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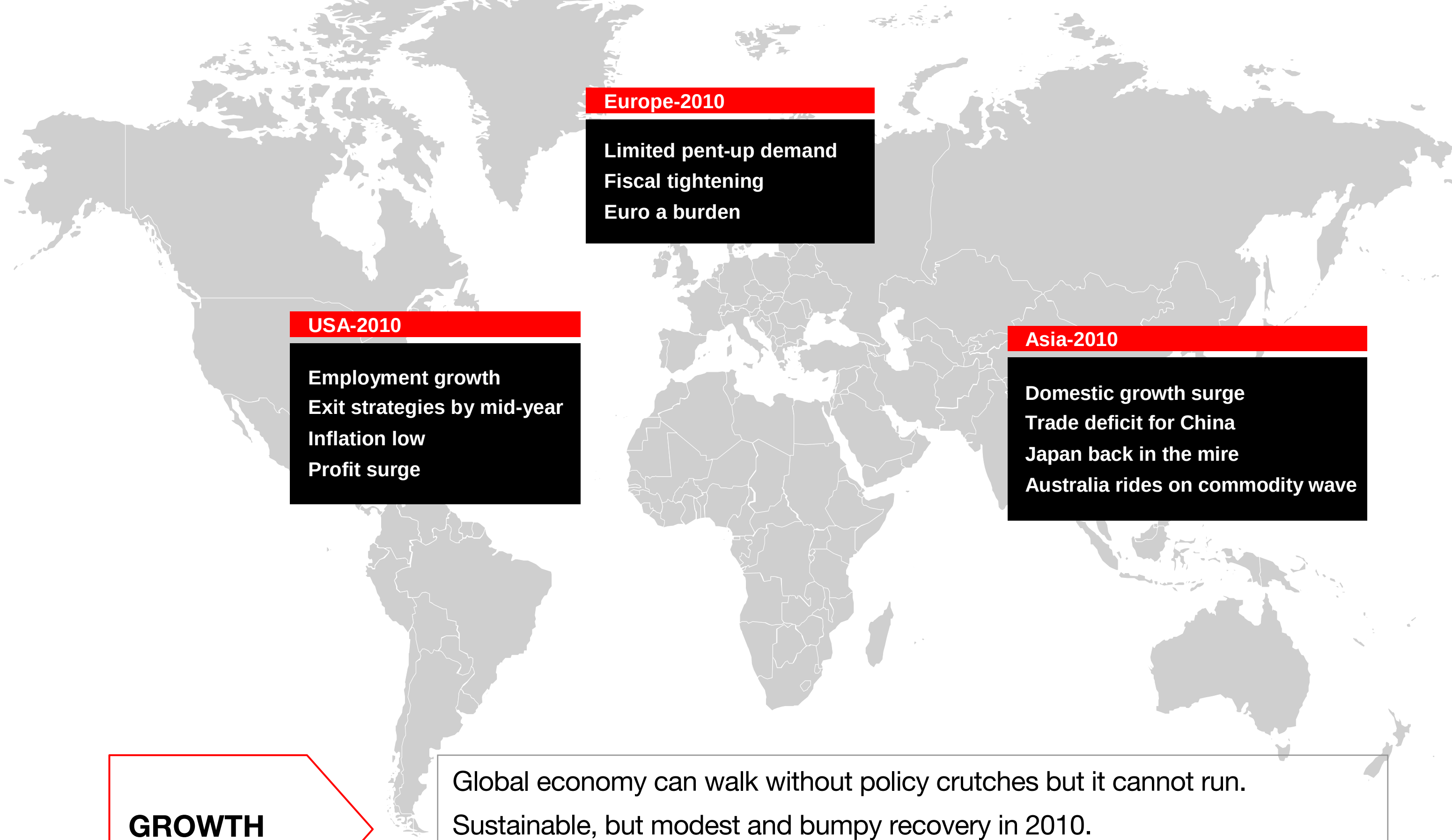
Global Economic Outlook

Recovery 2010 – Now comes the hard part



GROWTH

Global economy can walk without policy crutches but it cannot run.
Sustainable, but modest and bumpy recovery in 2010.
Key growth drivers are in Asian, emerging and commodity-rich nations.

INFLATION

Large output gaps keep core inflation low.
Rising commodity prices, huge public deficits could fuel long-term worries.

POLICY

Central banks embark on multi-year exit odyssey. Policy tightening to start later rather than sooner - they remain extremely cautious.

RISK

Persistent loose monetary policy could trigger a return to exuberance.
Impaired credit and policy normalisation are obvious negative risks for 2011.

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World economic summary

	Q1	Q2	Q3e	2009 Q4e	Q1e	Q2e	Q3e	2010 Q4e	2007	2008	2009e	2010e	Average 2011
GDP growth (% qoq saar)													
US	-6.4	-0.7	3.0	3.6	3.7	3.5	2.7	3.1	2.1	0.4	-2.5	3.1	2.8
Euro area	-9.6	-0.7	1.5	1.9	1.0	0.8	0.7	1.3	2.7	0.6	-3.9	1.1	1.2
UK	-9.3	-2.3	-1.7	2.0	1.2	1.4	2.2	2.7	2.6	0.6	-4.7	1.0	1.6
Japan	-12.2	2.7	4.8	-1.5	-1.1	1.0	1.5	2.9	2.3	-0.7	-5.4	0.7	0.3
China (% yoy)	6.1	7.9	8.9	10.0	8.4	7.3	8.8	9.5	13.0	9.1	8.2	8.5	9.5
Consumer spending (% qoq saar)													
US	0.6	-0.9	3.4	2.0	2.5	2.9	2.9	3.0	2.6	-0.2	-0.5	2.5	2.9
Euro area	-2.1	0.3	-0.1	0.4	0.2	0.2	0.2	0.8	1.6	0.3	-0.9	0.2	0.7
UK	-6.0	-2.6	-0.8	1.6	1.2	1.2	1.6	1.6	2.1	1.0	-3.1	0.9	1.6
Japan	-4.3	3.9	2.8	-1.5	-0.3	1.0	0.7	0.6	0.7	0.6	-0.9	0.5	0.8
China (Nominal retail sales %yoy)	14.9	15.0	15.4	19.0	21.0	22.0	23.0	25.0	16.7	21.7	16.1	22.8	25.0
Inflation (% yoy, averages)													
US	-0.2	-0.9	-1.6	1.0	2.1	1.7	1.6	1.9	2.9	3.8	-0.4	1.8	1.8
Euro area	1.0	0.2	-0.4	0.3	0.9	1.0	1.2	1.1	2.1	3.3	0.2	1.0	0.8
UK	3.0	2.1	1.5	1.7	2.5	2.5	2.6	2.6	2.3	3.6	2.1	2.5	1.9
Japan (headline, % yoy)	-0.1	-1.0	-2.2	-2.3	-1.7	-1.5	-1.5	-1.5	0.1	1.4	-1.4	-1.6	-0.9
China	-0.6	-1.5	-1.3	0.0	1.0	1.5	2.5	3.1	4.8	5.9	-0.9	2.0	5.1
Unemployment rate (%, averages)													
US	8.1	9.3	9.6	10.2	10.4	10.2	9.9	9.6	4.6	5.2	9.3	10.0	8.8
Euro area	8.8	9.3	9.5	10.0	10.3	10.4	10.6	10.7	7.5	7.5	9.4	10.5	10.2
UK	7.3	7.9	8.0	8.3	8.5	8.7	8.9	8.9	5.3	5.9	7.8	8.8	9.3
Japan	4.4	5.2	5.5	5.5	5.3	5.2	5.1	5.0	3.9	4.0	5.2	5.2	4.8
China	4.2	4.3	4.3	4.2	4.2	4.2	4.2	4.1	4.0	4.1	4.2	4.2	4.2

Source: SG Cross Asset Research

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Key central bank rates

	19 Nov 09	Dec 09	Mar 10	Jun 10	Sep 10	Dec 10	2007 ave	2008 ave	2009 ave	2010 ave	2011 ave
USA	0.25	0.25	0.25	0.25	0.25	0.25	5.05	2.08	0.25	0.25	1.66
Japan	0.10	0.10	0.10	0.10	0.10	0.10	0.47	0.46	0.10	0.10	0.10
Euro Zone	1.00	1.00	1.00	1.00	1.00	1.00	3.85	3.88	1.26	1.00	1.28
United Kingdom	0.50	0.50	0.50	0.50	0.50	1.00	5.51	4.68	0.64	0.56	2.00
Norway	1.50	1.50	2.00	2.50	3.00	3.50	4.38	5.31	1.73	2.50	4.19
Sweden	0.25	0.25	0.25	0.50	1.00	1.50	3.46	4.13	0.64	0.66	2.28
Switzerland	0.25	0.25	0.25	0.25	0.25	0.25	2.42	2.48	0.28	0.25	0.53
Australia	3.50	3.75	4.25	4.75	5.25	5.75	6.39	6.68	3.19	5.00	6.25
New Zealand	2.50	2.50	2.50	3.00	3.50	4.00	7.87	7.68	2.88	3.06	5.25
Canada	0.25	0.25	0.25	0.50	1.00	1.50	4.30	2.75	0.31	0.81	2.50

Source: Bloomberg, SG Cross Asset Research

Interest rate forecasts

10 year bond yields (local market convention)

	19 Nov 09	Dec 09	Mar 10	Jun 10	Sep 10	Dec 10	2007 ave	2008 ave	2009 ave	2010 ave	2011 ave
USA	3.33	3.25	3.15	3.25	3.75	4.25	4.63	3.64	3.20	3.48	4.75
Japan	1.31	1.30	1.20	1.40	1.60	1.75	1.68	1.49	1.35	1.43	2.00
Euro Zone	3.27	3.20	3.30	3.35	3.50	3.80	4.23	4.00	3.26	3.41	4.00
United Kingdom	3.64	3.60	3.50	3.75	4.00	4.40	5.00	4.48	3.57	3.81	4.80
US - Eurozone	0.07	0.05	-0.15	-0.10	0.25	0.45	0.40	-0.36	-0.06	0.06	0.75
UK - Eurozone	0.38	0.40	0.20	0.40	0.50	0.60	0.77	0.49	0.32	0.40	0.80
US - Japan	2.03	1.95	1.95	1.85	2.15	2.50	2.95	2.15	1.85	2.04	2.75

Source: Bloomberg, SG Cross Asset Research

Exchange rate forecasts

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USD1=

	19 Nov 09	Dec 09	Mar 10	Jun 10	Sep 10	Dec 10	2007 ave	2008 ave	2009 ave	2010 ave	2011 ave
Japan	89	90	95	100	105	112	118	103	94	100	120
Euro Zone	0.67	0.68	0.65	0.63	0.65	0.68	0.73	0.68	0.72	0.65	0.71
United Kingdom (£1=)	1.66	1.68	1.72	1.82	1.82	1.79	2.00	1.85	1.57	1.75	1.79
Norway	5.65	5.61	5.26	4.94	5.23	5.54	5.85	5.60	6.27	5.62	5.82
Sweden	6.92	6.89	6.52	6.25	6.45	6.80	6.75	6.55	7.60	6.80	6.71
Switzerland	1.02	1.02	0.99	0.99	1.03	1.09	1.20	1.08	1.08	0.98	1.14
Australia (A$1=)	0.92	0.94	1.00	1.04	1.01	0.97	0.84	0.85	0.79	0.82	1.00
New Zealand (NZ$1=)	0.73	0.74	0.77	0.79	0.78	0.77	0.74	0.71	0.64	0.66	0.75
Canada	1.07	1.05	1.00	0.95	0.97	1.00	1.07	1.07	1.14	1.12	1.05
China	6.83	6.80	6.75	6.70	6.65	6.60	7.61	6.95	6.83	6.75	6.54

Source: Bloomberg, SG Cross Asset Research

EUR1=

	19 Nov 09	Dec 09	Mar 10	Jun 10	Sep 10	Dec 10	2007 ave	2008 ave	2009 ave	2010 ave	2011 ave
USA	1.49	1.48	1.55	1.60	1.55	1.47	1.37	1.47	1.39	1.54	1.40
Japan	132	133	147	160	163	165	161	152	130	155	168
United Kingdom	0.89	0.88	0.90	0.88	0.85	0.82	0.68	0.80	0.89	0.88	0.78
Norway	8.40	8.30	8.15	7.90	8.10	8.15	8.01	8.24	8.73	8.67	8.15
Sweden	10.29	10.20	10.10	10.00	10.00	10.00	9.25	9.63	10.58	10.49	9.40
Switzerland	1.51	1.51	1.54	1.58	1.60	1.60	1.64	1.59	1.51	1.51	1.6
Australia	1.62	1.57	1.55	1.54	1.53	1.52	1.63	1.73	1.76	1.87	1.40
New Zealand	2.04	2.00	2.01	2.03	1.99	1.91	1.85	2.06	2.19	2.33	1.87
Canada	1.59	1.55	1.55	1.52	1.50	1.47	1.47	1.57	1.59	1.72	1.47
China	10.15	10.06	10.46	10.72	10.31	9.70	10.43	10.22	9.51	10.42	9.16

Source: Bloomberg, SG Cross Asset Research

Snapshot

Our Global Scenario at a glance

■ **Can the world economy walk without crutches in 2010 and 2011?** Growth rates in 2009 and expected growth in 2010 are revised modestly higher in our latest Global Economic Outlook. Despite the improvement, there are deep uncertainties on whether the economy can sustain gains without the massive fiscal and monetary support that have been put into place since the Lehman Brothers bankruptcy. Eventually, a healed economy can walk without these crutches, but the first steps can be tentative. We expect a modest recovery that is likely to experience a few bumps as policy supports are withdrawn.

■ **2010 marks the beginning of the Exit Odyssey for central bankers and the markets.** Too early a withdrawal, policymakers could trigger an economic relapse. Too late, and the risk of long-term inflation and new asset-price bubbles intensifies. Of course we expect near-perfect timing from our central bankers, but the risks are to err on the side of caution, and therefore be late in withdrawing liquidity from the financial system. Such a bias could support markets, but raise long-term inflation concerns.

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■ **De-leveraging and slow healing in the credit markets remain the chief impediments to a faster economic recovery in the US and western Europe**. On the upside, earlier growth projections in 2009 may have been too severely retarded by these concerns. Growth expectations have moved slightly higher. Growth in 2010 and the recovery overall remain significantly slower than earlier recoveries.

■ **Inflation in the immediate future looks quite low.** Excess capacity in most economies contributes to downward pressure on core prices. Inflation expectations have stabilized for now and are highly uncertain, given dramatic changes in policy ahead. Longer-term, a late start by central banks in withdrawing money and high fiscal deficits suggest upward inflation risks. Policy efforts need to balance these risks. With short-term dis-inflation risks and long-term inflation risks, successful monetary policy steering is all about timing.

■ **Asian economies, with the exception of Japan, and many commodity-rich countries are in the strongest position and are leading a global growth dynamic.** China is NOT adding to the productive capacity of the export sector. China is, however, spending the equivalent of its export share of GDP to boost domestic demand in order to absorb the current production capacity of its economy.

■ **Central banks of commodity-rich nations and non-Japan Asian economies should be among the first to hike rates.** The Reserve Bank of Australia has already begun this process. Late to the game should be central banks of more mature, commodity-importing countries where output gaps remain stubbornly high in the face of a sluggish recovery.

■ **China moves to a trade deficit in 2010.** The Chinese trade balance may already be hovering close to zero, if not already taking its first tentative plunge into the red. This is a strong departure from the Japanese style of export-led growth. Importantly, it also implies China may no longer have the means to finance western deficits.

■ **Western budget deficits remain large and unsustainable for outer years. In 2010**, there may be more competition for funds, particularly if private-sector borrowing increases. Crowding out is a concern. Fiscal restraint is seen in 2011, particularly in western Europe.

The big picture

Recovery - now comes the hard part

The global economic recovery began in Q3 2009. The timing met expectations. The pace of growth is modestly exceeding forecasts, but not by enough to overcome a sense that the recovery is fragile. Growth expectations for 2010 are being revised upward in most countries and globally, but the outlook for 2011 is cloudy and the recovery relative to earlier recoveries is expected to be slow and bumpy.

We can trace back this fragility to several sources. Two stand. Banks are not yet lending significantly outside government-supported programs and employment continues to decline. Lacking a more robust improvement in labour markets and banking credit, there are serious doubts surrounding the economy's ability to sustain a recovery without heavy-handed government supports.

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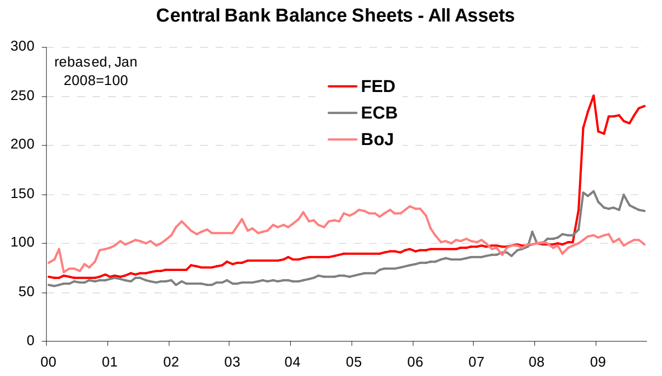
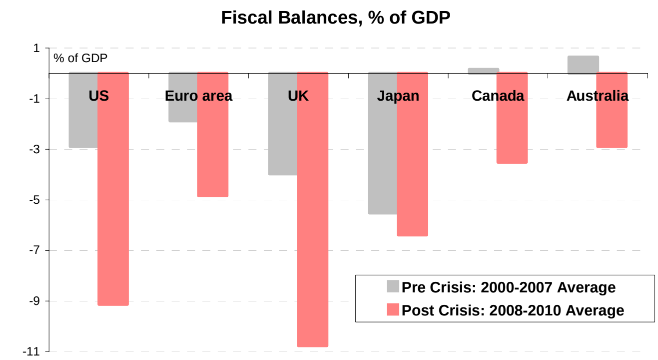
Can the recovery continue as massive policy supports are withdrawn? Yes, but the recovery is mild!

Monetary policy – CB balance sheets exploded on exceptional tools



Source: Bloomberg, SG Cross Assets Research

Fiscal policy - Injections were the greatest in decades



Source: OECD and SG Cross Assets Research

Policy supports, however, are destined to fade. In 2010, central bankers need to seriously contemplate the withdrawal of exceptional monetary policies that have been instrumental to recovery. For the central banks, withdrawing funds prematurely risks triggering another decline in economic activity. Waiting too long, however, sows the seeds of inflation. Inflation risks are very limited on our forecast horizon, but the actions of central banks over the next year have important consequences for inflation in 2012-2015.

Fiscal stimulus was unprecedented for a number of countries in 2009, including China and the US. Such programs cannot be funded forever without risks and many governments are already on an unsustainable path. Fiscal tightening is a more serious threat in our 2011 view. If monetary policy were to tighten prematurely, we could imagine a quick relapse. **A premature tightening of fiscal policy is probably the greater threat of a double-dip recession.**

Policy efforts were turned on full-blast in 2009. The financial crisis and panic justified full-fledged, rapid responses from policymakers who learned their lessons from the Great Depression and from the Japanese situation. Despite initial scepticism in the marketplace, the combination of massive monetary and fiscal policy efforts worked to stabilize economic conditions and financial markets in 2009. These programs cannot be sustained forever and the strength of private sector demand—in either developed or emerging market economies—may not be able to pick-up sufficiently as government demand pulls back.

Financial market gains in 2009 have been impressive on growing evidence of recovery—even a mild one—for the global economy. The S&P 500 index in the US is up 55%-60% from the March 2009 low and is up 18% YTD. Strong equity market gains have taken place across the globe and raised concerns that such gains are running ahead of fundamentals. Of course, stronger asset markets do help to support consumption and investment in due course so to some extent soften that risk.

Yet at the start of year, depression was a real fear and certainly a much greater risk than it has been in decades. Markets were pricing for depression. Credit spreads and equity volatility, a measure of fear and uncertainty, were at their highest levels since the Great Depression. A recession, no matter how bad, was a far better outcome than depression, giving the market upside potential. A re-pricing in the financial markets from a potential depression to a deep recession was likely a once-in-a-career, or generation, call on the market that only in hindsight seems easy.

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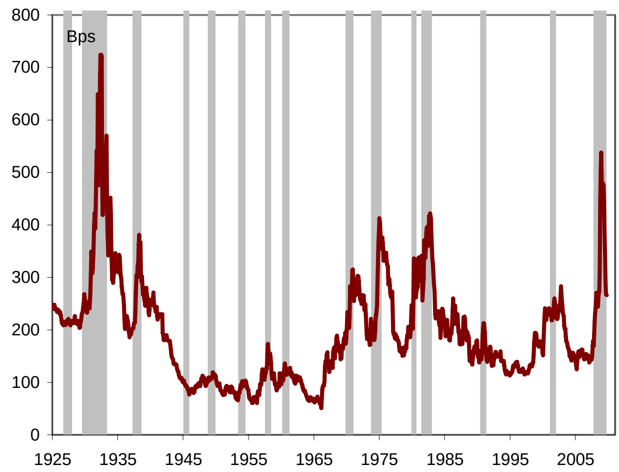
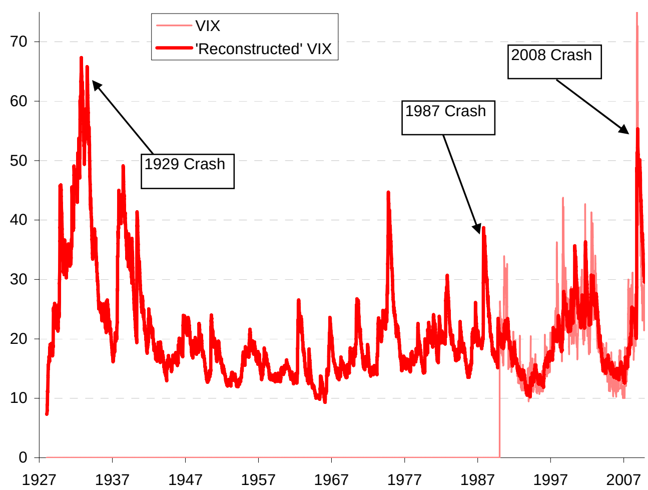
Financial markets no longer pricing Armageddon - Gradually more supportive to growth

Corp Credit BAA spreads to Treasury



Source: Global Insight, SG Cross Assets Research

Equity volatility subsides from highest since Depression



Source: Global Insight, Congressional Budget Office (CBO), and SG Cross Assets Research

From a financial market standpoint, the objective now is fine-tuning the call on the global growth rate. Markets today are still priced for defaults and uncertainty. Incoming evidence on a global recovery may remain helpful, but even greater precision on growth rates and sustainability are in question. Moreover, as fears subside, markets should take greater consideration of divergences in growth rates between countries and regions. At present, we see significant gains in most economies from the deep holes at the start of the year. The recoveries, like the deep pullback at the end of 2008, were well synchronized economic moves. As recoveries unfold, greater distinctions should open up.

Highly synchronized now – Divergences arise, but decoupling a myth

The upturn in the second half of 2009 has been fairly uniform for the major economies. The UK economy has lagged to a certain degree but is expected to resume GDP growth in the fourth quarter. The most remarkable upturn has been in the manufacturing sector, spurred on by the inventory recovery and the resumption in trade that came to a virtual halt at the turn of the year.

The PMIs (purchasing managers' indices), or the ISM for the US, describe the timing and extent of the upturn in activity. What is interesting in the recent PMI data is the leading upturn in the Chinese PMI from a very early point in 2009 in response to the substantial fiscal policy programs launched by the Chinese government in November 2008. It is doubtful that Chinese demand played a major role in turning the global trends, but Chinese government spending was forceful. (See our "Drivers of Growth" theme for further insights into the Asian and Chinese ability to drive global growth).

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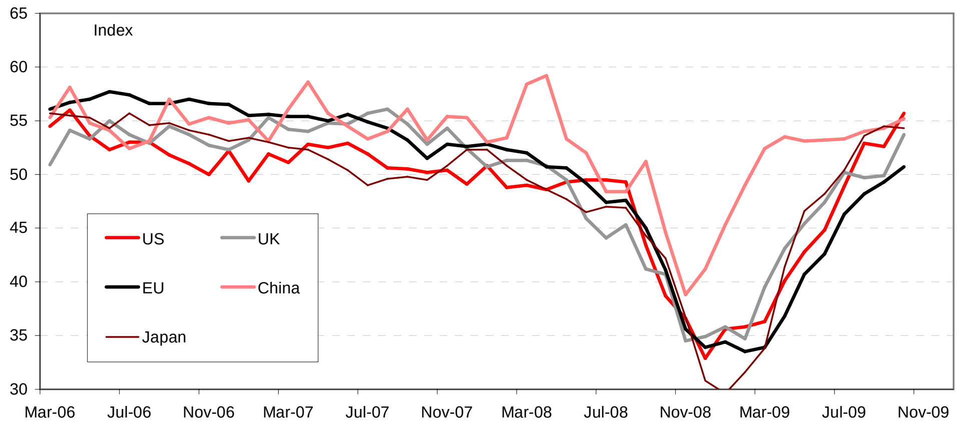
A fairly well-synchronized global recovery in latter half of 2009

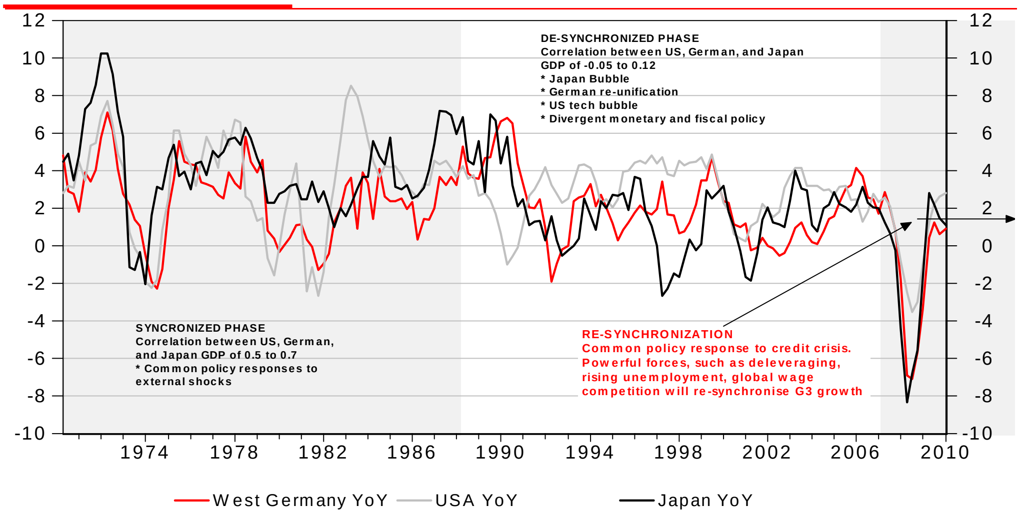


Source: Bloomberg, MARKIT

The global manufacturing cycle remains very strong at the end of 2009 and heading into 2010. In an era when decoupling had been a building view, the forcefulness of the synchronized decline and synchronized upswing in activity is impressive. The downturn and upswing highlight the increased integration of economies that is threatened only by protracted protectionist policies.

The downturn can be tied to the surge of energy prices, the shock induced by the bankruptcy of Lehman Brothers in September of 2008, and vigorous efforts to cut inventories. Efforts to dramatically cut inventories in predominantly import countries such as the United States impaired export capabilities among the exporting nations. Nearly every country was afflicted with weak demand for manufacturing goods and only those countries that could revive domestic demand via policy, managed to restart manufacturing activity.

A synchronized cycle rather than de-coupling has marked the 2008-2010 era



Source: SG Economic Research

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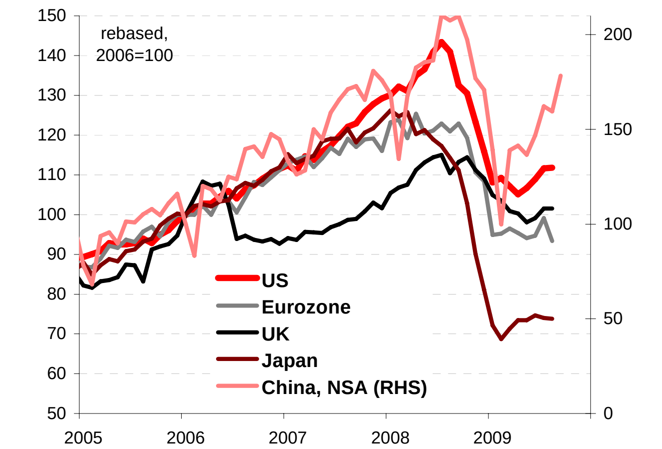
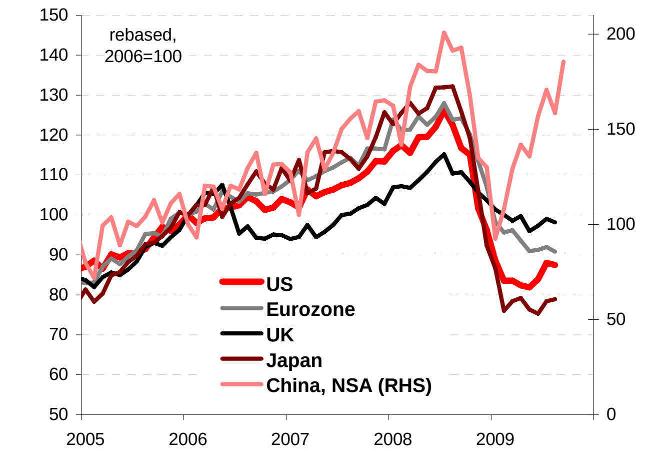
A resumption of manufacturing activity was made possible only after policy initiatives introduced in each country or region stabilized demand. Policy efforts may not have been well co-ordinated, but policymakers in each country and region were responding to the same global financial crisis and deployed monetary and fiscal policies to contain the biggest threat to the global economy since the Great Depression.

Exports -- flows from local trade accounts



Source: Bloomberg, SG Cross Assets Research

Imports -- local trade accounts



Source: Bloomberg, SG Cross Assets Research

Gains in manufacturing activity are now consistent with rising global trade flows. The latest figures on international trade are encouraging. According to our global indicator of mainly industrial goods exports, sales had regained 18% by August from February's trough. This is quite an impressive performance. Were this trend to continue, the volume of world trade could return to its highs of the pre-crisis period by the middle of next year.

The sharp increase in global trade over the last two decades has been a key engine for growth worldwide, certainly the most powerful means of spreading growth across the world and sharing it more successfully between countries. This has also been a key factor keeping inflation under control, which ultimately also helped maintain a relatively stable currency market environment. Protectionism would reverse these gains. While we worry rightfully about protectionist reflexes in the downturn, what is remarkable in this deep recession was the minor infractions. An upswing should subdue latent protectionist pressures.

Highly integrated trade patterns have been largely due to strong consumption in the more mature countries that have imported cheap, manufactured goods from abroad. In turn, developing economies have imported large quantities of capital goods. Looking ahead, the need for greater savings among the more mature economies suggests weaker imports of consumer goods. The maturing of many developing economies and deepening of capital goods capabilities imply weakening demand for capital goods. Consumer activity in the G-7 is likely to be weak.

De-coupling is a myth. Certain economies may have advantages going forward but in recent decades the rising integration of economies has been brought about by free markets, comparative advantages, and a desire of many emerging economies to adopt reforms that allowed them to close the gap on western economies. More recently, in response to shocks and simultaneous policy efforts, global growth is most striking for being synchronized.

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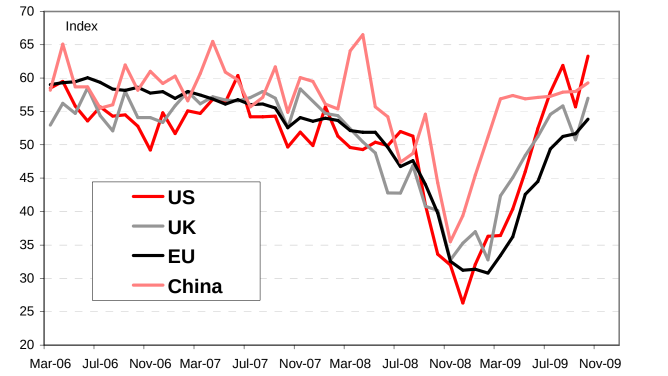
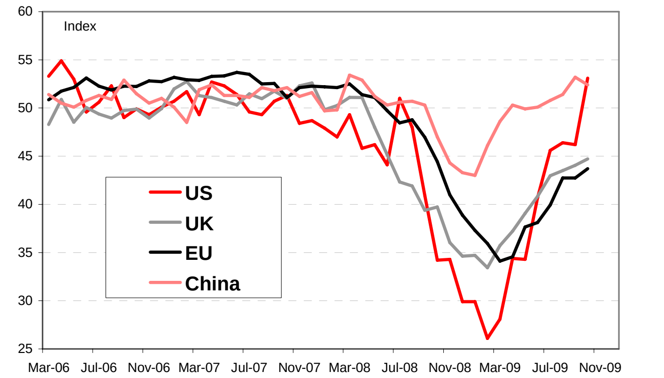
Global PMI/ISM trends --- Production

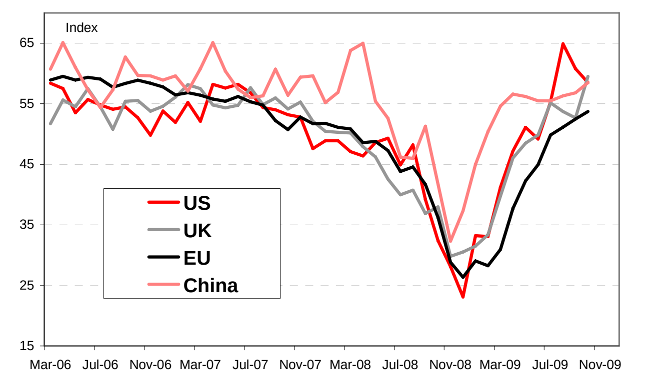


Employment

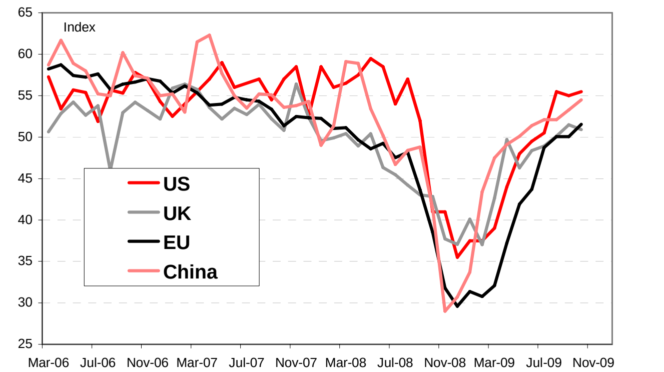


Source: Bloomberg, SG Cross Asset Research

New Orders



Export Orders



Source: Bloomberg, SG Cross Asset Research

Where is the relative value among global economies?

Major economies went into retreat following the Lehman Brothers' bankruptcy and are posting bounces in reaction to policy efforts and a growing sense of calm. Divergences should emerge in 2010. Divergences are not the same as de-coupling. We continue to view the global economy as highly interdependent. Within the cycle, however, there are winners and losers.

China and many commodity-rich countries should outperform. This feature has immediate ramifications for exit strategies. The Reserve Bank of Australia was the first major central bank to reverse course and commence a tightening of monetary policy. Australia benefits from its rich natural resources and its trading relationships with China. The first and most substantial tightening of policies is expected to come from non-Japan Asian economies and from commodity-rich countries. The better performance of these economies, and the earlier rate hikes by their central banks should strengthen their currencies.

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Within the developed world, we see the US as better positioned to sustain the recovery into 2010. This would mark a significant departure from the highly synchronized recession and early recovery cycle. It may also seem counterintuitive to the longer-term deleveraging pressures facing the US economy. The reasons for our view – discussed in greater detail in one of our thematic sections – include substantial pent-up demand, better prospects for employment, an undervalued currency and smaller risk of fiscal tightening. While the US is likely to outperform, decoupling would be far too strong a characterization. Prospects are for a modest economic recovery relative to previous recoveries. The differences between these two major economic regions are not nearly as substantial as, say, between China and the majors. Foreign exchange and interest rate markets, however, should be aware of the increasing potential for the growth prospects these two economic regions to diverge

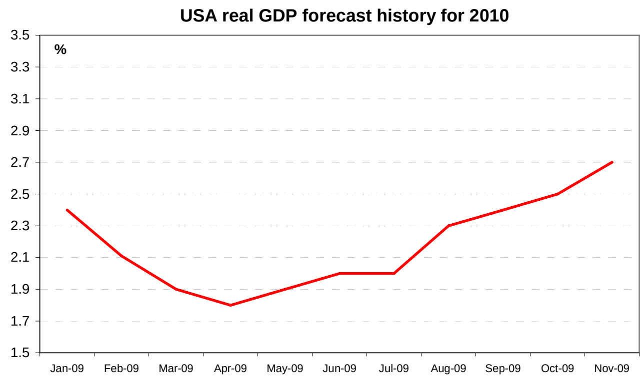
These differences are not about bragging rights. These factors suggest earlier and/or greater tightening of monetary within the block of major economies, should determine investment flows and have heavy repercussions on the currencies. At present the dollar and pound are among the weakest currencies. The yen and the euro are the strongest. Yet, these currencies create benefits and burdens on the economies. The Japanese economy has some of the weakest prospects, despite its proximity and integration into a strong Asian region. The limited pullback and the strength of its currency which has weakened its competitive position are factors.

What is a sub-par recovery?

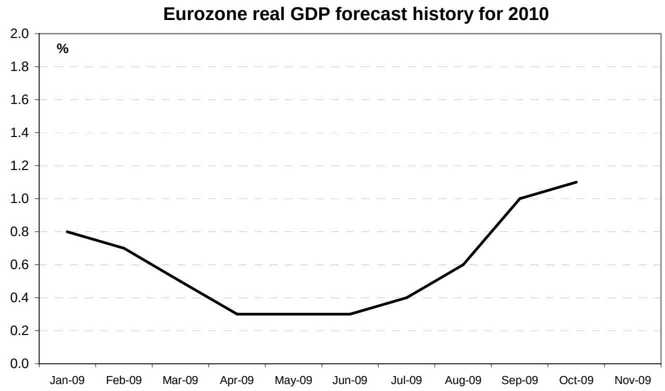
Growth expectations are rising, and may rise further, given recent momentum. Growth, however, is likely to remain substantially slower than a typical recovery. For a strong recovery, GDP growth needs to be exceptionally higher than potential growth to absorb excess capacity. At a pace near or even slightly above trend, considerable time is needed to absorb excess labour and capacity.

The outlook for 2010 global growth has gradually been on the upswing since last spring. We illustrate the rise in market consensus expectations for 2010 in the charts below. The upturn has coincided with market gains, although the cause/effect is not at all straightforward, and both are reacting to updated information.

Consensus Growth expectations on rise for 2010 -- momentum is up



Source: Blue-Chip Economic Survey and SG Economics



Source:, Consensus Economics and SG Economics

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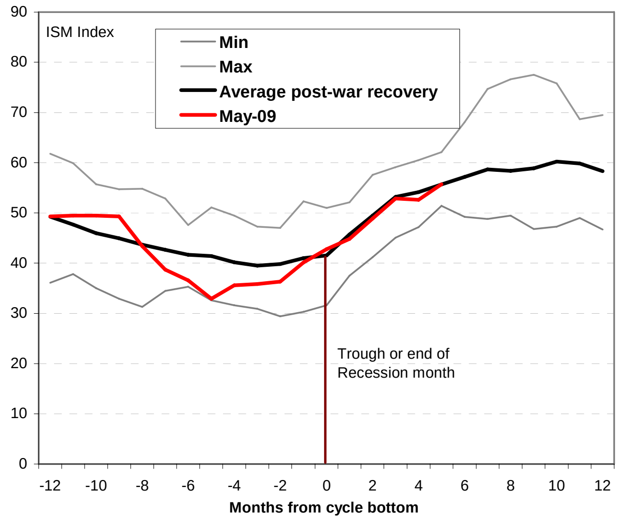
The major impetus for gains in activity has been inventories and trade. Businesses globally reacted swiftly to the financial crisis and weaker consumption trends by shutting down production and cutting inventories. In many cases, it appears the reaction was too abrupt. Consumption has been weak, but production and employment cuts brought about unprecedented inventory cutbacks. Even last spring, our economic forecasts focused on the inventory rebound as a source of growth. As we end 2009, we can see that we were too conservative regarding the amount of growth that could result from an inventory upswing, and even today, inventories may be still an underestimated source of growth for the global economy. The good news is for late 2009 and early 2010, when the positive momentum could propel growth targets higher. Unfortunately, sustainability questions plague the longer-term view.

For 2010, we continue to look for a sub-par recovery, although as growth estimates rise, a clearer picture of a sub-par recovery is materializing. Too often, there is an implicit assumption that a sub-par recovery implies growth below long-term trends or potential. Growth of 3.0% is too readily viewed as economic good times. That assumption makes sense if the US economy is operating close to its potential. Today, however, the economy is operating far below potential. The output gap, the deviation between actual and potential performance is at a post-war record, even allowing for the uncertainty in this measure. At 3.0% real GDP growth, the US economy would not close the output gap until 2014. This type of growth, which is above current consensus forecasts, would still mark a very sub-par recovery for the US.

The deepest recessions historically have been followed by the strongest recoveries. **The average recovery in the US during the post-war period resulted in two-years when real GDP posted an average growth rate of 5.0% per year.** The symmetry reflects a tendency to close the output gap relatively quickly. We do not expect the strongest recovery for the global economy, but perhaps something closer to average is warranted. If history were to repeat itself, 2010 would be among the strongest years of economic growth. Yet, our forecast for 2010 for the global economy is just 2.5%. That pace is heavily tilted by strong growth expectations for China and non-Japan Asia overall.

Manufacturing – near normal recovery for the US



Source: Global Insight, SG Cross Assets Research

Recoveries from deepest recessions in the US

Start date of recession	Decline % in real GDP during recession	Growth, % avg annual, for 2 years in recovery	Potential GDP via CBO
Q4 2007	**-3.7**	**?**	*1.7*
Q3 1957	**-3.7**	**5.7**	*2.8*
Q4 1973	**-3.2**	**4.7**	*3.2*
Q3 1981	**-2.9**	**6.6**	*3.1*
Q2 1953	**-2.6**	**5.0**	*3.5*
1929-1933	**-26.6**	**9.9**	*NA*

Source: Global Insight, Congressional Budget Office (CBO), and SG Cross Assets Research

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Between our modest growth expectations and a strong recovery there may be more upside risk than previously imagined. We focus primarily on downside risks because of the crisis, the need for financial reform, and a need to rebalance global growth. Add to that a need to unwind exceptionally strong policy stimulus efforts, and there are many reasons to turn cautious. Yet from the weak start point, we may be underestimating the ability for economic forces to normalize.

The chart and table above offer a historical context for recessions and recoveries in the United States. The table on the right shows the deepest US recessions in the post-war period of the United States. The recent recession starting in Q4 2007 matches the weakest recession that started in late 1953. Both posted a 3.7% drop in real GDP from the peak to the trough. In the first two years of recovery after the 1953 recession, real GDP growth averaged 5.0% per year, significantly above potential GDP at the time and significantly above current consensus growth forecasts.

Current consensus estimates for US growth in 2010 and 2011 are between 2.5% to 3.0%. Even at the top of that range, a recovery would take considerable time to return to its pre-recession peak, and much longer to return to its underlying potential. At 3%, the US economy would not return to its Q4 2007 level until the third quarter of 2010, more than a year—five quarters—from its trough. Such a scenario would also meet the average characterization of the IMF study that suggests longer recovery times. The key conclusion we make here is that there is further upside risk to the strength of the US recovery and yet it would still meet the specifications from the IMF for an average recession/recovery triggered by a financial crisis.

2010 – Exit Odyssey

Exiting from exceptional stimulus policies too soon could trigger a relapse for the global economy. Too late, and inflation or new asset-price bubbles might be created. The Odyssey is an epic tale of a 10-year trip by Odysseus to return home to Ithaca after the Trojan War. The epic covers a long series of adventures on his progress home, a trip complicated by unexpected distractions, experiences, and hardships. Exit strategies should extend beyond 2010, but hopefully not as long as 10 years.

The coming year should bring the initial unwinding of various policy efforts - both monetary and fiscal - but also of temporary bank regulation. Certain elements of this unwinding have already begun. Central bankers have let some temporary liquidity programs expire. Fading demand from the marketplace has made certain programs nearly obsolete, even if they were critical at certain days, weeks or even months during the height of the crisis.

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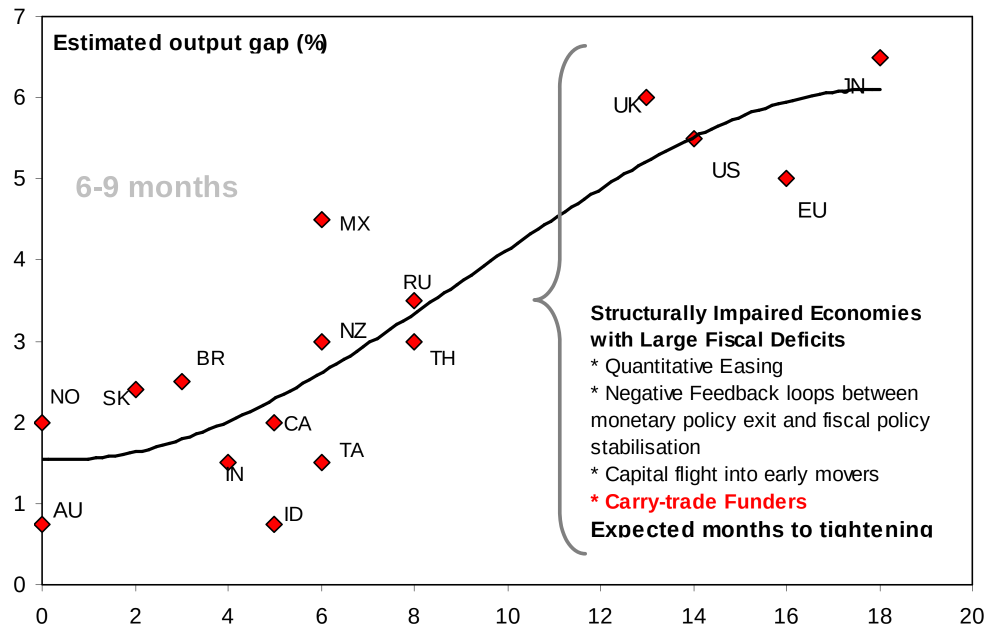
The start of rate hikes globally depends on size of output gaps



Source: SG Cross Assets Research

For 2010, exit strategies most commonly refer to the exits made by central banks from their exceptional policies, or quantitative easing that have greatly inflated the balance sheets of the central bank and left short-term target rates close to zero. We generally envision central bankers taking steps to absorb excess reserves offered to the banks before commencing with rate hikes. A few elements need to be in place before central banks seriously consider rate hikes:

- Economic growth needs to return, somewhat close to potential and bankers need some degree of confidence that growth trends remain positive. For the US Federal Reserve, such confidence comes with employment gains.
- Financial institutions must show signs of healing. Profits are up, and banks have managed to raise funds without government guarantees. There is the possibility of more write-offs though.

■ Inflation expectations need to have bottomed. The concern more recently has been the potential rise of inflation expectations. It would not be hard to imagine, however, that a sluggish recovery, new bank write-down pressures and falling oil prices could reduce inflation expectations.

Timing of rate hikes is of top importance to the financial markets. Already the Reserve Bank of Australia and Central Bank of Norway have hiked rates. **Rate hikes from the major central banks are not expected until the end of 2010, or more likely the start of 2011**. Employment gains and further GDP gains in 2010 are very likely to shake up the anticipated timing of central bank moves. Very recently, markets began speculating on rate hikes by the Fed prior to mid-2010 on the back of GDP gains.

Inflation trends remain low for the immediate forecast horizon and as such, temper long-term bond yields, aid the recovery of real estate markets, and allow central bankers more time before lifting rates and taking other steps to exit exceptional policy measures from 2007-2009.

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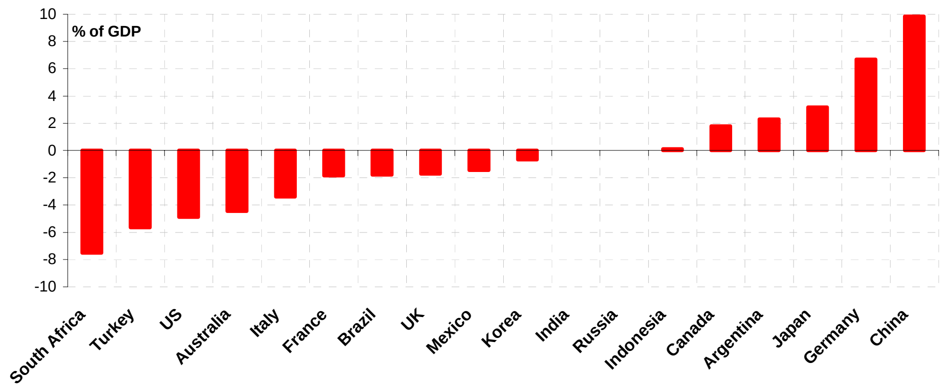
Rising gold prices, heavy government budget deficits and chances that the central banks could move too cautiously in withdrawing reserves from the banking system could be adding to longer term inflation expectations. Gold price gains may be a reflection of long-term inflation expectations that are not being captured in the inflation-indexed government bond markets. Expectations should remain a key variable closely watched by central bankers.

Rebalancing growth

Chinese government policies were aimed at supporting domestic demand rather than struggling export sectors following the collapse in world trade after the Lehman bankruptcy. Meanwhile, weaker consumption recoveries in the mature, western economies are the basis for expecting the sub-par recovery overall.

Finally it's time to work down extreme current account positions -- 2008 CA balances

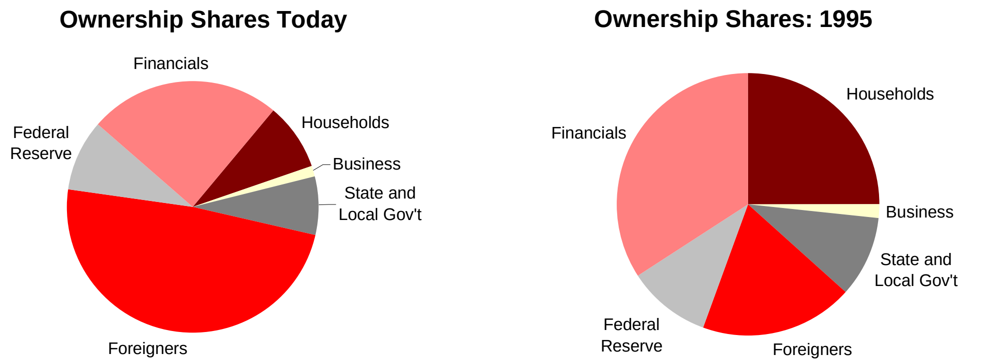


Source: SG Cross Asset Research

With deficits in China, who will fund massive US and western debts? Increasingly there is a need to be self-funding. This is of course a healthy re-balancing, but like exercising toward improved health, there is often soreness, injuries and stumbling. Higher savings rates are underway in the US. From less than 1.0% at the start of the recovery, the most recent savings rate was 3.0% in Q3 2009. The path has already been very erratic with a high of 5.9% to a low of 2.8% in August. Large and frequent revisions of the savings rate make it difficult to ascertain with any confidence what the current rate is.

The trouble in rebalancing is whether the take-up in funding the US deficit by domestic savers will match the withdrawal from foreign investors. Another worrisome point is that US investors have re-allocated investments out of US Treasuries due to low returns relative to other assets. It requires higher savings and a risk/reward outcome to attract domestic investors into the market again. Back in 1995, just ahead of the Asian crisis, was the last time a combination of US households and US financial institutions owned a majority of the debt.

Who buys US Treasuries? Owners of US Treasury securities



Source: SG Cross Assets Research and Federal Reserve Flow of Funds

Crowding-out adds to concerns that increased returns may be needed to again attract domestic investors back to the US Treasury market. Through recent auctions, we see no sign of a major pullout of foreign investors from the US Treasury market. However, foreign investors are heavy sellers of Agency debt as they buy Treasury debt. We wonder if that pattern will hold after the Federal Reserve stops its Agency purchase program in March 2010. Crowding-out should become more of an issue as corporate debt issuance picks up in 2010. We do not foresee a large gain in debt by US households.

Slowing debt paydown as auto and home sales recover is the more appropriate expectation. US businesses, however, may be in a stronger position to issue new debt. Already gross issuance is recovering. Strong profits and rising business investment, inventories and payrolls suggest a pick-up in debt growth in 2010. Treasury issuance, which registered $1.8 trillion in FY 2009 had limited competition for funds, but even a smaller amount of Treasury issuance in FY 2010 of $1.2bn to $1.4bn could be challenged by competition with the corporate debt market. The most recent Treasury quarterly refunding cycle in November 2009 included concerns on this issue from the Treasury Borrowing Advisory Committee.

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Upside risks – exuberance

Normalization should not be ruled out. The progress made at year-end 2009 is considerably greater than expectations during the first quarter of 2009. Few imagined the run-up of market pricing for risk assets. Few saw US home prices turn around as early as mid-2009. Nearly every conceivable upside risk centres around the massive amounts of liquidity that have been injected into the marketplace and contributing to the market gains. Importantly, confidence and risk-taking easily follow.

Availability of cheap money for banks is one of the more striking examples of early normalization. The crisis began in August 2007 when banks faced increasing short-term funding difficulties. The cost of short-term funds soared and the supply of funds beyond a few weeks became scarce. Charted below is the 3-month LIBOR rate compared to the expected fed funds rate. It was commonly received wisdom during the crisis that banks would no longer enjoy cheap financing costs as they had during the years prior to the crisis. Trust in the banks had vanished. Higher risk premiums would prevail. Yet funding costs, as measured by LIBOR fell below 30bp in August 2008, or roughly 12bp over the effective fed funds rate. Money has rarely been cheaper for banks in a relative sense and never cheaper in absolute terms.

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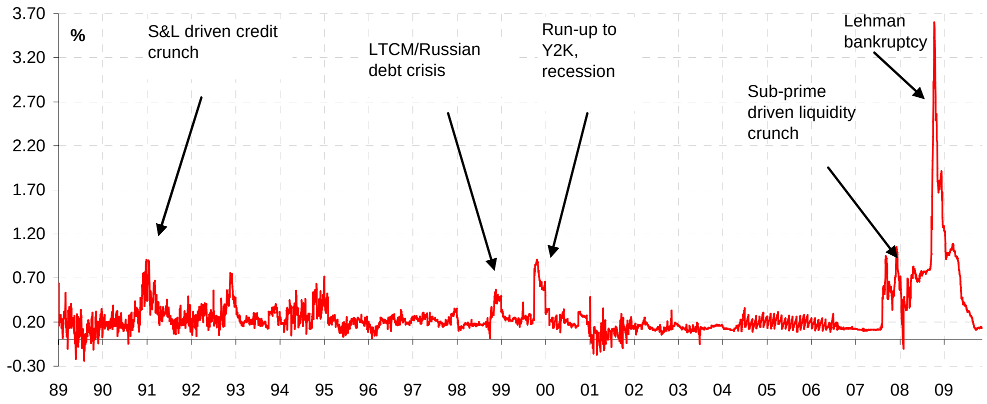
3-month Libor spread to fed funds rate—cost of banking funds



Source: Bloomberg and SG Cross Assets Research

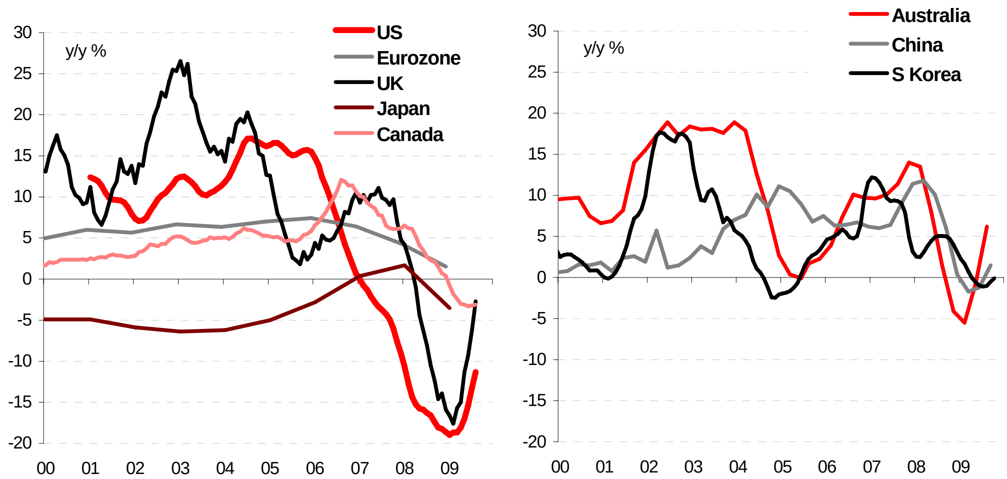
Cheap funds are important. Investors are using these cheap funds and investing them in a wide variety of asset classes. The US dollar has become the funding currency of choice. Nearly all assets, aside from the US dollar, are benefiting. How far can this go? Likely until investors fear Fed rate hikes, refinancing risks and overall a reduced supply of cheap funding.

Reflation is one description of this process. The mother of all carry trades is another. For the economy, cheap funding can make investments, physical as well as financial, look far more attractive than they should. Central banks may need to worry about more than inflation. Asset bubbles are another concern. Over time, central banks will be considering asset prices far more than they did in the years preceding the current crisis and the 1998-2000 equity price bubble. **With employment weak and inflation readings low, central banks are more likely to be cautious and err on the side of waiting too long. Such a bias can fuel asset price gains in the near term.**

The economy can also respond to climbing asset prices. Equity and home price gains can greatly benefit household wealth. Corporate profitability is already strong in the US. These factors can generate more upside risks than currently appreciated.

US home prices are turning at mid-2009 when we had expected a turn to occur only two or more quarters after sales turned higher. Home prices were a key trigger in the unfolding crisis. A rise in prices now could support values of mortgage securities. We expect much stricter underwriting standards from banks and other mortgage originators whose numbers are far fewer today than three years ago. Yet, banks now have easy money. Government support programs are working at full blast. There should be significant pent-up demand for housing in many countries, given the very low level of construction projects. If wealth is rising and lenders have access to cheap money, there may be more risks to the leverage cycle than imagined.

Home prices may turn sooner than expected



Source: Bloomberg and SG Cross Assets Research

It is easy to lecture borrowers and lenders on what is prudent. It is natural to expect that households and banks could be far more conservative for several years. Financial market gains, such as the 60% rise in the S&P 500 from the low point, may be a warning light that upside risks remain.

Should this scenario play out in 2010, the economy and inflation risks would both be greatly to the upside. The US dollar would deteriorate significantly because of its position as a funding currency. We would expect the central bankers to eventually tighten their reins on markets. The precise timing might be difficult, because the exuberance scenario is based on a belief that high unemployment and low inflation readings maintain highly accommodative policies. Rate hikes could be very pronounced in 2011 or later, rising far more than expected.

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Downside risks—pulling the plug on BRICs

Heavy policy supports remain in place throughout much of the developing world. The chief risk is premature exits on some of these policies. Monetary policy is unlikely to turn so abruptly as to derail a recovery, unless of course inflation expectations soar, or an asset bubble becomes a serious threat. Even then, central bankers could deploy other tools, perhaps through the regulatory side, to remove financing support for any forming bubble.

A premature tightening of fiscal policy is another obvious risk and perhaps a growing one for 2011 rather than 2010. Another collapse of a major financial institution could be a problem. Yet, CIT and GMAC have undergone major setbacks without triggering systemic risks. Policymakers continue to shield the economy and the financial markets from such an event. The deteriorating performance of the Commercial Mortgage-Backed Securities market and its negative repercussions on banks is a well known current risk. That segment of the financial markets remains under distress, but the Fed's TALF program is already in place. Moreover, it would be one of the most advertised and anticipated crises ever to unfold. The commercial real estate market faces hard times, but rebounding corporate profits, a recovery of the underlying economies, and massive monetary policy support remain in place.

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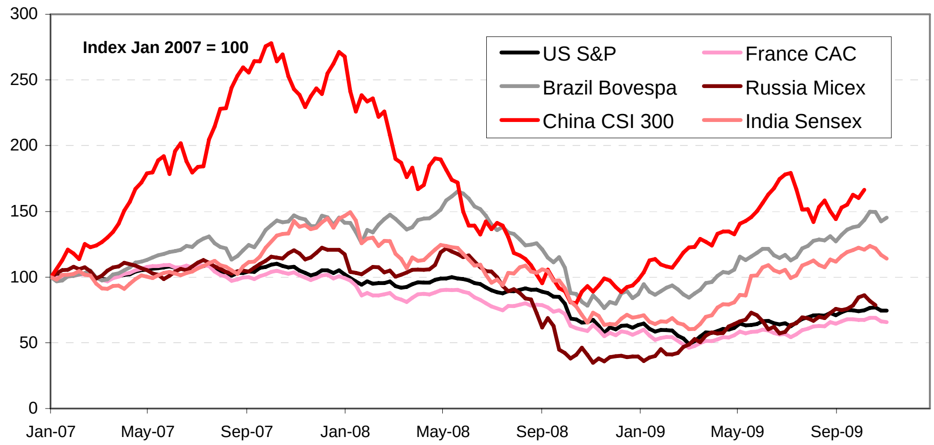
Global equity markets tilted in favour of BRICs and the like

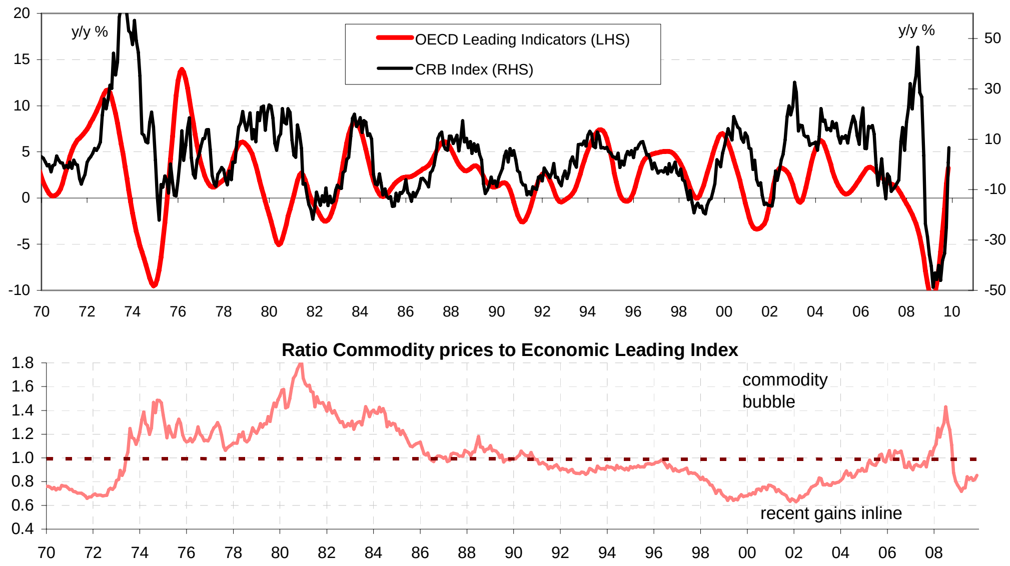


Source: Bloomberg and SG Cross Assets Research

An overlooked risk could be in the emerging market/commodity sector. Considerable investments are currently directed at the developing economies. Market performance for BRIC assets has been stellar and requires increasing attention as risks mount. The economies appear sound and strengthening. A large number of emerging economies depend on the prospects for commodity prices. That claim can also be made for a handful of very well-developed economies such as Canada and Australia. **The potential for a commodity price bubble and the exposure of certain countries and investors to commodity prices could be another source of risk for the global economy.**

We map the CRB Commodity Price index against the OECD Leading Economic Indicators. From this simple exercise, we can make some insights as to how far commodity price trends might be diverging from global economic trends. We used this method to warn of an intensifying commodity price risk in the first half of 2008. At present, gains in commodity prices appear well in step with gains in economic activity.

Commodity Prices to Leading OECD Index



Source: SG Cross Assets Research

Even if this works on a global basis, the simple process cannot detect the wealth transfer that may be underway between commodity-rich/exporting countries and commodity-consuming countries. Rising growth in commodity-rich countries along with rising prices can pose serious challenges to major commodity importers. This would be a de-coupling scenario. We reject the de-coupling angle, because we believe that substantial downward pressures on commodity-consuming countries would eventually trigger declines in commodity prices. Falling energy prices offered some relief to consumers in developed nations in late 2008 and early 2009. That could remain a factor, but it seems a greater global risk now would be for commodity prices to plunge, impairing growth prospects for emerging markets which constitute the important drivers of growth in the current conjuncture. Commodity prices, in a sense, have a narrow channel to run in during the next few years and sharp swings could wreak havoc on the fragile recovery.

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Thematic *Drivers of Growth*

Asia's Serendipitous Tipping Point

Domestic demand is strengthening in Asia independently of external demand. This is not decoupling; it is even more profound than that. The causality of coupling has switched. The delta in Asian growth now drives the delta in global growth.

One year ago, the only D word on people's minds was Depression. Today, the D word is decoupled; however, that term continues to be as misappropriated as always. Asia remains coupled; however, rather than causality running from the high-income economies to Asia, growth causality is running the other way. Fed Chairman, Bernanke, for instance, gave an entire speech in San Francisco on the 18th October where he spoke about how Asia's industrial production was growing independently of export demand due to stronger domestic demand. Bernanke noted that the Asian recovery to date has been significantly driven by domestic demand and that "the revival of demand in Asia has, in turn, aided global economic growth".

Asia's Industrial Production and Exports from September 2008

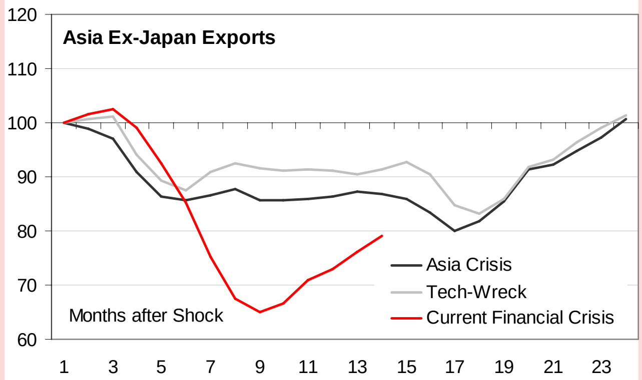
Country	Industrial Production	Exports
China	**1.14**	**0.85**
India	**1.1**	**0.86**
Indonesia	**1**	**0.8**
Australia	**1.02**	**0.78**
Korea	**1.11**	**0.92**
Thailand	**1**	**0.92**
Singapore	0.92	0.89
New Zealand	0.88	0.9
Malaysia	0.94	0.8
Hong Kong	0.91	0.91
Philippines	0.85	0.89
Taiwan	**1**	**0.87**
Japan	0.8	0.69

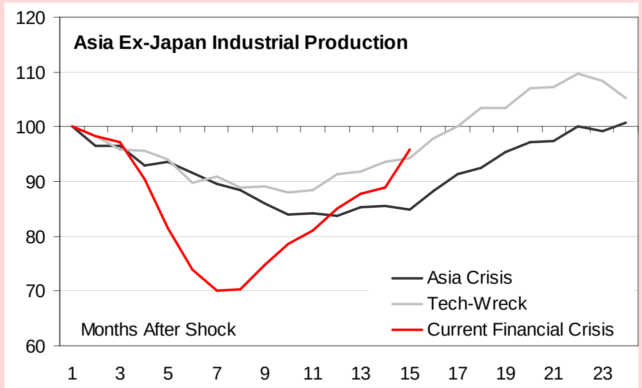
Source: IMF, Bloomberg, & SG Cross Assets Research

Not only has industrial production growth in China, India, Indonesia, Australia, Korea, and Thailand reached new highs, regional production is comprehensively outstripping regional export growth. This is exactly the type of pattern you would expect to see if growth in domestic demand, rather than growth in exports, was the predominant driver of increases in domestic production.

Earlier this year, many of the Asian economies were in freefall, and a quick recovery seemed difficult to imagine.

The rebound in Asian Industrial production is remarkable relative both to exports and historical experience





Source: CEIC, SG Cross Asset Research

In both 1996-97 and 2000-01, Asia devalued its currencies and exported its way back to recovery. Quite the opposite is occurring this time. This recovery is taking place in the context of appreciating currencies across the region and exports that remain down around 20-25% across the region compared to pre-crisis levels. So what is going on?

Policy had better traction in this cycle. Asian central banks have cut policy rates to unusually low levels. As a result, the Non-Japan Asia short-term rate has more than halved from 5.5% in July 2008 to around 2.4% in early 2009. Fiscal balances shifted from a small surplus of around 0.1% of GDP in 2007 to an average deficit of around 4.5% of GDP in 2010. Policy moved to an easier footing in dramatic contrast to previous crises where external constraints either forced or constrained the ability of Asian policy makers to act unilaterally to support growth.

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The overall macroeconomic backdrop in Asia was much more conducive to transmitting this policy easing to the real economy. Asia's banking system was in a strong position and easier credit conditions became readily apparent. In a similar vein, non-Japan Asian currencies depreciated significantly against the USD over the initial crisis period. Finally, whereas in previous crises the government deficit was used to bail out the financial sector, this time, it could be used entirely to support the real sector of the economy.

Asia appears to have moved through the tipping point where a low-income population becomes first-time purchasers of cheap mass-produced vehicles.

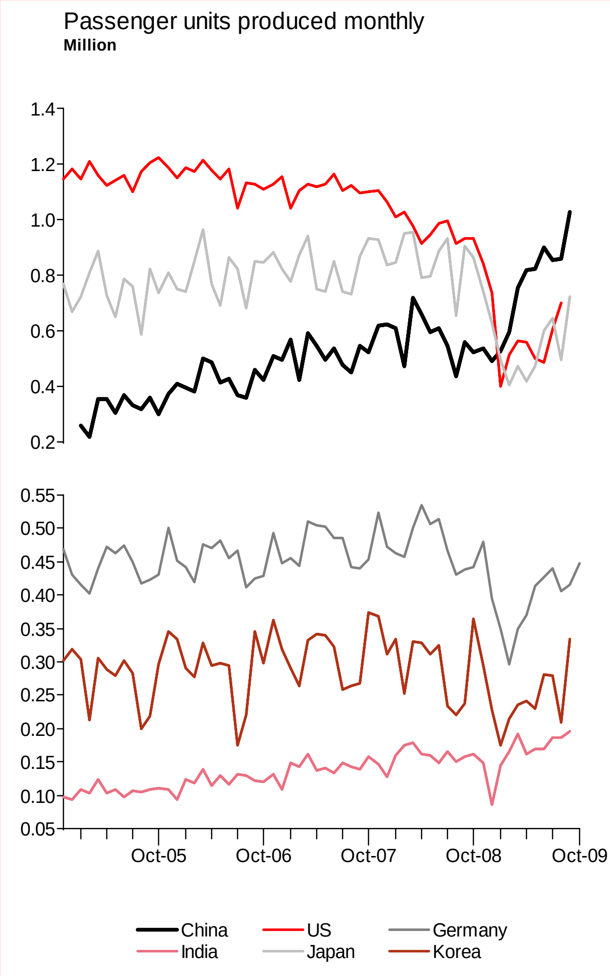
However, policy only partially answers Asia's out-performance. There appear to be two, more powerful, dynamics that have underpinned Asia's quick turnaround. One appears to be a response to the crisis, the second, coincidental to it. Cash-for-clunkers programmes globally have supported the auto sector and the components-heavy Asia-supply chains role in that. Second, just as western world was rocked by sub-prime, both China and India appeared to be move through the "tipping point" where low-income households could suddenly afford cheap mass-produced vehicles. Non-Japan Asian automakers have collectively produced over 600,000 passenger vehicles since the start of the crisis to meet first-time demand.

Serendipitous surge in auto production

Though exports remain weak, we are seeing a clear V-shaped recovery in industrial output in the region. China, India and Indonesia, with relatively higher domestic demand growth have fared better than other economies in the region and are leading this dynamic. However, Korea and Thailand are also now showing strong year-ago improvements in production. The rebound in production appears to be linked strongly to domestic demand. In particular, auto demand, and ancillary industries given the strong forward and backward linkages autos have through the supply chain. At first, this demand was "mistakenly" attributed to global cash-for-clunkers programmes. But now it is apparent that this demand is being created within Asia.

In China over the period of the crisis, vehicle sales have grown by 83%. In India and Korea, passenger vehicle sales have risen by 31% and 77% respectively. This has allowed the Asia production chain to rapidly redirect itself inwards.

The serendipitous rebound in Asian auto production



Source: CEIC SG Cross Asset Research

In the current crisis, the number of cars sold in China exceeds the number sold in the United States. In contrast, in the Asia crisis, for every 100 cars sold in the United States, only 10 were sold in China. Similarly, Indian car sales have trebled over the past eight years.

Reflecting this, global steel production has shifted dramatically between crises. China currently accounts for almost 50% of the global output of steel compared with less than 15% at the time of the Asia crisis.

The Asia Supply Chain is reactivated.

Asia ex-Japan (AXJ) industrial production growth has continued to accelerate in recent months, reaching around 8.0% YoY in September. On a three-month moving average basis, industrial production is now growing around 6.0% after having troughed at around 5.0% in the first quarter of 2009. Asia-ex Japan GDP growth is following a similar

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profile, accelerating to 5.0% in Q2 2009 from a low of 2.5% in the first quarter and this momentum looks set to be maintained in the second half of the year.

For the Asia supply chain, there is only one thing that counts, volume. That volume is now coming from within Asia, not from outside Asia.

China narrows her trade surplus

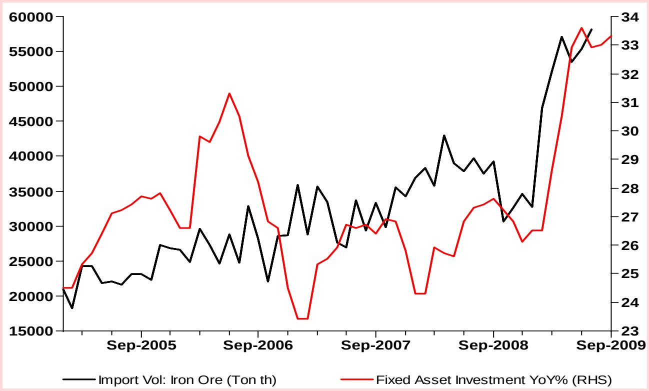
In addition to the autonomous boom in automobile production in China, reactivating the Asia supply chain, China will also support global growth through the dissipation of its trade surplus over the course of 2010. China is in the midst of an import-intensive growth cycle (infrastructure and investment spending should continue to suck in raw materials and basic capital equipment). As China attempts to offset a constrained western consumer with a massive frontloading of planned infrastructure work, China will move into the unfamiliar territory of imports outstripping exports by a wide margin. Over the course of 2010, we expect that surplus to be exhausted and China's trade balance to flip into deficit.

After posting a cumulative trade surplus of USD300bn in 2008, we expect that surplus to shrink to around USD190bn for 2009 and slide into a full-year deficit of USD100bn for 2010.

There can be no doubt that China's policy for economic salvation is an import-intensive one. As China's enormous stimulus efforts have gained traction over the course of the year, we have seen a surge in imports of raw materials and capital goods which respectively make up 30% and 45% of China's import bill. This has been neatly mirrored in surging exports from China's principal capital goods suppliers (Japan, South Korea and Taiwan) and the principal bulk commodity suppliers (Australia and Brazil).

The dispersal of China's trade surplus back to the rest of Asia will be the reversal of the trend of China subsuming the regional trade surplus with the rest of the world, which has been in play since China's accession to the World Trade Organisation in 2001. As the investment programme that China has committed to and the spawning of a first generation of new car purchasers are both trends that will play out over the medium to long term, the support that China will provide to the region via a narrower trade surplus could potentially continue for several years.

Fixed Asset Investment and Iron Ore Imports



Source: CEIC, SG Cross Asset Research

Sustainability of these trends

The predominant school of thought continues to be that if growth is weak in the advanced economies then it is inevitable that it will be weak in Asia. The western consumer and US in particular are still credited as being the end drivers of demand for the region. This is certainly true, and weaker growth in the advanced economies weighs on our Asia forecasts but we must also recognise the positive feedbacks from Asia to the rest of the world.

We have always retained the view that the business cycles of the globe are interconnected. Whilst accepting that interconnection means Asia must inevitably experience a reduction in aspects of its medium-term growth trajectory on softer global consumption, we must also recognise that Asia has the capability to grow strongly through domestic, not external, demand.

After all, the US economy, with a few hundred million people, has grown for many decades largely on the back of domestic, rather than foreign, demand. There is no reason that the approximately 3½ billion people in Asia cannot do the same if the right policy choices are made.

Certainly, in China's case, we find that the country has only completed around 20-25% of the planned spending under the fiscal stimulus programme (see China section). As China's spending is likely to continue at the same pace, the support China is currently providing to the capital goods and commodity exporters of the region could well run into mid-2011.

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Thematic

Going our separate ways

Different potentials for US and Eurozone

Differences in growth prospects between the US and the Eurozone are now emerging and should increase over the course of 2010. Decoupling would be far too strong a characterization. Prospects are for a modest economic recovery relative to previous recoveries. The differences between these two major economic regions are not nearly as substantial as, say, between China and the majors.

Foreign exchange and interest rate markets, however, should be aware of the increasing potential for the divergence of growth prospects in these two economic regions.

Differences between Europe and the US in response to the crisis result in greater pent-up demand in the US and a relatively greater need to hire new workers. This dynamic favours stronger growth and perhaps earlier US exit strategies in 2010 and 2011.

We expect growth of 3.3% in the US in 2010 vs. 1.1% in the Eurozone. The key point is that the US economy should grow much closer to its underlying potential than the Eurozone economy. This difference should become increasingly important to central bank policy setting, interest rate spreads and the heavily traded USD/EUR.

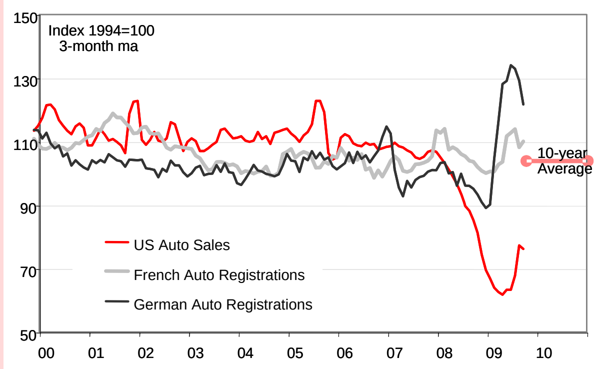
One of the key implications of this divergence is that the Fed should be in a position to signal a policy reversal before the ECB. If that occurs, re-pricing of rate expectations would likely lead to unwinding of the carry trades, triggering a spike in financial market volatility.

Difference in consumption potential

The inventory cycle has been the major driver of growth on both sides of the Atlantic. The wave has lifted all boats, regardless of the underlying demand fundamentals. It has produced the most synchronized recovery cycle in recent history, allowing the two largest core-European countries, France and Germany, to technically emerge from recession before the US.

However, as we shift from the production-led to demand-led recovery, we see potential for growing divergences between regions. Asia and commodity producers should continue to be the leaders – no change here – but one potential surprise could be the out-performance of the US economy relative to Europe.

Car Sales - US more upside potential



Source: SG Economic research

There is a commonly held belief that the US will under-perform its peers due to de-leveraging forces that will suppress consumer spending. That may be true in the long-run, but when gauging the near-term outlook, one must consider the corrections in demand that have already taken place. We consider auto sales which capture the most volatile and most cyclical component of consumption.

Auto demand also captures the impact of government incentives and potential payback effects once those incentives expire. The picture – shown above – does not require much commentary: it is quite clear that demand in the US remains substantially below its demographic trend while European sales are running above long-term norms.

The car incentives, though seemingly achieving the same effect on both sides of the Atlantic, in fact had very different effects: in Europe (Germany in particular), consumers “borrowed” against future demand, while in the US the incentives triggered realisation of pent-up demand. A simple mean reversion assumption leads to a conclusion that the US could out-perform by a wide margin in the next 12 months, even if consumers realize only a portion of the pent-up demand.

Once the easy part of the recovery is over, auto trends could trigger a notable divergence between US and European GDP readings in early 2010. This, in turn, could have important ramifications for the markets. The most important is the timing of policy.

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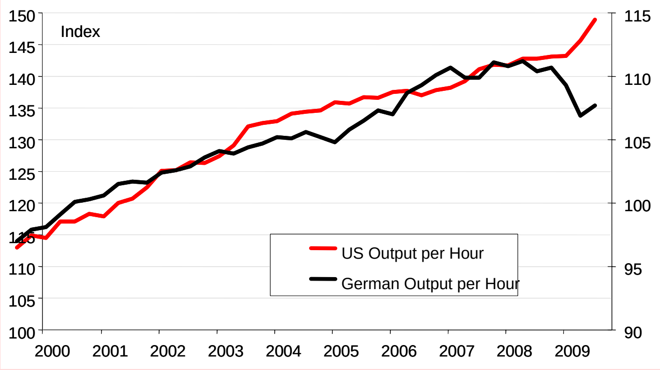
Different employment potential

Productivity Differences – US and Germany



Source: SG Economics- An index of real GDP divided by the number of employees.

A similar conclusion is suggested by the prospects for labour markets on the two sides of the Atlantic, which are of key importance in the transition to domestic demand-led growth.

During the recession, developments in US and Euro area employment were strikingly different. In the US, employment fell unusually rapidly, while the adjustment in the Euro area was muted, not just compared to the US, but also relative to its own history. Calculations by the ECB suggest that using a sample since Q1 1999, an estimate of the impact of a 1% change in GDP on the unemployment rate is materially affected if the three most recent quarters are included: the impact declines from 0.4% to 0.3% (the regression has a constant of 0.6).

By implication, labour productivity in the US has held up reasonably well while it has plunged in the Euro area, and unit labour cost growth in the US has been contained, while it has soared in the Euro area, with the obvious consequences for profitability.

The upshot is that employment in the US is likely to begin expanding relatively quickly once GDP starts to grow. In our view, payrolls are likely to start expanding early in 2010, helping the US make the transition to domestic demand-led growth. In the Euro area, employment is likely to remain weak for a prolonged period of time, as companies work to raise productivity, reduce unit labour costs and restore profitability. Indeed, we expect positive employment growth to only return at the very end of 2010. Wage growth is likely to remain subdued on both sides of the Atlantic but there is the potential for wages and salaries to rebound sooner and more powerfully in the US, providing substantially more support for private consumption than is likely to be the case in the Euro area.

Lastly, it is worth noting that there have been large variations between EMU member states. At the one extreme lie Italy, Germany and the Netherlands with particularly small increases in unemployment given the declines in GDP; at the other extreme are Spain and Ireland, where, again compared to the decline in GDP, unemployment has risen particularly sharply.

Exploiting these potential differences

Consumption and labor potential in the regions begins from two very different vantage points. US consumption has been significantly restricted relative to Euro area gains. These potential differences may never be exploited, but it is important to recognize a potential energy in the US consumer/labor outlook that is not present in the Euro area.

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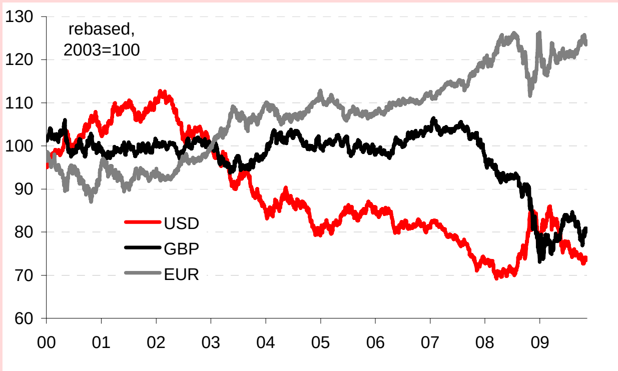
Effective Exchange Rates



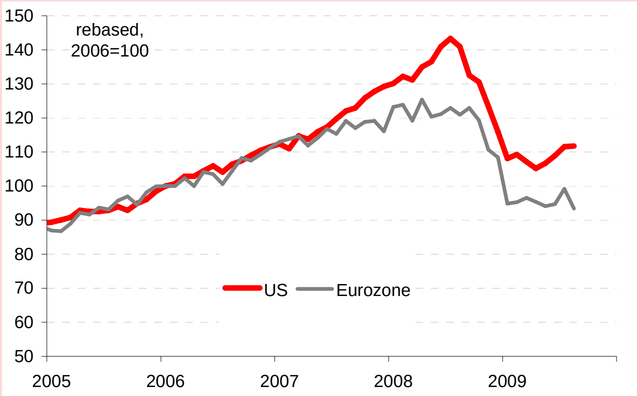
Source: Bloomberg, SG Economics

Currency values offer different export potential

The dollar is a weak currency and the Euro is over-valued. The situation is likely to prevail for a significant time even if the dollar rallies. Long-term purchasing-power models suggest a fair-value exchange rate closer to 1.20 versus the current 1.50 prevailing. The strength of the Euro is already creating some divergence in export trends. There is no certainty these export trends will persist. An analysis of product type and demand strength of importers must be considered, but currency valuations offer US companies greater competitiveness relative to the Eurozone.

Fiscal Policy Difference

Export trends from US and Eurozone

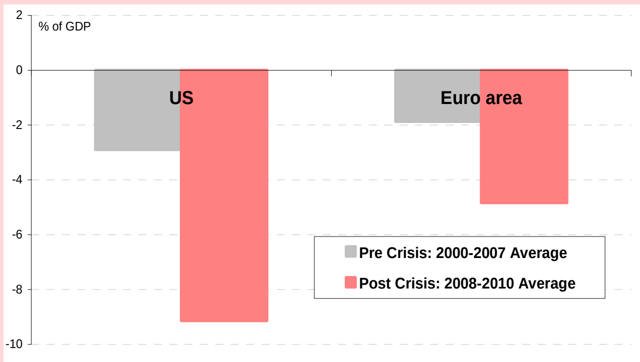


Source: SG Cross Assets Research

Fiscal tightening is expected more in 2011 than in 2010 in both regions. The fiscal stability pact in Europe is likely to drive much tighter policies in 2011. In the US, earlier tax breaks are legislated to expire. There is a strong likelihood that the 2010 congressional elections in the US will encourage officials to extend tax breaks for lower- and middle- Income households, particularly with the unemployment rate at 10% or above.

Fiscal policy in the Eurozone meanwhile must have some adherence to EC policy and oversight.

Fiscal Policy Deficits to GDP in US and Eurozone



Source: OECD, SG Cross Assets Research

Weak economic performance and politics create pressures to raise government spending. Large deficits alone may not be enough to control spending desires. Often, it is the discipline from the markets and the rise of interest rates and market volatility that induce tighter spending policies. At present, there are no bond vigilantes in sight nor are they expected.

Politicians may be unpredictable, but recent performance is a matter of historic fact. Over the past two years, US fiscal policy has already substantially exceeded Eurozone spending. Budget deficit figures from the OECD offer some glimpse into this difference. The multiplier effects of the fiscal stimulus programmes should remain in place for much of 2010.

Central Bank and Market reactions

The Federal Reserve and the ECB are expected to begin hiking rates by early 2011 in the case of the Fed and by mid-2011 for the ECB. From a vantage point of a year or more before these rate hikes, the differences in precise timing for the ECB and the Federal Reserve appear modest.

Stronger differences could easily emerge. We outline above these divergent growth prospects. Historically, the Fed may have a faster reaction function. Timing is one aspect, and magnitude of rate hikes after the start is another important consideration.

If these differences materialize through 2010, markets should begin pricing in earlier, and greater, rate hikes from the Federal Reserve relative to the ECB. As they do, two market trends are likely to transpire. First, the Euro would peak and second, Treasury yields should climb relative to European government yields.

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3 Thematic

Global rebalancing – Step One

The possibility of a less painful adjustment

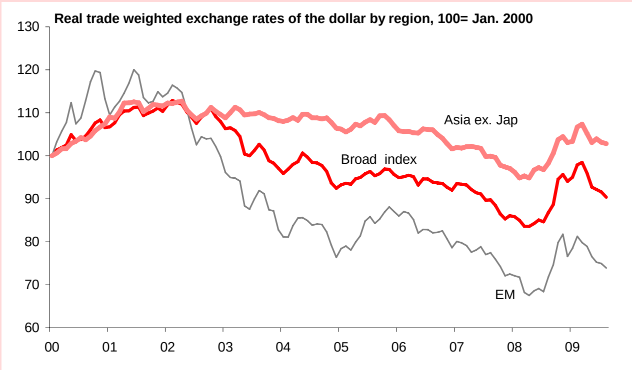
Is there a better way to curb the current account imbalances between Asian economies and the western world than by a rebalancing of consumption across the world and the associated rebalancing of savings? While this process has often been considered by many economists as achievable via the currency mechanism alone, assuming considerable depreciation of the dollar, **the orientation of the global economy post-crisis could well raise the possibility of a less painful adjustment than suggested by such conventional wisdom.**

Currency adjustment fails to reduce imbalances

The efficiency of a lower dollar in reducing the US current account deficit has hardly been supported by the facts so far. Between 2001 and 2008, the real value of the dollar trade weighted exchange rate fell by 25%, a considerable move, not far from what academics generally assume as the degree of the depreciation required to correct the US imbalance.

Rather, the American current account deficit doubled over the same period. By how much, then, would the dollar need to depreciate to have the required impact on the current account? The answer is probably by an unsustainable extent for the rest of the world, especially as rigid exchange rate policies in Asia are preventing the adjustment from taking place where it should.

Rigid exchange rate policies prevent the adjustment taking place where it should



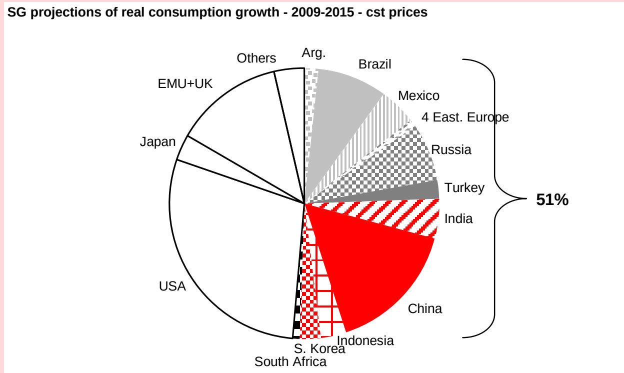
Source: SG Economic estimates based on CPI, SG Cross Asset Research

According to our estimates, the real exchange rate of the dollar against Asian currencies excluding Japan has remained broadly unchanged since the beginning of the decade.

The shift in global consumption under way is more promising

A shift in the global balances of consumption probably offers more hope of eventually correcting the current account imbalances. In this respect, recent developments are undoubtedly moving in the right direction. In the wake of the severe export shock of last year, Chinese government initiatives to accelerate the rebalancing of its growth in favour of domestic demand are at the heart of a more general trend to strengthen consumption in an increasing number of emerging countries.

25% of growth in real consumption likely to come from the main four emerging Asia by 2015



Source: SG Economists estimates, SG Cross Asset Research

Our analysis of consumption prospects for the G20 emerging plus main eastern European countries suggests that, by 2015, more than half of the total increase in global consumption is to come from these countries. This is a substantial increase in comparison to the last ten years, when those countries contributed one-third of the global increase in demand. While Asia is certainly not the only region of the world able to participate in this trend, the main countries of the region represent one-quarter of global growth, with China alone absorbing 15% of this additional demand and the other three, India, South Korea and Indonesia, another 10%.

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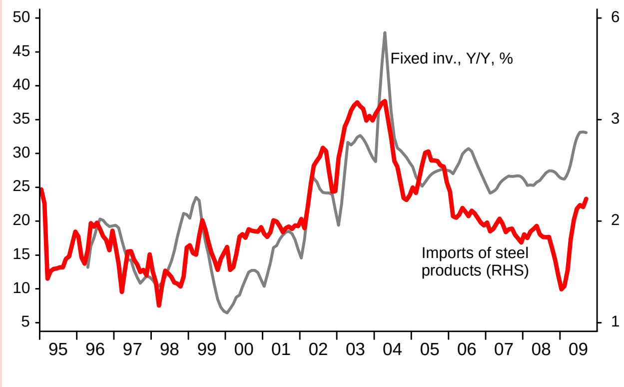
Rebalancing is not a one-way process, but, in the US, there is evidence of small shifts in the right direction too. Our baseline scenario on US consumption/savings is an essential part of the story but not the only one. We expect real consumption to recover from recent lows but remain below the past trend and see savings stabilising before a gradually creep higher medium term. With, on the opposite tack, the catch-up of Asian consumption paving the way for lower savings, the wheels should all thus gradually turn in the right direction. The Obama Administration's policy aim to rebuild economic growth potential and to eventually make growth less dependent on imports and maybe also less dependent on consumption is another change potentially in the direction of reducing in the long run the US external deficit.

Rolling surpluses before rebalancing

Ongoing changes on both sides are, all in all, relatively promising but will obviously take a long time before providing some visible results on current account imbalances.

Here, the time required could well extend to five years or even more before we see the results of today's changes. Our forecast that the Chinese surpluses will disappear in the course of 2010 should not be mis-interpreted. The disappearance of the Chinese surpluses will not find its counterpart in the reduction of the US deficit at this stage but more likely in the **increasing surpluses of commodity providers.** China will import considerably more from them than in the recent past to achieve its programme of infrastructure development, the keystone of its ambitious programme to generate consumer-driven growth in the long run.

Chinese Fixed investment versus imports of steel in volume



Source: Ecowin, SG Cross Asset Research

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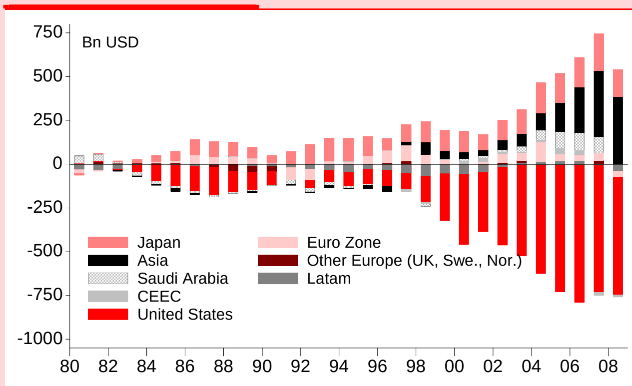
The expected impact on commodity prices from this surge in demand may eventually be a powerful factor to convince the Chinese authorities of the advantage of letting the renminbi appreciate. This would help to complete the structural shift towards a more balanced global situation. In the short run, however, higher commodity prices are more likely to delay the required rebalancing of the US economy to achieve a more sustainable current account position.

Global current accounts



Source: Ecowin, SG Cross Asset Research

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Thematic — *Heading for the exit*

How central banks will absorb excess liquidity

The global recovery that started in the second half of 2009 has fuelled a strong rally in equity markets. This improved confidence has led markets to start asking when exit strategies will be enacted. The diagram below offers an overview of global liquidity and how we see this liquidity influencing the demand for assets. In aggregate, the current stock of global liquidity can be attributed to three sources:

1) the direct injections of short-term funds provided by the central banks;

2) the outright asset purchases also made by central banks; and

3) a third source of liquidity and potentially the largest and most important are the funds that would have normally been held on short-term deposit or in money market funds and other short-term instruments.

We see this pre-existing liquidity as increasingly price sensitive, seeking higher yields by moving out of traditionally 'safe' asset classes because of the low level of returns offered. In our view, this flow of funds towards higher yielding assets has been one of the main factors sustaining the rally in credit and to a certain extent the recovery in equities and commodities. It is therefore natural to ask what could happen to this stock of global liquidity as central banks begin to head for the exit.

Circumstances across countries obviously vary, but, as far as possible, we expect the central banks to begin by reducing their provision of short-term liquidity that has sustained their banking systems' funding needs. This is seen as being a largely automatic process that has progressed as private capital market sources of bank finance have recovered. Hence demand for the Fed's temporary liquidity programmes has been declining, enabling the Fed to reduce the duration and size of the facilities offered through the TAF and the TSLF. In the euro area, demand for the ECB's money market operations has also been falling, although this partly reflects the fact that banks' liquidity demands were sated by the ECB's earlier twelve month tender. We think the central banks will increasingly attempt to co-ordinate a reduction in excess liquidity during the course of 2010. This should in turn hopefully lead to a gradual normalisation of the money markets with the result that overnight rates again converge towards the policy rate.

In terms of asset purchases, we see very little desire on the part of central banks to start selling these assets for fear of destabilising the market and pushing up yields. Instead the increase in central bank balance sheets that these imply could be wound down by reverse repos or issuing short-term bills.

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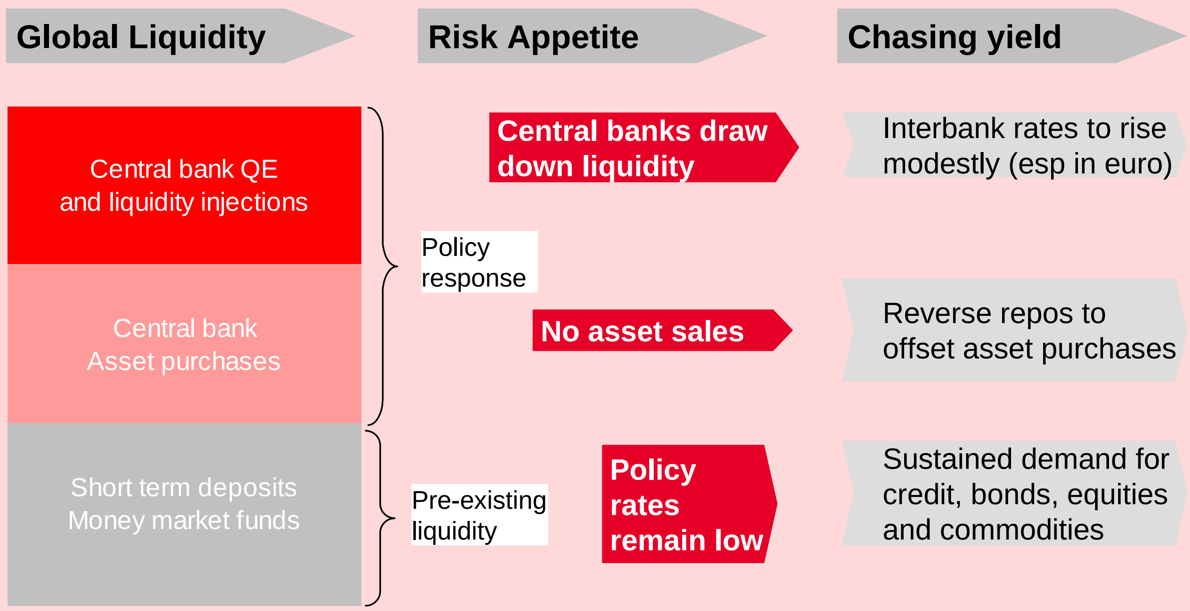

In our view these first moves by central banks for the exit should largely be accomplished with policy rates held at their currently low levels. With inflationary pressures largely absent, there is no urgency for central banks to begin increasing interest rates. The Fed made the earliest and deepest rate cuts. It is likely to start rate hikes before the ECB, supporting the dollar – an effect that will be particularly welcome to European governments and the ECB – and to make bigger moves than the ECB.

This said the ECB's task of withdrawing liquidity should be considerably easier than either the Fed's or the Bank of England's. This is because the ECB's injections of liquidity are directly related to the financing requirements of the banking system. As the banks begin to feel more confident and demand less liquidity from the central bank then the ECB's outstanding money market operations will automatically decline. In contrast, given the asset purchase programmes of the Fed and the Bank of England, reductions in liquidity will require a much more conscious and deliberately targeted approach.

The Fed – no slimming of balance sheet just yet

As of mid-November, the Fed held roughly $2.1 trillion in assets. The size of the Fed's balance sheet has been fairly stable since the beginning of the year, but the composition has changed dramatically in recent months. We estimate that short-term liquidity programs now make up only 15% of the Fed's assets vs. more than half at the start of the year. To date, the Fed's asset purchases have been growing at roughly the same rate as liquidity programs have shrunk.

Could the Fed implement some of its exit strategies earlier than expected to reduce the size of its balance sheet? In theory, that is entirely possible. While asset sales are unlikely at this stage for risk of dislocating credit markets, the Fed could begin to implement reverse repos or take term deposits from banks. The Fed is unlikely to use these to shrink excess reserves from current levels, but could use these programs to offset any future growth in excess reserves. Success of these programs would have the added benefit of demonstrating the ability to unwind the balance sheet quickly when the time is right.

Outright reduction of the Fed's balance sheet from current levels is still unlikely to occur until the middle of 2010, with rate hikes following later.

The ECB - funding problems still the main challenge for European banks

In the euro area, the ECB's "enhanced credit support" has been directly focused on the banking sector as this is the overwhelming source of funding in the euro area economy (in the US, bond markets play a larger role in financing).

This process should commence in the first half of 2010. The most likely sequence of steps to pursue the exit from the ECB's enhanced credit support would look like this:

Step 1: Phasing out of the one-month, six-month and twelve-month Long-Term Refinancing Operations (LTRO), leaving only three-month LTROs, which have always been part of the operational framework. Initially, the latter would continue to be offered at fixed rates with full allocation.

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Step 2: Return to offering three-month liquidity at variable rates and abandoning full allocation, but maintaining full allocation and fixed rates at the weekly Main Refinancing Operation (MROs).

Step 3: Return the MRO to variable rates, but continue to supply large amounts of excess liquidity to the market.

Step 4: Gradually reduce the amount of excess liquidity from the money market.

Step 5: Cease buying additional Asset-Backed Securities (covered bonds) in June 2010, when the €60bn target has been reached, as planned. Selling these off would come only very late in the process, probably not before 2011.

The Bank of Japan - not strictly quantitatively easing

Quantitative easing aims to directly target the volume of money bypassing dysfunctional financial systems. This is what Japan did in 2003-2005. Fortunately, Japan's financial institutions did not rush out and re-leverage as soon as they had finished a decade of painful deleveraging. Hence, the Bank of Japan was in the slightly different position of having a functioning financial system that was not overly leveraged. However, Japan's corporate sector was being absolutely pummelled by the complete collapse in external demand and the freezing up of global trade finance liquidity over the latter part of 2008.

Hence, in the current crisis, the Bank of Japan's unorthodox policy measures were aimed at the corporate sector, not the financial sector. Whereas the ECB and the Fed were taking toxic assets off the financial sector, the Bank of Japan was accepting a broader range of collateral from the corporate sector. In effect, the Bank of Japan was expanding its balance sheet to facilitate corporate financing and was bypassing the financial system altogether.

Moreover, the size of the financing mechanisms Japan has put into place is relatively small compared to the profound expansion of the Fed, ECB and BoE's balance sheets. This simply reflects the fact that corporate financing markets in Japan are quite small. The entire corporate bond market in Japan is around JPY7trn and the BoJ has absorbed much less than JPY1trn of corporate issuance over the period of the crisis.

In the exit strategy debate, it is also important to remember that the Bank of Japan NEVER actually exited quantitative easing entirely. The Bank continued to purchase around JPY1.2trn of JGBs every month, even after the current account target had been wound back below required reserves and a non-zero interest rate policy was in place.

Like most central banks, the BoJ is debating the execution and timing of exit strategies. The Governor and a few outspoken members of the board of the BOJ are stating that domestic financial conditions are no longer a drag on activity. Further, that a strong yen does not pose a threat to exports. These two statements (the last not fully shared throughout Japan) are precisely the types of arguments that signal an inevitable turn in policy. The tolerance for a strong yen is a new feature that may be separate from the timing of BOJ rate moves. The stronger yen would in itself be a form of tightening.

Domestic financial conditions are no longer holding back growth. The Bank of Japan has publicly stated several times that the domestic financial strains that prompted these unorthodox policy moves are no longer apparent. Indeed, the Bank has actually removed them from its risk scenario for the economy. Bank of Japan Governor Shirakawa said in late September that the overall domestic financial climate, ranging from the health of lenders to funding ease and costs, is not posing a threat to a steady economic recovery. Funding conditions may still be tough for small businesses but financing for major firms is showing a clear improvement, with credit spreads for commercial paper and corporate bonds narrowing.

On 30 September, the Bank of Japan said that the credit easing measures due to expire in December would not be rolled over. The Bank is clearly of the view that corporate financing mechanisms have healed to a sufficient extent that the extraordinary support provided by the Bank is no longer required.

We now expect most of the emergency policies enacted over the course of this crisis to end by December and all of them to be closed, effectively by expiry, at the start of the 2010 financial year in April 2010.

The one exception is the Bank's ongoing monetisation of the fiscal deficit by continuing to purchase JGBs at JPY1.8trn per month. Indeed we believe that the new administration's economic support measures and supplementary budget will require these purchases to be increased to JPY2.0-2.2trn by mid FY2010 (Q3 calendar year).

Once again, Japan's experience highlights the profound difficulty of simultaneously exiting extreme fiscal and monetary policy settings. Indeed, the real question should be: is the Bank of Japan actually exiting unorthodox easing or has the monetisation of fiscal policy become so complete that it is impossible to distinguish between the two?

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The Bank of England – starts with rate increases and bill sales

The recent £25bn increase in the Bank of England's asset purchase programme to £200bn is widely seen as the final push. Once these purchases are completed in February, we expect that the Bank will say it is "pausing" and then the emphasis in the markets will switch to the exit.

The Bank has already mapped this out. It will comprise three parts:

1. Raise rates
2. Sell Bank of England bills to reduce excess reserves;

The Bank will most likely use steps 1 and 2 together but has made It clear that the signal for the start of the exit will be a rate rise;

3. sell back the gilts purchased, but very slowly! – the Bank will have bought gilts equal to more than 14% of GDP, greater than the size of the budget deficit. To dump these back on the market would cause massive movements in the yield curve. Indeed, in the latest (November) Inflation Report the central projections are made on the assumption that all of the gilts that have been purchased will then "remain there throughout the forecast period." In all the previous communications on the exit strategy, the Bank has said that it would "stagger" the pace of gilt sales. In these assumptions it suggests it will sell nothing for the next three years.

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5 Thematic

Fiscal policy

"In the long run, we are all dead"

This famous maxim from John Maynard Keynes was a call to take immediate economic policy action rather than wait for self-corrective measures to take place "in the long run". Following this approach led governments to take decisive action in the current crisis to avoid a 1930s-style collapse in activity and financial markets, and the rebound in activity widely seen today is the proof that this action has been successful. Now, there is always a price to pay for everything, and the outcome of these ultra loose budgetary policies has been a massive slippage in budget deficits and debt ratios.

Huge slippage in deficit and debt ratios

	Deficit			Debt		
% of GDP	2007	2010	2011	2007	2010	2011
US	-1.3	-8.6	-7.3	35.5	60.4	65.4
Japan	-3.8	-6.0	-6.8	167	189	199
UK	-2.4	-12.5	-11.5	36.5	65.6	73.9
EMU	-0.6	-6.8	-6.3	66.2	83.3	87.8
Germany	0.2	-5.0	-4.6	65.0	76.3	79.2
France	-2.7	-8.0	-7.5	63.8	83.8	90.0
Italy	-1.5	-5.5	-5.0	103.5	116.3	117.5
Spain	1.9	-10.1	-9.3	36.1	64.4	72.4
Ireland	0.3	-14.0	-13.3	25.1	83.8	98.1

Source: SG Cross Assets Research

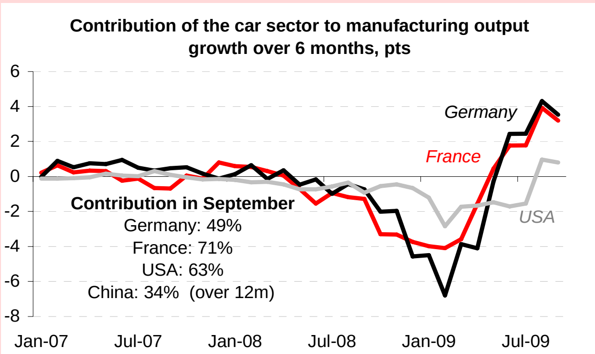
Once growth seems secured, governments will have to change tack and to follow Keynes' principles to implement policy aimed at quickly curbing deficits and stabilising debt ratios. The key questions today are If, When, and How, will this take place? Despite terrible budgetary projections, it appears far from obvious that governments will effectively implement very tight budgetary policies from 2011, as growth should remain very fragile on this horizon. **In many respects, the budgetary equation appears without any solution.**

Budgetary support to fade in 2010 but deficit reduction postponed to 2011… or later

Support from budgetary policy has been massive and helps to explain the relatively better-than-expected behaviour of the global economy in **2009**. With rare exceptions, countries came out of recession in Q3 or even Q2, thanks in particular to specific aid to the car sector. These were not, of course, the only measures to fight the crisis, but by their direct impact on demand, these were the most emblematic.

A large part of the recovery in industrial activity is so far directly tied to these measures, by between 30% and 70% from China to the main EMU countries and the US according to our calculations. In the US, the rebound in car sales has also been driven by structural factors and thus appears a bit more solid, though.

2009: year of the car



Source: Datastream, calculations SG Cross Assets Research

In terms of fiscal policy, **2010** is widely seen as a transition year, before the first year of a long and painful adjustment. The latest European Commission forecasts point to a very moderate easing in fiscal policy in the euro area in 2010 (the structural deficit is expected to deteriorate by 0.2 point of GDP) after having plunged by 2 points in 2009. The IMF provided roughly the same estimates for the EMU and for the US economies in its latest Economic Outlook released in October. This means that policy should remain very accommodative compared to its pre-crisis starting point but should hardly add to economic growth from 2009 to 2010.

And then what? Every government is supposed to tighten policy once the economy looks strong enough to withstand a strict diet, which leaves **2011** at the obvious starting point for the great fiscal tightening… or not. Indeed, so far, we have seen only vague promises or even opposite commitments: **in the US**, on the one hand some tightening should naturally occur due to the removal of tax cuts implemented by the previous administration but, on the other hand, the focus is still on the possible vote of the very costly health-care system reform.

In Europe, the European Commission is putting strong pressure on governments to implement very tight policy as

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soon as 2011 in order to reduce deficits to 3% of GDP in 2013. Most countries seems more or less (2013 or 2014 is still debatable) to agree with this target apart from Spain, Ireland and Greece, which will have no choice but to tighten policy sharply from 2010. However, a singular approach has been adopted by the new German government, which announced further tax cuts (€24bn p.a. year from 2011 to 2013). Thanks to its historically strong credibility and a new constitutional law imposing from 2016 a maximum deficit of 0.35% of GDP for the entire public sector, Germany is still getting the benefit of the doubt, but the message sent is confusing. The French government appears determined to reduce the deficit from 2011, but its credibility is low, as successive French governments have been unable to significantly reduce deficits and, above all, in light of its past expenditure. **In Japan**, the new government has expressed its willingness to "eliminate risks linked to public deficits" but has been short of a concrete plan so far.

In any event, political willingness should be crucially dependent on economic conditions, and while our forecasts assume stronger growth in the US, the output gap is expected to remain negative through 2014, and unemployment should be slow to decline from its high levels (likely close to 11% by spring 2010). In Europe, we think persisting dire conditions in job markets, especially Germany (due to a lack of adjustment so far having led to a sharp fall in productivity), will not put the government in a position to implement very tough fiscal adjustments. Under these circumstances, the fiscal situation is unlikely to improve in 2011 and the debt ratio would continue to increase significantly (see table on the previous page).

Take your pick: out-of-control deficit and debt or terrible fiscal tightening ahead

Given the likely sub-par recovery that usually follows financial crises and, as a consequence, lagging budgetary adjustment, budget deficits should remain high for a while and debt ratios will continue to increase at a rapid pace. **Most of the major developed countries, it is already the case in Japan and Italy, should see their debt ratios approach or top 100% of GDP in the next three to four years**. This looks unavoidable. The European Commission, the OECD and the IMF have worked intensively on this topic and all have come to a similar conclusion: **deficit and debt ratios will not automatically return to their starting points**, even if economic conditions improve, as output gaps will remain large: the tax base has shrunk, unemployment has surged and permanent policy measures represent around 25% of stimulus packages adopted by advanced G-20 countries according to the IMF. **So deficit reduction will have to come from cuts in expenditure and tax increases, or more likely, from a combination of the two.**

According to IMF calculations (Fiscal Monitor, November 2009), if no action were taken, the required effort for advanced economies would rise from 3.5 points of GDP to 9.5% of GDP by 2020.

Required adjustment of structural primary balances

GDP %	Required adjustment... between 2011 and 2020		
2030 debt target	Int. rate-GDP growth (r-g)*		
	0%	1%	2%
60% of GDP			
Advanced economies	6.6	7.8	9.1
High debt	7.1	8.4	9.8
80% of GDP			
Advanced economies	5.2	6.5	7.9
High debt	5.7	7.0	8.5
Pre-crisis levels (2007)			
Advanced economies	6.5	7.7	9.0
High debt	7.0	8.3	9.6
Post-crisis levels (2012)			
Advanced economies	3.4	4.3	5.2
High debt	3.6	4.6	5.6

* The required adjustment is equal to p-(r-g)*b with
p: primary structural balance
r: interest rate
g: GDP growth rate
b: debt ratio
For more details, European Themes, J. Nixon, Sept. 21 2009

Source: IMF,Fiscal Monitors November 2009, SG Cross Asset Research

Case 0 assumes the target is minimal and aims only to stabilise the debt ratio at its expected 2012 level, thus close to 100% of GDP on average, with interest rates equivalent to growth rates. This looks unrealistic for several obvious reasons: such a permanently high debt ratio sharply reduces a country's ability to deal with any shock in interest rates or recession (the case of Italy during this crisis). Moreover, high public sector indebtedness can both crowd out private investment from financing sources (thus eventually reducing potential growth) and trigger Ricardian effects (thus leading to structurally weak consumer spending). Finally, interest rates may increase and thus tighten the sustainability constraint, which depends on the key difference between the interest rate and growth rate.

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Case 2 describes a scenario where the debt ratio would return to 60% of GDP (the Maastricht limit) by 2030 with interest rates being two points higher than GDP growth. This is also probably unrealistic, being too severe this time, as very tough budgetary policy would certainly trigger rather accommodative monetary policy and low interest rates.

A more realistic assumption (Case 1) could be for countries with a close to 100% debt ratio to target a return to 80% by 2030, in a context where the spread between the interest rate and the growth rate is 1 point. **This would require an effort close to 7% of GDP by the end of the decade, thus say 1 point of GDP per year if the adjustment only really starts from 2012 or 2013.** Reference to past experiences (in modern economic history) where countries managed to reduce sharply their debt ratios seems a bit irrelevant, as in the present case, the specificity would be a widespread tightening in budgetary conditions, thus considerably weakening potential export growth.

Past experiences of large deficit reduction

	Deficit reduction (1) GDP %	Length (2) Years	(1)/(2)
Advanced eco.	8.3	7.3	1.4
G7 economies	6.5	9.3	0.7

Source: Data IMF, Calculation SG Cross Asset Research

On the basis of the 30 experiences listed by the IMF for countries having achieved a significant increase in their structural primary balance (thus having tightened substantially their budgetary policy), the average effort has been 1.4% of GDP per year. However, the same calculation made for (the former) G7 countries, shows an average effort of only 0.7 point per year. This difference seems logical as growth in smaller countries relies heavily on exports, which eases the pain inflicted on domestic demand. **All in all, this tends to demonstrate that a scenario where developed economies pursue at the same time efforts to reduce structural deficits by one point per year is somewhat unrealistic.**

For European countries in particular, where the potential growth rate is probably no more than 1.5%, and where unemployment is already very high, this is a very worrying prospect.

Emerging countries: the exception

The state of public finances and the dire consequences it has for the prospects for most developed economies adds weight to the conclusion that structural changes will affect the global economy after this crisis. Leading emerging countries have in general registered significantly less deterioration or no deterioration at all in their public finances since the beginning of the crisis, despite managing to implement large recovery plans. In 2007, advanced G20 economies had an average deficit of 2% of GDP against a slight surplus for G20 emerging countries. In 2010, the spread is expected to have doubled (-8.4% of GDP against -4.1% of GDP (IMF forecast). **The divergence seen in debt ratios, which will have lasting consequences, is even more striking: 78.2% of GDP for G20 advanced economies in 2007 against 37.4% for G20 emerging countries. In 2010, the expected ratios are 118.4% against 36.2%...**

As a result, there seems to be a rather high probability that the only possibility for developed countries to implement significant budgetary adjustment that would lead to a trend reversal in debt ratio in the coming years would be to rely on very strong emerging countries' growth. **This looks a bit premature and thus the temptation to ease the debt burden with stronger inflation may remain a credible scenario for markets for a while to come**.

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Thematic

Financial healing

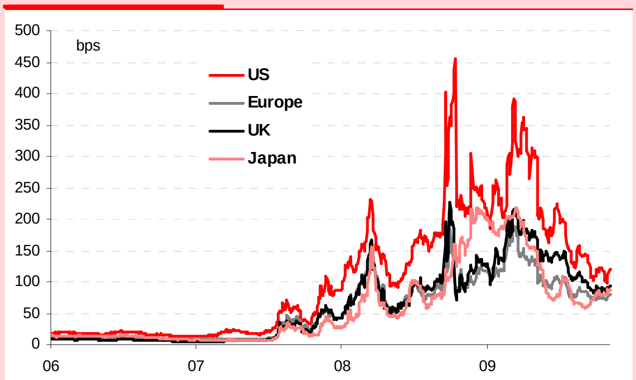
A slow but steady thaw

Recessions triggered by financial crises are typically followed by sub-par recoveries. The banking systems in the US and Europe continue to face credit losses and the uncertainty about asset values is almost certain to restrain lending in the year ahead. This, in turn, is likely to limit the credit-induced boost to growth that would normally occur at this stage of the business cycle. Ongoing credit restraint is the key reason for the asymmetric recovery implicit in our GDP forecasts.

Banks in better shape …

To be sure, policy efforts have done a lot to facilitate the necessary restructuring of the financial sector while limiting the adverse impact on the economy. Capital injections that have been encouraged or imposed by the regulators have ensured that banks have meaningful capital cushions against future credit losses. Stronger bank earnings are also supporting capital levels. As a result, confidence in the financial sector has been restored and banks can now fund themselves in the markets, with reduced reliance on central bank backstops. Libor spreads have dropped to pre-crisis levels and longer-term bank CDS spreads have also narrowed sharply since the crisis. As a result, funding and balance-sheet constraints are no longer seen as a major hurdle to restarting credit growth.

Bank CDS spreads

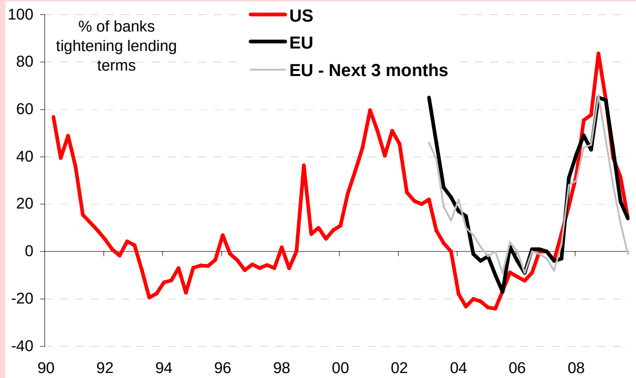


Source: Bloomberg, SG Cross Asset Research

… but not yet lending freely

Yet, other hurdles remain. Getting banks into better shape is an important step towards normalizing broader credit conditions, but healthier banks do nothing for the economy unless they are willing to lend. Here, the news has been mixed.

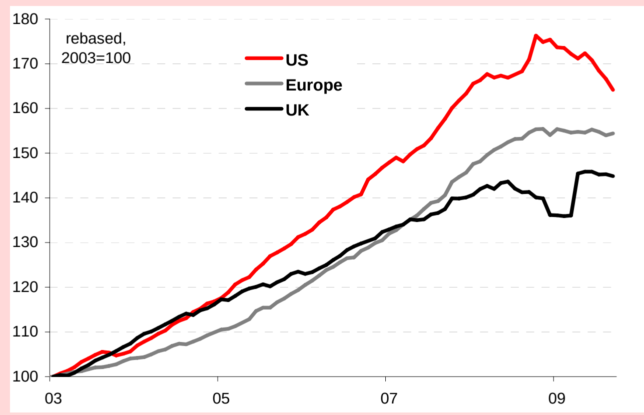
Bank lending terms on business loans



Source: Federal Reserve, ECB

Bank lending surveys suggest a notable, marginal improvement in the banks' willingness to extend credit to households and businesses. These marginal improvements are a good start, but outright easing is needed from the overly stringent lending standards currently in place.

Bank loans outstanding



Source: Federal Reserve, ECB, Bank of England

For now, loan volumes on bank balance sheets continue to shrink, or are stagnant at best. The US has seen the deepest contraction in bank credit, driven by an especially big drop in business loans.

Capital markets to the rescue

Though the US has experienced a sharp drop in business loans, a big portion of that decline reflects refinancing of bank debt into corporate debt. Corporate bond issuance surged in the first half of 2009 as businesses took advantage of the low rate environment to replace short-term bank debt and commercial paper with longer-term financing.

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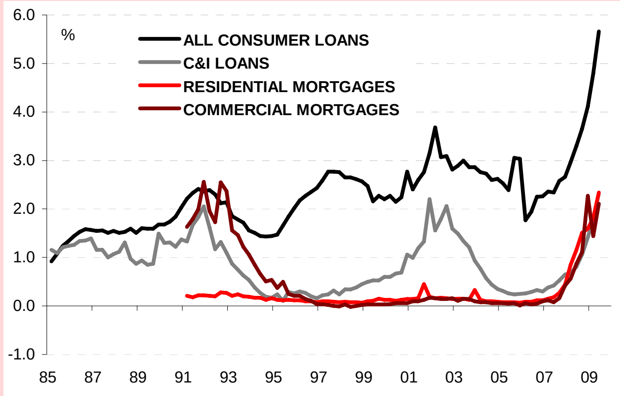
Yet, there are many sectors of the economy that have no access to capital markets. The European corporate sector as a whole is far more dependent on bank credit, and therefore more vulnerable. In the US, small businesses, which have been the main driver of growth, remain at the mercy of banks and have not benefited from improvements in the capital markets.

Credit outlook still a hurdle

The reasons for ongoing restraint in bank lending have now less to do with funding and capacity constraints and more to do with uncertainty about asset values. In senior loan officer surveys, banks report that credit quality and the economic outlook are top reasons for tightening lending terms. Until there is a clear sense that the recovery is sustainable and that credit losses are abating, banks will continue to ration credit.

US bank charge-off rates

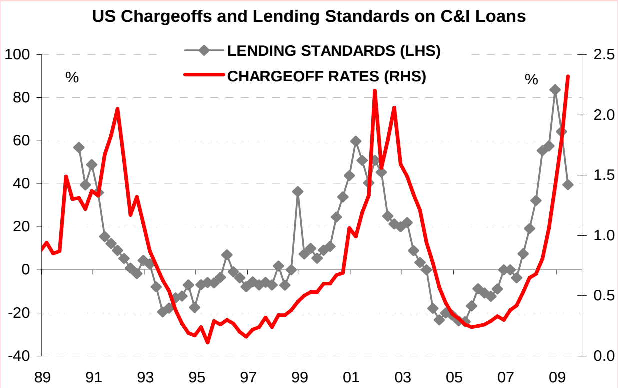


Source: Federal Reserve

Given the outlook for subdued growth and rising unemployment rates, credit losses are likely to continue through 2010, although the worst may have already passed. Indeed, the IMF has recently downgraded its projection for global credit losses to $3.4 trillion from $4 trillion projected in April. Banks globally have recognized about half of this total projection; however, there are significant regional divergences. The UK and US banks are further along than their European counterparts, having already reported about 60% of their total expected losses. In the Euro area, banks have written down only about 40% of their total impaired assets according to IMF estimates.

Though credit losses will continue to accumulate near-term, 2010 should mark the peak for charge-off rates. For example, Moody's now expects the global corporate default rates to peak in November 2009. In the US, delinquency and default rates on credit cards appear to have peaked already and should continue to improve through 2010 as unemployment stabilizes. Delinquencies on residential mortgages continue to move up and foreclosures are set to rise further in the next two quarters. However, by mid-2010, the peak in unemployment and a more stable home-price environment should also stabilize mortgage collateral.

Lending terms lead charge-offs



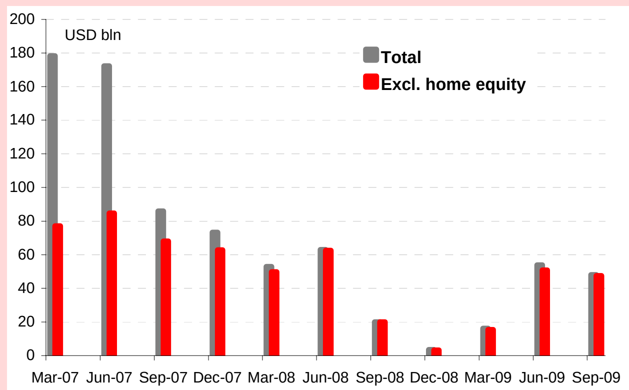
Source: Federal Reserve

Importantly, banks' willingness to extend credit appears to be running ahead of charge-off rates. Therefore the anticipated improvements in 2010 could prompt banks to begin relaxing lending terms as soon as early 2010.

Securitization markets – a slow but steady thaw

The inability to securitize loans and free up balance-sheet space has been another roadblock in efforts to restore credit flows. However, the Fed's launch of the TALF program in March 2009 was an important stepping stone in overcoming this hurdle. To date, the Fed has financed about $50bn of new ABS paper and the Fed's financing has supported over $90bn of TALF-eligible issuance. This has brought the quarterly run-rate nearly back to pre-Lehman levels. The majority of recent deals have been concentrated in auto and credit card paper.

US ABS issuance



Source: SIFMA

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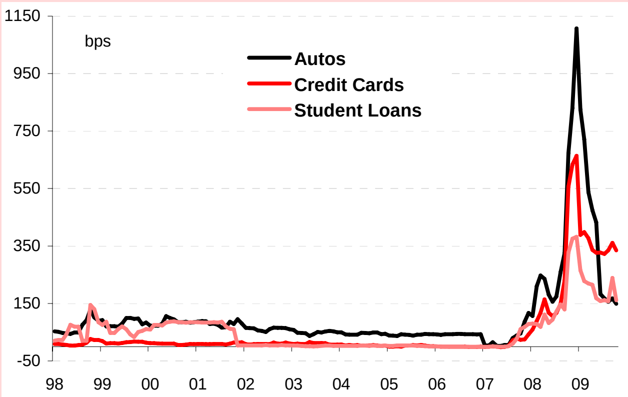
Importantly, the demand for ABS paper spurred by the Fed's financing has led to a substantial reduction in ABS spreads. The decline in rates demanded by investors has, in turn, allowed banks to reduce rates offered to consumers. For example, the average interest rate on auto loans spiked to 8.2% in January but has since fallen below 4%.

US ABS spreads



Source: Bloomberg

Conclusion

The credit environment should continue to improve slowly in 2010 as credit deterioration begins to subside and the values of bank assets stabilize. However, the process is likely to be slow and downside risks remain. As a result, we assume that credit restraint will continue to suppress the expansion in 2010 and, despite substantial pent-up demand, the recovery will be slow.

US vs. Europe

In relative terms, the US financial system may be somewhat better positioned than the European system to support the recovery in 2010. There are two reasons. First is the strong recovery of capital debt markets which is a more important source of corporate financing in the US. In Europe, debt capital markets have historically played a much smaller role and businesses in the region are more dependent on banks for meeting their financing needs.

Secondly, while bank lending is likely to remain impaired on both sides of the Atlantic, US banks appear to be slightly ahead of their European counterparts in completing the necessary restructuring of bank balance sheets. According to the IMF, Euro area banks as of mid-2009 had a Tier1/RWA ratio of 8.5%, compared to 11.5% in the US. These lower capital ratios give European banks less of a cushion for absorbing unexpected credit losses. The IMF estimates that in order to maintain an 8% Tier 1 capital ratio in the face of estimated future losses, European banks will need to raise an additional $150bn in fresh capital while US banks do not need additional funds. Capital pressures appear to be much heavier in Europe, making European banks less likely to support the recovery in the near-term.

One of the reasons for higher capital ratios in the US is that policymakers have been more proactive in recapitalizing weak institutions. European regulators did conduct their own stress tests, but in a less transparent fashion that did not include bank-by-bank outcomes. Without individual results, it is not clear that remedies to address capital shortfalls will be adequate. One of the lessons from Japan was the importance of a speedy restructuring of the financial system, which includes timely write-offs of impaired assets and recapitalization following the losses. The alternative is a zombie banking system unable to provide credit to the economy. The US appears to be better positioned to avoid such a scenario. This is yet another argument supporting our call for diverging performance between the US and the Euro zone.

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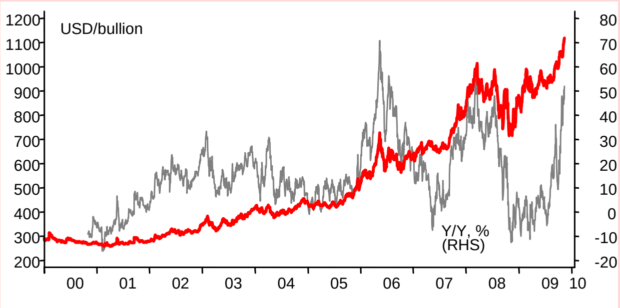
Inflation risk or…

The rationale for surging gold prices

Gold has the bizarre property of being considered by some investors as a good hedge against deflation as well as being the best protection against inflation. Persistent disagreement on the outcome of the current crisis among investors on the back of short-term disinflationary forces versus longer-term inflation concerns has, under such circumstances, been particularly supportive for gold over the last two-three years. However, according to the overall financial market environment since spring, there is little doubt that the surge in gold prices since then has more to do with increasing inflation fears than anything else. Despite negative inflation readings since the start of the year, nothing in any other market segment really suggests that markets have been seriously pricing any deflation scenario in recent months. Rather, equity market performance, falling volatility, the abrupt drop in risk aversion, together with the uptrend in inflation breakevens as expressed by inflation-linked bonds, all tell us that **deflation risks have been markedly dispelled in recent months.** Consistent with these observations is the fact that the steady rise in the price of gold does increasingly reflect rising inflation fears. Is there any rational basis for these concerns?

Gold prices signalling inflation ahead



Source: Ecowin, SG Cross Asset Research

Short-term economic forecasts remain far removed from an inflation scenario

There are numerous reasons to justify increasing concerns about inflation in the long run. We addressed this topic in a report in April already stressing factors behind such reasoning and none of these factors have eased as of today. Central bank balance sheets remain extraordinarily high; public debt is skyrocketing while government involvement in the management of the economies has increased spectacularly since the start of the crisis; world trade remains anaemic and commodity prices have already returned to their upward trend. **Not only has the next economic cycle every chance of being one of excessive money supply, it will also likely be one of persistent upward pressure on commodity prices and with a less demanding competitive environment as globalisation stalls.** With such a cocktail of ingredients, there is nothing missing for those tempted to think that unsustainable levels of debts will eventually lead to a return of inflation.

However, few of these factors are expected to be strong enough to increase the short-term risk of inflation in the current economic situation (see below on SG's short-term inflation outlook). Inflation expectations from the consensus of economists all point to very low out-turns for 2010. In the October survey, the highest reading of inflation in industrialised countries was expected to be in the UK, at 2%! This hardly suggests any potential stress that would reconcile economic expectations with gold price trends.

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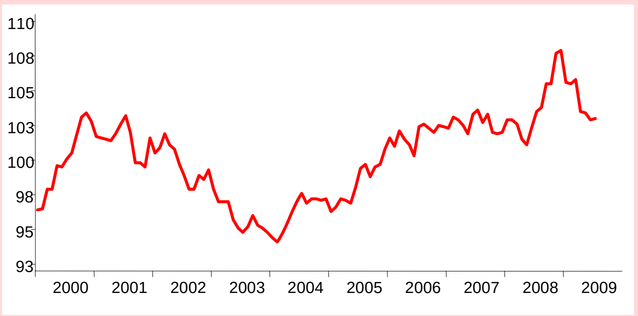
Short-term hysteresis or early signals of a more inflationary backdrop?

However, the analysis of price sensitivity to the economic crisis illustrates suspicious distortions relative to past experience in the recent process of price formation: we observe a number of anomalies that have not attracted the attention of economists so far but could well play a predominant role in the future perception of inflation risks by markets.

Although the collapse in headline inflation suggests that prices responded well to the economic shock, **the examination of core price adjustments illustrates, on the contrary, unusual inertia**. In other words, most of the fall in headline inflation was due to the reversal of energy prices and, to a lesser extent that of food prices since their peak in July 2008 while **core inflation and indeed wage growth have been relatively resilient to the shock of activity so far.**

There are numerous observations suggesting such inertia in the price adjustments relative to the economic downturn. The modest downturn seen in producer prices or import prices of manufactured goods excluding energy is, in itself relatively surprising given the extreme shock on demand. It is worth noting, for example, that Eurozone import prices, although significantly down since year-end 2008 are still close to levels seen in H1 08. In the US, producer prices of capital goods and finished consumer goods ex. food and energy did not register any contraction at all, and indeed continue to rise at respectively 1.4% and 2.4% y/y, slightly above their averages of the last 25 years. This inertia in price adjustments is even more striking when comparing the current situation to that of 2002-2003 when all prices were collapsing at a much more alarming rate.

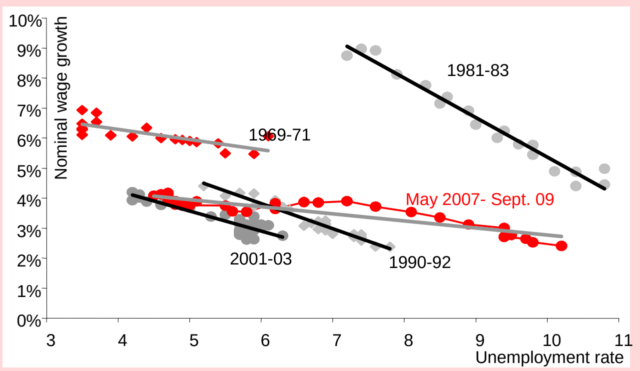
Eurozone import price index of manufactured goods



Source: Ecowin, SG Cross Asset Research

More solid evidence of this stickiness or hysteresis arises from the analysis of the current sensitivity of core inflation and wages to the cyclical shock from the labour market. In particular, the Phillips curve relationship between unemployment and nominal wages, which had held relatively solid in most countries over the last two to three decades, appears to be strongly distorted today.

Phillips curve's dislocation – US unemployment vs. wages relation during periods of rising unemployment



Source: Ecowin, SG Cross Asset Research

As illustrated by the graph above, wage growth eased considerably in past periods of rising unemployment, showing on average a relationship of 0.8ppt to 1.3ppt drop in nominal wage growth for one point of unemployment rise. In the past, only one episode of wage inflation did not respond to the same extent to rising unemployment: this was from 1969 to 1971, a few quarters before the economy shifted to high inflation. Since May 2007, the starting point of the current rise in unemployment, wage elasticity has been, on average, 0.2. This is less than one quarter of the average during the past 25 years. More visible on the chart above, this inertia is illustrated by the flattening of the current trend in comparison to the steep relationship usually observed.

Here, unfortunately, the weaknesses of EMU databases do not enable us to carry out a similar analysis for the Eurozone but anecdotal evidence tends to suggest the same kind of distortions on the both sides of the Atlantic. Wage growth moderation is quite limited in Eurozone countries so far, in particular among white collar workers, according to a number of unofficial surveys.

The reasons behind this inertia are not clear at this stage and it would be certainly premature to assume a definitive change in the economic backdrop from these observations. In particular, the possibility that the energy price spike in mid-2008 generated some lags in wage adjustments needs to be considered. However, in a context of renewed and early cyclical rises in commodity prices, the persistence of these anomalies is certainly a risk to be taken into account. Such persistent distortions would not amount to inflation at this stage but rather **could prevent the expected drop in core inflation from taking place during 2010**. This could certainly be enough to convince markets that the economic environment is becoming more inflationary, and that any sustained recovery in growth could eventually make the return of inflation a reality, hence justifying rising inflation expectations.

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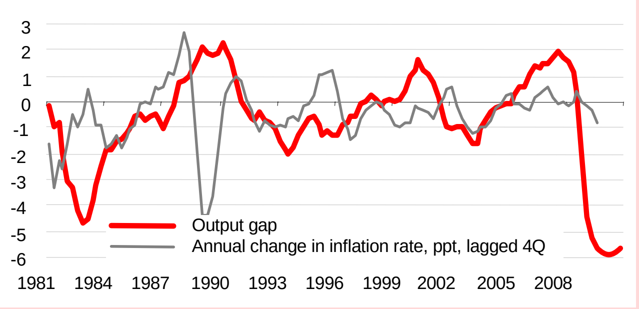
The shorter-term outlook
Output gaps point to declining core pressures

A key driver of underlying inflation pressures in the global economy over the next one to two years is the output gap. Certainly in OECD countries, the output gap has already reached levels of around 5.5% of potential output, a magnitude that has not been seen in at least thirty years according to the OECD's own estimates. And, if anything, the shortfall is expected to get larger in the near term. As a result, cyclical inflation pressures are expected not just to remain low, but to continue to diminish.

A look at history indicates that this expectation is reasonably well founded in experience, though the long-term downtrend in OECD inflation since the early 1980s makes the evidence less than straightforward to interpret. Hence, we have chosen to focus on the change in inflation over one year (in percentage points), lagged by one year, and compare this to the output gap. Although the relationship is anything but iron-clad, more often than not, when the output gap is negative (actual below potential), inflation tends to slow, and rise when the output gap is positive (keeping in mind that the average rate of decline in inflation was 0.3ppt over the period- see chart below).

OECD output gap and changes in inflation



Source: Datastream, SG Cross Asset Research

As described in the country sections, economies differ in their sensitivities to the output gap. Typically, the higher degree of flexibility in the US economy, and its labour market in particular, makes its inflation more reactive to output gaps, whereas euro-area inflation tends to be stickier, albeit at lower rates. Indeed, were it not for relatively stable inflation expectations, the output gap alone would point to outright deflation in the US. Regardless, both economies are expected to continue to see declines in core rates. Japan, with a large output gap and already in deflation, is expected to remain mired in negative core and headline inflation.

But, energy to drive headline inflation higher

While underling inflation pressures are likely to trend downwards, headline rates of inflation are rising practically everywhere, and are expected to do so at least through the first quarter of 2010. This increase reflects mostly energy price effects: powerful base effects from the steep decline in crude oil prices during the second half of 2008 will mechanically drive up annual rates. In addition, recent increases in oil prices are putting upward pressure on the energy component of price indices.

Upward price pressures from energy are expected to peak in Q1 10, but an upward bias on prices is expected to remain in place throughout 2010 and 2011. Our oil price assumptions are for an average Brent price in 2010 of $82/bbl (+34% yoy), and $100 in 2011(+23%yoy). Consequently, headline rates of inflation are likely to run ahead of core rates over most of the forecasting horizon.

Outside of G7, upside risks dominate

The notion that output gaps will dominate inflation applies to the G7 and most of the OECD, but beyond these, the picture is quite different. In non-Japan Asia, in particular, and in much of the developing world, upside risks to inflation are greater, for several reasons: 1) growth has mostly held up far better, and/or has rebounded more strongly, so that output gaps are mostly small. For example, this is the case in Australia and New Zealand, but also in Brazil. In addition, inflation has proven to be unexpectedly sticky in these economies. 2) lower-income economies also tend to be far more sensitive to commodity prices and food prices in particular. So, strength in energy prices is cause for greater concern for those economies and, even more importantly, agricultural commodity prices have shown strength in recent months, raising fears of a renewed food price scare as occurred in 2007. It is partly for this reason central banks in emerging economies are expected to tighten policy earlier than those in western, industrialised economies. Indeed, the process is already underway.

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Policy action points to longer-term risks

Unprecedented stimulus from both fiscal and monetary policy actions taken over the past one to two years imply the risk of higher inflation over a longer-term horizon. Monetary easing, in particular, through super-low interest rates and quantitative easing has injected unprecedented quantities of high-powered liquidity into the global economy. In the context of deleveraging, this has to-date had little impact on broad money growth, and so the imminent risk of an upsurge in inflation is low or non-existent. However, much will depend on whether central banks manage to drain these funds in time, meaning before they set off a credit boom. In our view, there is every chance that this will be achieved, but the degree of uncertainty is clearly high. The view that these liquidity injections are already giving rise to an asset price bubble is in our opinion inaccurate, though it is hard to deny that bond markets have benefited both from exceptionally low short-term interest rates as well as from outright purchases of fixed-income securities.

A separate risk to inflation arises from fiscal policy. Of course, if fiscal policy stimulus is kept in place for too long, the risk of overheating increases, and this would stoke upside price risks. But, fiscal consolidation paradoxically may also raise inflation pressures, if governments choose to raise revenue through indirect tax hikes or administered prices, because this can sometimes push up inflation expectations.

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Country sections

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United States

Economic forecasts: the US outlook at a glance

% (qoq saar unless otherwise stated)	Q1 09	Q2 09	Q3 09	Q4 09	Q110	Q2 10	Q3 10	Q4 10	2007	2008	2009	2010	2011
GDP	-6.4	-0.7	3.0	3.6	3.7	3.5	2.7	3.1	2.1	0.4	-2.5	3.1	2.8
Consumer expenditure	0.6	-0.9	3.4	2.0	2.5	2.9	2.9	3.0	2.6	-0.2	-0.5	2.5	2.9
Government expenditure	-2.6	6.7	2.3	1.8	1.7	1.7	1.6	1.5	1.7	3.1	2.0	2.1	1.6
Investment	-39.2	-9.6	-4.8	1.6	3.8	5.4	4.2	5.9	6.2	1.6	-17.8	1.9	5.4
Exports	-29.9	-4.1	15.5	5.0	6.0	7.0	7.0	6.5	8.7	5.4	-10.8	6.6	6.3
Imports	-36.4	-14.7	20.0	10.0	8.0	8.0	8.0	8.0	2.0	-3.2	-14.3	8.2	8.0
Contribution to GDP													
Inventories	-2.3	-1.4	1.1	2.0	1.2	0.6	0.0	0.3	-0.3	-0.3	-0.7	0.9	0.2
Net exports	2.6	1.7	-0.9	-0.8	-0.4	-0.3	-0.3	-0.4	1.0	0.7	0.6	-0.4	-0.5
CPI headline (% yoy)	-0.2	-0.9	-1.6	1.0	2.1	1.7	1.6	1.9	2.9	3.8	-0.4	1.8	1.8
CPI core (% yoy)	1.7	1.8	1.5	1.6	1.4	1.1	0.9	0.9	2.3	2.3	1.7	1.1	1.1
Unemployment rate (%)	8.1	9.3	9.6	10.2	10.4	10.2	9.9	9.6	4.6	5.2	9.3	10.0	8.8
Employment (% yoy)	-3.1	-3.9	-4.2	-3.8	-2.5	-1.2	-0.1	0.8	1.1	-0.4	-3.8	-0.8	1.9
Average hourly earnings (% yoy)	3.5	3.0	2.6	2.0	1.6	1.6	1.4	1.5	4.0	3.8	2.8	1.5	2.0
Savings rate (%)	3.7	4.9	3.3	3.0	3.0	3.2	3.4	3.4	1.7	2.7	3.7	3.3	3.6
Current account (% of GDP)									-3.8	-3.6	-2.5	-2.8	-3.2
Budget balance (% of GDP)									-1.3	-4.7	-11.2	-8.6	-7.3
Public debt (% of GDP)									35.5	40.0	53.8	60.4	65.4
Fed Funds Target (%)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	5.05	2.08	0.25	0.25	1.66

Sources: Global Insight, SG Cross Asset Research

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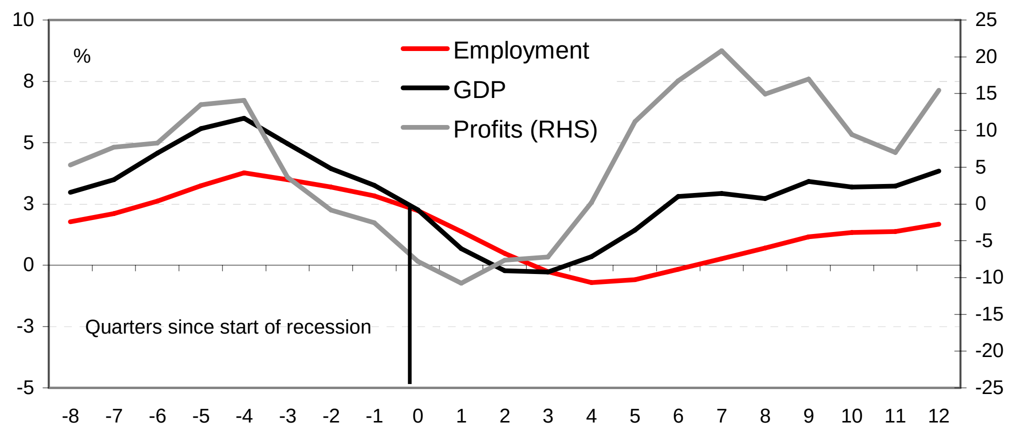
Well beyond green shoots, the modest recovery still faces uncertainty

US GDP is registering stronger economic gains at the end of 2009 despite scepticism, and the pace should extend into early 2010. We revise up our growth target for 2010 to 3.3% on the basis of recent gains in manufacturing and housing.

The classic recovery profile in the US is emerging. The profit recovery has been strong so far, aided by significant productivity gains. The GDP recovery did not start until Q3, and appears mild. The employment recovery is not expected to begin until spring 2010.

So far, a classic recovery is unfolding, even if expectations are moderate



Source: SG Cross Assets Research

Until employment recovers, doubts about the US consumer and Fed policy should remain very heavy. Even for employment, we only anticipate moderate gains. The reversal of job trends, even if mild, supports a sustainable recovery outlook and the eventuality of rate hikes by the Federal Reserve. To that extent, employment is a sea-change event for expectations.

Credit growth remains lacklustre. Deleveraging restrains performance. Survey data suggest that weak credit growth is as much a weak demand issue as a restricted supply issue. To the extent that demand impairs credit creation in the US, rising home prices and improving labour markets should be noted with tremendous care. Rising wealth and job creation could foster stronger credit conditions. As analysts, we may recommend further credit austerity for the US consumer, but the US consumer has a tendency to surprise.

A classic recovery – even by industry - is unfolding. Housing, autos and inventories are most often the major sources of growth early in an economic recovery. True to form, these sectors again contributed to the recovery in Q3 09. The reliance on government programmes for autos and housing raises concerns about the sustainability of these sources of demand strength. Yet, these fears may be misplaced, even if the question of government support is a major issue going forward. The cash-for-clunker programme, in our mind, was too brief a programme to offer the economy anything beyond fleeting support. For spending, the tax-incentive programme influenced buying decisions. Sales of new vehicles in October 2009, at a 10.5 SAAR million unit pace, were the strongest of the year outside of the cash-for-clunker programme. Going forward, it is not the withdrawal of government tax incentives that hampers the auto sales recovery, but rather the appetite and availability of credit. These latter features are much weaker than in prior recoveries.

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Housing gains are bouncing back more strongly in 2009. In Q3, residential investment posted a 23% annualised rise. These gains are from severely depressed bottoms at the start of 2009, and should have further to go into early 2010. The tax-incentive for first-time homebuyers has been helpful but too much emphasis may be on this programme, which was very narrowly targeted. The government has extended the tax incentive out to April 2010 and the extended programme has been broadening out.

Government support for housing has been strong, but is coming from a different source—Freddie-Mac and Fannie Mae (two government sponsored housing agencies). The Treasury takeover of these two institutions and the Federal Reserve's purchases of Agency debt have been instrumental in reducing mortgage rates and making mortgage credit available to potential buyers. These institutions kept a vital part of the US credit market open during the harshest months of the crisis. The Federal Reserve plans to end its Agency-MBS purchase programme in March 2010. The end of that programme could add to mortgage rates. We expect the rise to be modest, since the event is well-known in advance, but this is nevertheless a source of concern on housing.

US profit resurgence due to the flexible labour force

Incoming earnings releases from companies compare favourably with our own top-down expectations for profits. Moreover, as we highlight in the charts below, CEO business confidence is at the highest level in over four years. Historically, confidence is strongly correlated with profitability.

The US profit resurgence is due to sharp cost reductions. Earnings growth stemming from cost cuts as opposed to top-line sales does not win confidence easily, but is actually part of a normal cyclical recovery. We highlighted these trends last June in our American Themes publication. It is very normal that, as GDP stabilises and employment reductions remain deep, profit margins expand. Steady GDP and falling employment are captured in soaring productivity and falling unit labour costs. It is the drop in unit labour costs that widens margins. Our chart below, showing our proxy on profits, is based on unit labour costs.

The strength of profits and cash flows has several important ramifications. First, improved cash flow for companies bolsters their balance sheets and reduces their borrowing needs as well as borrowing costs.

Secondly, rising profits and cash flows raise confidence among business executives who turn from cost cutting towards revenue expansion. Businesses look for the opportunities within their existing areas of activity. They make investments in areas of potential growth, and further, they return to general maintenance and upgrades of their current operations that might have been put off during the harsher days of the recession.

Lastly, the profits and cash flows along with investment plans and the resumption of upgrades, finally prompt companies to consider making needed new hires.

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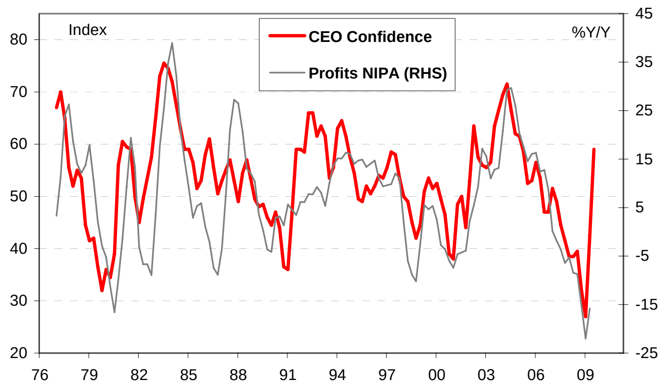
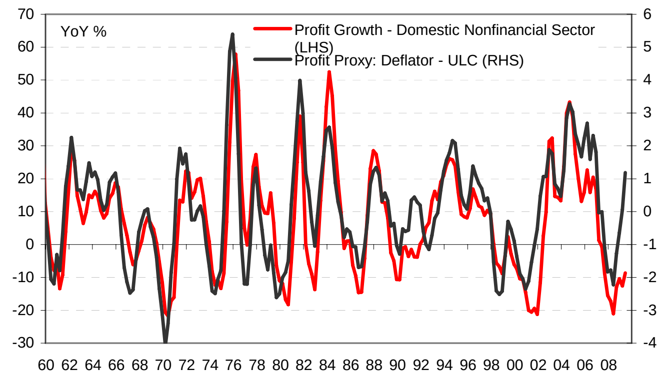
Profits and CEO Confidence are rebounding



Profits aided by soaring productivity gains



Source: Global Insight, SG Cross Assets Research

Business investment stabilises as GDP rises more than 3% in Q3

Business purchases of software and equipment eked out a minor 1.1% gain in Q3 of 2009. More important is the turn. Orders evidence for capital equipment is pointing towards larger gains in Q4 and early 2010. The rise in equipment purchases is due to an upturn in profits, a need to resume standard upgrades and maintenance that was put off during the crisis and a rise in capacity utilisation.

Excess capacity suggests that new equipment purchases will not be made by businesses. Capacity utilisation rates in the US averaging 70%, or near historic lows, would suggest no need for additional equipment. Our own modelling strongly suggests that it is the directional movement of capacity utilisation and not the level that is dominant in determining capital equipment purchases. The rise in capacity utilisation from 68.3 as a low in June 2009 to 70.5 in September was entirely consistent with stabilising investment in equipment.

Others sectors of GDP growth at the Q3 turn—consumers are key

Real consumption spending posted 3.4% growth in Q3. That rate was elevated by the cash-for-clunker auto tax programme offered by the government in late July through mid-August. Rather than adding to overall GDP growth, the cash-for-clunker programme resulted in a faster than usual drawdown of auto inventories. Auto production was already humming near full blast after being shutdown during the first half of the year. The motor vehicle industry contributed 1.7% of the total 3.5% growth for Q3 GDP. Auto production gains should moderate from this initial start-up pace but, even in Q4, we expect further positive contributions.

Consumption, of course, is the key sector that ultimately decides on the sustainability of the US expansion. Currently hanging over the consumer are weak job markets. Second is the limited ability to increase debt.

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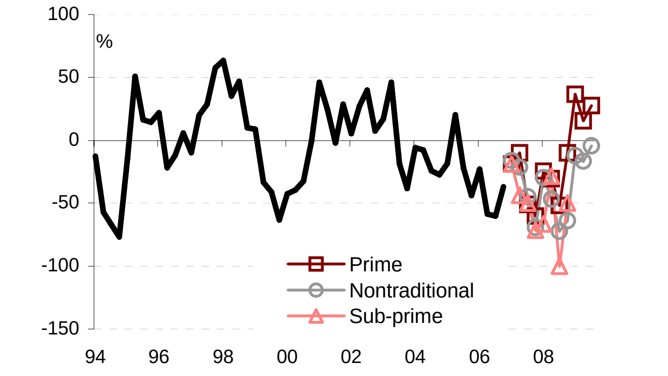
Debt availability is gradually turning. Mortgage debt has been restored in the conventional loan market thanks to the government's backing of Fannie Mae and Freddie Mac. Mortgage availability in the jumbo market and loan amounts that exceed conventional Agency limits have improved but have further to go. Sub-prime credit channels have partially been replaced by the FHA (Federal Housing Administration) but this sector of the mortgage market remains greatly impaired. Auto and credit-card loan availability has improved thanks to TALF, and other government assisted programmes.

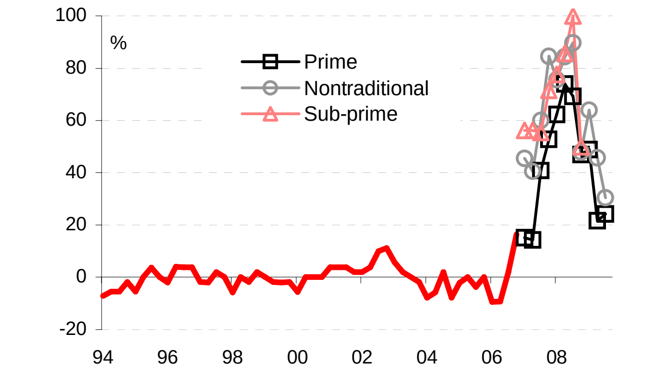
Mortgage loan demand is recovery and banks are not tightening as much. Sub-prime remains impaired

Net Pct of Banks reporting stronger demand



Source: Global Insight, SG Cross Assets Research

Net Pct of Banks tightening standards

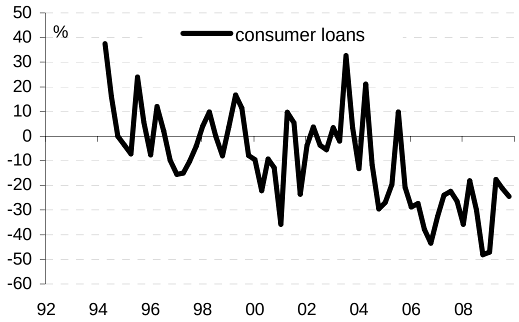


Source: Global Insight, SG Cross Assets Research

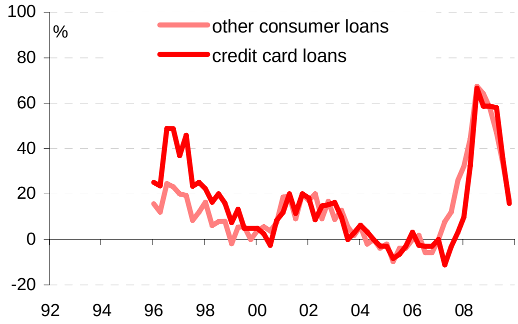
Other forms of consumer credit show consistently weak demand. The greater fear is the lack of credit availability, but the Federal Reserve's Senior Loan Officer survey suggests that demand may be the greater issue behind shrinking loan volumes. The Troubled Asset Liquidity Facility (TALF) has greatly enhanced the ability of financial institutions to originate loans. There is still further work to be done here, but banks are now tightening loan standards at ever-decreasing rates. Weak employment and the potential for default may still be the factors hampering credit extensions from the financial institutions, but not necessarily the weak capital positions of the banks.

Demand remains very weak for non-mortgage consumer loans……. Availability concerns have improved more

Net Pct of Banks reporting stronger demand



Net Pct of Banks tightening standards



Source: SG Cross Asset Research

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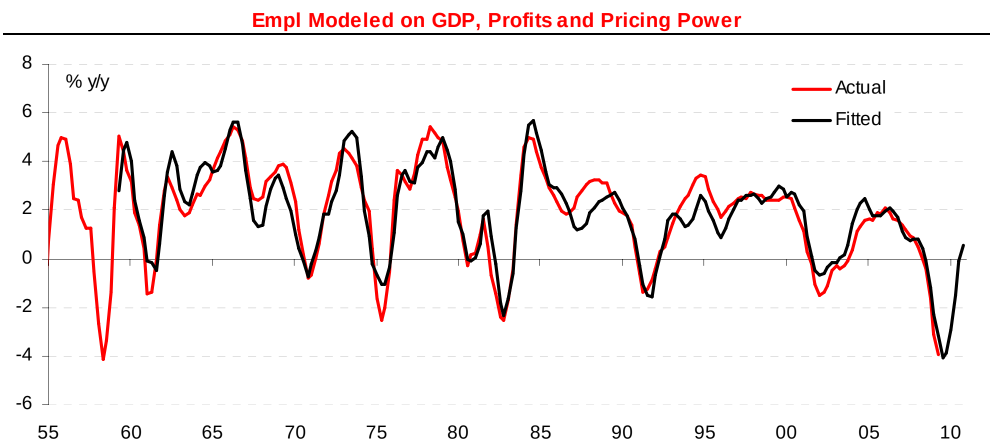
Employment gains expected in early 2010

Following the profit and GDP gains in 2009, we expect employment trends eventually to reverse in early 2010. Our modelling of employment growth strongly points to a normal two-quarter lag between employment and GDP. It is during this time period that productivity surges. In Q3 2009, labour productivity soared 9.5%.

Employment gains to follow profit and GDP growth



Source: Global Insight, SG Cross Assets Research

Employment gains may be slim – particularly at first. Despite robust profits, the GDP outlook is modest as is consumer spending. Demands for strong productivity are likely to continue for some time. The result is limited employment growth, which, in turn, is limiting consumer activity.

A sea-change ushered in by employment: When employment does turn positive, it should lend weight to expectations of an ongoing expansion. The confidence in the expansion's sustainability should contribute to spending confidence and intensifying speculation on the Federal Reserve policy stance.

Inventories should contribute to growth for several quarters

Inventories fell by another $130bn in Q3 of 2009. Eventually inventories need to stabilise. Even with flat sales, to stop the haemorrhaging of inventories, output gains must rise another $130bn. This would also to add to the GDP growth rate. This is happening in the auto sector. Sales of US produced motor vehicles are running at 8.5 million units p.a. while production has increased to just above a 7.0 million units p.a.. Further production gains are needed to stem the loss of inventories. Businesses reacted swiftly to their fears for the economy. They aimed to cut back on inventories, resulting in immediate sales, orders and production declines. Along with the sales and production declines was a falling need for working capital and a steep drop in Commercial and Industrial loans. The drop in loan volumes, just as in consumption, is the result of both demand and supply factors. The rise in production more recently should bolster greater demand for business credit.

Fiscal policy—concern for deficits builds

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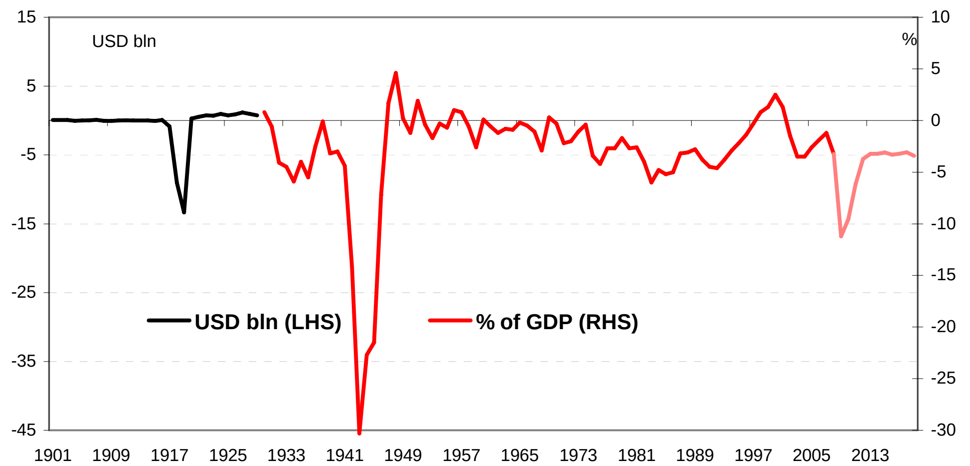
The US deficit posted a record $1.4 trillion in fiscal year 2009 and not much improvement is expected for FY 2010. High unemployment is reducing tax receipts. Meanwhile, the large size of the social programmes and the bailout add substantially to the deficit. As a percentage of GDP, the US budget deficit posted its highest level since World War II.

Serious deficit controls are absent in Congress. Rather, spending programmes are largely being increased. Bailout efforts such as the home-buyer programme are being extended. The Federal Government still has its 2009 stimulus package in place. Further stimulus money is possible, not as a large package, but more likely as a series of minor ones such as the home-buyer extension that also extended payments for the long-term unemployed.

Healthcare reform is the immediate large-scale effort of Congress and the Administration. The path is choppy and there are various versions of healthcare legislation. Serious negotiations must be made before the House, Senate and White House all agree on healthcare provisions. On chances for success, it should be noted that the 2010 elections are approaching and support for President Obama and the Democrat-controlled Congress is slipping significantly due to healthcare concerns.

A nearly unprecedented Federal budget deficit



Source: SG Cross Assets Research

As an economic measure, healthcare reform has enormous long-term consequences for the United States that could be factored into long-term profit and debt outlooks. For the immediate economy, the uncertainty factor of healthcare is the most prominent. Removing this uncertainty could be helpful.

Healthcare reform is not spending control. Some of the more easily enacted tax hikes could be made to pay for the healthcare legislation. These tax increases, however, are needed to add discipline to the budget process.

Tax increases are already legislated for the start of 2011 as temporary tax cuts dating all the way back to 2001 and 2003 expire. In this important congressional election year, we expect that these temporary tax breaks could be extended again for lower- and middle-income households. The effort could be marketed as a stimulus or a tax break, but in reality it is a partial postponement of a tax hike. Deficit forecasts from the government currently assume that tax breaks expire. As such, they underestimate the deficit.

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On the positive side, strong corporate profits and the gains in the financial markets offer new tax revenues for the government. Corporate tax receipts and capital gains taxes should exceed government estimates. On the whole, we look for a FY2010 deficit of $1.2 trillion.

Fed exit strategies

As employment gains, we expect the Fed to begin signalling rate hikes. Before hiking rates, however, we expect the Fed to absorb more reserves from the banking sector, and thereby reduce the amount of excess reserves currently held by the banks. The Fed has many different avenues through which to conduct its exit strategies.

- **End the quantitative easing programmes:** The Fed has already ended its $300 bln Treasury purchase buying programme and, by the end of Q1, will have finished its $1.25 trillion Agency-MBS purchase programme. By far, the Agency purchase programme had the biggest market impact. Fed buying drove down mortgage rates and the end of this programme could lift mortgage rates modestly.

- **Reverse repos:** Term deposits and other instruments to absorb excess bank reserves. This process should commence in the spring as confidence in the recovery solidifies and bank lending stabilises. The Fed is already conducting tests, whereby it will temporarily sell its Agency securities to investors with the agreement to repurchase the securities at a specified date, usually just days or weeks ahead. The money the Fed takes in from its sales absorbs funds from the banking system.

- **Rate hikes:** We expect signals from the Fed that rate hikes are coming. Actual rate hikes are not expected for some time. The Fed should begin signalling markets for the eventuality of hikes quite early in 2010 to coincide with stability in labour markets, somewhere in the February-May window. During this time, the FOMC will communicate the signal by dropping references to any time period in its statements. Currently, the FOMC claims it will keep the fed funds target exceptionally low for an extended period. Dropping the reference to an extended period should come well ahead of an actual rate hike. The specific timing should run parallel to employment gains and bank lending.

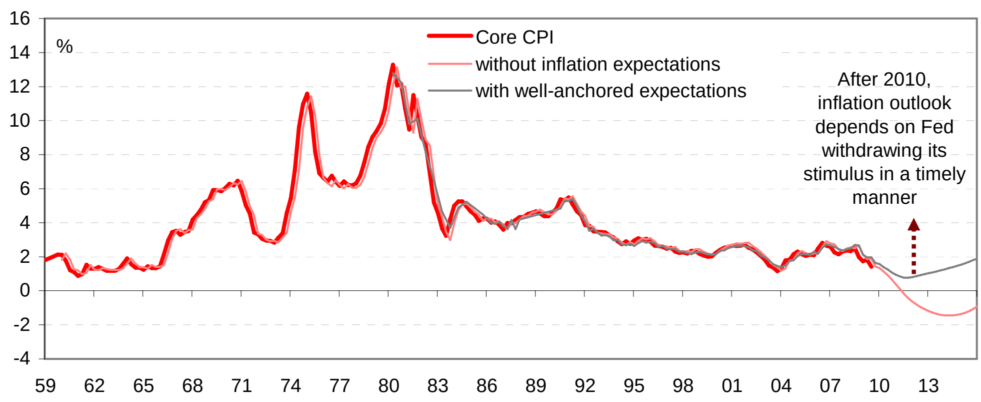
Once the Fed starts hikes, the pace should be more abrupt than in the gradual steps taken by the Greenspan Fed. Rate hikes are not expected until the start of 2011 but, after employment gains, odds for rate hikes should build throughout the second half of 2010. It is our view that the Fed is more likely to err toward a slow start. Once the Fed starts, the pace of hikes should be rapid.

Inflation risks are low during the period out to the forecast horizon

The overhang of surplus labour (with unemployment rates above 10% currently) and under-utilised capacity, core price pressures remain extremely modest and should remain so throughout 2010 and 2011. Our modelling using the output gap measures of excess capacity in the economy suggests that core inflation should continue to slow throughout our short-term forecast horizon.

Inflation expectations strongly influence pricing behaviour. Simply put, if consumers expect widespread price softness they are likely to delay consumption. Conversely, pricing increases can speed up spending. The Greenspan Fed defined zero inflation as the rate that did not influence real volume decisions. The Fed still defines a 1.5%-2.0% pace of inflation as desirable to meet that objective.

Inflation – supported by well-anchored expectations **Core CPI trends and expectations**



Source: Global Insight, SG Cross Assets Research

Rarely have inflation expectations been too low. Such is the domain of deflation. Negative price readings can occur, but deflation is sustained price declines that impede spending and drag the economy downward. The Fed had deflation fears earlier this year when inflation expectations measures were falling fast. The threat prompted the Fed to take all means necessary and, since the Lehman Brothers' bankruptcy, it has taken unprecedented steps to support the economy.

More recently, inflation expectations have stabilised. Various measures provide different results, but, in our models, we assume inflation expectations remain anchored at 2.0%. The inclusion of inflation expectations in our models maintains a forecast for core inflation near 1.0%. The very latest inflation expectations readings are rising above 2.0%. Surveys are drifting toward 3% and the expected long-term inflation rate implied in the Treasury inflation-indexed bonds has just broken above 2.5%. Higher gold and gasoline prices reflect and are factored into inflation expectations. A weak dollar, huge government deficits and very loose monetary policy also contribute to rising inflation expectations.

The Fed needs to be more responsive to this expectations component. Our 2011 call on the Fed is based on expectations remaining steady.

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Euro area

Economic forecasts: Euro area outlook at a glance

% (qoq saar unless otherwise stated)	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	2007	2008	2009	2010	2011
GDP	-9.6	-0.7	1.5	1.9	1.0	0.8	0.7	1.3	2.7	0.6	-3.9	1.1	1.2
Consumer expenditure	-2.1	0.3	-0.1	0.4	0.2	0.2	0.2	0.8	1.6	0.3	-0.9	0.2	0.7
Government expenditure	2.4	2.7	2.8	2.7	2.0	2.1	1.9	1.8	2.2	2.1	2.6	2.3	1.4
Investment	-20.0	-5.6	-4.1	-2.4	-2.1	-0.5	0.2	1.3	4.8	-0.6	-10.5	-1.8	1.3
Exports	-32.1	-4.4	9.3	4.1	3.5	3.4	4.0	5.1	6.1	1.0	-14.4	3.8	4.8
Imports	-24.1	-13.6	5.0	2.8	2.6	3.5	4.2	5.2	5.2	1.0	-12.5	2.5	4.6
Contribution to GDP													
Inventories	-2.5	-2.3	0.5	1.0	0.5	0.3	0.2	0.2	0.0	0.1	-0.7	0.3	0.1
Net exports	-2.4	2.3	1.7	0.5	0.4	0.0	-0.1	0.0	0.4	0.0	-1.1	0.5	0.1
CPI headline (% yoy)	1.0	0.2	-0.4	0.3	0.9	1.0	1.2	1.1	2.1	3.3	0.2	1.0	0.8
CPI core (% yoy)	1.6	1.6	1.3	1.1	1.2	1.0	1.1	0.8	1.9	1.8	1.4	1.0	0.5
Unemployment rate (%)	8.8	9.3	9.5	10.0	10.3	10.4	10.6	10.7	7.5	7.5	9.4	10.5	10.9
Employment (% yoy)	-1.3	-1.9	-2.2	-2.4	-1.9	-1.6	-1.3	-1.0	1.7	0.6	-2.0	-1.4	-0.2
Unit wage cost (% yoy)	5.7	4.7	3.4	0.8	-0.9	-1.4	-1.2	-1.1	1.1	1.6	3.6	-1.2	0.3
Savings rate (%)									10.9	11.2	16.2	15.8	15.2
Current account (% of GDP)									0.4	-0.8	-0.4	0.3	0.5
Budget balance (% of GDP)									-0.6	-1.9	-6.4	-6.8	-6.3
ECB main refi. rate (%)	1.25	1.00	1.00	1.00	1.00	1.00	1.00	1.00	3.90	3.90	1.26	1.00	1.40

Sources: Datastream, SG Cross Asset Research

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Euro area exits recession but heads for a sub-par recovery

Euro area GDP rose by 0.4% in the third quarter to post the first expansion in five quarters. The speed of this recovery and the subsequent escape from recession is significantly faster than could have been expected back in the spring and is testament to the power of fiscal policy. The turnaround in manufacturing has played an important part in this recovery with industrial production rising by 2.2% in the third quarter, after a 1% fall in Q2 and a precipitous 8.6% decline in Q1. This recovery largely reflects the impact of car incentives on the auto sector and, while some of this expenditure should carry over to Q4, it is hard to see what will sustain the recovery in the longer term.

Despite the recovery, industrial production is still down 17.1% from its peak. Fiscal policy has also been used very effectively to subsidise short-term working, preventing a large reduction in employment particularly in France and Germany. Employment levels have therefore fallen by just 1.8% while GDP has fallen 4.5% since the start of 2008. The result has been plunging productivity and a sharp fall in company profitability. This trend will have to be reversed in the coming year which suggests a protracted period of labour market adjustment and slow growth. So, while growth may have returned faster than expected in the short term and is therefore generating upward revisions in annual calendar year growth forecasts for 2010, the underlying quarterly path for next year remains one of a significantly sub-par recovery.

This will leave the euro area carrying a significant negative output gap, while high and initially rising unemployment will continue to weigh on nominal income formation. Inflationary pressures should therefore be largely absent and we forecast headline HICP inflation will slip below 1% in 2011. In this environment, there is little need for the ECB to begin raising interest rates. In 2010 therefore we expect the ECB to focus on reducing its support to the banking sector, before embarking on a limited normalisation of rates in 2011.

Fiscal headwinds

The euro area has staged an impressive recovery in the second half of 2009 with activity largely supported by the fiscal stimulus adopted in the wake of the financial crisis. With car incentives in particular playing a prominent role, euro area GDP grew by 0.4% q/q in Q3 after falling by over 5% in the preceding five quarters. This still leaves GDP some 4¾% lower than its peak at the start of 2008 which is testament to the large negative output gap that the recession has opened up. Even allowing for some destruction of potential output, the latest European Commission estimates suggest that the output gap in the euro area is currently around 3% of GDP and is not expected to be closed for several years. This will continue to put downward pressure on inflation and weigh on nominal wage formation throughout 2010 and 2011. In this environment, the real challenge for the years ahead will be sustaining a strong recovery in the face of a number of negative headwinds. We suspect the euro area will struggle and expect a long period of sub-par expansion.

In the short term, the message is clearly that fiscal policy works and that given renewed government commitments this may have further to run in the next couple of quarters. Moreover we continue to think there is scope for a particularly strong inventory cycle to boost growth in the short term. This reflects the fact that the credit crunch was largely propagated through the global economy by a reduction in trade credit and finance for inventories. As a result, the last couple of quarters have seen a sharp reduction in stock building which has made a significant negative contribution to GDP. The latest data for the third quarter indicate that a correction is still largely absent. This suggests scope for inventories to make a positive contribution to activity in the next couple of quarters which may sustain a stronger recovery.

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However, much of the recovery in manufacturing is the result of car incentive schemes which have largely boosted growth this year by bringing forward consumption from 2010. As these stimulus programmes begin to expire, growth is likely to slow during the course of 2010. The best quarters of growth over the entire forecast period may therefore be those we are experiencing now. After a fiscal stimulus of around 2.0% of GDP in 2009, the latest European Commission estimates suggest that the fiscal deficit in 2010 will only be slightly bigger. The table below on primary structural balances shows that fiscal policy added over two percentage points to GDP in 2009 but that next year it will only contribute a further 0.2pp to growth. Moreover we expect the fiscal expansion to be reversed in 2011 with governments committing to a fiscal tightening of around 0.3% of GDP in order to begin to put government finances back on a sustainable footing. In the longer term a deeper fiscal consolidation will be needed and will therefore make a negative contribution to growth for several years to come. The first of those negative headwinds is therefore likely to come from fiscal policy.

Cyclically adjusted government primary balance for selected euro area countries (% GDP)

		2007	2008	2009	2010	2011
Germany	Primary structural balance	1.6	1.2	0.8	-0.8	-0.6
	Change in primary structural balance		-0.4	-0.4	-1.6	0.2
France	Primary structural balance	-1.0	-1.0	-4.2	-4.1	-3.5
	Change in primary structural balance		0.0	-3.2	0.1	0.6
Italy	Primary structural balance	2.1	1.7	1.3	1.0	1.3
	Change in primary structural balance		-0.4	-0.4	-0.3	0.3
Spain	Primary structural balance	2.8	-2.8	-8.2	-6.1	-5.2
	Change in primary structural balance		-5.6	-5.4	2.1	0.9
Euro area	Primary structural balance	1.1	0.1	-2.0	-2.2	-1.9
	Change in primary structural balance		-1.0	-2.1	-0.2	0.3

Source: European Commission, SG Cross Asset Research

Improving profitability will mean further reductions in employment

In the absence of continued stimulus, it is hard to see what other sources of private sector demand exist. The whole thrust of the policy initiatives taken in the aftermath of the banking sector crisis has been to cushion the impact of the crisis, drawing out the slimming down that will inevitably have to take place as firms adjust to the new lower level of demand. In the labour market for example, short-time working initiatives have enabled firms to maintain employment levels by cutting back hours worked. The result is that most of the jobs lost to date have been in Spain and Italy; by contrast the labour market adjustment in France and Germany has been rather modest. This is reflected in a sharp reduction in productivity and a sharp increase in unit labour costs. As a result, profit growth has collapsed in the euro area which suggests firms will soon have to start putting in place measures to restore profitability. Unless demand suddenly recovers, this suggests that firms are simply putting off the adjustment that will ultimately have to be made. We therefore expect job losses to be sustained throughout 2010 with unemployment continuing to rise.

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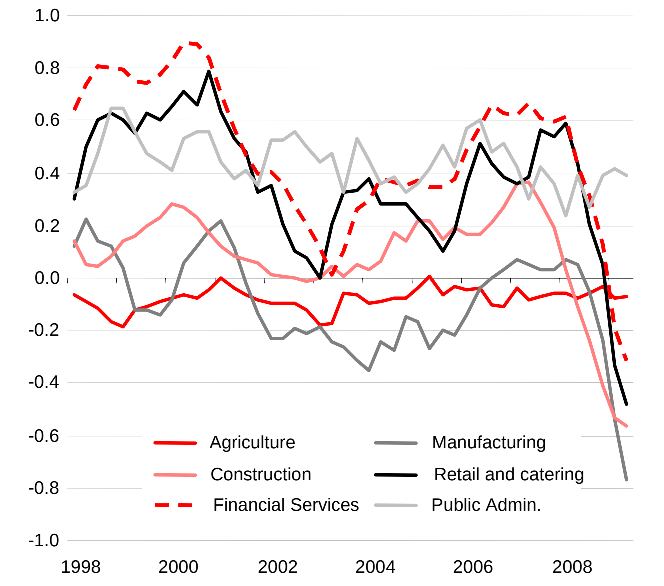
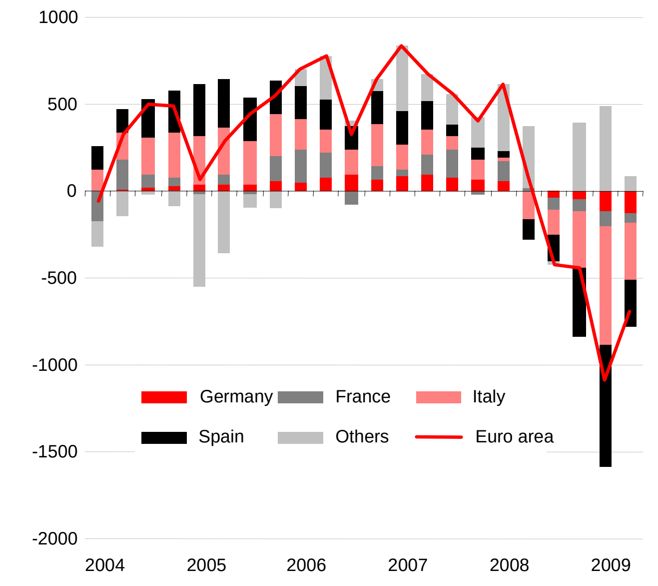
One of the more remarkable features of the euro area is that it has been extraordinarily successful at creating jobs since its inception. In total some 16.5 million new jobs have been created since 1999. The majority of the new jobs has been created in just three sectors. Financial services, real estate and other business services have been the largest sources of new jobs, generating two huge waves of employment in 1998-2000 and 2005-2007. Only slightly less important have been retail sales, hotels and catering, transport, and communication, which have added some five million jobs over this period. The last sources of significant employment growth have been public administration, education and health. Manufacturing, and even to a certain extent construction, have not been particularly significant sources of job growth. The latest available data (until the end of Q2) suggest that the euro area has lost some 2.6 million jobs since the onset of the recession in the second half of 2008, pushing the unemployment rate up to 9.6% from a low of 7.2% in the spring of 2008.

Euro area employment by sector (contrib. to annual growth %)



Euro area employment by country (quarterly change, 000s)



Source: Datastream, SG Cross Asset Research

These changes speak of huge structural changes taking place in the economies of the euro area. However, the point is that, in an environment of sustained weakness in consumption, it is hard to see either financial services or retail-associated sectors providing a major boost to employment in the future. At the same time, given the pressure to rein in government deficits, it is hard to see the public sector continuing to be a significant source of job growth. Rather, this points to a long period of muted employment growth.

Weak real wage growth will be a drag on consumption

At the same time high and rising unemployment will continue to weigh on nominal wage growth. Exact predictions are difficult since there is little precedent to the current downturn. However historical correlations between hourly wage costs and unemployment suggest that wage growth could slow to below 1% if unemployment rises significantly above 10%. Combined earnings and employment growth are therefore expected to remain very subdued with only a very modest recovery evident in 2011. Nominal income growth is therefore likely to average around 1% in 2010. At the same time, the recent increase in oil prices already means that headline inflation will rise from current lows further limiting increases in consumer purchasing power. Real income growth is therefore expected to be almost zero in 2010, with what increases there are eroded by rising inflation. We therefore expect consumption growth to remain very limited. Overall we expect euro area consumption to fall by 1.0% in 2009, largely as a result of the 0.5% declines in Q4 2008 and Q1 2009, before rising by just 0.2% in 2010.

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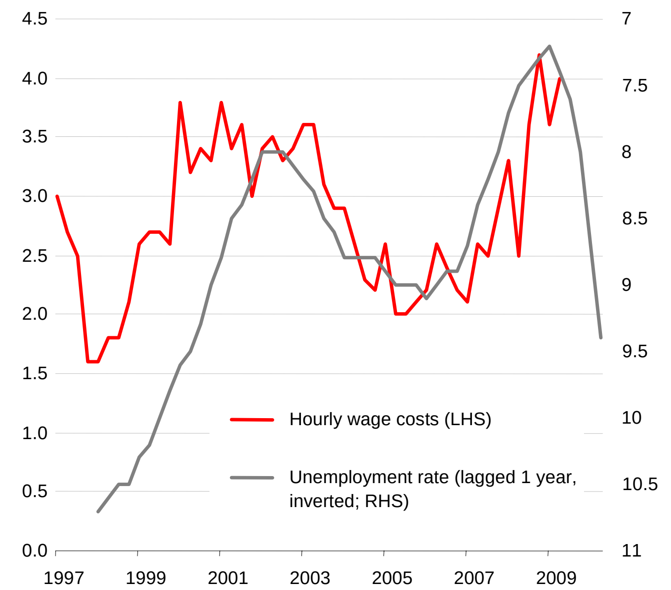
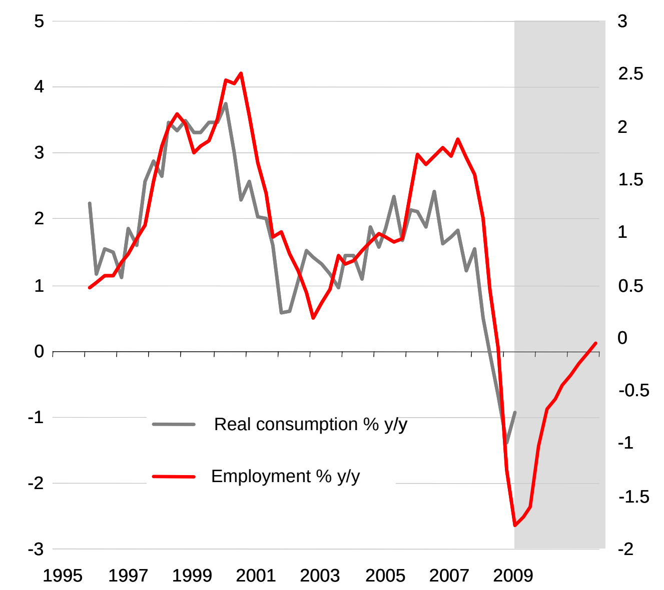
Companies are cash-rich

In this respect, one area where we do see liquidity building up is on the balance sheet of non-financial companies. Although European corporates have generally been deleveraging since the start of the year, reducing their outstanding stock of bank debt by some €70bn, they have, at the same time, been borrowing very heavily in the credit market. This has left European corporates enormously cash rich; we find for example that the median level of cash as a percentage of assets for the iBOXX non-financial companies is now above its 2004 level.

Euro area hourly wage costs and unemployment



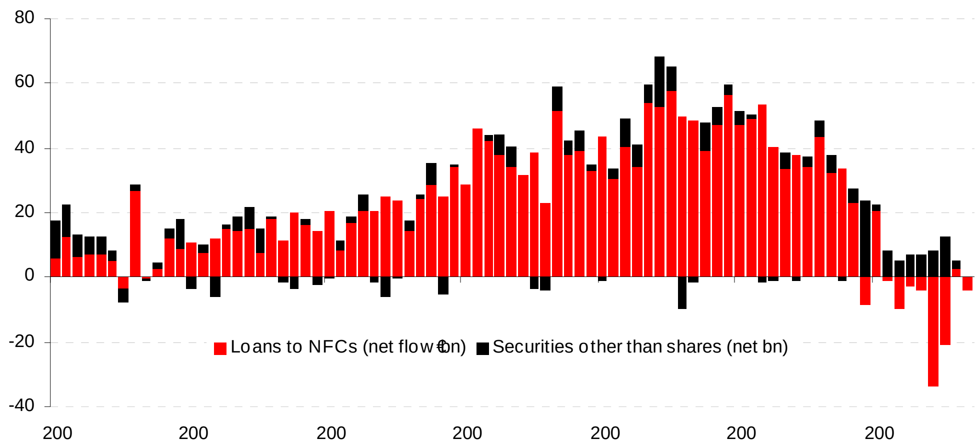
Euro area private consumption against euro area employment



Source: Datastream, SG Cross Asset Research

The question is what will companies do with this huge war chest? Ordinarily, the reserves of cash might be used to finance investment. However, with capacity utilisation at all time lows, there is very little incentive to invest in extra capacity. This suggests the money will be used to further reduce bank loans, in effect continuing the deleveraging dynamic. Later in the cycle, this cash will also likely be used to finance the purchases of other companies, bringing about the consolidation that is needed to reduce excess capacity. None of this, of course, should boost activity and for this reason we are rather pessimistic on the prospects for investment spending. Equipment investment is therefore set to remain very depressed as a result of the historically low level of capacity utilisation and deteriorating profits.

Funds raised by the euro area corporate sector



Source: Datastream, SG Cross Asset Research

The final negative driver that the euro area will have to contend with is the euro's sustained appreciation. This implies a steady loss in competitiveness that will subtract from growth in 2010. However the impact is likely to fall disproportionately on those southern European economies, such as Italy and Spain, which had long-standing structural weaknesses resulting in a trend loss of competitiveness. Northern European economies, Germany in particular, are typically far more non-price competitive and tend to be more resilient to the euro's appreciation. A substantial proportion of German exporters for example even argue that a euro appreciation actually improves their profitability because their inputs are priced in foreign currency while their export demand is not particularly price elastic.

Inflation still sub-1%, even in 2011

Much as expected, the euro area's flirtation with deflation is turning out to be a short-term experience, lasting just five months. By November 2009, inflation is expected to be firmly back in positive territory, and in 2010 is expected to average just over 1%. But the headline rate is at this stage somewhat deceptive, not only because of the well-known dominant influence of energy prices. Underlying inflation pressures are likely to continue to ease over the whole forecasting horizon, including 2011. We believe core inflation (all items ex energy, food, alcohol, tobacco) is likely to ease from 1.4% in 2009 to around 0.5% in 2011. That would put headline inflation below 1% in 2011.

Of course, the output gap is the dominant, but not the only, factor pointing in that direction. Based on European Commission estimates, which have been adjusted substantially to take account of the likely detrimental effect of the crisis on potential growth, the euro-area output

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gap reached 2.9% of GDP in 2009, and is expected to widen further. That is a high value, and is bound to reduce inflation substantially – on its own, it points to a risk of outright deflation. This is not our scenario, not least because of well-anchored inflation expectations, the usual inertia of euro-area inflation, as well as several other factors.

Beyond the output gap, labour cost trends also suggest slowing underlying inflation. Until Q1 2009, unit labour cost (ULC) growth accelerated sharply, to a peak of 5.8% yoy but a recovery in productivity and slowing wage growth are likely to produce negative ULC growth by 2011. Lastly, the recent and further expected appreciation of the euro also points to declining price pressures.

Headline inflation is expected to run ahead of core rates for most of 2010 and throughout 2011, reflecting increases in oil prices (34% in 2010 and 23% in 2011, on a dollar basis) as well as a normalisation in food prices, which have corrected downward sharply in 2009, and are currently running 1.5% below year-ago levels. In addition, fiscal consolidation is exerting upward pressure on consumer prices. Indeed, were it not for the tobacco tax hike in France in November of this year and the pending imposition of the carbon levy, as well as the sharp VAT rate hike in Spain in July 2010, our 2010 forecast would have been below 1% as well.

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ECB on hold throughout 2010 but liquidity should be drained in H2

For the ECB, the emphasis, at least for the time being is on continuing to offer full allotment fixed interest rate tenders but at shorter durations. This suggests that liquidity will continue to be abundant throughout the first half of 2010. At the margin, the ECB could accelerate the process and absorb some of the excess liquidity through reverse repos but this seems unlikely unless there is an especially large take-up of liquidity in December. This continues to suggest that there could be quite a pronounced reduction in liquidity in June 2010 as the €442bn of liquidity in the first of the ECB's 12 month tenders is unwound. This may also coincide with the reintroduction of variable rate tenders. Material reductions of liquidity will therefore be postponed until after June but, once they start, should see a sizable reduction in the spread between overnight rates and the ECB's refinancing rate. Although not a necessary condition, this regaining of control over overnight money market rates would leave the ECB well placed to begin tentatively withdrawing monetary accommodation in 2011 by raising rates.

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Germany

Economic Forecasts: The German outlook at a glance

% (qoq saar unless otherwise stated)	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	2007	2008	2009	2010	2011
GDP	-13.4	1.8	2.9	2.7	0.8	0.7	0.8	1.6	2.6	1.0	-4.8	1.5	1.3
Consumer expenditure	2.6	2.9	-0.8	-0.4	-1.0	0.4	0.4	0.8	-0.3	0.2	0.7	-0.1	0.6
Government expenditure	4.3	1.7	2.3	4.1	2.8	2.8	2.4	2.0	1.7	2.0	2.6	2.8	1.1
Investment	-27.5	3.1	0.8	-2.4	-1.7	-0.6	0.4	1.3	5.3	2.3	-8.9	-0.6	1.3
Exports	-35.8	-4.7	12.1	4.9	3.5	3.0	3.0	5.0	7.8	2.4	-15.2	4.2	4.6
Imports	-19.6	-19.0	9.5	3.2	2.0	4.1	4.1	5.3	5.0	3.9	-9.5	2.5	4.4
Contribution to GDP													
Inventories	0.0	-7.4	1.4	1.7	0.4	0.4	0.4	0.4	-0.1	0.5	-0.7	0.3	0.2
Net exports	-10.7	6.9	1.4	0.9	0.7	-0.3	-0.3	0.1	1.6	-0.5	-3.6	0.9	0.3
CPI headline (% yoy)	0.8	0.3	-0.4	0.3	0.7	0.9	1.0	0.9	2.3	2.8	0.2	0.9	0.7
CPI core (% yoy)	1.3	1.6	1.3	1.2	1.0	0.9	0.7	0.7	1.9	1.3	1.3	0.8	0.6
Unemployment rate (%)	8.0	8.2	8.2	8.3	8.5	8.8	9.1	9.3	9.0	7.8	8.2	8.9	9.7
Employment (% yoy)	0.4	0.1	-0.2	-0.5	-0.8	-1.0	-1.3	-1.4	1.7	1.4	0.0	-1.1	-1.0
Wages and salaries (% yoy)	0.0	-0.8	-0.9	-1.0	0.8	0.8	0.8	0.8	1.7	2.5	-0.7	0.8	0.8
Savings rate (%)									10.7	11.3	11.0	11.3	11.4
Current account (% of GDP)									7.9	6.6	4.4	4.8	5.0
Budget balance (% of GDP)									0.2	0.0	-3.4	-5.0	-4.6
Public debt (% of GDP)									65.0	65.9	73.1	76.3	79.2

Sources: Datastream, SG Cross Asset Research

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Powerful rebound to give way to sluggish expansion

Germany experienced one of the most savage downturns in GDP anywhere in the euro area with a peak-to-trough decline of 6.7%. Among EMU members, only Ireland, Finland and Slovenia fared worse, though Italy did nearly as badly. This goes some way to explaining why we expect GDP growth in Germany to be relatively strong compared to the euro-area aggregate, at 1.5% and 1.3% in 2010 and 2011 respectively. Of key importance is also that fiscal policy is likely to boost growth in 2010 to a substantially greater extent than in 2009 and more than almost anywhere else in the euro area (see chart below). Latest estimates by the European Commission are that Germany's structural deficit will increase by 1.7% of GDP, compared with just 0.4% in the euro area in aggregate. Given the new government's 2010 fiscal plans, the German expansion could be greater. That said, in 2011 there will be no additional stimulus, and the risk is skewed towards some tightening, even if the new government is committed to tax cuts. Lastly, given that much of Germany's recession came through the external trade channel (see chart below), the revival of world trade is expected to lead to a positive contribution to growth. Nevertheless, even at the end of 2011, our forecasts imply that GDP would still be down 2.6% from the peak in Q1 2008.

In other words, after a powerful initial rebound in Q3 and Q4 of 2009, with annualized growth of around 3%, we expect growth to slip below potential – given the uncertainty following the global recession, we loosely put the rate at around 1% - for most of 2010, and only slightly above that in 2011. Hence, the recovery is expected to be weak beyond the second half of 2009, during which slower inventory reductions will add to growth substantially.

In addition, this loss of momentum reflects several features that apply quite specifically to Germany: 1) there has been practically no adjustment in employment to date, but such an adjustment is still probably inevitable; 2) the car-scrapping scheme, which has been hugely successful, has effectively expired at the end of Q3; 3) in contrast to the euro area in aggregate, Germany's household savings rate declined over the first half of the year, and probably did so again in Q3, but is likely to recover; 4) as a highly export-dependent economy, the likely slow pace of recovery in global trade should limit upside growth potential, magnified by the strength of the euro (even if Germany's exports don't tend to be particularly exchange-rate elastic).

Notwithstanding recovery, private consumption is likely to slow

One of the distinguishing marks of Germany's recent economic development has been the robust performance of private consumption, but the factors that made this possible are likely to disappear. It is indeed remarkable that, despite the slump in GDP, private consumption will have grown in 2009, by around 0.8%. For comparison, private consumption in the euro area is expected to have contracted by nearly 1%, and by 0.5% in the United States.

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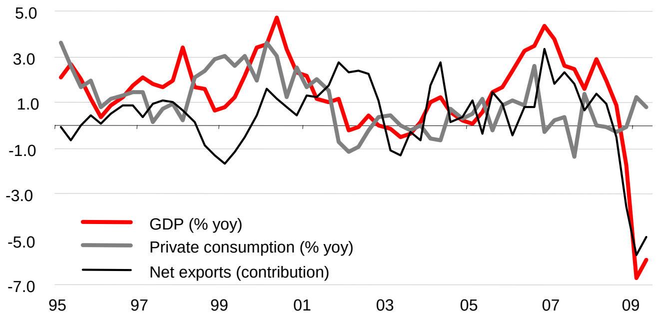
However, the factors that made this expansion possible are likely to fade. Of key importance has been the remarkable stability of employment: from its peak in October 2008 to September 2009, payrolls have declined by just 0.3% (see chart below). Of course, there has been a substantial reduction in hours worked, made possible not least by Germany's short-time working arrangements, which have been extended to 24 months. Nevertheless, we doubt that labour market adjustment can be avoided altogether, and expect employment to contract more rapidly over the forecasting horizon, by around 1% in 2010 and again in 2011. Positive employment growth before 2012, or late-2011 at best, is difficult to imagine.

Wage trends, both in nominal and, especially, in real terms, also point to weaker income, and hence expenditure growth. Negotiated pay rates, even including one-off payments and ancillary benefits, were still up 2.5% yoy in the first eight months of the year, but that looks practically certain to slow. Admittedly, wages and salaries per employee were down in annual terms in Q2, but that ignores the boost from public transfer payments that are part of the short-time working scheme. The bottom line is that nominal wage growth is likely to be sluggish. At the same time, rising inflation will again widen the wedge between nominal and real earnings growth, as headline inflation is expected to average 0.9% in 2010, up from 0.3% in 2009. So, real wage growth is likely to slow more sharply than it will in nominal terms.

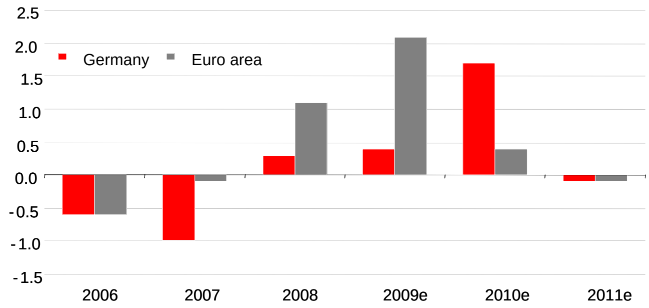
Meanwhile, the end of the car-scrapping incentives is likely to have a profound impact on household spending. Remarkably, German new car registrations in the first ten months of 2009 were up 26% from the previous year, and will this year run some 18% above their ten-year average. But we believe that much of this surge essentially cannibalized future sales, and we expect a sharp pull-back, of between 20% and 30%, in 2010. Moreover, these incentives have probably contributed to the decline in the savings rate, and we believe that some increase in precautionary savings in 2010 and beyond is likely.

German GDP - massive trade shock has swamped consumption strength



Source: Datastream, SG Cross Asset Research

Changes in cyclically adjusted general government borrowing* (% of GDP)



Source: European Commission. * positive value signifies larger deficit

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Given this background, it is perhaps surprising we expect any consumption growth at all in 2010. The main reason is the fiscal easing, mostly benefiting families (through higher child benefit and tax allowances), which will come into effect in January 2010.

Record-low capacity utilization to limit growth in investment and exports

Industrial capacity utilization rates have fallen to historical lows, not just in Germany, but in most industrialized economies. That alone suggests that domestic business investment activity will remain weak. In addition, although investment in machinery and equipment has declined 22% from its peak, its share in GDP remains quite high compared with previous, far less severe, recessions, even in nominal terms (see chart below). An early revival consequently looks unlikely, though the rate of decline is expected to slow sharply of 2010 and a modest revival is expected in 2011.

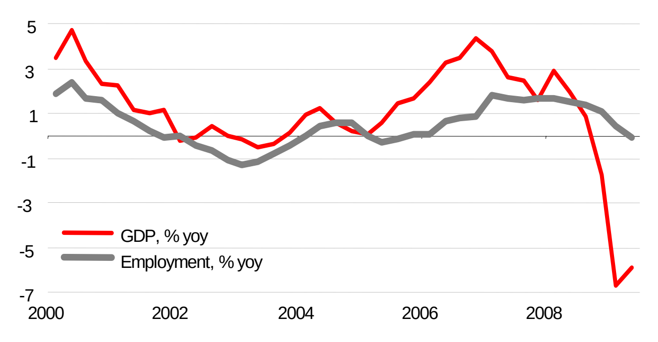
Weak business investment in the main export markets, to which Germany is particularly exposed, also suggests only a moderate revival in net trade, as does the dependence on the car sector, where demand prospects, especially in Europe, are also muted.

Construction investment, meanwhile, has held up well this year, though, despite growth in the first half of the year, the full-year figure will be negative, owing to a big negative carry-over. But supported by increasing fiscal works in 2010, and unencumbered by any past real estate bubbles, building is expected to grow moderately over the forecasting horizon.

Not much upside for growth in 2011

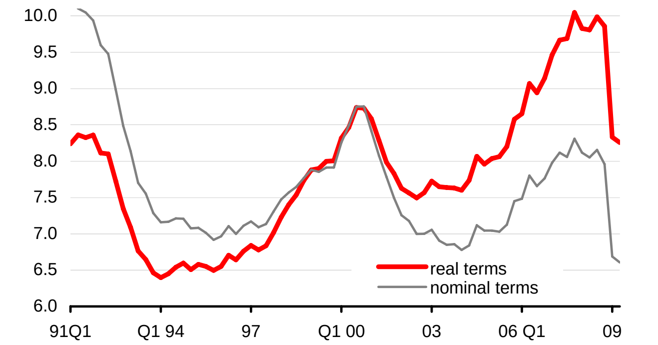
Our first attempt at 2011 forecasts has been guided by several factors. One, a shift in fiscal policy seems inevitable. The large fiscal impulse of 2010 is extremely unlikely to be repeated. But at this stage there is great uncertainty about the new government's budget plans for 2011, which are torn between the need to consolidate public finances over the medium term and a desire to cut taxes. Our working assumption is a small contraction in the structural deficit. Two, as mentioned, employment is expected to continue to contract for most of 2011, which will hamper a building of momentum in private consumption. Three, global trade growth is expected to remain subdued as policy stimulus, including the monetary measures, is wound back in most trading partners, limiting scope for German exports to add much to growth. All in all, we expect average annual growth in 2011 to be somewhat weaker than in 2010.

GDP and employment – adjustment inevitable?



Source: Datastream, SG Cross Asset Research

Machinery and equipment investment as a share of GDP



Source: Datastream, SG Cross Asset Research

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Inflation pressures declining, notwithstanding headline recovery

As pretty much everywhere else, the low point in headline inflation appears to have passed, and average rates in 2010 and 2011 should be higher than the 0.3% of 2009. This is the well-known oil-price effect. Underlying inflation pressures, in contrast, are likely to ease and, despite assuming substantial increases in oil prices, we predict that inflation in Germany will remain below 1% in 2010 and 2011. There are two main arguments: first, wage growth is likely to slow as employment declines, and also as a result of low inflation. With GDP back to positive growth, that implies rising labour productivity and a reversal in the steep increase in unit labour costs. This should allow core inflation to drift lower from an already moderate rate of around 1% currently. Secondly, price pressures should be contained by the appreciation of the euro's exchange rate since the start of the year. Core rates in the vicinity of ½% consequently look perfectly realistic.

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France

Economic Forecasts: the French outlook at a glance

% (qoq saar unless otherwise stated)	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	2007	2008	2009	2010	2011
GDP	-5.5	1.1	1.1	3.0	2.0	0.9	0.7	1.4	2.3	0.3	-2.2	1.6	1.3
Consumer expenditure	0.6	1.1	0.1	1.6	1.2	-0.8	0.0	0.8	2.4	0.9	0.6	0.6	0.7
Government expenditure	0.3	2.2	2.8	1.9	1.9	1.9	1.5	1.5	1.5	1.1	1.6	2.0	1.6
Investment	-9.9	-4.6	-5.4	-1.6	-1.6	-0.3	0.8	1.2	6.5	0.4	-7.0	-1.5	1.1
Exports	-26.5	2.4	9.3	4.9	4.1	3.2	3.2	3.6	2.5	-0.6	-10.8	4.5	4.0
Imports	-22.0	-10.2	1.4	4.5	4.9	3.2	4.1	4.1	5.4	0.6	-10.0	2.9	3.8
Contribution to GDP													
Inventories	-3.2	-2.4	-0.4	1.9	1.5	1.0	0.5	0.5	0.1	(0.2)	(1.4)	0.8	0.3
Net exports	-0.7	3.9	2.0	0.0	-0.3	-0.1	-0.3	-0.2	(0.9)	(0.4)	0.0	0.3	(0.0)
CPI headline (% yoy)	0.7	-0.2	-0.5	0.3	1.2	1.4	1.2	0.8	1.6	3.2	0.1	1.2	0.6
CPI core (% yoy)	1.7	1.5	2.2	1.9	2.1	2.6	1.3	1.0	1.5	2.0	1.8	1.7	0.7
Unemployment rate (%)	8.5	9.1	9.1	9.3	9.6	9.8	9.9	10.0	8.0	7.4	9.0	9.8	10.1
Employment (% yoy)	-2.2	-2.4	-2.1	-1.9	-1.0	-0.5	-0.4	0.0	1.8	0.3	-2.2	-0.5	0.4
Monthly wage growth (% yoy)	2.8	2.2	2.0	1.7	1.7	1.9	1.8	1.8	2.7	2.9	2.2	1.8	1.9
Savings rate (%)									15.5	15.3	16.3	15.8	15.2
Current account (% of GDP)									-1.0	-2.3	-2.1	-2.0	-2.1
Budget balance (% of GDP)									-2.7	-3.4	-8.3	-8.0	-7.5
Public debt (% of GDP)									63.8	67.4	78.0	83.8	90.0

Sources: Datastream, Ministry of Finance, Forecasts SG Cross Asset Research

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The French economy appears to be one of the most resilient to the crisis in the developed world. The GDP contraction may be limited to -2.2% on average in 2009, half the setback registered by the whole euro area economy. One of the common beliefs is that factors explaining this relative outperformance will become handicaps in the recovery phase. This is not our view, at least for 2010. Indeed, we would agree with the opinion expressed by the Prime Minister, according to which the French economy could report 1.5% GDP growth in 2010 and should be one of the leaders of the euro area. However, longer-term prospects remain clouded by the dire state of public finances. If the government commits to cutting the deficit to around 3% of GDP in 2013 or even 2014, this would require severe austerity from 2011, which could prove somewhat difficult to digest for a still very fragile economy. We think this target will likely prove unrealistic. Nevertheless even a “classic” budgetary tightening of around ½ point of GDP would prevent any acceleration in GDP growth. In 2011, France, caught-up by its deficits, could then underperform the rest of the euro area.

Recovery lacks strength

The French economy came out of recession as soon as Q2 and confirmed its rebound in Q3 with a similar 0.3% qoq GDP increase. Although disappointing, this modest rise in activity was achieved, despite a still negative inventory contribution, which should no longer be the case in Q4. Moreover, the positive momentum shown by activity in the last few months (despite the decline in industrial activity in September) and the improvement in business surveys and consumer confidence suggest growth should be stronger in Q4. The reduction in destocking should now support production as demand firms in parallel. Moreover, activity in the auto sector should remain robust as the prospect of the reduction in car purchase incentives in 2010 (from €1000 now to €700 in H1 and €500 in H2) is bringing consumers into car dealers’ shops. The European environment will also remain quite supportive for car makers, as there has been some lag between the end of the measure in September in Germany and the impact on production and as other countries see their markets fully benefiting from measures implemented rather recently (Italy, the UK, Spain). These trends should still be in play in Q1 2010 so that growth should near 2.5% on average over the next six months.

Actually, much of the 2010 growth performance should be achieved during this period: according to our estimates, growth carry-over for 2010 would be 0.8% after Q1 2010. In many respects, the year 2010 will be a year of transition between the current recovery, triggered by supportive economic policy, and 2011 when budgetary tightening is expected to take place. We believe growth momentum gradually will fade in 2010, although GDP growth numbers should on average post a significant improvement (+1.6%).

Consumer spending less dynamic but resilient

Unfortunately, it is difficult to expect this. Indeed, on the household side, consumer spending should suffer from a setback after the likely boost received by car sales in Q4 2009-Q1 2010. Even if incentives are gradually removed, the current acceleration seems to show the shift to lower bonuses will have more impact than the end of the measure scheduled for end 2010. We thus expect a significant slowdown and even temporary contraction around spring and summer 2010. We currently expect consumer spending growth to remain broadly stable from 2009 to 2011 at around +0.7% p.a., as the sharp increase in the savings ratio registered between summer 2008 and spring 2009 should be reversed, which should help to soften the negative impact of the expected slowdown in consumers' purchasing power. Another supportive factor should be the temporary rebound in the housing market. Most recent indicators have been pointing to an improvement: a rebound in credit distribution and transactions, the stabilization in prices in some areas. This is fully explained by the sharp fall in loan rates and by special incentives for first-time buyers and investors (*Loi Scellier*). However, the core situation of the market has not improved very much. Indeed, the downward correction in prices has been rather limited and buyers' purchasing power has improved only marginally. Thus the market remains under threat of any rise in interest rates and of any removal of incentive measures. This should not occur before 2011, however, and 2010 should appear as a respite period on this front.

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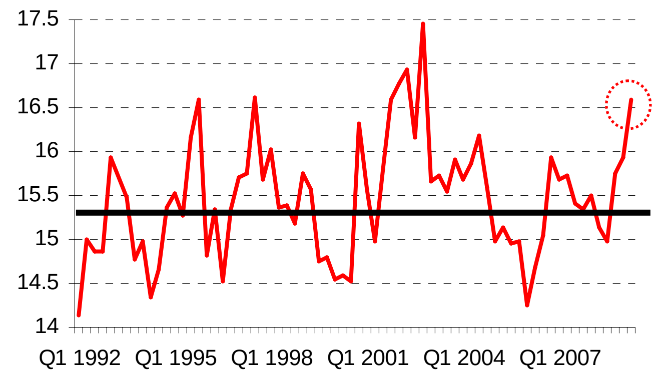
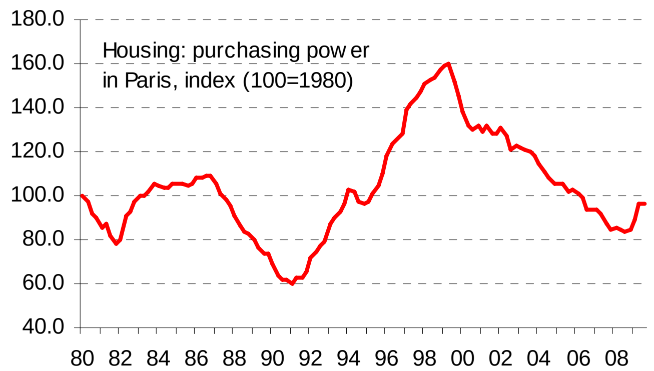
High savings ratio gives consumers some room for manoeuvre



Housing market: this cannot be a true recovery



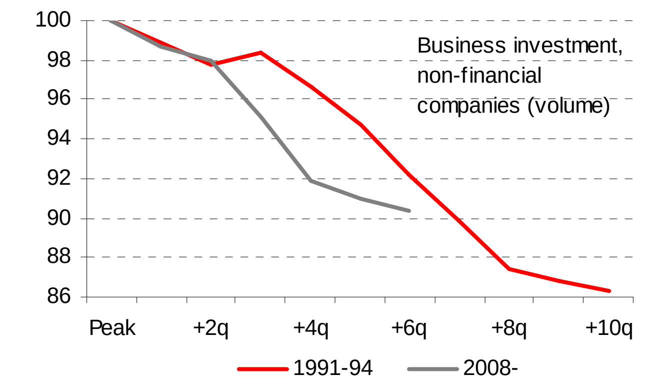
Source: Datastream, SG Cross Asset Research

Business investment: a fall of historic proportions

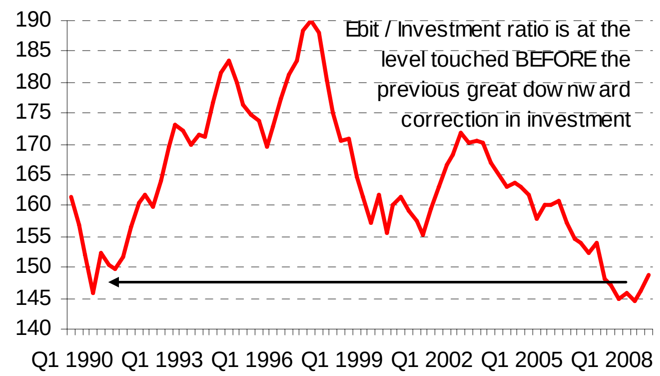
On the corporate side, past recessions tell us the recovery in investment is always a very slow process and current surveys fully confirm that. Industrial investment is expected to fall by 22% in 2009 and again by 5% next year. In the 1993 recession, total business investment fell by 14% over a period of ten quarters. In this crisis, it has already declined by 10% over the last six quarters and the situation may get worse. First, the capacity utilization ratio fell to record low levels (70%) and has only recovered a fraction of its fall (to 73% in Q3). Second, the investment ratio has remained relatively high and the potential for rebound looks fairly limited.

Finally, the corporate financial situation is seriously damaged and financing conditions remain especially dire for SMEs. We thus do not expect the business investment decline to stop before H2 2010, and the recovery to take place very gradually in 2011. Conversely, inventory adjustments should continue to boost activity growth in the coming quarters, adding 0.8 points to GDP growth in 2010 after having cut it by 1.4 points in 2009. Between 2009 and 2010, more than half of the growth differential should be directly attributable to inventories. The impact should remain positive but much more limited in 2011.

Business investment: it could be worse than in 1993



Investment recovery: crucial need for credit



Source: Datastream, SG Cross Asset Research

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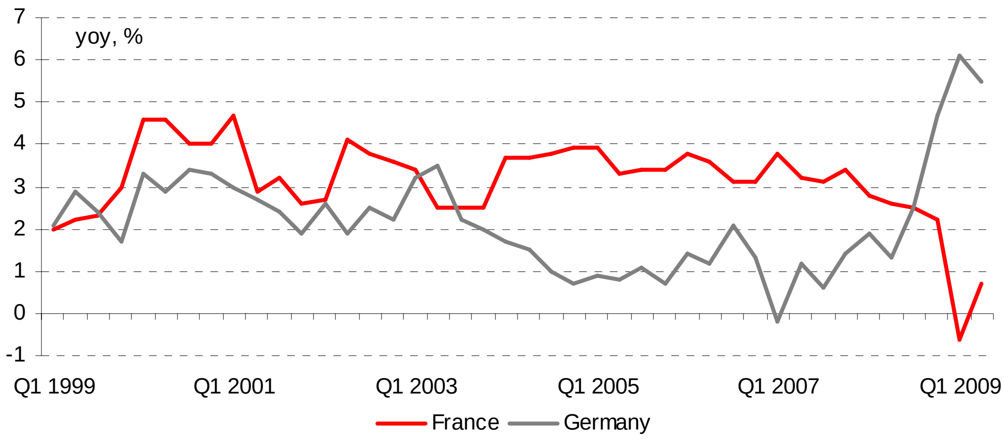
Weak European environment

Finally, net exports should support growth in 2010 but become slightly negative again in 2011. This is one of the crucial assumptions of our scenario. Normally, a classic recovery should show exports gathering pace in 2010 and 2011, while we expect the acceleration to be short lived. The first negative factor should be fading support from car purchase incentives across Europe. The second factor should be the tightening in budgetary policy in some of France's main European partners as soon as 2010, especially Spain and likely the UK, as both countries absorb 15% of France's exports and provide a yearly surplus of almost €10bn to the French trade balance. The euro strength may constitute a third negative factor for exports outside the EMU. The sluggish European environment likely will prevent the recovery from developing.

Unemployment to rise further; inflation to be low and less volatile

The job market adjusted quickly in the wake of the drop in activity through a massive decline in the number of temporary jobs, illustrating the fact that French job market flexibility has improved considerably since the middle of the 90s, at least in the private sector. Then unemployment stopped falling abruptly mid-year, as government support measures became efficient. Employment almost stopped contracting in Q3 and temporary jobs rebounded. This seems very fragile and premature. However, we do not put the French and German job markets in the same basket. French productivity has declined quickly reaching -1.3% yoy, very close to the lows reached in 1994 and 2001. However, it rebounded in Q2 and likely did so in Q3 as well. There is no need for an adjustment as occurred in Germany if the recovery disappoints, as we fear it will. Does this mean the unemployment rise is over? Probably not. In very recent months, unemployment began to rise a bit more strongly again and the poor financial situation of the corporate sector may not be able to prevent another slowdown. We thus expect the job market to continue deteriorating at least through 2010, but relatively moderately. This should push the unemployment rate towards 10%.

Labour costs in total industry & services: France in a much better position than Germany



Source: Eurostat, SG Cross Asset Research

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Inflation should thus remain moderate. Monthly wages have already slowed from +3% yoy to +2% yoy since the beginning of the year. We see the core inflation rate falling towards 1% by the second half of next year. Headline inflation should nevertheless still be boosted by various tax hikes implemented at the beginning of 2010 (the carbon tax in particular), as tobacco taxes were increased in November (+6%). It should also reflect the gradual rise in energy prices. After the sharp fluctuations reported in 2008 and 2009, the inflation rate should come back to a more stable level but below the range of inflation rates registered between 2000 and 2007, i.e. around 1.3% on average.

Tighter fiscal policy from 2011. Not yet enough to stabilize debt

French public finances are in a dire situation, essentially because they were already in pretty bad shape before the start of the crisis. As this situation reflects a structural inability to address this problem and in particular to reduce expenditure, the French government is under strong pressure from the EU Commission to deliver a credible and efficient program of deficit reduction, the target being to cut the deficit to 3% of GDP in 2013 from more than 8% in 2010. The French government (and probably the EU Commission as well) knows this target is somewhat unrealistic as it would require a structural adjustment of at least 1.3 points of GDP per year, i.e. a budgetary tightening policy equal to €25-30bn/year. Such a tightening took place in 1996 to qualify for the EMU, but there were massive strikes in December 1995 leading up to the change. Against the backdrop of low growth and high unemployment and as general and presidential elections are already in sight (spring 2012), we do not expect a sharp reduction in the deficit starting in 2011. That said, it seems reasonable to expect a tightening in budgetary policy equivalent to ½ point of GDP, which would allow a similar reduction in the deficit ratio as growth should be close to its potential. To stabilize the debt ratio, however, this would be insufficient. The debt ratio should thus near 90% of GDP in 2011, with the 100% threshold likely reached in the next two to three years. The *Grand* Emprunt (government loan from the private sector currently under discussion) may add little to existing debt (1 to 2% of GDP maximum), as reimbursements from the banking sector and private funds may help finance the big projects that will be selected. The amount will likely be around €35bn.

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Italy

Economic forecasts: the Italian outlook at a glance

% (qoq saar unless otherwise stated)	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	2007	2008	2009	2010	2011
GDP	-10.5	-1.9	2.5	1.3	0.7	1.3	0.5	1.3	1.5	-1.0	-4.7	1.0	1.3
Consumer expenditure	-4.7	1.2	0.8	1.0	0.8	0.4	0.6	0.8	1.2	-0.9	-1.7	0.8	1.0
Government expenditure	0.8	5.4	0.8	2.0	0.4	0.4	0.8	1.2	1.0	0.6	1.7	1.2	1.1
Investment	-18.4	-11.1	-6.0	-2.2	-1.4	1.9	1.1	4.0	1.6	-2.9	-13.2	-1.5	3.5
Exports	-39.6	-14.0	8.2	2.8	2.8	4.1	4.1	5.3	4.0	-3.7	-19.8	2.9	5.1
Imports	-31.4	-11.6	-2.8	1.2	1.2	2.0	4.1	6.1	3.3	-4.5	-16.2	0.6	5.6
Contribution to GDP													
Inventories	-0.4	-0.4	0.1	0.2	0.0	0.0	-0.1	0.0	0.0	-0.3	-0.2	0.2	0.1
Net exports	-0.7	-0.1	0.6	0.1	0.1	0.1	0.0	-0.1	0.2	0.2	-1.0	0.5	-0.2
CPI headline (% yoy)	1.4	0.9	0.1	0.6	1.2	1.0	1.2	0.9	2.0	3.5	0.7	1.1	1.0
Unemployment rate (%)	7.3	7.4	7.5	7.6	7.7	7.8	7.9	8.0	6.2	6.8	7.5	7.9	8.1
Employment (% yoy)	-0.9	-1.2	-1.1	-1.0	-0.8	-0.6	-0.5	-0.3	1.1	0.8	-1.1	-0.5	-0.1
Compensation of Employees (% yoy)									2.2	3.3	1.7	1.6	1.8
Savings rate (%)									14.6	15.1	15.4	14.8	14.7
Current account (% of GDP)									-1.8	-3.0	-2.4	-2.4	-2.5
Budget balance (% of GDP)									-1.5	-2.7	-5.3	-5.3	-5.1
Public debt (% of GDP)									103.5	105.8	114.6	116.7	117.8

Sources: Datastream, SG Cross Asset Research

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Back to anaemic growth as old problems return

Italy was the only one of the larger euro area countries not to introduce a major fiscal stimulus package to alleviate the impact of the financial crisis. As a result, the decline in Italian GDP has been on a par with the largest declines experienced in the euro area even though low household debt and a relatively solid financial system have provided some shelter from the financial turmoil. The government's policy response to the crisis was constrained by Italy's fragile public finances, in particular its very high public debt. Stimulus efforts have therefore been limited to reallocating public expenditure towards growth-enhancing items, while limiting the impact of the crisis on the most vulnerable groups.

On top of this lack of stimulus, deep-seated structural problems evident in a long period of low productivity growth had weakened the Italian economy long before the global downturn. A marked slowdown in economic activity was already under way before the deepening of the financial crisis. In the second quarter of 2008, real GDP started declining at an increasing pace, initially driven by the impact of surging commodity prices and subsequently by the collapse in global trade and rising risk aversion. Overall, between the first quarter of 2008 and the second quarter of 2009, the cumulative loss of real GDP was 6½%, similar to that of Germany but higher than in most other euro area countries. Even when the recovery from the current downturn starts to take hold, structural weaknesses, including very high public debt, are expected to continue to weigh on the Italian economy. Unless these weaknesses are tackled, economic activity is set to return to an anaemic growth path after the crisis.

Private consumption and exports to drive the recovery

In 2010 and 2011, economic activity is projected to recover gradually. The improvement in private consumption over the forecast horizon relies on the household sector reducing precautionary savings made over 2008-2009 as the global financial crisis fades. Private consumption, for example, had already fallen in the second quarter of 2008 due to the loss of purchasing power related to the surge in commodity prices. It contracted again in the final quarter of 2008 and the first quarter of 2009 because of the high uncertainty brought about by the financial crisis. The tightening of spending on durable goods was followed by a decrease in expenditure on non-durable goods on the back of strengthened precautionary savings. Several measures taken by the government since October 2008, such as the "social card" to support the daily purchase of consumables, the "family bonus" one-off transfer to poorer households and the expansion of wage-supplementation schemes to additional categories of workers, have all helped to underpin household income. Thanks also to tax incentives supporting the purchase of durable goods, in particular vehicles, private consumption recorded a mild recovery in the second quarter of 2009. This recovery is set to gather strength in the rest of the year, carrying a moderate positive growth impulse into 2010.

Investment expenditure is expected to improve over 2010, also boosted by a tax break for equipment investment ending in June 2010 and despite the projected reduction in public investment. It is expected to record positive growth in 2011 as the increase in corporate investment is projected to more than offset a further drop in government capital spending.

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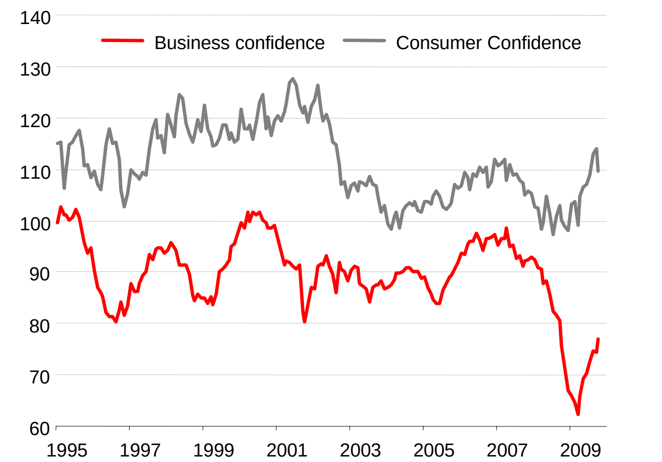
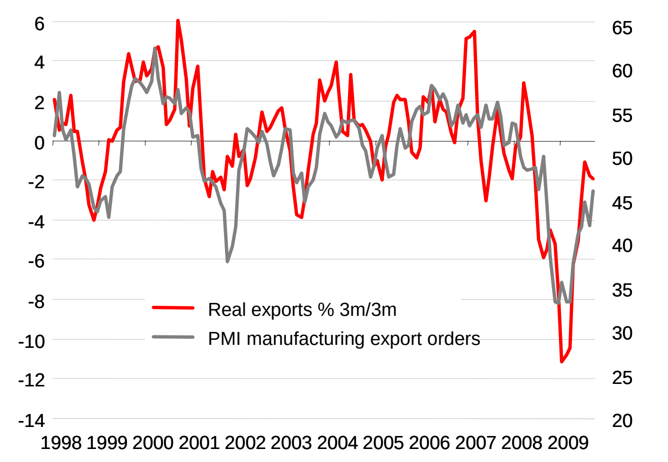
The assumed increase in demand from Italy's trading partners is set to provide an impulse to exports. Imports are expected to regain even more strength, but the projected improvement in the terms of trade should allow the trade balance to remain broadly stable in both 2010 and 2011. Export growth is expected to continue to lag behind global demand over the forecast horizon also due to Italy's failure to recoup the heavy losses in cost and price competitiveness accumulated since the start of this decade. The size of the market share loss also depends on the ability of firms to survive the crisis. The Italian manufacturing sector has undertaken a deep restructuring process in recent years to face increasing global competition, in particular in traditional and medium-to-high technology products. Non-price competitiveness has been improving, namely in terms of product quality. The global financial crisis could jeopardise the ongoing restructuring process as export-oriented firms are hit hard. Having heavily invested in opening up internationally and starting from a relatively low capitalisation, some firms have been taking on debt and now have to cope with both tighter financial conditions and the fall in demand.

Italian business and consumer confidence



Italian exports have bottomed but are still not recovering



Source: Datastream, SG Cross Asset Research

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Spain

Economic Forecasts: The Spanish outlook at a glance

% (qoq saar unless otherwise stated)	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	2007	2008	2009	2010	2011
GDP	-6.3	-4.1	-1.2	-0.7	0.0	0.5	-0.2	0.9	3.6	0.9	-3.6	-0.4	1.0
Consumer expenditure	-9.1	-5.9	-0.3	-0.8	0.0	1.2	-0.8	0.8	3.6	-0.6	-5.1	-0.4	0.9
Government expenditure	4.7	1.8	6.7	2.0	2.0	2.8	2.0	2.0	5.5	5.5	5.1	2.7	0.8
Investment	-22.8	-15.5	-9.0	-4.3	-4.5	-3.8	-2.2	-1.3	4.6	-4.4	-15.5	-5.2	-0.7
Exports	-30.4	2.4	9.4	4.1	4.1	4.1	6.1	6.1	6.6	-1.0	-12.2	5.0	4.7
Imports	-37.6	-9.1	8.4	0.0	0.8	2.0	2.8	3.2	8.0	-4.9	-18.5	1.5	2.6
Contribution to GDP													
Inventories	-0.4	-0.3	-0.1	-0.7	-0.2	-0.4	-0.4	-0.4	-0.3	0.4	-0.1	-0.4	-0.1
Net exports	6.3	3.8	-0.2	1.1	0.9	0.5	0.8	0.7	-1.2	1.7	3.5	0.9	0.5
CPI headline (% yoy)	0.5	-0.7	-1.0	-0.1	0.7	0.8	1.7	1.6	2.8	4.1	-0.4	1.0	1.0
Unemployment rate (%)	16.4	17.9	18.9	19.3	19.7	19.7	19.8	19.8	8.3	11.4	18.1	19.7	19.8
Employment (% yoy)	-6.4	-7.3	-7.2	-6.0	-3.0	-1.2	-0.4	0.0	3.1	-0.5	-6.8	-1.2	0.4
Compensation of employees (% yoy)									4.5	6.1	3.7	2.0	2.0
Savings rate (%)									10.6	12.9	18.8	17.8	17.3
Current account (% of GDP)									-10.0	-9.5	-5.4	-4.8	-4.4
Budget balance (% of GDP)									1.9	-4.1	-11.2	-9.8	-9.0
Public debt (% of GDP)									36.1	39.7	54.3	63.8	71.6

Sources: Datastream, SG Cross Asset Research

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Domestic imbalances inhibit recovery

The recession in Spain is taking longer to overcome than in most other economies, reflecting the need to correct several large imbalances. Chief among these is the real estate sector, where a large overhang of unsold properties points to protracted weakness in construction investment and to ongoing negative wealth effects. Also, a history of poor productivity growth and strong cost inflation has led to a severe adjustment in the labour market, which has in turn depressed household expenditure. In addition, high household sector indebtedness, especially mortgage debt, means that deleveraging is likely to play a greater role in Spain than in the euro area. Fiscal policy also suggests underperformance against the euro area, especially in the near term, as policy in Spain is being tightened already in 2010. That said, after shrinking at a relatively moderate rate in Q3, the economy is expected to stabilise early in 2010 before a slow and uneven recovery sets in during 2010.

The Spanish recession is fundamentally quite different from the rest of the Euro area, in the sense that it has been principally driven by domestic demand. It is true that Spanish exports have fallen as well, but reflecting an even steeper decline in imports, net exports have made a strong positive contribution to growth since 2008, and this is expected to persist right through the forecasting horizon, albeit at a diminishing rate.

Three years of declining private consumption

Alongside construction investment, private consumption has been the key drag on the economy, shrinking by around 5% in 2009, after a decline of 0.6% in 2008. This weakness reflects a host of forces, which are expected to fade only slowly. Most importantly, the Spanish labour market has deteriorated far more than anywhere else in the euro area, pushing the unemployment rate up by 10 percentage points (euro area +2.5ppt). Two factors are likely to have been key drivers: 1) given the high labour-intensity of construction, the retrenchment in this sector has had an obvious impact. This factor will fade, but is not expected to disappear until after 2011; 2) the loss of competitiveness over many years is also likely to have contributed to the severity of the labour market correction. Some ground has been gained, given that employment has declined much more sharply (8.7%) than GDP (4.5%), making

Spain one of the very few economies where labour productivity (per person) has increased during the recession. Again, the intensity of the adjustment is likely to fade, but the magnitude of the previous loss of competitiveness suggests this process has further to run.

Private consumption growth will also be hampered by slowing wage growth, which in 2009 was still supported by indexation clauses that reflected relatively high rates of inflation in late 2008. Wage agreements in 2010 will take place against the backdrop of negative inflation in 2009 as well as sharply higher unemployment. Meanwhile, average inflation in 2010 will be much higher at around 1% compared with -0.4% in 2009, boosted, of course, by the sharp increase in VAT rates in July next year. Hence, real wage growth will be much weaker. Additional fiscal measures will also weigh on disposable income growth.

In short, the outlook for private consumption in Spain is rather bleak. The only arguments in support of some stabilisation come from declines in variable mortgage interest rates which completely dominate the market, and are still feeding through to mortgage debtors, and from a likely moderation in the pace of increase in the savings rate, which is estimated to have risen by nearly 9 percentage points of disposable income in two years. At the same time, consumption is likely to be volatile, as direct tax increases hit incomes, and the VAT increase encourages consumers to bring forward purchases of big-ticket items. All in all, we expect private consumption to fall a further 0.4% in 2010, and only recover slightly in 2011 (0.9%).

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Construction sector adjustment has further to run

Notwithstanding the precipitous falls in construction investment over 2008 and 2009, of 5.5% and some 11% respectively, the shrinking of Spain's building sector is likely to run for at least another two years. The long-run argument is that the share of construction investment in the overall economy still looks large - some 11% in real terms from a peak of close to 13%. For comparison, Germany reached a peak of around 14% in the unification boom, and slumped to just over 9% (admittedly, these real shares are technically problematic).

As mentioned above, a large overhang of new unsold residential buildings will weigh on the sector for some time. But the bigger near-term change is likely to come from public sector demand, as fiscal policy shifts from expansion to deficit reduction, even if the Local Investment Fund (to boost public sector infrastructure) has been partially extended into 2010.

Inflation pressures have virtually disappeared, but the VAT hike will boost the inflation rate, albeit temporarily

The Spanish economy has shown a similarly high degree of price flexibility on the downside as on the upside. Core inflation has dropped to zero, down by three percentage points in a single year. While a few months of negative core rates are clearly possible, core inflation is probably close to its low. In the near term, stabilisation at very low rates looks the most likely scenario, until higher VAT rates boost both the headline and the core measures. The 2ppt hike in the full VAT rate (to 18%), and the 1ppt hike in the reduced rate (to 8%), is expected to boost headline inflation by around 1¼ ppt, and the core rate by slightly more. Excluding this factor, inflation would basically be zero in both 2010 and 2011.

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United Kingdom

Economic forecasts: the UK outlook at a glance

% (qoq saar unless otherwise stated)	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	2007	2008	2009	2010	2011
GDP	-9.3	-2.3	-1.7	2.0	1.2	1.4	2.2	2.7	2.6	0.6	-4.7	1.0	1.6
Consumer expenditure	-6.0	-2.6	-0.8	1.6	1.2	1.2	1.6	1.6	2.1	1.0	-3.1	0.9	1.6
Government expenditure	0.3	2.4	2.4	2.4	-2.4	-2.4	-2.4	-2.4	1.2	2.5	2.2	-0.6	-2.4
Investment	-26.2	-19.3	-14.3	-9.5	-5.6	-0.7	2.1	4.9	7.8	-3.3	-16.0	-6.1	3.6
Exports	-25.5	-5.5	15.2	0.0	4.1	8.2	12.6	12.6	-2.8	1.0	-9.6	6.3	6.9
Imports	-25.2	-8.4	14.8	0.0	1.9	5.3	8.9	8.6	-0.7	-0.8	-11.6	4.3	5.4
Contribution to GDP													
Inventories	-1.6	1.3	0.8	1.9	1.3	0.6	0.6	0.6	0.1	-0.4	-1.2	1.1	0.3
Net exports	0.6	1.0	-0.2	0.0	0.5	0.6	0.8	0.9	-0.6	0.5	0.9	0.4	0.3
CPI headline (% yoy)	3.0	2.1	1.5	1.7	2.5	2.5	2.6	2.6	2.3	3.6	2.1	2.5	1.9
Unemployment rate (%)	7.3	7.9	8.0	8.3	8.5	8.7	8.9	8.9	5.3	5.9	7.8	8.8	9.3
Employment (% yoy)	-1.5	-2.2	-1.8	-2.3	-1.8	-1.4	-1.5	-1.2	0.7	0.6	-1.9	-1.5	-0.7
Average hourly earnings (% yoy)	-0.5	2.5	1.2	0.8	3.8	1.0	1.2	1.4	4.0	3.6	1.2	1.8	1.9
Savings rate (%)									2.2	1.7	5.0	6.0	6.0
Current account (% of GDP)									-2.7	-1.6	-2.1	-1.3	-2.0
Budget balance (% of GDP)									-2.4	-6.3	-12.5	-12.5	-11.5
Public debt (% of GDP)									36.5	43.0	55.4	65.6	73.9
Bank of England Bank Rate (%)	0.50	0.50	0.50	0.50	0.50	0.50	0.50	1.00	5.51	4.68	0.64	0.56	2.00

Sources: Datastream, SG Cross Asset Research

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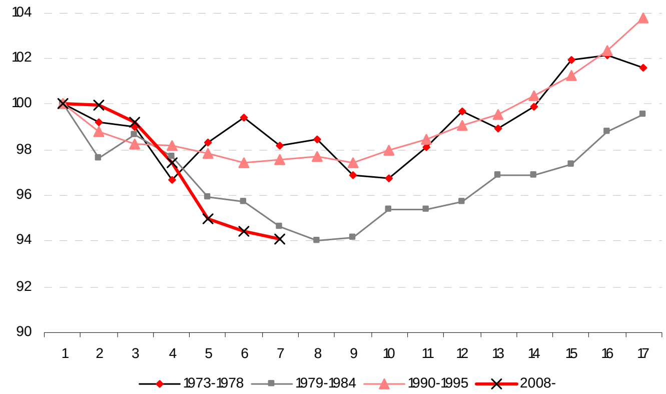
The last in the easing phase but earlier in the tightening phase?

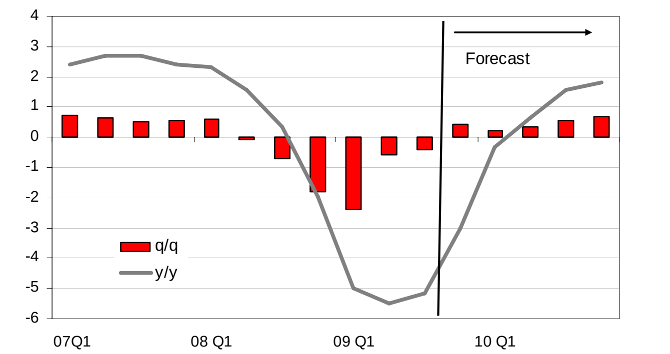
The UK economy suffered more than many other countries in Europe during the crisis and now seems to be underperforming in the recovery phase. Moreover, as the left hand chart below shows, the path has been lower than in previous UK recessions. Many countries managed to claw their way out of recession in Q3 09 (some even achieved this in Q2) but the UK was still experiencing further falls in GDP in that quarter. To some extent, this is a result of a less supportive car scrappage scheme in the UK than in other countries, but it also reflects the deep-seated structural problems caused by the bloated state of the banking sector.

GDP path in the current and previous recessions



Source: Datastream, SG Cross Asset Research

Economy should exit recession in Q4



However, the latest PMIs for October and the industrial production data for September strongly suggest that the UK will have finally shaken off recession during the fourth quarter of 2009. The manufacturing PMI moved well above 50 to 63.7, the services PMI made further significant gains to 56.9, and the composite PMI rose from 54.3 to 56.9. Furthermore, manufacturing and industrial output rose by 1.7% and 1.6% respectively in September, which provides a firm base for Q4 industrial output. All in all, the prospects are for a healthy gain in GDP of 0.5% qoq in Q4, with the risk of a higher number. Moreover, in due course, the Q3 data will probably be revised up but, even if this does materialise, they are still likely to show the economy was in recession in Q3.

Despite this more encouraging news, the Bank of England chose to make a further increase of £25bn in the Asset Purchase Facility (APF) in November. Growth in Q3 was below the MPC's expectations, even allowing for the possibility of upward revisions. Furthermore, even though the MPC is going to great lengths to downplay the importance of money supply as a measure of the success of the APF, it will have been profoundly disappointed that its favoured M4 ex IOFC variable actually fell in Q3.

This increase of £25bn brings the size of the programme to £200bn which will take three months to reach, i.e. by the time of the next MPC Inflation Report meeting in February. This is a halving of the pace of asset purchases from the £50bn in the three months to November. This is a strong signal that we are in the closing stages of the asset purchase programme. £200bn now looks like the top but, if that is confirmed in February when the MPC members next assess the programme in depth, it is likely to be described as a pause for reflection rather than a definite end. The November vote was split three ways – 7 for the eventual increase, 1 for no change and 1 for a larger increase. This lack of unanimity keeps all the options open but, with the cracks in the vote already, appearing the likelihood of a further increase seems small.

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So where to from here? We cannot be sure that asset purchases have reached their limit until the February 2010 meeting. This should push back the market's expectations of the timing of the first rate increase from the current consensus of around the middle of the year. Our forecast is that the first move will not take place until Q4 2010 and the MPC decision is consistent with that.

The fiscal outlook is dire - but it might give the BoE room for manoeuvre. On December 9 the Chancellor will deliver the Pre-Budget which will be the last serious opportunity to change fiscal policy before the election. There will be a Budget in March or April but that is too close to the expected May general election to permit major tightening measures. The budget deficit is projected to reach 12.5% of GDP this fiscal year and should be close to that next year. Mr Darling is likely to provide at least some specifics of how he plans to reduce the cyclically adjusted deficit to zero by 2017/18. The more credible the plans are, the more notice the MPC can take of them when setting the stance of monetary policy. In the short term, this could provide the MPC with the justification to delay the first rate increase until later than the market foresees. This is one of the reasons that we predict the Bank will be able to wait until the fourth quarter of 2010 before activating its exit strategy, which will start with a rate increase.

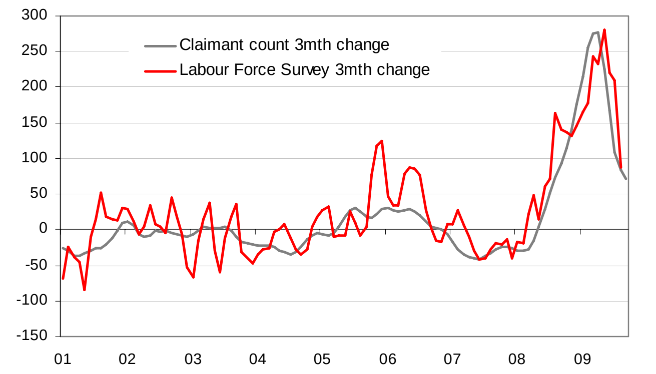
Unemployment might take a long time to reach its peak

Even though doubts remain about the strength and sustainability of any recovery, the employment plans of companies in both the manufacturing and services sectors betray few such doubts. The amazing feature of the UK labour market response has been the ever-increasing signs that the big wave of lay-offs has already passed. Changes in the claimant count measure of unemployment peaked at 136.6k in February and have since fallen back to only 12.9k by October of this year. The wider LFS measure corroborates that pattern.

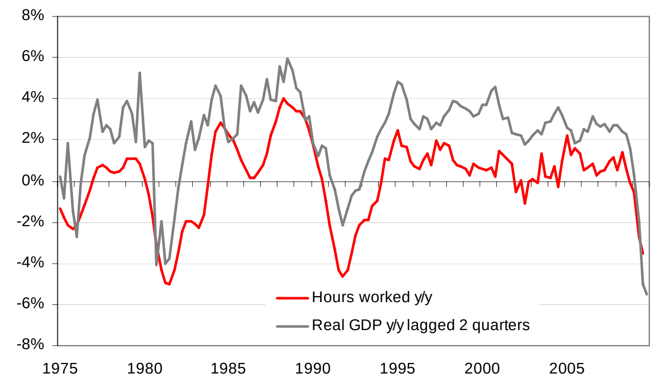
What is going on? It appears that producers took a gamble in the depths of the downturn that the collapse in demand would be short lived and so they retained their staff to be ready for the upturn. The bigger response has then been in the total number of hours worked, which have fallen pretty much in line with the pace of economic activity. So, to justify this strategy, companies need to see the pick-up in demand on which this strategy is predicated.

Whilst hours worked have fallen far more dramatically than headcount numbers, it is still an open question whether or not they have been cut enough. In the right hand chart below, one can see that, in the previous two recessions, hours worked fell by even more than real GDP whereas, in the current recession, they have fallen far less. Labour demand tends to respond to activity with a two quarter lag. Thus, the chart suggests that growth in hours worked should continue declining into the early part of 2010.

Lay-offs peaked whilst output was still collapsing



Hours worked track real economic activity



Source: Datastream, SG Cross Asset Research

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At the very least, the higher-than-expected level of employment is likely to make businesses much more cautious about resuming hiring during the upturn. In the last recession, the peak in unemployment was very well defined. The unemployment rate fell very sharply as growth returned. This time, we first expect a very slow rise to the peak, which could eventually be close to 10%, but not until 2011.

This will also have an impact on investment. A higher level of employment means higher costs, lower margins and lower profits. Here, there is a big contrast with the USA where labour was shed aggressively and profits are already recovering. Such a scenario is most unlikely in the UK. One qualification is necessary, though. Manufacturers cut jobs far more deeply than did service sector companies. Perhaps because of that, the latest CBI Industrial Trends survey reported a surge in investment intentions. The same is unlikely for service companies.

Inflation remains a risk

The consequence of the slow and partial labour market response is that unit wage costs (UWC) are still growing far too rapidly, despite a peak-to-trough reduction in GDP of 6%. For the economy as a whole, those costs rose by 5.7% yoy in the second quarter of 2009. The news is better for the manufacturing sector, though. UWC growth in that sector peaked at 10.5% 3mth yoy in February but has since fallen to 3.5% 3mth yoy by August. The message from the October manufacturing PMI is that employment was still falling at the same time as output was bouncing. Moreover, earnings growth is still cooling. The sum of these effects will be to reduce manufacturing UWC growth further.

The same process is under way in the services sector but in a less dramatic fashion. Therefore, we are far less optimistic about whole economy UWC growth. The implications of this for inflation are worrying. Core inflation has been volatile but has not displayed a downward trend as unemployment has risen. Add to this the observation that unemployment is rising more slowly than expected and one is led is to the conclusion that, even if the recovery in GDP growth is only muted, there is a risk inflation could rise quickly from its current rate of 1.5% yoy.

And, this brings with it a policy risk as well. It is striking that the low point of the inflation cycle in the UK is likely to be the 1.1% yoy recorded in September. Compare this to the floor in Euro area inflation, which was -0.7% yoy in July. Yet, the UK and Euro area have the same inflation target of 2%. This makes it abundantly clear that, if any external price shock hits these two areas, then the policy response is likely to come first in the UK.

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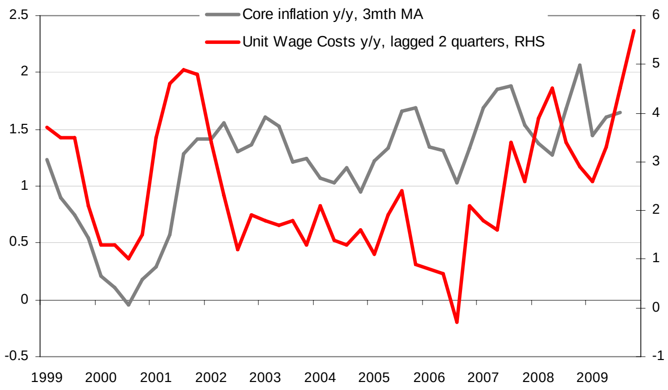
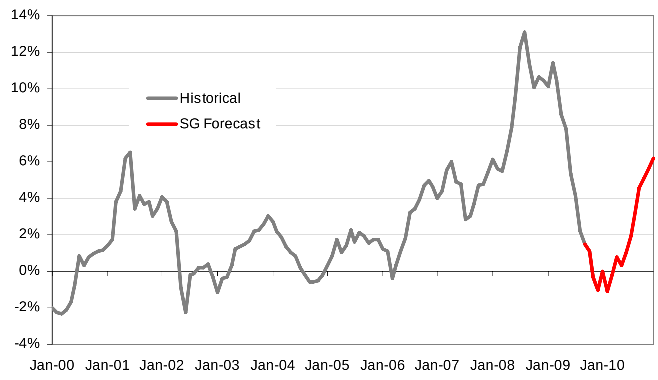
And what might that shock be? As discussed elsewhere in this document, it could come from commodities. Considerable attention is paid to petrol prices, but, in the UK, food prices have also been very important in the recent past, partly because of the fall in sterling. As well as implying a risk of premature monetary policy tightening, such a price shock would also reduce real disposable income growth and so add a downside risk to consumer demand too.

Core inflation has been stable



Food price inflation might soon start to rise again



Source: Datastream, SG Cross Asset Research

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Japan

Economic Forecasts: The Japanese outlook at a glance

% (qoq saar unless otherwise stated)	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	2007	2008	2009	2010	2011
GDP	-12.2	2.7	4.8	-1.5	-1.1	1.0	1.5	2.9	2.3	-0.7	-5.4	0.7	0.3
Consumer expenditure	-4.3	3.9	2.8	-1.5	-0.3	1.0	0.7	0.6	0.7	0.6	-0.9	0.5	0.8
Government expenditure	2.5	4.4	1.0	-2.0	-1.5	-2.5	-2.8	-2.5	0.2	-0.5	2.2	-1.4	0.0
Investment	-29.1	-15.6	6.6	6.2	-2.8	5.8	0.0	0.0	5.3	-4.0	-17.7	1.2	-0.6
Exports	-62.2	27.9	28.0	14.2	4.5	4.5	4.4	4.4	9.6	2.1	-25.0	10.2	4.3
Imports	-45.4	-15.6	14.1	6.6	3.8	3.8	7.5	3.7	1.5	0.9	-14.9	4.6	5.9
Contribution to GDP													
Inventories	-0.3	-0.7	0.4	-0.3	0.1	-0.1	-0.1	0.4	0.1	0.0	0.2	0.1	-0.1
Net exports	-1.6	1.3	0.4	0.3	-0.1	0.2	0.5	0.3	1.3	-2.5	-0.4	1.5	2.5
CPI headline (% yoy)	-0.1	-1.0	-2.2	-2.3	-1.7	-1.5	-1.5	-1.5	0.1	1.4	-1.4	-1.6	-0.9
CPI core (% yoy)	-0.2	-0.5	-0.9	-1.7	-1.6	-1.2	-0.8	-0.7	-0.3	0.0	-0.8	-1.1	-0.5
Unemployment rate (%)	4.4	5.2	5.5	5.5	5.3	5.2	5.1	5.0	3.9	4.0	5.2	5.2	4.8
Employment (% yoy)	-0.8	-2.0	-1.8	-2.3	-2.5	-2.5	-2.3	-2.1	0.5	-0.4	-1.7	-2.4	-0.9
Total contractual earnings (% yoy)	-3.0	-3.5	-3.3	-3.1	-2.7	-2.2	-1.5	0.0	-1.5	-1.2	-3.2	-1.6	1.7
Savings rate (%)									3.3	2.7	3.3	3.2	3.1
Current account (% of GDP)									4.9	3.2	2.7	3.5	4.5
Government Finance (% of GDP)									-3.8	-3.0	-5.0	-6.0	-6.8
Bank of Japan Policy Rate (%)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.5	0.5	0.1	0.1	0.1

Sources: CEIC, Bloomberg, & SG Cross Asset Research

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Deflation as far as the eye can see

Japan's most severe deflationary adjustment is yet to occur. Many believe that Japan's longest post-war expansion from Q1 01 to Q2 08, ignited by the structural reforms of the Koizumi era, squeezed deflation out of the Japanese economy. The return of positive year-on-year CPI inflation for every month of 2008 was the proof of this. However, the inflation of 2008 now appears to have been entirely a currency and commodity price dynamic. That is, it was imported. If we strip the impact of the commodity price shock out of the inflation figures, inflation was barely positive at just 0.2% in 2008. Realistically, deflation, characterised as a surplus of supply over demand has never really ended in Japan. Neither will it in the near future.

This is a complete failure of the legally mandated objective of the Bank of Japan to achieve "price stability". The Bank of Japan is forecasting core CPI deflation of between 1.6% and 1.4% in FY09, between 1.2% and 0.7% in FY10, and between 1.0% and 0.3% in FY11. This will prove to be the most prolonged and severe deflationary episode in Japan's modern economic history. The cumulative decline in the Nationwide CPI during the severe 1997-98 recession and through the global deflation scare of 2000-01 was a little over 3.0%. Now, a much more significant deflation adjustment is in the offing. This is purely a function of the gaping output gap that has amassed in Japan over the course of the financial crisis and that will be extremely slow to close, given the severe downward revision to the estimate of potential growth for the economy. The output gap is estimated to be between 6 and 8% of GDP and the Bank of Japan has revised potential growth down to around 0.5%. Assuming the economy immediately returns to the potential growth path in the post-crisis period it would take 12 years to close the output gap!

Good Politics is Bad Economics. The change in administration, though clearly a fresh political broom in Japan, is a negative for the economic outlook. The Hayamoto administration was swept to power on a pledge to abolish public works spending and replace it with job creation and child-care spending. However, the marginal propensity of households to spend in Japan is terribly low and the marginal returns on government spending under the new administration will therefore be much lower. Though much maligned by western observers, public works programmes have many linkages through the economy, particularly via capital works, capital expenditure, commodities demand and employment.

The abandonment of the Aso stimulus package replaces high multiplier expenditure with low multiplier revenue and is a serious policy error. For all the criticism of the Liberal Democratic Party's (LDP) "bridges to nowhere" and other wasteful public spending, the Democratic Party of Japan's (DPJ) public spending has proved to be no less opportunistic. Though electorally popular, there are no long-term efficiencies to be gained from the allocation of fiscal funds to childcare and/or job creation in an economy in the final stages of complete hollowing out. Demographically, childcare spending and short term job-creation makes no long-term sense at all. The Bank of Japan's downward revision to potential growth to almost zero is a reflection of the likelihood that Japan's inputs to production will soon be shrinking and the dividend from combining these inputs is fading.

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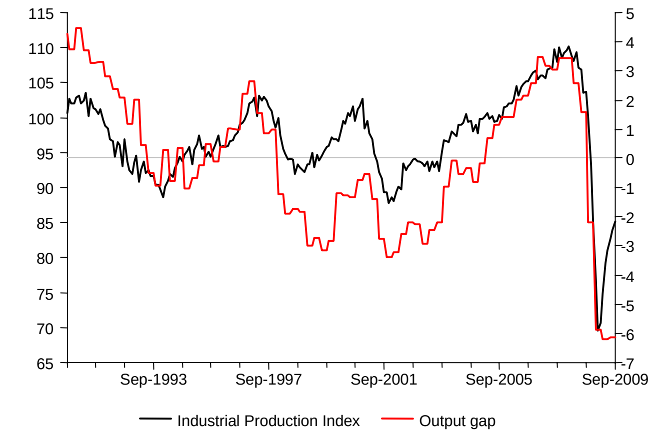
Japan's famous "virtuous circle" is no more. Industrial production is no longer leading to higher employment and higher income, and therefore higher consumption. The so-called virtuous or self-reinforcing cycle that saw Japan commence monetary policy normalisation in 2005 is no more. Industrial production appears to be stabilising at a level around 80% of its pre-Lehman's peak. This compares to South Korea, China and India where industrial production is already back above last year's levels. Obviously, relative currency movements are having an effect, but the basic point is that Japan's industrial production recovery has not been sufficient to prevent unemployment rates from rising nor deflation from intensifying as the economy's internal supply-demand imbalance worsens.

Unemployment keeps on rising. At this stage, it remains very difficult to pinpoint when the unemployment rate in Japan will stabilise. Traditional leading indicators such as the job-to-applicant ratio continue to deteriorate and the September Tankan showed that corporate Japan still considered its overall employment situation to be characterised by excess. Indeed, manufacturers appear to be enjoying some improvement in their overall earnings by savagely reducing personnel expenses (headcount), which does not bode well for the overall employment outlook. Not only is headcount being reduced, but wages and bonuses are also being trimmed savagely. According to figures compiled by Nippon Keidanren, winter bonuses will decline by 15.91% yoy in 2009, almost the same as the -17.15% change seen in summer bonuses.

Deteriorating profits, very weak investment figures and the implied weakness in employment all suggest that Japan's recovery will lose momentum sharply in 2010. The most disconcerting feature of current business surveys is the broad characterisation of "excess". The September Tankan revealed that firms continue to be saddled with excess equipment and workers. In the same vein, capital expenditure plans have been revised sharply down. It is also likely that employment plans are being revised down. Labour and income conditions should thus weaken further in the year ahead, suggesting a very weak consumption outlook.

Enormous capacity overhang



Source: Bloomberg & SG Cross Asset Research

The Bank of Japan forecasts persistent deflation

BoJ's Forecast from April 2009 YoY %	Real GDP	Domestic CGPI	Core CPI
Fiscal 2008	-3.2 to -3.1 [-3.2]	+3.3	+1.2
Forecasts made in January 2009	-2.0 to-1.7 [-1.8]	+3.0 to +3.2 [+3.1]	+1. to +1.2 [+1.2]
Fiscal 2009	-3.7 to -3.0 [-3.1]	-7.6 to -6.9 [-7.5]	-1.6 to -1.4 [-1.5]
Forecasts made in January 2009	-2.5 to -1.9 [-2.0]	-7.0 to -6.0 [-6.4]	-1.2 to -0.9 [-1.1]
Fiscal 2010	+0.8 to +1.5 [+1.2]	-2.4 to -1.4 [-1.8]	-1.1 to -0.8 [-1.0]
Forecasts made in January 2009	+1.3 to +1.8 [+1.5]	-1.5 to -0.8 [-0.9]	-0.6 to 0.0 [-0.4]

BoJ's Forecast from October 2009 YoY %	Real GDP	Domestic CGPI	Core CPI
Fiscal 2009	-3.4 to -3.0	-5.4 to -5.0	-1.6 to -1.4
SG Forecast	-4.0	-4.0	-2.0
Fiscal 2010	+0.7 to +1.5	-1.5 to -0.9	-1.2 to -0.7
SG Forecast	0.0	2.0	-1.5
Fiscal 2011	+1.4 to +2.5	-1.1 to -0.2	-1.0 to -0.3
SG Forecast	0.0	3.0	-1.0

Source: CEIC & SG Cross Asset Research

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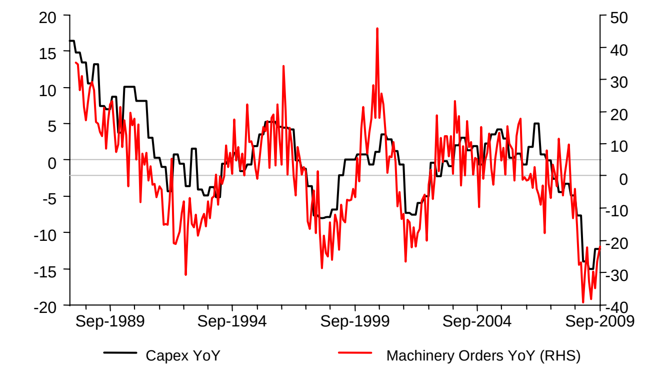
Investment will remain mired by large output gap and capacity overhang

Domestic capital goods shipments were up over the September quarter, suggesting that private sector capex would make its first positive contribution to growth in six quarters. Still, the contribution was hardly stellar. After a cumulative decline of over 24% in the past six quarters, private fixed asset investment increased by 1.2% in the June quarter. Only the most starry-eyed of economists would be tempted to refer to this as a rebound. We have argued for some time that the global financial crisis has not been kind to Japan and the land of the rising sun faces the post-crisis landscape with an enormous capacity overhang. It would be extremely surprising to see anything remotely like the previous capex rebounds experienced in the previous three recent recessions in the 2-3 years ahead, even allowing for an upside cyclical surprise in the global economy, for several reasons.

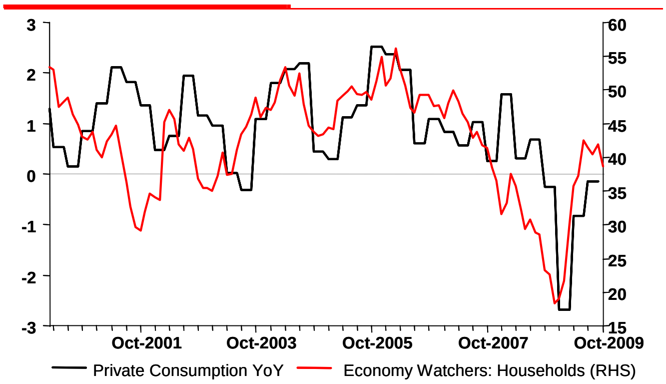
First, the preferred leading indicators of private capex are machinery orders. It is difficult to confirm at this time whether machinery orders have indeed bottomed. Second, capacity utilisation rates are well below levels seen even at the bottom of the bursting of the IT bubble. Finally, companies continue to maintain a very cautious stance on investment, as evidenced in the Q3 Tankan survey.

Investment and Machinery Orders



Source: Bloomberg & SG Cross Asset Research

Consumption and Economy Watchers (Households)



Source: CEIC & SG Cross Asset Research

We believe we are likely to move into a stop-start period of intermittent advances and retreats for private capital expenditure.

Consumption to weaken in line with incomes

Another upside surprise that seemed to go against every piece of anecdotal evidence and fundamental development over the quarter - private consumption increased by 0.7%qoq in the September quarter, adding 0.4ppt to growth. The unemployment rate peaked at a high of 5.7% early in the quarter, overall household spending decelerated and consumer confidence started to ebb lower from mid-quarter. Though a welcome surprise, like capital expenditure, we can have no confidence that any strength in private consumption will be maintained.

One of the better leading indicators of the Japanese economy this year has been the economy watchers' survey - for consumption, the household component has been particularly useful. In October, mass-retailers' department stores and other general retail suffered major slumps due to further signs of deflation, with those stores surveyed reporting that discounted sales were turning into wars of attrition with rivals and customers were becoming more price-sensitive. In other words, Japanese customers appear to be, once again, deferring consumption, anticipating cheaper prices in the future.

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In light of the severe employment and income environment, as seen in large cuts to summer bonuses and the rising unemployment rate, private consumption put in a good showing. However, the positive effects of pro-consumption government policies have largely run their course and cannot be expected to contribute much in the future. Concerns about a severe consumption slowdown in coming quarters are one of our red flags for Japan.

External trade dependent on China

Net exports continue to underpin Japanese growth, accounting for 2.0ppt of growth recorded in the past two quarters. Exports were up 6.4% on quarter, posting the second consecutive quarterly gain, while imports rose 3.4% qoq, a reversal from the 4.2% drop in Q2. Looking forward, imports are likely to continue to enjoy some support from a stronger yen and we expect the net export contribution to growth will gradually fade in the coming quarters. With both domestic and external demand contributions fading, the economy should generally post more muted growth outturns in the coming quarters, as external trade has been the major driver of growth. However, we look for net exports to resume contributing to growth by mid-2011 on the back of firmer external demand and stabilisation in the yen.

Japanese exports continued to recover through the third quarter but still underperform those of North Asian trade competitors. The volume of exports in September improved to -21.4% yoy from -25.4% yoy in August. By destination, Japanese exports (volume) to the US and Europe were still off by around 30%yoy, but exports to Asia continued to recover strongly with the drop shrinking to single-digits (-9.6% yoy). Clearly, Asia continues to be the engine for Japan's export recovery. Within that recovery, Japanese exports to Asia also continue to be led by those bound for China. September exports (value) to the so-called newly industrialized economies (NIEs) were -25.0% yoy and those to ASEAN were -24.9% yoy, while exports to China were only -13.8% yoy.

China's increased appetite for imports has benefited Japanese exports. Nonferrous metals, chemical products and IT-related products led China-bound Japanese exports in H1 2009. Even exports of general machinery, which had been lagging other sectors, have recently started to pick up. Chinese fixed asset investment continues to grow at a pace of more than +30%yoy. Various leading indicators (new projects, etc.) suggest this growth will remain at a high rate. Though China has implemented various policies to curb excessive equipment levels, these measures are limited to only a few industries and are not expected to have a significant impact on overall investment nor China's demand for the high quality capital goods produced by Japan.

Deflation nation

As we mentioned at the outset, the Japanese economy continues its long slow deflation. The nominal size of the Japanese economy is around 10% smaller than the peak reached in the 1990s (Q2-1997). In comparison, nominal GDP has risen by 75% in the USA and by 50% in Europe over the same period. For the September quarter of 2009, in nominal terms, the Japanese economy contracted by 0.1%qoq or 0.3% saar, the sixth consecutive quarter of nominal decline. From a year earlier, Q3 GDP dropped 4.5%, posting the fifth straight y/y drop after -7.0% in Q2.

The GDP deflator in the third quarter rose 0.2% from a year earlier after rising 0.5% in the previous quarter. The increase in the GDP deflator is being driven by the sharp declines in the imports deflator, which under the national accounts arithmetic is subtracted from the other deflators. We prefer to focus on the domestic demand deflator as a true indication of the dire deflationary state of the Japanese economy. The domestic demand GDP deflator fell 2.6% in Q3 after posting a revised 1.8% drop in Q2.

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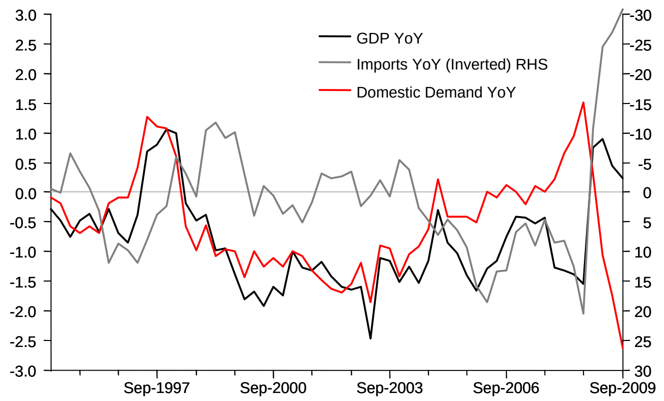
Will the deflation of the Japanese asset bubble ever be complete? Deflation in Japanese land prices is intensifying. Nationwide prices fell by 4.4% in the 12 months to June 2008 – the largest fall in the past five years. The Japanese land price bubble has now been deflating for 18 consecutive years.

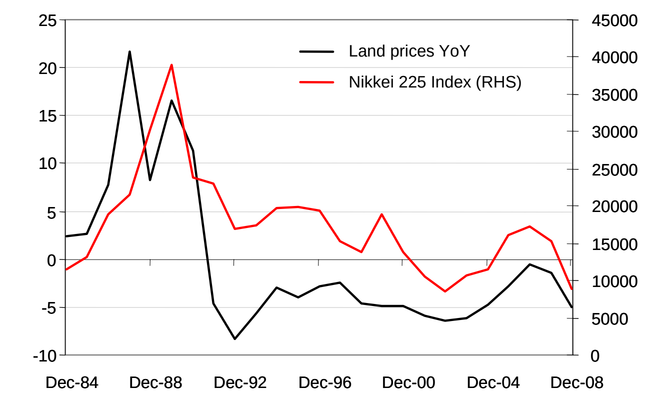
What is especially striking in the report is just how broad-based price declines remain, a fact that the headline scantily captures. Residential and commercial land prices fell in all 47 prefectures. This is first time in the history of the index such absolute weakness has occurred. Further, of the roughly 23,000 locations in the annual land survey, only three recorded price rises. This is also the lowest occurrence in the history of the series. Japan has collected land price figures since 1975.

Obviously, the 12 months to June 2008 were a period of acute asset price deflation globally; however, the breadth and magnitude of the decline in Japanese land prices is truly remarkable. Commercial property prices in Tokyo today are at the same level as they were 35 years ago. In the case of Japan, this begs the question, whenever will the "Hesei Bubble" stop deflating?

Deflation distorted by the import price deflator



Will Japan's asset bubbles ever stop deflating?



Source: SG Cross Asset Research

Policy implications and outlook

We note the likely multi-year persistence of deflation in Japan. We also note that the Bank of Japan is the first major central bank to revise its assessment of potential growth in the post-crisis world, to an alarmingly small "around 0.5%"

Clearly, Japan will be the last major economy to raise interest rates. It would be silly for the Bank to consider raising rates over the course of 2010, unwise over the course of 2011, and most probably imprudent over the course of 2012. Indeed, the Bank of Japan is likely to move through varying degrees of policy accommodativeness over the course of 2010-2012 as temporary measures are either rolled over, expire or mature. In this sense, it is useful to consider the signalling mechanism of the Bank under Governor Masaaki Shirakawa.

Since July 2008, Shirakawa has expanded the post-meeting communiqué to include four key points that aid the transparency with which the Bank conducts monetary policy. They provide an opportunity to give guidance on inter-meeting operations as well as an assessment of the evolution of risk factors. In short, the Bank statement now contains: 1) a guideline for money market operations in the period between meetings; 2) an economic and price assessment; 3) an examination of risk factors; and 4) thoughts on monetary policy conduct.

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The key elements as we transit away from the temporary credit easing measures into the more vanilla very-low interest rate policy environment become items 1 and 4. To provide an example from the 13-14 October Monetary Policy Meeting, at the press conference following that meeting Governor Shirakawa said: "*Regardless of how temporary measures are handled, the BoJ plans to maintain its present extremely low interest-rate policy and an ample supply of liquidity, and thereby to maintain an extremely accommodative financial environment that will solidly support the economy.*"

According to the minutes of that meeting, which were released on 5 November, in debating the exit strategy from these temporary measures: "*Many members said that, regardless of the manner of dealing with temporary measures, it was most important that the Bank clearly explain its basic policy stance of steadily implementing measures to maintain the accommodative financial environment.*"

However, what exactly is "accommodative"? The Bank always uses the word "accommodative" in a relative sense. In reference to the financial environment, it is often based on a comparison between the policy rate and the rate of real GDP growth. For example, Governor Shirakawa explained during his 30 October press conference: "*If the economic growth rate rises, in other words, if corporate earnings gradually rise, the easing effect of even the same interest rate will greatly increase. In this regard, even though interest rates remain the same, our policy has already become more accommodative.*"

But how then, can Japanese monetary policy remain accommodative if potential growth is slightly above zero? The other side of the Bank's downward revision to potential growth is that, in the absence of the economy growing strongly above potential for reasons not determined by domestic policy conditions, it is very hard to imagine policy becoming anything other than mildly accommodative in the two years ahead.

Indeed, under our central risk scenario of a double-dip recession for Japan in early 2010, the "relativity" argument of policy accommodativeness would suggest policy was indeed tightening. Under our central scenario of a double-dip recession (in fact, it is a triple-dip recession over 2010-11) the Bank of Japan will have to return to a genuine time commitment if it is to encourage monetary policy accommodativeness. A return to an outright zero policy seems unlikely, given the Bank's views that it distorts the intermediary functions of money markets whilst a return to quantitative easing also seems unlikely given that Japan's financial system is largely sound. In this case, the only viable and feasible monetary policy option left for Japan is a firmer time commitment. For example, "we will maintain an extremely accommodative financial environment until Japan achieves sustainable growth with stable positive price growth". Whenever that will be is anybody's guess.

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China

Economic Forecasts: The Chinese outlook at a glance

% YoY	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	2007	2008	2009	2010	2011
GDP YoY	6.1	7.9	8.9	10.0	8.4	7.3	8.8	9.5	13.0	9.1	8.2	8.5	9.5
Nominal retail sales	14.9	15.0	15.4	19.0	21.0	22.0	23.0	25.0	16.7	21.7	16.1	22.8	25.0
Nominal fixed asset investment	27.2	32.3	33.1	36.0	38.0	41.0	37.0	33.0	25.8	26.3	32.2	37.3	33.5
Real estate investment	4.0	10.0	16.0	22.0	23.0	23.0	24.0	24.5	38.0	30.0	13.0	23.6	24.5
Exports	-19.7	-23.4	-20.3	-15.4	24.2	13.1	12.1	10.0	25.9	17.9	-19.7	14.8	17.4
Imports	-30.8	-20.2	-12.0	24.9	74.7	40.9	21.1	16.7	26.6	20	-9.5	38.3	11.8
Contribution to GDP													
Inventories	-1.6	1.3	1.0	2.0	1.5	1.0	0.0	-0.5	0.2	0.3	0.7	0.5	0.5
Net exports	-5.4	.4	0.4	0.0	-1.4	-2.3	-1.5	-1.2	2.4	1.5	-1.2	-1.6	0.6
CPI headline (% yoy)	-0.6	-1.5	-1.3	0.0	1.0	1.5	2.5	3.1	4.8	5.9	-0.9	2.0	5.1
PPI core (% yoy)	-4.6	-7.2	-4.0	0.0	2.5	3.8	5.8	7.6	3.1	6.9	-4.0	4.9	9.6
Unemployment rate (%)	4.2	4.3	4.3	4.2	4.2	4.2	4.2	4.1	4.0	4.1	4.2	4.2	4.2
Employment (% yoy)	1.0	0.7	0.5	2.0	5.4	3.0	3.0	2.5	2.4	2.3	1.1	3.5	1.1
Nominal wage index (% yoy)	14.1	13.6	12.0	11.0	10.0	11.0	12.0	9.1	21.5	20.9	12.7	10.5	13.5
Savings rate (%)									53.5	53.0	55.0	56.0	55.0
Current account (% of GDP)									11.0	8.8	6.0	5.0	4.0
Government Finance (% of GDP)									17.0	20.0	22.5	25.0	27.0
PBOC 1yr working capital rate (%)	5.27	5.27	5.27	5.27	5.28	5.27	5.27	5.27	4.06	5.31	5.27	5.27	6.89
PBOC reserve requirement ratio (%)	15.5	15.5	15.5	15.5	15.5	15.5	15.5	16.0	14.5	17.0	16.5	17.5	17.3

Sources: CEIC, Bloomberg, & SG Cross Asset Research

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8% was always going to be easy. Imbalances are now the question

China has never been as dependent on investment for growth as it is now. So far, in 2009 investment has accounted for 95% of published growth. This is extraordinarily unbalanced growth and more than doubles the 43% norm of the past decade. The trade balance will be one rupture from this imbalanced growth as commodities and capital goods imports (which are 30% and 45% of China's imports respectively) surge on the back of this investment wave, and we expect China to move into trade deficit in 2010. Consumption will be another rupture. Investment of this magnitude is simply crowding out all other expenditure components of growth.

In its modern economic history, China has experienced three profound waves of investment strength. These have all been policy induced state-led investment waves that have normally followed an economic shock or been associated with an internal shock. These waves follow below.

- Modern economic reforms of 1978. Investment's contribution to GDP peaked at 83% in 1985.
- China's isolation following the Tiananmen incident. China needed to re-engage with the West and kick-start the economy. Investment's contribution to GDP growth peaked at 81% in 1995.
- In the lead-up to and immediately after WTO ascension. Investment's contribution to GDP growth peaked at 65% in 2003.
- China, by its own policy design, is now in The Fourth Wave. Investment was responsible for 95% of GDP growth so far in calendar 2009. This may well not be the peak.

In the previous Three Great Waves, the trade surplus either narrowed sharply or shifted into deficit. Every time! The same dynamic is already playing out now. Exports will have posted their first full year decline in 30 years in 2009 and are only expected to increase modestly in 2010. Imports on the other hand could increase dramatically. Import prices will rise sharply compared to export prices, with the terms of trade effect amplifying the effect.

Fixed Asset Investment accounted for 95% of growth over Q1-Q3 2009

With the Chinese state-owned banks acting as "fiscal agents", nearly CNY9trn of funds were offered to the various ministries, state-owned, local government, conduit and quasi-official enterprises that all fall under the state umbrella in China. There can be no mistaking the prompt payback of these efforts. Across the motherland, investment has grown by 33.1%YoY to September.

And it won't stop there. On our calculations, China is not even close to completing its planned fiscal spending. In the case of railway spending, for instance, China plans to spend CNY2trn on railway infrastructure over the next three years including laying 15,000 kilometres of track. Over the nine months to July 2009 in quantity terms China completed around 20% of its planned works in terms of railway track length laid. China, however, only spent 10% of allocated funds reflecting the fact that a lot of the higher value-added items of the fiscal plan, China is building its own rolling-stock for instance, will occur later in the plan. Nonetheless, across a whole range of projects we generally find China is only around 20-25% of the way through these projects and the current envelope of spending will support activity until Q1 or Q2 2011.

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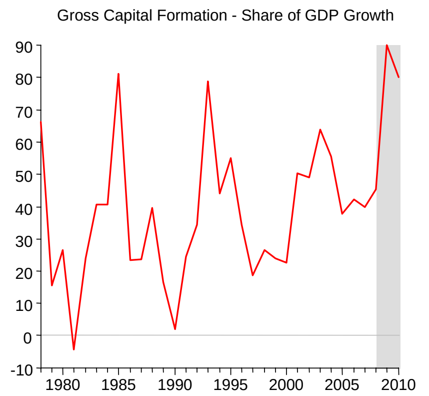
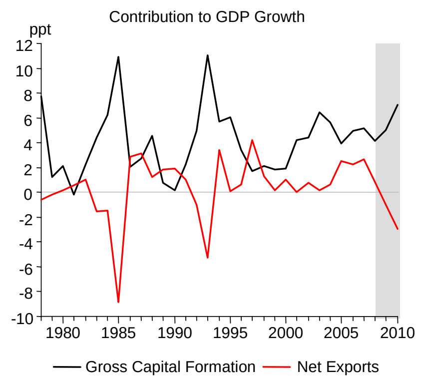
Trade deficits are inevitable

These are incredibly commodity and capital intensive projects China is undertaking. The quantities alone argue for trade deficits. However, the relative elasticity of demand and supply appear to be working to create a negative terms of trade shock. In short the price of China's exports should remain relatively stable in 2010 to 2011 whilst the price of China's imports should pick up dramatically.

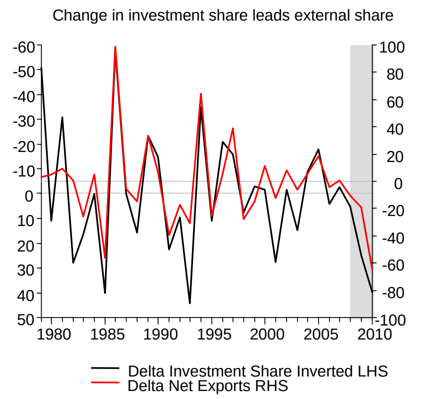
Investment share of growth surge



Net exports the mirror of investment



Net exports to detract from growth



Source: Datastream, SG Cross Assets Research

Whereas inside China policy operates with no lag, given the command nature of the economy, outside China the supply equation is characterised by inelasticity and physical constraints. In short, the faster China moves to "save" itself the more it is likely to cost. Secular global forces (de-leveraging consumers and slack OECD demand) and enormous output gaps are acting to suppress export prices. The leviathan scale of China's demand response continues to suggest further upside risks to commodity, freight and input (import) prices.

At the same time, China is augmenting this massive public works program with subsidies on durable goods and income measures aimed at supporting consumption. As China moves to encourage an entire generation of "First Time" buyers for household durable goods, conservative estimates suggest that 600 million home appliances worth nearly CNY2trn (nearly USD300m) could be sold in rural China by 2012. Hence, we are in the unique situation where China is simultaneously trying to push domestic savings lower (to finance consumption) and simultaneously driving investment higher.

It sounds like the ideal policy prescription but it is not working. One of many nameless officials once famously described the Chinese economy as a cart pulled by two strong horses and one weak donkey. The two strong horses were investment and exports and the weak donkey was consumption. The past two five-year plans aimed to rebalance growth away from investment and exports towards consumption; however, investment is now pulling the cart single-handedly. To be so dependent on just one driver of growth is clearly a concern and Beijing will be hesitant to prematurely tighten policy and choke off the sole driver of growth – particularly given the interest rate sensitivity of investment.

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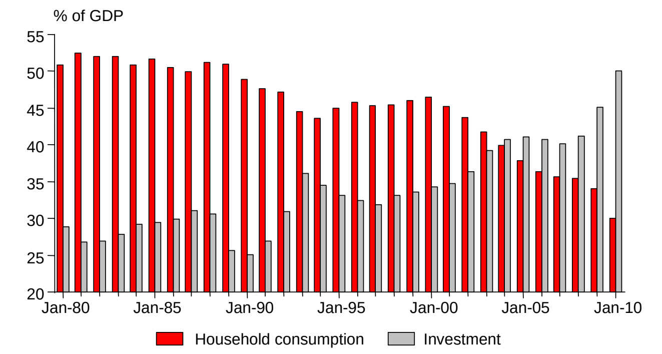
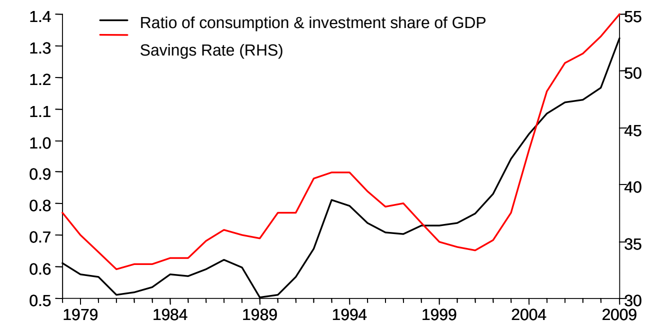
Consumption is being crowded out and savings are rising

Based on the third quarter arithmetic we estimate that the investment share of GDP rose to around 46% of GDP. This is a record for China. In fact, it is most probably a record for any major economy. More worryingly, the sharply accelerating rate of investment share (88% in Q2 and 80% in Q1) suggests that investment share of GDP is on track to pierce the critical 50% of GDP threshold early in 2010. This will be the tipping point at which export and consumption share of growth start to fall more dramatically.

Investment is crowding out consumption



Savings rate has risen to finance investment



Source: CEIC, SG Cross Assets Research

The flip side of the dramatic rise in investment share is the rapid collapse in consumption share. As investment share hit its record high, we estimate consumption share fell through its record low of 36% of GDP. China has the lowest consumption share of GDP of any major economy. Consumers are capturing a smaller slice of an ever-growing pie and the speed at which that dislocation is occurring is accelerating, not slowing, as the last two five-year plans of economic policy have sought to address. For China, this systemic issue has arisen from prioritising investment and industrialisation as the primary policy goal. China has simply "crowded out" consumption and this process is accelerating, not slowing.

Consumption is weaker than retail sales suggest and savings are already rising. Retail sales rose by 16.2% YoY in September. The headline retail sales figures show a clear strengthening, auto sales for one are very strong (see Thematic Box 1) but "true" consumer spending is probably weaker than implied by the retail number (retail sales figures include some business and government purchases for instance). Separate surveys point to weaker consumption growth suggesting that the rural household subsidies programs we mentioned above are not gaining significant traction at this time. The household expenditure survey suggests consumption growth was around 10% YoY over the same period. The GDP expenditure data suggests private consumption slowed to 8.2% in the period Q1 to Q3 inclusive from 8.5% in the final quarter of 2008. Both the household survey and the implied expenditure GDP data are pointing to weakening consumption. Reinforcing this theme from the expenditure side, a Q3 PBoC survey of households found that 43% of urban residents wanted to increase savings whilst only 15% wanted to increase consumption.

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Labour market will send misleading signals in coming months

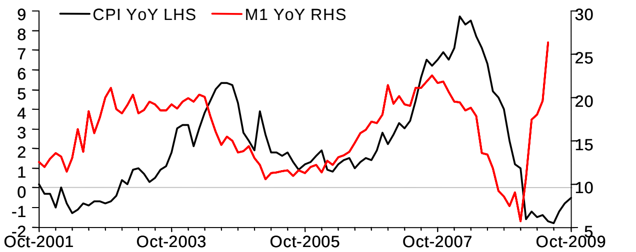
Chinese workers will appear to be a lot poorer. The National Bureau of Statistics has announced that it will expand its future wage data releases to incorporate the private sector as well. While this change in basis will make reading the all-important wage-growth figures a tricky task for the next year, in the short run we will get a much more accurate picture of the absolute wage level. The expanded NBS coverage will increase the workforce coverage for the wage survey, for instance, from 121m to 188m workers. The crucial point is that private sector wages are far lower than those reported in state sector surveys. The previously published average annual urban wage in 2008 was nearly RMB30,000 whilst the average private sector wage was nearly 42% lower at RMB17,100. Overall, the NBS expects that the wider survey will reduce the national average urban wage by around 15% to around RMB25000.

This is not just a statistical affect; corporate transfers will be lower as they are based on national estimates of the "official" wage. Though many will argue that this is merely a statistical change, it is not. A reduction in the official wage will also mean a reduction in employer social security contributions. In other words, business will get a tax cut. This is likely to be a further positive for investment and a further negative for consumption in 2010.

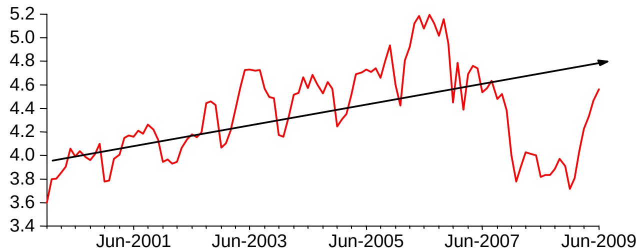
Inflation. The velocity of money looks reassuring

As with many economies, a glance at the monetary aggregates suggests the chance of inflation break-out in China is high. Both narrow and broad money have spiked in China this year. Unlike other economies, the absolute growth rates of money in China are not unprecedented, with money growth after both the Asia crisis and also the Tech Wreck being quite strong. The importance, however, is the velocity of money and here we find much less cause for alarm.

Is this an inflation shock waiting to happen?



Long run monetisation of the economy has to be taken into account in considering estimates of "money velocity"



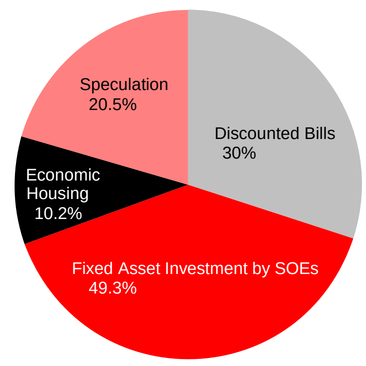
Source: CEIC, Cross Assets Research

A monetary expansion is not inflationary if the velocity of money has collapsed. As the velocity of money cannot be observed we have taken the ratio of M2 to the monetary base as a proxy. The velocity of money is on an observable trend increase given the ongoing monetisation of the economy. The effects of the drastic tightening in the Reserve Requirement Ratio over the course of 2007 are evident (shifting more money onto the central bank's balance sheet) by the collapse in the velocity of money. Indeed it is reassuring that the rebound in M1 growth which looks alarming when plotted against the CPI does not look anywhere near as alarming when we look at the velocity of money which is still well below long run trend.

Bank Lending

Given the single growth driver in the Chinese economy, it is premature to be talking about policy tightening. The market continues to interpret the slower headline figure as a sign that Beijing is in fact tightening lending quotas. Nothing could be further from the truth. What is merely happening is that discounted bills (3-month papers issued at a deep discount to ordinary lending rates to ease tight credit conditions for small and medium sized enterprises) are now maturing and this is showing up as a negative in the bank lending figures. Overall bank lending still looks to be on track for CNY10trn total lending for 2009. That is around 33% of GDP, or broadly equivalent to the export share of the economy in 2008.

General composition of bank lending



Source: SG Cross Asset Research

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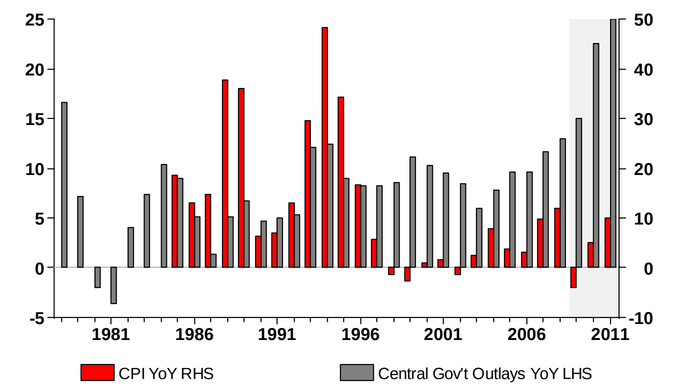
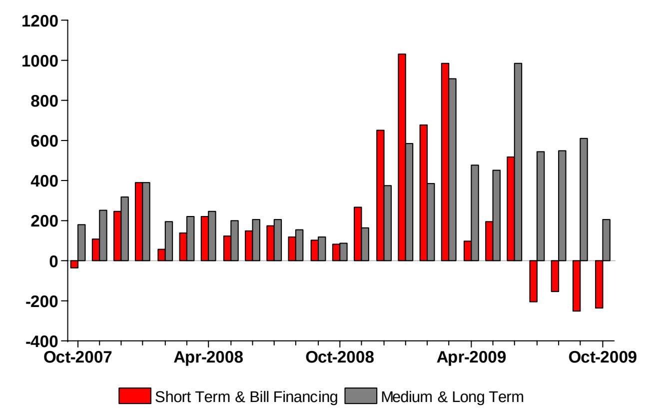
Policy Implications and Outlook.

China is in a position to use fiscal policy more effectively than in previous slowdowns. Central government fiscal revenue was only 5.8% of GDP in 1997/98 compared to 10.9% now. Fiscal deficits averaged 1.9% in 1998-2000 whereas we now expect the fiscal deficit to average 3.7% in 2009 and 4.0% in 2010.

Fiscal policy could become more fully engaged



Bank lending is not slowing, guided or otherwise



Source: CEIC, SG Cross Asset Research

The Central Economic Working Conference (CEWC), which normally sets the tone of policy objectives for the following year, will convene in mid-to-late December this year. We expect policymakers to reiterate their pro-growth bias, with a lack of certainty on the sustainability of the global recovery likely to be a feature. It would be most surprising if the CEWC chose to move away from a fully stimulatory policy before the National People's Congress (NPC) in March 2010. This suggests, at the very least, that we have at least another two quarters of very strong investment growth ahead of us.

A Three-Stage Schema for Monetary Policy Exit

Normalization in policy (not tightening per se) is likely to occur in three stages. As of now, officials and regulators remain very supportive of growth and will continue to retain a pro-growth policy until evidence emerges that growth has broadened beyond just public investment or significant upside inflation risks are readily apparent, not merely forecast. Indeed, new loans extended of Rmb516bn in September (34.2%yoy growth) suggest that financial conditions remain very loose in the system and, despite monthly noise in the system, confirm that Beijing is still running a very loose monetary policy. Over the course of 2010, but not before the second quarter, we expect that policy to evolve thus:

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- **Informal Guidance:** The CBRC will begin to target the quality of loans but with no absolute restrictions or ceilings placed on the total amount of lending. This is a crucial point given the clear behavioural characteristic for Chinese banks to lend aggressively in the first part of the year. The bulk of the CNY6-8trn of lending we expect for 2010 is likely to occur in the first six months of the year. Informal guidance is likely to be the strongest component of tightening.

- **Quantitative Restrictions:** The PBOC restricts the volume of lending by lifting the Reserve Requirement Ratio (RRR). In the second half of 2010, the PBOC will start to restrict the quantity of funds available for lending by lifting the RRR ratio. Our initial target is two 50bp moves at the tail-end of Q3 and Q4. Quantitative restrictions are likely to be the second strongest component of tightening.

- **Rate hikes:** The PBOC will also move to adjust the cost of money starting in the third quarter of 2010 and we look for three 27bp adjustments in the 1-year working capital rate in each quarter into the first quarter of 2011. This is largely fine-tuning and the 81bp of tightening is expected to largely augment the first two components of the tightening schema.

A clear change in exchange rate policy. Gradualism is the key.

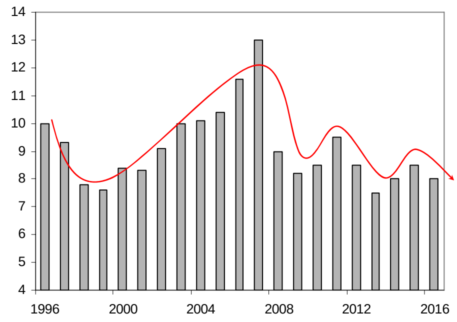
Of course, the exchange rate will also be adding to the overall tightening of monetary conditions. The Q3 PBOC report details a policy goal to "improve RMB exchange rate system by catering to the changes of fund flow and major currency changes in global market." This replaces the previous wording which was to "maintain the RMB exchange rate stable at equilibrium level."

That China announced the goal in the week US President Obama was due to visit needs no explanation. We look for a 3-5% appreciation in the CNY over the course of 2010, which will dampen some imported inflation and marginally take the edge off China's enormous import bill in coming years.

Risks – Not a short-term double dip. A medium-term double dip.

We retain our confidence in the ability of China to be able to save itself and deliver 8% growth. The key question is sustainability. In a state-directed command economy China can obviously run a significant disequilibrium for longer than other economies; however, China's starting point to rebalance the economy becomes more stretched the longer investment is allowed to run rampant. Moreover, the economy probably has lower medium term capacity to grow. The economy has averaged 10% growth in the period 1978 to 2008. In the period 2010 to 2020 that growth rate is likely to be 8.0% given the lower desire for credit and leverage to which western consumers will have access. The imbalances China is building up now will take longer to correct in the new single-digit growth decade ahead.

A mid-cycle correction to lower potential growth of around 8.0%



Source: SG Cross Asset Research

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Australia

Economic Forecasts: The Australian outlook at a glance

% (qoq saar unless otherwise stated)	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	2007	2008	2009	2010	2011
GDP	1.6	2.5	3.6	4.1	8.4	1.7	2.5	1.1	4.0	2.4	1.3	4.1	2.6
Consumer expenditure	2.0	3.4	2.1	1.3	2.6	-2.5	2.6	2.6	4.4	2.6	1.7	1.4	2.2
Government expenditure	-2.5	3.2	-2.0	0.0	1.3	0.6	0.6	0.6	2.8	6.2	1.2	0.5	0.6
Investment	-22.6	7.7	7.6	13.0	12.6	12.2	11.8	19.7	13.8	13.9	-0.2	12.0	16.4
Exports	8.2	3.9	4.1	3.5	21.9	13.5	13.1	12.7	3.3	3.8	2.3	11.7	12.3
Imports	-27.2	8.6	3.4	13.8	27.9	26.1	24.5	23.1	11.8	11.3	-9.7	19.8	11.1
Contribution to GDP													
Inventories	0.2	0.2	0.0	0.5	0.4	0.3	-0.2	-0.2	0.7	-2.2	1.0	0.4	0.0
Net exports	2.2	-0.2	0.0	-0.5	-0.4	-0.7	-0.7	-0.7	-1.9	0.0	1.4	-2.4	0.4
CPI headline (% yoy)	2.5	1.5	1.3	1.8	2.0	2.5	2.5	2.8	2.4	4.4	1.8	2.4	2.8
CPI core (% yoy)	4.5	4.2	3.8	3.5	3.0	2.8	2.5	2.5	3.8	4.0	4.0	2.7	2.0
Unemployment rate (%)	5.3	5.7	5.8	5.7	5.6	5.5	5.4	5.4	4.4	4.2	5.6	5.5	5.2
Employment (% yoy)	0.6	0.1	-0.1	0.0	0.1	0.1	0.3	0.4	2.8	2.2	0.2	0.2	1.0
Average weekly earnings (% yoy)	4.3	4.1	3.9	3.7	3.7	3.8	3.9	4.0	4.1	4.1	4.0	3.9	4.2
Savings rate (%)									2.1	2.7	5.4	4.5	4.0
Current account (% of GDP)									3.9	-4.2	-5.7	-6.2	-2.0
Government Finance (% of GDP)									-4.0	-1.0	-4.9	-4.5	-3.5
RBA Policy Rate (%)	3.00	3.00	3.00	3.75	4.25	4.75	5.25	5.75	6.75	6.68	3.19	5.00	6.25

Sources: CEIC, Bloomberg, & SG Cross Asset Research

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Commodities at the end of the economic rainbow

Australia sailed through the global financial crisis, posting only one quarter of negative growth but, more importantly, with export volumes having actually expanded throughout the freeze in global trade following the collapse of Lehman Brothers in September 2008. Australia's serendipity arose from the unique swiftness with which China was able to implement infrastructure-led pump priming of its economy and the sheer scale of that stimulus. Domestic policy proved to be equally effective. The RBA is now the first G-20 central bank to be in a position to start normalising the emergency settings of monetary policy and appears to be at the forefront of a new monetary policy dogma that seeks to fold asset price stability into the more traditional central banker's consumer price stability mandate.

Short term – Australia is testament that fiscal policy works

Australia is in this incredibly fortunate position simply due to the fact that fiscal policy works – not just domestically, but in the Asian economies that were particularly nimble in putting substantial fiscal stimulus to work. Indeed, it has been quite some time since Australia has seen such a strong co-ordinated fiscal impulse emanating from Asia. Over the past decade and a half, Asia has largely been constrained in its conduct of fiscal policy by the straight jacket of the Asian crisis and the fear of capital flight that a loose fiscal ship entails. With the exception of Japan, Asia's fiscal position remains comparatively healthier than the G20.

Australia's largest export markets are in Asia, dominated by China, Japan and South Korea. These economies, responding to China and the globe's infrastructure-led response to the crisis, have ramped up steel production and Australia's exports of coal and iron ore have surged. When we adjust for the depreciation of the Australian dollar, Australia stands out as one of the few, if not the only, economies whose export volumes expanded during the collapse in trade volumes in the six months from Q4-2008 to Q1-2009.

The early onset of the Chinese stimulus and the maintenance of bulk commodity export volumes, as well as the automatic stimulus provided by a depreciating currency over 2008, appears to have resulted in a classic "labour hoarding" in the resource and minerals sector. The unemployment rate has risen much less then expected and appears to be stabilising at a level much lower, and much sooner, than previously feared.

Given this, Keynesian multipliers have proven to be most effective. Business and consumer confidence stabilised well before other industrialised economies as the central bank and the Rudd (Centre) government were seen to quickly ease policy. The quick stabilisation in confidence allowed Keynesian multipliers to work. The greater proportion of tax cuts was spent, rather than saved, as were the substantial one-off income support payments made to families. Monetary policy was also particularly effective with 80% of Australian mortgage holders having a variable mortgage rate which has tracked the RBA cash rate lower.

The sum of all these dynamics has seen the Australian economy make its way sure-footedly through the crisis and it is now set to resume above-trend growth in 2010 with moderation to trend growth in 2011. This is an economic outturn that can only be described as nothing short of miraculous. The risk is obviously inflation. With no output gap and China intent on saving itself via a commodity-intensive infrastructure growth model, Australia has little or no margin for policy error.

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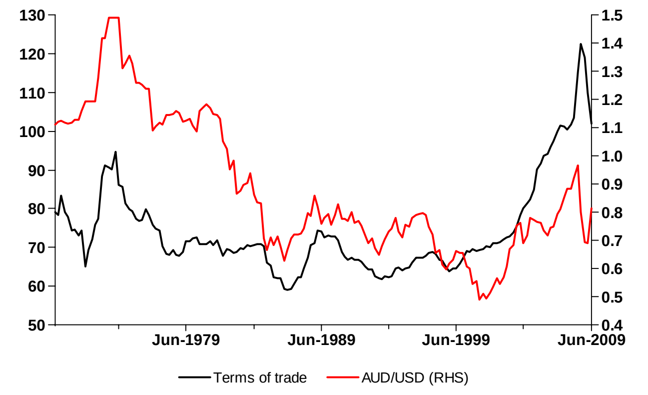
Medium to long term – potential growth will be higher, renewed positive terms of trade shock, a golden age of prosperity.

As the world's developed economies continue to deal with the legacy of recession and impaired financial systems, most are in the process of revising estimates of potential growth lower. Japan set the sombre tone for this post-crisis reality check when it revised down its assessment of Japan's potential growth rate to "around 0.5%" when it released its October 2009 semi-annual statement on monetary policy. Australia is at the opposite end of this dynamic. The official policy family in Australia is now steering the debate towards the profound adjustments that need to occur in the Australian economy if the first glimpse of the post-crisis lay of the land turns out to be true.

The continued post-crisis evolution of the Australian economy would involve higher potential growth rates, a deepening of the resources sector, accelerated decline of the manufacturing sector, a renewed terms of trade shock and commensurate structural appreciation of the Australian dollar. The internal policy debate within Australia is clearly turning to the profound adjustments that need to occur within Australia in the post-crisis world. The first point that is almost unanimously agreed upon is that the crisis, by holding back the growth of developed economies, will accelerate the relative catch-up of emerging economies but particularly China and India. As emerging economies forge ahead, pursuing resource-intensive growth models, there will be a considerable deepening in the importance of the resources sector in Australia. Over the medium term this will lead to a considerable disparity between state economic performances with the resource heavy states outperforming. Internal migration and the provision of social services and urban infrastructure will have to respond accordingly. The mining states will receive a bigger share of national income and jobs growth.

A new, stronger terms of trade shock



Source: Bloomberg & SG Cross Assets Research

Population adds to the factors of production

Source: CEIC & SG Cross Assets Research

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The deepening of the resources sector, coupled with a structural appreciation of the currency, will accelerate the decline of the manufacturing sector. One of the key assumptions both the Reserve Bank of Australia and the Treasury are making in their assumption for Australian growth in the next year is that the terms of trade are expected to trough in 2009 and will start to rise again through 2010, imparting an expansionary impulse to incomes. As we outline separately in the China section, there is an unprecedented investment wave occurring in China that has only been partially completed and is likely to continue for several years. The renewed terms of trade shock will support national income growth, manifesting itself at a micro level in greater corporate, household and government expenditures.

Investment, on all measures, expected to surge in Australia. Not only is business investment expected to recover in Australia in 2010, it is likely to move into a multi-decade expansionary phase. Business investment intentions, especially in the mining related areas, have already been revised up strongly for 2010 and the persistence of strong demand could see these estimates prove to be too conservative. Infrastructure investment will remain at elevated levels and we continue to acknowledge a clear under-provision of key infrastructure by both state and federal governments over the past fifteen years. Housing lending, especially for new construction, is recovering and should support a strong lift in dwelling investment in 2010. House prices are rising on all measures and the Reserve Bank of Australia, for one, has raised particular concern about the supply side of the house-price equation. Policy measures, which support significantly higher levels of dwelling investment in Australia, particularly in the context of rising population, are expected to be announced in the 2010 Federal Budget.

Growth in the factors of production

GDP growth over the long term depends very much on the growth in the labour force, the capital stock, and how these two factors interact (the Solow Residual). Australia is currently witnessing very strong population growth translating into stronger labour force growth and, as we outline above, there is likely to be significant growth in the capital stock on the back of the resources boom. Tracking China, the share of investment in GDP in Australia has risen to its highest level in recent decades – a trend we expect to continue.

The RBA recently said that *"if current rates of factor accumulation were to continue, and there was even modest growth in multifactor productivity, growth in potential output in the [short term] is likely to be above the standard estimates of growth of recent years".* As Treasury Secretary Henry suggests above, the official family seems to be leaning towards Australia moving towards a much more powerful dynamic where stronger population growth, stronger capital stock growth, stronger terms of trade effects and stronger multi-factor productivity effects deliver a period of unbridled prosperity for Australia.

Worrying degree of "stickiness" in Australian inflation

The Australian Q3 inflation report revealed core inflation continuing to run well above the ceiling of the RBA's 2-3% target band. Headline CPI rose by 1.0% in the third quarter on the back of higher fuel, electricity, and water charges though the general thrust of price increases was broad-based across the basket. Given strong base effects, inflation eased to 1.3% but we feel this will mark the low point for headline inflation in this cycle. The key core measures (trimmed mean and weighted median) both rose by 0.8% qoq to see the annual rates ease to a still lofty 3.5%. Interestingly, non-tradable inflation (a gauge of domestically generated costs) rose by a strong 1.5% in the quarter while the stronger A$ helped to temper tradable goods inflation which rose by just 0.2% in the third quarter. Though we forecast inflation to moderate, we believe inflation will stabilise at the top of the RBA's target band towards the end of this year with the global economy regaining cyclical momentum as we head into 2010.

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Policy Outlook

Business and consumer confidence continue to strengthen, despite the start of the RBA interest rate normalisation cycle. Business sentiment has now rebounded to levels that are consistent with investment growing around 25% yoy. As strong resources demand from emerging Asia drives Australia's business cycle, we appear to be in the vanguard of a particularly strong capital expenditure cycle. Business investment peaked at 25% during 2002 immediately after the Tech Wreck crisis after a strong rise in Australian business confidence and we expect Australian business investment to turn around just as strongly in the coming quarters.

This is consistent with the view we expressed earlier that commodity economies are experiencing unusually sticky inflation, and hence are embarking on more serious rate tightening cycles than the market currently has discounted. The stickiness of inflation in Australian and the absolute doggedness of non-tradable goods inflation mean that the RBA has limited room for policy error. Given that Australian growth is likely to be above potential in 2010, the truculence of inflation argues that cash rates should be returned to at least neutral (5.5%-6.5%) in 2010, if not outright restrictive (6.5%-8%).

The argument that Australia simply needs to remove excessive stimulus or move extraordinary policy to less accommodative policy is a gross misreading of the Australian economy. Australia is uniquely positioned in the global economy, is returning to above-trend growth in 2010, has a closed output gap and is facing a renewed positive terms of trade shock. Inflation appears to be stabilising at the top of the RBA's target band and asset prices (equity and houses) are once again rising strongly. We believe that the market is fundamentally misinterpreting the Reserve Bank of Australia and fundamentally mispricing terminal cash in Australia. Whether or not the Bank moves at every meeting and specific cash rate targets at specific months in the year ahead is missing the point. The Reserve Bank is responding to a generational change in Australia's economic circumstance that requires a multi-year adjustment in interest rates. We believe that the Bank is likely to reach a 5% cash rate by mid-2010 and a 6% cash rate by the end of 2010. Terminal cash in Australia is likely to peak around 7.5% around 2011-2012. If that sounds alarming, the level of the cash rate before the global crisis was 7.25%, after all.

Risks

Is the official policy family in Australia at risk of hubris? The most senior policy makers in Australia are talking about prosperity and income shocks at a time when the rest of the world is still dealing with the painful legacy of the global financial crisis. The official family may be in danger of veering into hubris now and the road to ruin is paved with good intentions. Reading the Australia section of this quarterly may remind many readers of the analysis many economists were presenting during the tech-sector bubble of the late 1990s. However, these are issues that do need to be canvassed. China moves with alarming alacrity and those economies leveraged primarily off China, if they acknowledge the China dynamic as sustainable, must be prepared to respond to these changes promptly to prevent their own supply side imbalances and misallocation of resources developing. Australia's policy makers are clearly in the school that believes the China story will play out for some time yet.

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Canada

Economic Forecasts: The Canadian outlook at a glance

% (qoq saar unless otherwise stated)	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	2007	2008	2009	2010	2011
GDP	-6.1	-3.4	2.0	3.5	3.6	3.7	3.5	2.8	2.5	0.4	-2.4	2.9	2.9
Consumer expenditure	-1.2	1.8	2.0	3.0	3.0	3.0	3.0	2.5	4.6	3.0	0.0	2.8	2.5
Government expenditure	3.1	5.0	4.0	4.0	3.0	3.0	2.0	2.0	3.3	3.7	2.4	2.8	2.0
Investment	-27.2	-11.9	4.0	5.0	5.0	4.0	4.0	4.0	4.0	1.8	-11.7	3.4	4.1
Exports	-30.4	-19.3	-5.0	2.0	5.0	6.0	6.0	6.0	5.8	0.8	-17.6	2.1	4.5
Imports	-38.9	-8.5	-2.0	2.0	4.0	4.0	4.0	4.0	1.1	-4.7	-16.5	1.9	5.9
CPI headline (% yoy)	1.9	1.2	0.1	-0.2	0.9	1.5	1.9	1.5	2.1	2.4	0.5	1.6	1.5
CPI core (% yoy)	1.3	1.2	1.3	1.5	1.5	1.5	1.5	1.5	2.0	1.2	1.2	1.5	1.5
Unemployment rate (%)	7.6	8.3	8.4	8.6	8.6	8.4	8.0	7.8	6.0	6.2	8.2	8.2	7.3
Employment (% yoy)	-1.1	-1.7	-1.8	-2.0	-0.3	0.9	1.9	2.7	2.3	1.5	-1.7	1.3	2.8
Average hourly earnings (% yoy)	2.3	1.7	2.0	0.5	0.5	2.0	2.0	2.0	4.1	3.5	1.6	1.6	2.0
Current account (% of GDP)									1.2	1.0	-2.6	-2.0	-0.5
Budget balance (% of GDP)									1.6	0.1	-3.1	-2.5	-1.1
Bank of Canada policy Rate (%)	0.50	0.25	0.25	0.25	0.25	0.50	1.00	1.50	4.30	2.75	0.31	0.81	2.50

Sources: Global Insight, SG Cross Asset Research

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Hot and cold recovery—the average is modest

Every recovery has a mix of industries and regions that outperform or underperform the average. Yet prospects for Canada stretch these normal extremes. In a world where emerging economies are strengthening as more mature economies face a slow and gradual recovery, Canada benefits and suffers from both of these extremes.

Blessed with an abundance of natural resources, particularly energy, Canada should continue to benefit for several years. Exports of materials from the western provinces continue to feed strong Asian demand. The pace of growth in the western regions is expected to strengthen into 2010.

Eastern provinces have greater concentrations of manufactured goods for export. The primary destination of these exports is the United States and the recession there, combined with strength of the Canadian dollar, has induced a severe economic setback.

Policy responses in Canada have been strong. With balanced budgets prior to the crisis, the government had ammunition to increase spending and cut taxes. The programmes announced have not been as aggressive as those in the United States, but the Federal government has boosted payments to the provinces while continuing to invest in long-term healthcare and education programmes.

The deep pullback in the US economy constituted the greatest source of weakness in the Canadian economy in late 2008 and early 2009. Exports from Canada plunged. Inventories rose relative to sales, exacerbating the need to cut back production sharply. The auto sector in particular experienced deep shocks due to widespread plant closures by GM and Chrysler in the first half of 2009. Canadian imports of auto parts plunged during this time. The steep decline in both imports and exports captures the two-way flow of goods tied to the auto industry. Auto production has resumed at a pace below crisis levels, but on a quarterly basis, the pickup is tremendous.

As exports plunged, investments in capital equipment also retreated. In the second half of 2009 as US imports recover, Canadian production should also gain traction. The US inventory cycle has turned. Import demand in the US is recovering.

Consumer demand has limited upside

Consumer demand retreated and weak job and income trends contributed to a mild pullback. Wealth gains, government stimulus efforts, credit availability and a strong currency, have, however, provided some measure of resiliency.

Due to this mild pullback, however, the upside for 2010 and 2011 may not be that strong. Pent-up demand for goods is relatively absent. Without that, consumer demand in Canada remains tied to the income growth and wealth gains. These are expected to be positive in 2010, but are not the makings of a robust rebound.

Business investment, in contrast, should experience strong growth into early 2010. Delayed projects at the end of 2008 should come back on line in late 2009 and early 2010. Investments in the IT and raw materials sectors should be solid.

Inflation pressures subdued

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With excess capacity in the economy and a relatively strong currency, pricing is likely to be weak moving forward. The exception is the commodity sector, which could see stronger demand and absorb excess slack in the western provinces at a faster pace than expected. Not all commodity prices are rebounding and, notably, natural gas prices are soft. This is an important export commodity for Canada and large supplies in the North American market suggest prices could be low for an extended period.

BoC on hold due to pre-commitments, soft price trends and a firm currency

The Bank of Canada took the unorthodox step of committing to holding its policy target rate at 0.25% until June 2010. Despite sporadic speculation that the BoC could accelerate its time plan, the economic situation does not really press for immediate action. Moreover, having made such a commitment, changing the rate before June 2010 might damage the Bank's credibility. The BoC's primary credibility is achieved by maintaining low inflation. In extreme circumstances, as have been experienced over the past year, central banks need to influence the longer-term path of rate expectations in order to restore confidence in funding and reduce long-term rates. Setting a specific time frame is one method, but one seldom used. The Bank of Japan tied its long-term commitment to a zero-interest rate policy to specific inflation trends. The US Fed only committed to a vague, "extended period." As it is rare to make such a long-term commitment to a specific policy, it would be unwise to break any such commitment now.

Fortunately, inflation trends remain subdued for now. Core inflation trends are expected to hold near 1.5% for the next year. Stronger economic growth could absorb the economy's excess slack at a faster pace, but the BoC could always hike rates at a faster rate after June 2010. Lastly, the Canadian dollar has been strengthening again, although not to the extent of other dollar-block, commodity-rich countries. There is a risk the Canadian dollar could catch-up, particularly if the auto segment and natural gas prices recover more rapidly. The currency's strength is another reason to hold off rate hikes, and could be a reason to delay hikes well after June 2010. At present, thanks to the economic trends, the BoC should be able to honour its June commitment date.

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World growth and inflation summary

Annual growth rate, %

	Real GDP					Inflation				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
World (current $ weights)	4.0	2.0	-2.1	2.9	2.9	3.1	4.8	0.3	2.2	2.5
World (PPP weights)	5.0	2.9	-1.2	3.5	3.6	3.7	5.5	2.0	2.7	3.0
Industrialised countries (PPP)	2.5	0.4	-3.3	2.0	1.9	2.2	3.2	-0.1	1.2	1.2
Emerging countries (PPP)	8.2	5.8	1.2	5.2	5.6	5.5	8.1	4.4	4.5	5.2
USA	2.1	0.4	-2.5	3.1	2.8	2.9	3.8	-0.4	1.8	1.8
Japan	2.3	-0.7	-5.4	0.7	0.3	0.1	1.4	-1.4	-1.6	-0.9
Canada	2.5	0.4	-2.4	2.9	2.9	2.1	2.4	0.5	1.6	1.5
Australia	4.0	2.4	1.3	4.1	2.6	2.4	4.4	1.8	2.4	2.8
New Zealand	3.2	0.0	-1.3	2.5	3.5	3.5	4.3	2.2	2.5	3.5
EU 27	3.1	1.0	-4.1	1.1	1.5	2.4	3.6	0.8	1.4	1.2
Euro Zone	2.7	0.6	-3.9	1.1	1.2	2.1	3.3	0.2	1.0	0.8
France	2.3	0.3	-2.2	1.6	1.3	1.6	3.2	0.1	1.2	0.6
Germany	2.6	1.0	-4.8	1.5	1.3	2.3	2.8	0.2	0.9	0.7
Italy	1.5	-1.0	-4.7	1.0	1.3	2.0	3.5	0.7	1.1	1.0
Netherlands	3.6	2.0	-4.1	0.6	1.1	1.6	2.2	1.0	0.7	1.0
Spain	3.6	0.9	-3.6	-0.4	1.0	2.8	4.1	-0.4	1.0	1.0
Denmark	1.7	-1.2	-4.4	0.7	1.3	1.7	3.4	1.3	1.7	2.0
Norway	3.2	2.1	-1.1	2.4	2.0	0.7	3.8	2.2	1.7	2.1
Sweden	2.7	-0.4	-4.6	2.0	1.6	2.2	3.5	-0.3	1.2	1.5
Switzerland	3.6	1.8	-1.8	1.0	0.9	0.7	2.4	-0.5	0.6	0.7
UK	2.6	0.6	-4.7	1.0	1.6	2.3	3.6	2.1	2.5	1.9
Eastern Europe	7.3	4.7	-7.8	2.2	3.3	7.6	9.9	7.5	6.1	5.4
Russia	8.1	5.6	-9.2	3.5	3.5	9.1	10.0	9.2	8.0	7.0
Poland	6.8	4.9	1.0	1.5	3.0	2.5	4.2	3.4	1.8	2.5
Czech Republic	6.1	2.8	-4.3	1.3	2.6	2.9	6.3	1.1	1.1	1.8
Turkey	4.7	0.9	-6.5	2.5	3.5	8.8	10.4	6.3	5.8	5.5
Total Asia Ex Japan	10.0	6.9	5.1	7.1	7.4	4.6	6.7	2.2	3.3	5.4
China	13.0	9.1	8.2	8.5	9.5	4.8	5.9	-0.9	2.0	5.1
Asian NICs ex China	5.8	2.9	-0.8	4.5	4.0	3.0	6.1	1.7	2.7	4.1
HK	6.4	2.4	-3.5	2.5	4.0	2.0	4.3	0.4	2.0	1.9
India	9.4	7.4	6.4	7.7	7.3	6.4	8.4	10.0	6.9	7.1
Indonesia	6.3	6.1	4.8	5.5	5.5	6.3	10.1	5.0	4.9	6.4
S. Korea	5.1	2.2	-0.1	5.5	4.0	2.5	4.7	2.9	3.8	4.8
Malaysia	6.2	4.6	-3.1	3.2	3.2	2.0	5.4	0.9	2.0	2.8
Philippines	7.1	3.8	1.3	3.0	3.5	2.8	9.3	2.9	3.4	5.7
Singapore	7.8	1.2	-1.9	3.6	4.2	2.1	6.5	0.2	-0.2	2.3
Taïwan	5.7	0.1	-4.8	5.0	2.6	1.8	3.5	-1.0	0.8	2.8
Thailand	4.9	2.6	-3.6	3.4	4.3	2.2	5.5	-1.3	1.0	2.6
Vietnam	8.5	6.2	4.2	6.9	6.8	8.3	23.1	6.7	5.0	14.3
Latam	5.7	4.1	-2.3	2.7	3.2	5.5	8.1	6.4	6.0	6.3
Brazil	5.7	5.1	0.0	3.8	4.2	4.1	6.6	4.9	4.0	3.9
Mexico	3.3	1.4	-7.1	3.0	2.5	4.0	5.1	5.3	3.3	3.8

Source: Datastream, Consensus Economics, EIU, SG Cross Asset Research

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