



Bank of the year winner
2005-2009



World Economic Quarterly

First quarter 2010

2010 to be turning point for world economy

December 2009 | 1st Edition

Corporate Markets



Lloyds TSB | for the journey...

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Foreword by

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December 2009

Foreword

2010 to be a year of global economic recovery

In this, our inaugural World Economic Quarterly (WEQ), we focus on the G10 and E10 countries. Our G10 and E10 groups are defined as the top ten countries by gross domestic product (gdp) in each segment. The rest of the world is also analysed, but in less detail. Our approach is to recognise that investors want to focus on the fastest growing, and largest, of the world's economies, but at the same time not lose touch with what is occurring in other parts of the world. Many countries in the latter are also fast-growing and are as instrumental in the reshaping of the world economy that is underway.

Two decades or so ago, the developed economies accounted for over two-thirds of global gdp, by 2006 this fell closer to one-half and on current trends it will fall to around one-third by 2020. That is a measure of the pace at which the global economy is evolving and why there needs to be focused research and analysis of the opportunities and challenges this opens up for companies. In this publication, we focus on the economic and financial market implications of this rapid change over the next two years.

The overall theme is that 2010 will be a year of global economic recovery after the deepest downturn since the Great Depression. However, the effects of the policy loosening that has led to recovery will also be felt for many years.

Chart 1: E10 to lead world gdp growth in 2010

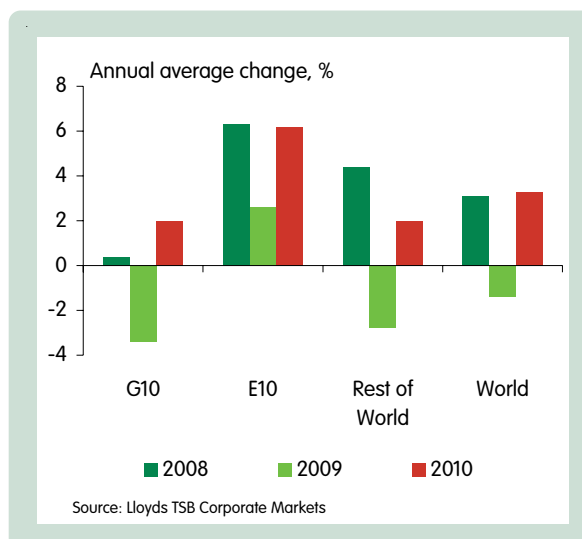
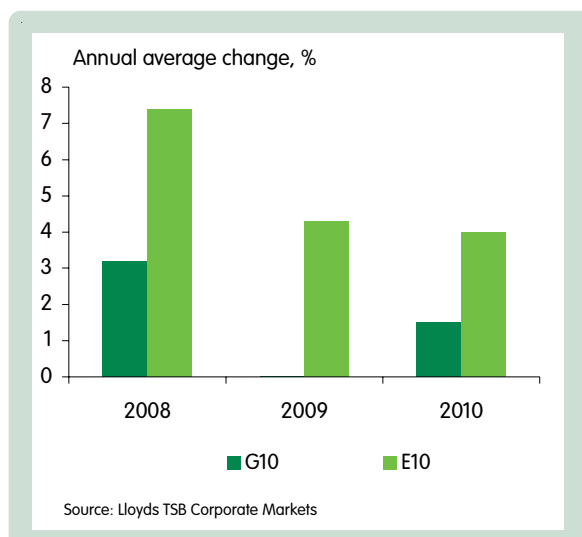


Chart 2: E10 CPI to outpace G10



Key macroeconomic forecasts for our G10 & E10 groupings

	GDP growth %			CPI inflation %				GDP growth %			CPI inflation %		
	2009e	2010f	2011f	2009e	2010f	2011f		2009e	2010f	2011f	2009e	2010f	2011f
World	-1.4	3.3	4.4	2.4	3.1	3.3							
G10	-3.4	2.0	2.5	0.0	1.5	1.8	E10	2.7	6.3	6.8	4.3	4.0	4.3
US	-2.5	3.0	3.5	-0.3	1.8	1.9	China	8.7	9.5	8.8	-1.0	1.1	2.7
Japan	-5.6	1.0	1.3	-1.2	-0.5	-0.2	Brazil	-0.4	3.6	4.6	4.9	3.7	4.9
Germany	-4.8	1.5	1.8	0.4	1.9	2.3	India	6.4	6.8	8.3	10.2	7.6	5.6
UK	-4.5	0.8	2.2	2.0	2.2	2.5	Russia	-9.1	3.4	4.4	11.7	8.4	6.6
France	-2.3	1.2	1.2	0.1	1.8	2.1	Mexico	-6.7	4.6	6.0	5.4	4.1	3.0
Italy	-4.8	1.0	1.2	0.8	2.0	3.2	South Korea	0.2	4.6	4.7	2.7	2.1	2.9
Spain	-3.6	-0.7	0.6	-0.4	1.0	2.7	Turkey	-5.6	4.2	4.8	6.2	7.3	7.0
Canada	-2.7	2.6	3.4	0.2	1.5	2.1	Poland	1.4	1.1	3.8	3.9	3.5	4.1
Australia	1.0	2.7	3.4	1.8	2.6	1.8	Indonesia	4.1	4.5	6.2	5.1	4.9	5.8
Netherlands	-4.1	0.8	2.6	1.2	0.8	2.6	South Africa	-2.1	1.0	4.4	7.3	5.6	6.3



Global economic outlook 2010

G10 macro overview

After a vertiginous decline in activity, global economic recovery now seems to be underway. We forecast world output (on a purchasing power parity basis) to expand by 3.3% in 2010, after a decline of 1.4% this year. The recovery is likely to be led by the emerging markets, which in the main were less directly affected by the global financial crisis compared with developed countries. Across our G10 category, we look for gdp growth of 2.0% in 2010, after a drop of 3.4% in 2009. The rebound is likely to be weaker compared with previous recoveries, reflecting the structural nature of the 'shock' to the financial sector. Accordingly, downside risks remain and unprecedented policy support in the form of both monetary and fiscal stimulus will need to be withdrawn gradually, potentially creating further headwinds for private sector demand.

In the US, we expect gdp growth of 3.0%, after a decline of 2.5% in 2009 as various stimulus measures aimed at restoring credit provision to the real economy impact more forcefully. As for the "core" euro-zone economies, we look for Germany to expand by a more modest 1.5% in 2010, given the euro's strength and a potentially sharp increase in unemployment when the current scheme of government labour market subsidies expires (see chart opposite). For the euro zone overall we look for GDP growth of just 1.1% in 2010, following a fall of 3.9% in 2009. In the UK, a sharp depreciation in sterling should benefit net exports. But the domestic economy faces major challenges as the private sector embarks on a relatively longer de-leveraging process and fiscal support is withdrawn. We forecast UK gdp growth of 0.8% in 2010 following a decline of 4.5% in 2009. Major commodity producers such as Canada and Australia should be supported by Asian demand (especially China), along with other developing economies. We look for Canada to register gdp growth of 2.6% in 2010, with Australia expanding by 2.7%.

E10 macro overview

Reflecting significantly stronger growth and rising inflationary pressure, E10 monetary policy tightening seems likely to take place earlier than in our G10 category. This should benefit the currencies of various nations, mostly in emerging Asia. We look for economic growth in our E10 region to outpace that of our G10. E10 GDP growth is forecast at 6.3% in 2010 after expansion of 2.7% in 2009. This view hinges crucially on prospects in China and India, with both expected to be among the fastest growing countries next year, at 9.5% and 6.8% respectively (the former aided by an effective re-pegging of its exchange rate - see chart). Within the E10, two Latin American countries - Brazil and Mexico - have had contrasting fortunes in 2009, with Mexico's output set to fall by around 6.7% and Brazil's by 0.4%. Looking ahead, the picture seems uniformly encouraging. Mexico is likely to benefit from improving US economic conditions in 2010, while Brazil has recently adopted a resurgent China as its main trading partner. Meanwhile, Eastern Europe continues to face difficult economic and financial conditions, although Poland is a notable outperformer.

Chart 1: Positive gdp growth returns

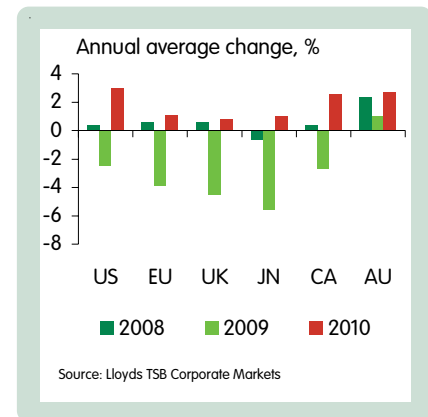


Chart 2: Unemployment to rise further

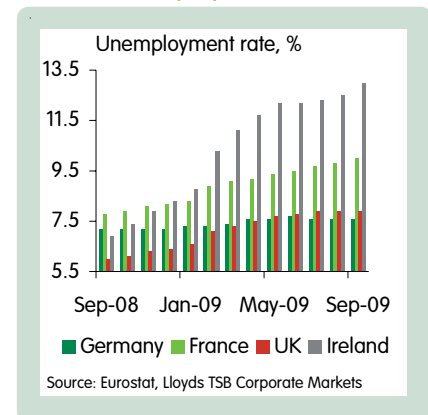


Chart 3: EM gdp growth led by China

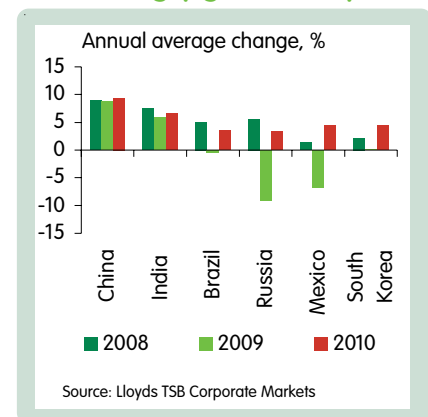
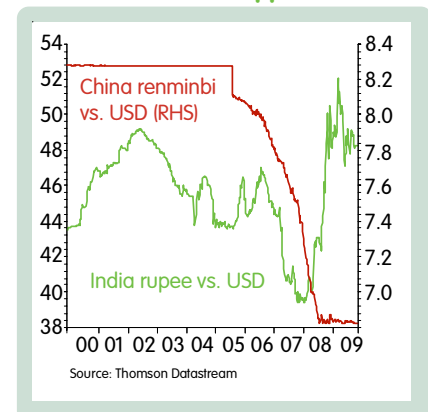


Chart 4: Renminbi to appreciate v US \$



Financial market themes in this Quarterly

1. US dollar to rally against its main trading counterparts

Among our G10 advanced economy grouping, we look for the US to record the fastest pace of economic growth in 2010. A more rapid closure of its output gap should see the US Federal Reserve raising interest rates well before the ECB, BoJ and BoE. This is likely to support the US dollar going forward. In addition, we feel that the dollar will soon start to benefit from stronger US economic fundamentals as the theme of a dollar-positive response to risk aversion fades on a better-established global recovery.

2. Emerging Asian currencies to extend gains in 2010

The main impetus to global economic recovery will continue to come from emerging markets in 2010, notably in emerging Asia. Assuming only a limited risk that activity in China slows in response to rising bad debts after the recent surge in bank lending, the orientation of emerging East Asian economies towards export-led activity should propel global growth. Relatively faster growth and accelerating inflation pressures (related to rising commodity prices) should see some emerging market central banks raise interest rates from early 2010, benefiting their currencies. But some (East European) emerging markets are in a different position, with interest rates likely to be lowered further now that the risk of currency collapse has been reduced (often as a result of IMF bail-outs). Hungary is one such example.

3. Divergent economic performances to keep volatility high

Notwithstanding our central view of a return to global economic growth, starkly divergent performances across countries will almost certainly feature in 2010. This may be a source of uncertainty and volatility in financial markets. As noted above, some emerging market economies - particularly those dependent on external financing - may experience difficulties in the form of additional currency weakness and/or higher bond yields. Equally, confirmation that the rally in 'riskier' assets seen since March is sustainable could fuel a further rebound in equities and commodities with government bonds falling out of favour. Given the challenging fiscal backdrop in many countries at the moment, rising government bond yields and tougher financing conditions represent a potentially significant downside risk to the global outlook.

4. Inflation pressures of increasing concern for central banks

At first glance, the excess spare capacity created by deep recessions in various economies points to subdued inflation pressures going forward. In economics jargon, aggregate supply exceeds aggregate demand. But under these conditions, inflation pressures will only be muted if inflation expectations are under control. At the current juncture, there is a risk that these expectations start to become elevated. First, inflation rates in many countries are poised to accelerate in the short term as energy price declines in the previous year fall from the annual comparison. Second, central banks around the world may keep so-called 'unconventional' monetary policy measures in place for too long (or unwind them too slowly). And third, the nature of the economic and financial crisis means that supply potential in many countries will have been partially destroyed, so adding to inflation pressures. All of these indicate potentially significant upward pressure on government bond and swap yields over our forecast horizon.

5. De-leveraging holds the key for the US dollar longer term

While our central view is for the US dollar's trade-weighted exchange rate to appreciate into next year, the medium to longer-term outlook may be rather different. If private and public sector de-leveraging is too slow (or non-existent), the US will run large current account deficits well into the future - a structural drag on the US dollar. Our latest forecasts show the US current account deficit narrowing to 3.2% of gdp in 2009, from a shortfall of 4.9% in 2008 but then widening back to a similar level by 2013. Given that progress is likely to be only gradual, it is not inconceivable that financial markets turn their attention to the theme of wider external deficits quite quickly (as they have in the past).

For more information on any of the above themes email:

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Fixed income overviews - G10

US

- In recent communications, the Federal Reserve has reiterated that it believes that current economic conditions continue to warrant 'exceptionally low levels of the federal funds rate for an extended period'. We take this to mean that the fed funds rate is unlikely to be increased from its current level of 0-0.25% for up to six months. However, purchases of both agency debt (\$175bn) and agency mortgage backed securities (\$1.25trn) should be completed by the end of the first quarter of 2010.

At the current juncture, we feel that there is a considerable amount of spare capacity in the US economy. However, the extremely low level of the fed funds rate and the likelihood that the traditional lags associated with monetary policy may have been extended could still see the Fed start raising interest rates from the second half of 2010. Clearly, the precise timing will hinge crucially on labour market conditions and inflationary trends. The pace of tightening is likely to be gradual and we forecast the fed funds target rate at 1.5% at end 2010, rising to 3.75% by end 2011. The implication for the yield curve is that 3 month Libor rates and front-end Treasury yields could rise significantly once the fed signals a change in policy is imminent, outstripping gains in longer-dated yields and leading to a bearish flattening of the curve. There is a risk that the whole yield curve shifts up, should inflation fears rise or supply concerns intensify.

Japan

- While corporate financing conditions continue to show signs of improvement, the Bank of Japan (BoJ) has expressed concern that 'recent international financial developments and foreign exchange market instability might pose adverse effects on economic activity through impacts on business sentiment and others'. In response to this, the BoJ has introduced a new funds-supplying operation to encourage a further decline in long-term interest rates. This takes the form of ¥10trn in 3-month loans at a fixed interest rate of 0.1%.

Looking further out, the chances of an increase in the BoJ's overnight call rate in 2010 seem slim in a deflationary environment. And it is not clear that stockbuilding will continue contributing strongly to gdp, as in Q3. Meanwhile, unemployment is trending higher. We look for the 5-year swap rate to rise above 1% by end-2010.

Euro zone

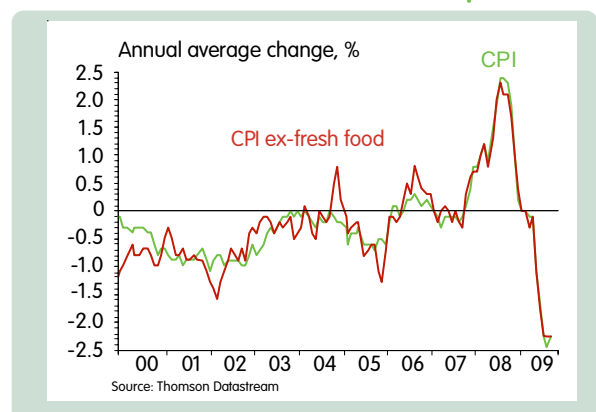
- The ECB's monetary policy 'exit' strategy is a 'hot' topic at present. The euro zone has emerged from technical recession, but a durable economic recovery is not yet assured. So for us, a tightening of 'conventional' policy measures - notably a rise in the ECB's main refinancing rate - still seems some way off. We envisage an unchanged ECB rate of 1.0% during 2010, with a first hike in 2011Q1.

But it is the potential unwinding of 'unconventional' policy measures that is currently attracting the most interest. Recent comments by ECB Council members suggest that its 1-year Long-Term

Chart 1: US inflation expectations remain subdued...



Chart 2: ...while deflation returns in Japan



UK

Refinancing Operations (fixed rate, with unlimited liquidity) will not continue beyond the end of 2009. Over the next six months or so, we think that banking system fragility in the euro-zone - along with muted inflation expectations - still warrant unlimited liquidity being provided in the ECB's other, shorter-term operations. But beyond this, the ECB may start to nudge euro money market rates towards the main refinancing rate as an early step towards a first increase in its key policy rate. It could achieve this through a shift away from money market tenders with full allotment, back to a partial allotment system (which gives the ECB greater control over the rate paid by banks).

- November's three-way split decision to extend the Bank of England's asset purchase programme to £200bn illustrates the high degree of uncertainty surrounding the outlook for the UK economy. With CPI inflation set to accelerate over the short term on energy price base effects and the restoration of the VAT rate to 17.5%, the current high degree of policy stimulus risks a significant upshift in inflation expectations. Indeed, so-called 'breakeven' inflation rates have been edging higher recently. While we forecast Bank Rate to stay on hold at 0.5% throughout next year, a possible cut in the rate paid on commercial bank reserves also points to potential yield curve steepening in 2010.

Canada

- Canadian CPI stood at just 0.1% in the year to October, while recent currency appreciation still suggests some risk of deflation. To introduce inflation expectations into the system, the BoC has indicated that its key overnight target rate is likely to remain at its present level of 0.25% well into next year. Canada has now emerged from recession, but a still-fragile recovery means that this policy stance is unlikely to be abandoned quickly. Given this, our latest forecasts show the 5-year swap rate rising relatively modestly to 3.75% by end-2010, from around 2.4% at present.

Australia

- The Reserve Bank of Australia (RBA) raised its cash rate by 25bp in December, to 3.75%, following a similar move in November. However, the AUD swap yield curve remains steep in the 1- to 5-year area as the market anticipates a more rapid pace of rate tightening further out. From 3.75% at present, we look for the RBA's cash rate to reach 4.75% by end-2010.

Fixed income overview - E10

E10

- Compared with the G10, we think the E10 is likely to feature significantly stronger economic growth next year. Alongside this, inflation pressures seem likely to mount more quickly in the E10 so that monetary policy tightening - especially in emerging Asia - seems likely to occur sooner in 2010.
- This view hinges crucially on economic prospects for China and India. Indeed, we expect China to expand by some 9.5% next year, with India registering a healthy 6.8%. In China, the degree of economic momentum is clear but the likely type of monetary policy tightening (i.e. interest rate and/or exchange rate), is less so. This reflects continuing caution on the part of the Chinese authorities. Assuming the renminbi resumes its gradual appreciation versus the US dollar in 2010, we think that official interest rate rises may commence in late 2010. The Reserve Bank of India (RBI), meanwhile, has already started reversing some stimulus measures. It recently raised the statutory liquidity ratio to protect against a pick-up in inflation expectations. Despite much-needed fiscal consolidation, we feel that improving economic confidence and a further pick-up in inflation pressures will prompt the RBI to raise its benchmark repo rate from 4.75% currently to 6.5% by the end of next year. Meanwhile, outside emerging Asia, countries such as Poland, which avoided technical recession, and Brazil will also be among the first to raise interest rates in 2010.

FX overviews - G10

US

- The turnaround in global economic prospects since the first quarter of 2009 has weighed on the US dollar, leading the currency lower as it breached key levels against its main trading peers. €/£ is back above 1.50, \$/¥ recently eased to a 14-year low below 85.0 and \$/Chf is near parity. Although further selling pressure remains a possibility in the short term, we look for the US dollar to stage a significant rebound in 2010. We expect the main driver behind this rally to be growing confirmation of our view that US economic growth will significantly outpace that of its main G10 peers in 2010. We look for real gdp growth of close to 3% next year compared to nearer 1% for the euro zone, Japan and UK. This relatively robust pace of economic growth is forecast to prompt the Federal Reserve to raise its target rate before other major central banks and ahead of current market expectations.

Japan

- Since mid-2007, the Japanese yen has been on a sustained upward path against the US dollar. Indeed, Bank of Japan currency intervention to weaken the yen has re-emerged as an important market theme. While Japan's exports are benefiting from its close trade links with China, domestic demand faces significant challenges in the form of weak labour market conditions and lacklustre fixed investment spending. And data on CPI ex-fresh food show that a deflationary environment remains in place. The Japanese yen is therefore unlikely to receive interest rate support, in contrast to the US dollar, as the global economy continues its recovery. We look for the yen to weaken to 103 against the dollar and 151 versus sterling by end-2010.

Euro zone

- For several months now, the ECB has expressed its support for the US's strong dollar policy (itself reiterated by Fed Chairman Ben Bernanke recently). At present, we remain in an environment where the Usd continues to weaken on firmer economic data, reflecting the ebb and flow of investor risk appetite. But from early 2010, we look for a weaker euro to result from a better-established US economic recovery (alongside with Federal Reserve interest rate increases), with stronger US economic data interpreted as US dollar-positive. We expect the euro to move to 1.25 against the dollar by end-2010.

UK

- In trade-weighted terms, sterling has trended higher over the past couple of months, though this needs to be viewed in the context of a near 25% fall since summer 2007. Going forward, we think that the combination of a broad US dollar recovery and the ongoing fragility of the UK economy will drag sterling lower (our end-2010 projection stands at 1.47). Against the euro, however, a modest appreciation of sterling is envisaged, to 0.85, by end-2010.

Canada

- Like other commodity-rich economies (such as Australia - see below), Canada has witnessed a significant appreciation in its currency against the US dollar over the past year or so. However, we expect Cad strength to be an essentially short-term development, as the US dollar stages a broad-based rally from around the turn of this year. But against sterling, however, we look for Cad to continue its appreciation into 2010H1 (to 1.67 from current levels) on the back of a still-vulnerable UK economy (and an associated sterling risk premium).

Australia

- The Aud recently reached a 16-month high versus the US dollar. In the short term at least, it is unclear that Chinese demand for Australia's commodities (China is a particularly important trade partner) will fade any time soon, and this will provide some support for the Aud vis-a-vis other currencies. Nonetheless, we look for Aud gains versus the US dollar to start unwinding from 2010Q1 as the Usd strengthens on continued US economic recovery. From a current level of 1.09, our end-2010 forecast stands at 1.13.

FX overview - E10

- Within our E10 grouping, the Indonesian rupiah has exhibited the biggest gains against the US dollar since the start of this year, appreciating by more than 17%. The rupiah is closely followed by the South Korean won, which has also risen sharply on a reviving economy and its yield advantage over the western economies, together with prospective central bank rate hikes in the short term.
- These performances owe much to the rebound in China's economy. Despite a rather different view from the PBoC, the government's policy line on the renminbi seems likely to remain an effective re-pegging to the US \$. Assuming a satisfactory pace of growth is achieved, we look for this appreciation to continue (although meaningful progress does not seem likely until later next year).
- Finally, the Indian rupee has also made significant gains this year. While we think the rupee is likely to continue benefiting from foreign capital inflows arising from higher relative yields, factors such as weak public finances and a potential re-emergence of risk aversion are key downside risks.

Key financial forecasts - as at 1 Dec 09

Official benchmark interest rates

G10					Forecast (%)				
Country	Rate	Current (%)	Last change	Decision (%)	+6m	+12m	+24m	+36m	Next meeting
US	Fed funds	0-0.25	16/12/08	-0.75	0.50	1.50	3.75	5.00	16/12/09
Japan	Overnight rate	0.10	19/12/08	-0.20	0.10	0.10	0.50	1.75	18/12/09
Euro zone	Refinancing rate	1.00	08/05/09	-0.25	1.00	1.00	2.25	4.00	03/12/09
UK	Bank rate	0.50	05/03/09	-0.50	0.50	0.50	1.50	2.50	10/12/09
Canada	Overnight rate	0.25	21/04/09	-0.25	0.25	1.00	4.25	6.00	08/12/09
Australia	Cash target rate	3.75	01/12/09	0.25	4.25	4.75	5.50	5.00	02/02/10

E10					Forecast (%)				
Country	Rate	Current (%)	Last change	Decision (%)	+6m	+12m	+24m	+36m	Next meeting
China	Lending rate	5.31	22/12/08	-0.27	5.31	6.12	7.20	6.93	n/a
Brazil	SELIC rate	8.75	22/07/09	-0.50	9.75	10.25	11.25	11.25	09/12/09
India	Repo rate	4.75	21/04/09	-0.25	6.00	6.50	8.75	8.75	29/01/10
Russia	Refinancing rate	9.50	29/10/09	-0.50	8.75	7.50	9.25	10.75	n/a
Mexico	Overnight rate	4.50	17/07/09	-0.25	5.75	6.50	7.25	7.50	15/01/10
South Korea	Call rate	2.00	11/02/09	-0.50	3.25	3.75	6.00	6.75	09/12/09
Turkey	Interbank rate	6.75	15/10/09	-0.50	8.25	10.75	18.50	16.50	17/12/09
Poland	Repo rate	3.50	24/06/09	-0.25	5.00	7.00	7.00	5.00	23/12/09
Indonesia	Reference rate	6.50	05/08/09	-0.25	7.50	7.75	8.00	8.25	03/12/09
South Africa	Repo rate	7.00	13/08/09	-0.50	8.00	9.25	10.00	9.25	26/01/10

For more detail and our latest currency and interest rate forecasts please refer to our monthly publication the [International Financial Outlook](#)

G10 & E10 currencies

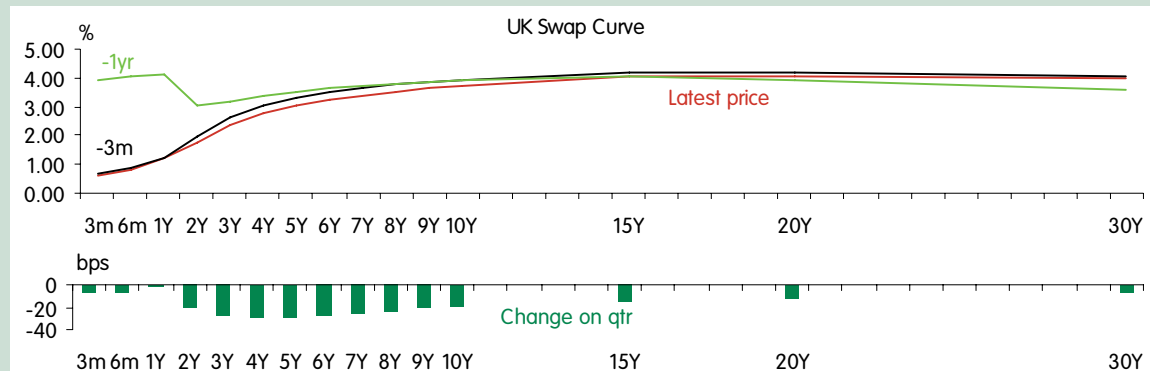
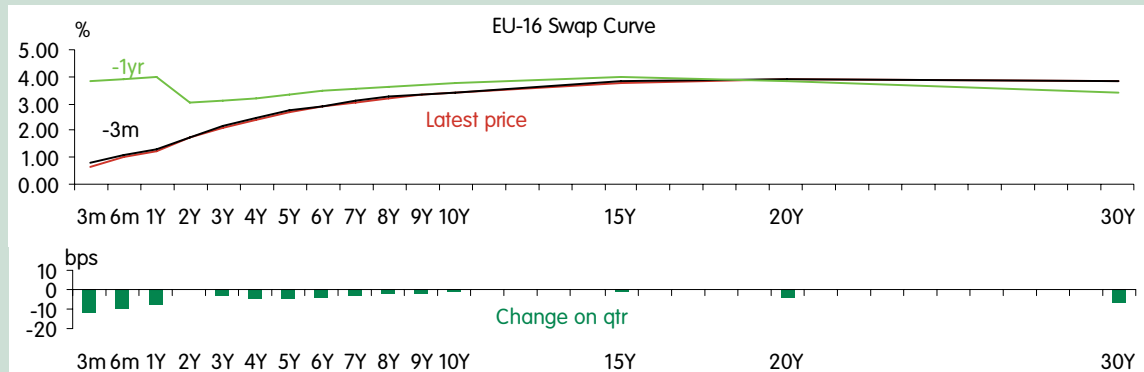
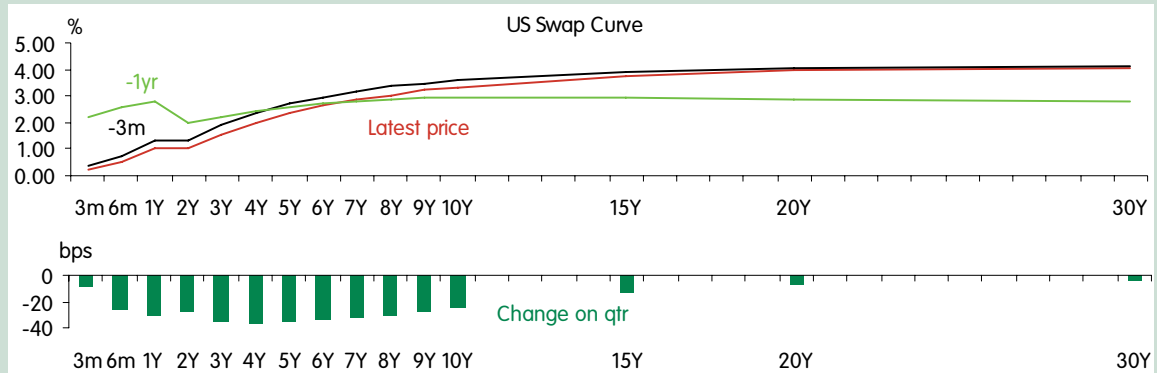
G10

	Current	Forecast →				
		+6m	+12m	+24m	+36m	
€/\$	1.51	1.30	1.25	1.25	1.25	
\$/¥	87	102	103	101	100	
€/¥	131	133	129	126	125	
£/\$	1.66	1.48	1.47	1.49	1.45	
€/£	0.91	0.88	0.85	0.84	0.86	
£/¥	144	151	151	150	145	
\$/Cad	1.04	1.13	1.15	1.18	1.21	
£/Cad	1.74	1.67	1.70	1.76	1.76	
\$/Aud	1.08	1.15	1.13	1.25	1.25	
£/Aud	1.80	1.70	1.66	1.86	1.82	

E10

	Current	Forecast →				
		+6m	+12m	+24m	+36m	
\$/Cny	6.83	6.72	6.61	6.38	6.17	
\$/Brl	1.72	1.80	1.75	1.80	1.75	
\$/Inr	46.34	47.74	47.00	46.20	45.00	
\$/Rub	29.06	30.92	30.98	31.67	30.88	
\$/Mxn	12.86	13.04	13.08	12.91	12.91	
\$/Krw	1157	1166	1135	1097	1020	
\$/Try	1.50	1.41	1.35	1.30	1.35	
\$/Pln	2.73	3.18	3.27	3.03	3.14	
\$/Idr	9455	9597	9693	9754	9793	
\$/Zar	7.30	7.20	7.35	7.82	8.20	

Recent trends in key swap curves - as at 1 Dec 09



US

Country report

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Economic summary

December 2009

- After declining for a post-war record four consecutive quarters, the US economy expanded by 2.8% (saar) in the third quarter, led by a rebound in personal consumption and gross private investment. Recent data suggest the recovery has continued in the fourth quarter and a modest pick up in the pace of growth looks possible. We forecast US real gdp to contract by around 2.5% in 2009 - a significantly better performance than most of its G10 peers. Furthermore, we expect real gdp growth to outpace that of most other developed economies next year at 3%, with the risks evenly balanced on either side.
- Labour market trends will be crucial to US economic prospects in the year ahead. The unemployment rate has risen above 10% for the first time since 1983 and is expected to continue rising into 2010. We look for a peak of close to 10.5% before gradually easing back in the second half of 2010. It is noticeable that the US labour market has proved more flexible than other major developed economies, boosting overall productivity but weighing on consumer confidence and spending. We forecast personal consumption to expand by 1.9% in 2010, recovering from a fall of 0.6% this year but significantly weaker than its previous trend rate of growth. After declining by over 16% in 2009, gross fixed investment is forecast to rise by 4%, led by a recovery in the residential sector. However, government consumption will provide less support to economic growth in 2010. And with the budget deficit forecast to exceed 10% of gdp in 2009, significant tightening may be required once recovery is more firmly established.
- Although CPI inflation is likely to push higher in the near-term, as last year's energy price declines fall out of the annual comparison, there is considerable slack in the economy and general price pressures should remain muted. The weak labour market is likely to keep wage pressures in check, while low capacity utilisation at the firm level should also help to subdue pipeline price pressures. The main upside risk is a potential pick up in inflation expectations arising from the weaker dollar and significant loosening of monetary and fiscal policy. We forecast inflation of 1.8% in 2010, up from -0.3% this year.

Chart 1: US unemployment rate soars above 10%....

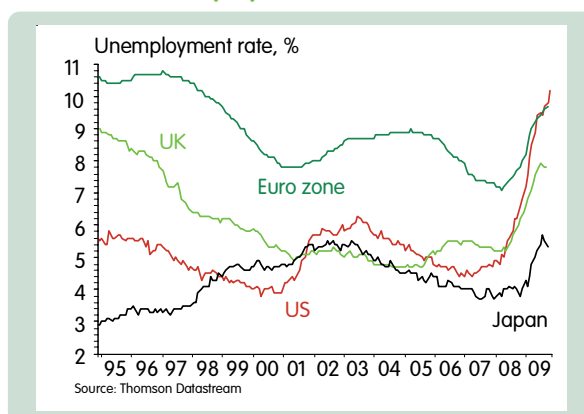


Chart 2:leading to a sharp rise in productivity...

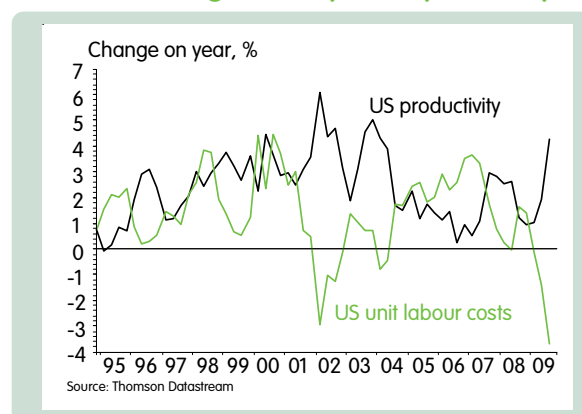


Chart 3:but weakening consumer confidence

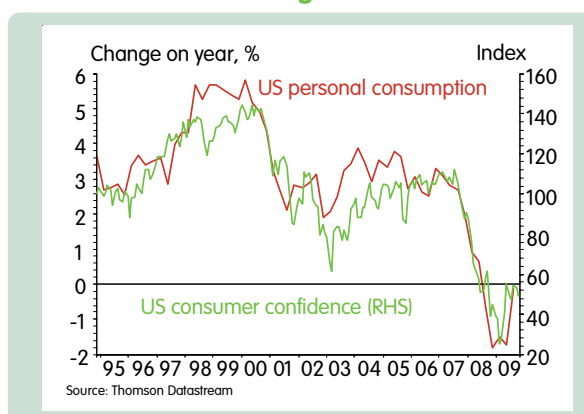


Table: Key US macroeconomic forecasts

US	(Yr % chg unless stated)	2008	2009e	2010f
Real GDP		0.5	-2.5	3.0
Household consumer spending		-0.2	-0.6	1.9
Gross investment		-0.8	-16.1	4.0
Government consumption		3.0	1.9	0.5
Exports		5.6	-10.9	4.9
Imports		-3.2	-14.8	9.4
Industrial production		-2.2	-9.9	7.4
Unemployment rate (% , Q4)		6.9	10.3	9.9
CPI		3.8	-0.3	1.8
Budget balance % GDP (cal yr)		-6.1	-10.2	-9.8
Current account % GDP		-4.9	-3.2	-3.7

Euro zone

Country report

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Economic summary

December 2009

- The euro zone economy exited technical recession in Q3, expanding by 0.4% quarter-on-quarter. But as ECB President Jean-Claude Trichet has noted, the recovery path going forward is likely to be 'uneven'. Partly reflecting the stock cycle, business surveys seem to augur well for future economic activity. November's euro PMI surveys, for example, showed outright expansion in both the manufacturing and services sectors for the second consecutive month.
- However, a key concern going forward is that this return to growth is being propelled by more 'volatile' gdp components such as exports and inventories, rather than solid domestic fundamentals. Germany, for example, relies increasingly on the appetite of East Asian economies (notably China) to drive its exports. But a strong euro exchange rate, along with the possibility of slower Chinese demand growth and a particularly weak domestic banking sector, could signal problems ahead. Fortuitously for the euro zone as a whole, activity in countries like France is relatively less reliant on net exports, being supported more by domestic demand. We look for the euro zone economy to contract by 3.9% this year, prior to expansion of 1.1% in 2010. As in other western economies, the key to an upside surprise in economic growth next year lies in a revival in bank lending to households and firms. Monetary data in the euro-zone still suggest this is some way off (see chart).
- We look for the euro to weaken towards 1.25 against the US dollar by end-2010, as the theme of dollar weakness on enhanced investor risk appetite matures and US economic recovery becomes entrenched. We also note that the ECB continues to express its support for the US's strong dollar policy.
- Over the coming months, we look for the annual rate of euro zone CPI to consolidate its recent move back into positive territory. But a high degree of spare capacity in the economy is likely to ensure that inflation pressures remain subdued further out. Against this backdrop, we envisage an unchanged ECB refinancing rate of 1% throughout 2010.
- As with other central banks, monetary policy 'exit' strategy is a 'hot' topic at present. At November's ECB press conference, Mr. Trichet noted that "not all our liquidity measures will be needed to the same extent as in the past", hinting that the ECB's one-year Long-Term Refinancing Operations (LTROs) may not continue beyond end-2009 (June's LTRO was particularly successful, providing some €442bn). Such a move would be an example of a natural unwinding of an 'unconventional' policy measure which we think the ECB will confirm imminently. But we think continuing fragility in the banking system - along with muted inflation expectations - warrants the ECB retaining unlimited liquidity provision in its other, shorter-term, operations. However, as inflation pressures begin to emerge, we envisage a back-up in market rates with the five-year swap yield breaching 3% by the end of Q2 next year.

Chart 1: Euro-zone bank lending is slowing rapidly

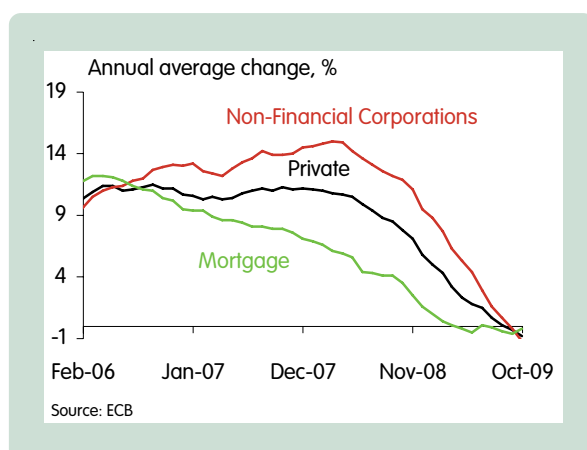


Table: Key euro-zone macroeconomic forecasts

Euro zone (Yr % chg unless stated)	2008	2009e	2010f
Real GDP	0.6	-3.9	1.1
Household consumer spending	0.3	-1.0	-0.2
Gross investment	-0.6	-10.3	-0.8
Government consumption	2.1	2.6	1.5
Exports	1.0	-14.7	3.5
Imports	1.0	-12.7	1.3
Industrial production	-2.4	-13.1	1.3
Unemployment rate (% Q4)	8.0	10.1	10.7
CPI	3.3	0.3	1.6
Budget balance % GDP (cal yr)	-2.0	-6.2	-6.8
Current account % GDP	-1.5	-0.5	0.0

Japan

Country report

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Economic summary

December 2009

- Although Japan was among the first major advanced economies to exit technical recession this year (Q2) and despite posting stronger-than-expected growth of 4.8% (saar) in Q3, the economy is still likely to contract by around 5.6% in 2009 - the worst performance within our G10 grouping. While we expect economic growth to remain positive in coming quarters, its pace is likely to moderate as the boost from net exports fades and domestic demand recovers only gradually. We forecast real gdp growth of 1.0% in 2010, with an small upside risk based on a stronger-than-expected global economic recovery.
- Japan's economic prospects in 2010 are closely linked to global growth and world trade. Although we forecast world trade to continue to recover gradually, yen strength (it recently rose to a 14-yr high versus the US \$) could make it more difficult for exporters to take advantage. However, Japan has impressive links with China and other faster-growing emerging markets. Growth in exports of goods and services is forecast to outpace that of imports in 2010, leading to a sharp widening of Japan's trade surplus.
- Domestic demand is likely to stay subdued as households contend with difficult labour market conditions and companies continue to restrain investment. Although the withdrawal of stimulus measures could lead to some consumption smoothing, new policy initiatives by the DPJ government represent a wildcard. However, the room for additional significant fiscal expansion appears limited, with the budget deficit forecast to widen to over 10% of gdp in 2010, potentially pushing outstanding public debt to over 200% of gdp. We look for household consumption to rise by 0.8% in 2010 after a fall of 1.0% in 2009. Fixed investment spending is forecast to contract by 0.5%, following a sharp 13.4% drop this year.
- The return of deflation poses a significant challenge for Japan. A potentially very large output gap, suggests that economic recovery is unlikely to generate meaningful inflation pressure until 2011 at the earliest. The Bank of Japan is therefore unlikely to raise the overnight call rate for sometime yet.

Chart 1: Japan returned to positive growth in Q2....

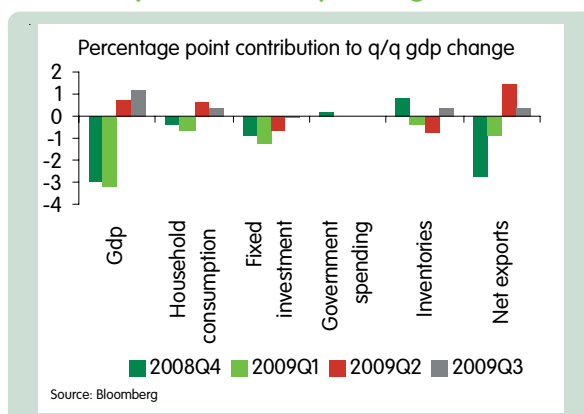


Chart 2: ...but rising unemployment...

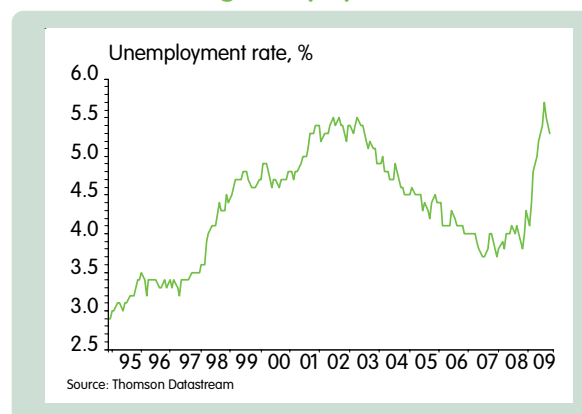


Chart 3: ...and the return of deflation threaten recovery

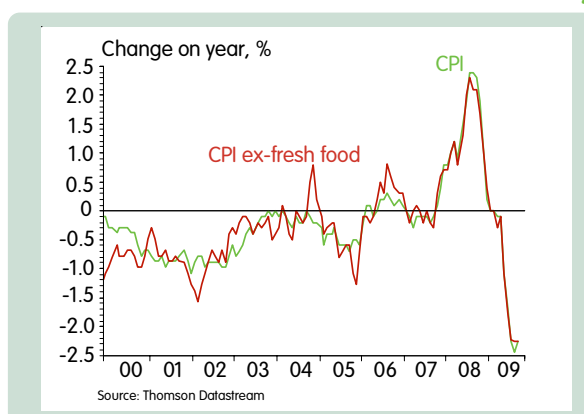


Table: Key Japan macroeconomic forecasts

Japan (Yr % chg unless stated)	2008	2009e	2010f
Real GDP	-0.7	-5.6	1.0
Household consumer spending	0.6	-1.0	0.8
Gross investment	-5.2	-13.4	-0.5
Government consumption	0.8	0.9	1.9
Exports	2.2	-25.4	9.4
Imports	0.9	-15.0	6.2
Industrial production	-3.3	-22.2	10.9
Unemployment rate (% Q4)	4.0	5.8	6.0
CPI	1.4	-1.2	-0.5
Budget balance % GDP (cal yr)	-4.9	-9.4	-10.4
Current account % GDP	3.2	2.1	2.1

UK

Country report

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Economic summary

December 2009

- The UK looks set to be the last of the major economies to emerge from recession if, as recent indicators suggest, gdp growth moves back into positive territory in the fourth quarter. Still, the recovery is likely to be a slow and protracted one. Amid high levels of debt, continued credit constraints and ongoing uncertainty about the economic outlook, both households and businesses are expected to continue to pay down debt. A further downside risk is the state of the UK's public finances, with fiscal policy set to tighten considerably from 2010. Despite the competitive boost imparted by the fall in sterling's exchange rate, the hoped for rebalancing away from consumer spending towards net exports has yet to fully materialise. For this to occur, the UK exchange rate is likely to have to fall further.
- Over the coming year, we expect unemployment to continue to rise, peaking at just below 3 million in mid-2010. Encouragingly, the recent pace of unemployment has slowed markedly. Nonetheless, we would caution against reading too much into this. It appears to largely reflect the desire of firms to hoard labour and cut hours worked instead. Nonetheless, we expect conditions to steadily improve. The unprecedented monetary stimulus has already boosted asset prices; credit conditions, while tight, have eased; and the global economy is on a recovery path. As these improvements start to bite, UK gdp growth should steadily recover. Overall, we expect real gdp to contract by 4.5% this year, before rising by 0.8% in 2010 and 2.1% in 2011.
- Over the coming months, the reversal of the VAT cut and base effects associated with higher petrol price inflation are forecast to push the annual CPI from 1.5% currently towards 3%. Over the medium term, however, CPI inflation is forecast to gravitate back towards the government's 2% target, weighed down by high unemployment and a large output gap. Longer term, there are risks: the fall in sterling, rising commodity prices and the degree of monetary policy stimulus all have the capacity to push inflation up sharply, but not, we suspect, until demand is on a much firmer footing.

Chart 1: UK: A broad-based downturn

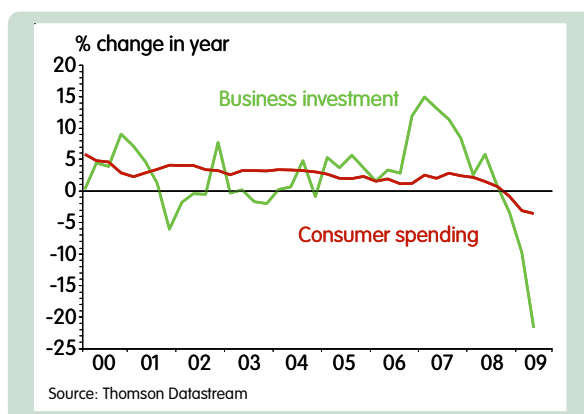


Chart 2: Current debt levels look unsustainable

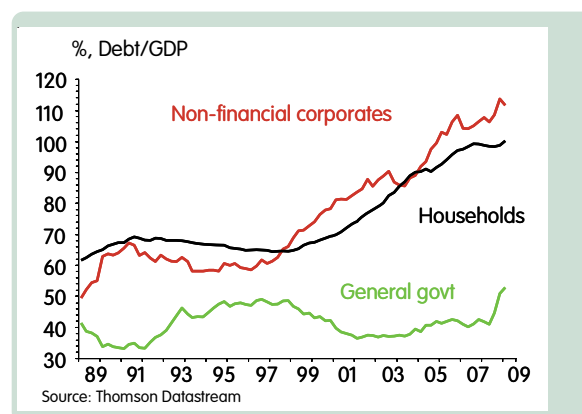


Chart 3: Fall in sterling should aid rebalancing

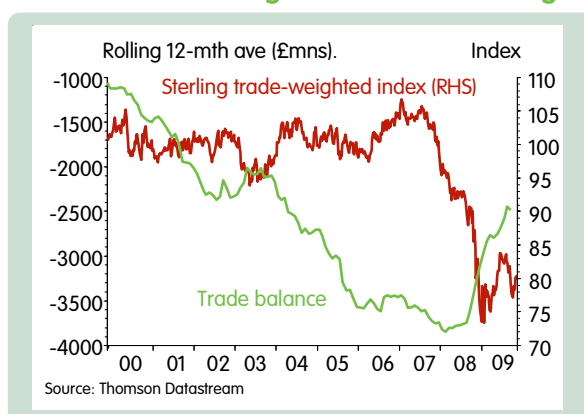


Table: Key UK macroeconomic forecasts

UK	(Yr % chg unless stated)	2008	2009e	2010f
Real GDP		0.6	-4.5	0.8
Household consumer spending		0.9	-3.1	-0.5
Gross investment		-3.3	-15.2	-3.2
Government consumption		2.5	2.1	0.7
Exports		1.0	-10.4	3.4
Imports		-0.7	-12.5	0.7
Industrial production		-3.1	-9.9	0.7
Unemployment rate (% Q4)		6.5	8.4	8.7
CPI		3.6	2.0	2.3
Budget balance % GDP (cal yr)		-5.2	-12.0	-13.3
Current account % GDP		-1.6	-2.3	-1.9

Canada

Country report

Mark Miller +44 (0)20 7574 8649

Economic summary

December 2009

- Gdp data show that the Canadian economy has now emerged from recession. But the underlying position remains fragile, with quarterly annualized growth of just 0.4% in Q3. Monetary and fiscal stimulus, lower market risk premia and encouraging signs from business surveys all augur well for activity in Canada looking ahead. The Ivey PMI survey has been trending higher since March and at 61.2 in October, is currently hovering near an 18-month peak. In addition, the upswing in global commodities clearly benefits Canada's resource-rich economy. Canada's close trade links with the US should prove positive for its net trade outlook, provided that the US economic recovery continues.
- The flip-side of this is continued CAD strength in an environment where the US dollar continues to weaken in response to firmer economic indicators. Encouragingly, however, demand for a country's exports is typically a more important consideration for net trade than movements in the bilateral exchange rate. In any case, we expect CAD strength to be an essentially short-term development, as the US dollar stages a broad-based rally from early next year. So going forward, given improving financial market conditions, we anticipate a reasonable mix of growth between domestic demand and net exports. Our gdp forecasts stand at -2.7% and 2.6% for 2009 and 2010, respectively.
- But other things equal, recent CAD strength implies weaker inflation pressures going forward, via lower import prices. Indeed, the Bank of Canada now sees CPI returning to its 2.0% target in 2011Q3 - one quarter later than it thought likely in July. In October, CPI was just 0.1% higher than a year ago and recent currency appreciation is likely to act as a further drag on prices. This explains the Bank's strategy of stating that the key overnight target rate is likely to stay at its existing low level (0.25%) well into next year. This policy seems designed to raise inflation expectations. The Canadian swap yield curve is steep from the one-year time horizon onwards.

Chart 1: Business surveys are looking promising...

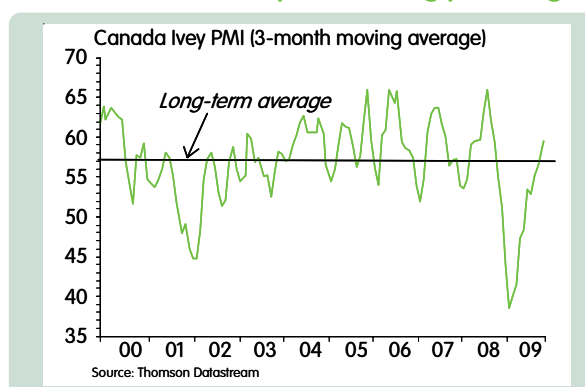


Chart 2: ...and credit conditions are improving

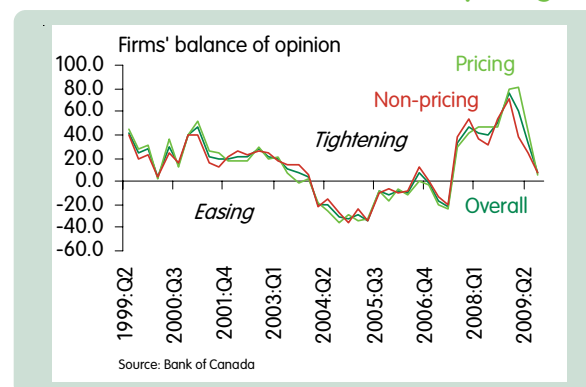


Chart 3: ...while the CAD has strengthened recently

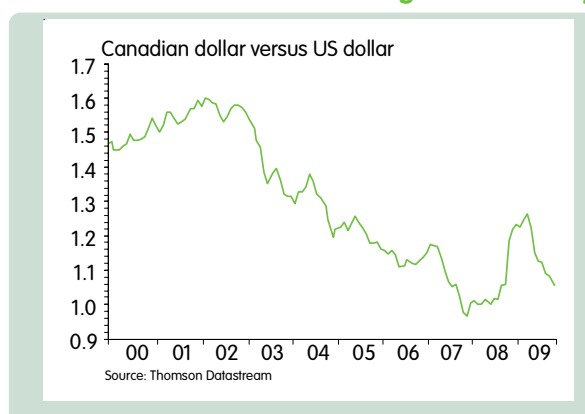


Table: Key Canadian macroeconomic forecasts

Canada (Yr % chg unless stated)	2008	2009e	2010f
Real GDP	0.4	-2.7	2.6
Household consumer spending	3.0	-0.2	2.6
Gross investment	0.9	-10.8	1.5
Government consumption	3.7	2.5	2.7
Exports	-4.7	-15.6	4.3
Imports	0.8	-17.1	7.1
Industrial production	-4.2	-11.2	2.2
Unemployment rate (% Q4)	6.4	8.7	9.0
CPI	2.4	0.2	1.5
Budget balance % GDP (cal yr)	1.6	-2.9	-2.8
Current account % GDP	0.5	-2.3	-2.1

Australia

Country report

Mark Miller +44 (0)20 7574 8649

Economic summary

December 2009

- The Reserve Bank of Australia (RBA) raised its cash rate by 25bp, to 3.75%, in early December following a similar move in November. Australia has avoided technical recession and is benefiting from a pick-up in activity among other Asia-Pacific countries, notably China. Indeed, recent business surveys show confidence at above-average levels and labour market conditions have deteriorated by less than originally expected by the RBA. Employment has risen in three of the past four months helped in part by the continuing commodities boom. Meanwhile, credit conditions have been mixed - but favourable compared with many western economies. Secured credit to households, for example, is running at healthy levels reflecting robust housing market conditions. Uncertainties remain, but these trends continue to equate to an environment of broad-based AUD strength.
- The AUD has recently strengthened to a 16-month high versus the US dollar, though we look for some unwinding of these gains from Q1 next year as the US economic recovery gathers pace. Against the EUR, we look for a relatively longer period of AUD appreciation, in part reflecting relative interest rate differentials. The RBA's cash rate is likely to rise further during the course of next year in contrast to the ECB's refinancing rate, which we expect to remain at 1% through to end-2010. Our end-2010 EUR/AUD target stands at 1.41 (while for AUD/USD it is 1.13).
- The Australian swap yield curve is still relatively steep in the 1- to 5-year area. Chinese demand for Australia's commodities seems unlikely to fade quickly, suggesting that economic activity will continue to perform relatively well. As noted elsewhere, a significant slowdown in China is possible although an effective re-pegging of the renminbi against the US dollar is a potentially important backstop. Together with Australia's banking sector being less affected by the financial crisis compared with many other developed economies, the RBA seems poised to continue raising its key policy rate into next year. From 3.75% at present, our end-2010 cash rate forecast stands at 4.5%.

Chart 1: Business surveys have turned higher

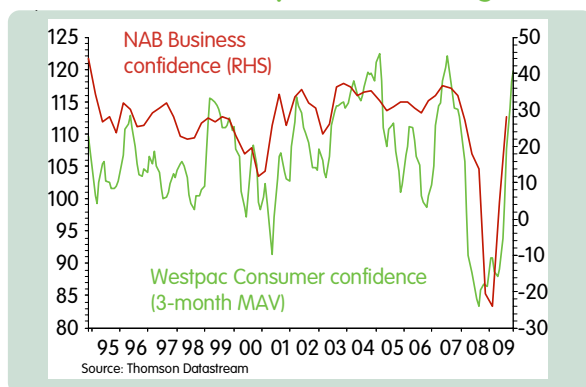


Chart 2: Employment: Crisis? What crisis?

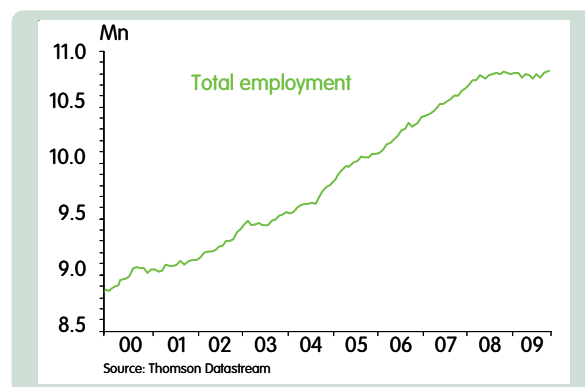


Chart 3: Interest rates already moving up

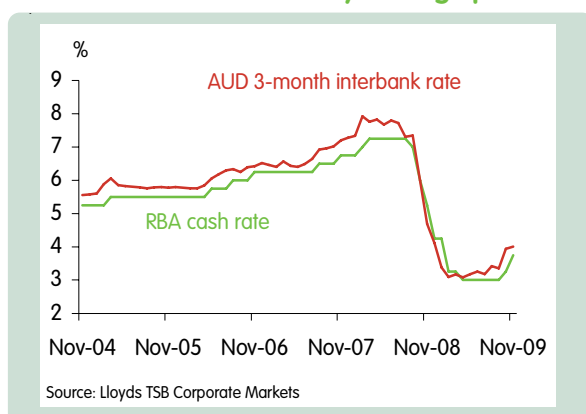


Table: Key Australian macroeconomic forecasts

Australia (Yr % chg unless stated)	2008	2009e	2010f
Real GDP	2.4	1.0	2.7
Household consumer spending	2.6	1.6	2.2
Gross investment	9.6	-2.2	3.2
Government consumption	4.1	2.2	1.6
Exports	3.8	1.3	3.5
Imports	11.3	-7.9	10.3
Industrial production	2.8	-3.0	1.5
Unemployment rate (% Q4)	4.5	5.9	6.0
CPI	4.4	1.8	2.6
Budget balance % GDP (cal yr)	1.2	-4.1	-2.9
Current account % GDP	-4.6	-4.2	-4.4

Switzerland

Country report

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Economic summary

December 2009

- Recently published figures confirmed that the Swiss economy expanded by 0.3% in the third quarter of 2009, ending a series of four consecutive quarterly declines. Near-term, the recovery is likely to remain underpinned by a rebound in export activity, reflecting stronger demand from Switzerland's main trade partner, Germany, and Asia. Private consumption, which has expanded quite briskly in recent quarters, may be more subdued in coming quarters, as unemployment continues to rise. We predict the economy will contract by 1.7% in 2009, which compares favourably with the EU-27 average of 3.7%. Real gdp growth of 1.3% is pencilled in for 2010, a slightly stronger pace to that projected for the EU-27.
- Inflationary pressures are likely to remain muted, reflecting the large negative output gap which is likely to widen further next year. After remaining negative for the majority of this year, we forecast annual CPI inflation to turn positive in coming months as base effects related to falling energy prices last year continue to fade. We forecast annual average CPI inflation of -0.4% in 2010, rising to 1.2% in 2011.
- Although Switzerland's large banking sector represents a potential key risk to its financial stability should global economic conditions deteriorate, its underlying economic fundamentals remain favourable. After a modest surplus this year, a budget deficit of 1.6% of gdp is forecast for 2010, while outstanding debt represents less than 50% of gdp. The current account balance should remain in healthy surplus.

FX forecasts

- Growing concerns about deflation has led the Swiss national bank (SNB) to pursue an unconventional policy of purchasing foreign currencies to prevent the franc from further appreciating against the euro. The policy started in March and the chart below shows that it has been successful in reducing volatility in Eur/Chf, with the rate remaining in a narrow band between 1.54 and 1.50 since its inception. We expect this policy to potentially remain in place in for the majority of 2010 but some other 'unconventional' measures may be withdrawn sooner. Reflecting this, our latest forecast shows Eur/Chf rising modestly over the forecast period to 1.54 at end 2010, from 1.51 currently. It is worth noting though that while the SNB is looking to prevent appreciation of the franc (effectively limits downside for Eur/Chf beyond 1.50), there is a risk that other factors could also put upward pressure on Eur/Chf. \$/Chf has recently eased to parity but we currently predict it to rise to 1.17 by end June 2010, before gaining to 1.23 at end-2010.

Interest rate outlook

- The SNB is likely to retain its current expansionary monetary policy stance until well into 2010, with signs of sustainable recovery the most important consideration before tightening policy. We forecast the target range for three-month libor to remain at 0-0.75%, with the aim of keeping the target rate close to 0.25%. Ahead of raising interest rates, the SNB is expected to announce that it will no longer purchase Swiss franc corporate bonds, leading the three month libor rate to gravitate higher within its range.

Chart: The Swiss franc at parity to the US \$

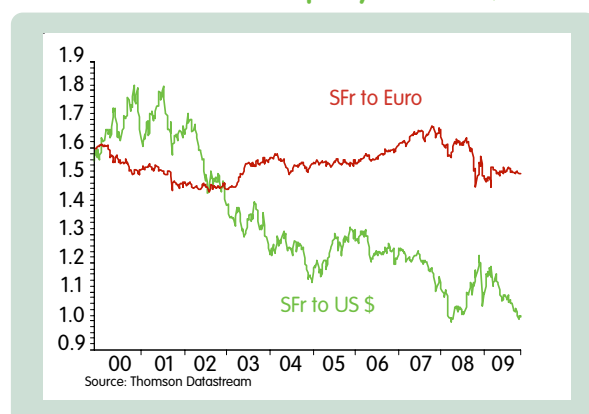


Table: Key Swiss macroeconomic forecasts

Switzerland (Yr % chg unless stated)	2008	2009e	2010f
Real GDP	1.8	-1.7	1.3
Household consumer spending	1.7	0.9	-0.2
Gross investment	0.4	-3.7	-1.1
Government consumption	-0.1	2.9	0.5
Exports	2.9	-12.0	3.5
Imports	0.5	-8.7	0.2
Industrial production	1.4	-11.5	1.9
Unemployment rate (% Q4)	2.7	4.6	4.6
CPI	2.4	-0.4	1.2
Budget balance % GDP (cal yr)	0.8	0.1	-1.6
Current account % GDP	1.6	8.4	9.1

China

Country report

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Economic summary

December 2009

- Chinese gdp expanded by 8.9% in the year to 2009Q3. This was the second consecutive increase in the pace of economic activity following the 6.1% trough in gdp growth recorded in Q1. Much was made of China's efforts to strengthen its currency against the US dollar during mid-2005 to July 2008 (it abandoned the old renminbi peg of 8.28 in July 2005). But since the economic and financial crisis started to impact more meaningfully, the Chinese government has put this renminbi adjustment on hold, action apparently opposed by the People's Bank of China (PBoC) who recently suggested the currency should be determined principally by market forces. The renminbi has remained broadly stable against the US dollar since mid-2008. This move, combined with a government stimulus package aimed at boosting lending by state-owned banks is likely to ensure that the official government target of 8% gdp growth will be easily exceeded this year (see table). Forward-looking business surveys suggest as much. At 55.2 in November, the Chinese manufacturing PMI survey registered its ninth consecutive monthly expansion. There are, however, lingering concerns that the sheer scale of the increase in bank lending could be associated with a build-up of bad loans, potentially prompting a slowdown in activity. There are also worries that too much of the recent stimulus package has been directed towards asset markets such as property and stocks and not enough to households and firms. Our own forecast for Chinese growth in 2010 stands at 9.5%, following an 8.7% pace of growth this year although as noted above, some downside risks should be acknowledged.

FX forecasts

- By effectively re-pegging the renminbi to the US dollar, China has protected itself against a slowdown in the pace of infrastructure spending growth and a build-up of spare capacity in the industrial sector. We do, however, look for the renminbi to resume its appreciation versus the dollar during the course of 2010, but at a significantly slower pace compared with the mid-2005 to mid-2008 period. This represents a form of monetary policy tightening in response to a robust pace of economic activity. Our end-2009 target stands at 6.80, while for end-2010 and end-2011 it is 6.61 and 6.38, respectively.

Interest rate outlook

- China's one-year lending rate (currently at 5.31%) and deposit rate (2.25%), have been steady since late last year. But while the degree of economic momentum in China is clear, caution on the part of the Chinese authorities over wider global economic prospects suggests that the PBoC is unlikely to sanction rate increases in the short term at least. Assuming some exchange rate appreciation, we think that such a rate move could take place towards the end of next year.

Chart: China's manufacturing sector is growing

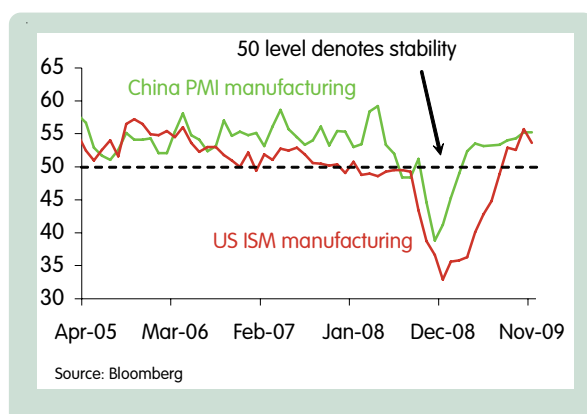


Table: Key China macroeconomic forecasts

China (Yr % chg unless stated)	2008	2009e	2010f
Real GDP	8.9	8.7	9.5
Household consumer spending	8.1	11.4	9.7
Gross investment	8.5	18.0	7.9
Government consumption	9.6	15.1	11.2
Exports	8.6	-17.3	10.3
Imports	6.2	-9.0	12.0
Industrial production	9.3	8.4	10.2
Unemployment rate (% Q4)	4.2	4.2	4.1
CPI	5.9	-1.0	1.1
Budget balance % GDP (cal yr)	1.0	-1.5	-2.4
Current account % GDP	9.8	5.7	4.3

India

Country report

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Economic summary

December 2009

- Although we expect India to be among the fastest growing nations in 2010, real gdp growth of around 6.8%, up from 6.4% in 2009, will be significantly below the 9.5% pace averaged in 2005-7. However, we look for India's growth rate to accelerate in future years, particularly if crucial economic reforms are finally undertaken by the latest congress party-led United Progressive Alliance (UPA) coalition. India urgently needs to improve its basic infrastructure platform to sustain faster economic growth as frequent bottlenecks lead to capacity problems and stoke inflationary pressures. Investment in areas such as transport infrastructure, would also support increased foreign direct investment.
- Looking more closely at near-to-medium-term prospects, we expect economic growth to be underpinned by recovering private consumption and investment spending, while government stimulus spending should also remain considerable. There are also growing signs that exports are picking up at a good clip, buoying manufacturing production. In fact, led by a sharp pick-up in manufacturing output, annual real gdp growth accelerated for the second consecutive quarter to 7.9% in Q3 2009, in spite of the weakest monsoon rains since 1972.
- As well as impacting growth, the weak monsoon has also stoked inflationary pressures. Food shortages have caused prices to surge, leading both wholesale and consumer price inflation to reach double digits. This has raised pressure on the Reserve Bank of India (RBI) to start to tighten monetary policy.
- Government spending has been raised significantly in response to the slowdown and ahead of the recent election. However, the budget position has deteriorated significantly and will need to be addressed to limit 'crowding out' of private investment. The budget deficit is likely to exceed 10% of gdp in 2009.

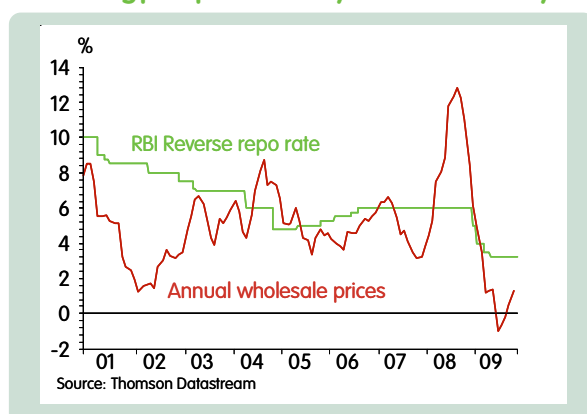
FX forecasts

- Over the past year, the Indian rupee has mainly traded in a relatively narrow band against the US \$ between 46 and 50. We forecast \$/Inr at the lower end of this range in the year ahead, with a target of 47.0 at end-2010. The authorities may even tolerate a stronger currency, if inflationary pressures intensify. The rupee should be supported foreign capital inflows attracted by India's comparatively robust economic growth rate and higher interest rate yields. The main downside risks for the rupee stem from India's weak fiscal position and any intensification of generalised global risk aversion, which has the potential to hit most emerging market currencies.

Interest rate outlook

- The RBI has taken initial steps to tighten monetary policy, including raising the statutory liquidity ratio and closing some special refinancing facilities. We believe rising inflationary pressures and growing confidence about recovery will lead it to raise its benchmark interest rates early next year. We look for the repo rate to increase to 6% by end Q2 2010, from 4.75% currently.

Chart: Rising price pressures may see RBI hike in early 2010 Table: Key India macroeconomic forecasts



India	(Yr % chg unless stated)	2008	2009e	2010f
Real GDP (cal yr)		7.5	6.4	6.8
Household consumer spending		3.7	2.3	6.0
Gross investment		9.0	4.2	8.1
Government consumption		19.5	10.2	7.8
Exports		17.4	-4.9	8.2
Imports		27.9	-15.6	8.5
Manufacturing production		4.4	6.5	7.6
CPI		8.3	10.1	7.6
Budget balance % GDP (fiscal yr)		-10.7	-10.3	-9.6
Current account % GDP		-3.1	-0.9	-1.9

Brazil

Country report

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Economic summary

December 2009

- Brazil's economy has proved surprisingly resilient to the global financial crisis, posting just two quarters of contraction and resuming growth in the second quarter of 2009. Although we look for real gdp to contract by 0.4% in 2009, there is a possibility that a particularly robust performance in the second half of this year could yet see modest growth for this year as a whole. We forecast real gdp growth to accelerate to 3.6% in 2010, with the risks biased to the upside.
- Boosted by both fiscal and monetary stimulus, domestic demand has rallied. A banking system largely untainted by the problems facing most developed economies has meant that credit availability has been less impaired. Furthermore, the banking sectors' reliance on foreign borrowing for domestic credit provision was also more limited than in most emerging markets. We see consumer spending growth slowing to 2.8% in 2009, from an average of close to 5% in the previous five years, before recovering to around 4% in 2010. Strong job creation recently saw the unemployment rate fall to its lowest level this year. Improving business confidence should see investment spending rebound by 6.6% in 2010, following a sharp fall this year, while government spending could pick up slightly to 3.6%.
- Robust external demand for Brazil's key commodity exports is another major plus for the economy. However, after posting a sizeable trade surplus in 2009, we expect rising import demand to significantly trim this next year, reducing the contribution to gdp growth from net trade. Encouragingly for Brazil, fast-growing China became its largest trade partner earlier this year and the discovery of significant offshore oil fields suggests it has the potential to also become a major oil exporter in the future.
- The economic slowdown has led annual inflation to slow markedly, while inflation expectations have also moderated. The widening output gap should keep downward pressure on prices in the year ahead. We forecast CPI inflation to average 4.9% in 2009 and 3.7% in 2010, from 5.7% in 2008.

FX forecasts

- So far in 2009, the Brazilian real has been the best performing currency against the US \$, rising by over 30%. It has primarily been underpinned by foreign portfolio capital inflows, hoping to take advantage of Brazil's more favourable economic prospects and the relatively high yield on its domestic assets. However, reflecting the often speculative nature of these flows and possibly the current strength of the currency, the Brazilian authorities have taken steps to limit such inflows, including the new 2% IOF tax. This could temper gains in the near-term. Our forecast shows \$/Brl rising to 1.80 at end Q2 2010.

Interest rate outlook

- The relatively benign inflationary backdrop suggests that the central bank can afford to hold off from raising policy rates until after Q1 2010. However, much depends on the pace of economic recovery and inflation expectations. We look for the SELIC overnight rate to potentially exceed 10% by end-2010.

Chart: Brazil introduces controls to limit capital inflows

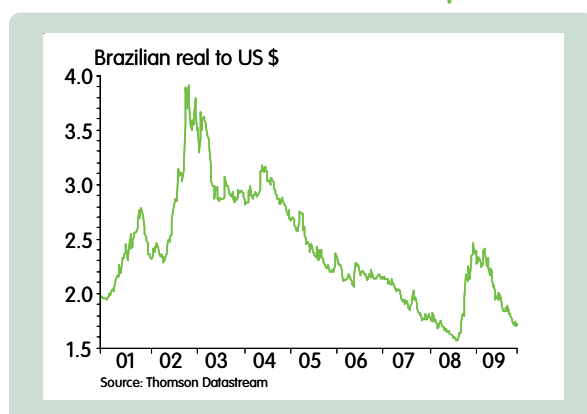


Table: Key Brazil macroeconomic forecasts

Brazil	(Yr % chg unless stated)	2008	2009e	2010f
Real GDP		5.1	-0.4	3.6
Household consumer spending		5.4	2.8	3.9
Gross fixed investment		13.9	-14.6	6.6
Government consumption		5.7	3.0	3.6
Exports		-0.6	-9.9	5.8
Imports		18.8	-13.4	9.0
Industrial production		3.0	-8.0	6.4
Unemployment rate (% Q4)		7.3	7.5	7.2
CPI		5.7	4.9	3.7
Budget balance % GDP (cal yr)		-1.9	-4.3	-3.2
Current account % GDP		-1.8	-1.1	-1.5

Other G10 & E10 economic forecasts

Italy (Yr % unless stated)	2008	2009E	2010F
Real GDP	-1.0	-4.8	1.0
Household consumer spending	-0.9	-1.8	-0.1
Gross investment	-2.9	-12.8	-0.5
Government consumption	0.7	1.8	1.6
Exports	-3.7	-21.2	1.8
Imports	-4.5	-16.6	-1.2
Industrial production	-3.4	-17.5	2.3
Unemployment rate (% , Q4)	7.0	9.2	8.8
CPI	3.4	0.8	2.0
Budget balance % GDP (cal year)	-2.7	-5.4	-6.6
Current account % GDP	-3.4	-3.2	-3.0

Germany (Yr % unless stated)	2008	2009E	2010F
Real GDP	1.0	-4.8	1.5
Household consumer spending	0.2	0.8	-0.5
Gross investment	2.3	-8.6	1.3
Government consumption	2.0	2.5	0.7
Exports	2.4	-15.3	4.3
Imports	3.9	-9.6	1.7
Industrial production	0.0	-16.9	1.8
Unemployment rate (% , Q4)	7.6	8.2	9.2
CPI	2.7	0.4	1.9
Budget balance % GDP (cal year)	-0.2	-4.3	-4.8
Current account % GDP	6.6	4.2	5.2

Spain (Yr % unless stated)	2008	2009E	2010F
Real GDP	0.9	-3.6	-0.7
Household consumer spending	-0.6	-5.1	-0.9
Gross investment	-4.4	-15.8	-8.1
Government consumption	5.5	4.5	2.2
Exports	-1.0	-13.5	2.3
Imports	-4.9	-20.5	-3.3
Industrial production	-7.6	-16.2	-1.5
Unemployment rate (% , Q4)	13.9	19.3	20.0
CPI	4.1	-0.4	1.0
Budget balance % GDP (cal year)	-3.8	-11.3	-10.7
Current account % GDP	-9.6	-5.2	-3.9

France (Yr % unless stated)	2008	2009E	2010F
Real GDP	0.3	-2.3	1.2
Household consumer spending	1.0	0.6	0.1
Gross investment	0.4	-6.7	0.0
Government consumption	1.1	1.5	1.3
Exports	-0.6	-10.8	4.3
Imports	0.6	-10.1	1.4
Industrial production	-2.6	-11.7	1.3
Unemployment rate (% , Q4)	7.8	9.7	11.0
CPI	2.8	0.1	1.8
Budget balance % GDP (cal year)	-3.4	-8.3	-8.7
Current account % GDP	-2.3	-1.5	-1.2

Netherlands (Yr % unless stated)	2008	2009E	2010F
Real GDP	2.0	-4.1	0.8
Household consumer spending	1.3	-2.5	-0.4
Gross investment	4.9	-10.6	0.5
Government consumption	2.0	3.5	3.9
Exports	2.7	-9.9	4.7
Imports	3.7	-8.9	5.4
Industrial production	1.5	-10.3	1.6
Unemployment rate (% , Q4)	3.9	5.7	7.0
CPI	2.5	1.2	0.8
Budget balance % GDP (cal year)	0.7	-3.5	-4.9
Current account % GDP	4.8	4.5	3.4

South Korea (Yr % unless stated)	2008	2009E	2010F
Real GDP	2.2	0.2	4.5
Household consumer spending	0.9	0.2	3.3
Gross investment	-1.7	-0.7	3.3
Government consumption	4.2	6.0	2.8
Exports	5.7	-0.5	10.1
Imports	3.7	-9.0	10.3
Industrial production	3.1	-0.8	10.5
Unemployment rate (% , Q4)	3.1	3.7	3.7
CPI	4.7	2.7	2.1
Budget balance % GDP (cal year)	1.3	-3.2	-2.3
Current account % GDP	-0.4	5.1	2.3

Russia (Yr % unless stated)	2008	2009E	2010F
Real GDP	5.6	-9.1	3.4
Household consumer spending	11.2	-7.4	1.2
Gross investment	10.0	-17.2	1.9
Government consumption	2.5	1.8	2.7
Exports	0.5	-9.8	3.3
Imports	15.0	-32.4	11.7
Industrial production	2.5	-10.2	6.3
Unemployment rate (% , Q4)	6.4	8.4	8.7
CPI	14.1	11.7	8.5
Budget balance % GDP (cal year)	4.2	-7.0	-5.7
Current account % GDP	6.2	3.9	3.7

Mexico (Yr % unless stated)	2008	2009E	2010F
Real GDP	1.4	-6.7	4.6
Household consumer spending	1.6	-5.3	4.2
Gross investment	5.0	-11.2	2.4
Government consumption	0.6	1.7	1.9
Exports	1.6	-15.4	12.4
Imports	4.6	-16.9	9.0
Industrial production	-0.9	-7.3	6.2
Unemployment rate (% , Q4)	4.3	6.5	5.4
CPI	5.1	5.4	4.1
Budget balance % GDP (cal year)	-1.3	-3.2	-2.3
Current account % GDP	-1.5	-1.4	-1.0

Turkey (Yr % unless stated)	2008	2009E	2010F
Real GDP	0.9	-5.6	4.0
Household consumer spending	-0.1	-2.5	3.9
Gross investment	-5.0	-20.5	6.7
Government consumption	1.9	3.1	2.9
Exports	2.3	-6.6	5.2
Imports	-3.8	-18.2	9.6
Industrial production	-0.9	-11.0	6.2
Unemployment rate (% , Q4)	12.6	14.9	13.8
CPI	10.4	6.2	7.3
Budget balance % GDP (cal year)	-1.9	-6.4	-4.4
Current account % GDP	-5.6	-2.1	-3.3

South Africa (Yr % unless stated)	2008	2009E	2010F
Real GDP	3.1	-2.1	1.0
Household consumer spending	2.3	-2.8	0.4
Gross investment	10.2	-0.3	-6.7
Government consumption	5.0	3.9	3.0
Exports	1.8	-19.8	7.7
Imports	2.2	-16.4	7.5
Industrial production	0.8	-13.5	4.7
Unemployment rate (% , Q4)	21.9	27.7	28.0
CPI	9.9	7.3	5.6
Budget balance % GDP (cal year)	-0.5	-6.0	-6.1
Current account % GDP	-7.4	-4.9	-5.4

Poland (Yr % unless stated)	2008	2009E	2010F
Real GDP	5.1	1.4	1.1
Household consumer spending	5.3	3.3	0.3
Gross investment	8.2	-1.3	0.8
Government consumption	7.1	2.1	0.6
Exports	5.8	-10.2	2.2
Imports	6.1	-14.6	1.9
Industrial production	2.3	-4.7	3.4
Unemployment rate (% , Q4)	9.1	11.2	11.8
CPI	4.4	3.9	3.5
Budget balance % GDP (cal year)	-3.7	-5.3	-6.8
Current account % GDP	-5.1	-1.0	-1.4

Indonesia (Yr % unless stated)	2008	2009E	2010F
Real GDP	6.1	4.1	4.5
Household consumer spending	5.3	4.8	4.3
Gross investment	11.7	2.9	2.6
Government consumption	10.4	11.6	4.6
Exports	9.5	-10.9	6.1
Imports	10.0	-15.4	6.9
Industrial production	3.0	0.9	2.8
Unemployment rate (% , Q4)	8.1	10.0	9.5
CPI	9.9	5.1	4.9
Budget balance % GDP (cal year)	0.2	-2.5	-2.5
Current account % GDP	0.1	1.0	0.9



Financial market trends - as at 1 Dec 09

Fixed income

% unless stated	Latest	-1m	-3m	-1yr	1yr bp chg
US 2yr yields	0.66	0.91	0.90	0.89	-22
US 10yr yields	3.29	3.41	3.31	2.67	62
US 2/10yr spd bps	263	250	241	179	84
EZ 2yr yields	1.25	1.30	1.17	2.12	-87
EZ 10yr yields	3.19	3.24	3.23	3.05	14
EZ 2/10yr spd bps	194	194	206	93	100
UK 2yr yields	1.17	0.90	0.90	1.77	-59
UK 10yr yields	3.59	3.66	3.55	3.48	11
UK 2/10yr spd bps	242	276	265	172	70
JP 2yr yields	0.18	0.26	0.25	0.56	-37
JP 10yr yields	1.26	1.39	1.32	1.36	-10
JP 2/10yr spd bps	107	113	107	80	27
CAD 10yr yields	3.25	3.42	3.35	3.15	10
AUD 10yr yields	5.32	5.52	5.39	4.34	98
MOVE Index	87.5	113.5	135.0	213.3	-126

Short-term market interest rates

% unless stated	Latest	-1m	-3m	-1yr	1yr bp chg
US 3m Libor	0.26	0.28	0.33	2.22	-196
bps	12	13	16	185	-173
Ted spread	0.22	0.22	0.22	2.18	-196
EZ 3m Libor	0.68	0.67	0.79	3.82	-314
bps	24	22	39	166	-142
UK 3m Libor	0.61	0.59	0.68	3.88	-327
bps	19	20	34	251	-232

Commodities

	Latest	-1m	-3m	-1yr	1yr % chg
WTI crude oil, \$/bbl	78	79	70	60	30
Gold, \$/oz	1,215	1,060	979	782	55
Silver, \$/oz	19	16	15	10	101
Copper, \$/tonne	7,075	6,480	6,200	3,590	97
Aluminium, \$/tonne	2,103	1,908	1,845	1,735	21
Corn, \$/bushel	413	396	333	408	1
Wheat, \$/bushel	584	537	505	609	-4
Soybeans, \$/bushel	1,059	998	954	863	23
Baltic Dry Index	3,836	3,103	2,423	700	448

Swaps

% unless stated	Latest	-1m	-3m	-1yr	1yr bp chg
US 3yr swaps	1.56	1.85	1.86	2.18	-63
US 5yr swaps	2.39	2.66	2.65	2.58	-20
US 2/10yr spd bps	83	81	80	40	43
EZ 3yr swaps	2.10	2.23	2.16	3.08	-98
EZ 5yr swaps	2.65	2.75	2.72	3.27	-62
EZ 2/10yr spd bps	170	171	171	60	111
UK 3yr swaps	2.33	2.60	2.62	3.04	-70
UK 5yr swaps	3.04	3.28	3.33	3.35	-30
UK 2/10yr spd bps	202	195	198	85	117
CAD 5yr swaps	2.45	2.78	2.59	2.10	35
AUD 5yr swaps	5.71	5.97	5.69	4.74	96

Credit markets

Index	Latest	-1m	-3m	-1yr	1yr % chg
Itraxx 5yr EUR CDS	85.3	89.3	98.5	184.4	-99
Itraxx 5yr crs over	526.7	526.1	621.1	942.4	-416
US IG index	102.6	107.9	124.5	259.5	-157

Sov 5yr CDS

bps	Latest	-1m	-3m	-1yr	1yr bp chg
US	32.1	19.3	23.0	49.4	-17.3
Japan	68.8	61.5	38.1	52.0	16.9
Germany	22.5	20.7	23.1	40.5	-18.0
UK	70.2	48.1	57.8	104.5	-34.3
France	26.6	23.0	22.5	55.3	-28.7
Italy	87.7	73.2	78.9	165.0	-77.3
Spain	84.3	73.1	70.7	103.7	-19.4
Australia	37.5	33.7	43.6	94.2	-56.7
Netherlands	30.5	25.1	35.2	71.7	-41.3
China	87.5	81.5	87.5	232.5	-145.0
Brazil	121.1	135.7	142.4	348.1	-226.9
Russia	203.8	192.8	289.4	768.5	-564.7
Mexico	140.5	166.0	185.8	340.3	-199.8
South Korea	96.5	101.5	146.5	412.5	-316.0
Turkey	199.7	191.5	225.6	458.1	-258.4
Poland	119.8	114.2	125.4	244.2	-124.4
Indonesia	216.5	204.5	234.4	755.3	-538.8
South Africa	163.3	151.8	172.9	433.8	-270.5

Equity markets

Index	Latest	-1m	-3m	-1yr	1yr % chg
S&P 500	1,109	1,043	995	849	31
Dow Jones	10,472	9,789	9,281	8,419	24
Nikkei 225	9,609	9,803	10,280	7,864	22
Dax	5,767	5,431	5,320	4,532	27
CAC 40	3,772	3,639	3,573	3,153	20
FTSE 100	5,303	5,105	4,818	4,123	29
Shanghai SE	3,270	3,077	2,715	1,890	73
Sensex	17,152	15,896	15,467	8,739	96
Bovespa	68,408	61,546	55,386	35,001	95
WSE WIG 20	2,384	2,264	2,114	1,738	37
VIX Index	22	30	29	63	-65

Chart 1: 10-year bond yields pare back

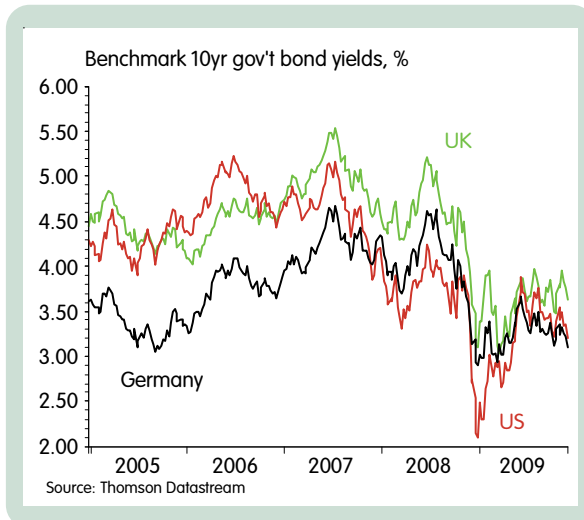


Chart 2: Libor/OIS spreads have fallen

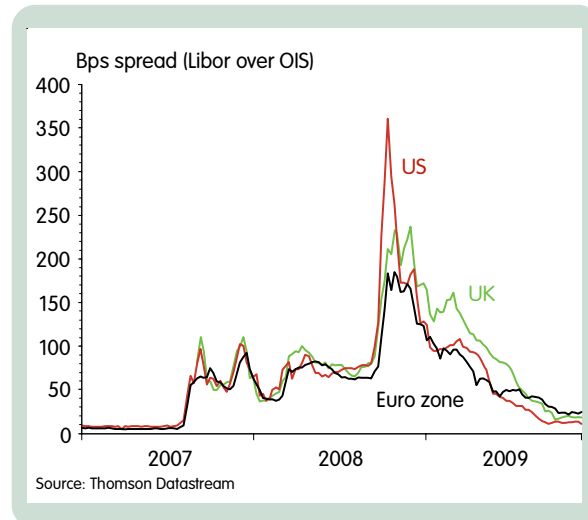


Chart 3: Emerging market spreads fall sharply

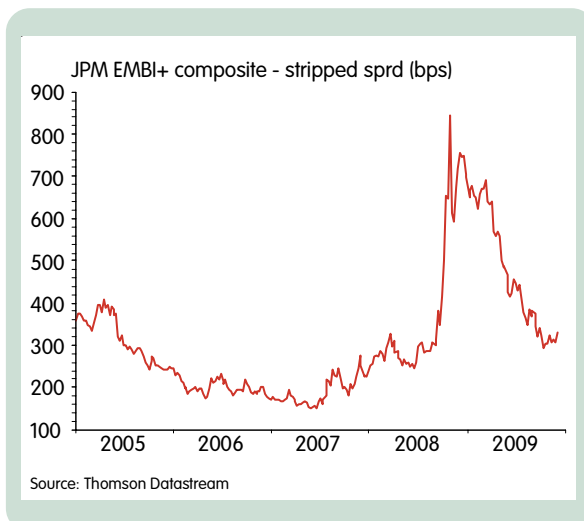


Chart 4: Gold and crude oil prices head higher

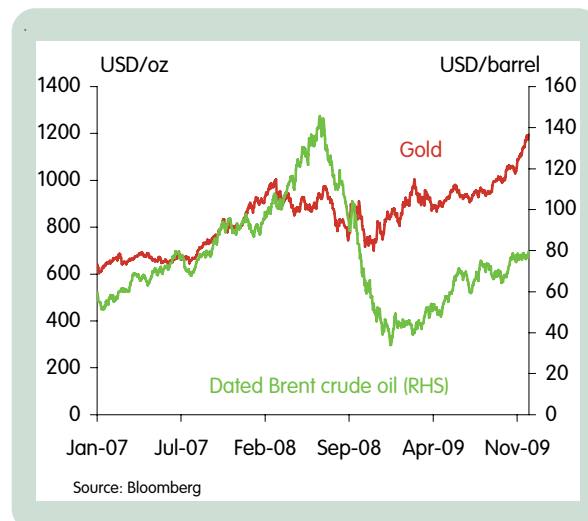
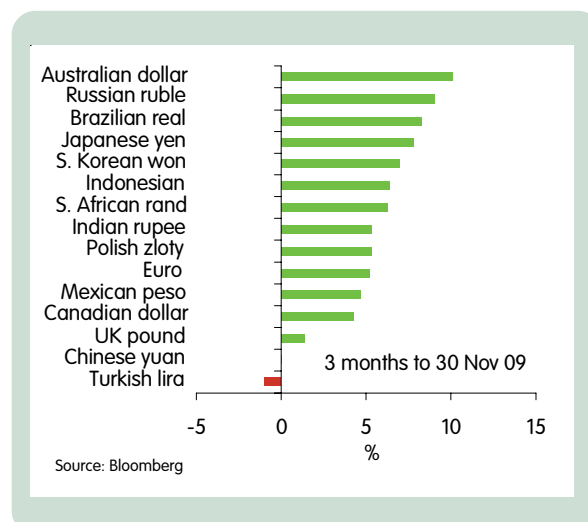


Chart 5: US \$ falls as global economy recovers



Chart 6: Our G10 & E10 - % change v US \$



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