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Main Macro Views and Market Strategy:

- Encouraging signs have recently appeared that the global economy is starting to recover from the severe contraction that took place in Q4 08 and Q1 09, as massive fiscal and monetary stimulus has managed to stabilize expectations, putting a halt to the freefall of economic activity.

- Our leading indicator of a rebound of the US economy currently points to a probability of 57% that the worst is over, well above the average level of 34% which the indicator had reached at the end of the previous 10 recessions.

- We believe that the US recession will likely end by late summer and the global economy will start to rebound by year-end. However, the recovery will be weak, as policy shocks fade, oil prices stay elevated and bond yields increase due to excessive fiscal deficits. Hence, we expect the Fed to keep short term interest rates unchanged until Q2 2010.

- With increasing evidence that the worst is likely over for the global economy, we believe that the equity bear market has ended. We expect China and the US to emerge first from the global recession and suggest overweight positions in US equities and selective EMs.

- In style positioning, we continue to prefer large growth stocks as a defensive strategy against a backdrop in perceived prospects of global growth, as markets will increasingly look for confirmation from hard data that the global recovery is alive and well.

- With quantitative easing and excessive public debt issuance in the US, we expect Treasury yields to increase and prefer TIPS over Treasuries.

- With the main risks to the global economy being inflation and a US dollar depreciation, gold is likely to rally, as investors will seek for safety in real assets. The risk of a double-dip recession also favours gold, as the yellow metal has generally exhibited negative correlation with global equities.

Macro Forecasts

	2008	2009		2010	
		Eurobank EFG	Consensus	Eurobank EFG	Consensus
Real GDP Growth (y-o-y average)					
US	1.1	-2.8	-2.7 (-3.4 – -1.4)	1.3	1.9 (-0.2 – 3.8)
EA	0.8	-4.4	-4.3 (-5.0 – -3.9)	0.5	0.6 (-1.8 – 1.5)
Japan	-0.6	-5.5	-6.0 (-7.0 – -5.6)	0.3	1.0 (-5.4 – 2.2)
CPI Inflation (y-o-y average)					
US	3.8	-1.0	-0.5 (-1.4 – 3.0)	2.0	1.8 (-0.5 – 4.0)
EA	3.3	0.5	0.5 (0.3 – 0.7)	1.1	1.5 (0.5 – 2.1)
Japan	1.4	-1.5	-1.2 (-1.5 – 0.3)	-0.8	-0.8 (-1.4 – -0.5)
Short Term Interest Rates (end of year)	Current				
US	0.00-0.25	0.00-0.25	0.25 (0.00 – 1.25)	0.50	1.25 (0.00 – 3.00)
EA	1.00	1.00	1.00 (0.75 – 1.00)	1.50	1.25 (1.00 – 1.50)
Japan	0.10	0.10	0.10 (0.00 – 0.10)	0.10	0.10 (0.00 – 0.10)

Note: Range of forecasts by Bloomberg's survey in parentheses below point estimates.

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Executive Summary

Dimitris Malliaropulos, Olga Kosma, Maria Prandeka

Global economy: the worst is over

Over the past few months, signs have appeared that the global economy is recovering from the severe contraction that took place in Q4 08 and Q1 09 as massive fiscal and monetary stimulus has managed to stabilize expectations, putting a halt to the freefall of economic activity. Leading indicators in the US, such as the closely watched ISM manufacturing index have increased significantly from their trough levels in January. Consumer confidence has been on an upward trend since March, as lower oil prices relative to H1 08, tax rebates, falling prices of goods and services and lower mortgage rates have supported real disposable income and personal consumption. US employment is also showing some signs of stabilization as job losses have eased from their peaks of the previous six months, although the rate of unemployment continued to increase. Our leading indicator of a rebound of the US economy – which condenses information from a wide range of economic variables – currently points to a probability of 57% that the worst is over, well above the average level of 34% which the indicator had reached at the end of the previous ten recessions.

Sluggish recovery ahead

Given this improvement, we believe that the US recession will likely end by late summer. However, issuing a call for the end of the US recession is far from issuing a call for a sustained and dynamic recovery. We expect real GDP in the US to contract by 2.1% q-o-q in Q2 09, stabilize in H2 09 and increase modestly by 1.3% in 2010. There are several reasons for a sluggish recovery both in the US and the global economy. First, the notable improvement in expectations over the past few months may be an overreaction to massive government support, implying that leading indicators may level off soon as policy shocks fade away and overconfidence effects vanish. Second, oil prices have more than doubled from their trough in early 2009, putting pressure on real disposable income of consumers and leading to further slowdown of domestic demand. Third, excess public debt and the expansion of the Fed's balance sheet increase the risk of a sharp pickup in inflation and bond yields in 2010-2011, leading to a crowding out of private investment and, ultimately, a second leg in the economic downturn.

Outside the US, economic conditions have been improving too, most notably in Australia, which posted positive growth in Q1 and seems to have come out of the recession, and China, where the PMI manufacturing index has recently climbed above the threshold of 50 and industrial production has picked up, suggesting that the Chinese economy is rebounding already.

After a sharp slide at the start of the year, the Euro area's economy has probably passed the trough and could well get back to positive growth by early 2010. Although leading indicators are still very low by historical standards and consistent with a contraction in real economic activity, they have recently shown signs of stabilization. Our latest projections confirm a further substantial downgrade to the growth outlook for 2009 to -4.4% y-o-y and a modest and gradual recovery in 2010, with real GDP growth hovering around zero.

Although Japan was the worst-performing economy among major industrialized countries in Q1 09, due to its dependence on international trade, its economic cycle seems to be running ahead of the US and the Euro area, due to a revival in industrial production and exports. However, the positive moves are partially offset by a rather bleak picture for private domestic demand. We expect the Japanese economy to show renewed weakness towards 2010, as the positive effect on consumption growth from economic stimulus measures fades and the economic recovery in major trading partners proves to be sluggish.

Recent economic indicators are showing clear signs of improvement in most Emerging Markets economies as well, with China being the main stabilization force. However, returning soon to buoyant growth rates seen in recent years will be difficult to achieve, mainly due to a sluggish global recovery and reduced access to external financing. Indeed, most of the recent rebound in Emerging Markets' economic activity is fueled by domestic demand (particularly public investment), given that world trade is still contracting sharply.

Risk #1: Inflation will be back sooner than expected

Looking forward, there are three major risks to our global outlook. The first is a resurgence of global inflation as oil prices continue their upward trend and monetary policy in major parts of the world remains loose well into 2010. This risk is particularly high in the US, where quantitative easing has already led to a significant acceleration of money supply growth, especially base money, which has more than doubled over the past twelve months. The recent extension of a number of the Fed's liquidity facilities into early 2010 suggests that US monetary policymakers opt for a late exit strategy from quantitative easing, increasing the risk that inflation will be much more difficult to control when the economic recovery is well under way. Besides, "inflating away" the public debt by tolerating a reasonable but not excessive rate of inflation over the next few years will increasingly become an attractive political choice for US policymakers.

Risk #2: A breakdown of the US dollar

The second risk is a breakdown of the US dollar as excessive public debt issuance by the US government threatens to push Treasury yields higher and trigger a flight out of US dollar assets. The recent suggestions by the Peoples' Bank of China to launch a supranational reserve currency is a stark reminder that the status of the US dollar as the major international reserve currency is increasingly getting under threat.

Risk #3: A double-dip recession

The third risk is a double-dip recession similar to 1980-82, as rising energy prices and long-term interest rates depress private spending in late 2010 or 2011. It is worth noting that the so-called “green shoots” are so far mainly related to a rebound in business expectations indices such as the ISM index. In contrast, hard data, such as industrial production have not yet confirmed that the rebound in expectations has led to a real improvement in economic activity. Notably, according to our research, in five out of ten past US recessions, the ISM index has been a false dawn as the economy continued to deteriorate for several months after the ISM index has rebounded.

Implications for investors

Equities: Bear market has ended but earnings outlook remains negative

Global equity markets have rebounded sharply from their inflection point in early March as leading indicators started to improve, suggesting that the pace of contraction of the global economy is flattening. To a large extent, the equity market rally reflects, in our view, a significant decline in risk premia, as massive intervention by governments and central banks has taken out the tail probability of a generalized collapse of the global financial system. As a result of increasing risk appetite, implied volatility declined quickly from its peaks of 80+ after the collapse of Lehman in September 08 to well below 30 in late June, risk premia declined and equity valuations increased sharply. With increasing evidence that the worst is likely over for the global economy, we believe that the equity bear market has ended.

However, with the S&P 500 index having rallied by 40% from its trough in March and some emerging markets having gained more than 60% year-to-date, it is difficult to imagine equity markets can rally much further without confirmation from hard data that global growth is in the process of returning to positive territory. Besides, despite the rebound in leading economic indicators, the outlook on corporate earnings remains negative. On the positive side, there is substantial evidence that the US recovery is very much intact and the risk of a freefall of economic activity and a freeze of credit markets has abated. However, new headwinds are surfacing. US consumers have embarked upon a process of long-term deleveraging, rising oil prices weigh on disposable income and spending, excessive fiscal deficits threaten to push long-term interest rates higher and inflationary pressures are gradually re-building. Against this backdrop, we suggest to remain cautious in the short-term but maintain a bullish long-term view for equities.

Within global markets, we expect EMs and the US to emerge first from the global recession and suggest overweight positions in US equities and selective EMs. Relative to small- and mid-cap equities, large caps seem to be less vulnerable to sup-par economic growth and earnings risk continues to be a concern for small caps as they are more exposed to a setback in economic activity. Overall, we continue to prefer large growth stocks as a defensive strategy against a backdrop in global growth.

Government bonds: Treasury yields on an upward trend

We maintain our view that excessive government debt issuance in the US may eventually push Treasury yields higher despite the planned buying of Treasury Notes by the Fed. With the US economy starting to emerge from the recession and inflation expectations on an upward trend, we expect 10-year Treasury yields to approach 4.2% by year-end and 4.6% by mid-2010, a full percentage point above current levels. With oil prices having more than doubled since January and favourable base effects from higher oil prices in H1 08 fading in the second half of the current year, we expect headline CPI inflation to make a dynamic comeback in Q4 and increase to 2.6% by end-2010. With the 10-year Treasury Inflation Protected Securities (TIPS) pricing in headline CPI inflation of 1.9% on average over the next 10 years, we continue to see value in TIPS.

Foreign Exchange: USD weakness

We believe that the threat of a dynamic comeback of US inflation in 2010 – triggered by massive quantitative easing by the Fed and excessive public debt issuance by the US Treasury – will potentially undermine the value of the US dollar in the medium term (12 months) although the dollar may be supported in the short term by a renewed bout of risk aversion. Given the risk of a correction in global equity and credit markets as the optimism that has built up over the past three months may be starting to fade, we favour the Japanese Yen against the euro in the short term (1-3 months), as investors are likely to flight back into save haven currencies and real assets.

Commodities: Gold is the winner

Overall, prospects for commodities are favourable in the long-term, as the global economy starts to rebound. However, with the main risks to the global economy being inflation or a US dollar depreciation, gold has, in our view, the best chances of a solid performance, as investors will increasingly seek for safety in real assets. Our third risk of a double-dip recession also favours gold as the yellow metal has generally exhibited negative correlation with global equities.

Industrial metals are also likely to gain from inflation and currency uncertainty but they are more vulnerable in the short term to a deterioration of global economic conditions. The positive case for industrial metals is that they will likely post significant gains when global industrial production starts to rebound. In addition, we expect industrial metals' prices to be supported by increased demand from China, where manufacturing activity is picking up and the PBoC seems to start diversifying its foreign currency reserves away from the US dollar.

We are less favourable for crude oil in the short term, as it seems to be a one-way bet that the global recovery is well under way and would look for lower levels (USD 50-60) to enter this market.

II. EFG Macro Model Forecasts

US Economy & Markets

	Actual	------------- Forecasts ---------------						
	2009:Q1	2009:Q2	2009:Q3	2009:Q4	2010:Q1	2008	2009f	2010f
GDP q-o-q saar	-5.5	-2.1	0.7	1.1	1.7	-0.9	-1.5	2.4
GDP y-o-y	-2.5	-3.7	-3.4	-1.5	0.3	1.1	-2.8	1.3
Consumption y-o-y	-1.4	-0.4	0.1	2.0	2.0	0.2	0.0	1.9
Labor Market								
Civilian Employment y-o-y	-3.6	-3.6	-3.8	-3.8	-3.2	-0.8	-3.7	-2.4
Civilian Unemployment Rate	8.5	9.4	9.4	10.4	11.0	5.8	9.3	10.5
Inflation								
Headline CPI y-o-y	-0.5	-1.9	-1.3	-0.3	0.8	3.4	-1.0	2.0
Core CPI y-o-y	1.8	1.5	1.6	1.7	1.8	2.2	1.6	1.9
Core PCE y-o-y	1.8	1.6	1.6	1.7	1.6	2.1	1.7	1.7
Interest Rates (% end of quarter)								
Fed Funds	0.13	0.13	0.13	0.13	0.13			
10-y Treasury yield	2.71	3.50	3.58	3.74	3.78			
Spreads (bps, end of period)								
10y-2y Treasury	256.0	335.0	343.2	359.5	363.2			
10y Treasury-Bund	-29.2	-10.6	-14.5	-17.5	-21.6			
Exchange Rates (end of quarter)								
USD/EUR	1.32	1.39	1.31	1.41	1.45			
Probability of								
10y-1m Spread to increase	0.99	0.99	0.81	0.91	0.94			
S&P500 to outperform 10-y UST	0.00	0.90	0.42	0.72	0.69			
Bund to outperform 10-y UST	0.81	0.38	0.26	0.48	0.43			

Note: All forecasts are based on the estimates of a quarterly econometric model of the US economy and main financial markets. Point forecasts and probability estimates are subject to risks and should be only indicative of medium-term trends of the economy and financial markets.

Probabilities in the bottom part of the table are based on probit model estimates. They range between zero and one. A probability of more than 0.5 suggests that we regard this event as more likely to happen. All numbers in the table are pure model forecasts. They serve the purpose to provide a consistent view of the US economy and main financial markets based on historical regularities.

Euro area economy

	Actual	------------- Forecasts	---------------					
	2009:Q1	2009:Q2	2009:Q3	2009:Q4	2010:Q1	2008	2009f	2010f
GDP y-o-y	-4.8	-4.9	-4.7	-3.0	-0.7	0.8	-4.4	0.5
Consumption y-o-y	-1.1	-1.0	-0.9	-0.8	0.1	0.3	-1.0	0.4
Labor Market								
Employment y-o-y	1.6	-2.7	-3.5	-3.3	-2.3	0.8	-2.0	-1.0
Unemployment Rate	8.7	9.5	9.9	10	10.4	7.5	9.5	10.5
Inflation								
Headline CPI y-o-y	1.0	0.3	-0.2	0.8	1.2	3.3	0.5	1.1
Core CPI y-o-y	1.6	1.5	1.1	0.6	0.7	2.4	1.2	0.7

Note: All forecasts are based on the estimates of a quarterly econometric model of the Euro area economy.

III. Global Economic Outlook

1. The US economy

Dimitris Malliaropulos, Olga Kosma

- Leading indicators have been recently showing signs of improvement, reinforcing the optimistic view that the rate of the economic contraction is slowing down. With the policy stimulus gaining traction, we expect economic activity to rebound in H2. Our baseline projections suggest that real economic activity will decline by about 2.8% y-o-y in 2009, with an anaemic rebound of about 1.3% in 2010.
- We expect a rather “jobless US recovery” -as was the case in the last two US recessions- with the labor market continuing to weigh on the real economy well into 2010. Moreover, given the excessive public debt, bond yields could increase sharply in 2010, leading to a crowding out of private investment and, ultimately, a second leg in the economic downturn.
- While headline inflation is expected to continue declining in the short term, rising oil and commodity prices will eventually push inflation higher towards 2010.
- With consumer inflation moving to negative territory for the first time in 55 years and an anemic recovery ahead for the US economy, we believe that the Fed’s commitment to low interest rates will hold good until the housing and the financial markets stabilize and the labor market recovers.

Sluggish economic rebound ahead

Leading indicators have been recently showing significant improvement, reinforcing an optimistic view for real economic activity in the US. The PMI manufacturing index has gradually increased by 10 units from its recent trough in December 2008, climbing to 42.8 in May 2009. Consumer confidence indices have been on an upward trend since March 2009, as lower oil prices relative to H1 08, tax rebates and Fed intervention in MBSs has supported real incomes and real house prices. Housing activity, including sales and new construction, appears to have stabilized in the past few months, while the collapse in payrolls has abated with job losses slowing significantly in May. Our leading indicator of a US economic rebound[1] -based on the ISM manufacturing index, the ISM inventories index, the unemployment rate and the industrial production - currently points to a 57% probability of recovery, standing well above the 34% average probability that the model had forecasted during the final two months of the previous 10 recession episodes (Figure 1.1). Based on historical experience, when this probability peaks, the US economy starts expanding two months later. Hence, if history is any guide, the US recession should end by the end of the summer. However, although we do believe that the rate of the economic contraction has slowed markedly and the recession is nearing to an end, we remain cautious about the US recovery and expect a gradual and sluggish economic rebound. The sudden rebound in expectations since February may be an overreaction to massive government support, so we should be alert to confirm that the positive signs in economic activity remain intact as policy shocks fade away and the overconfidence effect vanishes.

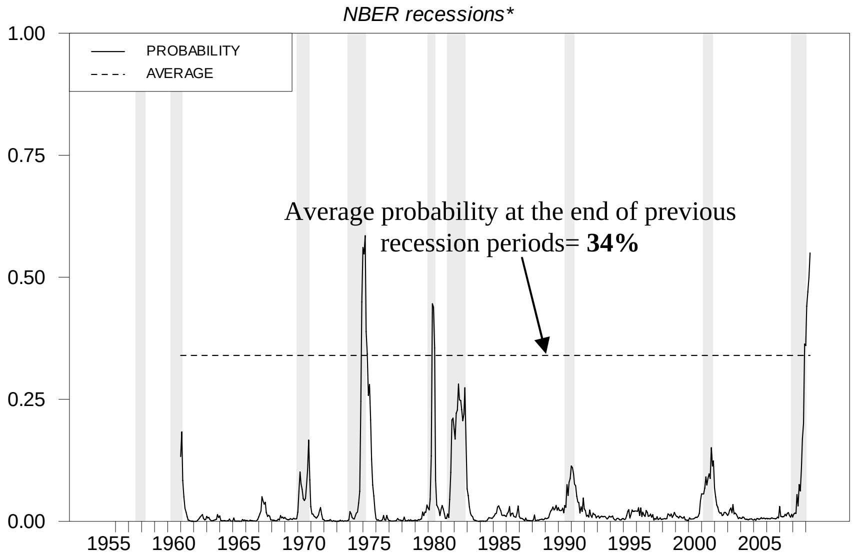
Besides, hard data, such as industrial production, has not yet shown any signs of stabilization. As we have stated in our previous Global edition (March 2009), in 5 out of 10 previous US recessions, the ISM manufacturing index gave a false signal of an economic recovery. That is, the index dipped to a cyclical low and then increased over the next few months, before reaching the trough of each recession. The behaviour of the index generates a great deal of uncertainty about whether the manufacturing slowdown has peaked. Furthermore, it should be pointed out that in the current recession the

[1] For details about our leading indicator of a US economic rebound see our March 2009 Global edition.

historical correlation between ISM and industrial production seems to have broken down (Figure 1.2). In previous business cycles, when the ISM manufacturing index had finally bottomed out, the annual growth of industrial production index started to bottom out a couple of months later. The ISM manufacturing index has been gradually improving since January 2009, while industrial production is still decelerating sharply, with the y-o-y growth rate falling to -13.4% in May from -12.7 in April. We expect a restrained industrial production recovery in the coming months, as, in our view, the ISM manufacturing index surge seems to overstate the magnitude of future production increases.

Figure 1.1

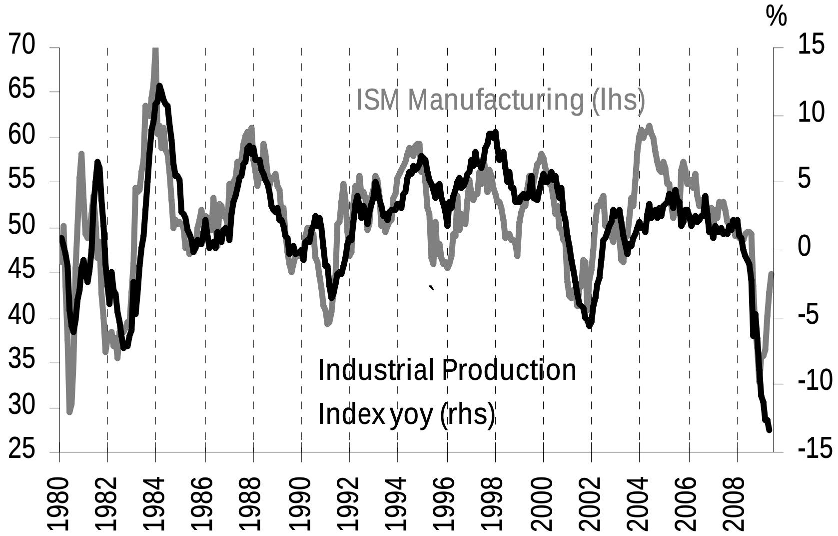
Probability of recovery has increased above historical standards



*The shaded areas represent US recession periods determined by the National Bureau of Economic Research.
Source: Eurobank EFG estimates

Our baseline projections suggest that real economic activity will continue to contract in Q2 09, although at a slower pace. In particular, we expect real GDP to contract by 2.3% q-o-q saar in Q2 from 5.7% in Q1 09, and stabilize in the second half of the year. Overall, we believe that real GDP will decline by about 2.8% y-o-y in 2009, with an anaemic rebound of about 0.8% in 2010. However, as we have previously stated (see our Global March edition), we cannot rule out a W-shaped recession. Oil and energy prices have recently surged. The expected global recovery could result in a generalized commodity price surge and, consequently, increasing inflationary pressures. This would probably have negative effects on commodity importers, putting pressure on real disposable income of households and leading to further demand slowdown. Moreover, as the government support fades, many US tax cuts (on incomes, capital gains, estates, dividends) will expire in 2010-2011, leading to a real disposable income squeeze. Given the excessive public debt, another risk would be a sharp increase in bond yields in 2010, leading to a crowding out of private investment and, ultimately, a second leg in the economic downturn.

Figure 1.2



Source: Bloomberg, Federal Reserve Bank of St. Louis

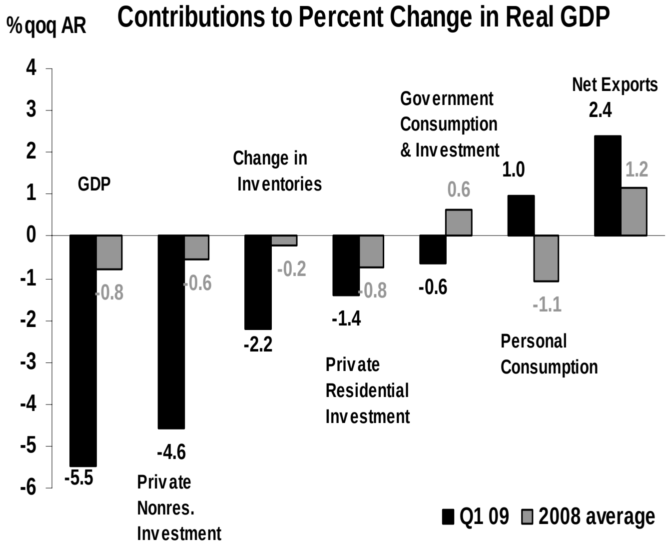
Real economic activity keeps contracting sharply in Q1, with consumption giving the most encouraging sign

Real GDP declined by 5.5% q-o-q saar in Q1 09, after a 6.3% contraction reported in Q4 08 (Figure 1.3). Real final sales decreased by 3.3%, as inventories' sharp fall accounted alone for almost half of the GDP contraction. Gross private domestic investment followed its traditional pattern of weakness in a recession, plummeting by 49% q-o-q saar. Both business and residential investment plunged by 37% and 34%, subtracting 4.6% and 1.4% from real GDP growth, respectively. Firms responded to the lack of corporate profits to finance growth; purchases of equipment and software fell by 34%, marking the sharpest quarterly decline since the 1958 recession. Nonresidential structures declined by 43%, given the economic uncertainty and the global credit crunch. Residential investment continued its downward trend, after a 28% annualized decline in the fourth quarter of 2008. As for net trade, real exports decreased 30% due to the global recessionary environment, while imports fell by a much faster pace at 36%, which led to a positive contribution of net exports of about 2.4%. Government expenditure surprisingly had a negative contribution of -0.6% due to a decline in defense and local government spending.

The most encouraging sign came from the consumer side, with personal consumption expenditures increasing by 1% q-o-q at an annualized rate in Q1 09. The stronger than expected consumption, concentrated in purchases of cars and other durable goods, is being underpinned by rising consumer confidence. Both measures of Conference Board and University of Michigan have been on an upward trend since March, suggesting that consumption is on track to stabilize in the coming months. Although the Conference Board confidence index suffered a modest setback in June after three consecutive strong gains, it still remains well below the multi year low of 25.3 announced in February. However, real consumer spending growth in the first quarter of the year was mainly concentrated in January. Inflation adjusted personal spending fell by 0.3% mom in March and by another 0.1% mom in April, dipping below the first-quarter average. While Fed measures to ease credit conditions, in combination with improving consumer expectations of economic and financial conditions and the fiscal stimulus package, might help private spending to stabilize by year-end, there are still a number of forces posing downside risks to consumption growth. Real disposable income may be squeezed in the remainder of the year, should the fiscal impulse and the tax cuts fade and inflation accelerates due to higher oil prices. In this case, the savings rate would continue its upward trend, dashing the prospects for a consumption recovery and an end to the recession. Nevertheless, in our view this is not the most likely scenario for the US consumer. With house prices starting to stabilize over the last couple of months, personal consumption has likely seen the worst. House price decline has decelerated in Q1 09 (Figure 1.5), while the housing affordability index is at multi-year highs (Figure 1.6). Moreover, the housing market index, an indicator of builder perceptions of current and future home sales, has been gradually increasing to 15 in June from the recent low of 8.0 in January 2009. Although housing starts and building permits continue declining by about 50% in April on a y-o-y basis, the decline of new home sales has decelerated from the trough of -46% y-o-y reported in January, normalizing the imbalance between housing supply and demand. According to our estimates, personal consumption will contract at a slower pace in Q2 09 and stabilize towards year-end, with an average growth rate close to zero for 2009.

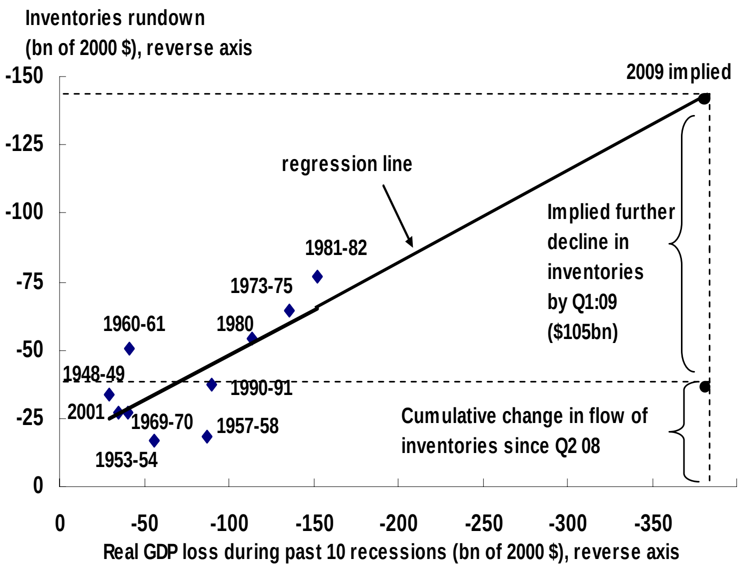
Figure 1.3

Contributions to Percent Change in Real GDP



Source: U.S. Bureau of Economic Analysis (BEA)

Figure 1.4

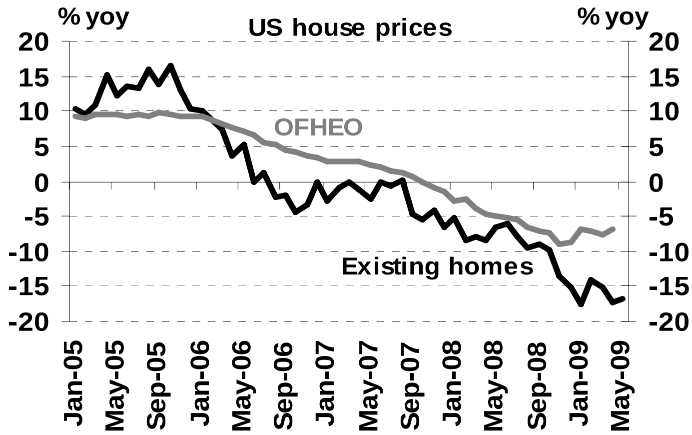


Source: Eurobank EFG estimates

Inventories drawdown has probably further way to go

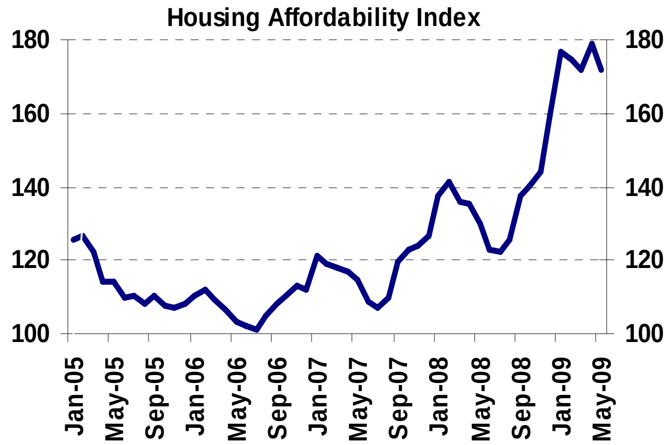
In contrast to personal consumption, which makes up for over 70% of US GDP, inventories are a relatively small fraction of overall economic activity. However, they are a critical component of changes in GDP during turning points of the business cycle. In line with our forecasts (see our Global March issue), GDP data confirmed that business inventories plunged in Q1 09. Private businesses decreased inventories by $87.1 bn, following decreases of $25.8 bn in Q4 and $29.6 bn in Q3 08. As Figure 2 shows, during the past ten US recessions, the loss in real GDP was accompanied by a significant rundown of companies' inventories, measured by the cumulative change in the flow of inventories from peak to through of the business cycle. The inventories' rundown during the ten recessions in the post-war period accounts on average for 62% of the GDP contraction (see Table 1.1).

Figure 1.5



Source: Federal Housing Finance Agency (FHFA), Bloomberg

Figure 1.6



Source: National Association of Realtors

Table 1.1
Inventory investment during US recessions

NBER US Recessions	Duration (in quarters)	Decline in real GDP (bn of chained 2000 $)*	Decline in inventories (bn of chained 2000 $)*	Decline in inventories as a % of the decline in real GDP
Q4 48 - Q4 49	5	-29.6	-33.3	113%
Q2 53 - Q2 54	5	-55.7	-16.7	30%
Q3 57 - Q2 58	4	-86.8	-18.6	21%
Q2 60 - Q1 61	4	-41.2	-50.5	123%
Q4 69 - Q4 70	5	-40.7	-27.3	67%
Q4 73 - Q1 75	6	-135.7	-64.3	47%
Q1 80 - Q3 80	3	-113.9	-53.9	47%
Q3 81 - Q4 82	6	-152.7	-76.5	50%
Q3 90 - Q1 91	3	-90.0	-37.2	41%
Q1 01 - Q4 01	4	-34.8	-27.4	79%
Average	**4.5**	**-78.1**	**-40.6**	**62%**
Current	**5**	**-366.9**	**-36.5****	**10%**

*The declines in real GDP and private inventories correspond to the largest peak-to-trough decline in real GDP within each recession. The decline in inventories is measured by the cumulative change in the flow of inventories from peak to trough of GDP, i.e. the second derivative of the stock of inventories.
**Cumulative change in the flow of inventories from Q2 08 to Q1 09.

Although the stock of inventories has cumulatively declined by roughly $37bn since the peak of GDP in Q2 08, the regression line in Figure 1.4 suggests that the decline in the flow of inventories by Q1 09 should have already amounted to $142bn. Hence, in order to match historical correlations, inventories will likely have to decline further by another $100bn, suggesting that the rundown of inventories has further way to go, in sharp contrast to the consensus view that inventories are at very low levels already and ought to increase sharply over the next few months. Monthly business inventories reinforce our view, falling by 1.1% m-o-m in April after a 1.3% drop in March 2009, due to declines in sales as firms continued to cater to slowing demand by running down on inventories. Besides, the PMI inventories index in the manufacturing sector, which is a leading indicator for inventories, continued to deteriorate in June 2009, revealing negative prospects for inventories in Q2 09.

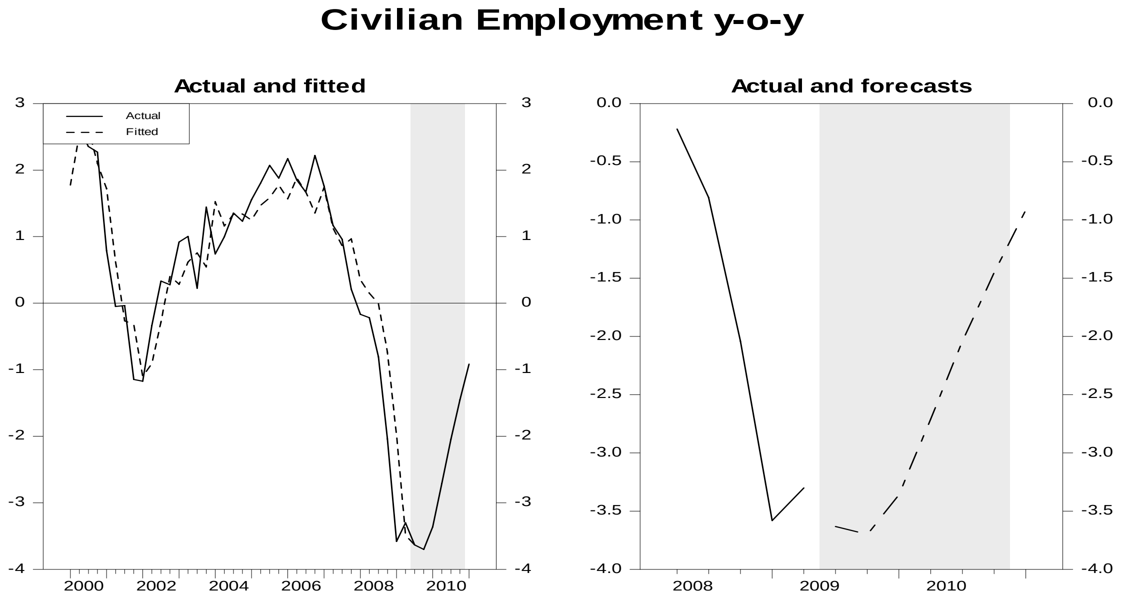
Is the US labor market at a turning point?

The US labor market continued its weakness in the first half of 2009, which carried over from 2008. However, the April and May employment report introduced some positive signs, increasing the list of data points which imply that the steepest part of the economic contraction in now behind us. Although job losses rose again in June, the pace of job losses remains well below the peak in the first months of the year. In particular, nonfarm payrolls decreased by 467k in June, with the three month average falling to -436k, about half of the monthly job losses of 741k reported in January 2009. The household survey added evidence to the relatively positive news for employment. Nonfarm private employment decreased 473k in June, after falling 485 in May. This is a notable improvement over the first quarter of the year, when monthly losses averaged 691k. The pace of job losses eased in many sectors including services, although job losses remained relatively high in manufacturing. Another piece of somewhat encouraging news came from jobless claims. Initial unemployment claims have been declining during April and May, reporting in the first week of June the lowest level since January 2009. Although claims rose 22k to 627k in the last two weeks ending June 19, they still remain well above the multi year peak of 674k reported in the week ending March 9. At the same time, while continuing claims rose 29k in the week ended June 12, they remain 97k below the record high of 6.84 million reported in the last week of May 9.

Consecutive declines in initial claims have been associated with the end of the last five NBER recessions, so if claims peaked in March 2009 then the NBER trough of the current business cycle is likely to occur in the coming months. Historically, declines in initial claims at the end of prior US recessions have also been followed by consecutive declines in continuing claims, which started in the week of June 5 with a reported fall of 126k relative to the preceding week. However, it should be noted that in the last two recessions although initial claims peaked right before the end of the recessions, they remained elevated for a long period in the expansion period following the recession. We expect this recovery to be sluggish too, with claims remaining at high levels for the coming months. The recent improvement in jobless claims might imply slower pace of job losses and increase in the unemployment rate ahead, but we believe that both will keep rising through 2009 and most part of 2010. Besides, the unemployment rate is still on the rise, increasing to 9.5% in June from 9.4% in May 2009. Our job market model suggests that civilian employment growth will remain negative for the remainder of 2009, close to levels reported in Q1 09, averaging at -3.7% in 2009 and easing to -2.4 for

2010 (Figure 1.7). As a result, the unemployment rate will continue to increase well into 2009, with a year average of 9.3% and a further rise to 10.5% in 2010, reporting the biggest cumulative increase ever reported in the post war era.

Figure 1.7



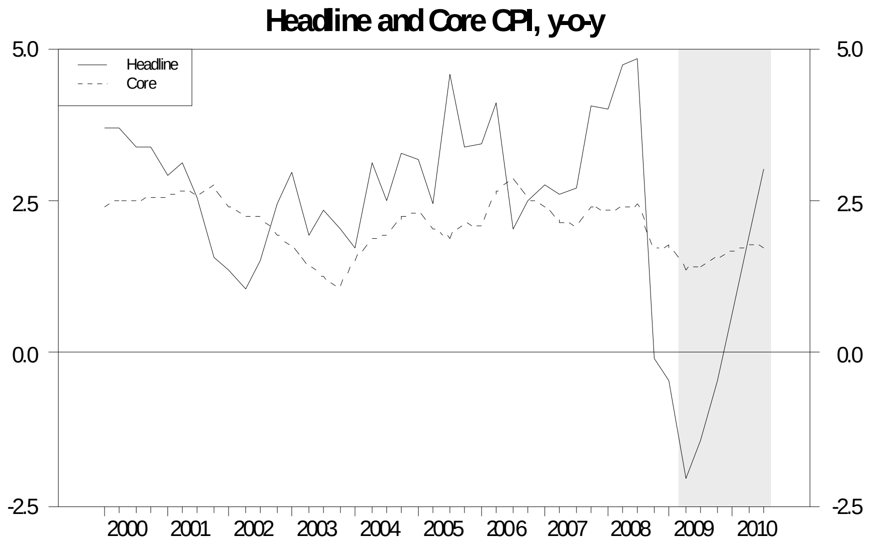
Source: Eurobank EFG estimates

Inflation or deflation?

The erosion of wealth from the housing and the equity market fall, combined with a decelerating labor market, has severely strained the finances of the US consumer, generating a deflationary environment over the past six months. US households have been in a process of deleveraging to reduce their debt, cutting back on consumption and setting up an upward trend in the personal savings rate. The savings rate gradually rose to 5.7% in April from 4.5% in March 2009, and stands well above the 0% savings rate reported one year ago. Total CPI inflation declined to -1.0% y-o-y in May -the lowest rate reported since January 1950- as a result of unfavourable base effects and declining commodity prices. While headline inflation is expected to continue declining, reaching -2% y-o-y over the next few months, the sharp increase in oil prices in H1 suggests that the large base effects currently weighing on headline inflation will begin to fade moving into the fall months. Given the recent resurgence of oil and food price pressures, total inflation deceleration should ease gradually over the second half of 2009, ending the year around -0.5% y-o-y.

Core consumer prices slowed to 1.8% y-o-y in May 2009, bringing the annual increase down by 0.7% from the recent peak of 2.5% growth rate in September 2008. Although core goods price inflation has been boosted by a surge in the price of tobacco products, new cars and light trucks, core service price inflation has been on a downward trend over the last 6 months. Important components of core services such as owners' equivalent rent and medical services have been decelerating, revealing broad-based weakness in core services. Core inflation is expected to remain on a mild downward trend, owing to ongoing weakness along the production pipeline and record low utilization rates. The ongoing deceleration in the core PPI inflation for finished goods, which slowed steadily to 3% y-o-y in May 2009 from 4.6% in October 2008, combined with continued declines in the core intermediate PPI, points to further slowing ahead. We expect that core inflation will continue to ease to 1.3% y-o-y during the summer, as high unemployment rates and low operating rates will exert downward pressure on prices and costs (Figure 1.8).

Figure 1.8



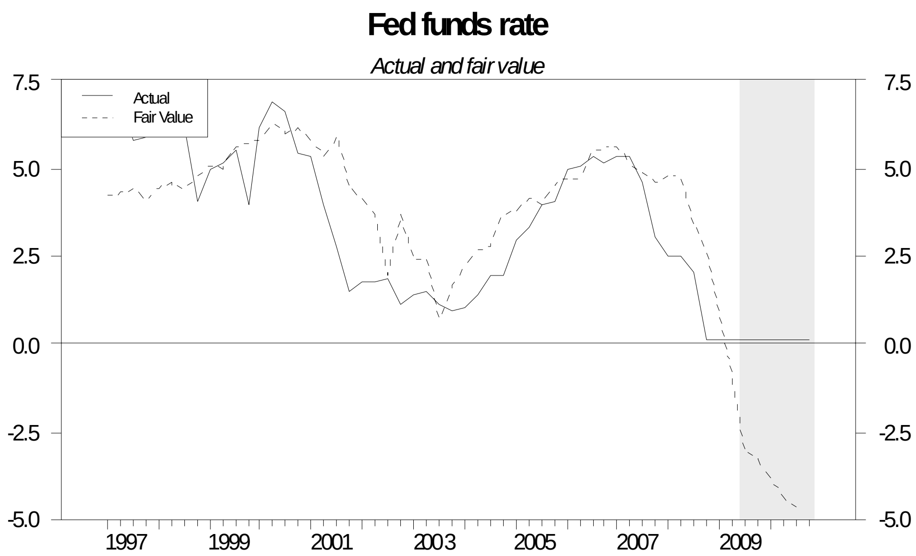
Source: Eurobank EFG estimates

Negative policy neutral interest rates force the Fed into quantitative easing

Although the Federal Open Market Committee (FOMC) acknowledges that the pace of economic contraction is decelerating and financial conditions have been recently improving, it underlines that economic conditions are likely to warrant a stable policy rate at near zero levels for an extended time. The Federal Reserve has now focused on quantitative measures as the primary means of easing strains in the financial markets in order to stimulate real economic activity. By the end of 2009, the Federal Reserve will purchase up to $1,25 trillion of agency mortgage-backed securities, up to $200 billion of agency debt and up to $200 billion of Treasury securities. These “balance sheet management” measures have come as a substitute to standard monetary policy measures, as the policy-neutral fed funds rate has turned negative (Figure 1.9). Furthermore, the Federal Reserve announced on June 25 extensions of and modifications to several liquidity programs. Market functioning in many areas remains impaired, so the Federal Reserve is extending a number of its liquidity facilities through February 1, 2010 in order to promote financial stability and support the flow of credit to households and businesses. This extension of several liquidity facilities into early 2010 suggests that US monetary policymakers opt for a late exit strategy from quantitative easing, increasing the risk that inflation will be much more difficult to control when the economic recovery is well under way. Non-conventional easing measures have already led to a significant acceleration of money supply growth over the past 6 months, increasing inflationary pressures in the long run.

Our model of the policy rate, based on the unemployment rate, the median duration of unemployment and the inflation rate suggest that the Fed funds rate ought to be nearly -5% in order to support economic recovery and preserve price stability (Figure 1.9). Although financial markets are starting to discount an imminent change in the direction of the US monetary policy, we do believe that monetary tightening is highly unlikely before H2 2010, when the recovery of the US labor market will probably have started and the stabilization of the US housing market will probably be on the way. Historical experience shows that it is difficult to determine accurately turning points in interest rate policy. However, as the economy begins to recover towards 2010, the Fed must firstly unfold an appropriate exit strategy for all the special liquidity facilities that are now in place in order to improve macro monetary conditions and financial market liquidity, before making any changes on official rates. Besides, the Federal Reserve Board's decision to extend a number of its liquidity facilities through early 2010 reduces the chances for rate hikes before Q2 2010 even further.

Figure 1.9



Source: Eurobank EFG estimates

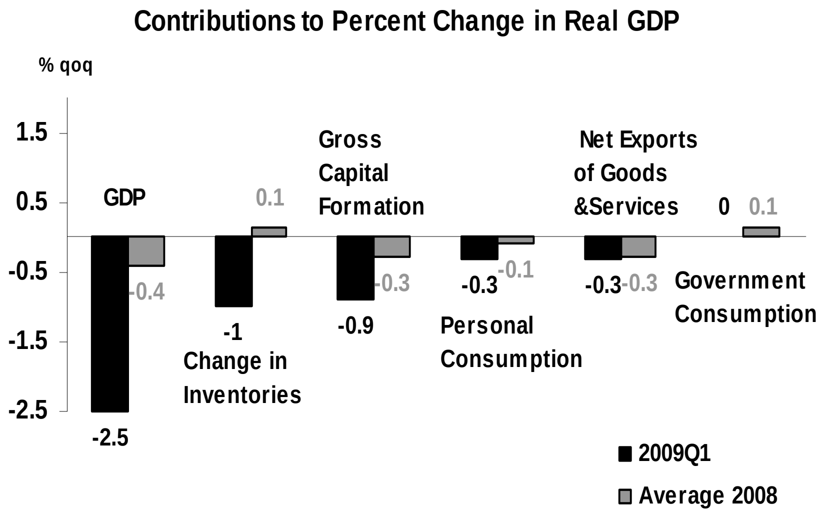
2. The Euro area economy

Dimitris Malliaropulos, Olga Kosma

- The euro area recession deepened in Q1 09, suggesting that the economy's contraction will persist well into 2009. Our latest baseline projections confirm a further substantial downgrade to the growth outlook for 2009 to -4.4% y-o-y.
- We believe that we have probably passed the trough in quarterly growth and expect real economic activity to decline by about 0.8% q-o-q in Q2 09. We expect the second quarter to be the worst on a y-o-y basis, with real GDP growth declining by 5.1%.
- The implementation of the fiscal stimulus packages in many countries will contribute to a modest and gradual recovery in 2010, with real GDP growth hovering around zero.
- We expect euro area inflation to turn negative this summer, averaging 0.5% in 2009 from 3.3% in 2008, due to negative base effects from oil, lower wage growth and lower import prices.
- However, our forecasts do not incorporate increasing risks of deflation. i.e. a generalized fall in all components of headline consumer prices.
- While the ECB has not ruled out further monetary easing, we believe that 1% will probably be the floor for the refi rate in this business cycle, as the ECB moves on to unconventional policy measures. Should the recovery falter, or downside risks to price stability continue to build, the Governing Council may proceed to further rate cuts.

The euro area recession deepened in Q1 09, with real GDP contracting by a larger-than-expected 2.5% q-o-q, reporting the fourth negative growth rate in a row. The economic downturn was widespread among euro area countries, with real economic activity declining remarkably in Germany (-3.8%), Austria (-2.8%) and Netherlands (-2.8%). The first breakdown of GDP shows broad-based weakness and suggests that both domestic and external demand have been flagging exceptionally. Sharply declining business investment and markedly negative net trade were key factors driving GDP downwards. Exports and investment contractions in Q1 09 were similar in magnitude to Q4 08 (-8.1% q-o-q and -4.2%, respectively), subtracting 3.2% and 0.9% from quarterly GDP growth. Moreover, factories have drastically slowed down their production to reduce inventories that have soared since the summer, due to the fast drop in domestic sales and exports. The heavy pace of destocking subtracted 1% from real economic activity, but we expect the ongoing trend of inventory reduction to boost growth momentum ahead (Figure 2.1).

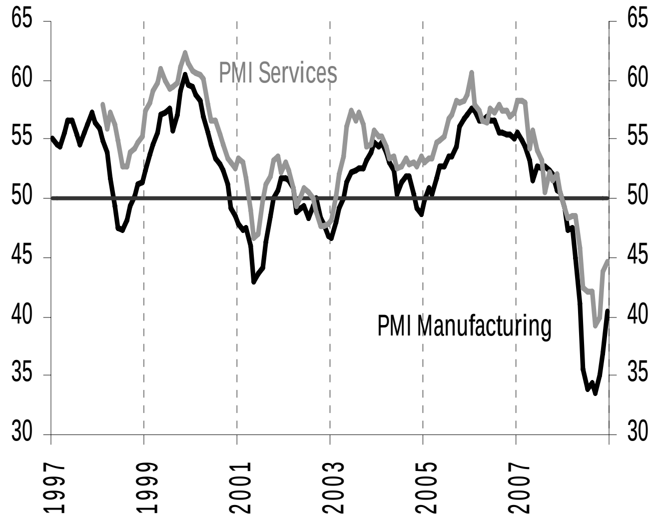
Figure 2.1



Source: Eurostat

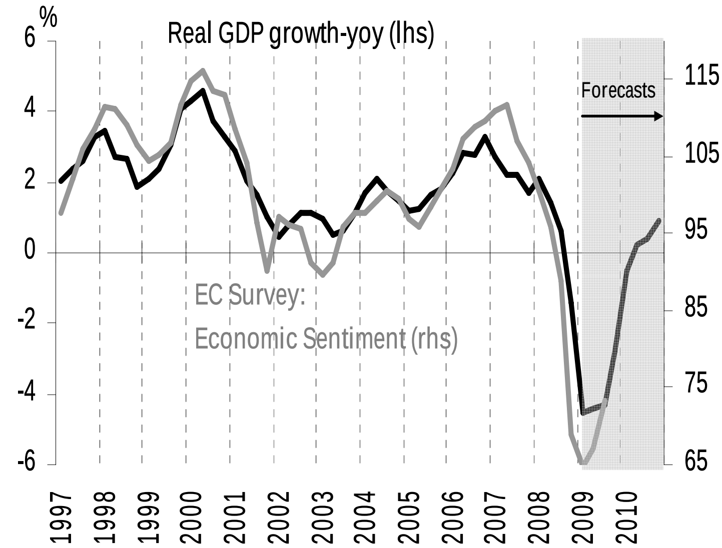
Although leading indicators are still very low by historical standards and consistent with a continuing contraction in real economic activity, they have shown signs of stabilization over the last couple of months. The composite PMI index jumped to the highest level in 8 months, with the manufacturing sector reporting the largest monthly gain since the series started in 1997 (+3.9). The services sector marked a more moderate recovery since it has experienced lessening rates of decline during 2008 (Figure 2.2). Moreover, the economic sentiment index increased further in June to 73.3 from 70.2 in May, leaving well behind its March record low of 64.7 (Figure 2.3). The IFO expectations index has been on an upward trend since March 09, after 9 months of severe deterioration. Although the ZEW current conditions index continued its downward trend in May, the ZEW expectations index more than doubled for Germany and the Euro area region as a whole, each climbing to its highest level for three years.

Figure 2.2



Source: Ecowin

Figure 2.3



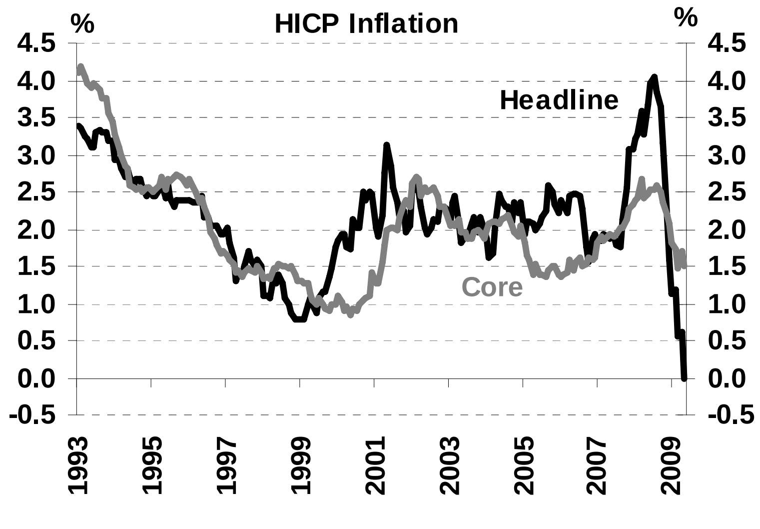
Source: Eurobank EFG model estimates, Bloomberg

Should this positive momentum continue, the economic contraction may alleviate within the next few months. The current level of the composite PMI index is consistent with a real GDP growth rate of about -0.7% q-o-q in Q2 09, a significantly better reading than the 2.5% contraction reported in Q2. However, it should be noted that the composite PMI has consistently understated the weakness in activity in the previous quarters, so we remain cautious about taking their quantitative implications at face value. We believe that we have probably passed the trough in quarterly growth and expect real economic activity to decline by about 0.8% q-o-q in Q2 09. Should our forecasts prove correct, the second quarter will be the worst on a y-o-y basis, with real GDP growth declining by 5.1%. Our latest baseline projections confirm a further substantial downgrade to the growth outlook for 2009 to -4.4% y-o-y, due to a weaker than expected outcome for Q1 09 (Figure 2.3). In our view, the Euro area will return to positive growth rates by year-end, and to a more sustained growth pattern in 2010. The Eurosystem staff's latest macroeconomic projections incorporate a more pessimistic view of the recovery and include a negative output growth for both 2009 and 2010. This downbeat forecast implies that the Euro area is unlikely to return to positive territory before H2 2010.

The deteriorating state of the economy, coupled with the decline in commodity and oil prices from their June 08 peaks, has led to a remarkable decline in euro area inflation to an all-time low of zero. Euro area HICP inflation posted the first negative reading in June (flash estimate), declining by 0.1% y-o-y after a zero reading in the previous month. Looking ahead, the trend remains on the downside due to base effects caused by past commodity price increases. EC's measure of selling price expectations in the manufacturing sector continues its consecutive negative readings since December 2008, while consumer price expectations over the next 12 months have turned negative for the first time since 1985, when the series started. We expect euro area inflation to turn negative this summer, averaging 0.5% in 2009 from 3.3% in 2008, due to base effects, lower wage growth and lower global inflation helping to alleviate import prices. However, our forecasts do not incorporate increasing risks of deflation. i.e. a generalized fall in all components of headline consumer price inflation.

Although headline inflation has fallen sharply over the past few months, core inflation has been relatively stable. The commodity price shock in 2007-08, which boosted headline inflation from 1.7% in August 2007 to 4% in July 2008, did not lead to a significant increase in the core index. Weaker demand deterred retailers from passing increases in input costs on to consumers, so consumer inflation excluding food and energy prices has increased only marginally from 2% to 2.7%. As a result, the decline that followed the commodity price shock was reduced to about 1%. Given that core inflation is a lagging indicator of total inflation and that domestic producer prices are currently declining at their sharpest rate since the series started in the early 80s, we expect that the downward trend will pass through to the core index with a time lag. Besides, a widening output gap, coupled with rising unemployment rates, points to a significant decline in the core index to come throughout the remainder of this year and next year. We believe that core inflation will edge lower, close to zero levels by year-end, with the average annual rate falling to 1.2% in 2009 from 2.4% in 2008.

Figure 2.4



Source: Eurostat

In a deepening recession and a low-inflation environment, the ECB has lowered its policy interest rate by 325 bps since October 2008, recording the largest cut over such a short period in the Euro area. The Governing Council kept the refinancing rate unchanged at 1% at its June meeting, even with consumer price inflation falling to zero levels. We believe that 1% will probably be the floor for the refi rate in this business cycle, as the ECB moves on to unconventional policy measures. The Central Bank took the lead as early as 9 August 2007, providing €95 bn to the market (through a fixed rate operation with full allotment) within a few hours. When the crisis intensified in 2008, the ECB expanded the maturity of its regular refinancing operations. Banks have acquired access to unlimited liquidity at maturities of, initially, up to 6 months. This non-standard measure was supplemented by a further expansion to longer-term refinancing operations with a maturity of up to 12 months in early May. Moreover, the ECB's Governing Council has expanded the list of assets eligible as collateral in Eurosystem credit operations[2]. Last but not least, the ECB increased the number of counterparties that are able to take part in the refinancing operations. In line with the initially expressed objective of credit support to the market, the Central Bank announced a €60bn covered bond purchase programme in early June 2009. The purchases, which represent about 0.5% of euro area GDP, will start in July 2009 and are expected to be fully implemented by the end of June 2010 at the latest. While the ECB has not ruled out any further monetary easing below 1%, we believe that the Central Bank wants to see first how the existing measures are working. Should the recovery falter, or downside risks to price stability continue to build, the Governing Council may proceed to further rate cuts. We do not expect the ECB to start hiking policy rates before the economy has started to stabilize by mid-2010.

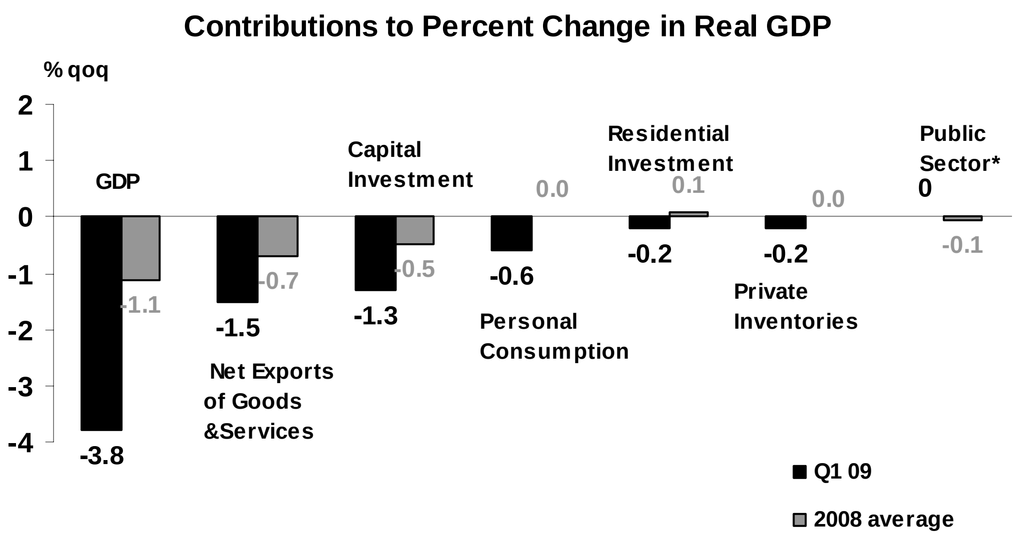
[2] eg. marketable debt instruments denominated in other currencies than the euro, namely USD, GBP and JPY, euro-denominated syndicated credit claims governed by UK law.

3. The Japanese economy

Dimitris Malliaropulos, Olga Kosma

- Due to its dependence on international trade, Japan was the worst-performing economy among major industrialized countries in Q1 09.
- However, catching-up on the earlier strong underperformance, Japan's economic cycle seems to be running ahead of the US and the Euro area, due to a revival in production and exports in Q2 09.
- The outperformance will be rather temporary, and questions about the sustainability of the positive momentum in 2010 remain, as prospects for domestic demand remain bleak.
- Business investment is most likely to plummet again in Q2 09, due to declining corporate profits and very low capacity utilization rates.
- Job uncertainty and lower income will probably weigh on consumer spending, as the effect of the economic stimulus package fades and the economic recovery in major trading partners proves to be sluggish.
- The deterioration in the labor market, combined with a widening output gap, raises concerns of a potential deflationary spiral in Japan. Hence, in our view, the BoJ is still far from removing its quantitative easing measures.

Figure 3.1



*Public Sector = Government Consumption + Public Investment + Public Inventories

Source: Economic and Social Research Institute (ESRI), Cabinet Office, Government of Japan

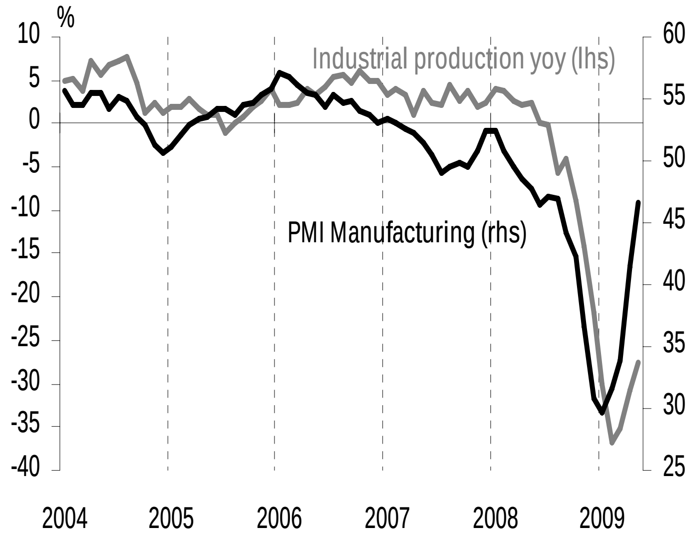
Due to its dependence on international trade, Japan was the worst-performing economy among major industrialized countries in the first quarter of the year. The Japanese economy contracted for a fourth consecutive quarter by 3.8% q-o-q in Q1 09, reporting the biggest decline since GDP records began in 1995. Weakness remained evident for both external and domestic demand. In terms of contributions to the quarterly growth rate, domestic demand reduced GDP by -2.3%, with private investment deepening its decline to 8.9% q-o-q and personal consumption suffering a major setback (-1.1% q-o-q) despite government handouts. External demand accounted for the remaining -1.5%, with exports plunging 26% q-o-q -the steepest fall on record- and imports declining by 15% q-o-q (Figure 3.1).

However, Japan's economic cycle seems to be running ahead of the US and the Euro area, although from an extremely low level. Exports, the mainstay of the country's economic activity, appear to be stabilizing over the last couple of months. Japanese exports witnessed a remarkable gain in April and May in all regions except for oil producing countries (the Middle East and Russia), supported by progress in inventory liquidation abroad. The stabilization of the export environment is consistent with the improvement in the PMI manufacturing index in the US (Figure 3.2) and in Emerging economies such as China, Russia and India since the beginning of 2009. In particular, emerging economies account for a relatively high proportion of Japanese exports, so the overall positive trend in these economies will probably create a more favorable Japanese export environment in the following quarters. Meanwhile, we expect the inventory cycle to support the uptrend in export growth, as the replenishment of depleted inventories around the globe will probably have a positive impact on Japanese external demand. Historical experience suggests that export growth tend to be strong in the early stages of recovery after inventory liquidation. However, the rebound in exports may be relatively more moderate compared to previous economic cycles, given the existing financial system problems in the US and Euro area and the weak global business investment environment.

Figure 3.2

Source: Ecowin, Bloomberg

Figure 3.3

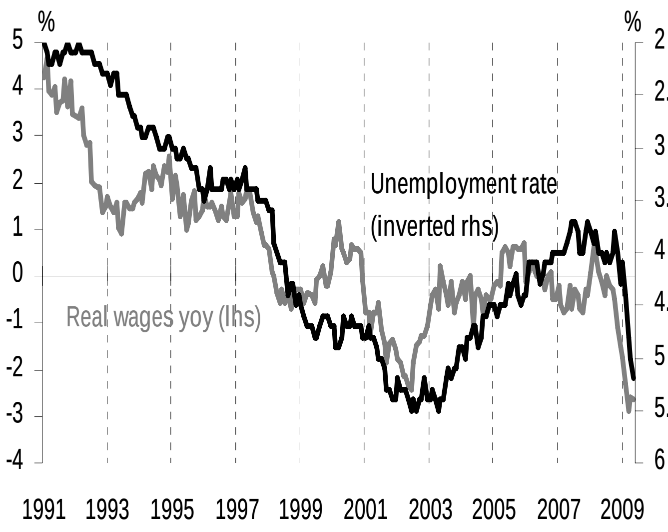


Source: Ecowin, Bloomberg

Broadly in line with the sharp inventory liquidation and the impressive performance in Japan's export volumes, industrial production has recently rebounded. In particular, industrial production increased in May for a third month in a row, repeating the record monthly increase of 6% recorded in the previous month. The inventory cycle has undoubtedly been the most important driver of the industrial activity surge. Large declines in inventories to historical lows are usually followed by increasing production trend. The positive development in the manufacturing sector is being underpinned by the PMI manufacturing index, which jumped to 46.6 in May from 41.4 in April (Figure 3.3). Furthermore, the Economy Watchers Survey of future economic conditions, which is a leading indicator of industrial production over the next quarter, improved for a fifth consecutive month in May, suggesting that industrial activity will continue to expand in the months ahead.

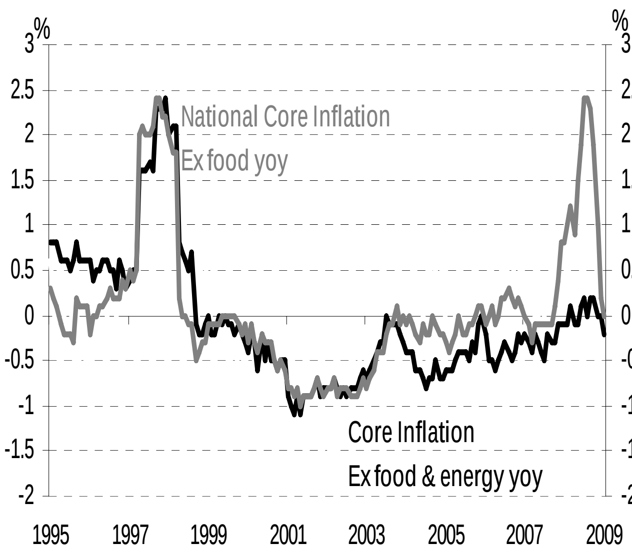
However, these positive moves are expected to be partially offset by a rather bleak picture for private domestic demand. Private machinery orders excluding ships and power plants, which is a leading indicator for business investment, dropped by 5.4% m-o-m in April versus a market forecast of +0.4%. Meanwhile, deterioration in corporate profits, combined with unusually low capacity utilization rates, is very likely to depress business investment in Q2 09. Furthermore, worsening labor market conditions will likely take their toll on consumer spending and residential investment. Japan's unemployment rate rose further to 5.2% in May, while average monthly cash earnings fell for the 10th month in a row (Figure 3.4). The job offers to applicants ratio, which is used for the coincident business condition diffusion index, fell to the worst level on record since 1963 (0.44 in May from 0.46 in the previous month), signaling ongoing labor market deterioration. Job uncertainty and lower income seem to be negatively affecting consumption and housing investment. Housing starts collapsed in April as well, marking the sharpest monthly decline since August 2007. Moreover, housing construction plunged by 5.6% m-o-m, bringing the annual growth rate down to -33%. However, economic stimulus measures, such as cash handouts to households and rebates for replacement purchases of eco-friendly cars and energy-efficient home electronics, should give a boost to private consumption in the near term. In the May household survey, real spending (households with two or more people) rose by 0.3% y-o-y for the first time in 15 months, after a 1.3% y-o-y decline in April, reflecting the effects of recent government measures. Although this positive trend in private consumption could last for about two of three quarters, we expect the Japanese economy to show renewed weakness towards 2010, as positive effects from various boosting measures will be running low and the economic recovery in major trading partners will prove to be sluggish.

Figure 3.4



Source: Bloomberg, Ministry of Internal Affairs & Communications

Figure 3.5



Source: Bloomberg

We expect the excessive slack to exert strong downward pressure on consumer price inflation in 2009 and 2010. The national core CPI reported in May the steepest decline since records began in 1970, raising concerns of a potential deflationary spiral. In particular, core inflation excluding fresh food dropped for a third consecutive month by -1.1% y-o-y in May, from -0.1% in the previous month (Figure 3.5). Consumer prices have been negatively affected by base effects due to the oil price surge in 2008, underpinned by a widening output gap. According to the Cabinet Office, the output gap has gradually widened to -8.5% in Q1 09 from -4.5% in Q4 08, marking the biggest decline since the series started in 1980. Given that core CPI tends to lag the output gap by about six months, we expect national core inflation to continue its downward trend at a more rapid pace in the coming months despite the recent upsurge in crude oil and other commodity prices.

The Bank of Japan (BoJ) decided to maintain its current monetary policy, upgrading slightly its view of the Japanese economy for the second month in a row. Given that the economy seems to be bottoming out, owing to a recovery in industrial production and exports, the BoJ will not probably announce further major quantitative easing measures and increase its purchase of government bonds further. Non conventional measures seem to have had a positive effect on the financial markets. Growth in the monetary base has accelerated and interbank rates, corporate and commercial paper yields have recently declined. However, given the renewed risks of deflation and the widening output gap, the BoJ is still far from removing its quantitative easing measures. Core CPI inflation will probably continue to decline further into negative territory in the remaining of the year, thus we believe that a change in the policy direction with interest rate hikes before H2 2010 is highly unlikely.

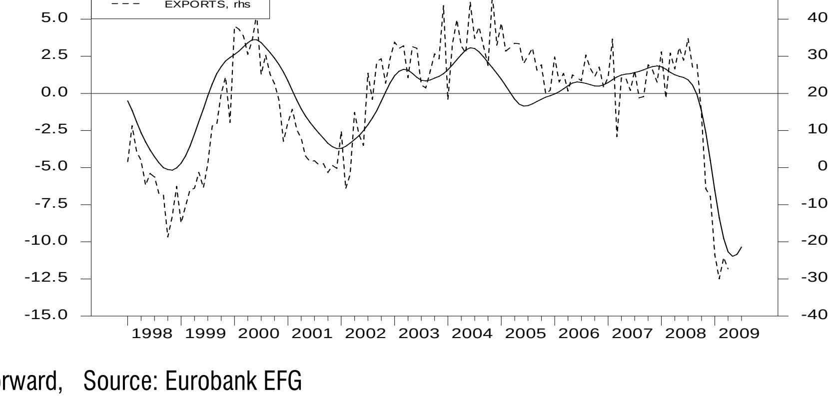
Emerging Markets

Dimitris Malliaropulos, Maria Prandeka

- The dramatic weakening of export growth and its spill over effects on the real economy are the main challenges for Emerging Markets economies.
- As we have already envisaged in our previous issue (March 2009), Emerging Asia seems to be the first region to pull out from the current recession, reflecting significant monetary and fiscal policy responses and better external balances.
- Should the Chinese government's massive stimulus package prove to be successful in promoting a sharp rebound of Chinese demand, Latin America will benefit significantly.
- Emerging Europe will continue to underperform compared to the rest of the emerging world, as it is highly dependent on a sustained recovery in the euro area –its main trading partner- which will not take place before 2010.

The sharp drop in economic activity in most parts of the developed world has hit hard even the largest Emerging Markets economies. The economic weakness has spread into EMs mainly by hitting exports to the developed world as demand dried up in the US, Japan and Europe and by impeding external financing. A sustained rebound in EMs' economic activity is mainly dependent on each country's exports structure, as well as the extent of borrowing from abroad and the effectiveness of the fiscal and monetary measures. The economies that entered the current global crisis in a relatively strong financial position and had the opportunity to apply their own monetary and fiscal policy responses (China, for example, which has announced a CNY 4 trillion ($585 billion, 13% of 2008 GDP) stimulus package to be spent over the 2009-2010 period), have already shown clear signs of improvement. Particularly, recent data on Emerging Asia's manufacturing PMI show that the indexes are back into growth territory for the first time since last summer, which is consistent with an economic expansion in the region. The latter will stimulate a recovery in Latin America, due to increased trade with Asia. Besides, our BRICs leading indicator seems to be stabilizing, suggesting that the pace of the decline in BRICs exports should ease gradually over the second half of 2009 (Figure 4.1). As far as Emerging Europe is concerned, the region still has some way to go until a sustained recovery takes place, as it is highly dependent on external financing, as well as on a sustained recovery in the euro area –its main trading partner- which will not take place before 2010.

Figure 4.1
BRICs Leading Indicator*, % yoy

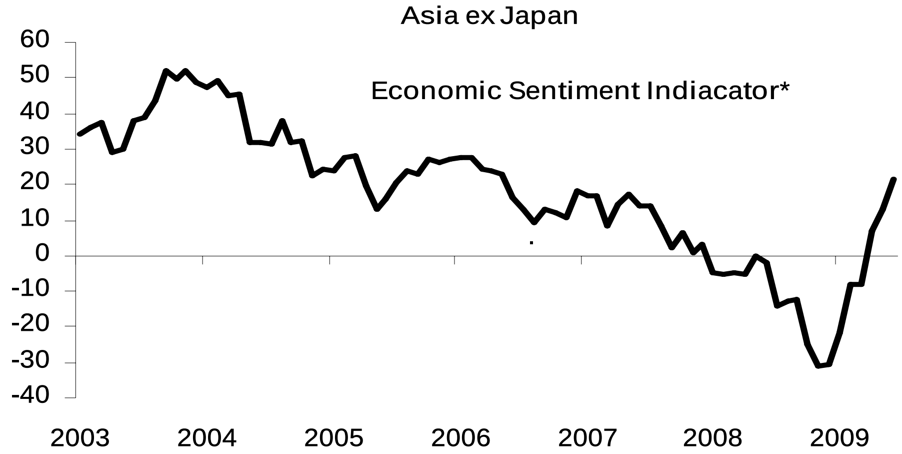


* 3 month forward, Source: Eurobank EFG

Emerging Asia

We believe that growth has bottomed out in the region, with China being the stabilization force. In fact, Emerging Asia seems to be the first region to pull out from the current crisis, reflecting significant monetary and fiscal policy responses and better external balances. Incoming data continues to surprise to the upside, with the Asia ex Japan economic sentiment indicator suggesting signs of improvement in the Asian economies, as it has been increasing since December 2008 (Figure 4.2). The pace of the decline in exports and industrial production, which brought much of the downside impetus in the region, appears to be slowing. In Korea, industrial production has been increasing on a m-o-m basis since January 2009, in line with the recent drop in inventory/shipment ratio (from 1.29 in December 2008 to 1.01 in April). Meanwhile, in China, the PMI new export orders index increased above the 50-point-level (to 50.1) in May 2009 for the first time in 11 months, suggesting that the pace of exports decline should start to abate in the coming months. Nevertheless, downside risks to these expectations come from the fact that the region is largely reliant on external demand and capital. Therefore a deeper recession in advanced economies combined with further deterioration in global financial conditions will exert further pressure on the region's growth outlook. In order to return to pre-crisis growth rates, Emerging Asian policymakers should steer the region's economies towards domestic demand.

Figure 4.2



*The sentix sentiment indicator is a monthly survey among financial analysts and institutional investors about the expected economic situation.
Source: Ecowin

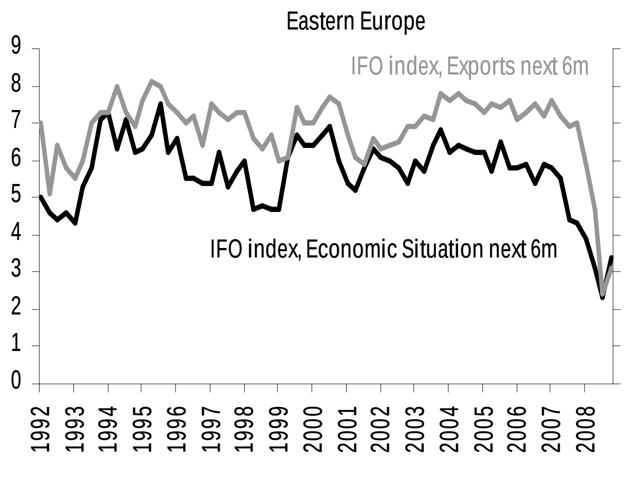
Emerging Europe

Emerging Europe is the region that was hit the most by the global turmoil compared to other EM regions. The adverse effects of the widespread capital outflows, slumping external demand and lower commodity prices will lead almost every single economy in the region in recession in 2009. The transmission of the general weakness into the real economy constitutes a major concern for the region. In Russia, industrial production fell sharply for the seventh consecutive month in May by 17.1% y-o-y, reporting the worst performance since September 1998, with the weakness concentrated mainly in the manufacturing sector. In line with the weakness in the industrial sector, fixed capital investment contracted by 23.1% y-o-y in May. Besides, worsening labor market conditions reinforce the gloomy picture for the region, as it intensifies downside risks for consumer spending. Russian unemployment rate increased to 9.9% in May from an average of 6.4% in 2008, adding to the pressures faced by some economies in the region that are heavily dependent on Russia for remittances. Meanwhile, as the pace of the decline in the global economy has started to ease, Emerging Europe economies will be confronted with country specific challenges. Particularly, countries with large current account deficits and dependence on external financing are more vulnerable to downward pressures on economic growth. Moreover, we believe that, despite the appreciation of national currencies seen in recent weeks, there are still risks for a further increase in non performing loans, owing to the prevalent foreign exchange denominated lending. Overall, while it seems that the worst of the financial crisis should soon be behind us, Emerging Europe economies still have some way to go until a sustained recovery takes place most likely in mid-2010. Indeed, although the Eastern Europe IFO economic situation index appears to be bottoming out (in line with the rebound in global leading indicators), it is still well below the 5-point-level, suggesting that expectations that Emerging Europe will continue to underperform compared to the rest of the emerging world have not abated so far (Figure 4.3, left).

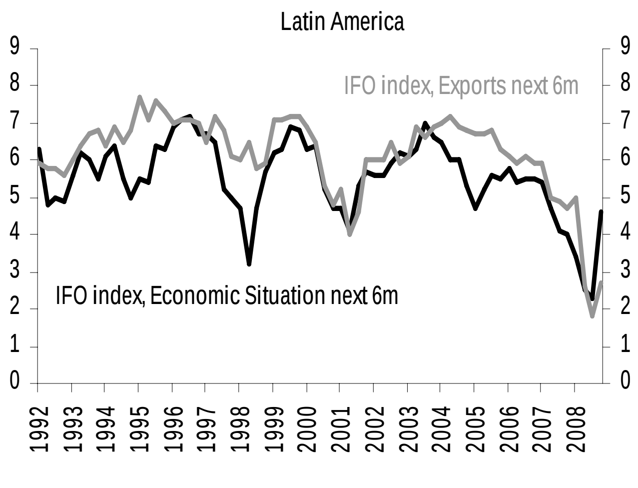
Latin America

The global financial crisis has hit Latin America through lower commodity prices, deteriorating capital inflows and weakening external demand. As a result, the region faces a severe economic contraction in 2009. However, economies in Latin America are better positioned to weather the storm than in the past, due to improved policy frameworks and a modernized banking system. A significant increase in commodity prices will support economic recovery. In addition, the region will enjoy some benefit from the Asian recovery, owing to increased trade linkages with Asia. Indeed, Brazil's exports to China as a share of total exports have risen to 19% in June, well above Brazil's exports to US (9% as a share of total exports). Indeed, the Latin America IFO index for export volumes over the next six months has increased in Q2 09 for the first time since the global downturn has started to take full effect upon the region's economic activity in Q3 08 (Figure 4.4). Should the recession in major trading partners proves to be deeper or longer, the risks for the region's economic activity are tilted to the downside.

Figure 4.3



Source:Ecowin



Source:Ecowin

4.1 China Economic Outlook

- Real GDP growth decelerated to 6.1% y-o-y in Q1 09, marking the lowest reading in the past ten years. Weak external demand continues to be one of the main challenges for China's economy. However, recent monthly economic indicators suggest that China's economic outlook is clearly improving.
- Economic growth is powered mainly by domestic demand, in particular, the strong rebound in domestic investment growth, driven by public investment and rapid credit expansion.
- The decline in headline y-o-y inflation, in our view, reflects mainly high base effects and the fading effect of one-off shocks.
- We don't expect further interest rate cuts, but the tightening of monetary policy will begin only when the economy has shown clear signs of recovery and CPI inflation returns to positive territory.

Overview

As we have already envisaged in our previous issue (March 2009), the combined fiscal and monetary policy actions appear to have helped the economy not only to avoid a sharp economic downturn in 2009, but also to stage a gradual and steady recovery in the remainder of the year. Though, the main factors that helped the economy to recover from the near stall at the end of 2008 are the rapid expansion of government infrastructure investment and the unprecedented domestic credit expansion. Overall, we expect real GDP growth to moderate to 7% in 2009 from 9% in 2008 and recover to 8.5% in 2010. In our view, risks to our projections are skewed to both sides and are roughly balanced. On the one hand, as long as global demand remains sluggish, exports will continue to be a drag on China's growth and, consequently, it is unlikely that China will soon return to double digit growth rates seen in recent years. Furthermore, the effect of fiscal stimulus on the real economy will most probably fade in 2010. Nevertheless, the strong rebound in domestic investment growth and a possible stronger than expected private consumption growth will pave the way for further recovery, offsetting the strong headwinds from external demand.

Table 4.1
China Main Economic Indicators and Forecasts

	2007	2008	2009e	2010e
Real GDP (% y-o-y)	13.0	9.0	7.0	8.5
Industrial Production (avg, % y-o-y)	17.5	12.7	9.0	12.0
Inflation (avg, % y-o-y)	4.8	5.9	0.5	2.0
Unemployment rate (avg, %)	4.0	4.2	4.6	4.3
External Balance				
Real Exports of Goods & Services (% y-o-y)	18.0	10.0	-12.0	6.0
Real Imports of Goods & Services (% y-o-y)	15.0	7.0	-14.0	7.0
Trade Balance (% GDP)	7.3	6.8	6.5	6.0
Current Account (% GDP)	11.0	10.0	8.0	7.0
Interest Rates	Dec 2008	Current	Dec 2009	Dec 2010
Lending Interest Rate (%)	5.3	5.3	5.3	5.3
Exchange Rates				
Exchange Rate (USD/RMB, eop)	6.8	6.8	6.8	6.7

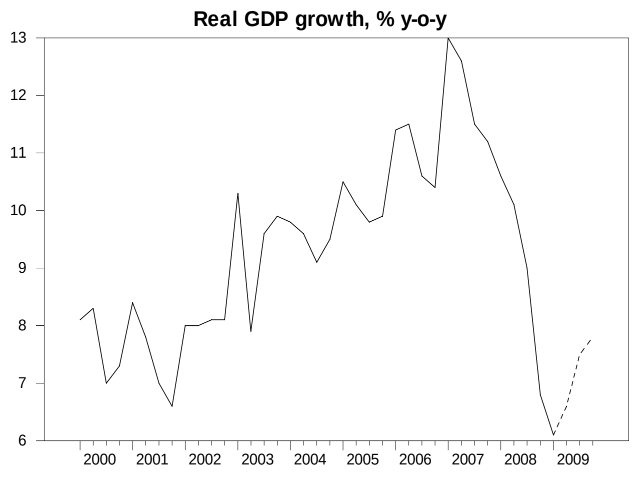
Source: Eurobank EFG, Bloomberg, Ecowin

The Chinese economy seems to have bottomed out

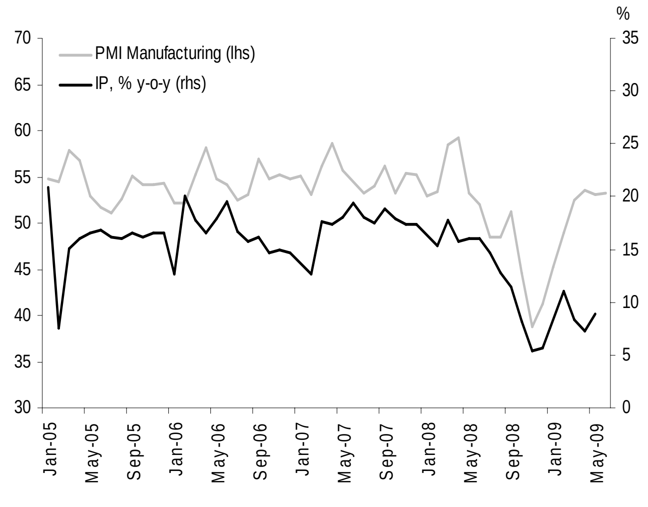
Real GDP growth decelerated to 6.1% y-o-y in Q1 09, marking the lowest reading in the past ten years, on the back of declining exports (Figure 4.4, left). Indeed, value-added output from secondary industry, which mainly includes export-oriented companies, rose by 5.3% y-o-y in Q1 09 compared to 9.3% in the preceding quarter. However, signs are mounting that the worst may be over for the world's third largest economy. Indeed, on a quarterly basis, GDP growth accelerated to around 5-6% in Q1 09 from only 1-2% in Q4 08. Moreover, recent monthly economic indicators point out upside risks to China's economic outlook. Industrial production growth surged to 8.9% y-o-y in May from 7.3% y-o-y in April, significantly above the consensus forecast of 7.7% y-o-y (Figure 4.4, right). Despite strong seasonality, China's NBS PMI manufacturing index held up in June, remaining largely flat at 53.2 from 53.1 in May (Figure 4.4, right). The upside surprise in industrial production is mainly attributable to much stronger than expected fixed asset investment growth. In particular, FAI rose rapidly by 32.9 y-o-y in the first five months of 2009 (the highest reading since 2004), underpinned by government-sponsored projects.

Meanwhile, robust private consumption reinforces the upbeat picture for domestic demand. Consumer indicators suggest that private consumption has so far held up reasonably well, with nominal and real retail sales increasing by 15.2% y-o-y and 17.3%, respectively, in May. Moreover, encouraging signs for private consumption comes from the Chinese housing market which is showing some signs of stabilization. Home sales increased sharply by 45.3% y-o-y in the first five months of 2009, while real estate investment is slowly gaining momentum, growing by 12% y-o-y in May, compared to 1% y-o-y in February 2009. Generally, we believe that worsening labor market conditions and gradual elimination of initial stimulus effects will reinforce downside risks for consumer spending, whereas tax cuts and falling inflation will boost households' purchasing power.

Figure 4.4



Source: Eurobank EFG, National Bureau of Statistics (NBS)



Source: Ecowin

However, weak external demand will remain a significant drag on economic activity

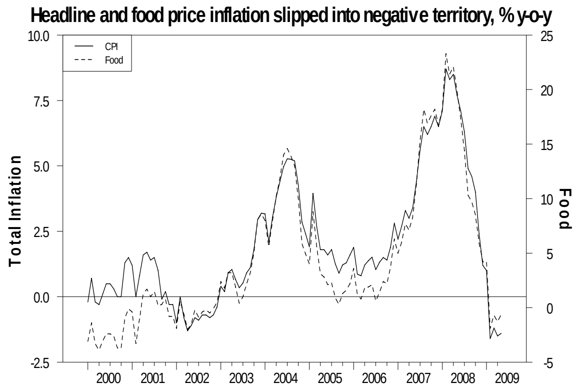
The dramatic weakening of export growth and its spill over effects on the real economy continues to be one of the main challenges for China's economy. Exports contracted further by 26.3% y-o-y in May, reporting the lowest reading since the series started in 1995. According to the PMI new export orders index, the pace of decline should start to abate in the coming months, as the index increased above the 50-point-level (to 50.1) in May 2009 for the first time in 11 months. However, we believe that Chinese exports are likely to continue to face strong headwinds from the weak global economy. We expect real exports to contract by around 12% in 2009 and rebound to 6% in 2010, supported by a low base in 2009 and a sluggish recovery in global economic activity. Meanwhile, import spending fell by 25.2% in May y-o-y, compared with 23% y-o-y in April, in response to weaker export orders which undermined the demand for imported components that Chinese manufacturers assemble and, in turn, re-export to the rest of the world (around 50% of China's imports).

Deflationary pressures clearly abating

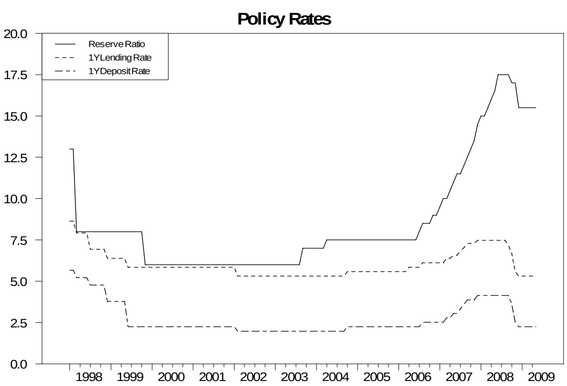
China's headline CPI inflation came in at -1.4% y-o-y in May 2009, compared with -1.5% y-o-y in April (figure 4.5, left). The decline in headline y-o-y inflation, in our view, reflects mainly high base effects and the fading effect of one-off shocks, such as diseases and bad weather. We believe that deflation pressures are subsiding, as, according to our estimates, month-on-month CPI inflation increased over the past month, with forward looking indicators reinforcing this view. Input prices from the PMI survey has risen consistently since November 2008 and rose above 50 in April, while money supply (M2) increased sharply over the past months, suggesting that the stimulus package will likely prevent the economy from falling into deflation. We expect headline CPI inflation to fall to 0.5% in 2009 from 5.9% in 2008 and rise to 2% in 2010.

The PBoC has loosened monetary policy in recent months in order to combat the concerns about the slowdown of the economy and the deflationary risks (figure 4.5, right). Looking forward, we don't expect further interest rate cuts. However, the tightening of monetary policy will begin only when uncertainties concerning weak external demand have faded and, consequently, the economy has shown clear signs of recovery, and CPI inflation returns to positive territory.

Figure 4.5

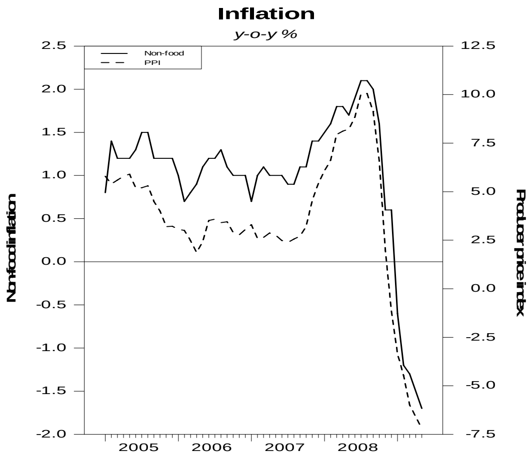


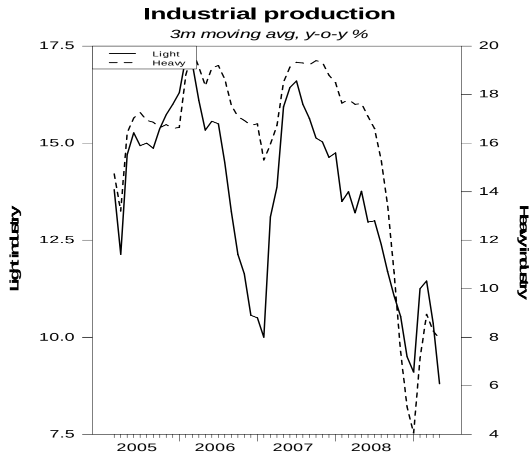
Source: Bloomberg, Ecowin

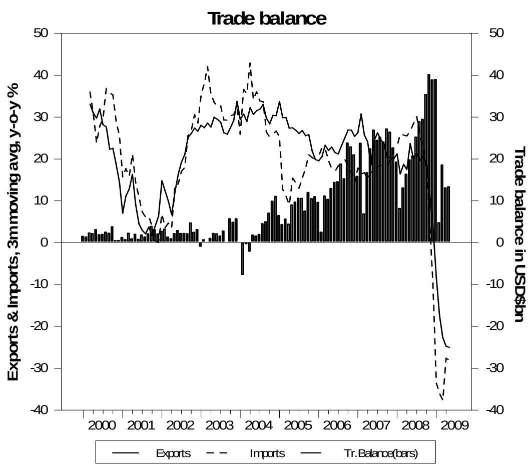


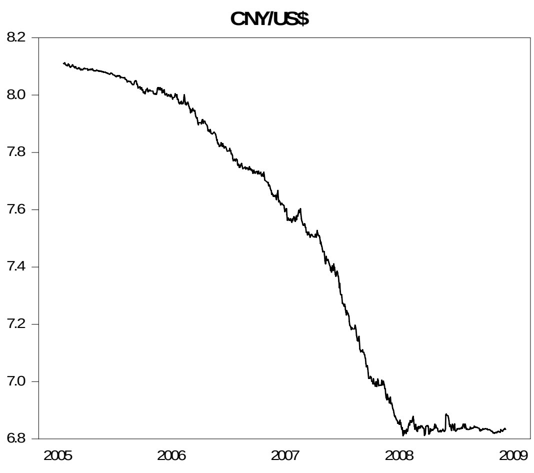
Source: Bloomberg

CHINA CHARTS









Source: Bloomberg, Ecowin

4.2 India Economic Outlook

- Real GDP surprised on the upside with growth recording 5.8% y-o-y in Q1 09 (consensus expectations: 5%), on the back of strong government spending.
- However, India's economy has decelerated sharply from the annual growth rates of 9%-10% recorded in recent years, reflecting its increased vulnerability to the global crisis, as India is highly dependent on foreign capital.
- Although recent monthly economic indicators are showing some signs of improvement, the rebound in economic activity is mainly fueled by domestic demand, given that exports are still declining sharply.
- The economy is still facing a number of headwinds, as any improvement in global demand will be sluggish and labor market conditions may deteriorate further given the slowdown in IT export sectors.

Overview

After five years of impressive performance, India's economic growth has slowed down markedly in 2008 (7.5%) from the buoyant 9%-10% annual rates witnessed in recent years, amid global financial strains and increased risk aversion in the domestic financial sector. However, India's economy remains one of the fastest-growing among the other Asian peers, given its relatively closed economy (total exports account for about 20% of GDP, while China's total exports represent 40% of GDP), as well as the proactive fiscal and monetary measures initiated by the government and the Reserve Bank of India. With recent economic indicators already suggesting that India's economic outlook is clearly improving and a marked improvement in consumer and investor confidence following the elections results, we expect activity to pick up in the second half of the year. Yet, returning to 9%-10% growth rates seen in recent years will be difficult to achieve, mainly due to a sluggish global recovery and large fiscal imbalances, which have limited India's ability to respond to a further deterioration in global economic prospects. Indeed, the fiscal deficit rose to 6.2% of GDP in 2008 and is expected to exceed 10% of GDP in 2009. Meanwhile, rating agencies have warned of further downgrades of India's sovereign outlook, unless the government reins in the widening fiscal deficit and proceed with reforms. Nonetheless, increasing spending in order to support the economy seems to be the main economic policy priority, despite concerns about debt ratings.

Table 4.2

India Main Economic Indicators and Forecasts

	2007	2008	2009e	2010e
Real GDP (% y-o-y)	9.3	7.5	5.8	6.8
Industrial Production (avg, % y-o-y)	10.0	4.5	2.0	4.0
Inflation (WPI, avg, % y-o-y)	4.7	9.1	2.0	4.0
External Balance				
Real Exports of Goods & Services (% y-o-y)	2.7	17.4	-1.0	7.0
Real Imports of Goods & Services (% y-o-y)	4.8	27.9	2.0	8.0
Trade Balance (% GDP)	-7.0	-10.0	-9.0	-9.0
Current Account (% GDP)	-1.5	-3.5	-1.5	-2.0
Interest Rates	Dec 2008	Current	Dec 2009	Dec 2010
Short Term Interest Rate (Repo rate, %)	6.50	4.75	4.75	5.50
Exchange Rates	Dec 2008	Current	Dec 2009	Dec 2010
Exchange Rate (USD/INR, eop)	48.7	48.6	48.5	47.0

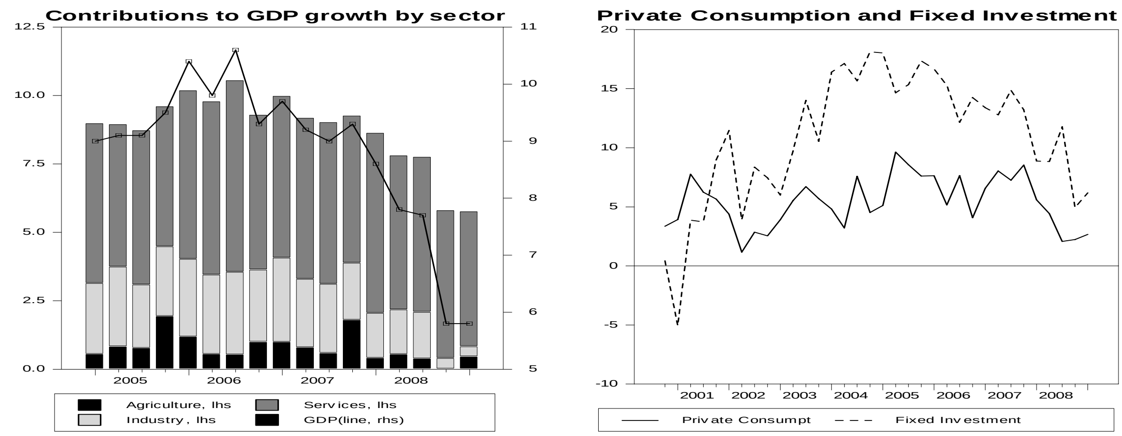
Source: Eurobank EFG, Bloomberg, Ecowin

India's economy held up relatively well, ...

First quarter 2009 real GDP surprised on the upside with growth recording 5.8% y-o-y (consensus expectations: 5%) on the back of strong government spending (21.5% y-o-y). Growth in Q4 08 was revised upward as well (5.8% y-o-y from 5.3% yo-y) bringing the 2008 GDP growth rate to 7.5%. Regardless of the revisions, this figure represents a sharp deceleration from the annual growth rates of 9%-10%, recorded in recent years. The economic slowdown reflects India's increased vulnerability to the global crisis, due to its high dependence on foreign capital and IT exports. Expenditure-based GDP data show that private consumption remained largely stable, increasing by 2.7% y-o-y, while gross fixed capital formation grew by 6.4% y-o-y compared to 5.1% y-o-y in Q4 08 (Figure 4.6, right). However, much of the growth that occurred in investment may be attributable to higher public investment. As far as external demand is concerned, net exports contributed positively to real economic activity, given that real imports declined much faster (-5.7% y-o-y) than real exports (-0.8% y-o-y).

On the supply side, the services sector, which accounts for 60% of GDP, continues to be the main engine of growth, though it rose at a slower pace than during the boom years 2004-2008 (Figure 4.6, left). Muted domestic demand alongside with tight liquidity conditions and higher lending costs undermined the industrial sector, where the pace of growth slumped to 1.4% y-o-y in Q1 09 from an average of 5.2% y-o-y in 2008. Value-added from the manufacturing sector was the main factor driving industrial production downwards. In particular, manufacturing production contracted by 1.4% y-o-y for the first time in more than a decade.

Figure 4.6
Real GDP Growth

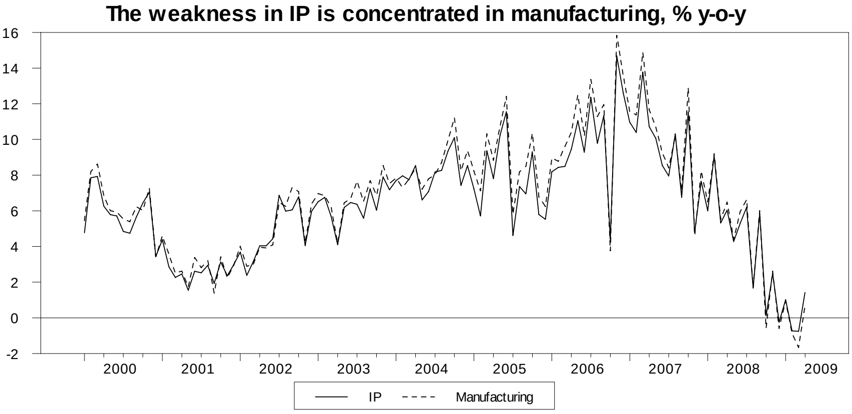


Source: Bloomberg, Ecowin

...with recent monthly economic indicators showing signs of improvement, albeit sluggish

Industrial production moved back into positive territory in April 2009 for the first time in three months. Indeed, industrial production increased by 1.4% y-o-y well above the consensus forecast of a 0.1% decline (Figure 4.7). The rebound was led by all three segments of the industrial sector; manufacturing, mining and electricity. Besides, the PMI manufacturing index rose for a third consecutive month above the threshold of 50 in June, driven by a rise in new orders. However, it seems that the improvement is most likely driven by the lagged impact of fiscal and monetary policy measures. This means that the rebound in industrial production is mainly fueled by domestic demand, given that exports are still declining sharply. Thus, we believe that there are some downside risks to India's industrial sector. In particular, any improvement in global demand will be sluggish (global trade is about to report its sharpest contraction in 80 years) and labor market conditions may deteriorate, given the slowdown in IT export sectors (India is capitalizing on its workforce to become a major exporter of software services), posing risks to consumer spending. The downbeat private consumption outlook is also confirmed by non-oil imports, which contracted further in May for the fifth consecutive month, signalling still weak domestic demand.

Figure 4.7

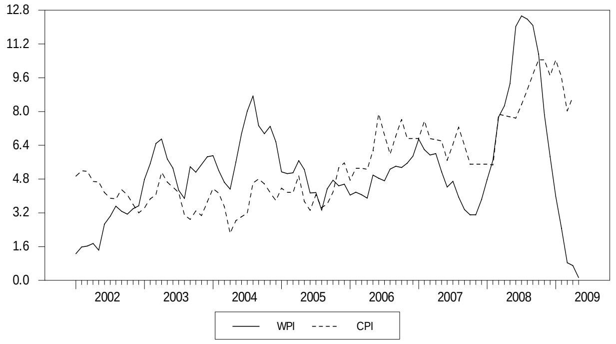


Source: Bloomberg

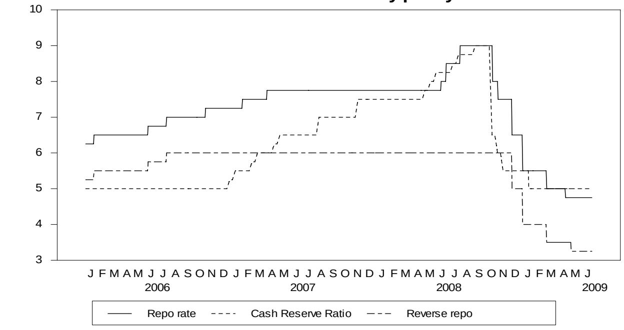
Easing inflation supports rate cuts

Inflationary pressures have been sufficiently relieved, with wholesale price inflation (WPI) falling to 0.1% y-o-y in May 2009 from an average of 9.1% in 2008 (figure 4.8, left), on the back of favorable base effects coupled with declining fuel prices and a slowdown in the cost of manufactured products. Although some months of negative inflation cannot be ruled out, fiscal deficit and liquidity injections are generating significant sources of risk for inflation outlook. In the meantime, given increased concerns over domestic liquidity and macroeconomic stability, the Reserve Bank of India has continued its easing monetary stance. Since October 2008 the RBI has cut the repo rate by a total of 425bps, from 9% to 4.75% (figure 4.8, right). We believe that the RBI will not proceed with further rate cuts, as higher government spending will stimulate demand and fuel inflationary pressures.

Figure 4.8

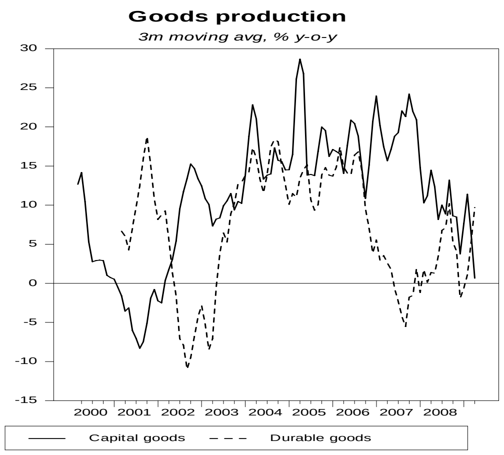


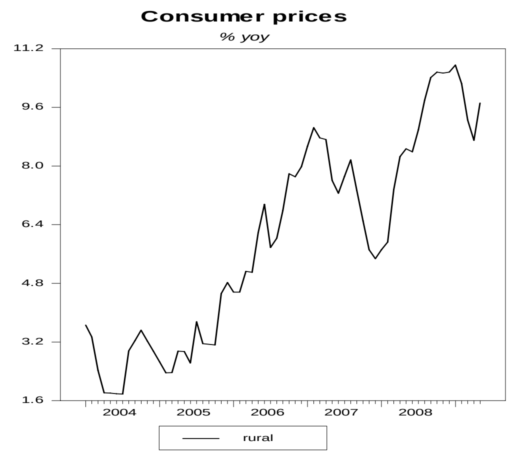
Source: Bloomberg

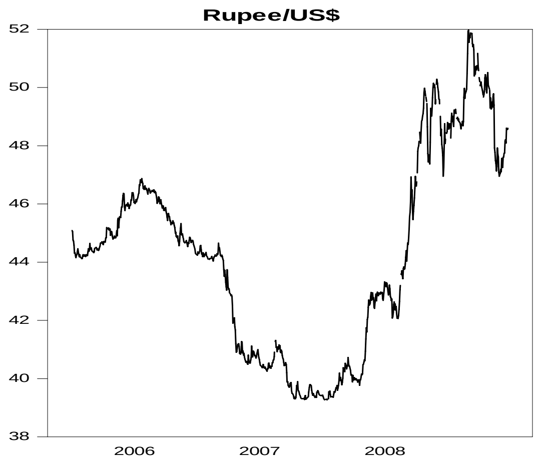


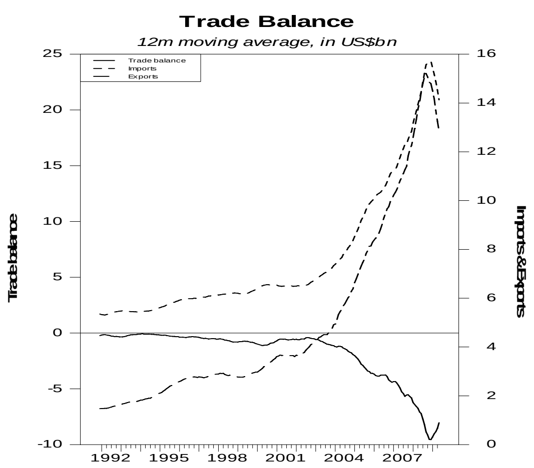
Source: Bloomberg

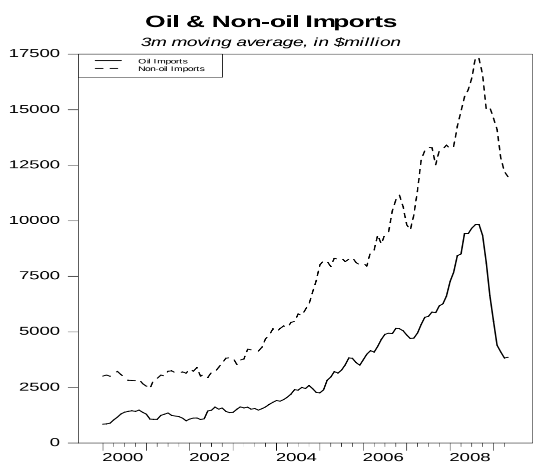
INDIA CHARTS











Source: Bloomberg, Ecowin

4.3 Russia Economic Outlook

- The Russian economy is heading into a severe recession on the back of collapsing private investment and weak capital flows. Real GDP growth dropped sharply by 9.5% y-o-y in Q1 09 from +1.2% y-o-y in Q4 08.
- Recent monthly economic indicators suggest that compared to other emerging markets, Russia lags behind in getting out of the recession.
- The latest data on industrial activity suggest that real GDP contraction in Q2 09 may be stronger than the 9.5% decline in Q1 09.
- Should we take into account the continued deterioration in external demand, the Russia's economic outlook is encumbered even more.
- Lower inflation coupled with concerns over a worsening growth outlook and a buoyed ruble are providing room for additional monetary easing.

Overview

In the context of a sharp adjustment in global oil and energy prices, an ongoing global liquidity squeeze and a sharp decline in global economic activity, Russia is heading for its deepest -and probably longest- recession since 1998. Although significant government stimulus measures have been announced and the Russian financial markets have stabilized in the past few months due to a resurgence in global risk appetite, the economy is still facing a number of headwinds. Indeed, still worsening industrial production and deteriorating labor market conditions are likely to lead to a deeper contraction than was previously expected. Russia's economic recovery is mainly dependent on a substantial fiscal package, a significant increase in commodity prices and a general improvement in financial and external demand conditions. Going forward, although anti-crisis measures should start to have an effect on the real economy over the second half of the year, the outlook for global growth remains subdued –especially for euro area, Russia's leading export market-, implying only a gradual recovery. Moreover, given the ongoing global deleveraging by financial institutions, capital inflows are unlikely to return soon to pre-crisis levels. Thus, according to our estimates, real GDP seems likely to contract by a hefty 7% in 2009 and recover only modestly in 2010, growing by 1% y-o-y.

Table 4.3

Russia Main Economic Indicators and Forecasts

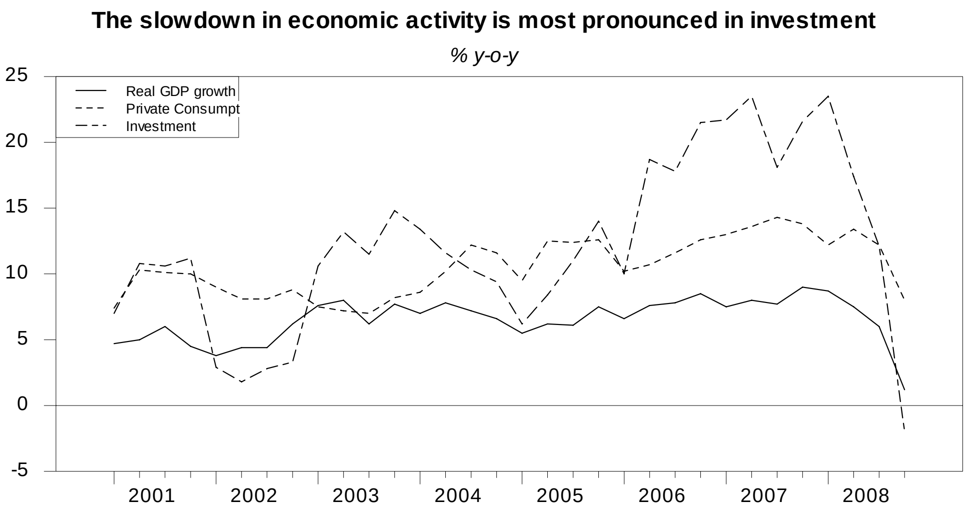
	2007	2008	2009e	2010e
Real GDP (% y-o-y)	7.4	5.6	-7.0	1.0
Industrial Production (avg, % y-o-y)	6.4	2.7	-9.0	2.0
Inflation (avg, % y-o-y)	9.0	14.1	12.0	10.0
Unemployment rate (avg, %)	6.1	6.3	9.0	9.0
External Balance				
Real Exports of Goods & Services (% y-o-y)	6.1	0.9	-8.0	2.0
Real Imports of Goods & Services (% y-o-y)	26.9	15.7	-18.0	4.0
Trade Balance (% GDP)	10.1	10.5	5.0	7.0
Current Account (% GDP)	6.0	6.0	0.5	1.4
Interest Rates	Dec 2008	Current	Dec 2009	Dec 2010
Refinancing Rate (%)	13.0	11.5	10.5	10.0
Exchange Rates	Dec 2008	Current	Dec 2009	Dec 2010
Exchange Rate (USD/RUB, eop)	29.4	31.1	31.0	30.0

Source: Eurobank EFG, Bloomberg, Ecowin

Real economic growth is slowing sharply amid global financial turmoil

Confirming a weakening economic outlook, real GDP growth slowed sharply to 9.5% y-o-y in Q1 09 from 1.2% y-o-y in Q4 08 (Figure 4.9). The slowdown is reflected in several economic activity indicators, with the most pronounced slide witnessed in domestic demand where growth has been dragged down by a halving in real investment spending. Indeed, fixed capital investment growth, which is more prone to volatility in an economic downturn, contracted by 23.1% y-o-y in May 2009 for the seventh consecutive month, in the wake of higher borrowing costs, tighter domestic liquidity conditions and increased uncertainty surrounding investors. Meanwhile, recent monthly economic indicators suggest that, compared to other emerging markets, Russia lags behind in getting out of the recession. In particular, business surveys have yet to show a rebound of confidence and most indexes remain below the expansionary threshold. Moreover, plunging consumer confidence suggests a significant deterioration in labor market conditions, confirming the downbeat outlook for private consumption. Indeed, retail sales declined further in May by 5.6% y-o-y, mainly due to a slump in real wages, which have been declining by an average of 2% y-o-y since the beginning of the year. In the meantime, the unemployment rate has increased by 4.5 pp in May 2009 since its recent trough a year ago (5.4% May 2008), while employment growth has been declining by an average of 2.6% y-o-y over the past six months, adding to the pressures already weighing on consumers.

Figure 4.9

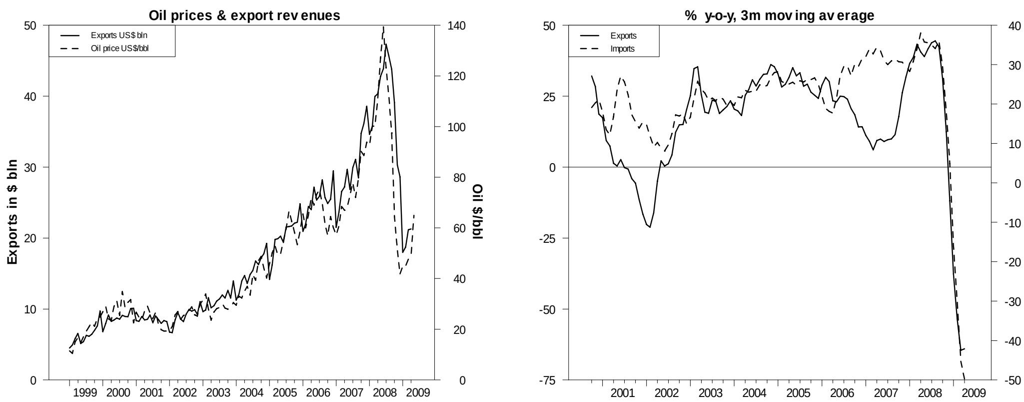


Source: Bloomberg

The latest data on industrial activity suggest that real GDP contraction in Q2 09 may be stronger than the 9.5% decline in Q1 09, given that industrial production fell by more in the April-May period than over the first quarter of the year (average decline 14.2% y-o-y). Indeed, industrial output fell sharply for the seventh consecutive month in May by 17.1% y-o-y, reporting the worst performance since September 1998, with the weakness concentrated mainly in the manufacturing sector. Should we take into account the continued deterioration in external demand, the outlook is rather uncertain. Indeed, exports have been declining by an average of 47% y-o-y since January 09, following an increase of almost 40% y-o-y in 2008 (Figure 4.10). Given that euro area, Russia's main trading partner, is facing its worst recession and is not expected to recover before 2010, exports growth will probably remain extremely weak for the rest of the year, adding to concerns for a sharp deceleration of economic growth. Meanwhile, although the PMI manufacturing index improved slightly to 47.3 in June from 45.3 in May, it is still well below its recent peak of 55.3 in January 2008, reflecting contraction in manufacturing. Thus, industrial production may continue to shrink in the coming months, albeit at a slower pace, bringing the average 2009 IP growth to -9.0%. Against this background of worsening domestic economic activity and a recessionary global environment real GDP is expected to contract sharply by 7% y-o-y in 2009, and rebound only by 1% y-o-y in 2010.

Figure 4.10

Exports & Imports

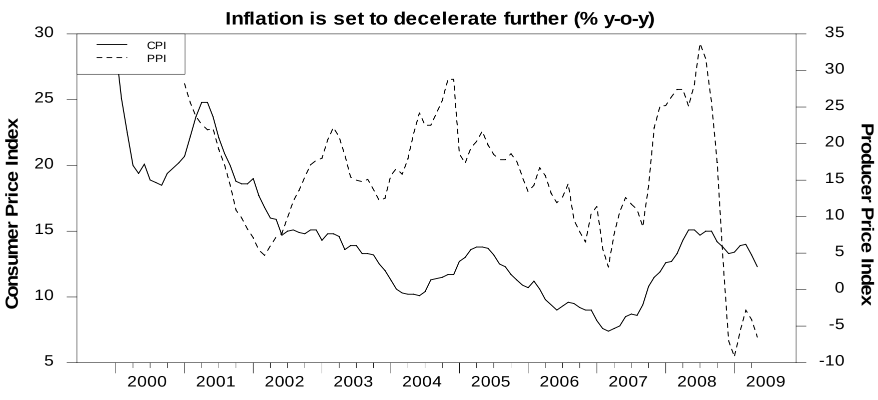


Source: Bloomberg

Lower inflation leaves room for further cuts

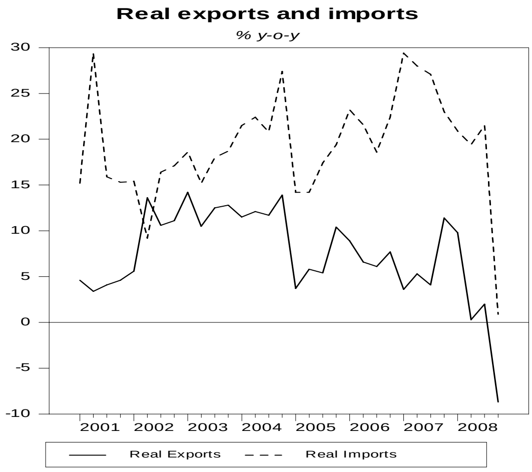
After peaking at 14% y-o-y in March 2008, headline CPI inflation moderated slightly to 12.3% y-o-y in May 2009, on the back of declining food and domestic fuel prices. Producer price inflation, an early gauge of inflationary pressures in the economy, remains in negative territory since December 2008 (Figure 4.11). The latter coupled with the fading pass-trough effect from currency depreciation indicate that inflation will keep slowing. Lower inflation combined with concerns over a worsening growth outlook and a buoyed ruble by higher oil prices are providing more scope for the monetary authorities to lower interest rates. Indeed, the Russian Central Bank has cut the refinancing rate three times since April 2009, by a total of 150 basis points.

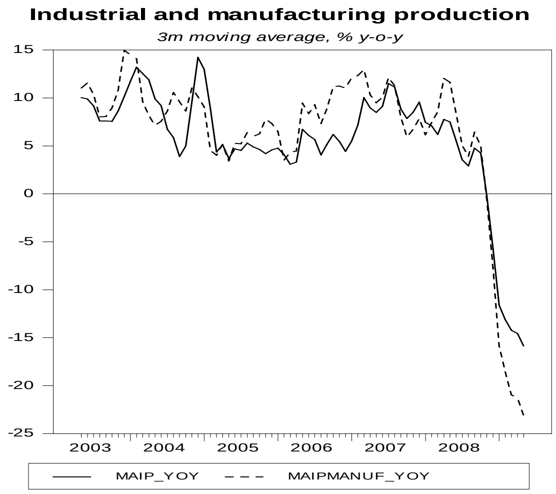
Figure 4.11

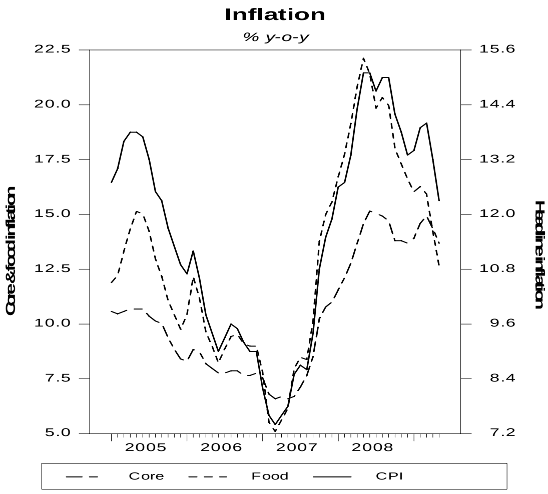


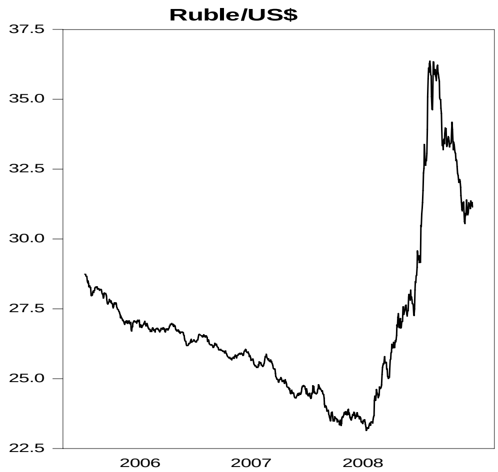
Source: Bloomberg

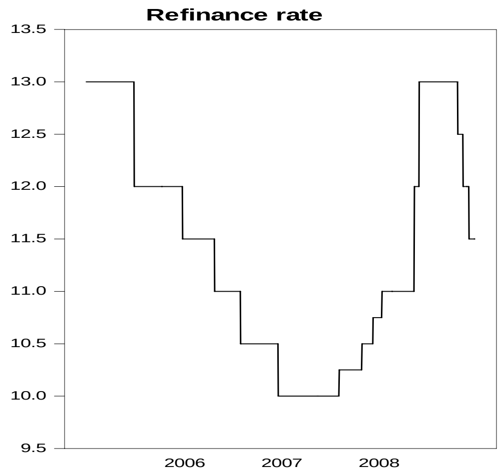
RUSSIA CHARTS











Source: Eurobank EFG, Bloomberg, Ecowin

4.4 Brazil Economic Outlook

- Real GDP contracted by 1.8% y-o-y in Q1 09, as the global recession put a halt to Brazil's investment activity. On a qoq seasonally adjusted basis real GDP fell by 0.8%, from -3.6% in Q408, confirming the technical recession.
- However, the drop in GDP was lower than anticipated, mainly due to the expansion of private consumption and the services sector.
- Recent economic indicators show clear signs that the economy is gradually recovering. Particularly, both industrial production and retail sales have been increasing on a m-o-m basis since January 2009.
- Nevertheless, the recovery of Brazil's economy will most probably be sluggish, given the investment slump and fading fiscal stimulus.
- The benign inflation outlook will provide room for some additional monetary easing.

Overview

Tighter credit conditions coupled with weakening external demand and a reversal in commodity prices have weighed significantly on Brazil's economic growth after the third quarter of 2008. Nonetheless, Brazil's economy has been more resilient during the first half of 2009 than consensus was expecting (consensus estimate: -2.8% y-o-y). In particular, domestic demand has remained robust, while the Brazilian economy has benefited from China's strong commodity demand. Indeed, in April 2009, for the first time, China surpassed the US as Brazil's biggest trading partner. Moreover, a resurgence in global risk appetite and improving commodity prices attracted strong capital inflows in May. Should this trend continue in the coming months, capital inflows will generate better growth prospects for the rest of the year and 2010. However, the rebound in economic activity should be gradual given still weak domestic activity and the fading effect of fiscal stimulus.

Recent economic indicators show clear signs that the economy is recovering from the Q4 08 slump

Real GDP contracted by 1.8% y-o-y in Q1 09, as the global recession put a halt to Brazil's investment activity (Figure 4.12, left). Gross fixed capital formation plunged by 14% y-o-y in Q1 09 after almost two years of double digit growth.

Table 4.4
Brazil Main Economic Indicators and Forecasts

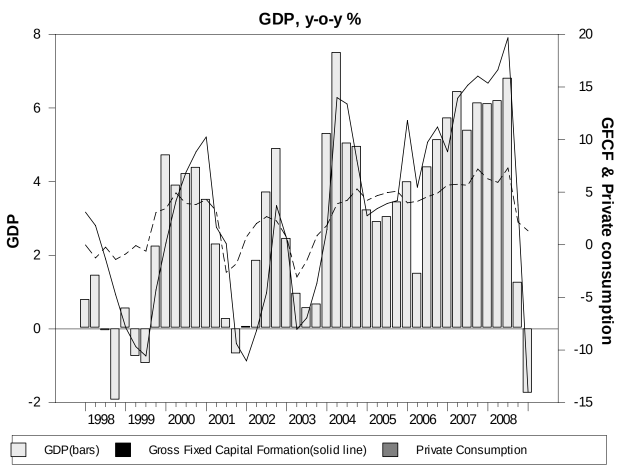
	2007	2008	2009e	2010e
Real GDP (% y-o-y)	5.7	5.1	-1.0	3.0
Industrial Production (avg, % y-o-y)	5.9	3.1	-7.0	5.0
Inflation (avg, % y-o-y)	3.6	5.7	4.5	4.0
Unemployment rate (avg, %)	9.3	7.9	10.0	9.0
External Balance				
Real Exports of Goods & Services (% y-o-y)	6.7	-0.6	-10.0	5.0
Real Imports of Goods & Services (% y-o-y)	20.8	18.8	-15.0	4.0
Trade Balance (% GDP)	3.0	1.5	1.0	1.0
Current Account (% GDP)	0.1	-1.8	-1.5	-1.5
Interest Rates	Dec 2008	Current	Dec 2009	Dec 2010
Short Term Interest Rate (Selic rate, %)	13.75	9.25	8.75	9.50
Exchange Rates	Dec 2008	Current	Dec 2009	Dec 2010
Exchange Rate (USD/BRL, eop)	2.3	2.0	2.0	2.0

Source: Eurobank EFG, Bloomberg, Ecowin

On a qoq seasonally adjusted basis, real GDP fell by 0.8%, from -3.6% in Q408, confirming the technical recession. However, the drop in GDP was lower than anticipated, mainly due to the expansion of private consumption and the services sector. Particularly, private consumption rebounded to 0.7% q-o-q in Q1 09, from -1.8% q-o-q in the preceding quarter, on the back of government transfers, lower interest rates and lower inflation. In addition, the services sector, which accounts for roughly 65% of GDP, expanded by 0.8% q-o-q. Meanwhile, April retail sales surprised on the upside, increasing by 6.9% y-o-y after declining by 1.3% in March, the lowest reading in more than five years. However, the y-o-y figure was likely exacerbated by the Easter holiday. Leaving aside the calendar effect, total sales dropped by 0.2% m-o-m, suggesting that although the worst for economic activity may be over, growth remains sluggish and well below 2008 levels. The mixed performance of domestic demand is also confirmed by the FGV consumer confidence index which stills remains subdued, despite its marginal improvement in May.

Meanwhile, the labor market outlook remains rather bleak. Although the unemployment rate declined slightly to 8.9% in April from 9% in March, most of the slide has been mainly caused by a decline in the labor force (figure 4.12, right). Furthermore, the manufacturing labor market report (IBGE) showed further contraction in April, dropping by 5% y-o-y. Indeed, unemployment rate is expected to increase further as firms adjust their production and the downturn in economic activity will probably spread from manufacturing to services sector. The slack in the labor market is expected to depress somewhat wages, which have marked a considerable growth over the past few years. Indeed, both nominal and real wages have lost momentum since their recent peak in August 2008 (figure 4.12, right). Given that the labor market is an important driver of household spending and that access to credit is limited, private consumption is expected to slow markedly in 2009 and recover in 2010, as the lagged impact of the aggressive monetary easing of the past six months gains traction.

Figure 4.12



Source: Bloomberg, Ecowin

The figures from the supply side of the economy indicate that tighter credit conditions and the sharp contraction of world trade have weighted sharply on industrial production. Indeed, industrial production has been contracting since November 2008, leading to an average decline of 13.8% y-o-y in Q1 09. Weak industrial production data suggest that firms have met demand by reducing inventories, confirming the unfavourable investment and employment figures. Meanwhile, there are some signs that industrial activity may have picked up in the second quarter of 2009. Particularly, on a m-o-m basis industrial production growth has been in a positive territory for the fifth consecutive months in May, owing to the increase in the production of both capital and consumer goods. Indeed, the increase in capital goods production suggests that in Brazil's investment outlook is improving.

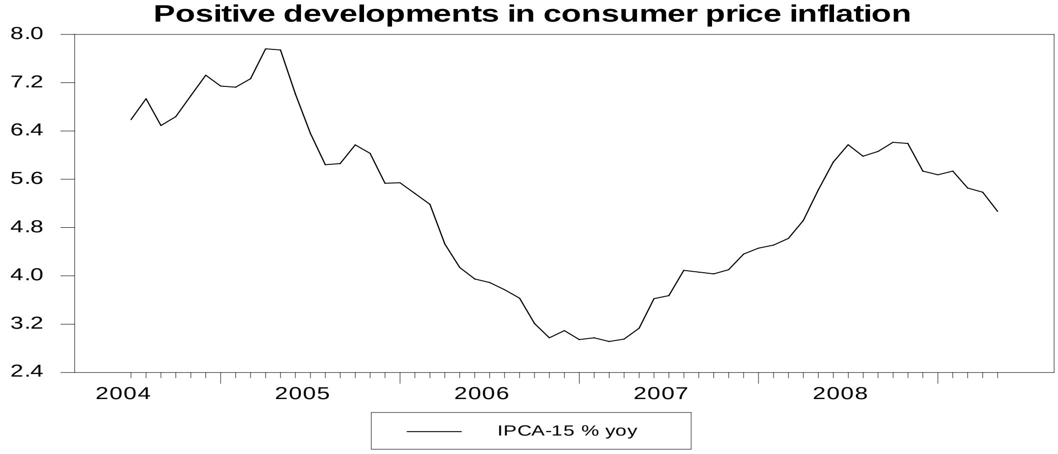
However the recovery should be gradual, given the investment slump and fading fiscal stimulus

Slowing external demand, corporate earnings erosion and weaker real wage growth have taken a big toll on government revenue growth, which is almost near zero. As a result, tax incentives will gradually be restored and the fiscal stimulus effect will start to wane. The latter, in combination with still low levels of investment growth, impede somewhat a sharp recovery in domestic demand. Meanwhile, exports remained in the doldrums for the seventh consecutive month in June. However, the negative contribution of exports to real GDP growth was partially offset by a significant drop in imports, as weakening domestic demand dragged down the import bill. Overall, we expect real GDP to decline by 1% y-o-y in 2009, and rebound by 3% y-o-y in 2010.

Benign inflation outlook allowed the Central Bank to respond to the downside risks to growth

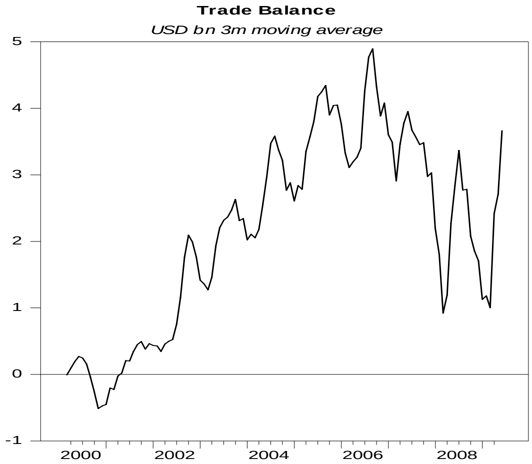
Cooling domestic demand and lower commodity prices have already contained inflation pressures, stemming from the pass-trough effect from currency depreciation. Brazil's inflation dropped to 5.2% y-o-y% in May, after having increased steadily since the first quarter of 2008 well above BCB's target rate of 4.5% (figure 4.13). The general economic downturn has led to a downward adjustment of inflation expectations for 2009 to 4.2% from their peaks of 6.0% at the beginning of the year. Thus, we expect inflation to decline to 4.5% y-o-y in 2009. The benign inflation outlook will probably pave the way for some additional easing, especially if commodity prices soften and activity weakens in the coming months. After a decrease of 450 basis points in the Selic interest rate since January 2009, we believe that the current easing cycle will end in 2010, when improving domestic demand, as well as oil prices fuel renewed inflationary pressures.

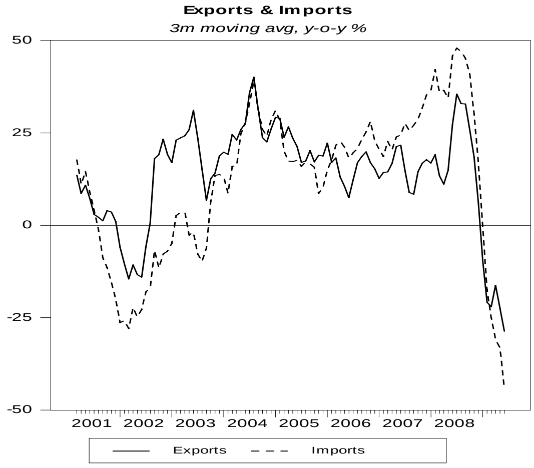
Figure 4.13

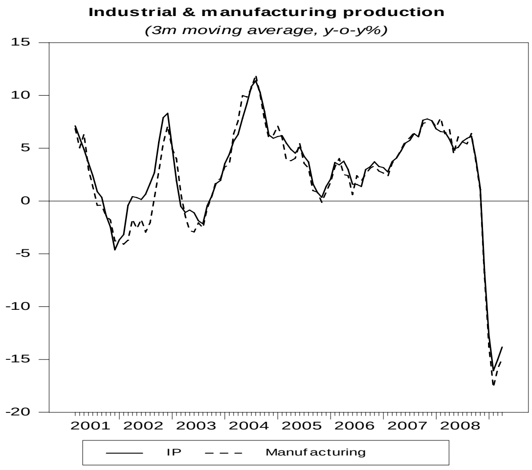


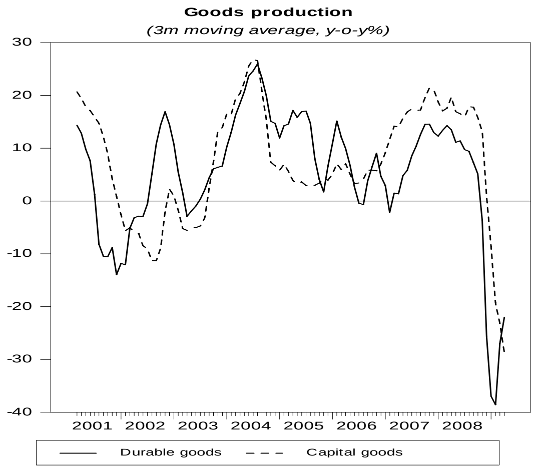
Source: Bloomberg

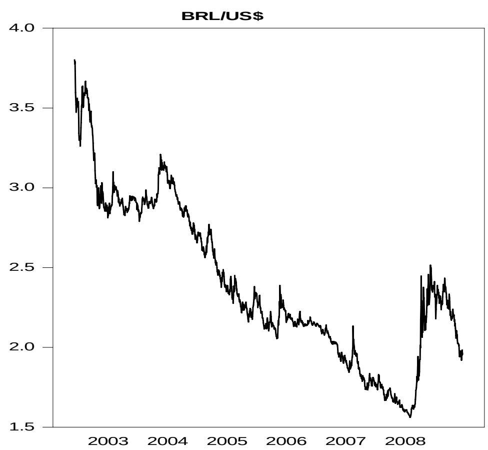
BRAZIL CHARTS

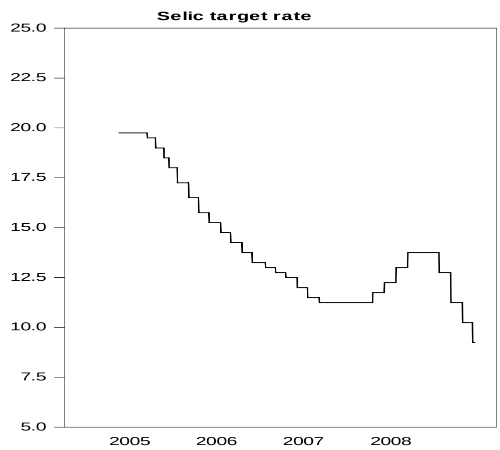












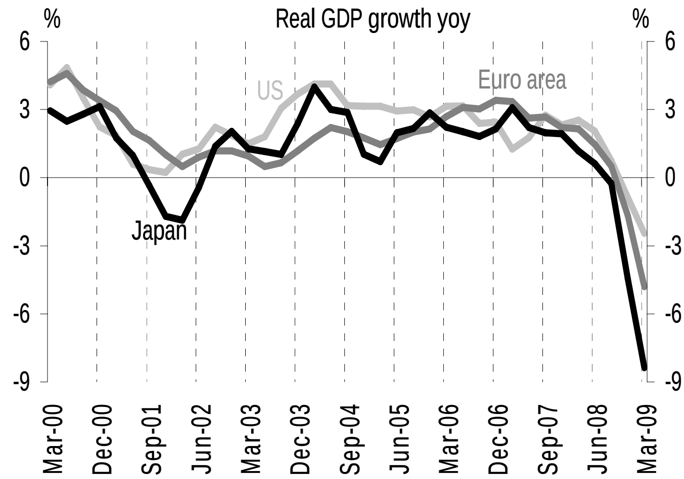
Source: Bloomberg, Ecowin

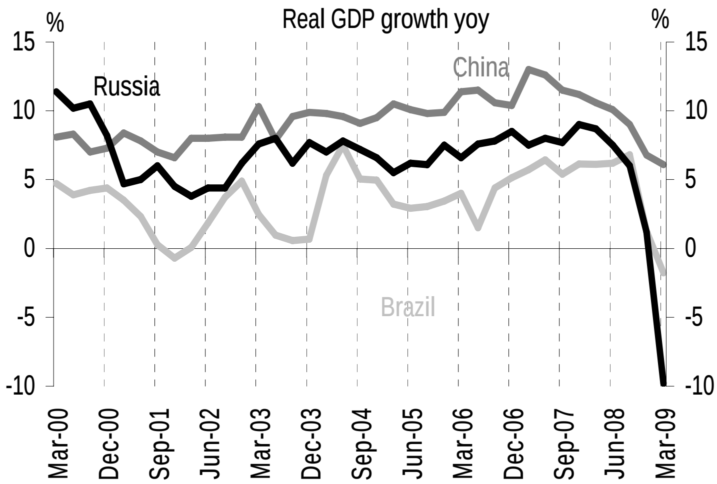
IV. GRAPHS

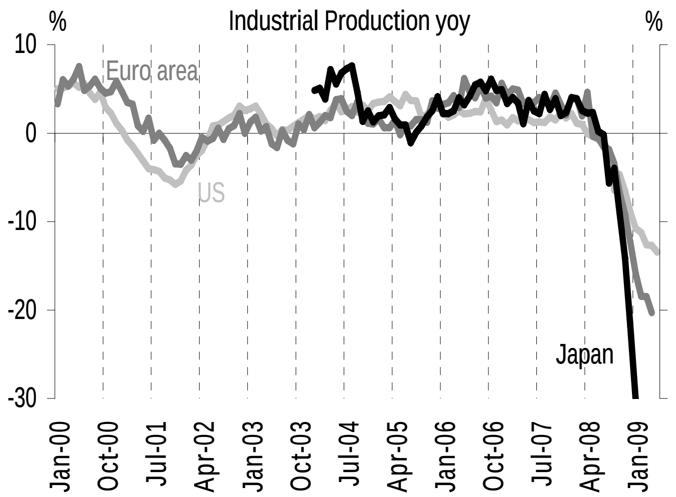
Global Economic Indicators

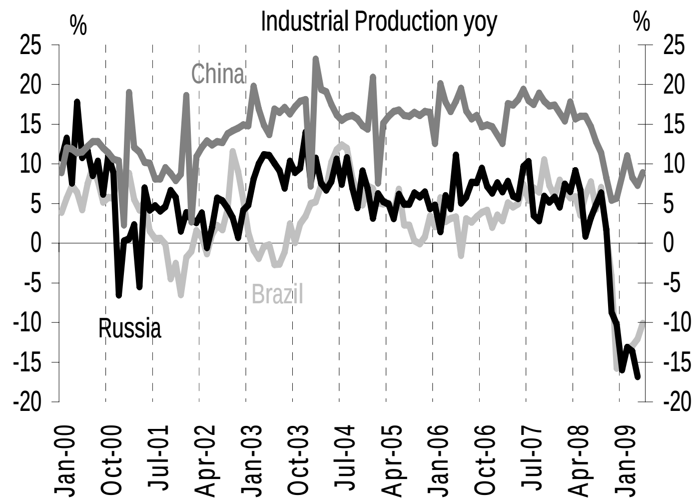
Advanced Economies

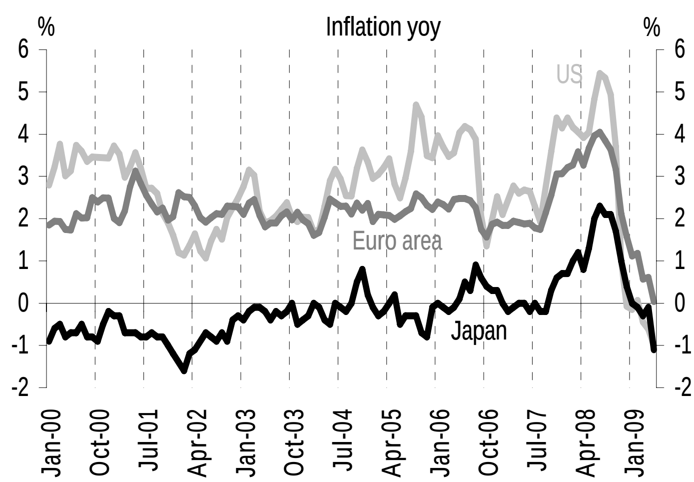
Emerging Economies

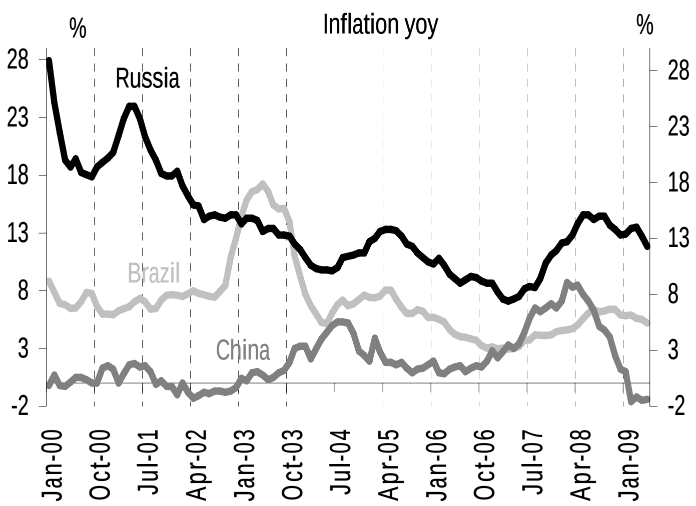








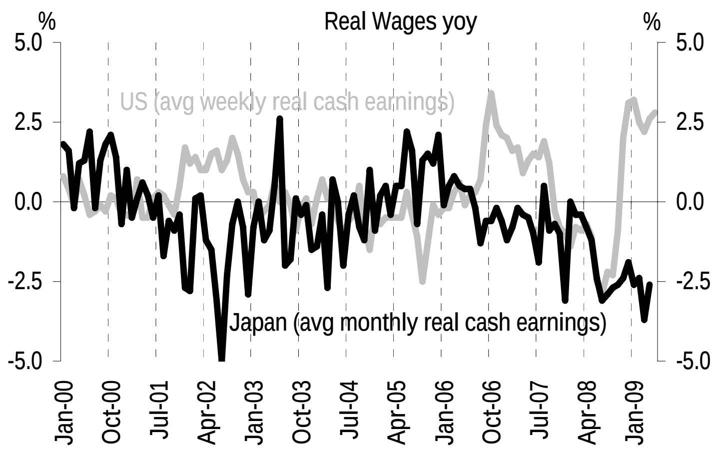


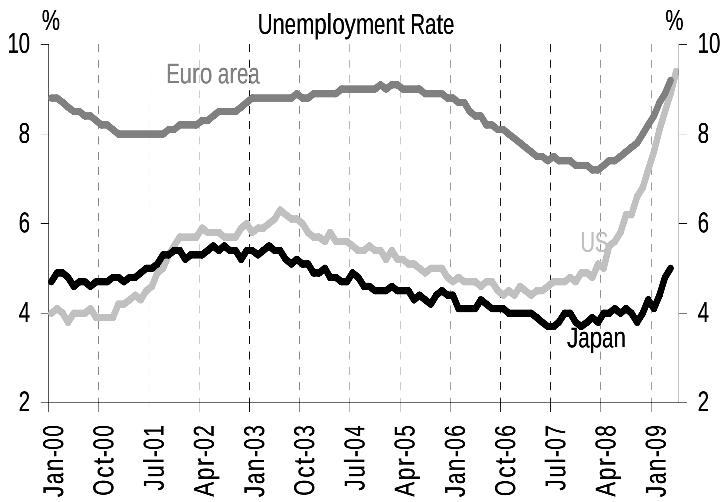


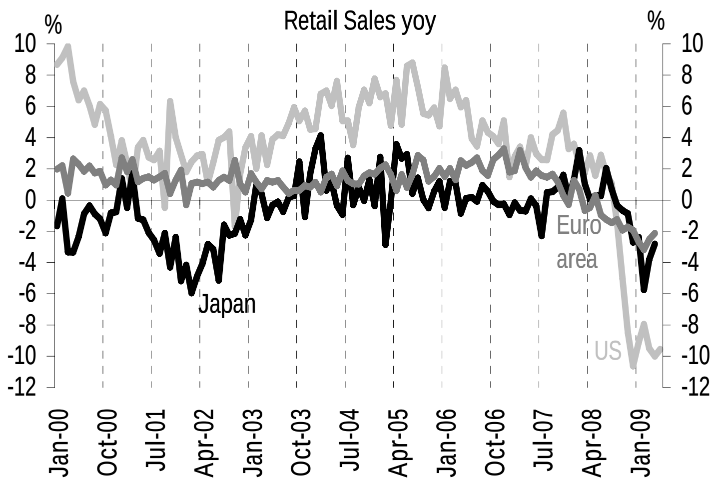
Source: Bloomberg, Ecowin

Global Economic Indicators

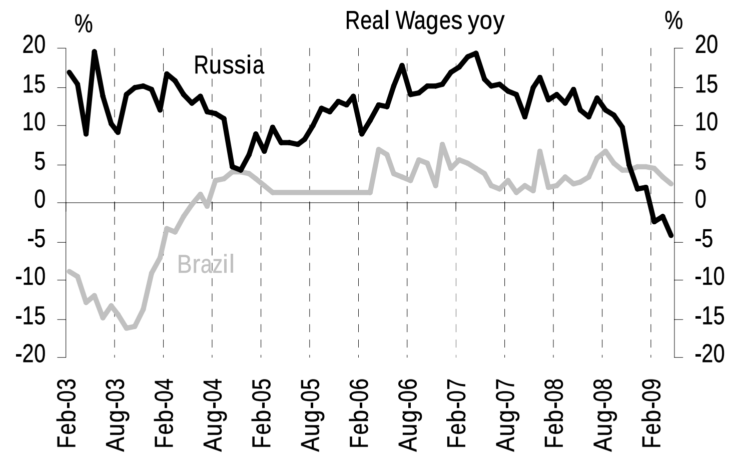
Advanced Economies

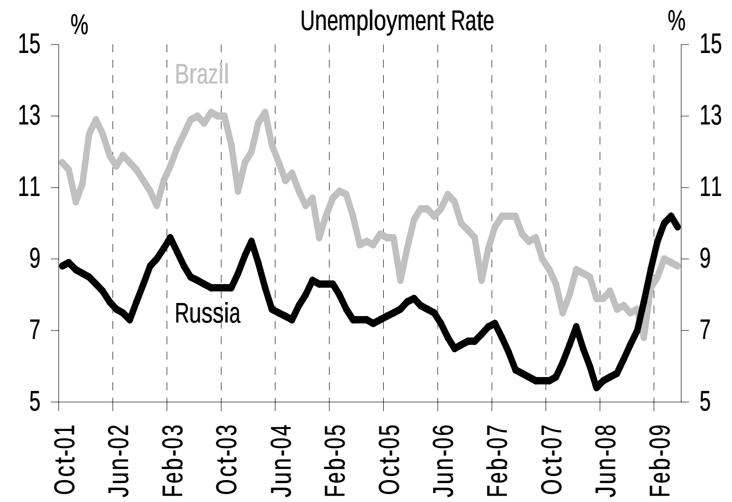


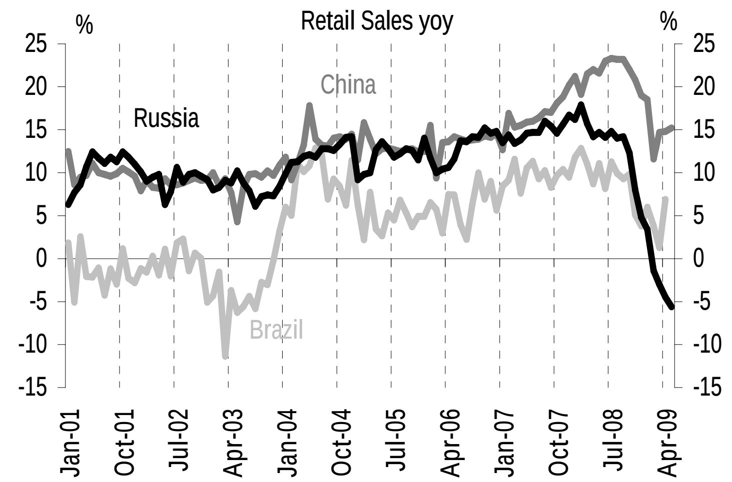




Emerging Economies





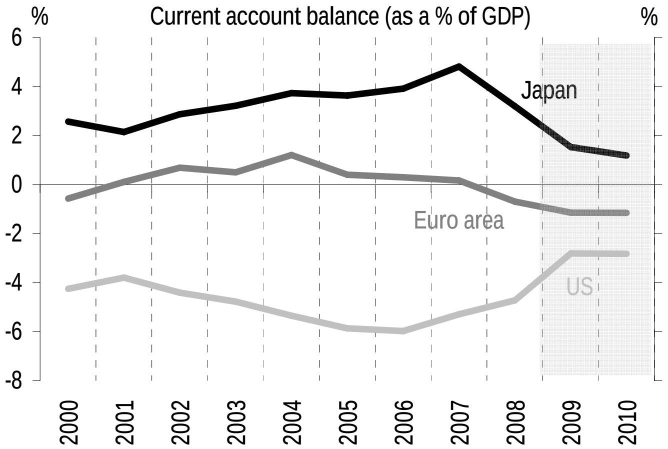


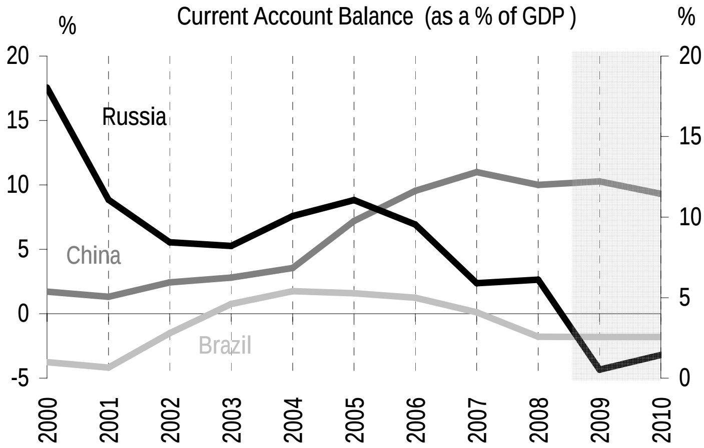
Source: Bloomberg, Ecowin

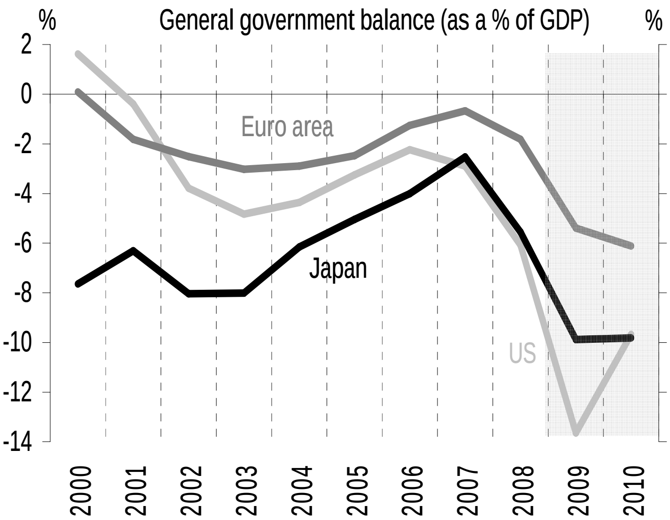
Global Economic Indicators

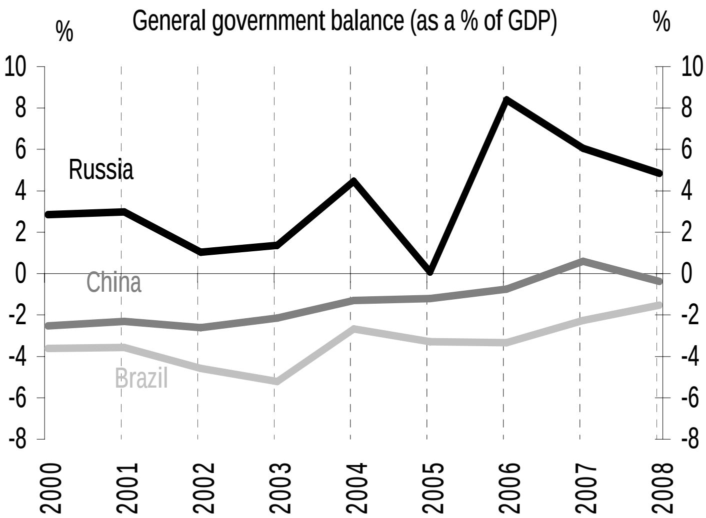
Advanced Economies

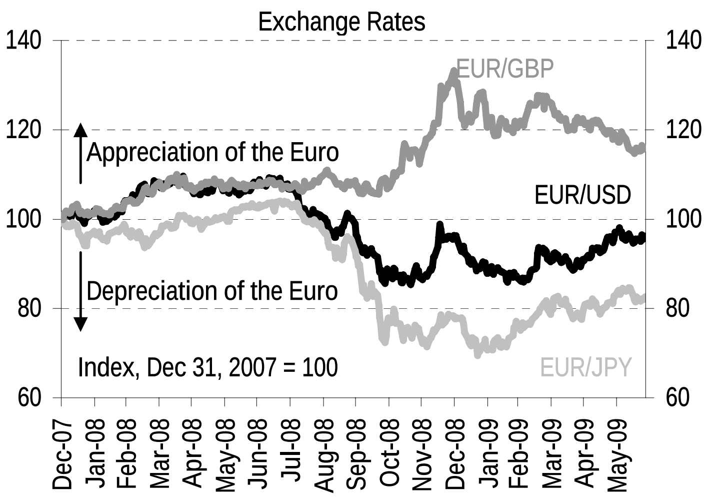
Emerging Economies

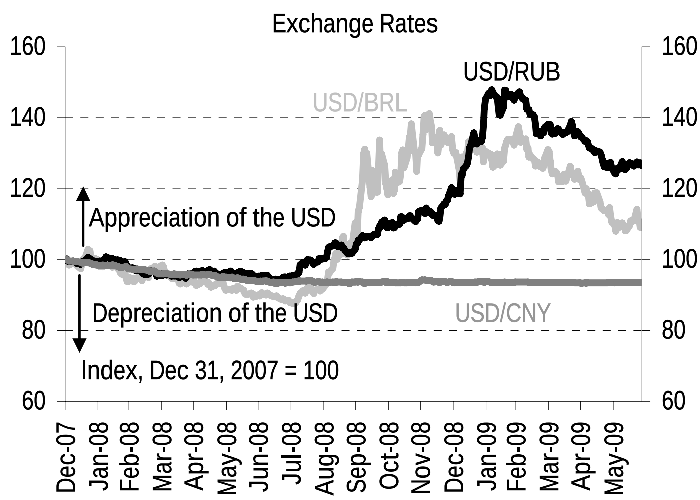








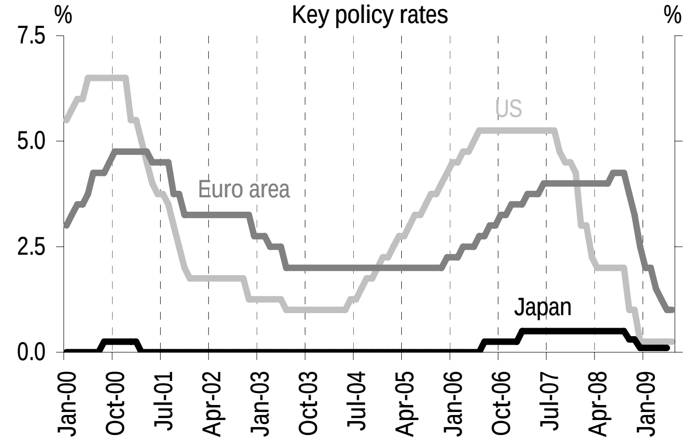




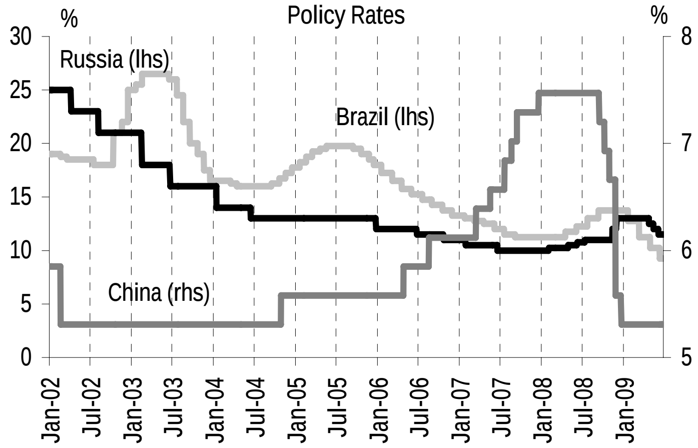
Source: Bloomberg, Ecowin, IMF

Global Economic Indicators

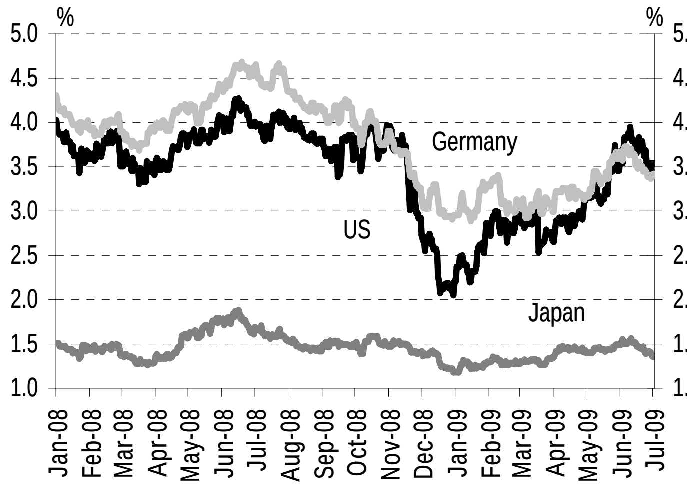
Key policy rates



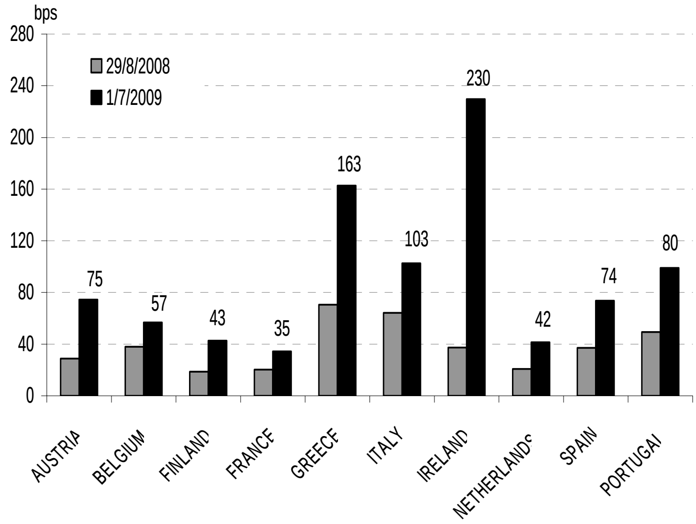
Policy Rates



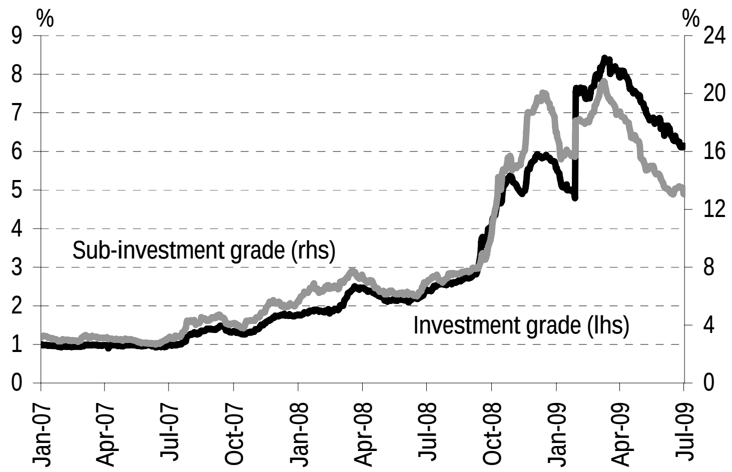
10y Government Bonds



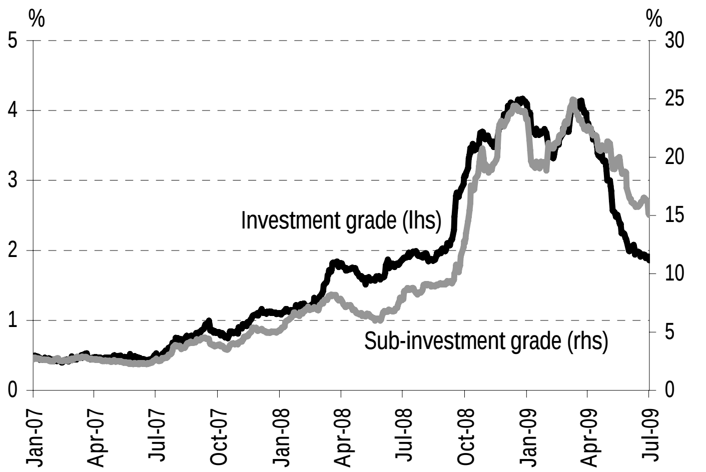
10yr government spreads vs Germany



US Corporate bond yield spreads vs 10-yr government bond



EU Corporate bond yield spreads vs 10-yr government bond



Source: Bloomberg, Ecowin

Global Equities & Sector Performance

Total Return (%) as of July 1, 2009

Global Equity Indices (in local currency)

Region	Index	Last Price	1w	1m	6m	12m	YTD	2008
US	S&P 500	923.3	2.5	-2.3	-0.9	-26.8	2.2	-38.5
EURO AREA	DJ Euro Stoxx 50	2449.7	2.0	-3.3	-3.4	-25.5	0.1	-44.4
GERMANY	DAX	4905.4	2.2	-4.6	-1.4	-22.2	2.0	-40.4
FRANCE	CAC 40	3217.0	1.7	-4.8	-4.0	-25.1	0.0	-42.7
UK	FTSE 100	4340.7	2.1	-3.0	-4.8	-20.0	-2.1	-31.3
JAPAN	Nikkei	9939.9	1.5	2.4	12.2	-25.2	12.2	-42.1
CHINA	CSI 300	3237.9	3.8	13.0	78.1	19.9	78.1	-65.9
INDIA	SENSEX	14645.5	2.1	-1.5	47.1	7.2	51.8	-52.4
RUSSIA	MICEX	1012.5	5.3	-15.5	63.4	-40.8	63.4	-67.2
BRAZIL	IBOV	51543.8	3.8	-4.5	28.1	-15.6	37.3	-41.2

Source: Bloomberg

Sector performance as of July 1, 2009

US Sector Indices (in USD)

US – S&P 500	Last	1w	1m	6m	12m	YTD	2008
1. Consumer Discretionary	217.9	3.1	-3.9	8.6	-16.8	8.6	-33.5
2. Consumer Staples	325.9	1.3	-1.4	-1.8	-10.8	-1.8	-15.4
3. Energy	525.2	1.8	-8.2	-2.1	-41.8	-2.1	-34.9
4. Financials	226.5	2.6	-2.6	-3.4	-39.2	-3.4	-55.3
5. Health Care	384.0	2.5	2.2	0.2	-12.0	0.2	-22.8
6. Industrials	250.7	2.3	-6.5	-5.9	-34.6	-5.9	-39.9
7. Information Technology	307.4	1.9	0.7	24.9	-18.6	24.9	-43.1
8. Materials	214.6	1.6	-7.4	13.9	-38.3	13.9	-45.7
9. Telecommunication Services	161.6	0.6	1.5	-4.0	-18.3	-4.0	-30.5
10 Utilities	258.0	1.9	2.2	-1.7	-28.7	-1.7	-29.0

Source: Bloomberg, Ecowin

Global Equities & Sector Performance

Sector performance as of July 1, 2009

European Sector Indices (in €)

Europe - DJ Stoxx 600	Last	1w	1m	6m	12m	YTD	2008
1. Consumer Discretionary							
Automobiles & Components	319.0	3.1	-4.7	7.1	-9.5	11.5	-43.4
Travel & Leisure	145.4	0.5	-5.9	-0.3	-19.9	2.9	-44.0
Media	191.4	0.3	-5.4	-5.1	-13.4	-1.8	-38.5
Retail	345.1	2.4	1.4	15.9	4.9	20.5	-42.2
2. Consumer Staples							
Food & Beverage	375.6	1.6	3.7	4.9	-3.1	6.7	-28.6
Personal & Household Goods	407.7	1.8	-0.4	6.9	-11.7	10.5	-40.8
3. Energy							
Oil & Gas	519.0	3.3	-6.2	6.1	-24.9	11.7	-37.9
4. Financials							
Banks	330.6	3.0	-2.5	18.3	-32.8	22.3	-62.7
Financial Services	349.8	3.2	-3.8	12.5	-28.2	16.5	-54.6
Insurance	193.6	3.6	-3.2	-6.0	-29.5	-4.0	-44.4
Real Estate	79.8	2.0	-1.7	-8.1	-41.5	-3.8	-52.4
5. Health Care	425.6	0.9	3.8	-3.2	-8.9	-2.8	-16.6
6. Industrials							
Industrial Goods & Services	293.6	3.4	-3.1	7.0	-24.2	10.5	-46.2
7. Information Technology	173.2	2.8	-3.0	9.6	-18.3	13.0	-49.6
8. Materials							
Basic Resources	600.8	2.9	-8.9	31.1	-46.6	44.4	-64.1
Chemicals	560.2	2.4	-6.4	5.0	-27.4	8.1	-36.5
Construction & Materials	342.7	2.8	-5.4	5.2	-17.9	8.4	-46.1
9. Telecommunication Services	378.9	2.4	5.4	-3.3	-15.5	-1.1	-33.6
10. Utilities	576.1	0.7	-2.9	-8.9	-29.2	-7.1	-36.3

Source: Bloomberg

Sector performance as of July 1, 2009

Asia Sector Indices (in USD)

Asia – S&P 50 Index*	Last	1w	1m	6m	12m	YTD	2008
1. Consumer Discretionary	5472.4	0.1	-5.1	48.3	-19.0	48.3	-53.3
2. Consumer Staples	11058.7	2.8	1.0	26.1	-4.1	26.1	-21.1
3. Energy	8127.4	2.3	-10.9	32.0	-19.2	32.0	-50.4
4. Financials	2863.3	3.9	-0.1	34.9	-16.8	34.9	-45.8
5. Industrials	1640.1	2.5	-9.2	19.9	-36.7	19.9	-58.4
6. Information Technology	5748.7	4.4	-3.8	40.1	-17.6	40.1	-42.6
7. Materials	3114.5	4.4	-4.5	20.0	-33.7	20.0	-52.2
8. Telecommunication Services	2393.1	2.2	-1.6	1.9	-23.7	1.9	-38.9
9. Utilities	2547.3	1.6	1.3	10.7	-19.1	10.7	-21.4

Source: Ecowin

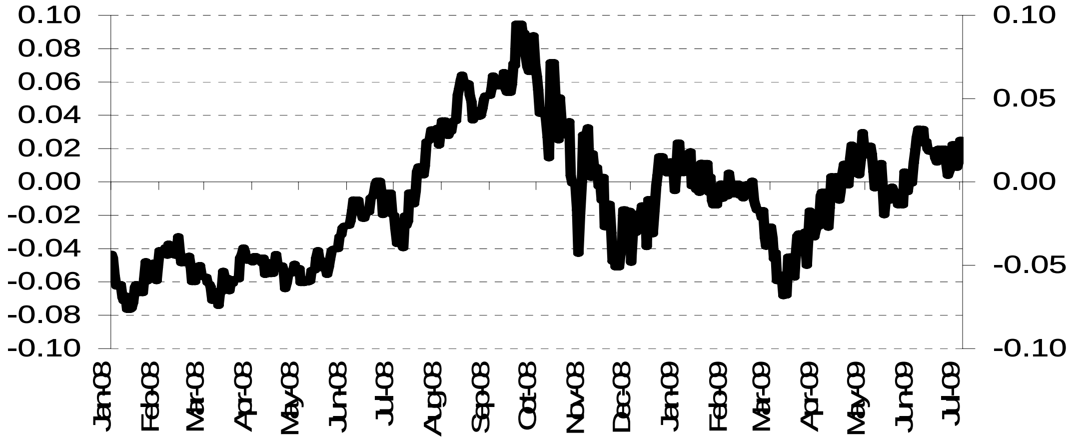
US Style Equity Indices

Total Return (%) as of July 1, 2009

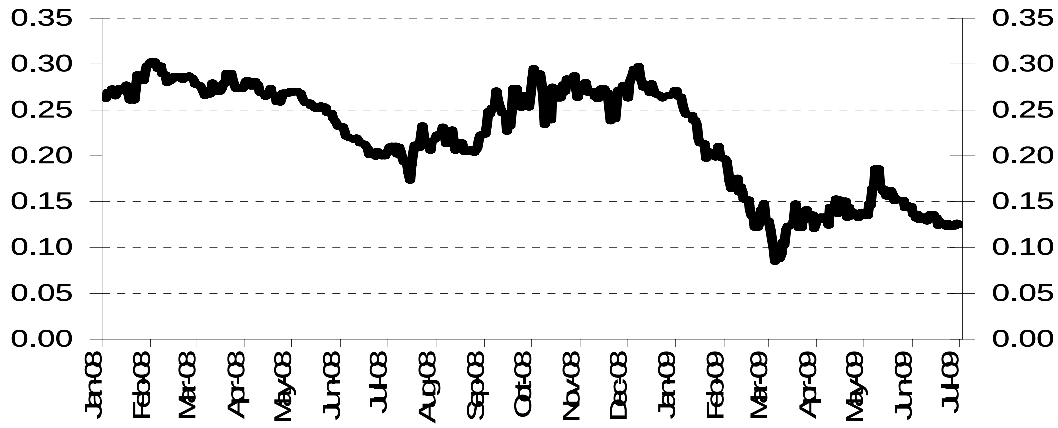
US Style Indices (in USD)

Index	Last Price	1w	1m	6m	12m	YTD	2008
Russell 1000 (Large Cap)	504.6	2.7	-2.3	0.3	-27.0	3.5	-39.0
Russell 2000 (Small Cap)	517.5	4.5	-1.7	2.3	-23.0	3.6	-34.8
Relative performance (Small vs Large)		1.9	0.6	2.0	4.0	0.2	4.2
Russell 1000 Value	467.0	2.6	-2.9	-6.7	-30.2	-4.1	-38.8
Russell 1000 Growth	412.2	2.7	-1.8	7.3	-24.0	11.1	-39.3
Relative performance (Value vs Growth)		0.0	-1.1	-14.0	-6.2	-15.2	0.5

Relative Performance (small vs large)
(logarithmic scale)



Relative Performance (value vs growth)
(logarithmic scale)

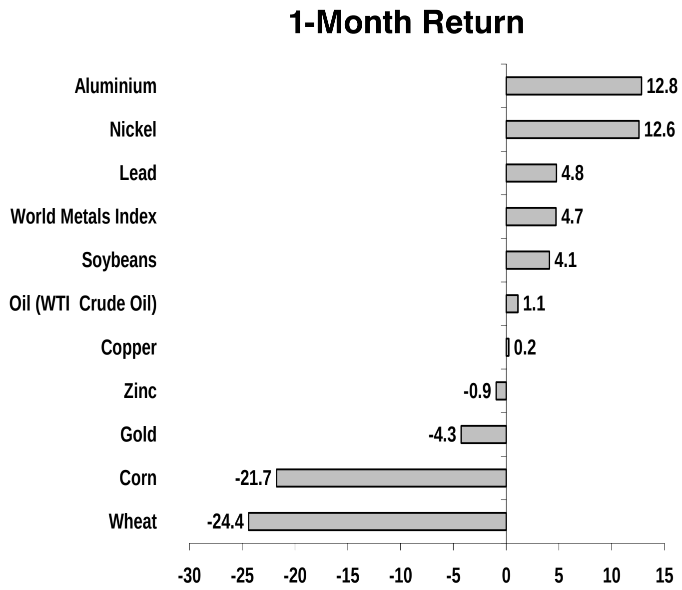


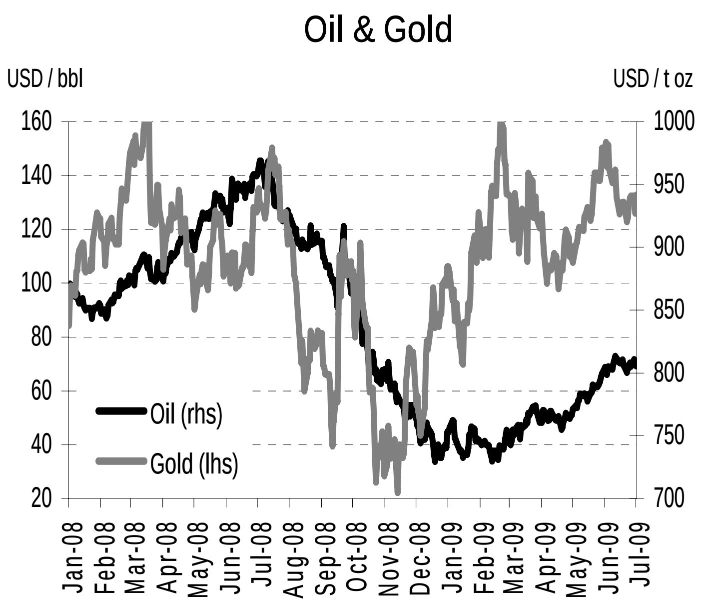
Source: Bloomberg

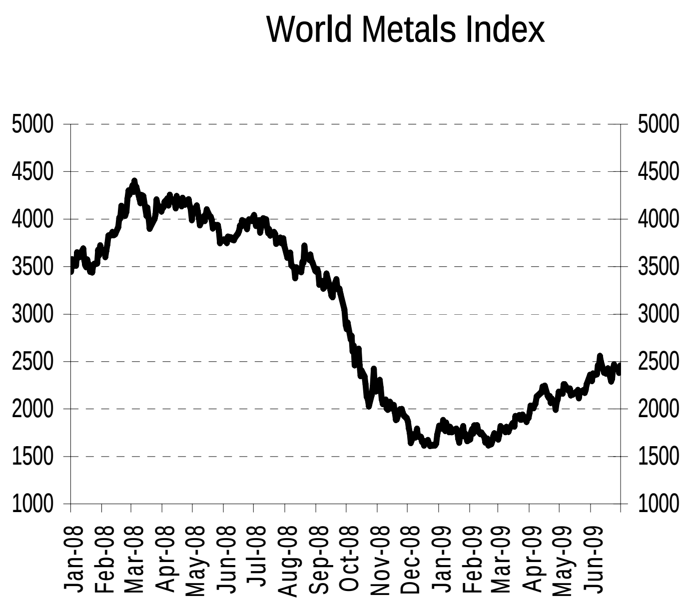
Commodities

Commodity Performance (%) as of July 1, 2009

Commodities	Units	Last Price	1w	1m	6m	12m	YTD	2008
Oil (WTI Crude Oil)	USD/bbl	69.3	-1.3	1.1	49.6	-51.7	55.4	-53.5
Gold	USD/t oz	941.3	0.2	-4.3	7.0	-0.5	6.4	5.5
Base Metals								
World Metals Index		2453.3	-0.6	4.7	35.0	-39.2	42.4	-49.2
Aluminium	USD/lb	1663.0	0.2	12.8	8.0	-47.3	8.0	-36.1
Copper	USD/mt	5087.5	0.6	0.2	65.7	-40.9	65.7	-54.0
Lead	USD/mt	1739.0	2.0	4.8	74.1	-1.5	74.1	-60.8
Nickel	USD/mt	16495.0	6.4	12.6	41.0	-23.5	41.0	-55.5
Zinc	USD/mt	1595.0	-1.0	-0.9	32.0	-17.3	32.0	-49.0
Agriculture								
Corn	USD/bu	351.8	-8.0	-21.7	-14.7	-53.0	-13.6	-10.6
Soybeans	USD/bu	1258.5	5.2	4.1	25.9	-23.4	25.5	-10.9
Wheat	USD/bu	506.3	-5.0	-24.4	-17.1	-41.5	-17.1	-31.0







Source: Bloomberg

Eurobank EFG

A few words about EFG Eurobank Ergasias S.A. (Eurobank EFG)

EFG Eurobank Ergasias S.A. (Eurobank EFG), is the second largest bank in Greece with assets of around €45 billion. Founded in 1990, Eurobank EFG has received high marks from the most reputable international rating agencies (Standard & Poor's, Fitch and Moody's), not only for its financial strength, but also, for the Group's client focus, high level of services, its heavy investment in modern technologies and its professional and dynamic management and personnel. As a member of EFG Group – a Geneva-based banking Group – it has access to all European financial markets.

Eurobank EFG offers a comprehensive array of banking products and services for individuals, corporations and institutions. It currently employs more than 23,700 people in Greece and abroad and runs a distribution network of over 1,550 branches and alternative distribution channels. In recent years, the Bank has expanded into Bulgaria, Romania, Serbia, Turkey, Polan, Ukraine, Luxemburg, United Kingdom and Cyprus.

More information about Eurobank EFG can be found at http://www.eurobank.gr

More research by Eurobank EFG's Division of Economic Research & Forecasting can be found at http://www.eurobank.gr/research

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