

A deflation-inflation scenario



RESEARCH

Global Economics Team
MLPF&S (UK)

Riccardo Barbieri
Economist/Strategist
MLPF&S (UK)
riccardo_barbieri@ml.com

+44 20 7996 5897

Deflation is a threat, at least for the advanced economies

Low growth and deflation are a risk in the aftermath of the financial crisis, especially for the advanced economies. Moreover, as long as globalisation holds, it is difficult to generate inflation in a competitive world economy characterised by rising unemployment and low capacity utilisation rates. Commodity prices could cause a temporary rise in the CPI, but the experience of the past ten years shows that they cannot create persistently high inflation.

We believe Europe is at greater risk of deflation than US

Given the approach taken with respect to the banking system, the rigidities in the economy, a strong exchange rate, a smaller monetary and fiscal stimulus and unhelpful demographics, Europe is relatively more at risk of experiencing at least a mild form of the Japanese syndrome than the US. Policy actions can still avert this adverse scenario. Hopefully, Europe will respond more forcefully and in a more concerted fashion after the German elections.

Capital markets recovery is an encouraging sign

Japan's long period of deflation in 1998-2005 was due among other factors to a credit crunch as banks' capital was wiped out by losses on equity portfolios and real estate. Capital markets failed to provide sufficient financing for the economy. We thus believe that the recent recovery in corporate bond issuance in the US, Europe and Asia is an encouraging sign. If it gradually spreads to the high-yield and securitisation markets, it will mark a success for the central banks and a signal that deflation can be averted.

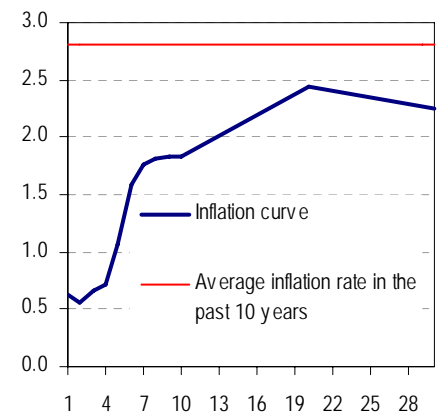
In the longer term, inflation risks are significant

A large and sustained monetary stimulus in the advanced economies could ultimately generate inflation in the medium to long term if the world's output gap turned out to be smaller than expected and/or protectionist measures became more pervasive. Indeed, due to scrapping of some of the existing capacity and to labour market segmentation, global potential output growth could decline. On their part, protectionist measures would make economies less open. Despite rising unemployment, organised labour could regain power as political winds turned.

Inflation breakevens will probably rise as economy recovers

Breakevens have risen since the turn of the year, as confidence that outright deflation can be averted returned to the markets. Still, the markets are now pricing in a benign scenario in which, for instance, even in five years' time US inflation would be lower than the average for the past ten years. While high inflation can only be characterised as a risk at this stage, we believe that breakevens will rise further as the economy recovers and the Fed and other central banks, while talking about 'exit strategies', keep printing money in order to prevent a relapse.

Chart 1: US inflation curve



Note: The x-axis is measured in number of years ahead.
Source: Bloomberg

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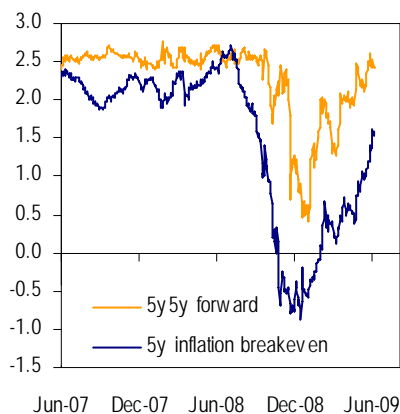
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Global overview

A deflation-inflation scenario

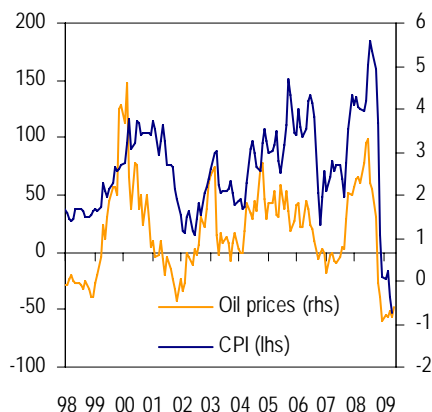
Judging by the recovery in inflation breakevens since the start of the year, the bond market has taken the view that risks of a long period of deflation as a result of the financial crisis are low. Indeed, taking US breakeven as an example, the market is currently pricing in a 0.6% inflation rate in the next two years and 1.62% in the next five years. Inflation expected in the following five years (the closely watched 5Y/5Y forward) is significantly higher, at 2.38%. The ten-year breakeven is 1.93%. By way of comparison, the average US inflation rate in the past ten years was 2.8%, and in the previous ten years 3.3%.

Chart 2: US inflation break even vs 5y5y forward



Source: Bloomberg

Chart 3: US inflation and oil prices (% yoy)



Source: Haver Analytics

The market is thus projecting a continuation of the disinflation trend that has been in place since the early 1980s, but it has moved away from the extreme pessimism of late 2008, when the US ten-year breakeven fell to zero. Indeed financial asset and commodity prices are recovering on the back of improving chances of an economic recovery. If anything, a number of investors we recently met expressed greater concerns about inflation than deflation in view of the substantial monetary base creation by central banks.

As suggested by our team's forecasts, we believe that inflation risks are limited in the short run (2009-2010) and, if anything, headline inflation will turn negative in most advanced economies as a result of base effects from last year's surge in oil prices. As regards the medium to long run, we have not come up with long-term projections yet, but we believe that the huge policy stimulus that has been deployed by central banks and governments will have some inflationary effects, though they are more likely to be reflected in asset prices than in the goods inflation.

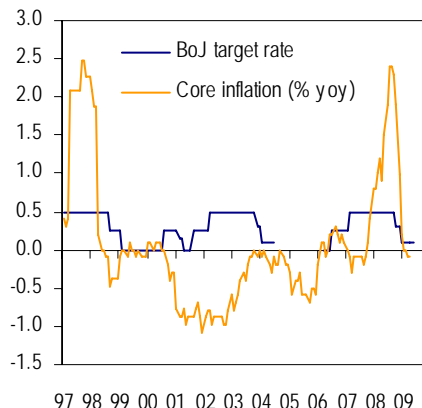
In our view, as long as the crisis produces only minor forms of protectionism – such as the ones that have already been observed in recent months – the competitive forces at work in the global economy should keep inflation relatively under control. (In a closed and protected economy, it is easier to 'create' inflation.) Granted, a shortage of resources could create inflation in coming years via rising oil and commodity prices. However, it is remarkable that in the ten years to July 2008, despite a compounded annual growth in oil prices of almost 30%, the US CPI increased at a compound rate of only 3.0%. Starting from today's WTI price, a 30% compounded growth rate for ten years would take the oil price to US\$950pb – more than most oil experts would be prepared to predict! While other factors driving inflation could evolve unfavourably (eg, globalisation and the deflationary impact of China), oil prices per se are not sufficient to generate high inflation.

A sustained acceleration in inflation would require the whole global economy to experience tightness in labour markets and capacity constraints in manufacturing – something that is at least a few years away but cannot be totally ruled out given unprecedented monetary easing and given that the international monetary system remains based on a partial dollar standard – with the Fed's policy affecting monetary conditions in countries such as China that enjoy much higher growth rates than the US. In fact, changes in currency regimes (eg, a free float in the renminbi) would also be necessary to create inflation on a global scale.

On the whole, creating inflation in a globalised economy will not be much easier than it would have been in the past decade. Like the inflation market, we believe

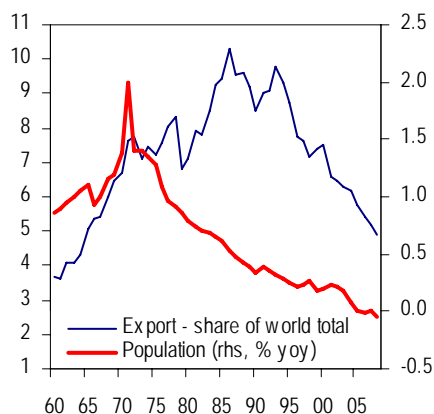
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Chart 4: Japan core inflation vs BoJ policy rate



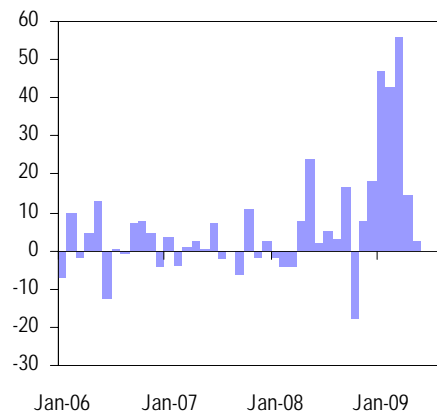
Source: Haver Analytics

Chart 5: Japan's population growth and export market share



Source: IMF, Haver Analytics

Chart 6: EMU non-financial corporations high grade bond issuance (yoy, US\$ billion)



Note: Latest data point in May is US\$2.2bn.
Source: Banc of America Securities-Merrill Lynch

that inflation risks are very moderate on a two- to three-year view, but beyond that we feel that bond yields and breakevens should reflect a greater *risk* that the stimulus administered to the ailing global economy may be too strong or last for too long. Inflation breakevens will rise further, in our view.

At the opposite side of the spectrum, deflation has been a concern for policy makers and investors since the stock-market bubble burst in 2000-01 and the Fed started worrying about a repeat of Japan's deflation experience. Japan's fight with deflation is the most important example in recent history of how a financial crisis can ultimately lead to a period of slow growth and deflation.

In the following pages, our Japanese economists Masayuki Kichikawa and Takuji Okubo review the period of deflation and its roots in the early 1990s bursting of the real estate and equity bubbles. In their view, one of the key causes of deflation was that banks' capital was wiped out due to their exposure to real estate and equities, while the capital markets did not provide sufficient support to the real economy. This induced a drop in capital accumulation and GDP growth which then led to a spiral of pessimism and deflation.

The Japanese syndrome is in fact a source of concern in today's situation. This is especially true in the case of Europe (and notably Germany), where the banking system plays a relatively bigger role in the financing of the private sector and the approach of governments and regulators to acknowledging losses and recapitalising the banking system has been less aggressive than in the US. When banks sit on illiquid positions, mark-to-market losses and non-performing loans, they are unable to extend needed financing to the economy.

On a more positive note, though, the recovery in the equity and credit markets has recently led to a significant pickup in capital market activity. There is now talk among the experts that even high-yield bond issuance is about to return. Our colleagues who cover the securitization market believe that recovery is some way off, but they concede that their sector is a lagging indicator and that 2010 could see a resumption of issuance.

The improvement in the markets still rests on fragile foundations, but there can now be little doubt that the 'second derivative' in the economy has turned positive – witness the slowdown in job losses in the US. A return to positive growth in the third quarter, consistent with our forecast for the US and most advanced economies, is now looking quite likely. This should keep the equity and credit markets well supported and promote a continuation of new issuance.

We also believe that the world economy as a whole does not suffer from some of the shortcomings that held down Japan's growth in the last two decades, such as lack of population growth and a declining export market share. Perhaps even more importantly, the Fed and other central banks have responded forcefully to the crisis, and fiscal policy has been loosened aggressively. On the whole, it seems to us that low inflation will prevail on a three-year view, but we are not persuaded that deflation is the key risk for the *global* economy.

Whether some of the *advanced* economies escape deflation is a different story. Given the approach taken with respect to the banking system, the rigidities in the economy, a strong exchange rate and unhelpful demographics, Europe is at risk of experiencing at least a mild form of the Japanese syndrome. Policy actions can still avert this adverse scenario. Hopefully, Europe will respond more forcefully and in a more concerted fashion after the German elections.

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Masayuki Kichikawa +81 3 6225 8214
Takuji Okubo +81 3 6225 7636

In focus: Financial crisis and deflation

Lessons from Japan's 'lost decade'

Japan's period of deflation lasted just under nine years, from 1998 to 2005. During this time, core CPI (which excludes fresh food) declined by 3.2%. A breakdown by component reveals that CPI deflation was the product of: (1) a sharp decline in household durables/leisure durables/communication costs, and (2) flat prices in services except for education. In this sense, Japanese deflation might be exaggerated to some extent by the decline in the prices of durable goods, which were hit by the very rapid technological progress and deeper penetration of imported goods, especially from Asian countries.

But larger declines in the GDP deflator strongly suggest that the pricing power of the domestic corporate sector was very depressed and that Japan experienced at least mild deflation during these years.

In this article, we first summarize our views on the factors that brought deflation to Japan, then look into the dynamics of the credit crunch in greater detail. Finally, we briefly outline the response of major economic sectors and financial markets to deflation which, we hope, could offer some guide for the future.

1. Factors that brought deflation in Japan

What caused deflation in Japan? As with any complex economic processes, there are no simple answers. We think the bursting of the asset bubble in Japan around 1990 and the failure of Japanese policy makers to offset its repercussions were primarily responsible. Below, we summarize the chain of events that likely caused deflation in Japan.

The forming of the Japanese bubble

Between 1985 and 1989, Japanese share prices rose by 215%. The stock market peaked in 1989, but the real estate bubble lasted longer. Prices climbed by 64% between 1985 to a peak in 1991. In terms of value, corporate equity in Japan rose by 642tn yen between 1985 to a peak in 1989, equivalent to 198% of GDP in 1985. For real estate, the increase in nominal value between 1985 and 1990 was a staggering 1,474tn yen, equivalent to 450% of GDP in 1985.

Bursting of the bubble

The BoJ started to tighten monetary policy aggressively in 1989, raising its policy rate by 350bp between May 1989 and August 1990. Then in early 1990, the Ministry of Finance, the banking sector regulator, issued strong guidance to banks to restrain lending to the real estate sector. The combination of an aggressive monetary policy and credit tightening sparked off a rapid fall in equity and real estate prices. Between their peak in 1989 to the end of 1995, the nominal value of Japanese corporate equity fell by 386tn yen, equivalent to 88% of GDP in 1990. The value of real estate fell by 625tn yen, 142% of GDP in 1990.

Asset deflation deprived RE sector of its collateral role

Policy makers initially welcomed the fall in real estate prices. However, the price falls had serious repercussions, and ultimately crippled Japan's financial system. Japanese banks relied heavily on real estate as the principal collateral for their loans, in particular loans to SMEs. Japanese companies, for their part, tended to hold sizeable real estate assets on their balance sheet to meet bank demands for collateral. At the end of 1990, real estate assets accounted for 33.2% of the total assets of Japanese non-financial corporations. As prices rose during the bubble,

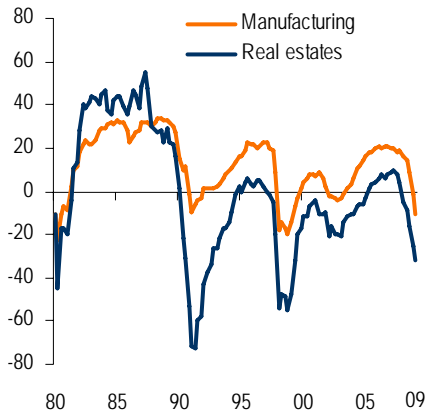
Table 1: CPI and its components for 1999-2005

	Change (1999- 2005) (%)	Contribution to total index (ppt)
Total	-3.2	(-3.19)
Total exl. fresh food (Core)	-2.7	(-2.53)
Total exl. food & energy (Core-core)	-3.5	(-2.38)
(Subgroup index)		
Food	-4.0	(-1.05)
Housing	-0.2	(-0.03)
Fuel, light & water charges	-0.1	(-0.01)
Furniture & household utensils	-18.4	(-0.75)
Household durables	-37.0	(-0.63)
Clothes & footwear	-6.8	(-0.33)
Medical services	1.0	(0.04)
Transportation & communication	-1.1	(-0.15)
Education	6.8	(0.23)
Leisure & recreation	-10.1	(-1.20)
Recreation durables	-60.0	(-1.72)
Miscellaneous	2.4	(0.13)

Source: Statistics Bureau

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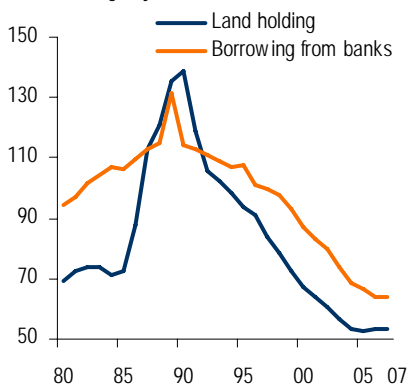
Chart 7: Lending standards of financial institutions by industry



Source: BoJ

Chart 8: Land holding and borrowing from banks by private non-financial corporate sector

(Outstanding at year-end, % of GDP)



Source: BoJ

companies took on new debt, securing it against the rising value of their collateral. By the end of 1990, Japanese non-financial companies had debt outstanding of 623tn yen, 31.5% of the balance sheet. As the value of real estate fell, bank loans became under-collateralized and companies were unable to raise new debt. Banks became undercapitalized as NPLs mounted throughout the 1990s. The credit crunch cycle, stemming from the loss of creditworthiness of the borrowers and the inability of undercapitalised banks to lend is often known as the negative financial accelerator.

The lower the profitability, the higher the credit

Judging from lending attitude surveys, the impact of the credit crunch only really hit with any severity in 1998 with the failure of large banks and security brokers, which led to financial panic in Japan. However, there were symptoms of malfunctioning in the banking sector already in the early 1990s. Academic studies show that Japanese banks tended to increase their lending to industries where profitability was low. In an effort to cover up NPLs, banks were providing new lending to companies with negative cash flows. Another study showed a positive correlation between indebtedness and new borrowing. Banks were extending new loans to already indebted companies. Between 1991 and 1999, the share of loans extended to real estate and construction increased from 17.1% to 19.2%.

Credit crunch reached its peak in 1998

In 1998, the credit crunch was so severe that Japanese banks were charged a “Japan premium” on their international borrowings and the MoF had to deposit its forex reserve with banks that were unable to borrow dollars abroad. Bank lending fell by 5.4% between in 1999. The financial crisis was eased by the MoF injecting capital into the banking system, but it was not until 2004 that Japanese banks were considered to be free of their legacy NPLs.

Falling productivity led to large output gap and deflation

The malfunctioning of the financial sector and declining overall productivity led to a drop in Japan’s long-term growth expectations, also possibly attributable in part to the falling birth rate and decline in the working population from 1995. These lower growth expectations led to a fall in investment demand in the corporate and household sectors alike. This feedback mechanism would explain an empirical paradox whereby a fall in “current” productivity leads to a wider negative output gap. A widening output gap leads to deflation, both in flow prices and asset prices; this further fuels the negative financial accelerator.

2. Lessons from Japan’s credit crunch

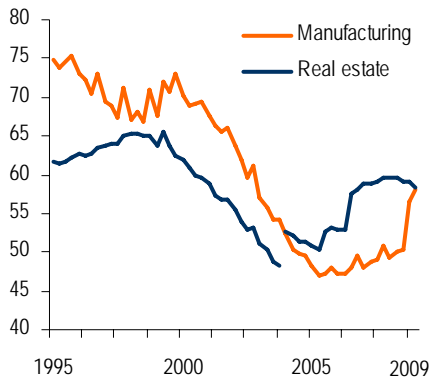
Credit crunch began in earnest in 1998

Looking at the financial institutions lending attitude diffusion index in the BoJ Tankan survey, we find that lending standards were tightened primarily in respect of the real estate sector, but that it remained easy for industries such as manufacturing to obtain funding (Chart 7).

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Chart 9: Bank lending to manufacturing and real estate sector

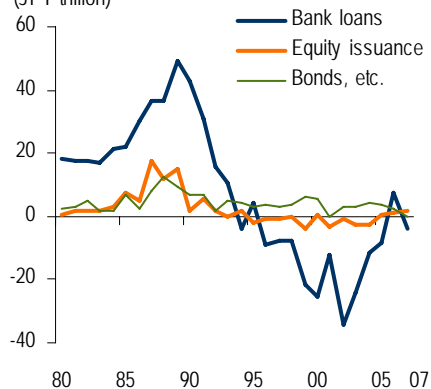
(Outstanding at the end of quarter, JPY trillion)



Note: There is a discontinuity for the lending to real estate sector at the beginning of 2004 due to changes in definition.
Source: BoJ

Chart 10: Fund raising by private non-financial corporate

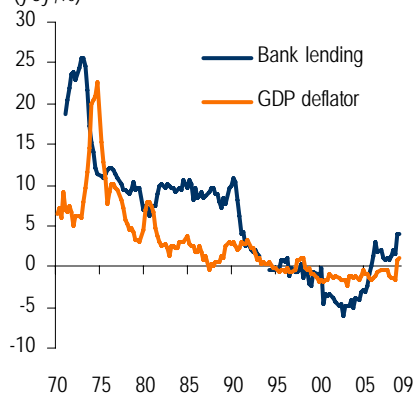
(JPY trillion)



Source: BoJ

Chart 11: Bank lending and GDP deflator

(yoy, %)



Source: BoJ

However, when the real estate price correction (principally land) gathered pace as a result of the credit squeeze, bank loans – mostly backed by real estate collateral – began to turn bad. From the latter half of the 1990s the banks became more restrictive in their lending policies to the overall corporate sector (same chart). From 1997-98, the decline in real estate prices and the curbing of bank lending had clearly strengthened. Lending to the real estate sector, which had been on a slight uptrend from the early 1990s, declined steeply from 1998; thereafter, with a one to two-year lag, outstanding loans to the manufacturing industry also declined noticeably (Chart 9).

Since Japanese banks were key players in the equity market, the deterioration of bank balance sheets became a factor undermining the supply-demand balance in the equity market. This overlapped with a setback in the corporate bond market; the scale of direct funding available from the capital markets – equities and bonds – remained limited, and it became impossible to offset a contraction of credit to the corporate sector even with quantitative easing by the BoJ (Chart 10).

If we look for verification of this, soon after the sudden drop in bank lending began, growth in the GDP deflator turned negative, suggesting that the sudden credit squeeze was the cause of deflation, or at the very least the trigger for deflation.

Lessons learned

Looking at the US/European situation today, the ability of financial institutions to extend new credit will likely remain constrained by the time it takes for the damage to balance sheets to be repaired. Based upon Japan's experience, the extent to which the functioning markets that substitute for financial institutions (the equity and bond markets) can recover as a result of government help (such as the US toxic asset purchasing programmes) will probably determine the success of quantitative easing in these countries.

3. Economic sector & financial market response Households or corporations?

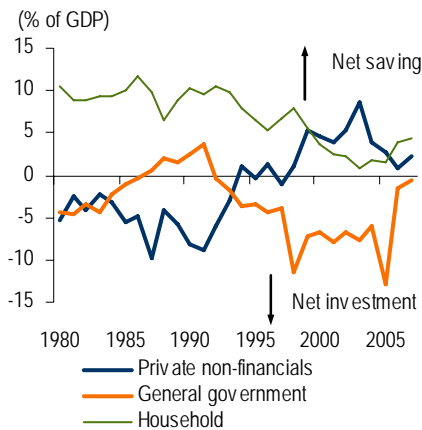
Here we consider the savings-investment balances of the household, corporate and government sectors. In Japan, the corporate sector, which had taken on excess debt in the 1980s and had an investment surplus (a savings shortfall), was forced to reduce debt from the latter half of the 1990s. It shifted, by a major curtailment of investment, into savings-surplus mode. Meanwhile, it is clear that the downward cyclical pressure created by the reduction of corporate investment was absorbed by a compression of household savings and a significant expansion of the government's fiscal deficit. Today, the US and UK household sectors have accumulated excessive debt, and just how far they continue to curb consumption will be (unlike Japan) a key focus.

Financial market response

Table 2 shows Japanese financial market performance during Japan's period of deflation, from the latter half of 1998 to 2005 (starting in June 1998, just prior to when core CPI inflation turned negative). We show market changes through to the end of 2004 (one year prior to the end of deflation) compared with changes through to the end of 2005 (end of deflation). While a close analysis of how financial markets react during a period of deflation is beyond the scope of this article, an account of the facts follows below.

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Chart 12: IS balance



Source: BoJ

Looking at the period as a whole, the equity market was essentially at a standstill. However, the peaks and bottoms throughout reveal considerable volatility. At the end of 2004, one year before the ending of Japan's period of deflation, equity prices were below their starting point prior to the onset of deflation, but rose in 2005 and were above their starting point by the time deflation had ended.

As to long-term interest rates, the 10-year JGB yield dropped below 1% immediately after Japan entered a period of deflation; thereafter, yields were quite volatile, spiking temporarily above 2% on concerns about the widening fiscal deficit and the downgrade of Japan's sovereign debt rating. However, during 1998-2005, yields bounced within a range at low levels; they were caught in a tug-of-war between the downward push of deflation-led nominal GDP growth below 1% and the upward push of the expanding fiscal deficit.

A sector breakdown of bond purchases since 1998 shows that the bulk of JGBs were bought by financial institutions, including the central bank. The increase in bank deposit holdings by households, and the BoJ's purchases of JGBs under its quantitative easing programme, absorbed the large-scale issuance of JGBs. Judging from the above, a continued increase in global interest rates may depend on the ability of the US and European economies to avert Japanese-style deflation and low nominal growth.

Table 2: Financial markets during deflation

	Jun-98	Dec-04	(Change from Jun-98) (%)	Dec-05	(change from Jun-98) (%)	Lowest (Date)	Highest (Date)
TOPIX	1230.38	1149.63	(-6.6)	1649.76	(34.1)	1757.95 (Feb-00)	770.46 (Apr-03)
JPY/\$	138.77	102.63	(-26.0)	117.75	(-15.1)	101.25 (Nov-99)	147.66 (Aug-98)
Nominal ERR (*)	265.7	336.9	(26.8)	299.3	(12.6)	356.3 (Dec-99)	258.5 (Aug-98)
Real ERR	113.2	119.9	(5.9)	103.1	(-8.9)	148.1 (Dec-99)	110.1 (Aug-98)
10 year JGB yield (**)	1.615	1.435	—	1.470		0.530 (May-03)	2.100 (Jan-99)

Note: Stock price index and JGB yield are levels at the end of the month. (*) Effective exchange rate index by BoJ. Mar-73=100, (**) Based on monthly data by BoJ

Source: TSE, BoJ

Table 3: Who bought JGBs? (JPY trillion)

FY	Net fund raising through JGB issuance	Breakdown of buyers				Overseas
		Financial Institutions	Central bank	General government	Households	
97	16.33	17.22	1.47	0.81	0.21	-1.47
98	40.32	31.28	5.43	1.35	-0.59	7.16
99	36.21	39.79	4.34	0.66	-0.40	-6.47
00	35.54	28.50	3.15	-0.38	3.11	7.09
01	68.54	56.21	22.07	15.34	2.37	-5.26
02	60.27	45.55	7.74	10.01	0.11	3.96
03	52.10	37.11	6.17	11.83	2.43	1.65
04	69.95	41.86	5.76	11.00	6.93	7.60
05	44.17	19.01	-3.77	10.82	6.75	4.60

(Note: JGBs includes central government bonds and FILP bonds.)

Source: BoJ

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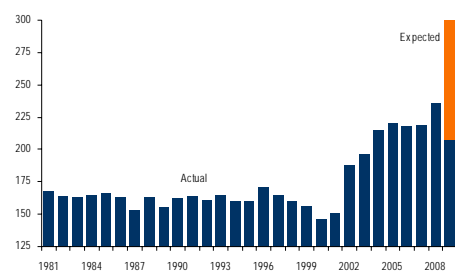
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Weekly economic update

US: Limited government

Recent market movements suggest that the Federal Reserve and the Treasury Department are nearing their limits on their ability to further influence the evolution of the economy.

Chart 13: A record number of auctions



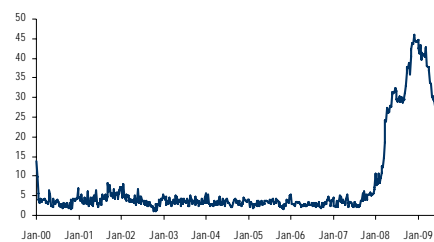
Source: US Treasury, Banc of America Securities-Merrill Lynch

Flow of debt, not stock, the issue for the US Treasury

The ability of the Treasury to finance another stimulus package of any significant size without causing a counterproductive increase in yields is limited. We believe long-term solvency issues for the US government are overstated, especially if compared with countries where demographic trends are more negative. As of the end of March, the net debt to GDP ratio is 47%. By the end of fiscal year 2010, we see the net debt to GDP ratio at 62.3%. Even this higher figure is a long way from any level thought needed to trigger a debt downgrade.

The key issue for the Treasury is the sheer volume of Treasury issuance and the number of auctions that will be required to fund the deficit and roll over existing debt this year and next. As of publication, the Treasury seems set to conduct 300 auctions this fiscal year, an average of 1.2 auctions per day and almost 37% more auctions than in fiscal year 2007 (Chart 13). In short, even absent the lacklustre response to some Treasury auctions we have witnessed, there is limited room in the year to add more auctions.

Chart 14: % of balance sheet linked to FF falling



Source: Federal Reserve, Banc of America Securities-Merrill Lynch

Stock of balance sheet, not flow, the issue for the Fed

Like the Treasury, the Federal Reserve is also wrestling with policy limits. Additions to the previously announced Treasury and mortgage-backed security buying programs could result in a weaker dollar, higher inflation expectations, or both. As such, Chairman Bernanke has shifted his tone and, in his recent speech, focused on the Fed's willingness to remove liquidity while also stressing fiscal responsibility. We continue to believe that the Fed may face difficulties in removing liquidity in a timely manner once conditions improve. Indeed, if the Fed's balance sheet consisted only of its announced buying programs, its balance sheet would still be 140% larger than it was prior to the collapse of Bear Stearns. This may be one reason that Bernanke felt the need to note that the "exit strategy is...to begin to raise interest rates." However, this option may prove less effective than the Fed assumes (Chart 14). With the market focused on the Fed's exit strategy, attempts by the Fed to further expand its balance sheet and drive down yields is likely to be met with concern. This reduces the Fed's available options to "open mouth operations."

Policy parameters

The net result of these emerging limitations is that we should not expect any substantial additions to existing policies as they may prove counterproductive. The visible constraints on future policy actions are the behaviour of the dollar, inflation expectations and Treasury yields. This also suggests that, with regard to Fed policy, timing the eventual first rate hike – which we do not expect prior to 2011 – may have more to do with lowering long-term yields by crimping inflation expectations than with movements in the actual rate of inflation. As Kansas City Fed President Hoening warned yesterday "markets won't be fooled by artificially low rates for long...a period of high deficits and accommodative monetary policy is an invitation to increased inflationary pressure. I suspect we are experiencing the first signs of...concerns in the rising rates and increased volatility in longer-term Treasury markets."

Lori Helwing +1 646 855 9317

The week ahead

Good news/bad news

The week ahead includes a fair amount of economic data, the highlights being May retail sales, April business inventories and the latest instalment of the Federal Reserve's Beige book. On Thursday, the Fed will also release Q2 Flow of Funds figures which should confirm an ongoing destruction of household wealth, given poor equity market performance and ever-lower home prices. Several Fed official speakers are on tap, though the calendar begins to wind down ahead of the upcoming FOMC meeting on 23-24 June. At the end of the week, Treasury Secretary Geithner will head to Italy to join the G-8 group of finance ministers who are likely to discuss the government budget and management of future deficits.

Claims could print a 5-handle but set to pick up again

Initial unemployment claims are likely to fall to 580k on 1 June – the first break below 600K since mid-January. Investors will welcome this news with open arms but we caution that more volatile seasonal factors and accelerating layoffs in the auto industry are set to boost claims well above 600k a week later. The balance of June is likely to include ongoing prints in the mid-600ks, before a more consistent moderation in claims unfolds, as accelerated cuts in the auto industry are offset by fewer layoffs elsewhere. Separately, the number of ongoing benefit claimants is expected to rise by 24k to 6.76 million after a surprise drop in last week's figures, and the first such decline since the first week in January. After first breaking above 4.7 million to new record highs 19 weeks ago, we are still a far cry from any meaningful "improvement" in the pool of those unemployed.

Retail sales likely positive in May but "control" flat

Retailers are expected to report a sluggish gain of 0.4% mom in May boosted by increases in both gasoline sales (on higher prices) and auto sales. Excluding these two categories, sales should be down 0.1% mom for the third straight monthly decline. We anticipate broad-based declines in sales of discretionary items, while basic goods categories (food and healthcare) continue to benefit. Such themes were echoed in recent chain store sales figures where declines were reported in clothing, home furnishing and luxury goods retailers. Retail "control" (components from this report that feed directly into consumer spending) sales are forecast to be flat implying that real consumption growth is still on track to drop 1.2% qoq in Q2 after a 1.6% gain in Q1.

Beige Book to show ongoing recession with rays of light

The Fed's latest Beige Book findings (due on Wednesday), covering anecdotal evidence on the state of the economy, is expected to show ongoing malaise in the manufacturing, housing, consumer and investment sectors. The results will cover mid-April to late May in preparation for the upcoming FOMC meeting. While the nation is still mired in recession, most will be gleaming the text for "green shoots" references, which we anticipate will be the hallmark of this report.

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Sheryl King +1 646 855 7111
Dan Sukmanowsky +1 416 369 4095

Weekly economic update

Canada: BoC takes aim at dollar

No QE/CE yet but probability remains high

The Bank of Canada made a deliberate attempt to slow the rise in the Canadian dollar in the statement accompanying its decision to leave rates at the effective lower bound of 0.25%. This comment implies that the bank may opt for quantitative easing (QE), if there is no further improvement in financial conditions sufficient to offset the punishing effects of the dollar's rise.

'Fully offset'

The BoC's concerns that the markets are getting ahead of themselves in pricing in a global recovery rang loud and clear in the statement. The Canadian dollar's 'unprecedented rapid rise' could 'fully offset' the recent improvement in other financial conditions, according to BoC analysis. More broadly, the bank's outlook for the domestic and global economy was an unchanged assessment that the recovery would 'be more muted than usual'.

Restructuring to increase slack in economy

One change to the BoC's outlook was the mention of restructuring in a number of sectors. While the bank noted this factor in the April Monetary Policy Report, this week's comment made the more overt point that restructuring would be negative for both production and supply. The restructuring could, as a result, lead to a widening in the output gap despite the fact that shuttered capacity could reduce potential GDP growth. (A rule of thumb is that a restructuring is a two-thirds hit to actual GDP and a one-third hit to potential GDP, so the net result is a widening in the output gap.)

Conditional commitment unchanged

Despite the policies put in place, and balanced risks to their growth profile, the bank judges that the risks to inflation remain slightly to the downside. As such, it made no change to its conditional commitment to leave rates at the effective lower bound until mid-2010. We concur that the risks are skewed to the downside, which is another reason we believe that the possibility of the bank implementing further quantitative or credit easing is higher than the market is currently discounting.

The week ahead

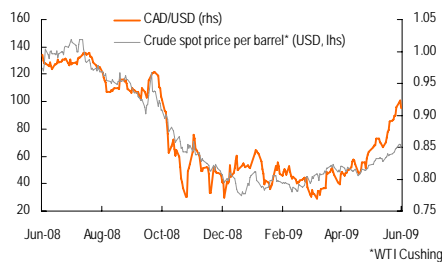
Merchandise trade surplus expected, but not from 'good' sources

The data flow is light next week with a few material releases. Markets will likely be focused on Wednesday's trade numbers, though housing starts could garner attention if they come in as we expect, ie, considerably better than the market forecasts. The capacity utilization rate for Q1 should reach a new record low in line with the 5.4% annualized drop in GDP growth. Plus, we will have the first post-FAD comments from BoC Governor Carney on Thursday.

Housing starts remain at low levels

In our view, housing starts will eek out a 5.0% mom gain in May to 123.5k units, still well below the household formation rate of 175k. This would slow the pace of decline to 42.3% yoy from the above 60% drop in Q1, but is only the fifth time that the rate has dipped below -40 in roughly the last 11 years. The inventory of new homes is at its highest level since 1995, and that glut of supply needs to be worked off before we see any improvement in starts. The recent pick-up in sales should help absorb the glut of supply but the recent upturn in rates threatens to choke off this boon, not to mention those tight credit conditions.

Chart 15: CAD taking flight



Source: Banc of America Securities - Merrill Lynch / Haver Analytics

Trade surplus driven by falling imports, again

We think it is likely that Canada will post a merchandise trade surplus of C\$1.1bn in April, the third consecutive surplus since recording its first deficit in 34 years in December 2008. Unfortunately, we do not see that surplus coming from a 'good source' (ie, rising exports or improving terms of trade). We expect the steep appreciation of the CAD through April to drive a 1.9% mom plunge in import prices, versus a meek 0.5% bounce in export prices led by commodity gains. On a volumes basis, we forecast both real exports and imports will decline by 0.5% mom and 2.5% respectively, signalling ongoing weakness in global trade and domestic demand. Canadian exporters are in dire need of a currency depreciation in order to re-establish the competitiveness of exports.

Capacity utilization to hit all-time low in Q1

We expect the capacity utilization rate to contract by a record 5.3% in Q1, dragging the level down to 69.5, the lowest since the series began in 1987. In Q1, Canada recorded its worst quarterly contraction in 19 years led by considerable declines in consumer spending and capital expenditure. This in turn drove a 15.0% annualized decline in goods-producing industries, with staggering drops in construction and manufacturing, which fell 12.8% and 22.0%, respectively. We expect further declines in CAPU as the expected weak US recovery prevents Canadian counterparts from achieving above-trend growth.

New home prices will likely continue to fall

We expect a drop of 0.6% mom in April in the New Housing Price Index after the rate of decline slowed from -0.7% mom in February to -0.5% in March on seasonal factors, binging the yoy rate down to -2.4% (the lowest in 13 years). The excess inventory of new homes will continue to exert downward pressure on prices. Moreover, Canadian home values exceeded their fundamentals, similarly to what was observed in the US, thus we should see a further 7-10% HPI depreciation on this side of the border.

Nothing new to come out of BoC speech

Lastly, Governor Carney's speech on Thursday will likely give an overview of the current state of the economy, as did the BoC this week, but pack no punches. Recent GDP and inflation reports have not been so out of line with BoC forecasts as to suggest any material changes. We may get more elaborate comments on the recent rise in bond yields and the sharp appreciation of the CAD in an attempt to quell markets. A press conference will follow the Governor's remarks.

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Holger Schmieding +44 20 7996 2587

Weekly economic update

Eurozone: ECB done and dusted

The ECB does not expect to ease policy further. Although the bank was careful to leave the door open for lower rates or for less timid credit easing last Thursday, the ECB made it plain that it considers its current policy stance as “appropriate”. For the ECB, this is the usual codeword to signal that it does not want to change interest rates in the near future. More importantly, the ECB emphasised repeatedly that this assessment takes into account the decisions which the Council took in May, namely the 25bp cut in the refi rate to a historic low of 1%, and the additional “enhanced credit support measures”, that is the introduction of 12-month refinancing auctions and the €60bn programme to buy covered bonds.

Is the ECB overdoing it again?

Once again, the ECB projections differ from our own calls. This time, however, the ECB seems to have gone from overly optimistic to excessively bearish. The ECB slashed its forecasts for GDP dramatically, taking the mid-point of the staff projections from -2.7% to -4.6% for 2009 and from 0.0% to -0.3% for 2010. For both years, the ECB is now well below our own calls of -4.2% for this year and +1.2% for next year. The ECB expects GDP to decline further for the remainder of this year, to hit bottom at some time in H1 2010 and to start expanding again by mid-2010. We look for the economy to rebound at least modestly from Q3 2009 onwards already.

ECB swinging from excessive optimism to excessive pessimism?

ECB has braced itself for more bad news than we are likely to get

Unsurprisingly, the ECB did not fully close the door to further policy easing. Asked whether rates could go lower, Trichet repeated what he had said in May, namely that “we did not decide today that the level of our policy rates was the lowest that can never be crossed”. Also, he explained that the ECB has not decided to not go beyond its current €60bn programme to buy covered bonds by either buying more of them or by extending it to other asset classes. But the ECB has braced itself for a lot of bad news. Starting from such a subdued outlook for the real economy, the actual data are very unlikely to disappoint the ECB. Hence, the bank should have no reason to correct its assessment that rates are appropriate and ease policy further.

No major change to the inflation outlook

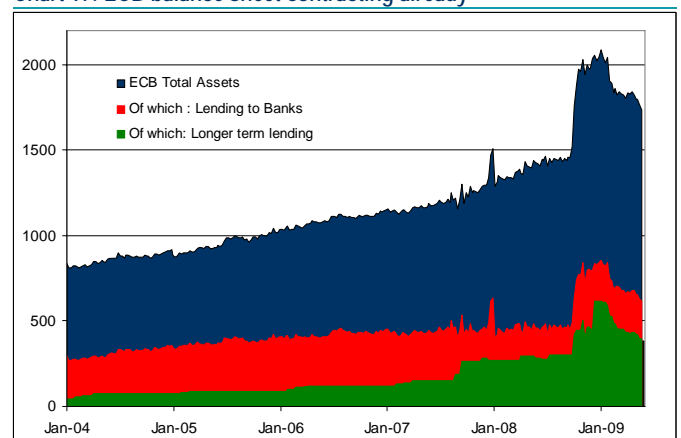
The ECB did not change its inflation outlook much. In the staff projections, the ECB shaved the mid-point of its 2009 call from 0.4% to 0.3% but left its 2010 call

Chart 16: Hitting bottom



Real ECB rate deflated by core CPI. Source: ECB, Banc of America Securities-Merrill Lynch projections

Chart 17: ECB balance sheet contracting already



In € billions. Source: ECB

unchanged at 1.0%. A wider output gap as a result of a deeper and longer recession and the recent rebound in oil prices seem to roughly offset each other in their impact on ECB projections.

Chance of a further ECB rate cut falls to no more than 15%

So far, we had seen a 30% probability that the ECB go reduce rates below 1%. We now downgrade this to 15%. We maintain our view that the ECB will start to reverse its sizeable monetary stimulus at some time in H2 2010, probably with a first rate hike in September 2010. Well before that, the ECB will probably be able to largely reverse the post-Lehman expansion of its balance sheet. With less impaired money markets, banks will need fewer funds from the ECB. This process has already started in the last two months (Chart 17).

Just a little side show

No major surprise on covered bonds

Upon providing more details about its programme to buy €60 billion in covered bonds, the ECB did not spring a major surprise. All in all, the announcement that the ECB may take a full year, from July 2009 to June 2010, to actually buy that amount shows once again that the ECB purchases of covered bonds are not changing the ECB's monetary policy stance in any meaningful way.

Purchasing managers see light at the end of the tunnel

Hard data down, soft data up

The data sprang no major surprise in the past week. As in April, the flash estimates for the purchasing managers indices were revised up slightly, from 40.5 to 40.7 for manufacturing and from 44.7 to 44.8 for services. The upward revision suggests that those purchasing managers reporting late were slightly less optimistic than those who had sent in their assessment in time for the flash estimate. This points to further gains ahead.

A worse finish to 2008 lowers our forecast for 2009 GDP

Upon releasing its details for Q1 GDP, Eurostat revised down the data for the last quarter of 2008 from -1.6% to -1.8% qoq. That lower starting level takes our call for the 2009 average from -4.0% to -4.2%. The demand details for early 2009 revealed a 0.5% qoq drop in private consumption, a 4.2% qoq plunge in investment and an 8.1% fall in exports. As imports fell by less (-7.1% qoq), net exports subtracted 0.4% from GDP. The additional 0.9% drag from an inventory correction could be seen as a good sign. The leaner inventories are, the better then chance that some rebuilding of inventories will add to GDP later. But as the inventory data are very unreliable, we would not base any strong argument on them.

Political noise

The week ahead

The political fall-out from the EU parliamentary elections may dominate the news early this week. Voters often treat the European elections as an opportunity to castigate their incumbent national governments.

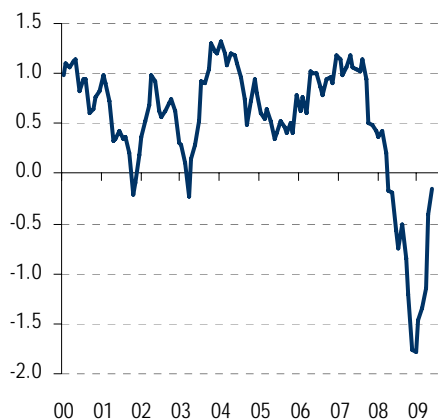
Orders and output: close to the bottom, but not quite there yet

As to economic data, attention may focus on German factory orders and Eurozone industrial output data. After a surprise 3.3% monthly rebound in **German factory orders** in March, we look for a sizeable correction in April. The record 58% yoy decline in German machinery orders reported by the VDMA industry association for April does not bode well for the manufacturing data as a whole. In a similar vein, **industrial output in the Eurozone** probably declined further by 0.6% mom in April. But in line with the recent rebound in leading indicators, we expect the hard backward-looking data such as output and orders to trough in the next few months before starting to turn up modestly from Q3 onwards.

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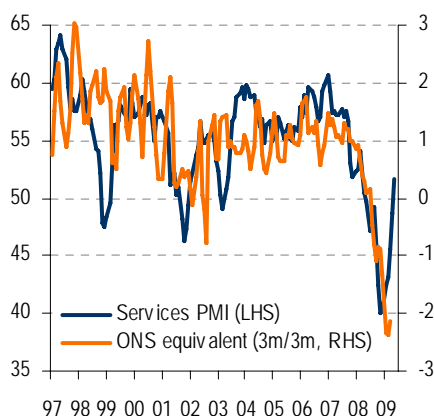
Nick Bate +44 20 7995 4262

Chart 18: Survey-based activity indicator*



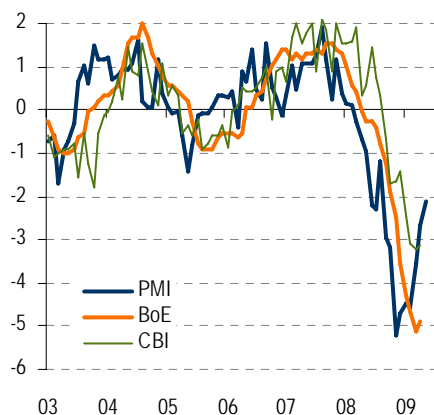
Source: BAS-ML. *%, 3m rate.

Chart 19: PMI stronger than official data



Source: Bloomberg, ONS, BAS-ML. ONS equivalent = Index of Services excluding retail and government sectors.

Chart 20: Manufacturing surveys*



Source: Bloomberg, Bank of England, CBI, BAS-ML. *Standard deviations from 1997-2007 average.

Weekly economic update

UK: PMIs rebounding strongly

As was widely expected, the MPC left Bank Rate on hold at 0.50% at their June meeting, and voted to continue with their £125bn Quantitative Easing (QE) programme. That programme will take them until the end of July to complete, and so we did not expect them to pre-commit themselves beyond that time at the June meeting. As usual when policy is left unchanged, they made no statement on the broader economy.

PMIs continue to rebound strongly in May

The manufacturing, construction and services PMIs all rose strongly again in May, indeed with the latter surprising notably on the upside and signalling outright expansion in the service sector for the first time since spring 2008. Moreover, combining the PMIs with other survey evidence could suggest that the economy contracted only marginally in May – a strong rebound after the precipitous falls in Q1 (Chart 18).

Nevertheless, although perhaps in part reflecting their timeliness, and while they are by no means inconsistent, the PMIs are a little more buoyant than other evidence on the UK economy at present. Latest comparable official data shows output in the service sector contracting at a 3m/3m rate of around 2% in March (Chart 19). While the recent month-on-month data was consistent with that rate of contraction narrowing to around 1%, further notable strengthening would still be required to keep pace with the rises in the PMI. In addition, the manufacturing PMI is also a little more buoyant than other survey evidence at present (Chart 20).

With some overhang from the pronounced weakness in Q1 and less buoyancy in other indicators, at present we expect GDP growth in Q2 to be somewhat more downbeat than suggested by the PMIs. But nonetheless, we have revised up our estimate for GDP growth in Q2 from -0.7% to -0.5%, and indeed if incoming new data over the next few weeks conform with the PMIs, there could be upside risks to that. More broadly, indicators are increasingly consistent with the contraction in Q2 being much less severe than in 09Q1 and 08Q4. Although at present there is little information with which to assess the durability or the strength of the recovery thereafter (for example to the extent that the rebound in Q2 reflects a slower pace of de-stocking, that might just change the timing of growth over the next few quarters rather than the overall magnitude), exiting the recession and moving past the most severe downside risks to the economy is a positive first step, and reduces the chances of the MPC expanding their QE programme beyond the current £125bn.

The week ahead

Surveys suggest manufacturing recession not over yet

- Although having picked up notably in recent months, the manufacturing PMI is still consistent with contracting output. And with the CBI and Bank of England's agents surveys less buoyant, we expect another fall in official manufacturing output data in April.

The RICS survey has generally strengthened in recent months - with new buyer enquiries picking up very sharply - but is still consistent with notable weakness in the housing market. We expect further modest improvements in May.

Masayuki Kichikawa +81 3 6225 8214
Takuji Okubo +81 3 6225 7636

Weekly economic update

Japan: Green shoots in auto sector and labour market

Japanese consumers are starting to respond to fiscal stimuli. New car sales are still down yoy, but the pace of decline has retreated to 19% yoy in May from 30% yoy in the first few months of the year. Our auto analysts have revised up their new car sales forecast in fiscal year 2009 to a 6% yoy increase from -4% yoy. We expect private consumption to stabilize towards the summer on the back of the fiscal stimulus and improved consumer sentiment.

The labour market in Japan is still in the doldrums, but as in the US, there are some green shoots. Overtime working hours increased in April for the first time in six months. The speed of decline in employment also slowed markedly in April.

BoJ officials highlight fiscal sustainability

Two BoJ officials spoke during the week, including Governor Masaaki Shirakawa. When asked to comment on rising long-term rates, both commented that rising yields may be a reflection of a better economic outlook, but that a rise in yields due to concerns about fiscal sustainability would be harmful, putting pressure on policy makers to clarify the longer-term fiscal outlook beyond the current emergency fiscal expansion.

The week ahead

Important releases for the week of 8-12 June are: May bankruptcy data (8 June), April machinery orders (10th), revised Q1 GDP estimate (11th) and May consumer confidence (12th).

Corporate bankruptcy peaking out

The yoy increase in bankruptcy cases seems to be peaking. Japanese banks provided liquidity to those companies shunned by the credit markets and the government has in many cases extended loans to companies suffering from the credit crunch. Liquidity holding of Japanese corporations started to grow yoy in December 2008. We think the worst period for corporates is over.

Capital expenditure - any sign of life?

Machinery orders, a leading indicator of capital expenditure, are likely to show modest growth in April. With industrial production coming off the bottom, and the easing in corporate financing, we expect managers to start to unfreeze capex plans.

A downward revision likely in Q1, but contents better

We expect the Q1 GDP estimate to be revised down as a result of the steeper-than-anticipated inventory reduction. However, private and public capital expenditure was better than initially estimated.

Consumers still in the doldrums, but with less uncertainty

We expect consumer sentiment to remain on the upward trend seen since January. Incomes remain tough, but there is less uncertainty on employment prospects and the fall in consumer prices is boosting consumer purchasing power.

05 June 2009

John Rothfield +1 415 622 9459

Weekly economic update

Australia/New Zealand

Australia beats its peers, but there remain question marks

Table 4: Australian GDP positive

	Q208	Q308	Q408	Q109	Yr to Q1
Household	-0.1	0.1	0.3	0.6	0.8
Government	1.2	1.4	-0.4	-0.2	1.9
Residential I	1.5	1.1	-2.6	-5.6	-5.7
Non-residential I	0.2	5.2	1.7	-4.3	2.6
Plant & Equipment	8.2	0.3	-0.4	-9.6	-2.3
Domestic demand	0.9	0.6	0.0	-1.0	0.5
Inventory	-0.5	-0.1	-1.4	0.0	-1.9
Net exports	-0.4	-0.3	1.7	2.2	3.2
Stat discrepancy	0.3	0.0	-0.9	-0.7	-1.4
GDP	0.3	0.2	-0.6	0.4	0.4
(Non farm GDP)	0.5	-0.1	-0.8	0.5	0.0
(Real NNDI)	3.2	2.7	-1.7	-1.7	2.4

Source: Australian Bureau of Statistics, BAS-ML

Australian GDP rose 0.4% qoq in Q1 2009, the rather volatile result of the averaging of the expenditure (+1.1%), income (+0.9%) and output (-0.9%) measures. Net national disposable income (NNDI) actually fell for the second quarter in succession. That got lost in the headlines. NNDI is the impact on the economy from terms of trade and income impulses from offshore. This can be significant for the economy after the impact of the sizable fiscal stimulus goes away. Also of interest, the household savings rate, which had increased last quarter, was revised down and the Q1 measure of the ratio dropped back from 6.9% to 1.8%. This indicates that household balance sheet adjustment may not be as advanced as we had thought.

Table 5: But warnings in the trade figures

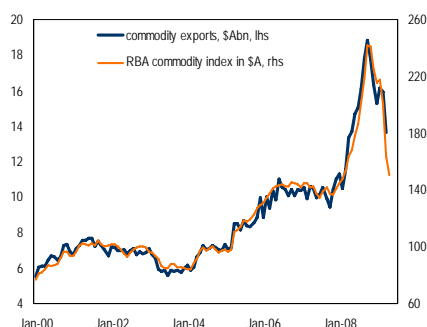
% change in:	Jan'09	Feb'09	Mar'09	Apr'09	Yr to Apr
Exports:	-4.8	3.9	-0.4	-11.3	-0.8
Commodities	-6.4	5.6	-1.6	-14.2	2.2
other goods	-5.7	1.9	3.2	-13.8	-18.5
Services	1.4	0.1	0.5	0.7	6.7
Imports:	-6.6	0.0	-3.2	-1.7	-2.0
Consumption	-4.8	-13.3	14.8	-0.7	3.1
Capital	-15.2	7.9	-11.5	-1.1	10.0
Intermediate	-5.2	3.6	-9.5	-3.7	-11.5
Services	-1.9	0.4	0.5	0.4	1.4
Balance (\$bn)	0.7	1.7	2.3	-0.1	8.8

Source: Australian Bureau of Statistics, BAS-ML

The markets and the official sector have been engaged in a dialogue since the GDP report on the key issue about whether Australia has, through prudent use of monetary and fiscal policy, managed to manoeuvre through a global 'V' without much damage, or is due now to have a lagged period of below zero growth. In a speech on Thursday, Australian central bank Governor Stevens was relatively upbeat, suggesting that the global plunge in output was to pare back inventories and was rebounding in most key Asian countries, "even Japan". The general tone of his speech seemed to imply that the economy might end up doing better than set out in the bank's May monetary statement or the Treasury's federal budget assumptions for the growth path.

While there has been focus on investment in Australia and the partial unwind that is going on in the investment to GDP ratio (which had soared by 10 points of GDP during the resources boom), the key to the outcome lies in the external sector. Stevens' speech included a table showing that, whereas Australian real exports rose by about 2% in the two quarters to March, the rate of decline in real exports in other countries ranged between -37% in Japan to -10% in the UK, with most in the -12 to -24% range. The other issue in Australia is that export prices have started to fall, imparting downside to nominal GDP and national income. In fact, the Treasury has nominal GDP and national income declining outright in the next fiscal year, which has not happened before.

Chart 21: Commodity revenue getting into steepest point of decline



Source: Australian Bureau of Statistics, RBA, BAS-ML

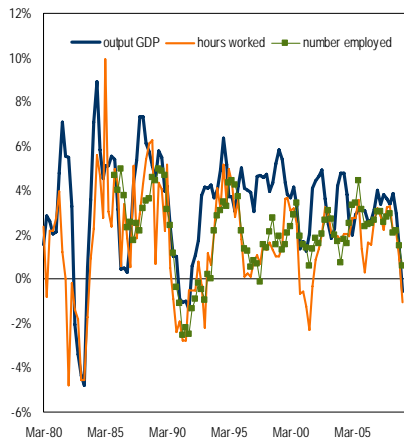
We do not want to overplay the downside risk to Australia. In fact, we think the economy is probably on a higher path than in either RBA or Treasury assumptions; thus we now have only one 25bp RBA cut in our projections (August) with risk of none at all. That said, the story for investors should be that we have not yet reached the point of maximum difficulty for the economy. We were reminded of this the day after the GDP report when Australia's trade balance went from two quarters of record surplus back into small deficit. Based on further commodity price developments, the deficit will widen in the next few months as commodity unit returns take their last big hit.

The week ahead

We had expected the **Australian** data for the first quarter and April to be strong. That was generally the case this past week, especially for retail trade, new home sales and building approvals. The AiG industry surveys were also better, albeit still very low on a level basis. The week ahead brings another slate of important Australian releases, especially May business sentiment, June consumer sentiment and the May jobs report. Consumer sentiment was released late last

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Chart 22: Australian jobs cycle probably more like the 1990-91 recession than mini dips in 1995 and 2001



Source: Australian Bureau of Statistics, BAS-ML

Table 6: NZ forecasts compared

RBNZ March 2009 MPS				
Real GDP	3.1	-0.8	0.2	4.8
U-rate	3.7	5.2	6.8	6.0
CPI	3.4	3.1	1.6	2.2
CA/GDP	-8.1	-8.4	-8.3	-5.8
NZT May 2009 budget				
Real GDP	3.1	-0.9	-1.7	1.8
U-rate	3.7	5.0	7.5	7.5
CPI	3.4	3.0	2.4	1.7
CA/GDP	-8.0	-8.6	-6.9	-5.4

Source: New Zealand Treasury, RBNZ, BAS-ML

month in anticipation of consumer reaction to the federal budget, which was generally negative; thus a reversal in the index from 93 to 89. Consumers did not like aspects of the plan such as raising the old pension age and cuts to certain government programs. Since then the local stock market has jumped again and the government is getting credit for the positive GDP figure, so a sentiment number in the mid-90s would not surprise.

The jobless figure will be of real interest. In this cycle, the unemployment rate troughed at 3.9% in February 2008 and has already risen to 5.4%. In the 1990-91 recession the u-rate rose by over five percentage points bottom to top over three years, starting in Q4 1989, about two quarters before GDP started to decline outright. If similar in this cycle, this would push the u-rate up to about 9% in early 2011. In its budget, the Treasury suggests that, in the absence of government policy measure, the u-rate might have reached 10% in this cycle because the growth of the labour force is faster now than in the past. However, the Treasury also predicts that the fiscal stimulus (and perhaps a much lower real cash target in this cycle than in the 1990-91 recession) will reduce the peak in the u-rate to a projected 8.5% by H1 2011. Further, the RBA noted in its recent monetary statement that a recent shift of full-time workers to temporarily working shorter hours was in past cycles a sign of an imminent rise in the u-rate, especially if falling asset values delay the 'discouraged worker effect' from reducing the labour force participation rate. Thus, both the RBA and the government expect the u-rate to keep rising and will regard last month's surprise 27k gain in jobs and 0.3 point drop in the u-rate as noise in a typically volatile data set. Still, in our view, there is a strong possibility that unemployment will not reach the 8.5% rate assumed by the Treasury and that firms will get by for a longer period with reducing hours and hiring part-timers in case the economy catches a second wind later this year.

In **New Zealand** this week (Thursday, 11 June), RBNZ Governor Bollard will announce the first interest rate decision since the annual budget and issue the next quarterly monetary policy statement. Of issue here is that the government budget was treated favourably by the ratings agencies for being fiscally responsible. The absence of further stimulus means the central bank has more leeway to cut rates further in an economy that still seems 'winded' after six quarters of downturn. Also, the trade weighted exchange rate, at a current level of 60, is now a full 22% above the level assumed by the bank for H2 2009 in its March MPS. The NZ 5yr bond yield is also 65bp above its March average of 4.00%, imparting further negative bias to the economy where mortgage rates are largely set off the long end. We therefore think the RBNZ will implement another 25bp rate cut. There are some tentative green shoots in the economy in the form of house sales and migration, and the business survey index just shot above 50. However, late last year the business sentiment number went above 50 for one month and then plunged the next, so the authorities will not want to take the rebound for granted. The rebound in migration, normally a good sign for future spending, housing demand and investment, is still tepid; there is an uptrend still in place for both arrivals and leavers.

Of further interest in the MPS will be how RBNZ economic projections vary from the NZ Treasury's budget, as shown in Table 6. The well-respected think-tank NZIER seemingly endorsed the Treasury GDP numbers by predicting a contraction of 'only' 1.4% in the March 2010 year, after an expected -2% in the year to March 2009; that works out as similar to the Treasury numbers for -1.7% on average in the FY, although other private forecasters are more bearish.

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TJ Bond +852 2161 7152

Weekly economic update

EM Asia: Hong Kong - dumping ground for global liquidity

Bottom Line: Hong Kong's monetary base doubled after September 2008. Along with China, it is one of two Asian economies that has matched the quantum leap in global monetary policy.

Why is narrow money exploding? We think Hong Kong sits at the confluence of three key trends in global liquidity: (1) loose Fed policy; (2) China's appetite for non-USD foreign assets; and (3) the world's desire for China-linked assets.

Hong Kong is a small, open economy. We expect a sharp upturn in the second half of the year; but global demand will remain a medium to long-term headwind. Still, the liquidity boom has already proved inflationary for asset prices. We expect it to help reflate the economy and eventually inflate goods prices. So we are increasing our 2010 GDP forecast to 3.8% from 2.9%. (No change to 2009.) We are also raising our inflation forecasts to 0.9% for 2009 and 2.0% for 2010.

Old-fashioned reflation

Hong Kong's stock market has outperformed the 4% year-to-date rise in the S&P500. Even more surprisingly, property prices are rising, up 3.1% this year through March, compared with a 6.2% drop in the Case-Shiller index in the US and a 0.2% drop in property prices in China.

This is not a story of relative economic strength. Hong Kong contracted 7.8% year-on-year in the first quarter, compared with a 2.5% contraction in the US and a 6.1% expansion in China. Like the US, Hong Kong's job market is deteriorating: the unemployment rate has increased 120bp this year, to 5.3% in April.

As a small, open economy, Hong Kong is likely to struggle against the medium-term headwind of weak global demand. But if our core global views are right (a near-zero Fed funds rate, a robust Chinese economy through 2010), these liquidity themes could help cushion Hong Kong's growth and asset prices for years to come. Indeed, they may become important for the Asian region as a whole.

Liquidity upturn

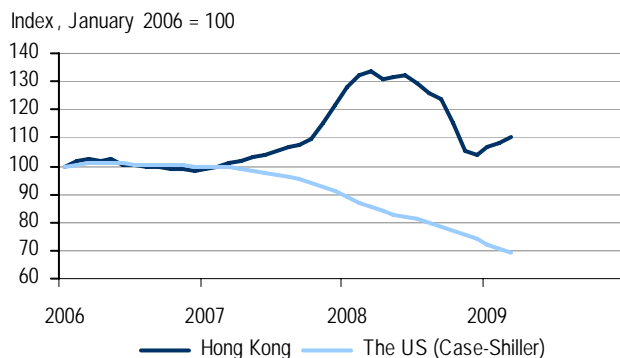
We've always believed that "liquidity" is important to the Asian region and its financial markets (*The great Asian liquidity game*, 14 February 2005). However, there's no widely accepted view of what liquidity is or how it works. Everybody

Table 7: Hong Kong – key forecast changes

	2008	2009E	2010E
Real GDP growth			
Old forecast	2.4	-3.1	2.9
New forecast	2.4	-3.1	3.8
CPI inflation			
Old forecast	4.3	-1.2	1.1
New forecast	4.3	0.9	2.0

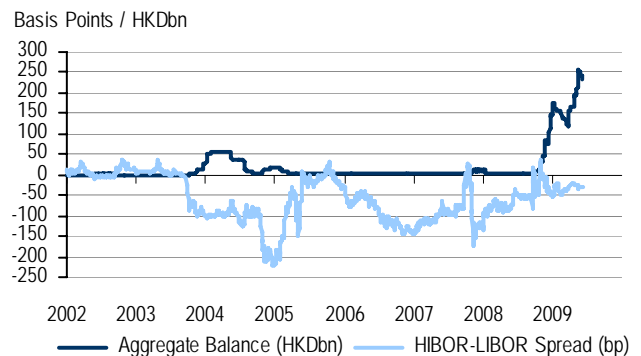
Source: CEIC, Banc of America Securities - Merrill Lynch estimates and projections.

Chart 23: A tale of two property markets



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

Chart 24: Interest rates below US rates, money creation has surged



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

has a different definition. So rather than opening up the grand debate, let's look at a broad range of indicators:

- **Narrow money:** Hong Kong's monetary base increased by 112% after the failure of Lehman Brothers in September 2008, driven by a surge in the aggregate balance (commercial bank deposits held at the central bank). Interestingly, the US monetary base by grew almost the same amount.
- **Broad money:** M2 and M3 have increased at a 12% annualized rate since September 2008. This has fallen short of the rise in narrow money, so Hong Kong's money multiplier has fallen, mirroring trends elsewhere in the world. On the other side of the balance sheet, credit growth has been weak, and the loan-deposit ratio has declined. There is room for an upturn in credit as the economy turns around and risk appetite improves.
- **Balance of payments** data is only available with a lag. But foreign exchange reserves have increased by US\$32bn since September 2008, suggesting some US\$17bn of capital inflows (after adjusting for the estimated current account and outflows of direct investment).
- **Market turnover:** average daily turnover for all securities on the Hong Kong Exchange rose to HKD79bn in May, up from HKD43bn in December 2008. Property transactions volumes have more than tripled from December lows.

Table 8: Hong Kong – growth forecast breakdown

	2008	2009E	2010E
Real GDP growth	2.4	-3.1	3.8
Private consumption	8.7	-2.0	4.2
Fixed investment	2.9	-6.5	4.5
Exports of G&S*	9.3	-9.4	6.6
Imports of G&S*	9.4	-9.7	7.4

*G&S = goods and services. Source: CEIC, Banc of America Securities - Merrill Lynch estimates and projections.

Same monetary policy, different results

Why are monetary growth rates picking up? The basic mechanism is well understood. Because of its peg to the USD, Hong Kong can't run an independent monetary policy of its own. HKD interest rates are tied to US rates. The city thus "imports" US monetary policy: short-term rates have mirrored the sharp decline in the Fed funds rate (aside from a temporary spike in interbank rates during the credit crisis). The Fed's quantitative easing has pushed down bond yields in both the US and Hong Kong.

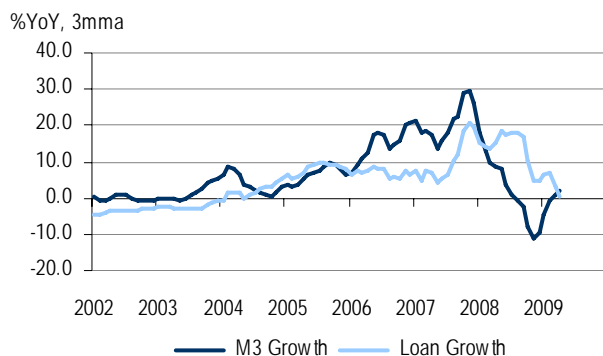
So far so good – straight from the textbook. But there are some real-life twists that turbo-charge Hong Kong's liquidity mechanism in practice.

1. Real rates can diverge

The peg constrains *nominal* interest rates to be the same, but *real* interest rates can diverge.

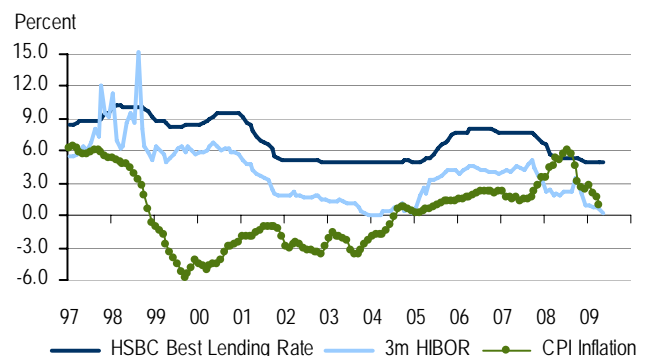
This is a familiar concept to investors in Hong Kong. Will it matter in the near term? For average consumption and investment decisions, probably not much.

Chart 25: Broad money growth is picking up



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

Chart 26: Interest rates and inflation



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

The sharp downturn has left a wide output gap, and broad-based measures of goods price inflation (like CPI) are likely to be subdued. Deposit rates and short-term money market rates are negative in real terms, but lending rates are not.

Of course, the story changes if people think property prices will keep rising. Mortgage rates are low (2.5%) and it is not hard for a property investor to conclude that real rates are negative. John Kim, our property analyst, concludes that [low mortgage rates and increased liquidity](#) are key factors behind the recent upturn in property prices.

2. It's not just prices - volumes matter too

Even if interest rates are constant, the exchange rate peg can allow huge shifts in the money supply, which feed through into the economy.

It works like this: (1) demand for the Hong Kong dollar and HKD assets goes up; (2) to keep the exchange rate from appreciating past the strong side of the band, the Hong Kong Monetary Authority (HKMA) must buy foreign currency and sell HKD, boosting the monetary base; then (3) broad money rises; and finally (4) armed with a bigger balance sheet, banks start to expand credit.

An aside: one of Ben Bernanke's nicest academic papers modeled this "credit transmission channel," and showed how it differed from the traditional "interest rate transmission channel." See [Credit, Money, and Aggregate Demand, American Economic Review, May 1988](#). This credit channel is especially important right now, with short-term interest rates near the zero bound.

Right now, we're at stage 3 of the above process: broad money has picked up; credit growth is the next thing to turn. What provided the initial boost in demand for the HKD? Two key dynamics have come into play, in our view.

- China is doing well. The bulk of Chinese securities available to the rest of the world are listed in Hong Kong.
- Hong Kong is emerging as an important destination for Chinese savings.

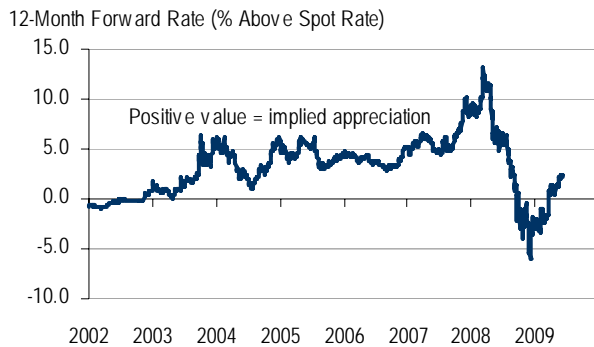
On the last point, official channels (such as China's QDII scheme to allow local institutions to invest in Hong Kong) are not quantitatively that large. Unofficial flows are probably more important right now. For example, BAS-ML's John Kim points out that mainlanders may have purchased up to 50% of recent luxury property launches.

3. Will the peg go?

Our view is no, not any time soon. And right now, it looks like financial markets concur.

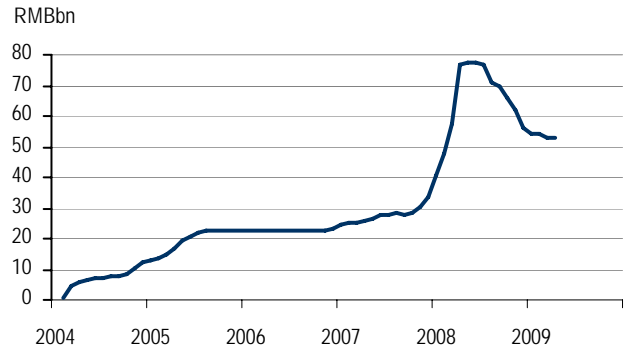
The renminbi is the major driver of expectations for an HKD revaluation, and that market is calm. The spot exchange rate has been stable against the USD, and the non-deliverable forward market is pricing in a mere 2% appreciation over the next 12 months. Renminbi deposits in Hong Kong – the only area outside the mainland where such deposits are available – have declined in recent months.

Chart 27: Subdued expectations for renminbi appreciation



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

Chart 28: Renminbi deposits in Hong Kong



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

So Hong Kong's peg appears credible right now. But it is the nature of pegs to lose credibility from time to time – often, at precisely the most inconvenient moment. If markets were to again question the durability of the peg – because the USD looks unstable, or because Chinese exports stabilize and the renminbi starts to appreciate again – domestic interest rates would fall, and inflows would pick up. That would add even more fuel to Hong Kong's liquidity dynamic.

Back to the economy

In the short term, we think Hong Kong will benefit from the snapback in global trade in H2, as the G3 economies return to positive sequential growth. As one of the economies hardest-hit by the downturn, Hong Kong is positioned to yo-yo sharply back up during the upturn.

Beyond that, Hong Kong will likely struggle against the medium-term headwind of a weak and recession-prone global economy. Still, we expect the loose liquidity backdrop to persist, helping to buffer asset prices and domestic demand.

So we are raising our 2010 growth forecast to 3.8%, from 2.9% previously. (Our 2009 forecast is unchanged.) We're also increasing our inflation forecasts for 2009-10. We see a brief brush with year-on-year deflation over the summer, but expect inflation to rapidly return to positive territory.

The improved outlook for growth should be reflected in the labor market. Hong Kong has lost 44,000 jobs since last fall, mostly in the trade, transport, and financial sectors. We think unemployment will continue rising to a peak of 6-6.5% in Q1 2010. (Previously, we expected a 7-7.5% peak in the middle of that year.)

What to watch: China's monthly data

Next week is all about the **China** data. We expect a mixed message in May, due to China's position in the cycle (exports to the G3 are still weak) and seasonality. On the monetary front, total new bank loans in May should be similar to April levels, while M2 growth should pick up slightly. On trade, export growth could slow further year-on-year, while import growth should be flat, leading to a slight narrowing of the trade surplus. Fewer working days and a high base of comparison suggest that headline industrial production could ease in May from April; however, trends in power usage point to a pickup in industrial momentum. And fixed investment should continue to accelerate in May, underpinned by residential construction as well as fiscal spending.

Finally, **Taiwan's** exports should post a sequential increase in May after the disappointing April outturn.

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Radoslaw Bodys +44 20 7995 3237
 Turker Hamzaoglu +44 20 7996 2417
 Carmen Nel +27 11 3055 169
 Julia Tsepliaeva +7 495 662 6073
 Ivan Bokhmat +7 495 662 6052
 Ceren Coskun +44 20 7996 1527

Weekly economic update

EEMEA: Latvian flu

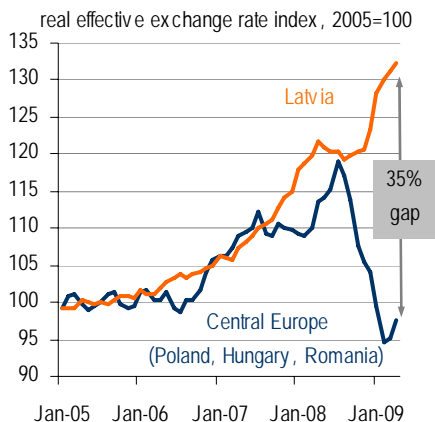
Market focus in EEMEA has been dominated this past week by “Latvian flu”, ie, fresh talks about a risk of FX devaluation in Latvia (following the failure of the government’s T-bills auction) and its possible contagion effects on other CEE markets. If Latvia devalued that would clearly adversely affect other CEE markets – Romania and Hungary the most, and the Czech Republic the least, in our view. However, if the devaluation was part of the broader arrangement with the IMF, negative market impact would likely be short-lived.

CEE: Latvian flu

In **central Europe**, the focus next week will be on May CPI inflation data from the Czech Republic, Hungary and Romania. We see headline CPI falling across the region in May: to 1.3% yoy in the Czech Republic (from 1.8% in April), to 2.8% yoy in Hungary (from 3.4% a month ago) and to 6.0% yoy in Romania (from 6.5% in April) – largely driven by favourable base effects. The main risk for continued disinflation near term is a sharp rise in commodity prices in the past few weeks. Otherwise, inflation trends have recently diverged somewhat within the region, as disinflation continues in the Czech Republic, while it stalled in Hungary, Romania and Poland (MinFin’s “flash” estimate published last week put May CPI at 3.8% yoy) – likely driven by FX weakness. In the Czech Republic, besides our expected decline in the headline CPI rate in May, noteworthy is that the short-term underlying core inflation trend (6-month trimmed mean of % mom saar rates) slipped below zero, which is likely to prompt more monetary easing from the CNB, in our view (we expect at least a 25bp rate cut in the next 1-3 months).

The main issue of the past week has been the risk of FX devaluation in Latvia and possible contagion effects on other CEE markets. There is little doubt that Latvia’s lat is overvalued (Latvia’s REER is about 35% stronger than Central Europe’s REER, even though Latvia is in a much worse economic position). The question is how to engineer an “exit strategy” so that the economy is not pushed into an even deeper recession (already contracting at nearly 20%). Given very high indebtedness of the private sector (external debt close to 130% of GDP), a simple unilateral devaluation seems sub-optimal economically as well as politically, which is why Latvia is apparently working with the IMF on alternative “exit scenarios”. If Latvia devalued that would undoubtedly adversely impact other CEE markets – with Romania and Hungary most affected, and the Czech Republic least affected, in our view. However, if the devaluation was part of the broader arrangement with the IMF, the negative market impact would probably be short-lived.

Chart 29: Latvia’s lat vs CEE currencies



Source: BIS. Note: BIS’s broad real (CPI-adjusted) effective (trade-weighted) exchange rate (monthly). Last plots are for April 2009.

Turkey: economic activity crawls up from the trough

In **Turkey**, the main macro releases of the week are April industrial production, the May capacity utilisation rate and the April current account balance. We expect economic activity data to continue to improve from the distressed levels of Q1 2009. While survey data and leading indicators have continued to improve each month for some time, the effect of the inventory build-up is likely to be reflected in the hard data, markedly from June onwards. Both the CBT survey and car and durable goods sales since March suggest that inventories in the manufacturing industry have been largely depleted thanks to the tax cut. For April industrial production, we pencilled in a contraction of 16.3% yoy and expect the capacity utilisation rate to continue to increase and reach 69% in May. While green shoots across the globe and abundant liquidity have started to reflate commodity prices,

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the impact of higher oil prices on the current account will only materialise through Q4 2009 with a lag. Meanwhile, weak economic activity is still driving down the deficit and we have pencilled in a C/A deficit of US\$1.1bn for April, which we expect will lead to a decline in the 12m trailing deficit to US\$26bn from US\$31bn in March. If oil prices remain around US\$70/bbl in H2 2009, our C/A deficit forecast of 1.1% of GDP for 2009 is likely to increase to 1.7% of GDP, or US\$10bn.

Russia: official Q1 GDP report to bring more clarity

In **Russia**, this week the FSSS is scheduled to release its first official estimate of GDP growth in Q2 2009. The preliminary release in May showed a sizable contraction of 9.5% yoy and revealed inconsistency between GDP by use and GDP by production estimates. Currently, according to the Economy Ministry data, the gap between economic growth suggested by the GDP by use method and that by the production method is vast, exceeding 4ppt. The FSSS release should resolve this puzzle. We do not expect revisions in the GDP growth figure (-9.5% yoy) but do anticipate major data revisions (downgrade of consumption growth, for example) going forward. At the same time, we still believe the deepest phase of the recession is over and that gradual stabilisation has already begun from the low base of Q1 2009. A global environment with rebounding oil prices to US\$65/bbl and ambitious government stimulus plans for 2009 should be supportive for recovery. We maintain our GDP growth forecasts of -4.9% in 2009 and 1% in 2010.

Table 9: Russian Q1 2009 – components estimates do not tally with -9.5% yoy on GDP as a whole

	MinEcon view	MinEcon simulated
GDP	-9.5	-5.4
Private Consumption	-2.2	-2.2
Government Consumption	-2	-2
Fixed Capital Investment	-15.2	-15.2
Inventories	n/a	n/a
Net exports	-12.6	-12.6

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

Table 10: Russian GDP by production in Q1 2009 (% yoy)

	BAS-ML	MinEcon
GDP	-8.5	-9.5
Industry	-14.3	-14.3
Agriculture	2.1	1.2
Construction	-19.3	-19.3
Trade	-1.1	-6.1
Transp. & Communication	-17.6	-13
Banking	-15	n/a
Real Estate	-10	n/a
Government	-2	2.1
Education	0	1
Healthcare	0	0
Other	-3	n/a

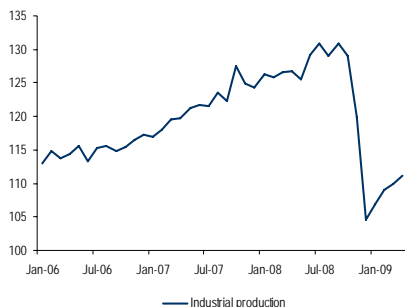
Actual figures in bold.

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

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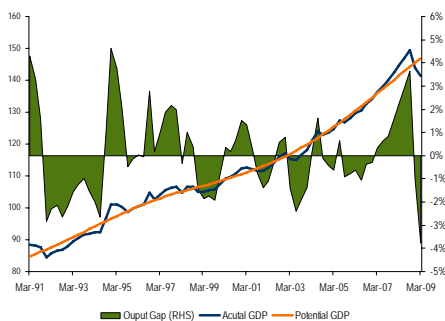
Felipe Illanes +1 646 855 9512
Edgar Camargo +52 55 5230 6429
Alejandro Cuadrado +1 646 855 9496
Virgilio Castro Cunha +55 11 2188 4368

Chart 30: Brazil – industrial activity



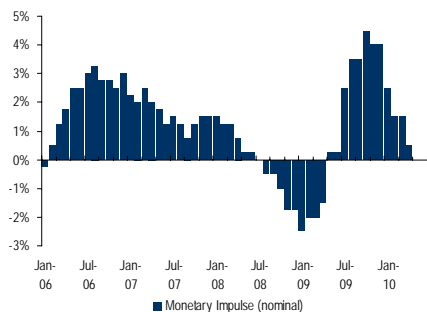
Source: IBGE, Banc of America Securities-Merrill Lynch

Chart 31: Brazil – output gap



Source: IBGE, Banc of America Securities-Merrill Lynch

Chart 32: Brazil – monetary impulse



Source: Bloomberg, Banc of America Securities-Merrill Lynch

Weekly economic update

LatAm: Brazil – enter single-digit rate

We think that the Brazilian Central Bank (BCB) will cut the Selic rate by 100bp to 9.25%pa at this week's COPOM (decision on Wednesday, 10 June, after 5:00pm EDT). If confirmed, this would be the fourth consecutive reduction of the benchmark rate and would put the Selic in single digits for the first time ever. Also, we now expect the COPOM to deliver an additional final 50bp cut at the July meeting, interrupting the easing cycle with the Selic at 8.75%.

Domestic activity reviving

The data released since the April meeting support the perception that consumer demand remains reasonably resilient as industrial activity recovers from its sharp Q4 2008 drop. March retail sales gained 0.3% mom, increasing 2.2% qoq in Q1, sharply up from -0.6% qoq in the previous quarter.

While industrial production (IP) posted a 7.8% qoq drop in Q1 2009, this was mostly due to its December 2008 collapse. In fact, so far in 2009, IP has posted four consecutive monthly gains (Chart 30). Although the recovery speed is timid, the upward IP trend should push Q2 GDP figures higher.

Q1 GDP figures will be released the day before next week's COPOM meeting (9 June). We forecast a 1.9% qoq drop, mostly driven by the cited IP contraction. While there is an unusually high degree of uncertainty around this release, the main takeaway should be that the global crisis pushed domestic activity well below potential (Chart 31).

While we think that this economic slack facilitates a sharp rebound in the coming quarters, we leave that discussion for next week, when we will revisit our growth forecasts in light of the Q1 2009 GDP release. The immediate implication of this large output gap is the constraint it imposes on inflationary pressures, a fact amply recognized by the BCB in the last meeting minutes.

The need to look forward

The last COPOM minutes also stress that an evaluation of the additional room for easing needs to consider the lagged and cumulative impact of monetary policy. Chart 32 makes both points clearly, showing estimates of the monetary impulse likely to hit the economy at each point in time, given our path for the Selic.

Note that we are only now entering the period of monetary stimulus impact. The impulse will not peak until Q3 2009, but when it does, it will be more powerful (albeit less lasting) than that of the previous easing cycle. At that time, even in an environment of much lower credit penetration, domestic demand will have responded promptly.

As such, we believe the BCB will signal an imminent slowing of the easing pace. Indeed, there is a reasonable chance that the COPOM may drive the point with a reduction of the easing pace to 75bp already at next week's meeting.

Will rates stay there?

More important than the exact distribution of additional cuts (that is unlikely to differ much from the 150bp we now forecast) is whether real interest rates will remain consistently lower going forward. Frankly, no one really knows for sure. This will be a pragmatic trial-and-error process in which the behavior of inflation expectations will be the judge. With that said, we have strong reasons to believe that lower real rates are indeed here to stay.

Ironically, the strongest argument comes from the crisis itself. While low capacity utilization would certainly allow for lower real rates in the transition, it says nothing about where they should be in the new equilibrium. We think that the most important element is how well all aspects of the economy (balance of payments, FX, inflation, monetary and fiscal policies) have behaved during the crisis. This final confirmation of our longstanding prediction that improved fundamentals would differentiate Brazil favorably when tested should allow for a lower risk premium, and associated lower equilibrium real rates.

The week ahead: Brazil-focused

This will be a key week in **Brazil** with first tier releases on activity and inflation ahead of the COPOM meeting on Wednesday. First, on Tuesday (9 June), IBGE will finally release Q1 2009 GDP figures. We forecast a 1.9% qoq contraction in the period (-2.9% yoy) but note that there is an unusually high degree of uncertainty around this forecast. Also, a considerable revision to the previous print (-3.6% qoq) cannot be discarded.

On Wednesday morning (10 June), we get the May IPCA, which we expect to show a 0.46% mom gain, pushing the yearly rate down 34bp to 5.19%. If confirmed, this would put the yearly rate at its lowest level since April 2008. Later that day, the COPOM is likely to cut the Selic rate by 100bp to 9.25%. As explained above, a smaller (75bp) cut cannot be dismissed.

In **Mexico**, we anticipate a benign May inflation report on Tuesday. (9 June, 10am EST). Despite lingering pressures on core merchandise inflation, easing pressures on core services—reflecting the hit on tourism stemming from the influenza outbreak at the beginning of the month—benefited overall inflation.

Meanwhile, in **Argentina**, INDEC will release May inflation (10 June: BAS-ML: 0.4% mom), which should push the 12-month measure even lower, to 5.5%. Still, we believe *real* inflation in Argentina is running close to three times higher.

Finally, in **Ecuador**, the government is expected to announce the final results of the buyback of the defaulted 2012 and 2030 bonds by 12 June. Also, trade releases in Chile and Peru will test the recovery in commodity prices and domestic demand.

Global economic calendar

Industrial activity stabilising

April IP data an important check of PMI improvement

Despite the recent turnaround in survey results, the hard economic data have yet to show concrete improvements outside of Asia. Industrial production figures will be released by several countries across the developed and emerging world next week. We expect the European data to show a mixed picture, with the Italian and French figures in positive territory and the German in negative. The overall message, however, should be that we are entering a stabilisation phase after the huge drop of the previous months. In the US, the Fed's Beige book will probably report that conditions are improving somewhat in some districts, while the auto sector is causing renewed weakness in the Midwest. Meanwhile, China looks well on track for recovery. The economic data releases for May will likely be mixed, but any downside surprises in exports and production are partly due to working-day and seasonal effects. Finally, we expect larger policy rate cuts in Brazil and New Zealand than the consensus.

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

Table 11: Key events in the week ahead

BST	Country	Data/Event	BAS-MLe	Cons.	Previous
Monday, 8 June					
00:50	Japan	Current account (Apr, ¥)	750.0bn	850.0bn	1485.6bn
10:00	Germany	Factory orders (Apr, mom)	-2.0%	-0.1%	3.3%
Tuesday, 9 June					
07:30	France	BoF business sentiment (May)	76.0	77.0	75.0
10:00	Germany	Industrial production (Apr, mom)	-0.5%	-0.2%	0.0%
13:00	Brazil	GDP (Q1, yoy)	-2.9%	-2.8%	1.3%
15:00	Mexico	CPI (May, mom)	-0.25%	-0.26%	0.35%
Wednesday, 10 June					
00:50	Japan	Machine orders (Apr, mom)	5.0%	-0.7%	-1.3%
03:00	China	CPI (May, yoy)	-1.4%	-1.3%	-1.5%
07:45	France	Industrial production (Apr, mom)	0.0%	-0.3%	-1.4%
09:00	Norway	CPI (May, mom)	-0.1%	0.1%	0.2%
09:00	Italy	Industrial production (Apr, mom, sa)	1.0%	0.8%	-4.6%
09:30	UK	Industrial production mom (Apr)	-0.1%	-0.2%	-0.6%
19:00	US	Fed's Beige Book	-	-	-
22:00	Brazil	COPOM rates decision	9.25%	9.50%	10.25%
22:00	New Zealand	RBNZ rates decision	2.25%	2.50%	2.50%
Thursday, 11 June					
00:50	Japan	GDP (Q1, saar, F)	-15.8%	-14.9%	-15.2%
02:00	Korea	BoK rate decision	2.00%	2.00%	2.00%
02:30	Australia	Employment change (May)	-20.0k	-30.0k	27.3k
03:00	China	Urban fixed asset investment (May, ytd)	31.6%	31.0%	30.5%
-	China	Exports (May, yoy)	-25.0%	-23.0%	-22.6%
08:30	Sweden	CPI (May, yoy)	-0.5%	-0.5%	-0.1%
13:30	US	Retail sales (Apr, mom)	0.4%	0.4%	-0.4%
23:45	New Zealand	Retail sales (Apr, mom)	0.3%	0.2%	-0.4%
Friday, 12 June					
03:00	China	Industrial production (May, yoy)	7.1%	7.7%	7.3%
10:00	Eurozone	Industrial production mom (Apr)	-0.6%	-0.5%	-2.0%
15:00	US	U of M consumer sentiment (Jun, P)	68.0	69.2	68.7

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

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Global forecasts Economic forecasts

Table 12: Global economic forecasts

	GDP growth, %				CPI inflation*, %				Short term interest rates**, %			
	2007	2008	2009F	2010F	2007	2008	2009F	2010F	Current	2008	2009F	2010F
Global and Regional Aggregates												
Global	5.0	3.0	-1.1	3.2	3.6	5.5	1.4	2.6	3.05	4.11	2.85	3.34
Global ex US	5.8	3.6	-0.6	3.7	3.8	6.0	1.9	3.0	3.91	5.29	3.64	4.25
Developed Markets	2.7	0.7	-3.7	1.7	2.2	3.3	-0.2	1.1	0.51	1.17	0.50	1.02
G5	2.6	0.6	-3.7	1.7	2.2	3.3	-0.2	1.0	0.44	1.08	0.44	0.92
Emerging Markets	7.9	5.9	1.9	4.9	5.4	8.1	3.2	4.4	6.29	7.85	5.73	6.06
Europe, Middle East and Africa (EMEA)	4.3	2.1	-3.5	1.4	4.0	6.2	3.0	2.8	3.49	5.00	3.25	4.13
European Union	3.3	1.0	-4.1	1.1	2.4	3.5	0.8	1.2	1.32	2.75	1.21	2.20
Emerging EMEA	6.5	4.7	-2.5	1.8	7.4	11.3	7.5	5.9	8.90	10.45	8.16	8.53
PacRim	7.7	5.2	2.5	6.0	3.2	5.5	-0.2	2.6	3.27	3.95	3.04	3.56
PacRim ex Japan	9.1	6.7	4.5	6.5	4.1	6.5	0.1	3.2	4.09	4.95	3.73	4.26
Emerging Asia	9.5	7.1	5.1	6.9	4.3	6.6	-0.1	3.3	4.27	5.13	3.88	4.36
Americas	3.1	1.9	-2.4	2.1	3.5	4.8	1.4	2.5	2.40	3.41	2.29	2.33
Latin America	5.7	4.2	-1.1	3.3	5.3	7.8	6.7	5.6	8.77	12.32	8.28	8.34
<i>Memo item: Global (nominal weights)</i>	4.1	2.2	-2.1	2.7								
G5												
US†	2.2	1.1	-2.8	1.6	2.9	3.8	-0.6	1.4	0.125	0.125	0.125	0.125
Euro area	3.0	0.6	-4.2	1.2	2.1	3.3	0.3	0.8	1.00	2.50	1.00	2.00
Japan	2.4	-0.7	-5.9	3.6	0.0	1.5	-1.4	-0.3	0.10	0.10	0.10	0.50
UK	3.0	0.7	-3.6	1.0	2.3	3.6	1.8	1.9	0.50	2.00	0.50	2.00
Canada	2.7	0.5	-2.7	2.3	2.2	2.4	-0.2	1.5	0.25	1.50	0.25	0.25
Euro area												
Germany	2.6	1.0	-5.8	1.1	2.3	2.6	0.2	0.7	1.00	2.50	1.00	2.00
France	2.1	0.3	-2.8	1.1	1.6	3.2	0.0	0.9	1.00	2.50	1.00	2.00
Italy	1.4	-1.0	-4.7	0.7	2.0	1.2	0.4	0.9	1.00	2.50	1.00	2.00
Spain	3.7	1.1	-3.6	-0.5	2.8	4.1	0.5	2.2	1.00	2.50	1.00	2.00
Netherlands	3.5	2.1	-4.3	0.8	1.6	2.2	1.0	1.6	1.00	2.50	1.00	2.00
Belgium	2.6	0.9	-2.9	1.0	1.8	4.5	1.0	2.0	1.00	2.50	1.00	2.00
Greece	4.0	2.7	-1.2	1.2	3.0	4.2	1.6	3.0	1.00	2.50	1.00	2.00
Austria	2.1	-0.2	-4.5	1.2	2.2	3.2	0.6	1.8	1.00	2.50	1.00	2.00
Portugal	1.9	0.3	-3.0	1.2	2.4	2.7	0.4	2.0	1.00	2.50	1.00	2.00
Finland	4.4	1.6	-2.5	1.2	1.6	3.9	1.3	2.4	1.00	2.50	1.00	2.00
Ireland	6.0	-2.3	-9.0	-1.0	2.9	3.1	-0.5	1.3	1.00	2.50	1.00	2.00
Other Developed Europe												
Sweden	2.6	-0.4	-5.5	1.1	2.2	3.5	-1.4	1.0	0.50	2.00	0.50	2.25
Switzerland	3.3	1.6	-3.2	1.0	0.7	2.4	-1.5	0.3	0.25	1.20	0.30	1.00
Norway	6.2	2.5	-1.9	1.4	0.7	3.8	1.8	2.0	1.50	3.00	1.00	2.50
Asia Pacific												
China	11.9	9.0	8.0	8.3	4.8	5.9	-1.0	2.5	5.31	5.58	4.77	4.77
India	8.9	7.5	6.1	7.1	4.8	9.1	-0.4	5.5	3.25	5.00	3.00	4.50
Korea	5.0	2.5	-3.0	3.0	2.5	4.7	2.5	2.5	2.00	3.00	1.50	2.00
Indonesia	6.3	6.1	3.6	4.8	6.4	9.8	6.0	6.0	7.25	9.25	6.50	7.50
Australia	4.0	2.1	-1.0	1.2	2.3	4.4	2.0	2.6	3.00	4.25	2.50	4.00
Taiwan	5.7	0.1	-5.5	3.5	1.8	3.5	-1.2	0.8	1.25	2.00	0.75	1.50
Thailand	4.8	2.6	-3.3	2.9	2.2	5.5	-0.8	2.0	1.25	2.75	1.25	1.25
Malaysia	6.3	4.5	-4.0	3.5	2.0	5.4	0.2	0.9	2.00	3.25	2.00	2.00
Philippines	7.3	3.8	1.4	2.5	2.8	9.3	4.0	6.1	4.50	5.75	4.75	5.00
Hong Kong	6.4	2.4	-3.1	3.8	2.0	4.3	0.9	2.0	0.63	1.23	1.15	1.50
Singapore	7.7	1.1	-6.5	3.2	2.1	6.5	-0.5	0.0	0.86	0.75	0.75	1.25
Latin America												
Mexico	3.3	1.3	-5.6	2.6	4.0	5.1	5.6	3.5	6.00	8.25	4.75	5.75
Brazil	5.7	5.1	0.5	4.5	3.6	5.7	4.7	4.2	10.25	13.75	8.75	8.75
Argentina	8.7	7.0	1.0	2.1	8.8	8.6	5.8	6.2	12.56	19.80	14.00	11.50
Colombia	7.5	2.5	0.5	3.3	5.5	7.0	5.2	4.2	7.00	9.50	4.75	6.00
Venezuela	8.4	4.8	-0.4	0.5	18.7	31.3	32.1	29.9	21.42	21.85	22.00	20.00
Chile	4.7	3.2	-0.4	3.3	4.4	8.7	3.0	2.0	1.25	8.25	1.00	3.50
Peru	8.9	9.8	2.6	4.4	1.8	5.8	4.0	2.8	4.00	6.50	2.50	3.50
Ecuador	2.5	4.8	-0.4	1.8	3.1	8.4	4.6	3.8	0.00	9.00	8.25	7.00
Uruguay	7.4	11.6	1.6	3.0	8.1	7.9	6.7	4.4	0.00	7.75	6.75	6.00
Panama	11.2	9.2	3.3	4.5	4.2	8.8	3.2	3.4	0.00	8.30	6.50	6.00

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Table 12: Global economic forecasts

	GDP growth, %				CPI inflation*, %				Short term interest rates**, %			
	2007	2008	2009F	2010F	2007	2008	2009F	2010F	Current	2008	2009F	2010F
EEMEA												
Russia	8.1	5.6	-4.9	1.0	8.7	14.1	10.7	8.1	12.50	12.00	11.00	11.00
Turkey	4.7	1.1	-2.5	3.2	8.8	10.4	6.3	6.7	9.75	15.00	9.25	11.50
Poland	6.6	4.9	-1.0	1.2	2.5	4.2	3.6	2.6	3.75	5.00	3.00	4.00
South Africa	5.1	3.1	-0.6	3.3	7.1	11.5	5.6	6.3	8.50	11.50	7.50	9.00
Egypt	7.1	7.2	3.5	3.0	11.0	11.7	15.0	6.0	10.00	10.50	9.00	8.00
Ukraine	7.3	2.1	-7.5	-2.0	12.8	25.3	19.1	12.9	12.00	12.00	12.00	10.00
Nigeria	6.2	6.3	2.5	4.5	5.4	11.6	10.5	9.0	0.00	9.75	7.00	9.00
Romania	6.0	7.1	-6.4	-2.5	6.6	6.3	5.2	4.0	9.50	10.25	8.00	6.00
Czech Republic	6.0	3.5	-4.3	1.1	2.8	6.4	1.3	1.5	1.50	2.25	1.25	2.25
Hungary	1.1	0.5	-6.5	-1.4	8.0	6.1	4.1	2.9	9.50	10.00	7.50	5.50
Israel	5.3	3.9	-2.0	1.8	0.5	4.6	1.1	1.5	0.50	2.25	0.25	1.50
Kazakhstan	8.7	3.2	-0.9	1.6	10.8	17.3	9.0	8.1	9.50	10.50	8.00	7.00
Slovakia	10.4	6.4	-5.5	1.4	3.4	4.4	1.9	3.1	2.50	2.50		
Bulgaria	6.2	5.9	-4.0	0.8	12.5	7.8	4.2	3.5				
GCC												
Saudi Arabia	3.4	4.2	-0.2	3.1	4.1	9.9	3.0	3.3				
United Arab Emirates	7.4	6.8	-1.0	2.0	11.1	11.8	0.5	1.0				
Kuwait	4.4	5.6	-1.9	2.0	5.5	10.6	2.8	3.1				
Qatar	15.3	16.4	5.7	8.1	13.7	15.1	5.0	5.2				
Oman	7.7	6.4	1.5	2.3	5.9	12.5	3.2	3.5				
Bahrain	8.1	5.4	1.8	2.4	3.3	3.5	2.0	2.2				

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 rates forecasts

Table 13: Quarter-end government bond yield forecasts

		Latest	2009Q2	2009Q3	2009Q4	2010Q1	2010Q2	2010Q3	2010Q4
US	3m	0.63	0.65	0.55	0.45	0.40	0.40	0.45	0.50
	2 yr	1.07	0.95	1.00	1.00	1.00	0.90	0.95	1.00
	5 yr	2.76	2.40	2.50	2.60	2.60	2.45	2.35	2.25
	10 yr	3.88	3.65	3.85	4.10	3.95	3.75	3.55	3.35
	30 yr	4.70	4.40	4.55	4.75	4.65	4.55	4.40	4.20
Euroland	3m	1.27	1.25	1.25	1.25	1.30	1.40	1.70	2.00
	2 yr	1.68	1.40	1.40	1.55	1.75	1.90	2.25	2.60
	5 yr	2.83	2.60	2.60	2.75	2.95	3.05	3.23	3.40
	10 yr	3.72	3.55	3.60	3.80	3.90	4.00	4.10	4.20
	30 yr	4.39	4.30	4.35	4.45	4.50	4.55	4.55	4.55
Japan	2 yr	0.58	0.30	0.40	0.45	0.55	0.60	0.80	0.85
	5 yr	0.91	0.55	0.65	0.90	1.00	1.00	1.25	1.50
	10 yr	1.52	1.20	1.35	1.60	1.55	1.60	1.75	1.95
	30 yr	2.43	2.10	2.15	2.35	2.25	2.40	2.30	2.55
U.K.	3 mth	1.26	1.30	1.30	1.30	1.40	1.70	2.30	2.80
	2 yr	1.29	1.10	1.10	1.35	1.75	2.10	2.60	3.00
	5 yr	2.79	2.55	2.45	2.80	3.05	3.30	3.65	3.95
	10 yr	3.92	3.70	3.60	3.80	4.00	4.10	4.30	4.50
	30 yr	4.64	4.60	4.65	4.70	4.75	4.80	4.80	4.80
Australia	2 yr	3.73	3.60	3.50	3.80	4.00	4.10	4.10	4.20
	5 yr	4.95	4.70	4.60	5.40	5.40	5.10	5.50	5.80
	10 yr	5.59	5.10	4.80	5.60	5.50	5.20	5.60	5.90
Canada	2 yr	1.21	0.80	0.80	0.90	1.10	1.25	1.25	1.25
	5 yr	2.53	1.80	1.75	1.75	1.90	1.95	2.00	2.00
	10 yr	3.46	3.00	2.75	2.60	2.60	2.55	2.50	2.50
Sweden	10 yr	3.72	3.65	3.60	3.80	3.90	4.10	4.20	4.30
Norway	10 yr	4.34	4.25	4.25	4.45	4.50	4.60	4.70	4.75

Source: Banc of America Securities-Merrill Lynch Global Rates Strategy. *3m rates are LIBOR

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Commodity forecasts

Table 14: Commodity forecasts

	2009Q1	2009Q2	2009Q3	2009Q4	2009	2010Q1	2010Q2	2010Q3	2010Q4	2010
Oil - WTI Crude (US\$/bbl)	42.0	49.0	56.0	61.0	52.0	62.0	56.0	62.0	68.0	62.0
Nickel (US\$/lb)	4.14	4.10	4.40	4.60	4.31	4.70	5.20	5.20	5.04	5.03
Aluminium (US\$/lb)	0.55	0.51	0.57	0.64	0.57	0.72	0.78	0.82	0.86	0.79
Zinc (US\$/lb)	0.51	0.56	0.58	0.62	0.57	0.66	0.66	0.66	0.66	0.66
Lead (US\$/lb)	0.42	0.42	0.44	0.44	0.43	0.48	0.48	0.48	0.48	0.48
Molybdenum (US\$/lb)	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Cobalt (US\$/lb)	12.0	11.0	11.0	10.0	11.0	10.0	11.0	11.0	11.0	10.8
Uranium (US\$/lb)	46.0	45.0	45.0	44.0	45.0	45.0	45.0	45.0	45.0	45.0
Gold (US\$/oz)	1000	1000	1000	1000	1000	1050	1050	1050	1050	1050
Silver (US\$/oz)	14.5	14.5	14.5	14.5	14.5	15.0	15.0	15.0	15.0	15.0
Platinum (US\$/oz)	1010	1150	1200	1240	1150	1216	1233	1261	1289	1250
Palladium (US\$/oz)	200	220	240	260	230	283	292	308	317	300
RHODIUM PRICE (US\$/oz)	1120	1200	1330	1550	1300	2141	2170	2220	2269	2200
Coal - Thermal Australia (US\$/t)	130	70	70	70	85	70	65	65	65	66
Coal - Hard cooking (US\$/t)	300	129	129	129	172	129	95	95	95	104
Coal - Semi soft coking (US\$/t)	240	85	85	85	124	85	70	70	70	74
Iron ore - Lump (US\$/DLTU)	2.02	1.41	1.41	1.41	1.56	1.41	1.41	1.41	1.41	1.41

Source: Banc of America Securities-Merrill Lynch

Monetary policy forecasts

Table 15: Key meeting dates and expected rate change (bp)

	Current	Jun-09	Jul-09	Aug-09	Sep-09	Oct-09	Nov-09
Developed market							
Fed	0.00 - 0.25	24th	-	12th	23rd	-	4th
ECB	1.00	unch	2nd	6th	3rd	8th	5th
BoJ	0.10	16th	15th	11th	17th	14th	20th
BoE	0.50	unch	9th	6th	10th	8th	5th
BoC	0.25	unch	21st	-	10th	20th	-
Riksbank	0.50	-	2nd	-	-	22nd	-
SNB	0.25	18th	-	-	17th	-	-
Norges Bank	1.50	-50 (18th)	-	12th	23rd	28th	-
RBA	3.00	unch	7th	-25 (4th)	1st	6th	3rd
Emerging Asia							
China (lending rate)	5.31	-	-27	-	-	-	-
Req. res. ratio*	15.50	-100	-	-	-	-	-
India**	3.50	-	-25	-	-	-	-
Repo rate	5.00	-	-25	-	-	-	-
Cash res. ratio	5.00	-	-	-	-	-	-
Korea	2.00	11th	9th	-25 (11th)	10th	9th	12th
Indonesia	7.25	-25	-25 (3rd)	-25 (5th)	3rd	5th	4th
Taiwan	1.25	-	-	-	-25	-	-
Thailand	1.25	-	15th	26th	-	21st	-
Malaysia	2.00	-	29th	29th	-	28th	24th
Philippines	4.25	-	9th	20th	-	-	-
Latin America							
Mexico	5.25	-25 (19th)	-25 (17th)	21st	18th	16th	27th
Brazil	10.25	-100 (10th)	-50 (22nd)	-	2nd	21st	-
Colombia	5.00	-25 (19th)	24th	28th	18th	30th	27th
Chile	1.25	-25 (16th)	9th	13th	8th	13th	12th
Peru	3.00	-100	-50 (9th)	(6th)	10th	7th	5th
Uruguay	9.00	-150 (22nd)	-	-	-	-	-
Emerging EMEA							
Turkey	9.25	-50 (16th)	16th	18th	17th	15th	19th
Poland	3.75	-25 (24th)	29th	-25 (26th)	30th	-25 (28th)	25th
South Africa	7.50	25th	-	13th	22nd	22nd	17th
Romania	9.50	-50 (30th)	-	-50 (4th)	-50 (29th)	-	3rd
Czech Republic	1.50	25th	-	-25 (6th)	24th	-	5th
Hungary	9.50	-50 (22nd)	20th	-50 (18th)	-	-50 (19th)	23rd
Israel	0.50	22nd	27th	24th	29th	26th	23rd

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

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FX forecasts

Table 16: Quarterly forecasts - G10 currencies

	Spot	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
G3								
EUR-USD	1.40	1.28	1.20	1.22	1.24	1.26	1.28	1.30
USD-JPY	98.2	100	108	112	115	117	115	113
EUR-JPY	138	128	130	137	143	147	147	147
Dollar Bloc								
USD-CAD	1.11	1.33	1.35	1.37	1.33	1.25	1.21	1.15
AUD-USD	0.802	0.660	0.640	0.640	0.670	0.700	0.730	0.760
NZD-USD	0.633	0.520	0.530	0.540	0.550	0.570	0.590	0.610
Europe								
EUR-GBP	0.874	0.890	0.870	0.850	0.830	0.810	0.790	0.770
GBP-USD	1.60	1.44	1.38	1.44	1.49	1.56	1.62	1.69
EUR-CHF	1.52	1.52	1.52	1.52	1.53	1.54	1.55	1.56
USD-CHF	1.08	1.19	1.27	1.25	1.23	1.22	1.21	1.20
EUR-SEK	10.90	10.50	10.00	9.50	9.25	9.20	9.20	9.20
USD-SEK	7.77	8.20	8.33	7.79	7.46	7.30	7.19	7.08
EUR-NOK	8.97	8.80	8.40	8.20	8.10	8.00	8.00	8.00
USD-NOK	6.40	6.88	7.00	6.72	6.53	6.35	6.25	6.15

Notes: End of period forecasts. Spot exchange rates as of 5 June, 2009. The left of the currency pair is the denominator of the exchange rate. Source: Banc of America Securities-Merrill Lynch

Table 17: Quarterly forecasts - EM currencies

	Spot	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
Latin America								
USD-BRL	1.95	2.25	2.20	2.05	1.95	2.05	2.15	2.25
USD-MXN	13.3	14.0	13.8	13.3	13.3	12.8	13.0	12.5
USD-CLP	566	580	610	625	610	540	520	515
USD-COP	2,057	2,450	2,550	2,500	2,600	2,600	2,500	2,400
USD-ARS	3.75	3.70	3.90	4.00	4.00	4.00	4.05	4.10
USD-VEF	2.15	2.70	2.70	2.70	2.70	2.70	2.70	2.70
USD-PEN	2.97	3.35	3.40	3.25	3.15	3.00	2.90	2.80
Emerging EMEA								
EUR-PLN	4.54	4.75	4.80	4.60	4.30	3.80	3.55	3.45
EUR-HUF	287	315	330	299	285	275	270	270
EUR-CZK	27.0	27.5	28	26.25	26	26	26	25.5
USD-UAH	7.62	8.75	8.75	9	9	9.5	9.5	9.5
USD-RUB	30.89	35.1	36.8	37.0	35.9	33.8	31.7	31.5
USD-ZAR	8.04	9.50	10.00	9.45	9.25	9.00	8.75	8.50
USD-TRL	1.54	1.66	1.75	1.65	1.60	1.60	1.60	1.60
EUR-RON	4.22	4.50	4.80	4.50	4.10	4.00	4.00	4.00
USD-EGP	5.60	5.90	5.90	5.90	5.85	5.75	5.75	5.75
USD-ILS	3.94	4.40	4.55	4.35	4.00	3.85	3.75	3.70
USD-AED	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67
USD-KWD	0.288	0.295	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	3.75
USD-QAR	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64
Asian Bloc								
USD-KRW	1,250	1,450	1,350	1,200	1,200	1,150	1,100	1,000
USD-TWD	32.6	34.5	35.0	35.0	35.0	34.5	33.6	33.2
USD-SGD	1.45	1.53	1.55	1.52	1.50	1.48	1.46	1.45
USD-THB	34.2	36.0	35.8	35.5	34.0	33.0	32.5	32.0
USD-HKD	7.75	7.80	7.80	7.80	7.80	7.80	7.80	7.80
USD-CNY	6.83	6.80	6.75	6.65	6.60	6.55	6.50	6.45
USD-IDR	9,940	11,000	10,500	10,000	10,000	9,800	9,800	9,700
USD-PHP	47.0	50.0	51.0	51.0	50.0	48.0	47.0	46.5
USD-MYR	3.50	3.66	3.70	3.65	3.60	3.50	3.40	3.30
USD-INR	47.1	50.0	48.0	47.0	45.0	45.0	45.0	45.0

Notes: End of period forecasts. Spot exchange rates as of 5 June, 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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