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Main Macro Views and Market Strategy:

- Leading indicators of economic activity have shown substantial gains over the past three months, reinforcing our view that the global economy has started to rebound from its worst post-war recession.

- A number of large economies seem to have emerged from recession already in Q2 09, as import demand from Emerging Asia has rebounded strongly.

- We believe that the global recovery will prove stronger than currently expected, particularly in countries where fiscal and monetary stimulus has been strong, such as the US, and in open economies which have been hit hard by the collapse of global trade, such as Germany and Japan.

- We expect the current recovery to be more sustainable than generally expected. In contrast to a widely- held view, we believe that the risk of a W-shaped recession is currently contained.

- Negative base effects of declining oil prices on headline inflation are currently wearing off, moving away the risk of deflation.

- On the back of the recent improvement in economic and financial conditions, we expect a gradual rewinding of quantitative policy measures. We believe that central banks will first ensure that the recovery is convincingly established, before beginning rate normalization.

- In terms of valuations, we believe that, even after the strong rally since March, equities remain more attractive than government and corporate bonds, as growth will likely surprise on the upside, inflation premia start to get priced into long-term yields and bond markets start to discount the end of monetary easing.

- We expect corporate earnings to improve substantially in H2 09 and in 2010 in an environment of strong economic growth and low interest rates. In our view, earnings growth, particularly in the US, will continue to be supported by a widening of corporate profit margins as companies continue to cut costs, a trend which started to get visible in Q2 09.

Macro Forecasts

	2008	2009		2010	
		Eurobank EFG	Consensus	Eurobank EFG	Consensus
Real GDP Growth (y-o-y average)					
US	0.4	-2.4	-2.6 (-3.1 – -1.3)	2.8	2.4 (-0.1 – 4.0)
EA	0.6	-3.8	-3.9 (-4.3 – -3.5)	1.5	1.0 (-0.5 – 2.1)
Japan	-0.7	-5.5	-5.7 (-6.6 – -3.4)	1.4	1.0 (0.0 – 3.1)
CPI Inflation (y-o-y average)					
US	3.8	-0.7	-0.5 (-1.0 – 1.2)	1.9	1.9 (-0.5 – 4.0)
EA	3.3	0.3	0.4 (0.2 – 0.7)	1.0	1.2 (0.5 – 2.1)
Japan	1.4	-1.3	-1.1 (-1.5 – 0.0)	-1.0	-0.6 (-1.0 – -0.0)
Short Term Interest Rates (end of year)	Current				
US	0.00-0.25	0.00-0.25	0.25 (0.00 – 0.50)	1.00	1.00 (0.25 – 3.00)
EA	1.00	1.00	1.00 (1.00 – 1.00)	1.50	1.50 (1.00 – 2.00)
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.

Table of contents

Executive Summary 4

I. Economic Outlook and Asset Allocation 5

II. EFG Macro Model Forecasts 12

III. Global Economic Outlook 14

1. The US economy 15
2. The Euro area economy 26
3. The Japanese economy 32
4. Emerging Markets 36

4.1 China economic outlook 40
4.2 India economic outlook 42
4.3 Russia economic outlook 44
4.4 Brazil economic outlook 46

IV. Graphs 48

1. Global Economic Indicators 49
2. Global Equities & Sector Performance 53
3. US Style Equity Indices 55
4. Commodities 56

Executive Summary

Leading indicators of economic activity have shown substantial gains over the past three months, reinforcing our view that the global economy has started to rebound from its worst post-war recession. A number of large economies seem to have emerged from recession already in Q2, as import demand from Emerging Asia has rebounded strongly. More leveraged economies are expected to have emerged from recession in Q3 as the housing market started to improve. However, although most investors would currently accept that the global economy started to recover from the recession, they are worried about the sustainability of this recovery.

We believe that the global recovery will prove stronger than currently expected, particularly in countries where fiscal and monetary stimulus has been strong, such as the US and in open economies which have been hit hard by the collapse of global trade, such as Germany and Japan. Our research of past recession episodes suggests that deep recessions are followed by strong rebounds. In addition, the stronger globalization will work as a multiplier on the upside as it worked on the downside.

Furthermore, we expect the current recovery to be more sustainable than generally expected. In contrast to a widely-held view, we believe that the risk of a W-shaped recession is currently contained. Our view rests on a series of arguments: (a) Double dips can happen when monetary policy tightens too fast, too soon (1980-82 US recession). (b) Both fiscal and monetary policy shocks transmit to the real economy with a substantial lag of one to one and a half year. This implies that the monetary and fiscal policy easing in 2009 will likely boost growth for all 2010-11. (c) Our research suggests that rapid credit expansion is not a necessary condition for a robust economic recovery. (d) The recent sharp jump in personal savings is rather temporary, as wealth effects are about to reverse as property prices start to rise, stock markets continue to rebound and unemployment stabilizes.

The risk of deflation has abated considerable in recent months. We expect the FOMC and the ECB to start hiking rates in mid-2010 at the earliest, when consumer price inflation will be setting in a positive territory and labour market conditions will be improving significantly. However, we should not disregard the risk of an early monetary tightening, in case oil and generally consumer prices rebound much faster than monetary authorities expect, sinking global economic prospects.

The combination of strong growth and super-loose policy (both monetary and fiscal) are very favourable for risky asset markets, in particular for equities, emerging markets and commodities. Equities remain in our view more attractive than bonds (both governments and corporates), as growth will likely surprise on the upside, inflation premia start to get priced into long-term yields and bond markets start to discount the end of monetary easing. In addition, net supply of credit to the private sector is due to increase sharply in 2010 when the Fed starts to rewind quantitative easing, implying a general rise of bond yields.

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Economic Outlook and Asset Allocation

Dimitris Malliaropulos, Olga Kosma, Maria Prandeka

Global economy to rebound strongly

Leading indicators of economic activity have shown substantial gains over the past three months, reinforcing our view that the global economy has started to rebound from its worst post-war recession. Surveys of manufacturing and business activity, such as the ISM manufacturing index, tentatively confirm the substantial improvement, surging above the threshold of 50% that indicates an expanding economy. Global industrial production has rebounded for three months in a row. Global trade, which had contracted by 19% y-o-y until May, has also increased by a total of 5% in June-July.

A number of large economies seem to have emerged from recession already in Q2, as import demand from Emerging Asia has rebounded strongly: Australia and Japan in Asia but also large European exporters such as Germany and France have shown positive GDP growth in Q2. More leveraged economies such as the US and the UK are expected to have emerged from recession in Q3 as the housing market started to improve. However, although most investors would currently accept that the global economy started to recover from the recession, they are worried about the sustainability of this recovery. In fact, the notable improvement in leading economic indicators since the beginning of the year was the result of massive government support, implying that the initial improvement in economic activity may level off as policy shocks fade away.

We believe that the global recovery will prove stronger than currently expected, particularly in countries where fiscal and monetary stimulus has been strong, such as the US and in open economies which have been hit hard by the collapse of global trade, such as Germany and (to a lesser extend) France. Our view is based on two main factors:

First, we expect the rebound to be strong for the same reasons that the recession was deep. Our research of past recession episodes suggests that deep recessions are followed by strong rebounds. Looking at the five major US recessions over the past sixty years, we find that they were all followed by a strong rebound of GDP over the next four quarters of 4-7%.

Second, the stronger globalization will work as a multiplier on the upside as it worked on the downside. In fact, the 2008-09 recession was a globally synchronised recession, which has hit open economies such as Japan and the euro area the most, as global trade has collapsed. Hence, a synchronised rebound of economic activity will magnify itself as it will lead to multiplier effects through global trade linkages. In that respect, it is not surprising that open economies such as Germany, France and Japan (widely thought as traditional laggards) were the first to emerge from this recession.

A second important issue is how sustainable will this recovery be. A large part of the investment community – including analysts and economists – is worried that the initial rebound of the global economy will soon make place to renewed

weakness as the impact of the policy stimulus will gradually fade away. Hence, the global economy could end up with a W-shaped recession, similar to the 1980-82 period.

Risk of a W-shaped recession is contained

We expect the current recovery to be more sustainable than generally expected. In contrast to a widely- held view, we believe that the risk of a W-shaped recession is currently contained. The case of a double-dip in economic activity rests on a series of arguments: the effects of policy stimulus will fade soon, creating a growth vacuum in 2010; banks' ability to lend is constrained as they have to raise capital and clean up their balance sheets; US consumers have embarked on a process of deleveraging; in addition, rising unemployment will continue to weigh on personal consumption. We find these arguments not convincing for several reasons.

First, double dips can happen when monetary policy tightens too fast, too soon. There is only one historical incident of a double-dip recession in the post-war US history, the recession of 1980-82, when the Fed has sharply raised interest rates by 10 percentage points in twelve months in order to bring down inflation. The current recession has no similarities to the 1980-82 recession. With consumer prices still declining, we expect Fed funds to remain near zero until mid-2010.

Second, both fiscal and monetary policy shocks transmit to the real economy with a substantial lag of one to one and a half year. This implies that the monetary and fiscal policy easing in 2009 will likely boost growth for all 2010-11. In addition, a substantial part of fiscal policy is still in the pipeline as large parts of the global stimulus is in infrastructure programmes (especially in China, but also in the US), the effect of which is spread over several years.

Third, rapid credit expansion is not a necessary condition for a robust economic recovery. In general, bank credit is a lagging indicator of economic activity, especially during economic rebounds, when defaults and delinquencies continue to increase for some time after the economy has hit bottom, constraining bank credit. We find that, in nine out of ten previous recessions in the US during the post-war period, personal consumption has rebounded three quarters earlier than consumer credit. This pattern also applies to industrial production, which rebounds on average two quarters earlier than credit expansion to the private sector.

Fourth, the recent sharp jump in personal savings is rather temporary as wealth effects are about to reverse as property prices start to rise, stock markets continue to rebound and unemployment stabilizes. The deleveraging of the US consumer is in our view a long-term process which will lead to a gradual increase in savings rates, implying a gradual drag to economic growth for the years to come.

Getting rid of deflation

Deflation was predominantly the result of the burst of the commodity price bubble in the summer 2008. Oil prices have declined sharply from their peak of $145 in July 2008 to less than $35 in February 2009, driving headline inflation into negative territory. However, since the start of the year, oil prices have doubled. Hence, the negative base effects of

declining oil prices on headline inflation are currently wearing off, pushing inflation up in the last quarter of 2009 and in 2010. Along with inflationary pressure building up in headline indices, core consumer price inflation will probably continue moving downwards to historical lows over the next quarters, reflecting the downward pressure from the huge slack in the labour market.

Monetary policy to remain loose for long

On the back of the recent improvement in economic and financial conditions, we do not expect further easing policy measures. Focus is now centred on the future exit strategy that will start normalizing monetary policy. The unprecedented easing should give rise to an outright tightening, by unwinding the non-standard policy measures or by increasing the policy intervention rates. We believe that the central banks will first ensure that the recovery is convincingly established, before beginning rate normalization, so as to minimize the probability of a double dip recession. Hence, we expect the FOMC and the ECB to start hiking rates in mid-2010 at the earliest, when consumer price inflation will be setting in a positive territory and labour market conditions will be improving significantly.

Risk factors to our global outlook

In our view, there are two main risks factors to our upbeat global outlook:

(a) *The US consumer*: We expect a rather "jobless US recovery" -as was the case in the last two recessions- with the labor market continuing to weigh on the real economy. Labor market will probably have negative effects on over-indebted US households through labor income weakness. Hence, apart from the fiscal impact on consumption expenditures (tax cuts through the fiscal stimulus measures and the "cash for clunkers" program), the US consumer constitutes a big risk factor in this economic rebound, as he may not be strong enough to support a sustainable US recovery to growth rates above potential. Looking ahead, debt overhang of households may gradually raise the savings rate and reduce the consumption share of GDP.

(b) *Early monetary tightening*. Given the unprecedented fiscal and monetary measures taken, it is important for the central banks to be able to manage inflation expectations and set up a sound exit strategy. The second risk factor concerns the possibility of an early monetary tightening, in case oil and generally consumer prices rebound much faster than monetary authorities expect.

Asset Allocation

The combination of strong growth and super-loose policy (both monetary and fiscal) are very favourable for risky asset markets, in particular for equities, emerging markets and commodities. Equities remain in our view more attractive than bonds (both governments and corporates), as growth will likely surprise on the upside, inflation premia start to get priced into long-term yields and bond markets start to discount the end of monetary easing. In addition, net supply of credit to the private sector is due to increase sharply in 2010 when the Fed starts to rewind quantitative easing, implying a general rise of bond yields.

In equity markets we have seen a strong rally since March, which has led global equities to recover almost half of their losses from their October 2007 peak. Although the magnitude of the initial rebound is not atypical in the aftermath of secular bear markets, the short period over which it occurred and the low participation in this rally raise questions about whether equity markets have pushed ahead of economic fundamentals.

We find that both the PE multiple expansion and the price gains during the recent rally are roughly in line with the average of the previous seven bull markets in the S&P 500 following US recessions (see Table 1). Typically, trailing PEs use to increase by six points on average during the early stage of a bull market and stock prices increase 42% on average. During the recent rally, PEs have increased by nearly nine points (from 10.9x to 19.7x) and prices have gained 42% from end-February to end-September. Using forward PEs, however, price multiples have increased by only six points to 15x currently, which is still three points lower than their long-term average of 18x, suggesting that equities are still cheap.

What is atypical, though, is that the increase in PE multiples during the recent rally took place in only seven months, half the time they used to during previous bull markets, raising questions about the sustainability of the rally. Interestingly, however, we find that in previous bull markets, prices have continued to increase much longer after PEs have peaked, driven by increasing future earnings.

At the risk of generalisation, we can distinguish three stages of a typical bull market in equities (Table 1):

Stage I is the typical relief rally, during which prices increase due to a decline in perceived risk premia while earnings are still on a downward trend. As a result of higher prices and lower earnings, price multiples increase sharply. This stage has an average duration of fourteen months.
Stage II is the consolidation/correction phase, where prices start to reflect revisions in expectations about future earnings and typically correct by an average of 11%. This stage lasts about six months on average.
Stage III of a typical bull market rally is an extended period of price increases, driven by improving earnings. This stage lasts 39 months after the peak in PEs and leads to price increases of 68% on average.

We believe that markets have likely entered the consolidation phase of Stage II. Hence, looking forward, valuations will be increasingly driven by earnings expectations and improving macroeconomic fundamentals.

We expect earnings to improve substantially in H2:09 and in 2010 in an environment of strong economic growth and low interest rates. In our view, earnings growth, particularly in the US, will continue to be supported by a widening of corporate profit margins as companies continue to cut costs, a trend which started to get visible in Q2. The main driving force behind this cost-cutting process is in our view the decline in unit labor costs, a consequence of the significant increase in unemployment during this recession. With corporate prices reversing their downward trend over the next quarters and the decline in ULCs intensifying due to persistently higher unemployment, corporate profit spreads are likely to increase further (Figure 1). As a result, we expect earnings of the S&P 500 companies to increase 24% y-o-y and reach USD 70 by end 2010 (Figure 2).

In terms of valuations, we believe that, even after the strong rally since March, equities are still undervalued relative to bonds. Figure 3 plots our estimate of valuation gap between the S&P 500 and 10-year Treasuries based on earnings, real interest rates and consumer confidence. Positive values of the index imply that stocks are expensive relative to bonds. Our index suggests that stocks are still 10% undervalued relative to US government bonds.

The implication of our analysis for asset allocation is to overweight equities and underweight positions in fixed income. After the sharp narrowing of credit spreads to pre-Lehman levels, we believe that the adjustment in credit markets has largely run its course. Corporate credit will likely continue to perform better than government bonds as credit conditions keep improving and corporate profits increase. However, a repeat of the equity-like returns of this year in credit markets is in our view highly unlikely as spreads have already narrowed substantially and the Fed will terminate its MBS and agency debt purchase programme in March 2010, putting upward pressure on yields.

Table 1: The typical evolution of a bull market (S&P 500 seven major bull markets)

	Stage I					Stage II			Stage III	
NBER recessions	Market trough	PE at market trough	PE peak during market rally	Duration from market trough to PE peak (months)	S&P 500 return from market trough to PE peak	S&P 500 correction during market rally	Duration of correction (months)	Market Peak	Duration from PE peak to market peak (months)	S&P 500 return from PE peak to market peak
08/57 - 04/58 04/60 - 02/61	Dec-57	11.8	20.1	16	44.0%	-11.8%	15	Dec-61	32	24.2%
12/69 - 11/70	Jun-70	14.2	20.2	10	43.0%	-9.6%	7	Dec-72	20	13.6%
11/73 - 03/75	Sep-74	7.7	13.2	17	56.9%	-11.9%	3	Dec-76	10	7.8%
01/80 - 07/80	Mar-78	8.3	9.5	6	18.7%	-10.2%	1	Nov-80	27	36.0%
07/81 - 11/82	Jul-82	7.2	13.5	12	51.8%	-10.5%	11	Aug-87	49	102.9%
07/90 - 03/91	Oct-90	14.7	26.1	21	36.9%	-15.6%	2	Aug-00	97	257.8%
03/01 - 11/01	Sep-02	17.5	20.8	17	40.4%	-10.2%	3	Oct-07	44	35.3%
	Average	**11.6**	**17.6**	**14**	**41.7%**	**-11.4%**	**6**		**39**	**68.2%**
12/07 - ?	Feb-09	10.9	19.7	7	42.0%*					

*From end-February to end-September, Source: Eurobank EFG

Figure 1

Corporate Profit Spread y-o-y

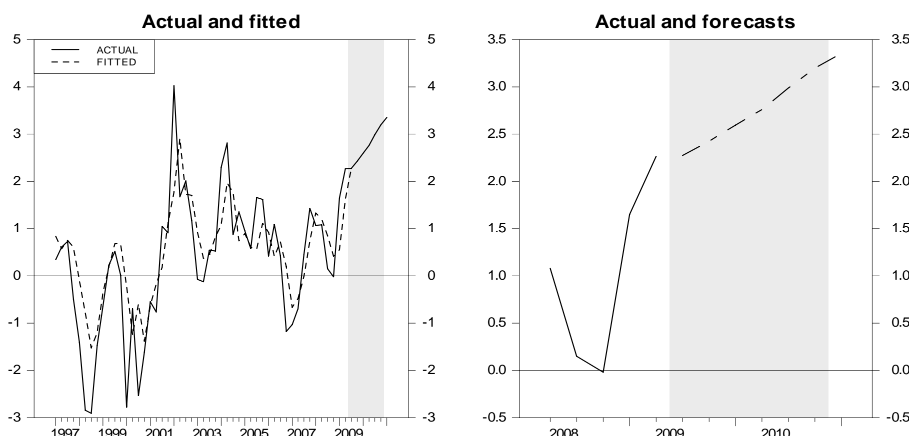


Figure 2

Corporate Profits y-o-y

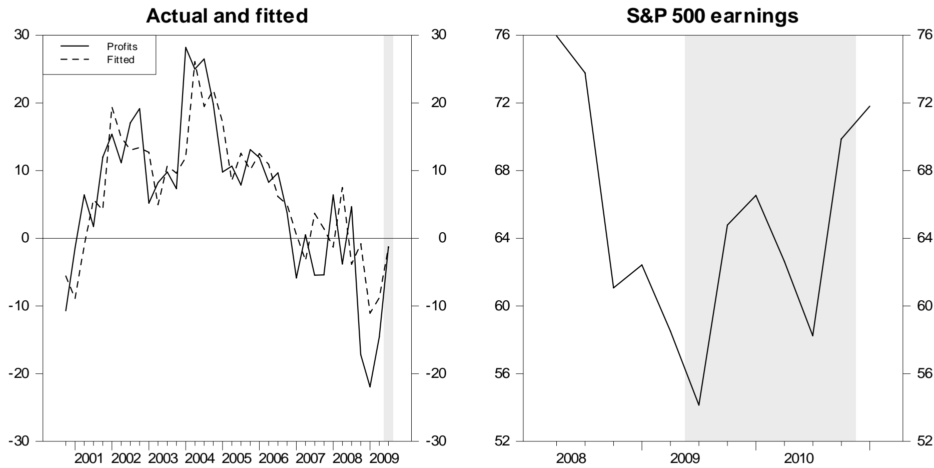
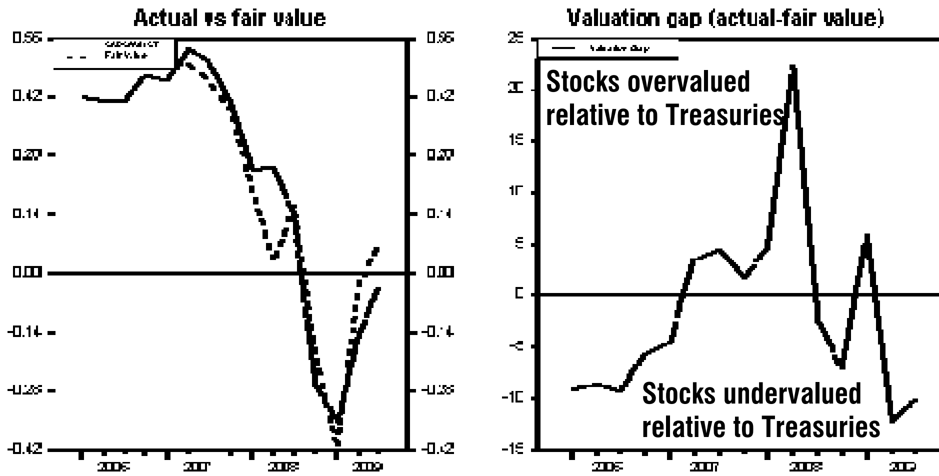


Figure 3

S&P500 relative to US Treasury



Source: Eurobank EFG estimates

EFG Macro Model Forecasts: US Economy & Markets

	Actual	------------- Forecasts ---------------					
	2009:Q2	2009:Q3	2009:Q4	2010:Q1	2010:Q2	2008	2009f	2010f
GDP q-o-q saar	-0.7	3.5	4.0	4.0	3.2	-1.9	0.0	2.0
GDP y-o-y	-3.9	-2.4	0.0	2.6	3.7	0.4	-2.4	2.8
Consumption y-o-y	-1.8	-1.4	0.8	0.8	0.8	-0.3	-1.0	0.8
Labor Market								
Civilian Employment y-o-y	-3.9	-4.3	-4.0	-3.3	-2.5	-0.8	-4.0	-2.1
Civilian Unemployment Rate	9.3	9.6	10.0	10.2	10.2	5.8	9.3	10.5
Inflation								
Headline CPI y-o-y	-1.2	-1.5	0.2	1.1	1.8	3.4	-0.7	1.9
Core CPI y-o-y	1.7	1.3	1.4	1.4	1.3	2.2	1.6	1.3
Core PCE y-o-y	1.5	1.2	1.3	1.4	1.4	2.3	1.4	1.4
Interest Rates (% end of quarter)								
Fed Funds	0.13	0.13	0.13	0.13	0.13			
10-y Treasury yield	3.54	3.31	3.06	3.47	3.66			
Spreads (bps, end of period)								
10y-Fed Funds	338.7	315.5	291.4	332.5	351.0			
10y Treasury-Bund	15.6	8.1	4.5	3.8	4.7			
Exchange Rates (end of quarter)								
USD/EUR	1.40	1.46	1.51	1.55	1.51			
Probability of								
10y-1m Spread to increase	0.99	0.63	0.82	0.86	0.82			
S&P500 to outperform 10-y UST	0.88	0.64	0.25	0.59	0.57			
Bund to outperform 10-y UST	0.35	0.32	0.42	0.56	0.51			

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.

EFG Macro Model Forecasts: Euro area economy

	Actual	------------- Forecasts	---------------					
	2009:Q2	2009:Q3	2009:Q4	2010:Q1	2010:Q2	2008	2009f	2010f
GDP y-o-y	-4.7	-3.9	-1.6	1.2	1.6	0.6	-3.8	1.5
Consumption y-o-y	-0.8	-0.8	0.0	0.6	0.7	0.3	-0.8	1.0
Labor Market								
Employment y-o-y	-2.1	-2.3	-2.4	-2.2	-1.6	0.8	-2.0	-1.0
Unemployment Rate	9.3	9.8	10.1	10.3	10.4	7.5	9.5	10.5
Inflation								
Headline CPI y-o-y	0.2	-0.5	0.4	0.9	0.8	3.3	0.3	1.0
Core CPI y-o-y	1.5	1.2	0.7	0.8	0.5	2.4	1.3	0.8

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

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- The US economy seems to have come out of recession in June 2009. We believe that the US recovery will prove much stronger than currently expected by the consensus, with the fiscal stimulus package having a large effect on quarterly growth rates.
- The housing and manufacturing sectors will probably lead the US recovery, in combination with a swing in the inventory liquidation.
- Housing fundamentals have turned considerably more positive over recent months. We believe that a recovery in housing activity is on the cards for H2 09, providing a boost to the economy through greater residential investment.
- However, longer term risks and vulnerabilities in the US economy, in combination with the effects of the current credit and financial crisis, point to weak long-term economic prospects.
- The US consumer is the risk factor to a sustainable rebound, as the weakness of the labor market continues to constitute a heavy drag on personal income.
- The risk of deflation has abated considerably in recent months. On the back of the recent improvement in financial conditions and signs that the US economy is out of recession, focus is now centred on the future exit strategy that will start normalizing monetary policy.
- We expect monetary policy tightening in mid-2010, when the recovery is convincingly established.

Strong economic rebound ahead, with the housing sector and manufacturing activity leading the way

The strong rebound of leading indicators since February suggests a V-shaped recovery of the US economy. Surveys of manufacturing and business activity tentatively confirm the substantial improvement, with the Institute for Supply Management (ISM) index surging above the threshold of 50% that indicates an expanding economy. In particular, the ISM manufacturing index has increased from its most recent trough of 32.9 in December 2008 to 52.6 in September 2009, surpassing the corresponding average increase recorded during the ten recessions in the post-war period (Table 1.1).

Along with the ISM survey pointing to robust growth in manufacturing output, hard data on industrial output surprised on the upside over the last couple of months, after 1.5 years of negative readings. The industrial production index jumped 0.8% m-o-m in August, coming on top of a large upward revision in the previous month from 0.5% to 1% m-o-m. The pick-up in production can be partially attributed to the auto sector, as the “cash for clunkers” program has led to an increase in auto demand. However, evidence of improvement in the industrial sector is not confined to the auto industry. Based on historical experience, the industrial production index is one of the most reliable signals of an end to a US recession. We find that the annual growth rate of industrial production has on average reached its trough during the last month of each recession in the post-war period. June industrial production growth sat at its worst point since 1946, reporting a multi year low of -13.3% y-o-y, while the average trough in the last 10 US recession episodes is only -8%. The strong monthly increases reported in July and August brought the annual growth to -12.4 and -10.7%, respectively, reinforcing the case for a cycle trough, marking the official end of the US recession in June 2009, as defined by the NBER. This would make the 2008-09 recession the longest recession in the post war era.

Table 1.1
ISM manufacturing pick-up during US recoveries

NBER US Recessions	Duration (in quarters)	Trough (T) in ISM manuf during each recession	$ISM_{(T+8)}$-$ISM_{(T)}$
Q4 48 - Q4 49	5	06/49: 31.6	+28.9
Q2 53 - Q2 54	5	12/53: 35.6	+13.0
Q3 57 - Q2 58	4	01/58: 33.4	+26.4
Q2 60 - Q1 61	4	02/61: 43.6	+18.6
Q4 69 - Q4 70	5	11/70: 39.7	+14.7
Q4 73 - Q1 75	6	01/75: 30.7	+23.7
Q1 80 - Q3 80	3	05/80: 29.4	+19.8
Q3 81 - Q4 82	6	05/82: 35.5	+10.5
Q3 90 - Q1 91	3	01/91: 39.2	+15.7
Q1 01 - Q4 01	4	11/01: 40.8	+12.8
Average	**4.5**	**36.0**	**+18.4**
2008-09		**12/08: 32.9**	**08/09:+19.7**

*ISM(T) = Trough of ISM manufacturing index during each recession
ISM(T+8) = ISM manufacturing index 8 months after each trough
**% change in S&P 500 index after 8 months of trough of ISM manufacturing

Table 1.2: Comparison with Consensus q-o-q growth rates

US	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
Consensus	-0.2	0.7	0.6	0.6	0.6
EFG estimates	-0.2	0.9	1.0	1.0	0.8

Source: Bloomberg, Eurobank EFG estimates

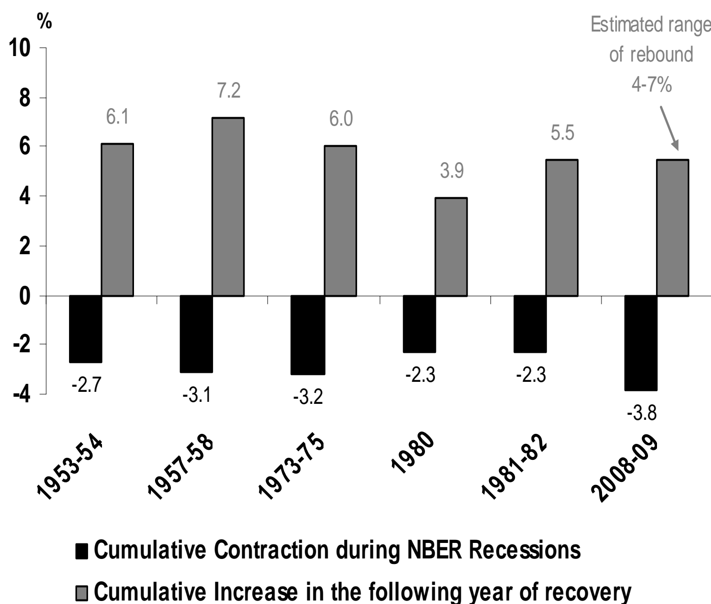
In line with our US outlook in our July Global edition, we continue to believe that the US is set to emerge from its recession in the second half of the year. We believe that the US recovery will prove much stronger than currently expected by the consensus, mainly due to the large fiscal and monetary stimulus. Moreover, housing fundamentals have turned considerably more positive over recent months, reinforcing the view that the US housing activity is set for a rebound. Negative wealth effects stemming from the housing bubble are about to reverse as property prices start to rise, stock markets continue to rebound and the pace of job losses decelerates. Meanwhile, the weaker dollar will help bring about a rebound in US exports, given the impressive recovery in Emerging Asia and Latin America. We envisage strong real GDP growth rates of about 4% q-o-q saar in H2 09, with the fiscal stimulus package having a large effect on quarterly growth rates (Table 1.2).

Figure 1.1 shows that, deep recessions in the US were followed by a significant pick up in real GDP growth, measured by the cumulative increase over the subsequent year of recovery. The 2001 shallow recession was accompanied by a

sluggish rebound, whereas deep recessions, such as the 1957-58 and the 1973-75 recessions, were accompanied by a remarkable rebound in real economic activity. Based on the historical experience, the 2008-09 recession, which has led so far to a 3.8% cumulative decline in real GDP, may be followed by a strong rebound ranging from 4 to 7% q-o-q annualized in the second half of 2009 and the first half of 2010.

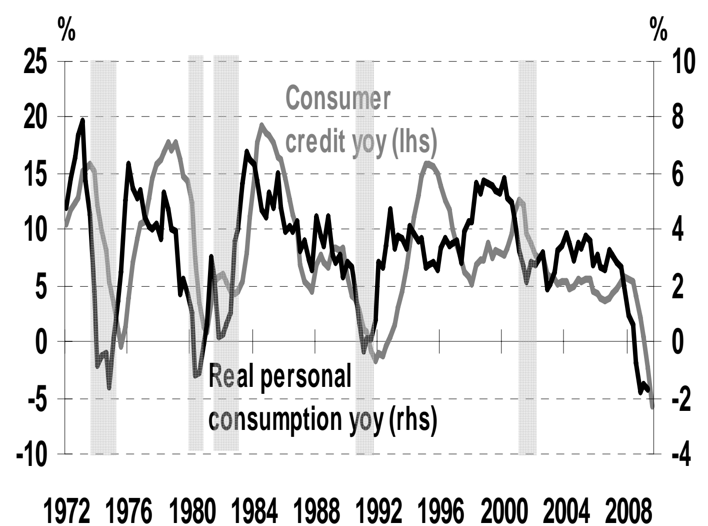
Objections to a robust and sustainable US recovery basically focus on credit availability constraints, both for consumers and businesses. Indeed, bank credit of commercial banks continues to decline, easing to a 0.7% annual growth in September 2009, from its peak of 11% in March 2008. How does the current recession compare with previous recessions in terms of credit growth? Our analysis suggests that credit growth usually lags the business cycle. In strong recoveries, such as the 1953-54 and the 1973-75, industrial production started to increase several months before consumer credit did. In five out of ten previous recessions defined by the NBER since 1948 (1953-54, 1973-75, 1980, 1990-91, 2001), manufacturing output turned stronger about two quarters earlier than total credit growth. Furthermore, we find that in nine out of ten previous recessions in the post war period, real personal consumption has rebounded three quarters earlier than consumer credit growth (Figure 1.2). The only exception was the 1969-70 recession, as both real personal consumption and consumer credit growth rebounded in Q1 71 that the recovery started. Therefore, historical experience suggests that rapid credit expansion is not necessary for a robust recovery of the US economy.

Figure 1.1



Source: Fed of St. Louis, Eurobank EFG estimates

Figure 1.2



Source: Federal Reserve, Eurobank EFG estimates

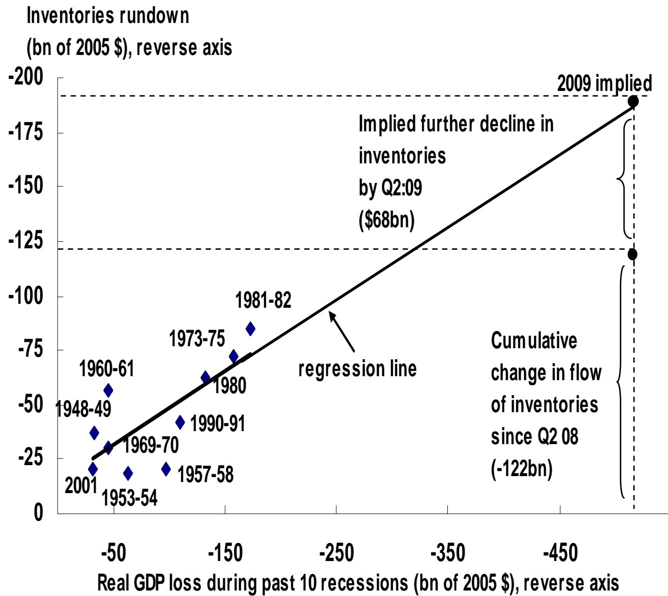
Table 1.3
Inventory investment during US recessions

NBER US Recessions	Duration (in quarters)	Decline in real GDP (bn of chained 2005 $)*	Decline in inventories (bn of chained 2005 $)*	Decline in inventories as a % of the decline in real GDP
Q4 48 - Q4 49	5	-32.7	-36.8	113%
Q2 53 - Q2 54	5	-62.7	-18.7	30%
Q3 57 - Q2 58	4	-97.7	-20.6	21%
Q2 60 - Q1 61	4	-45.1	-57.0	126%
Q4 69 - Q4 70	5	-45.7	-30.5	67%
Q4 73 - Q1 75	6	-157.8	-72.2	46%
Q1 80 - Q3 80	3	-131.9	-62.2	47%
Q3 81 - Q4 82	6	-172.9	-85.1	49%
Q3 90 - Q1 91	3	-109.3	-42.1	39%
Q1 01 - Q4 01	4	-31.2	-20.1	64%
Average	**4.5**	**-88.7**	**-44.5**	50%
2008-09		**-522.8**	**-122.1****	**23%**

*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.

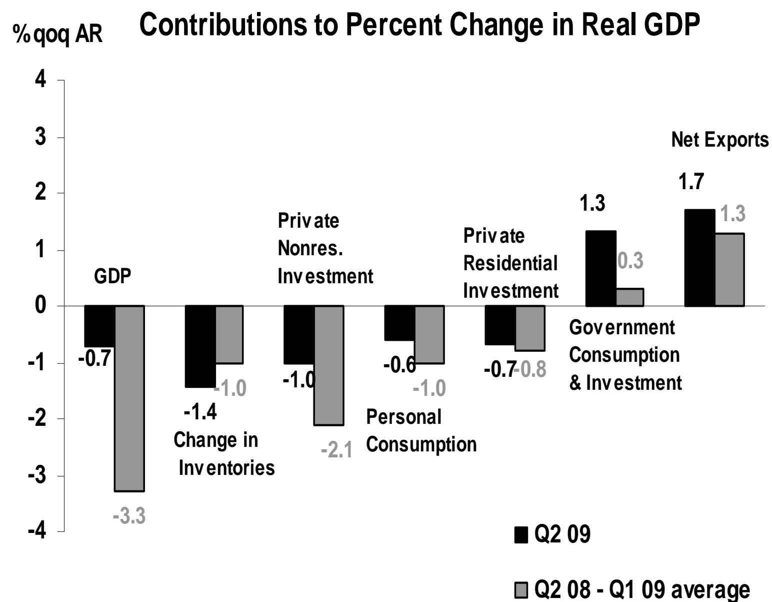
The housing and manufacturing sectors will probably lead the recovery, in combination with a swing in the inventory liquidation. More specifically, businesses decreased inventories by $159.2 bn (measured now in 2005 chained dollars) in Q2 09, following a (downwardly revised) decline of $113.9 bn in the previous quarter. During the past ten US recessions, the loss in real GDP was accompanied by a significant drawdown of inventories, measured by the cumulative change in the flow of inventories from peak to trough of the business cycle (Figure 1.3). The inventories' rundown during the ten recessions in the post-war period accounts on average for almost half the GDP contraction (Table 1.3). The huge rundown of inventories during the 2008-09 recession currently accounts for almost 23% of the total GDP decline. The regression line in Figure 1.2 suggests that the decline in the flow of inventories by Q2 09 should have already amounted to $190 bn. Therefore, in order to match historical correlations, inventories would have to decline further by another $68 bn. We expect destocking to continue in H2 09, but the rate of contraction should decelerate, thereby boosting quarterly GDP growth. Reinforcing our view, the monthly contraction of business inventories softened somewhat in July, while the PMI inventories index in the manufacturing sector -a leading indicator for inventories- increased in July and August, revealing a turnaround in inventory levels after a year of contraction.

Figure 1.3



Source: Eurobank EFG estimates

Figure 1.4



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

However, US structural headwinds undermine future growth prospects of the US economy

While many economists focus on the slope of the US recovery, we believe that the crucial issue is whether the growth recovery will be sustained or weaken below potential levels over the following years, once this severe recession is over. Longer term risks and vulnerabilities of the US economy, in combination with the effects of the current credit and financial crisis, point to weak long-term economic prospects.

As we have previously stated, we expect a rather “jobless US recovery” -as was the case in the last two recessions- with the labor market continuing to weigh on the real economy well into the next two years. Labor market conditions will probably have negative effects on the over-indebted US households through labor income weakness. Apart from the fiscal impact on consumption expenditures (tax cuts through the fiscal stimulus measures and the “cash for clunkers” program), the US consumer will not be strong enough to support a sustainable US recovery to growth rates above potential. Debt overhang of households will gradually raise the savings rate and reduce the consumption share of GDP in the coming years. Furthermore, the Fed liquidity programs have not helped wiping out constraints on credit availability. Lending to the corporate sector, as well as consumer credit, are still contracting, undermining future prospects for private investment and consumption. Given the enormous financial sector damage, the de-leveraging process of banks in order to clean up their balance sheets will probably take years to complete, reducing credit growth and securitization.

More importantly, the stimulus impact enacted in 2009 will fade by late 2010, constituting a significant drag for US economic growth over the following years. The Fed and the Treasury will be confronted in the future with an exit strategy from the massive monetary and fiscal stimulus. The timing of the rollback of excessive money supply is crucial for the

sustainability of the US recovery, so we do not believe that the policymakers will let the stimulus measures run off in the short-term by raising taxes and/or cutting spending, as in this case, the economy would slip back into a recession again. However, once the US economy ensures its recovery and the unemployment rate embarks upon a downward trend, the Fed and the Treasury would be confronted with a substantial fiscal burden. Large structural deficits and excessive public debt should be brought back on a sustainable path, so as to blunt inflationary expectations and increasing pressure on bond yields and borrowing rates will likely lead to a crowding out of private-sector investment and spending.

Besides, potential output growth is determined by the speed with which productivity improves and by labor force growth, and both inputs suggest a remarkable deceleration in the pace of economic expansion going forward. Labor supply is growing more slowly as the population ages, while the share of women and students working has declined. The Congressional Budget Office (CBO) estimates that the civilian labor force will grow an average 0.7% per year through to 2013, down from a pace of about 1.3% in recent decades. Meanwhile, the IT productivity revolution, which sent annual productivity growth in the manufacturing sector from 1.1% in 1989 to its peak of 6.9% in 2002, has waned. Even without factoring in the financial crisis, we expect US potential growth to decelerate significantly over the following years.

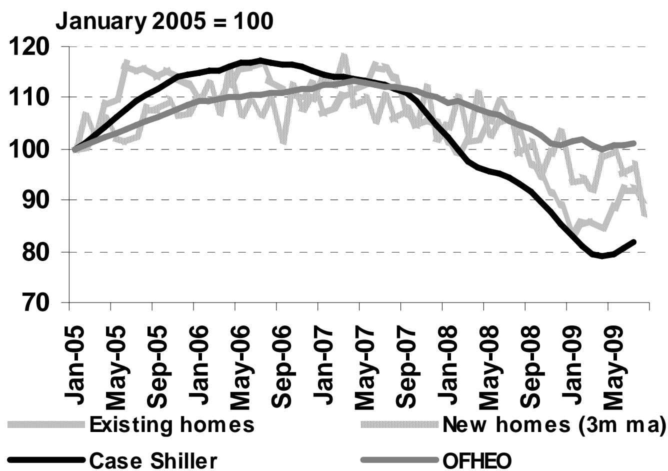
Real economic contraction softens in Q2, with the stimulus boost saved rather than spent

After contracting by roughly 6% q-o-q saar in the previous two quarters, the decline in real GDP decelerated substantially in Q2 09 to 0.7%. While real final sales -GDP less change in inventories- actually rose by 0.7% in Q2 09 after a decrease of 4.1% in Q1 09, the decline in private inventories subtracted 1.4% from Q2 real GDP growth. Real personal consumption did not continue its Q1 positive performance, declining by 0.9%. Private fixed investment fell by 12.5% q-o-q saar, led by a 23.3% decline in residential investment and a 9.6% decline in nonresidential investment. Compared to the previous quarter, the decline in real fixed investment was actually confined to one third, subtracting a total of 1.7% from real economic activity. Government consumption expenditures and gross investment increased by 6.7% q-o-q saar, after an unexpected decline of 2.6% in Q1 09 due to a cut in defense and local government spending. As far as net trade is concerned, real exports decreased 4.1%, while imports fell by a triple rate of 14.7%, leading to a positive contribution of net exports of 1.7% (Figure 1.4).

While government transfers in the form of tax cuts and social security payments gave a small boost to the personal income of US households in the first quarter of the year, most of the transfer income was saved rather than spent. High household debt means that a larger share of income goes into reducing debt through savings. The US personal saving rating reached 6% in May 2009, the highest rate in more than 10 years, reflecting the continuing balance sheet repair of the US households. As a result, personal consumption expenditures declined by 0.9% q-o-q saar in Q2 09, subtracting 0.6% from real quarterly GDP growth. The temporary boost to savings seems to be gradually fading in recent months, with the personal saving rate falling back to 4.5% and 4.2% in June and July, respectively. Given the labour market slack

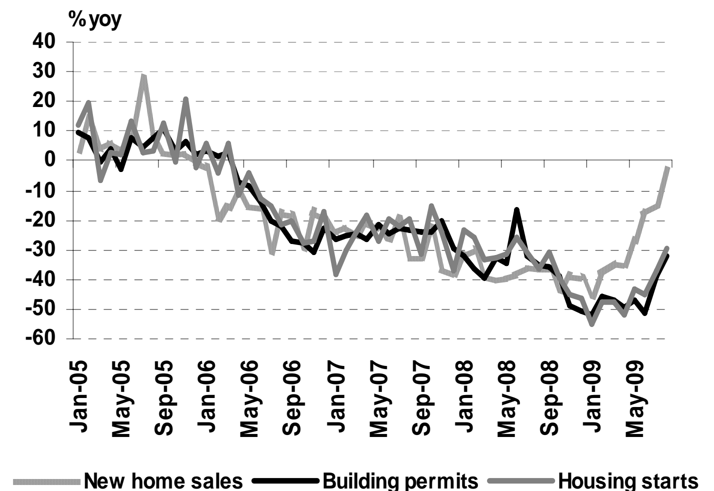
and the huge wealth losses of US households over the past two years, we would expect personal spending to remain fairly subdued in H2 09. However, the "cash for clunkers" program, which creates a financial incentive for consumers to exchange old cars and stimulates demand for new efficient vehicles, is expected to contribute to positive real GDP growth in Q3 and Q4 09. Indeed, personal spending rose 0.2% in July, driven largely by a 1.3% surge in durable goods spending as a response to the cash for clunkers program. In addition, total retail sales increased by a remarkable 2.7% m-o-m in August, bringing the annual growth up to -5.3% from -8.5% in July. Even after excluding motor vehicles and parts dealers, retail sales increased by 1.1% m-o-m, reinforcing the view that consumption expenditures will come back on an upward track by year-end. Besides, the University of Michigan consumer sentiment increased by a total of 8 units to 73.5 in September, the highest level since January 2008. Furthermore, although the Conference Board confidence index eased slightly to 53.1 in September from 54.5 in the previous months, it stands well above its recent trough of 25.3 in February 2009.

Figure 1.5: US House Prices



Source: Bloomberg, US Census Bureau, Federal Housing Finance Agency

Figure 1.6: US Housing Measures



Source: Ecowin, US Department of Commerce

Signs of stabilization in the US housing market have emerged

On the positive side for the US consumer, the ongoing turnaround in housing activity will probably remove a major factor of uncertainty for US households. Signs of stabilization in the housing market have already emerged, with new home sales increasing for the fifth consecutive month in August (Figure 1.6). Inventories of unsold homes continue to come down, declining to 7.3 months of supply in August from its peak of 12.4 in January 2009. Furthermore, the National Association of Realtors' index of pending home sales has jumped to its highest level since June 2007, housing construction has gradually improved and the freefall in home prices has ended. In particular, the S&P Case-Shiller national composite index increased in June and July by an average of 1.5% m-o-m, respectively, translating to a 13% y-o-y decline, the smallest since February 2008. The improvement has been fairly consistent across a range of housing price measures (Figure 1.5). Home sales are likely to remain well supported throughout 2009, as first-time buyers take advantage of the $8000 tax credit which is set to expire on December 1, 2009. We believe that a recovery in home sales

and construction is on the cards for H2 09, providing a boost to the economy through greater residential investment. Both housing starts and building permits increased in August on a m-o-m basis, stabilizing at their highest level since November 2008 (Figure 1.6). Although real private residential investment continued its downward trend in Q2 09, the pace of quarterly contraction broadly halved, to 6.5% compared with 12% q-o-q in Q1 09, adding to the evidence that the housing sector has come out of one of the most severe housing recessions in the post war era. Table 1.4 depicts that real private residential investment has so far contracted by an average of 26% y-o-y since Q4 07, when the US economy officially entered into a recession, well above the 11% average decline during post-war recessions.

The labour market is crucial for the outlook of US personal consumption

The final catalyst for housing demand, as well as consumption prospects for US households, is a stabilization in the labor market. Job losses moderated further in August to 216k, from the recent peak of 741 in January 2009, underlying the gradual improvement in labor market conditions. Moreover, the ISM sub-indices on employment improved in August for both the manufacturing and the services sector. However, the 70% deceleration in the pace of payrolls contraction after the trough in January is a rather slight improvement, compared to the corresponding average improvement of 126% recorded in the post war recessions (Table 1.5). The sluggish improvement in the labor market conditions seems to be affecting consumer sentiment of US households. Table 1.6 shows that, although the consumer confidence index of the Conference Board had eased to the unprecedented trough of 25.3 in February 2009, it has only increased so far by 29 units. The bottom line is that consumer confidence has not recovered so far as sharp as it has fallen since the onset of the recession, as the weakness of the labor market seems to constitute a heavy drag on the recovery of the US consumer.

Table 1.4
Real Private Residential Investment growth during US recessions

NBER US Recessions	Duration (in quarters)	Average y-o-y growth in residential investment during each recession	Average q-o-q growth in residential investment during each recession
Q4 48 – Q4 49	5	-7.6%	0.5
Q2 53 - Q2 54	5	1.1%	0.6
Q3 57 - Q2 58	4	-6.4%	-1.3
Q2 60 - Q1 61	4	-10.7%	-2.8
Q4 69 - Q4 70	5	-6.2%	0.2
Q4 73 - Q1 75	6	-22.1%	-6.8
Q1 80 - Q3 80	3	-26.3%	-8.9
Q3 81 - Q4 82	6	-17.9%	-3.6
Q3 90 - Q1 91	3	-15.7%	-5.9
Q1 01 - Q4 01	4	0.6%	0.4
Average	**4.5**	**-11.1%**	**-2.8%**
2008-09		**-26.2%**	**-7.3%**

Meanwhile, the "household survey" was less favorable than the employment situation, as it indicated a 0.3% increase in the unemployment rate, from 9.4% in July to 9.7% in August, while initial and continuing claims remain unexpectedly high. Upside risks remain for the unemployment rate, given that those who have left the labor force will rejoin it as the economy begins to expand. Besides, the labor force recovered in August (+73k) only a small part of the decline reported for the two previous months (-577k). In addition, in the early stages of recovery, we expect companies to raise the average number of weekly hours instead of payrolls in order to increase production. All these factors will probably keep exerting upward pressure on the civilian unemployment rate in the remaining of 2009 and in H1 2010, acting as a brake on household income and private consumption expenditure. Our job market model suggests that employment will keep declining for the remainder of 2009 and H1 10, though at a slower pace (Figure 1.7). The unemployment rate is expected to remain on an upward trend until 2011, with a year average of 9.3% in 2009 and 10.5% in 2010.

Table 1.5
Deceleration in the pace of contraction of nonfarm payrolls and change in consumer confidence during US recoveries

NBER US Recessions	Duration (in quarters)	Highest pace of contraction of nonfarm payrolls	Deceleration in the pace of contraction after 7 months (%)	Trough in Consumer Confidence	Change in Cons Conf after 6 months of trough
Q4 48 - Q4 49	5	10/49: -834k	-141%	NA	NA
Q2 53 - Q2 54	5	11/53: -336k	-79%	NA	NA
Q3 57 - Q2 58	4	02/58: -501k	-154%	NA	NA
Q2 60 - Q1 61	4	05/60: -219k	-167%	NA	NA
Q4 69 - Q4 70	5	10/70: -430k	-149%	05/71: 75.2	+5.1
Q4 73 - Q1 75	6	12/74: -602k	-141%	12/74: 43.2	+29.0
Q1 80 - Q3 80	3	05/80: -431k	-145%	05/80: 50.1	+37.1
Q3 81 - Q4 82	6	07/82: -343k	-77%	10/82: 54.3	+28.8
Q3 90 - Q1 91	3	02/91: -306k	-111%	01/91: 55.1	+22.6
Q1 01 - Q4 01	4	10/01: -325k	-98%	11/01: 84.9	+25.4
Average	**4.5**	**-433k**	**-126%**	**60.5**	**+24.6**
2008-09		**01/09: -741k**	**08/09: -71%**	**02/09: 25.3**	**08/09:+28.8**

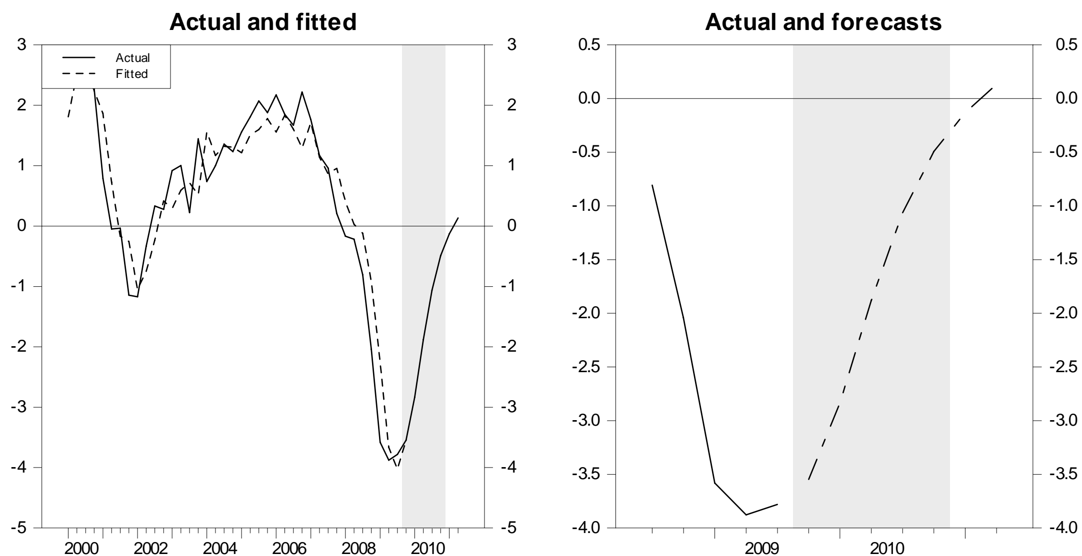
The risk of deflation has abated considerably

Headline CPI declined by 1.5% y-o-y in August 2009, after bottoming at -2.1% y-o-y in July, reporting the largest annual contraction in nearly 60 years due to a sharp decline in energy prices. Looking ahead, base effects on headline inflation will probably weaken over the coming months, as energy prices peaked in July 2008. Given that energy prices remain at current levels, the annual rates of declines of headline inflation should moderate significantly moving into the fall months. According to our estimates, total consumer inflation should turn slightly positive by year-end, ascending

towards 2% by H1 2010 (Figure 1.8). Core inflation, which has so far been very slow to decline, eased further to 1.4% y-o-y in August 2009, driven mainly by declines in the gasoline index and the new vehicle index. We believe that core consumer prices will keep moving downwards to historical lows over the next quarters, reflecting the downward pressure from the huge slack in the labour market. Unit labor costs have already entered deflationary territory and will continue to slow for the next several quarters.

Figure 1.7

Civilian Employment y-o-y



Source: Eurobank EFG estimates

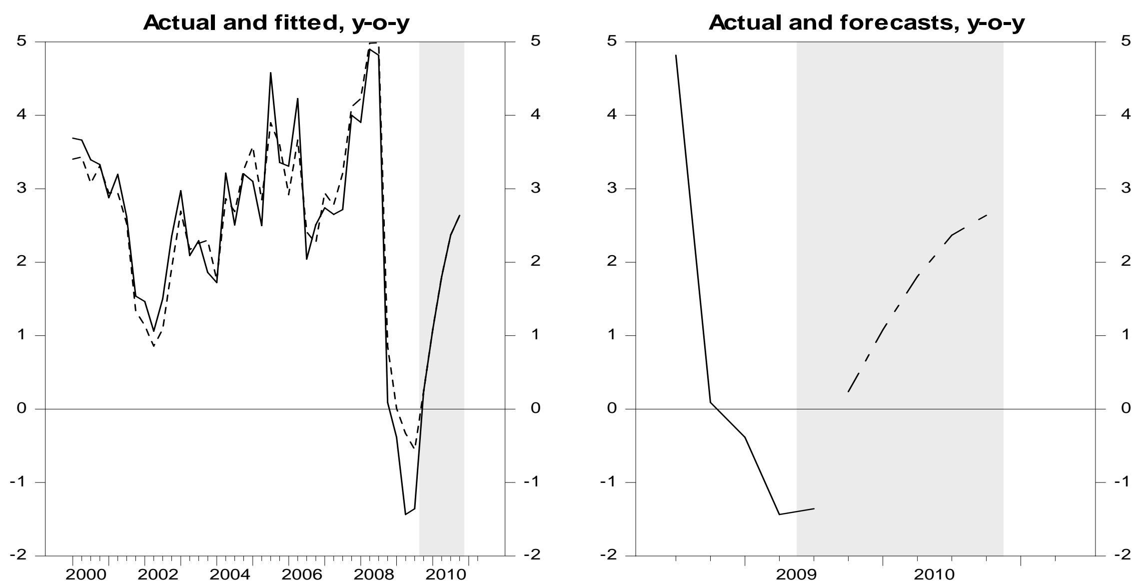
Monetary tightening in mid-2010, when the recovery is convincingly established

The Federal Open Market Committee (FOMC) decided at its September meeting to leave its key funds rate target unchanged at 0-0.25%, upgrading its outlook for the US economy. While noting that economic activity “has picked up” following its severe downturn rather than “is levelling out”, the Fed stated that it will maintain its target range for the Federal Funds Rate target at “exceptionally low levels for an extended period”. As far as the present asset purchases programs are concerned, the Fed has almost completed its program to purchase US$300bn of Treasuries, which officially expires at the end of October 2009. The pace of the planned US$1.25tr purchases of Mortgage Backed Securities (MBS) and US$200 bn purchases of agency debt will gradually slow, but the Committee will extend the purchases until Q1 2010 rather than the end of 2009 expected earlier.

The risk of deflation in a depressionary environment has abated considerably in recent months. On the back of the recent improvement in financial conditions and signs that the US economy is out of recession, we do not expect further easing measures. Focus is now centred on the future exit strategy that will start normalizing monetary policy. The

unprecedented easing should give rise to an outright tightening, in terms of selling back MBS, agencies or Treasury securities or by increasing the fed funds target rate and the interest rate paid on excess reserves. We believe that the Fed will ensure that the recovery is convincingly established, before beginning rate normalization, so as to minimize the probability of a double dip recession, like in the cases of 1937 or 1981. We expect the FOMC to start hiking rates in mid-2010 at the earliest, when consumer price inflation will be setting in a positive territory well above 1% and labour market conditions will be improving significantly.

Figure 1.8



Source: Eurobank EFG estimates

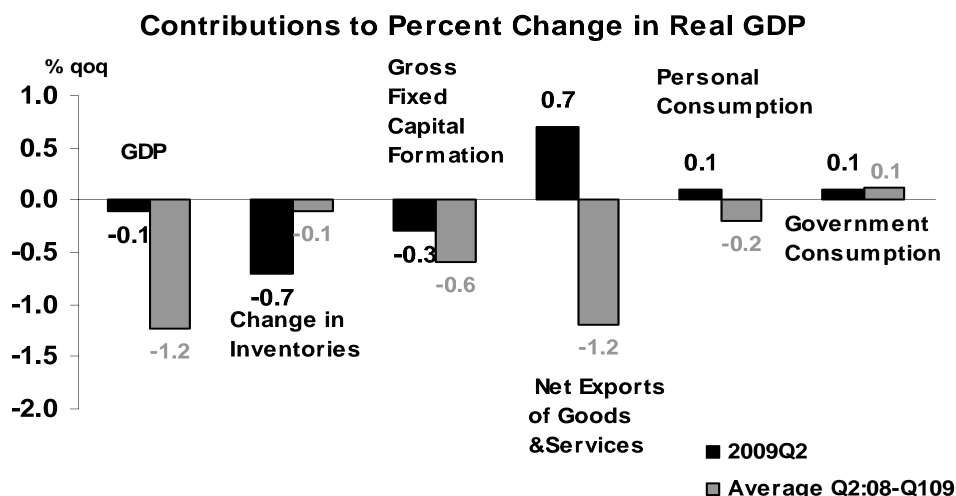
2. The Euro area economy

Dimitris Malliaropulos, Olga Kosma

- After an unprecedented downturn at the beginning of the year, Euro area GDP fell by a better-than-expected 0.1% in Q2 09, providing some reassurance that the economy is getting out of recession.
- Driven mainly by a recovery in global trade and a turn in the inventory cycle, we have revised upwards our growth forecasts, which are currently more optimistic than the consensus estimates. We expect GDP to contract by an average of -3.8% in 2009 and to grow by 1.5% in 2010.
- The significant divergence in the pattern of economic growth amongst several Euro area countries that was revealed in Q2 GDP readings will likely persist well into 2010.
- Short-term prospects for Euro area domestic demand are generally favored by fiscal stimulus and the "cash for clunkers" program implemented in several Member States.
- However, we still remain cautious about longer-term growth prospects due to a long-lasting weakness in the labor market and the consequent squeeze on real income growth, contracting bank credit and the fading effect of governments' fiscal stimulus measures.
- Given the so far fragile economic recovery and the disinflationary environment, the ECB will keep its refi rate low until at least Q1 2010, moving gradually towards a tightening of monetary policy and an unwinding of its unconventional measures in H2 2010.

After a deep downturn in the first quarter of the year, Eurozone GDP fell by a mere 0.1% in Q2, a better-than-expected result providing some reassurance that the contracting Euro area economy has started to stabilize. Leading the stabilization, Germany and France surprised positively with a 0.3% q-o-q GDP growth. The other major Euro area economies remained weak, although their pace of contraction decelerated significantly. Real GDP in Spain contracted by 1.1% q-o-q in Q2, while real economic activity in Italy declined by a smaller 0.5% q-o-q. Sharply declining inventories and deteriorating fixed investment were key factors driving real GDP downwards by a total of 1%. Private consumption increased by a solid 0.2% q-o-q, after a 0.5% drop in Q1, with the strongest boost stemming from the German consumer. Real exports continued to contract, though at a much lower pace (-1.1 q-o-q versus -8.8 in Q1), while imports fell faster than exports. As a result, net trade contributed positively to growth by a firm 0.7% (Figure 2.1).

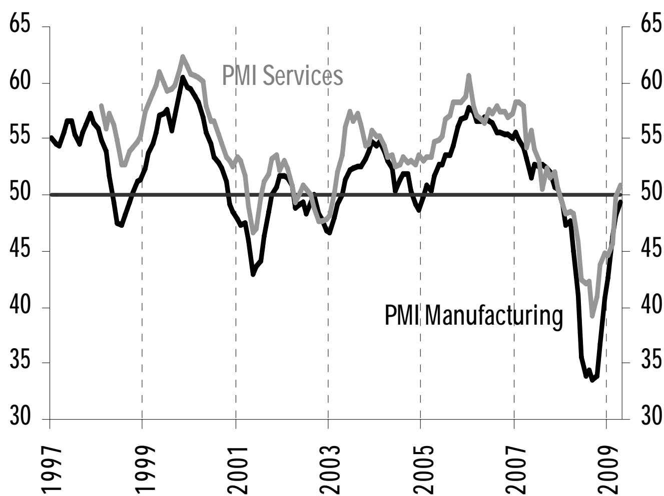
Figure 2.1



Source: Eurostat

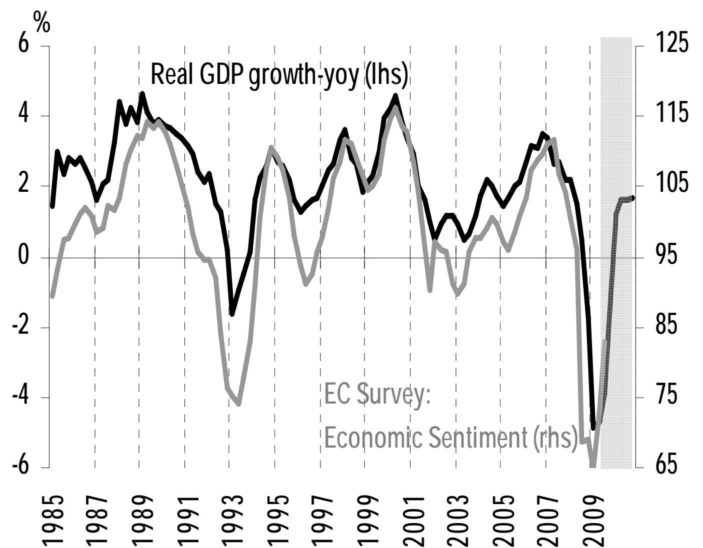
Leading indicators suggest that real economic activity should expand in the second half of the year in the presence of fiscal stimulus measures, driven mainly by a recovery in global trade and a turn in the inventory cycle. Euro area total exports have already posted positive monthly gains in June and July, increasing by 0.9% and 4.1% m-o-m, respectively, although they still remain 20% below on a y-o-y basis. Although industrial production data for July pointed to continued weakness in the manufacturing sector at the start of Q3 09, the PMI manufacturing index, which has been on an upward trend since March 2009, increased further to 49.3 in September from 48.2 in August. Besides, industrial new orders in the Euro area confirmed the positive momentum in the manufacturing sector, increasing cumulatively by a total of 6.5% in June and July, with the y-o-y growth rate up to -25% in July from -33% in February 2009. The PMI service sector index showed even a more remarkable improvement above the 50 level which separates contraction from expansion, due to a significant improvement in new orders (Figure 2.2). Furthermore, the EC's Economic Sentiment Indicator rose to 82.8 in September from 80.8 in August, reporting its highest level since September 2008 (Figure 2.3). In addition, the IFO Business Survey and the ZEW economic sentiment index increased considerably in September 2009, both for current business conditions and expectations.

Figure 2.2



Source: Markit, Bloomberg

Figure 2.3



Source: OECD, EC, Eurobank EFG model estimates

Table 2.1: Comparison with Consensus q-o-q growth rates

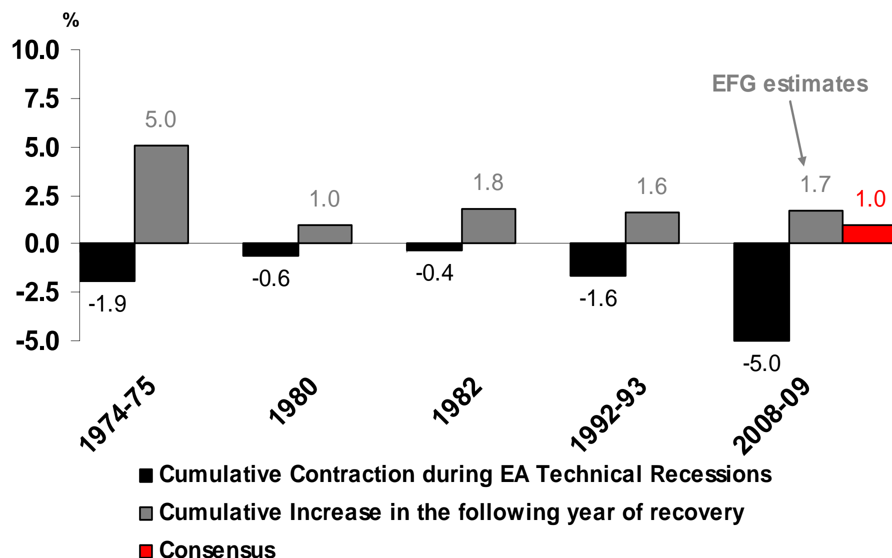
	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10
EA					
Consensus	-0.1	0.3	0.2	0.3	0.1
EFG estimates	-0.1	0.5	0.5	0.3	0.3

Source: Bloomberg, Eurobank EFG estimates

Consistent with this improvement, we expect to see q-o-q GDP growth of about 0.5% in H2 09 and 0.3% in H1 10 (Figure 2.3). Our forecasts are more optimistic than the consensus estimates, which expect q-o-q GDP growth of about 0.3% in H1 09 and 0.2% in H1 10 (Table 2.1). Figure 2.4 depicts the cumulative real GDP contraction during the past

four Euro area recessions and the cumulative GDP increase in the following year of recovery. Based on historical standards, the cumulative increase in real economic activity is expected to be fairly higher than the consensus estimate of only 1%. The major source of growth will be the synchronized recovery of the global economy that is well under way, leading to a strong rebound in Euro area exports. The significant divergence in the pattern of economic growth amongst several Euro area countries that was revealed in Q2 GDP readings will likely persist well into 2010. Fiscal stimulus plans and a strong rebound in global trade should benefit countries like Germany and France that were hit the most by the world trade collapse, while other countries, such as Ireland and Spain, should lag behind due to the fallout from the bust of the property bubble. In addition, the structural weaknesses of several Euro area economies, such as Italy and Greece, with high deficits and problems in international competitiveness, should limit economic growth for 2010 in those countries.

Figure 2.4

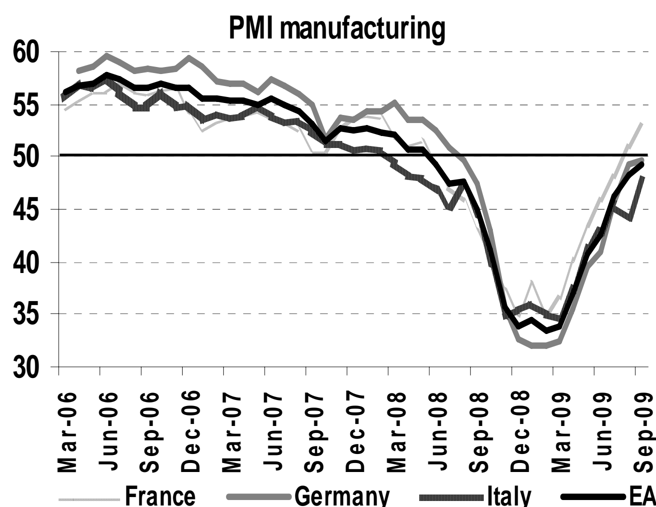


Source: OECD, Eurobank EFG estimates

France and Germany currently appear to be doing best in the recovery race. The French PMI manufacturing index increased remarkably to 53 in September from 50.8 in August, while the German equivalent index rose marginally to 49.6 from 49.2 (Figure 2.5). Given its export-dependent economy, Germany was severely affected by the contraction in global trade. Table 2.2 shows that Germany was the country which reported the biggest cumulative contraction amongst the major Euro area countries (-6.8), mainly due to an 18.3% cumulative decline in exports of goods and services. However, real economic activity in Germany is now boosted more than elsewhere in the Eurozone from the recovery in external demand. The pick up in orders accelerated markedly in July, as strong demand from Asia was accompanied by a surge in orders from the Euro area. The downturn in France was about half the contraction in Germany (-3.5%), partly owing to lower trade openness and a more resilient consumer. As the pace of the contraction in inventories has slowed, manufacturing activity has rebounded strongly in recent months. While Euro area industrial output kept contracting in July 0.3% m-o-m, French industrial output was up for the third consecutive month in July, having increased by a total of

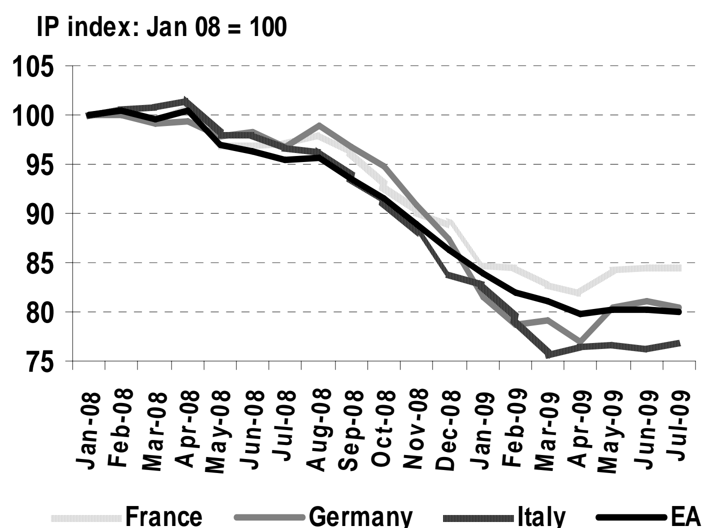
3.3% since May 2009 (Figure 2.6). Part of the sharp rise in French production can be attributed to a significant increase in car production due to the government's "cash for clunkers" program.

Figure 2.5



Source: Markit, Bloomberg

Figure 2.6



Source: Bloomberg, Eurobank EFG

Table 2.2
Cumulative GDP Contraction during Recession

	Recession Period	GDP (%)	Personal Consumption (%)	Government Consumption (%)	Gross Fixed Capital Formation (%)	Exports of Goods and Services (%)	Imports of Goods and Services (%)
EA16	Q2 08 - Q2 09	-5.0	-1.2	3.1	-12.8	-18.5	-16.1
Germany	Q2 08 - Q1 09	-6.8	-0.1	2.5	-11.5	-18.3	-7.6
France	Q2 08 - Q1 09	-3.5	0.6	1.2	-7.6	-16.5	-10.2
Spain	Q2 08 - Q2 09	-4.4	-6.7	6.7	-20	-18.1	-27.3
Italy	Q2 08 - Q2 09	-6.7	-2.6	2.8	-16.6	-27.4	-20.8

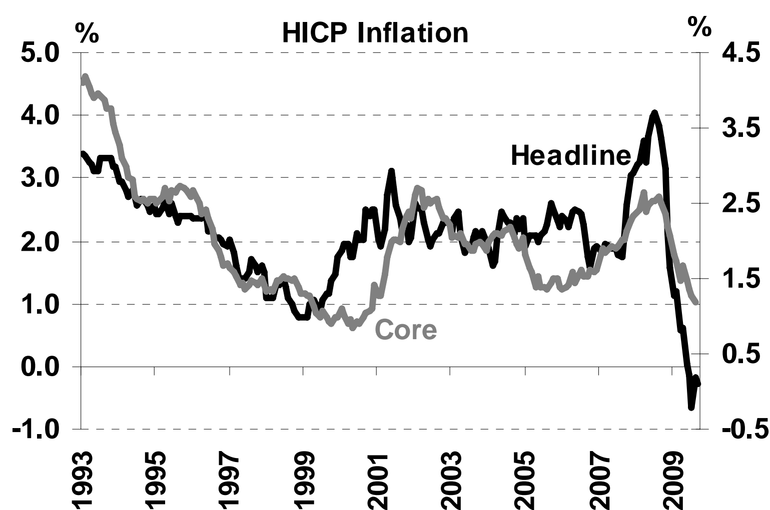
Source: Eurostat

The sustainability of the Euro area recovery will largely depend on labor market conditions, which continue to constitute a major risk for consumers. Quarterly data for Euro area employment confirm that the annual growth dropped in Q2 2009 to its lowest level in more than 16 years. The unemployment rate hit the highest level for more than a decade, climbing to 9.6% in August from 9.5% in July. Although German unemployment declined for the third consecutive month in September, bringing the German unemployment rate down to 8.2% from 8.3% in August, the German labour office highlighted that "a re-orientation of employment policy has dampened the rise in unemployment". Without this change in government employment schemes, unemployment would have increased by a monthly average of 11,500 in August and September. Besides, evidence from the rest of the Euro area countries confirms the broad-based weakness in the

dynamics of the Euro area labour market. The August PMI employment index in the manufacturing sector remained stable at 42.7 in September, while the corresponding index in the services sectors declined significantly to 45.6 from 47.8 in August, signaling continued payrolls' cuts in both the manufacturing and services sectors. Given that the developments in the labour market usually lag behind changes in economic activity, we expect further contraction in euro area employment throughout 2010, with a year average of about 10.5% in 2010 from 9.5% in 2009. In several member states of the Euro area, unemployment increases have been kept in check by fixed term government financed jobs and temporary adjustments of working hours ("short time"). Many of these measures are going to expire by year-end, so this fact strengthens our case for continued weakness in the euro area labor market.

Surging unemployment will probably constitute a significant risk factor for consumption in the Euro area, which is expected to contract by 0.8% in 2009 and return to positive levels at the beginning of 2010. Although consumption growth was a key driver of the stabilization in growth in the second quarter of the year, particularly in Germany (+0.6% q-o-q) and France (+0.2% q-o-q), it is still considerably weak in most Euro area countries. The large fiscal stimulus plans enacted in France and Germany that create positive prospects for consumption for the remainder of 2009, in contrast to the absence of any significant measures in other countries, highlight the diverging prospects of euro area countries. The outlook manifested in the European Commission survey was relatively optimistic. Although the headline consumer confidence indicator remains well below its long-term average, it has been increasing steadily over the last six months, moving from -34.2 in March to -19 in September. Although short-term prospects for Euro area domestic demand are generally favored by fiscal stimulus and the "cash for clunkers" program implemented in several Member States, we still remain cautious about longer-term prospects due to a long-lasting weakness in the labor market and the consequent squeeze on household real income growth, contracting bank credit and the fading effect of governments' fiscal stimulus measures.

Figure 2.7



Source: Eurostat

Headline HICP inflation hit its lowest level since the start of the series in July 2009, will the y-o-y growth dipping to -0.7% (Figure 2.7). The flash September estimate confirmed that Euro area headline inflation passed its bottom, with the annual growth coming in at -0.3% (+0.1% m-o-m). We expect headline inflation to move out of negative territory by year-end due to weaker base effects going forward and rising energy prices. EC's measure of selling price expectations in the manufacturing sector hit rock bottom in May 2009, shifting to an upward monthly trend over the past four months. Core inflation has gradually eased to 1.2% y-o-y in August, due to excess capacity and weak consumer demand that have started to take effect on firms' prices (Figure 2.7). We expect core prices to remain low in the Euro area in the remainder of 2009 and 2010, moving towards 0.5% by mid-2010.

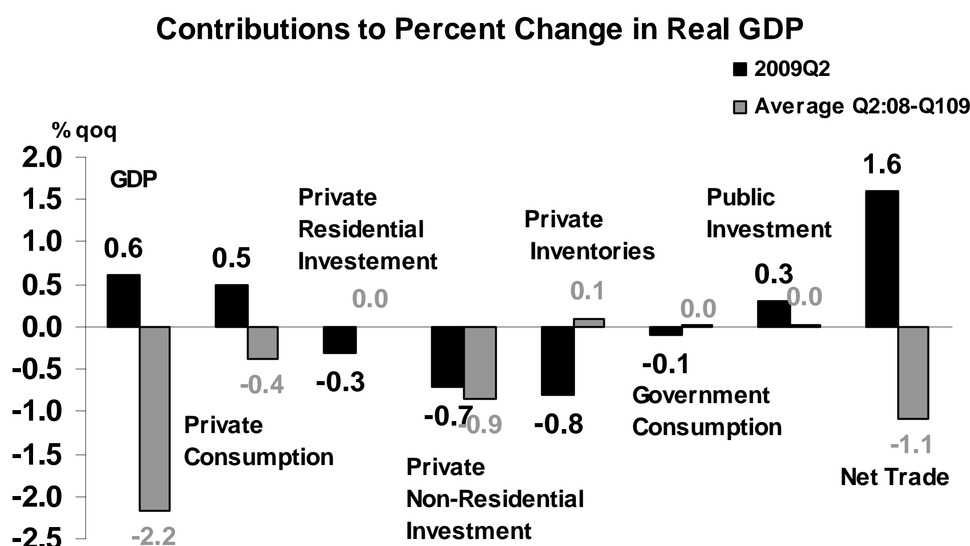
Given the fragile economic recovery, in combination with a disinflationary environment, the ECB left its key policy refi rate stable at 1% in its meeting on the 8th of October. As soon as its enhanced credit support improves conditions and the economic recovery of the Euro area is proved to be sustained, the ECB will start to bring monetary policy back to normal levels by hiking its main refinancing rate or by unwinding some of its unconventional measures (fixed-rate full allotment, expansion of collateral, longer-term liquidity provision, liquidity provision in foreign currencies, financial market support through purchases of covered bonds). As the President of the ECB Jean-Claude Trichet highlighted, the exit framework can include a change in the short-term interest rates while keeping some non-standard policy measures. We believe that the ECB will keep its refi rate low until at least Q1 2010, and then move gradually in H2 2010 towards a tightening of monetary policy, with a policy rate target at 1.50% by the end of 2010.

3. The Japanese economy

Dimitris Malliaropulos, Olga Kosma

- The Japanese economy has come out of recession in Q2 09, mainly due to a strong bounce in external demand and a robust increase in public investment that outweighed the sharp fall in inventory and private investment.
- We believe that real GDP will continue to be strongly supported by an inventory-led rebound in exports to emerging markets in H2 09.
- However, a sustained recovery of the Japanese economy is doubtful without a revival in private domestic demand, which remained a significant drag for real economic activity in Q2 09.
- Consumption has been recently boosted by economic stimulus measures, but we see downside risks towards year-end stemming from labour market weakness.
- Deflationary pressures are rising steadily, given the intensifying negative output gap and the lower wages stemming from the weak labour conditions.
- The BoJ will not probably start unwinding its temporary unconventional measures until the Japanese economy has assured its stability. Given a deflationary environment in 2009 and 2010, a change in the policy direction towards monetary tightening seems highly unlikely before 2011.

Figure 3.1

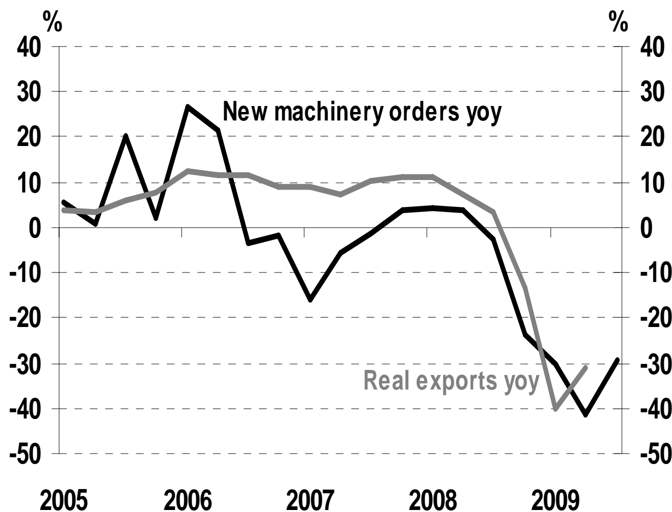


Source: Cabinet Office, Eurobank EFG

The Japanese economy seems to have already come out of recession, posting a slight increase of 0.6% q-o-q in Q2 2009, after a year of negative quarterly readings. The cumulative contraction in real GDP from Q2 08 to Q1 09 roughly reached 9%, making the 2008-09 recession the deepest one since records began in 1955. The drivers for the Q2 positive GDP reading were a strong bounce in external demand, a modest rebound in consumer spending due to the fiscal stimulus package and a robust increase in public fixed investment that outweighed the sharp fall in inventory and private investment. (Figure 3.1).

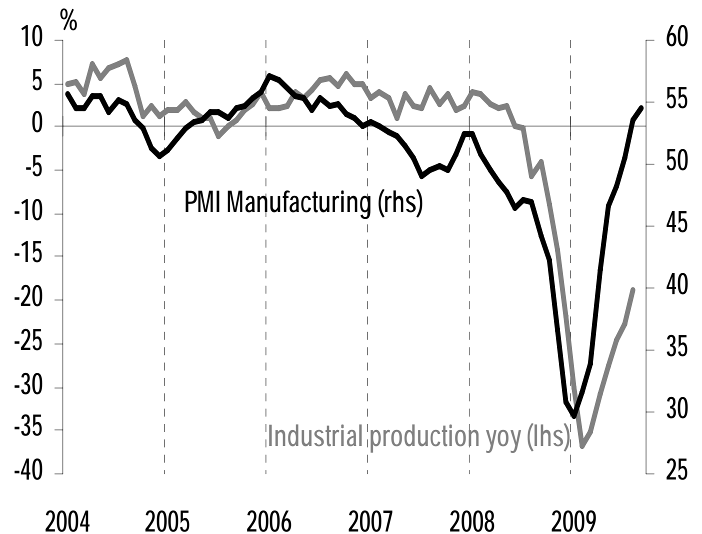
We believe that real GDP will continue to be strongly supported by an inventory-led rebound in exports to emerging markets in H2 09 (Figure 3.2). Indeed, Japanese exports have shown signs of improvement, with exports to Asia experiencing another narrowing in decline in August, from -18.6% in July to -15.8% y-o-y in August. Furthermore, led by the auto industry which is benefiting from the "cash for clunkers" program, the decline in exports to the US decelerated to 29.3% y-o-y from 34.7% in July. We expect a recovery in exports to accelerate in Q3 09, as has been suggested by the recent rebounds in manufacturing new orders indices in the US and China. External machinery orders increased by 22% m-o-m in July, turning positive for the second consecutive month. Meanwhile, industrial production increased for the sixth consecutive month, with the y-o-y growth rate moving to -19% in August from its trough of -37% in February 2009 (Figure 3.3). The positive trend in industrial production numbers over the past two quarters is consistent with the improvement in the PMI manufacturing index and the September Reuters Tankan Manufacturing Survey, indicating that production will remain on the path to recovery. In particular, the PMI manufacturing index, which has been on an upward trend since February 2009, increased further to 54.5 in September from 53.6 in August signalling expansion in the industrial sector (Figure 3.3). In addition, the Manufacturing Tankan Survey, which was conducted from August 26 until September 11, revealed a surge to -33 in September from -42 in the previous month.

Figure 3.2



Source: Cabinet Office, Ecowin

Figure 3.3



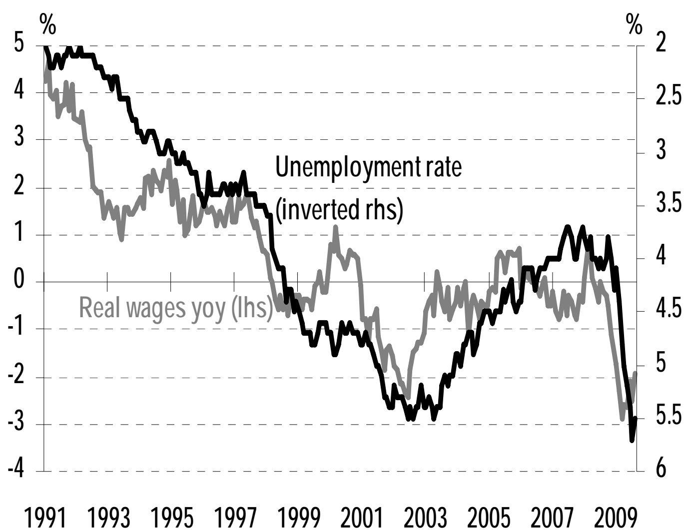
Source: Ecowin, Bloomberg

However, a sustained recovery of the Japanese economy is doubtful without a revival in private domestic demand, which remained a significant drag for real economic activity in Q2 09. Capital investment in the corporate sector dropped for the fifth consecutive quarter by 16% q-o-q saar in Q2 09, although the pace of contraction was much slower than the 30% decline reported in the previous quarter. We believe that capital investment may be at or near a bottom, given that shipments of capital goods, which are a leading indicator for capital investment, moved into positive territory in Q3 09 for the first time in two years' time, increasing by 1.9% q-o-q after a 17% decline in the previous quarter. Although the most recent July machinery orders posted a 9.3% drop m-o-m nearly offsetting the June increase,

it is unlikely that orders will fall further in the following months, given the continued recovery in production, external demand and public sector orders.

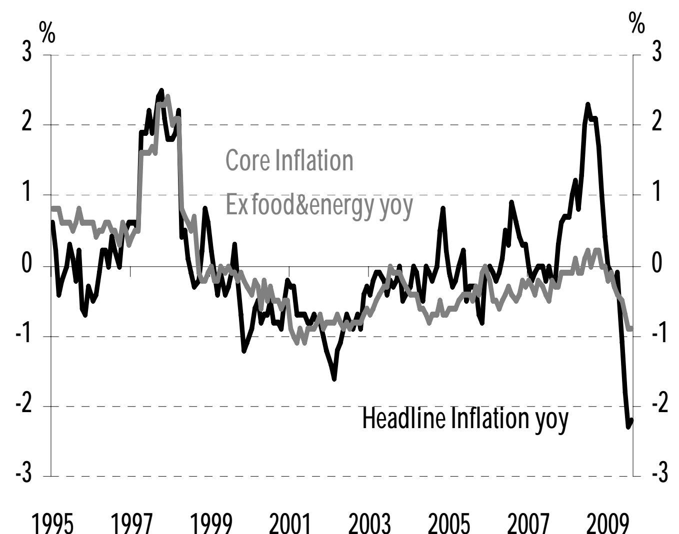
The August household survey confirmed a better-than-expected 2.6% y-o-y growth in personal spending. Real private consumption exceeded market forecasts, posting its first monthly increase since May 2009, in response to policy stimulus and special holiday demand. Moreover, the August production numbers reported the sixth consecutive month of growth in durable consumer goods shipments and the second straight month of growth for non-durable consumer goods shipments. It seems that economic policy measures such as "eco prints" are still having a positive effect on consumption. However, we continue to see personal consumption as a major concern for the Japanese economy in 2010, as positive effects from various boosting measures will be running low. Consumer sentiment, which has been improving since January 2009 due to the additional stimulus measures, has recently shown signs of deterioration. The August household Economy Watchers Survey revealed a drop from 41.4 in July to 40.3 in August, pointing to the waning effect of stimulus measures and the deteriorating employment and income environment.

Figure 3.4



Source: Bloomberg, Ecowin

Figure 3.5



Source: Bloomberg

The unemployment rate has reached a record high in July, and signs of a stabilization in the labour market are beginning to show off, with the jobless rate improving to 5.5% in August from 5.7% in July (Figure 3.4). The August new jobs offers/applicants ratio dropped to 0.76x from 0.77x in July, pointing to continued declines in the Japanese labour market. However, we expect the rate of decline in the number of employed to narrow by year-end, as industrial production recovers.

Deflationary pressures are rising steadily, given the intensifying negative output gap and the lower wages stemming from the weak labor conditions (Figure 3.4). The national core CPI (excluding fresh food) reported its sharpest decline since the series started, falling by -2.4% y-o-y in August after a -2.3% drop in the previous month. The nationwide core

index (excluding both energy and food) fell by -0.9% y-o-y, maintaining its weak performance of the previous month (Figure 3.5). Although the pace of decline in prices will probably slow towards year-end, we expect the deflationary environment for consumer prices to persist well into the remainder of 2009 and in 2010, with a year average of about 1.3% in 2009 and 1.0% in 2010.

As far as monetary policy is concerned, the Bank of Japan (BoJ) has confirmed that it does not have any preconceptions about extending its temporary unconventional measures (such as outright purchases of commercial paper, corporate bonds and government bonds). Given that corporate financing conditions have been recently stabilizing, we do not believe that current situation prompts a move to a more aggressive quantitative easing, unless there is a sharp deceleration in real economic activity over the coming quarters. On the other hand, given the generalized slack in the Japanese labour market and domestic demand, we believe that the Central Bank will not start unwinding its temporary unconventional measures until the Japanese economy has assured its stability. Given a deflationary environment in 2009 and 2010, a change in the policy direction towards monetary tightening seems highly unlikely before 2011.

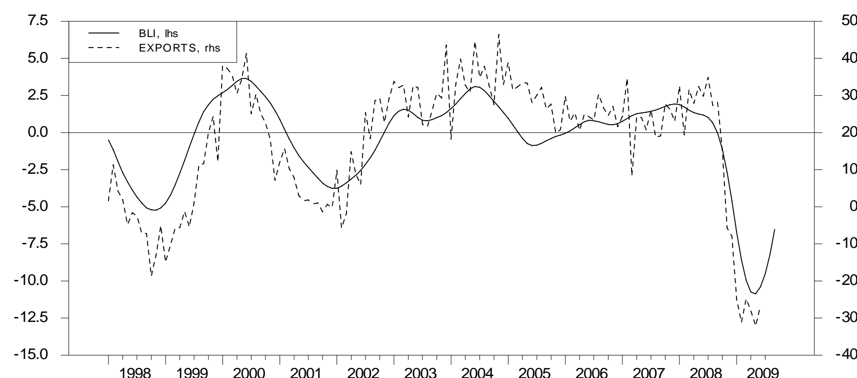
4. Emerging Markets

Dimitris Malliaropulos, Maria Prandeka

- Emerging Markets economies have rebounded strongly in the second quarter of the year, as less leveraged private sector and stronger external balances allowed them to weather the storm better than was expected.
- Economies in Emerging Asia are leading the recovery from the global downturn, mainly due to aggressive monetary and fiscal policy measures.
- Emerging Europe's outlook will gradually improve as euro area -its main trading partner- recovers.
- Leading indicators suggest that Latin America is entering the upswing phase of the business cycle, on the back of rising commodity prices.

After a sharp slide at the start of the year, Emerging Markets (EM) economies have started to recover significantly in the second quarter of the year. Business and consumer confidence indicators have improved significantly over the past months. Our BRICs leading indicator has also improved, suggesting that the pace of the decline in BRICs exports should ease gradually over the remainder of 2009 (Figure 4.1). Overall, the economies that entered the current global crisis with solid economic fundamentals and had the opportunity to apply their own policy responses in order to boost domestic demand have already shown clear signs of improvement. Generally, EMs' recovery will prove strong, albeit it is not certain if they will manage to return soon to buoyant growth rates seen in recent years, as authorities should steer EM economies to more sustainable paces of growth. As far as single regions are concerned, Emerging Asia is the best-performing area within the EM's, due to significant monetary and fiscal policy responses and better external balances. Almost all the countries in the region have returned to positive real GDP growth in Q2 09. As a result, there is less need for additional fiscal and monetary easing compared to Emerging Europe where there are only tentative signs of stabilization. However, widening fiscal deficits reduce the margin for carrying out expansionary fiscal policy. The region's recovery is highly dependent on external financing, as well as on a sustained recovery in the euro area, its main trading partner. As far as Latin America is concerned, the region is enjoying some benefit from the Asian recovery, owing to increased trade linkages with Asia. Furthermore, higher commodity prices triggered by a global manufacturing pick up will be particularly supportive for commodity producing countries in the region.

Figure 4.1
BRICs Leading Indicator*, % yoy

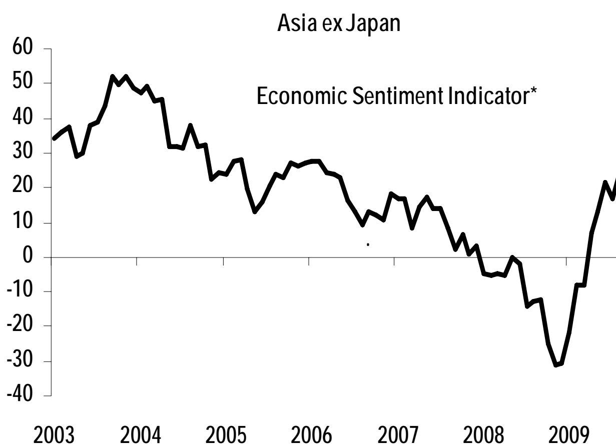


* 3 month forward
Source: Eurobank EFG

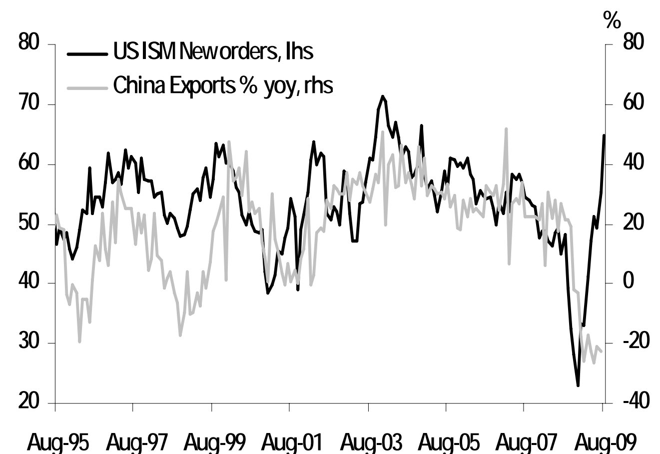
Emerging Asia

Emerging Asian economies appear to be bouncing back from the global downturn much more strongly than any others. This is in large part due to significant monetary and fiscal policy responses and better external balances. The Asia ex Japan economic sentiment indicator improved further in August, suggesting that the recovery continues in the region (Figure 4.2, left). Indeed, real GDP growth rebounded strongly across the region in Q2 09, with the most pronounced evidence of recovery witnessed in China, where real GDP growth accelerated to 7.9% y-o-y from 6.1% y-o-y in Q1. Moreover, countries such as Taiwan and Singapore, which were hit hard by the global financial crisis, reported positive q-o-q seasonally adjusted growth rates, after contracting sharply in Q4 08 and Q1 09. Furthermore, industrial production has begun to expand, reflecting the end of inventory rundown. In South 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 a record low of 0.93 in July). Meanwhile, in China, the PMI new export orders index rose for a fourth consecutive month above the threshold of 50 in August (to 52.1), suggesting that the pace of exports decline should start to abate in the coming months. Indeed, the US ISM new orders index, which has increased significantly from its trough level in December 2008, reinforces this view (Figure 4.2, right). Nevertheless, there are some challenges to the region’s upbeat growth outlook. A major challenge is that robust growth rates witnessed in the second quarter, particularly in China, could not be maintained for the rest of the year, because the region will not be fully benefiting from the fiscal boost. Furthermore, inflation has surprised on the downside allowing policymakers to loose monetary policy. However, given the large share of food in consumer price baskets in the region, a resurgence in food prices will pose upside risks to headline inflation, forcing central banks to start tightening monetary policy before a sustained recovery take place. Generally, returning to robust growth rates seen in recent years will be difficult to achieve, unless policymakers steer the region’s economies towards domestic demand.

Figure 4.2



Source:Ecowin



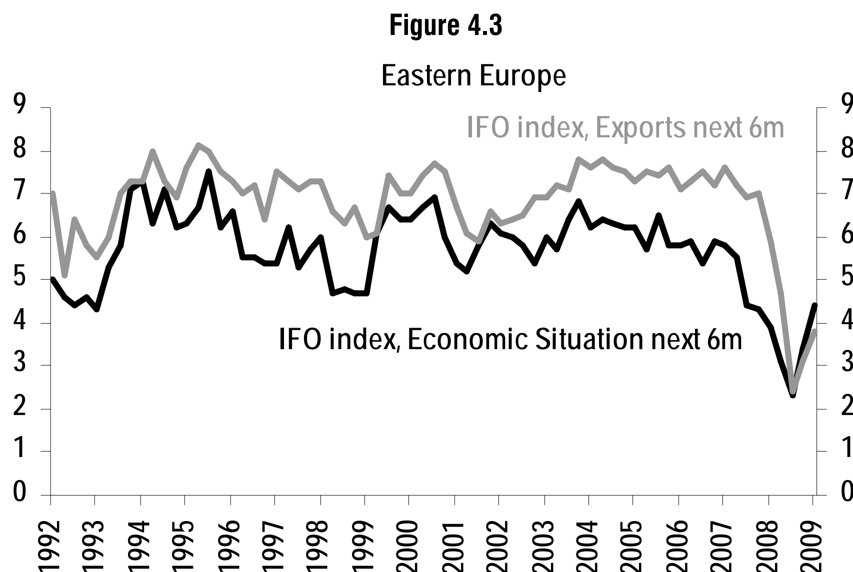
Source:Ecowin

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

Emerging Europe

Emerging Europe continues to underperform compared to the rest of the emerging world, but the outlook for the region will gradually improve as euro area -its main trading partner- recovers. Indeed, although Q2 GDP data show significant annual growth contractions, the pace of decline has already started to ease on a quarterly basis. Manufacturing PMI indices across the region improved further in August and this is beginning to show in industrial production numbers. In Russia, for example, PMI passed the threshold of 50 that indicates expansion, while industrial production recorded a m-o-m growth of 4.7% in July, suggesting that industrial activity may have hit bottom in H1 2009. In our view, the recovery in Emerging Europe will be mainly export driven, as there are plenty of domestic headwinds. In some countries labor market conditions remain under stress, intensifying downside risks for consumer spending. Russian unemployment remains elevated and around 1-2 million migrant workers have lost their jobs, adding to the pressures faced by some economies in the region that are heavily dependent on Russia for remittances. Furthermore, retail sales continue to decline, as disposable income deteriorates and the Russian households' savings rate marked an upward trend in Q2 09. Moreover, the prevalent foreign exchange denominated lending across the region means that households' balance sheets remain vulnerable to further currency weakness. Taking into account these backdrops, the risk of a further increase in non-performing loans rises, keeping credit conditions in the region tight. Meanwhile, sizeable deterioration in public finances due to massive fiscal stimulus suggests that there is little scope for further fiscal easing, impeding the recovery in the region. Overall, while it seems that the worst of the financial crisis is over, 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 has bottomed 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).

Figure 4.3



Source: Ecowin

Latin America

Recent economic indicators suggest that the region is gradually recovering from the severe contraction that took place in H1 2009. The effectiveness of the fiscal and monetary measures in combination with improved policy frameworks and a modernized banking system indicate that economies in Latin America (LA) are better positioned to weather the storm than in the past. Indeed, the Latin America IFO economic expectations index has increased further in Q3 09 from its trough in Q1 09, suggesting that the region is entering the upswing phase of the business cycle (Figure 4.4, left). This is largely supported by the recent strong recovery of Asian economies, particularly China, a key destination of LA's exports. In fact, Brazil's exports to China as a share of total exports were 13.9% in June, well above Brazil's exports to US (10.6% as a share of total exports). In line with the positive outlook for the region's export growth, that has been a key factor driving the recent improved growth performance, the Latin America IFO index for export volumes over the next six months has increased further in Q3 09 (Figure 4.4, right). The benign outlook for China's economy has already created favourable prospects for commodities, contributing positively to LA's recovery. However, given the region's sensitivity to the commodity cycle and that China's demand for commodities has already started to slow over the past few months, a major challenge for the region is that a sustained reduction in Chinese imports of commodities may weigh on their prices and, consequently, on LA's outlook.

Figure 4.4

Source: Ecowin

Source: Eurobank EFG, Ecowin

* Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Venezuela

4.1 China Economic Outlook

The combined fiscal and monetary policy actions have effectively helped the economy not only to avoid a sharp economic downturn in the beginning of 2009, but also to stage a robust recovery in the remainder of the year. Given that a substantial part of fiscal policy is still in the pipeline, fiscal support will continue to contribute positively to growth. Furthermore the lagged effects from the unprecedented domestic credit expansion are likely to become more apparent on investment and consumer spending in the coming months.

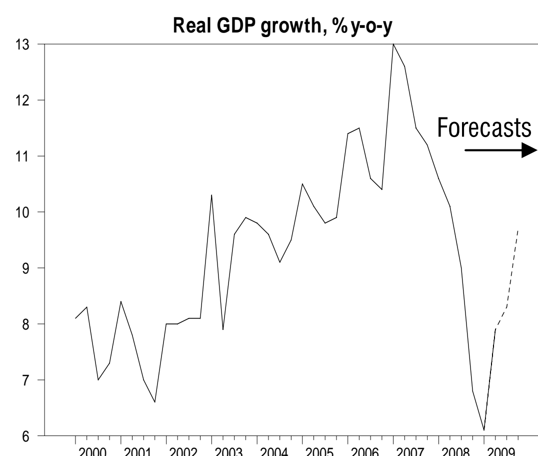
Real GDP growth accelerated to 7.9% y-o-y in Q2 09 from 6.1% in Q1 09, on the back of a strong rebound in domestic investment growth. The surge in fixed asset investment (FAI) growth was driven by significant public investment (accounting for about 30% of total FAI in 2008) and credit expansion. Meanwhile, in the past few months real estate investment –the key driver of private investment growth- has picked up strongly, boosted by a buoyant property market. Should property investment maintain this robust momentum in the next few quarters, the negative impact to FAI growth from the expected slowdown in public investment will be offset. In addition, improving corporate profits will promote business investment in 2010. In line with our views that China's recovery remains well on track, recent monthly economic indicators are showing continued strong growth. Particularly, industrial production growth surged to 12.3% y-o-y in August, the best reading so far this year. China's NBS PMI manufacturing index picked up to 54.3 in September from 54 in August, with employment and new exports orders sub indices showing particularly strong improvement. Indeed, the employment sub index increased to an 18-month high, suggesting benign labor market conditions. The latter alongside an improving housing market and rising consumer confidence due to higher asset prices will support private consumption growth. On the external demand front, even though exports surprised on the downside in August, they showed significant positive signs on a sequential basis. With China's main export destinations (euro area and US), expected to post a robust recovery, China's exports are set to benefit strongly in the remainder of the year. As far as monetary policy is concerned, we don't expect further interest rate cuts. The tightening of monetary policy is unlikely in the short term. Indeed, it will likely begin only when the PBoC ensures that the recovery is sustainable and CPI inflation returns to positive territory. Overall, we expect real GDP growth to grow by 8.0% in 2009 and 9.5% in 2010.

Table 4.1
China Main Economic Indicators and Forecasts

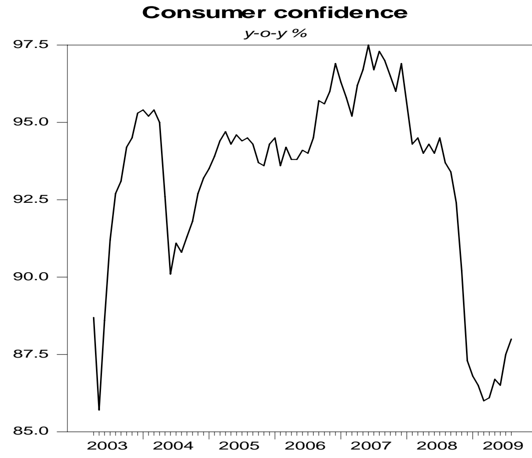
	2007	2008	2009e	2010e
Real GDP (% y-o-y)	13.0	9.0	8.0	9.5
IP** (avg, % y-o-y)	17.5	12.7	10.0	13.0
Inflation (avg, % y-o-y)	4.8	5.9	-0.6	2.5
Unemployment rate (avg, %)	4.0	4.2	4.3	4.2
External Balance				
Real Exports of G & S* (% y-o-y)	18.0	10.0	-11.0	7.0
Real Imports of G & S* (% y-o-y)	15.0	7.0	-10.0	9.0
Trade Balance (% GDP)	7.3	6.8	6.0	5.5
Current Account (% GDP)	11.0	10.0	7.0	6.0
Interest Rates	**Dec 08**	**Current**	**Dec 09**	**Dec 10**
Lending Interest Rate (%)	5.31	5.31	5.31	5.85
Exchange Rates	**Dec 08**	**Current**	**Dec 09**	**Dec 10**
USD/RMB, eop	6.8	6.8	6.8	6.7

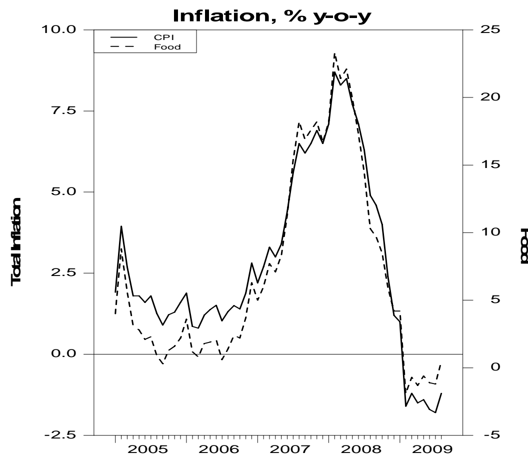
*Goods & Services, **Industrial Production, Source: Eurobank EFG, Bloomberg, Ecowin

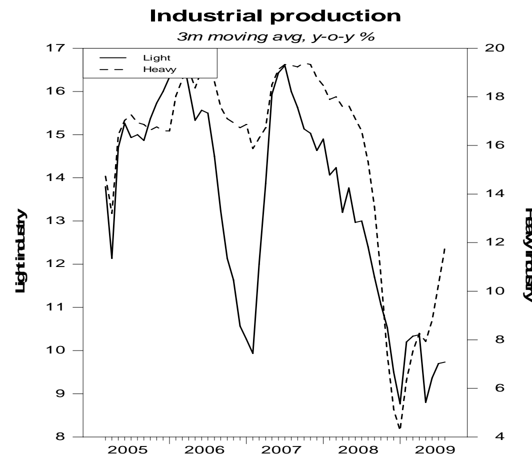
Figure 4.5

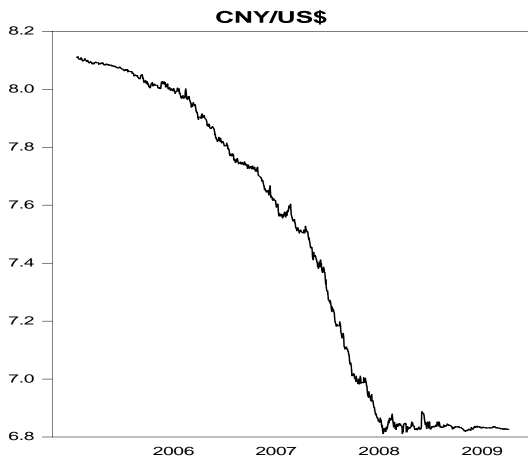


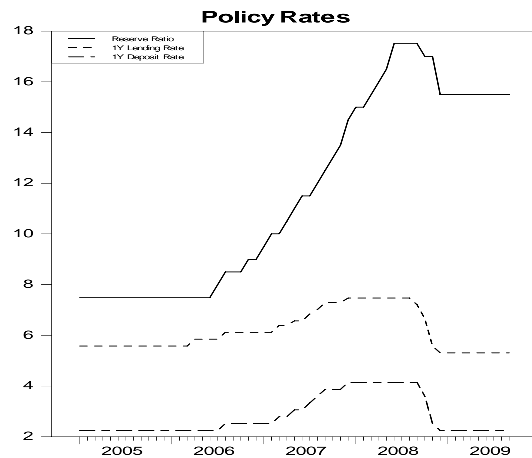
CHINA CHARTS











Source: Bloomberg, Ecowin

4.2 India Economic Outlook

India is one of the first economies among the other Asian peers that emerged from the global downturn, given its relatively closed economy, as well as the proactive fiscal and monetary measures initiated by the government and the central bank. The recovery of global demand and improving credit conditions are reviving manufacturing activity, which in turn should buffer negative impacts on GDP from the unexpected drought.

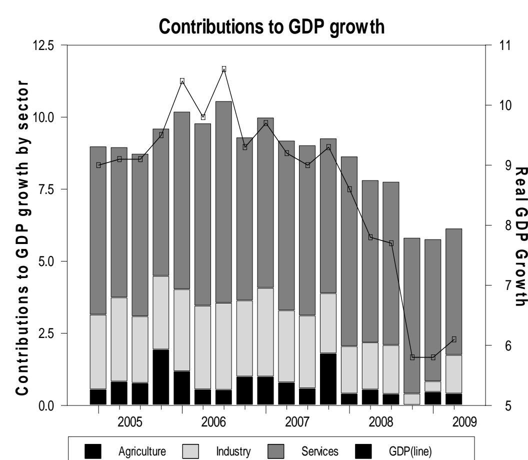
India's economy grew by 6.1% y-o-y in Q2 09, following a 5.8% y-o-y growth in Q1 09. Strong government spending (10.2% y-o-y) continued to prop up domestic demand, while lagged effects of fiscal and monetary policy easing started to show in manufacturing activity which moved back into positive territory (3.4% y-o-y in Q2 09 from -1.4% y-o-y in Q1 09). Indeed, recent economic indicators confirm that domestic demand is bouncing back. Industrial production increased by 6.8% y-o-y in July 2009 after an upward revised growth of 8.2% y-o-y in June. The rebound was led by all three segments of the industrial sector; manufacturing, mining and electricity. Output of consumer durable goods recorded a marked growth of 19.8% y-o-y, reflecting rising consumer confidence. Besides, the PMI manufacturing index rose for a sixth consecutive month above the threshold of 50 in September (to 55 from 53.2 in August). Meanwhile, improving global credit conditions have proved particularly favorable for capital inflows and, consequently, for business spending. Furthermore, both exports and imports have improved on a sequential basis in July, underpinned by the global recovery and strong domestic demand. We believe that downside risks to India's economic outlook are more country specific. Firstly, large fiscal imbalances limit the government's ability to support growth by increasing spending. Indeed, the fiscal deficit rose to 6.2% of GDP in 2008 from 2.7% of GDP in 2007 and is expected to increase further 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 proceeds with reforms. Nonetheless, increasing spending in order to support the economy seems to be the main economic policy priority, despite concerns about debt ratings. The second risk is that the worse than anticipated drought this year is likely to put further pressures on consumer prices, which in turn would constrain private consumption growth and force the Reserve Bank of India to hike policy rates.

Table 4.2
India Main Economic Indicators and Forecasts

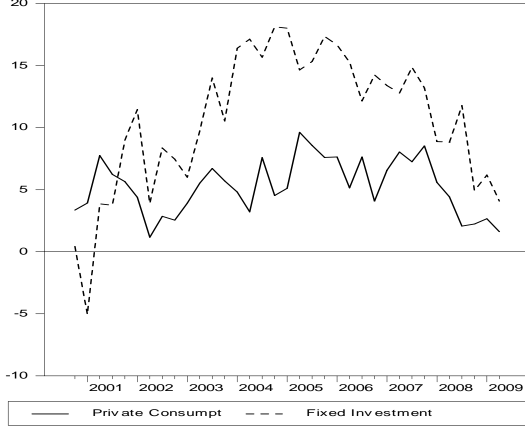
	2007	2008	2009e	2010e
Real GDP (% y-o-y)	**9.3**	**7.5**	**5.8**	**7.5**
IP (avg, % y-o-y)**	**10.0**	**4.5**	**4.0**	**6.0**
Inflation (WPI, avg, % y-o-y)	**4.7**	**9.1**	**2.0**	**5.0**
External Balance				
Real Exports of G & S* (% y-o-y)	**2.7**	**12.8**	**3.0**	**5.0**
Real Imports of G & S* (% y-o-y)	**6.9**	**17.9**	**2.0**	**6.0**
Trade Balance (% GDP)	**-7.0**	**-10.0**	**-7.0**	**-8.0**
Current Account (% GDP)	**-1.5**	**-2.5**	**-1.5**	**-2.0**
Interest Rates	**Dec 08**	**Current**	**Dec 09**	**Dec 10**
Repo Rate	**6.50**	**4.75**	**4.75**	**5.50**
Exchange Rates	**Dec 08**	**Current**	**Dec 09**	**Dec 10**
USD/INR, eop	**48.7**	**47.5**	**47.0**	**46.0**

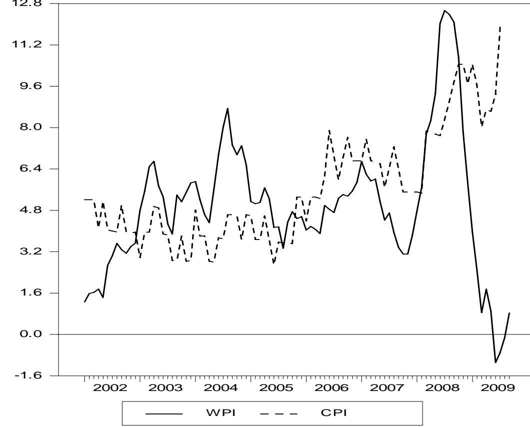
*Goods & Services, **Industrial Production
Source: Eurobank EFG, Bloomberg, Ecowin

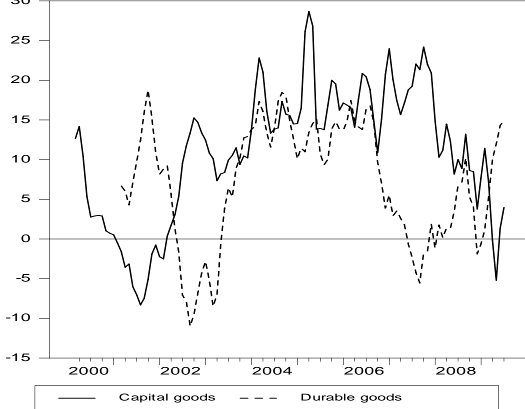
Figure 4.6

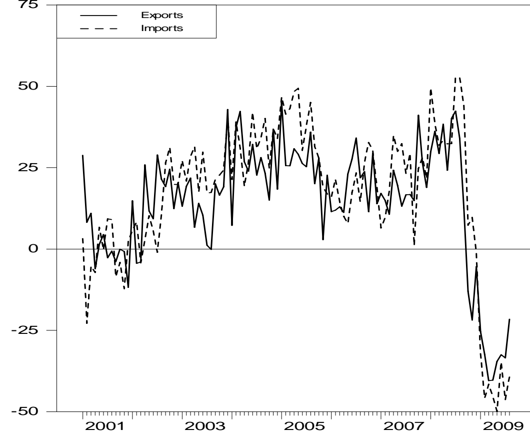


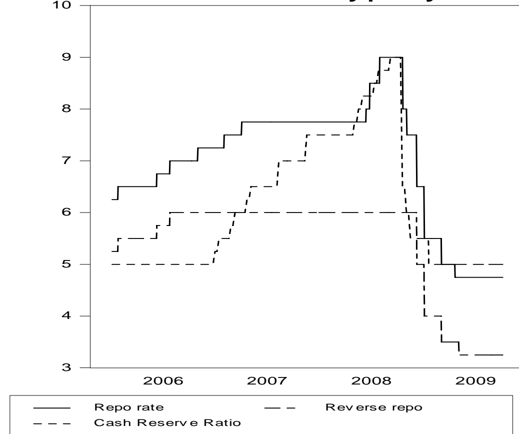
INDIA CHARTS











Source: Bloomberg, Ecowin

4.3 Russia Economic Outlook

A combination of a substantial fiscal package, a significant increase in commodity prices and a general improvement in financial and external demand conditions helped output to start rising gradually in the third quarter, pointing that the Russian economy is entering a recovery phase. We believe that the economic recovery will rely mainly on sustained high commodity prices and strengthening external demand, as the economy is still facing a number of domestic headwinds including weak labor market conditions and a fragile banking sector.

As we have already envisaged in our previous issue (July 2009), real GDP contraction in Q2 09 (-10.9% y-o-y) was stronger than the 9.5% decline in Q1 09. 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 collapse in real investment spending. Indeed, fixed capital investment growth, which is more prone to volatility in an economic downturn, contracted by 19.4% y-o-y in August 2009 for the tenth consecutive month, in the wake of higher borrowing costs and tighter domestic liquidity conditions. However, recent monthly economic indicators suggest a gradual stabilization of the industrial sector in response to improved external demand and rising oil prices. Confirming signs of recovery in industrial activity, the PMI manufacturing index passed the threshold of 50 in September, jumping to 52 from 49.6 in August. Apart from export performance, the rebound in oil prices has also triggered a boost in confidence which was accompanied by improving capital flows in Q2 09, after large capital outflows in 2008 ($132.8 billion). Should this trend continue in the coming months, capital inflows will generate better growth prospects for the rest of the year and for 2010. In the meantime, while the Russian economy is finally bottoming out, personal consumption has yet to show signs of picking up, due to falling disposable income and rising unemployment. In August, retail sales dropped by 9.8% y-o-y for the seventh consecutive month, marking the sharpest annual drop in a decade. Against this background of worsening domestic demand conditions -the main driver of growth over the past decade- real GDP is expected to contract sharply by 7.5% y-o-y in 2009. We expect a return to positive growth in the first quarter of 2010 as the lagged impact of the aggressive fiscal and monetary easing gains traction.

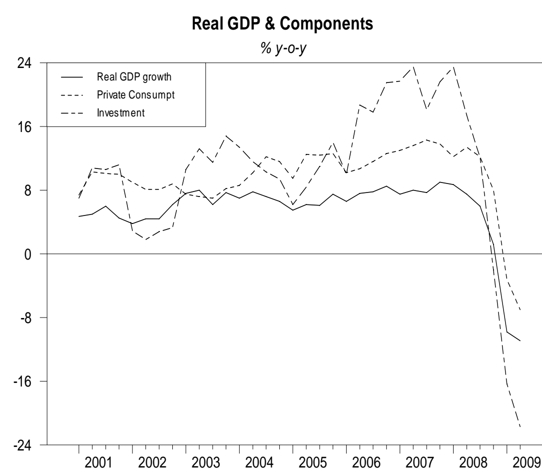
Table 4.3

Russia Main Economic Indicators and Forecasts

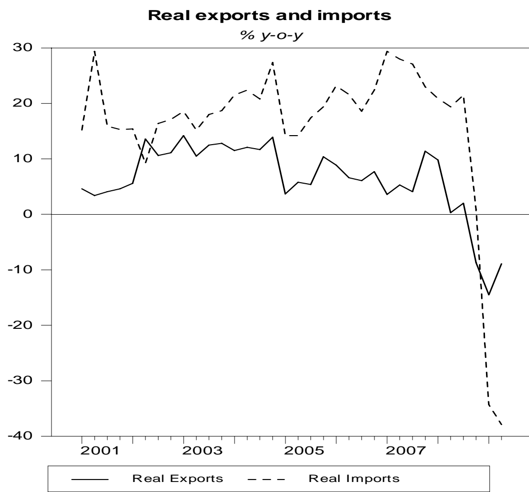
	2007	2008	2009e	2010e
Real GDP (% y-o-y)	8.1	5.6	-7.5	3.0
IP** (avg, % y-o-y)	6.4	2.7	-10.0	2.0
Inflation (avg, % y-o-y)	9.0	14.1	12.0	10.0
Unemployment rate (avg, %)	6.1	6.4	9.0	9.0
External Balance				
Real Exports of G & S* (% y-o-y)	6.1	0.9	-8.0	4.0
Real Imports of G & S* (% y-o-y)	26.9	15.7	-18.0	4.0
Trade Balance (% GDP)	10.1	10.5	5.0	7.0
Current Account (% GDP)	6.0	6.1	2.0	2.5
Interest Rates	**Dec 08**	**Current**	**Dec 09**	**Dec 10**
Refinancing Rate	13.0	10.0	10.0	9.5
Exchange Rates	**Dec 08**	**Current**	**Dec 09**	**Dec 10**
Exchange Rate (USD/RUB, eop)	29.4	30.1	30.0	29.0

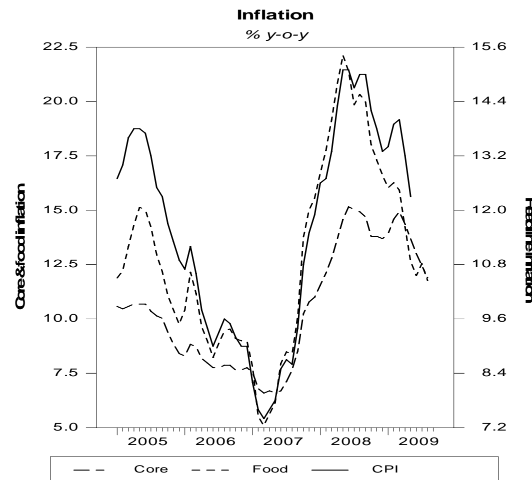
*Goods & Services, **Industrial Production, Source: Eurobank EFG, Bloomberg, Ecowin

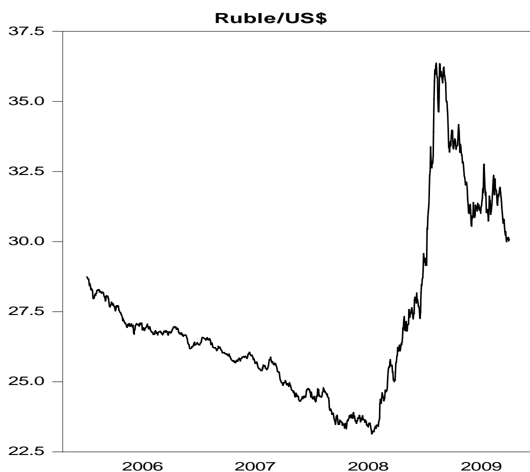
Figure 4.7

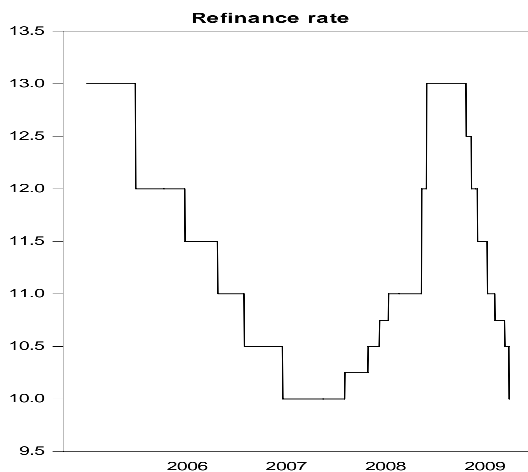


RUSSIA CHARTS









Source: Eurobank EFG, Bloomberg, Ecowin

4.4 Brazil Economic Outlook

Strong macroeconomic fundamentals coupled with effective monetary and fiscal policies have helped the Brazilian economy to emerge from recession, which proved short-lived and mild. Amid strong domestic growth perspectives, fast job creation and favorable developments in commodity prices, Brazil's economy is set to gain momentum in the next quarters.

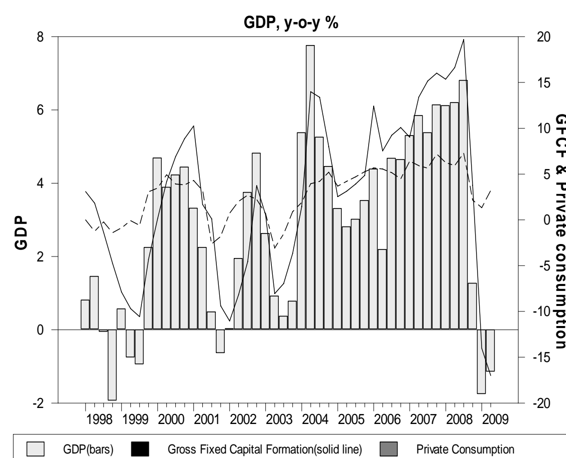
Brazil's economy expanded 1.9% q-o-q in Q2 2009 on a seasonally adjusted basis, after an accumulated contraction of 4.3%, reported in Q4 08 and Q1 09, when the economy was in technical recession. The resiliency of private consumption and a revival in exports were key factors driving GDP growth. Private consumption rebounded to 2.1% q-o-q sa in Q2 09, from -0.9% q-o-q sa in the preceding quarter, underpinned by tax breaks and record low borrowing costs. Meanwhile, robust labor market conditions indicate that consumer spending is set to post further gains. Indeed, the unemployment has been brought steadily down to 8.1% in August from its recent peak of 9% in March 2009, mainly due to growing employment. Net formal job creation jumped to 242,126 in August, the most robust rise since September 2008 when the global crisis started to weigh on labor market. Consumer spending will be also supported by a strong rebound in consumer confidence as reflected by the FGV consumer confidence index which is in an upward trend since April. A sustainable improvement in household expenditure coupled with rising capacity utilization, a positive inventory cycle and better global economic conditions should help fixed investment -the largest drag on real GDP growth in 2009- to recover in 2010. In the meantime, increasing risk appetite due to a stronger than expected global economic rebound should continue to attract capital inflows and trigger further interest on Brazilian assets. Moreover given that a large extent of massive fiscal stimulus aims at infrastructure investment, commodities such as industrial metals and energy are expected to benefit the most. In turn, a resurgence in commodity prices would be particularly supportive for Brazil's export earnings. Optimism about Brazil has led to an upward adjustment of growth expectations according to the latest BCB's consensus survey. In particular, real GDP growth expectations for 2009 rose steadily to 0.0% from their trough of -0.7% y-o-y in May.

Table 4.4
Brazil Main Economic Indicators and Forecasts

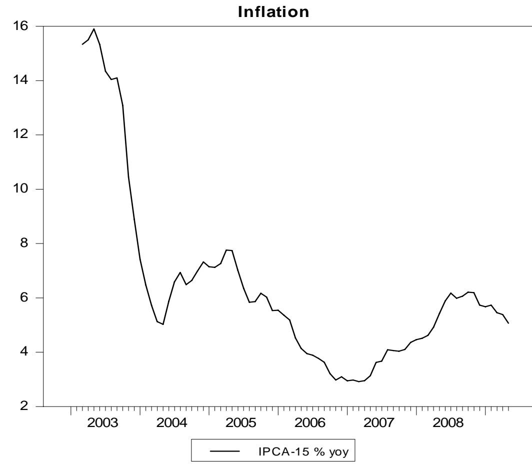
	2007	2008	2009e	2010e
Real GDP (% y-o-y)	5.7	5.1	0.0	4.0
IP (avg, % y-o-y)**	5.9	2.8	-7.0	8.0
Inflation (avg, % y-o-y)	3.6	5.7	4.5	4.0
Unemployment rate (avg, %)	9.3	7.9	8.3	8.0
External Balance				
Real Exports of G & S* (% y-o-y)	7.0	-0.6	-8.0	5.0
Real Imports of G & S* (% y-o-y)	20.7	18.8	-12.0	6.0
Trade Balance (% GDP)	3.0	1.6	1.5	1.0
Current Account (% GDP)	0.1	-1.8	-1.3	-1.5
Interest Rates	**Dec 08**	**Current**	**Dec 09**	**Dec 10**
Selic rate	13.75	8.75	8.75	9.50
Exchange Rates	**Dec 08**	**Current**	**Dec 09**	**Dec 10**
Exchange Rate (USD/BRL, eop)	2.3	1.8	1.8	1.7

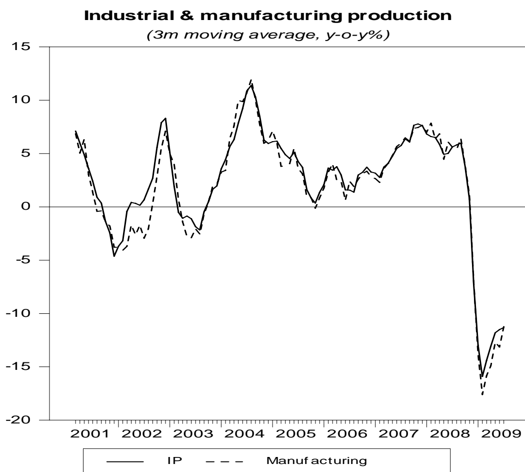
*Goods & Services, **Industrial Production
Source: Eurobank EFG, Bloomberg, Ecowin

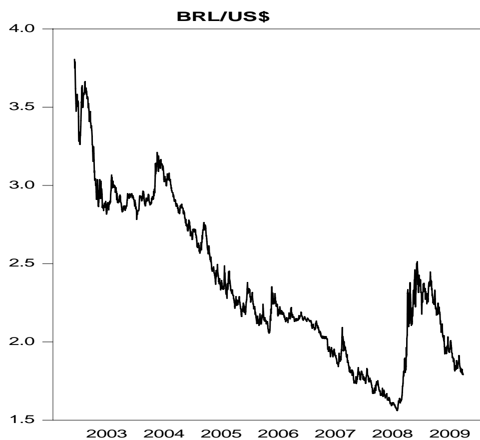
Figure 4.8

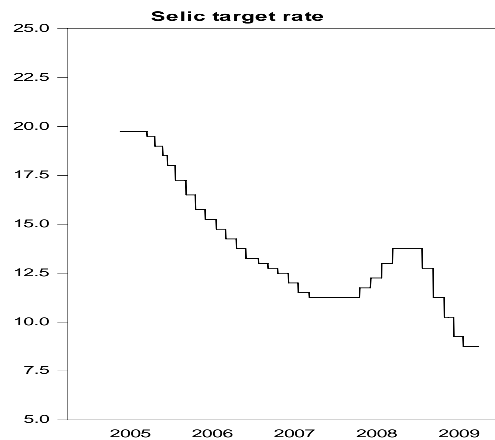


BRAZIL CHARTS









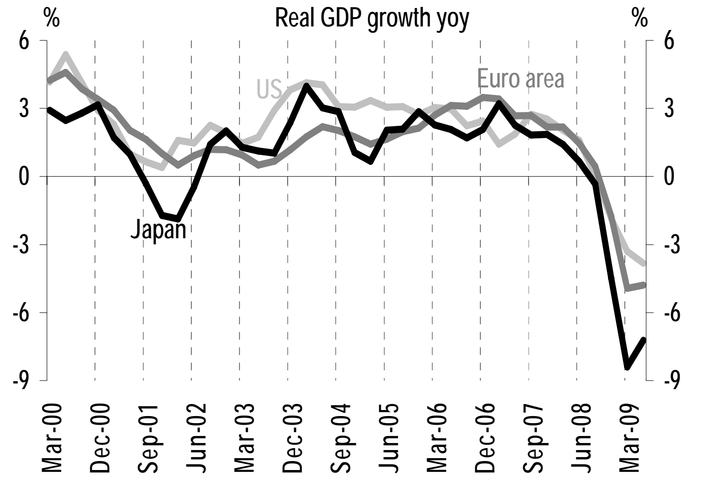
Source: Bloomberg, Ecowi

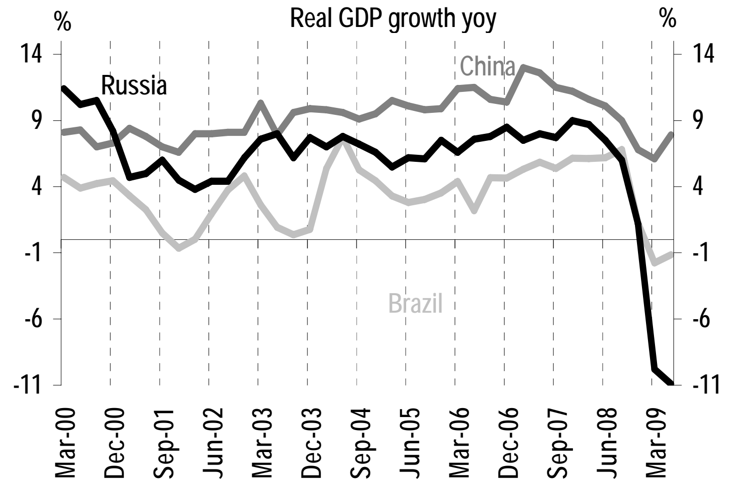
IV. GRAPHS

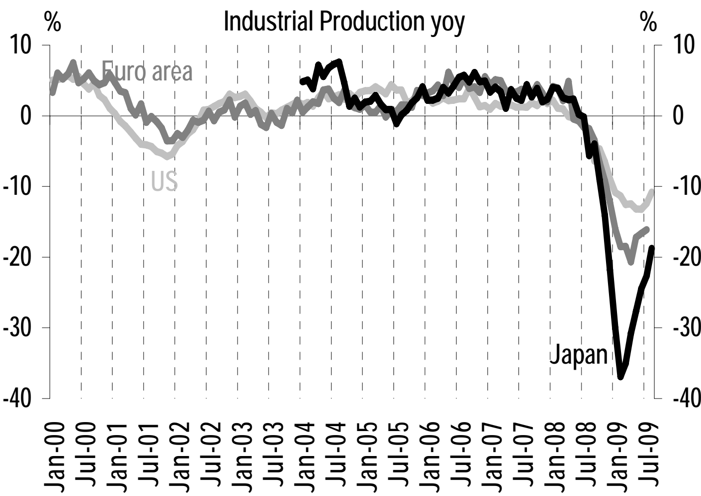
Global Economic Indicators

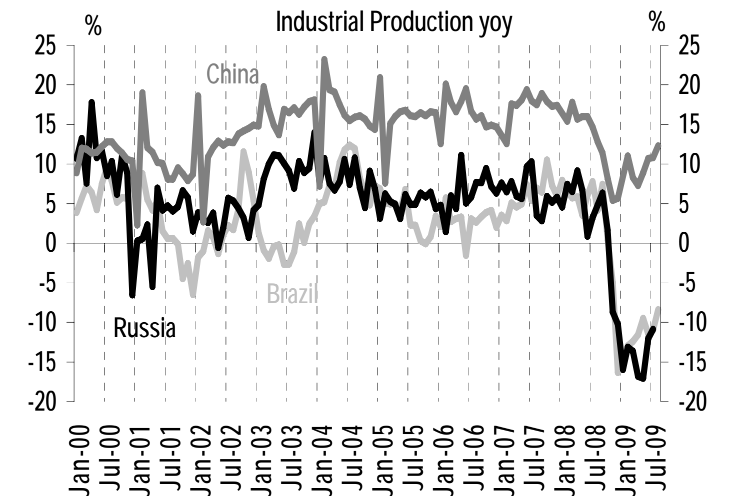
Advanced Economies

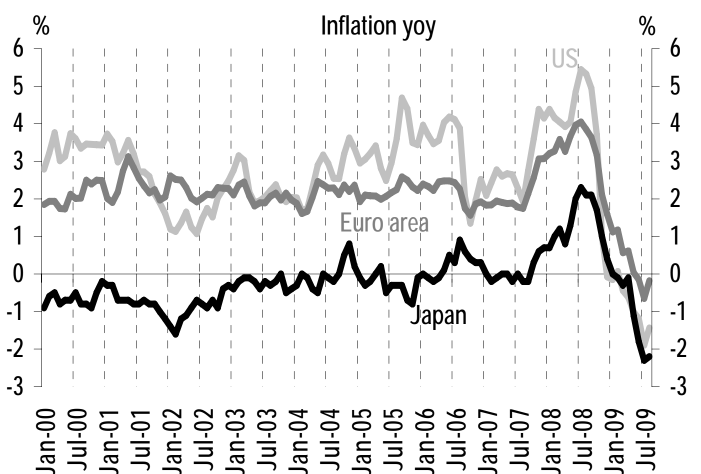
Emerging Economies

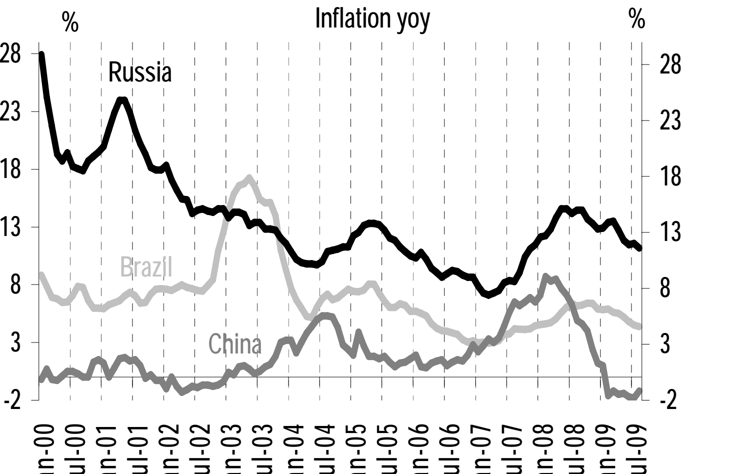








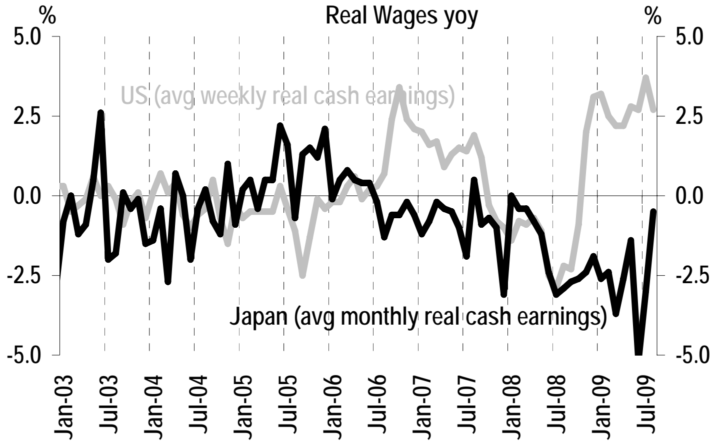




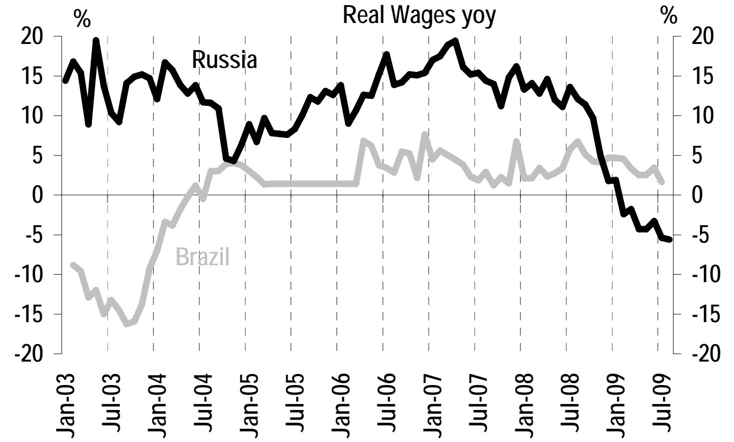
Source: Bloomberg, Ecowin

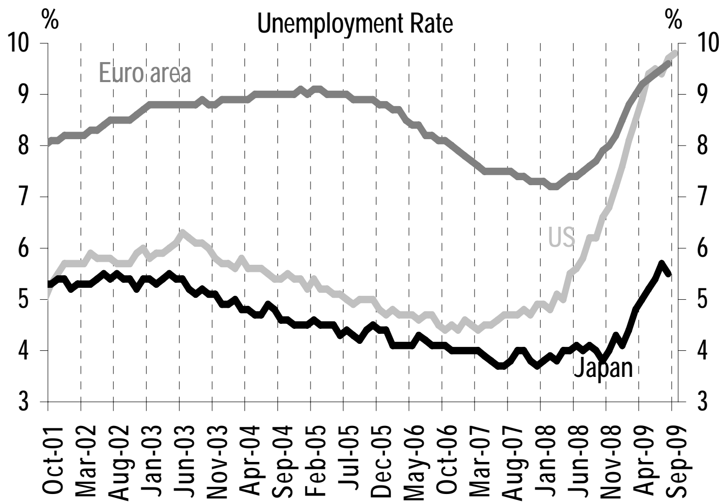
Global Economic Indicators

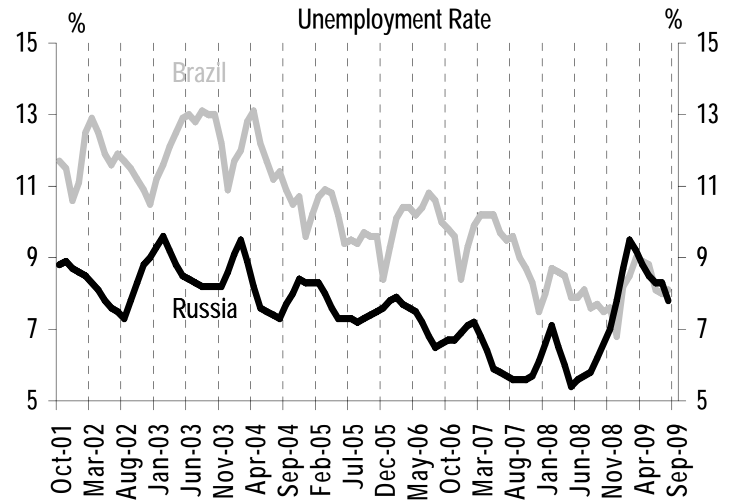
Advanced Economies

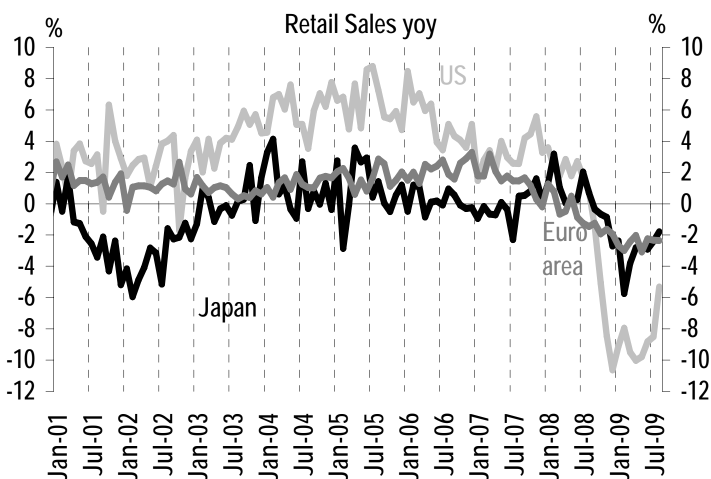


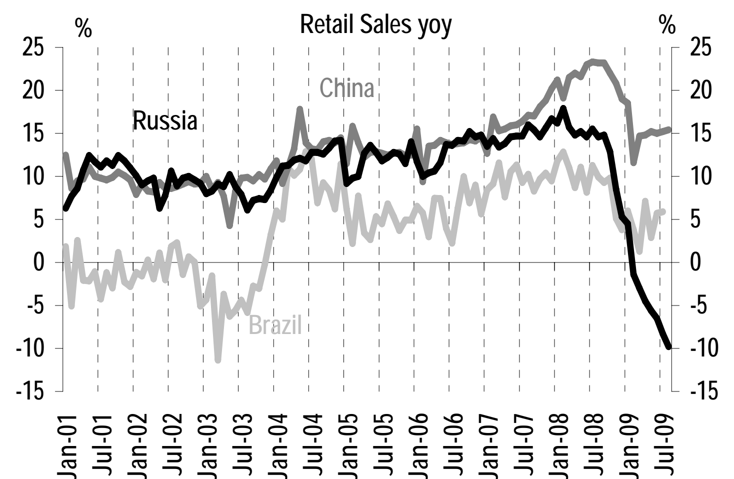
Emerging Economies







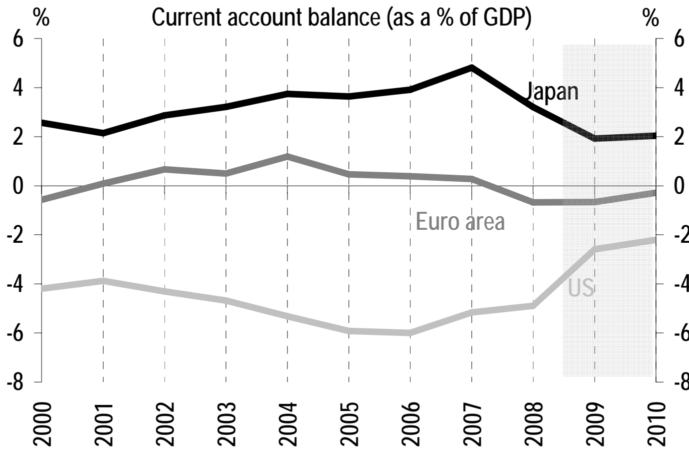




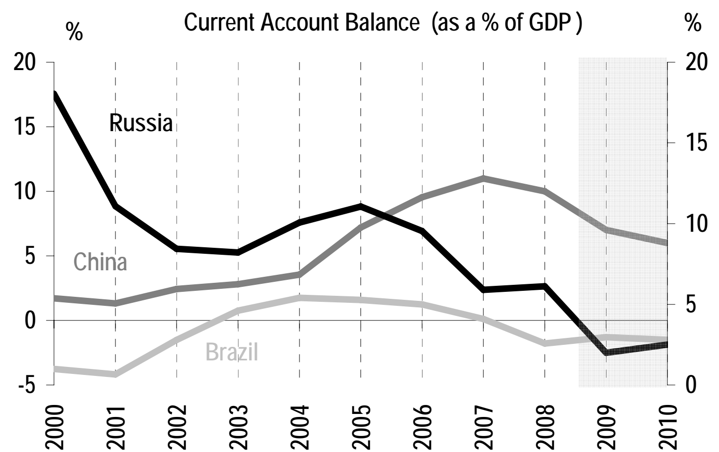
Source: Bloomberg, Ecowin

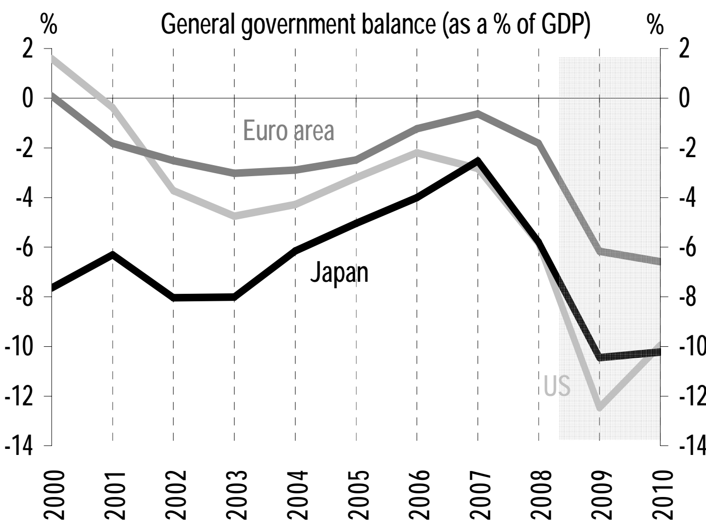
Global Economic Indicators

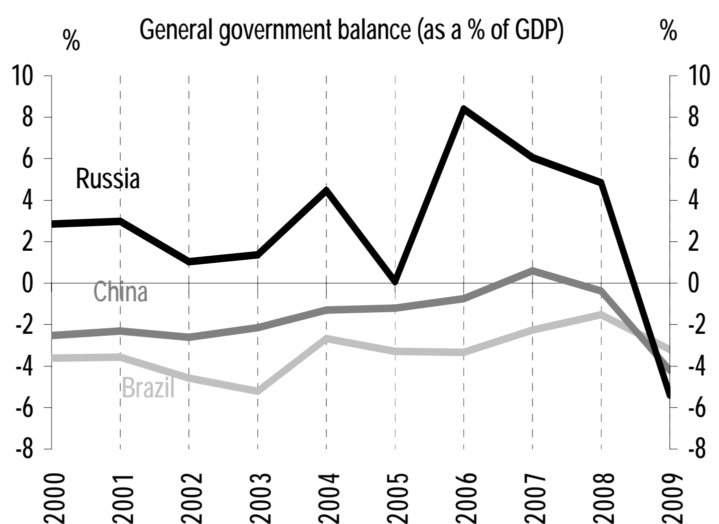
Advanced Economies

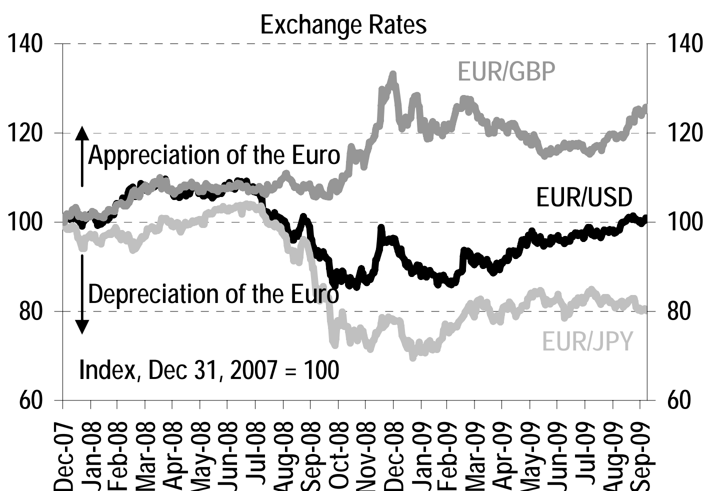


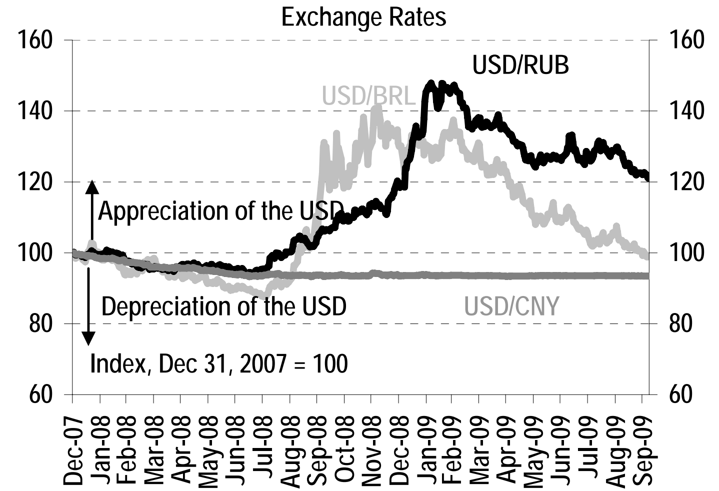
Emerging Economies





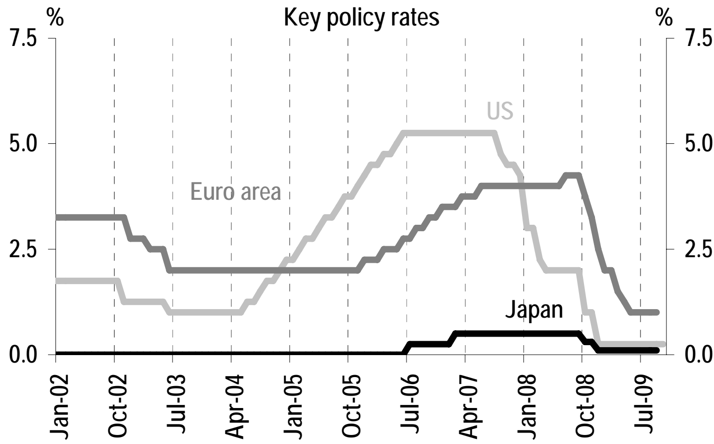


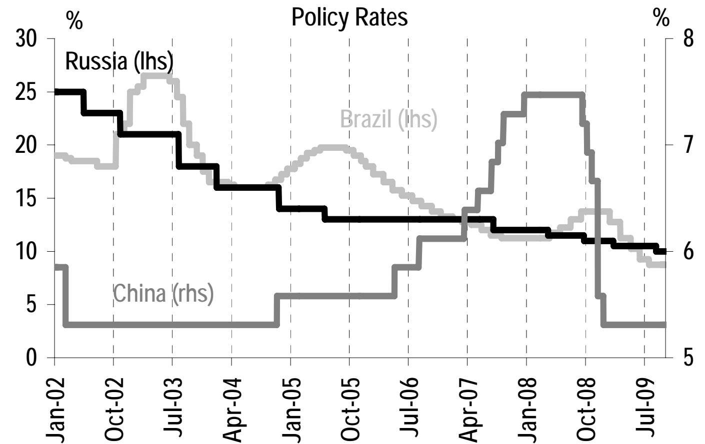


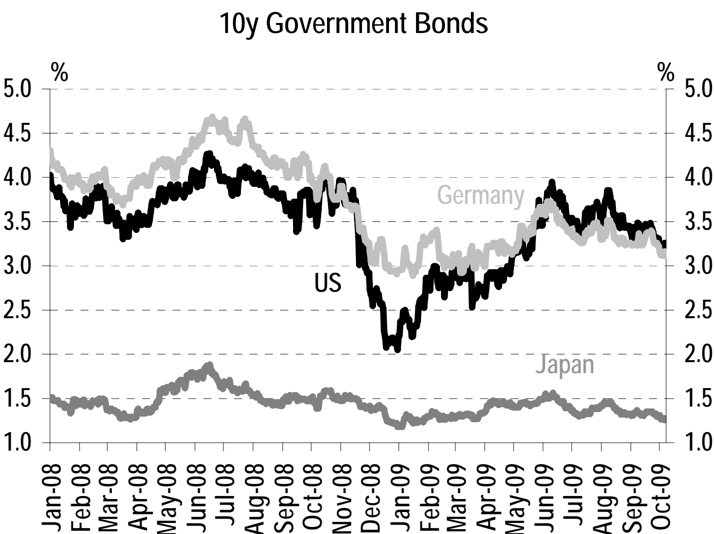


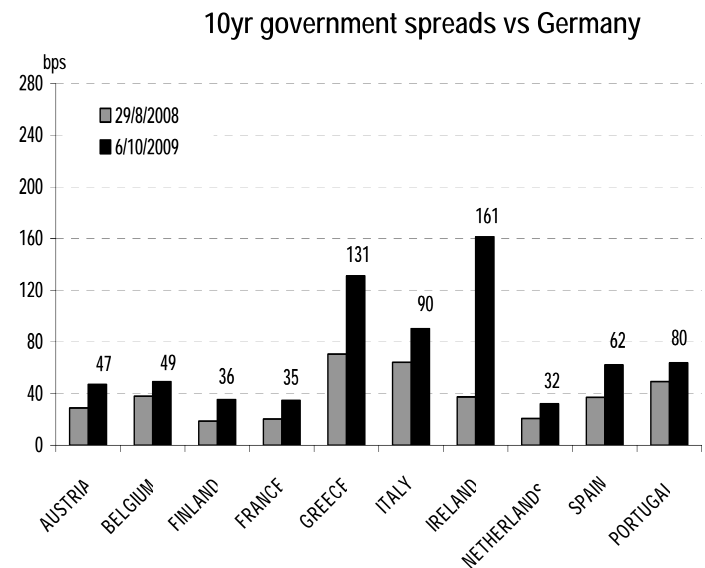
Source: Bloomberg, Ecowin, IMF

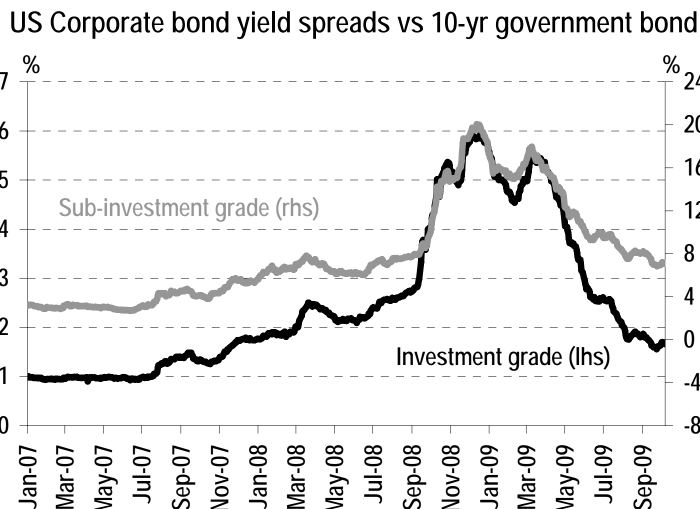
Global Economic Indicators

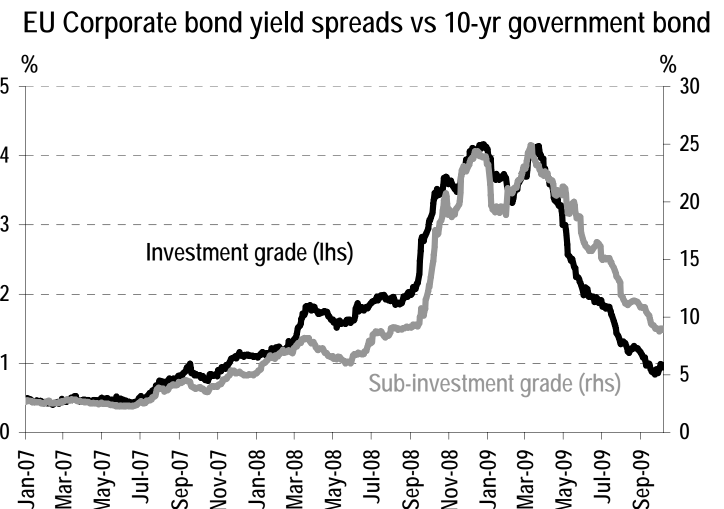












Source: Bloomberg, Ecowin

Global Equities & Sector Performance

Total Return (%) as of October 6, 2009

Global Equity Indices (in local currency)								
Region	Index	Last Price	1w	1m	6m	12m	YTD	2008
US	S&P 500	1054.7	-0.2	3.8	29.3	5.9	16.8	-38.5
EURO AREA	DJ Euro Stoxx 50	2865.7	-0.2	2.9	32.3	-0.5	17.1	-44.4
GERMANY	DAX	5657.6	-0.3	3.6	30.9	6.2	17.6	-40.4
FRANCE	CAC 40	3770.2	-0.7	3.2	29.9	1.0	17.2	-42.7
UK	FTSE 100	5138.0	0.1	4.2	30.7	11.6	15.9	-31.3
JAPAN	Nikkei	9691.8	-4.4	-6.7	12.8	5.3	9.4	-42.1
CHINA	CSI 300	3004.8	-1.8	5.7	17.9	33.9	65.3	-65.9
INDIA	SENSEX	16958.5	0.6	5.9	61.0	45.0	75.8	-52.4
RUSSIA	MICEX	1220.5	1.9	9.8	44.7	63.9	97.0	-67.2
BRAZIL	IBOV	62670.6	1.9	10.6	43.0	56.1	66.9	-41.2

Source: Bloomberg

Sector performance as of October 6, 2009

US Sector Indices (in USD)							
US – S&P 500	Last	1w	1m	6m	12m	YTD	2008
1. Consumer Discretionary	255.2	-2.3	3.1	28.4	10.1	27.2	-33.5
2. Consumer Staples	362.2	0.0	3.2	18.0	-0.8	9.2	-15.4
3. Energy	571.0	-1.8	3.5	14.4	-5.1	6.4	-34.9
4. Financials	280.7	-1.8	4.1	57.4	-16.2	19.7	-55.3
5. Health Care	414.7	-1.8	-0.2	18.9	1.9	8.2	-22.8
6. Industrials	299.2	-3.0	3.4	31.0	-2.6	12.2	-39.9
7. Information Technology	351.0	-2.2	1.8	29.2	18.9	42.6	-43.1
8. Materials	254.3	-2.9	1.4	31.0	8.1	35.0	-45.7
9. Telecommunication Services	168.8	-1.4	3.1	0.5	4.7	0.3	-30.5
10 Utilities	269.9	-2.3	0.8	14.3	-0.4	2.8	-29.0

Source: Bloomberg, Ecowin

Global Equities & Sector Performance

Sector performance as of October 6, 2009

European Sector Indices (in €)

Europe - DJ Stoxx 600	Last	1w	1m	6m	12m	YTD	2008
1. Consumer Discretionary							
Automobiles & Components	330.7	-0.3	2.4	20.1	1.2	15.5	-43.4
Travel & Leisure	163.2	-0.5	2.6	21.9	2.2	15.5	-44.0
Media	226.4	-0.4	2.8	21.1	12.1	16.2	-38.5
Retail	358.6	-0.9	-1.6	19.2	7.1	25.2	-42.2
2. Consumer Staples							
Food & Beverage	416.5	-0.7	1.8	25.9	5.9	18.3	-28.6
Personal & Household Goods	467.0	-1.0	-0.2	29.7	5.1	26.6	-40.8
3. Energy							
Oil & Gas	549.3	-0.4	0.7	21.9	8.2	18.3	-37.9
4. Financials							
Banks	428.0	-1.0	1.2	73.0	-5.4	58.3	-62.7
Financial Services	391.3	-1.1	0.5	36.8	-1.2	30.4	-54.6
Insurance	246.8	-0.1	7.8	55.2	1.0	22.4	-44.4
Real Estate	100.6	-0.4	-0.2	35.7	-17.2	21.2	-52.4
5. Health Care	467.3	-0.8	1.3	19.2	-2.2	6.7	-16.6
6. Industrials							
Industrial Goods & Services	351.2	-0.6	2.6	38.5	15.5	32.2	-46.2
7. Information Technology	189.6	-0.7	0.6	21.6	8.8	23.7	-49.6
8. Materials							
Basic Resources	693.4	0.8	1.6	47.8	13.3	66.7	-64.1
Chemicals	659.3	0.0	3.5	34.2	10.7	27.2	-36.5
Construction & Materials	423.5	0.4	3.7	43.1	28.9	34.0	-46.1
9. Telecommunication Services	429.7	0.7	2.4	21.5	5.9	12.2	-33.6
10. Utilities	629.2	-1.5	0.1	21.3	-9.8	1.5	-36.3

Source: Bloomberg

Sector performance as of October 6, 2009

Asia Sector Indices (in USD)

Asia – S&P 50 Index*	Last	1w	1m	6m	12m	YTD	2008
1. Consumer Discretionary	7065.3	-6.8	-3.4	48.4	42.4	91.4	-53.3
2. Consumer Staples	13426.2	-0.3	5.9	55.5	41.1	53.1	-21.1
3. Energy	9102.7	0.3	5.5	35.6	40.8	47.8	-50.4
4. Financials	3307.4	-1.1	2.0	47.5	-3.9	55.8	-45.8
5. Industrials	1790.1	-4.3	-0.7	22.6	12.8	30.9	-58.4
6. Information Technology	7225.5	-2.7	2.3	43.2	42.4	76.1	-42.6
7. Materials	3773.6	0.9	10.3	37.4	25.4	45.4	-52.2
8. Telecommunication Services	2417.9	-0.1	-0.1	12.8	2.5	3.0	-38.9
9. Utilities	2860.9	0.4	4.6	25.8	-4.1	24.4	-21.4

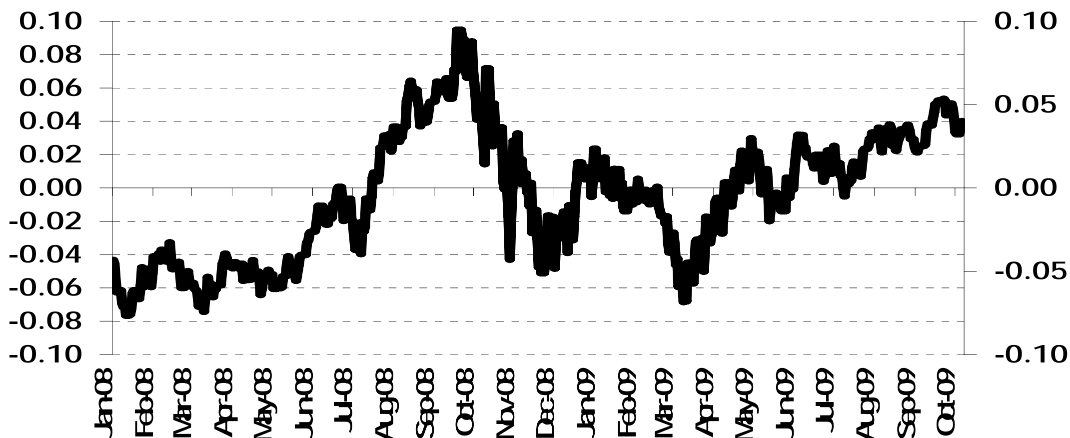
Source: Ecowin

US Style Equity Indices

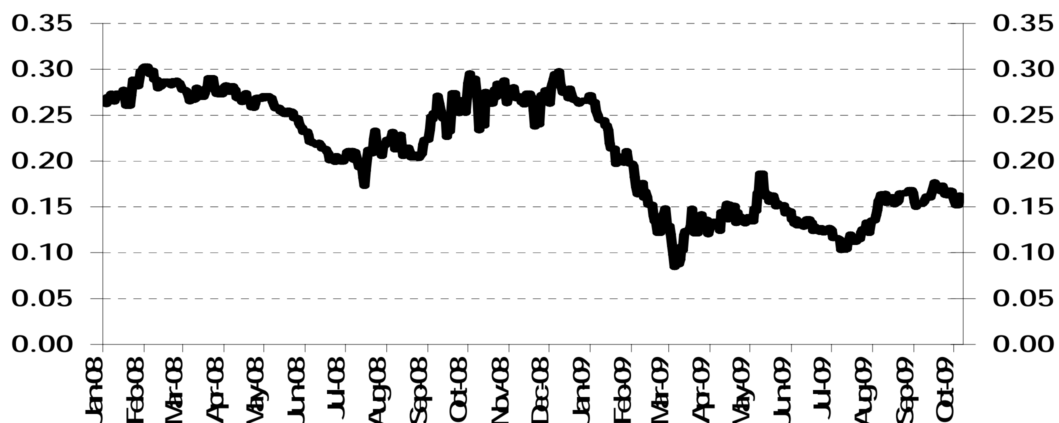
Total Return (%) as of October 6, 2009

US Style Indices (in USD)							
Index	Last Price	1w	1m	6m	12m	YTD	2008
Russell 1000 (Large Cap)	578.4	-0.3	4.0	30.4	7.5	18.6	-39.0
Russell 2000 (Small Cap)	602.0	-0.4	5.5	39.4	7.7	20.5	-34.8
Relative performance (Small vs Large)		-0.1	1.6	9.1	0.2	2.0	4.2
Russell 1000 Value	545.4	-0.2	4.4	32.4	1.2	12.0	-38.8
Russell 1000 Growth	463.9	-0.3	3.5	28.3	13.6	25.0	-39.3
Relative performance (Value vs Growth)		0.1	0.9	4.1	-12.3	-13.0	0.5

Relative Performance (small vs large)
(logarithmic scale)



Relative Performance (value vs growth)
(logarithmic scale)

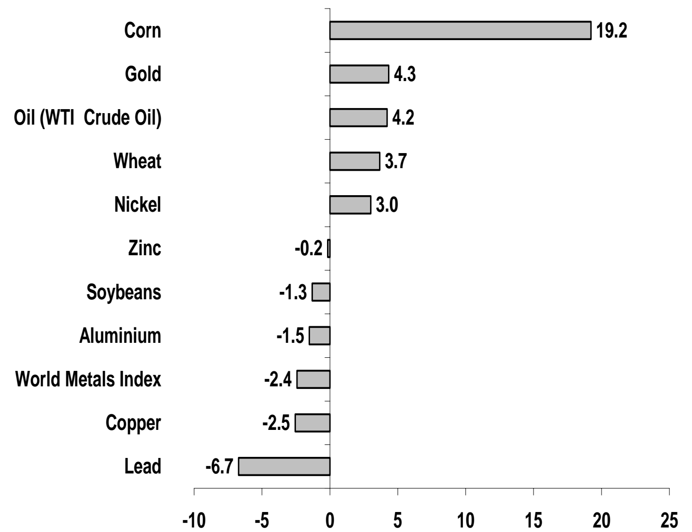


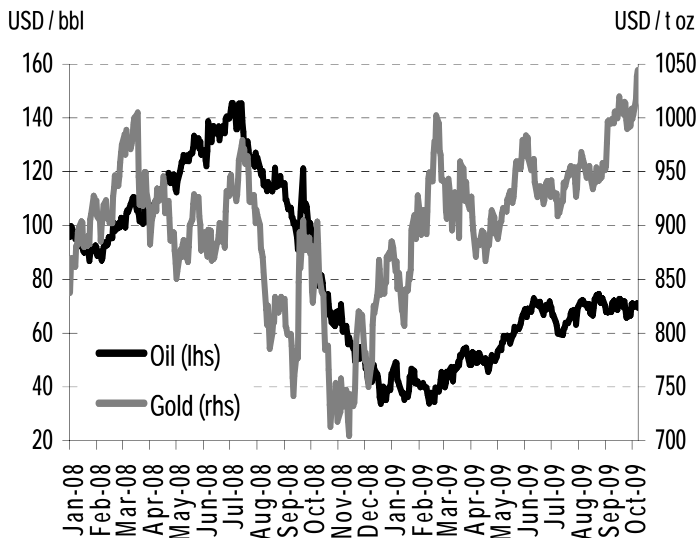
Source: Bloomberg

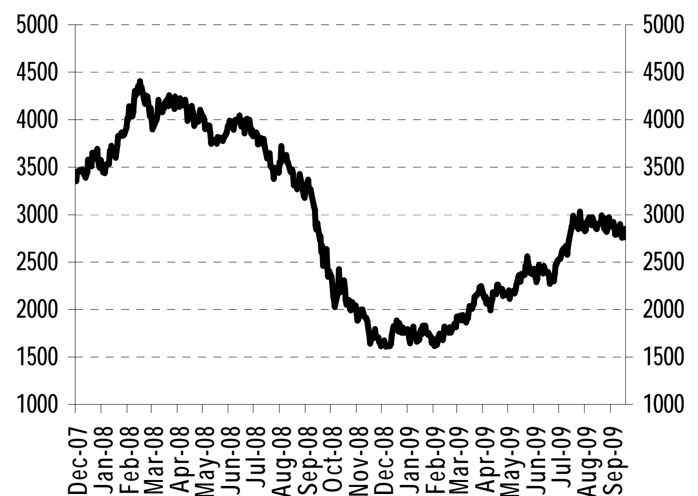
Commodities

Commodity Performance (%) as of October 6, 2009

Commodities	Units	Last Price	1w	1m	6m	12m	YTD	2008
Oil (WTI Crude Oil)	USD/bbl	70.9	0.4	4.2	44.2	-21.3	58.9	-53.5
Gold	USD/t oz	1038.6	3.0	4.3	17.7	18.2	17.4	5.5
Base Metals								
World Metals Index		2845.9	-1.7	-2.4	39.2	2.9	65.1	-49.2
Aluminium	USD/lb	1822.0	-1.6	-1.5	24.4	-19.0	18.3	-36.1
Copper	USD/mt	6115.0	2.3	-2.5	43.2	10.0	99.2	-54.0
Lead	USD/mt	2150.0	-3.7	-6.7	61.7	31.5	115.2	-60.8
Nickel	USD/mt	18130.0	5.8	3.0	68.7	26.8	55.0	-55.5
Zinc	USD/mt	1922.0	2.1	-0.2	41.3	24.1	59.1	-49.0
Agriculture								
Corn	USD/bu	358.3	4.1	19.2	-9.6	-14.1	-12.0	-10.6
Soybeans	USD/bu	910.0	-1.8	-1.3	0.2	-5.9	-9.6	-2.9
Wheat	USD/bu	460.3	0.6	3.7	-14.7	-23.7	-24.6	-31.0







Source: Bloomberg

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