

# A more optimistic GDP forecast

## 2010 global real GDP forecast hiked from 3.2% to 3.7%

Downward pressures on economic activity remain strong, particularly with respect to falling employment and credit growth, as well as weak consumer spending in the advanced economies. However, the leading indicators for the supply side of the economy keep improving, the process of de-stocking cannot go on for ever, additional fiscal stimulus has been deployed in the US, and central banks continue to pump liquidity into the banking system. Our forecast for global real GDP growth in 2009 remains at -1.0%.

## US and Asian projections raised, Europe largely unchanged

The US forecast improves from -2.6% in 2009 and +1.7% in 2010, to -2.1% in 2009 and +2.6% in 2010. The forecast for emerging economies also improves significantly, especially in the case of Asia, where China is now expected to post a 9.6% growth rate in 2010, up from 8.3% previously, and India is projected to grow 7.3% versus the old forecast of 7.1%. The outlook for the smaller Asian economies also improves significantly, with the Korean forecast rising from 3.0% to 4.0%, and Taiwan from 3.5% to 4.5%.

## Emerging economies set to continue outperforming

The new forecast is consistent with a slow exit from the dramatic recession that the world economy has experienced since the end of last summer. Even with a projected 2.1% growth in 2010, real GDP in the advanced economies would remain 1.4% below its 2008 peak. On the other hand, the real GDP of emerging economies would stand 7.5% above its 2008 level, largely on account of continuing growth in India and China. Despite the "recoupling" that took place in the second half of last year, the global downturn has not interrupted the ascendancy of Emerging economies, China and India in particular.

## New global forecast banks on continuing fiscal stimulus

We see risks to our new global forecast as being tilted on the downside. The depth and duration of the recession could cause an aggravation in personal and corporate defaults that would negatively feed back into the banking system. Furthermore, the credit crunch continues, and geopolitical or other exogenous shocks could cause a double-dip if they hit the economy during the early stages of the recovery. On the upside, though, we believe governments are cognizant of the risks entailed by a continuation of the recession and, as a result, will inject an additional dose of fiscal stimulus into their respective economies well into 2010.

## Reading the tea leaves: surveys point to output gains ahead

Business surveys point to a bottoming out in US real GDP in Q3 and, more tentatively, in the Euro area economy. We have run a simple back-testing exercise on the US manufacturing PMI, where we had been closely watching the gap between the indices for new orders and inventories. The gap predicted the rise in the production component in June and points to further gains in Q3.

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Table 1: Global economic forecasts

	2009		2010	
	New	Old	New	Old
Global	-1.0	-1.0	3.7	3.2
Advanced economies	-3.4	-3.5	2.2	1.8
Emerging Markets	1.9	1.9	5.5	4.9
Emerging EMEA	-3.3	-2.5	2.4	1.8
Emerging Asia	5.3	5.1	7.7	6.9
Latin America	-1.1	-1.1	3.3	3.3
US	-2.1	-2.4	2.6	1.8
Euro area	-4.4	-4.4	1.2	1.2
Japan	-5.6	-5.6	3.5	3.4
UK	-4.1	-3.6	1.1	1.0
Canada	-2.0	-2.7	2.7	2.3
Germany	-6.0	-5.9	1.2	1.1
France	-2.8	-2.8	1.1	1.1
Italy	-4.9	-4.9	0.7	0.7
China	8.0	8.0	9.6	8.3
India	6.3	6.1	7.3	7.1
Brazil	0.5	0.5	4.5	4.5
Russia	-7.3	-4.9	2.4	1.0

Notes: Global and regional aggregates are based on the IMF PPP weights.  
Source: Banc of America Securities-Merrill Lynch

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Global overview

## A more optimistic GDP forecast

We have raised our global GDP forecast for 2010 as a result of a mid-year assessment of current conditions and of the economic outlook. Indeed, the latest data releases suggested that the downward pressures on economic activity remain strong, particularly with respect to falling employment and credit growth, as well as weak consumer spending in the advanced economies. However, the leading indicators for the supply side of the economy keep improving, the process of de-stocking cannot go on for ever, additional fiscal stimulus has been deployed in the US with the introduction of incentives to buy new cars, and central banks continue to pump liquidity into the banking system.

Our forecast for global real GDP growth in 2009 remains at -1.0% (using PPP-adjusted weights), while the 2010 forecast rises from +3.2% to +3.7%. The forecast upgrade comes almost entirely from the US and the Emerging economies. Indeed, the Euro area real GDP forecast for 2010 stays at +1.2% and the one for Japan improves only marginally, from +3.4% to +3.5%.

The US forecast improves from -2.6% in 2009 and +1.7% in 2010, to -2.1% in 2009 and +2.6% in 2010. The forecast for emerging economies also improves significantly, especially in the case of Asia, where China is now expected to post a 9.6% growth rate in 2010, up from 8.3% previously, and India is projected to grow 7.3% versus the old forecast of 7.1%. The outlook for the smaller Asian economies also improves significantly, with the Korean forecast rising from 3.0% to 4.0%, and Taiwan from 3.5% to 4.5%.

On the inflation front, the global CPI forecast rises only marginally, from 1.4% to 1.5% in 2009 as a result of higher oil prices, while the forecast for 2010 stays at 2.7%. Our commodity strategists expect the recent rise in oil prices to be partly reversed in the second half of the year, with an average price in the second half of 2009 just below the level at the time of writing (US\$66.75/bbl for the WTI). For 2010, they feel that the current level of the December 2010 contract (US\$74.75/bbl) is in the correct ballpark. (New official forecasts out next week.)

### Key factors driving upward revisions in GDP forecasts

The upward revision in the US forecast is discussed in [their recent publication](#). Our US forecasters now expect a slightly stronger recovery in personal consumption, largely on account of the fiscal stimulus gaining traction, though the real growth rate expected for 2010, at 1.5%, is still less than half the ten-year average growth rate in personal consumption pre-2008 (3.4%) and also way below the growth rates typically recorded during the first year of previous economic recoveries (eg, 3.3% in 1992 and 2.7% in 2002).

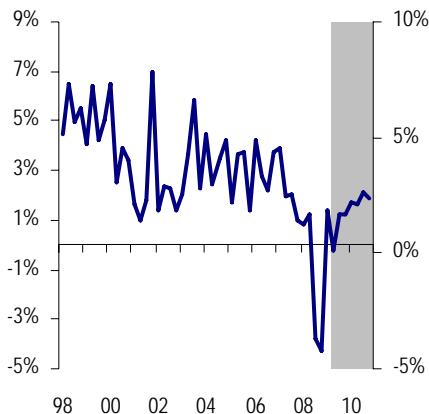
In addition, the US forecast now features an inventory cycle, while it previously incorporated a continuing contraction in inventories. As of Q1 2009, changes in inventories had been negative for eight of the past nine quarters, that is, for more than two years. The forecast now looks for a further four quarters of de-stocking, though the process loses intensity (and thus becomes supportive for quarter-on-quarter growth) in Q3 2009. Stock-building turns slightly positive in Q2 2010. According to the old forecast, inventory accumulation was negative through to Q4 2010. Note that in 2001-2002, the process of de-stocking lasted only five quarters. On our new forecast, it would last twelve quarters, while on the old one it totalled fifteen quarters, that is, more than three and a half years.

Table 2: Global economic forecasts

	2009		2010	
	New	Old	New	Old
Global	-1.0	-1.0	3.7	3.2
Advanced economies	-3.4	-3.5	2.2	1.8
Emerging Markets	1.9	1.9	5.5	4.9
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Euro area	-4.4	-4.4	1.2	1.2
Japan	-5.6	-5.6	3.5	3.4
UK	-4.1	-3.6	1.1	1.0
Canada	-2.0	-2.7	2.7	2.3
Germany	-6.0	-5.9	1.2	1.1
France	-2.8	-2.8	1.1	1.1
Italy	-4.9	-4.9	0.7	0.7
China	8.0	8.0	9.6	8.3
India	6.3	6.1	7.3	7.1
Brazil	0.5	0.5	4.5	4.5
Russia	-7.3	-4.9	2.4	1.0

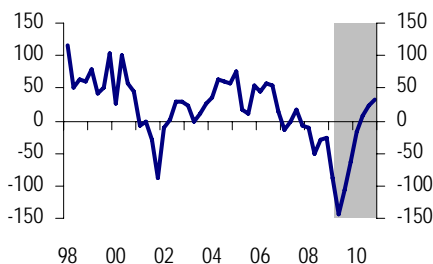
Notes: Global and regional aggregates are based on the IMF PPP weights.  
Source: Banc of America Securities-Merrill Lynch

Chart 1: US real PCE growth (% qoq, saar)



Note: Shaded area represents BAS-ML forecast. Source: BAS-ML, Haver

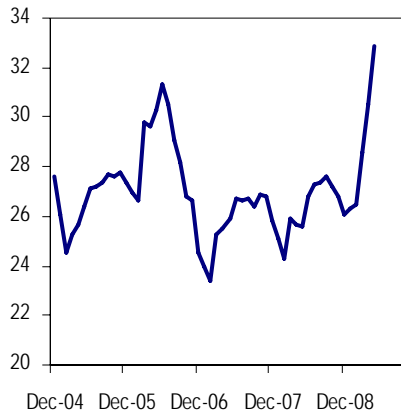
Chart 2: US inventory accumulation (US\$bn)



Note: Shaded area represents BAS-ML forecast. Source: BAS-ML, Haver

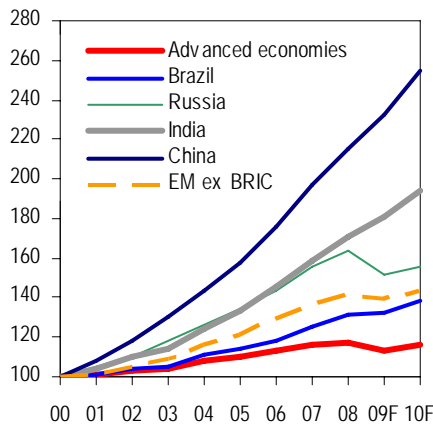
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Chart 3: China fixed asset investment (ytd, % yoy)



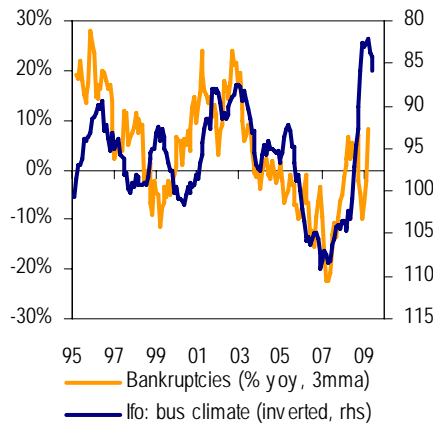
Source: Haver Analytics

Chart 4: Real GDP (2000=100)



Source: BAS-ML

Chart 5: German business bankruptcies vs Ifo survey



Source: Haver Analytics, BAS-ML

Other upward revisions in the US forecast include residential investment, which is now expected to bottom out in the current quarter, and net foreign trade, where exports are projected to resume growing in Q4 2009, albeit at a slow pace. Here the forecast contains a dose of optimism, as imports are expected to rise only moderately from Q4 2009 even as domestic final sales rise and the inventory cycle turns. On the whole, we reckon that a slightly more cautious projection for personal consumption, residential construction and imports would produce an annual real GDP growth rate of 2.2% in 2010 – still significantly higher than the old official forecast of 1.8%.

Turning to the Asian forecast, the upward revision is driven by a more optimistic assessment of domestic demand growth in China and India, as well as by stronger export projections for the whole region. The new foreign trade forecasts are inspired at least in part by the hike in the US forecast. The new Asian projections also reflect the success of fiscal stimulus across the continent. On our economists' latest estimates, the 2009 fiscal impulse ranges from 0.2ppt of GDP in India (which, however, enjoys a large monetary stimulus) to as high as 4.9ppt in Malaysia, with China at a sizable 3.1ppt (the largest program in nominal terms). A substantial stimulus is likely to be maintained in 2010, in our view. In other emerging regions, our Latin America team is still looking for a robust recovery in Brazil, with an unchanged 4.5% real GDP growth forecast for 2010, while our EEMEA team has lowered this year's estimate for Russia from -4.9% to -7.3%, but has raised the 2010 forecast from 1.0% to 2.4%

Europe sees very limited revisions to our forecasts, which should come as little surprise given the recent disappointing performance of Euro area indicators and the significant headwinds still confronting the continental economies. Euro area real GDP is estimated to fall by -4.4% this year and to recover by only 1.2% in 2010, still a much more optimistic prediction than the -1.0/+0.4% range forecast by the staff of the ECB. The 2010 forecast for the UK improves marginally, from 1.0% to 1.1%, but in the meantime the 2009 forecast has declined from -3.6% to -4.1% on the back of the revised official Q1 2009 data.

**Emerging economies set to continue outperforming, especially in Asia**

The new forecast is consistent with a slow exit from the dramatic recession that the world economy has experienced since the end of last summer. The advanced economies in particular would grow by 2.1% in 2010, following a 3.4% contraction this year. This would leave 2010 real GDP in the advanced economies 1.4% below its 2008 peak. On the other hand, the real GDP of emerging economies would stand 7.5% above its 2008 level, largely on account of continuing growth in India and China. It is thus evident that, despite the “re-coupling” that took place in the second half of last year, the 2008-09 global downturn would not interrupt the ascendancy of emerging economies, and China and India in particular.

**New forecast banks on continuing fiscal stimulus**

Following this revision, we see risks to our forecast as being slightly tilted on the downside. Indeed, the depth and duration of the recession could cause an aggravation in personal and corporate defaults that would negatively feed back into the banking system. Furthermore, the credit crunch continues, and geo-political or other exogenous shocks could cause a double-dip if they hit the economy during the early stages of the recovery. On the upside, though, we believe that governments are cognizant of the risks entailed by a continuation of the recession and, as a result, will inject an additional dose of fiscal stimulus into their respective economies going into 2010.

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Global business cycle

# Reading the tea leaves

With most of the key June business and consumer surveys out, it is now possible to draw a first assessment of the second quarter. The expectation that the pace of contraction in economic activity would slow ('positive second derivative') is now confirmed by the data. Moreover, both the surveys and the 'hard data' suggest that the large Asian economies have resumed growing.

Where do we go from here? In our view, the business surveys point to a positive first derivative in US real GDP in the third quarter and, more tentatively, in the Euro area economy. We have run a simple back-testing exercise on the US manufacturing PMI, where we have been closely watching the gap between the diffusion index for new orders and the one for inventories for a few months now. That gap has improved sharply in recent months, reaching a level of 18 points in May and June – a level that exceeds two standard deviations.

We have looked at prior downturns during which the manufacturing PMI was lower than 50 for at least 12 months and the said gap then rose to a level of at least 2 standard deviations. In five out of six cases in the history of the PMI (more than sixty years) in which these circumstances occurred, the PMI moved above 50 within the next two months. The only exception (a lag of six months) was the period following the terrorist attacks of 11 September, 2001, which caused a temporary setback in the PMI and delayed the upswing signalled by the sharp widening in the 'gap'. This precedent supports an argument that we have been making for some time now, namely that the improvement in the 'gap' looks very promising, but an exogenous shock could still derail the nascent recovery.

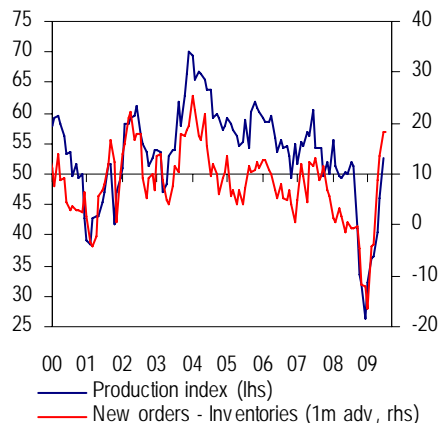
Considering what happened once the PMI rose above the 50 level, the median time it took for the index to fall back below 50 was 21 months. This means that recoveries/expansions that followed deep recessions and pronounced de-stocking were relatively long. The only time the PMI experienced a relapse within a year was in the upswing following the July 1952 breakout, when the index fell back below 50 after nine months.

A few buy-side economists we met recently argued that a bounce-back in the manufacturing PMI could be simply due to the initial impact of the fiscal stimulus package and to an inventory cycle and, as such, may not be sustainable. Indeed, a pickup in final demand is necessary in order for the recovery to last. We have thus run an additional test, in which we considered the PMI in conjunction with the data on real personal consumption expenditures (PCE). Not surprisingly, in cases in which the PMI broke above the 50 level and PCE growth exceeded half of its long-term growth (3.4 pct), the recovery proved to be sustainable.

The bottom line is the following:

1. The sharp improvement in the gap between the new orders and inventory diffusion indices points to a high probability that the US manufacturing PMI will rise above 50 in coming months. In fact, the production component of the PMI rose to 52.5 in June already (Chart 6).
2. Once the composite PMI breaks above 50, there is a very high probability that it stays above that level for almost two years, ie, that the manufacturing industry experiences a sustained recovery.
3. If real PCE growth also picks up to at least 1.7pct annualised, then the broad economy is likely to recover and manufacturing has a 50pct probability of expanding in each of the following twelve months.

Chart 6: US ISM survey



Note: New orders/Inventories gap is advanced by 1 month.  
Source: BAS-ML, Haver Analytics

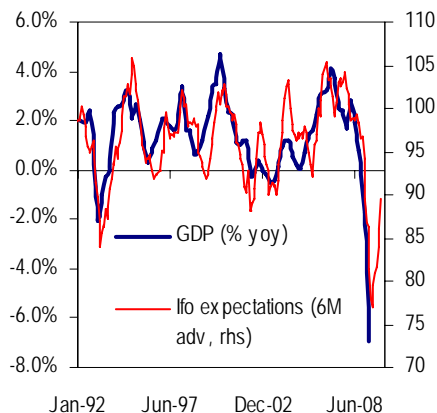
Table 3: ISM analysis - episodes when PMI has been below 50 for twelve consecutive months and new orders/inventories gap rises to more than two standard deviations

	Months till PMI	
	rises above 50	then relapses below 50*
Jul-Aug 1949	2	21
Jul 1952	1	9
Apr 1954	1	34
Apr-May 1958	2	21
Mar 1961	1	69
Aug 2001	6	12
May-Jun 2009	...	...
<b>Median</b>	<b>2</b>	<b>21</b>

Notes: \*Counted from the month when ISM above 50. Relapse is defined as ISM falling back below 50 for 3 consecutive months or more.

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Chart 7: German real GDP growth vs Ifo expectations



Note: Ifo expectations index is advanced by 6 months.  
Source: BAS-ML, Haver Analytics

German Ifo survey, June 2009:  
<http://www.cesifo-group.de/portal/page/portal/ifoHome/a-winifo/d1index/10indexgsk>

PCE rose by only 0.2% in real terms at an annual rate in the three months to May. The lack of a meaningful acceleration in PCE is thus a significant concern. However, the 'cash-for-clunkers' incentives that are about to go into effect are good news, as they should boost durables consumption and, in due course, auto production.

Looking further out, the economy could experience a relapse when the fiscal stimulus is removed. Professor Christina Romer, who chairs the President's Council of Economic Advisors, recently argued that the key medium term risk is that the fiscal and monetary stimulus could be removed too early, as was the case in 1937. Given the downside risks for the economy, in her view the best course of action is to err on the side of policy accommodation. This has also been our view for quite some time, and we believe that the auto incentives could be followed by other measures to support households' spending capacity.

Another objection we heard from some investors is that the inventory/shipments ratio in the US economy remains large, so the 'gap' we consider above may not be relevant. Here it is important to recall that the ISM PMI is a diffusion index that measures how conditions changed in each given month compared to the previous one (first derivative). A new orders index above 50, for instance, means that the share of firms reporting growing orders is larger than the share reporting declining orders.

A widening 'gap' between new orders and inventories means that, in relative terms, new orders are improving faster or declining more slowly than the rate at which inventories are falling. Thus, the 'gap' contains information about the second derivatives of new orders and inventories. Inventories may fall faster than orders even though their *level* is still high compared to shipments. If this continues to a significant degree, this should be supportive for production growth, as indeed has been the case already in June.

Moving to Europe, considering Germany's IFO survey, the current conditions index has kept deteriorating through to June, albeit at a slower pace. The expectations component, however, has now been improving for six months, rising by 12.5 points from the December trough. Over the years, the expectations component has sent a number of 'false signals.' However, its recoveries following outright recessions (at least two quarters of negative real GDP growth) have generally sent correct anticipatory signals about the business cycle.

For instance, in the final stages of the post-reunification recession in 1991-93, the IFO expectations index started rising in December 2002, correctly anticipating the recovery that commenced in Q2 1993. The track record of this survey is shorter than that of the manufacturing PMI in the US, but the improvement in expectations does suggest that there are good chances of a mild German (and European) recovery in the final months of the year. IFO publishes a nice chart that plots current conditions and expectations in four quadrants. The chart indeed suggests that if the recent evolution continued in the next three to four months, then the economy should enter a mild upswing.

We plan to extend our analysis to other European and Asian 'tea leaves' in forthcoming commentaries.

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## Mid-year review

# US: upgrading the US outlook

### A new beginning with some nagging reminders of the past

We are revising 2009E real GDP higher as well as the trajectory of growth through 2010 and into 2011. While the US will continue to suffer from the effects of recapitalization and restructuring within the financial sector, ongoing balance sheet repair in the household sector and fall-out from recent auto bankruptcies – all multi-year processes – we believe headline GDP stands to print stronger than we previously anticipated as growth emerges from a multitude of sources.

### H2 2009E growth now substantially above consensus

Our revision to growth over H2 2009E is significant and above consensus. We now expect growth to average 2.7% qoq annualized versus 1.4% previously and consensus expectations of 1.3% (as per the June Blue Chip survey). The reasons for this revision are:

- **Consumer spending:** Likely to benefit from two stimulus programs over the next several months, the first being the US\$250/social security recipient that was delivered in May. Under the assumption that only a portion of this money gets spent, retail sales should benefit in both June and July. Secondly, the Obama “Cash for Clunkers” program could boost auto sales starting in August, but will likely pull forward demand from early 2010.
- **Residential investment:** We are now tracking positive sequential growth in Q3, after 3½ years of declines, and a 53% correction from the peak is set to add to growth over the H2. This stabilization in homebuilding and slightly positive home sales could continue. Higher mortgage rates, sluggish demand and an inventory overhang will continue to put downward pressure on home prices through year-end.
- **Net exports:** Stronger projected rest of world growth, particularly in Q4 2009, boosted our estimate for exports, while a firmer consumer and investment spending profile in the US lifted import growth. On balance, we expect trade to add to headline GDP through the rest of this year.
- **Inventories:** Companies should continue to work down stocks at a rapid clip through Q2 with less of a draw-down in H2 – this mathematically translates into a positive contribution to GDP growth of around 1.4ppt in both Q3 and Q4 and a bigger swing than we had previously expected.

Table 4: Key GDP component revisions

Real Economic Activity, % SAAR	2009		2010	
	Old	New	Old	New
Real GDP	-2.4	-2.1	1.8	2.6
Final Sales	-1.7	-1.4	1.6	1.6
Domestic Demand	-2.8	-2.5	1.3	1.4
Consumer Spending	-1.0	-0.7	1.2	1.5
Residential Investment	-22.0	-20.1	-4	4.5
Nonresidential Investment	-16.6	-16.7	1.3	0.8
Structures	-14.3	-14.2	-3.7	-3.4
Equipment and Software	-17.9	-18.2	4.1	3.1
Government	1.3	1.7	2.1	1.0
Exports	-16.0	-15.7	-0.3	1.3
Imports	-20.5	-19.9	-2.6	-0.3
Net Exports (Bil 00\$)	-242.9	-248.7	-207.5	-228.7
Inventory Accumulation (Bil \$)	-111.7	-100.2	-88.4	11.4

Shaded region represents BAS-ML forecast.

Source: Banc of America Securities-Merrill Lynch

### 2010: consumer stuck in neutral

Our outlook for growth next year is also better, with real GDP growth averaging 2.6% yoy versus 1.8% previously. Again, inventory re-stocking should add 1ppt to headline growth as companies see firming demand and plan for future growth. Residential investment should also begin to recover, albeit slowly, led by a bottom in home prices (still another 10% away) and increased turnover. A peak in the unemployment rate at 10.5% in Q2 2010 should give way to increased hiring over the back half of the year. This, in turn, should lift wage and salary growth, enabling consumers to spend at a 2.0% qoq annualized rate in H2 – the strongest pace since mid-2007. Nevertheless, the trauma to household balance sheets will still likely mean an upward-trending savings rate that heads toward 7.0% by end-2010E. This is consistent with positive but sluggish consumer outlays, averaging 1.5% yoy (half the pace of pre-recession spending) through 2010. Separately, government spending should begin to fade as fiscal issues shift to the forefront and efforts are made to recoup prior stimulus via higher taxes.

## Inflation and the Fed to dominate the 2011 landscape

Despite our outlook for higher growth, we believe the economy will continue to suffer from an enormous amount of slack that extends beyond our forecast horizon. The output gap (actual GDP as a share of potential GDP) is expected to trough at -6.8% in Q2 2009, reaching -5.5% at end-2010 and only -4.3% by end-2011. This sub-par recovery should ensure that inflation remains well contained over the next 12-24 months and is consistent with our call for only 1.5% annual growth in CPI for 2010. The shift in inflation, we believe, will begin in mid-2011 when it heads above the Fed's comfort zone. Annual growth of 3.0% yoy will be supported by better consumer spending (2.0% yoy) on the heels of a more meaningful recovery in the labor market, in our view. Capex should also stage a stronger rebound with gains in non-residential investment and tech spending. On top of stronger growth, the Fed will begin to implement its exit strategy, thereby taking back some stimulus. We expect two rate hikes of 25bp each, bringing the Fed Funds rate to 75bp by end-2011E.

Table 5: US economic forecast summary

Real Economic Activity, % SAAR	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	2008	2009	2010	2011
Real GDP	-6.3	-5.5	-0.5	2.6	2.8	3.0	2.6	2.8	2.5	1.1	-2.1	2.6	3.0
% Change, Year Ago	-0.8	-2.5	-3.2	-2.5	-0.2	2.0	2.7	2.8	2.7				
Final Sales	-6.2	-3.3	1.5	1.3	1.3	1.4	1.8	2.2	2.1	1.4	-1.4	1.6	2.6
Domestic Demand	-5.8	-5.4	0.2	0.6	1.1	1.5	2.0	2.2	2.0	0.0	-2.5	1.4	2.5
Consumer Spending	-4.3	1.4	-0.2	1.2	1.2	1.7	1.6	2.1	1.9	0.2	-0.7	1.5	2.0
Durables	-22.1	9.5	-7.0	2.6	4.8	-1.0	1.5	2.0	3.2	-4.3	-5.3	1.2	2.8
Nondurables	-9.4	-0.4	-1.0	2.8	1.0	1.2	2.0	2.2	1.5	-0.6	-2.4	1.5	1.8
Services	1.5	0.9	1.3	0.3	0.7	2.4	1.5	2.0	1.8	1.5	0.9	1.5	2.0
Residential Investment	-22.7	-38.8	-12.5	2.5	2.0	9.0	7.5	6.0	5.5	-20.8	-20.1	4.5	6.1
Nonresidential Investment	-21.7	-37.3	-4.4	-8.0	-1.0	2.6	4.3	4.5	5.7	1.6	-16.7	0.8	7.4
Structures	-9.4	-42.9	4.5	-15.0	-8.0	-2.5	-0.5	2.0	6.0	11.2	-14.2	-3.4	7.5
Equipment and Software	-28.1	-33.7	-9.5	-4.0	3.0	5.5	7.0	6.0	5.5	-3.0	-18.2	3.1	7.3
Government	1.3	-3.1	5.0	2.0	1.6	-1.0	1.3	1.0	0.5	2.9	1.7	1.0	1.4
Exports	-23.6	-30.6	-16.5	-6.5	5.0	2.5	3.0	6.0	7.0	6.2	-15.7	1.3	5.7
Imports	-17.5	-36.4	-24.0	-10.5	3.0	2.6	4.2	5.0	5.5	-3.5	-19.9	-0.3	3.8
Net Exports (Bil \$)	-364.5	-296.8	-247.7	-227.4	-223.0	-224.7	-230.8	-230.5	-229.0	-390.2	-248.7	-228.7	-213.5
Inventory Accumulation (Bil \$)	-25.8	-87.1	-144.8	-106.6	-62.4	-17.0	6.2	22.7	33.7	-29.1	-100.2	11.4	47.0

Shaded region represents BAS-ML forecast. Source: Banc of America Securities-Merrill Lynch

## The week ahead: the data doldrums

The highlights of the data releases for the week will be the ISM non-manufacturing index for June and the trade data for May, as the second week of July offers little for economists to ponder. Second-tier indicators including consumer credit, wholesale inventories, import prices and consumer sentiment are all that are left to fill in the calendar. We look for the data to confirm recent trends consistent with a gradually improving economy partially restrained by consumers' ongoing desire to continue with balance sheet repair. There are no significant Fed speakers scheduled during the week.

## Surfeit of supply

The slow data week will not be without activity. The Treasury will conduct four coupon auctions and at least three bill auctions. It will auction a 10-year inflation-indexed note, a 3-year note, a 10-year note and a 30-year bond to raise a net US\$57bn. In addition to these auctions, the Fed will conduct two purchases of US Treasury securities as part of its ongoing buying program, likely purchasing less than US\$10bn of government debt.

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## Mid-year review

### Canada: BoCguise

Fiscal and monetary policy will start reviving the Canadian economy by the end of the year, in our view, and the more optimistic outlook for the US economy will provide some boost to 2010 as well. That fuelled-up growth may well test the Bank of Canada's commitment to leaving rates at the effective lower bound until mid-2010. We do not believe the Bank will go as far as raising administered rates any time soon, but any softening on the conditional commitment, or throttling back on term PRA transactions, will push long rates higher, with the 10-year likely to top out at close to 4.00% by the end of the year.

#### GDP higher, unemployment peak lower

We have revised our GDP forecast up to -2.0% for 2009 (was -2.7%) and now expect 2010 to post a 2.7% increase versus 2.3% in our previous forecast. By the end of the year, we think job losses will probably taper off and give way to some modest employment growth in the fourth quarter, allowing the unemployment rate to top out at a 12-year high of 9% this autumn.

#### Not fighting the feds, but not turning bullish

Summing up our forecast in one phrase – we are not going to fight the feds. Both fiscal policy and monetary policy are in easy mode and the magnitude of the policy response should produce growth. While these are rather significant upgrades to the outlook, we remain bearish longer term. Restructuring and credit issues are going to be headwinds for the Canadian economy for the next couple of years, in our view, much like the Bank of Canada laid out in the last Monetary Policy Report. Nonetheless, signs of accelerating growth and the absence of any significant rollover in core inflation will, in our view, prompt the Bank to overreact much as it overreacted to the downside risks to growth earlier this year. All of which suggest the upturn in the economy will be very short-lived indeed.

#### Consumers take low rate/discount bait

If the June auto sales numbers are any guidepost, consumers are taking advantage of low financing rates as well as those fire-sale prices at closing auto dealers – a sign that monetary policy is working. We estimate that sales jumped 8.5% mom in June, with the April-June figures likely to be up an impressive 23% qoq annualized, and the Q3 may produce a similar outturn. Some of this spending may be pulling future sales forward so there could well be some slowing in consumer purchases of durable goods early next year.

#### Capex stabilizes but building will languish

Low interest rates, alongside a gradual absorption of spare capacity, should also work their magic on business purchases of capital goods, with machinery and software spending likely to begin picking up in 2010. However, nonresidential construction will probably not see any significant recovery until beyond our current forecast horizon, in 2011. Residential home construction will not fare much better, in our view, as the expected run-up in longer-term rates puts upward pressure on mortgage rates.

#### Disappointing disinflation

On the inflation front, we still expect a rather notable slowing in core CPI, but the yearly rate will probably not slip below the 1% marker until 2010. Massive restructuring in many sectors – most notably the auto sector – will reduce capacity in the economy and slow the pace of productivity growth. Combined with stronger growth in the back half of 2009 and early 2010, this should close the output gap more quickly than previously expected, limiting the downside to core inflation this year.

## The week ahead

Next week will see two major data reports on Friday morning, with a host of housing market indicators scattered throughout the week. Markets will be focused on Friday's employment data, which we expect will show further labour market deterioration in June, pushing the unemployment rate to 8.7%, the highest since January 1998. Elevated inventory levels and weak demand continue to spawn job (and production) cuts, with more negative reports likely in the pipeline. The other major piece of data will be Canada's international trade balance, which we expect to move deeper into deficit in May. Underlying weak trade flows are expected to be the key driver, but a surge in the CAD should take some of the sting out of the headline number by drastically lowering import prices.

### Housing starts to remain soft

We expect housing starts to fall to 125.0k in June after an unexpected bounce in May. A result consistent with our forecast is still well below the household formation rate of 175k, echoing a bigger need to work down excess inventories (currently at their highest level since 1995) before we see any sustained recovery. Recent sales activity is an encouraging sign that some of that inventory is starting to be worked through, but homebuyers still face considerable employment headwinds and tight credit conditions that should restrict home purchases in the coming months. Overall, we expect the number of starts to show signs of bottoming through the summer.

### Job losses in June will likely drive unemployment to 8.7%

Employment data from the Labour Force Survey (LFS) are likely to reveal further deterioration in the labour market. We expect a net job loss of 35.0k in June, which would bring the total drop in employment to 397.5k since last October. Ongoing production cuts and the closure of nearly half of all GM dealerships in Canada are sure to weigh on the auto sector. Additional cuts to manufacturing jobs are likely as firms continue to pare back production in the face of still-elevated inventories. We could see some upside from public service employment, which has added roughly 17k jobs over the past two months. A result in line with our forecast would drive the unemployment rate to 8.7%, in line with consensus and the highest since January 1998. In the coming months we will look for the rate of job loss to slow as production and demand stabilize.

### Canada to maintain trade deficit in May

We expect Canada to run a -C\$0.7bn trade deficit in May, the fourth in just six months. Anecdotal evidence suggests a third straight month of weak underlying trade flows, and we anticipate a 5.0% mom drop in real exports will overshadow a 1.0% drop in real imports. However, a sharp appreciation of the CAD over the month will translate into plunging import prices (-4.1% mom by our estimate) that will provide an improvement in Canada's terms of trade despite our forecast for a 1.9% drop in export prices. On balance, we think the trade numbers for May will emphasize the fragile state of trade, with much of the world economy still mired in deep recession.

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## Mid-year review

### Eurozone: the laggard hits bottom

Let us start with the good news. We can detect ever more signs that the vicious recession could already be coming to an end over the course of Q3. This is slightly earlier than we had expected in March. Five of the six components of our Recovery Checklist have edged up further in recent weeks. For example, ZEW investor confidence, Ifo expectations and the composite PMI all rose in June. The only exception is industrial orders, which fell again in April. But as we had not expected them to turn up before May or June, that alone does not spoil the outlook so far.

#### The stimulus is small but is starting to work

In addition, the ECB's monetary stimulus and fiscal boosts provided by national governments, even if much less pronounced than in the US, are having an impact. By securing €442bn in ECB liquidity at 1% in the first-ever 12-month refinancing operation on 23 June, Euro-area banks now have cheap funds to use until mid-2010. Subsidies for the purchase of new cars upon scrapping an old one ("cash for clunkers" in US parlance) have revived car sales temporarily. German construction orders show a 13% yoy increase in civil engineering orders in April, reflecting increased public infrastructure spending.

The inventory correction is also progressing fast. According to the Eurozone manufacturing PMI, the ratio of new orders to inventories is now slightly above the long-term average (Chart 8). The period in which Eurozone production had to run even below the dismal level of demand as firms cleared their inventories should come to an end at some point in H2 2009.

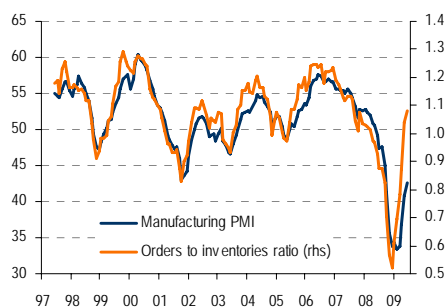
The good news makes us more confident that business investment abroad and at home will start to recover at least slightly from the vicious "post-Lehman" slump in late 2009. A cautious rebuilding of inventories could add to the possible gains in domestic and foreign demand for investment goods in 2010.

Unfortunately, we also have to contend with bad news. First, because the Eurozone has less monetary and fiscal stimulus than the US and suffers from an overvalued exchange rate to boot, it will likely start to rebound slightly later and somewhat more haltingly than the US (and the UK). While our US colleagues had grounds to recently upgrade their forecasts substantially, we have little reason to do so in Europe. Second, oil prices rose to €49/bbl for Brent crude in June versus an average of €34.5/bbl in the first three months of 2009. Such an increase raises the consumer price index by roughly 0.8% and hits real disposable incomes accordingly.

#### GDP forecast: largely confirmed

On balance, the good and bad news roughly offset each other. We thus leave our annual GDP forecasts of -4.4% for 2009 and 1.2% for 2010. We make only marginal adjustments to the quarterly profile, reducing our call for Q3 from 0.2% to 0.1% qoq while raising our call for Q1 2010 from 0.3% to 0.4% qoq. As before, the risks are to the downside near term but may well be to the upside from early 2010 onwards. For 2011, we project 2.4% growth, above the Eurozone's 2% potential rate. Once the labour market stabilises in mid-2010, private consumption should add some momentum to the rebound in overall demand. Unlike their US and UK counterparts, Eurozone consumers have no reason to raise their savings rate longer term.

Chart 8: Inventory correction to end soon



Source: Markit; EU Commission survey

Good and bad news roughly offset each other

Although we reaffirm our overall calls for GDP in 2009 and 2010, we adjust the various demand components:

**Private consumption:** the recent rebound in oil prices will weigh on consumption. In addition, the success of the car purchase subsidies now means that, because many consumers will have new cars soon, many fewer than usual will need to buy a new one next year. We no longer expect consumer spending to stabilise over the summer. We now look for modest consumption declines through Q1 2010. This takes our call for the overall change in consumption growth next year to -0.3% from 0.8%.

**Investment** could rebound a bit less timidly than projected so far, helped by some government spending programmes, a lessening of the major declines in residential construction and some modest if patchy rebound in business investment around the globe. Some firms should see less need to hoard cash and reactivate at least some of the replacement investment plans which they had summarily shelved in late 2008. We raise our 2010 call from 1.6% to 2.3%, following a massive 9.4% slump in 2009E.

**Net exports:** more subdued consumption will weigh on imports, and favourable news from the US, Asia, and some oil countries will support exports. We raise our call for the net export contribution in 2010 from -0.1% to 0.2%.

### Inflation: driven by oil base effects

Eurozone core inflation has come down from an average of 1.85% in the second half of 2008 to 1.5% in May. Record-lows in manufacturing capacity utilisation, sharp rises in unemployment, the impact of a still-overvalued euro and the squeeze of real disposable incomes caused by the recent rebound in oil prices should push core inflation down further to a trough of 0.8% in early 2010. However, the base effect from the very low oil prices in early 2009 will add around 0.8% to this. We revise our inflation forecasts accordingly.

In terms of monthly data, we expect the oil price base effects to lift headline inflation from a likely trough of -0.3% yoy this July to a peak of 1.6% in February 2010 before falling back to 1% by mid-2010. In terms of annual data, we raise our forecast for average inflation from 0.4% to 0.5% for 2009 and from 0.9% to 1.2% for 2010. We expect only a small rise to 1.5% in 2011 as the economic upswing will absorb spare capacity only gradually.

None of these changes is substantial enough to have any impact on our ECB call. After its misguided rate hike last July, the ECB has learned the hard way not to react with its policy stance to gyrations in headline inflation caused solely by energy prices. We expect the ECB to stay on hold at 1% until September 2010. While the ECB may increase the size of its €60bn programme to buy covered bonds, the probability of outright purchases of corporate securities such as commercial paper remains well below 50%, in our view.

### The week ahead

Attention will focus on German data for factory orders (7 July) and industrial output (8 July). The weak VDMA report for machinery orders points to a further decline in overall factory orders. However, after a 1.9% monthly drop in April, likely exacerbated by the late timing of the Easter holiday, industrial output could rebound modestly. We project a 0.6% mom gain.

Core inflation coming down - but only gradually

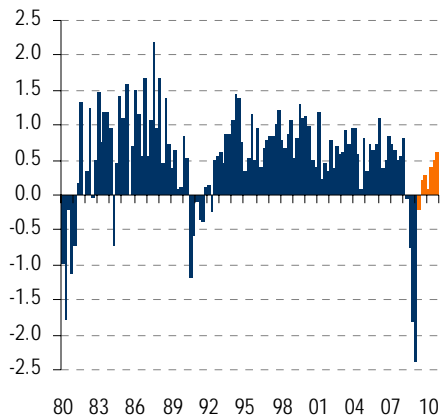
Mind the base effects

Output and orders

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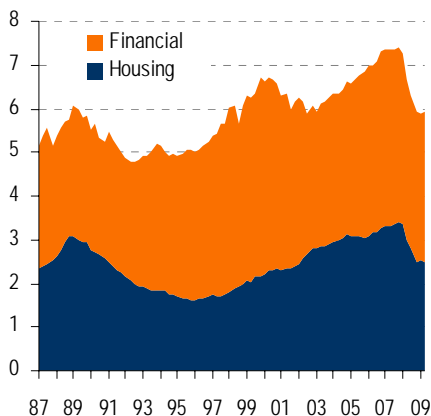
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Chart 9: GDP growth (% qoq)



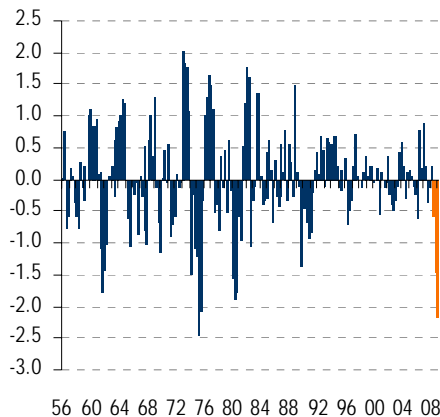
Source: ONS, BAS-ML forecasts

Chart 10: Household net wealth\*



Source: ONS, BAS-ML. \*Multiples of annual income.

Chart 11: Inventories contribution to yoy GDP



Source: ONS, BAS-ML

## Mid-year review

### UK: recession over, slow recovery

The UK economy may now be exiting recession: there is emerging evidence that activity has been broadly flat in recent weeks. But over the full course of the recession, output may have contracted by around a cumulative 5.2%: a slightly larger decline than in the early 1980s recession, and around double that in the early 1990s (Chart 9). Moreover, despite the swift rebound from the precipitous falls in output in Q4 2008 and Q1 2009, we expect GDP growth to remain muted over the next few quarters: after a 4.1% contraction in 2009, we expect a recovery to only just above 1% in 2010.

### Stock cycle turning, consumer spending weak

Changes in firms' inventories have accounted for around 2.2ppt of the 5% contraction in GDP over the last year (Chart 11). Such a large drag on growth was unlikely to continue for very much longer – implying ever-sharper falls in inventories – and thus a reduced pace of inventory liquidation could have accounted for a sizeable part of the firming in the economy in recent weeks. But in turn, that could imply that the support to the recovery from inventories – which was always likely to come at some (albeit unknown) point – has occurred sooner rather than later: it need not augur anything for the overall strength of the recovery over the next few quarters as a whole.

The circa 20% falls in house prices and 35% declines in equity markets since summer 2007 have had a marked impact on many households' balance sheets: reducing the measured net wealth of the household sector by around 150% of annual income (Chart 10). In addition, the unemployment rate has risen by around 2ppt, and wage growth has fallen back notably. So with tight credit conditions continuing to mute the housing market and consumer borrowing, and the labour market adjusting further to the precipitous falls in output in recent quarters, we expect the considerable damage to households' balance sheets and continued concerns over income and employment prospects to result in households restraining their spending and increasing their savings over the next few quarters.

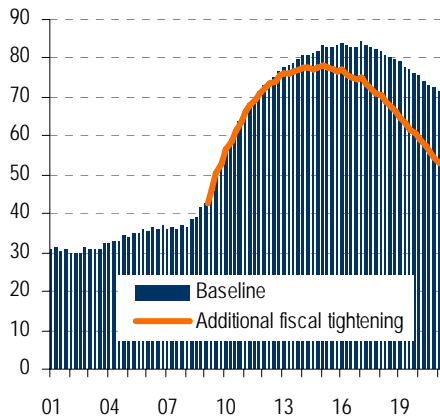
### Further fiscal tightening seems likely

The public finances have deteriorated sharply over the last year, and we expect borrowing to reach around 12.9% of GDP in 2009-10. Moreover, despite a cyclical recovery, some structural tightening (VAT returning to 17.5%, the new 50% income tax rate and slower growth in public spending) and sharp cuts in public sector investment, we expect Public Sector Net Borrowing (PSNB) to still be around 7% in 2013-14, with Public Sector Net Debt (PSND) correspondingly at around 80% of GDP, compared to 36% in 2007-08.

Against that backdrop, while subject to the underlying strength of the economy, we think a greater degree of structural fiscal tightening could be implemented. For example, the cumulative effects of an additional fiscal tightening of 0.5% of GDP per year for five years would put the public finances back onto a notably firmer footing: reducing Public Sector Net Debt (PSND) to around 50% of GDP again by 2020-21, compared to a more moderate fall to around 70% otherwise (Chart 12). Though contingent upon meeting the inflation target, that additional fiscal tightening would put more of an onus on monetary policy to support a recovery in the economy – thus weighing towards lower interest rates than otherwise.

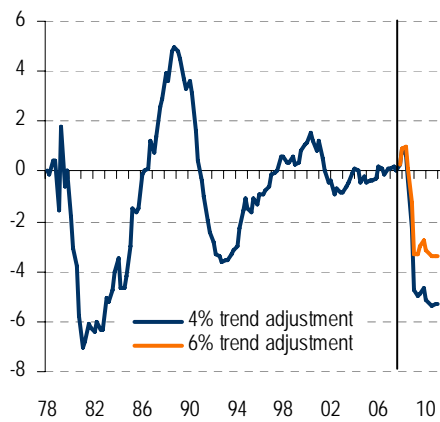
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Chart 12: PSND (% GDP)



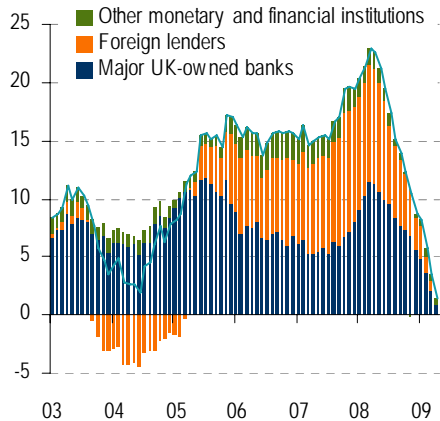
Source: ONS, BAS-ML. Additional tightening from 2011-12 for 5 years.

Chart 13: Output gap estimates (%)



Source: BAS-ML

Chart 14: Contributions to corporate lending growth (ppt, yoy)



Source: Bank of England

### Inflation surprised on the upside, but prospects are muted

Over the last six months as a whole, CPI inflation has not fallen back from its peaks in autumn 2008 as quickly as expected. Stronger-than-anticipated pass-through from the circa 20% sterling depreciation since mid-2007 seems a likely explanatory factor. However, alongside the strengthening in the exchange rate since early-2009, import prices have levelled off, and imported inflationary pressures – at least at the early stages of the supply chain – are now fading.

Even trying to take account of the potentially large negative impact on the supply capacity of the economy from the global financial crisis, the recession and the muted growth prospects ahead will open up a significant degree of slack in the economy (Chart 13). We see that muting the inflation outlook considerably, increasingly dominating upward pressures from the weaker exchange rate. Thus, while headline CPI inflation will be heavily influenced by energy price and VAT effects over the next few quarters, we expect underlying inflation to ease back.

### Credit supply conditions are a key risk

In recent months, banks have reportedly eased credit supply conditions to the corporate sector a little, and expect to loosen lending criteria further going forwards. At the same time, conditions for (predominantly large) firms to secure financing through capital markets – rather than through banks – have also improved. However, despite those improvements and some of the large UK banks' commitments to increase lending, the still-tight credit conditions imposed by banks, the exit/scaling back of operations by foreign banks in the UK, and the expiry of significant government/Bank of England support facilities in due course (which will then need to be fully financed by the private sector again) still pose significant downside risks to the outlook, in our view (Chart 14). Indeed, as the banking sector continues to adjust to a more sustainable position – with regulatory changes potentially adding to the required adjustments – credit supply conditions could continue to weigh heavily on the economy.

### MPC to increase quantitative easing to £150bn

In light of the recent improvements in both financial markets and the broader economy, we think the MPC may pause with their quantitative easing (QE) programme at £125bn in July: giving them a little more time to assess both the emerging signs of its effectiveness, and the potential strength and sustainability of the recovery in the economy more generally. However, the August Inflation Report will provide an important vehicle for the MPC to reassess the outlook more fully, and with the downside risks to inflation from the sizeable degree of spare capacity in the economy and still-tight credit conditions dominating, we expect them to increase the size of their QE programme to the full £150bn currently available to them.

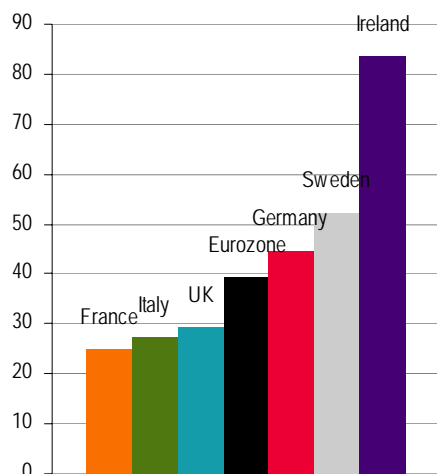
In due course, the MPC can be expected to tighten monetary policy again through a combination of raising Bank Rate, selling assets bought under QE back into the market, or issuing Bank of England bills. However, we think that is still some way off. While there are of course very large uncertainties, we currently envisage the MPC starting to raise Bank Rate again in around mid-2010: a somewhat looser monetary policy stance compared to current market expectations of around 100bp of tightening by then.

[This is a summary of a longer article, to be published next week].

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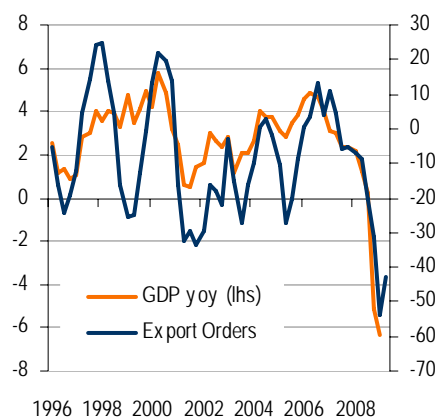
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Chart 15: Export share in GDP



Source: National sources

Chart 16: Signs of stabilisation



Source: Haver

## Mid-year review

### Sweden: exports can hurt

Sweden is a small open economy with a specialisation in capital and intermediate goods exports. The collapse in global demand which followed the equivalent of a near heart attack in the financial system has hurt the economy badly. Like Germany, exports account for some 50% of GDP. We look for a 5.5% plunge in GDP this year with only a modest 1.1% recovery next year. Sweden's economic and financial links to the Baltic states remain a key risk to the outlook, in our view.

#### Stabilisation after dramatic plunge

Signs of a stabilisation in global demand suggest less severe economic decline in Q2, and possibly a return to growth late this year. On the positive side, Sweden's PMI index has rebounded sharply from the 32.7 record-low set in December to 50.5 in June, signalling modest expansion. Export orders have bounced off record lows but remain moribund (Chart 16). The inventory correction appears to have run its course – after subtracting a massive 2.9ppt off Q4 quarter-over-quarter GDP growth, inventories added 0.4ppt to Q1 growth. However, rapidly rising unemployment will likely increasingly weigh on consumer spending. Having already surged 3.8ppt to 9.0% over the past 10 months, we expect the unemployment rate to rise above 10% next year. Consumer spending is likely to decline into 2010 even as the economy returns to growth later this year.

#### Baltic risks

The Bank of International Settlements estimates that Sweden has made some US\$75bn in loans to the Baltics, approximately 18% of Sweden's GDP. A currency devaluation in one of the Baltic states, such as Latvia, would likely lead to large loan losses for Swedish banks as Latvian residents became unable to service their more expensive foreign currency-denominated loans. The G20 deal to quadruple the IMF's resources has significantly reduced the threat of financial contagion in Eastern Europe and the Baltics, in our view.

#### What inflation?

Headline inflation is already negative, falling 0.5% yoy in May. This stems from the dive in oil prices since mid-2008 as well as sharp falls in household utility prices and mortgage interest rates. Excluding mortgage interest payments, underlying inflation has seen less pronounced swings. Capacity utilisation rates in the capital and intermediate goods sectors are at decade lows. The sharp deceleration in average earnings growth from an average 3.5% yoy in the past few years to a record low of 1.3% in March (since recovered to 2.3% in April) will be a drag on core inflation. We believe headline inflation could remain negative until Q4 when base effects from the late 2008 plunge in oil prices will likely push inflation back into positive territory. Underlying inflation is likely to fall to a trough of 1% by end-2009 and remain at this level through much of 2010.

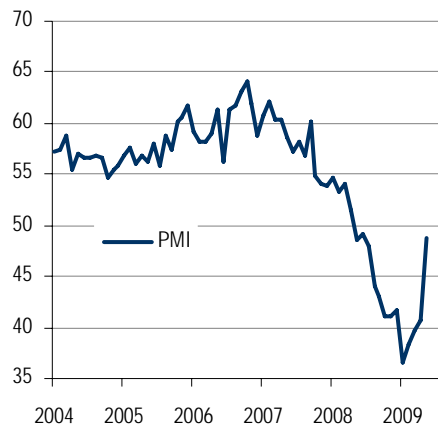
#### Taking no chances

The Riksbank is taking no chances with a still-fragile recovery. Not only did it cut rates unexpectedly by 25bp to a record low of 0.25% in July, it also attempted to improve liquidity further by offering a fixed-rate 12-month loan auction ([see report](#)). We believe that rates will remain at current levels over the coming year. We expect a first hike of 0.25% at the earliest in July 2010. If financial markets continue to heal and leading indicators strengthen into the autumn, the Riksbank may see little need to go down the quantitative easing route.

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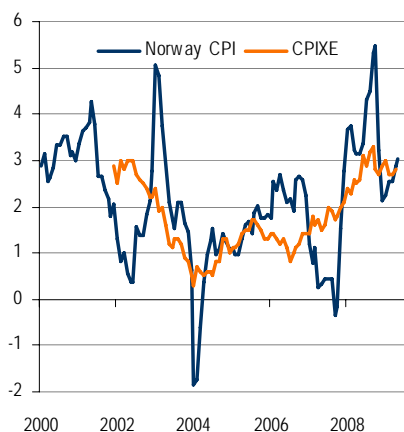
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Chart 17: Looking up



Source: NIMA

Chart 18: Sticky inflation



Source: National statistics

## Mid-year review

### Norway: oil can help

As a commodity producer, Norway has got off relatively lightly in the current global recession compared with some of its European peers. We expect the Norwegian economy to contract 'only' 1.7% this year. This would not be nearly as bad as the -4.4% we project for the Eurozone or our -5.5% call for Sweden.

#### Favourable dynamics

The more favourable economic outlook stems partly from the better fiscal position of Norway relative to its peers, which has provided room for comparatively larger fiscal stimulus. Nominal government spending was running at an above 10% yoy pace in Q1 2009, double that in the Eurozone. The non-oil budget deficit will likely increase by around 4.2ppt of GDP between 2008 and 2009 to 4.6%. In addition, given most households are owner-occupiers on variable rate mortgages, the plunge in interest rates has boosted disposable income, while the only modest pick-up in unemployment so far is unlikely to provide a significant headwind to consumption once sentiment recovers. Also, the current level of energy prices supports Norway's important oil sector. Throughout the global downturn, oil-related investment has remained robust.

#### By no means smooth sailing

Mainland manufacturing activity, like elsewhere, has been hard hit, with traditional goods and services exports plunging some 10% yoy in Q1. On the plus side, the inventory correction appears to have run its course. Inventories knocked a relatively modest 1.0ppt off quarter-on-quarter growth in Q4 and subsequently added 0.9ppt back in Q1. Business surveys have recorded a sharp bounce-back in activity. The manufacturing PMI surged to 48.7 in June, a 14-month high, having bottomed out at 36.5 in February this year. Green shoots have not been confined to the business sector. Consumer sentiment has also turned, reaching a 9-month high of -4.4 in Q2, but still well below the survey average of +19. On balance, the data suggest the economy could start expanding from as early as Q3, with a 1.5% rise in GDP possible in 2010, in our view.

#### Sticky inflation

Inflation has shown some stubbornness of late, rising further above target in the most recent two months – now 3.0% on the headline measure and 2.8% on the core CPIXE index. We still expect inflation to fall back in the months ahead in the face of lower capacity utilisation and weaker nominal wage growth, which operate on prices with a considerable lag. We expect that core CPIXE inflation will probably fall back to around 2.0% by early next year, below the Norges Bank's 2.5% inflation target. With the economy growing well below trend next year, the negative output gap will probably leave core inflation fairly subdued and below the inflation target throughout 2010.

#### Done for now

The Norges Bank's latest rates projections signal that 1.25% represents the trough. Still, the statement explicitly noted that the deposit rate would remain "close to 1% for some time", which probably leaves the door ajar for further easing should the economic data disappoint. The Norges Bank's fan chart projections suggest the earliest time we could expect monetary tightening is Q2 2010, which is broadly in line with our call that the first 25bp hike will not come until June next year. We expect rates to be raised gently to 2.25% by end-2010. With room still to cut rates in the near term, possible moves into credit/quantitative easing programmes do not seem very likely to us at this stage.

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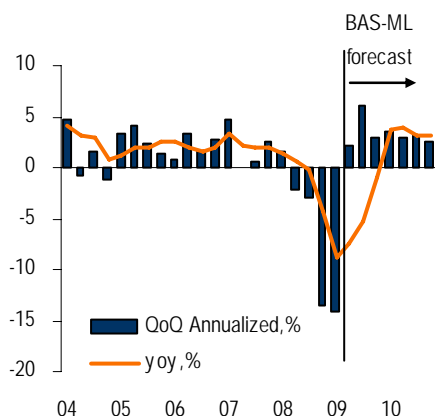
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Table 6: Economic outlook

	CY08	CY09	CY10
GDP	-0.7	-5.6	3.5
Private Consumption	0.6	-0.7	1.4
Private Capex	-4.0	-18.4	2.5
Private Resid. Investment	-7.6	-6.5	3.0
Exports	1.8	-30.5	13.5
Imports	0.9	-14.3	4.7
Industrial Production	-3.3	-26.0	12.3
Unemployment rate	4.0	5.0	4.7
CPI	1.5	-1.3	-0.5
Policy rate	0.10	0.10	0.50
JGB 10-year	1.17	1.60	1.95

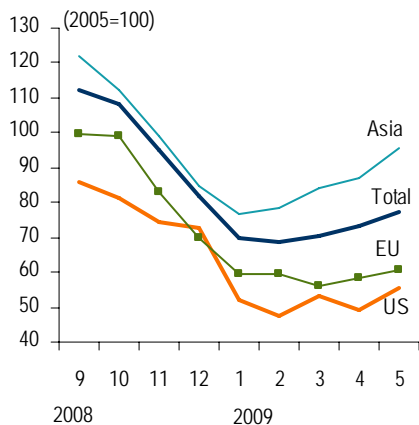
Source: BAS-ML forecast

Chart 19: Quarterly GDP growth



Source: Cabinet Office, BAS-ML forecast

Chart 20: Export volume indices by region



Source: MoF, Cabinet Office

## Mid-year review

### Japan: transition to recovery phase

The Japanese economy suffered its steepest-ever decline of 3.8% qoq (-14.2% annualized) in Q1 2009, but we think a return to growth is likely in Q2. Looking ahead to H2 2009 and beyond, we maintain our view that the economy will avoid a double-dip because we believe that stock adjustment in the corporate sector will be past its nadir, and that the economic stimulus measures implemented at home and abroad will start to have a tangible impact. The main elements in our latest revision arise from an upward adjustment to our projections for the US economy. We revise up our overall growth rate estimate for 2010 by 0.1ppt.

### H1 2009 review: transition from financial crisis to rebound to growth

The growing severity of the financial crises in the US and Europe precipitated a steep drop in exports and a corresponding large-scale stock adjustment in inventories, facilities and corporate headcount from the start of 2009, leading to a sharp decline in Q1 real GDP growth. Looking more closely at the breakdown of the hefty negative growth in Q1 2009, the contribution from external demand remained negative (-1.4% qoq, -5.4% annualized), exacerbated by a particularly conspicuous slump in private sector capital expenditure (-8.9% qoq, -31.0% annualized).

However, viewed from a different perspective, this negative growth on an unprecedented scale was the result of swift action by corporate Japan to adjust stock. There is a growing pool of data showing a return to positive growth since the start of Q2, and we attribute this to the rebound to growth in exports and inventory investment as stock adjustment winds down, combined with the gradually emerging knock-on effects of fiscal stimulus and recovery in the Chinese and other Asian economies.

### H2 2009 outlook: recovery, backed by domestic and external economy stimulus initiatives

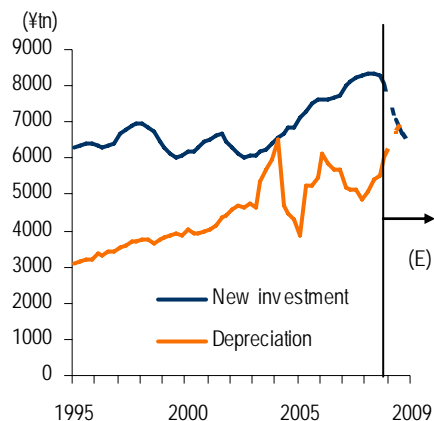
Our view is that the recovery, which began in Q2 as a “rebound to growth” from corporate stock adjustment, is likely to continue through H2 2009 and 2010 as economy pump-priming measures adopted at home and abroad have a visible effect and the knock-on effect from Asian economic recovery comes through.

Looking at external demand, since April-June exports have been in the rebound phase from the abnormally low levels caused by overseas inventory destocking. The problem lies in what happens once the simple rebound is over, but our view is that Japanese exports should begin to find support if Asian firms resume capital expenditure deferred in the midst of the crisis, as the Chinese and other Asian economies recover. Assuming that the US and European economies will bottom out gradually in the latter half of the year, we estimate that the partial recovery from abnormally low levels in Q1 2009 will continue.

There is the risk that capital expenditure could remain weak, as indicated in the Bank of Japan’s June Tankan. However, as a result of the steep decline since Q2 2008, the level of capital expenditure is likely to be below the level of depreciation of capital stock in H2 2009, suggesting capital expenditure has declined to a low enough level to bring a net decrease in capital stock and thus, excess capacity. Accordingly, we estimate that capital expenditure will ebb and flow at a low level from H2 2009, and that the brakes will be applied to the steep decline.

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**Chart 21: Capital expenditure to be less than depreciation in H2 2009**



Source: Cabinet Office

**Table 7: Economic Package (April 2009, ¥tn)**

	Central govt. cost	Project cost
Emergency Measures	4.9	44.4
Employment measures	1.9	2.5
Finance measures	3.0	41.8
Growth strategy	6.2	8.8
Low carbon revolution	1.6	2.2
Health, longevity, child rearing	2.0	2.8
Realization of basic strength	2.6	3.8
Realizing security and vitality	4.3	5.0
Regional vitalization	0.2	0.4
Safety guarantee	1.7	2.2
Support for regional govt.	2.4	2.4
Tax code revisions	0.1	0.1
<b>Total</b>	<b>15.4</b>	<b>56.8</b>

Source: Cabinet Office

Falling incomes caused by worsening unemployment will be a constraining factor for consumption. Nevertheless, we think a breakdown in consumption will be avoided due mainly to incentives for automobile and home appliance purchases included in pump-priming initiatives, as well as to income support measures, and to a gradual decline in the savings rate as the population ages.

Measures to stimulate the economy are moving into the implementation phase, and we estimate that these will add 1.5-1.7ppt to real GDP growth. If the general election leads to a change in administration, the stimulus measures for the rest of the year and 2010 will also change. However, the Democratic Party of Japan's manifesto for the Lower House General Election includes fiscal initiatives amounting to expenditure of ¥17tn. Irrespective of the general election result, government fiscal policy is likely to remain stimulative at least until the upper house election scheduled in July 2010. In light of the above, we maintain our view that GDP growth will continue to recover, and that the economy will avoid a so-called double-dip.

### Small revision to GDP growth projection

The main reason for the latest revisions to our projections lies in adjustments to our US economic forecasts. We have revised up our H2 2010 export growth estimate to reflect an upward revision to our projection for domestic US demand in areas such as personal consumption and housing. However, if it is export-led demand that supports the economy, a rising fiscal deficit and growing public sector liabilities will mean the additional fiscal stimulus measures we envisage from the end of 2009 through 2010 are likely to be on the small side. We estimate that personal consumption and other elements of domestic Japanese demand will be lower than we had originally expected by a corresponding degree. In light of these factors, we revise up our overall growth rate estimate for 2010 by 0.1ppt.

Turning to prices, we have not changed our view that deflation in 2009 will be followed by a return to just about zero growth in 2010. As far as the Bank of Japan's monetary policy is concerned, we broadly expect it to maintain its current position, in the absence of any untoward yen appreciation in exchange rates, and we think some of the accommodative measures may be revised in H2 2010. We also think the BoJ is likely to extend most of emergency measures to support corporate finance until the end of March or June 2010.

### The week ahead: May machinery orders

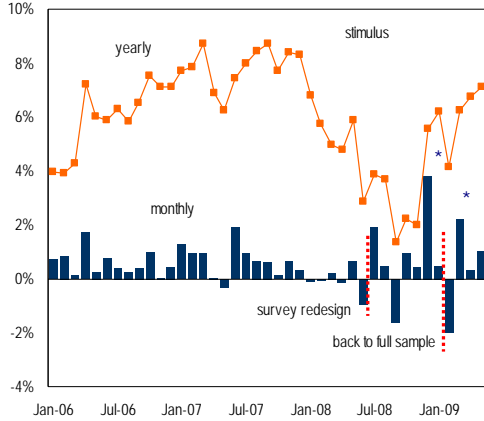
Key statistics next week are May machinery orders and trade statistics on customs clearance for the first 20 days of June, both scheduled on 8 July. Machinery orders are likely to show growth of 2.0% mom in May. This would be the key gauge of whether capex deterioration is finally ebbing. In the trade data, yoy change in exports is in focus. The balance of payments and money stock for May are also due on 8 July.

The gubernatorial election in Shizuoka on 5 July is our political focus. The poll outcome will likely affect Prime Minister Taro Aso's decision to dissolve the Lower House for the general election.

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Chart 22: Australian retailers are loving it



Source: Australian Bureau of Statistics, Merrill Lynch

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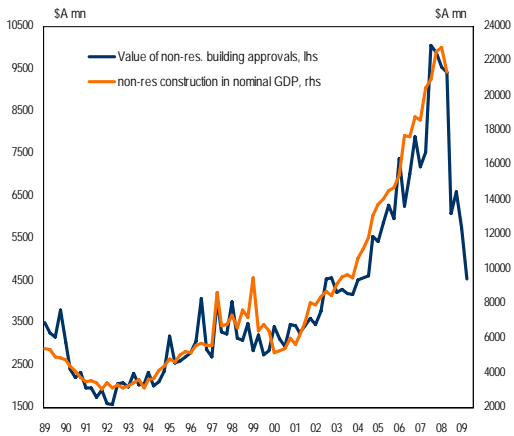
## Australia: recent flurry 'false start'

Australia's economy has been growing slowly for some time, and in fact non-farm GDP recorded two negative quarters in H2 2008. Australia's economy was largely flat when its trading partner economies were contracting at about a 6% pace in the quarters around the turn of this year. Rather than continuing to characterize Australia as a laggard into recession, it is probably more appropriate to say that the recent flurry of strong data is a 'false start'. A bona fide recovery phase is unlikely until next year in our view, and meanwhile the impact of the large terms of trade decline this year still has to filter into incomes and spending. Indeed, continued deceleration in non-housing credit growth confirms that the bottom in nominal GDP growth is still ahead. So we think the worst that economic agents can do is to extrapolate recent numbers into what is still a challenging period ahead.

### Bout of solid figures has reduced downside risk, though

As noted above, Australia's economy finished H1 2009 with something of a flourish. Major retailers are aggressively revising up their estimates for sales for their fiscal years, most of which end in June or July, and their future earnings guidance. A 'clean' measure of Australian house prices, the hedonic home value index, has risen 4% in the first five months of 2009, and 5-6% in the bigger, non-resource state, eastern cities. This is not only important for the housing sector but also for consumers, since an estimated 70% of Australian net household worth is in the housing stock. Australian businesses have eliminated fewer jobs than expected, relying on temporary reductions in hours. Rather than a soft labour market reducing wage demands, manufacturing sector unions are pursuing increases of 4-6%. Disposable income continues to grow above trend, supported by low consumer and mortgage debt rates and tax cuts. Both consumers and businesses are spending a larger percentage of the fiscal stimulus than traditional models would imply. Treasury expected the household savings rate to rise to 6% during this transition, but it was less than 2% in Q1 2009.

Chart 23: But not all the economy is that strong, for example non-residential construction



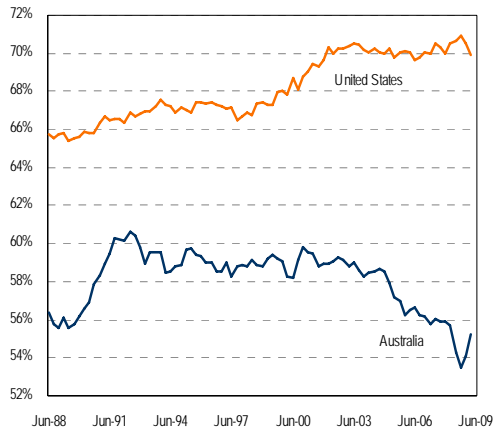
Source: Australian Bureau of Statistics, Merrill Lynch

We have steered a middle course between bullish reports 'on the ground' and the very cautious assessments of the IMF and OECD, both of which project outright GDP declines in the middle quarters of 2009 and a tepid, public-spending-led recovery during 2010. We continue to expect soft GDP outcomes for the rest of this year and into early 2010 as the impact of the reduction in revenue from bulk commodities feeds into incomes across the board and as non-residential construction adjusts downwards. However, we have raised our GDP call for this calendar year from -0.4% to -0.2%. Our 2010 forecast (+2.0% GDP) has always been stronger than the IMF's (1.4%) and OECD's (1.2%), and remains so.

Australian householders have already made some adjustments to their balance sheets to account for an estimated 10% drop in household net worth – about half the percentage loss of worth experienced by US households. However, consumer spending will slow in the year ahead because the 12% surge in nominal disposable income during 2008 (which was further propped up in H1 2009 by tax cuts), the lower stream of mortgage payments and the positive wealth impact of a rising currency are bound to recede in the year to mid-2010. There may well also be some revival in the household savings rate if financial asset and housing markets cool off. However, Australian household consumption is still only 55% of GDP, well below its 1990s average. In the US, personal consumption is 70% of GDP and well above its 1990s average. Australian consumers are still likely to outspend their US counterparts in trend terms.

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Chart 24: Consumption to GDP ratio – Australia vs US



Source: Australian Bureau of Statistics, BEA, Merrill Lynch

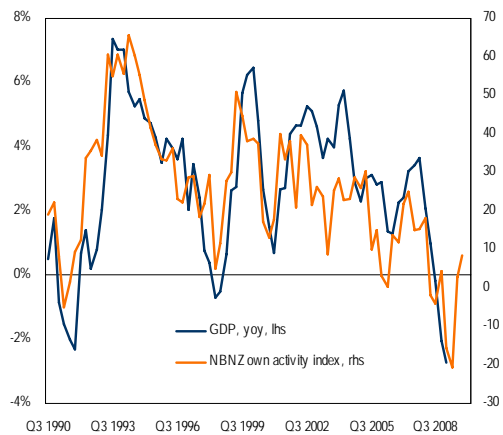
Australian building approvals data suggests that construction will be weak in the next few quarters, especially non-residential construction, although part of the impact will be taken in a draw-down of the unusually large pipeline of projects already in place. A further modest drop in the investment to GDP ratio from the unsustainable highs of the resources boom period would be welcome, and may well be associated with some further modest improvement in real net exports given the identity with the savings-investment imbalance.

On the basis of these recent trends we now consider that the RBA is unlikely to cut its cash target in August. The output gap is unlikely to open up enough to ensure RBA projections for a deceleration in core inflation toward 2% by end-2010. There remains some chance of a cut later this year, but below 50-50 in our view. Rather, our most likely scenario is that the cash target will be held at 3.00% for some time, perhaps well into 2010.

## New Zealand: modest signs of hope

The NZ economy appears to be finishing up a six-quarter recession. While many investors are still very gloomy on New Zealand, and monetary conditions (including the currency's value) are considerably tighter than where the authorities would like them, there have at least been some encouraging signs recently. Net inward migration (an important indicator because of the high net worth of the average migrant to NZ), home sales, dairy and wood exports, non-residential building approvals and survey indicators have all improved from a low base. Still, firms' expectations for profits and their investment and hiring intentions remain soft, and another downgrade in the vital dairy sector payout for the year ahead is in the offing. It is unclear how much the improved migration numbers reflect a positive story or worse conditions overseas (eg, NZ temporary workers who cannot get European work permits renewed, and fewer new jobs in neighbouring Australia). Most likely New Zealand's economy will start to show positive growth but below potential, with no clear upside drivers, in our view.

Chart 25: Surveys suggest worst might be over for NZ

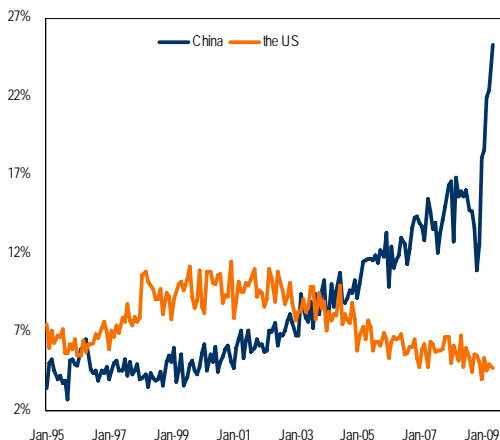


Source: Statistics New Zealand, NBNZ, Merrill Lynch

## What about Asia's impact?

Commodity exports did not experience the huge dip that exporters of manufactures did in Q4 2008 and Q1 2009, so any V-shaped rebound in global manufactures trade supporting Asia has less direct impact on growth in Australia and NZ than one might expect. However, China's share of Australian exports has surged despite recently lower prices, implying stockpiling; more than ever, China is key to what happens next in Australia.

Chart 26: Share of China in Australia's goods exports soars, even as export prices for bulks wobble



Source: Australian Bureau of Statistics, Merrill Lynch

## The week ahead

Another important week of Australian data includes consumer sentiment, housing finance and jobs. The RBA cash target will almost certainly be kept at 3.00% but the question is what will happen to June's easing bias ("the prospect of inflation declining over the medium term suggests that scope remains for some further easing of monetary policy, if needed".) If it does retain that bias, which is still our call, it will be largely to keep its options flexible and to avoid spooking the curve into pricing in more 2010 tightening.

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Mid-year review

# EM Asia: raising our Asian forecasts

**Bottom Line:** Our view on Asia this year has been relatively constructive. Despite an economic “heart attack”, we thought the region would return to positive sequential growth in Q2 2009, boosted by Chinese policy stimulus and an export recovery.

The latest data support this view, and revisions to our US and China growth forecasts increase our confidence in the outlook. We are revising up our projections for Asian growth. In particular, we have raised our 2010 growth forecast for China to 9.6% (from 8.3% previously). For emerging Asia as a whole, our growth outlook stands above consensus.

Table 8: Growth forecasts for 2009-10: BAS-ML versus the consensus

	ML		Consensus		Difference (bp)	
	2009	2010	2009	2010	2009	2010
APR Region	4.4	7.1	4.0	6.3	40	80
Australia	-0.2	2.0	-0.2	1.5	0	50
China	8.0	9.6	7.5	8.4	50	120
Hong Kong	-3.1	4.5	-4.6	2.6	150	190
India	6.3	7.3	5.8	7.0	50	30
Indonesia	3.6	4.8	3.7	4.7	-10	10
Korea	-1.2	4.0	-2.7	3.1	150	90
Malaysia	-3.8	4.2	-3.2	3.6	-60	60
Philippines	1.4	2.5	0.6	3.2	80	-70
Singapore	-5.0	4.0	-7.0	3.5	200	50
Taiwan	-5.0	4.5	-5.4	3.2	40	130
Thailand	-3.3	2.9	-3.8	2.8	50	10

Source: CEIC, Consensus Economics, Banc of America Securities - Merrill Lynch calculations.

## Chinese policy + export recovery

The major features of our call on growth in 2009 – a second-quarter export recovery and a policy-driven upturn in China – appear to be panning out as expected. We recognized that the global financial crisis would have a severe impact on international trade. However, we expected Asian exports to stabilize and resume sequential growth in Q209. And we thought that China’s aggressive fiscal and monetary policies would limit the scope of the slowdown there.

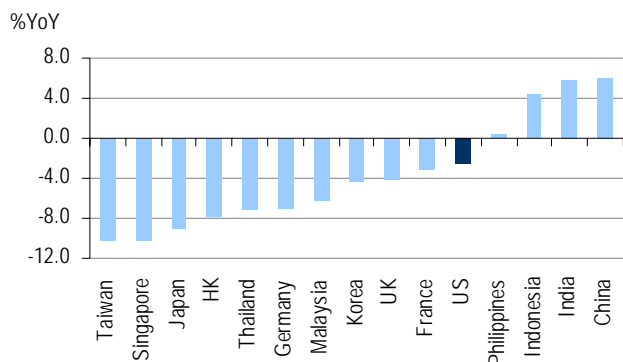
On balance, we think our call on growth has proven roughly correct. We did underestimate the scope of the slowdown in the more open countries of the region (Korea, Malaysia, Singapore, Taiwan, and Thailand). In contrast, our 2009 growth forecast for China has remained unchanged, and we raised our 2009-10 forecast for India to 6.3%, from 5.8%, at the beginning of the year. Perhaps the more striking revision was made to inflation, where we lowered our 2009 regional forecast by 250bp.

## Domestic demand: a tale of two extremes

The pace of contraction in the smaller, open economies has been astonishing: Hong Kong, -7.8% yoy in Q1 2009; Singapore, -10.1%; Taiwan, -10.2%. At the other end of the spectrum, the larger, relatively closed economies weathered the storm quite well: China: +6.1% yoy in Q1 2009, Indonesia, +4.4%; India, +5.8%.

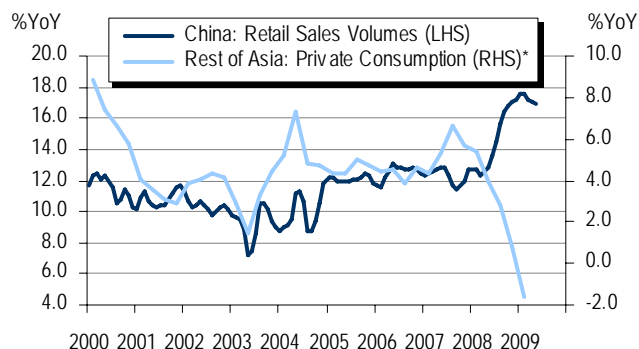
The reason for the difference was not exports, which have dropped precipitously across the region, but rather the dramatically different performance of domestic consumption and investment. China and the smaller countries of Asia look like mirror images.

Chart 27: Asia’s larger, more closed economies have outperformed



Source: CEIC, Banc of America Securities - Merrill Lynch calculations.

Chart 28: The consumption mirror image



\*Simple average of Asian growth rates, excluding India. Source: CEIC, Banc of America Securities - Merrill Lynch calculations.

- **Consumption** in China has accelerated since the financial crisis broke out (at least, according to the retail sales data). In contrast, it has dropped elsewhere in the region, from an average growth rate of +3.9% in Q2 2008 to -1.6% in Q1 2009.
- **Fixed investment** has also accelerated in China, but fallen in the rest of Asia, from an average growth rate of +6% in Q2 2008 to -10.9% in Q1 2009.

So much for the rear-view mirror. Looking ahead, the recent collapse in domestic demand actually favours the smaller economies of Asia over the next two quarters, in our view.

This is what we call the "yo-yo" recovery. The principle is very simple: as exports stabilize, confidence returns, and financing conditions ease, pent-up demand for inventories and final expenditure can boost growth rapidly. What goes down must come back up (the yo-yo). As this happens, the countries that have experienced the deepest contractions could well post the steepest rebounds.

### The export recovery is driven by China

The second-half recovery we expect needs to be led by exports. Fortunately, there are signs that exports are turning around. Year-on-year comparisons are still ugly, but exports bottomed out in the first quarter and are rising in sequential, seasonally adjusted terms.

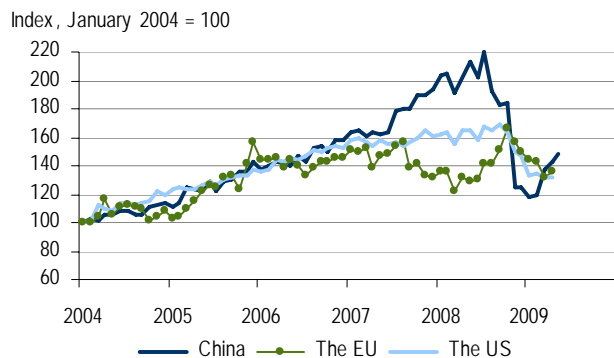
However, China is the main driver of the recovery to date. Its own exports have stabilized, but have not yet turned up. This suggests that Chinese domestic demand (not re-exports to the US or Europe) is driving Asia's export recovery.

In contrast, exports to the G3 continue to decline. So the export recovery critically depends on a G3 turnaround in the second half of the year. Fortunately, there is ample evidence that the G3 will indeed come through. Shipment-inventory ratios – one of the best lead indicators of Asian exports – are signaling that a sharp upturn could begin within the next few months.

### Inflation: too soon to worry

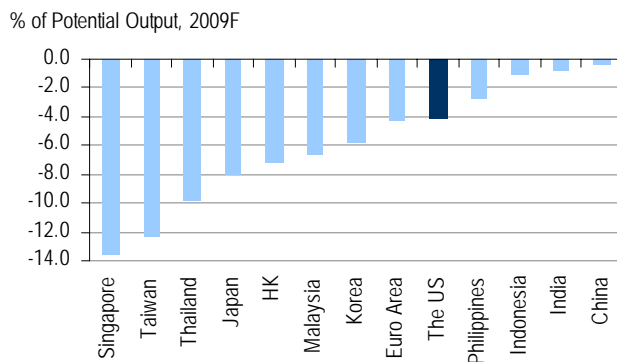
Inflation is where we have made the biggest revisions to our numbers. Despite our growing optimism about the recovery and extremely aggressive monetary policies put in place by the US and China, we think it is still too early to worry about inflation.

Chart 29: Asian exports to China, the US, and the EU



Source: CEIC, Banc of America Securities - Merrill Lynch calculations.

Chart 30: Asian output gaps widening, especially in small countries



Source: CEIC, IMF, Banc of America Securities - Merrill Lynch calculations.

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**Table 9: Inflation forecasts for 2009-10: BAS-ML versus the consensus**

	ML		Consensus		Difference (bp)	
	2009	2010	2009	2010	2009	2010
	APR Region	0.2	3.2	0.6	2.8	-50
Australia	1.7	2.6	1.6	2.2	10	40
China	-1.0	2.5	-0.3	1.6	-70	90
Hong Kong	0.9	2.0	0.8	1.3	10	70
India	0.8	5.5	0.5	5.6	-30	-10
Indonesia	5.2	6.0	5.4	5.8	-20	20
Korea	2.7	2.7	2.5	2.6	20	10
Malaysia	0.2	1.0	0.9	2.0	-70	-100
Philippines	4.0	6.1	3.6	4.4	40	170
Singapore	-0.5	0.8	-0.1	1.2	-40	-40
Taiwan	-0.8	1.2	-0.9	0.8	10	40
Thailand	-0.8	2.0	-0.7	2.4	-10	-40

Source: CEIC, Consensus Economics, Banc of America Securities - Merrill Lynch calculations.

Empirical studies of inflation typically find three main causes: money, commodity prices (especially oil), and resource utilization. The last one is the key reason why we are not yet worried about inflation. It is hard for inflation to rise when resources – labor, industrial capacity – stand idle. High unemployment rates make it difficult for wages to rise. Low capacity utilization rates make it difficult for companies to raise prices.

The sharp slowdown of the past three quarters has left rampant spare capacity in Asia and the global economy. Our estimates indicate that the “output gap” has hit historical levels in the smaller economies of the region. We think this is likely to persist even after the strong recovery we expect in the second half of the year.

Oil prices are a second major driver of inflation, and many investors are concerned about the doubling of oil prices from their lows in the first quarter. However, pass-through takes time, and volatile movements in oil prices are usually not fully reflected in headline CPIs. Thus, Asian inflation never completely priced in the US\$145/bbl high (July 2008), or the US\$31/bbl low (December 2008). (In fact, oil prices have averaged US\$70/bbl over the past year.) We estimate that the impact of oil on CPI inflation has turned positive, but is not out of line with previous years.

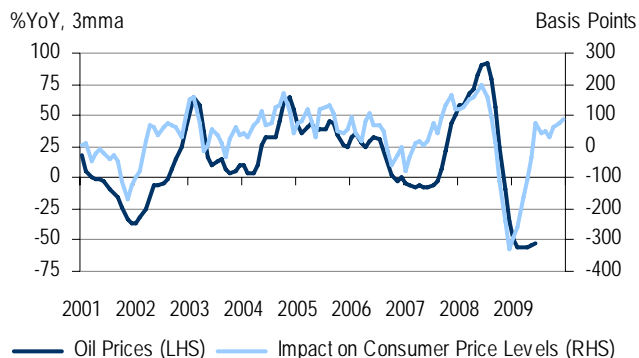
**Policy: too soon to hike rates**

Looking beyond the export-led recovery in the second half of 2009, can Asia succeed in breaking its addiction to export-led growth and rely more on domestic demand? This is crucial for restoring medium-term growth to the levels of the past. It would also facilitate an adjustment of global imbalances by narrowing Asia’s current account surpluses.

We are strong believers in Asia’s structural positives (high savings rates, current account surpluses, healthy and liquid banking systems, underlevered consumers and firms). But these structural conditions have been in place for some time. The next step is getting the right policy mix. We want to see: (1) appreciating exchange rates; and (2) aggressive monetary and fiscal policies.

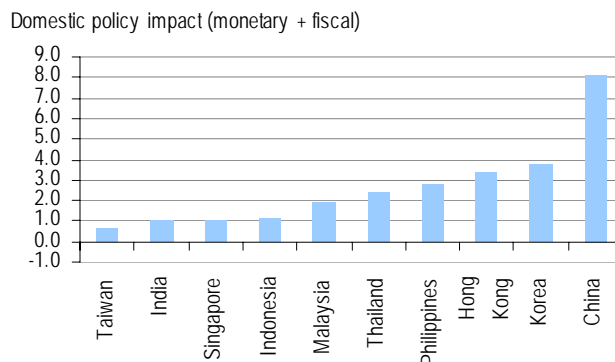
This is what China is doing. Despite widespread concerns, we think China’s policy mix is about right. Yes, there are risks (asset price bubbles, inefficient investment, NPLs). But over time, we think China’s policy stance should lead to a healthier, more balanced economy. Domestic policies are also reasonably aggressive in Korea and Hong Kong, mainly reflecting an aggressive fiscal stance. Unfortunately, as we argued [last week](#), the rest of emerging Asia is relying too much on its traditional exchange rate tool. The average Asian currency is undervalued by 9½%. In contrast, policy rates are only 45bp below neutral.

**Chart 31: Oil is not a major inflation shock**



Source: CEIC, Banc of America Securities - Merrill Lynch calculations.

**Chart 32: Assessing the domestic impact of macro policies**



Source: CEIC, Banc of America Securities - Merrill Lynch calculations.

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Table 10: Macro policy settings

%	Real interest rate		FX mis-alignment	Fiscal impulse
	Neutral	Current		
Asian average	1.90	1.55	-9.6	2.6
China	1.50	1.99	-4.5	3.1
Hong Kong	2.50	1.35	-12.2	5.6
India	2.50	1.67	-11.4	0.2
Indonesia	2.00	2.96	-15.0	2.1
Korea	2.00	0.11	-41.5	3.1
Malaysia	1.50	2.65	-14.7	4.9
Philippines	2.50	-0.01	14.1	1.2
Singapore	1.50	2.10	-7.5	2.7
Taiwan	1.50	2.14	-1.5	2.0
Thailand	1.50	0.54	-2.3	3.8

Notes:

- Negative figure indicates FX undervaluation.
- Fiscal impulse is 2009 estimate, as percent of GDP.

Source: CEIC, FX Strategy Team (COMPASS model), Banc of America Securities - Merrill Lynch calculations.

We are optimistic that the rest of emerging Asia will eventually get it right. However, we may need to reach a “point of pain”—a loss of domestic momentum in early 2010, especially as fiscal stimulus is withdrawn—before central banks rebalance their policy stance. This (plus the inflationary slack we see across the region) is why we are not calling for near-term interest rate hikes in Asia, even though we expect a decent recovery. (However, we do recognize that central banks could make the temporary mistake of hiking rates and resisting currency appreciation.)

China: gaining ground, raising our forecasts

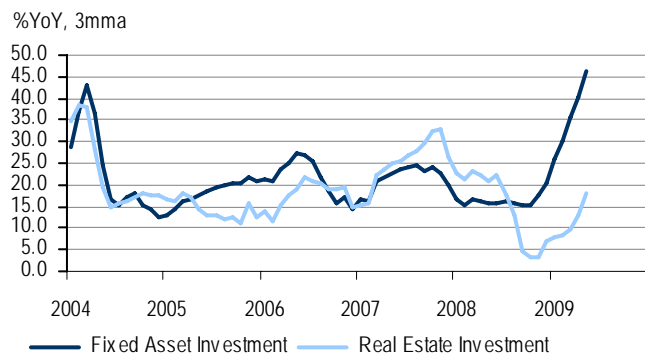
With macro policy visibly gaining traction and the global recovery in sight, we are becoming increasingly confident in the outlook for China. We are not changing our 8% growth forecast for 2009, although there may be some upside risks as the recovery unfolds. However, we are turning more optimistic for 2010, for three main reasons.

First, the upward revisions to our US forecasts suggest that China’s export recovery could be stronger and more prolonged than we previously anticipated. Second, private spending is picking up steam as policy gains traction, evidenced by the robust growth of fixed asset investment and retail sales. In particular, the recovery in the property sector removes a key downside risk to the economy, with a rebound in property sales helping developers to draw down inventories, recoup cash, and accelerate construction. (In nominal terms, the growth of real estate investment picked up to 12% yoy in May from 1% in January-February.)

Finally, we do not expect a premature withdrawal of policy stimulus. Why would the government act aggressively to support growth in 2009, but allow a big downturn in early 2010? Public debt is low (around 20% of GDP), allowing room for further fiscal expansion if needed. We do expect credit growth to decline from the heady levels of early 2009, but this should not have a significant impact on the real economy. (Note that credit growth amounted to some 22% of GDP in H1 2009, far in excess of the 6-7% growth rate of nominal GDP.)

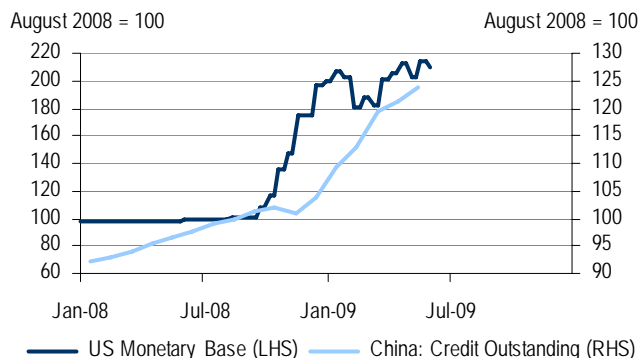
We do expect a modest tightening of policies as early as spring 2010, in response to concerns about wasteful investment, overcapacity, NPLs and inflation. However, we believe tightening measures will be limited to direct control of bank credit growth, administrative control of investment projects on the part of the NDRC, and stricter measures to limit speculation on stocks and properties.

Chart 33: Fixed investment in urban areas and the real estate sector\*



\*Deflated by the producer PPI. Source: CEIC, Banc of America Securities - Merrill Lynch calculations.

Chart 34: Aggressive monetary policy in the US and China



Source: CEIC, Banc of America Securities - Merrill Lynch calculations.

Table 11: Recent revisions to our growth forecasts for emerging Asia

	Old	New	Old	New
APR Region	4.2	4.4	6.3	7.1
China	8.0	8.0	8.3	9.6
Hong Kong	-3.1	-3.1	3.8	4.5
Korea	-3.0	-1.2	3.0	4.0
Malaysia	-4.0	-3.8	3.5	4.2
Singapore	-6.5	-5.0	3.2	4.0
Taiwan	-5.5	-5.0	3.5	4.5

Source: CEIC, Banc of America Securities - Merrill Lynch calculations.

For these reasons, we are raising our 2010 growth forecast for China to 9.6%, from 8.3% previously. We will explore the underlying rationale in more detail in an upcoming report.

## India

We expect India to bottom out near the end of the calendar year. The key drivers are: (1) exports; (2) softer lending rates; (3) the additional fiscal stimulus (½-1% of GDP) expected in the July 6 budget; and (4) a recovery in private investment, partially funded by a recovery in capital inflows.

The recovery should be led by a turn in the consumption cycle. Good harvests and a hike in government salaries by the 6th Pay Commission are already buffering the consumer from the global recession – witness stronger sales of passenger cars and two-wheelers. Aggressive auto and home loan rate cuts by government-owned banks should help revive urban consumer demand; and a recovery in G3 demand should reduce job uncertainty in the financial, software, and export sectors. (The bulk of the quarter-million Indian jobs lost during the September 2008-March 2009 period were in these sectors).

On the investment side, the mix of softer lending rates and a reopening of external sources of project finance – external commercial borrowings, foreign investment in equity offerings – should help revive investment projects that are being postponed due to financing difficulties. (Note that India tends to use foreign capital to finance longer-term investment projects.) Finally, government infrastructure spending could be stepped up, especially if proceeds from the sale of public assets and 3G auctions help to ease the financing constraint.

## The week ahead: Korea, Singapore, Taiwan

**Singapore's** preliminary GDP release will be one of the first in the region. We expect a strong sequential rebound in Q2 GDP given the robust industrial production in April and May. However, the pace will likely moderate as we move into H2 2009.

**Taiwan's** export recovery should continue in June, based on export orders in May and Korean exports released on 1 July. Still, the high base last year will keep the yoy number deep in negative territory.

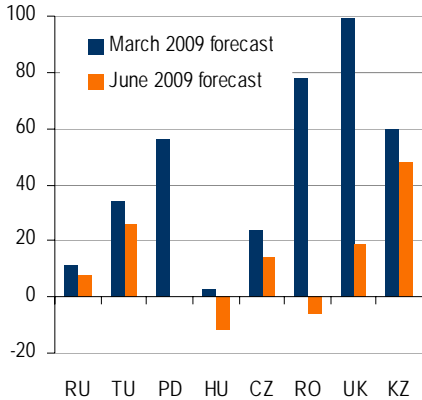
In **Korea**, we expect the central bank to keep interest rates on hold at 2.0% for the fifth consecutive month. In the **Philippines**, by contrast, we expect a 25bp cut, as inflation remains in check and the economic recovery is still weak.

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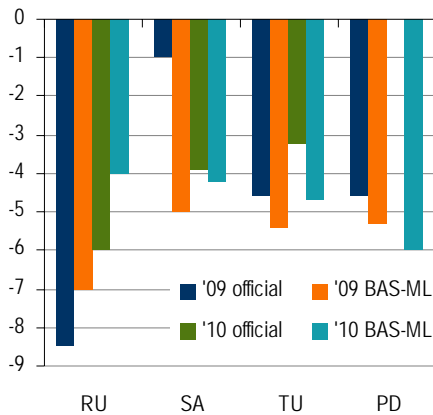
**NOTE: More detail in the EEMEA weekly on Monday. See also a recent [report on EEMEA's long-term growth outlook](#).**

**Chart 35: BOP financing gap ('09, % of reserves)**



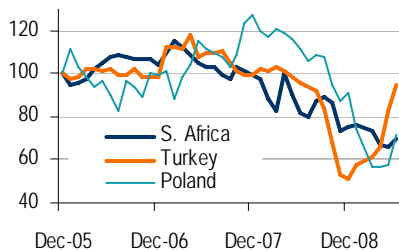
Source: BAS-ML

**Chart 36: Fiscal deficits (overall bal., % of GDP)**



Source: BAS-ML, governments (2010 government target for Poland n.a.)

**Chart 37: Leading indicators are picking up**



Source: Bloomberg (SA Investec PMI, PD and TU business confidence)

Mid-year review

## EEMEA: the laggard gets on the way

EEMEA lagged in the rally and we think is likely to lag also in the recovery of the real economy relative to EM Asia and LatAm. However, we are overall relatively constructive as vulnerabilities are much reduced and activity has bottomed.

### Vulnerabilities much reduced

The most notable regional trend of the past months, in our view, has been the reduction in vulnerabilities across the region. Although [we were constructive on the region even at the peak of the crisis](#), we were still surprised on the upside: governments have been proactive in getting IMF help; current account gaps shrank fast as demand collapsed and exchange rates depreciated; and rollover ratios have remained high as foreign banks did not precipitously withdraw. A [recent revision of our external cash flow projections](#) thus resulted in a significant reduction in the projected 2009 external financing gaps, with Poland's gap closed by the IMF programme and Russia's gap small relative to reserves (Chart 35).

However, Turkey still has a large financing gap, which leaves no margin for error. Besides, the Q1 2009 GDP report showed that raising the required funding domestically weighed heavily on growth. Kazakhstan and Ukraine – despite expected rescheduling – will also use much of their reserves, in our view, unless they decide to approach the IMF (Kazakhstan) or get more funding (Ukraine). A special case is S. Africa, where we do not expect major financing problems, but believe with our strategists that the ZAR has to weaken over the longer term in order to bring down [a current account deficit that is unsustainable, in our view](#).

Our baseline scenario of substantially reduced vulnerabilities is subject to several risks – in addition to those on the global level. First and foremost, rising NPLs could result in a second round of banking crisis, endangering the commitment of foreign banks to these countries. Moreover, a devaluation by [Latvia](#) – which we expect in H2 2009 but in an orderly manner with only short-lived contagion – could get out of hand, causing sentiment to plummet again. In addition, a number of upcoming elections could lead to a shift towards more populist forces that could weaken the commitment to the painful adjustment programmes: eg, Hungary (spring 2010), Romania (Nov 2010), or Ukraine (Jan 2010).

But the main vulnerabilities are fiscal. We forecast a sharp rise in deficits in most countries of the region, implying financing much above current plans (Chart 36). However, there are two perhaps surprising exceptions: under the pressure of the IMF, Hungary and Romania are cutting their deficits into the recession, [implying much improved underlying fiscal positions](#). In combination with fully-financed IMF programmes, sharply dropping current account deficits, and much room for rate cuts, this makes for two remarkable stories to watch.

### Recovery initially V-shaped but then protracted

We believe that activity across the region bottomed in Q1 2009 when most results surprised on the downside. Russia contracted 9.8% yoy, Turkey 13.8%, and S. Africa 1.3% as companies cut investment and inventory even more than expected. The sole positive surprise was delivered by Poland, which achieved 0.8% growth on the back of relatively robust domestic demand and a favourable contribution from net exports. Going forward, the region should benefit from the G-3 recovery that our colleagues expect to start in Q3 at a qoq saar rate of roughly 3% in the US and 2% in the Eurozone during the following four quarters.

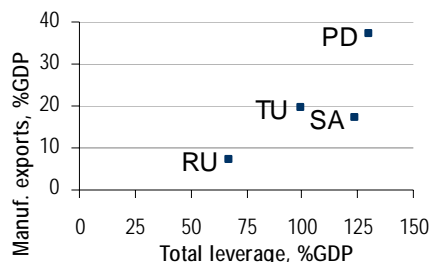
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Table 12: BAS-ML GDP growth forecasts

	qoq saar				yoy			
	RU	SA	TU	PD	RU	SA	TU	PD
2009					-7.3	-0.6	-3.5	0.2
Q109	-31.5	-6.4	-11.9	1.6	-9.8	-1.3	-13.8	0.8
Q209	1.3	-0.4	15.0	-1.6	-10.1	-1.0	-5.6	-0.1
Q309	13.5	3.0	14.1	-2.0	-7.5	-0.3	0.5	-0.2
Q409	16.9	3.9	2.3	0.6	-2.1	0.1	4.5	0.3
2010					2.4	3.3	4.5	2.0
Q110	-26.1	3.1	1.1	1.4	-0.2	2.5	7.4	0.6
Q210	13.7	5.0	5.1	2.2	2.8	3.0	5.3	2.5
Q310	17.2	2.5	0.5	2.8	3.6	3.5	2.4	1.7
Q410	16.6	0.8	6.3	3.6	3.5	4.0	3.6	3.0

Source: Haver, BAS-ML

Chart 38: Trade openness versus total leverage



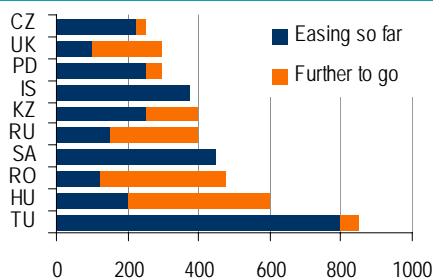
Source: Haver, BAS-ML

Table 13: BAS-ML inflation and rates views

	RU	SA	TU	PD
<b>inflation trough</b>	2012	Aug-09	Oct-09	Dec-10
Level, %	6.5	7.0	4.2	2.0
<b>policy rate trough</b>	Jun-10	May-09	Jul-09	Nov-09
Level, %	9.0	7.5	8.25	3.0
<b>first hike</b>	Dec-10	Oct-10	Mar-10	Sep-10

Source: BAS-ML

Chart 39: Some central banks only get started



Source: Bloomberg, BAS-ML

A recovery is likely to be initially V-shaped but then protracted, in our view. The economies that dropped furthest are likely to rebound first and most strongly. On a qoq seasonally adjusted basis, the recovery likely started in Q2 2009 in Turkey which saw the largest Q1 collapse, S. Africa's is likely to begin in Q3, while Poland may still have negative qoq growth in Q2 and Q3 before it sees an export-led recovery, in our view (Table 12). A return to the Q3 2008 GDP level (the peak in most cases) is likely in H2 2010, in our view; this would be 1½-2 years after the prior peak, in line with the [experience of previous post-crisis recoveries](#).

For 2010, we believe the best-placed countries are manufacturer-exporters with a depreciated exchange rate and little leverage. Given this, none of the EEMEA-4 is perfect (Chart 38): Poland is export-oriented but leveraged, while Russia has little debt (some large firms aside) but gained little competitiveness. In sum, we believe that the countries in the middle – Turkey and S. Africa – are best-placed, partly thanks to their healthy banks. We forecast 3.3% growth for S. Africa next year, in contrast to about 2% for Poland and Russia. [For Turkey, we have just revised down our 2009 forecast to -3.5% and our 2010 forecast up to 4.5%](#). In the GCC, we are most constructive on UAE and Saudi Arabia (see our [Quarterly](#)).

[Revising our Russia GDP forecast to -7.3% in 2009 and +2.4% in 2010](#) Russia is a special case as it has not benefited from a policy stimulus. The fiscal stimulus was large only on paper, as the government failed to execute, while the CBR squeezed liquidity to stabilize the rouble (base money remains 15% below the peak despite recent loosening). The latest credit data still show a month on month decline. No wonder the economy contracted by 9.8% in Q1 and a similar contraction seems likely for Q2. We believe that only Q4 will bring a large rise in government spending and credit to the economy. In qoq terms, this implies an initially V-shaped rebound in output in the second half of this year, but a potential relapse in early 2010 as fiscal spending will likely drop again. We thus cut our 2009 GDP growth forecast to -7.3% but symmetrically raised 2010 to 2.4% as base effects coalesce with dearer oil (our strategists expect US\$62 on average but with upside risk), lagged effects of the fiscal “explosion” in Q409, and better credit conditions.

### Central bank rate cuts mostly done, but some yet to start

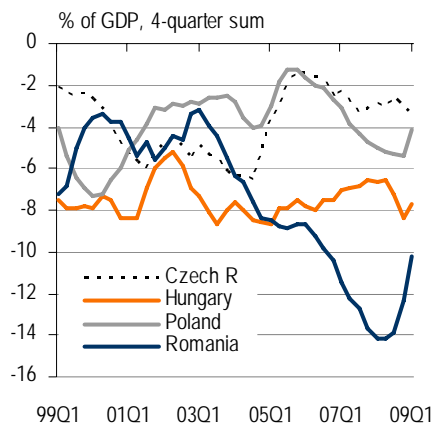
Most central banks are likely done with rate cuts, in our view. While we expect inflation to continue to be dampened by wide output gaps, we see it near the trough in S. Africa (at a high level) and Turkey (Table 13). Poland, and Russia in particular, should see further disinflation. [We do not expect any further cuts from the SARB](#), but another 50bp from the CBT and the NBP. However, three central banks may only get started now, given their lower FX vulnerability: foremost the [NBH where we see no less than 400bp in cuts for 2009-10](#) – likely starting in July. The CBR and the NBR also have large easing in store, in our view (Chart 39).

### Investment implications

The [recommendations of our fixed income strategists](#) reflect the variation in monetary policy and fiscal outlook across the region. On the one hand, are short-end receivers in Hungary and Russia, where easing could get under way now as vulnerabilities ease. On the other hand, are steepeners/payers in Poland, S. Africa, and Turkey, where fiscal risks dominate. On external debt, the long-only portfolio currently overweights Iraq, market-weights Lebanon and Russia, and underweights S. Africa, Turkey, and Ukraine. Moreover, our strategists favour short ZAR exposure vs a EUR-USD basket. On equities, our strategists like several EEMEA markets, including Russia (valuation), CEE and GCC (rally laggards), S. Africa (commodities), and Turkey (V-shaped recovery).

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Chart 40: CEE: narrowing current account deficits (% of GDP)



Source: BAS-ML, central banks.

## The week ahead

### CEE: narrowing current account deficits

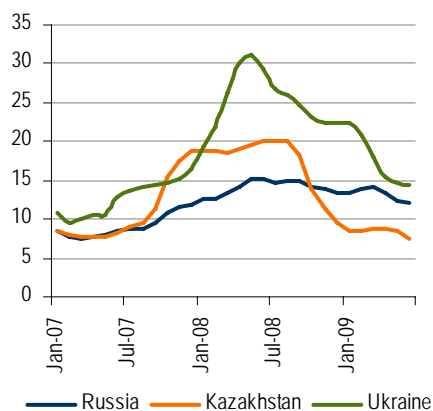
In **central Europe**, a light week lies ahead on the macro front with the focus on the June CPI inflation reports from the Czech Republic and Romania (we see headlines picking up slightly, to 1.4% yoy and 6.0% yoy, respectively) as well as on industrial output data from Hungary (we expect headline year-on-year IP to contract by 24.7%, but stabilise on a monthly basis).

Highlights of the past week were the central bank meeting in Romania, the Q1 current account data from Hungary and "flash" June CPI estimate from Poland. In **Romania**, the NBR cut interest rates by 50bp, to 9.00%, as expected, reassuring our expectations for continued monetary easing (we see rates falling to 8.0% this year and further towards 6.0% in 2010).

**Hungary's** current account deficit plunged by 65% in Q1, taking the four-quarter deficit-to-GDP ratio down to -7.7% (from -8.4% a quarter earlier), with the short-term seasonally-adjusted trend suggesting a further narrowing of the headline deficit towards 4% of GDP over the next two to three quarters.

In **Poland**, the Ministry of Finance's "flash" estimate put the June CPI at 3.4% yoy (vs 3.6% yoy in May). This is in sharp contrast with our forecast for a jump to 3.9% yoy. The difference comes from food prices, which (based on sample data) the MinFin forecasts to decline in June (in contrast with a rise in the CRB food index in PLN terms). Given the MinFin's advantage of having access to (publicly unavailable) sample food price data, we adjust our June CPI expectations down but still see a risk of upside surprise in the official CPI release (14 July), expecting the CPI to come out at 3.6% yoy.

Chart 41: CIS – inflation dynamics (% yoy)



Source: Bloomberg, BAS-ML

### In CIS inflation is still far from trough

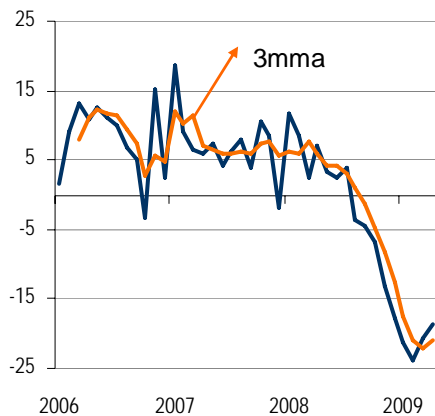
We expect the CPI to decline from last month in both Russia and Ukraine. Inflationary pressure is being relieved by fairly fast consumer capitulation, particularly in Ukraine and Kazakhstan, as well as by a strongly positive base effect. Kazakhstan's below-consensus CPI figures released last week support this point of view. Despite monetary easing, the money supply pressure is still insufficient to become an issue, in our view. The central banks in the region are readily following the trend by cutting rates – CBR, NBU and NBK have all cut policy rates by at least 100bp since the beginning of the year.

### S. Africa: external balance roller-coaster

Next week, no major data is expected. Last week, the rollercoaster of S. Africa's external sector data rolled on. After a downside surprise on the Q1 current account, May's trade balance surprised on the upside, with a ZAR2.0bn surplus, up from -ZAR1.5bn and the best reading since Dec 2005. The 12-month rolling trade balance was the best since end-2006. The improvement was due to compression of imports – particularly capital goods – by 6.4% mom and growth in exports, particularly vehicles, by 2%. While this trade data is encouraging, we underscore that the current account deficit is to a large extent driven by the "invisibles" balance that is much stickier than the trade balance. We thus remain worried about the financing of South Africa's current account deficit, [as we recently discussed in detail](#), in line with our strategists' negative ZAR outlook. Otherwise, the May private sector credit (5.7% yoy) and M3 money supply (7.3%) data surprised on the downside but we believe the [high underlying inflation rate](#) (taking base effects into account) makes further rate cuts very unlikely.

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Chart 42: Turkey: industrial production (% yoy)



Source: Turkstat

### Turkey: IP contraction slows, CA is still on the mend

In Turkey, the main macro releases of next week are May's industrial production on Wednesday, the CBT's bi-weekly inflation survey on Thursday, and the current account balance on Friday. While we expect the contraction in industrial production to slow further, the CA balance should continue to improve. As we expect annual CPI inflation to accelerate temporarily in June, a modest increase in inflation expectations would not be surprising.

The recent release showed that Turkish economic activity tanked in Q1 2009. GDP contracted by an unprecedented 13.8% yoy and nominal annualised GDP contracted for the first time ever. This is likely to be the trough of Turkey's recession, in our view. While domestic demand and expectations recovered somewhat in Q2 2009, the re-stocking is likely to have started only in late May. This is likely to be more pronounced on activity data in Q3 2009.

We expect the improvement in the second derivative of May industrial production to continue (consensus -16.7% vs our forecast of -15%). We expect a larger bounce (ie, low single-digit year-on-year contraction) in June.

On the current account balance, the story is unchanged and the deficit is narrowing (consensus US\$1.8bn and our forecast is US\$1.7bn). The annual current account deficit is likely to fall to US\$23.6bn from US\$26.7bn in April with our US\$1.7bn forecast for May. The impact of higher oil prices will be lagged, and weak domestic demand remains the main driver.

Finally, CBT will announce its bi-weekly inflation survey and we'll be watching inflation expectations. As we expect a temporary increase in annual CPI inflation in June (will be announced by the time the weekly goes out), expectations are likely to mimic that. However, as the bank is more focused on the wide output gap, rather than the rigid expectations for the time being, we maintain our 50bp rate cut call for the July MPC meeting.

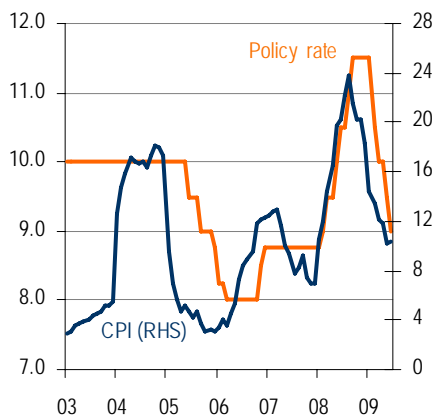
### Egypt: CPI may increase, but only temporarily

June CPI inflation will be announced next Thursday and we expect a slight uptick in inflation, though we anticipate it will prove to be only temporary in July.

CPI inflation continued to fall and declined to 10.2% in May 2009 from its peak of 23.7% in Aug 2008. This was mainly due to lower domestic food inflation, which fell from 31% yoy in Aug 2008 to 12.5% in May 2009. We expect CPI inflation to post a 0.8% mom increase, which will push the annual CPI inflation to 10.4% in June from 10.2% in May. However, we still believe that CPI inflation should come down to close to 7.5% by Sep 2009 and close the calendar year around 11% on the back of the weak base year effect, before coming down to 8% by the end of FY2010 (Jun 2010).

GDP growth is likely to increase 4.5% in FY2009 compared to our earlier forecast of 3.5%. However, the stronger performance is not broad-based and is still fragile. There are growing signs that increased fiscal spending crowds out the private sector (ie, credit to the private sector loses pace), since Egypt's budget deficit is likely to reach 8.5% of GDP. Hence, domestic demand remains weak, and we expect the CBE to carry on with further rate cuts, lowering policy rates to 8.00% at the end of 2009.

Chart 43: CPI inflation and policy rate



Source: CAPMAS, Bloomberg

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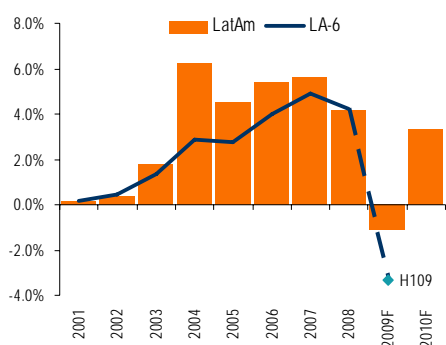
Mid-year review

# Latin America: halftime

## First half: recession offence

The last six months saw Latin America follow other regions in mounting a frontloaded response to the global recession. The authorities cut base rates anywhere from 375bp (Mexico) to 750bp (Chile) and delivered fiscal stimulus ranging between 0.6% of GDP (Mexico) and 8.0% (Chile). Amid this, the expected economic slowdown materialized, especially on the supply side, as a severe inventory adjustment took place. This has been followed by softer labor markets in a process that should see unemployment only peak during H2 2009. All in, we expect the LatAm-6 bloc to post growth of -3.4% yoy in H1 2009<sup>1</sup>.

Chart 44: LatAm real GDP growth



Note: LA-6 is Argentina, Brazil, Chile, Colombia, Mexico and Peru.  
Source: Banc of America Securities-Merrill Lynch

However, developments to date support our expectation that healthier fundamentals this time around will not allow a repeat of previous external shocks prompting even worse domestic crises. External balance-sheet repair has allowed local currencies to overshoot but then recover. Credible monetary management has kept inflation expectations anchored. Fiscal stimulus has been of a scale consistent with funding constraints (ie, not pressured CDS). Finally, sound regulation and low loan-to-deposit ratios have kept banking sectors free from the kind of stress witnessed elsewhere.

## Second half: recovery defense

The second half of the game still has to be played. Monetary policy will need to walk the thin line of remaining stimulant to avoid double-dip scenarios while avoiding signaling complacency, especially as recovery at the end of the year becomes more certain, in our view. On the fiscal side, the temptation to deliver incremental stimulus as peaking unemployment impacts the popularity of incumbents should be monitored. This will be especially true as 2010 budget discussions get underway in Q3 2009. Steep local yield curves, however, are already reminding authorities of the constraints to incremental stimulus at this stage. Still, relief will only come with the definition of 2010 programs and their funding requirements, in our view.

Table 14: Projected 2009 adjustment breakdown

	Total easing (bp)	Total fiscal (% GDP)	GDP change (ppt)	FX change (%)
Argentina*	575	-1.9	-5.1	15.8
Brazil	500	-0.3	-4.6	-22.3
Chile	750	-9.1	-3.6	-2.1
Colombia	500	-1.2	-2.4	11.2
Mexico	375	-1.9	-6.9	0.6
Peru	450	-3.9	-7.8	-1.1

\* Badlar rate.  
Source: Banc of America Securities-Merrill Lynch

Beyond common trends, the region should continue to see significant differentiation in the balance of the year. We still think that, consistent with the stimulus delivered, Brazil and Chile will be the first economies to evidence a recovery in Q3 2009. At the other end, and while a series of negative shocks in H1 2009 may provide a favorable base, Mexico should be among the last to show domestic demand recovering. All in, we see the region posting a -1.1% real GDP contraction. This will put LatAm growth in line with global growth but well above that which we expect of developed markets (-3.5%).

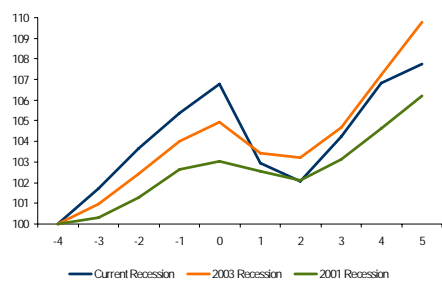
## Brazil: rebound in Q2, recovery in H2

After the strong positive surprise delivered by Q1 GDP figures (see: [Brazil beats expectations, 15 June](#)), we are even more confident about our above-consensus expectations of a marginal GDP expansion in 2009 (+0.5% yoy). We continue to believe that Brazil will be one of the first LatAm countries to emerge from the current crisis, with GDP expanding by 2.1% already in Q2 2009. After contracting by over 11% in the last two quarters, industrial production is likely to benefit from this extremely depressed base of comparison and post a respectable gain in Q2.

<sup>1</sup> LA-6 growth would contract 5.4% yoy if we use our estimates for Argentine GDP growth vs official statistics.

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Chart 45: Brazil real GDP

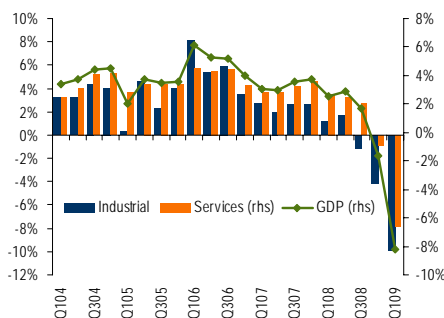


Source: IBGE, Banc of America Securities-Merrill Lynch

Beyond that, the combination of higher public expenditures and a still resilient domestic consumer should make for another strong quarter for overall consumption. Investments, on the other hand, are likely to remain subdued as record-low levels of capacity utilization act as a strong headwind.

While we realize that this expansion in Q2 is more of a technical rebound than a genuine recovery, we do expect the latter to come to life in H2 2009. According to our models, the easing cycle initiated in January will start to impact the economy in Q3 2009 and won't reach full throttle until latter in the semester. While we think unemployment is unlikely to peak before the end of Q3 2009 (at approximately 10%), the worsening of labor conditions are already losing steam and should be dominated by the loosening of credit. As such, we expect growth to average 1.8% in H2 2009. If this forecast is confirmed, it would put the statistical carryover to 2010 at over 3.5%. This fact, combined with the expectation of a decent expansion in that year, this leads us to predict overall GDP growth to reach 4.5% in 2010. In light of this, we expect the BCB to interrupt its current easing cycle with the Selic at 8.75%. While the expected H2 2009 recovery of domestic activity will raise concerns about the inflation outlook, we anticipate actual GDP will still be running considerably below potential until the end of 2010, allowing the BCB to leave rates unchanged.

Chart 46: Mexico GDP growth and main components (% yoy)



Source: INEGI, Banc of America Securities-Merrill Lynch

### Mexico: lagging in recovery

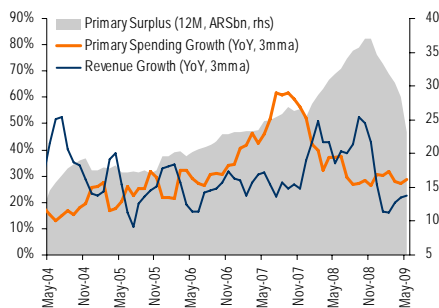
Showing negative quarter-on-quarter readings since Q3 2008, Mexico entered a recession already in Q4 2008, becoming the most severely affected economy by the global recession in LatAm. The significant contraction in industrial production aggravated by the influenza outbreak led to a record 12.2% yoy decline in activity. This reaffirms our expectation of a double-digit contraction in GDP during Q2 (BAS-ML: -10.2% yoy). Further, given the tight manufacturing links with the US auto industry, we do not foresee a significant rebound in industrial output in H2 2009. Indeed, in spite of a dramatic collapse in H1 2009, industrial production should still be down around 5.0% yoy in H2 2009.

Unfortunately, economic policy stimulus in support of a faster recovery will likely be limited. Still high inflation and the fiscal revenue shortfall (both oil and non-oil) will limit monetary and fiscal policy reaction. On the monetary side, Banxico delivered 375bp in rate cuts throughout H1 2009, bringing the Fondo rate to 4.75%. However, the deterioration in the balance of risks (ie, higher oil prices driving gasoline prices, government's revenue shortfall forcing reliance on higher tariffs), limit Banxico's easing room. As such, we expect only one more 25bp rate cut in H2 2009 (at 4.50%).

The fiscal front is where Mexico faces its real challenge. The fiscal deficit is set to reach 2% of GDP in 2009 and a similar print next year. More concerning, in the absence of a medium-term strategy implemented via tax measures and/or a medium-term fiscal framework, similar or even higher deficits could become persistent in subsequent years. This concern led Fitch and S&P credit rating agencies to place Mexico's ratings on negative outlook earlier this year. As such, a potential downgrade will ultimately depend on how the government faces such challenge in H2 2009.

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Chart 47: Argentina dwindling fiscal resources



Source: Ministry of Economy, Banc of America Securities-Merrill Lynch

## Argentina: an opportunity to adjust

We expect the Argentine economy will continue shrinking in H2 2009 due to the limitation in applying countercyclical policies and continued political uncertainty leading to further investment contraction. While some activity indicators, particularly industrial production, show signs of bottoming out, the recovery will be sluggish in absence of stronger growth engines (agriculture is down due to the drought, construction still contracting). As a result, fiscal deterioration will continue to press Argentine assets despite the fact that the country has the capacity to meet its short-term obligations, in our view.

Indeed, without access to international financing, the external and fiscal constraints push for a pro-cyclical policy response, likely leading to further contraction in H2 2009. Also, while the central bank maintained financial stability, providing liquidity and managing the AR\$ depreciation, we believe more AR\$ weakness will be needed to absorb the external and domestic shocks. The results of the mid-term elections create an opportunity to build political consensus and normalize the economy. Indeed, the external agenda (holdouts, Paris Club, IMF) may be brought back to the drawing board, but we still believe this will not be a priority until fiscal cushions are depleted.

## Chile: policy stimulus to the rescue

As an open, commodity-based economy with the deepest financial penetration in LatAm, Chile was severely hit by the global recession. Growth indeed disappointed in H1 2009, and unemployment is still on the rise. Cyclically sensitive sectors (industry, retail) remain weak, driving domestic confidence below the recovery seen in other economies. But fiscal and monetary stimulus will mark the bottom of the crisis in Q2 2009 and should drive a gradual recovery in H2 2009.

The government is using up accumulated resources to run an 8.0% of GDP stimulus package that will hit ground stronger in H2 2009. This will be boosted by the lagged impact of BCCH's aggressive monetary easing (750bp YTD) and rates remaining low for a longer-than-expected period. As a result, unemployment should peak by the end of Q3 2009 as the economy is filled with inexpensive credit and the construction sector regains momentum.

## The week ahead: Chile and Peru rates

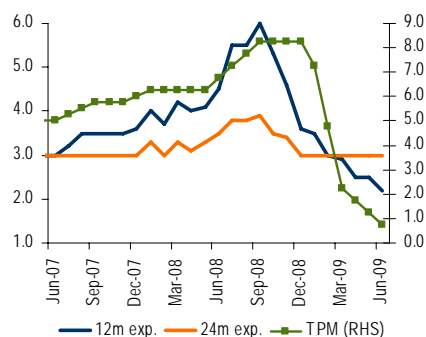
The main focus this week will be on Chile and Peru central bank decisions. In Chile, we believe the BCCH will pause (Thursday, 9 July) after signalling an end to the monetary easing cycle in its last policy meeting. The bank also indicated that it does not plan to withdraw the stimulus anytime soon, seeking to support the credit channel via lower longer term yields. Prior to the meeting, attention will focus on potential signs of a bottoming out in May activity (BAS-ML: -3.7% yoy; 6 July) and on June inflation (BAS-ML: 0.2% mom; 7 July).

Also on Thursday, we believe the Central Bank of Peru (BCRP) will continue its aggressive easing by reducing the reference rate another 100bp, to 2.00%. The sharper-than-expected drop in activity and inflation grant the room.

In Brazil, June consumer and wholesale prices will dominate local attention. The IGP-DI is expected to remain in negative territory (BAS-ML: -0.07%; 7 July) as lower iron ore and fertilizer prices push industrial wholesale prices lower. On Wednesday, 8 July, we expect the IPCA to gain only 0.24% in June. This would push the yearly rate down to 4.68%, from 5.20% in May. In July, the yearly rate should drop below the center of the inflation target (4.5%) for the first time since December 2007. Indeed, we expect the yearly rate to remain below target until the end of 2010. Also note that local markets will be closed on Thursday, 9 July.

Finally, in Mexico, while digesting the outcome of mid-term congressional elections, markets will focus on June's inflation report (BAS-ML: 0.20% mom). Benefiting from lower prints on core and non-core components, inflation likely maintained its gradual annual decline in June, to 5.76% in line with Banxico's base scenario.

Chart 48: Chile TPM policy rate and inflation expectations



Source: BCCH, Banc of America Securities-Merrill Lynch

## Global economic calendar

### US quiet, watch IP elsewhere

#### Green shoots also in the hard data?

After the recent solid rounds of PMI surveys, we'll be watching closely a number of IP releases for evidence of a more meaningful translation into real economic activity. In Europe in particular, we expect improvements after the Easter-driven weakness in April, with both the UK and Germany likely to post positive mom gains. Meanwhile, central banks in the UK, Australia, Korea, the Philippines, Chile and Peru meet next week. We look for unchanged rates except for the Philippines and Peru, where we see 25bp and 100bp rate cuts, respectively.

*Please refer to the latest [Global Economic Calendar](#) for the full list and our review/preview of events.*

#### Key events in the week ahead

BST	Country	Data/Event	BAS-MLe	Cons.	Previous
<b>Monday, 6 July</b>					
15:00	US	ISM non-manufacturing (Jun)	45.0	46.0	44.0
23:00	New Zealand	NZIER bus survey - own trading (Q2)	-35.0	n.a.	-47.0
<b>Tuesday, 7 July</b>					
05:30	Australia	RBA rates decision	3.00%	3.00%	3.00%
08:00	Hungary	Industrial production (May, yoy, P)	-24.7%	n.a.	-25.3%
09:00	Norway	Industrial production (May, mom, sa)	-0.7%	n.a.	-1.6%
09:30	UK	Industrial production (May, mom)	0.2%	0.0%	0.3%
11:00	Germany	Factory orders (May, mom)	-0.6%	n.a.	0.0%
<b>Wednesday, 8 July</b>					
07:30	France	BdF business sentiment (Jun)	83.0	n.a.	81.0
08:00	Turkey	Industrial production (May, yoy)	-15.0%	-16.6%	-18.5%
08:30	Sweden	Industrial production (May, mom, sa)	-1.5%	n.a.	-2.1%
11:00	Germany	Industrial production (May, mom)	0.8%	n.a.	-1.9%
<b>Thursday, 29 July</b>					
02:00	Korea	BoK rate decision	2.00%	n.a.	2.00%
02:30	Australia	Employment (Jun, '000s)	-10k	n.a.	-1.7k
05:01	Malaysia	Industrial production (May, yoy)	-8.0%	n.a.	-11.4%
09:00	Philippines	BSP rate decision	4.00%	n.a.	4.25%
12:00	UK	BoE rates decision	0.50%	0.50%	0.50%
12:00	South Africa	Manufacturing production (May, yoy)	-17.9%	-17.5%	-21.6%
23:00	Chile	BCCH rates decision	0.75%	0.75%	0.75%
-	Peru	BCRP rates decision	2.00%	n.a.	3.00%
<b>Friday, 10 July</b>					
00:50	Japan	Domestic CGPI (Jun, yoy)	-6.0%	-6.4%	-5.4%
-	India	Industrial production (May, yoy)	n.a.	n.a.	1.4%
07:45	France	Industrial production (May, mom)	-0.1%	-0.2%	-1.4%
09:00	Italy	Industrial production (May, mom, sa)	-0.6%	-2.0%	1.1%
09:30	UK	PPI output (Jun, mom, nsa)	0.6%	n.a.	0.4%
		PPI input (Jun, mom, nsa)	-0.9%	n.a.	0.4%
12:00	Canada	Employment change (Jun, mom)	-35.0k	-30.0k	-41.8k
15:00	US	U of M confidence (Jul, P)	71.5	71.0	70.8

Source: Banc of America Securities-Merrill Lynch, Bloomberg, Central banks

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## Global forecasts Medium-term economic forecasts

Table 15: Global economic forecasts

	GDP growth, %							CPI inflation*, %							Short term interest rates**, %			
	2008	2009F	2010F	2011F	2012F	2013F	2014F	2008	2009F	2010F	2011F	2012F	2013F	2014F	Current	2008	2009F	2010F
<b>Aggregates</b>																		
Global	3.0	-1.0	3.7	4.3	4.5	4.4	4.4	5.5	1.5	2.7	2.6	2.7	2.7	2.7	2.75	4.11	2.85	3.28
Global ex US	3.6	-0.6	4.1	4.6	4.7	4.8	4.9	6.0	2.1	3.1	2.8	2.9	2.9	2.9	3.49	5.29	3.64	4.17
Developed Markets	0.7	-3.4	2.2	2.6	2.7	2.5	2.3	3.3	0.0	1.2	1.6	1.6	1.8	1.7	0.49	1.17	0.50	1.00
G5	0.7	-3.4	2.2	2.6	2.7	2.4	2.2	3.3	-0.1	1.2	1.5	1.6	1.7	1.7	0.42	1.08	0.44	0.92
Emerging Markets	5.9	1.9	5.5	6.0	6.3	6.4	6.5	8.1	3.4	4.4	3.8	3.8	3.7	3.6	5.63	7.85	5.72	5.96
EMEA	2.1	-3.9	1.6	2.8	3.0	3.0	3.0	6.2	3.2	3.0	3.0	3.3	3.2	3.2	3.13	5.00	3.23	4.01
European Union	1.0	-4.2	1.1	2.5	2.5	2.5	2.4	3.5	1.1	1.5	1.5	2.0	1.9	2.0	1.32	2.75	1.16	2.19
Emerging EMEA	4.7	-3.3	2.4	3.6	4.0	4.0	4.0	11.3	7.7	6.0	5.4	5.7	5.4	5.2	7.85	10.45	8.12	8.20
PacRim	5.2	2.8	6.6	6.8	6.8	6.9	6.9	5.5	0.0	2.5	2.5	2.5	2.6	2.6	2.96	3.95	3.12	3.58
PacRim ex Japan	6.7	4.8	7.4	7.7	7.9	7.9	7.9	6.5	0.3	3.2	3.0	2.9	2.9	2.9	3.68	4.95	3.83	4.27
Emerging Asia	7.1	5.3	7.7	8.0	8.1	8.2	8.2	6.6	0.2	3.3	3.1	2.9	2.9	2.9	3.85	5.13	3.98	4.39
Americas	1.9	-1.8	2.8	2.9	3.3	3.0	2.7	4.8	1.4	2.6	2.4	2.2	2.3	2.2	2.17	3.41	2.21	2.26
Latin America	4.2	-1.1	3.3	3.2	3.5	3.7	3.8	7.8	6.5	5.6	3.7	3.8	3.7	3.6	7.91	12.32	7.99	8.09
<b>G5</b>																		
US†	1.1	-2.1	2.6	3.0	3.5	3.0	2.5	3.8	-0.4	1.5	2.1	1.8	2.0	1.8	0.125	0.125	0.125	0.125
Euro area	0.6	-4.4	1.2	2.4	2.2	2.2	2.2	3.3	0.5	1.2	1.5	1.9	1.9	1.9	1.00	2.50	1.00	2.00
Japan	-0.7	-5.6	3.5	2.5	1.5	1.5	1.5	1.5	-1.3	-0.5	0.2	0.5	0.8	1.0	0.10	0.10	0.10	0.50
UK	0.7	-4.1	1.1	2.5	3.2	3.1	3.0	3.6	2.0	1.9	1.4	1.5	1.7	1.9	0.50	2.00	0.50	2.00
Canada	0.5	-2.0	2.7					2.4	-0.2	1.5					0.25	1.50	0.25	0.25
<b>Euro area</b>																		
Germany	1.0	-6.0	1.2	1.9	1.8	1.8	1.8	2.6	0.5	1.0	1.3	1.8	1.8	1.8	1.00	2.50	1.00	2.00
France	0.3	-2.8	1.1	2.1	2.1	2.2	2.2	2.8	0.1	1.1	1.6	1.9	1.9	2.0	1.00	2.50	1.00	2.00
Italy	-1.0	-4.9	0.7	1.9	1.8	1.7	1.7	1.2	0.5	1.0	1.6	2.0	2.2	2.2	1.00	2.50	1.00	2.00
Spain	1.1	-3.7	0.1	1.8	2.0	2.0	2.0	4.1	-0.2	1.4	1.4	1.7	2.0	2.0	1.00	2.50	1.00	2.00
Netherlands	2.1	-4.0	1.6	1.7	2.1	2.5	2.5	2.2	1.4	1.0	1.0	1.2	1.3	1.5	1.00	2.50	1.00	2.00
Belgium	1.0	-2.9	1.6	1.9	1.9	1.9	1.9	4.5	1.0	1.1	1.6	1.8	1.8	1.8	1.00	2.50	1.00	2.00
Greece	2.9	-1.6	0.8	1.1	1.6	2.0	2.5	4.2	2.1	2.3	2.5	2.5	2.5	2.5	1.00	2.50	1.00	2.00
Austria	1.7	-3.3	1.5	2.0	2.1	2.1	2.3	3.2	1.0	0.9	1.3	1.8	1.8	1.9	1.00	2.50	1.00	2.00
Portugal	0.0	-3.4	1.6	1.4	1.8	1.8	1.8	2.7	0.7	1.1	2.0	2.0	2.0	2.0	1.00	2.50	1.00	2.00
Finland	0.9	-4.6	1.6	1.5	2.5	3.0	3.5	0.9	1.6	1.2	1.3	1.3	1.3	1.3	1.00	2.50	1.00	2.00
Ireland	-2.3	-8.2	0.2	1.0	2.3	2.5	2.6	3.1	-0.9	0.5	1.6	1.9	1.9	1.9	1.00	2.50	1.00	2.00
<b>Other Developed Europe</b>																		
Sweden	-0.4	-5.5	1.1	1.8	2.2	2.5	2.5	3.5	-0.2	1.1	1.8	1.9	2.0	1.9	0.50	2.00	0.25	1.50
Switzerland	1.6	-2.6	0.9	1.5	1.8	1.8	1.8	2.4	-1.5	0.4	1.9	1.9	1.9	1.9	0.25	1.20	0.30	1.00
Norway	2.5	-1.7	1.6	2.5	2.5	2.8	2.8	3.8	2.6	2.0	2.5	2.5	2.5	2.5	1.50	3.00	1.25	2.25
<b>Asia Pacific</b>																		
China	9.0	8.0	9.6	9.5	9.5	9.5	9.5	5.9	-1.0	2.5	2.0	1.9	1.9	1.9	5.31	5.58	4.77	4.77
India	7.5	6.3	7.3	7.8	8.0	8.0	8.0	9.1	0.8	5.5	5.5	5.5	5.5	5.5	3.25	5.00	3.25	4.50
Korea	2.5	-1.2	4.0	4.5	5.0	4.8	4.6	4.7	2.7	2.7	3.0	3.0	3.0	3.0	2.00	3.00	2.00	2.50
Indonesia	6.1	3.6	4.8	6.0	6.5	6.5	6.5	9.8	5.2	6.0	5.0	4.0	4.0	4.0	7.00	9.25	6.50	7.50
Australia	2.3	-0.2	2.0	3.2	3.5	3.3	3.3	4.4	1.7	2.6	2.7	2.8	2.9	3.0	3.00	4.25	3.00	4.00
Taiwan	0.1	-5.0	4.5	4.3	4.3	4.3	4.3	3.5	-0.8	1.2	1.8	1.8	1.8	1.8	1.25	2.00	1.25	1.50
Thailand	2.6	-3.3	2.9	3.5	4.0	4.0	4.0	5.5	-0.8	2.0	2.5	3.0	3.0	3.0	1.25	2.75	1.25	1.25
Malaysia	4.5	-3.8	4.2	4.8	4.8	4.8	4.8	5.4	0.2	1.0	2.5	2.5	2.5	2.5	2.00	3.25	2.00	2.00
Philippines	3.8	1.4	2.5	3.0	3.5	4.0	4.0	9.3	4.0	6.1	5.0	5.0	5.0	5.0	4.25	5.75	4.00	5.00
Hong Kong	2.4	-3.1	4.5	5.0	4.5	4.5	4.5	4.3	0.9	2.0	2.5	3.0	3.0	3.0	0.36	1.23	0.25	0.35
Singapore	1.1	-5.0	4.0	5.3	5.3	5.3	5.3	6.5	-0.5	0.8	1.5	1.5	1.5	1.5	0.64	0.75	0.75	1.25
New Zealand	-1.0	-2.2	1.3	2.5	2.7	2.8	2.8	4.0	1.5	2.0	2.5	2.5	2.5	2.5	2.50	5.00	2.00	4.00
<b>Latin America</b>																		
Mexico	1.3	-5.6	2.6	2.5	3.0	3.4	3.6	5.1	5.5	3.7	3.6	3.8	3.7	3.5	5.25	8.25	4.50	5.50
Brazil	5.1	0.5	4.5	4.6	4.7	4.8	4.9	5.7	4.7	4.2	4.5	4.5	4.3	4.0	10.25	13.75	8.75	8.75
Argentina	6.8	1.6	2.2	2.3	2.6	3.0	3.0	8.6	5.8	6.2	5.2	5.3	5.8	6.0	12.94	19.80	14.00	11.50
Colombia	2.5	0.1	3.0	3.5	3.3	3.6	3.8	7.0	5.2	4.2	4.0	4.5	4.3	4.5	5.00	9.50	4.50	6.00
Venezuela	4.8	-1.0	0.6					31.3	30.1	29.9					22.03	21.85	22.00	20.00
Chile	3.2	-0.4	3.3	4.0	4.2	4.4	4.5	8.7	2.6	1.4	2.9	3.4	3.2	3.0	1.25	8.25	0.75	3.25
Peru	9.8	2.1	4.2	4.2	4.8	5.3	5.6	5.8	3.3	1.8	3.0	2.5	2.3	2.2	3.00	6.50	2.50	3.50
Ecuador	4.8	-0.4	1.8					8.4	4.6	3.8					9.00	8.25	7.00	
Uruguay	11.6	1.6	3.0					7.9	6.7	4.4					7.75	6.75	6.00	
Panama	9.2	1.9	3.5					8.8	2.5	2.8					8.30	7.00	7.00	

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Table 15: Global economic forecasts

	GDP growth, %							CPI inflation*, %							Short term interest rates**, %			
	2008	2009F	2010F	2011F	2012F	2013F	2014F	2008	2009F	2010F	2011F	2012F	2013F	2014F	Current	2008	2009F	2010F
<b>EEMEA</b>																		
Russia	5.6	-7.3	2.4	2.5	3.0	3.5	3.5	14.1	10.7	8.1	7.8	7.5	7.5	7.0	11.50	12.00	11.00	10.00
Turkey	1.1	-3.5	4.5	4.5	4.5	4.5	4.5	10.4	6.3	6.7	5.0	5.0	5.0	5.0	9.25	15.00	9.25	11.50
Poland	4.9	0.2	2.0	4.8	4.2	3.5	3.7	4.2	3.9	2.5	2.0	3.8	2.2	2.5	3.75	5.00	3.00	4.00
South Africa	3.1	-0.6	3.3	3.8	4.0	4.5	4.5	11.5	7.3	6.4	6.0	6.0	6.0	6.0	7.50	11.50	7.50	9.00
Egypt	7.2	3.5	3.0	5.0	5.0	5.0	5.0	11.7	15.0	6.0	7.5	8.0	8.0	8.0	9.50	10.50	9.00	8.00
Ukraine	2.1	-11.5	-3.0	1.5	3.5	4.0	4.0	25.3	19.1	12.9	11.0	10.0	9.0	8.5	12.00	12.00	11.00	10.00
Nigeria	6.3	2.5	4.5	5.2	5.5	6.0	6.0	11.6	10.5	9.0	9.0	9.0	9.0	9.0	9.75	7.00	9.00	9.00
Romania	7.1	-6.4	-2.5	3.5	5.2	4.4	3.6	6.3	5.2	4.0	2.7	4.5	3.2	2.8	9.50	10.25	8.00	6.00
Czech Republic	3.5	-4.3	1.1	2.1	3.0	2.5	2.2	6.4	1.3	1.5	1.0	2.6	1.8	2.0	1.50	2.25	1.25	2.25
Hungary	0.5	-6.5	-1.4	2.5	4.1	3.2	2.7	6.1	5.5	4.2	1.2	3.7	2.8	2.5	9.50	10.00	7.50	5.50
Israel	3.9	-2.0	1.8	4.0	4.0	4.0	4.0	4.6	1.1	1.5	2.0	2.0	2.0	2.0	0.50	2.25	0.50	1.50
Kazakhstan	3.2	-0.9	2.7	2.5	3.5	4.5	4.5	17.3	9.0	8.1	7.0	7.0	6.5	6.5	9.00	10.50	8.00	7.00
Slovakia	6.4	-5.5	1.4					4.4	1.9	3.1					2.50	2.50		
Bulgaria	5.9	-4.0	0.8	4.0	5.5	4.2	4.3	7.8	4.2	3.5	2.7	5.1	4.0	3.8				
<b>GCC</b>																		
Saudi Arabia	4.2	-0.2	3.1	4.5	4.5	4.5	4.5	9.9	3.0	3.3	2.5	2.5	2.5	2.5				
United Arab Emirates	6.8	-1.0	2.0	4.0	4.0	4.0	4.0	11.8	0.5	1.0	2.0	3.5	3.5	3.5				
Kuwait	5.6	-1.9	2.0	4.0	4.0	5.0	5.0	10.6	2.8	3.1	3.0	3.0	3.0	3.0				
Qatar	16.4	5.7	8.1	8.0	8.0	3.0	3.0	15.1	5.0	5.2	5.0	4.5	4.5	4.0				
Oman	6.4	1.5	2.3	4.0	4.5	4.5	4.5	12.5	3.2	3.5	3.0	3.0	3.0	3.0				
Bahrain	5.4	1.8	2.4	3.5	4.0	4.0	4.0	3.5	2.0	2.2	2.0	2.0	2.0	2.0				

Notes: Global and regional aggregates are based on the IMF PPP weights unless stated otherwise. Countries within each region are ordered according to these weights.

\* Annual averages. The HICP measure of inflation is used for Euro area economies. \*\* Central bank target rate, year-end, where available, short-term rates elsewhere. † US short-term rate forecast for 2008, 2009 and 2010 year end is 0-0.25%.

Midpoint used in table above for global and regional aggregation purposes.

Source: Banc of America Securities-Merrill Lynch

## Interest rate forecasts

Table 16: Quarter-end government bond yield forecasts

		Latest	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10
US	3 mth*	0.58	0.55	0.45	0.40	0.40	0.45	0.50
	2 yr	0.98	1.00	1.00	1.00	0.90	0.95	1.00
	5 yr	2.42	2.50	2.60	2.60	2.45	2.35	2.25
	10 yr	3.49	3.85	4.10	3.95	3.75	3.55	3.35
	30 yr	4.32	4.55	4.75	4.65	4.55	4.40	4.20
Euro area	3 mth*	1.06	1.25	1.25	1.30	1.40	1.70	2.00
	2 yr	1.22	1.40	1.55	1.75	1.90	2.25	2.60
	5 yr	2.39	2.60	2.75	2.95	3.05	3.23	3.40
	10 yr	3.34	3.60	3.80	3.90	4.00	4.10	4.20
	30 yr	4.15	4.35	4.45	4.50	4.55	4.55	4.55
Japan	2 yr	0.27	0.40	0.45	0.55	0.60	0.80	0.85
	5 yr	0.68	0.65	0.90	1.00	1.00	1.25	1.50
	10 yr	1.33	1.35	1.60	1.55	1.60	1.75	1.95
	30 yr	2.18	2.15	2.35	2.25	2.40	2.30	2.55
U.K.	3 mth*	1.16	1.30	1.30	1.40	1.70	2.30	2.80
	2 yr	1.26	1.10	1.35	1.75	2.10	2.60	3.00
	5 yr	2.89	2.45	2.80	3.05	3.30	3.65	3.95
	10 yr	3.75	3.60	3.80	4.00	4.10	4.30	4.50
Australia	30 yr	4.46	4.65	4.70	4.75	4.80	4.80	4.80
	2 yr	3.81	3.50	3.80	4.00	4.10	4.10	4.20
	5 yr	5.05	4.60	5.40	5.40	5.10	5.50	5.80
Canada	10 yr	5.43	4.80	5.60	5.50	5.20	5.60	5.90
	2 yr	1.17	0.80	0.90	1.10	1.25	1.25	1.25
	5 yr	2.43	1.75	1.75	1.90	1.95	2.00	2.00
Sweden	10 yr	3.35	3.60	3.80	3.90	4.10	4.20	4.30
	10 yr	3.35	3.60	3.80	3.90	4.10	4.20	4.30
Norway	10 yr	4.12	4.25	4.45	4.50	4.60	4.70	4.75

Source: BAS-ML Global Rates Strategy. \*3m rates are LIBOR. Latest as of mid-day of publication.

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## Monetary policy forecasts

Table 17: Key meeting dates and expected rate change (bp)

	Current	Jul-09	Aug-09	Sep-09	Oct-09	Nov-09	Dec-09
<b>Developed market</b>							
Fed	0.00 - 0.25	-	12th	23rd	-	4th	15th
ECB	1.00	2nd	6th	3rd	8th	5th	3rd
BoJ	0.10	15th	11th	17th	14th, 30th	20th	18th
BoE	0.50	9th	6th	10th	8th	5th	10th
BoC	0.25	21st	-	10th	20th	-	8th
Riksbank	0.25	2nd	-	3rd	22nd	-	16th
SNB	0.25	-	-	17th	-	-	10th
Norges Bank	1.25	-	12th	23rd	28th	-	16th
RBA	3.00	7th	4th	1st	6th	3rd	1st
<b>Emerging Asia</b>							
China (lending rate)	5.31	-27	-	-	-27	-	-
Req. res. ratio*	15.50	-	-	-	-	-	-
India**	3.25	-	-	-	-	-	-
Repo rate	4.75	-	-	-	-	-	-
Cash res. ratio	5.00	-	-	-	-	-	-
Korea	2.00	9th	11th	10th	9th	12th	10th
Indonesia	6.75	-25 (3rd)	-25 (5 <sup>th</sup> )	3rd	5th	4th	3rd
Taiwan	1.25	-	-	25th	-	-	-
Thailand	1.25	15th	26th	-	21st	-	2nd
Malaysia	2.00	29th	29th	-	28th	24th	-
Philippines	4.25	-25 (9th)	20th	-	-	-	-
<b>Latin America</b>							
Mexico	4.75	-25 (17th)	21st	18th	16th	27th	-
Brazil	9.25	-50 (22nd)	-	2nd	21st	-	9th
Colombia	4.50	24th	28th	18th	23rd	20th	18th
Chile	0.75	9th	13th	8th	13th	12th	15th
Peru	3.00	-100 (9th)	6th	10th	7th	5th	10th
Uruguay	8.00	-	-	-	-125 (21st)	-	-
<b>Emerging EMEA</b>							
Turkey	8.75	-50 (16th)	18th	17th	15th	19th	17th
Poland	3.50	29th	-25 (26th)	30th	-25 (28th)	25th	23rd
South Africa	7.50	-	13th	22nd	22nd	17th	17th
Romania	9.00	-	-50 (4th)	-50 (29th)	-	3rd	-
Czech Republic	1.50	-	-25 (6th)	24th	-	5th	3rd
Hungary	9.50	-50 (20th)	(18th)	-50 (28th)	19th	-50 (23rd)	21st
Israel	0.50	27th	24th	29th	26th	23rd	28th

Note: Bolded data are expectations in basis points. "-" denotes either no meeting or meeting date yet uncertain. \*Major five banks. \*\*Reverse repo rate. Source: Banc of America Securities-Merrill Lynch forecasts, Central banks

## Commodity forecasts

Table 18: Commodity forecasts

	2009Q1	2009Q2	2009Q3	2009Q4	2009	2010Q1	2010Q2	2010Q3	2010Q4	2010
Oil - WTI Crude (US\$/bbl)	43.2	49.0	56.0	61.0	52.3	62.0	56.0	62.0	68.0	62.0
Nickel (US\$/lb)	4.74	5.90	6.00	6.05	5.67	6.20	6.60	6.60	6.00	6.35
Aluminium (US\$/lb)	0.62	0.66	0.72	0.72	0.68	0.72	0.72	0.72	0.74	0.73
Zinc (US\$/lb)	0.53	0.68	0.65	0.68	0.64	0.74	0.80	0.82	0.82	0.80
Lead (US\$/lb)	0.53	0.65	0.62	0.65	0.61	0.68	0.70	0.70	0.70	0.70
Molybdenum (US\$/lb)	12.8	12.5	12.5	12.5	12.6	12.5	12.5	12.5	12.5	12.5
Cobalt (US\$/lb)	15.4	11.0	11.0	10.0	11.9	10.0	11.0	11.0	11.0	10.8
Uranium (US\$/lb)	46.9	45.0	45.0	44.0	45.2	45.0	45.0	45.0	45.0	45.0
Gold (US\$/oz)	909	990	1050	1050	1000	1050	1050	1050	1050	1050
Silver (US\$/oz)	12.6	16.1	16.1	16.2	15.2	16.2	16.2	16.2	16.1	16.2
Platinum (US\$/oz)	1028	1150	1200	1240	1154	1216	1233	1261	1289	1250
Palladium (US\$/oz)	201	220	240	260	230	283	292	308	317	300
RHODIUM PRICE (US\$/oz)	1168	1200	1330	1550	1312	2141	2170	2220	2269	2200
Coal - Thermal Australia (US\$/t)	130	70	70	70	85	70	80	80	80	78
Coal - Hard cooking (US\$/t)	300	129	129	129	172	129	115	115	115	119
Coal - Semi soft coking (US\$/t)	240	83	83	83	122	83	85	85	85	85
Iron ore - Lump (USC/DLTU)	2.02	1.13	1.13	1.13	1.35	1.13	1.13	1.13	1.13	1.13

Source: Banc of America Securities-Merrill Lynch

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## FX forecasts

Table 19: Quarterly forecasts - G10 currencies

	Spot	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
<b>G3</b>							
EUR-USD	1.40	1.32	1.38	1.30	1.28	1.26	1.24
USD-JPY	96.0	105	110	112	114	116	118
EUR-JPY	134	139	152	146	146	146	146
<b>Dollar Bloc</b>							
USD-CAD	1.16	1.15	1.10	1.06	1.00	1.03	1.05
AUD-USD	0.799	0.750	0.800	0.820	0.840	0.860	0.880
NZD-USD	0.631	0.590	0.630	0.640	0.650	0.650	0.660
<b>Europe</b>							
EUR-GBP	0.857	0.860	0.850	0.830	0.810	0.790	0.790
GBP-USD	1.63	1.53	1.62	1.57	1.58	1.59	1.57
EUR-CHF	1.52	1.52	1.52	1.53	1.54	1.55	1.56
USD-CHF	1.09	1.15	1.10	1.18	1.20	1.23	1.26
EUR-SEK	10.89	10.00	9.50	9.25	9.20	9.20	9.20
USD-SEK	7.77	7.58	6.88	7.12	7.19	7.30	7.42
EUR-NOK	8.98	8.40	8.20	8.10	8.00	8.00	8.00
USD-NOK	6.41	6.36	5.94	6.23	6.25	6.35	6.45

Notes: End of period forecasts. Spot exchange rates as of 3 July, 2009. The left of the currency pair is the denominator of the exchange rate. Source: Banc of America Securities-Merrill Lynch

Table 20: Quarterly forecasts - EM currencies

	Spot	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
<b>Latin America</b>							
USD-BRL	1.95	1.85	1.80	1.80	1.80	1.95	1.75
USD-MXN	13.2	13.8	13.8	13.8	13.5	13.4	12.9
USD-CLP	543	610	625	610	540	520	515
USD-COP	2,084	2,400	2,500	2,550	2,600	2,550	2,400
USD-ARS	3.80	3.90	4.00	4.25	4.35	4.20	4.15
USD-VEF	2.15	2.15	2.70	2.70	2.70	2.70	2.70
USD-PEN	3.01	3.15	3.10	3.15	3.00	2.90	2.80
<b>Emerging EMEA</b>							
EUR-PLN	4.35	4.80	4.60	4.30	3.80	3.55	3.45
EUR-HUF	273	315	299	285	275	270	260
EUR-CZK	25.9	28	26.25	26	26	26	25.5
USD-UAH	7.63	8.75	8.5	8.5	8.5	8.5	8.5
USD-RUB	31.27	33.7	31.4	31.7	31.1	30.4	29.8
USD-ZAR	7.91	9.00	8.75	8.50	8.35	8.25	7.75
USD-TRL	1.53	1.70	1.65	1.60	1.55	1.55	1.50
EUR-RON	4.21	4.80	4.50	4.10	4.00	4.00	4.00
USD-EGP	5.57	5.75	5.90	5.85	5.75	5.75	5.75
USD-ILS	3.88	4.20	4.00	3.85	3.65	3.55	3.40
USD-AED	3.67	3.67	3.67	3.67	3.67	3.67	3.67
USD-KWD	0.287	0.298	0.301	0.301	0.301	0.301	0.301
USD-SAR	3.75	3.75	3.75	3.75	3.75	3.75	3.75
USD-QAR	3.64	3.64	3.64	3.64	3.64	3.64	3.64
<b>Asian Bloc</b>							
USD-KRW	1,269	1,200	1,050	1,100	1,100	1,050	1,000
USD-TWD	32.9	31.0	30.5	30.0	32.0	32.5	32.0
USD-SGD	1.45	1.45	1.47	1.48	1.47	1.47	1.48
USD-THB	34.1	33.6	33.8	34.0	34.2	34.2	34.5
USD-HKD	7.75	7.80	7.80	7.80	7.80	7.80	7.80
USD-CNY	6.83	6.75	6.70	6.65	6.60	6.55	6.50
USD-IDR	10,190	9,700	9,500	9,400	9,300	9,200	9,200
USD-PHP	48.0	48.0	48.5	49.0	50.0	49.0	48.0
USD-MYR	3.53	3.53	3.55	3.55	3.50	3.50	3.40
USD-INR	47.9	46.0	45.0	45.0	44.0	43.5	43.0

Notes: End of period forecasts. Spot exchange rates as of 3 July, 2009. The left of the currency pair is the denominator of the exchange rate. Source: Banc of America Securities-Merrill Lynch

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