1. The European policy package of two weeks ago failed to prevent new lows in many assets and broadening risk reduction. With renewed funding stresses and extreme volatility, we have acknowledged that this pullback is different to those seen thus far in the recovery. In that context, our decision to put on fresh ‘pro-risk’ positions in several places around the time of the policy response was premature. We have been stopped out of some of these positions (NJA FX vs JPY, PLN and TWD) and have so far narrowly escaped in the others (DAX, MXN). Continued declines in inflation – and the flight to quality – have however validated our controversial view that bond yields would fall.

2. Despite the growing gloom, it is clear that risk has been reduced and cyclical assets have been de-rated to a point where signs of transmission of damage to the real economy may now be needed to validate the moves. Other key themes that we have liked – “core” versus “periphery” in rates and FX for instance – are also offering potentially attractive entry points. For the market to find its feet is likely to require both some easing in funding stresses and clear signs that expectations have fallen below the incoming macro cyclical news. Neither is clear yet, but we are on watch and there have been scattered but encouraging signs in the last few days. Macro data remains reasonably firm, secondary debt markets have been stable, forward LIBOR-OIS spreads are off their peaks, some China-related assets have stabilized and yesterday’s sharp US equity reversal points to a market that may have become oversold.

3. The price action over the last week or so has revealed an interesting shift. The relative stability in the EUR and peripheral European bonds; the combination of huge pressure on EUR crosses and outsized pressure on the AUD in FX; the dramatic drop in long-dated bond yields; sharp falls in some precious metals (including briefly, gold) despite rising uncertainty; and the underperformance of US to European equities all point to a shift away from the pricing of a European debt problem to a broader contraction of balance sheets and position-cleaning. And despite the commonly heard notion that the damage has spread to ‘cyclical assets’, here too there have been large differences with cyclical currencies under brutal pressure while cyclical equities continue to hold up relatively well. All this suggests that positioning and risk reduction have played a major role.

4. In weighing the damage, the market – and our own internal debate – generally oscillates between two poles. The good version of the story is that the macro cyclical picture still looks healthy, sovereign worries are prompting policy to stay easier than otherwise and the market has just de-rated cyclical assets to a large degree on fear and a massive position reduction. The bad version of the story is that funding stresses may spread the damage through the banking system, that other sovereigns will come to be challenged, that the Eurozone problems have no obvious solution and that the (presumably significant) cyclical damage is yet to come. And of course there are many things in between. **Our bias – and our forecasts – is very clearly still with the first of these. But we think there is enough uncertainty not to be too dogmatic.**

5. Current reality has elements of both stories. On the positive side, the basic growth news is still healthy and there is as yet no smoking gun for a significant slowing in the global economy. Europe’s secondary debt markets have been much more stable since the policy package two weekends ago. And on the basis of future growth fear, interest rates have fallen sharply (including US mortgage rates) in most major economies. On the negative side, measures of funding stress have widened. Possible banking exposures remain opaque. Policymakers have so far not succeeded in providing complete clarity about the ultimate resolution of the European sovereign issues. And the increased focus

on financial regulation – from Germany's short-selling ban to the passage of the US financial reform bill in the Senate – is arguably reinforcing pressures for balance sheet contraction that are contributing to market illiquidity.

6. The balance between these alternative paths comes down to a large degree to two related issues of 'contagion'. The first is the degree to which financial market problems transmit to the real economy. Even in Europe itself, our view on this front has been benign, given the offsets from Euro weakness and falling rates for the core Eurozone economies. The risks here are that banking sector problems constrict lending or that we see a greater impact on confidence – and spending - in the Eurozone 'core' from the crisis than expected (so the drop in Eurozone flash PMIs needs to be watched). **As Andrew Tilton argued in the latest US weekly, the financial channel is also the main channel through which damage might spread across the Atlantic – exports are simply too small. The second is the degree to which sovereign worries themselves spread. So far, the evidence has been very reassuring with yields falling in most major markets even as they rise in the most vulnerable.** Our view remains that solvency is much less challenging in most other places. But here too there have been pockets of concern (Japan's CDS has risen materially lately). If the market turns its focus to the larger economies, the situation could quickly worsen.

7. Underlying this debate is a broader issue of what the correct analogy for the current crisis should be. Many of the conversations we have assume that 2008 is the appropriate template, where financial damage spread into the real economy and a US problem quickly 'went global'. But there are also clear examples where even dramatic regional crises did not (at least not fully) go global. Even the Asian financial crisis, which led to a sharp regional recession had much smaller effects on the global economy and global markets ultimately than was generally feared, despite a bumpy ride. And the policy easing it induced boosted assets in many places, one reason for our interest in those who may benefit from easier policy than otherwise.

8. In keeping with that theme, China has slipped off the radar screen a little as Europe has taken centre stage. But as elsewhere, the risks to growth and stability out of Europe may be influencing policy choices there too. Notwithstanding Mr. Geithner's current attempt to press further for CNY appreciation, noises out of Beijing hinted at a step away from domestic tightening. Since this has been the major concern for that market for many months, this shift may be significant. A-shares – including the property sector – may be forming a bottom, as has copper (where our Commodity Research team have recommended a long at good levels), and the Baltic Dry index continues to rise. Mike Buchanan and team have been right to warn about the near-term headwind to tightening – a headwind that has blown our long H-share Top Trade firmly backwards lately. But our medium-term views remain positive and so these latest signs are intriguing.

9. Beyond that, the cyclical picture may provide a little less help than after the January/February downturn. The recovery in asset markets from mid-February to mid-April was helped by a sharp acceleration in global data after a soft patch at the start of the year. We are now coming off that strong data set and the result has been a patch of healthy but generally more mixed data than before (Jan Hatzius reiterated his conviction in our more moderate US forecast in his latest US views) . Even our Global Leading Indicator suggests – particularly after stripping out some of the 'retrending' issues that may be distorting momentum readings – that momentum may be fading under the hood. None of this is particularly worrisome and is inevitable at this point in the recovery and consistent with our forecasts. But it means the chances of strong positive surprises from

the macro news may have to rely a bit more on falling expectations than improving reality.

10. While the last few weeks have hurt some of our trading views, they have clearly helped others. Our long-standing view that bond yields would fall rather than rise has played out. The US economy has continued to grow, the Fed has ended its purchases and 10-year yields are at …..3.20%! No doubt, flight to quality has helped and some will argue that this is simply a consequence of the European crisis. But relative performance tells a different story: the US equity market is still only a touch worse than flat this year and US 10-year yields are over 60bp lower. Francesco Garzarelli and team captured this successfully through a US flattener and a UST-Bund spread narrowing trade, both of which were closed out close to target on Friday. The key macro story here is disinflation – core inflation is now running below 1% on a year-over-year basis and at 0.3% annualized on a 6-month basis, the lowest post-war readings outside a brief patch in the early 1960s. This has allowed better bond performance than 'normal' correlations would suggest. But as we have pointed out in both our US and global research, it is completely consistent with the lessons from prior post-bust recoveries.

11. Despite the recent dip into pro-risk views, the performance of our tactical trading recommendations remains respectable. We sat out of pro-risk trades through most of January, re-entered in early February and cut back in mid-April. And while we have clearly been too early to jump back in again lately on this front, other trades have hit their targets in the last week (our bond trades, and a long Venezuela/short Argentina position in EM CDS). Our strategic Top Trades however, have fared less well after a very strong 2009 and are generally underwater. Two issues stand out. First, we have underestimated the dovishness of European central banks and the downdraft to the EUR, to which some trades have had implicit exposure. With a further across-the-board shift in our European rate views, we have decided to crystallize the losses on our short Turkish 2-year rates, where our less hawkish policy views now undercut the rationale. Second, after a long and successful run our views on volatility (lower over the course of the year) have been flat out wrong these last few weeks, though we think there is scope for the damage here to ease. Elsewhere, we are hanging on – it is May and plenty of months (and we hope some fresh ideas) still to play out.

12. What more can be done by policymakers to help the situation? **Part of the problem for markets is that the answers are not entirely clear. Further liquidity provision by the ECB (and the Fed too, perhaps through a TAF reinitiation) would help as might be a reduction in the penalties for using those facilities. Markets would welcome signs that the most disruptive parts of the financial reform bill may be omitted.** And further clarity from Spanish authorities and others on dealing with domestic banking problems (including something akin to a 'stress test') would be welcome. But the basic issue has no 'silver bullet': the possibility that the European situation is a harbinger for a broader set of sovereign problems and/or fiscal restraint. There is no doubt that many governments will need to address their balance sheets in an aggressive way. But the fragility of early recovery argues against doing that too soon or too quickly. The issue – at its simplest – is whether governments can convince markets to give them the time to deal with the problem in a more gradual manner and can credibly commit to forward plans that allow them to address the problem only as the recovery builds.