

# Bond Compass

Q2  
2020

## Choosing the Path Forward

04 Investor Sentiment —  
Flows and Holdings

10 PriceStats®

13 Interview with  
PriceStats® Founder

17 Q2 Investment Outlook

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# A Leader in Fixed Income Index Investing

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## \$433

billion in indexed  
fixed income assets

### The Scale to Specialize

- State Street Global Advisors' global scale enables our portfolio managers, traders and investment strategists to be sector specialists and based in their geographic markets
- Our dedicated capital markets teams provide 24-hour coverage across global markets, offering enhanced liquidity and cost-efficient\* trading strategies
- Entrusted with \$433 billion in indexed fixed income assets, managing 30+ currencies across 40 different countries\*\*

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## 24

years of  
bond index  
investing  
experience

### Proven Track Record

- 24 years of bond index investing — our first fixed income index fund launched in 1996
- Manage more than 100 fixed income index strategies, providing choice for investors
- More than 100 fixed income professionals dedicated to conducting research, managing risks and costs, and supporting our clients

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## 100+

fixed income index  
strategies

### Innovative Solutions for Bond Investors

- Comprehensive range of cost-effective\* ETFs
- Offering access to government and corporate bonds across the yield curve, using a consistent index methodology

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\* Frequent trading of ETFs could significantly increase commissions and other costs such that they may offset any savings from low fees or costs.

\*\* State Street Global Markets, as of 31 March 2020.

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# Investor Sentiment — Flows and Holdings

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**A snapshot of global fixed income flows, holdings and valuations, based on data provided by State Street Global Markets.\***

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\* The fixed income flows and holdings indicators produced by State Street Global Markets, the investment, research and trading division of State Street Corporation, are based on aggregated and anonymized custody data provided to it by State Street, in its role as custodian. State Street Global Advisors does not have access to the underlying custody data used to produce the indicators.

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## Fixed Income Flows and Holdings

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State Street Global Markets builds indicators of aggregated long-term investor behaviour in fixed income markets from a substantial subset of \$10 trillion worth of fixed income assets under custody and administration at State Street.<sup>1</sup>

This captures behavioural trends across tens of thousands of portfolios and is estimated to capture just over 10% of outstanding fixed income securities globally.

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### Analysis

The first quarter was one for the history books and we applaud you all for surviving what was one of the most intense periods of volatility in modern market history. Long forgotten is the strong investment tone that allowed US equities to hit a series of all-time highs and the apparent unquenchable appetite for corporate credit. Instead, we saw the fastest bear market in history, while the corporate bond markets emerged as a significant systemic risk. The monetary and then fiscal response has been unprecedented, and the impact will likely take years to fully understand, although for the moment it has provided comfort for frazzled markets.

The investor response to plunging yields has been to sell duration, with 20-day weighted sovereign flows at their lowest decile in both the developed and emerging markets. Credit had been stable during the earlier stages of last quarter's volatility, but gapping spreads and the shutdown of primary activity resulted in selling across both the investment grade and high yield markets, with flows to the latter also in the lowest decile.

Given how quickly markets have been moving, we are also looking at shorter-term moves that may provide an earlier indicator of changing risk tolerance. In this vein, five-day flows into emerging Latin America and Asia have bounced off their lows and currently show some buying — but of course, that could change.

<sup>1</sup> Source: State Street Global Markets, as of 31 December 2019.

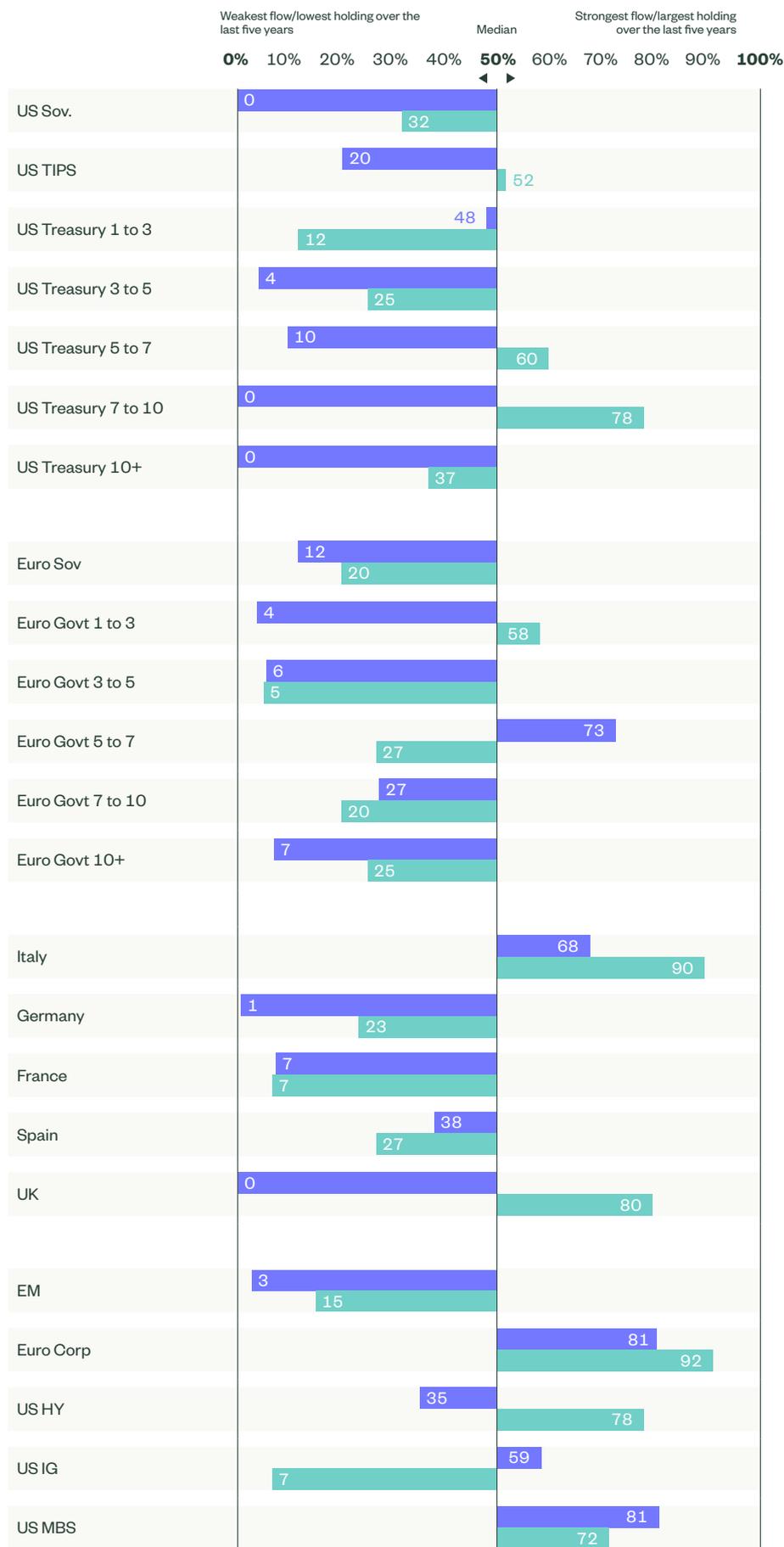
## Q1 2020 Flows & Holdings

90-Day Flows

Holdings\*

These metrics are generated from regression analysis based on aggregated and anonymous flow data in order to better capture investor preference and to ensure the safeguarding of client confidentiality. The figures are shown as percentiles, expressing the flows and holdings over the last quarter, relative to the last five years. The benefit of this approach is that it provides perspective on the size of flows and holdings compared to their historical trends, whereas a single, dollar figure provides less context.

For more information please visit [globalmarkets.statestreet.com](http://globalmarkets.statestreet.com)



Source: State Street Global Markets, as of 31 March 2020. Flows and holdings are as of date indicated. They should not be relied thereafter. \*As at quarter end.

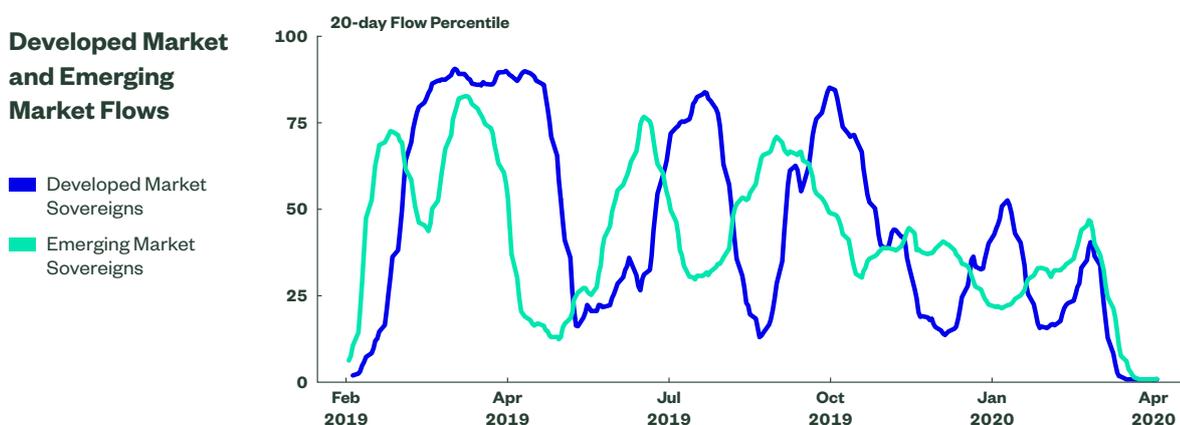
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## Hard to Find Value

The world is in a very different place since we provided our 2019 year-end overview a few months ago. What was a low yield environment became even lower yielding, as essentially every central bank cut rates this past quarter. In the developed markets, which were never able to normalise post Global Financial Crisis, this has pushed policy rates back to the effective lower bound (ELB), only to be supplemented with aggressive asset purchases. Emerging markets also needed to cut rates, although their equilibrium has been challenged by weakening currencies, capital flight and, in some instances, inflationary concerns.

Given this backdrop, developed market rates have been one of the few shelters from the storm. However, instead of using sovereign bonds as a safe harbour asset, both developed and emerging flows are at their lowest levels in five years. The generally flat yield curves that exist within the developed markets anchored at the ELB by policy rates offer no real return for investors. The need to rebalance portfolios following the volatile quarter also contributed to negative flows. These factors were less of an issue for emerging markets, which still offer real yields but are challenged by slumping global demand, capital repatriation and weak commodity prices.

### Developed Market and Emerging Market Flows



Source: State Street Global Markets, Bloomberg Finance L.P., as of 31 March 2020.  
Flows and holdings are as of the date indicated. They should not be relied on thereafter.

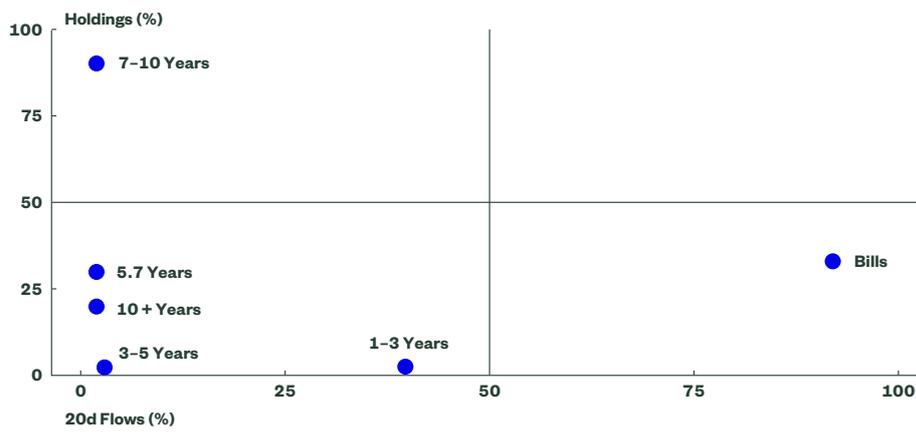
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## Safety in the Short End

While we have witnessed broad outflows from all sovereign markets, including the US, it is notable that there continues to be strong interest in the T-bill space, offset by weakness out of the curve. This has been a trend since late last year, as investors lightened up on duration, expecting a steeper curve. The gap down in yields during the first quarter simply accelerated this trend, and outflows from US Treasuries have been the most aggressive in five years when measured from a duration-weighted perspective.

This overall negative picture obfuscates investor demand for bills, which currently stands at the 84th percentile. These flows have risen from neutral levels just before the spike in market volatility, which preceded the outflows from Treasury coupons. Since we view bills as a close substitute for cash, market volatility and dislocations placed a premium on assets that offered the strongest return of capital protection. Treasury issuance to fund the CARES Act will therefore be disproportionately weighted towards T-bill issuance given strong demand as affirmed by investor flows.

## Treasury Holdings vs. Flows



Source: State Street Global Markets, Bloomberg Finance L.P., as of 31 March 2020. Flows and holdings are as of the date indicated. They should not be relied on thereafter.

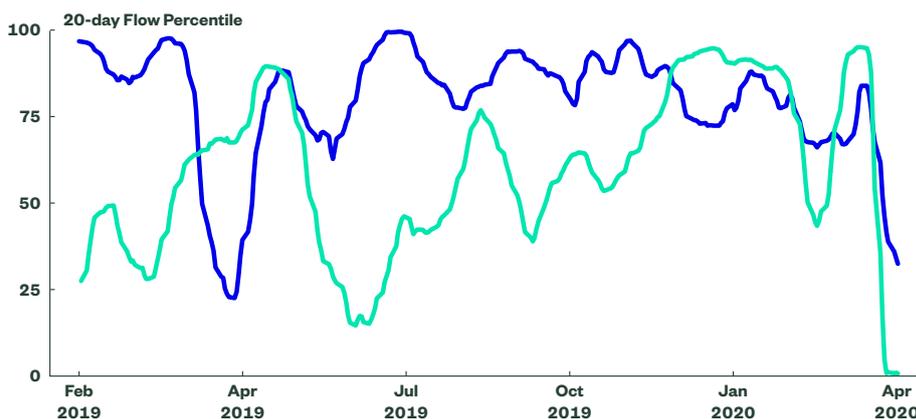
## Credit Following the Fed

Of the many asset classes that were stressed in Q1, corporate bonds were one of the most problematic. Credit spreads in both the investment grade and high yield markets had initially remained relatively calm when compared with the volatility witnessed in other risk assets, particularly equities. As a result, overall US corporate bond flows remained mostly positive during Q1, led by strong buying of the high yield asset class until mid-March.

This idyllic construct started to fall from mid-March, however, as it became apparent that the virus could no longer be contained to just China and Italy, and widespread shutdowns would bring economic activity to a standstill across many economies. At the same time, companies began aggressively drawing down their credit lines in the face of limited access to the new issue and commercial paper markets. Spreads subsequently widened out by 180 bps for investment grade (IG) credits and over 500 bps in the high yield space during the final three weeks of the quarter. During that period, flows reversed from the 70th and 90th percentiles for IG and HY, respectively, to 30% and near 0 now. The Fed subsequently announced several programs that will purchase IG bonds, which likely provided more support for this rating category versus high yield, which has not seen this level of outflows since 2016.

## US Investment Grade and High Yield Flows

■ US IG  
■ US HY



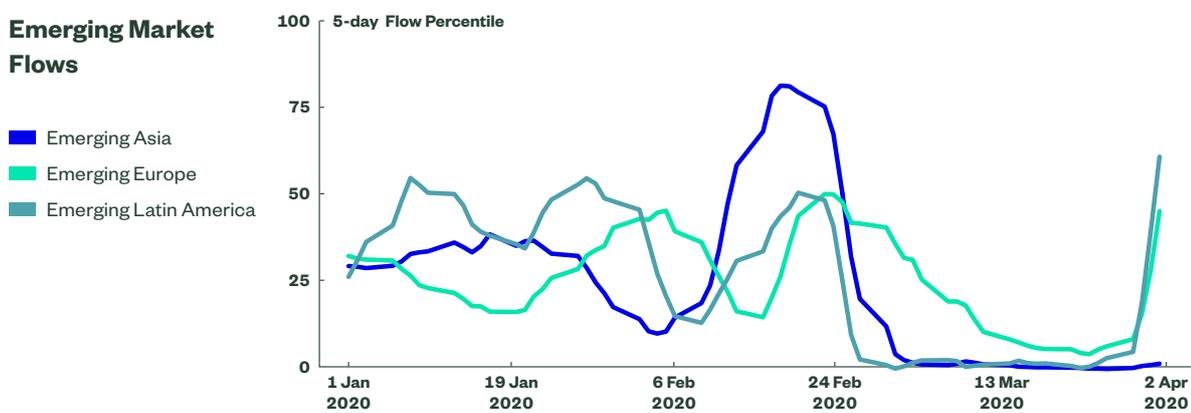
Source: State Street Global Markets, Bloomberg Finance L.P., as of 31 March 2020. Flows and holdings are as of the date indicated. They should not be relied on thereafter.

## Nascent Signs of Risk-Taking Emerge

Given how quickly markets have moved, it is useful to consider investor flows from various time perspectives. As the other charts in this quarterly update indicate, most fixed income indicators showed strong outflows, which is no different for the emerging markets (EM). This negative bias reflects the challenges for emerging economies in the face of slowing global growth, along with a home bias for investors during times of market volatility. However, when we compress the timeframe of these flows to just a five-day moving average (versus our typical 20- or 60-day analysis) we can see some nascent buying of EM fixed income again. Just as one data point does not make a trend, the continuation of this trend very much depends on the evolution of the virus and how it affects market volatility.

Having said that, this EM buying has initially focused on Latin American and Eastern European sovereigns, while Asia EM flows remains near the lower bounds. The stronger flows into LatAm reflect a reach for yield as the region remains a high yielder despite rate cuts from numerous regional central banks. Sovereign yields from Asia have generally been compressed even before recent rate cuts and concerns over the extent of China's stimulus emerged. While real yields have fallen globally, they are negative in most of the developed markets, giving EM the advantage of positive income, albeit with the caveat that global growth concerns can disproportionately impact emerging economies.

### Emerging Market Flows



Source: State Street Global Markets, Bloomberg Finance L.P., as of 31 March 2020.  
Flows and holdings are as of the date indicated. They should not be relied on thereafter.

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**Quarterly measure of inflation based on prices from millions of items sold by online retailers, helping investors anticipate and evaluate the impact of inflation.**

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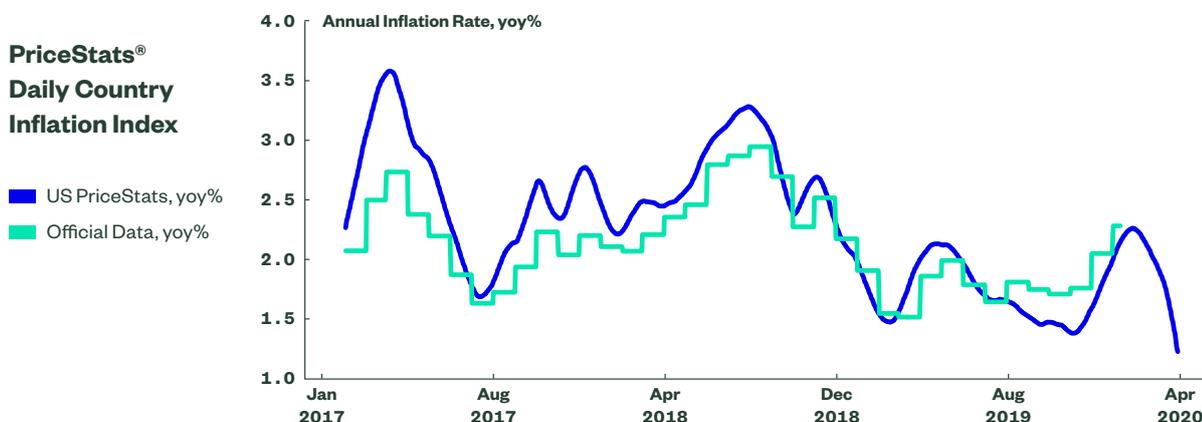
PriceStats® provides high-frequency measures of inflation and real exchange rates drawn from prices on millions of items sold by online retailers. This real-time pulse of global economic trends helps investors anticipate and evaluate the impact of inflation, including the impact on monetary policy and the degree of exchange rate misalignments.

This information is available on a daily basis from State Street Global Markets: [globalmarkets.statestreet.com](https://globalmarkets.statestreet.com).

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### US: Deflation Watch

Our US PriceStats® metrics only capture the prices of goods, not actual purchases. However, the pricing behaviour of retailers can still be informative about demand conditions. This was certainly the case in the aftermath of the Lehman bankruptcy in September 2008; PriceStats® recorded an almost immediate collapse in retailer price power. Such a sharp collapse in prices has not occurred in 2020. Nevertheless, the modest fall in online prices in March was still the weakest in the past decade and will lead to a sharp decline in the annual inflation rate.



Source: State Street Global Markets, as of 31 March 2020.

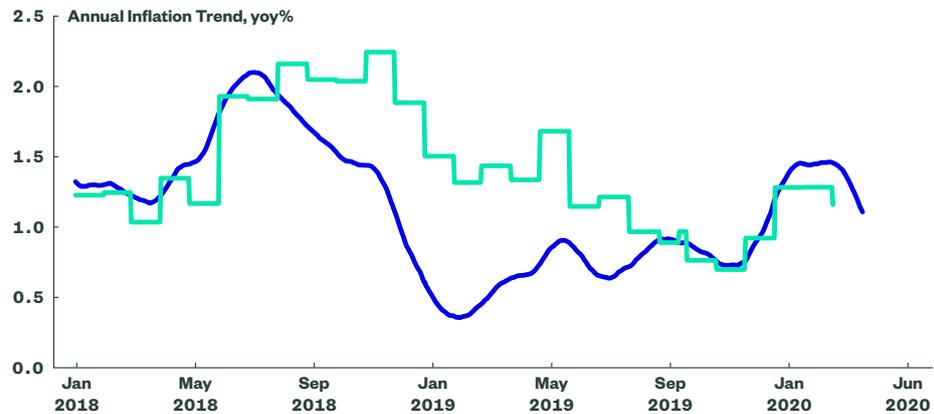
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## Eurozone: Little Room for Prices to Fall Further (Outside of Energy)

Euro inflation had been staging a modest recovery up until the virus hit, but that will now change quickly. Euro fuel prices are already close to 10% lower YoY. Headline inflation will correct sharply lower as a result, falling back below 1% once more. And given core Euro inflation was only 1.2% before this began, there's little room for prices to fall further, outside of energy. The ECB will be watchful of deflation expectations building once more.

### PriceStats® Daily Eurozone Inflation Index

■ Eurozone PriceStats®  
■ Official Data



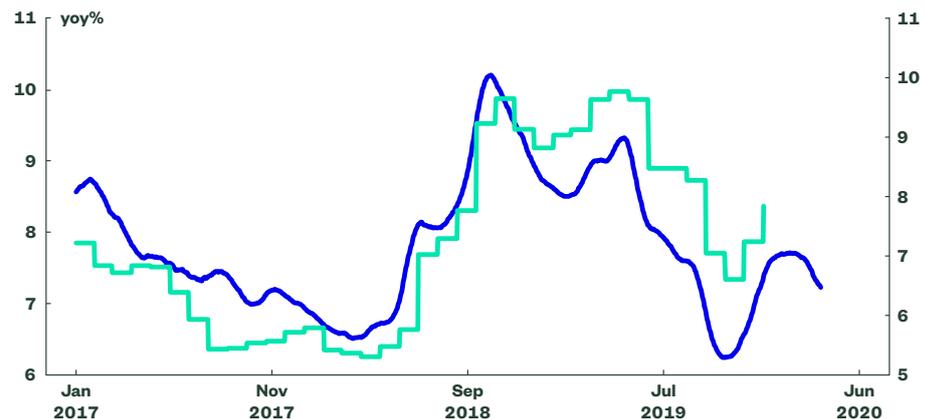
Source: State Street Global Markets, as of 31 March 2020.

## Emerging Markets: Headline Inflation Headed Lower

A number of emerging market currencies have weakened significantly in the past month; however, the impact on inflation has been offset by an even larger fall in energy prices. The combination thus far means that headline emerging market inflation is still headed lower. This will be helpful for emerging market central banks and, indeed, bond investors as the last challenge emerging market economies need to face now is a bad case of stagflation.

### PriceStats® Daily EM Inflation Index

■ EM PriceStats®  
■ Official Data  
(Right Hand Scale)



Source: State Street Global Markets, as of 31 March 2020.

# Interview with PriceStats<sup>®</sup> Founder

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**Alberto Cavallo, the founder of PriceStats<sup>®</sup>, describes the creation of the revolutionary inflation tool, how it works and what it can tell investors.**

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**Alberto Cavallo, Ph.D.**  
Founder of PriceStats®  
and the Billion Prices  
Project at MIT

## **Interview with Alberto Cavallo, Ph.D.**

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What were the conditions around and impetus behind the development of PriceStats®? Why was Argentina the ideal place to create PriceStats®?

I started developing daily inflation statistics using online prices in 2007 as part of my Ph.D. thesis at Harvard. One of my goals was to prove that Argentina's Consumer Price index (CPI) was being manipulated, and inflation was much higher than the government recognized. Argentina was an ideal place to experiment with online prices because the retail market was highly concentrated in a few companies that had both a physical and online presence.

In 2008, I began working with Roberto Rigobon at MIT, and we expanded the data collection to many other countries in an academic initiative called The Billion Prices Project. We then partnered with Pilar Iglesias in 2010 to found PriceStats® so that we could improve the quality and coverage of the data even further, and look for ways to bring the academic research to market. PriceStats® has been distributing real-time inflation indices through an exclusive partnership with State Street since May 2011.

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What is the PriceStats® approach to inflation measurement?

PriceStats® uses web scraping technologies to monitor online prices every day. We use a combination of commercial and custom scraping solutions to address the complexities of monitoring prices across thousands of retailers. We identify the best retailers we can use for inflation measurement, and we make a significant effort to select retailers with large market shares, in relevant cities, that sell both online and offline.

Once our data collection is complete, we run a set of automatic procedures to ensure the viability of the data for inflation measurement. The data is structured and cleaned so it can be used consistently, and then it is categorized across economic sectors and sub-sectors. We compute our daily statistics using advanced econometric techniques and publish them with a three-day lag. From a practical perspective, the real-time nature of our indices is the greatest advantage relative to the official indicators in many countries.

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## How can investors use PriceStats® information?

PriceStats® Indices allow investors to make decisions using our timely insights to key macroeconomic variables and the performance of a wide range of investments. Our high-frequency view of inflation and relative prices across major economies can help investors anticipate shifts in inflation trends, measure exchange-rate valuations and build dynamic strategies to improve portfolio return and manage risk.

In addition to our series' higher frequency and shorter publication lag than official country inflation statistics, our research has shown evidence that trends in PriceStats® can anticipate trends in CPI for a range of potential reasons, including:

- It is generally easier and less costly for retailers to adjust prices on their website than in all of their physical stores. This may lead online prices to react faster to shocks than offline prices.
- Online consumers often have less loyalty, are accustomed to price changes and may have less recollection about past prices. Retailers know this and price their online products accordingly.
- Online retailing is much more competitive in terms of price comparisons than physical stores. So when inflationary pressures arise, stores tend to change online prices relatively quickly. The anticipation effect implies that trading strategies can be designed to take advantage of the economic information embedded in the PriceStats® series. For example, it suggests potential applications to trading real versus nominal bonds, as well as baskets of inflation-sensitive stocks.

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## How do you respond to the idea that globalization, the internet, and in particular Amazon might be keeping inflation down?

I think these are all contributing factors with varying degrees of importance. In particular, when people talk about the "Amazon Effect," they mostly consider the possibility that Amazon is putting downward pressure on retailer margins, so that they refrain from raising prices even if demand is rising. But there is a limit to how much margins can fall, so this is likely a temporary effect. I believe Amazon, and online commerce more generally, will affect inflation dynamics in more persistent ways by changing how pricing decisions are made.

In a recent paper I presented at the Fed's Jackson Hole conference, I showed that in the last 10 years large retailers facing online competition in the US have nearly doubled the frequency of price changes, possibly because many of them are using pricing algorithms and closely matching each other's prices. This has tended to increase the pass-through of some shocks (in particular gas prices and exchange rates) into consumer prices, and it provides a connection between the internet and globalization explanations.

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In your view, are central banks correct to target inflation as the main macroeconomic driver?

I am not a fan of single mandates and an exclusive focus on inflation. Central banks should also pay attention to output, employment and many other macroeconomic variables as well. Even when it comes to prices, I think central banks have to pay attention to non-standard metrics, which is one of the reasons why PriceStats® developed the PPP series, which track the cost of nearly identical baskets of hundreds of goods across countries.

Many central bankers would prefer to ignore exchange rates, but that is impossible in some cases. Understanding how exchange rates and prices relate to each other in different countries and settings is important for anyone, but especially for some central bankers now facing massive exchange-rate shocks.

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Inflation 2020: In which geographies do you see the biggest pockets of risk? Can we isolate the impact of coronavirus consequences in inflation measures?

Obviously, the most important shock now is the coronavirus pandemic. As of mid-March, we had still not seen a major impact on prices, except for a significant decline in fuel. In the short run, there is a surge in demand for groceries that is creating some stock outs but this has had little effect on prices for now. PriceStats® has quickly documented the increasing trend of out-of-stock items in many countries, as Tim Graf from State Street Global Markets has been writing about.

Moving forward, aggregate inflation is likely to fall in line with the negative demand shock we will probably experience, but some sectors may also see higher inflation as the supply shocks continue over time. It is impossible to know which countries are likely to experience more or less inflation, but this is precisely the kind of moment when having a real-time measure of inflation is important.

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What is the future of inflation measurement with PriceStats®? Do you have any new features or changes in the pipeline?

PriceStats® continuously expands its portfolio of inflation indices and PPP indicators. We are developing several indicators that will be announced shortly. Our goal is to continue to provide metrics that capture the most fundamental economic trends in real time.

# Q2 Investment Outlook

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**State Street Global Advisors has identified the key considerations for investors in the coming quarter.**

# Investment Theme #1

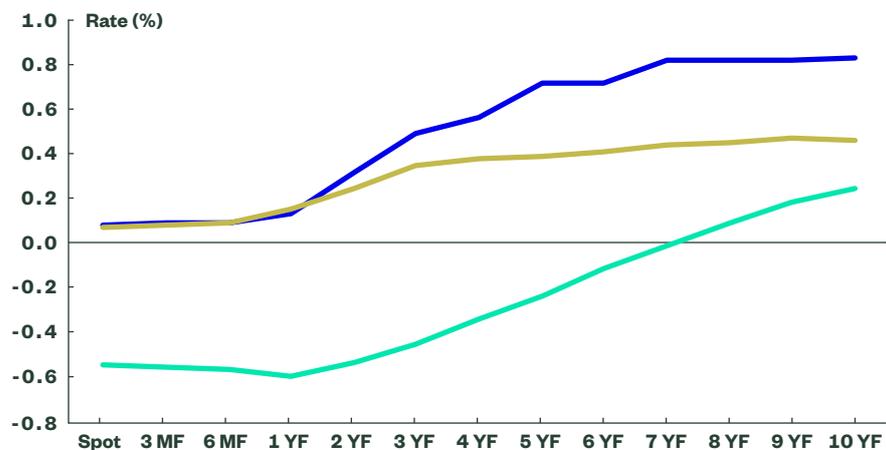
## Safety First

Q1 was a wild, largely unpleasant ride for most market participants. What started as concerns over the economic impact of COVID-19 morphed into something resembling the 2008/09 financial crisis as markets started to seize up. Thankfully, central banks and governments intervened, managing to stabilise markets. Despite substantial monetary and fiscal stimulus, economic data will continue to deteriorate as it reflects the scale of country shutdowns.

The bounce in risk assets at the end of Q1 has been taken by some as a sign that the worst is over — but is it safe yet? Interest rate markets price central bank rates remaining close to zero, or below, for an extended period (see chart below) while the relative flatness of the curve points to expectations that asset purchases will keep bond yields from rising. The big question, however, remains how long will the virus persist and to what degree will economies suffer? It is difficult to become bullish on risk assets while this question persists.

### Markets Not Pricing Rate Rises For Some Time

- USD
- EUR
- GBP



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 6 April 2020. Chart shows the forward pricing of the 1M Overnight Index Swap rates.

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## Investment Theme #2

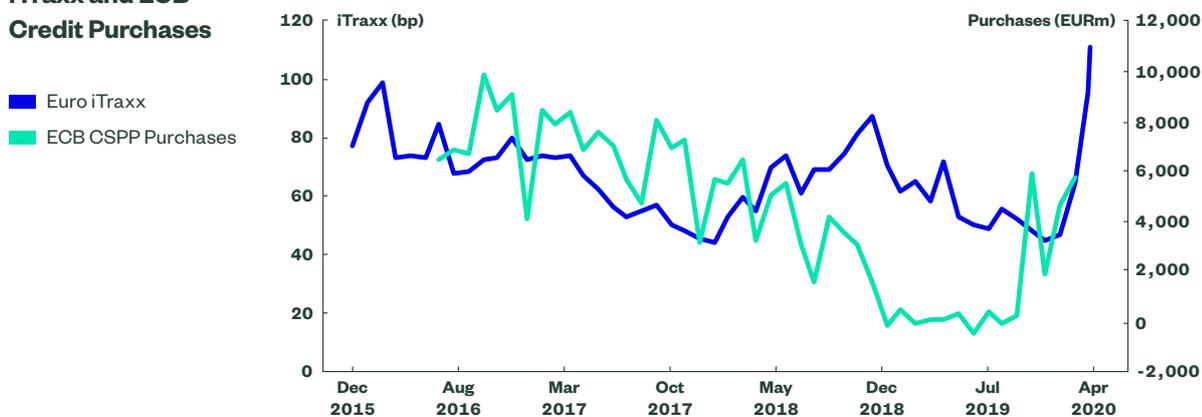
### Central Banks to the Rescue

COVID-19 presents a different set of challenges versus the crisis of 2008/09 but, crucially, central banks have acted quickly. Rate cuts and balance sheets were initially deployed to limit the worst effects of the economic slowdown on households and businesses. However, signs of acute market stress, akin to those seen in the Global Financial Crisis, also saw them dust off many of their older programs used to ensure markets continue to function.

A key ambition for central banks is to keep credit flowing to corporates. This means that buying programs for corporate bonds have been reactivated by the Fed, ECB and BoE. These all target investment grade paper, with the Fed's program buying paper out to 5 years, the ECB out to 30 years while the BoE is unconstrained. The Fed has announced it will also purchase corporate bond ETFs.

The economic backdrop for corporates looks uncertain but central banks have effectively offered a backstop, with scope to increase the size of these programs if signs of stress re-emerge.

#### iTraxx and ECB Credit Purchases



Source: State Street Global Advisors, Bloomberg Finance L.P., Markit, ECB, as of 3 April 2020.

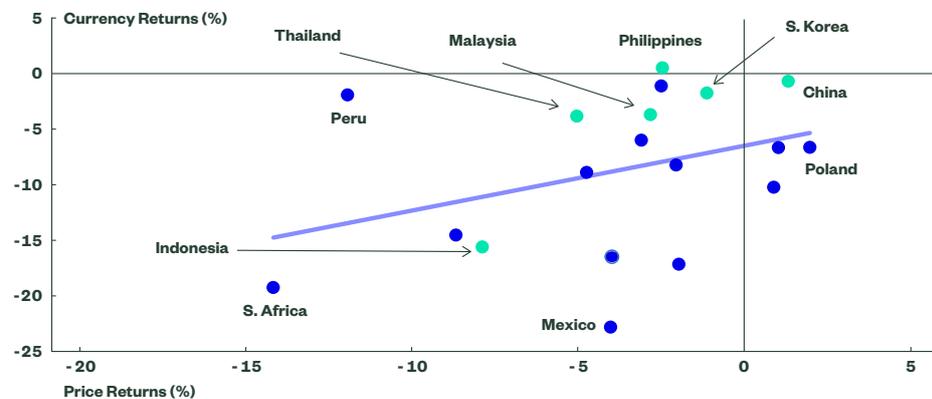
## Investment Theme #3

### Maintaining EMD Exposure

Recent weeks saw a perfect storm hit emerging markets (EM). Many countries were slowing before COVID-19 forced shutdowns. Add to that the collapse in demand for manufactured products and the price of commodities, oil in particular, and it is not surprising investors have fled for less risky areas. With markets having returned to a more stable equilibrium, there is still a case to hold EM risk in debt portfolios.

- **Higher yields on offer** The Bloomberg Barclays EM Local Currency Liquid Government Index has a yield to maturity of 4.45% and the ICE BofA 0–5 Year EM USD Government Bond index is 5.78%. These are well above the returns offered by developed market bond funds.
- **Given the degree of the sell-off, there is scope for a bounce** Price gains in EM bonds can come through various sources: gradual economic recovery; rebound in commodity prices; rebound in local currency bonds against the USD; and central banks starting to buy domestic bonds.
- **EM debt provides risk diversification** With G10 bond yields so low, there is an asymmetry to potential returns. This is not the case for EM debt, which is viewed more as a risk asset, and so should perform if the global recovery comes more quickly than expected.

#### Price and Currency Returns



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 6 April 2020.  
Past performance is not an indication of future returns.

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The units of the Sovereign Bond Flow Indicators are standardised by debt outstanding at each point in the curve and then for the aggregates are duration weighted. State Street Global Markets ("SSGM") then aggregate the indicators into percentiles to gauge the significance of a flow or positioning metric over a variety of time periods and countries. SSGM's use is aimed at being a simple way of ranking flow and positioning indicators relative to their own history. For all of the flow indicators within the State Street Bond Compass, State Street Global Markets calculates the percentiles based on the distribution of flows over the last five years using the daily aggregate time periods shown in the charts. As a guide a 100th percentile reading represents the strongest buying in five years; and a zero percentile equals the strongest selling. A reading in the 50th percentile would signal that net flows in the asset over the period are at their average level, typically close to zero.

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## Calendar of Events

Q2 2020

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### April

<b>3</b>	Fri	US	Change in Nonfarm Payrolls
<b>10</b>	Fri	US	CPI YoY
<b>22</b>	Wed	UK	CPI YoY
<b>28</b>	Tue	JN	BoJ Rate decision
<b>29</b>	Wed	US	FOMC Rate decision
<b>30</b>	Thu	EC	GDP SA QoQ
<b>30</b>	Thu	EC	CPI YoY
<b>30</b>	Thu	EC	ECB Main Refinancing Rate decision

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### May

<b>7</b>	Thu	UK	BoE Rate decision
<b>8</b>	Fri	US	Change in Nonfarm Payrolls
<b>12</b>	Tue	US	CPI YoY
<b>12</b>	Tue	UK	GDP QoQ
<b>15</b>	Fri	EC	GDP SA YoY
<b>20</b>	Wed	UK	CPI YoY
<b>28</b>	Thu	US	GDP Annualized QoQ
<b>29</b>	Fri	EC	CPI YoY

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### June

<b>4</b>	Thu	EUR	ECB Main Refinancing Rate decision
<b>5</b>	Fri	US	Change in Nonfarm Payrolls
<b>10</b>	Wed	US	CPI YoY
<b>10</b>	Wed	US	FOMC Rate decision
<b>17</b>	Wed	UK	CPI YoY
<b>18</b>	Thu	UK	BoE Rate decision
<b>30</b>	Tue	EC	CPI YoY