BARCLAYS CAPITAL

RESEARCH
June 2010

GLOBAL OUTLOOK

REBOUND, BUT NO RAGING BULL MARKET

PLEASE REFER TO THE LAST PAGE FOR ANALYST CERTIFICATION(S) AND IMPORTANT DISCLOSURES

FOREWORD

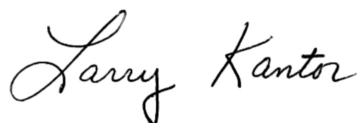
The key question for investors these days is whether the recent market setback spells the end of the global recovery in economic activity and financial markets that began more than a year ago. Our answer to this question is no. The drop in risky asset prices – strikingly similar across all regions and products – looks to us like a healthy correction to markets that had run up extremely rapidly.

The events of the past couple of months should pose little risk to the global economic recovery, and we have made few changes to our economic forecasts. Fiscal sustainability issues in peripheral European countries are not likely to have a significant effect on demand in the US and Asia: Lower oil prices and interest rates should provide enough of a boost to offset any negative impact from weaker import demand from Europe. Indeed, the recent market instability seems to be delaying monetary tightening: we have moved back our forecast for the first rate hike by the Fed from September to next April (and edged up our near-term US GDP forecast). Even within Europe, the boost from a weaker euro – as well as from lower interest rates and oil prices – should offset fiscal drag over the next year or so.

If the economic recovery remains intact, we see this market setback as having created a near-term buying opportunity, especially in equities. Stocks have sold off far more than corporate bonds – much of the increase in corporate spreads has been caused by the rally in government bonds – so that relative valuation has shifted decisively in favor of equities. Valuations in the US and Europe look particularly attractive, as some of the early recovery countries such as China and Brazil are tightening monetary policy in an effort to avoid overheating. Moreover, the easy money/tight fiscal policy mix that we expect in developed markets has tended to be associated with strong equity market performance.

But while we are optimistic that markets will bounce back in the near term, we believe there are constraints on how far the rally can go. Equity market performance is not as uniformly positive at the beginning of the monetary tightening process as it is in the early stage of economic recovery. Moreover, the fiscal challenges facing many developed markets are significant (US, UK and Japanese fiscal positions are all worse than for Europe as a whole), and it is not yet clear that the adjustment process can be delivered while maintaining solid economic growth. Finally, the difficulties policymakers have had in re-establishing financial market stability in the wake of the Greek crisis has undermined investor confidence, which was just beginning to recover following the most severe financial crisis since the Great Depression. Until some of these issues are resolved, investors will likely remain cautious and asset values are unlikely to reach anywhere near the peaks of recent business cycles.

We have drawn upon the expertise and collaboration of our researchers across every product area and region to deliver to you, our clients, a comprehensive and integrated analysis of the global economy and markets. We sincerely hope you find it a useful guide to your investment decisions.



Larry Kantor
Head of Research
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SUMMARY OF ASSET ALLOCATION THEMES

	KEY FORECASTS	KEY RECOMMENDATIONS
Equities	■ In the US, we think the near-term earnings outlook for the S&P 500 is positive, but we are less sanguine post-earnings season as the prospect of fiscal tightening nears. ■ We believe that the equity market is assigning far too high a probability of double-dip scenarios and would continue to accumulate stocks on corrections. Our year-end price target for the S&P 500 is 1,210, the product of $76 operating EPS and a 16x multiple. ■ In Japan, we see favourable conditions for renewed buying of stocks, with sustainable earnings recoveries supported by external demand expansion and undervalued share prices. Our Nikkei225 price target is about JPY 12,500 at year-end.	■ Our positive stance on European equities into year-end is driven by historically low relative and absolute valuations, the risk of higher longer-term inflation volatility and improving sentiment in peripheral European bond markets. ■ In the US, we favor segments with a strong demand base across the major economies (easier monetary policy) and would avoid segments geared to emerging markets and demand from the developing world (tighter monetary policy). Also, we would look at cheap to fair defensives. ■ In Japan, we expect export-related stocks to outperform domestic demand sectors. External demand growth, not only from China but also from US later this year, is likely to boost sales of export-related companies.
Bonds	■ After the flight to quality in Q2 10, global bond markets should start to normalize in Q3. We expect US rates to rise slowly across the curve, driven by improvement in labour markets and inflation readings, as well as a rising term premium. ■ On the European side, sovereign debt spreads should stabilize, given a likely slowdown in supply and plans for deficit cuts. Unlike the US and Europe, Japan should have some further flattening in Q3, but out along the curve.	■ In the US, put on curve steepeners in rates and flatteners in the swap spread curve. We also recommend being outright receivers of longer swap spreads, which should tighten on heavy Treasury supply and a worsening US fiscal situation. ■ The 10y sector in Europe looks rich outright but cheap relative to 10y US Treasuries. Bund ASW now seems fair, while Bobl ASW has room to tighten near term. Medium term, though, most such spreads should widen as fundamentals improve.
Commodities	■ Commodity market fundamentals should re-emerge as the main price drivers as risk aversion eases. ■ Demand data have continued to strengthen and should stay positive, as a robust recovery in OECD is offsetting a slower pace of growth in EM. ■ Recovery risks have grown, especially in China, so we recommend selective exposure to markets where supply constraints are most pressing.	■ Oil inventories to continue drawing relative to seasonal norms, supporting a steady move up in prices. US natgas is weakest energy market and spread shorting attractive. ■ Copper mine supply is underperforming - build long positions on dips towards $6,000/t. ■ Easing of risk aversion could be negative for gold in the short term, but its role as a hedge of financial market tail risks suggests medium-term prospects are strong.
Inflation	■ Breakevens in G4 markets may richen as nominal dislocations fade, but inflation data are supportive only in the UK.	■ 3-10y UK breakevens, particularly IL16, are very cheap, given that the BoE is not raising rates to allow for the fiscal adjustment.
Credit	■ Moderate tightening of credit spreads over the remainder of the year, driven by improving macro-economic and corporate fundamentals. ■ Limited prospects for higher total returns in investment grade. More upside in high yield and leveraged loans. ■ US credit to outperform Europe, continuing the recent trend in investment grade and reversing that of high yield.	■ Position for increased divergence between US and European banks, particularly once the final version of financial reform legislation in the US is known. ■ Rotate out of high yield credits with exposure to European peripherals and into either US credits or names with exposure to core European countries.
Emerging Markets	■ Investors are looking beyond the cycle, focusing on longer-term global risks and challenges to the world economy. ■ Although the fiscal and financial risks that plague many industrial economies are absent from most emerging market economies, EM asset markets have in the short term been tightly coupled with advanced economy markets, and we expect this to remain the case.	■ We expect Q3 to begin somewhat more positively, as anxieties about the global context fade and permit investors to re-focus on generally positive EM fundamentals. ■ Tactically, we are bullish risk and recommend higher-beta assets that were punished in the downdraft. We recommend taking profits early in such a rally, as concerns about the longer-term outlook will likely last.
Foreign Exchange	■ The need for fiscal consolidation is far greater in the larger economies. The worst of the euro area fiscal crisis is likely behind us, but the hard work for all of the G4 economies is just beginning. ■ FX is likely to be driven less by attitudes to risk, so is likely to be less closely correlated with other asset classes. ■ Inflationary pressures may lead the smaller economies to tighten monetary policy while the G4 keep rates very low.	■ Sell the G3 currencies against the smaller G10 currencies, which have better fiscal position. ■ Buy the wings of USD/CAD – it should perform well in any scenario other than if inflation remains close to target in all economies.

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The potential for equity-like returns has re-emerged in several higher-risk fixed-income categories (including US high yield, leveraged loans, CMBS and non-agency mortgages) and relative equity valuations have cheapened to their most attractive levels in decades.

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Markets may be overly pessimistic about the possibility of a near-term debt incident in peripheral Europe. The longer-term implication of the European crisis is likely not to be default, but rather fiscal consolidation among advanced economies too early in the cycle.

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With the recovery in commodity demand looking sustainable and supply constraints re-emerging in several sectors, we expect fundamental dynamics within individual commodity markets to re-establish themselves as the main price drivers.

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We expect the G4 currencies to underperform the rest of the FX world, as their economies face much more significant fiscal pressures and are likely to keep real interest rates lower while risk appetite and liquidity recover.

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Recovering from Q2

After the flight to quality in Q2 10, global bond markets should take the first steps towards normalization in Q3. We expect US rates to rise slowly across the curve, driven by improvements in labor markets and inflation readings, as well as a rising term premium.

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Sovereign risk takes centre stage

Sovereign risk has clearly been a key driver of volatility this quarter, along with concerns about financial reform in the US. We expect moderate spread tightening over the rest of the year, with the US markets outperforming Europe.

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Low valuations drive positive stance

Our positive stance on European equities into year-end is driven by historically low relative and absolute valuations, the risk of higher longer-term inflation volatility and improving sentiment in peripheral European bond markets.

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In the shadow of fear

Tactically, we remain bullish on emerging asset markets. But if the rally materializes as we expect, we would be inclined to pare back risk on the view that longer-term challenges will continue to justify caution in risk asset markets.

OVERVIEW

Rebound, but no raging bull market

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- **Recent market moves should be viewed as a healthy correction that has restored value in many asset classes.**
- **They do not pose a serious threat to the continuation of economic recovery: financial conditions remain strongly supportive of growth even after the correction.**
- **However, we see significant roadblocks to a sustained bull market given the headwinds of monetary tightening in EM countries and fiscal issues in developed countries.**
- **We still recommend selective exposure to risky assets as the recent bout of risk aversion has probably peaked in the near term.**

The past few months saw consistently favorable economic news and a sharp decline in financial asset prices – as well as a surge in volatility – following one of the strongest market rallies in decades. We view the economic data as confirmation that a sustainable global expansion has taken hold and see the market setback as a correction that has restored value in many asset classes, rather than as a threat to economic recovery. Moreover, fiscal tightening in the wake of the Greek crisis is not expected to pose a significant risk to growth over the next few quarters, and we have made few changes to our above-consensus economic forecasts. As a result, we recommend that investors maintain selective exposure to risky assets (particularly, equities in Europe and the United States).

Surging government debt and extreme monetary ease can support growth and markets for a time, but they do not provide a firm foundation for a low volatility, sustained expansion

The market reverberations around the Greek crisis, however, suggest that it will not be smooth sailing over the intermediate term. The inability of policymakers to restore confidence and financial market stability has undermined their credibility and fostered the impression that markets are dictating policy, rather than the other way around. More fundamentally, surging government debt and extreme monetary ease can support growth and markets for a time, but they do not provide a firm foundation for a low volatility, sustained expansion. Asset valuations hit bottom back in the 1970s when investors lost confidence in the ability of the authorities to deal with the problem of the day – inflation – and then peaked around the millennium when investors believed the Federal Reserve had the means and the inclination to assure strong market outcomes (the Greenspan put). While authorities may still have the inclination, few investors now believe they have the means to assure a favorable result. Markets, thus, are unlikely to reach excessive valuations, even when near-term economic performance is strong and monetary policy is extremely supportive.

Broad-based asset value de-rating

While the market downturn was sharp, it was not particularly severe in the context of the preceding rally

The most salient feature of the recent correction in financial markets is its breadth. With the lone exception of gold and safe haven assets such as Bunds and Treasuries, all asset classes in all geographies experienced a significant setback: asset values were de-rated across the board. While the market downturn was sharp, it was not particularly severe in the context of the preceding rally. The Dow Jones Global Equity Index, for example, fell 16% over seven weeks following an 86%, 13-month rally. The roughly 30% retracement is typical of the experience of a broad range of assets, with essentially no market giving up as much as 50% of its prior gains.

The Greek debt crisis and Asian growth concerns were triggers of the broad market sell-off, rather than causes

The market setback had several triggers. Most dramatically, the Greek debt crisis and disorganized European efforts to contain it brought back memories of earlier, not fully successful efforts to contain the spread of the banking crisis. More mundanely, growing signs of overheating in China and increasingly aggressive attempts by the authorities to rein in credit growth and the surging property market set off Asian growth concerns. The breadth of the market correction, however, suggests that these were triggers, rather than causes, and that the setback should be viewed as a natural and probably healthy correction to markets that had run up extremely rapidly.

Market moves do not threaten expansion

Financial conditions remain strongly supportive of growth even after the correction

Unlike two years ago, when the financial crisis was unfolding, the current market moves in themselves do not pose any serious risk to the continuation of the economic expansion. While bank funding spreads have increased modestly and credit spreads have widened – mainly because of the strong rally in government bonds – the moves have been modest. Moreover, the rally in Treasuries has brought mortgage and high grade corporate bond yields lower, and the fall in oil prices is boosting real incomes, thus providing some offset. Financial conditions remain strongly supportive of growth even after the correction.

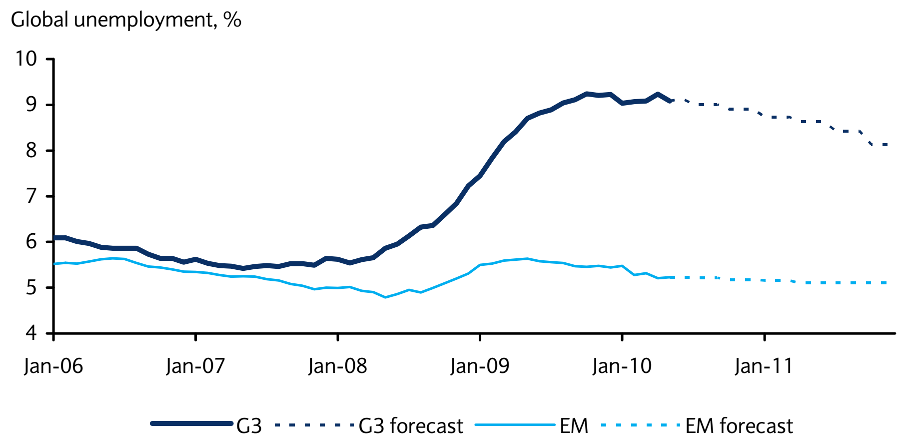
Just as consistently, strong economic data were putting to rest fears that the hangover from the debt crisis precluded a solid economic recovery; however, recent events highlighted two other challenges to the sustainability of the global expansion. One relates to emerging economies: can they make a smooth transition from the policy-boosted early-cycle surge in growth to a more modest, sustainable pace of expansion? The other relates to the developed economies: can they achieve the necessary degree of fiscal consolidation without jeopardizing their expansions?

Emerging markets less attractive near term

From a cyclical point of view, we favor developed markets over the next few months

Emerging markets have generally outperformed developed markets for at least a decade, but from a cyclical point of view we favor developed markets over the next few months, as the scope for above-trend economic growth is much greater there (Figure 1). China has led the way in the recovery and is showing clear signs of overheating, although a significant tightening in credit appears to be moderating activity. The loosening of the exchange rate peg – to the extent that it substitutes for higher policy rates – is a modest positive for global growth. Still, labor shortages, wage pressures and rising inflation suggest that concerns

Figure 1: More scope for above-trend growth in developed economies



Note: Dotted lines represent BarCap forecasts. G3 refers to the US, euro area and Japan. EM refers to Brazil, China, and Russia.
Source: Datastream, Haver, Barclays Capital

about policy tightening will continue to weigh on markets. Recoveries in other emerging economies are not quite as advanced, but other major EM countries, including India and Brazil, are showing signs that the scope for additional above-trend growth is limited, suggesting the need for considerable policy tightening going forward. Policy tightening in many EM countries is either in its early stages or not yet even begun, and policy stances remain very easy.

Signs of strong growth in EM will generate concerns about more policy tightening, while signs of weaker growth will induce worries of too much slowing

Periods of policy tightening aimed at slowing growth tend to produce uncertainty and financial market volatility. The coming months may be something of a no-win situation in emerging markets: signs of strong growth will generate concerns about more policy tightening, while signs of weaker growth will induce worries of too much slowing. We are optimistic that transitions to sustainable expansions will be achieved in most emerging economies, and any rebound in risk appetite should benefit emerging markets. But until these tightening cycles play out further, we would recommend a somewhat more cautious approach to emerging market assets, especially local market debt.

China approaches a turning point

For China, the approaching transition is more than just cyclical, as it appears that the once bottomless pit of surplus labor is beginning to run dry. This means that the sustainable rate of growth will be at least modestly lower and that inflation will likely become somewhat harder to contain. We expect this transition to be gradual, however, with growth well maintained next year at 9% and inflation under 4%. But the changing fundamentals in China introduce another note of uncertainty, which is likely to keep investors cautious.

Can developed countries pay their bills?

The combination of a lack of fiscal discipline and the resulting build-up of debt levels over past decades, the sheer size of government spending relative to GDP, the impact on finances of the severe recession and policy response to it, and unfavorable demographic trends are challenging the fiscal capabilities of most developed countries. While the focus has been on Europe because of Greece, the severity of the problem and the extent of needed tightening are greater elsewhere, including the US, which has seen one of the sharpest deteriorations in fiscal position as it boosted its deficit aggressively to counter the recession (Figure 2).

Figure 2: Fiscal positions in developed countries

	Fiscal Positions in Developed Countries			
	Budget Deficit %GDP	Debt net %GDP	Spending % GDP	Expected tightening 2011 (%GDP)*
Euro Area	-6.1	59.0	50.8	1.0
United Kingdom	-10.1	77.3	47.3	2.0
United States	-11.0	66.2	41.4	0.8
Japan	-9.8	121.6	39.6	0.4

Note: *Barclays Capital forecasts. Source: IMF

Developed countries are set to tighten fiscal policy in 2011

The budget recently released by the new government shows that the UK is embarking on aggressive fiscal tightening, while the euro area as a whole seems set to tighten more gradually, reflecting the relatively benign fiscal positions of Germany and France. The amount of tightening the US will undertake in 2011 is less clear. Under current law, US fiscal policy would tighten by well over 2% of GDP next year as the Bush tax cuts expire and much of the stimulus spending runs out. However, Congress, with the support of the Administration, is expected to pass various extensions of stimulus measures and make

permanent many of the Bush tax cuts. With the mid-term elections not until November, few politicians in Washington want to focus on fiscal issues before they have to, and the amount of fiscal tightening in the US will remain uncertain until late in the year. Given the lack of commitment in Washington to immediate fiscal tightening, we expect it to amount to less than 1% of GDP in 2011.

Fiscal tightening in developed economies in 2011 will be balanced by extremely easy monetary conditions

It is unlikely that such fiscal tightening will derail the expansion in 2011. To be sure, we would not downplay the seriousness of the fiscal challenges facing the world's major economies as a medium-term issue. If governments do not make significant progress getting their fiscal houses in order in the next few years, there will be more Greece-like situations the next time the global economy experiences a recession. But the tightening is coming after a solid recovery has been established and in a magnitude – less than 1% of global GDP – that is not out of line with what has occurred in past expansions. Most importantly, it will be balanced by exceptionally easy monetary policy, as the major central banks, including the BoE, the ECB, the BoJ and the Fed, now place support of solid economic expansions above all other objectives. Largely because of the European debt crisis and the associated market dislocations, we have delayed the assumed start of tightening by the major central banks by an average of six months, despite no downward revisions to either growth or inflation forecasts. The bottom line is that developed countries will face a relatively favorable policy environment in 2011, with fiscal tightening balanced by continued exceptional monetary stimulus.

Asset allocation conditioned by expected near-term bounce in risk appetite

The Greek crisis produced a significant sell-off in equities and commodities; a rally in government bonds (outside of those peripheral European bonds that were directly under pressure); a widening of corporate spreads; a sharp decline in European currencies generally; and rebounds in safe-haven, low-yielding currencies. To a large extent, this can be characterized as a global risk aversion trade.

The recent bout of risk aversion has probably peaked in the near term

Concerns about tightening in EM countries and fiscal sustainability in developed countries are likely to make it more difficult for a sustained bull market to take hold over the next several years. But if the economic recovery remains intact and outperforms current (lowered) expectations, we would expect that the recent bout of risk aversion has probably peaked in the near term. It is also helpful that the European response to the Greek crisis appears to have recently turned constructive. Bond yields in peripheral Europe have fallen since the EU/IMF package was announced and the ECB began to buy these bonds, and a consensus about fiscal consolidation in Europe seems to be developing. Countries are taking action: Recent Greek budget figures are meeting tough targets, and the UK, France, Spain and Germany all have announced fiscal consolidation measures. Meanwhile, expectations for monetary tightening have been delayed, and the tight fiscal, easy money policy mix expected in developed markets has tended to be favorable for asset prices, particularly equities.

Developed country equities look attractive

With the developed economies early in their expansion cycles – leaving plenty of room for sustained above-trend growth – and with policymakers committed to realizing that potential and profit margins high, it is easy to see a few years of solid earnings growth. Following the recent sell-off, valuations now appear reasonable, with S&P trading at 12.5 times estimated 2010 earnings, and Europe trading even cheaper. Indeed, following the sell-off associated with the Greek crisis, European equities seem historically attractive, especially given the drop in the euro. We recommend overweighting US and European equities, slightly favoring the latter (see *Equity Outlook* section on page 63).

Interest rates unlikely to go lower; equities more attractive than IG credit

The widening of corporate spreads during the European debt crises reflected the rally in governments rather than a significant sell-off in corporate bonds, and stocks sold off a lot more than bonds. This has two implications from an asset allocation perspective: the first is that government bond yields are extremely low; if we are correct that the global economic recovery is intact and that risk aversion has peaked in the near term, they are much more likely to rise than fall further. The second is that the relative valuation of stocks versus bonds has shifted in favor of stocks (to an extreme, according to our valuation metrics).

Overweight equities in the US and Europe and high yield corporate bonds, underweight Treasuries

Along with our recommendation to overweight equities in the US and Europe, we advise short positions in core government bonds and selective positions in corporates. The short position in governments is tactical rather than strategic; we would not maintain the position if there is a significant retracement of the recent risk-aversion market moves. For example, we recommend selling of US Treasuries at 10-year yields less than 3.5%, but believe that yields above 4% are difficult to sustain as long as the Fed holds overnight rates close to zero. Within Europe, peripheral spreads have probably peaked in response to policy actions and the expected near-term decline in supply. Meanwhile, we are constructive on credit spreads given our continued above-consensus economic growth forecasts, but prospects for absolute returns – especially in investment grade credit – are not as compelling, given our view on interest rates. That said, prospective returns on high yield corporate bonds and leveraged loans now look attractive (see *Credit Strategy section* on p. 53).

Dollar rise likely over for now

The safe haven currencies are likely to underperform

The fiscal crisis in Europe led to selling of European currencies generally (including the euro and EMEA FX) and relative strength in the safe haven currencies including the US dollar (USD), Japanese yen (JPY) and the Swiss franc (CHF). Signs that the fiscal situation in Europe is being contained suggest that the extreme selling of European currencies may well have run its course, especially considering that the significant decline in the euro has brought the currency – according to our valuation metrics – close to fair value. More broadly, if risk aversion takes a breather in response to continued evidence of economic recovery, we are likely to see some reversal in risk aversion trades. The safe haven currencies are thus likely to underperform, and the less liquid currencies – particularly in EM countries that are tightening monetary policy – are likely to outperform. It is also worth noting that the easy money, tight fiscal policy mix that we expect in the developed countries is typically not supportive for the underlying currencies. The relative strength of USD and JPY – despite relatively large fiscal imbalances – is thus unlikely to persist.

A modestly bullish environment for some commodities

Our above-consensus forecasts for the global economy are generally good news for commodity prices, especially in markets where supply is constrained. Although the expectation of slower growth in emerging economies should limit price gains, prospects for a somewhat weaker dollar provide an offset, as does continued above-trend growth in developed markets such as the US. While we do not anticipate the kind of price swings we have seen in recent years, we are modestly bullish on crude oil and some industrial metals such as copper.

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The arduous path to global policy normalization

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- **During the recent correction, correlations have returned to levels reached during the depths of the credit crunch.**
- **As a result, the potential for equity-like returns has re-emerged in several higher-risk fixed-income categories (including US high yield, leveraged loans, CMBS and non-agency mortgages) and relative equity valuations have cheapened to their most attractive levels in decades.**
- **We advise increasing exposure to risky assets at current levels, reducing exposure on rallies and generally approaching markets as if they were stuck in a range.**

The tug of war between fiscal and monetary policy

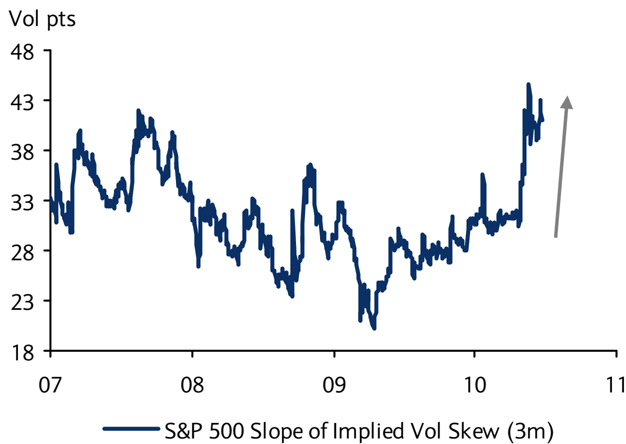
The Great Recession may eventually prove to have been the turning point for the large global imbalances that built up throughout the previous decade, but, for now, growth in the developing world (Asia) continues to outpace growth in the developed world (the US and, especially, Europe) – and the discrepancy is growing. Meanwhile, the Keynesian fiscal policy response to the global recession, combined with central bank balance sheet expansion, may ultimately prove to be the undoing of the disinflationary trend of the previous three decades. In this environment, asset allocation is complicated by the fact that the policy response to the global recession is already being reversed in some parts of the world (e.g., India and Brazil). As such, our general strategic approach is to avoid equity markets where monetary policy is being tightened and to increase exposure to regions where monetary policy remains easy.

A widely held view in 2009 was that correlations across asset classes would fall in 2010 as unconventional monetary policy was unwound. But during the recent correction, correlations have returned to levels reached during the depths of the credit crunch. As a result, the potential for equity-like returns has re-emerged in several higher-risk fixed-income categories (including US high yield, leveraged loans, CMBS and non-agency mortgages) and relative equity valuations have cheapened to their most attractive levels in decades.

Although we do not think risk premia will shrink considerably in the near term, we do recommend adding exposure now

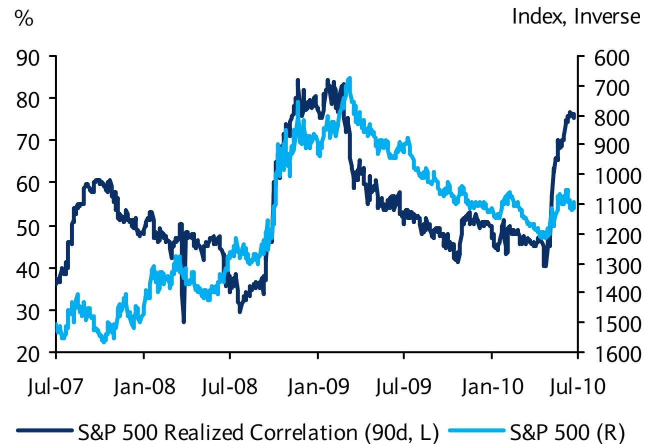
Although we do not think risk premia will shrink considerably in the near term, we do recommend adding exposure now. We would stay alert and flexible, though, as we expect European-style fiscal-tightening concerns to develop in the US early this autumn as market participants begin to quantify the impact of various fiscal-tightening scenarios on the 2011 US growth outlook. We thus urge investors to respect the highly correlated trading environment for risky assets and to increase exposure at current levels, reduce exposure on rallies and generally approach markets as if they were stuck in a range. Although we view deflation and double-dip scenarios in the US and core Europe as low-probability outcomes, we do not dismiss the risk of adverse shocks; indeed, we note that US and European equity market valuation and index option downside skew (the price for so-called disaster insurance) are discounting greater risk now than during the depths of the Great Recession.

Figure 1: Index option downside skew is discounting greater risk now than during the depths of the Great Recession



Source: Barclays Capital

Figure 2: We urge investors to respect the highly correlated trading environment for risky assets and to increase exposure at current levels, reduce exposure on rallies



Source: Barclays Capital

Many market participants expected the first half of 2010 to be free of fiscal and monetary tightening in the developed economies

The Great Depression taught policymakers to respond to a massive credit crunch aggressively and decisively. In our view, the actions of the US and China (on the monetary and fiscal stimulus fronts) were the catalysts for a sustainable recovery in global growth. Many market participants expected the first half of 2010 to be free of fiscal and monetary tightening in the developed economies (a "sweet spot" for risk, in a sense), but the fact that China was forced to begin tightening policy just as recession was ending in the US helped set the stage for the faster-than-expected closing of the easy-policy window.

The Great Depression does not offer a roadmap for the timing of fiscal and monetary stimulus removal

Despite the far more decisive monetary and fiscal policy response relative to the early 1930s, investors continue to worry about premature fiscal tightening in response to capital outflows. The German and UK economies saw their gold reserves rapidly dwindle following a banking crisis in Austria in 1931 and responded with fiscal austerity measures. The current problems in the Spanish banking system and sharp drop in the euro have heightened investor concerns; however, we would point out that massive fiscal and monetary policies contributed to a stabilization and reversal of economic activity. This was not the case in the 1930s, when central banks failed to act in a coordinated fashion and inflexibility related to the gold standard precluded fiscal stimulus. So, while we don't believe the 1930s offer an appropriate road map for the timing of policy removal, investors continue to focus on periods like 1937, when premature monetary policy liquidity draining prompted a second sharp drop in US economic activity. In other words, because the response was so aggressive during the Great Recession, we believe it can and will be removed faster and this process will be a major factor in asset performance for the foreseeable future. In the near term, we think monetary policy will have a more immediate impact than fiscal policy on financial markets and, as a result, asset allocation decisions.

Central bank balance sheet expansion is an example of the complexities inherent in this cycle. In a typical monetary-tightening regime, central banks simply begin raising rates as the output gap closes (as has already occurred this year in Canada, Australia, Norway and Brazil). Although the ECB tried to avoid employing unconventional policy measures as aggressively as the Fed, fiscal automatic stabilizers and decades of failing to consider labour or pension reform arguably contributed to government deficits. And the more tentative central bank response did little to accelerate the financial-sector deleveraging process. The ECB's more cautious response led to concerns about weaker sovereigns' ability to service their debt, and their banking systems' exposures to that debt. As spreads widened, the ECB

was dragged into balance sheet expansion beyond interbank lending programs, purchasing sovereign debt under duress.

On the other hand, the US aggressively bought mortgage and Treasury debt and, *at this point*, it appears to have done so without any significant repercussions. In both cases, there are direct and indirect risks to balance sheet expansion. For the ECB, a future debt restructuring by Greece could lead to a capital loss. Given the underwriting standards of the agency MBS bought by the Fed (it bought recent-vintage, post-housing bubble mortgages), the risk of capital losses seems low and lower rates are causing the portfolio to run off faster than expected. Still, a significant rise in rates driven by inflation could leave the Fed in a position in which the increase in its balance sheet would itself contribute to rising inflation, thereby forcing it to sell mortgages into a falling market. In the near term, we think both are low-probability outcomes, though the risks could increase over time.

Markets have forced an earlier-than-expected fiscal tightening process in Europe

For the rest of 2010 and, most likely, 1Q11, risks to the Fed/ECB exit from easy monetary policy look minimal, as markets have forced an earlier-than-expected fiscal tightening process in Europe and, with the expiration of the Bush tax cuts in the US at year-end, the Fed would seem to have missed its window to begin reversing monetary policy accommodation in 2010. With global capital flows and goods prices linked more tightly now than in any other cycle, we doubt the risk of further Fed balance sheet expansion has been completely mitigated and see inflation pressures building at the goods level in the US, particularly in the producer and import price measures.

Meanwhile, falling bank lending and shelter inflation in the US are masking underlying inflationary pressures, in our view. China's currency policy and macro prudential guidance during the recession (which also stimulated a significant increase in its monetary base and velocity of money) was quite successful in stimulating growth, which has closed the country's output gap and led to inflationary pressures (wages, food, real estate, etc.). China is being forced into multiple tightening measures, including bank lending curbs and a return to the crawling peg. Our economists are confident that China will manage the slowdown effectively, but expect markets to remain more concerned about the possibility of a policy mistake leading to a sharper-than-expected slowdown.

Cheap financing from the world's most developed markets will likely continue well into 2011, absent considerable acceleration in global growth

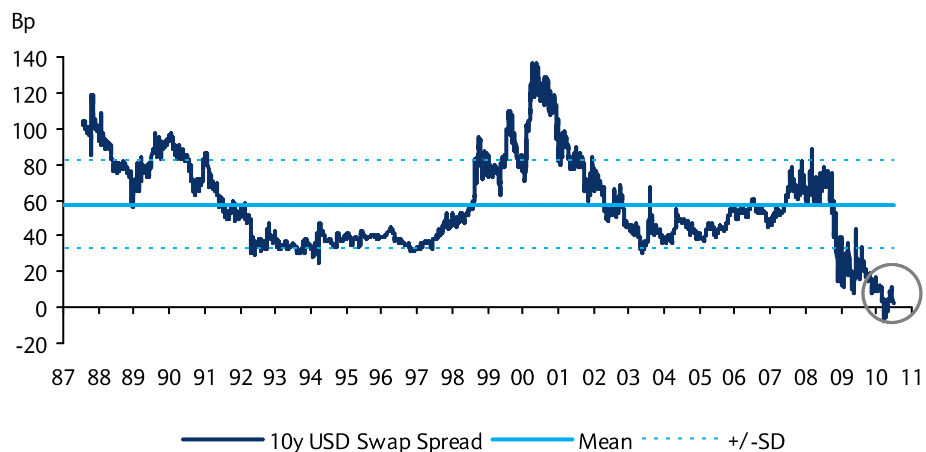
So, we are left with the ECB being dragged into quantitative easing well after the recession has ended, the Fed's exit strategy on hold in part because of Europe's cautious approach to the crisis, and China and several developed and developing markets already well into the monetary tightening process. Still, with three of the four largest economies in the world (US, Germany, and Japan) in no position to tighten monetary policy significantly, cheap financing from the world's most developed markets will likely continue well into 2011, absent considerable acceleration in global growth.

Fiscal tightening has become an offset to monetary easing in Europe as markets have forced politicians into pro-cyclical measures. As the aftershock developed this spring, uncertainty associated with the nature and timing of fiscal tightening was a significant catalyst for a cheapening of risky assets. We understand investor concerns: the austerity measures taken during the early stages of the Great Depression to slow capital outflows from Germany and the UK exacerbated the contraction. One can debate whether fiscal stimulus is being withdrawn prematurely, but the measures are being taken after the recession has ended and after a massive monetary and fiscal policy response.

As policymakers delineate the path to tighter policy, the slightly reduced uncertainty allows investors to quantify the implications for the growth outlook. The recent release of the UK budget is a case in point: with investors now in a position to quantify the impact of the

measures on growth, UK equities look attractive. The steps that have been taken in Europe will likely be a drag on growth in 2011 and beyond. However, the drop in the euro has boosted the near-term outlook, and equities in particular are fully discounting the slower growth trajectory, in our view. The June German IFO Business Confidence reading underscored this growth trajectory. The *current conditions* index beat expectations while the *expectations* index fell more than expected; however, both remained at levels consistent with an economic recovery. We note that this framing of the fiscal tightening process has not yet begun in the US; we believe the inversion of 10-year swap spreads in March was a warning sign that the US is not immune to investor concerns about the outlook, despite stronger growth and the US dollar's status as the world's reserve currency.

Figure 3: We believe the inversion of 10-year swap spreads in March was a warning sign that the US is not immune to investor concerns about the outlook



Source: Barclays Capital

In our view, a US election outcome that points to a greater reliance on tax hikes than spending cuts will be viewed as a reduction in potential growth

As the US mid-term elections loom and politicians are no longer able to avoid discussion of the mix of spending cuts and tax hikes in 2011 and beyond, we expect markets will become concerned that the current level of government spending as a percentage of GDP (26% up from the average since 1960 of 20%) is unsustainable. In our view, an election outcome that points to a greater reliance on tax hikes than spending cuts will be viewed as a reduction in potential growth. Our reading of the conventional wisdom in the political system and media is that the Democratic majorities in each branch of Congress are too great to overcome. However, we do not believe that investors have discounted this outcome. It is too early for a strong view on the election, particularly ahead of the fiscal tightening debate, but we are confident that investors will eventually move closer to the media view that Democrats will maintain control of both branches of Congress.

To be clear, we think the US and global capital markets associate the Democrats with a greater mix of tax hikes and larger deficits. Already, with the capital markets having recovered in recent weeks, 10-year swap spreads are threatening to go negative again. Clearly, technical issues are at work (financial corporate issuance swapped to a floating rate and a lack of mortgage convexity hedging), but the massive government supply is the real story, in our view. We judge that the US is not immune to fiscal tightening pressures, particularly while the market outlook for US growth lingers around potential (the Fed views potential as roughly 2.8%, and the current Bloomberg consensus is 2.8-3% for 2H10 and 1H11). If an above-consensus US growth outlook materializes (as forecast by Barclays Capital), the market will worry less about debt service; however, the normal ebbs and flows of the data imply that there will continue to be periods of market concerns about the fiscal tightening process.

Given our outlook for fiscal tightening and easy monetary conditions in the US, Europe and Japan, we thought it would be useful to examine past episodes of fiscal tightening (three-year periods in which the structural adjustment has been greater than 2.5% of GDP) combined with low, stable policy rates or monetary easing. We identified nine such examples since the early 1980s and found the common theme to be the outperformance of stocks relative to bonds, with commodities lagging both (Figure 4). We do not expect absolute returns to approach these levels, but the relative performance history fits our view of relative value across asset classes and our outlook for China and emerging markets. We like developed market equities and fixed income spread markets that offer equity-like returns, and we are cautious on fixed income and commodities.

Figure 4: During past episodes of fiscal tightening combined with low, stable policy rates or monetary easing, the common theme has been an outperformance of stocks relative to bonds, with commodities lagging both

	Triennial period ending:	Monetary policy Start Date	Monetary policy End Date	Policy rate at start date	Policy rate at end of period	Annualised average Equity return	Annualised average Bond yield change	Annualised Average commodity return (GSCI)
Fiscal tightening combined with low and stable policy rates								
Japan	1985	Oct-83	Dec-85	5.0%	5.0%	22.6%	-0.65	-2.3%
Finland	1998	Sep-96	Nov-98	4.0%	4.0%	54.2%	-1.16	-18.0%
Sweden	1999	Dec-96	Nov-97	4.1%	4.1%	41.2%	-0.60	-13.4%
Denmark	2005	Jun-03	Nov-05	2.0%	2.0%	28.9%	-0.16	27.0%
Average						36.7%	-0.64	-1.6%
Fiscal tightening combined with monetary easing								
Denmark	1984	Oct-82	Dec-84	11.0%	7.0%	24.1%	-2.77	-0.4%
Germany	1994	Aug-92	Dec-94	9.7%	4.9%	15.1%	-0.27	-1.3%
Sweden	1996	Dec-95	Dec-96	8.9%	4.1%	43.9%	-1.76	5.8%
UK	1999	Sep-98	Aug-99	7.5%	5.0%	31.5%	0.16	19.9%
Hungary	2009	Oct-08	Dec-09	11.5%	6.3%	43.0%	-1.61	14.2%
Average						31.5%	-1.25	7.6%

Source: Barclays Capital

Buy the spoos (equities) and sell the 2s (Treasuries)

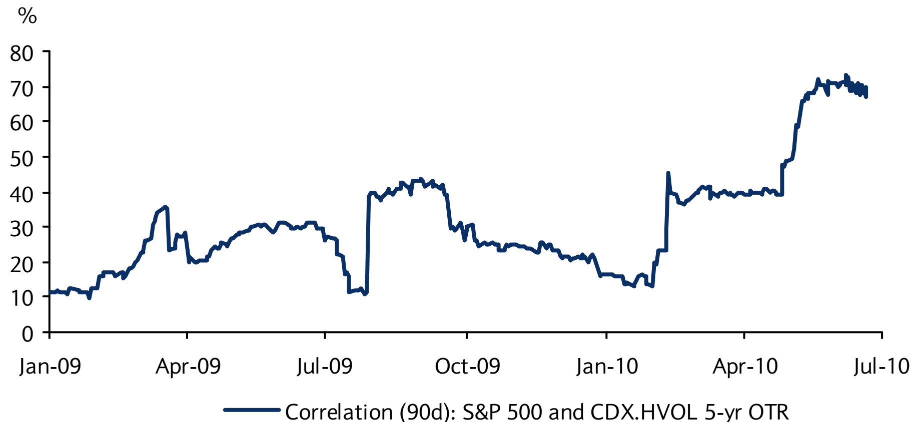
Asset volatility and returns should diverge on rallies and converge on corrections

The recent highly correlated correction in risky assets has cheapened equities to their most attractive levels relative to low-risk fixed income for the cycle, and higher-risk fixed income spread assets are back to nearly double-digit loss-adjusted returns. We expect the 2010 correlation pattern (rising on corrections and falling on rallies) to continue. In other words, asset volatility and returns should diverge on rallies and converge on corrections. If this pattern persists, asset selection will be important for rallies, while the correct approach for corrections will be to reduce risk across the board. Given the role that quantitative easing played in the 2009 US capital markets recovery, we expected cross-asset class correlations to fall, given that such purchases stopped at the end of 1Q10. In other words, as Fed purchases slow, the process of pushing capital out the risk curve towards higher-risk asset values should dissipate and returns will increasingly be determined by individual asset class fundamentals. Indeed, this theme was prevalent during the rally from mid-February through late April.

However, during the correction, correlation spiked sharply. The combination of developing world monetary policy tightening (China, Brazil and India), the European fiscal crisis and a

reduction in the US market-implied growth outlook from the rapid 4Q09 pace caused correlation to leap back towards the levels of the Great Recession. The highly correlated correction resulted in most risky asset classes again appearing attractive and we suggest reasonable (but not maximum) exposure to risky assets.

Figure 5: Correlation has leapt back towards the levels of the Great Recession



Source: Barclays Capital

The risks of an adverse shock in the near term have declined

So, as we think through the three key risks that served as catalysts for the correction, we expect significant improvement in only one of them in the near term (the US growth outlook, though that should be enough to trigger a reasonable rally in risky assets). However, in our view, the risks of an adverse shock in the near term have also declined. In Europe, this implies that although the political struggle in Spain related to labour and pension reform will linger (and we do not expect bank stress tests in Europe to be as positive for capital markets as they were in the US in 2009), the risk of an interbank lending crisis is small (though Libor looks to be climbing for structural reasons). In China, while we view the small incremental step of loosening the peg as equivalent to monetary policy tightening, the tightening process is not yet far enough advanced for the market to significantly lower the probability of a policy mistake. However, the peg had been viewed by the markets as a major source of monetary risk; therefore, this change does reduce the tail risk of a spike in inflation. On balance, the risks from Europe and developing world policy tightening will likely linger, but, in our view, those risks are acceptable. And if the US growth outlook improves as we expect, the global capital markets should be pulled higher.

Although we see plenty of reason for caution on the corporate earnings outlook in the US and Europe in 2011 (amid fiscal tightening, slow credit creation and potentially emergent headwinds in the form of labour and commodity costs), we think current valuation levels leave considerable room for a slowing in the earnings growth rate. The compression in real bond yields and expansion of the equity earnings yield without the benefit of financial sector earnings (in the US, the financial sector accounted for 30% of earnings in 2006. but we project its 2010 contribution to be less than half that) have left the equity risk premium relative to investment grade credit and Treasuries at levels not seen in two decades, and with a higher-quality earnings stream associated with the equity earnings yield.

Figure 6: The compression in real bond yields and expansion of the equity earnings yield have left the equity risk premium relative to investment grade credit and Treasuries at levels not seen in two decades

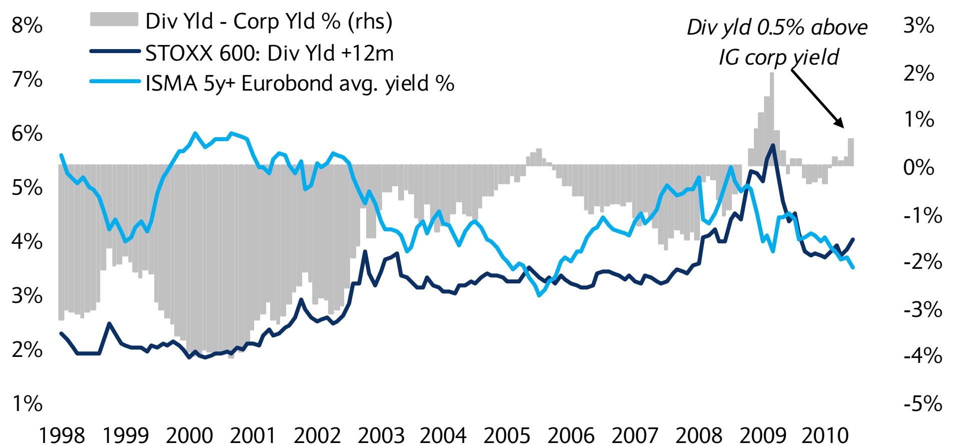
Source: Barclays Capital

We would not conclude that equity risk premiums are on the verge of a period of secular contraction as was the case in the mid-1990s, when disinflation and productivity gains consistently drove the equity risk premium lower, culminating in a negative equity risk premium at the height of the tech bubble. Still, in a period of easy monetary policy and low rates, the excess returns offered by equities should be attractive to investors even if growth in earnings and revenues are closer to nominal GDP than was the case last cycle.

We like equities relative to fixed income and would be neutral to underweight commodities until the monetary policy tightening process in China and emerging markets is closer to completion

With equity risk premiums elevated and a positive history for relative equity returns in periods of fiscal contraction and monetary accommodation, we like equities relative to fixed income and would be neutral to underweight commodities until the monetary policy tightening process in China and emerging markets is closer to completion. Within fixed income, we are negative on real rates primarily based on supply and an improving growth outlook and we are positive credit spreads and breakevens. In Europe, this implies being short German bunds, though we do not view Spain at 250bp and Portugal at 300bp over

Figure 7: Even measured relative to dividend yields, European fixed income is unattractive relative to equities



Source: Barclays Capital

Germany, respectively, as compelling relative to being long European equities at a 9½% forward earnings yield. Even measured relative to dividend yields, European fixed income is unattractive relative to equities. Still, because the European growth outlook is weaker than that of the US, the banking system is in considerably worse shape and monetary policy accommodation is likely to continue, longer bunds are perhaps more attractive than US Treasuries. We are not particularly interested in being long either market, though we suspect at times that as growth concerns and tail risks such as the European banking system increase, they will perform reasonably well. Therefore, we would be underweight German bunds and US Treasuries. However, given our view that risks will linger through the third quarter, our overweight of equities relative to the lowest-risk fixed income assets would not be extreme.

In the US, credit looks attractive relative to Treasuries; however, we would hedge rate risk, and we prefer high yield and similar spread assets that offer equity-like returns

In the US, investment grade credit looks attractive relative to Treasuries because of the recent spread widening. However, we would hedge rate risk, and we prefer high yield and similar spread assets that offer equity-like returns. Still, even where earnings yields are comparable to loss-adjusted high yield corporate or securitized assets, we prefer equities given our expectation of an improved growth outlook, at least in the US. In other words, when we consider earnings yields to real fixed income yields, the earnings component is not fixed and is positively correlated to growth, which is not the case with any fixed income instrument, even high yield. Even the Fed and ECB will need to implement their exit strategies eventually. The Fed, for example, might begin draining liquidity this autumn if the growth outlook improves. And although we do not expect the Fed to be able to begin normalizing conventional rate policy ahead of 2011 fiscal tightening, the markets might pull forward rate hikes if the Fed begins a program of reverse repos and opens the term deposit facility. Ultimately, the Fed should be able to persuade markets that liquidity-draining is a technical measure that does not imply an immediate normalization of conventional rate policy, however, not before rates in the belly of the Treasury curve back up significantly. This would lead to an equity market correction as well. Strong growth and central bank tightening would indeed be a problem for equities, yet absent another 2004-06 Treasury yield curve conundrum, with rates at current levels a conventional monetary policy tightening cycle would be a far more serious issue for US Treasuries than equities. With Asia ex-Japan either already tightening monetary policy or needing to begin a tightening cycle, we would avoid fixed income in the region. Inflation breakeven trades in the US and the UK look attractive. We do not think commodities are an efficient way to capitalize on a bottoming in developed world inflation measures, though we do like energy relative to base metals because of the greater leverage to improving growth in the developed world.

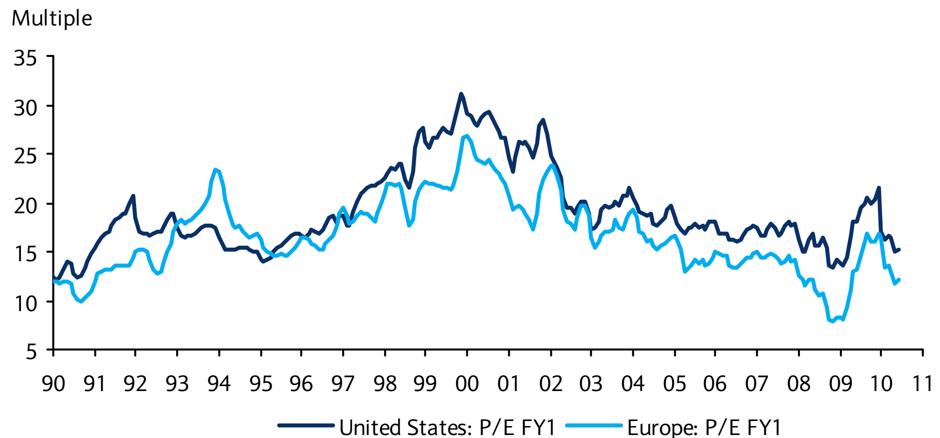
European equities look cheap relative to US equities

There is a long history of European equities appearing cheap relative to US equities, and we believe there are valid reasons why this should continue to be the case. Still, the recent correction left European equities at levels we consider reasonably compelling, and we would overweight them relative to the US.

The market is implying greater risk than was the case during the depths of the Great Recession

Interestingly, in both the US and Europe, equity index put skew is at or above the most expensive levels reached during the Great Recession. At the same time, valuation metrics have reached very attractive levels relative to other asset classes. In our view, this is a key determinant of our favourable view on equities. In essence, the market is implying greater risk than was the case during the depths of the Great Recession. Indeed, with so much uncertainty removed the market appears to have overshot the risks. This presents a complexity in implementation, in that the intuitive risk to being long equities is a tail event in which policymakers lose control of the capital markets. However, the heavy cost of protecting

Figure 8: The recent correction left European equities at levels we consider reasonably compelling, and we would overweight them relative to the US

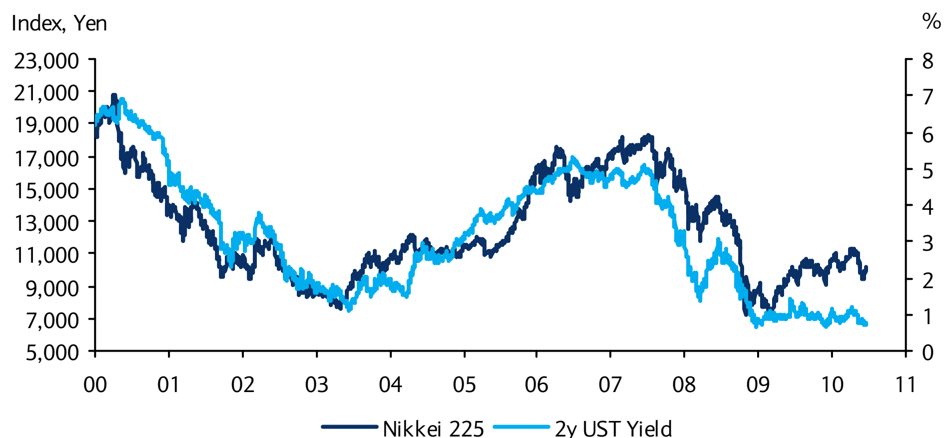


Source: FactSet, Barclays Capital

against that risk makes buying out-of-the-money puts an inefficient hedge. We prefer buying ratio call spreads rather than selling downside puts to capitalize on elevated skew, given our expectation of a rebound in the markets. As the markets rally, implied volatility falls for the out-of-the-money calls the investor is short, while the long call loses gamma as it moves more in the money; and if the tail events do materialize the market moves away from the strike prices, leaving the investor losing only the premium paid for the position.

We have mixed views on Japanese equities. On the positive side, Japan's capital goods companies look well positioned to capitalize on continued growth in China. On the negative side, a chart of Japanese equities and 2 year US Treasury yields (Figure 9) underscores the continued leverage to US growth.

Figure 9: On the negative side, the relationship between Japanese equities and 2y US Treasury yields underscores the continued leverage to US growth



Source: Barclays Capital

Until the Fed is ready to withdraw liquidity, the markets will likely remain sceptical about the outlook for US growth, and, as previously noted, we expect lingering Chinese policy concerns to preclude positive returns in Asia. Additionally, Japanese PE ratios remain high (Figure 10) and book values low (Figure 11) relative to the rest of the world, underscoring

the country's continued struggle with deflation (we attribute the low price to book to expectations that corporate assets will fall in value). Korea scores much better on this front; it is leveraged to capital goods (a sector we like globally) and is one equity market in Asia in which we would have a slight overweight position.

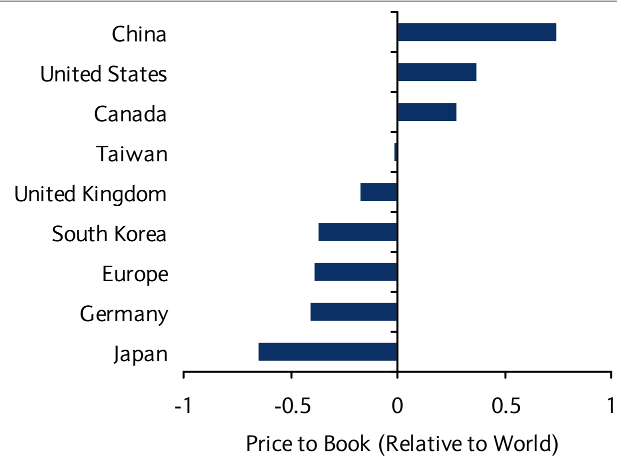
We will leave a discussion of equity sector views to the relevant section of this report, though we note a common theme: underweight financials. Any rallies on better-than-expected outcomes for European bank levies or financial regulatory reform in the US are, in our view, opportunities to reduce exposure ahead of years of restrained asset growth related in part to higher global capital standards and liquidity frameworks, whether Basel III provides the outline or regulators raise these standards independently. We expect financials to trade similarly to technology stocks in the US following the bursting of the technology bubble, when they rebounded sharply in 2003 before spending two years going nowhere.

So, despite investor concerns about premature policy normalization, we rate the risks of a double dip for growth or associated deflation as minimal, though those fears are likely to keep risk premiums in the asset class most leveraged to growth, equities, relatively high. Generally we would avoid markets where monetary policy tightening is in progress and concentrate on markets where the fiscal tightening process has begun as long as monetary policy remains accommodative. As the growth outlook in the US improves, global capital markets should rally; however, until the fiscal tightening process in the US begins to take shape, investors should consider risky assets to be range bound. This implies reducing risk in all asset classes after rallies and adding risk in equities after corrections. We find current valuation levels for equities and risky assets attractive and prefer European equities to those in the US, because valuations have been stretched beyond their typical discount and the fiscal tightening process is under way in Europe, which should serve to remove uncertainty.

Figure 10: Japanese PE ratios remain high …

Source: FactSet, Barclays Capital

Figure 11: … and book values low



Source: FactSet, Barclays Capital

ECONOMIC OUTLOOK

Slouching towards the new normal

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- **The cyclical factors that have been driving growth for the past six quarters will likely begin to yield to medium-term secular forces.**
- **We believe markets may be overly pessimistic about the possibility of a near-term debt incident in peripheral Europe. The longer-term implication of the European crisis is likely not to be default, but rather fiscal consolidation among advanced economies too early in the cycle. Policy inflexibility increases the downside risks to growth.**
- **Emerging markets are decoupling again, and absent a large negative shock, we believe medium-term strong economic outperformance is likely to continue.**
- **China's soft landing is under way, but we do not believe it poses a large risk to global growth. Chances of a hard landing appear low despite deflation of the property bubble.**

With cyclical factors supporting global growth for the next two to three quarters...

We have highlighted in several of our publications that global economic momentum remains positive. Incoming data suggest, for example, that manufacturing output is booming in most economies. Also, we believe that cyclical factors, including unprecedented policy stimulus and inventory rebuilding, will support global production for the next two or three quarters.

...we focus on the more medium-term secular forces that will be the key drivers of growth in 2011

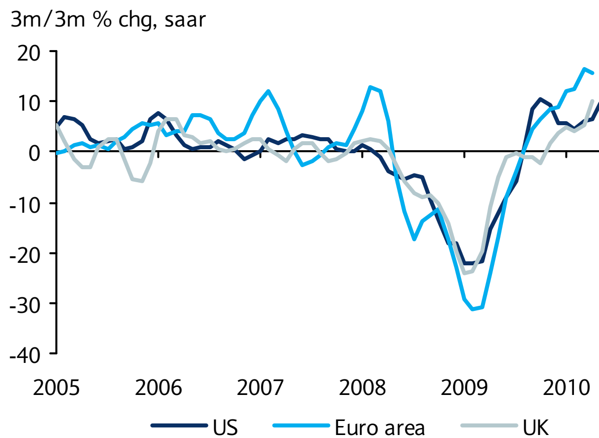
With cyclical forces having driven growth over the past six quarters, we focus on the more medium-term secular forces that will likely be the key drivers of growth in 2011. Those forces will, in our view, be determined largely by three major factors: the longer-term implications of the European debt crisis; the effects of the changes in banking regulation; and management of the policy-induced soft landing in China.

Peripheral Europe's debt problem

The European mega-package was effective in short-circuiting negative feedback loops and preventing a restructuring

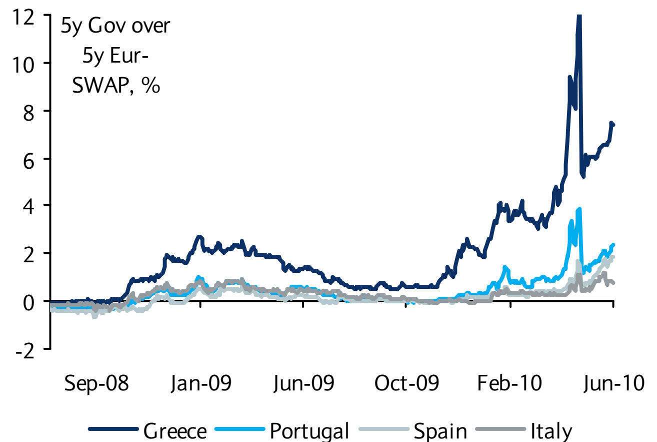
Absent the May 9 mega-package, market dynamics may have forced one or more of the countries in the euro periphery to restructure. In that respect (short circuiting the negative feedback loops), we think the package was reasonably successful. But it has not dispelled solvency concerns, and yields have remained elevated, in some cases trending higher again.

Figure 1: Manufacturing production growing sharply



Source: Haver, Barclays Capital

Figure 2: Peripheral Europe yields are lower, but still elevated



Source: Bloomberg, Barclays Capital

Obviously, dispelling such concerns was never the program's intention. Indeed, some market pressure is still needed to encourage countries to continue making the required fiscal adjustments to stabilize debt dynamics. However, if yields continue to move higher, new measures could be needed.

Greece's fiscal realities remain challenging, but a near-term restructuring appears unlikely

Greece's fiscal realities have not changed; the required fiscal adjustments remain unprecedented for a country that is expected to grow little over the next few years. However, barring implementation risk of the mega-package (including an unlikely but not fully discarded negative ruling by the German Constitutional Court), a near-term Greek restructuring appears unlikely. This is not to say, however, that yields should fall significantly from current levels. This is because recovery values are projected to be low, and beyond one year, default probabilities are high. This suggests that Greek yields will remain elevated and that the country will be out of the markets for some time.

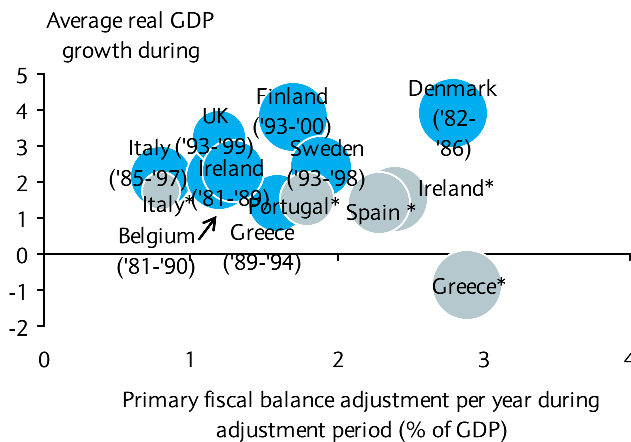
Spain has attracted attention recently because of its size and banking sector problems

The need to reduce market nervousness suggests that Spain could choose to draw resources from the EU-IMF pre-emptively

Among the other countries in the euro periphery, Spain has attracted the most attention recently because of its size and potential problems associated with its banking system's involvement in the real estate sector after the bubble burst. Spain's sovereign debt dynamics are not as bad as Greece's, as we have discussed in previous reports (*Euro Area Periphery - Implications of the EU's 'mega package'*, May 12, 2010) and should not be a huge source of market concern. But deterioration over the past few years implies that the fiscal room to absorb potential banking system losses is much smaller, and the possible credit crunch associated with banking system problems could slow growth in a way that negatively affects debt dynamics. The need to reduce market nervousness (which can quickly spiral out of control) suggests that Spain could choose to draw resources from the EU/IMF pre-emptively.

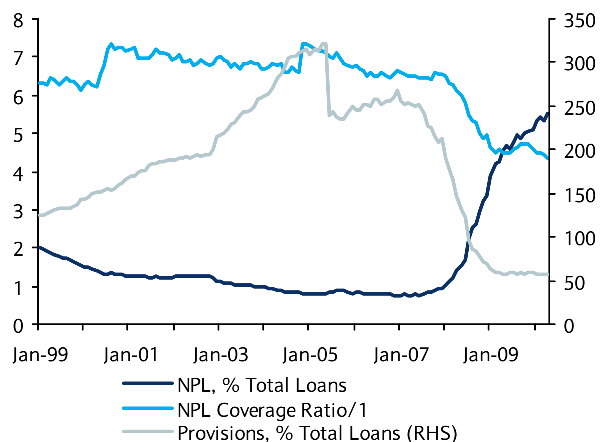
We believe that Spanish banking system losses are manageable. Yet with unemployment hovering around 20%, deflating housing prices (down 13% from the peak in mid-2007), and rising funding costs, credit institutions will likely face further increases in problem loans in the second half of 2010, as well as shrinking profitability. While most of the banks and the larger savings institutions should be able to absorb additional portfolio losses, some of the medium-sized and small saving banks may need to go through the restructuring and resolution process, which has already started under the financial support of a government-sponsored program (the "FROB").

Figure 3: Fiscal adjustment in peripheral Europe in context



Note: *Light blue bubbles show adjustment needs 2010-14. Size of bubble = total primary balance adjustment (% GDP).
Source: Eurostat, Greece Ministry of Finance, Haver, Barclays Capital

Figure 4: Indicators of the Spanish banking system



/1: NPLCR = (Capital + Provisions – NPLs), % Assets
Source: Bank of Spain, Barclays Capital

Given overinvestment during the credit boom years, commercial real estate is by far the riskiest segment in banks' portfolios

Given overinvestment in the real estate sector during the credit boom years, commercial real estate is by far the riskiest segment in banks' portfolios. Bank of Spain data show that the system has approximately USD445bn of exposure to the commercial real estate sector (25% of total bank credit to residents, or about 45% of GDP). Of this total, approximately USD166bn is in 'problem loans' (calculated as the sum of doubtful loans, substandard loans, foreclosed assets, and loan write-offs). Current provisions cover 35% of these potential losses, and considering expectations of net income for this year, the collateral value of the loans could fall at least 50% (and probably as much as 70%) before the banking system incurs further losses.

We expect credit conditions in Spain to remain tight as banks continue deleveraging

We expect credit conditions in Spain to remain tight as banks continue deleveraging. Credit institutions have reportedly started to dispose of real estate assets, forced in part by tighter provisioning requirements from the Bank of Spain. Sales of large stocks of real estate held by banks will likely push real estate prices down further, contributing to imbalances in the real estate sector.

Change in the policy mix

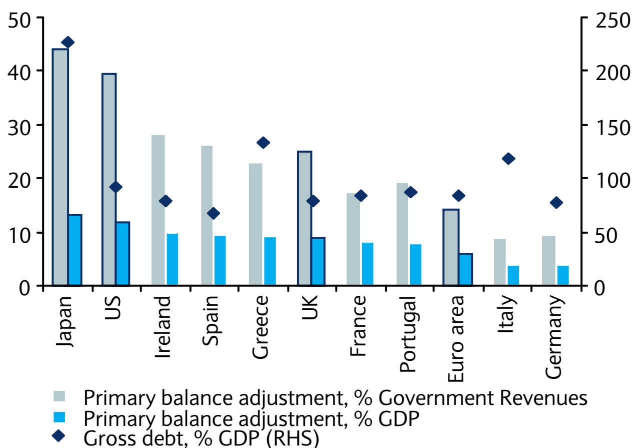
Debt sustainability concerns are not exclusive to the euro periphery …

Debt sustainability concerns are not exclusive to the euro periphery. According to the IMF, the expected increase in debt-to-GDP ratios in advanced economies (considered the announced fiscal plans) will be approximately 37pp between 2007 and 2015. Figure 5 shows both the stock of gross debt and the primary fiscal adjustment required to reduce debt-to-GDP ratios to pre-crisis levels (as a percentage of GDP and of government revenues). An observation of solvency ratios encompassing a subset of advanced economies suggests that while the euro peripheral countries are, on average, worse than Japan, the UK and the US, the differences are not enormous. Also, the euro area as a whole has the best solvency ratios in the G4.

…but differences in yields are large because of safe-haven status and credibility

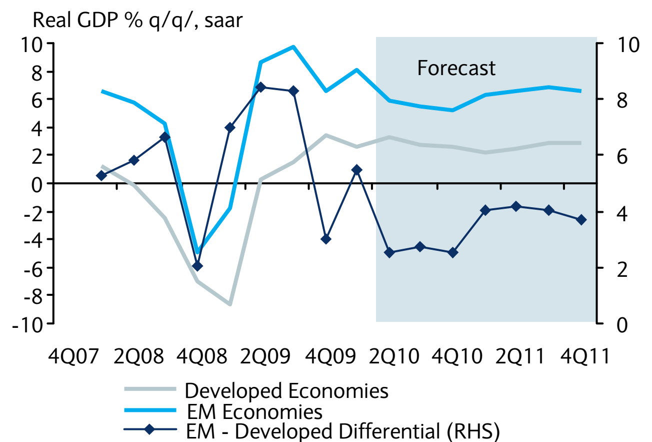
Small differences in debt dynamics but larger variances in yields are related to safe-haven status (for the US and Japan), credibility in the countries' ability to make fiscal adjustments, and the ability to (if everything else fails) use central bank balance sheets to buy government bonds. But there is an element of circularity here. If markets were to start questioning the ability of these core countries to stabilize debt dynamics, changes in yields could be abrupt. Cognizant of those potential risks and how rapidly market dynamics can change, we believe that a strong case can be made for a pre-emptive initiation of the required fiscal consolidation, even if current yields suggest that it is not something that markets are demanding right now. Recent tightening measures in the UK and Germany, while only down payments on the

Figure 5: Gross debt and required fiscal adjustment



Source: IMF, Barclays Capital

Figure 6: Growth rotation



Source: Barclays Capital

However, yields can change abruptly if the market starts questioning the ability to adjust

consolidation that will ultimately be required, have provided a useful signal of the countries' willingness to shift public finances onto a more sustainable footing. In the coming quarters, investors may look for similar signals from Japan, the United States, and other systemically important economies with challenging fiscal situations.

Independent of whether policymakers decide to bring debt-to-GDP ratios back to pre-crisis levels or stabilize them at higher post-crisis levels, the magnitude of fiscal adjustment needed will be sizable; and for the foreseeable future, public debt levels will remain high in the systemically significant industrial economies. This implies both that fiscal retrenchment will likely be a drag on domestic demand in the next few years and that, in advanced economies, fiscal policy will not be a serious countercyclical policy tool.

This last point is not immediately relevant in light of our view that the global economic recovery is self-sustaining and unlikely to need additional policy support in the near future. But as we emerge from the current cycle, virtually every systemically important economy in the world, other than China, will be saddled with public debt that is likely to preclude the kind of counter-cyclical policy response that was available in 2008-09. A useful case in point is Italy, which was unable to mount an ambitious fiscal response to the recent recession because its public debt was so high, at roughly 100% of GDP. The fiscal constraints that applied to Italy are likely to apply to major industrial economies almost across the board. This is a sea change in the global economy that will likely amplify downside economic risks over the longer run.

Fiscal consolidation should lead directly to a reduction in demand, but countervailing adjustments will likely be created elsewhere

Turning to the immediate future, measuring the effect of fiscal consolidation on growth is not a straightforward exercise. The direct effect will, of course, be a reduction in demand. But that should trigger changes in interest rates, exchange rates, and other relative prices that will create countervailing adjustments in demand elsewhere in the economy. In a process as gradual and generally foreseeable as the fiscal adjustments in the industrial economies are likely to be, there is plenty of time for changes to be made. Also, these adjustments will, of course, be facilitated by monetary policy, which will likely need to remain loose for a long time to offset the fiscal tightening.

Monetary policy needs to remain loose for longer to offset fiscal tightening, as well as ongoing banking system concerns

Monetary policy will also likely need to remain loose because of ongoing concerns about the banking system, particularly in Europe. The health of the European banking system has been called into question recently as a result of potential exposure to countries under sovereign stress, making it vulnerable to the increase in wholesale funding costs associated with the increase in sovereign risk. We do not want to downplay those risks, but as Figure 7 shows, exposure to peripheral Europe assets is moderate, and to the extent that we do not see an escalation of sovereign problems, risk should be easily contained.

Figure 7: Banks' holdings of Greek and southern European assets

	France	Germany	US
Holdings of Greek assets			
Amount ($bn)	78.8	45.0	16.6
Share in the total external claims of the banking sector (%)	2.1	1.4	0.7
Share in total banking sector assets (%)	0.8	0.5	0.1
Banking sector capital and reserves ($bn)	354.0	413.0	1,410.0
Holdings of Greek, Portuguese and Spanish assets			
Amount ($bn)	334.9	330.4	79.3
Share in the total external claims of the banking sector (%)	9.1	10.1	3.2
Share in total banking sector assets (%)	3.6	3.7	0.6

Source: BIS Locational and Consolidated Banking Statistics April 2010, OECD Banking Statistics 2009, Barclays Capital

A much more important force is global financial regulation, which will likely reduce the supply of credit to the economy

Potentially much more important are the upcoming global financial regulatory changes, which, while still uncertain in terms of detail, suggest some clear objectives: raising capital ratios, improving liquidity requirements, relying on longer-term wholesale and deposit funding, and increasing bank taxes. This suggests a higher cost of funding, lower bank profits, and smaller balance sheets and is likely to reduce the supply of credit to the economy and affect growth, suggesting another reason monetary policy is likely to remain loose – to help offset these forces.

A tighter fiscal/looser monetary policy mix is not necessarily a problem; hence, we are not reducing our growth forecasts

As long as there are no observed trade-offs, a policy mix of tighter fiscal/looser monetary is not necessarily a problem for the growth outlook, and we are not reducing our growth projections for advanced economies. But if inflation expectations in advanced economies were to increase, monetary policy could be more constrained. Downward risks to our growth projection have certainly increased.

Inflation expectations could increase for a number of reasons, including reduced output gaps. In that case, there would be no problem tightening monetary policy, as it would be the optimal policy response to a demand-driven increase in inflation and inflation expectations. If an increase in inflation expectations were driven by commodity price increases (say, from strong growth in EM), it is not obvious that monetary policy would need to be tighter, except to the extent that the supply-side shock begins to affect expectations and underlying inflationary pressures, which is likely to be modest if industrial country output gaps are large.

The biggest problem could arise if high debt–to-GDP ratios and incomplete fiscal adjustments lead to concerns about more sustained deficit financing, the creation of seigniorage, and efforts to partly liquefy public debt. It is worth noting that a perceived linkage between public sector debt problems and monetary policy (called “fiscal dominance” of monetary policy in emerging market economies) need not be a high probability base case to complicate monetary policy management – even if “fiscal dominance” is perceived as a low probability but significantly disruptive outcome, it can affect asset prices and the economy.

We think secular variables will play a more significant role in 2011 and beyond; growth in advanced economies is likely to be slower and more volatile than before the crisis

To summarize, as we think about 2011 and later, secular variables beyond the cyclical bounce are likely to play a more significant role. Growth in advanced economies is likely to be not only slower than before the crisis but also, perhaps, more volatile. Monetary policy could play an increasingly important role in offsetting both the upcoming fiscal consolidation and tighter banking regulations.

EM is different

The outlook for EM countries is different – low debt ratios mean there is no need for fiscal consolidation

It is always dangerous to claim decoupling, but the outlook for most EM countries is different from the above scenario. Precisely because they were not provided with the financial rope to hang themselves, their debt-to-GDP ratios are significantly lower than in advanced countries – there is no need for fiscal consolidation; hence, it is unlikely to be a drag on growth.

Slower growth in advanced economies is not neutral for EM growth, but EM performance over the past few years supports the view that the beta of EM growth to advanced economies has declined, absent global disturbances. We expect emerging markets to continue on the decoupling path started around the beginning of the last decade and interrupted briefly by the Lehman Brothers collapse.

This differentiated outlook implies that monetary policy normalization will continue

The differentiated growth outlook implies that monetary policy normalization will continue among EM economies. The process is likely to be uneven (Latin American countries seem to be willing to tighten earlier than Asian and Emerging European countries), but the increase in interest rate differentials, coupled with higher risk-adjusted growth, is likely to continue.

Figure 8: EM tightening at full steam

2009-Q2 10	2010		2011		
	Q3	Q4	Q1	Q2	Q3
Brazil	Korea	China	Colombia	Euro area	South Africa
Chile	Thailand	Indonesia	Czech	Egypt	
India		Philippines	Mexico	Hong Kong	
Israel		Sri Lanka	Poland	US	
Malaysia		Turkey			
Peru					
Vietnam					
Australia					
New Zealand					
Taiwan					

Source: Barclays Capital

Have the risks increased in China? Only marginally

China has been a huge source of stability, but two recent developments require scrutiny

China has been a huge source of stability for the global economy over the past 18 months, and we expect this to continue over the next several quarters, but two recent developments require scrutiny: the potential effects of the deflation of the real estate sector bubble and recent wage pressures, which suggest that the days of surplus labour may be coming to an end.

We see the Chinese wage increase as more benign and a natural result of rapid growth and, hence, a relative scarcity of labour

Of the two, the wage increase has attracted more attention recently but is likely to be the more benign. We believe that China may be reaching a phase at which labour is becoming scarcer, and as a result, wage increases may continue. We see this as a natural result of high growth, an improvement in rural sector conditions, and Chinese demographics. However, we do not expect the wage increases to result in significant near-term inflationary pressure, as they have been confined to a few coastal cities and profit margins are likely to absorb some of the increase.

We are not overly concerned about near-term inflationary pressures or the negative effect on import demand for now

At the same time (and using the Japanese and Korean experiences as an example), over the medium term, this may result in somewhat lower growth and higher inflation. But the effect on import demand from the rest of the world should be modest, as Chinese GDP growth in constant dollars is unlikely to be affected, even if lower in constant renminbi terms.

The policy-induced deflation of the real estate bubble carries implementation risks...

The policy-induced deflation of the real estate bubble carries more implementation risks, in our view. We expect housing prices to decline 20-30% over the next few quarters. In countries with different characteristics, a correction of that magnitude could lead to a hard landing, but China may be exceptional. One key difference is that Chinese consumption is unlikely to be affected by housing prices through the wealth effect. Indeed, in our view, this is neutral, as 50% of the population lives in rural areas where there is no active property trading, and low income and migrant workers could benefit from housing price declines, as they would become more likely to buy. Another important difference is that most countries that experienced asset price bubbles in the past also ran current account deficits and, hence, were vulnerable once capital stopped flowing. This is not the case in China, which is an exporter of

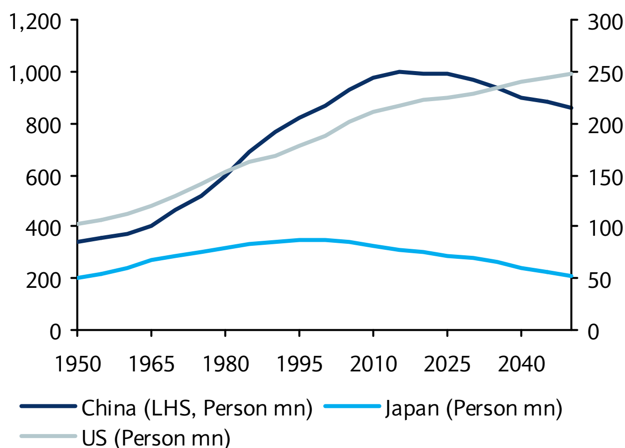
…but we should not automatically extrapolate from the experiences of other countries …

capital. Perhaps most important, the main channel through which housing price deflation typically affects economic activity and leads to an undershooting of the correction is banking. Again, China is somewhat different in this respect. Mortgage-related loans represent approximately 20% of total loans. Even a 30% reduction in housing prices is unlikely to wipe out bank capital (CAR is at 10%, and 17% of deposits are kept at PBOC as reserve requirements). But even if bank capital were wiped out, banks are unlikely to limit credit lending to the non-bank sector; since they are state owned for the most part, credit conditions would be determined by top-down political directives.

…as China's peculiarities suggest that the outcome is likely to be different

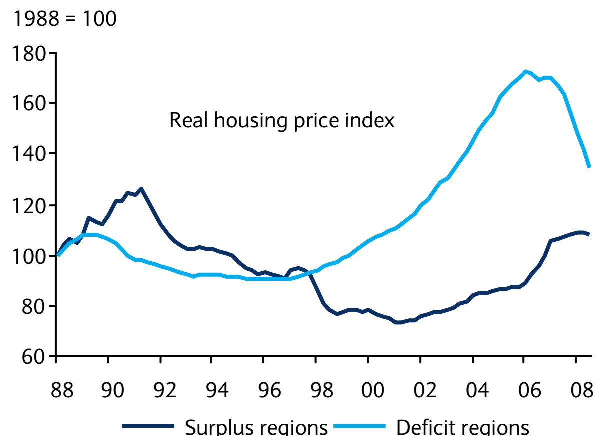
This is not to say that there are no implementations risks, as errors can be made and we must be vigilant, but we should not automatically extrapolate the deflation of housing price bubbles in other countries to China, as the country's peculiarities suggest that the outcome is likely to be different.

Figure 9: China's working age population to peak soon



Source: Haver, UN, Barclays Capital

Figure 10: Housing price bubbles associated with deficits



Note: Regional housing price indices are weighted by GDP. Surplus region index includes Germany, China, Korea, HK, Indonesia, Taiwan, Russia, and Norway. Deficit region index include US, UK, Australia, and Spain.
Source: Haver, Barclays Capital

Box 1. Fiscal Policy

When it comes to fiscal policy, it is generally recognized that the industrial countries are in a weaker position than the typical emerging market economy, while there are major differences between countries in the emerging markets universe. But it is not always recognized how stark both of these differences are. Here, we highlight some facts about the fiscal outlook, using projections from the recently published IMF Fiscal Monitor, supplemented with Barclays Capital projections where necessary.

With one exception, we present the IMF's outlook for the gross public debt, rather than net debt, mainly because comparable data are available for many more countries. The exception is Japan, where the gross debt (at 250% of GDP) grossly exaggerates the admittedly daunting fiscal challenge facing the country. In what follows, regional aggregates are GDP-weighted averages of the IMF country data.

The IMF's fiscal projections underscore the magnitude of the challenge facing most industrial economies. In the five largest industrial economies, the IMF projects that debt will reach 94% of GDP in 2010. The 2010 fiscal deficit is estimated at 10% of GDP, reflecting not only the recession, but also a large structural deficit. The cyclically adjusted primary deficit (which subtracts interest payments and the effect of the recession from the overall deficit) is 6.3% of GDP. The slow correction of fiscal imbalances means that public debt is forecast to continue to rise in the years to come, to over 110% of GDP in 2015. Only in Germany is the public debt forecast to be below 90% of GDP in 2015.

In the emerging market economies that we cover, the public debt is expected to average about 39% of GDP in 2010: 37% in both Asia and EMEA, and 50% in Latin America. But unlike in the major industrial economies, the IMF expects deficits to fall, on average, in emerging markets, reflecting public finances that are significantly less over-extended than in the industrial economies. One measure of this is the estimated fiscal adjustment that would be required between 2010 and 2020 to put the fiscal accounts on a sustainable footing. In the five largest industrial economies, the IMF estimates that adjustment at nearly 11% of GDP, ranging from 4% in Germany to 12% in the United States and 13% in Japan. In southern Europe, it averages just under 7% of GDP. In EM, it is 2.5% of GDP.

Of course, not every emerging market economy is in pristine fiscal condition. Among the more precarious stories are:

- India's public debt, at nearly 80% of GDP, is closer to the industrial-country average than to the emerging market norm. The IMF suggests that a large fiscal adjustment will eventually be required to achieve a sustainable fiscal position. But in the meantime, debt dynamics are supported by very rates of economic growth, and strong domestic support for a tightly controlled government bond market.
- In Poland, Latvia, Lithuania and Malaysia, public debt is still at moderate levels by international standards. But structural imbalances are still meaningful, debt levels are forecast to rise, and the IMF estimates that fiscal adjustments of 7-8% of GDP will be required to achieve long-term sustainability. These countries should probably be on emerging market investors' fiscal watch list in the months and years to come.

Hungary's public debt is also near 80% of GDP and the country is widely viewed as having one of the more precarious fiscal positions in EMEA. But an important fiscal adjustment has already been made, the IMF is projecting a meaningful decline in the public debt in the next five years, and it is not suggesting that a large additional fiscal effort will be required to achieve sustainability. Here, too, investors need to remain vigilant. However, the question is not how Hungary will achieve sustainability, but rather whether governments will stay the course in the years to come.

Fiscal balances (% GDP)

	General gov't balance		Gross debt		Cyclically adjusted	Required adjustment	S&P
	2010	2015	2010	2015	primary balance 2010	between 2010-20	rating
Big 5	-10.0	-5.7	94	111	-6.3	10.8	AAA
France	-8.2	-4.1	84	95	-4.6	8.3	AAA
Germany	-5.7	-1.7	77	82	-1.6	4.0	AAA
Japan*	-9.8	-7.3	122	155	-6.5	13.1	AA
UK	-11.4	-4.3	78	91	-5.4	9.0	AAA
US	-11.0	-6.5	93	110	-7.6	12.0	AAA
Southern Europe	-7.8	-5.5	98	113	-2.4	6.9	A
Greece	-8.1	-2.0	133	140	-2.4	9.2	BB+
Ireland	-12.2	-5.3	79	94	-6.0	9.8	AA
Italy	-5.2	-4.6	119	125	0.9	4.1	A+
Portugal	-8.8	-4.4	87	98	-4.1	7.8	A-
Spain	-10.4	-7.7	67	94	-5.8	9.4	AA
EM (GDP weighted)	-3.9	-2.5	39	36	-1.4	2.5	BBB
EM (benchmark weighted)	-3.3	-2.1	46	43			BB+
EM Asia	-4.1	-2.5	37	32	-2.1	3.2	BBB+
China	-3.0	-2.4	20	18	-2.5	3.1	A+
Hong Kong	-1.4	-0.1	1	1	-3.5	3.8	AA+
India	-9.2	-4.4	79	67	-3.7	7.0	BBB-
Indonesia	-2.0	-1.6	28	23	-0.1	0.3	BB
Malaysia	-6.1	-5.4	57	62	-4.0	6.8	A-
Korea	1.1	2.9	33	26	2.8	-3.3	A
Pakistan	-4.6	-2.0	56	48	0.0	1.3	B-
Philippines	-3.4	0.3	48	37	-0.4	0.8	BB-
Sri Lanka**	-7.5	N/A	86	N/A	N/A	N/A	B
Thailand	-2.3	-0.5	48	51	-0.8	2.3	BBB+
Vietnam	-7.0	-7.0	48	48	N/A	N/A	BB
EMEA	-4.6	-3.5	37	39	-1.5	2.4	BBB
Bulgaria	-1.8	0.5	16	9	0.7	-0.8	BBB
Czech Republic	-5.1	-5.3	38	50	-2.4	3.7	A
Egypt**	-7.7	N/A	78	N/A	N/A	N/A	BB+
Hungary	-3.8	0.1	79	64	3.5	-1.3	BBB-
Israel	-4.4	-2.2	77	70	-1.0	2.8	A
Latvia	-12.9	-1.8	49	52	-7.1	8.8	BB
Lebanon**	-11.0	N/A	154	N/A	N/A	N/A	B
Lithuania	-8.6	-7.3	39	71	-4.9	8.0	BBB
Poland	-7.5	-3.8	55	62	-4.5	7.2	A-
Romania	-6.5	-2.6	35	39	-1.6	2.1	BB+
Russia	-2.9	-4.2	8	13	-1.1	1.6	BBB
South Africa	-6.1	-1.2	35	36	-3.2	3.4	BBB+
Turkey	-3.4	-1.9	45	44	0.0	0.4	BB
Ukraine	-3.1	-2.0	37	31	-1.8	2.2	B
Latin America	-2.4	-1.4	50	43	1.1	-0.2	BBB-
Argentina	-3.5	-2.2	51	50	-0.6	1.6	B-
Brazil	-1.5	-0.7	67	54	3.4	-2.1	BBB-
Chile	-1.8	1.3	4	3	-2.6	3.0	A+
Colombia	-3.5	-2.0	35	32	-0.6	1.1	BBB-
El Salvador	-4.7	-4.7	52	52	N/A	N/A	BB
Mexico	-3.4	-2.7	45	42	0.1	0.5	BBB
Panama**	-2.6	N/A	N/A	N/A	N/A	N/A	BBB-
Peru	-1.6	0.0	27	20	-0.9	1.1	BBB-
Uruguay**	-1.9	N/A	49	N/A	N/A	N/A	BB
Venezuela**	-0.5	N/A	37	N/A	N/A	N/A	BB-

Note: * Net debt used for Japan, ** BarCap forecast for 2010 deficit and debt. For purposes of computing regional averages, 2015 debt/GDP ratios are assumed to equal 2010. *** El Salvador, Panama – IMF staff report. Source: IMF Fiscal Monitor, Barclays Capital

Figure 11: Summary of Barclays Capital economics projections: GDP and inflation

		Real GDP % y/y					CPI inflation % y/y**				
	Weight*	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
Canada	1.8	2.5	0.5	-2.5	3.8	3.1	2.1	2.4	0.3	1.9	2.2
US	20.5	2.1	0.4	-2.4	3.6	3.5	2.9	3.8	-0.4	1.7	1.7
North America	24.4	2.2	0.4	-2.4	3.6	3.5	2.8	3.7	-0.3	1.7	1.7
Argentina	0.8	8.7	3.3	-4.0	6.1	3.8	18.4	26.7	16.3	22.8	27.2
Brazil	2.9	6.1	5.1	-0.2	7.3	4.4	4.5	5.9	4.3	6.1	5.0
Chile	0.3	4.7	3.7	-1.5	4.2	6.6	4.4	8.7	1.5	1.9	3.5
Colombia	0.6	7.5	2.4	0.4	4.5	4.3	5.5	7.0	4.2	2.2	3.1
Mexico	2.1	3.3	1.5	-6.5	5.0	3.6	4.0	5.1	5.3	4.4	3.8
Peru	0.4	8.9	9.8	0.9	7.1	6.4	1.8	6.7	0.2	2.7	2.7
Venezuela	0.5	8.4	4.8	-3.3	-5.4	2.0	18.7	30.9	25.1	34.3	29.3
Latin America	5.6	5.9	3.9	-2.5	5.0	4.1	6.5	10.0	7.2	9.1	8.5
The Americas	30.0	3.1	1.3	-2.5	4.0	3.6	3.4	2.8	2.6	2.6	2.5
Austria	0.5	3.4	1.8	-3.4	1.1	2.5	2.2	3.2	0.4	1.7	1.7
Belgium	0.6	2.8	0.8	-3.0	1.5	2.5	1.8	4.5	0.0	2.4	2.0
Finland	0.3	4.9	1.2	-8.1	0.5	2.4	1.6	3.9	1.6	1.6	1.6
France	3.0	2.3	0.1	-2.5	1.3	1.8	1.6	3.2	0.1	1.7	1.5
Germany	4.0	2.6	1.0	-4.9	2.0	2.5	2.3	2.8	0.2	1.2	1.3
Greece	0.5	4.5	2.0	-2.0	-3.1	-2.7	3.0	4.2	1.3	4.5	2.4
Ireland	0.3	6.0	-3.0	-7.1	0.0	1.6	2.9	3.1	-1.7	-2.1	-1.3
Italy	2.5	1.4	-1.3	-5.1	1.2	1.6	2.0	3.5	0.8	1.5	1.6
Netherlands	0.9	3.6	2.0	-4.0	1.3	2.1	1.6	2.2	1.0	0.8	0.8
Portugal	0.3	2.4	0.0	-2.6	1.1	0.1	2.4	2.7	-0.9	0.8	1.0
Spain	2.0	3.6	0.9	-3.6	-0.9	-1.1	2.8	4.1	-0.2	1.9	1.9
Euro area	15.1	2.8	0.4	-4.1	1.1	1.8	2.1	3.3	0.3	1.6	1.5
Norway	0.4	5.4	2.0	-1.5	1.5	2.4	0.7	3.8	2.2	2.5	1.9
Sweden	0.5	2.7	-0.6	-5.1	3.3	2.9	2.2	3.4	-0.3	1.1	1.7
UK	3.1	2.6	0.6	-4.9	1.2	2.4	2.3	3.6	2.2	3.1	3.0
W Europe	19.8	2.8	0.5	-4.1	1.1	1.7	2.1	3.3	0.6	1.7	1.7
Czech Republic	0.4	6.1	2.5	-4.1	1.1	2.8	5.5	3.6	1.0	2.0	1.8
Hungary	0.3	1.2	0.6	-6.3	1.1	3.6	7.4	3.5	5.6	2.9	3.1
Poland	1.0	6.8	4.9	1.7	2.9	3.3	4.2	3.3	3.5	2.3	2.3
Central Europe	1.8	6.2	3.9	-1.3	2.3	3.4	3.4	4.0	3.0	2.4	2.5
Russia	3.0	8.1	5.6	-7.9	4.5	5.0	11.9	13.3	8.8	6.1	6.8
Turkey	1.2	4.7	0.9	-4.7	6.3	4.0	8.4	10.1	6.5	7.7	6.9
Europe	27.1	3.7	1.3	-4.4	1.8	2.1	2.8	4.2	1.4	2.2	2.2
Australia	1.2	4.0	2.4	1.3	3.4	3.9	2.3	4.4	2.1	3.3	3.4
PR China	12.5	14.2	9.6	8.7	10.1	9.0	4.8	5.9	-0.7	3.5	3.5
Hong Kong, SAR	0.4	6.4	2.2	-2.8	5.1	4.0	2.0	4.3	0.5	2.5	2.5
China, Taipei	1.0	5.7	0.7	-1.9	7.5	4.0	1.8	3.5	-0.9	1.2	1.8
India	5.1	9.4	7.4	6.7	8.8	8.3	4.7	8.4	3.8	7.0	5.5
Indonesia	1.4	6.3	6.1	4.5	6.4	6.3	6.4	10.3	4.3	4.5	5.8
Japan	6.0	2.3	-1.2	-5.2	3.4	1.7	0.0	1.5	-1.3	-1.0	-0.3
Malaysia	0.5	6.2	4.7	-1.7	7.5	5.0	2.0	5.4	0.6	1.5	1.8
Philippines	0.5	7.1	3.7	1.1	6.0	5.0	2.8	9.4	3.2	4.4	3.7
Singapore	0.3	7.8	1.8	-1.3	9.5	4.0	2.1	6.6	0.6	2.8	1.7
South Korea	1.9	5.1	2.2	0.2	5.7	4.0	2.5	4.7	2.8	2.6	1.5
Asia	31.6	8.5	5.3	3.7	6.6	6.4	2.8	3.5	-0.8	2.4	2.7
South Africa	0.7	5.5	3.7	-1.8	3.3	4.5	7.1	11.5	7.1	5.0	5.7
G10	43.4	2.4	0.3	-3.6	2.8	2.6	2.1	3.3	0.0	1.4	1.5
Above countries	96.0	5.3	2.9	-0.8	4.7	4.3	3.1	4.3	0.9	2.5	2.4

Note: * IMF weight of real GDP using PPP, 2009 estimates for real GDP; nominal GDP (2009) for CPI inflation. ** Conventional rate; HICP for euro area.
Source: Barclays Capital

Figure 12: Summary of Barclays Capital economics projections: External and government balances

		Current account (% GDP)					General gov't. (% GDP)**				
	Weight*	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
Canada	2.3	1.0	0.5	-2.5	-1.5	-0.5	1.6	0.1	-4.9	-3.0	-2.0
US	24.6	-5.2	-4.9	-2.7	-3.3	-4.2	-1.2	-3.2	-10.0	-8.5	-7.0
North America	28.4	-4.6	-4.4	-2.6	-3.2	-3.9	-0.9	-2.9	-9.5	-8.0	-6.5
Argentina	0.5	2.7	2.2	3.7	2.4	1.8	0.2	0.9	-2.6	-2.3	-2.7
Brazil	2.7	0.1	-1.7	-1.5	-2.4	-2.7	-2.8	-1.9	-3.3	-2.5	-2.3
Chile	0.3	4.5	-1.5	2.6	0.0	-1.0	8.7	5.3	-4.4	-2.1	-3.0
Colombia	0.4	-2.9	-2.8	-2.1	-2.4	-3.2	-0.6	-0.1	-2.8	-3.6	-2.9
Mexico	1.5	-0.8	-1.5	-0.6	-0.3	-0.9	0.0	-0.1	-2.3	-2.7	-1.9
Peru	0.2	1.2	-3.7	0.2	-1.3	-1.4	1.7	2.1	-1.8	-0.3	0.5
Venezuela	0.6	8.8	12.4	3.6	10.1	9.4	-2.8	-2.6	-4.5	-1.9	-2.4
Latin America	4.8	0.9	-0.1	-0.2	-0.2	-0.7	-1.0	-0.7	-3.1	-2.4	-2.2
The Americas	33.2	-4.5	-3.6	-3.7	-4.2	-4.4	-0.9	-2.5	-8.3	-7.0	-5.7
Austria	0.7	3.5	3.2	2.0	2.7	3.8	-0.6	-0.6	-3.1	-3.1	-2.8
Belgium	0.8	1.7	-2.5	-1.0	-0.9	-0.4	-0.2	-1.2	-6.0	-5.4	-4.4
Finland	0.4	4.2	3.1	1.3	0.0	0.8	5.2	4.4	-2.7	-3.7	-3.0
France	4.6	-1.0	-2.3	-2.2	-2.3	-2.6	-2.7	-3.4	-7.7	-7.8	-6.5
Germany	5.8	7.6	6.7	4.9	6.0	7.0	-0.2	0.0	-3.3	-4.3	-3.4
Greece	0.6	-14.3	-14.5	-11.2	-10.6	-8.2	-3.6	-7.8	-13.6	-7.5	-4.8
Ireland	0.4	-5.4	-5.2	-2.9	1.8	3.3	0.3	-7.1	-14.2	-8.9	-5.9
Italy	3.7	-2.4	-3.4	-3.2	-2.1	-1.5	-1.5	-2.7	-5.3	-4.6	-3.5
Netherlands	1.4	8.7	4.8	5.4	7.0	8.0	0.2	0.7	-5.3	-5.4	-4.6
Portugal	0.4	-9.0	-11.6	-10.0	-8.4	-7.8	-2.6	-2.7	-9.3	-6.8	-3.2
Spain	2.5	-10.0	-9.7	-5.4	-4.3	-3.9	2.2	-3.8	-11.2	-9.0	-6.3
Euro area	21.2	0.2	-1.7	-0.7	0.2	0.9	-0.6	-1.9	-6.3	-6.0	-4.6
Norway	0.7	14.1	18.6	13.8	15.2	15.5	17.7	19.1	9.7	9.8	10.5
Sweden	0.7	8.2	9.3	7.4	8.0	8.8	3.8	2.5	-0.5	0.0	0.5
UK	3.8	-2.7	-1.6	-1.3	-2.0	-1.8	-2.6	-6.3	-10.4	-9.5	-7.2
W Europe	27.7	0.8	0.0	0.2	0.8	1.3	-0.2	-1.8	-6.1	-5.7	-4.3
Czech Republic	0.3	-3.2	-3.1	-1.1	0.7	1.2	-0.6	-2.7	-5.9	-5.3	-4.4
Hungary	0.2	-6.5	-7.0	0.3	-0.7	-1.1	-4.9	-3.8	-4.0	-3.9	-3.5
Poland	0.7	-4.7	-5.0	-1.7	-1.9	-1.9	-1.9	-3.9	-7.5	-6.9	-6.0
Central Europe	1.5	-4.7	-5.0	-1.9	-1.7	-1.6	-2.1	-3.5	-6.4	-5.8	-5.1
Russia	2.1	5.9	6.0	3.9	6.1	4.6	5.4	3.8	-5.9	-4.6	-2.5
Turkey	1.1	-5.8	-5.6	-2.3	-5.0	-4.9	-2.6	-2.2	-5.8	-4.7	-4.5
Europe	32.4	0.4	0.4	0.5	0.6	0.6	0.0	-1.5	-6.1	-5.6	-4.3
Australia	1.7	-6.3	-5.8	-3.4	-4.6	-5.7	1.5	-0.3	-2.2	-4.4	-2.9
PR China	8.5	10.6	9.4	6.1	5.3	5.0	0.6	-0.4	-2.2	-2.7	-2.0
Hong Kong, SAR	0.4	12.3	13.6	8.7	7.8	7.2	7.5	0.1	0.8	-1.5	-0.7
China, Taipei	0.7	8.4	6.2	11.1	7.5	3.9	-0.2	-0.7	-4.1	-2.5	-1.9
India	2.1	-1.3	-2.4	-2.5	-2.8	-2.8	-7.3	-9.8	-11.0	-8.3	-7.5
Indonesia	0.9	2.4	0.1	2.0	1.3	1.0	-2.1	-0.1	-1.6	-1.5	-1.5
Japan	8.7	4.8	3.2	2.8	3.5	3.6	-2.5	-2.9	-8.8	-9.5	-8.0
Malaysia	0.3	16.0	17.5	16.4	14.9	13.2	-3.2	-4.8	-7.4	-4.4	-3.0
Philippines	0.3	4.9	2.1	5.3	5.0	4.6	-1.6	-0.9	-3.9	-4.0	-3.7
Singapore	0.3	26.6	18.6	17.8	15.4	12.7	11.1	0.1	-1.2	-0.3	0.5
South Korea	1.4	0.6	-0.6	5.1	1.8	1.3	3.5	1.2	-1.7	-0.2	0.2
Asia	25.8	4.4	5.5	-4.7	8.2	5.5	-0.9	-2.0	-5.2	-5.4	-4.4
South Africa	0.5	-7.2	-7.1	-4.0	-3.6	-4.9	0.9	-1.2	-6.7	-5.7	-4.8
G10	57.2	-1.1	-1.7	-0.8	-0.7	-0.9	-1.1	-2.7	-8.1	-7.5	-6.0
Above countries	96.4	-0.3	-1.0	-0.2	-0.2	-0.4	-0.2	-1.1	-5.1	-4.5	-3.5

Source: Barclays Capital

Figure 13: US economic projections

	2009				2010				2011				Calendar year average		
% Change q/q saar	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2009	2010	2011
Real GDP	-6.4	-0.7	2.2	5.6	3.0	4.5	4.0	3.5	3.0	3.5	3.5	3.5	-2.4	3.6	3.5
Private consumption	0.6	-0.9	2.8	1.6	3.5	3.5	3.0	3.0	2.5	3.0	3.0	3.5	-0.6	2.7	2.9
Public consump and invest.	-2.6	6.7	2.6	-1.3	-1.9	4.0	1.5	1.5	-0.2	-0.7	-1.0	-1.2	1.8	1.0	0.3
Residential investment	-38.2	-23.3	18.9	3.8	-10.7	20.0	30.0	30.0	25.0	20.0	15.0	10.0	-20.5	7.1	22.8
Equip. & software investment	-36.4	-4.9	1.5	19.0	12.7	15.0	15.0	10.0	7.0	8.0	15.0	15.0	-16.6	11.8	10.7
Structures investment	-43.6	-17.3	-18.4	-18.0	-15.3	2.0	4.0	6.0	8.0	8.0	10.0	10.0	-19.8	-10.0	7.1
Net exports ($bn, real)	-387	-330	-357	-348	-368	-384	-396	-414	-426	-432	-439	-451	-356	-391	-437
Final sales	-4.1	0.7	1.5	1.7	1.4	4.2	3.7	3.3	2.6	3.0	3.3	3.3	-1.8	2.4	3.3
Ch. inventories ($bn, real)	-113.9	-160.2	-139.2	-19.7	33.9	43.6	51.6	56.6	61.6	69.6	75.6	81.6	-108.3	46.4	72.1
GDP price index	1.9	0.0	0.4	0.5	1.0	1.3	1.3	1.2	1.5	1.5	1.8	1.9	1.2	0.9	1.5
Nominal GDP	-4.6	-0.8	2.6	6.1	4.1	5.8	5.4	4.8	4.5	5.0	5.4	5.5	-1.3	4.5	5.0
Industrial output	-19.0	-10.4	6.4	6.9	7.6	8.0	7.0	6.0	6.0	5.5	5.0	5.0	-9.7	6.0	6.0
Employment (avg mthly chg, K)	-753	-477	-261	-90	87	199	140	270	315	335	345	350	-395	174	336
Unemployment rate (%)	8.2	9.3	9.6	10.0	9.7	9.8	9.4	9.1	8.8	8.6	8.3	7.9	9.3	9.5	8.4
CPI inflation (%y/y)	0.0	-1.2	-1.6	1.4	2.4	1.8	1.5	1.3	1.5	1.7	1.7	1.8	-0.4	1.7	1.7
Core CPI (%y/y)	1.7	1.8	1.5	1.7	1.3	0.9	0.9	0.8	1.2	1.3	1.3	1.4	1.7	1.0	1.3
Core PCE price index (%y/y)	1.7	1.6	1.3	1.5	1.4	1.1	1.0	0.9	1.0	1.1	1.2	1.3	1.5	1.1	1.2
Current account (%GDP)	-2.7	-2.4	-2.7	-2.8	-3.0	-3.2	-3.4	-3.7	-3.9	-4.1	-4.3	-4.6	-2.7	-3.3	-4.2
Federal budget bal. (%GDP)													-10.0	-8.5	-7.0
Federal funds rate (%)	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0.75	1.25	1.75			

Note: Q/Q data are seasonally adjusted annualized. *Fiscal year basis. Source: Barclays Capital

Figure 14: Euro area economic projections

	2009				2010				2011				Calendar year average		
% Change q/q	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2009	2010	2011
Real GDP	-2.5	-0.1	0.4	0.1	0.2	0.5	0.4	0.4	0.3	0.4	0.6	0.6	...	...	...
Real GDP (saar)	-9.6	-0.4	1.6	0.5	0.8	1.9	1.5	1.6	1.2	1.5	2.4	2.5	...	...	...
Real GDP y/y	-5.2	-4.9	-4.1	-2.1	0.6	1.2	1.2	1.5	1.5	1.4	1.7	1.9	-4.1	1.1	1.8
Private consumption	-0.6	0.1	-0.2	0.2	-0.1	0.1	0.3	0.3	0.2	0.3	0.4	0.4	-1.2	0.2	1.1
Public consumption	0.7	0.7	0.7	0.0	0.6	0.1	0.0	0.0	-0.1	-0.1	0.0	0.1	2.7	1.2	-0.2
Investment	-5.1	-1.7	-1.0	-1.3	-1.1	0.5	0.4	0.4	0.1	0.2	0.6	0.7	-10.9	-2.4	1.4
residential construction	-2.2	-2.3	-2.3	-2.0	-1.5	0.1	-0.3	-0.1	0.0	0.2	0.3	0.4	-9.8	-4.8	0.2
non-residential construction	-1.0	-0.7	-1.3	-1.8	-2.6	1.0	0.6	0.1	-1.2	-1.4	-0.1	0.4	-5.4	-3.7	-1.6
non-construction investment	-8.8	-2.0	-0.1	-0.7	-0.3	0.5	0.7	0.9	0.8	1.2	1.3	1.3	-14.2	-0.4	3.8
Inventories (q/q contribution)	-1.1	-0.5	0.5	0.1	0.8	-0.1	0.0	0.1	0.0	0.0	0.1	0.1	-0.9	1.0	0.2
Net exports (q/q contribution)	-0.1	0.6	0.0	0.2	-0.6	0.4	0.1	0.1	0.2	0.2	0.2	0.2	-0.8	0.2	0.6
Industrial output (ex construction)	-7.7	-2.9	0.9	2.2	4.1	1.3	0.1	0.2	-0.1	0.4	0.6	0.7	-14.9	6.6	1.1
Employment q/q	-0.8	-0.5	-0.5	-0.2	0.0	-0.2	-0.2	-0.1	0.0	-0.1	0.0	0.1	-1.9	-0.9	-0.3
Unemployment rate %	8.8	9.3	9.7	9.8	10.0	10.0	10.2	10.3	10.3	10.3	10.2	10.0	9.4	10.1	10.2
CPI inflation y/y	1.0	0.2	-0.4	0.4	1.1	1.5	1.7	1.9	1.8	1.5	1.4	1.3	0.3	1.6	1.5
Core CPI (ex food/energy) y/y	1.6	1.6	1.3	1.1	0.9	0.8	1.0	1.0	1.1	1.1	1.0	0.9	1.4	0.9	1.0
Current account % GDP	-1.3	-0.6	-0.4	-0.3	-0.2	0.2	0.4	0.5	0.6	0.8	0.9	1.1	-0.7	0.2	0.9
Government balance % GDP	...	...	...	...	...	...	...	...	...	...	...	...	-6.3	-6.0	-4.6
Refi rate (period end)	1.50	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.50	1.75	1.00	1.00	1.75

Note: Q/Q data are non-annualized unless specified otherwise. Source: Barclays Capital

Figure 15: UK economic projections

% Change q/q	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	Calendar year average 2009	Calendar year average 2010	Calendar year average 2011
Real GDP	-2.6	-0.7	-0.3	0.4	0.3	0.7	0.5	0.6	0.6	0.7	0.6	0.6	…	…	…
Real GDP (saar)	-10.0	-2.7	-1.1	1.8	1.2	2.7	2.1	2.2	2.5	2.7	2.3	2.4	…	…	…
Real GDP (y/y)	-5.3	-5.9	-5.3	-3.1	-0.2	1.1	2.0	2.1	2.4	2.4	2.4	2.5	-4.9	1.2	2.4
Private consumption	-1.6	-0.9	0.0	0.4	0.0	0.5	0.5	0.7	0.7	0.8	0.5	0.6	-3.2	0.9	2.6
Public consumption	-0.4	0.9	0.6	1.0	0.5	0.5	-0.6	-0.6	-0.2	-0.2	-0.2	-0.2	2.2	1.7	-1.1
Investment	-7.3	-7.2	2.8	-2.7	1.5	-1.0	-0.6	0.1	1.0	1.1	1.2	1.3	-14.9	-2.0	2.2
Net exports	0.0	0.4	-0.2	-0.3	-0.4	0.1	0.1	0.2	0.1	0.0	0.1	0.1	0.7	-0.4	0.4
Industrial output	-4.8	-0.5	-1.0	0.4	1.1	0.3	0.3	0.3	0.3	0.4	0.3	0.3	-10.2	1.3	1.3
Employment	-0.6	-0.8	0.0	0.0	-0.2	0.2	0.1	0.1	0.2	0.2	0.1	0.2	-1.6	-0.2	0.6
Unemployment rate %	7.1	7.8	7.8	7.8	7.9	7.9	7.9	8.0	8.0	7.9	7.9	7.9	7.6	7.9	8.0
CPI inflation y/y	3.0	2.1	1.5	2.1	3.3	3.4	3.0	2.9	3.0	3.0	3.1	2.8	2.2	3.1	3.0
Core CPI y/y	1.6	1.6	1.7	2.2	2.8	2.9	…	…	…	…	…	…	1.8	…	…
Current account % GDP	-1.2	-1.9	-1.7	-0.5	-1.8	-2.2	-2.1	-1.8	-1.8	-1.8	-1.7	-1.7	-1.3	-2.0	-1.8
Government balance % GDP	…	…	…	…	…	…	…	…	…	…	…	…	-10.4	-9.5	-7.2
Key Central Bank rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	1.00	1.50	2.00	2.50	0.50	0.50	2.50

Note: Q/Q data are non-annualized unless specified otherwise. Source: Barclays Capital

Figure 16: Japan economic projections

% Change	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	Calendar year average 2009	Calendar year average 2010	Calendar year average 2011
Real GDP q/q saar	-15.8	6.9	0.4	4.6	5.0	3.0	1.4	2.1	1.6	0.9	1.7	1.9	-5.2	3.4	1.7
Real GDP q/q	-4.2	1.7	0.1	1.1	1.2	0.7	0.3	0.5	0.4	0.2	0.4	0.5	-	-	-
Private consumption q/q	-1.2	1.0	0.6	0.7	0.4	0.2	0.2	0.4	0.3	0.2	0.3	0.3	-1.0	1.9	1.1
Public consumption q/q	0.7	0.1	0.1	0.7	0.4	-0.5	-0.4	-0.3	0.0	-0.1	-0.2	-0.2	1.5	0.3	-0.7
Residential investment q/q	-7.1	-9.8	-7.3	-2.6	0.4	3.1	0.3	-0.5	-2.6	-1.7	0.7	0.3	-14.2	-5.5	-2.9
Public investment q/q	3.8	7.5	-0.8	-0.9	-0.5	0.8	1.9	0.5	0.5	-1.0	-1.1	0.3	7.4	2.1	0.7
Capital investment q/q	-9.7	-3.8	-2.1	1.1	0.6	2.1	2.1	1.4	1.0	0.5	0.8	1.3	-19.3	2.2	4.9
Net exports q/q*	-0.7	1.8	0.3	0.7	0.7	0.3	-0.2	0.0	0.0	0.1	0.2	0.1	-1.3	1.8	0.2
Ch. Inventries q/q*	-1.4	-0.2	-0.1	-0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.3	0.0	0.2
Nominal GDP q/q	-4.4	0.2	-0.3	0.3	1.3	-0.1	0.1	0.6	0.3	-0.1	0.2	0.3	-6.1	1.6	1.0
Industrial output q/q	-20.0	6.5	5.3	5.9	7.0	2.2	1.0	1.8	1.4	1.5	1.5	1.5	-21.9	19.3	6.5
Employment q/q	-0.6	-0.7	-0.3	-0.2	0.5	0.0	0.1	0.2	0.2	0.2	0.4	0.3	-0.5	0.0	0.9
Unemployment rate %	4.5	5.1	5.4	5.2	4.9	5.0	5.0	5.0	4.9	4.8	4.7	4.5	5.1	5.0	4.7
CPI inflation y/y	0.0	-1.0	-2.3	-1.7	-1.2	-1.3	-1.1	-0.7	-0.7	-0.2	-0.1	-0.3	-1.3	-1.0	-0.3
Core CPI (ex food/energy) y/y	-0.2	-0.5	-0.9	-1.1	-1.1	-1.6	-1.3	-0.8	-0.7	-0.2	-0.1	-0.3	-0.7	-1.1	-0.3
Current account % GDP	1.8	3.0	3.1	3.3	3.8	3.3	3.5	3.6	3.6	3.6	3.6	3.6	2.8	3.5	3.6
Government balance % GDP	…	…	…	…	…	…	…	…	…	…	…	…	-8.8	-9.5	-8.0
Key Central Bank rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10

Note: Q/Q data are non-annualized unless specified otherwise. Source: Barclays Capital

COMMODITY MARKETS OUTLOOK

Resetting the compass

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- **Despite a strong data flow, commodities have been blown off course by a greater degree of risk aversion and uncertainty over the global growth outlook, mainly owing to concerns about EM tightening and developed country debt.**
- **However, with the recovery in commodity demand looking sustainable and supply constraints re-emerging in several sectors, we expect fundamental dynamics within individual commodity markets to re-establish themselves as the main price drivers.**
- **Although we expect a resumption of upward price trends in many markets before long, risks to the recovery have grown and markets are nervous, so the likelihood is that there will be further periodic recurrences of volatility.**

Commodity price volatility spiked in Q2 as macro concerns grew

After a long period of relative calm, volatility finally returned to the commodity markets with a vengeance in Q2. Perhaps it is not surprising given the unprecedented scale of the financial crisis that faith in the subsequent global economic recovery and commodity prices has proved to be fragile and easily shaken. However, in the past few months there has been a remarkable level of disconnectedness between the pessimistic sentiment afflicting financial markets and the steady flow of both stronger-than-expected economic and commodity-specific data.

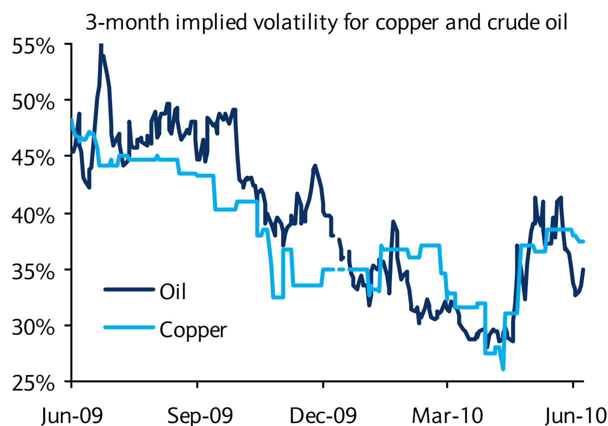
Though the flow of commodity data has stayed strong

That disconnect has affected all risky assets and has been particularly intense in some commodity markets. Indeed, commodity analysts kept in a darkened room for the past few months and permitted access only to a data feed of commodity prices as their sole source of information would probably emerge extremely surprised to find that the world is not spiralling into the second leg of a double-dip recession. In contrast, the analysts would probably be rather shocked at the robust glow of health being generated by the flow of macroeconomic data and the strength of commodity-specific fundamentals in many of the markets where prices have fallen most heavily.

A revival in risk appetite should restore the importance of commodity fundamentals

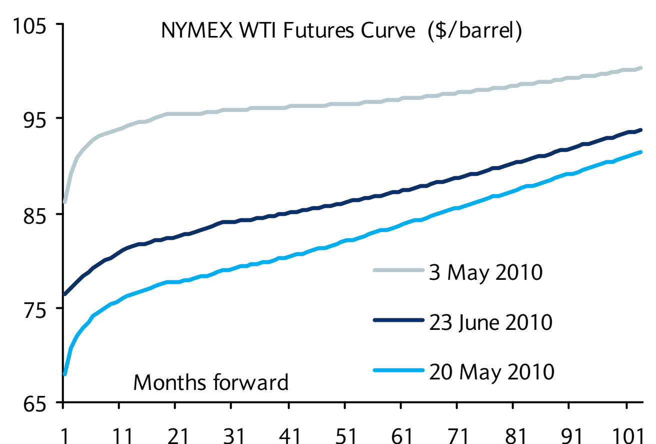
More recently there have been signs of risk appetite returning to the markets and there are some indications of a tentative recovery developing in commodity prices as well. Ultimately, we expect to see the influence of the unfolding cyclical recovery and the fundamental dynamics within individual commodity markets re-establish themselves as the main price drivers.

Figure 1: Commodity market volatility bounces back



Source: Barclays Capital

Figure 2: Oil weakness is mainly at front end of price curves



Source: Barclays Capital

Outlook for FX sets a more favourable commodity backdrop

Our expectation for an end to the recent phase of US dollar strength also sets a more positive FX backdrop for energy and industrial commodities, though perhaps less so for gold, which has benefitted from the same safe-haven trends that have been dollar-supportive. Meanwhile, a more flexible China currency regime is also likely to be supportive of market sentiment. Although the move is likely to result in only a very minor strengthening of the CNY this year, it clearly adds some further momentum to the upward pressure on operating costs for China's commodity producers, which are in many sectors (including aluminium, nickel pig iron, zinc, coal, and iron ore) among the highest cost swing producers.

But uncertainties over EM tightening and sovereign debt will likely linger

Nevertheless, looking further ahead, markets are likely to remain beset by a greater degree of risk aversion and uncertainty than has characterised previous recoveries because of persistent concerns about EM tightening and developed country debt. Thus although we expect a resumption of upward trends for certain commodities where supply is constrained (crude oil, some industrial metals, especially copper), the likelihood is that price trends will be choppy and interspersed with further periods of volatility similar to the recent one.

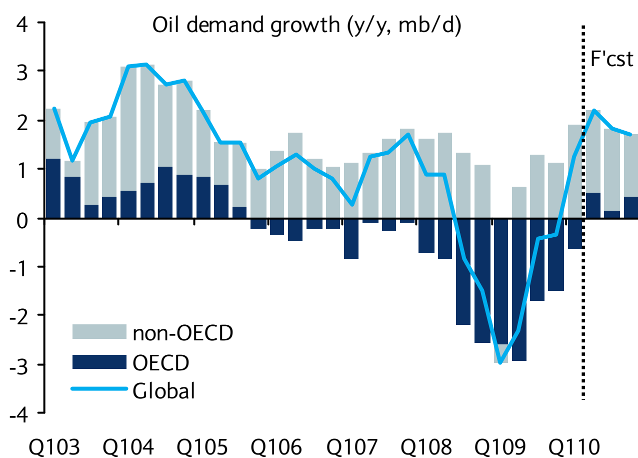
Sovereign debt default risk has clearly driven the recent phase of risk aversion and investors have again become concerned about the broad health of the financial system. However, we think the markets may have overreacted. Policymakers are aggressively targeting the debt crisis; Spain, Portugal, Ireland, and Greece are just 4% of global GDP, while European exporters are benefitting from euro weakness, adding to the strength of the recovery in northern Europe. Indeed, in recent times some of the strongest commodity markets have been the European energy markets where local gas and coal prices have made substantial gains; the strength of industrial production is an important supportive factor.

The other major concern, which is particularly important for commodities markets, are fears that a property market bubble is about to burst in China with potential dire consequences for the whole economy and that would lead to a steep contraction in the demand for construction-related commodities such as industrial metals.

With additional concerns about China's overheating economy

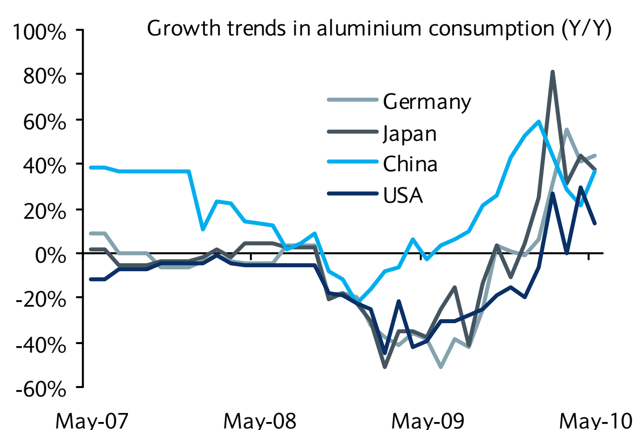
However, we believe that risks posed by the property market overheating in China need to be kept in perspective. The threat to the wider economy is likely to be minimal given the small proportion of fixed asset investment that is accounted for by private property construction and the limited exposure of banks to the sector. For commodity demand, a slowdown in the pace of high-value property construction in urban areas is likely to be more than offset by government plans to substantially accelerate the build out of low-rent houses this year.

Figure 3: OECD recovery reduces drag on oil demand growth



Source: Barclays Capital

Figure 4: Metals demand now growing strongly in all regions



Source: CRU International

OECD has been stronger than expected

Although there has been somewhat of a transition in the global economy recently – with China and some other emerging nations appearing to have passed the period of most rapid growth in their recovery cycles – the more delayed recovery in developed economies has only recently embarked on its phase of most rapid expansion. Not only does the evidence show that commodity demand in the industrialised economies is recovering fast, but also that the flow of economic data for the main OECD economies has proved to be even stronger than what was expected by optimistic market participants.

China is slowing, but from exceptionally strong levels

Moreover, as far as commodities are concerned, we note that the most recent evidence of a moderation in China's demand growth rates followed a period of exceptional strength in demand for many industrial and energy commodities, as well as a buoyant situation for precious metals imports and also for some agricultural products. There is evidence of destocking in some commodity sectors in China, notably base metals, but any slowdown in local demand growth is coming from levels that have turned out to be much higher than expected even just a few months ago.

So the outlook for commodity demand is very strong

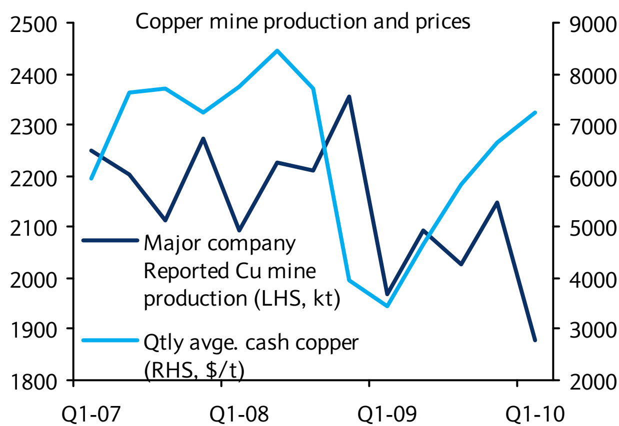
China's robustness, alongside the faster-than-expected recovery in OECD economies, means the overall outlook for commodity demand is a positive one. A shift to greater optimism on growth will likely provide some support to all commodities for at least a brief period. We do not think this is the right time to go short unless a specific market's fundamentals look particularly negative and prices significantly misaligned.

At present there are few areas of the commodity universe where it looks like this is the case. Indeed one of the features of the past few months has been the re-emergence of some of the supply strains and stresses that provided the basis for the big price increases of the last decade.

While long-term supply constraints are becoming apparent again in some markets

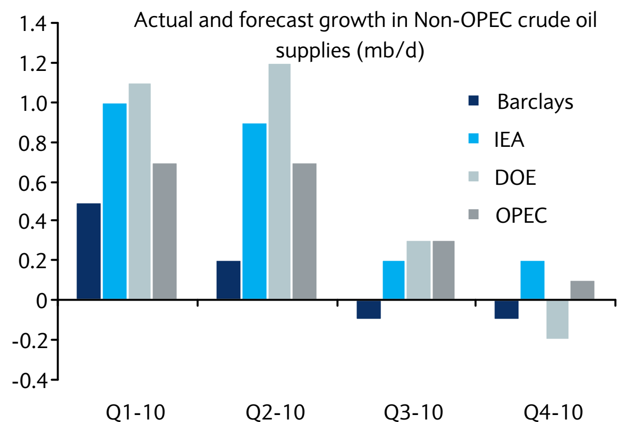
These range from the infrastructure problems that are hampering coal exports from South Africa and Russia, to the declining ore grades and technical problems that are keeping global copper mine production depressed despite much higher prices. They also include the slippages in new project schedules for LNG so far this year, which look likely to contribute to a much tighter global balance than previously expected. These misalignments extend to the Macondo oil spill; it appears this has given rise to a further perhaps fatal undermining of the notion that technological advances in oil production can comfortably redress the imbalance that exists between projected long-term demand growth rates and supply potential.

Figure 5: Copper mine production is falling again



Source: Company reports, Ecowin, Barclays Capital

Figure 6: Non-OPEC oil supply growth is expected to slow



Source: Barclays Capital

The outlook across commodity markets is far from uniform

While the long-term price outlook for a whole host of important commodities remains a very positive one, in our view, short-term price trends have certainly become more divergent recently and the extent of near-term upside price potential is likely to depend very much on the outlook for fundamentals in individual markets.

Energy markets

Oil has the best fundamentals in the energy sector…

… with global demand growth gaining momentum

In energy markets it is still crude oil that appears to possess the most clearly positive fundamental trends. At the global level oil demand growth is back in positive territory. Although China has slowed a little from the breakneck demand growth pace of Q1, the drag that was coming from hefty y/y declines in OECD demand earlier this year is now dissipating fast. We estimate that Q2 was the first quarter of y/y growth for OECD oil demand since Q3 05. Moreover, distillate demand, which had been lagging a long way behind an earlier recovery in gasoline, appears to be improving very rapidly now, as commercial transport activity picks up in the world's main producers and consumers of manufactured goods.

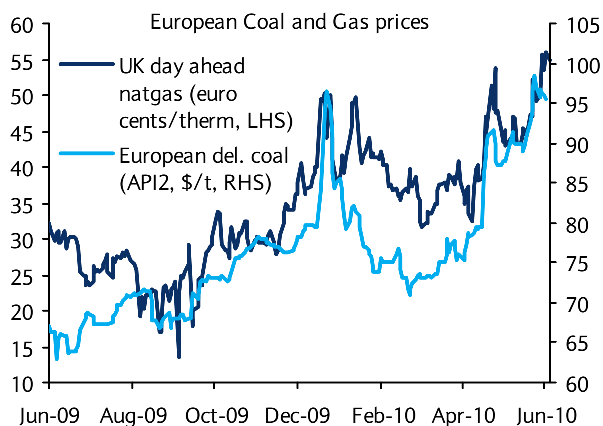
Supply is growth is modest in comparison…

Meanwhile, even with the momentum of recovery in non-OPEC output that was established in 2009 and is likely to be maintained in 2010, overall supply growth is unlikely to match the expansion in demand. OPEC output is significantly above target, but its rate of growth has slowed substantially. Indeed m/m growth has been stable since August 2009, assisted by tight compliance levels in the core gulf producing countries. In contrast non-OPEC supply expanded strongly in Q1. Although there has been a general and justifiable lifting of projections for non-OPEC over the past 18 months – driven mainly by much better-than-expected output growth in the US and Russia – there are signs that suggest that growth may have peaked in Q1. Norwegian production is performing poorly again; the tax changes that supported last year's Russian output growth are being withdrawn and US growth prospects have been reduced by a combination of the six-month deepwater drilling moratorium and forecasts for a more active hurricane season.

… and inventories should continue to fall

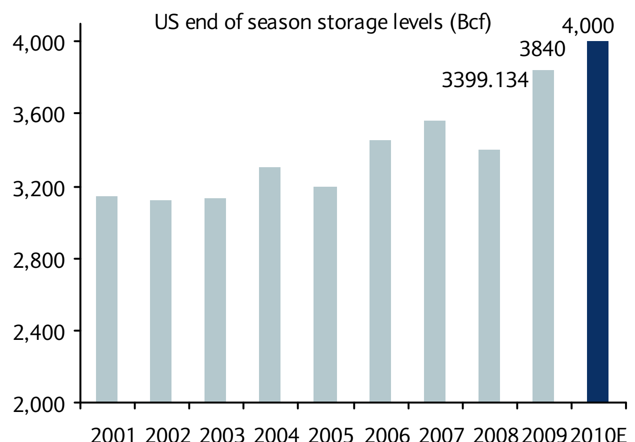
Global inventory levels of crude and products are still relatively high, but this partly reflects a one-off shift to on-shore storage of oil that was stored in ships during the period of maximum OECD demand weakness in 2009 and early 2010. Now that phase is over, we expect a more consistent picture of inventory declines over the second half of 2010 and for that to support a steady appreciation in price levels.

Figure 7: European energy prices have soared in Q2



Source: Ecowin, Barclays Capital

Figure 8: US natural gas storage to make fresh highs in 2010



Source: Barclays Capital

Refined oil product margins are likely to remain well supported for now

Given the recent robust performance of refined product differentials in the face of a significant overhang of spare refining capacity globally, it might at first sight appear tempting to start shorting some of the more liquid crack spreads. However, with a strong cyclical rebound under way in distillate demand, the risk/reward of such a position does not look attractive yet, despite the big move up in heating oil crack spreads since April/May. Gasoline crack spreads have been stable at fairly high levels recently. However, lower US retail prices, forecasts of good weather during the driving season, and no sign yet of the start of the usual seasonal build in US gasoline inventories all suggest strong support for gasoline differentials at current levels.

Further upside in European energy markets is limited after recent gains

The strongest energy commodity markets in the past month or so have been European gas and coal. These have been boosted by a combination of lower-than-expected global LNG supplies, some specific problems in Norwegian gas availability, and stronger-than-expected demand in Northern Europe, supported by buoyant local industrial production. However, upside price potential in these markets now looks limited given the scale of recent increases. European delivered coal prices in particular are now on the high side, but given the strength of the global coal market there is perhaps only limited downside, so the risk to reward of shorting these markets does not look very attractive at this point.

US gas needs lower prices in order to regain power demand from coal

US natural gas appears to be the more obvious short to us. Global LNG markets look tighter than we previously expected but domestic US supply is growing faster, and, again this year, gas will need to displace coal in power generation, but at a price below where current forward values lie. Our own forecasts suggest that US gas in storage will hit an all-time high by October. The current very narrow contango at the front end of the curve is at odds with this reading of fundamental developments and provides a good entry point for a contango widening trade, in our view.

Metals markets

Sovereign debt concerns have supported gold prices but undermined industrial metals

In metals markets, sovereign debt concerns have affected different markets in different ways. Modelling metals prices using a range of fundamental and financial variables confirms that the southern European sovereign debt crisis has added strong support to the price of precious metals such as gold and silver recently, while pushing prices for industrial metals to levels below those that are currently justified by individual market fundamentals or the broader backdrop of strong global manufacturing growth.

For gold it is possible to construct a simple model with a relatively small number of financial market variables that explains price movements quite accurately for most of the past two years. These include attitudes to the financial system (modelled using values for credit-default swaps, Libor and the spread between it and the risk-free interest rate, OIS); long-run inflation expectations (the 10y yield of US government bonds) as well as equity market risk aversion (S&P 500) and FX trends (the dollar trade weighted exchange rate index). However, recently this model has become much less effective at explaining gold price variations as actual and modelled values have diverged.

Part of this gap can be explained by the inclusion of a variable constructed using Greek, Spanish and Portuguese CDS spreads. This “Med” CDS variable captures the divergence between actual gold prices and our simulation fairly well. Southern European sovereign debt spreads started to widen from November 2009 when actual and modelled gold values also began to consistently diverge. Although this model does not take account of gold supply and demand trends, some of which have been price supportive over the same period, it does help confirm that rising fears of sovereign debt contagion in the euro area have been a key factor supporting higher gold prices thus far in 2010.

Gold now seen as a good way of hedging some less quantifiable financial risks

This suggests that gold prices could prove fragile should concerns about European debt contagion begin to recede and investor interest slow as a result; however, the real significance of this exercise is the way it illustrates the extent to which gold is now seen by investors as a very good way of hedging some of the more nebulous market concerns engendered by the sovereign debt crisis. The most notable symptom of this has been another huge surge in buying interest. Since the intensification of the sovereign debt crisis in early February, gold investment via ETPs has risen by 285 tonnes or almost 16%.

Although the scale of the potential decline in gold prices suggested by our modelling exercise seems unlikely (see Figure 12), it highlights that should the concerns over Southern European sovereign debt concerns ease, gold will need to find a new price driver. However, given the seriousness of the fiscal challenges that many of the world's major economies are facing and the potential for inflation concerns to rise again, the likelihood is that enough investors will continue buying gold to support further gains over the medium term.

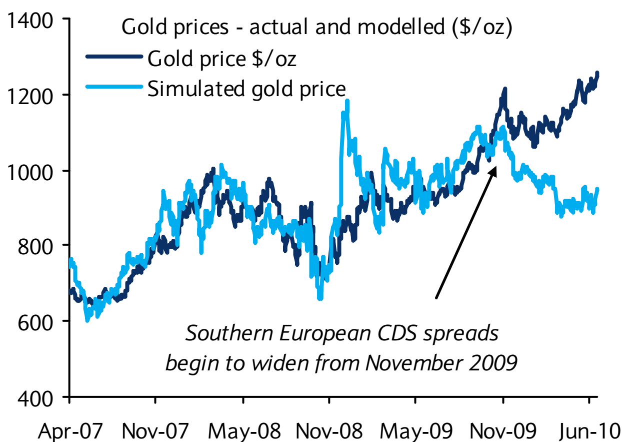
In base metals unlike gold, prices have failed to make the kind of progress expected given the evidence of strong demand, declining inventory levels, and rising physical premiums. Our modelling exercise helps to demonstrate this effect. In addition to some of the financial market variables used in our precious metals model we have included several "fundamental" variables including the ratio of global inventories to consumption for each metal as well as global IP, as a broad gauge of metals-related economic activity.

Several base metals now look undervalued

The results suggest significant price undervaluation for copper, aluminium, and lead in the past month. In the case of nickel, our model suggests that after being highly overvalued since December last year, prices have slipped back to levels more consistent with modelled values. The exercise suggests further dissipation in recent euro area and China macro uncertainties should lead to further short-term price gains for some metals.

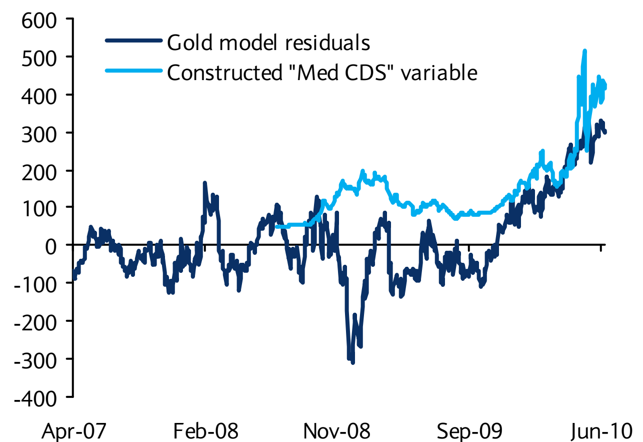
However, the extent of any base metals price rebound is likely to be most pronounced in those markets where supply fundamentals are also supportive. Supply is growing very rapidly indeed in some markets – notably aluminium and zinc markets – mainly driven by China, which is now the world's largest producer.

Figure 9: Gold prices have traded at a premium recently…



Source: Barclays Capital

Figure 10: … with Med govt debt concerns a key driver



Source: Barclays Capital

Aluminium and zinc prospects are constrained by oversupply

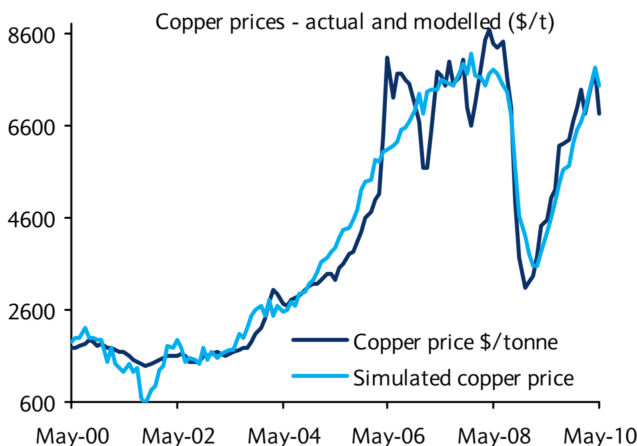
As a consequence, the recent price declines do not appear quite so out of line with fundamentals in these two markets since aluminium and zinc inventory levels look likely to continue rising even in a strong demand environment. In order to balance the market, a slowdown in production growth is probably required and this is likely to occur only following a period of relatively low prices and some output cuts. In aluminium almost 40% of producers are cash negative at recent monthly average prices and some higher-cost zinc mines have also been loss-making. Relative to operating costs, prices have held up better in copper with most of the industry profitable on a short-term cash basis at recent price levels. However, with the front end of the copper curve testing $6,000/t recently, prices have been at close to break-even levels in terms of long-run marginal costs including capital. Given the sluggish performance of the copper supply side and the urgent need for a high level of new project development over the long term, we suspect that this kind of price level approximates to a floor for copper prices, unless demand growth expectations deteriorate very significantly.

Fundamentals look strongest for copper and lead

In terms of the potential for a strong price rebound over the next few months lead and copper have the best prospects, in our view. In copper, supply underperformance remains endemic. So far this year there has been very little growth in mine production with most of the world's major miners reporting y/y production declines in Q1. Given the extreme tightness that currently exists in copper raw material markets and with few major new sources of supply on the horizon, the likelihood is that even the modest growth achieved in refined output so far in 2010 will not be sustained. With copper supply struggling to match demand growth, prices are supported by what looks like being a substantial global deficit this year and we would recommend buying copper on dips toward $6,000/t.

Lead has been the weakest LME metal so far in 2010, but we expect an improvement in fundamentals in H2 10. Supply has expanded fairly quickly so far this year but is slowing in China owing to less secondary production and droughts affecting smelter output. Consequently, we expect China to become a net importer of lead in H2 and we suspect that the big premium for local lead over LME prices that has developed in the past month is an early signal that China's lead market is tightening. Our projections suggest the market is heading for deficit in H2 and inventories should reverse their recent upward trend supporting a period of outperformance by lead relative to other base metals.

Figure 11: Copper prices are below modelled values



Source: Barclays Capital

Figure 12: Under/overvaluation relative to modelled values

	March	April	May	June to date
Base metals				
Aluminium	-7%	-4%	-13%	n.a.
Lead	10%	8%	-13%	n.a.
Copper	-1%	-1%	-9%	n.a.
Zinc	-4%	0%	0%	n.a.
Nickel	9%	17%	0%	n.a.
Tin	12%	16%	8%	n.a.
Precious metals				
Gold	15%	22%	24%	25%
Silver	9%	17%	23%	25%
Palladium	1%	8%	10%	10%
Platinum	1%	3%	2%	-3%

Source: Barclays Capital

Agricultural markets

Expected record harvests are keeping grains markets under pressure…

… but corn should benefit from demand strength in China and from ethanol makers

In the agricultural sector, grains markets have stayed under pressure from supply-side expectations of projected record global grains production; an accelerated pace of US plantings; a rebound in Southern Hemisphere production and higher inventories as well as weak external markets. However, recent support has come from adverse weather conditions in the US Midwest, excess rainfall in Canada and lingering dry weather in China. Weather conditions will be key in driving grain price direction, with the markets having been complacent over recent months on high global supplies. Across the grains we continue to favour corn, which is likely to be the key beneficiary of increased Chinese demand and potentially higher imports as well as an expected upward revision in the US ethanol blend rate this autumn.

In the softs markets we remain positive on cocoa prices for the rest of 2010 on the back of a rebound in grindings and both near- and longer-term problems besetting Ivory Coast production while higher Indian and Brazilian output is likely to weigh on sugar leading to a lower price profile in H2 compared with H1.

Figure 13: Portfolio of existing trades

	Contract	Entry Date	Entry price	Current price (Jul-23)	Unit	Gain/Loss $	%
Open trades							
Rationale: Copper prices to benefit from easing concerns over sovereign debts, global demand is strong. Copper to outperform other LME metals due to supply constraints							
Long LME copper	Sep-10	10/12/2009	7062	6513	$/t	-285	-3.9%
Rationale: We are rolling forward our long corn position believing the bulk of negative news regarding higher supply is priced in. US ethanol production has hit yet another record high & we expect corn to benefit from an increase in the US blending rate later this year							
Long CBOT corn	Dec-10	10/12/2009	404.4	398	c/Bsh	-57	-14.0%
Rationale: Recovery in global oil demand growth to continue, OPEC to continue maintaining supply restraint and crude and product inventories to continue their downward trend							
Long NYMEX crude oil	Dec-10	22/02/2010	82.4	78.8	$/b	-3.6	-4.3%
Rationale: Cotton is the agricultural commodity most leveraged to economic recovery, the market has comfortably absorbed news of higher US production this year, Chinese imports are growing and we expect further improvements in demand ahead							
Long ICE cotton	Dec-10	14/04/2010	75.7	78.2	c/lb	2	3.2%
Rationale: Although sovereign debt concerns show signs of easing, investment interest in physically backed ETPs as well as gold futures looks like benefitting from inflation concerns							
Long Comex gold	Dec-10	11/05/2010	1225	1239	$/oz	14	1.1%
Rationale: We have rolled forward our crude oil spread tightening trade further out on the futures curve. Front end Brent spreads have eased recently, but further forward spreads have tightened and we expect this process to continue							
Crude oil spread tightening		14/04/2010	-3.0	-6.5	$/b	-4.3	n.a.
Long nearby Brent crude	*Dec-10*		*89.4*	*78.1*	*$/b*	*n.a*	*n.a.*
Short forward Brent crude	*Dec-12*		*92.4*	*84.6*	*$/b*	*n.a.*	*n.a.*
New trades							
Rationale: US gas supply is expanding fast and prices need to fall in order to displace coal in power generation. We expect storage to hit fresh all-time highs by October and for the current October 2010/Jan 2011 contango to widen							
US natural gas spread widening		21/06/2010			$/mmbtu	0.07	n.a.
Short nearby NYMEX natgas	*Oct-10*		*5.01*	*4.97*	*$/mmbtu*	*n.a*	*n.a.*
Long further forward NYMEX natgas	*Jan-11*		*5.67*	*5.69*	*$/mmbtu*	*n.a.*	*n.a.*
Rationale: We expect China to turn into a consistent net importer of lead over the remainder of this year, for the global lead market to move into deficit and this to support a strong recovery in lead prices							
Long LME lead	Dec-10	21/06/2010	1851	1735	$/t	-116	-6.3%

Note: Our open crude oil spread tightening trade includes losses incurred on our original June 2010/December 2010 position. We have rolled our long position in the June 2010 LME copper contract to the September contract. We have also rolled forward our long position in July CBOT corn. Source: Barclays Capital

FOREIGN EXCHANGE OUTLOOK

Smaller currencies gleam more brightly

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- **We expect the G4 currencies to underperform the rest of the FX world, as their economies face much more significant fiscal pressures and are likely to keep real interest rates lower while risk appetite and liquidity recover.**

FX moves have reflected the euro area crisis and increased risk aversion, but also the ongoing recovery

Moves in global currencies since the previous *Global Outlook* was published have reflected three dominant themes, in our view.

- The most important was the increased concerns about the euro area fiscal situation. This resulted in a significant underperformance of European currencies, in the G10 and EM.
- Partly as a result of the euro area crisis, international investors became more cautious, which led to perceived 'safe haven'/relatively liquid currencies performing well. The USD and JPY were among the strongest currencies, and the CHF also appreciated sharply against the EUR.
- Finally, despite increased market nervousness, the move away from the global recession continued and global growth consolidated, supporting many of the currencies outside Europe. Over the past three months, the strongest G10 currency was the NZD, followed by the USD and JPY – a highly unusual pattern during the financial crisis and its aftermath.

All three factors are likely to matter for FX over the next quarter, but we expect the pattern to be very different. The euro area crisis is likely to dissipate to some extent, leading to some increase in risk appetite, though uncertainty is extremely high at present and likely to remain marked. But growth is likely to continue to strengthen and a reduction in spare capacity at a global level may mean that inflation concerns become an increasing issue for FX investors.

Fiscal issues still matter, but the EUR crisis will likely lessen

Fiscal concerns led to EUR depreciation but the JPY and USD appreciated despite their own fiscal issues…

The fiscal crisis that started in Greece and spread to some of the other 'peripheral' euro area countries dominated financial markets over the past quarter, raising the perceived importance of government finances in general. For FX investors though, an important aspect of the recent crisis has been the absence of a simple relationship between the size of the fiscal deficit or debt and exchange rate performance. An economy might have a deteriorating position for some time before the market becomes truly concerned, but then the situation can deteriorate very quickly. The GBP and EUR have had significant depreciations since the start of the crisis, which were related to a change in the view of the severity of the fiscal problems the economies faced. But the other two economies with very large fiscal deficits, Japan and the US, saw their currencies perform strongly over the past quarter (Figure 1), as they have during the crisis in general.

…highlighting the difference between a fiscal crisis and just a large stock of debt

We think the relationship between currencies and the state of the public finances reflects two linked, but different, issues. One is the effect of a fiscal crisis when there is a significant deterioration in the perceived ability or willingness of governments to repay the debt. The other is the ongoing effect of having a large debt and doing something about it. During periods of crisis, capital tends to fly towards perceived safe and liquid investments and the

larger, more liquid currencies tend to outperform. That can result in the seeming paradox of increased fiscal worries leading to the JPY appreciating strongly despite Japan having the largest debt/GDP ratio in the G10, even larger than Greece's. Indeed, at times over the past quarter when euro issues were heightened, the EUR appreciated against many of the smaller European currencies.

We expect the crisis part of the fiscal issues to diminish this quarter

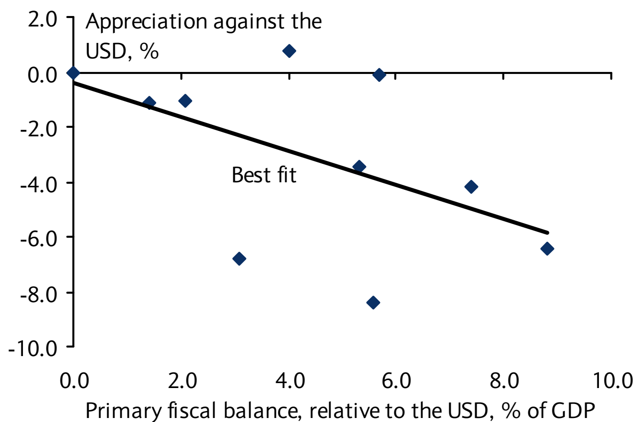
However, we think that market fears of an escalation of the euro area issues are likely to diminish over the coming months and attention will move towards the economies that need fiscal consolidation (and what it means for their currencies). The G4 economies have much larger stocks of debt than the rest of the G10, even relative to the size of the economy, and we think that fiscal issues are likely to lead all four to underperform, even though the different economies are approaching the problem in rather different ways. The UK and euro area are addressing the issue and are likely to have a tight fiscal/loose monetary policy mix, which may lead to currency weakness; Japan and the US are not at present and may finally see investors become more reluctant to lend to them. Bond yields are likely to rise in the US, but to persuade investors to borrow, not because the debt is more attractive.

Among the G4, GBP appears the most attractive currency from a fiscal perspective

Of the four, prospects appear brightest for GBP. The UK appears to be tackling the problem fairly aggressively and does not have the political complications that exist in the euro area. GBP is also alone among the G4 in having been a 'high beta' currency for much of the past two years. During periods of heightened risk, GBP tended to depreciate. In our view, this reflected the perception that if bad news hit the global economy the state of the UK's public finances and banking sector would be particularly hard hit. GBP-denominated assets were thus likely correlated with other risky assets, particularly when price moves were extreme. Conventional asset pricing theory would therefore suggest that GBP should carry a sizeable risk premium, which appears to have been the case. The tough stance taken by the new UK government may have reduced this vulnerability though, while it has probably increased in other economies – in particular, the euro area.

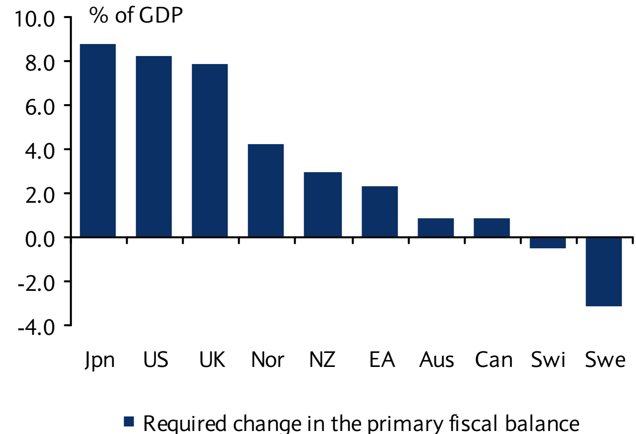
The best way to trade FX, given the fiscal problems may be the most straightforward – sell those currencies with large fiscal problems and buy those with a good fiscal position. In the G10 that would mean selling the JPY and USD and buying the CHF and SEK (Figure 2).

Figure 1: On average, currencies with large fiscal deficits appreciated over the past quarter



Source: OECD, Reuters EcoWin, Barclays Capital

Figure 2: Japan and the US need to make the largest fiscal adjustments to ensure sustainability



Source: OECD, Reuters EcoWin

The links between FX and other asset classes to become more complicated

When risk dominates, as in the past quarter, asset prices tend to move in tandem

All relative asset prices are affected by risk. So when either the price or quantity of risk changes sharply (and both tend to happen together), correlations between asset returns tend to increase within asset classes and between them. This appears to have been the case over the past quarter. The co-movement among G10 USD crosses is historically high, driven, in our view, by the liquidity and reliability of USD-denominated assets during a period of heightened uncertainty. We expect this to become true in Q3 as investor sentiment improves. This environment would lead to a more complicated, and potentially more profitable, environment for currency investors.

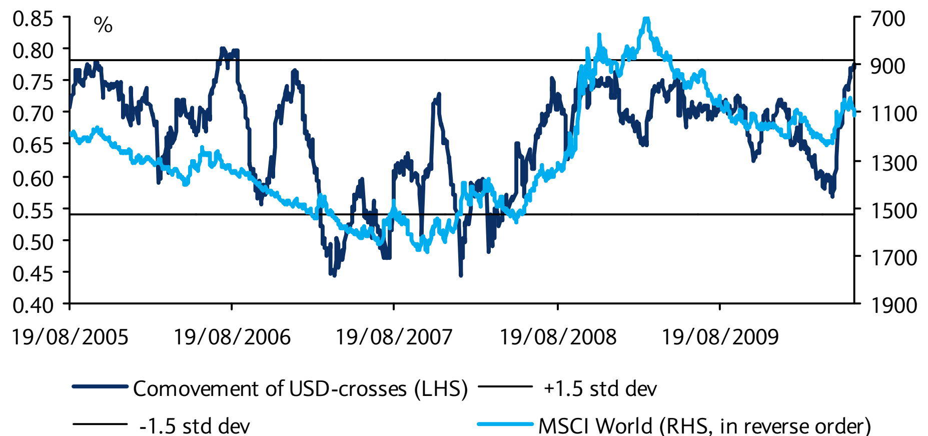
We expect markets to become somewhat calmer during Q3

We approach this issue by examining plausible scenarios for the global economy using past relationships between the different G10 currencies and other asset classes during similar periods. Our core scenario for Q3 is the euro area debt crisis leading to a further delay to the start of policy tightening in the G4 until H1 11. Also, while EM Asia continues to normalize policy in Q3, it is doing so more tentatively than in Q2. Under these circumstances we expect cyclical assets such as commodities and equities to outperform credit and bonds. Our analysis of USD-cross sensitivities to different asset classes suggests the AUD, NZD and SEK would outperform European currencies and the JPY in this environment.

We also estimate expected rates of return for USD crosses by assigning probabilities to different risk scenarios: a 60% probability is assigned to our core scenario; 10% to a 'risk-off' scenario; 20% to a scenario in which inflationary pressures start to build and bonds sell off; and 10% to a scenario in which EM Asia tightens policy aggressively. The SEK has the highest expected return, followed closely by the NZD. The expected returns of the GBP, CHF and especially the JPY trail significantly.

By assigning probabilities, we can also measure the riskiness of the trades – how variable their performance is in different states of the world. When calculating risk-adjusted returns, the differences between the attractiveness of the G10 currencies decline somewhat. In our opinion, this reflects the fact that there are fewer obvious discrepancies between currency levels and longer-run estimates of fair value. To a large extent, this is due to EUR depreciation, which took it from being significantly overvalued against many currencies to close to fair value relative to the USD and significantly less overvalued against many of the

Figure 3: Currencies are more likely to move together against the USD when equity markets come under pressure



Source: Barclays Capital

other G10 currencies. Nonetheless, if our research view proves correct in terms of economics and the overall mix of asset price movements, the smaller, less-liquid G10 currencies should outperform.

Divergent inflation pressures may increase the attractiveness of the carry trade

We think investors need to worry about assumptions they are making that may turn out to be false. If something has persisted for a long time, it is easy to take it for granted, but, as many events in the crisis have showed, things can change. Inflation around the world may be an example of this. Over recent years, inflation in the developed world has been low and stable. It follows that another feature of inflation in recent years is that there has been little dispersion between economies. However, this has not always been true in the past and may not be true in the future.

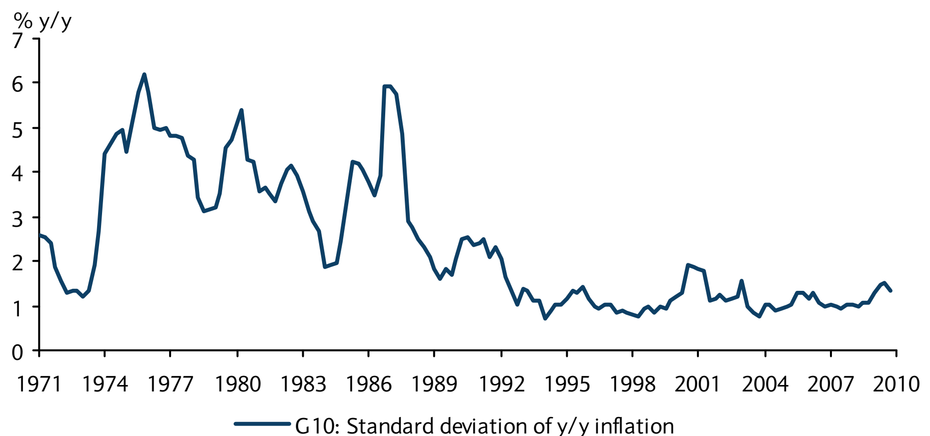
Investors should not assume that stable and homogenous inflation will persist indefinitely

Over past decades, the "great moderation" has held to an even greater extent for inflation than for output growth. In many ways, the stability of inflation during the recession has been remarkable. Despite the deepest global recession since the Second World War, the severely impaired global banking system, huge commodity prices swings and some of the largest economies in the world conducting monetary policy in a way that they had never previously used, inflation remained low and close to either explicit or implicit targets. Will this persist? In our view, it is far from certain.

Opinions differ markedly as to prospects for inflation – will too much spare capacity mean that the world economy will become like Japan in the 1990s, or will loose monetary policy lead to another "great inflation", as happened in the 1970s? In our experience, investors tend to have very strong views on this issue and tend to view it as a homogenous global phenomenon – inflation will be either universally high or the world as a whole will slip into a deflationary trap. But something that investors may not be placing enough weight on is the possibility that some countries get stuck in a low inflation, low demand rut, while others have too high inflation. How should investors position themselves in that case?

To help us think about the FX consequences we looked back to the 1970s, a decade in which inflation variability, across time and countries, was markedly higher than it has been recently (Figure 4). During that decade equities performed very badly, as did FX carry

Figure 4: G10 inflation rates have moved together over the past two decades



Source: Haver Analytics, Barclays Capital

trades, or at least those based on nominal interest rate differentials. In our view, that was due to high nominal interest rates lagging high inflation – so high nominal interest rates tended to be associated with low real interest rates. Even though central banks might not get everything right, they are very conscious of history and we think that increasing inflationary pressures in some countries relative to others will lead to a rather different response this time.

Global inflation pressures could bifurcate: some countries get caught in a deflationary rut, while others need to tighten policy aggressively

We think there is a fairly high probability that some economies – Japan and the euro area seem the most probable – will have very low inflation, and that all the large economies are likely to keep monetary policy extremely loose. By contrast, Asian growth, which for many years led to global disinflation via cheaper labour-intensive goods, is likely to become an increasingly inflationary force, for example via higher commodity prices. The combination of loose monetary policy from the large economies and inflationary pressure from the fast-growing economies may lead to inflation worries picking up in many parts of the world. However, in contrast to the 1970s, this is likely to lead to a pre-emptive increase in nominal interest rates in many economies. To some extent this has already happened, especially in Australia, but there is likely to be a greater increase in interest rate differentials between the larger and smaller economies. In our view, therefore, the FX carry trade is likely to become more attractive over the next quarter and should perform well. We also think that USD/CAD would likely move significantly in either a relatively high or low inflation world. High inflation would likely be associated with strong commodity prices so its terms of trade would benefit, and very low inflation may lead to another bout of risk aversion, in which case the USD would be strong against most currencies. Given the recent stability of this cross, buying the wings seems an effective way of positioning for a change in the inflationary environment.

Figure 5: G10 FX Forecasts

	Spot	1m	3m	6m	12m
EUR/USD	1.23	1.20	1.20	1.25	1.25
USD/JPY	91	92	94	96	98
GBP/USD	1.48	1.48	1.52	1.60	1.60
USD/CHF	1.11	1.13	1.13	1.13	1.13
USD/CAD	1.02	1.00	1.00	1.03	1.07
AUD/USD	0.88	0.90	0.90	0.84	0.82
NZD/USD	0.71	0.72	0.72	0.69	0.67
EUR/JPY	112	110	113	120	123
EUR/GBP	0.82	0.81	0.79	0.78	0.78
EUR/CHF	1.37	1.36	1.40	1.42	1.45
EUR/SEK	9.51	9.50	9.30	9.25	9.20
EUR/NOK	7.88	8.00	7.90	7.85	7.80

Source: Barclays Capital

INTEREST RATES OUTLOOK

Recovering from Q2

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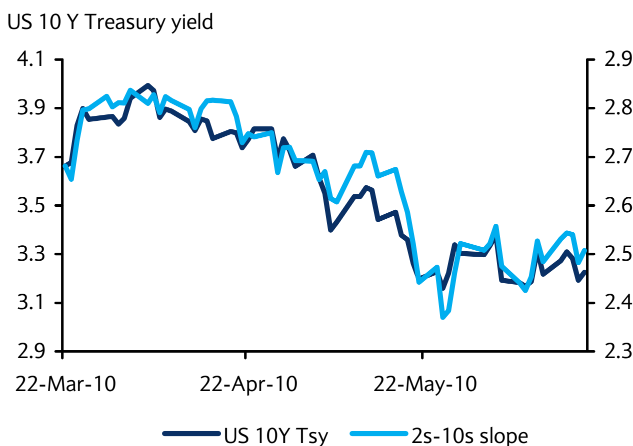
- **After the flight to quality in Q2 10, global bond markets should take the first steps towards normalization in Q3. We expect US rates to rise slowly across the curve, driven by improvements in labor markets and inflation readings, as well as a rising term premium. The big wild card is regulation. If liquidity regulation is actually implemented in the proposed phase-in period, US banks could become heavy buyers of Treasuries. This could keep rates lower than our forecasts, but at a heavy cost to bank lending.**
- **On the European side, we expect sovereign debt spreads to stabilize, for several reasons. The political willingness and mechanism to solve the European funding crisis seem to be in place, as are plans for deficit cuts. The technical situation in peripheral sovereigns has improved, and supply should drop over the next few months. Nevertheless, the implementation of deficit cuts will be tricky, which is why we recommend being long euro versus US sovereign debt in the 10y sector.**
- **Unlike the US and Europe, Japan should have some further flattening in Q3, but out along the curve. Japanese banks have vast surpluses on hand, which they will likely term out, helping 5s-10s flatten. Fears of supply should also be contained, given the new administration's planned curbs on JGB issuance. In Australia, the RBA has stopped its tightening cycle after the European problems.**

US: A slow recovery from the risk aversion trade

In May and June, a big risk-aversion trade sparked a massive flight to quality into US Treasuries

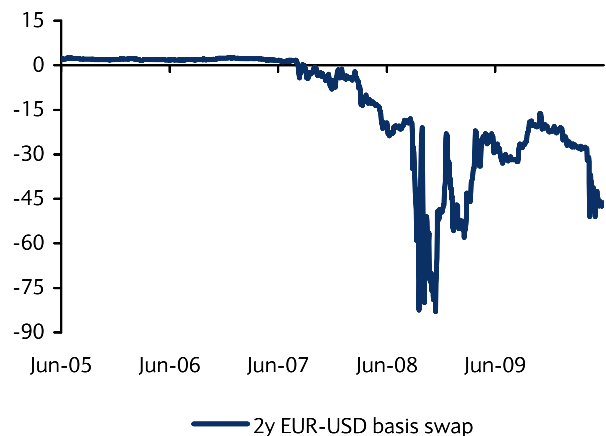
US rates market stayed on script in April, with 10y yields rising to nearly 4%. Then came the risk-aversion trade, brought on by the European fiscal/banking crisis. From the start of May, Libor spiked, equities dropped, credit spreads blew out, and US Treasuries experienced a massive light to quality. The resultant bull flattening in May has largely persisted so far in June (Figure 1). For the next several months, we expect US rates investors to focus on two questions – where are US rates headed, and are bank funding pressures likely to abate?

Figure 1: Bull flattening in US rates in Q2 10



Source: Barclays Capital

Figure 2: Cross-currency basis swap suggests funding stress



Source: Barclays Capital

Funding pressures, but not a systemic crisis

There seems to be strong bifurcation even within European banks

While some European banks are definitely having funding problems, there is little evidence of a systemic crisis. Consider the numbers – we estimate that non-US banks borrow about $1.5trn in the USD wholesale funding markets to fund about $1.2trn (according to BIS estimates) in USD assets. Of the $1.5trn, we calculate that about $925bn is in wholesale deposits, $370bn in commercial paper, and $170bn in a net short repo position. If there were truly a funding crisis, we would expect foreign banks to bid aggressively for wholesale deposits in the US, and to repatriate existing dollars back to their head offices. Neither has happened in size so far, unlike in the financial crisis of H2 08. Similarly, US branches of European banks still keep hundreds of billions of dollars in excess reserves at the Fed. Why would firms lend to the US central bank at 25bp if they were facing issues financing themselves even at much higher levels? Finally, Euribor has lagged the rise in Libor over the past couple of months (unlike in H2 08), and Libor itself has stabilized for several days. Finally, the ECB has taken unprecedented policy measures, and euro area policy makers now seem to recognize that they still have to fix the fiscal issue even if they solve the liquidity problems – every second day seems to bring an announcement of spending cuts by one European country or another.

We believe that while Libor should continue to rise slowly, a systemic crisis is far from likely

None of this implies that there are no funding pressures. CP issuance for non-US banks has dropped substantially in May, and the cross-currency basis swap (Figure 2) suggests a sharp need for USD. Also, Libor settings of US banks have recently been more stable than those for European firms. Our conclusion – there is significant bifurcation within financial firms, and even within European financial firms. The big European banks that make up the Libor panel and have diverse sources of funding in the US seem to have few problems funding themselves. But smaller firms, especially from countries with fiscal issues, are stressed. Importantly, the market seems to have priced this in – Libor is expected to be at about 65bp in September and has recently stabilized below 54bp. That leads us to believe that while funding pressures for parts of the banking system could continue, systemic risk should be contained.

US rates forecasts: A slow sell-off

We expect 10s to rise above 4% only by Q1 11

The view expressed above plays a big role in our rates forecasts. At current levels, we believe rates are too low but expect 10s to breach 4% only by Q1 11 as the recent risk aversion slowly declines (Figure 3). 2s are more influenced by the updated Fed call – with the first hike now expected only in April 2011, they should rise almost in lockstep with 10s. Hence, our 2s/10s slope is steeper than the forwards for the next nine months.

Rates forecasts are a combination of two estimates – the 'expectations' component and the term premia

These forecasts are a combination of two estimates – the 'expectations' component and term premium. The former is what we expect the funds rate to average over, say, a 10y period, if we are talking about the 10y Treasury forecast. This expectation of the long-run path of fed funds depends mainly on inflation and unemployment forecasts. That explains Figure 4 – the decrease in rates over the past two decades is mainly because declining inflation has driven down the long-run expectations of the fed funds rate. Based on our model, the expectations component for 10y yields is about 2.5%, while the actual rate is 3.25%. This means the other 75bp is the term premium. Several factors go into the model of term premia, including the budget deficit, how accommodative monetary policy is, etc. For instance, the high level of term premia in 2002-03 was because the Fed stayed very accommodative in the face of stronger data. Right now, term premia are above historical averages, largely because heavy budget deficits have led to high supply.

Both the 'expectations' component and the term premia should rise in coming months

Our models suggest that both expectations and term premia should rise. We expect the labor market to improve and inflation to stabilize in H2 10 before inching higher next year, which should push up the expectations component. At the same time, with the Fed likely to stay accommodative for a while, term premia should rise. The Fed's act of draining reserves (this should start before the hikes begin) should also push them up, although mainly at the front end. The risk aversion of May and June should be partially reversed over the next few months, also pressuring rates. Most important, while budget deficits may drop, debt/GDP ratios should keep rising fast – Figure 5 shows that absent significant changes in spending and taxation policies, the total deficit is unlikely to drop below $1trn in any year over the next decade. Add it all up and we end up with the mild sell-off and steep curve in Figure 3. All in all, while the European fiscal scare in Q2 is definitely a concern, it should not cause a European banking crisis. If we are right, the developments of Q2 should merely push out our rates and economics views, without changing them significantly.

US housing and securitized markets: Easing into summer

Longer-end swap spreads should remain at record tights

For the past several months, US housing/mortgage markets have receded from the headlines; this should continue into the summer. Secondary mortgage markets have been largely unhurt by this quarter's flight to quality, and investors have also been unfazed by the end of the Fed's agency MBS purchase program. As monetary policy remains accommodative to offset upcoming fiscal tightening, the carry trade should do well and help agency MBS spreads. At current valuations, we like non-agency MBS as a sector and see little downside for CMBS spreads.

Secondary mortgage markets continue to do well, while primary origination remains anaemic

One reason secondary markets are doing so well is the lack of primary issuance. New non-agency MBS or CMBS deals are few and far between, and that is unlikely to change for the foreseeable future. Agency MBS issuance has also been light – credit conditions are tight for Fannie- and Freddie-backed loans, and the bulk of purchase mortgages are now done through the GNMA program. Finally, while there are likely still significant losses to come (especially in commercial mortgages, but also in non-agency residential loans), these seem to be priced into securities valuations. Meanwhile, the risk of a sudden jump in our base case loss estimates recedes with every passing day. Lack of primary issuance, attractive carry and lower tail risk all point to MBS prices retaining support in the summer.

Figure 3: 2010-11 rates forecasts

	Spot	Q3 10	Q4 10	Q1 11	Q2 11
2y	0.71	1.1	1.4	1.8	2.1
5y	2.00	2.5	2.8	3.1	3.2
10y	3.21	3.7	3.85	4.1	4.1
30y	4.14	4.6	4.7	4.8	4.8
2s10s	2.5	2.6	2.45	2.3	2.0
2s10s Mkt	2.5	2.38	2.29	2.19	2.08

Source: CBO, Barclays Capital

Figure 4: Expectations component has fallen for two decades

Source: Barclays Capital

Housing market developments also support this positive view of spreads. We believe that foreclosure stock peaked in March 2010, at 3.8% of all mortgage borrowers (Figure 6). On the other hand, real estate owned (REO) stock still has a long way to go; we expect the REO peak in August 2011. Banks continue to push homes from foreclosure to REO (and, thus, on the market) at a pace that is manageable for the market. While the expiration of the tax credit could be a challenge to housing demand from June onward, the slow foreclosure-to-REO timeline will help prices. The next couple of readings (data for April and May) should be supported by strong seasonals and the tax credit. But even beyond that, home prices seem to have limited downside, although the weight of shadow inventory should prevent prices from rising in many parts of the country.

The regulation wild card

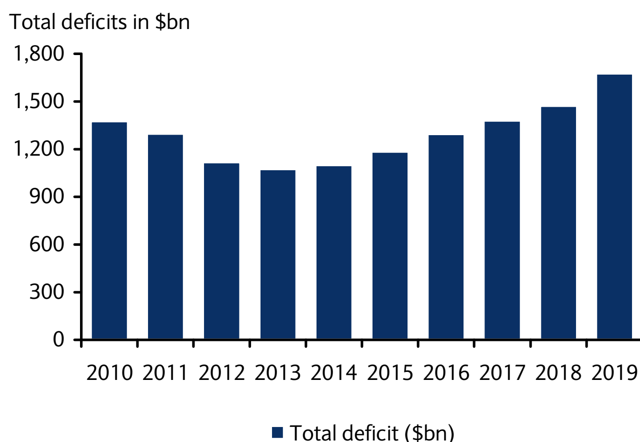
US banks have a USD850bn-1.7trn funding gap if BIS liquidity guidelines are implemented in the proposed phase-in period of two years

While housing is no longer a wild card for US fixed income investors, regulation definitely is. The financial regulatory reform bill is still in conference in the US Congress, and it is difficult to comment until the details become clearer. But we have more insight into the liquidity regulations proposed by the Basel committee last December. Our analysis suggests that US banks are far from compliant with BIS liquidity rules (for details, see *Liquidity Regulation: (Un)intended Consequences?*', June 18, 2010). Specifically, banks have a funding gap of $850bn as defined by the liquidity coverage ratio and as much as $1.7trn as measured by the net stable funding ratio.

Liquidity regulation could force US banks into heavy Treasury buying, but at a considerable cost to bank lending

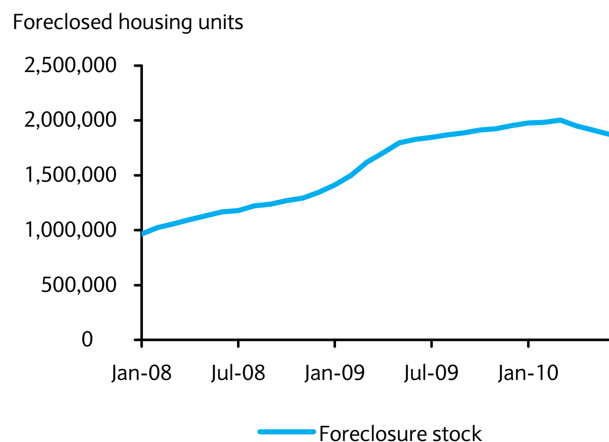
This liquidity shortfall (if the Basel proposals are truly implemented) is not very evident because of the $1trn or so that banks hold in excess reserves with the Fed. But as and when the Fed starts to drain reserves, banks might have to alter their balance sheets significantly. Historically, they have shed securities and increased loan growth as the economy recovers from recessions. But this time around, if the recovery is accompanied by a draining of reserves, they would have to ramp up their securities holdings to maintain their liquidity profiles. Specifically, our estimates are that if banks are forced to comply with these regulations over a two-year period, they might be forced to increase their Treasury holdings by as much as $1trn. This would not only affect our rates forecasts; it would also have implications for bank lending and, thus, GDP growth. It is possible that as policy makers become aware of this effect on growth, they will soften the liquidity requirements or considerably increase the phase-in period. But as they stand now, regulatory changes are clearly a big wild card for US rates markets.

Figure 5: Total deficits over the next decade



Source: Barclays Capital

Figure 6: Foreclosures probably peaked in March 2010



Source: Loan Performance, Barclays Capital

Euro area: Back from the brink

The euro area found itself in the eye of the storm in Q2 10

Action from the EU and ECB has helped to stabilise the markets

The euro area found itself in the eye of the storm in Q2 10: there was extreme volatility in cross-market spreads, with all peripheral markets widening aggressively as contagion spread from Greece and bond market liquidity steadily dried up. The very existence of the euro area was questioned, which was almost unthinkable less than six months ago. A number of policy responses have since helped stabilise the situation, and the extreme negativity in the euro area over the past few months has moderated somewhat going into H2 10. A lot of details remain to be fleshed out on the EU stabilisation mechanism (the €700bn EFSF), and our base-case scenario is that it will be put in place, but probably not used. At the same time, the support provided by the ECB Securities Markets Programme (SMP, in which the ECB buys, for the first time, public sector debt) has helped to mitigate some of the selling impact seen from investors willing to reduce their peripheral exposures in illiquid markets. The pace of the SMP buying has slowed (it currently stands at €51bn), reflecting reduced selling by investors (despite the recent downgrades of Greece to junk level), and we still believe the size of the programme will remain fairly limited (say €75-100bn) and focused on just the smaller peripheral markets (Greece, Portugal and Ireland).

ECB intervention will not be a substitute for further fiscal reform

The ECB will likely remain reluctant to get involved in the bigger markets (Spain and Italy), as any such buying is likely to have only a temporary effect. It is more important for these countries to achieve and maintain fiscal stability and demonstrate they can continue to access the funding markets. In that respect, the lower net and gross issuance likely to be seen in the coming three months should be helpful, especially compared with the heavy issuance over the past few months. Important challenges remain, and country spreads will probably stay volatile for some time, as gross issuance is likely to remain stable at a high level for the next two years, but it will have to be reallocated more towards domestic investors. However, overall, we would expect worries about euro area sovereign risk to moderate from here and, consequently, spreads to be less volatile, if not tighten.

Focus on money markets

Bank funding remains a key issue

The sovereign turmoil has somewhat spilled over into funding markets and modified the ECB normalisation flight path. More differentiation between banks in the euro area, combined with increased regulatory pressure (Basel III proposals) and a change in the liquidity provision from the ECB (towards shorter-maturity OMOs: the 1y LTROs are maturing, and the longest new OMOs are for 3m), will continue to push the cost of funding for banks higher. Liquidity will likely remain abundant until the end of the year, as the ECB is sticking with its full allotment procedure for 3m LTROs (and weekly MROs) until October at least, and as such, EONIA should stay low. However, there is likely to be more uncertainty than before on the level of the surplus, and credit and regulatory issues will remain important, even if the €442bn of the June 2009 LTRO is rolled successfully into a 3m LTRO. We expect FRA-OIS spreads to widen a bit further from current levels, while Euribor rates could move higher.

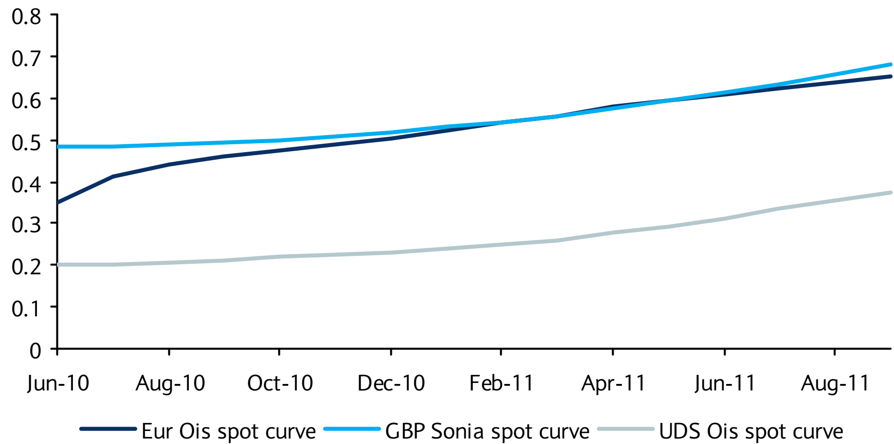
We expect the ECB to keep the refi rate unchanged until 2011, but rates to begin to push higher in Q3 10

At the same time, the ECB is likely to stay on hold for longer than previously expected: our economists now see a first hike only in June 2011, three to six months after the Fed commences its tightening cycle, so at the end of 2010 at the earliest, short rates should be range trading. We firmly believe we are currently at the bottom end of the range across the yield curve and that risks are biased towards slightly higher rates in Q3 10, as risk aversion diminishes and the shorter end of the curve starts to price in a less dovish ECB (the EONIA curve currently is pricing a return to 1% only very late in 2011, which is overly optimistic, in our view). On the curve, even the 10y sector, which we have been positive on until recently,

The 10y sector has begun to look rich outright but is still cheap in relative value

is now looking expensive (even taking into account lower medium-term growth prospects) on an outright basis – it still looks the cheapest on a relative basis on the curve, though. Curve-wise, we do not look for much change: initially a bit of re-steepening, but medium term, flattening should still prevail in 2s/10s, with the 5y sector cheapening. The post-10y sector still looks flat and should re-steepen as risk aversion fades.

Figure 7: US, EUR and UK OIS Curves



Source: Barclays Capital

Long short-end euro vs USD rates

Surprisingly, euro rates have actually underperformed US rates over the past quarter, almost across maturities. This is partly a result of the economic data that have lagged in the US, but also of international buying flows, which benefited the US market as the euro fell. From here, we recommend being long euro versus the US, especially in the 2-3y sector. Spreads at the longer end should widen as well, up to the 10y sector.

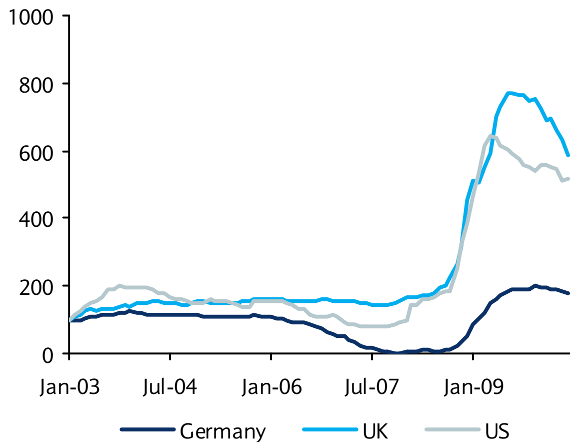
Euro spreads, volatility and inflation-linked

Swap spreads

Bund ASW vs Eonia tightened to historically cheap levels in March

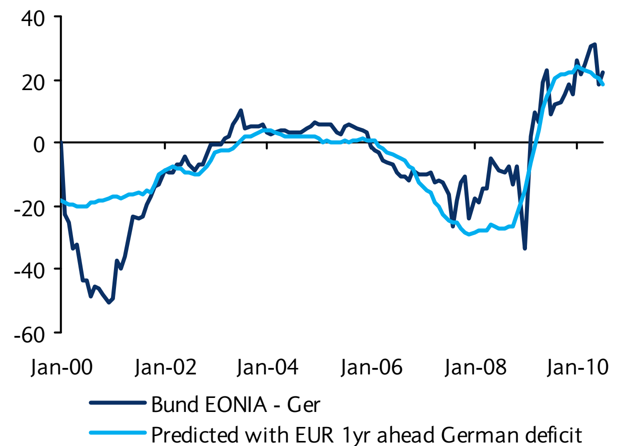
Bund ASW versus EONIA tightened to EONIA + 33bp, an all-time low, by the end of March. This came on the back of heavy swapped issuance and as the first signs emerged that Greece was likely to get help from the EU and IMF. However, as uncertainties about the help packages to Greece persisted during much of Q2 and the sovereign risk issue spilled over to other eurozone debt markets, Bund ASW bounced sharply, widening as far as EONIA ie, + 13bp on flight-to-safety flows. This widening was also helped by the lack of swapped issuance during the market turbulence with, in particular, pipelines in the corporate and covered bond markets hitting historical monthly lows in May. Some market stabilisation so far in June, combined with the return of swapped issuance, has pushed Bund ASW 10bp wider against EONIA.

Figure 8: 1y ahead budget deficit expectations Jan 03 = 100



Source: Barclays Capital

Figure 9: Bund EONIA Spreads vs Model



Source: Barclays Capital

Bund ASW now seem close to fair value, while Bobl ASW can tighten more in the near term….

Trading at EONIA +22bp, the Bund ASW is approaching fair value at current levels, in our view, while tactically we still see some more tightening room in Bobl ASW versus EONIA in the near term. Overall, our view is that Bund ASW is still likely to trade in a 20bp range over the coming months and should be traded tactically. However, taking a more strategic view, ie, looking at end of 2010-early 2011, we see room for EUR swap spreads to start to widen fundamentally. As economic growth remains solid and governments implement fiscal consolidation plans, budget deficits should improve gradually into 2011, which should be supportive of swap spread wideners. Indeed, we have already seen budget deficit expectations bottoming out globally and starting to improve, particularly in the UK (Figure 8). Moreover, we are also constructive on FRA-EONIA wideners. Strategically, we think FRA-EONIA basis, at around 30bp, looks on the tight side. If the ECB starts to withdraw liquidity surplus or if credit market conditions worsen, the FRA-EONIA basis is likely to widen.

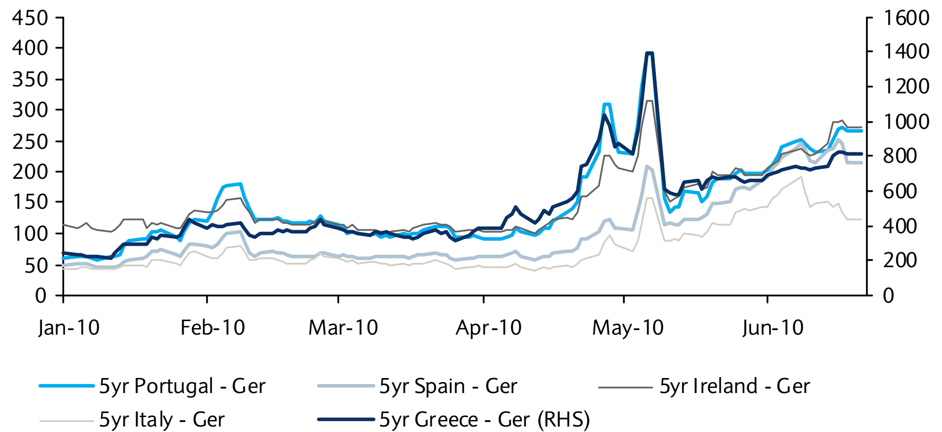
…but in the medium term, we expect a re-widening of spreads as economic fundamentals improve

Euro cross-market spreads

Periphery spreads have widened, but issuance continues to be placed successfully

Q2 10 saw a general widening of euro area cross-market country spreads versus Germany. The largest moves came in Greek bonds, which came under extreme pressure as April and May redemptions approached and assistance packages were activated in order to negotiate them. Subsequently, the launch of the European Stabilisation Mechanism, alongside coordinated buying of peripheral bonds by the ECB, caused spreads to tighten sharply (Greek front-end bonds moved tighter versus bunds by more than 1,000bp). However, the market was not fully assuaged and spreads widened again, with Spanish bonds suffering, in particular, as nervousness grew about the ability of Spain to meet its July redemption. Nevertheless, Spain and the other peripherals have been able to fund successfully over the quarter, albeit at elevated spread levels, and any concerns that redemption obligations will not be met seem to be overdone, given the cash position of Spain, in particular.

Figure 10: Peripheral EGB Spread Evolution



Source: Barclays Capital

Cash flows for the second half of the year are more favourable

Of the €265bn of redemptions scheduled over the rest of 2010, a large proportion falls due in July, when €80bn of principal repayments are available to support the market, while another €37bn of coupon payments will be made, resulting in cash returned to investors of c.€45bn during the month, making July easily the most cash flow-friendly month in 2010. These flows also come after five consecutive months of high cash demand on the market, which has seen EGB investors drained of a total c.€219bn of cash. With spreads currently at such elevated levels, this upcoming period of more positive flows may reduce some of the stress in the market. Also, with traditionally low supply levels also likely to characterise the market in August, some of the current valuations may tighten as redemptions and coupon flows are put to work in the early part of the coming quarter. While issuance will pick up in gross terms in September, it will remain lighter than usual in net terms.

Volatility

Market turmoil has left gamma at elevated levels

Volatility remained elevated during the April-May turmoil (even as realised volatility remained low), but has since moderated, especially on short-expiry options (gamma) on euro rates. Currently, gamma is trading about 1bp/day in normalised vols above delivered volatility across underlying swaps (€1y to €30y). In particular, the recent aggressive selling of gamma on €30y swaps has brought it in line with realised vols, particularly for €1y30y options. Another factor driving selling in gamma on €30y swaps has been the re-steepening of the €10s30s curve from this year's low of 20bp to back above 35bp. Gamma on €30y swaps can soften even more if the €10s30s curve steepens, but not much more, because the vol risk premium (implied less realised vol) is already close its floor (typically around 0.75bp/day in normalised vols). In our view, gamma on shorter swaps can soften even more if rates-on-hold sentiment persists. Implieds could increase significantly on renewed funding fears for sovereigns and banks, but could also drop further if investors decide to sell a lot of short-expiry options before the summer lull (typically less issuance, less trading, fewer monetary policy decisions). The latter would see the Street being taken long gamma, and given the nature of dynamic delta hedging of options books, we could see rates constrained to tight ranges, which would increase pressure on short-expiry options.

In longer-dated options, there is increased focus on the implications of the Solvency II framework

The volatility of longer-expiry options (vega) has been partly affected by the dynamic in short-expiry options. On a historical basis, pivot points in euro vega (€5y5y and €10y10y vols) are trading about 10bp in normalised vols above their long-term average levels. However, if we exclude the extreme vol levels of 2008, vega is now trading on the rich side. In particular, the area

from €5y3y vol to €20y10y is trading close to very rich levels (again excluding the extremes from 2008). The recent talk about the implementation of the Solvency II framework for insurance companies is likely to have an effect on long-expiry vols. (In short, insurance companies have been buyers of long-dated callable bonds for yield enhancement, ie, sellers of long-dated volatility, and Solvency II would force them to set aside more capital against 'riskier' assets or buy back volatility to make their positions more neutral). This theme is unlikely to go away, and we expect vega to trade rich.

Inflation-linked markets

Inflation markets remain distorted by fiscal concerns

If distortions from fiscal fears ease in the coming months, it should be positive for inflation-linked bond breakevens in all developed markets. US TIPS are typically hit hardest by breakeven position squaring such as in May and, thus, could benefit more from market stabilisation than other areas, but broader dynamics may favour other linker markets more. Absent a bounce in oil prices, shorter-dated TIPS may struggle to perform until there is clear evidence of a turnaround in the deflationary trend in shelter costs, which our economists expect to see in the H2 data. Longer-end TIPS need to adjust to increased supply in an environment in which the level of yields may limit new allocations; in particular, the reopening of the 2040 is likely to be challenging if long real yields are below 2%.

We see value in 3-10y UK breakevens

The UK is the only G4 economy for which we see significant inflation risk in the short term and, hence, the most economically attractive inflation-linked bond breakeven value. This stems mostly from high realised levels of inflation (due to the combination of currency pass-through and indirect tax hikes) already starting to feed back into consumer inflation expectations. It is not reflected in bond breakevens, though, which have retreated significantly since the Bank of England MPC expressed concern about market-implied inflation expectations in the minutes of its April meeting. We see attractive value in 3y to 10y breakevens, particularly the IL16 at 2.4%.

In the Eurozone, €5y HICPx offers value at 1.6%

In the euro area, we do not expect the effect of the fiscal crisis to push inflation down over the next two years despite the negative implications for growth. The combination of a cheaper euro and accelerated indirect tax increases is likely to offset the disinflationary effect of southern European fiscal consolidation, while in aggregate, euro area fiscal tightening may be less extreme than elsewhere in the G4. In this context, a breakeven of below 1% on the OBL€i13 appears attractive and should widen if the premium on nominal German bonds declines. Other bond breakevens do not seem particularly cheap, but we see value in 5y HICPx swaps at 1.6%, while 5y5y forwards are at a three-year low below 2.3%.

UK: Welcome to the new austerity

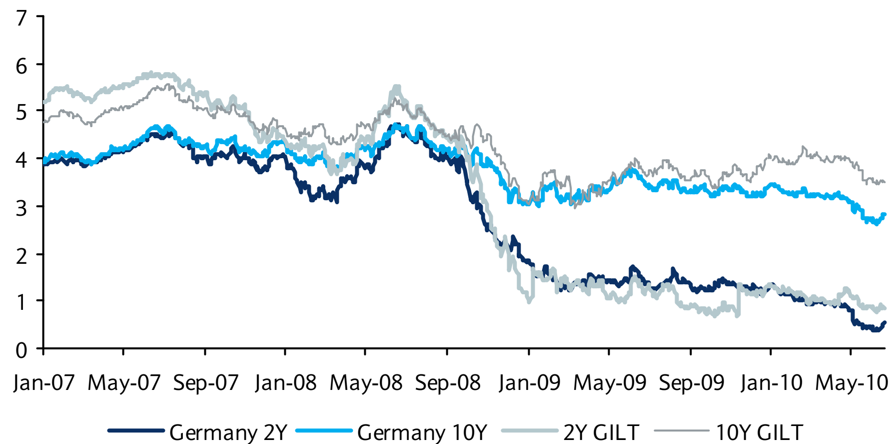
Expectations of aggressive fiscal consolidation and accommodative monetary policy have supported gilts

In the UK, the coalition government has outlined plans for fiscal consolidation that are as aggressive as anything seen in the post-war era, aiming to reduce the structural budget deficit by around 5% over four years. Gilts have been aided by three specific factors: tougher fiscal rhetoric; a substantial short base from international investors; and, finally, a reassessment by the market of the relative balance between monetary and fiscal policy. While inflation is now expected to decline from its multi-year peak, and even though the recent survey of household expectations spiked higher, the Bank of England believes medium-term expectations are still well contained. This has left the OIS market pricing in little for the MPC over the next year, with 1y OIS at 61bp and the 1y1y at 1.25%. The widespread view is that tighter fiscal policy will leave consumer activity subdued and, therefore, curtail the ability of the MPC to commence rate normalisation.

As medium-term expectations improve, we expect the curve to come under flattening pressure

We expect no move from the MPC until Q1 11, and Governor King has now said that rate normalisation will precede asset sales, with the latter likely to be conducted over an extended period. So on an outright basis, short-dated gilt valuations are likely to be supported, while it is the long end that looks cheap in spreads, cross market and on the curve. We would expect the move towards further fiscal consolidation to cause intermediate forward asset-swap spreads to richen relative to shorter forwards as a reduced issuance profile is factored into the markets. We also expect cheap valuations and reduced issuance to exert a flattening bias on the long end, as historically, fiscal consolidation disproportionately richens long conventionals. Further support for flattening may come from increasing discomfort from some MPC members over the persistence of high inflation, putting the 1y1y part of the swap curve under bearish pressure. All told, we expect gilts to outperform cross market and the curve trade with a flattening bias in Q3.

Figure 11: UK and German 2y and 10y bond yields



Source: Barclays Capital

Japan: Fiscal factors to support flattening trend

While the economy is improving, we have yet to see a major change in monetary policy

The Japanese economy should continue to expand in July-September, but could slow further on an easing of overseas demand. The JGB market has already begun to discount this subtle change in the economic cycle from April-June, but fundamentals should remain neutral to slightly positive for the market in July-September.

Even so, the economic cycle has yet to trigger a major change in monetary policy, making it difficult to expect much more of the short- to medium-term sector flattening seen during April-June. In terms of supply and demand, however, banks continue to hold vast surplus funds, so flattening pressures are expected to extend gradually from the medium term-to-longer sectors. For the JGB curve, we see room for additional flattening in the 5-10y sector. As ALM demand from life insurers is expected to weaken to some extent with the decline in absolute yields, any flattening beyond the 10y sector is likely to be limited. If there is flattening in that area, it looks more likely to occur in swaps.

We expect additional flattening in the 5-10y sector

Our expectation for bull flattening in JGBs is related not only to the economic cycle and banks' increase in surplus funds, but also to fiscal factors. When FY 09 tax revenue figures are disclosed in July, the markets will likely start to expect an upward revision to the outlook for tax revenues in FY 10. This, together with the tight expenditure caps outlined by the government in its medium-term fiscal framework (released on 22 June), should strengthen

the outlook for curbs on JGB issuance. Although large-scale tax increases (eg, hikes in the consumption tax) are clearly required in order to achieve a more serious reduction of the fiscal deficit, we would at least expect fears about supply to be contained versus last year. Whereas the second half of 2009 saw mounting fears about JGB supply when the DPJ compiled the FY 10 budget, we expect the JGB market to draw support from the FY 11 budget process when it begins from July to September.

Auction sizes are likely to increase

From the viewpoint of supply technicals, however, the heavy reliance on TBs and 2y JGBs to cover the sharp increase in issuance from FY 09 means that there will be pressure to address the increase in refinancing bonds in FY 11. As an increase in auction sizes could be considered as early as October-December, there will probably be some speculation about the effect on the yield curve from the end of July-September. Likely targets for an increase in issuance could include 5y, 20y and 30y bonds. However, we would not expect increases of more than 3-4% from current levels, so the effect should be limited compared with FY 09, when there were several increases of around 10-20%. In this context, it is hard to see the increase in issuance causing a major change in the bull-flattening trend.

Australia: RBA's pause looks likely to be short lived

Growth momentum slows in Q1

Growth momentum slowed going into 2010, with GDP expanding at only 0.5% q/q. Much of this weakness can be explained by one-off factors eg, government incentives pulling forward demand from Q1.

Australian economic recovery is well established

Nonetheless, the Australian economic recovery appears to be well established, with public and private investment spending, employment gains and dwelling construction the key drivers. We, along with the Reserve Bank of Australia (RBA) and the Federal Treasury, are forecasting above-trend GDP growth over the next couple of years. The terms-of-trade income surge lies at the core of this robust economic growth profile.

RBA tightening pauses in June, but it remains positive on the Australian economy in the medium term

The situation in Europe and the recent severe erosion in global market confidence were key factors in the RBA's decision to deliver a pause in its tightening cycle in June, according to the board minutes. RBA board members judged that moving borrowing costs from expansionary to average settings over recent months "afforded policy the flexibility to await information on how recent market uncertainty might affect the global economy". Nonetheless, the RBA board noted that the medium-term outlook for the Australian economy remained positive. "Prices for Australia's key commodity exports were still elevated" and "the high level of the terms of trade would add to domestic incomes and demand."

Monetary authorities appear willing to accommodate tighter fiscal policy

The RBA's view is consistent with our assessment that the global recovery would not be derailed by developments in Europe, despite the fact that some governments were in the difficult position of having to tighten fiscal policy at a time when growth remained weak. Crucially, monetary authorities appear willing to accommodate this move to a tighter fiscal stance.

Central banks in the US and Asia also appear willing to defer rate hikes

Outside Europe, our assessment is that central banks are also likely to defer rate hikes. In the US, we have pushed back our expectation of tightening until April 2011, in part because of our view that the Federal Reserve will want to see how the US economy responds to fiscal tightening due in January. Our economists also believe that Asian monetary authorities are inclined to defer rate hikes until market conditions stabilise. Importantly, the June RBA minutes flagged a similar assessment, stating that "in areas such as Asia where growth had recently been strong, it had become more likely that the withdrawal of policy stimulus would be delayed as a result of the developments in Europe".

The less global central banks tighten, the more heavy lifting the RBA will need to do

Given its previously stated view that "Asian central banks are expected to take further steps in the process of withdrawing policy stimulus as inflationary pressures build further", the RBA's post-European crisis assessment appears to align with our view. That is, the key risk for the RBA is a 1998-like scenario, in which an accommodative global policy stance (global nominal GDP growth less global policy rate) leads to higher commodity prices and increased inflationary pressures in Australia (see figures below). In other words, the less global central banks contribute to cooling global inflationary pressures, the more 'heavy lifting' the RBA will need to do. It is therefore not surprising that the June RBA board minutes highlighted the importance of the June quarter CPI data, which are to be released in late July.

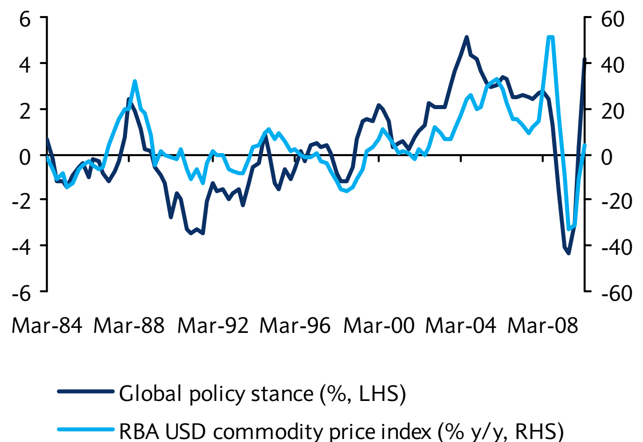
August is the next 'live' board meeting for the RBA

For the above-mentioned reasons, we believe August is the next 'live' board meeting for the RBA. Whether the RBA tightens in August clearly depends on the inflation outcome and the situation in Europe and global markets in general. Given our long-held constructive outlook for the global and Australian economies, we still expect further cash rate increases over the second half of 2010 and into 2011. Global market volatility, however, currently makes it difficult to hold and initiate hawkish positions, eg, short-end paid positions and curve flatteners, especially given their negative roll/carry. Accordingly, we have been recently focussing on positive and zero roll trades, such as NZ-AU short-end spread wideners (pay AU, receive NZ) and an AU 1s3s5s swap butterfly 1y forward.

Figure 12: Global nominal GDP vs global policy rate

Source: Bloomberg, Barclays Capital

Figure 13: Global policy stance vs RBA commodity price index (USD)



Source: Bloomberg, Barclays Capital

Global Bond Yield Forecasts

US Treasuries							
	Fed funds	3m Libor	2y	5y	10y	30y	10y RY
3Q10	0.00-0.25	0.65	1.10	2.50	3.70	4.60	1.35
4Q10	0.00-0.25	0.70	1.40	2.80	3.85	4.70	1.45
1Q11	0.00-0.25	0.85	1.80	3.10	4.10	4.80	1.60
2Q11	0.75	1.30	2.10	3.20	4.10	4.80	1.60
3Q11	1.25	1.85	2.30	3.30	4.10	4.80	1.60
4Q11	1.75	2.15	2.40	3.30	4.10	4.80	1.60

US swap spreads				
	2y	5y	10y	30y
3Q10	40	30	5	-20
4Q10	40	30	0	-30
1Q11	40	30	-5	-35
2Q11	40	30	-5	-35
3Q11	40	30	-5	-35
4Q11	40	30	-5	-35

Euro government							
	Refi rate	3m	2y	5y	10y	30y	10y RY
3Q10	1	0.7	1.15	2.4	3.1	3.75	1.25
4Q10	1	0.8	1.35	2.55	3.2	3.8	1.35
1Q11	1	1.25	1.7	2.65	3.35	3.85	1.5
2Q11	1.25	1.8	2.05	2.9	3.45	3.9	1.6
3Q11	1.5	2	2.35	3	3.55	3.9	1.7
4Q11	1.75	2.1	2.55	3.15	3.65	3.95	1.8

Euro area swap spreads				
	2y	5y	10y	30y
3Q10	50	40	30	-5
4Q10	55	40	30	0
1Q11	55	40	30	5
2Q11	55	40	30	5
3Q11	55	40	30	5
4Q11	55	40	30	5

UK government							
	Repo rate	3m	2y	5y	10y	30y	10y RY
3Q10	0.50	0.96	1.20	2.80	4.20	4.50	1.05
4Q10	0.50	1.03	1.45	3.15	4.50	4.65	1.25
1Q11	1.00	1.50	1.80	3.40	4.80	4.75	1.50
2Q11	1.50	1.95	2.20	3.80	5.10	4.80	1.80
3Q11	2.00	2.45	2.60	4.25	5.10	4.80	1.80
4Q11	2.50	2.98	3.00	4.50	5.25	4.80	1.95

UK swap spreads				
	2y	5y	10y	30y
3Q10	55	5	-30	-40
4Q10	55	5	-40	-40
1Q11	55	5	-40	-35
2Q11	60	10	-40	-35
3Q11	60	10	-40	-35
4Q11	60	10	-40	-30

Japan government							
	Official rate	3m	2y	5y	10y	30y	10y RY
3Q10	0.10	0.20	0.15	0.40	1.15	2.25	1.60
4Q10	0.10	0.20	0.15	0.40	1.15	2.25	1.60
1Q11	0.10	0.20	0.15	0.45	1.20	2.20	1.60
2Q11	0.10	0.20	0.15	0.45	1.25	2.25	1.60
3Q11	0.10	0.20	0.15	0.50	1.30	2.30	1.60
4Q11	0.10	0.20	0.15	0.55	1.35	2.30	1.60
1Q12	0.10	0.30	0.20	0.65	1.40	2.35	1.60

Japan swap spreads				
	2y	5y	10y	30y
3Q10	28	18	10	0
4Q10	30	20	10	0
1Q11	30	20	10	5
2Q11	30	20	10	5
3Q11	30	20	10	5
4Q11	30	20	10	5
1Q12	30	20	10	5

Source: Barclays Capital

CREDIT MARKET OUTLOOK

Sovereign risk takes centre stage

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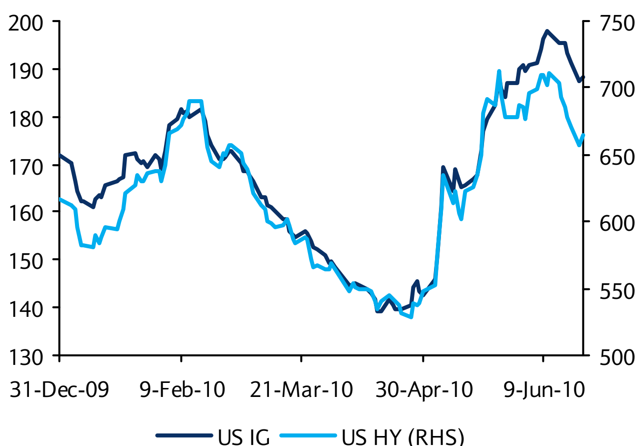
- **Despite improving macroeconomic and corporate fundamentals, corporate credit spreads have widened significantly in the second quarter. Even after a strong first quarter, the major credit asset classes are now wider on the year, with the exception of European High Yield.**
- **Sovereign risk has clearly been a key driver of volatility this quarter, along with concerns about financial reform in the US.**
- **We expect moderate spread tightening over the rest of the year, with the US markets outperforming Europe. The prospects for total returns are more limited, in our view, based on our interest rate forecasts.**

In line with the broad global macroeconomic trend, corporate fundamentals continued to improve over the second quarter. This is evident in any number of metrics, including declining leverage, increasing cash on balance sheets, and a lower default rate. However, the focus of the credit markets this quarter was on the European sovereign situation and financial reform in the US, rather than on earnings and balance sheets, and spreads widened across regions as a result (Figure 1). Credit is now broadly wider on the year, after having tightened for much of the first quarter, particularly in the US.

Despite the increase in spreads, yields have fallen, as interest rates benefited from a flight to quality. This has led to positive total returns in investment grade and high yield (Figure 2). In fact, we believe low absolute yields are one of the main obstacles to spread tightening, as the demand from real money investors is unlikely to increase meaningfully absent higher rates. This is in contrast to concerns about the potential for higher rates at the beginning of the year.

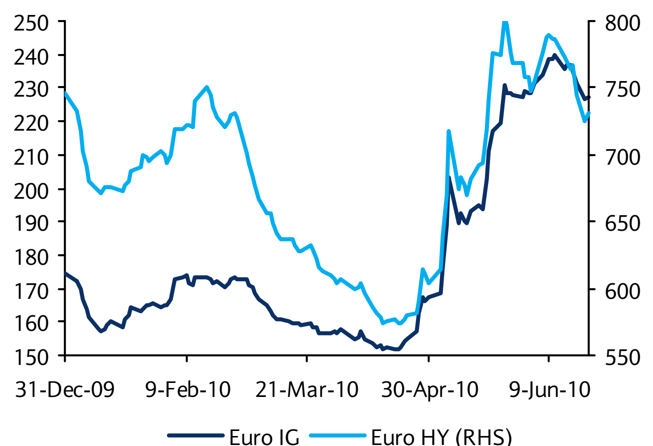
We expect moderate spread contraction across credit over the second half of the year. However, the prospects for further increases in the total returns to investment grade are less positive, given our view on interest rates. We expect better absolute performance in high yield and leveraged loans, due to higher carry and lower sensitivity to interest rates.

Figure 1a: US corporates – IG versus HY OAS (bp)



Source: Barclays Capital

Figure 1b: Euro corporates – IG versus HY OAS (bp)



Source: Barclays Capital

Performance has varied across regions, with US investment grade and European high yield outperforming

The performance across regions has varied by asset class. In investment grade, European spreads have underperformed the US, leading to more negative excess returns. We expect this to continue, particularly for banks. Although European banks have been amongst the worst performers, US ones have also widened substantially over the past several months due to concerns about financial reform, so have outperformed European banks less than one would expect, given the exposure of the European banking system to sovereign debt. We expect financial reform to be finalized by early July, and the recent indications are that some of the most contentious components of the bill may be reduced in scope. Once this uncertainty in the US is eliminated, we expect valuations to begin to reflect the relative capitalizations and funding needs of European versus US banks. One part of the market where we believe the underperformance of European names has been overdone is utilities. Still, the best relative value opportunities again seem to be in the US – the USD issues of these names have widened disproportionately as US investors reduce European exposure at all cost.

Figure 2: Yields and total returns for US and European corporates

	31 Dec 09 yield	22 Jun 10 yield	Yield change	YTD total returns
US IG	4.73	4.35	-0.38	4.78
US HY	9.06	8.97	-0.09	5.13
Euro IG	4.03	3.76	-0.27	3.33
Euro HY	10.74	9.58	-1.16	8.73

Source: Barclays Capital

In high yield, European Sovereign and bank concerns have not derailed European high yield's significant outperformance versus the US market. In local currency terms, the Pan-European High Yield Index had risen 8.73% year-to-date as at 15 June, versus the 3.33% return for the US High Yield Index. The majority of the discrepancy can be traced to the outperformance of the high yield financials, which make up a larger fraction of the European indices than of the US indices, and to local rates rallying more in Europe.

Given more acute sovereign and economic concerns in Europe, we believe US high yield provides better relative value, at least in the near term, particularly for cyclical industries. Furthermore, we are especially cautious on credits operating in the peripheral European countries. Investors wishing to express a bullish financial view, however, may find better opportunities in Europe because of the larger pool of financial credits.

US Investment grade

Since reaching its tights on April 15, the US Credit Index has widened sharply, driven by concerns about European sovereign risk and financial reform here in the US. At this point, the index OAS has reached 175bp, 20bp wider on the year (Figure 3). Across sectors, financials have been marginally worse than other sectors, widening by 27bp, compared with 24bp and 18bp for industrials and utilities, respectively.

Figure 3: OAS changes YTD

	31 Dec 09	22 Jun 10	Change
US Credit Index	156	175	19
Industrials	138	157	19
Utilities	161	173	12
Financials	226	245	19

Source: Barclays Capital

The drivers of the recent sell-off have been the twin pressures of European sovereign risk and financial reform in the US. The implications of sovereign risk have been felt most strongly by European banks, although other Yankee issuers have also underperformed in the US (see the Overview section). While the stresses in Europe are real, we believe the programs announced by the EU and IMF greatly reduce the risk of near-term defaults or restructurings, and we expect US investors' attention to return to domestic developments over time.

Uncertainty about financial reform should be resolved at some point in July

Several aspects of the financial reform legislation have potential implications for the credit markets. First, the Collin's amendment restricting the use of trust-preferreds as Tier 1 capital would reduce US bank capital by about $125bn. This has obvious implications for capitalization ratios and lending, absent any grandfathering provisions. While we expect grandfathering to be included in the final bill, there is a risk that the provision will not be altered. Second, the Lincoln swaps provision has similar potential implications for lending. Forcing banks to capitalize their derivatives operations separately may result in credit contraction as large banks divert capital toward the new derivatives subsidiaries. Again, it appears that this provision will be altered. We think the final form of the legislation will become clear in early July, and assuming that some of the more contentious parts of the bill are changed the way we expect, passage of the bill will reduce uncertainty, which would be positive for risky assets.

As the market has focused on financial reform and Europe, improving fundamentals and positive issuance technicals have been largely ignored. Fundamental developments on the macroeconomic and corporate fronts have been positive. The improvements in the macro environment (discussed in more detail in the economics sections of this report) have been reflected in corporate earnings, allowing the deleveraging that began as the credit crisis faded in March 2009 to continue. The median debt/EBITDA for non-financials is now below 1.5x. Cash on balance sheets is at all-time highs for non-financials, equivalent to about 5% of assets – compared with 2.5% of assets pre-crisis. The same is true for US banks, which have increased cash and equivalents from roughly $400bn pre-crisis to more than $1.3trn currently.

Primary supply is down from last year, leading to positive technicals. Relative to the first two quarters last year, issuance is down 20% (Figure 4). Most of the drop is due to lackluster supply in May and June, which was at least partly driven by the market volatility. Across sectors, domestic financials are slightly up for the year – although the 2009 number is skewed down by the TLGP program. Total issuance in that sector is down materially. The only sector that has a substantial increase in issuance is Yankee financials, which is up more than 400%, issuing a total of $76bn of paper.

Figure 4: Investment grade issuance is down 20% YTD

Year	Yankee Fins	Yankee Non-Fins	Domestic Fins	Non-Fins	Total
2009	17.8	179.3	62.1	234.2	493.4
2010	75.6	126.5	63.2	129.6	394.9

Source: Barclays Capital

US high yield: Loving the coupon

Similar to the rest of capital markets, sub-investment grade corporate bonds traded off substantially during the May de-risking. High yield bond year-to-date returns peaked at 7.1% on May 3 and leveraged loans reached almost 6% at the same time. However, while the S&P 500 was down 6% for 2010 at the lows, high yield and loan returns remained

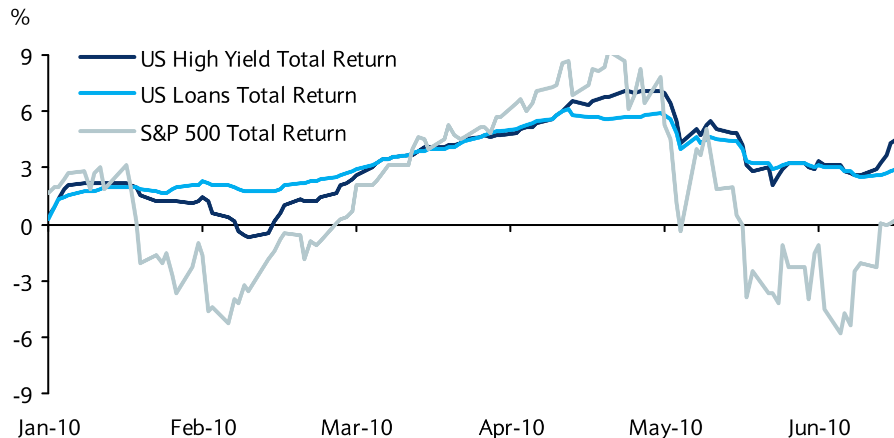
positive, never dropping below 2%. The substantial coupon on high yield of 8.4% and the benefits from Treasuries rallying were the major reasons why high yield bonds outperformed equities. For loans, higher Libor rates helped marginally, but the continued strong bid for secured product was a larger factor.

The market largely ignored a strong 1Q earnings season for macro concerns in May. As a result, yields moved as much as 150bp wider and traded to the same 9.5% level last seen in the February sell-off. The effect on spreads was even greater during this period, as Treasuries rallied substantially. Markets have stabilized in June and 2010 high yield returns surged to 4.5%. Incorporating our 3% default forecast with a 30% average recovery, if the market simply earned its coupon for the rest of the year, it would return 7.25% in 2010. If this was the case, the OAS would still exceed 600bp based on our Economics team's forecast for interest rates at year-end. We expect fundamentals to remain strong; therefore, this spread appears cheap to us compared with long-term averages for the high yield market. That being said, we do not expect investors to be intrigued by yields inside of 8% in the current macro environment, which would represent an OAS in the low 500s. This leads us to expect a 10-12% total return for the year in high yield.

The performance of leveraged loans in May makes us even more confident in our view that the secured part of the capital structure offers better risk-adjusted returns. The beta between loans and bonds was 0.41 from May through June 18. This compares with 0.64 during the harsh sell-off in 4Q08. We believe the reason for the better performance of loans this time is that loans are not owned in size with recourse leverage. As a result, there were no forced unwinds to affect the historically more stable performance of loans. Loans have also been slower to rally back in June and the asset class is up approximately 3% year-to-date. With a lower coupon but more upside potential from early par repayments, we expect loans to underperform bonds slightly this year with a 9-11% total return.

As we mentioned above, we remain positive on fundamentals, as EBITDA growth should lead to deleveraging. Another significant source of deleveraging for the market could be IPOs. We expect the majority of proceeds from equity issuance to be used for debt repayment, therefore, the health of the equity markets will be even more important than normal for the high yield market. Among big mid-2000s LBOs that this could affect in the near term are VNU/Nielsen, Toys R Us, NXP, Sabre, and HCA.

Figure 5: Comparison of US high yield, loan, and equity performance year-to-date



Source: Barclays Capital

The substantial outflows from high yield mutual funds were a large contributing factor to the weaker technicals in May. For the period ending June 16, flows turned positive for the first time in seven weeks. At this point, retail flows have been basically flat ($204mn outflow) for the year, and we expect them to be modestly positive for the remainder of the year. That being said, inflows from institutional accounts should be the bigger factor for the rest of 2010. With the Fed maintaining its accommodative policy, Institutional investors may be forced to move into high yield to pick up additional yield.

Once the market stabilizes, the opportunistic issuance that has dominated the calendar over the past year should return. Since the vast majority of issuance remains the refinancing of maturities that are well in the future, companies decided not to come to market when levels were less attractive. Despite the hiatus over the past six weeks, we still expect high yield to have a record issuance year of $175-185bn. Although more than one-third of these proceeds has gone to refinance loans year-to-date, the institutional loan market has still posted $70bn of issuance. This is higher than was expected, with acquisition financing accounting for ~20% and LBOs and dividend/recap deals at 10% each. Refinancing volume has been strong as well, running at just under half of issuance. We now expect institutional loan issuance to be $125-135bn in 2010.

Based on our fundamental and technical outlook, we highlight the following recommendations:

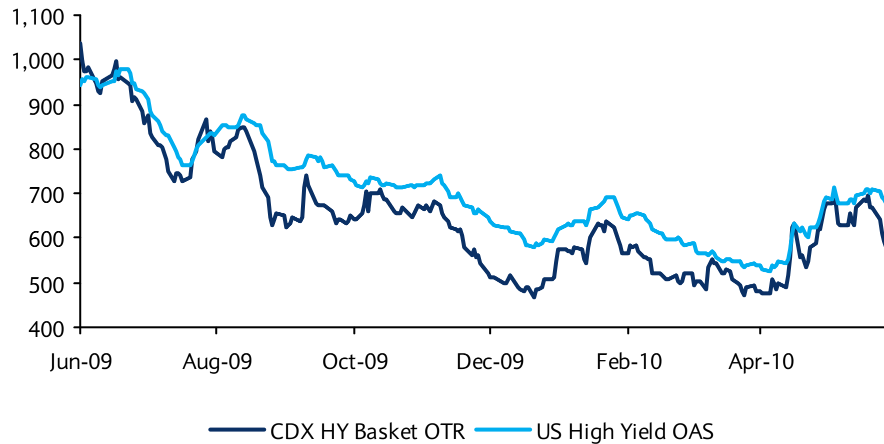
- **Barbell** – We recommend an Overweight to Ba paper, given its historically wide spread. As has been the case in most sell-offs over the past two years, Ba paper has cheapened up substantially versus Baa paper. On a more selective basis, we also prefer lower-quality paper, which should benefit from a stronger economy and potential access to equity market capital.

- **Duration** – High-quality, short-duration bonds have value, in our view, given the wide spreads at which many still trade. In addition, investors can pick up yield in short-duration bonds of high-beta credits, which have ample liquidity and runway to meet near-term maturities. Increased focus on this part of the market from non-core HY accounts should help as well. We also favor long-duration bonds of higher-quality credits where investors can move down in dollar price and pick up yield. This strategy should be particularly effective for credits in transition (eg, rising star candidates).

- **Basis** – CDX (and, to a lesser extent, single-name CDS) outperformed the cash market during the recent snapback. As a result, the basis is back to its most negative levels of the year. With fewer catalysts, due to declining default rates, we generally are not enticed by basis trades unless they are at negative 150bp or more. One exception right now would be short-dated basis where an early takeout of the bond is a catalyst. When the market widens, CDS has tended to underperform and there have been good opportunities to set longs through CDS that trade with a positive basis. Most of the remaining positive basis opportunities are in points upfront.

- **Secured/Unsecured** – We believe the resilience of the loan market in the recent sell-off highlights the strong value of owning secured assets. Hedge funds and distressed investors still possess significant cash balances and will be buyers on weakness. The high yield bond market has been fairly dormant for the past month, but we expect issuance to return as soon as the market feels stable and the use of proceeds will once again be focused on loan takeouts. Proceeds from equity offerings should also be most positive for loans trading below par. For specific examples where we favor loans over bonds, please refer to *Loans versus Bonds Relative Value, 21 May 2010*.

Figure 6: Cash vs. CDX performance (TTM)



Source: Barclays Capital

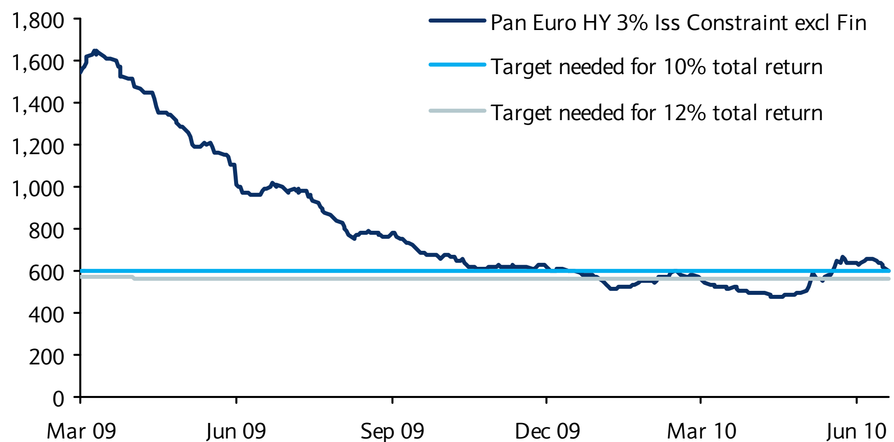
European high yield and leveraged loans: Carry me home

Despite poor returns in May and a slow June, it is worth remembering that high yield and leverage loans have returned 4.28% and 4.9%, respectively, so far this year. The main concerns are exogenous: sovereign risk, the prospect of a double-dip recession, further regulation of the financial sector/derivatives markets and concerns over bank funding in mainland Europe.

While we expect a volatile quarter, we are not changing our FY201 returns or default forecasts

With such concerns hanging over the market, we expect some volatility in the secondary market during the third quarter. However, we are leaving our full-year total return forecasts (10-12% and 11-13% for bonds and loans, respectively) and our 3-4% default range on high yield bonds for FY 2010 unchanged. Low levels of issuance in the quarter (especially July/August) should keep both asset classes broadly supported in secondary markets. Carry once more will likely be the main driver of return.

Figure 7: Spread needed for 10% total return in FY 10



Note: Uses PEHY 3% ex. Fin index. Source: Barclays Capital.

HY is priced for a c.10.5% total return for 2010

As Figure 7 shows, at current levels, European high yield is pricing in a c.10.5% total return for 2010, well within our 10-12% target. For high-yield, carry will be the key driver in hitting this. There is enough time for spread tightening after the summer if macro volatility

quietens and the market normalises. Also, fundamentals on high yield corporates are still generally strong across balance sheets (deleveraging) and income statements (EBITDA growth) for most credits. Credit quality is reducing in importance in the space for now as accounts look to macro factors but the weakening of the Euro should give a short-term improvement to fundamentals in the more industrial credits on cheaper exports.

European fund flows have been stickier than the US

Although the US market has now experienced net outflows this year, European fund flows appear to be stickier. High yield funds have had outflows from retail investors but at much lower volumes than in the US. Institutional investors have also allocated to the product. We expect some accounts to hold some inflows in cash (on concern about possible outflows). Leverage loan investors have carry and prior inflows from IPOs, as well as refinancings to invest.

Q3 will be broadly quiet for issuance after early July

Primary supply has resumed with some deals expected in the short term. If these offerings succeed, there should be continued supply in early July ahead of the summer break.

Key recommendations

- **CDS/Cash-CDS:** Curve steepeners are not worth executing in the short term, in our view, amidst low liquidity and slow issuance. Hence, we recommend buying short-dated protection against cash bonds to benefit from a spread tightening and give a positive value in case of default. The 2y CDS also gives investors an exit window with limited downside. Please refer to: *European Credit Alpha: The World Cup is not enough, 11 June 2010* for details.

- **US versus Europe:** Given the expected volatility driven by acute sovereign and economic concerns in Europe, we feel that US high yield gives better relative value, especially for cyclical credits. For investors who can trade indices, we would prefer selling protection on CDX.HY against the iTraxx crossover. While the crossover is a higher-quality portfolio, there is a risk of more volatility on further sovereign concerns.

- **Loans:** The loan market should see technical support as accounts clip coupons and feed cash back into the market. We would look at reinvesting such coupon proceeds in names that have the possibility of refinancing later in the year.

- **Quality:** Overweight BBs and Bs in a more defensive strategy.

  - However, we believe that fallen angels are expensive in cash. Active cash managers should still be wary of exceeding allocations in this space if they want to outperform the index (though passive managers will have to allocate up to their index limits).

  - Our analysts are still constructive on bonds from TMT/cable, basic materials and packaging on exit strategies.

European high grade

The outlook for European high grade credit is skewed to the downside over the next three months. In our view, the key issues are:

- **A European sovereign seeking funding under the EFSF would drive corporate and sovereign spreads wider.** There is little information that can be used to determine how soon a government might ask for funding under the program (auctions are opaque and the rate at which governments would borrow from the facility is not yet clear).

- **Bank liquidity will remain under pressure.** There is €660bn of maturity bank debt (including covered bonds) this year, but only €275bn has been issued so far. At worst,

banks will have to shrink balance sheets for lack of funding; at best, they will face substantially higher funding costs. We believe further policy measures – perhaps in the form of further ECB covered bond purchases – are possible, but only more volatility will induce a policy response.

- **Bank capitalization will remain a known unknown.** At the country level, we know that France and Germany are most exposed to Greek sovereign paper, and that much of this resides with bank and insurers. But, particularly in France, entity-level disclosure is poor. Investors will continue to paint all institutions with the same brush until there is more transparency. One panacea could be stress tests plus capital injections (a European TARP), but the feasibility of national regulators assuming losses on sovereign debt large enough to satisfy skeptical investors is questionable.

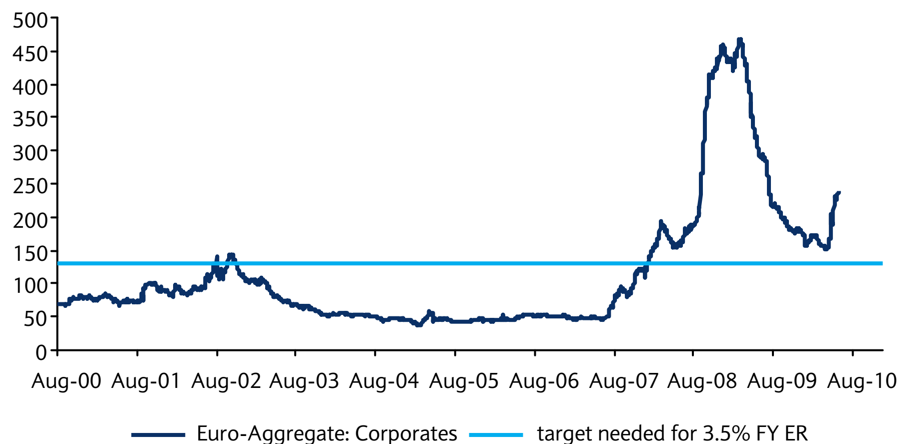
Despite our bearish three-month view, we think European credit could trade tighter by year-end. Our reasoning is as follows:

- **A Western European sovereign default will not take place in 2010 or 2011.** Current valuations are, to some degree, pricing in a tail risk event, such as a European sovereign default, but we do not believe this will materialize soon. Sovereigns cannot impose losses on debt holders while relying on those same investors to finance deficits. No European country will be close to eliminating its deficit in the next few years. Moreover, there is no motivation for such a cold-turkey response while the EFSF backstops liquidity.

- **Austerity-induced fiscal policy tightening will not push the euro area into another bout of sustained economic contraction.** Monetary policy will remain at emergency settings, and a weak euro will help the large economies which export beyond the euro area. Not all austerity measures – especially those that derive from cutting government expenditure rather than raising taxes – will be negative for growth. The global economic recovery led by China will not be derailed by European sovereign volatility.

- **In our view, higher sovereign risk will entail credit spreads that are generically higher than the levels in the 10 years leading up to the credit crisis. This, however, does not preclude spreads being tighter than where they are today, especially at the index level, which is dominated by French, German, Scandinavian and UK risk.** There are some crucial arguments to be made for credit trading tighter than current levels by

Figure 8: Although spread could be tighter by year-end, European credit is likely to fall short of the 3.5-4% excess return we targeted only two months ago



Source: iBoxx, Barclays Capital

year-end, including very robust global growth, solid corporate fundamentals and supportive technicals. However, an ongoing repricing of peripheral versus core risk also seems likely and such a secular transition may be only at the early stages.

Asia credit: Better technicals, but global concerns dominate

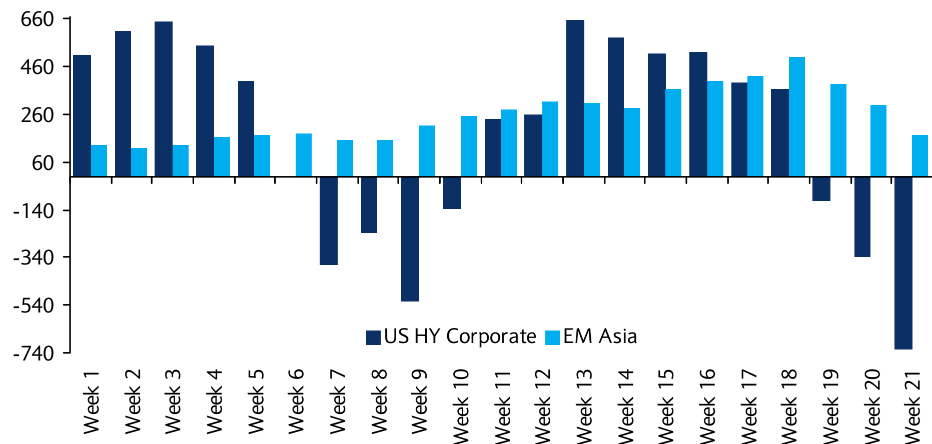
Asian credit markets have enjoyed inflows through the period of risk aversion. While technicals remain supportive, near-term direction is likely to be driven by global concerns. We recommend Indonesian coal mining corporates and bank capital.

Q2 was characterized by concerns about sovereign deficits in Europe and US financial reforms. In addition, heightened tensions in the Korean peninsula, violence in Thailand and headlines around policy tightening China weighed on investor sentiments. After touching tights for the year in mid-April, the EM Asia USD Credit Index moved wider and is currently close year-to-date wides (275bp as of June 22, 2010 wides: 293bp). While the macro fundamentals in Asia remain strong and technicals are likely to be supportive, tail risks are meaningful. We recommend that investors focus on relative value trades and dislocations as a means to generate alpha.

After achieving record numbers in Q1 (USD15.9bn), Asian credit issuance was slightly muted in Q2 (USD10bn through June 22). Increased risk aversion, coupled with an overhang of paper from issuance in April, led to a swift deterioration in market sentiment. Primary markets in Asia have reopened in recent days, mirroring the sentiment in US and Europe. We believe issuers who have been on the sidelines will tap the market as risk aversion abates; thus, we maintain our full-year supply forecast of USD50-55bn.

Mutual fund flows into EM Asia have been robust. Furthermore, even though US HY funds are seeing outflows, EM Asia has recorded incremental inflows (Figure 9). We believe this dynamic is part of the broader shift in allocation towards EM assets and expect this to provide further support to the technicals in the region.

Figure 9: 2010 EM Asia bond fund flows resilient through periods of stress (USD mn)



Note: Flows are 4-week moving average. Source: Lipper, EPFR Global, Barclays Capital

Coal prices have remained high throughout the year and fundamentals for the Indonesian coal mining sector continue to improve, making that our top pick in high-yield. The Chinese property sector has been in the spotlight in Q2. Despite headlines around new regulations

cooling property prices, the sector recorded about USD2.87bn of issuance, including three maiden issuers. From a credit perspective, during the next few months, the focus will be on the extent to which sales momentum has declined and how liquidity could be affected. We believe there will be increased differentiation in the complex in the coming months and favour the larger, more diversified Chinese real estate issuers with stronger liquidity and more conservative growth strategies. We are Market Weight on Chinese property sector and would recommend adding selectively upon dislocations.

In the high grade segment, we expect strong fundamentals and a benign technical backdrop to provide ongoing support for bank capital securities across the region. We think the recent market pull-back has presented attractive entry levels into these securities. In the sovereign space, we expect Indonesia, Vietnam, and Pakistan bonds to outperform, while we remain Underweight Philippine bonds because of tight valuations and lack of potential upside catalysts.

EQUITY MARKET OUTLOOK

Low valuations drive positive stance

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- **Our positive stance on European equities into year-end is driven by historically low relative and absolute valuations, the risk of higher longer-term inflation volatility and improving sentiment in peripheral European bond markets.**
- **For the US, we think the near-term earnings outlook for the S&P 500 is positive, but we are less sanguine post-earnings season as the prospect of fiscal tightening nears.**
- **Forecast P/Es for Japanese stocks have plunged on a combination of more moderate profit-growth expectations and recent market declines, suggesting attractive valuation levels.**

European equities: Stepping back from near-term panic

As a result of the intensification of fears related to euro-area sovereigns, risk aversion in European equities has recently surged to new peaks, judging by the sharp spike in demand for downside index put protection (sending implied volatility skew levels to extremes beyond even the post-Lehman bankruptcy peaks, Figure 1) and the surge of money into bond "safe havens" (sending European real bond yields as low as 0.5%, Figure 2).

We do not suggest dismissing structural problems, including long-term funding concerns in Spain's financial system or the risks in multi-year execution of the various European fiscal austerity packages, but we would highlight three reasons for our positive stance on European equities into year-end: 1) historically low relative and absolute valuation levels; 2) the risk of higher longer-term inflation volatility; and 3) improving sentiment in peripheral European bond markets.

Long-term valuations at rock bottom

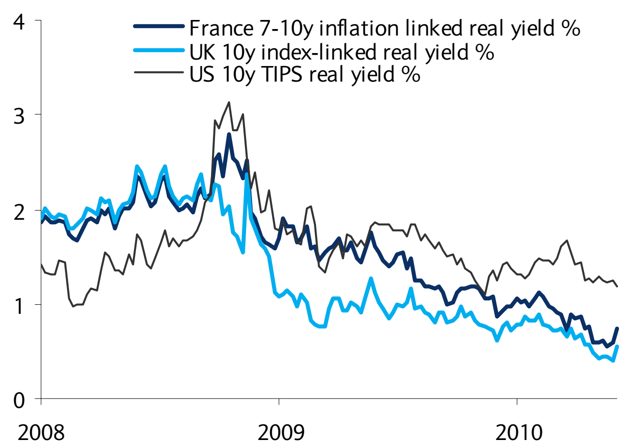
Long-term dividend and earnings-based valuations at multi-decade lows

Whether one looks at long-term equity market valuations relative to government or corporate bonds, or at absolute valuations today versus history, one thing is clear: valuations are at or near multi-decade extremes by dividend- or earnings-based measures.

Figure 1: Downside skew recently exceeded Nov 2008 highs…

Source: Barclays Capital

Figure 2: …but risk aversion drove real yields to new lows



Source: Bloomberg, Barclays Capital

UK prospective dividend yields today offer a 25% premium to long-term gilt yields, the first time this has been the case in more than 50 years (Figure 3), while the European 10-year cyclically adjusted P/E sits some 40% below its long-term average (Figure 4).

In addition, the European prospective dividend yield of 4.2% remains some 50bp above long-term European investment-grade credit yields. All of this looks very supportive for European equities on a medium-term horizon.

European deflation fears exaggerated?

Central banks to stay behind the curve in order to balance fiscal tightening

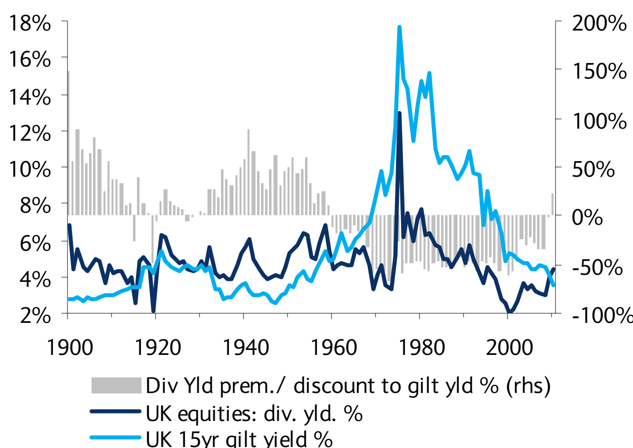
Although it seems clear that core inflation in Europe should remain modest in the near term, given the effect on growth of substantial government fiscal tightening programmes, we think that there are longer-term inflation risks brewing globally that could lead to even higher inflation volatility as central banks stay "behind the curve". Why does this matter for equities? Quite simply, we contend that the higher the inflation rate – and the more unpredictable it is from year to year – the more investors should look to real assets (e.g., equities, real estate, commodities or inflation-protected bonds), instead of nominal assets (classic government or corporate bonds) to hedge against inflation risk in the long term.

First, inflation in emerging markets is rising on commodity prices (including food) and wages (see, for example, the recent 20% hike in the minimum wage in China's Guangdong coastal region), suggesting that the longstanding deflationary trend in exported goods from China may be coming to an end. To wit, the euro-area goods CPI has already returned to its 10-year average of 1.9% y/y.

Second, recall that euro area inflation tends to be "sticky" because of labour-market rigidities. This is reflected in surprisingly high wage growth (Q4 09 annual hourly labour cost growth remained well above 2%, in sharp contrast to the slowdown to 0.3% in the US; Figure 5).

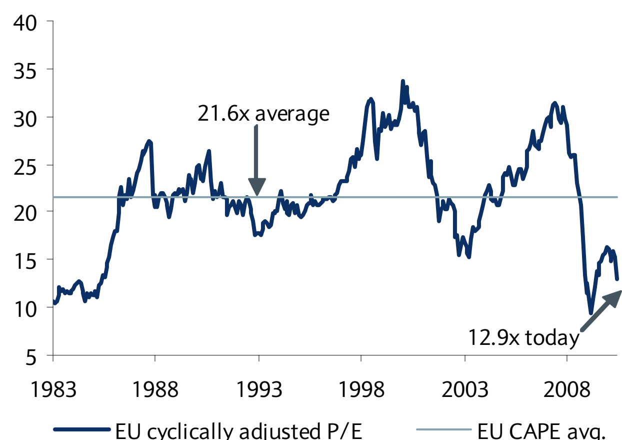
Add to this ongoing negative real interest rates in mature and emerging economies, structurally rising food and oil prices, the inflationary effect on imported goods in Europe of a weaker euro combined with higher wages in China, and rising consumer inflation expectations driven in Europe by a weaker euro and hikes in VAT (Figure 6). All these factors point to inflation potentially surprising to the upside in the long term and at the very least remaining volatile versus historical standards, rather than risking deflation. Global inflation volatility has in fact been on the rise since late 2006.

Figure 3: UK dividend yield at 50-year high versus gilt yield



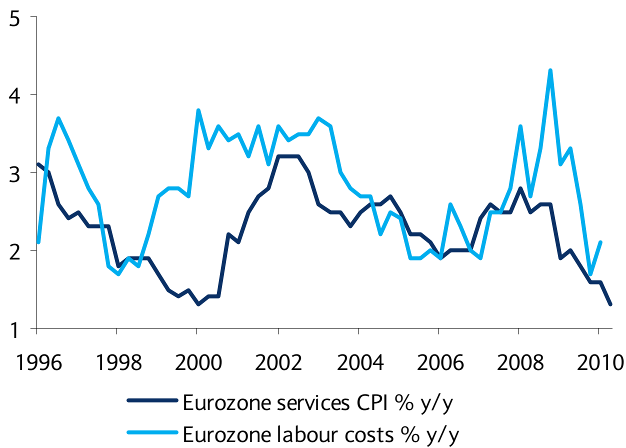
Source: Equity Gilt Study, Barclays Capital

Figure 4: Europe cyclically adjusted PE 40% below average



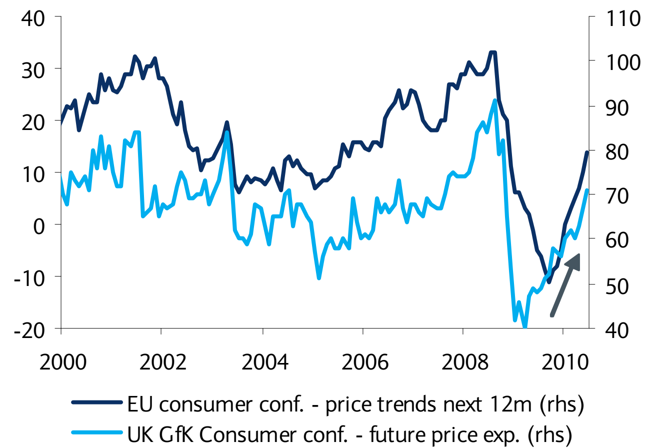
Source: Datastream, Barclays Capital

Figure 5: Euro area wage inflation actually picked up in Q1



Source: Bloomberg, Barclays Capital

Figure 6: Inflation expectations rising fast, even in Europe



Source: Bloomberg, Barclays Capital

The risk of ongoing high inflation volatility is significant, in our view, and favours investment in real, as opposed to nominal, assets. Based on our analysis, long-term investors would be well served by long-term inflation hedges, such as high dividend-paying equities where the dividend can be grown over time (see *Quality dividends: Back in vogue*, February 22, 2010).

Improving bond market the trigger for European equities?

Peripheral European bond auctions so far passing off without incident

There are some tentative signs in government bond markets that sovereign crisis fears are starting to ease: recent Spanish and Italian bond auctions have achieved high coverage ratios, highlighting demand for Southern European government paper at these higher spreads over bunds. This reflects receding sovereign risk fears, which could trigger easing of credit spreads and, thus, some relief for equities. This is particularly important for financial sectors in Europe (some 23% of the STOXX 600 by market capitalisation), given that financial sector corporate bonds represent over 50% of the Barclays Capital European investment-grade corporate bond universe and have proved very sensitive of late to underlying sovereign bond spreads.

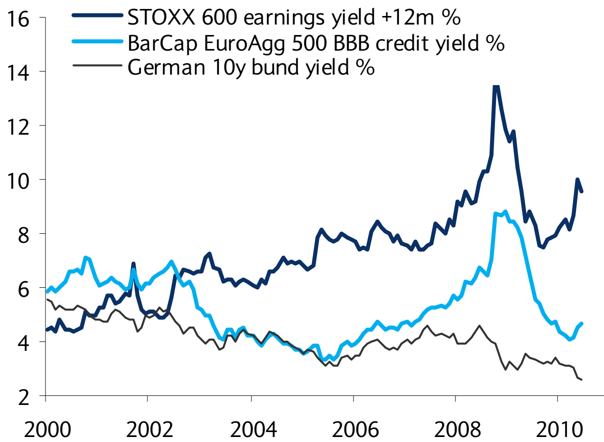
Dividend futures suggest substantial earnings cuts

European equities, dividends pricing in double-digit 2011 earnings drop

Is the market correct to price in substantial cuts to European earnings from 2011 onwards, as a 2011 P/E under 10x on current consensus forecasts would seem to imply? EuroSTOXX 50 dividend futures would be consistent with that view, given the 18% cumulative drop in dividends over two years implied by the 2012 dividend future (based mostly on 2011e earnings; Figure 8). However, this ignores a number of salient factors at the corporate and macro levels.

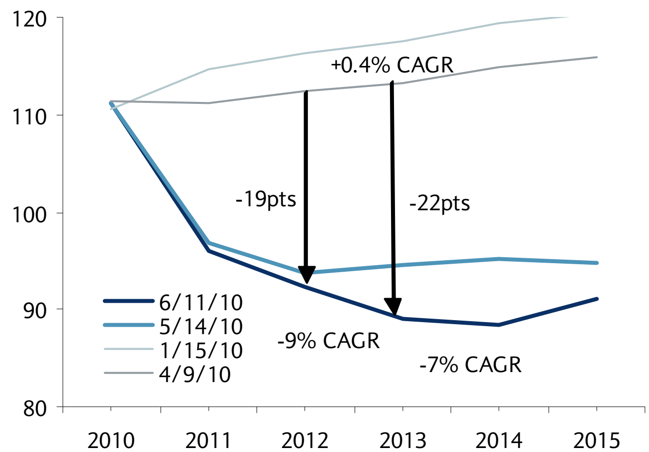
First, the strong sales and EPS momentum observed in Europe and the US in Q1 (average sales surprise of +1.3%; EPS surprise of +8.4% versus consensus) looks set to persist into the upcoming Q2 results season, not least because of the earnings-boosting effect of a 10% drop in the trade-weighted euro, together with solid nominal economic growth outside of Europe. Moreover, European corporates are posting strong free cash flows and many boast strong balance sheets.

Figure 7: Equity earnings yield not tracked by BBB credit



Source: Bloomberg, Barclays Capital

Figure 8: EuroSTOXX50 dividends imply 20% drop to 2013



Source: Bloomberg, Barclays Capital

Global Q2 economic momentum has in general remained buoyant

Second, if anything, economic activity, both real and nominal, has continued to surprise into Q2. China looks set to deliver real Q2 GDP growth in excess of 10%, on our estimates, and an inflation rate that has now started to exceed the central bank's 3% target. Similarly, in Brazil, Q2 momentum remains stronger than consensus expectations, with industrial production in April still 17% higher than a year ago, driven largely by rapid growth in capital goods. According to the Brazilian central bank, market expectations of inflation continue to rise, hitting 5.6% for the end of this year. And finally, even in the euro area, manufacturing momentum remains strong, boosted by capital goods exports from Germany and strong industrial production in Italy.

A good entry point into European equities

Risks to the downside clearly remain for the euro area and, thus, for the global economy. European nations' structural debt issues will not be resolved overnight, and governments will need to demonstrate over time that they can achieve their stated deficit-reduction targets. With certain investors (e.g., hedge funds) recently exhibiting signs of panic-selling of liquid assets, such as dividend futures, to reduce risk positions, we think these risks are more than priced in to European equities, given the historically low valuation levels at which European equities now trade.

This looks to us a good entry point for long-term equity investors who can stomach the high volatility regime that is likely to persist for some months. We maintain our EuroSTOXX 50 year-end target of 3100 (17% potential upside), based on a modest rerating from the sub-10x 2011e consensus P/E, combined with high single-digit 2011e EPS growth (far below the 20% bottom-up consensus forecast, but better than the implicit double-digit decline in 2011 EPS priced into European equity indices today).

We think that the combination of a modest euro area nominal GDP growth outlook, world ex-Europe nominal GDP growth of about 7% both this year and next, and continuing improvement in profit margins and free cash flow generation (the lasting benefit of deep reductions in cost structure in 2008-09), can deliver this modest expected growth rate, even before considering other potential positive factors, such as accelerated write-backs of banking sector provisions as underlying financial conditions improve.

US equities: Favorable risk reward despite headwinds

Valuations look reasonably attractive and we expect US data to improve

Equities have cheapened beyond what one would expect, given the level of real interest rates

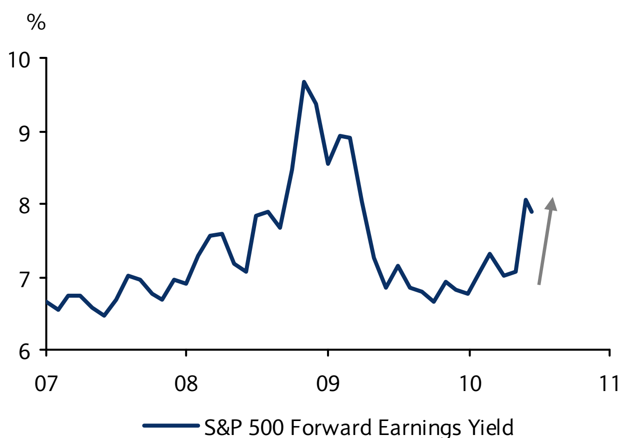
Despite the three major headwinds facing the US equity market (Asian and emerging market monetary policy tightening, European fiscal tightening and a slow patch in the US economic recovery), valuations look reasonably attractive and we expect US data to improve. A key element of our thesis for the 2010 US equity market outlook was a pronounced increase in the earnings yield (P/E multiple contraction) in the first half. There were several reasons for this view, including an inflection point in the business cycle (in recoveries, equities generally get ahead of earnings, then multiples contract as earnings catch up to prices), expectations for the components of the equity risk premium and the projected path for inflation. In many of our meetings following the Q1 10 company reporting season, we were asked about our year-end earnings and P/E multiple forecasts, which comprise our S&P 500 price target. It now appears that our 2010 earnings forecast was low (we raised it recently from $71 to $76) and our multiple forecast high (we lowered it recently from 17x to 16x). Although inflation and the earnings yield have followed our expected path, earnings are recovering faster and multiples have contracted further than we anticipated. The current earnings yield of 7% cannot be fully explained by either actual or market-implied inflation (there is a 3-4% gap between headline CPI inflation and the earnings yield). In other words, equities have cheapened beyond what one would expect (Figure 9), given the level of real interest rates (Figure 10).

Global growth concerns drove the Q2 10 US equities correction

We expect lingering market concerns about monetary policy tightening in the developing world

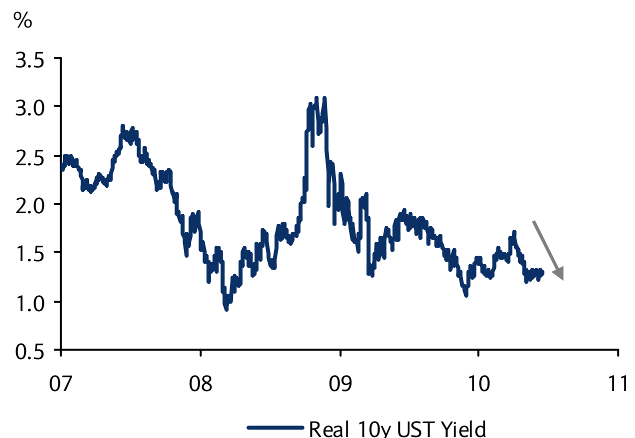
In our view, the cheapening of US equities has happened for three key reasons: 1) monetary policy tightening in the developing world; 2) European sovereign debt spread widening and banking system concerns; and 3) the outlook for US growth. The first reason is intuitive, given that the developing economies are the engine of global growth. Markets have been periodically concerned about Chinese policy tightening since it began last August, just as the US recovery was beginning. Prior to the Chinese New Year in February, another bout of fear cropped up when it became clear that external demand (exports) had reaccelerated, leaving the Chinese economy firing on all cylinders. When Brazil and India began tightening, market concerns only intensified, and we expect them to linger.

Figure 9: Equities have cheapened beyond what one would expect …



Source: Barclays Capital

Figure 10: … given the level of real interest rates



Source: Barclays Capital

As fiscal stimulus programs are crafted, reduced uncertainty will help restore investor confidence

As for the second reason, European sovereign debt spread-widening and banking concerns, the near-term economic effect is unlikely to be significant in terms of US exports to Europe or a business confidence shock. Still, the timing and nature of fiscal tightening has led to much uncertainty about the 2011 outlook. Additionally, the ECB's actions during the crisis were not as aggressive as those of the US and, as a consequence, the European banking system has not deleveraged as quickly as that of the US. We believe that as fiscal stimulus programs are crafted, reduced uncertainty will help restore investor confidence; however, this process is unlikely to be quick and will probably remain a risk for financial markets.

Labor and consumption data will drive market-implied growth, in our view

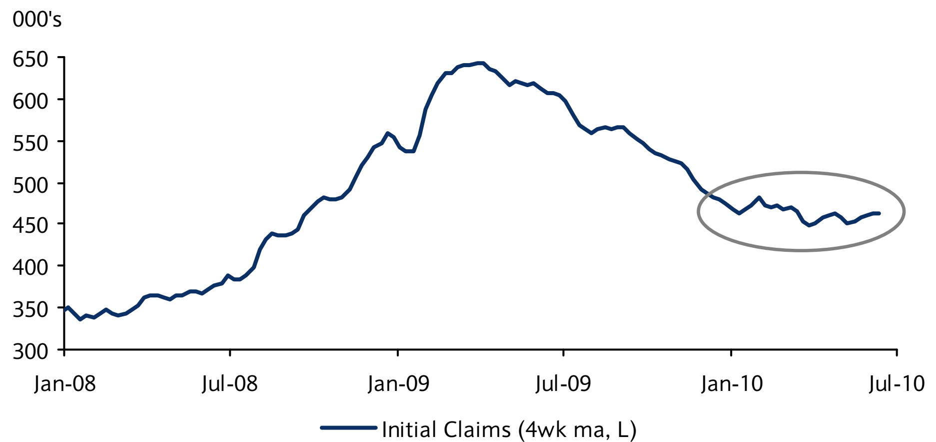
On the third reason, the outlook for US growth, there have been three significant corrections in US equities since March 2009 (June-July 2009, January-February 2010 and April-June 2010); in each case, the growth outlook has slipped toward 3%. Although we acknowledge that the recovery has been subpar relative to the magnitude of the contraction, we still expect growth to be well above potential in Q2 10 and H2 10. We never expected housing to be a driver of the recovery, and it has not been. Manufacturing has likely reached its point of maximum upside velocity, but remains strong (when the recovery broadens to the next stage of the expansion, it is important not to focus solely on second-derivative indicators, such as ISM manufacturing new orders). In our view, it is the labor and consumption data that will drive market-implied growth. Indeed, despite the soft private payroll report for May, labor income is growing at nearly twice the rate in Q2 10 as in Q1 10, implying sustainability and improvement. Still, until jobless claims resume their downward trend, the market may continue to struggle with a soft macro backdrop (Figure 11).

The near-term earnings outlook for the S&P 500 is favorable

Loss of momentum in analysts' earnings estimate revisions and sharp equity market rallies before the last three reporting periods may have contributed to the size of subsequent corrections

In addition to our expectation that market-implied growth will improve, we believe the near-term earnings outlook for the S&P 500 is favorable. Another element of our cautious view on H1 10 was analyst earnings estimate revisions. Net revisions increased at a fast pace from Q4 08 to Q2 09 before losing upside momentum in early 2010 (much like the ISM manufacturing new orders index does once a recovery is well under way). In our view, the loss of momentum in analyst earnings estimate revisions and the sharp equity market rallies in the 4-6 weeks before the last three reporting periods contributed to the magnitude of the subsequent corrections, despite earnings beating estimates soundly. This quarter, the risk/reward of being long equities heading into earnings season is more favorable, barring a

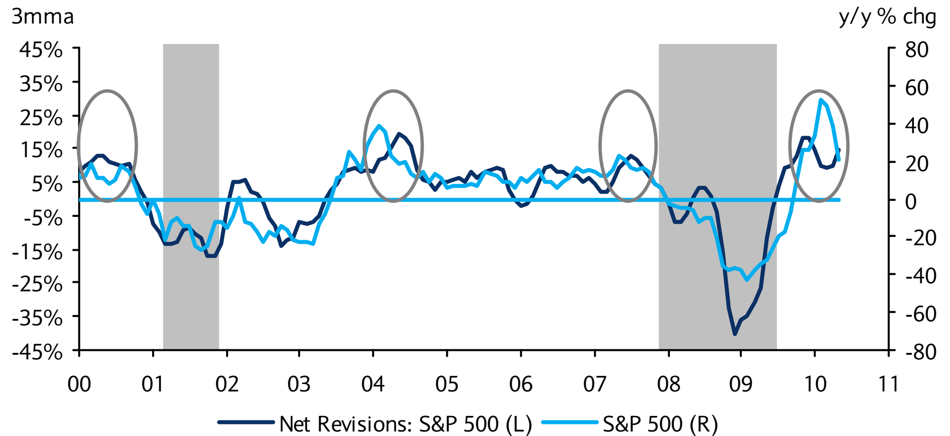
Figure 11: Until jobless claims resume their downtrend, the market may continue to struggle with a soft macro backdrop.



Source: DOL, Haver, Barclays Capital

sharp rally between now and mid-July, with net revisions moving back toward their highs and stocks closer to the bottom of their recent range (Figure 12).

Figure 12: With net revisions moving back toward their highs and stocks nearer the bottom of their recent range, the risk/reward of being long equities heading into earnings season is more favorable



Source: Barclays Capital

Policy normalization, optimistic earnings forecasts and fiscal tightening pose hurdles for US equities

As we look out into the H2 10 post-earnings season, we see several hurdles for equities beyond the lingering risks of European fiscal or developing economy monetary tightening. For a start, if our economists' forecast is correct, the Fed may become convinced that the recovery is sustainable and begin draining the $1.3trn of excess reserves in the banking system via large-scale reverse repos and the term deposit facility. Although we believe the Fed missed its window to start normalizing conventional policy in 2010, it should ultimately be successful at convincing markets that liquidity draining is a technical operation (implying that conventional rate hikes are not imminent). However, the liquidity draining process could potentially spark a correction in rates that would negatively affect equities (we put the probability of this at less than 10%).

The next issue is our 2011 S&P 500 earnings forecast of $80, which is far below fundamental analysts' consensus forecast. We derived our estimate using our economics team's above-consensus GDP forecast and what we consider to be reasonable assumptions for margins. Ultimately, this number does not make us decidedly bearish on equities, given current valuations; however, as we get closer to year-end, and if it becomes clear that 2011 forecasts are far too optimistic, equities will likely struggle.

Finally, there is the outlook for fiscal tightening. As it stands, the expiration of the Bush tax cuts will be equivalent to subtracting 200bp from GDP growth, on our estimates. Currently, politicians are not discussing the issue (the Administration and Treasury are exhorting Europe to slow the fiscal tightening process); however, we believe that as the November elections near, the issue will become unavoidable. Clearly, it is very difficult to forecast the outcome; but, generally speaking, we believe the removal of uncertainty is a positive in and of itself (although the mix of spending cuts and tax hikes and the nature of those tax hikes certainly matters for growth and equity market valuations). The conventional wisdom of the media, pollsters and Washington is that the Democratic majorities in the House and Senate are too

large to overcome, though we believe market participants think otherwise. At some point this autumn, we expect the market to come under pressure as this conventional wisdom moves to the investor class, as most seem to believe in smaller government and do not believe (rightly or wrongly) that the current mix will significantly shrink the historically high level of government spending relative to GDP (currently 26%, up from an average of 20% since 1960).

We are positive on US stocks at current levels

This has been a lengthy discussion about what could go wrong, and we want to make it clear that we are positive on US stocks at current levels. Indeed, equity valuations relative to investment-grade credit have improved to levels last reached in the late 1980s. Downside equity index option skew has richened to levels greater than any point during the Great Recession or the period preceding it. These two factors can be read as implying that the market is, in some ways, discounting greater risk than it was even during the worst of the crisis. While that is certainly not true across all asset classes, given that equities are the most growth-sensitive asset class, it appears to us that the equity market is assigning far too high a probability on double-dip scenarios. As a result, we recommend continuing to accumulate equities on corrections related to any of the reasons we cited (and for some we haven't); barring a resumption of the credit crisis, we think that equities should perform well for alert and flexible investors.

Sector strategy: Hard hats or party hats?

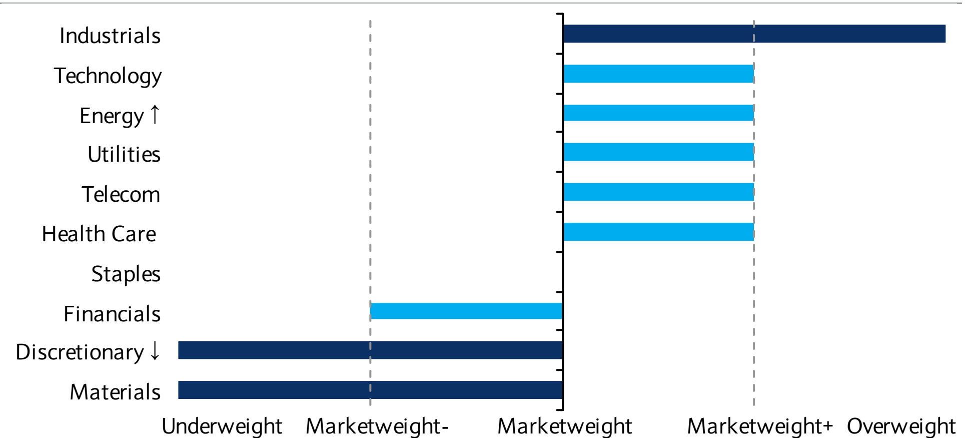
How might the macro forces we have identified shape prospective equity sector returns? As previously mentioned, large economies have large fiscal problems, which is a key reason for our belief that the developed world is likely to keep rates low for longer. As such, we remain optimistic about the cyclical growth impulse and, in the near to intermediate term, we think it makes sense to favor segments with a strong demand base across the major economies, such as *Industrials*, *Technology* and *Energy* (upgrading from Marketweight to Marketweight Plus). One exception in the developed world is *Financials*, which we expect to remain constrained by reform, higher capital and liquidity requirements, rising funding costs and deleveraging in the public and private sectors.

By contrast, smaller economies generally do not have big problems; the developing world has already begun to raise rates to slow growth, curb credit creation and take the bite out of inflation. We see these as good reasons to avoid segments like *Materials* which are geared to emerging markets and demand from the developing world. Put another way, Chinese equities (proxies for the demand outlook in the developing world) are still very weak, but Korea's stock market (a proxy for the global growth outlook) is very strong, suggesting the developed demand base for energy remains intact while the developing demand base for raw materials is under siege. For example, the controlled RMB revaluation may be viewed as a *de facto* tightening of policy in China.

One of our more structural themes is the ongoing shift in the mix of aggregate economic demand from consumers to businesses. Specifically, business-facing companies such as *Industrials* and *Technology* typically outperform consumer-facing ones, including *Discretionary*, when private nonresidential fixed investment improves relative to personal consumption. Given the transition from the early to later stage of the cycle, the broadening and durable manufacturing recovery and the shift from personal consumption to business investment, we're inclined to maintain our positive bias toward *Industrials* and *Tech* and our negative stance on *Discretionary* (downgrading from Marketweight Minus to Underweight).

While we have set our sights on a breakthrough, in the event of a breakdown, we think it is wise to consider segments offering downside protection and some income. Thus, we would look at cheap to fair defensives such as *Utilities*, *Telecom* and *Health Care*, which we expect to continue outperforming if the overall market tone remains weak.

Figure 13: On a *breakthrough*, we would favor Industrials, Technology and Energy; on a *breakdown* we would consider Utilities, Telecom and Health Care



Note: ↑/↓ = increases/decreases on 6/24/10 to ratings in place since 3/18/10 or earlier. Source: Barclays Capital

Japanese equities: Earnings should continue to support stock prices

Earnings driven by external demand likely to support Japanese stock prices

Growth in external demand and declines in forecast P/E are likely to support stock prices

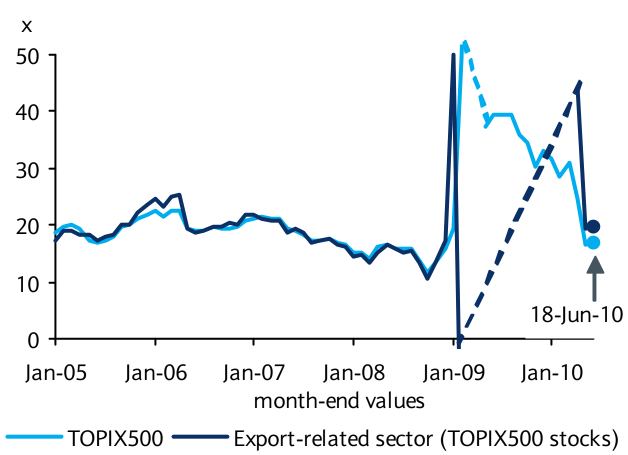
There are numerous external uncertainties, including global credit instability triggered by fiscal solvency problems in southern Europe and volatile exchange rates in conjunction with an appreciating yen. Furthermore, companies are issuing earnings guidance that is generally more conservative than analysts' estimates, which will also likely weigh on share prices in the near term.

However, this does not mean expectations of earnings recovery are necessarily receding. If the effect associated with the external causes of concern subsides, conditions should again foster expectations for sustained earnings recovery and a revaluation of Japanese share prices from levels that appear undervalued from a valuation metrics perspective. Forecast P/Es for Japanese stocks have sharply declined on a combination of more moderate profit-growth expectations and recent market declines, and this should offer share price support.

We expect upward revisions of earnings guidance, mainly in export-related and economically sensitive sectors, to come around autumn, with increased clarity for first-half results. Growth in external demand not only from China but also from other emerging countries in Asia and developed nations is likely to boost sales of export-related companies. We foresee the Nikkei 225 advancing toward 12,500, primarily on external-demand stocks after autumn.

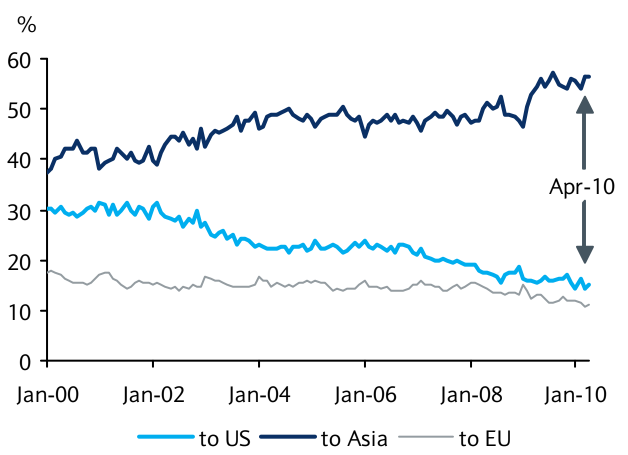
Foreign investors have accounted for roughly 60% of Japanese equity transaction value over the past 1-2 years. We expect an increase in their net buying as earnings momentum of exporter stocks picks up later this year. In terms of domestic demand, factors such as sluggish consumption and protracted deflationary conditions are clouding the visibility of the growth prospects. Thus, we expect another clear decoupling in the share prices of external demand companies and domestic demand-driven companies.

Figure 14: Forecast P/E for TOPIX500 and export-related sector



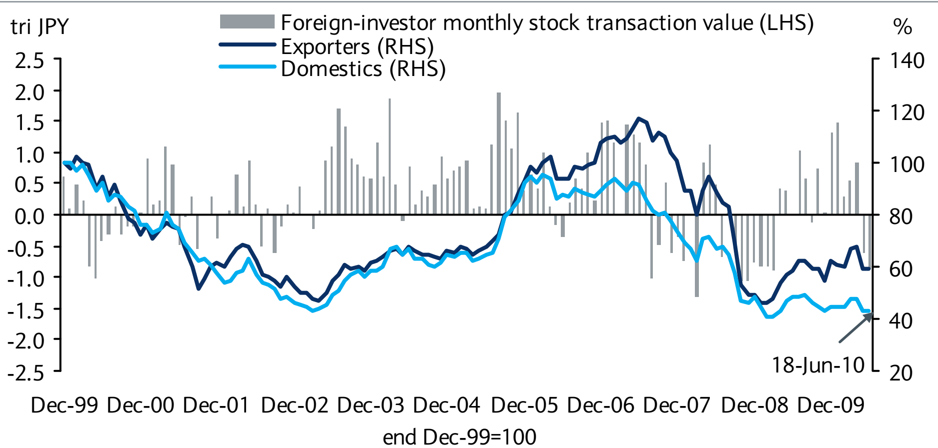
Source: I/B/E/S, Factset, Barclays Capital

Figure 15: Transition of country and regional ratio in exports of Japan



Source: MOF, Barclays Capital

Figure 16: Share-price performance of exporter stocks and domestic stocks and foreign-investor stock transaction value



Source: TSE, Factset, Barclays Capital

Strong expectations for sustainability of earnings recovery for export-related and economically sensitive sectors

Expectations of a shift from cost reduction to sales growth and profit-margin improvement, and a significant rise in FCF, are positive factors

Earnings growth expectations for export-related sector stocks and economically sensitive sector stocks remain strong. The earnings forecast revision DI based on consensus estimates shows substantial earnings growth expectations for both sectors. In addition, expectations of sales growth have strengthened over the past few months. In our view, a positive cycle may be taking hold in which companies could transition from cost reduction to sales growth expectations as the primary earnings driver.

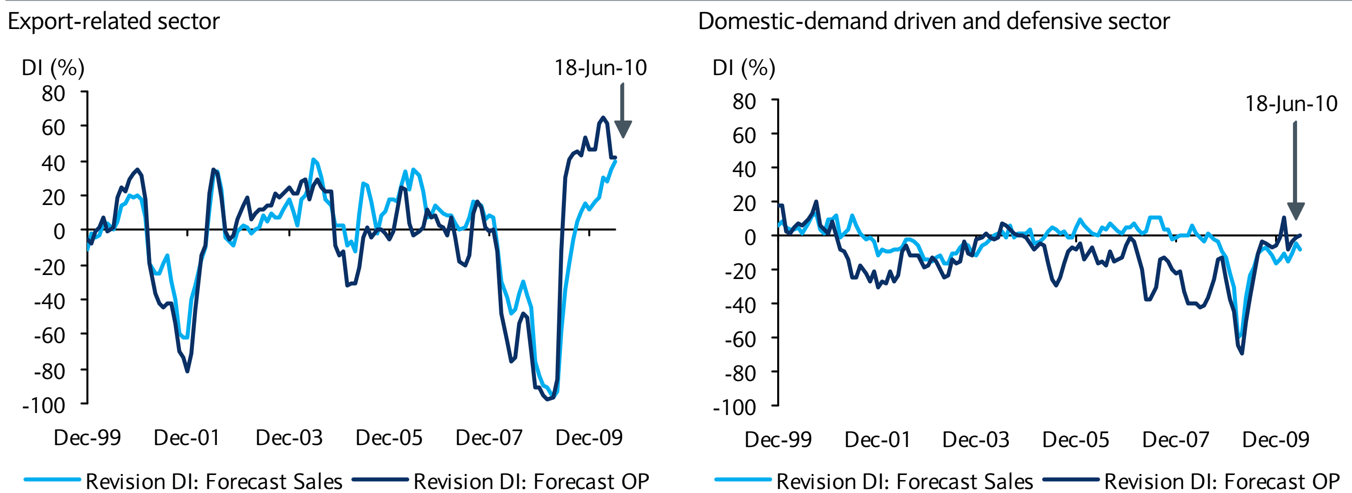
The export-related sector is trading on its near-lowest P/B ratio since 2000. But analysts have very high profit-margin improvement expectations that imply strong ROE gains, which should provide support for P/B. Free cash flow (FCF) started recovering just before earnings bottomed and continued to show strong gains thereafter at export-related companies. The momentum of earnings recovery has also become very strong. We think that a wider emphasis on cash flow at exporter companies will support the sustainability of the earnings recovery as a global demand picks up.

We expect longer-term earnings growth at capital goods companies in the machinery and electric appliances sectors

Labour-saving investment in China makes capital goods exporter stocks look attractive

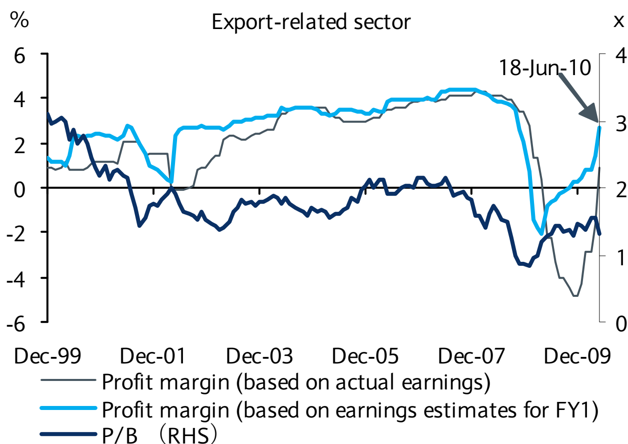
The Chinese government's "income-doubling plan" should stimulate greater demand for labour-saving investments aimed at curbing labour costs (Figure 19, not only in terms of factory automation but across various industries, including agriculture and construction. We expect the effect of these moves also to spill over to Vietnam, India and other emerging nations in Asia in the long run. Furthermore, if China aims to sustain high growth levels, we believe it will also face the possibility of worsening labour shortages. Numerous Japanese capital goods companies in the machinery and electric appliance sectors should stand to benefit from greater labour-saving investment demand in China (Figure 20).

Figure 17: Earnings forecast revision DI for sector stocks (TOPIX500 stocks)



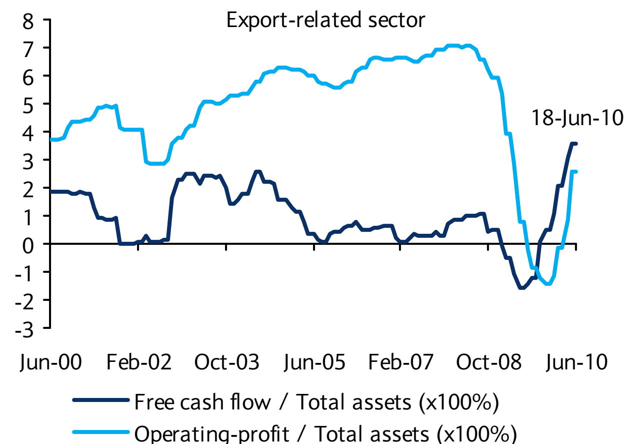
Source: I/B/E/S, Factset, Barclays Capita

Figure 18: Trends in P/B and profit margin Export-related sector (TOPIX500 stocks)



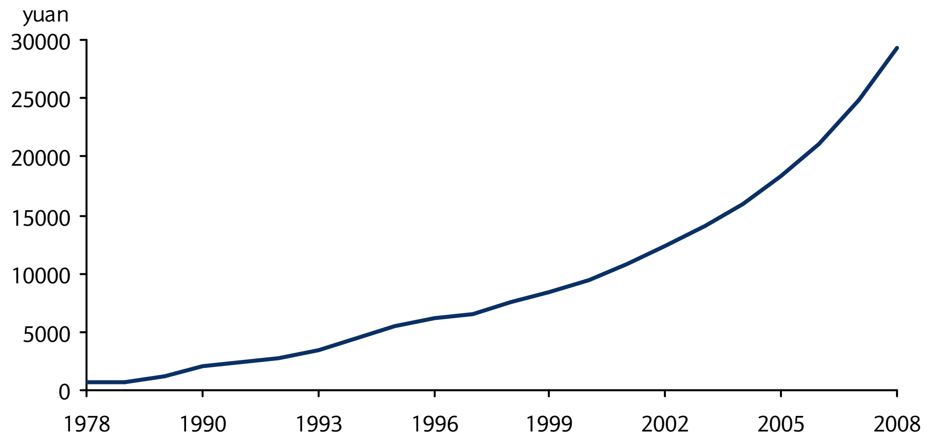
Source: I/B/E/S, Factset, Barclays Capital

Figure 19: Free cash flow and operating profit trends Export-related sector (TOPIX500 stocks)



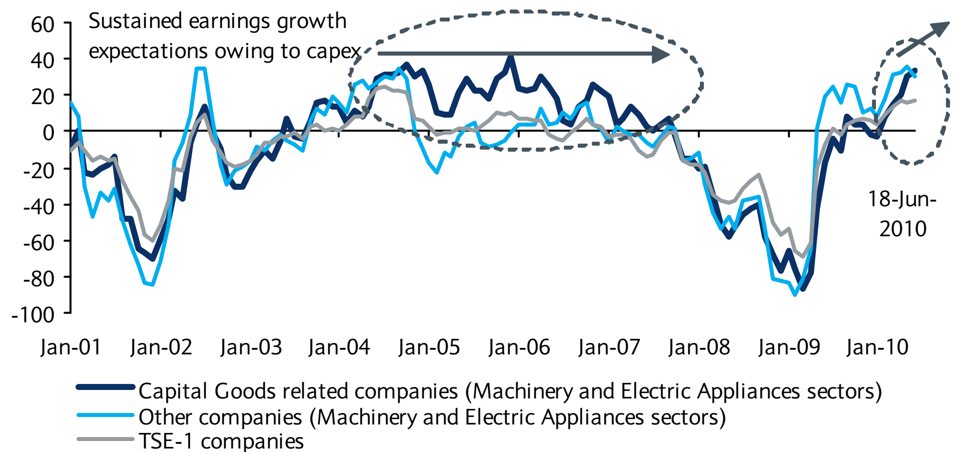
Source: I/B/E/S, Factset, Barclays Capital

Figure 20: Average yearly wage of staff and workers in China



Source: National Bureau of Statistics of China, Barclays Capital

Figure 21: Earnings forecast revision DI for capital goods-related companies



Source: I/B/E/S, Toyo Keizai, Factset, Barclays Capital

The recent improvement in corporate earnings is also having an increasingly positive effect on capex trends. In the context of the machinery and electric appliance sectors, analysts' expectations of earnings improvement at capital goods companies have been rising rapidly of late. The addition of this special demand could create a longer-term investment theme.

EMERGING MARKETS OUTLOOK

In the shadow of fear

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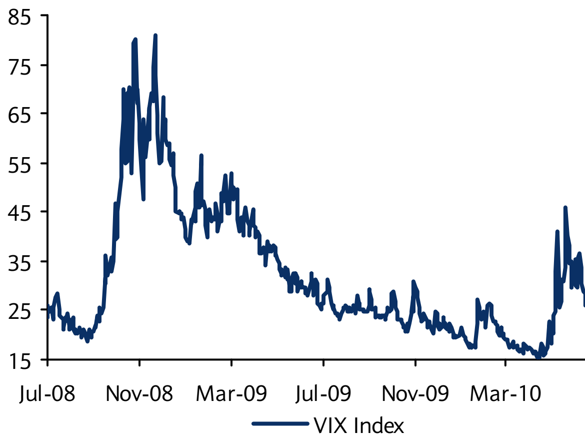
- **Our economic forecasts for 2010 and 2011 are even more market supportive than previously, with a moderately stronger cyclical recovery and interest rates lower for longer in most of the world. However, the former is now largely anticipated by investors, who are increasingly focusing on longer-term risks and challenges that will confront world financial markets in the years to come. We think this is appropriate and consistent with our gradually fading emphasis on the cyclical recovery as a market driver in recent quarters.**
- **The increasing salience of medium-term developments poses two challenges for emerging-market investors. The first is to manage the tension between the immediate future, when economic developments seem likely to remain market supportive, and the more uncertain and riskier medium-term outlook for global financial markets. The second is to manage the tension between a generally positive fundamental outlook for emerging markets and the more challenging outlook for most industrial economies, the fear of which is spreading to emerging markets – unjustifiably, in our view.**
- **Tactically, we remain bullish on emerging asset markets. But if the rally materializes as we expect, we would be inclined to pare back risk on the view that longer-term challenges will continue to justify caution in risk asset markets.**

What we thought

More peril than climb in Q2…

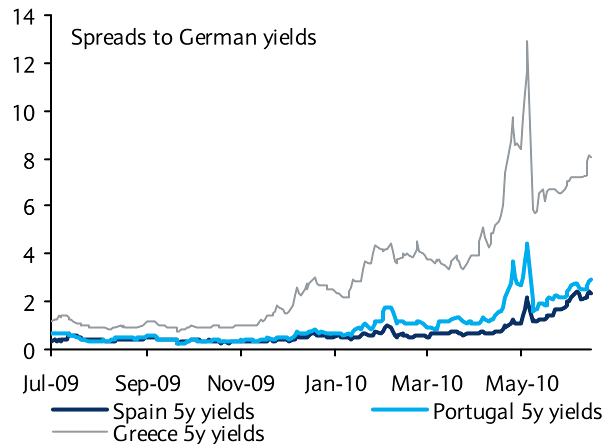
In our previous quarterly, we called for 'a perilous climb' in emerging markets, acknowledging the salience of the global risks that were then affecting investor sentiment, but arguing that these were either exaggerated (especially regarding China and the US economic recovery) or likely to unfold in a timeframe slow enough so that they would not be dominant drivers of Q2 market developments. In particular, we thought that concerns about Greece would at least temporarily fade on the EU backstop that, at that point, seemed to us almost guaranteed and that markets would continue to be supported (though not blindsided) by the ongoing economic recovery.

Figure 1: A more volatile quarter



Source: Bloomberg

Figure 2: Southern Europe remained in the cross-hairs (pp)



Source: Bloomberg, Barclays Capital

What happened

… despite generally upbeat news on the global economy

Well, we got the peril, but we did not get much in the way of a climb. The spike in volatility and market sell-off occurred despite news about the world economy that was predominantly upbeat, leading to at least modest upgrades in consensus (and BarCap) forecasts of 2010 and 2011 growth in the US, Japan, China, emerging Asia, EMEA, and Latin America, with Europe the only exception. While we think that tail risks to the world recovery remain a concern for many investors, they have found little support in Q2 data or in consensus forecasts for the coming 12-18 months.

Southern European debt problems were in the spotlight…

The most important disturbance of the international financial peace came from the drama surrounding the public finances in southern Europe. Contrary to our expectation that an EU bailout of the Greek government would put the issue on the back burner for a couple of months, markets have remained anxious. The issue remained alive due in part to a messy policy process that did little to reassure investors about the authorities' capacity to mount effective and well-coordinated policy initiatives. Scepticism and anxiety about highly indebted sovereigns have not only intensified, but also broadened well beyond Greece in recent months. Deterioration in sentiment toward Spain has been most significant and would seem to pose the greatest immediate market risk, but it is no secret that the fiscal imbalances facing many large industrial economies are comparable in magnitude to those facing much of Southern Europe.

… along with new concerns about the state of the world's banks

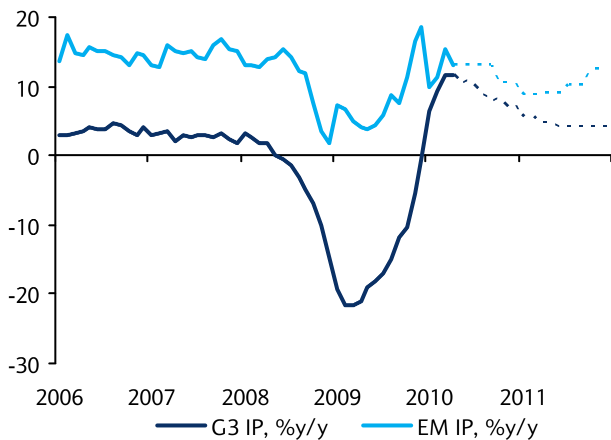
Finally, banks have emerged as a new risk for investors. Concerns about the global banking system were triggered by an abrupt rise in USD Libor, which created fears of a funding crunch analogous to the dollar squeeze that followed the Lehman failure. While those fears have so far proven overdone, investors remain anxious about legacy costs from the previous economic crisis, especially in Spain, where the real estate crash is still playing out; new and potentially devastating costs that could be created by a sovereign debt event; and the implications for banks of new regulatory frameworks that are being put in place in much of the world.

What we learned

Market developments highlight a heightened sensitivity to tail risks, arguably a legacy of the last financial crisis

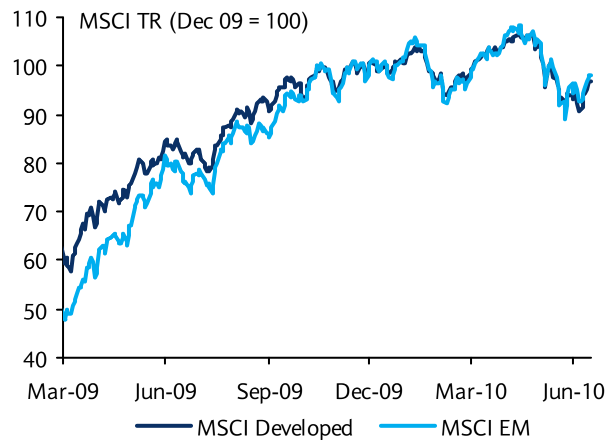
While news flow on key market drivers was generally in line with our expectations going into the quarter, the market traded much more anxiously than we had anticipated. Sometimes that just happens, but in this case we think there is a lesson to be learned. With the benefit of hindsight, it seems that we underestimated the market's sensitivity to

Figure 3: A generally brighter outlook for growth…



Note: EM refers to Brazil, China, India, Indonesia and China.
Source: Datastream, Barclays Capital

Figure 4: …not reflected in Q2 asset prices



Source: Bloomberg, Barclays Capital

perceived risks of low-probability, potentially very disruptive events – even if they are not likely to materialize for some time. This heightened sensitivity to tail risks is probably a legacy of the previous crisis, in which so many nearly unthinkable events actually materialized with such disruptive consequences, and it will in all likelihood be with us for some time. We have calibrated our assessment of market sensitivities to the various tail risks that face the world economy accordingly.

While we are still optimistic about the ongoing cyclical recovery, it is largely priced in, and we share many market concerns about the longer term

At the same time, the sheer passage of time is causing us to shift our focus from the cyclical economic recovery that was previously such a potent driver of markets toward the medium term, post-rebound outlook, which raises questions about the 'new normal' that is more structural than cyclical. While we have been consistently optimistic in our assessment of the cyclical rebound, we take seriously the challenges and risks that confront the world economy over the coming years. We think this shift of focus poses two key tensions for emerging market investors. The first is between a relatively positive outlook for the world economy in the near term, while cyclical considerations remain important, and a new normal that looks meaningfully less reassuring. The second is between a medium-term outlook that looks generally quite positive for most emerging market economies and the considerably less comfortable outlook for the industrial economies that are such potent drivers of world markets.

The cyclical backdrop remains market supportive

The cyclical recovery, while not the market driver it has been, still provides a positive backdrop

Our shift in emphasis does not reflect a change in outlook for the immediate future, during which the global economic backdrop is likely to remain market supportive. We now forecast global economic growth of 4.7% in 2010 and 4.3% in 2011. Restrained inflationary pressure and concerns about the potential effect of an event in Europe have induced policymakers around the world to postpone monetary normalization. In the US, we have dropped our view that the Fed will hike this fall and are now expecting it to remain on hold until April of next year. This is, of course, reflected in our interest rate forecasts, which now see the US 10y bond at 3.85% by year-end, compared with a forecast of 4.3% three months ago. The bad news is that nervous markets may require a supportive economic and financial context to counter anxieties about the medium term; the good news is that they are likely to get it.

Figure 5: 2010 growth forecasts generally stronger…

		Q1 10 forecasts		Q2 10 forecasts	
		2010F	2011F	2010F	2011F
US	Consensus	3.1	3.0	3.3	3.1
	BarCap	3.6	3.2	3.6	3.5
Other developed	Consensus	1.4	1.8	1.6	1.7
	BarCap	1.4	2.0	1.7	1.8
China	Consensus	9.9	9.1	10.2	9.0
	BarCap	9.6	9.0	10.1	9.0
EM Asia (ex-China)	Consensus	6.4	6.1	7.0	6.4
	BarCap	6.8	6.3	7.5	6.2
EMEA	Consensus	3.4	4.1	4.3	4.1
	BarCap	4.1	3.8	4.2	4.3
LatAm	Consensus	4.0	3.8	4.9	3.9
	BarCap	4.8	3.9	5.3	4.1

Source: Consensus Forecast, Bluechip, Reuters, BCB

Figure 6: …but monetary tightening is being delayed

2009-Q2 10	2010		2011
	Q3	Q4	Q1
Brazil	Korea	China	Colombia
Chile	Thailand	Indonesia	Czech
India		Philippines	Mexico
Israel		Sri Lanka	Poland
Malaysia		Turkey	Q2
Peru			Euro area
Taiwan			Egypt
Vietnam			Hong Kong
Australia			US
New Zealand			Q3
			South Africa

Source: Barclays Capital

Faster-than-expected growth in emerging economies…

Emerging markets are, of course, very much a part of this positive backdrop (Figure 5). Since our previous quarterly publication, we have increased our forecast of 2010 growth in China (by 0.5%), other EM Asia (by 0.7%), EMEA (by 0.1%) and Latin America (by 0.5%). For 2011, our forecast revisions have been small except in EMEA, where we have increased our growth forecast by 0.5%, to 4.3%, and our current forecasts are close to consensus in every time zone.

… is not leading to tighter monetary policy

The stronger-than-expected cyclical recovery is generally not leading to more rapid monetary tightening than previously expected (Figure 6). Echoing a theme from the industrial economies, and with some notable exceptions such as Brazil and, to a lesser extent, Chile, we have generally been postponing the initiation and scaling back the magnitude of the coming monetary normalization. This is motivated in part by precautionary considerations in the world's central banks, which see risks to world growth from fiscal imbalances in southern Europe and in the industrial economies more generally. But it also reflects a generally benign outlook for inflation; some fading of cyclical drivers that is reducing the risk of overheating, even as output gaps close; and, in Asia, a substantial reduction in the contribution of fiscal policy toward demand growth, as temporary stimulus measures fade in significance.

Market outlook – Two tensions

Tension between a positive present context and a riskier future

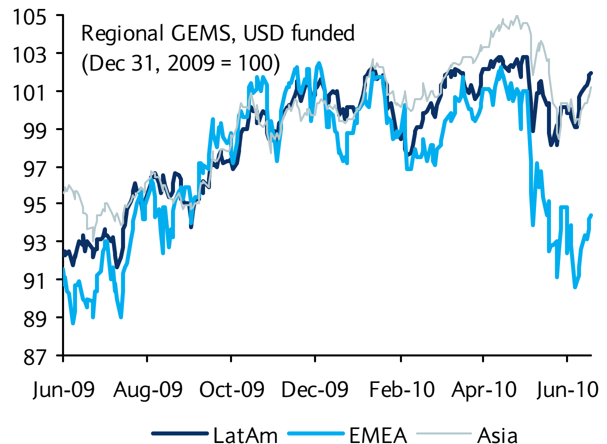
As we enter the second half of the year, it seems to us that emerging market investors face two key tensions. The first is the very sharp contrast between a very supportive present market context and a riskier medium-term outlook. For now, and in our base case for some time to come, emerging market investors are confronted with a robust economic recovery and rock-bottom policy rates that provide punishingly low returns for investors who remain out of risk assets. At the moment, valuations are generally more appealing than at year-end, and considerably more attractive than three months ago, while the recent outbreak of volatility seems to have improved positioning in most markets. Risks to this context are low probability (though potentially quite disruptive) events and/or in the relatively distant future. Yet investors have shown a strong disinclination to disregard them.

We think that we will be living in this world for quite a while. The tail risks that concern investors are not going to vanish any time soon, but while anxieties are likely to remain, investors cannot hide in low-risk, even lower-return assets indefinitely. We think this sets up

Figure 7: Emerging market equities have not dramatically underperformed as in 2008-09

Source: Bloomberg, Barclays Capital

Figure 8: EM FX – Moderate declines in Asia and Latin America, underperformance in EMEA



Source: Barclays Capital

a context similar to the one in which we have been living: volatile asset markets constrained (by present realities and the high cost of safety) in their abilities to sustain sell-offs and (by fears about the future) in their abilities to stage a lasting bull market.

EM outperformance, not de-coupling

The second tension is between a medium term that looks cloudy for industrial countries, but much more positive for most EM economies. The case for emerging market economic outperformance seems to become more compelling by the week, as the depth of the industrial economies' fiscal and financial challenges becomes more apparent. This would pose no conundrum if markets were not so tightly linked, but as we have seen, anxiety about core markets continues to be reflected in EM asset performance, and we do not expect this 'coupling' to change any time soon. So the question arises, how to retain exposure to EM asset classes without sustaining serious losses when anxieties surface about the industrial economies, as we suspect they will periodically in the quarters to come.

One answer is to find low beta, including relative value investment themes that insulate positions from broad market developments; we present some of our ideas along these lines in *The Emerging Markets Quarterly*. But intra-EM relative value can provide only limited exposure to broad EM themes. Beyond that, we think the coming quarters will reward a range-trading approach, being willing to fade fears that exaggerate immediate market risks, as well as market rallies that seem difficult to sustain in light of the genuine tail risks that face the markets and the world economy.

Tactically bullish

We are now generally bullish EM asset markets, as we wait for the near-term market recovery that our global strategy team expects and for a further unwinding of the (generally mild) EM asset underperformance that was associated with the recent market downdraft. This is a tactical position, though; we stand ready to adopt a more cautious stance in the event that the rebound is associated with a substantial dissipation of market anxieties because we doubt that concerns will be gone for long.

EM sovereign credit

EM sovereign debt followed global markets down in Q2

With a few exceptions, EM sovereigns behaved more or less in line with global markets, underperforming industrial-country credit markets in the downdraft and staging a moderate recovery as global markets found their footing. Unsurprisingly, the high-beta credits Argentina and Venezuela were among the worst performers. Hungary's dramatic underperformance reflected anxiety associated with the incoming government's fiscal intentions and the fact that most of the Hungarian debt in the benchmark is euro-denominated.

We expect roughly flat returns on the debt market portfolio in Q3

For Q3, we expect a continued recovery in risk appetite to support emerging debt markets in the near term, with valuations somewhat undermined by an expected back-up in the US yield curve that is more modest than we previously forecast, but still enough to create a mild market headwind; we expect the US 10y yield to rise to 3.70% by the end of the quarter. We look for spread compression to offset this in part, resulting in roughly flat returns for the benchmark portfolio, with higher-beta credits outperforming higher-quality names.

Tactically comfortable with higher-beta credits

On that basis, we remain moderately overweight high-beta credits where we also consider local fundamentals supportive, including Argentina, Ukraine, and Russia. Despite their strong underperformance in Q2, we share investor concerns about Hungary and Venezuela. In Hungary, we are underweight; short-dated CDS offer value, but in bonds we think it is too early to take a strong view that the incoming government will convince investors that it intends to stay the course of fiscal adjustment. In Venezuela, we are recommending a marketweight allocation; while we remain of the opinion that the country retains its ability and willingness to pay, and acknowledge the potential for some market rebound from quite

depressed levels in the coming weeks, the country's economic policies are deeply incoherent and in some ways pose headline and market-technical risks for investors in the medium term.

Away from these higher-beta credits, we recommend:

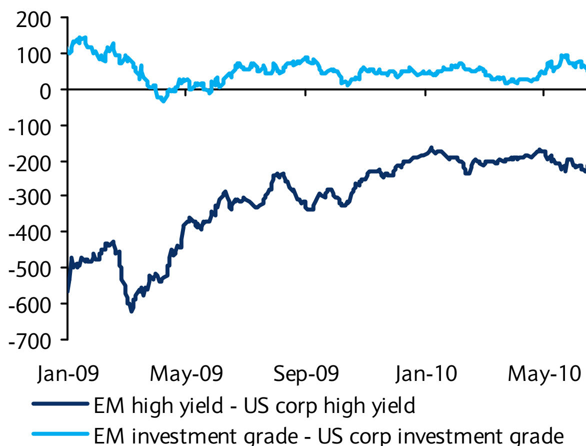
- A modest overweight position in Indonesia, at the expense of Philippines. Philippine outperformance in Q2 highlights the credit's relatively defensive positioning, but in the reasonably supportive market environment that we expect in Q3, we think investors should focus on Indonesia's strong growth prospects and credit profile.
- Overweight Turkey, at the expense of South Africa, on grounds of valuations and Turkey's more rapid economic and fiscal recovery.
- Underweight the higher-quality Latin credits: Brazil, Mexico, Panama and Peru. These have performed well in the defensive environment year to date, but look expensive now. With election risks behind Colombia and a stronger economic recovery ahead, we feel more comfortable with it and are recommending a neutral position.

EM FX

A difficult quarter for EM FX…

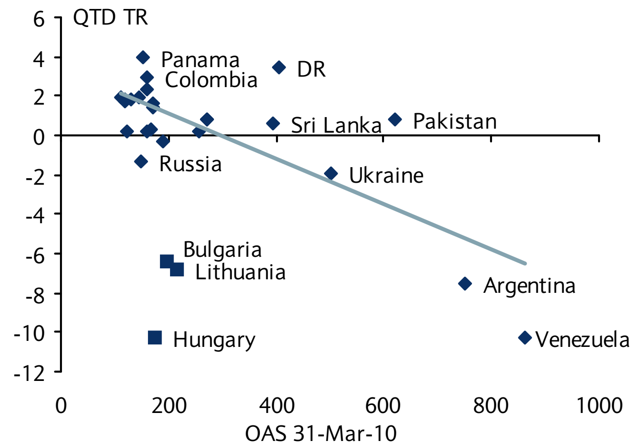
The second-quarter euro and market downdraft were, of course, unfriendly for EM FX. Currencies generally weakened against the dollar, despite some rebound late in the quarter as market anxieties waned. Against 'logical' financing baskets (we advocated financing against a basket that minimizes ex-ante volatility of the EM FX position, see *EM Weekly 'Return of Risk', 22 January 2010*), performance was less negative, reflecting the fact that those baskets generally include at least some EUR financing (Figure 11). By this metric, the BRL was the quarter's star performer; the minimum-variance financing basket is almost entirely EUR, but in Q2 the currency traded like part of the dollar bloc. Those close to the euro area generally underperformed, with the HUF also undermined by policy statements that sapped confidence in the new government. In Asia, the KRW underperformed, reflecting its relatively high beta to global risk appetite and some idiosyncratic developments including renewed tension with North Korea and a revision of financial market regulations that put some pressure on the currency market.

Figure 9: Modest underperformance of EM sovereign credit (bp)



Source: Barclays Capital

Figure 10: Credit performance largely in line with historical market sensitivities



Note: Bulgaria, Hungary and Lithuania are not included in computation of the trend line. Source: Barclays Capital

… but Q3 looks more positive

We expect far less intense headwinds from global markets in Q3. In some key areas (notably with respect to Spain), market sentiment towards Southern Europe has overshot our assessment of the genuine risk. Partly because of this, we think that the EUR has found stability around current levels; risks remain, of course, but we do not expect a continuation of the EUR downdraft. Also, the recently announced revision of the FX regime in China has drawn investors' attention to the fact that risk-supportive surprises are possible, not just negative ones. After the recent outbreak of volatility, we believe that positioning is relatively supportive.

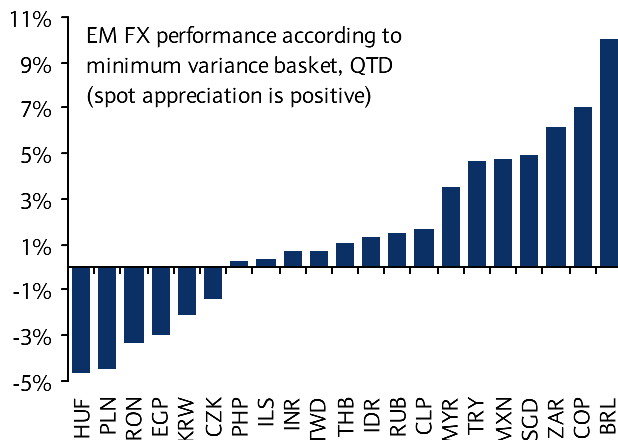
We think this sets the stage for a market in which global risks recede and positive emerging market fundamentals advance as drivers of EM FX. We think that the themes we have been highlighting since the beginning of the year will return to relevance, with some modulation, as drivers in Q3 10. We highlight the following themes from our regional strategy teams, discussed in more detail in the regional market outlooks that follow.

Stage is set for renewed currency appreciation in Asia

In Asia, we think the stage is set for renewed currency appreciation, given the strong cyclical recovery and the associated prospect of monetary normalization well in advance of the industrial economies, strong external payments positions, reasonable currency valuations (with some qualifications), and support from the recent relaxation of the *de facto* CNY peg to the dollar.

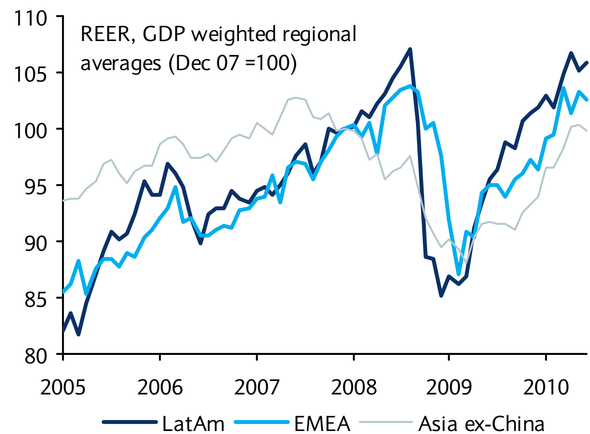
The MYR, TWD, KRW, and PHP sit near the top of our EM FX scorecard, supported by advanced economic recoveries, strong valuation metrics (according to our metric in Figure 13, the KRW is the most undervalued currency in our universe, though the PHP is on the expensive side), and strong external positions (with the KRW relatively weaker here). We recommend long positions in these, with some qualifications to the KRW due to the short-term effect of bank regulatory measures that may continue to put pressure on the currency market in the near term. We are less enthusiastic about the INR, as the EUR depreciation has led to a strong appreciation of the real exchange rate that creates the likelihood of a policy response to substantial additional appreciation.

Figure 11: EM FX generally stronger against variance-minimizing financing baskets



Source: Bloomberg, Barclays Capital

Figure 12: Real exchange rates approaching pre-crisis highs



Source: BIS, Barclays Capital

In Latin America, we would still sell BRLMXN

In LatAm, we remain of the view that the BRL is to some extent defying gravity and that the MXN will outperform, with the key question mark being timing and the catalyst. By our metrics, the BRL is the most expensive exchange rate in our universe, while the MXN is cheaper than any other than the KRW and TWD. In fact, on a trade-weighted basis, the Brazilian real is now meaningfully stronger than at its mid-2008 peak. BRL/MXN has been nearly unchanged for five months, during which Europe and the euro (to which Brazil is substantially more tied than is Mexico) have dramatically underperformed the US (Figure 14). While a stronger CNY is not particularly negative for Brazil, it benefits the MXN directly by offering some relief in trade competition in the US market. A key difference, of course, is monetary policy, carry, and the cyclical context, where Banxico's blasé response to the long period of above-target inflation contrasts sharply with Bacen's more decisive defence of the inflation target. Currency markets may need Mexican monetary normalization as a catalyst to unlock the value in the MXN. We see this as a risk to the trade, but still favour being long the MXN versus the BRL.

Elsewhere in Latin America, the CLP stands out for its reasonable valuation and a positive outlook, supported by the monetary tightening associated with the country's rapid recovery from the earthquake.

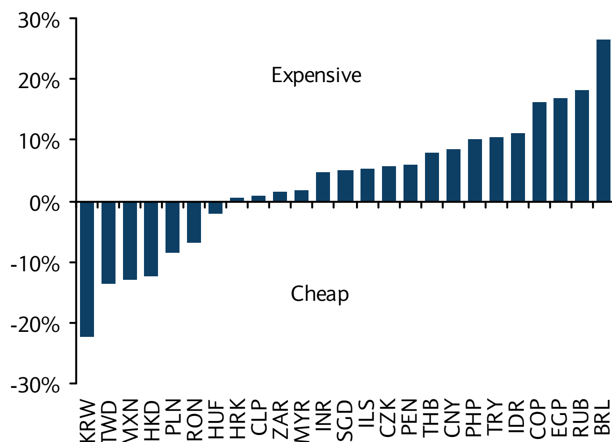
More circumspect in EMEA

In EMEA, we are more circumspect, in light of the region's proximity to the troubled economies of Europe. We see meaningful upside in the RUB and TRY, against EUR-USD baskets. In both cases, light positioning protected these currencies from the worst effects of the May-June downdraft and, in our view, reduces their vulnerability. For low beta longs, the EGP and UAH are particularly appealing. An improving political and policy context in the Ukraine and balance of payments trends in both countries reinforce the capacity of central banks to maintain stable exchange rates. We also find EMEA relatively fertile ground for 'tail risk' trades, including owning a low-delta HUF put/EUR call, on the view that Hungary is most at risk in the event of another outbreak of anxiety about the euro area.

EM rates

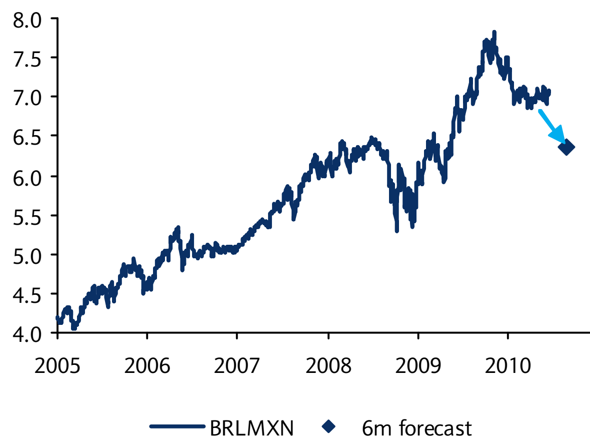
The recent performance of local bond and rates markets underscores their generally defensive nature and (beyond that) their resistance to global generalizations. On the one hand, the longer-term challenges facing the world economy favour long positions in rates, since they are less exposed to tail risks and because they should benefit from the low (short

Figure 13: BarCap index of historical currency valuation



Source: BIS, Barclays Capital

Figure 14: BRL/MXN – Defying gravity?



Source: Bloomberg, Barclays Capital

tenor) interest rates that will likely be needed to support activity in years to come. On the other hand, rates are, almost by definition, one of the most idiosyncratic assets in EM, which, together with their defensive nature, explains why their valuation is not particularly compelling in many cases.

Local rates are a lower beta-asset class; with positive carry, local markets are probably going to see further inflows to bonds

The upward slope in the majority of EM curves still prices in monetary normalisation with the upshot that most receiving rates trades are afforded positive carry on an FX-hedged basis. Given the extremely low rates in core money markets, the carry on FX-unhedged receiving trades – for example, through owning local government bonds – is even more advantageous. However, we are not advocates of having generally received rates/long bond trades in EM at this juncture, as our view on the EM growth cycle is bullish. Nevertheless, one can understand how current investor anxieties regarding growth and tail risks could continue to benefit inflows into local bonds.

EMEA rates: supported by an improved inflation outlook and tail risks to growth

EMEA offers more opportunities than the other regions, in our view, for being received rates. The economic and financial linkages with Europe are a tail risk for EMEA growth, and inflation in the region is generally more subdued than we had previously expected, leading us to push out our forecasts of rate hikes anyway. Our highest conviction recommendation is to be long (FX-unhedged) Russian 3y and Turkey 2y local government bonds. The robust FX outlook in Russia dovetails with our forecast of further interest rate cuts by the Bank of Russia and the ample local money market conditions caused by capital inflows. Turkey is a slightly different proposition: there is no room for further cuts, and the pace of rate hikes is likely to be slower than what is priced in by the market. Moreover, positioning technicals are helpful for Turkish bonds, with a strong local bid and a low level, by historical standards, of offshore holdings. The front end of the South Africa curve, given the stretched valuations, may be a good location for paying trades either on an outright basis or to hedge received trades elsewhere.

Latin American yields are high but the inflation premia could still be higher

LatAm, by contrast, seems a more fertile ground for bearish/paying rates trades. Inflation expectations are still at risk of being de-anchored in Brazil and Mexico. In the former, the valuations on shorter real bonds suggest investors should be long breakevens. In Mexico, stretched valuations at the back end of the nominal curve (in part due to the fact that the country has already benefited from index-related bond flows) highlight 10y TIIEs as a good location for paying trades. A series of 50bp rate hikes in Chile in the coming four meetings is not priced in and suggests that front-end rates are likely to remain under pressure; we therefore think investors should look to be paid 2y IRS. Due to potential global financial jitters, the BCCh may decide to slow the normalization cycle, but there is little indication of this right now.

Asia: Cash investors converging on local bonds

Asia local rates and bonds stand at an interesting junction. The growth outlook is generally positive, but regional policymakers favour moving cautiously on monetary normalisation. Meanwhile, the region continues to see real money inflows to the local debt markets, with the ‘stickiness of flows’ contrasting to the slightly more volatile debt portfolio flows elsewhere (EMEA, for example). We think these flows are in part motivated by the low fiscal overhangs in the region and an anticipation of a steady climb in Asian currencies, likely reinforced by the recent CNY policy shift. In Korea, we recommend receiving 1y rates, as forward-implied rates are high and we believe the Korean central bank will be significantly more cautious in its rate hiking cycle. We also favour long 10y KTBs, which are supported by a strong duration bid by Korean institutional investors. We still like Indonesian government bonds but, given the recent outperformance at the belly of the curve, recommend investors look to the wings (5y and 20y) for value.

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Analyst Certification(s)

We, Larry Kantor, Jeffrey Meli, Paul Robinson, Bradley Rogoff, Krishna Hegde, Michael Gavin, Piero Ghezzi, Barry Knapp, Laurent Fransolet, Chotaro Morita, Ajay Rajadhyaksha, Kevin Norrish and Matthew Leeming, hereby certify (1) that the views expressed in this research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

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