

# Political risks / policy inertia

## Summary

Political risks on both sides of the Atlantic will dictate how 2012 will unfold. Markets that have grown used to having policymakers come to their rescue whenever they are in trouble may be in for more surprises next year.

The two key assumptions behind our central scenario are: (1) the situation in Europe will have to get worse in order to force policymakers to move irrevocably toward closer fiscal integration; (2) the global economy will struggle to decouple from the first round of US fiscal tightening.

We believe these two themes will collide in Q1 which will lead to outperformance of the USD and US Treasuries. The visibility beyond Q1 is low, but we are concerned that the recession in Europe will undermine the political support for reforms and the euro, which may have unpredictable but crucial consequences.

In our preparation of this report, we have focused on identifying trade ideas that offer value, provide decent risk-reward trade-offs, and don't have high correlations. Please take a look at our report for our best 10 trade ideas for 2012.

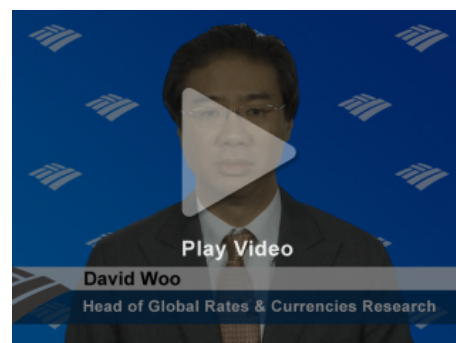


Global Rates & Currencies Research  
MLPF&S

David Woo +1 646 855 5442

FX and Rates Strategist  
MLPF&S  
david.woo@baml.com

[See Team Page for Full List of Contributors](#)



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Refer to important disclosures on page 40 to 41. Analyst Certification on Page 39. Link to Definitions on page 39.

David Woo +1 646 855 5442

## Political risks / policy inertia

After a very volatile 2011, it requires certain hubris to sit down and write a year-ahead report that purports to predict the market outlook for the next 12 months. While it is tempting to think that after such a year it can only get easier, we do not believe this is the case. Indeed, if there is anything we are confident about with respect to 2012 it is that both uncertainty and volatility are likely to remain very high. We fear politics, which has grown in importance in 2011, will continue its ascendancy, making it more difficult to decipher the reaction functions of policymakers and often producing market-unfriendly outcomes. The real challenge facing investors next year is navigating the increasingly volatile political landscape.

The two key assumptions behind our central scenario are that (1) the situation in Europe will have to get worse to force policymakers to move irrevocably toward closer fiscal integration and (2) the global economy will struggle to decouple from the first round of US fiscal tightening. We believe these two themes will collide in Q1 which will lead to outperformance of the USD and US Treasuries. The visibility beyond Q1 is low, but we are concerned that the recession in Europe will undermine the political support for reforms and the euro, which may have unpredictable and crucial consequences.

### Global growth to slow

We expect global growth to slow in 2012. Europe will enter a recession as fiscal austerity and bank deleveraging take hold. Notwithstanding the recent spate of strong US data, household spending will slow as fiscal tailwinds dissipate. Even Chinese growth will decelerate as external demand softens. The only major economy to enjoy a growth spurt will be Japan that will benefit from a pick-up in reconstruction related spending. Our economics team is looking for the world GDP growth to slow to 3.5% in 2012 from 4.1% in 2011.

### Monetary policy to ease

In the face of the global slowdown, we expect a loosening of monetary policy around the world. However, different countries will have different easing requirements. For example, we expect the ECB to cut more than the market currently expects but the RBA to cut less than what is priced in. We believe the increased probability that the ECB will eventually embark on QE of its own suggests some convergence of eurozone and US real yields is likely. Given that the US has the least scope to ease monetary policy, the USD should do better next year on shrinking interest rate differentials.

### Monetary policy is no panacea

With interest rates already very low, easing of monetary policy will have limited positive impact, especially as inflation is likely to prove to be sticky. Regarding QE3, as we recently pointed out, given bond yields are already reaching their lower limits, it will likely be both less positive for risky assets and less negative for the USD ([The curse of vanishing safe havens](#)). We share the view of our commodity team that monetary easing in the face of elevated commodity prices should cause gold to outperform most currencies.

### Resolution of the eurozone crisis in H1

With the menu of policy responses to the eurozone crisis rapidly shrinking, we believe the markets will soon force a resolution of the crisis in one way or another. European policymakers have begun to move towards the only viable path forward – closer fiscal integration – but we believe things might have to get worse to force policymakers to cross the Rubicon.

### Risks to our central scenario

Developments over the past week suggest that risks to our central scenario have increased. One such risk is that US growth momentum becomes self-sustaining and the payroll tax cuts are extended without offsets. Another risk is that European policymakers mount on December 9<sup>th</sup> a successful coordinated campaign to engineer a positive confidence shock to create a virtuous circle. If either risk materializes, it will place into doubt our call of a Q1 rally in government bonds and the USD.

## Our best 10 trade ideas for 2012

It would be an understatement to say that 2011 has been a challenging year for many investors. Increased volatility, absence of clear market trends, and proliferation of event risks (in 9 out of 18 weeks since August, S&P500 has had a 2% plus move on the Monday) have all been eating into performance. Moreover, a significant increase in the correlation of asset prices means investors have been spending most of their time trading “risk-on” and “risk-off”. Finally, increased redemption risk has reduced the staying power of many investors in long-term trades.

The challenge we set for ourselves in preparing this report is to come up with a list of trade recommendations that have the following characteristics:

- their returns (either on their own or jointly) should not be too correlated with general market risk
- they should provide good value (regardless whether they would benefit from a bearish or bullish risk environment)

Below is a list of trade ideas we have come up with and we divide them into three categories:

### Trades that would benefit from a negative environment

- **Receives EUR forward real yields.** This trade would benefit from more interest rate cuts by the ECB than is priced in and the ECB embarking on QE
- **Buy USD against AUD.** This trade would benefit from a US slowdown induced by our projected fiscal tightening
- **Sell FNMA against FFCB.** This trade would benefit from a potential downgrade of the GSEs in the run-up to the 2012 elections
- **Pay CAD 5y swap spread.** This trade would benefit from contagion from eurozone crisis or a sharp slowdown of the Canadian housing market

### Trades that would benefit from a positive environment

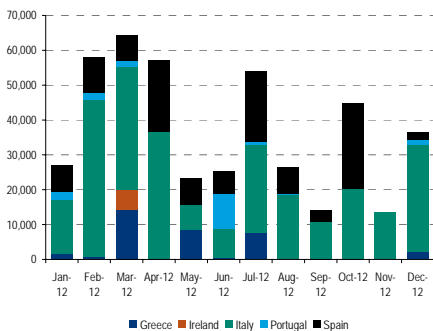
- **Buy ERH2 99.00/12/25/37 condor.** This trade stands to benefit from 1y tender, bank debt guarantee scheme and ECB rate cuts
- **Pay AUD 1y rates.** This trade is an extremely cheap way to position for an easing of concerns of Chinese hard landing scenario
- **Buy USD/JPY vol against EUR/JPY vol.** This trade would profit from a positive environment in which USD/JPY moves away from the intervention levels and vol declines in general

**Trades that could benefit from either a positive or negative environment**

- **Sell US 10y breakeven.** This trade would benefit from either a sharp global slowdown (deflationary) or the US economy sustaining its recent growth momentum (that reduces the probability of QE3)
- **Buy gold against the EUR.** This trade would benefit from the ECB adopting QE
- **Buy CNY, PHP and IDR against PLN, ZAR and RUB.** This trade would benefit from China loosening policies while European banks going through a prolonged period of deleveraging

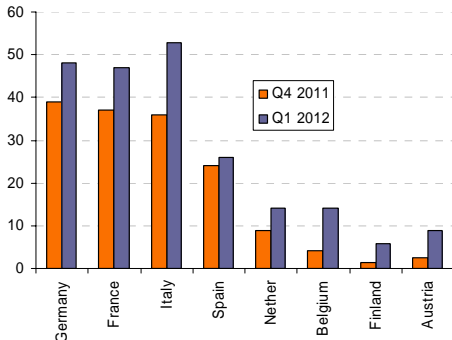
Ralf Preusser +44 20 7995 7331  
 Athanasios Vamvakidis +44 20 7995 0790  
 Richard Cochinos +44 20 7995 1242  
 Max Leung +44 20 7996 6580  
 Sphia Salim +44 20 7996 2227  
 Naeem Wahid +44 20 7996 6062

**Chart 1: Government debt maturities (principle, million EUR)**



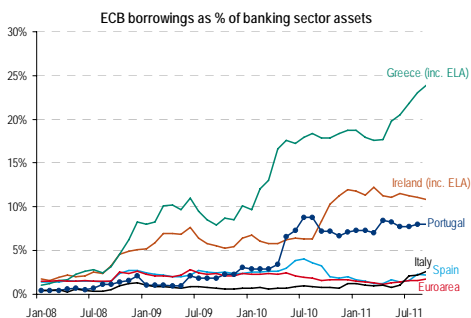
Source: BofA Merrill Lynch Global Research.

**Chart 2: Increase in conventional bond issuance in Q1 2012 (BofAML estimates \*) vs Q4 2011 (€ bn)**



Source: BofA Merrill Lynch Global Research. (\*) Estimates for Q1 2012 are based on a front loading of 2012 bond issuance similar to that seen in 2011.

**Chart 3: Borrowing at the ECB (% of bank assets)**



Source: BofA Merrill Lynch Global Research.

## EZ: Are we nearly there yet?

The market could soon force a resolution of the Eurozone crisis. While we are of the view that fiscal integration is the only viable path forward (see [End game: constructing the Eurobond](#)), the situation may need to deteriorate further to force policymakers to cross the Rubicon ([‘What-if’ scenarios](#)). The volatility still ahead and changing correlations across instruments makes it difficult to hold long-term trading views. We therefore focus on a portfolio approach in our recommendations: trades that we believe will perform well into Q1; trades with limited downside; and trades that provide hedges against tail risks.

### Growth outlook warrants ECB rate cuts

We expect a Eurozone recession next year (-0.6 yoy real GDP growth), driven by a combination of the deterioration in confidence, the fiscal drag, the negative feedback loop between funding costs, bank deleveraging and growth, and a weakening external environment ([Eurozone flirting with recession](#)). In response, we expect the ECB to cut rates to 0.5%, as well as to provide further bank liquidity support.

### Endgame is ECB QE and fiscal integration

Peripheral spreads are likely to remain a key driver of markets in 2012 (particularly early in the year, given the heavy maturity calendar shown in Chart 1, and the increased bond issuance highlighted in Chart 2). We believe that the crisis will eventually warrant a significant expansion of the ECB’s balance sheet, as well as more meaningful steps towards closer fiscal integration, including the issuance of Eurobonds (see [The case for ECB QE](#)).

ECB balance sheet expansion could be justified on the basis of rising deflation concerns, as well as the impairment to the monetary transmission mechanism implied by the repricing of sovereign spreads across the Eurozone. More short-term, however, the ECB is critical, as it could intervene without a balance sheet constraint, to provide ‘bridge financing’ until policymakers take more credible steps to resolve the crisis.

Fiscal integration is in our view the most realistic way of addressing the underlying moral hazard inherent in monetary union and the toxic combination of deteriorating public finances and worsening growth outlooks that have made debt burdens unsustainable in many Eurozone countries. However, political constraints suggest that the policy reaction function is likely to remain reactive, which in turn suggests a repeat of the trading patterns of this year, both for the currency, as well as for spreads. Put simply, the pain is not yet deep enough for policymakers to jump their shadow. Next week’s Summit meeting is therefore unlikely to prove a game-changer just yet - [Euro area failing to meet expectations](#).

### But tail risks remain significant

In the meantime, the list of downside and tail risks is growing:

- A recession implies that austerity programmes across the troika-countries could likely require additional funding. Rating momentum will remain negative. Funding costs are expected to increase further, which in turn risks strengthening the adverse feedback loop between sovereigns and banks with the rising risk of deposit outflows in the periphery. Indeed, the Greek banking system has lost about 1/5 of its private sector deposits in the last two years, while banks in Italy and Spain have increased sharply their reliance on ECB funding (Chart 3).

Table 1: Elections scheduled up to end of 2012

date	country	Type
04-Dec-11	Slovenia	Parliament elections
11-Dec-11	Cyprus	Municipal elections
22-Jan-12	Finland	Presidential, 1st round
05-Feb-12	Finland	Presidential, 2nd round
19-Feb-11	Greece	Parliament elections -
10-Mar-12	Slovakia	Parliament elections
10-Mar-12	Malta	local elections in local councils
22-Apr-12	France	Presidential, 1st round
May-12	Italy	Municipal elections
06-May-12	France	Presidential, 2nd round
06-May-12	Germany	Schleswig-Holstein State
Jun-12	Germany	Left Party Internal leadership
10-Jun-12	France	Parliament, 1st round
17-Jun-12	France	Parliament, 2nd round
Oct-12	Austria	Burgerland Local elections
08-Oct-12	Slovenia	Presidential
28-Oct-12	Finland	Municipal elections

Source: BofAML

- The pro-European political consensus could change in one of the triple-A core countries: 1/ the strong polling of Marine Le Pen in the French Presidential election could affect the tone of French politics; 2/ the minority government in the Netherlands could be at risk if Geert Wilder withdraws his support over any attempted treaty changes; 3/ Austria requires a two-third majority to approve treaty changes, with the Eurosceptic right holding almost one-third of the seats.
- The PSI discussions in Greece and the elections (expected for mid-February) imply the continued threat of a disorderly resolution of the unsustainable Greek debt situation. While this is largely priced for Greek bonds, the likely contagion, especially in Portugal, remains underestimated, in our view.
- Wide-spread capital flight from the Eurozone as a whole could take place in a tail risk scenario in which policy paralysis completely erodes investors' appetite for Eurozone assets.

### Implications for rates

Our long-term view is constructive for the periphery, but entering these trades now would be premature. Our central scenario suggests a long position in the European periphery, as well as most likely a short position in Bunds. In fact, a short position in Bunds would perform both in a capital flight scenario, as well as in a scenario in which Germany is perceived to be absorbing peripheral risk (be it through an expansion of the ECB's balance sheet, or explicit fiscal integration, or both). Positioning clearly becomes an issue of timing. We would argue that entering year-end positioned for QE and Eurobonds is premature, especially in light of the tail risks highlighted above. In fact, the lesson from 2011 for investors seems to be to position for the blow-out that triggers the policy response, rather than the policy response following the blow-out.

### Implications for the EUR

In our baseline scenario, we expect the EUR-USD to drop to 1.25 in early 2012, as the Eurozone crisis deteriorates, the ECB adopts a more dovish stance, and the US starts tightening its fiscal policy (see US section). Steps to address the crisis could keep the EUR-USD in a range, although narrower than the one in 2011. However, an even more substantial EUR weakening could not be ruled out if some of the above risks materialize. A short EUR position probably offers a better risk reward than a short Bund position, given that internal growth risks would rise significantly in a capital flight scenario, mitigating the sell-off in fixed income. Although the EUR has so far remained resilient to the crisis, our analysis points to substantial downside risks (see [What would it take for the USD to go up?](#), and [EUR crisis? What EUR crisis?](#)).

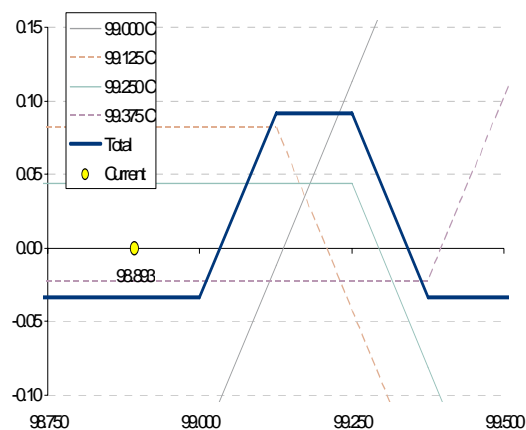
### Trade recommendations:

In this context, we would recommend the following trades:

#### Bullish EUR front-end

We still like receiving Dec ECB meeting Eonia and 1Y Eonia as we expect further ECB rate cuts ([Dr Draghi, the banks aren't felling very well](#)). In addition, we expect FRA/OIS spreads to gradually tighten on the back of the increasing likelihood of the ECB relaxing the collateral framework. The view of spread tightening will be best expressed via receiving fixed in Euribor-based swaps in the front-end, as we don't see spread tightening as a result of higher Eonia swap rates. We like buying Mar12 expiry Euribor call condors (ERH2 99.00/12/25/37 condor, entered at 3 ticks, currently 4 ticks) and receiving fixed in 6m fwd 1y (vs 3s) entered at 1.25%, currently 1.02%, target 0.80%, stop-loss 1.20%).

Chart 4: Payoff profile at maturity for ERH2 99.00/12/25/37 call condor



Source: BofA Merrill Lynch Global Research

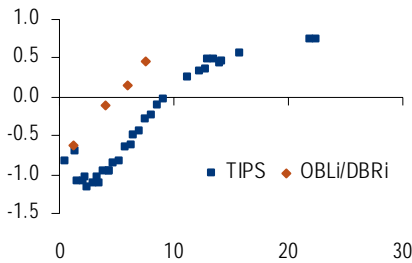
Receive EUR forward real yields

The euro inflation-linked market has seen a magnification of the stresses of the nominal market. Negative breakeven inflation rates for much of the Italian inflation-linked segment and the collapse in the breakevens of French paper bear no relation to the mild decline seen in inflation swap rates since late August. Two prime problems have been the issuer concentration, with France and Italy heavily over-represented compared to the nominal sovereign market, and the historic dependency on an asset swap bid (which, in turn, facilitated real rate receiving in swaps by the euro area's pension funds). Additional but related problems include, in no particular order, the ECB's SMP intervention focus on nominals, risk that Italy's ratings might be downgraded to the point where it loses index eligibility, a growing appreciation of the link between inflationary expectations and creditworthiness and (even) questions being asked over the legal status of the index uplift of principal in the event of default.

As investors have sought to maintain an inflation hedge but address index related risk there has been some migrating from euro to global inflation-linked benchmarks. As a result, the core German linker segment has suffered badly with, for instance, 5y Bundeis real yields currently 50bp above their early November lows of -0.67%. Note that we similarly had a rise in real rates in the U.S. in 2008 as liquidity dried up in TIPS.

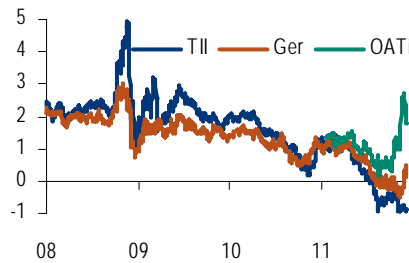
With the real yield curve between the 2013 OBLi and 2016 Bundeis fairly steep (Chart 5), the forward real yield between the bonds currently stands at 0.14%. This compares to -0.89% between similarly-dated TIPS issues (Chart 6). The 103bp spread between the German and US forward real yields is close to a record (Chart 7).

Chart 5: Real yields versus duration for German and US linkers



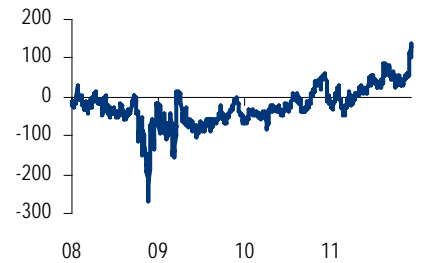
Source: Bloomberg

Chart 6: 2013-to-2016 forward real yields



Source: Bloomberg

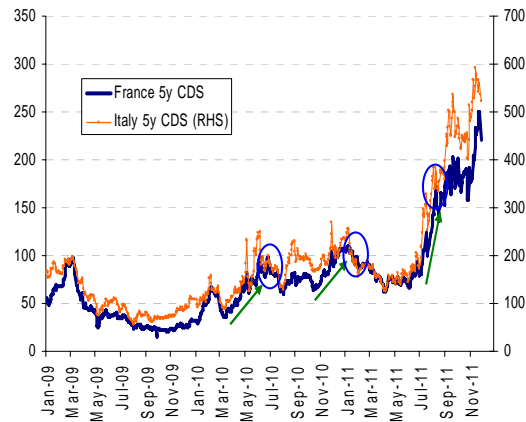
Chart 7: 2013-to-2016 Germany-US real yield spread



Source: Bloomberg

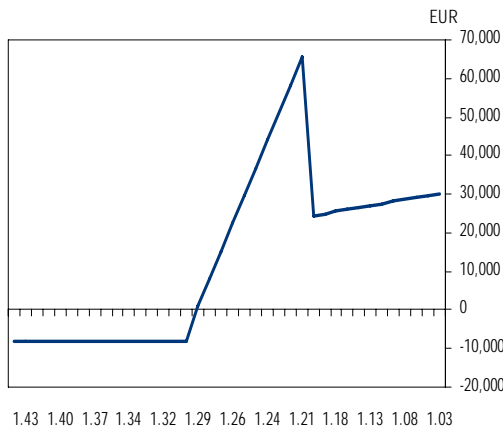
To us, the positive forward real rate in German linkers – for a three year span beginning in less than 18 months – prices monetary tightening occurring far too early. The crisis has aggressively tightened effective policy rates across the euro area, while the fiscal austerity in progress and the constricted credit channels warrant a long era of compensating monetary policy easiness. We would oppose this implied tightening by extending duration with cash-for-cash switches out of the 2013 OBLi into the 2016 Bundeis, at an implied forward real yield of 0.27% with a target of -0.30%. We set our stop loss at 0.56%.

**Chart 8: French CDS very much correlated to Italian CDS, but underperforming in periods where crisis deteriorates and prompts intervention of EU or ECB**



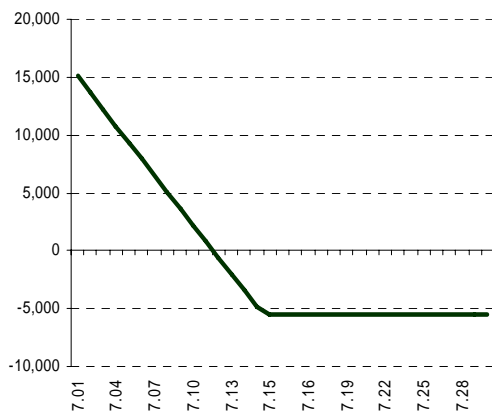
Source: BofA Merrill Lynch Global Research

**Chart 9: Payoff profile for 1mn EUR notional**



Source: BofA Merrill Lynch Global Research

**Chart 10: EUR-DKK put: payoff profile for 1mn EUR notional, breakeven around 7.11**



Source: BofA Merrill Lynch Global Research

**Buying protection on France**

Even as CDS spreads are close to record levels, we still believe that buying protection on France is an attractive way to position for tail risks. The French CDS is likely to widen inline with peripheral spreads in the scenarios of a credit crunch, a disorderly default in Greece, and capital flight from the Eurozone, but the French credit would also suffer from a resolution mechanism in which it is perceived to absorb additional peripheral risk (Chart 8).

We believe France will be more sensitive than other AAAs to these developments, due to the important exposure of its banks to peripheral countries, the larger percentage of its debt held by non-domestics and its weaker fiscal metrics which limit its potential, as a AAA issuer, to support the periphery. Finally, the presidential elections in April-May, followed by the parliamentary ones, could represent another source of pressure for French CDS, given the threat they pose to the pro-European camp (see above), but also the uncertainty they generates with regard to the implementation of the required fiscal consolidation.

We target 300bp for the 5y French USD CDS, from 200 bp on 1- Dec. The risks to the trade are 1) a material reduction in volatility, which would alleviate widening pressures in the CDS market and 2) some resolution of the crisis based on a large IMF intervention instead of EU/ECB support.

**Buy EUR downside protection**

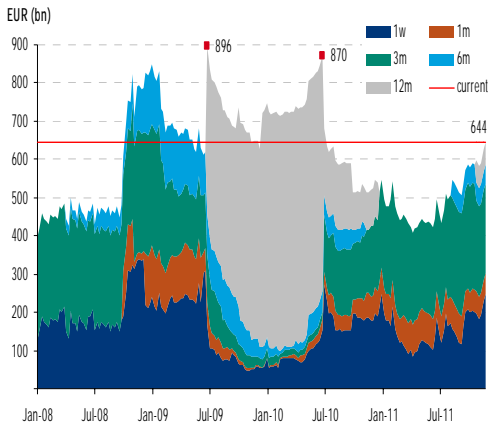
Buy 3m 1.30 EUR put, sell a 3m 1.26 EUR put with a knock-in at 1.21 (cost 0.75% of notional). Although we expect the EUR-USD to weaken in Q1, we do not expect a very sharp weakening or a complete dissolution of the Eurozone over that horizon. We therefore recommend owning a 3m EUR put at 1.30 to capitalize if a solution to the EZ debt crisis is not immediately forthcoming. However we look to cheapen this position by selling a 1.26 EUR put, with a knock-in at 1.21, 14 figures from current spot levels. The holder of this trade receives a 9-to-1 payout ratio with full exposure in EUR weakness from 1.30 to 1.21, which is well below our baseline EUR projection in Q1 (Chart 9). Should the EUR fall heavily under a tail risk scenario, triggering this barrier, the holder still would receive an approximate return of 3.0%.

**Buy EUR-DKK as a cheap tail risk hedge**

In a tail risk scenario that could threaten the Eurozone as a whole, currencies currently pegged to the euro could face strong upward pressure, risking the break of the peg. As volatility in a pegged currency is extremely low, this event risk is easily managed via the purchase of an out of the money put. We would recommend to hedge against such a tail risk with a 1-year 7.15 EUR-DKK put, which currently costs 0.57% (Chart 10). The DKK is currently part of ERM-II and is held in a  $\pm 2.25\%$  band, centered on 7.46038. Over the lifetime of the euro, EUR-DKK has held this band relatively well, rarely moving more than 1%. However, the peg could be challenged in the event that a EZ breakup becomes likely.

Max Leung +44 20 7996 6580  
Ralf Preusser +44 20 7995 7331

Chart 11: Breakdown of outstanding ECB MRO and LTROs by maturity



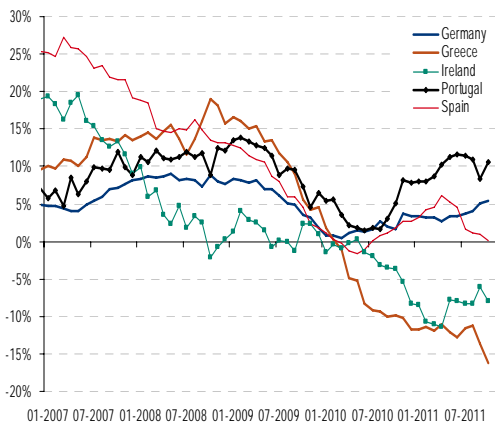
Source: ECB, BofA Merrill Lynch Global Research

Table 2: Changes in market values of sovereign and bank bonds\* since the beginning of the year (€ bn)

	3-Jan	25-Nov	Chg
Euro sovereigns	4166	3928	-6%
- Portugal, Italy,			
Ireland, Greece, Spain	1610	1373	-15%
- Other sovereigns	2471	2555	+3%
Portugal, Italy, Ireland,			
Greece, Spain Euro			
financials	109	86	-22%
Other Euro financials	710	664	-7%

Source: BofA Merrill Lynch Global Research. \*Calculations based on BofAML fixed income indices

Chart 12: Deposit growth of PIGS and German banks



Source: ECB, Haver Analytics

## EZ special topic: collateral shortage

The impact of the European debt crisis on banks is not limited to deposit outflows and higher funding costs. The significant decline in market value for banks' assets and the increased valuation haircuts in collateralised transactions also caused banks' eligible collateral pool to shrink. If collateral standards in the private repo market tighten further, the interbank market remains frozen and the bank deposit flights continue, it is not unreasonable to expect more banks failing in manners similar to that of Dexia – out of cash and out of collateral. We would argue that such a tail risk provides a good case for the ECB to relax the collateral rules for its repo operations soon.

After President Draghi mentioned in a recent speech that the scarcity of eligible collateral is one of the difficulties faced by banks, we believe that the ECB might decide on relaxing the collateral eligibility criteria and/or the haircut schedule as soon as the December meeting. However, relaxing the rules is only the first step to recovering the interbank market, as ECB liquidity measures can only address the symptoms (bank funding) but not the disease (sovereign insolvency).

### Recent signs suggest banks facing collateral constraints...

On an aggregate level, the European banking sector does not seem to face the problem of insufficient ECB-eligible collateral. The total amount of such securities should be well over €10 trn<sup>1</sup> even after the change in the ECB-eligibility rules for asset-backed securities earlier this year. That amount would be more than sufficient for a sizeable increase in banks' borrowings from the ECB from the €644bn in MRO and LTROs currently outstanding.

The real question is how this collateral is distributed among the banks. With the scarcity of term funding in the interbank markets (both secured and unsecured), large take-ups were anticipated in the 6m and 1y LTROs conducted in August and October respectively. However, demand in these operations has so far been weaker than the market expected, especially when the results are compared with the strong demand seen in the similar tenders in 2008/09 (Chart 11).

It is understandable that some banks might not have the appetite and/or the ability to engage in carry trades via these tenders, and that they could be saving up collateral for the next 1y LTRO in December. That said, it can also be argued that there wouldn't be the need to save up collateral had there been no constraints. The situation should be more acute for the periphery banks – natural holders of their countries' government debt – as their eligible securities holdings have likely shrunk the most given the multiple downgrades on the ratings of their sovereigns as well as theirs (Chart 12). Non-periphery countries' banks might also have suffered from sizeable declines in the values of their securities holdings as they are also large holders of banks bonds (€1.8trn as of Sep-11, versus €1.4trn in government securities).

### ...which has forced banks to use ELA in extreme cases

The decline in the securities' values, as well as the recent increase in repo haircuts for BTPS on LCH, means that these banks need to fund a larger portion of their assets using unsecured funding, deposits or other funding sources. But these other sources have also not been very reliable given the almost-complete shut-down of the unsecured funding markets and the continued deposit outflows in certain countries' banks (Ireland and Greece, Chart 12).

<sup>1</sup> According to the ECB's 2010 Annual Report, the average amount of eligible collateral was €14trn last year and ABS accounts for only €1.3trn.

Table 3: ECB borrowings (MRO+LTROs) breakdown by countries, and ELA borrowings

Amt (€ bn)	Jun11	Jul11	Aug11	Sep11	Oct11
Euroarea	455	497	514	587	598
Ireland	103	98	98	100	99
Ireland ELA*	56	57	56	53	48
Belgium	14	12	15	17	20
Italy	41	80	85	105	111
Spain	49	57	82	79	86
Germany	58	46	38	31	21
France	20	22	38	87	101
Greece	103	96	93	77	n/a
Greece ELA*	n/a	13	20	40	n/a
Portugal	44	44	46	46	46

Source: BofA Merrill Lynch Global Research, national central banks. \*ELA borrowings are estimates from the balance sheet of the respective national central banks; the ELA figures are separate from the sum of MRO and LTROs

In the extreme cases of the Ireland and Greece, the banks have been so short of collateral that a large part of their central bank borrowings is now in the form of Emergency Liquidity Assistance (ELA) extended by the Irish and the Greek central banks (Table 3).

### Reversing collateral standards to 2008-2010 is possible

With few signs that the conditions in the interbank markets will improve soon, we believe that the ECB could relax the collateral rules as soon as the 8 December meeting – to allow sufficient time for banks to prepare for the second 1y LTRO that is scheduled for 21 December. Possible ways to relax the rules include (and are not limited to) the following:

1. **For asset-backed securities:** allow ABS with only one rating above A- to be eligible (currently all ABS must have at least two ratings above A-)
2. **For eligible securities rated below A-:** lower their current haircuts to levels similar to those applied between Oct-08 and Dec-10, i.e. a flat add-on 5% to those corresponding haircuts for similar securities rated at or above A- (see Table 4 for current haircuts)
3. **For non-Euro denominated securities:** allow marketable debt instruments denominated in US dollar, pound sterling and Japanese yen, *and issued in the euro area*, to become eligible

These changes are not totally new to the ECB and the banks, as the ECB adopted similar collateral standards during the peak of the 2008/09 financial crisis. We would argue that as long as the standard of the modified collateral rules is at least as strict as those of 2008/09, then it should be simple for the ECB to justify the changes and should not face such criticisms as going against market trends (which are to tighten the collateral standards, e.g. LCH).

It is unclear by what extent the value of eligible assets held by banks will immediately expand<sup>2</sup>, as such calculations would require estimates at individual bank level. However, we should not ignore the reassuring effects from lowering the haircuts – that banks know that rating downgrades would likely result in an additional 5% haircut rather than 22.5% in the extreme cases. We also should not forget that banks should be able to create new collateral, particularly ABS (Charts 13 and 14), quicker if the first change above is implemented.

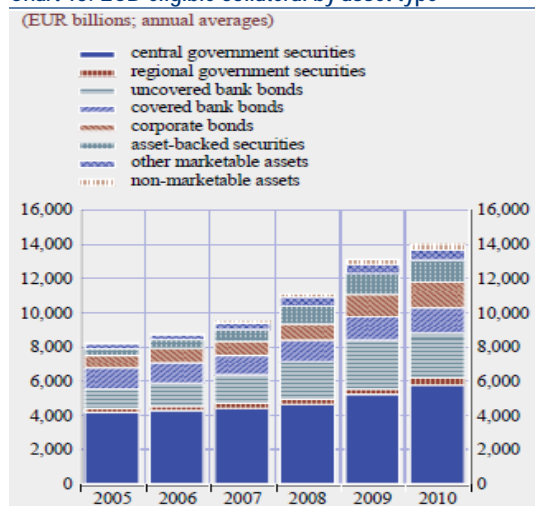
Relaxing the collateral rules would both allow and encourage banks to borrow more from the ECB if needed. Making the changes before the 1y LTRO would also allow banks more flexibility when planning for their 2012 issuance, with the issuance season resuming in January.

### ECB measures only address the symptoms, not the disease

Allowing banks to borrow more from the ECB and for longer term are very powerful tools to address European banks funding problems, but these measures (looser collateral rules, longer term tenders) are not the magical solutions that will unfreeze the interbank market overnight. The whole healing process of the interbank market brought about by these measures will likely be gradually felt – credit lines, which were cut in the past few months, could take weeks or even months to recover, as banks will likely remain risk-averse for a long time to come. In the end, ECB liquidity measures can only address the symptoms (bank funding) but not the disease (sovereign insolvency).

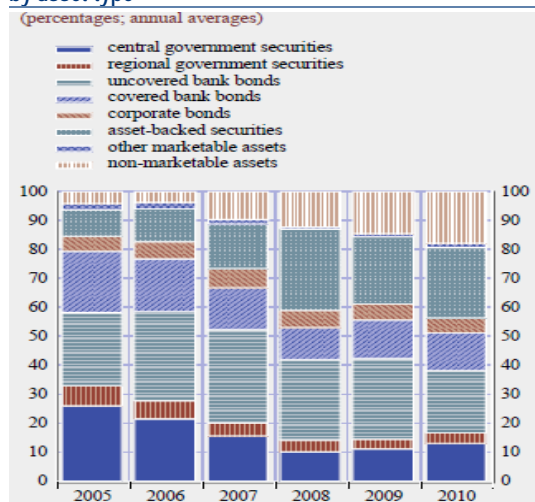
<sup>2</sup> The ECB estimated that around €870bn of additional marketable assets became eligible as a result of the expansion in collateral framework in 2008.

Chart 13: ECB-eligible collateral by asset type



Source: ECB Annual Report 2010

Chart 14: Breakdown of assets put forward as collateral by asset type



Source: ECB Annual Report 2010

## Market implications: front end rally led by Euribor/FRA

We believe that an expansion of the list of eligible collateral is likely and the ECB could make the announcement as soon as the December meeting. We remain bullish in the front end. The collateral announcement could trigger some unwinding of the crowded FRA/OIS spread wideners, but further tightening may have to wait until early next year when we get a better idea of how the interbank market functions. The view of spread tightening will be best expressed via receiving fixed in Euribor-based swaps in the front-end, as we don't see spread tightening as a result of higher Eonia swap rates.

## Trade recommendations

- Buy a ERH2 99.00/12/25/37 condor: entered at 3 ticks with 4% delta, currently 4 ticks. We expect 3m Euribor fixing to eventually go below 1%, with the help of the 1y tender and the bank debt guarantee scheme
- Receive fixed in 6m fwd 1y (vs 3s): entered at 1.25%, currently 1.02%, target 0.80%, stop-loss: 1.20%; 3m carry = +1bp. We prefer forwards rather than spot as the latter has significant negative carry (-9bp over three months)

## Box: Current ECB collateral haircut schedule

Table 4: Valuation haircuts (in ppt) applied to eligible marketable assets with *fixed coupons*

Credit quality	Residual maturity	Category I	Category II	Category III	Category IV	Category V
AAA to A-	0-1y	0.5	1.0	1.5	6.5	
	1-3y	1.5	2.5	3.0	8.5	
	3-5y	2.5	3.5	5.0	11.0	16
	5-7y	3.0	4.5	6.5	12.5	
	7-10y	4.0	5.5	8.5	14.0	
	>10y	5.5	7.5	11.0	17.0	
BBB+ to BBB-	0-1y	5.5	6.0	8.0	15.0	
	1-3y	6.5	10.5	18.0	27.5	
	3-5y	7.5	15.5	25.5	36.5	Not Eligible
	5-7y	8.0	18.0	28.0	38.5	
	7-10y	9.0	19.5	29.0	39.0	
	>10y	10.5	20.0	29.5	39.5	

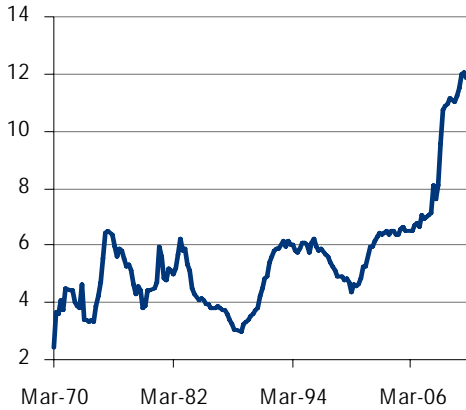
Table 5: ECB Liquidity categories for marketable assets

Category I	Category II	Category III	Category IV	Category V
Central government debt instruments	Local and regional government debt instruments	Traditional covered bank bonds	Credit institution debt instruments (unsecured)	Asset-backed securities
Debt instruments issued by central banks	Jumbo covered bank bonds	Debt instruments issued by non-financial corporations and other issuers	Debt instruments issued by financial corporations other than credit institutions (unsecured)	
	Agency and supranational debt instruments	Other covered bank bonds		

Source: ECB General Documentation

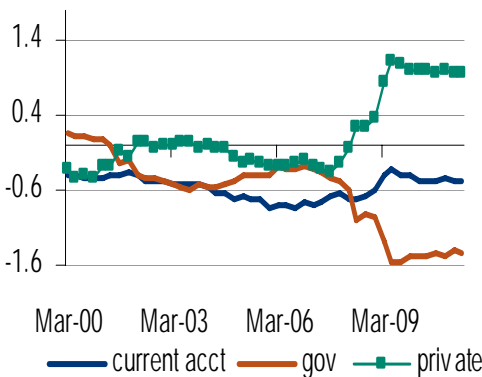
David Woo +1 646 855 5442  
Priya Misra +1 646 855 6467  
Marcus Huie +1 646 855 6389

**Chart 15: Net transfers from the government as a share of personal disposable income (%)**



Source: BofA Merrill Lynch Global Research

**Chart 16: Break-down of the US saving and investment balance (\$trn)**



Source: BofA Merrill Lynch Global Research

**Table 6: Fair value of 5s and 7s under different assumptions of the start of Fed hikes**

	5s	7s
Current*	0.97	1.55
Jun-13	1.15	1.70
Jun-14	0.75	1.35
Dec-14	0.59	1.17

Source: BofA Merrill Lynch Global Research. Current levels reflect the close as of Nov28<sup>th</sup>, 2011

## US: A fiscal turnaround story?

We believe the outlook for US fiscal policy will be a key macro theme and driver for the rates and currencies markets in 2012. Unlike 2011 in which the debt ceiling debacle and the failure of the super committee highlighted the lack of political will in Washington to tackle difficult fiscal challenges, 2012 has the potential to deliver some good news on the fiscal front, in our view. Indeed, although negotiations over the extension of the payroll tax cuts and emergency unemployment insurance benefits are continuing as this report goes to press, there is a good chance that we will see an outright US fiscal drag in 2012, for the first time since the end of the financial crisis. In our central scenario, US fiscal deficit will decline to about \$1trn next year, from \$1.3trn in 2011.

Moreover, with the pending expiration of the Bush tax cuts at the end of 2012 and the start of spending cuts under sequestration in 2013, political pressures will increase on both Republicans and Democrats to reach agreement on a more ambitious plan to address the long-term fiscal concerns ahead of the general elections. Our bottom-line: we expect the USD and US Treasuries will benefit from a potential turnaround in investors' perception of the near- and medium-term US fiscal outlook.

### Fiscal drag and recoupling

Fiscal tightening will be a significant negative for the near-term US growth prospect. Domestic demand remains very dependent on net transfers from the government<sup>3</sup>, which has swung by 5% of household disposable income in Q3 compared to pre-crisis levels (Chart 15), so lower benefits and higher taxes will hurt. Our economics team is looking for US GDP growth to decelerate from 3% in 4Q 2011 to just 1% in Q4 2012 before the expiration of the Bush tax cuts.

Fiscal tightening will not be good for global growth either. Indeed, we think many investors do not fully appreciate the role of US fiscal policy in the global recovery of the past 3 years - the \$1trn increase in the US private savings-investment balance since 2009 would have reduced the US current account deficit much more and had a greater negative impact on global growth, if it had not been for the extremely expansionary US fiscal policy under President Obama (Chart 16). We believe the world economy will struggle to decouple from significant US fiscal tightening.

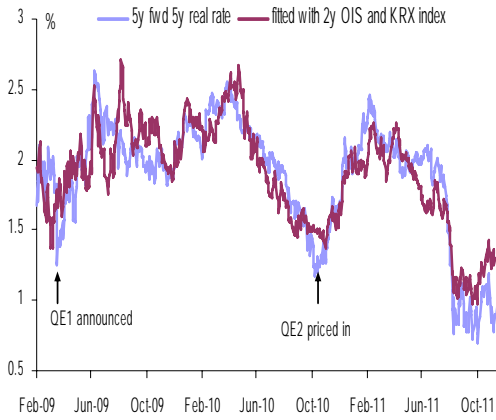
Finally, this tightening will also reduce the US fiscal deficit, albeit still at high levels. We forecast that net Treasury issuance will decline to \$950bn next year, down from \$1.1trn in 2011 (\$1.35trn adjusted for cash balance changes due to drawdown of the SFP program) and \$1.5trn in 2010.

### Implications for Treasuries

We believe that fiscal tightening and policy uncertainty all year should be a headwind for growth and therefore should be bullish for US Treasuries. In addition, we expect the net supply of Treasuries to also decline. We believe that a weaker growth picture and downside risks from Europe should result in the Fed committing to a longer on-hold period, either explicitly or via a framework. We therefore recommend owning Treasuries in the belly of the curve which is the most sensitive to Fed hike expectations (Chart 16). Further, we believe that the decline in rates will be led by inflation expectations. Hence, we expect nominal Treasuries to outperform TIPS as the recent decline in TIPS breakevens should continue.

<sup>3</sup> We define net transfers as government social benefits to persons minus contributions to social insurance.

**Chart 17: 5y5y real rates are lower than implied by the Fed**



Source: The chart shows 5y fwd 5y real rate (from our spline) vs its fitted value based on 2y OIS rate and the log of KRX stock index of regional banks. We assume the real rate and the OIS rate are co-integrated with 1/1 weights.  
Source: BofA Merrill Lynch Global Research

We also expect the 5s-30s curve, which has flattened significantly over the past 3 months, to continue its flattening trend. This trade is directional with the level of rates, and also benefits from the Fed's Operation Twist program, which takes out all the net supply in the 10+ year sector over the next 6 months.

**What does QE3 mean for interest rates?**

Fiscal tightening could delay the start of Fed tightening but it may also increase the probability of QE3. What does QE3 mean for our bullish Treasury call, especially given the start of QE2 is remembered by many to have provided a catalyst for a Treasury sell-off? At this point, we believe that there is a high likelihood of QE3 already being priced into the market. Our view is informed by our model for 5y5y real rates. We think the pricing in of asset purchases should be reflected in the deviation from the fit of the model and this divergence was noticed at QE1, QE2 and Operation Twist. Note that our model suggests now a deviation from the fit by as much as was seen when the market was pricing in QE2 and Operation Twist. This would argue that about \$500bn of 10year equivalents of asset purchases is priced into the market.

This is also consistent with the level of TIPS breakevens and the level of the curve. With 10year real rates in negative territory reflecting growth concerns, the level of breakevens at 2% and a steep curve can mostly be explained by QE3. As an example, in late September, when European contagion risk was high, real rates were about the same as today, while breakevens were 20bp lower and the curve was 10bp flatter.

Even though we do believe that the Fed will launch QE3 in response to a weak growth outlook, downside risks from Europe, and fiscal uncertainty, we don't see it happening soon. First, economic data in 4Q has been fairly robust and 4Q GDP is tracking 3%. Second, inflation expectations are still relatively high. Third, mortgage supply has not really increased which makes QE3 via mortgages look less plausible. Our mortgage strategists expect MBS supply to pick up only by 2Q, at which point QE3 may make a lot more sense.

**Our forecasts**

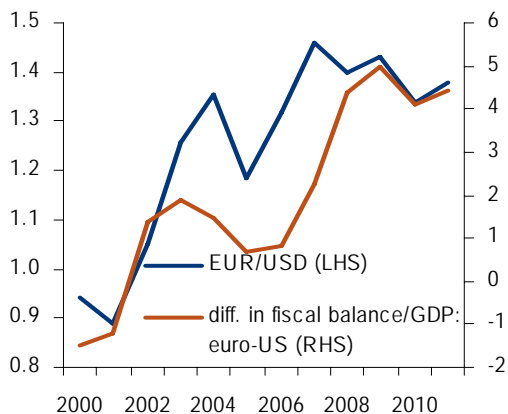
We forecast a declining trajectory of interest rates in 1H due to weaker growth, flight to quality from Europe and a Fed extending out the extended period some more. We see rates bottoming out at 1.6% in late 1Q or early 2Q. We also see the curve continuing to flatten in 1H as Operation Twist exacerbates the mismatch between supply and demand for duration in the long end. Then we expect some increase in rates in the 2H as the Fed embarks on QE3 and we head into the elections which should reduce some of the political uncertainty. Our forecast for the 10year Treasury yield at year end 2012 is at 2.4%.

**Implications for the USD**

In our past analysis, we have found that relative fiscal positions are a very important driver of the USD (Chart 18) and that a 1 percentage point relative improvement of the US structural fiscal balance as a share of GDP could lead to a 7% appreciation of the dollar, all else being equal. There are three main channels through which a tightening of US fiscal policy will benefit the USD:

- A smaller fiscal deficit will help reduce the risk premium investors have required to hold the dollar. This should provide a boost to the greenback as sustainable fiscal policy is a prerequisite for a reserve currency.

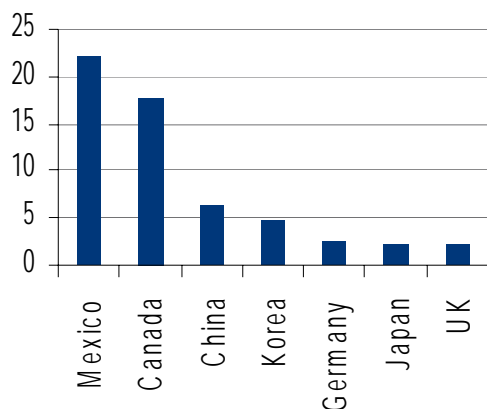
**Chart 18: EUR/USD versus the relative fiscal balance as a share of GDP (pp)**



Source: BofA Merrill Lynch Global Research

- An improvement of the US fiscal position is also likely to lead to an improvement of the US current account deficit which we expect to fall below 3% of GDP next year. This will reduce the dependence of the US on foreign financing of current consumption.
- The contraction of the US current account will help transmit the growth shock to US trading partners. From this point of view, currencies of countries whose exports to the US are large relative to their GDP would be the most vulnerable (Chart 19).

Chart 19: Exports to US as a share of GDP (%)



Source: BofA Merrill Lynch Global Research

## Our forecasts

We expect the USD to appreciate against most major currencies at the start of 2012. In our view, Q1 will provide the window for most of the USD gains as the first installment of the US fiscal tightening bites, the eurozone goes into a recession, and investors begin to question the ability of the rest of the world to decouple from the slowdown of the two largest economies in the world that account for 50% of global GDP. We expect EUR/USD to reach 1.25 and AUD/USD to reach 0.92 by the end of Q1. The USD's outlook for H2 of 2012 lacks visibility as it depends very much on highly uncertain outcome of the eurozone crisis and whether China will be able to avoid a hard landing. In our central scenario of closer fiscal integration in the eurozone and soft landing for China, we have the USD retracing some of its Q1 gains in Q3 and Q4 and EUR/USD and AUD/USD ending 2012 at 1.30 and 0.96, respectively.

## Trade recommendations

We recommend the following specific trade recommendations

- Own 5-year Treasuries at 0.97bp: A longer commitment of Fed on hold. Our target is 0.6%, with a stop loss at 1.2%.
- Short 10year TIPS breakevens at 207bp: pricing out of QE3 in the near term. Our target is 1.8%, with a stop loss at 2.25%.
- We recommend buying a 4m 0.98/0.93/0.88 AUD/USD put butterfly in 1x2x1 notional for 50bp at spot reference of 1.0224.

## Risks

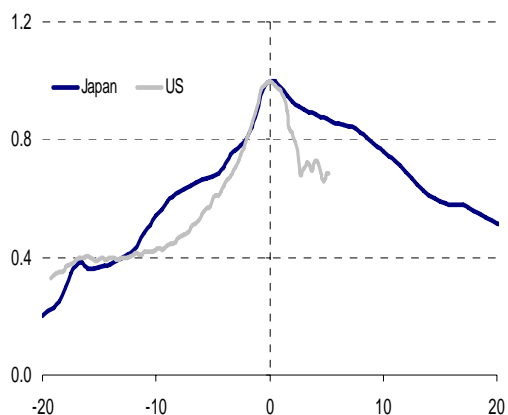
The biggest risk to our view is that Congress surprises by extending the temporary stimulus that is set to expire at the end of 2011 without offsetting spending cuts or revenue increases. In other words, a repeat of the December 2010 agreement to extend the expiring Bush tax cuts and provide additional stimulus in the form of a payroll tax cut could threaten our bullish view on rates. Last year's announcement sparked a sharp increase in interest rates and risky assets, decline in the USD and upgrades to growth forecasts, and the same could happen again.

The Fed could also embark on QE3 faster than we currently expect but we do not believe that this would have a huge impact on rates or the dollar as the market has seems to have already priced in a high probability of QE3. Also, as we recently pointed out, given bond yields are already reaching their lower limits, QE3 will likely be both less positive for risky assets and less negative for the dollar ([The curse of vanishing safe havens](#)).

Ralph Axel +1 646 855 6226

2012 could bring the first major test of the government's support of Fannie Mae and Freddie Mac since the summer of 2008.

**Chart 20: Home price bubbles in US and Japan**



Source: Bloomberg. For US, the data is Case-Shiller USA Home Price Index, for Japan it is Land Price National Residential. Each data series is normalized to equal 100 at its peak.

Capital injections beyond 2012 are limited to 150bn for Freddie and 125bn for Fannie.

## US special topic: agency credit risk

We see a heightened risk of a credit rating downgrade for Fannie and Freddie next year. This is driven by a combination of falling home prices, limited available capital, and reduced assumptions of government support.

In this event, Fannie/Freddie debt spreads have scope to widen relative to Federal Home Loan Bank and Federal Farm Credit spreads because FHLB and FFCB have sufficient capital and only a small government rating uplift.

### Credit rating risk rising for the GSEs

2012 could bring the first major test of the government's support of Fannie Mae and Freddie Mac since the summer of 2008. The rating agencies may be an important catalyst, as they have been for the US government, in bringing this issue to the market's attention. The credit rating agencies have become much more conservative and aggressive, and given the unexpected length of the GSE conservatorship and the continued negative outlook for housing, there is a growing probability that rating agencies will become more critical of the long term credit outlook for Fannie and Freddie. This would likely be a force to widen Fannie/Freddie spreads relative to other GSE or federal agency obligations.

The key driver of risk is that Treasury capital support becomes limited for Fannie/Freddie at the end of 2012, and this raises the question of long term solvency. If the housing market were healthier, the limited capital would be less of a concern. But with an additional 8 million distressed home sales expected through 2015, there appears to be little chance for a housing recovery next year. And although a 2013 recovery is our base case outlook, there are significant risks. Although comparisons to Japan can be misleading, it is interesting to at least note that since the Japanese housing bubble burst in 1990 home prices fell for the next 21 years and are still falling.

The rating agencies like to see a plan. Even if risks are elevated in the near term, a clear strategy to protect debt holders in the long run or at least to clarify the exposure that bond holders face would be helpful. But because 2012 is a presidential election year, we believe it would be difficult for Congress to address these GSE reform issues next year. This sets up the potential for increased criticism from rating agencies, more likely in the second half of the year, especially if Fannie and Freddie continue to require significant capital draws from the Treasury on a quarterly basis while the housing market remains weak.

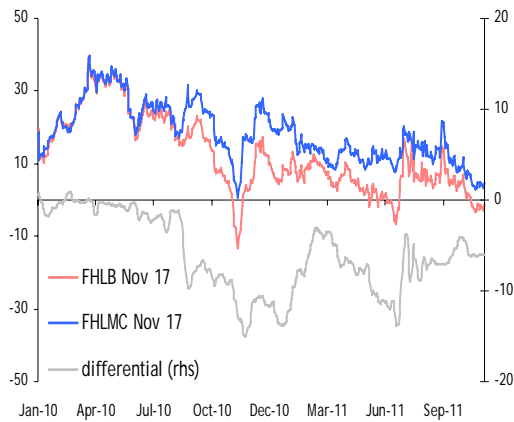
For this reason, we think there is scope for Federal Farm Credit debt and Federal Home Loan Bank debt to outperform Fannie and Freddie especially towards the second half of the year.

### Limited capital is the core of the problem

In its final form, the preferred stock purchase agreements between Fannie/Freddie and the government allow the government to inject as much capital as needed for the 3-year period ending December 2012, but capital injections beyond 2012 are limited to 150bn for Freddie and 125bn for Fannie.

It will take several years to see how credit losses accumulate, with the main variable being home prices. The GSE regulator (FHFA) recently ran simplified economic scenarios and found that an additional 50 to 170bn in capital draws may be required through 2014 depending on the path of home prices. In all of their housing scenarios they have home prices reaching a bottom in 2012. The BofA Merrill Lynch Economics team expects home prices to bottom in early 2013, but also sees a chance for larger price declines over a longer period of time ([US Macro Viewpoint, 16 November 2011](#)).

**Chart 21: FHLB and FHLMC spreads have remained close over time (asw, bp)**



Source: BofA Merrill Lynch Global Research

The trend of rating agencies is to lower the assumed strength of government support as regulatory frameworks aim to reduce instances of too-big-to-fail.

The deteriorating US fiscal outlook should also play a role in determining the level of assumed government support.

According to FHFA, with 185bn of capital already drawn (and carrying a 10% annual dividend rate), it is unlikely that the GSEs can earn enough in future years to fully pay dividends – and this is even in the best case scenario of a stabilizing housing market. This means that GSEs are expected to continue making capital draws to pay dividends, as they have generally been doing. This in turn increases the annual capital draw, thereby accelerating the rundown of available capital. The rating agencies must determine whether the limited capital buffers available to Fannie and Freddie together with some degree of additional assumed implicit government support are sufficient to warrant a credit rating equal to that of the US government in the context of home price uncertainty over the next several years. The degree of assumed government support may also be subject to review.

**Uplift has been reduced in the “new normal”**

Under normal circumstances the rating agencies assume the highest level of government support for Fannie and Freddie and this results in ratings equal to the US sovereign rather than their standalone ratings which are near the lowest level. By comparison, FFCB and FHLB have standalone credit ratings only one or two notches below their current ratings (which build in a government support assumption). Given the integral function that Fannie and Freddie serve in the mortgage market, it has historically been assumed that government support would always be forthcoming if needed. The fact that the government owns 185bn of GSE preferred shares and 950bn of agency debt and MBS also argues in favor of very high implicit support.

But the new trend of rating agencies is to lower the assumed strength of government support as regulatory frameworks aim to reduce instances of too-big-to-fail. In the special case of Fannie and Freddie, there is additional political pressure to end the government’s support and wind them down as quickly as possible. As seen in the White House proposal earlier this year, even democrats have yielded to political pressure and have turned in favor of winding them down and privatizing mortgage finance (with or without some form of FDIC-like government insurance fund). The fact that there is no bipartisan support for Fannie and Freddie could put additional downward pressure on the rating agencies’ assumption of the highest level of implicit government support.

**Eksportfinans a recent dramatic example of reduced uplift**

A major recent example of this was the downgrade of Eksportfinans by both Moody’s and S&P. This case had some special factors and it was an extreme downgrade (Moody’s dropped the rating 7 notches to Ba1). But the bottom line for Moody’s was that it believed “the inability of Eksportfinans’s owners to come to a solution enabling Eksportfinans to maintain its prior operations indicates the owners’ low willingness to support the institution.” The Norwegian government has a 15% ownership share in this case, and so a significant part of “ownership willingness to support” is the Norwegian government’s willingness.

**US fiscal outlook could also worsen uplift**

The deteriorating US fiscal outlook should also play a role in determining the level of assumed government support. When considering the strength of government support for Fannie and Freddie, rating agencies must consider not only the willingness but also the ability of the US federal government to raise whatever additional funds might be needed for such support. The less ability the US has to raise new debt and worsen its debt-to-GDP ratio, the less able will it be to fund future bailouts. If unlimited capital support is assumed for Fannie and Freddie, it would likely lead to additional strain on the US government’s credit ratings, which are already vulnerable to downgrade in early 2013 according to recent agency reports.

### **Banks are also feeling the removal of life support**

As another example, in September several US banks were downgraded by Moody's due to a decrease in the perceived probability that the US government would support the banks if it became necessary. This process is still ongoing and S&P downgraded many banks in November. It is also not a positive development for banks, or government support in general, that Thomas Hoenig is likely to take the position of vice chairman of the board of directors of the FDIC. As an outspoken critic of "too big to fail" this is yet another step in a building trend of reducing the uplift of assumed government support.

In September, Standard and Poor's announced an advance notice of proposed changes to its rating criteria of surpanationals. Like its bank review process, the goal is to review its methodologies and in part to improve the comparability of ratings between multilateral lending institutions and commercial banks. We see this as another potential move in the direction of reducing the government uplift in credit ratings of implicitly supported or partially government-owned financial institutions.

### **The end game**

Ultimately we believe that the government will have to stand behind the obligations of Fannie and Freddie because the alternative is unacceptable for the economy and housing market. But the transition from the current implicit level of support and limited capital to what may later be full support is unlikely to be smooth, and the issue may in part be forced by rating agency downgrades or threats. We believe other GSEs such as FFCB and FHLB which have sufficient capital and have very little government uplift in their credit ratings have scope to outperform in the process. We would position for a spread widening between FFCB and FNMA debt in the 5-year sector as we progress through 2012.

Ultimately we believe that the government will have to stand behind the obligations of Fannie and Freddie because the alternative is unacceptable for the economy and housing market.

### **Trade recommendation**

Buy 101.7mm FFCB 4.875% 1/17/17, sell 100mm FNMA 5% 2/13/17 at a yield spread of -2.5bp (FFCB yield is lower by 2.5bp). Target = -25bp, stop loss = +8bp. In terms of outright spread levels, 5-year FNMA debt currently trades about 40bp cheap to Treasuries and can widen to 60bp if credit rating risk increases.

### **Risks**

If the government acts more quickly to fully backstop or nationalize Fannie Mae then 5yr FNMA debt can tighten significantly versus Treasuries and outperform FFCB debt. If Fannie Mae is required to reduce its balance sheet more quickly than expected it could result in a sharper reduction in debt supply and a potential richening of its debt relative to FFCB.

Bin Gao +852 2536 3969  
Adarsh Sinha +852 2161 7155

## Australia: keep rolling

In our view, the Australia rates market is too dominated by global risk concerns. We believe the significant pessimism priced into the front end and belly part of the curve will fail to be confirmed by the RBA and see good opportunity to stay short of this sector for yield roll-up.

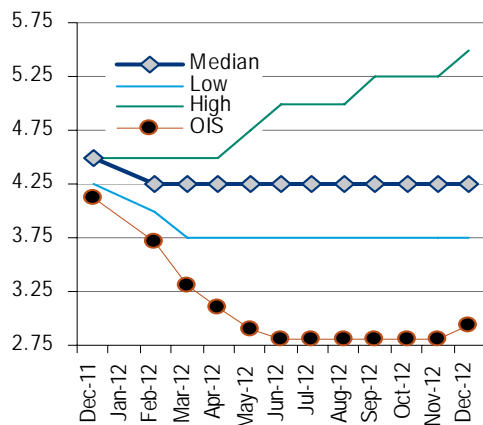
In contrast, AUD/USD remains elevated close to parity, arguably pricing in further near-term easing by the Fed, which we think is unlikely, as well as a relative decoupling of the Asia-Pacific region from a slowdown in the US and Europe, which will be increasingly questioned. We expect the AUD/USD to fall to 0.92 during the first half of 2012.

### Australian bonds as insurance policy

Contrary to the period of 2008, when Australia was considered one of the most vulnerable countries to succumb to a global financial crisis, it emerged out of the crisis as one of the better countries to deal with the ongoing one. The fiscal situation has improved; the 4.5% policy rates also leave plenty of room for the RBA to maneuver in case the domestic economy turns for worse. Partially because of high policy rates, investors, at the “when in doubt” moment – a theme we have discussed throughout the year, continue to flock to Australia’s government bond and interest rate swap market to hedge the outlier risk of deep and swift RBA cut in case of global situation worsens much further. Such positioning pushes the implied rates much lower than the level of economist consensus (Chart 22). What is striking is not that the OIS priced-in level undershoots the median consensus; they are nearly 100bp lower than the most pessimistic estimates by economists for almost the whole second half of 2012.

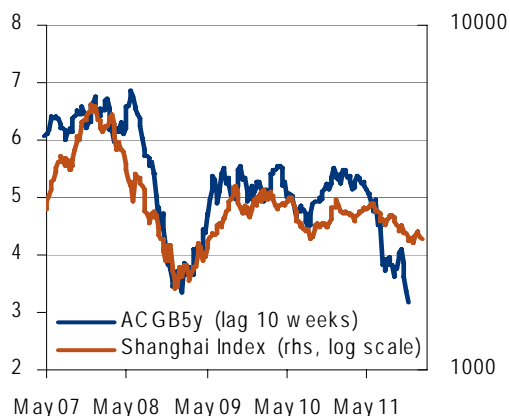
One of the key “when in doubt” moments lies in the fear of China hard landing risk. No doubt this risk has risen, and we for one have discussed this possibility ([A possible funding crisis in China? 7 September 2011](#)). China’s equity market seems to lead Australia rates (Chart 23). However, some of the risks have been addressed. For example, recent new measures to deal with the Ministry of Railway (MoR)’s debt problem has at least addressed the short term cash flow stress. The soft housing market will be offset somewhat by the affordable housing project. The very fact that the policy itself is tight offers room to adjust.

Chart 22: Policy rates median/low/high forecasts by Bloomberg survey and priced in by OIS



Source: Bloomberg, BofA Merrill Lynch Global Research

Chart 23: Shanghai A-shares leading Australia rates by 10 weeks



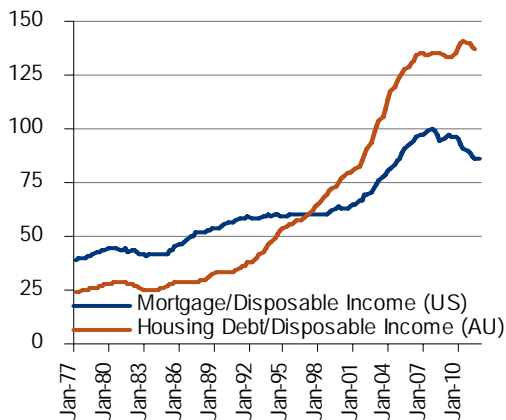
Source: Bloomberg, BofA Merrill Lynch Global Research

### Outlook for RBA rate path

**The external forces in Asia.** RBA consistently cites mining investment as a reason not to cut. Japan and China are the top two markets for Australia’s mineral exports. China soft landing and Japan reconstruction pickup will continue to keep this ball rolling.

**Growth strength balances inflation outlook.** Inflation irregularity due to the rebasing and floods/cyclone distortion earlier in the year will fade. The RBA lowered its inflation forecast in the most recent statement on monetary policy though the most inflation print surprised to the upside. Though the lower inflation provides room for lower rates, the RBA expects 4% growth in 2012 as coal exports returns to normal levels as infrastructure repair finishes. It also expects 3.25% headline inflation by end-2012 due to carbon tax starting in July. For long term outlook, 3% real growth and center-of-the-band 2.5% inflation hardly justifies aggressive rate cuts.

Chart 24: Housing debt vs disposable income for Australia and US household



Source: RBA, BofA Merrill Lynch Global Research

**Get more deleverage while it can.** The high leverage of Australia's household has consistently been a risk factor both investors and the RBA are keenly aware of (Chart 24). Peaking at 158.2%, the household was finally able to bring the debt level down to 153.5% by 2Q this year through savings. Recent drop in housing prices have been cited by some as a reason for the RBA to lower rates, but we beg to differ. With the economy performing better than most others in the developed world, it should be acceptable if these savings result in further reduction of housing prices as long as it is paced and business credit expansion continues. As a matter of fact, both are happening, eliminating any urgency for the RBA to quickly to step on the gas.

Amid the global concern, we do see another 25bp precautionary cut, likely in December. The RBA may even do another 25bp early 2012 to make the policy slightly easy. Still 50bp cut makes policy rates 4%, not sub 3%. The large spread between the economist forecast and the OIS implied suggests a significant degree of risk aversion. Though it is difficult to predict how this risk premium will evolve in the near term due to the inherent difficulty of predicting the global risks dominated by politics, we can analyze the path the RBA would like to take with much more confidence. Our main view is that the market rate will rise with the RBA delivery closer to what economists forecast. The fair value for government bond yield should be higher than the current level due to our view on policy rates but the support for bond can last longer due to the global diversification need.

### Implications for rates

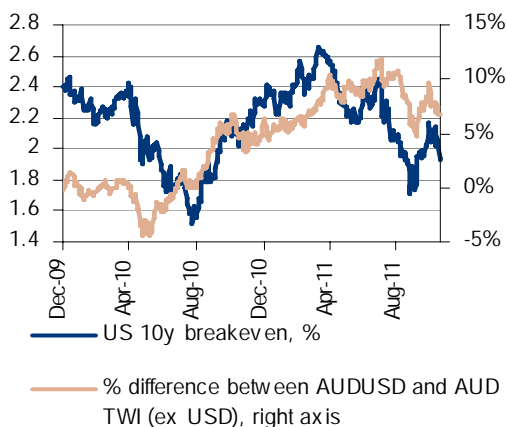
Under these scenarios, we see the front end rates to rise, pushing the fair value yield level higher for Australia 2y government bond to 4% toward the second half of 2012. The 10y in the meantime should rise to 4.75%. Currently, the 2y yield is around 3.3%, so the rise of yield is much less than what we think the OIS rate can do, climbing from 2.80% for some meeting months in 2012 to 4 to 4.25%. Part of the reason derives from OIS does prices in higher rates in 2013, part of the reason derives from the yield premium the ACGB can demand due to the diversification needs of global investors leaving Euro-region, and the last part derives from the government commitment to fiscal surplus in 2013, reducing the supply of government bond.

### Implications for the AUD

Despite the pricing of aggressive cuts in the OIS market, AUD/USD has been relatively resilient, anchored around parity for the best part of 2011. We attribute this to three factors - expectations of Fed easing particularly of the QE variety, the RBA's persistently hawkish bias relative to market pricing of rate cuts, and the pricing in of a soft landing scenario for China. The first is particularly crucial for the bilateral exchange rate - a marked divergence emerged between AUD/USD and our estimate of the AUD trade weighted index (ex USD) from August 2010 (Chart 25). This, in our view, was symptomatic of QE2 expectations and its eventual implementation. The divergence has narrowed sharply over the past month, but AUD/USD remains elevated relative to other AUD crosses (by over 8%).

Chart 25 shows this divergence has been closely correlated with the US 10y breakeven rate - consistent with the influence of QE expectations on both AUD/USD and US breakevens. In our view, expectations of near-term QE are misplaced - both US growth and inflation expectations need to be materially lower than current levels before additional easing is implemented, particularly since Operation Twist will be underway until the middle of next year.

Chart 25: QE expectations' influence on AUD/USD and USD breakevens



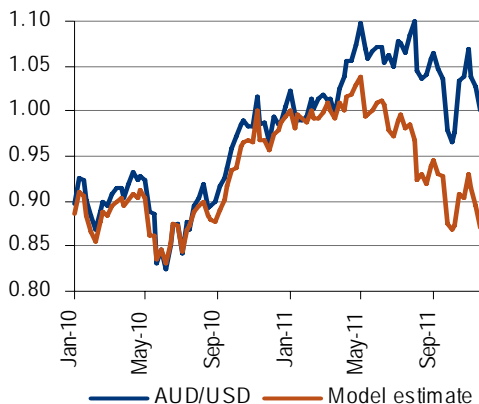
Source: Bloomberg, BofA Merrill Lynch Global Research

A broader USD rally in the absence of QE3 (or if it is deemed ineffective), as well as more weakness in Asian markets, which have generally benefited from QE-related inflows, could lead to a further narrowing of this divergence. US fiscal concerns may also account for some of this relationship as it would be associated with both a weaker USD and wider breakevens.

#### Fair value for the AUD

We have previously modeled AUDUSD changes as a function of three variables: (1) interest rate differential (1y1y forward), (2) commodity prices (CRB Index), and (3) VIX index (as a proxy for risk aversion), over the period since January 2010 ([AUD: How low can it go?](#)). This parsimonious model has very high explanatory power for changes in the exchange rate with little evidence that this is achieved by over-fitting. Chart 26 plots AUD/USD versus its estimated value showing the divergence since February 2011. This narrowed temporarily during the recent sell-off, but remains over 10%, indicating the fair value for AUDUSD is below 0.90.

Chart 26: AUDUSD model based on interest rates, commodity prices and VIX



Source: Ecowin, BofA Merrill Lynch Global Research

This model also allows us to judge the impact from the RBA not delivering the magnitude of cuts priced into the rates market: a 50bp rise in the AU 1y1y forward rate for instance will be associated with a 2.6% rise in the fair value estimate of AUDUSD, taking it closer to 0.90. We expect the first half of 2012 to be the most difficult for the AUD, against a backdrop of US fiscal tightening and persistent uncertainty around the Euro zone, and target a decline to 0.92. Thereafter, the prospect of further easing by the Fed and fewer cuts from the RBA, as well as a broadly weaker US dollar, should lead to a moderate recovery in AUD/USD later in the year.

#### Trade Recommendations

- Pay AUD 1y swap at 3.80%, against BBSW3M fixing at 4.55%. Target exit: 4.25%; stop: 3.5%.
- We recommend buying a 4m 0.98/0.93/0.88 AUD/USD put butterfly in 1x2x1 notional for 50bp at spot reference of 1.0224.

#### Risks:

We believe there are two main risks: China hard landing and European bank failures. China hard landing will likely kill mining investment and sharply slowdown economic growth in Australia, but its impact on financial sector will be limited. European bank failure will more likely spell trouble for Australian banks, which still relies on wholesale funding with loan/deposit ratio at 115%. The non-resident liability stalled at 20%. In the meantime, European banks claim on Australia remains stable at USD320bn, 35% of Australia GDP. Large scale asset sales by European banks remain a significant risk.

Shogo Fujita +813 6225 6684  
 Tomoko Fujii +813 6225 7142  
 Ling Wu +81 3 6225 6315  
 Shuichi Ohsaki +81 3 6225 7747

## Japan: Steady as she goes

With the growth outlook of the global economy set to deteriorate in 2012, Japan is, ironically, in an unusual sweet spot. While Europe and the US embrace fiscal austerity, Japan is set for fiscal expansion next year, driven by outlays on post-earthquake reconstruction. Our estimate for public investment growth is +16% next year. As a result, we expect Japanese GDP to increase 2.3% in 2012, which will make Japan the fastest growing G7 economy. Meanwhile, very low inflation will allow Japan to maintain very accommodative monetary policy. The mix of loose fiscal and loose monetary policy will provide Japan with an optimal policy mix to position for the global slowdown.

### 'Relative' flight to safe haven

It is important to see everything in "relative" terms. During Japan's "lost 20 years," investors have been concerned about the sustainability of its debt dynamics. We are fully aware of the long-term fiscal challenges facing Japan. However, it is important to recognize that Japan's fiscal position relative to other developed economies has improved in the past three years, mainly due to the dramatic deterioration of its peers' positions. As we set out in our report [Sovereign risk compared: surprising lead for Japan; rock-solid safe haven?](#), we believe Japan will enjoy a safe haven status to continue attracting capital inflows at least through 2012.

Indeed, the best performance on a risk-return basis in Japan since the Lehman Shock has been delivered by the Japanese Yen and JGBs (Chart 27). As we discussed in our report [Tough year for portfolio construction; rising correlation, JGBs walk their own path](#), Japan will benefit from a world in which investors increasingly seek to build portfolios which protect asset values rather than maximize return for higher implicit risk.

### Implications for JGBs

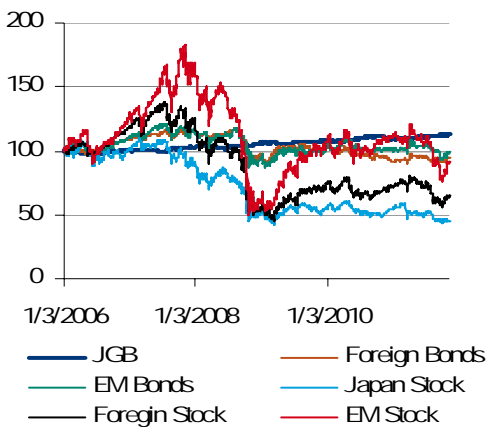
The results of this tendency are already plain to see, in our view. If Japan is set to maintain its relative safe haven status throughout next year, this suggests that interest rates on JGBs will fall a notch further because of the powerful influence of external factors, even if the domestic economy stages a recovery. This will be all the more so if external factors lead to a clear slowdown in the economy. As we set out in our report [Global flattening - the "haves" and the "have-nots"](#), a relative influx of cash into the "have" countries will lead to a bull-flattening of the yield curve, whereas the "have-not" countries are likely to see bear-flattening as transactions are mainly traded on recovery prices. We envisage further bull-flattening for Japan as a relative safe haven.

We project a range of 0.80–1.50% for the 10-year bond yield in 2012, mostly running at the bottom of the range. Even if interest rates were to rise slightly, we estimate that they would stay lower than current implied forward rates, and thus a bull-flattener will still be effective.

### Implications for the JPY

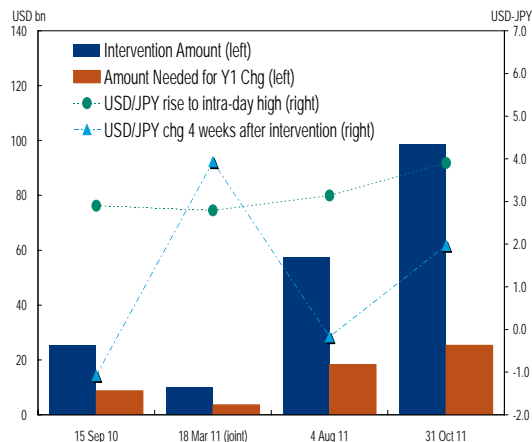
The JPY is likely to maintain its safe haven status and firm modestly during the first half of the year on risk aversion and US Fed easing expectations holding down US market rates. The Japanese authorities' responses via intervention and the BoJ's expansion of asset purchases should help limit JPY gains but are not likely to push the JPY sustainably lower (Chart 28). The MoF probably cannot conduct excessive interventions for fear of criticism from the G7, particularly the US, and the BoJ's response will probably remain reactive. Therefore, we expect

Chart 27: Various assets (yen base):2006/1=100



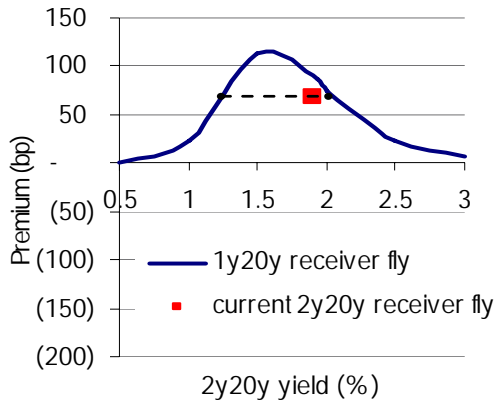
Source: BofA Merrill Lynch Global Research

Chart 28: Intervention amount, amount needed for Y1 chg and USD/JPY price changes



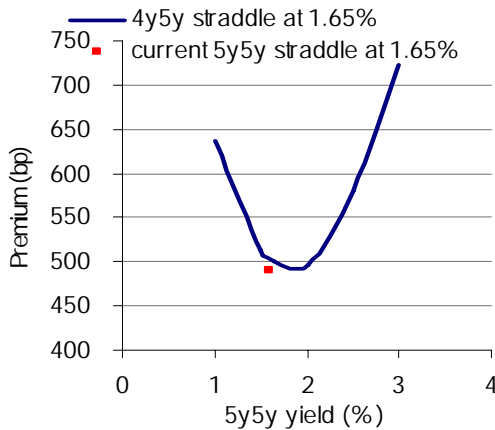
Source: Ministry of Finance, Bloomberg, BofA Merrill Lynch Global Research

Chart 29: 2y20y receiver fly @ 1.2/1.45/1.7



Source: BofA Merrill Lynch Global Research

Chart 30: 5y5y straddle strike at 1.65%



Source: BofA Merrill Lynch Global Research

USD/JPY to drop to 73 in Q2 2012, despite a possibility of temporary rebounds on interventions. In the second half of 2012, improving risk appetite following the Fed's QE3 implementation should pave the way for modest USD/JPY gains. Modest US market rates gains we envision should limit the upside for the pair.

## Trade recommendations

- **Buy a 2y20y receiver fly with strikes at 1.2/1.45/1.7.** The receiver fly is currently trading around 75bp, it will roll up by 16bp to a 1y20y receiver fly if the curve and volatility do not change. If the 2y20y yield, currently around 1.95%, were to stay around 1.25% to 2.1% range for the next year, the position would be profitable with a max gain around 50bp. If risk takes yield beyond the range, the downside of premium would still be capped at zero (Chart 29).

## Risks

The risk scenario lies in full-scale contagion to triple-A asset class given the ongoing European debt crisis. This would lead to selling-by-association for Japan, forcing domestic investor unwinds as risk management kicks in. Under such a scenario we would mainly expect city banks' medium-term zone portfolios to unwind, possibly leading to an abrupt bear-steepening phase ([City banks turning into MoF's fund raisers](#)). Even if such a scenario were to emerge, we believe it would prove short-lived, given the abundant domestic cash position and potential support from BoJ. With Japan still in deflation, there is really no hard limit on how much BoJ can print. However, should these all fail, the trade mentioned below would be an effective way to monetize the risk scenario, as well as positioning for an extension of the base case.

## Risk trade

- **Buy a 5y5y straddle struck at 1.65% to balance the risk/reward.** With its very high debt/GDP ratio, Japan's safe haven status could be seriously tested in a full-blown eurozone crisis. We like buying a 5y5y straddle struck at 1.65%. The receiver leg of the 5y5y enjoys large positive carry as the yield rolls down the curve quickly. The carry on the receiver leg will offset the time decay at the payer leg, resulting in a positive carry of 5bp with static yield curve and volatility. The straddle will benefit from a decline in yield from current level, especially a bull-flattening as in our baseline scenario. It will benefit from a quick sell-off as in our risk scenario, if 5y5y yield were to surge beyond 2.2% (Chart 30). Slow rate increases will be the most damaging to the trade due to potential loss on both Delta and Vega.

Downside risks to our USD/JPY view would come from increasing difficulty in the Japanese authorities' intervention, a prolonged Eurozone crisis and US sovereign downgrade concerns. Upside risks to USD/JPY would arise from positive surprises on global growth and risk sentiment, more aggressive BoJ easing and Japan's retreat from medium-term fiscal consolidation.

John Wraith +44 207 996 0405  
Richard Cochinos +44 207 995 1242

## UK: monetary activism and risk aversion

The early months of 2012 will be characterised in the UK by ongoing fiscal austerity, deep concern over the implications for the domestic economy of the crisis in the Eurozone, and ongoing unconventional monetary policy to offset the impact of the first of these, and to limit the damage caused by the second.

While the UK's own borrowing outlook and economic prospects remain highly uncertain, events elsewhere and aggressive asset purchases by the Bank of England are expected to keep Gilts performing strongly over the coming months. This will be magnified if our expectations of rapidly slowing consumer price inflation and a mild, two quarter recession over the first half of 2012 are realised. The ramifications of such policy, and poor economic ranking of the UK relative to the G10, should continue to put downside pressure on GBP-USD, in our opinion. However, given our expectations of a prolonged Eurozone crisis, there exists scope for sterling appreciation against the Euro in the first quarter of the year.

### Fiscal austerity and monetary accommodation

We expect fiscal austerity and quantitative easing (QE) to be the most significant themes in the UK in 2012. On the fiscal front, we do not expect the Government to deviate materially from its determination to stick to the structural deficit reduction plans. Any fresh disappointment on the growth front is likely to be combated by a combination of additional initiatives aimed at improving conditions in the wider economy through guarantees, and support programmes utilising the Government's sovereign creditworthiness, without adding materially to the deficit.

On QE, we expect the MPC to be left with little choice but to continue with asset purchases, funded by the creation of Central Bank reserves, and for these to consist overwhelmingly of conventional Gilts. If our expectations of two negative quarters of growth at the start of 2012 prove accurate, additional QE is almost certain to be endorsed by February, with a third tranche before the middle of the year also increasingly likely.

### Implications for Gilts

We believe cash Gilts can continue to richen materially as the twin influence of safe haven demand and aggressive Central Bank purchases combine to overwhelm concepts of fundamental valuation, and therefore retain a bullish bias for Gilts relative to forwards and on asset swap.

The relationship between money market rate expectations and the broader yield curve remains strong in the swaps market (Chart 31), and with those expectations now close to their lower limit, the scope for shorter end swap rates to fall in outright terms, or for the shape of the front half of the curve to materially change, may be limited. Moreover, the probability of a subdued environment for front end yields on very steady rate expectations argues for the shape of the longer end of the swaps curve also to exhibit a high degree of stability (Chart 32). A swaps curve restricted by rate expectations approaching their lower limit, coupled with powerfully bullish influences on longer Gilts from the combination of QE and safe haven demand from overseas' investors, point to marked richening of longer Gilts on asset swap.

Chart 31: Benign rate expectations are likely to mean low volatility in shorter swap rates...



Source: BofA Merrill Lynch Global Research

Chart 32: ...which in turn suggests a more stable environment for the longer end too



Source: BofA Merrill Lynch Global Research

We have written at length about [our view that](#) the Bank's Gilt purchases will exert a far more persistent influence on Gilts than occurred during the first round of QE between March 2009 and February 2010, and there is already mounting evidence of falling offer-to-cover ratios and rising average prices paid compared to mid prices at the buyback deadlines. We expect this to intensify as the Bank eats more deeply into the free float of bonds, and as ongoing distress in the Eurozone strengthens investors' determination to hold onto their Gilts.

Heavy skew in the Bank's purchases towards the longer end, and investors' insatiable demand for yield in the increasingly rarefied asset class of AAA-rated sovereign debt, lead us to recommend overweight positions in long Gilts. We expect cross market outperformance, ongoing flattening of 10s30s, and look for long Gilt yields to fall well below matched maturity swap rates in due course. We expect Gilt yields to rise gradually through the second half, though our bullishness in the first half, and our concerns that the fiscal plans will mean any recovery over the coming years lacks momentum, lead us to conclude that yields will remain well below implied forward rates for the entirety of 2012.

### Implications for GBP

GBP is caught between the opposing forces of greater fiscal credibility and further Gilt purchases by the central bank. The FX implications of additional QE might at first seem obvious - the net supply of GBP is increasing, logically suggesting the price should decline. However, typical yield curve triggers such as spread differentials, curve slope and relative curves have all failed to adequately signal GBP selling. In 2009, a marked weakening of the pound was only triggered following the second and third subsequent increase in the QE programme (Chart 33). Ultimately, significant GBP selling in the current round will again be predicated on further richening of Gilts on swap spread. With our expectations building for this under the deteriorating economic environment in Q1, we remain bearish on GBP-USD.

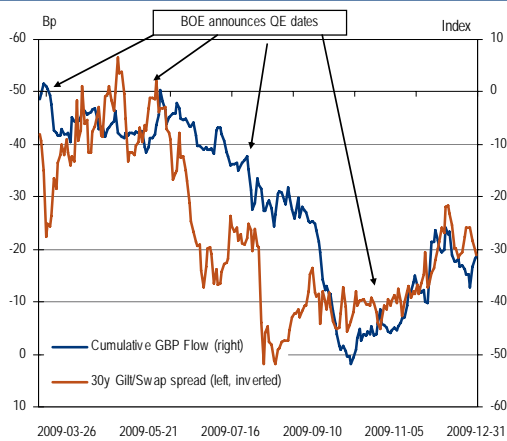
While the near term economic outlook for the UK remains troubling, there may be a case for cautious optimism to change the trajectory of yields later in 2012. We expect UK inflation to slow rapidly from the beginning of next year, meaning that real wages may finally return to positive territory for the first time in over three years. In addition, a comprehensive resolution of the Eurozone crisis would boost confidence at the same time as leading investors to reassess the appeal of Gilts and GBP in a less risky environment, placing pressure to the upside in EUR-GBP.

Defensive flows and overall lower global growth will continue to support USD outperformance of the higher beta GBP (Chart 34). Against the EUR, we see scope for GBP near term outperformance, eventually being undermined by the size and scope of the purchase programme.

### Trade recommendations

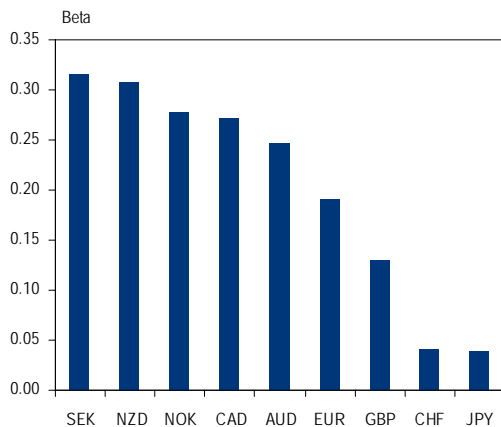
- Buy 10y / 30y flattener in Gilts
- Buy 30y Gilts (4Q 40) on asset swap
- Buy 3m 1.54/1.47 GBP-USD put spread with KO 1.62
- Buy 6m .086/0.90 EUR-GBP call spread with 0.83 KI

Chart 33: GBP selling over QE1



Source: BofA Merrill Lynch Global Research

Chart 34: Currency betas vs. stocks (USD crosses)



Source: BofA Merrill Lynch Global Research

Sheryl King +1 416 369 8756  
Ryan Bohren +1 416 369 8764

## Canada: position for rate cut and vol spike

Canada rates and credit markets are not immune to the stresses percolating in the Eurozone, and in our opinion, investors are underestimating 1) the potential spike in volatility, 2) the impact risk aversion will have on the economy and 3) the Bank of Canada's reaction – which we believe will be a 75bps cut in policy rates early next year to the 0.25% effective lower bound. Therefore, positioning for a spike in volatility and bull steepening make sense at the start of the year in our view. In the credit market we expect to see spread widening, but fundamentals imply non-financial credit will be the best performer, followed by CMBS (CMHC mortgage backed securities), financial corporate and provincial bonds. Over a 12-month horizon we like real return bonds on an outright basis though breakevens could come under pressure in the near-term under bouts of high risk aversion.

**Table 7: Canada 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: BofAML Global Research.

**Table 8: Canada interest rate forecast (Percent, EOP)**

	2011		2012			2013
	4Q	1Q	2Q	3Q	4Q	
Overnight Rate	1.00	0.25	0.25	0.25	0.25	2.50
3-mth	0.80	0.30	0.25	0.35	0.45	2.50
2-yr	0.80	0.60	1.25	1.75	1.90	2.70
5-yr	1.25	1.35	1.60	1.90	2.10	2.75
10-yr	2.10	1.90	2.15	2.50	2.75	3.10
30-yr	2.75	2.55	2.80	3.15	3.40	4.00

Source: BofAML Global Research.

### Housing could come under pressure

The Canadian housing market has continued to defy expectations of a slow down, and is largely considered to be in overvalued territory and certainly venturing into a construction overshoot. Although we are not expecting a major pull-back in national home prices in 2012, the risk of a correction is increasing in many of the major markets. The Toronto condo market in particular is likely in the late stages of an inventory cycle, with close to 5-years worth of units in the construction pipeline. Indeed, an increase in the unemployment rate, which we expect to be more severe in the GTA since the region is so dependent on the financial services industry, and a pull-back in housing demand will expose this market as oversupplied.

### Banking sector well protected

We do not believe a potential pull-back in home prices is a significant threat to [Bank balance sheets](#). About 75% of the Canadian mortgage market is fully insured by the Government of Canada, and all mortgages with a loan-to-value ratio (LTV) above 80% are insured and therefore carry a zero-risk weighting on bank balance sheets. Almost all mortgages in Canada have full recourse, which implicitly lowers the LTV and reduces the risk of strategic default.

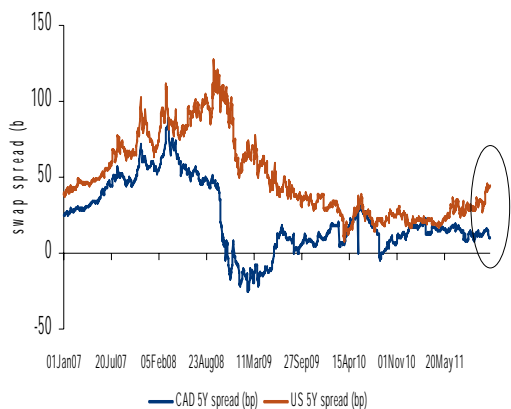
Additionally, about 30% of the mortgage market is funded by investors with a full government guarantee, significantly reducing the risk of any sort of liquidity event affecting mortgage funding. Furthermore, if liquidity becomes an issue for Canadian banks, the Government of Canada would almost certainly resurrect the insured mortgage purchase program (IMPP). We believe this program can be implemented with no threat to the government of Canada's AAA credit rating, because the loans are already fully guaranteed by the federal government.

### Volatility - CAD credit risks are not zero

We believe that, despite the recent resiliency of Canadian swap spreads to events in Europe, the potential for a global credit flare-up spreading to Canada bank credit is high. We recommend paying in 5 year CAD spreads to position for widening in a scenario where risks from Europe could trigger a deleveraging in Canada.

While swap spreads in the US and Europe have widened significantly in past months due to contagion risks from Europe, Canadian swap spreads have been remarkably well behaved (Chart 35). This makes sense to some extent given that CDOR has not risen and Canada is less exposed to European banks. However, Canada is exposed to the US, which is more exposed to the European banking system. While US swap spreads are already discounting this risk to some extent, Canadian swap spreads are not.

**Chart 35: Canadian swap spreads have not widened recently with US swap spreads (basis points)**



Source: BofA Merrill Lynch Global Research.

Also, the issue has morphed from one of financial sector contagion to one of growth contagion. We view Canada/US swap spread wideners as a cheap tail risk trade for prospective weakening growth in Canada. The Canadian banking system is extremely exposed to domestic risks. Consumer debt levels are fairly high. Loan delinquencies can become a concern if growth stalls, as we expect, and the unemployment rate starts to climb. Job creation has flattened in recent months and outright job losses are a distinct possibility early next year. Canadian bank CDS has been widening and banks stocks are well off their highs, reflecting these concerns.

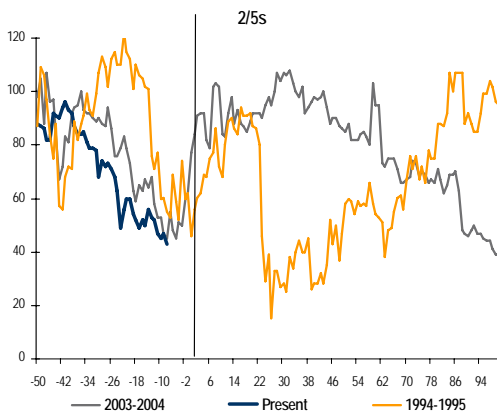
We also believe bonds will outperform versus swaps due to structural demand for Canadian government bonds from a variety of investors seeking AAA sovereign investments. International investors now hold one quarter of Canada government debt held by the public. Even so, foreign portfolio managers remain underweight Canada's relative to benchmarks and should remain buyers.

### Front end - 2s5s bull steepener

The market 2s5s curve is very close to pricing the full program of rate cuts we expect the BoC to deliver next year. There could be a further 10-15bps of flattening in the very first part of the year which will be a good set up for a bull steepening as the Bank eases. As the market moves further towards pricing in lower policy rates from the BoC early next year, we expect limited further flattening in the front end of the government of Canada curve.

We think the coupon curve is following a very similar pattern to the mid-cycle slowdowns of 2003-2004 and 1994-1995. When gauging how flat the yield curve could go ahead of BoC easing, it is important to bear in mind the limits to curve flattening because policy rates are so close to the zero lower bound. We estimate that a 2s5s curve of 30bps is the flattest the curve could go because of the embedded option premium. As can be seen in Chart 36, the 2s5s curve will probably steepen by around 50bps when the BoC does cut rates. At the same time, we expect the overnight to 2s to flatten by a similar amount to about -50bps.

Chart 36: Curve set up for steepener. (basis points)



Source: Cansim, BofAML Global Research. 0 = first rate cut

The BoC has indicated it will be somewhat more accommodative to higher consumer inflation, by stretching out the time period over which core inflation returns to target to 3 years from the normal 6-8 quarters.

### Inflation to remain elevated

In the near-term we think real return bond breakevens will remain under pressure, mainly driven by a higher liquidity premium. Longer-term our breakeven target is unchanged at 2.50%, as risk subsides and inflation persists above the 2% CPI target.

Several factors will keep inflation at relatively elevated levels. Most importantly, the BoC has indicated it will be somewhat more accommodative to higher consumer inflation, by stretching out the time period over which core inflation returns to target to 3 years from the normal 6-8 quarters. As well, energy prices remain elevated with WTI 23% off the early October lows and hovering around US\$100/bbl. Food prices have not seen the full pass-through of the rise in agriculture prices earlier this year. Recent provincial and municipal budget updates revealed a host of new higher user fees. Furthermore, rents will likely start accelerating as landlords pass along last year's higher utility costs.

### Credit - non-financial corps to outperform

Consistent with the view that the Canadian economy weathered the 2008 financial crisis rather well, the credit markets have remained calm in recent months with spreads widening out but remaining well below levels reached 2008. We think all credit spreads could widen from current levels if, as we expect, the Europe sovereign crisis worsens and economic growth comes under even more pressure.

**Table 9: Credit spread risks under various scenarios.**  
**(basis points)**

	Spot level	BAD Spot - 2H08	UGLY Spot - Max08	GOOD Spot - 1H10
Corporate	182	76	218	-53
Provincial	72	2	40	-21
CHT - CMBs	21	21	47	-5
Financial	188	79	235	-66
AA	128	100	227	-3
A	202	71	243	-59
BBB	239	94	258	-61

Source: BofAML Global Research, as of Nov 28, 2011

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%.

We think non-financial corporate bonds will outperform other Canada credit, given the high cash on corporate balance sheets and the historic low leverage ratios. In assessing the risks to credit we think recent spread behavior provides some guidance. The average behavior of spreads in the second half of 2008 as the US banking crisis raged could be a guidepost for our base case scenario. Under this scenario, the Eurozone is in recession and suppresses global growth but does not cause a full blown recession.

As can be seen in Table 9 the corporate index averaged about 75bps wider than current spot levels. CHT-CMBs was about 20bps wider and financials were about 80bps. One sector which could come under more spread pressure than in 2008 is provincial bonds, since provinces are heading into this economic slowdown running much higher deficits and carrying high levels of debt. Additionally, the prospect of the GoC resurrecting IMPP will likely keep CMBs from reaching 2008 spread levels.

## Trade recommendations

We recommend the following specific trades:

- Buy 100MM of the current 5y note – the 2.75% of 9/16 at an asset swap spread of 7bp.
- 2s5s steepener in 1H as BoC eases. 50bps of upside on 75bps cut in policy rates.
- Breakevens tactically short on spike in risk aversion. 12-month target widening to 250bps.
- Short credit. Nonfinancial credits and CMBS to outperform financials and provincial bonds.

## Risks: Hope for best, prepare for worst

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 Eurozone. 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%. 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 redeploy non-conventional policy easing as well.

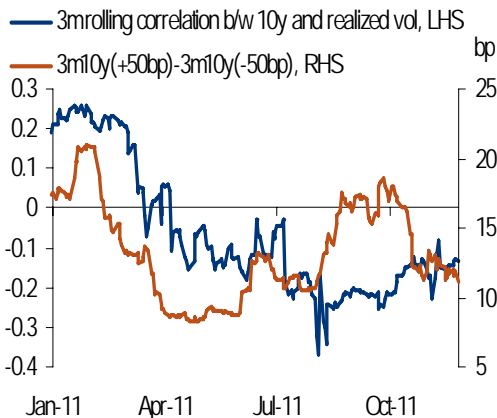
John Hopkinson +1 646 855 6246  
Ruslan Bikbov +1 646 855 9770

**Chart 37: It's all about Europe**



The chart shows 3m rolling correlation between 10y swap rate and daily realized vol of this rate. The realized vol is computed using 30-minute intraday changes in the 10y rate between 8am and 4pm EST. The chart also shows the difference between 50bp high and 50bp low 3m10y implied vols. Last data point: 11/23/2011.  
Source: BofA Merrill Lynch Global Research

**Chart 38: Negative directionality of rates and realized vol**



The chart shows 3m rolling correlation between 10y swap rate and daily realized vol of this rate. The realized vol is computed using 30-minute intraday changes in the 10y rate between 8am and 4pm EST. The chart also shows the difference between 50bp high and 50bp low 3m10y implied vols. Last data point: 11/23/2011.  
Source: BofA Merrill Lynch Global Research

**Table 10: skewness of daily changes in the 10y**

last 3m	-0.47
last 2m	-0.52
last 1m	-0.31

The table shows skewness of daily changes in the 10y rate for the last 1, 2 and 3 months. The skewness is defined as a normalized third moment.  
Source: BofA Merrill Lynch Global Research

## RV: systemic risks mispriced

We believe the eurozone sovereign crisis is unlikely to abate soon and, if anything, the crisis may need to deteriorate further to force politicians to move decisively towards closer fiscal integration. Until then, risk sentiment across markets will continue to be driven by headlines from Europe in the short term, and that the recent high correlations seen across assets will continue, in our view.

We identify structural risk premiums in US payer skew, and JPY and CHF volatility that can be exploited in the current risk environment. We recommend buying 3m10y OTM receivers versus payers to position for the disconnect between implied and realized skew. We also recommend buying 3m USDJPY volatility against selling 3m EURJPY to exploit the stickiness of EURJPY volatility

## Politics driving risk

The sovereign crisis in Europe continues to dominate risk sentiment across markets, with uncertainty over both the final outcome of the crisis, and the potential consequences of each outcome. As a result, markets are trading in a highly correlated fashion, with for example, the correlation between 10y US rates and Euro Stoxx 50 reaching 60% (Chart 37). In the case of FX, all currencies are currently moving in a highly correlated fashion relative to the Dollar. With little political consensus and contrasting domestic considerations, we therefore believe that a quick resolution to the crisis is unlikely, so that the correlated price action will continue in the short term.

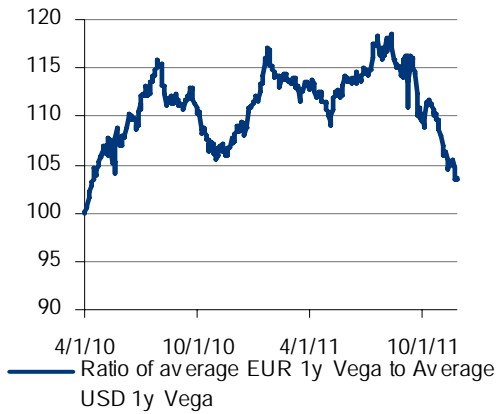
## A global problem

When the debt problems in Greece first caught the attention of markets in April 2010, the initial reaction in currency markets was to price an increase in risk premium for the EUR. The average 1y implied volatility for EUR pairs in G10 rose by 10% relative to the average for USD pairs. (Chart 39) This premium was well justified, as initially the markets assumed that the crisis would be contained to Europe, so that currencies became highly correlated relative to the Euro. Following the political summit at the beginning of November this premium has been erased, not as a result of reduced uncertainty regarding Europe, but rather due to the markets pricing a greater risk of a global contagion from Europe. One manifestation of this is the widening of the basis swaps markets, as US banks are reluctant to lend Dollars. This is a key driver of the high Dollar correlations in our view. With intervention in Japan and Switzerland reducing the effectiveness of CHF and JPY as safe haven currencies, the result has been a demand for USD vega in general, and USD calls in particular.

## Structural premiums to exploit

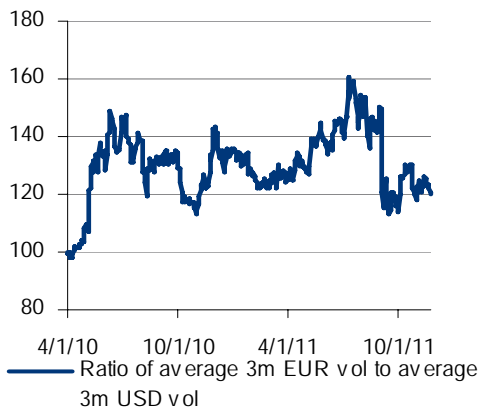
When the Fed entered a period of extremely loose monetary policy following the collapse of Lehman, investors began looking for instruments to provide protection against the inflation that they feared would result. Payer swaptions are one such instrument, and this structural demand for payers creates a premium relative to receivers that is inconsistent with the price action in the current risk environment. A further rally in rates, if it occurs, is likely to be caused by the escalation of the sovereign debt crisis and/or bank funding stress. This scenario is likely to be associated with heightened risk aversion, continuing deleveraging and uncertainty about the policy response (primarily on the part of the ECB and the Fed). As a result, the volatility of long-term rates should increase despite longer Fed-on-hold expectations. On the other hand, a sell-off in rates appears unlikely unless the European crisis abates. In this case the decline in the risk aversion and policy uncertainty should lead to lower volatility.

Chart 39: Premium in EUR 1y vega relative to USD 1y vega vs G10



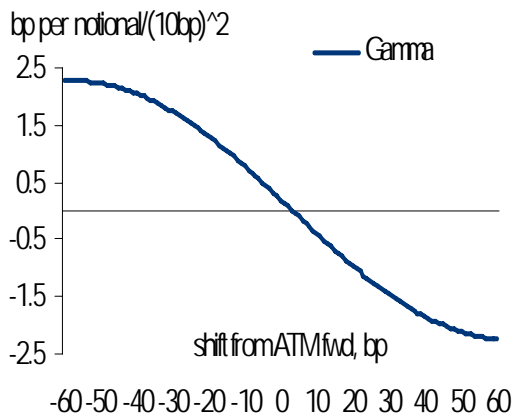
Source: BofA Merrill Lynch Global Research

Chart 40: Premium in EUR 3m vol relative to USD 3m vol vs CHF and JPY



Source: BofA Merrill Lynch Global Research

Chart 41: Gamma profile of the rates trade



The chart shows gamma profile of the trade as a function of the deviation from the ATM fwd rate. Date: 11/23/2011.

Source: BofA Merrill Lynch Global Research

We can see this dynamic in the recent realized distribution of US rates. For example, the correlation between daily realized volatility and the level of the 10y rate has turned into the negative territory (Chart 38). Similarly, the recent realized skewness of daily changes in the 10y rate has been negative (Table 10). While the payer skew in short-dated swaptions has somewhat cheapened recently, it is still implying a distribution skewed higher in rates (Chart 38).

In FX, there is a similar structural premium for CHF and JPY vega as arbitrageurs regard the current low volatility due to intervention as a temporary phenomenon, and expect CHF and JPY eventually to resume their traditional roles as safe havens. The stickiness of vega in EURCHF and EURJPY that results means that the risk premium in EURCHF and EURJPY relative to USDCHF and USDJPY remains in place. (Chart 40) In our view, the recent price action where USD correlations are outperforming will continue in the short term, so that there is some value in selling this relative premium.

With intervention in CHF and JPY having the tendency to equalize realized volatility, we prefer to position long USDJPY against EURJPY where we receive premium, rather than long USDCHF against EURCHF where we would pay. While the performance of USDJPY gamma has been relatively poor in the absence of intervention, in our view the move in the Yen basis, which has coincided with a pick-up in USDJPY volatility, means that going forward this will be less of an issue. As the recent Dollar strength moves USDJPY away from the levels at which intervention would be expected, the premium in the gamma for intervention should disappear.

### The longer term view

In FX vega, our expectation is that the premium for USD vega relative to EUR vega will increase if anything in the short term, before ultimately returning to normal levels over a period of 2-3 years. In this instance it is the relative value for USDCHF versus EURCHF which is attractive. There is a structural supply of long dated USDCHF vega which creates a downward sloping volatility curve. However, the EURCHF curve is currently very steep, as the longer dated vols are naturally the most sticky in the declining vega environment post intervention. This means that we could position long 2y USDCHF vega 3y forward starting at comparable or potentially even lower levels than a short 3y2y EURCHF position. Given our expectations for the USDCHF vega premium to increase relative to the EURCHF in the short term, and the fact that normal levels are for EURCHF to be much lower than USDCHF, this position looks very attractive to us.

## Trade Recommendations:

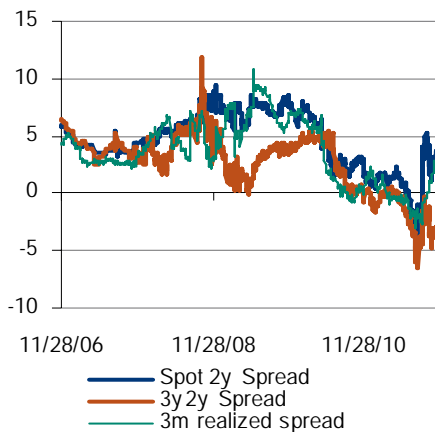
### Buy 3m10y OTM receivers vs payers

We recommend selling delta-hedged 3m10y payer vs receivers to position for the negative correlation between rates and realized vol and monetize the richness of the payer skew over receiver skew:

- Sell \$100mn of 3m10y payers struck 20bp out
- Buy \$100mn of 3m10y receivers struck 20bp out

The trade pays 6bp per notional at initiation. We recommend to delta-hedge the trade daily. We would target a cumulative P&L of 45bps, and set a stop at -22bp. The trade is approximately gamma-neutral at the current level of rates, long gamma at lower rates and short gamma at higher rates (Chart 41). As a result, the trade should outperform if realized volatility increases in a market rally and declines in a sell-off.

Chart 42: Spread between USDCHF and EURCHF volatility



Source: BofA Merrill Lynch Global Research

### Buy 3m USDJPY vs selling 3m EURJPY

We recommend buying a 3m straddle in USDJPY at 9.9% against selling a 3m straddle in EURJPY at 15.25%. We would recommend delta hedging daily at the New York close, ahead of any likely intervention from Japan. As we are trying to capture realized volatility, we don't have any specific target in the implied spread. However, we would consider stopping out of the trade if the implied spread widened beyond 8%.

For investors with a longer investment horizon, and the ability to withstand mark-to-market losses, we would also recommend selling 3y2y EURCHF against buying 3y2y USDCHF. As a long dated and illiquid product the availability and pricing of this trade is variable, but indicatively 3y2y EURCHF may be sold around 14.7% against buying 3y2y USDCHF at 13.7%. The current spread of 2y volatility is around 4% (USDCHF higher), and if the crisis has been resolved in 3y, we may see the spread revert to the historical average of around 6% (Chart 42).

### Risks

Our trades are predicated on the view that politicians rather than policymakers will dictate the near term direction of the European crisis. The main risk to the rates trade is a sharp sell-off in rates, most likely in our opinion as a result of decisive action from the ECB, which is the only European institution with firepower sufficient to stop the vicious cycle of liquidity deterioration. In our view the ECB will not take such an action unless the crisis has escalated, so a large back-up in rates is most likely to occur from lower levels of rates, where the gamma of our trade is positive.

Similarly, the main risk to our JPY trade is that the Dollar funding pressure is eased, again most likely as a result of Central bank action, which would isolate the problem to the eurozone. The likely result in this scenario is that USDJPY would trade steadily lower, while the positive correlation between EUR and JPY would break down, making EURJPY relatively more volatile. There is also the risk that the crisis deteriorates substantially, and EURJPY vega increases substantially more than USDJPY vega. Our view is that the current level of premium is sufficiently high to justify taking this risk.

The main risk to our CHF trade is that the SNB floor in EURCHF is broken and as a result EURCHF vega goes ballistic. Again, given the level at which we can enter this trade, we regard the risk reward for this scenario as being very favourable.

We also note that due to the illiquidity of this trade there is limited ability to exit the trade prior to maturity, and therefore it is necessary to have a long term investment horizon.

MacNeil Curry +1 646 855 6781

## Technical view: Gold to shine in 2012

Chart 43: Long term chart of spot gold



Source: BofA Merrill Lynch Global Research

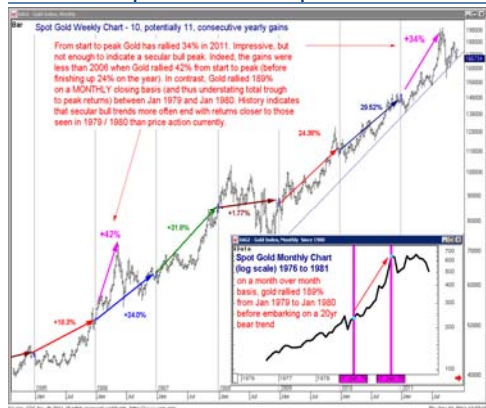
From a technical perspective we believe that the bull trend for gold remains intact, despite the recent ongoing consolidation. While the trading dynamics of this recent range (1921/1533 in USD dollar terms or 1359/1175 in EUR terms) indicate persistence into Q1 2012, once it completes we look for renewed gold strength and ultimately its 11<sup>th</sup> consecutive yearly advance. Into H2 2012 we look for gold to target 2150/2200 in US Dollars or approximately 1500/1550 in EUROs. (please see here for the fundamental argument for higher gold – link with PID 11093337) However, with investor anxiety likely to remain elevated and the persistence of the gold bulltrend, the risks are to the upside for our forecast.

### Conditions for a Top not yet in place

From past observations across asset classes, there are 3 conditions necessary for the completion of a secular bull trend. Gold has not achieved any of them

1. The upside peak must wildly exceed the most optimistic price forecasts. Most reasonable analysts have been looking for 2000 or so (albeit in 2012), price would need to significantly better that, perhaps by a multiple of 2 or more.
  2. Price action must turn parabolic - between the 3 months of Oct 1979 and Gold's peak in Jan 1980 price appreciated 135%. Since the start of the current bull trend (begun back in 1999) the most explosive gain has been a 26% advance in 6 weeks back in 2006 (Chart 45). Impressive, but not the stuff of long term tops. Indeed, long term momentum readings remain significantly below the peaks seen in the run up to the 1980 high (see Chart 45) indicating significant upside potential
  3. Realized Daily Volatility must increase dramatically – secular bull trends tend to end with extremes in realized volatility. While there are many ways to measure realized volatility, one way is to look at daily ranges as a percentage of price. While this percentage will vary depending on the market in question, for gold we would look for daily ranges around a secular high to vary around 10-20% of flat price The most recent peaks saw daily ranges between 5% and 6% of price.
- Until these conditions are met this we remain secular bulls on gold. .

Chart 44: Additional perspective on recent Gold advance compared to the 1979 peak



Source: BofA Merrill Lynch Global Research

Chart 45: German 2yr Swap Spread



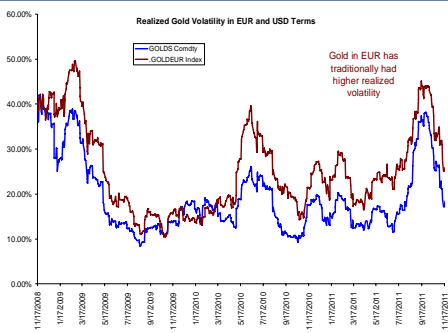
Source: BofA Merrill Lynch Global Research, COG

### Forecasts and Trade Recommendations

With Gold having not yet met any of the conditions necessary for a top, we look for significant strength in the years ahead, ultimately targeting a top between 3000/5000 USD and ounce. However, this is story for 2013/2014. For 2012 gold will target the Triangle objectives at 2150/2200 & 1500/1550 (USD & EURs, respectively), with risks to the topside. There are many different ways to position for a resumption of the gold bull trend. We prefer to invest in gold against EURs given the ongoing anxiety in Europe (as highlighted by the rising 2yr German swap spread in Chart 45). In both US dollar and EUR terms the trend for a higher gold price is quite strong. And while, historically, realized volatility has been higher in Gold denominated in EUR terms (see Chart 46), the potential for significant breakdown in EURUSD should not be ignored.

As such we recommend a 6m 1400/1550 call spread (Gold Call / EUR Put) at 32.50 EURs per oz, providing a max of with a max payout of 4.6 to 1.

**Chart 46: Realized Gold Volatility in USD and EURs**



Source: BofA Merrill Lynch Global Research

## Risks

There are two risks to our bullish Gold in EUR view. The first is that gold fails to rally or reverses trend. The second is that the EUR holds its ground and rallies sharply against the US Dollar. In the 1<sup>st</sup> instance we think a reversal of trend is very unlikely as none of the conditions for a lasting top have been met. In the second, even if the EUR were to rally, it is unlikely to outpace the rise in gold. Indeed, gold in EURs has rallied in 12 of the past 13 years (the down year was 2003 when it fell 5.6%)

**Chart 47: Gold in EURs per oz. upside targets**



Source: BofA Merrill Lynch Global Research

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

## GEMs: The sum of all fears

The global environment will remain troubling into 2012, with Europe heading into recession and the US struggling to produce above-trend growth in an environment characterized by fiscal headwinds and rising political uncertainty. China and other large emerging economies remain vulnerable to such a problematic outlook, and that is why we chose to title our GEMs year-ahead report, released on 1 December, 2012: "[The sum of all fears](#)".

We forecast growth in developed economies of 1.3% next year, and expect GEM growth to slow to 5.5% in 2012, after 6.3% in 2011. All regions will slow down next year, 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 Eurozone 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.

Against this backdrop of weaker global growth, we also expect GEM inflation to decline to 5.4% next year, leaving policymakers with room to act. We therefore expect GEM central banks to ease interest rates, which many have already started doing, relax macro-prudential regulations, and intervene in FX markets to smooth volatility. We see central banks being the most proactive in LatAm, and the least proactive in Asia. Out of the 19 central banks that we monitor, we anticipate 12 to cut interest rates next year, by a median of 50bp. We also expect governments to stand ready to provide fiscal support should downside growth scenarios materialize, although this will likely be more limited than in 2009. This is because the starting fiscal position for EM is now less healthy than it was in 2008.

In our central scenario, such policy responses should prevent the developed economies' malaise to turn into a global slump, although we do anticipate first-half of 2012 economic performance and asset price behavior to be weaker than second half. Primarily, this is because we anticipate European policymakers to react to their first half recession and market pressures with a move to fiscal union and ECB balance sheet expansion, providing for some asset price recovery in the second half (see Table 1 for expected returns in the three GEM asset classes).

**Table 11: GEMs forecast 2012 total return (in %) for a cash investor of three EM asset classes**

		Forecast TRR		
		1H	2H	Full year
	<b>Contributions to return</b>			
<b>FX</b>	% change in FX, yield	1.8	7.4	9.4
<b>LDM</b>	% change in FX, yield, rate change, duration	2.4	7.9	10.4
<b>EXD</b>	US rates change, spread change, duration, yield	-0.3	2.2	1.9

Source: BofA Merrill Lynch Global Research

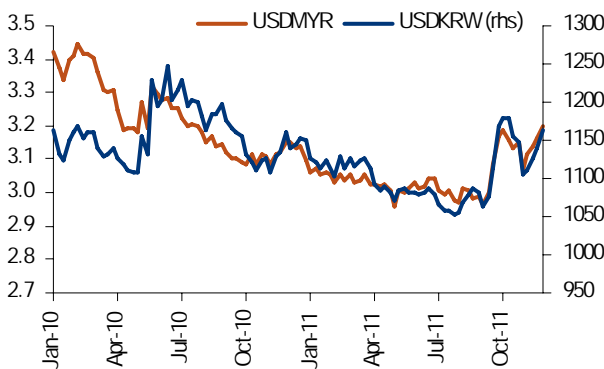
Our analysis suggests that there are significant downside risks to GEM growth in 2012. Importantly, the tail risks emanating from a Eurozone crisis are non-negligible and cannot be ignored. We expect price action to be choppy, with periods of capitulation followed by periods of relief rallies. While this may leave scope for some tactical positioning, it does not warrant taking too much beta exposure in the medium term, in our view.

Our top trades for 2012 have therefore favored inter and intra-regional ideas wherever possible, to benefit from valuation and economic fundamental differences. The tone of our trade ideas generally has a bearish bias, and we have also selected some ideas that would work well if the situation deteriorates further. Here are three ideas to highlight for global macro investors:

## Trade recommendations

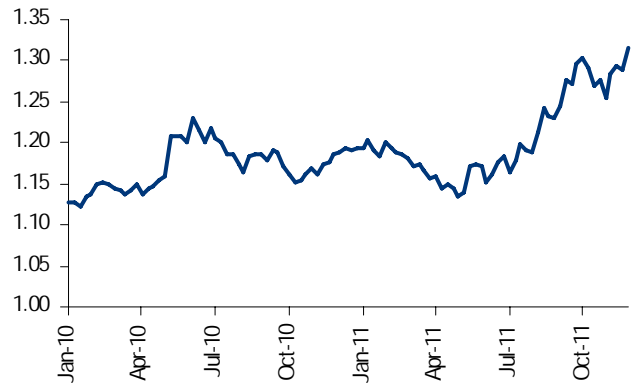
- Long 5y Russia CDS.** Heading into 2012, we retain a tail-risk hedge via long 5y protection in Russia. Fundamentally, Russia is relatively insulated from European problems compared to peers, and has improved its own financial stability metrics since the 2008 crisis. However, financial market linkages are high, and Russian CDS is still one of the few liquid hedging variables available to investors. Foreign positioning in the CIS Eurobond market, where fundamentals/liquidity can be worse than the Russian sovereign, creates a natural source of hedging flow. Thus, since European risks remain large, we favor holding this tail risk hedge.
- Long USD against short KRW and MYR 3m NDF basis.** KRW and MYR are both highly dependent on the export cycle; and despite current account surplus positions, both are vulnerable to capital outflows (equity outflows in Korea's case, bond outflows in Malaysia's). MYR is also rich against SGD on an REER basis, and Bank Negara may be more willing to allow MYR weakness as a discreet easing of monetary conditions.
- Cross-regional FX trade: long CNY, IDR & PHP vs PLN, RUB & ZAR.** Though lower than 2011, we expect EM Asia growth in 2012 to be a robust 7.1% yoy, versus 3.0% for EEMEA. Our house call for a Eurozone recession poses significant downside risks to EEMEA, which is more exposed to developed Europe through trade and financing channels; therefore, contagion and tail risks are bigger. Also, FX reserves in EM Asia are much higher; as a result, central banks there have more firepower to defend their FX in case of a broad based sell-off. Additionally, the trade is underpinned by strong momentum (Chart 49). We like CNY, IDR and PHP on better relative growth prospects and less dependence on Europe, contrary to PLN, RUB and ZAR, which are more exposed to the Eurozone turmoil.

Chart 48: Will the sell off in pro-cyclical Asia FX continue?



Source: Bloomberg, BofA Merrill Lynch Global Research

Chart 49: Long Asia vs EEMEA set to outperform in new year



Source: BofA Merrill Lynch Global Research

02 December 2011

# 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
<b>Global and Regional Aggregates</b>												
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
<b>G5</b>												
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
<b>Euro area</b>												
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
<b>Other Developed Europe</b>												
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
<b>Asia Pacific</b>												
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

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## Global economic forecasts

	GDP growth, %				CPI inflation*, %				Short term interest rates**, %			
	2009	2010	2011F	2012F	2009	2010	2011F	2012F	Current	2010	2011F	2012F
<b>Latin America</b>												
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
<b>EEMEA</b>												
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
<b>GCC</b>												
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

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## 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
	<b>10y</b>	<b>2.00</b>	<b>1.75</b>	<b>1.85</b>	<b>2.10</b>	<b>2.40</b>
	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
	<b>10y</b>	<b>2.10</b>	<b>2.10</b>	<b>2.20</b>	<b>2.30</b>	<b>2.30</b>
	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
	<b>10y</b>	<b>1.05</b>	<b>1.35</b>	<b>1.25</b>	<b>1.20</b>	<b>1.22</b>
	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
	<b>10y</b>	<b>2.15</b>	<b>2.05</b>	<b>1.95</b>	<b>2.10</b>	<b>2.25</b>
	30y	3.35	2.85	2.70	2.85	3.10
Canada	<b>2y</b>	0.80	0.60	1.25	1.75	1.90
	<b>5y</b>	1.25	1.35	1.60	1.90	2.10
	<b>10y</b>	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	Mar '13	Jun '13	Sep '13	Dec '13
<b>G3</b>										
EUR-USD	1.35	1.30	1.25	1.25	1.28	1.30	1.32	1.34	1.35	1.35
USD-JPY	78	76	74	73	74	76	78	79	81	83
EUR-JPY	105	99	93	91	95	99	103	106	109	112
<b>Dollar Bloc</b>										
USD-CAD	1.01	1.07	1.09	1.09	1.07	1.05	1.04	1.03	1.02	1.01
AUD-USD	1.02	0.98	0.92	0.94	0.95	0.96	0.94	0.93	0.92	0.90
NZD-USD	0.78	0.77	0.72	0.74	0.76	0.77	0.76	0.75	0.75	0.75
<b>Europe</b>										
EUR-GBP	0.86	0.85	0.81	0.82	0.83	0.85	0.87	0.89	0.90	0.92
GBP-USD	1.57	1.53	1.54	1.52	1.54	1.53	1.52	1.51	1.50	1.47
EUR-CHF	1.23	1.23	1.23	1.24	1.25	1.26	1.27	1.28	1.29	1.30
USD-CHF	0.92	0.95	0.98	0.99	0.98	0.97	0.96	0.96	0.96	0.96
EUR-SEK	9.11	9.30	9.40	9.40	9.20	9.10	9.00	8.95	8.90	8.85
USD-SEK	6.77	7.15	7.52	7.52	7.19	7.00	6.82	6.68	6.59	6.56
EUR-NOK	7.81	7.90	7.95	7.95	7.90	7.85	7.80	7.75	7.75	7.75
USD-NOK	5.81	6.08	6.36	6.36	6.17	6.04	5.91	5.78	5.74	5.74

Note: Forecast as of 02 December 2011. Spot exchange rate as of 01 December 2011. The left of the currency pair is the denominator of the exchange rate. Source: BofA Merrill Lynch Global Research

### Quarterly Forecasts- EM currencies

	Spot	Dec '11	Mar '12	Jun '12	Sep '12	Dec '12	Mar '13	Jun '13	Sep '13	Dec '13
<b>Latin America</b>										
USD-BRL	1.80	1.88	1.90	1.90	1.88	1.85	1.88	1.90	1.93	1.95
USD-MXN	13.62	13.80	13.70	13.70	13.50	13.30	13.25	13.20	13.10	13.00
USD-CLP	515	530	540	540	520	500	505	510	515	515
USD-COP	1,946	1,975	2,000	2,000	1,950	1,925	1,931	1,937	1,944	1,950
USD-ARS	4.28	4.35	4.60	4.80	5.00	5.20	5.50	5.80	6.10	6.50
USD-VEF	4.29	4.30	4.30	4.30	4.30	4.30	7.50	7.50	7.50	7.50
USD-PEN	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70
<b>Emerging Europe</b>										
EUR-PLN	4.48	4.45	4.45	4.45	4.30	4.30	4.30	4.30	4.30	4.30
EUR-HUF	305	305	315	315	300	300	300	300	300	300
EUR-CZK	25.23	25.50	26.00	26.00	25.00	25.00	25.00	25.00	25.00	25.00
USD-UAH	8.01	8.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00
USD-RUB	30.74	31.00	31.00	32.00	30.00	30.00	30.00	30.00	30.00	30.00
USD-ZAR	8.07	8.30	8.10	8.00	7.50	7.60	7.60	7.60	7.60	7.60
USD-TRY	1.83	1.85	1.85	1.80	1.70	1.70	1.70	1.70	1.70	1.70
EUR-RON	4.36	4.35	4.40	4.30	4.30	4.30	4.30	4.30	4.30	4.30
USD-EGP	6.00	6.00	6.00	7.50	7.50	7.50	7.50	7.50	7.50	7.50
USD-ILS	3.74	3.75	3.75	3.75	3.65	3.65	3.65	3.65	3.65	3.65
USD-AED	3.67	3.67	3.67	3.67	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	0.27	0.27	0.27	0.27
USD-SAR	3.75	3.75	3.75	3.75	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	3.64	3.64	3.64	3.64
<b>Asian Bloc</b>										
USD-KRW	1,126	1,160	1,220	1,180	1,160	1,140	1,120	1,050	1,000	980
USD-TWD	30.13	30.00	32.00	31.50	31.00	30.50	31.00	30.50	30.00	29.00
USD-SGD	1.28	1.29	1.38	1.35	1.33	1.32	1.30	1.30	1.28	1.27
USD-THB	30.82	30.80	32.50	32.00	31.00	30.80	30.00	30.00	30.50	30.80
USD-HKD	7.77	7.82	7.83	7.80	7.76	7.78	7.75	7.76	7.76	7.78
USD-CNY	6.37	6.35	6.40	6.35	6.30	6.20	6.30	6.25	6.20	6.20
USD-IDR	8,998	9,000	9,300	9,200	9,100	9,000	9,000	9,100	9,000	9,000
USD-PHP	43.28	43.00	45.00	44.00	43.00	41.00	42.00	41.00	42.00	42.00
USD-MYR	3.14	3.20	3.25	3.20	3.15	3.10	3.00	2.90	2.90	3.00
USD-INR	51.47	51.50	55.00	53.00	52.00	49.00	51.00	50.00	49.00	48.50

Note: Forecast as of 02 December 2011. Spot exchange rate as of 01 December 2011. The left of the currency pair is the denominator of the exchange rate. Source: BofA Merrill Lynch Global Research

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## Team Page

### Global Rates & Currencies Research

**David Woo** +1 646 855 5442  
FX and Rates Strategist  
MLPF&S  
david.woo@baml.com

**MacNeil Curry, CFA, CMT** +1 646 855 6781  
Technical Strategist  
MLPF&S  
macneil.curry@baml.com

### Europe

**Ralf Preusser, CFA** +44 20 7995 7331  
Rates Strategist  
MLI (UK)  
ralf.preusser@baml.com

**Mark Capleton** +44 20 7995 6118  
Rates Strategist  
MLI (UK)  
mark.capleton@baml.com

**John Wraith** +44 20 7996 0405  
Rates Strategist  
MLI (UK)  
john.wraith@baml.com

**Alan Stewart** +44 20 7996 7236  
Rates Strategist  
MLI (UK)  
alan.stewart@baml.com

**Max Leung** +44 20 7996 6580  
Rates Strategist  
MLI (UK)  
max.leung@baml.com

**Sphia Salim** +44 20 7996 2227  
Rates Strategist  
MLI (UK)  
sphia.salim@baml.com

**Athanasios Vamvakidis** +44 20 7995 0790  
FX Strategist  
MLI (UK)  
athanasios.vamvakidis@baml.com

**Naeem Wahid** +44 20 7996 6062  
FX Strategist  
MLI (UK)  
naeem.wahid@baml.com

**Richard Cochinos** +44 20 7995 1242  
FX Strategist  
MLI (UK)  
richard.cochinos@baml.com

**Moisés Romero Morales** +44 20 7995 1400  
FX Strategist  
MLI (UK)  
moises.r.morales@baml.com

### US

**Priya Misra** +1 646 855 6467  
Rates Strategist  
MLPF&S  
p.misra@baml.com

**Ralph Axel** +1 646 855 6226  
Rates Strategist  
MLPF&S  
ralph.axel@baml.com

**Marcus Huie** +1 646 855 6389  
Rates Strategist  
MLPF&S  
marcus.huie@baml.com

**Jabaz Mathai** +1 646 855 6217  
Rates Strategist  
MLPF&S  
jabaz.mathai@baml.com

**Ruslan Bikbov** +1 646 855 9770  
Rates Strategist  
MLPF&S  
ruslan.bikbov@baml.com

**Brian Smedley** +1 646 855 9809  
Rates Strategist  
MLPF&S  
brian.smedley@baml.com

**Shyam S.Rajan** +1 646 855 9808  
Rates Strategist  
MLPF&S  
shyam.rajan@baml.com

**John Shin** +1 646 855 9342  
FX Strategist  
MLPF&S  
joong.s.shin@baml.com

**John Hopkinson** +1 646 855 6246  
FX Strategist  
MLPF&S  
john.hopkinson@baml.com

**David Grad** +1 646 855 9674  
FX Strategist  
MLPF&S  
david.grad@baml.com

**Ankur Singh** +1 646 855 6193  
FX Strategist  
MLPF&S  
ankur.singh@baml.com

### Canada

**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

### Pac Rim

**Bin Gao** +852 2536 3969  
Rates Strategist  
Merrill Lynch (Hong Kong)  
bin.gao@baml.com

**Shogo Fujita** +81 3 6225 6684  
Rates Strategist  
Merrill Lynch (Japan)  
shogo.fujita@baml.com

**Ling Wu** +81 3 6225 6315  
Rates Strategist  
Merrill Lynch (Japan)  
ling.wu@baml.com

**Shuichi Ohsaki** +81 3 6225 7747  
Rates Strategist  
Merrill Lynch (Japan)  
shuichi.ohsaki@baml.com

**Ethan Mou** 852 2536 3741  
Rates Strategist  
Merrill Lynch (Hong Kong)  
ethan.mou@baml.com

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**Adarsh Sinha** +852 2161 7155  
FX Strategist  
Merrill Lynch (Hong Kong)  
adarsh.sinha@baml.com

**Tomoko Fujii** +81 3 6225 7142  
FX Strategist  
Merrill Lynch (Japan)  
tomoko.fujii@baml.com

**Global Emerging Markets**

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**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