

The background of the top half of the page is a blurred image of a financial market data screen. It shows various columns of numbers, some with percentage changes, and a line graph with a white line fluctuating against a dark background. The overall color scheme is blue and white.

# Economic & Interest Rate Outlook

2nd Quarter 2009

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# Summary

## Global: Tentative signs of optimism, but formidable obstacles remain

Over the past few weeks global equity markets have improved noticeably. Growing optimism that the policy measures taken will be sufficient to arrest the downturn have coincided with tentative signs that the pace of decline in output may be easing. Ironically, it has been the savings-deficient countries that have shown some early signs of improvement. Meanwhile, savings-rich countries that are highly dependent on net exports have been particularly hit by the collapse in world trade. We expect this pattern to continue.

## UK: Unprecedented stimulus should pave the way for a gradual recovery

Interest rates are at their lowest for four-hundred years; the Bank of England is creating money; the banking sector has been underpinned by various state support measures; energy prices are falling; and the weakness of sterling has boosted UK competitiveness. In normal times this would be a recipe for rampant inflation. But these are not normal times. While the worst of the recession may be over, rising unemployment, high debt levels and tight credit conditions point to further falls in output and subdued inflation over the coming quarters. Still, the policy actions taken suggest that conditions should start to improve as we move into next year.

## US: Expected to be amongst the first to emerge from recession

The US was the first to be hit by the credit crisis and is likely to be the first of the major economies to emerge from recession. The US authorities have thrown almost everything at trying to ease credit conditions and stimulate aggregate demand. The impact of this stimulus should start to be felt more strongly over the second half of this year. Still, in the absence of state support, demand conditions remain fragile. Unemployment is heading higher and household net worth has fallen precipitously. Moreover, rising public sector debt levels and the vulnerability of the US dollar pose key risks. For now, US bond markets are likely to remain supported, but the case for a significant correction is building.

## Eurozone: Downturn likely to spur more radical policy action

The ECB is poised to announce further 'non-standard' measures to support recovery in the euro area. However, there remains a perception in financial markets that it remains 'behind the curve' in terms of fighting the downturn. We think a shift to outright quantitative easing - incorporating purchases of government bonds - is likely during 2009H2. Interest rates, meanwhile, look set to be lowered modestly further to 1% - assuming deflation pressures do not emerge.

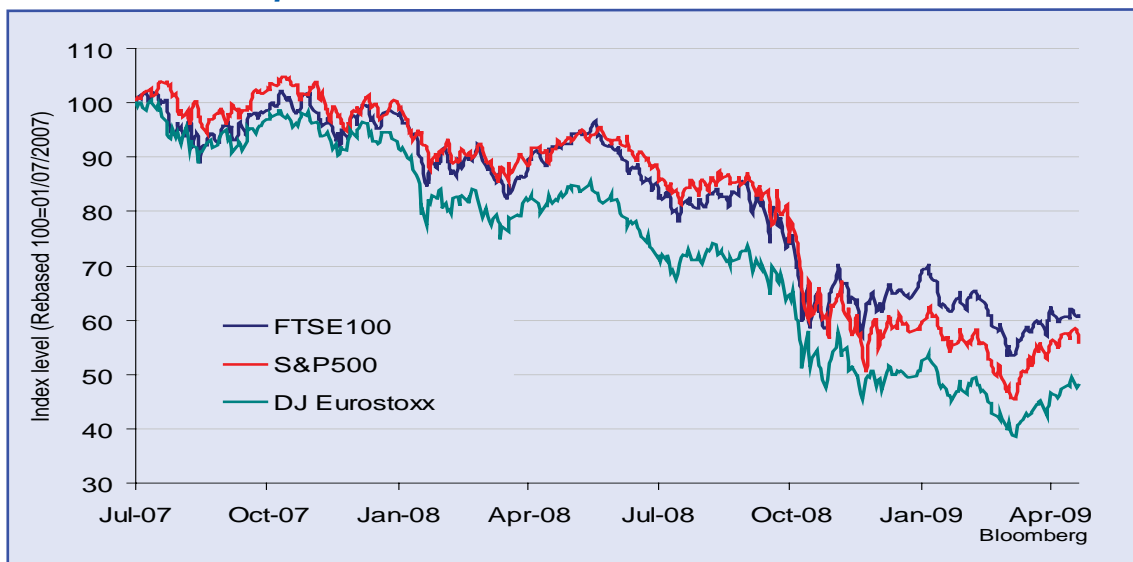
## Canada: Recovery hopes hinge crucially on prospects for the US

Economic weakness in Canada is broad-based, with the external sector under particular pressure. But just as direct trade links with the US are vital for Canada's economic recovery, so are the *indirect* effects of efforts to bolster the US banking system.

## FX & Commodities: US dollar to weaken over the medium-term, as global recovery emerges

With the prospect of a broad-based recovery in the global economy still distant, bouts of risk aversion are likely to provide periodic episodes of support for the US dollar over the near term. Similarly, commodities are unlikely to stage a meaningful rally until confidence is more fully restored to financial markets.

### **Improvement in equity market sentiment raises hopes that the worst of the downturn is over**



**Ironically, it is the savings-rich countries that are suffering particularly badly in the downturn. For those that have savings deficits, tentative signs of improvement are emerging.**

Recent events have led us to question whether there might now be a case for some cautious optimism. Over the past few weeks global equity markets have improved noticeably. Growing confidence that the actions taken by global policy-makers will be sufficient to arrest the downturn have coincided with tentative signs that the pace of decline in global output may be easing.

Ironically, it has been the savings-deficient countries that have shown some early signs of improvement; savings-rich countries that are highly dependent on net exports have suffered disproportionately from the collapse in world trade. Year to date, world trade volumes have dropped around 20 per cent. For economies like China, Germany, Japan and South Korea, the collapse in world trade has been particularly painful. In the UK and US, however, where household debt-to-income ratios are amongst the highest, there are tentative signs that the worst of the recession may now be over.

Given the credit crisis, the recent tentative signs of stability in the savings-deficient countries may seem surprising. But it reflects a number of factors. First, since they were initially amongst the hardest hit, they have moved more quickly and more aggressively to implement stimulus. In the US alone, the fiscal injections and bailouts announced since the start of the crisis total nearly \$3trn (20 per cent of GDP).

Second, savings-deficient countries tend to be more responsive to stimulus. By implication, they have relatively high marginal propensities to consume, so stimulus tends to be more effective in boosting aggregate demand than in countries that have relatively high saving ratios, such as Germany (and historically, Japan).

We expect the savings-rich countries to continue to underperform over the next two years, with Germany, Japan and, to some extent, China liable to a continued shift of demand back to home markets. That is not to say that the savings-deficient countries will not weaken further. They almost certainly will. The root cause of the problem has been, and remains, the build-up of excessive leverage and debt across these coun-

tries. Moreover, although the measures taken represent major steps forward, they are not a panacea.

With confidence in the wholesale funding markets still fragile, unemployment headed higher, global trade flows falling and household and business balance sheets undergoing a process of repair, the prospect of any near-term recovery in global economic confidence or activity remains limited.

The best that can be hoped for is that conditions improve in 2010 - by which time we expect global equity markets to be on a firmer footing, the labour market adjustment to be largely complete, house prices to have stabilised, and the stimulus measures announced across the G7 to have gained some traction.

The recovery, when it does arrive, however, is likely to be relatively subdued. Although credit conditions are expected to ease, permanent changes in the cost and availability of wholesale term funding are likely to act as an ongoing constraint on balance sheet expansion in the financial sector. Moreover, at some stage, the substantial stimulus that has been unleashed to engineer recovery will need to be reversed.

Public sector debt levels across the G7 are becoming a major concern. Over the past three years, G7 public sector debt has risen from 85 to around 100 per cent of GDP. While the public sector has a key role to play in mitigating the fall in demand during recessions, the rise in public sector borrowing, and the eventual need for fiscal restraint, risk undermining the recovery when it materialises.

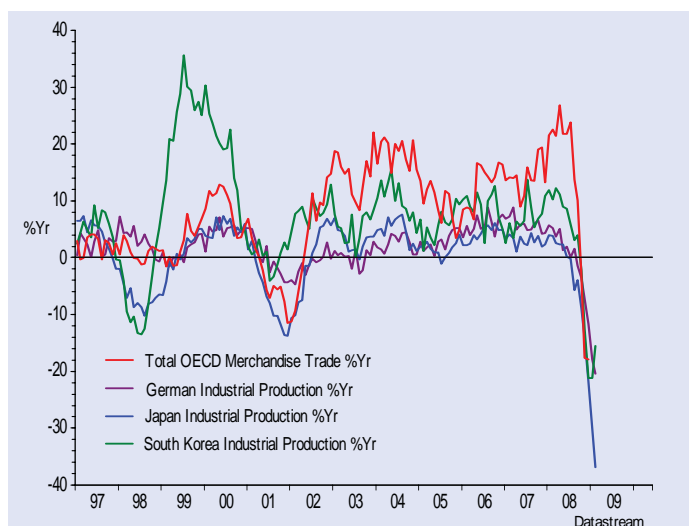
Furthermore, efforts to rein in public sector borrowing are likely to occur around the same time that global monetary policy is being tightened. Managing this tightening without precipitating a renewed global economic downturn or allowing inflation pressures to take root will pose a massive policy challenge over the medium term.

How the markets expect this to break will have a key bearing on asset prices over the coming year. For now, continued uncertainty over the prospects for global recovery are likely to temper any improvement in risk appetite. Although we are cautiously optimistic that equity prices may have seen their lows, a sustained rally is likely to require more compelling signs of a recovery in economic confidence and a turn in the corporate profit cycle.

While risk appetite remains constrained, fixed income markets are likely to remain well supported. Indeed, over the next few months medium and long-term rates are expected to edge lower, underpinned by continued signs of weak growth and central bank purchases of government bonds as part of their quantitative easing programs.

The risks, however, are not evenly balanced. The burden of public sector debt issuance, the risk of a resurgence of inflation and the future withdrawal of monetary stimulus raise the likelihood of a substantial upward correction once clearer signs of recovery unfold. In this regard, the savings-deficient countries are particularly vulnerable.

**Countries reliant on external trade have been hit hardest**



With unemployment likely to top three million by the end of the year, talk of ‘greenshoots’ is premature. Still, there are grounds for optimism that the worst may now be over.

The past few weeks have witnessed the first tentative signs in the UK that the worst of the economic and financial market downturn may now have passed. Since early March, the FTSE 100 has recovered by nearly 20%; sterling has appreciated; and the sterling three-month Libor/OIS spread – a proxy for the liquidity premium for three-month wholesale funds - has hit a seven-month low.

The recovery in financial market sentiment has been driven by two key developments: first and foremost, by hopes that the unprecedented actions taken by global policy-makers are starting to gain traction; second, by some tentative signs of improvement in the economic data.

The latest surveys of purchasing managers - leading indicators of business confidence - registered an improvement in March. Moreover, the housing market has shown signs of stabilizing. Mortgage approvals and mortgage lending have turned higher, buyer enquiries have picked up and the Nationwide reported that UK house prices rose last month (by 0.9%) for the first time since October 2007.

Could it be that the UK economy is starting to recover? If so, this would represent a remarkable performance. Unfortunately, such hopes are almost certainly premature. The improvements that have occurred have been from a very low starting point and have not been broad-based. For example, Halifax reported that house prices dropped 1.9% last month, while indicators of production, employment and sales continue to head south.

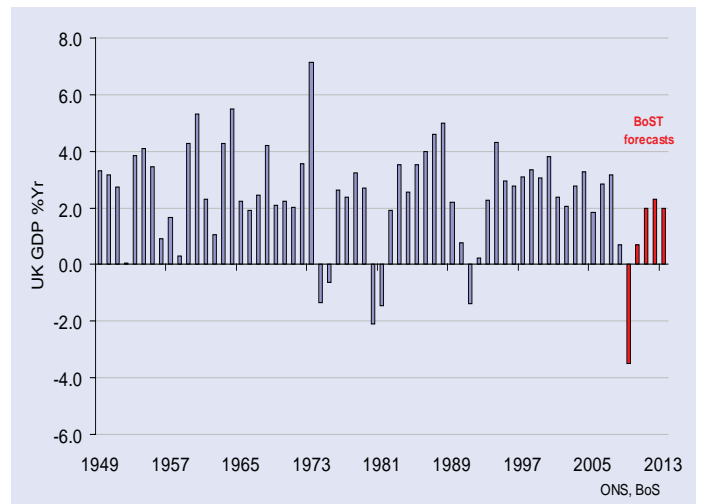
Nonetheless, the recovery in UK equity prices in recent weeks has been the strongest and most sustained since the credit crisis began. Given the importance that financial market sentiment plays, the recent improvement must provide some grounds for cautious optimism.

Although the downturn looks set to continue over the coming quarters, the unprecedented policy actions taken in recent months represent significant steps forward in addressing the credit crisis. Although the full impact will take time to emerge, the stimulus that has been unleashed raises the prospect that the downturn may not be quite as deep or as protracted as previously feared.

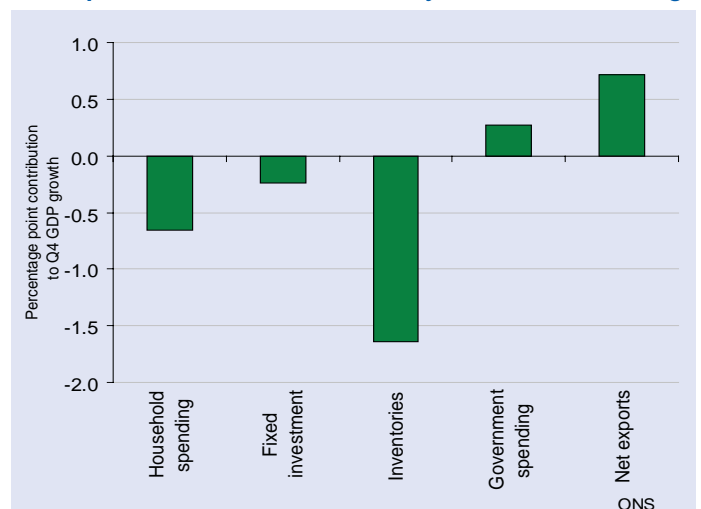
At 0.5%, official interest rates are at their lowest level since the Bank of England was formed in 1694. Having effectively run out of interest rate ammunition the Bank has now turned to the heavy artillery of quantitative easing (QE) as a means of stimulating money growth and nominal spending. So what is QE and will it work?

Effectively, quantitative easing is a means of printing money. In early March, the Bank announced that it would undertake the purchase of £75bn (equivalent to 5% of nominal GDP) of gilts and corporate bonds, financed through the creation of £75bn of central bank reserves. By doing so, the Bank of England hopes to (i) encourage banks to draw down on these excess reserves to fund an increase in lending; and (ii) ease strains in the corporate bond markets.

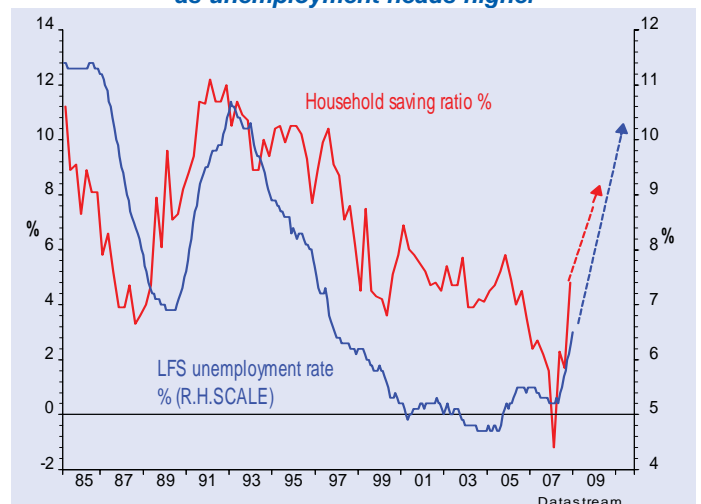
**GDP is expected to fall this year by its sharpest rate since WWII**



**Sharp fall in Q4 GDP was driven by massive de-stocking**



**Households repair their balance sheets as unemployment heads higher**



To date, total asset purchases under the programme have totalled £32bn. The remainder will be injected into the economy over the coming weeks, with the Bank having Treasury approval to undertake an extra £75bn of asset purchases after three months if it deems it necessary.

Although the authorities have the ability to print as much money as they want to stimulate the economy, there is no guarantee that the program will result in a smooth and orderly expansion of monetary growth. In an environment where bank capital is constrained and wholesale funding conditions remain tight, there is a significant risk that banks hoard the additional liquidity.

This risk has been reduced, however, by various other schemes to re-capitalise the banking system and ease funding conditions. By far the most important of these has been the recently-announced Guaranteed Asset Protection Scheme (GAPS).

Under GAPS, the government has effectively agreed, in exchange for a fee, to insure participating banks against any losses incurred on a predetermined pool of assets beyond a set limit. By taking part in the scheme, banks have been able to improve the risk profile of their balance sheets and substantially boost their core tier 1 capital ratios – both preconditions for an eventual recovery in bank lending.

Still, it is likely to be some time before the impact of QE and GAPS is fully felt. Although banks' capital positions have been boosted, their ability to undertake balance sheet expansion remains impeded by ongoing uncertainty regarding the potential scale of impairments and continued constraints on term liquidity.

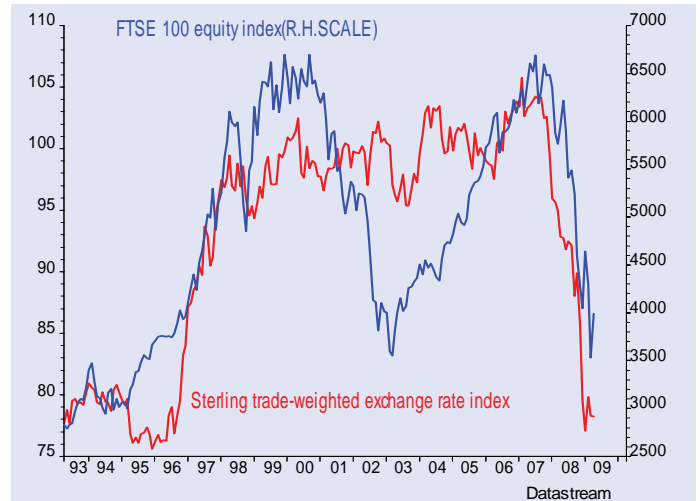
Moreover, it is not only impediments to the supply of money that are restraining lending growth. Money demand has also weakened. With unemployment now rising sharply, the prospect of any substantial turnaround in either nominal spending and/or money demand over the coming year remains limited – even allowing for the new policy measures.

The downturn in the labour market poses a key risk. Over recent months unemployment has picked up sharply, with the claimant count rising by 138.4K in February – its largest one-month increase since the government started compiling claimant data in 1971. Over the coming year, we expect unemployment on the broader ILO measure to increase from two million to over three million - matching the peak of the early 1990s.

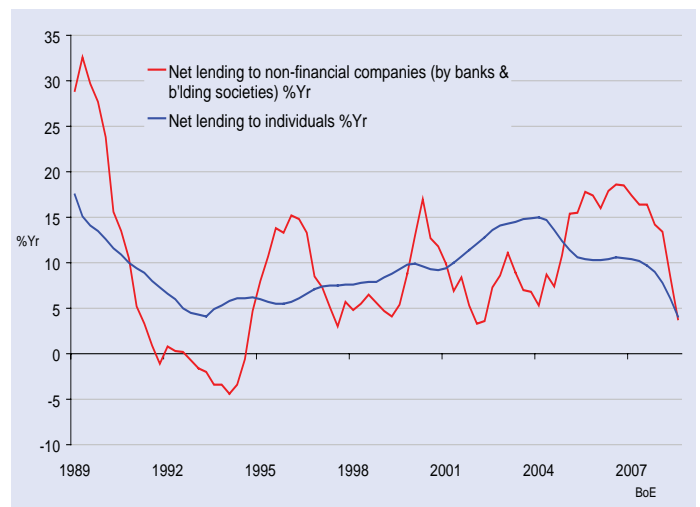
Continued job losses are likely to put further pressure on household and business spending. Having held up well over Christmas, retail sales dropped by 1.9% in February – the third biggest monthly fall in eighteen years. The fall in sales that month was reportedly exacerbated by poor weather. Nonetheless, the underlying trend is weakening, as households seek to repair their balance sheets. Over the past six months, the household saving ratio has moved noticeably higher, while in January, households made a net repayment on their debt for the first time since records began in 1993.

Businesses, too, continue to face difficult conditions. Corporate bankruptcies are trending higher and profit margins

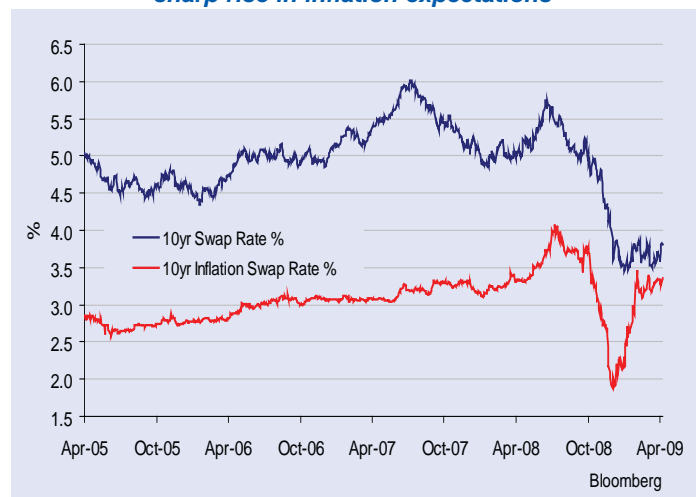
**Sterling and equities have fallen sharply over the past year, reflecting reduced risk appetite**



**Private sector credit growth continues to fall**



**Swap rates remain at historical lows, despite the sharp rise in inflation expectations**



are being squeezed by the downturn in demand and rising import prices. With spare capacity rising, household demand weakening and access to credit still constrained, business investment looks set to fall further over the coming quarters.

Given the above, we doubt the UK economy will emerge from recession until the turn of the year, at the earliest. Overall, we expect GDP to contract by 3.5% in 2009. If realised, this would be the UK's worst annual performance since the Second World War. Nevertheless, there are grounds for optimism that the pace of decline should steadily ease over the coming year, paving the way for a modest recovery in 2010.

First, the various policy actions should steadily start to gain traction. Second, the competitive boost from the fall in sterling should help to limit the downturn in UK exports, and provide a boost to domestic production as consumers substitute away from higher-priced imports. Third, the process of de-stocking should steadily ease, as inventory levels are reduced to desired levels. And lastly, the decline in energy prices should help to cushion the downturn in real household disposable incomes.

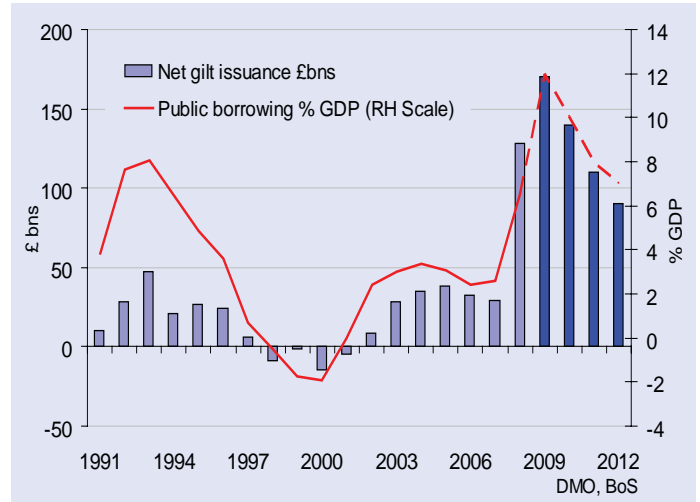
Indeed, the fall in energy costs, coupled with favourable base effects and a more general squeeze in prices, is expected to push headline inflation, currently 2.9%, to below 1% by the end of the year. The downturn in inflation, however, is unlikely to last long. With import prices rising, last December's VAT cut due to expire in January, and the favourable base effects set to reverse in 2010, headline CPI is projected to rise back up towards the government's 2% target by the end of next year.

Thereafter, the inflation outlook remains highly uncertain. Given the degree of monetary stimulus there is a clear risk that inflation pressures build. Keeping them in check is likely to require a substantial tightening in both monetary and fiscal policy over the medium term. Whether or not policy-makers succeed in their objective of keeping inflation in check beyond 2010 will have a key bearing on both short and long-term interest rates.

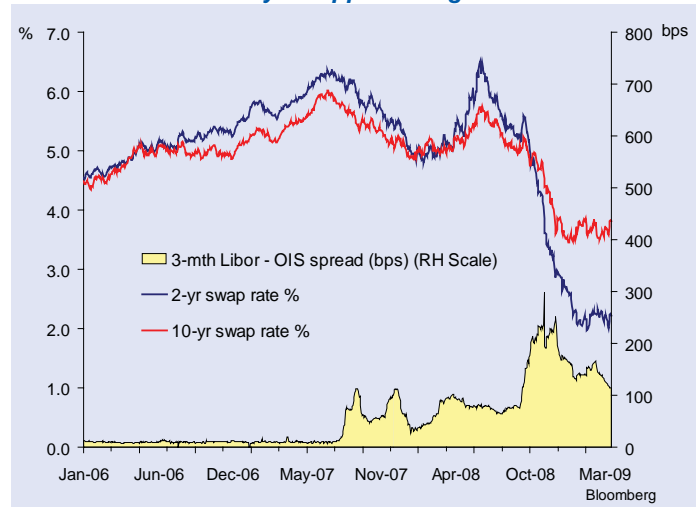
If policy-makers delay a reversal in policy for too long, they risk precipitating a significant rise in fixed-term interest rates – particularly at the medium and long end of the yield curve. Furthermore, the policy tightening subsequently required to bring inflation back on track would be that much more severe. Conversely, if they move too quickly to raise interest rates or tighten fiscal policy, they run the risk of precipitating a renewed, and potentially more severe, economic downturn.

How these developments unfold will have a key bearing on sterling bond markets. For now, we believe sterling bond markets are likely to remain well supported. Continued gilt purchases by the Bank of England under its quantitative easing programme, falling inflation and ongoing signs of economic weakness, are expected to push gilt yields and swap rates lower over the next few months. Further out, however, the case for a substantial upward correction in yields is building: over the medium term, inflation expectations are likely to rise; the outlook for growth is likely to improve; and the market will be faced with a continued deluge of gilt supply as the government finances its rapidly deteriorating fiscal position.

### Surge in public borrowing risks putting significant strain on the gilt market



### Libor liquidity premium has eased, but longer-dated swap rates may be approaching a floor



### UK forecasts

Annual % chg	2008	2009	2010
<b>GDP</b>	<b>0.7</b>	<b>-3.5</b>	<b>0.7</b>
Household Spending	1.4	-2.8	-1.2
Public Spending	3.4	2.4	0.6
Private Investment	-3.1	-8.4	-0.7
Stocks % GDP	0.1	-1.0	0.2
Exports	0.1	-5.2	2.0
Imports	-0.6	-5.7	0.2
<b>CPI (Q4)</b>	<b>3.9</b>	<b>0.7</b>	<b>1.5</b>
%	Spot	Sep-09	Mar-10
<b>UK Bank Rate</b>	<b>0.50</b>	<b>0.50</b>	<b>0.50</b>
3-mth Libor	1.55	1.30	1.10
2-yr swap rate	2.20	2.00	2.30
5-yr swap rate	3.21	2.90	3.50
10-yr swap rate	3.75	3.40	4.20

Although falling inflation and weak growth continue to provide support to US bond markets, the weight of supply and the fragility of the US dollar pose growing risks.

After an extended period of extreme risk aversion, the past few weeks have witnessed a noticeable improvement in US financial market sentiment. An increase in risk appetite has been evident across most asset classes, but notably equities.

Since early March, the VIX index - a measure of implied volatility on the S&P500 - known colloquially as the 'fear gauge' - has fallen sharply and is now back at levels not seen since last September. Over the same period, the S&P500 has recovered by nearly 30 per cent, with the index of financials having rallied around 80 per cent since the low hit earlier this year.

The recovery in financial market sentiment has been driven by growing optimism that the raft of policy measures taken by the US (and other) authorities will be sufficient to arrest the credit crisis and reverse the economic downturn. But so far, there is little sign of this.

In the fourth quarter, GDP contracted at an annualised pace of 6.3 percent - its sharpest quarterly decline for 26 years. Although that out-turn was accentuated by the collapse of confidence in the wake of Lehman Brothers bankruptcy, GDP looks set to post another sharp contraction in Q1, with little improvement expected in Q2.

The downturn in aggregate demand precipitated by the tightening in credit conditions and last year's sharp fall in asset prices has spread to all areas of the economy. Although there are some signs that consumer and business confidence may be stabilising, the improvements have occurred from an extremely low base, with surveys still pointing to sharp contractions in both spending and output.

In the household sector, the list of challenges remains formidable. Over the past year, household net worth has dropped by around 20 per cent, as households have suffered a double-whammy of falling equity and home prices.

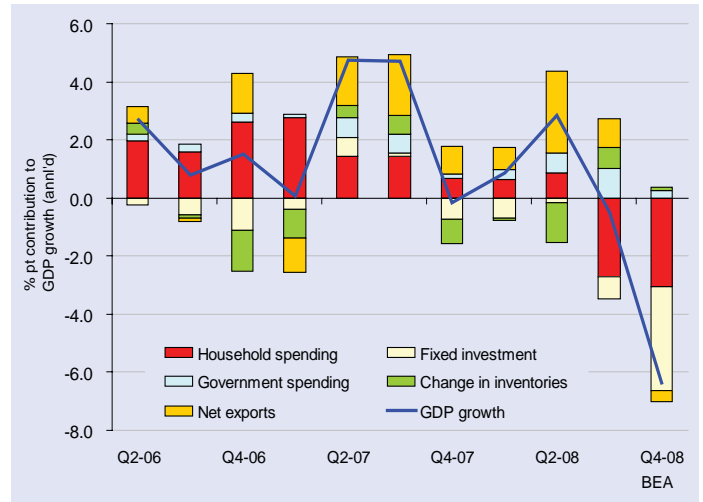
Compounding the hit to confidence, unemployment is now rising sharply. Since the beginning of 2008, non-farm employment has dropped by nearly five million. Two million of these job losses have been recorded in the past three months alone.

Declining net worth and rising unemployment is a pernicious combination. It raises the prospect of a further sharp retrenchment by the consumer sector. Indeed, the forces bearing down on consumers are far heavier than the recession of the early 1990s, when unemployment rose sharply, but household net worth as a percentage of disposable income remained relatively stable.

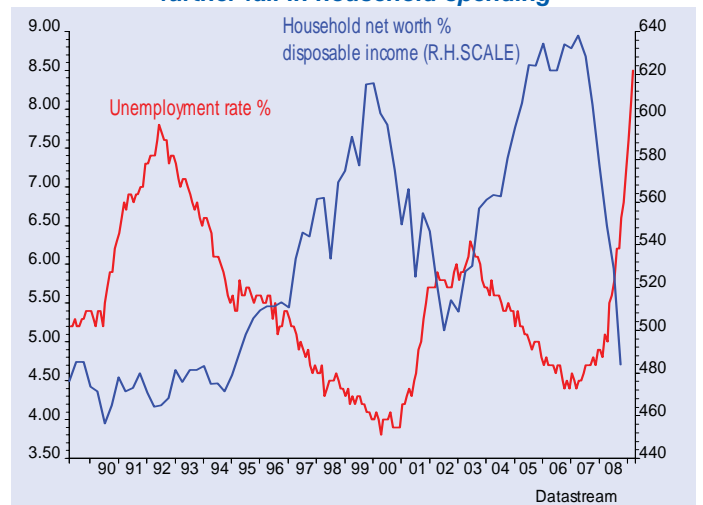
Just how much further household net worth falls remains uncertain. Although some encouragement can be gleaned from the recent recovery in equity prices, the improvements have reportedly been driven by short-term speculators; real money investors have remained on the sidelines.

Still, based on most measures of fair value, equity prices

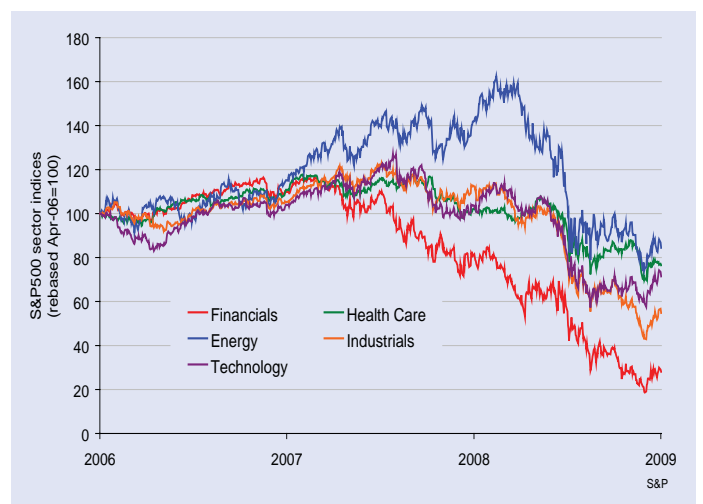
*The US economy is weakening on almost all fronts*



*Rising unemployment and declining net worth point to a further fall in household spending*



*US equities may have found a base*



appear oversold. With recent earnings results from the financial sector suggesting the worst of the crisis may have passed, we are cautiously optimistic that a more enduring recovery could emerge over the summer.

Similarly, we believe house prices appear close to reaching a base. Since reaching a peak in mid-2006, US house prices have fallen by nearly 30 per cent. Rising repossessions and unemployment have driven sharp falls in both home sales and housing starts. Still, there are signs that the supply adjustment may be reaching an end, with the stock of unsold homes on realtors' books having fallen since last July. Moreover, with official interest rates at effectively zero, and term rates having fallen sharply, the cost of debt finance is exceptionally low for those that can access it.

Our central expectation is that a recovery in equity prices and signs of stability in the housing market should pave the way for an improvement in the economy towards the end of this year. By this time, the various policy measures aimed at stabilising the banking sector and stimulating aggregate demand should start to take effect.

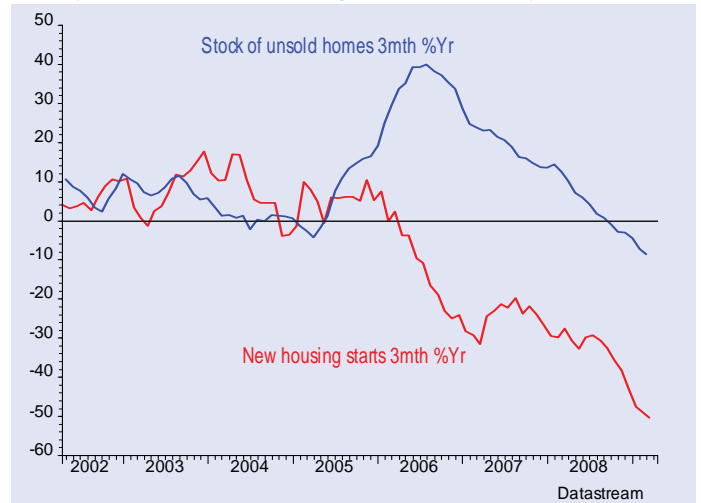
These measures have been substantial. In January, Congress signed-off on a further \$900bn emergency fiscal stimulus; the Federal Reserve is now undertaking quantitative easing; and the administration has embarked on various initiatives to rid the banking sector of its riskier assets (notably the TARP and TALF programmes). Combined, the total stimulus to date is estimated at 20 per cent of GDP.

Financing the stimulus poses a key threat to the bond markets. The US Federal deficit is expected to reach \$1.75trn in the current fiscal year, with little prospect of any material improvement in 2010. The Federal Reserve has already resorted to increasing the size and frequency of its government bond issuance, with total net Treasury sales this year and next projected to climb by over \$3trn.

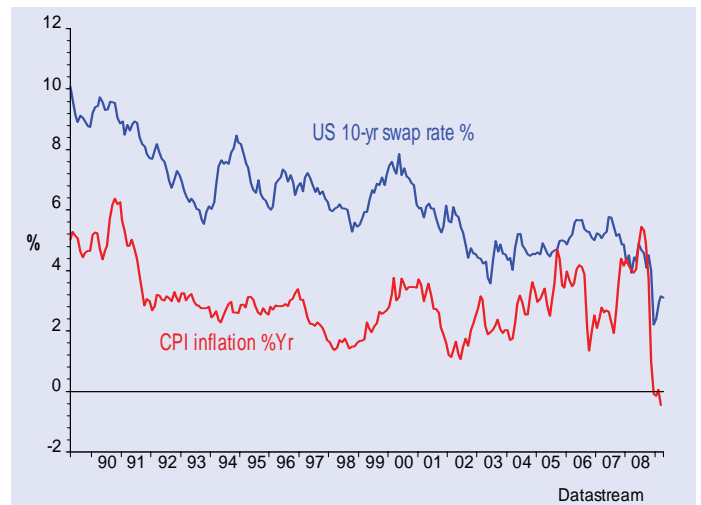
For now, concerns in the bond markets over rising government bond issuance are likely to be overshadowed by the downturn in growth, falling inflation, and the Federal Reserve's government bond purchases (as part of its quantitative easing programme). Although longer-dated bond yields have crept higher in recent weeks, we expect them to fall back again over the coming months. In particular, bond markets are likely to receive support from the anticipated weakness of inflation. In March, the annual rate of headline CPI turned negative for the first time since 1955. It looks set to fall further over the coming months, as declining energy prices, favourable base effects and rising spare capacity bear down on prices.

Over the medium term, however, bond yields are unlikely to remain at these lower levels. If, as we expect, clearer signs of recovery emerge over the second half, market attention is likely to shift from deflation towards the medium-term prospects of recovery and reflation. The emergence of these concerns, and a potential weakening of the US dollar as risk appetite improves, risks putting US bond yields under intense upward pressure. The correction could be all the more severe given the weight of government supply over the next few years.

### Decline in starts and unsold homes suggests supply adjustment in the housing market is nearly complete



### Falling inflation supporting bond markets - for now



### US forecasts

Annual % chg	2008	2009	2010
<b>GDP</b>	<b>1.2</b>	<b>-2.6</b>	<b>1.6</b>
Household Spending	0.4	-1.4	1.8
Public Spending	2.9	1.9	2.5
Residential Investment	-20.4	-18.0	-4.9
Nonresidential Investment	2.1	-16.0	-5.2
Stocks % GDP	-0.4	-0.6	0.1
Exports	8.0	-11.0	0.9
Imports	-2.4	-11.8	-1.2

CPI (Q4)	1.6	-0.1	1.8
%	Spot	Sep-09	Mar-10
<b>US Federal Funds rate</b>	<b>0-0.25</b>	<b>0-0.25</b>	<b>0-0.25</b>
3-mth Libor	1.10	1.10	1.00
2-yr swap rate	1.53	1.40	1.60
5-yr swap rate	2.40	2.20	2.80
10-yr swap rate	3.00	2.80	3.70

## The ECB is poised to announce further 'non-standard' policy measures to support recovery. But we think this gradualist approach will eventually be replaced by fully-fledged QE.

Like other regions, the eurozone faces numerous downside risks to economic activity. But following recent moves by the Bank of England and the US Federal Reserve to introduce quantitative easing (QE), the European Central Bank (ECB) has yet to take action. Earlier this month, Jean-Claude Trichet signalled the ECB's intention to employ 'further non-standard measures' to aid recovery in the euro region. However, there remains a perception in financial markets that the ECB is 'behind the curve' in terms of fighting the downturn.

Stopping short of QE, Mr. Trichet has stressed the ECB's continuing use of 'non-standard' policy tools. To date, these have included the ECB's fixed rate tender with full allotment in all its money market operations, along with a significant expansion in eligible collateral. This liquidity-based strategy broadly suits the eurozone, where banks act as a relatively more important source of finance for firms and households compared with say, the US. And it may explain why the ECB's last credit conditions survey showed a prospective easing in banks' credit standards over the next three months.

We doubt, however, that emphasis on banks alone will be sufficient to combat the current crisis. At this early stage, further improvements in credit conditions are not automatic. The recent narrowing in the spread between 3-month Euribor and the ECB's main refinancing rate compared with equivalent spreads in the UK and US suggests that eurozone rate cuts are being transmitted more effectively.

But risk premia in the eurozone remain high. At around 65bp currently, the difference between 3-month Euribor and the corresponding OIS rate is still far above the levels prevailing before the credit crisis began. Furthermore, data on bank lending to the eurozone private sector have deteriorated sharply. Growth of just 4.2% in the year to February compared with 11% a year earlier.

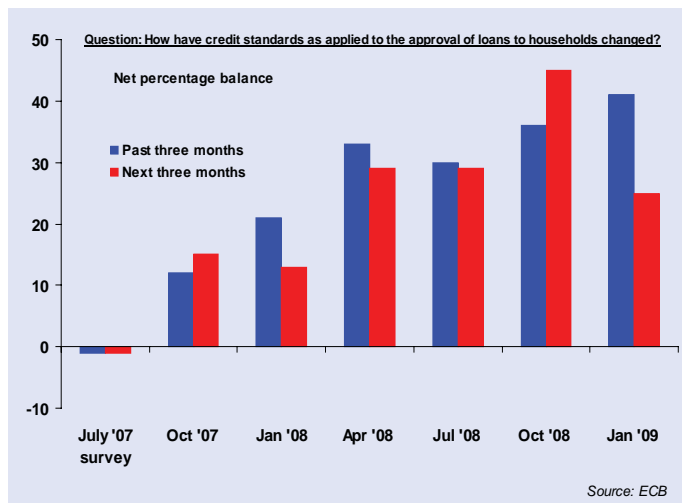
For its part, the ECB is poised to announce additional 'non-standard' measures at its next policy meeting on 7 May. Various Governing Council members have hinted at initiatives which involve extending the maturity of loans offered by the ECB to other banks in its money market operations. This should provide further help on bank funding.

Other options include ECB purchases of private sector assets (e.g. high-quality corporate bonds). But with risks to eurozone economic activity increasingly skewed to the downside, we think a shift to fully-fledged QE – involving purchases of government bonds - is warranted. The quantity of money in the economy can be increased more effectively when QE incorporates government bond purchases, since private sector asset markets tend to be relatively smaller in size.

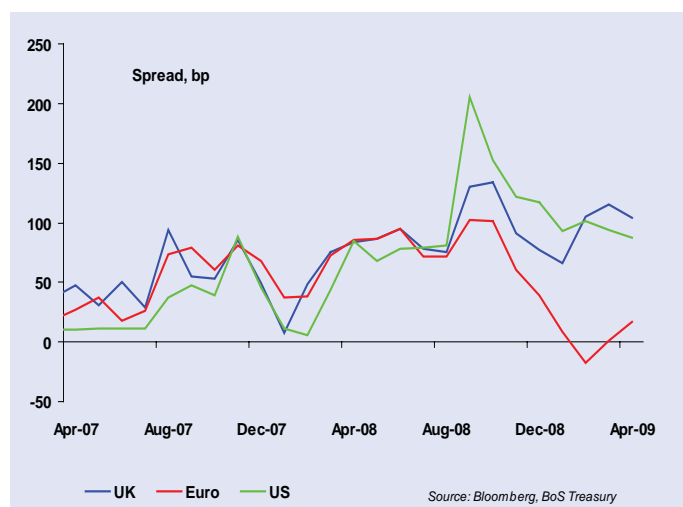
The effectiveness of any QE from the ECB should also be enhanced by the Bank of England and Federal Reserve being pre-committed to such action. If the latter improves sentiment, proceeds from euro area government bond sales are more likely to be lent on to households and firms. In short, the risk of hoarding by banks would be mitigated.

Our eurozone swap yield forecasts assume that the ECB

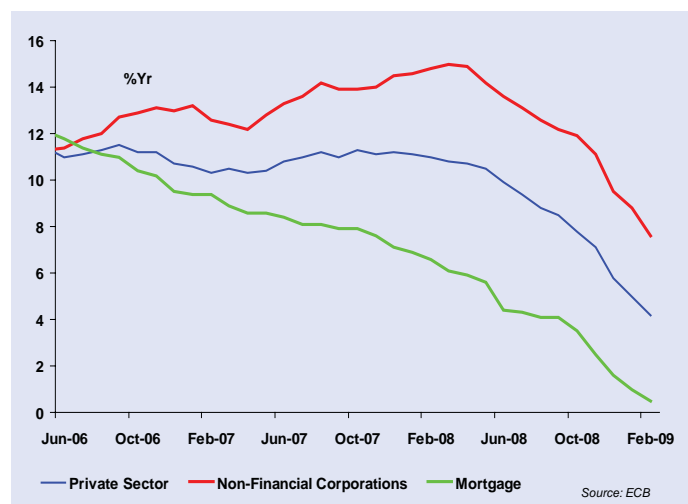
### Recent ECB liquidity-enhancing measures seem to have improved credit conditions...but can this be sustained?



### 3-month Libor minus official central bank policy rates



### Slowdown in eurozone bank lending growth continues...



begins a policy of fully-fledged QE in the second half of this year. To the extent this QE is targeted at medium and longer-dated government bonds, there is potential for marked curve flattening during Q3 and Q4. Although swap spreads may widen, by the end of this year the spread between 2-year and 10-year swap rates is forecast to have dropped from 150bp towards 120bp. The flattening is expected to be driven by the longer end, with the 10-year euro swap rate expected to drop from 3.6% to around 2.7% by end-year

There is a risk, however, that any QE-induced fall in market yields is rapidly reversed, as markets focus on the poor state of public finances in various eurozone countries. But the more significant – and durable – curve steepening is likely during the course of 2010, as the economy responds more effectively to past ECB rate cuts, fiscal and quantitative easing, alongside a recovery in global risk appetite.

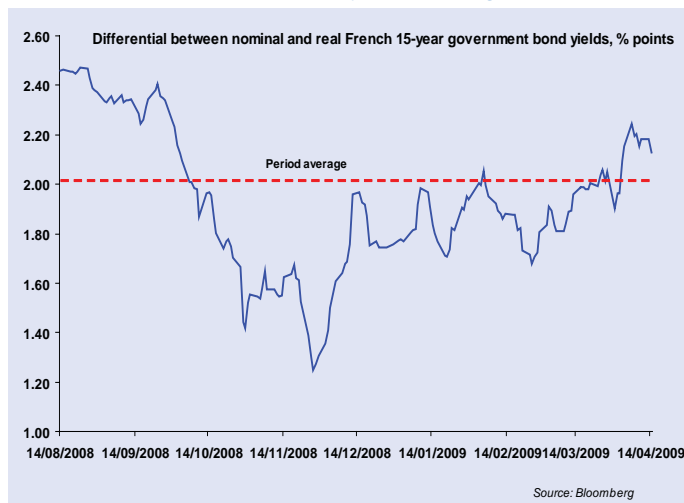
'Non-standard' policy measures have now taken centre-stage at the ECB. But Mr. Trichet has also noted that further interest rate easing, from a current main refinancing rate of just 1.25%, is possible. Based on the economic outlook we expect the ECB's main rate to be cut once more, by 25bp at the next ECB meeting. Further modest cuts in the refinancing rate cannot be ruled out, but it is questionable how much impact this would have, as the focus of monetary policy has shifted away from the main refinancing rate, to the deposit rate. This rate - where banks can park funds overnight - is already effectively at zero (0.25%).

One scenario which might warrant the ECB's cutting its main refinancing rate below 1% would be an episode of deflation. In these circumstances, further easing could be justified on the grounds that, other things being equal, *real* interest rates would be lower. As things stand, deflation – a persistent period of year-on-year price declines – seems unlikely. While the current euro CPI rate has fallen to just 0.6% in the year to March, longer-term inflation expectations remain positive and have actually risen since November.

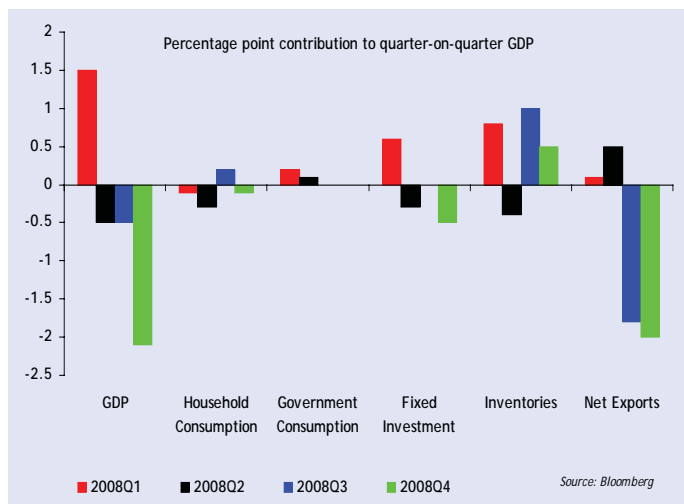
This is not to understate the extent of the current slowdown. On our forecasts, the eurozone will remain in recession during 2009, with only anaemic growth expected in 2010. In some ways, the eurozone finds itself in a similar position to countries like Japan. Weak demand for exports is exerting a significant drag on activity. In Germany, for example, GDP fell by some 2.1% quarter-on-quarter in Q4, almost all of which was accounted for by net exports, traditionally a key driver of growth.

The outlook for eurozone exports is further challenged by deteriorating economic prospects in Eastern Europe. Around 30% of the euro area's exports are directed to this region. The combination of weaker export demand (and a further slowdown in bank lending) points to continued weakness in output this year and next. Overall, eurozone GDP is forecast to contract by 3.1% in 2009, followed by a very modest expansion of 0.2% in 2010.

### Longer-term inflation expectations remain positive - and have actually been rising



### Net exports were by far the biggest drag on German GDP in 2008H2



### Eurozone forecasts

Annual % chg	2008	2009	2010
<b>GDP</b>	<b>0.7</b>	<b>-3.1</b>	<b>0.2</b>
Household Spending	0.3	-0.6	0.1
Public Spending	1.9	2.4	2.8
Private Investment	-0.2	-6.6	-1.2
Stocks % GDP	0.1	0.1	0.1
Exports	1.1	-7.1	-0.1
Imports	1.2	-3.5	0.1
<b>CPI (Q4)</b>	<b>2.3</b>	<b>0.5</b>	<b>1.6</b>
%	Spot	Sep-09	Mar-10
<b>ECB Refinancing Rate</b>	<b>1.25</b>	<b>1.00</b>	<b>1.00</b>
3-mth Euribor	1.41	1.20	1.20
2-yr swap rate	1.92	1.60	1.50
5-yr swap rate	2.75	2.30	2.40
10-yr swap rate	3.43	3.00	3.00

## Economic weakness is broad-based, with the external sector under particular pressure. Recovery in Canada depends on financial, as well as trade, links with the US.

Canada remains in recession with weakness evident in both the domestic and external sectors. Emphasis placed by the Bank of Canada (BoC) on recovery in the *global* economy has been noticeable. Most obvious in this regard is the US, which accounts for some 75% of Canada's exports. Meanwhile, the BoC has reduced its key overnight rate by some 425bp since December 2007, to just 0.25%. A shift to quantitative easing (QE) seems possible in the near term.

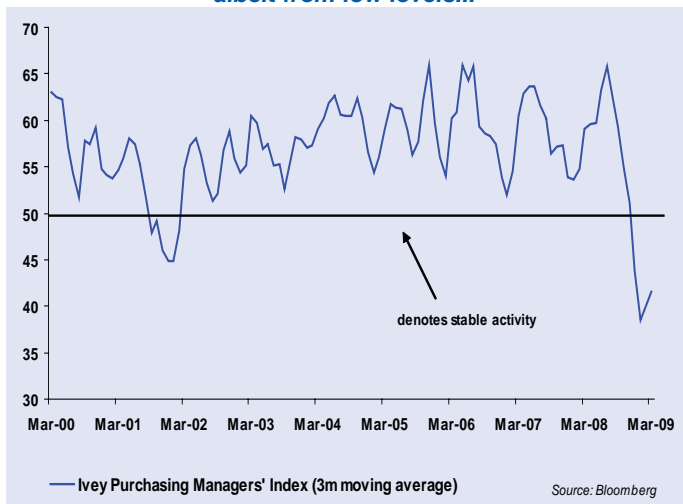
Since our last *Outlook* in January, labour market conditions in Canada have deteriorated. But there have also been tentative signs of stabilisation – albeit from low levels - in business surveys such as the Ivey PMI, with similar findings in the BoC's Q1 Business Outlook. The wider problems of tighter bank credit availability remain - at least for the time being. The most recent BoC senior loan officer survey, for example – conducted between 17 and 24 March – showed the net balance of respondents citing tighter credit conditions gauged in terms of price (e.g. bank interest rate spreads and/or fees) was the highest since records began in 1999Q2.

The survey period for this report closed just as US Treasury Secretary Timothy Geithner announced a plan to tackle problem loans on banks' balance sheets and free up the market in various types of (toxic) assets. BoC Governor Mark Carney noted recently that stabilization of the global financial system remains a precondition for economic recovery in Canada. So it may be that the US measures improve credit availability in Canada's banking sector going forward. But this process is likely to be gradual. On our projections, Canadian domestic demand is unlikely to stage a meaningful recovery much before early 2010. Just as direct trade links with the US are vital for Canada's economic prospects, so are the *indirect* effects from efforts to bolster the US financial system.

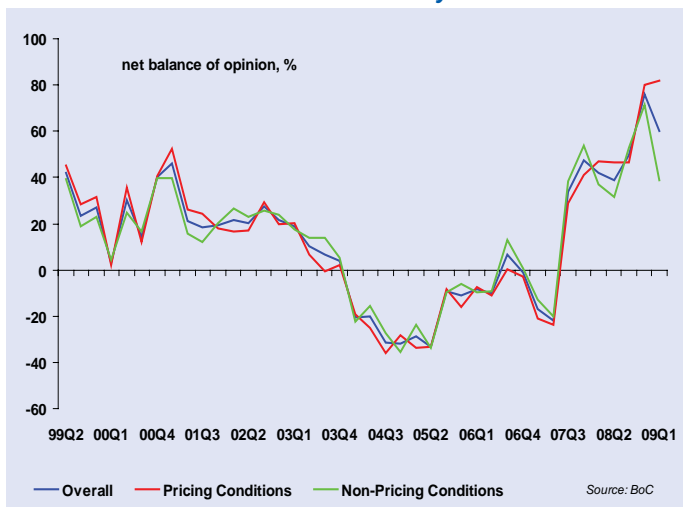
Indeed, Canada's close ties with the US probably go some way to explaining some of the measures in the recent Budget. For instance, C\$12bn earmarked for a Secured Credit Facility to support financing of vehicles and equipment, resembled the recent US Term Asset-Backed Securities Loan Facility (TALF). Overall, the Canadian Budget - with both spending on public infrastructure projects and tax cuts – should reinforce domestic economic recovery next year. Our GDP forecasts stand at -2.5% and 2.2%, respectively, for this year and next.

Downside risks to economic activity in 2009 suggest rising spare capacity and hence weaker inflation pressures. The BoC's latest Business Outlook survey suggests as much. The percentage of firms reporting they would have significant difficulty meeting an unexpected increase in demand fell to its second lowest reading on record. And some firms anticipated falls in output prices over the next 12 months. At 1.2% in the year to March, Canada's CPI rate is at the lower end of the BoC's 1-3% target range. So the possibility of deflation – though not currently embodied in financial markets via inflation expectations – cannot be ruled out. From a current 2s-10s swap spread of 190bp, near-term yield curve flattening in Canada seems likely. This would be reinforced, at least over the short haul, should the BoC shift to some form of QE. But looking towards 2010, the prospect of a US-led back-up in term rates transmitting to Canadian yields remains an important theme.

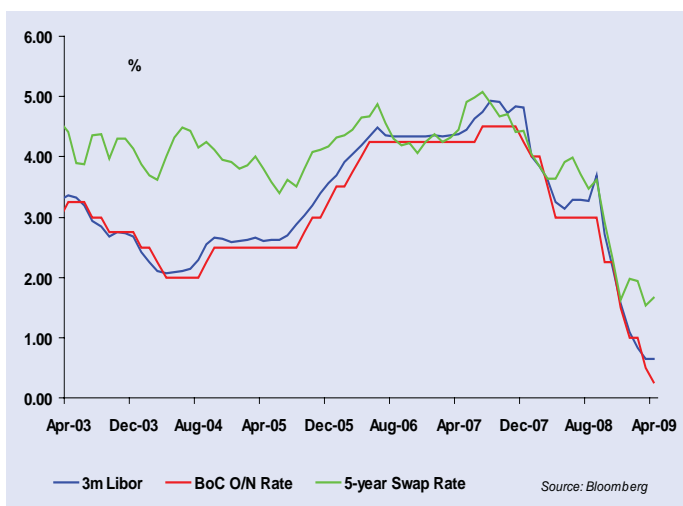
### Business surveys showing tentative signs of stabilisation - albeit from low levels...



### ...but credit conditions remain very tight, as the latest BoC senior loan officer survey attests



### A shift towards QE seems likely from the BoC...



## Foreign Exchange

The first quarter of 2009 has been characterised by general range-bound trading in most G10 currencies against the US dollar (USD). GBP/USD and EUR/USD have traded in the \$1.35-\$1.54 and \$1.24-\$1.41 ranges, respectively. Foreign exchange volatility remains elevated compared with historic levels, although there has been a marked pull-back in recent months. Current annualised (implied) volatility still remains around 7% above its historical average in both currency pairs, having peaked around 23% above long-term average volatility levels.

Two counter-balancing forces are helping to stabilise the USD. First, risk aversion driven by weak economic data and a collapse in global trade have provided a USD-positive environment. Over the past year, the US current account deficit has dropped from 6% to 3.7% of GDP. The second and opposing force has been created by extremely aggressive US policies aimed at limiting the fall-out from the recession - namely, an unprecedented loosening in monetary policy and massive fiscal stimuli.

The impact of global fiscal stimuli are now beginning to emerge and should continue to have a larger impact in Q2 and Q3 2009. Global leading indicators, such as the purchasing managers' indices, have begun to improve, indicating that the pace of decline in global output is moderating. Whilst a return towards growth would be USD-negative (as emerging market nations begin to diversify reserves again), the prospect of a broad-based recovery in G10 growth remains limited. In the meantime, bouts of risk aversion are likely to provide periodic episodes of support for the USD.

The sterling trade-weighted index has been in a consolidation formation in Q1 and is now close to a 3-month high. This has been supported by a rise in UK banking stocks and tentative signs of improvement in UK economic data. This has allowed EUR/GBP to fall from the extremely overbought levels reached late last year, when the currency pair approached parity. The ECB continues to loosen monetary policy. Narrowing in Eurozone/UK interest rate spreads, and the expected announcement of 'non-standard' measures by the ECB in May, followed by the possibility of fully-fledged quantitative easing later in the year, suggest EUR/GBP could fall further.

**Sterling in consolidation formation reaching 3-month high**



## Commodities

The rapid declines in commodity prices observed in the second half of 2008 appear to have come to an end as the CRB (the broad commodity price index) declined by just 4% in the first quarter of this year. The index had fallen by 25% and 33% in Q3 and Q4 of 2008, respectively.

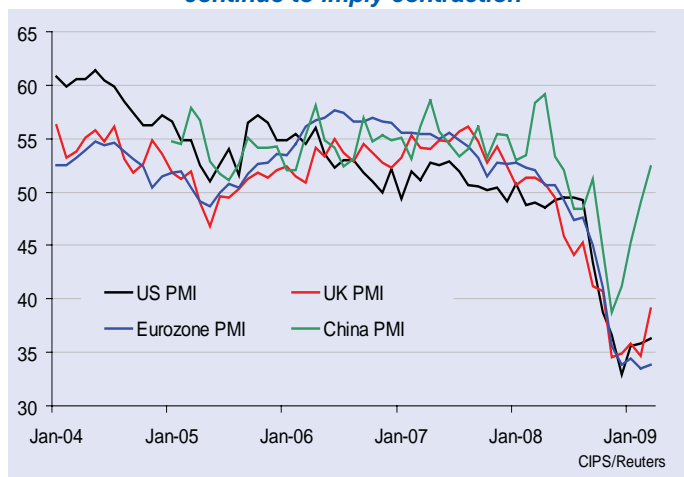
Over the last quarter, the Baltic Dry Freight Index (a barometer for the international shipping of commodities and materials) has gained traction and more than doubled in value. Although this bounce is large enough to initiate debate of a recovery, it should be viewed in the context of the massive decline recorded earlier in the year: between June and December 2008, the index dropped from 12000 to a low of just over 600. Hence, it is still far too early to suggest the recovery in the index points to a growth-led rally.

Global PMIs have started to turn higher. However, the majority (with the notable exception of China) remain well below 50 and therefore consistent with continued recession. Nonetheless, the moderation in the pace of decline suggests that demand destruction in the commodities market is beginning to abate. Whilst the move by the Chinese PMI into expansionary territory is fuelling debate over a sustainable recovery, a reading of just 36.3 in the latest US manufacturing ISM survey implies the outlook for commodity demand remains weak. This suggests that conditions are not yet sufficient for a sustainable commodity rally. Any further rise in risk aversion is likely to result in commodities re-testing their cycle-lows.

Oil has benefited from the aggressive OPEC production cuts, fixing it firmly around the \$50/barrel mark. Crude oil stocks, however, remain high and global refining capacity is still growing. In the absence of further production cuts by OPEC, the current rally in oil appears vulnerable to a downside correction. The gradual improvement in the economic data, however, suggest that a new cycle-low is unlikely.

The ongoing global stimulus should help to stabilise economic output over the coming year, reducing demand destruction and creating a medium-term positive factor for commodity prices. A sustainable rally in commodity prices, however, is unlikely until confidence returns to financial markets. For this, we need to see not only an improvement in the leading and coincident indicators, but also clearer signs that credit conditions have normalised.

**Global PMIs starting to turn higher but most continue to imply contraction**



# Key Economic Forecasts

	2007	2008	2009	2010
<b>GDP (%yr)</b>				
United Kingdom	3.0	0.7	-3.5	0.7
United States	2.0	1.2	-2.6	1.6
Eurozone	2.6	0.7	-3.1	0.2
Canada	2.6	0.5	-2.5	2.2
<b>CPI Inflation (Q4 %yr)</b>				
United Kingdom	2.1	3.9	0.7	1.5
United States	4.0	1.6	-0.1	1.8
Eurozone	2.9	2.3	0.5	1.6
Canada	2.4	1.9	0.6	1.9
<b>Unemployment Rate (Q4 %)</b>				
United Kingdom	5.3	6.1	10.4	10.0
United States	4.8	6.9	10.5	9.8
Eurozone	7.3	8.0	10.2	10.2
Canada	5.9	6.4	9.5	9.2

# Interest Rate Forecasts

	Current	Sep-09	Dec-09	Mar-10
<b>Official Interest Rates (%)</b>				
UK Bank Rate	0.50	0.50	0.50	0.50
US Federal Funds Rate	0-0.25	0-0.25	0-0.25	0-0.25
ECB Refinancing Rate	1.25	1.00	1.00	1.00
Canada Overnight Rate	0.25	0.25	0.25	0.25
<b>2-Yr Swap Rates (%)</b>				
United Kingdom	2.20	2.00	2.10	2.30
United States	1.53	1.40	1.40	1.60
Eurozone	1.92	1.60	1.50	1.50
Canada	0.80	0.70	0.60	0.80
<b>10-yr Swap Rates (%)</b>				
United Kingdom	3.75	3.40	3.70	4.20
United States	3.00	2.80	3.10	3.70
Eurozone	3.43	3.00	2.70	3.00
Canada	2.68	2.50	2.70	3.10
<b>30-yr Swap Rates (%)</b>				
United Kingdom	3.90	3.60	3.90	4.50
United States	3.33	3.10	3.30	3.80
Eurozone	3.80	3.40	3.20	3.40
Canada	3.64	3.40	3.60	4.00

# Currency Forecasts

	Current	Sep-09	Dec-09	Mar-10
<b>Currencies</b>				
GBP/USD	1.46	1.54	1.62	1.68
GBP/EUR	1.13	1.20	1.23	1.25
EUR/USD	1.29	1.28	1.32	1.34
USD/CAD	1.25	1.20	1.15	1.11
AUD/USD	0.70	0.72	0.77	0.82

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