Economics

Bank of America

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Global Economics & Financial Markets Weekly

Recession

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The official arbiters of business cycle dating have not yet weighed in, but almost all available data suggests that the US, the UK and Japan fell into recession during the summer and that the Eurozone has now followed suit. With many emerging markets also succumbing to the global financial storm, the last major pillar of support for the export-oriented economies of Japan and core Europe is crumbling. Over the last three weeks, as the financial crisis in confidence intensified, leading central banks in the Western world have pumped in liquidity and relaxed the terms for their liquidity operations so much that they have de facto taken over part of the money market functions. Last week's capital injections and extensive guarantees for bank funding by the US and European governments directly addressed the crisis in confidence. Initial improvements have begun to surface in financial markets: LIBOR spreads have narrowed, CP activity has re-emerged and private sector bond and equity issuance has risen. However, the credit crunch and the associated psychological damage now point toward deteriorating economic conditions in the Eurozone, UK and US. Restoring order in financial markets will take some time, during which high volatility will persist. Despite the support from lower oil prices, lower central bank rates in Europe and the US and some possible further fiscal stimulus on both sides of the Atlantic, the recession will last at least into early 2009.

Forecast Changes

- **Eurozone:** We reduce our 2009 GDP forecast from 0.1% to –0.2%. We expect the ECB to ease again in November and reach a 2.5% trough in spring 2009.
- **US GDP:** We cut our 2009 call from 0.4% to –0.5%.
- **UK:** We lower our 2009 GDP call from –0.1% to –0.5% and now expect the BoE to reduce the Bank rate to 2.50% by mid-2009 instead of 2.75%.

Key Events/Indicators

- **BoC (Tue 21):** Likely to cut the overnight target rate by 25bps to 2.25%
- **Riksbank (Thu 23):** Look for an unchanged repo rate at 4.25%

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Strategy Highlights

Currency Strategy

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USD index has come off its recent highs as tensions in money markets ease

- The USD index has come off its recent highs as tensions in the money markets have started to ease, removing the dollar bid created by the extreme shortage of USD liquidity. The first major level of support would be seen at 80.39, the 23.6% retracement of the rise from the July low to the October 10 peak.
- EUR/USD may have bottomed out for the year. Indeed, the pair's recent failure to close below its 200-week moving average did suggest that additional losses could be limited. As USD Libor continues its descent and the dollar "recouples" with the weak US economic fundamentals, we expect EUR/USD to climb higher. Our year-end forecast remains at 1.4500.
- EUR/GBP has slipped as Euribor has eased to a greater extent than GBP Libor. Indeed, the 3-month Euribor — OIS spread has declined by nearly 40bp since October 10, while the equivalent rate for GBP funding has fallen by only 5bp. As these tensions in the GBP Libor market ease and the BoE eases aggressively, we look for EUR/GBP to print new record highs.
- USD/JPY has declined precipitously in recent weeks as risk aversion has increased. Further turmoil in the financial markets could push USD/JPY closer to its March 2008 low of 95.78. The potential for increased expectations of additional monetary easing from the Federal Reserve also creates downside risks for the pair.

Fixed Income Strategy

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Governments take capital stakes in banks

- Treasuries sold off on the Treasury's decision to invest capital directly into banks through the TARP. Yet, signs that the economy is in a recession have helped Treasuries to recoup most of their losses near the end of the week. Consumer spending looks to have declined more than 3% in 3Q, which would be the weakest result since 1980.
- The Treasury financed its needs this past week with cash management bills (CMBs). With an expanded budget deficit, TARP and a possible second stimulus plan under a new president, the FY 2009 financing need looks to be $1.5tn. The Treasury is unlikely to be able to finance that with CMBs and the current auction schedule (even with the resumption of 3-year issuance), so we expect additional snap reopenings, especially with the shortage of repo collateral in the 5-year sector.
- In Europe, we expect rates to fall and the yield curve to steepen further. We believe that the swap curve will steepen more than the bond curve on a three-month view, as ASW spreads tighten relatively more at the front end, where they are still abnormally high. The tightening may be modest, though, as long as the equity markets are in panic mode and risk aversion is high.
- In addition, we believe that the Euro swap curve is too flat on a forward basis and will ultimately fall as investors realise that the ECB and the BoE will not reverse their rate cuts by the end of next year, as the market is currently discounting.

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Emerging Market Strategy

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Short-lived relief rally...volatility and discomfort remain

- Recent G7 policy proclamations and follow-up measures by individual governments represented an unusual show of force by the official sector throughout the world. The depth and breadth of actions and proposals should help truncate “tail risk” through the offer of substantial guarantees and assistance to financial institutions. The unprecedented move by officials helped reverse adverse sentiment in various financial markets including those in Emerging Market economies—albeit temporarily. Although we expected the “relief rally” to fade quickly, the duration lasted hours rather than days.

- In coming days, Emerging financial markets will likely remain adversely impacted by outsized volatility and the substantial slowdown in global economic activity. The volatility of the Bank of America EM overall currency index spiked over the last week, reaching 19.2% or above the previous historical high of the index (17.2%) experienced coincident with the Asia Crisis. In fact, recent volatility of the index even surpasses peak currency fluctuations in other reputed financial market crises such as the correction in the NASDAQ in 2000-01 and even the Tequila crisis back in 1995. Typically, volatility remains elevated before reverting to lower levels. We measure the volatility of the index based on a 22-day moving average of annualized observations.

- Ripples from the global financial crisis will likely take the form of substantially lower economic growth with even more limited prospects for a meaningful increase in commodity prices. Both factors served to substantially bolster EM financial markets coincident with the meaningful rally in EM commencing 2003. However, a slide in economic activity and weaker demand for commodities should exert a similar—but opposing—influence, auguring for a weaker recovery in coming weeks. The Bank of America economics group now expects a slowdown, followed by a contraction in economic activity. For example, real GDP will likely essentially halt with growth a mere 0.1% in 3Q on a qoq seasonally adjusted annual basis with a drop of 2.6% in 4Q and a further slide of 0.2% in 1Q 2009. Likewise, the composition of US growth is likely to be skewed toward government spending and exports to the rest of the world rather than personal consumption and investment—which would prove more supportive of emerging financial market prospects.

- Going forward, wider fluctuations of asset prices coupled with lower commodity prices make investment in Emerging financial markets relatively less attractive with the prospect for continued swings in currencies.

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United States: Economic Reports Flash Recession

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Amid tentative signs that government attempts to unclog the credit markets may be starting to work, last week's economic releases pointed to recessionary conditions. Large broad based declines in September retail sales indicated that consumption is declining rapidly this quarter, following a sizable drop in Q3, while manufacturing activity is in free fall. Falling consumer confidence is likely to further delay housing recovery. Combined with a large-scale reduction in capital spending plans, we foresee a substantial recession lasting into at least 1Q 2009, with sharp rises in unemployment extending past midyear.

While recessionary conditions have arrived, the size of the declines will depend in part on the timing and pace of credit market repair

As term Libor rates cautiously crept lower last week and volatile equity markets showed some signs of stabilizing amid an easing of panic, economic reports began to confirm that the financial crisis and credit market dysfunction of recent weeks has already done significant damage to the real economy. How much economic activity will be lost remains highly uncertain, with the timing and pace of repair in credit market conditions extremely speculative and the psychological impact of the financial crisis on highly interdependent consumer and business behavior difficult to guage. But the early returns indicate steep decline.

We estimate that consumer spending fell 3.6% annualized in 3Q 2008 and will fall even more rapidly in 4Q

According to the September retail sales report, consumer spending continued to weaken last month, as falling employment and declining home and equity valuations, combined with steadily increasing financial turmoil. Sales fell for a third consecutive month and by over a full percent, and July and August sales estimates were also revised downward. Overall retail sales fell an estimated 1.2% in September, while ex-auto retail sales fell 0.6%. Sales ex-auto and gasoline, a closer proxy for the portion of retail sales used in GDP measurement, fell 0.7% in September, following a downwardly revised 0.6% decline in August. Almost all categories of retail sales fell in September. While health and personal care store sales rose 0.4%, general merchandise stores, food services and drinking places, nonstore retailers, sporting goods stores, and electronic and appliance stores all reported declines. We estimate a large 0.5% decline in real consumption in September, likely to be the 4th consecutive monthly drop. We estimate that real consumption fell 3.6% annualized in 3Q 2008 and is likely to fall even more rapidly in 4Q.

Manufacturing surveys also indicate rapid decline in factory activity in recent weeks

Manufacturing surveys also indicate rapid decline in factory activity in recent weeks. The Philadelphia Fed Business Outlook Survey weakened sharply in October, exhibiting recessionary conditions. The overall survey reading for current conditions was –37.5, the weakest reading since 1990. Orders and shipments fell rapidly, with the new orders index (–30.5) at its weakest since 1980. Employment weakened, and pricing power also diminished. The Empire manufacturing survey showed similar results. While regional surveys have their limits, they likely provided a better indicator of the ongoing production response to falling consumer and business demand than the September industrial production report which was highly influenced by hurricane activity and the Boeing strike.

Housing activity also has weakened further in recent weeks, aggravated by the deteriorating financial conditions

Housing activity also has weakened further in recent weeks, aggravated by the deteriorating financial conditions. The National Association of Homebuilders (NAHB) index set another all-time low in October, with predictions of future activity showing clear weakening following recent modest signs of improvement. Single-family housing starts also fell 12.0% in September, their largest drop in almost two years, as declines accelerated anew. The September level of single-family starts was last seen during the recession in 1982.

We now foresee a substantial recession with sharp rises in the unemployment rate

Based on these reports and typical cyclical responses of capital spending and inventory building during times of significant decline in consumer spending and domestic final sales, we estimate that GDP will fall 1.4% over the 4 quarters ending mid-year 2009, with a 3.9% annualized GDP decline this quarter. We also expect the unemployment rate to rise above 7.5% in the 2H 2009.

Figure 1. US Economic Indicators

Day	GMT	Indicator	For	BAC	Mkt	Last
Mon 20	14:00	Leading Indicators	Sep	-0.1%	-0.2%	-0.5%
Thu 23	12:30	Jobless Claims	Wk 10/18	n.a.	465k	461k
Fri 17	14:00	Existing Home Sales	Sep	4.90mn	4.98mn	4.91mn

Source: Bank of America, Bloomberg and Haver Analytics.

Leading Indicators

The Conference Board's index of leading economic indicators, which posted declines in July (–0.7%) and August (–0.5%), is expected to post a small decline in September. Rising initial claims, falling stock prices and building permits, and a shrinking factory workweek were likely negative contributors to the index. Surprisingly large offsets came from a rebound in consumer expectations, the steep yield curve, a jump in the money supply and longer delivery times.

Existing Home Sales

Over the past ten months, existing home sales have held within a narrow range of 4.85 million to 5.03 million. We anticipate that sales remained in that range in September. A jump in pending home sales may have indicated nascent stability in the existing home sales market. However, the financial market dysfunction that grew last month and the impact of hurricane activity likely offset the positive indications from pending sales. Going forward, the financial crisis and worsening economic conditions will push home sales even lower.

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Japan: More Downward Forces on Economy, Low Probability of BoJ Rate Cut

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The global financial crisis has intensified downward forces on economic activity. An expected tightening of banks' lending stance will probably add to downside risks to the economy. In response to the deeper economic slump, the Bank of Japan (BoJ) will probably show a more flexible stance, but we expect no change in the overnight rate target (currently 0.50%) throughout 2008-2009.

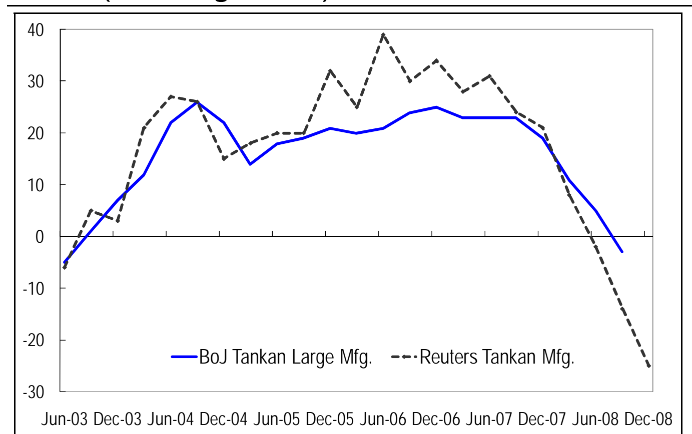
The global financial has added to downward forces on economic activity

The global financial crisis has intensified downward forces on economic activity through a cooling-down of sentiment, deteriorating global demand prospects and tighter financial conditions. The seasonally adjusted Consumer Confidence Index dropped from 32.3 in 2Q to a record low of 31.2 in 3Q on the back of growing concerns about employment and income. Falling equity prices must have added to the sentiment setback as well. The yoy drop in nationwide department store sales widened to –4.7% in September from –3.1% in August, although the deterioration was probably exaggerated by two fewer holidays versus a year ago. According to Reuters' Tankan survey of major non-financials, the manufacturing business conditions judgment index plummeted from –14 in September to –25 in October, the lowest since June 2002, led by assembly industries facing rapidly deteriorating export prospects.

Banks' tighter lending stance will probably hurt economic activity further

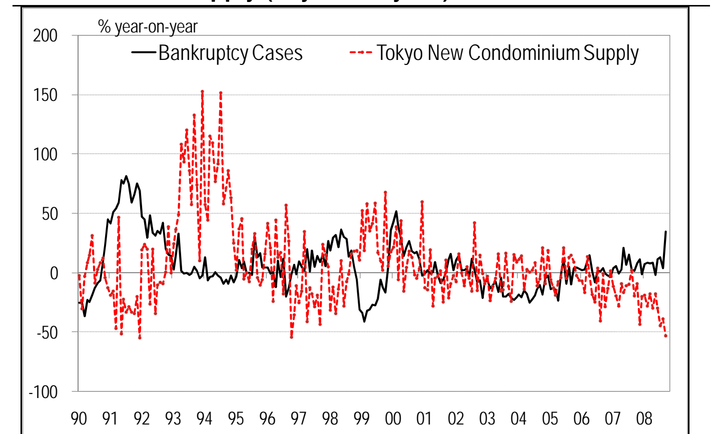
Of particular concern is the high probability of tighter bank lending stance. In FY2007 (to March 2008), after-tax net income plunged by 42% for 11 major banks and by 21% for 110 regional banks (on a parent basis), already suggesting some balance sheet constraints affecting banks' lending and investment activities. The subsequent deepening of the economic slump suggests a cyclical increase in problem loans. According to the Tokyo Shoko Research, bankruptcy cases surged by 34.5% yoy in September (+4.2% yoy in August), the highest since March 2000, suggesting growing credit costs. Moreover, the worsening real estate market bust will probably prompt collateral value-sensitive banks to be increasingly cautious toward real estate-related loans. Tokyo new condominium supply plunged by 53.3% yoy in September, the sharpest since October 1996, following August's 38.8% decline. Moreover, the recent plunge in equities probably should add to banks' balance sheet constraints, with the TOPIX down by 26% since the start of FY2008.

Figure 2. Japan: Major Manufacturers' Business Conditions Indexes (Percentage Points)



Sources: Bank of Japan and Reuters

Figure 3. Japan: Bankruptcy Cases and Tokyo New Condominium Supply (% year-on-year)



Sources: Tokyo Shoko Research and Bloomberg

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The probability of a BoJ rate cut is low, in our view

In response to the deeper economic slump, the BoJ will probably show a more flexible stance, but we expect no change in the overnight rate target (currently 0.50%) throughout 2008-2009. We attach the probability of about 30% for a 25bp rate cut by 1Q 2009, as the rate cut option will probably be reserved for an emergency like a domestic financial crisis. In its semi-annual outlook report to be released on October 31, the Policy Board is highly likely to downgrade its growth forecasts for FY2008-09, so their policy stance language will probably emphasize greater flexibility. Our own real GDP growth forecast is 0.0% for FY2008 and 0.7% for FY2009, and the Policy Board's central forecast will probably be only slightly higher than our numbers and well below their potential growth estimate range of 1.5-1.9%. Barring a renewed upward trend in oil prices, we expect core inflation (excluding fresh food) to peak in 3Q 2008 and to slip below 2% yoy in December 2008. We expect average core inflation to slip from an estimated 1.9% in FY2008 to 0.9% in FY2009, just below the midpoint of the BoJ Policy Board's "medium-term price stability range" of 0-2%. We would expect the BoJ Policy Board's revised central forecast of core inflation to be little different from ours.

Room for JGB yield declines

Despite pessimism about the economy and risk aversion, position unwinding pressures due to the global financial crisis and declining risk-taking ability have limited JGB yield drops so far. However, as the global market environment will probably stabilize thanks to major countries' bank rescue initiatives, there should be room for JGB yield declines in coming months. The Aso Administration will announce another economic support package during the week of October 27, perhaps including a personal income tax cut of ¥1-2tn, small firm finance support, a re-introduction of the precautionary bank recapitalization scheme, and public investment spending. However, the enactment of the second supplementary budget to implement the economic package will probably be delayed until early 2009. Meanwhile, progress in global bank rescue initiatives have limited risks of panicky risk aversion causing a JPY surge, but upside risks to the JPY are not likely to dissipate anytime soon.

Figure 4. Japan Economic Indicators

Day	GMT	Indicator	For	BAC	Mkt	Last
Mon 20	01:00	Bond Transactions, Major Bank Net Purchases of JGBs (¥)	Sep	n.a.	n.a.	43.4bn
	23:50	Bank Lending Stance Survey, Corporate Funding Demand	4Q	n.a.	n.a.	-14
Tue 21	23:50	All Industry Activity Index mom	Aug	-1.7%	-1.7%%	0.8%
Wed 22	05:00	Supermarket Sales yoy	Sep	n.a.	n.a.	-1.0%
	23:50	Trade Balance (¥, nsa)[1]	Sep	576bn	610.0bn	1608.7bn
		Adjusted Trade Balance (¥)		-67bn	131.2bn	-113.3bn
	23:50	Foreign Bond/Note Investment (¥)	Oct 12 - 18	n.a.	n.a.	793.4bn

[1] The last value refers to the year-ago level. Source: Bloomberg, Reuters and Bank of America estimates.

Bank Lending Stance

The BoJ's quarterly bank lending stance survey should underscore a deepening slump in corporate funding demand and a clear tightening of banks' lending stance.

All Industry Activity Index

The August all-industry index likely dropped by 1.7% mom (up by 0.8% mom in July), based on tertiary industry activity index data, leaving the July-August average 0.6% below the 2Q 2008 level.

Supermarket Sales

The adverse combination of the financial market turmoil and two fewer holidays versus a year ago probably led to a wider yoy decline in department store sales from -1.0% yoy in August.

Customs-clearance Trade

The September unadjusted trade balance likely maintained a surplus, which narrowed sharply to an estimated ¥576bn from ¥1.61tn a year ago, however. The seasonally adjusted trade balance will probably post a modest deficit of ¥67bn in September, smaller than August's ¥113.3bn. Nominal export growth likely picked up to 6.0% yoy in September from 0.3% yoy in August partly because of the low level posted a year ago, and September real exports probably rose slightly mom.

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Eurozone: The ECB Is Doing Whatever it Takes

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The ECB is taking extremely bold measures to unclog the money market, by fully reforming its liquidity injection procedures, loosening collateral rules and embarking onto currency swaps with private banks. This is starting to improve conditions on the money market. However, it is probably too late to avoid a recession. We now think that the ECB may further relax monetary policy as soon as November, instead of December previously.

Spectacular steps to unclog the interbank market

Last week, the ECB took further spectacular steps to unclog the interbank market, acting on the auction method for longer-term refinancing operations and addressing the collateral shortage issue to maintain sufficient access to liquidity on the interbank market and more directly steer money market rates down beyond the overnight maturity. A reduction of the 3 month and 6 month rates is crucial to mitigate the spreading of the banking system problems to the real economy. Those maturities are widely-used bases for loans to corporations and individual borrowers granted on a variable rate basis. The ECB is trying to ensure that at least a significant share of the 50 bp rate cut to which it consented on October 8 will be effectively passed to the rest of the economy. By significantly broadening its already relatively loose collateral rules and by embarking on — unsecured — currency swaps with banks, the ECB is taking more risk onto its balance sheet. The ECB may have taken its time, but one has to admit that it is now fully acknowledging the depth of the credit market crisis and is ready to make radical moves to mitigate its impact on the real economy.

A reform of the main refinancing operation the week before

The week before, the ECB had already magnified the impact of its 50 bps rate cut by reforming its main refinancing operation. Instead of an auction in which cash-constrained banks are led to bid at a high interest rate to be certain to obtain liquidity, banks will be served at a fixed interest rate, and will receive the full amount of liquidity that they asked. The ECB also lowered the cost of holding "precautionary liquidity" by narrowing the "interest rate corridor": while the main refinancing rate was taken down by 50 bps to 3.75%, the deposit facility rate through which banks can unload their excess liquidity onto the ECB was maintained at 3.25%. Under the previous system, the deposit facility rate would have been lowered to 2.75%.

Reform of the long term refinancing operations last week

Last week, the ECB announced that fixed-rate, full allotment auctions will also be used in the Longer Term Refinancing Operations (LTRO) at 3 and 6 months, instead of the previous competitive bidding procedure. Between July and October 2008, the effective average interest rate paid in the 6 month LTROs shot up by 54 bps to 5.57% on account of the extreme reluctance of banks to lend to each other, which encourages them to draw abnormally high levels of liquidity from the ECB.

More frequent LTROs

Of course, LTROs cannot totally control the money market, since they represent only a fraction of the amounts traded on the interbank markets. However, the ECB has announced that it will dramatically step up the frequency of the LTROs in the coming months. For instance, the outstanding 6-month LTRO maturing in January 2009 will be rolled-over, and four additional 6-month LTROs in November, December, February and March. This will have a significant impact on the effective interbank interest rates, in our view, but in order to quantify this effect, we need to see where the ECB will set the fixed interest rate for the LTROs. The first auctions under the new regime will be conducted on October 28 (3 month) and November 11 (6 month). The ECB will probably choose to set the interest rate noticeably below the current market rates on 3 and 6 month maturities, but still at a comfortable margin from the overnight rate to reflect the extra risk taken by the ECB in those longer-term refinancing operations.

Looser collateral rules

On the same day, the ECB announced that it will broaden the range of collateral eligible to its refinancing operations (securities the banks give to the ECB in exchange for central bank money). This is a spectacular U-turn from last month, when the ECB restricted eligible collateral from February 2009 onward. This decision may be a response to reports of a shortage of good quality collateral for some cash-constrained banks. These banks will now have more paper to mobilize in exchange for ECB refinancing.

Lower credit ratings, foreign currency paper

The most striking change is the lower rating threshold for eligible paper. At least until the end of 2009, the ECB will accept securities with ratings down to BBB- instead of A- previously, except for ABS. However, an additional 5% haircut will be imposed on BBB- paper, to reflect the additional risk taken by the ECB on its balance sheet. The ECB will also accept additional asset classes as collateral, such as marketable debt instruments denominated in USD, GBP and JPY, if they are issued in the Eurozone, with an additional haircut of 8%. Previously, only euro-denominated paper was eligible.

Unsecured currency swaps with banks

Furthermore, the ECB is taking further steps to address the shortage of dollars in the Eurozone. The ECB had already set up a currency swap line with the Fed. Eurozone banks could obtain dollar liquidity from the ECB in exchange for collateral. On top of this facility, they will from now on engage into "straightforward" euro/dollar swaps with banks. There are probably two main reasons behind this decision. First, currency swaps address the collateral shortage issue since they do not entail pledging securities as guarantee. Second, currency swaps are more flexible than the formal auctions under the ECB/Fed agreement. This will enable the ECB to steer more tightly the cost of dollar funding in Europe. It is also a discreet and potentially powerful tool to ensure that the most cash-constrained banks in the Eurozone get access to dollars.

The ECB has significantly raised its tolerance to risk

At the beginning of the crisis, the ECB had repeatedly stated that its monetary policy framework was particularly adapted to respond to a liquidity crisis. Indeed, collateral rules were much less restrictive in the Eurozone than in the US and the UK. By changing its framework now, the ECB makes another U-turn after the change of tack on the monetary policy stance on October 8. The ECB has significantly stepped up its tolerance to risk. True, additional haircuts provide some protection and offset top some extent the deterioration in the average quality of the ECB balance sheet, but the by launching unsecured swaps, the ECB has accepted a significantly increased counterparty risk on top of a new exchange rate risk. The naturally prudent ECB is now ready to do whatever it takes to keep the money market in working order.

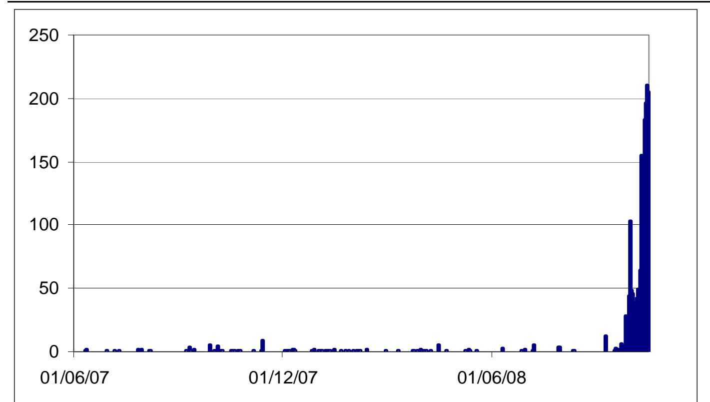
Some tentative impact on money market conditions, but tension remains high

These bold steps, on top of the European bank rescue plan and the 50 bps cut in the policy rate are starting to have a tangible impact on money market conditions. The 3 month LIBOR fell to 5.02% on October 17, 37 bps below a recent peak at 5.39% on October 8. The differential vis-à-vis 3-month Treasury bills has started to come off (see Figure 5). This is still not a full transmission of the policy rate cut but an indication that the money market is starting to unclog. Still, tension remains high and banks continue to maintain huge precautionary liquidity, as shown by the amount of cash they unload onto the ECB through the deposit facility (€204bn on 16 October, only marginally below the all-time-high €210bn on 15 October—see Figure 6).

Figure 5. 3-Month EURIBOR – 3-Month T-Bill

Source: ECB, Reuters

Figure 6. Use of Deposit Facility



Source: ECB, Bloomberg. €bn

We now expect the ECB to cut rates further as soon as November

Progress on the money market is likely to remain slow and a significant credit crunch in the Eurozone, noticeably hampering investment, is probably unavoidable. We expect GDP to decline by 0.2% in 2009 instead of growing by 0.1% previously. In these circumstances, time is of the essence. We, therefore, think that the ECB may cut rates further as soon as November, by at least 25 bps, instead of waiting until December to cut by 50 bps. In terms of fair value, we thing that pricing in a 30 bps cut for November and 50 bps for December is reasonable.

Figure 7. Eurozone Economic Indicators

Day	GMT	Country	Indicator	For	BAC	Mkt	Last
Mon 20	06:00	Germany	Producer Prices mom	Sep	-0.5%	-0.4%	-0.6%
			yoy		7.4%	7.6%	8.1%
Tue 21	-	Spain	Business Confidence	3Q	-18.0	n.a.	-14.0
Wed 22	08:00	Italy	Retail Sales (sa) mom	Aug	0.0%	0.1%	0.6%
			yoy		-0.7%	-0.6%	2.1%
	09:00	Eurozone	Deficit/GDP Ratio	2007	-0.6%	n.a.	-1.3%
			Debt/GDP Ratio		66.6%	n.a.	68.6%
Thu 23	06:45	France	Business Confidence Indicator	Oct	89	90	92
			Production Outlook Indicator		-46	-45	-42
	06:45	France	Household Consumption (sa) mom	Sep	-0.2%	-0.2%	-0.3%
			yoy		0.5%	0.5%	-0.1%
	08:00	Italy	Trade Balance (Non-EU, €)	Sep	n.a	n.a.	-2.1bn
	08:00	Eurozone	Current Account Balance (sa, €)	Aug	-1.9bn	n.a.	-1.7bn
	09:00	Eurozone	Industrial New Orders (sa) mom	Aug	0.6%	0.3%	1.0%
			(wda) yoy		-0.1%	-0.4%	1.6%
	13:00	Belgium	Business Confidence (sa)	Oct	-16.0	n.a.	-14.4
Fri 24	07:00	France	PMI Manufacturing (prel)	Oct	42.3	42.5	43.0
			PMI Services (prel)		49.5	49.6	50.1
	07:00	Spain	Unemployment Rate	3Q	11.6%	11.5%	10.4%
	07:30	Germany	PMI Manufacturing (prel)	Oct	46.0	46.3	47.4
			PMI Services (prel)		49.0	48.8	50.2
	07:30	Italy	Business Confidence (sa)	Oct	81.8	81.8	82.7
	07:30	Italy	Consumer Confidence (sa)	Oct	101.0	100.8	102.8
	08:00	Eurozone	PMI Manufacturing (prel)	Oct	43.7	44.0	45.0
			PMI Services (prel)		47.0	46.7	48.4
			PMI Composite (prel)		45.0	45.0	46.9

Source: Bloomberg, Reuters and Bank of America estimates.

French business confidence

Subdued consumer spending has already significantly weighed on manufacturing activity since the start of the year. Tighter financing conditions and bleak prospects for the global economy on the back the recent intensification of the credit market turmoil will probably have a noticeable impact on business investment. Accordingly, we expect the INSEE confidence index to fall further in October

Eurozone PMI

We expect the PMI index to fall further below stagnation territory in October, foretelling a serious recession in 4Q 2008 and 1Q 2009.

Bank of America

UK: Money Markets Start to Thaw But Economic Pain is Only Just Beginning

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Although global financial markets showed signs of pulling back from the precipice last week, this will not be enough to prevent a sharp slowdown in economic activity, either domestically or in the world at large, in our view. With the UK economy probably moving into recession last quarter and the contraction in activity probably extending into early next year, we expect to see a sharp further rise in unemployment over coming quarters. With GDP likely to fall 0.5% over the course of next year, the BoE is likely to ease monetary policy significantly in coming months—despite inflation reaching a fresh 16 year high in September—with the Bank Rate falling to 2.5% during 2Q 2009.

Money markets start to thaw ….

The cumulative effect of the £400bn UK bank bailout plan, which was subsequently paralleled by a remarkable pan-European effort to support its banking system to the tune of €1.1bn as well as a US package worth some $250bn, led to some stabilization in financial markets last week. Most importantly, the benchmark 3-month libor rates in the money market pulled back modestly from their highs set 2 weeks ago. Three-month dollar libor has fallen some 30bps over the past week to 4.5% while the equivalent euribor rate has declined 35bp to 5.04%. The UK remains the laggard, with 3-month sterling libor down only 10bp, to 6.18%. In our view, the ECB has been more aggressive than the BoE in its efforts to liquefy money markets. Last week, for instance, the ECB announced that its term 3-month and 6-month lending would be one on a full allotment, fixed rate basis. By contrast, the BoE is still conducting its term auctions on a minimum-bid rate basis which may partly explain the relative stickiness of sterling libor rates. In any case, inter-bank lending rates still remain significantly elevated. However, the declining spread over the central bank base rates suggests a sliver of confidence is now returning into the market.

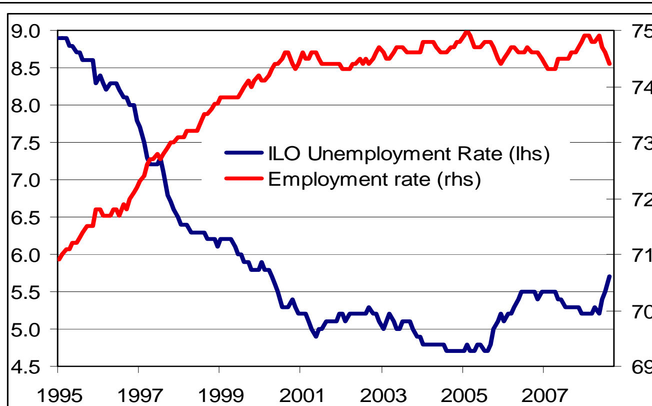
… but economic pain is only just beginning

Against the admittedly very tentative signs that the credit freeze was beginning to thaw, equity markets were subject to a torrid week as concerns over recessionary economic conditions returned to the fore. After last Monday's 8% relief rally to 4,257, the FTSE 100 had lost much of these gains by the end of the week, closing at 4,063. A key macro-economic driver for the equity sell-off in the UK was last Wednesday's labour market data, in our view, which painted a grim picture of the impact from the sharp slowdown in economic activity. Of most concern, we see the current deterioration in the labour market as only the start of a process that is likely to see unemployment rise further by up to half a million by the end of next year.

Jobless claims up for the 8th consecutive month

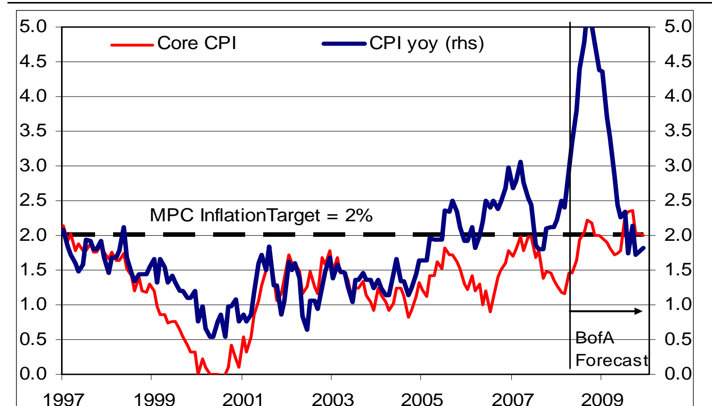
Jobless claims rose a further 31.8k in September, the 8th consecutive monthly increase. Claims have risen around 130k so far this year, the largest such increase since the early 1990's recession. The claimant count unemployment rate picked up last month to an 18-month high of 2.9% from 2.8%. Separately, the internationally comparable ILO measure—which includes all individuals out of work but still actively looking for a new job, not just those receiving benefit—recorded that the unemployment rate rose to a fresh 7-year high of 5.7% from 5.5%. This entailed an increase in the level of unemployment between the quarter to May and the quarter to August of 164k, the largest quarterly increase in 17 years.

Figure 8. Unemployment Rising Sharply



Source: ONS.

Figure 9. Inflation Surge to Peter Out Soon



Source: ONS and BofA forecasts.

Vacancies and employment are falling

As businesses downsize, both vacancies and employment rates have declined. Since the start of this year, the number of vacancies has fallen 66k, to 610k, an almost 2-year low. Most of the decline this year has come from the services sector (–53k), with financial services contributing a 24k drop and retail & distribution eliminating 32k potential posts. Employment is also falling. In the latest 3 months to August, total employment declined 122k since the quarter to May, a fall that has lowered the employment rate 0.4%, to 74.4% over the same period.

Downward pressure on wages

The deterioration in the labour market is likely to be a key factor keeping downward pressure on wages going forward. Headline average earnings growth, already muted, revealed further signs of easing in August, dipping to 3.4% on the 3-month average of the year-over-year rate—a 5-year low—from 3.5%. Ex-bonus earnings also softened, to 3.6% 3m yoy from 3.7% in July. The MPC's "pain threshold" for earnings growth is probably much higher at around 4.5%, in line with the trend pace of nominal GDP growth (2.5% real GDP + 2% CPI inflation target).

Surge in CPI inflation to a fresh 16 year high of 5.2% is very much yesterday's news, in our view

With the labour market unraveling fast and wage growth muted, the surge in CPI inflation to a fresh 16 year high of 5.2% in September from 4.7% in August is very much yesterday's news, in our view. For starters, oil prices have plunged some 50% since the mid-July peak of $147bbl. Producer data last week revealed that factory gate price inflation receded for the second consecutive month to 8.5% yoy in September having peaked at 10.0% in July. More fundamentally, the severe housing market correction and the unprecedented global financial market turmoil over the summer will likely lead to a substantial output gap emerging in coming quarters which should significantly restrain inflationary pressures, in our view.

CPI inflation likely to fall back to target by mid-2009, in our view

We predict that CPI inflation will fall below 4.0% during 1Q 2009 and move below 3% during 2Q, reaching the 2% target some time during 3Q 2009. Still, we would not be surprised if core inflation continued to edge up for the next month or two. Excluding energy, food, alcohol, and tobacco prices, the core CPI inflation rate jumped to 2.2% yoy last month—the highest rate since the measure was created in 1997—from 2.0% in August. This highlights that the increase in costs since late last year was still working its way through into underlying inflation last quarter. However, the collapse in commodity prices since mid-July and recessionary economic conditions imply that underlying inflationary pressures will begin to dissipate during 1H 2009, in our view.

Households under severe pressure

The ongoing global financial market turmoil, the correction in the domestic housing market and historically weak household disposable income growth from recent surges in energy costs and now rising unemployment will extract a heavy economic toll on the household sector, in our view. Survey data on retail spending continues to look gloomy as consumers pull back on non-essential purchases. Last week, the BRC's retail sales survey showed that spending on the High Street fell for the 4th consecutive month in September, with like-for-like sales 1.5% lower than a year ago. We expect consumer spending to decline 0.9% next year after a modest 2.0% rise this year. As a result, we now expect overall GDP to shrink by 0.5% in 2009.

Further significant easing from the BoE is likely, in our view

The UK economy probably moved into recession last quarter already. With the sharp contraction in activity likely extending into early next year, we expect to see an ongoing rise in unemployment over coming quarters. We believe that the ILO unemployment rate could peak at around 7.5% by the end of next year, entailing a more than 500k increase in the number of people without a job from the current 1.8mn level. With near-term inflation risks now firmly behind us, we expect the BoE to continue to lower the Bank rate substantially in coming months to shore up the faltering economy and fragile financial sector. We still look for a 50bp cut to 4.0% next month, although signs of stabilising financial markets suggest a risk of a smaller 25bp move instead. We expect the Bank rate to fall to 2.50% by mid-2009, with a growing chance of further easing into 2H 2009.

Figure 10. UK Economic Indicators

Day	GMT	Indicator	For	BAC	Mkt	Last
Sun 19	23:01	Rightmove House Prices yoy	Oct	-7.3%	n.a.	-3.3%
Mon 20	08:30	Public Sector Net Borrowing (£)	Sep	6.7bn	6.5bn	10.4bn
		Public Finances (PSNCR)		10.2bn	10.0bn	5.1bn
	08:30	M4 Money Supply (prel) mom	Sep	0.7%	0.9%	1.4%
		yoy		11.0%	11.2%	11.5%
Tue 21	10:00	CBI Industrial Trends Survey (monthly order books)	Oct	-30	n.a.	-26
		(monthly expectations)		-19	n.a.	-16
		(quarterly business confidence)		-44	n.a.	-40
Thu 23	08:30	Retail Sales (sa) mom	Sep	-0.9%	-0.6%	1.2%
		yoy		1.8%	2.2%	3.3%
	08:30	BBA Mortgage Approvals	Sep	20.0k	n.a.	21.1k
Fri 24	08:30	GDP (prel, sa) qoq	3Q	-0.2%	-0.2%	0.0%
		yoy		0.6%	0.5%	1.5%
	08:30	Index of Services 3m/3m	Aug	-0.2%	-0.1%	0.0%

Source: Bloomberg, Reuters and Bank of America estimates.

Public finances

With the economy slowing down sharply, public finances are under extreme pressure. We expect public sector borrowing to rise from £35.8bn in financial year 2007/08 to £56.5bn this financial year and £61.8bn in 2009/10, equivalent to 3.9% of GDP. This estimate does not include the additional borrowing for the Treasury's bank £50bn recapitisation plan which is roughly 3.5% of GDP. In terms of the total UK debt picture, the inclusion of the £50bn bank capitalization plan as well as the nationalization of Northern Rock and Bradford & Bingley will likely push the debt-to-GDP ratio close to 50%, in our view. There is also an open question of how the ONS treats the liabilities of those UK banks in which the government ends up having a significant stake in. For example, RBS's liabilities could add around £1.8tn to the government's balance sheet which would push the debt/GDP ratio up to 170%. It is worth noting, however, that the recent deterioration in the debt/GDP ratio—as well as the even worse scenario of adding a major financial institution's liabilities to the government's balance sheet—would be overstated as the ONS does not offset the liabilities from its bank recapitalizations or nationalized institutions against their non-liquid assets i.e. their mortgage books.

CBI Industrial Trends Survey

The manufacturing sector has already entered into recession in our view. According to official data, output fell 0.9% qoq in 2Q with the July/August average a further 0.9% below 2Q. We expect the CBI survey to record a further decline in the headline monthly order book balance to –30 in October which would be a 5-year low.

Retail Sales

Survey data has continued to paint a gloomy picture of the High Street. In September, the BRC's retail sales survey fell for the 4th consecutive month with like-for-like sales down 1.5% yoy. The CBI's survey did rebound to –27 in September from –46, although this was off a 25 year low. Amid the widely reported financial market turmoil last month, there are risks of a sharp pullback in spending, in our view.

3Q GDP

The first reading of GDP—based on the output approach which measures activity in the production and services sectors—is likely to show a 0.2% qoq fall, the first decline since 2Q 1992. We expect the contraction in activity to continue through the current quarter into early next year as the UK economy experiences a modest recession.

Other Europe: Norges Bank Joins the Party Late

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Amid unprecedented global financial market turmoil and a sharp slowdown in world economic growth, we believe that the Norges Bank will lower rates modestly further in coming months to 4.0% by 2Q 2009 with a chance of more aggressive easing.

Norges Bank cuts rates ahead of schedule

The Norges Bank cut its central bank rate by 50bps to 5.25% last week—a week after key central banks had slashed their base rates by a similar magnitude to help stave off a collapse in financial markets.

Norway's economy already showing signs of easing

Higher interest rates, a global credit squeeze and weakening foreign demand have already begun to put a brake on the previous robust Norwegian economy. GDP growth has halved over the past year, reaching a 4 year low of 3.6% yoy in 2Q 2008 after 4.1% in 1Q. The latest signs that the US, Eurozone and UK are either in, or close to, slipping into recession. The unprecedented financial market turmoil provides an additional drag on the Norwegian economy. The 50% plunge in oil prices since their mid-July peak of $147bbl will also undermine a key stimulus of growth in recent years.

Domestic slowdown is "faster and more pronounced" than expected

On cutting rates by 50bps to 5.25% at its earlier-than-scheduled October monetary policy meeting, the Norges Bank warned that the international crisis is having a greater effect on the domestic economy than it had previously thought. The statement also conceded that the slowdown in the domestic economy was "faster and more pronounced than before." Furthermore, it warned that the outlook for the global economy in 2009 has "considerably worsened." The Norges Bank also acknowledged that "the forces that have fuelled inflation have diminished." It also confirmed that the October Monetary Policy Report would be published as previously scheduled on October 29.

Clear easing bias

The Norges Bank statements would appear to signal a clear easing bias, in our view, making further rate cuts in coming months likely, at least to get rates down to more neutral levels. As a result, we look for a further 25bp cut to 5.0% in December and expect the deposit rate to be lowered to 4.0% by the end of 2Q 2009. The risk to the call is that ongoing weak economic data require more aggressive rate easing next year.

Figure 11. Other Europe Economic Indicators

Day	GMT	Country	Indicator	For	BAC	Mkt	Last
Tue 21	06:15	Switzerland	Trade Balance (CHF)	Sep	1.2bn	n.a.	1.4bn
	07:00	Switzerland	M3 Money Supply yoy	Sep	1.8%	n.a.	2.5%
Thu 23	07:30	Sweden	PPI mom	Sep	-0.6%	n.a.	0.1%
			yoy		2.6%	n.a.	3.8%

Source: Bloomberg, Reuters and Bank of America estimates.

Bank of America

Canada: Twice In October

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Decoupling gives way to a more difficult period

The market is looking for a 25bp cut by the BoC on Tuesday and we concur, expecting a quick follow up to the 50bp cut announced in the coordinated global action on October 8th.

Most Canadian economic indicators continue to fare better than their US counterparts, suggesting ongoing 'decoupling' through the early summer. For example, data this past week showed that Canadian auto sales are now 1% below their 2007 average but US car sales are 20% below. Canada has benefited from a diversion of its foreign trade to non-US trade partners and the terms of trade benefits of strong commodity export prices through mid year. Reflecting these benefits, Canadian real gross domestic income has grown faster (4.3% pa) than the standard real gross domestic product (2.5% pa) since the resources boom began. GDI has a better relationship with spending, tax revenue and jobs. That said, recent real export and manufacturing shipments data showed a further slide in the Canadian auto and forest product output sectors (already struggling from the US slowdown) but now with less offset from resilience and strength in other industries. With our US economists now expecting US final domestic demand to decline outright by more than 2.5% in the year ahead and trigger a deeper reduction in US import demand, this will have more impact on Canadian industries since 75% of Canadian exports are to the US. Yet Canada's economy will not now enjoy the 'cushion' from stronger non-US trading partner growth and high-flying prices for its resource exports have now sharply reversed. With this in mind the BoC is now likely to further cut its overnight interest target. The BoC joined the global rate cut action on October 8 with a 50bp reduction to 2.50%. The rate is now down 200bps since the global credit crunch started in July 2007, a more timely reaction than many central banks and more consistent with the neighboring Fed. A much smaller response of Canadian core and food inflation to the global liquidity surge in 1H 2008 than many countries experienced allowed the BoC to focus more on supporting growth than fighting inflation. Referencing the CAD, the October 8 statement said that 'the recent depreciation of the Canadian dollar will help cushion the effects of the weaker global outlook on the domestic economy, (but) it will not completely offset them'. The CAD TWI is down 8% since the October 8 rate move but oil prices are down 20%, the US economy has dropped away more than expected and the soft export and manufacturing reports may mean further downward revisions to Canadian GDP despite the shock upside surprise in Canadian September jobs. Important retail sales and CPI reports will be after this week's BoC meeting. We expect further 25bp cuts this Tuesday, December and January for a 'terminal' rate of 1.75%. The market is looking for either 2% or 1.75% as a terminal rate.

Figure 12. Canada Economic Indicators

Day	GMT	Indicator	For	BAC	Mkt	Last
Mon 20	12.30	International Securities Transaction – Inflow (CAD)	Aug	-3.0bn	+1.0bn	-5.6bn
		– Outflow (CAD)	Aug	-2.0bn	n.a.	-6.8bn
	12.30	Wholesale Sales mom	Aug	-0.8%	0.3%	2.3%
Wed 22	12.30	Leading Index mom	Sep	0.0%	0.1%	0.2%
	12.30	Retail Sales mom	Aug	-0.3%	0.2%	0.1%
		Ex Autos mom		0.2%	0.5%	0.4%
Fri 24	11.00	CPI yoy	Sep	3.2%	3.3%	3.5%
		Core CPI yoy		1.7%	1.7%	1.7%

Source: Bloomberg, Reuters and Bank of America estimates.

[5] *John Rothfield is a Bank of America GFX strategist. The opinions expressed by Mr. Rothfield should not be read as impartial because the relevant trading desk may have positions in, or be engaged in trading in, instruments referred to herein. For further information, please read the Bank of America NA (London) general policy statement on the handling of research conflicts, available on request.*

Bank of America

Australia/New Zealand: Bollard's Turn

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3Q 2008 inflation data in Australia and New Zealand will be mostly ignored as both central banks assumed that this would be the quarterly peak. More important will be speech by RBA Governor Stevens and a rate decision from RBNZ Governor Bollard. We expect both central banks to quickly move rates down into the 4-5% region from 6% and 7½% respectively at the moment.

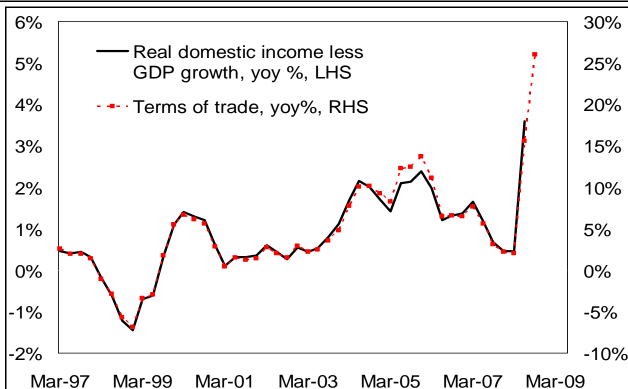
Australia started this global downturn with some momentum and a safety net

Australia: Apart from the announced fiscal stimulus which should alleviate the economic slowdown by some 0.5% of GDP in early 2009, there were a few interesting data this past week. First, the NAB business survey showed a consolidation rather than further slide. Second, the Westpac/MI leading index fell to 2.5% but remains comfortably above the LI dips in the 1990-91 recession and the slowdowns of 1995-96 and 2000-01. Third, Australia's terms-of-trade (ToT) rose by more than 8% qoq in 3Q 2008 with export price increases of 14% qoq swamping import price inflation of 5% qoq. While the official ToT figure is not released until early December, this means that Australia's ToT have risen by an estimated 24% through the first three quarters of this year, an incredible result even by the standards of the prior five years when ToT rose by a cumulative 42% or 7.25% per annum. As we have noted before, real gross domestic income (real GDI) better captures the benefits to Australians from the resources boom, essentially valuing commodity export revenue by its purchasing power, whereas GDP deflates commodity revenue by export prices, essentially disguising the benefit. Based on the typical relationship, by the third quarter of this year Australian real GDP should be growing at a pace some 5%+ above real GDP growth.

Greater boost

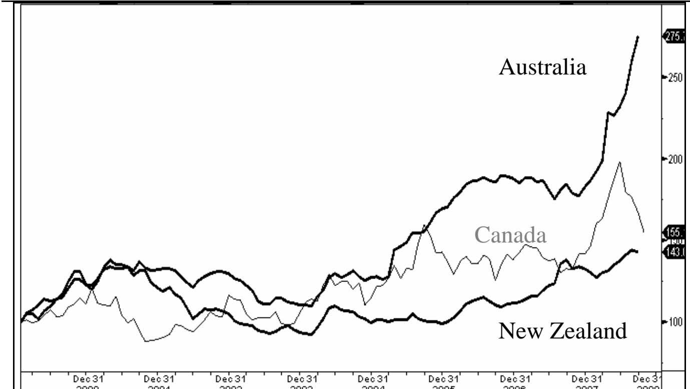
Australia is also due to receive a larger boost from the net impact of changes to the exchange arte and commodity prices than its counterparts New Zealand and Canada (see Figure 14). Now it is true that prices for farm, industrial metals and energy prices—which make up about half of Australia's RBA commodity price index—have plunged 20%-25% from their September average in USD terms. Meanwhile, even though the coal and iron ore contract prices are set through next April, spot prices for spot iron ore ($95) are now well below this year's contract price of $148 and thermal coal at $116 has slipped from well above to slightly below the contract price of $125. On a commodity-weighted basis, the USD value of Australia's commodity basket is likely to have fallen by about 15% since September even allowing for stable contract prices for coal and iron ore. That said, the AUD, currently trading at 69 US cents, is also 15% below its September average of 82 US cents, so in AUD terms the index may be maintaining its elevated September levels which are some 50% above the rather stable 2006-07 average. For a country in which commodity export revenue is more than 60% of exports and 18% of nominal GDP, this is a big deal.

Figure 13. Australia Terms of Trade vs Gap Between Real GDI and Real GDP



Source: Australian Bureau of Statistics

Figure 14. Dollar Bloc Commodity Price Indices in Local CCY Terms, Normalized to January 2000



Source: Bloomberg

[6] *John Rothfield is a Bank of America GFX strategist. The opinions expressed by Mr. Rothfield should not be read as impartial because the relevant trading desk may have positions in, or be engaged in trading in, instruments referred to herein. For further information, please read the Bank of America NA (London) general policy statement on the handling of research conflicts, available on request.*

Bank of America

CPI data and a Stevens speech

The stimulus from fiscal policy and now the surge in the local currency price of commodities has to be put in the context of the global financial crisis, deepening US recession (the correlation between Australian and US GDP is much higher than implied by the 6% US share in Australian exports) and softening Asian economies, but worth noting as a moderating influence on any Australian downturn. It is also relevant in a week in which Australia announces 3Q 2008 inflation figures, minutes of the Board meeting where a 100bp rate cut was effected and a timely speech by RBA Governor Stevens. The CPI headline and underlying inflation numbers are expected to be in the 4.5%-5% range, almost double the 2%-3% medium term inflation target range but in July the Governor noted that the bank would tolerate 10 or so quarters of above target inflation noting a similar undershoot in the late 1990s. And now of course an old fashioned local economic down-cycle combined with falling energy prices will get us more quickly back into the inflation range, perhaps in 2009. Knowing the Governor's 'risk management' approach to interest rates and in light of persistent negative economic risk we think the bank will largely ignore the stimuli noted above and cut another 50bps in each of November, December and February for a 'terminal' rate of 4.50% at which time a bottoming US economy and the expansionary impact of the drop in the currency kick in. The market on Friday was looking for deeper cuts to 3.75% by Easter. We will know more after this week's minutes and speech.

Bollard may give a deep rate cut in the shadows of the November 8 election

New Zealand: 3Q 2008 inflation is expected to be a little higher than the 1.3% qoq/4.9% yoy surmised by the RBNZ in its September quarterly monetary policy statement. While energy prices have receded, the quarterly average for petrol was actually higher and food prices have kept rising. The currency fell 5% on a TWI basis, adding to tradables inflation. A lot of things have changed in the six weeks since that last decision (–50bps in the OCR to 7.50%) and MPS on September 11, not the least of which is a surge in the bank bill yield-OIS spread this Friday to 160bps from 40bps on 9/11. With large ongoing offshore borrowings by NZ banks, clogged global credit markets have added 'rollover' risks to NZ. The RBNZ has also since 9/11 added regulatory powers over the 'deposit taking' sector and announced an opt-in retail deposit guarantee scheme. We now expect a 100bps RBNZ cut this Thursday and -50bps in each of December, January and March, taking the rate down to 5.00%.

Figure 15. Australia and New Zealand Economic Indicators

Day	GMT	Country	Indicator	For	BAC	Mkt	Last
Sun 19	23.00	New Zealand	Business NZ Performance of Services Index	Sep	n.a.	n.a.	479
Mon 20	00.30	Australia	Imports (sa) mom	Sep	2.0%	n.a.	-3.0%
	00.30	Australia	PPI qoq	3Q	2.5%	1.0%	1.0%
			yoy		6.0%	4.5%	4.7%
	21.45	New Zealand	CPI qoq	3Q	1.7%	1.6%	1.6%
			yoy		5.2%	5.1%	4.0%
	21.45	New Zealand	Food Prices mom	Sep	-1.0%	n.a.	2.7%
Tue 21	00.30	Australia	Vehicle Sales mom	Sep	0.0%	n.a.	-3.5%
	02.00	New Zealand	Credit Card Spending yoy	Sep	1.5%	n.a.	2.5%
	21.45	New Zealand	Long Term Migration	Sep	n.a.	n.a.	+400
Wed 22	00.30	Australia	CPI qoq	3Q	1.0%	1.0%	1.5%
			yoy		4.8%	4.8%	4.5%
			Trimmed Mean CPI yoy		4.4%	n.a.	4.3%
			Weighted Median CPI yoy		4.5%	n.a.	4.5%

Source: Bloomberg, Reuters and Bank of America estimates.

Emerging EMEA: Turmoil Shifts Rates Risk to Upside

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Financing concerns intensify for emerging EMEA countries. We believe that Turkey and South Africa face the greatest risks, while Poland and Russia are relatively well-placed, and the Czech Republic and Hungary fall in the middle. The currency sell-off has also shifted the rates risks firmly to the upside, in our view. In any case, we would have expected the Hungarian and Turkish central banks to stay on hold this week. However, if current exchange rates are sustained, we expect the first rate cuts in these countries, as well as in South Africa, to be pushed from 1Q2009 to later in the year. In fact, we do not exclude surprise hikes if the current turmoil persists. In Poland, even the hawks have dismissed the need of further hikes, but cuts will also have to wait until 2009. The CNB, however, will likely cut by 25bp on November 6.

Financing concerns intensify for EM EMEA

The financial crisis will have asymmetric effects on emerging EMEA countries. Our analysis suggests that the PLN and the RUB will be relatively well-placed to weather the global crisis. The CZK and the HUF fall in the middle, given the size of remaining foreign investor equity market positions and relatively moderate financing needs on the one hand, but high Eurozone exposure on the other hand. In contrast, the TRY and the ZAR face much greater financing needs, which may be exacerbated by the potential for further large portfolio outflows in ZAR's case (*see Forex Focus: EM-EMEA – Gauging the Exposure to the Crisis*, October 14).

The Czech economy deteriorates quickly

The recent flow of economic data in the **Czech Republic** supports a rate cut on November 6. Following a large fall in IP, retail sales fell by -3.3% yoy in August from +3.6%. PPI inflation also slowed more than expected to 5.5% yoy from 5.7%. Meanwhile, the C/A balance came in at -CZK12.2bn in August from -CZK0.3bn in July, driven by a deteriorating trade balance (CZK6.1bn from 10.2bn), as exports are slowing sharply. Our baseline is for a 25bp cut by the CNB on November 6. While the rest was for 50bp until recently, the recent CZK weakness likely precludes such a bold move.

Disinflation quickens in Hungary…for now

Disinflation quickens in **Hungary** in reflection of lower commodity prices, but the global crisis calls for a wait-and-see stance by the NBH. CPI slowed to 5.7% yoy in September from 6.5%, and the core rate down to 5.1% yoy from 5.8%. Wage growth is also easing quickly, to 7.2% yoy in August from a high of 13.1% in February. While inflation pressures elsewhere are easing, FX risks call for caution from the central bank. We calculate that the recent HUF sell-off, if sustained, pushes up inflation by 2pp by 4Q09 relative to the latest NBH forecast.

Inflation coming off sharply, but NBP on hold till 1Q09

In **Poland**, September data provided further reassurance that the NBP will stay on hold for the rest of the year. The CPI came in slightly higher than expected, at 4.5% vs. 4.4%, but substantially down from the August peak at 4.8%. The decline was essentially due to food price inflation as well as fuel price inflation. Meanwhile, producer prices were up 2.1% yoy, somewhat lower than the 2.2% expected and only slightly up from the previous 2.0%. Sold industrial output was up 7.0% yoy, in a rebound from the aberration of the 3.7% drop in August, and somewhat more than the expected 6.0%. However, the 3-month moving average stabilized at 3.1% yoy, the lowest level since 2005. This data just confirms what has become quite clear recently after several comments from MPC hawks about a "neutral bias": the NBP is very likely to stay on hold in October, as well as for the rest of the year. Going forward, the key issue, in our view, will be the pass-through from the recent PLN sell-off: if it is sustained, it will likely push our call for the first cut from Q1 back to Q2 of next year.

Inflation concerns move to the background in Israel

Israel's CPI rose by the fastest pace in 5½ years, at 5.5% in September, but inflation concerns have moved to the background, as the BoI focuses on supporting growth. We currently look for a 25bp rate cut at the November meeting following this month's surprise cut of 50bp. However, we would not rule out an earlier move at the Oct-27 meeting already, given the high uncertainty in the global environment and the BoI's proactive approach.

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[7] *David Hauner and Mai Doan are Bank of America GFX strategists. The opinions expressed by Mr. Hauner and Ms. Doan should not be read as impartial because the relevant trading desk may have positions in, or be engaged in trading in, instruments referred to herein. For further information, please read the Bank of America NA (London) general policy statement on the handling of research conflicts, available on request.*

Domestic demand continues to worsen in SA

In **South Africa,** domestic demand continues to adjust to higher interest rates and rising prices. Retail sales fell for the fourth consecutive month, at -5.5% yoy in August after -4.6% in July. The continued deterioration in the domestic and external growth prospects should pave the way for SARB rate cuts next year, though there is a risk of delay to our current call of the first rate cut of 50bp in January 2009, given the recent sharp ZAR depreciation.

Financing the C/A gap remains a concern for Turkey

In **Turkey**, the August C/A deficit narrowed to $3.3bn from previously $4.1bn. However, it was substantially worse than last year due to higher commodity prices. Going forward, we believe that the C/A will improve on the back of lower commodity prices, but that this will be offset by increasing financing problems, overall generating a worsening BOP outlook.

Figure 16. Emerging EMEA Economic Indicators

Day	GMT	Country	Indicator	For	BAC	Mkt	Last
Mon 20	12:00	Hungary	NBH Rate Announcement	Oct 28	8.50%	8.50%	8.50%
Mon 20+	-	Russia	Real Wages yoy	Sep	13.0%	13.0%	15.7%
	-	Russia	Real Retail Sales yoy	Sep	13.0%	13.9%	14.0%
	-	Russia	PPI mom	Sep	0.7%	0.6%	0.5%
Tue 21	12:00	Poland	Net Core Inflation yoy	Sep	4.1%	4.1%	4.0%
Wed 22	07:00	Hungary	Retail Sales yoy	Aug	-2.4%	n.a.	-1.8%
	16:00	Turkey	CBT Rate Announcement	Oct-23	16.75%	16.75%	16.75%
Thu 23	08:00	Poland	Retail Sales yoy	Sep	12.3%	12.0%	7.7%

Source: Bloomberg, Reuters and Bank of America estimates.

Hungary: NBH rates, Retail Sales

We expect the National Bank of **Hungary** to keep the base rate on hold at the October 20 meeting. This is also the universal expectation according to the Bloomberg survey. In fact, despite faster disinflation, we look for steady rate until January 2009, when we expect the first cut of 50bp. The Bank will not be able to ease rates as long as the forint remains significantly under pressure. Indeed, we see now see the interest rate risk on the upside if the exchange rate weakens further. If the current weakness is sustained, the first easing may be delayed until later in 2009 (see above). Meanwhile, retail sales will likely decline more than in August yoy, due to working day effects.

Poland: Net core inflation, Retail sales

In **Poland,** net core inflation will likely show a small uptick, but this will not affect the MPC's stance to stay on hold in the October meeting, in our view. Retail sales will likely rebound from the blip in August, but a clear downtrend has become established.

Russia: Wages, PPI, Retail sales

In **Russia**, the data flow will likely continue to reflect a weakening but still robust economy. Real wages and real retail sales likely slowed substantially in September relative to the August yoy growth. Meanwhile, producer prices are likely to show some up-tick, but the CBR is currently entirely focused on liquidity and will tolerate rising inflation at least until end-08.

Turkey: CBT rates

Turkey's base rate will very likely stay on hold this week, as universally expected according to the Bloomberg survey. The CBT has previously indicated an easing bias, but even without the recent turmoil, we would have seen rates on hold for the rest of the year. In fact, the pronounced lira weakness puts the risk on the upside, and we would not entirely exclude a surprise rate hike. In any case, at current USD/TRY levels, the CBT will not be able to cut for a long time—and beyond 1Q2009 where we would otherwise have expected the first easing.

Bank of America

Latin America: MXN under pressure

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In Brazil, the freeze in available credit and substantial deterioration in the global macro environment will likely push the Copom to pursue a much less hawkish stance than is projected in the BCB survey for a 50bp hike. A move of 25bps is likely, if global markets stabilize. Otherwise, BCB may hold. In Mexico, in recent days the MXN suffered from the worst volatility episode in the FX market since 1998. MXN pressure derived from increased risk aversion was exacerbated by a few Mexican Corporates engaged in Fx structured options that needed to cover short USD positions leading the MXN to trade at an historical high of USD/MXN 14.32 and forcing a central bank intervention in the Fx market.

Brazilian consumer maintains momentum

Brazil: August retail sales reached 9.8% yoy or higher than the expected 8.7% yoy. The release for the previous month was also revised up from 11.0% to 11.3% signaling the Brazilian consumer maintained momentum through the summer, despite prior rate hikes. The dip in commodity prices, higher rates, and financial turmoil should dent demand in coming releases. Nonetheless, retails sales remained robust at about the 3month ma of 9.8%.

Fewer inflation strains

Copom minutes, released a few weeks ago, were in line with expectations that signs of inflation are beginning to ease and provide the BCB with some comfort. Fewer inflation strains are evident from recent price movements as well as the potential for falling commodity prices reduce pressures going forward. Copom clearly remained concerned at the September meeting regarding the pace of the domestic expansion, namely that demand exceeds supply. Nonetheless, the freeze in available credit and substantial deterioration in the global macro environment will likely push the Copom to pursue a much less hawkish stance than is projected in the BCB survey for a 50bp hike. A move of 25bps is likely, if global markets stabilize. Otherwise, BCB may hold.

In Mexico, economic prospects have deteriorated significantly, in our view

Mexico: The significant deterioration in the global economy and financial markets has led to rate cuts by several central banks. In Mexico, Banxico maintains the overnight lending rate unchanged at 8.25% while closely monitors the evolution of the balance of risks. While economic activity prospects have deteriorated significantly, higher inflation lies ahead for several months yet. It is worth highlighting however, that various facts as easing commodity prices, absence of domestic demand pressures, lack of producer pricing power and in particular an increasingly evident weakening of economic activity in coming months, added to the gradual effect of recent Banxico hikes constitute factors that will likely attenuate inflation in 2009. Therefore, the beginning of a series of rate cuts by the end of 1Q 2009 by Banxico now appears likely.

MXN under pressure

Greater global uncertainty and risk aversion have translated into higher financial volatility. In recent days, the MXN suffered from the worst volatility episode in the FX market since 1998. MXN pressure derived from increased risk aversion was exacerbated by a few Mexican corporates engaged in FX structured options that needed to cover short USD positions leading the MXN to trade at an historical high of USD/MXN 14.32 and forcing a central bank intervention in the FX market. Although fundamentals—like the slowdown in the US already affecting Mexico and global commodity prices particularly oil edging lower—argued for a weaker MXN, current weakness seems excessive. We expect a recovery towards USD/MXN 11.80 by year-end.

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Figure 17. Latin America Economic Indicators

Day	GMT	Country	Indicator	For	BAC	Mkt	Last
Mon 20	10:00	Brazil	IGP-M Inflation, mom	Oct 17	n.a.	0.64%	0.04%
Wed 22	19:30	Mexico	Retail Sales, yoy	Aug	2.6%	2.5%	2.9%
Thu 23	11:00	Brazil	Unemployment Rate	Sep	n.a.	7.4%	7.4%
	11:00	Brazil	IPCA-15 Inflation mom	Oct	n.a.	n.a.	0.26%
	12:30	Brazil	Current Account ($)	Sep	n.a.	-1.5bn	-1.1bn
	19:30	Mexico	Trade Balance (Prel, $)	Sep	-1,4bn	-1,7bn	-2,2bn
	14:00	Mexico	CPI (1H) mom	Oct	0.30%	0.30%	0.44%

Source: Bloomberg, Reuters and Bank of America estimates.

Figure 18. Critical Events

Day	GMT	Venue	Event
Mon 20	00:30	Tokyo	BoJ hold quarterly Branch managers' meeting
	12:00	Prague	ECB Tumpel-Gugerell speaks at ECB-CFS conference
	16:00	Milan	ECB Bini Smaghi presents his book "The paradox of the euro"
	16:45	Atlanta	Fed Lockhart speaks about the US economic outlook
Tue 21	00.30	Sydney	RBA publish Board minutes from October 7 meeting
	02.10	Australia	RBA Governor Stevens speaks on 'Australia, New Zealand and the International Economy'
	04:00	Escanaba	Fed Stern speaks
	13:00	Ottawa	BoC announces interest rate decision
	19:10	Leeds	BoE Governor King speaks
	-	Dublin	ECB Gonzalez-Paramo speaks
Wed 22	08:30	London	BoE publishes minutes from October 8th monetary policy meeting
	20:00	Wellington	RBNZ announces interest rate decision (local time October 23 @ 09:00am)
Thu 23	07:30	Stockholm	Riksbank announces monetary policy decision
	12:45	Frankfurt	ECB Governing Council meeting. No interest rate announcement scheduled.
	14:30	Ottawa	BoC publishes quarterly Monetary Policy Report
Fri 24	10:45	Madrid	ECB Gonzalez-Paramo speaks
	13:30	Vienna	ECB Nowotny and Tumpel-Gugerell speaks at globalisation symposium

Source: Bloomberg, Reuters and Bank of America estimates.

Figure 19. Central Bank Meetings

Fed	ECB	BoJ	BoE	BoC	SNB	Riksbank
Oct 29	Nov 06	Nov 21	Nov 06	Oct 21	Dec 11	Oct 23
Dec 16	Dec 04	Dec 19	Dec 04	Dec 09	Mar 11	Dec 17
Jan 28	Jan 15	Jan 22	Jan 08	Jan 20	Jun 18	Feb 10
Mar 17	Feb 05	Feb 19	Feb 05	Mar 03	Sep 17	Apr 20
Apr 29	Mar 05	Mar 17	Mar 05	Apr 21	Dec 10	Jul 01

Norges	RBA	RBNZ	Brazil/COPOM	Banco de Mexico	Poland NB	Hungary NB
Dec 17	Nov 04	Oct 23	Oct 29	Nov 28	Oct 29	Oct 20
Feb 04	Dec 02	Dec 04	Dec 10		Nov 26	Nov 24
Mar 25	Feb 03	Jan 29			Dec 23	Dec 22
May 06	Mar 03	Mar 12				
	Apr 07	Apr 30				

Date denotes monetary policy announcement in local time
Source: Bloomberg, Reuters and Bank of America estimates.

Figure 20. Economic Forecasts

	PPP Weight	USD Weight	GDP % change			Unemployment (%)			CPI % change			Current Account as % of GDP			Budget Balance as % of GDP		
			2007	2008	2009	2007	2008	2009	2007	2008	2009	2007	2008	2009	2007	2008	2009
World (USD)		**100.00**	**3.9**	**2.7**	**1.7**												
World (PPP)	**100.00**		**5.4**	**4.1**	**3.4**												
THE AMERICAS	**28.70**	**34.83**	**2.7**	**1.8**	**0.4**												
United States	19.31	25.85	2.0	1.3	-0.5	4.6	5.7	7.4	2.6	3.6	1.0	-5.3	-4.8	-3.5	-1.2	-2.8	-3.9
Canada	1.72	2.64	2.7	0.5	0.8	6.0	6.1	6.5	2.1	2.7	2.0	0.9	1.5	1.3	0.8	0.8	0.5
Latin America	**7.43**	**6.25**	**5.5**	**4.3**	**3.7**												
Brazil	2.55	2.43	5.6	4.6	4.8	9.5	8.8	8.3	3.6	4.7	3.9	0.3	-0.4	-1.7	-2.2	-1.6	-0.9
Mexico	1.75	1.66	3.2	2.4	1.0	3.7	3.8	3.6	3.8	5.5	3.9	-0.7	-1.2	-1.3	0.0	0.0	0.0
Argentina	0.95	0.47	8.4	7.1	5.7	8.5	6.7	6.3	8.8	9.3	11.0	1.9	0.1	-0.6	0.5	0.0	-0.5
Chile	0.32	0.30	5.4	5.1	5.0	7.3	7.7	6.9	4.4	6.3	4.2	5.6	3.8	3.8	9.7	5.5	3.3
EUROPE	**26.55**	**36.59**	**3.4**	**1.8**	**0.5**												
Eurozone	14.22	22.37	2.7	1.1	-0.2	7.4	7.4	8.0	2.1	3.5	1.8	0.3	-0.3	-0.3	-0.5	-1.1	-2.9
Germany	3.74	6.11	2.6	1.5	-0.1	8.4	7.4	7.7	2.3	2.8	1.5				0.0	-0.4	-1.6
France	2.85	4.71	2.1	0.8	-0.2	7.9	7.4	8.2	1.6	3.2	2.3				-2.7	-3.1	-4.0
Italy	2.62	3.88	1.4	0.0	-0.4	6.2	6.8	7.6	2.0	3.6	2.4				-1.9	-2.7	-3.5
Other Western Europe	**4.61**	**8.06**	**3.2**	**1.3**	**-0.1**												
United Kingdom	3.14	5.17	3.0	1.0	-0.5	5.4	5.5	7.0	2.3	3.8	2.5	-3.8	-1.5	-1.3	-2.5	-3.8	-3.9
Switzerland	0.40	0.78	3.3	1.9	0.5	2.8	2.5	2.7	0.7	2.6	1.6	16.7	13.5	12.6	1.2	1.2	1.0
Sweden	0.46	0.81	2.9	1.0	0.3	6.1	6.8	7.2	2.2	3.5	2.5	8.4	8.0	6.3	2.7	2.5	2.7
Norway	0.30	0.69	6.3	2.7	1.1	2.6	2.6	3.6	0.7	4.2	2.9	18.6	15.8	13.4	18.0	13.0	7.0
Other Europe	**7.41**	**6.16**	**6.2**	**4.8**	**3.9**												
Poland	0.85	0.77	6.6	5.2	3.2	12.8	9.7	8.6	2.5	4.2	3.9	-4.4	-4.6	-4.4	-2.0	-2.5	-2.3
Hungary	0.29	0.26	1.3	2.2	2.4	7.4	7.7	7.3	8.0	6.3	4.0	-5.0	-4.4	-4.1	-5.0	-3.6	-3.4
Czech Republic	0.36	0.32	6.6	4.2	3.9	6.6	5.9	5.7	2.8	6.6	3.1	-1.8	-2.2	-2.7	-1.8	-1.9	-2.4
Russia	2.65	2.29	8.1	7.2	6.5	7.2	7.0	6.9	9.0	14.0	9.3	5.9	6.2	0.7	7.2	6.2	4.5
Turkey	1.00	0.90	4.8	3.2	3.6	9.9	10.1	10.0	8.8	10.1	6.9	-5.7	-6.7	-5.8	-1.7	-2.0	-3.0
ASIA & PACIFIC	**38.67**	**23.78**	**6.1**	**4.7**	**4.4**												
Japan	6.14	8.15	2.1	0.5	0.2	3.8	4.1	4.5	0.0	1.7	1.1	4.8	3.5	3.5	-2.8	-3.6	-3.3
China	15.83	6.09	11.4	9.8	9.1	4.0	4.5	4.6	4.8	6.2	4.0	9.5	9.5	9.0	-0.7	-0.6	-0.5
Other Asia	**15.06**	**7.63**	**6.6**	**5.5**	**5.8**												
Oceania	**1.21**	**1.92**	**4.0**	**2.0**	**2.2**												
Australia	1.02	1.67	4.2	2.4	2.3	4.4	4.5	5.2	2.3	4.5	2.8	-6.2	-4.7	-3.5	1.4	1.2	1.0
New Zealand	0.16	0.23	3.0	-0.5	1.0	3.6	4.0	4.5	2.4	4.2	2.9	-8.2	-8.8	-7.0	3.3	2.6	1.5
AFRICA / MID EAST	**6.54**	**4.79**	**6.0**	**5.8**	**5.9**												
South Africa	0.91	0.51	5.1	3.3	2.3	24.3	25.5	25.2	6.5	11.5	7.2	-7.3	-7.8	-8.0	0.6	0.7	0.5

ASSUMPTIONS		2007	2008	2009
Oil Prices (WTI)		72	105	80
World Trade		6.6	6.2	5.7

Note: GDP and CPI data are annual averages. Weights are calculated according to current USD value. (Source: IMF).

Source: National statistical offices and Bank of America estimates.

Figure 21. Interest Rates and Monetary Policy Forecasts

Key Central Bank Rates	Next Move	Current	3-Month Forecast	6-Month Forecast	12-Month Forecast
Fed Funds	-25 bp in Oct 2008	1.50	1.00	1.00	1.75
EMU Refi	-50bps in Nov 2008	3.75	3.25	2.50	2.50
JPY ON Call	+25bp in Jan'10	0.50	0.50	0.50	0.50
UK Base	-50bp in Nov '08	4.50	3.50	2.75	2.50
SNB 3-month Libor Target	-25bps in Dec 2008	2.0-3.0	1.75-2.75	1.75-2.75	2.0-3.0
BOC Overnight Target	-25bp in Oct 2008	2.50	2.00	1.75	2.25
RBA Cash Rate	-50bp in Nov'08	6.00	5.00	4.50	5.00
RBNZ OCR	-50 bp in Oct'08	7.50	6.00	5.00	5.00
Swedish Repo	-50 bps in Dec 2008	4.25	3.75	3.25	3.25
Norway Deposit Rate	-25bp in Dec-08	5.25	4.75	4.25	4.00
Brazilian Selic ON	+50bp in Sep 2008	13.00	13.50	14.00	13.00
Mexican Overnight Rate	-25bps in Mar 2009	8.05	8.05	8.05	7.75

Source: Bloomberg, Reuters and Bank of America estimates.

Interest Rates	Current	3-month		6-month		12-month	
		Forward	Forecast	Forward	Forecast	Forward	Forecast
USD: 3mo	4.25	2.58	1.80	2.35	1.70	2.50	2.50
10yr	3.94	3.97	3.50	3.96	3.75	3.94	4.40
EUR: 3mo	5.18	3.70	4.20	3.38	3.20	3.46	3.00
10yr	3.98	3.94	4.10	3.90	4.20	3.80	4.80
JPY: 3mo	0.88	0.80	0.98	0.77	1.00	0.84	1.05
10yr	1.58	1.58	1.38	1.60	1.40	1.53	1.65
GBP: 3mo	6.40	4.39	5.30	3.80	4.30	3.83	3.25
10yr	4.67	4.66	4.20	4.59	4.30	4.47	4.50
CHF: 3mo	3.62	2.42	2.50	2.29	2.25	2.35	2.50
10yr	3.00	2.98	3.00	2.97	3.10	2.96	3.50
CAD: 3mo	3.75	2.33	3.10	2.11	3.20	2.42	3.30
10yr	3.73	3.71	3.70	3.71	3.90	3.68	4.30

Source: Bloomberg, Reuters and Bank of America estimates.

3m Interest Rates	Current	3 Month Forecast	6 Month Forecast	12-Month Forecast
SEK	4.53	4.80	4.20	3.60
NOK	6.49	4.85	4.23	4.10
DKK	5.50	4.25	3.25	3.05
CZK	4.64	3.08	3.08	2.83
HUF	8.00	8.25	7.45	6.70
PLN	7.02	6.55	6.30	6.05
RUB	10.08	10.08	10.08	10.08
TRY	18.92	18.67	18.42	17.67
ARS	16.38	n.a.	n.a.	n.a.
BRL	11.25	11.75	11.75	11.75
MXN	8.06	8.10	8.10	8.00
AUD	6.63	6.40	6.30	6.50
NZD	7.75	7.30	6.80	6.30
HKD	3.79	3.60	3.50	3.60
SGD	1.31	2.70	2.70	2.60
ZAR	12.35	12.22	11.22	9.72

Source: Bloomberg, Reuters and Bank of America estimates.

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Figure 22. Exchange Rate Forecasts

Exchange Rates	Current	3-Month		6-Month		12-Month	
		Forward	Forecast	Forward	Forecast	Forward	Forecast
USD vs							
EUR	1.34	1.34	1.45	1.34	1.46	1.33	1.34
JPY	101.7	100.9	105.0	100.4	106.0	99.5	110.0
GBP	1.73	1.73	1.75	1.72	1.76	1.71	1.61
CHF	1.13	1.13	1.08	1.13	1.05	1.13	1.15
CAD	1.18	1.18	1.08	1.18	1.12	1.18	1.15

Source: Bloomberg, Reuters and Bank of America estimates.

Exchange Rates	Current	3 Month Forecast	6 Month Forecast	12-Month Forecast
USD vs				
ARS	3.21	3.28	3.38	3.59
BRL	2.11	2.20	2.00	1.90
MXN	12.74	11.80	11.55	11.00
CNY	6.83	6.73	6.67	6.50
KRW	1334	1160	1120	1100
INR	48.88	46.00	44.00	45.00
SGD	1.47	1.48	1.46	1.45
ZAR	10.01	9.90	9.09	8.87
PLN	2.64	2.34	2.19	2.39
AUD	0.70	0.78	0.79	0.74
NZD	0.62	0.66	0.66	0.62
EUR vs				
JPY	137	152	155	147
GBP	0.78	0.83	0.83	0.83
CHF	1.53	1.56	1.54	1.54
SEK	9.95	9.75	9.70	9.40
NOK	8.78	8.20	8.10	7.90
CZK	24.9	24.5	24.0	24.0
HUF	264	255	240	227
PLN	3.54	3.40	3.20	3.20

Source: Bloomberg, Reuters and Bank of America estimates.

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