Economic Analysis

Economics | Global | Economics
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We're all Europeans now

Bank of America Merrill Lynch

Global Economics Team +1 646 855 9322
MLPF&S

Ethan S. Harris +1 646 855 3755
North American Economist
MLPF&S
ethan.harris@baml.com

Alberto Ades +1 646 855 4044
GEM FI Strategist, Economist
MLPF&S
alberto.ades@baml.com

Gustavo Reis +1 646 855 6356
Global Economist
MLPF&S
gustavo.reis@baml.com

See Team Page for Full List of Contributors

Global: We're all Europeans now

The global economy can handle a modest European recession, but we see a high risk of a more adverse outcome.

United States: Triple dip

While 2011 is ending on a strong note, we expect the US and European fiscal crises to lower growth to just 1% in Q4 2012.

Canada: Euro *Sturm und Drang*

We forecast Canada's deteriorating growth and credit backdrop will prompt the Bank of Canada to cut rates early next year, though the Bank will not tarry long at the zero bound as core CPI lingers above target.

Euro area: Walking on the edge of a cliff

We believe all Euro area countries will post negative growth in the first half of 2012. ECB policy (re-)action would end the downward spiral in confidence. However, imbalances remain unresolved, and are likely to continue to dampen growth prospects and keep trend growth below pre-2007 levels.

UK: Renewed recession, but inflation finally falling

We expect the UK to fall into a minor recession over the next few months, pulled down by the effects of the nearby Euro zone sovereign debt crisis. Consequently, we expect the BoE to expand QE again in 2012.

Japan: The time for reconstruction and reform

We expect Japan's economic growth to return to positive territory at +2.3% yoy in 2012 as fiscal spending for reconstruction increases. Our baseline scenario is that any fiscal crisis can be avoided during the forecast period.

Global Emerging Markets: The sum of all fears

We forecast GEM growth will slow to 5.5% in 2012, from 6.3% in 2011. Against this backdrop of weaker growth, we also expect inflation to decline to 5.4% next year, leaving policy makers with room to act.

Emerging Asia: Weathering turbulence

Asia has not decoupled and remains vulnerable to a US or Europe recession. But a healthy balance sheet should help Asia weather the downturn and turbulence, with little risk of wider systemic impact.

Emerging EMEA: No risk-on, no fun-ding

Funding is the key variable in the deleveraging world for 2012, in our view. It determines growth and scope for stimulus. Russia appears best placed, and we forecast the highest growth there, even though below consensus. We are most bearish on growth in Turkey, S Africa and Hungary; Poland is in the middle.

Latin America: Keep it up, China, please!

LatAm activity is likely to slow down in 2012, to 3.3% from 4.1% in 2011 in our central scenario. We expect inflation to decelerate, but only marginally. In any case, most central banks will loosen monetary policy in 2012. Watch for presidential elections in Mexico (July) and Venezuela (October).

Click the image above to watch the video.

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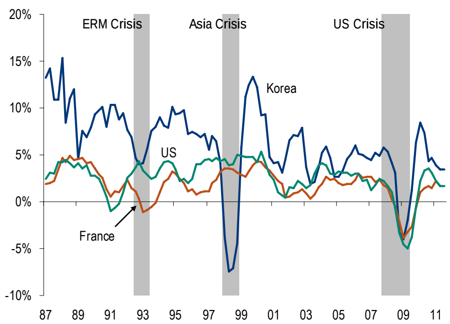
Ethan S. Harris +1 646 855 3755

Table 1: Our 2011 forecast: Then and now (annualized %)

2011	GDP Then*	GDP Now	CPI Then*	CPI Now
Global	4.3	3.9	3.4	4.3
US	2.9	1.8	1.2	3.2
Euro area	1.6	1.5	1.9	2.7
Emerging Markets	6.4	6.3	5.3	6.0

*Then = as of 7 January 2011
Source: BofA Merrill Lynch Global Research

Chart 1: Three GDP shocks
Real GDP (year-over-year % change)



Source: BofA Merrill Lynch Global Research, OECD, Haver Analytics

Chart 2: US bank funding pressures rising
Two-year US swap spreads (basis points)

Source: Bloomberg, BofA Merrill Lynch Global Research

Global overview

We're all Europeans now

The past year has featured a lot of dramatic events – Japan's tsunami, the escalating crisis in Europe and the US debt debacle, to name a few. However, from an economic forecasting point of view, the big story was oil. Oil prices surged in the spring, averaging about $20/bbl more than expected. That "supply shock" fully explains both the downside surprise in GDP growth and the upside surprise on inflation (Table 1).

With the oil shock steadily fading into history, the big story in 2012 will likely be the growing crisis in Europe. In particular, our key themes are:

- In our base case, Europe slips into a mild recession, driven by tighter credit, fiscal austerity and weakening confidence.
- Historically, Europe has had a small impact on other regions, but the banking and confidence linkages from Europe have grown over time. In a worst case scenario, if the European crisis spins out of control, a global recession is likely.
- With this weak growth backdrop, the recent inflation spurt will likely recede quickly, triggering monetary easing in many countries.
- Investors are on alert for a bad outcome. The surprise would be if the global economy performs well in the year ahead. The key upside risk is decisive actions from both the ECB and Italian fiscal authorities.

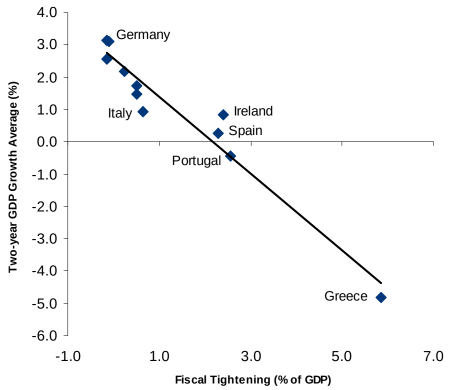
Growth: When Europe sneezes

For several decades the Euro zone has been more of a follower than a leader of global growth. The region is big, accounting for about one-fifth of global GDP; one-fourth of global trade; and roughly 30% of identifiable currency reserves. However, Europe has tended to box below its weight in global markets. While US events have had a strong "CNN effect" on global markets, European news has rarely been as powerful. For example, the US payroll report is much more impactful than the German IFO index and the Fed usually overshadows the ECB.

The dominance of the US and the relative lesser importance of Europe have been evident in recent economic cycles. Consider the three big regional crises of the last two decades: Europe's ERM crisis in 1992, the Asian crisis in 1997-98 and the US subprime crisis in 2007-09. While each of these crises caused local recessions, only the US crisis became global in nature (Chart 1). Apparently, when the US sneezes the world catches a cold, but when Asia or Europe sneezes the world offers a handkerchief.

Unfortunately, the current strain of euro-flu is more contagious. Europe matters a lot more today due to capital market linkages. Consider the impacts on the US. Troubles in Europe have already impacted funding costs for US banks (Chart 2). As of this writing, the two-year swap spread has surged close to its 2010 peak although it remains well short of 2008-9 crisis levels. Similarly, the US stock market is increasingly wedded to events in Europe. Looking back, we identified the 10 biggest stock market moves in each of the last five years. From 2007 to 2009, events in Europe explain only one out of 30 top-10 days. However, in the last two years, European news drove about half of the top-10 moves. This can be partly explained by the exposure of US companies to Europe, but the bigger story is that the "CNN effect" now goes both ways.

Chart 3: More fiscal tightening, less growth

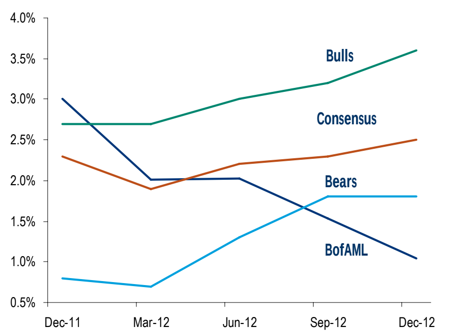


Source: BofA Merrill Lynch Global Research

At this stage, a recession in Europe seems almost inevitable. Europe is facing three growing shocks: a credit crunch, fiscal austerity and a steady erosion of confidence. In the long run, fiscal austerity can improve growth performance, particularly if it eliminates wasteful government and includes market reforms. In the short run, however, it can be quite painful. It is no coincidence that the countries tightening their belts the most – Greece, Portugal, Spain and Ireland – are also the four weakest economies in the last two years. Unfortunately, our Euro zone team expects the core of Europe to join them in the year ahead. Chart 3 compares GDP growth to the degree of fiscal tightening for the 11 Euro zone countries we cover. Specifically, we compare average GDP growth in 2010 and 2011 to the average change in the structural budget balance as a share of GDP.

Outside of Europe, the biggest concern is the US. The good news is that as the center of global capital markets the US plays by different rules than peripheral Europe. Despite the dysfunctional budget process, with threats of shutdowns, defaults, sudden shifts in spending and taxes and no real progress on the deficit, the US can still fund itself at very low rates in global capital markets. However, this erratic behavior comes at a cost. The long-run cost of failure to fix the deficit is that the US could suffer a Greek-style debt crisis.

Chart 4: Bulls, bears, BofAML and consensus Real GDP forecasts (qoq % annualized)

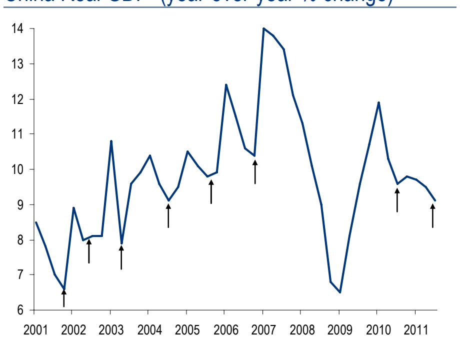


Source: BofA Merrill Lynch Global Research, Bloomberg

In the short run, erratic policy is undercutting market, consumer and business confidence. This was dramatically confirmed with the 7% drop in the US stock market on the day S&P downgraded the US debt. We are particularly concerned about next summer and fall, when investors will look beyond the election to what we view as three ticking time bombs: big spending cuts, big tax increases and another debt ceiling debacle. While the consensus forecast is for a pick-up in US growth next year, we expect growth to slow over the year (Chart 4).

For the rest of the world, our expectation is that there will be some degree of decoupling from the US and Europe. Most countries have avoided banking and real estate crises, and policy makers can cushion shock waves out of the US and Europe with rate cuts, bailouts and fiscal policy as needed. In emerging markets, developing Europe is most vulnerable, followed by LatAm, with Asia a distant third. We are skeptical about the China hard landing scenario. Every year, it seems, the widespread view is that China is about to have a hard landing (Chart 5), but with its vast currency reserves and savings China can paper over the bad loans and inefficient investments perma-bears point to, in our view. Obviously, the decoupling story gets thrown out the window in the event of a full-blown Euro zone crisis.

Chart 5: China: Lots of soft landings China Real GDP (year-over-year % change)

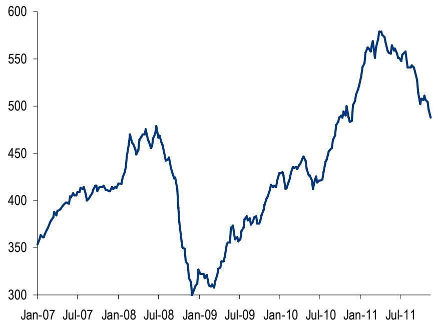


Source: BofA Merrill Lynch Global Research, Haver Analytics

Inflation: low growth trumps high liquidity

One of the most misleading stories in recent years has been that high liquidity injections by central banks will cause high inflation. The problem with this view is that bank reserves don't magically morph into inflation. Even in a monetarist framework, there is a transmission mechanism: bank reserve growth only causes inflation if the reserves are lent out, leading to rapid growth in spending. This simply hasn't happened: despite significant reserve injections, credit has remained tight and nominal GDP has remained weak. Since the recession, annualized growth has been 0.2% in Japan, 4.4% in the US and 4.2% in the UK. As long as central banks sop up the liquidity when bank lending booms, the policy is not inflationary.

Chart 6: Commodities cooling
CRB Commodity Index (1967=100)



Source: BofA Merrill Lynch Global Research, Haver Analytics

Outside of commodity prices, we believe serious inflation is only likely once the global economy has healed. After spiking in April, commodity prices have generally eased back (Chart 6). Meanwhile, after a brief sojourn into boom territory, global GDP growth is dropping back below its historical average. Even if there has been some damage to potential growth, the world still has a significant output gap.

Policy: Piercing the Maginot Line

While a number of central banks have run out of conventional ammunition, most have room to ease further. Most important, we expect President Dragi of the ECB to ignore the one percent Maginot Line left by Mr. Trichet and cut rates to 50bp by February and then reluctantly adopt full-blown quantitative easing. Faced with a choice between financial crisis and deflation on the one hand and QE on the other, we would expect the ECB to choose the latter. In North America, we expect the Fed to do further QE and for the Bank of Canada to cut rates close to zero. In emerging markets, some economies with large current account deficits may have to raise rates, but most others will be cutting rates.

Risks: A real spaghetti western

While there are many risks to the outlook – US fiscal policy is a concern, and both a China hard landing and an oil shock are perennial favorites – Europe is the clear and present danger, in our opinion. As a result, this year we have stress tested our global economics and strategy forecasts with three scenarios for Europe:

- **Good:** European leaders act decisively to contain the crisis, with quick budget actions in the countries under stress, triggering a more active approach from the ECB

- **Bad:** Our baseline scenario, with a recession but not a full-blown global crisis.

- **Ugly:** A major banking and debt crisis triggers a major recession Europe.

At one extreme, even Europe avoids recession; at the other extreme, the world suffers a mild recession. Table 2 shows the results.

Table 2: For a few euros more
2012 GDP Growth

	Good	Bad*	Ugly
Euro zone	1.0	-0.6	-2.5
US	2.5	1.9	-0.5
EM	6.3	5.5	3.8
Global	4.3	3.5	1.0
Probability	10	50	40

*Bad = Baseline forecast
Source: BofA Merrill Lynch Global Research

It is important to emphasize that Europe can avoid a major recession. In many respects the crisis may be caused by self-fulfilling expectations. For example, there is a feedback loop between investor confidence in a country's debt, the interest rate on that debt and the sustainability of the debt payments. Investors have not completely given up on Europe, yet. However, what the markets will not tolerate is more of the same, in our view. Buying time is not a viable strategy because it means steady erosion in confidence and growth. We believe policy makers must move decisively to stop the crisis atmosphere or face a much worse outcome.

Ethan Harris +1 646 855 3755

United States

Triple dip

The US economy approaches 2012 with considerable momentum. With the oil and Japan shocks fading, GDP growth has picked up from sub-1% at the start of the year to an estimated 3% growth in the current quarter. Enjoy it while it lasts.

The risks next year are primarily to the downside: if the Euro zone crisis spins out of control it will likely push the US economy into a mild recession

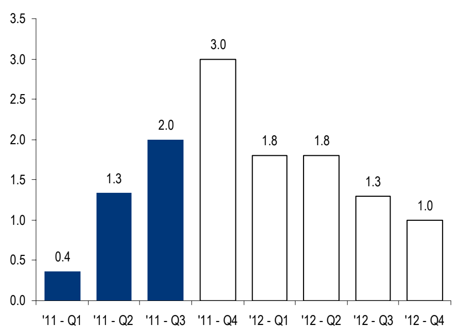
In many respects, we expect 2012 to play out like 2011, only in reverse:

- We expect growth to gradually slow as three shocks hit: fiscal tightening, a recession in Europe and a policy uncertainty shock prior to the election.
- Inflation will likely slow as commodities level off and firms face increasing resistance from cash constrained consumers.
- The Fed will continue to respond to signs of weakness. In the spring, we expect it to extend the interest rates on hold promise into 2014 and next summer we expect it to start QE3.
- The risks are primarily to the downside: if the Euro zone crisis spins out of control it will likely push the US economy into a mild recession.

Growth: duelling debt debacles

Despite the recent pick-up in growth, we expect the economy to slow over the course of 2012 (Chart 7). Three things argue for weaker growth.

Chart 7: GDP growth peaking
Real GDP (qoq % change annualized)



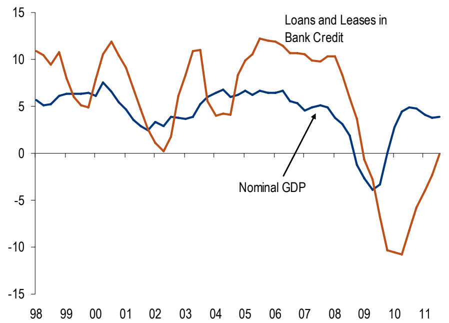
Note: Unshaded bars represent BofA Merrill Lynch forecasts.
Source: BofA Merrill Lynch Global Research, Bureau of Economic Analysis

Fiscal tightening: Fiscal policy is gradually moving from easing to tightening. Spending from the 2009 stimulus plan is steadily fading. The number of workers receiving extended unemployment benefits has already fallen 40% from the March 2010 peak. The payroll tax cut boosted growth in the first half of 2011 and faded in the second half. The good news is that despite this modest policy tightening the economy accelerated over the course of the year. The bad news is that we expect further tightening in 2012. In our view, Republicans are likely to reject all of President Obama's jobs bill, arguing that the economy needs regulatory reform and permanent tax cuts, not gimmicks. As a result, on top of the ongoing tightening, we expect the payroll tax cut and extended unemployment benefits (roughly $150bn between the two programs) to expire. Extension of the payroll tax cut could add a few tenths of a percent to our first half forecast, but only if it is not "funded" with immediate cuts in other parts of the budget.

Euro flu: Our European team believes a recession in the first half of next year is almost inevitable. Under our baseline forecast, European GDP falls at about a 2% annual rate in the first half of the year and then recovers at a similar pace in the second half. Historically, the US economy has tended to breeze past Euro-centric crises, but as we argue in the global overview, banking and stock market linkages to Europe have grown in recent years.

Policy uncertainty shock: A differentiated aspect of our growth forecast is that we have explicitly incorporated a shock to growth from fiscal policy uncertainty. We expect the economy to slow sharply in the second half of 2012 as businesses and households anticipate three post-election shocks: an across-the-board income tax increase (1 ½% of GDP), across-the-board cuts in discretionary spending (1% of GDP) and another debt ceiling deadline. Keep in mind that two of these potential time bombs are set to go off during a lame duck session of Congress. Even if each of these time bombs is ultimately defused, it will be very hard to be confident about that outcome in advance.

Chart 8: Broken transmission mechanism
(year-over-year % change)



Source: BofA Merrill Lynch Global Research, Haver Analytics

Inflation: It takes two to tango

One of the surprises of 2011 was the rise in core CPI inflation. At the start of the year, we expected inflation to inch lower, from 0.8% yoy in November 2010 to 0.6% by December 2011. Instead, core inflation has accelerated to just over 2%. Despite the pick-up, we expect core and headline inflation to moderate in 2012. To understand why, it is important to understand why inflation picked up in the first place.

As we noted in the Global Overview, by some accounts, the pick-up in inflation is the natural consequence of super expansionary monetary policy. For example, in May 2009, Allan Meltzer warned that, “the enormous increase in bank reserves — caused by the Fed’s purchases of bonds and mortgages — will surely bring on severe inflation if allowed to remain.” Since then the Fed has expanded its balance sheet even further.

We always disagreed with this view and continue to disagree to this day. The monetary transmission mechanism is broken: despite a tripling of high powered money (reserves and cash), banking lending is barely growing and nominal GDP is up just 3.7% over the last 12 months (Chart 2). Easy policy has also had little impact on inflation expectations: both market and survey expectations of inflation remain low. The reserve expansion story is a red herring.

Table 3: Three price pressure points
(year-over-year % change)

	Dec 2010	Oct 2011
Core Crude PPI	16.8	12.6
Consumer Import Prices	0.3	3.6
Rent	0.4	1.8

Source: BofA Merrill Lynch Global Research

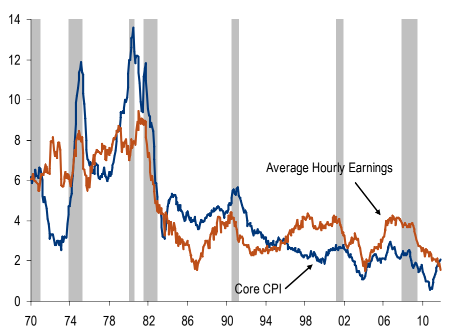
In our view, three factors caused the acceleration in inflation. Two of these factors are fading, while the other persists:

1. Commodity price pass-through has been stronger than expected. Inflation models using data from the last 25 years show very little impact of commodity prices on the core. However, the pass-through this year seems to have increased, with core goods inflation accelerating from -0.3% at the end of last year to 2.1% in the 12 months through October.

2. In a similar vein, overseas pricing pressures have pushed up consumer import price inflation faster than expected. It took almost a decade of dollar weakness to push import price inflation up to 3.4% in 2008; by contrast, just two years of both a weak dollar and rising foreign wages has boosted import inflation to 3.6%.

3. Despite a surplus of housing, a shortage of rental units has created rent pressure.

Chart 9: The wage-price squeeze
(year-over-year % change)



Note: Shaded region represents US recession.
Source: BofA Merrill Lynch Global Research, Bureau of Labor Statistics

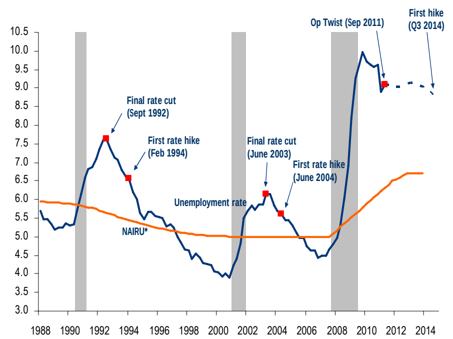
Looking ahead, we expect a partial reversal of these pressures. On the one hand, rent inflation will likely continue as foreclosures drive people into the rentals. On the other hand, commodity prices have already started to level off and the growth slowdown should take some of the pressure off of global wages. Stepping back, the deeper reason for lower inflation is that households have a budget constraint. With persistently high unemployment, wage growth continues to slow (Chart 9). Moreover, US workers neither expect, nor are likely to get, cost of living increases. Hence rising inflation puts an ever tighter squeeze on living standards. We expect considerable purchasing power pushback in the years ahead.

Policy: Better go down fighting

As we noted above, fiscal policy is tied up in political knots. In our view, an effective policy would couple modest fiscal stimulus in the near term, with credible deficit reduction in the longer term. Neither seems likely, in our view. In the near term, while there is some chance of an extension of the payroll tax cut, Republicans would prefer to do nothing until after the election. In the longer term, the debt ceiling agreement leaves excessive entitlement spending untouched, keeps all of the revenue side of the budget off-limits, and sharply cuts back discretionary spending. We would not be surprised to see a significant portion of the cuts in discretionary spending rescinded after the election.

While fiscal policy is tied in knots, the Fed is likely to remain active in the year ahead. In the face of a disappointing recovery the Fed has had two options: give up trying and admit it is out of ammunition, or keep easing using unconventional methods. As expected, Bernanke has consistently chosen the latter. In 2012, we expect the Fed to repeat the same pattern as the prior two years: if growth slows on a sustained basis, as we expect, the Fed will ease further. So in the spring we expect the Fed to extend its "promise" to hold interest rates near zero into 2014. And after Operation Twist ends in June, we expect the Fed to announce another big asset buying program.

Chart 10: Heal, then hike



Note: Shaded region represents US recession. NAIRU is based on CBO estimates through 2008 and our judgmental forecast thereafter.
Source: BofA Merrill Lynch Global Research, BLS, CBO Federal Reserve

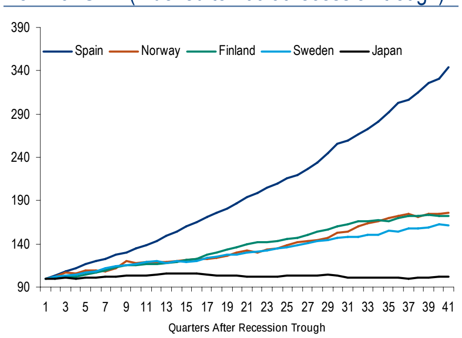
In our view, both the markets and many Fed watchers have made two mistakes in judging Fed policy. First, Bernanke and the majority of the Fed have a different view of what constitutes a recovery in the economy. In the market's mind, the clock started ticking toward rate hikes the day the economy exited from the recession. In reality, as we saw in the last two business cycles, the Fed does not even think about hiking until there is real healing in the economy (Chart 10). In the current context, that means a steady and sustainable drop in the unemployment rate, and some sign that damaged sectors of the economy, such as housing, are getting back on their feet. This suggests that the Fed is no closer to hiking rates today than it was at the start of the recovery.

The second mistake is that the markets seem to be seduced by the views of the hawks on the FOMC. In the past the hawk commentary was sometimes a good leading indicator of rate hikes. Today, however, the hawks and the doves are in two different worlds. For the hawks, quantitative easing is a dangerous mixture of monetary and fiscal policy and should end as soon as possible. By contrast, Bernanke et al embrace QE as a necessary policy when a central bank runs out of conventional policy ammunition. Our advice to investors: ignore the hawks.

Risks: Stale on arrival?

Year-ahead pieces often have very short shelf lives. This year the risk of our Year Ahead report becoming stale quickly is higher than normal. The crisis in Europe is escalating as this goes to press and as such we are being cautious with our view, assuming three scenarios for European GDP growth: **good** (Europe grows 1% in 2102), **bad** (mild recession with -0.6% growth) and **ugly** (major crisis with -2.5% growth). In our view, only the latter scenario pushes the US itself into a recession. Nonetheless, given the crisis in Europe, fiscal follies in the US and the usual array of other risks, we see a 40% probability that the US slips into recession at some point in 2012.

Chart 11: Rehab recoveries
Nominal GDP (Indexed to 100 at recession trough)



Source: BofA Merrill Lynch Global Research

A common question from clients is whether the US (and Europe) are at risk of a "Japan scenario," with a long period of essentially zero nominal GDP growth. We think such an outcome is possible, but unlikely. In the post-war period, five countries have gone through major banking and real estate crises. In each case, a very weak recovery followed, with real GDP growth averaging 2 to 3% for several years. Deleveraging recoveries are weak and fragile. The extreme case is Japan: nominal GDP has been flat in Japan for two decades, by contrast in the other four instances nominal GDP was up at least 50% 10 years later (Chart 11).

Michael S. Hanson +1 646 855 6854

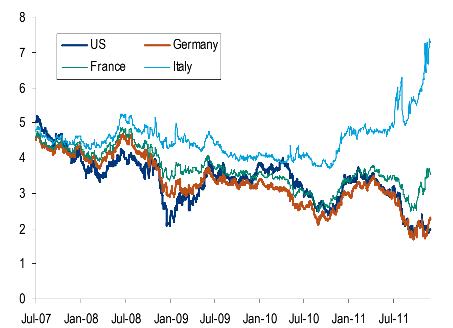
Hot topic: US policy outlook

Careful what you wish for

Fiscal policy remains one of the key risks to the US outlook in 2012 and beyond. Put simply, US policy makers have made haphazard progress on deficit reduction to date. Indeed, current fiscal policy is arguably the opposite of what it should be: policy is set to tighten notably in the near term as a weak economy remains susceptible to downside risks. Meanwhile, the failure of the so-called "Super Committee" illustrates the lack of progress toward a credible longer-term plan. The US does not face an imminent risk of a fiscal crisis (Chart 12), in our view, but we are approaching a crossroads. The US's "exorbitant privilege" can be used either to buy time to fix its budgetary problems, or to procrastinate until more difficult and painful choices cannot be avoided. We are concerned about the latter.

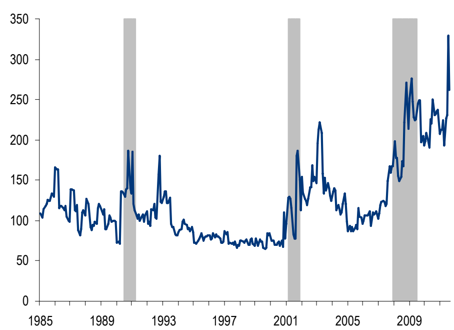
With unfinished budgetary business still before Congress, there is always the chance that events will overtake our analysis even before the ink is dry. Below we discuss how a few important fiscal decisions that are likely over the next 13 months might impact our views on the budget and the economy. But the biggest challenge to forecasting the longer-term fiscal outlook is the national election in November 2012. The range of potential outcomes following the election is quite wide, and this is a major factor in the uncertainty shock we anticipate will hit growth in the second half of 2012 (Chart 13).

Chart 12: The last safe haven?
(10-year bond yields, percent)



Source: OECD, BofA Merrill Lynch Global Research

Chart 13: Ever more uncertain policy
(Policy uncertainty index)



Source: Stanford GSB, BofA Merrill Lynch Global Research

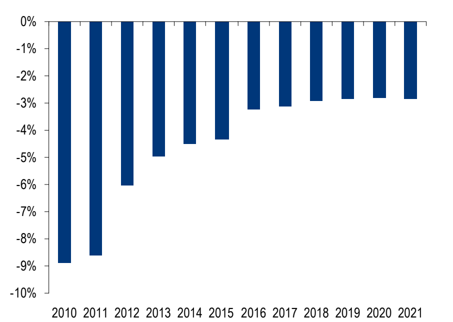
Credibility is key — and lacking

The fundamental problem for US fiscal policy is credibility, in our view. As we noted in the Year Ahead last year, we are much less concerned about the Fed in part because it has articulated an exit strategy for monetary policy. Despite tense negotiations over the FY2011 budget and the debt ceiling, despite the 10-year proposals and counter-proposals from the two parties, despite the President's deficit commission and the "Gang of Six" and the Super Committee, there still is no agreement on a plan to shift the US to a sustainable fiscal path. A credible plan would give US policy makers some flexibility to provide targeted support to the fragile economy today without risking a spike in interest rates. Over time, a more credible plan should keep rates and thus interest costs lower, easing the adjustment.

Recovering the fiscal fumble

Like last year, Congress has been unable to pass a budget and is instead funding the government weeks at a time. The current continuing resolution expires on December 16, and it will need to be extended to avoid a government shutdown. More significantly, several stimulus measures are set to expire at year's end, including the payroll tax cut and extended unemployment benefits. As we write, Republican leaders in Congress have softened their opposition to extending the payroll tax cut. As the multiplier on temporary tax cuts is likely small, the bigger question is whether this extension would be coupled with dollar-for-dollar offsets to make it deficit-neutral — if so, the impact on growth could actually be negative.

Chart 14: Honey, I shrunk the deficit
(Deficit/GDP forecast, percent)



Source: CBO, BofA Merrill Lynch Global Research

At this point, we see a small upside risk to our forecast in first half of 2012 should an extension of the payroll tax cut occur, in part because we expect politicians won't be able to avoid the temptation to assuage voters ahead of the election — the bill can be paid at a later date. Conversely, that does put some upside risk to our FY2012 deficit outlook. Right now, with several programs ending and the economy showing some signs of life recently, the deficit is projected to fall to $940 bn in FY2012 from $1.30 tn in FY2011. Equivalently, as a share of GDP, deficits should shrink to 5.9% from 8.5% last year (Chart 14). Extending the existing payroll tax credit without any offset would likely raise the deficit for FY2012 back above $1 tn — or about 6.6% of GDP. The more offsets, the lower the deficit impact and the smaller any stimulus for near-term spending.

The big one

Our base case is that some sort of "middle class tax relief" or tax reform goes through, but not all of the Bush tax cuts survive.

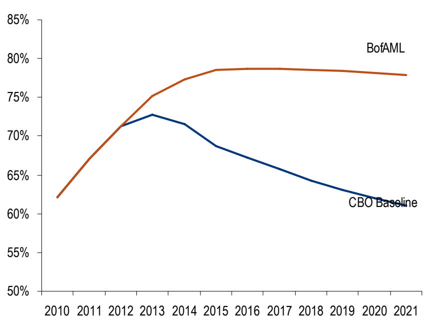
Ironically, the best hope for a credible deficit reduction plan may come from inaction: the Congressional Budget Office estimates that the sunsetting of the Bush tax cuts at the end of 2012 could reduce the cumulative deficits from 2013 to 2021 by $4.6 trillion (including nearly $700 bn in reduced debt service costs). Extending these tax cuts would require finding offsetting deficit reduction elsewhere in order to put the debt/GDP ratio on a sustainable path — either through revenue or spending cuts. Given the inability of the Super Committee to "go big," we are not optimistic that such offsets could be found.

Our base case is that some sort of "middle class tax relief" or tax reform goes through, but not all of the Bush tax cuts survive. In effect, that means retaining over $3 tn of the tax cuts through 2021. Whether or not Republicans win the presidency, the chances of a filibuster-proof majority in the Senate don't look high. That means Senate Democrats will likely retain some bargaining power, and we would then expect some compromise to win out over outright expiration. But of course, the range of potential outcomes remains wide.

Doin' the downgrade

The rating agencies have indicated that they will be looking carefully at the outcome of the debate over the Bush tax cuts, because they are expecting US fiscal authorities to deliver roughly another $2 tn of deficit reduction on top of the $2.1 tn in spending cuts from the August Budget Control Act ($900 bn in initial cuts and $1.2 tn in sequestration). Threatening either of these objectives would raise the likelihood of a debt downgrade by the middle of 2013, in our view. Given the recent kerfuffle over the sequestration process, we would not be surprised to see attempts to reverse them or replace them with budget gimmicks. This, along with foot-dragging on real budget reform, makes a 2013 downgrade a real risk.

Chart 15: Tough curve to bend
(Public debt/GDP forecast, percent)



Source: CBO, BofA Merrill Lynch Global Research

Indeed, it may take another debt downgrade to ultimately concentrate the minds of US politicians to finally make the hard choices to cut spending and raise tax revenue in order to stabilize the debt/GDP ratio and get it to start to decline by the end of the decade. Our longer-term deficit forecast assumes that Congress dithers for a few more years before embarking on real deficit reduction over the second half of the decade. While policy uncertainty remains high, we currently foresee the deficit as a share of GDP declining from 6% in 2012 and 5% in 2013 to less than 3% by 2018. At that rate, the US would actually be running small primary surpluses (excluding interest payments on the debt).

Assuming this occurs, the ratio of publicly-held debt to GDP would peak at nearly 79% in 2017, before starting to gradually decline to 78% by 2021 (Chart 15). Under the CBO's baseline scenario, in which all the programs set to expire actually do — most notably the Bush tax cuts — this debt/GDP ratio peaks at nearly 73% in 2013 before declining to 61% by 2021. However, there is little chance that the whole panoply of programs that need to expire to bring about this outcome actually will. Right now, polls show Americans themselves are unwilling to cut entitlements or raise taxes. But any realistic plan to narrow the gap between outlays and receipts and to put the US on a path to debt sustainability will have to do both. Delay will only necessitate a much more unpleasant dose of fiscal medicine — with potentially worse side-effects — before too long.

Michelle Meyer +1 646 855 6261

Hot topic: US housing market

Housing still hurts

With 2011 drawing to an end, we mark the sixth consecutive year of the housing recession. It is a somber anniversary – housing has been central to both the biggest recession in the postwar period and one of the weakest recoveries. In a normal expansion, the housing market pulls the economy out of the doldrums, adding an average of 0.7pp to growth in each of the first two years of recoveries from construction. In this "recovery", housing construction added only 0.1pp during the first year and subtracted 0.2pp during the second.

The construction sector has found a bottom and should add to growth next year through the multifamily sector and renovations.

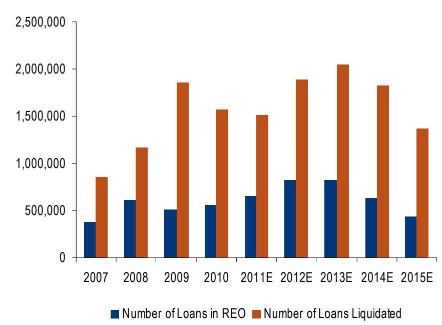
Eventually the housing market will turn, and when it does, the strength will likely come as a surprise, in our view. The crucial factor when timing the turn in the housing market is the magnitude of foreclosures and the pace by which they are cleared. Little was accomplished this year in reducing the shadow inventory of homes in the foreclosure pipeline. We believe foreclosure timelines – the time it takes to transition from seriously delinquent to liquidation – will increase next year and policy initiatives will be taken to reduce excess inventory.

In this note, we provide a succinct outlook for the housing market over the next year and beyond. In our view, the construction sector has found a bottom and will add to growth next year through the multifamily sector and renovations. But, we see further pain from home prices with declines through early 2013, translating to a cumulative drop of 38% from the peak. This feeds back into the macroeconomy negatively through the wealth and credit channels. We are still at least two years away from a true housing recovery, in our view.

Foreclosures are everything

The most crucial input to our forecast for construction and home prices is our assumption for foreclosures. Our securitized products research team estimates another eight million homes will be liquidated over the next four years, which adds to the six million homes that have already been liquidated since 2007. All told, we expect 14 million foreclosures or a quarter of all homeowners with a mortgage.

Chart 16: Foreclosure forecasts: Liquidations to peak in 2013 (# of homes)

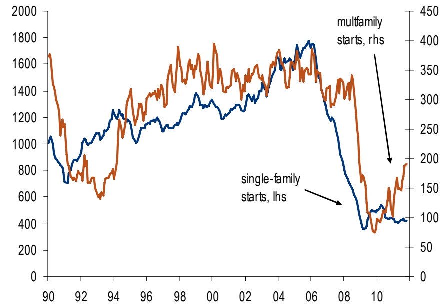


Source: BofA Merrill Lynch Global Research, CoreLogic

The forecast for foreclosures – both REO ("real estate owned" by banks) and liquidations – can be seen in Chart 16. This assumes a gradual return to "normal" foreclosure timelines in the years ahead. Currently, it takes between 25 and 30 months on average for a non-agency mortgage to transition from 60 days delinquent to liquidation, about double the amount of time it took back in 2008. The extended timelines reflect capacity issues with significantly more than normal mortgages in the pipeline, government mandated modification efforts and the nationwide investigation by the state Attorneys General on the foreclosure process. We assume that the latter is resolved in the near term.

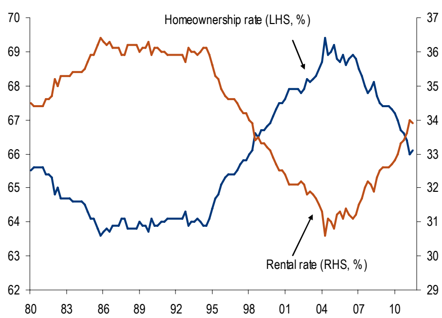
In addition, we look for a policy to be introduced for REO asset disposition, which would encourage investors to buy foreclosed properties and convert them to rentals. The policy would only target government backed mortgages, which means those owned by Fannie Mae, Freddie Mac and the Federal Housing Authority (FHA). Combined they currently have about 300,000 mortgages in REO, but there is a big pipeline; we project a total of 3.4 million. This represents about 40% of the total pipeline of future liquidations.

Chart 17: Multifamily starts increasing as single-family remain low (millions home homes, saar)



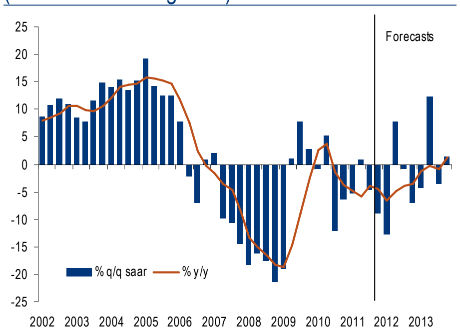
Source: BofA Merrill Lynch Global Research, Census Bureau

Chart 18: Downtrend in homeownership (% of occupied housing stock)



Source: BofA Merrill Lynch Global Research, Census Bureau

Chart 19: Home prices likely to fall further (S&P Case Shiller growth)



Source: BofA Merrill Lynch Global Research, S&P Case Shiller

Construction coming back … kinda

Historically, when thinking about the outlook for residential construction, the focus is on construction of single family homes. Prior to the housing crash, single family construction made up 55% of residential investment, but after the nearly 80% drop from the peak, it is now only 35%. Multifamily construction and renovations have become increasingly important. We believe this trend will strengthen next year and beyond.

We expect single-family housing construction to decline modestly next year as demand for new homes suffers amid competition from existing properties. Although activity will likely be down slightly on a growth basis, it should only translate to a few thousand homes given that single family housing starts are only running at a 425,000 annual rate. This weakness should be more than offset by a gain in multifamily construction. The boom in multifamily construction already started in the second half of the year, as we predicted back in March in The American Dream Home. Based on our forecast for the last two months of the year, multifamily starts are likely to be up about 50% from last year (Chart 17).

This sharp gain in multifamily construction is simple to explain: a shift from homeownership to renting increases demand for multifamily properties since most renters live in apartments. We expect the shift from owning to renting to persist for the next few years as a result of three factors. First, foreclosures will naturally transition many homeowners to renters. Second, it will be challenging for current renters to become homeowners given the drop in net worth and income. Third, we expect credit conditions to remain tight for some time. In our view, the homeownership rate is likely to stabilize at 64%, with a risk of briefly undershooting (Chart 18).

The construction sector should also receive some much needed support from an increase in spending on renovations, owing to the greater share of foreclosure sales. Since foreclose properties are typically in worse condition than the average existing home, they require more spending on home improvements. In addition, many homeowners who are underwater on their mortgage will choose to renovate their property – perhaps building additional space – rather than to sell at a loss.

The expected coming boom in multifamily construction and pickup in renovations spending are the two bright spots for the construction industry. Some of the 2.3 million construction workers who lost their jobs during this past recession will be able to find work. It is likely that this is already the case, but is not showing up in the statistics as most home improvement work is done by self-employed contractors. But even if some of the employment is happening in the “underground economy”, it is still adding to income growth and supporting consumer spending.

More price pain

National home prices have declined 33% from the peak in 1Q06 through 3Q11, returning to mid-2002 levels. In our view, this has left prices fairly valued relative to per capita income growth and rent prices. However, we expect prices to undershoot relative to fair valuation, declining another 7% from 3Q11 through 1Q13 (Chart 19). The model for this forecast is explained in detail in our recent comprehensive piece on the housing market. (Note, at the time of the report, we were forecasting an 8% drop Q2. With Q3 data released since, showing prices down 1%, close to our expectations; we are now looking for a 7% decline through 1Q13).

In the next few years, the most important factor when forecasting home prices is foreclosures. They enter the model in the form of months supply (inventory-to-sales ratio) and the share or distressed sales. Once these variables peak, which will happen when liquidations peak, home prices should find a bottom. In our view, this will occur in 2013, as can be seen by our forecasts for liquidations in Chart 20. But, if we are disappointed on the policy front and we fail to see a REO asset disposition plan, the pain will be dragged out and the bottom will come later.

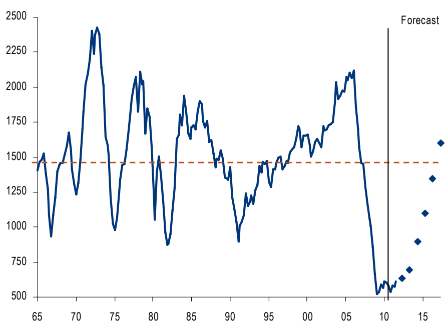
Waiting for a jolt

The housing crisis is far from over. Over the next two years, we should expect more of the same as the market struggles to clear foreclosures.

The good news is that we believe that absent another recession in the US, a recovery in housing is just a matter of time, but for the next two years the roads will likely still be treacherous. The biggest obstacle is to clear the excess inventory of foreclosures. The more efficiently this is accomplished, the faster the housing market will return to normal.

Once this hurdle is cleared, we believe the upside for the housing market will likely surprise many. As we outline above, the housing market has undershot in both construction and home prices. Housing starts have fallen sharply to the lowest since the data started in the early 1960s. Given the competition from distressed inventory and low household formation, such a feeble pace of construction is warranted. But, once household formation picks up, demolitions increase as a result of foreclosures, and much of the distressed inventory is cleared, housing construction should rebound.

Chart 20: Housing starts should turn in 2014
(millions of homes, saar)



Source: BofA Merrill Lynch Global Research, Census Bureau

We believe the most important factor will be household formation, which has slowed to about 550,000 a year since 2007 compared to a normal pace of 1.2 million. This means there is a great deal of pent-up household formation, which should be realized once the economy heals. In our view, housing starts will turn in 2014, picking up speed over the next 3-4 years to return to a normal pace of activity by 2017 (Chart 20). The increase in housing turnover should also support home prices. Based on our model, prices should start to turn higher in 2014, reverting to fair valuation by 2019. We expect average annual appreciation of 5% from 2015 to 2020.

The housing crisis is far from over, in our view. Over the next two years, we should expect more of the same as the market struggles to clear foreclosures, leaving downward pressure on home prices and sluggish single family housing construction. We are getting closer to the end, and when the market turns, we believe it will likely feel like a jolt. Fasten your seatbelts for what we expect will be a bumpy ride now and a big bounce later.

Sheryl King +1 416 369 8756

Canada

Euro *Sturm und Drang*

We expect the hard landing BofAML Global Research expects in Europe will shave at least 0.3ppt off 2012 GDP growth in Canada, with 1H flirting with outright contraction. And in our view, the growth and credit backdrop will prompt easing by the Bank of Canada (BoC). We expect the Bank will cut rates back to the effective lower bound of 25bp early next year from the current 1.0%. The policy easing will likely be temporary as persistent above-target inflation brings the BoC back to hiking rates in 2013.

Table 4: Forecast summary

	2011	2012	2013
GDP *(% change)*	2.4	2.1	2.6
Current Account *(% GDP)*	-2.7	-1.5	-1.8
Fiscal Deficit *(% GDP)*	-1.7	-0.9	-0.5
Overnight rate *(EOP)*	1.00	0.25	2.50
10-year note *(EOP)*	2.10	2.75	3.10

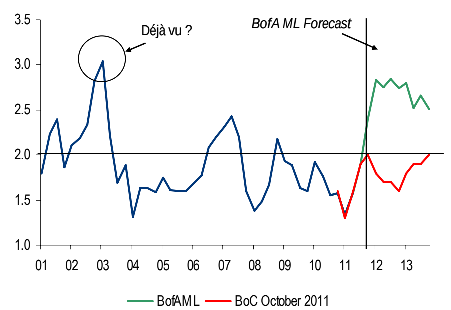
Source: BofA Merrill Lynch Global Research.

Growth: Uncertainty to cap capex

The uncertainty about the global outlook wrought by the Euro zone financial crisis will be the main drag on economic activity in 2012, not the direct trade links. We expect the uncertainty to manifest in reduced consumer spending on big ticket purchases and reduced business capital expansion and hiring plans.

We forecast that as the unemployment rate creeps up to 7.5% early next year, consumer spending will contract in 1Q and advance by just 1% in 2Q. Business investment in machinery and equipment should contract by about 6% on average over the second half of this year and 1Q 2012 as uncertain global demand curtails business expansion plans. Though exports will probably decline 3.5% in 1H, we do not believe the real trade deficit will widen significantly since the slump in domestic demand will also curtail imports. Commodity prices may not roll over sharply, so the current account will likely continue to shrink as a percentage of GDP, to about 2% by mid 2012 from 3.6% in mid 2011, in our opinion.

Chart 21: Inflation outlook
(year-over-year % change)



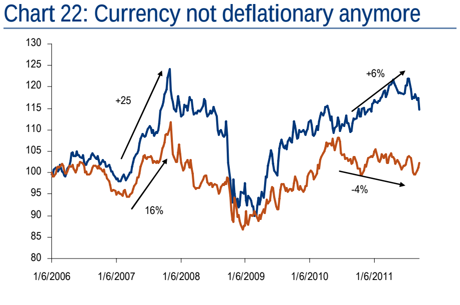
Source: BofA Merrill Lynch Global Research, Statscan, Bank of Canada

Even though rate cutes are ultimately positive for earnings growth and equity valuations, we estimate the weak demand backdrop will slow earnings growth to 6.4% from an expected 22% in 2011. However, equity valuations will be supported by an estimated acceleration in earnings in 2013 of 7.7%. This brings our top-down S&P/TSX 2012 EPS estimate to 910, and our 2013 EPS estimate to 980, implying a fair value S&P/TSX target of 13650 in 2011 and 14700 in 2012.

Inflation: Pass-through and pass-along

In spite of weakening consumer demand, in our view inflation will continue to press higher for at least the early part of 2012 as this year's commodity price surge is passed along and, more importantly, provincial governments boost taxes and fees to raise revenue.

Chart 22: Currency not deflationary anymore



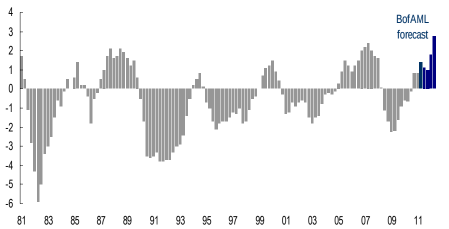
Source: BofA Merrill Lynch Global Research, Statscan

We expect core inflation to rise to 2.6% by the end of 2011 and crest at roughly 3% in 1H 2012. High commodity prices will likely keep headline inflation in this range as well. The starting point heading into the economic slowdown suggests inflation will be very slow to roll over. Even though GDP growth will slow in 1H 2012, the level of activity will probably stay above potential GDP, so will support retail prices. In addition, similar to US retailers, Canadian stores are cautious about the upcoming holiday season and intend to keep inventories quite lean to minimize discounting of post-holiday merchandise.

Regulated prices (13% of core CPI) – everything from drivers license fees and real estate taxes to university tuition – will probably undergo stiff annual price increases as governments continue to close budget gaps by increasing user fees and tax rates. And, consumer inflation shows much less offsetting influence from the strength of the currency on the price of imported goods. The Canadian dollar has appreciated by just 6% against the US dollar over the past year. Moreover, against non-US currencies, the dollar has actually depreciated over the last year – an important impediment to deflation at the consumer level given that 80% of consumer goods are imported from non-US sources.

Policy: Back to ZIRP

Chart 23: Economy to stay in excess demand (Output gap)



Source: BofA Merrill Lynch Global Research, Bank of Canada

Inflation will likely linger as a problem for the BoC, though it will not prevent the Bank from easing, in our view. With the Euro zone sovereign debt and banking crisis showing no sign of containment, we believe uncertainty will quickly morph into reduced economic growth. In response, the Bank of Canada (BOC) likely will cut rates back to the effective lower bound of 25bp early next year from 1.0% currently. Liquidity measures to ensure smooth funding in the Canadian financial system will likely be employed first, and perhaps by the end of the year.

Though we expect policy rates to drop to the effective lower bound early next year, policy is not likely to remain at that emergency accommodative level. Core inflation will probably remain above the 2% target in 2012, suggesting the Bank will not want to linger too long at emergency rate levels. As a result, we expect a rate hike very soon after the economy shows signs of stabilization, to ensure the Bank's credibility as an inflation fighter is protected. If the recovery is once more driven by consumer and housing demand, the Bank will want raise rates if only to dampen credit demand from an already over-levered household base.

Government cutbacks to be deferred to 2013

Fiscal policy will probably be less of a drag in 2012 than we predicted a year ago as the federal and provincial governments push plans to reduce spending into 2013 amid the growth economic uncertainty. There is a low probability the federal government will implement more active expansionary fiscal policy in the next 12 months, in our view.

Risks: Hope for the best, but prepare for the worst

Even an upside surprise on growth may still prompt a rate cut from the BoC. The pessimistic case of global recession and sharp drop in commodity demand would push the economy into outright recession, with GDP contracting by roughly 1.0%.

The uncertainty around our base case is wider than normal given how closely correlated the global outcome is to the political paralysis currently afflicting the Euro zone. In the more optimistic case, Canadian GDP would expand 2.5% in 2012 versus our base case of 2.1%. This case may reduce the amount of rate cuts the BoC delivers, but we would still lean toward monetary policy easing of 25 to 50bp as an insurance measure.

The pessimistic case of global recession and a sharp drop in commodity demand would push the economy into outright recession with a contraction of just under 1.0%, by our estimates. The one factor that remains in Canada's favor is that both the central bank and the federal government have more capacity to ease policy than in most developed economies. The downturn in the economy would likely exert downward pressure on core inflation, as an output gap of about 1.5% emerges by mid 2012. So in the pessimistic case, in our view the Bank would not only cut rates to the lower bound of 25bp, but it would redeploy non-conventional policy easing as well.

Laurence Boone +44 20 7995 6706

Euro area

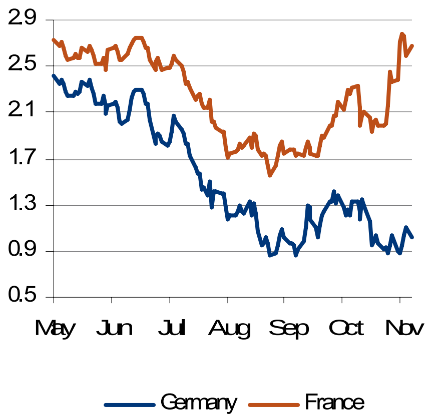
Walking on the edge of a cliff

The Euro area has entered a sort of limbo: the safety net for countries with funding difficulties cannot meet all the Euro area needs. As contagion has spread from small periphery countries to large ones, potentially threatening the core, Euro area governments appear unable to find a solution to prevent the crisis from spreading. The debate among Euro area policy makers has been reduced to a few options:

- Muddling through with the increasing risk that contagion spreads to the core countries and that investors factor in the risk of a default for some countries. This has the unpleasant effect of keeping banks away from market funding and remaining increasingly reliant on ECB liquidity provisions.
- Separation, with some countries finally admitting that structural divergence cannot be sustained in a monetary union framework and that deleveraging will be eased by currency devaluation. If some countries exit the euro, it would likely shake the foundations of the currency union, possibly threatening fragile countries which may have decided to stay. This would be a negative shock, at least in the short term, for most countries.
- Fiscal integration, with a roadmap for centralizing budgetary decisions. A Eurobond would be the carrot and would require implementation of Germany's economic model. In this scenario, yields would drop more rapidly as investor confidence returned, and public sector deleveraging would likely be eased. This would be a positive shock, boosting confidence across Europe and outside, even if it did not prevent the necessary deleveraging from proceeding thereafter.

Overall, there seems to be little accord across Euro area governments on a policy roadmap. They are torn between putting an end to the crisis (the means by which they cannot agree) and the desire to retain budgetary sovereignty. Meanwhile, the ECB errs on the side of sovereign bond purchases while refraining from indulging fully in QE, an option strongly rejected by Germany and other Northern European countries.

Chart 24: Contagion to core countries in 2011
Five-year government bond yields (%)



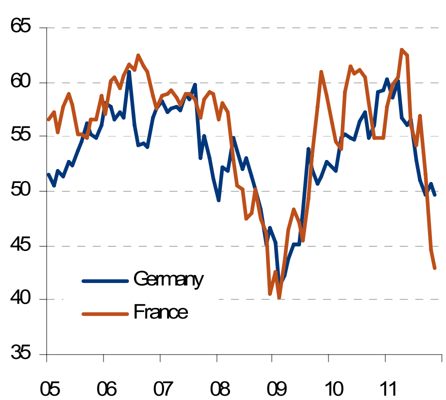
Source: Bloomberg, BofA Merrill Lynch Global Research. 5y sovereign yield.

Ineffective muddling-through the most likely scenario

Against this background of indecision, three headwinds are dampening Euro area activity: bank deleveraging, fiscal contraction and a drop in confidence.

- Deleveraging is likely to leave banks with minimal appetite to lend, with what little there is focused mainly on domestic markets. Estimates of bank deleveraging vary widely, but plans for around €1tn came out of our annual banks conference. In addition, funding difficulties both in the short and medium term may trigger more deleveraging as banks try to reduce their balance sheets further in order to match their funding capacities.
- Fiscal contraction is unevenly spread across Euro area countries (Table 5): it is greatest in the periphery (with Greece and Ireland tightening by 2.25ppt of GDP and more), while at the core, Spain and Italy still have to confirm their tightening efforts. France has embarked on tightening while Germany's fiscal policy is neutral, given that most of the change in its primary balance is due to a smaller output gap. Overall, Euro area countries are embarking on a fiscal adjustment of around 1.25ppt of GDP, which could reduce GDP growth by about 0.6 to 0.9ppt of GDP in 2012.

Chart 25: Confidence declining sharply



Source: Markit, BofA Merrill Lynch Global Research. Note: services PMI

Table 5: Change in primary government balance as a % of GDP from SGP and country budgets

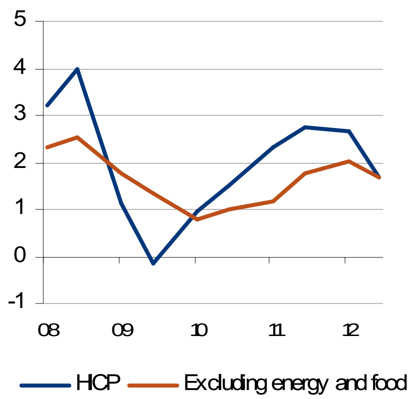
	Austria	Belgium	France	Germany	Greece	Ireland	Italy	Netherlands	Spain	Portugal	Euro area
2011	0.6	0.6	1.6	1.8	2.9	22.1	1.1	1.6	3.7	4.8	2.2
2012	0.6	0.6	1.3	1	2.4	2.2	2	1.6	1.4	2	1.3
2013	0.6	0.5	1.3	0.5	2.2	2.7	1.6	0.7	1	1.9	1
2014	0.3	1.1	1.2	0.5	2.6	2.8	0.6	0.6	0.9	0.7	0.8

Source: National stability programmes, BofA Merrill Lynch Global Research

- Waning confidence is the main factor undermining the economic outlook. Consumer and business confidence dropped sharply throughout the Euro area, and for some indicators is now akin to levels in 2008-09. This is why we believe all Euro area countries will post negative growth in the first semester of 2012, reducing cyclical divergence to some extent. But on the periphery, countries that have been in recession for a while would still be the most affected for fiscal reasons.

Given a sharp contraction in consumption and investment, we would expect unemployment to rise again and prices to decelerate more quickly than anticipated, and inflation to fall below the ECB's 2% target in 2012. Energy and food price volatility, together with fiscal adjustments often yielding VAT or administered price increases, mean we do not exclude some bout of volatility in headline inflation numbers over the course of the year.

Chart 26: Inflation set to decelerate
(year-over-year % change)



Source: Haver, BofA Merrill Lynch Global Research

Policy (re-)actions

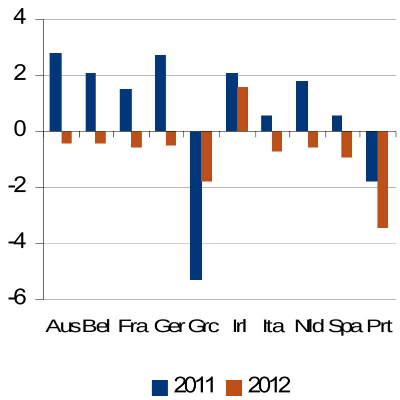
Policy makers in the Euro area have considerable room to take bold and decisive action, despite their apparent inertia. On the budgetary side, they could move toward central decision making, but that is unlikely to be a swift move. Several propositions to strengthen budget centralization have been offered by the European Commission and Germany's Economic Advisers Council. However, all would require treaty changes, albeit of varying magnitudes. The one institution that can react quickly is of course the ECB. We assume that the ECB will take decisive action to prevent a dangerous deterioration of the crisis, we think most likely when conditions appear to be at a tipping point.

Our central scenario is that the ECB will use its monetary tools to better effect by:

- Cutting interest rates to 50bp by February
- Possible further purchases of sovereign bonds to bring yields down along the entire maturity spectrum (though not to the extent decided upon by the Fed or the BoE).

The only restriction the ECB faces is on primary market sovereign bond purchases. But it could target the entire yield curve on the grounds that there is a risk of deflation, and purchase a basket of Euro area country bonds at different maturities. The ECB also has the option of trying to restore normal monetary policy transmission channels to ensure that longer term yields are maintained below a certain threshold (see What next for the ECB?). We assume that the ECB will act when faced with a worsening first half outlook, frozen interbank markets, the impediment to banks' medium term funding and possible deposit outflows, as well as weak sovereign auctions despite the fiscal measures. A trigger event could also be a worsening political outlook in Greece leading to a suspension of the Troika program.

Chart 27: Recession across the Euro area
Annual GDP Growth (%)



Source: BofA Merrill Lynch Global Research

ECB policy (re-)action would likely end the downward spiral in confidence, and lead to some stabilization of the Euro area economic outlook. However, imbalances remain unresolved in the Euro area, and are likely to continue to dampen growth prospects and keep trend growth below pre-2007 levels. As a result, we project that growth will stabilize only modestly on the back of monetary easing, with average second half 2012 growth 0.5% above that of the first half.

Risks

Two key risks could materialize in 2012, one positive, one negative, and both possibly arising from a sharp worsening of the Euro area debt (confidence) crisis. The positive outcome would be a swifter move toward fiscal integration and the prospects of a Eurobond. A bold move toward greater fiscal union with a detailed and clear timetable for its implementation on the basis of Treaty changes endorsed by all euro countries would boost confidence. Such an event should bring a return to higher growth, though recovery could take time, owing to structural unemployment and the lack of investment recovery so far (other than in Germany).

A negative outcome would be that the current practice of muddling through continues to the point where economic activity is even more seriously impaired, and there is no policy reaction. A full-fledged (banking) crisis could ensue.

How the ECB can purchase sovereign bonds within its mandate

In our view the ECB could proceed with QE without being accused of monetizing the debt as long as it does not target a specific sovereign, and argues on two fronts: either that deflation is a threat (essentially the Fed's argument for proceeding with QE), or that yield volatility disrupts the normal monetary policy transmission mechanism. In practice, this means yield targeting and/or buying a basket of sovereign bonds:

- Disruption to monetary policy transmission mechanism: the ECB would announce unlimited purchases of bonds to keep interest rates below a pre-determined level. The ECB would not necessarily need to announce its yield target

- Fighting deflation: the ECB would commit to purchasing a basket of all sovereign bonds including Germany's, together with a commitment to maintain interest rates at a very low level over the medium term (akin to the action taken by the Bank of Canada in 2009-10)

Nowhere in the treaty is there an obligation of sterilization, but the ECB argues that its price stability mandate provides the justification for sterilization. The strict obligation is that the ECB does not purchase bonds on the primary market.

However, for its economic theoretical beliefs, the ECB is reluctant to intervene when other options are available. Hence, we think that ECB interventions are likely to remain modest unless the Euro area crisis continues to deteriorate.

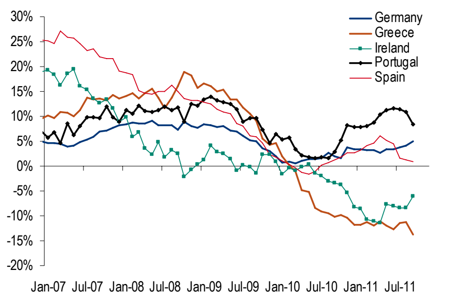
Gustavo Reis +1 646 855 6356
Laurence Boone +44 20 7995 6706

Hot topic: Sustainability risks

Europe is still failing stress tests

Europe is facing daunting risks. Ongoing bank deleveraging may not prevent (and may cause) a liquidity crunch. This would enhance the feedback loop between funding conditions for banks and sovereigns. Bank deposits have been shrinking in Greece and are threatening to ebb in Italy (Chart 28). Moreover, difficulties implementing adjustment programs could materialize again in Italy, Spain or Greece and pressure sovereign yields upwards. And, adding insult to injury, a downgrade of France would have a negative impact on the efficacy of the EFSF.

Chart 28: Bank deposit growth (%yoy)



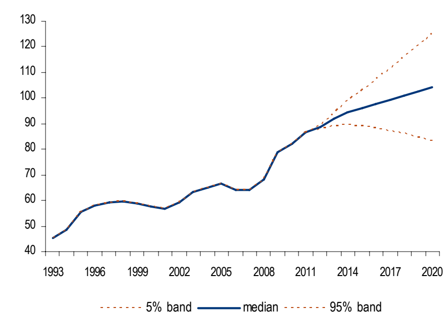
Source: Haver Analytics and BofA Merrill Lynch Global Research

As confidence deteriorates, the risk of a sharper contraction in H1 2012 is rising. Recalibrating our base case to reflect a confidence double-whammy would lead to a 2% GDP contraction in 2012 as opposed to our baseline 0.6% recession. We would not expect this contraction to extend into 2013 as we believe the ECB would step in forcefully with balance sheet expansion under such an adverse scenario. But the fast-paced deterioration in sentiment would still hinder the effectiveness of the eventual ECB rescue.

The complexity of the current crisis argues against neat predictions, especially when it comes to timing. We thus see significant risks to our base case, and many of these risks stem from the challenge of tightening fiscal policy alongside the need to restore competitiveness. The Euro area is a distinctive, historically unprecedented experiment, but fiscal adjustment with fixed exchange rates is not. The scenarios we simulate in the next section illustrate the interplay between low growth and fiscal sustainability, in a context of fixed exchange rate.

How sustainable is low competitiveness?

Chart 29: Debt sustainability risks in France (% of GDP; median scenario is not a baseline)



Source: BofA Merrill Lynch Global Research

During the Argentinean crisis the debate raged on the relative importance of the economy's overvalued real exchange rate versus the lack of fiscal discipline as the key impediment to growth. Time has failed to bridge the differences, as prominent local economists continue to diverge on what ultimately rolled the economy over[1]. But competitiveness and the fiscal stance are not independent. Tornell and Velasco (2000) for instance argue that fixed exchange rates in fact induce fiscal laxity. A recent review of FX regimes finds their reasoning "powerful"[2]. In Europe, this argument could be associated with the moral hazard created by low interest rates after peripheral countries joined EMU.

We therefore stress-test our fiscal sustainability scenarios taking into account the relationship between the level of real effective exchange rates, the interest rates, the growth rates and inflation. The idea is to generate a large number of alternative scenarios while making sure that all these numerous cases are economically plausible and consistent. A scenario of high growth, for example, would be incompatible with overvalued exchange rates and high interest rates. The goal, therefore, is to match financial risk management – generation of multiple scenarios – with economic plausibility[3].

1 Cavallo (2011), "Looking at Greece in the Argentinean Mirror", voxeu.org; Levy Yeyati (2011), "How Argentina left its Eurozone", voxeu.org.

2 Rose (2011), "Exchange Rate Regimes in the Modern Era: Fixed, Floating and Flaky", American Economic Review.

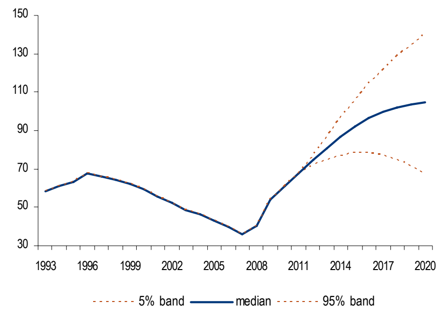
3 Garcia and Rigobon (2004), "A Risk Management Approach to Emerging Market's Sovereign Debt Sustainability with an Application to Brazilian Data", NBER working paper, WP 10336.

Following Garcia and Rigobon (2004) we estimate vector autoregressions and generate multiple forecasts of growth, inflation, interest rates and the real exchange rate for France, Italy and Spain. Feeding these forecasts to a debt sustainability model yields a wealth of possible debt paths, which illustrate fiscal risks based on coherent economic outcomes. The results suggest risks to debt trajectories are mostly skewed to the upside.

A deeply united Europe on the risks front

Our exercise reveals that debt sustainability risks are skewed to the upside in France (Chart 29). In our view, the biggest risk stems from a sharp rise in yields but another potential threat is contingent liability in the banking sector, as we highlighted in our recent note on France. Although the French government has laid out fiscal adjustment plans for the next few years, our exercise suggests that it should err on the side of more effective fiscal control and promotion of financial stability and stronger growth.

Chart 30: Long-run risks balanced in Spain (% of GDP)



Source: BofA Merrill Lynch Global Research

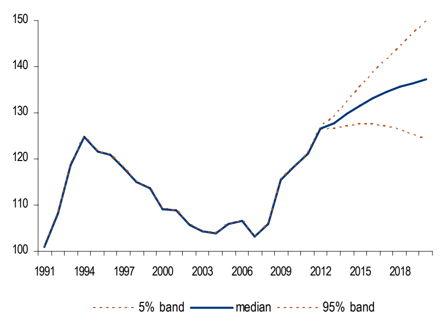
Spain is likewise facing upside risks to its debt trajectory, although most of the simulated debt paths tend to stabilize over the long run (Chart 30). But the potentially large bank recapitalizations needs pose clear short-term risks. In Italy, the results suggest that the recent pace of rising indebtedness is unlikely to continue. But risks to the debt path are skewed to the upside (Chart 31). As we have argued in our baseline analysis, Italian public debt looks sustainable if the fiscal effort is maintained. One important risk, thus, is the onset of fiscal fatigue. This would cap the fiscal effort at low primary surpluses, which would fail to stabilize the debt path.

All in all, these results illustrate the challenge of putting the fiscal house in order when the overall economy is under strain. One upshot is that Euro area leaders have been responding to the unfavorable balance of risks and stepping up their commitment to fiscal health. But on the other hand the multiple economic scenarios simulated here were based on historical correlations, whereas the alternative downside scenarios do not correspond to anything seen in recent history.

Policy uncertainty to remain high

Taking the long view, the current crisis could be seen as a stepping stone toward the EU's super-state status. But that lies in the hands of the EU Council. Back in 1955 EU founding father Jean Monnet went candid about the European project: "Is it possible to have a Common Market without federal social, monetary and macroeconomic policies?" Fifty-odd years later this was still the question market participants posed when the financial crisis struck. By late 2011, however, the Euro area's existential dilemma had become a rhetorical question. The ongoing debt crisis has made it clear that it is the deeper integration way or the highway. But whereas this acknowledgement provides a sense of direction, it does not answer whether governments will move forcefully and in a timely manner to weather the crisis. This uncertainty will likely continue to haunt investors in 2012.

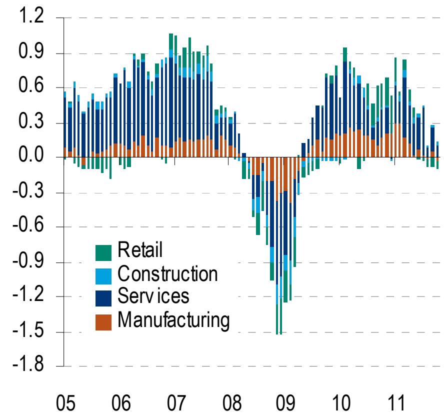
Chart 31: Slower indebtedness growth in Italy? (% of GDP)



Source: BofA Merrill Lynch Global Research

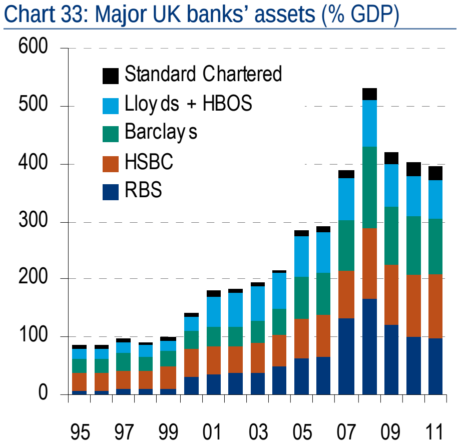
Nick Bate +44 20 7995 4262

Chart 32: Survey-based GDP growth indicator



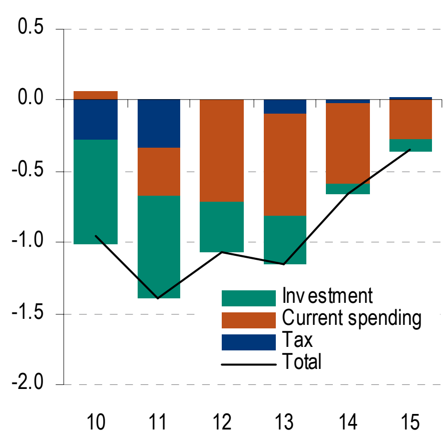
Source: BofA Merrill Lynch Global Research

Chart 33: Major UK banks' assets (% GDP)



Source: BofA Merrill Lynch Global Research, Individual banks, Bloomberg

Chart 34: Fiscal impact on GDP growth (ppts)



Note: Fiscal years. Source: BofA Merrill Lynch Global Research

United Kingdom

Renewed recession, but inflation finally falling

UK GDP growth was volatile through 2011, driven by effects from poor weather, the Japanese tsunami and the Royal wedding. But the underlying trend was weak, averaging 0.1% qoq in the year to 2011Q3. More recently, growth appears to have softened further, with evidence from the PMIs, for example, suggesting that output is broadly stagnant (Chart 32).

Looking ahead, the Euro zone sovereign debt crisis casts the greatest shadow over the UK economic outlook, in our view: it has raised stresses across the financial system significantly over the last few months, and has likely contributed notably to the renewed declines in business and consumer confidence. Moreover, the effects of the more-distressed financial system on the broader economy – most notably through tighter credit conditions – are yet to be fully felt, in our view. And of course, the Euro zone crisis is far from resolved.

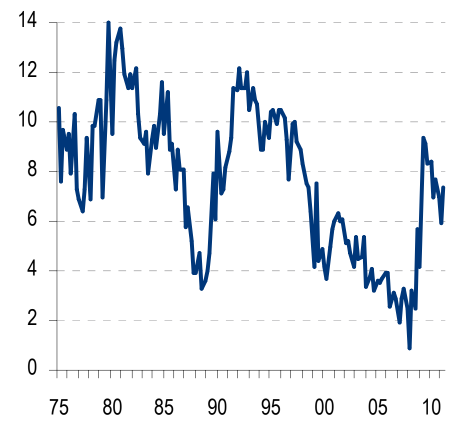
UK banks have deleveraged significantly since 2008, both through raising capital and reducing assets (Chart 33). But nevertheless, there is increasing risk of renewed credit tightening, which need not be driven by oft-cited funding concerns or attempts to further deleverage. Reductions in banks' own risk tolerance/appetite – perhaps attributable to deteriorating economic or bad debt expectations – could also contribute. At the same time, we expect deleveraging in the broader European banking sector to contribute to a recession in the Euro zone over the next few months: with the Euro zone directly accounting for around 45% of UK exports that will clearly weigh on UK growth prospects too.

Alas, alongside the UK's main export market in recession, prospects for UK domestic demand appear relatively weak. Fiscal tightening has imparted a notable underlying drag on growth over the last few quarters, and will continue to do so through 2012 (Chart 34). Sharp cuts in public sector jobs have contributed significantly to the renewed increases in aggregate unemployment in recent months, and as private sector firms adjust their workforces to the weaker growth prospects that have emerged since the spring, we expect the unemployment rate to rise above 8.5% over the next few months.

Strong CPI inflation – pushed up markedly by higher VAT, energy and import prices – has squeezed consumers' real incomes and real spending significantly over the last few quarters. While consumer spending in nominal terms has grown at around pre-crisis average rates since late 2009, in real terms it has declined over the last year. Looking ahead, significant easing in CPI inflation over the next few months should ameliorate the squeeze on real income and spending markedly. But nevertheless we expect real consumer spending to fall a little further as the labor market softens and households – with confidence very weak – take a relatively cautious approach to spending by maintaining their savings rates well above pre-crisis levels (Chart 35). Similarly, the corporate sector continuing to run large surpluses is consistent with companies taking a restrained approach to stepping up spending, and with capacity utilization below average and the demand outlook weak, we expect business investment to remain very soft over the next few quarters.

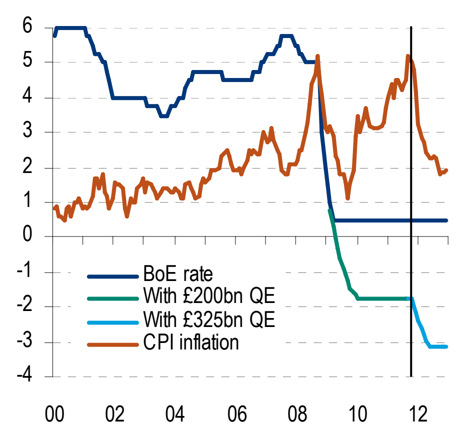
As a result, with the UK's main export market the epicenter of the crisis and UK domestic demand prospects also soft, we expect the economy to slip back into a minor recession over the next few months, with growth in 2012 as a whole only

Chart 35: Household saving ratio (%)



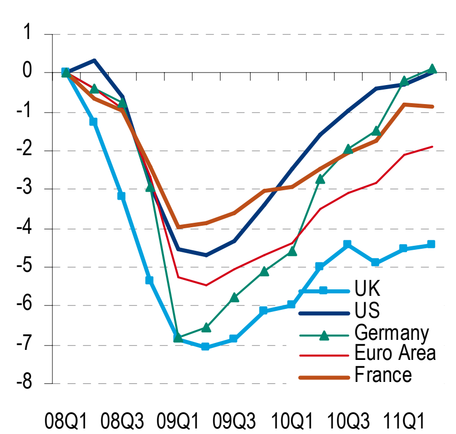
Source: BofA Merrill Lynch Global Research, ONS

Chart 36: Inflation and interest rates (%)



Source: BofA Merrill Lynch Global Research, ONS

Chart 37: Changes in GDP since 08Q1 (%)



Source: BofA Merrill Lynch Global Research, Haver

+0.3%. In due course though, we expect further monetary policy easing, ameliorating downward pressures on real incomes from declining inflation, and improvements in the Euro zone to result in the economy strengthening somewhat again through 2H 2012.

Inflation: Finally heading down after six years above target

CPI inflation has been above the BoE's 2% target for around 80% of the time since 2006, peaking at 5.2% in September. However, we expect significant declines over the next few months: as the effects of the sharp increases in petrol prices in late 2010 and early 2011 and the VAT rise in January 2011 fade, their combined impacts upon inflation could fall back by around 1.5pps by spring 2012.

More broadly, the robust increases in import prices since the start of the year could impart further upward pressure on CPI inflation ahead, in our view. However, set against that, with GDP expected to contract modestly over the next few months, a somewhat larger degree of slack in the economy seems likely to open up. That should dampen inflationary pressures, and overall, we expect CPI inflation to soften steadily through the remainder of 2012 after the sharp declines in late 2011 and early 2012.

Policy: Even more QE from the BoE

The BoE's November Inflation Report set out a clear case for adding to its current £275bn (18% GDP) QE program. Nevertheless, the minutes from the November meeting did not suggest that further expansion was imminent, in our view. But as the economy softens, CPI inflation falls back sharply and the current program of gilt purchases ends in January, we anticipate another £50bn of QE to be announced at the February meeting (Chart 36). Moreover, further expansions are possible beyond then, in our view. At the same time, there have not been signs recently of the BoE considering policies other than QE to loosen monetary policy further. For example, there have been no suggestions of cutting interest rates below 0.5%, or expanding purchases to private sector assets.

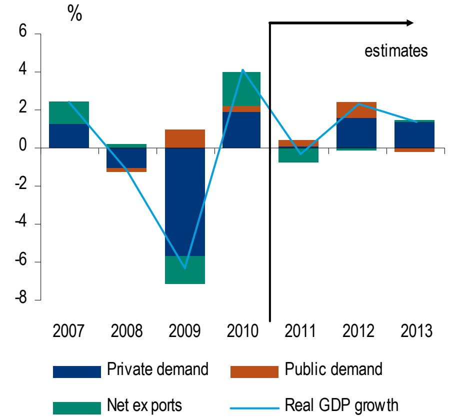
Risks: Anything other than the Euro zone?

The Euro zone sovereign debt crisis poses by far the greatest downside risk to the outlook, in our view. Our current forecasts envisage cumulative declines in GDP of around 1% in the main Euro zone economies (the Bad Euro zone risk scenario). However, alongside the financial crisis of 2007-2009, peak-to-trough falls in output were around 4-7% (Chart 37). Thus, a broadening and deepening of the crisis (the Ugly Euro zone risk scenario) could clearly have very severe implications. Even though the UK is not at the epicenter of the crisis, UK sovereign debt is currently perceived favourably, and UK banks have made significant adjustments already, a more severe recession in the Euro zone and greater stresses in the financial system could weigh heavily on the UK too.

Related to that, the risks are skewed toward the BoE being more proactive than our central forecast, in our view: expanding QE by more and/or earlier than our central projections. While we think there could be upside risks to CPI inflation from higher import prices and weaker-than-expected downward pull from spare capacity in the economy, those pressures will become more evident only over a longer time frame. In the shorter term, ongoing weakness in the economy and significant softening in inflation seem likely to prompt further monetary policy loosening in early 2012, in our view.

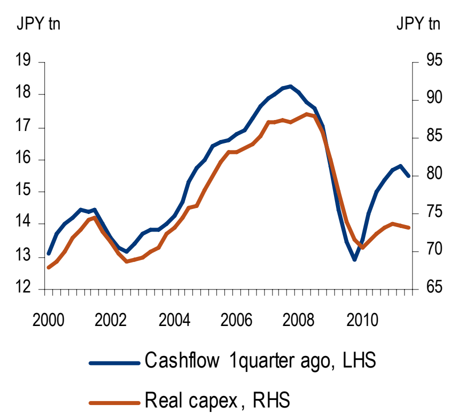
Masayuki Kichikawa +81 3 6225 8214

Chart 38: Composition of GDP growth



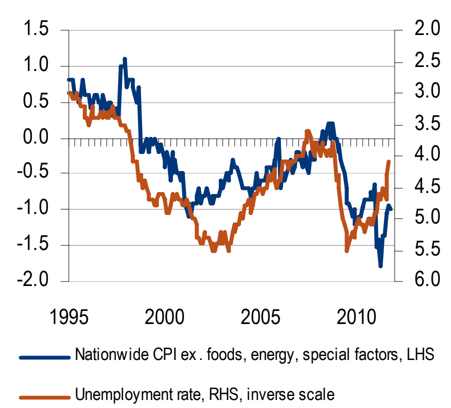
Sources: Cabinet office, BofA Merrill Lynch Global Research

Chart 39: Capex level remaining low



Note: Cash flow = recurring profit ×0.5 + depreciation
Source: MoF, cabinet office

Chart 40: Unemployment rate needs to decline below 4% for Japan to escape from deflation



Source: Statistics Bureau, BofA Merrill Lynch Global Research

Japan

The time for reconstruction and reform

Growth: reconstruction spending to give some resilience

We estimate that Japan's economic growth will return to positive territory at +2.3% yoy in 2012 as fiscal spending for reconstruction increases. The growth rate is likely to slow down to 1.3% in 2013 as the fiscal stimulus peaks out.

The March earthquake triggered supply constraints, and growth was negative in both 1Q and 2Q 2011. But growth rebounded to an annualized 6.0% in 3Q as supply constraints were overcome in the near term. We expect exports to soften through the end of 2011 as Euro zone economic weakness takes its toll. We estimate that growth will slow to just about flat in 4Q, keeping annual growth in 2011 in negative territory at -0.3%.

We expect exports to stop falling in 1H 2012 due to some pick-up in Asian economies as the impact of monetary easing comes through. Even then, however, we envisage a tug-of-war with the weakening European and US economies, and estimate external demand's contribution to the Japanese economy will be close to zero in 2012. That said, growth in the mid-2% range is feasible, in our view, boosted by domestic demand from two points: (1) a 0.7pp fillip to growth from fiscal policy as earthquake restoration budgets are implemented; and (2) something of a rebound in consumption, housing investment and capital expenditure as they return to normal after the declines triggered by the financial crisis and earthquake.

In 2013, the impact of fiscal stimulus will likely peak, and European and US economic recovery is likely to remain limited. But the post-crisis rebound in consumption and the increase in capex to deal with the labor shortage would support 1.3% growth, which is close to Japan's potential.

As a result of higher energy imports after the earthquake and the impact of yen appreciation, Japan's trade surplus likely has been reduced significantly to 0.0-0.5% of GDP. But Japan still has more than ¥550tn in external financial assets and will continue to have an income surplus larger than 2% of GDP. We still project current account surpluses of ¥11.1tn (2.4% of GDP) in 2011, ¥11.4tn (2.4%) in 2012 and ¥12.9tn (2.7%) in 2013.

Inflation: deflation to continue but moderate toward 2013

We expect the output gap to narrow in 2012 if growth is close to the baseline forecast, but it will not be enough to end deflation, in our opinion. We forecast core-core CPI (excluding energy and food) will remain at about minus 0.5% yoy because it cannot turn positive until unemployment falls below 4%, and, the yen's appreciation during 2011 will impact prices after a time lag.

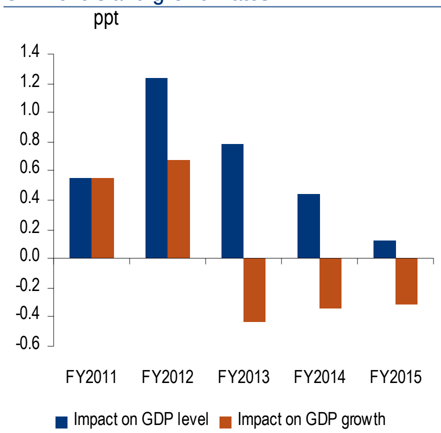
Our baseline scenario for 2013 is that deflation moderates and approaches zero. After more than a decade of deflation, the gap between domestic and overseas prices has narrowed to a degree. We would expect deflation to moderate after 2012 provided the yen retreats from its recent highs. We expect the supply-side factor of a faster decline in the working population as the post-war baby boomer generation turns 65 to be a further contributor to weakening deflationary pressure, as it means less slack in the labor market.

Table 6: Outlook for current account surplus and budget deficit (% of GDP)

	2011	2012	2013
Current account surplus	2.4	2.4	2.7
Budget deficit	10.8	8.8	8.5

Note: Current account balance is on calendar year basis. Budget outlook is on fiscal year and general government basis.
Source: BofA Merrill Lynch Global Research, MoF, Cabinet office

Chart 41: Impact of reconstruction budget on GDP levels and growth rates



Source: BofA Merrill Lynch Global Research, MoF, Cabinet office

Table 7: Sensitivity of Japan's GDP growth to risk factors (%, pp)

	Rate of change		Effects on Real GDP
US growth rate	1.0	→	0.3～0.4
EZ growth rate	1.0	→	0.3～0.4
China growth rate	1.0	→	0.2～0.4
JPY effective ex rate	10.0	→	0.5～0.6
JPY/Euro	10.0	→	0.05～0.1
Change in foreign reserve* of major emerging countries	$100 bn	→	0.3～0.4
Public investment	10.0	→	0.3～0.4
Oil price	20.0	→	0.1～0.2
Electric power shortage	1.0	→	0.1～0.3
World exports	1.0	→	0.1～0.2

*BRICs + Korea
Source: Source: BofA Merrill Lynch Global Research

Policy

Monetary policy: no exit

In 2012, we would not rule out the possibility of the Bank of Japan expanding its asset purchase program or taking additional quantitative easing measures, considering the possibility of additional Fed quantitative easing and yen appreciation. Even in 2013, we do not anticipate the Bank of Japan exiting from its quantitative easing, as the inflation/deflation rate is likely to stay close to zero.

Fiscal policy: reconstruction first

The Japanese government has decided to put aside ¥19.0tn for "the five-year intensive reconstruction period (2011-15)," which is four times larger than the government spending on the Kobe earthquake (¥5.02tn). We estimate reconstruction spending peaks in 2012 and increases growth by 0.7pp. In 2013, we expect fiscal policy to begin to contribute negatively to growth rate (-0.2pp for 2013 and -0.4pp for FY2013) as reconstruction spending peaks.

We expect the debate over tax and social security reform to intensify, as the Noda administration plans to submit legislation to raise the consumption tax to the ordinary session of the Diet (January-June 2012). But the actual consumption tax rate hike is likely to come only after 2014, or later depending on the result of the general election to be held in August 2013 or earlier. As a result, we forecast the budget deficit (general government basis) to remain very high at 10.8% of GDP in 2011, 8.8% in 2012 and 8.5% in 2013.

Sovereign debt crisis for Japan?

One question is whether Japan would be allowed to increase fiscal spending for expansion while only reforming the tax system gradually. We believe any fiscal crisis such as sharply rising long-term interest rates can be avoided during the forecast period because domestic investors, which hold more than 90% of JGBs in issue, are unlikely to embark on large-scale bond sales amid ongoing deflation. Also, any move toward a weaker yen would reinflate the country's trade and current account surplus (Japan's savings as an overall nation, seen from a different perspective), so it is still structurally capable of covering a budget deficit.

Risks: US-EZ scenarios, the yen, oil prices, baby boomers

The above projections reflect the baseline projection for the US and European situation – Bad with a recession but not a full-blown crisis. In a Good scenario, higher growth in the US and Euro zone would lead to stronger exports, as well as some yen depreciation, and Japan' growth rate would accelerate to 3.5% in 2012. For an Ugly scenario, in addition to the influence of negative growth in the US and Euro zone, significant capital outflows from emerging economies would depress the global growth. Combining the impact of yen appreciation, we estimate Japan's growth rate would sink to -1.0% in 2012 in this scenario.

The above projections also reflect our expectations that the Bank of Japan gears up its monetary easing policies and halts yen appreciation at or near to ¥75/US$, leading the yen to soften to some degree in 2H 2012. If the Bank of Japan fails to take action, a higher yen would depress Japan's growth rate. A sharp rise in oil prices would not only hurt growth but also lead to a significant shrinkage of Japan's current account surplus, and could trigger a debt crisis for Japan.

On the other hand, in our opinion, upside potential lies in a better-than-expected improvement in the labor market as the baby boomer generation, which will begin to reach 65 in 2012, retires from the labor market and reduces the deflationary pressure more than expected.

Alberto Ades +1 646 855 4044
Vasileios Gkionakis +44 20 7995 0143
Isidore Smart +1 646 855 8083

Global Emerging Markets

The sum of all fears

The recovery in developed economies is sputtering, and our economists forecast only 1.3% growth next year. This comes on the back of a weaker-than-expected 2011 macro backdrop due to the Japanese supply chain disruptions, the 1H surge in oil prices and the deepening European debt crisis. Growth in 2012 will be hampered by continued austerity in Europe and political uncertainty and fiscal headwinds in the US; and this growth malaise will likely weigh on GEM activity through the export and financing channels.

The combination of lower growth in developed economies and moderately high commodity prices places GEMs in a difficult position.

Our global commodity strategists expect oil demand to remain on a softening path into early next year as global growth heads lower and lost Libyan supplies slowly come back on line. This should still leave oil prices averaging above $100/bbl in 2012, creeping higher throughout the year. Likely global monetary easing will also place upward pressure on commodity prices as central banks look to improve liquidity conditions in the face of a global downturn.

The combination of lower growth in developed economies and moderately high commodity prices places GEMs in a difficult position. We expect slowing growth will be the main concern of investors and policy makers, especially as they digest events in Europe. Historically, the US has been the center of attention for capital markets. However, we expect Europe will likely continue to grab the headlines as the high level of debt maturities in 1H12, bank deleveraging and austerity drive the region into recession next year. Support from positive US data will also likely subside; our US team expects sub-2% growth in 1H and a subsequent weakening in 2H as political uncertainty and fiscal tightening concerns increase.

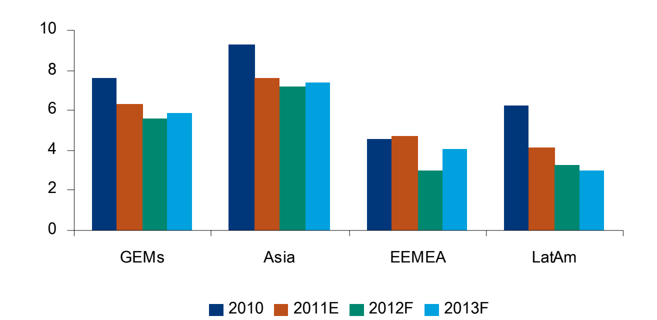
GEM growth heading lower in 2012

We see downside risks to our growth forecasts heading into a tumultuous year.

We expect GEM GDP growth to slow down to 5.5% in 2012, from 6.3% in 2011. The slowdown will be partially due to domestic factors, as monetary policy was tightened earlier this year to deal with the resurgence in commodity prices. However, external factors should play a large part as well; export growth will be muted next year primarily due to the slowdown in global activity and strains in financing channels.

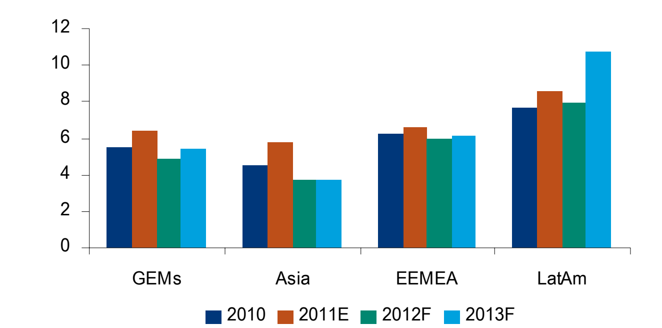
While developed market growth shocks result in less persistent effects on GEM growth, emerging markets are not completely immune; exports remain a sizeable part of GEM GDP and, importantly, financial linkages have increased. We see downside risks to our growth forecasts heading into a tumultuous year.

Chart 42: GEMs growth slowing into the new year ...



Source: BofA Merrill Lynch Global Research

Chart 43: ... as well as inflation



.Source: Bloomberg, BofA Merrill Lynch Global Research

All regions will slow down in 2012, by our estimates, but Asia should remain the most resilient, with growth slowing 40bp to 7.1%. We expect LatAm to decelerate 90bp to 3.3% and EEMEA's growth rate to slow the most by 190bp to 3.0%. With the Euro zone contracting 0.6% next year, EEMEA will be the most affected region due to its significant export and financial ties with developed Europe. For GEM-10 (the 10 largest GEM economies in GDP terms), we expect growth to decelerate to 6.1% in 2012, from 6.8% in 2011.

Inflation peaking across GEMs

We see risks to our inflation forecasts tilted to the downside as the risk of a more pronounced global slowdown remains substantial.

While our commodities team expects average prices to stay relatively high, we think slower growth will drag GEM inflation down to 5.4% in 2012, from 6.5% in 2011. We see risks to our inflation forecasts tilted to the downside as the risk of a more pronounced global slowdown remains substantial. This would place downward pressure on inflation in the shorter term, though upside risks could materialize down the road as the likely monetary easing response would push commodity prices higher. Although highly unpredictable, the impact on food and energy prices due to weather risks should also be watched closely.

We expect the largest inflation decline in Asia as headline eases 160bp to 4.2% in 2012. We expect inflation in EEMEA to fall 50bp to 6.3% and LatAm inflation to rise a slight 10bp to 8.6%. The "momentum" of our 2012 inflation forecasts has been flat with no revision to our GEMs aggregate over the past month. We raised our LatAm and EEMEA forecasts by 70bp and 10bp, respectively, largely on the back of idiosyncratic issues in countries like Argentina and Turkey. However, we lowered our Asia forecast by 40bp as slower exports lead to weaker activity, and therefore lower inflation.

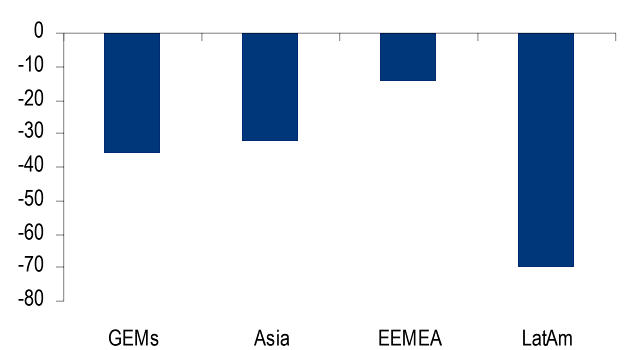
Policy makers to the rescue

We think policy makers have ample room on the monetary, fiscal, macro-prudential and FX fronts to help protect their economies from external shocks.

With growth risks firmly to the downside and inflation peaking, we think policy makers have ample room on the monetary, fiscal, macro-prudential and FX fronts to help protect their economies from external shocks. Monetary policy will likely be the first line of defense, and we expect an average of 36bp in cuts across the GEM central banks we follow. LatAm has hiked the most aggressively during the recovery; therefore, we expect them to be the most dovish.

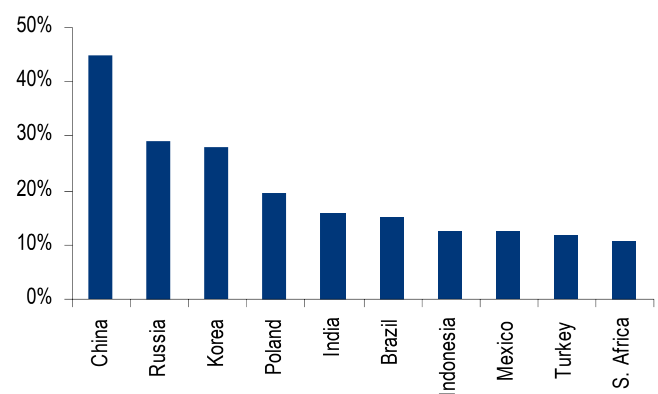
Monetary policy easing will likely be followed by easing macro-prudential regulations. The numerous RRR hikes, financial transactions taxes, and more stringent lending standards could be repealed in an effort to support growth through an easing of credit availability and a boost to confidence through asset price appreciation. On the FX policy front, the substantial buildup in FX reserves will allow central banks to smooth the volatility caused by risk aversion induced FX sell-offs.

Chart 44: Expected monetary policy rate changes (in bp)



Source: BofA Merrill Lynch Global Research

Chart 45: FX reserves across GEM-10 (as % of GDP)



.Source: Bloomberg, BofA Merrill Lynch Global Research

On the fiscal front, GEM policy makers have some room to ease since fiscal balances have improved from crisis lows. However, GEMs entered the 2008-09 crisis with a deficit of 1.2% of GDP, versus the 2.5% deficit we expect for 2011.

Risks to our baseline forecasts

As policy uncertainty, fiscal austerity and bank deleveraging in the developed world increase next year, GEMs will unlikely escape unscathed.

While our baseline view for 2012 is already fairly negative, we continue to see downside risks to our forecasts. Although policy makers in GEMs have room to shelter (to some extent) their economies from external risks, the potential combined shocks coming from the US and Europe next year could be quite large. The recent policy discord on both sides of the Atlantic does not seem like it will dissipate with the coming of a new year. As policy uncertainty, fiscal austerity and bank deleveraging in the developed world increase next year, GEMs will unlikely escape unscathed. In particular, we see risks to GEMs stemming from:

- **The European crisis moving further to the downside.** If European policy makers continue with reactive and temporary fixes to the debt problems in 2012, the situation will likely continue to get worse, even going into 2H12. This should result in bank deleveraging, periphery-to-core capital flight, recession and reform fatigue becoming entrenched. While in our base case we expect the crisis to worsen in 1H and lead to some form of fiscal union or ECB purchases, there is also real potential for policy discord and a break-up of the Euro zone. This would likely result in a significant EMFX sell-off, with curves also steepening across the board.
- **A hard landing in China.** While we expect a soft landing in China, with GDP growing 8.6% in 2012, we see growing risks from Europe and the domestic property sector. Should the European crisis develop similar to the Lehman bankruptcy, without stimulus we think China's growth could slow to 6.6% next year. Domestically, large inventory build up and declining demand due to policy measures have increased the risk of a sharp decline in the property sector. In the event of a downward spiral in property prices and sales volumes, we would expect GDP growth of 7.0%. Policy rates would likely be lowered, and curves would steepen in such scenarios.
- **Possible upside surprises in the US.** Depending on the combination of political decisions and the likelihood of further monetary stimulus, the US could continue to surprise on the upside as it has in 2H11. Growth expectations for next year are already quite low (our US colleagues only forecast 2.0% growth), so we think there could be room for activity data to surprise higher. We view this as a positive tail risk, and if it materializes, we would expect real activity in LatAm and CEE to benefit, and BRIC FX correlations to the EUR/USD to increase.
- **Where will oil be in 2012?** In our base case, oil averages slightly above $100/bbl next year, but demand shocks could provide surprises in both directions. With supplies tight, and central banks easing to cushion their economies from global growth, oil prices could move higher next year. Within GEM-10, we think Turkey and Korea would be the most exposed, while domestic demand in China and Indonesia provide some cover. Of the oil exporters, we believe GCC countries remain the safest and Venezuela offers the highest beta. However, a more severe global downturn would likely send prices sharply lower, hurting exporters while providing some support to importers in Asia.

Hak Bin Chua +65 6591 0409

Emerging Asia

Weathering turbulence

The year 2011 has been tumultuous. Asia was severely affected by Japan's earthquake in March, with disruptions to the auto and tech supply chain, followed by the US debt ceiling debacle in August and Europe's worsening sovereign debt crisis. And 2012 will probably be as turbulent. The Water Dragon looks set to usher in plenty of thunder and lightning. We expect a meaningful slowdown, but no recession: emerging Asia GDP is forecast to expand 7.1% in 2012, down from 7.5% in 2011 (Table 8). China (+8.6%), India (6.8%) and Indonesia (+6%) remain anchors; we forecast most of the rest will grow at below 4%. Several themes will likely dominate in 2012.

Table 8: Emerging Asia's latest GDP forecasts

	2010	2011	2012	2013
GDP Growth (yoy)	Actual	F'cst	F'cst	F'cst
Emerging Asia	9.3	7.5	7.1	7.4
China	10.3	9.2	8.6	8.5
Hong Kong	7.0	5.1	3.9	4.6
India	8.5	7.0	6.8	7.6
Indonesia	6.1	6.4	6.0	6.3
Korea	6.1	3.8	3.6	4.3
Malaysia	7.2	4.8	3.6	5.0
Philippines	7.3	3.7	4.4	5.9
Singapore	14.5	4.5	2.8	4.0
Taiwan	10.9	4.4	3.2	4.4
Thailand	7.8	1.8	4.0	3.9

Source: BofA Merrill Lynch Global Research, CEIC

Water Dragon year: plenty of thunder and lightning

Europe's slide into recession and escalating debt crisis will hurt Asian exports and increase financial stress. Our Europe team is forecasting three negative quarters, starting from 4Q 2011. Negative impact from trade on Asia is more quantifiable. Europe is Asia's largest trading partner, accounting for 16.8% of emerging Asia's exports and 5.2% of Asia's GDP (Table 8). Europe makes up a large share of exports for China (21.2%), India (19.2%) and Singapore (14.1%).

Table 9: Emerging Asia's CPI forecasts

	2010	2011	2012	2013
CPI inflation (yoy)	Actual	F'cst	F'cst	F'cst
Emerging Asia	3.6	4.7	3.8	3.6
China	3.3	5.5	3.5	4.0
Hong Kong	2.4	5.2	4.5	3.9
India	9.5	8.8	7.2	6.5
Indonesia	5.0	5.4	4.7	5.0
Korea	3.0	4.4	3.2	3.0
Malaysia	1.7	2.9	2.6	3.0
Philippines	3.9	4.4	3.3	3.8
Singapore	2.7	5.2	3.6	2.7
Taiwan	1.0	1.5	1.6	1.5
Thailand	3.3	3.9	3.4	3.0

Source: BofA Merrill Lynch Global Research, CEIC

Negative impact via the financial channel is less easy to quantify because Europe's bank deleveraging could be a long, drawn out affair. Risk of a bank crisis could trigger a sudden freeze in credit markets and hit Asia harder. European bank claims on emerging Asia stand at US$1.4trn, accounting for 12.6% of Asia's GDP (Table 9). European bank claims are disproportionately concentrated in Hong Kong and Singapore, given their financial hub status, but most of the funding is destined for the immediate neighborhood. As a percentage of GDP, European bank claims are also high for Malaysia (25%), Taiwan (21.3%), Korea (18.7%) and India (9.2%). European banks have a large presence in trade financing, and disruptions could hurt Asian trade volumes and growth significantly.

Table 10: Asia's Exposure to Europe

	Exports to Europe			*Exposure to European banks		
	US$bn	% of Total Exports	% of GDP	US$bn	% of GDP	% of FX reserves
Emerging Asia	571.7	16.8	5.2	1,382	12.6	29.5
China	334.7	21.2	5.6	264	4.4	9.3
Hong Kong	8.3	11.0	3.7	360	160.1	134.1
India	42.8	19.2	2.5	159	9.2	59.4
Indonesia	17.8	11.3	2.5	36	5.1	40.4
Korea	56.8	12.2	5.7	187	18.7	65.3
Malaysia	23.7	11.9	10	59	25.0	62
Philippines	7.1	13.7	3.8	15	8.2	28.4
Singapore	25.8	14.1	11.6	186	83.3	82.2
Taiwan	33.8	12.3	7.8	92	21.3	24.1
Thailand	21.0	10.8	6.6	23	7.3	14.1

Note: Figures for exposure to European banks are as at June 2011.
Source: BofA Merrill Lynch Global Research, BIS, CEIC

Room for monetary and fiscal easing in 2012

Asia is expected to step up monetary and fiscal easing in 2012. Growth concerns will likely outweigh inflation risks. Only Indonesia, Singapore and Thailand have eased monetary policy so far. We expect Asian central banks to cut policy rates in India (-100bp), Indonesia (-50bp), Malaysia (-50bp), the Philippines (-50bp) and

Thailand (-25bp). Central banks in Korea and Taiwan may stay on hold. Asian governments also have ample room to respond fiscally given healthier balance sheets. Several Asian governments have unveiled more aggressive fiscal budgets or measures, including Malaysia, Thailand and Philippines. Singapore and Indonesia have signaled that fiscal measures are in the pipeline.

Table 11: Emerging Asia's policy rate path

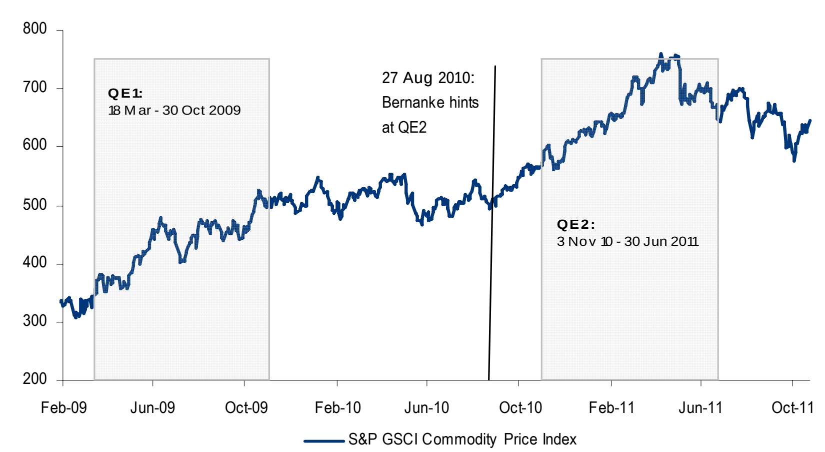
Policy rate (%, eop)	Current	2011 F'cst	2012 F'cst	2013 F'cst
China	3.50	3.50	3.75	4.00
Hong Kong	0.30	0.25	0.45	0.55
India	7.50	7.50	6.50	6.50
Indonesia	6.00	6.00	5.50	5.50
Korea	3.25	3.25	3.25	3.75
Malaysia	3.00	3.00	2.50	2.50
Philippines	4.50	4.50	4.00	4.00
Singapore	0.38	0.40	0.50	0.50
Taiwan	1.88	1.88	1.88	1.88
Thailand	3.25	3.25	3.00	3.00

Source: BofA Merrill Lynch Global Research, CEIC

We expect China to continue its "loose fiscal, tight monetary" policy. But policies will likely turn increasingly pro-growth, given fading inflation risks, with some fine tuning of the current tight monetary stance (China: Macro themes and policies in coming months, 22 Nov 2011). The reserve requirement ratio could be cut by 150bp, while policy rates could be asymmetrically hiked (+25bp in one-year deposit rate and +15bp in one-year lending rates). Annual target of new bank loans could be set at around RMB7.6trn, generating +13.9% loan growth in 2012. Fiscal policy will likely be more proactive, with higher infrastructure investment. But structural reforms may take a back seat, as conservatism typically sets in during major leadership changes. The RMB will likely appreciate at a slower pace in 2012, by our estimates, reaching 6.20 against the US$ by year-end 2012.

Asian central banks remain mindful of inflation risks (Table 9). Inflation is forecast to fall to 3.8% in 2012 from 4.7% in 2011, but will likely remain somewhat stickier than past downturns. Oil prices have not fallen as sharply compared to 2008 so far. A possible QE3 in the US, coupled with the ECB being forced to act as lender of last resort, is also raising concerns that Asia may face pressures from capital inflows and rising commodity prices longer term. Upside inflation risks include fuel subsidy cuts (Indonesia, Malaysia and Thailand) and higher food prices because of adverse weather conditions (La Nina, Thai floods).

Chart 46: Will QE3 in 2012 deliver another boost to commodity prices?



Source: BofA Merrill Lynch Global Research

End-game: QE in US and Europe

Our US team forecasts a 50% probability of QE3 over next the six months, with Operation Twist ending in June 2012. G3 fiscal policies are constrained, given political pressure to downsize public debt and deficits. QE appears to be the policy end-game, especially given the painful adjustment from fiscal austerity. QE may not be a silver bullet for US growth or jobs, but has historically done a good job of delivering higher commodity prices and capital inflows into Asia. Past QE episodes have also weakened the US dollar and lifted Asian – especially Southeast Asian – currencies. The ECB faces a stark choice if a financial crisis erupts in Europe. Explicit monetary easing from an ECB QE could further fan the Fed's QE policy, re-igniting capital inflows and re-stoking inflation pressures in Asia in the second half of 2012.

Asia: Resilient balance sheets

Asia has not decoupled and remains vulnerable to a US or Europe recession. But a healthy balance sheet should help Asia weather the downturn and turbulence, with little risk of wider systemic impact, in our view. Public debt ratios generally have declined over the last five years for most of Asia – especially those coming from higher leverage ratios – including Indonesia, Philippines, Thailand and India (Table 12). Asia still runs current account surpluses, except for India (and probably Indonesia next year). Foreign reserves have ballooned over the last five years, more than tripling in the case of China, Thailand, Philippines and Indonesia. External debt ratios have declined across Southeast Asia.

Table 12: Asia - Resilient balance sheet (2005 & Latest)

	Public Debt (% GDP)		CA Balance (% GDP)		FX Reserves (US$ bn)		***Domestic Credit/ Loans (% GDP)		**Household Debt (% GDP)		Fiscal Balance (% GDP)		Foreign Ownership of Govt Bonds (%)		Gross External Debt (% GDP)		Govt Debt, Foreign (% GDP)	
	2005	2Q11	2005	2Q11	2005	3Q11	2005	2Q11	2005	2Q11	2005	2010	2005	3Q11	2005	2Q11	2005	2Q11
China	17.6	18.5	5.9	4.0	819	3,202	105.4	125.0	11.9	20.6	-1.2	-2.1	…	…	12.4	8.6	1.5	0.6
Hong Kong	1.7	0.6	11.4	6.1	124	277	140.0	182.1	56.2	60.9	1.0	4.2	…	…	255.6	385.4	0.9	0.6
India***	58.0	49.1	-1.4	-2.7	131	276	44.8	53.9	13.8	13.0	-4.0	-5.1	…	0.9	17.3	18.8	5.6	4.1
Indonesia	47.3	26.1	0.1	0.6	35	115	25.2	29.6	11.7	15.3	-0.5	-1.5	8.1	30.9	45.8	28.6	23.6	11.7
Korea	28.6	32.9	2.2	2.5	210	296	71.6	84.0	64.2	72.5	0.4	1.0	…	18.4	19.1	36.8	1.3	0.8
Malaysia	43.8	49.1	15.0	11.5	71	146	107.2	119.1	54.6	57.4	-3.6	-5.6	4.9	34.6	37.8	30.5	5.7	2.1
Philippines	78.8	57.6	2.0	4.1	19	75	37.7	39.3	3.2	5.2	-2.7	-3.7	…	…	52.8	28.8	39.8	22.1
Singapore*	95.8	98.8	21.1	20.9	116	234	115.0	124.0	71.1	66.4	-0.3	-0.9	…	…	175.0	241.1	0.0	0.0
Taiwan	30.2	33.5	4.8	8.4	253	389	132.6	147.7	62.5	67.9	-0.1	-3.1	…	…	23.8	24.4	3.8	1.6
Thailand	46.5	40.7	-4.3	4.7	52	180	78.3	92.4	14.4	26.8	0.1	-0.3	3.1	10.7	33.7	32.7	6.6	2.0

Note: *Singapore's high public debt is due to development of bond market, not finance deficits. **Singapore's household debt includes HDB housing loans; flat buyers are given the option to borrow from HDB at a prevailing concessionary rate of 2.6%, which is revised every quarter; ** *Domestic credit and household debt figures based on 2010 for India and Philippines. Singapore and Hong Kong gross external debt and domestic credit ratios are high because of their financial hub status.
Source: BofA Merrill Lynch Global Research estimates

Points of vulnerability include larger fiscal debt and deficits in India and Malaysia; high foreign ownership of local currency bonds in Malaysia, Indonesia & Korea; and relatively high and rising household debt in Korea, Taiwan, Singapore, Hong Kong and Malaysia. High gross external debt in financial centers Hong Kong and Singapore highlights the possible negative impact on Asia if US$ funding stress worsens. Korea has also seen an increase in gross external debt in recent years.

Table 13: Bull & Bear Scenarios in 2012

	Baseline	Bull Case	Bear Case
Probability	50%	10%	40%
US	1.8	2.5	-0.5
Europe	-0.6	1.0	-2.5
EM Asia	7.1	7.8	5.7
China	8.6	9.2	7.5
Hong Kong	3.9	4.5	1.7
India	6.8	7.5	6.0
Indonesia	6.0	6.8	4.5
Korea	3.6	4.4	1.8
Malaysia	3.6	5.8	-1.0
Philippines	4.4	5.2	3.7
Singapore	2.8	5.0	-3.0
Taiwan	3.2	4.2	1.2
Thailand	4.0	5.0	1.5

Source: BofA Merrill Lynch Global Research estimates, CEIC

Risks: Europe financial crisis, US double dip

Tail risks are fat in 2012. Our global economics team assigns a 40% probability to a bear case scenario – a deep recession in Europe (-2.5%) coupled with a double-dip recession in the US (-0.5%). Asia would see a much bigger negative shock if the bear case materializes, with EM Asia growth falling to an estimated 5.7% in 2012. China's growth could fall sharply to 7.5%, which, for some, counts as a hard landing. Singapore and Malaysia would likely fall into recession, while in Taiwan, Korea, Hong Kong and Thailand, growth could slip below 2%.

Negative impact from global downturns on Asia historically is magnified in US and global recessions compared to slowdowns. That amplification is partly due to stress created by financial linkages and contagion, going beyond trade channels. Even small financing gaps in fiscal (India, Malaysia) or current account deficits (India, Indonesia), and foreign currency debt exposures (Korea, Thailand) could become major stress points in such bear scenarios.

Ting Lu +852 2536 3718
Xiaojia Zhi +852 2161 7815
Larry Hu +852 2536 3419

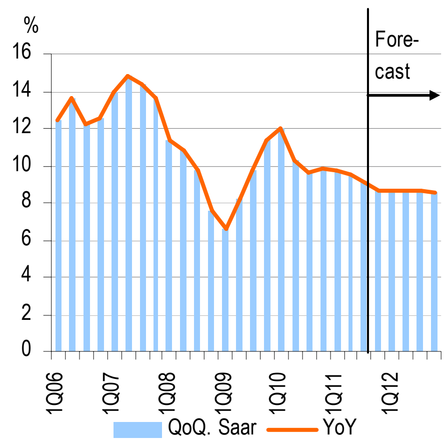
China

Slower growth on weaker exports

We forecast that China's economic growth is likely to slow further to 8.6% in 2012 from around 9.2% in 2011. Part of the slowdown reflects reduced potential, driven mainly by a labor shortage, and part of the slowdown is cyclical, as China will be faced with a possible Euro zone recession in 2012. We expect GDP growth in 2013, 2014 and 2015 to gradually slow to 8.5%, 8.0% and 7.0-8.0%, respectively. Inflation concerns will likely be greatly allayed, thanks to a weaker global economy and a high comparison base. We expect CPI and PPI inflation to drop to 3.5% and 2.0% in 2012 from 5.5% and 6.2% in 2011, respectively.

With this macro backdrop plus the leadership change in 2012-13, the Chinese government should continue its "loose fiscal, tight money" policy stance, though falling inflation risks could allow Beijing to be slightly more pro-growth by avoiding over-tightening credit supply. Put differently, it's unlikely for Beijing to make a U-turn on policy stance, in our view, but we do expect some further fine tuning in a changing macro environment. A conservative tone dominates among top politicians during leadership changes, so structural reforms unfortunately will likely take a back seat.

Chart 47: Soft landing of GDP growth



Source: BofA Merrill Lynch Global Research, CEIC

Chart 48: CPI and PPI inflation to fall in 2012

Source: BofA Merrill Lynch Global Research, CEIC

Risks to our soft-landing view

The one-time hot debate on China's growth prospects (hard vs. soft landing) has been cooling, but it may be only temporarily. This is because most of the overly bearish views on China are based on deep-rooted misunderstandings and occasionally intentional distortions, which cannot be corrected, in our view. Though there are both external and internal risks to our growth forecasts, the major risk to our soft landing call is a much worsened Euro zone sovereign debt crisis. Rather than providing a scenario analysis, we estimate that a one ppt slowdown in Euro zone GDP growth would lead to a 60bp decline in China GDP growth. For China bears, China's domestic issues such as local government debt, property tightening, private lending issues and capital flight could lead to a hard landing in growth and even a severe economic recession. To be sure, China has to deal with a variety of domestic problems, but in our opinion, the bears either overstate the risks or underestimate China's ability to handle them.

Growth drivers in 2012

We consider the three growth drivers on the demand side: fixed asset investment (FAI), consumption (proxy by retail sales), and exports. In 2011, nominal growth of FAI, retail sales and exports could be 24.5%, 16.9% and 20.2%, while real growth is around 17.5%, 11.5% and 11.0%, respectively. In 2012, we expect real FAI and retail sales growth will remain around 17.5% and 11.5%, but real growth of exports could slow to 6.5% (implying 10.0% in nominal terms). The 4.5ppt slowdown in real export growth would have a 60bp impact on China's GDP growth. That's why we expect GDP growth to slow to 8.6% in 2012 from 9.2% in 2011. Regarding yoy quarterly GDP growth in 2012, the structural slowdown could be compensated by an improved situation in the Euro zone, so we forecast relatively flat quarterly growth in 2012 (8.7%, 8.6%, 8.6% and 8.5% from 1Q12 to 4Q12).

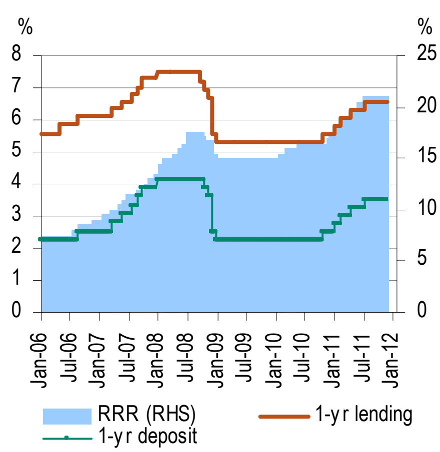
Inflation: Set to moderate

We expect CPI and PPI inflation to drop to 3.5% and 2.0% in 2012 from 5.5% and 6.2% in 2011, respectively, and both inflation readings will likely rebound to above 4.0% toward year-end 2012. As we enter the downturn of the pork price cycle, CPI inflation could surprise on the downside in 2012 (the mirror of the upside surprise in 1H11).

Chart 49: Money and credit growth will be stable

Source: BofA Merrill Lynch Global Research, CEIC

Chart 50: RRR looks set to be revised down



Source: BofA Merrill Lynch Global Research, CEIC

Implications on improved terms of trade: FAI and profit margin

The weakness of the EU/US economies could put a lid on energy/raw material prices, delivering below-trend PPI inflation in 2012. Though China's export sector will likely suffer from the weak developed economies, China should have improved terms of trade (mainly cheaper prices of energy/raw materials), and low PPI inflation should allow China more room to ramp up FAI to partially offset the slowdown in export growth, in our view. The other implication is that profit margins in China's downstream manufacturing sector could improve significantly in 2012 on the back of a sharper slowdown in PPI inflation.

Policy: Fine tuning loose fiscal, tight money

The CPI inflation target and GDP growth target could be set at 4% and 8.0% for 2012, respectively, the same as in 2011. Beijing could set a lower growth target, but it seems that Chinese politicians once again wish to use the glorified 8% to deliver confidence to both their own people and the world. The overall policy stance of "proactive fiscal and prudent monetary policy" will likely be maintained in 2012, but the details may be fine tuned due to the changing macro backdrop.

Specifically, fiscal policies could be slightly more active, as the ratio of fiscal deficit to GDP could be raised from 1.9% in 2011 to 2.2% in 2012. Monetary policy is complicated, but we expect that liquidity conditions – measured by interbank rates and discount rates for bankers' acceptances – could be improved thanks to allayed inflation concerns. New bank loans may be set at around RMB7.6tn (versus RMB7.5tn in 2011), which would deliver 13.9% loan growth in 2012. Although 13.9% is slower than possible 15.8% loan growth in 2011, in real terms (adjusted for GDP deflator) loan growth would accelerate from 10.0% in 2011 to 11.0% in 2012. Last but certainly not least, the reserve requirement ratio (RRR) could be cut by 150bp, while policy rates could be asymmetrically hiked (25bp in the one-year deposit rate and 15bp in the one-year lending rate) in 2012.

Shrinking current account surplus and RRR

The combination of weak external demand and robust domestic demand resulted in a smaller trade surplus in 2011 (US$141bn), and the trend will likely strengthen. In 2012, we expect 10.0% export growth, 16.5% import growth and a meager US$41bn in trade surplus. The current account surplus could be halved from US$305bn in 2010 to US$175bn in 2011, and could fall to just US$40bn in 2012. A much narrower current account would have strong policy implications. Pressure on the yuan would be greatly alleviated, allowing Beijing to truly benchmark the yuan to a basket and to deliver two-way volatility of RMB-USD. We expect three RRR cuts in 2012 due mainly to a shrinking current account surplus and some reversal of the previous hot money inflows.

Interest rates: No cut, one asymmetric hike

Though CPI inflation could dip below 3.0% yoy for some months in 2012, in our view there is only a slight chance the PBoC will cut rates. Now, the one-year deposit rate is 3.50% and the one-year lending rate is 6.56%. CPI inflation could rebound to 4% yoy in 4Q12. In addition, cutting rates could confuse markets about the government's determination to control home prices. And, higher deposit rates benefit less-privileged depositors. In contrast, we believe Beijing is likely to asymmetrically hike rates once in 2H12 (25bp for one-year deposits and 15bp for one-year lending) to compensate depositors while making the hike more politically acceptable (higher lending rates hurt big SOE borrowers). The popular call of a simultaneous rate hike and RRR cut appears reasonable, but in our view RRR cuts could be more frequent than rate hikes.

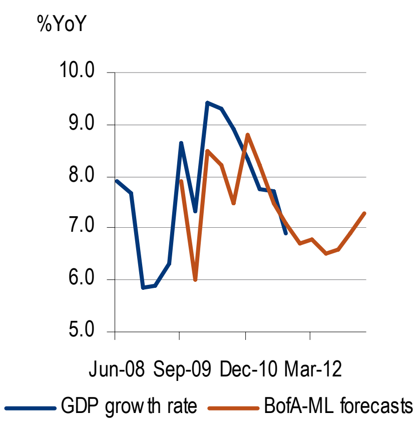
Indranil Sen Gupta +91 22 6632 8653

India

Muddling through

India will muddle through 2012 like the rest of the world, in our view. In our base Bad case, the economy should grow a sub-trend 6.8%. Growth will likely slip to 6%, in our Ugly case. With inflation moderating to 7.0% levels, we expect the RBI to cut policy rates by 200bp from April onward in two parts with a tense pause in between. In our view, India's twin deficits will continue to prove overdone. The fiscal deficit, at 8.6% of GDP, should not crowd out credit, especially with loan demand coming off to 17% levels. The current account deficit, at 3.0% of GDP, will likely get funded by capital inflows.

Chart 51: Slowing – 6.8% - growth



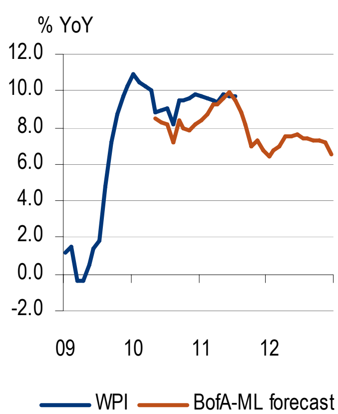
Source: BofA Merrill Lynch Global Research estimates, CSO

A battle of nerves

The year 2012 will be a battle of nerves, in our view. Growth will likely notch a sub-trend 6.8%, in our base Bad case, with global uncertainty impacting export demand and business confidence. High rates will likely pull growth down to sub-7% levels until mid 2012. With inflation likely to peak off in December, we expect the RBI to cut rates by 100bp April onward to combat the slowdown. A rebound in inflation, on administered fuel price hikes, however, will likely force the RBI to pause in 2H2012. Rate cuts should resume after inflation peaks off in early 2013. In response, we expect growth to bottom out to 7.5% in 2HFY2013.

We continue to expect domestic demand to be sustained by consumer demand. We remain skeptical of any revival of capex until the G-3 stabilizes. We expect the investment rate to drop by 2% of GDP in FY2012-13, comparable to the 150-200bp cuts during the Asian credit crisis, the dot-com bust or the Lehman collapse. Given an incremental capital output ratio of 4.0-4.5, a reduction in investment by 100bp of GDP impacts overall growth by 20bp.

Chart 52: Inflation peaking off for now



Source: BofA Merrill Lynch Global Research estimates, Ministry of industry

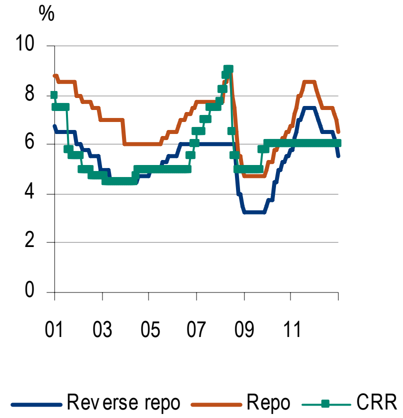
Growth: Second growth haven after China

We still expect India to remain the second growth haven after China as in 2008. We assess that the ability to fight a global downturn has come off like that of every other economy. Still, strong domestic demand should prevent growth from slipping below 6%. The bad news is that the fiscal stimulus option has been exhausted because the gross fiscal deficit has almost doubled since 2007. The good news is that the RBI has more headroom to ease than in 2008. In fact, India is likely the only large country in which lending rates have pierced 2008 levels. FX reserves, at over US$300bn, should prove sufficient to fund any portfolio outflows á la 2008.

Rural demand a buffer

We continue to expect rural demand, and by extension, domestic demand, to remain a buffer against a global recession. A bumper autumn *kharif* harvest has likely pushed up farm income by 15.3% atop 36.5% last year. The winter *rabi* harvest should also do well with the Indus, which waters the winter wheat crop, filled to the brim. The 2012 monsoon should also benefit from the persistence of the *La Nina*, the cooling of the Pacific that brings rains to Indian skies, predicted by the Australian weather board. Farm income from fruits, vegetables and milk (7.5% of GDP) will likely also remain robust with rising income generating excess demand.

Chart 53: RBI rate cuts – with a mid-year pause



Source: BofA Merrill Lynch Global Research estimates, RBI

Inflation peaking = rates topping off (with mid-year pause)

We expect the rate cycle to peak off with inflation topping off. Inflation will likely come off in 1H12 with a good harvest dousing agflation, commodity prices stabilizing and tight monetary policy curbing demand (Chart 53). Against this backdrop, we expect the RBI to cut policy rates by 100bp between April-June. Inflation will likely turn up to 7.5% in 2H12 after Delhi hikes administered fuel prices after the summer Uttar Pradesh polls. This will likely force the RBI to halt rate cuts. As inflation comes off, we expect it will again cut 100bp in early 2013. Lending rates will also likely come off by 150-200bp from April 2012 onward, with high interest rates pulling down loan demand. We expect loan demand to bottom at 15% in mid FY2013 and climb back to 17% by March 2013. In our Ugly case, the RBI will likely cut policy rates 400-500bp by shifting the money market to reverse repo from repo mode.

Fiscal deficit not to crowd out materially

India's twin deficit risks are overdone, in our view. We expect the fiscal deficit to persist at a high 8.6% of GDP (Table 14). This, however, should not crowd out the private sector. After all, the growth slowdown that is reducing tax collections is also reducing loan demand. It is for this reason we expect the government to be able to put through its Rs6331bn/ US$135bn (6% of GDP) net borrowing program without unduly stressing interest rates. We continue to expect the RBI to subscribe to about a third of the borrowing program via open market operations to generate liquidity. This should contain the 10-year at mid-cycle 8-8.5% levels.

Table 14: 8.6% of GDP manageable fiscal deficit

Item/Rsbn	FY12E (US$108/bbl)	FY13E (US$112/bbl)
Revenue receipts	7678	8563
Tax revenue	6413	7298
Non-tax revenue	1265	1265
Total receipts	7978	9063
Total expenditure	13513	15203
Gross fiscal deficit	5535	6140
% of GDP	6.1	5.9
States fiscal deficit	2280	2817
% of GDP	2.5	2.7
Combined fiscal deficit % of GDP	8.6	8.6

Source: Government of India, BofA Merrill Lynch Global Research estimates

Risks: Balance of payments risks overdone

Balance of payments risks also are overdone, in our view. Our expected current account deficit, of 3% of GDP, should be funded by capital flows in our Bad case (Table 15). If risk aversion results in capital outflows, the RBI would still have sufficient FX reserves to fund the gap. FX reserves also remain a relatively comfortable 2.3x of short-term external debt due in a year. Our FX strategists expect the INR to appreciate back to Rs49/USD by December 2012 with the US dollar likely to stabilize at 1.30/Euro levels.

What if risk aversion dries up capital flows? We believe that the RBI's US$314bn FX reserves should allow it to sell about US$20bn fund 2008-type capital outflows. In case of a global recession, the same risk-off that will result in capital outflows will likely pull down oil prices to US$80/bbl according to our commodity strategists. An US$10/bbl swing in oil prices impacts the current account deficit by US$8bn (0.4% of GDP).

Table 15: 3% of GDP current account deficit

Item	FY12 (US$108/bbl)	FY13 (US$112/bbl)
Current Account	-60.0	-65.0
% of GDP	-3.1	-3.0
Trade balance	-149.0	-165.0
Invisibles	89.0	100.0
Capital Account	66.0	78.0
Foreign investment	26.0	28.0
- NRI deposits	5.0	8.0
ECBs	16.0	18.0
External assistance	5.0	6.0

Source: RBI, BofA Merrill Lynch Global Research estimates.

We assess rollover risk for short-term external debt at a manageable US$15-20bn, like in 2008. In fact, 2008 had full rollover. We do not expect the non-resident deposits of US$43.4bn to be withdrawn. Public sector oilcos that account for half the US$68.5bn trade credit are also unlikely to face rollover risk, in our view. The actual rollover risk thus should not exceed US$15-20bn (5% of FX reserves), even with a 25% probability of default for the rest of the US$137.2bn. European banks operating in India have borrowed only a limited US$6bn from abroad.

We see no risk to political stability

We do not anticipate any risk to the political stability of the Congress-led ruling United Progressive Alliance government. Key state elections in Manipur, Punjab and Uttarakhand (in February), Uttar Pradesh (in summer) and Gujarat (in October) are unlikely to have significant national political impact.

David Hauner +44 20 7996 1241

Emerging EMEA

No risk-on, no fun-ding

Funding is the key variable in the deleveraging world for 2012, in our view. It determines growth and scope for stimulus. Russia appears best placed, and we forecast the highest growth there, even though below consensus. We are most bearish on growth in Turkey, S Africa and Hungary; Poland is in the middle.

Growth: show me your funding

The biggest call to make for 2012 is about capital flows, in our view. Those to EEMEA likely will remain negative or muted unless the Euro zone situation surprises us significantly for the better in 2012. While the paradigm of 2010 and most of 2011 was about excessive capital inflows, now EMs with external funding deficits struggle. Among the major EEMEA markets, Russia and the GCC are best placed, in our view, while Hungary is worst; Poland and S Africa are better off than Turkey. Our forecasts for real credit growth reflect the extremes of Russia and Hungary; with the others falling in the middle (see bubbles in Chart 54). Another key driver, though secondary to funding, in our view, will be demand from the rest of the world. Again, the Euro zone is crucial: as long as it muddles through, and the world avoids a recession, demand for commodities and German (and CEE) manufacturing exports will likely slow down but not collapse.

Table 16: GDP growth (% yoy)

	2011F		2012F		
	Old	New	Old	New	Consensus Economics
Russia	4.0	4.0	4.0	3.6	4.0
Turkey	6.0	6.8	3.0	0.0	2.6
South Africa	3.1	3.2	3.5	2.5	3.5
Poland	3.5	3.8	2.9	2.6	3.0
Hungary	1.5	1.5	1.0	-0.6	1.0
GCC	6.9	6.9	3.9	3.4	n.a.
Egypt	1.8	1.8	3.0	3.0	3.2
Nigeria	7.1	7.1	7.2	7.0	7.2
Kazakhstan	6.2	6.2	4.6	4.1	5.7

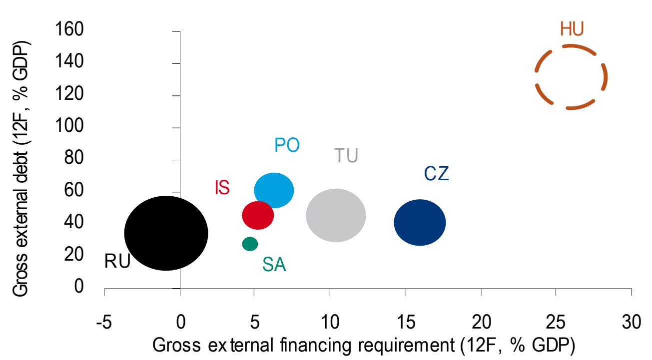
Source: BofA Merrill Lynch Global Research

The relative growth champion among the major markets will likely be Russia, at 3.6%, followed by Poland, S Africa and Israel; frontier is growing faster, with Nigeria's 7% and 3-4% in Egypt and Kazakhstan (Table 16, Chart 55). Compared to consensus, we are definitely bearish. Our strongest views relative to consensus are Turkey where we forecast zero growth; S Africa where we forecast only 2.5%; and Hungary where we expect negative GDP growth. Also in Poland and Russia we are about half a percentage point below consensus. Relative to 2011, we forecast a slowdown across the board, with Russia being relatively most resilient.

Inflation: pass-through not passing through

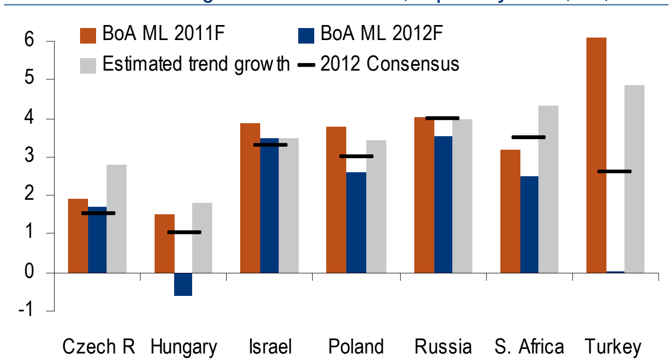
To what extent present FX weakness is passing through not only to import prices but subsequently to service prices and wages is the crux of the inflation view. The recent run-rate of inflation (3m/3m SAAR) suggests little underlying pressure, with core below target in all economies except Turkey (Chart 56). However, sizeable FX depreciation could add several percentage points in 1H12: we forecast average CPI

Chart 54: Russia with best external funding, Hungary with worst



Note: Top right corner is most vulnerable, bottom left corner least so. Gross external financing requirement = current account deficit + short-term debt. Bubble size shows real credit growth forecast for 2012; Hungary's empty bubble indicates a real credit contraction. Source: BofA Merrill Lynch Global Research, Haver

Chart 55: Bearish on growth vs consensus, especially in HU, SA, TU



Source: BofA Merrill Lynch Global Research, Haver, Consensus Economics, Bloomberg inflation of 8.7% in Turkey, 6.6% in S Africa, 6.3% in Russia and about 4% in Hungary and Poland. However, the limited pricing power of firms and workers is likely to limit further pass-through to services and wages relative to past experience. This will leave some central banks scope for rate cuts if necessary.

Table 17: Policy rate (% eop)

	2011F		2012F	
	Old	New	Old	New
Russia	7.75	7.75	7.00	7.00
Turkey	5.75	5.75	5.75	5.75
South Africa	5.50	5.50	6.50	6.50
Poland	4.50	4.50	4.00	4.00
Hungary	6.00	7.00	5.00	8.00
Egypt	8.25	8.25	8.25	8.25
Nigeria	12.00	12.50	13.00	13.50
Kazakhstan	7.50	7.50	7.00	7.00

Source: BofA Merrill Lynch Global Research

Policy: all about funding (again)

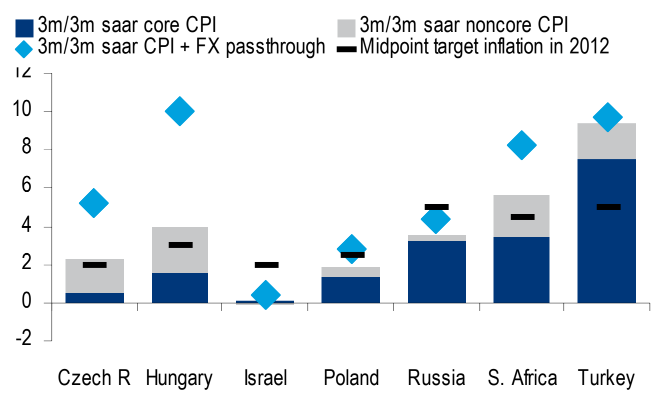
Whether EM policy makers will be able to stimulate growth or not will crucially hinge on the external funding situation. They face a dilemma between still negative output gaps and bloated external financing requirements, which require them to maintain reasonably high real rates and tight budget deficits (Chart 57). Hungary and Turkey are most constrained on the external funding side, and S Africa and Turkey in terms of inflation. Russia is best positioned to afford stimulus, followed by Poland, the Czech Republic and Israel. We forecast policy rate cuts in these markets (Chart 58). In contrast, Hungary will likely have to hike rates or get IMF help. S Africa and Turkey are likely to keep the policy rate on hold due to concerns about FX weakness and inflation. However, Turkey is likely to reduce the RRR rates to stimulate growth.

On the fiscal side, we expect mostly tightening due to funding concerns, with the exception of Russia (Turkey's bigger deficit is due to lower growth). S Africa continues to run the biggest fiscal deficit, and Russia the smallest. A key country-risk variable in the present environment is policy implementation capacity, in our view. It crucially depends on the government's support in parliament and the population. Russia and Turkey are best-placed in this context, in our view.

Risks: nothing beats the Euro zone

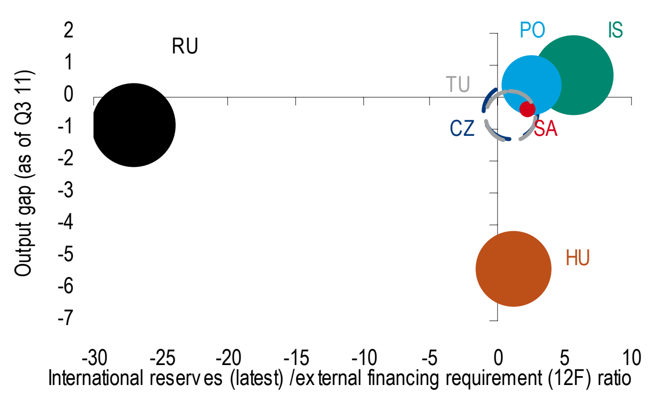
The biggest risk to the baseline stems from the Euro zone. Muddling through will become more and more precarious as deleveraging, capital flight from the Periphery to the Core, an associated recession, and reform fatigue become entrenched, while the scope for bailouts is becoming ever more limited. As a result, the most likely risk to our baseline is to the downside. Potential triggers seem to be: (1) pressure on some Core countries that undermines the EFSF; (2) political support for austerity breaking down in some of the Peripherals, pushing them into default and euro exit; or (3) a bank run spreading from the Periphery. An upside scenario would almost certainly involve significant steps to fiscal union. Most likely, this could occur through a more open-ended commitment of the ECB to buy Peripheral bonds (whether directly or through the EFSF) which would

Chart 56: Core inflation in last 3 months below target, ex Turkey



Note: Passthrough to headline inflation over the next 12 months if FX sell-off since end-August does not reverse based on the long-term average rate of passthrough. Source: BofA Merrill Lynch Global Research, Haver

Chart 57: Hungary, S Africa, Turkey with least room for policy easing



Note: FX reserves excluding gold. Size of the bubble shows 2y swap rate (currency for RU and TU, interest otherwise) deflated by the latest 3m/3m saar CPI. Source: BofAML Global Research, Haver, Bloomberg

Table 18: FX exchange rate (eop)

	Spot	1Q 12	2Q 12	3Q 12	4Q 12
USD/RUB	30.80	31.00	32.00	30.00	30.00
USD/TRY	1.81	1.85	1.80	1.70	1.70
USD/ZAR	8.18	8.10	8.00	7.50	7.60
EUR/PLN	4.42	4.45	4.45	4.30	4.30
EUR/HUF	311	315	315	300	300
USD/EGP	5.98	6.00	7.50	7.50	7.50
USD/NGN	158	158	160	158	156
USD/KZT	148	148	148	148	148

Source: BofA Merrill Lynch Global Research

effectively introduce the fiscal union through the back door of the common central bank balance sheet. Unfortunately, such an upside scenario is most likely to materialize only after another round of dislocations and likely requires inflation to fall sufficiently for the ECB to be able to justify QE with concerns about deflation.

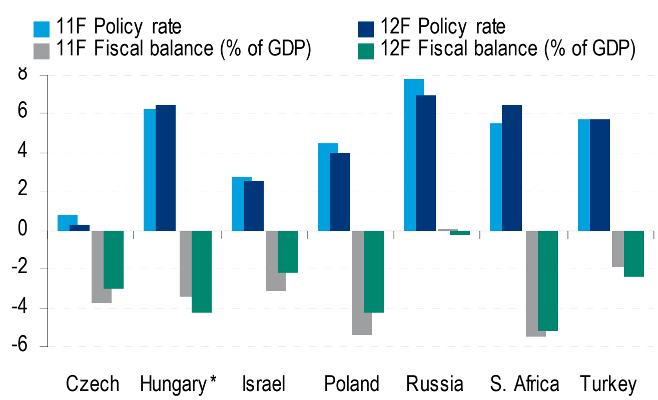
The impact of both scenarios (downside and upside) on EEMEA will be primarily a function of the vulnerability to capital outflows, in our view. Chart 59 summarizes the size of potential portfolio outflows and the rollover risk in external bank financing relative to international reserves. Russia appears least vulnerable, followed by the Czech Republic. Hungary is most exposed by far. Otherwise, Israel and S Africa have large foreign positioning, and Turkey has the lowest reserve coverage. Poland faces the second-largest exposure to foreign banks. Compared to 2008-09, Hungary is fundamentally stronger, but this time lacks the support from an IMF program. Russia boasts the greatest improvement since then, while Turkey is more vulnerable due to a larger funding requirement. Which of the two markets will perform better, however, will hinge on oil. As long as it remains solid, Russia is likely better off; but if it drops sharply, so will Russian assets, in our view.

Afterthought: how did we do in 2011?

Our EEMEA year ahead outlook for this year largely materialized on the back of a bearish view on the global debt crisis. In terms of our four themes: 1) Domestic demand was the key driver of growth, and Russia and Turkey outperformed. 2) Abundant capital flows led to a rebalancing of current accounts in the first half. However, the main flaw in our 2011 view was that we did not expect US growth concerns and the EZ crisis to reverse capital flows to GEM as it did in the second half; rather, we focused on the EM-positive abundant G-10 liquidity. 3) Central banks remained dovish, and only Poland surprised us on the hawkish side. 4) Three of our four main risks materialized: commodity inflation in 1Q; sovereign risk and US (almost) double-dip later on.

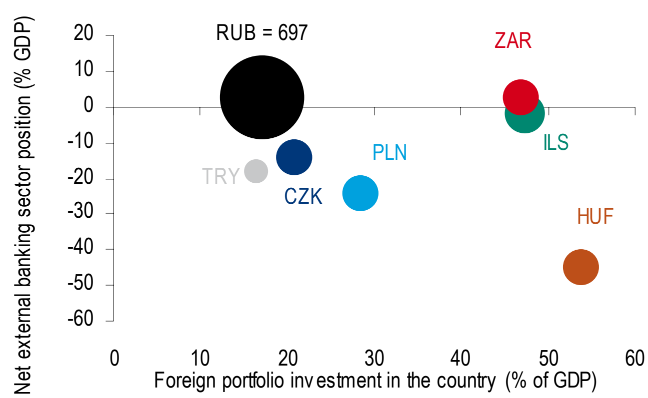
Evaluating our forecasts relative to consensus at the time of our year ahead publication, our three best calls were Turkish GDP, S African CPI and the Czech policy rate; the three biggest misses were the policy rate in Poland (too low) and S Africa (too high) and Israeli inflation (too low).

Chart 58: Rate cuts in CZ, IS, PD, RU, hikes in HU; biggest deficit in SA



Note: *ESA95 accounting rules require asset transfers from private pension funds to be recorded as revenues.
Source: BofA Merrill Lynch Global Research, Haver

Chart 59: Russia least vulnerable to capital outflows, Hungary most



Note: Bottom right corner is most vulnerable. Foreign portfolio investment shows the stock of debt and equity holdings. The net external banking sector position shows cross-border loans and deposits. Bubble size shows the ratio of international reserves to the 12-month gross external financing requirement + portfolio investment.
Source: BofA Merrill Lynch Global Research, Haver

Marcos Buscaglia +1 646 855 2582

Latin America

Keep it up, China, please!

We expect LatAm growth to decelerate to 3.3% in 2012, from 4.1% in 2011 and 6.2% in 2010 (Table 19). We cut our growth forecasts recently (Europe's double dip tweaks LatAm 2012) after our European team cut its 2012 forecast to -0.6% from +0.8%.

In 2012 we expect Brazil and Mexico, which represent 70% of LatAm's GDP at current market prices, to grow 3.4% and 3.0%, respectively. This merits some explanation, as Brazil's growth has sputtered in 3Q, and our US economists expect sluggish growth in 2012. Two facts support our relatively positive forecast for Brazil. First, fiscal and monetary policy tightening has impacted 2011 growth. By contrast, in the coming months we expect monetary policy to become significantly looser (more below). Second, the minimum wage should increase by about 14% in 2012, bringing with it about a 1.7% of GDP income boost (Brazil: minimum wage to boost income in 2012).

Mexico's 3% growth forecast is predicated on still resilient US industrial production. In addition, the real depreciation of the peso as well as some productivity gains in the manufacturing sector will keep the external sector moving, in our view. Plus, domestic demand has been catching up and there is still room for more, as we expect credit to continue growing. The labor market is giving Mexico a bonus: with fewer Mexicans migrating to the US, employment is growing fast but not generating inflationary pressures, as unemployment is high.

Table 19: Growth slowdown in 2012 (%)

	2011E	2012E
LatAm	4.2	3.3
Argentina	5.5	1.0
Brazil	3.1	3.4
Chile	6.3	3.5
Colombia	5.6	4.1
Mexico	4.0	3.0
Peru	6.5	5.2
Uruguay	6.1	4.0
Venezuela	4.1	5.0

Source: BofA Merrill Lynch Global Research

Growth: High beta countries, with their own dynamics

Argentina is where we expect growth to decelerate the fastest in 2012, from 5.5% in 2011 to 1% in 2012. The combination of tighter monetary and fiscal policies, as well as the weak growth in Brazil, supports this view. However, recent FX controls imposed by the government further dented confidence, in our view, and could lead to an even faster portfolio dollarization in coming months, and to a full-blown crisis (see Wrong medicine risks crash landing).

Venezuela is the only country where we expect growth to accelerate, from 4.1% in 2011 to 5% in 2012 (Venezuela: spending-led recovery gathers steam). This is not surprising. With presidential elections in late 2012, we expect the government spending to expand nearly 49.9%. This will likely create significant funding pressures in 2012; even though the government holds assets equivalent to 12.3% of GDP, we expect an issuance of about US$15bn in 2012.

Inflation: Receding, but not by much

We expect inflation to only drop from 4.1% in 2011 to 3.7% in 2012 within inflation-targeting countries (Table 20). In Mexico, we actually expect inflation to increase in 2012, though slightly, due to one-off effects that drove inflation down this year (new CPI basket and regulatory changes). But with the output gap around zero we do not expect strong demand-side pressures. In Brazil, there are upside risks to our forecasts, as the central bank embarked on a monetary easing cycle while services inflation is still running well above the inflation target ceiling. Moreover, the above-14% increase in the minimum wage will likely impact services inflation. By contrast, the change in the CPI basket that takes effect in 2012 will have some downward effect on inflation, of about 0.3%.

Table 20: Inflation to slow down only slightly (%)

	2011	2012
LatAm	8.6	8.3
Argentina	25.0	25.0
Brazil	6.4	5.3
Chile	3.6	3.0
Colombia	3.7	3.3
Mexico	3.5	3.7
Peru	4.3	3.0
Uruguay	8.1	6.5
Venezuela	28.6	35.0
Inflation targeters	4.3	3.7

Source: BofA Merrill Lynch Global Research

Table 21: Policy rates to drop (%)

	2011E	2012E
Argentina	19.50	19.75
Brazil	11.00	9.50
Chile	5.00	4.00
Colombia	4.75	5.25
Mexico	4.50	4.00
Peru	4.25	4.00
Uruguay	8.00	7.00
Venezuela	29.50	29.50

Source: BofA Merrill Lynch Global Research

La Niña represents an upward risk to inflation in some countries, such as Colombia. In fact, food inflation has been surprising on the upside in several countries in recent months for this very reason.

We expect inflation to remain high in Argentina and Venezuela. In Argentina, the deceleration of the economy should provide some inflation relief. However, the removal of subsidies to utility prices is likely to have about 5% impact on inflation in 2012. In addition, there is a meaningful risk that some prices start indexing to the parallel exchange rate. In Venezuela, inflation is likely to accelerate as stronger government spending overheats the economy.

Policy: Will central banks believe without seeing the slowdown?

We expect the Brazilian Central Bank to cut rates to 9.5% in 50bp clips (Table 21). We expect the bulk of the monetary easing will be via lower rates, given that the central bank probably seeks to take advantage of the global slowdown to "normalize" real interest rates and lower the BRL carry. However, pressures in the banking system may lead the central bank to *also* lower reserve requirements.

The policy rate call is more difficult for the rest of LatAm. It is clear to us that they would cut rates aggressively in case of a Lehman-type event, starting with Chile. But in the context of a moderate slowdown, the call is not as clear cut; although we would actually expect activity to decelerate faster if central banks do not ease policy rates, the main question is whether they would act preemptively or wait to see the slowdown in the data.

We expect most central banks to act somewhat preemptively. We expect BCCh and Banxico to start cutting rates by 25bp in December 2011 and in January 2012, respectively. However, we acknowledge that there are risks of delays in both cases (Mexico: rate cut on the doorstep). In Mexico, the level and volatility of the MXN will play a role in the decision. We also expect BCRP to cut rates in 1Q 2012. All in all, we expect BCCh, Banxico and BCRP to send policy rates to 4% in 2012. Colombia is different; given the buoyancy of the economy, we expect Banrep to *hike* rates by 50bp to 5.25%, or at least be the last to cut under stress.

Current account deficit increases

We expect LatAm's current account deficit to increase from nearly US$49bn to US$77.5bn in 2012. Brazil will likely drive most of the change, as we expect its deficit to expand from US$52.9bn in 2011 to nearly US$77.5bn in 2012 (Table 22). We actually expect every LatAm country to be running current account deficits in 2012, except Venezuela. This is not surprising, as we are forecasting moderate negative terms of trade shocks in 2012 for most countries in LatAm.

Elections: Chavez and PRI with the upper hand

Polls currently show the PRI carrying the 1 July presidential elections in Mexico; so far, it is well ahead of the PAN and the PRD in electoral preferences. Yet PRI and PAN candidates still must be chosen. Enrique Pena Nieto, former governor of Mexico State, is a leading candidate to be elected by the PRI. Josefina Vazquez Mota may end up running as the PAN's candidate. Lopez Obrador is running again for the PRD.

Although the election seems likely to be more entertaining than what current polls show, Pena Nieto still appears most likely to be elected. We do not expect significant changes in macro or micro policies in coming years, but there are potential upside surprises in terms of PEMEX and the regulatory environment.

Table 22: CA deficit to increase (US$bn)

	2011	2012
LatAm	-49.2	-77.5
Argentina	0.7	-1.0
Brazil	-52.9	-72.1
Chile	0.2	-3.8
Colombia	-10.4	-9.5
Mexico	-14.1	-17.0
Peru	-3.7	-4.2
Uruguay	-0.9	-1.1
Venezuela	31.9	31.2

Source: BofA Merrill Lynch Global Research

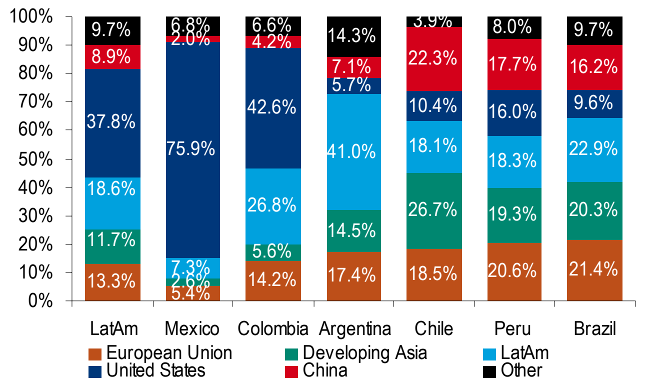
In Venezuela, stronger fiscal spending may help President Chavez be re-elected. In addition, Chavez's recent health problems have boosted his popularity, although there is still uncertainty about whether Chavez will be able to run given his health. Focus will also be on the February primary among opposition candidates.

Risks: Look more to China than to Europe

A mild contraction in Europe would not hurt LatAm significantly, in our view. Although exports to Europe are significant for most countries except Mexico (Chart 60), most of these are commodities. Therefore, if commodity prices remain robust, we expect the impact to be limited.

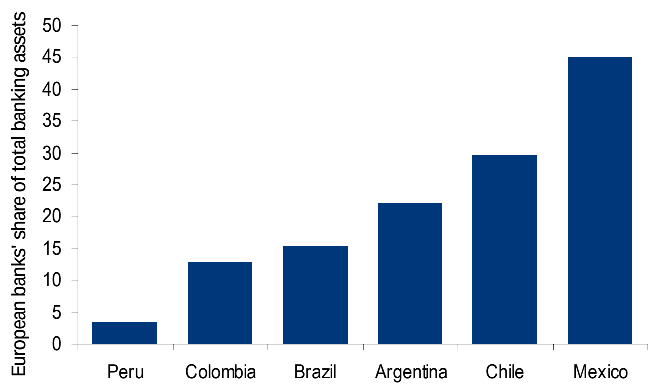
The financial channel would be more important, in our view. Europe has been an important source of FDI in recent years. In particular, a significant share of LatAm banking assets are owned by European banks (Chart 61); as a result, the transmission mechanism could be slower lending and investment (see Investment slowdown risks harder landing).

Chart 60: Exports breakdown by main destination in the last 12 months



Source: BofA Merrill Lynch Global Research

Chart 61: European banks hold a large share of LatAm banking assets



Source: BofA Merrill Lynch Global Research

We expect a Lehman-type event would freeze financial markets and likely have an adverse impact on LatAm. For example, recently we showed that financial factors are the main external driver of Brazil's growth (Global factors to drive BCB to cut at least another 100bp). This is not surprising, given the substantial portfolio flows that reached Brazil in recent years.

LatAm is closely watching export growth to China. Exports to China have gained share in recent years for all LatAm countries except Colombia and Mexico (Chart 60). According to our commodity strategists, a hard landing in China would impact copper and nickel more adversely than other commodities (Metals demand holds despite confidence drop). In a crisis scenario, gold will probably hold up, as it would likely be deemed a relative safe haven. Oil prices would probably drop to about US$80/bbl (Brent prices), and hold up better than copper prices. Such a scenario figures to be worse for Chile than Peru, and it is likely Venezuela and Mexico would fare better than them. Soft commodity prices would also suffer in such a scenario, the extent of which would also be driven by climate and inventories factors.

In a major crisis, we would expect LatAm growth to contract by at least 0.1% in 2012. The countries most exposed would be those very open to trade, such as Chile and Mexico, or those with weak policies, such as Argentina (Table 23). For Venezuela, the elections would only delay the worst potential outcome; in this scenario, we would expect a sharp contraction in 2013.

Table 23: Major crisis scenario (%)

	GDP	Inflation
LatAm	-0.1	9.7
Argentina	-4.0	40.0
Brazil	1.0	4.0
Chile	-1.0	1.5
Colombia	0.5	2.5
Mexico	-1.0	2.0
Peru	1.5	3.0
Venezuela	3.3	45.7

Source: BofA Merrill Lynch Global Research

David Beker +55 11 2188 4371

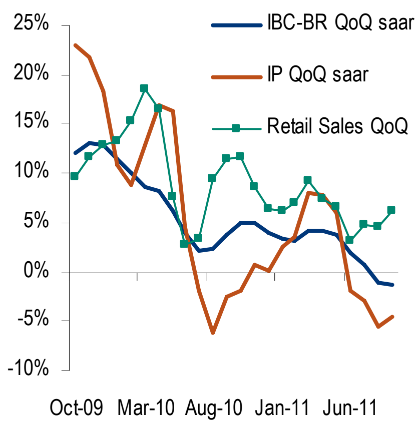
Brazil

Defensive driving on a bumpy road

We expect GDP growth to accelerate to 3.4% in 2012 from 3.1% this year. Economic activity is already running below potential (Chart 62) and the recent monetary stimulus should impact growth in the upcoming quarters. Moreover, the country still has room for further monetary and fiscal easing given both the recent monetary tightening and current levels of public indebtedness, in our opinion (Chart 63). Government authorities, especially President Dilma, are unlikely to tolerate growth below the 3% threshold in 2012 and will use available instruments more aggressively if downside risks for growth increase, in our view.

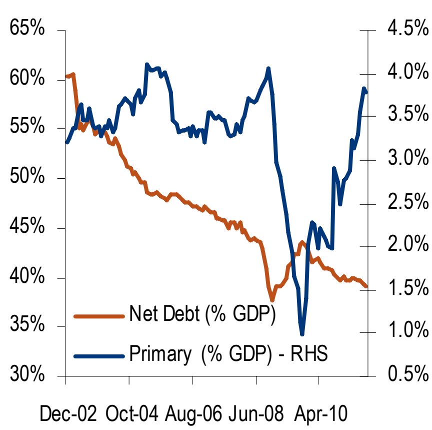
Domestic consumption should be the main growth driver in 2012. As we argued recently (see Minimum wage to boost income in 2012), the impacts of the minimum wage adjustment (over 14% in nominal terms, according to our estimates) should cushion the economic slowdown. The increase in income will reach over BRL80bn and include 85 million workers and pensioners. Credit growth is still resilient (growth hovering around 20% in nominal terms throughout the year) and the Brazilian Central Bank already has started to unwind some of the macro-prudential measures implemented since December 2010, such as the reduction in banks' capital requirements announced on 13 November.

Chart 62: Economic activity underperforming



Source: IBGE, BofA Merrill Lynch Global Research

Chart 63: Good fiscal stance: room for stimulus



Source: BofA Merrill Lynch Global Research, BCB

All eyes on the external front

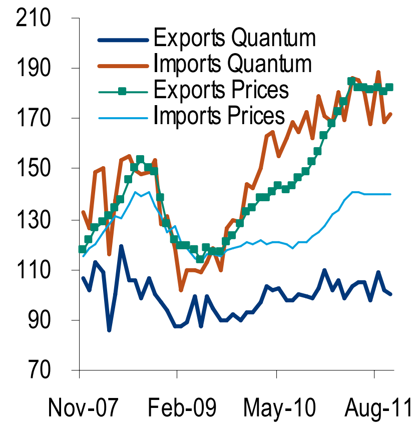
A disruptive global environment is the main risk to this recovery scenario, in our view. Global factors are an important driver of growth in Brazil (see Global factors to drive BCB to cut at least another 100bp), and we believe external conditions will likely lead to slow growth in Brazil until year-end. We have modeled the most important channels through which the slowdown in global activity could impact the Brazilian economy, namely exports, lower commodity prices, expectations, credit conditions and foreign investments and business confidence.

With our economists in Europe now penciling in a recession in upcoming quarters, external demand is likely to show further deterioration, reducing global growth. Europe accounts for more than 20% of Brazilian exports, and besides this contagion channel, we should also monitor the balance of payments. Profits and dividend outflows to Europe increased in recent months, and European exposure in the utilities, telecommunications and banking sectors in Brazil is large. In the global credit market it will be key to monitor how financing lines behave because this can add considerable pressure to credit concessions locally, as was the case in 2008.

The BCB has been closely monitoring the external environment and its effects on domestic activity, as signaled by the bank's latest official publications. In case of a more pronounced slowdown, in our view monetary authorities could accelerate the easing pace and use more macro-prudential measures. It appears that the government will concentrate the stimulus using interest rate cuts this time in comparison to the counter-cyclical measures implemented in the 2008-2009 crisis.

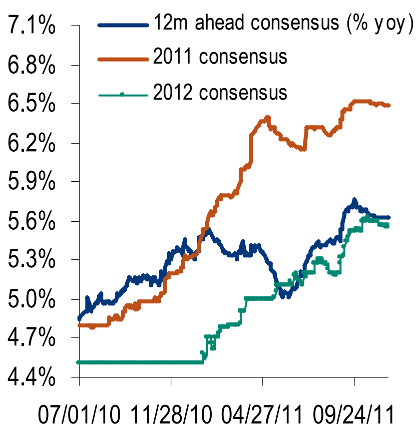
So far in 2011, the current account (CA) deficit has widened less than expected; we expect it to be at 2.2% of GDP by year-end. A significant terms-of-trade shock (Chart 64) has prevented the trade balance from deteriorating in the year, which helps to explain the downside surprise vis á vis our initial expectations. We expect further widening of the CA deficit in 2012, reaching over 3% of the GDP. Still strong consumption should keep pressuring imports and a weaker global environment could worsen terms of trade for Brazilian exports. While profits and dividend outflows are expected to remain high, the weaker BRL should reduce international travel outflows.

Chart 64: Terms-of-trade shock prevented further CA deterioration



Source: BofA Merrill Lynch Global Research, Funcex

Chart 65: Inflation expectations stabilize



Source: BofA Merrill Lynch Global Research, BCB

On the capital account front we expect the FDI to remain the main source of financing for the current account as the portfolio inflows remain low. Key focuses of attention are the financing lines and global credit markets, which exacerbated the slowdown in 2008-2009. If the scenario deteriorates in Europe, some companies could sell some of their assets locally, particularly in the utilities, telecommunications and banking sectors.

Policy: How much monetary easing should be expected?

Our central scenario is for a total easing cycle of 300bp in the Selic rate. Assuming the BCB does not change the current 50bp pace of cuts, this would bring the Selic rate to 9.5% by April 2012. In our view, there still may be changes in the cutting pace, depending on how much more global growth prospects deteriorate.

In Global backdrop limits BCB cuts risks, we argued that unless there is an important recovery in the international backdrop, inflation would not end 2012 above the target ceiling (6.5%). We highlighted unanchored inflation expectations as the main risk to our central scenario, but as inflation has been posting benign results over the past few months, expectations improved at the margin. That said, while the BCB continues to talk about inflation convergence toward the 4.5% center of the target next year, consensus continues to forecast inflation within the upper portion of the inflation target band. Even with the ongoing downgrades in growth forecasts, analysts have not significantly reduced their inflation forecasts.

The IBGE released the new weights of the IPCA basket on 28 November. Groups that have been significantly under pressure, such as education and food, will lose relative importance from February 2012. On the back of this, we revise downwardly our IPCA forecast for 2012 to 5.3% yoy, from 5.6% yoy previously.

A key risk comes from the effects of the minimum wage increase on prices (see Minimum wage links) and services inflation in general. A 14% increase in the minimum wage could push the IPCA around 50bp higher next year. However, we think the ongoing slowdown in activity is already impacting labor markets, which could help partially curb the effects of the minimum wage increase on prices.

A more challenging fiscal backdrop in 2012

We expect fiscal policy to be neutral in 2012 compared to the tightening in 2011. The need for big infrastructure investments (eg, those related to the World Cup and Olympics) and the impact of the increase in the minimum wage on social security accounts should pressure fiscal accounts next year. The minimum wage increase alone will generate a net fiscal impact of more than BRL22bn next year.

To achieve the 3.1% primary surplus target in 2012, the government will again have to rely on fiscal revenues. But this task will not be easy given the economic slowdown. This means the government will have to find other revenue sources, which will probably include non-recurrent revenues as concessions and dividends. For now, we forecast the primary surplus at 2.8% of GDP.

We expect the government to announce a budget cut of more than BRL50bn in early 2012 to send a message about its commitment to achieving the fiscal target. If this does not happen, investors would tend to be more skeptical about fiscal accounts, which could work against the anchoring of inflation expectations.

Vasileios Gkionakis +44 20 7995 0143
Jaewoo Lee +82 2 3707 0465
Francisco Rodriguez +1 646 855 5910
Marcella Chow +852 2161 7236
Matthew Sharratt +27 21 815 2625
Alberto Ades +1 646 855 4044

Hot topic: GEMs decoupling

Decoupling on track but downside risks prevail

- We expect the 10 largest emerging market economies (GEM-10) to grow 6.1% yoy in 2012, below our 6.8% estimate for 2011 and compared to our 1.3% forecast for developed economies.
- We think risks are to the downside, as muted export growth remains a concern and bank deleveraging globally is lurking.
- As risks of a European contraction increase, threatening to disturb liquidity and global trade, GEMs will not come out unscathed. Rebalancing toward domestic activity is under way, however, cushioning a big chunk of the potential blow.

GEM exports: still the Achilles heel?

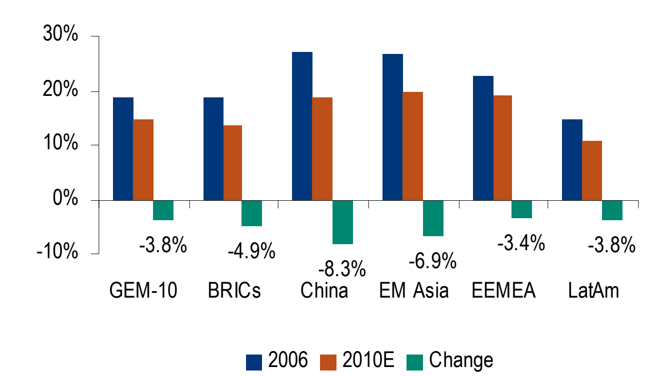
With the latest US data having shaved a reasonable chunk off the probability of recession, the main external risk to GEM activity is Europe, in our view.

Exports as a % of GDP have declined over the last five years; we expect them to decline further in 2012. From a GEM-10 perspective, the ratio of exports to GDP is forecast to drop from 27% (2006) to 23% (2012). Furthermore, exports to developed markets (DM) as a % of GDP are estimated to have declined from 19% (2006) to 15% (2010). The drop is more vivid when we look at "core" GEMs; for BRICs and China, exports to DMs as a % of GDP have declined 4.9% and 8.3%, respectively (Chart 8). From a regional perspective, LatAm is the least exposed region to DMs; among other things, this is due to LatAm's high share of trade with other emerging markets.

With the latest US data having shaved a reasonable chunk off the probability of recession, the main external risk to GEM activity is Europe, in our view. Our European economists now expect a small contraction in the Euro zone (-0.6% yoy) due to tighter fiscal policies, bank deleveraging and tight credit availability.

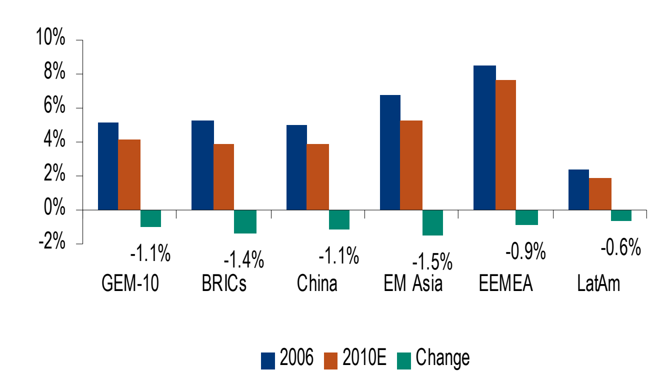
To gauge the level of vulnerability, we look into the exposure of GEM exports in the Euro zone. We find that exports as a % of GDP have declined from 5.2% (2006) to 4.1% (2010). All regions have had a uniform reduction of 1pp over the last five years (chart 2); however, EEMEA remains the most heavily exposed region, with a ratio of exports/GDP of 7.6%. Again, LatAm is the least exposed, with Mexico the only major economy in the region to have increased the share of exports to the Euro zone during this period.

Chart 66: GEM exports to DMs as % of GDP



Source: BofA Merrill Lynch Global Research

Chart 67: GEM exports to the Euro zone as % of GDP



Source: BofA Merrill Lynch Global Research

Overall, we think data suggest a continuation of rebalancing away from external factors. However, exports remain a significant driver of economic activity in GEMs; although Euro zone exposure is relatively small, the existing linkages place downside risks to next year's growth should a European crisis unfold.

xGEM: export growth rates remain muted

We are concerned GEM-10 export growth may get stuck in a subdued range that could inhibit domestic activity.

Recently, we introduced an *almost real-time* model of export growth in GEM-10 (xGEM; see GEMs Macro Viewpoint, 11 October 2011). Between July and September, our model registered a big deterioration, predominantly due to a deceleration reflected in PMI new export orders. However, the most recent data hint at a modest improvement (Chart 68). Although this pick-up is welcome, we are concerned GEM-10 export growth may get stuck in a subdued range that could inhibit domestic activity.

This does not reflect a sharp drop in global trade, but it does bring additional downside risks to our 2012 GDP forecast. For example, if quarterly real export growth maintains its pace of 0.8% (the average 3-month/3-month rate over the last three months), it could shave roughly 0.7% from 2012's forecast. This would leave GEM-10 growing at 5.4% yoy, a meaningful reduction from our current 6.1% forecast.

European bank lending: what if the spigot shuts off?

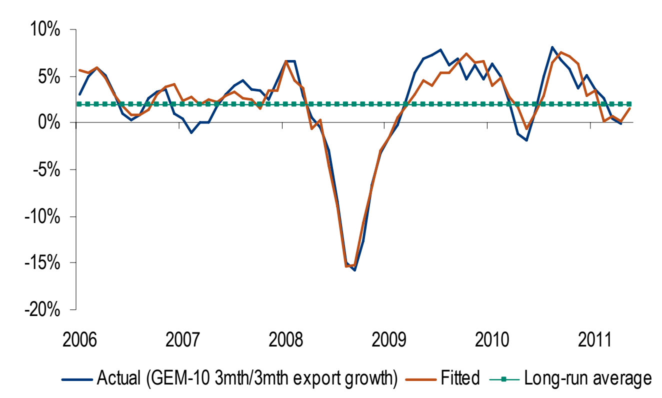
There is little evidence to suggest financial spillovers are significantly different now than what they were in the run-up to the Lehman collapse.

Despite persistent stress in the Euro zone, EU banks have increased their loans to GEMs in the past two years. This probably reflects confidence in GEMs' strong macro fundamentals, as well as the immense amount of liquidity pumped into global banking following the financial crisis. So far this year, EU banks have lent in excess of 14% *more* funds to EM Asia and LatAm compared to 2010. The increase in EEMEA has been less pronounced at 8% (Chart 69); EEMEA does remain the most exposed region with EU bank claims (including subsidiaries and domestically funded lending) accounting for 22% of the region's GDP.

However, there is a wide variance of exposure *within* regions. For example, EU bank claims in LatAm (as % of GDP) range from 7% in Colombia to 36% in Chile. The key implication is that even if a region does not look overexposed, some economies in it could be vulnerable.

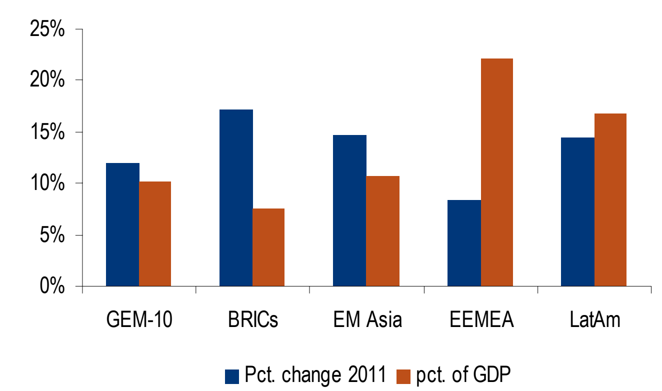
Also, there is little evidence to suggest financial spillovers are significantly different now than what they were in the run-up to the Lehman collapse.

Chart 68: xGEM points to soft real export growth



Source: BofA Merrill Lynch Global Research

Chart 69: EU bank claims on GEMS – consolidated BIS statistics



Source: BofA Merrill Lynch Global Research

Chart 70 highlights that correlations of GEM CDS with European CDS have declined marginally in EM Asia and EEMEA, but have increased slightly in LatAm. Overall, a major pullback of bank funding could tighten liquidity, raise borrowing costs and have knock-on effects on trade financing across GEMs. As a result, bank deleveraging poses an additional source of downside risk to emerging market growth in 2012.

Decoupling(?)

GEMs are more insulated now, but would not escape unscathed if a Euro zone crisis unfolds to full blown bank deleveraging.

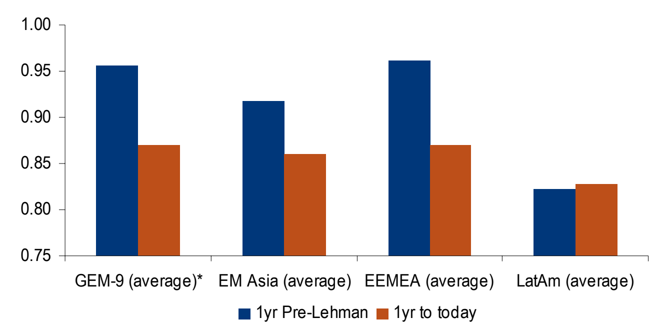
Last year we argued that trend growth between GEMs and DMs is diverging, while the cyclical components have become more synchronized (GEMs Year Ahead, 01 December 2010). This year, we attempt to quantify this by using cyclically adjusted quarterly growth rates of GEM-10 and a GDP-weighted combination of US and Euro zone. When we estimate a model for 1998-2006, we find that DM affects GEM-10 growth contemporaneously, as well as with a quarter lag. Taking into account the years up to 2011 reveals the magnitude of the contemporaneous impact has increased, but that lagged effects have become insignificant[4]; in other words, persistence of spillovers has come down recently.

For example, if a negative shock hits DM growth[5], our latest estimates reveal the initial response of GEM-10 growth is larger, but that reversion to trend growth is faster compared to what it would have been five years ago (Chart 71). Importantly, our results show that negative shocks to DM growth produce a cumulative effect on the GEM-10 GDP level that is now smaller than it was five years ago. In that sense, GEMs appear to have "decoupled" more from DMs over the last five years. Nonetheless, some spillover effects remain in place.

Another point is that while GEM-10 was small relative to the US, it is now about the same size. This should generate some decoupling effect as the relative weight of GEM-10 and their non-tradable sectors are both larger at present. Nonetheless, this does not fundamentally change the underlying relationship between the US and GEM-10 via trade and finance.

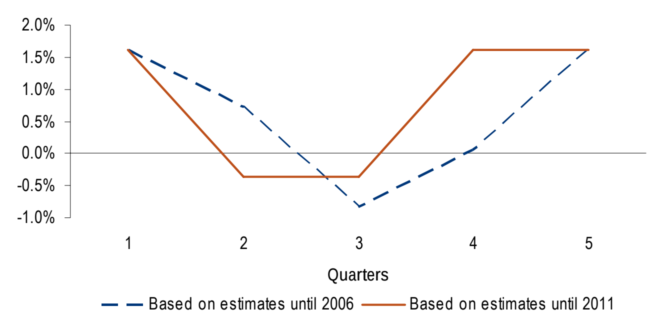
Overall, there is substance to this "decoupling" story. But transmission channels from DMs to GEMs are still very much operational via exports and the financial system. This suggests GEMs are more insulated now, but would not escape unscathed if a Euro zone crisis unfolds to full blown bank deleveraging.

Chart 70: Financial linkages down … but not out



Source: BofA Merrill Lynch Global Research
*GEM-10 excluding India

Chart 71: Response of GEM-10 growth to a shock in DM



Source: BofA Merrill Lynch Global Research

[4] We do this exercise by running regressions of GEM-10 growth on DM growth for 1998-2006 and separately for 1998-2011.

[5] We assume a 3.8std negative shock which is roughly the same as the one that hit US and EZ growth in 4Q09 and 1Q10.

Global forecasts

Economic forecasts

Global economic forecasts

	GDP growth, %				CPI inflation*, %				Short term interest rates**, %			
	2009	2010	2011F	2012F	2009	2010	2011F	2012F	Current	2010	2011F	2012F
Global and Regional Aggregates												
Global	-0.9	5.0	3.8	3.5	1.6	3.2	4.3	3.5	3.31	2.61	3.02	2.94
Global ex US	-0.1	5.6	4.4	4.0	2.2	3.6	4.6	4.0	4.19	3.28	3.79	3.74
Developed Markets	-3.9	2.8	1.6	1.2	0.0	1.4	2.7	1.7	0.71	0.58	0.59	0.43
G5	-4.1	2.7	1.4	1.1	-0.1	1.4	2.7	1.6	0.61	0.46	0.46	0.27
Emerging Markets	2.6	7.5	6.2	5.5	3.5	5.2	6.1	5.0	6.50	4.84	5.58	5.17
Europe, Middle East and Africa (EMEA)	-4.1	2.6	2.2	0.6	3.1	3.2	4.1	3.2	2.85	2.56	2.63	2.31
European Union	-3.9	1.9	1.6	-0.1	0.9	2.0	3.1	2.0	1.46	1.22	1.28	0.88
Emerging EMEA	-3.4	4.3	4.3	2.8	7.7	5.7	6.2	5.6	6.68	6.12	6.24	5.97
PacRim	3.9	8.0	6.0	6.2	0.5	3.5	4.7	3.5	4.59	2.88	3.60	3.38
PacRim ex Japan	6.1	8.8	7.2	6.9	0.9	4.4	5.6	4.2	5.70	3.47	4.30	4.01
Emerging Asia	6.6	9.2	7.5	7.1	0.9	4.6	5.8	4.2	5.95	3.52	4.40	4.05
Americas	-3.1	3.9	2.6	2.3	1.4	2.9	4.1	3.2	2.63	2.50	2.87	2.65
Latin America	-2.0	6.3	4.5	3.5	6.4	6.3	6.7	6.7	9.33	8.88	10.17	9.44
G5												
US	-3.5	3.0	1.8	1.9	-0.4	1.6	3.2	1.8	0.250	0.130	0.125	0.125
Euro area	-4.2	1.8	1.5	-0.6	0.3	1.6	2.7	1.8	1.25	1.00	1.00	0.50
Japan	-6.3	4.1	-0.3	2.3	-1.3	-1.0	-0.4	-0.4	0.10	0.05	0.05	0.05
UK	-4.4	1.8	0.9	0.3	2.2	3.3	4.5	2.3	0.50	0.50	0.50	0.50
Canada	-2.8	3.2	2.4	2.1	0.3	1.8	3.0	2.6	1.00	1.00	1.00	0.25
Euro area												
Germany	-4.7	3.6	2.7	-0.5	0.2	1.2	2.4	1.4	1.25	1.00	1.00	0.50
France	-2.6	1.4	1.5	-0.6	0.1	1.7	2.2	1.5	1.25	1.00	1.00	0.50
Italy	-5.2	1.2	0.6	-0.7	0.8	1.6	2.8	1.6	1.25	1.00	1.00	0.50
Spain	-3.7	-0.1	0.7	-1.0	-0.2	2.0	3.1	1.7	1.25	1.00	1.00	0.50
Netherlands		1.6	1.8	-0.6	1.0	0.9	2.6	1.5	1.25	1.00	1.00	0.50
Belgium	-2.7	2.3	2.1	-0.4	0.0	2.3	3.5	1.8	1.25	1.00	1.00	0.50
Greece	-2.3	-4.4	-5.3	-1.8	1.3	4.7	3.2	3.1	1.25	1.00	1.00	0.50
Austria	-3.8	2.3	2.8	-0.4	0.4	1.7	3.5	1.9	1.25	1.00	1.00	0.50
Portugal	-2.5	1.3	-2.2	-2.0	-0.9	1.4	3.4	2.0	1.25	1.00	1.00	0.50
Finland	-8.2	3.6	2.6	-0.7	1.6	1.7	3.3	1.6	1.25	1.00	1.00	0.50
Ireland	-7.0	-0.4	2.1	1.6	-1.7	-1.6	1.1	0.9	1.25	1.00	1.00	0.50
Other Developed Europe												
Sweden	-5.1	5.3	4.7	2.2	-0.5	1.2	2.9	2.2	2.00	1.25	2.00	2.00
Switzerland	-1.9	2.7	1.9	0.2	-0.5	0.7	0.3	-0.2	0.00	0.25	0.00	0.00
Norway	-1.6	1.8	2.6	2.4	2.2	2.4	1.3	1.2	2.25	2.00	2.25	2.25
Asia Pacific												
China	9.2	10.3	9.2	8.6	-0.7	3.3	5.5	3.5	6.56	2.75	3.50	3.75
India	8.0	8.5	7.0	6.8	3.6	9.5	8.8	7.2	7.50	5.75	7.50	5.50
Korea	0.3	6.2	3.8	3.6	2.7	3.0	4.4	3.2	3.25	2.50	3.25	3.25
Indonesia	4.5	6.1	6.4	6.0	4.9	5.0	5.4	4.7	6.00	6.50	6.00	5.50
Australia	1.3	2.7	2.0	4.3	1.8	2.8	3.5	3.0	4.50	4.75	5.00	5.75
Taiwan	-1.9	10.9	4.4	3.2	-0.9	1.0	1.5	1.6	1.88	1.63	1.88	1.88
Thailand	-2.5	7.8	1.8	4.0	-0.9	3.3	3.9	3.4	3.25	2.00	3.25	3.00
Malaysia	-1.7	7.2	4.8	3.6	0.6	1.7	2.9	2.6	3.00	2.75	3.00	2.50
Philippines	0.9	7.3	3.7	4.4	3.2	3.9	4.4	3.3	4.50	4.00	4.50	4.00
Hong Kong	-2.7	-2.7	7.0	5.1	0.5	0.5	2.4	5.2	0.50	0.38	0.25	0.25
Singapore	-0.8	14.5	4.5	2.8	0.6	2.7	5.2	3.6	0.18	-	-	-
New Zealand	-2.1	1.5	1.4	4.5	2.1	2.3	4.2	2.5	2.50	3.00	2.75	4.50

Global economic forecasts

	GDP growth, %				CPI inflation*, %				Short term interest rates**, %			
	2009	2010	2011F	2012F	2009	2010	2011F	2012F	Current	2010	2011F	2012F
Latin America												
Mexico	-6.1	5.4	4.0	3.0	5.3	4.2	3.4	3.9	4.50	4.50	4.50	4.00
Brazil	-0.6	7.5	3.1	3.4	4.9	5.0	6.6	5.5	11.00	10.75	11.00	9.50
Argentina	0.9	9.2	8.7	2.5	6.3	10.5	9.8	9.9	18.44	11.08	19.50	19.75
Colombia	0.8	4.3	5.6	4.1	4.2	2.3	3.4	3.5	4.75	3.00	4.75	5.25
Venezuela	-3.3	-1.7	4.1	5.0	28.6	29.1	26.2	32.4	18.03	29.50	29.50	29.50
Chile	-1.5	5.2	6.3	3.5	0.4	1.4	3.2	3.1	5.25	3.25	5.00	4.00
Peru	0.9	8.8	6.5	5.3	2.9	1.5	3.3	3.4	4.25	3.00	4.25	4.00
Uruguay	2.9	8.5	6.1	4.0	5.9	6.9	8.1	6.5	8.00	6.50	8.00	7.00
EEMEA												
Russia	-7.9	4.0	4.0	3.6	11.7	6.9	8.6	5.7	8.25	7.75	8.00	7.00
Turkey	-4.7	9.0	6.8	0.0	6.3	8.6	6.4	8.8	6.50	6.50	5.75	5.75
Poland	1.6	3.8	3.8	2.6	4.1	2.7	4.1	3.0	4.50	3.50	4.50	4.00
South Africa	-1.7	2.8	3.2	2.5	7.1	4.3	5.1	6.7	5.50	5.50	5.50	6.50
Egypt	4.7	5.1	1.8	3.0	16.2	11.7	11.1	9.2	8.25	8.25	8.25	9.25
Ukraine	-15.1	4.3	3.8	2.7	15.9	9.4	8.7	14.0	7.75	7.75	7.75	8.25
Romania	-7.1	-1.3	1.5	3.5	5.6	6.1	6.3	2.8	6.00	6.25	6.25	5.75
Czech Republic	-4.1	2.3	1.9	1.7	1.1	1.5	2.2	2.7	0.75	0.75	0.75	0.25
Israel	0.8	4.5	3.9	3.5	3.3	2.7	3.7	2.8	2.75	2.00	2.75	2.50
Hungary	1.4	1.5	-0.6	0.7	4.9	3.9	4.2	3.0	6.50	7.00	7.00	7.00
GCC												
Saudi Arabia	0.2	3.8	6.8	4.2	5.1	5.4	5.2	4.8				
United Arab Emirates	-2.0	1.4	3.9	3.1	1.6	1.0	1.0	2.0				
Kuwait	-2.9	2.4	4.1	5.0	4.0	3.0	4.0	3.0				
Qatar	8.6	14.5	17.4	7.5	-4.9	-2.9	2.5	3.5				
Oman	1.1	4.0	4.2	4.0	3.5	4.0	4.3	3.0				
Bahrain	3.1	4.1	2.0	2.9	2.8	2.5	-0.5	2.0				

Notes: Global and regional aggregates are based on the IMF PPP weights unless stated otherwise. Countries within each region are ordered according to these weights.

* Annual averages. The HICP measure of inflation is used for Euro area economies. ** Central bank target rate, year-end, where available, short-term rates elsewhere. † US short-term rate forecast for 2008, 2009 and 2010 year end is 0-0.25%. Midpoint used in table above for global and regional aggregation purposes. Source: BofA Merrill Lynch Global Research

Three scenarios and market implications

	2012 GDP*	US Rates	Agency MBS	Credit	Munis	EM Mkts	S&P 500	MSCI world	FX	Gold/Oil
		Market impact (average for 2012)								
Present market level		*US 10y 2%*	*108bps*	*260 HG/790HY*	*10y/30y 2.3%/3.8%*	*EM Sov spd +422bps*	*1200*	*290*	*EUR = 1.33*	*1700/112*
Base case - BAD (50% probability)										
US: Slow growth w/some QE3. Fiscal drag means growth eases to 1-1.5% in 2H12.	EZ: -0.6%	10y =2.25%. Small rise in rates as the tail risk of Euro break-up fades but Fed on hold for much longer as growth headwinds remain due to fiscal drag.	Spreads in 90-115bp range in environment of stable rates, limited supply, and manageable prepayment risk	160HG/500HY This is "Goldilocks" for corporate bonds. Not a recession and growth is not fast enough to prompt a big shift into equities.	State budget gaps widen. Pension returns sound. 10y@2.81%/ 30y@4.37%. Supply sensitive. USA downgrade sensitive. Some downgrades.	Stable FX with a mild appreciation of around 2% vs USD, mostly in 2H12. Lower short term rates, concentrated in LatAm due to lower growth. Credit spreads 15bp wider.	1300. Europe recession is a growth headwind for foreign exposed cyclical sectors, but B2B spending and oil prices remain solid.	330. Modest upside for equities. Deleveraging & slower earnings growth limits upside. QE policies, valuation & positioning limit downside.	1.35. This is a scenario currently priced into markets so implications for EUR/USD will be limited.	1850/108 Gold continues to trend higher as Fed and ECB engage in some QE. Growth is sluggish but supply is tight so Brent stays supported.
Europe: Recession w/strong policy response: ECB cuts target to 0.50%, ramps up QE and might implicitly target rates. As a result, 2H12 is an improvement.	US: 2.0%									
China: Modest growth downtick based on lower export growth.	EM: 5.7%									
Bearish - UGLY (40% probability)										
US: Europe contagion affecting US financial sector	EZ: -2.5%	10y = 1.50% Bull flattener. Significant flight to quality event with risk of spillover to US banks. Higher US, recession risk limits fiscal easing/ bailout options.	Spreads widen to 125-150 bp range on flight to quality trade, increased funding costs, and higher credit risk for GSEs. QE3 is a backstop.	330HG/1000HY HY spreads typically peak at 1100bps in recession but balance sheets in better shape. Low interest rates and flat curve detrimental to HG, esp. financials.	State budget gaps even wider. Revenues behind estimates. 10y@1.75%/30y @ a ratio of 125%. More downgrades.	Further FX depreciation in excess of 10% vs USD w/EMEA underperforming. Bull steepening reflecting higher risk premium. Credit spreads 150bp wider.	1000. Global recession and falling oil prices result in a significant market correction consistent with the average recessionary peak to trough decline of about 30%.	225. Bear market driven by policy mistakes & recession. US tech, EM consumer & global energy stocks underperform as investors forced to sell risk.	1.20: the USD would be the best performing currency in the world in this scenario of flight to safety.	1600/80 Gold heads lower as deflation takes hold in Europe, US. Global oil demand drops off sharply, taking Brent prices much lower.
Europe: A major banking and debt crisis triggers a deeper recession	US: -0.5%									
China: Liquidity issues = harder landing.	EM: 3.8%									
Bullish - GOOD (10% probability)										
US: Pro-activity by Washington and less contagion from Europe	EZ: 1.0%	10y =2.75% Bear steepener, but Fed stays on hold until 2014, which will limit how high 10yr rates can go.	Spreads tighten to 75-85 bp range as refinancing potential and volatility drop.	160HG/500HY There is no difference between a growth rate of 2.5% and 2% as credit will be driven more by liquidity technicals than fundamentals.	Supply sensitive. Upgrades possible. 10y@2.50%/30y @100% ratio. Fewer ST Note Sales. Greater demand overall.	Strong currency appreciation of 7% or more vs USD. Bear flattening. Credit spreads about 70bp tighter.	1500. S&P 500 EPS comes in better than expected for cyclical sectors, Financials enjoy a relief rally, and the avoidance of a recession results in a lower equity risk premium.	375. Bull market driven by above trend recovery & "good" bear market in bonds. EU/US banks, Asian industrials, Japan autos, EM resources outperform.	1.45: USD remains a countercyclical currency that is vulnerable to good news.	2000/118 Gold heads higher as Europe, US engage in aggressive QE. Global oil demand reaccelerates, pushing oil higher.
Europe: Quick budget actions by countries under stress triggers aggressive ECB action	US: 2.5%									
China: Exports surprise to upside keeping growth closer to 9%	EM: 6.3%									

* As of 1 December 2011. Source: BofA Merrill Lynch Global Research

Bond yields forecasts

Quarter-end government bond yield forecasts (%)

		Q4 11	Q1 12	Q2 12	Q3 12	Q4 12
US	3m Libor	0.55	0.60	0.65	0.50	0.40
	2y	0.25	0.25	0.25	0.30	0.35
	5y	0.85	0.60	0.70	0.80	1.00
	10y	2.00	1.75	1.85	2.10	2.40
	30y	2.90	2.50	2.70	3.10	3.60
Euroland	3m Euribor	1.40	0.90	0.80	0.75	0.75
	2y	0.65	0.45	0.55	0.65	0.75
	5y	1.25	1.25	1.35	1.50	1.55
	10y	2.10	2.10	2.20	2.30	2.30
	30y	2.85	2.85	2.90	3.00	3.00
Japan	3m Libor	0.20	0.21	0.21	0.21	0.21
	2y	0.15	0.23	0.22	0.20	0.22
	5y	0.30	0.60	0.50	0.40	0.45
	10y	1.05	1.35	1.25	1.20	1.22
	20y	1.75	2.10	2.00	1.90	1.90
	30y	1.95	2.25	2.15	2.05	2.05
U.K.	2y	0.50	0.35	0.35	0.50	0.60
	5y	1.10	0.95	0.90	1.10	1.25
	10y	2.15	2.05	1.95	2.10	2.25
	30y	3.35	2.85	2.70	2.85	3.10
Canada	2y	0.80	0.60	1.25	1.75	1.90
	5y	1.25	1.35	1.60	1.90	2.10
	10y	2.10	1.90	2.15	2.50	2.75

Source: BofA Merrill Lynch Global Research

FX forecasts

Quarterly Forecasts- G10 currencies

	Spot	Dec '11	Mar '12	Jun '12	Sep '12	Dec '12
G3						
EUR-USD	1.33	1.30	1.25	1.25	1.28	1.30
USD-JPY	78	76	74	73	74	76
EUR-JPY	104	99	93	91	95	99
Dollar Bloc						
USD-CAD	1.03	1.07	1.09	1.09	1.07	1.05
AUD-USD	1.01	0.98	0.92	0.94	0.95	0.96
NZD-USD	0.77	0.77	0.72	0.74	0.76	0.77
Europe						
EUR-GBP	0.85	0.85	0.81	0.82	0.83	0.85
GBP-USD	1.56	1.53	1.54	1.52	1.54	1.53
EUR-CHF	1.23	1.23	1.23	1.24	1.25	1.26
USD-CHF	0.92	0.95	0.98	0.99	0.98	0.97
EUR-SEK	9.16	9.30	9.40	9.40	9.20	9.10
USD-SEK	6.88	7.15	7.52	7.52	7.19	7.00
EUR-NOK	7.76	7.90	7.95	7.95	7.90	7.85
USD-NOK	5.83	6.08	6.36	6.36	6.17	6.04

Source: BofA Merrill Lynch Global Research

Quarterly Forecasts- EM currencies

	Spot	Dec '11	Mar '12	Jun '12	Sep '12	Dec '12
Latin America						
USD-BRL	1.81	1.88	1.90	1.90	1.88	1.85
USD-MXN	13.64	13.80	13.70	13.70	13.50	13.30
USD-CLP	516	530	540	540	520	500
USD-COP	1,951	1,975	2,000	2,000	1,950	1,925
USD-ARS	4.28	4.35	4.60	4.80	5.00	5.20
USD-VEF	4.29	4.30	4.30	4.30	4.30	4.30
USD-PEN	2.71	2.70	2.70	2.70	2.70	2.70
Emerging Europe						
EUR-PLN	4.51	4.45	4.45	4.45	4.30	4.30
EUR-HUF	305	305	315	315	300	300
EUR-CZK	25.38	25.50	26.00	26.00	25.00	25.00
USD-UAH	8.00	8.00	10.00	10.00	10.00	10.00
USD-RUB	30.70	31.00	31.00	32.00	30.00	30.00
USD-ZAR	8.11	8.30	8.10	8.00	7.50	7.60
USD-TRY	1.83	1.85	1.85	1.80	1.70	1.70
EUR-RON	4.36	4.35	4.40	4.30	4.30	4.30
USD-EGP	6.01	6.00	6.00	7.50	7.50	7.50
USD-ILS	3.76	3.75	3.75	3.75	3.65	3.65
USD-AED	3.67	3.67	3.67	3.67	3.67	3.67
USD-KWD	0.28	0.27	0.27	0.27	0.27	0.27
USD-SAR	3.75	3.75	3.75	3.75	3.75	3.75
USD-QAR	3.64	3.64	3.64	3.64	3.64	3.64
Asian Bloc						
USD-KRW	1,143	1,160	1,220	1,180	1,160	1,140
USD-TWD	30.33	30.00	32.00	31.50	31.00	30.50
USD-SGD	1.28	1.29	1.38	1.35	1.33	1.32
USD-THB	30.90	30.80	32.50	32.00	31.00	30.80
USD-HKD	7.77	7.82	7.83	7.80	7.76	7.78
USD-CNY	6.38	6.35	6.40	6.35	6.30	6.20
USD-IDR	9,113	9,000	9,300	9,200	9,100	9,000
USD-PHP	43.58	43.00	45.00	44.00	43.00	41.00
USD-MYR	3.18	3.20	3.25	3.20	3.15	3.10
USD-INR	52.21	51.50	55.00	53.00	52.00	49.00

Note: Forecast as of 31 August 2011. Spot exchange rate as of 29 August 2011. The left of the currency pair is the denominator of the exchange rate. Source: BofA Merrill Lynch Global Research

Link to Definitions

Macro

Click here for definitions of commonly used terms.

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Team Page

Global Economics

Ethan S. Harris +1 646 855 3755
North American Economist
MLPF&S
ethan.harris@baml.com

Gustavo Reis +1 646 855 6356
Global Economist
MLPF&S
gustavo.reis@baml.com

United States Economics

Michael S. Hanson +1 646 855 6854
US Economist
MLPF&S
michael.s.hanson@baml.com

Michelle Meyer +1 646 855 6261
US Economist
MLPF&S
mmeyer2@baml.com

Neil Dutta +1 646 855 9322
US Economist
MLPF&S
indraneil.dutta@baml.com

Joshua Dennerlein +1 646 855 8027
US Economist
MLPF&S
joshua.dennerlein@baml.com

Developed Europe Economics

Laurence Boone +44 20 7995 6706
Europe Economist
MLI (UK)
laurence.boone@baml.com

Nick Bate +44 20 7995 4262
UK Economist
MLI (UK)
nick.bate@baml.com

Tina Sidemark +44 20 7995 9237
Europe Economist
MLI (UK)
tina.sidemark@baml.com

Japan Economics

Masayuki Kichikawa +81 3 6225 8214
Japan Economist
Merrill Lynch (Japan)
masayuki.kichikawa@baml.com

Setsuko Yamashita +81 3 6225 7139
Japan Economist
Merrill Lynch (Japan)
setsuko.yamashita@baml.com

Canada Economics

Sheryl King +1 416 369 8756
Canada Economist
Merrill Lynch (Canada)
sheryl.king@baml.com

Ryan Bohren +1 416 369 8764
Canada Economist
Merrill Lynch (Canada)
ryan.bohren@baml.com

Global Emerging Markets Fixed Income Strategy and Economics

Alberto Ades +1 646 855 4044
GEM FI Strategist, Economist
MLPF&S
alberto.ades@baml.com

Vasileios Gkionakis +44 20 7995 0143
GEM FI Strategist, Economist
MLI (UK)
vasileios.gkionakis@baml.com

Isidore Smart +1 646 855 8083
GEM Economist
MLPF&S
isidore.smart@baml.com

Emerging Asia Economics

Hak Bin Chua +65 6591 0409
ASEAN Economist
Merrill Lynch (Singapore)
hakbin.chua@baml.com

Jaewoo Lee +82 2 3707 0465
Korea Economist
Merrill Lynch (Seoul)
jaewoo.lee@baml.com

Ting Lu +852 2536 3718
China Economist
Merrill Lynch (Hong Kong)
ting.lu@baml.com

Indranil Sen Gupta +91 22 6632 8653
India Economist
DSP Merrill Lynch (India)
indranil.sengupta@baml.com

Marcella Chow +852 2161 7236
Emerging Asia Economist
Merrill Lynch (Hong Kong)
marcella.chow@baml.com

Larry Hu +852 2536 3419
China Economist
Merrill Lynch (Hong Kong)
weijun.hu@baml.com

Xiaojia Zhi +852 2161 7815
China Economist
Merrill Lynch (Hong Kong)
xiaojia.zhi@baml.com

EEMEA Fixed Income Strategy and Economics

David Hauner, CFA +44 20 7996 1241
EEMEA FI Strategist, Economist
MLI (UK)
david.hauner@baml.com

Turker Hamzaoglu +44 20 7996 2417
Turkey, MENA Economist
MLI (UK)
turker.hamzaoglu@baml.com

Vladimir Osakovskiy +7 495 662 6168
Russia, CIS Economist
Merrill Lynch (Russia)
vladimir.osakovskiy@baml.com

Matthew Sharratt +27 21 815 2625
S. Africa, Nigeria Economist
Merrill Lynch (South Africa)
matthew.sharratt@baml.com

Raffaella Tenconi | +44 20 7995 9173
Italy, CEE, Ukraine Economist
MLI (UK)
raffaella.tenconi@baml.com

Mai Doan | +44 20 7995 9597
CEE Economist
MLI (UK)
mai.doan@baml.com

Jean-Michel Saliba | +44 20 7995 8568
MENA Economist
MLI (UK)
jean-michel.saliba@baml.com

Latin America Economics

Marcos Buscaglia | +1 646 855 2582
LatAm Economist
MLPF&S
marcos.buscaglia@baml.com

David Beker | +55 11 2188 4371
Brazil Econ, LatAm FI Strategy
Merrill Lynch (Brazil)
david.beker@baml.com

Carlos Capistran | +52 55 5201 3350
Mexico Economist
Merrill Lynch (Mexico)
carlos.capistran@baml.com

Francisco Rodriguez | +1 646 855 5910
Andean Economist
MLPF&S
francisco.r.rodriguez@baml.com

Oscar Munoz | +1 646 855 2308
LatAm Economist
MLPF&S
oscar.munoz@baml.com