



# Balancing Act – Why rising Asian Inflation will change Global Markets



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May 2010

## China has been part of the global imbalance causing the Crisis

Supply oriented, surplus generated business model caused China exporting capital at a rapid speed. The rest of Asia followed the Chinese example

Asia has invested surpluses in liquid and secure Western bond assets.

Western bond yields declined below levels justified by the level of nominal GDP expansion

The asset boom and yield enhancement trades were the outcome

Low volatilities and melting risk premiums pressed investors into the carry trade

China could get away with this policy approach as the integration of its labour market into the global production process kept inflation moderate

Central bankers called failed separating the China prices from general price trends.

Greenspan talked about the 'Great Moderation'

China's / Asia's liquidity impulse into Western markets/economies was emphasised by relative easy monetary conditions.

It was a great time to be living in.



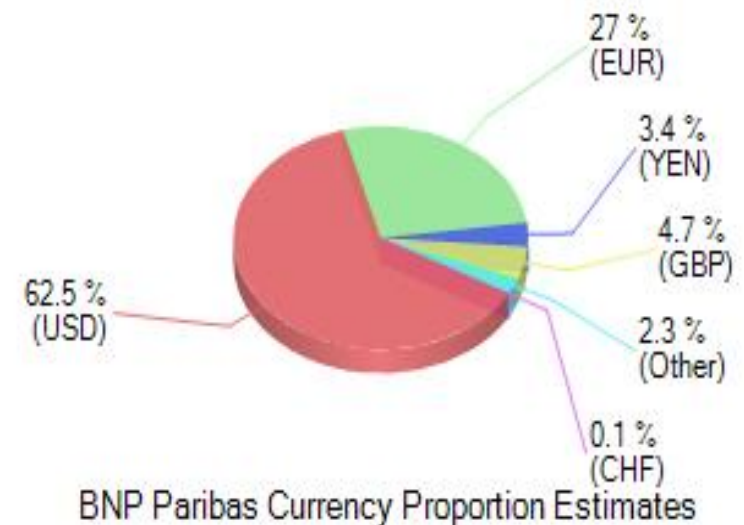
## Reserve Growth has provided liquidity to Western Markets

- Over the past year currency reserve growth has reached USD1019bln of which USD493bln has been provided by China
- Asian currency reserve growth has reached EUR737bln. Central bank intervention leaving local currencies quasi USD pegged has supported currency reserve growth
- We expect reserve growth to peak due to rising currencies, a change in the composition of growth and higher Asian inflation rates
- Consequently, there will be less funds channelled into Western markets

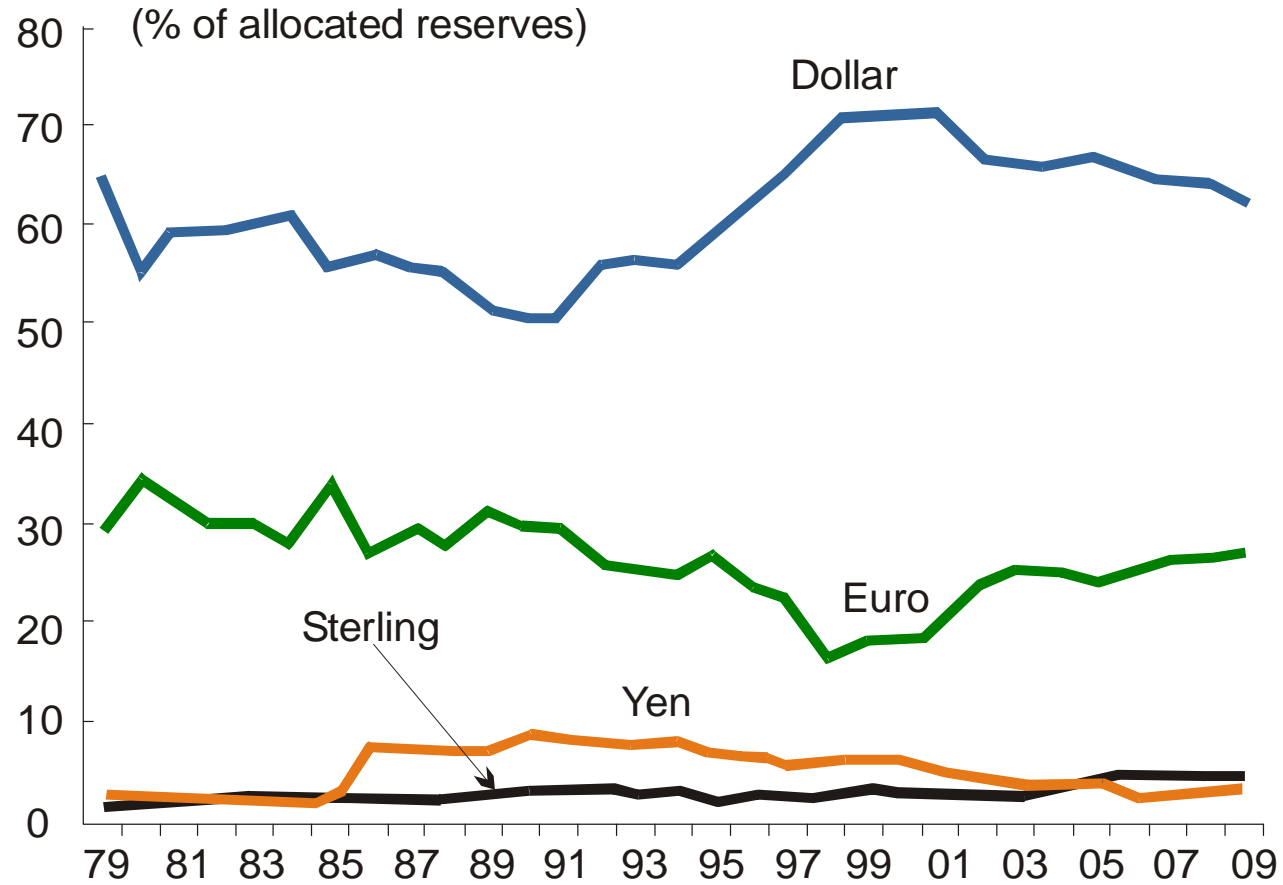
### Global and Asian currency reserves



### Composition of Reserves



# Currency Composition of Foreign Reserves

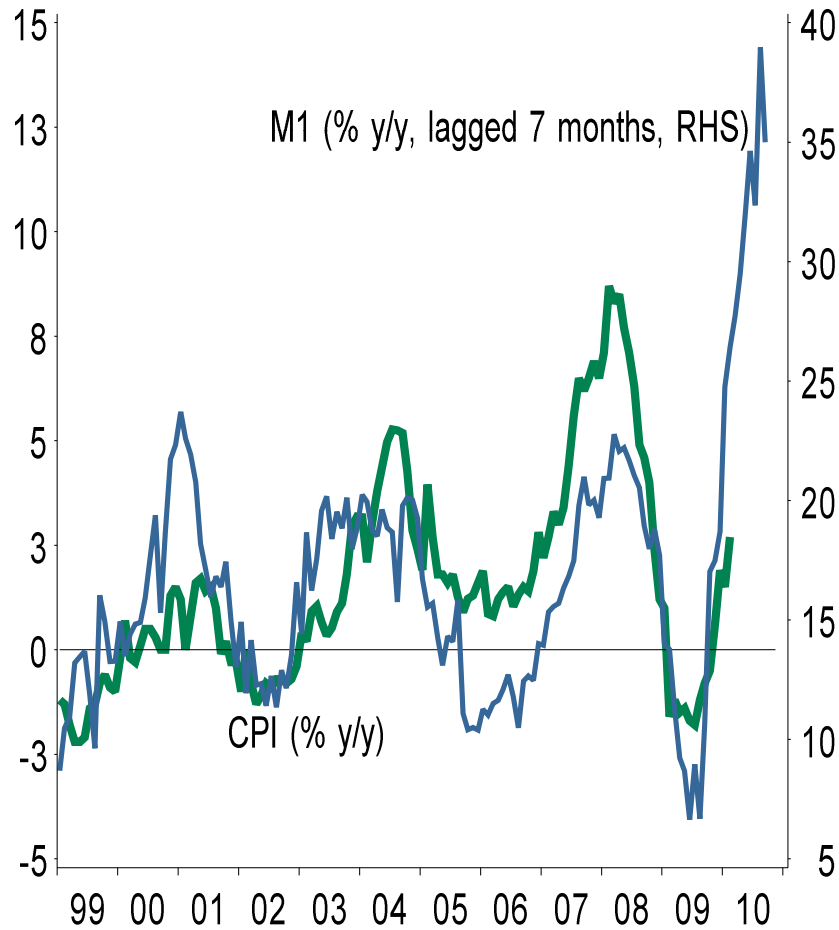


Note: Prior to 1999 data for euro is the sum of reserves held in the legacy currencies and ecus

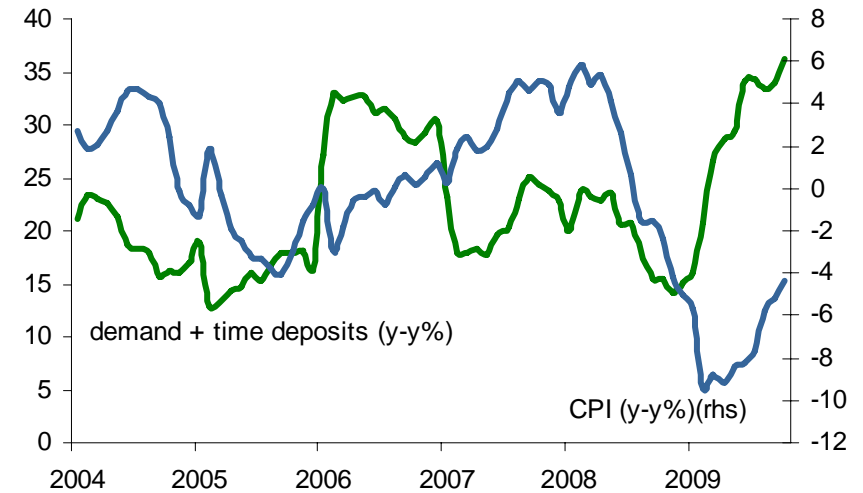


# China sees inflation expectations rising

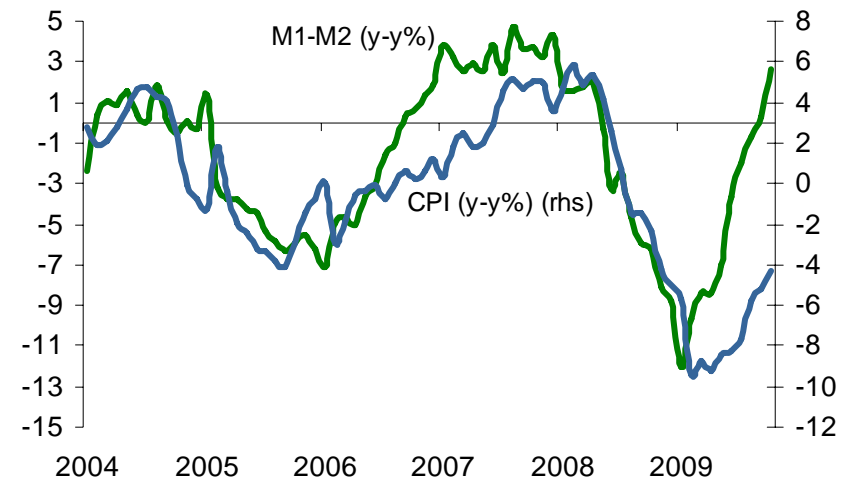
M1 moves 7 months ahead of CPI



Consumer switching deposit structure



CPI vs. M1 – M2 growth gap (12m lag in last cycle)

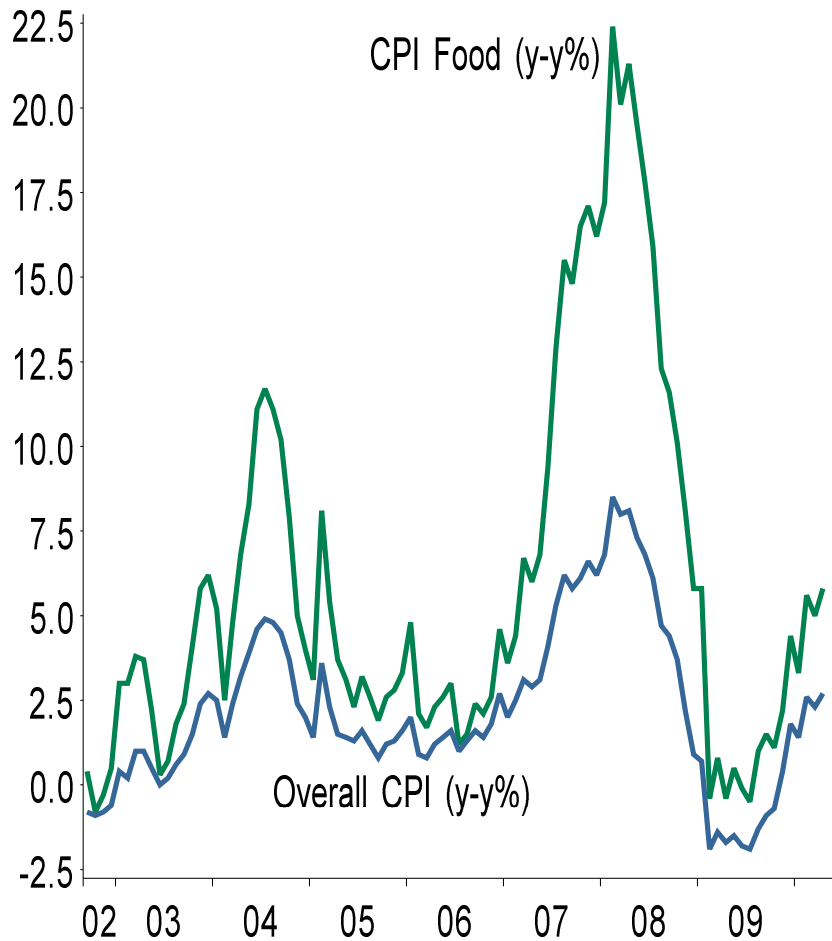


Source: Reuters EcoWin Pro, BNP Paribas



# China; Food inflation on the move

## M1 moves 7 months ahead of CPI



## Composition of CPI basket

	Weight (%)
Headline CPI	100.0
1 Food	33.2
2 Non-food	66.8
2.1 Garments	9.0
2.2 Household facilities and services	6.0
2.3 Medical care and personal articles	11.0
2.4 Transportation and communication	9.3
2.5 Recreational, educational and cultural articles	14.5
2.6 Residences	13.6
2.7 Tobacco & liquors	4.4

## Inflation outlook

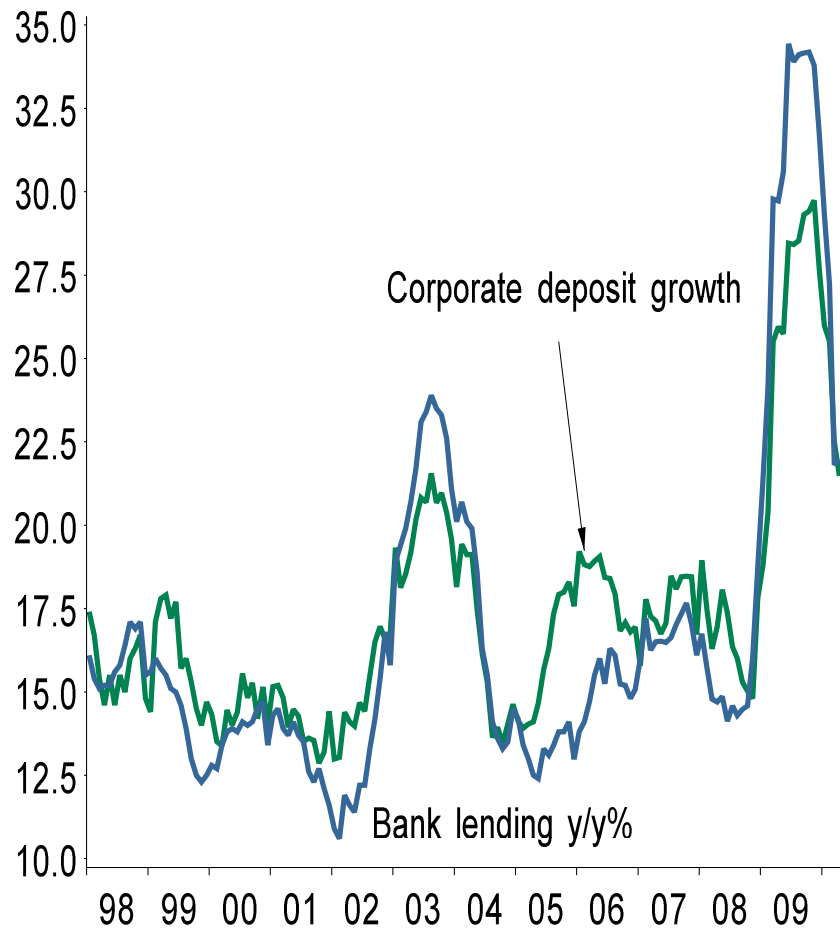
1. Soft commodity prices are rising fast and account for 33.2% of the index
2. Composition of growth has changed and has become demand driven
3. China will produce higher inflation rates as the integration of rural based labour force into the production process has slowed down.

Source: Reuters EcoWin Pro, BNP Paribas

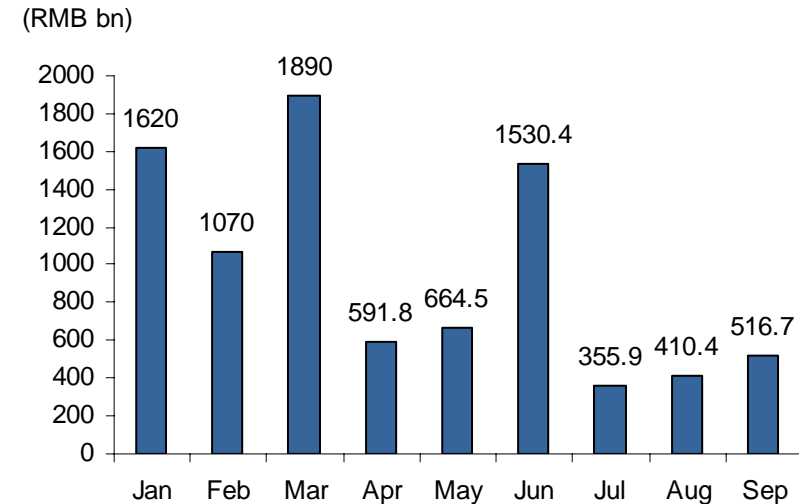


# China: Monetary policy to manage excessive liquidity

## Slowing down money velocity



## Substantially reducing new loans



## Sterilising excessive liquidity in the system:

1. Securities repos;
2. Central bank bill issuing;
3. Raising CB bill coupon rate;
4. Raising RRR;
5. Hiking benchmark rate;
6. Control the size and speed of foreign capital inflow and FX reserve building.

Source: Reuters EcoWin Pro, BNP Paribas

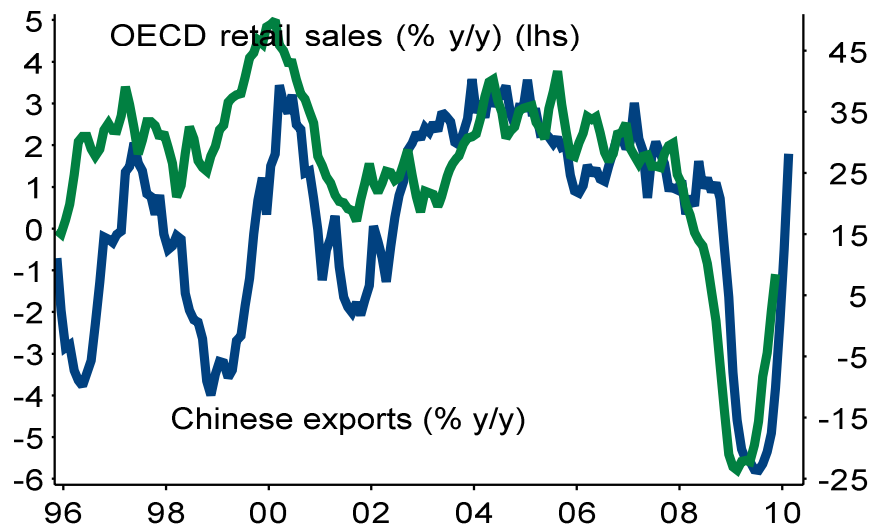


## Timing of CNY Revaluation

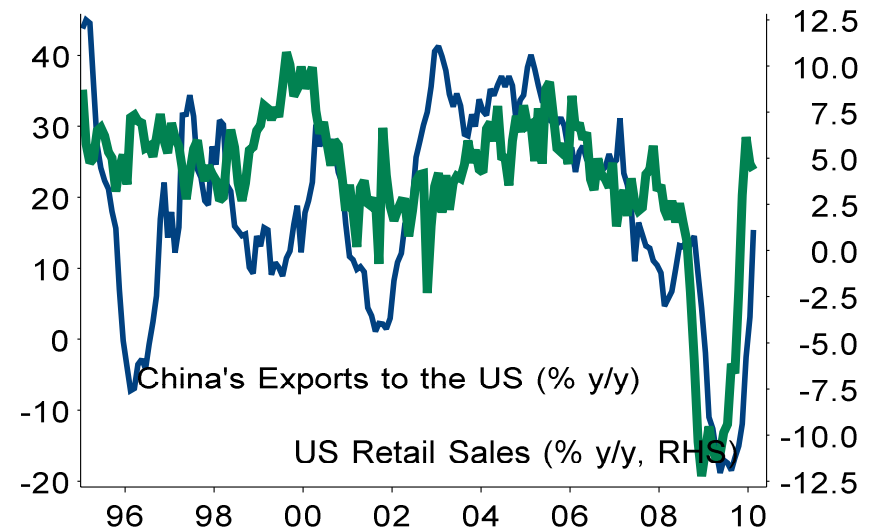
### External factors may determine timing of CNY revaluation

- The sharp increase of Chinese loans and the rapid increase of inflation in China has triggered the start of the tightening moves in China...
- ...but the timing of an eventual CNY revaluation could be determined by external factors...
- ...with the pace and sustainability of the recovery in the US being one of the major factors
- Chinese exports remain closely correlated to the behaviour of the US consumer

Chinese Exports and OECD Retail Sales



China's Exports to US and US Retail Sales

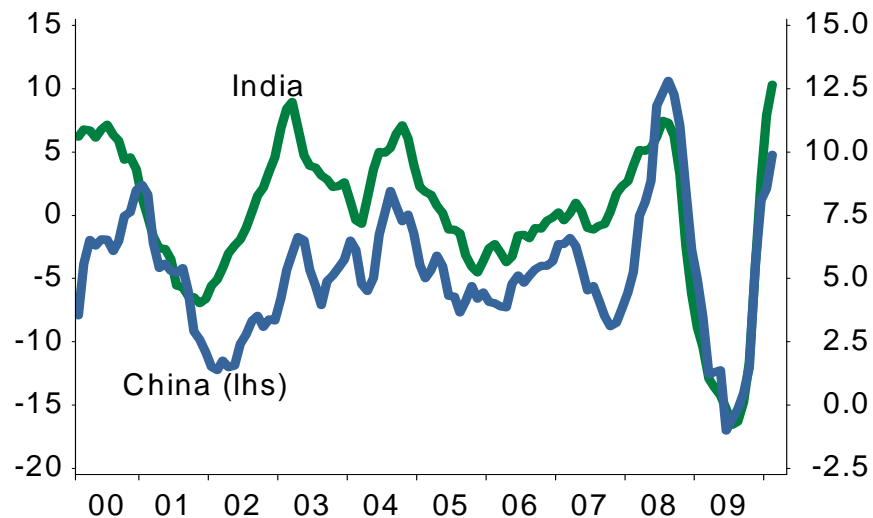


## Will Chinese Tightening be Domestically Orientated

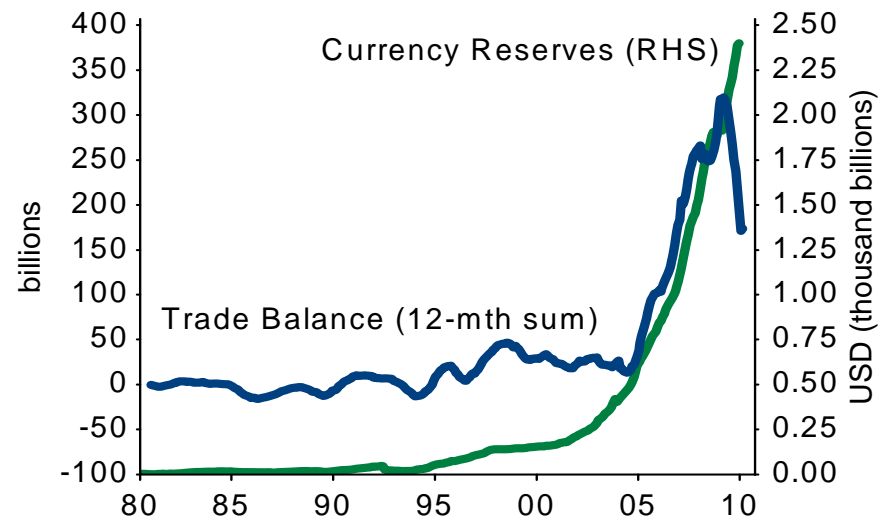
### India surprised with a rate hike...will China be next

- China has suggested that the March trade data may show a significant deficit which implies that a rebalancing of the economy is taking place...
- ...however, this also suggests that monetary tightening measures by China are more likely to be domestically orientated (interest rates) rather than international (exchange rate)
- India has already surprised the market with an interest rate hike and further tightening is expected...
- ...increasing speculation that China will follow in Q3 2010

Chinese and India PPI



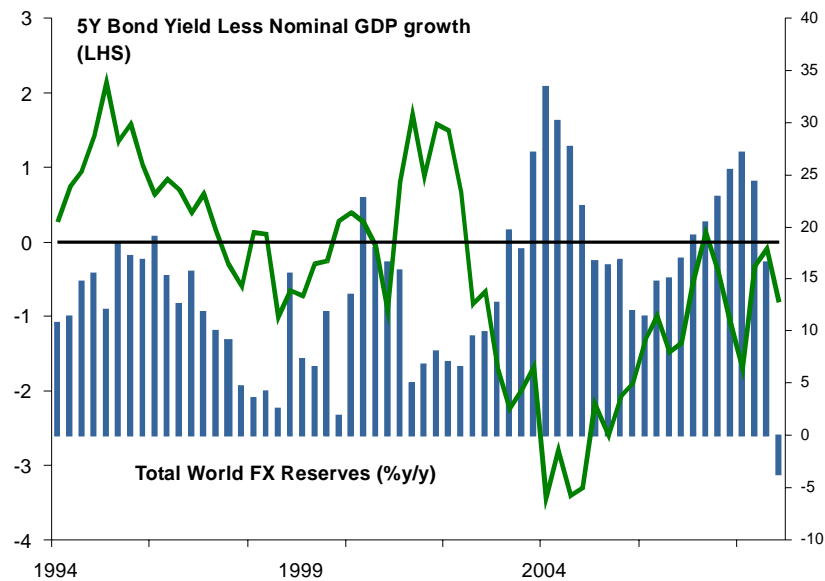
Chinese Reserves and Trade Balance



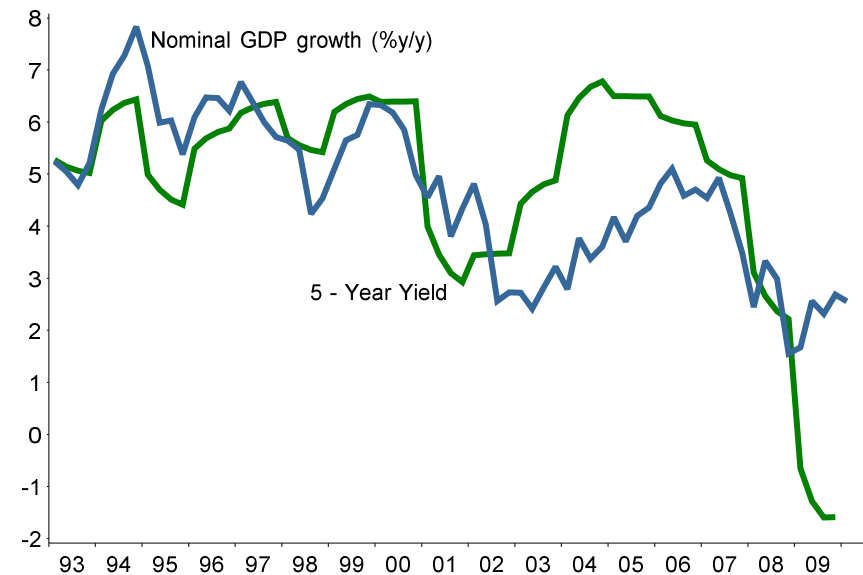
## China's move into financial USD assets distorted 'yield balance'

- From 2002 to 2004 real yields dropped to levels inconsistent with higher output levels
- Asset prices had to move higher and ...
- ... yield enhancement strategies became common place
- Both bubbles had to burst

### Currency reserve flows depressed yields



### Yields only reluctantly followed output levels



Source: Reuters EcoWin Pro, BNP Paribas



## What to expect now

Asian growth composition becomes demand oriented increasing Asian inflation

Asian (Global) currency reserve growth to decline

Asia exports less liquidity into Western markets reducing bond demand

Real yields will rise over time (liquidity, bond supply and productivity related)

High real yields will depress asset prices unless compensated by Western central banks bumping liquidity into the system.

Europe is facing a deflationary shock aiming to reduce the inner EMU competitive gap and fiscal imbalances

The ECB will have to bump liquidity trying to keep EMU together. The EUR will decline sharply. German export shares will rally sharply



## ECB Intervening or Bank Taking the Loss?

<b>Eurozone member</b>	<b>Share of paid-up ECB subscription (%)</b>	<b>Implied loss from a \$150bln writedown on Greek debt held by the ECB (\$bln)</b>	<b>End-2009 Q4 private banking sector exposure to Greece (\$bln)</b>
Germany	27.9	41.85	45
France	21	31.5	78.8
Italy	18.4	27.6	6.9
Spain	12.2	18.3	1.2
Netherlands	5.9	8.85	12.2
Belgium	3.6	5.4	3.8
Austria	2.9	4.35	4.8
Portugal	2.6	3.9	9.8

- Jacob Funk Kirkegaard of the Peterson Institute produced a very insightful piece weighing in the cost of a default whether it happens as Greek is held by the ECB or the banking system. It explains the relative vested interest of different member states for one solution instead of the other.

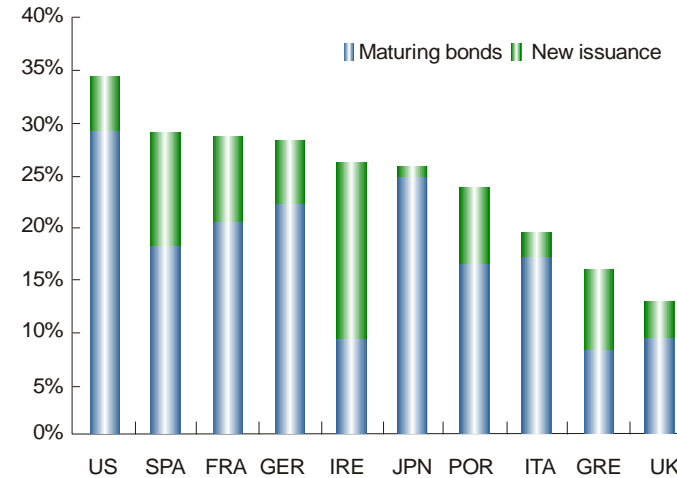
Source: BIS, ECB, Peterson Institute.



# Debt market worries will keep currency markets volatile

- Issuance activity relative to outstanding debt is the highest in the US and in Spain
- UK outstanding debt maturity is the highest, but issuance jumped with Labour coming to office in 1997 keeping refinancing needs high
- Greek retirement obligations are 800% of GDP

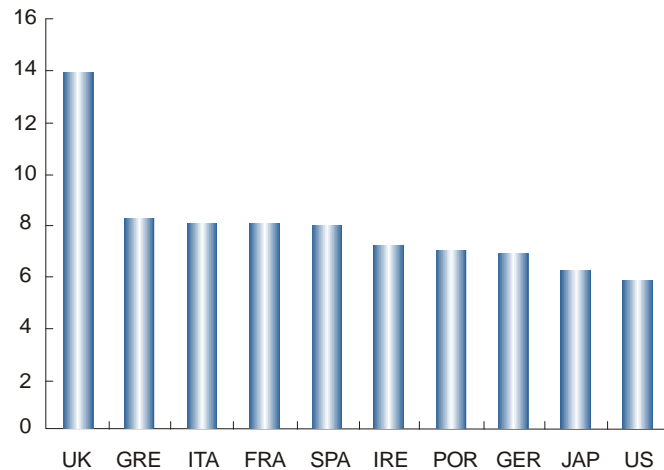
## % stock of outstanding debt to be issued this year



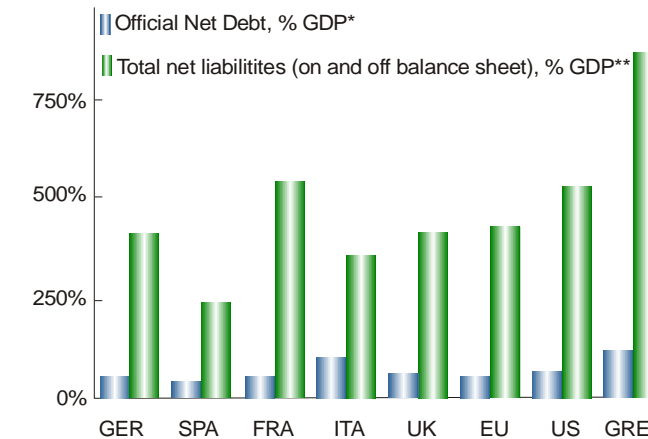
Source: OECD, Bloomberg

## Off and on balanced sheets, unfunded pensions and health obligations

### Maturity of sovereign debt portfolios



Source: Bloomberg



\* 2010 OECD projections \*\* 2005 estimates of total fiscal imbalance

Source: Gokhale, OECD



## Leverage (% GDP) (per Dec 2008)

- On an aggregate basis Japan is still highly leveraged. Household, Corporate and Sovereign debt has reached 466% GDP by the end of 2008. The UK's debt level is lower at 295% but the combination of high public debt (now at 85%) and the non-financial corporate sector debt level leaves the UK highly vulnerable. Highly leveraged economies have to seek growth contributions via net exports for which a strong corporate sector will be required. The high corporate sector debt level combined with ballooning public sector debt suggests a lower sterling down the road.

	<b>Govt debt (%GDP)</b>	<b>Hsehold sector debt (%GDP)</b>	<b>Corp sector debt (%GDP)</b>	<b>Total</b>
EMU	80.5	67.8	131.2	<b>279.5</b>
US	40.2	96	78	<b>214.2</b>
Japan	193	76.1	197	<b>466.1</b>
UK	63.4	108.1	124	<b>295.5</b>
Canada	28.9	85.7	175.9	<b>290.5</b>
Australia	14.3	104	156	<b>274.3</b>
Sweden	47.4	78.8	160	<b>286.2</b>
Norway	56	82.4	99.5	<b>237.9</b>



## Main themes for 2010

### Recovery underway...but risks remain

- Global economy to rebound with EMK setting the pace of the recovery...
- ...but, Industrialised countries will be exposed to substantial risks
  - De-leveraging of households and banks
  - Credit is still crunching
  - Regulation risk
- Rates within the industrialised world will remain low, while EMK economies will see higher inflation and local interest rates
- Industrialised countries will tighten via withdrawing QE and fiscal support
- Sovereign risks
  - Major G-7 countries might be downgraded (Japan, UK) as deficits lead debt/GDP ratios higher
  - Emerging sovereign risk will improve



# Economic Forecasts

**Table 1: GDP (% y/y)**

	2008	2009	2010	2011	2012
World	3.0	-0.8	4.2	3.8	4.2
G7	0.2	-3.4	2.3	2.2	2.5
US	0.4	-2.4	2.8	2.6	3.1
Japan	-1.2	-5.2	2.2	2.0	1.8
Eurozone	0.5	-4.0	1.0	1.2	1.8
UK	0.7	-4.8	1.9	1.2	1.5
Canada	0.4	-2.6	2.8	2.9	3.1
Other Advanced	1.4	-1.3	2.6	2.9	3.4
Asia Ex-Japan	6.9	5.7	8.9	7.3	7.6
CEE & Russia	3.7	-5.4	3.8	3.5	4.4
Latin America	4.1	-2.0	4.0	4.2	4.1

Source: BNP Paribas

**Table 2: Contributions to Global Growth**

	Weight*	Contributions to Global Growth (pp)				
		2008	2009	2010	2011	2012
World GDP (% y/y)	100.0	3.0	-0.8	4.2	3.8	4.2
G7	41.9	0.1	-1.4	1.0	0.9	1.1
US	20.6	0.1	-0.5	0.6	0.5	0.6
Japan	6.3	-0.1	-0.3	0.1	0.1	0.1
Eurozone	15.7	0.1	-0.6	0.2	0.2	0.3
UK	3.2	0.0	-0.2	0.1	0.0	0.0
Canada	1.9	0.0	-0.1	0.1	0.1	0.1
Other Advanced	3.6	0.1	0.0	0.1	0.1	0.1
Asia Ex-Japan	24.7	1.7	1.4	2.2	1.8	1.9
CEE & Russia	8.2	0.3	-0.4	0.3	0.3	0.4
Latin America	8.6	0.4	-0.2	0.3	0.4	0.3

Source: BNP Paribas, IMF WEO October 2009

Note: \*Weights based on the PPP valuation of country GDP

**Table 3: CPI (% y/y)**

	2008	2009	2010	2011	2012
World	5.7	1.7	3.5	3.1	3.1
G7	3.2	-0.1	1.3	0.7	0.7
US	3.8	-0.3	2.0	0.9	0.8
Japan	1.4	-1.4	-1.3	-0.6	-0.4
Eurozone	3.3	0.3	1.2	1.2	0.9
UK	3.6	2.2	2.8	1.3	1.1
Canada	2.4	0.3	1.5	1.4	1.4
Other Advanced	3.7	1.1	2.2	2.4	2.4
Asia Ex-Japan	6.6	0.6	4.9	4.5	4.0
CEE & Russia	10.2	7.9	4.9	5.7	6.2
Latin America	8.2	4.8	7.3	6.4	8.2

Source: BNP Paribas

**Table 5: Interest Rate Forecasts (%)\***

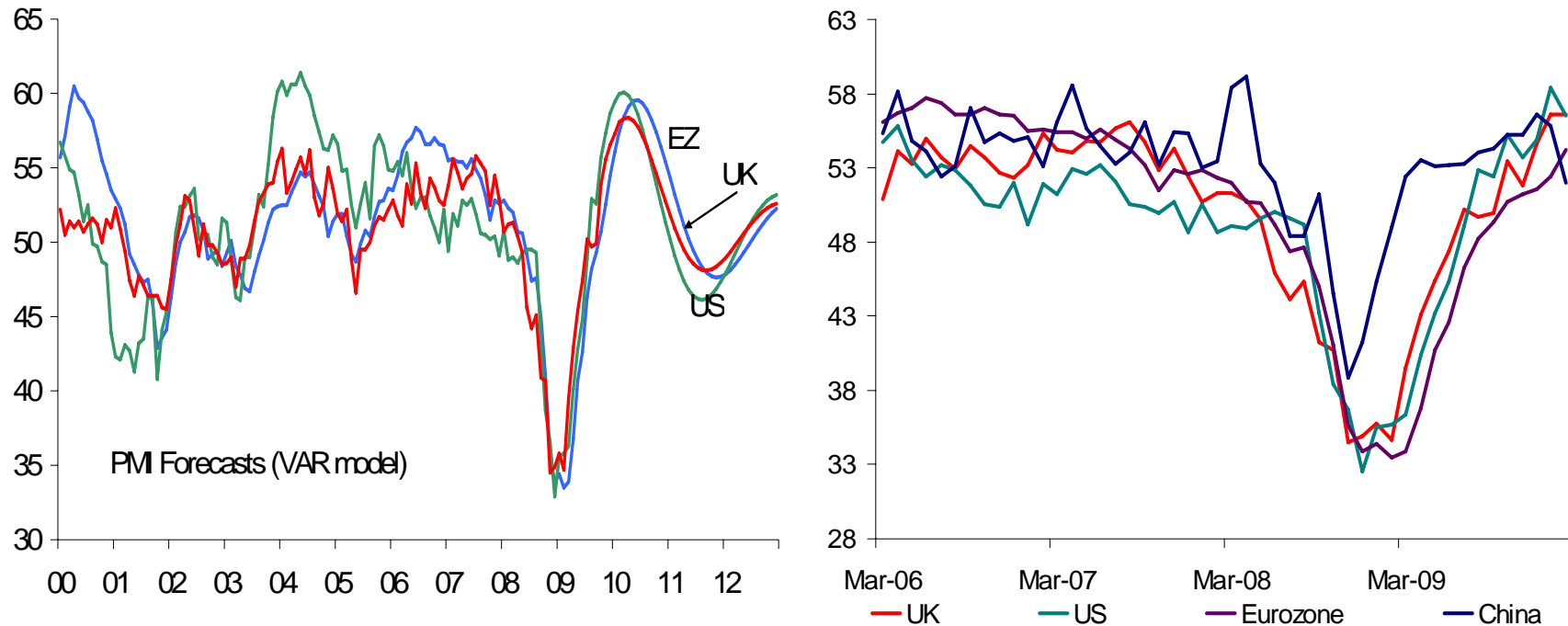
	Spot	Q2'10	Q3'10	Q4'10	Q1'11	Q4'11
<b>US</b>						
Fed Funds	0.25	0.25	0.25	0.25	0.25	1.50
10-year	3.64	3.50	3.50	3.75	3.85	4.50
<b>Eurozone</b>						
Refi	1.00	1.00	1.00	1.00	1.00	1.25
10-year	3.13	3.00	3.00	3.10	3.15	3.50
<b>Japan</b>						
ODR	0.30	0.30	0.30	0.30	0.30	0.50
Call Rate	0.10	0.10	0.10	0.10	0.10	0.25
10-year	1.38	1.40	1.60	1.65	1.80	2.10

Source: BNP Paribas. End Period, Spot Rates as at 18 March

\* Preliminary, to be confirmed in the Global Outlook



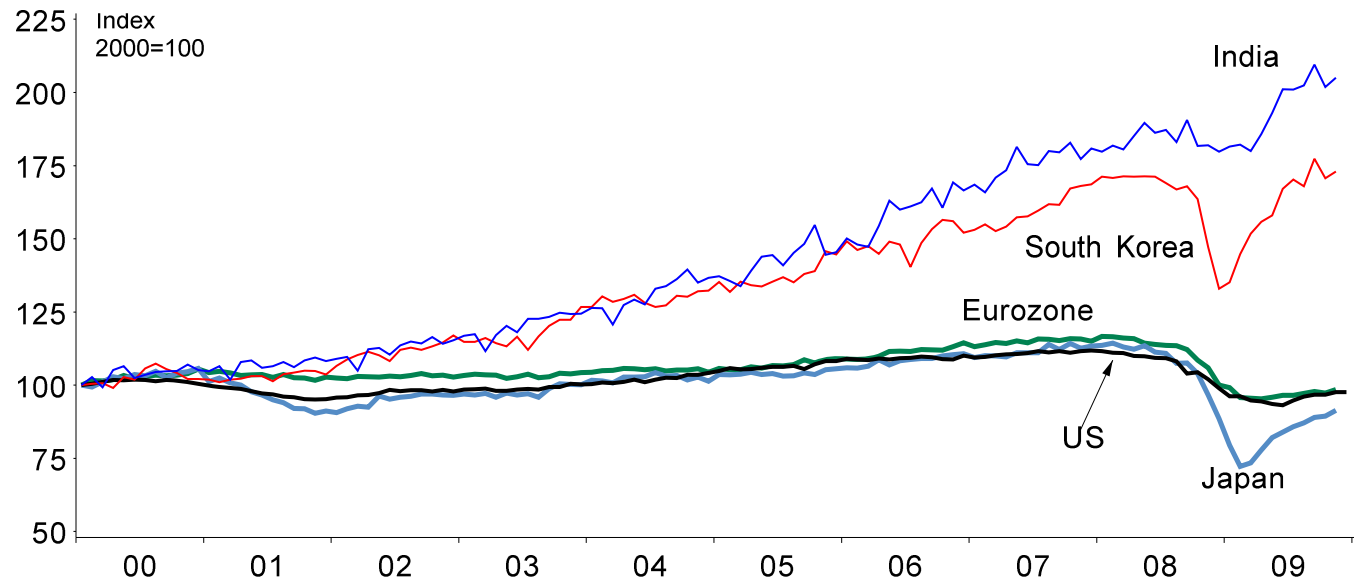
## Global: Modelling of Manufacturing PMIs



- Given the current momentum in the PMIs, past relationships tell us to expect more strength is still possible...
- ...but with a turning point early in 2010, suggesting a 'double dip'
- Chinese PMI is already turning lower – leading the way



## Industrial Production Levels

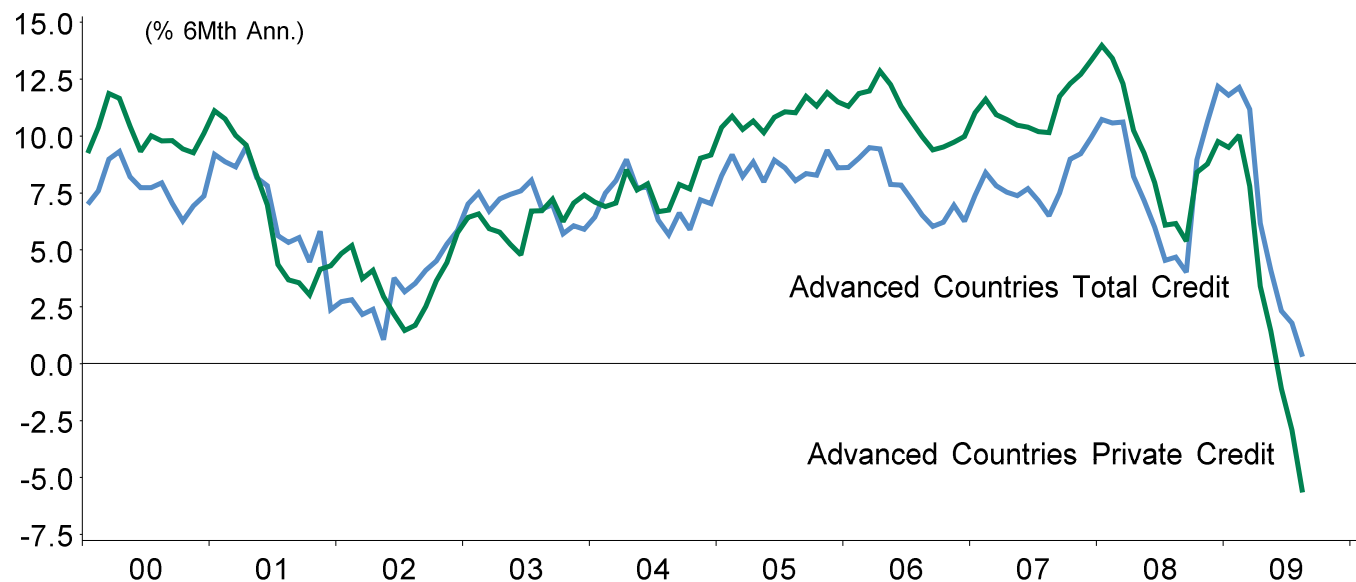


Source: Reuters EcoWin Pro, BNP Paribas

- German industrial orders are growing at the fastest pace since the 1970s
- This leaves them 19% above their February trough...
- ...but still more than 25% below their pre-crisis peak
- Not the same in Asia - South Korean IP back to the peak, little spare capacity in Australia, India now 17% up on trough



## Advanced Country Credit Growth

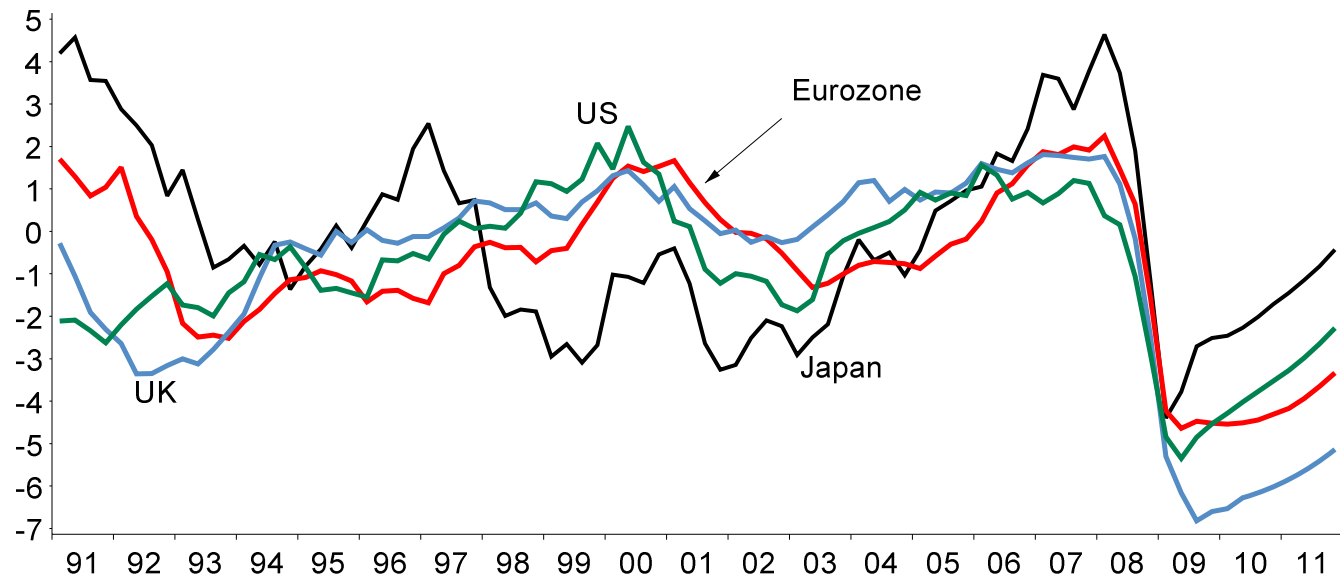


Source: Reuters EcoWin Pro

- Who says the credit crunch is over?
- Lots of losses still to come...and tighter regulation
- The fall in private credit growth is accelerating.
- Bond issuance has risen sharply but small and medium sized companies don't issue bonds



## Output Gaps in Advanced Economies (% of GDP)

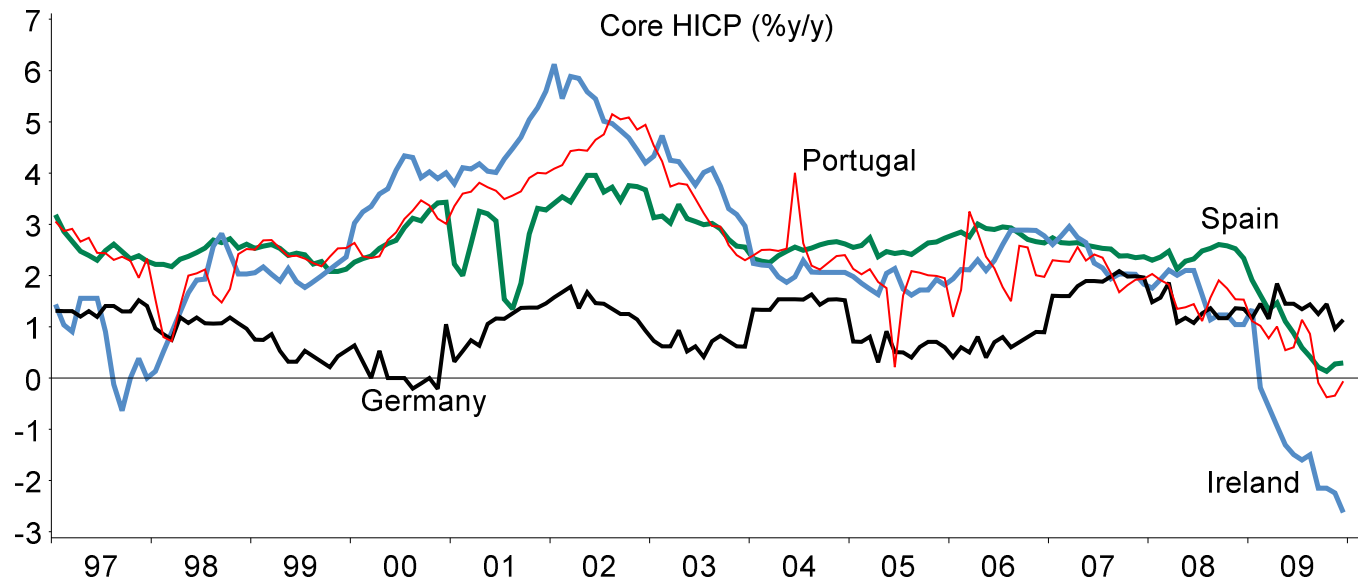


Source: Reuters EcoWin Pro

- All the major economies have massive output gaps at the same time
- According to the OECD when we look at the level of output those gaps are not going to close any time soon
- Domestically orientated inflation will not be a problem for some time in the developed world



## Deflation Likely in the Eurozone



Source: Reuters EcoWin Pro

- Structural pressures (uncompetitive economies) increase likelihood of deflation in the eurozone
- Some countries need to deflate wages and prices relative to Germany
- Strong exchange rate and relatively timid non-conventional policy also raised risk of deflation

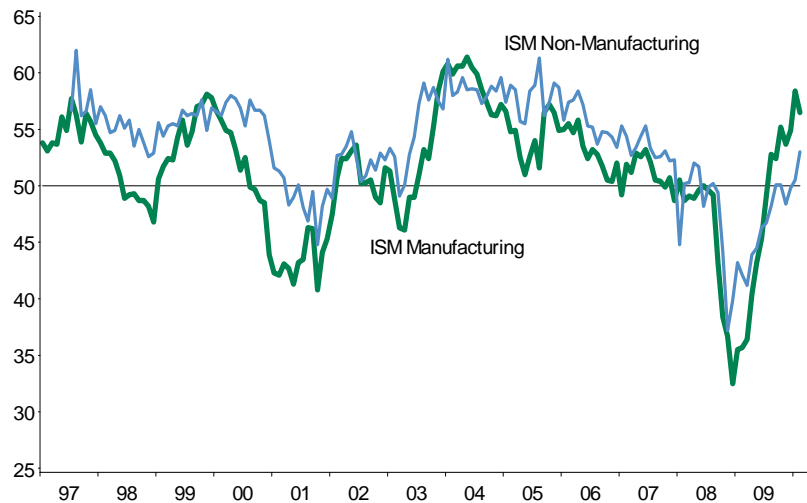


## US – least ugly of the majors

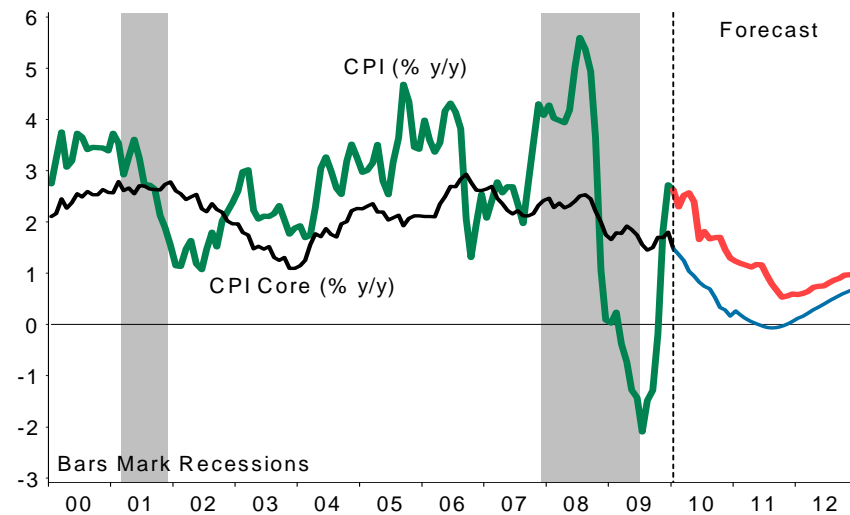
### US recovery will lead the way among the majors...

- We expect the US to develop a self sustaining domestic demand led recovery...
- ...compared to a far more sluggish performance in Japan and the eurozone where growth is still reliant on exports
- Deflation is also likely to be less of a threat in the US...
- ...allowing the US to be the first to hike interest rates among the majors
- Fed expected to hike in Q2 2011 while the ECB hiking in Q4

US ISM (Manufacturing and Services)



US CPI Inflation Forecast

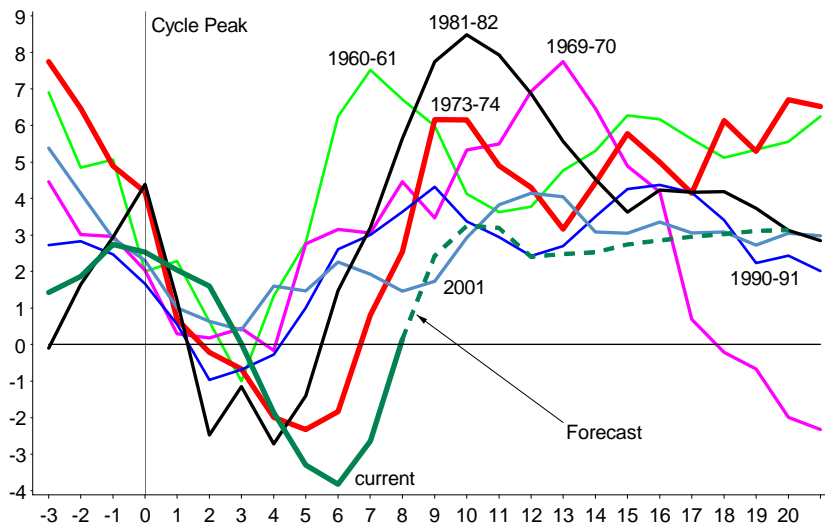


## US – but recovery will be slow

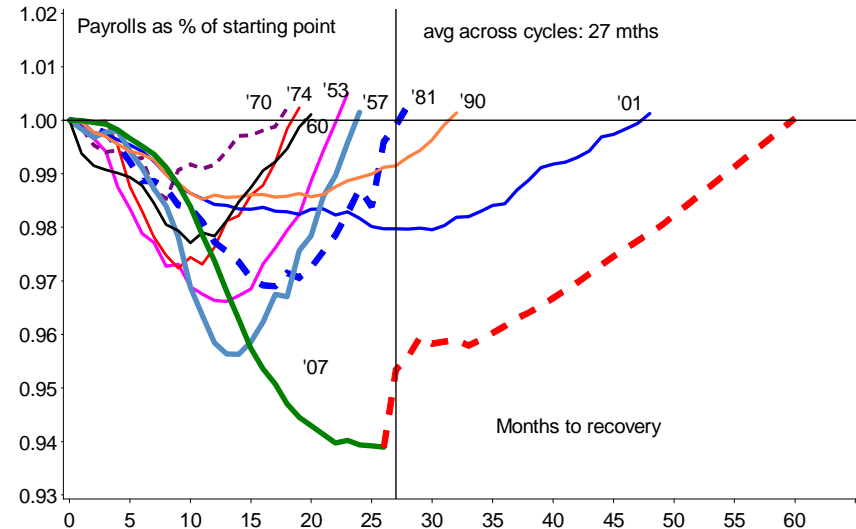
### ...but US recovery will be slow by historical standards

- The US recovery will be slow by historically standards...
- ...growth will be constrained large household debt overhang and de-leveraging
- House holds have lost 23% of their wealth and savings are being rebuilt
- One exception is the corporate sector which is enjoying huge gains in productivity...
- ...building its free cash flow and preparing to invest in equipment and strategic acquisitions

#### US Growth Cycles



#### US Non-Farm Payroll Cycles

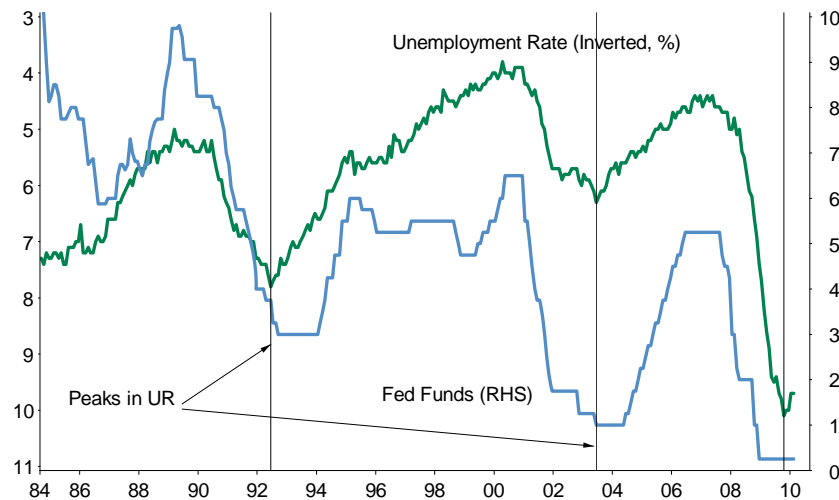


## US – Fed to be first in G3, but in no rush

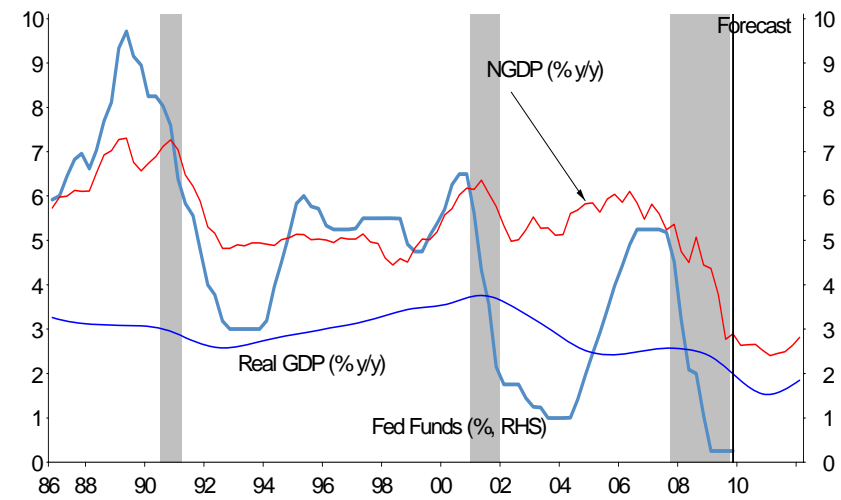
### The Fed is likely to be the first in the G3 to hike rates

- We expect the Fed to be the first to hike rates among the G3, but they will not be any rush
- Even using traditional labour market and growth indicators suggests that the Fed is still along way from tightening
- The Fed usually waits 12-months after unemployment has turned before the hiking interest rates
- Unemployment is only just showing signs of turning around, suggesting that it will be at least 12-months before a hike if traditional relationships hold

Fed Funds and Unemployment Rate



Fed Funds and GDP Growth



## USD – A Mixed Performance in 2010

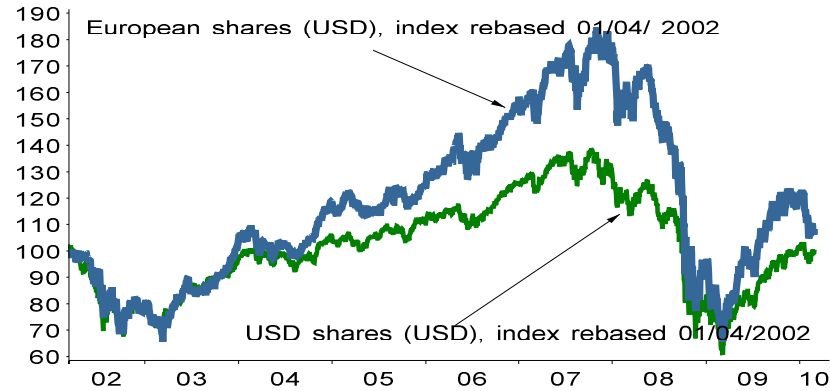
### USD recovery – a slow start

- The USD's downtrend is coming to an end and we expect a rebound in 2010
  - USD recovery will be gradual initially
  
- Initial USD performance likely to be mixed
  - USD expected to remain under pressure against Asian regional currencies...
  - ...and commodity currencies in the first half of the year
  
- USDJPY to lead the way with strong rally throughout 2010
  - Sustained yen weakness
  
- But USD to start rebound against the European countries
  - Euro under performance
  - Outright sterling weakness
  
- Quantitative easing will be withdrawn

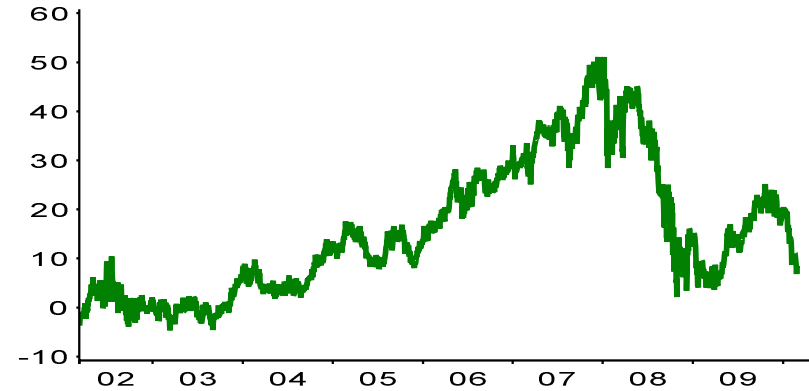


# Asset Markets Drive the USD

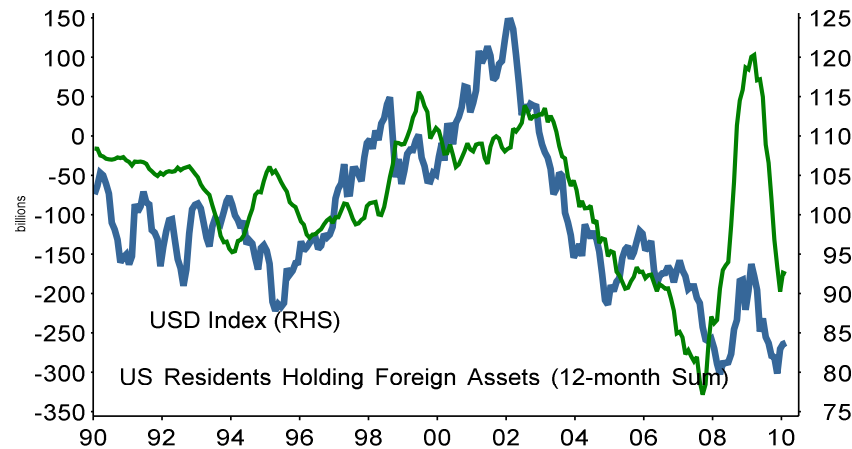
## European shares were the better bet....



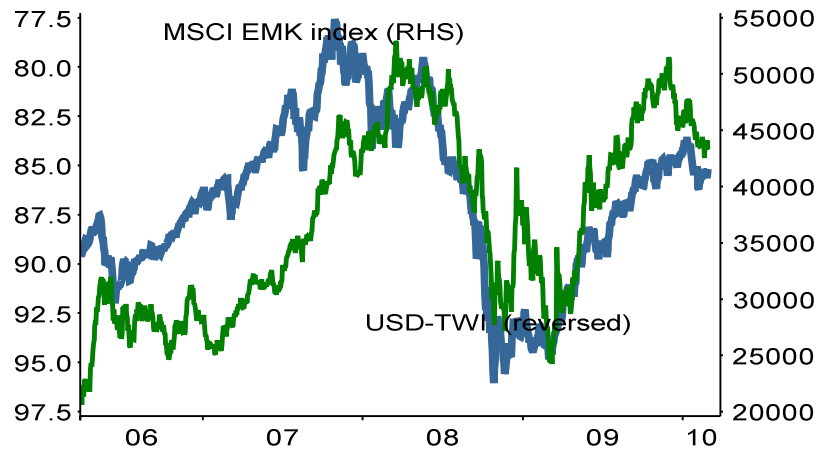
## ...allowing non USD equity portfolios to outperform



## US residents buying less foreign assets



## When equities fall, the USD rises

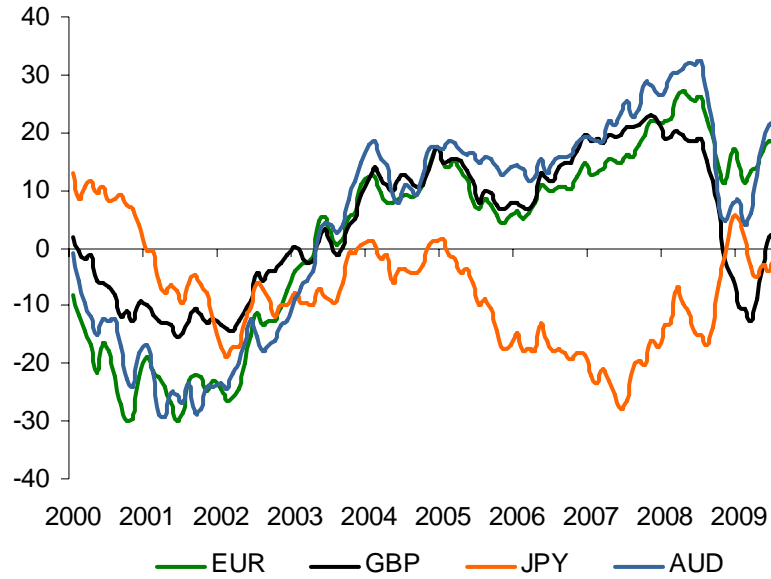


SOURCE: REUTERS ECOMM F10



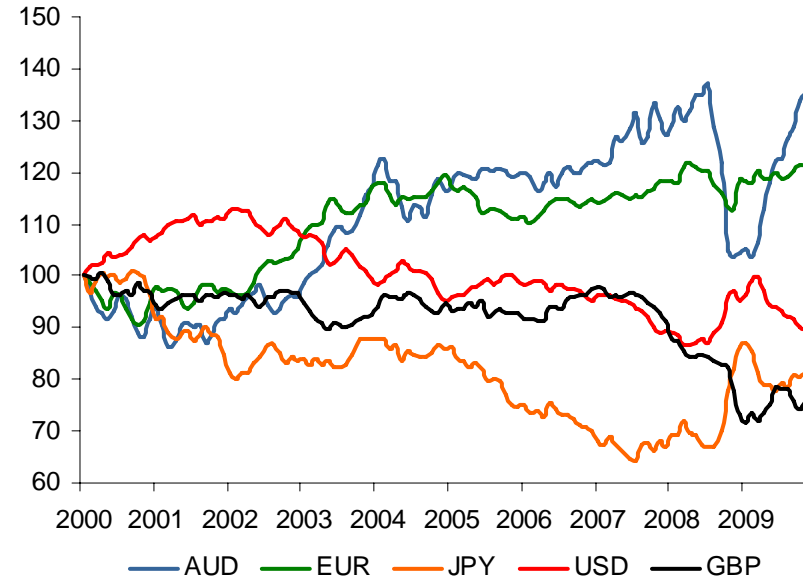
# Fair Value

Deviation from Fair Value: PPP, USD Crosses



EUR	23%	overvalued
GBP	5%	overvalued
JPY	3%	overvalued
AUD	32%	overvalued
USD-TWI	15%	undervalued

REER rebased at 100 in Jan 2000



Source: Reuters EcoWin Pro, BNP Paribas

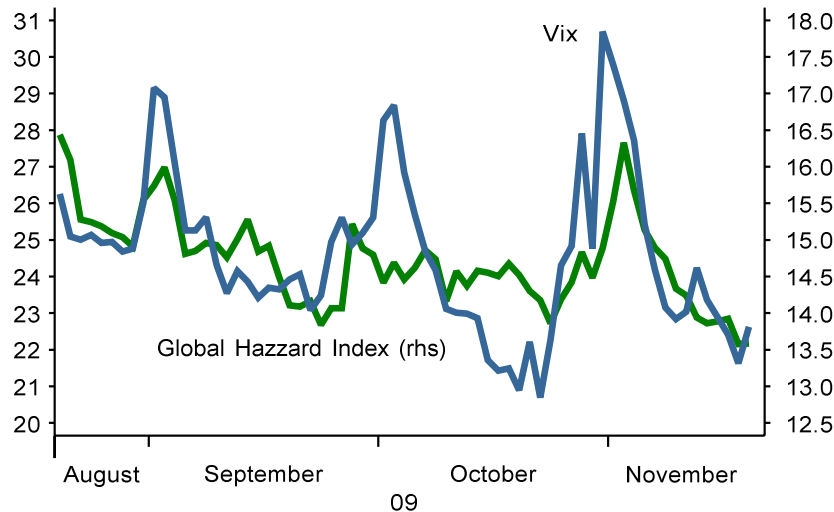


## Liquidity holds the key

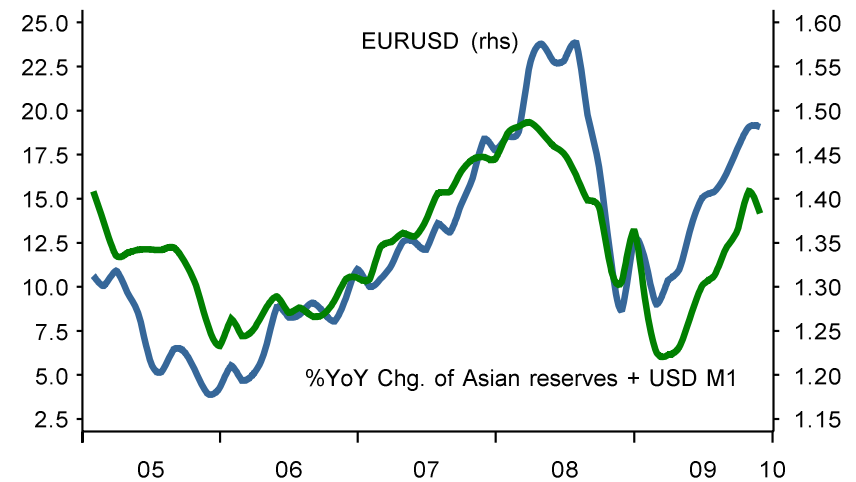
### Central banks preparing to withdraw liquidity

- Currency volatility no longer lags VIX as USD liquidity drives asset markets.
- This means that asset trend changes might first be spotted on FX markets
- Chart 2 defines liquidity is defined by narrow money supply growth and Asian currency reserves growth.
- Asian currency reserves growth adds to USD liquidity as Asian inflows are mostly USD denominated

Global Hazard versus VIX



USD Liquidity versus EURUSD

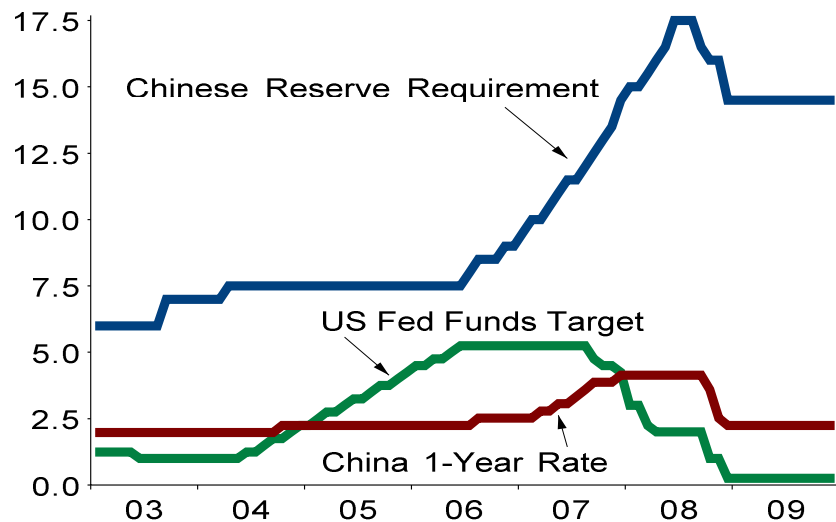


## China has started to tightening process

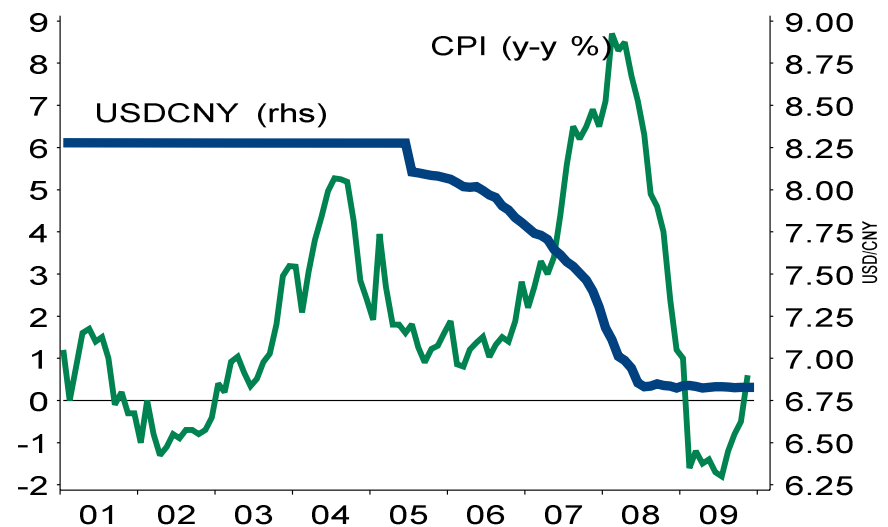
### Chinese tightening under way

- China has started the monetary tightening process with rises in the Bank Reserve Requirement Ratio (RRR)
- However, overall liquidity withdrawal will be gradual
- In 2003 there was a year between the rate hike in the RRR and the first rise in the benchmark interest rate
- The CNY was not revalued for nearly two years after the RRR hike in 2003

Chinese and US Monetary Policy Cycle



USDCNY and Chinese Inflation

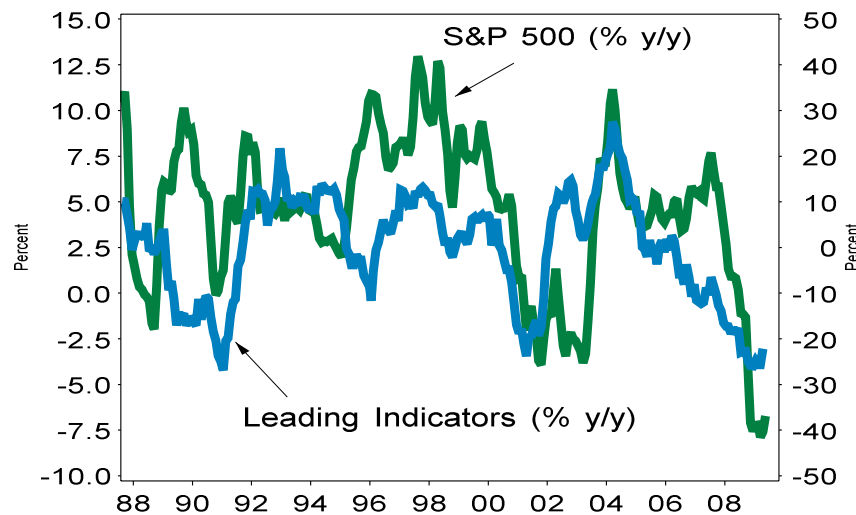


## Riding a Wave of Optimism

### Asset market rally...is the worst really over

- Economic leading indicators have moved sharply higher, triggering claims by global policy makers that the worst is over
- Recovery fuelling financial market optimism
- Liquidity generated by quantitative easing and other unorthodox policy measures driving markets higher
- Equity markets follow traditional pre-emptive bounce while volatility normalises

Leading Indicators and S&P 500



VIX Index

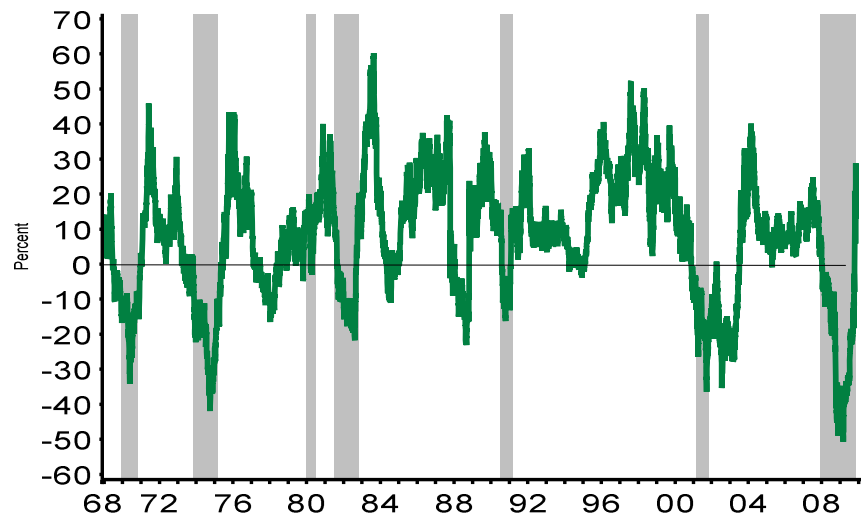


## Normalisation of Asset Markets

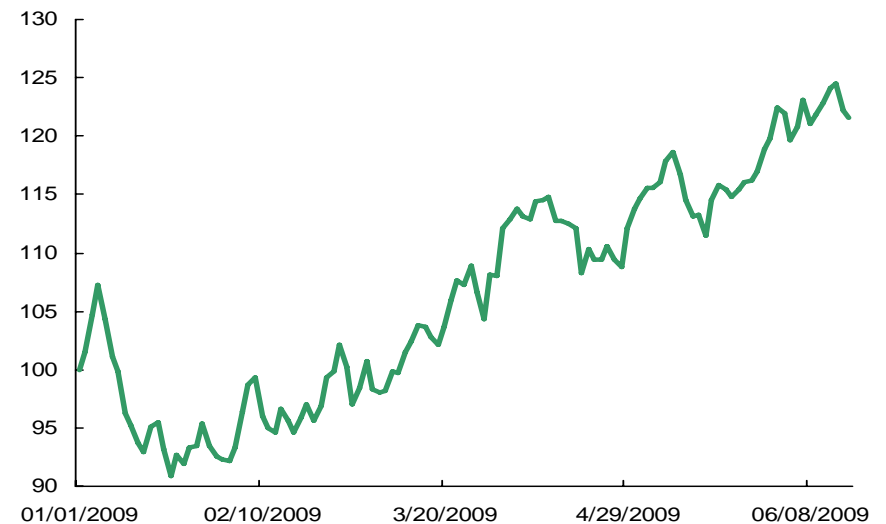
### Market normalisation, risk appetite returns

- Risk appetite has started to returned driven by liquidity...
- ....risky asset markets have out performed...
- ...with many EMK (excluding CEE) also out performing
- Typical carry trade has made 25% return year-to-date
- But can this be sustained as liquidity is withdrawn?

S&P 500 (% y/y) and Recessions



Carry trade performance (Jan 2009 = 100)

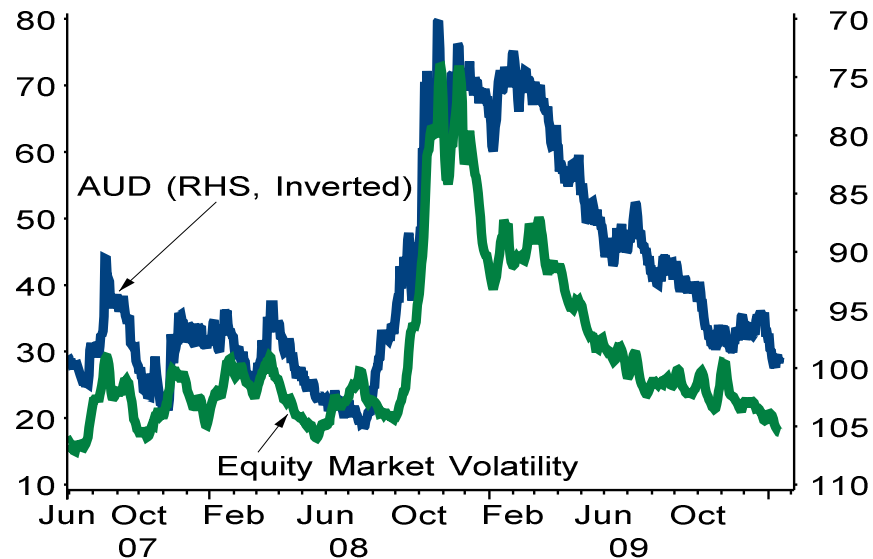


## AUD still supported...for now

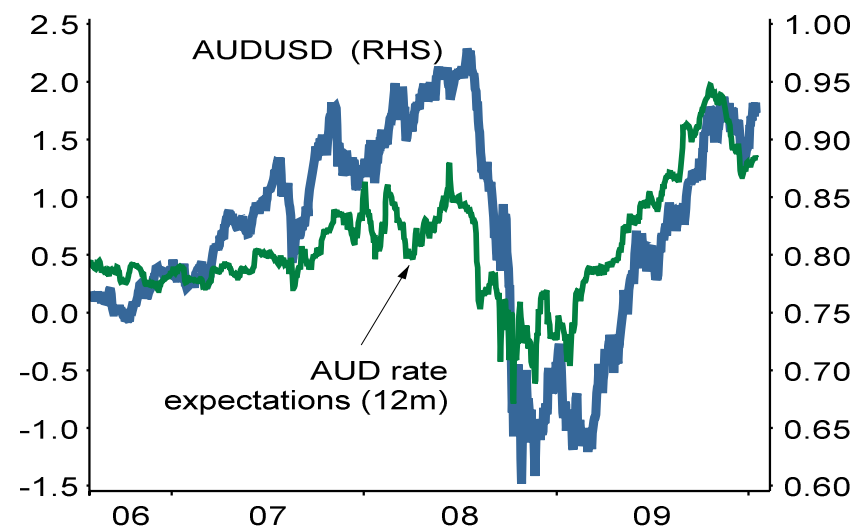
### Gradual liquidity withdrawal AUD supportive...but risks building

- The AUD has been driven by risk appetite and liquidity
- The initial gradual withdrawal of liquidity by China will not harm the AUD too much initially.
- Domestic Australian data is strong as is Chinese demand for Australian resource assets
- But, once more aggressive tightening in China starts to take place, the risks for the AUD will increase...
- ...AUD vulnerable, especially in H2 2010

AUD and VIX

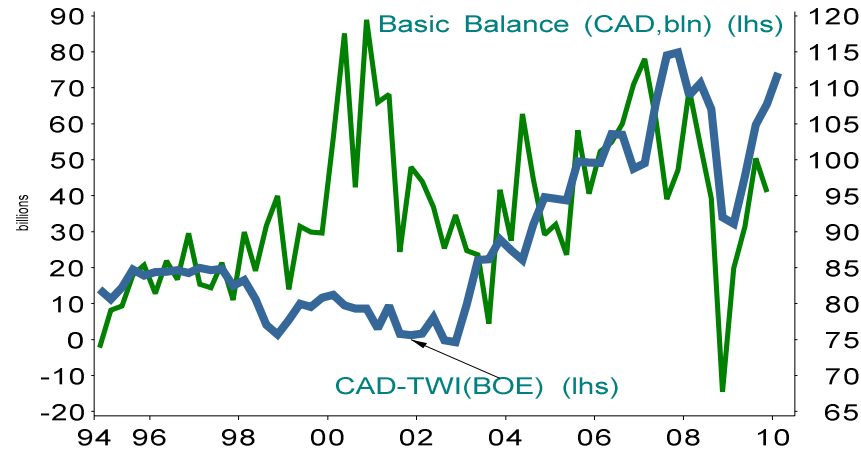


Rate Expectations and AUDUSD

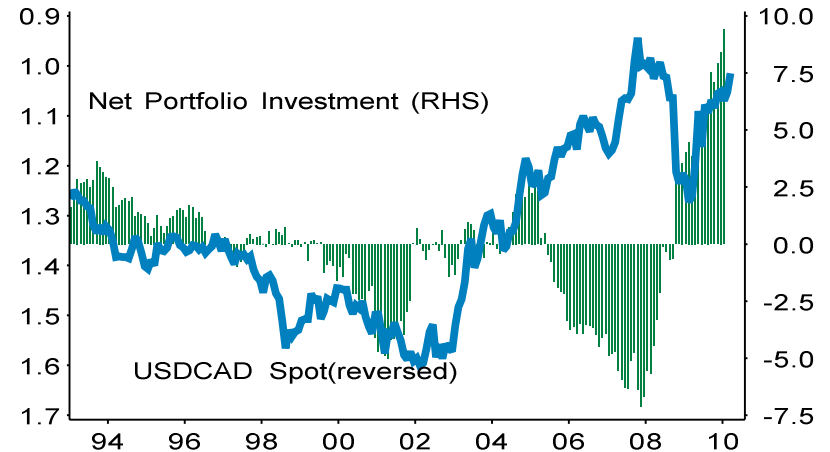


# CAD: Strong Fundamentals, but risk driven

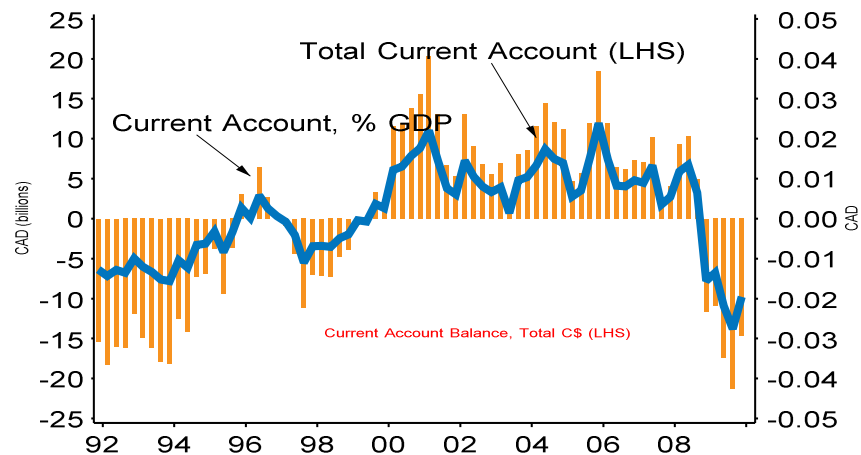
## Basic balance strong, but....



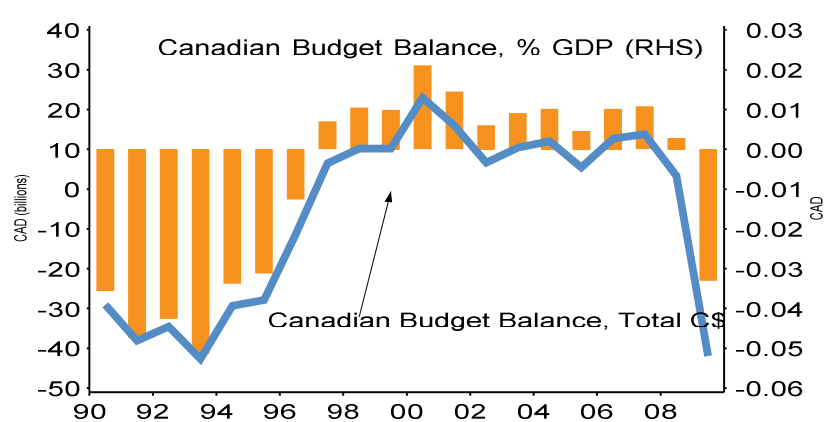
## ...driven by portfolio flows ...



## ..while the current account turned negative



## ...and so has the fiscal account

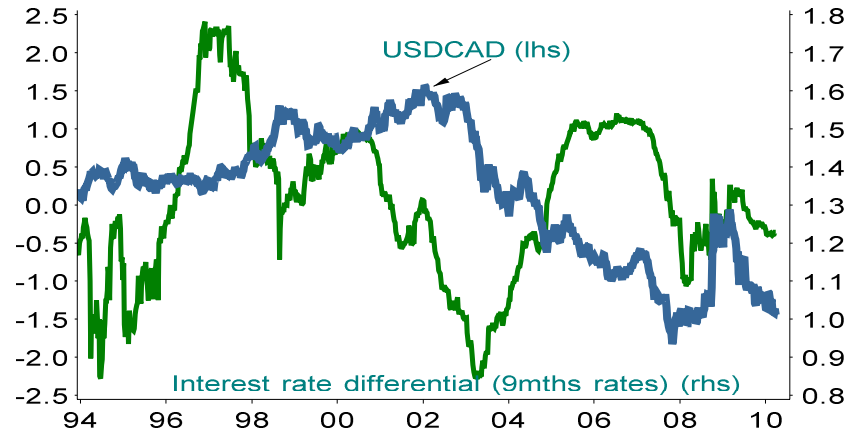


Source: Reuters EcoWin Pro

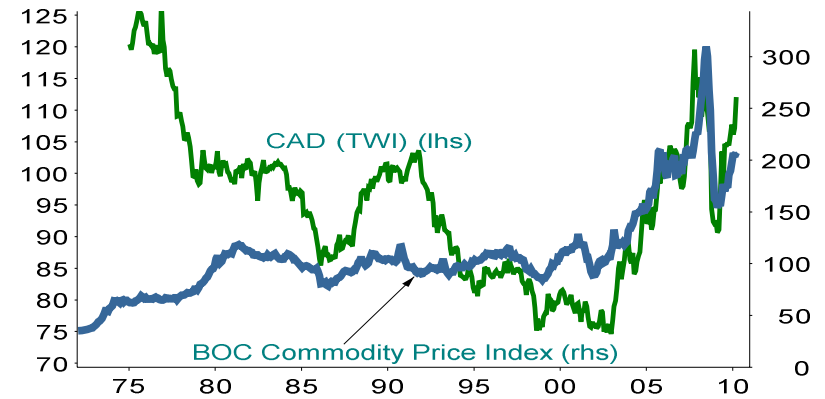


# So what drives the CAD?

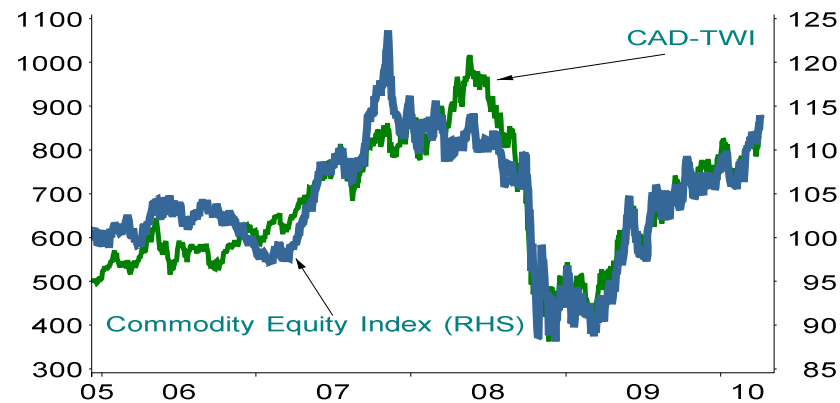
## Forget rate differentials



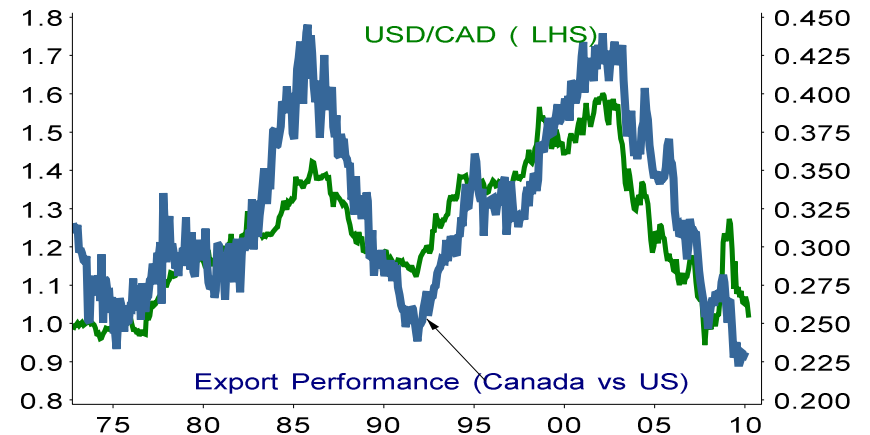
## Commodity prices have become more important



## Watch risk when trading the CAD



## Net exports have declined to its lowest level since 1993



Source: Reuters EcoWin Pro

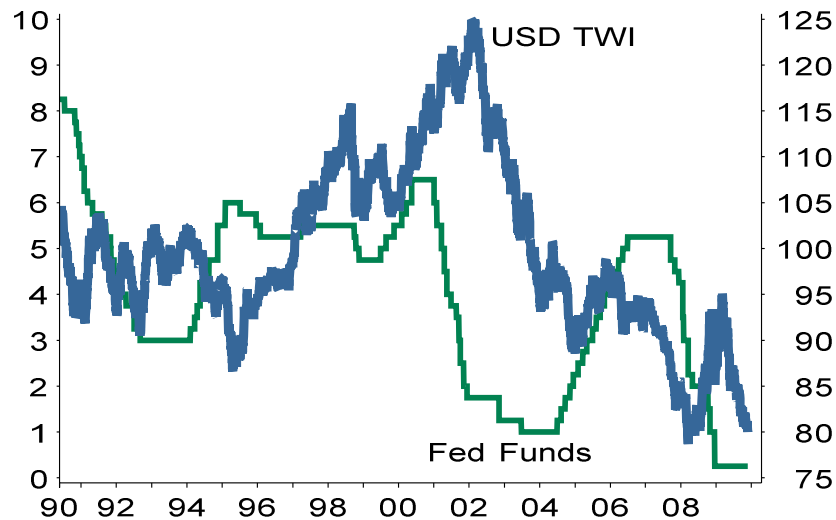


## Choice of Funding Currencies key for 2010

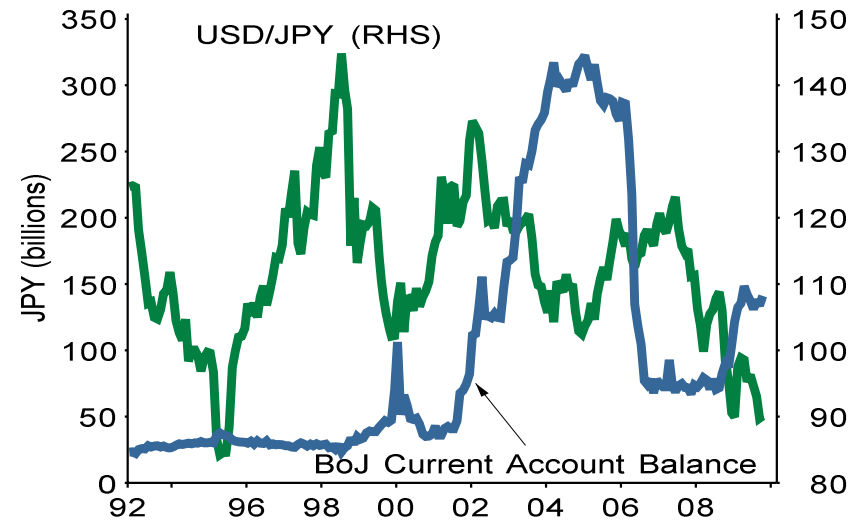
### Currency trends to be uneven in 2010

- USD has been the funding currency of choice over the past year, given near-zero rates and depreciating trend...
- ...however, USD likely to rebound in 2010
- Longer term, US rates expected to rebound sharply...Fed to raise rates in Q2 2010
- JPY strong appreciation trend expected to come to an end in 2010...
- ...BoJ may even have to consider renewed QE as Japan remains in grip of deflation

USD TWI and Fed Funds



USDJPY and BoJ Current Account Balances

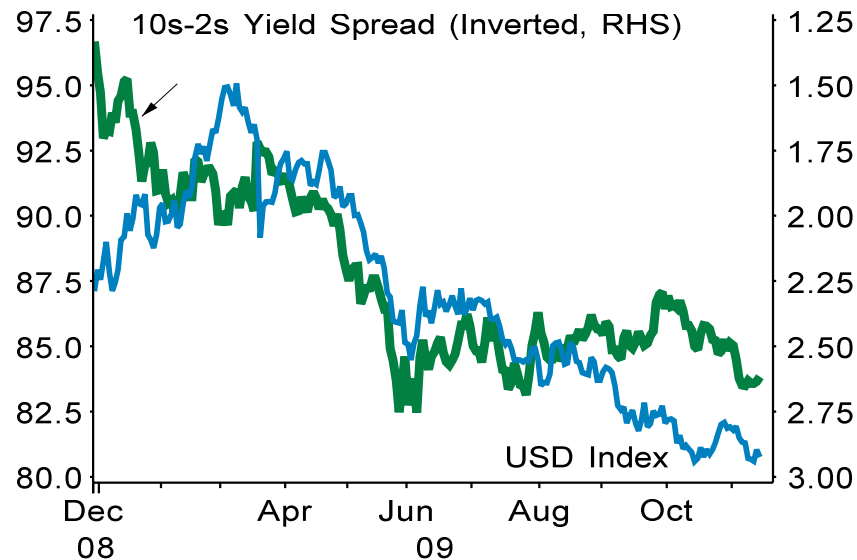


## USD used as a funding currency

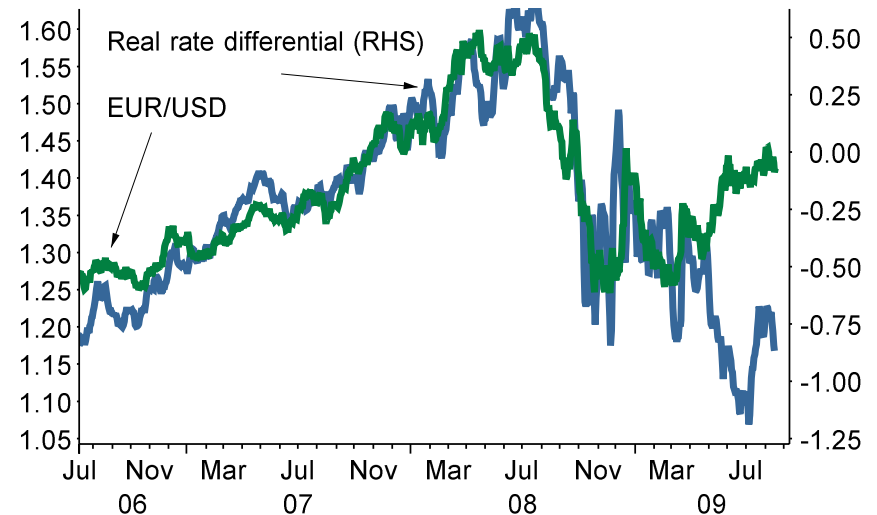
### USD to gain support from an eventual position unwinding

- The USD has been used extensively as a funding currency during the recent build up of risk appetite...
- ...suggesting that the USD will gain support on any position unwinding
- Anticipated investor disappointment at the slow pace of recover to provide renewed support for the USD...
- ...real yield and interest rate differentials suggest a higher USD
- Foreign investor confidence in US assets being restored by the Fed slowing down QE

USD Yield Curve and USD Index



Real Rate Differential and EURUSD

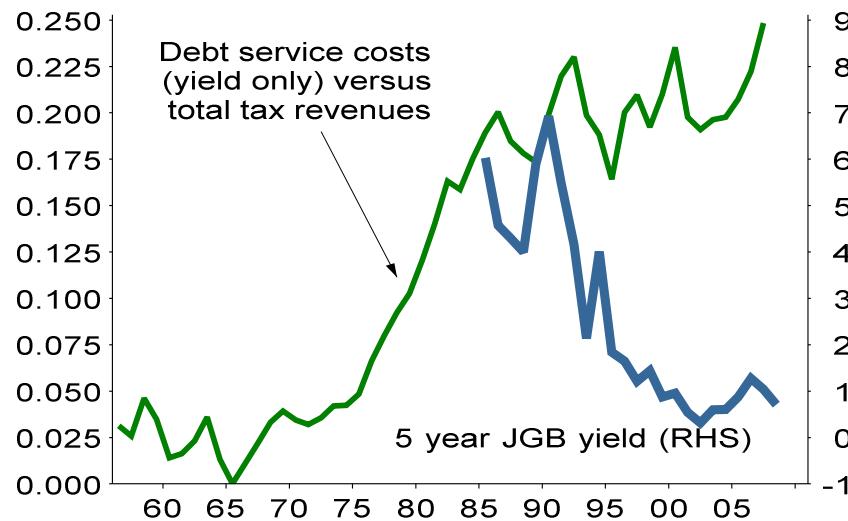


## JPY to come under pressure in 2010

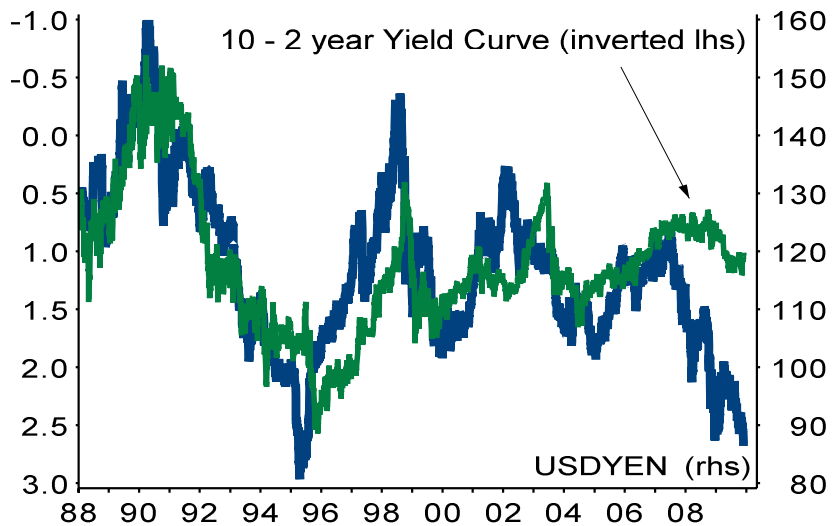
### JPY to regain funding currency status

- Japanese debt levels extremely high...
- ...Japan debt to GDP one of the highest globally (after Zimbabwe) forecast to exceed 200%
- ...debt servicing costs above 25% of total tax revenues...
- ...Japan must keep rates and yields low...BoJ buying of JGBs
- JPY to come under pressure, USDJPY to target 108/110 in Q4 2010/Q1 2011
- JPY to become funding currency again

Japanese Debt Servicing Costs



Japanese Yield Curve and USDJPY

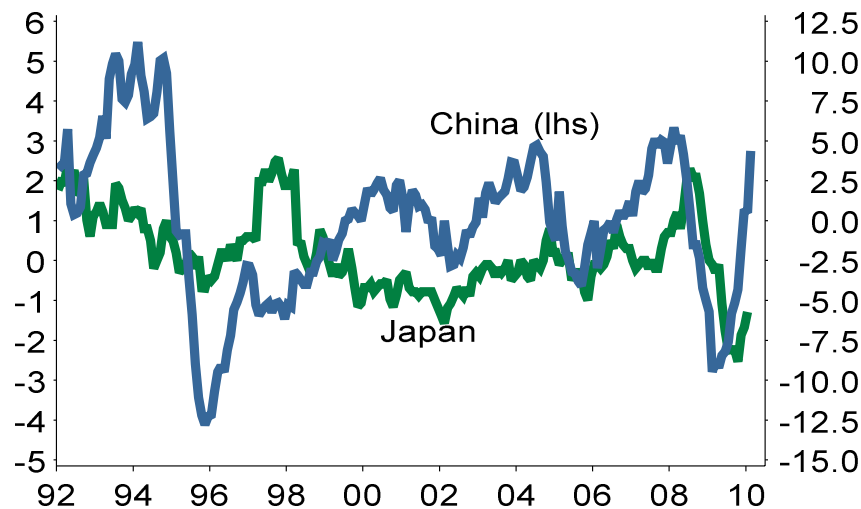


## BoJ under pressure to ease

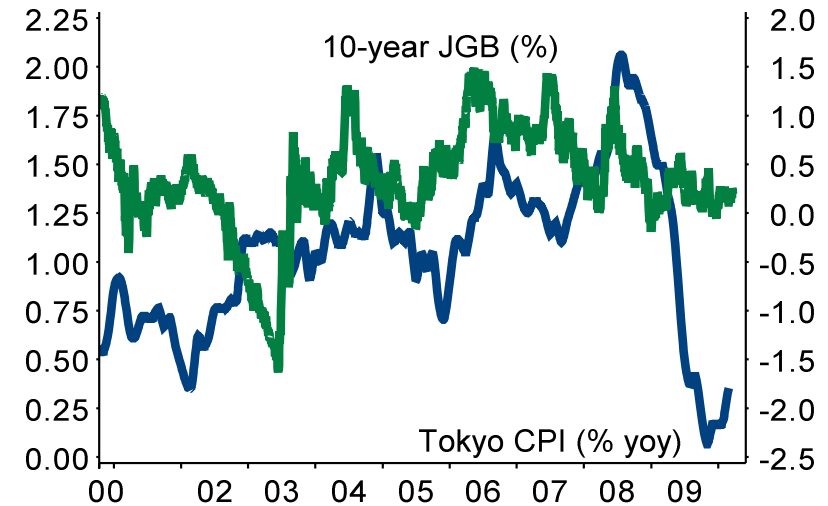
### Japanese Government putting BoJ under intense pressure

- The BoJ has eased policy further by extending special lending facilities following intense political pressure
- We expect further easing measures from Japan as deflationary pressure increases
- A move back into further quantitative easing – increased purchases of JGB's likely
- Increasing political desire to weaken the yen

Japanese and Chinese CPI



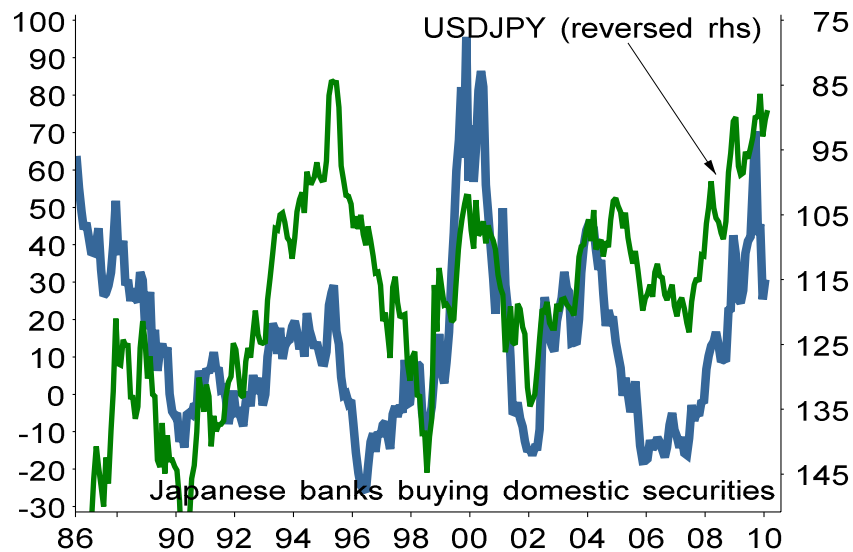
Japanese CPI and Yields



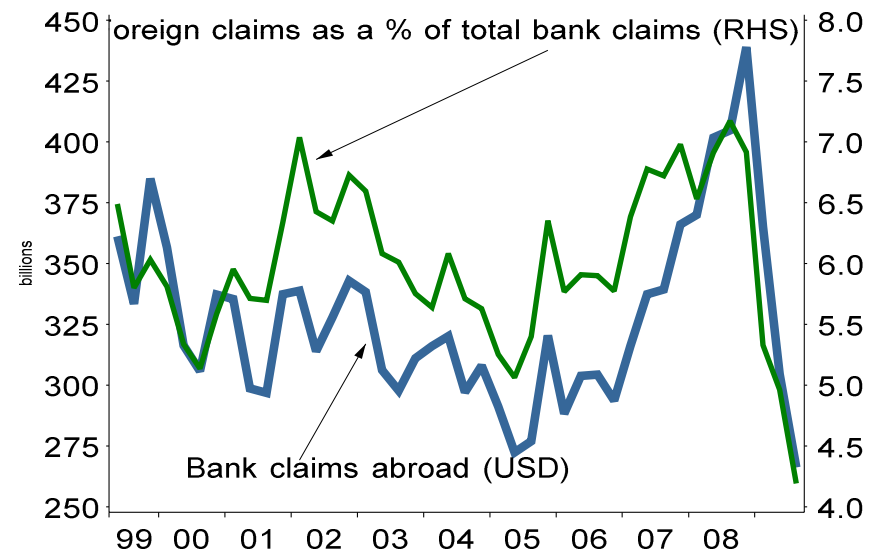
## The JPY Appreciates as Domestic Banks Change Behaviour

- In the past, Japanese banks regarded foreign credit as superior to domestic credit
- Hence domestic asset holdings of Japanese banks have been small relative to foreign claims
- This has changed with the crisis. Japan's banks have become domestic

Japan's banks buy domestic securities



Banks has reduced its foreign claims



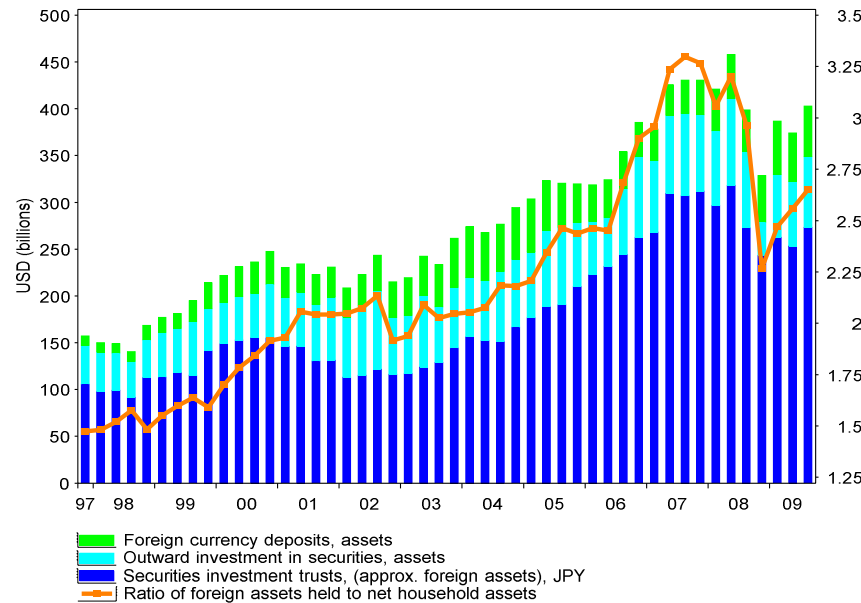
Source: Reuters EcoWin Pro, BNP Paribas



## Japan has started exporting capital

- Japan's households have increased their foreign investment once again...
- ...increasing investment into deposits, securities and investment trusts
- The dip in foreign investments late 2008 has proved temporary
- The JPY should enter a long-term weakening trend

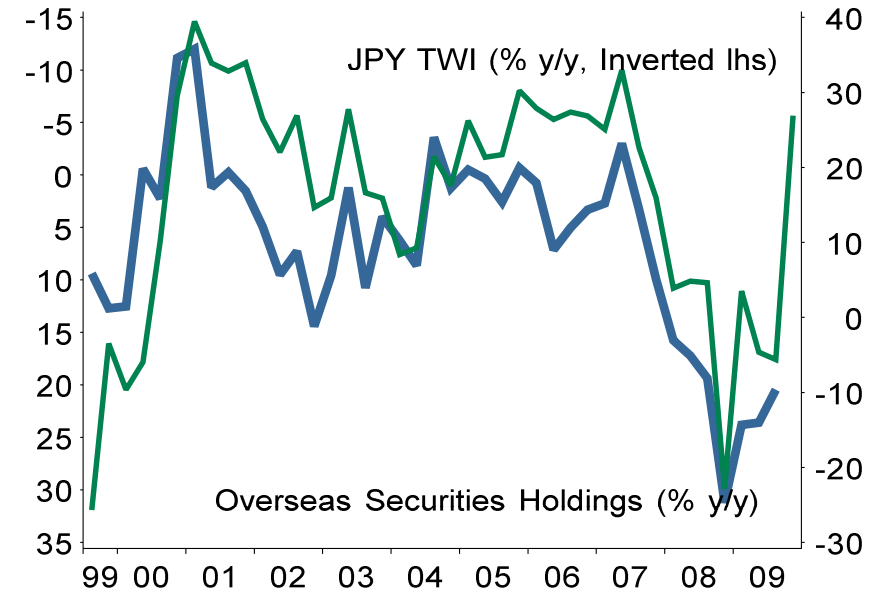
Japan's households net foreign asset holdings



Source: Reuters EcoWin

Source: Reuters EcoWin Pro, BNP Paribas

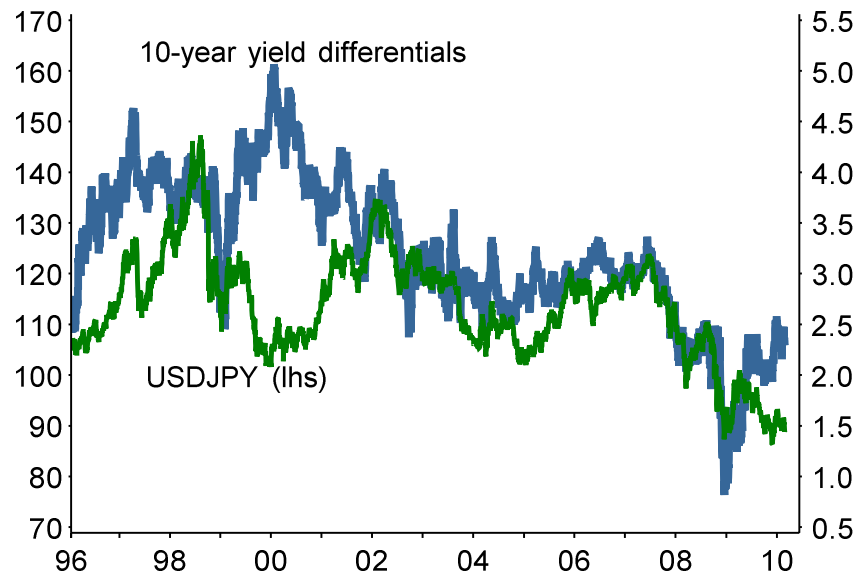
Reduced overseas security holdings caused JPY strength



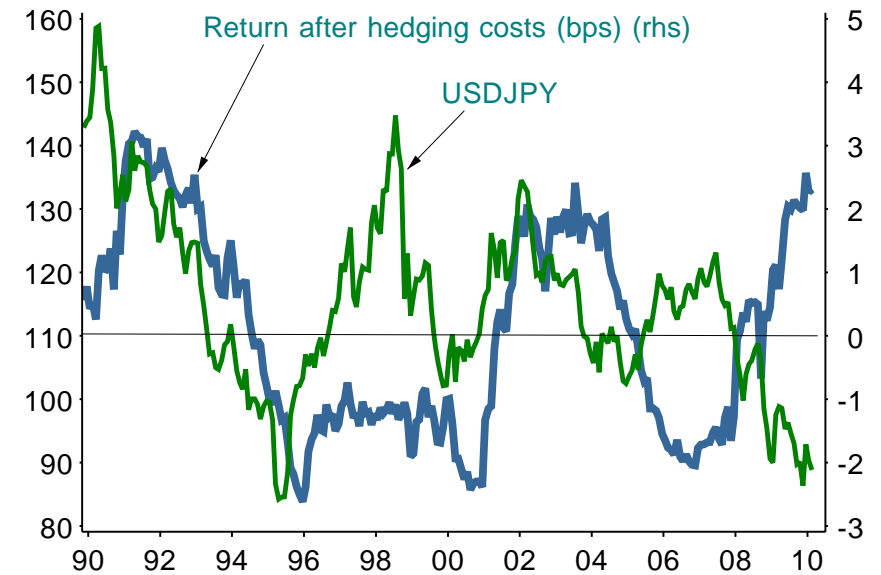
## The JPY message from foreign bond markets

- Widening of USD –JPY yield differential is not yet reflected in the exchange rate
- Japanese investors enjoy record returns on currency hedged foreign bond portfolios
- Most financial foreign asset holdings have been hedged...
- ...but there is now evidence that hedge ratios are being reduced as US rate expectations start to rise and the USD rebounds

Yield differential versus USDJPY

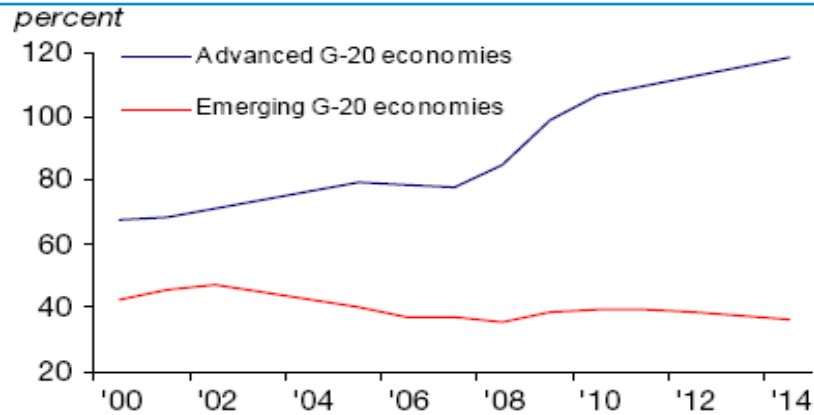


Currency hedged bond portfolio reaches record returns



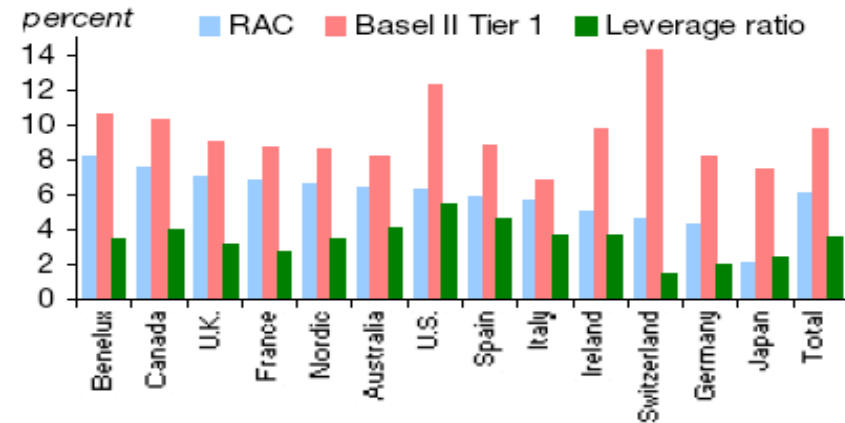
# Debt and Deficit Overview

## G-20 Countries: Evolution of Government Debt Ratios\*



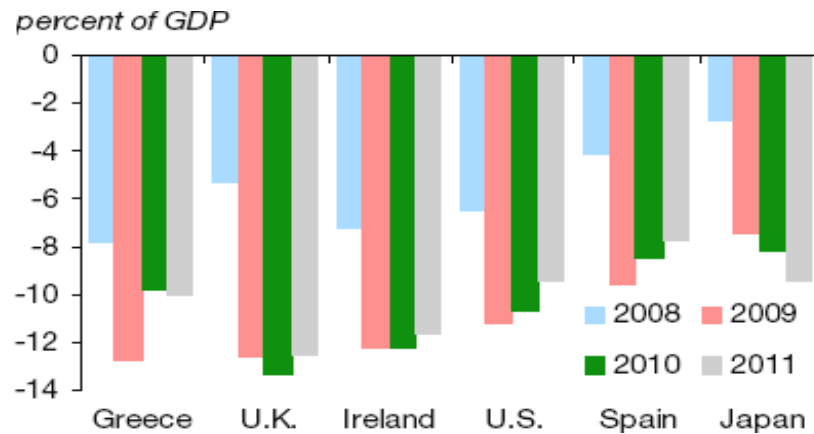
Source: IMF's "The State of Public Finances Cross-Country Fiscal Monitor: November 2009". \* Gross general government debt as a percent of GDP.

## Measures of Capital Strength for Selected Banks



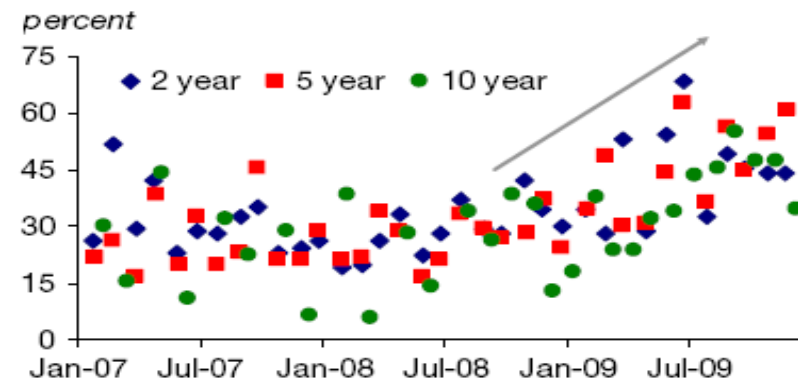
Source: Standard & Poor's. RAC = risk-adjusted capital; leverage ratio: capital as share of total assets.

## General Government Fiscal Balances



Source: OECD Economic Outlook 86.

## Indirect Bidders' Share at U.S. Treasury Auctions

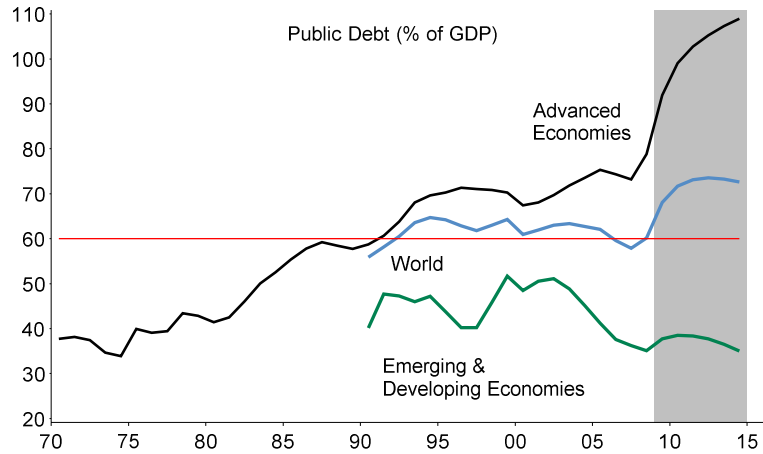


Research by the New York Fed indicates that "the indirect bid is a fairly good proxy for foreign purchases of Treasury notes (securities with original maturities of more than one, but not more than ten years)."



# Debt and deficits will develop currency impact

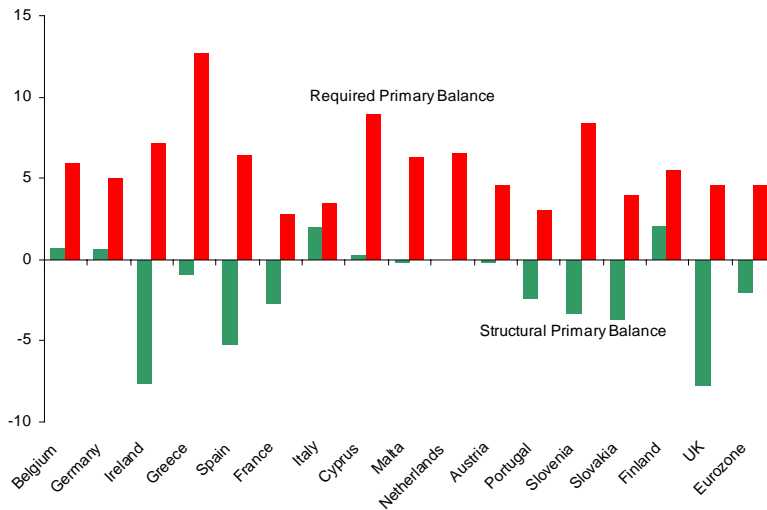
World: Public Debt



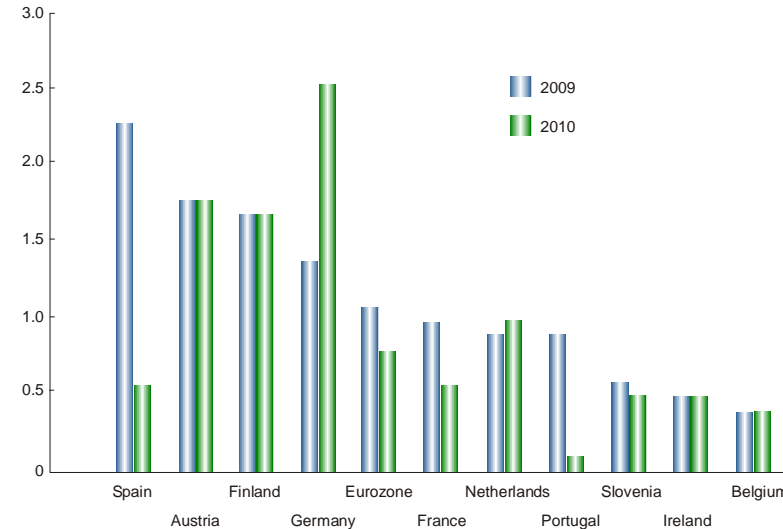
Eurozone: Net Financial Assets (% of GDP)



European Union: Required Primary Balance



Fiscal Stimulus Measures (as a % of GDP)



Source: Thomson Reuters Datastream; Consensus Economics; Capital Economics

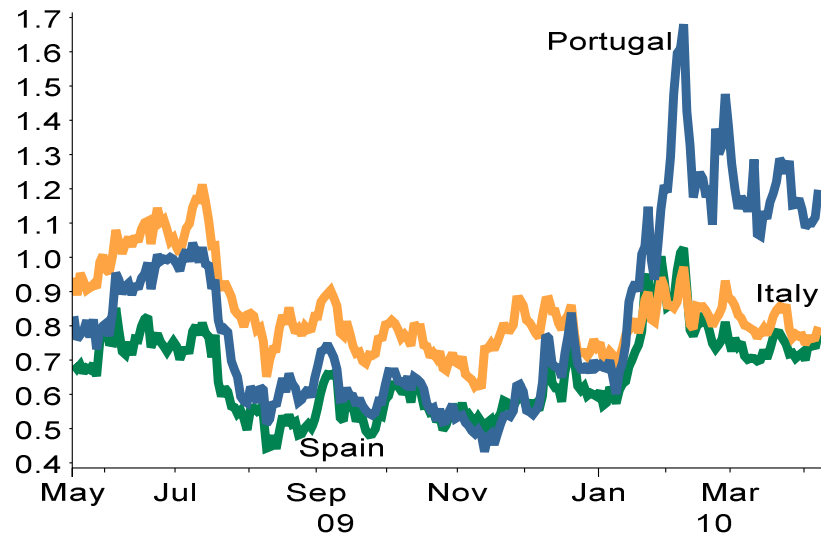


## European Problems Exposed

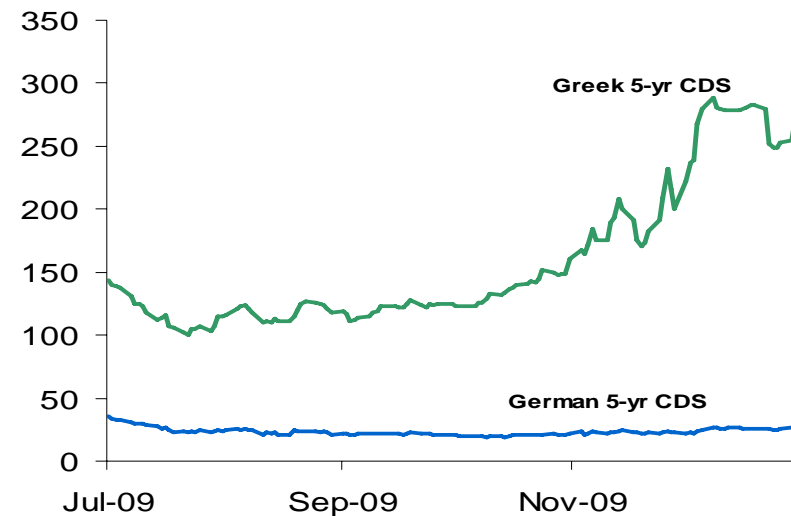
### Europe is in the most vulnerable position

- ECB preparing to start removing liquidity with the December 1-year repo the last
- ECB has warned European banks not to rely on ECB liquidity measures
- In 2010 problems in the eurozone will be revealed
- Greek banks have been using relative cheap funding to invest in local bonds...
- ...this helped Greek government funding
- Now that ECB liquidity is being withdrawn Greek government funding is becoming move difficult...
- ...local banks potentially under pressure as spreads widen

**Eurozone Sovereign Bond Spreads**



**Greek and German 5-Year CDS Spreads**



## EMU divergence unsustainable

### EMU Current Account dispersions and the implications for Net Foreign Asset (NFA) position

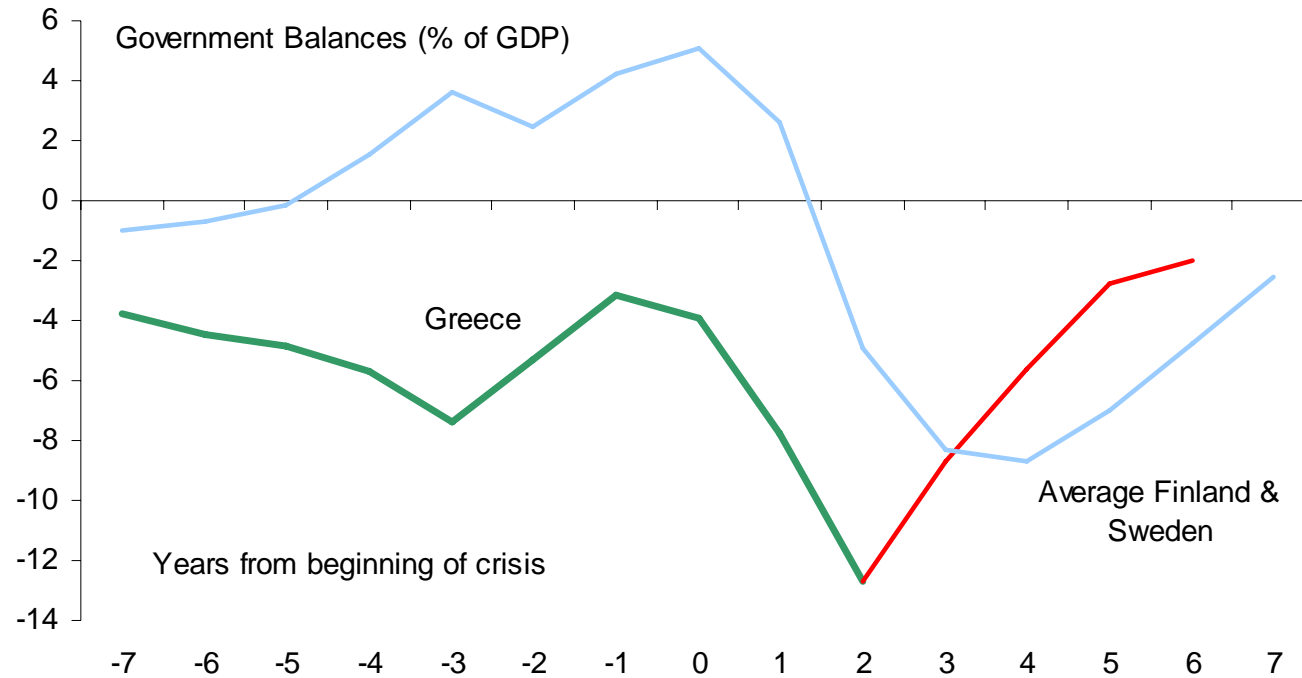
	Account Balance (1)	Estimated Equilibrium Current Account	NFA Position	NFA Position when the Current Account Balance reaches Estimated Equilibrium (2)
	2010	(2007, in percent of GDP)		
Austria	1.9	1.1	-20	-10
Belgium	-2.0	2.5	36	40
Finland	3.0	-0.3	-23	10
France	-2.2	0.6	-6	-9
Germany	4.1	2.5	33	52
Greece	-9.6	-4.4	-115	-174
Ireland	-1.5	1.1	-6	-45
Italy	-3.1	-0.1	-8	-22
Netherlands	5.5	2.2	3	35
Portugal	-10.1	-5.8	-95	-107
Spain	-5.2	-5.7	-90	-109

1) Data are based on the 2009 World Economic Outlook estimates

2) The estimated speed of convergence implies that 70% of the deviation of the current account from the steady state is closed in about 10 years.



## Greece: Public Balance

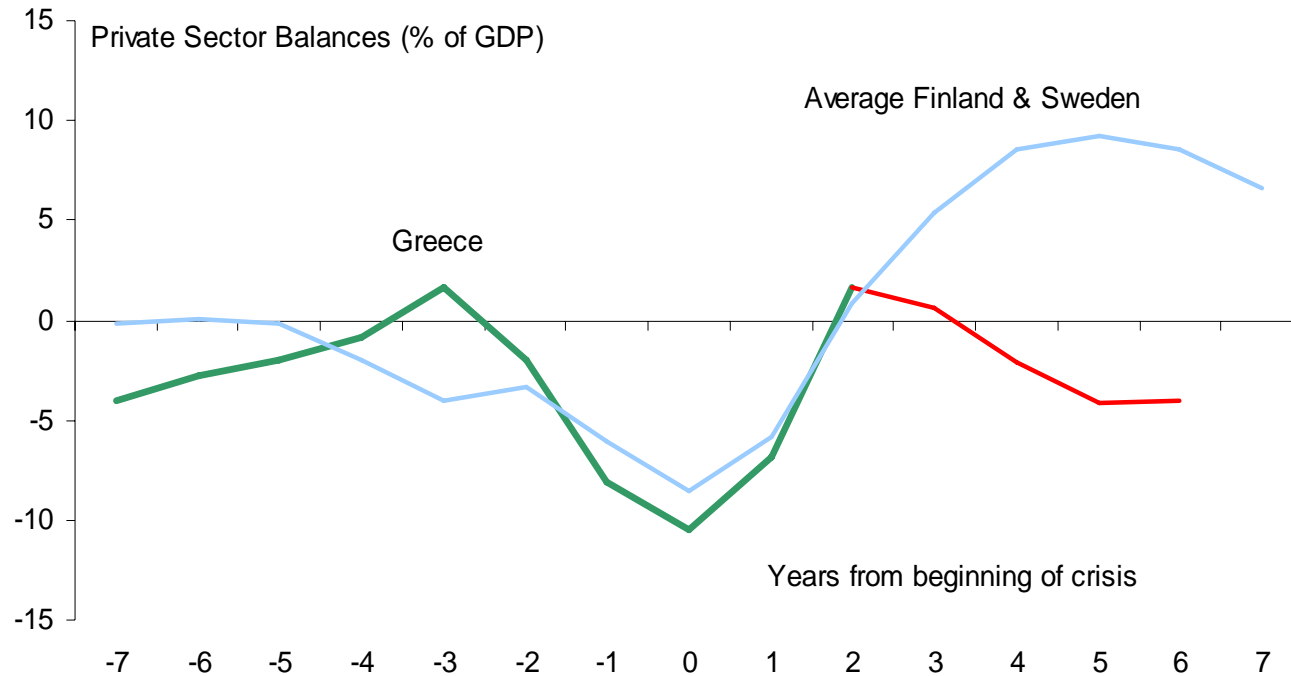


Source: OECD, BNP Paribas

- Aim to tighten more quickly than Sweden and Finland were able to after their early 1990s crises
- Is this realistic given track record?
- Is it realistic given increasing interest burden? Effective tightening is even greater



## Greece: Private Balance



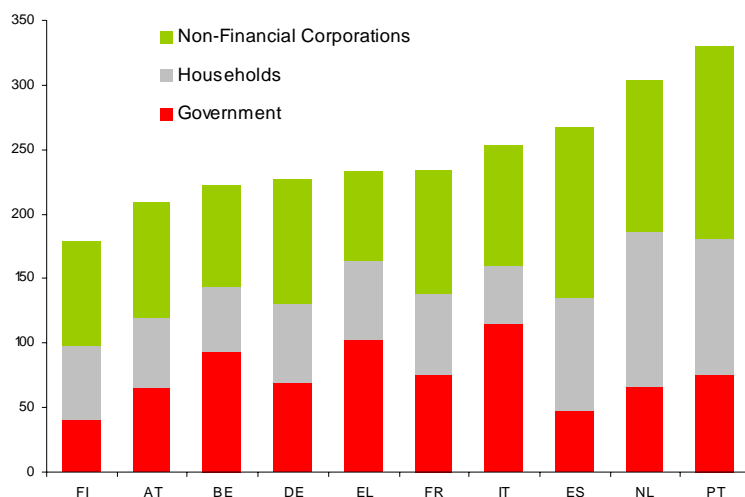
Source: OECD, BNP Paribas

- Also assuming private sector behaves very differently to past experience of crises
- Usually private sector retrenches for a number of years after financial crisis
- If private sector follows usual pattern, fiscal tightening will result in much weaker growth...
- ... or tightening to extent forecast just will not happen, or both

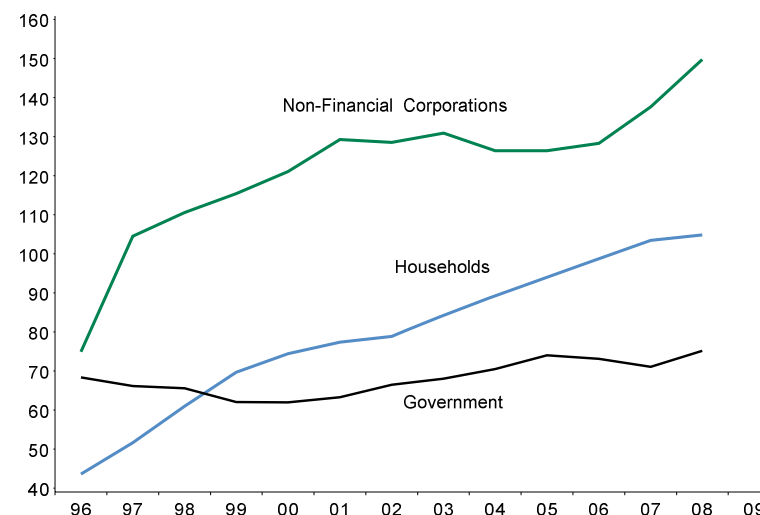


## Portugal: High Private Debt

Financial Liabilities (% of GDP)



Financial Liabilities (Portugal, % of GDP)

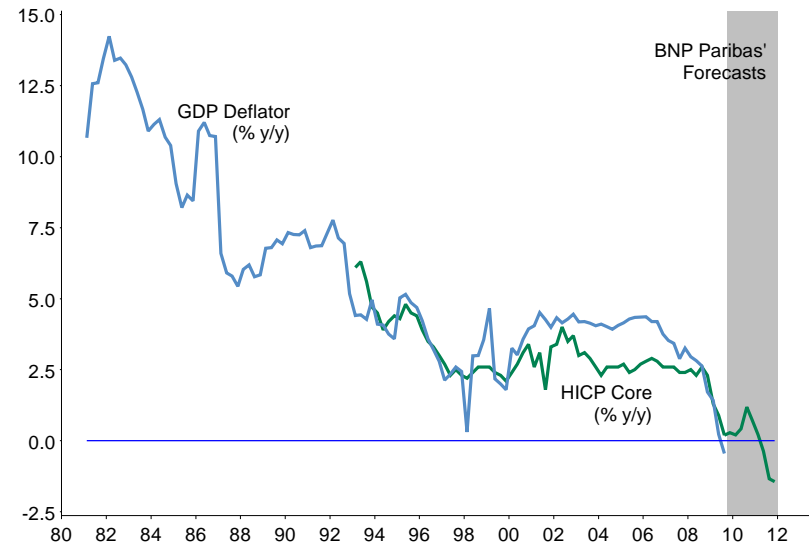
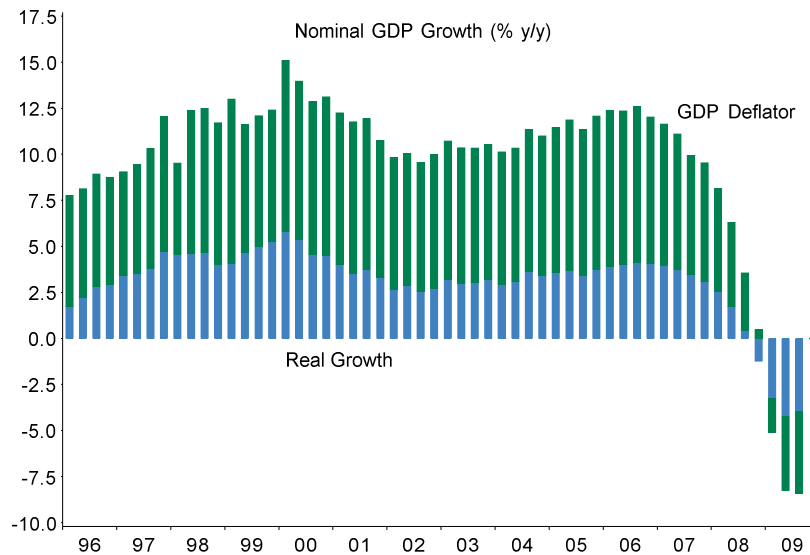


Source: Reuters EcoWin Pro, BNP Paribas

- General government liabilities as a % of GDP have been pretty much constant over the past ten years...
- ...and close to the eurozone average
- But debt of the private sector rose sharply
- Total liabilities as a % of GDP are the highest across eurozone countries, with the exception of Ireland



## Spain: The New Portugal?



Source: Reuters EcoWin Pro, BNP Paribas

- In the period 1998-2008, nominal growth averaged 7.3%, with real growth at 3.6%
- But the EU Commission estimates potential growth fell to zero following the financial crisis
- The change in the GDP deflator is also likely to be very low, probably negative, over the next few years



## Spain: Over-Ambitious Targets

	2007	2008	2009	2010	2011	2012	2013
Real GDP Growth (% y/y)	3.6	0.9	-3.6	-0.3	1.8	2.9	3.1
Nominal GDP Growth (% y/y)	7.0	3.4	-3.4	0.2	3.3	4.9	5.2
GDP Deflator (% y/y)	3.4	2.5	0.2	0.5	1.5	2.0	2.1
Net Public Lending (% of GDP)	1.9	-4.1	-11.4	-9.8	-7.5	-5.3	-3.0

*Source: Stability and Growth Plan 2010-2013, Ministry of Finance, January 2010*

- Fiscal targets are based on the assumption of real growth returning above trend by 2012
- Adding inflation, nominal growth is estimated at around 5% in 2012-13
- But the actual turnout might be well below those levels



# Competitive wealth gap

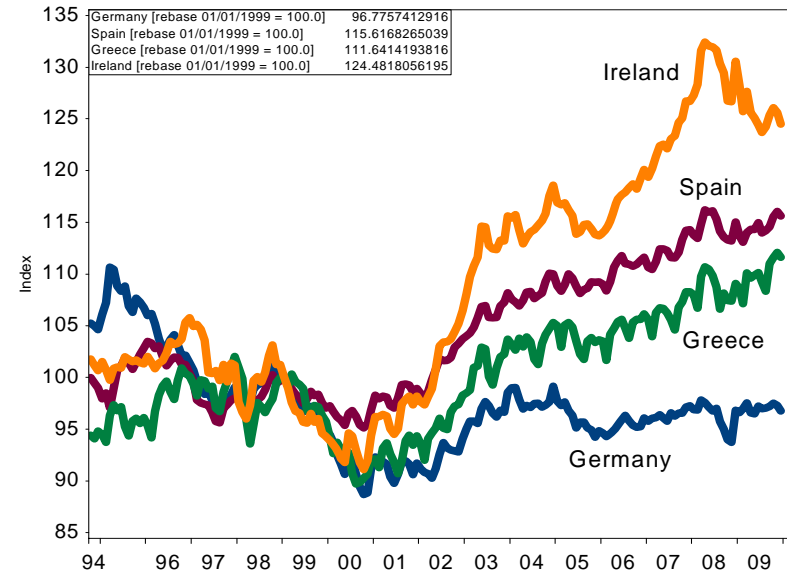
## Industrial Nations Debt Ratios on The Rise

	Fiscal deficits (% of GDP)				Public debt (% of GDP)			
	2007	2009	2010e	2014e	2007	2009	2010e	2014e
Australia	1.5	-4.3	-5.3	-1.1	10	17	23	28
China	0.9	-3.9	-3.9	-0.8	20	20	22	20
France	-2.7	-8.3	-8.6	-5.2	64	78	85	96
Germany	-0.5	-4.2	-4.6	0	63	79	85	96
India	-4.4	-10.4	-10	-5.7	81	85	86	79
Italy	-1.5	-5.6	-5.6	-5.3	104	116	120	129
Japan	-2.5	-10.5	-10.2	-8	188	219	227	246
U.K.	-2.6	-11.6	-13.2	-6.8	44	69	82	98
U.S.	-2.8	-12.5	-10	-6.7	62	85	94	108
G-20	-1	-7.9	-6.9	-3.7	62	75	80	86
Advanced	-1.9	-9.7	-8.7	-5.3	78	99	107	118
Emerging	0.3	-5.1	-4.1	-1.3	37	39	40	36

Germany has changed its constitution not allowing sovereign deficits from the year 2014 onwards. Other G-7 nations will continue accumulating debt with Japan leading this process.

Source: BNP Paribas

## The Real Effective Euro (OECD)



Source: Reuters EcoWin

Real effective exchange rates suggest that Ireland and Spain are operating with a higher effective euro rate than Greece, highlighting the extent of divergence in EMU.

Source: Reuters EcoWin Pro

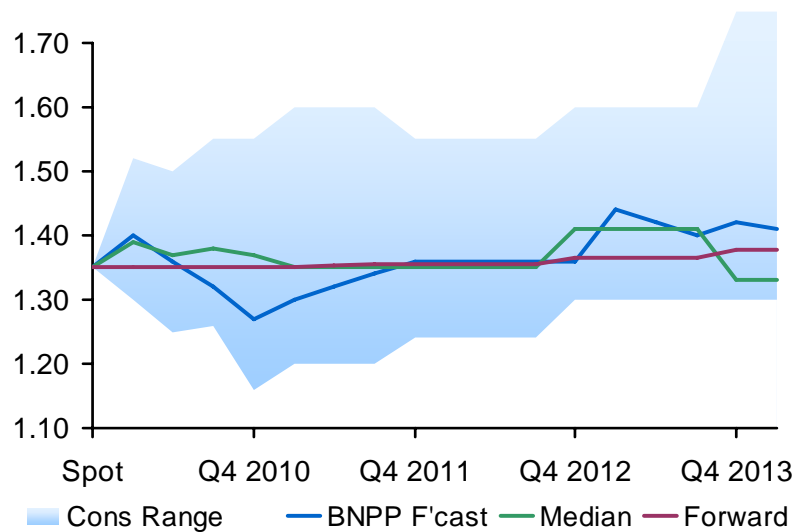


# BNP Paribas Euro Forecasts

## Euro to come under pressure in 2010

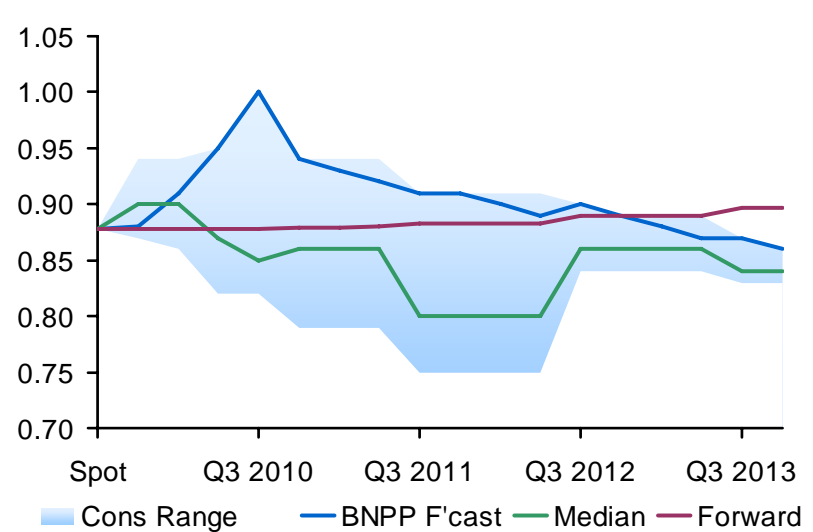
- We have a significantly below consensus forecast for the euro in 2010
- Market consensus has moved higher for the euro since December
- Euro weakness expected to accelerate in the second half of 2010

BNP Paribas EUR/USD vs Consensus and Forwards



Source: Reuters Bloomberg, BNP Paribas

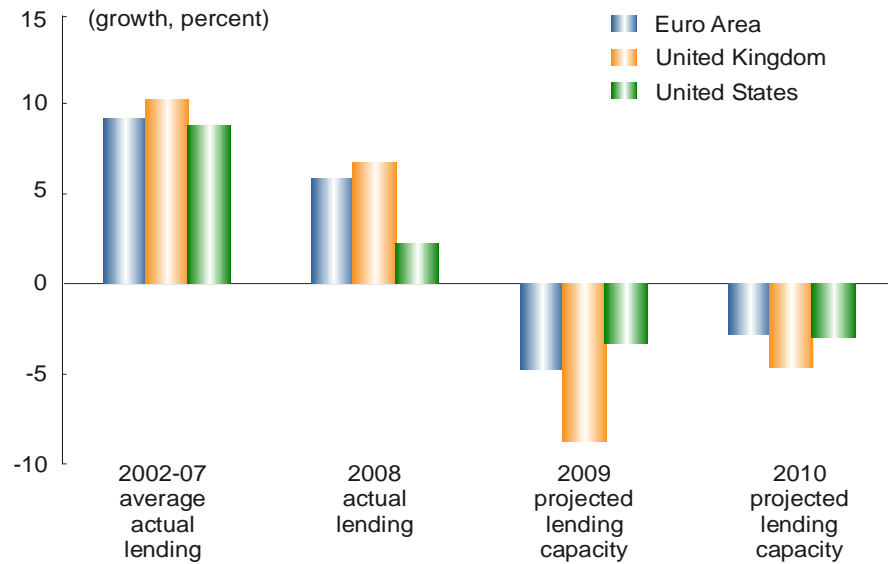
BNP Paribas EUR/GBP vs Consensus and Forwards



# Bank Lending constrained

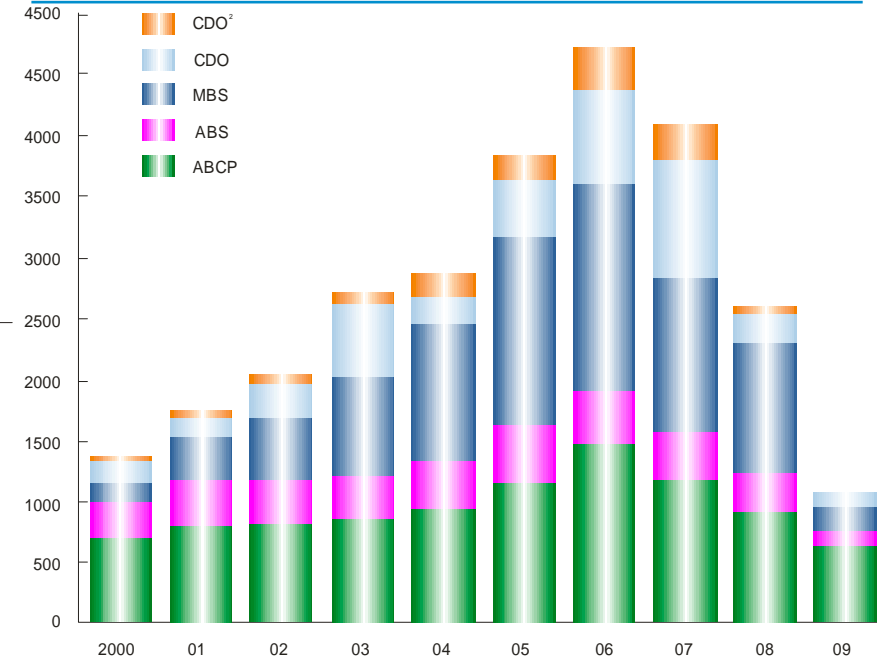
- Pressure on balance sheets is set to grow, diminishing their ability to increase lending
- Reduction in bank lending to be extended into 2010 according to IMF estimates with the UK hit the hardest
- The reduction in bank lending will have a significant impact on the pace of recovery, which we expected to disappoint market expectations.

## Bank Lending Capacity



Source: IMF

## Private Securitisation

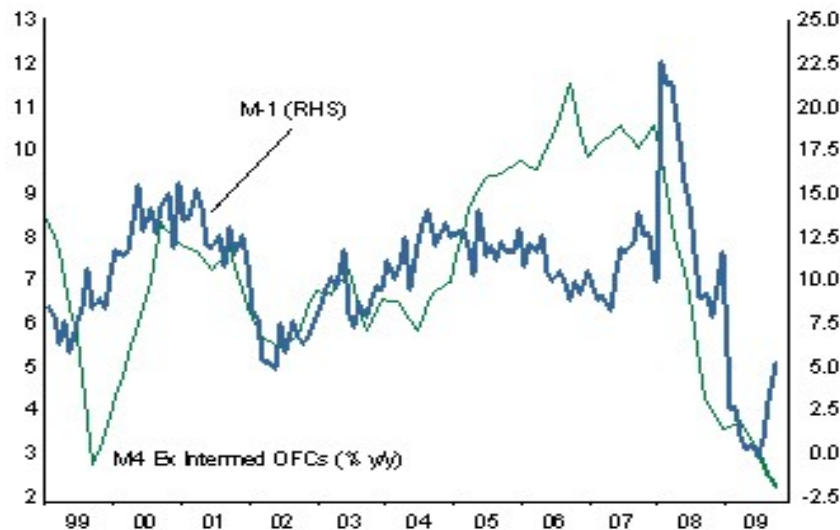


## UK Money Supply Implodes

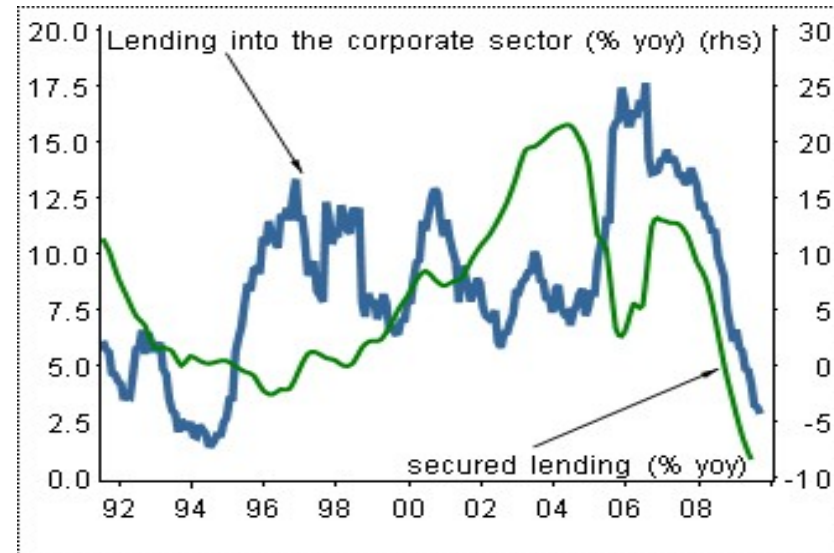
### Credit continues to contract

- The undistorted measure of UK money supply continued to collapse...
- ...with the contraction in credit growth leading the way
- A break down of the data shows the only rebound is being seen in mortgages while lending to corporates is still declining
- This suggests that credit is being channelled into unproductive area of the UK economy

UK Money Supply is Imploding



UK Corporate Credit growth Slows

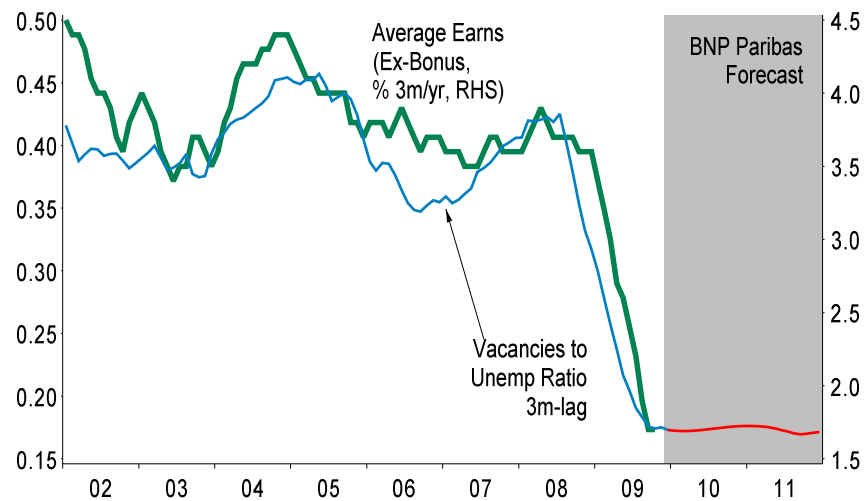


## Slow UK Recovery to Weigh on Sterling

### Sterling to remain the underperformer

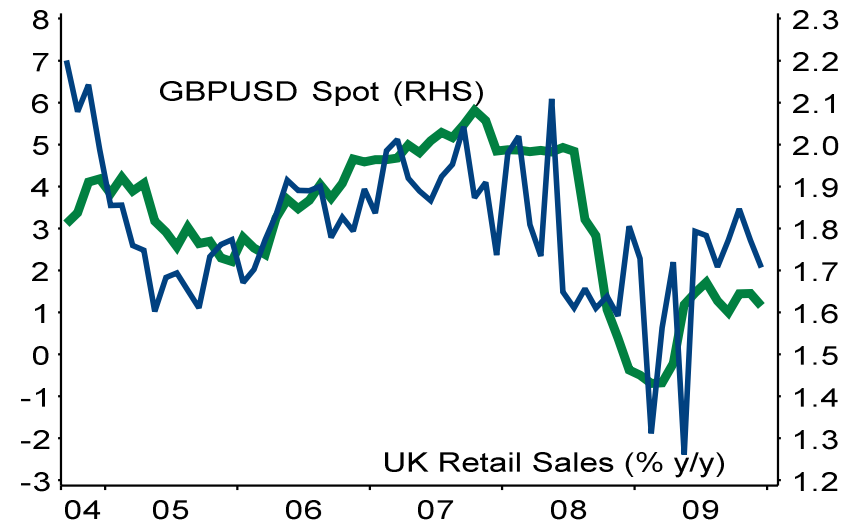
- The UK labour market is slack – vacancies down and unemployment up...
- ...suggests that wage growth will be slow
- Consumption is also likely to remain weak...
- ...rebound in retail sales may prove short lived (VAT hike)
- Sterling has traditionally correlated well with UK retail sales

#### UK Retail Sales and Labour Market



Source: Reuters Ecowin Pro, BNP Paribas

#### UK Retail Sales and GBPUSD

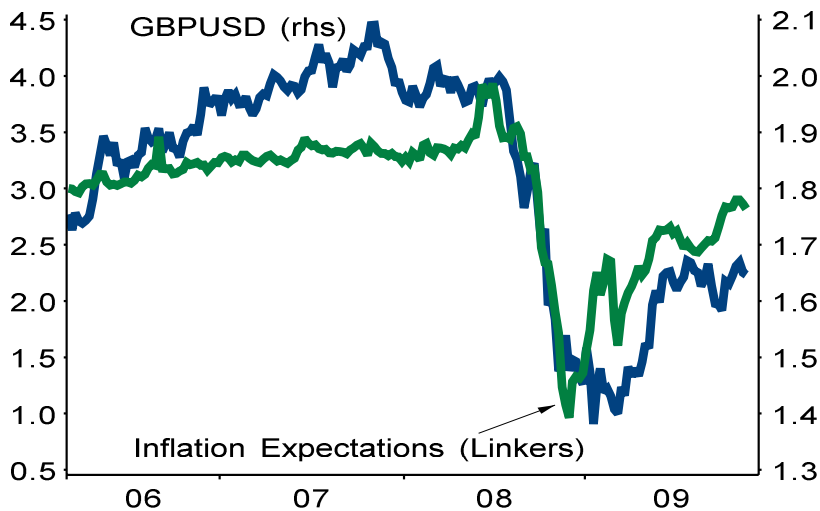


# UK Rate Expectations Overdone

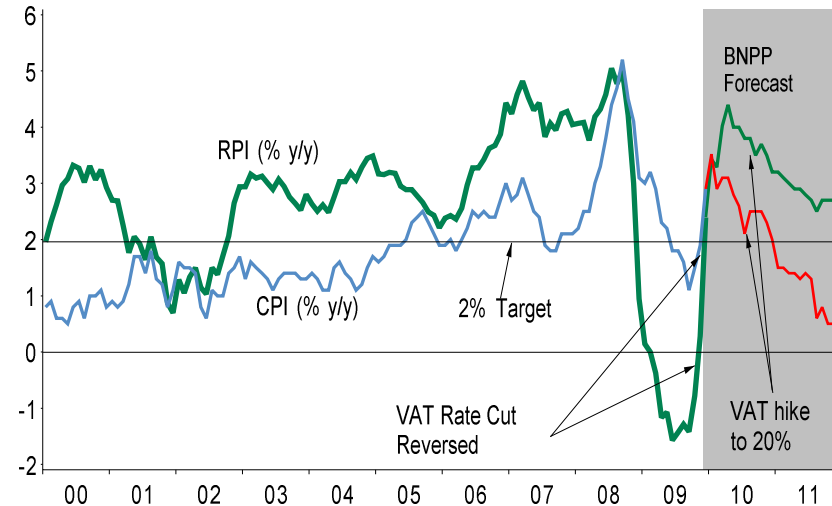
## UK Inflation spike will be temporary

- UK inflation is expected to spike higher in early 2010...
- ...but this will be temporary driven by oil and the reversal of the VAT cut
- This suggests that the BoE will not respond with a policy action to this event
- Hence, UK rate expectations are overdone and will have to be adjusted lower
- Sterling is expected to come under pressure in 2010
- EURGBP to target 1.00 and GBPUSD to target 1.40/1.38

### UK Inflation Expectations and GBPUSD



### UK CPI and RPI Forecasts

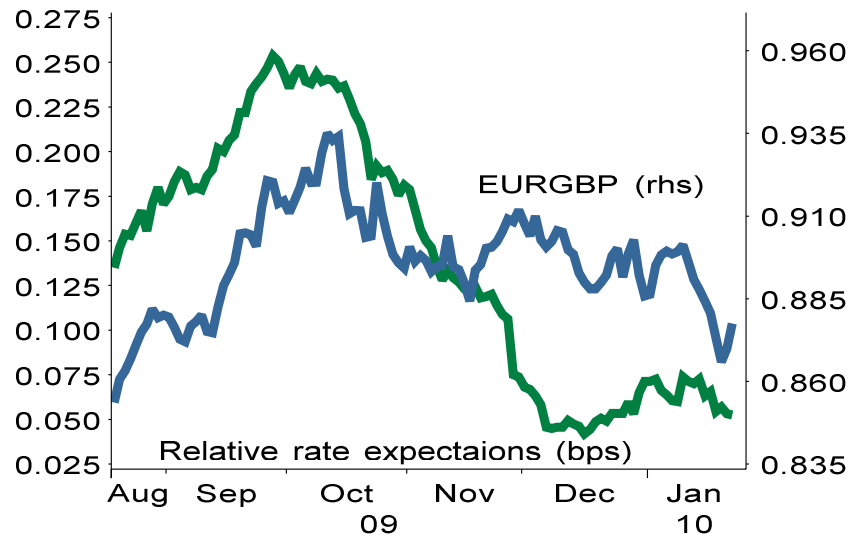


## Bearish sterling medium term

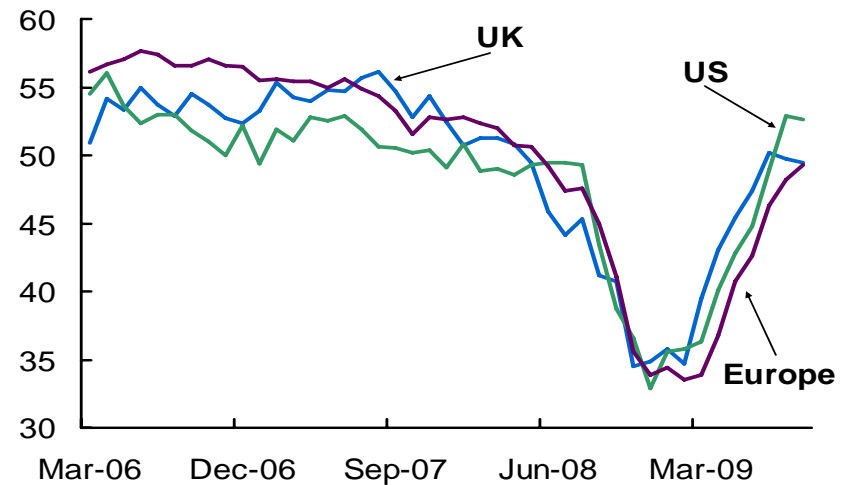
### Outright sterling weakness

- We expect sterling to come under pressure as the relative contrasting tones of the BoE and ECB are revealed
- Recent comments by BoE's King have remained on the dovish side...
- ...but inflation overshoot likely to constrain further QE moves
- Market rate hike expectations for the UK are overdone and will have to be scaled back, putting sterling under pressure
- The BoE is not expected to hike rates for an extended period of time

EURGBP and relative rate expectations



Manufacturing PMIs

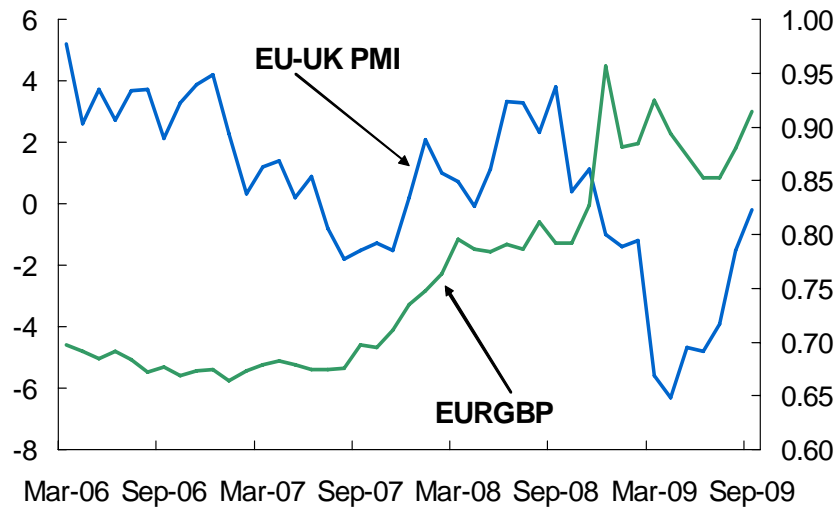


## Sterling supported by optimism

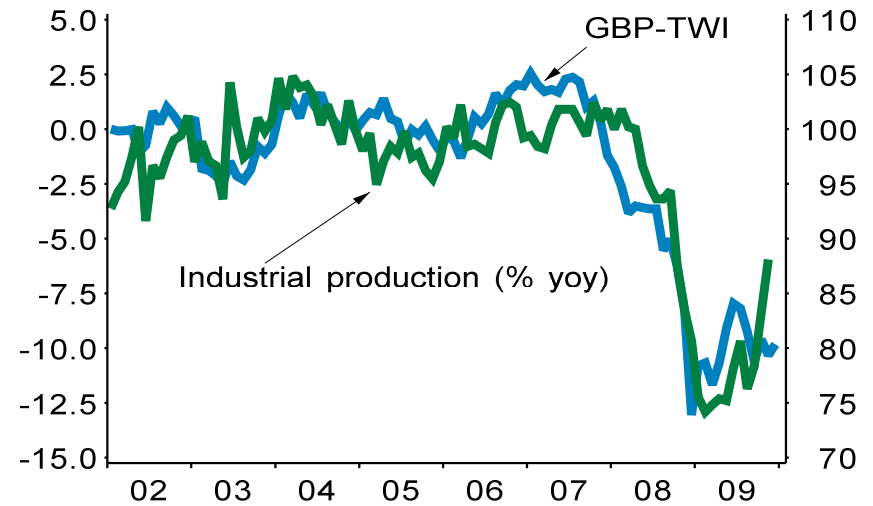
### UK set for disappointment

- Given the level of optimism built in to UK markets, this is where the largest risk of disappointment is currently developing in our view
- Activity data from the UK has struggled to match market optimism
- Despite the UK PMI being the first to rebound, UK GDP has been one of the last to recover
- By comparison optimism in the eurozone has been slower to build, suggesting less scope for disappointment

EU-UK PMI and EURGBP



UK Industrial Production

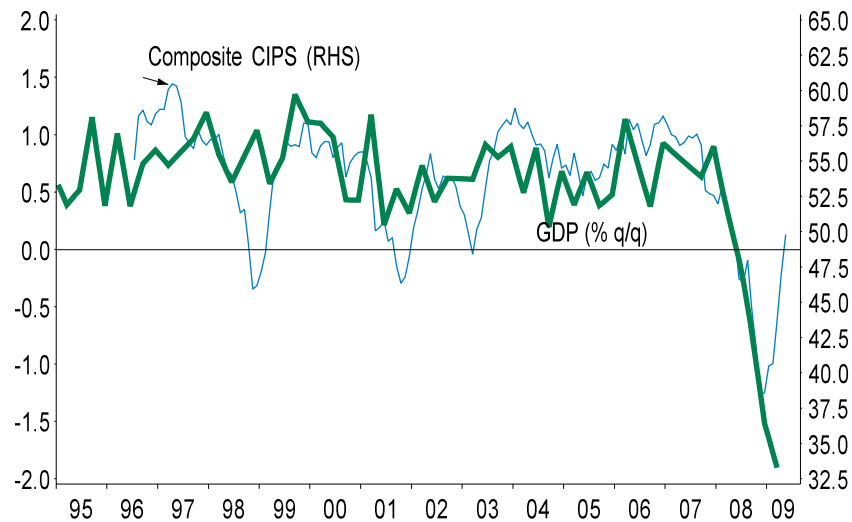


## UK short term positive signs...

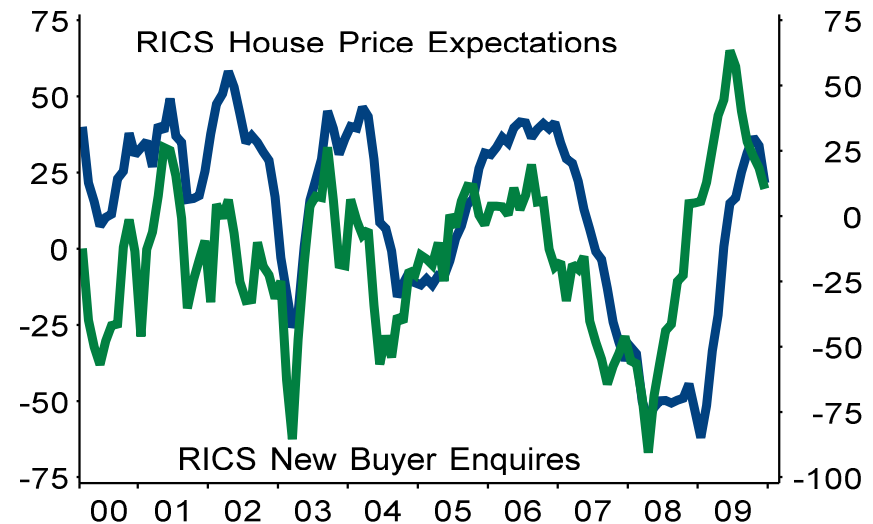
### The leading indicators in the UK are providing positive signals

- Many leading indicators are now moving sharply higher...
- ...the CIPS Survey has rebounded back above the 50 level, triggering talk of a return to positive growth
- Leading indicators in the housing market have been rebounding strongly...
- ...but housing indicators are now showing signs of moderating
- While equity markets maintain their recovery trend sterling will remain supported...
- ...but if asset markets stall sterling will be vulnerable

#### UK CIPS Composite and GDP



#### UK Housing Market Leading Indicators

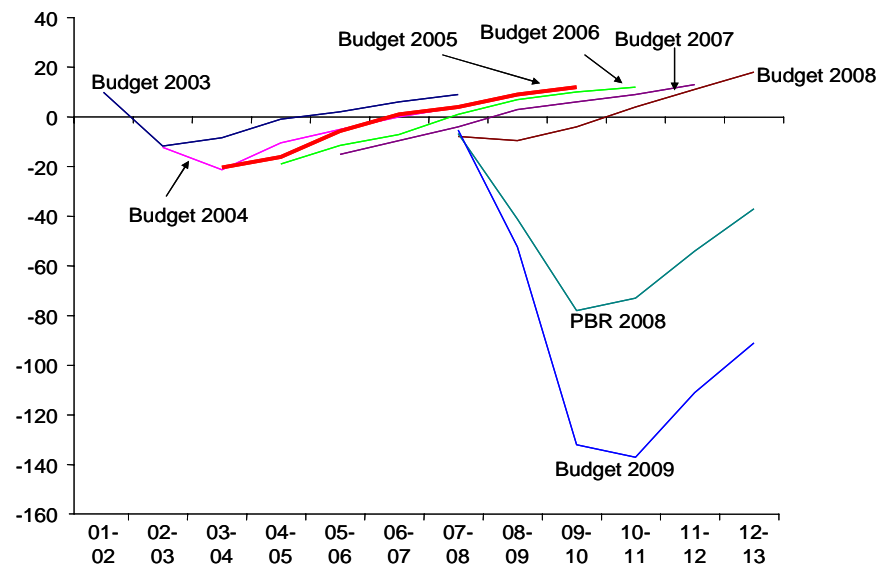


## ...put longer term problems building

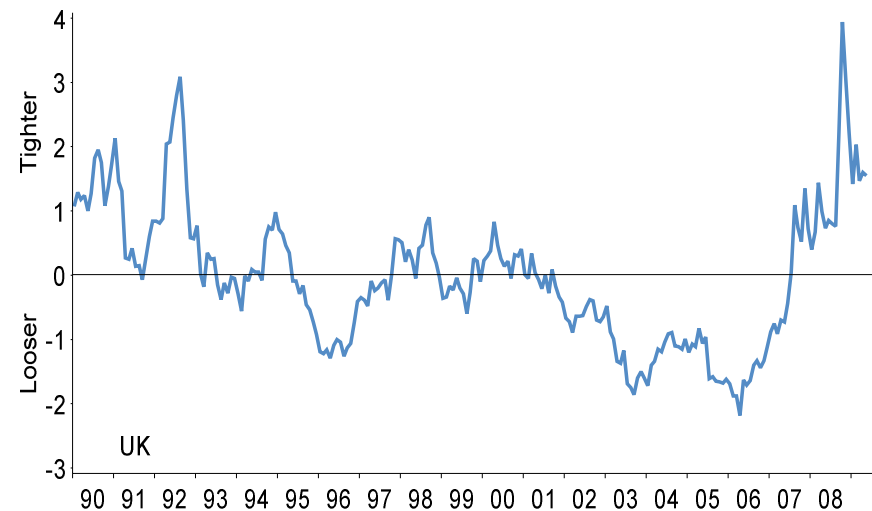
### The sharp deterioration in the UK fiscal position will cause problems

- The fiscal position is expected to deteriorate significantly in the UK...
- ...the budget deficit is expected to peak at 12% of GDP, but could well be higher (1% of GDP is GBP14bn)
- Tightening of fiscal policy post the UK general election is likely to leave the BoE with little choice than to run loose monetary policy...
- ...UK asset markets and sterling could be the longer term under performers

UK Budget Deficit/Surplus



UK Financial and Monetary Conditions Index

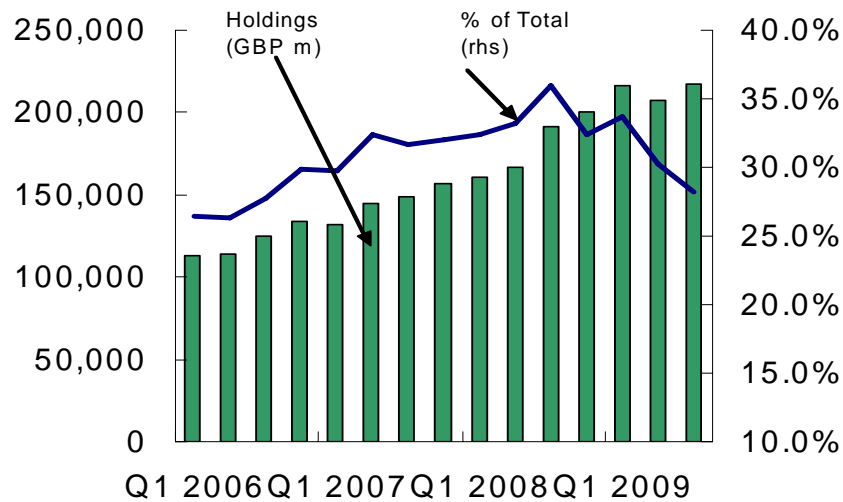


# End of BoE Quantitative Easing?

## Who will buy UK Gilts?

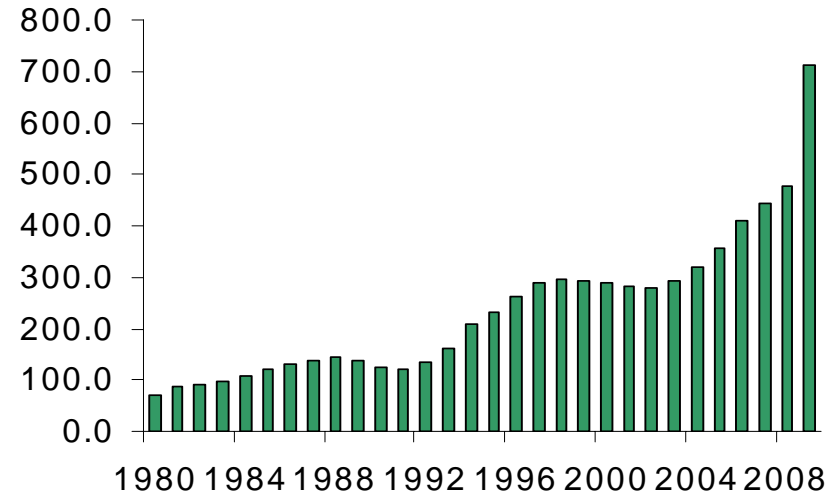
- There has been a decline in the overseas holding of UK gilts...
- The BoE gilt purchase programme appears to have bought almost all of the UK new gilt issuance last year
- Without the BoE who will fill the gap?
- Sterling will come under pressure if foreign investors turn their back on UK assets

Overseas Holding of UK Gilts



Source: UK DMO

UK Gilts Outstanding (GBP bn)

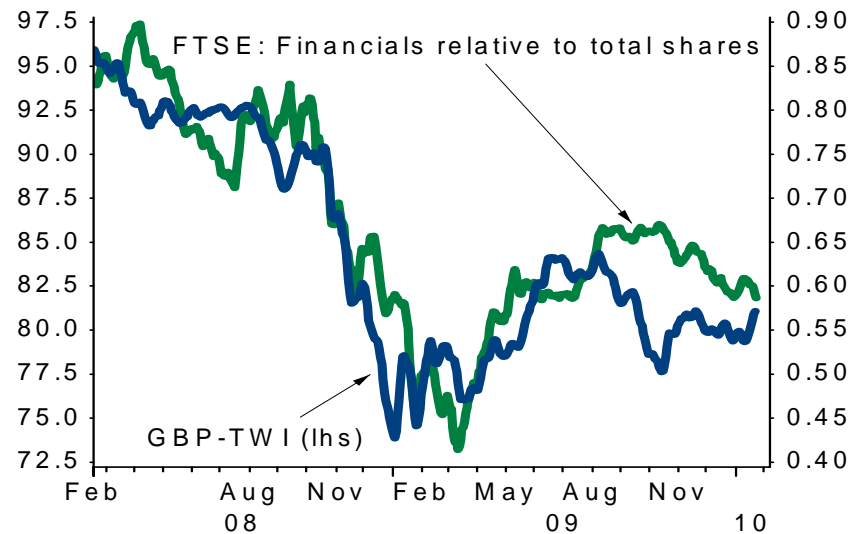


## Under performance of financials hits sterling

### Increasing regulation to weigh on sterling

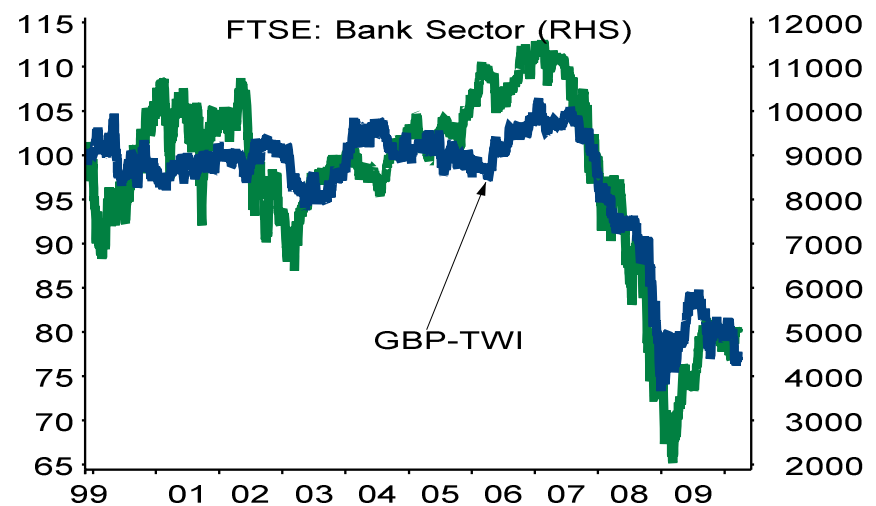
- Sterling is still closely correlated to the relative performance of the financial sector...
- ...the threat of increased regulation from politicians is weighing on financials and especially the banking sector
- Under performance of these sectors will put sterling under further pressure

GBP and relative performance of Financials



Source: Reuters Ecowin Pro

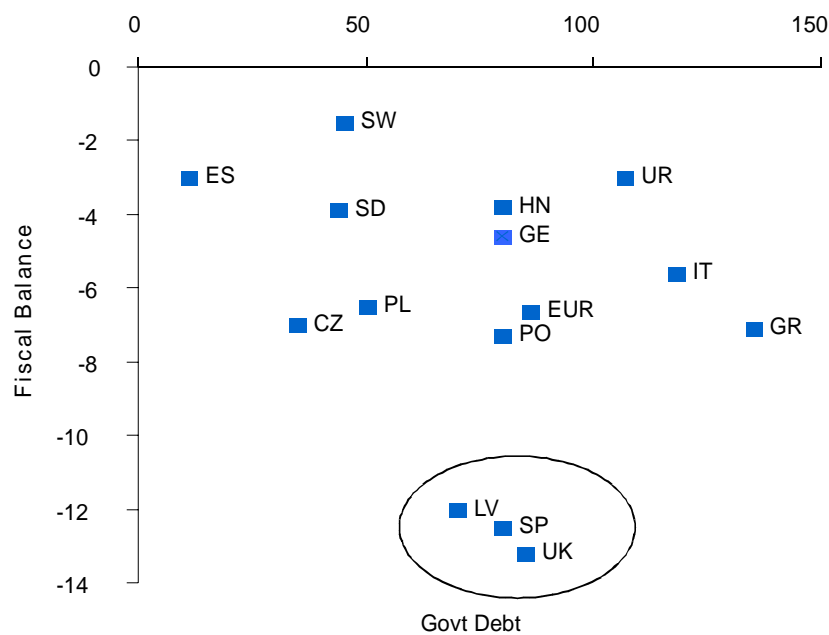
GBP and Banking Sector performance



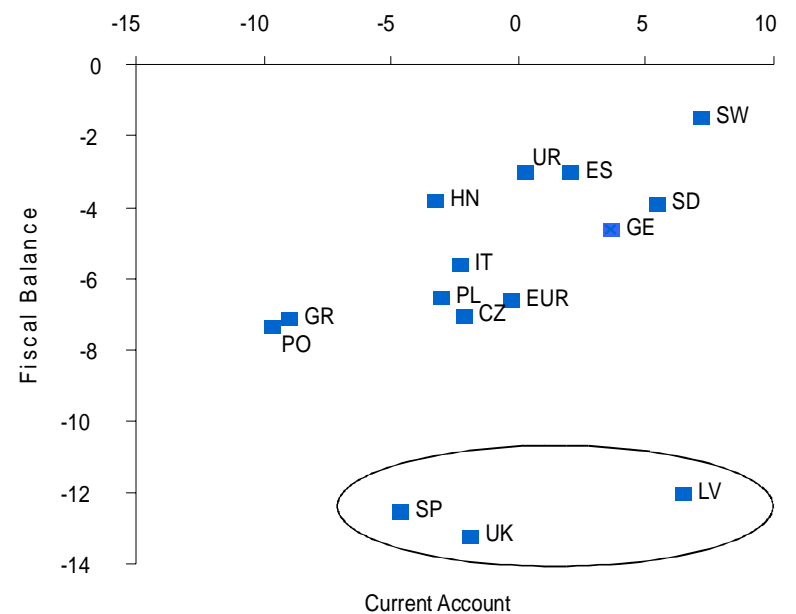
# Sterling: A clear case for devaluation

- The internal and external balance sheets of the UK are as bad as those of Spain and Latvia
- The BoE suggests that the UK is not the same as Greece and Spain because the UK has its own currency
- Competitive devaluation?

Fiscal Balances and Govt Debt for 2010 (% GDP)



Fiscal Balances and Current Account for 2010 (% GDP)



Source: BNP Paribas Win Pro, BNP Paribas

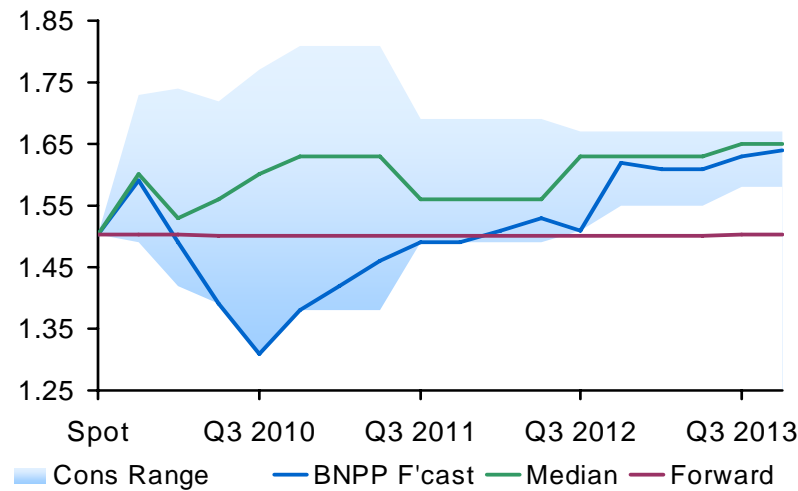


# BNP Paribas GBP Forecasts

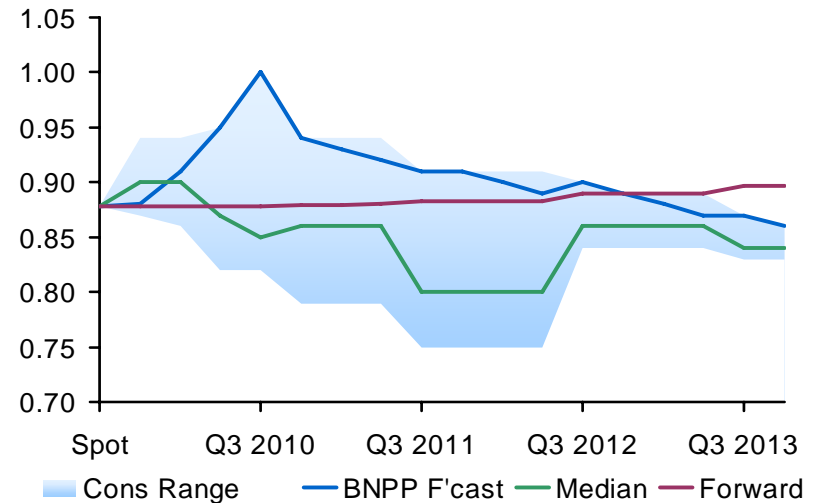
## Sterling to remain the underperformer

- We have one of the most bearish sterling forecasts in the market
- Market concerns has shifted slightly towards a weaker sterling, but market forecasts still remain moderate
- We anticipated EURGBP at 0.97 in 2010
- GBPUSD is set to target 1.31

BNP Paribas GBP/USD vs Consensus and Forwards



BNP Paribas EUR/GBP vs Consensus and Forwards



Source: Reuters Bloomberg, BNP Paribas

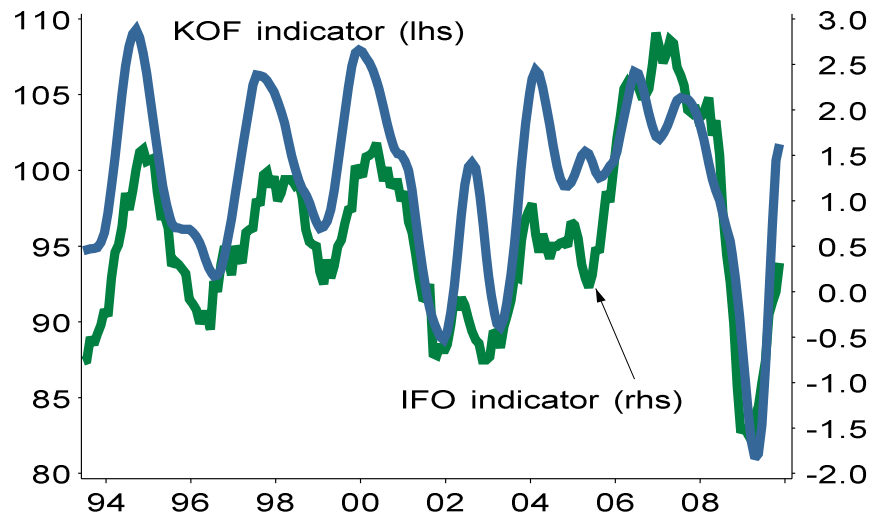


## Swiss Economy Recovering

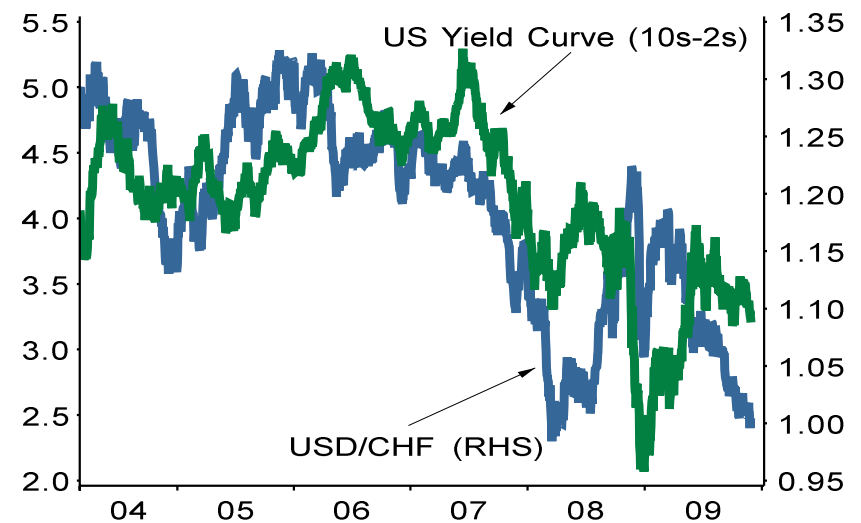
### Pressure on SNB to unwind non-conventional measures

- Economic indicators show that the Swiss economic recovery is gaining momentum
- The SNB are increasingly talking about exit strategies
- SNB appetite to intervene in FX market likely to diminish
- SNB becoming concerned regarding low levels of interest rates...
- ...but will have to soften commitment to prevent CHF appreciation before hiking rates
- CHF to remain supported in Q1 2010 before coming under pressure during remainder of the year

Swiss KoF and German Ifo

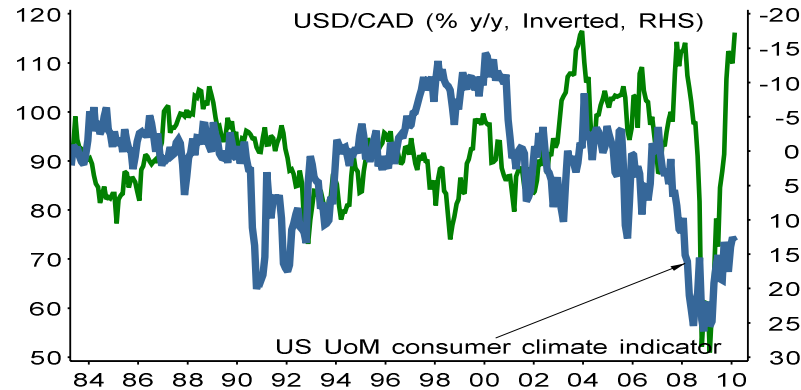


USDCHF and US Yield Curve

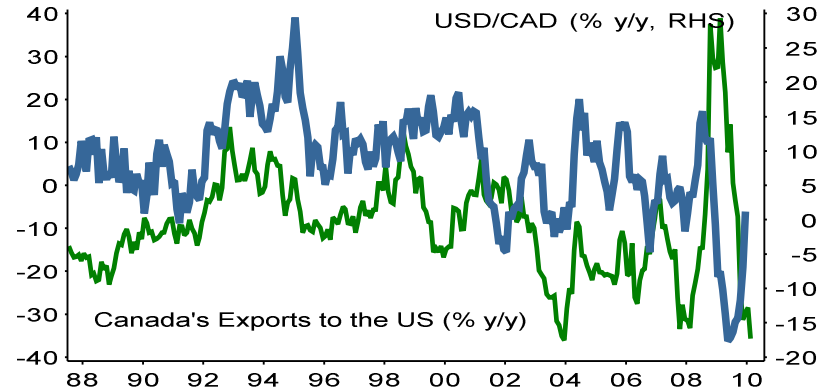


# Canada

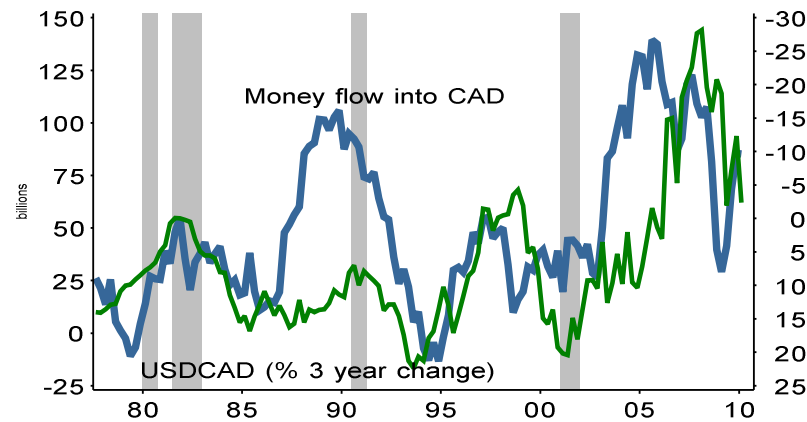
## CAD always takes the lead from the US...



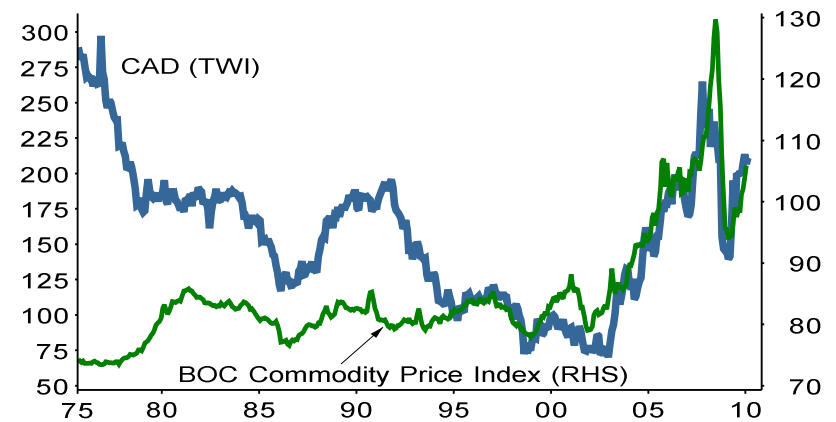
## ...via its export sector



## Money flow eases during US recessions



## Commodities rally has helped CAD



Source: Reuters EcoWin Pro



## Summary

### **Markets overly optimistic...disappointment the most likely outcome**

- The market had priced in the best case scenario of a “V” shaped recovery
- However, inflation fears are misplaced given the size of output gaps and talk of “exit strategies” have been misinterpreted
- The rise in rate hike expectations is unjustified in many cases, especially in the UK
- Equity markets will remain supported in the near-term...
- ...but will be vulnerable to correction later in 2010

### **Risks to be revealed in 2010**

- The global recovery will fail to match expectations and talk of “double dip” will drive markets
- Risk is that the recovery will be slower than currently anticipated
- Commodity trades and inflation hedges will be unwound
- Risk aversion trades back on the agenda...USD rebound
- Equity markets to come back under pressure in 2010
- Europe will have to contend with the additional risks of problems in the banking system
- UK assets vulnerable given the poor fiscal position
- Fiscal credibility will be a major differentiator in currency markets



## Currency forecasts

USD Bloc	Q2 '10	Q3 '10	Q4 '10	Q1 '11	Q2 '11	Q3 '11	Q4 '11	Q1 '12
EURUSD	1.22	1.16	1.08	1.00	1.04	1.07	1.10	1.15
USDJPY	88	92	100	105	110	115	118	120
USDCHF	1.17	1.22	1.31	1.40	1.34	1.31	1.29	1.25
GBPUSD	1.47	1.43	1.35	1.28	1.30	1.26	1.22	1.26
USDCAD	1.06	1.10	1.09	1.04	1.00	0.95	0.90	0.95
AUDUSD	0.87	0.82	0.85	0.87	0.90	0.92	0.92	0.92
NZDUSD	0.69	0.67	0.67	0.66	0.66	0.68	0.69	0.72
USDSEK	7.79	8.10	8.61	9.20	8.75	8.69	8.45	8.00
USDNOK	6.31	6.47	6.76	7.20	7.12	7.10	6.82	6.43
EUR Bloc	Q2 '10	Q3 '10	Q4 '10	Q1 '11	Q2 '11	Q3 '11	Q4 '11	Q1 '12
EURJPY	107	107	108	105	114	123	130	138
EURGBP	0.83	0.81	0.80	0.78	0.80	0.85	0.90	0.91
EURCHF	1.43	1.42	1.42	1.40	1.39	1.40	1.42	1.44
EURSEK	9.50	9.40	9.30	9.20	9.10	9.30	9.30	9.20
EURNOK	7.70	7.50	7.30	7.20	7.40	7.60	7.50	7.40
EURDKK	7.46	7.46	7.46	7.46	7.46	7.46	7.46	7.46
E. Eur Bloc	Q2 '10	Q3 '10	Q4 '10	Q1 '11	Q2 '11	Q3 '11	Q4 '11	Q1 '12
EURPLN	3.90	4.10	4.00	4.05	4.00	3.90	3.95	3.90
EURCZK	26.20	26.50	26.00	25.80	25.50	25.00	24.70	24.30
EURHUF	258	265	260	260	255	250	250	250
USDLVL	0.58	0.61	0.65	0.70	0.68	0.66	0.64	-----
EURRON	4.00	4.25	4.20	4.20	4.15	4.10	4.05	4.00
USDZAR	7.70	7.80	8.00	7.90	8.20	8.00	8.00	7.80
USD RUB	30.48	30.41	30.41	32.00	30.45	29.08	28.71	27.53
USDTRY	1.58	1.65	1.60	1.60	1.58	1.55	1.50	1.50
Asia Bloc	Q2 '10	Q3 '10	Q4 '10	Q1 '11	Q2 '11	Q3 '11	Q4 '11	Q1 '12
USDSGD	1.36	1.36	1.34	1.33	1.32	1.31	1.30	1.30
USDMYR	3.15	3.13	3.10	3.07	3.05	3.03	3.00	3.00
USDIDR	8800	8700	8600	8500	8400	8300	8200	8100
USDTHB	32.50	32.30	32.00	31.70	31.50	31.30	31.00	31.00
USD PHP	44.00	43.50	43.00	42.50	42.00	41.50	41.00	41.00
USDHKD	7.80	7.80	7.80	7.80	7.80	7.80	7.80	7.80
USDRMB	6.83	6.72	6.62	6.57	6.52	6.47	6.42	6.37
USDTWD	30.50	30.30	30.00	29.70	29.50	29.30	29.00	29.00
USDKRW	1090	1070	1050	1030	1020	1010	1000	1000
USDINR	44.00	43.00	42.00	41.00	40.00	39.00	38.00	38.00
USDVND	19500	20000	20500	20500	20500	20500	20500	20500
Latam Bloc	Q2 '10	Q3 '10	Q4 '10	Q1 '11	Q2 '11	Q3 '11	Q4 '11	Q1 '12
USDARS	4.00	4.10	4.20	4.25	4.35	4.45	4.50	4.60
USDBRL	1.85	1.80	1.75	1.75	1.80	1.80	1.85	1.85
USDCLP	530	525	515	515	510	500	500	500
USDMXN	12.50	12.25	12.00	12.00	11.75	11.75	11.75	12.00
USDCOP	2000	1950	1900	1875	1850	1825	1800	1800
USDVEF <i>Priority**</i>	4.29	4.29	4.29	4.29	4.29	4.29	4.29	8.80
USDVEF <i>Oil**</i>	2.59	2.59	2.59	2.59	2.59	2.59	2.59	5.30

*\*\*Following the devaluation of the VEF, there is now an official 'priority' exchange rate and a so-called 'oil' exchange rate used for certain transactions*

Source: BNP Paribas FX Strategy



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## Recommendation System:

Type	Terminology	Horizon
Credit Trend (1)	Positive/ Stable/ Negative	6 months
Investment Recommendation (2)	Buy/ Add/Hold/ Reduce/ Sell (*)	Up to 6 months

(1) Credit Trend is based on underlying Credit fundamentals, business environment and industry trends;

(2) Investment Recommendation is based on BNPP Credit Trend;

(\*) Buy: Overweight exposure within industry sector, based on strong financial profile, conservative risk, outperforming or demonstrating average performance within peer group;

Add Overweight exposure within industry sector/index, based on improving financial profile, and/or defensive characteristics and/or cheap valuation.

Hold: Exhibits solid to strong credit fundamentals, but average total return characteristics within peer group;

Reduce: Credit exposure should be pared down based on weakening fundamentals within peer group;

Sell: Sell exposure largely based on deteriorating credit fundamentals and/or negative headline or event risk.

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