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## 2010 Outlook: The year of living cautiously

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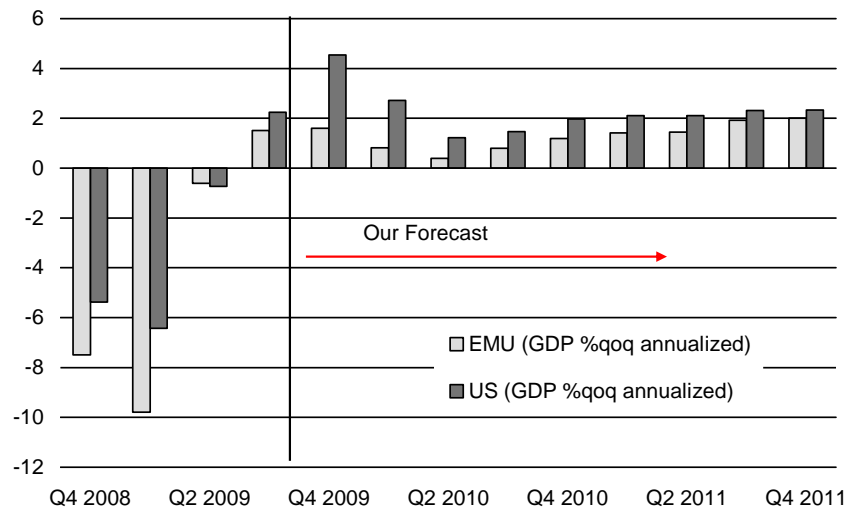
## Hot issues in 2010

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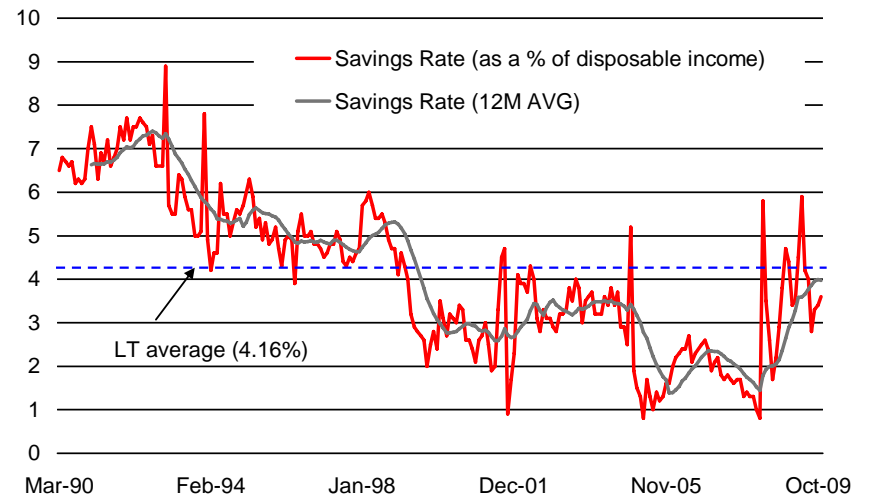
- Global recovery is sustainable, but its pace is not
  - Global inflation: not a threat in the next two years (but beware of expectations...)
  - Exit strategy: “Bernanke mistake” vs. “Japan mistake”
  - Will world trade and Asian growth solve global imbalances?
  - Eurozone: modest and uneven growth, low inflation
  - Sovereign risk and credit premium back in the spotlight
  - Cross country selection key for portfolio performance
  - International FX diversification & USD vs CNY
  - Has the positive correlation between Wall Street & the EUR-USD ended?
  - EUR-GBP: a break through the parity rate is not a done deal
  - Carry trades: appeal for these strategies will increase helped by a lower JPY
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# Global: A moderate recovery ahead

**GDP growth (quarterly annualized) in US and eurozone**



**Rebuilding personal savings in the US**

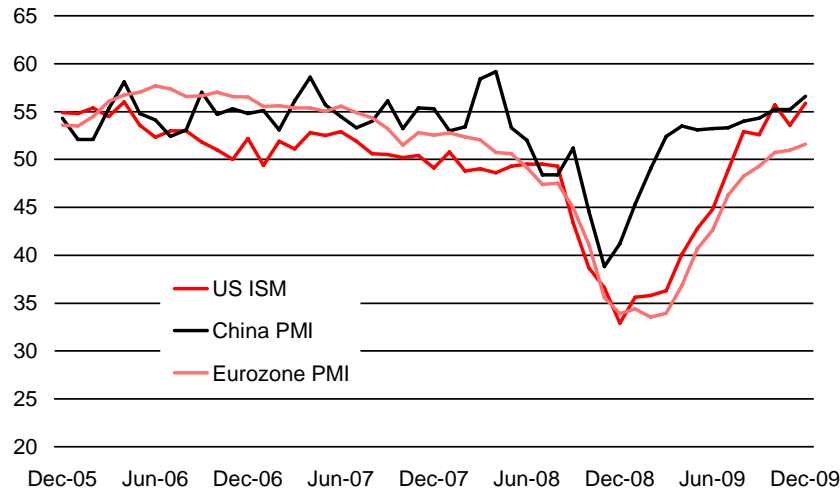


Source: BEA, Eurostat, UniCredit Research

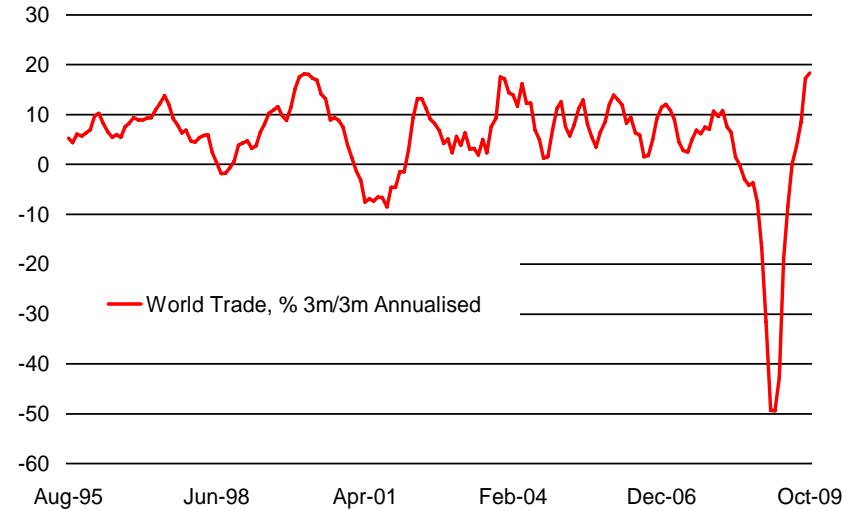
- Strong recent pick-up, thanks to inventories, global trade and a massive fiscal stimulus.
- Expect loss of momentum in 1H 2010, before growth stabilizes at lacklustre levels in US and Europe.
- Deleveraging by US consumers: the main engine of past global growth will slow down.

# Global: Inventory rebalancing and the rebound in Global Trade

**Global manufacturing is back on track**



**World Trade: Strong rebound**

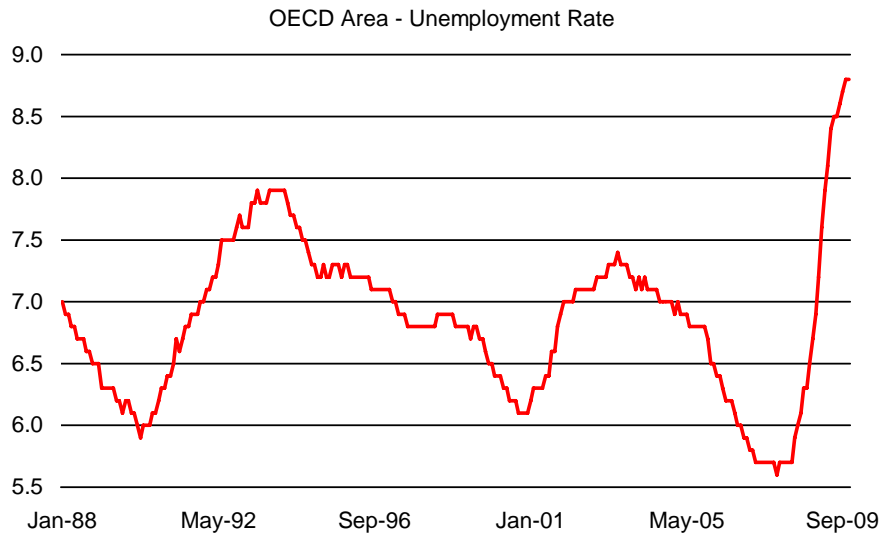


Source: PMI, Markit, Bloomberg, CPB, UniCredit Research

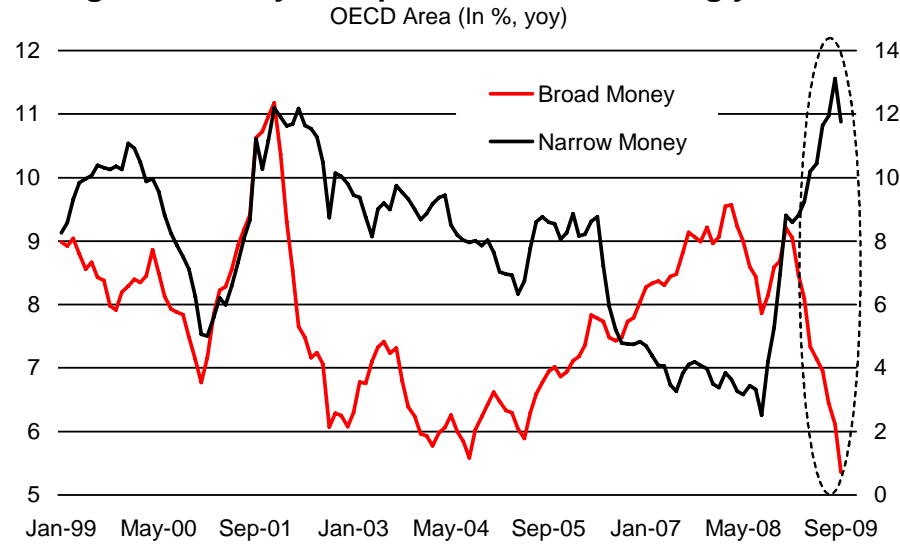
- Strong rebound in manufacturing thanks to inventory rebalancing and...
- ... global trade, defying fears of protectionism

# Global: Inflation is not (yet) an issue

## Labor market slack still on the rise



## The global money multiplier is not functioning yet



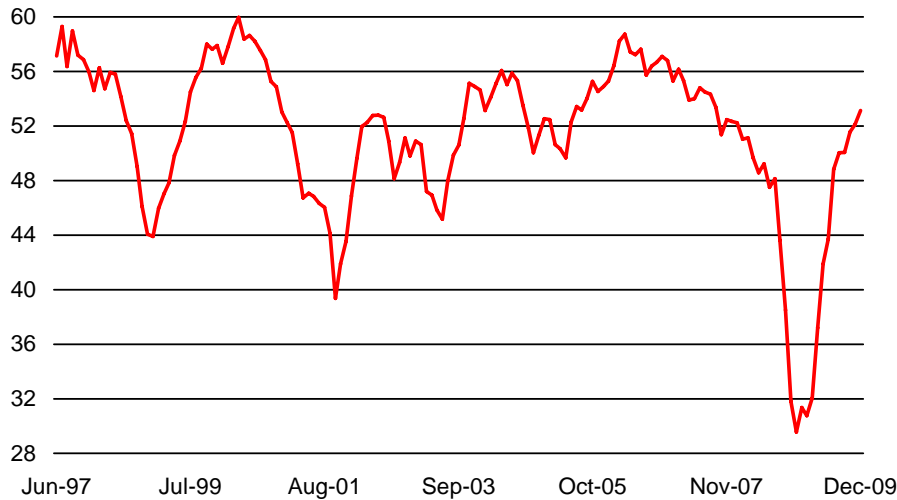
Source: OECD, UniCredit Research

- Our fundamental analysis: inflation at global level not an issue for next couple of years, due to...
- ...labor market slack—keeps price pressures at bay , and...
- ...deleveraging → impaired money multiplier → excess liquidity harmless.
- Bottomline: 2012 and, more likely, 2013 is when inflation might come back

# Eurozone: The recovery is (almost only) export-driven

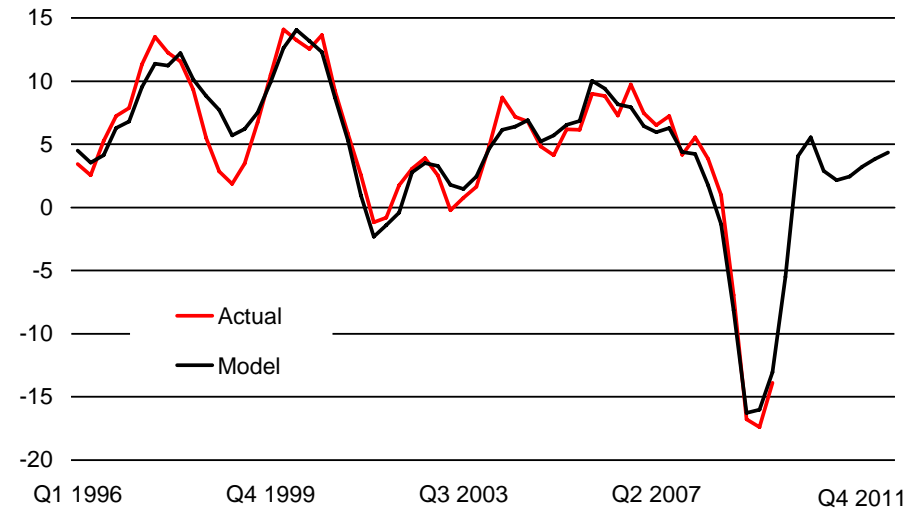
## Fast improvement in the export outlook

Factory PMI - Export Orders



## Export growth to remain moderate by historical standards

Exports (in %, yoy)



Source: ECB, Eurostat, Markit, UniCredit Research

- The eurozone emerged from the recession in 3Q thanks mostly to the stronger-than-expected pick up in global trade. In contrast, domestic demand remains very weak.
- As 2010 progresses, world trade is more likely to soften than accelerate further., and...
- ...exports help some countries/sectors much more than others
- This kind of export dynamics is unlikely to affect significantly the fundamentals of business investment, which continue to look relatively weak both for cyclical and structural reasons.

# How important is the Asian rebound?

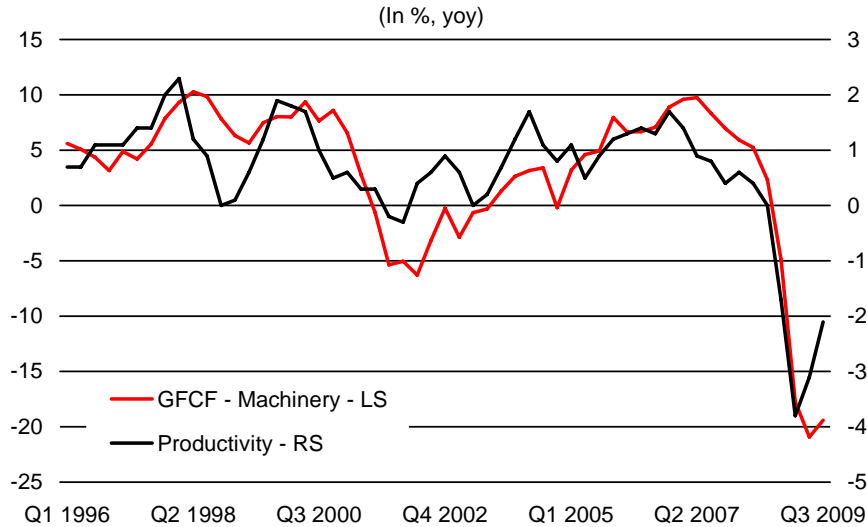


Source: National Sources, Bloomberg, UniCredit Research

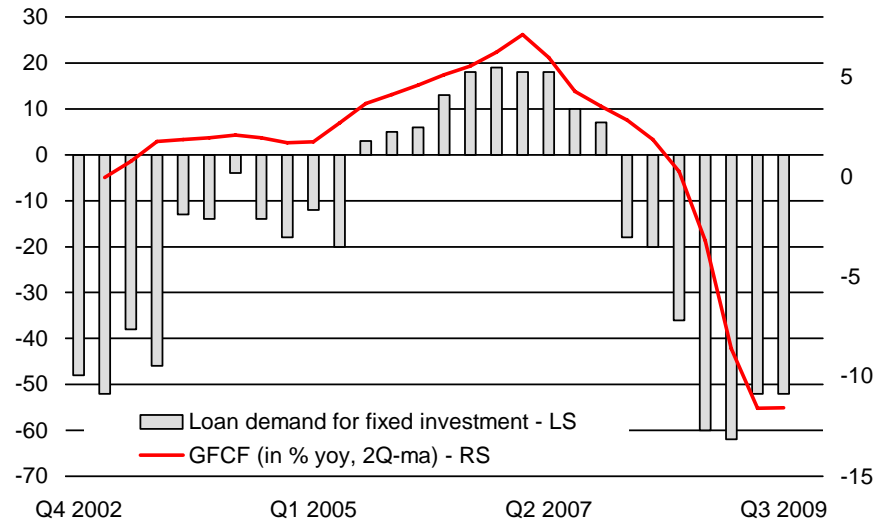
- Asian growth is great news, especially for Asia...
- ...but less so for Europe. Only 15% of German exports to Asia, compared to about 65% to the rest of the EU (including CEE).

# Too early for a new investment cycle

**Productivity has just started to recover**



**Loan demand for fixed investment keeps falling fast**

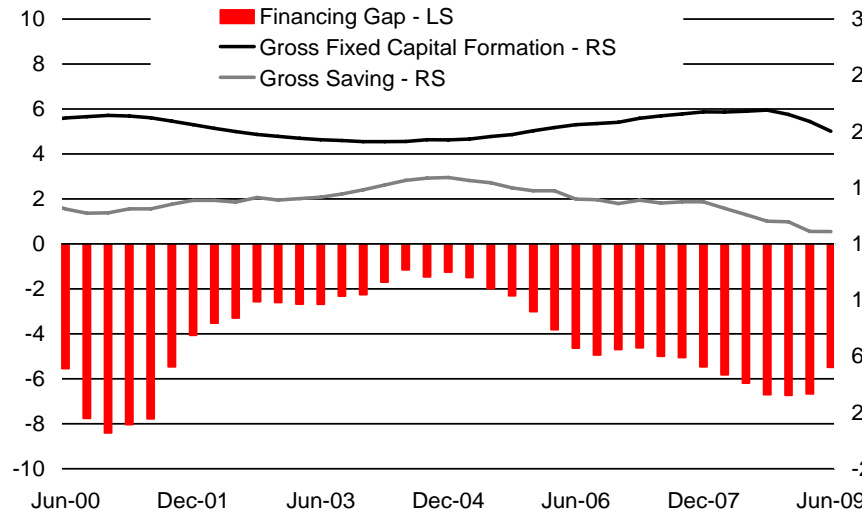


Source: ECB, Eurostat, UniCredit Research

- Productivity bottomed out in 2Q, but is still at a depressed level.
- Capacity utilization (70.7%) is only 1pp above the all-time low of mid-2009. Capex stabilization during the summer mostly reflects replacement schemes for old machineries, not a genuine investment upswing.
- Corporate loan demand for fixed investment, as reported by the Bank Lending Survey (BLS), continues to contract at a rapid pace. ECB monthly data keep showing markedly negative flows of lending to NFCs.
- Residential investment is set to stabilize only in 2011, given the inertia with which the housing supply adjusts to demand levels.

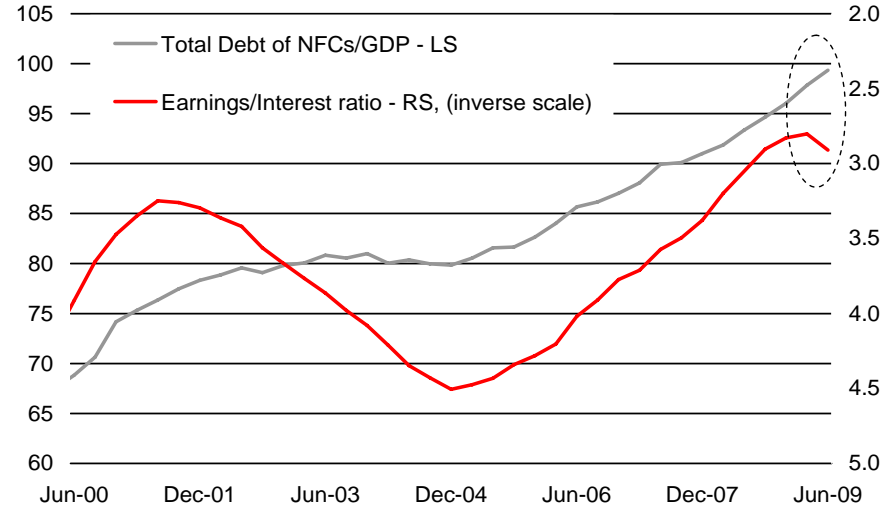
# The corporate sector is facing tough financial constraints

The financial position of NFCs is worrying\*



Note: (\*) % of Gross Value Added (GVA).

Strong corporate re-leveraging\*\*



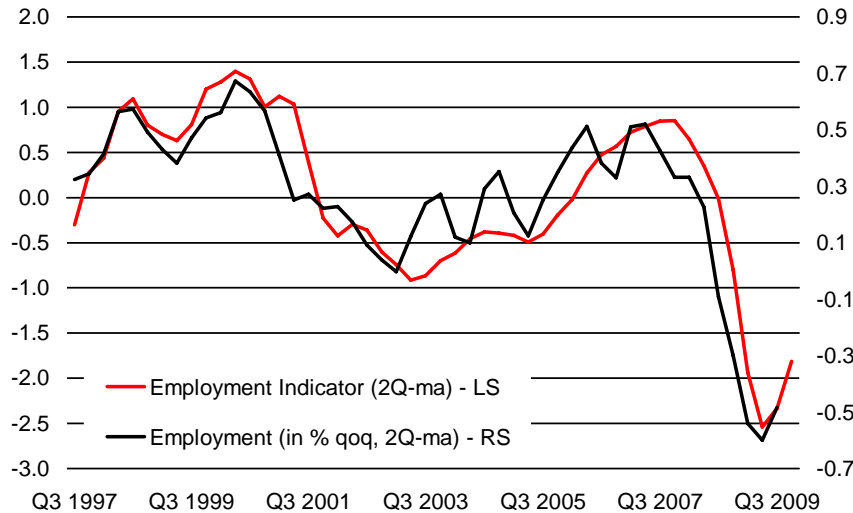
Note: (\*\*) Total Debt (loans and debt securities).

Source: Eurostat, UniCredit Research

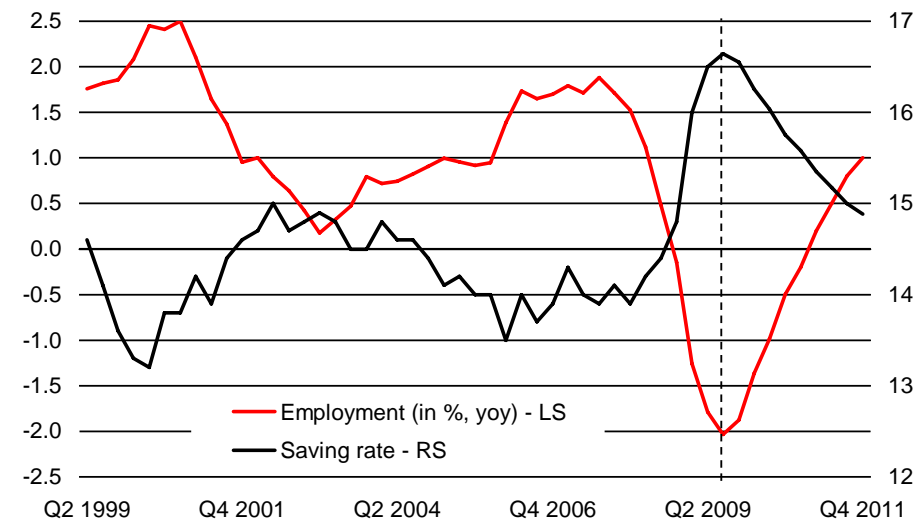
- Widening “financing gap” even with sharp fall in investment → serious vulnerability of NFCs.
- Lack of operating profits + high interest payments, due to elevated indebtedness → marked decrease in internally-generated funds.
- Excessive indebtedness of NFCs will keep impairing repayment capacity. Rising interest payments relative to corporate earnings determined a dramatic decline in the interest coverage ratio.

# Consumption: The worst is over, but the improvement will be slow

### Employment is falling at a slower pace



### Savings rate close to its peak

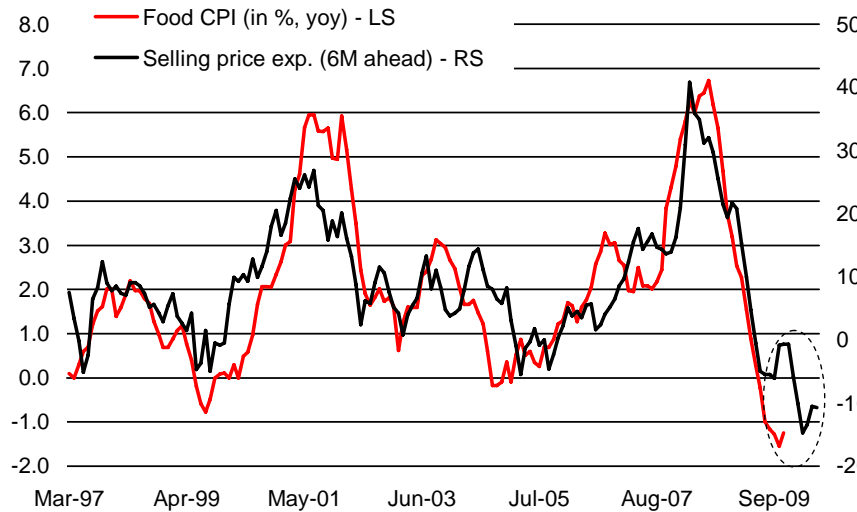


Source: Eurostat, UniCredit Research

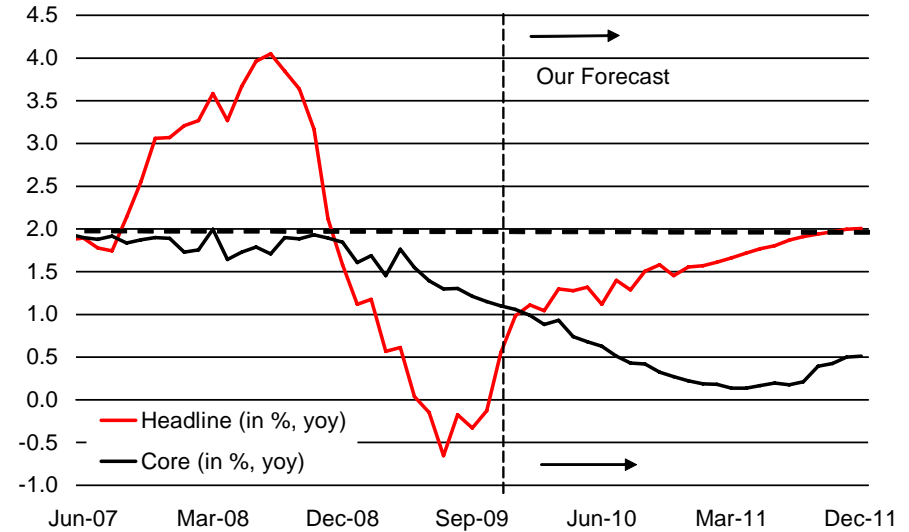
- The projected weak path for fixed investment means that the labor market recovery will be very gradual.
- Job growth unlikely to resume before end-2010. Unemployment rate to peak close to 11% between end-2010/early-2011.
- Consumption (ex cars) should have already troughed. Slower job cuts, still moderate CPI pressures and a slight easing in the savings rate will put a floor under household spending in 2010. But a more convincing recovery will be a matter of 2011 at the earliest.

# Benign CPI trend is here to stay

**Food manufacturers expect to keep cutting prices**



**Our baseline CPI scenario**

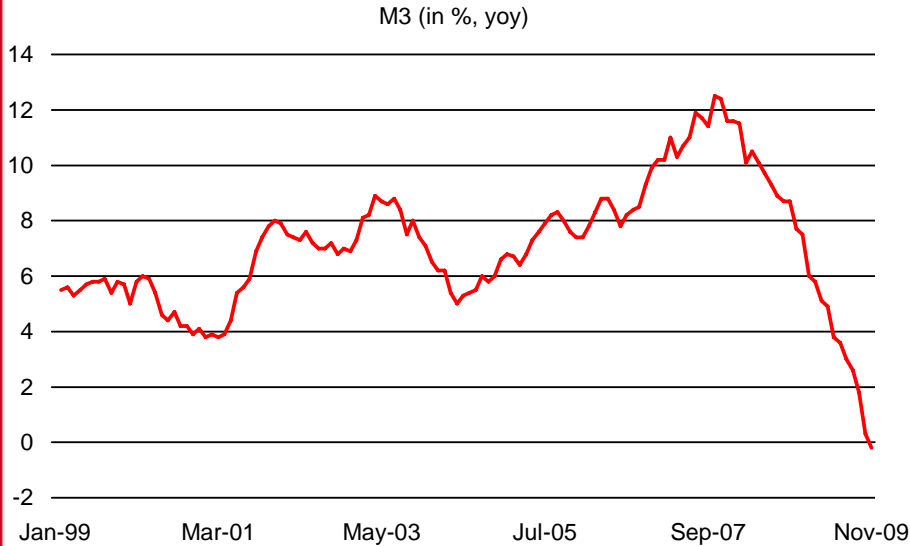


Source: EC, Eurostat, UniCredit Research

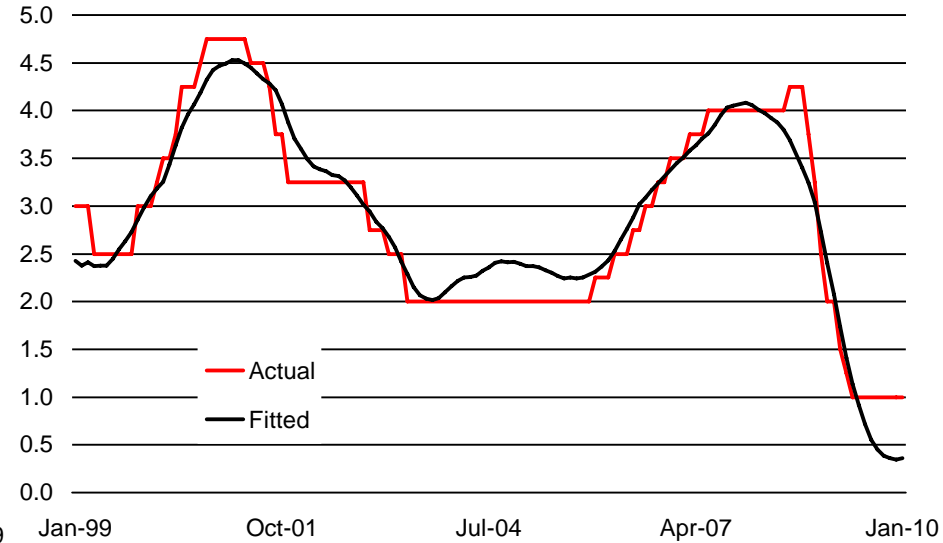
- Besides energy, there's very little behind the recent pick up in inflation.
- We expect core prices to slow substantially further due to huge economic slack.
- Food inflation is unlikely to revive soon – leading indicators remain at quite depressed levels.
- Overall CPI is likely to rise only 1.3% in 2010. In 2011, we have penciled in an acceleration to 1.8%, but this forecast strictly depends on the assumption that oil prices will breach again the USD 100 p/b mark.

# ECB to continue withdrawing liquidity, on hold on rates

## M3 falls in negative territory



## Our Taylor Rule



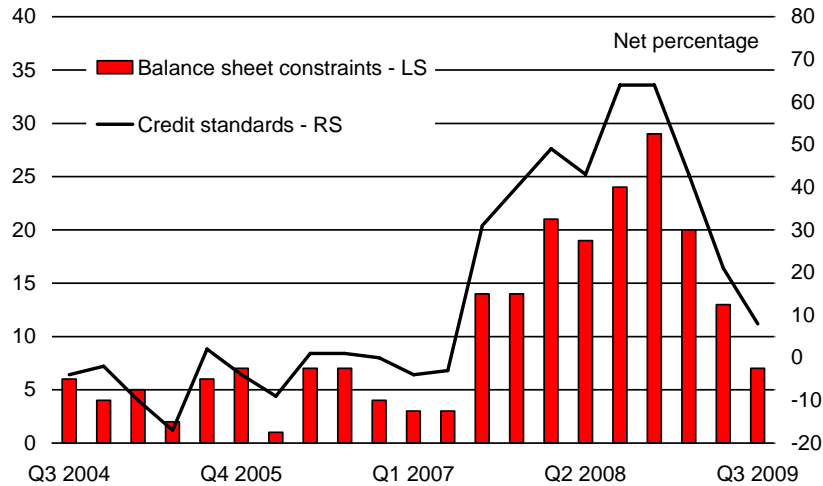
Source: ECB, Markit, UniCredit Research

- With activity unlikely to pick up in a sustainable way, money and credit growth set to remain depressed and inflation well below 2%, the ECB can afford to remove the monetary stimulus in a very gradual manner.
- 2010 should see only a withdrawal of liquidity, no rate hikes
- The tightening cycle should begin only next year, with a 2.50% refi rate target at end-2011.

# Bank Lending: Support from the supply side?

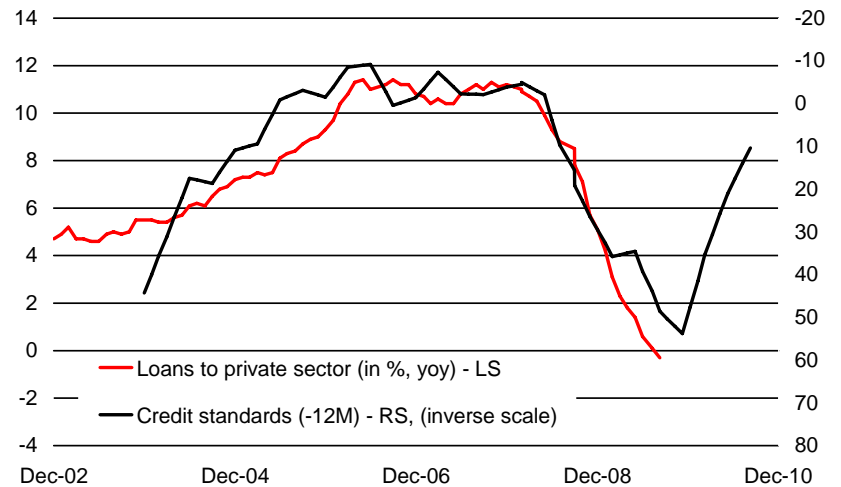
## The rise and fall of the “supply factor” –

Tightening of credit standards due to balance sheets constraints - NFCs



## Credit Standards lead lending growth

Composite (Households and NFCs) Credit Standards



Source: ECB, UniCredit Research

- In 2009, the demand side has been the key driver of the credit cycle, jointly with tightening of credit standards from the banking sector.
- In 2010, some recovery on the demand side and the past easing of credit standards (which impact on loans with a 12-month lag) should provide some support for credit to the private sector.

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## CEE outlook 2010: Variety is the spice of life!

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# Summary

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## 1. Key macro forecast highlights:

- ⇒ We raised our broad **CEE-17 2010 GDP growth** forecast to 2.3% (from 1.4%).
- ⇒ We project GDP growth to still **remain below the pre crisis level** across the whole CEE-17 region and forecast the CEE-17 region to **grow around 4% annually after 2011**.
- ⇒ **Inflation will remain off the agenda** across the region (all central banks will meet their inflation targets in 2010) but in case of Turkey the stronger rebound will warrant rate hikes.
- ⇒ Although **Poland** is outperforming at the moment we still believe that this reflects the late cycle nature of its economy, and expect this to turn into a moderate underperformance in 2011. This is the key reason behind our dovish NBP rate forecast (only 25bp hike).
- ⇒ **We upgraded our 2010 Turkish GDP growth to 4.5%** and now expect the CBT to be first central bank to hike rates in 2010 (+125bp).
- ⇒ We keep our **Russian** GDP forecast (2.7%) slightly below consensus due to weak domestic demand,
- ⇒ We expect **Hungary, the Baltic Countries, Bulgaria, and Romania to underperform**.

## 2. FI/FX market implications:

- ⇒ **FX:** We continue to see scope for underperformance of CEE FX vs. other asset classes, though we see value in selected relative value trades. We prefer **TRY** (due to monetary policy direction) and **PLN** (due to fundamental support). From shorter term perspective we also like **RON**.
  - ⇒ **Rates:** In the rates space we'd keep moderately long duration in Hungary and reduce Turkey to short. Keep Poland and Czech Republic and Russia duration exposure neutral.
  - ⇒ **Credit:** We believe that CEE credit could continue to outperform EMU periphery.
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# Our CEE GDP forecasts : we are generally more cautious than consensus (ex-Turkey)

UNICREDIT GDP FORECAST CHANGES AND COMPARISON VS. CONSENSUS

GDP	UniCredit Sep 2009 Forecast		UniCredit Jan 2010 Forecast		Focus Economics	
	2010	2011	2010	2011	2010	2011
Bulgaria	-2.5	2.0	-1.5	1.7	-0.6	2.7
Croatia	-1.5	1.2	-1.0	1.3	0.1	2.4
Czech Rep.	1.4	3.5	1.6	2.4	1.6	3.0
Estonia	-3.8	5.1	-3.9	4.8	-1.1	2.8
Hungary	-0.6	2.4	-0.3	2.7	0.1	2.9
Latvia	-5.4	6.0	-4.0	6.1	-3.3	2.5
Lithuania	-7.0	4.4	-5.5	4.7	-2.9	2.4
Poland	1.8	2.6	2.3	2.7	2.3	3.5
Romania	0.4	3.5	0.4	3.5	0.7	3.0
Russia	1.3	4.1	2.7	5.2	3.4	3.7
Turkey	3.2	4.5	4.5	4.5	3.4	4.2
Ukraine	1.7	3.3	2.0	4.0	2.3	4.1

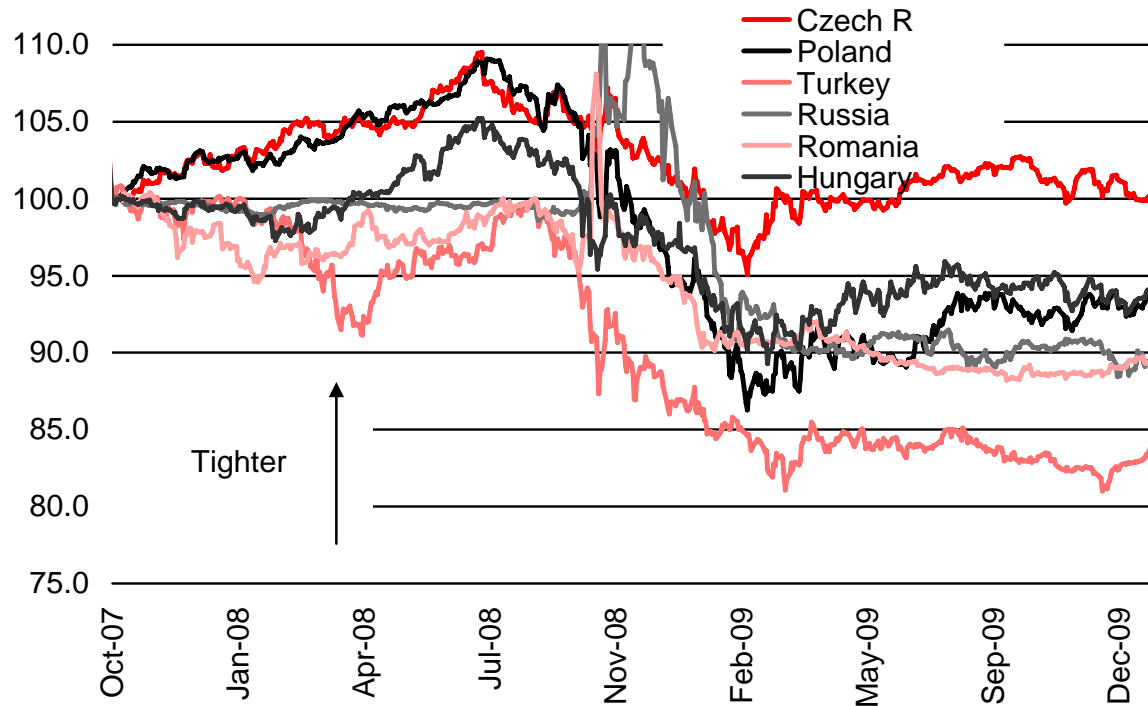
Source: Focus Economics, UniCredit Research

## ■ Why is our regional view is more cautious than consensus?

- ⇒ We are significantly below consensus with our 2010 EMU growth outlook (0.9%); ECB is at 0.8% but “true” consensus is probably around 2% - a generally relatively negative input for export outlook
- ⇒ In terms of local growth drivers we still see poor outlook for investments (significant excess capacity) and household demand to particularly in the more leveraged economies.

# Why are we bullish on Turkey? - the most significant monetary easing, healthy banking sector & balanced CA

Nominal monetary conditions (50% FX, 50% rates)



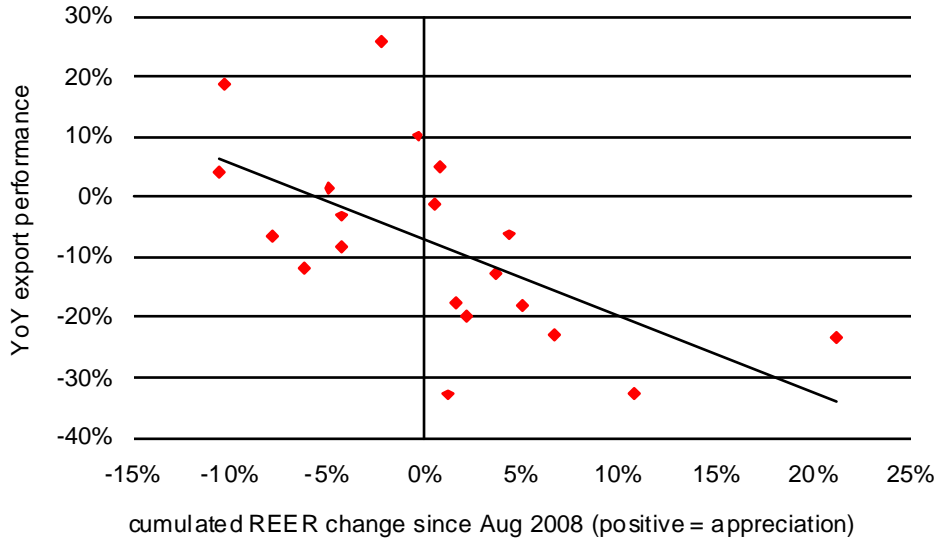
Source: UniCredit Research

## ■ Why are we bullish on Turkish GDP growth?

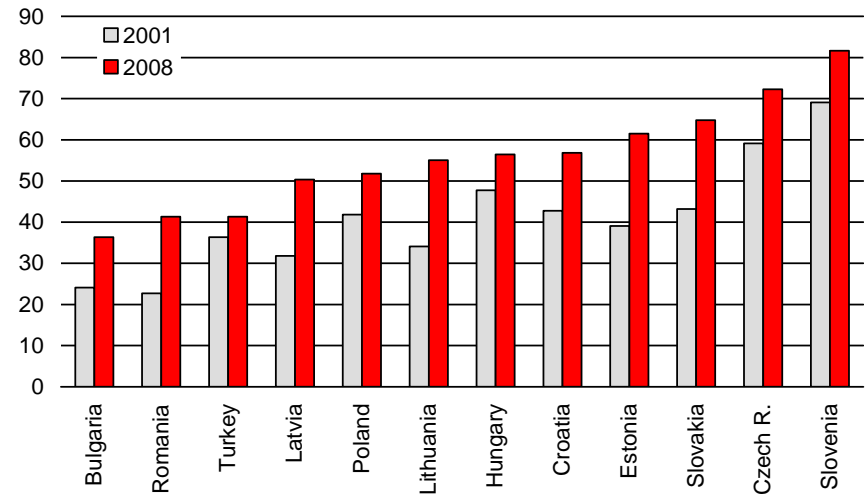
- ⇒ The most significant monetary easing occurred in Turkey both in terms of timing and in terms of length/magnitude (CBT cut its policy rate by 1025bp and TRY has underperformed the peers)
- ⇒ The local banking sector is healthy with relatively low level of loan to deposit ratio and current account is almost balanced.
- ⇒ **Key risk:** relatively high public debt roll-over might crowd out private borrowers (IMF agreement could be game changer)

# Longer term growth outlook –regional growth at 4%, about 1.0-1.5% below pre crisis levels

**Weaker FX helped export performance during the crisis**



**CEE is still cheap (compensation per employee, EU15=100)**



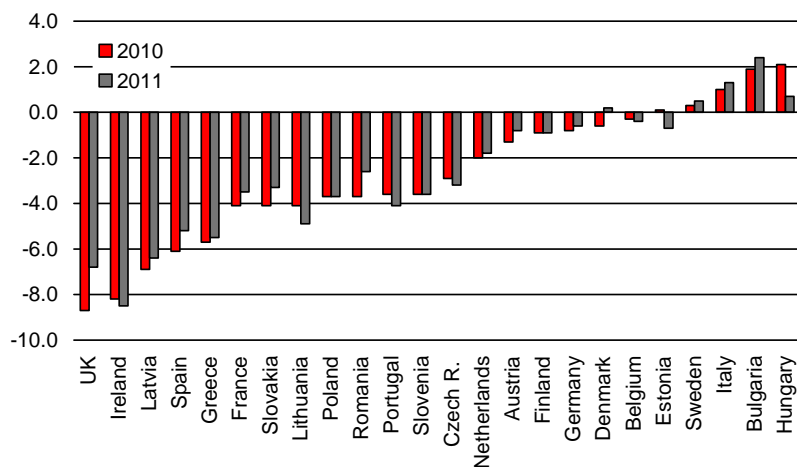
■ **We expect the CEE-17 region to grow about 4% beyond 2011 (this is about 1.0-1.5% below pre-crisis levels) – export competitiveness will become a more important differentiating factor.**

- ⇒ Beyond the inventory rebound **export seems to be a more sustainable driver of growth** for both the short and the medium term.
- ⇒ Even during the full-blown crisis period countries with weaker REER managed better export performance (chart 1) .
- ⇒ **Region still cheap in terms of labour cost** but this might be tested in Q1-Q2 2010 as appreciation pressure appears – concerns about FX strength are evident in recent comments

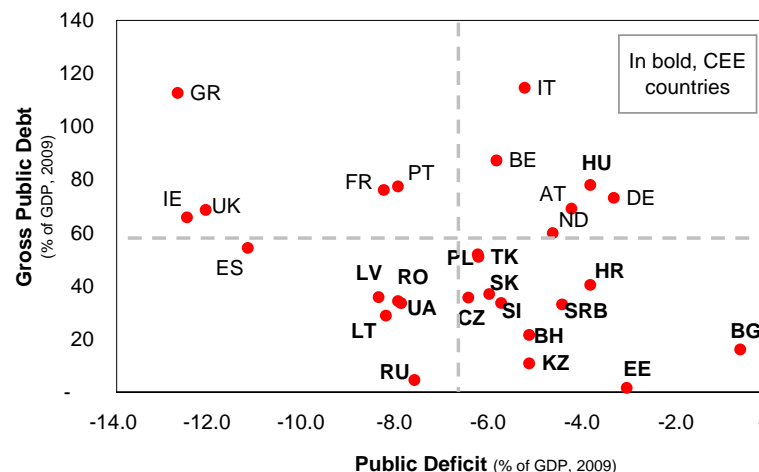
# Fiscal outlook: very diverse, but CEE looks better than many Western European countries

## FISCAL BACKDROP IS DIVERGING SIGNIFICANTLY

Cyclical adjusted primary balance (% of GDP)



Fiscal metrics look better in CEE than in many WE countries



## CEE PUBLIC FINANCES LOOK BETTER THAN IN EMU PERIPHERY COUNTRIES

2009, % of GDP	Current account	General Govt Balance	General Govt Debt	Moody's Rating	S&P Rating
Spain	-5.4	-12.2	54.3	Aaa	AA+
Portugal	-10.2	-8.0	77.0	Aa2	A+
Italy	-2.4	-5.3	114.6	Aa2	A+
<b>Greece</b>	<b>-8.8</b>	<b>-12.7</b>	<b>112.6</b>	<b>A2</b>	<b>BBB+</b>
Czech	-0.9	-6.5	35.6	A1	A
Poland	-1.3	-6.3	51.9	A2	A-
Hungary	-0.2	-3.9	78.0	Baa1	BBB-
Romania	-5.4	-8.0	34.3	Baa3	BB+

Source: European Commission, UniCredit Research

# Eurozone membership: budget deficit now the most important obstacle

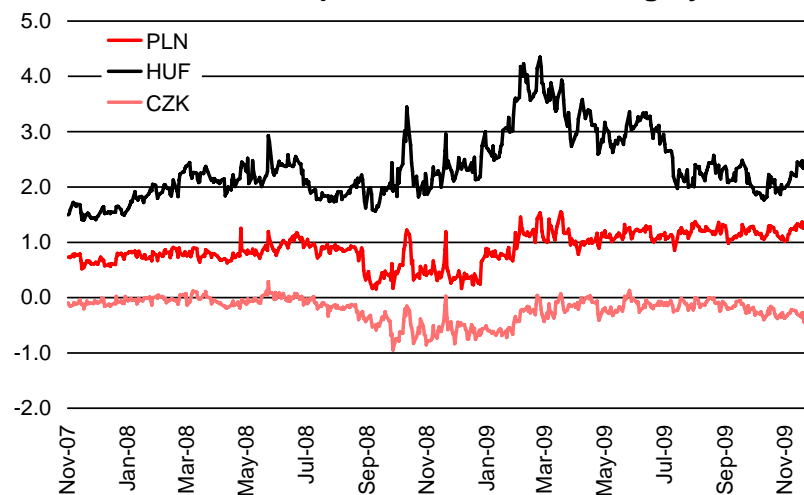
## Maastricht criteria and current fulfillment

	<i>Inflation</i>	<i>Budget deficit*</i>	<i>Public debt*</i>	<i>Long term rates</i>	<i>ERM2</i>
Bulgaria	0.30	-1.20	16.20	6.53	
Czech Republic	-0.60	-5.50	40.60	4.19	
Estonia	-2.10	-3.20	10.90	7.27	yes
Hungary	4.20	-4.20	79.80	7.37	
Latvia	-1.20	-12.30	48.60	13.75	yes
Lithuania	1.00	-9.20	40.70	14.50	yes
Poland	3.80	-7.50	57.00	6.14	
Romania	4.30	-6.80	27.40	8.24	

\*EC 2009 Autumn forecast for 2010, Source: Eurostat, green highlight = criteria is currently fulfilled

- **Budget deficits** seriously deteriorated during the crisis:
  - ⇒ According to the EC Autumn forecast only Bulgaria will be inside the 3%/GDP deficit limit in 2010
  - ⇒ Latvia, Lithuania seems to be most at risk
- The **debt level** is above the 60% limit only in Hungary
- Due to the significant recession **inflation** will not be a problem in any of the countries
- Based on the above factors the real obstacles are budget deficit and ERM2 membership. Accordingly the EMU membership becomes a political issue even more than before (i.e. are governments willing to cut fiscal spending)
- Given the **forthcoming election cycle in CEE** (7 countries in the pipeline) we doubt that this issue will move back to the agenda in 2010.

**5y5y fwd spreads vs. EUR do not price quick EMU membership from Poland and Hungary**



Source: Bloomberg, UniCredit Research

# FI/FX markets implications

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## 1. FX:

- ⇒ **Relative monetary policy outlook:** given that we expect the Turkish economy to significantly outperform the rest of the CEE region (4.5% GDP growth vs. 2.3%) the CBT will likely be the first central bank in the region to hike its interest rates in 2010. – **overweight TRY**
- ⇒ **Diverging fundamental support:** on a fundamental basis we still see value in PLN given its relatively better growth prospects, continuing deep undervaluation in REER terms and the likely further improvement in the current account balance (due to the undervalued currency). – **overweight PLN**
- ⇒ We keep **HUF and CZK underweight, reduce RUB to marketweight** following the recent big falls in interest rates.

## 2. Rates:

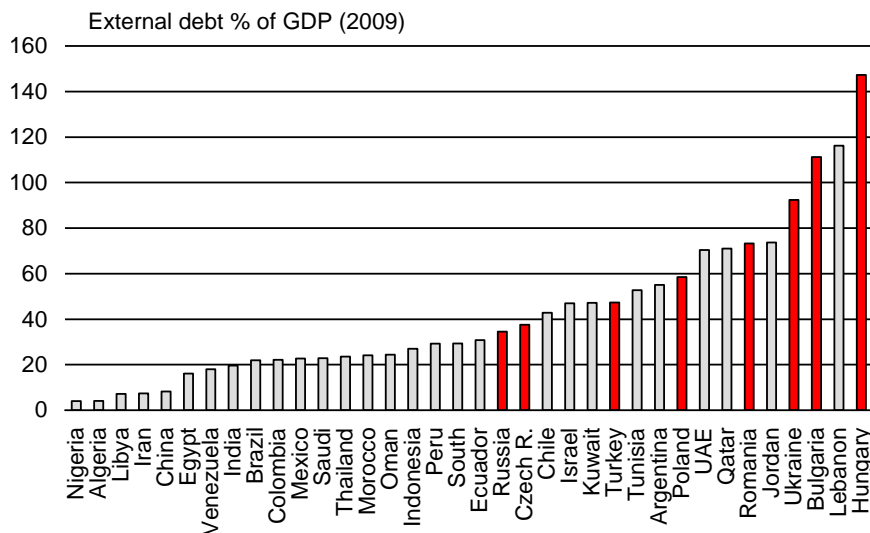
- ⇒ Central bank interest rate decisions will be driven by potential upside pressure on the currencies and likely further downside pressure on inflation (apart from Turkey). – **we expect further cuts in Hungary (-75bp), Romania (-100bp) and Russia (-100bp).**
- ⇒ Yield curves are pricing some risk premium but **we only keep long duration in Hungary (mod long)** and **reduce Turkey duration to short** as the CBT outlook is now more hawkish. We keep Poland, Czech R. and Russia neutral duration. **At the short ends we believe PLN and CZK rates are pricing too much hikes** and we are receiving these rates. We took profit on Russian receivers as the market went too far. **In the off benchmark space we favour Romania (both rates and FX).**

## 3. Credit:

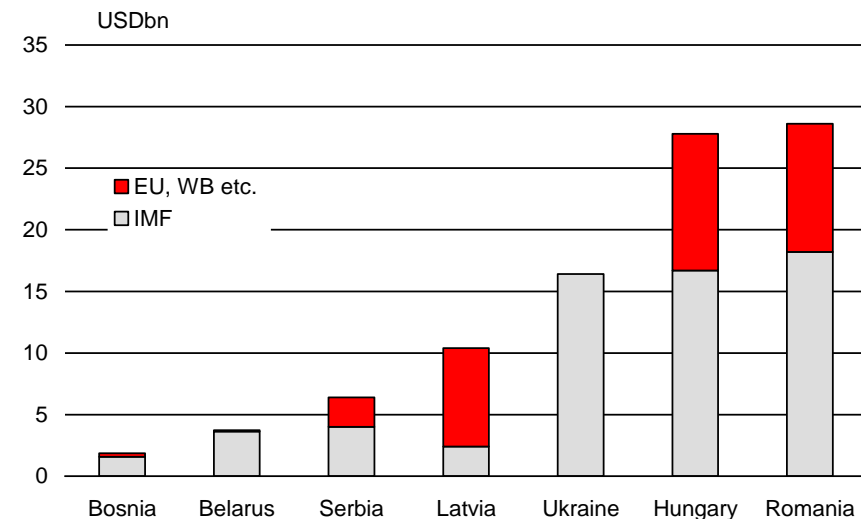
- ⇒ We believe that CEE credit markets could remain relatively “protected” from EMU fiscal fears and **recent outperformance (against a broader EMU periphery group) could continue in Q1**. The main reasons: **1.** the actual fiscal position of CEE countries is more solid than the Greek one. **2.** As opposed to Greece, the CEE economies had the possibility to loosen their monetary policy via the exchange rate channel (to a certain extent). Weaker currencies help them to correct the current account balances and also to avoid deflation.
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# Main risk: CEE still the most indebted region in EM universe – but external help removed tail risks

The CEE region still belongs to the high debt EM countries



But significant external help (IMF, EU, WB) removed tail risks



Source: UniCredit Resarch, IIF, IMF

- Given the CEE region is still a relatively highly indebted region (during the last year debt did not decline much but did not increase either) in the global EM universe any sudden swing in risk appetite might cause some pressure on the local and external markets. We see Hungary, Bulgaria and Ukraine the most at risk in this case. (chart 1)
- The good news is that the significant external assistance from the IMF, EU, WB and EIB (total USD95bn allocated to this region) have removed tail risks related to sudden stop of capital flows.
- High level of debt represent a risk mostly in the form of slower growth rate in the post crisis period.

# CEE interest rate forecasts

	Current	End 1Q 10	End 2Q 10	End 3Q 10	End 4Q 10
<b>CNB</b>	1.00	1.00	1.00	1.00	1.50
3M	1.39	1.40	1.40	1.60	2.00
2y IRS	2.43	2.50	2.55	2.60	3.10
5y IRS	3.18	3.30	3.50	3.60	3.90
10y IRS	3.66	3.80	4.00	4.20	4.40
<b>NBH</b>	6.25	5.75	5.75	5.50	5.50
3M	5.83	5.75	5.75	5.50	5.50
2y IRS	6.47	6.20	6.20	6.00	6.00
5y IRS	6.94	6.50	6.50	6.40	6.40
10y IRS	6.90	6.60	6.90	6.60	6.60
<b>NBP</b>	3.50	3.50	3.50	3.50	3.75
3M	3.95	3.90	3.95	4.00	4.30
2y IRS	5.02	5.00	5.00	5.00	4.50
5y IRS	5.67	5.60	5.50	5.50	4.70
10y IRS	5.72	5.70	5.70	5.50	5.00
<b>NBS</b>	1.00	1.00	1.00	1.00	1.00
10y IRS	4.51			4.00	4.10
<b>NBR</b>	7.50	7.25	7.00	6.75	6.50
RON 3M	9.01	8.70	8.50	8.60	8.71
<b>CBR O/N repo</b>	6.00	5.75	5.50	5.25	5.00
3M MOSPRIME	7.05	6.75	6.50	6.25	6.00
RUB 5y CCS	7.68	7.38	7.13	6.88	6.63
<b>NBSerb</b>	9.50	9.00	8.50	8.00	7.50
RSD 3M	10.6	10.00	9.50	9.00	8.50
CBT O/N	6.50	6.50	6.50	7.00	7.75
TRY 3M	6.97	6.97	6.97	7.25	8.50
TRY 5y CCS	10.19	10.30	10.50	10.80	11.00
BGN 3M	3.7	3.00	2.50	2.00	1.50
HRK 3M	2.8	3.00	3.50	4.00	6.00
KZT 3M	3.0	3.50	4.50	6.00	6.50
UAH 3M	18.8	18.00	17.00	16.00	15.00
<b>ECB</b>	1.00	1.00	1.00	1.00	1.00
Eur 10y	3.54	3.50	3.90	4.00	4.10

Source: UniCredit Research

## CEE exchange rate forecast

	EUR/CZK	EUR/HUF	EUR/PLN	EUR/HRK	EUR/RON	EUR/RSD
Current	26.3	269	4.09	7.28	4.16	97.6
End Q1 10	25.9	270	3.75	7.20	4.10	96.8
End Q2 10	26.0	270	3.70	7.15	4.15	97.0
End 3Q 10	26.1	265	3.80	7.40	4.21	99.0
End Q4 10	26.0	265	4.10	7.45	4.20	100.0

	USD/KZT	USD/RUB	RUB basket	USD/TRY	USD/UAH
Current	148.21	29.78	35.59	1.47	8.08
End Q1 10	135.00	28.50	35.55	1.50	8.20
End Q2 10	135.00	28.50	35.81	1.50	7.59
End 3Q 10	135.00	28.57	35.26	1.50	7.46
End Q4 10	135.00	30.43	37.00	1.51	7.40

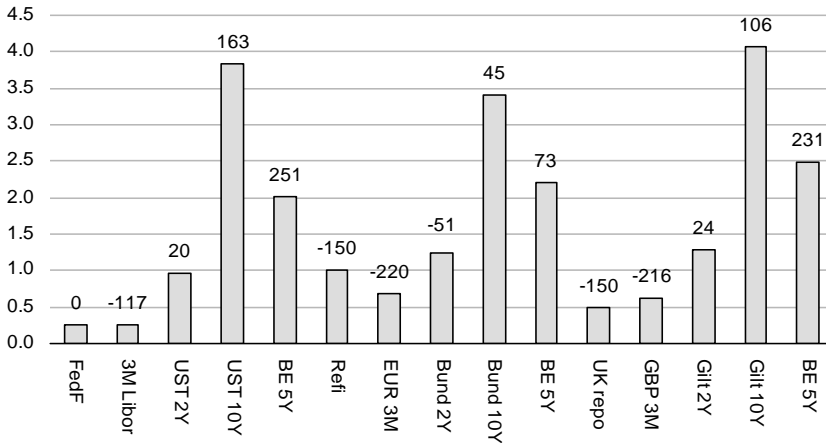
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## FI outlook 2010 : leaving the zero-zone?

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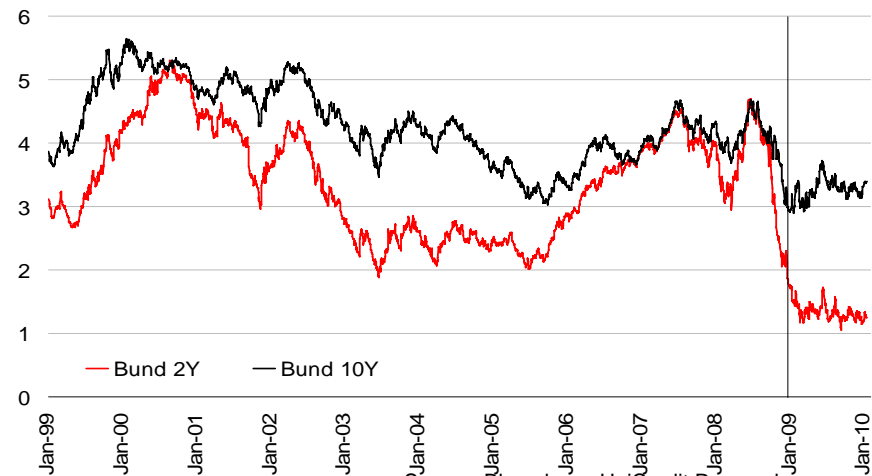
# 2009 has been extremely eventful !

FI markets: 1jan2010 level and 2009 changes



Bars denote the 1jan10 level, numbers above the bars show the 2009 change (bp)  
Source: Bloomberg, UniCredit Research

Eurozone bond yields: some history



Source: Bloomberg, UniCredit Research

- Policy rates cut (ECB 150bp, BoE 150bp). As a result, short end performed very well.
- Adoption of QE measures (ECB covered bond program, BoE and Fed purchase of corporate/government bonds)
- Deflation scenario priced-out on FI markets
- 10Y under pressure (more moderately in EU)
- Belly under pressure relative to the wings (mainly on supply pressure and state-guaranteed bank bonds)
- Spreads core periphery, iTraxx and other credit spreads have tightened from their crisis-peaks
- Swap spreads have cheapened ( especially in the US )
- Changed perception of sovereign risk (rating downgrades, rising debt/GDP, Greek crisis)

## 10 key themes for 2010...

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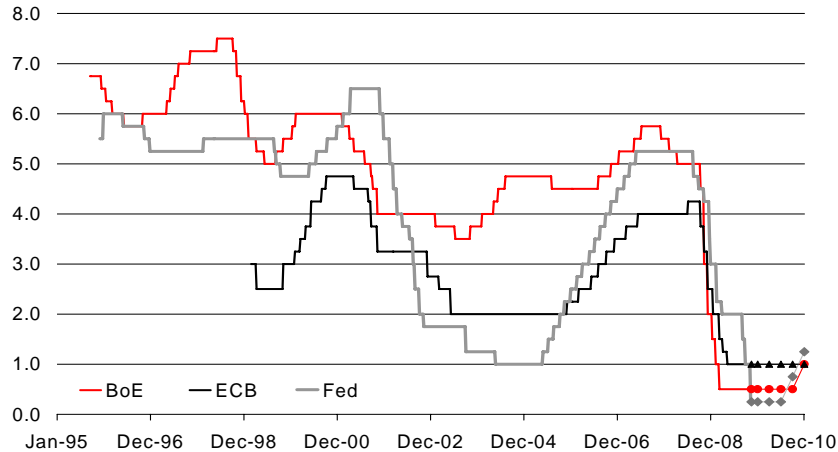
1. Exit strategy, drain of liquidity (and impact on FI carry trades)
2. Monetary policy normalization
3. Road to growth gets less bumpy
4. Global imbalances: is there a way out?
5. Mounting government debt (and rating outlook)
6. Medium term inflation (we disagree but ...)
7. EMU solidity, cross country spreads (Greece approaches sub-investment grade) and cross country divergences
8. Asset price bubbles (and if central banks should care)
9. International FX diversification & USD vs CNY
10. Tighter risk standards for financial intermediaries

### ... and key market trends

1. Increase in government bond yields
  2. Increase in short term / MM rates (but not as much as Libor futures are pricing)
  3. Bear Flattening on EU and US curve
  4. UST to under-perform Bunds
  5. Gilts to outperform Bunds & UST, especially at the short end
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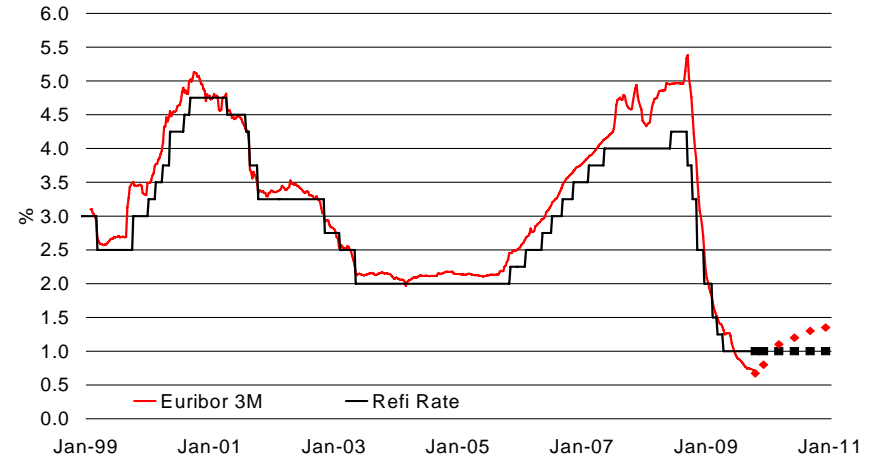
# 2010: the year of policy rates normalization

Policy rates leaving the zero-zone



Source: Bloomberg, UniCredit Research

Euribor should also revert to above-refi level

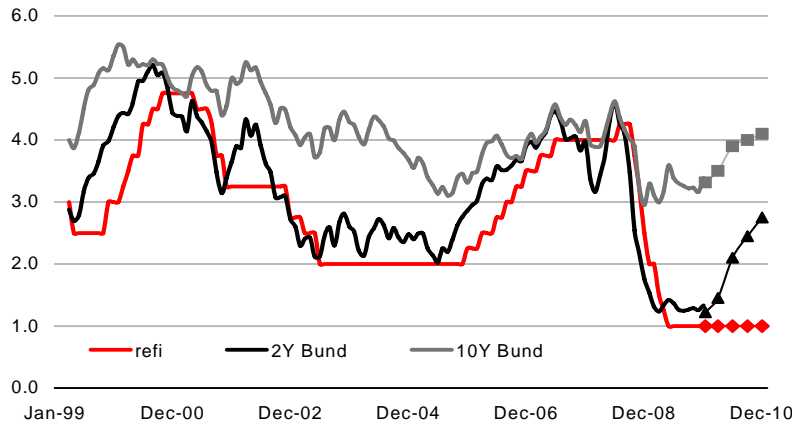


Source: Bloomberg, UniCredit Research

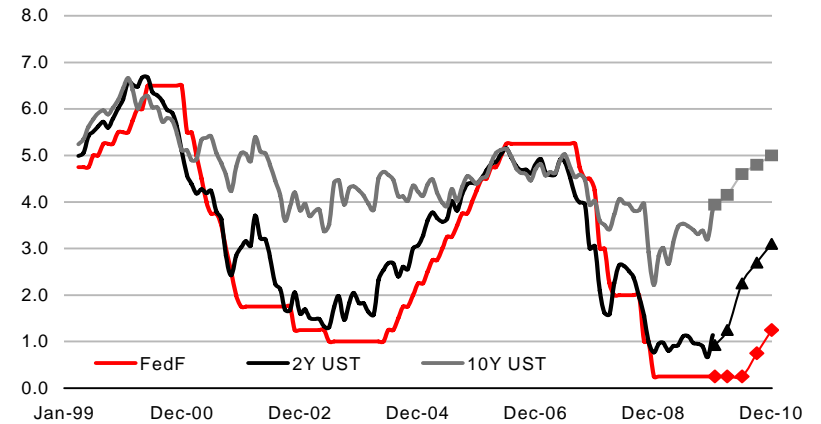
- **ECB:** We expect a gradual unwinding of the unconventional monetary policy measures. The most immediate impact should be on the EONIA, which should revert to the refi. The expiry of the first 12M LTRO (in Jun2010) should mark the transition. We expect the ECB to keep the refi on hold until 2011.
- **FED:** The monetary policy normalization is likely to start in Q3-2010. We expect the Fed to initially hike rates by 50bp steps (higher than in the last episode of tightening cycle). An improvement in the job market (reflected by a string of positive payrolls) is a necessary condition for the rates normalization process.
- **BoE:** UK is in a difficult growth situation, with the economy still contracting in 3Q-09. The BoE should thus start the tightening cycle later than the Fed, possibly in late 2010 if the economic outlook brightens over the coming months.
- **BoJ:** We do not expect economic condition in Japan to justify a rate hike, and we expect stable rates at 0.1%.

# Our forecasts at a glance

## EU



## US



- FI markets in 2010 will be mostly driven the changes in the central bank's rhetoric. We think the Fed will be the first to signal a change in monetary policy. This will lead to a sharp sell off on short end (2Y), likely in late Q2'10 or early in Q3'10. This will depend on development in the US job market and US consumption.
- With the ECB likely to act in a more prudent way, Bunds experience a more moderate sell-off.
- As investors start to price a policy rate normalization, the long end will also come under pressure. We project 10Y Bund in the 3.8/4.0% area around mid year and 10Y UST in the 4.3/4.5% range.
- We expect bear flattening both in EU and the US. The movement should happen in late Q2'10/early Q3'10 and continue until the end of 2010.
- We see growing fiscal deficit and supply as a potential upside risk.

## 2010: case for higher 10Y yields, case for stable 10Y yields

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### 10 Yields up because

- Economic data will signal improvement in growth dynamics
- Exit strategies come into the radar screen
- Yields are close to historical lows
- Massive deficits in EU, US and UK.
- Rating concerns (mainly in UK).
- Portfolio re-allocation from FI to equities.
- If dollar remains weak, speculation of foreign reserves diversification.
- Concerns on external funding (mainly US).
- Possible speculation of medium term inflation:
  - Stronger than expected GDP (lower output gap)
  - The effect of high CB liquidity
  - Governments incentive to use inflation to lower real value of debt.
  - Rising commodity prices in response to high growth in China

### 10Y Yields stable because

- Growth will be moderate in the US (1.9%) and in EU (0.8%).
- Inflation risks are not in sight in the near term (US 2.3%, EU 0%).
- Financial sector will remain weak and central banks will not be able to normalize rates as fast as we expect.
- Carry trades with CB liquidity remain popular.
- High debt means higher taxes in the long-run and hence lower growth
- Impact of regulation on banks liquidity buffer.

**Bottom line: We expect 10Y yields to rise significantly during 2010. The rise will be more pronounced in relationship to the Fed exit strategy (possibly as early as Q2'10) and should bring total return into negative territory.**

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## 2010: curve-shape scenarios

<b>Bull flattening</b>	<b>Bear flattening</b>
<p>Disappointing growth            Subdued inflation expectations            Liquidity remains abundant (carry trades)</p>	<p>Growth resumption            Monetary policy normalization            Subdued inflation expectations            Supply pressure high but manageable            Liquidity buffer rules</p>
Possible (10%)	Very likely (80%)
<b>Bull steepening</b>	<b>Bear steepening</b>
<p>Disappointing growth and more problems in the financial system lead to further drop in 2Y yields / policy rates (where possible)</p>	<p>Supply pressure disrupts demand            Credit premium repricing (Rating, deficit)            Inflation expectations rise            Central banks stick with low policy rates as financial system remains weak / economy does not re-start</p>
Extremely low (2%)	Low (8%)

## 2010: upside and downside risks

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### Upside risks

- Growth surprises on the upside (fiscal/monetary stimulus kick in)
- Rebound in housing market
- Stronger investment cycle
- QE (and regulators support) dries up

### Downside risks

- US job market (or: growth and consumption do not pick-up as expected)
  - China grows less than expected
  - Disorderly US depreciation
  - Asset price bubble forces rate hikes and the recovery gets killed
  - Geopolitical risks
  - Major surprises in corporate defaults
  - Crisis in a developed country (could be UK, Greece or Ireland)
  - Default in US local/state debt
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**FX outlook 2010 : G-10 Currencies still “sultans of swings”**

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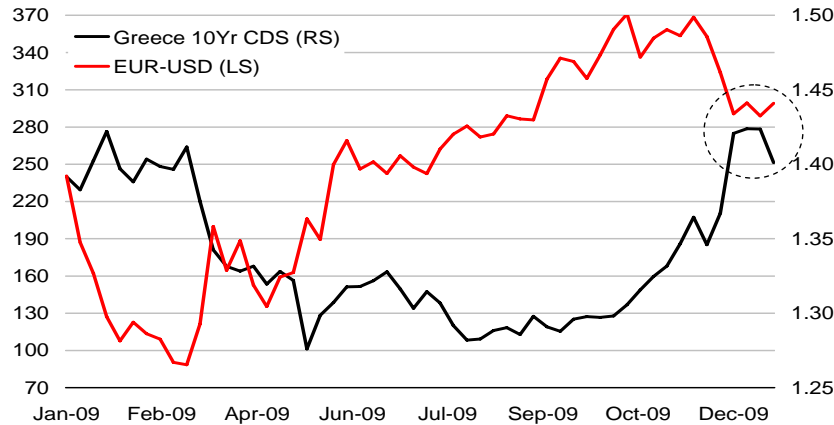
## Main FX View: G-10 Majors Still Sultans of Swings

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- **Global Picture:** The global economic scenario is still uncertain, struggling between signs of improvement and local crises (Dubai, Greece and Iceland). Key policy rates for the “big four currencies” (USD, EUR, JPY and GBP) will stay unchanged throughout 3Q10, limiting the impact of any exit strategy attempts. The tightening cycle will continue “at the antipodes” (in Australia and Norway, in particular).
  - **Basic FX Strategy:** As the Fed has repeated that interest rates will stay at low levels and latest US data disappointed, FX trends will return a risk appetite/risk aversion story, restoring the negative correlation between Wall St. and the USD and also making current low volatility levels a buying opportunity.
  - **USD:** The USD will also benefit less than in the past from the start of the tightening cycle in the US in 3Q10, as markets will bet that the other G-10 central banks will follow soon, while US debt woes will be a drag.
  - **EUR:** Greece woes remain a source of volatility in the near-term but not enough to prompt a break below 1.40. A steady Fed for now, firmer stock markets and gradually deflating EMU worries should bring back EUR-USD above 1.50 in 1H10. The Fed rate hike cycle in 3Q10 will push EUR-USD just back to 1.48-1.45.
  - **JPY:** The JPY will return the world's favored funding unit, as Japan has reentered a deflationary spiral and the newly-appointed Japanese MoF Kan has already called for a weaker JPY. USD-JPY should break above 95 and EUR-JPY should recover back above 140. Carry trade strategies will return attractive as well.
  - **GBP:** In the near term, sterling may benefit only from a weaker USD, as Dubai’s woes are still looming, as well as worries about the UK public deficit and risks over the UK sovereign debt and its AAA rating. On the other hand, as long as EUR-USD and cable manage to follow a common trend, we still rule out a EUR-GBP spike towards or even above parity.
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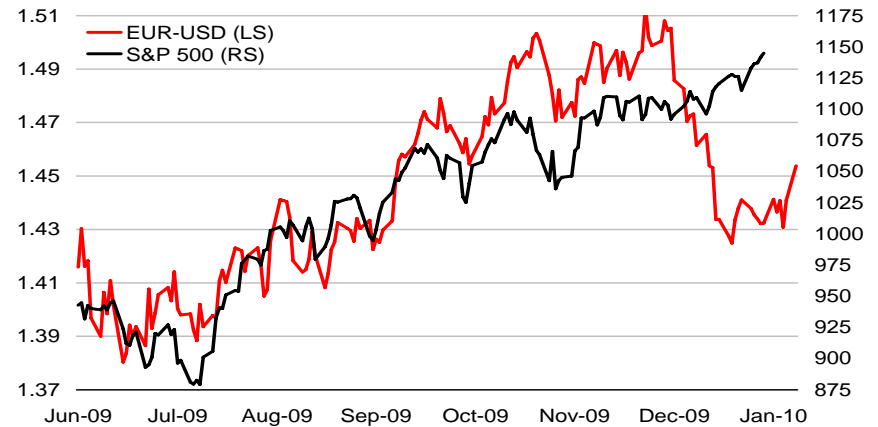
# EUR-USD: Surviving the Greek “hubris”

Easing Greece woes essential for a firmer EUR-USD...



Source: Bloomberg, UniCredit Research

...as well as a healthier US stock markets

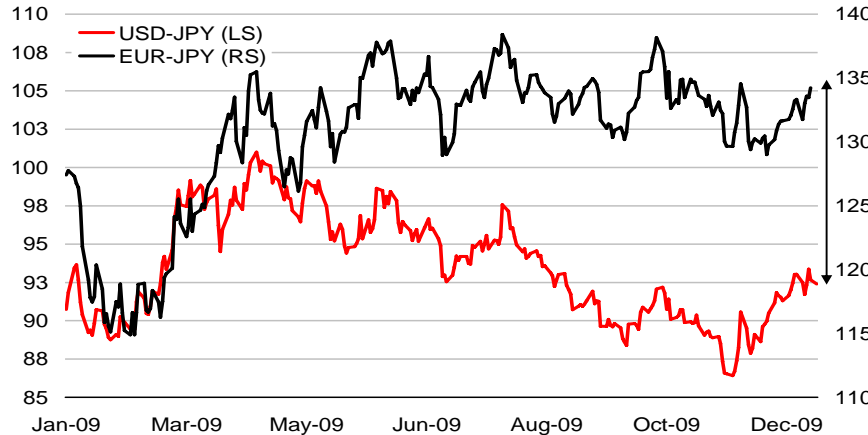


Source: Bloomberg, UniCredit Research

- Greece’s problems hurt the euro, but not enough to break the key 1.40 threshold.
- Easing Greece’s concerns is an essential prerequisite for more EUR strength to come, but the 25D 3M Risk Reversal has already signaled that selling pressures are receding.
- As the Fed has made it clear that the start of a tightening cycle won’t materialize soon (especially after the poor US Employment Report for December) expect USD to return on the offer side during 1H10.
- Restoring the “perverse” positive correlation with Wall Street as risk appetite improves should help bringing back EUR-USD to and above 1.50 during 1H10.
- The start of a tightening cycle in 3Q10 should limit the EUR-USD rally, but still concerns over the rocketing US debt should limit any downside potential to the 1.48-1.45 area.

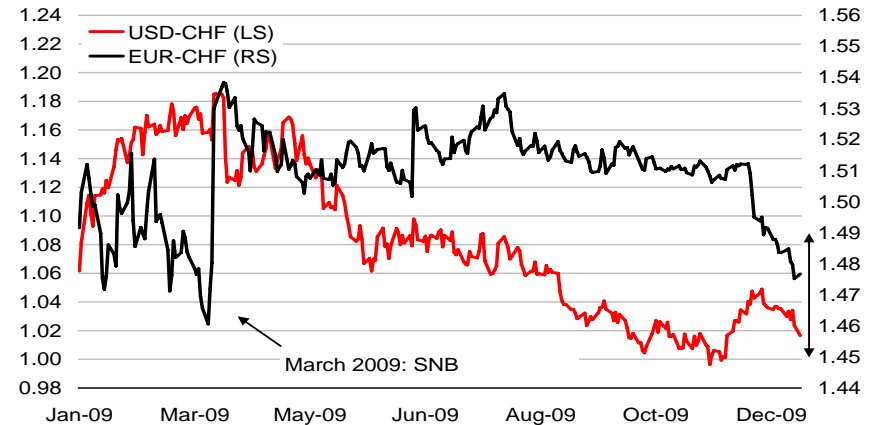
# The JPY & the CHF: Much weaker in the medium term

**USD-JPY & EUR-JPY: heading further higher**



Source: Bloomberg, UniCredit Research

**EUR-CHF: Risks of SNB intervention have increased**

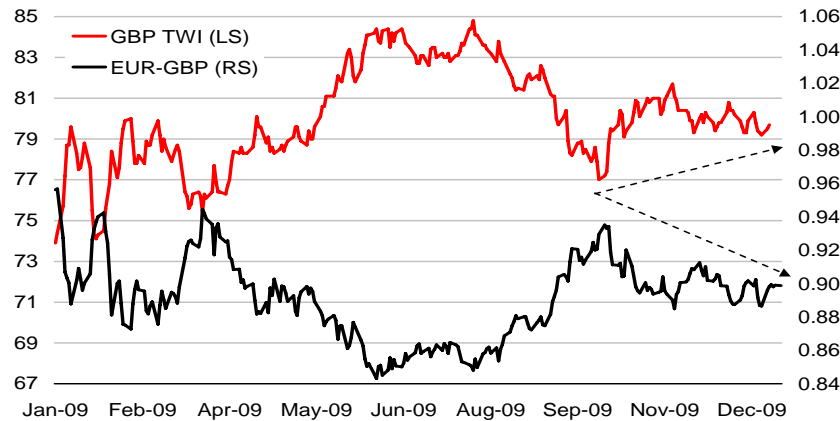


Source: Bloomberg, UniCredit Research

- The JPY will likely return the world's favored funding currency, considering that Japan has reentered a deflationary spiral, the newly-appointed Japanese MoF Kan has already called for a more competitive unit and the BoJ will likely be the last central bank within the G10 to start a tightening cycle over time.
- We recommend staying JPY short across the board: USD-JPY should break above the 95 level, MoF's Kan has hoped for, and move towards 100, while EUR-JPY should recover back above 140. Carry trades against the JPY, primarily involving the Aussie and the Kiwi dollar, should also return to attract investors' interest.
- The SNB has already started to talk the Swiss franc down, as EUR-CHF is getting closer to the 1.47 area that sparked intervention last March. We expect the SNB to intervene again and favor betting on a sharp EUR-CHF rebound well above 1.50 over time. Buying EUR-CHF 9m OTM calls should be favored also by current low implied volatility levels.

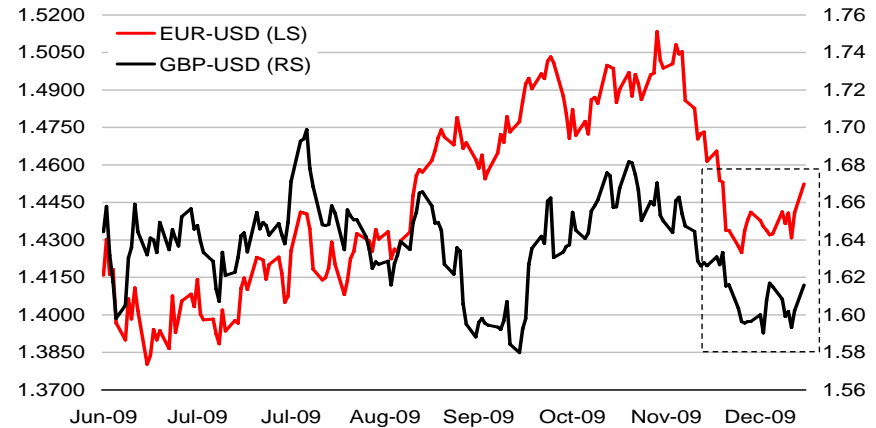
# GBP: Still room for a firmer sterling in the medium term

EUR-GBP still sensitive to UK idiosyncratic risks



Source: Bloomberg, UniCredit Research

But EUR-USD & cable resumed a common trend

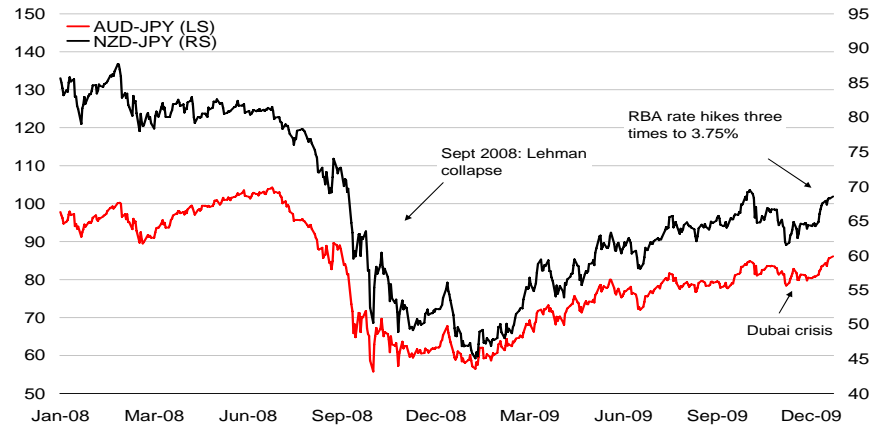


Source: Bloomberg, UniCredit Research

- Key idiosyncratic risks are still weighing on sterling, as Dubai's woes are still looming, as well as worries about the UK public deficit and concerns over the UK sovereign debt and its AAA rating.
- Indeed, investors will not stay heavily cable short in a new weak USD scenario. Rising risk appetite should back cable, once the 1.62-1.63 area has gone. UK General Elections, whoever wins, should have no impact.
- The Fed tightening cycle should not hurt cable much either, as the BoE should also start hiking rates in 4Q-10 with a 50bp move. We thus favor buying cable OTM calls at 1.65 with at least a 6M maturity.
- On the other hand, as we expect EUR-USD and cable manage to follow a common trend, we still rule out a EUR-GBP spike towards or even above parity. Moreover, the earlier BoE rate hike, compared to the ECB seen on hold at 1% for the entire 2010, should allow a EUR-GBP pullback below 0.85 by the end of 2010.

# The other G-10 Currencies: the “three dollars” & Nordics

## Carry trades are back!



Source: Bloomberg, UniCredit Research

## Nordics: buying a further stairway to heaven



Source: Bloomberg, UniCredit Research

- Factors supporting the Aussie, the Kiwi and the Loonie dollar are intact, as they include higher commodity prices, rising risk appetite and prospects of more rate hikes at home over time. The JPY weakness may also favor a resumption of carry-trade strategies over time.
- We thus recommend buying both AUD-USD and NZD-USD on dips below 0.92 and 0.73, respectively, and also considering long positions on AUD-JPY and NZD-JPY above 86 and 69, respectively.
- At this stage, we also see little reason why the two Nordic units may reverse their trend, unless of course risk aversion abruptly resurfaces again. In a sense, the NOK should prove to be more favored than the SEK due to more evident prospects of further rate hikes at home.
- We recommend using options to ride a further rally of these two units and investors should consider bear spreads on a 6M horizon, between 10.10-9.75 on EUR-SEK and between 8.10-7.90 on EUR-NOK.

## Macroeconomic forecasts

GROSS DOMESTIC PRODUCT						
	2006	2007	2008	2009	2010	2011
UNITED STATES	2.7	2.1	0.4	-2.5	2.3	2.0
JAPAN	2.0	2.3	-0.7	-5.2	1.5	1.0
EUROZONE	3.1	2.7	0.6	-3.9	0.9	1.3
GERMANY	3.4	2.6	1.0	-4.8	2.0	1.2
ITALY	2.1	1.5	-1.0	-4.8	0.5	1.0
FRANCE	2.4	2.3	0.3	-2.3	1.4	1.6
SPAIN	4.0	3.6	0.9	-3.6	-0.7	0.8
AUSTRIA	3.5	3.5	2.0	-3.8	1.3	1.4
SWEDEN	4.5	2.7	-0.5	-4.4	1.1	1.9
NORWAY (mainland)	4.5	5.5	2.1	-1.2	2.0	2.5
UNITED KINGDOM	2.9	2.6	0.6	-4.6	1.3	2.3
SWITZERLAND	3.6	3.6	1.8	-1.2	1.4	1.2

% yoy

CONSUMER PRICE INDEX						
	2006	2007	2008	2009	2010	2011
UNITED STATES	3.2	2.9	3.8	-0.3	2.2	2.2
UNITED STATES (Core CPI)	2.5	2.3	2.3	1.7	0.9	1.2
JAPAN	0.3	0.0	1.4	-1.5	-1.0	0.0
EUROZONE	2.2	2.1	3.3	0.3	1.3	1.8
GERMANY	1.6	2.3	2.6	0.3	0.9	1.5
ITALY	2.1	1.8	3.3	0.8	1.5	1.9
FRANCE	1.7	1.5	2.8	0.1	1.1	1.5
SPAIN	3.5	2.8	4.1	-0.2	1.4	2.1
AUSTRIA	1.5	2.2	3.2	0.5	1.2	2.0
SWEDEN	1.4	2.2	3.5	-0.2	0.6	2.2
NORWAY	2.3	0.7	3.8	2.2	2.3	2.5
UNITED KINGDOM	2.3	2.3	3.6	2.0	1.9	2.0
SWITZERLAND	1.1	0.7	2.4	-0.5	1.1	1.0

% yoy

# FI / FX forecasts

Euro land						US					
	current	Mar-10	Jun-10	Sep-10	Dec-10		current	Mar-10	Jun-10	Sep-10	Dec-10
<b>Key rate</b>	1.00	1.00	1.00	1.00	1.00	<b>Key rate</b>	0.25	0.25	0.25	0.75	1.25
<b>3M</b>	0.69	0.80	0.90	1.10	1.30	<b>3M</b>	0.25	0.50	0.85	1.15	1.65
<b>2Y</b>	1.25	1.45	2.10	2.45	2.75	<b>2Y</b>	0.98	1.25	2.25	2.70	3.10
<b>5Y</b>	2.41	2.58	3.15	3.38	3.55	<b>5Y</b>	2.60	2.65	3.50	3.83	4.08
<b>10Y</b>	3.40	3.50	3.90	4.00	4.10	<b>10Y</b>	3.84	3.75	4.35	4.55	4.75
<b>30Y</b>	4.13	4.20	4.50	4.55	4.60	<b>30Y</b>	4.73	4.50	5.15	5.25	5.35
<b>2/10</b>	215	205	180	155	135	<b>2/10</b>	286	250	210	185	165
<b>2/5/10</b>	8	10	15	15	13	<b>2/5/10</b>	19	15	20	20	15
<b>2Y SwSp</b>	54	30	30	25	25	<b>2Y SwSp</b>	28	20	20	10	5
<b>10Y SwSp</b>	15	20	15	10	10	<b>10Y SwSp</b>	11	10	10	0	-5

UK						SZ					
	current	Mar-10	Jun-10	Sep-10	Dec-10		current	Mar-10	Jun-10	Sep-10	Dec-10
<b>Key rate</b>	0.50	0.50	0.50	0.50	1.00	<b>Key rate</b>	0.25	0.25	0.25	0.50	0.75
<b>3M</b>	0.61	0.80	0.90	0.95	1.40	<b>3M</b>	0.25	0.40	0.50	0.70	0.90
<b>2Y</b>	1.28	1.40	1.80	2.30	2.60	<b>2Y</b>	0.36	0.60	1.15	1.60	1.95
<b>5Y</b>	2.88	2.93	3.38	3.73	3.95	<b>5Y</b>	1.03	1.55	2.00	2.40	2.70
<b>10Y</b>	4.08	4.15	4.60	4.80	5.00	<b>10Y</b>	2.01	2.40	2.75	3.15	3.40
<b>30Y</b>	4.51	4.75	5.00	5.15	5.40	<b>30Y</b>	2.41	2.85	3.10	3.40	3.55
<b>2/10</b>	280	275	280	250	240	<b>2/10</b>	165	180	160	155	145
<b>2/5/10</b>	20	15	18	18	15	<b>2/5/10</b>	-15	5	5	2	2
<b>10Y SwSp</b>	2	3	-5	-5	-10	<b>10Y SwSp</b>	50	45	45	40	40

vs. EUR	current	Mar-10	Jun-10	Sep-10	Dec-10	vs. USD	current	Mar-10	Jun-10	Sep-10	Dec-10
<b>EUR-USD</b>	1.452	1.550	1.570	1.520	1.480	<b>EUR-USD</b>	1.452	1.550	1.570	1.520	1.480
<b>EUR-JPY</b>	134.0	142.6	146.0	147.4	148.0	<b>USD-JPY</b>	92.3	92.0	93.0	97.0	100.0
<b>EUR-GBP</b>	0.90	0.88	0.86	0.84	0.82	<b>GBP-USD</b>	1.61	1.77	1.83	1.81	1.80
<b>EUR-SEK</b>	10.21	9.80	9.60	9.50	9.40	<b>USD-SEK</b>	7.03	6.32	6.11	6.25	6.35
<b>EUR-NOK</b>	8.16	8.20	8.15	8.10	8.00	<b>USD-NOK</b>	5.62	5.29	5.19	5.33	5.41

Source: UniCredit Research

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