BARCLAYS CAPITAL

RESEARCH
March 2011

GLOBAL OUTLOOK
WINDING DOWN THE RECOVERY TRADE

PLEASE REFER TO THE LAST PAGE FOR ANALYST CERTIFICATION(S) AND IMPORTANT DISCLOSURES

FOREWORD

Since the publication of our March 2009 *Global Outlook*, "Green shoots have arrived", we have generally advised investors to overweight risky assets. Following two years of economic recovery and strong gains in risky asset prices, we are now recommending more risk neutral positions. We are no longer in an environment where confirmation of the sustainability of economic recovery reduces risk premiums and generates a revaluation of cheaply priced assets. Instead, asset prices are closer to fair value and stronger growth is now accompanied by signs of higher inflation and an increased probability of policy tightening. This means that markets are more likely to be choppy than trending, and that investors will need to pay more attention to timing, as well as to asset and country selection.

We generally favor equities over bonds, and developed market equities – especially those in the US – over emerging market stocks. The biggest surprise in the past few months has been the rise in inflation, with data coming in higher than either we or policymakers expected. Bond yields have moved up since last fall – when fears of a double-dip recession were rampant – but not high enough in our view to fully reflect the risks of inflation and future policy tightening. We favor developed market equities because there is more room for economic growth without triggering significant policy tightening. That is particularly true in the US, where policy is still more supportive of growth than almost anywhere else, and where the Fed has a greater focus on core than headline inflation and is more inclined to look past short-term inflation developments. The corrections following the dramatic events of recent weeks have created attractive entry points.

Markets have been dominated by news surrounding the earthquake, tsunami and nuclear risk in Japan, as well as the political unrest and military action in the Middle East and North Africa and the associated rise in oil prices. These events are still unravelling and it is difficult to be confident of final outcomes. While we acknowledge that they have added greatly to uncertainty, we do not expect them to be significant drivers of markets in the coming months. Growth in Japan is likely to suffer a sharp decline in the near term, but we expect reconstruction later in the year to bring the overall level of activity back to roughly where it would have been otherwise by the end of the year. Meanwhile, oil prices have risen as a result of the loss of supply from Libya as well as the risks of more extended supply interruptions. While prices may rise somewhat over the next few months, there is still some spare capacity and our base case is that supplies will not be curtailed significantly further. At this point, we do not see the rise in oil prices as putting the recoveries in economies or markets seriously at risk.

As always, we endeavor to provide you, our clients, with the very best analysis of regions and financial products across the globe, integrated much in the way that markets are these days. We sincerely hope that you find this publication useful in your investment decisions.

Larry Kantor
Head of Research
Barclays Capital

SUMMARY OF ASSET ALLOCATION THEMES

	KEY FORECASTS	KEY RECOMMENDATIONS
Equities	■ We favor developed equity markets over developing. Our 2011 S&P 500 operating earnings forecast is $93 and our price target is 1,450. The recent correction has left US equity valuations at very attractive levels, in our view. ■ We reiterate our positive stance on European equities, with a 2011 target of 3,350 for the Euro STOXX 50 and 325 for the STOXX 600. ■ We expect Japanese companies to give very conservative earnings guidance for FY 11. We expect the Nikkei Average to fluctuate, centering on JPY9,800 until this summer.	■ While we prefer the US market, European valuations remain attractive and we would not significantly cut exposure because of ECB hawkishness. ■ In the US, we recommend sticking with cyclical positions in the one to two quarters leading to Fed policy normalization and favour energy, industrials, technology and financials. We recently downgraded consumer discretionary. ■ In Europe, we favour Utilities. We are underweight Autos, as they face supply disruptions as a consequence of the events in Japan, higher oil prices, tightening in emerging markets and high commodity prices.
Bonds	■ The Fed is likely to complete its $600bn asset purchase program. While economic data have improved, we expect front-end rates to decline further, as the Fed remains on hold and excess reserves rise. Further, the end of QE2 will likely have a limited effect. ■ The first rate hikes by the ECB and the BoE will likely occur in Q2 11. Markets have discounted a modest tightening cycle, given the numerous geopolitical and economic risks. Risks are skewed towards more being priced in. Fiscal issues are unlikely to have a systemic effect anymore, as markets are increasingly differentiating between countries.	■ In the US, we recommend long duration in the front to intermediate sector. The Fed is likely on hold for longer than is being priced in. We continue to like steepeners, as the long end remains subject to fiscal uncertainties. ■ We continue to be small short the front end of euro and UK curves and recommend flattening positions for the medium term. We also advise being long Bunds and Gilts vs. swaps. We hold our tightening positions in 10y Spain. ■ In Japan, we like bullish flatteners on any sell-off. Australian rates look attractive versus US ones.
Commodities	■ Commodity performance has become more divergent, with base metals prices severely affected by macro-economic pessimism. ■ The rate of incremental nuclear capacity growth is set to be more limited, with German capacity likely to fall. ■ Energy supply has been affected by the various MENA crises, and some of the key emerging geopolitical situations are likely to persist and cascade.	■ Long nickel and copper on intensifying supply-side constraints and the view that economic recovery will be more robust than is priced in to base metals prices. ■ Long carbon EUAs and API2 coal, due to the fuel substitution effects likely to arise from German energy policy in particular. ■ Long crude oil and long crude oil volatility, including far-out-of-the-money calls. Long gold.
Inflation	■ 5y breakevens remain relatively attractive, given upside inflation risks. Longer forwards are relatively fully priced, while real yields are liable to rise in most markets.	■ UK IL16 breakeven is cheap, even with index selling pressure. US and euro 3-5y breakevens are attractive, with defensive value in the broad portfolio.
Credit	■ The potential upside in nonfinancial credit is limited, given current valuations. IG spreads are close to pre-crisis levels, particularly in the US and EM, and the HY market is increasingly call-constrained in the US and Europe. ■ European sovereign risk may resurface, although we believe non-European credit will remain resilient in the face of sovereign volatility. ■ Event risk is an increasing concern. While much attention has been paid to LBO speculation, incremental increases in leverage at larger companies may be as important as large increases in leverage at small companies.	■ In US high grade, we prefer financials to industrials. In US high yield, we recommend swapping out of call-constrained bonds into CDS for credits with improving fundamentals, especially when there is a positive basis. ■ In Europe, swap out of tight-spread higher quality credits into potential rising stars. We maintain a cautious stance on peripheral credits and recommend selling on strong rallies. ■ Subordinated bonds look attractive. In Europe, we prefer T1 securities with high back-end coupons and covered bonds, particularly from Italian and Spanish banks. In the US, we prefer straight preferred stock and TRUPs trading below par.
Emerging Markets	■ Economic recoveries are generally in good shape. The slowdown in headline economic growth mainly reflects a transition from the recovery phase to trend growth. ■ Inflationary pressures continue to build, reflected in large part by unexpectedly sharp rises in energy and agricultural commodities. But underlying inflationary pressures are building as well, and monetary policy has, so far, generally been reluctant to respond forcefully.	■ With monetary tightening on the agenda, equity and local bond markets are set to struggle. We adopt a neutral outlook for EM risk and look for cost-effective hedges against tail risks. ■ We think high-quality external debt will outperform US Treasuries, but earn modest total returns. In local markets, we would be neutral or payers everywhere except South Africa and Brazil. In FX, we adopt structures to maintain exposure to EM FX appreciation while avoiding tail risks.
Foreign Exchange	■ The USD is set to remain at a weak level, but is unlikely to keep depreciating relative to more expensive currencies. European currencies continue to appear attractive, but the CHF much less so. GBP remains a favoured buy. Commodity prices may continue to rise, but commodity currencies are likely to benefit less.	■ Buy the USD against a basket of the NZD and AUD. ■ Buy NOK/CHF. ■ Buy GBP/JPY.

CONTENTS

OVERVIEW

Winding down the recovery trade

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- **We expect global expansion to continue, despite recent events in the Middle East and North Africa, and Japan.**
- **The recent correction creates attractive entry points in developed market equities such as the US, where policy is still easing and growth prospects remain strong.**
- **However, monetary authorities are quickly shifting their attention from growth to inflation, suggesting that policy normalization will be a constraint on market performance.**
- **As a result, we recommend that investors move to a more cautious position on risk, from overweight to neutral.**

The unexpected has dominated the news since the last issue of *Global Outlook* went to press. The suddenness and breadth of the political change in the Middle East and North Africa (MENA) and the extent of the human and physical devastation wrought by the earthquake in Japan are hard to grasp fully and entirely unexpected. While adding a significant degree of uncertainty to the outlook, we do not believe that these developments will be the key drivers of economic or market performance in the coming months. On the contrary, while geopolitical risks may stay elevated for some time to come, we remain confident that the global expansion will continue on track through the remainder of this year.

Despite that upbeat judgment, we are recommending that investors shift to a more cautious approach to markets than the risk-embracing positions we have recommended since the recovery got underway two years ago. As the global expansion has proceeded, the risks and rewards on offer have become more balanced. Asset valuations, although still reasonable, are no longer generally cheap. Importantly, inflation pressures have intensified more quickly than we or policymakers expected, and monetary authorities are shifting their focus from growth to inflation. While the shift is far more advanced in emerging than developed economies (and everywhere is proceeding cautiously), monetary tightening is quickly becoming the norm and will be a constraint on market performance. Moreover, the extreme nature of policy settings in the US and, to a lesser extent, in most developed economies – negative real interest rates and huge budget deficits sustained well into the recovery – suggests that policy normalization, when it does get seriously underway in the major developed economies, may be more challenging for both economies and markets than is usually the case, particularly if inflation pressures are already well advanced.

Against this backdrop, we believe that a neutral stance towards risk is appropriate and that investors need to pick their exposures with an eye toward timing and relative country performance. We generally favor developed country over emerging equity markets, particularly the US, where policy is still easing, immediate growth prospects are best and risks are relatively low. Indeed, the corrections following the events in MENA and Japan have produced attractive entry points. We would focus EM exposures on currencies and local markets that have not appreciated dramatically, such as Korea, using strategies that insulate positions against market and geopolitical tail risks. With inflation on the rise and monetary tightening spreading around the world, we would continue to avoid government bonds and believe that credit is now basically a range trade. We expect the dollar to trend lower against most currencies over time, but now may not be the time to initiate positions just as the acceleration in US growth is becoming fully evident.

Natural disasters don't usually change trends

The Tohoku earthquake and tsunami are likely to have caused less physical damage than did the Hanshin-Awaji earthquake in 1995, but are exacting a much greater human toll. With added fears about possible radiation discharges from damaged nuclear facilities, the shock has been intense. We anticipate, however, that most disruptions to production can be recovered in a matter of weeks or a few months and that the loss of about 6% of electric power capacity can be dealt with through conservation and alternative energy sources. The depth of the shock may mean that household spending will be hit more profoundly than it was after the 1995 earthquake (when consumption fell nearly 5% in the following month and took close to a year to return to its former level), adding to the initial drop in GDP. Reconstruction spending, however, should push growth rates higher after midyear, and we expect the level of GDP at year-end to be roughly what it was expected to be prior to the disaster, although the composition will be different.

Heightened MENA uncertainty not likely to derail global growth

Oil prices could well drift higher near term, but annual averages are expected to be in the vicinity of recent levels

The almost overnight change in the political landscape of the MENA countries from one of relative stability to one in which almost everything is in play injected a new source of uncertainty into energy markets. The situation in Libya has created a loss of supply in what was already a tightening market. Since demand has held up, current prices seem reasonably in line with current risks and fundamentals. Given the recent military actions and the unpredictability of political outcomes, there would seem to be more upside than downside risk to oil prices in the near term. That said, there is still some spare capacity in oil production and our base case is that there will not be a further significant disruption in supplies. Under those assumptions, we see oil prices rising another 5-10% over the next few months, and then drifting back down later in the year owing to slowing global demand, especially in the emerging markets. We are forecasting annual averages for 2011 not much different from current levels.

Emerging markets at a much more advanced stage of the business cycle

Decoupling – the buzz word of the last cycle – is certainly not an appropriate characterization of the current global expansion. Good growth, gradually intensifying inflation pressures, and a cautious monetary policy response is a fair depiction of most economies around the world. But while direction and speed are similar, progress along the road to recovery has varied significantly and is likely to be an important driver of market performance. Many emerging economies, including China, India, Korea, and Brazil – economies that account for close to 20% of global GDP – have completed their recoveries from recession and are operating at full employment and at high (in some cases record) levels of capacity utilization. By contrast, most of the developed economies are not nearly as far along the recovery road, and still have significant levels of slack and painfully high unemployment.

Inflation and monetary tightening are the focus in emerging economies

Policy tightening has a long way to go

Controlling inflation is rapidly becoming the focus of authorities in emerging countries, with China, Korea, Brazil and India, for example, explicitly elevating inflation control to their top priority. But even in these countries and in emerging markets generally, the approach is to move cautiously to avoid setting back growth too severely. The problem is that with operating rates already very high and labor markets in many cases tight, somewhat slower growth is not likely to eliminate inflation pressures quickly, if at all. The major developed economies – with their still supportive monetary policies – are likely to continue to grow solidly and keep pressure on global commodity prices even in an environment of softer

emerging market growth. It is thus unlikely that investors will get an "all clear", pro-growth swing in policy in the coming months or even this year. In fact, the still low level of real policy rates in many emerging countries and the very favorable external environment these countries are likely to face suggest that policy tightening in many cases has a considerable way to go.

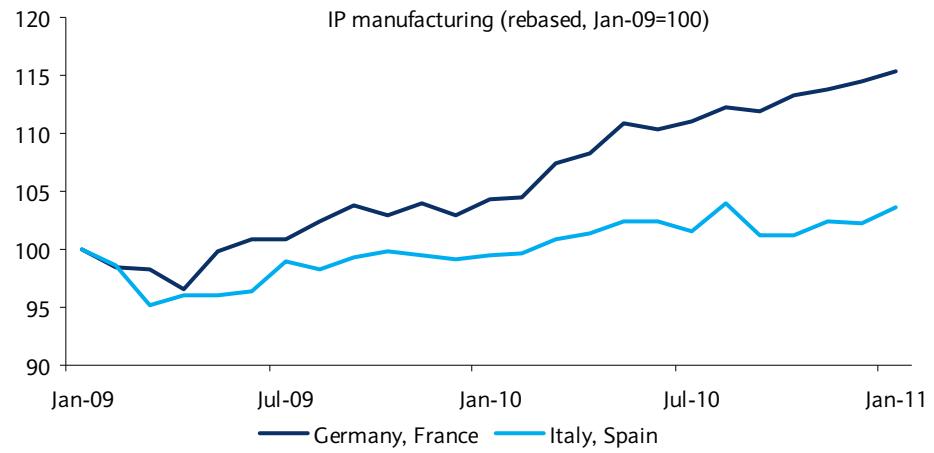
The developed economies are different

Gradual tightening in developed economies should leave policy settings supportive of growth well into 2012

Authorities in the developed economies such as the US are still focused on supporting growth in an effort to reduce high unemployment, a process that will take years. The result is that policy settings are extremely easy, with budget deficits large and real interest rates deeply in negative territory. When the time comes to normalize policy, there will be a lot to do. The euro area (and the UK) are taking a notably different approach to managing this policy challenge than is the US. Europe is starting the normalization process early and should be able to move gradually. We now expect the ECB to tighten by 50bp this year (25bp in April and another 25bp during Q3), an adjustment that is in response to the jump in inflation. And we anticipate 75bp of tightening by the BoE this year, as inflation has remained well above target. Euro area fiscal policy, in addition, is expected to be tightened by 1.2% of GDP in 2011 and further gradual tightening is expected in 2012. Fiscal tightening in the UK is even more pronounced, as it is expected to exceed 2% of GDP both this year and next. Overall, developed markets look set for a gradual tightening of policy that will still leave policy settings supportive of growth well into 2012.

A complicating factor for the European authorities is that fiscal tightening is not evenly distributed among member countries. Sharp fiscal tightening has led to continued economic weakness in Greece, Portugal and, to a lesser extent, Spain and Ireland. As a result, in the past six months a growth differential has opened up between the North and South (Figure 1). The weak performance of Spain and its need for further fiscal tightening has kept markets concerned about intra-euro credit issues, even beyond the small peripheral countries. The recent announcement of an expansion of the financial support package and surveillance framework reforms has been constructive, but credit concerns are likely to continue to produce market volatility in the euro area unless economic growth improves in southern countries such as Portugal and Spain. At the very least, any unexpected setback to growth would likely reignite euro-credit concerns.

Figure 1: A growth gap has opened up between northern and southern Europe



Source: Haver, Barclays Capital

The US goes for growth

US policy remains very supportive of growth, but faces a daunting policy normalization process into 2012

In contrast to Europe, US authorities decided late last year to implement another major round of fiscal and monetary stimulus, cutting business and payroll taxes by $200bn effective in January and launching a $600bn bond buying program. As a result, US policy is much more supportive of growth in 2011 than is the case in Europe (and nearly everywhere else). Beyond 2011, however, the US faces a much more daunting policy normalization process. The US will go into 2012 with an outsized budget deficit, real policy rates at record lows, and excess reserves in the banking system of over $1.5trn.

Fiscal consolidation will start in 2012 with the scheduled expiration of the business and payroll tax cuts and at least a modest degree of spending restraint. The new Republican-controlled House of Representatives has succeeded in shifting the focus in Washington towards the need for fiscal consolidation and, although there is a limit to what will be achieved before the 2012 presidential election, a degree of spending reduction is also likely. The Federal Reserve remains focused on providing support to growth, but the statement from the most recent FOMC meeting suggests that recently stronger economic activity and inflation data are beginning to impact its thinking. We see the FOMC ending the easing process when the currently scheduled round of bond buying is completed at midyear, but do not see any tightening before some time in 2012. US policy will thus go from full-bore stimulus in 2011 to a combination of tighter fiscal and gradually tightening – but still very easy – monetary policy in 2012.

What are investors to do?

Positioning needs to be more opportunistic

The global expansion has entered a phase in which market gains are harder to come by. It is no longer a one-dimensional world in which evidence of economic recovery leads to a reduction in risk premiums and a revaluation of cheaply priced assets. Assets are now generally priced close to fair value and signs of solid growth tend to be accompanied by evidence of rising inflation, with tighter monetary policy not far behind. This background is likely to produce considerable volatility and choppy rather than strongly trending markets, and positioning needs to be more opportunistic.

Inflation risks are greater than growth risks

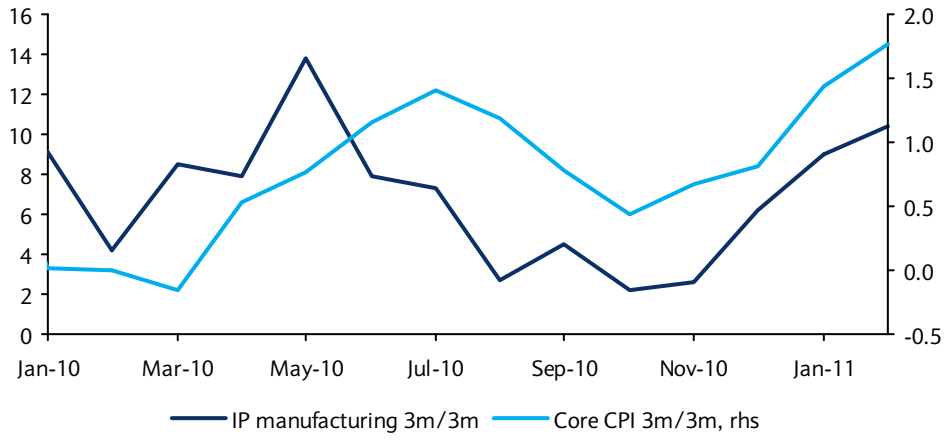
We would avoid bonds and focus risk on equities

The biggest surprises in the economic data since the last *Global Outlook* have been upside inflation surprises (and they have not been caused entirely by higher oil prices), while growth has tracked expectations reasonably closely. We have revised our 2011 global CPI forecast up sharply from 2.6% to 3.3%, while growth forecasts have been revised only modestly. Government bond yields have risen, but not adequately to reflect the rise in inflation pressures and likely policy responses, especially after the recent disaster-induced rallies. We would thus avoid bonds and focus risk on equities.

We favor developed market equities

We recommend focusing equity exposure on developed rather than emerging markets because this is where there is room to grow without unduly intensifying domestic inflation pressures that trigger significant monetary tightening. After the recent correction – which has been bigger in the major than developing markets – valuations look reasonable and there remains room for corporate margin expansion. Within the developed markets, we favor the US in particular. With both fiscal and monetary policies very supportive and the economy in the midst of a rebound, the risk of a growth disappointment in the next few months is very low (Figure 2). While inflation in the US is rising, as it is elsewhere, the Federal Reserve's focus on core rather than total inflation and its generally relaxed attitude towards short-term inflation developments suggest that a policy response is still a long time away.

Figure 2: US growth and inflation have picked up recently



Source: Haver, national sources, Barclays Capital

We are constructive toward European growth prospects, but with both fiscal and monetary policies beginning to tighten – even if only modestly – and following a period of generally better-than-expected economic data, we think that the risks of upside and downside growth surprises are more balanced. Moreover, the market response to any growth disappointment would be amplified in Europe by the return of sovereign credit concerns.

The dollar likely to fall, but now may not be the time to initiate positions

The differential policy approach of the US and Europe will eventually become more of a burden than a blessing for the US

While easier policies and a more relaxed approach to inflation favor the US equity market at the moment, they do not necessarily bode well for the US dollar over the medium term. When investors begin to focus in earnest on 2012, they will see that while Europe has gone a long way towards putting fiscal policy on a sustainable course and has made at least some progress in normalizing monetary policy, the US has yet to begin on both fronts. Moreover, investors will perceive the need and likelihood that the process will need to begin fairly soon, given high budget deficit figures and rising inflation readings. This means that the differential policy approach of the US and Europe will eventually become more of a burden than a blessing for the US, and this is likely to result in a weaker dollar. We consequently see further dollar weakness as the year progresses, and are looking for a spot to initiate positions, possibly following what we expect to be relatively strong US growth readings over the next few months.

Inflation breakevens: A hedge for a more advanced stage of the cycle

While the tightening cycle is now well underway, policymakers have been notably cautious during the process, an approach that can only be exacerbated by the various shocks that have been seen around the world, including European debt concerns, MENA political instability, and the earthquake, tsunami and subsequent nuclear safety concerns in Japan. This suggests the possibility that tightening may not be sufficient to keep inflation from rising further than is currently expected. Inflation breakevens have risen and are now roughly in line with our own inflation forecasts, but they remain an effective way to hedge the risk of higher-than-expected inflation. Technical factors, such as burgeoning demand from central banks, also support some allocation to this asset class. We continue to see better value in developed market breakevens, especially among the G3, than in emerging markets.

ASSET ALLOCATION

Adopting a neutral risk stance

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- **Rising macro risks point to a neutral risk stance, more cautious than we have been since early 2009.**
- **Rising inflation and oil price spikes remain the major threats to global economic growth and, thus, to risk assets.**
- **We continue to prefer developed market equities over emerging market equities and corporate credit.**
- **We favour positioning in G3 inflation breakevens to hedge the risk of sharply rising inflation.**

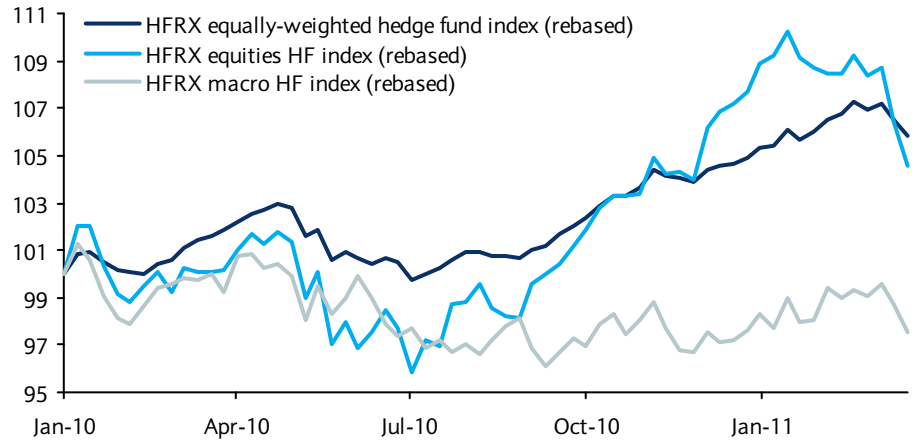
Rising risks call for a neutral risk asset stance

The first quarter of 2011 has been, in football parlance, a game of two halves: a continuation of the prevailing trends in rising equity and commodity prices, coupled with rising bond yields, through to mid-February. This has been followed by a sharp awakening and correction in equity and commodity prices, sparked by a panoply of risks to global economic momentum. Investors have been left scratching their heads and fretting over fund performance after a difficult January (in spite of the market rallying in absolute terms, thanks to savage style rotation away from momentum and towards value) and now March, with hedge funds on average down year-to-date according to HFRX (Figure 1).

The storm clouds threatening the global recovery, which, let us not forget, is only two years old, are gathering fast:

- **Crude oil prices are up sharply** (Brent crude +42% y/y, WTI +25% y/y) because of Middle East and North Africa (MENA) supply disruptions stemming from the ongoing conflict in Libya. Moreover, there is a risk that the Nigerian elections in April could exacerbate this situation, particularly for light, sweet crude. This factor is a clear drag on the GDP growth of oil-importing nations, with the ultimate drag on world economic growth dependent on the scale of recycling of these revenues by oil-exporting nations in terms of consumption and investment.

Figure 1: Hedge fund strategies gain 0.5% year to date, equity and macro strategies trail



Source: HFRX, Bloomberg

- **Higher inflation expectations**, driven principally, but not solely, by the rapid increase in commodity prices (not just oil, but also food and other raw materials), are in turn cajoling monetary policy responses from central banks. This is the case not only in emerging markets but now also in Europe, with the ECB signalling the start of a new rate cycle at its most recent post-meeting conference. We now expect the ECB to raise its reference interest rate in April and again in July. China also remains a key concern for investors in this regard, with rising interest rates and reserve requirements already feeding through to cooling broad money supply growth and falls in manufacturing and consumer confidence surveys.

- **Fiscal contraction** in Europe and potentially also in the US. In the euro area, our economists estimate fiscal drag (via a combination of public spending cuts and tax increases) will reduce growth by some 1.3% in 2011. For now, the manufacturing and services PMI surveys point to the resilience of European economic growth, despite these austerity measures, but they certainly put Europe at greater risk of economic slowdown from exogenous factors such as the oil price.

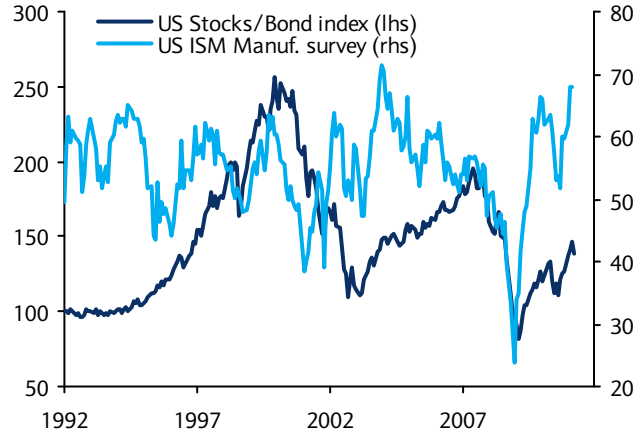
- **Difficult-to-quantify effect on global GDP growth from the Japanese earthquake and tsunami**. Our Japanese economists estimate a total economic cost of JPY12-17trn, some 2.4-3.4% of Japan's GDP (see *Economic costs of Japan earthquake to run around JPY12-17trn*, March 17, 2011). Clearly, global supply chain disruptions are very likely to result from interruptions to electricity supply and the necessary reconstruction efforts, but the scale of the disruption to global trade is not yet evident.

But not as simple as risk-on/risk-off

It may be easy to view the global economy as a glass half-empty with regard to risk-asset exposure, but let us not forget the global macro base scenario before the MENA and Japanese crises. Global economic momentum was very strong, exemplified by the US ISM manufacturing survey close to a multi-decade high with February's reading of 68 (Figure 2) and the German IFO survey hitting a post re-unification high of more than 111 last month (Figure 3).

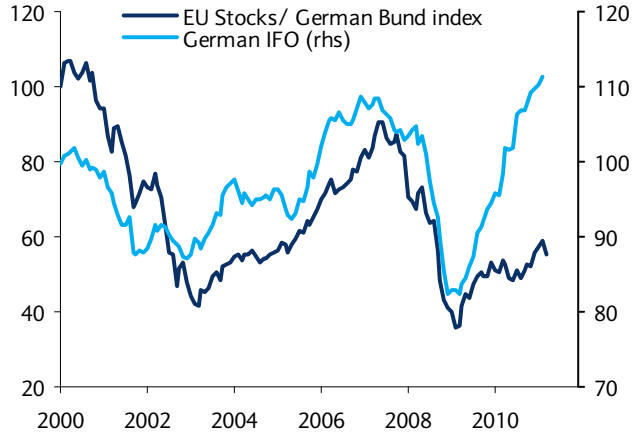
Normally, with such a pronounced positive economic trend, equities outperform government bonds; however, this has not been the case through March, as economic headwinds have intensified and significant tail risks have become more apparent.

Figure 2: US stock/bond ratio not following the ISM survey



Source: Bloomberg, Barclays Capital

Figure 3: A similar story in Europe



Source: Bloomberg, Barclays Capital

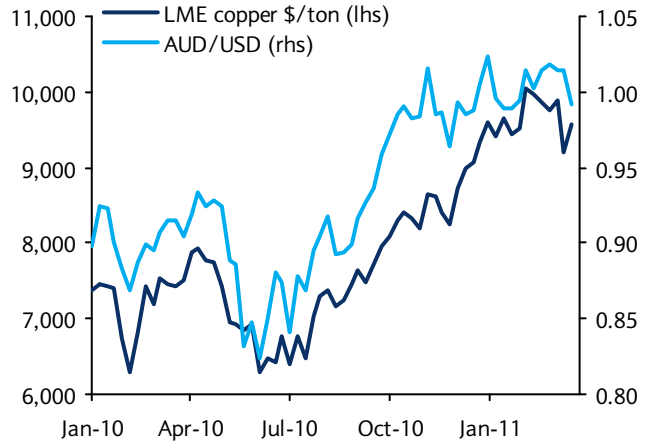
That said, it is not clear that the risk-off trade in March has been that pronounced; in the case of the commodities market, gold (the traditional safe haven) has not risen sharply over the month, and the setback in the economically sensitive copper price has been very limited compared with its 68% run-up from June last year to its peak of over $10,000/ton in February (Figure 4). The Australian dollar, which is a classic commodity currency, has not depreciated substantially, either.

Moreover, although emerging market equities have traditionally traded at a higher beta to developed markets and would thus be expected to underperform on a global equity market correction, in spite of the recent surge in crude oil prices, they have actually managed to outperform developed market equities since early February (Figure 5). We would attribute this surprising outperformance in large part to the fact that, prior to this, emerging market equities had already under-performed the S&P 500 by nearly 13% between mid-November 2010 and mid-February. Going forward, given the heightened inflation pressures evident in emerging markets and ongoing central banks, we continue to expect developed market equities (US and Europe in particular) to outperform their emerging market counterparts.

With classic safe-haven assets such as gold failing to spike on the conflict in Libya or events in Japan, and only a very modest retracement in US and German 10y bond yields in recent weeks, one could argue that the markets remain somewhat sanguine in the face of these emerging tail risks. Even equity-implied volatility has not exceeded the peaks reached in November 2010 at the time of the Irish crisis, let alone the heights reached in May 2010, when the Greek funding crisis erupted (Figure 6).

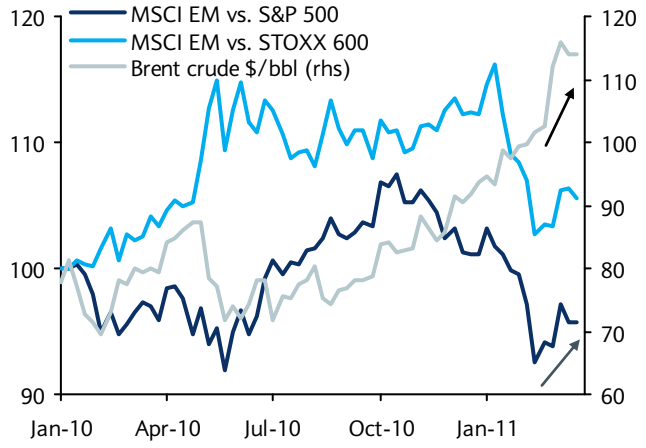
The relatively sanguine reaction of markets to the recent series of events might suggest that investors remain predisposed towards risk assets, such as equities, if for no other reason than being on the hunt for yield in what continues, for now, to be an ultra-low interest rate world. That said, we would consider it prudent to consider a number of potential tail risk hedge strategies against a worsening of any one of these situations.

Figure 4: No dramatic sell-off in copper, Aussie dollar…



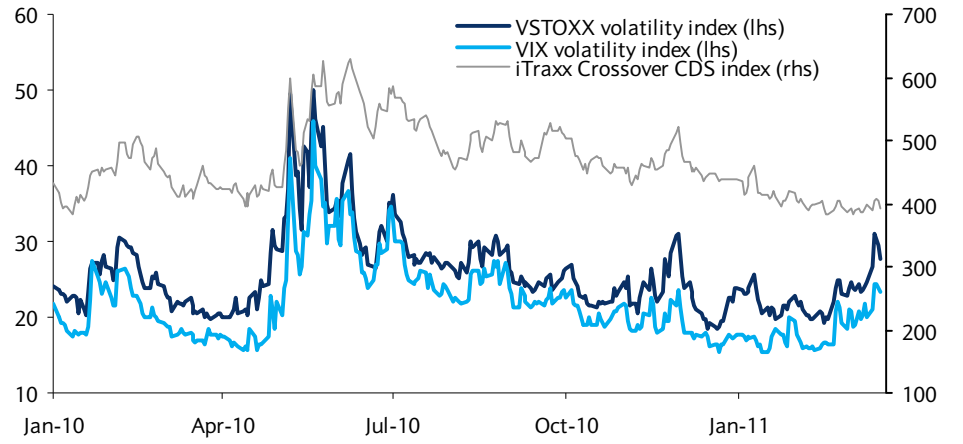
Source: Bloomberg

Figure 5: …and EM equities outperformed even as oil surged



Source: Bloomberg, Barclays Capital

Figure 6: Equity implied volatility falling from Irish crisis levels; iTraxx Crossover is stable



Source: Barclays Capital

The key focus: Inflation and tightening monetary policy

Although inflation concerns have been evident for some time in the faster-growing emerging markets and have already resulted in some central banks raising interest rates towards positive real interest rate territory, this is only now coming into focus in developed economies, with the ECB effectively flagging an April rate hike at its last post-meeting conference.

We are already, to an extent, in uncharted territory, as emerging market central banks are in the process of tightening monetary policy for the first time without the Federal Reserve for guidance, as in previous rate hike cycles. Interest rate cycles are already relatively well advanced in major emerging markets such as Brazil (SELIC target rate 11.75%, +300bp from the April 2010 low), China (six-month lending rate 5.6% from a 4.9% low in October 2010) and India (repo rate 6.75% from a 4.75% low in March 2010), while base rates in the US, euro area and Japan have remained unchanged at 0-1%.

Higher headline inflation rates, and the threat of secondary effects on inflation expectations and wage inflation, have now pushed the ECB into signalling a likely interest rate increase at its next council meeting on 7 April. After that, our economists expect a further rise of 25bp at the July meeting, with the ECB maintaining the reference rate at 1.5% to year-end – this despite the fact that euro area core CPI rate remains close to a historical low of just 1%, not far off the US personal consumption expenditure core price inflation rate of 0.8%.

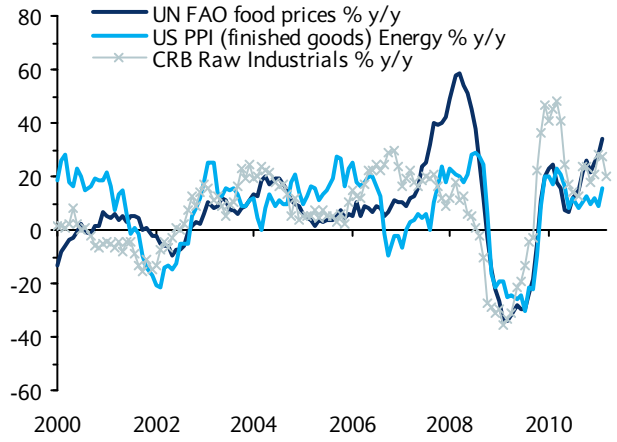
The principal risk from rising headline inflation rates lies in the potential for central banks to react more aggressively than expected in raising base rates, with a consequent hit to economic sentiment and then activity levels as credit availability is reduced. This is a particular risk in Europe, given the fiscal drag already at work on GDP growth rates, thus reducing the economy's ability to absorb a second drag from higher interest rates.

Food and energy prices provide the principal inflationary impulse

The principal driver of higher headline inflation rates has been commodity prices, in particular food and energy prices. According to the UN FAO, world food prices have recently hit an all-time high due to structurally higher demand and are 34% higher than a year ago (Figure 7). This has been coupled with disruptions to global supply from adverse weather conditions and exacerbated by suspension of grain exports from countries such as Russia.

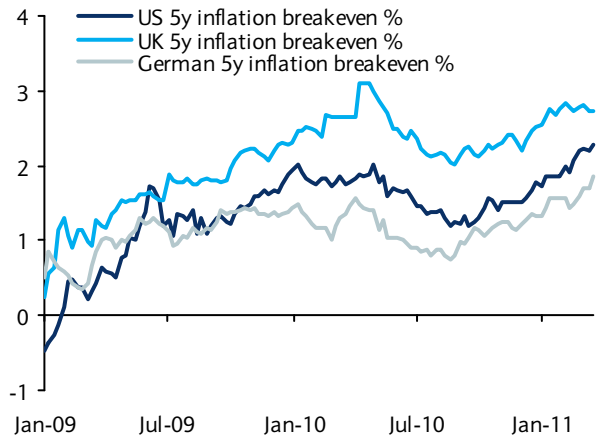
Add to this the pressures from higher crude oil prices (up over 40% y/y) and other raw materials such as copper, as noted above, and cotton (up 150% from a year ago), and the burgeoning pressures on consumer price inflation become evident.

Figure 7: World food prices +34% y/y; energy also high



Source: Bloomberg, Barclays Capital

Figure 8: Inflation breakevens have risen consistently



Source: Bloomberg

But core inflation is also on the rise, thanks to China

Second, although core inflation in developed economies remains well behaved, at about 1% in the euro area and 1.1% in the US, pipeline inflation pressures are mounting as a result of food and energy prices, with producer input prices also rising briskly, to 5.6% in the US and as high as 6.4% in Germany as of February. This also reflects the end of the decade-long trend of imported goods deflation from countries like China. A combination of higher raw materials costs and wage pressures is driving up goods exports prices from China and core inflation in developed nations is now starting to react, with further rises likely (US import prices from China are rising at 2% y/y, while euro area import prices from non-euro area countries were rising at 12.2% as of January).

Inflation breakeven rates have been steadily rising since September 2010 to reflect higher market expectations of medium-term inflation and are back around their pre-financial crisis levels (Figure 8), but risk is rising further in the absence of sufficient central bank action.

Global monetary policy tightening from a very loose base; EU, US diverge

As a reminder, global monetary policy remains very accommodative in general, with zero or negative real interest rates in the developed world and even in many emerging markets (Figure 9). Even in the euro area, our central scenario of a 1.5% reference rate by end-2011 and headline CPI of 2.5% would leave a negative real interest rate of -1%, so even that will not constitute a full renormalisation of ECB monetary policy by any means, particularly given the ongoing funding support for the euro area financial system that the ECB is continuing to supply.

Two-year bond yields have risen considerably over the past few months to reflect rising rate expectations, not only in Asia but also in Europe, with German 2y Schatz yields more than doubling over the past six months alone, to almost 1.7% today (Figure 10). There has also been a significant divergence in European and US 2y yields, widening from zero in July 2010 to more than 1% today, reflecting divergent monetary policy, with the Fed continuing to focus on the sustainability of US growth (and an uncomfortably high unemployment rate), while the ECB worries more about the risks of second-order inflation. This widening yield differential has been a prime driver of euro strength against the US dollar.

Figure 9: US, euro area, Chinese real rates still very low

Note: real interest rates calculated as central bank reference interest rate less headline CPI % y/y. Source: Bloomberg, Barclays Capital

Figure 10: Chinese, EUR rates to expected increase, but not in the US

Source: Bloomberg

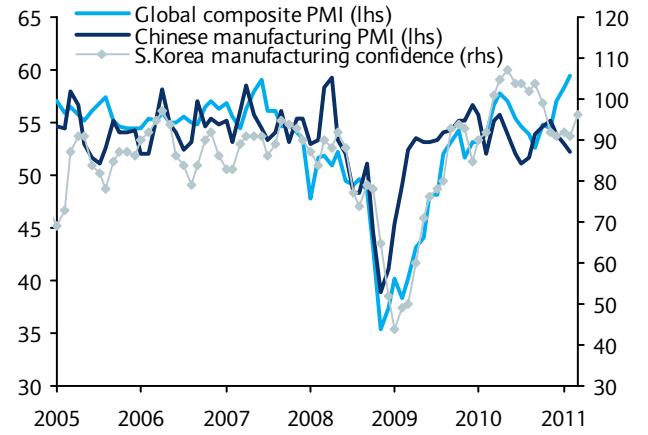
Although our central macro scenario does not anticipate aggressive action from either the ECB or the Fed (no fed funds increase until well into 2012), or even from major emerging market central banks (Brazil's peak SELIC rate seen at 12.25%; 50bp further rate tightening in China, to a six-month lending rate of 6.1%), the risk is clearly asymmetric, given the potential for further pass-through of commodity prices into not only headline, but also core inflation rates in developed as well as emerging markets.

EM central banks tightening most aggressively; better for EM bonds?

With emerging market central banks most advanced in rate tightening cycles, certain emerging market PMIs easing back off their 2010 highs (Figure 11) and money supply correspondingly starting to slow (Figure 12), EM bonds would seem better positioned than equities, given the historical leading relationship between EM money supply and the EM stock/bond ratio.

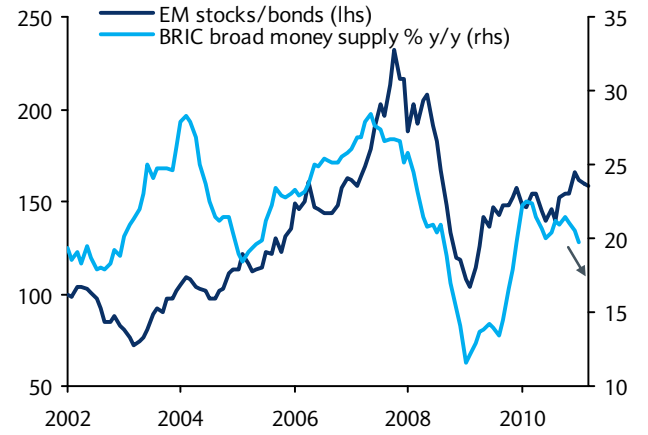
Structurally, we continue to like EM equities in the long term, given the higher long-term GDP growth rates that we expect (see *Equity Gilt Study 2011*, February 10, 2011, for more details). However, the risk remains that over this year, inflation rates will be persistently

Figure 11: Global PMI still rising, but Chinese PMI falling



Source: Bloomberg, Barclays Capital

Figure 12: Slowing BRIC money supply growth helps bonds



Source: Bloomberg, Barclays Capital

higher than forecast and require even higher short-term interest rates. This factor points to the risk of further relative underperformance of EM equities relative to bonds, until headline inflation rates look to have peaked.

A second key risk: The oil price

The oil price remains a key threat to global macro momentum, given the events in MENA, particularly in Libya. Our commodity strategists expect Libyan oil supplies to remain suspended for the rest of this year, removing 2% of world oil supply at a stroke for an extended period. Currently, there is sufficient spare capacity worldwide to replace this, principally in Saudi Arabia, and crude oil inventories of over 350mn barrels in the US remain some 4.5% above the five-year average. Nevertheless, the risk of a major price spike should further oil production be lost has clearly risen since the beginning of this year.

The result of this reduction in supply and the risk of disruption in other oil-producing nations such as Nigeria (where, as noted above. elections are due in April) is already evident at the front end of the oil futures curve (Figure 14), while from two years out, the curve has moved only modestly to reflect a higher long-term risk premium.

Replacing nuclear power generation increases fossil fuel demand

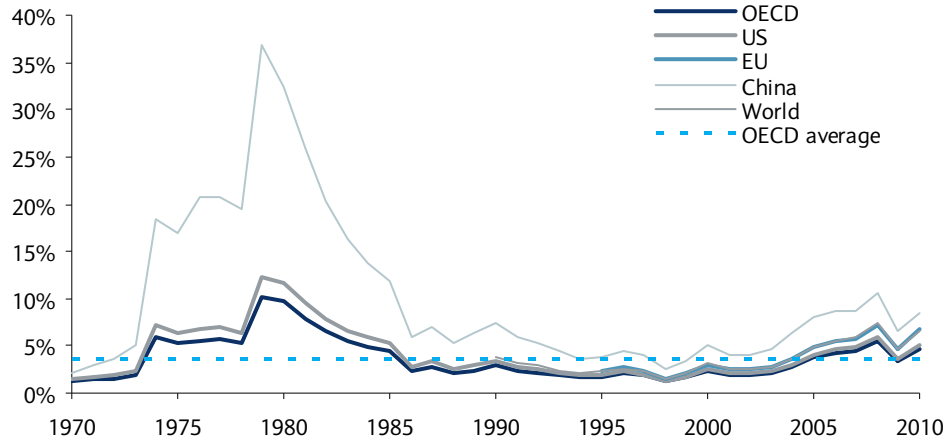
Further potential upward pressure on the oil price (and on gas and thermal coal prices) stems from the Japanese earthquake and tsunami. Already-lost and future electricity production in Japan will have to be replaced by greater reliance on generation using fossil fuels (currently 15% of total Japanese electricity production comes from nuclear generation), with the risk that other countries such as Germany may follow the same path, given current safety concerns over ageing nuclear generation capacity.

Current oil price estimates do not point to sharp economic slowdown

Our central scenario is that the oil price could well drift higher near term, but annual averages are expected to remain in the vicinity of recent levels. If this scenario were to play out, then the oil price should not represent a significant headwind to world growth.

In the OECD countries, crude oil expenditure represents less than 5% of GDP, versus close to 9% for China (Figure 13). For Europe, our economists estimate that a 10% increase in oil price takes off approximately 0.1% of euro area GDP directly (with a further drag on growth

Figure 13: China spends far more of GDP on crude oil than OECD countries



Source: BP Statistical Review of World Energy 2009, Barclays Capital

from a stronger euro), while the effect of a sustained rise to $130/barrel by year-end would shave 0.2% off US GDP growth. So, current oil prices clearly have a negative effect on European and US GDP growth but do not point to a sharp economic slowdown. In emerging markets, however, the effect is far greater among oil-importing nations, such as China and India, putting more pressure on government budgets given domestic fuel subsidies.

Crude oil and equities: +75% y/y the tipping point?

As far as equities are concerned, the rate of increase in the oil price, rather than the absolute level, tends to be the critical factor to consider. The relationship between the MSCI world index and Brent crude seems to suggest that a new bear market would require a yearly rate of increase in Brent crude of 75% or more (Figure 16), ie, a Brent oil price of $145/barrel or more ($30 above the current level).

At just over $3 for a December 2011 $150 Brent crude oil call option, the market is placing a small but significant probability on this eventuality. It is thus a tail risk event that an investor should consider for hedging purposes, rather than a central scenario, in our view.

Major asset classes: Neutral risk allocation

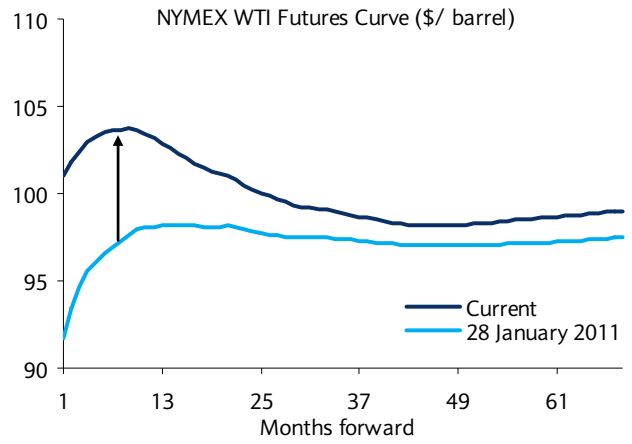
A number of tail risks for the global economy and, thus, for risk assets have risen over the past quarter, most notably in terms of inflation and the oil price. In our view, this argues for a neutral allocation to risk assets for the coming quarter at least, plus consideration of a number of potential tail risk hedges against these risks.

Within the main three asset classes of equities, bonds and cash, we remain constructive on equities, continuing to prefer developed market equities over emerging markets. Both macro and earnings momentum remain supportive, particularly in the US, valuations remain very attractive in both relative and absolute terms in Europe and Japan (equity risk premia remain high by historical standards), and we continue to see scope for further structural reallocation by European insurance companies from bonds back into equities.

Equities: Prefer lower-beta developed markets to EM

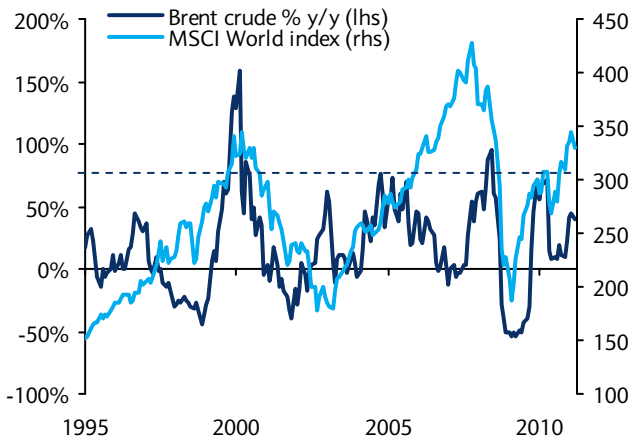
Within equities, we maintain our preference for developed markets over emerging markets, in spite of the better resilience of emerging markets in the recent equity market sell-off.

Figure 14: Front end of the oil curve has moved up sharply



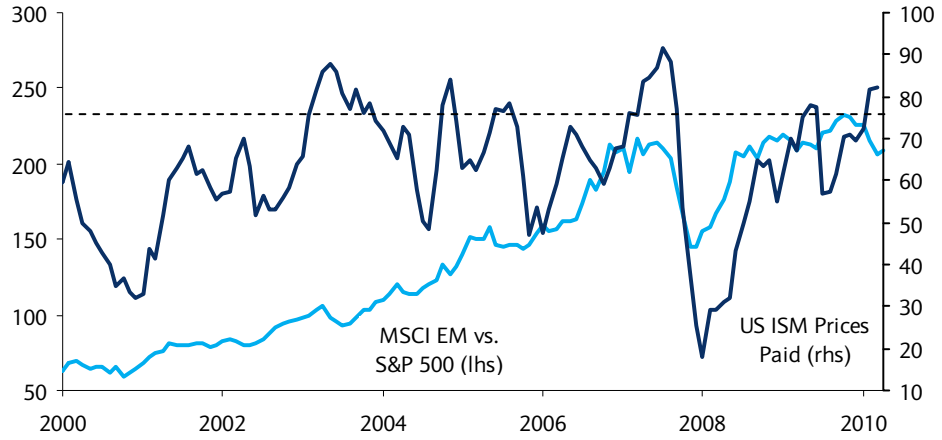
Source: Barclays Capital

Figure 15: A sharper spike in crude would be bad for stocks



Source: Bloomberg, Barclays Capital

Figure 16: MSCI EM underperforms S&P 500 when ISM Prices Paid exceeds 75



Source: Bloomberg, Barclays Capital

Greater risks remain for emerging markets from high and rising inflation rates, with the ongoing risk to growth from tighter monetary policy to hang over emerging market equities until central banks look to keep domestic inflation controlled. Typically, when the ISM manufacturing prices-paid component exceeds 75, signifying high pipeline inflation pressures, the MSCI emerging market index underperforms the S&P 500 for at least three months (Figure 16).

With year-end targets of 1450 for the S&P 500 and 3350 for the Euro STOXX 50 indices and equity risk premia that remain high versus history, we remain optimistic on the outlook for US and European equities for the remainder of this year.

However, over the next three months, given the greater immediate inflation pressures evident in Europe, coupled with a clearer monetary policy response from the ECB, Bank of England and the Swedish Riksbank, not to mention ongoing uncertainties over fiscal reform and sovereign funding of peripheral euro area members, US equities may offer a more attractive risk-reward profile.

US dollar: Risks underperforming further, particularly against Asian currencies

Another reason for preferring US equities comes in the form of the US dollar. The divergent monetary policy responses of the Fed and ECB have been clearly reflected in a widening 2-year bond spread between German bonds and US Treasuries, which in turn has been reflected in a EUR/USD rate that has recently moved north of the $1.40 level. With the ECB forecast to raise interest rates twice this year, with a third "stealth" rate rise in the form of EONIA-reference rate renormalisation, and the Fed expected to stand pat throughout 2011, the risk is that the US dollar weakens further against the euro in the months to come. This is in line with our FX strategists' 1-year forecast of $1.45 for EUR/USD, ie, modest further strength for the euro.

The greater move in terms of the trade-weighted US dollar index (which has recently hit a new 1-year low of 75.3) could yet come via further greenback weakness versus emerging market currencies. We expect Asian countries such as China to allow further currency appreciation in their efforts to control imported inflation (USD/CNY forecast to move from CNY6.57 now to CNY6.23 in 12 month's time). Our FX strategists also look for appreciation of the Malaysian ringgit, Singaporean dollar and South Korean won on a 1 year basis against the US dollar.

Net net, any such US dollar weakness should provide a fillip this year for the profitability of US large-cap companies with large overseas exposure via both transaction and translation effects, for instance in the technology and consumer staples sectors.

Bonds: Prefer euro area core periphery, euro yield curve flatteners

Although European and US 10y government bond yields remain 45-50bp below our bond strategists' year-end forecasts of 3.75% (for both benchmarks), US Treasuries should continue to be supported to end-June by the completion of the Fed's $600bn asset purchase program, with continuing reinvestment of maturing issues likely until at least September, suggesting no outright shrinking of the Fed's balance sheet before Q4 11 at the earliest.

In the euro area, the start of a new rate hike cycle in April by the ECB, with a further rate hike forecast by our economists for July and an implicit third rate hike in the form of progressive renormalisation of the spread between EONIA and the ECB's reference rate (from about 25bp under to 10bp over) over the year, should be supportive over Q2.

Within this, we continue to recommend EUR 2s/10s yield curve flatteners, as this should be supported by the ECB's tightening stance. We also prefer certain sovereign spreads such as being long the Spanish 10y bond after the surprising results of the recent 11 March EU summit, where it was agreed to increase the effective lending capacity of the EFSF to €440bn, reduce the interest on loans to Greece 100bp, extend the maturity of loans to 7.5yrs, and mandate the EFSF to buy bonds in the primary bond market.

Corporate credit: Remaining cautious despite the recent sell-off

In the recent risk asset sell-off, equity markets dramatically underperformed credit, particularly in Europe. We would thus remain relatively cautious on investment-grade and high-yield corporate credit as a result; if equities sell off further, then corporate credit could be expected to catch up on the downside. If equities continue to rebound, then corporate credit will underperform on the way up, given that CDS indices such as iTraxx Main and the CDX IG are only 5-6bp off their mid-February lows, thus still extremely tight relative to their range over the past 12 months.

Tail risk hedges: Inflation breakevens, calls on implied volatility

The major tail risk that we would look to hedge against from an asset allocation perspective is that of inflation rising faster than expected, necessitating a more aggressive response by central banks. The major risk could come from developed countries, rather than emerging markets, given the high degree of pipeline inflation already evident in US and European producer prices.

Within the context of a balanced portfolio, we favour positioning in G3 inflation breakevens, given a continued emphasis on upside inflation risk, with a balanced allocation across 5y breakevens. Longer-dated exposures would offer less protection against rising inflation and be more exposed if central banks credibly stepped up their inflation-fighting stance. UK inflation breakevens stand out as the cheapest relative to both our and consensus inflation forecasts but are also the least liquid. US breakevens are not cheap compared to our central inflation forecast, but are most sensitive to oil prices and also offer protection against the risk of the Fed being seen as being behind the curve.

A second tail risk hedge for equities positions that we had advocated previously was implied volatility. The VIX and VSTOXX implied volatility indices spiked sharply, to hit intraday peaks of over 31 and 39 on March 15-16, respectively, versus end-2010 levels of 18 and 24. Investors could still choose to hedge tail risk in equities (against a further oil price spike, for

instance) by buying implied volatility exposure (which can be bought in the form of VIX and VSTOXX ETNs). However, this can expose investors to potential carry losses, if implied volatility were to converge back on current realised volatility levels (the spread between three-month ATM implied volatility and 3m realised volatility on the S&P 500 index remains substantial at nearly 6%, as of 21 March 2011).

Our equity derivatives strategists thus prefer to focus instead on short-dated out-of-the-money VSTOXX or VIX calls, which can provide cheaper insurance in the absence of tail risk events, but which still pay out substantially in event of a sharp spike in implied volatility given their leveraged nature (see *Comparing Option Tail Risk Hedges*, 28 February 2011 for further details).

ECONOMIC OUTLOOK

Global growth steadies despite tail risks

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- **As the global recovery stabilizes, the growth gap between advanced and emerging economies narrows. In advanced economies, improvements in the labour-intensive service sectors are helping to reduce unemployment.**
- **Global inflation remains on the rise as a result of commodity prices, abundant global liquidity and closing output gaps. Emerging markets are leading in terms of monetary policy normalization, but major advanced economies are poised to follow.**
- **Key tail risks include a major disruption to Saudi oil supply, the effects of monetary tightening, and complications related to the euro-area periphery.**

State of the recovery

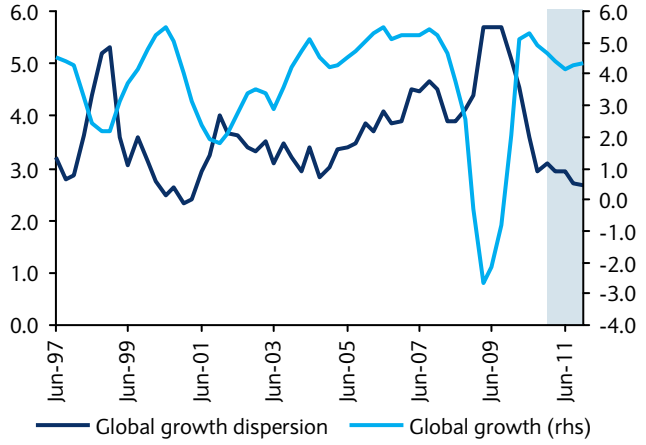
Growth gap between advanced and the emerging economies narrows

As the recovery stabilizes, the growth gap between advanced and emerging economies is narrowing. The dispersion of growth rates in our country sample is the smallest in a decade as momentum improves in advanced economies and softens in emerging markets (Figure 1). After a modest deceleration in 4Q10, most advanced countries are experiencing a rebound in 1Q11 and we expect this robust growth to persist for the rest of 2011 (Figure 2). By contrast, growth in emerging economies is slowly decelerating, though not uniformly. We expect this moderate growth convergence to deliver reasonably steady global growth of around 4.3%, on average, for the rest of 2011, close to the pre-crisis rate (about 4.2% in 1Q00-2Q08).

US and Germany are growing fast while China is slowing down, also on account of different policies

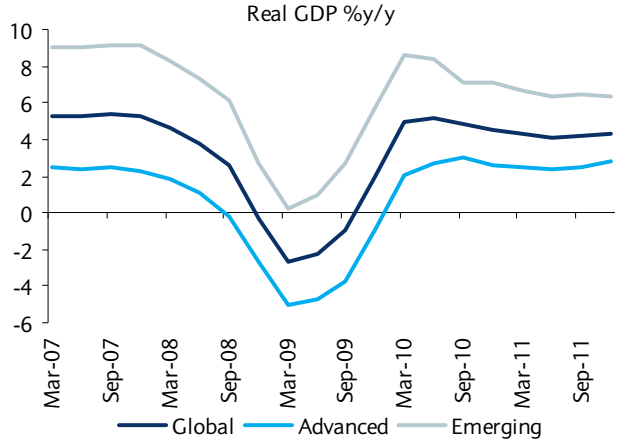
Among advanced economies, the US and Germany should experience 2011 growth significantly above their pre-crisis levels, supported by expansionary policies and/or economic momentum, while growth in the UK and peripheral Europe should remain below pre-crisis levels because of the contractionary effects of their fiscal stabilization plans. Among developing countries, we expect China's economy to slow, partly in response to monetary tightening, and for growth in 2011 to remain about 1pp below its pre-crisis level. Other Asian countries, notably India, and large Latin American countries, including Brazil and Mexico, should post higher growth in 2011 than in the pre-crisis period given that their monetary and fiscal policies remain highly supportive.

Figure 1: Growth getting more similar across countries…



Source: Haver, Barclays Capital

Figure 2: …while the growth recovery continues



Source: Haver, Barclays Capital

Business confidence at historical highs in advanced economies…

Near-term momentum looks strong, although a shift in the sectoral composition of activity seems to be under way. Business confidence (as reflected in the PMIs) in advanced economies has recently risen significantly, both in manufacturing and services, reaching historical highs in several countries (Figure 3). In the emerging world, we see a decoupling between China, where the incoming slowdown has depressed business sentiment for five consecutive months since October 2010, and most other emerging markets (notably India), where business confidence has been improving, especially in the manufacturing sector.

… particularly in the services sector…

Although sentiment in the service sector of the emerging world has led the global recovery since late 2008 (Figure 3), this is now tapering off, not just in China, but also in other emerging markets. In advanced economies, by contrast, sentiment in the services sector has clearly picked up recently, particularly in the US, Germany, and France.

… which is helping bring unemployment down

The broadening of the recovery from manufacturing to services in advanced economies is helping to reduce unemployment, given the labour-intensiveness of the service sector. Indeed, the unemployment rate has started to fall, albeit slowly (Figure 4), and seems to be on a secure downward trend (barring other risks that we discuss below).

The recovery in trade is still lagging that in GDP…

The strength and composition of the recovery are also driving trade developments. The recovery in trade is still lagging that of GDP. The collapse in trade during the crisis was much larger than the fall in GDP, as demonstrated by the 10pp decline in trade as a share of GDP in 2008, and trade has yet to regain the pre-crisis share of global GDP (in past major crises, it has generally taken three years for trade to recover).

… as GDP levels are below pre-crisis trends in large importers…

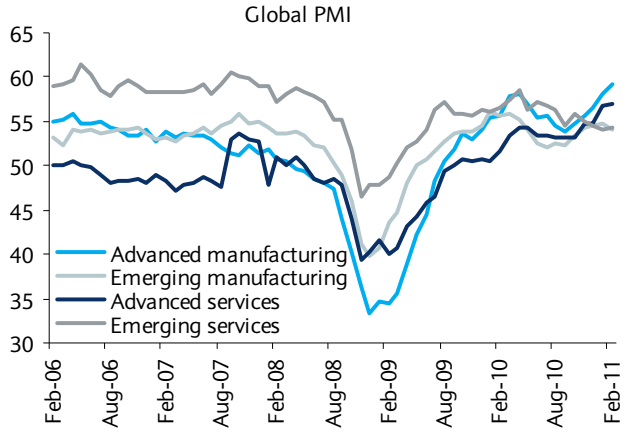
…and the large fiscal expansion shifted spending domestically

Several factors have impeded the trade recovery. First, demand in many large economies remains low relative to before the crisis. For example, US GDP passed its pre-crisis peak level only in December and does not seem destined to revert to the pre-crisis trend anytime soon (Figure 5). Second, a demand composition effect is at play. Given the huge fiscal expansion undertaken by many advanced economies to limit the output decline, the share of aggregate demand from the public sector has risen relative to that from the private sector. And given that public spending falls more heavily on domestic goods, this reduces the import share of demand.

Trade deficit in the US is widening again but remains way below the pre-crisis levels

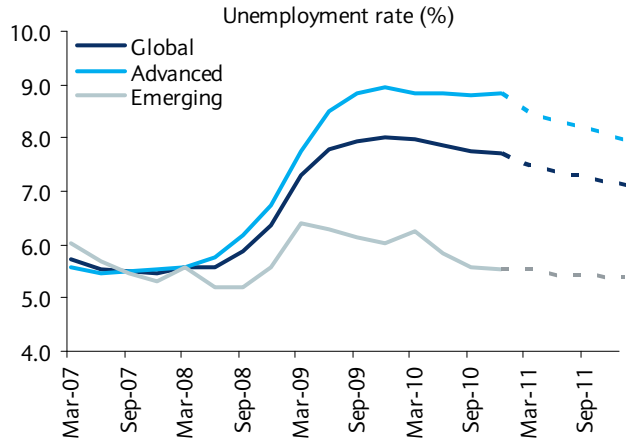
In the US, the strong growth recovery is driving up imports and widening the trade deficit from the lowest level in early 2009. However, imports and the trade deficit look set to remain below the pre-crisis trend for some time because US GDP is unlikely to revert quickly to its pre-crisis trend (given high unemployment), private domestic savings have risen, and the composition

Figure 3: Business confidence is up in advanced economies



Source: Haver, Barclays Capital

Figure 4: Unemployment is falling in advanced economies



Source: Haver, national sources, Barclays Capital

of domestic demand has shifted in favor of domestic goods. Recent data show a modest widening of the deficit from $40.3bn in December to $46.3bn in January, the result not only of the energy bill, but also of a broader surge in capital goods imports.

Trade surplus recently declining in China and Germany and likely to remain below pre-crisis level

Some of the largest export-oriented countries (eg, China and Germany) have recently experienced a surge in imports and a decline in their trade surpluses (Figure 6). Although the very low trade surplus recorded in China in January (USD 6.5bn) may in part reflect temporary factors (eg, Chinese New Year and worse terms of trade), there are reasons to believe that China will not revert to the surpluses of the pre-crisis era. Indeed China has begun a shift towards domestic demand as a source of growth, a trend we expect to continue for years to come. Although the latest low level of trade surplus recorded by Germany in January (EUR 10.1bn) may reverse on seasonality, we also expect Germany to post a progressive worsening of the trade balance in the coming quarters (from about 6.1% of GDP in 1Q11 to 5.7% in 4Q12), on account of strong domestic demand and adverse movements in the terms of trade.

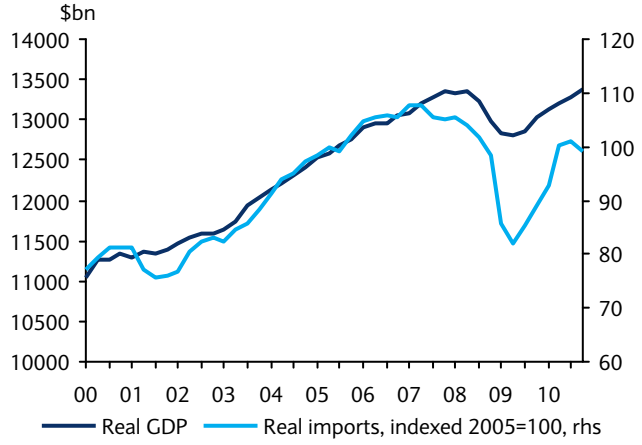
Global inflation up due to commodity prices, abundant global liquidity, and closing output gaps

Inflation has picked up globally as a result of the surge in commodity prices that began last summer, abundant global liquidity, and narrowing output gaps (see "*Easy money is not easy for all EM*", January 19, 2011 and Chapters 1 and 3 of the *Equity Gilt Study 2011*). The surge in inflation began in emerging markets, rising from 5.2% in 3Q10 to 5.9% in 4Q10, because of their higher sensitivity to commodity prices (particularly in food items), and demand pressure from their earlier recovery and loose policies. But in the past few months, advanced economies have also been affected by high energy and food prices, bringing average inflation from 1.5% in 4Q10 to 2% in 1Q11, and casting doubt on the need to maintain very loose monetary policy. Indeed, although the risk of deflation is clearly off the table in most advanced economies, the risk of excessive inflation is emerging.

Monetary policy normalization is on its way, but further ahead in emerging markets than in advanced economies

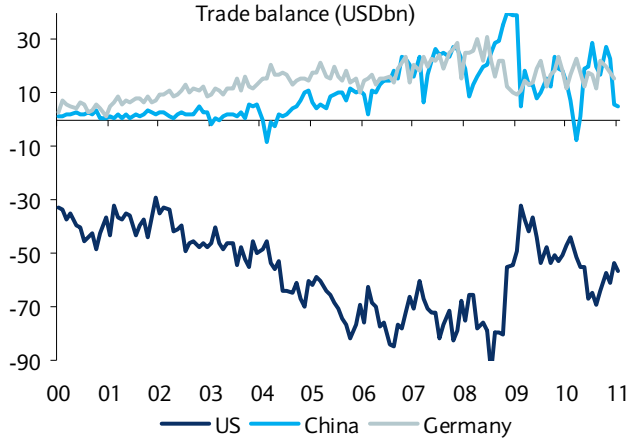
As a result of increased inflationary pressures, monetary policy is on a normalization trend that we expect to remain heterogeneous across countries. Monetary tightening is more visible in emerging markets (where the average policy rate looks set to increase from about 5% in 2Q10 to about 6% in 2Q11) than in the large advanced economies (where we expect the average policy rate to increase from 0.6% to 0.7% over the same horizon). Of the 26 countries covered in the Official Interest Rates and Forecasts table of our *EM Quarterly*, 17 have already started the tightening cycle, and we expect four more to start in 2011 (Czech Republic, Philippines, Sri Lanka, and Turkey), accompanied by additional tightening by 16 countries in 2011. We project only five emerging markets to start the tightening cycle beyond

Figure 5: US imports not keeping up with GDP recovery



Source: Haver, Barclays Capital

Figure 6: Trade imbalances to remain lower than pre-crisis



Source: Haver, Barclays Capital

2011 (Egypt, India, Mexico, Romania, South Africa). In advanced economies, only the smaller economies, including Australia, Canada, Norway, and Sweden, have started policy normalization, and we expect the BoJ, the Fed, and SNB to start tightening beyond 2011.

Real policy rates are still low globally

Overall, real policy rates are still very low. Most policy rates are, in real terms, negative or only moderately positive in 1Q11 and are generally well below the pre-crisis period. The gap between real policy rates in 1Q05-2Q08 and 1Q11 is about 2pp in both advanced economies and emerging markets (Figure 7). However, in the latter economies, we expect rates to rise faster than inflation, bringing the gap to about 1% by 4Q11. In advanced economies we expect inflation to increase faster than central banks raise rates, increasing the gap moderately.

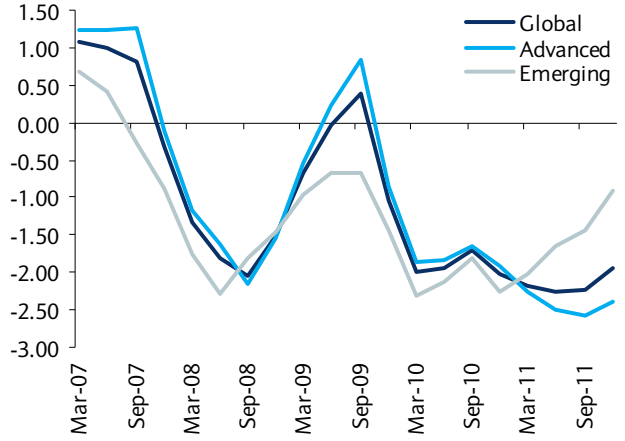
Loose monetary policy in the presence of strong growth reflects unemployment concerns, ambitious objectives, and a much stronger dislike for deflation than inflation

The degree of looseness of monetary policy just as growth is generally as high as in the pre-crisis period and inflation is on the rise, reveals several aspects of policymakers' objectives and perceptions. First, some policymakers emphasise reducing unemployment and closing the output gap. Second, they often think they can reach employment and output objectives that may be higher than the economy's natural rate after such a deep crisis. Third, policymakers have a much stronger dislike for deflation than for inflation, given the potential effect of the former on borrowers' bankruptcies and on delaying consumption. Differing perceptions of the relevance of these factors across the ECB and the Fed may make the two central banks move policy in opposite directions in coming months for the first time in history (Figure 8).

US growth is strong, unemployment is coming down, and inflation is picking up, leading the Fed to a more upbeat tone recently

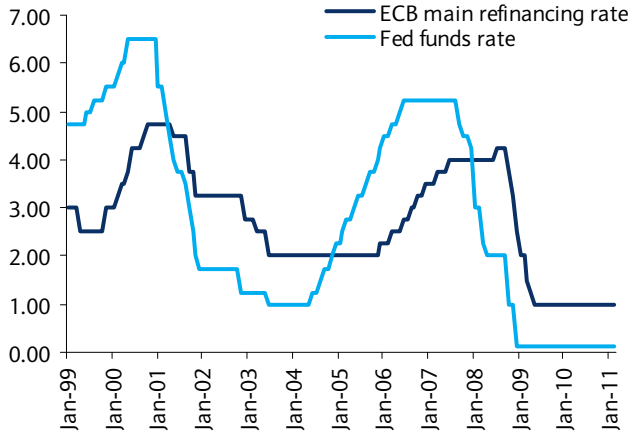
In terms of country-specific developments, the US economic recovery appears firmly on track, with growth in the 3-3.5% range over the next few quarters and unemployment coming down to 8.4% by the end of this year (getting closer to our NAIRU estimate of 7%). Inflation (both headline and core) has picked up recently as a result of global commodity prices as well as the increase in shelter costs. Overall CPI reached 2.1% y/y in February, while core CPI printed 1.1%. We nonetheless expect inflation to remain under control in the quarters ahead. Consistent with the improvement in the labour market, real consumer spending is getting much firmer. Despite the improved macro-economic environment and significant revisions to the economic outlook by the FOMC on 15 March, we do not expect a major change in monetary conditions, with the Fed likely to continue QE2 until the end of June. However, given the more upbeat tone of the last FOMC meeting, we believe the probability of the Fed embarking on a new round of quantitative easing is slim.

Figure 7: Real policy rates as deviation from 1Q05-2Q08



Source: Haver, national sources, Barclays Capital

Figure 8: Fed & ECB monetary stances have never diverged



Source: Haver, Barclays Capital

China's monetary tightening to combat inflation started having an effect on growth

After strong growth in the second half of 2010, we expect China's economy to slow, from 11.5% in 4Q10 to 7.8% in 3Q11. We expect growth in 2011 to hover about one full percentage point below its pre-crisis level of 10.5% (1Q00-2Q08). This in part reflects monetary tightening aimed at containing inflationary pressures, but also a progressive slowdown that is already under way. Industrial production and investment are still growing strongly, but sentiment indicators have been weakening for some time. Overall, business confidence has weakened since October 2010 and in February it reached the same low levels that prevailed in mid-2010 (ie, just ahead of the 3Q10 slowdown in growth). Consumer confidence has also fallen since mid-2010 and in January reached its lowest level since the inception of the index in 1996. The monetary authorities have been tightening policy for several months via interest rate hikes and higher reserve requirements, to fight inflationary pressures arising from high commodity prices and an overheating economy.

Japan's earthquake will slow the strong recovery from the crisis, but only temporarily until reconstruction begins

Our expectations for Japan have clearly changed since the earthquake, but its economic impact looks unlikely to be huge at this stage. Japan's outlook had improved markedly in the past few months, especially since it became clear that a turnaround in market sentiment had been in effect since October 2010 (focusing on the manufacturing sector). There is still much uncertainty as to the effect of the disaster. The earthquake-affected areas account for 6-7% of the country's economic activity, population, and capital stock, and we tentatively estimate that the damage amounts to about 3% of GDP (for a detailed assessment, see *Japan Focus: Economic implications of earthquake*, 15 March 2011). As a consequence, we have revised downwards our growth projection for 2Q11 by 2.4pp, to 0.8%. As the reconstruction efforts pick up, growth should rebound, and we have correspondingly revised upwards our growth forecasts for 3Q11 and 4Q11. That said, any figure is subject to large uncertainty at this stage. Overall, we expect growth in 2011 to drop by only 0.3pp, to 1.6%, which is close to the pre-crisis average since 2000 (1.7%). Monetary and fiscal policies were already very expansionary, and the disaster prompted additional loosening. In the aftermath of the earthquake, emergency liquidity to the tune of JPY15trn was immediately injected into the economy and the BOJ asset-purchasing fund was doubled to JPY10trn from JPY5trn. Within a week of the earthquake, the Japanese government announced it would issue JPY10trn of bonds to finance reconstruction.

We expect the ECB to raise rates on 7 April due to strong growth and inflation above target

The euro area is set to grow at 2.1% in 2011, which is the average of growth in the pre-crisis period since 2000, supported mainly by strong performances in France and Germany. Business confidence is improving in virtually every country for which PMI surveys are available, including several peripheral countries, such as Spain and Ireland, although Greece is an exception. Inflation has been increasing, mainly on account of high energy and food prices. It reached 2.4% in February and we expect it to remain above target for several months. The developments on the inflation and economic activity fronts prompted the ECB to signal at its meeting on 3 March that an increase in the policy rate to 1.25% is likely at the next Governing Council meeting, on 7 April. We expect the ECB to carry this out.

The UK may raise rates in May although growth remains subdued as inflationary pressures are very strong

The UK outlook remains cloudy. Current indications are that the sharp fall in GDP in 4Q was largely erratic and we expect a bounce-back in 1Q. Growth remains subdued, however, and there are still significant concerns about the effects of fiscal tightening on confidence and demand. Consumer confidence has fallen back to levels seen in the depths of the recession in 2009, and house prices, another indicator of household sentiment, have been drifting lower. Inflation is high, however – more than twice the target rate – and pressure has been building on the MPC to tighten policy. The fact that much of the elevated inflation rate can be accounted for by imported inflation and January's rise in VAT has made the committee reluctant to act, but it has become tangibly more hawkish in recent months and we now expect the first rate hike in May – although the fragile demand outlook suggests monetary tightening will be cautious and gradual.

Risks to the global recovery

Although our central view is fairly benign, the global economy faces some important tail risks

A simple reading of recent activity data provides grounds for optimism that the recovery can be sustained. However, the global economy still faces small tail risks that, taken together, present a non-negligible risk to global economic activity, in our view. This is compounded by the fact that the benign view is also becoming the consensus view, amplifying the potential impact of alternative scenarios. Indeed, most investors seem to believe that the world is moving away from the "Goldilocks" period of the past 18 months towards a "Silverlocks" scenario of higher inflation and somewhat tighter monetary conditions but still supportive of growth and financial markets (see *Global Macro Survey: From "Goldilocks" to "Silverlocks"?*). Moreover, we reiterate that, given current policy settings, scope for further support in the event of a large adverse shock seems limited (see Chapter 1 of the *Equity Gilt Study 2011*). Below, we examine three potential sources of adverse news: a major energy supply shock; policy errors in managing the cyclical recovery; and European sovereign debt.

Energy supply shock

Oil prices have jumped since mid-February, reflecting concerns about supply disruption

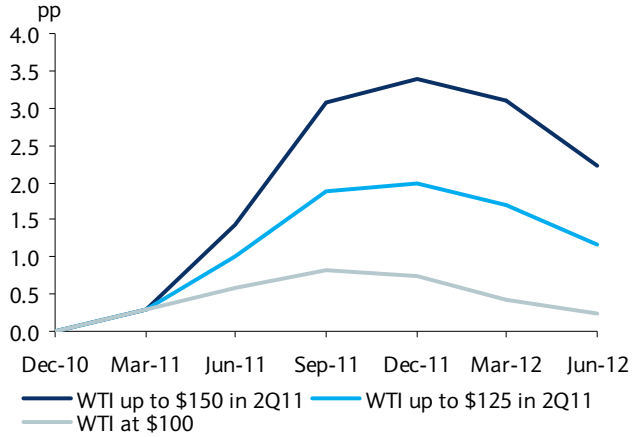
Oil prices have risen by about 15-20% since the start of the year. Initially, this was a continuation of the steady upward trend of 2H10 (when prices rose by more than 20%), driven by improving prospects for global activity and abundant global liquidity. The price jumped in mid-February, however, as popular uprisings in parts of the Middle East and North Africa raised fears of supply disruptions (see *MENA Monthly – Special Edition: Winds of Change*, 25 February 2011). Oil supply has now been disrupted: the conflict in Libya has effectively removed the world's 17th largest producer from the market for an indefinite period. However, given that the shortfall can be easily offset by higher output from Saudi Arabia, we see the extra premium in the oil price as reflecting not a current shortage of supply but concerns that the disruption could spread.

The earthquake in Japan has compounded the situation. Although oil prices initially declined on expectations of lower Japanese oil imports, the subsequent difficulties in securing Japan's nuclear reactors has spurred concerns of a global backlash against the nuclear industry and a widespread reversion to fossil fuels, driving oil higher.

The current price does not pose a material threat to global activity, in our view

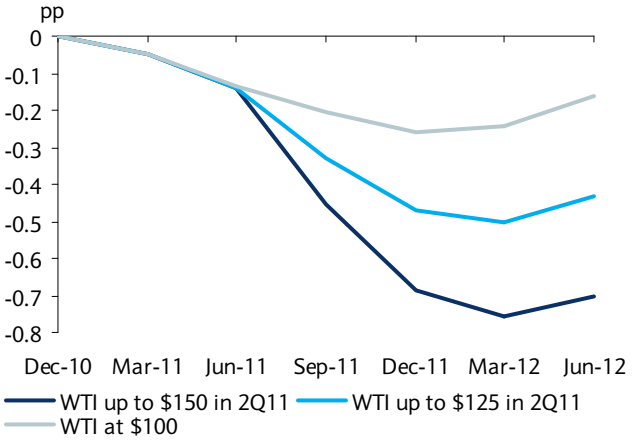
The effects of the price jump so far have been material but far from alarming, in our view. We have used a model of the consumption behaviour of 30 countries, distinguishing oil importers from oil exporters, to estimate the effects of a pure oil-supply shock on global GDP and inflation (see "Oil risks on both planets", in *Global Economics Weekly*, 4 March 2011). To

Figure 9: Effect on global inflation of three oil scenarios



Source: Barclays Capital

Figure 10: Effect on global GDP growth of three oil scenarios



Source: Barclays Capital

assess the potential effects of an oil shock on inflation, we use the framework developed in "*Easy money is not easy for all EM*" (19 January 2011), and extend it to advanced economies. This analysis suggests that a supply-induced rise in the oil price of $25/bbl, for example, would lower global GDP by about 0.25% and raise global inflation by about 1pp in the first year (Figure 9 and Figure 10). The negative effect on demand reflects the fact that higher energy prices curtail global consumption and that although higher oil prices redistribute wealth from oil importers to oil exporters, the former have typically shown a larger marginal propensity to consume in the short term. In our view, the oil price rise in 2008 significantly contributed to the recession and the financial crisis in the US, which then spread globally. By raising CPI inflation, it reduced real disposable incomes and, hence, the purchasing power of average households, leading to a contraction in real consumer spending and lowering the ability to repay mortgages.

A $50 oil price rise would induce a fall in GDP of about 0.5% and boost inflation by about 2pp.

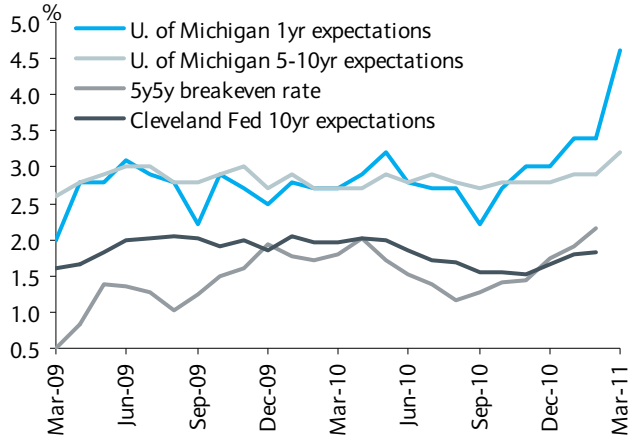
Our model effects are broadly linear. Thus, a $50 price rise would induce a fall in GDP of about 0.5% and boost inflation by about 2pp. These calculations suggest that substantially larger oil price increases than have so far been observed would be needed to materially threaten the global recovery and/or spur an inflationary spiral.

Shocks much larger than that are likely to have very non-linear effects on global economic activity and inflation as they would probably require a major disruption in Saudi Arabia, the world's key marginal supplier of oil (Figure 13). Around three quarters of the world's spare oil capacity is under Saudi Arabia's political control. The conventional view is that when global spare capacity falls below the traditional threshold of 5%, oil price fluctuations pick up. With global oil demand at around 90mb/d, we are close to the threshold. The probability of a major disruption in Saudi Arabia may be small but it is certainly not zero and higher than it was. If it were to materialize, we would effectively move to a 'risk off' environment with a big uncertainty shock and pretty dramatic effects on the global economy.

Any major disruption to Saudi Arabian oil supply could have dramatic effects on the global economy

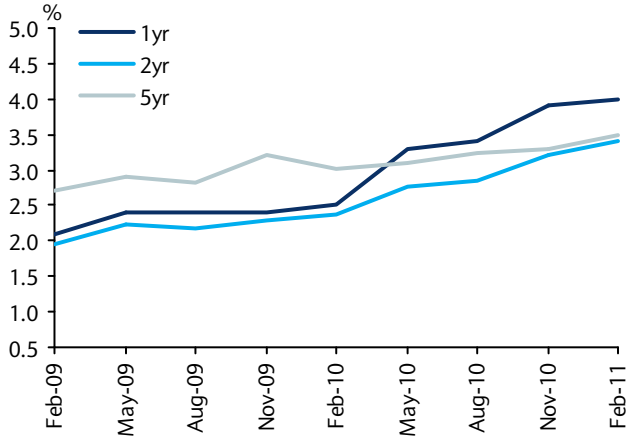
However, the relatively low probability of such an event suggests we should focus more on the effects of large, but not catastrophic, oil shocks. The inflationary impact of oil shocks would compound the pre-existing inflationary effect of the sizable increase in commodity prices since last summer. We have previously discussed the inflationary consequence of energy and food price increases under various scenarios (see "Approaching the negative inflation scenario", in *Global Economics Weekly*, 21 January 2011) and those effects appear to be in operation. Although it was first felt in the emerging world, where a larger share of CPI is

Figure 11: Inflation expectations up in the US…



Source: Bloomberg, Haver, Barclays Capital

Figure 12: … and in the UK (BoE Survey)



Source: Bank of England

sensitive to food and energy prices, commodity-led inflationary pressures have recently emerged in advanced economies, including the euro area, the US and the UK, as is evident in rising inflation expectations (Figure 11, Figure 12).

Further oil price shocks would complicate the policy calculus in some countries

There is then the question of the likely policy response. As discussed in the next section, policymakers are already having to deal with the effects of rising commodity prices driven by strong demand growth in some countries and loose monetary policy in advanced economies. In the economies that are seeing strong demand (primarily Asian emerging markets) the policy prescription has so far been straightforward – tightening is required. However, for those developed markets that are commodity importers, which include the US, the euro area and the UK, the effects of higher commodity prices are similar to those of a supply shock. As documented below, policymakers in the US and Europe have shown a divergence in their views about the appropriate monetary response to these global inflation developments, with Europe seeking to tighten policy and the US continuing to loosen. Whether a further large oil price shock would exacerbate the differences, or cause the policies to converge (with the more likely adjustment, in our view, being that European policymakers step back from their tightening plans) remains to be seen. Clearly, however, a significant oil supply shock would add major complications to the global policy calculus.

The global economy should be better able to withstand a large oil shock now than it was in the 1970s

Finally, will the oil crisis of the 1970s be repeated? Probably not, in our view, even in the event of a shock of similar proportions, unless policymakers make serious mistakes. Indeed, there are similarities but also key differences with respect to the 1970s. To put things in context, oil prices would need to reach $200 a barrel to deliver a supply shock of a similar order of magnitude to the two that occurred in the 1970s (Figure 14).

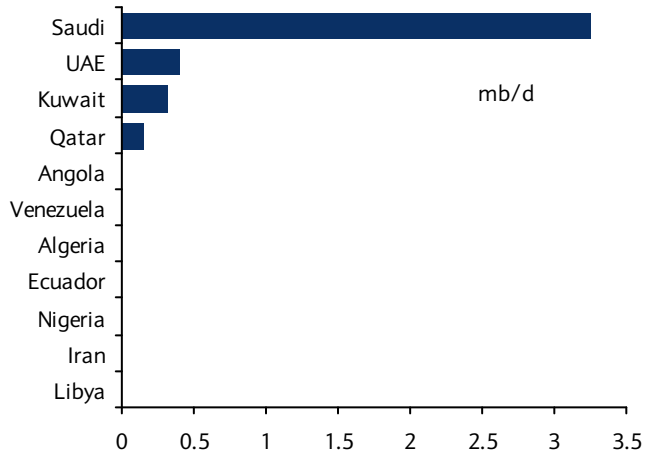
Monetary easing helped also commodity prices rise back then

A clear similarity between now and the 1970s is that easy monetary conditions and demand pressures started driving food prices before the first oil shock (Figure 15, Figure 16). Interestingly, Fed Chairman Ben Bernanke highlighted this feature of the 1970s situation in a *speech in 2003*. And we have been writing that easy monetary conditions maintained by advanced economies to support the recovery, and demand pressures from fast-growing large emerging markets, have been driving food and energy prices up in recent months.

But there is now more policy credibility…

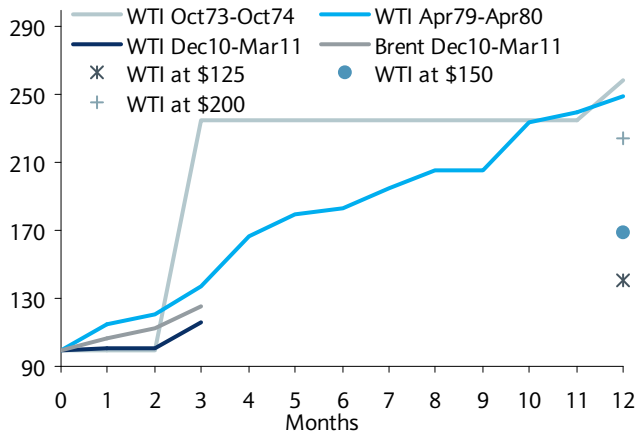
However, one key difference is that in the 1970s, inflation credibility was seriously deficient and helped generate second-round effects from the initial oil shock. Inflation credibility was damaged in the 1970s because policymakers tried to exploit the Phillips curve by generating higher employment even at the cost of higher inflation and dismissed the oil and other

Figure 13: Highly concentrated spare capacity in the oil market



Source: Datastream, Markit, Barclays Capital

Figure 14: Still far off the oil supply shocks of the 1970s



Source: Bloomberg, Haver, Barclays Capital

inflationary shocks as supply-side driven and hence not under the control of central bankers. Although we see a risk of some complacency among some central bankers, particularly at the Fed, the orders of magnitude are very different.

…and less energy-intensive production

An additional difference is in the much lower energy intensity of global economic production these days. This implies that the impact of an oil shock on the economy is lower today than in the 1970s, as also demonstrated by the limited effect on growth of sizable swings in oil prices over the past decade, with the exception of the peak in 2008.

Managing the cyclical recovery

The risks associated with cyclical tightening appear more pronounced than usual

Inflation pressures had been building even before the recent turbulence in the oil market, and there is a normal cyclical risk during a recovery that policy may be tightened too slowly or too fast. These risks strike us as particularly pronounced during this recovery, however. In part, this is because EMs are leading the upturn and the tightening cycle, and their importance for global growth and inflation is much greater than in the past. A slowdown in China is a key feature of our outlook, but engineering this in a controlled way may be challenging for the authorities. There are also concerns about developed economy policies: monetary tightening in Europe may be premature against a backdrop of fiscal consolidation and periphery debt risks, while the extreme looseness of US policy is too great to ignore. In fact, the contrast between the European and US policy stances is remarkable, and it is worth considering why the differences exist, whether they are sustainable and, if not, how they might unwind.

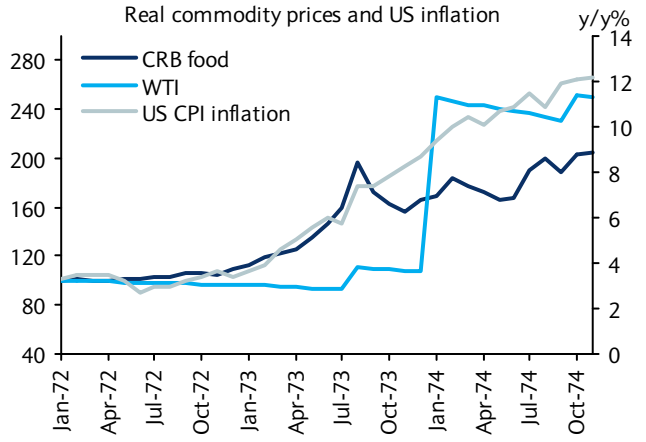
China's slowdown[1]

China's reliance on export-led growth means it needs to limit the appreciation of its real exchange rate. Achieving this involves two policy prongs: containing the pace of nominal exchange rate appreciation and limiting domestic inflationary pressures. In our view, official tolerance for nominal exchange rate appreciation remains low. Thus, we maintain our working assumption that a steady pace of appreciation of around 5% a year will be pursued.

The Chinese authorities are battling to contain inflation

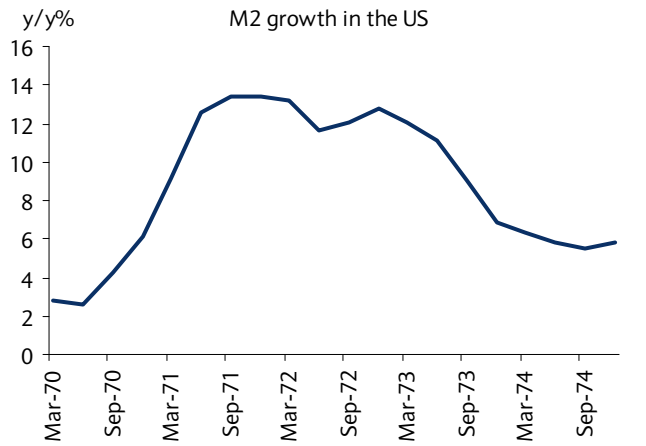
The inflation outlook is more uncertain. CPI inflation was 4.9% y/y in February, above expectations, and pipeline inflationary pressures remain acute, with commodity price rises and stronger producer prices putting more pressure on non-food inflation.

Figure 15: Food inflation picked up before the oil shock…



Note: Commodity prices are deflated using US CPI, and indexed to Jan-72=100.
Source: Haver, Bloomberg, Barclays Capital

Figure 16: … perhaps as result of increased money supply?



Source: Haver, Barclays Capital

[1] This section borrows heavily from "China: slowdown coming? 4 March 2011 and "China: Lower growth target reflects government's emphasis on quality of growth; moderate CNY appreciation", 28 February 2011.

Over the past several months, the PBoC has implemented a wide range of policies aimed at tightening monetary conditions, from higher reserve requirements to higher benchmark lending and deposit rates. Tight liquidity conditions are now evident in the interbank money market and the higher cost of capital. The 7-day Shanghai interbank offer rate (Shibor) has exhibited extreme volatility, with yields moving between 2.5% and 8.5%. Longer-dated Shibor rates continue to rise: 1y Shibor has risen to 4.6% from 2.7% since 30 September 2010 (Figure 17). Broad money and credit growth fell in February to pre-2009 levels.

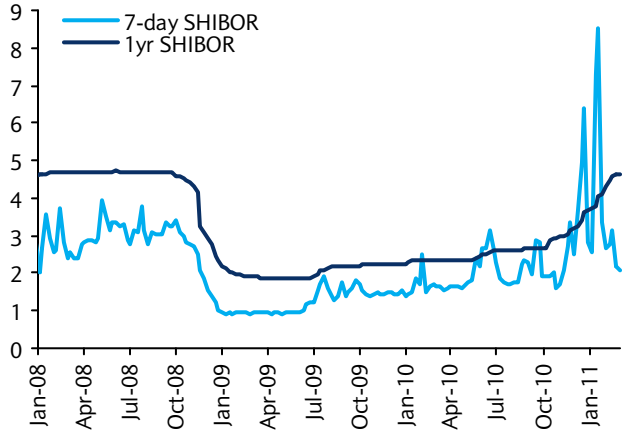
Financial markets may become nervous at signs that China is slowing

There are now also signs the real economy is slowing. Retail sales have been weaker than expected, reflecting weakening consumer confidence and the real income squeeze wrought by elevated inflation. Indicators of business confidence have fallen significantly, and surveys of credit availability and overall financial conditions indicate that monetary policy is now quite restrictive. We forecast GDP to slow to 9.3% in 1Q, to 8.2% in 2Q and to 7.8% in 3Q, with the risks skewed to the downside. Developments in interest rate-sensitive sectors of the economy (autos, real estate) will be crucial in updating our expectations. Even if the authorities achieve this measured moderation, markets may become nervous in the face of slowing activity, as happened when Chinese growth dipped to 8% in 2Q last year.

The downside risks should not be overstated, however. Some support for Chinese demand will likely come from fiscal policy. The budget deficit is likely to be around 2% of GDP in 2011, with public spending emphasizing education, healthcare, affordable housing (10mn units in 2011 and 36mn units in 2011-15) and employment. Furthermore, the Chinese authorities have a track record of exceeding their stated growth targets, which puts a question mark over their willingness to dampen growth to achieve their inflation objective.

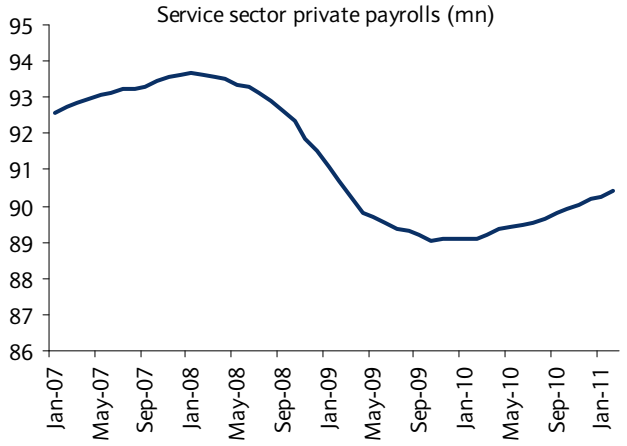
In the new five-year plan, released in February, the authorities indicated that they are aiming for slower growth that is more sustainable, more environmentally friendly and more equal across the regional and social spectra. The authorities set an annual growth target of 7% for 2011-15 (Figure 19). However, these statements were also present in the previous 5-year plan. The target was lowered from the 7.5% target in the last five-year plan 2006-2010, a period during which growth registered 11.2%. We expect average annual growth to exceed the 7% target by almost 2pp over the next five years.

Figure 17: China's liquidity conditions are tightening



Source: Bloomberg, Barclays Capital

Figure 18: US service sector is recovering



Source: Haver, Barclays Capital

Figure 19: China's real GDP growth rate in the recent Five-Year Plans (average %y/y)

FYP (%)	8th (91-95)	9th (96-00)	10th (01-05)	11th (06-10)	12th (11-15)
Target	6	8	7	7.5	7
Actual	12.3	8.6	9.8	11.2	8.9*

Note: * Forecast. Source: Barclays Capital

The US could turn less dovish this year

The drop in the US unemployment rate suggests QE2 is working

With regard to global monetary policy, the US is the elephant in the room, continuing to loosen policy while tighter monetary conditions pervade in the rest of the world. When it embarked on QE2, the Fed set itself a high bar for success, aiming to bring the unemployment rate down from close to 10% to around 5-6%, and we do not expect any changes to the pace or scale of the $600bn asset purchase programme currently under way. The policy appears to be working, however, with the expansion continuing to gain durability. The 0.9pp drop in the unemployment rate over the past three months is remarkable, and in our view a clear sign that the momentum is in the right direction.

Particularly encouraging is the fact that the private service sector is rapidly adding jobs. The service sector accounts for more than 80% of private employment, so job gains here are essential for the expansion to move into a more mature phase. Figure 18 shows that the recent gains moved the recovery in the service sector back to its pre-crisis trend. Other indicators also suggest the labor market recovery is gaining breadth. For example, Figure 20 shows a sharp improvement in the employment diffusion index, which measures how many industries are adding workers versus those losing workers. The employment component of the ISM manufacturing index has also moved to its highest level since 1973. On the wave of the economic recovery, but also on high international commodity prices, inflation is rising fast: the 3m inflation rate has increased much faster in recent months, from 0.9% in November 2010 to 4.6% in February for overall CPI, and from 0.7% to 1.8% for core CPI.

Expectations of Fed tightening could be brought forward

The FOMC statement following the March meeting reflected these developments. It stated that the recovery was "on a firmer footing" and that conditions in the labor market appeared to be "improving gradually". Just as important, the statement dropped previous statements about employers' reluctance to add to payrolls and omitted references to disappointment with the pace of recovery. In addition, the FOMC acknowledged that oil market developments had worsened the near-term inflation outlook and indicated that it would pay "close attention" to inflation and inflation expectations.

Thus, the risk emanating from the current loose policy stance may be less that the US is faced with runaway inflation down the line and more that a continuation of supportive data could prompt a sharper change in the Fed's tone. If expectations of US tightening were to shift forward sharply, this would have significant implications for financial market dynamics.

European tightening could be premature

The ECB is set to tighten, possible prematurely

The ECB has signalled that, barring any further adverse shocks, it is likely to raise the policy rate in April. This announcement surprised financial markets, which had underestimated the ECB's determination to clamp down on rising inflation. Some members of the ECB Governing Council have become increasingly uncomfortable with the level of its policy rate, especially in real terms, and we think this discomfort is likely to persist until the rate is 2-3% in nominal terms. As a result, we expect the ECB to show a continuing propensity to raise rates, provided that the economic, monetary and financial environment is consistent with this.

This is a material proviso, however, and in our view the ECB is preparing to raise rates too early. We think the euro area economy would benefit from more time to get onto a sustainable footing, particularly because it is still too early to gauge the effects of the substantial fiscal tightening that many countries are in the process of implementing. We also view the money and credit data as being unsupportive of a rate increase at this stage, as demonstrated by slowing growth in M2 since 2009 (Figure 21).

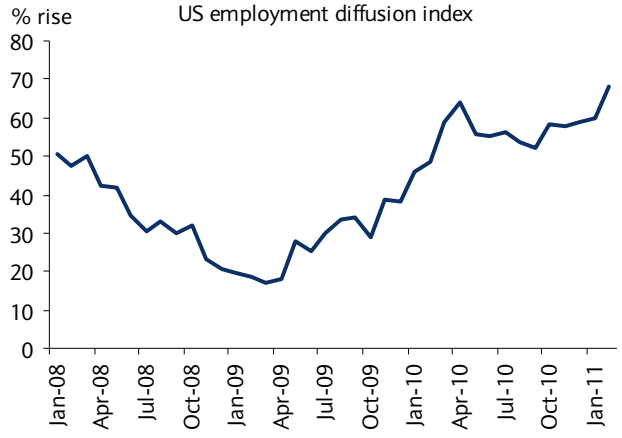
Although excessive aggression in tackling inflation poses a risk to euro-area economic activity, it is worth bearing in mind that the ECB has shown a remarkable degree of pragmatism in its operations over the past couple of years and has not shied away from U-turns. In particular, the July 2008 rate rise was quickly reversed and the ECB back-pedalled on its stated intention in December 2009 to unwind non-standard liquidity operations. We would not expect an outright reversal of a rate hike in April – in fact, we expect a second increase in July – but we forecast that the ECB will then pause for the remainder of the year as headline inflationary pressures abate following a decline in commodity price pressure. More generally, as long as the euro area economy is exposed to marked downside risks, we would hesitate to assume that the policy rate path will be steep, however hawkish the ECB may sound.

We expect the UK to begin tightening, although the growth outlook there is more precarious

The growth and inflation outlooks in the UK seem particularly unfavourable, providing the MPC with an acute dilemma. CPI inflation was 4.4% in February, more than twice the target rate, and has exceeded the target for the past 14 months. Inflation is widely forecast to stay well above target for the rest of the year (Figure 12). Governor Mervyn King wrote four letters to the Chancellor of the Exchequer in 2010 explaining why inflation was so far above target, and has said he expects to write four more such letters this year. The sequence of persistently high inflation outturns has led to questions being raised about the MPC's competence in forecasting inflation and its commitment to delivering on-target inflation.

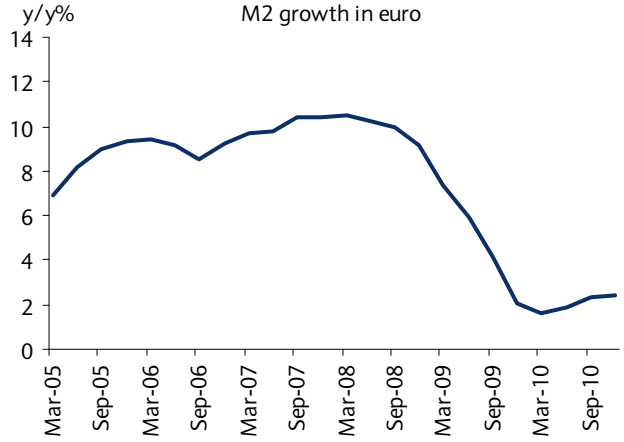
Nevertheless, the fragility of aggregate demand means the case for tighter policy is not clear-cut. GDP is estimated to have fallen by 2.3% q/q (saar) in 4Q, and although part of this was the result of weather-related disruption, it raised concerns of more deep-seated weakness. Consumer confidence has fallen back near the levels seen in the depths of the recession amid concerns about the effects of fiscal tightening and the squeeze in real income stemming from high inflation and weak wage growth. Housing market activity and prices, which had shown signs of recovery in the first half of 2010, have ground to a halt.

Figure 20: US economic recovery is broadening



Source: Haver, Barclays Capital

Figure 21: Not much money growth in Europe



Source: Haver, Barclays Capital

The MPC is split on how to act in this environment. Three of the nine committee members voted to hike rates in February, while one voted for policy to be loosened. Governor King appears firmly against hiking rates in the near term. Even so, the February *Inflation Report* seemed to be consistent with a gradual policy tightening cycle, starting with a 25bp rate increase in May, and we now forecast similar rises in August, November and February 2012.

The US-Europe policy gulf

The gap between the US and European monetary policy outlooks is extraordinary

In the two interest rate cycles since the ECB came into being, the Fed has been quicker both to cut rates and to raise them. Yet in our central scenario, the ECB will start hiking in April while the Fed will continue with quantitative easing until June. This would be the first time the ECB has led a change in policy cycle – it normally lags the Fed by several months – and the first time that the two central banks have moved policy in opposite directions *in the same month* (Figure 8). To the extent that the Bundesbank may be a proxy for the behaviour of the ECB, we have to go back 20 years to find a previous example of monetary policy divergence, in the early 1990s, just after the first Gulf war.

This potential reversal highlights the central banks' differing willingness to tolerate rising headline inflation in the face of the commodity supply shock (see *Global Economics Weekly: Living on different planets*, 22 October 2010). But it also reveals different perceptions of the cyclical versus structural nature of the employment and output gaps. Supply shocks tend to increase inflation and weaken growth, presenting the central bank with a dilemma. The received wisdom is that if the shock is a one-off it should be accommodated, in the sense that no monetary response is necessary. The annual inflation rate will, mechanically, be higher for a year, but as long as there are no 'second-round effects' the rate of inflation beyond one year should be largely unaffected. Indeed, the weakening in economic activity may itself be helpful in ensuring that no second-round effects materialise.

The difference reflects both different economic outlooks and different policy preferences

The Fed's unblinking response to rising global commodity prices is consistent with this textbook advice. The Fed's view is that the labor market remains too weak for second-round effects to take hold. Although the unemployment rate has fallen materially, at 8.9% versus the Fed's 5-5.5% estimate of the natural rate of unemployment (see *Market Strategy Americas: A change in tone, but not policy*, 10 March 2011), the implied unemployment gap remains large. The hawkishness in Europe, by contrast, seems to reflect the view that there is more reason to be concerned about second-round effects. In core Europe – Germany, in particular – hiring intentions have strengthened and unemployment has begun to fall. Moreover, a sizable fraction of the rise in unemployment in Europe, particularly that relating to the construction sector, is considered to be structural, implying that the unemployment gap is not as large as the rise in the unemployment rate on its own would imply. The ECB's action may also be an attempt to bolster the credibility of a still-young currency that has been shaken by concerns that sovereign debt problems could lead to its demise.

The latest FOMC, however, seems to bring the Fed closer to the ECB

An interesting question is whether these differences in approach are likely to be sustained, and, if not, how they might unravel. As noted above, we believe that the ECB is sufficiently flexible that if signs were to emerge that activity had been harmed – by premature tightening or other factors – it would slow the pace of rate normalisation, perhaps for a prolonged period. Equally, although we view an outright reversal in US policy as unlikely in the near term, rising inflation and inflation expectations against the backdrop of an improving labor market could put pressure on the Fed to adopt more hawkish rhetoric, and cause a significant shift in market rate expectations. Indeed the changes in the FOMC statement suggest potential flexibility from the Fed as well.

There is therefore scope for the policy gulf to close from both directions, and the range of possible policy outcomes seems unusually wide at this stage of the recovery cycle.

European sovereign debt risks remain

The outlook for euro-area sovereign debt has improved a little but the adjustment challenges remain formidable

The recent euro-area summit helped to disperse some of the gloom that had once again begun to envelop European sovereign debt markets. We have generally been a little more optimistic about the outlook for European debt than have many investors, and most of the specific proposals from the summit were in line with our expectations. However, we found the new indications of euro-area governments' resolve to overcome the currency bloc's financial problems to be especially encouraging, highlighting that the exit of a member state or a break-up of the union remain unlikely prospects. Even so, improvements in the crisis resolution framework cannot disguise the fact that implementation risks are very large as the fundamental economic adjustment required in the crisis countries remains formidable.

Regarding the existing European Financial Stability Facility (EFSF), key agreements included raising its effective lending capacity, lowering interest rate charges (subject to conditions) and allowing purchases of sovereign bonds in the primary market (in exceptional circumstances and in the presence of a financing program). In addition, there was an agreement to increase the size of the European Stabilisation Mechanism (ESM). Tellingly, the announcements lacked any details about how and when the additional funding would be provided, giving the German government an important degree of freedom in dealing with this sensitive domestic political issue ahead of state elections at the end of March.

The summit produced an agreement that there would be no participation by the private sector in any sovereign debt restructurings before 2013, and that collective action clauses would be included in all euro-area government bond contracts after mid-2013. There was also widespread support for the Franco-German economic governance framework labelled the 'pact for the euro'. In particular, there was an agreement by all euro-area member states that fiscal rules would be incorporated into national legal frameworks. Moreover, it was agreed that the provision of additional financial assistance to member states would be conditional on commitments to specific economic and governance reforms, as stipulated in the aforementioned pact.

Greece was an immediate beneficiary of the changes. In return for agreeing to pursue a large-scale privatization program and adopt a formal fiscal rule, the interest rate charged on bilateral financial support loans to the country was cut by 100bp and the maturity of the loans extended from three years to 7.5. Furthermore, the ability of the EFSF to buy bonds in the primary market provides a further back-stop for Greece should market interest rates on its debt fail to fall notably (Greece is scheduled to return to issuing bonds in 2012).

We do not expect a restructuring of Greek debt in the near term but there remains a significant chance of slippage

The Greek fiscal position remains precarious, however. Even if all fiscal, structural and privatization measures are adopted, unless vigorous growth returns, the debt-to-GDP ratio is unlikely to stabilize. We still do not see the need for a pre-emptive debt restructuring (a position that is also maintained by EU officials) as the adjustments required under the EU/IMF program are vital in any case to the longer-term health of the Greek economy. At the same time, however, we would not rule out the need for a restructuring/rescheduling before the end of the program if the Greek government fails to deliver on the program commitments or the program fails to reduce the deficit as envisaged.

Ireland failed to secure approval for a lower EFSF interest rate because of its refusal to countenance a rise in its corporation tax rate, a key demand of the German and French governments. We do not see this as a bad outcome, however. In our view, although a harmonization of corporation tax rates across Europe might be welcome over the medium term, a rise in the Irish corporation tax rate at this point would reduce growth and lead only

to a moderate increase in tax revenues. The net effect on public debt dynamics could well be negative. A compromise, whereby Ireland agreed to phase in higher corporation tax over the medium term would be preferable, in our view.

The capital needs of Irish banks are key to the public finances

More generally, there remain serious risks to the Irish situation. Probably the most pressing relates to the European bank stress tests scheduled for the end of March. If Irish banks are found to need further substantial capital injections, the government debt ratio – which at present we expect to stabilise around 2014-15 – could be blown off course once more. Poor stress test results could also increase the government's determination to draw senior bank debt holders into the restructuring arithmetic, potentially with adverse contagion effects on banks in other parts of the EU.

Portugal's fiscal sustainability is on a knife-edge, but Spain appears solvent

The Portuguese situation remains on a knife-edge. It is possible that the country will muddle through without external financial assistance. However, given its economy's fundamental lack of competitiveness, we do not believe it is sustainable for the country to borrow at current market interest rates, and the potential to access funds at the reduced EFSF interest rate is likely to become increasingly attractive. Although the minority government has recently announced further adjustment measures to re-establish a sustainable debt profile, it may be too weak to succeed in pushing through the requisite reforms.

We continue to believe that Spain is solvent, and the fact that the euro-area summit did not make reference to the country suggests that EU officials agree with this assessment. The main risks continue to stem from the cost of restructuring the *cajas*. The latest official estimates of the total recapitalization needs are lower than our own, but recourse to external financial assistance seems unnecessary unless the situation is much worse than we envisage. From this perspective, although financial markets may have taken some reassurance from the increase in the EFSF's effective lending capacity, which should mean that Spain could be accommodated by the facility should the need arise, we do not view the new measures as pivotal to the Spanish situation.

Figure 22: Summary of Barclays Capital economics projections: GDP growth and inflation

	Real GDP % over previous period, saar					Real GDP % annual chg			Consumer prices % over a year ago				Consumer prices % annual chg		
	4Q10	1Q11	2Q11	3Q11	4Q11	2010	2011	2012	4Q10	1Q11	2Q11	3Q11	2010	2011	2012
Global	3.9	5.0	3.9	4.3	4.2	4.9	4.3	4.4	2.9	3.3	3.5	3.6	2.6	3.5	2.8
Developed	1.5	3.0	2.3	2.9	3.0	2.5	2.4	2.7	1.5	2.0	2.3	2.6	1.3	2.4	1.7
Emerging	6.8	7.4	5.9	6.0	5.8	7.8	6.5	6.5	5.9	6.1	6.1	6.0	5.3	5.9	5.3
BRIC	7.8	8.3	7.1	7.4	6.4	8.8	7.7	7.7	6.0	6.3	6.2	6.0	5.0	5.9	5.1
America	3.2	3.7	3.4	3.7	3.7	3.7	3.4	3.7	2.7	3.3	3.8	4.1	2.7	3.9	3.1
United States	2.8	3.5	3.0	3.5	3.5	2.8	3.0	3.6	1.3	2.1	2.8	3.1	1.5	2.9	2.0
Canada	3.3	3.0	2.5	2.5	2.5	3.1	2.7	2.5	2.3	2.2	2.1	2.1	1.7	2.3	2.2
Latin America	4.4	4.2	4.7	4.4	4.4	6.2	4.4	4.3	8.2	8.2	8.1	8.7	7.6	8.4	7.8
Argentina	9.0	6.5	6.0	5.0	5.0	9.2	6.2	4.6	25.8	24.0	22.9	23.5	22.3	23.5	23.5
Brazil	3.0	3.6	5.1	4.5	4.7	7.5	3.9	4.5	5.6	6.0	6.0	7.0	5.0	6.4	5.4
Chile	3.8	6.0	5.0	5.0	5.0	5.2	6.4	4.5	2.5	2.8	2.9	3.6	1.4	3.4	3.8
Colombia	3.0	4.0	6.0	6.0	4.5	3.9	4.0	4.5	2.7	3.4	3.7	3.9	2.3	3.6	3.1
Mexico	5.1	3.5	3.0	3.0	3.0	5.5	3.9	3.5	4.2	3.5	4.0	4.4	4.2	4.0	3.9
Peru	10.6	8.7	7.9	7.4	7.1	8.8	8.3	7.1	2.1	2.3	2.9	3.0	1.5	2.9	3.1
Venezuela	-0.7	2.8	3.9	4.7	4.9	-1.9	3.1	4.2	27.2	28.6	25.6	25.8	28.2	26.6	25.9
Asia/Pacific	4.7	8.2	5.9	6.6	6.0	8.0	6.5	6.5	3.0	3.2	3.2	3.1	2.3	3.0	2.7
Japan	-1.3	1.9	0.8	3.2	3.0	3.9	1.6	1.9	-0.5	-0.3	0.2	0.5	-1.0	0.1	0.1
Australia	3.1	2.4	4.3	4.3	3.9	2.7	3.2	3.6	2.7	2.5	2.5	2.6	2.8	2.6	2.9
Emerging Asia	6.2	10.0	7.2	7.5	6.8	9.2	7.9	7.7	4.9	5.2	4.9	4.5	4.1	4.6	4.1
China	11.5	9.3	8.2	7.8	8.9	10.4	9.3	9.0	4.7	4.9	4.8	4.3	3.3	4.3	4.0
Hong Kong	6.1	5.3	4.9	4.1	4.9	6.8	5.1	4.5	2.8	3.7	4.4	5.3	2.4	4.5	4.0
India	-5.4	13.6	8.2	11.5	3.6	8.6	8.0	8.3	8.8	8.2	7.5	7.4	9.5	7.4	6.3
Indonesia	10.6	5.3	4.5	7.4	7.4	6.2	6.5	6.5	6.3	7.0	6.7	5.7	5.1	6.5	6.0
South Korea	2.2	8.5	4.9	3.8	5.1	6.1	5.0	4.0	3.6	4.4	3.7	2.9	3.0	3.4	2.2
Malaysia	8.2	7.0	6.0	4.5	6.5	7.2	5.4	6.0	2.0	2.7	3.1	3.0	1.7	3.0	2.5
Philippines	12.7	6.1	5.3	0.8	4.5	7.3	5.1	5.3	2.9	4.1	4.9	5.5	3.8	5.0	3.8
Singapore	3.9	12.4	6.7	4.6	2.4	14.5	5.0	5.5	4.0	5.4	4.3	3.2	2.8	3.8	1.5
Taiwan	0.0	16.8	1.6	2.2	2.7	10.8	5.2	4.0	1.1	1.7	2.1	1.8	1.0	2.0	2.0
Thailand	4.8	6.5	5.0	3.0	6.5	7.8	4.0	5.0	2.9	2.9	2.8	3.5	3.3	3.2	2.6
Europe and Africa	3.5	2.5	2.1	2.3	2.7	2.4	2.6	2.7	2.9	3.3	3.4	3.6	2.6	3.4	2.6
Euro area	1.1	2.7	1.8	2.2	2.3	1.7	2.1	2.0	2.0	2.4	2.5	2.6	1.6	2.5	1.9
Belgium	2.0	2.3	2.3	2.2	2.2	2.1	2.2	2.0	3.2	3.5	3.0	3.1	2.3	3.1	2.5
France	1.4	2.4	2.0	2.5	2.4	1.5	2.0	2.2	1.9	1.9	1.9	2.1	1.7	2.0	1.6
Germany	1.5	3.9	2.1	2.4	2.4	3.5	3.0	2.1	1.6	2.1	2.3	2.5	1.2	2.4	1.7
Greece	-5.6	-2.9	-0.5	-0.6	-0.1	-4.5	-3.2	0.9	5.1	4.2	3.5	3.3	4.7	3.8	2.1
Ireland	-0.2	0.3	1.1	1.7	1.7	-0.5	0.6	2.1	-0.6	0.8	1.5	1.6	-1.6	1.4	1.4
Italy	0.5	1.5	1.0	2.0	2.3	1.2	1.3	1.4	2.0	2.1	2.3	2.3	1.6	2.3	2.2
Netherlands	2.3	2.3	2.3	2.5	2.2	1.7	2.2	2.1	1.5	2.0	2.0	2.5	0.9	2.3	2.7
Portugal	-1.2	-2.1	-2.3	-1.0	0.2	1.4	-1.1	0.8	2.3	3.4	2.9	2.8	1.4	3.0	2.4
Spain	0.9	0.4	0.8	1.6	2.5	-0.1	0.8	1.9	2.5	3.2	3.1	3.2	2.0	3.1	2.1
United Kingdom	-2.3	2.7	2.3	2.0	2.3	1.3	1.7	2.2	3.4	4.1	4.1	4.3	3.3	4.1	1.9
Switzerland	3.5	2.4	1.6	1.2	1.2	2.6	2.4	1.3	0.3	0.2	0.2	0.7	0.7	0.5	1.1
EM Europe & Africa	11.3	1.9	2.8	2.6	3.8	4.4	4.1	4.4	6.1	6.3	6.9	7.1	5.8	6.7	5.9
Czech Repub.	1.4	2.5	2.8	4.5	2.9	2.2	2.8	3.5	2.1	2.0	1.6	1.6	1.4	1.8	2.3
Hungary	0.8	7.9	-2.6	3.8	2.0	0.8	2.5	3.7	4.3	4.1	4.3	4.0	4.9	4.1	3.6
Poland	4.7	4.2	1.7	1.5	1.6	3.9	4.0	4.1	2.9	3.7	3.8	3.8	2.7	3.7	3.3
Russia	18.6	0.3	2.2	2.0	2.4	4.0	4.3	4.6	8.2	9.7	10.2	9.7	6.9	9.6	7.4
Turkey	8.4	1.9	5.1	2.5	8.8	8.3	4.7	4.4	7.4	4.5	6.0	7.9	8.6	6.5	6.6
Israel	7.8	0.8	4.9	4.9	4.8	4.7	4.3	4.3	2.6	4.3	3.4	3.6	2.6	3.6	3.3
South Africa	4.4	3.8	3.9	4.0	4.2	2.8	3.8	4.3	3.5	3.8	4.4	4.9	4.3	4.6	5.9

Note: Weights for averages based on IMF real PPP GDP (2008-2010) for real GDP growth, and nominal GDP (2008-2010 average) for CPI inflation.
Source: Barclays Capital

Figure 23: Summary of Barclays Capital economics projections: External and government balance

	Current account (% GDP)					Government Balance (% GDP)				
	2008	2009	2010	2011F	2012F	2008	2009	2010	2011F	2012F
Global	-0.3	0.0	-0.2	-0.6	-0.7	-3.0	-7.2	-6.6	-5.6	-4.5
Developed	-2.0	-1.3	-1.3	-1.5	-1.4	-3.9	-8.6	-8.2	-6.9	-5.4
Emerging	3.5	2.9	2.3	1.5	0.9	-1.0	-3.9	-2.9	-2.7	-2.3
BRIC	5.4	3.1	2.7	2.0	1.4	-1.2	-4.0	-3.1	-2.9	-2.7
America	-3.4	-2.2	-2.7	-2.9	-3.2	-4.8	-9.3	-8.3	-7.1	-5.7
United States	-4.7	-2.7	-3.2	-3.5	-3.8	-6.3	-11.3	-10.2	-8.8	-7.0
Canada	0.4	-2.8	-3.1	-2.4	-2.1	0.1	-5.5	-4.9	-2.9	-2.1
Latin America	**-0.2**	**-0.3**	**-0.7**	**-0.8**	**-1.4**	**-0.8**	**-3.4**	**-2.8**	**-2.6**	**-2.4**
Argentina	2.2	3.6	1.0	0.2	-2.2	0.9	-2.5	-1.7	-2.4	-2.4
Brazil	-1.7	-1.5	-2.3	-2.4	-3.0	-2.0	-3.3	-2.6	-3.0	-2.8
Chile	-1.9	1.6	1.9	6.4	5.7	4.3	-4.4	-0.4	2.2	2.4
Colombia	-2.8	-2.1	-2.2	-1.9	-2.4	-0.1	-2.7	-3.0	-3.5	-0.9
Mexico	-1.5	-0.7	-0.5	-1.3	-1.7	-0.1	-2.3	-2.8	-2.5	-2.0
Peru	-4.2	0.2	-1.5	-2.8	-3.4	2.2	-2.1	-0.6	0.7	1.5
Venezuela	14.8	4.5	6.2	7.0	7.7	-2.7	-8.2	-6.9	-4.9	-6.6
Asia/Pacific	4.6	3.7	3.6	3.1	2.9	-1.9	-5.0	-4.7	-4.8	-4.0
Japan	3.3	2.8	3.6	3.9	4.2	-2.9	-8.8	-9.5	-9.2	-7.8
Australia	-4.5	-4.3	-2.6	-2.2	-2.0	-0.7	-2.1	-2.8	-2.8	-0.7
Emerging Asia	**6.3**	**5.1**	**4.3**	**3.4**	**2.7**	**-1.5**	**-3.3**	**-2.3**	**-2.6**	**-2.3**
China	9.6	6.0	5.2	4.3	3.6	-0.4	-2.2	-1.6	-1.9	-2.0
Hong Kong	13.7	8.7	7.6	8.6	7.3	0.1	0.8	4.0	-0.9	0.0
India*	-2.3	-2.8	-2.7	-2.8	-2.5	-8.9	-9.5	-8.2	-8.3	-7.3
Indonesia	0.0	1.9	0.9	0.5	-0.2	-0.1	-1.6	-0.6	-1.5	-1.3
South Korea	0.3	3.9	2.8	1.6	1.2	1.2	-1.7	-0.2	0.2	0.9
Malaysia	17.4	16.4	11.8	12.0	8.7	-4.8	-7.0	-5.3	-4.3	-3.3
Philippines	2.2	5.4	5.3	3.7	4.2	-0.9	-3.9	-3.7	-3.2	-2.7
Singapore	14.6	19.0	22.2	15.0	12.9	0.1	-1.2	0.2	0.0	0.5
Taiwan	6.9	11.4	9.4	6.1	6.0	-0.7	-4.1	-2.5	-1.9	0.0
Thailand	0.8	8.3	4.6	3.0	1.9	-1.1	-4.4	-2.0	-2.3	-1.7
Europe and Africa	-1.1	-0.6	-0.8	-1.3	-1.0	-2.1	-6.7	-6.2	-4.6	-3.6
Euro area	-1.5	-0.6	-0.6	-1.2	-0.9	-2.0	-6.3	-6.2	-4.7	-3.6
Belgium	-1.8	0.9	1.0	0.7	1.6	-1.3	-6.0	-4.3	-4.1	-2.9
France	-1.9	-2.0	-2.1	-2.4	-2.4	-3.3	-7.5	-7.5	-6.0	-4.7
Germany	6.7	5.0	5.1	5.5	5.5	0.1	-3.0	-3.5	-2.5	-1.6
Greece	-14.7	-11.1	-10.5	-7.6	-7.0	-9.4	-15.5	-9.5	-8.0	-6.9
Ireland	-5.6	-3.0	-1.2	1.4	2.1	-7.3	-14.4	-31.5	-10.1	-8.8
Italy	-3.0	-2.2	-3.5	-3.8	-3.5	-2.7	-5.3	-5.1	-4.8	-4.3
Netherlands	4.3	4.6	6.6	9.1	9.9	0.6	-5.4	-5.0	-4.2	-2.7
Portugal	-12.6	-10.9	-9.9	-8.3	-8.2	-2.9	-9.3	-7.9	-6.0	-5.6
Spain	-9.7	-5.5	-4.5	-2.5	-2.1	-4.2	-11.1	-9.2	-6.6	-4.7
United Kingdom	-1.6	-1.7	-2.4	-2.2	-1.1	-6.8	-11.5	-9.9	-7.5	-5.6
Switzerland	2.4	-5.5	-4.5	-2.5	-2.1	2.0	0.8	0.2	0.4	0.6
EM Europe & Africa	**-0.1**	**0.6**	**0.1**	**-0.9**	**-1.2**	**0.1**	**-6.1**	**-4.7**	**-3.0**	**-2.5**
Czech Republic	-0.7	-3.2	-3.8	-4.5	-5.1	-2.7	-5.8	-4.8	-4.3	-3.8
Hungary	-6.9	-0.4	0.9	0.3	-0.5	-3.7	-4.4	-3.9	1.8	-3.0
Poland	-4.7	-2.3	-3.2	-3.5	-3.4	-3.9	-7.5	-7.9	-5.9	-4.0
Russia	6.2	3.9	5.0	3.8	2.6	3.8	-5.9	-4.1	-1.7	-1.0
Turkey	-5.7	-2.3	-6.5	-7.7	-5.8	-2.5	-5.9	-4.0	-3.1	-3.3
Israel	0.8	4.0	3.1	1.5	0.5	-1.2	-5.2	-3.7	-3.0	-2.0
South Africa	-7.1	-4.1	-3.2	-3.5	-4.2	-1.2	-6.9	-5.4	-5.5	-5.1

Note: * India forecasts are on FY basis. Weights for averages based on nominal GDP (2008-2010 average) for current account to GDP and government balance to GDP.
Source: Barclays Capital

Figure 24: US economic projections

	2010				2011				2012				Calendar year average		
% Change q/q saar	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2010	2011	2012
Real GDP	3.7	1.7	2.6	2.8	3.5	3.0	3.5	3.5	3.5	3.5	4.0	4.0	2.8	3.0	3.6
Private consumption	1.9	2.2	2.4	4.1	3.5	2.5	3.0	3.5	3.5	3.5	4.0	4.0	1.8	3.1	3.5
Public consump and invest.	-1.6	3.9	3.9	-1.5	0.0	-0.5	-1.0	-1.0	-1.0	-1.0	-0.5	-0.5	1.0	0.1	-0.9
Residential investment	-12.3	25.7	-27.3	2.8	20.0	15.0	15.0	10.0	10.0	10.0	12.0	12.0	-3.0	7.8	11.3
Equip. & software investment	20.4	24.8	15.4	5.5	13.0	16.0	16.0	17.0	15.0	13.0	12.0	12.0	15.1	13.7	14.6
Structures investment	-17.8	-0.5	-3.5	4.5	5.0	8.0	10.0	10.0	11.0	11.0	11.0	11.0	-13.8	4.9	10.5
Net exports ($ bn, real)	-338	-449	-505	-395	-442	-473	-488	-508	-521	-536	-547	-560	-422	-478	-541
Net exports (contr to GDP, pp)	-0.3	-3.4	-1.8	3.4	-1.5	-1.1	-0.6	-0.8	-0.6	-0.6	-0.6	-0.7	-0.5	-0.5	-0.7
Final sales	1.1	0.9	0.9	6.7	2.4	2.3	3.1	3.3	3.4	3.3	3.8	3.8	1.5	3.1	3.4
Ch. inventories ($ bn, real)	44.1	68.8	121.4	7.1	39.0	59.0	69.0	74.0	76.0	82.0	86.0	90.0	60.4	60.3	83.5
Ch. inventories (contr to GDP, pp)	2.6	0.6	1.8	-3.6	1.1	0.7	0.3	0.2	0.1	0.2	0.2	0.2	1.4	0.0	0.2
GDP price index	1.0	1.9	2.1	0.4	1.5	1.5	1.8	1.9	2.1	2.3	2.3	2.3	1.0	1.5	2.1
Nominal GDP	4.8	3.7	4.6	3.2	5.1	4.5	5.4	5.5	5.8	5.9	6.4	6.4	3.8	4.6	5.7
Industrial output	7.1	7.2	6.2	3.2	4.5	5.0	5.0	5.0	5.0	5.0	6.0	6.0	5.7	4.8	5.2
Employment (avg mthly chg, K)	39	181	-46	139	145	200	220	235	245	250	250	250	78	200	249
Unemployment rate (%)	9.7	9.6	9.6	9.6	8.9	8.8	8.6	8.4	8.2	7.9	7.6	7.3	9.6	8.7	7.7
CPI inflation (% y/y)	2.4	1.8	1.2	1.3	2.1	2.8	3.1	2.8	2.2	1.9	2.0	2.1	1.6	2.7	2.0
Core CPI (% y/y)	1.3	0.9	0.9	0.7	1.1	1.3	1.3	1.6	1.6	1.6	1.8	1.9	1.0	1.3	1.7
Core PCE price index (% y/y)	1.8	1.5	1.2	0.8	1.0	1.1	1.3	1.5	1.5	1.6	1.7	1.9	1.3	1.2	1.7
Current account (% GDP)	-3.0	-3.4	-3.4	-3.1	-3.4	-3.5	-3.6	-3.6	-3.7	-3.8	-3.8	-3.8	-3.2	-3.5	-3.8
Federal budget bal. (% GDP)	…	…	…	…	…	…	…	…	…	…	…	…	-8.9	-7.9	-6.2
Federal funds rate (%)	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0.75	1.25	…	…	…

Note: All numbers expressed in q/q saar % unless otherwise specified. The budget balance is fiscal year. Source: BEA, BLS, Federal Reserve, US Treasury, Barclays Capital

Figure 25: Euro area economic projections

	2010				2011				2012				Calendar year average		
% Change q/q	Q1	Q2	Q3	Q4E	Q1E	Q2E	Q3E	Q4E	Q1E	Q2E	Q3E	Q4E	2010E	2011E	2012E
Real GDP	0.4	1.0	0.3	0.3	0.7	0.4	0.5	0.6	0.4	0.5	0.5	0.4	...	...	
Real GDP (saar)	1.6	4.0	1.4	1.1	2.8	1.7	2.1	2.3	1.6	2.1	2.1	1.6	...	...	
Real GDP (y/y)	0.8	2.0	1.9	2.0	2.3	1.7	1.9	2.2	1.9	2.0	2.0	1.8	1.7	2.1	2.0
Private consumption	0.4	0.2	0.1	0.4	0.5	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.7	1.4	1.5
Public consumption	0.0	0.2	0.4	0.1	0.0	-0.1	0.0	0.0	0.1	0.1	0.2	0.1	0.7	0.3	0.3
Investment	-0.2	2.1	-0.1	-0.6	0.9	0.6	0.9	0.8	0.7	0.6	0.7	0.7	-0.8	2.2	3.2
- Residential construction	-0.7	2.2	-0.5	-1.3	1.1	0.4	0.5	0.5	0.5	0.4	0.4	0.4	-3.0	1.2	1.9
- Non-residential construction	-2.4	1.5	-1.0	-2.5	0.7	-0.4	0.3	0.3	0.4	0.4	0.4	0.4	-4.6	-1.4	1.2
- Non-construction investment	1.4	2.4	0.5	0.8	1.1	1.3	1.5	1.4	1.1	1.0	1.0	1.1	2.5	4.7	4.8
Inventories contribution (pp)	0.4	0.3	-0.1	-0.2	0.1	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.4	0.1	0.1
Net exports contribution (pp)	-0.2	0.2	0.4	0.4	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.0	0.9	0.7	0.3
Industrial output (ex construct.)	2.3	2.4	1.1	1.9	0.8	0.2	0.5	0.6	0.2	0.4	0.4	0.1	7.2	4.0	1.5
Employment (q/q)	0.0	0.1	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2	-0.5	0.2	0.4
Unemployment rate %	9.9	10.0	10.0	10.0	9.9	9.7	9.6	9.5	9.3	9.1	8.9	8.7	10.0	9.7	9.0
CPI inflation (y/y)	1.1	1.6	1.7	2.0	2.4	2.5	2.6	2.7	2.2	1.8	1.7	1.7	1.6	2.5	1.9
Core CPI (ex food/energy) y/y	0.9	0.9	1.0	1.1	1.0	1.1	1.1	1.1	1.2	1.3	1.4	1.6	1.0	1.1	1.4
Current account % GDP	-0.1	-0.3	-0.6	-1.4	-1.4	-1.3	-1.2	-1.0	-1.0	-0.9	-0.8	-0.9	-0.6	-1.2	-0.9
Government balance % GDP	...	...	...	...	...	...	...	...	...	...	...	...	-6.2	-4.7	-3.6
Refi rate (period end %)	1.00	1.00	1.00	1.00	1.00	1.25	1.50	1.50	1.75	2.00	2.00	2.00	1.00	1.50	2.00

Note: All numbers expressed in % q/q unless otherwise specified. Source: Barclays Capital

Figure 26: UK economic projections

	2010				2011				2012				Calendar year average		
% Change q/q	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2010	2011	2012
Real GDP	0.3	1.0	0.7	-0.6	0.7	0.6	0.5	0.6	0.6	0.5	0.5	0.5	...	...	...
Real GDP (saar)	1.3	4.2	2.8	-2.3	2.7	2.3	2.0	2.3	2.4	2.1	2.1	2.1	...	...	...
Real GDP (y/y)	-0.3	1.5	2.5	1.5	1.8	1.3	1.2	2.3	2.2	2.2	2.2	2.2	1.3	1.7	2.2
Private consumption	-0.1	0.5	0.0	-0.1	0.0	0.1	0.1	0.2	0.3	0.3	0.3	0.3	0.8	0.3	1.0
Public consumption	0.5	0.3	-0.3	0.7	-0.1	-0.1	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3	1.0	0.1	-1.0
Investment	3.3	1.1	3.7	-2.5	1.6	1.0	0.6	0.9	1.1	1.4	1.5	1.6	3.1	3.1	4.6
Inventories (q/q cont.)	0.9	0.2	0.3	0.0	0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0	1.4	0.4	0.0
Net exports (q/q cont.)	-0.8	0.3	0.0	-0.3	0.3	0.2	0.4	0.3	0.3	0.2	0.1	0.1	-0.9	0.6	1.1
Nominal GDP	2.1	0.7	1.0	-0.1	1.8	1.2	1.0	1.0	1.3	1.2	1.2	1.2	4.3	4.2	4.8
Industrial output	1.2	1.0	0.4	-0.6	0.4	0.3	0.2	0.3	0.5	0.7	1.0	1.2	1.7	0.8	2.3
Employment	-0.2	0.6	0.6	-0.2	-0.3	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.2	0.0	0.3
Unemployment rate %	8.0	7.8	7.7	7.9	8.1	8.1	8.2	8.2	8.2	8.3	8.3	8.3	7.9	8.2	8.3
CPI inflation y/y	3.3	3.4	3.1	3.4	4.1	4.1	4.3	3.8	2.2	1.9	1.7	1.8	3.3	4.1	1.9
Core CPI y/y	2.9	3.0	2.7	2.8	3.2	3.3	3.4	3.2	…	…	…	…	2.9	3.3	...
Current account % GDP	-2.7	-1.4	-2.6	-3.0	-2.6	-2.4	-2.1	-1.8	-1.4	-1.2	-1.1	-0.9	-2.4	-2.2	-1.2
Govt. balance % GDP*	...	...	...	...	...	...	...	...	...	...	...	...	-10.2	-7.8	-6.2
Bank Rate	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25	1.50	2.00	2.50	2.50	0.50	1.25	2.50

Note: *Fiscal year forecasts, 2010 = FY 10-11; includes the impact of financial sector interventions, which reduces overall borrowing.
Source: ONS, Barclays Capital

Figure 27: Japan economic projections

	2010				2011				2012				Calendar year average		
% change	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2010	2011	2012
Real GDP (q/q, saar)	6.1	2.1	3.3	-1.3	1.9	0.8	3.2	3.0	1.3	1.1	1.6	2.6	3.9	1.6	1.9
Real GDP (q/q)	1.5	0.5	0.8	-0.3	0.5	0.2	0.8	0.8	0.3	0.3	0.4	0.6	-	-	-
Private consumption (q/q)	0.5	-0.0	0.9	-0.8	0.4	-0.2	0.4	0.3	0.3	0.2	0.2	0.2	1.8	0.3	1.0
Public consumption (q/q)	-0.3	1.1	0.3	0.3	0.1	0.3	-0.2	-0.2	-0.2	0.0	0.3	0.3	2.3	0.9	-0.0
Residential investment (q/q)	1.6	-0.3	1.8	2.9	3.8	2.0	-0.4	-1.2	-0.5	0.0	0.2	0.5	-6.3	7.9	-0.9
Public investment (q/q)	-1.4	-4.0	-2.0	-5.6	1.2	2.3	3.6	1.4	-1.7	-2.5	-0.7	0.0	-3.2	-1.1	-0.6
Capital Investment (q/q)	0.7	2.9	1.4	0.5	0.9	0.2	1.7	1.6	1.0	1.2	1.7	1.5	2.1	4.2	5.3
Net exports (q/q)*	0.5	0.3	-0.1	-0.1	-0.2	0.2	0.0	0.1	0.0	0.1	0.0	0.1	1.8	-0.1	0.3
Ch. Inventories (q/q)*	0.7	-0.1	0.3	0.3	0.1	-0.2	0.1	0.2	0.0	0.0	0.0	0.0	0.6	0.4	0.1
Nominal GDP (q/q)	1.7	-0.6	0.6	-0.7	0.2	-0.0	0.6	0.7	0.1	0.1	0.1	0.6	1.8	0.3	1.2
Industrial output (q/q)	7.0	1.5	-1.8	-1.6	3.9	-0.2	2.9	4.3	2.7	1.5	2.5	2.5	15.9	5.0	3.6
Employment (q/q)	0.4	-0.4	0.3	-0.1	0.2	0.2	0.4	0.3	0.3	0.3	0.2	0.2	-0.3	0.7	1.2
Unemployment rate (%)	5.1	5.1	5.0	5.0	4.9	4.8	4.7	4.5	4.4	4.2	4.0	4.0	5.1	4.7	4.2
CPI inflation (y/y)	-1.2	-1.2	-1.1	-0.5	-0.3	0.3	0.6	0.2	0.1	0.0	-0.1	0.0	-1.0	0.2	0.0
Core CPI ex food/energy (y/y)	-1.1	-1.6	-1.5	-0.9	-0.6	0.0	0.6	0.2	0.1	0.0	-0.1	0.0	-1.3	0.0	0.0
Current account (% GDP)	3.8	3.3	3.6	3.5	3.7	3.9	3.9	4.0	4.1	4.2	4.2	4.3	3.6	3.9	4.2
Government balance (% GDP)	…	…	…	…	…	…	…	…	…	…	…	…	-9.5	-9.2	-7.8
Overnight call rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10

Note: *Contribution. Central bank rates are for end of period %. Source: BoJ, Cabinet Office, METI, MIC, MoF, Barclays Capital

COMMODITY MARKETS OUTLOOK

Here be dragons

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- **After broad-based commodity market strength in Q4, there has been a significant split in performance brought on by the various crises in MENA and the Tohoku earthquake. Energy prices have advanced, while base metals have been held back by the resumption of pessimism regarding demand prospects.**
- **In our view, the downwards move in base metals has been overdone, and we expect prices for copper and nickel to rally on supportive fundamentals and a diminution of macroeconomic fears.**
- **We expect oil prices to remain elevated due to a sharp compression in global spare capacity combined with the confluence of the geopolitical situations. Agricultural prices are likely to stay supported in H1, but we expect a modest easing in H2. Food price inflation is likely to remain high on the agenda for policymakers.**

A sharp change in the dynamic in Q1

Thus far in 2011, there has been a significant departure from the business-as-usual conditions that characterised commodity markets in 2010. The characteristics of 2010 as a whole were well demonstrated in an amplified, even extreme, way by market performance in Q4. Across a wide selection of key commodities, demand growth showed few signs of slowing, and indeed continued to surprise to the upside, led by a renewed surge in Chinese demand in particular. In general, monetary conditions remained highly conducive for the continuation of robust global growth, and the occasional bouts of market pessimism about the prospects for growth and commodity demand were becoming less frequent and less severe. Further, in addition to the effect of rapid demand growth, in several key commodities, supply constraints were coming back into view, with the whittling away of any cushions of spare capacity or additional inventory cover built up through the 2008-09 economic down-cycle. Weather conditions were also supportive, continuing to provide impetus for some key agricultural markets, while robust heating demand provided support, even for supply surplus-prone commodities such as US natural gas. In all, the underlying conditions for the broad base of commodities in Q4 were almost as positive as they possibly could be. As a result, price performance was heavily skewed to the upside. Of the 53 commodities futures contracts listed in Figure 1, no less than 51 recorded an increase across Q4. The modal performance was a gain of 12.2%, the unweighted average was an increase of 12.6%, prices for 31 commodities rose more than 10% and only two commodities recorded a fall (the very small rough rice and milk contracts).

At the start of this year, the scale of the momentum built up in Q4 looked strong enough to carry on through Q1 with relatively little deflection, given the solidity of the fundamental background. The positive demand shocks looked set to continue, market sentiment seemed likely to continue its progression to a more positive and less sceptical stance, and the added injection of capacity concerns looked set to add impetus across a wide sweep of commodities. That pattern did indeed survive through January, but then the dynamic changed.

Figure 1: Commodity price performance in the year-to-date

Commodity	% change	Price as at 21 March	Units	Exchange
Milk	47.5	19.5	cts/lb	CME
Cotton	37.5	199.12	cts/lb	NYCE
Gasoline (Tokyo)	27.5	73480	¥/kilolitre	TOCOM
Gasoil (London)	27.5	972.25	$/tonne	ICE
RBOB gasoline	21.4	294.94	cts/gal	NYMEX
Dubai/Oman average	20.4	56300	¥/kilolitre	TOCOM
Brent	20.2	113.93	$/b	ICE
Heating oil	19.0	302.43	cts/gal	NYMEX
Kerosene	17.4	73540	¥/kilolitre	TOCOM
Arabica coffee	15.1	276.8	cts/lb	CSCE
Silver (NY)	13.4	35.06	$/Troy oz	COMEX
Silver (Tokyo)	13.3	91.3	¥/g	TOCOM
Tin	11.0	29920	$/tonne	LME
Lean hogs	10.8	88.325	cts/lb	CME
WTI	10.6	101.07	$/b	NYMEX
Corn	8.7	683.5	cts/56 lb bu	CBOT
Nickel	7.2	26765	$/tonne	LME
Natural gas (UK)	6.5	65.01	p/therm	ICE
Lumber	5.8	319.4	$ per 1000 ft	CME
Feeder cattle	5.0	128	cts/lb	CME
Lead	4.9	2712.5	$/tonne	LME
Live cattle	3.5	111.65	cts/lb	CME
Aluminium (London)	3.1	2536.5	$/tonne	LME
Cocoa (NY)	3.0	3127	$/tonne	CSCE
Rubber (Tokyo)	1.5	411	¥/kg	TOCOM
Gold (Tokyo)	0.2	3711	¥/g	TOCOM
Gold (NY)	-0.4	1415.9	$/Troy oz	COMEX
Soybean meal	-0.6	367.9	$/ton	CBOT
Cocoa (London)	-0.7	2003	£/tonne	LIFFE
Wheat (Kansas City)	-0.7	845	cents per bushel	KBOT
Wheat (Minneapolis)	-1.6	867.5	cents per bushel	MGE
Canola	-1.9	572.8	C$/tonne	WCE
Soybeans	-2.2	1362.5	cts/60 lb bu	CBOT
Copper (London)	-2.3	9519	$/tonne	LME
Wheat (London)	-2.3	194.35	£/tonne	LIFFE
Copper (NY)	-2.5	4.3295	$/lb	COMEX
Platinum (Tokyo)	-2.5	4509	¥/g	TOCOM
Rough rice	-2.6	1363.5	cts/56 lb bu	CBOT
Platinum (NY)	-2.8	1723.4	$/Troy oz	NYMEX
Soybean oil	-3.4	55.77	cts/lb	CBOT
Corn (Paris)	-4.5	224.5	€/tonne	MATIF
Orange juice	-5.2	163.45	cts/lb	NYCE
Natural gas (US)	-5.4	4.168	$/mmbtu	NYMEX
Zinc (London)	-5.4	2300	$/tonne	LME
Wheat (Paris)	-8.2	231.75	€/tonne	MATIF
Coal	-8.3	73.33	$/ton	NYMEX
Sugar (London)	-8.6	710.6	$/tonne	LIFFE
Palladium (Tokyo)	-8.9	1893	¥/g	TOCOM
Palladium (NY)	-9.0	731.4	$/Troy oz	NYMEX
Wheat (Chicago)	-9.0	723	cts/60 lb bu	CBOT
Rapeseed	-9.1	452	euros/kg	MATIF
Oats	-10.7	352	cts/56 lb bu	CBOT
Sugar (NY)	-13.7	27.71	cts/lb	CSCE

Key : Energy
Base metals
Precious metals
Agriculture/livestock

Source: Commodities exchanges as listed, Barclays Capital

As is shown in Figure 1, commodity price performance in Q1-to-date has been very different from Q4. The unweighted average performance has been an increase of 4.3%, and modal performance has been a decline of 0.4%, with 26 contracts rising in price and 27 falling across the quarter. Taking the past month alone, the nature of the differential in performance becomes even clearer. Of the contracts shown in Figure 1, 11 of the strongest 13 over the past month have been energy contracts – even the weakest energy contract, ie, US natural gas, has risen 7.5% – and base metals, with the exception of lead, have fallen.

This sharp discontinuity in the price dynamics of commodity markets has been the combined and dominant effect of the political fractures and military activation across the MENA region and the direct consequences of the Tohoku Pacific Coast earthquake. These events have had immediate consequences for the supply or demand of some key commodities, while others have been negatively affected by the associated resurgence in more general concerns about demand growth and the prospects for the economic recovery. We consider the main commodity sub-groups in detail below. However, at the aggregate level, we identify three main themes for commodities strategy, together with their associated trading implications.

1. Go long the economic recovery

While events in MENA and Japan have been central to commodity markets, we do not expect them to derail the global economic recovery, nor should the economic outcomes be both discontinuous and negative. This leads us to advocate being long those commodities which have priced in the greatest degree of economic pessimism and in which an overshooting of economic alarm has overwhelmed the effect of supportive fundamentals. In our view, the commodities group that most fits that description is base metals, and while the risk of further short-term sentiment deterioration remains, we advocate positioning for a long exposure to copper and nickel in particular. Copper still has a very sizeable forecast deficit for 2011 due to strong demand and intensifying supply-side constraints, and nickel has a welter of short-term sources of support, including restocking in the stainless steel industry, robust Chinese demand and supply difficulties. Should, as is our base case, the global economic recovery demonstrate its longevity and should China experience a soft landing to a more sustainable growth path rather than a crash, then after their recent corrections, copper and nickel are, in our view, the commodities most geared to positive global economic news. In addition, we expect the long process of reconstruction in Japan to prove to be highly metals-intensive.

2. Go short the future of nuclear power

In our view, the course of events at the Fukushima Daichi facility has represented so significant a concentration of severe events and technical failures that the future development of nuclear power on a global basis is likely to be, at the very least, significantly slowed. However, the effect may well not just be limited to the pace with which incremental capacity comes on stream. A long process of reviews in several key countries, together with heightened political and public concern, is also likely to result in the earlier decommissioning of older plants plus an extended period of increased downtime of capacity for checks, upgrades and maintenance. Further, in our view, markets have been slow to begin the process of fully pricing in the consequences of a flatter growth profile for nuclear energy into the longer term. Therefore, we recommend several commodities trades associated with a broad-based adoption of a more sceptical view on the prospects for nuclear power. A world with less incremental nuclear power supply should be one in which the relative price of carbon is higher; hence, the first trade is to go long carbon EUAs, a trade

supported by the ending of free carbon allowances to utilities under the EU ETS. Less nuclear usage at the margin is also likely to involve more use of fossil fuels. We see it as supportive of coal prices, with the European market further bolstered in the short term by the likelihood of a truncation of the German nuclear programme in particular. Prior to the earthquake, we were advocating a positive exposure to API2 coal (ie, European delivered coal), based on supportive global balances for 2011, and the logic of that trade remains strong, in our view. The implications of the nuclear problems for oil markets in the short run are more difficult to trade outside physical markets. They include a stronger and, we expect, extended bid for direct burning crudes (especially Indonesian waxy crudes), more use of low sulphur waxy residue (LSWR) and fuel oil. Combined with short-term refinery outages in Japan, they also include higher Asian refinery profit margins in general. Natural gas is also likely to gain support and market share, and we would see a pro-gas view because of nuclear retrenchment as being best effected through long positions in UK NBP prices, rather than the more insular and supply surplus-prone US natural gas market.

3. Expect geopolitical shocks to have some longevity

In our view, the series of geopolitical events across the MENA region is likely to have some longevity, with a whole cycle of longer-term implications and continuing issues. The future political shape and regional stance of Egypt is unknown and likely to evolve very slowly. Libya has entered what looks likely to be a prolonged period of political and economic evolution with a significantly reduced capacity to export energy, whatever the duration and outcome of the immediate military conflict. Perhaps most profoundly, the escalation of tension in Bahrain has reopened and emphasised some deep pan-regional tensions and seems likely to lay the basis for a series of further longer-term tensions, albeit potentially punctuated by periods of relative calm. In our view, the regional status quo as it stood at the start of the year has now been so severely disturbed that a swift return to anything approximating it is now impossible. The reshaping of the regional political balance already appears to be as profound as that which surrounded the first oil shock of 1973 and may yet prove as sweeping as the background to the second oil shock of 1978-79. Most, but not all, of the consequences for commodity markets are likely to be centred on the oil market, which is likely to experience lower levels of spare capacity and a heightened degree of tail-end risks as a result. This should reinvigorate long crude oil trades, as well as increase the attraction of various volatility-related strategies, including far-out-of-the-money crude call options. The other geopolitical position is a long exposure to gold, which we expect to exceed $1500 per oz, before prices may recede on inflationary fears and the potential for the turning of the interest rate cycle.

Energy markets

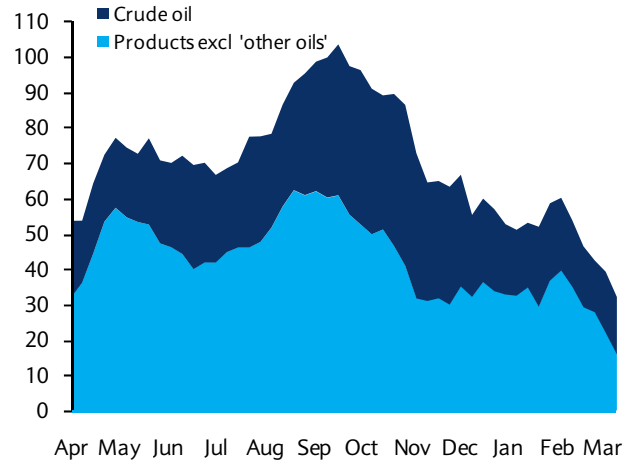
Oil prices began their latest significant move up in the middle of 2010, with the monthly average of Brent crude now having risen for eight consecutive months. Brent first reached $100 per barrel for the front of the curve at the end of January, driven by a tightening market caused by the continuation of the strong positive demand shock of 2010. Demand growth in 2010 was the greatest in more than 30 years, led by 0.94 mb/d (11.1%) of demand growth from China but also including a surprisingly strong growth of 0.68 mb/d (1.5%) from the OECD. The ascent to $100 per barrel occurred before any significant addition of geopolitical concerns and implications. Indeed, in that context, the initial reaction of prices to events in MENA, leading up to and including the loss of Libyan oil, can be seen as having been extremely muted.

What the demand shock achieved in terms of market dynamics was to whittle away the significant cushion of inventories and spare capacity that had built during the sharp downturn in demand in late 2008 and early 2009. The strength in demand, centred primarily on strong diesel and other middle distillates demand, was such as to create a persistent supply deficit through the year which was filled by the emptying of surplus inventory cover. A significant buffer of floating inventories that at one point neared 150 mb was dispersed relatively quickly, and then recorded onshore inventories outside the US fell back to, and then below, their five-year average. Finally, excess US inventories also began to dissipate, with the surplus above the five-year average for crude and products combined falling from above 103 mb in September 2010 to just 32 mb in March 2011.

The other aspect to this process of cleaning up and tightening within the oil market has been a reduction in global spare capacity. At its low point in August 2008, global spare upstream capacity had fallen to below 1.5 mb/d, ie, well below 2%. The financial crisis and associated fall in economic activity took that level of slack up above 5.5 mb/d (6%) by mid-2009. The demand shock of 2010 and the associated rise in Saudi output has this year brought the level of sustainable spare capacity down to just above 3 mb/d (about 3.3%), primarily held in Saudi Arabia (about 2.6 mb/d), with a residual 0.6 mb/d held by the combination of the UAE, Kuwait and Qatar. With the loss of Libyan exports yet to be fully replaced, the current level of spare capacity is still associated with a significant supply deficit at the margin, and we would expect the level of spare capacity to thin further when output from the Gulf moves up.

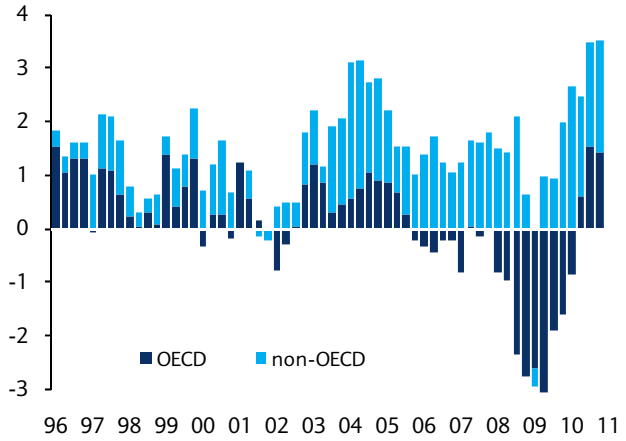
The various crises across MENA have produced two main direct outcomes for the oil market. First, there has been a significant truncation of exports out of Libya, amounting to some 1.3 mb/d. The crude oil component of that is predominantly light sweet crude oil with very short supply lines, used primarily in southern European refineries to produce high yields of gasoline and diesel. Its loss has resulted in the bidding up of prices for equivalent North Sea and West African grades, and, ultimately, its replacement for what may prove to be an extended truncation of exports is likely to involve higher output of lower-quality crude with longer supply lines. The second implication has come from the prospect of a further narrowing of spare capacity when the Libyan outage begins to be partially replaced, increasing the sensitivity of the market to further shocks. In our view, anything less than 5% spare capacity (4.5%) is suboptimal, and the current level of just above 3 mb/d is already

Figure 2: US oil inventories above their five-year average have fallen (mb)



Source: EIA, Barclays Capital

Figure 3: A surge in both OECD and non-OECD oil demand growth in 2010 (mb/d)



Source: Barclays Capital

fairly tight. The prospect of that falling well below 3 mb/d means that a series of other potential market risks would have the capability to remove a significant slice of the remaining flexibility. Of particular concern is the potential for disruptions out of Nigeria in advance and in the aftermath of the presidential elections that are set for April.

The key feature of oil market fundamentals over the past year has been the relatively low price elasticity of demand and the tendency for price effects to be swamped by positive income effects. Indeed, we expect the upwards drift in prices to continue until clearer evidence emerges of any significant degree of burning off of demand at higher prices. Until some solid evidence of that emerges, the continuation of demand strength and a highly volatile geopolitical situation, combined with thinning cover and low spare capacity, is likely to keep prices well supported at high levels.

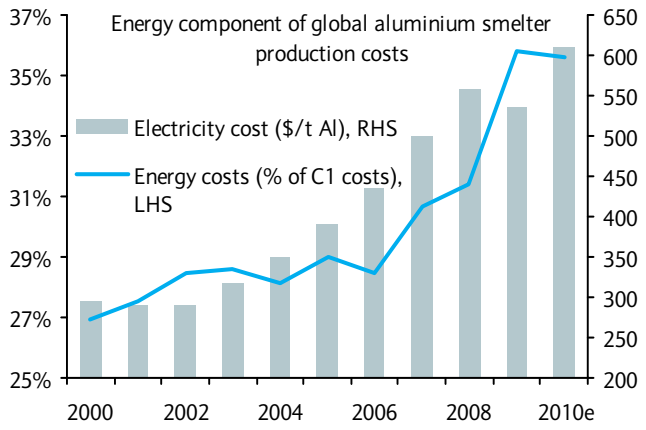
While oil has some strong underlying fundamentals, the background for US natural gas is weaker. The market is likely to remain characterised by a supply surplus at the margin, with record inventories expected at the end of the 2011 injection season due to demand remaining anaemic. While upwards price progress is likely to be capped well below $5 per mmbtu, there is a floor of about $3.50 per mmbtu, which is set by the competition with coal for power generation. The European gas market is expected to be relatively stronger, particularly with the increased competition for LNG cargoes following the outage of Japanese nuclear capacity. That higher demand is likely to remove what had looked likely to be a surplus of LNG cargoes this year. The closure of nuclear plants in Germany also supports gas and coal, and there have also been some supply losses from Libya and the possibility of further LNG supply insecurity out of Nigeria. The international coal market also looks relatively tight. Coal balances have been bolstered by a series of natural disasters, most particularly the severe flooding in Australia, while the demand side has stayed highly robust. Nuclear issues have added to that supportive background, and we expect API2 to outperform all other major coal benchmarks.

Base metals

Base metals demand in 2010 posted a robust recovery, with demand for all of them (except tin) hitting a record high. The scale of the recovery in OECD demand was particularly impressive. That global base metals demand can hit a record high with the OECD still below pre-crisis levels for many of them is a true reflection of the structural rebalancing towards the emerging markets. For 2011, macroeconomic developments remain a key theme and are likely to remain the backbone of market sentiment. Since summer 2010, China has been in destocking mode, running down supply-chain inventories and importing less metal. Subsequently, domestic spot physical market activity has been soft and premiums weak. This has given rise to concerns that the tightening measures on economic growth will be a negative for metals demand. However, it was forecast to slow sharply anyway this year, following 2010's strong recovery. Overall demand indicators are robust, and anecdotal and statistical evidence suggests that end-user demand has continued to grow apace.

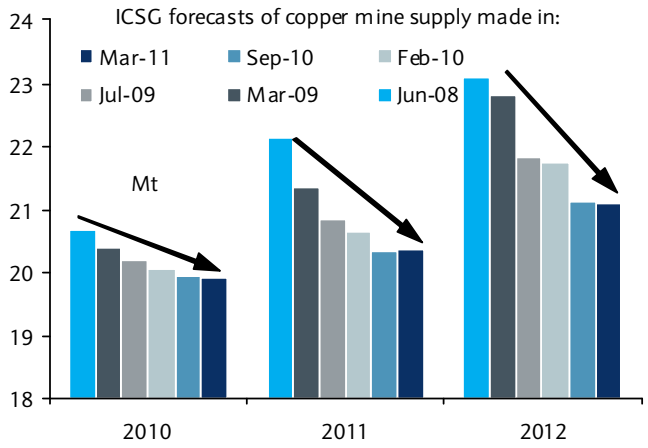
Feeding this has been a drawdown in finished good inventories and supply-chain stocks of refined metal, in our view. We expect the catalyst for the next move higher in prices to be a resumption of Chinese buying, the timing and extent of which will determine the price profile for much of H1 11. While our market balances suggest that China will need to increase copper buying in Q2 11, there is the risk that if high prices are sustained, it will dampen enthusiasm for restocking. Another potential negative is the level of non-visible inventory available to China, which could delay the timing of a pickup in imports.

Figure 4: Energy cost inflation is likely to continue to drive aluminium costs firmly higher



Source: Brook Hunt, Barclays Capital

Figure 5: Copper continues to face a constrained mine supply picture, kt



Source: ICSG, Barclays Capital

In the near term, Middle Eastern political uprisings and the earthquake in Japan have increased downside risks to global growth and metals prices. The immediate effect is the closure of refined copper and zinc production and weaker consumption, but medium term, we believe there will be a boost to demand from reconstruction works. Lead demand could rise very quickly due to the need for generators and batteries, while copper demand is also likely to increase early on as power utilities move fast to replace damaged power lines and transformers. In the face of heightened uncertainty, aluminium has offered amongst the best risk/reward credentials of the base metals, and we continue to advocate it as a defensive trade.

The ongoing geopolitical concerns in the MENA region have implications for aluminium production costs, in particular through the effects of energy cost inflation. Even before these events, marginal aluminium production costs had risen to a new record high in 2010. As the most energy-intensive base metal to produce – electricity represented 36% of costs in 2010 – this will ultimately put further upward pressure on aluminium production costs.

Overall, with copper-specific fundamentals set to improve markedly in the coming months, we advocate a long position in copper and view dips in prices as buying opportunities. Copper demand is back to pre-crisis peaks, while the supply picture remains markedly weak. The other base metal we view most positively is nickel, with the ongoing trend in LME stock draws, rising physical premiums and encouraging anecdotal reports with regard to stainless sector activity. Recent developments on the supply side are also supportive for nickel prices, with recent announced shutdowns and delays to ramping up supply using the new generation of high-pressure acid leach technology (HPAL).

Precious metals

The long move up in gold prices is nearing a pause, in our view, although we expect another leg higher, to new record prices above $1500, on a raft of positive short-run support. Our view that a variety of geopolitical issues is likely not only to persist, but also to cascade into other uncertainties, is expected to heighten interest in gold. The disaster in Japan generated a series of margin calls that, in turn, have created the impetus for some profit-taking in precious metals, but this effect is likely to be short-lived. Throughout Q2, we would expect the combination of investor interest conditioned on geopolitical turbulence and the support of good physical demand to cause gold prices to

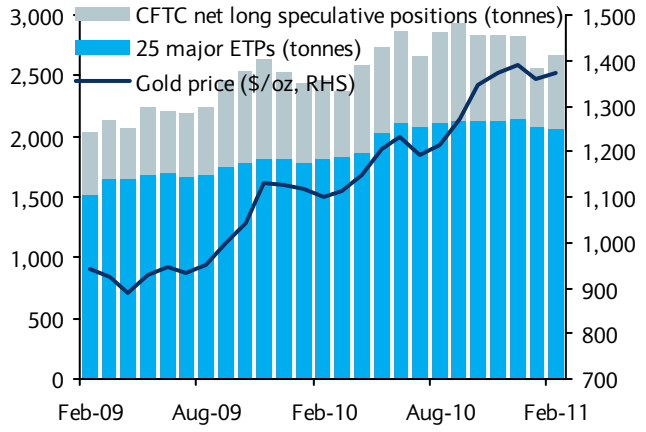
move higher. However, after Q2, our view is more cautious, as we expect investors to become more concerned by the timing of interest rate increases in Europe and in the US, turning more negative on gold as inflationary fears rise. So far, investor flows have proved relatively resilient to the re-emergence of inflationary concerns, with ETP gold holdings recovering from some strong outflows in January. While the potential for the turning of the interest rate cycle is likely to create a significant hiatus for gold prices, the downside seems relatively limited. Physical demand, most particularly out of Asia, is likely to cushion the downside, and investor interest would, in our view, be likely to remerge above $1200 even as the time for interest rate rises draws closer.

While gold prices may have a relatively high floor, the rise in silver prices has been largely decoupled from its physical fundamentals and we would see the scope for a more significant downside when investor interest wanes. Even with some interesting sources of new demand from the solar panel industry, we still forecast that silver faces a period of structural surplus. The best prospects for precious metals towards the end of the year lie with the platinum group metals (PGMs). We see scope for upside in both, based on supply-side constraints arising from South Africa in the case of platinum and Russia in the case of palladium. We expect the palladium market to show a physical deficit in 2011, whether or not there is a substantial slowdown in Russian state inventory shipments.

Agriculture

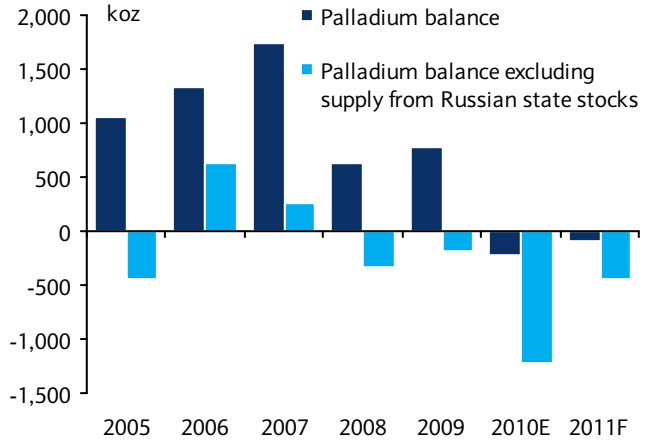
Agricultural commodities have been amongst the strongest performing of commodity markets over the past year and fundamentals remain supportive for prices to stay at elevated levels. However, in terms of the price profile, we expect an easing in prices in H2 11. Akin to other non-energy commodities, in the near term, agricultural prices have faced selling pressure on a combination of geopolitical concerns, the move higher in oil prices which has raised concerns on the effect on the global economy, and more recently the earthquake and tsunami in Japan with its potential implications for import demand (Japan is the world's largest corn importer and among the top five importers for wheat and soybeans). Amid the tumultuous and downward shift in prices, it would be easy to lose sight of the strong fundamental underpinning of the rally in agricultural markets, which, in our view, remains intact. Key supply-side dynamics over the past year and which are likely to stay so are weather and acreage, in tandem with an environment of low inventories and

Figure 6: Longer-term investor interest in gold remains stable… for now



Source: Ecowin, various ETP issuers, CFTC, Barclays Capital

Figure 7: Palladium market swings into deficit with or without Russian state inventory shipments



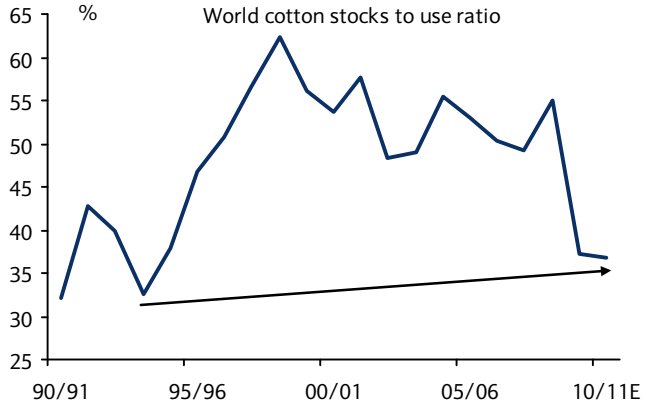
Source: Johnson Matthey, Barclays Capital

an increased desire by policymakers in emerging markets to control food inflation by implementing export bans/quotas. These wide-ranging supply issues are likely to be a source of price support in an environment of strong demand conditions and bode well for enduring elevated price conditions, although the current attractive high prices should help alleviate tightness across some of these markets by year-end.

We expect the current price environment to be reflected in increased acreage and plantings overall. However, increased acreage will need to be split across various agricultural commodities, keeping in mind the broad-based rally across these markets. Crucial for determining price direction is likely to be the USDA's *Prospective Plantings* report in end-March. With strong price gains, we expect corn and cotton to be the key beneficiaries of increased US acreage, but with US inventories of both at very low levels, the process of stock rebuilding cannot be sorted out with one year of higher plantings. The US corn stocks-to-use ratio at 5% is at its lowest level since 1995-96, while US cotton inventories are at their lowest level since 1990-91. The issue of low inventories co-existing with higher global production lies at the crux of why agricultural commodity markets have tended to be so vulnerable to supply disruptions. The buffer stocks of inventory that the grains markets held through previous decades appear to be a thing of the past, while inventory levels across the board, including in soft commodities such as cotton, coffee and sugar, remain low. This environment of low inventories has come on a juxtaposition of shorter-term factors such as lower production and adverse weather, as well as more structural changes in the demand landscape, including the rapid growth in consumption driven by emerging markets and new end-use sectors with an increased diversion to biofuel production.

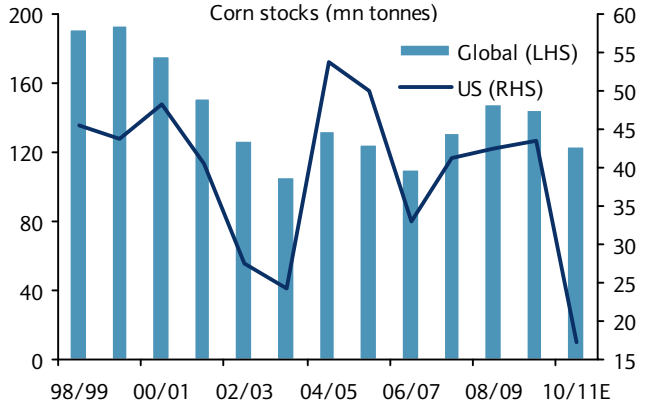
In addition to increased acreage, benign weather conditions are necessary to produce greater supply, and weather will be a key concern. Further supply-side concerns revolve around infrastructure bottlenecks in key exporting countries and the effect of export bans, which tend to pass inflation to importing countries and obfuscate domestic price signals to farmers. Despite ample sugar, wheat and cotton production in 2010-11, India has export curbs in place for these commodities. Meanwhile, drought last summer resulted in a swift cut to Black Sea production (which produces the most competitively priced feed-quality wheat) and led Russia to apply an export ban. Political factors have been influential in a more direct way in agricultural markets as well, with the turmoil in the Ivory Coast (the world's largest cocoa producer at 35% of global production). The country's cocoa sector is

Figure 8: Global cotton inventories hover at their lowest level in a decade and a half



Source: USDA, Barclays Capital

Figure 9: US corn inventories are estimated 60% lower y/y, keeping them at dangerously low levels

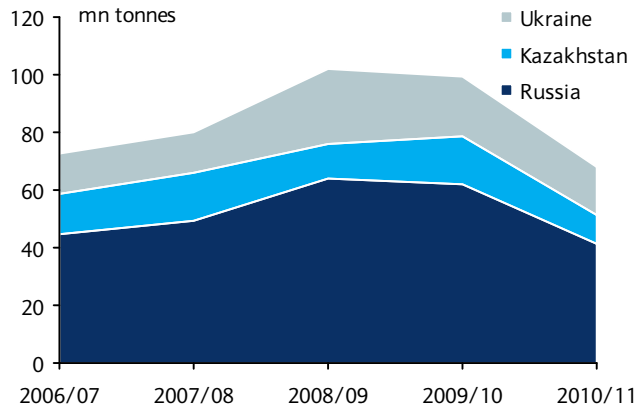


Source: USDA, Barclays Capital

being held hostage between the two warring sides, with the presidential claimant Ouattara extending a ban on Ivorian cocoa exports, while the incumbent Gbagbo's cocoa authority recently announced that exporters had until end-March to ship beans they have in stock and pay the appropriate taxes or risk seizure of stocks.

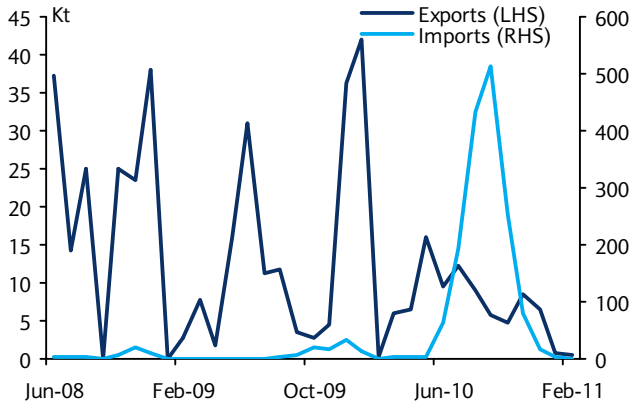
On the demand front, China is likely to be a wildcard this year, with continued signals that its plan for grains self-sufficiency will prove an arduous task. In 2010, it stayed a net corn importer for seven consecutive months. High imports, in our view, reflect nearer-term tight domestic conditions and signal a broader move towards increased import dependence and an inability to remain self-sufficient. For the global market, the timing has had an effect, with this move up in Chinese imports coinciding with a period of tighter coarse grain supplies globally and a marked cut in US corn yields. Chinese wheat imports in 2010 were up over a third y/y, and lowered production this year may imply further imports, although Chinese stocks are more comfortable for wheat than corn. With grains markets underpinned by tight supplies, the potential for higher Chinese imports could have a marked effect on international markets.

Figure 10: Drought leads to a sharp drop in Black Sea wheat production



Source: USDA, Barclays Capital

Figure 11: How long can China hold on to its self-sufficient status in corn?



Source: China Customs, Reuters, Barclays Capital

FOREIGN EXCHANGE OUTLOOK

Daylight moves west

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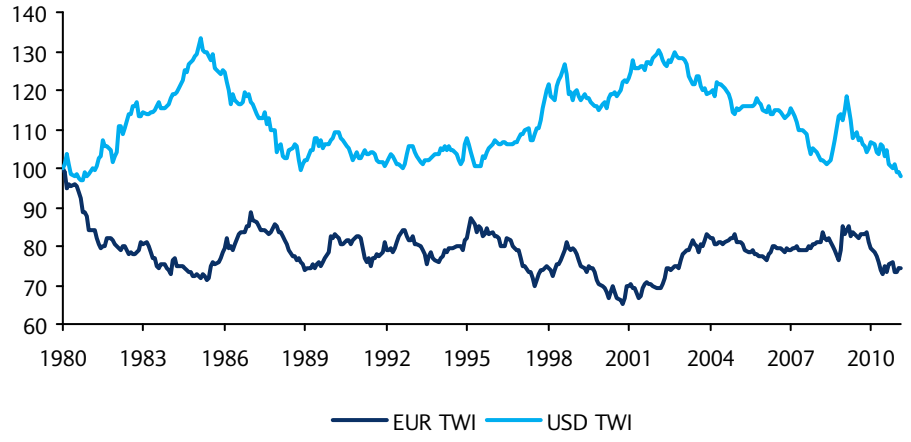
- **The USD has underperformed significantly over the past three months. We expect it to remain at a low level but think that further depreciation is much less likely.**
- **European currencies have outperformed, and we expect them to continue to do so. Europe has lagged the global recovery and, while we do not expect strong growth, monetary policy tightening is likely to lead to broad strength.**
- **Commodity currencies, so long the darlings of the FX world, are now at very high levels. We expect them to struggle in the face of more difficult trading conditions.**

The "ugly contest" has continued

It has been a difficult quarter for FX investors. This is partly because completely unexpected events have dominated the news, a situation that FX has shared with all asset classes. But that only explains some of the difficulty. Despite the remarkable events that affected the world as a whole, FX volatility remained subdued relative to the crisis period. And, in contrast to some other asset classes – commodities, for example – it was widely thought that there were no overriding FX themes. That may reflect the ongoing perceived unattractiveness of the USD and continued nervousness about prospects for the EUR (Figure 1), despite its appreciation over the quarter, coupled with stretched valuations in many of the smaller currencies and the recent increase in use of intervention and other measures to limit real exchange rate appreciation, even while tightening monetary policy in much of the EM world. Many investors were comfortable being bearish the USD, but had to decide which currency they preferred, and it was not an easy choice.

Figure 1: The USD and EUR tend to be negatively correlated but have recently come under pressure simultaneously



Note: The chart shows the USD and EUR real trade-weighted indices excluding the effect of EUR/USD itself. Prior to 1999, we use the synthetic EUR. Source: Barclays Capital

These difficult trading conditions are unlikely to persist, in our view. Interest rates across the yield curve remain at very unusual levels in many economies and central banks are responding to increasing inflationary pressures in markedly different ways; fiscal deficits are huge and governments are taking widely divergent approaches to the issue; and commodity price

moves may have much further to go. The world may have recovered, to a large extent, in flow terms from the financial crisis, but it cannot be viewed as being in a steady state. As it continues to rebalance, currencies are likely to carry on playing an important role.

The pressures on the USD are not going to go away quickly, but may lessen

The USD has depreciated against all G10 currencies other than the NZD, (a special case this quarter) since the last *Global Outlook,* December 9, 2010. It is not difficult to find reasons for concern about the USD. The Fed is almost alone among global central banks in continuing to ease monetary policy for cyclical reasons (as opposed to one-off factors such as the New Zealand earthquake). This is unlikely to play as important a role over the next quarter as it has over the past three months. Commentary from different FOMC members shows a range of views but the most influential over the committee as a whole – Bernanke, Yellen and Dudley, in the opinion of our economists – have given no suggestion that the initial QE2 plans will not be completed. Thereafter, it seems unlikely that there will be any tightening of policy, either active or passive, before 2012. So US monetary policy looks set to remain extremely loose, and this is likely to continue to lead to a weak level for the USD, but we think that that will come as little surprise to the market. Indeed, US growth may surprise to the upside, in our view, which will not lead to early tightening, but may increase future expected interest rates and, therefore, offer some support for the USD.

Fiscal policy is less likely to support the USD. The US is not alone in having a fiscal deficit that is much larger than is consistent with long-run fiscal sustainability but it does appear to face more complicated political issues than the other large deficit economies. The UK has some similarities – a fiscal position which deteriorated significantly in the wake of the financial crisis and a prolonged current account deficit. But the UK government is taking a very different approach to the problem than is the case in the US, and the UK political system makes addressing politically contentious situations such as this somewhat more straightforward. The euro area faces less of a problem in aggregate terms and the peripheral crisis has forced the authorities into addressing the issues more proactively than may otherwise have been the case. Perhaps the most interesting comparator, though, is Japan, which has a larger fiscal deficit but much higher domestic saving. Sooner or later, we think the Japanese fiscal situation is likely to lead to depreciation. But, in light of the recent events, the short-run pressure may be for the JPY to appreciate. The USD may find itself temporarily alone among the majors in coming under pressure due to fiscal concerns mounting.

European currencies may continue to benefit most from higher commodity prices

The dominant themes of the quarter: the political tensions in the MENA region, particularly in Libya; the Japanese earthquake, tsunami and nuclear concerns; and increasing signs of inflationary pressures building in the global economy, all led to upside pressures on commodity prices. The CRB index has risen by close to 12% since the last *Global Outlook* and oil prices have increased even more. Given that, it is telling that the strongest-performing currencies were non-commodity producers in Europe: the RON, CZK, HUF and SEK, and within the G10, after the SEK, the strongest currencies were the CHF, NOK (more because it is European than an oil exporter in our view) and the EUR itself.

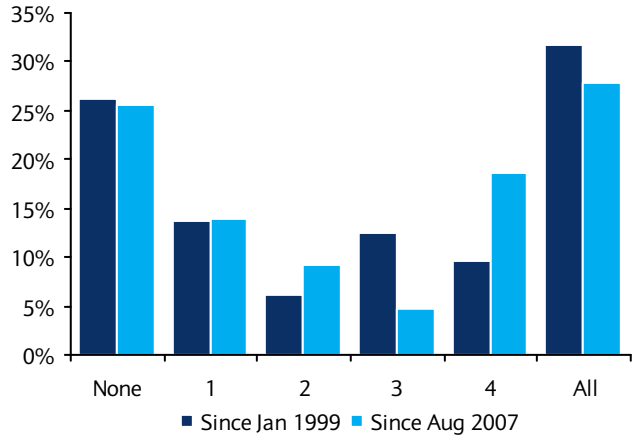
Several factors may explain this. The most important, in our view, has been the monetary policy response to higher inflation rates. Central banks outside Europe and North America had been raising rates for some time already and the Fed has continued to concentrate on domestic factors, which continue to point to limited pressure on core inflation at the same

time as the unemployment rate remains very high. By contrast, the ECB has responded to inflation peeking above 2% by clearly suggesting that it would raise rates in the near future. Even if the ECB were alone in becoming more hawkish, all European currencies tend to move together relative to the USD. Figure 2 shows how many of the five European G10 have appreciated against the USD in a typical month since the start of the EUR. If European moves were independent, the distribution would be expected to be uniform, but the extremes – all appreciating or all depreciating – are clearly more common. In addition, BoE comments have made rate rises over the next quarter significantly more likely than we had previously thought. And the Riksbank and the Norges Bank have also suggested quicker tightening than previously expected.

The second reason for the outperformance of the European currencies is that the MENA crisis led to higher oil prices because of weaker supply, not stronger Asian demand, which was the dominant factor in previous quarters. This benefits Europe because it is less energy intensive on the whole (Figure 3), and because the taxation of high-profile consumer goods, such as gasoline, is so much higher in Europe than anywhere else in the world, European consumers are affected proportionately less by high oil prices. Finally, a factor that matters for EUR/USD to a greater extent than other currency pairs is that the economies which benefit a lot from higher oil prices tend to invest disproportionately in European assets (see *Oil and the currency distribution of global savings*, 4 March 2011).

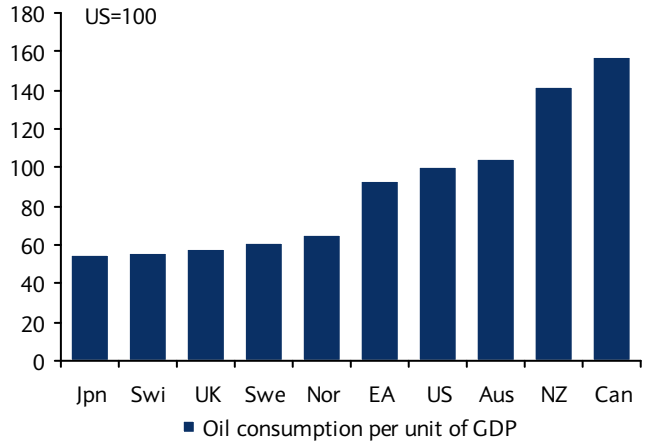
We expect commodity prices to continue to rise over the next quarter and it is, therefore, possible that the divergence between ECB and Fed policy may widen further, adding to EUR strength. That is particularly likely if higher prices come from further supply disturbances. However, our core view is that the MENA political and Japanese nuclear issues should become less important in terms of their financial market impact and instead prices should continue to increase because of strong demand and limited supply, as was the case in 2010. This is not as obviously positive for European currencies, but they remain at reasonable levels from a valuation perspective (other than the CHF) and all the central banks have plenty of room for further tightening. The EUR is not likely to be the star European performer, though. As discussed below, we continue to think that some of the smaller European currencies are likely to outperform.

Figure 2: It is all or nothing for European currency appreciation against the USD



Note: Monthly data since January 1999. The chart shows the proportion of time that none, 1, etc of the EUR, GBP, CHF, SEK and NOK appreciate against the USD.
Source: Reuters EcoWin, Barclays Capital

Figure 3: European economies tend to be less oil intensive than the G10 norm



Source: Barclays Capital

Pressures on the JPY to appreciate in light of the Japanese problems may be less than many think

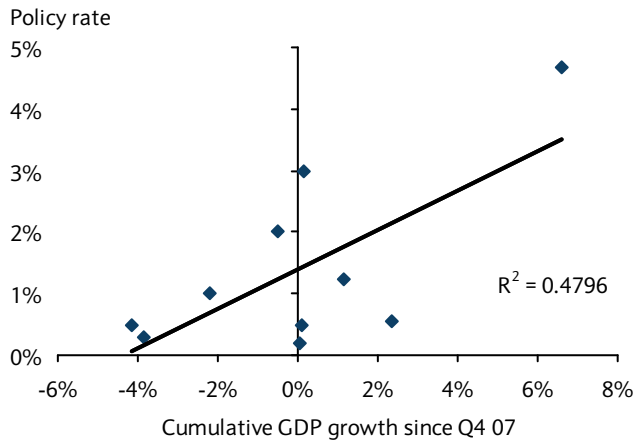
The JPY is likely to be primarily driven by domestic factors in the aftermath of the earthquake, tsunami and nuclear worries. Clearly, there has been a huge amount of destruction, and the conventional response would be that the rebuilding process will lead to pressures on the real exchange rate to appreciate. This is typically couched in terms of repatriation of capital. But it could also be viewed as being due to increased domestic demand relative to supply (the normal response to a one-off shock to real wealth is to limit the immediate hit to consumption by borrowing more than would have been the case otherwise – or saving less, in the Japanese example). A stronger real exchange rate does not necessarily need capital inflows; less capital outflow than the counterfactual would have the same effect.

We would caution against expecting significant nominal appreciation, though. First, some real appreciation may come via an increase in the Japanese price level in light of the negative supply shock. Second, the experience following the Kobe earthquake, which many use as a baseline, may overstate the upwards pressure on the real exchange rate, partly because there was a large change in Fed policy at roughly the same time. Third, the effect on the nominal exchange rate will be a function of the policy response. There has already been intervention to limit the effect on the JPY and, more generally, the Japanese authorities may loosen monetary policy in response to weak confidence. The big risk facing Japan is that very weak growth may exacerbate the problems and Japan may return to a vicious circle in which low inflation leads to tighter policy, resulting in still lower inflation. Finally, the situation that prevailed prior to the crisis does still matter: Japanese conditions probably already merited looser monetary policy; the events of the recent past may make this more likely than was previously the case.

Prospects still appear rosy for the truly peripheral European currencies in the G10

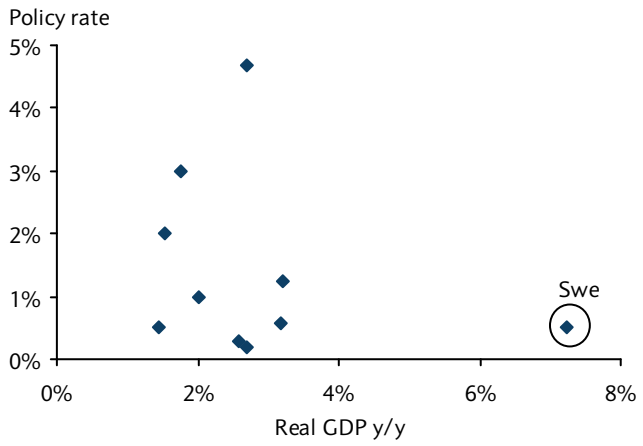
As noted above, the European currencies, in general, have benefitted from EUR strength relative to the rest of the world. We think that prospects remain bright for the GBP, SEK and NOK. In each case, monetary policy has room to tighten a long way. And in the SEK's case, and even more so the GBP's, valuation continues to appear attractive. The most controversial, by far, is the GBP, which seems to split investors down the middle. Our economists expect the BoE to start tightening policy in May, followed by two further rate hikes this year. Though some tightening is priced in, we think that current market pricing hides a large amount of uncertainty about the need, or even ability, of the MPC to tighten policy. So if policy is tightened in May, the effect on the GBP may be significantly more positive than many expect. The other major unknown it faces is the likely effect of the government's fiscal consolidation plans. As is the case with monetary policy, some investors think that the consolidation will progress reasonably smoothly, while many others think that it will prove counterproductive, slowing growth to such an extent that it exacerbates the problems. It will not be a comfortable period but we think the plans will generally be adhered to, the effect on the UK economy will not be excessive and the resulting reduction in uncertainty will be a key GBP support.

Figure 4: Growth since the start of the crisis is a key determinant of current policy interest rates in the G10…



Note: GDP growth is until Q4 10, other than NZ (Q3). Source: Haver Analytics, Reuters EcoWin

Figure 5: … but current growth is likely to matter more for future rate changes



Note: GDP growth in the year to Q4 10, other than NZ (Q3). Source: Haver Analytics, Reuters EcoWin

We also expect the SEK and NOK to appreciate further. In both cases, interest rates have a lot of room to appreciate and growth prospects look bright. This is particularly true for the SEK. Figure 4 shows the unsurprising (though important) point that the economies where interest rates are relatively high tend to be those that suffered least during the crisis or recovered earliest. But this will not last forever, and as Figure 5 shows, Sweden does appear to be a significant outlier in terms of recent growth. How long can an economy have y/y industrial production growth at 15% and annual GDP growth over 7% and keep policy rates well below 2%? Some tightening is priced in by the market but we think that the Riksbank is likely to need to raise rates for longer, and to a higher level, than the market currently expects. That will not happen immediately, and excessively rapid appreciation may lead the Riksbank to slow tightening – but if the main risk to currency appreciation in the medium term is excessive currency appreciation in the short run, it tells a story. Prospects are less bright for the NOK: valuation is less of a positive, growth is less robust and the Norges Bank may lean against appreciation to a greater extent. But higher oil prices benefit the Norwegian economy more than any other in the G10, and while the Norwegian authorities try to limit its effect on the NOK, the resulting increase in wealth will tend to lead to real exchange rate appreciation.

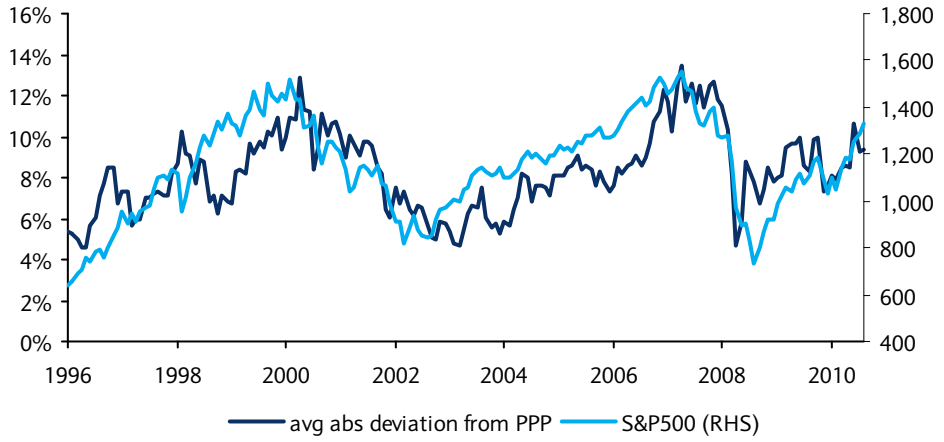
But other G10 commodity currencies may come under pressure

Commodity currencies have been the star performers during the recovery. The AUD has appreciated 57% against the USD, the NZD well over 40% and the CAD more than 30% since the equity market trough in March 2009. It is easy to find reasons why: stronger commodity prices are, of course, a significant part of the story, together with good fundamentals and stronger cyclical growth, which have led to tighter monetary policy than in the majors, though less so for the CAD. The G10 commodity currencies may also have benefitted from the measures taken by various EM countries to limit the appreciation of their real exchange rates in the face of tighter monetary policy and plentiful global capital seeking relatively strong returns.

But good fundamentals alone cannot justify continued appreciation – they would have to be constantly improving in relative terms. Similarly, higher interest rates (as opposed to rising relative interest rates) are sometimes associated with appreciation – when the carry trade performs strongly – but often does not. We expect neither relative fundamentals nor relative interest rates to continue to move in the commodity currencies' favour. In addition, FX intervention in the EM world is likely to have only a temporary effect on EM currencies, in

our view. The CFTC data suggest that non-commercial investors have unusually long open positions in the CAD and AUD. And finally, as a general rule, the G10 commodity currencies now all appear to be overvalued. According to our PPP estimates, relative to the USD the CAD is 17% overvalued, the NZD 26% and the AUD 33%. We have also developed a more general model of fair value – a multilateral version of the so-called "BEER" model – which allows for changes in the terms of trade, among other factors. All the non-European G10 commodity currencies remain overvalued relative to the USD, in particular the AUD, even after accounting for the effects of the rise of commodity prices over recent years.

Figure 6: Equity prices and typical currency misvaluations have moved closely together



Note: the PPP numbers are the average absolute deviation among the G10 currencies, using a 10y rolling mean of the trade-weighted real exchange rates for PPP. Source: Bloomberg, Barclays Capital

The difficulty is judging when valuation matters. We look for two key characteristics. The first is moves in other asset markets and perceived risk. Figure 6 shows the relationship between FX valuation gaps (based on our PPP model) and the S&P500. The remarkably close relationship over the past 15 years or so is not going to last forever – equity prices tend to rise over time, while currency misvaluations do not, but the relationship is far from spurious, in our view. It points to a general characteristic of FX markets: when risk appetite weakens, investors pay greater attention to fundamentals such as valuation. Though we are not equity bears, as discussed in the overview, we do think that the need for caution among investors is increasing. The second characteristic is any major change in the key relationships that have underpinned the appreciation. Most important here is G4 monetary policy. We strongly believe that this, together with questionable fundamentals in all of them, has had a significant effect on the commodity currencies. The G4 economies' fundamentals are slowly being addressed and while monetary policy is not suddenly going to become tight, it is likely to tighten, either through central bank policy in Europe or robust growth leading to higher market yields in the US.

In both cases, the traffic light has changed from green to amber for the commodity currencies. It is too early to expect rapid depreciation, but we do not expect further appreciation over the next three months. Beyond that, we think they are likely to start depreciating, and the risks are generally to the downside: a quicker slowdown than we expect for Chinese growth; negative oil supply shocks (bad for the AUD and NZD, though not for the CAD); an increase in risk aversion, given equities' long rise; and, perhaps the elephant in this particular room, the possibility of a change of tone by the Fed could all lead to earlier depreciation than we expect.

INTEREST RATES OUTLOOK

Monetary policies back in focus

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- **US rates investors will face several challenges in Q2. We believe that some, such as the end of QE2 and questions about Japanese demand for US debt in the face of repatriation needs, will be tackled without problems. But negotiations over the debt ceiling could push up the risk premium if political gridlock persists. Meanwhile, the longer-term fiscal picture continues to deteriorate. We expect longer rates in the US to rise as the recovery continues, and risk premia associated with fiscal issues and lack of political will to tackle those issues to be priced in. On the other hand, the front end still seems to be too aggressive, pricing in Fed hikes later in 2011. Consequently, the curve should remain steeper than the forwards over the next few months.**
- **On the European side, the focus has turned from fiscal issues back to inflation and monetary policy. Both the ECB and the BoE are forecast to hike rates in Q2 11, and to follow up with additional tightening in the remainder of the year and 2012. The direction of rates will thus be generally higher, with short-end rates suffering the most, and the curves under continued flattening pressures. The euro area peripheral issues, while still there, are unlikely to have as systemic an effect as they had in 2010, as markets have started to differentiate between countries (and will likely continue to do so).**
- **In Japan, the bond markets will continue to react to the dramatic recent events, but overall, we suspect the direct effect on bond yields will be relatively limited. We recommend taking advantage of excessive bear steepening moves on the back of fiscal worries.**

US: Geopolitics versus fundamentals

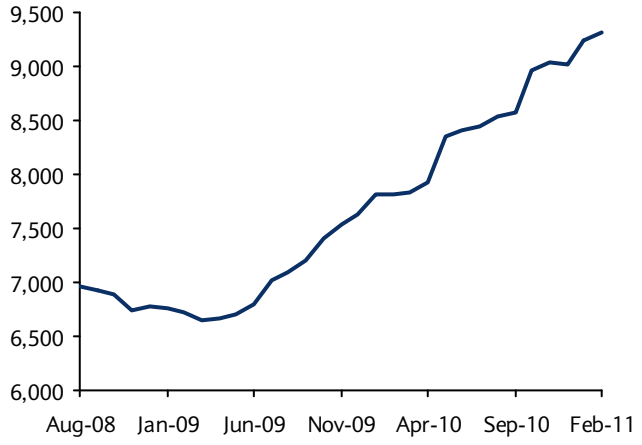
US rates have been caught between improving data and geopolitical crises

Treasury yields are very close to the levels at which they started the year. But this masks the high volatility over Q1 11. 10y yields rose to 3.75% by mid-February, as data improved and the labor market showed signs of improvement. But turmoil in the Middle East, a sharp rise in the price of oil, and then the Japan earthquake all pulled yields back. Over the next few months, rates investors will have their hands full. Factors affecting rates markets include life after QE2 (the second round of Fed buying of Treasuries expires in June), any effects from the Japan earthquake on Japanese investor demand, as well as the effect of the debt ceiling negotiations on yields.

The end of QE2 should have little impact on yields

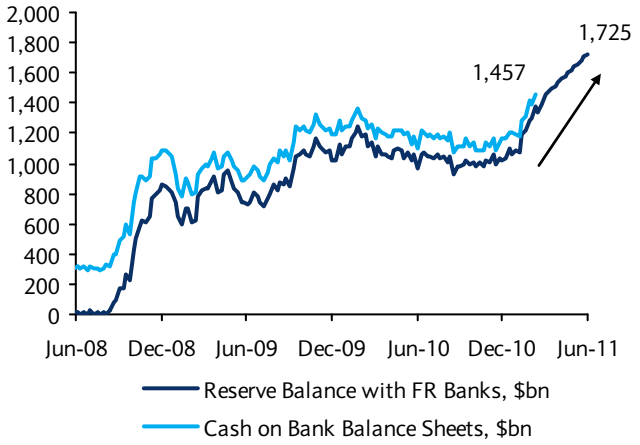
We expect bond markets to be unfazed by the end of QE2. On the supply side, heavy Treasury issuance should be offset by lack of spread product issuance. On the demand side, foreign investors should remain strong buyers (they bought more USD fixed income assets in 2010 than the Fed) as global FX reserves rise (Figure 1). Moreover, banks should increase their securities purchases to offset NIM (net interest margin) pressures from rising cash on their balance sheets (Figure 2). Empirical evidence also points in the direction of no "cliff effect" after the Fed buying finishes. For example, the Fed finished its $1.25trn purchase program of agency MBS in March 2010, and spreads stayed well behaved. Similarly, when the Fed increased the first round of quantitative easing to $1.25trn, 10y yields rallied 50bp over the next few days, and then sold off 150bp over the next three months. The current exit has been well telegraphed, and we feel the market has already priced it in. For example, nominal and real 10y yields are now higher than the day QE2 was announced.

Figure 1: FX reserves continue to grow



Source: Barclays Capital

Figure 2: Rising cash on bank balance sheets



Source: Barclays Capital

Japanese investor demand for Treasuries is unlikely to decline

Meanwhile, some investors have expressed fears that repatriation by Japanese firms would affect their demand for US Treasuries. Demand from Japanese investors is unlikely to decline in a meaningful way, as insurance companies have enough domestic liquid assets to cover losses. While US debt will face competition from reconstruction-related financing needs in Japan, we believe the savings rate in Japan should rise, as it did following the 1995 earthquake, providing an offset. Moreover, the Japanese government will be very concerned about any strength in the JPY, and is likely to offset that by selling JPY and buying USD; any such intervention typically leads to the Ministry of Finance buying Treasuries.

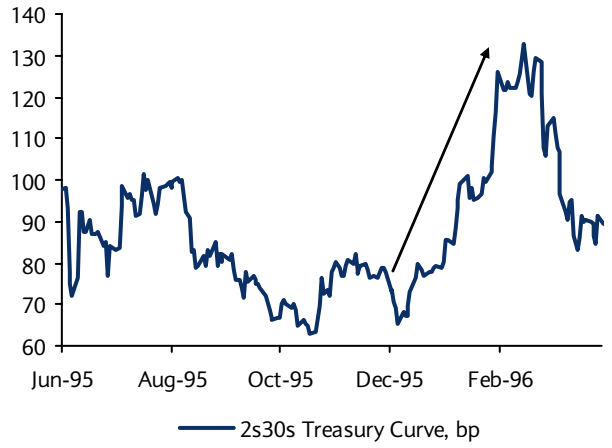
US rates: Biased short, with all eyes on the debt ceiling

While the end of QE2 and questions about Japanese buying do not pose big risks to yields, the debt ceiling is a wild card. The statutory debt ceiling will be hit sometime between April and May of this year. After that, the Treasury can use various measures (such as suspending reinvestments, selling its financial holdings, etc) to add another two to three months before it runs out of money. Although the idea of limiting growth in government debt is good for yields, the debt limit debate comes too late in this process. It does not change the country's indebtedness, since the spending/revenue decisions have already been made. The debt that Treasury accumulates is simply to fund obligations that have already been established.

The debt ceiling negotiations are a wild card for rates in Q2

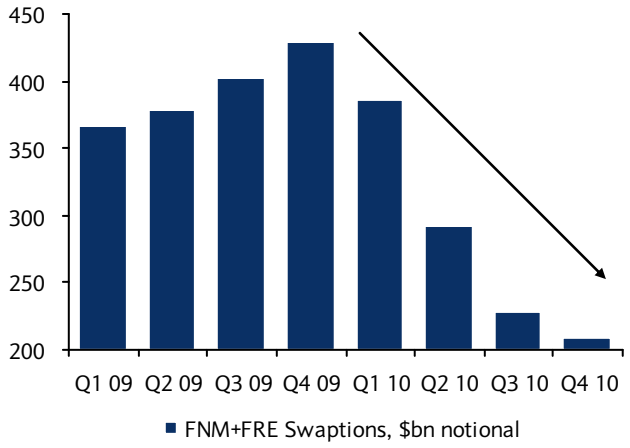
Moreover, the regularity and predictability of issuance plays an important role in minimizing the cost of borrowing – any disruption can raise those costs. The most visible example is 1995-96, when the political situation was similar: a fiscally conservative Congress with a Republican majority and a Democratic administration. On November 30, 1995, Congress passed the Balancing Budget Act, which raised the debt ceiling but coupled it with spending cuts. President Clinton (who pushed back against some cuts, just like President Obama plans to do now) vetoed this bill on December 6. The debt ceiling was finally raised on March 29, 1996. But the fall-out of this uncertainty was a sharp rise in the risk premium; 2s30s steepened almost 60bp between December 6, 1995, and March 29, 1996 (Figure 3). Given the worsening US fiscal outlook currently, uncertainty about the debt ceiling could lead to a higher risk premium again.

Figure 3: 2s30s steepened sharply during 1995-96



Source: Barclays Capital

Figure 4: GSE option portfolios have declined sharply



Source: Barclays Capital

Longer term, the US fiscal picture looks set to worsen. The President's budget forecasts a deficit of $1.65trn for the year, and the Congressional Budget Office projects that federal debt/GDP would rise to 87% by 2021. Moreover, the fiscal debate points to a lack of a political will to tackle the issues that matter. While Congress seems focused on discretionary spending cuts, there has been little talk of revenue increases or entitlement reform, both of which will be needed. And with no final resolution on 2011 and 2012 spending votes, we believe there is a risk that the long end of the yield curve will start to price in a fiscal risk premium, as it did during the 1995-96 budget impasse.

We expect the curve to stay steeper than the forwards

Clearly, our bias is for the back end of the curve to head higher. But we are hesitant to put on outright shorts until geopolitical risks in the Middle East subside. We have more conviction in our view that the front end is still cheap. Our economists expect real GDP to grow 3.0-3.5% and the unemployment rate to fall to 8.5% by the end of this year. But our models indicate that the market is priced for a more optimistic outlook. It is pricing in that the Fed will start hiking late this year, which indicates a stronger improvement in the labor market than we expect. Therefore, we prefer to stay long the front end and expect the curve to remain steeper than the forwards.

Interest rate derivatives: Moving sideways in both swaps and vol

Most of the option surface cheapened in Q1 11, with the exception of long-dated options. Volatility was pushed down mainly by heavy issuance of callable zeroes and FHLB-issued callable notes. In addition, the two GSEs (Fannie Mae and Freddie Mac) have been net sellers of options (see Figure 4) for the past few quarters as their MBS holdings have declined. Finally, the mortgage option remains weak, reducing hedging needs, as borrowers' ability to refinance has been squeezed by tight credit conditions.

Callable issuance should slow, lowering the pressure on option prices

But while many of the bearish drivers of volatility (such as weak demand from mortgage hedgers, a Fed-on-hold environment, etc) remain, we are cautious about initiating new short volatility positions. Callable supply could taper off in the next few weeks. Existing callable notes have extended due to the rate sell-off of the past few months, which has limited the callable note investors' capacity to buy new issuance. Also, with rates now higher, insurance companies may buy protection to hedge their variable annuity business. Hence, instead of outright positions, we recommend that investors look to relative value trades in options. For example, we like buying the 1y*5y payer ladder (3.25%, 3.5%, 3.75%), as well as the 1y*2y bull steepener hedged with 1y single-look 2y-10y CMS curve cap.

Longer swap spreads should widen after QE2 ends

Swap spreads were rangebound in the first quarter, as many of the risk factors that kept spreads volatile in 2010 (such as European sovereign concerns) dissipated. Treasury purchases by the Fed offset the tightening pressure on spreads due to increased supply expectations following the tax cut deal late last year. Bank credit quality remained stable, which contributed to the stability of front-end swap spreads. But things should change in the second quarter. With QE2 unlikely to be extended past mid-year and the focus shifting to fiscal problems, spreads in the belly of the curve should narrow.

Front-end spreads, on the other hand, will face widening pressure from the drop in available front-end paper as the Supplementary Financing Bill program rolls off. The possibility of cuts in front-end auctions, if there is a stand-off on the debt ceiling issue, also argues for widening. But this should be offset by declines in Libor-OIS spreads, which in our view, were pricing in too much of a risk premium at the start of the year. Some of this risk premium has unwound, and we expect the trend to continue as the situation in Europe stabilizes and bank funding concerns dissipate. 2y swap spreads have traded around 20bp for most of Q1; that should continue in Q2.

US housing finance: The debate continues

The GSE white paper on housing finance contained few surprises

The US Treasury released its much-awaited white paper on US housing finance in Q1 11. There were no major surprises, but the paper outlined three general options for housing finance. All are designed to reduce government involvement in the housing market to below pre-crisis levels. The first option calls on the private sector to be the sole provider of mortgage credit (with the exception of the FHA program, which is a government program). The second allows for the government to operate counter-cyclically, ramping up credit availability in tough times. The third proposal replaces Fannie Mae and Freddie Mac with privately capitalized guarantors, which in our view are simply new GSEs by another name. These entities would securitize and guarantee MBS, and pay an insurance premium to the government for an explicit guarantee.

Treasury did not endorse any of these options, but we would expect Democrats to prefer the third option, which has the most government involvement, and Republicans to prefer the first solution. Given the party-line gridlock on this issue, no proposal is likely to become law until at least after the 2012 Congressional elections. Even after that, any transition to the private sector will take many years. Treasury Secretary Geithner has suggested a 5- to 7-year timeline for implementation; we think 15 to 20 years is more workable, to avoid disruptions in the housing market (for details, see "US housing finance: No silver bullet," *U.S. Interest Rates: Outlook 2011*, December 16, 2010). This opens the door to policy error after 2012, if legislators do try to push for a 5- to 7-year transition to the private sector.

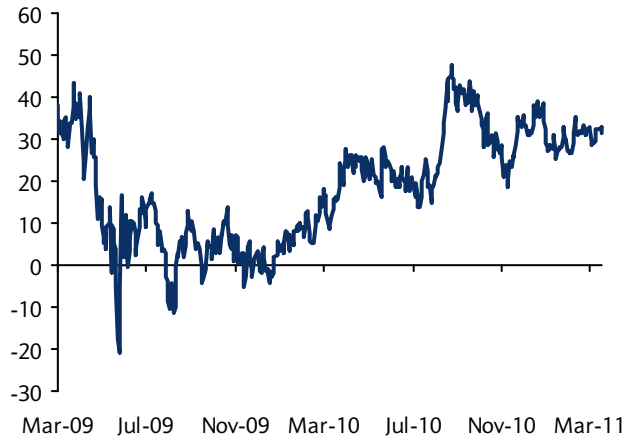
In the near term, regulators will likely try to lower the government's share of new mortgages in two ways – by raising guarantee fees and by reducing conforming mortgage limits. But private sector securitization is likely to remain anemic in the next few quarters – the government will remain the primary source of mortgages originated in the US.

US securitized markets: The end of government buying

Treasury is planning to sell its agency MBS holdings…

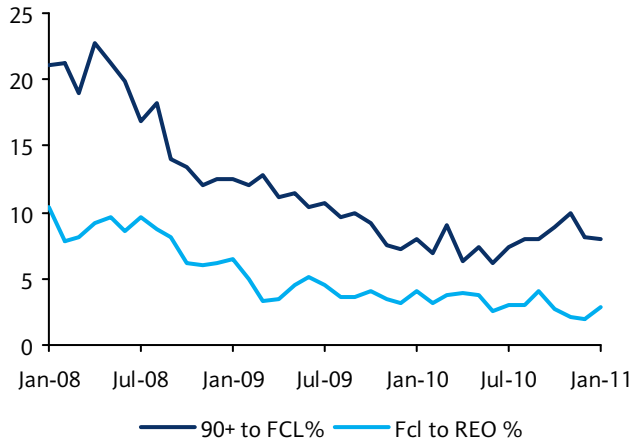
While the government remains heavily involved in origination, it is starting to pull back from its role as a buyer of MBS. For the first time in more than a decade, the GSEs (Fannie Mae and Freddie Mac), the Fed, and the US Treasury are all net sellers of agency MBS. The Fed and the GSEs are simply allowing their portfolios to pay down. But the Treasury has been more aggressive and has announced outright sales of up to $10bn a month until its $142bn portfolio is wound down. Despite this selling, we do not expect MBS spreads to widen sharply – we are currently neutral on the basis. The biggest reason is that net mortgage issuance should stay very low.

Figure 5: Current coupon MBS spread near recent wides



Source: Barclays Capital

Figure 6: Resolution rates in housing have slowed further



Source: Barclays Capital

… but we expect banks, money managers, and foreign investors to pick up the slack

Net mortgage debt rises either because home prices are rising (requiring more debt to buy the same house) or because new home sales are robust. In the absence of either, we expect net agency MBS supply of only around $50bn in 2011 (especially since defaults extinguish some existing mortgage debt). Even with selling from government entities, money managers, banks and foreign investors should be able to absorb supply, especially with spreads close to recent wides (see Figure 5). We expect mortgage spreads to stay close to current levels in Q2.

On the housing front, one of the more high profile developments of Q1 was a ruling by the Massachusetts State Supreme Court that overturned a previously completed foreclosure. Despite fears to the contrary, we do not expect this to lead to a flurry of lawsuits by borrowers looking to overturn foreclosures. But it *will* make banks more cautious. Foreclosure timelines have already slowed, as seen in Figure 6, which tracks the pace at which delinquent loans move on to the market. This should reduce the near-term pressure on home prices from distressed sales, but it could also hurt the potential for longer-term price appreciation.

Europe: The start of the hiking cycles

ECB and BoE back in focus

In Q1 11, the euro markets focus shifted back to the more traditional concerns of rate investors: namely, the outlook for growth, inflation and monetary policy. The ECB flagged a rate hike for 7 April, earlier than most commentators and investors expected (even if the tightening, as such, was not unexpected). The short end of the curve sold off accordingly, the curve flattened and cross-market euro rates underperformed, all textbook moves. Medium term, this should continue: we forecast still higher rates and flatter curves. But in the very near term, it may not sell-off much more, and the moves will likely be driven more by external developments (eg, the effect of the Japanese earthquake and tsunami, the Middle East and North Africa situation, the Fed outlook) than by purely euro area factors.

This is not to say that the sovereign crisis and peripheral issues have disappeared, but in Q1 11 their impact was noticeably lower. For the first time in almost a year, markets have shown signs of decoupling between, in particular, the smaller peripheral countries (Greece, Ireland, Portugal), which continue to be affected by idiosyncratic issues, and the bigger, more systemic countries, in particular Spain, which is being seen as one of the keys. In our view, this will continue to be the case. Absent a significant deterioration in the economic outlook, markets will continue to differentiate between countries, and the peripheral situation is unlikely to have as systemic an impact as it had in the middle of 2010. Over time, we expect tighter spreads, especially in longer maturities.

Short rates

ECB hikes to start in April, but tightening cycle likely to be limited

The ECB affirmed its separation principle by flagging a (25bp) rate hike for April 7, while at the same time continuing to provide liquidity at "full allotment" (ie, as much as banks demand), to help, in particular, the smaller peripheral countries' banks. The market has readjusted to pricing in around two-and-a-half rate hikes by the end of the year, and in the coming months, we believe the market will continue to price in about the same: between two and three rate hikes in 2011, with the same in 2012. This is not aggressive by historical standards, although it is a bit more than our economists expect: we look for a June or July rate hike as the follow-up to the April increase, a pause until Q2 12 and just two 25bp hikes in 2012. In our view, the risks are that the markets keep pricing in more than our forecast, as pricing in a long pause of about 12 months so early in the tightening cycle would be very unusual. It is also worth noting that, for the moment, ECB rate hike expectations have been kept more or less in check by the various risks still surrounding the outlook – the Japanese earthquake, the fragile geopolitical situation, the impact of the rate hikes on peripheral countries – but also, the consensus view that the ECB can not raise rates aggressively in the context of the Fed staying on hold until mid-2012 and the Bank of England hiking reluctantly. Thus, the outlook for short euro rates also will depend significantly on the outlook for US rates.

The sell-off of about 50bp in 2y rates since the beginning of the year, but 100bp since Q3 10, was broadly in line with historical standards: short rates typically sell-off between 75bp and 125bp in the six months leading up to the first hike. From here, the sell-off is likely to be more gradual and driven by actual rate hikes. We look for 2y swap rates to grind higher, to 2.50-2.70% or so by the end of Q2, and thereafter move higher by about 20bp a quarter.

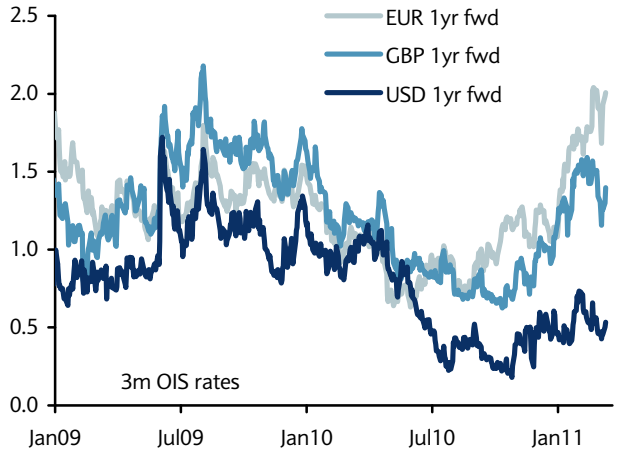
We do not expect much dislocation in money markets to come from the rate hikes, or from the ECB keeping its full allotment policy and/or changing its rate corridor. The key will be the evolution of the liquidity surplus, which we expect to remain broadly stable in the EUR30-50bn range. This should be enough to keep Eonia about 35bp below the refi rate (even if there continues to be some "predictable" volatility in Eonia during each ECB maintenance period).

Longer-end rates

Money markets should be able to withstand the rate hikes

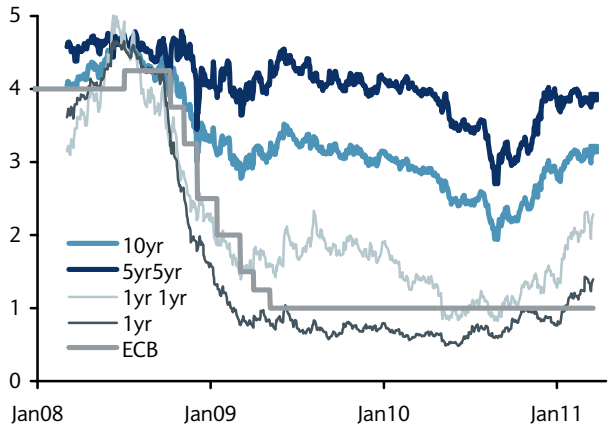
Following the large Q4 10 sell-off in long-end euro rates (see December *Global Outlook*), the 5y5y fwd rate traded in a tight 25bp range and, if anything, it recently rallied slightly, even as short rates sold off. We believe medium-term forward rates will stay broadly in the same range for now (3.75-4.00% in OIS terms, 35bp higher in Libor terms), even if they are more

Figure 7: Short European rates sold off on hike expectations…



Source: Barclays Capital

Figure 8: … while long rates have stayed in a tight range



Source: Barclays Capital

likely to move up rather than down from current levels. Indeed, the current market value for the 5y5y fwd rate is still at the low end of our estimated fair value range (between 3.65% and 4.85%), and tactically, the 2s10s curve looks a bit too flat. We still recommend 2s10s flatteners in the medium term, but we do not expect too much flattening in the coming months (maybe 10bp or so). Cross market, there continue to be few strong valuation signals at the longer end: spread moves between euro, US and UK rates likely will be driven by short-end considerations for now.

Euro swap spreads

Medium-term forward rates are likely to stay in their range

In *European Rates Trade Ideas 2011*, 5 January 2011, we recommended going long bund ASW. Since the first week of the year, the Eonia-Germany component of the bund ASW has widened 5bp. We still recommend positioning for widening on a medium- to long-term horizon, for a few reasons. First, the strong growth outlook in Germany has resulted in a significant improvement in the prospects for the country's budget deficit since early 2011. The one-year-ahead German budget deficit forecast from Consensus Economics has narrowed to €58bn in March 2011 from €130bn at the beginning of 2010. Looking at the lead/lag relationship between the GDP and deficit expectations, we think the deficit is likely to come down towards €40bn by the end of 2011 (around 1.6% of GDP).

German bonds are cheap given the deficit improvements

Given the current level of expectations for the deficit, our models indicate fair value for the bund ASW is about 3.5bp lower than Eonia. Given that bund ASW versus Eonia is trading 14bp higher than Eonia, this leaves bund ASW versus Libor about 17bp cheap assuming the FRA-Eonia component remains stable (we do not expect much tightening in FRA-Eonia spreads). Also, given that we are getting closer to rate hikes from the ECB, this should also facilitate the widening of swap spreads going forward. One of the misperceptions about swap spreads is that when the bund sells off on an outright basis, swap spreads should tighten. Flight-to-quality rallies in the bund usually result in swap-spread widening, and outright sell-offs, which typically are a reaction to these episodes, lead to tightening of swap spreads.

However, in the longer run, when rates are rising due to priced-in/realized rate hike expectations, swap spreads widen and vice versa. Intuitively, in a rate-hiking environment, deficits continue to narrow as the growth outlook improves, which is in turn good for swap-spread widening. Moreover, the supply and demand side of the swap leg of the swap-spread position turns in favor of spread wideners, as bank treasuries and corporates start to pay outright swaps to lock in the low level of yields.

There are two main risks to the trade: 1) the swapped issuance pipeline; and 2) the contingent liabilities assumed by Germany in the EFSF/ESM mechanisms. The YTD swapped issuance pipeline has been notable, with the peripheral eurozone debt market situation improving/stabilizing since early January, and covered bond, unsecured bank, investment grade corporate and SSA issuance has been high. Although we do not rule out some temporary tightening episodes in bund ASW over the next month or so due to swapped issuance, this should be taken as an opportunity to add to wideners in our view. In terms of the latter risk, we note that there are unlikely to be additional commitments in the medium term above those agreed at the 11 March EU summit (which increased the EFSF lending capacity to €440bn, likely via bigger guarantees from core AAA countries). According to latest headlines, Germany's contribution to the €80bn paid-in capital for the ESM is about €22bn, which will be raised over the next four to five years. We forecast the tightening impact of this will only be up to 2bp. In fact, the market reaction was very limited with Bund ASW actually widening/holding stable in the week after these announcements. All in all, we recommend a swap-spreads widener on the German curve, with a particular focus on the 10y sector, which offers the most attractive valuations.

Euro cross-market spreads

The markets have been differentiating between countries

Q1 11 began very much as Q4 10 ended, with a generalized widening of spreads versus Germany by all EGB issuers, as supply (actual and expected) weighed heavily. Portuguese, Spanish and Irish bonds all approached record wides once again by mid-January, before retightening due to a number of factors, chiefly a better-than-expected reception for the supply, general short positioning by investors and dealers, and positive signals on the political front. The most notable performers were Spain and Italy, which tightened c.67bp and 34bp, respectively, in the 10y area (and considerably more in the front end), followed by Belgium, which tightened c.25bp. Irish and Portuguese bonds initially managed to rally in line with moves elsewhere, but both failed to maintain this performance and slipped back to record wides versus bunds by mid-March as concerns about the Irish banking sector and the potential likelihood of Portugal accessing the EFSF weighed. All in all, the market showed a strong decoupling between the smaller issuers and the larger ones, for the first time since the beginning of the crisis. Notably, Spain performed very well compared with Italy, despite heavy supply from the Spanish government sector.

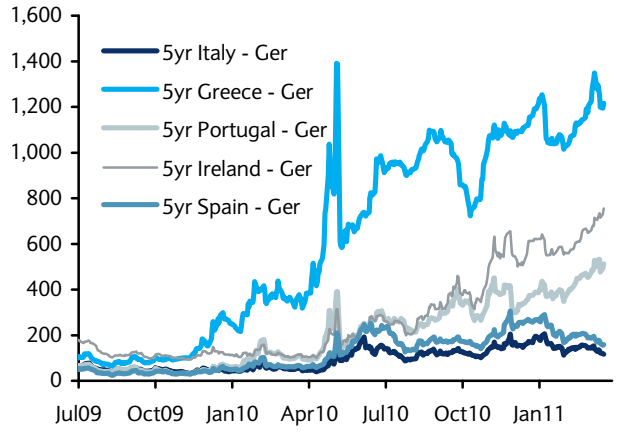
Spain and Italy should continue to perform better

We expect the larger peripheral markets – Spain and Italy – to continue to benefit from better liquidity, better investor sentiment, and strong signs of support in the form of a strengthened and reformed EFSF. Further tightening over the quarter seems probable for both Spain and Italy, in particular in the 10y sector. However, we would be wary that the ongoing volatility in spreads could still result both from domestic and external factors. In this regard, the progress of bank recapitalization plans in Spain should be closely watched, particularly as private sector investors become involved in the process. Similarly, the evolution of the plans for bank recapitalizations in Ireland – in particular, the extent of "burden sharing" by bondholders – in the next few weeks can be a key driver of risk appetite for EGBs.

Smaller markets will remain under pressure

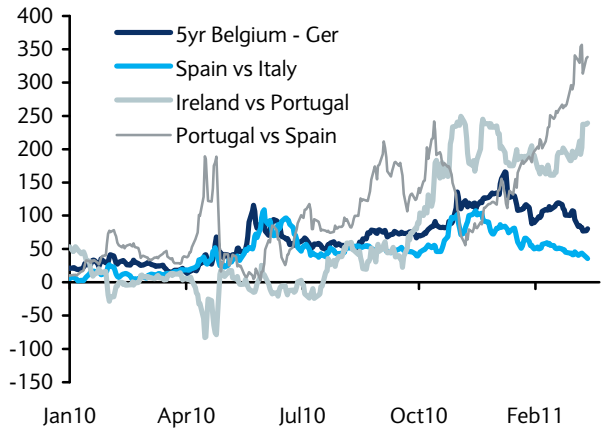
External headwinds exist, too. The publication of the details of the ESM seems likely to be a catalyst for S&P to downgrade several smaller peripherals in late March or early April, and Portugal will remain in the spotlight. The minority government in Portugal remains adamant that it will not seek help; however, the appetite of international investors to continue to fund Portugal remains in question, and as with Ireland, the potential fallout from increasingly stressed PGB markets could mean that ultimately some sort of official assistance for Portugal becomes inevitable, as the authorities look to avoid spill-over effects into the wider EGB market. The market, though, has effectively started to distinguish between Spain and Portugal, and we suspect this will remain the case.

Figure 9: Decoupling in peripheral markets (bp)



Source: Barclays Capital

Figure 10: Spain has done very well recently (bp)



Source: Barclays Capital

Volatility

Fundamentals and flows matter

Unsurprisingly, implied volatilities on short-expiry options on short rates have generally increased, even if positioning and other events also contributed to the moves. For example, implieds actually fell after the March ECB press conference because dealers (especially market makers in listed options) were long high-strike options (in rates terms) from bearish trades (ie, expecting rates to go up), before rebounding on the events in MENA and Japan. Typically, gamma (volatility of short-expiry options) tends to go up two to three months before the first hike, with a subsequent softening. However, before we see gamma moving down, the first hike has to be delivered in April, and we also note that gamma on short-rates is trading in line with delivered volatility. In these uncertain times, we still recommend: 1) rolldown trades on the short end (eg, 2y x 3y ATM/ATM-45bp/ATM-90bp 3m Euribor floor ladders for zero cost); with 2) protection if the ECB does commence a hiking cycle and rates go up (eg, 2y x 3y ATM/ATM+70bp/ATM+140bp 3m Euribor cap ladders for zero cost). Either of these trades could become worthless on a mark-to-market basis if rates go in the opposite direction (with no initial cost to enter them) because delta (rate) and vega (volatility) risks become close to neutral, while the other trade should perform.

In the vega space (options with longer expiries), we have seen a correction in dislocations highlighted in the December *Global Outlook* (eg, options on 10y swaps had become too expensive compared with options on 30y and, in particular, 20y swaps). Going forward, vega will be mainly driven by hedging flows resulting from issuance of structured notes in a chase for better returns in an environment of historically still very low yields. Rather than callable notes (which create a supply of volatility but are not very attractive in a rising rate environment), we expect continued focus on CMS rates (despite expensive volatility and payer skew levels).

UK rates: Tightening monetary and fiscal policies

Bank of England likely to hike three times in 2011

In the UK, we expect the Bank of England to begin its tightening cycle in May with a 25bp rate rise. We then expect two further 25bp hikes over the course of the year tied to the Inflation Report cycle (ie, August and November). The most recent increase in geopolitical risk and the Japanese earthquake has left the front end pricing slightly less than our forecast, with the first full 25bp rate hike priced by August and around 50bp of tightening priced into the OIS market compared with our expected 75bp by year-end. However, with economic uncertainty in the UK still high, given the weak Q4 10 GDP print and the effects of the planned fiscal austerity yet to be fully gauged, we expect the ultra-short end of the curve to remain volatile but ultimately for outright yields to move higher.

Curve flatteners still provide value in the UK

We see better value in expressing a bearish market bias not via outright positioning, but through curve flatteners and butterfly trades. The gilt and swap curves remain steep by historical standards, and we expect the curve to come under steady bear-flattening pressure over the quarter, as the market more fully prices a rate-tightening cycle. Equally, we still see the 5y point as vulnerable to further correction on the GBP 2s5s10s, which continues to look rich. Similarly, we recommend longs in 10s versus the wings: the GBP 5s10s30s remains a flat carry trade in swaps and looks cheap when regressed versus the GBP 5y5y/15y15y spread.

Gilts still look cheap vs swaps

In asset-swap space, it is notable that 10y gilt asset swaps continue to look cheap versus models, given the government's ongoing fiscal austerity measures, the rising rate environment and continued robust demand for gilts from both banks and overseas investors. With the SLS unwind still progressing (according to the BoE, some £94bn of the £187bn of bills made available to the banking system have been repaid), we still see value in longs in 2y spreads versus 5y spreads, as the 5y part of the curve will bear the brunt of short-dated issuance. In the longer part of the curve, we expect to see cheapening in

longer-dated asset swaps, given supply and as some existing longs in long-dated gilt asset swaps are unwound by institutional investors. Therefore, we would retain a short in this part of the curve versus 10y spreads as a bearish positive-carry structure.

Scandinavia: In the midst of tightening policy

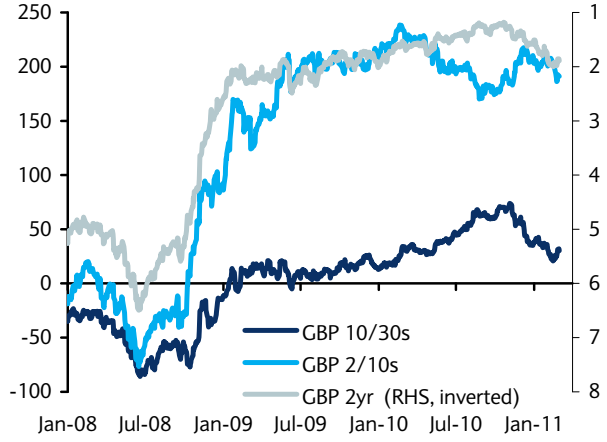
Further rate hikes forecast in Scandinavia

While GDP growth is likely to slow from the solid 5.5% pace recorded in 2010, leading indicators in Scandinavia continue to support expectations of broad-based, above-trend growth well into H2 11. The recovery in the labor market has continued to surprise on the upside, and the fiscal situation suggests ample room for reforms going into 2012. As such, we expect the Riksbank to hike the policy rate another 100bp, taking it to 2.50% by year-end 2011, which would be in line with the Riksbank's policy rate path and current market pricing. While we remain vigilant of the policy risk of "unwarranted" SEK appreciation," in the near term we believe further SEK appreciation needs to be significant (perhaps 5-10%) to have a material impact on policy.

In 2012, we expect the Riksbank to raise the policy rate another 100bp, to 3.50%. This is significantly more aggressive than is discounted by the market (roughly 3.0%). We would also caution against underestimating the RB majority's willingness to "lean against the wind", with the 2005-08 hiking cycle suggesting a clear risk that the central bank might raise the policy rate above what is suggested by inflation and output gap developments alone. All in all, we continue to see little value in challenging the pricing at the very front end of the SEK money market curve. Instead, we hold on to our short-end steepening bias, which we expressed via Dec '11/Dec '12 3m FRA steepeners. We also continue to see value in ASW wideners in the 5y segment (SGB 1050), despite recent performance.

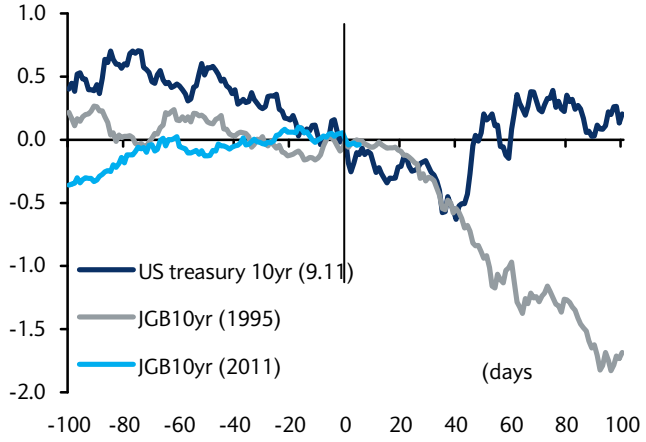
The Norges Bank left policy rates unchanged at 2.0% at its recent meeting, but its updated forecast implies that the policy rate will be hiked 25bp at either the 12 May or 22 June policy meeting, and to 2.75% by year-end 2011 and 4.0% by year-end 2012. This is in line with our forecast, but more aggressive than what is priced by the market (about 2.75% by year-end 2011 and 3.50% by year-end 2012). As such, we also hold on to our short-end steepening bias in Norwegian rates.

Figure 11: UK curve likely to flatten further as BoE hikes



Source: Barclays Capital

Figure 12: Bond yields around Japanese earthquakes and 9/11



Source: Barclays Capital

Japan: Bear-steepening likely to be limited

Current fiscal outlook different from what it was in 1995

Japan's experience with the Great Hanshin-Awaji Earthquake of 1995 serves as a useful reference point in determining what kind of policy and market implications to expect in the wake of the Tohoku Pacific Coast Earthquake that occurred on 11 March. There are also many similarities that help in forecasting how much the reconstruction effort will cost. In addition, the Japanese government has plenty of precedents in working out specific measures to cope with natural disasters. But there is one big difference with 1995: fiscal conditions have deteriorated sharply. At the time of the earlier quake, the government was inclined to boost macroeconomic demand in the name of reconstruction. There was also a need to help manufacturers suffering from the effects of JPY appreciation thereafter. This time around, few (aside from a handful of politicians) are seeking to use the earthquake as an excuse to spend heavily. This should provide a measure of support for the JGB market. While fiscal spending related to the reconstruction effort will create a certain amount of pressure for JGB issuance, it is difficult to see economic growth surging on reconstruction demand. In this sense, the BoJ's strengthened accommodative stance is likely to remain intact for a longer period.

Sell-off in yields likely to be limited

The 1995 experience also suggests another important implication: the market is likely to converge toward its medium- to long-term trend following its initial response to the earthquake. In 1995, JGB yields initially rose in anticipation of increased fiscal spending, but ultimately traded in a range during the first month after the earthquake. Over the next six months, 10y yields ended up falling 200bp from their levels immediately prior to the earthquake as fears of economic slowing strengthened amid JPY appreciation (Figure). This time around, JGB yields started to rise as the Japanese economy came out of its soft patch last fall, but the uptrend had already taken a breather in February, prior to the earthquake, as emerging Asia – the engine behind Japan's recovery – started to slow as policy tightening and rising oil prices began to be viewed as a potential drag on growth. Due to Japan's persistent deflation, there was already a general consensus that the BoJ would be slower to tighten than its US and European counterparts. In short, this month's earthquake struck at a time when factors weighing on long-term yields were gradually strengthening. In this context, we believe it is rather difficult to expect 10y JGB yields to exceed 1.4% and 2-10y spreads to widen more than 110bp any time soon.

Although some market participants believe the earthquake will prolong the period of BoJ accommodation, it is probably more accurate to say that the curve went too far in discounting an early BoJ rate hike in response to the rise in short-term European yields, and that the earthquake served as a trigger for a correction to fair levels. We had forecast bear-steepening for Jan-Mar, but expect long-term yields to hover in a range during Apr-Jun even if the steepening bias remains intact during this period. We do not expect a full-scale resumption of the bear-steepening trend. Although the steepening could continue temporarily on fears about an increase in JGB issuance linked to the supplementary budget, we believe the MoF will take various measures to curb the amount of issuance to be taken down by the market. It could, for example, postpone some of the issuance to FY 2012.

If market sentiment deteriorates and the curve steepens dramatically from April to May in response to fiscal developments, we would view it as a good opportunity to take bull-flattening positions.

Australia: Turning point in AU-US spreads seems to have been reached

RBA tightening cycle has further to run

Despite the small probability that the market attaches to an easing, we believe the Reserve Bank of Australia (RBA) is likely to view the expected reconstruction efforts in Japan as a potential medium-term positive for Australia. Accordingly, we believe Australia's tightening cycle has further to run, although not as much as some market participants. This view is consistent the RBA's underlying inflation forecast. A nine-month-forward underlying CPI inflation forecast above 2.75% has historically led the RBA to tighten policy. The Q1 11 CPI, released in late April, may reduce the probability of a rate hike by encouraging the RBA to lower its forecast, but at this stage we believe investors should position based on the current CPI forecast.

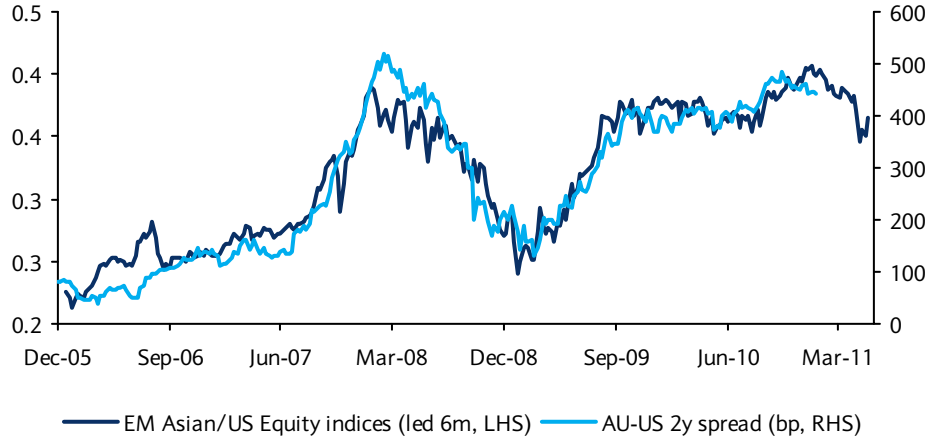
AU-US 10y spread appears to have peaked

While we believe the market is mispricing the risk of near-term RBA action, it is important not to lose sight of the medium term – in particular, the fact that the top appears in sight for AU-US rate spreads. Indeed, across the curve, AU-US rate spreads appear to have peaked in late 2010, with 10y AU versus US spread narrowing 75bp to around 200bp since then.

Asian growth underperformance supports AU-US 10y spread narrowing

With the AU 10y in the vicinity of cycle highs, the sell-off in US Treasuries has quickly translated into a narrowing in the AU-US 10y spread. Looking ahead, the key question is whether it can continue. With inflation and bond yields on the rise globally, it may be intuitively appealing to believe the Australian market can outperform. Nonetheless, with Australia's terms of trade pushing to new heights, is there any fundamental justification for a continuation of the spread narrowing?

Figure 13: EM Asian / US equities vs AU-US 2y spread



Source: Bloomberg, Barclays Capital

Australia's economic destiny is tied to Asia

On the assumption that Australia's economic destiny is linked to Asia – a fair assertion in our opinion – Figure 9 appears to provide the justification for further AU-US 10y spread narrowing. The ratio of EM Asian equities to US equities tends to be a reliable leading indicator for AU-US rate spreads. The intuition is that economic developments in Asia affect Australia with a lag, and that equity indices are leading indicators of economic activity.

Global inflation-linked markets

Inflation breakevens have risen in almost every market over recent months. The rally in G3 markets has generally been led by the front end, correcting sub-5y bond breakeven valuations that had been uncomfortably low relative to central bank inflation targets. It leaves valuations notably less out of line with our economists' inflation projections, though

still attractive value for those looking for inflation protection within portfolios. We continue to see better value in developed than emerging markets, where inflation-linked bonds imply inflation above acceptable central bank tolerance bounds in every market other than Mexico. JGBis once again yield notably above nominal debt, having underperformed on post-earthquake position reduction, and may offer attractive longer-term value for those able to invest in what are now very illiquid bonds. The combination of increased imported inflationary pressures and the potential for fiscal pressure to produce an agreement on a consumption tax increase leaves substantial upside, in our view.

US TIPS are rightly more sensitive to oil than other inflation-linked markets due to the higher pass-through into the CPI than elsewhere, but the belly of the curve seemed to overreact to the move in front-month WTI crude above $100/bbl, given that longer-dated oil rallied much less. This likely reflects an overemphasis on carry among tactical investors, but in our view it leaves the asset class relatively fairly priced versus nominal Treasuries. It is hard to see how sub-10y real yields can richen through their all-time lows as the current asset purchase phase draws to a close, despite ongoing demand from global central banks, but for those expecting a notable correction in nominal yields, TIPS offer an attractive defensive alternative. However, long-end TIPS breakevens likely offer the best defensive value, as a bearish change in the Fed's tone could limit upside in 5y5y forward breakevens.

While short-dated euro linkers have reflected increased inflation pressures, they are only marginally richer than the 2% top of the ECB's definition of price stability, with the exception of 2012 maturity bonds. Forward breakevens beyond 5y cheapened on the back of the "strongly vigilant" ECB stance on inflation risks, so also reflect relatively limited inflation risk premium. The front end of the UK is the only linker market significantly cheaper than our economists' and consensus inflation forecasts. We continue to see significant value in the IL13 and IL16 breakevens, despite a very strong performance in recent months and relatively poor liquidity. UK linkers benefit from rate hikes feeding into RPI inflation via mortgage interest costs, limiting the degree to which a hiking cycle hits RPI real yields. The IL16 will likely come under increasing pressure from index selling ahead of it dropping out of over-5y indices in late July, but, in our view, it offers very attractive breakeven value for medium-term investors.

Global bond yield forecasts

US Treasuries							
	Fed funds	3m Libor	2y	5y	10y	30y	10y RY
1Q11	0.00-0.25	0.35	0.50	1.95	3.40	4.60	0.85
2Q11	0.00-0.25	0.35	0.70	2.10	3.50	4.75	0.90
3Q11	0.00-0.25	0.35	0.95	2.40	3.65	4.90	1.05
4Q11	0.00-0.25	0.35	1.10	2.50	3.75	5.00	1.10

US swap spreads				
	2y	5y	10y	30y
1Q11	17	35	20	-20
2Q11	17	35	20	-20
3Q11	17	25	15	-25
4Q11	17	20	10	-30

Euro government							
	Refi rate	3m	2y	5y	10y	30y	10y RY
1Q11	1.00	1.20	1.80	2.60	3.35	3.70	1.20
2Q11	1.25	1.70	2.05	2.85	3.50	3.85	1.30
3Q11	1.50	1.90	2.20	3.00	3.65	4.00	1.40
4Q11	1.50	2.00	2.35	3.10	3.75	4.00	1.55

Euro area swap spreads				
	2y	5y	10y	30y
1Q11	60	45	25	5
2Q11	65	50	30	5
3Q11	70	55	35	10
4Q11	75	60	45	15

UK government							
	Bank rate	3m	2y	5y	10y	30y	10y RY
1Q11	0.50	0.82	1.80	3.00	3.90	4.50	0.90
2Q11	0.75	1.05	2.25	3.25	4.20	4.60	1.20
3Q11	1.00	1.35	2.40	3.40	4.35	4.70	1.25
4Q11	1.25	1.65	2.60	3.50	4.50	4.75	1.40

UK swap spreads				
	2y	5y	10y	30y
1Q11	50	30	0	-30
2Q11	55	30	5	-30
3Q11	60	30	15	-25
4Q11	60	30	20	-25

Japan government							
	Official rate	3m	2y	5y	10y	30y	10y RY
1Q11	0.10	0.20	0.20	0.45	1.25	2.15	1.20
2Q11	0.10	0.20	0.20	0.45	1.20	2.10	1.20
3Q11	0.10	0.20	0.15	0.35	1.15	2.05	1.15
4Q11	0.10	0.15	0.10	0.25	0.90	1.90	1.05
1Q12	0.10	0.10	0.10	0.15	0.70	1.75	0.85
2Q12	0.10	0.10	0.15	0.30	1.00	1.90	0.85

Japan swap spreads				
	2y	5y	10y	30y
1Q11	20	15	0	-5
2Q11	20	15	5	-5
3Q11	15	15	5	0
4Q11	15	15	5	0
1Q12	15	15	10	0
2Q12	15	15	10	0

Source: Barclays Capital

CREDIT MARKET OUTLOOK

Nonfinancials look increasingly full

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- **We believe the potential upside in nonfinancial credit is limited, given current valuations. Investment grade spreads are close to pre-crisis levels, particularly in the US and emerging markets, and the high yield market is becoming increasingly call-constrained in the US and Europe.**
- **Subordinated financials remain attractive, in our view. We recommend Tier 1 securities in the US and Europe, while remaining cognizant of extension risk and the risks posed by regulatory calls. Covered bonds, particularly in Spain and Italy, are also attractive. We are more cautious on European senior financials, given valuations and the potential for senior haircuts at certain distressed institutions.**
- **An important macro risk is a potential spike in energy costs associated with unrest in MENA and the effects of the Japanese earthquake and tsunami. Furthermore, European sovereign risk may resurface, although non-European credit will likely remain resilient in the face of sovereign volatility.**
- **Event risk is an increasing concern. While much attention has been paid to LBO speculation, incremental increases in leverage at larger companies may be as important as large increases in leverage at small companies, in our view.**

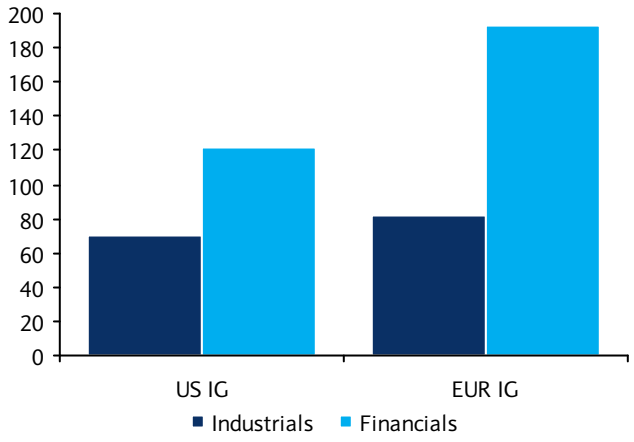
In the developed world, we expect the differentiated performance between financials and nonfinancials to continue throughout the remainder of 2011. We believe the deleveraging cycle for nonfinancials has largely ended, and as a result, we see limited upside in that universe. Although we do not expect a significant change in aggregate, we believe an increasing number of companies will increase leverage in 2011 – both in the form of LBOs and through M&A and more generic increases in leverage. The price of AT&T, which widened 10bp after announcing its plan to purchase T-Mobile, is one recent example. Given the weight of AT&T in the index, even a small move can have large implications for credit investors.

Figure 1: YTD index returns (bp)

	Excess Return	Total Return
US Investment Grade	88	140
US High Yield	305	361
European Investment Grade	131	-1
European High Yield	(37)	367
EM USD Corporate	160	223

Note: As of March 21, 2011. Source: Barclays Capital

Figure 2: YTD returns – Industrials vs financials (bp)



Note: As of March 21, 2011. Source: Barclays Capital

Financials have outperformed in the US and Europe (Figure 2), and we continue to find subordinated bonds attractive in both markets. In Europe, we prefer T1 with high back-end coupons, to limit the extension risk. We are more cautious on European senior financials. First, we are concerned about the effect of potential haircuts in certain distressed institutions on the broader market for senior financials. Second, European banks continue to have substantial funding needs, which include ~EUR300bn of redemptions this year, plus potential issuance related to unwinding ECB funding facilities. We prefer covered bonds, particularly those issued by Italian and Spanish banks. In the US, we prefer straight preferred stock and TRUPs trading below par, which have limited risk from early regulatory calls.

Emerging market corporate credit has outperformed emerging equities and EM sovereign credit. Despite admittedly positive technicals, we believe there will be better entry points into this market over the coming quarter. If the unrest in the region subsides, high-quality Middle Eastern credits, which have widened substantially, would be set to outperform.

The recent announcements from Europe have been positive, particularly the ability of the EFSF to buy sovereign bonds in the primary market, which should ease peripheral funding pressures. We expect more details in the coming weeks. Based on the recent tone, we expect regulators eventually to take the steps necessary to stabilize markets, but systemic risk will remain a concern in the near term. As a result, we believe the sovereign crisis will remain an important driver of spreads in Europe, but that the implications for other markets will stay muted. Fundamentally, we are likely in for a couple of challenging years in peripheral Europe, for which we do not think investors are being paid in domestically focused businesses. This week's announcements from the rating agencies are particularly interesting along these lines, as they now explicitly tie corporate ratings to sovereign ratings. We remain underweight peripheral credits versus core credits and would use any bounce in peripheral credits based on the March 24-25 summits as an opportunity to lighten up further on peripherals.

Higher rates pose another risk, particularly as more central banks react to rising inflation. We have already seen this trend in emerging markets (eg, China has hiked the benchmark 12-month lending rate by 75bp in the past six months). We expect rate hikes this year in the developed world as well, starting with the ECB and BOE. This clearly has the potential to pressure total returns – evidenced by the performance of investment grade in Europe – which would reduce demand and, thus, weaken what is otherwise a strong technical picture for credit.

US investment grade: A quarter of two halves

The events in Japan have weighed on the US investment grade market, with credit spreads widening 5bp since March 10. They exacerbated the weakness in credit that began with the unrest in the Middle East and Northern Africa. As a result, credit spreads, which tightened materially until mid-February owing to improving economic fundamentals, have since erased nearly half of those gains. The US Credit index is now at 136bp, 9bp tighter YTD but nearly 8bp off the tights of the year. YTD excess returns have been 88bp; total returns, at 140bp, have been higher as a result of the recent rally in Treasuries.

We expect the performance of nonfinancials and financials to diverge in 2011. Despite the recent pullback, nonfinancial valuations appear full. While corporate fundamentals remain strong, the industrial segment of the Credit index is trading only slightly wider than levels achieved pre-crisis, suggesting that there is limited room for further outperformance (Figure 3). At current levels, the risk/reward profile for many industrial credits appears unfavorable – they have limited upside in a rally given the tight spread levels, but are exposed to broader market sell-offs, as evidenced by the recent market weakness.

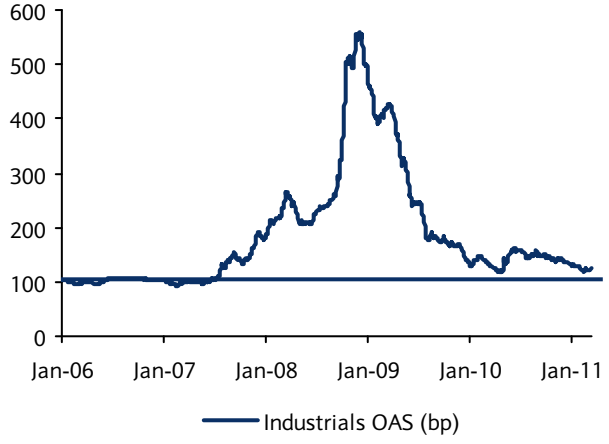
The re-leveraging of corporate balance sheets will be a key theme for nonfinancials in 2011. Consistent with our view that this year will mark the end of the overall deleveraging cycle and that cash will increasingly be directed to shareholders, many companies announced major repurchase plans/dividend increases in Q1 including Kohl's, HP, 3M, and Verizon. We do not expect this to be a negative for credit in the near term, since most initial distributions to shareholders will likely come from accumulated cash and cash flow. However, we expect some activity to be financed with incremental debt. Of note is the recent AT&T merger with T-Mobile, which resulted in AT&T spreads widening 10bp on an increase in leverage. LBO risk is also a concern, although we believe the spread widening in CDS of event risk credits is overstated from a portfolio standpoint.

While many nonfinancial credits appear rich/fairly priced, we still find value in financials (across the capital structure), which trade substantially wider than industrials (Figure 4). We have a fundamental overweight recommendation on banks, life insurers and REITs and expect most of the outperformance of the index to be driven by these sectors. Valuations are likely to be volatile in the near term, however, as demonstrated during the recent sell-off, when financials underperformed the rest of the investment grade space.

The technical backdrop for investment grade is strong. While there have been concerns about negative fund flows in December and January, we believe they do not provide a complete picture of demand for investment grade credit. Retail investors account for a smaller portion of total demand for investment grade bonds than in other asset classes, such as municipal bonds or high yield. In addition, other buyers, such as pension funds and insurance companies, are arguably more likely to purchase corporate debt as rates (and equities) rise.

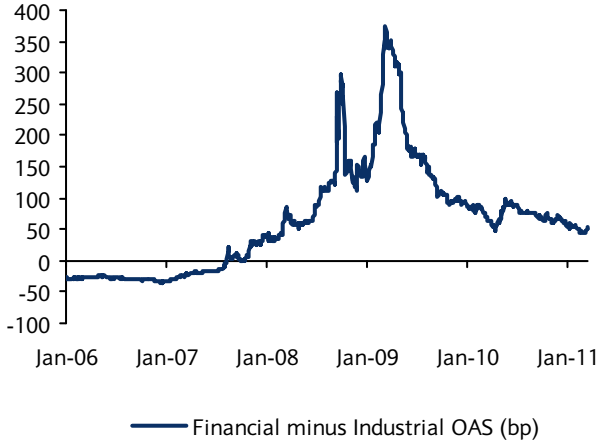
The strong demand for credit was evident in the performance of primary deals. Despite a fairly heavy new issue calendar, many new issues were oversubscribed, priced at the tighter end of indications and rallied after issuance. Financials were the leading issuers in January, but industrials have picked up since then. The supply of floating-rate bonds has also increased in 2011, as issuers have tapped into the strong demand for floating-rate paper amid concerns about the duration exposure of fixed-coupon product. Year-to-date, there has been nearly $55bn of FRN issuance, compared with full-year 2010 issuance of $62bn.

Figure 3: Industrials only slightly wider than pre-crisis levels



Source: Barclays Capital

Figure 4: Financials still have room to compress to industrials



Source: Barclays Capital

Key trading themes

1) Financials vs industrials: The difference between financial and industrial OAS is currently 54bp, substantially wider than the pre-crisis level of -28bp (Figure 4). While we do not expect financials to trade inside industrials, given the removal of implicit government guarantee for US bank debt under resolution authority, we believe there is room for about 20bp of compression in the financial-industrial basis.

2) Negative basis trades: We expect the new margin requirements for CDS to result in a less negative CDS-cash basis. As a result, we recommend basis trades on credits we are constructive and that trade at a substantial negative basis.

3) Pair trades: While nonfinancial valuations look full in aggregate, we believe there are several opportunities for pair trades that could profit from relative movements between sectors and individual credits. There are many examples of credits that have comparable features and credit metrics, but trade at different levels and have the potential to converge (for instance, Nordstrom versus Target, and Yum versus McDonald's). Similarly, pair trades involving credits that trade at similar levels but have very different characteristics, creating a potential for divergence, also appear attractive (for instance, Constellation versus FirstEnergy, and Omnicom versus General Mills).

4) Capital structure trades: We believe that hybrids are cheap relative to senior parts of the capital structure and expect the senior-hybrid basis to compress 20-30bp in 2011. In addition to a favorable fundamental backdrop, positive technicals emanating from changes in the rating agency and regulatory treatment of these securities are likely to be supportive of valuations. That said, investors should avoid high-coupon trust preferreds with regulatory par calls, which have potential downside from early redemptions.

US high yield

The high yield market kicked off 2011 with solid returns, after an uneven finish to 2010. Year-to-date high yield total returns reached as high as 3.8% by early March, before the more recent sell-off after Japan's earthquake and nuclear crisis, and now stand at 3.6%. As 5y and 10y rates increased in the first part of February, high yield benefitted from its low sensitivity to Treasuries relative to investment grade: through February 8, the total-return loss due to rates was 1.1% for high yield and 1.9% for investment grade corporates. On the flip side, from early February to mid-March, the high yield market saw less benefit from the rally in rates, owing to renewed macro risks.

The high yield index equaled its all-time low yield of 6.74% in the quarter and reached an average price of just over $104. At that time, the gap between the index yield to worst and yield to maturity widened substantially, testifying to the increasingly large proportion of the market that had become call-constrained. The market began to stall at close to $104 as MENA risks became more pronounced. As we discussed in our annual outlook, the callable nature of most high yield debt makes it difficult for the market to experience significant price returns once it gets above par. Therefore, despite the strong year-to-date run rate, we reiterate our forecast of 5-6% total returns for the asset class.

Although high yield has cheapened somewhat, the all-in yield remains only 30bp from its historical lows. However, until G3 rates increase substantially or high yield fundamentals deteriorate, neither of which we expect in the near term, we believe demand will remain robust. Moreover, if the economic impact of recent events in Japan leads spreads to widen further, we would expect significant renewed buying interest at around the 7.5% yield (or ~525bp OAS) mark. On the other hand, we believe there is some risk of Japanese repatriation of assets as

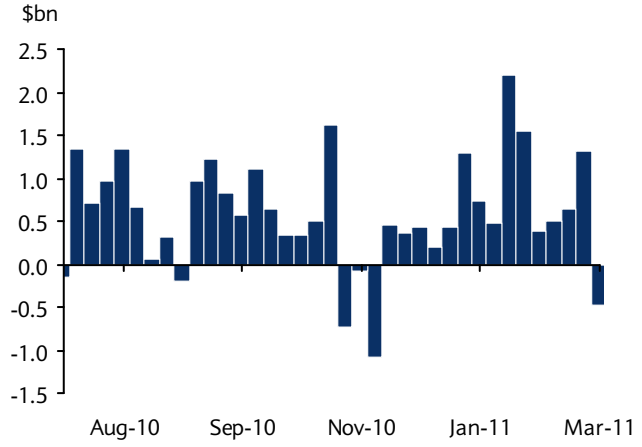
post-earthquake and tsunami rebuilding begins. As we highlighted in *Will High Yield Inflows Stick?*, we estimate that Asian investment represents about 5% of the overall market, or approximately $50bn, and offshore fund flows have represented a decent share of the recent market growth. Thus, recent events in Japan could lead to a reduction in overall demand.

New issue volumes have been robust this year, as strong performance and historically low yields have enabled a significant amount of opportunistic issuance. Dollar-denominated supply of $67bn is on pace to beat last year's record of $263bn, but we expect issuance to subside somewhat and believe a full-year total of $225-250bn is more likely. With about $50bn in launched institutional loans year-to-date (excluding purely opportunistic repricings), issuers are less reliant on the high yield market to refinance LBO-era loan maturities. While bond-for-loan refinancings remain common, demand for floating-rate debt has picked up substantially. Year-to-date loan fund inflows have been nearly $14bn, and flows have now been positive for 37 consecutive weeks. We expect the positive technical backdrop to continue for loans as long as rates remain a major risk factor in credit. However, we caution that the recent repricing trend limits the upside potential in loans and reiterate our 5-7% full-year total return target.

For the second quarter, we think investors should take advantage of the following themes in high yield:

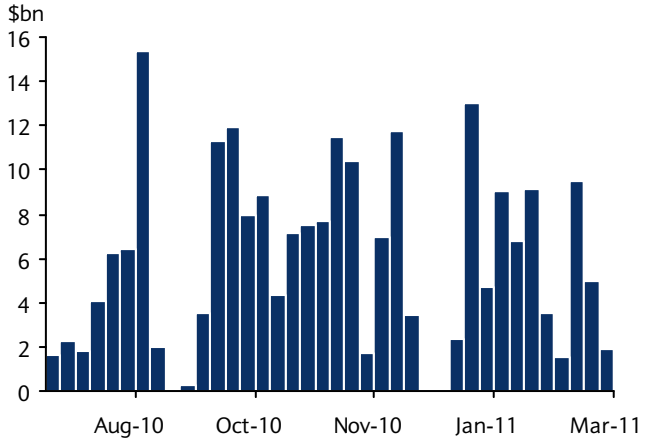
- **Ratings cliffs:** BB/BBB and CCC/B spreads look attractive when normalized for absolute spread levels. We expect $30-40bn in rising stars in 2011, and these benefit from a strong technical as investment grade accounts rebalance their portfolios. Upgraded CCCs outperformed the CCC Index by an average of nearly 7% in 2009 and 2010, and also benefit from higher demand, as some high yield investors are restricted in their purchases of the lower ratings categories.
- **Positive basis:** With the index trading in the $103-104 range, a large proportion of the high yield universe is trading to its first call. For credits with improving fundamentals, we recommend swapping out of call-constrained bonds into CDS to capture further upside potential, especially when there is a positive basis.

Figure 5: Weekly high yield fund flows



Note: Includes weekly and monthly reporters. Source: Lipper

Figure 6: Weekly USD high yield supply



Source: Barclays Capital

- **Shorts to manage duration:** Even in the absence of a negative outright credit view, those with a negative rates outlook should consider shorting premium bonds with capped upside. We recommend limiting the universe to liquid, low-coupon issues to minimize costs and avoiding names with potentially positive credit events.
- **Capital structure:** OAS gaps between senior and junior bonds in high yield have rallied, but some outliers remain in the lower part of the capital structure. In addition, call constraints can present opportunities in certain capital structures to move up in seniority with little to no give-up in spread.

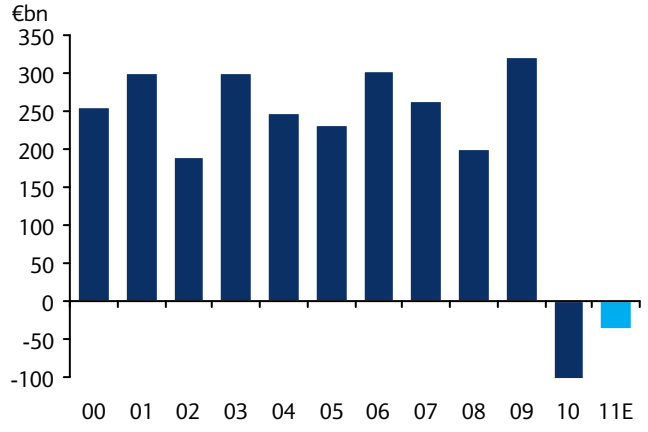
European high grade credit

We expect volatility to remain high for the next one to two months, driven by EU peripheral sovereign and financial restructuring efforts and still-developing MENA volatility. Although we expect more finality about the EC's policy plans shortly, we still think Portugal and Spain, in particular, will be subject to volatility for some time to come. In addition, the degree to which fiscal austerity and rising inflation affect European economies will be a noteworthy risk throughout the year. That said, we continue to view the total and excess return pictures in European IG credit differently. Despite expectations of near-term volatility, we remain constructive on European IG credit spreads for the whole of 2011, given that our baseline expectations remain that "core" Europe will be able to weather the current storm of volatility and maintain the emerging recovery. Importantly, however, the transition to rate-hiking regimes in Europe and the US should challenge total return performance for the foreseeable future. With the potential for rate hikes in Q2 by the ECB and the BoE, we believe total return investors remain wary.

European IG credit has posted +139bp of excess return YTD, an impressive performance, given the level of global macro risk. Financials (+193bp) have meaningfully outperformed nonfinancials (+81bp) following their late-2010 weakness. Minimal total returns (flat), however, highlight how susceptible the market remains on a total return basis and reinforces our aforementioned total return concerns.

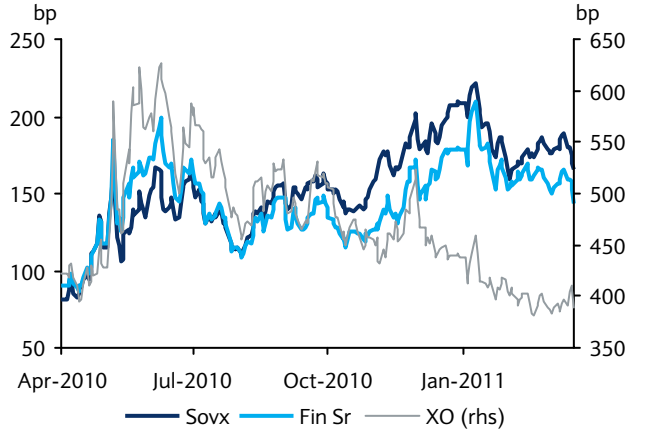
We expect the technical picture to be a mixed bag in the near term. The positive effects of negative net new supply (Figure 7) should help mitigate the reallocation of funds from credit to equities that we have begun to see at the retail level.

Figure 7: Net European IG issuance



Source: Markit, Barclays Capital

Figure 8: SovX, Fin Sr, and XO, LTM



Source: Barclays Capital

For the medium term, we suggest trading the range in peripherals and moving down in quality in non-financials (Figure 8).

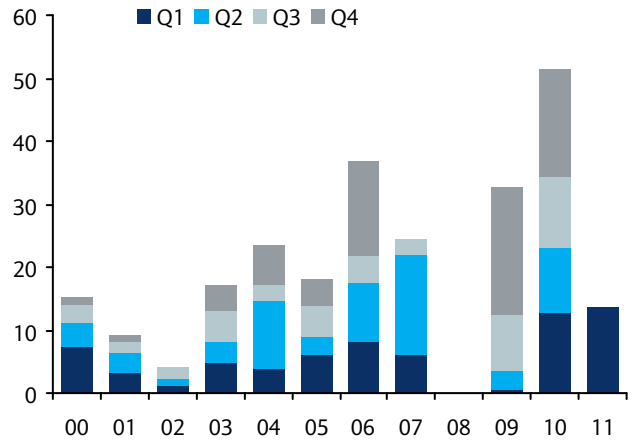
- **Remain cautious peripheral credit**. Given our expectations that real fundamental weakness will continue for peripheral credits, we believe investors should sell peripheral credit into strong rallies.
- **Own barbell positions in financials, with longs in covered and sub paper**. We remain cautious on senior unsecureds, given the risk of potential haircuts, and on banks with meaningful peripheral exposure. We expect sub paper to continue to drive outperformance in the banking sector, as it has in Q1 11.
- **Underweight tight-spread leveraging candidates**. We think fundamentals are at/near cyclical peaks and do not believe the risk of equity-friendly moves is priced into many non-financials.
- **Swap out of tight-spread single-A and triple-B industrials into potential rising stars**, where fundamental improvements and a positive ratings trajectory should drive outperformance.
- **Overweight 5y versus 10y paper**, given flat credit curves and ongoing rate risk.

European high yield and leveraged loans

European high-yield has performed well year-to-date, with total returns on the PEHY 3% ex-Fin index of 2%. Despite the strong start, we expect returns to be toward the bottom end of our 6.5-8.5% forecast for the full year, given our rates forecasts. Technicals are still strong, despite adverse macro events in the MENA region and Japan. Funds were sitting on cash, with January showing an €1.8bn inflow from investors and a further €2.5bn in bonds already called this year.

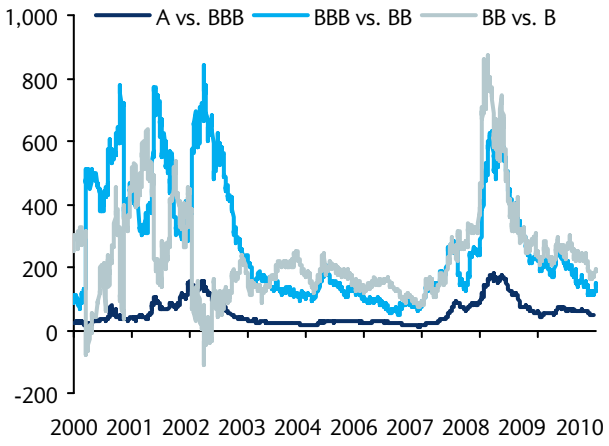
We expect new issuance to remain strong. So far, €13.6bn has been priced in 2011, with deals pricing even amid the uncertain macro picture. Although 82% of deals are driven by refinancing, LBO credits are reappearing. However, there has been a relative lack of EUR-denominated issuance thus far. With sterling and dollar deals accounting for 26% and 30%, respectively, of primary volume, some investors have had to choose between holding cash and buying secondary product.

Figure 9: High yield issuance by quarter



Source: Barclays Capital

Figure 10: Credit quality premia (bp)



Source: Barclays Capital

Fundamentals remain solid, with few exceptions. The recent round of results continued to show strong, cash-generating performance from bellwether credits in the TMT/cable/ industrial sectors. We expect more of the same in Q2. Given the new trading range for oil, results in Q3 may begin to show increased cost pressure among industrial credits. The key is whether companies can pass these cost increases on to customers.

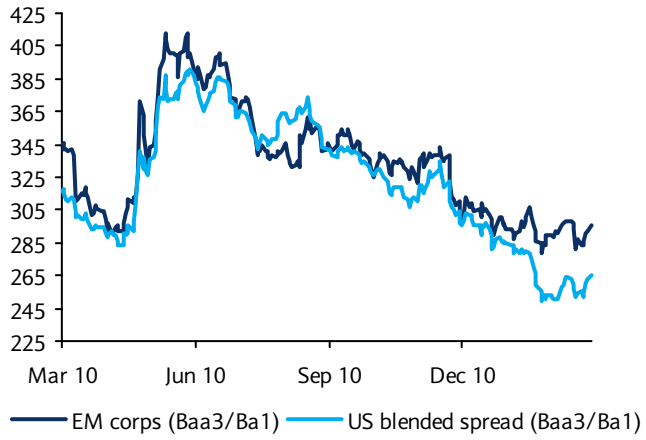
Loan prices remain supported by a strong technical backdrop. Primary issuance is lower than prepayments, and recovering credits are also looking at loan-to-bond transactions. In addition, strong investor appetite for floating-rate paper continues, on rising rate expectations. This is leading to amend-to-extends on older loans and repricings on newer deals.

- **Quality**: We prefer single-B credits, which we expect still to benefit from yield compression. They are trading 139bp wide of BBs, roughly 66bp inside historical median levels and 90bp off their tights.
- **Manage exposure to call-constrained bonds**: With 73% of our index ex-financials trading above par, we believe it will benefit investors to switch out of call-constrained bonds into less constrained issues and, for investors who are able, to move longs into less-constrained, "bullet" CDS.
- **Refinancing candidates**: We recommend buying refinancing candidates that still have some upside to their call price. (*European Credit Alpha: Patience is a virtue*, 18 February 2011).
- **Fixed to floating**: Switch from senior-secured bonds into first-lien loans to enhance returns and reduce exposure to rising interest rate risk. (*European Credit Alpha: Buffeted on all sides*, 11 March 2011).

EM corporates: Moderate underperformance on geopolitical risk

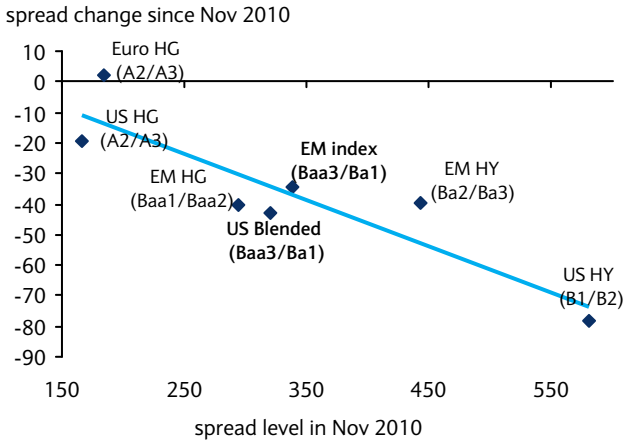
Given the degree of uncertainty and limited repricing in bond valuations (25bp off the 8 February tights), being long EM corporate credit over the next month or so holds more downside risk than upside potential, in our view. We expect better entry points, perhaps after EM spreads realign with EM sovereigns or EM equities. Some credits in the Middle East are now looking cheap and becoming sensible longs as headline risk recedes. We

Figure 11: EM corporates underperformed US corporates after Egypt hit the headlines



Note: EM spreads based on the Barclays Capital USD EM corporate sub-index. The US blended spread is an average of US high grade and high yield spreads (OAS). Source: Barclays Capital

Figure 12: This reflects outperformance of US high yield credit and the underperformance of EM high yield



Note: Spreads based on Barclays Capital indices. EM HG and HY spreads based on constituents of the Barclays Capital EM corporate credit index. HY excludes PDVSA. Source: Barclays Capital

recommend investors watch conservative credits in Qatar, the UAE, and Saudi Arabia. Despite our tactically cautious stance, we remain constructive over the medium term (for more details, please see *The Emerging Markets Quarterly*, 22 March 2011).

EM corporate credit, much like other EM assets, has lagged developed-market performance this year. Performance has been restrained by a number of factors: compressed corporate/sovereign valuations; the concentration of political headlines in emerging markets; policy tightening in China; expectations that the ECB and BoE will hike earlier than previously thought; good economic data from Europe and the US, combined with slowing growth in most EM regions; and heavy EM corporate bond issuance.

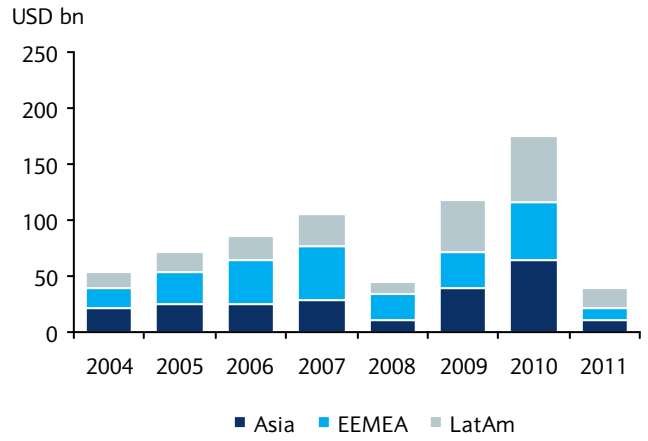
Heavy issuance is surprising, given recent headlines and underperformance, but is also probably partly to blame for that weak performance. YTD EM corporates have issued close to USD40bn, the vast majority of it in January (Figure 13). Historically, EEMEA has constituted the largest regional component of issuance in Q2.

Despite our constructive longer-term view, we maintain a cautious stance on EM corporates in the short run and recommend rotating into segments in which underperformance has created pockets of value. Our view is driven by the following EM-specific risks:

Downside growth risks in large EM economies (Brazil, China, India) and rising inflation concerns: In Brazil and India, industrial production growth has been very anemic. In China, the policy-induced slowdown in loan growth has led to a marked deterioration in business confidence indicators. A combination of growth concerns and rising inflation is the likely cause of underperformance of equity markets in India and Brazil (down 8% and 15%, respectively, versus MSCI EM down 5.5%, since 2010 highs). If the downside growth risks materialize, we would not be surprised by a pronounced reaction in the credit markets.

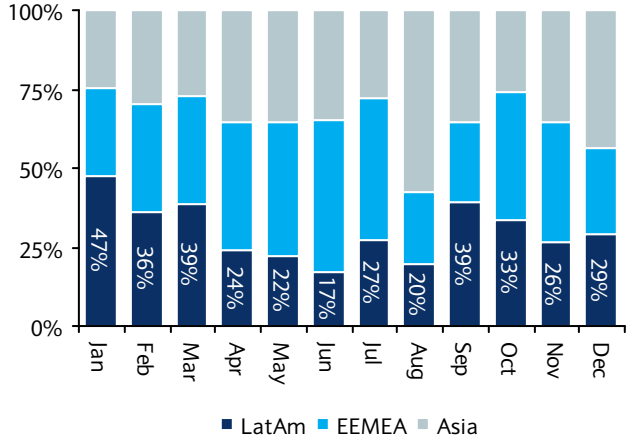
MENA, the Japanese earthquake, and implications for oil, commodities and EM corporates: In the view of our commodity analysts, the Japanese earthquake should not result in lower oil prices. Oil demand is likely to fall in the near term, but over the medium term, energy-intensive reconstruction should drive a quick rebound. Moreover, the situation in Bahrain warrants more attention from the market. Oil prices should decline modestly in Q2 but rebound in the second half of the year. High commodity prices would be positive for natural resource producers in Asia, but slightly negative for utility companies and tire producers. In LatAm, we

Figure 13: Lots of issuance this year, but more than 60% came in January – the pace has since slowed dramatically



Source: Dealogic, Barclays Capital

Figure 14: LatAm's heavy supply so far – 45% of total EM – is typical (% of total EM issuance by month, region; 2004-10)



Source: Dealogic, Barclays Capital

prefer integrated oil and gas participants with a strong bias towards exporters. We are negative or cautious (depending on the case) on price takers on crude, such as refineries and petrochemical companies. Metals and mining names such as Vale and SCCO should compress at least 25-30bp versus global peers, but Brazilian steel names already look somewhat tight to peers. In CIS, while we expect fundamentals in corporates as a whole to remain strong, valuations have rallied to the extent that there is little upside in increasing exposure, given the global uncertainties. The MENA region is complicated by being at the epicenter of political upheaval and higher oil prices. We believe Qatar (which has suffered a particularly sharp sell-off) and the UAE remain shielded to some extent from political unrest and are key beneficiaries of higher oil prices. Saudi Arabia maintains a strong economic profile. For those looking for an opportunity to get exposure to assets that have underperformed, we recommend selectively buying into Qatari, Saudi and UAE credits that feature strong fundamentals and a decent track record, have low refinancing needs, and appear to have been overly sold-off recently, most notably Rasgas in Qatar.

EQUITY MARKET OUTLOOK

Stick with developed world equities

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- **We continue to favor equity markets in developed countries over those in developing ones, and this theme should persist until the Fed begins the exit process in the second half of this year. Although we prefer the US, European equity market valuations remain attractive and we would not significantly cut exposure on ECB hawkishness.**
- **Our 2011 S&P 500 operating earnings forecast is $93 and our price target is 1,450. The correction following recent exogenous shocks has left US equity valuations at levels we consider very attractive. We recommend cyclical positioning in the 1-2 quarters leading up to Fed policy normalization and favour energy, industrials, technology and financials. We recently downgraded consumer discretionary in part because of its vulnerability to an adverse energy price shock.**
- **European valuations remain attractive and evidence suggests rising institutional interest in equities, which could lead to a re-rating. We reiterate our positive stance on European equities, with a 2011 target of 3,350 for the Euro STOXX 50 and 325 for the STOXX 600. Among sectors, we particularly favour Utilities (upgrading to Overweight). We have downgraded Autos to Underweight, as they face supply disruptions as a consequence of the events in Japan, higher oil prices, tightening in emerging markets and high commodity prices.**
- **In Japan, we expect very conservative earnings guidance for FY 11. We expect the Nikkei Average to fluctuate, largely centering on 9,800JPY until this summer.**

Sticking with developed world equities

Only one quarter into 2011 and the business cycle backdrop for global equity markets is becoming increasingly divergent. Valuations and fundamental drivers, such as earnings momentum and margins remain attractive; however, as the business cycle matures, the rate of improvement in fundamental factors naturally decelerates. In December, our core view favored developed over developing world equity markets. This outlook remains broadly intact, but the faster-than-expected increase in global inflation (partially attributable to recent events in the Middle East) has shortened the period of central bank accommodation in Europe and, perhaps, the UK, complicating the outlook. Still, although investors may turn their attention to tighter central bank policy later in the quarter, at present developed world equities are still more sensitive to the economic outlook than to monetary policy and interest rates. In addition, although the transition from monetary policy accommodation to normalization usually triggers equity market corrections, they are not typically terminal and, with growth remaining robust, such corrections tend to reverse quickly. Put another way, in the coming quarter, investors may worry about global monetary policy (excluding perhaps the US), but we do not expect the economic outlook to deteriorate.

In addition to the complexities in the European equity view brought on by a hawkish turn from the ECB, the Japanese earthquake has further complicated the developed world equity outlook. Considerable uncertainty (in terms of the implications for corporate earnings and margins in Japan) seems likely to preclude a sharp recovery in Japanese equities in the near term. Certainly, the banking system is in far better shape than it was in the aftermath of the Kobe earthquake in 1995, and the response from policymakers has been much more aggressive. However, the infrastructure damage seems far more significant this time, and government debt is much higher, so the rebuilding may be a drag on potential growth for some time.

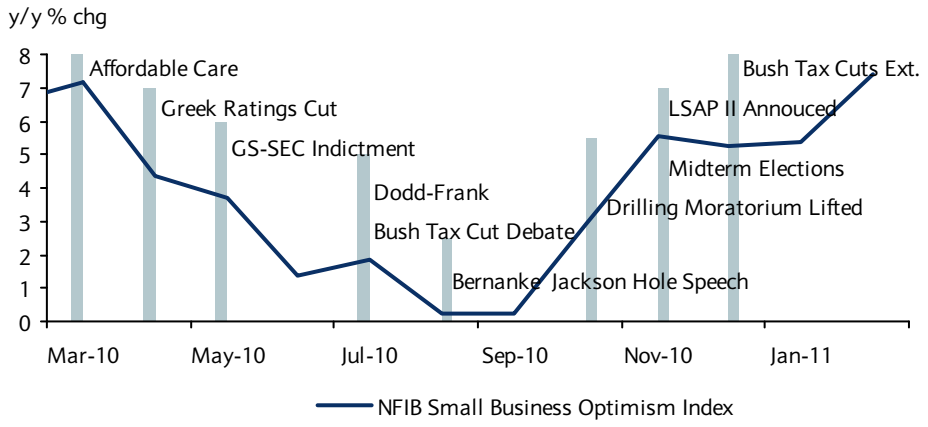
The ECB hawkishness was also unexpected; we are not completely convinced that it has been driven primarily by inflation risks. Instead, we think the ECB may be trying to force an expansion of the EFSF/ESM mandate to facilitate a recapitalization of the weaker parts of the European banking system. If we are correct and the ECB is successful, policy normalization might be fairly benign in terms of the magnitude of rate hikes. Our economists expect rate hikes totalling just 50bp 2011, which, in our view, will not derail the recovery in Europe. Still, until the ECB hiking process begins and there is increased banking system clarity, European equities may struggle, despite attractive valuations.

In our view, the case for avoiding developing world equities has strengthened since December. It seems clear that rising energy prices in countries with negative output gaps creates risks of unhinged inflation expectations. Many EM central banks are moving away from capital controls toward currency appreciation and more traditional monetary policy measures. This leaves the US as perhaps the only major market still in the sweet spot of the economic cycle, where growth is improving and the central bank is still easing monetary policy. This is, of course, critical to the global outlook for equity markets. If the US economic outlook is improving and driving US equity prices higher, we would be hard-pressed to expect strongly negative equity markets in the rest of the world. So, although we prefer the US, European equity market valuations remain attractive and we would not significantly cut exposure to this region as a result of the ECB hawkishness. We expect our view that developed equity markets will outperform those in developing countries to persist until the Fed begins the exit strategy process in 2H11.

US equities: Quantifying the downside, but remaining bullish

- The correction following the recent exogenous shocks has left US equity valuations at levels we consider very attractive.
- Our 2011 S&P 500 operating earnings forecast is $93 (11% y/y) and our price target is 1,450. Profit margin expansion is likely to decelerate in 2011, but an outright decline seems unlikely.
- After the last three recessions, equities gained momentum during the 1-2 quarters leading into Fed policy normalization. We recommend sticking with cyclical sectors and favour energy, industrials, technology and financials. We recently downgraded consumer discretionary in part because of its vulnerability to an adverse energy price shock.

Figure 1: A more favourable policy backdrop vs a year ago provides confidence that the US growth outlook is sustainable



Source: NFIB, Haver, Barclays Capital

Valuations are now at very attractive levels

We were not surprised that the US equity market underwent a correction in 1Q11, but the catalysts were clearly unexpected. The ensuing correction has left valuations at levels we consider very attractive. As a result, unless the growth outlook declines similarly to the 2Q10 deterioration, we believe US equities will resume their upward trend as the uncertainty associated with the events in the Middle East and Japan begins to dissipate. A primary factor in our confidence that the US growth outlook is sustainable is the far more favourable policy backdrop relative to a year ago. The monetary policy differences are clear; less so is the role that public policy initiatives played in the sharp drop in business confidence last year. If we are correct and the exogenous shocks do not lead to deterioration in US business confidence, equities should continue to rally until the Fed begins the monetary policy normalization process. In this cycle, we believe the necessary condition to trigger a typical 8-10% correction (associated with the end of a period of monetary policy accommodation) will be when the Fed begins to allow its balance sheet to contract. The earliest we believe this might occur is 3Q 2011; Barclays Capital's economics team's official forecast is 1Q 2012.

Sweet spot acceleration – limping into the exit process is unlikely

We believe the correction will be complete by the time the Fed actually begins hiking rates

Based on our conviction that the US economy has reached the self-sustainable stage of the business cycle, we believe the debate at the Fed, pending a string of strong payroll gains, has shifted to the speed and timing of the exit process. Unlike cycles prior to 2004, when unconventional policy measures were not employed, we believe the correction will be complete by the time the Fed actually begins traditional policy normalization (rate hikes). The trigger event, in our view, will be the Fed's likely decision to stop reinvesting paydowns from its System Open Market Account (SOMA) portfolio in September-November 2011.

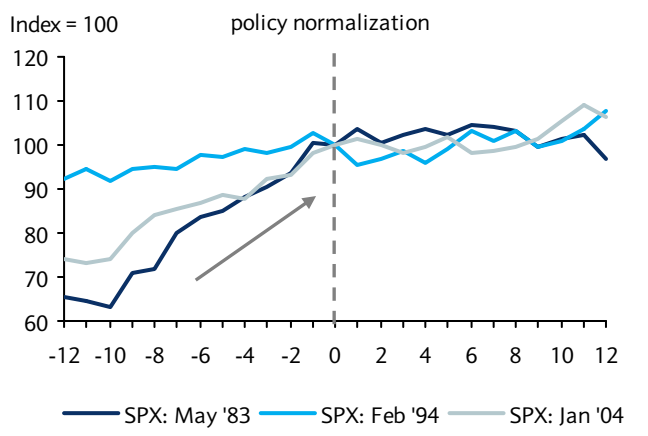
Given this timing, we have explored whether equities will likely struggle in the 1-2 quarters prior to the beginning of the Fed normalization process. We began by looking at equity returns in the months leading up to, during and following Fed policy normalization after the recessions of the early 1980s, early 1990s and 2001. In all three cases, equities gained momentum in the last 1-2 quarters, led by cyclical sectors.

Framing the downside

The S&P 500 forward earnings yield is 70bp higher than it was just before the 16% correction from late April to early July 2010

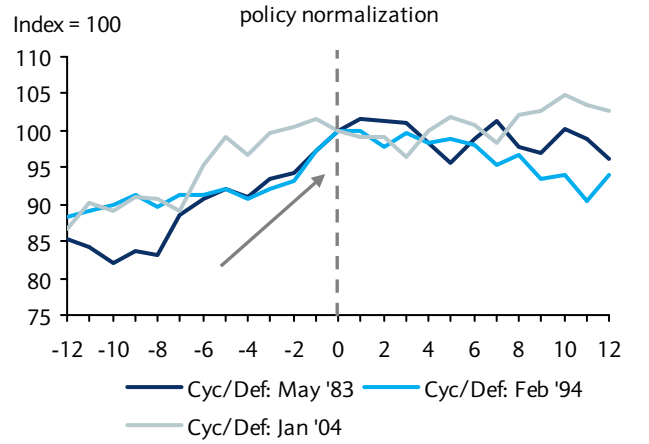
Some readers might be surprised to find that the S&P 500 forward earnings yield (the inverse of the PE multiple) is 70bp higher (7.7% vs 7.0%) than it was just before the 16% correction from late April to early July 2010. In addition, 10-year real Treasury rates are not only much lower than they were a year ago (0.8% vs 1.6%), but are also below their end-

Figure 2: After the last three recessions, equities gained momentum…



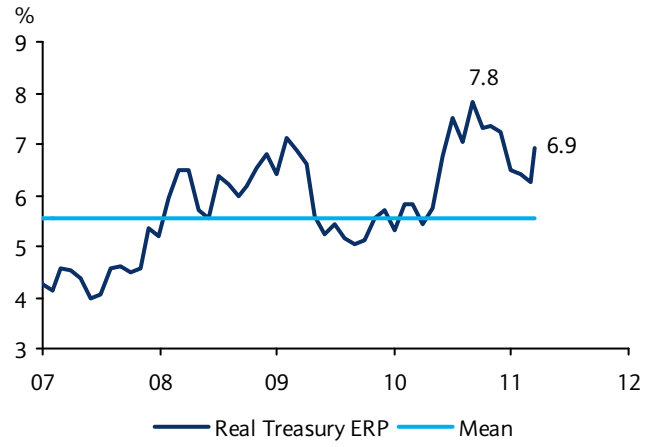
Source: Barclays Capital

Figure 3: … during the 1-2 quarters prior to Fed policy normalization, led by cyclical sectors



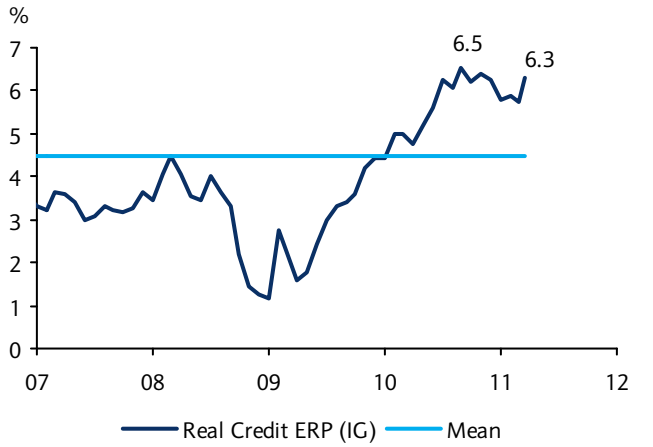
Source: Barclays Capital

Figure 4: A rise in the ERP to the August 2010 cycle peak …



Source: Barclays Capital

Figure 5: … would imply an S&P 500 index level of 1,200-1,220



Source: Barclays Capital

Until the Fed exit process begins, real and nominal rates will likely remain low

August 2010 level (the cycle peak in the equity risk premium (ERP)). The explanation for low real rates is Large Scale Asset Purchases II (LSAP II), which may be keeping real Treasury rates artificially low. Although nominal rates might also be lower absent LSAP II, the inflation component (inflation breakevens) has risen significantly from August 2010 levels as deflation risks have fallen; in other words, LSAP II has primarily lowered real rates. Until the Fed exit process begins, real and nominal rates will likely remain low.

If we assign a 20% probability to a non-transitory business confidence deterioration and an 80% probability to the recovery remaining on track, the expected value of the S&P 500 is 1,400

With those factors in mind, our modeled ERP is 6.9%, nearly 150bp above the pre-2010 correction level and 90bp below the late-August 2010 cycle high (Figure 4). If the ERP widened back to that peak, given the conditions in late August 2010 (falling growth forecasts, policy-related concerns, sliding business and investor confidence), this would suggest a fairly significant deterioration in the growth outlook. Assuming no sudden drop in the forward earnings estimate and a drop in real rates similar to last summer (a response to higher economic uncertainty), an increase in the ERP to the August 2010 level would leave the S&P 500 at 1,200 (12.1x forward PE). Our ERP model relative to investment grade credit suggests even less downside (Figure 5). In the weakened growth outlook scenario, if the ERP widened to 6.5% (August 2010 peak), the earnings yield would climb to 8.1% (12.3x forward PE). This implies S&P 500 downside potential of 1,220.

With the S&P 500 currently at 1,290, equities look very attractive at these levels

Assigning a 20% probability to a non-transitory business confidence deterioration (that pushes the ERP back to the late August high) and an 80% probability to the recovery remaining on track (our 1,450 base case scenario), the expected value of the S&P 500 is 1,400. With the S&P 500 currently trading at 1,290, we find equities very attractive at these levels.

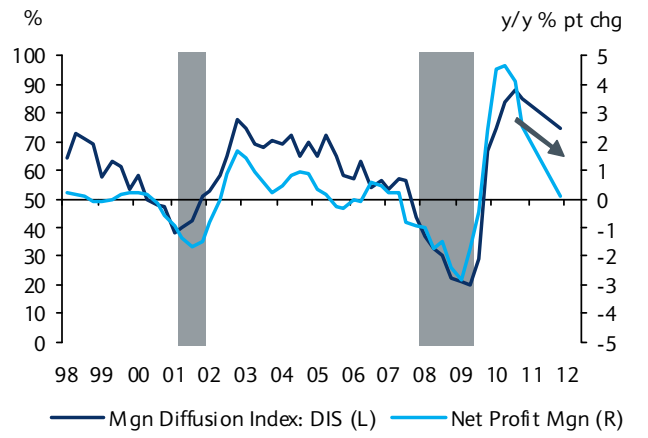
Earnings Outlook – Margins are decelerating, not declining

Large margin expansion in the financial sector is largely a function of lower loan-loss provisions

Investors seem to have three primary concerns with regard to profit margins: the sharp increase in commodity costs, expectations of rising unit labor costs, and the magnitude of the recovery in margins since the end of the Great Recession. We have attempted to address these questions from both a macro and micro perspective and find that both approaches lead to a similar result: S&P 500 margin expansion is likely to decelerate significantly in 2011, but an outright decline seems unlikely. Nevertheless, we believe investor concerns are warranted in some sectors, including consumer discretionary, staples and technology. Still, the primary driver of analysts' bottom-up consensus forecast for 70bp of margin expansion for the S&P 500 in 2011 is the financial sector, which, in our view, is almost entirely related to the improving credit cycle. To check the financial forecast, we calculated an implied forward ROE

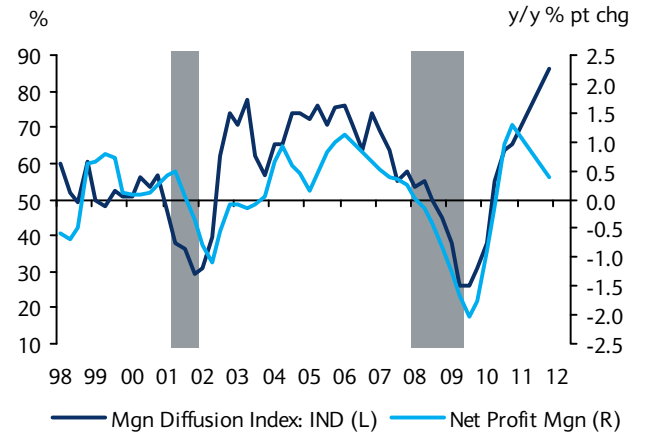
We bumped our margin forecast to 40bp because of increased confidence in the financial sector

Figure 6: The discretionary sector margin dispersion index is falling and margins are well above last cycle's highs



Source: Standard & Poor's, Reuters, FactSet, Barclays Capital

Figure 7: The industrial sector margin dispersion index is still rising and margins are below the prior peak

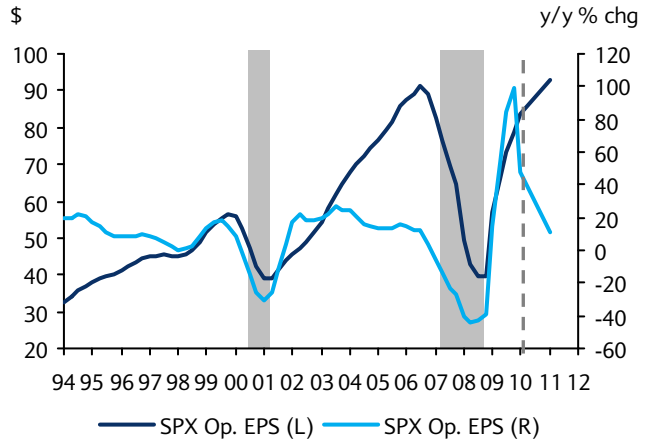


Source: Standard & Poor's, Reuters, FactSet, Barclays Capital

for the sector and found expectations at 9%, a level we view as reasonable. However, hefty margin expansion in the financial sector appears to be largely a function of lower loan-loss provisions. And although there is ample evidence that the credit cycle is improving, there is some degree of regulatory uncertainty with respect to provisioning. Excluding the financial sector, analysts' consensus forecast is only for 30bp of margin expansion.

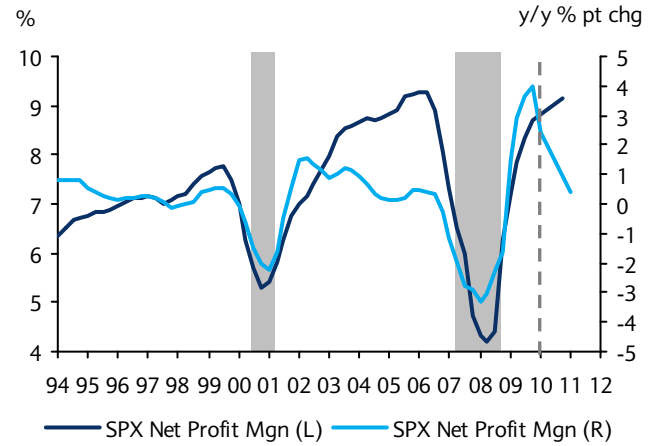
Our margin dispersion index (the number of companies with expanding margins divided by the total number of companies in the sector) supports our view that margin expansion is likely to decelerate in 2011. The sector dispersion indices generally yielded results consistent with where we thought risks were likely to develop. The technology and consumer discretionary sectors' dispersion indices are falling, perhaps because margins are well above prior cycle highs. In addition, consumer discretionary is particularly susceptible to rising materials and labor costs and the top line will likely be constrained by high consumer debt levels, which are likely to linger through the business cycle. Those high debt levels also may leave the consumer vulnerable to an energy price shock should the unrest in the Middle East deteriorate further. With little top-line growth, consumer staples' margins may also be vulnerable. On the positive side, the industrial sector margin dispersion index is still rising and margins are below the prior peak, suggesting this sector has further margin upside potential.

Figure 8: Our S&P 500 2011 operating earnings forecast is $93 (11% growth)



Source: Standard & Poor's, Reuters, FactSet, Barclays Capital

Figure 9: Our forecast is for 40bp of profit margin expansion in 2011; an outright decline seems unlikely



Source: Standard & Poor's, Reuters, FactSet, Barclays Capital

After working through the margins sector by sector and from the top down, considering the typical business cycle patterns, we bumped our forecast from a 30bp expansion to 40bp because of increased confidence in the financial sector. We think the risk to our forecast is probably on the high side.

With margins likely to expand by 40bp, our 2011 S&P 500 operating earnings forecast is $93

With margins likely to expand by 40bp, our 2011 S&P 500 operating earnings forecast is $93 (Figures 8 and 9). The sensitivity of our forecast to changes in margins is roughly 10 times that of revenues. As a result, if financial sector provisions fall as expected and ROEs increase faster than anticipated, then our forecast could prove light. However, if regulators keep the pressure on financials to maintain higher provisions and capital or proposed FASB 'expected loss' rules are implemented, then our numbers could prove high. Given the sector's key role and uncertainty about the margin forecast, an outcome in which financials are in line and rising commodity and labor costs lead to a big miss on non-financial margins seems a much lower-probability scenario.

Valuation and our price target

Given the economy's progression towards the self-sustaining middle of the business cycle, as well as still-high equity risk premiums, the effectiveness of LSAP II, and our earnings forecast, our S&P 500 price target is 1,450. Although we remain squarely in the bullish camp, we believe that, based on the current track, the Fed will begin exiting unconventional monetary policy in 2H11, which we expect will cause an 8-10% equity market correction. To be clear, Fed policy-normalization-related corrections are not typically terminal; after the market gets over the initial shock, the pullback is typically reversed as improving macroeconomic fundamentals in the middle of the business cycle offset the impact of higher interest rates.

Sector views – still cyclically biased

We remain generally overweight cyclicals and underweight defensives

We continue to believe that despite the recent oil price spike, US equities remain in the sweet spot: the economy is reaching the point where positive feedback loops more than offset continued headwinds and monetary policy remains very accommodative. In this part of the business cycle, valuation and even core fundamentals (such as earnings momentum, margins and revenue growth) take a back seat to the business cycle. With this in mind, although we have strayed slightly from our underweight on all defensive sectors and neutral or overweight on all cyclical sectors, we remain generally overweight cyclicals and underweight defensives. On February 25, 2011, we upgraded Industrials to Overweight, upgraded Financials to Market Weight+, upgraded Healthcare to Market Weight and downgraded Consumer Discretionary to Market Weight- (*Updating our 2011 forecasts*, US Portfolio Strategy Weekly). These changes were not driven by the progression of the business cycle; instead, the catalysts were fundamental, with valuation a secondary consideration.

Our 2011 S&P 500 price target is 1,450

Figure 10: We recently upgraded Industrials, Financials and Healthcare and downgraded Discretionary

Sector Scorecard					
S&P 500 Sector	Business Cycle	Sentiment (Relative Revisions)	Valuation	Key Risks	Recommendation
Energy	Positive	Rising, positive	Rich	Valuation	Overweight
Industrials↑	Positive	Rising, positive	Fair	Global growth	Overweight
Technology	Positive	Rising, positive	Cheap	Margins	Market Weight+
Financials ↑	Positive /Neutral	Neutral, negative	Fair to Rich	Regulatory	Market Weight+
Materials	Positive	Rising, positive	Rich	EM Monetary Policy	Market Weight
Healthcare ↑	Negative	Falling, negative	Cheap	Regulatory	Market Weight
Discretionary ↓	Positive /Neutral	Falling, positive	Fair to Rich	Oil price shock	Market Weight-
Staples	Negative	Falling, negative	Cheap	Margins	Market Weight-
Telecom	Negative	Falling, negative	Fair to Cheap	Regulatory	Market Weight-
Utilities	Negative	Falling, negative	Fair	Energy prices	Underweight

Source: Barclays Capital. Our sector recommendations reflect our expectations of sector performance relative to the S&P 500.

European equities: Uncovering diamonds in the rough

- **The overall macro environment remains positive and earnings have continued to show upward momentum (highlighted by a strong Q4 10). Valuations remain cheap and fund flow data suggest rising institutional interest in equities, which could lead to a re-rating. Thus, we reiterate our positive stance on European equities, with a 2011 target of 3350 for the Euro STOXX 50 and 325 for the STOXX 600, remaining wary of the triple threat of a rate hike, a stronger euro and a higher oil price.**

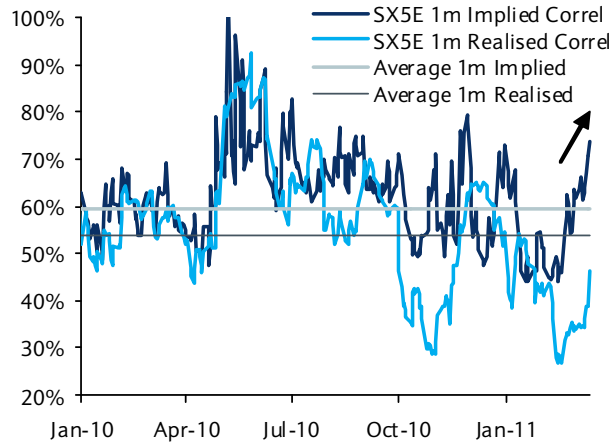
- **The indiscriminate sell-off (highlighted by a spike in realised correlations) has presented opportunities for exploiting mispricing in the European markets. Among sectors, we find Utilities particularly attractive (upgrading to Overweight), given that the risk to German nuclear power plants life extensions has already been heavily discounted by the market. However carbon, LNG and CO2 prices have received a major boost, as a corollary to this risk, which presents upside potential to earnings estimates, especially for non-nuclear exposed names. To fund our position, we downgrade Autos to Underweight as they face the quadruple threat of supply disruptions as a consequence of the Japanese earthquake, higher oil prices, tightening in emerging markets and high commodity prices (especially rubber).**

Tricky navigation between the Middle East Scylla and Japanese Charybdis

Since February, Europe's equity markets have been caught between the Scylla of the MENA political crisis and the Charybdis of the Tohuku earthquake. This Euro STOXX 50 is down by 7.6% since February 18, 2011, when the crisis in the MENA first erupted, and the VSTOXX spiked to 31 last week. The indiscriminate sell-off has seen realised correlations erupt, nearing levels seen during the peak of the sovereign funding crisis (Figure 11).

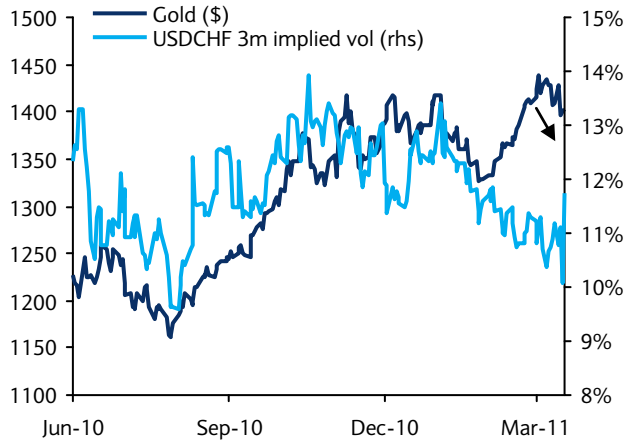
Paradoxically, the three-month 90-110% implied volatility skew has remained near its two-year average, indicating a lack of significant downside protection buying. Again, on a cross-asset basis, this has not been a clear "risk-off" period, given that traditional "safe-haven" assets, such as gold, have also sold off and volatility on "safe-haven" currencies such as USDCHF. has not spiked (Figure 12). Thus, for now, we see no definite clues pointing to a protracted equity sell-off over the next quarter.

Figure 11: Realised correlations spike on sell-off



Source: Barclays Capital

Figure 12: Gold and Swiss franc vols remain stable



Source: DataStream, Barclays Capital

We remain wary of the threat of rate hikes, a strong euro and oil prices

ECB still forecast to maintain negative real interest rates

A key concern for equity investors remains the expected hike in ECB rates in 2011. Our economists forecast the ECB to hike base rates only twice in 2011, by 25bp in April and July. However, some investors fear a derailment of European economic growth as a result of tightening of monetary policy.

For now, we remain of the view that a rate hike by the ECB should not threaten economic recovery or the stock market. A 50bp hike in the base rate would still imply a real interest rate of -1% at the end of 2011 (a base rate of 1.5% vs a forecast of 2.5% inflation for end-2011; Figure 13). Additionally, liquidity measures in terms of unlimited short-term funding for the banking sector are also set to remain in place, in accordance with the ECB's stated separation principle. However, if inflation data do start significantly surprising to the upside, rate hikes in addition to what we forecast could turn into a potential headwind for markets in the latter half of 2011.

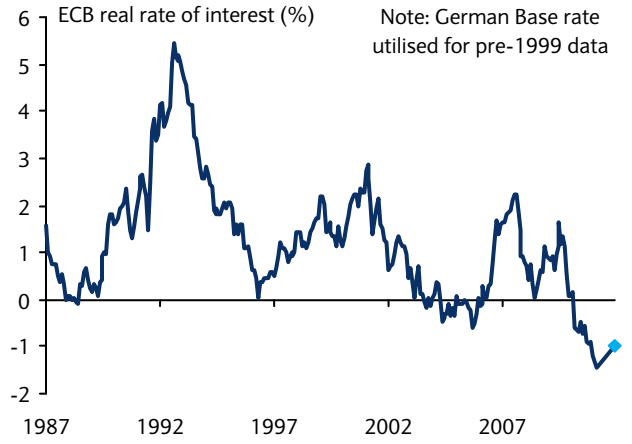
Drag of euro strength on corporate earnings looks overstated for now

As a result of the announcement of new EFSF measures on March 11, 2011 (pending approval on March 24) along with the expectations of the ECB hiking rates plus a higher oil price, expectations of EURUSD strengthening have risen. However, we note that, year-to-date, the euro has appreciated by only 2.2% relative to the dollar, and by only 2.0% on a trade-weighted basis, which in turn should lead to only a minimal impact on earnings (Figure 14). However, watch out for any significant moves in the euro. For now, our FX strategists expect EURUSD to strengthen to 1.45, ie, only 2.6%, in the next six months.

Crude Awakening: Watch out for the oil price

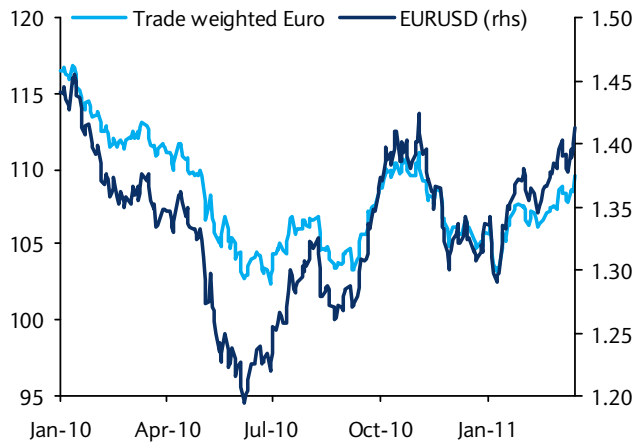
The structural risk premium in crude oil futures looks here to stay. However, the impact is greater on emerging economies than the developed world, given their higher energy expenditure as a percentage of GDP. Among sectors, Oil Services should benefit, while Autos, Retail and Travel & Leisure could be hit. Further developments in Saudi Arabia and Bahrain, and Nigerian elections in April 2011 are the key events to watch. (For more details, please see *European Equity Explorer: The monetary policy conundrum*, 9 March 2011)

Figure 13: Extraordinarily easy monetary policy still in place



Source: DataStream, Barclays Capital

Figure 14: YTD the TW-euro has appreciated by only 2%



Source: DataStream, Barclays Capital

We remain positive on European equity markets

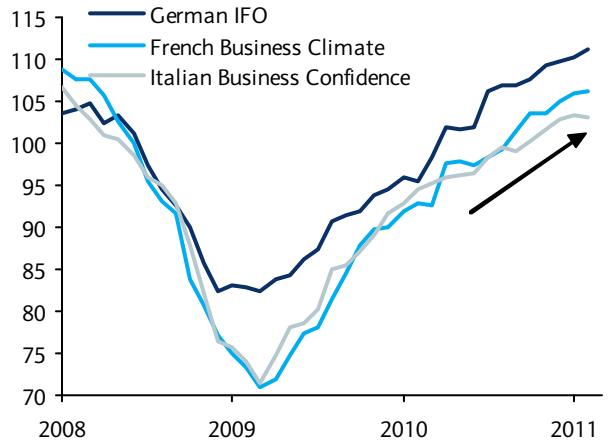
Our fundamental view on European equities remains positive for the following reasons:

- **European macro momentum still robust:** The improvement in the economic environment remains robust, with effervescent PMIs observable not just from Germany, but also from France and Italy (Figure 15).
- **Valuations remain attractive:** The European equity risk premium is currently at 4.0%, 2.8% higher than the long-term average (Figure 16). On Cyclically Adjusted PE, we are still trading at 15.5x, a 16% discount to the long-term average. This is despite a strong Q4 with an upside surprise from 64% of the companies reported (Figure 17).
- **Fund flows remain supportive:** In line with the arguments expressed in *European Strategy Essay: Renaissance* (October 20, 2010) we are seeing signs of a shift in asset allocation away from bonds in favour of equities. Figure 18 shows that the relationship between equity and bond flows has reversed quite significantly since Q4 2010. Although reinsurers including Munich Re, Swiss Re and Hannover Re may have already raised their allocation to equities (according to the *Wall Street Journal*, February 27, 2011), we await concrete evidence that European life insurers have followed suit. We believe that once QIS5 (within Solvency 2) is passed, insurers will look to increase equities weightings either directly or indirectly (using derivatives and structured products).

Conclusion: With the lack of support across asset classes, we believe it too early to extrapolate the equity downsizing move as a protracted period of equity underperformance, given the potentially limited impact on global growth from the events in Japan. For now, we view the fall in the markets as a healthy correction, given that most technical indicators were at overbought levels prior to the recent 'risk-off' trade.

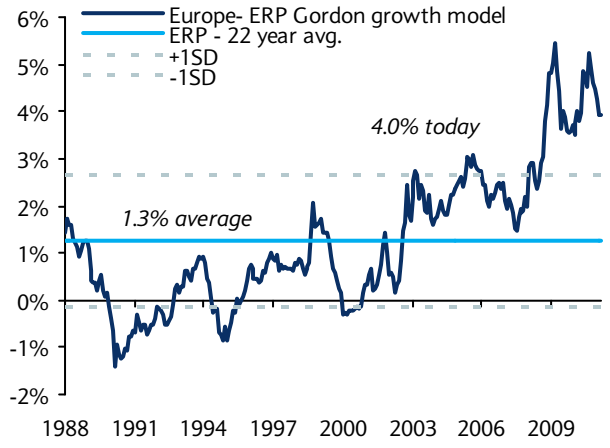
Hence, our fundamental view on the markets remains unchanged. We are positive on European equity markets given the strong macro environment, inexpensive valuations and a structural reallocation of flows to equities. We reiterate our year-end target of 3350 for the Euro STOXX 50 and 325 for the STOXX 600, despite risks to European growth from austerity, rate hikes, oil prices and a stronger euro.

Figure 15: Not just Germany leading the macro rebound



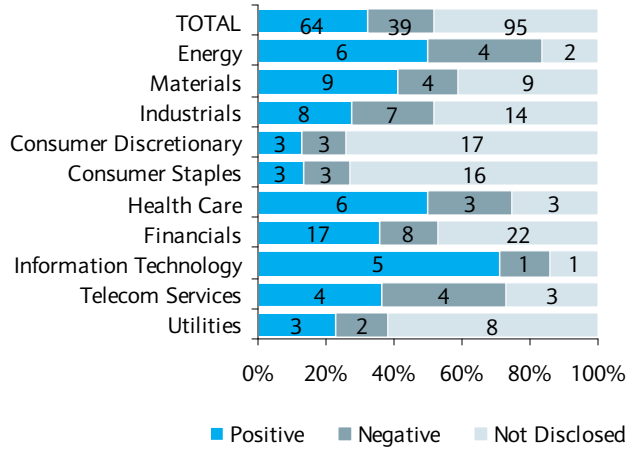
Source: Datastream, Barclays Capital

Figure 16: ERP well above 22-year average



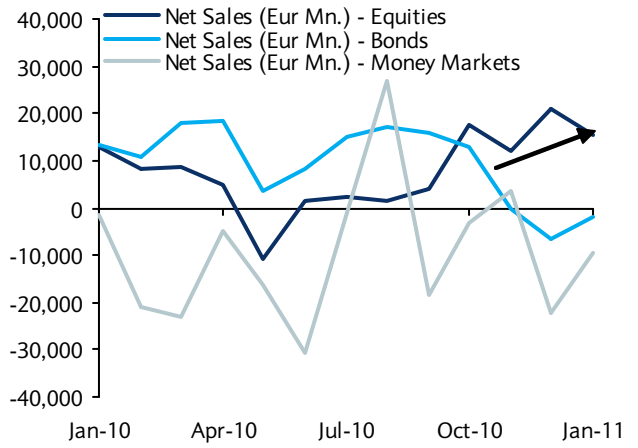
Source: Datastream, Barclays Capital

Figure 17: 64% earnings surprise in Q4 10



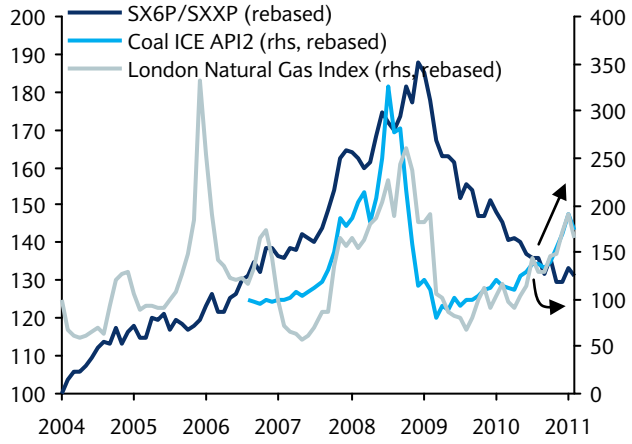
Source: Barclays Capital

Figure 18: Equity inflows remain robust



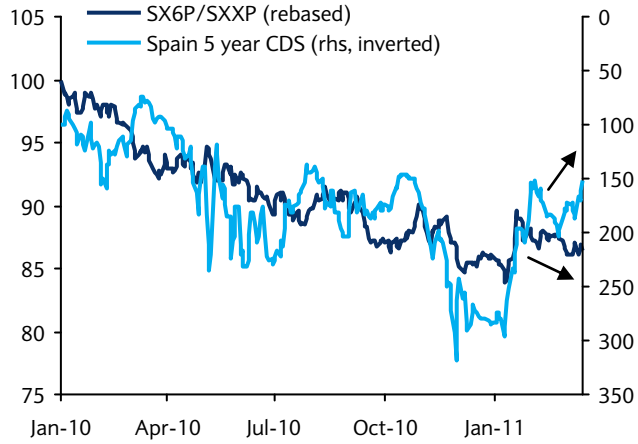
Source: Lipper

Figure 19: Higher power prices historically support Utilities



Source: Datastream, Barclays Capital

Figure 20: CDS contraction should also benefit Utilities



Source: Datastream, Barclays Capital

Uncovering diamonds in the rough

The recent sell-off has pushed realised correlations to the levels seen during the European sovereign funding crisis (Figure 11). We think the recent decline in market values for certain companies and sectors is unwarranted. In *European Strategy Elements: Fundamental calls following the Tohoku-led equity sell-off* (16 March 2011) we highlighted 23 European stocks that we think have become very attractive. Below, we explore this mispricing for the Utilities sector, funding our move to an Overweight position with an Underweight on the Auto sector.

Upgrade Utilities (SX6P) to Overweight from Market Weight

We upgrade the Utilities sector from Market Weight to Overweight for the following reasons:

- **Robust energy prices could jolt utilities into outperformance:** Our commodity strategists expect energy prices to remain strong as a result of the events in Japan following the disruption of its nuclear power plants and the possibility that nuclear life extensions in Germany could be suspended (Figure 21). High energy prices have historically been well correlated with earnings of non-regulated utility players such as EON, RWE, GDF Suez, Fortum and Verbund.

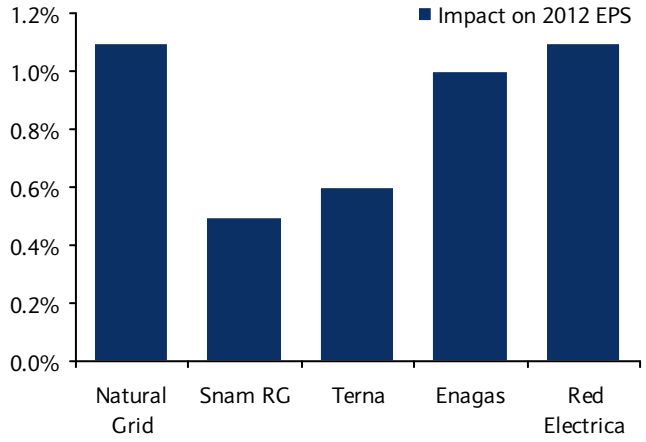
- **Reversal of nuclear power life extensions in Germany could be a positive:** We estimate that early closure of nuclear power stations could cause German power prices to rise by EUR 5-10/MWh[2]. Hence, the German utility stocks EON and RWE, which have seen very large negative share price movements since the announcement, could stand to benefit, as higher power prices may be more than enough to offset the negative EPS and valuation impact (Figure 21). Utilities in neighbouring power markets should benefit too.

- **CDS spread tightening an added benefit:** Following successful Spanish bond auctions in February and March and the constructive proposals set out at the EU Finance Ministers meeting on 11 March, sovereign CDS spreads have started tightening again. Given the sector's high leverage (2.8x net debt/EBITDA for 2011), it has not been surprising that relative sector performance has been so well correlated with CDS spreads. As a corollary, spread-tightening and, hence, an easing of financing costs, could spur outperformance by the index, with the key catalyst being the meeting on March 24 (Figure 20).

- **Regulated utilities to be helped on by inflation:** Inflation, via tariff adjustments is a key driver of growth for regulated utilities (European *Regulated Utilities: The inflation-bond yield dichotomy*, January 19, 2011). With a recovery in industrial production numbers pointing to a rise in heavy vehicle traffic growth (for toll-road operators) and improved CPI-linked pricing, earnings numbers for regulated utilities could surprise to the upside.

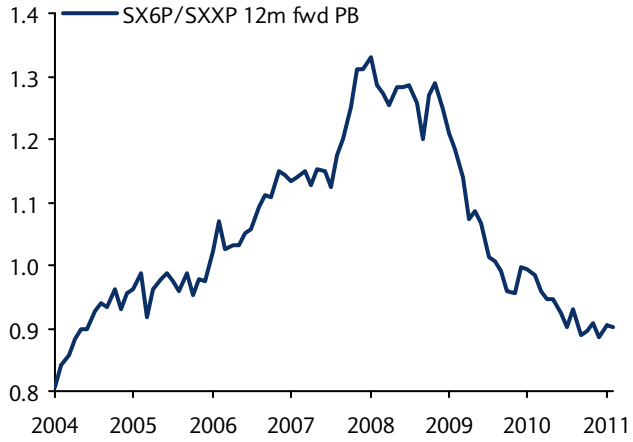
- **Relative valuations back to 2004 lows:** On valuations, the sector looks very attractive – now back to 2004 lows on 12m fwd price-to-book relative to the STOXX 600 (Figure 22). Our sector analysts expect Integrated Utilities & Generators to offer 9.2% CAGR EPS over the next five years, and the sector is trading at a 2011 PE (ex-CO2) of 12.4x.

Figure 21: 2012 EPS sensitivities for a 1% rise in inflation



Source: Barclays Capital

Figure 22: Relative price-to-book back to 2004 lows



Source: Barclays Capital, Datastream

[2] German Utilities: *Nuclear phase out = +EUR10/MWh power price?* (14 March 2011).

Downgrade Autos (SXAP) to Underweight from Market Weight

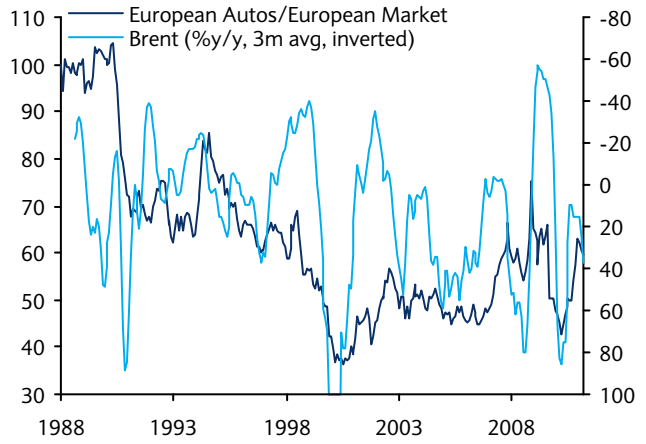
We downgrade the Autos sector (SXAP) to Underweight for the following reasons:

- **EM tightening should act as a drag on demand:** Higher interest rates in emerging markets should have a negative demand substitution effect for autos (as consumer spending comes under pressure from higher interest-rate-sensitive costs, such as mortgages and rents). For example, the Chinese central bank has sharply reduced M2, with new loan growth in China slowing to levels last seen in 2008 (Figure 23).
- **Higher oil and commodity prices:** An increase in oil prices has historically had a negative correlation with the performance of the Autos sector (we utilise data since 1988, Figure 24), again given the demand substitution effect. On the costs side, rubber prices are well above all-time highs and steel prices have also increased substantially, both of which should hinder margin expansion (Figure 25).
- **Concerns regarding supply chain disruptions from Japan:** Disruptions in the supply chain driven by recent events in Japan could put pressure on manufacturers to meet supply requirements. For example, Peugeot announced on 21 March 2011 that a part of its diesel production would be affected beginning on 23 March. Our auto analysts highlighted these concerns in "*Premium demand continues to impress, but all eyes now on Japan*, 17 March 2011", with companies still assessing the uncertainties. Recall that Japan controls 20% of global capacity in the semiconductor market (a key component in automobiles).
- **Not cheap on relative P/B vs the market:** Current levels of relative P/B are, if anything, near the high end relative to history (Figure 26).
- **Conclusion – No clear catalyst for the sector to outperform the market:** Given the uptick in commodity costs, coupled with pressures on demand from higher interest rates and oil prices, the profit margin expansion story that led to marked outperformance by Autos last year has clearly run out. For 2011, our Autos analysts expect margins to remain flat. Moreover, relative to the market, valuations do not look compelling. With no clear catalysts in the horizon, we prefer to utilise an Underweight position on the sector to fund our move to Overweight the Utilities sector.

Figure 23: Credit tightening to act as a drag on demand

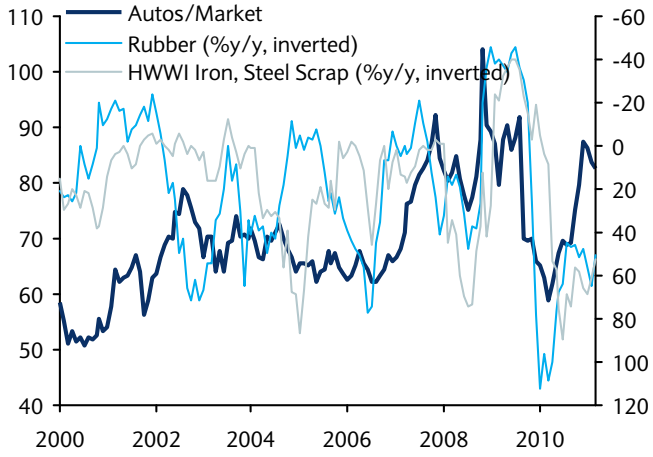
Source: Barclays Capital

Figure 24: Relative performance sensitive to oil price spikes



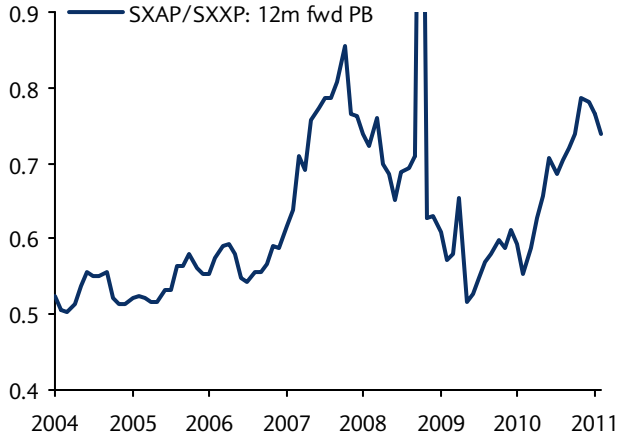
Source: Datastream, Barclays Capital

Figure 25: High commodity costs to pressurize margins



Source: Datastream, Barclays Capital

Figure 26: Certainly not cheap on relative valuations



Source: Datastream, Barclays Capital

Conclusion: The overall macro environment remains positive and earnings have continued to display upward momentum (highlighted by a strong Q4 2010). Valuations remain cheap and evidence suggests rising institutional interest in equities, which could lead to a re-rating. Hence we reiterate our positive stance on European equities, with a 2011 target of 3350 for the Euro STOXX 50 and 325 for the STOXX 600. However, there are also material risks; we remain wary of the triple threat of a rate hike, a stronger euro and a higher oil price.

In our view, the indiscriminate sell-off (highlighted by a spike in realised correlations) presents opportunities to exploit mispricing in the European markets. Among sectors, we find Utilities particularly attractive (upgrading to Overweight), given that the risk to the life extensions of German nuclear power plants has already been heavily discounted by the market. However carbon, LNG and CO_2 prices have surged as a corollary to this risk, which clearly presents potential upside to earnings estimates, especially for non-nuclear exposed names.

By contrast, we downgrade Autos to Underweight, as they face the quadruple threat of supply disruptions as a consequence of the Japanese earthquake, higher oil prices, credit tightening in China and high commodity prices.

Japanese equities: Earthquake likely to result in a flight to quality

- **The earthquake could have a major impact on the supply of certain industrial products, such as auto and electric components/parts, and high-function materials.**
- **Uncertainty about future earnings caused by the disaster, the risk of power shortages and the high oil price look likely to result in a flight to quality.**
- **We expect companies to post very conservative earnings guidance for FY2011. We expect the Nikkei Average to fluctuate, largely centering on 9,800 until this summer.**

Earthquake impact on economic and corporate activity

The quake could have a major impact on the supply of certain industrial products

The Tohoku Pacific Coast Earthquake on March 11 caused massive destruction. Many manufacturing plants and commercial facilities have had to suspend operation. Yet, there is a possibility that overall damage to corporate activity will be minor, given that the industrial zones in greater Tokyo have not been damaged severely. However, the electric power shortages resulting from the accidents in nuclear and thermal power plants threaten to depress economic and corporate activity on a medium- to long-term perspective. On top of electric power shortages, the high oil price is another risk factor for corporate earnings.

The area from Tohoku to northern Kanto is home to numerous manufacturing plants for a variety of industrial products extending from upstream items – mainly basic materials, such as chemicals and steel – to auto parts, electric components and automobiles. Many manufacturing facilities of products with high global market share, such as auto and electric components/parts and high-function materials are located in the disaster area. The earthquake could have a major impact on the supply of such industrial products.

Power shortages and high oil price will affect economy and corporate earnings

Concern over medium- to long- term electric power shortages is likely to hurt consumer sentiment

In Japan, electricity generated by nuclear power plants accounts for about 25% of total electric power supply. The Fukushima nuclear power plant No.1, which was seriously damaged by the earthquake and tsunami, covers 7% of Tokyo Electric Power Company's power generation. However, several thermal power plants were also damaged and forced to stop operation. By end-April, TEPCO expects to increase the power supply capacity towards 70% of the level prevailing before the earthquake.

Concerns about medium- to long-term electric power shortages are likely to hurt consumer sentiment in greater Tokyo. The possible power shortage problem could reduce corporate productivity and depress earnings, especially in the summer, when power consumption rises.

Japanese exporters remain vulnerable to increases in commodity prices

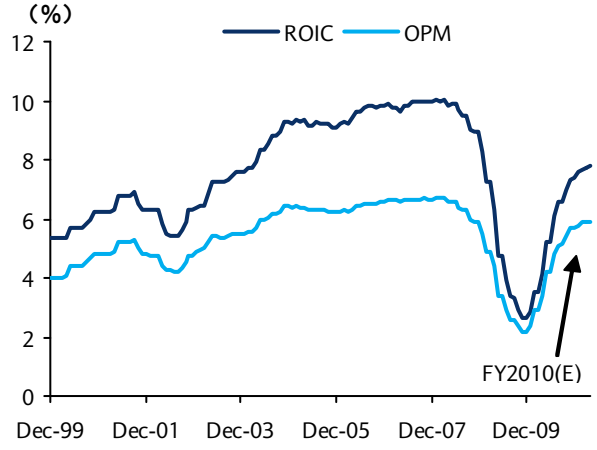
Another concern with regard to corporate earnings is the high oil price. Continued political instability in the Middle East and North Africa could keep oil and other commodity prices high. Japanese corporate earnings have improved recently, led by exporters. However, although Japan's exporters have bolstered their resilience to yen appreciation, they remain vulnerable to commodity price rises.

Earnings uncertainty and conservative guidance could pressure stock prices

Uncertainty about future earnings looks likely to result in a flight to quality

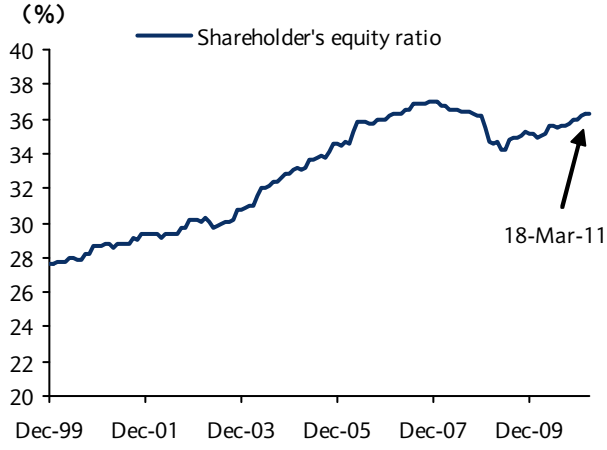
The earthquake has clouded the outlook for corporate earnings. Market activity since March 11 has shown a strong preference for high-quality stocks, with selling concentrated on highly leveraged stocks and those with low profit margins. Earnings-based stock selection parameters (eg, price to earnings ratio and earnings revision) have become less useful. The best-performing sectors since the earthquake have been construction and mining. This reflects market expectation of demand for reconstruction and fossil fuel supply development. The uncertainty about future earnings caused by the disaster, power shortage risk, and high oil price looks likely to result in a prolonged flight to quality.

Figure 27: Trends in ROIC and OPM (TOPIX500 stocks excluding financials)



Note: 1) ROIC is defined as forecast OP/(Net assets + interest bearing debt).
2) Earnings forecasts are based on I/B/E/S analyst consensus data.
Source: I/B/E/S, Factset, Barclays Capital

Figure 28: Trends in shareholder's equity ratio (TOPIX500 stocks excluding financials)



Source: Factset, Barclays Capital

We expect companies to publish very conservative earnings guidance for FY2011

We expect companies to post very conservative earnings guidance for FY2011, which may pressure stock prices. Yet earnings have recovered recently, chiefly on improved overseas demand, and we expect continuing demand expansion from emerging countries in Asia and economic recovery in the US. In addition, improving cash flow has enabled companies to maintain sound balance sheets and Japan's savings level is still high. For these reasons, we see little possibility of the Nikkei Average trading substantially below 9,500 for a long time, even though there are concerns about renewed risk aversion among investors.

We think stock price volatility will remain high for the next several months, reflecting unstable market sentiment. We expect the Nikkei Average to fluctuate, largely centering on 9,800 until this summer.

EMERGING MARKETS OUTLOOK

Shaken, stirred, still engaged

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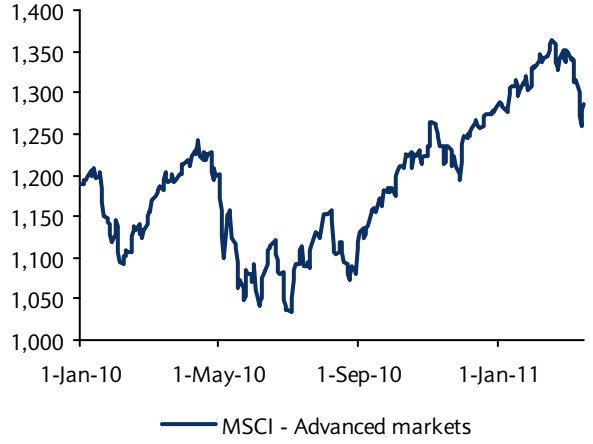
- **Much like three months ago, we find ourselves faced with a generally supportive financial backdrop, with significant tail risks to the benign base case. Like then, we think investors should be realistic, be wary, be selective, and remain engaged with emerging asset markets. Put differently, we think EM risk justifies a market weight, rather than the strong overweight we advocated through most of 2009 and 2010.**
- **In external debt, we continue to expect high-yielders to outperform, and in this space, we have shifted to Venezuela from Argentina. Our strategists have identified a number of ways to maintain exposure to the asset class while cost-effectively limiting the downside risks associated with global economic and financial tail risks.**
- **We expect local rates and EM FX to be driven primarily by policy responses to intensifying inflationary pressures; a sustained spike in oil prices is the most important risk. Our favorite currencies remain in Asia where, not coincidentally, we think it still pays to be paid.**

What we thought

Coming into the quarter, we saw a benign investment environment, with significant risks to our market-supportive base case

As we looked ahead to 2011 last December, we adopted an optimistic perspective on emerging markets. It seemed likely to us that the pace of economic recovery would continue to allay lingering concerns about the advanced economies' capacity to attain "escape velocity," and monetary policy in the advanced economies was slated to remain in asset-friendly, depression-fighting mode for a long time to come. Emerging market valuations had normalized, reflecting consensus views, which were no longer much more pessimistic than our own; therefore, we thought investors needed to be realistic about the returns by various EM asset classes. But in our view, it was better to earn a modest risk premium by remaining long a fully valued asset class in a generally positive investment environment than to pay it away by shorting the risk.

Figure 1: Global asset markets set back…



Source: Bloomberg

Figure 2: … by a spike in anxiety about MENA and Japan

Source: Bloomberg

The key risk, as we saw it, was the potential increase in long positions

Our main concern was that this was a consensus view, in both the base case and most of the risk cases surrounding it, and that the prevalence of this positive outlook could lead to positioning excesses that would eventually set the market up for volatile overreaction when the inevitable tail risk materialized.

The more things change, the more they stay the same

Time passes, things happen, and we enter the second quarter of the year with a somewhat altered base case and a rather different list of risks than we thought we faced in December. But while these changes in the market context are consequential, we find ourselves facing much the same question that we faced then: whether to focus on the generally supportive base case, or the headline-grabbing risks that surround it? We find ourselves gravitating toward much the same conclusion: be realistic, be wary, and be selective, but remain engaged in emerging asset markets.

What's new

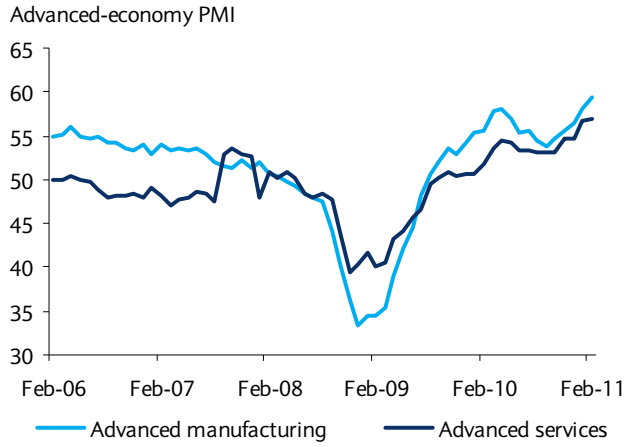
Global economic drivers likely to overshadow geopolitical events over the course of Q2

Our readers will need no reminder that global markets have been rocked by events in the Middle East and North Africa (MENA) and in Japan that will no doubt occupy the press, politicians, and eventually historians for some time to come. Momentous though these events are, we do not think they will be the dominant drivers of global or emerging markets in 2011, although they join a long list of tail risks that surround the most probable scenario. In our view, the more powerful driver of markets in Q2 and beyond is likely to be broad economic developments – growth, employment, inflation and monetary policy.

A firmer global recovery, largely embedded in market consensus

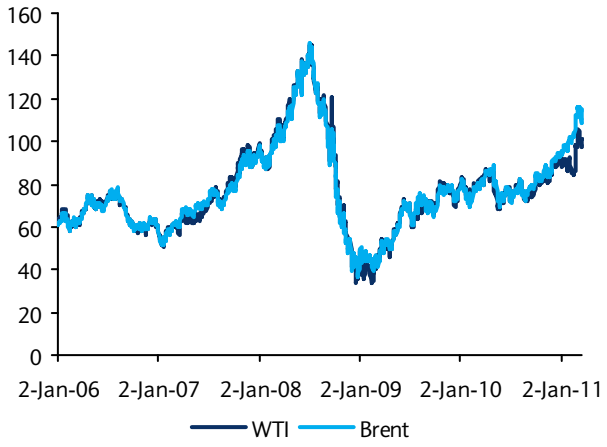
In recent months evidence has mounted that the recovery in the advanced economies is broadening (Figure 3), and doubts that this can be sustained by the virtuous circle of growth, income, and private demand have receded. Our views are little changed: we have modestly raised our forecast for 2011 growth in the advanced economies, and our forecasts are no longer meaningfully more optimistic than the consensus (except in EMEA, and even there the disagreement is not enormous). Implicit in these forecasts is a judgment (made explicit in *Global Economic Weekly: Global recovery should withstand the shocks so far*, 18 March 2011) that the anxiety, higher oil prices, and potential industrial dislocations that have been associated with political upheaval in MENA and the Japanese earthquake will not derail the global economic recovery.

Figure 3: Recovery in advanced economies is broadening



Source: National sources, Barclays Capital

Figure 4: Oil (and other commodity prices) have surged



Source: Bloomberg

Figure 5: Barclays Capital growth forecasts in line with consensus

	Barclays Capital			BarCap vs Consensus		Q1 11 vs Q4 10 BarCap Forecasts	
	2010	2011	2012	2011	2012	2011	2012
Global	4.9	4.3	4.4	0.1	0.1	0.2	0.0
G10	2.5	2.4	2.7	0.1	0.2	0.2	0.1
EM	7.8	6.5	6.5	0.0	0.1	0.0	-0.1
China	10.4	9.3	9.0	-0.1	0.0	0.0	-0.2
EM Asia ex-China	8.0	6.4	6.4	-0.1	-0.1	0.1	-0.5
EMEA	3.9	3.5	3.9	0.3	0.3	-0.2	0.1
Latin America	6.2	4.4	4.3	0.0	0.0	0.2	0.3

Source: Consensus Economics, Barclays Capital

The reduced sense of anxiety about the world economic recovery faltering is, of course, market supportive, but it also removes the likelihood of upside surprises about growth as a catalyst for future market performance.

More significant changes in the outlook for inflation

Changes in the outlook for inflation have been more significant. For 2011, our forecasts of inflation have increased significantly, particularly in the advanced economies (up 80bp) and Emerging Asia ex-China (up 90bp). In Emerging Asia, we have raised our 2011 inflation forecasts almost everywhere (the exceptions are China and Sri Lanka), with the largest revisions in India (up 150bp), the Philippines (up 140bp), Hong Kong (up 120bp), Singapore (up 120bp), and Korea (up 70bp). Our forecasts have also increased significantly in Russia (160bp) and Chile (120bp), with smaller increases in most other emerging markets.

Figure 6: Barclays Capital inflation forecasts – Sharp rise since December

	Barclays Capital			BarCap vs Consensus		Q1 11 vs Q4 10 BarCap Forecasts	
	2010	2011	2012	2011	2012	2011	2012
Global (ex-Argentina)	2.4	3.3	2.7	0.2	-0.1	0.6	0.2
G10	1.3	2.4	1.7	0.4	0.0	0.8	0.2
EM (ex-Argentina)	4.6	5.0	4.6	-0.2	-0.1	0.3	0.2
China	3.3	4.3	4.0	-0.3	0.3	0.0	0.0
EM Asia ex-China	5.2	5.3	4.3	0.9	0.1	0.9	0.1
EMEA	3.9	3.9	4.1	0.0	-0.5	0.0	0.3
Latin America (ex-Argentina)	6.7	7.4	6.8	0.1	0.2	0.3	0.3

Source: Consensus Economics, Barclays Capital

We see an earlier normalization of monetary policy, though not in the US

This higher inflation is largely, though not entirely, attributable to higher-than-expected food and energy prices. In the influential case of the US, the substantial rise in headline inflation (140bp, to 2.9%) is due mainly to non-core items, which we think the Fed will discount in its monetary policy deliberations. We still expect it to keep its interest rate near zero until August 2012. Elsewhere, however, we have generally brought forward and increased the magnitude of our forecasts of hiking cycles, including the ECB (with a first hike expected in April) and the BoE (which we expect to begin hiking in May).

In our view, it is only a matter of time before monetary policy is normalized in the advanced economies, and then we will face a different investment context. But the normalization is

likely to be very gradual, and for now it is hard to get overly concerned about the change in monetary conditions when a meaningful tightening of ultra-loose US monetary conditions remains as far into the distant future as we now expect.

The economic context still seems broadly supportive, even though consensus is no longer overly skeptical

On balance, then, the macroeconomic bedrock of our call on financial markets still seems solid. The world economy will be adversely affected to some degree by recent developments in MENA and Japan, but it confronts those shocks with substantial momentum. Global monetary conditions will eventually be normalized, and we expect this to begin in Europe in Q2. But in our view, it has been reasonably well telegraphed, discounted by markets and, in the US, is too far in the future to disrupt markets in the next few months. We discuss some risks to this view below.

Investment context supported by reasonable valuations, positioning

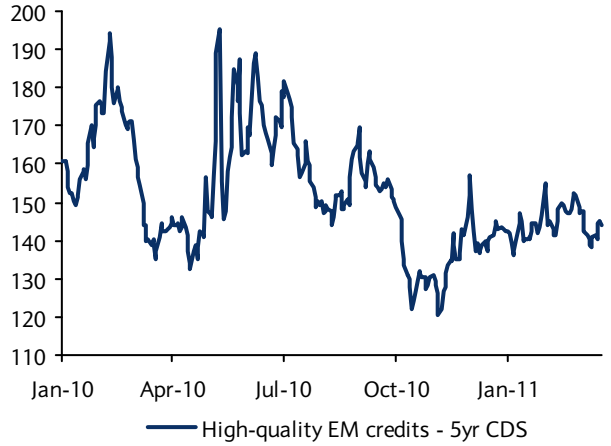
Emerging markets weathered the quarter-end anxiety trade well

Before we turn to the risks to our base case, we have a thought or two on how emerging markets fared during the most recent round of disruptions. Global anxieties did spill over to emerging markets in some of the expected ways, for example, in pressure on the "high-beta" sovereign credits, Argentina and Venezuela. But on balance, we find their response to the quarter-end anxiety trade reassuring. Away from these high-beta credits, external debt traded remarkably well – on average, higher-quality external sovereign debt barely budged throughout the March downdraft (Figure 7). EM equities significantly underperformed advanced economies during the tranquil months of January and February, but the underperformance ceased during the weaker and more volatile global markets that followed.

This suggests that market positioning is not problematic in the asset class as a whole

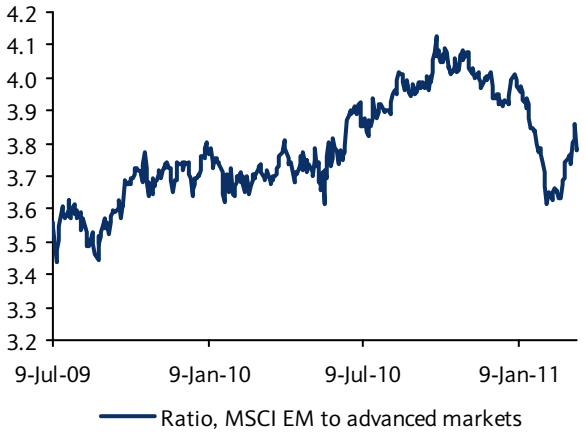
We are not suggesting that emerging markets have become the new safe haven from global market turbulence. However, the limited contagion from global to emerging markets does suggest that, for now at least, emerging markets as a whole are in a relatively comfortable spot in terms of market technicals and positioning. For what it is worth, the view that investors' positioning is not problematic finds support from our recently released quarterly survey of investors: 85% said their positioning is "average" to "very light" relative to their risk limits or capacity (Figure 9). This answer came from our entire investor base, not just EM investors, but we suspect that EM investors would answer similarly.

Figure 7: External debt: Muted response to global risk aversion



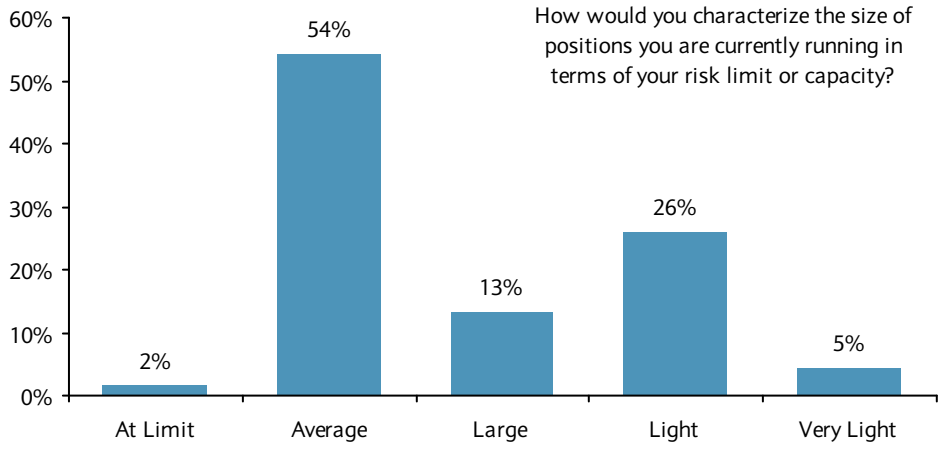
Note: 'High-quality' credits are sovereigns other than Argentina, Venezuela and Ukraine. Here they are weighted as in the Barclays Capital EM sovereign index.
Source: Bloomberg, Barclays Capital

Figure 8: EM equity markets underperformed before, but not during the recent downdraft in global markets



Source: MSCI, Barclays Capital

Figure 9: According to our survey, investors consider their positions average to light, relative to risk limit or capacity



Source: Barclays Capital

This is not to say that positioning is irrelevant, or not problematic in some specific market segments. If anything, the first quarter highlighted the salience of positioning where it was pronounced. The underperformance of Argentine bonds likely owed more to the popularity of the trade among leveraged investors entering the year than to specific news from or about the country. Conversely, the outsized rebound in Hungarian assets in Q1 likely reflected investors' skepticism about the situation coming into the quarter, and resultant very light positioning, which amplified the market response to positive signals from the country's policymakers. The broad underperformance of EM equities in the first two months of the year may also have been compounded by investor positioning, although the calm market response to the downdraft in March suggests that the situation had been cleaned up by then. Positioning clearly matters, especially when the global backdrop is providing relatively weak directional forces. But for now, we think it should be viewed as one of several idiosyncratic factors that drive specific trades, although a neutral to mildly supportive driver in the broad market context.

Valuations are largely unchanged from year-end and not particularly stretched from a historical perspective

Valuation is, of course, in the eyes of the beholder. Here, we simply reiterate our view that emerging assets generally are reasonably valued in historical terms, relative to their advanced-economy counterparts and in terms of the risk premium on offer in the different asset classes. (From a longer-term perspective, we would except EM equities from this statement; in our view, they are very cheap in light of longer-term growth differentials; see *Equity Gilt Study 2011*, "Chapter 2 – Navigating the new EM landscape: Where to find the best returns," 10 February 2011.) We would add that valuations are remarkably little changed since year end, with equities (Figure 11) and high-beta sovereign credit somewhat cheaper in absolute and relative terms, but currency and high-quality sovereign credit (Figure 10) largely unchanged.

In short, the investment context looks remarkably like the one that we confronted at the beginning of the year. Valuations and broad market technicals are neutral to mildly positive, in our view. EM assets are not cheap enough to hold out the prospect of anything like the above-normal returns that investors earned during the post-crisis recovery, nor are they expensive enough to create a presumption that a big market correction is looming. The macroeconomic backdrop is benign. We think the global recovery will withstand the shocks it has received so far, and while the window to take advantage of ultra-loose global liquidity may be closing, it is doing so slowly and is unlikely to snap shut in Q2. It is true that the

positive economic context is largely embedded in market consensus and prices, but an unsurprisingly benign economic context is one in which asset markets should be expected to return normal risk premia, not reward the skeptics.

Respecting tail risks

Tail risks remain substantial

That said, emerging market investors face substantial tail risks that need to be factored into investment decisions, alongside the base case. There is nothing new here, though the list of risks has changed, and their intensity has arguably risen since the beginning of the year. This is not the place for an extended discussion of the many risks that preoccupy investors; instead, we offer some brief thoughts on emerging markets' exposure to the risks and Barclays Capital's views on the nature and gravity of the risks.

Win some…

The good news is that a few anxieties seem to have lost force during the quarter:

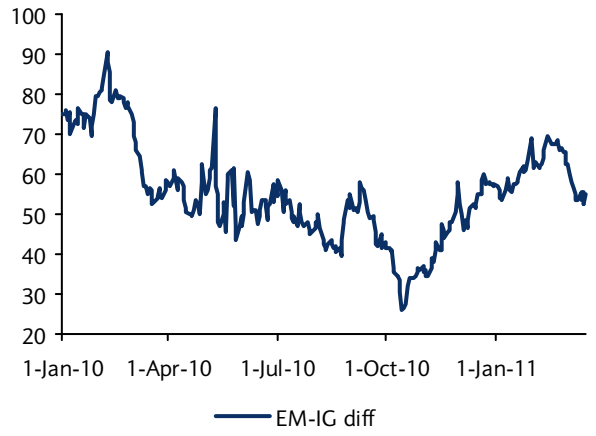
- As we have noted, doubts about the sustainability of the G10 economic recovery seem, for the time being at least, to have faded, and we doubt that they will return as a market driver in Q2.
- The peripheral European sovereign debt crisis seems to have lost its salience as a driver of emerging market assets, perhaps because growing confidence in Spain's ability to avoid seeking aid has reduced the perceived risks that the debt crisis in the smaller European sovereigns will morph from country-specific to continental in scope. At the moment, our main concern is technical in nature. Some investors have expressed a skeptical view of peripheral European sovereigns by buying credit protection on (for example) Greece, funding and hedging the position by selling protection on a high-yielding EM sovereigns, for example Venezuela. When the Greek leg of the trade is unwound, the EM leg will likely be unwound as well, putting pressure on those countries' CDS and sovereign curves. But this is an idiosyncratic risk that looms very small compared with the more broad-based contagion that was felt in much of 2010.

… lose some

The bad news is that these tail risks have been replaced by others that are at least comparable in their disruptive potential.

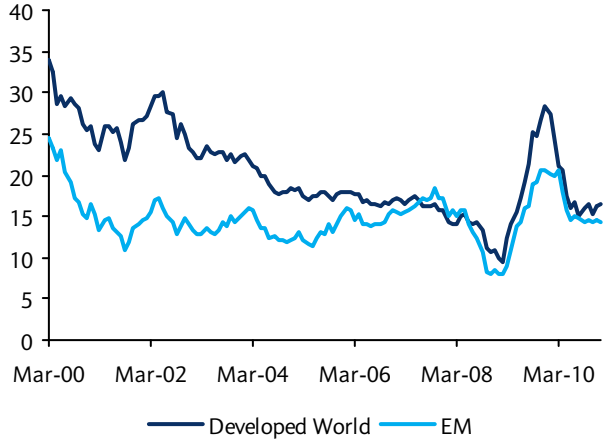
- The political upheavals in MENA are historic and, like so many political events, intrinsically unpredictable. But the geopolitical stakes are high, and the potential for an

Figure 10: Higher-quality EM sovereigns not particularly tight to investment grade credit (bp)



Source: Bloomberg, Barclays Capital

Figure 11: EM P/E ratios have fallen while advanced-economy markets have re-rated



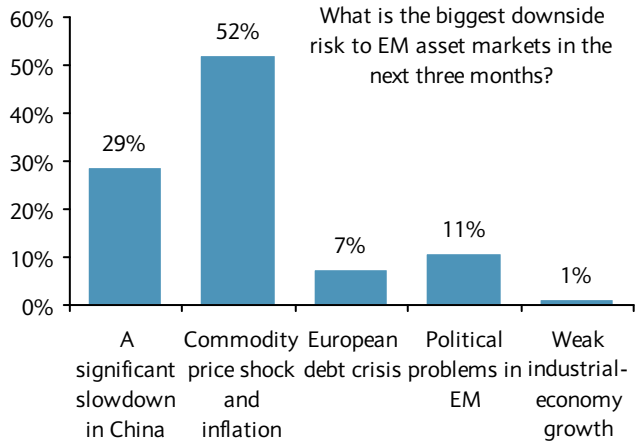
Source: MSCI

unnerving confrontation between Iran and Saudi Arabia (and, by extension, the US) looms large in Bahrain (see *Energy Flash: Bahrain – A wider struggle*, 16 March 2011). Disruption to energy markets has so far been modest; we estimate that there is $10-15/bbl of risk premium in world oil markets, and in our base case, this will fade in the months to come before normal supply-demand pressures put renewed upward pressure on oil prices later this year. (We forecast oil at $105/bbl in 2012). But already tight oil markets have been put under further pressure, and the risks – if (for example) Nigerian supplies are disrupted during the coming election – are meaningful. Coming into 2011, oil markets were assigning less than a 2% probability that Brent would reach $130/bbl within three months. They are now assigning a probability of almost 25%. We would probably assign a somewhat lower number, but the possibility that some shock could drive oil prices to levels that threaten the world recovery is meaningfully higher now than it seemed to be in December 2010. It is much easier to think of EM positions that are sensitive to large swings in oil prices than positions that are not.

- The Japanese earthquake, tsunami and nuclear crisis are likely to have indirect and relatively modest effects on emerging economies. If the nuclear crisis is resolved without catastrophe, the emerging world is likely to be affected by a transitory period of industrial disruption in the affected areas and a subsequent, much longer period of rebuilding. (See *Japan Focus: Economic implications of earthquake*, 15 March 2011, and *Global Economic Weekly: Global recovery should withstand the shocks so far*, 18 March, 2011). This seems unlikely to pose major long-term risks for emerging market economies, and some companies and countries will experience increased demand created by the rebuilding effort. But while the many unknowns in the drama are being resolved, the earthquake and its aftermath will contribute to uncertainties in the global economic and financial environment.

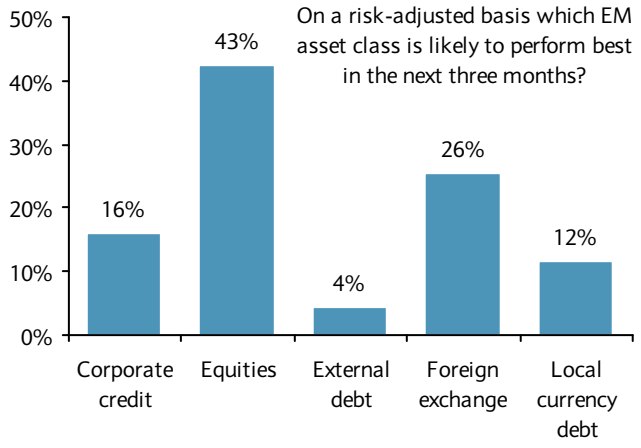
- China: For many months, we have urged investors to fade the anxieties about a Chinese hard landing that have arisen periodically. The stubbornness of inflation in the country and the increasingly stringent policies required to combat it are leaving us more open to consider downside risks of a cyclical nature associated with the monetary tightening (see *China: Slowdown coming?*, 4 March, 2011). A harder landing remains a risk case; our base case remains a soft landing to high growth. But investors should monitor the situation carefully and recognize the risk of a deeper cyclical dip in H2 than we (and

Figure 12: EM investors are mainly worried about China and commodity prices



Source: Barclays Capital

Figure 13: Investors expect equities and FX to outperform in the next three months



Source: Barclays Capital

consensus forecasts) are currently contemplating. If this should materialize, it would be important to recognize its cyclical nature and the opportunity may arise to fade an exaggerated response. But the first step is to avoid being blindsided by it.

- US monetary policy. Some investors are concerned that the likely termination of the Fed's Treasury purchase program (QE2) will be more disruptive than markets seem to be pricing. We disagree. We now have experience to support the view that well-telegraphed terminations of QE programs pass, as should be expected, with little market disruption. We would fade anxieties about QE2 and think that the risk that conventional monetary tightening will be brought forward to the immediate future remains remote.

EM strategy

Respect the tail risks, but do not be paralyzed by them

In short, very much like three months ago, we face a generally benign investment context with significant risks to the market-supportive base case. We continue to believe that emerging market assets will earn their keep this year and think that investors should remain engaged in EM asset classes. That said, we respect the tail risks that surround the base case and have worked to find cost-effective hedges that permit investors to remain exposed to the asset class, but limit exposure to the associated downside risks.

External credit

No large changes in bond strategy orientation

Our main views and recommendations in the external bond space are not much changed from last quarter. We still expect our EM sovereign benchmark to deliver a return of 4-5% in 2011. Year to date, the benchmark is up roughly 1.4%, marginally ahead of schedule for the year, bolstered by support from an end-of-quarter flight to safety in Treasury markets. Spreads on the high-quality core of the index were largely unchanged from year-end, both in bonds and CDS, while the high-beta credits, Argentina, Ukraine and Venezuela, underperformed, widening roughly 30bp and returning only 0.7% in the year to date.

We continue to believe that the riskier, high-beta credits will outperform over the year as a whole. We have increased our substantial overweight position in the model portfolio, while shifting the allocation from Argentina toward Venezuela, reflecting limited policy progress in the former credit, and a boost from higher oil prices to the latter. In Venezuela, we favor the short end of the sovereign and PDVSA curve for its very high carry and relatively greater visibility on the ability to pay. Higher-quality sovereign credits look expensive to us, particularly in Latin America, and we maintain an underweight recommendation with but a few exceptions, notably Indonesia and South Africa. Although we remain skeptical of most Middle Eastern credits, we think the sell-off in Qatar is overdone and have penciled an off-index allocation into our model portfolio.

Ideas for cost-effective hedges of tail risks in external credit

Our strategists have identified a number of opportunities to maintain exposure to EM sovereigns while cost-effectively hedging against potential market downdrafts associated with global tail risks. In Asian CDS, we recommend buying protection on Korea against Malaysia, a trade that serves as a low-cost hedge against geopolitical tensions. We also like a 1x2 put spread in CDX EM, which provides an effective hedge for very large downside moves at a low cost in a bull market. The cost is mainly reflected in a negative payout in moderately bearish markets; in our view, some investors may find this a price worth paying for protection against a major decline.

Our regional strategists have also identified a number of more idiosyncratic opportunities in Vietnam (we like), Peru (not so much), Poland, and more; do not miss the regional strategy reviews later in this publication.

Local rates and bond markets

Not too late to pay local rates curves

With inflationary pressures continuing to mount, we have now turned either neutral or payers of the front end in local rates throughout the emerging world, with the exceptions of South Africa and Brazil. We continue to see a benign global growth scenario in which inflation pressures in the emerging world linger. The risks, in our view, are that EM central banks are forced into a sustained hiking path beyond our current forecasts, or even beyond rates compatible with a neutral monetary policy stance.

Our highest conviction payers are in Korea, India, Poland, Thailand, Turkey, and the Czech Republic. We also see an opportunity to pay in Mexico, though there the trade needs to be tailored to our view that Banxico will not be tightening until early 2012.

Two short-rate receivers

One of the few receivers that we like is in South Africa 1y1y forward rates, on our view that the central bank will not begin hiking until January 2012, while the market is pricing 120bp of hikes until then, and another 150bp through March 2013. We also lean toward receiving the front end of the PreDI curve in Brazil. The market is pricing 157bp of hikes through the July 2012 meeting, when we only expect another 50bp hike in April. Tactically, though, we see better entry points ahead, as we expect the market to price more than the 42bp priced for the next meeting, and given there are risks that the IOF tax may be extended to local corporations funding themselves abroad, which may need to come back to pay the front end of local markets.

Longer rates

With inflationary pressures still on the rise, we are selective in our approach to local bond markets and the long end of local rates curves. We recommend receiving rates through NTN-F 2017 in Brazil, although we wait for better entry points in the days ahead. Breakevens have sold off to near 6.0%, as we expected, a level we consider more than fair for the inflation risks. We expect inflation to pick up to 6.3% this year, but see it receding to 5.1% in 2012. While there is some risk that the IOF tax on government bonds will be hiked, we consider it more likely that external issuance by Brazilian corporates will be targeted instead, and we think the central bank will raise rates only another 50bp. We recommend waiting to enter this trade for the same reasons we recommended waiting to receive Jul12 PreDI swaps.

Although we like Indonesian external debt, local bonds seem expensive for the risks. The central bank has delayed hiking in spite of high inflation, which is, we think, heading from the current 6.8% to 6% in Q3, but real rates remain low because the policy rate is 6.75%. The central bank has signaled more hikes, in line with our forecast of another 50bp through June, while allowing the currency to appreciate. But current bond prices make sense only if the market persists in its belief that the central bank will address mounting inflationary pressures, suggesting that bonds could sell off if the central bank remains reluctant to tighten.

EM FX

Still expecting upward pressure on Asian FX

A weaker dollar provided very limited support for EM FX in Q1, except for those currencies closely linked to the euro. EM currencies generally traded with very low volatility, particularly in light of the fraught international financial environment toward year-end. Our core view remains that reasonably valued currencies in rapidly growing Asia will likely trade higher in the quarters to come, as monetary policies are tightened to combat rising inflationary pressures. However, this directional call is undermined by higher oil prices and, to some extent, by uncertainties surrounding the industrial disruptions that may be created in the immediate aftermath of the Japanese earthquake and tsunami. The move stronger is likely to remain gradual and choppy.

KRW via options…

Our strongest trade recommendations in Asia are in the KRW, CNY, and SGD. In the KRW we propose an option structure (3m ATMF USD put/KRW call with reverse knock-out at 1,070), which protects against downside risks in the exposure via the call structure and reduces the cost of the exposure by selling away upside in the exposure that we feel fairly confident will not materialize in the grind-appreciation environment that we expect. We feel this structure could also be extended to EUR/PLN (RKO at 3.90 at a cost of 65bp) and the MXN (RKO at 11.70, at a cost of 55bp).

… CNY outright…

In line with our view that inflation pressures in China may prove harder to tame this time, we expect the monetary authorities to let the currency move faster than priced by forwards. The spot USD/CNY NDF has fallen 15bp month-to-date, with the 3m NDF implying a 0.3% decline in USD/CNY over the quarter. We expect a 1.1% fall over that period, with the Chinese authorities keen to lean against inflation. Moreover, this move is likely to be accelerated in the run-up to May's Strategic Economic Dialogue. We recommend an outright short on the 3m NDF (6.534), targeting 6.490.

… and SGD via put spreads

In this vein, we expect the MAS to allow a faster pace of currency appreciation when it convenes in April, favoring the SGD (via an increase in the NEER slope from an estimated 3.5% to 4.0%). We think it will frame recent developments in Japan and MENA as inflationary, on top of a still-firm economic growth backdrop. We recommend an outright short in USD/SGD. Those concerned with downside EUR/USD risks can add weight to a EUR/SGD outright short.

We are skeptical of TRY FX and rates

The context of a stronger developed world and tighter money is uncovering vulnerabilities in some EM currencies formerly seen as attractive and relatively safe carry trades, such as the TRY. Already facing a large current account imbalance, Turkey is on the wrong side of the recent run-up in oil prices. If financing the current account deficit becomes more difficult, higher rates, a weaker currency, or some combination of both would be in order. We recommend positioning accordingly in currency and rates. In the TRY, we also believe investors should expect higher volatility and, hence, recommend buying 3m 1.65-1.75 USD call/TRY put spreads (reference spot of 1.578). The upper strike is not our forecast, but a plausible outcome if risks materialize, boosting the maximum payout-to-cost ratio to 5:1.

More generally, we think the sluggish recent response of EM FX to the rise in volatility in other asset markets creates cost-effective opportunities to position for global economic and financial tail risks (see, for example, *The Emerging Markets Weekly: An eerie calm,* 10 March 2011.) These opportunities are often fleeting in nature. We encourage investors to capitalize on opportunities as they arise.

EM CREDIT PORTFOLIO

	OAS (bp)				Weights (%)			Returns (%)				Bonds we recommend…	
	31-Dec 2010	18-Mar 2011	3mF	OAD	Bench	Model		1w	2011 QTD	2011 YTD	3mF*	Buying	Selling
EM Portfolio	269	274	260	6.8	100	100		0.4	1.4	1.4	0.7		
Arg, Ven, Ukr	755	789	721	6.3	14	22	over	0.2	0.7	0.7	5.2		
Other	190	191	185	6.9	86	78	under	0.4	1.5	1.5	0.0		
EM Asia	176	195	179	7.3	14	12	under	0.2	0.3	0.3	0.5		
Philippines	139	149	150	7.9	7.2	3.5	under	0.3	0.8	0.8	-0.8		RoP 14s, 15s, 16s
Indonesia	166	191	165	7.0	5.3	6.0	over	0.0	-0.2	-0.2	1.4	Indo 20s	
Vietnam	359	333	300	5.5	0.5	1.0	over	0.4	3.5	3.5	2.0	Vietnam 20s	
Pakistan	727	874	750	4.3	0.3	0.3	neutral	0.2	-3.7	-3.7	7.1		
Sri Lanka	304	360	300	4.5	0.6	1.1	over	-0.2	-0.7	-0.7	3.1	Sri Lanka 12, 15s	
EMEA	237	239	230	5.7	41	39	under	0.6	1.8	1.8	0.5		
Turkey	168	200	180	6.9	12.9	12.8	neutral	0.6	-0.3	-0.3	1.0	Turkey 16s, 17s, 40s, 41s	Turkey 20s, 21s
Russia	197	195	180	6.0	10.0	9.9	neutral	-0.1	1.8	1.8	0.7	Russia 28s	Russia 15s
Lebanon	303	368	360	3.6	2.4	2.3	under	-0.1	-0.7	-0.7	0.8		
South Africa	152	157	140	5.5	3.1	3.4	over	0.9	1.5	1.5	0.7	SoAf 41s	SoAf EUR13s, 14s EUR16s
Ukraine	444	444	400	4.8	2.2	3.5	over	-0.2	1.9	1.9	2.7	Ukr 12s, 13s, 15s	
Hungary	416	316	350	4.7	4.3	2.5	under	1.6	8.7	8.7	-1.3		Hungary 20s
Lithuania	259	228	225	4.3	3.0	2.8	neutral	1.5	4.0	4.0	0.2	Lithuania 17s, 20, 21s	
Bulgaria	221	185	230	2.6	0.7	0.7	neutral	1.3	3.6	3.6	-0.9		
Egypt	197	359	375	8.2	0.4	0.1	under	0.5	-11.3	-11.3	-1.4		Egypt 40s
Croatia	311	303	340	6.0	1.7	0.5	under	0.6	2.8	2.8	-2.1		Croatia 19s, EUR 14s, 15s
Tunisia	170	288	300	1.1	0.2	0.1	under	0.3	-0.7	-0.7	0.4		
Qatar	152	183	130	6.4	0.0	0.5	over	0.0	-1.0	-1.0	3.0	Qatar 19s, 20s, 30s	
Abu Dhabi	130	155	140	3.9	0.0	0.0	neutral	0.1	0.1	0.1	0.5	ADGB 19s	
Latin America	325	330	310	7.6	45	49	over	0.4	1.3	1.3	1.0		
Brazil	136	131	126	7.3	12.3	11.1	under	0.4	1.3	1.3	-0.3	BR27, BR34, BR37, BR41	BR13, BR15
Mexico	146	133	126	7.6	10.1	9.3	under	0.6	2.4	2.4	-0.2	MX 40, MX 100	MX 19
Venezuela	1065	1089	978	5.3	5.8	10.7	over	-0.9	1.6	1.6	8.2	VE13, VE14 PDVSA 14, PDVSA 15	
Argentina	571	627	592	7.7	6.0	8.0	over	1.4	-0.7	-0.7	3.3	EUR Warrant, Boden 15, EUR Discount	USD Discount
Colombia	169	146	138	7.4	3.2	2.5	under	0.7	2.4	2.4	0.0	CO19	CO41
Peru	162	151	164	10.5	2.7	2.1	under	0.2	2.2	2.2	-2.5		PE 50
Panama	158	160	178	9.1	2.3	1.4	under	0.2	0.8	0.8	-2.5	PA 36	
Uruguay	173	176	159	9.8	1.6	1.6	neutral	-0.7	0.7	0.7	0.8	UY25	
El Salvador	303	320	386	8.5	1.1	0.5	under	0.1	-0.3	-0.3	-5.8	ELSALV 41	
Dominican Rep.	372	438	381	5.1	0.4	1.8	over	-1.1	-1.6	-1.6	3.4	DR18, DR27	DR 21

Note: *3mF is the 3-month forecast for the benchmark portfolio. Source: Barclays Capital

FX VIEWS ON A PAGE

Currency	Tactical bias	Strategic directional view	Current strategy/ trades we like	Vol adj 6m returns	Score (1-5)
Emerging Asia					
HKD	Neutral	Increasing CNY deposits onshore may result in "RMB-isation" of the economy.		0.32	4.05
CNY	Bullish	We expect the USD/CNY to move lower as the authorities react to elevated inflation. We expect this process to accelerate ahead of May's Strategic Economic Dialogue.	Sell 3m CNY NDF	0.38	4.05
THB	Bullish	We expect the THB's recent underperformance to reverse. A robust economy and a strong external position are likely to support modest THB appreciation.		0.36	3.75
MYR	Bullish	Stronger growth, rising commodity prices, and a healthy fiscal position should lend support to the currency.		0.34	3.75
KRW	Bullish	We believe still-sizeable current account surpluses and a preference to contain imported inflationary pressures will see USD/KRW move towards 1025 by year-end.	Buy 3m USD put/KRW call ATM-F with a RKO at 1070	0.29	3.55
TWD	Neutral	USD/TWD has moved sharply lower in recent weeks. We think the currency will be anchored at 29 over the next three months.		0.19	3.45
INR	Neutral	A weak current account and the paucity of capital flows could result in INR underperformance.		0.17	3.25
PHP	Bullish	We have slightly lowered our BoP surplus forecast. In addition, the central bank likely believes the REER is close to fair value. We expect a modest move lower in USD/PHP towards 41.5 by year-end.		0.32	3.15
SGD	Bullish	We expect building inflation pressures to prompt additional monetary tightening via a steepening of the SGD NEER slope.	Buy USD-EUR basket (60%-40%) versus SGD outright	0.16	2.65
IDR	Bearish	Although FDI continues to rise, the current account surplus looks set to shrink, providing a less favorable outlook for the IDR.		-0.12	2.20
Latin America					
PEN	Neutral	Supportive fundamentals (economic strength, commodity prices and risk of more aggressive than priced monetary policy normalization), but FX intervention limits upside in the near term. The technical position of local banks is not supportive, particularly in light of possible political noise ahead.		0.34	3.95
CLP	Bullish	Supportive fundamentals: strong domestic demand, hawkish monetary policy and bright outlook for copper prices. FX intervention risks increase as USD/CLP approaches 450.		0.33	3.10
BRL	Neutral	We see it range trading in 1.65-1.75. Attractive carry, but BRL is expensive in real terms and intervention risks are high.		0.29	2.95
MXN	Neutral	Improving domestic demand and US activity supportive, but hard to see a shift lower in USD/MXN unless Banxico signals more aggressive monetary policy stance than what is priced in. While positioning has improved, we do not think it is at outright clean levels.		0.12	2.50
COP	Neutral	Supportive fundamentals (oil prices and monetary policy normalization), but FX intervention limits downside for USD/COP.		0.05	1.10

Currency	Tactical bias	Strategic directional view	Current strategy/ trades we like	Vol adj 6m returns	Score (1-5)
Emerging EMEA					
RON*	Bullish	Improving C/A deficit plus prospects of further FX sale argue for, at worse, a stable RON. 7% yields with this backdrop should pull in capital inflows.	Buy 6m T-bills (6.7% indicative yield) FX unhedged	0.28	3.45
EGP	Bearish	Uncertainty over the transition process is likely to prompt more capital outflows. Meanwhile, some of the key BoP items are likely to be deteriorating (FDI and tourism).		1.25	3.40
HUF*	Neutral	A credible central bank stance continues to offset investor uncertainty on fiscal policy. Watch for potential asset (pension) repatriation flows later this year.	Sell TRY/HUF	0.14	3.35
PLN*	Neutral	Dovish MPC stance weighs on the PLN as investors see risks of inflation becoming more widespread. Positioning after the correction has improved, though.		0.17	3.30
CZK*	Bullish	The consumer recovery argues for a protracted hiking cycle likely to start later this year. This, plus the solid macro balances, should push the CZK higher.	Sell EUR/buy CZK	0.34	2.90
TRY	Bearish	Historically low nominal yields are likely to feed the already large C/A deficit, making external funding harder as well. Look for a difficult Q2, with relief likely only towards year-end after a policy adjustment.	Buy USD call/TRY put spread, 3m, 1.65-1.75 strikes, sell TRY/HUF	0.10	2.75
ILS	Bullish	Accelerated rate hikes are likely as the BoI gets to grips with an overheating economy. There is little room, in this scenario, for a weaker ILS.	Short EUR/ILS. Buy USD put/ILS call butterfly, 3.65, 3.60, 3.55 strikes	0.05	2.00
RUB	Bullish	Oil windfall is likely to keep the RUB well bid. But structural capital outflows and the election cycle argue for more challenging times later this year.		0.09	1.90
ZAR	Neutral	High commodity prices and a likely return of some portfolio flows on high real/nominal yields should provide enough capital inflows to fund the (modest) C/A deficit.		0.03	1.70
UAH	Neutral	Depressed yields leave the UAH more exposed, particularly as the best of the capital inflows/de-dollarization process are behind us.			
KZT	Bullish	Kazakhstan benefits hugely from high oil prices, and the central bank has said it expects some appreciation, suggesting continued managed appreciation.	Sell USD/buy KZT through 6m NDF		

Note: * Versus EUR. The variable score is an index which ranks EM currencies according to the vol-adjusted returns, PPP valuation, carry, systemic risk, basic balance/GDP and reserves accumulated over the past 5y/GDP. For more details on the trade recommendations, please see the EM Dashboard.
Source: Barclays Capital

Analyst Certification(s)

We, Larry Kantor, Piero Ghezzi, Simon Hayes, Luca Ricci, Paul Horsnell, Sudakshina Unnikrishnan, Paul Robinson, Laurent Fransolet, Chotaro Morita, Ajay Rajadhyaksha, Jeffrey Meli, Barry C. Knapp, Edmund Shing, Ph.D, Fumiyuki Takahashi, Michael Gavin, Alanna Gregory and Jose Wynne, hereby certify (1) that the views expressed in this research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

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