

# Monthly Outlook

1 May 2009

*Rabobank International*

Financial Markets Research

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# United States

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## Fed only changes its tune

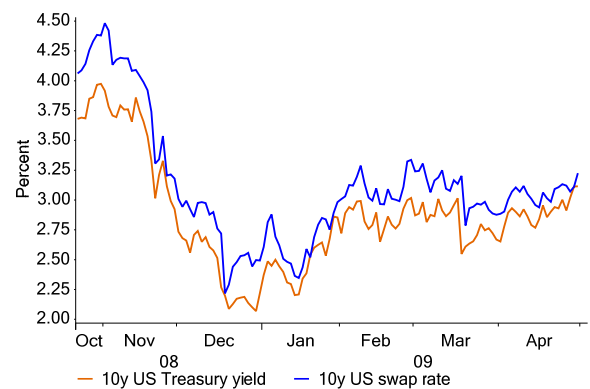
The US economy has contracted severely in 2008Q4 and 2009Q1. However, recent macro-economic indicators suggest that the contraction of the US economy has slowed down since the extremely poor readings for January. If the economic stimulus package, the Financial Stability Plan and the Fed's credit easing strategy stabilize the economy, we expect a modest recovery of the US economy in 2010. On 29 April, the FOMC decided to keep the targets for purchases of agency debt, agency MBS and longer-term Treasuries unchanged. The target zone for the fed funds rate has remained unchanged as well. The Fed's assessment of the economy was slightly more however: "the economy has continued to contract, though the pace of contraction appears to be somewhat slower." And: "although the economic outlook has improved modestly since the March meeting, ..., economic activity is likely to remain weak for a time." As markets have doubted that the purchases of \$300bn of longer-term Treasuries are sufficient to contain upward pressure on Treasury yields until September (and also because of the more optimistic tune of the Fed on the economy), the decision to keep the target for purchases of longer-term Treasuries unchanged led to a jump in the 10y Treasury yield from 3.02% to 3.12% after the release of the FOMC statement. Meanwhile the 10y USD swap rate jumped from 3.14% to 3.24%.

## Not enough stress in stress tests

While markets are looking forward to the publication of the results of stress tests that the Fed and other supervisors are conducting on banks, the economic scenarios used in the stress tests may not be as stressful as one would expect. Two scenarios are considered. The baseline scenario is based on an average of Consensus Forecasts, the Blue Chip survey and the Survey of Professional Forecasts in February. The more stressful scenario, called the 'alternative more adverse' scenario takes into account downside risk to the baseline scenario. However, between February and April, economic projections have been revised downward. For example, take Consensus Forecasts. The average GDP forecasts for 2009 and 2010 stood at -2.1% and 2.0% in February, but the April average published last week stands at -2.7% and 1.8%. The same story for unemployment. In February, the forecasts for 2009 and 2010 were 8.4% and 9.0%, but in April these figures are 9.0% and 9.6%. This means that the baseline scenario in the stress tests is more optimistic than the current consensus. In fact, the current consensus is closing in on the 'alternative more adverse' scenario. For example, in this scenario unemployment would average 8.9% in 2009, while the April consensus has already risen to 9.0%. All in all, there does not seem to be enough stress in the stress tests.

For more details, see: Philip Marey, *Not enough stress in stress tests*, Financial Markets Research Special, Rabobank International, 23 April 2009.

Chart 1: US capital market rates



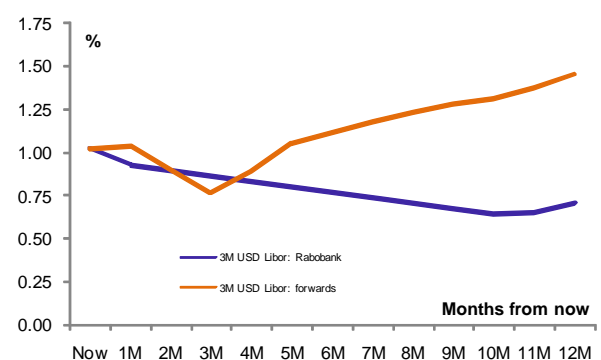
Source: Reuters EcoWin, Rabobank International

Table 1: Economic forecast

	Yearly ("in")			Quarterly (ar)			
	2007	2008	2009	Q4/08	Q1/09	Q2/09	Q3/09
<b>GDP</b>	2.2	1.1	-2.4	-6.3	-6.1	-1.7	-0.5
<b>Consumption</b>	2.9	0.2	-1.6	-4.3	2.2	0.0	0.2
<b>Business inv.</b>	4.8	1.7	-11.3	-21.7	-37.9	-24.0	-20.0
<b>Residential inv.</b>	-16.9	-20.7	-16.8	-22.8	-38.0	-27.0	-15.0
<b>Government</b>	2.1	2.9	3.6	1.3	-3.9	4.0	4.5
<b>Trade</b>	0.7	1.4	-0.3	-0.2	2.0	0.0	0.2
<b>Inventories</b>	-0.3	-0.2	0.1	-0.1	-2.8	1.0	0.8
<b>CPI (%y-o-y)</b>	2.9	3.8	-0.4				
<b>Unemp. %rate</b>	4.6	5.9	9.5				

Source: Rabobank International

Chart 2: Money market outlook



Source: Reuters, Rabobank International

# Eurozone

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## Will the 'green shoots' stand the heat?

When we wrote our last Monthly Outlook, there was barely any sign of a let-up in the sharp economic slowdown. That, at least, appears to have changed in the past couple of weeks. A string of macroeconomic indicators, among which purchasing managers' indices, suggest that the economy has shifted to a lower rate of contraction. But the big question is whether these 'green shoots' of recovery will be able to stand the harsh conditions that are still present outside. Our main concern is that while the pace of contraction may be slowing, several adverse feedback mechanisms continue to linger. The basic idea here is that severely weakened companies will only survive if demand returns to higher levels. As long as this condition isn't met, defaults will continue to rise. Besides, the problem of toxic assets has not been sufficiently dealt with and, as a result, deleveraging pressures are continuing. Therefore we remain wary of concluding that we have reached a true inflection point. As the IMF aptly put it in its latest Global Financial Stability Report: "Without a thorough cleansing of banks' balance sheets of impaired assets, accompanied by restructuring and, where needed, recapitalization, risks remain that banks' problems will continue to exert downward pressure on economic activity."

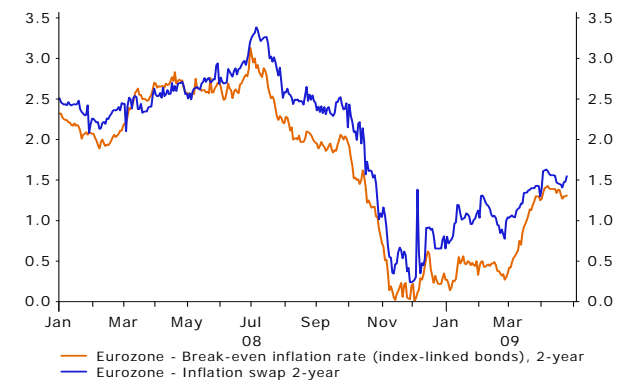
## Is the market overreacting to inflation worries?

Since their collapse in H2 2008, market-based inflation expectations have been steadily rising, with investors becoming increasingly worried that measures implemented by governments and central banks could fuel inflation further down the road. For the moment, however, the short-term downward trend in inflation persists and we actually think the market has been too aggressive in its reaction. Our forecasts for inflation (0.5% in 2009, 0.8% in 2010) remain significantly below those of the market, even when we assume a conservative inflation risk premium. Moreover, a huge output gap has opened up and we don't see it closing any time soon. This suggests that medium term deflation risks remain ubiquitous. Recent core inflation figures indicate that the weak economy is gradually starting to put downward pressure on underlying inflation. Excluding food, energy, alcohol and tobacco, eurozone inflation fell from 1.7% in February to 1.5% in March, its lowest level in nearly two and a half years. We see core inflation falling below 1% by the end of 2009.

## ECB planning next steps, but remains cautious

This may – eventually – alleviate fears among some ECB Governing Council members that implementing quantitative or credit easing policies could harm its inflation-fighting credentials. Together with the belief that the eurozone requires a different approach than some Anglo-Saxon economies, this has held the ECB off from taking the same route as the Fed or the Bank of England. So far, the Governing Council has appeared strongly divided about what steps it should take next. At its May meeting the ECB is likely to cut its policy rate by another 25bp along with policy changes that will probably focus on a further easing in the supply of liquidity. More aggressive action, however, requires a significantly worse inflation backdrop, something we don't see materialising over the next couple of months.

Chart 1: 2-year inflation expectations EUR



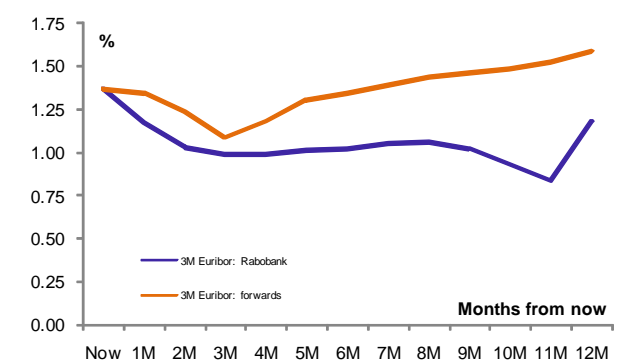
Source: Bloomberg data, Rabobank calculations

Table 1: Economic forecasts

	Yearly			Quarterly			
	2007	2008	2009	Q4/08	Q1/09	Q2/09	Q3/09
<b>GDP</b>	2.6	0.6	-3.9	-1.6	-2.0	-0.1	-0.8
<b>Consumption</b>	1.6	0.3	-1.8	-0.3	-0.8	-0.6	-0.4
<b>Investment</b>	4.3	-0.2	-11.6	-4.0	-5.0	-1.5	-3.5
<b>Government</b>	2.2	2.0	2.3	0.3	0.8	0.5	0.5
<b>Trade</b>	0.3	0.0	-0.2	-1.0	0.3	0.6	0.1
<b>Inventories</b>	0.0	0.1	-0.5	0.4	-0.8	-0.2	-0.1
<b>CPI (%y-o-y)</b>	2.1	3.3	0.5				
<b>Unemp. %rate</b>	7.4	7.6	9.4				

Source: Rabobank International

Chart 2: Money market outlook



Source: Reuters, Rabobank International

# Japan

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## Trading hope

### Writing off 1Q09

Preliminary 1Q09 GDP figures aren't due until mid-May, but it's already becoming clear from the monthly data we are facing a second consecutive quarter in which the economy shrank substantially. Going by the ongoing plunge in exports during January-February, net trade will once again be a big drag on economic growth. We are bracing for a quarter-on-quarter decline in GDP of as much as -3.0%. We have lowered our 2009 GDP forecast to a miserable -4.5% from -3.3% originally, but downside risks continue to loom large.

### Glimmers of hope in trade data

March trade data saw the free fall in exports finally arrested. The moderate rebound wasn't enough to undo the damage done to 1Q09 GDP in January-February, but opens up the prospect of a rebound in 2Q09. Given the extremely sharp correction in exports over the past two quarters, such a rebound is likely to give a substantial boost to 2Q09 GDP, even as it should be seen in the right context.

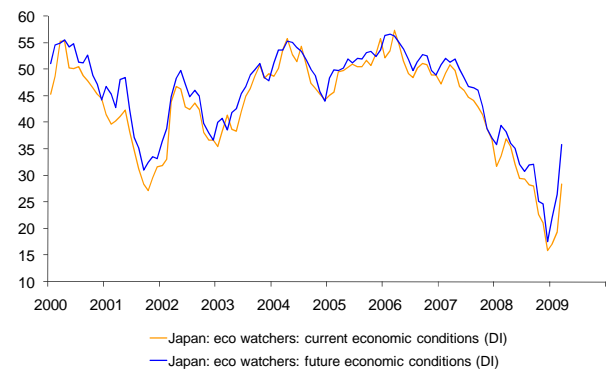
### Second fiscal stimulus package

Prime Minister Aso is on a dual mission to arrest the free fall in economic activity and lift his approval rating ahead of this year's elections. The price is a hefty stimulus package, for which the government pledged a record ¥13.9 trillion (US\$143 billion) in extra funding this fiscal year. The MoF's released a proposal to issue ¥10.8 trillion yen in new bonds to finance the majority of this additional budget, which would bring new bond sales to ¥44.1 trillion. The remaining ¥3.1 trillion yen will be financed from the so-called special accounts – funds set aside from the regular national budget. All of this amounts to a substantial fiscal stimulus being delivered, but obviously we are talking about cushioning the symptoms rather than the root causes of this severe recession. Unfortunately for Japan addressing the root causes is hardly an easy affair. A lack of domestic dynamics has left Japan far too dependent on exports. A good effort at export diversification has been rendered ineffective by an increased integration in global trade. There simply is no shelter for Japan from a synchronized severe global recession.

### No such thing as a free lunch

The case for fiscal stimulus may be clear, but Japan's fiscal position reads like a horror story. The nation's annual budget is set to increase to ¥102.5 trillion. Generating tax revenues continues to be at the heart of the problem. The ratio of tax revenue to annual spending is hitting a low of 45% this fiscal year, while the OECD expects the debt burden to surge to 197% of GDP. The latter estimate didn't yet include the impact of the latest stimulus package. Finance Minister Yosano recently admitted reaching the Koizumi goal of a balanced budget by 2012 would be impossible. A new target date hasn't been decided on yet.

Chart 1: Turning the corner?



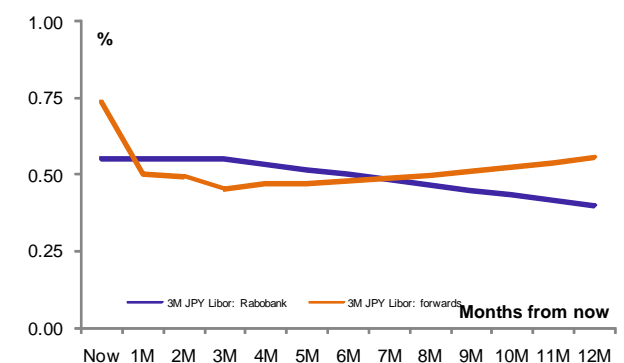
Source: CEIC Data, Rabobank International

Table 1: Economic forecasts

	Yearly			Quarterly			
	2007	2008	2009	Q1/09	Q2/09	Q3/09	Q4/09
<b>GDP</b>	2.4	-0.6	-4.5	-3.0	1.0	0.8	0.7
<b>Consumption</b>	0.7	0.5	-0.8	-0.8	0.2	0.3	0.3
<b>Investment</b>	1.2	-4.7	-5.7	-2.4	-0.4	0.9	0.7
<b>Government</b>	2.0	0.9	3.6	1.0	1.5	1.0	1.0
<b>Trade</b>	1.1	0.2	-3.0	-1.8	0.8	0.3	0.2
<b>Inventories</b>	0.3	-0.1	-0.2	-0.4	-0.2	-0.1	0.0
<b>CPI (%y-o-y)</b>	0.1	1.4	-1.0				
<b>Unemp. %rate</b>	3.9	4.0	5.0				

Source: Rabobank International

Chart 2: Money market outlook



Source: Reuters, Rabobank International

# United Kingdom

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## Doom, debt and depression

The most recent UK economic news flow cannot be described as underling much in the way of recovery prospects, this as the first estimate of Q1 GDP revealed the fastest contraction since 1979, unemployment registered a 10 year high, while RPI fell into negative territory for the first time in almost 50 years. Moreover, against such weak activity the budget deficit is forecast by the government to register 12.4% of GDP this year with only a modest improvement forecast over the medium term even when predicated on somewhat rather over optimistic medium term growth expectations, 3.5% growth in 2011 for example. Indeed for international investors in addition to lacklustre economic backdrop there is also the factor of a record level of gilt issuance in the current year, £220bn, with risks that the final numbers could prove to be higher to consider. Thus the combination of weak growth and rising indebtedness remains a source of concern.

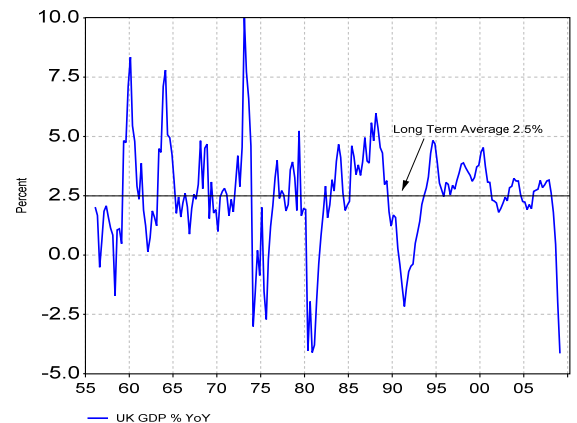
## Broad based deceleration

While there was some surprise in the scale of the initial contraction of Q1 GDP, -1.9%, estimates centred around -1.5%, following -1.6% in Q4, it was also the broad based nature of the initial estimates of contraction that proved to concern. Thus we witnessed industrial output decline by 5.5%, led by manufacturing down 6.2%, construction fell another 1.2% as service sector activity also fell 1.2%. While we are seeing a determination to run down inventories it would seem that when set against weak consumption it suggests there is not likely to be any immediate appetite for renewed industrial output. Thus having seen Q1 activity fall aggressively, although the data is subject to revision, our previous estimate of a contraction of 3.5% in the calendar year is already outdated and as such we have been forced once again to upscale the current downturn, not least as the labour market is likely to capitulate well into 2010.

## Hopes for the future?

The combination of weak activity, record bond issuance and a spiralling fiscal imbalance is likely to continue to weigh on the minds of international investors, not least as estimates of economic activity continue to be lowered. However, while there have been some potential fears regarding a potential downgrade of the UK's AAA sovereign credit rating, at least for now such fears should not be overstated. However, while the UK's economic prospects remain unpromising it remains the case that the UK is likely to perform better than either the eurozone or Japan. Thus we would argue that while we have seen RPI move into negative territory outright deflation fears should not be overplayed, even though CPI is likely to decline to near zero during Q3. Moreover while we are set to continue to see labour market weakness prove to constrain consumer confidence and ultimately spending, boosting precautionary saving, we anticipate that the competitive value of Sterling alongside the aggressive paring in UK interest rates and the likely result of the quantitative easing, initially amounting to £75bn, should together prove to ease economic downside risks in into year end. Thus we anticipate positive growth to set in early into 2010, likely in advance of many of the other major economies, perhaps excluding the US.

Chart 1: Growth capitulation



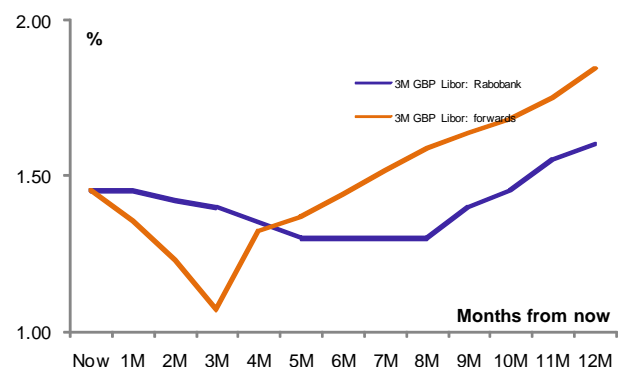
Source: Reuters EcoWin

Table 1: Economic forecasts

	Yearly			Quarterly			
	2007	2008	2009	Q1/09	Q2/09	Q3/09	Q4/09
<b>GDP</b>	2.9	0.7	-3.8	-1.9	-0.5	-0.2	-0.1
<b>Consumption</b>	3.0	1.4	-3.0	-1.3	-0.7	-0.5	0.1
<b>Investment</b>	7.3	-3.0	-11.7	-6.5	-2.5	-1.5	-1.6
<b>Government</b>	1.7	3.4	2.4	0.3	0.3	0.4	0.2
<b>Trade</b>	-0.6	0.6	-0.7	-0.4	0.0	0.0	-0.2
<b>Inventories</b>	0.3	-2.1	1.7	-0.9	-0.5	-0.2	0.1
<b>CPI (%y-o-y)</b>	2.3	3.6	0.9				
<b>Unemp. %rate</b>	5.4	5.6	9.5				

Source: Rabobank International

Chart 2: Money market outlook



Source: Reuters, Rabobank International

# The Netherlands

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## Economic recovery is still a long way off

Whilst people everywhere in the world are looking out for the first 'green shoots' of recovery, the worst for the Dutch economy is yet to come in more ways than one. The economy hit rock bottom in the first quarter of 2009 with an expected growth rate of -1.8%. We expect GDP to fall by a total of 4% in 2009.

### Unemployment on the rise

Whilst the unemployment rate reached a low of 3.8% six months earlier, the period January-March 2009 was the first in three years to see a rise in the unemployment rate relative to the same period a year before. In the first three-month period of 2009, an average of 4.1% of the total Dutch labour force was without a job. With economic growth reaching a low in 2009, the unemployment rate is set to increase further in 2009 and 2010 to almost 9% by the end of next year, up from more than 6% at this year-end. Only then will consumers feel the full extent of the economic crisis, causing consumption to fall by an estimated 2.2% in 2010.

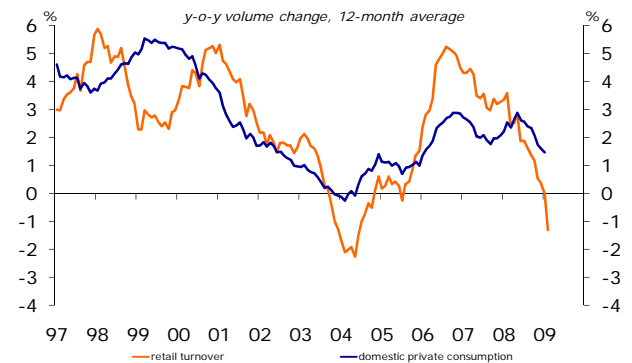
### Retail sales confirm downward path

The consumer was the last 'man' standing, with exports and production already plunging. We expect private consumption to decrease only slightly this year, thanks to government measures, high wage growth and low inflation. But it is not nearly enough to save economic growth, witness the fact that retail turnover was down by 4% in February relative to last year's figure. Consumers are finally beginning to walk their talk, as consumer confidence has been falling since the start of the financial crisis in the second half of 2007. However, consumer confidence picked up somewhat in April, to -28 from -34 the month before. The fall in manufacturing turnover was even steeper than that in retail sales, down 27% from a year before. Similarly, industrial production was down by 13% in February. A third of the decline in turnover is due to lower prices. Factory gate prices were nearly 10% lower in February than they were a year earlier. In June 2008 prices were still 12% higher than in June 2007, with price increases slowing down from then on. From November last year, prices have been falling. With sales and production plummeting, private investment is bound to follow on the downward path and could collapse by as much as 14.5% this year and another 7.1% the next.

### Number of bankruptcies continues to rise

In the last four months, the number of bankruptcies skyrocketed. In February, the number was almost double that of a year before and stood at 540 (against a total number of businesses of 797,840 in January 2008). The three-month moving average of 447 in February is the highest since mid-2003. May 2008 saw the lowest level in seven years. We expect the upward trend to continue both this year and the next.

Chart 1: Retail sales down substantially



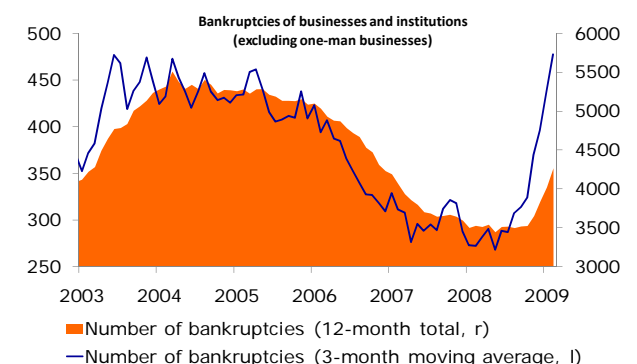
Source: Statistics Netherlands

Table 1: Economic forecasts

	Yearly			Quarterly			
	2008	2009	2010	Q1/09	Q2/09	Q3/09	Q4/09
<b>GDP</b>	2.0	-4.0	-1.0	-1.8	-1.3	-0.7	-0.3
<b>Consumption</b>							
- private	1.7	-0.5	-2.2	-0.2	-0.6	0.0	-0.7
- government	1.2	2.0	1.0	0.5	0.5	0.5	0.5
<b>Investment</b>	6.6	-14.5	-7.1	-5.0	-5.9	-3.9	-4.0
<b>Trade</b>	-0.8	-1.4	0.9	-0.4	-0.2	-0.2	0.5
<b>Inventories</b>	0.5	-0.3	0.0	-0.1	-0.2	-0.3	-0.6
<b>CPI (%y-o-y)</b>	2.1	1.0	0.5				
<b>Unemp. %rate</b>	4.0	5.5	8.0				

Source: Statistics Netherlands, Rabobank

Chart 2: Bankruptcies skyrocketing



Source: Statistics Netherlands

# Poland

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## Just slowdown

The domestic economy has been bearing the burden of the economic crisis. The International Monetary Fund recently put out a pessimistic growth forecast for this year of -0.7%. In our opinion Poland will not avoid a deep slowdown, but we still see a good probability that GDP increases by 0,9%. Individual consumption will not decline that much, and throughout 2009 next exports should contribute positively to growth due to the weak zloty. What will register significant falls are investments as, in the opinion of enterprises, the economic outlook is ever so gloomy. Moreover, according to revised data the budget deficit reached 3.9% GDP in 2008 and this year a further increase is very likely. However, a positive stimulus for investors could come from the fact that Poland received USD 20.5bn in the form of a flexible credit line by the IMF, which in principle is granted to countries with strong fundamentals, policies, and track records of policy implementation. Actually even if adverse scenarios materialise, Poland should remain the leader of growth with the CEE region all the same. In our opinion the Monetary Policy Council may revert to the easing cycle once the zloty becomes significantly stronger and inflationary pressure visibly abates. By the end of Q2 we see the reference rate at 3.50% and further cuts cannot be excluded.

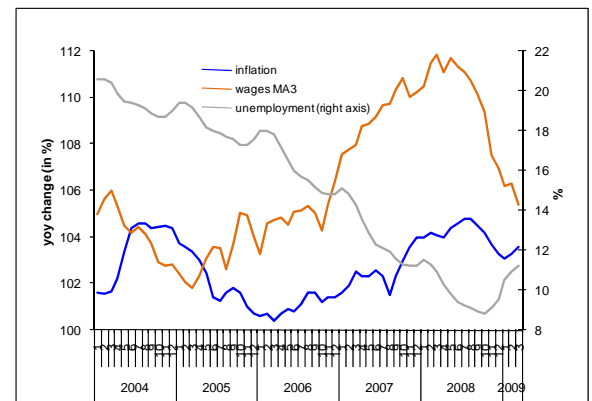
## Debt market under pressure from budget deficit.

After a stabilization in March and April, an improvement in global sentiment for emerging markets still seems to be the single factor able to pull down Polish bond yields. The interest rate cut cycle is supposed to end much earlier than was expected a few months ago, while the weakness of the zloty has created an additional threat in the form of a slower decrease in inflation. Adding factors such as a remote term of euro adoption and the rising budget deficit, demand for bonds is expected to stay low at least in May, while we also remain bearish for the remainder of 2009. Meanwhile the 10-2 yield spread is expected to approach 100bps as factors that should be favourable for the bond market typically influence the yields on short-term paper.

## The euro in the mist

During the second half of April the zloty suffered a strong depreciation, as sentiment towards the Polish currency among foreign investors collapsed. Expectations for ERM-2 entry in 2009 vanished, as Poland's budget deficit surpassed ERM-2 requirements. Nevertheless, the sharp appreciation seen until mid-April indicates that foreign investors consider the zloty as being undervalued, especially in comparison to other CEE currencies. The exchange rate is likely to remain under pressure from domestic economic woes, especially a deepening budgetary deficit. The international situation also remains unsupportive, as no real improvement in other CEE economies is believed to take place, preventing capital flows into the region. However, we do not expect the EUR/PLN rate to top levels seen in February (4.90). A broader and long-lasting recovery of the zloty still seems unlikely before the second half of the year, however.

Chart 1: Inflation, wages in enterprise sector and unemployment



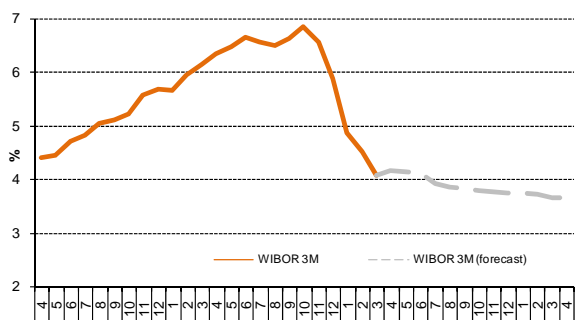
Source: Reuters, BGZ

Table 1: Economic forecasts

	Yearly			Quarterly			
	2007	2008	2009	Q1/09	Q2/09	Q3/09	Q4/09
<b>GDP</b>	6.7	4.8	0.9	1.1	0.4	0.8	1.3
<b>Consumption</b>	5.0	5.0	1.5	1.4	1.0	1.5	2.1
<b>Investment</b>	17.6	7.0	-3.2	-3.1	-6.1	-3.3	-0.4
<b>Government</b>							
<b>Trade</b>							
<b>Inventories</b>							
<b>CPI (%y-o-y)</b>	25	4.2	3.2	3.3	3.4	2.9	3.0
<b>Unemp. %rate</b>	11.2	9.5	12.6	11.2	11.0	11.5	12.6

Source: BGZ

Chart 2: Money market outlook Poland



Source: Reuters, BGZ

# Hungary

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## New government planning fiscal austerity

Hungary's parliament endorsed G. Bajnai as prime minister. G. Bajnai won support from the main Socialist party and the smaller liberal Free Democrats and promised painful spending cuts, fiscal discipline and measures including tax cuts to lift Hungary's waning economic competitiveness. Planned spending cuts will total 400 bn HUF (1.76 bn USD) this year and 900 bn HUF (3.97 bn USD) next year by eliminating an extra month's worth of public sector wages and pensions, freezing public sector pay and reducing some social spending, including sick leave and child benefits. The government also plans to reduce energy, public transport and home buying subsidies. G. Bajnai also announced tax changes including lifting the VAT rate to 25% from 20% this year, cutting payroll taxes by 5 pp. and slightly lowering personal income taxes. The National Bank of Hungary left its policy rate unchanged at 9.50% in April and it was the only proposal at the meeting. The governor A. Simor warned that tough fiscal measures proposed by the new Prime Minister will have a negative impact on the economy's performance, but only temporarily. The fall in corporate and household lending will also have a negative effect on GDP. The government projects the economy will contract 5.5%-6% this year. The central bank expects inflation to be around the 3% medium-term target. A. Simor noticed, however, that proposed changes in the tax system, most notably a value-added tax hike, will push inflation above the target temporarily.

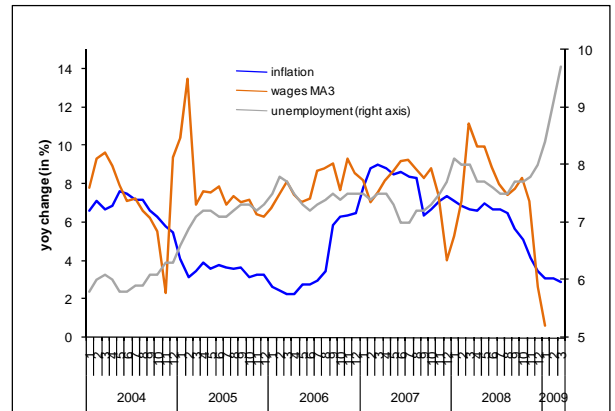
## Bonds set to follow global sentiment

Following a rally in March and stabilization in early April bonds are expected to perform bearish until the end of May. Current yield levels are admittedly attractive, but the risk of the swollen country's public deficit may successfully discourage investors. The entire yield curve is however supposed to continue steepening as more interest rate cuts are quite likely in the coming months and long-term papers would be weakened by the volatile forint and the accompanying risk of inflation. After the previous government of F. Gyurcsany collapsed, there is also some risk that the IMF would negatively revise the country's bailout plan at its meeting in May. Such a pessimistic scenario is in our view less likely, but it may affect demand for bonds negatively in coming weeks.

## No support in economy

The political situation has improved significantly since the appointment of the a new Prime Minister. But ongoing low public support for the PM indicates that political turmoil in Hungary may yet explode again. Apart from easing political tension, the forint also benefited from a sharp improvement of sentiment in global markets in April. However, the crisis in the domestic economy is far from over, as Hungary is on the brink of sliding into a severe recession this year. Moreover, despite concerns about the stability of the forint, the HNB will be forced to continue monetary policy easing in coming months, as the economy contracts. Therefore, the forint seems likely to continue to depreciate until the second half of 2009. We also expect the Hungarian currency to be one of the last in the region to benefit from an inflow of new capital.

Chart 1: Inflation, wages and unemployment



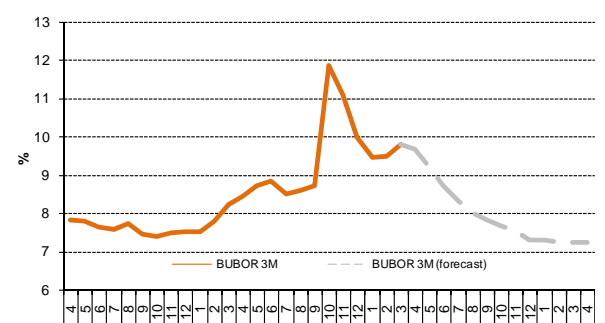
Source: Reuters, BGZ

Table 1: Economic forecasts

	Yearly			Quarterly			
	2007	2008	2009	Q1/09	Q2/09	Q3/09	Q4/09
<b>GDP</b>	1.4	0.6	-5.9	-6.2	-6.6	-5.8	-5.0
<b>Consumption</b>	-2.1	-1.4	-5.1	-2.2	-4.8	-6.0	-5.0
<b>Investment</b>	6.2	-2.6	-9.3	-10.5	-11.6	-8.6	-6.5
<b>Government</b>							
<b>Trade</b>							
<b>Inventories</b>							
<b>CPI (%/y-o-y)</b>	8.0	6.1	2.4	3.0	2.5	2.2	1.9
<b>Unemp. %/rate</b>	7.7	8.0	12.4	9.7	10.7	11.5	12.4

Source: BGZ

Chart 2: Money market outlook Hungary



Source: Reuters, BGZ

# Czech Republic

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## Still room for rate cuts

At the end of March the Czech Prime Minister M. Topolanek was defeated in a no-confidence vote. 101 members of the 200-member lower house of parliament voted against the Prime Minister. European Union foreign ministers on Friday backed M. Topolanek stewardship of the bloc's Czech presidency, despite the fall of his own government. Heads of the two most powerful Czech political parties have agreed to October being the date for early elections after the cabinet was toppled. Czech central bank board members voted unanimously at their last meeting to leave the headline interest rate unchanged at 1.75%, citing balanced inflation pressures and the uncertainty to predict future policy moves. Governor Z. Tuma said that it was hard for the bank to forecast the next step in monetary policy due to, among others, the very volatile koruna exchange rate. The next policy meeting is scheduled for May 7. Deputy Governor M. Hampl stressed that the Czech economy had suffered since faltering demand in the euro zone hit its export-reliant manufacturing sector, which is dominated by the auto and electronics industries. He added that there was still room for changes in rates.

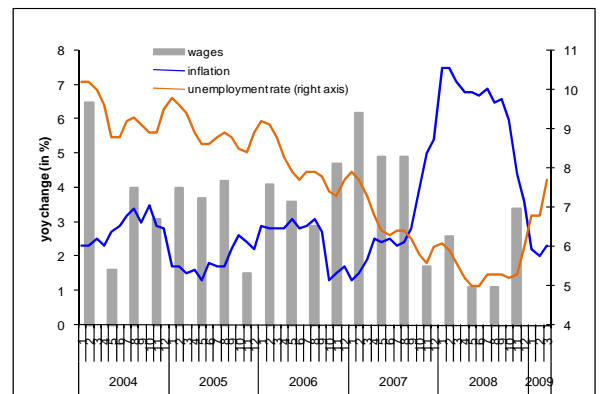
## Bonds likely to follow sentiment in core debt markets

The turbulence in domestic policy had little impact on bond market, which was tracking performance of German bunds. We believe the positive correlation between yields in Germany and Czech Rep. to be maintained in May, so our outlook on the bond market is bearish. Increment in yields on bonds would result from rising inflation expectations in the US economy and a possible improvement in risk appetite worldwide. Supportive for the Czech bond market, on the other hand, may be gradual decline in inflation and still likely interest rate cuts. Given the current shape of forward curve, this has already been discounted in prices, so overall our current outlook on Czech bonds remains bearish.

## Waiting for a recovery

The koruna remained stable in April after some volatile trading. Amid a sharp improvement in sentiment on global markets and an improvement in the domestic political situation, the currency failed to appreciate, as incoming real economy data hinted a severe degradation of domestic fundamentals. We expect sentiment for the Czech currency to remain mixed until the second half of 2009. Both local economic developments and a general CEE outlook are to remain a drag on the currency. Therefore, until the second half of the year the currency is likely to be affected by short-selling due to market liquidity. The Czech koruna is, however, expected to significantly benefit in case of a deeper recovery in global markets, as the credibility of local financial institutions is likely to play a major role in attracting foreign investors towards the country.

Chart 1: Inflation, wages and unemployment



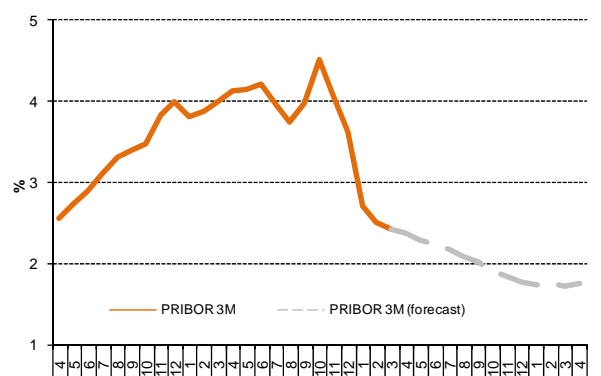
Source: Reuters, BGZ

Table 1: Economic forecasts

	Yearly			Quarterly			
	2007	2008	2009	Q1/09	Q2/09	Q3/09	Q4/09
<b>GDP</b>	6.5	3.1	-1.2	-1.7	-2.6	-0.8	0.4
<b>Consumption</b>	7.4	2.2	0.8	0.9	0.7	0.8	0.9
<b>Investment</b>	7.2	3.1	-2.7	-3.1	-5.4	-2.8	-0.2
<b>Government Trade</b>							
<b>Inventories</b>							
<b>CPI (%y-o-y)</b>	2.8	6.4	1.6	2.2	1.8	1.2	1.3
<b>Unemp. %rate</b>	6.0	6.0	10.5	7.7	9.0	9.7	10.5

Source: BGZ

Chart 2: Money market outlook Czech Rep.



Source: Reuters, BGZ

# Russia

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## Heading downwards

Preliminary data for January and February confirm previous draft estimates regarding Q1 GDP, which may even have reached -9% YoY. The Q2 number is expected to be even worse. Deputy Prime Minister A. Kudrin is thus convinced that this year the Russian economy will decline by much more than the official 2.2% forecast by the government. Such a severe recession will badly affect the federal budget, where the deficit may total 8% GDP this year and 10% GDP next year, following nine years of visible surpluses. The negative tendencies are also inevitable in the labour market and in the opinion of the President D. Medvediev 1 mn temporary jobs will be needed in order to help workers and small businesses to overcome the crisis. The federal government has declared it will spend RUB 76.9bn (USD 2.3bn) to support people who have lost their jobs in the wake of the crisis, out of which 60% has already been transferred to regional governments. In spite of strongly deteriorating fundamentals the ruble has recently ceased to depreciate. However, the banking system still needs huge sums of money and the state has decided to inject a further RUB 750bn (USD 22.3bn) to the banking system. There is a non-negligible threat that the funding will serve to finance capital flight instead of supporting economic growth or financial markets.

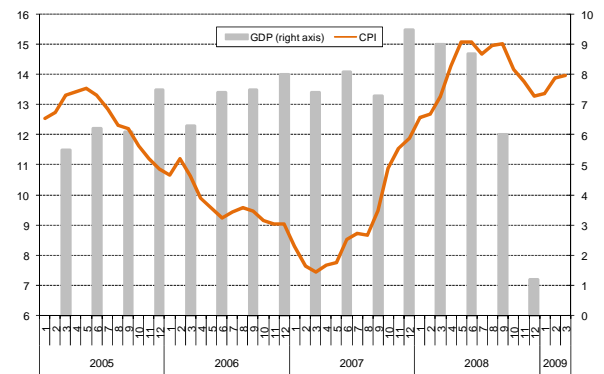
## Market still hurt by illiquidity.

The situation in Russian interest rate markets remains strained, as the financial sector continues to struggle with illiquidity. Admittedly, money market rates have stabilized, but yields on government bonds increased in March and the beginning of April. On the other hand, CDS rates on Russia have declined significantly over the recent few weeks giving some support for debt. Meanwhile what has also improved is the demand for corporate bonds. At the moment, however, we expect the money market rates to stay at high levels observed in the end of April, while yields may decline somewhat unless risk aversion renews sharply worldwide.

## Road to recovery

The ruble has stabilized and consecutively has followed a slow appreciating trend since February as global commodity prices, primarily oil, have risen. The Russian central bank also reported it was no longer losing FX reserves, which helped to rebuild the country's confidence. However, the relatively slow appreciation that we have seen lately is a reflection of the devastation that has been done to the domestic economy and the financial system. Market forecasts indicate a sharp contraction to be seen in the Russian economy in 2009. Nevertheless, the currency seems to have already survived the worst. We expect the ruble to experience a broader recovery over the second half of 2009, tracking developments in global commodity markets. Global monetary expansion is likely to attract speculative investments in commodities, particularly oil, amid rather suppressed demand. We therefore expect the ruble to surpass appreciation of other European currencies.

Chart 1: GDP and inflation



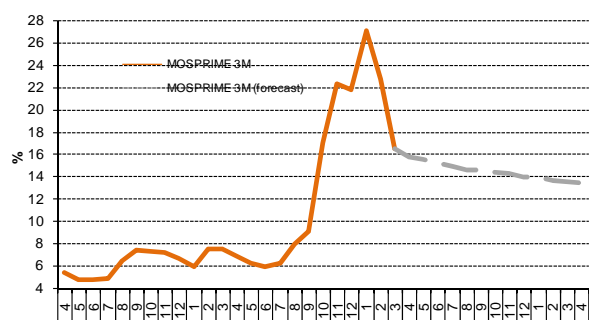
Source: Reuters EcoWin

Table 1: Economic forecasts

	Yearly			Quarterly			
	2007	2008	2009	Q4/08	Q1/09	Q2/09	Q3/09
<b>GDP</b>	8.1	5.6	-6.7	1.2	-9.1	-9.7	-5.2
<b>Consumption</b>							
<b>Investment</b>							
<b>Government</b>							
<b>Trade</b>							
<b>Inventories</b>							
<b>CPI (%y-o-y)</b>	9.1	14.1	12.1	13.8	13.8	13.1	11.2
<b>Unemp. %rate</b>							

Source: BGZ

Chart 2: Money market outlook Russia



Source: Reuters, BGZ

# China

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## Decoupling with "Chinese characteristics"

The decoupling theory has made a surprise come back. A slew of positive data released in April shows that China's export-led economy has apparently bottomed-out while the rest of the world economy is falling off the cliff. Upbeat analysts have already started pencilling in V-shaped graphs. But let's not get ahead of ourselves. Taking China's official statistics at face value (most notably during busts) can lead to wrong conclusions. We believe the true decoupling is between the economic reality in China and the statistics published by the authorities to please investors and citizens alike. The Goldman Sachs China Activity (GSCA) index, which is a useful proxy for China's economic activity, suggests that GDP growth was around half of the official figure for Q1-09 (6.1% yoy). However, even the GSCA could mask the true state of the economy as most of its components are data produced by the government.

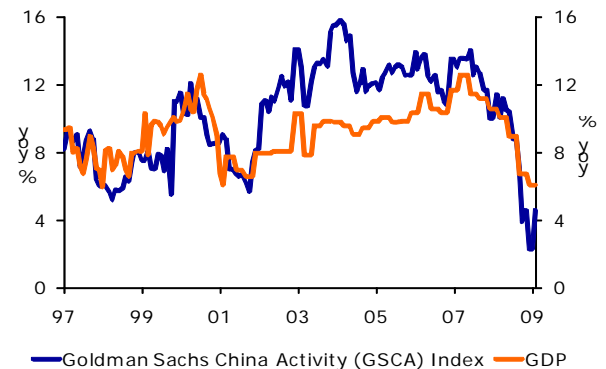
## Creative statistics

Firstly, let's look at the unexplainable surge in fixed asset investment (FAI) as reported by the government. Floor space started (similar to housing starts in the US) was down 17.6% yoy in March, compounding the 14.8% contraction in Jan-Feb. This would have undoubtedly hurt real estate investment, which accounts for a quarter of total FAI. Hence, we wonder how FAI has been so strong amid the massive housing correction in China, which has yet to run its course. Finally, financing FAI has become increasingly difficult. Bank lending rose 29.8% yoy in March, sharply up from 24.2% in February. However, domestic loans only financed 15.7% of total urban FAI in 2008. Self-raised funds (primarily through retained earnings) accounted for 62.2% of the total. As industrial profits dropped a whopping 37.3%, this must also have been a drag on China's FAI, the strength of which therefore remains a mystery. Industrial production also showed a robust recovery in March. This was quite an interesting development since industrial use of electricity – which is usually closely correlated to industrial production – actually fell 8.38% yoy in Q1-09. The China electricity council had no explanation for the discrepancy and stated that the issue required "further study". The mixed signals from the official purchasing managers' index (PMI) showing a strong improvement in March and the PMI released by CLSA showing the opposite is certainly not helpful either. Lastly, we could argue that the robust growth in retail sales amid the fall in consumer confidence to levels not seen since the SARS crisis in 2003 is questionable. A reason we can think of is that retail sales includes both government and corporate consumption as well.

## Going forward

We see clear upside risks to our official GDP growth forecast of 6.5% for 2009 due to the stronger-than-expected macro figures. Nevertheless, we still expect the true growth figure to be closer to 3.5% against a backdrop of tumbling global growth (see our Special Report 2009/03). Put differently, the slowdown in the pace of world economic contraction (in markets' jargon: "the second derivative") does not immediately suggest China is out of the woods. Falling domestic commodity prices and exports of the other Asian countries to China still point to further pain ahead.

Chart 1: China's economic activity



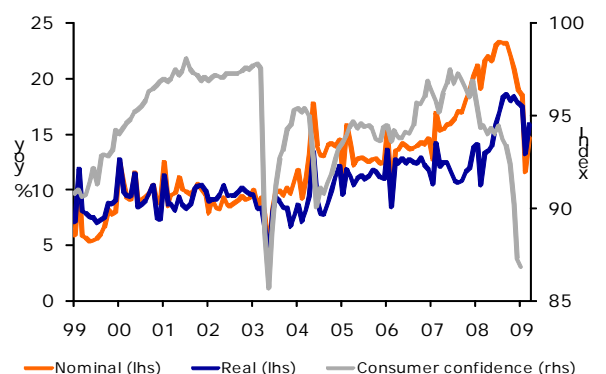
Source: Bloomberg, Goldman Sachs

Table 2: Economic data and forecasts

	Yearly			Monthly			
	2007	2008	2009	12/08	01/09	02/09	03/09
<b>GDP</b>	11.9	9.0	6.5	-	-	-	-
<b>Industrial production</b>	17.5	12.6	-	5.7	3.8	3.8	8.3
<b>Retail sales</b>	16.7	21.6	-	19.0	15.2	15.2	14.7
<b>Fixed asset invest.</b>	26.0	26.4	-	21.9	26.5	26.5	30.3
<b>Exports</b>	26.7	17.9	-	-2.8	-17.5	-25.7	-17.1
<b>Imports</b>	20.8	19.9	-	-21.3	-43.1	-24.1	-25.1
<b>CPI</b>	4.7	5.9	-	1.2	1.0	-1.6	-1.2
<b>M2</b>	17.5	16.7	-	17.8	18.8	20.5	25.5

Source: Reuters EcoWin, Rabobank International

Chart 2: Retail sales



Source: Bloomberg

# Foreign exchange

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## EUR USD: Still downside risks?

For the USD it could be argued that in the current environment that we could see EUR USD regain downside momentum on the basis of several provisos. It could prove to be renewed risk aversion which will boost the USD. Alternatively it could be the presumption of the USD garnering support by virtue of likely being the first major currency to revert back towards growth. Alternatively it could be on the basis of weakness in the euro area in terms of growth likely under shooting that in the US in both 2009 and 2010 but also due to ongoing questioning of the ECB policy stance. Moreover there is also the question of the potential scale of ongoing banking liabilities in the region compared to the US. In particular the IMF have highlighted the amount of liabilities that have been written off in the eurozone is substantially below that in the US, this as banking sector liquidity remains a live and ongoing issue. Overall, such factors are likely to conspire to suggest that without a durable breach of the broad EUR USD downtrend we remain likely on course to test towards 2008 lows.

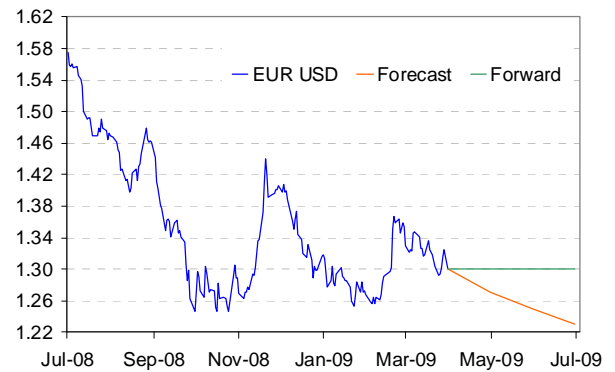
## EUR JPY: Ignoring the fundamentals

After having seen EUR JPY climb more than 20% from the early year lows in the wake of the improved risk parameters, predicated upon an equity market rebound, we have subsequently retraced more than half the move as ongoing concerns over the financial sector continue to be a matter of investor anxiety, such fears proving to come in addition to the worries as regards risks of a flu pandemic. Indeed in the current environment it would appear likely that the deterioration in the Japanese fundamentals will not prove to undermine the risk related demand for the JPY. Indeed in a zero interest rate world yield differentials are currently not a primary currency determinant, indeed even the extension of bond buying by the BoJ seems unlikely for now to undermine the JPY, even though most other currencies have proved to be destabilized at least temporarily by the advent of a quantitative easing policy. However, while the performance of the JPY may remain beyond relative fundamentals for now we would not expect the BoJ to follow the example of the SNB anytime soon.

## EUR GBP: Sterling warning

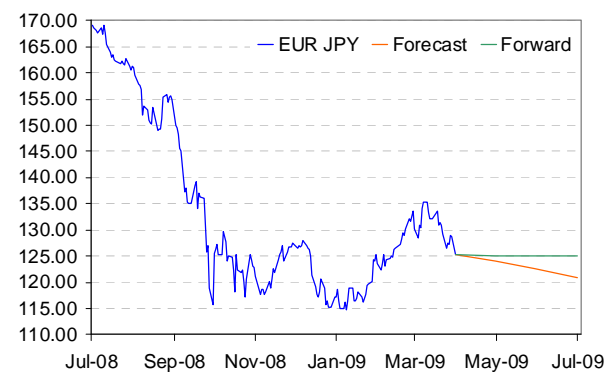
The UK fundamental backdrop in the month has proved something of a hurdle for Sterling, for example the budget revealed the scale of deterioration in the government finances even when set against optimistic medium term forecasts. However, while we have seen Q1 growth slide to 30 year lows amidst concerns regarding the maintenance of the AAA sovereign credit rating due to the budget deficit explosion, a likely expansion in GBP net short positions was a probable catalyst for the spike back through GBP0.90. Going forward it is clear that Sterling's performance will be partly predicated upon international investor appetite for the massive UK bond issuance, £220bn in the current financial year. However, while we would anticipate that the economic downturn and budgetary issues remain a risk parameter the prospect of an earlier recovery in the UK than the eurozone, in part benefiting from Sterling being 'cheap,' suggests that with the majority of the bad news already discounted this favours EUR GBP downside risks.

Chart 1: EUR USD



Source: Reuters EcoWin, Rabobank International

Chart 2: EUR JPY



Source: Reuters EcoWin, Rabobank International

Chart 3: EUR GBP



Source: Reuters EcoWin, Rabobank International

# Fixed Income EUR

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## Liquidity improving?

European market circumstances in the aftermath of the Lehman Brothers' collapse were so dire that investors were demanding significant premiums for holding various types of securities, particularly those that were already trading in relatively thin markets before the onset of the credit turmoil. However, since early March, there have been signs that market sentiment and liquidity conditions have improved, although conditions are still far from normal. Central bank measures, which have increasingly focused on the purchase of assets, may have supported the general improvement in market conditions. The 30y state-swap spread has narrowed with swap rates rising faster than their sovereign counterparts. Because the supply of 30y paper is relatively limited, the spread is partly driven by liquidity conditions. We have also seen a narrowing differential between 10y inflation swaps and the 10y break-even inflation rate derived from index-linked bonds since early March (although it has edge up again in recent weeks). Here too, index-linked paper can be subject to liquidity premiums, particularly in volatile markets. Finally, we have seen a narrowing sovereign yield spread between most eurozone member states and German benchmarks. Ireland's 5Y sovereign spread vis-à-vis Germany, for example, has fallen by more than 100bp since mid-March. We have used fixed GDP weights to calculate a 'EMU-11 ex-Germany average', as a simple indicator. Obviously the spread is also driven by sovereign credit concerns, but we would argue that the outlook for government finances hasn't exactly improved for most countries. Cash spreads have narrowed less than CDS spreads vis-à-vis Germany, which supports our case.

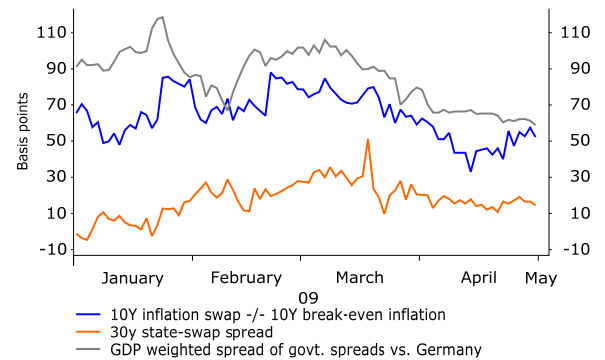
## Markets may be too concerned about inflation

Since their collapse in 2008H2, market-based inflation expectations in the eurozone have been rising steadily. Meanwhile, the inflation curve has flattened, with inflation expectations for the short term rising faster than those for the long term. At present, the forward curve for 1-year inflation is fairly flat for 2-years out, at a level of between 1.3% to 1.9%, depending on whether we look at inflation-linked or the swap market. However, beyond this horizon, the market expects inflation to rise sharply, to settle at levels of around 2.5 to 3%. Even if we assume a conservative inflation premium, this is clearly above the levels deemed consistent with price stability. Hence, in our opinion, the market has now become too concerned about inflation and we see value positioning for a modest fall in inflation swaps – even at the short-end of the curve.

## Not there yet

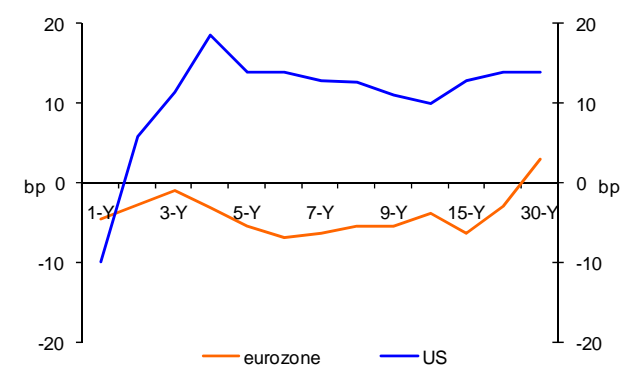
Recently, 'green shoots' of recovery have received much attention, suggesting that we may have seen the trough in yields. Whilst we concur that economies may have embarked on a slow but gradual path of recovery, we would stress that we are not there yet. We also think that inflationary pressures should continue to ease in the foreseeable future, since most economies are facing a record gap between actual and potential output. So we are not convinced that eurozone yields should make serious headway in coming months, although we may not see the market test previous lows of 2.9% in the 10-year Bund.

Chart 1: Spread indicators



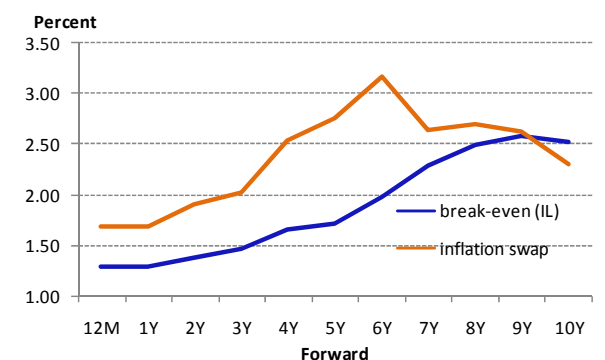
Source: Reuters EcoWin, Bloomberg, Rabobank

Chart 2: Change in swap rates 27/03 – 27/04



Source: Reuters EcoWin, Rabobank International

Chart 3: Forwards of 1-Y break-even inflation



Source: Reuters EcoWin, Bloomberg, Rabobank

# Euro credit spreads

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## Credit spreads in first phase of M-shaped recovery

### Spreads tighten on positive newsflow

Credits markets were slightly bullish in recent weeks. Since the start of April, the iTraxx Main index has tightened by roughly 20 bps from 175 bps. The iTraxx Xover has tightened by roughly 100 bps from 950 bps. This has been triggered by a number of positive developments.

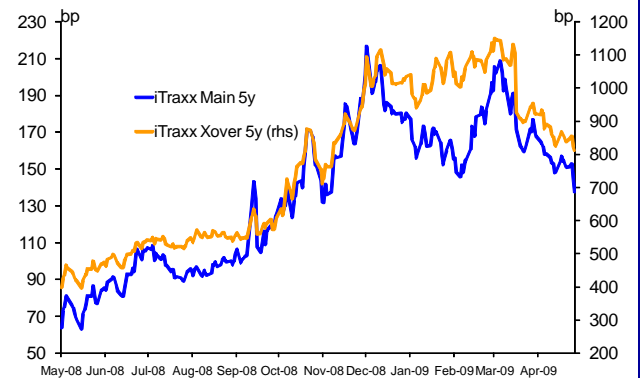
Firstly, there are some macro-economic figures which point to a deceleration in economic slowdown. In the US, data on home sales, home building and consumer spending show a more modest decline and, especially, the purchasing manager indices look promising. The regional purchasing manager indices and the national ISM manufacturing index have stabilized during 1Q09, albeit at very low levels that indicate that we still are in the midst of a severe recession. The stabilization itself has been perceived as early signs that an economic recovery is underway.

Secondly, appetite for (new) debt has returned with demand from pension funds and insurance companies looking for coupon income. This has a tightening effect on credit spreads in general.

Thirdly, the 1Q2009 results reported till so far at financials have been better than expected (e.g. Goldman Sachs, Credit Suisse, Citigroup). This has brought hope to the markets that the financial sector has left the worst behind and lending activities to corporates and consumers might start to recover in the near future. However, at this point there are no signs of that yet: chart 2 shows the Senior Loan Officer Opinion Survey on Bank Lending Practices on changes in the supply of, and demand for, loans to businesses and households over the past three months. In the January survey, the net fractions of respondents that reported having tightened their lending policies on all major loan categories over the previous three months stayed very elevated. Respondents indicated that demand for loans from both businesses and households continued to weaken, on balance, over the survey period. Also, banks reported having reduced credit limits on existing credit lines over the last three months across a wide range of loan types. Banks also reported an increase in the use of interest rate floors in new loan agreements during 2008.

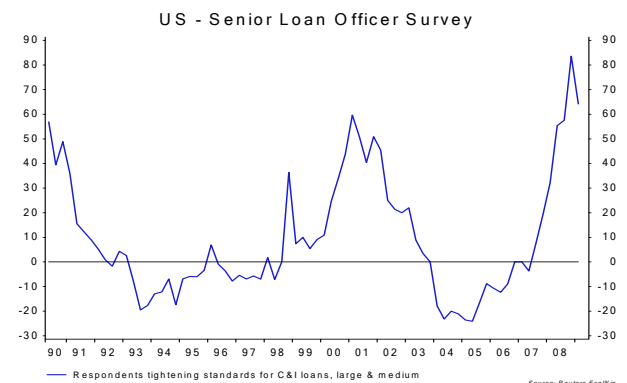
Additionally, from a technical perspective, our model indicates that the credit markets have been ripe for a technical rebound in sync with the performance in equity markets. While, since the beginning of April, the iTraxx Xover index tightened from 950 bps to roughly 806 bps, at the same time the Eurostoxx 50 equity index rose from 2097 to 2280 indexpoints.

Chart 1: iTraxx indices in tightening phase



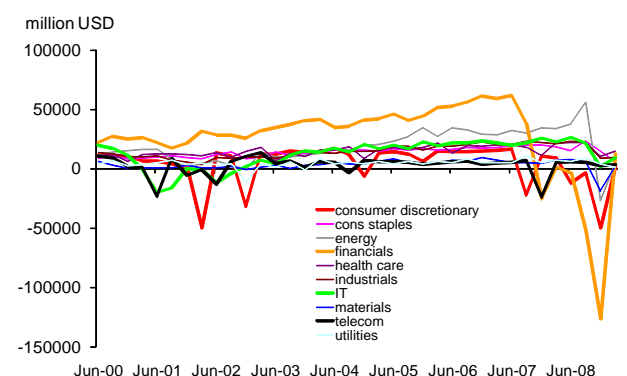
Source: Rabobank International, iTraxx

Chart 2: Senior loan officer survey indicates tight lending policies



Source: Rabobank International, Reuters Ecwin

Chart 3: Total net income per S&P 500 sector



Source: Rabobank International, Bloomberg

### Stress test results determine near term sentiment

Having said this, we believe that in coming weeks market sentiment will largely be determined by the stress tests conducted by the Fed on the largest 19 US banks to determine whether more capital is needed. The 19 banks together hold two-thirds of all US bank assets. The stress test will test whether banks are solvent enough to cope with losses on assets in a scenario where home prices would drop by 22% and unemployment rate would rise towards 10%. In case the answer should be negative, the bank will get six months to raise capital from private investors. If they do not succeed, the Fed will force them to accept new capital injections in the form of preferred stock convertible into common stock at the banks will. As an alternative method to shore up the capital base, the US Treasury has recently commented that it could swap government-held preferred shares into common shares instead. This way, it will prevent using up some of the USD 700 billion TARP resources. The stress tests are to be completed by April. The Fed has postponed the release of the stress test results, originally planned on 4 May, as it is likely that the Fed is still assessing any possible negative impact of the release on the financial markets. It is uncertain still how much information will be given by the Fed and whether they will name the banks who fail the tests. So far, they have stated not to publish names. It has been rumoured that at least 6 of the 19 banks are likely to fail the test and will need additional capital. The usual suspects are the large banks that have already received government aid and regional banks with more concentrated geographic exposure. We expect the credit markets to react volatile on the stress test results, having been fairly stable recently.

### Long term outlook

Regarding our longer term outlook for credit spread levels, we project the iTraxx Main index spread level should reach roughly 130 bps at the end of 2009. For the Xover index, we project a level of 900 bps. This is likely to be accompanied by intermediate volatility. We believe that our forecasted the M-shaped recovery (see previous monthlies) is in its first tightening leg. As we have mentioned above, there have been preliminary signs of better times ahead judging from the macro-economic data. Our economists forecast that the US economy should start to recover towards the end of 2009. Whereas financials have initially suffered from losses on structured credit, they are likely to experience losses on corporate and consumer loans in the coming years. However, the immediate threat of bankruptcies in the financial sector seem to be behind us now that some banks have even reported positive quarterly earnings again. However, the attention has already started to shift to the troubles at corporates, which will emerge in the current phase of the economic downturn and will likely lead to a renewed widening of credit spreads during the second half of 2009.

# Forecasts

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## Economic forecast overview

	GDP			Inflation			Unemployment		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
US	2.2	1.1	-2.4	2.9	3.8	-0.4	4.6	5.9	9.5
Euro-zone	2.6	0.6	-3.9	2.1	3.3	0.5	7.4	7.6	9.4
Japan	2.4	-0.6	-4.5	0.1	1.4	-1.0	3.9	4.0	5.0
UK	2.9	0.7	-3.8	2.3	3.6	0.9	5.4	5.6	9.5

## Foreign exchange forecasts

	01 May 09	3m	6m	12m		01 May 09	3m	6m	12m
EUR USD	1.32	1.23	1.25	1.30	USD JPY	99	98	100	102
EUR JPY	132	121	125	133	GBP USD	1.48	1.40	1.44	1.53
EUR GBP	0.89	0.88	0.87	0.85	AUD USD	0.73	0.67	0.65	0.71
EUR CHF	1.51	1.52	1.53	1.55	USD CAD	1.19	1.27	1.26	1.19

## Swap rate forecasts

U S D	01 May 09	3m	6m	12m	E U R	01 May 09	3m	6m	12m
Fed Funds	0.25	0.25	0.25	0.25	ECB refi	1.25	1.00	1.00	1.00
3m \$libor	1.02	0.86	0.77	0.70	3m euribor	1.37	0.99	1.02	1.18
2Y swap	1.48	1.42	1.60	2.90	2Y swap	1.82	1.55	1.61	1.80
5Y swap	2.58	2.47	2.57	3.65	5Y swap	2.72	2.59	2.68	2.85
10Y swap	3.24	3.09	3.16	4.10	10Y swap	3.44	3.35	3.50	3.70
30Y swap	3.64	3.35	3.30	4.19	30Y swap	3.75	3.59	3.69	3.74

JPY	01 May 09	3m	6m	12m	GBP	01 May 09	3m	6m	12m
o/n	0.10	0.10	0.10	0.10	Base rate	0.50	0.50	0.50	0.50
3m ¥libor	0.55	0.55	0.50	0.40	3m £libor	1.45	1.40	1.30	1.60
2Y swap	0.70	0.70	0.75	0.90	2Y swap	2.05	2.05	2.15	2.80
5Y swap	0.93	0.90	0.85	1.15	5Y swap	3.05	3.20	3.35	4.15
10Y swap	1.32	1.30	1.25	1.75	10Y swap	3.68	3.55	3.75	4.75
20Y swap	1.81	1.80	1.80	2.30	30Y swap	3.83	3.85	4.30	4.95

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