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Market Economics | Interest Rate Strategy | Forex Strategy

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Market Mover

- **Within the eurozone, the contagion into the AAA space has accelerated, with most spreads hitting record highs.**
- **Global investors' confidence in EGBs remains low, reflecting high vol, low liquidity and a lack of policy transparency.**
- **More fiscal measures to curb deficits and debts are a necessary condition, but not sufficient to remove uncertainty.**
- **A political plan to move towards fiscal union is needed to restore confidence, and the latest comments from German officials in this regard are rather positive.**
- **In the meantime, much greater intervention from the ECB will be required to stabilise the markets.**
- **Be ready for further swings within a wide range over the weeks ahead. Overall, the bid for safety will remain solid in the near term, supported by volatility and illiquid conditions.**
- **In the US, the threat that the budget supercommittee might fail to reach an agreement on proposals for slashing at least USD 1.2trn from fiscal deficits in the next 10 years could weigh on Treasuries, though US activity data remain firm.**
- **Despite bearish sentiment, the euro has failed to weaken significantly. As we expect the ECB to continue to loosen policy (rate cuts, QE) and do now not expect the Fed to start QE3 until Q2 2012, we expect EURUSD to decline between now and the end of Q1 2012.**
- **Wednesday's deadline for the US budget supercommittee may be key for the USD. We continue to expect a fall in USDJPY; evidence in recent days that the BoJ has started to sterilise its October FX intervention supports this view.**

Market Views

		Current	1 Week	1 Month
UST	10y T-note Yield (%)	1.98	↔↓	↔
	2y/10y Spread (bp)	172	↔↓	↔
EGB	10y Bund Yield (%)	1.89	↔	↑
	2y/10y Spread (bp)	145	↔	↑
JGB	10y JGB Yield (%)	0.96	↓	↓
	2y/10y Spread (bp)	84	↔↓	↓
Forex	EUR/USD	1.3485	↔	↔
	USD/JPY	77.01	↓	↓

Market Outlook

Sovereign risk continues to drive other markets, with EMU spreads at record highs and contagion into the AAA-space accelerating. Recent political developments in Italy (the new technocratic government) and Greece (the new national unity government) have been more encouraging, but are not enough to ensure the sustained stabilisation of the euro debt markets.

Contagion accelerating

In Italy, Mr. Monti announced his new government, entirely comprised of technocrats, but this is a double-edged sword. On the positive side, the cabinet is run by experts in the areas where much work is needed, but conversely, as no MPs have been appointed, the political obstacles to accepting and implementing policy changes have probably increased. Time will tell whether this proves to be a problem or not. The market reaction so far suggests that there are doubts about what can be achieved. One lingering concern is the desire of some politicians for an election before the end of the parliamentary cycle in spring 2013. Our assumption remains that this government can last until spring 2013, but it is by no means guaranteed.

ECB likely to do more… via the SMP

Once the new government has laid out its new programme and is *in situ*, the ECB could respond by further stepping up its bond purchases via the SMP – but only to a limited extent, as the ECB fears that if market pressure recedes, the reform process will stall. The prospect of radically larger intervention from the ECB is required to stabilise sovereign debt markets in a lasting way. In our view, the most probable route to such an outcome is for the ECB to focus on its existing policy framework for delivering price stability and, in particular, to place greater emphasis on the second pillar of its monetary policy strategy, i.e. analysis of money and credit trends. Such an approach is becoming more probable, but not as soon as markets would like.

The flight to safety remains solid because of volatility and illiquidity conditions. The most recent EGB auctions have met with poor demand, whatever the maturity. Despite a large degree of frontloading, demand for the ECB's liquidity is increasing sharply, pointing to liquidity stress. Overall, liquidity is ample, but that is not preventing the interbank market from collapsing, so we need the ECB to focus on quality rather than quantity. As regards the level of official rates, the curve is pricing in 15bp for December and a full cut by January.

Core EGB swinging within a wide range for

Be ready for further swings within a wide range over the weeks ahead. We maintain our recommendation of being rather long the benchmark in the 5-10y area and longer, as the curve is likely to flatten further in the short run. As illiquidity gains momentum, the back end of the swap curve will continue to benefit from receiving interest. The 10-30y swap spread will continue to flatten in the near term. A break through 10bp is possible over the coming sessions. As long as there are still some longs EUR ex-Germany, spreads have room to widen further in the short run.

Firm activity data in the US, more bad news ahead in the eurozone

The decoupling of US and European activity data is continuing. For now at least, the real economy spillovers from the problems in the eurozone have been limited. Activity releases in the US have remained firm, with industrial production for October getting Q4 off to a very strong start. The reverse has been true of the industrial sector in the eurozone, with the exceptionally weak end to Q3 auguring poorly for Q4's performance.

In contrast to the surveys in the US, the forward-looking elements of the business surveys in the eurozone, such as new orders for manufacturing and new business for services, have continued to slide since the summer. This points to further weakness in the 'flash' PMI figures for November out next week. Germany's Ifo survey is also vulnerable, with incoming hard orders data plunging 8% in the three months to September and increasing uncertainty about the economic outlook. The periphery's weakness is spreading to the core.

FOMC to leave the door open to more QE

The week ahead for the US will be disrupted by the Thanksgiving break. In the meantime, the FOMC minutes will be released. These should offer some further insight into the continuing debate within the Fed about its policy objectives and communication. More extensive discussion about the consequences of the problems in the eurozone is probable, with the door to more QE left open as a consequence. Core durable goods orders data are also significant as a signal of capex trends, which have so far been impressively robust.

Fitch's warning that eurozone contagion poses a threat to the outlook for US banks' ratings added to the risk-off sentiment. While US banks have been under scrutiny for some time because of their exposure to Europe, an explicit warning from a ratings agency spooked a market clearly short on confidence about the extent and impact of contagion.

Treasuries to remain well bid

We remain modestly bullish on Treasuries as the European crisis continues to drive investors to the safe havens of other sovereign paper. Limiting any significant upside is the political dysfunction and fiscal uncertainty highlighted by the congressional supercommittee's inability so far to agree on a USD 1.2trn package of deficit-cutting options. The possibility that the committee might fail to reach an agreement – and then proceed to dismantle the automatic cuts agreed in August – raises the spectre of another downgrade of US debt by one or more of the credit rating agencies.

Funding pressures continue to rise, as expressed by the continued and now accelerating climb in 3m Libor rates. This continues to push swap spreads wider, a trend we do not expect to reverse until there is significant progress made on resolving the European crisis. Our expectations are that 3m Libor will top 55bp by year end.

JGB yields on new lows

In Japan, strong GDP results for Q3 2011 have not been enough to dispel anxiety about the near- to medium-term economic outlook, and JGB yields are declining gradually. We continue to target a 10y JGB yield of 0.9%. The BoJ's Monetary Policy Board voted unanimously to maintain the status quo at its 15-16 November meeting, but is likely to further expand its asset purchase programme – and possibly also lengthen the duration of JGBs purchased under this programme – if the yen appreciates further.

While FX market opinion has been almost universally bearish towards the euro, the single currency has failed to weaken to any appreciable degree. While this suggests that the short EUR view is backed up with positioning and is, therefore, a crowded trade, it has also to be noted that the likes of Euribor/Libor spreads have been widening out, suggesting that euro credit is in at least as short supply as dollar credit.

EURUSD facing opposing forces

EURUSD has also not deviated substantially from what key rate-spread drivers are indicating as 'fair value'. We nevertheless expect that as the ECB's next policy meeting (8 December) looms into view, expectations of rate cuts will start to pull the euro lower. The 'flash' PMIs in the coming week, as well as the German Ifo survey, will be important in framing market expectations ahead of the December meeting.

The FOMC minutes on Tuesday will be of importance for the USD, as, too, will be Wednesday's deadline for the super committee. If the message is that agreement has not yet been reached, this could play to concerns about US sovereign downgrades and weigh on risk (with the usual perverse dollar-positive implications).

Lower USDJPY

We continue to see USDJPY lower, and evidence in recent days of the BoJ sterilising its October FX intervention supports this view. Sterling, meanwhile, remains immune to BoE QE and the prospect of more to come, with yield spread moves supportive of the EURGBP downtrend and the relationship between EURUSD and EURGBP still tight.

Global Outlook: Eurozone Holds the Key

We have just completed our latest forecasts, the preliminary results of which are summarised here. Our final forecasts will appear in the upcoming *Global Outlook*.

Our forecasts are dominated by the fiscal crisis in the eurozone. The potential outcome is binary. Either the crisis will take a turn for the better, which requires action on a number of fronts, in which case global growth will strengthen in H2 2012. Or there will be discontinuity in the eurozone, with a sharp and deep European recession and adverse spillovers to global trade and growth. We have assumed the former.

For this to be achieved, we believe we have to see the following steps taken:

- Substantial progress on a national level in addressing fiscal and structural problems, most notably in Italy;
- Progress in moving towards a more coordinated and more supportive system of fiscal cooperation in the eurozone (e.g. step-by-step moves towards fiscal union, which would narrow forward spreads and feed back into current spreads);
- More substantial buying of government debt under the SMP of non-programme country debt (Italy or Spain) or the putting into effect of the up-scaled EFSF to ensure these countries can achieve adequate funding in 2012;
- Easier monetary policy from the ECB, including quantitative easing to help to overcome the recession that will affect the whole of the eurozone in the next six months or so.

If we fail to see such progress, then growth will be worse than we currently predict, bond yields in safe havens will be lower and global risk appetite will be adversely affected. The consequences of this risk scenario could be a very substantial reduction in our growth forecasts, especially in Europe. That is precisely why we assume the eurozone authorities will move to improve matters, because the costs of not doing so are so severe.

Why, then, have they allowed us to move into a systemic crisis for the eurozone, as EU Commission president Manuel Barroso has characterised it? It is basically a failure of coordination and a reflection of the fact that the interests of the eurozone are not congruent with the interests of individual national politicians. That core countries are being dragged into the whirlpool of the sovereign crisis is a very bad

Table 1: GDP (% y/y)

	2009	2010	2011 (1)	2012 (1)	2013 (1)
World (2)	-0.6	5.1	3.9	3.2	4.0
G7	-4.1	2.9	1.4	1.0	1.8
US	-3.5	3.0	1.8	1.6	2.2
Japan	-6.3	4.1	-0.2	1.4	1.0
Eurozone	-4.2	1.8	1.5	0.0	1.2
UK	-4.4	1.8	0.8	0.2	2.1
Canada	-2.8	3.2	2.2	1.3	2.2
Other Advanced (2)	-1.3	3.0	2.2	1.8	3.2
China	9.2	10.4	9.2	8.5	8.3
India	7.0	8.9	7.3	6.5	8.6
Asia Ex-Japan Ex-China (2)	3.1	8.3	5.6	5.2	6.9
CEE & Russia (2)	-5.5	4.6	4.5	3.2	4.1
Brazil	-0.6	7.5	2.8	2.5	5.0
Latin America Ex-Brazil (2)	-2.7	5.5	5.0	3.4	3.6

(1) Forecasts (2) BNP Paribas estimates based on weights calculated using the PPP valuation of country GDP in the IMF WEO September 2011
Source: BNP Paribas

Table 2: CPI (% y/y)

	2009	2010	2011 (1)	2012 (1)	2013 (1)
World (2) (3)	1.8	3.4	4.6	3.6	3.4
G7	-0.1	1.4	2.6	1.7	1.7
US	-0.4	1.6	3.2	1.9	2.0
Japan	-1.4	-0.7	-0.2	-0.2	-0.2
Eurozone	0.3	1.6	2.7	1.9	1.5
Other Advanced (2)	1.0	2.1	2.6	2.0	2.3
China	-0.7	3.3	5.4	3.6	4.0
India (3)	2.4	9.6	9.4	6.9	5.7
Asia Ex-Japan Ex-China (2)	2.1	5.9	6.4	4.8	4.4
CEE & Russia (2)	8.5	6.4	7.8	6.8	5.7
Brazil	4.9	5.0	6.6	6.0	6.1
Latin America Ex-Brazil (2)	7.4	7.1	7.0	8.1	7.9

(1) Forecasts (2) BNP Paribas estimates based on weights calculated using the PPP valuation of country GDP in the IMF WEO September 2011
(3) HICP where available, India WPI
Source: BNP Paribas

Table 3: Contributions to Global Growth

	Weight	Cont. to Global Growth (pp)				
		2009	2010	2011(1)	2012(1)	2013(1)
World GDP (% y/y)	100.0	-0.6	5.1	3.9	3.2	4.0
G7	39.3	-1.6	1.1	0.6	0.4	0.7
US	19.5	-0.7	0.6	0.3	0.3	0.4
Japan	5.8	-0.4	0.2	0.0	0.1	0.1
Eurozone	14.6	-0.6	0.3	0.2	0.0	0.2
UK	2.9	-0.1	0.1	0.0	0.0	0.1
Canada	1.8	0.0	0.1	0.0	0.0	0.0
Other Advanced (2)	3.5	0.0	0.1	0.1	0.1	0.1
China	13.6	1.3	1.4	1.3	1.2	1.1
India	5.5	0.4	0.5	0.4	0.4	0.5
Asia Ex-Japan Ex-China (2)	14.4	0.5	1.2	0.8	0.7	1.0
CEE & Russia (2)	7.7	-0.4	0.4	0.3	0.2	0.3
Brazil	2.9	0.0	0.2	0.1	0.1	0.1
Latin America Ex-Brazil (2)	5.7	-0.2	0.3	0.3	0.2	0.2

(1) Forecasts (2) BNP Paribas estimates based on weights calculated using the PPP valuation of country GDP in the IMF WEO September 2011
Source: BNP Paribas

thing, but it will force countries in the core to find common ground. In other words, things have had to get worse for them to get better.

We believe the ECB has the power to prevent the liquidity crisis spilling out of control, but it also believes acting too early could lead to insufficient action by politicians – in the core to support the periphery, and in the periphery directly. We believe action by politicians will open the door to more ECB action, on the SMP for Italy, for example.

We see signs the ECB is going to ease policy further. We expect a 25bp cut in the repo rate at the December meeting and a further cut of 25bp – to 0.75% – in Q1 (to be accompanied by a narrowing of the corridor between the refi rate and the deposit rate to 50bp). We also see signs the ECB is preparing the ground for QE. References to money supply by the ECB are increasing, and Mr Draghi's lauding of the Bundesbank at the last press conference may signal that a bigger role for M3 may not be so far away.

With monetary growth very low and deleveraging by eurozone banks likely to take it lower (possibly even into negative territory), the monetary stance in the eurozone is far too tight. If the ECB concludes monetary growth is too low, as we expect, then virtually the only means of raising it is QE. We believe the effect on bank liquidity of such operations (which might be around EUR 300-500bn) would allow the ECB to claim this was not "monetisation". Indeed, central bank or high-powered money would be unchanged. What matters is broad money, however, as the Bundesbank always emphasised, and this would be raised. We expect to see QE in Q1, when inflation has fallen from its peak, but would love to see it sooner.

Given these assumptions, we feel the uncertainty could diminish in the coming months, with markets less likely to focus on "bad" outcomes. However, the Greek elections will probably be in February, creating new market uncertainty, and there will be opposition to some of the reforms proposed by Mario Monti in Italy (labour-market reform, for example). Moreover, we are likely to see recession in the eurozone in Q4 2011 and Q1 2012, so things will be far from plain sailing. Over time, we expect uncertainty to fall, giving more confidence to firms to invest and hire, especially as we expect official rates to trough below previous lows, the ECB to quantitatively ease and the currency to soften.

The immediate growth prospects are poor, however. Our own financial and monetary conditions index suggests the PMI for manufacturing in the eurozone may trough south of 40. Industrial production could fall more than 2% q/q in Q4. Accordingly, we expect a fall in GDP of the order of 0.4% in Q4 and a little less in Q1 next year. Given this weak end to 2011 and weak start to 2012, it is difficult to see average growth for the year much above zero, and flat is what we are predicting.

Table 4: Economic Forecasts (% y/y)

	2010	2011	2012	2013	2011	2012		
					Q3	Q4	Q1	Q2
US								
GDP	3.0	1.8	1.6	2.2	1.6	1.5	1.6	1.6
CPI	1.6	3.2	1.9	2.0	3.8	3.3	2.3	1.9
Core CPI	1.0	1.7	2.0	1.9	1.9	2.1	2.2	2.0
Eurozone								
GDP	1.8	1.5	0.0	1.2	1.4	0.8	-0.3	-0.2
CPI	1.6	2.7	1.9	1.5	2.7	3.0	2.5	1.9
Core CPI	1.0	1.4	1.3	1.2	1.3	1.6	1.6	1.3
Japan								
GDP	4.1	-0.2	1.4	1.0	0.0	0.7	1.5	2.2
CPI	-0.7	-0.2	-0.2	-0.2	0.1	-0.1	-0.3	-0.2
US-Like Core CPI	-1.2	-0.9	-0.7	-0.2	-0.4	-0.8	-1.0	-0.8
China								
GDP	10.4	9.2	8.5	8.3	9.1	8.8	8.2	8.1
CPI	3.3	5.4	3.6	4.0	6.3	4.7	3.9	3.3

Preliminary, to be confirmed in the Global Outlook
Source: BNP Paribas

Table 5: Interest Rate Forecasts (%)

	Spot	Q1'12	Q2'12	Q3'12	Q4'12	Q1'13
US						
Fed Funds	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25
2-year	0.24	0.20	0.25	0.30	0.35	0.45
10-year	2.05	2.25	2.50	2.75	3.00	3.10
Eurozone						
Refi	1.25	0.75	0.75	0.75	0.75	0.75
2-year*	0.37	0.45	0.55	0.65	0.75	0.85
10-year*	1.81	2.00	2.00	2.20	2.40	2.50
Japan						
ODR	0.30	0.30	0.30	0.30	0.30	0.30
Call Rate	0.10	0.10	0.10	0.10	0.10	0.10
2-year	0.13	0.15	0.15	0.15	0.20	0.20
10-year	0.95	1.00	1.10	1.10	1.15	1.20

** German Benchmark*
Preliminary, to be confirmed in the Global Outlook, Spot Rate as at 16 November
Source: BNP Paribas

Table 6: FX Forecasts

	Spot	Q1'12	Q2'12	Q3'12	Q4'12	Q1'13
EURUSD	1.35	1.28	1.35	1.40	1.40	1.35
USDJPY	77	73	71	70	70	75
GBPUSD	1.58	1.52	1.57	1.59	1.59	1.53
USDRMB	6.44	6.28	6.24	6.18	6.12	6.05

End Period, Spot Rates as at 16 November
Source: BNP Paribas

Germany and France will probably see better growth than this, but in the periphery things will be softer. Italy could contract by almost 1%, for example, and Portugal could well see a fall in GDP greater then 4%. Growth in 2013 should be better – of the order of 1.2% in the eurozone as a whole – but still far from solid.

The output gap in the euro area is widening and labour markets are softening, with some workers taking pay cuts. At the same time, base effects from last year mean inflation is hard-wired to fall. We expect the year-on-year rise in HICP inflation to dip from 3% now to 2½% early in Q1 next year and to below 2% in Q2. For the year as a whole, HICP inflation should be 1.9% in 2012 and 1.5% in 2013.

In terms of bond yields, we expect that some easing in the intensity of the crisis will see Bund yields back up from the 1.75% we expect at the end of this year to 2.0% in Q1 2011. Spreads within the eurozone should narrow, but we expect progress will be moderate rather than spectacular. Thus, we expect the Italian bond yield to subside to 6.0% by the end of Q1 next year (i.e. a spread to Germany of 400bp). By the end of 2012, we put the Bund yield in our latest forecast at just under 2½%, with the spread of BTPs to Bunds at 350bp.

In the US, our last forecast was for a short-lived recession starting in Q4. The data for Q3 have come out stronger than expected, and we no longer expect a recession, though we still expect a slowdown from here as a result of slower global growth and a halt in the recent fall in the savings ratio of US consumers.

Why did the US recession we expected fail to materialise? There was a combination of factors:

- The bounce back from the Japanese earthquake and its consequent supply disruptions was stronger then we expected;
- The household savings ratio fell by an unanticipated degree;
- Business investment held up better than some surveys (e.g., ISM orders) suggested, maybe because of tax breaks at the end of this year or very good cash flow;
- The reaction to the adverse news flow, especially from the eurozone, may be working though more slowly than expected.

We now expect a US GDP rise of 2.0% q/q aar in Q4 this year. However, the dynamics of personal incomes are not good, and with deleveraging still the order of the day, we do not expect further consumption-boosting falls in the savings ratio. Thus, we forecast that growth in Q1 next year will be only 0.5% q/q aar.

For 2012 as a whole, we are forecasting that US GDP will rise by 1.6% (after a 1.8% rise in 2011), with a slight acceleration in 2013 to 2.2%. One of the biggest uncertainties about the growth forecast is how US fiscal policy will evolve. We expect little tightening in the federal budget in 2012, but rather more in 2013. Were policy to prematurely tighten in 2012, then growth could be a lot weaker than we assume.

The year-on-year measure of US inflation was 3.9% in September, but fell to 3.5% in October. We expect further progress, as in Europe, on the basis of favourable base effects and very subdued labour costs. We expect US headline inflation to dip below 3% in January and to under 2% in the second quarter of 2012. For 2012 as a whole, inflation should average close to 2%, with a similar forecast for 2013.

We expect the Fed to spell its future policy out in more detail after its January 2012 meeting, when it will affirm Ben Bernanke's February 2011 testimony on the Humphrey-Hawkins Full Employment Act. We should get a better idea of the Fed's objectives in terms of inflation and unemployment.

Our forecasts of slowing growth and falling inflation next year set the scene for further Fed easing. The Fed will forecast inflation to be at or a little below its objective, but we may see no progress, or some backsliding, in terms of its unemployment mandate. Logically, this will lead to more easing, most probably in the form of QE3, which we expect to see in Q2 as Operation Twist expires. Based on our forecasts, we see no rise in the Fed Funds rate until 2014 at the earliest. The spelling out of the policy framework and the Fed forecasts should make this clear to the markets.

Treasury yields have been pushed down by the flight to safety in recent months. As in the eurozone, we see yields remaining low in the US. Our forecast for the 10-year Treasury at end-2011 is 2.0%, rising to 2.25% at end Q1 2012. As the economy recovers and as appetite for risk assets is likely to be boosted by QE from the ECB and the Fed, we are targeting a 3.0% yield for Treasuries at the end of 2012.

The bounce back in Japanese activity will prevent the economy from slipping into recession. After shrinking by 0.2% on average in 2011, Japanese growth should be 1.4% in 2012 on average, with a more muted rise of 1.0% in 2013. We expect Japanese deflation to average 0.2% in 2011 and each of the following two years.

The UK had a surprisingly strong GDP growth rate of 0.5% q/q in Q3 2011. This was distorted by bounce backs from a weak Q2, however, and the underlying picture is less rosy. With 60% of the UK's exports going to the eurozone, the strategy of rebalancing away from domestic demand and towards net trade has hit a significant headwind. We predict a short and relatively shallow UK recession, with a GDP fall of about half a percentage point taking Q4 2011 and Q1 2012 together. In 2012, on average, GDP should be up only 0.2%, after a growth rate of 0.8% in 2011.

As in other countries, headline inflation is set to fall sharply from the current 5.0% (the 5.2% in September looks to have been the peak). We forecast a fall to 3.4% by March, to less than 3% in Q3 and to 2% by the end of the year. With wages soft, the BoE fears undershooting its inflation target (the last forecast showed inflation lower than 2% late in 2012). We expect the Bank to announce another GBP 75bn of QE by February and an additional slug of GBP 50bn in May. This will take total QE to GBP 400bn, or about 30% of GDP and a third of the stock of gilts.

Chinese growth is slowing, with exports stalled because of weak demand abroad and because of the effects of the domestic tightening that has been necessary to slow inflation. The dynamics of these adverse shocks, with the PMI hovering around 50 and the prospect of electricity shortages, mean the economy will probably decelerate slowly in coming months, with the low point at the end of Q1 2012 or early in Q2.

Chinese GDP growth in 2011 as whole should be around 9.2%, and we envisage 8.5% in 2012 and close to that in 2013. Selective easing of monetary policy has already begun (e.g., ensuring adequate financing of existing projects), and with inflation now clearly off its peak, further steps in this direction should be followed by a reserve requirement reduction in the new year. Lower rates do not look on the cards, however. Chinese inflation is expected to fall further from here, averaging 3.6% y/y on our forecasts in 2012 against 5.4% in 2011.

Our forecast of growth in Brazil has been noticeably below consensus, and we remain there, as the economy has expanded beyond potential. In India, we also have south-of-consensus economic forecasts, as the RBI has had to tighten to slow the economy to reduce inflation, which has been worryingly high. For Brazil, we forecast growth of 2.8% this year (after 7.5% in 2010), slowing to 2.5% in 2012. We forecast India's growth at 6.5% in 2012 after 7.3% in 2011.

Overall, our global growth profile includes a slowdown in GDP growth from 5.1% in 2010 to 3.9% this year and to only 3.2% in 2012. In 2013, we see growth moving back to a trend-like 4%. Our inflation profile globally is pretty benign, with a decline of around 1pp in global inflation to 3.6% in 2012 before it edges down further to 3.4% in 2013.

In terms of currencies, the revision to a number of views has led to a significant re-evaluation of near-term currency prospects for EURUSD. Specifically:

- We have revised down eurozone growth in the near term.
- We have revised up US growth in the near term and no longer see a recession.
- We have the Fed instituting QE3 later than we previously forecast.
- We have the ECB cutting rates to 0.75% rather than 1% in our last forecast.
- And, crucially, we now expect the ECB to implement QE – and ahead of the Fed's next move.

Therefore, we now forecast that the euro will weaken over the coming months, with EURUSD ending Q1 2012 at 1.28. This will probably prove the trough, however: as global risk appetite improves and after the Fed quantitatively eases again, we expect the USD to soften. Our end-2012 forecast is for EURUSD at 1.40. We expect a continued slow appreciation of the RMB. We expect the JPY to remain strong, forecasting USDJPY at 73 at the end of Q1 next year and at 70 at the end of 2012.

ECB: Work to Do

- **Eurozone financial and monetary conditions have tightened markedly.**
- **The ECB should, and will, do more to reverse this tightening.**
- **We forecast a new low for the refinancing rate, to be followed by QE.**
- **An increased emphasis on money and credit developments is likely.**

Too tight

Monetary and financial conditions in the eurozone have tightened markedly since the spring, illustrated by the BNP Paribas FMCI (Chart 1). The tightening reflects a range of factors and has not been evident in the FMCIs for other countries – see *FMCI Update* in the *Market Mover* of 3 November.

In tandem with the ongoing tightening of fiscal policy in the eurozone, it is hardly surprising that economic conditions are deteriorating. The current FMCI level is consistent with past declines in the PMIs to the mid-low 40s, indicative of a sizeable output contraction. We are forecasting q/q declines in eurozone GDP in Q4 this year and Q1 next, with industrial output especially vulnerable to a sharp decline.

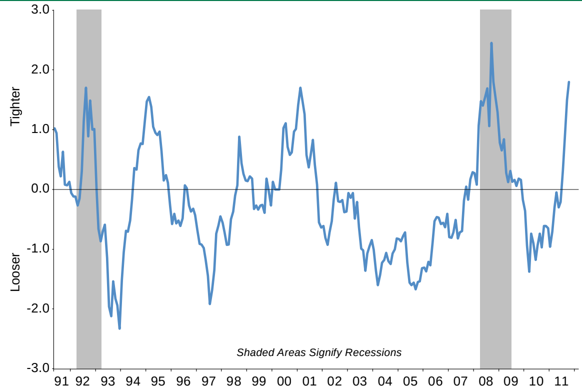
How economic conditions evolve thereafter will be heavily dependent on policy developments in the period ahead. We expect the ECB to do much more to loosen monetary conditions.

Policy rates first

The first step should be to reverse fully the hikes in policy rates delivered earlier this year. We continue to see another 25bp cut as the most likely outcome for the next rate-setting meeting on 8 December. A 50bp cut is possible, as the deterioration in economic conditions is significantly increasing the downside risks to price stability, and if the intention is to try and boost confidence, a 50bp rate cut is more likely to be successful.

That said, the ECB may prefer to keep some of its (limited) powder dry for the time being, potentially to be able to respond to an adverse event. On the basis of a 25bp cut being delivered in December, we would expect a further 25bp cut in Q1 next year, taking the refinancing rate to a new low of 0.75%.

Chart 1: Eurozone Financial and Monetary Conditions Index (FMCI)



Source: BNP Paribas

This could be delivered in tandem with a narrowing of its policy ‘corridor’ from 75bp to 50bp either side of the refi rate. The ECB made three changes to the bandwidth of the corridor in late 2008 and early 2009, narrowing it from 100bp to 50bp, re-widening it back to 100bp, before narrowing it to 75bp. There are arguments for and against a further reduction to 50bp. If there is a preference at the ECB for the rate on the deposit facility to remain above zero, then a lowering of the refi rate below 1% would necessitate a narrower corridor.

New broom

Generally speaking, with the ECB now 'under new management', we see a greater willingness to think about other options. November's decision to cut rates when this outcome was not priced in by markets and a month ahead of the new staff projections was a welcome illustration of a new approach.

This supports the case for the refinancing rate going below 1%. It also increases the probability of the ECB expanding its unconventional measures.

The rate cuts we expect around the turn of the year will make little difference to the overall policy stance. The overnight rate can fall a little further, but the downside is limited if the corridor is reduced and the rate on the deposit facility (the effective floor for overnight rates) is not cut to zero. Forward rates can be reduced if the ECB outlines an economic scenario that is consistent with record low policy rates for a considerable period of time. But with rates already low, this will not make a radical difference to the current position of our FMCI.

QE required

What could make a big difference is a large-scale expansion of the ECB's asset purchases. This could help to loosen monetary conditions via a number of channels, including: lowering the funding costs for sovereigns if, as seems likely, government bonds account for the bulk of future asset purchases; a re-steepening of yield curves, as shorter-maturity debt normalises as the likelihood of tail risk events diminishes; a lower exchange rate than would otherwise be the case as the ECB joins other major central banks in scaling up its asset purchases; and a fall in interest rates on a range of other assets, including covered and corporate bonds.

Conditional intervention

We see balance sheet expansion through much larger asset purchases as just a matter of time, given the deteriorating economic and financial outlook, though certain conditions will need to be met.

The ECB will want to see tangible progress towards supply-side reforms by national governments, in Italy, particularly. The events of August this year, when the previous Italian government started to back-track on its policy commitments once the SMP had begun to purchase Italian sovereign debt are impacting on the ECB's current behaviour. Long story short, the ECB will want to keep the pressure on, in order to ensure that politicians deliver ahead of any major uplift in sovereign debt purchases.

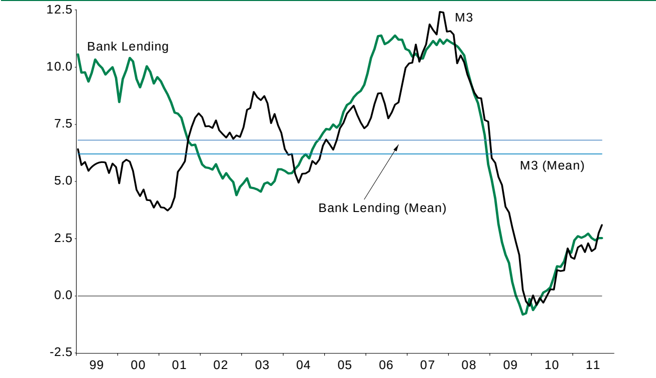
Once the new government in Italy has laid out its new programme and secured sufficient support in its parliamentary confidence votes, which is likely in the next few days, we would expect the ECB to respond by stepping up its bond purchases via the SMP, but only to a limited extent. In part, this is because of fears at the ECB that if the market pressure recedes, politicians are less likely to press on with the necessary, but socially contentious reforms. It also reflects the 'limited' scope of the SMP, as reiterated by Mr Draghi at his first press conference on 3 November.

Money matters

The prospect of a radically larger intervention from the ECB will be required to stabilise sovereign debt markets in a lasting way. In our view, the most probable route to such an outcome is for the ECB to focus on its existing policy framework for delivering price stability and, in particular, to emphasise more the second pillar of its monetary policy strategy, i.e. analysis of money and credit trends.

Growth in M3 (at 3.1% y/y in September) and bank lending to the private sector (at 2.5% y/y) are already well below the levels consistent with price stability over the period since 1999.

Chart 2: M3 & Private Sector Lending (% y/y)



Source: Reuters EcoWin Pro, ECB

Were it not for distortions to M3 related to the high level of stress in markets and ongoing uncertainty, broad money growth would be even lower still. In an environment of financial sector deleveraging and weak demand for loans across all key sectors, which the ECB's own data confirm, it is very likely that there will be a persistent shortfall in money and credit growth going forward.

The ECB's primary aim in its unconventional policy action to date has been to supply banks with plentiful liquidity in the hope that this will pass through to the economy via bank lending. But Plan A is not working, making a Plan B – bypassing the usual transmission channel of providing liquidity to banks and affecting the quantity of money directly – necessary.

One of the difficulties in making this happen is the potential opposition to QE of some members of the Governing Council. But a QE programme ought to be more palatable if presented in the context of the ECB's monetary analysis, which should conclude that the risks to price stability over the medium term are increasingly to the downside. For this reason, if the conventional ammunition has been exhausted, which it soon will be as a result of the rate cuts we expect, QE would be a logical next step.

In the last downturn, the ECB avoided the issue as its policy rates hit bottom in May 2009, by which time the economy was already improving (the trough was in March that year). Now, the economy is heading into a recession and the conventional policy tools are almost exhausted.

Coming out of retirement?

We expect to see an increased focus on monetary analysis and the implications for price stability in the period ahead – probably as soon as the next press conference on 8 December.

One option for the new ECB President is to revisit the reference value for M3 growth. This used to be updated on an annual basis in December each year (see Box, right). This process came to an end after the revision of monetary policy strategy in mid-2003 (which resulted in the shift of monetary analysis to be the 'second pillar' of the strategy). What better time than now, then, to re-introduce a review of the reference value for M3 growth?

Mr Draghi has already alluded in November's press conference to his admiration for the traditions of the Bundesbank, which gives monetary analysis the prime role in its assessment of inflation prospects for the medium term. Demonstrating this admiration for the Bundesbank's methods, by increasing the importance of monetary analysis to the ECB, would be a tactically astute move by Mr Draghi, drawing some of the sting out of a QE programme.

To implement QE in such a framework, the ECB will presumably want more evidence of a persistent shortfall of monetary growth, accompanied by data suggesting that inflation is on a downward trend. This would make a transition to QE more 'sellable' for the new President. This we see as plausible by late Q1, perhaps in tandem with the next round but one of staff projections in March.

March still looks a long way off given the stresses across markets, however, and, in extreme circumstances, the ECB could be forced to act much more quickly. We certainly would not rule out the ECB expanding its asset purchases in a major way before the pieces of the macro jigsaw fall into place.

How big?

What size of QE would it be reasonable to expect? The relationship between M3 and HICP inflation is a guide. Since 1999, HICP inflation has averaged marginally over 2%. The M3 growth rate consistent with that outcome has been just over 6% y/y (i.e. the average since 1999). M3 growth is currently around half that rate, at 3% y/y. Three percent of the money stock in the eurozone translates into a sum of around EUR 300bn.

But the shortfall could be much bigger. The trend in broad money and bank lending growth is likely to be downwards in the context of deleveraging and weak economic conditions. If we also take account of the shortfall in money growth between 2009 and now, this favours a larger QE programme. A reasonable assumption for the first batch of QE is, in our view, a sum of around EUR 500-600bn. If broad money and credit growth continued to be insufficient, there would be a case for more thereafter.

In comparison

Around EUR 500-600bn of asset purchases from the ECB would be equivalent to around 6% of eurozone GDP. Adding in the purchases under the SMP would take the ratio to around 8%. This is relatively modest in comparison with Fed and Bank of England asset purchases. The asset purchases to which the Bank of England has already committed run to around 18% of UK GDP, and we see a high chance of more being announced early next year. The Fed is in the same ballpark on the basis of its combined Treasury and other asset purchases, and we also see a high chance of more next year, probably in Q2.

Bottom line

In sum, we expect the ECB to do more to counteract the marked tightening of financial conditions in the eurozone. Policy rates will be cut to new lows, and a QE programme is increasingly likely, probably to be framed around the ECB's monetary analysis and its implications for price stability. The timing of QE is fluid, but on the basis of our assessment of political and economic developments, Q1 next year is most likely. The SMP can be expanded in between times.

There are limits to what QE can achieve. It is not a panacea. The eurozone faces structural challenges, including a need for supply-side reforms to improve longer-term growth prospects and debt sustainability. QE buys time to make progress in these areas, it is not a replacement. Still, QE can lower funding costs for sovereigns, alleviate market stress and reduce uncertainty, which, combined with a softer exchange rate, should improve economic conditions.

Box: ECB's Reference Value for Broad Money Growth

Until 2003, in December each year, the Governing Council announced a reference value for the growth of the broad monetary aggregate, M3.

This reference value referred to the rate of M3 growth deemed to be compatible with price stability over the medium term.

The reference value was derived from the following medium-term assumptions:

The definition of price stability (formerly below 2%);

An estimate of trend real GDP growth (formerly around 2%);

An estimate of the trend in the velocity of circulation of M3 (formerly 0.5%).

The assumptions implied a reference value of 4½%.

Substantial or prolonged deviations of M3 growth from the reference value would, under normal circumstances, signal risks to price stability over the medium term. However, monetary policy would not react mechanically to deviations of M3 growth from the reference value.

The process of publishing the findings of the annual review of the reference value was ended in 2003, in conjunction with the review of the ECB's monetary policy strategy in May that year.

This was explained as follows. *"To underscore the longer-term nature of the reference value for monetary growth as a benchmark for the assessment of monetary developments, the Governing Council decided to no longer conduct a review of the reference value on an annual basis."*

It was decided, however, "*to continue to assess the underlying conditions and assumptions*." On this basis, the assessment of the reference value in a more formal way could be reinstated.

This would probably require an adjustment of the assumption of the potential growth rate, down from 'around 2%' to probably around 1-1½%. There could be an upward adjustment in the assumption of trend velocity to compensate, however, which would leave the reference value at around the same level.

Source: BNP Paribas and ECB

UK: Carry On QEing

■ **It was a dovish *Inflation Report* from the Bank of England this week.**

■ **Two years out, the Bank is forecasting CPI inflation at around 1.5%.**

■ **Output is expected to be flat over the next few quarters.**

■ **On those parameters, the argument for more QE can easily be made.**

■ **And the MPC may well prove optimistic on growth.**

■ **Our own forecast for growth next year has been cut to just 0.2%. We expect a short and shallow recession in the UK over Q4 and Q1.**

■ **The weaker growth outlook and the MPC's dovish reaction function mean we are revising up how much extra QE we are expecting.**

■ **We expect the Committee to announce a further GBP 75bn of asset purchases by February and then an additional GBP 50bn in May.**

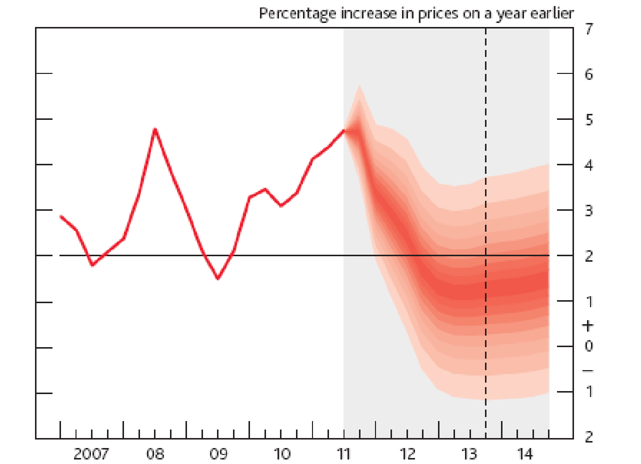
November *Inflation Report* sees inflation well below target

The Bank of England's latest *Inflation Report* was a dovish document, revising down the MPC's forecasts for growth and inflation. The Bank persists in believing growth will pick up strongly from the second half of next year. But even under its current projections, which may well turn out to be optimistic, the MPC could justify expanding the scale of QE asset purchases significantly.

In August, the MPC was projecting consumer price inflation to be 1.7% in two years under the modal (most likely) projection. Even back then, the question could have been asked why the Committee wasn't loosening policy, given the fall below the 2% inflation target. The circle was at least partly squared here by the Committee continuing to identify upside risks to inflation from such things as the possibility that supply capacity in the economy had been eaten away and the risk that workers would try to make good some of the erosion they had seen in their real wage. Those upside risks meant that the probability the Committee ascribed to an inflation reading above or below the 2% target was 'roughly equal'.

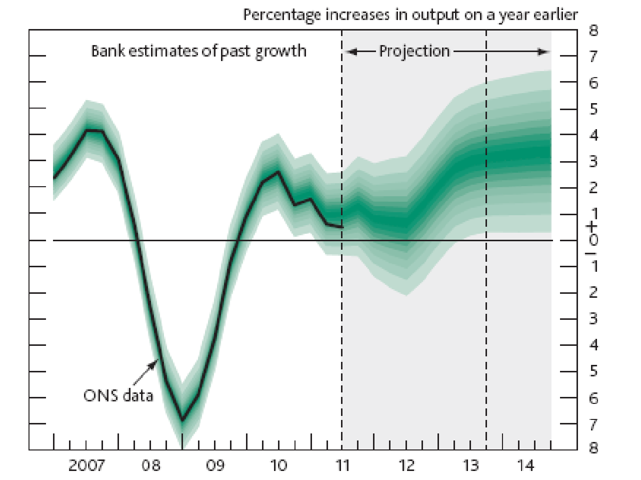
In the November forecast, the MPC has revised down its forecast for consumer price inflation on the two-year horizon to around 1.5%. This is a significant revision on its own, but it has also removed the reference to upside risks from its central projection. Consequently, the Committee believes there is a much larger probability that inflation will be below 2% in two years' time. In August, the MPC identified this at around 50%. In the November *Report,* it put the likelihood at around 70%.

Chart 1: November IR inflation projection



Source: Bank of England

Chart 2: November IR growth projection



Source: Bank of England

The door is wide open to more QE

The implications for policy of the November *IR* are obvious: more QE is coming. On the basis of the previous research published by the Bank, perhaps around GBP 100bn more in asset purchases would put the inflation rate in the MPC's projection close to the 2% target.

With commodity price news since the last *Report* fairly limited, the reason for the lower inflation profile rests largely on the weaker growth outlook identified by the Committee. Back in August, the MPC was forecasting year-on-year growth in Q4 2012 of 2.2% and in Q4 2013 of 2.7%. The November *Report* revises this outlook down to growth of around 1.0% at the end of 2012, though it is expected to rebound to a similar rate at the end of 2013 to that previously forecast. The implication is that the level of GDP will be lower throughout the projection, and this will weigh on inflation via a wider output gap and a deterioration in the labour market.

The *Report* and Governor King in the press conference studiously avoided the use of the word ‘recession’, but the report suggests that “output is likely to be broadly flat in the final quarter of 2011”. And it is clear from the fan chart around the level of GDP that the Committee would put a relatively high probability on there being a two-quarter contraction and, hence, a technical recession in the UK.

All told, the November *Inflation Report* was very close to our expectations, as set out in last week’s *Gilt Complex*. What is more noteworthy in the *Report* is what is missing rather than what is present. In particular, the discussion over the eurozone slowdown and its implications for the UK was fairly cursory. Clearly, events there lie largely out of the MPC’s hands, and it will have to watch how the political and economic developments unfold.

The Committee also persists in forecasting a fairly sharp recovery in the medium term, with quarterly growth rates of around 0.7% in 2013. If that does not materialise, the MPC will be revising down its view of growth again in subsequent *Reports*.

Our latest forecasts are somewhat more downbeat than the Committee’s

Our latest forecasts for UK growth are weaker than the Bank’s. With 50% of the UK’s exports going to the eurozone and signs from surveys suggesting a significant slide going into the fourth quarter, the strategy of rebalancing away from domestic demand and towards net trade has hit a further significant headwind. At the same time, final domestic demand in the UK remains weak.

We now expect a short and relatively shallow UK recession, with a GDP fall of about half a percentage point taking Q4 2011 and Q1 2012 together. In 2012, on average, GDP should be up only 0.2%, following a growth rate of 0.8% in 2011.

Our weaker profile for growth, other things being equal, implies less inflationary pressure in the UK, and we expect the Bank of England to eventually have to confront a weaker profile for growth and inflation than it published this week.

As a consequence, we have decided to revise up the amount of additional QE we believe the MPC will implement next year. We expect an additional GBP 75bn of QE by February and an additional slug of GBP 50bn in May.

Austria: Vulnerability Left, Right and Centre

- **Austrian government bond spreads have widened sharply over the past week as the eurozone debt crisis has spilled over to the bloc's core economies.**
- **Austria's major vulnerability is its banking sector, which is highly exposed to developing Europe, with the share of claims on Central and Eastern Europe amounting to 50% of total foreign claims and 70% of GDP.**
- **Austria's real economy moves in tandem with the German cycle because of its large share of exports (54% of GDP), a high proportion of which goes to Germany (21% of total exports).**
- **Fiscal stimulus to stabilise growth is unlikely, as the government needs to continue shoring up the banking sector, while at the same time implementing measures to lower its debt-to-GDP ratio from 72% of GDP in 2010 to 60% in 2020.**

The eurozone debt crisis has now reached the bloc's core economies. Like other AAA-rated economies, Austria's government bond yield spread to the German benchmark has surged rapidly over the past 10 days and has now reached record levels in both the 2-year and 10-year areas. We believe this is reason enough to remind investors of some of the key aspects of the Austrian economy, not least its strong economic correlation to Germany and the significant exposure of its banking sector to Eastern Europe.

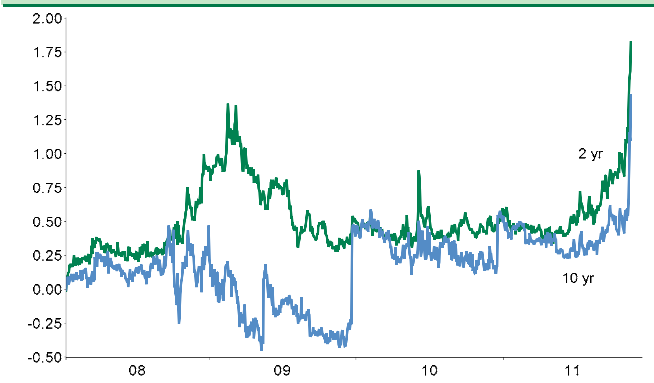
Banking sector exposure to Eastern Europe

The vulnerability of the Austrian banking sector lies in its exposure to Central and Eastern Europe. In September 2011, total foreign claims of Austrian banks amounted to USD 540bn, of which nearly 40% stemmed from the Czech Republic, Romania, Hungary, Croatia and Poland (in order of magnitude). For comparison, Austrian exposure to the GIPS economies and Italy only amounted to USD 39.9bn (7.4% of total claims).

Foreign claims of Austrian banks amount to more than 140% of GDP and claims on developing Europe are equivalent to close to 70% of GDP, underlining the vulnerability of the Austrian banking sector on its eastern neighbours.

Banks' high exposure to these economies already challenged the Austrian financial sector in 2008. Austrian government 2-year yield spreads to the German Bund surged from less than 25bp during

Chart 1: Austrian Government Bond Spreads



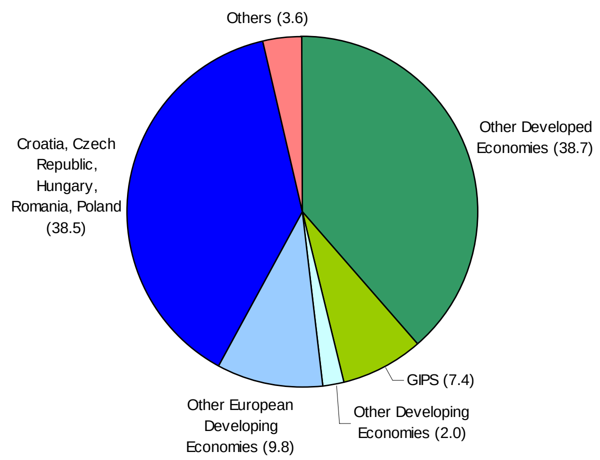
Source: Reuters EcoWin Pro

Chart 2: Banking Sector Foreign Claims

Foreign claims of Austrian banks (million USD)		
	Total	**% of GDP**
All countries	540346	142.3
Developed countries	248760	65.5
Italy	24220	6.4
Spain	7910	2.1
Greece	3276	0.9
Ireland	2725	07
Portugal	1760	0.5
Developing countries	271948	3.3
Europe	261366	68.8
Croatia	34220	9.0
Czech Republic	73544	19.4
Hungary	42217	11.1
Romania	42486	11.2
Poland	15799	4.2

Source: Reuters EcoWin Pro, BIS, BNP Paribas

Chart 2: Foreign Claims of Austrian Banks (%)



Source: BIS, BNP Paribas

most of 2008 to 137bp by February 2009. Favourable external conditions and the shoots of a global recovery in 2009 (also in Central and Eastern Europe) helped to rein in Austrian spreads to levels around 50bp.

Meanwhile, the government reacted with sizeable rescue packages in the form of deposit guarantee schemes, capital injections, interbank lending support and government guarantees for bank bond issuance (worth EUR 100bn in total). The OECD estimates nearly 20% of the measures to be still in place. Some of these are included in the core Tier 1 capital of Austrian banks currently, but shouldn't be under Basel III rules.

The significant depreciation of Eastern European currencies, however, together with the deteriorating outlook for their real economies, which remain highly dependant on the eurozone cycle (which we will be exploring in more detail in a forthcoming note), now present renewed risks to the Austrian banking system, as shortfalls in debt repayments could cause major losses.

And although the exposure of the banking sector to Italy is comparably low, the amplification of Italy's woes has also triggered rising yields on Austrian government bonds. Spreads have surged from less than 50bp in the first half of 2011 to over 180bp in mid-November on the 2-year bonds and from below 40bp to close to 150bp on the 10-year bonds.

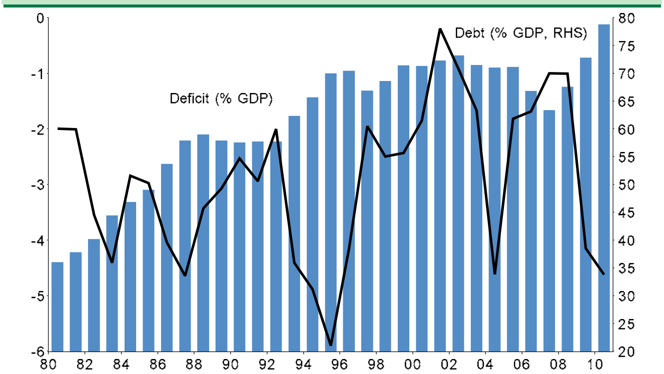
Economic exposure to the eurozone

While the Austrian banking sector is highly exposed to Central and Eastern Europe, the Austrian real economy is strongly correlated to its eurozone partners, especially Germany. Over the past 15 years, Austrian GDP has slightly outperformed German GDP growth year on year, mainly due to higher domestic demand growth. But the high export share of Austrian GDP (54% in 2010) and the high share of exports headed to Germany (21%) make the Austrian real economy very vulnerable to economic developments in the largest eurozone economy.

No more scope for fiscal stimulus

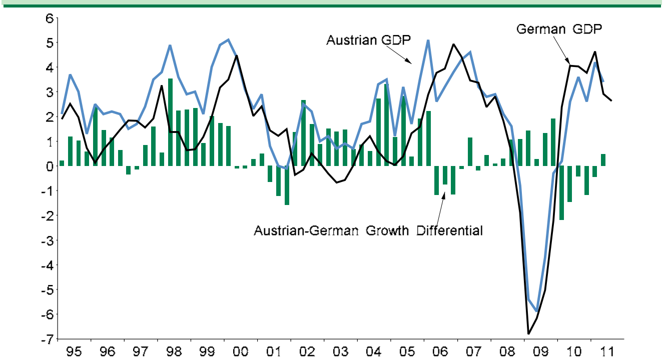
Moody's analysts are scheduled to visit Austria and assess Austria's current conditions in a week's time. The ratings agency's past determinations have criticised the public sector's lack of savings ambition. With the threat of a negative outlook, the scope for public stimulus is more than limited now. Instead, Austria's policy stance is moving towards considerable tightening. Since last Wednesday, the Austrian government has been debating a constitutional debt break. The discussed measures

Chart 3: Government Deficit and Debt



Source: Reuters EcoWin Pro

Chart 4: GDP Growth (% y/y)



Source: Reuters EcoWin Pro

should lead to a decline in the public deficit of EUR 2bn a year from 2012. By 2020, the debt-to-GDP ratio should have been lowered from 72% to 60%, equivalent to a decrease in the stock of debt of EUR 40bn. This will come hand in hand with significant fiscal tightening, at the cost of the economic growth.

Lack of scope hurts Austria's economic prospects

In 2009, external developments relieved the pressure on Austrian yields. The source of the current surge in spreads is the eurozone financial crisis, and to resolve this, Austria will again need more than domestic fiscal consolidation efforts or a bank-recapitalisation plan. That the pressure on government yields has spilled over from the southern eurozone to the core economies (Belgium and France have not been spared) means a euro-wide solution is called for. National policies will only have a limited impact, especially when finances are constrained by consolidation requirements required to maintain a country's AAA rating.

US: Macro Trades – Thanks but No Thanks

■ **The moves in the market continue to be dictated by developments in Europe. The uncertainty keeps many investors on the fence, causing them to avoid taking big positions.**

■ **In recognition of the ongoing aversion to taking macro positions, we also focus on what may, in other times, be considered as "small potatoes", i.e. small curve positions that are at attractive levels and may benefit if the markets begin to price in better days ahead.**

■ **STRATEGY: Consider 2s3s swap rate or spread steepeners.**

Has the Curve Become Too Flat in the Front End?

Many investors are on the defensive as we get closer to year-end. Unwilling to take on long-term macro positions in the face of the ongoing upheaval in Europe, the related balance sheet reduction, and the uncertainty due to the seismic regulatory changes looming in the not-so-distant future, they are more than happy to look for opportunities that may be more micro in nature, which may generate some returns without risking the ranch.

Enter front-end steepeners. Because of the Fed's prognosis that they will likely keep rates pegged at zero at least through mid-2013, the juice is gone from the front end. Adding to the flattening pressure is the relentless rise in Libor, indicative of rising funding pressures, which has also helped push the 2y swap spread to a new high since the (earlier) financial crisis began to recede in early 2009 (see Chart 1).

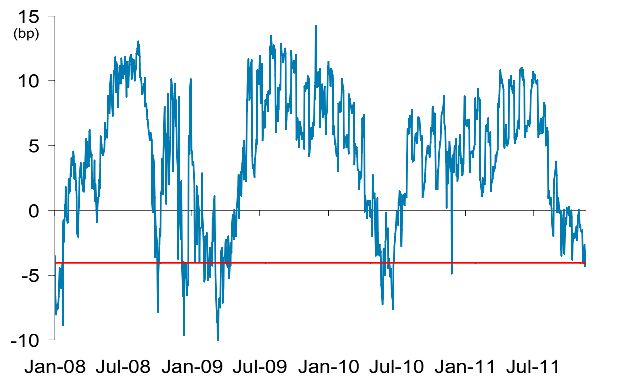
While the 2y swap spread may widen further yet, if the market suffers a wholesale liquidity crunch, it is very likely that the 3y swap spread, while lagging somewhat, will follow suit closely. After all, 2y and 3y swap spreads have shown a remarkable degree of correlation through many different periods (R-square typically upwards of 80%, with a beta in the 0.70 to 0.98 range, since mid-2000s). Therefore, while the 2s3s swap spread curve could flatten more in the event of further gains in the 2y swap spread, it probably will do so by no more than 5-6bp. Chart 2 illustrates the point: -10bp appears to be a very tough level for 2s3s box spread to break to the downside. This speaks to the attractive valuation of the 2s3s swap spread steepener at -4bp.

Furthermore, given that the 2s3s Treasury curve is already very close to its lows since 2009 (14bp vs 11bp), there appears to be limited downside to a 2s3s swap rate steepener. At 11bp, it may flatten 5-10bp in the event of a liquidity crunch and flight to quality – flattening the Treasury and the swap curves simultaneously – while the upside in the event that the outlook improves, is at least 10bp and potentially much higher (see Chart 3). The icing on the cake? Typical price behaviour around the 2y, 5y and 7y Treasury auctions is on our side, with a bias for 2s3s spread of spreads to steepen (see Auction Cycle Trades Redux).

Chart 1: 2y Swap Spread at Post-2009 High

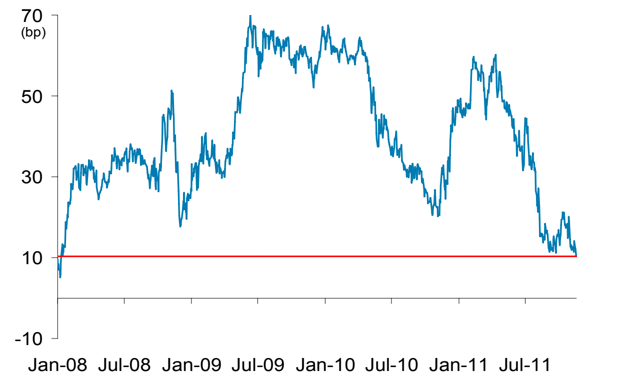
Source: BNP Paribas

Chart 2: 2s3s Box Spread Is within 6-7bp of Lows



Source: BNP Paribas

Chart 3: 2s3s Swap Rate Steepener is a Potent Way to Position for an Improving Outlook



Source: BNP Paribas

US: Risk-Off. Proceed with Caution

■ **Secured and unsecured funding rates continue to rise (see Chart 1). Overnight ABCP is above 60bp and is dragging 3m Libor up with it. Given that o/n ABCP rates are typically *below* 3m Libor, we continue expect upward pressure on unsecured financing. Financial CP rates remain bedrock low, as the only issuers remaining in the space are predominantly US-based, high-quality credits, as foreign banks and other foreign-based issuers have been squeezed from the market (see Chart 2).**

■ **The funding pressure due to the escalating European crisis has resulted into a sell-off in Eurodollar futures, which has followed through to higher swap rates sharply wider spreads from 2y to 7y. This widening has improved the yield pick-up for swaps vs. Treasuries, but the higher short-term Libor rates has eroded the carry, and the flattening of the swap curve over the past month has reduced roll down.**

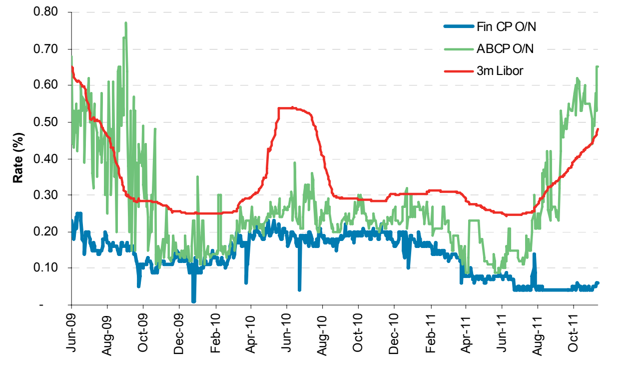
■ **Agency debt has also underperformed Treasuries recently - with spreads at the top of their multi-year ranges - but appear to be holding there. On the flip side, agencies have outperformed Libor by a wide margin in recent weeks, and are now at the richer end on an asset swap basis (see Table 1). This has improved the carry, roll down and projected total return of agencies vs. both swaps and Treasuries (see Table 2). We continue to advise caution, but agency obligations remain something of a safe haven in the rates space, and continue to offer better carry and roll down than either Treasuries or swaps.**

Outlook on Repo Heading into Year End

Repo rates have increased a bit since they flirted with zero in early July. Overnight general collateral rates for Treasuries, agency debt and MBS are 11, 13 and 15bp respectively, based on DTCC data. We expect overnight repo rates to remain in this range going into year-end, with the usual spikes at mid-month due to Treasury auction settlements.

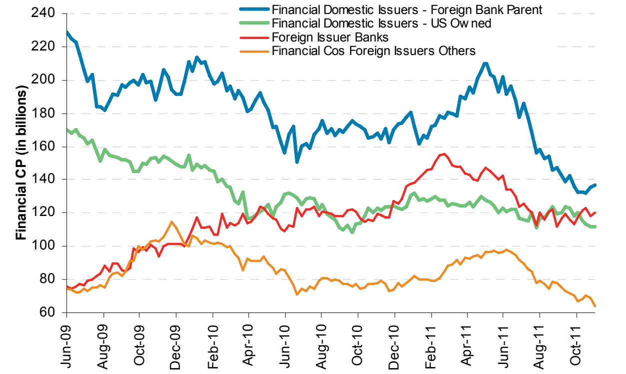
Much has been made of banks and broker-dealers delevering, and certainly, this is an important flow. On the flip side, as those players delever, much of that collateral can end up in the hands of investors who don't require financing – central banks, real money investors and the like. As one example, the

Chart 1: Funding Stress Intensifies



Source: BNP Paribas

Chart 2: Foreign CP Issuance Compromised



Source: BNP Paribas

Table 1: Agency Benchmarks

As of : 11/16/11	yield	spread to Libor	change on week	spread to Treas	change on week
FNMA 0 1/2 08/09/13	0.44	-28.9	-1.4	19.4	3.5
FHLMC 0 3/8 11/27/13	0.55	-19.3	0.8	26.9	5.1
FHLMC 0 3/8 10/30/13	0.54	-19.9	0.3	26.8	4.6
FNMA 0 5/8 10/30/14	0.72	-13.1	0.0	30.1	3.6
FHLMC 0 3/4 11/25/14	0.74	-12.3	0.7	30.9	4.2
FNMA 2 3/8 07/28/15	0.94	-6.2	1.1	37.5	4.6
FHLMC 1 3/4 09/10/15	0.98	-4.5	1.8	39.3	5.3
FNMA 1 3/8 11/15/16	1.30	-2.8	0.8	38.3	4.0
FHLMC 2 08/25/16	1.26	-1.6	0.5	40.6	3.9
FNMA 5 02/13/17	1.38	-1.2	-0.6	39.1	2.6
FHLMC 3 3/4 03/27/19	1.84	-1.9	-1.4	30.9	1.4

Source: BNP Paribas

Bank of Japan has recently been buying Treasuries as a result of their approximately USD 100bn currency intervention, and they do not utilize the financing markets, so that removes collateral from the system, making more cash available and keeping repo rates stable.

Another factor to consider is that the Fed's twist operation is on a net basis injecting cash into the system. The selling in the front end of close-to-par securities - which drains cash - is more than offset by the buying in the back end of generally high coupon, premium bonds. This flow will also help to keep overnight financing rates a bit low.

Term repo going into year-end is anybody's guess at this point. Term rates are in the high 20s to mid 30s and could spike much higher as the turn closes in. This dislocation is likely to peak the final week of December, as usual, and at this point, could go either way – towards zero or above 50bp. Either way, by early January term repo markets will have normalized, as money always needs to find a home.

Given the pressure in term, we recommend that any clients looking to finance over year-end lock in rates now. Otherwise we prefer rolling positions overnight and taking advantage of the additional carry offered in agencies and Treasuries.

Table 2: Cross rates comparison – carry, roll down and total return (6m horizon)

Treasuries	Price	Yield	Duration	DV01	Asset swap	6m Total ROR (%)	6m Dollar Return	6m Roll Down	6m Carry	Carry + Roll Down
2yT	99.99	0.25	1.95	195	-48	0.24	0.24	8.5	6.6	15.2
3yT	99.93	0.40	2.98	298	-45	0.38	0.38	10.0	7.7	17.7
5yT	100.52	0.89	4.86	489	-42	0.99	0.99	11.7	9.4	21.1
7yT	102.05	1.44	6.66	680	-34	1.56	1.59	12.2	10.8	23.0
10yT	99.83	2.02	9.33	931	-20	1.87	1.87	11.3	11.6	22.8
Swaps										
2yr swap	NA	0.74	1.73	173	0	NA	0.16	4.0	1.9	6.0
3y swap	NA	0.86	2.70	270	0	NA	0.36	4.4	6.4	10.8
5y swap	NA	1.33	4.61	461	0	NA	1.00	7.6	12.4	19.9
7y swap	NA	1.79	6.41	641	0	NA	1.29	8.9	10.2	19.1
10y swap	NA	2.22	8.91	891	0	NA	1.37	8.7	5.7	14.4
Agency Benchmarks										
FHLMC 0 3/8 10/30/13	99.67	0.54	1.94	193	-20	0.30	0.30	13.2	10.8	24.0
FHLMC 0 3/4 11/25/14	100.03	0.74	2.98	299	-12	0.55	0.56	14.4	10.5	24.8
FHLMC 1 3/4 09/10/15	102.86	0.98	3.69	381	-4	0.84	0.86	14.9	11.7	26.5
FHLMC 2 08/25/16	103.42	1.26	4.56	474	-1	1.16	1.20	15.1	12.7	27.7
FHLMC 3 3/4 03/27/19	113.10	1.84	6.58	748	2	1.47	1.67	13.9	13.5	27.4
FNMA 0 1/2 08/09/13	100.10	0.44	1.71	172	-29	0.25	0.25	12.9	8.9	21.8
FNMA 0 5/8 10/30/14	99.73	0.72	2.92	291	-13	0.53	0.53	14.3	10.1	24.4
FNMA 2 3/8 07/28/15	105.21	0.94	3.53	374	-6	0.78	0.82	14.8	11.4	26.2
FNMA 1 1/4 09/28/16	99.87	1.28	4.73	473	-2	1.20	1.20	15.1	12.4	27.5
FNMA 5 02/13/17	118.21	1.38	4.68	560	2	1.20	1.44	15.1	13.8	28.9

Source: BNP Paribas

US: Auction Cycle Trades Redux

■ **While market remain jittery about Europe, the sense of impending doom seems to be abating somewhat, thanks to the resilience of the US economy. This could help build a concession into next week's auctions.**

■ **In general, Swap spreads tend to widen going into the 2y, 5y and 7y auction cycle with 5y widening the most.**

■ **There is a clear trend of long end spreads tightening relative to the front end and the belly throughout the auction.**

■ **STRATEGY: For this auction cycle, we recommend 2s5s box spread steepeners and being long the belly in the 2s5s10s spread fly.**

A rather predictable setup into the auction and the takedown of supply at cheaper levels appears to be in force this auction cycle with the somewhat subdued sense of imminent doom helping engineer a concession. Rather than look at UST based trades, we look at swap spread market into and out of the auction cycle.

Swap Spread Curve Behaviour around Auctions

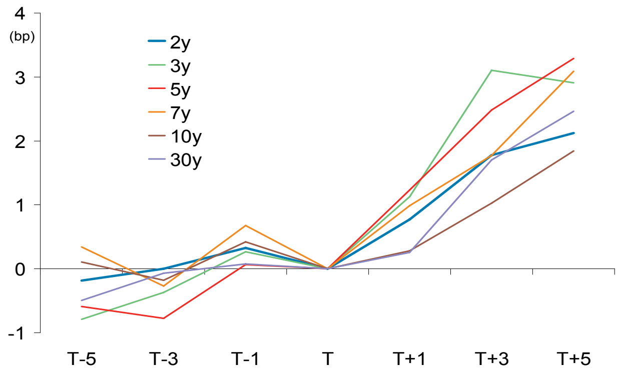
Chart 1 shows that coming out of the 5y auction, swap spreads widened on average with 5y widening the most and 10y the least. The 5y auctions have shown a tendency to have a tail, but that weakness appears to be shifting to the 7yr point, and we believe a widening should occur at the next 5yr auction.

With the 5y and 7y swap spreads having the strongest bias toward widening post-auction, the best strategy involves 2s3s, 2s5s and 2s7s steepeners (more on that below), as well as 5s10s, 7s10s flatteners (see Chart 2). Based on the history of the last 12 months, we believe that the best time to enter the 2s10s, 5s10s, 7s10s trades is 3 days prior to the auction with a potential exit up to 5 days after the event. The pickup varies based on the trade, but can range from 2-4bp.

RV Trades in Swap Spreads

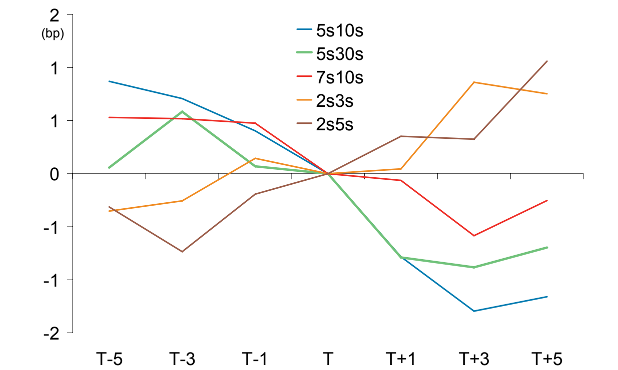
Given the uncertainty coming out of Europe, we are hesitant to take large directional bets. In that vein, there are some swap spread positions that are currently at attractive entry levels and offer less directionality. We have witnessed a strong bias for 5y spreads to outperform vs 2y and 10y spreads going into and coming out of auctions. As Chart 3 shows,

Chart 1: Spreads around 5y Auction



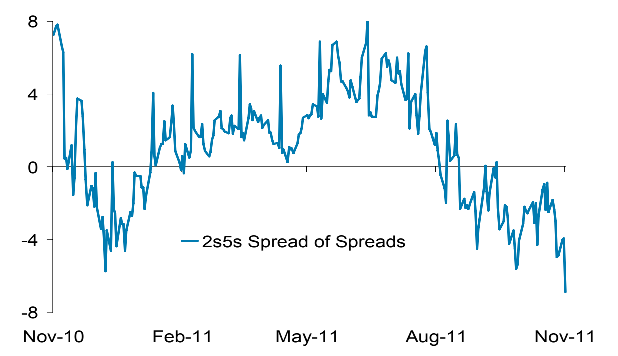
Source: BNP Paribas

Chart 2: Spread of Spreads around 2y, 5y and 7y Auction



Source: BNP Paribas

Chart 3: 2s5s Spread of Spreads to Back away from Lows?



Source: BNP Paribas

2s5s swap spreads are at the low end of the recent ranges, offering a potentially skewed risk/reward. The Fed's sellback in the 2y sector could also support the trade. In addition, 2s5s10s swap spread fly will fit better –given the tendency of the 5s10s box spread to flatten – if investors are trying to avoid duration risk. Both trades have been profitable in 11 of the past 12 auction cycles.

MBS: HARP Changes Not Too Major

- **HARP changes seem to be broadly in line with expectations and previous announcements.**
- **The delivery fee cap was reduced to 75bp from 200bp for non-investment property fixed rates with terms greater than 20 years and ARMs and reduced to 0bp for fixed rates with terms less than 20 years.**
- **FNM continues to offer the rep and warranty relief for same servicer refinancing but has now included specific language concerning exceptions (fraud, charter violations, etc.) which should bring greater certainty to origination.**
- **FRE, which didn't have any rep and warranty relief before, introduced it for same servicer refi, but it is not as clear as FNM's and will not be implemented until March 2012 for the guarantor business. We think Gold/FN swaps, particularly in higher coupons hold value.**
- **Neither agency offers a true rep and warranty relief for different servicer refinancing.**
- **MI and second lien issues do not seem to be freshly addressed.**
- **An expansion beyond 125% LTV should have a marginal impact, and such loans will not be securitised until June 2012.**
- **Decreased credit fees will not likely transfer to the borrower to the same extent. October prepays were indicative of the limited impact of increased moneyness on high premiums.**
- **Borrower solicitation is now more flexible and can be specifically targeted to HARP.**
- **We expect upto a 7 CPR impact on 2008 FN 6s and up to a 4 CPR impact on 2008 FG 6s due to these changes. HARP expires on 31 December 2013 (eligibility determined by note date).**
- **Freddie Mac announced that it will begin securitising certain mortgage loans that previously were delinquent and had been bought out from its PC pools.**

Overall changes announced to HARP were broadly in line with expectations based on initial announcements made on 24 October. In the context of reps and warrants, the GSEs went a step forward and defined fraud and other exceptions for which lenders continue to face repurchase risk, though FNM's disclosures are clearer in this regard. But the impact of this change is not likely to be outsized since only two cases and two perpetrators would constitute a pattern of fraud.

Freddie Mac had been expected to offer the (borrower) eligibility and underwriting rep and warranty relief that Fannie Mae already did for same servicer refinancing. But the language around the rep and warrants is not clear, and it is not clear if the relief is only restricted to eligibility and not fully to underwriting. Neither GSE has truly expanded rep and warranty relief to different servicer refinancing.

No new ground seems to have been broken on second lien and MI, which represent key hurdles to refinancing. Lower credit fees are not likely to translate into lower mortgage rates to the same extent. It was also abundantly clear from recent prepays that increased moneyness does little to increase refinanceability for higher coupons (5.5s, 6s). The maximum LLPA benefit for a 30y mortgage would be 125bp, which, using an IO multiple of 4, works out to around 30bp. We've seen almost a 100bp primary rate rally since the beginning of the year, and prepay speeds on 2008 FN 6s have actually declined. The universe of eligible borrowers (using 5.5s and above for 2006 through 2008 vintage) that benefit from the cap being reduced to 75bp from 200bp increases from 17% to 25%. Investor property fee caps have not changed.

FRE has distinguished between borrowers with current LTV less than or equal to 80% and above 80% while FNM does not appear to have made that distinction other than for LLPA caps. The population of greater-than-125% current LTV is not particularly large, and their efficiency in refinancing may not be as much as lower LTV loans; the eligibility kicks in at a later date as well. For ARMs, maximum LTV remains at 105%, as it does for longer-than-30y maturities. We continue to expect the impact of HARP changes to be contained. Specifically, on the benchmark 2008 6% cohort, we expect up to a 7 CPR impact on FNs and up to a 4 CPR impact on FGs due to these changes. The programme expires on 31 December, and mortgages must have Note Dates on or before 31 December 2013.

Reps and Warrants:

Fannie Mae had provided relief from eligibility and underwriting reps and warrants roughly since the inception of HARP for borrowers who had been current for 12 months and were refinancing through their current servicer. The criterion now changes to 6 months current with up to 1 delinquency over the past 12 months – this was as announced previously. Freddie Mac previously did not have any rep and warranty relief but was expected to match the relief that FNM already offered. The details on FRE's relief, however, are ambiguous, and it is not clear if lenders would fully be provided relief on underwriting reps and warrants. And that relief is only restricted to borrowers with more than 80% current LTV in case of FRE. The relief doesn't kick in until mid-March 2012 for the guarantor business (cash business is earlier at January 2012).

Specifically, FRE's seller/servicer guide text states that "The Seller is not required to represent and warrant that the Mortgage being refinanced met the Freddie Mac eligibility requirements in its Purchase Documents related to the following: •Borrower creditworthiness (credit reputation and capacity) and any other underwriting requirements •Value, condition and marketability of the Mortgaged Premises". It is not clear whether just eligibility requirements related to underwriting or the entire underwriting requirement itself is covered by the clause. If only the former, deficient underwriting could still be an issue.

On the other hand, FNM clarified the language around its pre-existing reps and warrants relief considerably – "Starting with application dates of December 1, 2011 the lender will only be responsible for representations and warranties on the original loan regarding original project eligibility, fraud, charter, and compliance with laws."

It also defined the specific conditions regarding these exceptions. Fraud was addressed in the following manner, "The lender represents and warrants that the original loan being refinanced by a Refi Plus mortgage loan was not originated or sold pursuant to any scheme or pattern of fraud that involved two or more mortgages and two or more perpetrators acting in common effort with respect to such mortgages. For purposes of the foregoing, 'fraud' is defined as a misstatement, misrepresentation or omission that cannot be corrected and that was relied upon by Fannie Mae to purchase the mortgage being refinanced. For purposes of the foregoing, a 'perpetrator' is an individual or entity involved in the origination or sale of the mortgage or the related real estate transaction, including, but not limited to, a mortgage broker, loan officer, appraiser, appraisal company, title or closing agent, or property seller, or the borrower(s) acting in conjunction with one of the former."

Fraud was addressed similarly by FRE as well, though not all exceptions such as Charter violations were explicated as in FNM's case. Overall, the rep and warranty relief offered by FRE appears to be narrow relative to FNM. By defining exceptions, GSEs, particularly FNM, appear to have taken a step forward in increasing the certainty of repurchases for lenders which should help origination. But only two loans and two perpetrators would be enough to meet the prerequisite for fraud. Given that underwriting quality took a backseat during the mortgage boom, this may not be a particularly insurmountable threshold.

Another element to the rep and warranty relief is appraisals. FNM had indicated that only about 30% of its HARP appraisals were being done via Automated Valuation Model (AVM) vs 80% for FRE and that its objective was to improve that percentage. The latest announcements do not appear to list any specific efforts in this regard. Furthermore, FRE seems to be tightening the use of AVMs. It will no longer be permitting any AVM other than its HVE (Home Value Explorer). The validity of HVE reduced from 180 days at settlement to 120 days at note date, which could decrease the time available to close a loan.

No true rep and warranty relief is provided in case of different servicer refinancing by either GSE. When a loan is put through DU for FNM (or LP for FRE), it becomes a new loan altogether, the previous loan ceases to exist. Now according to FNM FAQs Q29, FNM does offer underwriting rep and warranty relief on DU Refi's, and this is not new to HARP 2.0. But note that this is only if "All data in the loan casefile is complete, accurate, and not fraudulent". Essentially, DU is a Fannie system that processes the loan, so it makes sense to relieve the lender of that process. But the lender enters the data and is on the hook for that data (also responsible for following DU instructions etc.). So that rep and warranty relief doesn't really mean much in our opinion (and is not a new development either). In the manual (same servicer) refi, such errors are essentially forgiven. Fraud is not forgiven in any case. There had been some talk of providing rep and warranty relief for a fee, and we had construed that to be in the context of different servicer refinancing. But there are no such provisions concerning this issue.

Key Dates

FRE, Same Servicer with LTV Greater than 80%

Settlement Dates starting 1/3/12 (Loan application on or after 12/1/11)

- Eligibility Rep and Warrant Relief
- Delivery fee cap reduced to 75bp from 200bp for non-investment property fixed rates with terms greater than 20 years and ARMs
- Delivery fee cap reduced to 0bp from 200bp for non-investment property fixed rates with terms less than or equal to 20 years

2/1/12

- Removing maximum LTV ratio of 125% for fixed rate mortgages sold under fixed rate Cash

3/15/12

- Allowing usage of HVE to determine home-price for certain 2-unit properties (in addition to 1-unit properties)

6/1/12

- Removing maximum LTV ratio of 125% for fixed rate mortgages sold under fixed rate Guarantor

FRE, Same Servicer with LTV less than or equal to 80%

1/3/12

- Requiring maximum TLTV and HTLTV ratios of 105%
- Minimum FICO score of 620

FRE, Different Servicer with LTV Greater than 80%

3/15/12

- Removing maximum LTV ratio of 125% for fixed rate mortgages sold under fixed rate Cash

6/1/12

- Removing maximum LTV ratio of 125% for fixed rate mortgages sold under fixed rate Guarantor

With LTV Greater less than 80%

1/3/12

- Requiring maximum TLTV and HTLTV ratios of 105%

Loan Prospector (for FRE different servicer refi's)

- On or before 15 March 2012, Loan Prospector will be updated to recognise Relief Refinance Mortgages – Open Access with LTV ratios greater than 125%. Until Loan Prospector is updated, Sellers cannot complete loan assessments for Relief Refinance Mortgages – Open Access with LTV ratios greater than 125%.
- Loan Prospector has not been updated to reflect the maximum 105% TLTV and HTLTV ratios for Relief Refinance Mortgages – Open Access with LTV ratios less than or equal to 80%. Sellers must ensure that this requirement is manually applied.
- HVE values returned on Loan Prospector Feedback Certificates can be used to determine property value for Relief Refinance Mortgages – Open Access only for Loan Prospector submissions on or after 15 March 2012.

FNM

12/1/11

- Delivery fee cap reduced to 75bp from 200bp for non-investment property fixed rates with terms greater than 20 years and ARMs for loans with greater than 80% LTV
- Delivery fee cap reduced to 0bp from 200bp for non-investment property fixed rates with terms less than or equal to 20 years ARMs for loans with greater than 80% LTV

3/1/12

- The changes to the LTV ratio limits implemented in DU in March 2012. Until such time as DU is updated, DU loan casefiles that receive an Ineligible recommendation due to an LTV ratio above 125% will not be eligible for delivery.

6/1/12

- CR Prefix for 30Y fixed LTV greater than 125% for MBS Delivery
- CW Prefix for 15Y fixed LTV greater than 125% for MBS Delivery
- CV Prefix for 15Y fixed LTV 105.0%1 Thru LTV 125% for MBS Delivery

Fees

- Delivery fee cap reduced to 75bp from 200bp for non-investment property fixed rates with terms greater than 20 years and ARMs
- Delivery fee cap reduced to 0bp from 200bp for non-investment property fixed rates with terms less than or equal to 20 years

Solicitation

Previously, lenders were prohibited in singling out GSE loans for refinancing. But now, such soliciting is permitted for HARP purposes and only if a lender targets both FNM and FRE borrowers. Also, solicitation practices should not vary depending on whether the lender or someone else owns the underlying pool.

Freddie Reperformers

Freddie Mac announced that it will begin securitising certain mortgage loans that previously were delinquent and had been bought out from its PC pools. The criteria for repooling bought-out loans starting in November is that they have not been modified and are current for at least 4 consecutive months. However, for the initial securitisation this month, Freddie Mac has elected to securitise loans that have been current for at least 12 consecutive months. These PCs may back new Freddie Mac REMIC and Giant securities in the future. The new prefix for the Reperformers is "R". Based on Freddie Mac's latest 10Q, it had USD 161.4 bn of single-family mortgage loans of which USD 119.1bn were non-performing. That means that about USD 42.3bn of loans might be eligible for resecuritisation. One caveat is that modified loans are not eligible, so that USD 42.3bn might be an upperbound of eligible loans. As of now, it is unclear if these pools will be TBA deliverable, and the decision is up to SIFMA.

EUR: Illiquidity Gathers Pace

- **Despite a large amount of front-loading, demand for ECB liquidity is increasing sharply, pointing to liquidity stress.**
- **There is little scope for any easing before the 13mth tender (22 December).**
- **Strategy: Pay OIS/BOR spreads near term.**

Stress on liquidity evident in some areas

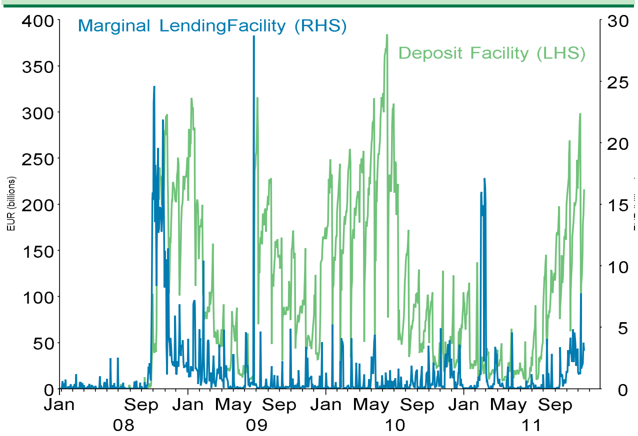
The stress on short-term liquidity has never really dissipated over the last four years, but since the ECB shifted to full, allotted, fixed-rate tenders, it has remained contained. Interbank liquidity is not functioning, but as banks are certain to find liquidity at the ECB, the risks of illiquidity remained subdued. It seems that the situation is deteriorating again, however, despite the accommodative conditions.

While the use of the marginal lending facility (MLF) is understandable as a temporary solution (banks can receive papers too late for a tender and, therefore, have to wait for the next one), it makes no sense when the use of the marginal lending facility persists beyond a week in the current fixed-rate, full-allotment environment. The recent use of the marginal lending facility is, therefore, a source of severe concern.

The level of this facility has been consistently well above "standard" levels for too long (early October) to be benign neglect. It is worth noting that the use of the marginal lending facility is a collateralised operation at a +75bp price versus regular tenders. Its use has, therefore, little to do with collateral problems. It highlights the fact that there is a growing number of banks managing liquidity on a daily basis.

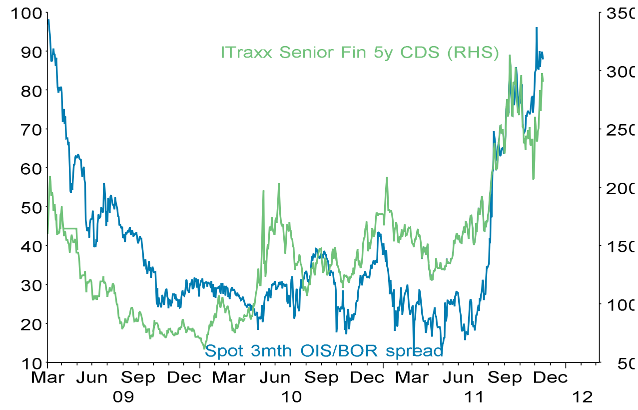
This is not a positive sign. Data by country on the use of the marginal lending facility in October are not available for all countries. However, it is worth noting that the use of the MLF in Belgium rose significantly in October. By contrast, there is no similar movement in Spain, for instance. The large increase of the use of the MLF has, therefore, little to do with the global situation in the markets, but is rather driven by specific situations. The use of the MLF is certainly limited to a very small number of banks in the eurosystem. Restructuring at some banks prevents them from managing liquidity beyond a daily basis. This was the case in Ireland, for example, when the banks were restructuring.

Chart 1: The MLF Signals Local Trouble



Source: BNP Paribas

Chart 2: The Stress Is Back



Source: BNP Paribas

But the global situation is worsening…

The use of the MLF points to specific situations at a limited number of banks. The large use of the deposit facility, regularly above EUR 200bn, while the cost of this excess liquidity is 75bp, means that the level of stress is global and increasing. The cost of excess liquidity is, on average, not so elevated, as banks are paid at DF + 10-15bp on seven-day term deposits, which now total more than EUR 180bn. But this level of excess liquidity is far too elevated in the context of the ECB's current accommodative conditions. It is a clear sign of mounting stress. OIS/BOR spreads point to such stress as well. The rebound in bank CDS also points to such concerns, and there is little scope for any improvement soon. At best, the 13mth tender the ECB will conduct next month (22 Dec) will offer some relief.

Strategy: Pay OIS/BOR spreads near term.

EUR: Contagion, Volatility and RV

■ **Our indicators suggest that contagion in the AAA space is accelerating.**

■ **The issue of high-return volatility is key for global investors and needs to be rapidly addressed to help (among other things) RV strategies to return to the EGB market.**

Relative value has been declared dead ever since the US subprime crisis started hitting the EGB market. In the good old days, the term "relative value" or "RV" was often done a disservice and confused within the realm of plain-vanilla carry and convergence strategies. A stricter definition of EGB RV, however, would have applied only to those strategies targeting small dislocations on a single country's yield curve and not dislocation between the yields of different countries (this strategy would have fallen under the umbrella of macro allocation).

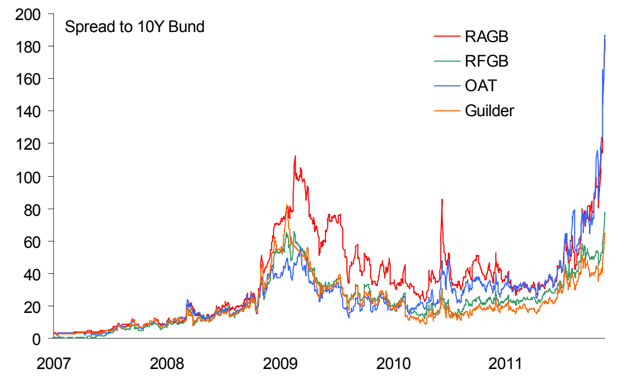
RV is independent of yield levels. RV strategies work at a 1% yield as well as a 7% yield; the theoretical concept is exactly the same. If we were to assume a scenario in which all countries (except Germany) were trading at 5-6% (AAA contagion is happening as we write, see Charts 1 and 2), then RV opportunities would open up again and market liquidity would be enhanced by the return of such strategies.

There is one caveat. Volatility is the killer of RV. The whole game of RV works independently of the level of yield, but not of the level of volatility. Why? Because RV strategies are cash intensive, thanks to their limited profit potential. Chart 3 shows the current levels of delivered volatility for AAA sovereigns in the Eurozone. Note how all countries, including Germany, are now trading at levels of volatility only seen in the aftermath of the Lehman crisis.

Last week, we listed the key variables driving global appetite for EGB allocation (*EUR: Why Are Investors So Cautious*?, 10 November 2011). Among other things, the high level of volatility was seen as a negative for global demand for EGBs. In addition, we believe volatility also has an indirect negative effect on EGB demand: a significant reduction in secondary market liquidity due to the absence of RV strategies.

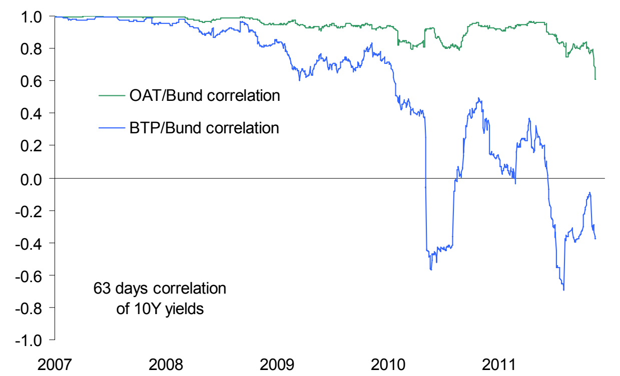
Proposals for bond-market regulation need to take into account the importance of volatility in the allocation equation. And the ECB's interventions must take into account volatility, as well as the level of yield.

Chart 1: Widening AAA Spreads to Bunds



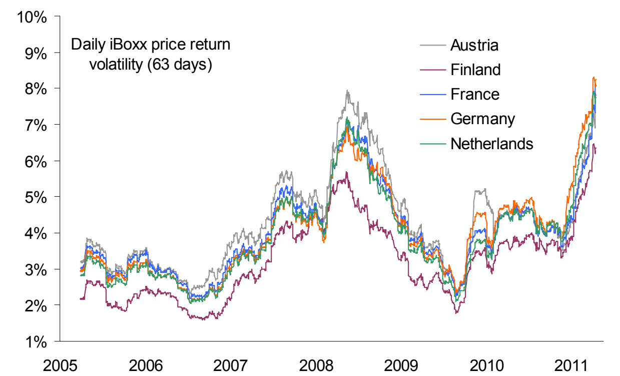
Source: BNP Paribas

Chart 2: AAA/Bund correlation dropping



Source: BNP Paribas

Chart 3: AAA volatility rising



Source: BNP Paribas

This section is classified as non-objective research

EMU Debt Monitor: CDS Analysis

Chart 1: CDS basis in Euros: back to May 2011 lows for France and Belgium

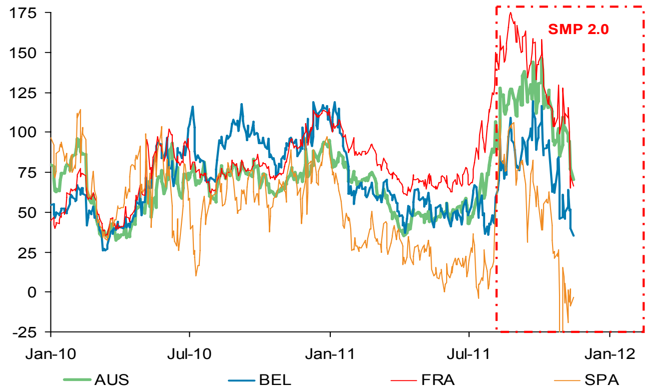
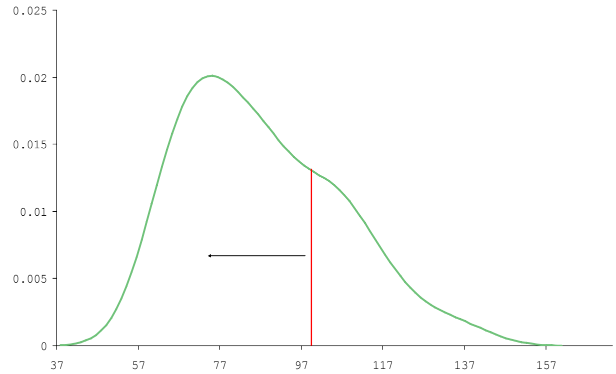


Chart 2: Italy/Spain CDS conditional on 5y BTP/Bono spread: CDS differential too wide relative to cash



Strategies:

Short Netherlands CDS basis: two weeks ago, we recommended selling the Netherlands CDS basis as it lagged the compression in most AAA CDS basis (Germany being the usual exception around 190bp). We keep our target of 120-125bp.

German CDS basis: all AAA CDS basis are significantly off their highs with the German CDS basis the only exception. If the past is any guide, periods of higher risk aversion have been consistent with a wider CDS basis (the 10y Bund yield’s correlation with German CDS is close to -95% since the end of Q2). With the Bund future unable to rally and post new highs in spite of the contagion to AAA countries, we consider that a change of trend on the German basis will soon be seen and recommend selling the basis targeting a return to 160-165bp.

CDS Table and Stats*

	CDS	CDS Weekly change	cash	Basis	Basis Weekly change	Quanto	Eur basis	Average	Max	Min	Z score**
Germany	92	0	-95	187	6			140	205	80	1.40
FIN	66	3	-20	86	-20	-9	78	95	139	54	0.08
NETH	115	14	-17	132	-17	-39	93	104	164	46	0.87
FRA	220	30	90	130	-16	-77	53	145	214	79	-0.14
AUS	211	34	96	115	-24	-63	52	115	191	62	0.10
BEL	333	29	242	91	-20	-76	16	113	178	74	-0.45
ITA	571	8	495	76	75	-91	-14	105	220	12	-0.34
SPA	463	40	383	80	-12	-98	-18	107	181	52	-0.46
IRE	770	-3	624	146	5	-76	70	52	339	-300	0

Chart 3: Quanto CDS posting new lows with the exception of Finland

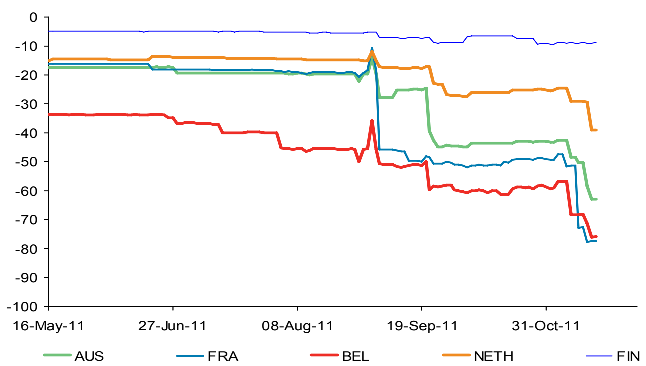
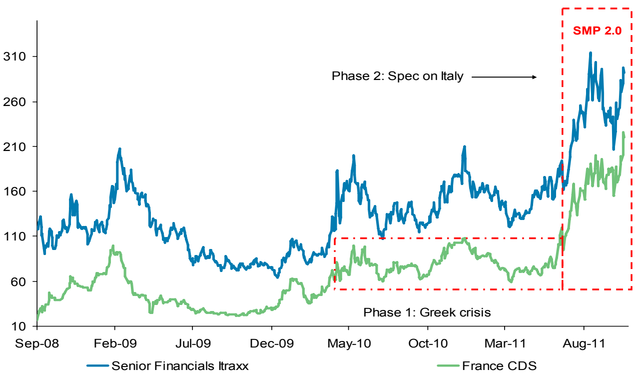


Chart 4: New highs on France CDS, but not on Senior financials



*Charts source: BNP Paribas * using Wednesday 16 November closing ** z score measures the deviation from six-month rolling average CDS basis of the country, expressed in numbers of standard deviations. A number above 1.50 means that the cash is trading historically expensive compared with its average basis level.*

This section is classified as non-objective research

EMU Debt Monitor: Key RV Charts

Chart 5: Bono Oct 13/Oct 20 spread back to 2010-11 lows

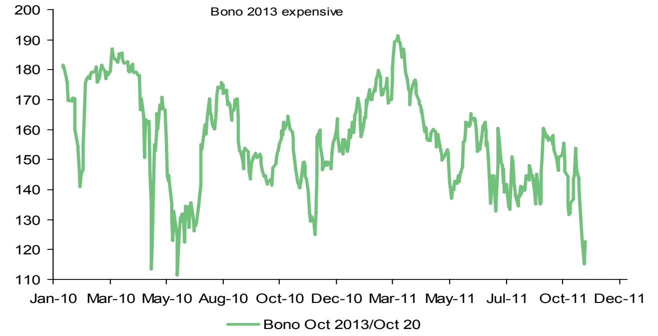
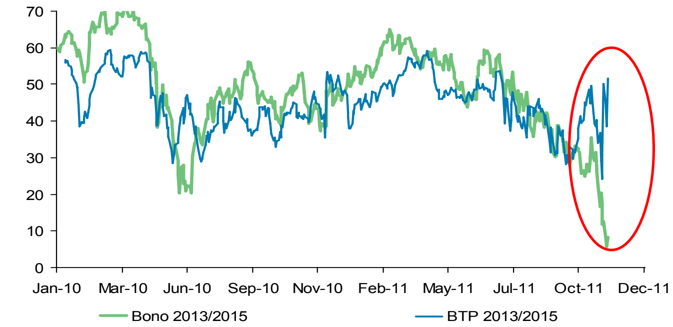


Chart 6: 2013/15 Bono & BTP spreads diverging: Apr 15 Bono too expensive



In early September we recommended Bono 2014/21 flatteners as the box to BTP was too high. With the bono 2013/20 segment back to the lows of 2010/11, we consider the risk/reward for Bono flatteners is becoming very poor.

The flattening of the Bono curve has been pronounced on the Oct 13/Apr 15 segment. The latter even diverged from the BTP Nov 13/Apr 15 which is now more than 25bp steeper. Long BTPs vs. Bonos should be traded on Apr 15 maturity.

Chart 7: OFR 10y BTP ASW flies and SMP 2.0

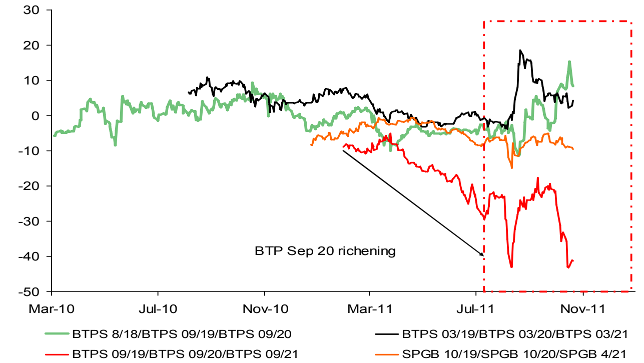
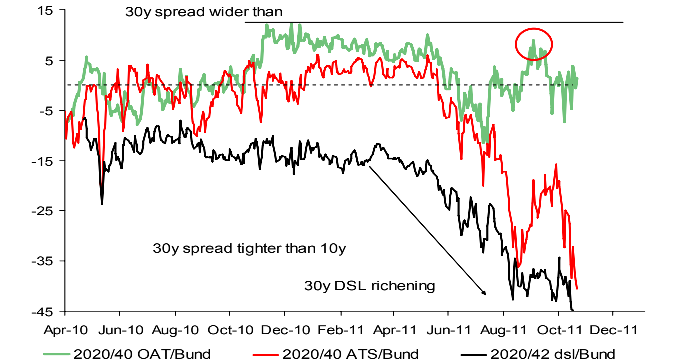


Chart 8: 10y/30y AAA/Bund box: 30y DSL & ATS richening



Within the 2018-21 BTP ASW curve, BTP Sep 20 after a temporary cheapening, is back to its richest level within the Sep 19/Sep 20/Sep 21 BTP ASW fly. Holders of Sep 20 should switch into Sep 21 after the recent cheapening.

While 10y/30y ATS and DSL boxes to bund posted new lows following the decoupling between 30y and shorter maturities, the OAT box has been surprisingly stable (i.e. 30y OAT has not richened). 10y/30y OAT segment has room flatten.

Chart 9: DSL/Bund ASW distribution per maturity

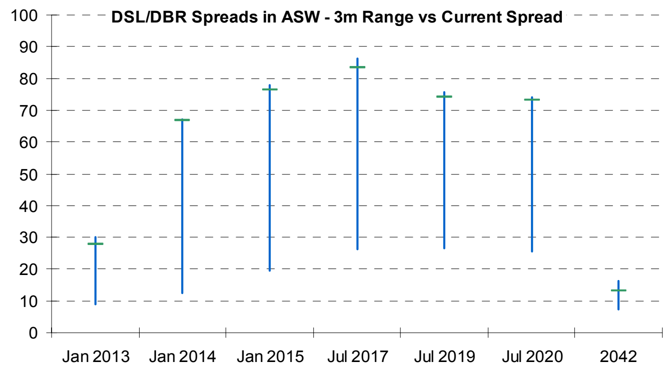
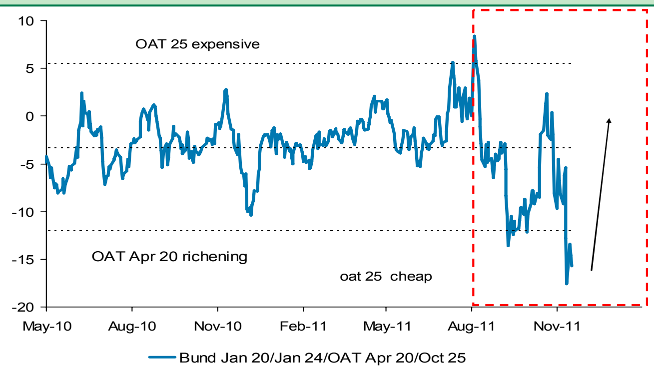


Chart 10: 10y/15y OAT/Bund box: 15y OAT still lagging Bund 15y



After staying in a tight trading range, DSL/Bund spreads spiked following OAT/Bund spreads. The only exception remains the 20y/30y area where spreads are trading close to their lows. Long 15y Bunds vs. 30y DSLs remain attractive.

Two weeks ago we highlighted the extreme cheapness of 15y Bunds versus 10 and 30y. 15Y Bund recovered while the OAT 15y lagged which pushed the 10y/15y OAT/Bund box to new lows i.e. OAT Oct 25/Apr 26 too cheap.

All charts source: BNP Paribas

EMU Debt Monitor: SSA and Covered Bonds

- **KFW Jul-16 is cheap: The ASW spread differential KFW/DBR Jul-16 is almost at its all-time high of 92bp, and 2y/5y/10y ASW flies of KFW and DBR are completely dislocated. Play a compression trade via KFW/DBR Jul-16 (first target, 25bp profit).**
- **CADES Sep-13 is rich: Switch from CADES Sep-13 into CADES Oct-14 to benefit from an unsustainable 50bp yield pick-up.**

With contagion spreading, KFW and other German names remain the exceptions in the agency market, outperforming swaps when the trend is to go wider.

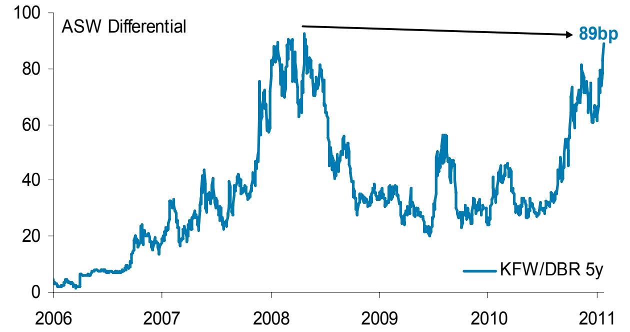
A notable development this week, however, was the EFSF outperforming CADES. For the first time since the end of September, the ASW spread differential CADES/EFSF returned to positive territory, thereby displaying a significant 20bp.

Despite a notable tightening of KFW, we like the 5y bullet, as it is only 3bp away from its historical highs versus Germany (Chart 1). Jul-16 is at an annual peak of 87bp in yield differential, 89bp in ASW, providing an attractive opportunity to investors hunting for safe havens. It is also noteworthy that Jul-16 has cheapened considerably versus the fitted curve over the past few months, going from rich levels into cheap ones, and is currently at its cheapest level versus fair value.

Another argument favouring KFW 5y is an analysis of the 2y/5y/10y fly. It is striking that the 2y/5y/10y ASW flies of KFW and the Bund are diverging completely, the former being back to cheap levels (17bp) and the latter back to the extremely rich level of -20bp, last seen in November 2008 (Chart 2). Both flies are indeed exceeding their 2SD range, but KFW the upper and Bund the lower. Overall, we would, therefore, recommend considering the RV trade of buying KFW Jul-16 and shorting DBR Jul-16, targeting a tightening of the spread differential towards 65bp (25bp profit).

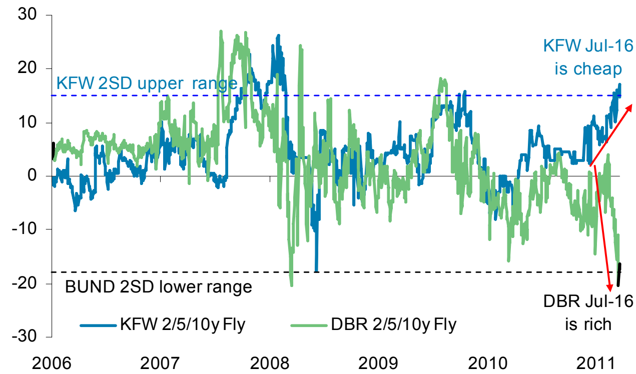
On the CADES curve, a rich/cheap analysis unveils the extreme richness of CADES Sep-13 versus the fitted curve. The benchmark is at the moment 10bp below its fair value in ASW terms (its richest level over the past four months), although the bond was trading around fair to cheap levels a few months ago. Interestingly, the next benchmark up, CADES Oct-14, has inversely normalised from extremely rich levels and is currently 3bp above fair value in ASW terms (its cheapest level over the past four months).

Chart 1: KFW/Bund 5y Back to the Highs



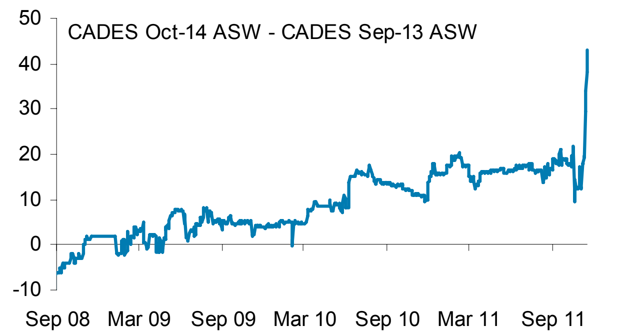
Source: BNP Paribas (based on in-house generic indices; latest benchmarks used in this analysis are KFW Jul-16 and DBR Jul-16)

Chart 2: KFW vs Bund 2y/5y/10y ASW Flies – Completely Dislocated



Source: BNP Paribas (based on in-house generic indices; latest benchmarks used in this analysis are DBR and KFW Oct-13, Jul-16, Jul-21)

Chart 3: Switch From CADES Sep-13 Into CADES Oct-14 for a Significant Pick-Up



Source: BNP Paribas

As a result, the ASW spread differential CADES Oct-14/CADES Sep-13 is at an all-time high of 40bp (Chart 3). We, therefore, recommend switching from CADES Sep-13 into CADES Oct-14 to benefit from an unsustainable 50bp yield pick-up.

EMU Debt Monitor: Trade Ideas

- **Keep or add OAT flatteners through BTAN Jan 14/OFR 10y OATs.**
- **Holders of DSL or Fin July 13 should switch into DSL July 14.**
- **At the long end, we still like long Bund July 2027 versus DSL Jan 42.**

This week, we provide a quick update on the past month's relative value recommendations.

OAT flatteners

On 24 October, we noted the extremely high levels reached by 2y/10y OAT boxes vs. Bund, DSL and Fin and recommended playing a normalisation through BTAN Jan 14/OAT Apr 20 flatteners in the 163/165bp area. After an initial steepening, the spread is back to our entry level. However, as Chart 1 illustrates, quite surprisingly, the sharp rise in BTAN 2y yields has been consistent with a parallel shift in the OAT curve.

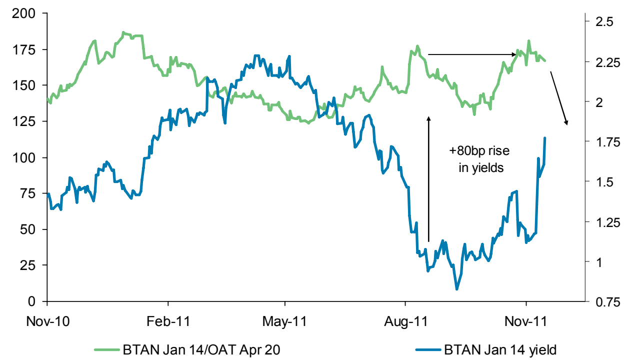
Using our non-parametric approach, we calculated the distribution of the OAT 2014/20 segment conditional on the level of 2y BTAN yields. Chart 2 plots the distribution along with the spread value. Clearly, the current OAT curve level is too overstretched in the wake of the 2y BTAN/BKO spread widening at the short end (the distribution peak is 20bp below current levels).

The experience of the BTP and Bono curves in 2011, both topping below 170/175bp – a similar level to the BTAN Jan 14/OAT Apr 20 segment – and moving to a bear flattening, supports our view. In the absence of more aggressive ECB commitment, we think further widening pressures on Italy and AAA countries in illiquid year-end markets are consistent with a flatter OAT curve.

Within the 10y/30 OAT segment, in early October (see *EMU Debt Monitor*, *Trade Ideas* section, 6 October), we suggested exploiting the excessive steepness of the OAT segment relative to its fair value. At that time, we recommended playing Apr 21/Apr 26 flatteners, targeting the low 40s. The spread has flattened marginally so far, but as Chart 3 shows, the OAT segment is almost trading 10bp too steep. And as the experience of the BTP and Bono curves tells us, an overshoot in flattening is likely on wider spreads near term.

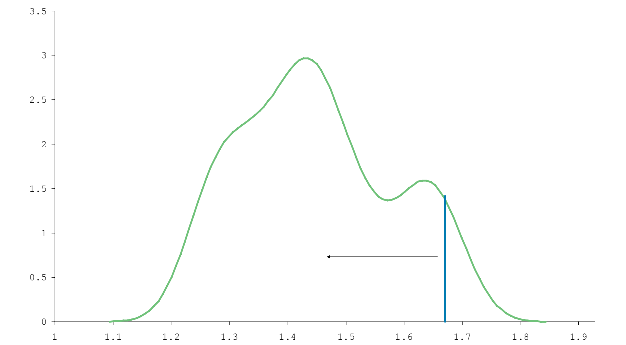
Strategy: Keep or add BTAN Jan 14/OAT Apr 20 flatteners, targeting at least a 20-25bp move.

Chart 1: Unchanged BTAN 14/OAT 20 Spread in Spite of 80bp Rise in Yields



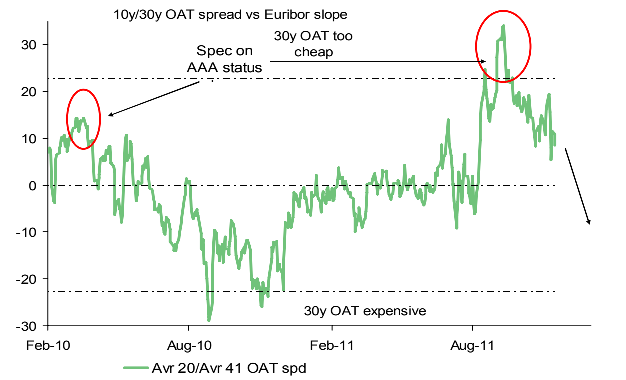
Source: BNP Paribas

Chart 2: Distribution* of BTAN Jan 14/OAT Oct 20 Conditional on BTAN Yield: Curve is Too Steep



*Source: BNP Paribas; *We calculate the distribution of the BTAN Jan 14/OAT Apr 20 using only the values of the spread when the BTAN Jan 14 yield is in 1.65-2.2% range*

Chart 3: Observed vs. Fitted OAT 10y/30y Segment: Still Room for Normalisation



Source: BNP Paribas

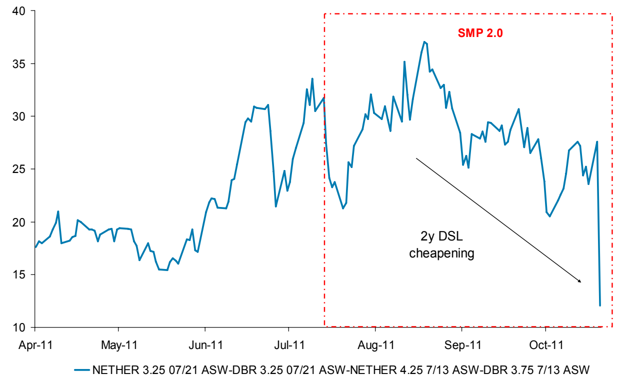
DSL curve dislocations: overshoot on 2013/14

The contagion effect from Italy to France in October has spread to DSL and Fin in recent days, with 10y DSL and Fin spreads to Germany widening by 20bp in just a couple of days. However, unlike OAT/Bund spreads, which widened more in the 10y area, selling pressures on DSLs were focussed on the short end. As Chart 4 underscores, the protracted cheapening of the 2y DSL within the 2y/10y DSL/Bund box has even accelerated. The box is now trading close to 15bp, compared with 45bp for OATs. Looking into the detail at the short end of the DSL, it appears that the widening of 2014 maturities has been even more pronounced than July 2013. As Chart 5 highlights, the July 13/July 14 micro box has risen by 10bp in recent days (i.e. DSL July 14 underperformed July 13).

At the very long end of the DSL curve, while the Bund and OAT 10y/30y segments are trading too steeply versus their fair value (5-8bp), the AAA contagion seen over the past days has led to an overshoot on the 10y/30y DSL segment. Chart 6 plots the times series of the observed versus fitted OFR 10y/30y DSL segment. In a few days, it has moved from a fair level to Q2 2009 extremes, with the DSL segment trading 20bp below its fair value. PF buying interest explains the structural expensiveness of the 30y DSL, but the current situation cannot be compared to the one of extreme stress on the 30y area seen in early 2009, when the 10y/30y swap segment was trading around -40bp.

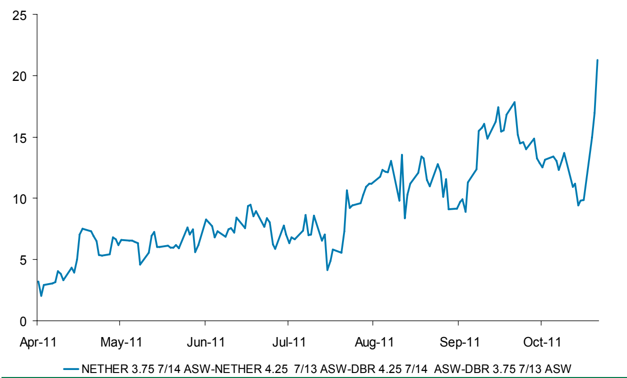
Strategy: Holders of DSL or Fin July 13 should switch into DSL July 14. The most aggressive ones could sell Bund July 14 vs. DSL July 14. The spread in the mid 60s should retrace below 40 over the coming month on stronger ECB commitment. At the long end, we still like long Bund July 2027 vs. DSL Jan 42.

Chart 4: 2013/21 DSL/Bund ASW Box: In Contrast to BTANs, 2y DSL Has Cheapened the Most



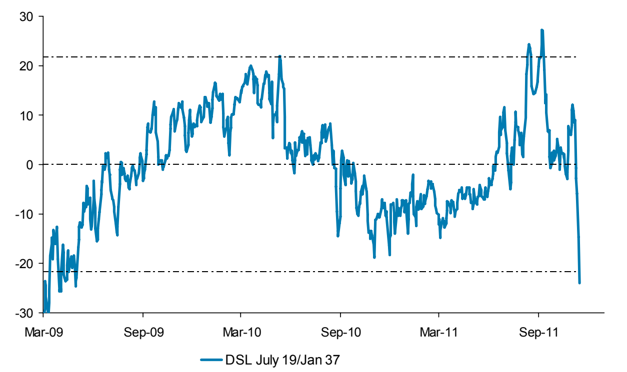
Source: BNP Paribas

Chart 5: July 13/14 DSL/Bund Box: 2014 DSL Cheapened Even More Than 2013



Source: BNP Paribas

Chart 6: Observed vs. Fitted OFR 10y/30y DSL: Segment Back to Q1 2009 Extremes



Source: BNP Paribas

EMU Debt Monitor: Redemptions

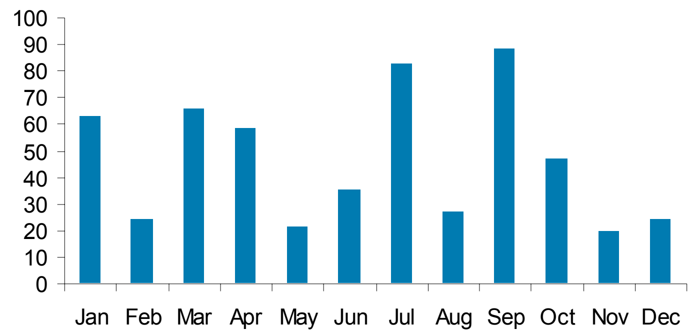
EGB Monthly Redemptions

Bonds	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2011
ITA		18.7	30.5		14.6	12.2		20.2	46.0		15.5		157.6
FRA	17.8			18.4			29.3		13.8	15.7			95.0
GER	23.3		15.0	19.0		15.0	24.0		16.0	17.0		18.0	147.3
SPA				15.5			15.5			14.1			45.1
GRE	0.0		8.7	1.0	7.0			6.8				5.8	29.4
BEL			11.3			3.4			12.7			0.5	27.9
NET	13.9						14.1						27.9
AUS	8.3											0.1	8.4
POR				4.5		5.0							9.5
IRE											4.5		4.5
FIN		5.7											5.7
Total	**63**	**24**	**66**	**58**	**22**	**35**	**83**	**27**	**89**	**47**	**20**	**24**	**558**

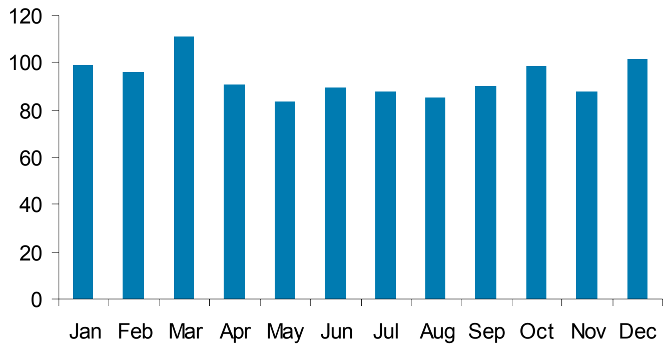
T-Bill Monthly Redemptions

T-Bills	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2011
ITA	17.4	17.3	17.3	17.3	14.6	19.3	16.3	16.2	15.7	15.7	14.9	22.5	204
FRA	33.3	35.9	38.3	31.9	32.1	32.7	30.9	28.7	36.4	36.1	34.8	37.1	408
GER	11.0	11.0	11.0	11.0	11.0	11.0	9.0	9.0	9.0	10.0	10.0	9.0	122
SPA	8.7	7.9	10.2	7.3	7.9	6.3	7.3	11.9	7.3	10.0	6.2	9.3	100
GRE	4.2	0.4	1.4	3.2	1.0		4.4	2.5	4.0	3.6	3.6	4.0	32
BEL	5.5	6.2	6.4	6.7	7.4	6.8	5.4	5.4	5.0	6.4	6.4	6.8	74
NET	9.7	8.3	17.4	7.0	6.9	10.9	7.7	6.2	7.8	12.7	7.1	10.1	112
AUS	0.1	2.2	0.9	3.4	0.5	1.9	2.4	2.0	0.2	0.7	1.2	0.3	16
POR	3.4	3.5	3.8				4.0	3.1	3.5	3.3	3.6	2.3	30
IRE	2.1	1.2	1.6	1.3									6
FIN	3.5	2.3	2.6	1.5	2.2	0.7		0.6	1.1	0.1	0.0		15
Total	**98.9**	**96.2**	**110.9**	**90.6**	**83.6**	**89.6**	**87.4**	**85.3**	**90.0**	**98.5**	**87.7**	**101.2**	**1120**

EGB Monthly Redemptions



T-Bill Monthly Redemptions



This Month's EGB Redemptions

Country	Bond	Maturity	Issued	EURs (bn)	CRNCY
ITALY	CCTS 0 11/01/11	01/11/2011	01/11/2004	**16.50**	EUR
ITALY	BTPS 1.9 11/01/11	01/11/2011	01/11/2001	**0.03**	EUR
IRELAND	IRISH 4 11/11/11	11/11/2011	11/11/2008	**4.40**	EUR

This Month's T-Bill Redemptions

Country	T-Bill	Maturity	CRNCY	EURs
AUSTRIA	RATB 0 11/07/11	07/11/2011	USD	0.07
AUSTRIA	RATB 0 11/07/11	07/11/2011	EUR	0.08
AUSTRIA	RATB 0 11/07/11	07/11/2011	USD	0.05
AUSTRIA	RATB 0 11/07/11	07/11/2011	EUR	0.02
AUSTRIA	RATB 0 11/07/11	07/11/2011	USD	0.29
AUSTRIA	RATB 0 11/08/11	08/11/2011	USD	0.40
AUSTRIA	RATB 0 11/08/11	08/11/2011	GBP	0.02
AUSTRIA	RATB 0 11/09/11	09/11/2011	USD	0.15
AUSTRIA	RATB 0 11/09/11	09/11/2011	EUR	0.10
BELGIUM	BGTB 0 11/17/11	17/11/2011	EUR	6.42
FINLAND	RFTB 0 11/08/11	08/11/2011	EUR	0.03
FRANCE	BTF 0 11/03/11	03/11/2011	EUR	8.26
FRANCE	BTF 0 11/10/11	10/11/2011	EUR	10.35
FRANCE	BTF 0 11/17/11	17/11/2011	EUR	7.82
FRANCE	BTF 0 11/24/11	24/11/2011	EUR	8.40
GERMANY	BUBILL 0 11/09/11	09/11/2011	EUR	5.00
GERMANY	BUBILL 0 11/23/11	23/11/2011	EUR	5.00
GREECE	GTB 0 11/11/11	11/11/2011	EUR	2.00
GREECE	GTB 0 11/18/11	18/11/2011	EUR	1.60
ITALY	BOTS 0 11/30/11	30/11/2011	EUR	8.80
ITALY	BOTS 0 11/15/11	15/11/2011	EUR	6.05
NETHERLANDS	DTB 0 11/30/11	30/11/2011	EUR	7.05
PORTUGAL	PORTB 0 11/18/11	18/11/2011	EUR	3.56
SPAIN	SGLT 0 11/18/11	18/11/2011	EUR	6.20

All charts sources: BNP Paribas

EUR: Deflationary Premia in the Options Market

- **We list the main stylized facts extracted from the current shape of the volatility surface and smile at the front end**
- **Strategy: Expect implied volatility at the front end to decrease further**

The shape of the implied volatility term structures is suggesting a deflationary path in the Eurozone. In particular, bull steepening pressures have weighed on the front end, with two-year implied volatility displaying a positive slope of term structure up to two years maturity and declining thereafter. Interestingly, it bears a strong resemblance to the front end of the Japanese implied volatility structure.

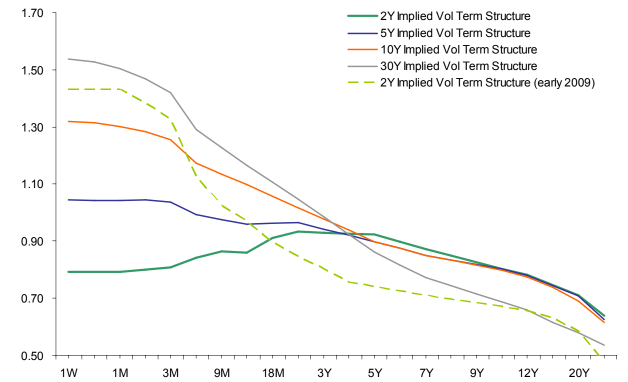
In the meantime, realised volatility at the front end is on a declining trend: Chart 2 plots 1y2y realised volatility (three-month window). Note that it has decreased by 16% since the beginning of the month. This is consistent with the market pricing in more accommodative monetary policy with the escalation of the sovereign debt crisis and the deterioration of the economic outlook. Interestingly, (forward-looking) implied volatility has been softening at a faster pace than (backward-looking) realised volatility since the beginning of the year, so that it looks cheap under the implied/realised ratio, which is currently at 88% (from more than 124% at the beginning of the year).

Gradual convergence towards ZIRP policy is flagged by the skew dynamics. Indeed, the slope of the skew is a decreasing function of the forward rate. As shown in Chart 3, the skew has significantly steepened since the beginning of the year, making out-of-the-money payers. Note that a simple linear econometric model of the skew suggests that it should steepen further over the coming months (payer skew is currently looking too cheap versus model fair value).

It is worth highlighting that our economists agree with the "bleak" outlook for the volatility market, as they expect one 25bp rate cut by the end of the year and an additional cut in Q1 2012.

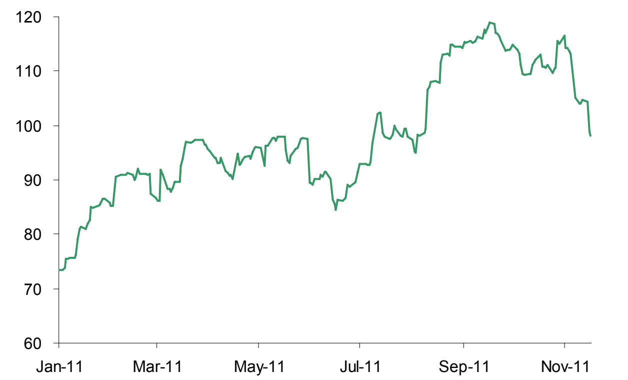
Accordingly, investors should consider selling the 1y2y payer spread for a premium takeout: for 100m notional, a short position in ATMF 1y2y payer vs 100bp OTM 1y2y payer entails 7k delta and -21k multiplicative vega risks. Six-month carry PnL is worth 67% of the upfront received premium.

Chart 1: Implied Volatility Term Structures



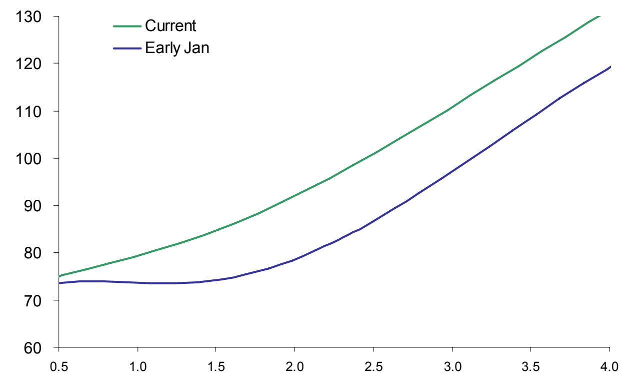
Source: BNP Paribas

Chart 2: 1y2y Realised Volatility



Source: BNP Paribas

Chart 3: 1y2y Implied Volatility Smile



Source: BNP Paribas

JGBs: Still Targeting 0.90%

- **The recent data show sales of foreign bonds by resident investors. The basis swap market is also showing concern about the outlook.**
- **STRATEGY: We remain bullish on rates, keeping our 0.90% target for the benchmark 10y.**

Capital inflows

The Ministry of Finance's international securities transactions data indicate that resident investors were net sellers of foreign bonds and notes to the tune of JPY 232.0bn for the week ended November 12. This was significantly lower than the JPY 1.6336trn in net sales the previous week, but nevertheless points to a further shift into yen bonds. European bonds are particularly likely to have been sold off as domestic institutional investors continue to reshuffle their portfolios.

Japan looks to be experiencing some capital inflows as a consequence of this selling. The government appears to have followed its massive yen-selling intervention of October 31 with a number of somewhat smaller actions, but the JPY continues to show a strengthening bias.

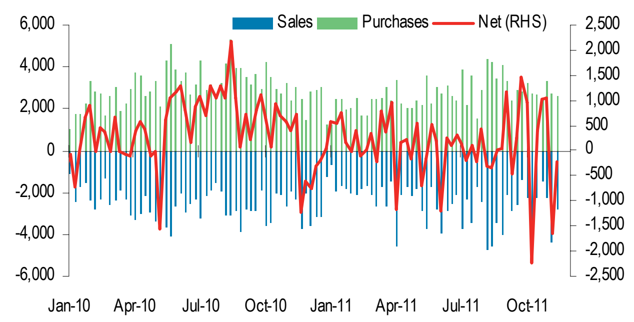
The Bank of Japan's Monetary Policy Board voted unanimously to maintain the status quo at its November 15–16 meeting, but is likely to respond with further expansion of its asset purchase programme – and possibly a lengthening of the duration of JGBs purchased under this programme – in the event of further yen appreciation. Strong GDP results for Q3 2011 have not been enough to dispel anxiety over the near- to medium-term economic outlook.

The basis swap market is also showing concern as to USD funding. The 1y basis swap fell bellow -60bp, with the rapid movement triggering loss cuts for some trades, as investors had paid those sectors for its juicy carry. The 5y area of the curve remains kinked, with issuances of Samurai bonds affecting the sector.

Capital inflows

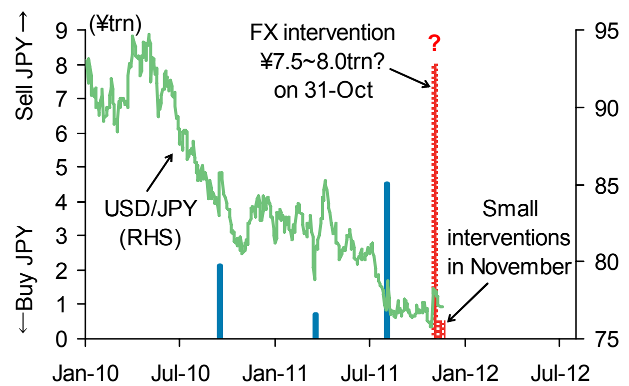
JGB yields continue to decline gradually amid growing concerns over the eurozone sovereign debt crisis, with the medium-term sector also benefiting from the BoJ's purchases of shorter-dated bonds.

Chart 1: Transactions in Foreign Securities (JPY bn)



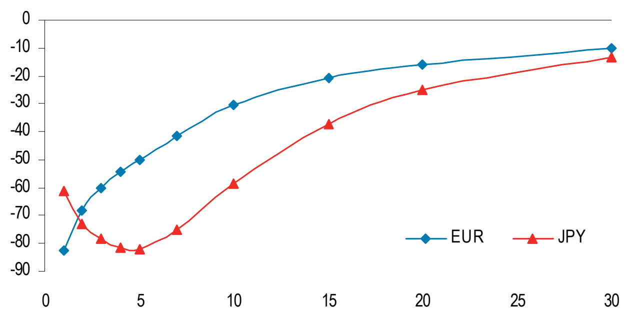
Source: MoF, BNP Paribas,

Chart 2: FX Interventions and USD/JPY



Source: MoF, BNP Paribas

Chart 3: Basis Swap (bp)



Source: BNP Paribas

With the December futures contract now having risen beyond the psychologically important JPY 143 level and the 5y yield dropping closer to 0.30%, we continue to target a 10y JGB yield of 0.9%, expecting recent resistance to be gradually overcome in the absence of a credible solution to the European crisis for now.

Global Inflation Watch

Inflation to ease in Japan and Canada as well

Few fresh inflation data are due out in the coming week. On Friday, 18 November, **Canadian inflation** is forecast to show a sharp decline from 3.2% y/y in September to 2.7% in October, in line with the decline seen in the US. On Friday, 25 November, the Japanese national rate is also likely to head south at -0.1% y/y in October after +0.2% the prior month. However, we expect a pause in November inflation, this could be signalled by **the Tokyo CPI** rate which we forecast stable at -0.5% y/y in November, with a possible slight recovery for core CPI at -0.3% y/y after -0.4%.

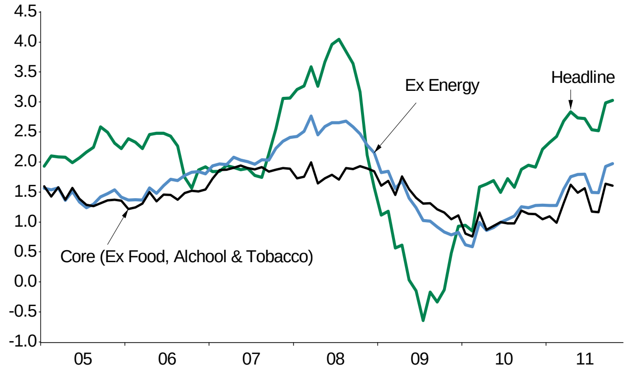
Eurozone HICP inflation was confirmed at 3.0% y/y in October, stable from the previous month. The details showed that core inflation was also stable, at 1.6% y/y. However, looking at the data to the second decimal place, headline inflation continued to rise marginally to 3.03% in October from 2.99% the previous month, whilst the core rate eased slightly from 1.64% to 1.60%. The decline in the core rate was driven by a fall in inflation on recreation and culture, hotels and restaurants, and education (in particular because some fees were scrapped in Germany). This was partly compensated for by a rise in the price of clothing. At the headline level, higher food prices and a significant jump in alcohol and tobacco pushed the index up.

The rise in the price of alcohol and tobacco was explained by higher indirect taxes. This factor also pushed up Italian prices, compared to most other eurozone countries. A similar effect, though on a smaller scale, is expected in France from January. Nevertheless, some convergence of national inflation rates is currently under way.

In the **US**, inflation fell sharply from 3.9% in September to 3.5% y/y in October, falling faster than market expectations, thanks to a sharp drop in the contribution of energy. However, core inflation rose from 2.0% to 2.1%; it was lifted by the on-going rapid increase in rents and OER, which have heavy weights in the CPI. The medium-term outlook for core inflation remains subdued thanks to low wage increases.

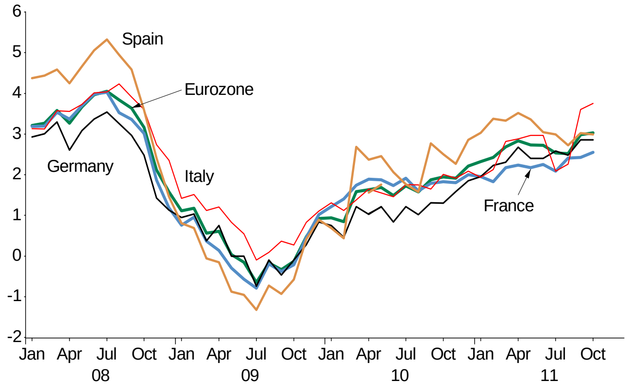
In the **UK**, both key measures of inflation eased; the CPI rate from 5.2% in September to 5.0% y/y in October and the RPI from 5.6% to 5.4% y/y. This was due to energy; core inflation was stable at 3.4% y/y.

Chart 1: Eurozone Headline and Core HICP (% y/y)



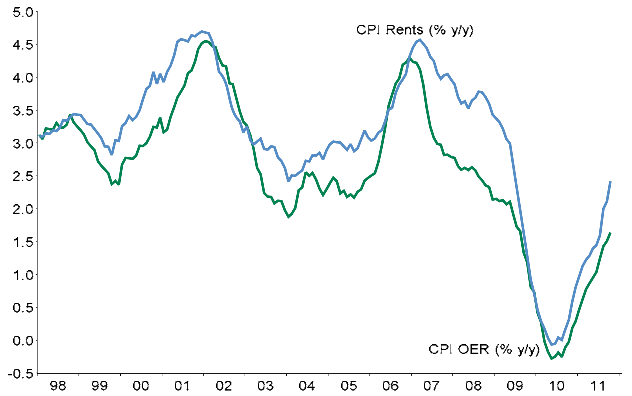
Source: Reuters EcoWin Pro

Chart 2: Eurozone HICP (% y/y) Main Countries



Source: Reuters EcoWin Pro

Chart 3: US CPI OER versus Rents



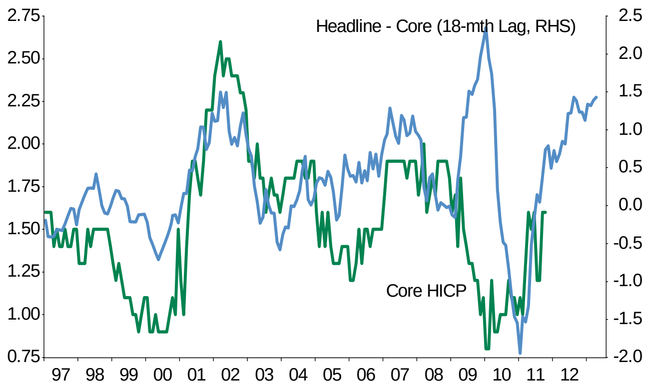
Source: Reuters EcoWin Pro

Table 1: BNP Paribas' Inflation Forecasts

	Eurozone						France						US					
	Headline HICP			Ex-tobacco HICP			Headline CPI			Ex-tobacco CPI			CPI Urban SA			CPI Urban NSA		
	Index	% m/m	% y/y	Index	% m/m	% y/y	Index	% m/m	% y/y	index	% m/m	% y/y	Index	% m/m	% y/y	Index	% m/m	% y/y
2010	109.8	-	1.6	109.5	-	1.5	121.1	-	1.5	119.8	-	1.5	218.1	-	1.6	218.1	-	1.6
2011[1]	112.8	-	2.7	112.4	-	2.7	123.7	-	2.1	122.2	-	2.0	224.9	-	3.1	225.0	-	3.2
2012[1]	115.0	-	1.9	114.5	-	1.8	126.0	-	1.9	124.4	-	1.8	229.3	-	1.9	229.3	-	1.9
Q1 2011	111.3	-	2.5	110.9	-	2.4	122.5	-	1.8	121.0	-	1.7	222.3	-	2.2	221.7	-	2.1
Q2 2011	113.1	-	2.8	112.8	-	2.7	123.9	-	2.1	122.4	-	2.0	224.5	-	3.3	225.5	-	3.4
Q3 2011	112.8	-	2.7	112.4	-	2.6	123.8	-	2.1	122.3	-	2.1	226.2	-	3.8	226.5	-	3.8
Q4 2011[1]	114.1	-	3.0	113.7	-	2.9	124.5	-	2.3	122.9	-	2.2	226.8	-	3.3	226.2	-	3.3
Q1 2012[1]	114.1	-	2.5	113.6	-	2.4	125.1	-	2.1	123.5	-	2.0	227.3	-	2.3	226.7	-	2.3
Q2 2012[1]	115.3	-	1.9	114.8	-	1.8	125.9	-	1.7	124.4	-	1.6	228.7	-	1.9	229.8	-	1.9
Q3 2012[1]	114.9	-	1.8	114.3	-	1.7	126.1	-	1.9	124.5	-	1.8	229.9	-	1.6	230.2	-	1.6
Q4 2012[1]	115.9	-	1.6	115.3	-	1.5	126.7	-	1.8	125.1	-	1.7	231.1	-	1.9	230.5	-	1.9
Jan 11	110.5	-0.7	2.3	110.11	-0.7	2.2	121.8	-0.2	1.8	120.32	-0.2	1.7	221.1	0.4	1.7	220.22	0.5	1.6
Feb 11	111.0	0.4	2.4	110.58	0.4	2.4	122.4	0.5	1.7	120.90	0.5	1.6	222.3	0.5	2.2	221.31	0.5	2.1
Mar 11	112.5	1.4	2.7	112.11	1.4	2.6	123.4	0.8	2.0	121.90	0.8	1.9	223.5	0.5	2.7	223.47	1.0	2.7
Apr 11	113.1	0.6	2.8	112.75	0.6	2.8	123.8	0.3	2.1	122.32	0.3	2.0	224.4	0.4	3.1	224.91	0.6	3.2
May 11	113.1	0.0	2.7	112.75	0.0	2.7	123.9	0.1	2.0	122.40	0.1	2.0	224.8	0.2	3.4	225.96	0.5	3.6
Jun 11	113.1	0.0	2.7	112.75	0.0	2.7	124.0	0.1	2.1	122.49	0.1	2.1	224.3	-0.2	3.4	225.72	-0.1	3.6
Jul 11	112.4	-0.6	2.5	112.03	-0.6	2.5	123.4	-0.4	1.9	121.94	-0.4	1.9	225.4	0.5	3.6	225.92	0.1	3.6
Aug 11	112.6	0.2	2.5	112.23	0.2	2.5	124.0	0.5	2.2	122.59	0.5	2.2	226.3	0.4	3.8	226.55	0.3	3.8
Sep 11	113.5	0.8	3.0	113.08	0.8	2.9	124.0	-0.1	2.2	122.49	-0.1	2.2	227.0	0.3	3.9	226.89	0.2	3.9
Oct 11	113.9	0.3	3.0	113.44	0.3	2.9	124.2	0.2	2.3	122.73	0.2	2.2	226.8	-0.1	3.6	226.42	-0.2	3.5
Nov 11[1]	114.0	0.1	3.1	113.56	0.1	3.0	124.4	0.1	2.4	122.84	0.1	2.3	226.7	0.0	3.4	226.22	-0.1	3.4
Dec 11[1]	114.4	0.4	2.8	113.96	0.4	2.7	124.8	0.3	2.2	123.18	0.3	2.1	226.9	0.1	3.0	225.86	-0.2	3.0
Jan 12[1]	113.4	-0.9	2.6	112.88	-0.9	2.5	124.7	-0.1	2.4	123.10	-0.1	2.3	227.0	0.0	2.7	226.13	0.1	2.7
Feb 12[1]	113.8	0.4	2.6	113.34	0.4	2.5	125.0	0.2	2.1	123.40	0.2	2.1	227.3	0.1	2.2	226.27	0.1	2.2
Mar 12[1]	115.0	1.0	2.2	114.51	1.0	2.1	125.6	0.5	1.8	124.02	0.5	1.7	227.7	0.2	1.9	227.65	0.6	1.9
Apr 12[1]	115.2	0.2	1.9	114.73	0.2	1.8	125.9	0.2	1.7	124.30	0.2	1.6	228.3	0.3	1.7	228.73	0.5	1.7
May 12[1]	115.4	0.1	2.0	114.89	0.1	1.9	126.0	0.1	1.7	124.44	0.1	1.7	228.8	0.2	1.8	229.94	0.5	1.8
Jun 12[1]	115.3	-0.1	1.9	114.79	-0.1	1.8	125.9	0.0	1.6	124.39	0.0	1.5	229.2	0.2	2.2	230.60	0.3	2.2
Updated	Nov 17						Nov 17						Nov 17					
Next Release	Nov Flash HICP (Nov 30)						Nov CPI (Dec 13)						Nov CPI (Dec 16)					

Source: BNP Paribas, (1) Forecasts

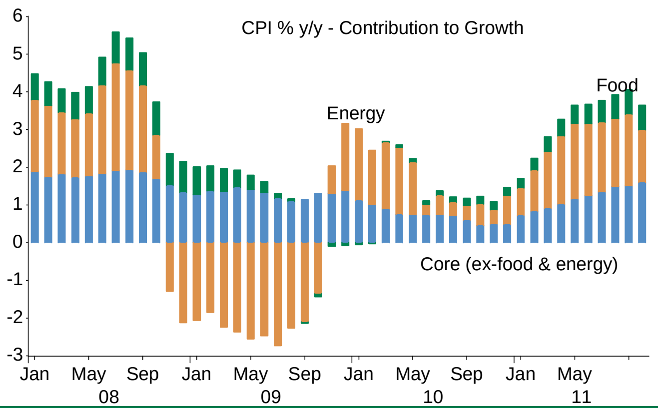
Chart 4: Eurozone HICP (% y/y)



Source: Reuters EcoWin Pro

Headline and core inflation were roughly stable in October at 3.0% and 1.6% y/y, respectively. The gap between the two inflation rates suggests that core inflation should rise further. Nevertheless, as in 2009, the sharp economic downturn should prevent core inflation from rising.

Chart 5: US CPI



Source: Reuters EcoWin Pro

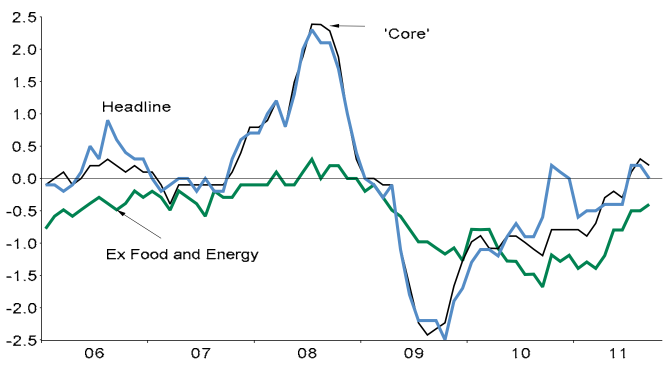
The sharp decline in inflation in October was mainly due to energy prices. We forecast energy prices will continue to pull headline inflation down, although the base effect on energy prices will not be as strong as in the eurozone. In a highly unusual manner, petroleum prices on each side of the Atlantic have been moving very differently for more than one year.

Table 2: BNP Paribas' Inflation Forecasts

	Japan						UK						Sweden					
	Core CPI SA			Core CPI NSA			Headline CPI			RPI			CPI			CPIF		
	Index	% m/m	% y/y	Index	% m/m	% y/y	Index	% m/m	% y/y	Index	% m/m	% y/y	Index	% m/m	% y/y	Index	% m/m	% y/y
2010	100.0	-	-1.0	100.0	-	-1.0	114.5	-	3.3	223.6	-	4.6	302.5	-	1.2	194.6	-	2.0
2011(1)	99.8	-	-0.2	99.8	-	-0.3	119.6	-	4.4	235.2	-	5.2	311.4	-	2.9	197.3	-	1.4
2012(1)	99.5	-	-0.3	99.5	-	-0.2	122.9	-	2.6	243.6	-	3.6	315.4	-	1.3	199.3	-	1.0
Q1 2011	99.8	-	-0.8	99.5	-	-0.8	117.6	-	4.1	230.9	-	5.3	308.1	-	2.6	196.1	-	1.4
Q2 2011	99.9	-	-0.3	100.0	-	-0.3	119.4	-	4.4	234.9	-	5.1	311.6	-	3.3	197.5	-	1.7
Q3 2011	99.7	-	0.2	99.9	-	0.2	120.1	-	4.7	236.2	-	5.2	311.9	-	3.3	197.2	-	1.6
Q4 2011(1)	99.6	-	-0.1	99.7	-	-0.1	121.3	-	4.7	238.7	-	5.1	313.9	-	2.6	198.2	-	0.9
Q1 2012(1)	99.6	-	-0.2	99.3	-	-0.2	121.8	-	3.6	240.3	-	4.1	313.7	-	1.8	198.5	-	1.2
Q2 2012(1)	99.6	-	-0.3	99.7	-	-0.3	122.9	-	3.0	243.9	-	3.8	315.4	-	1.2	199.3	-	0.9
Q3 2012(1)	99.4	-	-0.3	99.5	-	-0.3	122.9	-	2.3	244.1	-	3.3	314.9	-	0.9	199.0	-	0.9
Q4 2012(1)	99.5	-	-0.1	99.6	-	-0.1	123.8	-	2.1	246.3	-	3.2	317.5	-	1.2	200.3	-	1.0
Jan 11	99.8	0.0	-0.8	99.4	-0.3	-0.8	116.9	0.1	4.0	229.0	0.3	5.1	306.2	-0.5	2.5	195.2	-1.1	1.4
Feb 11	99.8	0.0	-0.9	99.4	0.0	-0.8	117.8	0.7	4.4	231.3	1.0	5.5	308.0	0.6	2.5	196.2	0.5	1.3
Mar 11	99.8	0.0	-0.7	99.7	0.3	-0.7	118.1	0.3	4.0	232.5	0.5	5.3	310.1	0.7	2.9	196.9	0.4	1.5
Apr 11	100.0	0.2	-0.3	100.0	0.3	-0.3	119.3	1.0	4.5	234.4	0.8	5.2	311.4	0.4	3.3	197.6	0.4	1.8
May 11	100.0	0.0	-0.2	100.1	0.1	-0.2	119.5	0.2	4.5	235.2	0.3	5.2	312.0	0.2	3.3	197.8	0.1	1.7
Jun 11	99.7	-0.3	-0.3	99.8	-0.3	-0.3	119.4	-0.1	4.2	235.2	0.0	5.0	311.3	-0.2	3.1	197.2	-0.3	1.5
Jul 11	99.8	0.1	0.1	99.8	0.0	0.1	119.4	0.0	4.4	234.7	-0.2	5.0	311.1	0.0	3.3	196.8	-0.2	1.6
Aug 11	99.8	0.0	0.3	99.9	0.1	0.2	120.1	0.6	4.5	236.1	0.6	5.2	311.2	0.0	3.4	196.8	0.0	1.6
Sep 11	99.6	-0.2	0.2	99.9	0.0	0.2	120.9	0.6	5.2	237.9	0.8	5.6	313.4	0.7	3.2	198.1	0.7	1.5
Oct 11(1)	99.6	0.0	-0.1	99.9	0.0	-0.1	121.0	0.1	5.0	238.0	0.0	5.4	313.4	0.0	2.9	197.9	-0.1	1.1
Nov 11(1)	99.6	0.0	-0.1	99.7	-0.2	-0.1	121.2	0.2	4.8	238.6	0.2	5.2	314.2	0.2	2.8	198.3	0.2	1.1
Dec 11(1)	99.6	0.0	-0.2	99.5	-0.2	-0.2	121.8	0.5	4.3	239.5	0.4	4.8	314.1	0.0	2.1	198.5	0.1	0.6
Jan 12(1)	99.6	0.0	-0.2	99.2	-0.3	-0.2	121.3	-0.4	3.7	239.1	-0.2	4.4	312.4	-0.5	2.0	197.6	-0.4	1.3
Feb 12(1)	99.6	0.0	-0.2	99.2	0.0	-0.2	121.9	0.5	3.5	240.4	0.6	3.9	313.6	0.4	1.8	198.5	0.4	1.2
Mar 12(1)	99.6	0.0	-0.2	99.5	0.3	-0.2	122.2	0.3	3.5	241.5	0.4	3.9	315.2	0.5	1.6	199.3	0.4	1.2
Apr 12(1)	99.6	0.0	-0.4	99.6	0.1	-0.4	122.8	0.5	2.9	243.5	0.8	3.9	315.6	0.1	1.3	199.6	0.1	1.0
May 12(1)	99.6	0.0	-0.4	99.7	0.1	-0.4	123.0	0.2	2.9	244.1	0.2	3.8	315.5	0.0	1.1	199.4	-0.1	0.8
Jun 12(1)	99.6	0.0	-0.1	99.7	0.0	-0.1	123.0	0.0	3.0	243.9	-0.1	3.7	315.1	-0.1	1.2	199.1	-0.2	1.0
Updated	Nov 17						Nov 17						Nov 17					
Next Release	Oct CPI (Nov 25)						Nov CPI (Dec 13)						Nov CPI (Dec 13)					

Source: BNP Paribas, (1) Forecasts

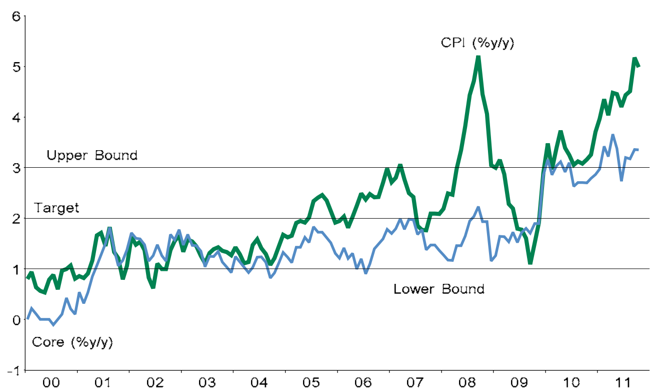
Chart 6: Japanese CPI (% y/y)



Source: Reuters EcoWin Pro

We expect CPI inflation to return to negative territory as early as October, as two special factors that are boosting the annual change by a combined 0.3pp – a tobacco tax hike and higher non-life insurance premiums – will fall out of the annual comparison.

Chart 7: UK CPI (% y/y)



Source: Reuters EcoWin Pro, BNP Paribas

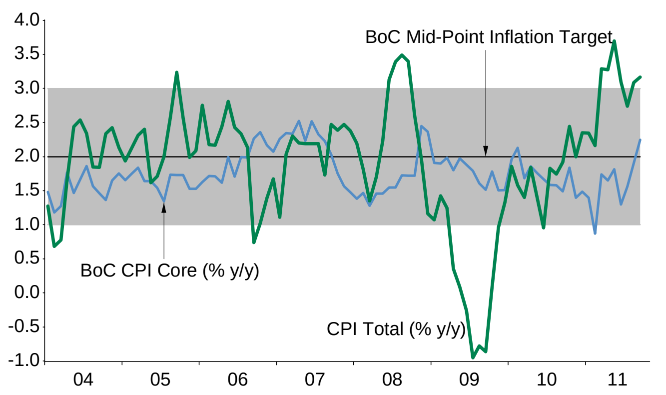
CPI inflation started to ease in October, at 5.0% y/y after 5.2% in September. We forecast the decline will gain pace over the next few months, as the contribution from energy diminishes and the base effect due to VAT disappears. Core inflation should return to within the target range by early next year.

Table 3: BNP Paribas' Inflation Forecasts

	Canada						Norway						Australia					
	CPI			Core CPI			Headline CPI			Core			CPI			Core		
	Index	% q/q	% y/y	Index	% q/q	% y/y	Index	% q/q	% y/y	Index	% q/q	% y/y	Index	% q/q	% y/y	Index	% q/q	% y/y
2010	116.5		1.8	115.6		1.7	128.8		2.4	120.1		1.4	172.6		2.8	-		2.8
2011(1)	119.9		2.9	117.6		1.7	130.6		1.4	121.3		1.1	178.7		3.5	-		2.5
2012(1)	122.8		2.4	119.8		1.9	132.7		1.6	123.6		1.8	183.6		2.8	-		2.5
Q1 2011	119.4	3.3	2.0	117.0	0.7	1.6	130.2	0.6	1.4	120.3	-0.2	0.8	176.7	1.6	3.3	-	-	2.3
Q2 2011	119.8	5.6	2.5	117.1	3.4	1.5	130.9	0.6	1.4	121.5	1.0	1.0	178.3	0.9	3.6	-	-	2.7
Q3 2011	120.6	0.8	2.8	118.4	1.6	1.6	130.1	-0.7	1.5	121.2	-0.3	1.1	179.3	0.6	3.5	-	-	2.5
Q4 2011(1)	120.8	1.4	2.9	118.7	2.9	1.7	131.1	0.8	1.4	122.2	0.8	1.4	180.3	0.6	3.6	-	-	2.6
Q1 2012(1)	122.0	2.6	2.9	119.2	1.0	2.0	131.6	0.3	1.1	122.5	0.2	1.8	181.9	0.9	2.9	-	-	2.5
Q2 2012(1)	123.2	4.7	2.7	119.6	1.7	2.0	132.9	1.0	1.5	123.8	1.0	1.8	182.7	0.4	2.5	-	-	2.3
Q3 2012(1)	123.2	1.2	2.6	120.4	2.3	2.0	132.7	-0.1	2.1	123.6	-0.2	1.9	184.3	0.9	2.8	-	-	2.6
Q4 2012(1)	123.7	0.6	2.4	120.8	1.9	1.9	133.6	0.7	1.9	124.4	0.7	1.8	185.4	0.6	2.8	-	-	2.5
Updated	Nov 17						Nov 17						Nov 17					
Next Release	Oct CPI (Nov 18)						Nov CPI (Dec 9)						Q4 CPI (Jan 25)					

Source: BNP Paribas, (1) Forecasts

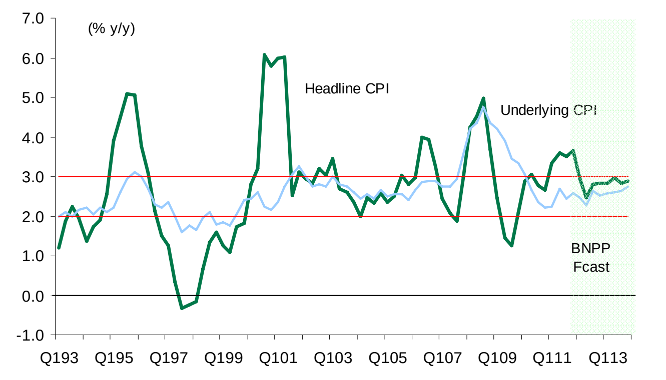
Chart 8: Canadian Headline vs. Core CPI (% y/y)



Source: Reuters EcoWin Pro, BNP Paribas

Wage pressures appear subdued, suggesting that headline inflation will soon move back within the BoC's target range. We expect the October data to confirm this.

Chart 9: Australian CPI (% y/y)



Source: Reuters EcoWin Pro, BNP Paribas

Underlying inflation is forecast to tick slightly higher in Q4, from 2.5% y/y to 2.6%. This should push headline inflation 0.1pp up to 3.6% y/y.

CPI Data Calendar for the Coming Week

Day	GMT	Economy	Indicator	Previous	BNPP F'cast	Consensus
Fri 18/11	12:00	**Canada**	CPI m/m : Oct	0.2%	0.0%	0.1%
	12:00		CPI y/y : Oct	3.2%	2.7%	2.8%
Thu 24/11	23:30	**Japan**	CPI National y/y : Oct	0.0%	-0.1%	-0.2%
	23:30		Core CPI National y/y : Oct	0.2%	-0.1%	-0.1%
	23:30		CPI Tokyo y/y : Nov	-0.5%	-0.5%	-0.5%
	23:30		Core CPI Tokyo y/y : Nov	-0.4%	-0.3%	-0.3%

Release dates and forecasts as at c.o.b. prior to the date of publication: See Daily Economic Spotlight *for any revision* *Source: BNP Paribas*

Inflation: BTAN+100bp or 6.5% Min Return

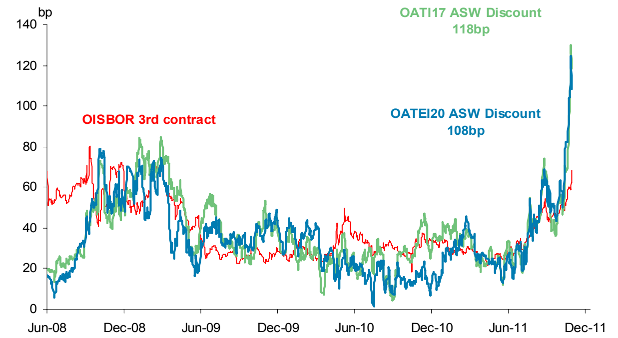
- **Data OK but investors still in panic mode in fixed income.**
- **EUR: we like BTANi-16 at BTAN+100bp and BTPei-16 at a 6.5% minimum real return.**
- **GBP: focus on UKTi-29 launch next week.**

Global: Activity data remain firm in the US and the UK, while the situation is deteriorating in the eurozone, where EGB spreads are reaching new highs. In money markets, OISBOR and cross-currency basis continue to move towards Lehman levels while financials equities are falling again. UK RPI and US CPI were weaker than expected, unlike EUR inflation, which surprised a touch on the upside. As far as commodities are concerned, WTI surged above USD 102/bbl for the first time since June and the Brent/Crude spread tightened to below USD 9/bbl for the first time since March. This trend probably partly explained the downwards surprise on US energy prices. Our economists do not expect the ECB to operate QE before March 2012. If they are right, inflation swaps are too high, like most risky assets. That said, there are very valuable carry trades for long-term investors.

EUR: France issued 1.1bn of linkers on Thursday. The total bid cover of 2.3 compares with a 2011 average of 2.5. Not so bad given current market's volatility but not so great given the cheapness of French linkers. More precisely, France sold 529mns of OATei-22 with a premium of 2bp and diversified bids, and sold 545mns of BTANi-16 with a premium of 3bp and one buyer taking around 60% of the offers. As said in our pre-auction desknote, we would agree with this buyer. At a breakeven below 1% and nominal + 100bp in ASW terms, the BTANi-16 is a buy. Generally speaking, flight to quality is bad for French linkers versus nominal, but France is the largest provider of liquidity in this market and also benefits from the largest domestic investor base. There are widening pressures still coming from money markets, but we doubt French buy-and-hold investors will wait for Q1 2012 to take advantage of current distressed levels in domestic and euro inflation linked bonds.

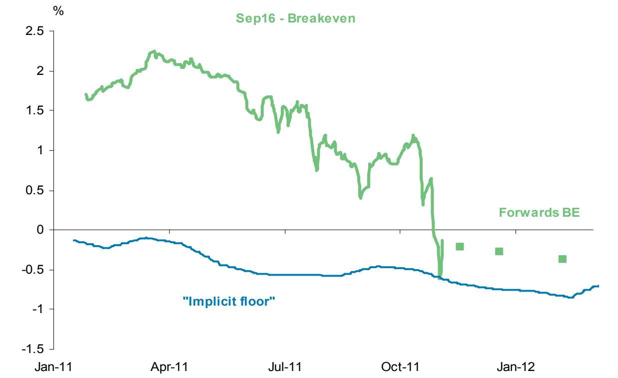
Another recommendation we keep is to buy the BTPei-16, in real yields, breakeven or versus BTPei-17 for instance. The BTPei-16 BE rebounded on its implicit floor of -60bp towards -20bp. Given it is still being affected by flows, the breakeven could still fall below -60bp. However, at -60bp of breakeven, we would still prefer a minimum REAL return than a

Chart 1: OATi17 and OATei20 ASW Discount vs. OIS BOR Since 2008



Source: BNP Paribas

Chart 2: BTPei16 breakeven vs. "Implicit Floor"



Source: BNP Paribas

NOMINAL return at the same level. Besides, to complete last week's article on BTPei, the following official publication from the Italian Tesoro suggests that, in the event of unlikely default, the recovery rate would be applied to principal amount multiplied by the inflation index ratio. Italian, French and Greek linkers should therefore not be affected by that specific issue. Please check out the link: http://www.dt.tesoro.it/export/sites/sitodt/modules/documenti_en/debito_pubblico/titoli_di_stato/Index_Linked_BTP.pdf

GBP: October RPI came in slightly weak at 5.5% y/y, with weakness in food prices, although core surprised to the upside. We expect the breakeven curve to continue steepening. Next week's syndicated launch of the UKTi 0.125% 22-March 2029 will probably offer a very low real yield, but breakeven and ASW levels look much more attractive. We see potential for a further concession into next week's UKTi-29 syndication as real money players will need to find value given likely limited LDI or dealer interest. See *Inflation Monitor,* 18 November 2011.

TIPS: Panic and Complacency

- **Global markets these days seem to have only two settings: panic and complacency.**
- **CPI was a short-term disappointment though the increase in core promises to provide a better long-term story for TIPS.**
- **Looking ahead to month-end, we remain at the mercy of broader risk sentiment to provide the flows that the index extension may not.**
- **The takeoff in energy may offer some positive sentiment for the front end, even as carry looks terrible into next year.**

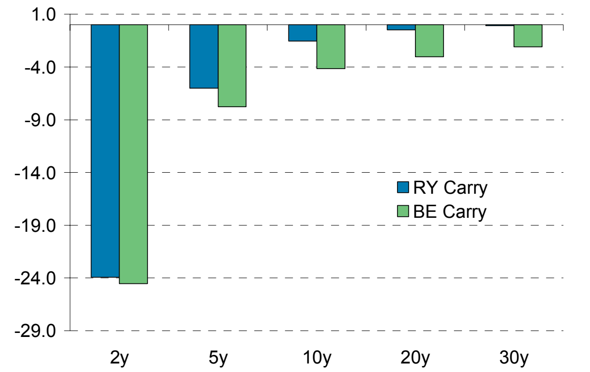
We remain in the bullish rates camp for now and believe that risk-taking will be a long time in recovery after the second financial crisis in less than five years. It's hard to overstate the psychological damage and the loss of faith in markets that investors must feel after two deep financial crises so close together. All that should provide a headwind for inflation products in the near term even as fundamentals in the US look good in the longer run.

Ironically, the recent CPI, despite coming in below our NSA call, gives us reason to be bullish TIPS over a longer horizon. The stability in core CPI (+0.1%), driven in part by a renewed jump in OER to 0.2% indicates that the weakness in the housing market persists, and the dynamic driving OER and core inflation remains intact. The drop in gasoline may have taken a bit of sting out of the headline number, but that's not likely to change the trend. This will take a few months to bubble up to the surface as the improvement in energy markets puts more upward pressure on future prints.

There is little in the short run (over the next few weeks) which compels investors to buy TIPS at historically low record yields. With the 10yr almost out of the way, no Fed operations left to speak of, and an index extension of only +0.01yrs, we remain cautious on flows into inflation in the next 2-3 weeks.

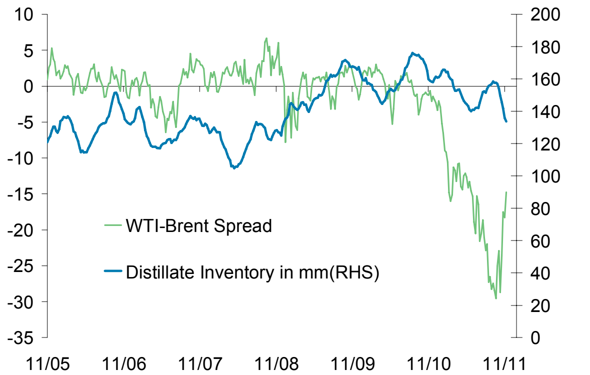
An earlier trade of ours, long front-end breakevens versus gasoline and WTI futures, has suffered as the energy markets have improved their tone significantly while front-end breakevens have fallen on sellbacks, sentiment and sliding carry. A further bounce in the near term seems less likely given the runup, but we still believe that lower distillate inventories, a resetting of the WTI-Brent spread, and potentially better risk sentiment may sponsor further gains in the

Chart 1: 6 Week Carry Profile in TIPS Dampens Enthusiasm



Source: BNP Paribas

Chart 2: A Resurgence in Energy Markets Driven by Brent/WTI and Distillates

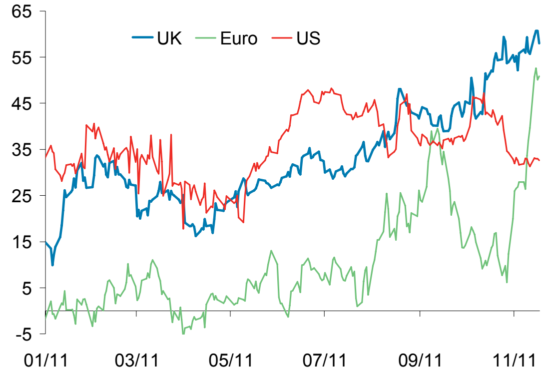


Source: BNP Paribas, Bloomberg

months ahead, especially for WTI. Front-end breakevens are still beholden to European headlines and may sell off a bit more given the meagre carry offered into the early part of next year. Conversely, they remain ripe for a jump should a resolution from Europe emerge and help sentiment.

We still believe that long-end asset swaps might be too narrow heading into year-end with 30yr asset swaps still near the 56bp level but showing signs of widening. Given the wides in other inflation markets (see last week's *Market Mover*), we will very likely continue that trend.

Chart 3: Asset Swap Spreads in the 10yr



Source: BNP Paribas, Bloomberg

Chart 1: Cost of Carry for Benchmark Linkers

Benchmark Carry												
Pricing Date	17-Nov-11		Term 1		Term 2		3m		6m		12m	
Sett. Date	18-Nov-11		01-Dec-11		01-Jan-12		20-Feb-12		18-May-12		19-Nov-12	
	Yield	BE	Real	BE	Real	BE	Real	BE	Real	BE	Real	BE
Short-end												
OATei Jul-12	-1.55%	2.55%	25.6	24.3	43.1	36.9	61.6	39.8	-99.4	-230.1		
OATI Jul-13	0.35%	1.26%	-2.2	-4.1	8.2	1.0	20.0	1.7	48.3	3.2	209.5	209.5
TIPS Jul-12	-0.55%	0.66%	6.8	6.9	-22.8	-22.3	-74.9	-72.9	-17.3	-6.1		
UKTi Aug-13	-2.15%	2.65%	0.5	0.6	7.9	8.4	-21.3	-19.5	56.6	61.8	49.2	95.1
5y												
BUNDEI Apr-16	-0.41%	1.30%	4.6	4.6	9.0	8.5	13.8	12.3	10.2	6.7	18.8	11.7
BTANI Jul-16	1.76%	0.90%	0.0	-1.2	6.3	0.9	14.6	1.6	30.8	2.8	77.6	77.6
TIPS Apr-16	-0.80%	1.57%	0.7	0.2	-3.6	-5.4	-8.7	-12.8	-3.8	-11.8	20.3	2.8
UKTi Nov-17	-1.10%	2.55%	4.6	4.0	5.1	3.1	11.5	7.2	14.5	5.9	30.3	12.5
JGBI-4 June-15	0.61%	-0.39%	-6.5	-6.7	1.9	1.5	-5.4	-6.2	-18.4	-20.1	7.1	3.4
10y												
OATEI Jul-22	2.23%	1.35%	2.7	1.8	6.8	2.7	12.6	3.0	18.2	-1.6	36.6	-5.0
OATI Jul-19	2.08%	1.21%	0.1	-0.9	4.4	-0.1	10.2	-0.6	21.0	-1.5	49.6	49.6
TIPS Jan-21	0.02%	1.83%	0.7	-0.1	-0.6	-3.2	-1.7	-7.4	3.2	-8.0	19.6	-3.8
UKTi Nov-22	-0.26%	2.46%	3.0	2.3	3.9	1.6	8.7	3.7	12.4	2.5	25.3	4.9
JGBI-16 June-18	0.92%	-0.43%	-10.3	-10.6	1.7	0.9	-1.7	-3.3	-7.2	-10.4	9.0	2.2
30y												
OATei Jul-40	2.31%	2.04%	1.2	0.7	3.1	0.7	5.8	0.0	8.2	-3.4	16.1	-7.5
OATI Jul-29	2.20%	2.10%	0.1	-0.7	2.4	-1.0	5.6	-2.5	11.2	-5.2	25.3	25.3
TIPS Feb-41	0.85%	2.15%	0.4	-0.2	0.2	-1.8	0.3	-4.0	3.0	-5.2	10.7	-6.0
UKTI Mar-40	0.08%	3.04%	1.2	0.7	1.7	-0.1	3.7	0.0	5.3	-1.9	10.6	-4.0
Short-end					Term 1 -> Term 2		Term 2 -> 3m		3m -> 6m		6m -> 12m	
OATei Jul-12					17.5	12.6	23.0	12.4	-161.0	-269.9	99.4	230.1
OATI Jul-13					10.4	5.1	11.9	5.1	28.3	1.5	161.2	206.3
TIPS Jul-12					-29.6	-29.2	-48.3	-47.2	57.6	66.8	17.3	6.1
UKTi Aug-13					7.4	7.7	-30.0	-29.2	78.0	81.3	-7.5	33.3
5y												
BUNDEI Apr-16					0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
BTANI Jul-16					4.3	3.9	4.2	3.6	-3.5	-5.6	8.5	5.0
TIPS Apr-16					6.3	2.1	6.5	2.0	16.1	1.2	46.8	74.8
UKTi Nov-17					-4.3	-5.6	-4.7	-6.2	4.9	1.0	24.2	14.6
JGBI-4 June-15					8.5	8.2	-4.9	-5.2	-13.0	-13.9	25.4	23.4
10y												
OATEI Jul-22					4.1	1.0	4.0	0.7	5.5	-4.6	18.4	-3.3
OATI Jul-19					4.3	0.8	4.4	0.7	10.8	-0.9	28.6	51.1
TIPS Jan-21					-1.3	-3.2	-1.4	-3.4	4.9	-0.5	16.4	4.2
UKTi Nov-22					1.0	-0.7	3.3	1.5	3.7	-1.1	12.9	2.4
JGBI-16 June-18					12.0	11.5	-2.3	-2.8	-5.5	-7.1	16.2	12.6
30y												
OATei Jul-40					1.9	0.0	1.8	-0.1	2.5	-3.4	7.9	-4.1
OATI Jul-29					2.4	-0.3	2.4	-0.4	5.7	-2.7	14.1	30.5
TIPS Feb-41					-0.2	-1.6	-0.2	-1.7	2.7	-1.2	7.7	-0.8
UKTI Mar-40					0.5	-0.7	1.4	0.1	1.7	-1.9	5.2	-2.1

Source: BNP Paribas

Technical Analysis: Interest Rates, Commodities

Bond & Short-Term Contracts

- **Europe 10y:** Still bottoming slightly (reversal), but must still preserve 1.61/1.64 (LT falling wedge sup & last low)
- **US 10y:** Still a ST bottoming bias; preserving 61.8% (1.95) could allow a rise to resume within a rising "C of ABC"
- **Short-term contracts h2:** Toppish bias on Euribor (2-top) and a ST weak one on ED approaching its MT 61.8%

Equities & Commodities

- **WTI (Cl1):** Pullback on key 99.60/100.35 area for then 106 target but stalling on critical 103.38 (LT 61.8%)
- **Equity markets:** ST toppish tone in US (stall on 61.8%) and a weak one in Europe testing 50/61.8% of last rebound

US 10y: Rising "C of ABC" scenario is still possible if 61.8% (1.95) holds — MT Trend: Down — Range: 1.95/2.15

MT SCENARIO remains down

1.48 <= 1.67 <= 1.86 <= 1.93/1.95 –!– 2.14 => 2.23 => 2.42 => 2.47

The breaks below 2.51 (LT triangle support), 2.33 (2010 low) and 2.03 (2008 low) strengthened the MT falling bias to reach a MT 138.2% extension of the 2010-11 rise at 1.78. Pullback seen on triangle support, and the main risk is if the fall now resumes and breaks first below 1.95 (61.8%), to resume a MT fall towards the 1.67 low and then 1.48 (LT falling channel support).

ALTERNATIVE SCENARIO… *Rise resumes*

A ST bottoming/up bias is still underway, sustained by rising divergences on weekly RSI. A preservation of 1.95 (61.8%) would allow a move first towards 2.14/2.23 (last trading range top+61.8%) and 2.42 (wave "A" top) to develop a rising wave "C of ABC" towards the 2.70 area (wave "C"=wave "A").

STRATEGY

Entered short on dips on 1.96 S/L below 1.90.

WTI: Pullback around key 99.60/100.35, with 103.38 (LT 61.8%) test — MT Trend: Neutral/up — Range: 94/105

MT SCENARIO is still rather down

92.22 <= 94.41 <= 97.65 <= 99.60/83/100.35 -!!- 103.39 => 106.00 => 114.83

The MT bias oriented down after the decisive break below the LT rising channel (99.89/126.35). This break is still targeting the 61.90 area, slightly below the critical LT support area at 63.89/64.24 (LT 61.8% and 2010 low). The current rebound could only be a classic pullback on the LT channel support. A renewed down move is now needed to rekindle the latest MT falling pressure for 92.22 (ST 38.2%) initially. A first step would be a break below 99.83 (ST rising channel sup).

ALTERNATIVE SCENARIO… *Rise extends*

The last two months' up bias following breaks above the ST falling channel and 90.52 (2-dip neckline) persists, with a pullback already above 99.60/100.35 (ST 61.8%+ LT rising channel support) to test 103.39 (LT 61.8%) again. A wider rise would see a 106.00 theoretical target area.

STRATEGY

Keep long if you are within the ST rising channel for 106. Put S/L now on 99.83.

Germany 10y: Slightly bottoming, but must preserve 1.64 low **MT Trend:** Down/bottoming **Range:** 1.75/1.98

MT SCENARIO is still slightly down 1.39 <= 1.52 <= 1.61/ 1.64 –!– 1.91 => 1.98 => 2.05 => 2.28

The sharp fall seen from the 3.50 top sent it sharply below 2.09 (2010 low), close to 1.51/1.54 (MT falling channel sup+ MT 138.2 extension). Despite the current ST bottoming bias, which saw a short-lived return above 2.09 (2010 low), the MT bias is still downward and would be rekindled by a move below the 1.64 low, first for the 1.51/1.54 area and then 1.39.

ALTERNATIVE SCENARIO... *rise resumes*
Despite the return close to the recent low, the ST slight bottoming bias persists, but it must now preserve 1.61/1.64 (LT falling wedge sup + last low). We need then a 2.02 daily gap filled, plus a move above 2.05 (61.8% of recent fall) to strengthen such a ST bottoming/up bias for a subsequent move back on 2.28 (last top and possible 2-dip neckline).

STRATEGY: Waiting for a signal

UK 10y: Still a ST bottoming bias within bottom broadening formation **MT Trend:** Down/bottoming **Range:** 2.10/2.35

MT SCENARIO is still down oriented 1.86 <= 1.98 <= 2.10/2.11 –!– 2.29/2.34 => 2.47 => 2.70/2.74 => 2.81

The large down move below 2009 and 2010 lows turned the MT study positive within the LT falling channel (2.10/4.60 now) and within the LT falling wedge (2.10/3.55). It reached the MT 161.8% extension area (2.09), with the next down target being the 138.2% extension at 1.98 if the fall extends.

ALTERNATIVE SCENARIO… *ST rise*
A ST bottoming bias is perhaps still developing, sustained by rising divergences on RSI within a ST broadening formation. It first needs a break above 2.48 (61.8% of the last fall) to strengthen again in a ST rising scenario, with 2.74 (broadening formation res) and 2.81 (ST 38.2%) as first resistances.

STRATEGY
Waiting for a significant signal

S&P: LT/MT 61.8% area is still the key area to overcome for an upturn **MT Trend:** Bottoming **Range:** 1190/1290

MT SCENARIO is still slightly down 1148/58 <= 1183 <= 1209 <= 1229 –!– 1258/63 => 1292 => 1343

The last fall, which developed in five waves, saw a break first below the key 1348 (LT rising channel sup), then 1229 (LT up 61.8 %) and 1148 (MT 61.8%) for a move towards the 1010 target suggested by the LT rising wedge break. This scenario weakened with a move around the key 1229/58 (LT 61.8% & ST 61.8%), which could, nevertheless, be only a classic pullback.

ALTERNATIVE SCENARIO… *Rise extends*
The market confirmed the ST bullish signals that had appeared recently (rising divergences + break above the MT weekly falling channel). It must now, however, break decisively above the key 1229/58/63 (LT 61.8%+ ST 61.8%+61.8%) to strengthen the rising bias initially towards 1348 (LT rising wedge support), then 1371 top

STRATEGY: Waiting for a significant signal.

Trade Reviews

Options, Money Market and Bond Trades – Tactical & Strategic Trades

This page summarises our main tactical (T) and strategic (S) trades. The former focus on short-term horizons (a few weeks), allowing one to play any near-term corrections within a defined trend, while the latter rely on a medium-term assumed trend. For each trade, we provide the expected target and the recommended stop loss.

	Current*	Targets	Stop	Entry	Carry /month	Risk**	P/L (ccy/bp)
Current Strategies							
Outright							
JPY Buy 10y JGB BUY JB316 1.1% 12/20/2011 10y sector should profit in a further rally. The sector also looks attractive from the prospect of carry.	0.920% (S)	0.9%	1.1%	1.045% (01-Sep)		500k	JPY 6250k
Yield Curves							
USD 2y/10y Box Spread BUY 2s10s . 6m-fwd vs 1y fwd The trade would tend to work in a sell-off	-6.5 (S)	30	-8	10 (19-Jul)		15K	USD -248k
EUR 1y fwd 2y/5y/10y swap fly REC 1y fwd swap fly 50% entered at 16.1 we would add the rest at 20bp. Observed fwd fly is still trading 13.5bp above its fair value and the spot/fwd differential is very high.	8.5 (T)	2/3	23	16.1 (26-Sep)		10K	EUR +76k
Money Markets							
USD Sell EDM5Z5M6 fly SELL M5Z5M6 . . Z5 looks quite cheap on the curve vs surrounding contracts (same goes for 4y1y swaps). On a fly, these points look almost at all-time cheap levels, and an added feature of the trade is its lack of directionality.	6 (T)	-3	16	9.5 (21-Sep)		30k	USD +105k
GBP Rec May 2012 MPC gap REC Sonia MPC . May 2012 Increasing reserve balances at BoE should push the overnight lower.	0.46 (S)	0.43	0.54	0.495 (01-Nov)		15K	GBP +45k
USD Buy EDZ2H3M3 Fly BUY Z2H3M3 Very little noticeable directionality in this RV position. Current shape of ED slope is quite flat out till H3, after which the curve starts creeping higher. This has created a kink in the curve, so the level of Z2H3M3 is currently around -4bp, and we like playing for a move back to flat (the 3m roll is +4bp).	-2.0 (T)	14.0	-12.0	-4.0 (08-Nov)		20k	USD 40k
Options							
JPY Buy 2y2y Payer BUY 2y2y 1% Payer With JPY vols in short tails suffering from the collapsing realized vols, buying OTM payers looks attractive.	10.7 (S)	30	5	14 (20-Oct)		100k	JPY -330k
USD Swaption Payer 7y/10y15y Fly BUY . . 1y payer 7s10s15s (either spot or 1y-fwd) has rarely gone above the current level of 11bp in its entire history, but using payers one can sell the fly at 17bp (due to vol advantage) if the trade is in the money at expiry.	-30 (S)	300	-150	0 (14-Jun)		1k	USD -30k
EUR Z1 Euribor 99.50 Call BUY Euribor 99.50 Call Z1 Nuke option on the ECB.	1.0 (S)	10	0	1 (10-Aug)		12.5K	EUR 0K

*Tactical (T) and strategic (S) trades. **Risk: vega, gamma for options, or ΔDV01 for futures, bonds and swaps.

Euro: Down, but Not Out

- **Upcoming ECB rate actions to undermine EURUSD**
- **ECB QE justified by shortfall in money/credit growth**
- **Fed QE3 call postponed, but drives USD lower in H2 2012**

▪ EURUSD equation becomes more complex

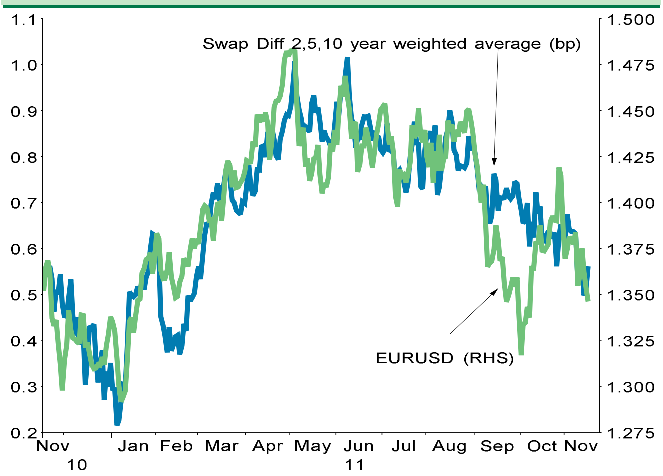
In the previous iteration of our G10 FX outlook, we suggested that the partial alleviation of prevailing Eurozone stresses would allow the EURUSD rate to rally back to the 1.40 area, but that gains beyond here were likely to be dependent on the Fed moving to further ease monetary policy. The first phase of this view panned out largely as expected, with EURUSD rallying to a high of 1.42 in the immediate aftermath of the 27 October EU Summit agreement. Since then, introspection on the nature and incompleteness of the 27 October agreement, rapid escalation of the sovereign debt crisis to engulf Italy (and latterly all Eurozone sovereigns bar Germany), the onset of monetary policy easing by the ECB and a postponement of our call for QE3 from the Fed introduce major new forces into the EURUSD exchange rate equation and, with that, our G10 FX views in general. We now have a particularly uncertain outlook for the single currency in the months ahead and from a starting point of EURUSD trading close to fair-value estimates derived with reference to key interest rate spreads (see Chart 1). We expect this to resolve in favour of a weaker euro in coming months.

▪ ECB rate cuts and QE to drive euro lower

The rapid deterioration in the Eurozone economic outlook evident in recent months' survey data and now showing through in hard activity data leads our European economists to expect the ECB to follow through on the quarter-point November rate cut with further cuts in relatively short order, taking policy rates to below the previous 1% cycle low by Q1 2012. With little by way of additional interest-rate easing priced into money markets at the time of writing, our expectation for rates being lowered to at least 0.75% implies a significant compression in the likes of the 1yr-1yr forward rate, to levels consistent with EURUSD trading in the mid-1.20s (see Chart 2).

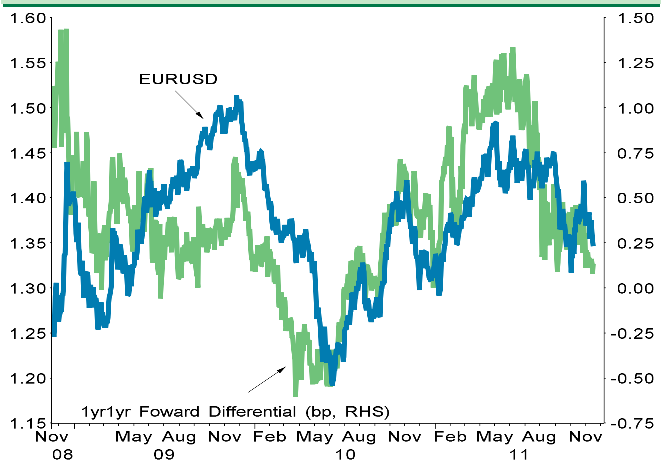
If between now and year end we see the right actions out of the technocrat governments in Athens and Rome, such that they lead to the ECB doing more via

Chart 1: EURUSD vs. 2-5-10yr Swap Rate Spreads



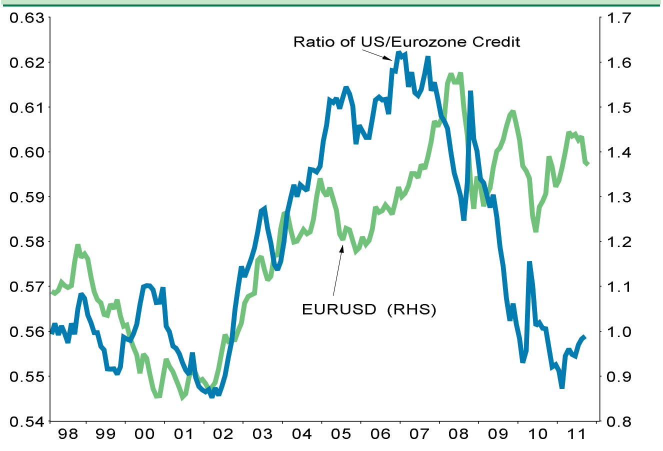
Source: Reuters Ecowin, Bloomberg, BNP Paribas

Chart 2: EURUSD vs. 1yr/1yr Forward Rate Spread



Source: Reuters Ecowin, Bloomberg, BNP Paribas

Chart 3: US/Eurozone credit vs. EURUSD



Source: Reuters Ecowin, Bloomberg, BNP Paribas the SMP to support euro-peripheral bond markets (Italy, in particular) and, at the same, noises out of the German chancellery suggesting that support for deeper political and fiscal union ('more Europe') is gathering momentum, it is possible EURUSD will not suffer significant short-term damage. But our expectation of further rate cuts come 2012, followed by QE (and justified exclusively by projected shortfalls in broad money supply/credit growth) at the same time as the Fed refrains (for now) from pulling the trigger on QE3, justifies our Q1 2012 forecast of 1.28. Thereafter and under our base-case scenario, in which bond-market stress is relieved by the actions of the ECB and the Fed subsequently launches an additional QE programme that drives additional broad-based USD weakness, EURUSD is seen recovering over the remainder of 2012.

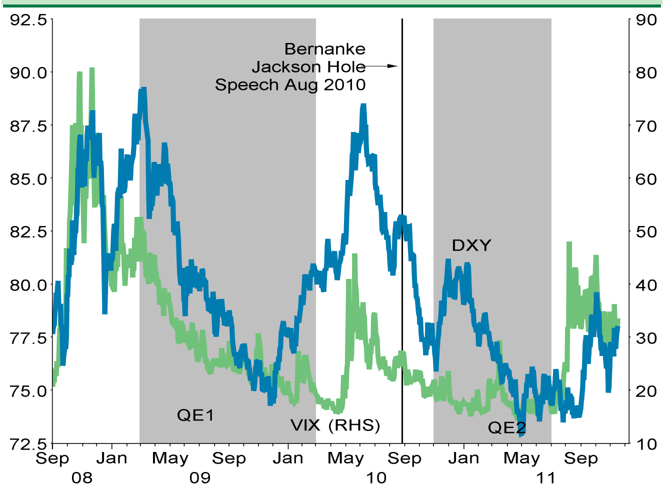
- **No US recession, but Fed not yet done**

While our US economists no longer expect the US to lapse back into recession, we still expect the Fed to ease further in 2012, via QE3, in tandem with a conditional commitment to keep rates near zero until key intermediate macroeconomic objectives, on unemployment in particular, are met. This is seen pulling US yields lower (in the intermediate segment of the benchmark yield curve, in particular), feeding directly into lower equilibrium estimates for the USD. Additional Fed QE is also seen working to support risk appetite, for the time being seen to remain negatively correlated with the USD. Of late, this negative correlation has held amid diminishing prospects for additional Fed easing as incoming US economic data have surprised to the upside and a relapse into recession looks to have been averted. Yet, even with the ECB moving to a more aggressive easing stance, concerns that the evident weakness in the eurozone economy will have contagion implications for the US, as well as local-market economies heavily dependent on exports to Europe, is seen undermining risk sentiment.

- **ECB QE in itself need not imply a weaker euro**

Under our central scenario, whereby the ECB goes beyond an ultra-low interest rate policy to QE, justified by significant shortfalls in money and credit growth, asset purchases are seen biased towards euro-peripheral sovereign bonds (as widening yield spreads are seen to be principally responsible for undermining the monetary policy transmission mechanism). This, then, has the side effect of relieving some of the current eurozone stress as an alternative (or complement) to efforts currently underway to significantly boost the bond-buying firepower of the EFSF.

Chart 4: Fed Balance Sheet vs. VIX, DXY



Source: Reuters Ecowin, Bloomberg, BNP Paribas

If the ECB does succeed in alleviating euro-peripheral stress, hopefully augmented (and ultimately necessitated) by meaningful structural and fiscal reform actions by various eurozone sovereigns, this could act to support the euro, even if such actions were perceived as back-door debt monetisation. At the same time, if ECB actions succeed in significantly easing financial conditions and offsetting an overall reduction in eurozone credit resulting from ongoing bank deleveraging, this should reduce upward pressure on the euro that would otherwise be expected to arise from a contraction in eurozone credit/money supply. Over lengthy time frames, there is a strong relationship between relative US/eurozone credit supply and EURUSD (see Chart 3).

- **Bank on the Fed winning any battle of the central bank balance sheets**

If it comes down to a battle of the (central bank) balance sheets, it would be a brave or foolish person who bets against the Fed. If it transpires that: (1) the Fed engages in a fresh asset purchase programme no later than Q2 2012, (2) ECB policy actions support a recovery by the eurozone from recession come H2 2011, (3) tangible reform actions by various individual eurozone sovereigns materialise as 2012 progresses, and (4) Germany and France initiate actions that convince markets that steps towards deeper fiscal integration are in motion, then we can expect the euro to regain its composure later in 2012. This is reflected in our forecast for EURUSD heading back to the 1.40 area in H2 2012.

TICS Show Safe-Haven Demand Lifting USD

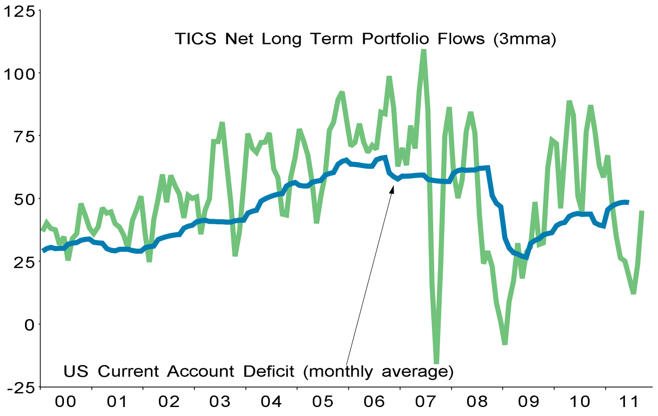
- **Recent TICS data confirm USD support coming from the risk-averse purchases of US Treasuries**
- **Longer-term concerns about the US attracting enough capital to finance its current account deficit could resurface ahead of the November 23 budget supercommittee deadline**

The monthly TICS data release, which is six weeks out of date at the time of release, has always tended to provide a rear-view-mirror snapshot of US capital inflows and outflows. However, the TICS data release for September confirmed that risk-averse purchases of US assets had driven the USD stronger over the month. The much watched long-term capital inflows showed a strong net inflow for the second month running, at USD 68.55bn, following USD 58bn in August and well above the USD 32bn average recorded for the past six months. The surge in inflows was largely driven by increased purchases of US Treasuries, which stood at USD 84.50bn, up from USD 60.12bn in August and well above the USD 36bn six-month average. As before, purchases of Treasuries were concentrated in Asia (USD 49bn), led by China (USD 24.2bn) and Japan. However, European countries also increased their exposure to Treasuries (USD 38bn), though by less than in August.

Recall that September was a particularly difficult month for risk markets, and this was reflected in FX, too, with the USD gaining around 10% against the likes of the AUD and KRW. The October TICS report may show a smaller inflow as a result of the sharp rebound in risk assets in October, inspired by the first signs of solidarity between the French and Germans with a view to tackling the European sovereign debt situation. However, besides the vagaries of risk appetite, the longer-term trend for US capital inflows has, by far, been negative. The US runs a current account deficit of about USD 40bn a month, and this should ideally be covered by long-term net inflows. In this regard, note that only for four months over the past year have longer-term capital inflows been able to cover the average current account deficit of USD 40bn (Chart 1).

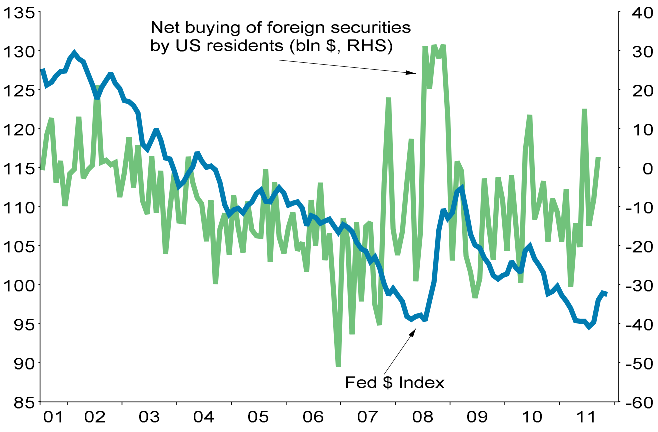
Currency markets have punished the USD in the past for its lack of progress on fiscal policy. This becomes clearer when we compare the UK and the US. The UK and US are similar, in that they both operate current account deficits that require financing. Moreover, both have very low yields, with both central banks engaging

Chart 1: Long-Term Capital Inflows vs. US Current Account Deficit



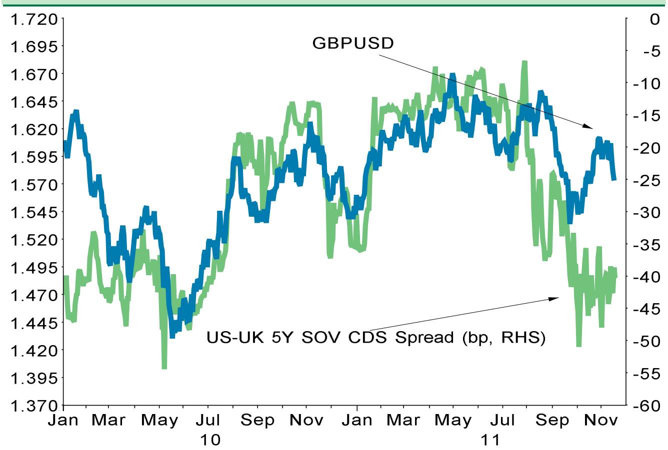
Source: Reuters Ecowin, Bloomberg, BNP Paribas

Chart 2: USD vs. US Net Buying of Foreign Securities



Source: Reuters Ecowin, Bloomberg, BNP Paribas

Chart 3: GBPUSD versus US-UK 5Y SOV CDS Spread



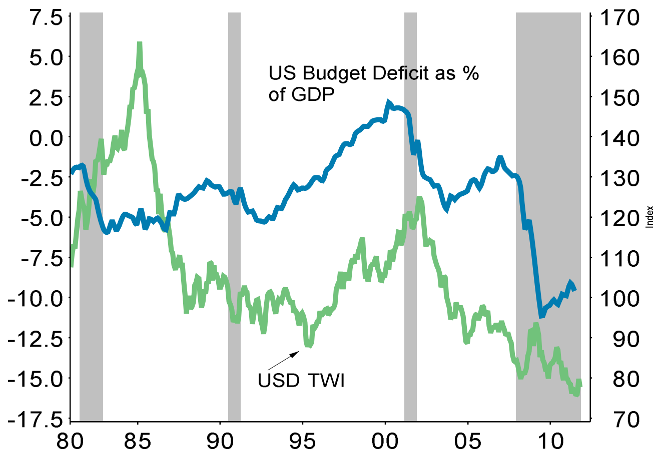
Source: BNP Paribas

in currency-weakening QE. The UK's relatively proactive fiscal stance from the end of last year favoured the GBP over the USD. This was the case for much of last year, as evidenced by the decent relationship between GBPUSD and relative CDS spreads (Chart 3). However, the correlation break suggests something else is at play now, namely, risk aversion and associated USD safe-haven flows, also mirrored in the TICS data of late.

However, while the USD has been gaining as a safe haven, the focus could shift back to the US' longer-term fiscal problems as we approach the November 23 deadline for the budget supercommittee. The panel of six Democrats and six Republicans have until this date to form a consensus on delivering at least USD 1.2trn in budget cuts over the next 10 years. If a deal isn't announced by this date, automatic budget cuts will be triggered beginning in 2013. As we approach the date, there appears to be very little in the way of consensus between the Democrats and the Republicans. The Republicans continue to prefer putting emphasis on cutting spending, while the Democrats have continued to stress revenue-raising measures.

Shorter term, a failure to agree could see the ratings agencies back to threatening a US downgrade, which could, perversely, support the USD to the extent that it promotes the already risk-off backdrop. However, longer term, the failure to address the widening budget deficit could continue to ensure that the trend remains for diversification away from US Treasuries, assuming that global FX reserve growth is maintained. This, in turn, suggests that bigger-picture US inflows may continue to fail to cover the current account deficit, casting continued questions as to the sustainability of any USD recovery, barring bouts of risk aversion.

Chart 4: USD and US Budget Deficit



Source: Reuters Ecowin, Bloomberg, BNP Paribas

Oil: No Winter of Discontent

■ **More risk and tightening fundamentals**

Oil has shaken off risk aversion since our last *Global Outlook*. In contrast to other risky assets, such as equities, it sustained an impressive rally (Chart 1) into mid-November. NYMEX WTI rose from a low of USD 75.37/bbl on 4 October to close at USD 98.99/bbl on 11 November. ICE Brent moved up from USD 99.79/bbl to USD 114.16/bbl over the same period. The S&P 500 and MSCI World indices, at the time of writing, had retrenched below their October highs.

Although continued low nominal interest rates and expectations of further US monetary policy accommodation remain positive for risk appetite and oil prices, fundamental considerations have recently taken on greater importance. Growth in global oil demand (Chart 1) has been resilient, particularly in emerging markets. And as the northern hemisphere's winter approaches, a peak period for demand, global oil demand will swing upwards. At the same time, inventories of crude oil and oil products in OECD countries have noticeably declined, moving below their five-year averages. On the supply side, OPEC shows no sign of wanting to step up volumes, while growth in non-OPEC supply continues to disappoint.

Because of our previous positive view on oil prices, we have therefore only made modest changes overall to our annual forecasts, though we have raised our winter price assumptions. WTI is expected to average USD 105/bbl in Q1 2012, with Brent averaging more than USD 120/bbl.

■ **WTI's discount to Brent: it's not over yet**

The strength in prompt WTI prices pushed the structure of the future curve into shallow backwardation. At the same time, WTI's discount to Brent (Chart 2) has narrowed. Some observers have attributed these moves to two things. The first is a decline in crude stocks at Cushing, WTI's delivery hub, and worries about supply shortages. The second is an impending return of light-sweet Libyan oil to the market after the country's political changes. However, we see both explanations as unsatisfactory. WTI's curve structure is historically inconsistent with the level of stocks at Cushing. Moreover, while domestic supply has resumed in Libya, exports have not. Thus, in the short term, WTI's discount is vulnerable to further episodic widening.

■ **Supply: falling short in crude and distillates**

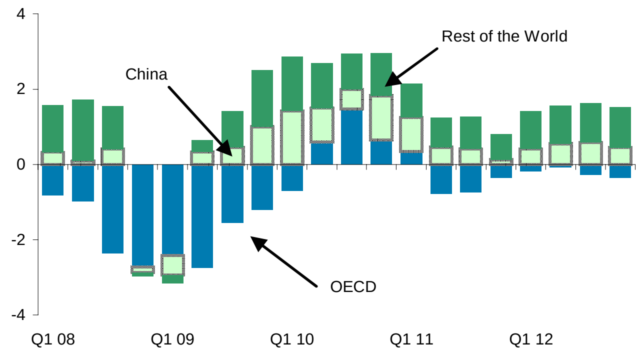
Notwithstanding the potential for oil prices to suffer intermittent corrections in tandem with swings in investor risk appetite, supply-side factors suggest price strength this quarter and next. Libya's production may reach 800 kb/d by year-end, according to the country's National Oil Corporation. But any rise in supply will be earmarked first for domestic refineries, not the international market. Material and sustained exports will have to wait for next year. Equally, OPEC is in no rush to raise its production and risk oversupplying the market. Notably, we see Saudi Arabia lowering its production as Libya's oil supply returns. Any upward drift in OPEC supply will lag the upcoming seasonal rise in demand, making the oil market dependent on a rise in non-OPEC supply. Finally, distillate stocks (which include heating fuels) have tightened across the world. If winter proves colder than usual, the resulting strength in gasoil and heating oil prices is more than likely to lift the crude oil complex higher.

Table 1: BNP Paribas Oil Price Forecast (USD/bbl)*

	WTI	Revision[1]	Brent[2]	Revision[1]
Q1 11 (actual)	94.60	..	105.52	..
Q2 11 (actual)	102.34	..	116.99	..
Q3 11 (actual)	89.54	..	112.09	..
Q4 11	96.00	4.00	114.00	0.00
Q1 12	105.00	9.00	119.00	4.00
Q2 12	102.00	5.00	114.00	1.00
Q3 12	100.00	-3.00	112.00	-5.00
Q4 12	107.00	0.00	119.00	0.00
2009 (actual)	62.09	..	62.97	..
2010 (actual)	79.61	..	80.34	..
2011	96.00	1.00	112.00	0.00
2012	104.00	3.00	116.00	0.00

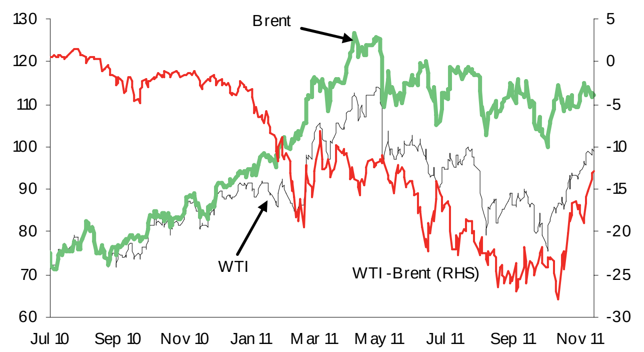
*Source: BNP Paribas 1) versus 14 September 2011. 2) Brent is derived from an assumed spread. *17 November 2011*

Chart 1: World Oil Demand Growth (mb/d, y/y)



Source: IEA Oil Market Report, BNP Paribas

Chart 2: NYMEX WTI and ICE Brent (USD/bbl)



Source: Bloomberg, BNP Paribas

US Natural Gas: Writing Off Winter…

■ Inventory surge slashes winter premium

In early August, we warned that increased supplies were likely to push US natural gas prices lower in the last stretch of the injection season.[1] Thanks to the magnitude and duration of the current sell-off, the market has fallen below our initial estimates. Although we mostly expected strong domestic supply growth, we underestimated the impact of the loss of electric power demand in the western states of the US[2] (Chart 1). This loss, stemming from a fall in air-conditioning demand, contributed to yet more supplies accumulating in storage, exacerbating the market's imbalance.

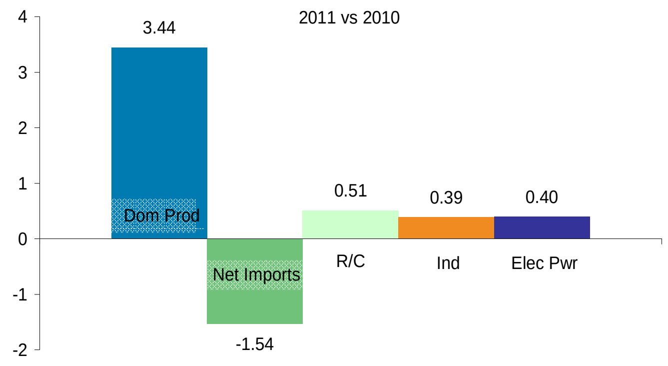
With US net supply (Table 1) roughly 2 Bcf/d greater than our earlier projections, the industry is on its way to developing an inventory surplus earlier than expected. In fact, we now see a surplus emerging this month that will probably persist for most of 2012. In our view, this inventory overhang largely reduces the scope for a winter price rally and, potentially, opportunities for gas prices to rise substantially in 2012. In light of these trends, we have revised down our gas-price profile (Table 2), particularly in Q4 2011 and Q1 2012. Our new profile reflects our expectations of higher levels of working gas in storage ahead of the peak winter heating season. At just USD 4.00 mmbtu, our depressed winter price forecast mostly reflects the expiration of last year's November-March futures strip.

■ Favourable fundamentals on the horizon?

While we think next year's fundamentals are not particularly supportive of prices, we do think net supply will diminish progressively, albeit slowly. Next year's slowdown in production hints at a potential turning point in US balances by 2013. It is at this juncture that the 'shadow' supply from completion deferrals will be exhausted. Equally, escalating well depletions will edge out lower-cost shale contributions. Moreover, we envision a very real medium-term risk that the market will need to lure drilling budgets away from oil-related plays and back into dry gas production. This will be necessary to meet impending structural demand growth from the electric power sector.[3]

A sluggish supply response to public policy-initiated demand growth, in turn, hints at the possibility of some price recovery in the second half of 2012.

Chart 1: US Gas Supply/Demand (y/y change, Bcf/d)



Source: US EIA, BNP Paribas

Table 1: US Gas Supply/Demand (y/y change, Bcf/d)

	2010/09	2011/10(1)	2012/11(1)
Domestic Production	2.71	3.44	1.39
Canadian Imports	-0.08	-0.71	-0.47
Mexican Exports	0.01	-0.47	-0.22
LNG Imports	-0.07	-0.36	-0.11
Net Storage	0.91	-0.43	0.16
Total Supply	**3.49**	**1.48**	**0.74**
Residential & Commercial	0.67	0.51	-0.37
Industrial	1.19	0.39	0.05
Electric Power	1.38	0.40	1.06

Source: US EIA, BNP Paribas *(1) Forecast*

Table 2: US Natural Gas Price Forecasts (USD/mmbtu)

	BNP Forecast 10/11/11	BNP Previous 03/08/11	US EIA 09/11/11
Q1 11 (actual)	4.20	..	..
Q2 11 (actual)	4.38	..	..
Q3 11 (actual)	4.20	4.30	4.15
Q4 11	3.75	4.45	4.38
2011	**4.10**	**4.35**	**4.27**
Q1 12	4.20	4.65	4.57
Q2 12	4.10	4.35	4.21
Q3 12	4.40	4.50	4.44
Q4 12	4.40	4.70	4.92
2012	**4.30**	**4.55**	**4.54**

Source: US EIA, BNP Paribas

[1] See BNP Paribas, *Another Year of Low Prices?*, 4 August 2011.

[2] Record hydro-generation in the western states has significantly curtailed gas generation dispatch, removing c.1 Bcf/d of electric power demand year on year, according to EIA estimates released in July 2011.

[3] See BNP Paribas, *EPA Rules Tighten Balances*, 16 September 2011.

Base Metals: Bloodied, but Not Broken

■ Still reasonably resilient

After falling by about 10% between Q1 and Q3 2011, aggregate average base metal prices look set to decline by well over 10% q/q in Q4. Once again, prices have been weaker than we expected since September. But relative performance has been more in line with our expectations. Aluminium, long our preferred defensive play, has held up relatively well, whereas nickel has retreated further than most from its early 2011 peak. And the price of the flagship base metal, copper, remains very high by historical standards (Chart 1).

Base metals are more geared to economic activity than are other commodity sectors and many other risky asset classes. So, given the recent tremors in the financial markets and mounting economic concerns, they have been remarkably resilient. Part of the explanation lies in the fact that metals demand growth is driven more by emerging countries than stressed developed nations. In addition, the supply-side fundamentals remain firm. This is particularly the case for copper, which, as the market leader, has propped up other metals. But some of the others are also supported by prices being close to production costs.

■ Fundamentals – still mostly supportive

World base metals demand growth was even stronger in H1 2011 than we had previously thought, perhaps 10% y/y for aluminium, for example. So, although it is likely to be slower in Q4, we still estimate above-trend growth in 2011 as a whole of at least 5% on average. Developed countries now account for little more than 30% of global first-use demand. This understates their share of final offtake, but demand in developing nations is now predominantly generated internally. Despite insipid economic prospects in developed countries, we continue to forecast world demand growth in 2012 of around 5%, before a marked reacceleration in 2013.

The supply-side fundamentals have, if anything, become even more supportive in recent months. Ore grades continue to fall at key copper mines and there have been long strikes at two of them. More generally, stakeholders, notably governments and unions, are all jockeying for a prime seat at the mining feast. This is adding to cost pressures at a time when, after a sharp rise in costs in recent years, the prices of some metals, especially aluminium, are crimping industry profitability. New capacity should start to boost copper output in 2012, but supply constraints will then begin to bite in the lead and zinc markets. Only nickel faces the prospect of a prolonged surplus, due to several new mines.

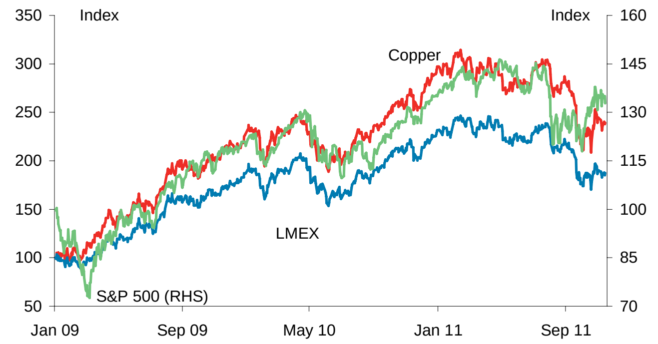
Another factor is that Chinese destocking, which masked deficits in the copper and tin markets in H1 2011, has since eased off. This may partly explain the decline in visible stocks in recent months (Chart 2).

Table 1: Base Metals Price Forecasts (USD/tonne)

	Spot Price(1)	2011(2)	2012(2)	2013(2)
Aluminium	2,097	2,415	2,400	2,750
Copper	7,592	8,875	8,900	8,200
Lead	1,982	2,410	2,500	2,950
Nickel	17,775	22,875	19,500	18,800
Tin	21,355	26,400	27,500	27,000
Zinc	1,911	2,200	2,275	2,625

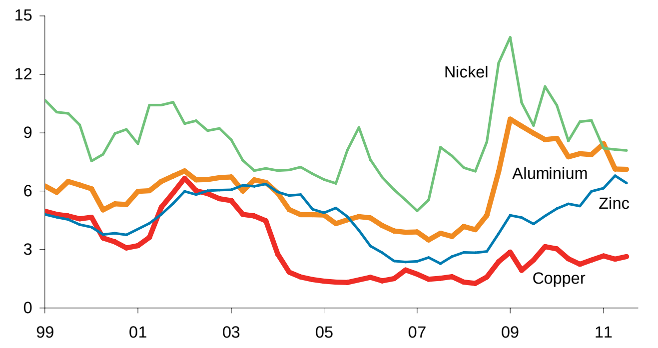
(1) As at 16 November 2011 (2) Forecast cash averages
Source: LME, BNP Paribas

Chart 1: LME Copper, LMEX and the S&P 500*



Source: LME, Bloomberg, BNP Paribas ** All rebased, January 2009 = 100*

Chart 2: Reported Metal Stocks, Weeks of Demand



Source: LME, COMEX, SHFE, IAI, CRU, BNP Paribas

■ Prices should recoup at least some lost ground

We have again lowered our price forecasts. But we still believe firm demand in emerging countries, supply constraints and cost issues, plus loose monetary conditions will underpin a broad price recovery in 2012. Downside risks certainly persist, but for some metals, notably aluminium, further losses might trigger producer cutbacks. We expect copper to regain some traction, although it may top out in mid-2012 as production growth finally picks up. Other metals are likely to track copper before most develop an impetus of their own as their own fundamentals improve.

Economic Calendar: 18 – 25 November

	GMT	Local			Previous	Forecast	Consensus
Fri 18/11			**Eurozone**	EU's Barroso, Barnier, Almunia Speak at Brussels Conference			
	08:00	09:00		ECB's Draghi Speaks in Frankfurt			
	09:30	10:30		ECB's Weidmann Speaks in Frankfurt			
	09:30	10:30		ECB's Bini Smaghi Speaks in Florence			
	07:00	08:00	**Germany**	PPI m/m : Oct	0.3%	0.1%	0.1%
	08:00	09:00		PPI y/y : Oct	5.5%	5.3%	5.3%
	09:00	10:00	**Italy**	Industrial Orders y/y : Sep	10.5%	6.2%	n/a
	10:15	11:15	**Spain**	ECB's Gonzalez-Paramo Speaks in Madrid			
	14:00	15:00	**Belgium**	Consumer Confidence : Nov	-7	-8	n/a
	12:00	07:00	**Canada**	CPI m/m : Oct	0.2%	0.0%	0.1%
	12:00	07:00		CPI y/y : Oct	3.2%	2.7%	2.8%
	13:15	08:15	**US**	Fed's Dudley Speaks on the Economy in New York			
	15:00	10:00		Leading Indicators m/m : Oct	0.2%	0.5%	0.5%
	18:15	13:15		Fed's Fisher Speaks on the Economy in Dallas			
Sun 20/11			**Spain**	Parliamentary Election			
Mon 21/11	23:50 (20/11)	08:50	**Japan**	Trade Balance (nsa) : Oct	JPY296.2bn	JPY30.1bn	JPY28.8bn
				BoJ Minutes			
			Eurozone	EU Foreign Ministers Meet in Brussels			
				Greek PM Lucas Papademos Meets EU Officials in Brussels			
	09:00	10:00		Current Account : Sep	EUR-6.3bn	EUR-3.5bn	n/a
	13:45	14:45		ECB's Stark Speaks in Dublin			
	15:00	10:00	**US**	Existing Home Sales : Oct	4.91mn	4.70mn	4.80mn
	19:30	14:30		Fed's Lockhart Speaks on Economy in Sao Paulo, Brazil			
Tue 22/11	08:30	09:30	**Sweden**	Unemployment Rate (nsa) : Oct	6.8%	6.8%	6.8%
	09:00	10:00	**Norway**	GDP (Mainland, sa) q/q : Q3	1.0%	0.6%	n/a
	09:00	10:00		GDP (Total, sa) q/q : Q3	0.4%	0.8%	n/a
	09:30	09:30	**UK**	PSNCR : Oct	GBP19.9bn		
	09:30	09:30		PSNB Ex-Interventions : Oct	GBP14.1bn	GBP6.7bn	n/a
	13:30	08:30	**US**	GDP (Prel, saar) q/q : Q3	2.5% (p)	2.1%	2.5%
	13:30	08:30		GDP Deflator (Prel, saar) q/q : Q3	2.5% (p)	2.5%	2.5%
	13:30	08:30		Corporate Profits (Prel, saar) q/q : Q3	3.3%		
	18:00	13:00		Fed's Kocherlakota Speaks in Winnipeg, Manitoba			
	19:00	14:00		***FOMC Minutes***			
	17:00	18:00	**Eurozone**	ECB's Coene Speaks at Financial Forum Conference in Brussels			
Wed 23/11			**Japan**	Public Holiday			
	07:45	08:45	**France**	Industry Survey : Nov	97	95	n/a
	09:00	10:00	**Eurozone**	PMI Manufacturing (Flash) : Nov	47.1	46.9	46.5
	09:00	10:00		PMI Services (Flash) : Nov	46.4	46.3	46.0
	09:00	10:00		PMI Composite (Flash) : Nov	46.5	46.4	46.0
	10:00	11:00		Industrial Orders m/m : Sep	1.9%	-2.7%	-2.5%
	09:00	10:00	**Norway**	Unemployment Rate AKU : Sep	3.2%	3.2%	n/a
	09:30	09:30	**UK**	***BoE MPC Minutes***			
	13:30	08:30	**US**	Durable Goods Orders m/m : Oct	-0.6%	-2.7%	-1.0%
	13:30	08:30		Personal Income m/m : Oct	0.1%	0.3%	0.3%
	13:30	08:30		Personal Spending m/m : Oct	0.6%	0.4%	0.3%
	13:30	08:30		Initial Claims	388k	390k	n/a
	14:55	09:55		Michigan Sentiment (Final) : Nov	64.2 (p)	64.5	64.5

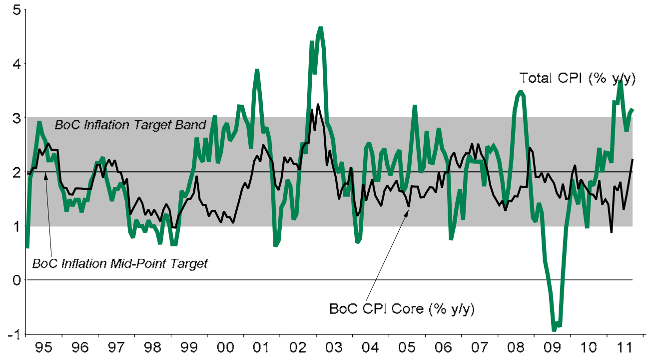
Economic Calendar: 18 – 25 November (cont)

	GMT	Local			Previous	Forecast	Consensus
Thu 24/11	07:00	08:00	**Germany**	GDP (Final) q/q : Q3	0.5% (p)	0.5%	0.5%
	07:00	08:00		GDP (Final) y/y : Q3	2.6% (p)	2.6%	2.6%
	09:00	10:00		Ifo Business Climate : Nov	106.4	104.2	105.5
	09:00	10:00		Ifo Current Conditions : Nov	116.7	114.2	115.5
	09:00	10:00		Ifo Expectations : Nov	97.0	95.0	96.0
	08:15	09:15	**Sweden**	Consumer Confidence (sa) : Nov	-7.5	-7.6	n/a
	08:30	09:30		PPI (nsa) m/m : Oct	-0.7%	0.1%	n/a
	08:30	09:30		PPI (nsa) y/y : Oct	-0.2%	0.6%	n/a
	09:00	10:00	**Italy**	ISAE Consumer Confidence : Nov	92.9		
			Portugal	Portugal's Parliament to Begin Discussions on 2012 Budget Proposals			
	09:30	09:30	**UK**	GDP (Rev) q/q : Q3	0.5% (p)	0.5%	0.5%
	09:30	09:30		GDP (Rev) y/y : Q3	0.5% (p)	0.5%	n/a
	11:00	11:00		CBI Distributive Trades Survey : Nov			
	11:00	11:00		CBI Monthly Industrial Trends : Nov			
	14:00	15:00	**Belgium**	Business Confidence : Nov	-10.4	-9.0	-11.0
			US	Public Holiday			
Fri 25/11	23:30	08:30	**Japan**	CPI National y/y : Oct	0.0%	-0.1%	-0.2%
	23:30	08:30		Core CPI National y/y : Oct	0.2%	-0.1%	-0.1%
	23:30	08:30		CPI Tokyo y/y : Nov	-0.5%	-0.5%	-0.5%
	23:30	08:30		Core CPI Tokyo y/y : Nov	-0.4%	-0.3%	-0.3%
	(24/11)						
	07:45	08:45	**France**	Consumer Confidence : Nov	82	79	n/a
	08:00	09:00	**Spain**	PPI m/m : Oct	0.2%	-0.5%	n/a
	08:00	09:00		PPI y/y : Oct	7.1%	5.9%	n/a
	08:30	09:30	**Eurozone**	Eurocoin : Nov	-0.13	-0.35	n/a
	09:00	10:00	**Italy**	Retail Sales : Sep			
During Week	25/11-5/12		**Germany**	Import Prices m/m : Oct	0.6%	-0.2%	-0.2%
				Import Prices y/y : Oct	6.9%	6.9%	6.9%

Release dates and forecasts as at c.o.b. prior to the date of publication: See Daily Economic Spotlight *for any revision* *Source: BNP Paribas*

Key Data Preview

Chart 1: Canadian Inflation



Sources: Reuters EcoWin Pro

m/m %	Oct (f)	Sep	Aug	Jul
Headline CPI	**0.0**	0.2	0.3	0.2
Bank of Canada Core	**0.2**	0.5	0.4	0.2

Key Point:
Headline inflation is likely to bounce back within the BoC's target as core retraces some of September's pop.

BNP Paribas Forecast: Softening

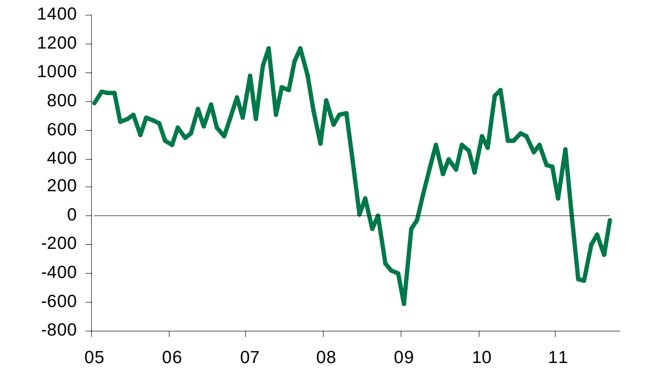
Canada: CPI (October)
Release Date: Friday 18 November

We expect Canadian headline CPI to be influenced by another decline in food and energy prices. Headline inflation is expected to be flat for the month, while core inflation is likely to be closer to 0.2% m/m. On a y/y basis, headline inflation is seen dropping from 3.2% y/y to 2.7%, back inside the 1-3% inflation target of the BoC.

Note that food, shelter and transportation prices make up 63.5% of the headline inflation index. Shelter prices are expected to be close to flat after a decline in September. Core inflation is expected to continue to retrace some of the September gains, as it is expected to move from 2.3% y/y back to 2.0% y/y for the month.

Looking ahead, the main upside risks to our inflation outlook include a larger commodity pass-through. However, the downside risks include the strengthening of the currency, a deceleration in the growth of unit labour costs and a larger correction in the housing market. On balance, underlying inflation still looks well contained, with some temporary and seasonal factors likely to reverse.

Chart 2: Japanese Trade Balance (sa, billion)



Sources: MOF, BNP Paribas

JPY bn	Oct (f)	Sep	Aug	Jul
Trade balance (nsa)	**30.1**	296.2	-779.6	67.9
Trade balance (sa)	**-297.2**	-21.8	-265.2	-129.8

Key Point:
With the exception of transport equipment, the export recovery is largely over, as supply chains have returned to normal. With exports expected to contract in October on the slowing global economy, the seasonally adjusted trade deficit should expand.

BNP Paribas Forecast: Large Trade Deficit

Japan: Trade Data (October)
Release Date: Monday 21 November

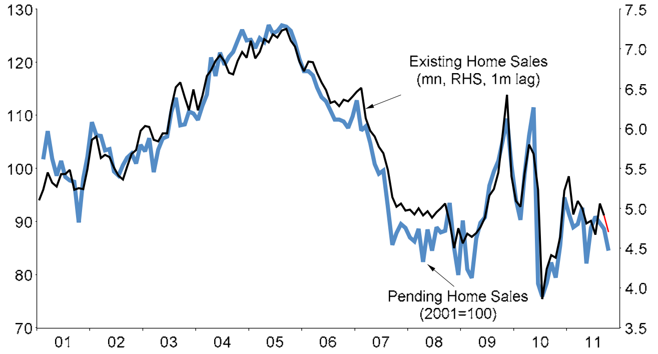
Based on data through mid-month, we expect real exports to have contracted roughly 4% m/m in October. Real exports have been on the mend since May, thanks to a recovery in production alongside the restoration of supply chains. Even so, with the exception of transport equipment (where output is still being ramped up), production growth and exports have moderated of late, as activity has largely returned to normal (the pre-disaster levels of February).

Consequently, the main determinant of export growth is foreign demand, which is starting to flounder as both developed and emerging economies show signs of losing momentum. Real imports, meanwhile, are expected to expand 1.0% m/m, as demand remains firm for mineral fuels (LNG, petroleum products), reflecting increased dependence on thermal power generation amid the shutting down of nuclear reactors.

Because imports on a nominal basis are expected to slightly grow, while nominal exports are expected to contract, the seasonally adjusted trade deficit should expand in October.

Key Data Preview

Chart 3: US Pending & Existing Home Sales



Sources: Reuters EcoWin Pro

	Oct (f)	Sep	Aug	Jul
Existing Home Sales (millions saar)	**4.70**	4.91	5.06	4.67
New Home Sales (thousands saar)	**310**	313	296	297

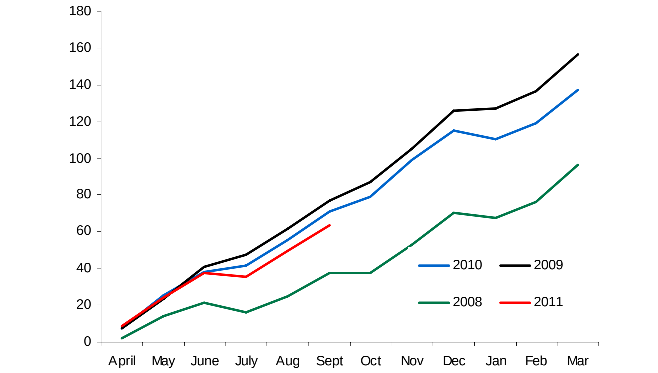
Key Point:
We expect resales to fall 4.3% to 4.7mn saar units in October on the back of three months of consecutive declines in pending home sales and weakness in mortgage applications.

BNP Paribas Forecast: Down

US: Existing & New Home Sales (October)
Release Date: Monday 21 & 28 Monday November

Pending home sales dropped by 4.6% in September as contract signings fell across the country. Three months of consecutive declines in the series is in line with the recent weakness in mortgage applications to purchase which have been hovering around the bottom at the levels last seen back in 1996. This does not bode well for existing home sales in October, and we could see another decline on the back of a 3% drop in resales in September (see chart). Despite record low rates, housing demand continues to deteriorate. We expect resales to fall 4.3% to 4.7mn saar units in October, while new home sales continue to bounce around just above 300k.

Chart 4: UK Cumulative Public Sector Borrowing



Sources: Bloomberg

	Oct	Sep	Aug	Jul
PSNB x interventions	**6.7**	14.1	13.7	-2.0

Key Point:
The borrowing figures are broadly in line with the forecasts in the budget, despite the weaker growth outlook.

BNP Paribas Forecast: Continuing Improvement

United Kingdom: Public Sector Borrowing (October)
Release Date: Tuesday, 22 November

In the September data, public sector borrowing on the government's preferred measure was GBP 14.1bn. That means the cumulative amount of borrowing over the fiscal year to date stands at GBP 63.5bn. At the time of the March budget, the Office for Budget Responsibility was forecasting borrowing for the full year of GBP 122bn. So, on that basis, the deficit is coming in a little above forecast.

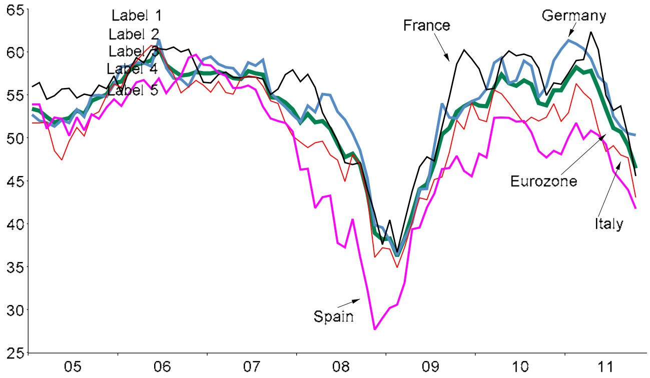
Revenue growth has come in a below forecast, though the bank payroll tax paid last year distorts comparisons somewhat. But spending has been coming in below forecast. As the local government figures are fairly inaccurate at this stage the fiscal consolidation programme appears broadly on track.

The figures for October usually show a relatively small deficit, or even a surplus, as a result of corporation tax receipts. The revenue from the higher supplementary change on oil firms should also appear in the account from this month. So, we should see an improvement from October last year.

This is the last release before the Chancellor's autumn statement on 29 November, at which a revised set of borrowing and growth figures will be released.

Key Data Preview

Chart 5: Eurozone Composite PMI



Sources: Reuters EcoWin Pro

	Nov (f)	Oct	Sep	Aug
Manufacturing	**46.9**	47.1	48.5	49.0
Services	**46.3**	46.4	48.8	51.5
Composite	**46.4**	46.5	49.1	50.7

Key Point:
An improvement in Italian manufacturing and French services after last month's sharp fall should have a stabilising effect.

BNP Paribas Forecast: Almost Unchanged

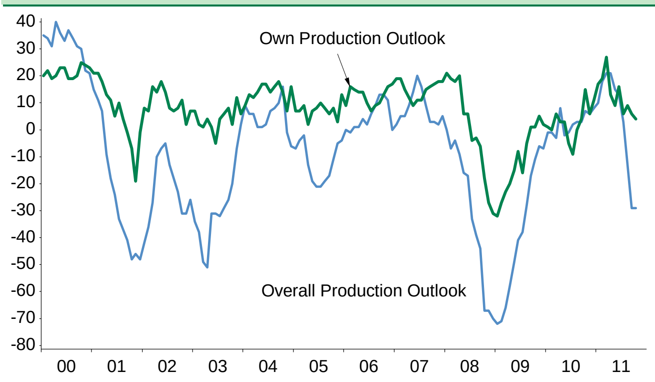
Eurozone: 'Flash' PMI (November)
Release Date: Wednesday, 23 November

Eurozone PMIs have declined sharply in recent months, as economic jitters have spread from the peripheral economies to the core. The composite index reached just 46.5m in October, its lowest level since July 2009, and we expect it to dip marginally again in November, to 46.4.

The component breakdown in October showed continued declines in new orders and business in both manufacturing and services, signalling that a further decline in the output component is yet to come. The employment component of the eurozone PMI also declined further to 50.1 in October, suggesting the eurozone labour market is set to stagnate.

By country, the decline in the October PMI was largely due to a rapid fall of more than five points in the Italian manufacturing PMI to 43.3 and a drop in the French services PMI to 44.6 from 51.5 in September. We expect a slight improvement in these two measures (and economies) in November, partly offsetting declines in various sectors and countries across the rest of the eurozone.

Chart 6: French Business Survey (manufacturing)



Source: INSEE, Reuters EcoWin Pro *NB: Diffusion indices*

Normalised Indices (sa)	Nov (f)	Oct	Sep	Nov 10
Industry	**95**	97	99	100
Services	**93**	94	95	101

Key Point:
A further decline in confidence is likely as more and more companies start to feel the pain.

BNP Paribas Forecast: Continued Easing

France: INSEE Business Survey (November)
Release Date: Wednesday 23 November

The fall in business confidence has been unevenly distributed. The general manufacturing output outlook has fallen sharply over the last six months. The diffusion index, which was at +21 in April, plunged to -30 in September and was marginally up in October. However this reflects the general mood rather than actual business activities. The outlook for own business eased at much slower pace, from +13 in April to +4 in October, with some volatility in between.

Inventories of finished goods have increased faster than manufacturers wanted. We believe the own-production outlook will continue to decline over the next few months, as production needs to adapt to the slower growth context.

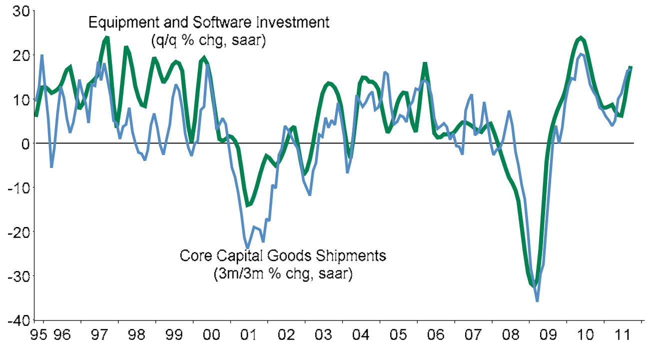
The general production outlook, although stable in October, is likely to deteriorate further. The trough of the manufacturing cycle has not yet been reached. We forecast the headline normalised index to decline faster in November than in October.

The situation in services is similar. The collapse of confidence has been steeper for the general outlook than in own-company terms. However, the gap is not as important as in manufacturing; the headline normalised index is actually already somewhat lower in services.

The activity decline has not weighed too much on staffing up to now. However, we believe the outlook for employment is likely to worsen, which will not be helpful at the macro level as far as future demand is concerned.

Key Data Preview

Chart 7: US E&S Investment vs Core Capital Goods



Sources: Reuters EcoWin Pro

% m/m	Oct (f)	Sep	Aug	Jul
Durable Goods	**-2.7**	-0.6	-0.1	4.2
Ex-Transport	**-0.5**	1.8	-0.1	0.8

Key Point:
Very weak Boeing orders on top of a general declivity in durable goods orders and a retracement in government orders is likely to result in a significant decline for the month.

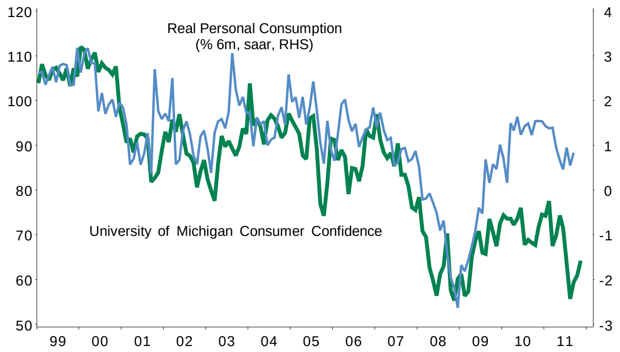
BNP Paribas Forecast: Retracement

US: Durable Goods (October)
Release Date: Wednesday 23 November

Durable goods orders are expected to fall 2.7% m/m in October on the back of a sharp decline in Boeing orders for the month. In addition, we expect orders ex transportation to decline by 0.5% in the month. The October report is likely to have a number of factors moving in the wrong direction. On top of the weak (7 in total) Boeing orders, motor vehicle and parts orders have been on a downward trend since August while defence orders unexpectedly spiked in September (we expect a retracement in October), and "other" durable goods orders have been weakening lately. In addition, we have seen weakness in the ISM new orders index as well as the Philly Fed capex intentions in the past few months that never fully translated into a decline in orders. The surveys have recovered in October, albeit to still-weak levels.

Core capital goods shipments (ex defence and aircraft) are expected to be flat for the month after a surprising 0.9% m/m decline in September.

Chart 8: US Confidence vs Consumption



Sources: Reuters EcoWin Pro

% m/m	Oct (f)	Sep	Aug	Jul
Personal Income	**0.3**	0.1	-0.1	0.1
Consumption	**0.4**	0.6	0.2	0.9
Core PCE Prices	**0.1**	0.0	0.2	0.2

Key Point:
A solid increase in spending that outstrips income gains is expected to lead to another downtick in the saving rate.

BNP Paribas Forecast: Moderate Gains

US: Personal Income & Spending (October)
Release Date: Wednesday 23 November

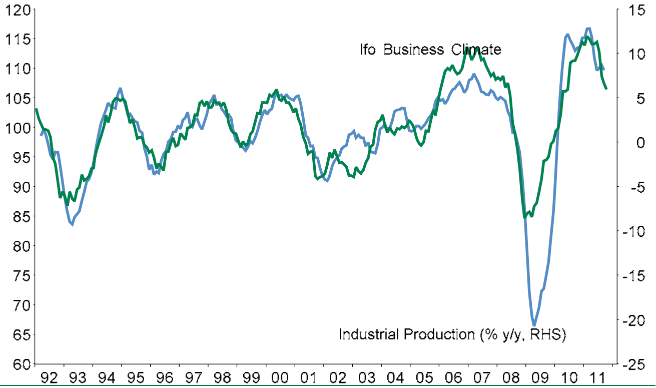
Personal consumption is forecast to rise 0.4% in October after a 0.6% gain in September. Nominal core retail sales rose a robust 0.6%, and auto sales rose 1.2%. However, a decline in utility spending and financial market trading volumes should weigh on service spending, which comprises 2/3 of all personal spending. Overall, the gain would be consistent with another moderate gain in consumption growth in Q4.

Meanwhile, personal income is forecast to rise just 0.3% after edging up 0.1% reflecting the rise in both aggregate hours worked and average hourly earnings. Income appears to have grown yet again more slowly than spending, suggesting a decline in the personal saving rate. At the moment, there is a tension between low consumer confidence and a falling saving rate.

The core PCE price index is expected to rise 0.1% in October after a flat reading in September leading the annual pace of core PCE inflation to tick up to 1.7%, still well within the Fed's comfort zone.

Key Data Preview

Chart 9: German Ifo and Industrial Production



Sources: Reuters EcoWin Pro

	Nov (f)	Oct	Sep	Aug
Headline	**104.2**	106.4	107.4	108.6
Expectations	**95.0**	97.0	97.9	100.0
Current Conditions	**114.2**	116.7	117.9	118.1

Key Point:
The pace of decline in the current conditions index is set to accelerate.

BNP Paribas Forecast: Further Deterioration

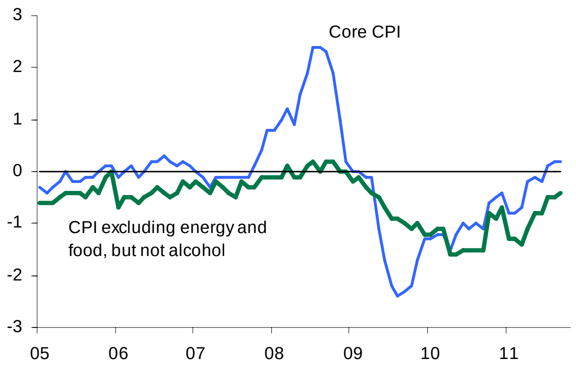
Germany: Ifo Business Climate (November)
Release Date: Thursday, 24 November

The German business climate is deteriorating further. The ZEW indicators fell for the ninth month in a row in November. The downturn in the assessment of current conditions was less pronounced than expected, but eurozone sovereign debt turbulence was at the origin of sharp declines in the expectations component.

Although the Ifo index is less vulnerable to purely financial developments and more indicative of real economic developments, we expect it to follow the same trend. Expectations for economic activity six months ahead have already declined by a cumulative 14.8 points over the past eight months. The current conditions index has dropped with a lag. Over the past four months, it has fallen a cumulative 6.4 points, so the room for further declines remains large.

We expect the pace of decline in the current conditions index to accelerate in November, indicating a further slowdown in growth. The expectations component will, based on the turmoil and deteriorating economic conditions in other eurozone countries, also continue to decline, bringing the headline figure down to its lowest level since June 2010. The headline indicator will, however, still be in line with rising industrial production in y/y terms.

Chart 10: Japanese Core CPI (% y/y)



Sources: MIC, BNP paribas

% y/y	Oct(f)	Sep	Aug	Jul
Core CPI	**-0.1**	0.2	0.2	0.1
CPI	**-0.1**	0.0	0.2	0.2

Key Point:
Core inflation to fall below zero again from October on the stripping away of special factors like the tobacco tax hike and higher non-life insurance premiums.

BNP Paribas Forecast: Small Negative Reading

Japan: CPI (National, October)
Release Date: Friday 25 November

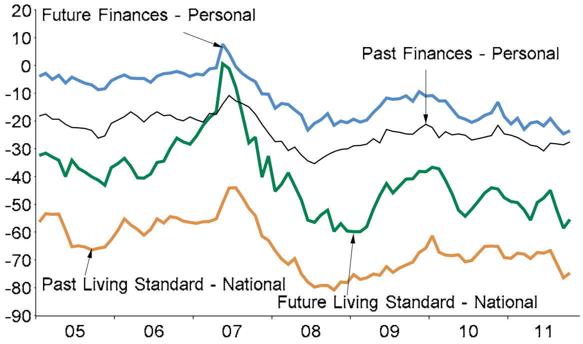
Japan's national core consumer prices rose 0.2% y/y in September, their third straight increase, though the advance was led by energy prices, which rose 6.4% and added 0.5pp to the growth figure.

That Japan is still mired in deflation is evident from US-style core-core prices, which were down 0.4% in September, marking 33 straight months of below-zero inflation. Core CPI has also been elevated by special factors – a tobacco tax hike and higher non-life insurance premiums – that will be stripped from the index in October. These special factors combined to add roughly 0.3pp to price growth (0.2pp for the tobacco tax, 0.1pp for insurance premiums).

Hence, core inflation is likely to turn negative again from October, with our forecast at -0.1% y/y.

Key Data Preview

Chart 11: French Household Survey (components)



Source: INSEE, Reuters EcoWin Pro

Indices (sa)	Nov (f)	Oct	Sep	Nov 10
Overall (normalised index)	**79**	82	80	89
Buying opportunity (diffusion index)	**-23**	-22	-25	-21

Key Point:
The October correction was probably a one-off and a sharp decline is likely in November.

BNP Paribas Forecast: Falling Anew

France: Household Confidence (November)
Release Date: Friday 25 November

As for business confidence, the household survey shows that people are more concerned about the general economic situation than their own personal one. Both the past and future living standards measured suffered severe losses in September (see chart). The personal financial situation survey did not worsen that much, particularly in terms of past finances.

In our view, the unexpected correction seen in October is no more than a temporary blip. The slight decline in diesel and petrol prices may have sent a signal that the trend increase was over. But prices for heating oil and diesel have rebounded since then, pushing down perceived purchasing power.

Moreover, the ongoing financial crisis and the second austerity plan since the summer holidays have probably accentuated general concern. Although some of the survey data were collected before details of the austerity package were made public, we believe household confidence should be impacted. We forecast the headline index at 79, which would be its lowest level since early 2009.

The outlook for the labour market is also deteriorating. However, we believe this is likely to be more visible in the December survey.

Nevertheless, given the already elevated savings ratio, we expect the impact of extremely poor confidence to be limited to the level of actual consumer expenditure.

Economic Calendar: 28 Nov – 23 Dec

28 Nov	29 Nov	30 Nov	1 Dec	2 Dec
Eurozone: Monetary Developments Oct **UK:** CBI Distributive Trades Q3 **Germany:** CPI (Prel) Nov **France:** Job Seekers Oct **Italy:** Business Confidence Nov **Sweden:** Retail Sales Oct **US:** New Home Sales Oct	**Japan:** Labour Oct, Household Consumption Oct, Retail Sales Oct **Eurozone:** Business & Consumer Survey Nov, Retail PMI Nov, EU Finance Ministers Meeting **UK:** Net Consumer Credit Oct, Mortgage Approvals Oct, Chancellor's Autumn Statement **France:** Housing Starts Oct **Italy:** Wages Oct **Spain:** HICP (Flash) Nov, Retail Sales Oct **Portugal:** Consumer Confidence Nov, Eco Climate Indicator Nov **Belgium:** CPI Nov **Sweden:** GDP Q3 **US:** S&P/Case-Shiller Home Prices Sep, FHFA HPI Sep, Cons Conf Nov	**Japan:** IP Oct, Housing Starts Oct **Eurozone:** HICP (Flash) Nov, Labour Oct **UK**: GfK Consumer Confidence Nov **Germany:** Labour Oct **France:** Retail Sales Oct, PPI Oct **Norway:** Retail Sales Oct **Italy:** CPI (Prel) Nov, PPI Oct **Portugal:** Retail Sales Oct **Neths:** Producer Confidence Nov **Switzerland:** KoF Nov **US:** ADP Labour Nov, Productivity & Costs (Final) Q3, Beige Book, Chicago PMI Nov, Pending Home Sales Oct, Challenger Layoffs Nov, **Canada:** GDP Sep & Q3	**Australia:** Retail Sales Oct **Eurozone:** Manufacturing PMI (Final) Nov **UK:** CIPS Manufacturing Nov **Switzerland:** GDP Q3, PMI Nov **US:** ISM Manufacturing Nov, Construction Oct	**Eurozone:** PPI Oct **Norway:** Unemployment Nov **US:** Labour Nov **Canada:** Labour Nov

During Week: UK Nationwide House Prices Nov, Halifax House Prices Nov

5 Dec	6 Dec	7 Dec	8 Dec	9 Dec
Eurozone: Retail Sales Oct, Services PMI (Final) Nov **UK:** CIPS Services Nov **Spain:** Industrial Production Oct **US:** Factory Orders Oct, ISM Services Nov	**Australia:** RBA Rate Announcement **Eurozone:** GDP (2nd Est) Q3 **UK:** BRC Retail Sales Nov **Germany:** Factory Orders Oct **Switzerland:** CPI Nov **Canada**: BoC Rate Announcement	**Australia:** GDP Q3 **Japan:** Leading indicator Oct **UK:** IP Oct **Germany:** IP Oct **France:** Trade Balance Oct **Italy:** IP Oct **Belgium:** GDP (Final) Q3 **Norway:** IP Oct **US:** Consumer Credit Oct	**Australia:** Labour Nov **Japan:** Machinery Orders Oct, Current Account Oct **Eurozone:** ECB Rate Announcement & Press Conference **UK:** BoE Rate Announcement **France:** Non-Farm Payrolls (Final) Q3, BoF Survey Nov **Netherlands:** CPI Nov **US:** Wholesale Trade Oct	**Japan:** GDP (Final) Q3, M2 Nov **UK:** PPI Nov, Trade Bal Oct **Germany:** LCI Q3, Trade Balance Oct, CPI Nov **France:** IP Oct, Budget Balance Oct **Portugal:** GDP (Final) Q3 **Netherlands:** IP Oct **Sweden:** IP Oct **Norway:** CPI Nov, PPI Nov **US:** Trade Balance Oct, UoM Sentiment (Prel) Dec

During Week: UK CBI Distributive Trades Dec, Germany WPI Nov

12 Dec	13 Dec	14 Dec	15 Dec	16 Dec
Australia: Trade Balance Oct **Japan:** CGPI Nov **France:** Current Account Oct, Wages (Final) Q3 **US:** Treasury Statement Nov	**Australia:** NAB Business Confidence Nov **Japan:** Tertiary Index Oct **UK:** CPI Nov **Germany:** ZEW Survey Dec **France:** CPI Nov **Sweden:** CPI Nov, PES Labour Nov **US:** Retail Sales Nov, Bus Inventories Oct, NFIB Small Business Optimism Nov, FOMC Rate Ann	**Australia:** Westpac Consumer Confidence Dec **Eurozone:** Industrial Production Oct **UK:** Labour Nov **Spain:** CPI Nov **Norway:** Norges Bank Rate Announcement **US:** Import Prices Nov	**Japan:** Tankan Dec **Eurozone:** HICP Nov, Employment Q3, ECB Monthly Bulletin **UK:** Retail Sales Nov **Italy:** CPI Nov **Switz:** SNB Rate Ann **Neths:** Retail Sales Oct, Labour Nov **US:** Empire State Survey Dec, PPI Nov, Ind Prod Nov, Philly Fed Survey Dec, TICS Data Oct	**Eurozone:** LCI Q3, Trade Balance Oct, EE15 New Car Registrations Nov **France:** Industry Survey Dec **Sweden:** Labour Nov **Switz:** SNB Rate Announcement **US:** CPI Nov, Current Account Q3

19 Dec	20 Dec	21 Dec	22 Dec	23 Dec
Eurozone: Current Account Oct **Italy:** EU Trade Balance Oct **Belgium:** Consumer Confidence Dec **US:** NAHB Housing Index Dec	**Australia:** RBA MPC Minutes **UK:** PPI Nov **Germany:** PPI Nov, Ifo Survey Dec **Italy:** Industrial Orders Oct **Neths:** Cons Conf Dec **Sweden:** Riksbank Rate Ann & Monetary Policy Report **US:** New Home Starts Nov **Canada:** CPI Nov	**Japan:** BoJ Rate Ann, Trade Balance Nov **Eurozone:** Cons Conf Dec **UK:** BoE MPC Minutes, GfK Cons Conf Dec, PSNB Nov, PSNCR Nov **Germany:** GfK Consumer Confidence Jan **Italy:** GDP (Final) Q3 **Belgium:** Bus Conf Dec **Sweden:** Cons Conf Dec **Norway: :** Labour Oct **US:** Existing Home Sales Nov	**Eurozone:** Governing Council Mtg (No Rate Ann) **UK:** GDP (Final) Q3 **Italy:** Retail Sales Oct, Non-EU Trade Bal Nov **Neths:** GDP (Final) Q3 **Belgium:** CPI Dec **Sweden:** PPI Nov **Norway:** Labour (nsa) Dec **US:** GDP (Final) Q3, Corp Profits (Final) Q3, UoM Sentiment (Final) Dec, FHFA HPI Oct, Leading Indicators Nov	**Japan:** Holiday **France:** GDP (Final) Q3, PPI Nov **Spain:** PPI Nov **Italy:** Wages Nov, ISAE Consumer Confidence Dec **Spain:** PPI Nov **US:** Durable Goods Orders Nov, Personal Income & Spending Nov, New Home Sales Nov **Canada:** GDP Oct

Source: BNP Paribas *Release dates as at c.o.b. prior to the date of this publication. See our Daily Spotlight for any revisions*

Treasury and SAS Issuance Calendar

In the pipeline - Treasuries:
Italy: BTP Nov 2014 (new) to be issued in Q4
Poland: May sell foreign currency-denominated bonds in Q1 2012 if market conditions are very favourable
UK: Cancelled the mini-tender scheduled for the week commencing 28 November
UK: Mini-tender in the week commencing 12 December (choice of gilt on Friday 2 December)
Czech Rep.: May delay plans to sell Eurobonds this year
Hungary: May sell foreign-currency denominated bonds this year to prefinance 2012, depending on the international situation
Slovenia: Plans to sell up to EUR 1bn in 18-month T-bills in December

In the pipeline - Agencies:
EFSF: Issues initially scheduled in Q4 2011 in support of Portugal could now be issued in early 2012
EFSF: Will issue T-bills in December (3m, 6m or 12m)

During the week:
UK: Index-Linked Gilt 0.125% Mar 2029 (new, syndicated, GBP)

Date	Day	Closing Local	Closing GMT	Country	Issues	Details	BNPP forecasts
18/11	Fri	11:00	16:00	US	Outright Treasury Coupon Purchase (2036 - 2041)		USD 2.25-2.75bn
21/11	Mon	14:45	14:45	UK	Gilt Purchase (12 Gilts 2015-2021)	GBP 1.7bn	
		13:00	18:00	US	Notes 0.25% 30 Nov 2013 (new)	USD 35bn	
					Outright T. Coupon Sales (Mar 2014 - Nov 2014)		USD 8-8.75bn
					Outright T. Coupon Sales (Feb 2012 - Jul 2012)		USD 8-8.75bn
22/11	Tue	12:00	03:00	Japan	JGB 20 Sep 2031	JPY 1.1tn	
		14:45	14:45	UK	Gilt Purchase (9 Gilts 2038-2060)	GBP 1.7bn	
				Neths	DSL 1% 15 Jan 2014 (Off-the-run facility)	EUR 2-3bn	
		12:00	17:00	Canada	Repurchase of 7 Cash Mgt Bonds (Dec11 to Dec12)	CAD 1bn	
		11:00	16:00	US	Outright Treasury Coupon Purchase (2036 - 2041)		USD 2.25-2.75bn
					Outright Treasury Coupon Purchase (2017 - 2019)		USD 4.25-5bn
		13:00	18:00	US	Notes 0.875% 30 Nov 2016 (new)	USD 35bn	
23/11	Wed	11:00	10:00	Germany	Bund 4 Jan 2022 (new)	EUR 6bn	
		14:45	14:45	UK	Gilt Purchase (8 Gilts 2022-2036)	GBP 1.7bn	
		12:00	17:00	Canada	CAN 5-year	17 Nov	
		13:00	18:00	US	Notes 1.375% 30 Nov 2018 (new)	USD 29bn	
24/11	Thu	11:00	10:00	Sweden	ILB 0.25% 1 Jun 2022 (# 3108)	SEK 0.75bn	
25/11	Fri	10:55	09:55	Italy	CTZ	22 Nov	EUR 2.5bn
28/11	Mon	10:55	09:55	Italy	BTPeis	22 Nov	EUR 1-2bn
		14:45	14:45	UK	Gilt Purchase	24 Nov	
		12:00	11:00	Belgium	OLOs	21 Nov	EUR 1-2bn
				Slovak Rep.	SLOVGB 7 Apr 2014 (#217) - zero coupon		EUR 0.15bn
		11:00	16:00	US	Outright Treasury Coupon Purchase (2020 - 2021)		USD 4.25-5bn
29/11	Tue	12:00	03:00	Japan	JGB 2-year	22 Nov	JPY 2.7tn
		10:55	09:55	Italy	3 & 10y BTPs and CCT	22 Nov	EUR 6-9bn
		14:45	14:45	UK	Gilt Purchase	24 Nov	
		11:00	16:00	US	Outright Treasury Coupon Purchase (2036 - 2041)		USD 2.25-2.75bn
30/11	Wed	11:00	10:00	Sweden	T-bonds	23 Nov	SEK 2bn
		14:45	14:45	UK	Gilt Purchase	24 Nov	
		12:00	17:00	Canada	CANi 30-year	24 Nov	
		13:00	18:00	US	Outright T. Coupon Sales (Apr 2013 - Oct 2013)		USD 8-8.75bn
01/12	Thu	12:00	03:00	Japan	JGB 10-year	24 Nov	JPY 2.2tn
		10:30	09:30	Spain	Bono 3-year (new)	28 Nov	EUR 3bn
		10:50	09:50	France	OATs and/or BTANs	25 Nov	EUR 5-7bn
		10:30	10:30	UK	Gilt 3.75% 7 Sep 2021	22 Nov	
05/12	Mon	14:45	14:45	UK	Gilt Purchase	1 Dec	
06/12	Tue	12:00	03:00	Japan	Auction for Enhanced-liquidity	29 Nov	JPY 0.3tn
		11:00	10:00	Austria	RAGBs	29 Nov	
		10:30	10:30	UK	Gilt 4.25% 7 Dec 2040	29 Nov	
		14:45	14:45	UK	Gilt Purchase	1 Dec	
				Denmark	DGBs	1 Dec	
07/12	Wed	11:00	10:00	Germany	OBL 1.25% 14 Oct 2016 (Series 161)	EUR 5bn	
		10:30	10:30	UK	Index-Linked Gilt 1.25% 22 Nov 2032	29 Nov	
		14:45	14:45	UK	Gilt Purchase	1 Dec	
		12:00	17:00	Canada	CAN 2-year	1 Dec	
08/12	Thu	12:00	03:00	Japan	JGB 30-year	1 Dec	JPY 0.7tn

Sources: Treasuries, BNP Paribas

Next Week's T-Bills Supply

Date	Country	Issues	Details
18/11	UK	T-Bills Dec 2011	GBP 1bn
		T-Bills Feb 2012	GBP 1bn
		T-Bills May 2012	GBP 1.5bn
21/11	Japan	T-Bills Jan 2012	JPY 2.5tn
	France	BTF Feb 2012	EUR 4.5bn
		BTF May 2012	EUR 1bn
		BTF Oct 2012	EUR 1.5bn
	Neths	DTC Feb 2012	EUR 2-3bn
		DTC Sep 2012	EUR 1-2bn
	Slovak Rep.	T-Bills Jul 2012 (#07)	EUR 0.2bn
	US	T-Bills Feb 2012	USD 29bn
		T-Bills May 2012 (new)	USD 27bn
	FHLMC	Bills 3-month & 6-month	18 Nov
22/11	Japan	T-Bills Mar 2012	JPY 5.1tn
	Spain	Letras Feb 2012	21 Nov
		Letras May 2012	21 Nov
	Canada	T-Bill Mar 2012	CAD 7.7bn
		T-Bill May 2012 (new)	CAD 2.9bn
		T-Bill Nov 2012 (new)	CAD 2.9bn
	US	T-Bills 4-week	21 Nov
	FHLB	Discount Notes	
23/11	Sweden	T-Bills Feb 2012	SEK 10bn
	FNMA	Bills 3-month & 6-month	21 Nov
24/11	FHLB	Discount Notes	
25/11	Italy	BOT May 2012	22 Nov
	UK	T-Bills	18 Nov

Sources: Treasuries, BNP Paribas

Next Week's Eurozone Redemptions

Date	Country	Details	Amount
23/11	Germany	Bubills	EUR 5.0bn
24/11	France	BTF	EUR 8.4bn
Total Eurozone Short-term Redemption			**EUR 13.4bn**

Comments and charts

■ EGB gross supply is likely to decrease to EUR 11bn in the week ahead, from EUR 20.6bn. In 10y duration-adjusted terms, this would be equivalent to EUR 6.4bn.

■ The Netherlands will kick off on Tuesday with EUR 2-3bn in the 2y DSL. Germany will follow on Wednesday, with the launch of a new Bund for EUR 6bn. On Friday, Italy is likely to issue EUR 2.5bn (estimated) in CTZ.

■ Outside of the eurozone, Sweden will raise SEK 0.75bn (ILB Jun-22), the US will issue three new notes in 2y, 5y and 7y for a total amount of USD 99bn, and Japan JPY 1.1trn in JGB Sep-31.

Chart 1: Investors' Net Cash Flows (EUR bn, 10y equivalent)

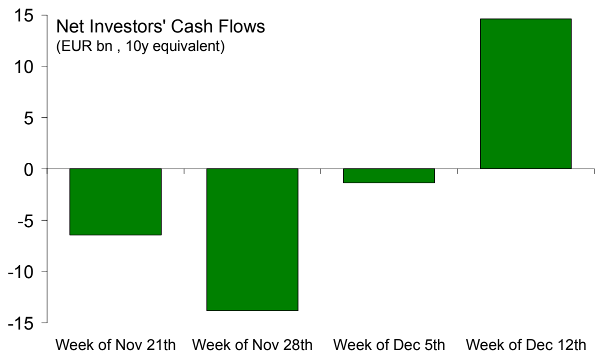


Chart 2: EGB Gross Supply Breakdown by Country (EUR bn, 10y equivalent)

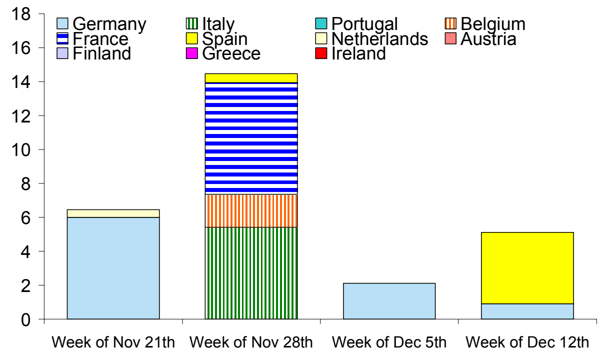
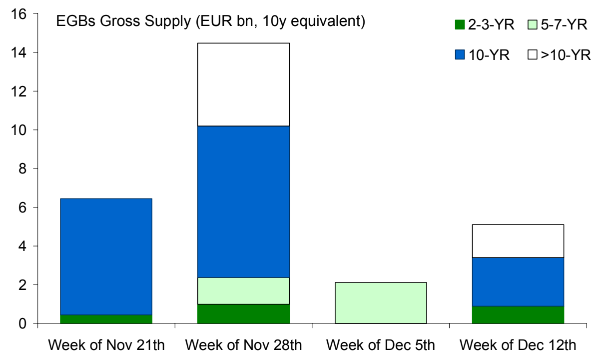


Chart 3: EGB Gross Supply Breakdown by Maturity (EUR bn, 10y equivalent)



All Charts Source: BNP Paribas

Central Bank Watch

Interest Rate	Current Rate (%)	Date of Last Change	Next Change in Coming 6 Months	Comments
EUROZONE				
Minimum Bid Rate	1.25	-25bp (3/11/11)	-25bp (8/12/11	The ECB cited the deterioration in the economic outlook when it announced the November rate cut. We expect more evidence that the economy is faltering, indicative of another rate cut soon.
US				
Fed Funds Rate	0 to 0.25	-75bp (16/12/08)	No Change	The FOMC is expected to keep the Fed funds rate at 0-0.25% for at least the next couple of years and the Fed launched Operation Twist in September. In light of the deterioration in the growth outlook and financial market conditions, we expect a third round of quantitative easing to be announced in Q2, probably at the April 24-25 FOMC meeting
Discount Rate	0.75	+25bp (18/2/10)	No Change	
JAPAN				
Call Rate	0 to 0.10	-10bp (5/10/10)	No Change	Economic activity has been picking up steadily on an easing of the supply-side constraints caused by the 11 March earthquake. However, should the yen appreciate sharply again, the BoJ may once more be forced to ease policy.
Basic Loan Rate	0.30	-20bp (19/12/08)	No Change	
UK				
Bank Rate	0.5	-50bp (5/3/09)	No Change	QE was increased by GBP 75bn in October. We look for another GBP 75bn by February, and then a further GBP 50bn in May.
DENMARK				
Lending Rate	1.20	-35bp (3/11/11)	***-30bp (8/12/11)***	Given the strength of the krone, we expect the central bank to deliver a rate cut bigger than that of the ECB in December, taking the policy rate spread to the ECB to -10bp.
SWEDEN				
Repo Rate	2.00	+25bp (5/7/11)	***-25bp (20/12/11)***	We expect the Riksbank to deliver a 25bp rate cut in December as growth slows. The bank will be unwilling to deviate too much from other advanced-country central banks, like the ECB.
NORWAY				
Sight Deposit Rate	2.25	+25bp (12/5/11)	***-25bp (14/12/11)***	Uncertainty regarding the economic outlook, low inflation and other advanced-country central banks easing policy should prompt the Norges Bank to deliver a 25bp rate cut in December.
SWITZERLAND				
3 Mth LIBOR Target Range	0 to 0.25	-50bp (3/8/11)	No Change	The SNB is enforcing a minimum exchange rate of 1.20 against the euro. This is in response to the appreciation of the franc and its risks to price stability and the growth outlook.
CANADA				
Overnight Rate	1.00	+25bp (8/9/10)	-25bp (17/1/12)	The BoC has lowered its global and domestic growth expectations sharply. This suggests that rates will remain low for a long time and that the BoC will probably cut its policy rate by a total of 50bp if our expectations of a global downturn are realised.
Bank Rate	1.25	+25bp (8/9/10)	-25bp (17/1/12)	
AUSTRALIA				
Cash Rate	4.50	-25bp (1/11/11)	-25bp (6/12/11)	The RBA has said that a more neutral policy stance is now appropriate. We estimate neutral to be 25bp below current levels. The current volatility in global markets and the lack of a January meeting mean we expect the RBA to cut by 25bp at its December meeting, rather than wait until February.
CHINA				
1Y Bank Lending Rate	6.56	+25bp (6/7/11)	No Change	The deterioration in the global growth outlook has reduced the odds of further rate hikes in China. However, because CPI inflation remains high, the authorities still have an incentive to narrow the negative gap between the deposit rate and inflation to address a source of social discontent. The impact on economic growth should be limited.
BRAZIL				
Selic Overnight Rate	11.50	-50bp (19/10/11)	-50bp (30/11/11)	The central bank is cutting rates, aiming to mitigate the impact of the global slowdown on the domestic economy. We foresee a full cutting cycle of 300bp (if not more), with rates down to 9.5% by mid-2012, at a pace of (at least) 50bp per meeting.

Source: BNP Paribas *Change since our last weekly in bold and italics*

For the full EM Central Bank Watch, please see our Local Markets Mover.

FX Forecasts*

USD Bloc	Q4 '11	Q1 '12	Q2 '12	Q3 '12	Q4 '12	Q1 '13	Q2 '13	Q3 '13	Q4 '13	Q1 '14	Q2 '14
EUR/USD	1.35	1.28	1.35	1.40	1.40	1.35	1.35	1.30	1.30	1.30	1.30
USD/JPY	76	73	71	70	70	75	80	85	85	90	90
USD/CHF	0.91	0.96	0.93	0.93	0.93	0.96	0.96	1.00	1.00	1.00	1.00
GBP/USD	1.57	1.52	1.57	1.59	1.59	1.53	1.53	1.48	1.48	1.48	1.48
USD/CAD	1.03	1.07	1.01	0.96	0.96	0.96	0.95	0.98	1.02	1.06	1.05
AUD/USD	1.01	0.98	1.05	1.10	1.12	1.10	1.10	1.05	1.00	0.95	0.95
NZD/USD	0.78	0.74	0.79	0.85	0.88	0.88	0.88	0.84	0.80	0.76	0.76
USD/SEK	6.72	7.15	6.74	6.51	6.43	6.67	6.67	7.02	7.02	7.02	7.02
USD/NOK	5.74	6.05	5.67	5.43	5.36	5.56	5.56	5.85	5.85	5.85	5.85

EUR Bloc	Q4 '11	Q1 '12	Q2 '12	Q3 '12	Q4 '12	Q1 '13	Q2 '13	Q3 '13	Q4 '13	Q1 '14	Q2 '14
EUR/JPY	103	93	96	98	98	101	108	111	111	117	117
EUR/GBP	0.86	0.84	0.86	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.88
EUR/CHF	1.23	1.23	1.25	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30
EUR/SEK	9.07	9.15	9.10	9.12	9.00	9.00	9.00	9.12	9.12	9.12	9.12
EUR/NOK	7.75	7.75	7.65	7.60	7.50	7.50	7.50	7.60	7.60	7.60	7.60
EUR/DKK	7.46	7.46	7.46	7.46	7.46	7.46	7.46	7.46	7.46	7.46	7.46

Central Europe	Q4 '11	Q1 '12	Q2 '12	Q3 '12	Q4 '12	Q1 '13	Q2 '13	Q3 '13	Q4 '13	Q1 '14	Q2 '14
USD/PLN	3.15	3.59	3.33	3.14	3.00	3.04	2.96	3.00	2.92	2.73	2.69
EUR/CZK	25.0	24.3	24.1	23.8	23.5	23.7	24.0	23.5	23.3	23.1	23.0
EUR/HUF	292	290	285	280	280	270	265	260	260	250	245
USD/ZAR	7.60	7.25	7.00	6.80	6.70	7.20	7.10	7.00	6.90	6.90	6.90
USD/TRY	1.78	1.75	1.68	1.72	1.73	1.72	1.70	1.69	1.69	1.54	1.55
EUR/RON	4.29	4.25	4.20	4.05	4.10	4.20	4.20	4.10	3.95	3.90	3.80
USD/RUB	31.45	31.97	30.67	28.81	27.97	28.51	28.94	29.07	29.96	28.63	29.07
EUR/PLN	4.25	4.60	4.50	4.40	4.20	4.10	4.00	3.90	3.80	3.55	3.50
USD/UAH	8.0	8.0	8.0	8.0	8.0	7.8	7.7	7.5	7.3	7.4	7.4
EUR/RSD	100	98	97	96	95	93	92	91	90	85	84

Asia Bloc	Q4 '11	Q1 '12	Q2 '12	Q3 '12	Q4 '12	Q1 '13	Q2 '13	Q3 '13	Q4 '13	Q1 '14	Q2 '14
USD/SGD	1.32	1.35	1.32	1.30	1.31	1.30	1.30	1.30	1.30	1.30	1.30
USD/MYR	3.20	3.30	3.20	3.15	3.17	3.15	3.15	3.15	3.15	3.15	3.15
USD/IDR	9100	9200	9100	9000	8700	8500	8500	8500	8500	8500	8500
USD/THB	31.00	32.00	31.50	31.30	30.90	30.80	30.80	30.80	30.80	30.80	30.80
USD/PHP	43.50	44.00	43.60	43.50	43.40	43.30	43.30	43.30	43.30	43.30	43.30
USD/HKD	7.80	7.80	7.80	7.80	7.80	7.80	7.80	7.80	7.80	7.80	7.80
USD/RMB	6.31	6.28	6.24	6.18	6.12	6.05	5.98	5.93	5.89	5.85	5.80
USD/TWD	30.30	31.00	30.80	30.60	30.50	30.30	30.30	30.30	30.30	30.30	30.30
USD/KRW	1150	1180	1150	1130	1080	1050	1050	1050	1050	1050	1050
USD/INR	51.00	52.00	51.60	51.50	51.40	51.00	51.00	51.00	51.00	51.00	51.00
USD/VND	21100	21200	21000	21000	21000	21000	21000	21000	21000	21000	21000

LATAM Bloc	Q4 '11	Q1 '12	Q2 '12	Q3 '12	Q4 '12	Q1 '13	Q2 '13	Q3 '13	Q4 '13	Q1 '14	Q2 '14
USD/ARS	4.40	4.51	4.66	4.78	4.95	5.10	5.20	5.35	5.55	5.70	5.85
USD/BRL	1.80	1.75	1.73	1.70	1.67	1.68	1.69	1.70	1.71	1.72	1.73
USD/CLP	495	467	455	463	474	479	484	489	494	496	497
USD/MXN	12.70	12.40	12.10	11.70	11.40	11.43	11.48	11.55	11.60	11.61	11.63
USD/COP	1930	1870	1790	1770	1760	1740	1715	1725	1735	1740	1745
USD/VEF	4.29	4.29	4.29	4.29	4.29	8.80	8.80	8.80	8.80	8.80	8.80
USD/PEN	2.68	2.66	2.65	2.63	2.62	2.62	2.63	2.64	2.64	2.65	2.66

Others	Q4 '11	Q1 '12	Q2 '12	Q3 '12	Q4 '12	Q1 '13	Q2 '13	Q3 '13	Q4 '13	Q1 '14	Q2 '14
USD Index	78.00	80.92	77.20	74.88	74.84	77.70	78.31	81.57	81.87	82.80	82.73

***End Quarter**

Market Coverage

Market Economics

Paul Mortimer-Lee	Global Head of Market Economics	London	44 20 7595 8551	paul.mortimer-lee@uk.bnpparibas.com
Ken Wattret	Chief Eurozone Market Economist	London	44 20 7595 8657	kenneth.wattret@uk.bnpparibas.com
Luigi Speranza	Head of Inflation & Fiscal Economics, Eurozone, Italy	London	44 20 7595 8322	luigi.speranza@uk.bnpparibas.com
David Tinsley	UK, Ireland	London	4420 7595 8150	david.tinsley@uk.bnpparibas.com
Gizem Kara	Scandinavia	London	44 20 7595 8783	gizem.kara@uk.bnpparibas.com
Evelyn Herrmann	Europe	London	44 20 7595 8476	evelyn.herrmann@uk.bnpparibas.com
Ricardo Santos	Europe	London	44 20 7595 8369	ricardo.santos@uk.bnpparibas.com
Dominique Barbet	Eurozone, France	Paris	33 1 4298 1567	dominique.barbet@bnpparibas.com
Julia Coronado	Chief Economist North America	New York	1 212 841 2281	julia.l.coronado@americas.bnpparibas.com
Jeremy Lawson	US	New York	1 212 471-8180	Jeremy.lawson@americas.bnpparibas.com
Yelena Shulyatyeva	US	New York	1 212 841 2258	yelena.shulyatyeva@americas.bnpparibas.com
Bricklin Dwyer	US, Canada	New York	1 212 471-7996	bricklin.dwyer@americas.bnpparibas.com
Ryutaro Kono	Chief Economist Japan	Tokyo	81 3 6377 1601	ryutaro.kono@japan.bnpparibas.com
Hiroshi Shiraishi	Japan	Tokyo	81 3 6377 1602	hiroshi.shiraishi@japan.bnpparibas.com
Azusa Kato	Japan	Tokyo	81 3 6377 1603	azusa.kato@japan.bnpparibas.com
Makiko Fukuda	Japan	Tokyo	81 3 6377 1605	makiko.fukuda@japan.bnpparibas.com
Richard Iley	Head of Asia Economics	Hong Kong	852 2108 5104	richard.iley@asia.bnpparibas.com
Dominic Bryant	Asia, Australia	Hong Kong	852 2108 5105	dominic.bryant@asia.bnpparibas.com
Mole Hau	Asia	Hong Kong	852 2108 5620	mole.hau@asia.bnpparibas.com
Xingdong Chen	Chief China Economist	Beijing	86 10 6535 3327	xd.chen@asia.bnpparibas.com
Ken Peng	Senior Economist , China	China	86 10 6535 3380	ken.peng@asia.bnpparibas.com
Marcelo Carvalho	Head of Latin American Economics	São Paulo	55 11 3841 3418	marcelo.carvalho@br.bnpparibas.com
Gustavo Arruda	Latin America Economist	São Paulo	55 11 3841 3466	gustavo.arruda@br.bnpparibas.com
Nader Nazmi	Latin America Economist	New York	1 212 471 8216	nader.nazmi@americas.bnpparibas.com
Florencia Vazquez	Latin America Economist	Buenos Aires	54 11 4875 4363	florencia.vazquez@ar.bnpparibas.com
Michal Dybula	Central & Eastern Europe	Warsaw	48 22 697 2354	michal.dybula@pl.bnpparibas.com
Julia Tsepliaeva	Russia & CIS	Moscow	74 95 785 6022	julia.tsepliaeva@ru.bnpparibas.com
Selim Cakir	Chief Economist Turkey, GCC, South Africa	Istanbul	90 216 635 2972	selim.cakir@teb.com.tr
Emre Tekmen	Economist Turkey, GCC and South Africa	Istanbul	90 216 635 2975	emre.tekmen@teb.com.tr
Nazli Toraganli	Economist Turkey, GCC and South Africa	IIstanbul	90 216 635 2986	lnazli.toraganli@teb.com.tr

Interest Rate Strategy

Cyril Beuzit	Global Head of Interest Rate Strategy	London	44 20 7595 8639	cyril.beuzit@uk.bnpparibas.com
Patrick Jacq	Europe Strategist	Paris	33 1 4316 9718	patrick.jacq@bnpparibas.com
Hervé Cros	Chief Inflation Strategist	London	44 20 7595 8419	herve.cros@uk.bnpparibas.com
Shahid Ladha	Inflation & UK Strategist	London	44 20 7 595 8573	shahid.ladha@uk.bnpparibas.com
Alessandro Tentori	Chief Alpha Strategy Europe	London	44 20 7595 8238	alessandro.tentori@uk.bnpparibas.com
Eric Oynoyan	Europe Strategist	London	44 20 7595 8613	eric.oynoyan@uk.bnpparibas.com
Matteo Regesta	Europe Strategist	London	44 20 7595 8607	matteo.regesta@uk.bnpparibas.com
Ioannis Sokos	Europe Strategist	London	44 20 7595 8671	ioannis.sokos@uk.bnpparibas.com
Camille de Courcel	Europe Strategist	London	44 20 7595 8295	camille.decourcel@uk.bnpparibas.com
Bülent Baygün	Head of Interest Rate Strategy US	New York	1 212 471 8043	bulent.baygun@americas.bnpparibas.com
Mary-Beth Fisher	US Strategist	New York	1 212 841 2912	mary-beth.fisher@us.bnpparibas.com
Aaron Kohli	US Strategist	New York	1 212 841 2026	aaron.kohli@americas.bnpparibas.com
Suvrat Prakash	US Strategist	New York	1 917 472 4374	suvrat.prakash@americas.bnpparibas.com
Anish Lohokare	MBS Strategist	New York	1 212 841 2867	anish.lohokare@americas.bnpparibas.com
Olurotimi Ajibola	MBS Strategist	New York	1 212 8413831	olurotimi.ajibola@americas.bnpparibas.com
Bo Peng	US Strategist	New York	1 212 8412241	bo.peng@americas.bnpparibas.com
Tomohisa Fujiki	Japan Strategist	Tokyo	81 3 6377 1703	Tomohisa.fujiki@japan.bnpparibas.com
Hidehiko Maejima	Japan Strategist	Tokyo	81 3 6377 1701	Hidehiko.maejima@japan.bnpparibas.com
Christian Séné	Technical Analyst	Paris	33 1 4316 9717	christian.séné@bnpparibas.com

FX Strategy

Ray Attrill	Head of FX Strategy – North America	New York	1 212 841 2492	raymond.attrill@us.bnpparibas.com
Mary Nicola	FX Strategist	New York	1 212 841 2492	mary.nicola@americas.bnpparibas.com
Steven Saywell	Head of FX Strategy - Europe	London	44 20 7595 8487	steven.saywell@uk.bnpparibas.com
Kiran Kowshik	FX Strategist	London	44 20 7595 1495	kiran.kowshik@bnpparibas.com
James Hellawell	Quantitative Strategist	London	44 20 7595 8485	james.hellawell@uk.bnpparibas.com

Local Markets FX & Interest Rate Strategy

Drew Brick	Head of FX & IR Strategy Asia	Singapore	65 6210 3262	Drew.brick@asia.bnpparibas.com
Chin Loo Thio	FX & IR Asia Strategist	Singapore	65 6210 3263	chin.thio@asia.bnpparibas.com
Robert Ryan	FX & IR Asia Strategist	Singapore	65 6210 3314	robert.ryan@asia.bnpparibas.com
Jasmine Poh	FX & IR Asia Strategist	Singapore	65 6210 3418	jasmine.j.poh@asia.bnpparibas.com
Gao Qi	FX & IR Asia Strategist	Shanghai	86 21 2896 2876	gao.qi@asia.bnpparibas.com
Bartosz Pawlowski	Head of FX & IR Strategy CEEMEA	London	44 20 7595 8195	Bartosz.pawlowski@uk.bnpparibas.com
Dina Ahmad	FX & IR CEEMEA Strategist	London	44 20 7 595 8620	dina.ahmad@uk.bnpparibas.com
Erkin Isik	FX & IR CEEMEA Strategist	Istanbul	90 (216) 635 29 87	erkin.isik@teb.com.tr
Diego Donadio	FX & IR Latin America Strategist	São Paulo	55 11 3841 3421	diego.donadio@@br.bnpparibas.com

For Production and Distribution, please contact:
Ann Aston, Market Economics, London. Tel: 44 20 7595 8503 Email: ann.aston@uk.bnpparibas.com,
Jessica.Bakkioui, Market Economics, London. Tel: 44 20 7595 8478 Email: jessica.bakkioui@uk.bnpparibas.com,
Danielle Catananzi, Interest Rate Strategy, London. Tel: 44 20 7595 4418 Email: danielle.catananzi@uk.bnpparibas.com,
Roshan Kholil, FX Strategy, London. Tel: 44 20 7595 8486 Email:roshan.kholil@uk.bnpparibas.com,
Martine Borde, Market Economics/Interest Rate Strategy, Paris. Tel: 33 1 4298 4144 Email martine.borde@bnpparibas.com
Editors: Amanda Grantham-Hill, Interest Rate Strategy/Market Economics, London. Tel: 44 20 7595 4107 Email: amanda.grantham-hill@bnpparibas.com;
Poilin Breathnach, Interest Rate Strategy/Market Economics, London. Tel: 44 20 7595 3145 Poilin.Breathnach@uk.bnpparibas.com,
Jeffrey Myhre, Interest Rate Strategy/Market Economics, New York. Tel: 212 471 8180 Email: jeffrey.myhre@us.bnpparibas.com

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