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GLOBAL ECONOMIC & MARKET OUTLOOK

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- Better management of tail risks in the euro area, slow but solid steps towards a permanent solution to the sovereign debt crisis and monetary easing from major central banks is expected to allow sentiment to improve and the global economy to grow faster in 2013 (3.5%) than in 2012 (3.0%).

- In the US, the expected fiscal restraint and global economic uncertainty will probably keep weighing on real economic activity in H2 2012. Overall, we expect a below-trend real GDP growth of 2.1% y-o-y in 2012 and 1.8% in 2013, with a fiscal drag of at least 1% in the following year.

- The euro area economy is expected to return to positive territory in 2013, after experiencing a double dip this year. However, annual GDP growth next year will remain anemic (0.3%) as domestic demand will remain muted due to ongoing pro-cyclical fiscal consolidation, record high unemployment and tight credit conditions. Net exports are expected to remain the main source of growth, while the divergent growth pattern will remain a key feature of our economic outlook.

- Tail risks of a euro area break-up have abated thanks to ECB's commitment to unlimited sovereign bond purchases. However, markets remain concerned about Spain's ability to tackle its fiscal and banking woes. While for the time being ECB's words are enough to keep yields in check, in our view, investors are very likely to drive Spanish borrowing costs higher and test the ECB's commitment to preserving the stability of sovereign bond markets.

- Further brinkmanship between the ECB and politicians is expected due to discords over a permanent solution to the euro area crisis. In our view, growth initiatives and a clear vision towards a closer fiscal and banking union are required in order to preserve social cohesion and put an end to doubts over the sustainability of the common currency.

- A major source of uncertainty to the global economic outlook is the US "fiscal cliff". The $607bn planned deficit reduction would constitute a significant drag for real growth, imposing a recession-sized fiscal tightening. In such a case, the risk of a W-dip recession of the US economy would be high, given that there is not enough room for monetary policy actions alone to boost a stagnant economy.

- In China, the release of dismal economic data in the third quarter underscores risks that the full-year growth rate may slide to its lowest in more than one decade. Risks are biased to the downside, particularly if the government fails to deliver further sufficient measures and implement them consistently and effectively in the next few months.

- Further monetary policy easing by major central banks is likely. In our view, the ECB could respond to poor economic conditions by another refi rate cut by 25bps to 0.5%, additional relaxation of collateral rules and another LTRO in 2013. The Fed might increase further the rate of asset purchases and extend the rate guidance should economic growth decelerate further due to the expected fiscal restraint in 2013. The Bank of Japan could upsize is Assets Purchases Program to fight persistent deflation and contain appreciation pressures on the yen.

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Executive Summary

Global economic activity has decelerated substantially in recent months, with lower Q2 GDP growth rates across major developed economies. Reflecting the weakness in global economic activity, the growth rate of global trade has declined by a total of almost 2 percentage points in the period June-July. Global uncertainty and the downturn in global trade have been translated into more broad-based domestic weakness. The ongoing slowdown in the global industrial sector and the downturn in leading economic indicators in several economies have pushed the latest global GDP numbers downwards, moving closer to our forecasts.

Recent ECB and Fed actions have reduced significantly tail risks, allowing financial market tensions to abate somewhat and risky assets to rebound, creating hopes for a reversal of the domestic demand downturn in the two largest economies. Easier monetary conditions and further steps towards the resolution of the European sovereign debt crisis should result in an improvement of economic sentiment. Emerging economies will continue to grow much faster than advanced economies, while their relatively healthier public finances leave them room to accommodate a sudden shock to their economies. We believe that easier monetary conditions will support global economic growth this year and in 2013. On the contrary, fiscal consolidation will be a major drag to economic growth in the euro area and the US in 2013. Our global GDP estimates remain intact for 2012 and 2013, with a deceleration of real growth from 3.8% in 2011 to 3.0% in 2012 and 3.5% in 2013.

Recent policy response by the ECB has offered a backstop to the euro area against break-up risks while it has bought policymakers time to proceed with adjustments and further institution building. Its commitment for unlimited amounts of government bond purchases in the secondary markets may prove successful in averting self-fulfilling crises. For the time being, ECB's words alone seem to be enough to keep borrowing costs of periphery countries in check. However, in a deeply recessionary environment, Spain may find it particularly challenging to fulfill its fiscal targets and reform obligations. In that case, given that financial assistance by the ECB is tied to strict conditionalities, markets will most likely push Spanish spreads higher and test the ECB's commitment to unlimited support.

In our view, growth stimulus and further mutualization of credit risks are essential parts of a permanent resolution to the euro area crisis. Successful as the ECB may be in reducing tail risks, it cannot solve the crisis alone. Growth initiatives would counterbalance the recessionary effects of pro-cyclical fiscal policy and render fiscal austerity and unpopular reforms more feasible from both a political and a social point of view. Instead, further muddling through keeps hopes of a timely exit from the crisis constrained, which could erode social cohesion and reinforce euro-skeptic extreme political forces, as was the case in Greece and as is now evident in Catalonia. European policymakers are taking steps in the right direction towards institution building. However, progress towards enhanced fiscal integration and a banking union will remain cumbersome. Creditor countries require centrally monitored discipline as the price for solidarity. On the other hand, debtor countries will have a hard time accepting reduced sovereignty in favor of enhanced federalism. As a result, the road ahead looks challenging and further brinkmanship between the ECB and governments is anticipated.

A major source of uncertainty to the global economic outlook particularly in 2013 is the so-called "fiscal cliff" in the US. Implementing effective consolidation and reform plans in a fragile US economic recovery will probably prove a real challenge for the US authorities at the end of the year. Should the currently enacted fiscal policy measures continue in the following years, the receipts collected by the federal government will fall short of government outlays. This disproportion between revenues and spending, combined with the aging of the population and the rising health care cost, could result in a greater accumulation of government debt and, therefore, create doubts about longer-term debt sustainability of the US economy. On the other hand, immediate spending cuts or tax increases would constitute a major drag on the weak economic recovery and on global demand. We believe that policymakers will probably act after the November elections to remove most of the fiscal restraint called for under current law in 2013.

Dimitris Malliaropulos

Economic Research Advisor

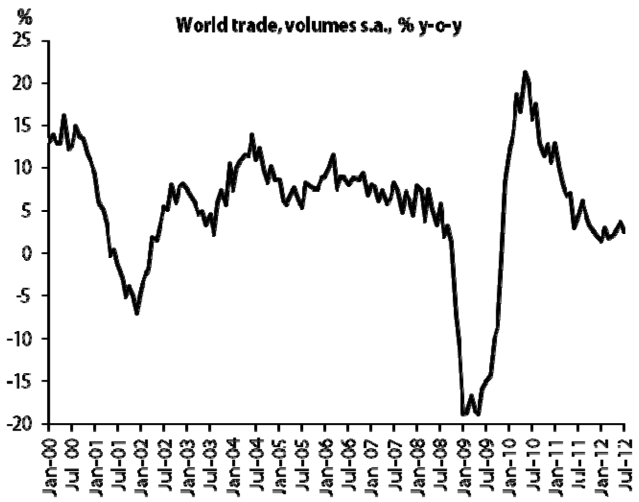
I. Global Outlook

Dimitris Malliaropulos, Vasilis Zarkos, Maria Prandeka, Olga Kosma

Monetary easing and declining uncertainty with respect to the euro area crisis may allow global economy to pick up in 2013

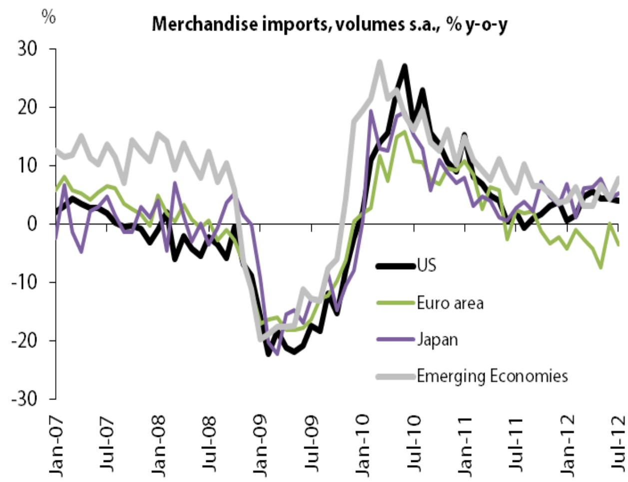
Global economic activity has decelerated substantially in recent months, with lower Q2 GDP growth rates across major developed economies. Reflecting the weakness in the global economic activity, global trade growth rate has declined by a total of almost 2 percentage points in the period June-July on a m-o-m basis (Figure 1). The volume of international trade of goods increased by an average of 2.5% y-o-y in the first seven months of the year, compared to an average increase of 5.8% y-o-y in 2011. Most of the drop in trade growth was driven by weak euro area imports, which account for about 12% of total merchandise world imports. Indeed, euro area annual import growth remains in a negative territory over the past ten months (Figure 2). Global uncertainty and the downturn in global trade have been translated into more broad-based domestic weakness. The ongoing slowdown in the global industrial sector (Figure 3) and the downturn in leading economic indicators in several economies (Figure 4) have pushed the latest global GDP numbers downwards, moving closer to our forecasts. Our global GDP estimates remain intact for 2012 and 2013, with a deceleration of real growth from 3.8% in 2011 to 3.0% in 2012 and 3.5% in 2013. Based on our estimates for real GDP growth, we project world trade growth of goods and services to fall below its thirty year average of 5.8% to 3.5% in 2012 and rebound to 5.0% in 2013.

Figure 1



Source: CPB Netherlands Bureau for Economic Policy Analysis

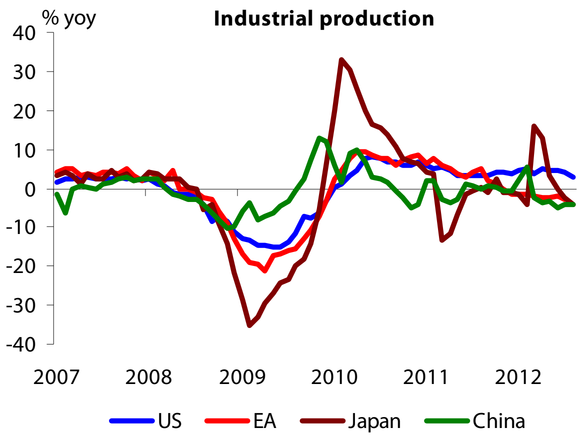
Figure 2



Source: CPB Netherlands Bureau for Economic Policy Analysis

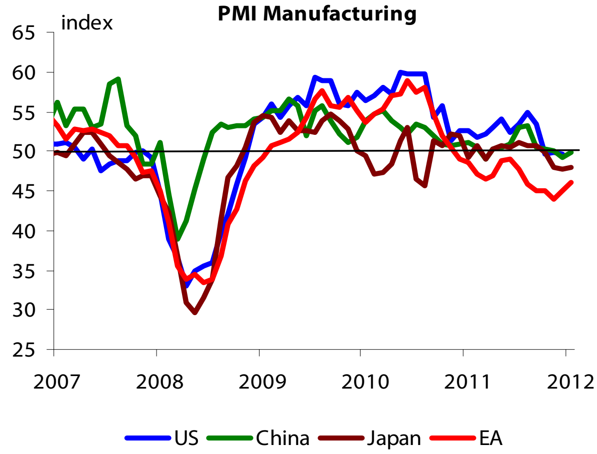
Recent ECB and Fed actions have reduced significantly tail risks, allowing financial market tensions to abate somewhat and risky assets to rebound (Figures 5 & 6), creating hopes for a reversal of the domestic demand downturn in the two largest economies. The global outlook is largely dependent on developments in the euro area, the handling of the US fiscal cliff and the extent of China's slowdown. Easier monetary conditions and further steps towards the resolution of the European sovereign debt crisis should result in an improvement of economic sentiment, giving way to an acceleration of the pace of growth globally towards 2013. Emerging economies will continue to grow much faster than advanced economies, while their relatively healthier public finances leave them room to accommodate a sudden shock to their economies. On the contrary, fiscal consolidation will be a major drag to economic growth in the euro area and the US in 2013.

Figure 3



Source: Ecowin

Figure 4

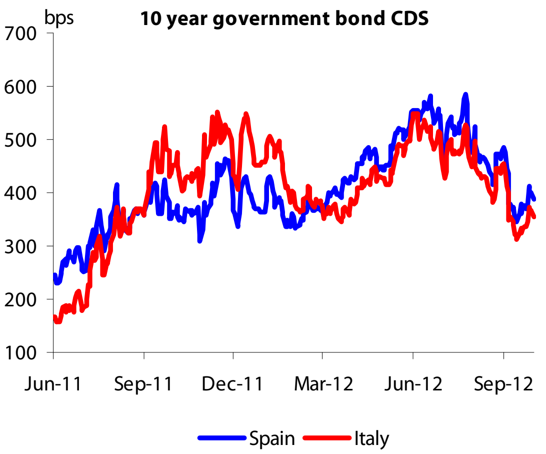


Source: Bloomberg

Easier monetary conditions are expected to be supportive for global growth

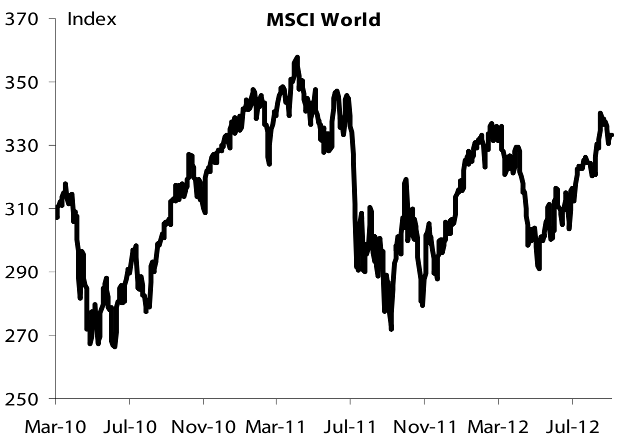
We believe that easier monetary conditions will support global economic growth this year and in 2013. In our view, given that growth in advanced economies will likely remain subdued, monetary authorities should maintain monetary policy loose, even if that means tolerating inflation persistently above their targets. In the US, the loss of momentum in the economic and, particularly, the labor market recovery has prompted the Fed to strengthen its rate guidance at least through mid-2015 and launch a third round of quantitative easing at its September FOMC meeting. Given our forecast of a marginal improvement in labor market conditions, it is very likely that the Fed will proceed to additional Treasury purchases after the completion of "Operation Twist" at year end. Should economic growth decelerate further due to the expected fiscal restraint in early 2013, the Fed might increase further the rate of asset purchases, combined with a further extension of the rate guidance.

Figure 5



Source: Ecowin

Figure 6



Source: Bloomberg

In the euro area, the ECB is likely to deliver another rate cut in the next three months, bringing the refi rate to 0.5% as a response to persistently tight credit conditions. At the current juncture, unconventional monetary policy matters more than conventional measures. In this context, we would not rule out the announcement of another long term operation by the ECB, most likely in 2013, to improve liquidity conditions for banks. In addition, the ECB may ease collateral rules further in order to facilitate liquidity take up. The Bank of Japan is expected to maintain its accommodative policy to contain appreciation pressures on the yen and fight deflation. The BoJ has recently expanded its Asset Purchase Program (APP) by increasing the amount of sovereign papers to be purchased. In our view, additional expansion of APP is on the cards as appreciation pressures on the yen may resume due to tensions in the euro area and inflation is most likely to remain below the inflation target of 1%, set out as the BoJ's "understanding" of medium/long-term price stability.

Against the background of weaker global growth outlook, most central banks in emerging markets proceeded with interest rate cuts in the past few months. We expect additional rate cuts in most EM countries in the rest of the year, as inflation is not a constraint on monetary policy in most parts of the emerging world at this stage, particularly as long as it remains substantially below its 2011 peak. Furthermore, soft global demand is likely to continue to offset the inflationary impact of higher commodity prices. In addition, most EM central banks still have scope for additional policy rate cuts, given that real rates are marginally positive, in contrast to negative real rates prevailing in advanced economies.

Country/regional economic outlook

Subdued GDP growth for the US economy in H2 2012 and 2013, with fiscal policy constituting a key risk factor for the outlook. Real GDP growth decelerated further in Q2 2012, as the expected fiscal restraint in the US and global economic uncertainty has led consumers and firms to hold back on spending and investment. High frequency economic indicators suggest that real GDP growth will remain subdued around 1.8% q-o-q saar in the following quarter, with an evident deceleration in the production side of the economy in response to the easing in external demand. Overall, we expect a modest acceleration of real economic activity for the whole year, with real GDP growth hovering around 2.1% y-o-y in 2012 from 1.8% in 2011. Our baseline scenario includes a fiscal drag of at least 1% in 2013, with the average GDP growth rate hovering around 1.8%.

Euro area GDP is expected to almost stagnate in 2013. The euro area is set to experience a double dip in 2012, as the economy is expected to keep decelerating in the second half of the year. On going pro-cyclical fiscal retrenchment across the euro area in combination with tight credit conditions preserves strong recessionary headwinds which confine domestic demand. GDP growth is anticipated to pick up as we move into 2013. Better management of tail risks will hopefully allow financial tensions to abate and reverse the contraction of private demand. However, continuing fiscal consolidation, a slowly healing banking sector and uncertainties along the road to a permanent resolution of the crisis are expected to allow only for a moderate economic expansion. Our annual growth projections have been revised downwards for both 2012 and 2013 to -0.5% and 0.3%, respectively from -0.3 and 0.7% a quarter earlier.

Japanese GDP growth is expected to moderate in the second half of 2012. The Japanese economy is expected to recede to a lower growth trajectory in the second half of 2012 as subdued global demand is expected to take its toll on industrial and export activity, while government measures that boosted private consumption in the first half of the year are expected to run their course. However, government financed reconstruction is expected to partially shield the economy from external shocks, allowing the Japanese economy to outperform its peers. Looking further ahead into 2013, annual real GDP growth is expected to recede to a lower trajectory (1.2%), as reconstruction expenditures will have run their course. Downside risks to our economic outlook stem mainly from the euro area crisis the fiscal cliff in the US and geopolitical tensions between Japan and China.

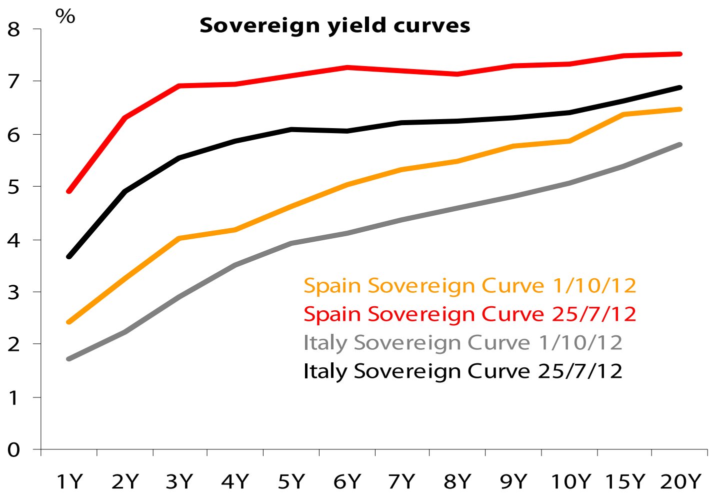
Growth in EM economies is expected to rebound only slightly in Q4 and in 2013. Recent ECB and Fed actions have reduced significantly tail risks and, particularly, those related to the euro area. This, along with policy stimulus and monetary easing in emerging markets, suggests that a firming of economic activity may be imminent. However, with fiscal consolidation continuing in most developed markets, growth rates of exports will remain relatively modest and below historical standards. Given that a significant share of the current slowdown in EM is structural in nature, the recovery is expected to be slow and growth rates would not return to the high levels recorded over the past decade. The outlook is largely dependent on developments in the euro area, the handling of the US fiscal cliff and the extent of China's slowdown. Generally, risks remain to the downside as long as the recovery in the global economy remains fragile and, thus, vulnerable to sudden shocks, all of which could dampen global demand.

China's growth is still in a soft landing territory but risks are biased to the downside. China's economy has entered a period of subdued growth, with weak exports, credit and property prices. The rest of 2012 will continue to be dominated by the persistent weakness in external demand and further property market adjustment, as the government recently reaffirmed its commitment to curb speculative activity in the real estate market. This adherence to the restrictive measures will most likely keep growth lower than it would have otherwise been. We project growth to moderate to 7.7% in 2012 and 2013 from 9.3% in 2011. Risks are biased to the downside and particularly if the government fails to deliver further sufficient measures and, what's more, implement them consistently and effectively in the next few months. In any case, a sustained economic rebound is far from assured, given that risks still remain mainly in the export sector.

Tail risks in the euro area have abated but the process towards a permanent solution will remain slow

Recent policy response by the ECB has offered a backstop to the euro area against break-up risks while it has bought policymakers time to proceed with adjustments and further institution building. Its commitment for unlimited amounts of government bond purchases in the secondary markets may prove successful in averting self-fulfilling defaults. Investors have reacted positively to the announcement of the OMT program with Spanish and Italian yields retreating across the curve (Figure 5). For the time being, ECB's words alone seem to be enough to keep borrowing costs of periphery countries in check. However, we believe that sooner or later markets will test the ECB's commitment to unlimited support. In a deeply recessionary environment, Spain may find it particularly challenging to fulfill its fiscal targets and reform obligations. In that case, markets will most likely push Spanish spreads higher, given that financial assistance by the ECB is tied to strict conditionalities.

Figure 5



Source: Bloomberg

In our view, growth stimulus and further mutualization of credit risks are essential parts of a permanent resolution to the euro area crisis. Successful as the ECB may be in reducing tail risks, it cannot solve the crisis alone. Growth initiatives would counterbalance the recessionary effects of pro-cyclical fiscal policy and render fiscal austerity and unpopular reforms more feasible from both a political and a social point of view. Instead, further muddling through keeps hopes of a timely exit from the crisis constrained, which could erode social cohesion and reinforce euro skeptic extreme political forces, as was the case in Greece and as is now evident in Catalonia. European policymakers are taking steps in the right direction towards institution building. However, progress towards enhanced fiscal integration and a banking union will remain cumbersome. Creditor countries require centrally monitored discipline as the price for solidarity. On the other hand, debtor countries will have a hard time accepting reduced sovereignty in favor of enhanced federalism. As a result, the road ahead looks challenging and further brinkmanship between the ECB and governments is anticipated.

The fiscal cliff poses downside risks to the US economic outlook

A major source of uncertainty to the US economic outlook particularly in 2013 is the so-called “fiscal cliff”. Implementing effective consolidation and reform plans in a fragile US economic recovery will probably prove a real challenge for the US authorities at the end of the year. Should the currently enacted fiscal policy measures continue in the following years, the receipts collected by the federal government will fall short of government outlays. This disproportion between revenues and spending, combined with the aging of the population and the rising health care cost, could result in a greater accumulation of government debt and, therefore, create doubts about longer-term debt sustainability of the US economy. On the other hand, immediate spending cuts or tax increases would constitute a major drag on the weak economic recovery, given the current fragile state of the US economy. We believe that policymakers will probably act after the November elections to remove most of the fiscal restraint called for under current law in 2013. Our baseline scenario includes the expiration of the payroll tax cuts and emergency unemployment benefits, but assumes the extension of the 2001/2003 tax cuts and alternative minimum tax rate and the replacement of the “sequester” automatic cuts by a smaller amount of spending cuts.

II. Global Economic Outlook

1. The US economy

Dimitris Malliaropulos, Olga Kosma

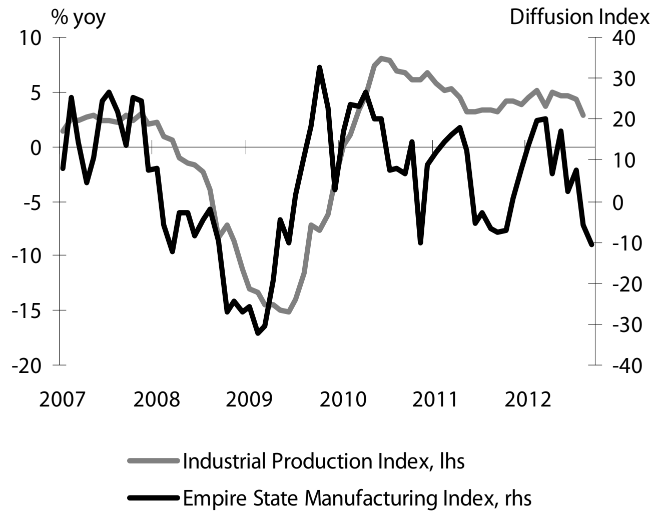
- Real GDP growth decelerated further in Q2 2012, as domestic fiscal issues in the US and global uncertainty regarding the European debt crisis has led consumers and firms to hold back on spending and investment.
- High frequency economic indicators suggest that real GDP growth will remain subdued around 1.8% q-o-q saar in the following quarter, with an evident deceleration in the production side of the economy in response to the easing in external demand.
- The gradual upturn in US housing sales and starts is boosting house prices, reinforcing our view that national home prices have bottomed and the recovery in the housing sector is slowly underway.
- A major source of uncertainty to the US economic outlook particularly in 2013 is the so-called "fiscal cliff". The $607bn planned deficit reduction would constitute a significant drag for real economic activity, imposing a recession-sized fiscal tightening. In such a case, the risk of a double-dip recession of the US economy would be high, given that there is not enough room for monetary policy actions alone to boost a stagnant economy.
- However, we believe that policymakers will probably act after the November elections to remove most of the fiscal restraint and expect a fiscal drag of about 1% in 2013, with the average GDP growth rate hovering around 1.8%.
- The loss of momentum in the labor market recovery has prompted the Fed to launch QE3 at its September FOMC meeting. Given our forecast of a marginal improvement in labor market conditions, it is very likely that the Fed will proceed to additional Treasury purchases after the completion of the "Operation Twist" at year end.

Overview

Real GDP growth decelerated further in the second quarter of the year, as the expected fiscal restraint in the US and global economic uncertainty has led consumers and firms to hold back on spending and investment. High frequency economic indicators suggest that real GDP growth will remain subdued around 1.8% q-o-q saar in the following quarter, with an evident deceleration in the production side of the economy in response to the easing in external demand. In particular, industrial production weakened sharply in August (Figure 1.1), while real exports declined significantly in July due to a softening of economic activity in major US trade partners. Although the September ISM manufacturing index moved back into expansionary territory, the persistent weakness in other regional manufacturing surveys (Figure 1.1) point to a rather weak pace of growth in the manufacturing sector. The fragile pace of the economic recovery and the most recent disappointing employment report in August has urged the Fed to strengthen its rate guidance at least through mid-2015 and launch a third round of quantitative easing at its September FOMC meeting. Overall, we expect a modest acceleration of real economic activity for the whole year, with real GDP growth hovering around 2.1% y-o-y in 2012 from 1.8% in 2011.

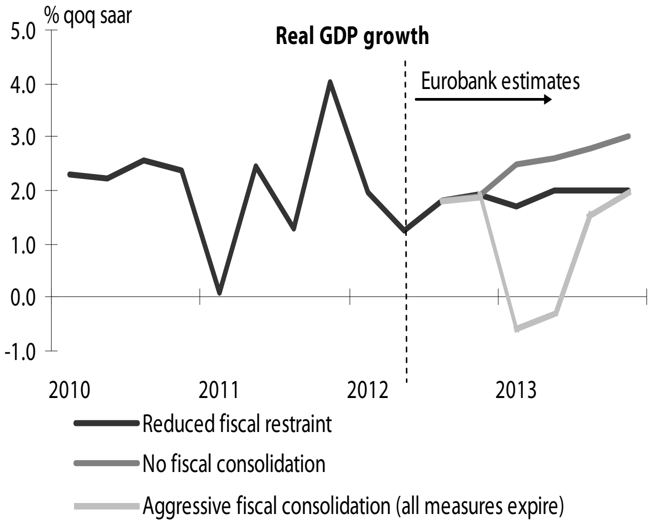
A major source of uncertainty to the US economic outlook particularly in 2013 is the so-called "fiscal cliff". Implementing effective consolidation and reform plans in a fragile US economic recovery will probably prove a real challenge for the US authorities at the end of the year. Should the currently enacted fiscal policy measures continue in the following years, the receipts collected by the federal government will fall short of government outlays. This disproportion between revenues and spending, combined with the aging of the population and the rising health care cost, could result in a greater accumulation of government debt and, therefore, create doubts about longer-term debt sustainability of the US economy. On the other hand, immediate spending cuts or tax increases would constitute a major drag on the weak economic recovery, given the current fragile state of the US economy. Based on OECD's staff calculations[1] for multipliers used to evaluate the fiscal packages in the US, the $607bn deficit reduction will lead to a decline of real GDP by 2% in 2013. However, we believe that policymakers will probably act after the November elections to remove most of the fiscal restraint called for under current law in 2013. Our baseline scenario includes the expiration of the payroll tax cuts and emergency unemployment benefits, but assumes the extension of the 2001/2003 tax cuts and alternative minimum tax rate and the replacement of the "sequester" automatic cuts by a smaller amount of spending cuts. In such a case, fiscal restraint would reduce growth by at least 1% in 2013, with the average GDP growth rate hovering around 1.8% (Figure 1.2).

Figure 1.1



Source: The Conference Board, Bloomberg

Figure 1.2



Source: US Bureau of Economic Analysis (BEA), Eurobank estimates

Real economic activity decelerated further in Q2, on the back of a softer pace of domestic demand growth

According to the third estimate of the Bureau of Economic Analysis (BEA), real GDP decelerated to 1.3% q-o-q saar in Q2 from 2.0% in Q1 2012, on the back of a softer pace of domestic demand growth (Figure 1.3). While net trade contributed positively to real economic activity (+0.23%), the US fiscal situation and the sovereign debt crisis is keeping both businesses and consumers cautious. In particular, real personal consumption decelerated from 2.4% in Q1 to 1.5% q-o-q saar in Q2, adding a mere 1.1% to real GDP growth from 1.7% in the previous quarter. Furthermore, real non-residential investment growth slowed to 3.6% from 7.5%, while residential investment growth declined from 20.5% to 8.5% q-o-q saar in Q2, contributing 0.4% and 0.2% to real GDP growth, respectively. On the negative side, the inventory accumulation component subtracted 0.5% from real economic activity, while the government sector kept contracting albeit at a slower pace, subtracting 0.1% from GDP growth.

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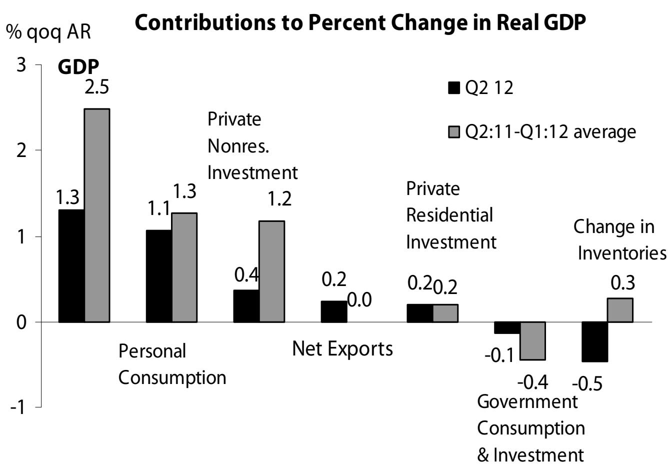
[1] *Barrell, R., D. Holland and I. Hurst (2012), "Fiscal Consolidation: Part 2. Fiscal Multipliers and Fiscal Consolidations", OECD Economics Department Working Papers, No. 933, OECD Publishing.*

http://dx.doi.org/10.1787/5k9fdf6bs78r

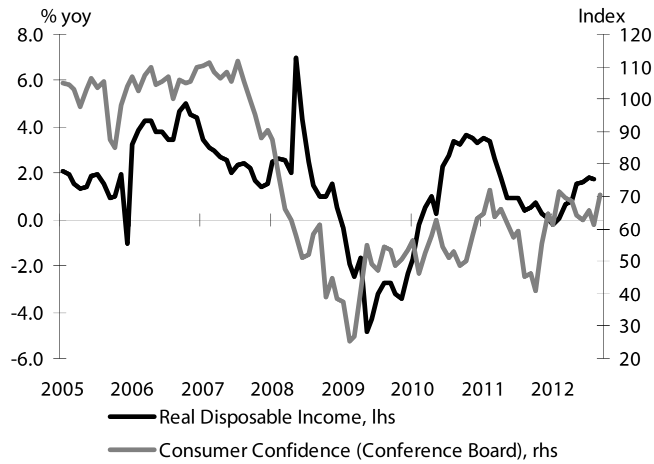
OECD Economic Outlook, Interim Report, Chapter 3, March 2009.

Figure 1.3



Source: US Bureau of Economic Analysis, Eurobank Research estimates

Figure 1.4



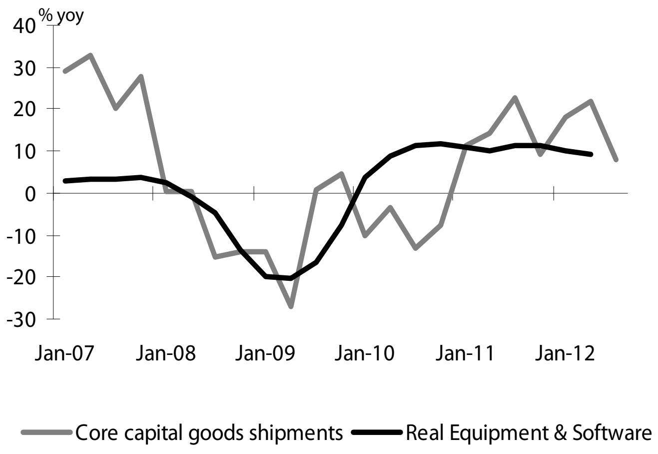
Source: US Bureau of Economic Analysis, The Conference Board

Global uncertainty and domestic fiscal finances are keeping a lid on economic activity

Although the recent decline in energy prices gave a boost to real income growth in the second quarter of the year, private spending growth decelerated significantly. Households' consumption was replaced by a significant rise in the personal savings rate due to increased consumers' uncertainty about their fiscal situation. After a rebound in July retail sales with broad-based increases across all major categories and an upward surprise in August and September vehicle sales which sparked expectations for a rebound in private spending, the August personal income and spending accounts revealed a 0.3% m-o-m decline in real personal income, the first decline since November 2011. Real private consumption increased by a mere 0.1% in August, fully financed by a decline in the personal savings rate. Although both measures of consumer confidence surged higher in September (Figure 1.4), we expect a slight acceleration of private consumption growth to about 2.0% from 1.5% q-o-q saar in Q2, with the softness in August core retail sales underpinning a rather modest pick-up in private expenditures. Looking ahead, we expect subdued private spending growth in H2 2012 and in 2013 around 2.0%, as the expected fiscal contraction in January next year will probably be a drag on consumer confidence and, consequently, income and spending gains.

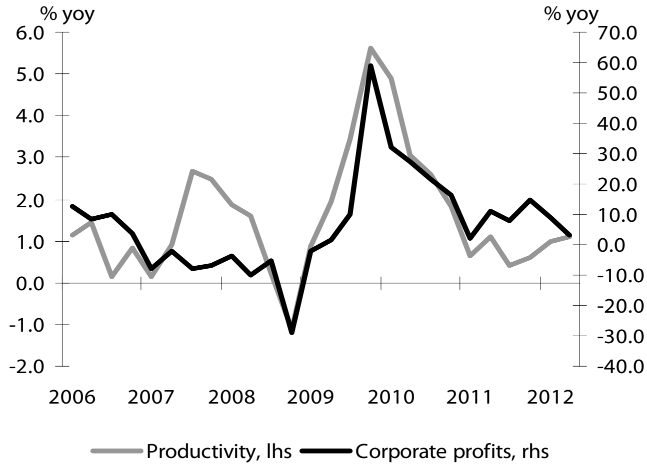
Real business investment growth has been on a downward trend since its recent peak in Q3 2011, with structures investment decelerating from 20.7% in Q3 2011 to 0.6% q-o-q saar in Q2 2012 and equipment and software investment growth falling from 18.3% to 4.8%, respectively. The general economic uncertainty has made firms more reluctant to invest and make commitments that are hard to reverse if the economy takes a turn for the worse. The recent softness in core capital goods shipments, which are the main input for equipment and software, bodes badly for investment growth in the following months (Figure 1.5). Furthermore, private non-residential construction spending declined further in August (-1.7% m-o-m) after a 0.5% drop in July, suggesting that structures investment will likely be a drag on Q3 GDP growth. Although the National Federation for Independent Business (NFIB) index of small business confidence rose to 92.9 in August from 91.2 in July, this increase followed three consecutive monthly declines, leaving the index below its recent high of 94.5 in April. We believe that increased uncertainty and loss of business confidence will weigh on business investment in the second half of the year, with the average quarterly growth falling from an annualized growth of 5.5% in H1 to about 3.5% in H2 2012. On an annual basis, we expect real business investment to decelerate from 8.6% in 2011 to about 8.0% in 2012, with the softness in labor productivity growth weighing further on corporate profit growth (Figure 1.6).

Figure 1.5



Source: US Bureau of Economic Analysis, US Census Bureau

Figure 1.6

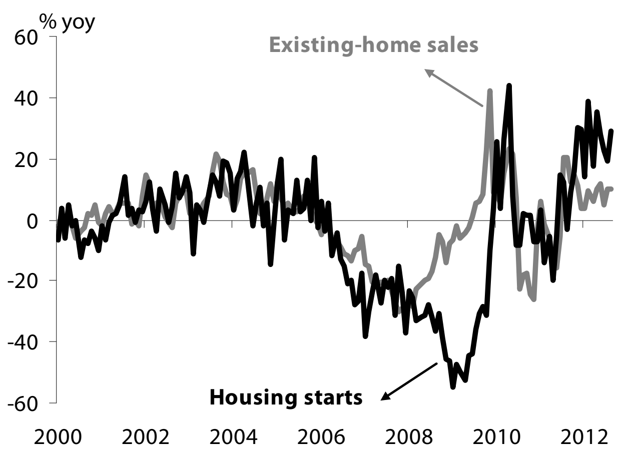


Source: US Bureau of Economic Analysis, US Bureau of Labor Statistics

The recovery in the US housing market is gradually underway

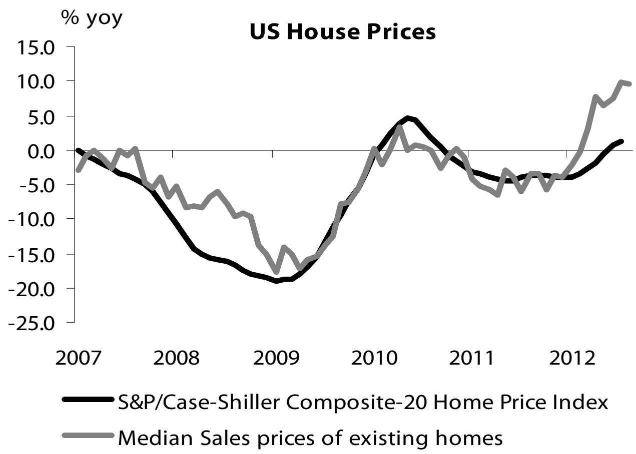
After a surge in residential fixed investment in the first quarter of the year due to unusually warm winter weather, real residential investment growth decelerated to 8.9% q-o-q saar in Q2 2012 from 20.5% in Q1 2012, contributing 0.2% to real economic activity. Despite this recent deceleration, the US housing market will probably keep adding to GDP growth in the following quarters. Indeed, private residential construction increased by 0.9% m-o-m in August, and the decline reported in July was largely revised away. Housing starts and building permits remain in an upward trend, with an annual growth rate of about 25-30% (Figure 1.7). Moreover, the National Association of Home Builders (NAHB) index of home builder confidence rose in September to its highest level since June 2006, while the recent strong momentum in sales of existing homes have led to a gradual decline in the supply of unsold homes (Figure 1.7). Most measures of US house prices have been increasing since the start of the year (Figure 1.8), reinforcing our view that national home prices have bottomed and the recovery is slowly underway. We expect residential construction spending and investment to increase by an average annual growth rate of 11% in 2012, after a decline of -1.4% in 2011. The ongoing recovery process should be gradual, restrained by the low availability of credit, the slow pace of improvement in labor market conditions and the overhang from distressed and foreclosed homes.

Figure 1.7



Source: US National Association of Realtors, US Census Bureau

Figure 1.8



Source: Bloomberg

Easing in external demand due to a softening of economic activity in major US trade partners

As far as external demand is concerned, real export growth accelerated to 5.3% q-o-q saar in Q2 2012 from 4.4% in the previous quarter, while import growth decelerated slightly to 2.8% q-o-q saar from 3.1% in Q1. As a result, net exports contributed 0.2% to overall GDP growth in Q2, after an average negative contribution of about -0.2% over the last three quarters. However, real exports declined by 2.2% m-o-m in July, reversing the gain in June and pointing to a likely drag to Q3 real economic activity. The recent deceleration of US export growth is in line with the ongoing softening of economic activity in Europe and China, which account for about 25% of US exports. Meanwhile, the new export orders component of the ISM survey, which rose to 48.5 in September from 47.0 in August, is still in negative territory and points to an export weakness ahead. We do not expect net trade to be a strong impetus for real economic activity in the second half of the year, as export demand to US main partners is expected to remain subdued. Last but not least, the deceleration of US personal consumption to a lower growth trajectory may affect global demand through global trade linkages, given that global growth remains highly dependent on US consumption.

The loss of momentum in the labor market recovery has prompted the Fed to launch QE3

After a brief acceleration in jobs growth in July, which gave hope for a stronger labor market recovery, the August employment report came in weaker than expected, with nonfarm payrolls increasing just 96k (Figure 1.9). Although the unemployment rate ticked down to 8.1% from 8.3% in the previous month, this decline was fully attributed to a decline in the labor force participation, as civilian employment actually declined by 119k. Chairman Bernanke's "grave concern" for labor market stagnation was evident at the 2012 Jackson Hole Symposium, citing his growing impatience with the unemployment rate which currently stands far above levels consistent with maximum employment. The weak pace of the economic recovery and the recent disappointing employment report has urged the Fed to provide further monetary accommodation at the September 12-13 FOMC meeting. In line with our (and the market's) expectations[2], the Fed strengthened its rate guidance and announced open-ended asset purchases:

- In particular, the Fed proceeded with an extension of its forward rate guidance with a promise to keep rates at exceptionally low levels at least through mid-2015, compared to the previous rate guidance for late 2014. Moreover, the FOMC highlighted that "a highly accommodative stance of monetary policy will remain appropriate for a considerable length of time after the economic recovery strengthens." This is a much stronger commitment, in the sense that the extension of rate guidance is not just the result of a significant downgrade of the economic outlook but something necessary to bolster faster growth even if the outlook begins to improve. In other words, the FOMC will stay committed to a low interest rate environment at least for a while after a faster economic recovery is evident.

- Furthermore, the Fed announced that it will continue the ongoing Maturity Extension Program (the so-called "Operation Twist") through year-end and initiate purchases of agency mortgage-backed securities at a pace of $40bn per month. Although the Fed did not proceed to additional purchases of long-term securities, it did leave the door open for further action, including new Treasury purchases. The FOMC statement indicated that "the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate in a context of price stability, if the outlook for the labor market does not improve substantially."

It is clear that the Fed is currently laying more emphasis on the labor market component of its dual mandate than before. Although FOMC participants' economic forecasts were upgraded for 2013 (Table 1.1), the Fed proceeded to a major easing step due to the lack of progress on labor market conditions. Given our forecast of a marginal improvement in the unemployment rate (from 8.9% in 2011 to 8.1% in 2012 and 7.8% in 2013), we expect the Fed to proceed to additional Treasury purchases after the completion of the "Operation Twist" at year end. The monthly rate of long-term Treasury purchases will likely be close to the $45bn pace implemented by the ongoing "Operation Twist", in addition to the $40bn purchases in agency mortgage-backed securities. Should economic growth decelerate further due to the expected fiscal restraint in early 2013, the Fed might increase further the rate of purchases, combined with a further extension of the rate guidance.

[2] *See Eurobank Research, Global Markets Special Focus Reports, "Additional easing by the Fed at its September FOMC meeting", September 12, 2012.*

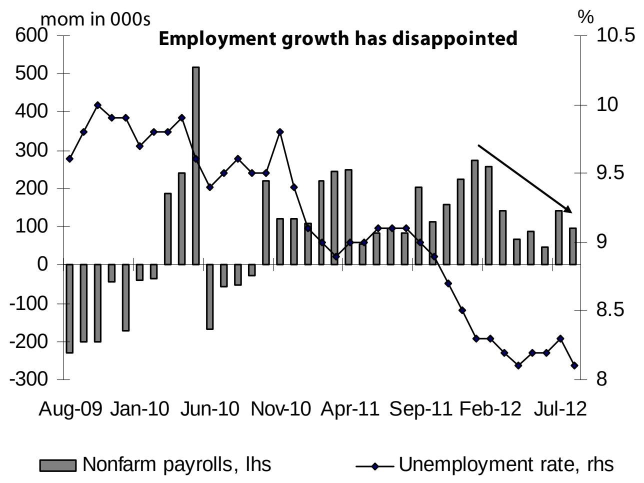
Table 1.1

Economic Projections of Federal Reserve Board Members and Federal Reserve Presidents, September 2012

	Central Tendency			
	2012	**2013**	**2014**	**2015**
Change in Real GDP				
September	1.7 - 2.0	2.5 – 3.0	3.0 – 3.8	3.0 – 3.8
June	1.9 – 2.4	2.2 – 2.8	3.0 – 3.5	n.a.
Unemployment Rate				
September	8.0 – 8.2	7.6 – 7.9	6.7 – 7.3	6.0 – 6.8
June	8.0 – 8.2	7.5 – 8.0	70 – 7.7	n.a.
PCE Inflation				
September	1.7 – 1.8	1.6 – 2.0	1.6 – 2.0	1.8 – 2.0
June	1.2 – 1.7	1.5 - 2.0	1.5 - 2.0	n.a.
Core PCE Inflation				
September	1.7 – 1.9	1.7 – 2.0	1.8 – 2.0	1.9 – 2.0
June	1.7 – 2.0	1.6 – 2.0	1.6 – 2.0	n.a.

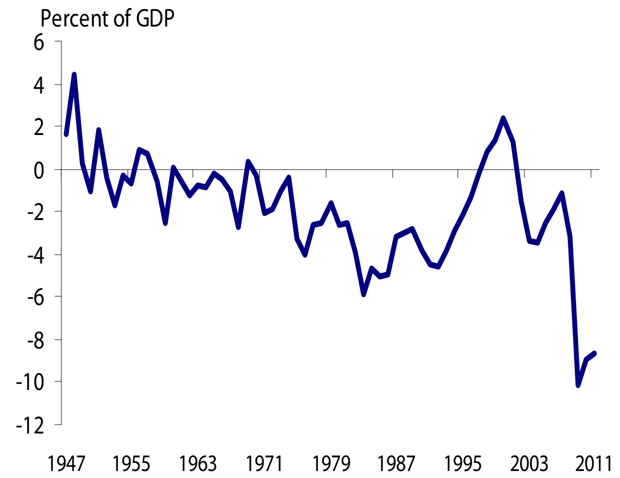
Source: Federal Reserve

Figure 1.9



Source: US Bureau of Labor Statistics

Figure 1.10: The Federal Surplus/ Deficit



Source: Fed of St. Louis

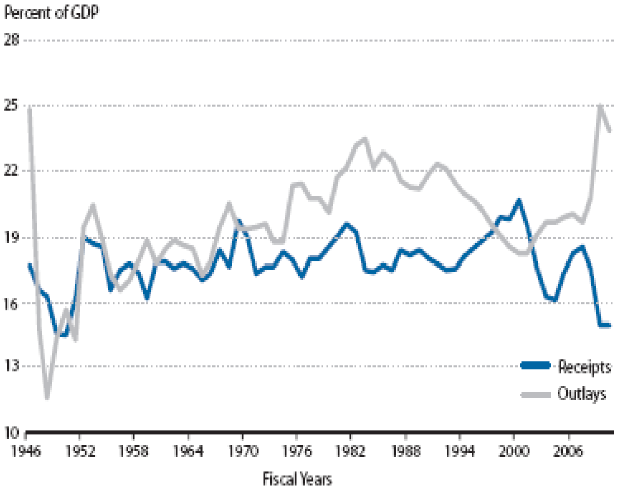
1.1 Special Focus: The US Fiscal Cliff[3]

The history of US fiscal imbalances

The US has been running persistent federal government deficits since 1970, with an average deficit as a percent of GDP of 2.5% from 1971 through 2007 (Figure 1.10). Looking back at government expenditures and revenues as a percent of GDP, we find that revenues and expenditures were a relatively constant percent of GDP from the early 1950s until the late 1960s; government receipts averaged 17.6% of GDP, while government outlays were slightly higher, averaging at 18.2%. From 1971 through 2007, government receipts stayed relatively constant as a percent of GDP, averaging at 18.2% of GDP. On the contrary, outlays increased from 17.6% of GDP during 1950-1970 to 20.6% of GDP during 1971-2007 (Figure 1.11), resulting in a 2.5% average deficit over the 1971-2007 period.

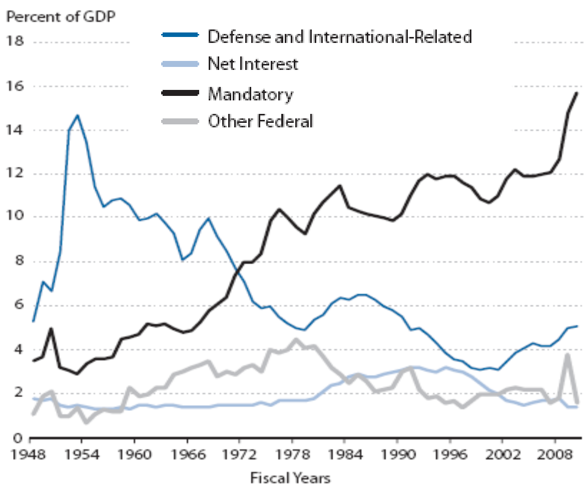
Looking back at the individual sources of outlays and receipts, we find that the composition of government expenditures by category has changed significantly since 1948. While net interest expenses and other federal spending have been stable at around 2% of GDP during 1948-2007, mandatory outlays have tripled since 1948, increasing from 3.5% of GDP to 12% in 2007 (Figure 1.12). A large part of the increase was driven by population aging[4], as more than half of mandatory spending includes Social Security benefits and Medicare expenditures. Mandatory spending has risen further to almost 16% since 2007, as the rapid increase in the unemployment rate during the financial crisis of 2007-2009 has led to a surge in unemployment benefits. In contrast, after its sharp increase during the Korean War at the beginning of 1950s, defense and international-related spending has trended down and ranging around 3-7% of GDP. As far as government revenues are concerned, corporate income and excise taxes have been on a downward trend, while social insurance and retirement revenues have increased significantly over time (Figure 1.13). Hence, the persistent deficit since 1971 is attributed to increased government spending and mainly its mandatory component, as total revenue as a percent of GDP has remained relatively stable since 1950.

Figure 1.11: Government Receipts and Outlays



Source: Fed of St. Louis, Office of Management and Budget

Figure 1.12: Federal Government Expenditures by Category

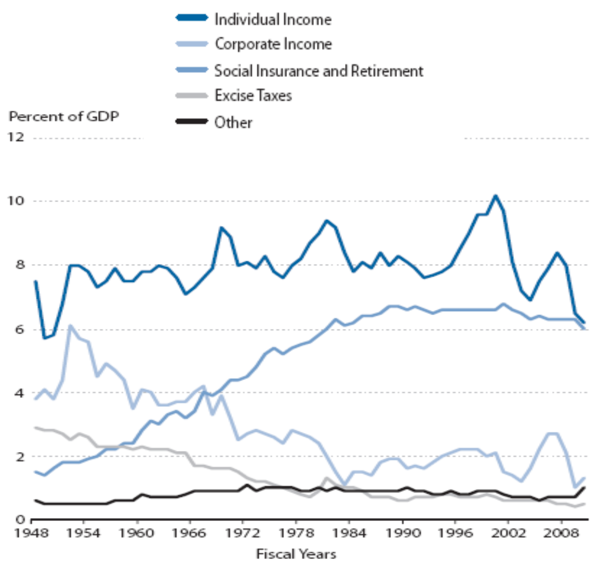


Source: Fed of St. Louis, Office of Management and Budget

3 *This Focus Note has been published under Global Markets Special Focus Reports, August 30, 2012.*

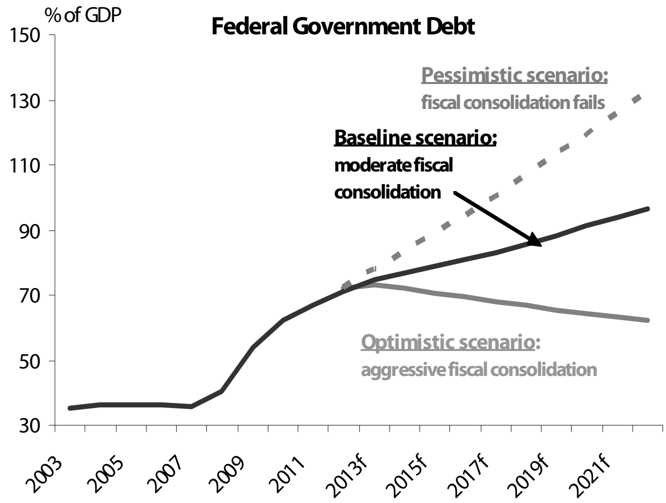
4 *The CBO projects federal spending on social security and health care to increase from 10.3% of GDP in FY2010 to 13.2% in FY2025.*

Figure 1.13: Federal Government Receipts by Category



Source: Fed of St. Louis, Office of Management and Budget

Figure 1.14



Source: Fed of St. Louis, Eurobank estimates

Fiscal restraint scheduled to occur in 2013

Under current law, several tax measures and spending policies that have been enacted or extended in recent years are set to expire at the end of 2012, resulting in a deficit reduction of about $600bn between fiscal year 2012 and 2013 (without taking into account any feedback from their impact on the US economy). About $400bn include the following changes in tax policies that will raise government revenues:

- Deficit reduction of $221bn: (a) Provisions of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 that limited the reach of the alternative minimum tax (AMT) expired at the end of 2011. The subsequent increase in taxes will be paid by taxpayers in 2013. (b) Other provisions of the 2010 tax act[5], originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the American Recovery and Reinvestment Act of 2009, expire at the end of 2012.

- Deficit reduction of $95bn due to the expiration of the 2% cut in the employee's portion of the payroll tax at the end of 2012. This provision initially went into effect in January 2011.

- Deficit reduction of $65bn due to the expiration of other provisions affecting the tax code, mainly including the expiration of partial expensing of investment property.

- Deficit reduction of $18bn due to increased tax rates on earnings and investment income for high-income taxpayers that are set to take effect at the beginning of 2013[6].

Furthermore, about $103bn include a reduction in government spending:

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[5] *Those provisions include the extension of lower tax rates and expansion of credits and deductions.*

[6] *The $18bn deficit reduction includes tax provisions of the Affordable Care Act, which comprises the Patient Protection and Affordable Care Act and the health care provisions of the Health Care and Education Reconciliation Act of 2010.*

- The automatic enforcement procedure established in the Budget Control Act of 2011 is scheduled to take effect at the beginning of 2013. According to the CBO's estimates, the reductions in both discretionary and mandatory spending should amount to as much as $65bn in 2013 and about $40bn in subsequent years.

- The expiration of emergency unemployment benefits established in the Middle Class Tax Relief and Job Creation Act of 2012 at the end of the year is expected to lower spending by about $25bn in 2013.

- Medicare's payment rates for physicians are set to be reduced at the end of the year, resulting in a decline of about $11bn in 2013.

Other changes in government receipts and outlays are expected to reduce the deficit by another $105bn in 2013, resulting in a total deficit reduction from fiscal policy changes of roughly $610bn. Should we take into account the economic feedback from changes in fiscal policy in the economy, given that the automatic response of the fiscal restraint is expected to lower taxable incomes and increase spending, the expected deficit reduction between 2012 and 2013 is about $560bn, i.e. 3.7% of GDP[7]. On a calendar year basis, the change in fiscal policy measures is even larger, resulting in a federal budget deficit reduction of about 4.7% of GDP, after taking into account the economic feedback to the change in the deficit.

The fiscal drag on US GDP growth in the short run

Based on OECD's staff calculations[8] for multipliers used to evaluate the fiscal packages in the US, a budget deficit reduction by 1% of GDP typically reduces real economic activity by about 0.5% within two years. The output cost for spending-based consolidation exceeds that for tax-based consolidation by 0.4%: a 1% GDP rise in taxes would result in a 0.3% average decline in real GDP growth, while a 1% cut in government spending would lead to a 0.7% average decline in real GDP growth. Using these estimations of the fiscal multipliers, the $607bn deficit reduction will lead to a decline of real GDP by 2%, given that about two thirds of the expected deficit reduction stems from changes in tax policies and only one third of the reduction stems from changes in government spending (Figure 1.2). The Congressional Budget Office (CBO) estimates that the fiscal cliff would weigh on real GDP growth in 2013 by nearly 4 percentage points, bringing the real GDP growth rate in calendar year 2013 down from 4.4% (CBO's growth estimate with no fiscal restraint) to just 0.5% (CBO's growth estimate under current-law fiscal policy). CBO's estimations for 2013 GDP growth include a recessionary contraction of -1.3% in H1 2013 as the fiscal restraint unfolds, before rebounding to 2.3% in the second half of the year (Table 1.2). This contraction in the first half of 2013 would probably constitute a mild US recession, like the two recent mild US recessions in 1990-91 and 2001 reported by the National Bureau of Economic Research (NBER).

Table 1.2: CBO's estimates: Growth of inflation-adjusted gross domestic product in 2013 under two alternative scenarios

(Percent at annual rates)	H1 2013	H2 2013	2013
Under Current-Law Fiscal Policy	-1.3	2.3	0.5
With No Fiscal Restraint			
Central estimate	5.3	3.4	4.4
Range	(1.0 - 9.6)	(1.9 - 5.0)	(1.4 - 7.3)

Source: Congressional Budget Office (CBO)

However, we believe that policymakers will probably act in late 2012 to remove most of the restraint called for under current law in 2013. The recent political debate on the fiscal tightening scheduled to occur after year end centers on the

7 *Congressional Budget Office, "Economic effects of reducing the fiscal restraint that is scheduled to occur in 2013", May 2012.*

8 *Barrell, R., D. Holland and I. Hurst (2012), "Fiscal Consolidation: Part 2. Fiscal Multipliers and Fiscal Consolidations", OECD Economics Department Working Papers, No. 933, OECD Publishing.*
http://dx.doi.org/10.1787/5k9fdf6bs78r
OECD Economic Outlook, Interim Report, Chapter 3, March 2009.

spending reduction under the "sequester", the 2001/2003 tax cuts and the alternative minimum tax (AMT). In particular, the House has voted to postpone most of the "sequester" automatic cuts for the fiscal year 2013 and replace them with other savings over the next ten years but the Senate has not acted yet. Moreover, both the Senate and the House have voted to extend the 2001/2003 tax cuts, but while the House insists on extending cuts on all levels of income, the Senate agrees on the extension of tax cuts on income below $250,000. Furthermore, the Senate has voted for the extension of expiring corporate tax provisions and a created "patch" for the Alternative Minimum Tax (AMT) covering both 2012 and 2013. Our baseline scenario includes the expiration of the payroll tax cuts and emergency unemployment benefits, but assumes the extension of the 2001/2003 tax cuts and alternative minimum tax rate and the replacement of the "sequester" automatic cuts by a smaller amount of spending cuts. In such a case, fiscal restraint would reduce growth by at least 1% in 2013, with the average GDP growth rate hovering around 1.8% (Figure 1.2).

Economic effects of alternative fiscal adjustment policies in the longer run

Trying to assess the economic effects of alternative fiscal policies in the longer run, we estimate a scenario analysis of US federal debt over the next ten years. In particular, we estimate federal government debt for the next 10 years using the dynamic debt identity $b_{t+1} = b_t + b_t\,(r_{t+1}\text{-}g_{t+1}) + def_{t+1}$, where b is the debt-to-GDP ratio, r is the real interest rate, i.e. the inflation adjusted interest rate on 10y Treasury notes, g is the real GDP growth rate and def is the primary deficit, i.e. the federal government budget deficit after deducting net interest payments (as shares of GDP). Our estimates are based on benchmark economic projections for real interest rates and real GDP growth to account for alternative fiscal adjustment policies, without taking into account the effect of the budgetary changes on the economy. In particular, real interest rates are projected flat for 2012 and 0.5% for 2013. For the long run, real interest rates are projected to gradually increase to around 2.0% until 2017, and stay stable around 2.5% during 2018-2022, which is near the average of the past four decades. We expect a 2.1% real GDP growth rate for 2012 and 1.8% for 2013. For the following years, real GDP increases gradually to about 2.75% per year, a rate well below its long term average in the post war period. We believe that the potential economic growth has slowed significantly over time due to labor market dislocations (higher long-term unemployment, lower job-market participation), the effect of deleveraging on the economy and a crowding-out effect on long-term growth from persistently higher public debt. In our optimistic scenario, which includes an aggressive consolidation program embodied in current law, the primary deficit is projected to decline gradually from about -7% of GDP in 2011 to about -0.5% by 2015, resulting in a primary budget surplus of 1.0% by 2022. In such a case, federal government debt would gradually fall from 73% in 2013 to about 60% in 2022 (Figure 1.14, optimistic scenario). However, this analysis does not take into account the substantial economic costs of such a sharp fiscal restraint, which would dip the US economy into a recessionary territory. The huge fiscal drag on economic activity would lead to slower revenues and higher budget deficits, so the debt reduction would not be as high as in Figure 1.14. The case of Greece is instructive in this respect, as the significant fiscal drag on the Greek economy has led to negative debt dynamics.

However, if the expected fiscal restraint was restricted by extending some of the existing policies, then federal government debt would gradually increase to about 97% over a 10-year horizon (Figure 1.14, baseline scenario). Under this scenario, the primary deficit is projected to decline slowly over the next ten years, from -7% of GDP in 2011 to about -3.0% by 2022. If all existing measures that expire at the end of the year were extended and the primary deficit stayed at the high level of around -7% of GDP, then debt would climb to about 130% of GDP (Figure 1.14, pessimistic scenario). Rising debt would induce higher interest payments on that debt, resulting in higher taxes or a reduction in social benefits and several services. Furthermore, households' savings used to finance investments in productive capital would have to be used to purchase government debt, while policymakers would not be able to use taxes and spending to tackle with potential economic downturns or financial turmoil and crises. Moreover, growing debt would increase the risk that bondholders become concerned about US public finances, diversifying away from investing in the US debt. As a result, interest rates would rise in the US, not only making it harder for the government to finance budget deficits and sustain debt, but also raising borrowing costs across the US economy, slowing investment spending and private consumption. The US dollar would weaken further, undermining the value of currency reserves around the world. Given that global growth remains highly dependent on US economic activity, slower growth in the US economy could affect global demand, which in turn could offset the positive contribution from the dollar weakness to US exports, creating a vicious cycle of negative implications for the US and the global economy.

To conclude, implementing effective consolidation and reform plans in a fragile US economic recovery will probably prove a real challenge for the US authorities. Given the recent softness of US economic data, fiscal consolidation focused on reinforcing medium-term debt sustainability should be gradual, so as not to curb growth prospects. In our view, policymakers should extend some measures that expire at the end of the year, widening the deficit in 2013 relative to what would occur under existing policies, but offsetting the changes in taxes and spending in the short run with a larger deficit reduction for the years to come. That approach to fiscal policy would minimize the short-run costs of narrowing the budget deficit rapidly and would support economic growth and employment, while at the same time minimizing the longer-run costs of allowing large deficits to persist.

2. The Euro area economy

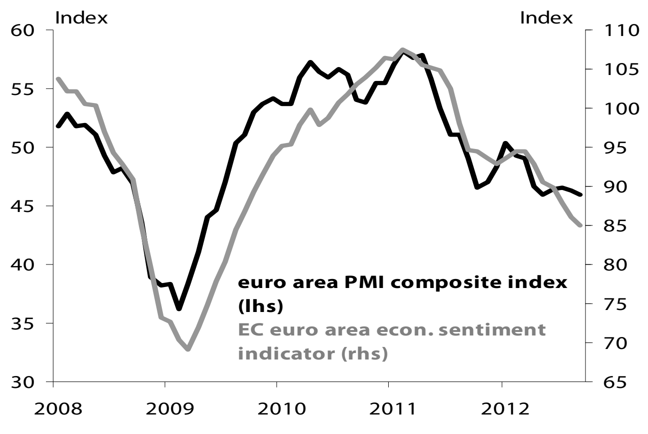
Dimitris Malliaropulos, Vasilis Zarkos

- Political hesitance to take bold steps towards a permanent resolution of the sovereign debt crisis keeps domestic demand subdued. As a result, the euro area economy is set to experience a double dip in 2012 with GDP growth hitting trough on a quarterly basis in the third quarter.
- A mild recovery is expected as we move into 2013 on the backdrop of better management of the crisis and reduced tail risks thanks to the ECB's action. Pro-cyclical fiscal policy, record level unemployment and tight lending conditions will keep domestic demand constrained. Net exports are expected to remain the main growth engine.
- While event risk has abated, the road ahead is expected to remain challenging due to the lack of a clear vision towards a closer union. In our view, the timeline for setting up a banking union will most likely prove optimistic.
- Spain faces the risk of sliding deeper into recession due to persistent headwinds, with negative implications on the execution of its reform program and smooth provision of support from the OMT program.

A double dip is expected to be followed by a weak rebound in 2013

The euro area is set to experience a double dip in 2012, as the economy is expected to keep decelerating in the second half of the year. Political hesitance to take bold steps towards a permanent resolution of the sovereign debt crisis has negative repercussions on business climate and economic activity. This is clearly illustrated by the PMI indices which have been hovering at levels well below the 50 threshold since last April. Other leading indicators reveal a similar downbeat picture (Figure 2.1). While we expected Q2 to be the worst quarter of the year and start picking up later on, we now anticipate the economy to slide deeper into recession in H2 2012, with Q3 marking the trough in quarterly growth rates. Protracted weakness has led us to revise slightly downwards our forecast for annual GDP growth to -0.5% from -0.3% a quarter earlier.

Figure 2.1



Source: Bloomberg

Looking further ahead, we anticipate the euro area economy to return slowly to growth at the beginning of 2013. We expect an improvement of economic sentiment on the backdrop of further steps towards the resolution of the sovereign debt crisis. Better management of tail risks will hopefully allow financial tensions to abate and reverse the contraction of private demand. However, continuing fiscal consolidation, a slowly healing banking sector and uncertainties along the road to a permanent resolution of the crisis are expected to allow only for a moderate economic expansion. Our baseline scenario points to annual GDP growth rate of 0.3%, revised downwards relative to our more optimistic forecast of 0.7% a quarter earlier.

Domestic demand will remain subdued, reflecting weaknesses in private consumption and muted investment plans due to reduced households disposable income and poor economic expectations. According to OECD data, fiscal consolidation is expected to gain momentum in France, the Netherlands and Portugal and remain severe in Spain and Greece dampening growth prospects (Table 2.1). Harsh labor market conditions and declining house prices (as is the case in Spain and the Netherlands) are anticipated to keep precautionary savings elevated.

Table 2.1

Cyclically adjusted budget balance as % of GDP				
	2010	2011	2012	2013
Belgium	1.4	-0.6	1.7	0.7
France	0.9	1.7	1.1	1.7
Germany	-1.7	2.3	0.1	0.2
Greece	6.8	4.2	3.6	2.6
Ireland	-14.5	16.8	4.3	0.3
Italy	1	0.3	3	1.6
Netherlands	1.6	0.3	1	1.8
Portugal	0	6.1	1.2	1.6
Spain	2.9	1.1	4	2.8

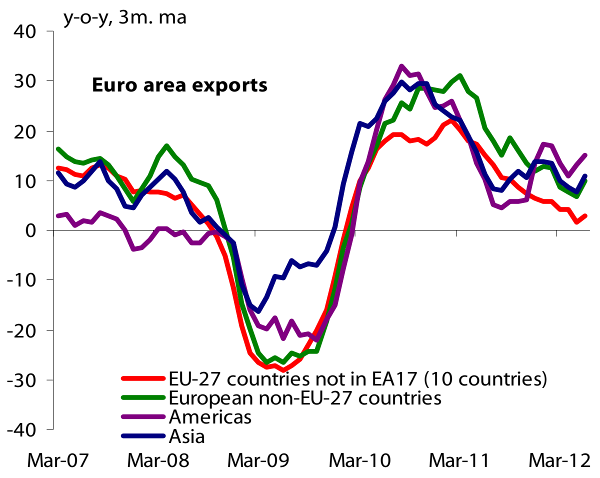
Source: OECD

Credit conditions remain a headwind to the euro area economy, as credit expansion remains anemic in most member-countries. Liquidity provision by the ECB earlier in the year has substantially removed liquidity risk from the ailing banking sector and averted the risk of a credit crunch. However, excess liquidity has failed to translate to credit expansion. Banks remain reluctant to finance the real economy due to elevated uncertainty. In addition, loan demand by the private sector is weak as households are struggling to reduce their debts and firms have largely postponed their investment plans.

Exports are expected to remain the main growth engine for the euro area. Members with particularly open economies, such as Germany and Ireland are expected to benefit significantly from solid growth in the US and several emerging markets. Export growth is mostly concentrated in Asia and the Americas. Exports to EU-27 countries not in EA17 has exhibited a declining trend (Figure 2.2) as they have been particularly affected by the recession in the euro area and by the deleveraging of euro area banks. Imports are expected to remain muted due to moderate domestic demand. Overall, we anticipate a substantial contribution to annual GDP growth from net exports both in 2012 and 2013.

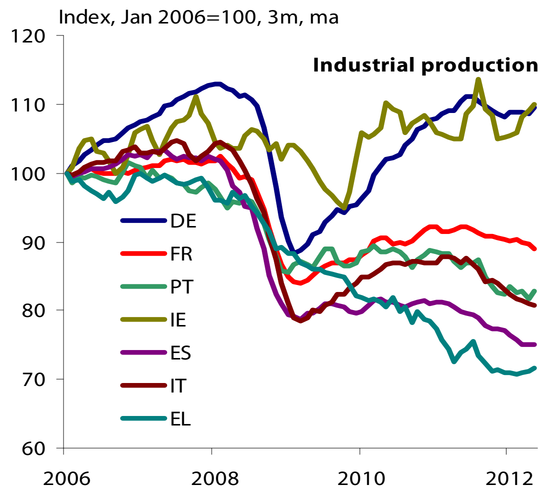
The divergent growth pattern of euro area members will remain a feature of our outlook. Industrial production data point out different output levels in several countries as a result of divergent economic fundamentals (Figure 2.3). The German outperformance is the result of a strong export sector and solid growth in emerging markets. Slowly rising unemployment in Germany illustrates the impact of anemic demand from ailing economies in the euro area on domestic economy, which is expected to experience a soft patch in Q3. However, Germany is expected to resume growth and remain the locomotive of the euro area aggregate GDP growth on the backdrop of robust domestic demand due to favorable labor market conditions and generous wage increases, ultra favorable lending rates and healthy public finances.

Figure 2.2



Source: Eurostat

Figure 2.3



Source: Eurostat

Euro area crisis: Tail risks have abated…

The ECB has been successful in addressing investors' concerns of a euro area break-up by launching the Outright Monetary Transactions program, a new scheme of short-term sovereign bond purchases. The OMT program has some remarkable differences compared to its predecessor Securities Market Program, which, in our view, increase its chances of keeping risk premia of periphery members in check. First, the ECB has committed to unlimited sovereign bond purchases under the OMT program, as long as conditionalities are fulfilled. This is in contrast to the limited and temporary nature of the SMP, which diminished its effectiveness as it eroded investors' confidence on the ECB's determination to stabilize the sovereign bond markets. In our view, the unlimited size of the OMT program effectively increases the firing power of the euro area artillery against the debt crisis, as the ECB's purchases in the secondary market add to the EFSF/ESM interventions in the primary market.

In addition, the ECB has decisively addressed subordination concerns of private creditors by accepting the same (pari passu) treatment as private investors on its bond purchases under the OMT. Given the ECB's intention to provide unlimited support to the debt burdened countries, dropping the seniority status becomes increasingly important. Markets were spooked by the ECB's preferred creditor status, especially after its denial to accept losses on the Greek PSI program. By lifting subordination concerns, the ECB may maximize the effectiveness of its bond purchases in reducing risk premia and entice private investors back to the Spanish and Italian sovereign debt markets. It also sends a strong signal that the ECB is confident about the sustainability of the euro.

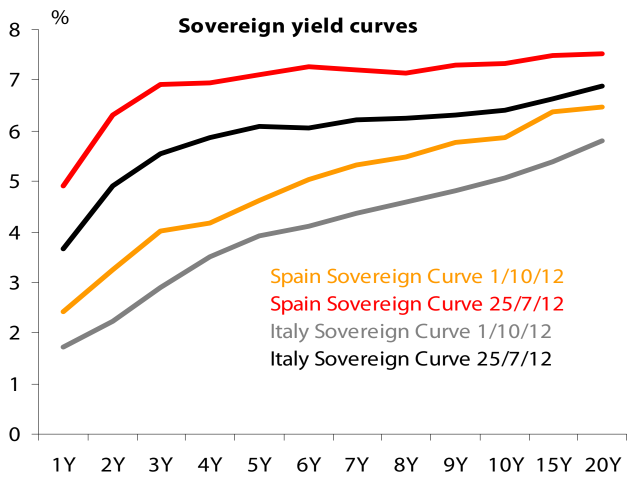
Overall, the OMT initiative may provide support to the periphery countries. Spain and Italy may benefit from lower borrowing costs and improved liquidity conditions for stressed banks, while the reduction of tail risks buys them time to proceed with their much needed reform programs. Markets have reacted in a constructive way (Figures 2.4, 2.5) as they seem to have appreciated ECB's commitment to avert self-fulfilling defaults.

…but the road ahead will likely remain bumpy.

Whereas we would assume that European policymakers will do everything they can to safeguard the euro, uncertainty about the developments on the way towards a viable solution remains high, implying that the road ahead will likely remain bumpy.

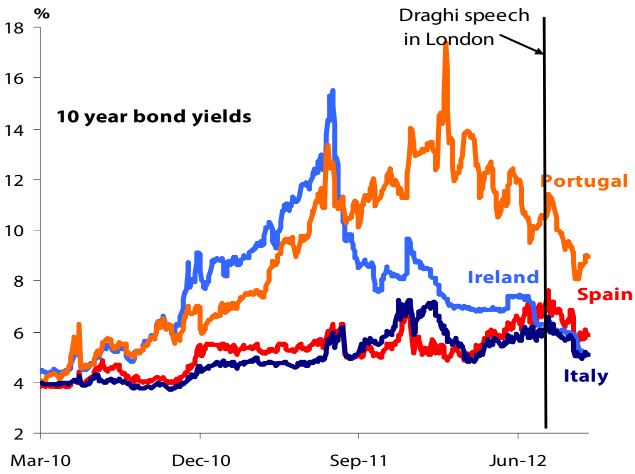
After the announcement of the OMT program, President Draghi has thrown the ball in the governments' courts, which need to apply for financial aid from the EFSF/ESM in order to take advantage of the bond purchases under the OMT scheme. Political pressure for Spain to formally request for financial aid and thus become eligible for the OMT program is building. Indeed, Spain is likely to place an official request in the next weeks. Yet, Spanish policymakers seem rather hesitant to ask for help, as they try to avoid the political stigma entailed by close monitoring of adjustment progress by troika inspectors. In our view, as long as the ECB's words alone keep yields low, Spain will likely refrain from applying for a bail-out program. However, given the persistent weaknesses of the Spanish economy and the difficulties the government is facing to get public finances under control, political resistance to request for financial assistance will sooner or later lead to a new bout of elevated sovereign bond spreads. With focus now centered on Spain, as it will be the first country on which markets will assess the ECB's commitment to preserve the euro under the OMT program, Italy will most likely remain out of the spotlight.

Figure 2.4



Source: Bloomberg

Figure 2.5



Note: 9 –year bond yields are depicted for Ireland
Source: Bloomberg

Once a country is in a program, the dependence of financial assistance by the ECB on strict conditionalities implies that the extent to which the country may take advantage from the OMT program rests with its ability to satisfy policy conditions. Yet, headwinds to weak members' economies persist, social and political reform fatigue is accumulating while further fiscal retrenchment has a negative impact on economic activity. This raises concerns about the ability of governments to hit their program targets. Government's failure to perform on their programs would have negative implications on the smooth continuation of the ECB's interventions in sovereign bond markets, bringing about periods of elevated borrowing costs.

Given the multiple sources of turbulence, the ECB may be forced to conduct large-scale transactions in sovereign bond markets in order to taper investor's fears about a euro break-up. However, the more government debt the ECB buys the more difficult it will be to pull the plug on OMT purchases, as this could raise the risk of large losses on its balance sheet. If that proves to be the case, the Bundesbank's opposition to the OMT, very likely joined by other central bankers, may become increasingly pronounced. Hence, the ECB may have to confront opposing political pressures: those pushing it to continue its purchases and those, led by Germany, pushing it to abandon the program. In that case, the dissenting views will most likely erode investors' confidence on the ECB's commitment to the OMT scheme.

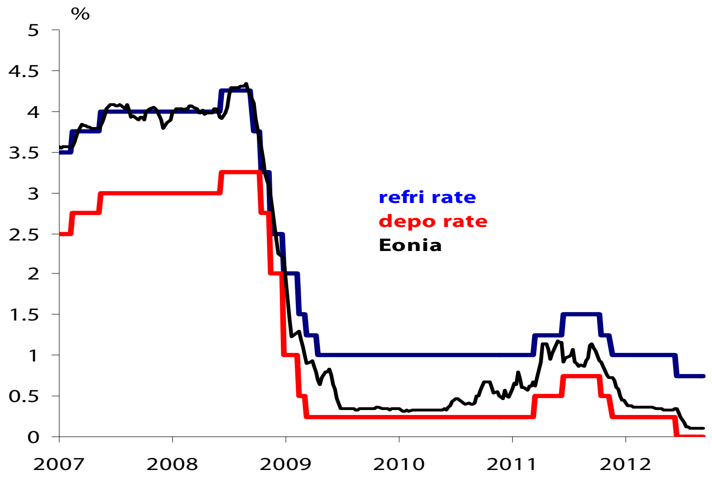
In mid September the European commission presented a proposal on the establishment of a single supervisory mechanism (SSM) for all banks of the European Union, giving the ECB the authority to supervise banks. The SSM is the first building block of a banking union which also comprises a common deposit insurance fund and a common bank resolution framework. The introduction of the SSM is anticipated to break the feedback loop between sovereign woes and bank tensions, as it is a pre-condition to allow the ESM to recapitalise banks directly in programme countries. According to the blueprint, agreement on the SSM should be reached by the end of the year. However, this timeline may prove too optimistic due to dissenting views over the modalities of the SSM. Most notably, Germany dissents with the view of including all banks under the supervisory authority of the ECB, as it would prefer to keep the politically sensitive regional banks under national authorities. In addition, safeguarding the independence of the monetary policy from the conduction of supervision duties is anticipated to be a source of friction. Even more challenging is expected to be the establishment of the other two pillars, i.e. a common deposit insurance fund and a bank resolution framework, as both imply transfers from taxpayers of creditor countries to the periphery.

In our view, growth stimulus and further mutualization of credit risks are essential parts of a permanent resolution to the euro area crisis. Successful as the ECB may be in reducing tail risks, it cannot solve the crisis alone. Growth initiatives would counterbalance the recessionary effects of pro-cyclical fiscal policy and render fiscal austerity and unpopular reforms more feasible from both a political and a social point of view. Instead, further muddling through keeps hopes of a timely exit from the crisis constrained, which could erode social cohesion and reinforce euro skeptic extreme political forces, as was the case in Greece and as is now evident in Catalonia. Although European policymakers are taking steps in the right direction, progress towards enhanced fiscal integration and a banking union will remain cumbersome. Creditor countries require centrally monitored discipline as the price for solidarity. On the other hand, debtor countries will have a hard time accepting reduced sovereignty in favor of enhanced federalism. As a result, the road ahead looks challenging and further brinkmanship between the ECB and governments is anticipated.

ECB: a policy rate cut remains likely

Another cut of the main refinancing rate by 25bps to 0.5% remains on the cards in the next three months. Given that credit conditions remain exceptionally tight in several euro area members, the ECB may need to respond by additional conventional monetary easing. However, cutting the rate of deposit facility below zero does not seem a likely option. The deposit rate has gained importance since the onset of the financial crisis. Indeed, the refi rate seems to have lost its meaning as a ceiling for overnight lending rates due to the provision of abundant liquidity through full allotment operations. Instead, the depo rate now serves as the floor for money market rates, determining the refinancing cost of banks with market access (Figure 2.6). While a low depo rate would theoretically promote inter-bank lending, the ECB may refrain from bringing the rate to negative territory as it is not confident about the consequences of negative rates on money markets.

Figure 2.6



Source: Bloomberg

3. The Japanese Economy

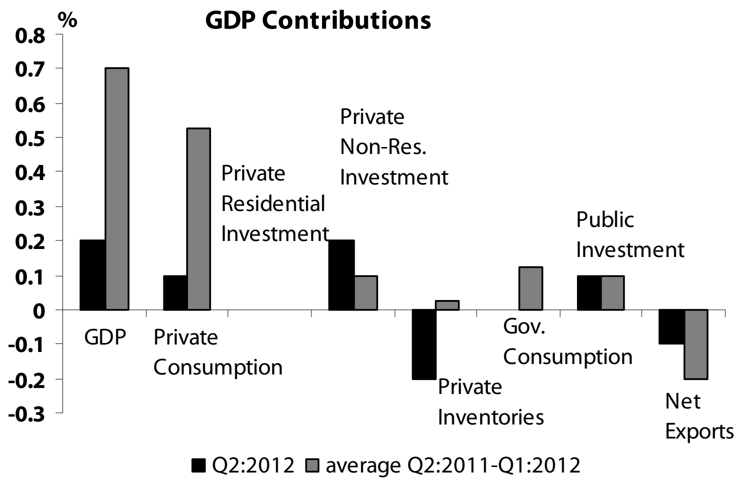
Dimitris Malliaropulos, Vasilis Zarkos

- The Japanese economy is expected to recede to a lower growth trajectory in the second half of 2012 as subdued global demand is expected to take its toll on industrial and export activity, while government measures that boosted private consumption in the first half of the year are expected to run their course. However, government financed reconstruction is expected to partially shield the economy from external shocks, allowing the Japanese economy to outperform its peers.
- Given that China is Japan's main trade partner, a boycott of Japanese products due to geopolitical tensions between the two countries would hurt seriously Japan's exports. Japan remains vulnerable to tensions in the euro area, while downside risks stem from the impact of the fiscal cliff on the US economy.
- Further action by the BoJ is likely as tensions in Europe and the Fed's QE3 may reignite yen appreciation pressures. Persistent deflation also raises scope for additional monetary easing. The latter may include further upsizing and extension of the BoJ's Asset Purchase Program.

Japanese GDP growth is expected to decline in the second half of 2012.

The Japanese economy grew by 0.2% q-o-q in Q2 (Figure 3.1), a clear slowdown relative to the first quarter of the year, when the GDP growth rate reached 1.3% q-o-q. The decline was mainly attributed to weaker private consumption and a negative contribution from private inventories. Public investment has continued supporting the economy, reflecting government-financed reconstruction.

Figure 3.1



Source: Cabinet Office

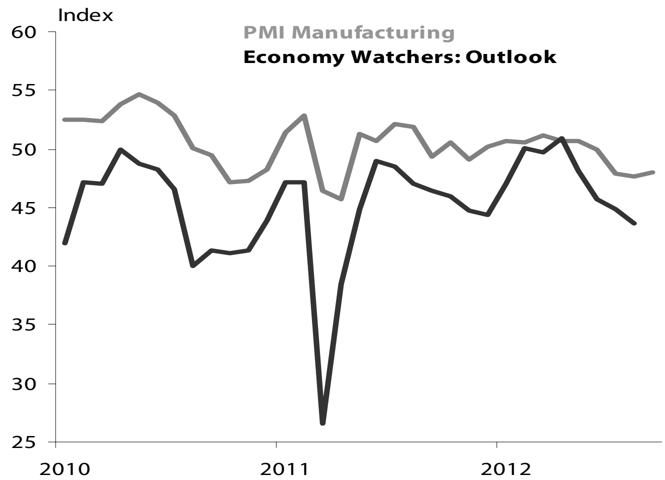
Weak economic growth is expected to persist in Q3, as the adverse global economic environment has led to a remarkable contraction in industrial production, mainly due to reduced exports (Figure 3.2). METI forecasts for industrial production point to further reduction in September by 2.4% m-o-m and a flat reading in October. As a result, we anticipate the economy to contract in the third quarter. That said, a technical recession with two consecutive quarters of negative growth is unlikely. We expect economic growth to turn positive in Q4, as policy action in Europe and monetary easing by major central banks are anticipated to improve economic confidence and avert a serious setback in exports. Nonetheless, we view geopolitical tensions between China and Japan as a downside risk. Given that China is Japan's main trade partner (exports to China represent 20% of total exports), a Chinese boycott to Japanese products could damage Japan's economy.

The exhaustion of the budget for eco-car subsidies in September is expected to weigh negatively on private consumption in the final quarter of the year. However, the impact will likely be limited as private consumption data imply that most consumers rushed to take advantage of the subsidy program in the first quarter of the year. On the positive side for GDP growth, post-earthquake reconstruction is expected to keep supporting the Japanese economy, offering a shield to weather turbulence in the global environment. About ¥8.5tn, or 1.7% of real GDP, are planned to be spent in FY 2012. As a result, the event of a sharp economic contraction is unlikely, while Japan is expected to grow in 2012 at a pace higher than its peers.

Figure 3.2

Source: Bloomberg

Figure 3.3



Source: Bloomberg

Leading indicators are in line with our view of subdued economic activity in the second half of 2012 (Figure 3.3). The PMI indicator has entered contractionary territory since June (standing in September at 48), pointing to weak manufacturing activity in the period ahead. In a similar vein, the Economy Watchers index of current conditions (a leading indicator that reflects sentiment of frontline workers such as taxi drivers and hairdressers) posted a reading below 50 for the fourth consecutive month. The component of the index concerning expectations of households and businesses for the next three months has also remained below the threshold of 50 the last four months. Overall, factoring in weak hard data and the ongoing deterioration in corporate and households sentiment, we have lowered our projection for annual real GDP growth in 2012 to 2.2% from 2.6% a quarter earlier. As regards the latest Tankan survey, the findings confirm the general soft sentiment, though they imply no further deterioration in Q4.

Looking further ahead into 2013, annual real GDP growth is expected to recede to a lower trajectory (1.2%), as reconstruction expenditures will have run their course. With respect to export activity, infrastructure spending in China, will likely decline, weighing negatively on Japanese exports. Moreover, exports to the US, Japan's second most important partner, depend on the impact of the fiscal cliff on the US economy. Exports to Europe are unlikely to recover quickly, while Japan will remain vulnerable to tensions stemming from the euro area sovereign crisis.

However later in 2013, the economy is likely to benefit from frontloading of private consumption and housing investment due to a VAT hike from 5% currently to 8% in April 2014. Moreover, a key issue for next year will be the event of renewed fiscal stimulus after the general elections set for mid 2013. Given that, according to the consumption tax bill, robust economic prospects is a precondition for the VAT hike, modest growth prospects likely prevailing at that time may fuel pressures for fiscal spending. Political parties have already announced spending plans (disaster prevention/reduction proposals) ranging from ¥100tn to ¥300tn allocated in 10 years. If these plans materialize, Japan will continue to be in a different league than most other developed countries which have been engaged in multi-annual fiscal discipline.

Further monetary easing is likely

Disappointing economic data have led the Bank of Japan to increase its Asset Purchase Program (APP) by ¥10tn to a total of ¥80tn in its September meeting (Table 1). The increase consists of ¥5tn each for T-bills and 1-3y JGBs. The timeline of purchases has been extended from June to December 2013. To facilitate the execution of the program, the BoJ also abolished the 0.1% level as the minimum bidding yield for asset purchases. Monetary easing is in line with the central bank's downward revision of the economic assessment ("the pick-up in economic activity has come to a halt"). That said, the BoJ was expected to ease monetary policy in October along with the issuance of its semi-annual outlook for Economic Activity, given that at the current juncture yen appreciation pressures have abated. Moreover, the size of the increase was also in the high end of expectations. Easing at an earlier stage was a positive surprise underscoring the BoJ's commitment to support economic growth.

Table 1: Asset Purchases Program

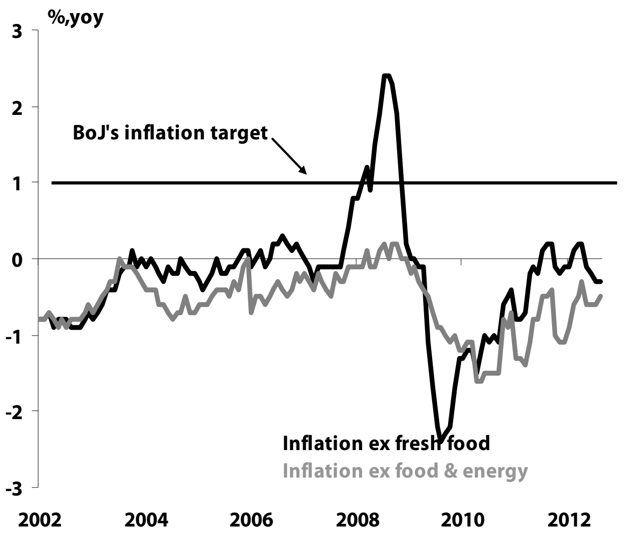
	Target (Dec. 2013)	% of total program	Realization (%), Aug 2012
Fixed Rate Fund Supplying	¥25tn	31.25	122.3
Asset Purchases	¥55tn	68.75	69.4
JGBs	¥34tn	42.5	65.5
T-bills	¥14.5tn	18.13	68.4
CP	¥2.1tn	2.63	72.6
Corporate bonds	¥2.9tn	3.63	88.9
ETFs	¥1.5tn	1.88	89.5
J-REITs	¥0.1tn	0.13	93
Total	¥80tn	100	

Source: Bank of Japan

Further actions later in the year or early 2013 are likely as yen appreciation pressures may resume. Tensions in the euro area sovereign debt crisis are likely to escalate due to the absence of a permanent solution, with negative ramifications on global sentiment, leading to a stronger yen. Furthermore, additional bond purchases by the Fed under its QE3 program raises questions on whether recent action by the BoJ will be enough to prevent a re-ignition of upward pressures on the yen. As the yen's strength favors imports to the detriment of domestic products, political pressure on the BoJ to intervene may remain high in the period ahead. Further actions by the BoJ would include upsizing the APP, accelerating the pace of monthly asset purchases and extending the maturity of bonds eligible for the program.

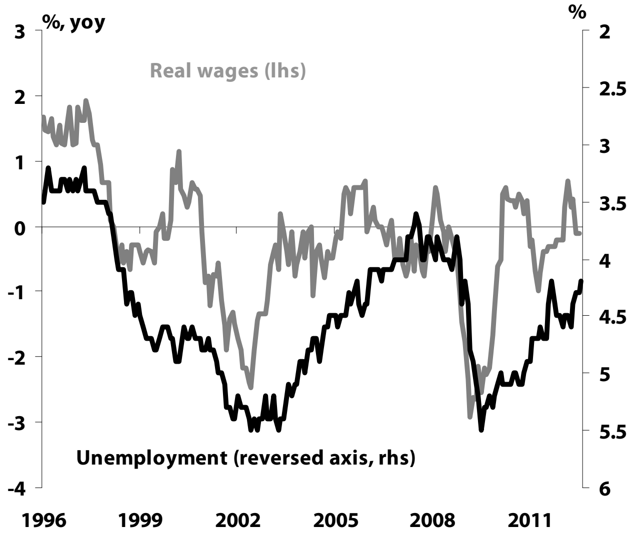
Persistent deflation raises the scope for additional monetary easing by the BoJ. The BoJ is expected to revise downwards its inflation forecasts for 2012 and 2013 in October. Inflation ex-fresh food (i.e. core inflation, the BoJ's target) hovers around 0%, well below the central bank's target of 1% (Figure 3.4). Subdued or even negative growth in real wages (Figure 3.5) points to downside pressure on the inflation rate. Upside risks to our inflation outlook (0% in 2012 and 0.2% in 2013) stem from rising energy and food prices.

Figure 3.4



Source: Bloomberg

Figure 3.5



Source: Bloomberg

4. Emerging Markets

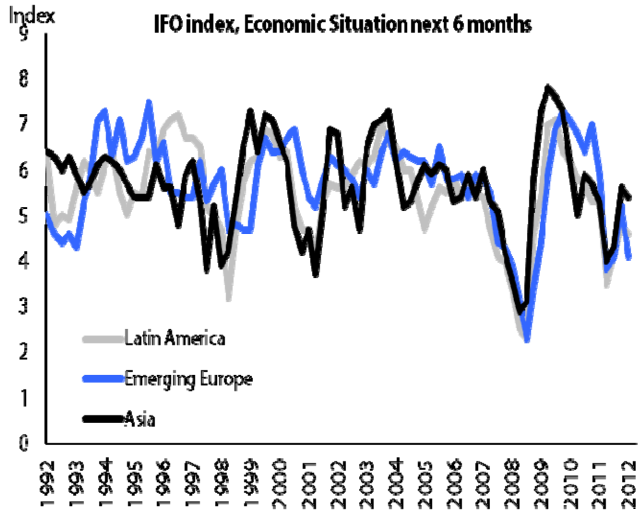
Dimitris Malliaropulos, Maria Prandeka

- Economic activity in emerging market (EM) economies remained weak in Q3 and earlier expectations for a rebound of EM growth in the second half have not materialized in most countries.
- A worse than expected deterioration in the euro area economy, the ongoing economic slowdown in China and softer data in the US and Japan were the main drivers of slowing EM growth. In some cases, notably in China, domestic policy also contributed to the economic slowdown.
- Most EM central banks still have scope for additional policy rate cuts, given that real rates are marginally positive. Moreover, inflation is not a constraint on monetary policy in most parts of the emerging world at this stage, particularly as long as it remains substantially below its 2011 peak and soft global demand continues to offset the inflationary impact of higher commodity prices.
- Recent ECB and Fed actions have reduced significantly tail risks and, particularly, those related to the euro area. This, along with policy stimulus and monetary easing in emerging markets, suggests that a firming of economic activity may be imminent. Given that a significant share of the current slowdown in EMs is structural in nature, the recovery is expected to be slow and growth rates would not return to the high levels recorded over the past decade.
- EM economic outlook is largely dependent on developments in the euro area, the handling of the US fiscal cliff and the extent of China's slowdown. Risks remain to the downside as long as the recovery in the global economy remains fragile and, thus, vulnerable to sudden shocks, all of which could dampen global demand. The situation in Europe presents the most significant source of risk going forward, particularly if conditions in the euro area prove worse than expected.

Economic activity remains subdued due to both cyclical and structural factors

With the global economic environment deteriorating over the second quarter of the year and domestic conditions softening, emerging markets' activity has been surprising to the downside. Economic activity in developing countries decelerated to a 4.6% annualized pace in Q2 from 5.4% in Q1 2012 (according to World Bank data). Meanwhile, purchasing manager surveys in most EM economies suggest that activity remained weak in Q3 and earlier expectations for a rebound of EM growth in the second half have not materialized in most countries. In addition, economic sentiment indicators across all EM regions subsided in Q3 after two consecutive quarters of improvement (Figure 4.1). A worse than expected deterioration in the euro area economy undermined EM export growth (Figure 4.2). The new export orders PMI index for Chinese manufacturers, for example, suggests subdued exports for the fourth consecutive month in September. The Chinese economy has been on a downward trend for six consecutive quarters, with real GDP growth slowing to 7.6% in the second quarter of 2012 and expected to slow down further to 7.5% y-o-y in Q3, the slowest rate since 2009. The ongoing economic slowdown in China and softer data in the US and Japan added to the picture of slowing EM growth. Countries that were heavily skewed towards exports of goods were hit harder than those that relied more on domestic demand, given that almost 40% of emerging and developing countries' exports are directed to the US and the EU. Added to that, the weakness in China's imports has hit particularly hard Latin America commodity producers and emerging Asian manufacturers. External trade conditions were not the only factor weighing on EM economies. In some cases, notably in China, domestic policy also contributed to the economic slowdown. A policy induced correction in the real estate market and a structural shift towards domestic demand are two of the main factors that led the Chinese economy to a gradual slowdown. Apparently, the Chinese government seems to accept the continued downward adjustment of growth expectations, since a more moderate performance of the economy is healthier and more sustainable. Indeed, many EM countries try to rebalance their economies towards domestic demand and, thus, reduce their dependence on exports in order to be less vulnerable to external shocks.

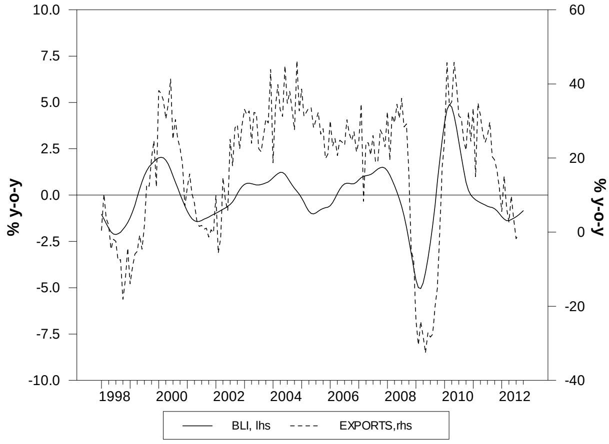
Figure 4.1



Source: Ecowin

Figure 4.2

BRICs Leading Indicator* & Exports



** 3 month forward*

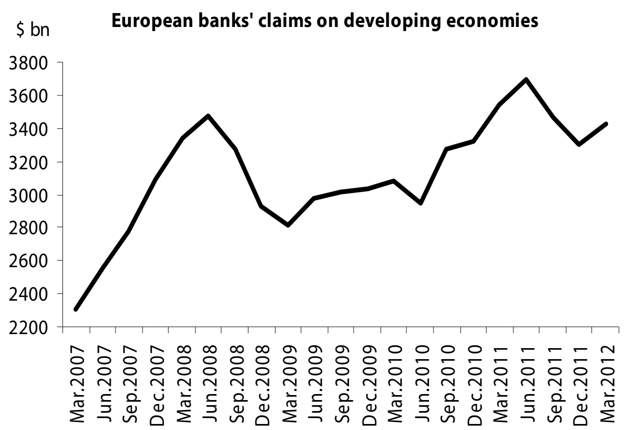
Source: Eurobank Research

The volatility of capital flows to emerging markets has increased over the past year

In the meantime, the release of good economic news early in 2012, along with the effect of the ECB's unconventional measures, led to an improvement in the global economic sentiment. Global risk aversion has declined, helping emerging market assets to rebound. As a result, net capital flows to emerging markets rebounded significantly over the first four months of 2012, regaining much of the loss incurred during the second half of 2011. Since the beginning of May, though, renewed concerns about a likely euro area break-up have reversed most of the gains witnessed in emerging equity markets over the first four months of the year. The increased market volatility triggered new capital outflows from EMs. According to the World Bank, gross capital flows to developing countries fell by about 40% in May m-o-m, with the decline concentrated mainly in bond and equity issuance. Capital flows recovered again in July to their April levels, due to improved financial market sentiment and in July were 9% above their levels a year ago. However, total capital flows during the first eight months of the year stand 16.8% below the corresponding level in 2011. European banking sector deleveraging has weighed the most on EM capital flows. Bank of International Settlement (BIS) data on cross-border bank claims indicate that in the second half of 2011, European banks' claims on EM economies (which account for about 20% of their GDP) decreased almost $400 billion (Figure 4.3). This was the biggest cumulative decline since 2008. Meanwhile, in the first quarter of 2012, European banks increased their claims on EM economies for the first time since June 2011, as a result of the ECB's massive 3-year repurchase operations. Despite this increase, the adverse developments in the euro area in Q2 continued to undermine bank lending conditions in emerging economies.

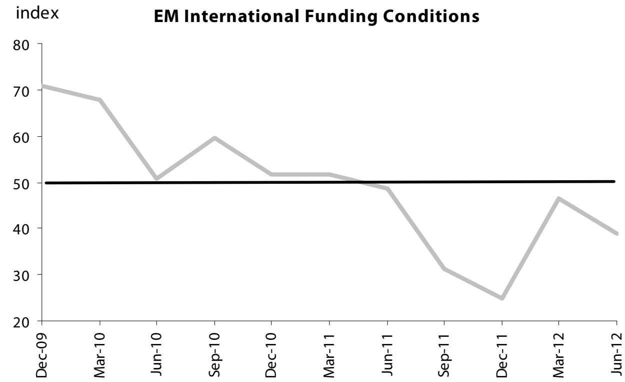
This is also confirmed by the latest Emerging Market Bank Lending Survey, conducted by the Institute of International Finance (IIF). Indeed, the IIF index of emerging markets bank lending conditions rebounded in Q1 2012 for the first time since the third quarter of 2010. However, this rebound also proved short-lived, as the index remained unchanged at 48.6 in Q2 2012 (below the threshold of 50 that indicates improvement), implying a net deterioration in overall emerging market lending conditions for a fourth consecutive quarter. Importantly, the IIF's index of international funding conditions declined to 39.0 in Q2 2012 (from 46.5 in Q1), confirming that spillovers from European banking sector deleveraging have worsened over the second quarter (Figure 4.4). As it was expected, the tightening in international funding conditions was most evident in Emerging Europe, with 50% of the banks in the region reporting a tightening.

Figure 4.3



Source: BIS

Figure 4.4



Notes: Values above 50 indicate improving conditions. Values below 50 indicate deteriorating conditions. The sample size more than doubled in 11Q1, introducing a statistical break in the data.

Source: IIF

Subdued capital flows to EM for 2012, but more positive prospects in the medium-term

According to the Institute of International Finance, total net capital inflows to EM are estimated to have been $1,093 bn in 2011, down from $1,157 bn in 2010 (Table 4.1). For 2012, net total capital inflows are projected to decline further to $959 billion (12.3% below those recorded in 2011), as both foreign direct investment (FDI) and bank lending are expected to contract, undermined by the elevated uncertainty in the global economy and the ongoing deleveraging by large global banks, particularly in the euro area. Only net portfolio inflows are expected to increase, mainly due to interest rate and bond yield differentials between emerging markets and advanced economies, as investors hunt for yields abroad which are higher than those available at home. Admittedly, recent policy actions by the ECB and the Fed raised expectations for a rebound of capital inflows to EM. It should be noted though that although inflows to EM rebounded during the launch of QE1, almost stalled during QE2. Hence, we should be cautious about the sustainability of the positive impact of those actions on EM capital inflows. In our view, in the short-term, the risks for capital flows to EM are tilted to the downside, as there are still some risks for disruptive events in the euro area that would no doubt trigger new capital outflows towards safe-haven assets. European investors have historically been important suppliers of capital to EMs.

Despite the volatile market environment, medium term prospects for capital flows to emerging economies are strong, as economic fundamentals in EM will continue to be robust and growth prospects are expected to remain substantially higher than in advanced economies. Moreover, monetary policy in EM is expected to remain tighter than in advanced economies, attracting portfolio investment flows and debt flows from other private creditors, particularly flows into bond markets and deposits into local banks, which account for about one third of total inflows.

Table 4.1

Capital flows to emerging markets

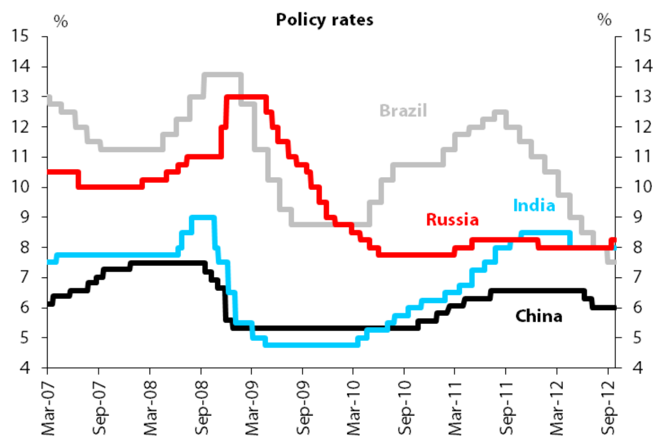
($ billion)	2010	2011e	2012f	2013f
Total inflows, Net	**1,157**	**1,093**	**959**	**1,045**
Private flows, net	1,088	1,030	912	994
Equity investment, net	607	545	560	577
Direct equity investment, net	459	524	499	481
Portfolio equity investment, net	148	21	61	96
Private Creditors, net	481	485	353	417
Commercial banks, net	159	143	73	123
Non banks, net	322	342	279	294
Official flows, net	69	63	46	51
International financial institutions	31	25	15	17
Official bilateral creditors	38	39	31	34

Source: Institute of International Finance

Monetary policy will continue to be supportive for growth

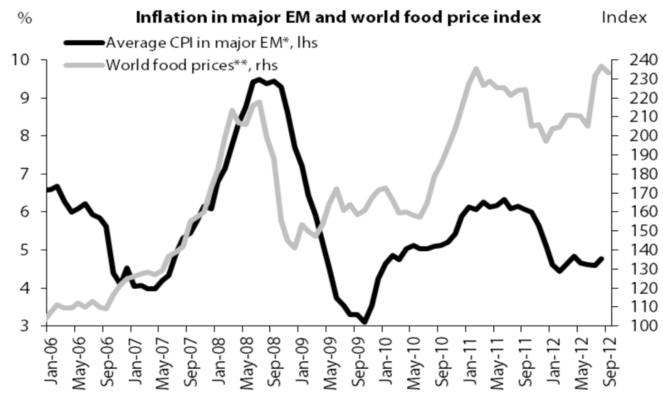
Against the background of weaker global growth outlook, most central banks in emerging markets proceeded with further interest rate cuts in the past few months (Figure 4.5). Meanwhile, following the recent spike in global food and commodity prices, average headline inflation across major EM economies has risen slightly in August to 4.8% y-o-y from an average of 4.6% over the first seven months of the year (Figure 4.6), creating a temporary curb on policy easing. This is particularly true in Russia, which raised benchmark interest rates by 25bps recently in an attempt to rein in inflationary pressures so as to meet its central bank's inflation target. We believe, however, that inflation is not a constraint on monetary policy in most parts of the emerging world at this stage, particularly as long as it remains substantially below its 2011 peak. Moreover, soft global demand is likely to continue to offset the inflationary impact of higher commodity prices. Also, most EM central banks still have scope for additional policy rate cuts, given that real rates are marginally positive, in contrast to negative real rates prevailing in advanced economies. Hence, we expect additional rate cuts in most EM countries in the rest of the year.

Figure 4.5



Source: Bloomberg

Figure 4.6



** Brazil, Chile, China, India, Indonesia, Philippines, Russia, Singapore*

*** The Economist Food Price Index*

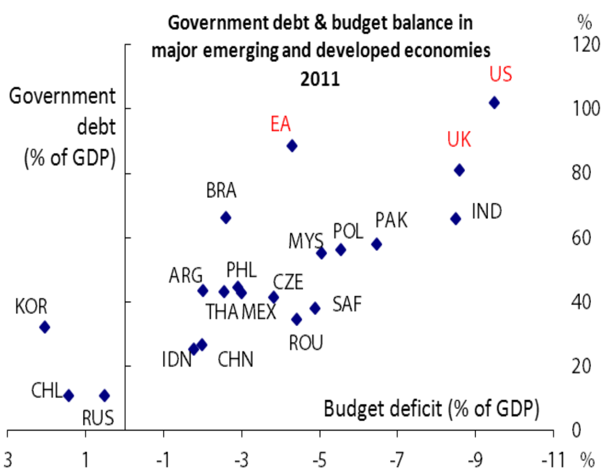
Source: Ecowin

Growth in EM economies is expected to rebound only slightly in Q4 and in 2013

Recent ECB and Fed actions have reduced significantly tail risks and, particularly, those related to the euro area. This, along with policy stimulus and monetary easing in emerging markets, suggests that a firming of economic activity may be imminent. Our BRIC's leading indicator, which has improved slightly over the past month (Figure 4.2), implies a slight pick up of EM exports. However, with fiscal consolidation continuing in most developed markets, growth rates of exports will remain relatively modest and below historical standards. Given that a significant share of the current slowdown in EM is structural in nature, the recovery is expected to be slow and growth rates would not return to the high levels recorded over the past decade. The outlook is largely dependent on developments in the euro area, the handling of the US fiscal cliff and the extent of China's slowdown. Generally, risks remain to the downside as long as the recovery in the global economy remains fragile and, thus, vulnerable to sudden shocks, all of which could dampen global demand. Moreover, the situation in Europe presents a significant source of risk going forward. If conditions in the euro area prove worse than expected, GDP growth in emerging economies would be much weaker than currently expected, reflecting mainly a drying up of international capital flows, trade effects and a significant degree of deleveraging of European banks.

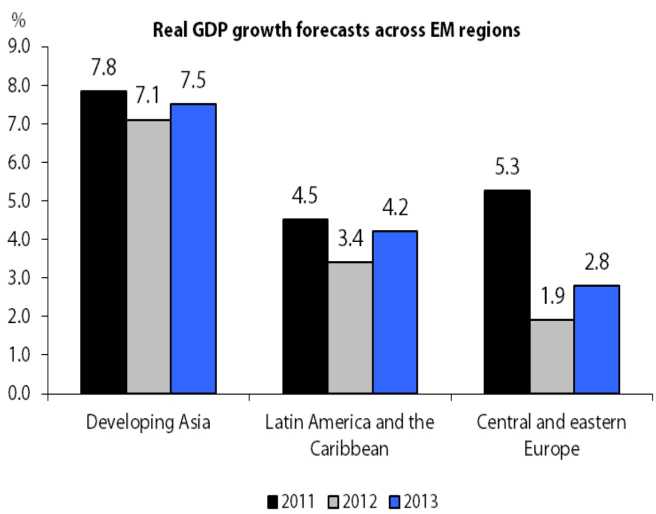
Nonetheless, EM will continue to grow much faster than advanced economies. Economic prospects in most developing regions remain brighter than in the developed world, as EM are better placed to face adverse shocks and has the resources and policy space to counteract their negative effects on growth. Their relatively healthy fiscal situation leaves them room to provide a cushion for growth in the event of a sudden shock to their economies (Figure 4.7). As we have already mentioned, there is also significant scope for monetary easing. According to the latest IMF forecasts, in 2012 growth in emerging and developing economies is expected to moderate to a still buoyant rate of 5.6% from 6.2% in 2011 and rebound slightly to 5.9% in 2013. Emerging Asia will retain its status of the world's fastest growing region, with growth of 7.1% this year versus 7.8% in 2011 (Figure 4.8). The region's high reliance on exports means that its countries are vulnerable to a prolonged softening in global demand. In Latin America, growth will be supported by sound macroeconomic policies and resilient domestic demand. However, subdued growth in the US –a key trading partner- during the remainder of 2012 will weigh on the region's growth. Moreover, China's ongoing slowdown also creates downside risks, particularly for the commodity exporters in the region. As the region most exposed to the troubles in the euro area, Emerging Europe's economic performance is expected to be the weakest in the emerging world. The recession in the euro area will weigh on the region's, with negative implications for trade, investment and bank financing. Therefore, its economic outlook will rely mainly on the depth of the euro area's recession.

Figure 4.7



Source: IMF

Figure 4.8



Source: IMF

4.1 China Economic Outlook

Dimitris Malliaropulos, Maria Prandeka

- A weaker global economic environment, a policy induced correction in the real estate market and a structural shift towards domestic demand led the Chinese economy to a gradual slowdown for six consecutive quarters.
- The release of dismal economic data in the third quarter underscores risks that the full-year growth rate may slide to its lowest in more than one decade.
- The government seems to accept the continued downward adjustment of growth expectations, since a more moderate performance of the Chinese economy is healthier and more sustainable. However, insufficient policy support could create significant downside risks to growth.
- We expect policy loosening to become more visible in the next few months, with the impact on the real economy to be felt only gradually. Therefore, growth is most likely to stabilize rather than recover in the second half.

Overview

A weaker global economic environment, a policy induced correction in the real estate market and a structural shift towards domestic demand led the Chinese economy to a gradual slowdown for six consecutive quarters, with real GDP growth slowing to 7.6% in the second quarter of 2012 from 8.1% y-o-y in Q1 2012 and 8.9% in Q4 2011 (Figure 4.1). The global slowdown, mainly related to the euro area crisis, made the deceleration more pronounced, slowing the economy more than expected and probably more than the authorities had intended. Following dismal economic data in the third quarter, China's second-half recovery looks to be on hold. Indeed, the data underscore risks that the full-year growth rate may slide to its lowest in more than one decade. Meanwhile, policymakers have held back on stimulus this year, particularly in the first half, in their attempt to rein in the property market boom and avoid a jump in bad debt. The government seems to accept the continued downward adjustment of growth expectations, since a more moderate performance of the Chinese economy is healthier and more sustainable. Further policy delay, however, could create additional downside risks to growth. We expect policy loosening to become more visible in the next few months, with the impact on the real economy to be felt only gradually. Therefore, growth is most likely to stabilize rather than recover in the second half of the year.

Figure 4.1

Source: Bloomberg

The slowdown continues in Q3 2012…

In contrast to the common expectation that China's economic growth should bottom in the second quarter, and despite some improvement in June, July and August activity indicators proved disappointing, showing that policy easing so far has not been strong enough to reverse the economy's weakening. Industrial production, the most reliable monthly proxy for overall activity and highly correlated with GDP, decelerated further to 8.9% y-o-y in August, its lowest rate since 2009, from 9.2% y-o-y in July and an average of 9.5% in Q2 and 11.6% in Q1 (Figure 4.2). Weak exports and slower investment activity continue to be the main causes of slower industrial production growth. Meanwhile, China's official manufacturing PMI index confirms that a second half recovery remains distant. The index slipped to 49.2 in August, down 0.9 percentage points from July, the first time in the past nine months to see a reading below the 50 threshold that indicates expansion. In September the index edged up to 49.8, but still remains below the threshold of 50, suggesting that industrial activity remains weak.

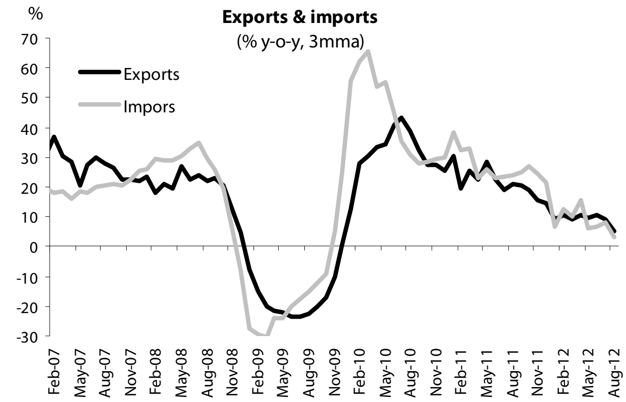
Figure 4.2

Source: Ecowin

With respect to China's trade, the deterioration of the external environment in conjunction with weak domestic demand is taking an increasingly significant toll on trade growth. Over the first half of the year, nominal export and import growth came in at an average of 9.7% y-o-y and 8.3% y-o-y, down from 20.6% and 25.5% in 2011, respectively (Figure 4.3). In the meantime, in July, export growth decelerated sharply to 1% y-o-y from 11.3% y-o-y in June and stabilized slightly up at 2.7% y-o-y in August. While export demand weakened across all markets, the slowdown of demand from the EU constituted the major drag on exports (Figure 4.4). In particular, exports to the EU, which accounts for 17% of total Chinese exports, declined by about 20 percentage points in August compared to a year earlier. Although growth of exports to the US remains at a positive territory, the decelerating trend is similar to that of the EU over the past few months. Even shipments to ASEAN, which is the strongest contributor to overall export growth and had remained resilient so far, declined significantly over the summer (10.3% y-o-y in August compared to 13.3% y-o-y in July and 19.8% y-o-y in Q2). Softer global demand combined with subdued expectations for new export orders point to weak exports for the rest of the year.

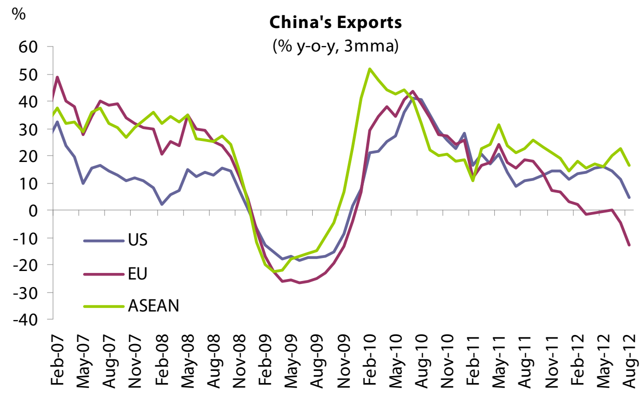
Import growth was dragged by industry destocking, tepid domestic demand and faltering exports, falling to -2.6% y-o-y in August from 4.7% y-o-y in July. The weakness in China's imports has mainly been driven by a broad-based slowdown in major commodity imports, which is attributed to both volume and price drops. Weak imports volume of major commodities reflects mainly the sustained weakness of investment demand, as well as continued slowing of stockbuilding on the back of weak industrial activity. In terms of volumes, crude oil imports turned negative, falling by 12.5% compared with 12.4% y-o-y growth in July. Imports of steel products continued to fall, declining by 11% y-o-y in August (July: -6.5% y-o-y), while iron ore import growth slowed to 5.7% y-o-y from 6.1% y-o-y in July (Figure 4.5).

Figure 4.3



Source: Bloomberg

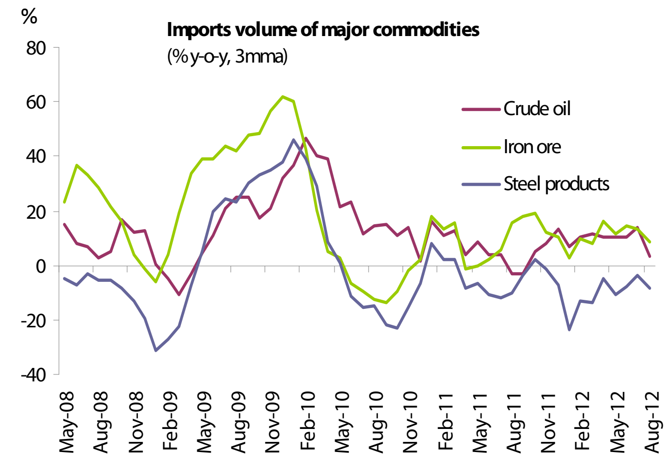
Figure 4.4



Source: Ecowin

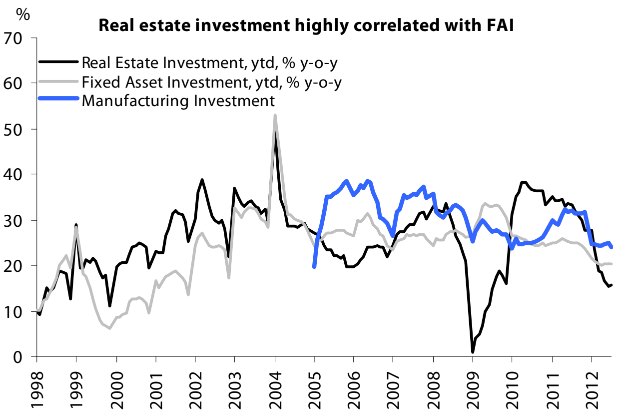
With respect to investment, there are two main reasons behind the marked slowdown of investment growth: the moderation in manufacturing mainly due to the exports slowdown and the deceleration in real estate investment as a result of persistent tightening measures to ease property price increases. Funding constraints have also curbed investment growth. The slowdown of gross fixed capital formation was particularly felt in manufacturing and real estate (Figure 4.6). Fixed asset investment excluding rural households and not adjusted for inflation rose 20.2% in the first eight months of 2012. That was the weakest increase for the Jan-August period since 2001. Property development investment for the first eight months of the year was up 15.6% from a year earlier compared to 27.9% in 2011, while manufacturing investment increased 23.9% year-to-August, down from 31.8% y-o-y in 2011.

Figure 4.5



Source: Ecowin

Figure 4.6

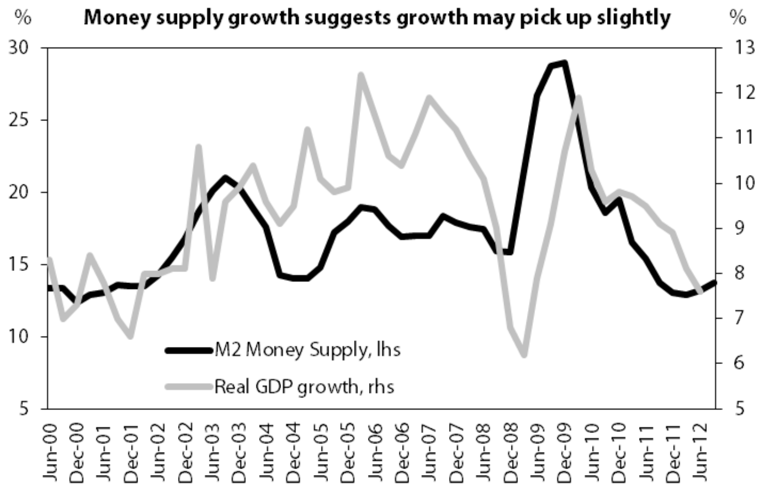


Source: Ecowin

…suggesting unchanged or weaker GDP growth in Q3 compared to the second quarter

Latest Chinese data releases confirm that Q3 GDP growth is most likely to remain unchanged or even slow down further compared to Q2, on the back of weakening external and domestic demand and inventory cuts. Indeed, based on the linear relationship between IP and GDP growth, we estimate real GDP growth to decline only modestly to 7.5% y-o-y in Q3 2012 from 7.6% y-o-y in Q2. In Q4 growth may pick up slightly as it is implied by money supply growth, a forward-looking indicator for growth, which appears to have bottomed. It climbed to an average of 13.7% y-o-y in July and August from an average of 13.2% y-o-y in Q2 2012 and 12.9% y-o-y in Q1 2012 (Figure 4.7).

Figure 4.7



Source: Bloomberg

Both fiscal and monetary policy action has been quite muted so far this year…

Weak activity growth in July and August increased the downside risks on the annual GDP growth forecast and fueled renewed fears of a possible hard landing of the economy. Moreover, it escalated the risk that the government will miss its full year growth target of 7.5%. In the meantime, both fiscal and monetary policy action has been quite muted so far this year, as the government is trying to rein in the property market boom and avoid a jump in bad debt. In fact, policymakers tolerate slower growth in order to rebalance the economy and transform the growth model. The central bank, in particular, has held off from monetary policy loosening since early-July when it cut benchmark interest rates for the second time in less than a month. Besides, the reserve requirement ratio has not been cut since May (the central bank lowered the reserve requirements three times since November 2011 by 50 basis points each time). Furthermore, in its attempt to strike a balance between unwinding the last fiscal stimulus and adjusting policies to support the slowing economy, the government has not implemented sufficient growth stimulating measures in order to turn the growth trend around. In other words, it seems that policy easing so far has worked to avoid a deeper downturn of China's economy, but not effective enough to trigger a rebound.

…but the government is expected to roll out more measures to stabilize growth in the coming months, though any measure will be targeted and cautious

Looking forward, we believe that the government will do what is necessary to bolster growth for two reasons. First, as the leadership transmission comes near, the authorities should be decisive to act firmly and effectively to prevent a prolonged slowdown in growth. Second, as we have already mentioned, the exports outlook for the rest of the year remains grim. This is particularly worrisome for policymakers as the export sector is labour-intensive. This implies that a continued slowdown in exports would result in a significant deterioration in job market conditions. Hence, policymakers are likely to be more determined to take measures to support growth and ensure social stability.

In fact, if needed, China has considerable room to ease monetary and fiscal policy to support growth. Unlike advanced economies, China has comfortable leeway to cut interest rates as they are still at a relative high level (for example the RRR for large banks stands at 20%) (Figure 4.8). Moreover, China's fiscal situation is relatively healthy. The budget for 2012 calls for the fiscal deficit to rise to 1.5% of GDP this year from 1.1% of GDP in 2011, which is still a low level. Overall government debt remains at comfortable levels, despite the increase in local government borrowing. National government debt (including local governments' debt) is about 45% of GDP, well below that of advanced economies, enhancing the government's capability to respond to a marked slowdown in growth. In addition, in a worst case scenario, some of the tightening measures targeting the calming down of the property market could be withdrawn. The problem is that both monetary and fiscal easing entails some drawbacks for the Chinese economy at this stage. Specifically, monetary easing will underpin a rebound in the property market, something that will not be greeted as good news by the government, given its commitment to contain house prices. Meanwhile, fiscal easing will have to rely mainly on investment and, particularly, infrastructure investment in order to have a significant impact on the economy. Apparently, this is not desirable at the moment, given China's attempt to rebalance the economy away from investment and towards consumption.

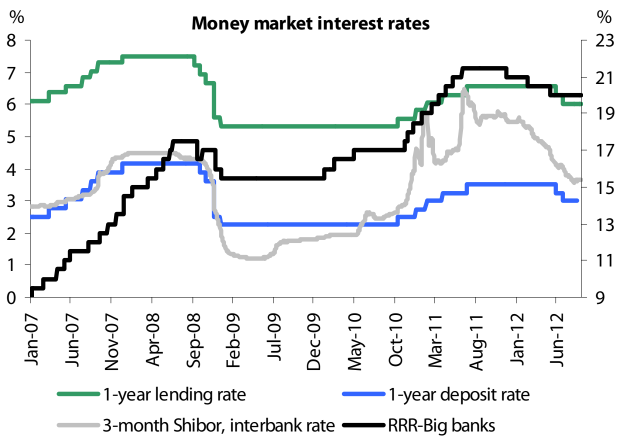
That said, we believe that any policy stimulus in the coming months will likely be moderate and targeted. The impact of such stimulus will most likely be felt only gradually. In particular, the government is tilted towards the following three areas:

1) *More monetary easing*. Weak growth should leave room for additional interest rate cuts. We expect the PBoC to proceed with two additional 25bp cuts to its leading benchmark rates in the rest of the year. In addition, we expect the reserve requirement ratio to be cut by 100-150bp before year end so as to keep liquidity in the banking system abundant. With respect to the slight increase in inflation in August (2.0% y-o-y from 1.8% y-o-y in July), we believe that it is not a constraint on monetary policy at this stage, particularly as long as it remains substantially below the central bank's target of 4.0% (Figure 4.9). The acceleration of inflation was led by an increase in food inflation from 2.4% y-o-y in July to 3.4% y-o-y in August, mainly due to bad weather in large parts of China that drove vegetables prices higher. We believe that the moderating trend in CPI inflation is due to continue amid a slowing economy and the index is likely to remain below 3% in the following months. Our full year forecast for 2012 is 2.9% y-o-y, down from 5.4% in 2011.

2) *More investment projects*. The NDRC, China's top planning agency, recently approved more investment projects, such as urbal subway lines, totaling CNY 1 trillion. Furthermore the State Council has announced a subsidy program (totaling 36.3 billion yuan) to encourage consumption in home appliances.

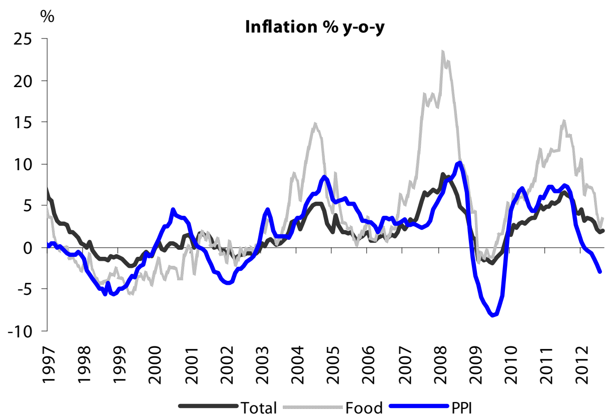
3) *Export tax rebate and consumption subsidies*. Policymakers have already approved measures to stabilize growth in foreign trade. These measures include the speed up of the export tax rebate process for companies, the expansion of trade financing for small enterprises, the increase of credit to qualified exporters, the optimization of the administrative procedures and the reduction of related costs. They may also introduce measures to support consumer spending, including lower taxes, cheap credit and cash subsidies.

Figure 4.8



Source: Ecowin

Figure 4.9



Source: Bloomberg, Ecowin

Growth still in a soft landing territory but risks are biased to the downside

To sum up, China's economy has entered a period of subdued growth, with weak exports, credit and property prices. The three decades of double digit growth is over and China's potential GDP growth is gradually slowing below 8.0%. The rest of 2012 will continue to be dominated by the persistent weakness in external demand and further property market adjustment, as the government recently reaffirmed its commitment to curb speculative activity in the real estate market. This adherence to the restrictive measures will most likely keep growth lower than it would have otherwise been. We project growth to moderate to 7.7% in 2012 and 2013 from 9.3% in 2011. Risks are biased to the downside and particularly if the government fails to deliver further sufficient measures and, what's more, implement them consistently and effectively in the next few months. In any case, a sustained economic rebound is far from assured, given that risks still remain mainly in the export sector.

Main risks to our China outlook

A deteriorating situation in Europe

The situation in Europe presents a significant source of risk. A worsening of the euro area crisis means a much weaker GDP growth than our baseline scenario, reflecting mainly trade effects and a decline in capital inflows. Risk aversion could escalate further and financial conditions would become tighter. The persistent fragility of the global economy would dampen demand for Chinese exports, which still account for a significant percentage of GDP (about 25%). Given that China's exports to the EU make up about 20% of total Chinese exports, we estimate that a 1 percentage point decline of European Union's real GDP growth would reduce China's export growth to the EU by about 5% and, consequently, shave about 0.3 percentage points off China's GDP growth.

Insufficient domestic policy support and a non-smooth transmission to a more consumption-driven model and consequently a lower trend growth

While rebalancing the economy away from its dependence on exports and investment, China is facing the challenge to sustain growth through a soft landing. The prospects for a gradual slowdown are high, since there is enough room for policy to respond to downside risks. However, there are significant concerns that growth could slow too quickly, should policymakers prove too slow to address ongoing growth risks.

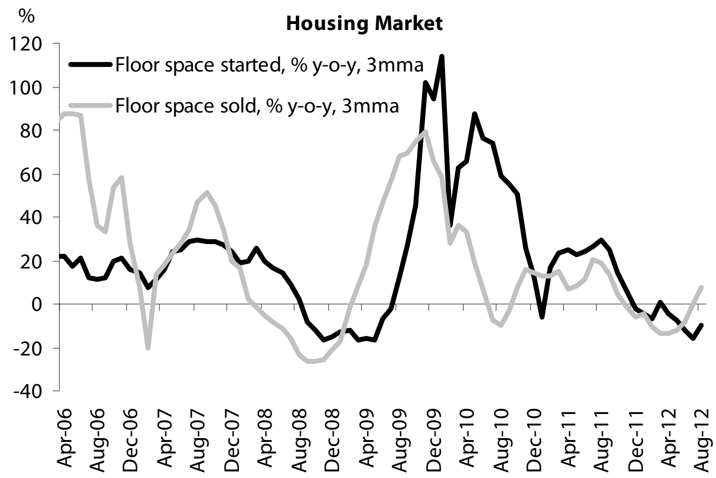
Risks related to political transition

There are some uncertainties surrounding the change in political leadership next March. The leadership change means that both outgoing and incoming policymakers may be conservative and try to deliver stable growth to ensure a stable leadership transition. Hence, policymakers may delay new spending plans. Furthermore, top leaders may have different opinions regarding the ideal growth stabilization rate.

The risk of a sharp correction in the real estate market has abated significantly

Over the first half of the year, one of the major risks to China's growth outlook was a sharp correction in the real estate market. However, in our Global Edition in June 2012, we had noted that this was not our baseline scenario. In fact, the government has managed an orderly correction in the property market, given that property policies have been relaxed at the margin. More specifically the government has been fine-tuning policies to support first-time home buyers and developers of affordable apartments. It has been also providing support to social housing construction. Recent data released point to a nascent recovery. New home prices in China rose in 25 out of 70 major cities from May to June. Additionally, they dropped in only 21 of the sampled cities, an improvement compared with May when prices fell in 43 cities. The overall m-o-m change was the most positive since July 2011. Moreover sales of new homes have been recovering since May, as a result of interest rate cuts (Figure 4.10). Thus, we believe that the risk of a sharp correction in the real estate market has been limited. This suggests that the negative contribution to growth from the property market may be less in the coming months. The crucial question, in our view, is how much the government will allow the property market to recover given that recently it has reiterated its stance that it does not intend to lift its property market curbs in order to revive growth in the economy. The consequence of lower growth is something that the government accepts in order to avoid a housing bubble and make housing affordable.

Figure 4.10



Source: Ecowin

III. Macro Forecasts

Real GDP growth						
	2010	2011	2012f		2013f	
			Eurobank	Consensus	Eurobank	Consensus
US	2.4	1.8	2.1	2.2 (1.7 – 2.7)	1.8	2.0 (1.4 – 4.0)
EA	1.9	1.5	-0.5	-0.5 (-0.7 – -0.1)	0.3	0.4 (-2.5 - 1.2)
Japan	4.5	-0.7	2.2	2.3 (1.5 – 2.8)	1.1	1.2 (0.6 – 2.0)
China	10.4	9.3	7.7	7.7 (7.4 – 8.2)	7.7	8.1 (7.4 – 9.0)
India	8.4	7.5	5.5		6.3	
Russia	4.3	4.3	3.8	3.8 (3.0 – 4.2)	3.6	3.6 (2.0 – 4.3)
Brazil	7.6	2.8	1.7	1.6 (1.0 – 3.3)	4.0	4.1 (3.2 – 5.5)

Inflation						
	2010	2011	2012f		2013f	
			Eurobank	Consensus	Eurobank	Consensus
US	1.6	3.2	2.3	2.0 (1.4 – 3.1)	2.1	2.0 (1.0 – 4.2)
EA	1.6	2.7	2.5	2.4 (1.9 – 2.6)	1.9	1.9 (1.2 – 2.7)
Japan	-0.7	-0.3	0.0	0.0 (-0.2 – 0.3)	0.2	0.2 (-0.3 – 0.6)
China	3.3	5.4	2.9	2.8 (2.0 – 3.5)	3.5	3.3 (0.5 – 5.0)
India (WPI)	9.6	9.5	6.5		6.0	
Russia	6.9	8.5	5.0	5.1 (4.9 – 7.0)	6.0	6.5 (5.6 – 7.6)
Brazil	5.0	6.6	5.2	5.3 (4.8 – 5.6)	5.5	5.4 (4.9 – 6.7)

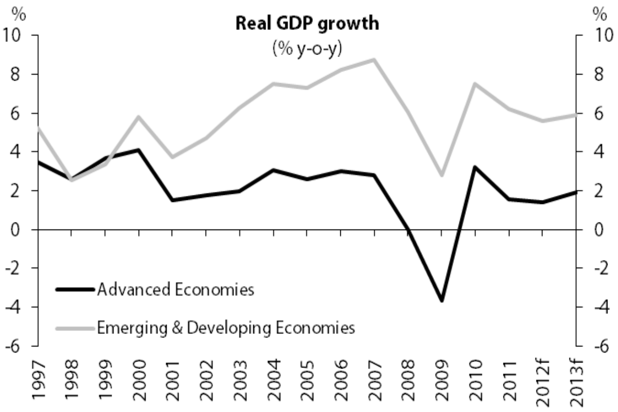
Note: Range of forecasts by Bloomberg's survey in parentheses below point estimates.

Policy Rates					
		Eurobank			
	Current	Q4 12f	Q1 13f	Q2 13f	Q3 13f
US	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25
EA	0.75	0.5	0.5	0.5	0.5
Japan	0.10	0.10	0.10	0.10	0.10
China	6.00	5.75	5.50	5.50	5.50
India	8.00	7.75	7.50	7.50	7.50
Russia	8.25	8.50	8.50	8.25	8.00
Brazil	7.50	7.25	7.25	7.25	7.25

IV. GRAPHS

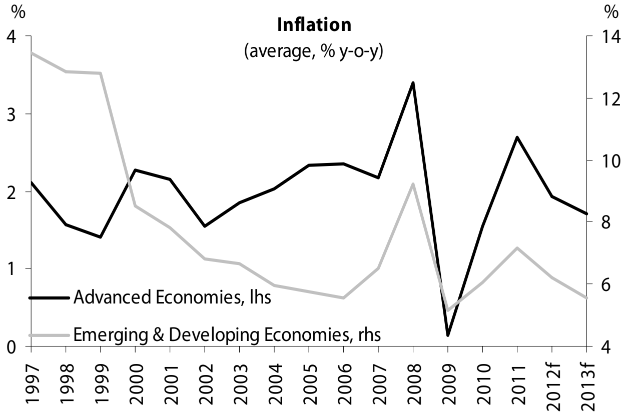
Global Economic Indicators – World Economy

World Economy

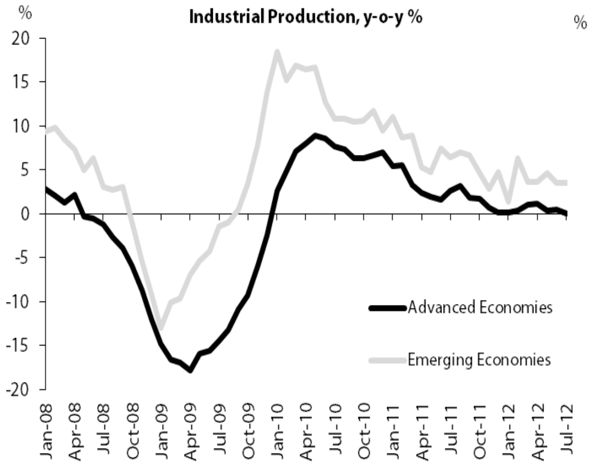


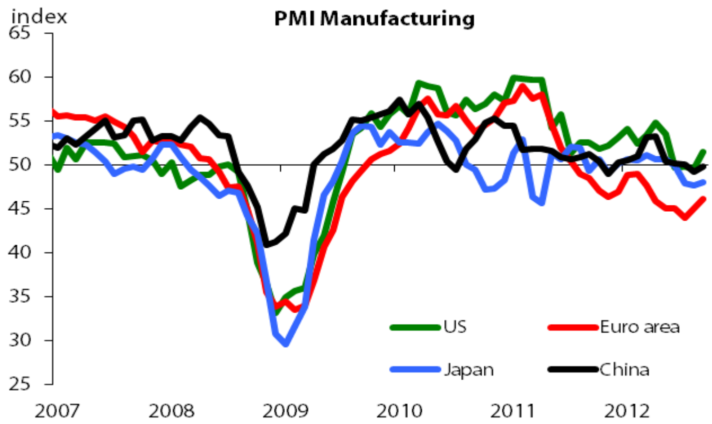
Source: IMF

World Economy



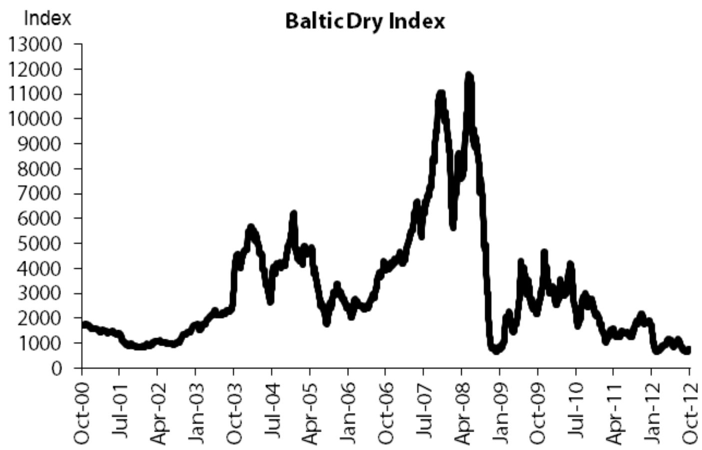
Source: IMF





Source: Bloomberg

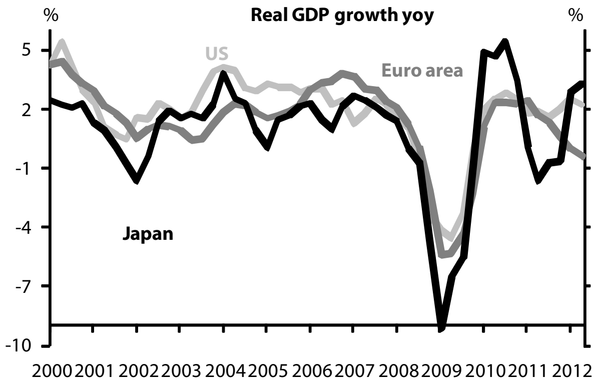
Source: CPB Netherlands Bureau for Economic Policy Analysis



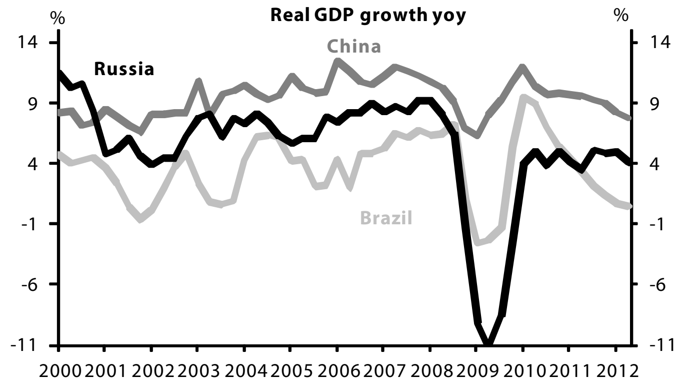
Source: Bloomberg

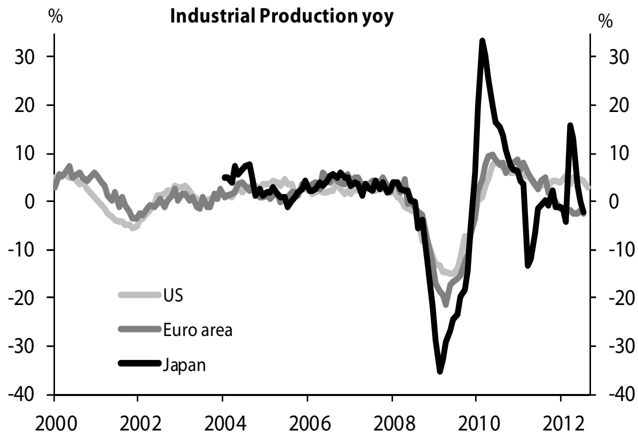
Global Economic Indicators

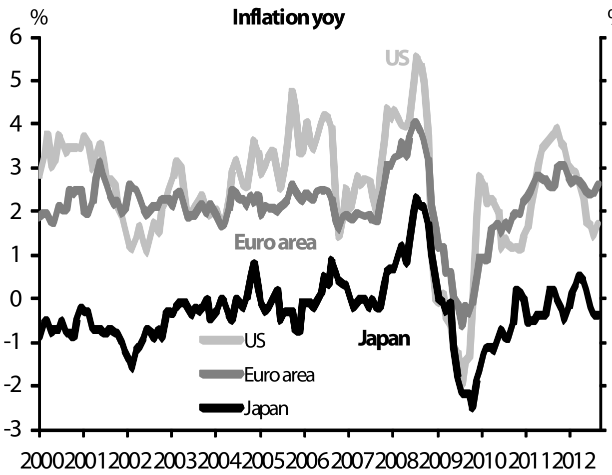
Advanced Economies

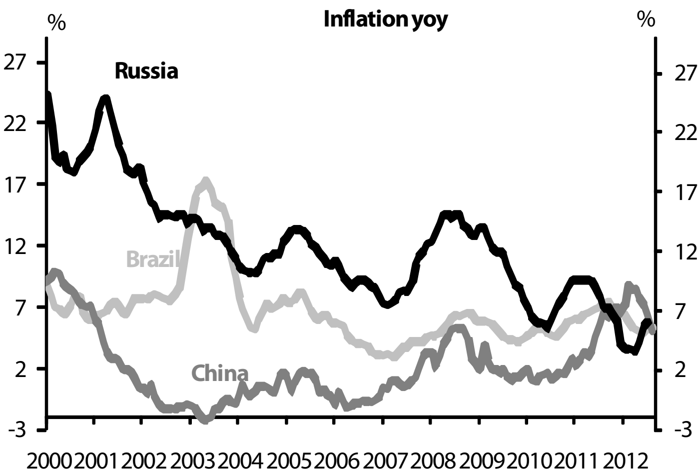


Emerging Economies





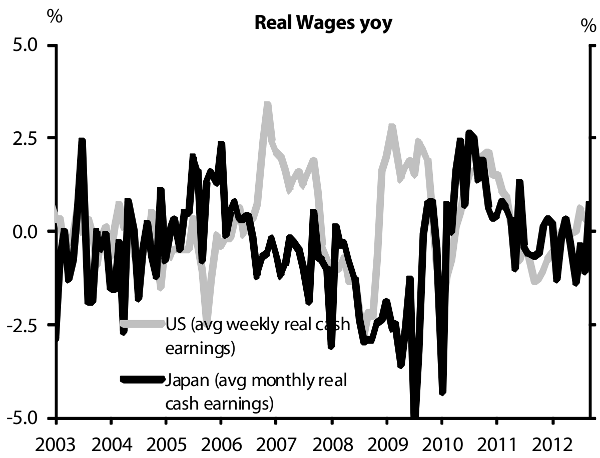


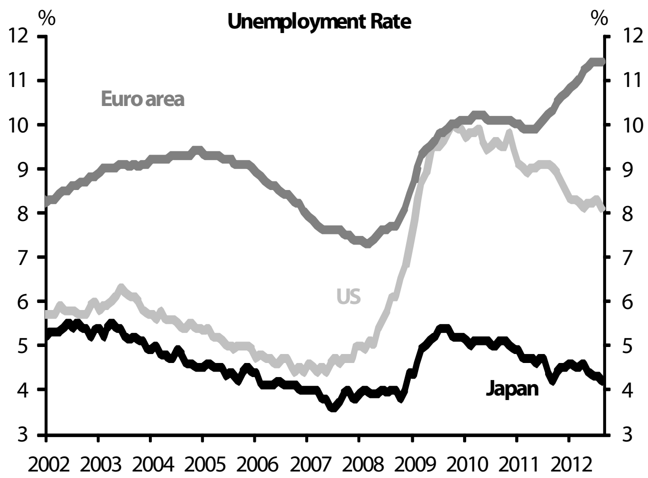


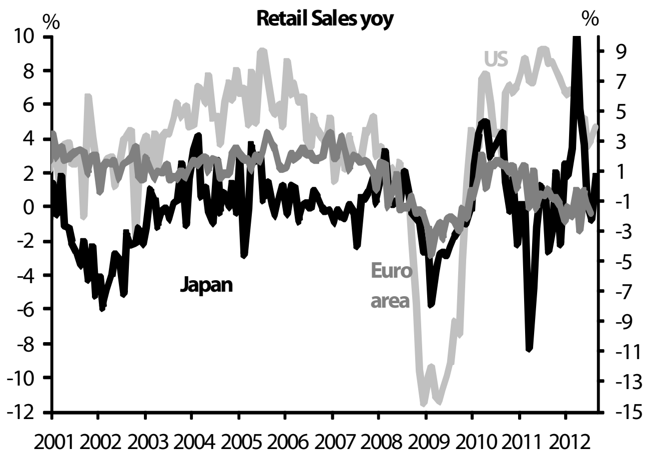
Source: Bloomberg, Ecowin

Global Economic Indicators

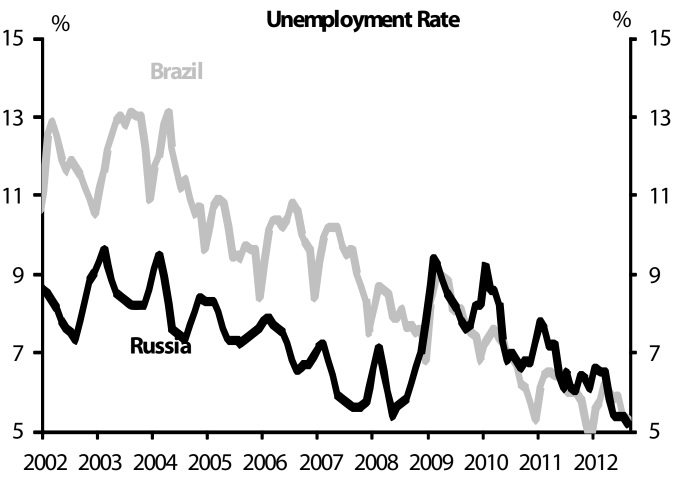
Advanced Economies

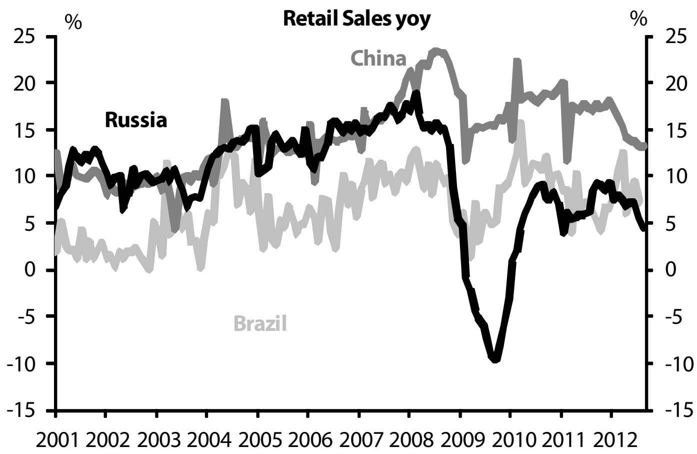






Emerging Economies

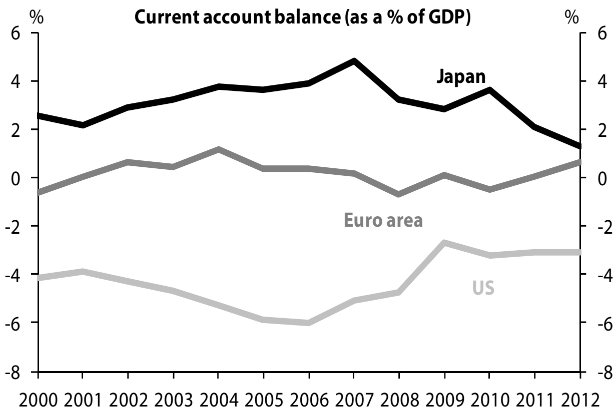


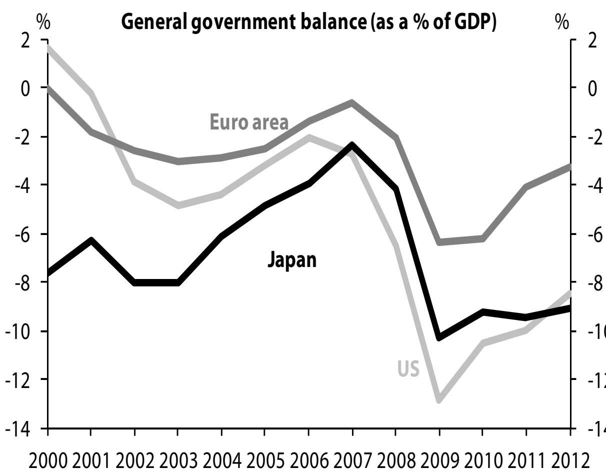


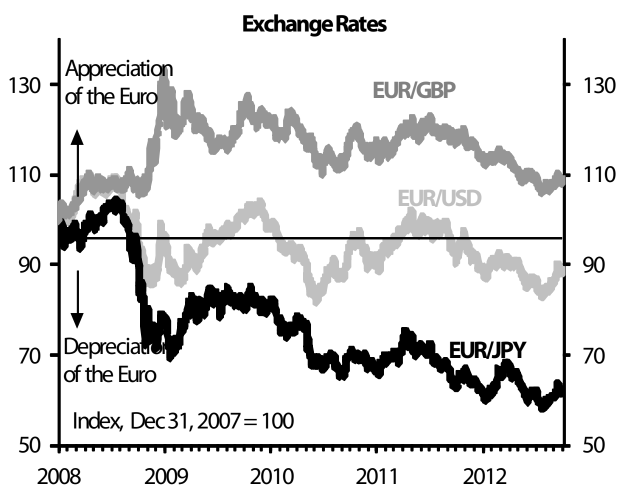
Source: Bloomberg, Ecowin

Global Economic Indicators

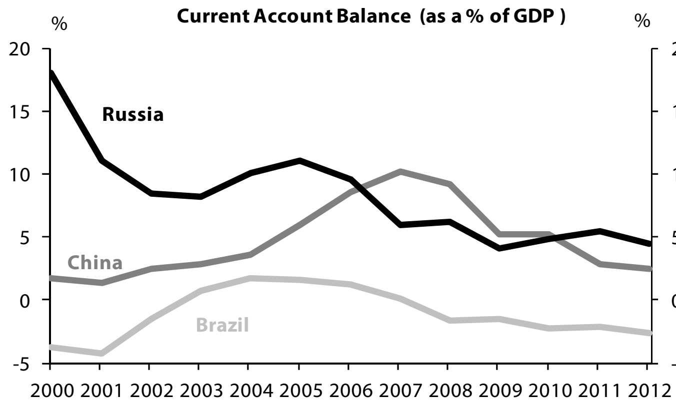
Advanced Economies

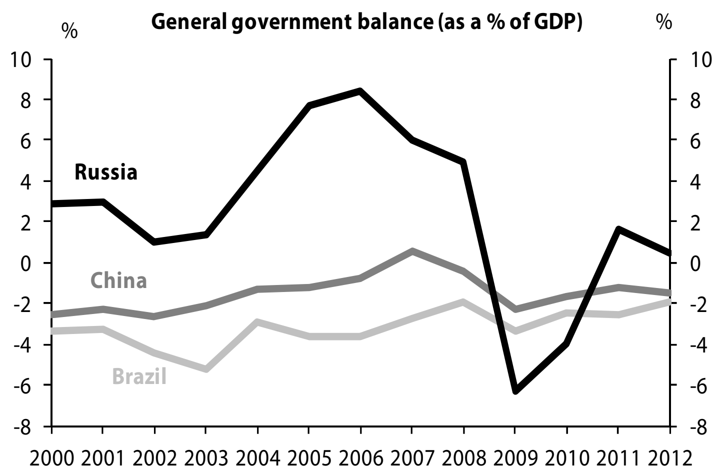


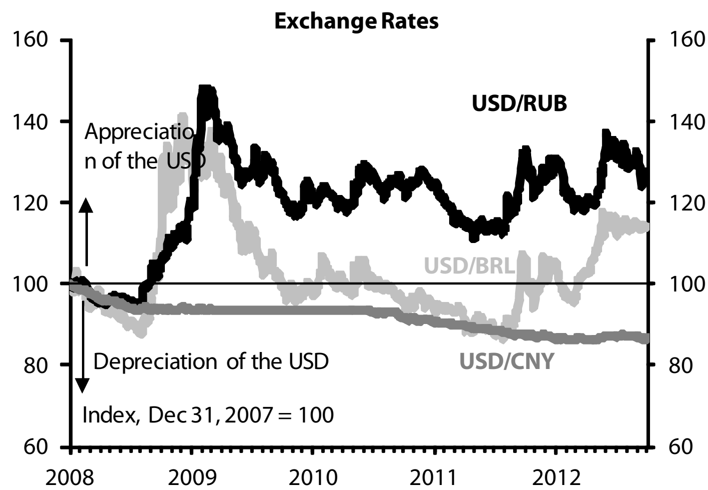




Emerging Economies

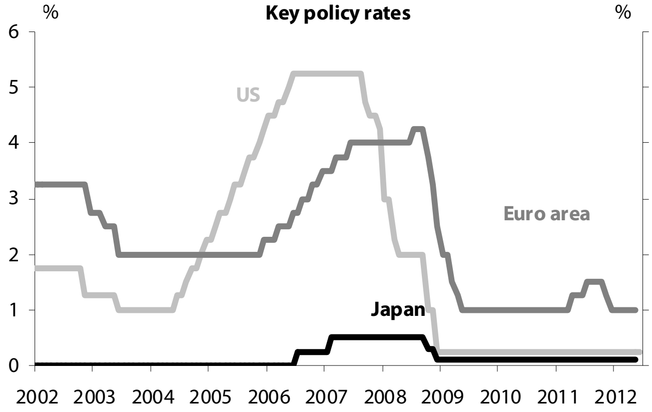


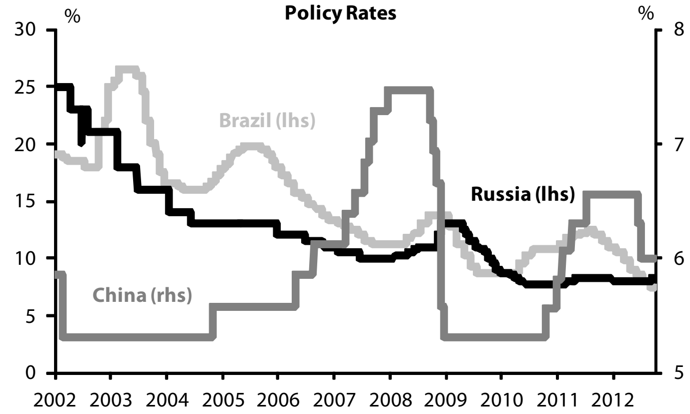




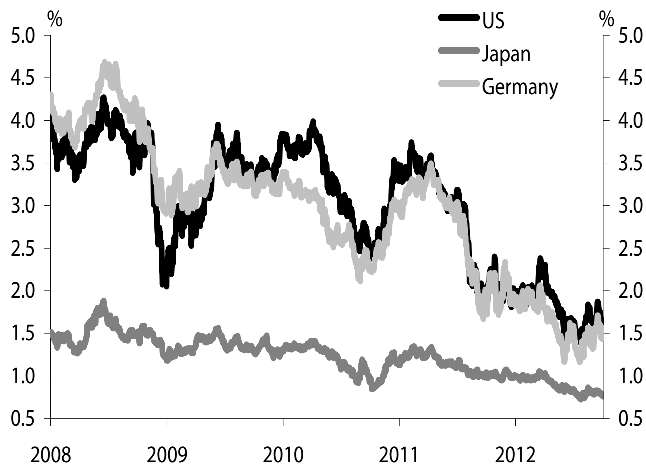
Source: Bloomberg, Ecowin, IMF, Eurobank Research

Global Economic Indicators

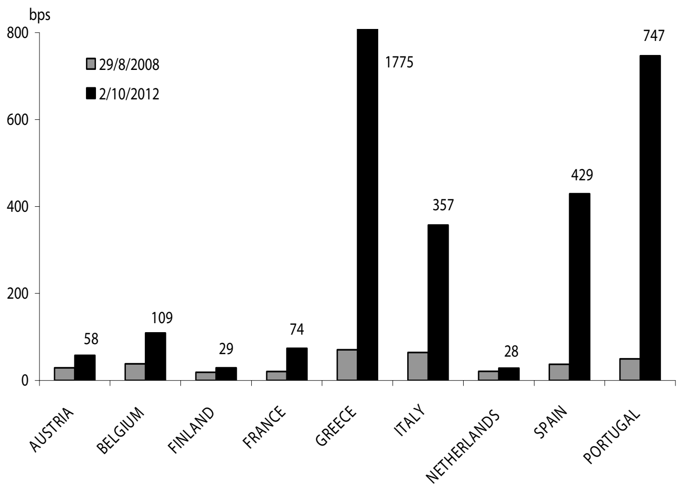




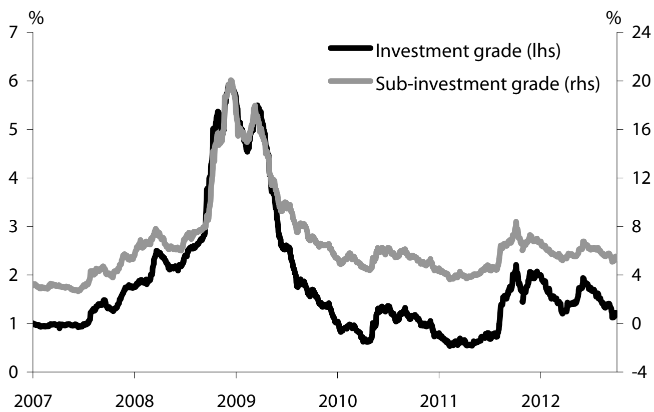
10y Government Bonds



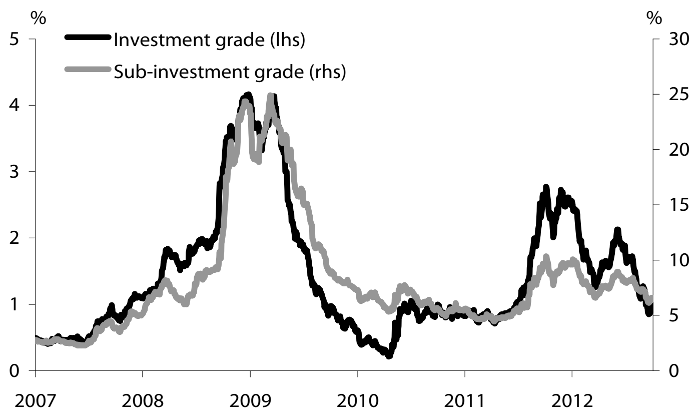
10yr government spreads vs Germany



US Corporate bond yield spreads vs 10-yr government bond



EU Corporate bond yield spreads vs 10-yr government bond



Source: Bloomberg, Ecowin

Global Equities & Sector Performance

Total Return (%) as of October 2, 2012

Global Equity Indices (in local currency)

Region	Index	Last Price	1w	1m	6m	12m	YTD	2011
US	S&P 500	1445.8	0.3	2.8	2.3	31.5	15.0	0.0
EURO AREA	DJ Euro Stoxx 50	2493.6	-2.9	1.2	1.4	16.6	7.6	-17.1
GERMANY	DAX	7305.9	-1.6	4.1	4.6	35.9	23.9	-14.7
FRANCE	CAC 40	3414.2	-2.8	-1.1	0.2	16.7	8.1	-17.0
UK	FTSE 100	5809.5	-0.9	0.9	-0.5	14.5	4.3	-5.6
JAPAN	Nikkei	8786.1	-1.4	0.0	-12.6	2.8	3.9	-17.3
CHINA	CSI 300	2293.1	4.3	4.0	-6.6	-11.2	-2.2	-25.0
INDIA	SENSEX	18823.9	0.7	8.0	7.7	14.4	21.8	-24.6
RUSSIA	MICEX	1485.6	2.8	3.2	-4.2	10.5	5.9	-16.9
BRAZIL	IBOV	59222.1	-2.1	3.4	-7.9	16.6	4.3	-18.1

Source: Bloomberg

Sector performance as of October 2, 2012

US Sector Indices (in USD)

US – S&P 500	Last	1w	1m	6m	12m	YTD	2011
1. Consumer Discretionary	465.2	0.4	3.0	4.2	40.3	21.1	6.1
2. Consumer Staples	562.9	0.8	2.2	7.3	27.1	13.5	14.0
3. Energy	833.6	1.4	4.0	4.2	32.2	8.2	4.7
4. Financials	313.2	1.4	4.2	0.2	42.2	22.5	-17.1
5. Health Care	633.8	1.3	5.1	8.7	35.2	19.1	12.7
6. Industrials	453.4	1.1	2.1	0.3	34.1	11.7	-0.6
7. Information Technology	546.7	0.8	1.2	-0.8	35.4	21.7	2.4
8. Materials	344.9	0.4	3.6	-0.1	32.3	11.7	-9.8
9. Telecommunication Services	291.3	-0.8	3.9	22.5	38.2	25.7	6.3
10 Utilities	387.4	0.1	1.2	5.5	15.6	4.3	19.9

Source: Bloomberg, Ecowin

Global Equities & Sector Performance

Sector performance as of October 2, 2012

European Sector Indices (in €)

Europe - DJ Stoxx 600	Last	1w	1m	6m	12m	YTD	2011
1. Consumer Discretionary							
Automobiles & Components	471.3	-3.3	1.7	-4.6	32.9	22.7	-22.7
Travel & Leisure	231.4	-2.2	1.7	9.9	35.8	24.1	-13.3
Media	305.4	-1.1	0.9	10.9	29.5	16.9	-7.4
Retail	461.8	-3.2	-1.0	4.9	18.7	8.3	-4.2
2. Consumer Staples							
Food & Beverage	751.3	-0.4	-1.0	11.1	33.0	19.6	8.0
Personal & Household Goods	830.1	-0.5	-3.5	2.7	31.8	17.6	3.3
3. Energy							
Oil & Gas	682.3	-2.0	-1.0	1.2	26.6	4.5	4.8
4. Financials							
Banks	298.6	-2.9	6.3	4.6	19.4	16.6	-30.4
Financial Services	457.9	-1.5	4.8	1.9	24.0	19.3	-19.3
Insurance	282.1	-1.7	3.6	9.5	38.0	27.6	-10.5
Real Estate	121.4	-1.1	-0.6	6.8	21.1	17.3	-12.1
5. Health Care	746.4	-0.1	1.3	12.0	28.5	16.0	15.3
6. Industrials							
Industrial Goods & Services	520.6	-0.6	2.3	3.6	33.1	19.1	-14.1
7. Information Technology	206.1	-2.3	-1.0	-5.9	16.0	9.5	-12.8
8. Materials							
Basic Resources	791.9	-1.3	3.3	-5.1	15.4	0.9	-28.8
Chemicals	1135.2	-0.6	4.9	8.9	47.5	27.6	-7.9
Construction & Materials	419.1	-2.2	3.0	-0.7	19.3	9.6	-17.4
9. Telecommunication Services	501.9	-2.6	-1.3	4.4	8.8	3.1	-0.7
10. Utilities	597.7	-2.2	1.6	6.5	7.7	8.7	-12.5

Source: Bloomberg

Sector performance as of October 2, 2012

Asia Sector Indices (in USD)

Asia – S&P 50 Index*	Last	1w	1m	6m	12m	YTD	2011
1. Consumer Discretionary	10557.0	-0.4	1.0	-2.3	10.5	10.9	-10.4
2. Consumer Staples	12663.0	-2.0	1.8	-11.1	-4.5	-8.3	5.0
3. Energy	13109.6	1.0	7.2	-1.5	18.6	11.2	-11.1
4. Financials	3467.9	0.5	7.1	3.7	0.8	16.4	-24.0
5. Industrials	2805.7	0.2	7.0	-3.3	27.3	16.9	-24.2
6. Information Technology	11413.6	0.8	9.1	2.0	46.0	24.9	-4.4
7. Materials	3945.8	-1.5	3.7	-6.1	1.8	1.7	-21.6
8. Telecommunication Services	2779.3	-0.8	2.1	2.6	10.3	10.0	0.1
9. Utilities	3850.3	1.4	5.4	9.2	12.8	12.6	7.2

Source: Ecowin

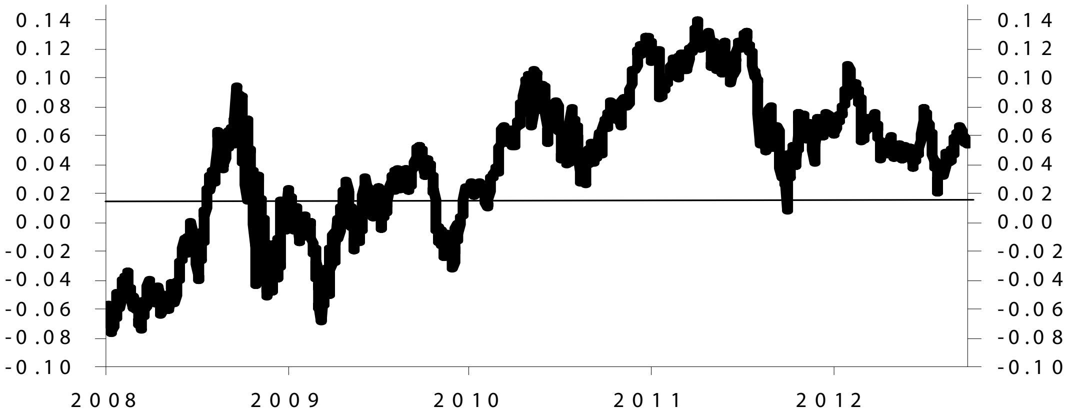
US Style Equity Indices

Total Return (%) as of October 2, 2012

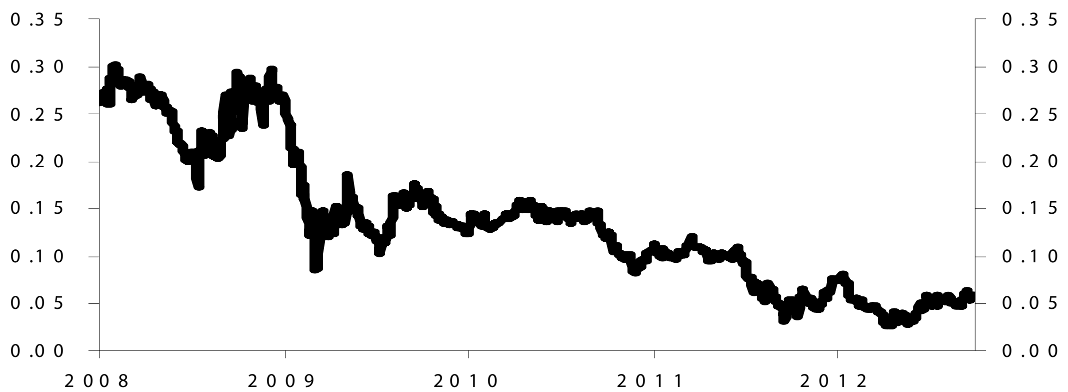
US Style Indices (in USD)

Index	Last Price	1w	1m	6m	12m	YTD	2011
Russell 1000 (Large Cap)	796.5	0.3	2.8	1.8	31.8	14.9	-0.5
Russell 2000 (Small Cap)	840.5	0.2	3.5	0.7	37.9	13.4	-5.5
Relative performance (Small vs Large)		-0.2	0.7	-1.2	6.1	-1.4	-4.9
Russell 1000 Value	714.1	0.4	3.4	3.2	32.5	14.1	-2.1
Russell 1000 Growth	671.9	0.2	2.1	0.5	31.1	15.7	1.1
Relative performance (Value vs Growth)		0.2	1.4	2.7	1.4	-1.6	-3.1

Relative Performance (small vs large)
(logarithmic scale)



Relative Performance (value vs growth)
(logarithmic scale)



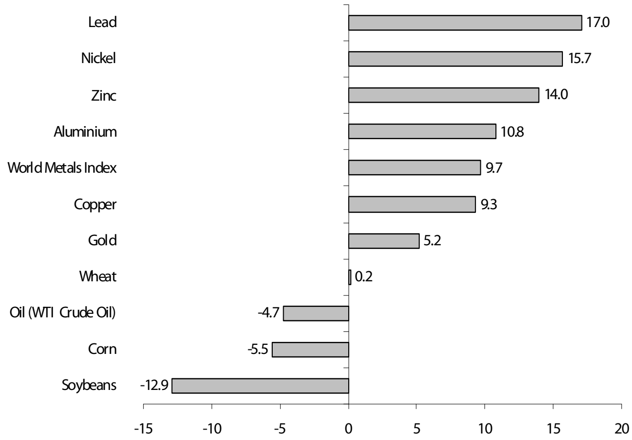
Source: Bloomberg

Commodities

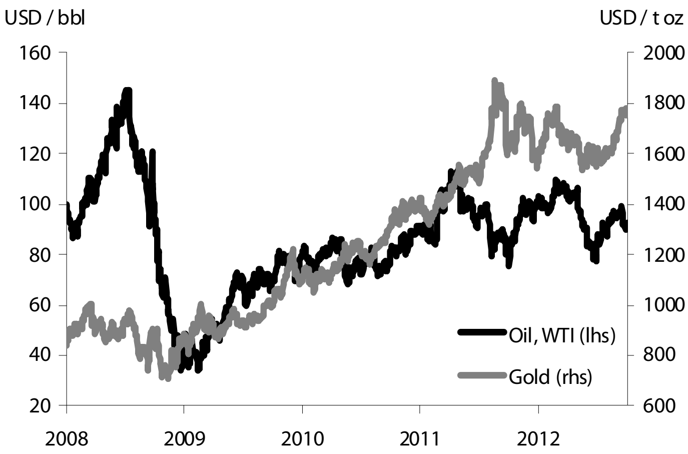
Commodity Performance (%) as of October 2, 2012

Commodities	Units	Last Price	1w	1m	6m	12m	YTD	2011
Oil (WTI Crude Oil)	USD/bbl	91.9	2.1	-4.7	-11.7	18.4	-7.0	8.2
Gold	USD/t oz	1772.7	1.3	5.2	6.1	7.0	13.1	10.2
Base Metals								
World Metals Index		3579.1	2.4	9.7	-1.6	10.8	8.3	-21.5
Aluminium	USD/lb	2107.0	0.1	10.8	-1.1	-2.3	4.3	-18.2
Copper	USD/mt	8325.5	0.6	9.3	-3.7	18.6	9.5	-20.8
Lead	USD/mt	2300.0	-0.9	17.0	11.5	15.9	13.0	-20.2
Nickel	USD/mt	18450.0	0.3	15.7	1.2	4.8	-1.4	-24.4
Zinc	USD/mt	2098.0	-1.8	14.0	4.5	12.8	13.7	-24.8
Agriculture								
Corn	USD/bu	758.3	4.6	-5.5	15.2	28.0	17.3	2.8
Soybeans	USD/bu	1530.5	-2.7	-12.9	11.0	28.3	27.1	-2.4
Wheat	USD/bu	871.5	0.3	0.2	32.4	40.7	33.5	-17.8

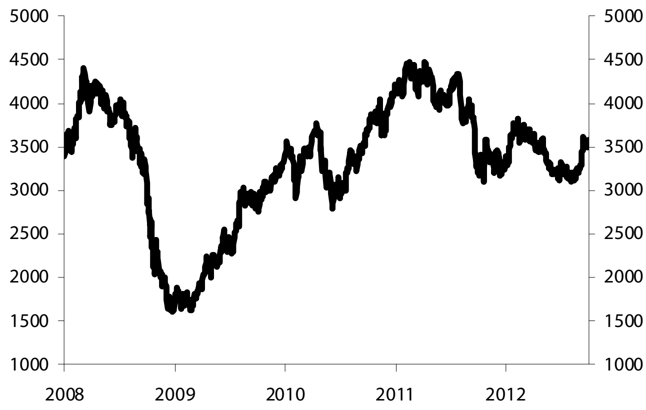
1-Month Return



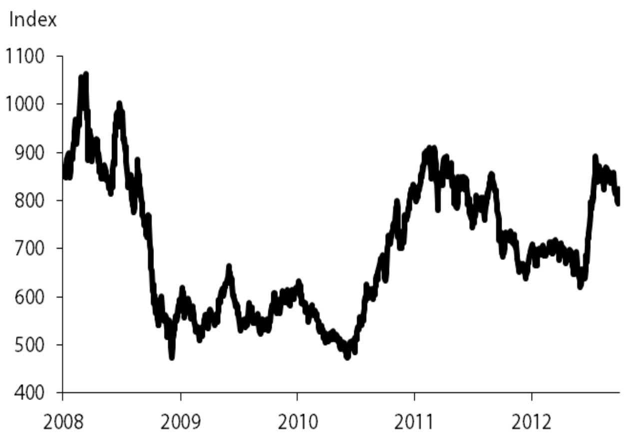
Oil & Gold



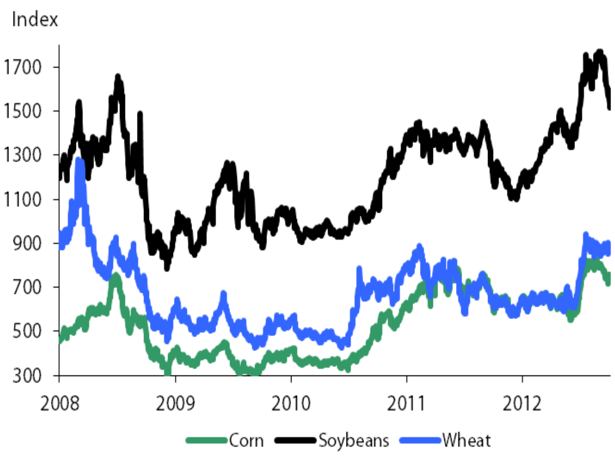
World Metals Index



Agricultural Index



Agricultural Indices



Source: Bloomberg, Ecowin

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