Global Macro: Economic and Market Outlook

Neil MacKinnon
+44 (0) 20 7334 8865
neil.mackinnon@vtbcapital.com

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www.vtbcapital.com

Key themes

- **<u>The global economy</u>:** We have, and continue to hold, a "below-consensus" view on global GDP growth for this year reflecting the impact of elevated oil and commodity prices in squeezing real disposable incomes, the lagged effects of EM/China monetary tightening in response to inflation pressures and generalised fiscal tightening (actual and impending) in the "advanced" economies. For 2011, our global GDP forecast is 3.4% with risks to the downside as recession fears dominate.
- **<u>Inflation</u>**: Policymakers in the G-20 face an uncomfortable "stagflationary" situation which previously compelled inflation-targeting central banks to tighten monetary policy at a time of sub-par economic growth e.g the eurozone. Now the global economy is slowing down. Brazil has cut rates and the ECB is more neutral. In the US, the Fed will ease policy again ("Operation Twist") in conjunction with a mortgage refi program
- **<u>Fiscal Policy:</u>** the main challenge for policymakers is an effective resolution to the escalation in budget deficits and debt/GDP ratios affecting many of the advanced economies. EM economies are generally better placed in this regard though rising rates of money supply growth and credit creation remain an issue.

Key medium-term themes

- Chinese growth to remain resilient …we look for a “soft landing” rather than a “hard landing” and look for medium-term GDP growth in the 8.0-8.5% region. We look for a smooth economic transition ahead of next year’s change in national leadership.

- Global imbalances gradually correct themselves but progress is slow. The weakness of the USD which is a function of the Fed’s QE policy will intensify pressure towards evolving a multi-polar currency system which will likely include the RMB.

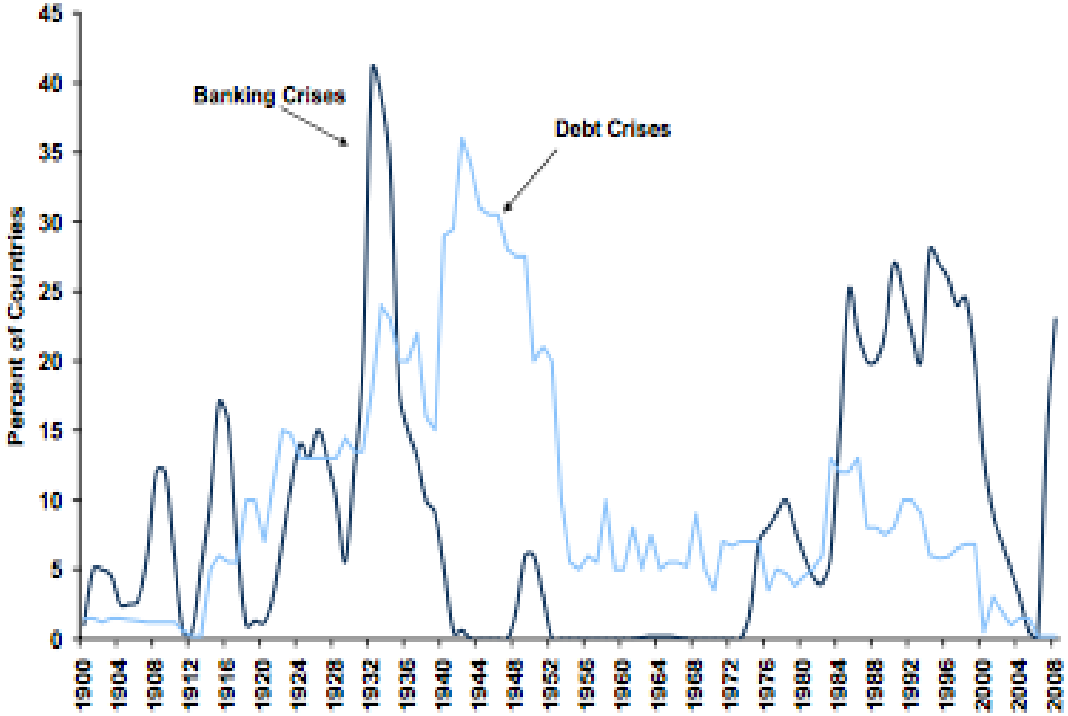
- For the advanced debt-burdened economies like the US and UK, **we expect the findings of the Reinhart-Rogoff thesis to apply** i.e a prolonged period of sub-par growth and high levels of structural unemployment. De-leveraging is still required but household debt levels remain high. **Risk of a re-emergence of deflationary forces** e.g US 10y Treasury below 2% and Shanghai Comp at lows for the year.

- EM economies have positive fundamentals and we expect relative GDP out-performance despite an absence of near-term “decoupling” as risk aversion increases thus dampening EM portfolio inflows.

- Downside risks include de-globalisation, an increase in protectionism and capital controls, and persistent geo-political tensions (Iran, Israel etc),

Sovereign Debt Crises Follow Banking Crises

Proportion of countries with banking and debt crises



Source: Banking Crises: An Equal Opportunity Menace by Carmen M. Reinhart and Kenneth S. Rogoff, Harvard University and NBER dated December 17, 2008

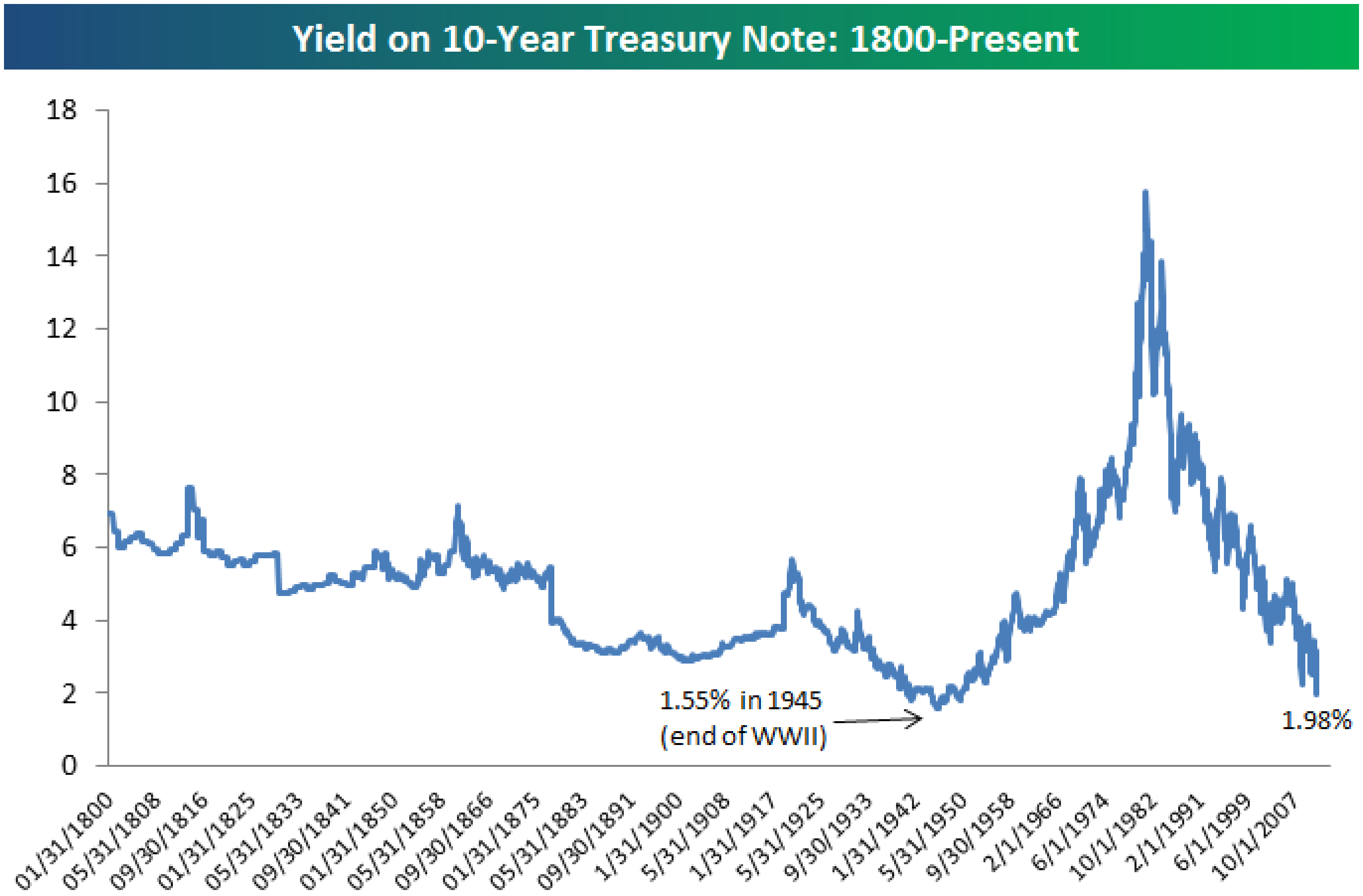
Eurozone Debt and Banking Crisis

- ECB contaminates its balance sheet…it is not the Buba !! Stark resigns
- A debt and banking crisis..a bailout for French and German banks !! $ funding pressures.
- Is Greece a “Bear Stearns” moment…Spain/Italy the “Lehman Moment” ? The contagion risk
- Rules are made to be broken and they have been broken
- When is a default not a default?
- The “end game”—Greek debt default, debt restructuring and bank recapitalisation…the ECB will print money
- The future of monetary union?

Markets-New Lows in 10 year bond yields

- In a post-balance sheet recession world (as per Reinhart-Rogoff), deleveraging and balance sheet repair constrains returns on equities. S&P500 target lows 1000 then maybe 840 then it is a “buy”
- QE2 did not help the economy but it did reflate commodity prices, EM equities etc.
- Financial repression, negative real rates, inflation liquidation of debt…all factors for bond investors to heed longer term
- EM equity markets in secular uptrend but inflation and credit growth are near term risks …capital controls etc
- FX—QE2 trashed the $ …signs of a $ comeback? SNB “floor” in EURCHF…deleveraging, capital preservation
- Eurozone-Greece is bust…default and debt restructuring inevitable…could Greece exit monetary union? Yes.

US 10 Year Treasury Yield Since 1800

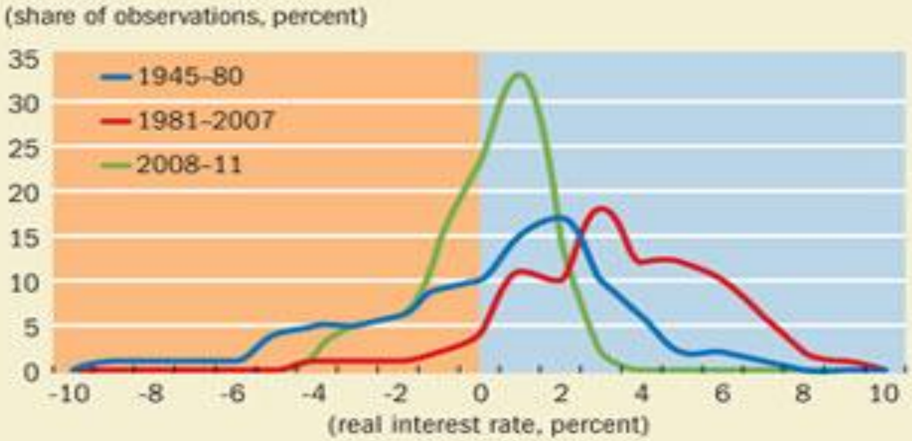


Financial repression here we come…

Chart 1

Real rates

In the three and a half decades following World War II and the three years since the global crisis, real rates, as exemplified by those on treasury bills from advanced economies, were on average negative.



Sources: Reinhart and Sbrancia (2011); IMF, *International Financial Statistics*; and authors' calculations.

Note: The economies represented are Australia, Belgium, Canada, Finland, France, Germany, Greece, Ireland, Italy, Japan, New Zealand, Sweden, the United Kingdom, and the United States. Interest rates for 2011 reflect monthly observations through February.

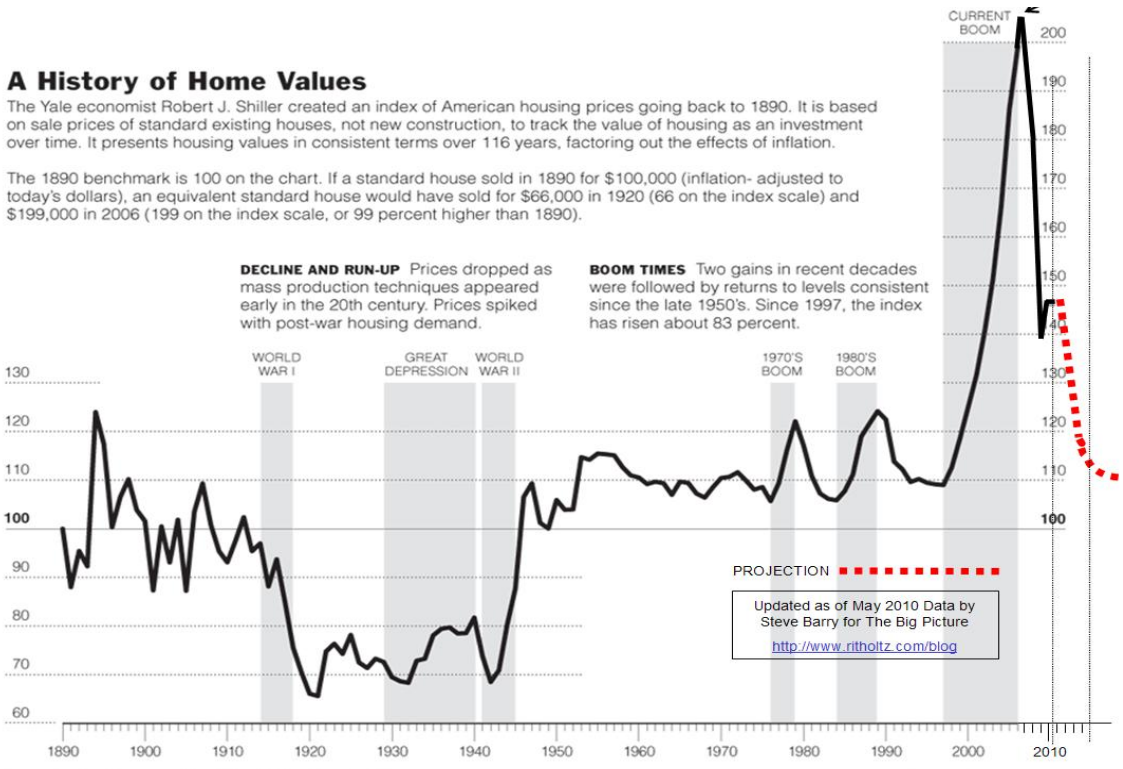
The US economy –running into headwinds

- We expect US real GDP to expand by 2.0% this year but we are alert to downside risks

- Consumer fundamentals are unexciting with subdued rates of wage growth, debt levels that remain too high and a housing market that remains depressed
- Slow recovery in the labor market too

- The fiscal stimulus of 2009 and 2010 has now ended …America's budget position requires fiscal consolidation though a significant program of policy tightening will likely wait until after next year's Presidential election…in 2012, net fiscal stimulus from America Jobs Act no more than 0.5% of GDP

- The Fed has pledged low fed funds rate until mid-2013



The US housing market remains depressed…house prices are at fresh post-bubble lows

We look for global GDP growth of 3.4% this year after 5.1% in 2010

GDP growth	2010	2011F	2012F
Global	5.1	3.4	3.9
Advanced	3.0	1.9	2.2
EM	7.4	5.6	6.0
US	2.9	2.0	2.5
Eurozone	1.8	1.5	1.8
UK	1.4	1.5	1.7
Japan	3.9	0.0	2.2
Brazil	7.5	4.5	4.1
Russia	4.0	4.5	4.2
India	10.4	8.4	8.1
China	10.3	8.9	8.5
World trade volume	12.4	6.9	6.6

Inflation	2010	2011F	2012F
Global (mfg, USD)	3.0	5.7	4.1
Advanced	1.6	2.6	3.5
EM	6.1	7.1	6.1
US	1.6	3.0	2.2
Eurozone	1.6	2.5	2.7
UK	3.3	4.4	2.7
Japan	-0.7	-0.1	0.5
Brazil	5.0	6.3	5.5
Russia	8.8	9.7	8.7
India (WPI)	8.5	9.5	8.0
China	3.3	5.4	5.5

Source: IMF, VTB Capital Research

FX and Bond Yield Forecasts:

	End-2011	End-2012
EURUSD	1.35	1.25
USDJPY	78.0	95.0
USDCHF	0.87	0.97
USDCNY	6.25	6.05
US 10 year Tsy yield	1.90	2.25
EUR 10 year yield	1.85	2.25
UK 10 year yield	2.25	2.30
JGB 10 year yield	1.15	1.35

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VTB Capital Offices

VTB Capital
Federation Tower West
12, Presnenskaya emb.
Moscow, 125047, Russia
Phone: +7 495 960 9999
www.vtbcapital.com

VTB Capital plc
Office 403
Currency House, Tower 2
DIFC
P.O. Box 482088
Dubai, UAE
Phone.: +971 (4) 377 0777
www.vtbcapital.com

VTB Capital plc
14 Cornhill
London EC3V 3ND
Phone: +44 (0) 20 3334 8000
Fax: +44 (0) 20 3334 8900
www.vtbcapital.com

VTB Capital plc
9 Battery Road #27-01
Straits Trading Building
Singapore 049910
Phone: +65 6220 9422
Fax: +65 6225 0140
www.vtbcapital.com