Deutsche Bank

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Early Morning Reid

Macro Strategy

Two weeks after the QE3 announcement many assets have now dipped below levels seen prior to Bernanke's new liquidity injection including the S&P500, Crossover S17, Euro Stoxx 600, Spain's IBEX and the EUR/USD cross. The fact that risk markets are struggling is partly due to the fact that markets rallied so much on good news prior to QE3 that they didn't have much more immediate room to rally after this last bit of 'good' news was out. The other reason is obviously Spain and we now enter a crucial 2-day period for the country after 10 year yields yesterday rose above 6% for the first time since the ECB plan was unveiled on September 6th. Rajoy's cabinet is due to meet in the morning to formally approve the 2013 budget followed by an official release which is expected at around 1-2pm London time. At the same time, the Spanish government is expected to unveil details of its "national reform plan" which many see as a "proto MoU", paving the way for an official request for a bailout. Over the past 24 hours, Rajoy said that he hasn't yet decided on whether to freeze inflation indexation of pensions, which will cost the state an additional EU6bn this year. Also, Reuters is reporting that Spain's 2013 budget will include a wage freeze for civil servants but would keep supplementary payments made to civil servants at periods such as Christmas, citing a trade union source. On Friday, Spain will release results of its independent banking stress tests (timing yet to be confirmed).

Ahead of this, markets were weaker yesterday. The S&P500 shed 0.6%, its 7th loss in the past 8 trading days. Nine out of 10 industry sectors closed in the red, with only the defensive Utilities sector trading up. Homebuilders fared particularly poorly following an unexpected drop in new homes sales in the US (-0.3%mom vs +2.2% expected), although absolute sales numbers remain close to two-year highs. The only bright spot was in the credit space where the US IG benchmark managed to close 0.75bp tighter on the day after a late-session short squeeze. Providing some support to the market, Chicago Fed President Charles Evans, a FOMC voter next year, reiterated his support for the QE3 program, adding that the Fed should adopt more explicit unemployment targets to prevent a "lost decade" similar to that experienced by Japan. Evans said that the US economy would need to add 200-250k of jobs per month for "several, several months" before he would revisit his policy stance.

Briefly recapping yesterday's European moves, risk assets were bathed in red with the Stoxx 600 finishing down 1.8%. Spanish and Italian bourses finished 3.9% and 3.3% weaker yesterday as images of protests in Madrid and Athens flashed across screens. The Bank of Spain suggesting that the Spanish economy had contracted at a "significant pace" in the third quarter didn't help. The previous day's joint statement from the German/Finnish and Dutch finance ministers that the ESM can take direct responsibility of banking sector problems that occur under a common banking supervision framework, but "legacy assets should be under the responsibility of national authorities" also weighed on sentiment, although interpretations of the statement were varied. Austria's finance minister sided with her northern European counterparts, agreeing that bank recaps should adhere to the "basic order of first using private capital, then national public capital and only as a last resort the ESM". *(Continued over the page)*

Periodical

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Market Data

Index	Close	Change
ITX Crossover	585	+33
ITX Europe 125	142	+7
CDX 125	102	-1
CDX HY - pts	100.00	-0.475
SovX WE Index	148	+11
S&P 500	1433	-0.57%
Brent Oil^	109.96	+0.16%
Gold^	1755	-0.33%
10 yr Treasury^	1.63	-4 bp
ITX HiVol	211	+10
ITX Sen Fin	210	+15
ITX Sub Fin	351	+19
CDX HiVol	193	-7
CDX EM	224	+3
ITX Japan	224	-5
ITX Australia	161	-3
ITX Asia XJ	142	-3
Euro NonSov	169	+6
Euro Corp	202	+6
Euro BBB	313	+10
Sterling NonGilt	218	+3
Sterling Corp	271	+4
Sterling BBB	397	+6
WTI Oil^	90.98	-1.07%
Dollar Index^	79.78	+0.15%
EUR/USD^	1.288	-0.39%
DJ Stoxx 600	271	-1.83%
NIKKEI	8902	-0.05%
Hang Seng	20628	+0.49%
VIX	16.81	+1.38

^ - Change from previous day's 05.30 GMT to 05:30 GMT.
Levels as of 05:30 London time. European and US CDS indices above refer to 'old' off the run series

Upcoming Events

Release	DB	Prev	Con
Initial jobless claims (9/22)	380k	382k	375k
Durable goods orders (Aug)	-4.0%	+4.1%	-5.0%
Real GDP (Final Q2)	+1.7%	+2.0%	+1.7%
Pending home sales (Aug)	+1.0%	+2.4%	Unch

Topical DB Publications

Credit Strategy Weekly : Searching for yield in IG credit, 14th September 2012
LT Asset Return Study: A Journey into the Unknown, 4th Sept 2012
Credit Strategy Weekly : Summer Session Preview: Key Events through September
Credit Strategy Weekly : Credit Curve Relative Value, 20th July 2012
Credit Strategy Weekly : European HY capital structure relative value, 13th July 2012
2012 Default Study : 5yrs of crisis - The default bark far worse than the bite..., 16th Apr 2012
EMR 5yr Anniversary Special : Lessons from 5 years of crisis reporting, 2nd Mar 2012
Credit Outlook 2012: Think the (even more) unthinkable...?, 12th December 2011

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Meanwhile, EC spokesman Olivier Bailly appeared to distance the European Commission from the statement saying that "Our position regarding breaking the vicious circle between banks and the sovereign is very clear…this should be done quickly" (WSJ).

Elsewhere in Europe, Bundesbank President Weidmann reiterated that it was the job of governments to bridge Greek funding gaps and this role "is not to be filled by the central bank". This followed yesterday's comment from the Greek finance ministry that a EU13-15bn funding gap, if the country was granted a two-year extension to meet fiscal targets, could be bridged by rolling over bonds held by the ECB. On a similar vein, Reuters reported that the IMF has been pushing for a comprehensive restructuring of Greece's debt owed to official-sector creditors including potential notional haircuts. This has reportedly exacerbated tensions with the EU and the ECB, who prefer giving Greece more time to meet bailout goals and are not willing to accept hair cuts at the moment.

Moving to overnight markets, Asian bourses are trading with a better tone with the Hang Seng (+0.5%) and KOSPI (0.3%) trading up. The Shanghai Composite (+0.3%) recovered from the session's earlier multi-year lows on news that the PBOC followed up yesterday's record RMB290bn of liquidity injections with an additional RMB180bn today - taking the weekly net total to RMB365bn in reverse-repos and bill redemptions. On a more sobering note, the Chinese government released statistics showing that industrial profits were down 6.2% from a year earlier in August, compared with -5.4% in July, the fastest pace of profit declines this year. The Nikkei (-0.1%) is underperforming on reports that Japanese car makers will slow production at Chinese facilities in response to slumping demand arising from the Sino-Japanese territorial dispute. On that note, Japanese PM Noda told media in New York that Japan will not compromise with China on the disputed Diaoyu/Senkaku islands.

Looking at the day ahead, Spain's budget and reform announcements will be the obvious focus. That aside, the Eurozone's economic confidence indices, M3 and German unemployment are the key data points in Europe. The UK will print final GDP revisions today. Meanwhile, it will be a busy day in the US with durable goods orders, August pending home sales and initial jobless claims all scheduled before the US market open. However, all eyes will be on Madrid today.

Appendix 1

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