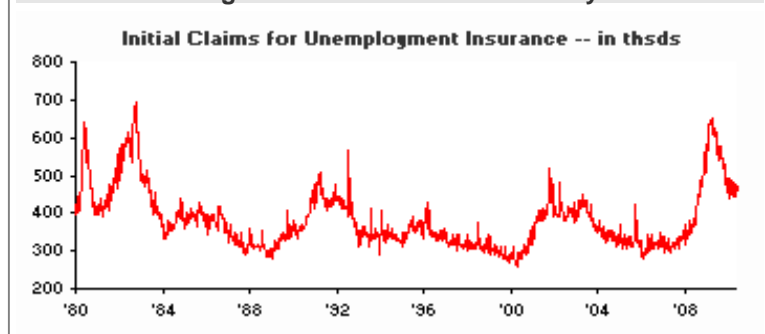
Active MBS 15YR

| | CPN | BID | ASK | YIELD |
|-------|-----|----------|----------|-------|
| FNMA | 4.0 | 104.2270 | 104.2330 | 2.539 |
| FHLMC | 4.0 | 104.2160 | 104.2220 | 2.506 |

Active MBS 30YR

| | CPN | BID | ASK | YIELD |
|-------|-----|----------|----------|-------|
| FNMA | 4.5 | 104.1670 | 104.1730 | 2.718 |
| FHLMC | 4.5 | 104.1610 | 104.1650 | 2.668 |
| GNMA | 4.5 | 105.1460 | 105.1520 | 2.986 |

Wrightson ICAPSM Chart of the Day



TODAY'S TOP NEWS

U.S. jobless claims rise, cast a pall on economy

New U.S. claims for unemployment benefits unexpectedly rose last week to the highest level since early April, highlighting a weak labor market and the fragile economic recovery.

Initial claims for state unemployment benefits rose 19,000 to a seasonally adjusted 479,000, the Labor Department said. That compared to market expectations for a drop to 455,000.

The government is expected to report that nonfarm payrolls probably fell 65,000 last month after declining 125,000 in June. Private-sector payrolls are seen rising a modest 90,000 and the unemployment rate is expected to climb to 9.6 percent from 9.5 percent in June.

In other data, U.S. retailers posted July sales below analysts' expectations in the latest sign that skittishness about high unemployment and the economy are causing consumers to cut spending. Obama defended his policies and said the economy still needed more time to heal.

Meanwhile, the process of repair is under way in the U.S. economy and financial markets but there is "still a long way to go," a senior U.S. Treasury Department official said.

U.S. CP market shrinks, dollar funding costs ease

The U.S. commercial paper market contracted for the first week since early July, Fed data showed.

And bank-to-bank dollar funding costs eased as market speculation about more Fed easing to stimulate the flagging U.S. economic recovery pushed shorter-term lending rates lower.

The size of the U.S. commercial paper market, a key source of short-term funding for companies' day-to-day operations, fell by \$4.6 billion to \$1.097 trillion outstanding, from \$1.101 trillion outstanding the previous week.

Asset-backed commercial paper outstanding rose by \$4.1 billion after falling \$1.7 billion the previous week. Unsecured financial issuance fell by \$13.4 billion after rising \$3.5 billion the previous week. The overall U.S. commercial paper market peaked at about \$2.2 trillion outstanding in August 2007 when the credit crisis broke out.

The three-month dollar Libor eased to 0.41813 percent from 0.42406 percent, reaching its lowest level since early May.

Meanwhile, the three-month euro interbank rate crept up to 0.83219 percent, but held below an 11-month peak of 0.83344 percent set late last month.

Japan bank buying helping to push down U.S. yields

Cash-flush Japanese banks have been big buyers of U.S. Treasuries in the past few months, playing a role in a sharp drop in U.S. yields that has contributed to the dollar's drop towards a 15-year low against the yen.

Japanese investors bought a net 1.274 trillion yen (\$14.8 billion) of foreign bonds last week, for a record 12th week in a row of net purchases, weekly capital flow data from the Ministry of Finance showed.

Total net foreign bond buying for the 12 weeks since early May has reached 11.3 trillion yen (\$131 billion), approaching last year's full-year total of 13.2 trillion yen and surpassing the 2008 figure of 7.3 trillion yen. Japanese investment in U.S. Treasuries is not helping the dollar as many Japanese banks make currency-hedged investments. On the contrary, their aggressive U.S. bond buying, and the subsequent fall in U.S. yields, are helping to push down the dollar against the yen.

Separately, Japanese Prime Minister Naoto Kan said the government may finance fresh stimulus steps with budget reserves for the current fiscal year to next March.

ECB Trichet: data strong but crisis battle not won yet

It is too early to declare victory over the financial crisis despite stronger than expected data suggesting the euro zone recovery is outstripping expectations, the ECB said.

The ECB held rates at a record low of 1.0 percent, as expected, and said it would only decide next month whether to resume its exit from generous liquidity supplies.

President Jean-Claude Trichet delivered an upbeat message on the economy, ruling out a return to recession and saying the third quarter would be better than expected. But he was also careful to retain an air of caution.

With inflation in the euro zone undershooting and the region's post-crisis economic recovery still in a delicate phase, the decision to keep rates at a record low for the 15th month running was widely expected.

Trichet said they remained at an "appropriate" level, bolstering the current consensus that they will stay on hold well into next year. Trichet declared himself happy with the results of the ECB's controversial program of buying government bonds, which has slowed to a trickle in recent weeks, and said there had been significant improvement in debt markets.

U.S. mortgage rates hit record lows - Freddie Mac

U.S. mortgage rates fell in the past week to the latest in a series of record lows amid concerns about the state of the economy, according to a survey released by Freddie Mac.

Rock-bottom rates offer a glimmer of hope for a housing market struggling to gain traction since the recent expiration of popular home-buyer tax credits.

Interest rates on 30-year fixed-rate mortgages averaged 4.49 percent, down from 4.54 percent a week earlier and 5.22 percent a year ago, according to the survey. Thirty-year rates have fallen to fresh lows in six out of the last seven weeks.

Fifteen-year fixed-rate mortgages averaged 3.95 percent, down from 4.00 percent last week, the lowest since Freddie Mac began surveying this loan type in 1991. Fifteen-year rates have hit fresh lows in five of the last seven weeks.

Separately, The Obama administration is not considering a change to its policy regarding mortgage finance giants Fannie Mae and Freddie Mac, a Treasury spokesman said.

Canada's Flaherty: C\$ rise "makes sense"

The rise in Canada's currency "makes sense" because investors are snapping up the country's assets and the economy is growing nicely, Canadian Finance Minister Jim Flaherty said.

It's a different world from the heady days of 2007, when the Canadian dollar zoomed up to a high near US\$1.10, Flaherty said. "There's more demand for Canadian investments. So the upward pressure on the dollar to me makes sense," said Flaherty, who previously voiced concerns about the "loonie's" rapid rise. "It would have to go significantly above parity. And that would be a concern for Canadian business, and therefore a concern of mine," Flaherty told Reuters in his Parliament Hill office. He is focused on prodding China and other Asian economies to let their currencies rise -- a perennial discussion point at finance minister meetings.

Flaherty's Asia focus fits with Canada's drive to stimulate trade with emerging markets, particularly resource-hungry China.

The share of Canada's exports going to the United States has steadily declined in the past decade, but still stands at three-quarters. Flaherty sees it going down to as little as 60 percent in the next five to 10 years on more Asia business and a possible trade deal with the EU.

TODAY'S TOP NEWS

Bank of England holds rates steady as expected

The BoE kept interest rates at a record-low 0.5 percent and announced no new quantitative easing purchases, a decision universally expected in a Reuters poll of economists.

None of the 61 economists polled last week expected a change in policy, and most did not expect a rise in interest rates until April next year at the earliest.

Although consumer price inflation at 3.2 percent is well above the BoE's 2 percent target, most policymakers view the factors that pushed it up -- sterling weakness, higher sales tax and higher oil prices -- as one-offs that will fade away.

Most economists predict growth will slow from the unexpectedly strong 1.1 percent recorded between April and June because of looming government spending cuts, weak European demand for UK exports and banks' continuing reluctance to lend.

The MPC will have had access to a quarterly update to the BoE's growth and inflation forecasts.

Greek review, Spanish debt sale signal Europe recovery

Greece won international lenders' approval for its efforts to fix its finances and Spain raised new funds at far cheaper rates than it had to pay just two months ago in further signs that Europe is getting over its debt crisis.

After some strong surveys on business activity in July, the euro strengthened on a further forecast-beating report, this time a big rise in manufacturing orders in Germany during the month of June.

More large banks in the region reported better earnings than expected, too, among them Barclays and Commerzbank.

ECB chief Jean-Claude Trichet predicted an "exceptional" report on economic output in the euro zone in the second quarter -- coupled nonetheless with a warning that the second half of 2010 would not be so hot. The news on the day was largely positive, both in terms of market confidence and in terms of economic activity in at least the second quarter of 2010.

Spain pulled off a successful bond auction, selling 3.5 billion euros (\$4.6 billion) of three-year bonds and paying a premium of just 2.276 percent compared with 3.317 percent at a June sale.

Obama unveils Ford loan guarantees to boost U.S. exports

President Barack Obama defended his decision to bail out U.S. auto makers as he unveiled a new loan guarantee for Ford Motor that will help to meet a White House goal of doubling U.S. exports.

The U.S. Export-Import Bank earlier said it had approved a Ford loan guarantee to finance \$3.1 billion in exports of cars and trucks to customers in Canada and Mexico.

Obama visited his home town of Chicago in an effort to highlight the U.S. auto industry's export potential and his administration's role in revitalizing the sector.

The bank's loan guarantee will cover more than 200,000 Ford vehicle exports, representing 15 percent of the company's 2009 production. The Obama administration points to the auto sector as one area where its actions saved jobs.

Ford plans to add 1,200 jobs for a second production shift at its Chicago Assembly Plant, where it expects to start building a new version of its Ford Explorer SUV later in 2010.

Wheat soars on Russia export ban, trade halted

Chicago wheat markets jumped 8 percent to near two-year highs, twice triggering trading curbs to restore order before easing back after Russia said it would temporarily halt grain exports.

Russia's worst drought on record has devastated crops in parts of the country and sent international grain prices soaring as markets placed bets that without shipments from one of the world's leading exporters, global supplies would be restricted.

Prime Minister Vladimir Putin signed an order banning grain and flour exports from Aug. 15 to Dec. 31, with a spokesman saying this would apply to contracts that had been already signed.

The International Grains Council said projected Russian production at 50 million tonnes, or nearly 8 percent of the world wheat harvest. Markets were also nervous that the continuation of Russia's drought conditions would disrupt the forthcoming sowing season for winter crops, a point made yesterday by both the UN's Food and Agriculture Organization and the head of the Institute for Agricultural Market Studies analysts.

NEXT UP

Top 20 analysts see U.S. July payrolls below consensus

The U.S. economy probably shed more jobs in July than the wider consensus for a 65,000 net loss on non-farm payrolls, according to the 20 most accurate economists polled by Reuters over the last year.

But for the second month running, the difference in forecasts between Reuters' top group of analysts and the wider consensus was very small, giving no clear steer on whether the latest non-farm payrolls data would come in much better or worse than the wider consensus.

This top 20 median showed an expectation for 70,000 jobs lost last month, compared with 65,000 job losses in the wider poll of 75 economists and an actual loss of 125,000 jobs in June. The mean average was slightly weaker, pointing to 75,000 job losses. Nineteen of the top 20 forecasters forecast at least 40,000 jobs shed in July, with only one economist seeing no change in the headline number.

Economists in the wider Reuters poll expect anywhere between a rise of 10,000 to a fall of 160,000. But none of the top 20 group predicted net jobs growth in July, with forecasts ranging from no change to a 140,000-job decline.

Euro rally to run out of steam as austerity bites

The euro's recent rally against the dollar will soon reverse as fiscal tightening and weak economic growth plague the common currency, the latest Reuters poll of foreign exchange analysts predicted.

The poll of around 60 analysts, taken August 2-4, predicted the euro would be worth just \$1.20 in a year's time -- not far from the four-year lows of below \$1.19 seen in June and well below Tuesday's three-month high of \$1.3262.

Median forecasts predicted the common currency would trade at \$1.30 in one month and 1.25 in three months, before falling to \$1.24 in six months' time.

This is the first time this year euro forecasts have been upgraded but is on the whole little changed from last month's poll, with analysts seeing the euro peaking at around \$1.35 in the next few weeks before it begins to sink again.

In the second half of last year the euro zone economy emerged from its worst post-war recession, and grew 0.2 percent in the first three months of 2010 but is expected to do little more than tick over in coming quarters.

DEEP DIVE Commentary and Analysis

Stocks, bonds and the earnings season dance

By James Saft

A look at company earnings implies it is a great time to be a corporation in America, but for investors a rising savings rate and the threat of deflation mean that, ugly and risky as they are, government bonds looks good in comparison to stocks.

So far it has been a pretty remarkable earning season in the U.S. Almost 80 percent of companies reporting have beaten analysts' estimates and profits among the largest companies are up more than 40 percent on the same period last year.

Perhaps even more remarkably, companies are managing to trouser a record 10.2 cents in every dollar of revenue after operating costs, according to Standard & Poor's.

That's the rub - profitability growth is outpacing revenue growth, which has been 9.0 percent, implying that the gangbusters pace of profits is more due to cost cutting and efficiencies than a sustainable expansion in anyone's business model.

So far, stock market investors seem to like it. The S&P 500 is up nearly 10.0 percent since its early July lows and has gained about 4.0 percent since the reporting season kicked off in earnest. Then again, earnings seasons are usually kind to stock, suspiciously kind.

It is almost as if someone pulled the plug on the feed of economic news to stock investors while allowing the earnings beat stories to keep on coming.

The real challenge for U.S. companies and for stock market valuations is how profit growth can be sustained in the face of anemic overall economic growth, if not a double dip recession.

How do you increase profits if consumers are not spending more and if they are not earning more, but are finally starting to save more. The figures really don't add up very well.

According to the U.S. Commerce Department June household income growth was unchanged and real spending rose just 0.1 percent. Company managers may be good, but it will take a magician rather than an MBA degree to spin that straw into further 40 percent increases in profitability.

Even more significant is the increase in the savings rate, which was revised up for May to 6.3 percent from a previous estimate of just 4.0 percent and which rose again in June to 6.4 percent.

It makes sense from an individual's perspective to be saving more, to offset losses on assets and to deleverage, not to mention as insurance against a terribly unforgiving job market. But collectively it will savage company earnings and tend to drive stock prices lower.

SIGNS NOT EVEN AN ANALYST COULD LIKE

And then there is the threat of deflation. On the Federal Reserve's favorite measure - the core personal consumption expenditure deflator - inflation was unchanged in June and has risen by just 1.4 percent in a year. That too spells trouble for companies and will underpin government bond prices.

This brings us to the outlook for company earnings, as seen through the prism of the sell-side analyst community. There is a funny phenomenon with company analysts. They are always terribly optimistic in the medium term - jam tomorrow - but tend to scale back that optimism as the due date for the jam to be spread today nears. That allows for companies to exceed expectations a satisfyingly happy amount of the time, which pleases the market, while investor can still contemplate a hazy but sunny vision of the future.

Andrew Laphorne, of Societe Generale in London, tracks the change in analyst optimism, meaning the percentage of earnings forecast revisions that are upgrades, which has proven to be a strong leading indicator of economic direction. Measured on a six month seasonally adjusted basis, this indicator has

turned sharply negative and is now in territory last plumed in 2000 when the dot com bubble was busily becoming dotbust.

Still, economists are cautious people and a double dip recession is only an outside possibility, right?

"We should all know full well that the sell-side will only call the recession long after it has begun and when it is far too late," wrote Societe Generale strategist Albert Edwards, who sees a yield on 10-year U.S. bonds below 2.0 percent eventually, down from 2.95 percent currently, and who sees a fall for equities below their March 2009 lows.

Companies, in the U.S. and elsewhere, have made a good job out of a mediocre economic recovery. Even they, though, are showing extreme caution, hoarding cash, and refinancing to ensure that the next credit crisis does not take them unawares.

I'd argue that while many are prepared to survive the worst, what won't survive is the current relationship between stock prices and earnings. That will head south as saving grows, spending flags, and bond yields continue to fall.

(James Saft is a Reuters columnist. The opinions expressed are his own. At the time of publication James Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund.)

Data start to show grounds for optimism on Greece

By Brian Love

Three months after Greece obtained the first tranche of an international bailout, economic data are starting to show grounds for cautious optimism that Athens can halt the rise of its debt mountain in coming years without defaulting.

Greece got a thumbs-up on Thursday when the European Commission, the International Monetary Fund and the European Central Bank ended a two-week review of its fiscal reforms, saying the country had made "a good start".

The review found Athens was so far implementing austerity measures "as agreed". The steps, and more like them needed in coming months and years, are key for Greece to slash its primary budget deficit from 8.6 percent of gross domestic product in 2009 to 2.4 percent this year, and to improve further to a 6.0 percent surplus in 2015.

Also important are signs that Greece's economy, although in deep recession, is faring slightly better than analysts had feared just a few months ago.

The Purchasing Managers' Index for the Greek manufacturing sector rose for a second straight month in July after hitting a 13-month low in May, though it continued to indicate contraction. A stronger-than-expected economic recovery in the euro zone, particularly in Germany, also suggests Greece could well exceed its GDP target this year.

"The survey data suggests the contraction may not be as bad as thought," said RBS economist Nick Matthews, though he added, "It is still early days."

The possible impact of better-than-expected GDP on Greece's debt position can be seen in a simple spreadsheet model of the country's economy and its debt dynamics, prepared by Reuters. (To obtain the model, [click here](#))

ASSUMPTIONS

Under Greece's long-term economic plan, approved by the EC and the IMF under the bailout terms, real GDP is assumed to shrink 4.0 percent this year after a drop of 2.0 percent last year. But if the economy were to contract by only 3.0 percent in 2010 instead of 4.0 percent, Greece's sovereign debt as a ratio of GDP would rise more slowly to 131.8 percent this year instead of the 133.1 percent which the economic plan shows, the



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spreadsheet model shows.

The difference is small compared to the total size of the debt but still equivalent to close to 3 billion euros. It is not negligible in the context of the government's austerity steps; for example, Athens is raising tax on gasoline, cigarettes, electricity and luxury goods to raise 1.1 billion euros of additional state revenues this year.

The EC and the IMF said on Thursday that they now expected Greek inflation this year to be 4.75 percent, instead of their initial assumption of 1.9 percent.

Plugging a similarly large increase beyond the initial assumption into the forecast for the GDP deflator, another measure of inflation, in the spreadsheet model shows the debt-eroding impact of inflation.

A 3.0 percent drop in economic growth and a GDP deflator of 3.85 percent in 2010 yield a debt ratio for this year of 128.6 percent of GDP, more than four percentage points below the economic plan's assumption.

The spreadsheet model cannot capture political risks in Greece,

the danger that prolonged austerity could destabilise the government and cause it to backtrack on reforms. It is not an econometric model so it does not fully show how different inputs can affect each other -- for example, the way tax revenues might react to changes in GDP.

But the model does illustrate how uncertainties in Greece's economic plan can run in a positive as well as a negative direction. Greek Finance Minister George Papaconstantinou said on Thursday that he hoped to beat the target of cutting Greece's overall budget deficit to 8.1 percent of GDP this year, despite lower-than-expected revenues in the first half.

That implies some reforms may be proving more effective than expected in restraining expenditure.

If this translates into an additional improvement of just 0.1 percentage point in the primary budget balance this year and in coming years, and given revised GDP and inflation figures for 2010, Greece's debt ratio in 2015 will be 133.0 percent instead of the 139.0 percent now assumed in the country's long-term plan, the spreadsheet suggests.

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