J.P.Morgan

Australia and New Zealand - Weekly Prospects

Summary

- Tomorrow's RBA decision is the clear highlight in **Australia** this week; we look for a 25bp rate hike and for upgrades to the RBA's growth and inflation forecasts in the quarterly statement on Friday. The steady stream of firm domestic data since the last rate decision in December, and last week's elevated core inflation measures, effectively locked in this week's hike. The RBA's commentary Tuesday probably will be balanced, with references to strong activity domestically and in Asia contrasted with equity market weakness, which drags on household balance sheets, and renewed global financial instability. We expect the Aussie banks to respond with variable mortgage rate rises of at least 25bp. An assertive response by the commercial banks is one reason why a follow up rate hike in March is, at best, a coin toss—the banks are doing some of the hard yards for the RBA, so there is no rush.
- RBNZ officials seem comfortable with the medium-term inflation outlook; this comfort, however, probably will abate as the economic recovery gathers momentum. We, therefore, maintain that Governor Bollard will lift the cash rate before official guidance suggests. That said, we now forecast the first rate hike will be delivered in April, rather than in March. Dr. Bollard on Friday said that while **New Zealand's** inflation targeting monetary policy has been "flexible, durable and successful", the risk now is that officials may keep monetary and fiscal conditions easy for too long. Indeed, he believes the successful removal of fiscal stimulus would ease pressure on monetary policy. Bollard highlighted that the RBNZ cut official interest rates in "big jumps", which means there could be some "meaty chunks" on the upside when the tightening cycle begins.
- The **global expansion** gained momentum into year-end, with global GDP rising at an estimated 3.7% ar in 4Q, more than a point above our estimate of trend. The challenge that lies ahead is to broaden and strengthen the foundation that has been established. To date, the recovery has depended heavily on the manufacturing sector, which delivered record 10% annualized output gains in 2H09, boosting GDP growth by an estimated 2%-pts. The factory boom still has room to run. Manufacturers boosted output as companies moved to trim the rate of inventory liquidation around the middle of last year.
- Along with Asia, the US is at the leading edge of the **inventory shift**, as seen in last week's US GDP report. Yet our metrics indicate that global inventories were still contracting at year-end. Combined with growth in final sales, this means inventory/sales ratios are still falling fast. Thus, we look for further robust gains in global manufacturing output in 1H10 (7% annualized).
- By contrast, activity outside of the industrial sector is improving slowly. This is seen most clearly in the production index of our **global services PMI,** which stands at a relatively subdued 52.1 and at a record low in relation to its manufacturing counterpart. This survey captures final demand and thereby understates inventory dynamics in the nonmanufacturing sector, so it is not necessarily signaling downside risk to growth. But it is a signal that the expansion remains narrowly based at this juncture. A move up in the services PMI in coming months would confirm that the expansion is broadening.

This week's highlight

The RBA decision Tuesday; local market economists are unanimous that the cash rate will rise. The main focus will be the tone of the commentary; we expect *balanced* comments, with officials leaving their options open.

February 1, 2010

Contents

JPMorgan Australia Ltd., Sydney
www.morganmarkets.com

Stephen Walters
(61-2) 9220-1599
stephen.b.walters@jpmorgan.com

Helen Kevans
(61-2) 9220-3250
helen.e.kevans@jpmorgan.com

Ben Jarman
(61-2) 9220-1669
ben.k.jarman@jpmorgan.com

JPMorgan Australia Ltd., Sydney
Stephen Walters (61-2) 9220-1599
stephen.b.walters@jpmorgan.com
Helen Kevans (61-2) 9220-3250
helen.e.kevans@jpmorgan.com
Ben Jarman (61-2) 9220-1669
ben.k.jarman@jpmorgan.com

Data and event previews - Australia and New Zealand

Date	Time (a)	Data/event	Forecast JPMorgan	Forecast Consensus (b)	*Previous*
Monday, February 1	10.30am	Aust. TD Securities Inflation Gauge (%m/m, Jan.)	**na**	na	*0.3*
Monday, February 1	11.30am	Aust. house price index (%q/q, 4Q)	**5.5**	3.5	*4.2*
Monday, February 1	11.30am	ANZ job advertisements (%m/m, Jan.)	**na**	na	*6.0*
Monday, February 1	1.00pm	NZ ANZ commodity price index (%m/m, Jan.)	**na**	na	*2.6*
Monday, February 1	2.00pm	Aust quarterly wage agreements (%q/q ar, 3Q)	**na**	na	*3.9*
Tuesday, February 2	8.45am	NZ LCI (%q/q, 4Q)	**0.3**	0.4	*0.5*
Tuesday, February 2	8.45am	NZ average hourly earnings (%q/q, 4Q)	**na**	0.5	*1.1*
Tuesday, February 2	11.30am	Aust. NAB business confidence (Index, 4Q)	**15**	na	*16*
Tuesday, February 2	2.30pm	RBA cash rate announcement (%, Feb.)	**4.00**	4.00	*3.75*
Wednesday, February 3	9.30am	AiG performance of services (Index, Jan.)	**na**	na	*50.0*
Wednesday, February 3	11.30am	Aust. trade balance (A$mn, Dec.)	**-1500**	-2400	*-1700*
Thursday, February 4	8.45am	NZ unemployment rate (%, 4Q)	**7.2**	6.8	*6.5*
Thursday, February 4	8.45am	NZ participation rate (%, 4Q)	**68.1**	68.1	*68.0*
Thursday, February 4	8.45am	NZ employment (%q/q, 4Q)	**-0.4**	-0.1	*-0.7*
Thursday, February 4	8.45am	NZ visitor arrivals (%m/m, Dec.)	**na**	na	*-3.7*
Thursday, February 4	11.30am	Aust. building approvals (%m/m, Dec.)	**-1.5**	0.0	*5.9*
Thursday, February 4	11.30am	Aust. retail sales (%m/m, Dec.)	**0.2**	0.2	*1.4*
Friday, February 5	9.30am	AiG performance of construction (Index, Jan.)	**na**	na	*49.3*
Friday, February 5	11.30am	RBA Qtrly Statement on Monetary Policy (Feb.)	**na**	na	*na*

(a) Australian Eastern Standard Time.
(b) Consensus based on Bloomberg survey.

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Helen Kevans (61-2) 9220-3250
helen.e.kevans@jpmorgan.com
Ben Jarman (61-2) 9220-1669
ben.k.jarman@jpmorgan.com

Data and event previews - contd.

Australia

House price index (%q/q, 4Q) - Aussie house prices probably increased a further 5.5%q/q in 4Q. First home buyers have kept prices well supported since October 2008, when the government expanded the buyers' (FHBs') grant. Over 2009, low interest rates, strong employment gains, and higher population growth also provided significant support. House price gains should moderate in 2010 as mortgage rates rise and FHBs retreat, given that the expanded FHB grant expired on Dec. 31.

NAB business confidence (Index, 4Q) - Business confidence should have moderated over the fourth quarter, owing partly to the RBA's three consecutive rate hikes. Business credit growth continued to deteriorate over 4Q according to the RBA's financial aggregates. Access to credit should improve over 2010 as banks look to rebalance their loan books away from housing finance.

RBA cash rate announcement (%) - The absence of downside surprises in last week's inflation report locked in the RBA for a fourth straight rate hike; the banks will respond with at least quarter point rises in their variable mortgage rates. We have for some forecast a February hike, a view supported by the run of firm data releases since the last RBA decision in December. Moreover, the medium-term inflation outlook looks troubling. On our forecasts, inflation is close to troughing for this cycle, and may already have done so. This implies RBA officials have further work to do in returning the cash rate target closer to a neutral setting. The official commentary on Tuesday probably will be *balanced*, with references to strong economic activity domestically and in Asia balanced against equity market weakness, which drags on household balance sheets, and renewed global financial instability.

Trade balance (A$mn, Dec.) - Preliminary data showed that goods imports fell 7%m/m in December, the largest fall since January 2009. Goods exports probably were down also, though the more modest fall will trim the trade deficit.

Building approvals (%m/m, Dec.) - The volatile building approvals series should show a 1.5%m/m decline over December, with continued financing difficulties constraining development of larger projects.

Retail sales (%m/m, Dec.) - Australia's retail data should show a subdued rise in sales values in December, owing partly to aggressive price discounting by retailers keen to generate store traffic, but a solid increase in volumes over the final quarter. Volumes in 4Q probably surged 1.9%q/q, after falling in 0.4% in 3Q.

RBA Qtrly Statement on Monetary Policy - the highlight will be the release of updated official forecasts. The growth and inflation projections released last November look low. We suspect, therefore, that both forecasts will be pushed higher by 0.25%. In recent statements, the RBA's inflation outlook has assumed a gradual increase in the cash rate; we will be watching to see whether this framework is maintained in the February statement.

New Zealand

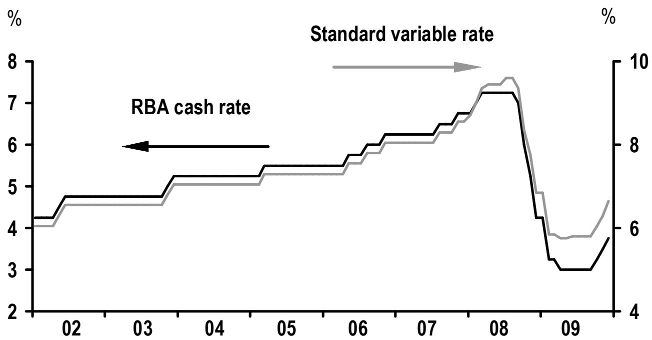
LCI (%q/q, 4Q) - Loose labour market conditions mean that wage growth will have remained subdued in the final three months of last year. Private sector labour costs (as measured by the LCI) will likely show a mere 0.3%q/q rise in 4Q, compared to 0.4% in the previous three months.

Unemployment rate (%, 4Q) - Employment probably contracted 0.4%q/q in 4Q, marking the fourth straight quarterly decline. The drop in employment, combined with a slight uptick in the labour force participation rate (from 68.0% to 68.1%), will mean that the unemployment rate will jump 0.7%-points to 7.2%. Details of the employment report will paint a gloomy picture, with the number of people underemployed, in particular, likely to have remained elevated.

JPMorgan Australia Ltd., Sydney
Helen Kevans (61-2) 9220-3250
helen.e.kevans@jpmorgan.com
Ben Jarman (61-2) 9220-1669
ben.k.jarman@jpmorgan.com

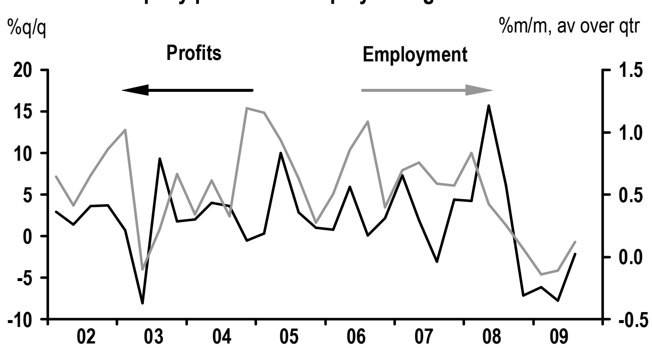
Feature charts

Australia: RBA cash rate and standard variable mortgage rate



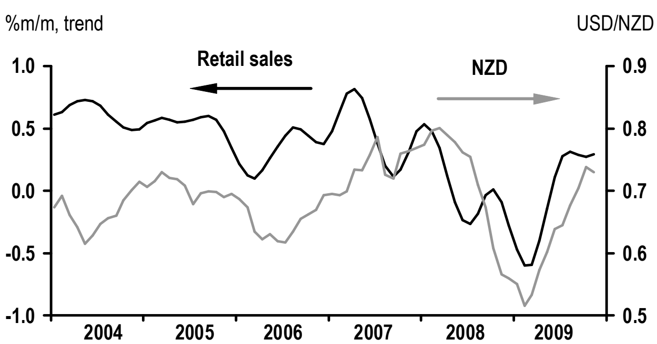
Throughout most of the last decade, variable mortgage rates moved lock-step with the RBA's cash rate target. As banks' funding costs have crept up in the wake of the credit crunch, a divergence has appeared between adjustments to lending rates and those to RBA policy. The aggressiveness of RBA rate hikes going forward may be tempered by increased uncertainty surrounding this mechanism, and the accumulated defacto tightening that already has occurred through higher bank lending rates.

Australia: company profits and employment growth



The decline in Australia's unemployment rate leading into the financial crisis was driven by soaring corporate profitability. Employment growth, while correlated to profit growth, is even more closely tied to profit margins. A shortage of skilled labour, as well as a repeal of previous industrial relations reforms, which tilt the balance back towards employees, will increase wage pressures and squeeze profit margins. The employment outlook is strong, however, despite these concerns, due to the solid demand in the resources sector, in particular.

New Zealand: retail sales and NZD



Appreciation of NZD depresses the cost of imported consumer goods. Presuming firms pass these savings on, the effect on retail sales in any given month depends on how positively volumes respond to discounted prices. Once we observe the trend in retail sales, the causality is reversed—the persistent improvement in Kiwi retail sales growth is a signal of recovering consumer demand. The upward shift in the inflation outlook is then expressed through further currency appreciation.

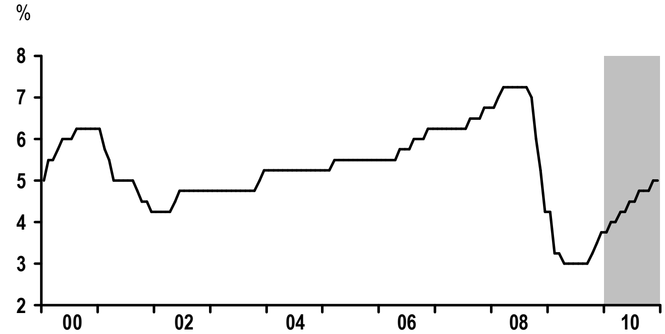
JPMorgan Australia Ltd., Sydney
Stephen Walters (61-2) 9220-1599
stephen.b.walters@jpmorgan.com
Helen Kevans (61-2) 9220-3250
helen.e.kevans@jpmorgan.com

Australia

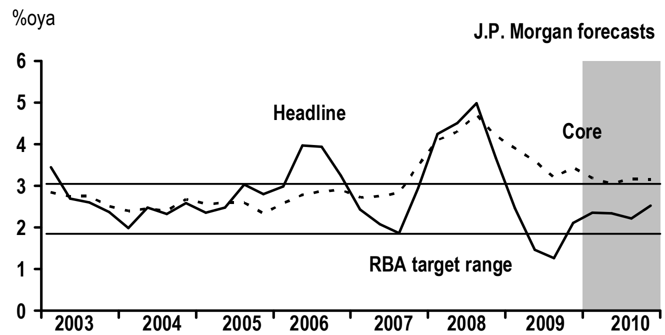
- **Elevated core inflation locks in RBA hike this week**
- **Aussie retail sales volumes probably spiked in 4Q**
- **Credit growth picked up in December**

The steady stream of firm data in Australia recently and last week's inflation report, which showed the core measures still above target, cement our view that the RBA will deliver a fourth straight hike when the Board meets this week. Current policy settings are too accommodative for an economy on what appears to be solid footing. The deteriorating medium-term inflation outlook means the RBA will have little time in 2010 to sit on the policy sidelines; policy settings will be restrictive by year-end.

Australia: RBA cash target rate



Australia: CPI



Another RBA rate hike this week

The absence of downside surprises in the Aussie inflation report locked in the RBA for a fourth straight rate hike for Tuesday. Only a material downside surprise in the inflation numbers would have kept the RBA sidelined, and even then it would have been a stretch. Indeed, we have for some time been forecasting a February rate hike, a view supported by the run of unexpectedly firm domestic economic data releases since the last RBA decision in early December. Thus, the inflation print and further anecdotal and survey evidence indicating that the inflation outlook has worsened merely confirm that the cash rate is too low.

The concern for the RBA is that the medium-term inflation outlook looks troubling. Indeed, on our forecasts, inflation is close to troughing for this cycle, and may already have done so. The economy has rebounded with what appears to be limited spare capacity, and there already is evidence that some sectors, like mining, are bumping up against the same constraints that blighted the previous period of expansion. In particular, skill shortages mean that wage pressures are building. Moreover, recent changes to Australia's industrial laws point to an increased risk of the outsized pay increases being claimed in sectors like mining spilling over into broader sectors of the economy, particularly with the unemployment rate seemingly having peaked below 6%.

This implies RBA officials have further work to do in returning the cash rate target closer to a neutral setting. This process is likely to be completed in small (25bp), steady steps. With growth in the economy exceeding official expectations and inflation poised to accelerate from elevated levels, there is a risk that the RBA may pull the policy trigger in March as well as February. Five straight rate hikes, though, would risk over-egging the pudding. Not all sections of the economy are firing (e.g., tourism, manufacturing, and some sections of the construction industry are in the doldrums), and the RBA has time on its side.

Friday, RBA officials release updated official forecasts in the quarterly statement. The growth and inflation projections released last November now look low. We suspect, therefore, that both forecasts will be pushed higher by 0.25%, on average across the forecast horizon.

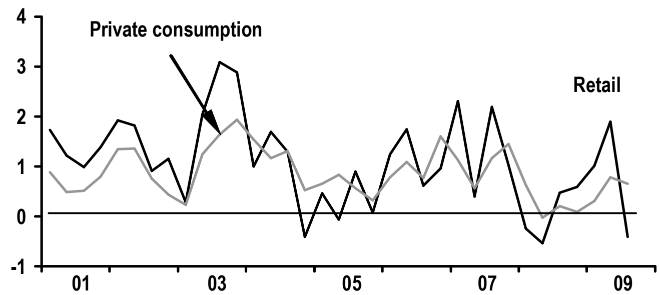
Core inflation still above RBA's target

Fourth quarter headline inflation printed as we had expected at 0.5%q/q (consensus: 0.4%), half the 1.0%q/q rise in the September quarter. The smaller quarterly rise, though, pushed the annual rate of headline inflation up to 2.1%oya (from 1.3%), with unfavourable on-year-ago base effects (headline CPI fell in 4Q08) playing a significant role here. The all-important core inflation prints averaged 0.65% in 4Q (trimmed mean 0.6%, weighted median 0.7%), the lowest outcome for two years. The average annual rate of change on the core measures, however, was unchanged at 3.4%oya, above the RBA's 2-3% target range for the ninth straight quarter.

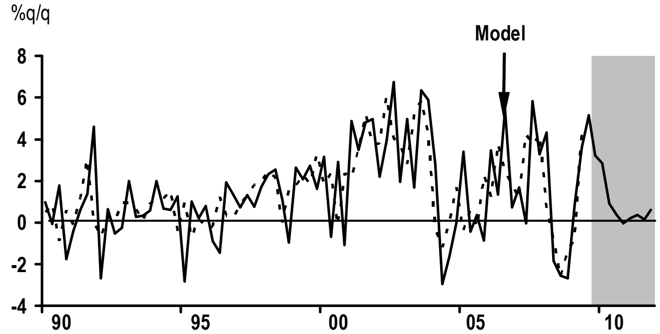
The main drivers of inflation in the quarter were a 16% rise in the price of fruit, a near 7% rise in the price of domestic holidays, a 1% rise in house purchase costs, and a 2.1% rise in the price of beer (ouch). Partly offsetting these increases were a 2.8% drop in automotive fuel prices, a 7.1% plunge in the prices of electronics (most of which are imported), and a 5.2% drop in drug prices. Imported inflation rose 0.1%q/q despite the prolonged strength of AUD, but non-tradables prices rose a worryingly-high 0.8%q/q.

With consumers seemingly having brushed off the RBA's three rate hikes in 4Q, and surplus stocks having been pared back, it is unlikely we will see the same level of retailer discounting that we saw over year-end. Similarly, commodity prices remain well-supported, which means raw material prices probably will feed into higher industrial costs structures. Moreover, the favourable base effects that helped drive headline inflation lower over recent quarters will move in the opposite direction from here. Also, much of the imported disinflation has run its course. In fact, AUD has fallen against key cross-rates in recent weeks.

Australia: private consumption and retail trade volumes



Australia: house prices and J.P. Morgan model



Retail volumes probably robust in 4Q

Australia's retail data this week should show a subdued rise in retail sales values in December, but a solid increase in volumes over the final quarter. Volumes in 4Q probably surged 1.9%q/q after falling in 0.4% in 3Q. The quarterly volumes numbers are important for our 4Q GDP forecast, with retail sales accounting for a quarter of GDP.

However, after spiking 1.4%m/m in November, retail sales values probably rose a mere 0.2% in December, partly due to payback for the strong result in the previous month, but also reflecting significant discounting by retailers and the adverse impact of the RBA's three rate hikes in 4Q. Preventing a larger fall in sales values, though, will have been strong gains in employment (nearly 100,000 jobs were added to the economy in the final quarter of 2009), healthy gains in the equity market, and positive wealth effects from significant house price gains.

Aussie house prices: the only way is up

Aussie house prices probably increased a further 5.5%q/q in 4Q, following gains of 4.2% in the two preceding quarters. The continued strength in house prices can largely be attributed to strong demand from first home buyers, who have kept prices well supported since October 2008, when the government expanded the buyers' (FHBs') grant. Median house prices across the country probably surged 13% in 2009, with low interest rates, strong employment gains, and higher population growth also providing significant support. The chronic shortage of new housing probably also kept upward pressure on house prices. House price gains should, however, moderate in 2010 as mortgage rates rise considerably and FHBs retreat, given that the expanded FHB grant expired on December 31.

Credit growth finally picks up

The RBA's December credit aggregates, released last week, showed an unexpectedly firm 0.3%m/m gain in the pool of credit (J.P. Morgan and consensus 0.1%). This pushed up growth over the year to a still soggy 1.5%oya. Credit to housing rose 0.7%m/m as expected, as did credit for 'other personal purposes'. Credit to business, however, fell another 0.2%—the eleventh straight monthly decline—although this was a smaller fall than we had expected.

It seems banks continue to fund increased lending for housing via restricted access to credit for smaller corporates, where the risk profile is more problematic. Some banks, though, have experienced very strong growth in credit to housing over the past year, and probably will move to cap the rate of expansion in 2010. Demand for home loans prob-

JPMorgan Australia Ltd., Sydney
Stephen Walters (61-2) 9220-1599
stephen.b.walters@jpmorgan.com
Helen Kevans (61-2) 9220-3250
helen.e.kevans@jpmorgan.com

ably will cool too owing, in particular, to higher borrowing rates and the winding back of the first home owners' grant. Banks simultaneously are likely to make more credit available to smaller businesses, given the more attractive returns available from higher risk lending. This is particularly so now that the mining investment pipeline has expanded. While the large mining companies rely on capital markets for the majority of their funding, rather than bank loans, the smaller firms doing the "grunt work" depend on relationships with their respective bank managers.

Data releases and forecasts

Week of February 1 - 5

Mon
Feb 1
11:30am

ANZ job advertisements
sa

	Oct	Nov	Dec	Jan
(%m/m)	-1.7	5.2	6.0	__

Mon
Feb 1
11:30am

House price index: eight capital cities
Weighted average

	1Q09	2Q09	3Q09	4Q09
(%q/q)	-0.8	4.2	4.2	5.5
(%oya)	-5.5	-0.7	6.2	13.6

Tue
Feb 2
11:30am

NAB business confidence
sa

	1Q09	2Q09	3Q09	4Q09
Percent balance	-24	-4	16	15

Tue
Feb 2
2:30pm

RBA cash rate announcement

25 bp hike expected

Wed
Feb 3
11:30am

Trade balance
sa

	Sep	Oct	Nov	Dec
Trade balance (A$ mn)	-1484	-2080	-1701	-1500

Preliminary data showed that goods imports fell 7%m/m in December, the largest fall since January 2009.

Thu
Feb 4
11:30am

Building approvals
sa

	Sep	Oct	Nov	Dec
%m/m	7.6	-1.8	5.9	-1.5
%oya	17.3	14.1	33.3	37.3

Thu
Feb 4
11:30am

Retail trade
Seasonally adjusted

	Sep	Oct	Nov	Dec
%m/m	0.0	0.4	1.4	0.2
%oya	6.1	5.8	7.3	3.3

Retail trade ex inflation

	1Q09	2Q09	3Q09	4Q09
%q/q	1.0	1.9	-0.4	1.9
%oya	1.5	4.2	3.3	4.4

Review of past week's data

Producer price index
% change

	2Q09	3Q09	4Q09
%oya	2.1	0.2	~~-0.5~~ *-1.5*
%q/q	-0.8	0.1	~~0.6~~ *-0.4*

WMI leading index
sa

	Sep	Oct	Nov
%m/m	1.0	0.4	__ *1.0*

Consumer price index
% change

	2Q09	3Q09	4Q09
Headline			
%oya	1.5	1.3	2.1
%q/q	0.5	1.0	0.5
Core (trimmed mean)			
%oya	3.6	3.2	~~3.2~~ *3.3*
%q/q	0.8	0.8	~~0.6~~ *0.7*

New Zealand

- **RBNZ to hike cash rate ahead of official guidance**
- **4Q labour report will show jump in unemployment rate**
- **Trade balance surprisingly returned to surplus**

RBNZ officials appear comfortable with the medium-term inflation outlook in New Zealand. This level of comfort, however, probably will abate soon, mainly owing to the fact that the economic recovery is garnering momentum. Consumer confidence is at a three-year high, consumers are loosening their purse strings, albeit slowly, business confidence is on the rise, and housing market activity remains robust. With respect to the latter, in particular, the RBNZ Governor will be reluctant to leave the cash rate at record lows for too much longer, or risk the emergence of another debt-fuelled housing bubble.

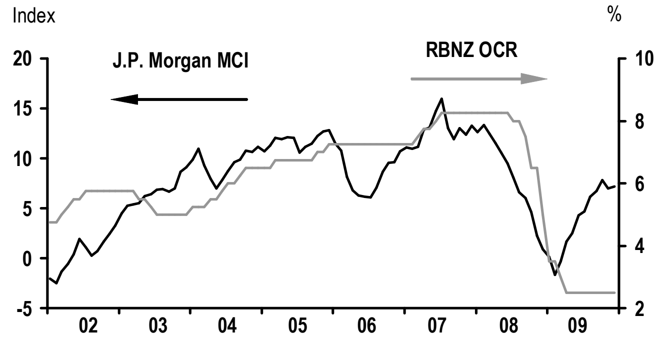
RBNZ keeps rates/guidance unchanged

The RBNZ left the cash rate (OCR) steady at 2.5% as expected and maintained that, provided the economy continues to recover in line with the RBNZ's projections, policy stimulus will begin to be removed "around the middle of 2010." The absence of more hawkish commentary on the medium-term inflation outlook does, however, mean a rate hike in March now carries significantly less risk. As such, we now forecast that the next tightening cycle will commence in April, rather than in March as previously forecast.

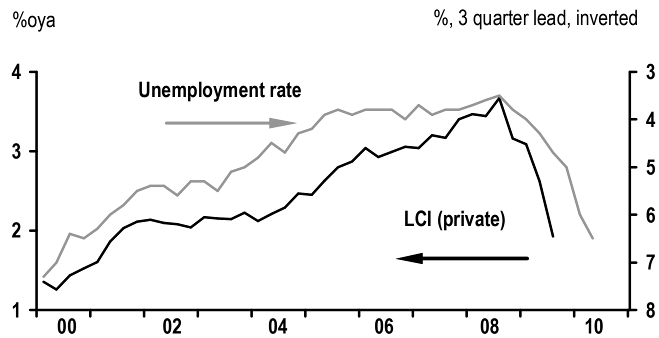
In the statement accompanying the announcement last week, RBNZ Governor Bollard highlighted that "annual CPI inflation is currently at the center of the target band, and is expected to track comfortably within the band over the medium-term." In our view, the medium-term inflation outlook will become a growing concern for the Governor. Annual CPI inflation will likely edge toward the top end of the RBNZ's 1%-3% target range over the medium-term given that domestic prices are rising and excess capacity is diminishing. It is for this reason, primarily, that the first rate hike will, in our view, be delivered earlier than official guidance suggests.

Apart from the inflation outlook, the statement was relatively balanced. On the one hand, Bollard acknowledged the improvement in export earnings and household spending, but on the other, remained cautious on the outlook for trading partner growth and highlighted that credit growth remained subdued. Interestingly, there was no mention of the adverse impact of elevated NZD. In the December statement, Bollard noted that the currency had limited the scope

New Zealand: RBNZ official cash rate and monetary conditions



New Zealand: LCI and unemployment



for exports to contribute to the recovery; this, though, was absent from last week's commentary.

With economic conditions offshore and at home improving, and the RBNZ likely to become less comfortable with the medium-term inflation outlook in coming months, we maintain that the next tightening cycle will commence before "the middle of 2010," with the first OCR hike likely to come in April. A 50bp move at the commencement of the tightening cycle is a risk, but a 25bp move should suffice given that the shift of borrowers toward shorter-dated borrowing and floating rate loans means the RBNZ will get more bang for its buck when it does tighten policy.

NZ unemployment still on the rise

Employment probably contracted 0.4%q/q in 4Q, marking the fourth straight quarterly decline. The drop in employment, combined with a slight uptick in the labour force participation rate (from 68.0% to 68.1%), will mean that the unemployment rate will jump 0.7%-points to 7.2%. Details of the employment report will paint a gloomy picture, with the number of people underemployed, in particular, likely to have remained elevated. In 3Q, of the 499,800 people em-

JPMorgan Australia Ltd., Sydney
Helen Kevans (61-2) 9220-3250
helen.e.kevans@jpmorgan.com

ployed part-time, 24% preferred to work more hours. The good news is that the Kiwi unemployment rate is, on our forecast, close to peaking, with the key rate expected to top out at 7.3% in the current quarter.

Loose labour market conditions mean that wage growth will have remained subdued in the final three months of last year. Private sector labour costs (as measured by the LCI) will likely show a mere 0.3%q/q rise in 4Q, compared to 0.4% in the previous three months.

Data releases and forecasts

Week of February 1 - 5

Thu Feb 4 10:45am — **Visitor arrivals**

nsa

	Sep	Oct	Nov	Dec
Total (%m/m)	3.4	-0.7	-3.7	__

Thu Feb 4 10:45am — **Labor force survey**

sa

	1Q09	2Q09	3Q09	4Q09
Unemployment rate (%)	5.0	6.0	6.5	7.2
Employment (000, q/q)	-30	-8	-16	-8
Participation rate (%)	68.3	68.4	68.0	68.1

Review of past week's data

RBNZ cash rate announcement

No change delivered.

Building consents

sa

	Oct	Nov	Dec
%m/m	~~10.7~~ *13.2*	~~1.2~~ *0.1*	__ *-2.4*
%oya	~~27.5~~ *27.7*	~~21.3~~ *20.3*	__ *23.6*

Trade balance

nsa

	Oct	Nov	Dec
Trade balance (NZ$ mn)	~~-495~~ *-502*	~~-269~~ *-276*	~~-200~~ *2*

JPMorgan Chase Bank, New York
Bruce Kasman (1-212) 834-5515
bruce.c.kasman@jpmorgan.com
David Hensley (1-212) 834-5516
david.hensley@jpmorgan.com

Global Essay

- **Uneven healing from deep recession increases risks that US and Western European policies undermine the recovery's vitality**
- **Growth indicators stay strong and dependent on goods-producing sectors**
- **Euro area and Japanese data deliver upside surprises**
- **Central banks send disparate signals amid generalized increase in confidence on growth**

This little piggy went to market

Despite expectations for a robust expansion in economic activity in 2010, the recovery from a deep global downturn will be uneven and produce political tensions in the major industrial economies. A central risk is that policies designed to ease social pain and fill budget holes produce regulatory and tax changes that damage medium-term growth prospects. There is also a near-term risk that policy uncertainty weighs on sentiment and tempers the shift away from retrenchment now under way. Recent developments have seen these policy uncertainties rise in both the US and Western Europe.

In Europe, a credibility shortfall is intensifying concerns about the difficult fiscal adjustments ahead. Part of this shortfall concerns the reliability of the fiscal data. This was particularly evident in Greece last quarter when the new government revised up the estimate of the 2009 deficit from 6% of GDP to 12.7% of GDP. Last week, Portugal revised up its estimate of last year's deficit from 8% of GDP to 9.3%, and Spain revised up its estimate from 9.5% to 11.4%. Given the scale of the fiscal adjustments needed, these revisions make the journey ahead all the more difficult.

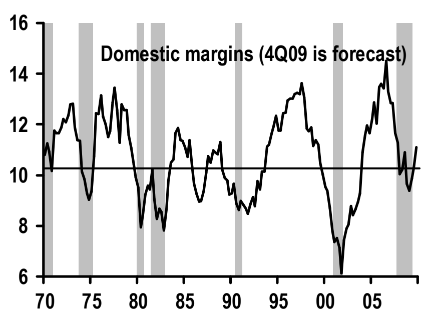
Against this backdrop, concerns regarding the political commitment to deficit reduction are understandable. For Greece, where the fiscal deficit has averaged 7.7% of GDP since 1980, investors are doubting whether the government is committed to making the hard decisions needed to stabilize the debt to GDP ratio. In Portugal, the 2010 budget contains only a modest fiscal tightening, which is somewhat surprising in the current environment in which financial market pressure is intense. The lack of a more assertive response in Portugal suggests that there are limits on what the minority government can achieve.

In general, governments are likely to make hard decisions under pressure. With Euro area politicians and policymakers saying that Greece cannot be ejected from the Euro area, that it will not be allowed to default, and that the IMF will not be invited to provide outside discipline, it is far from clear whether regional pressure can produce the desired result. The region's poor track record on ensuring fiscal discipline would risk turning any temporary support packages into a de facto fiscal transfer. At present, the risk of a European fiscal fudge looks more likely than a Greek restructuring. This would be a damaging outcome for a region in which sustained fiscal discipline by smaller countries is a key requirement.

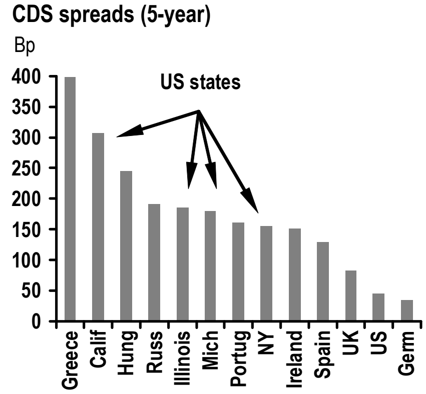
In the US, federal fiscal discipline is not the order of the day. This year's deficit is likely to remain close to $1.4 trillion (9.4% of GDP) and could move higher if current proposals to support job creation are implemented. What's more, the Obama administration's spending freeze for 2011 will be easily met by the roll-off in the ARRA stimulus plan. To be sure, there is a growing recognition of fiscal constraints. However, the shift in administration rhetoric points to an increased willingness to risk the vitality of the recovery for social objectives. The main support for economic growth in the coming quarters should come from profit-rich corporates that are poised to expand as margins move up toward their 40-year peak. The potential for actions that sap this

US non-financial domestic profit margins

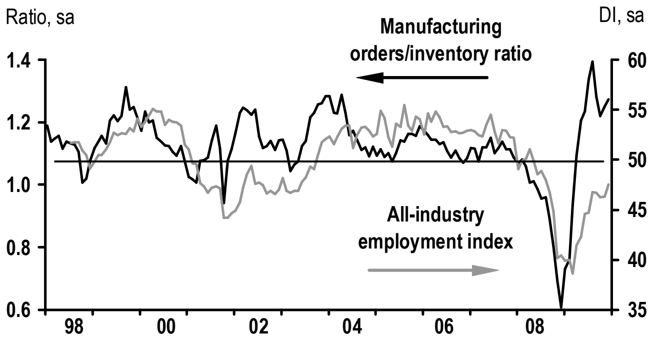
Adjusted pretax profits as a share of corporate GDP



CDS spreads (5-year)



Global PMI indicators



strength to deal with persistently high unemployment and budget deficits is a risk that is weighing on markets and possibly business decisions.

Global growth remains firm and uneven

The global expansion gained momentum into year-end, with global GDP rising at an estimated 3.7% ar in 4Q, more than a point above our estimate of trend. The challenge that lies ahead is to broaden and strengthen the foundation that has been established.

To date, the recovery has depended heavily on the manufacturing sector, which delivered record 10% annualized output gains in 2H09, boosting GDP growth by an estimated 2%-pts. The factory boom still has room to run. Manufacturers boosted output as companies moved to trim the rate of inventory liquidation around the middle of last year. Along with Asia, the US is at the leading edge of the inventory shift, as seen in last week's US GDP report. Yet our metrics indicate that global inventories were still contracting at year-end. Combined with growth in final sales, this means inventory/sales ratios are still falling fast. Thus, we look for further robust gains in global manufacturing output in 1H10 (7% annualized). This expectation has been bolstered by the latest round of IP and export reports out of Asia, most of which were blockbusters. Likewise, we look for yet another elevated reading in this week's global manufacturing PMI survey for January.

By contrast, activity outside of the industrial sector is improving slowly. This is seen most clearly in the production index of our global services PMI, which stands at a relatively subdued level of 52.1 and at a record low in relation to its manufacturing counterpart. This survey captures final demand and thereby understates inventory dynamics in the nonmanufacturing sector, so it is not necessarily signaling downside risk to growth. But it is a signal that the expansion remains narrowly based at this juncture (see "Global PMI not capturing full strength of economic recovery" in this *GDW*). A move up in the services PMI in coming months would confirm that the expansion is broadening.

A related requirement for self-sustaining growth is that the business sector resumes hiring. Businesses have made a substantial adjustment in recent months, pulling back from across-the-board retrenchment to broad stability in capex, inventories, and employment. But labour income growth is not yet sufficiently strong to support consumer spending growth in the major economies absent policy lifts. Following positive labour market reports last week from Germany, Japan, and Brazil, the focus shifts this week to the US. After a setback in December, we look for a modest gain of 20,000 nonfarm jobs in the January payroll report. We expect private sector job gains to climb above 100,000 per month in the US in the coming months.

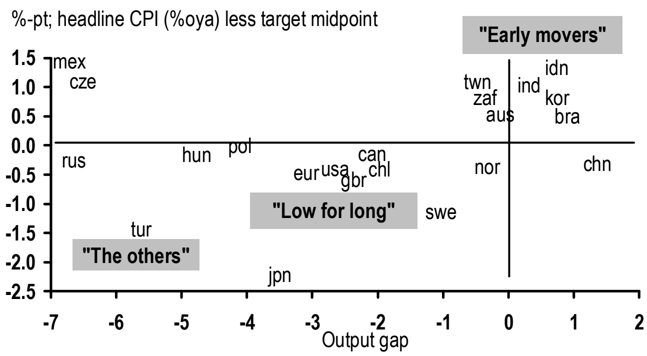
Data respite for the Euro area and Japan

We have received a steady stream of disappointing economic reports from the Euro area in recent weeks, casting downside risk on our view that the region will grow at an above-trend 2.5% pace this year. Last week's news was more upbeat. There was a large upward revision to German manufacturing orders in November; French consumption closed the quarter on a very strong note; and the German labour market continued to stabilize. Also important is the ongoing improvement in sentiment indicators. The Euro area composite sentiment indicator is now only 5pts (0.5 standard deviation) below its long-run average, suggesting that the economy's momentum may build after a sluggish start to the recovery. There also are signs of an improvement in the credit environment. Last week's M3/credit report and the ECB Bank Lending Survey suggested that the drag from tighter lending conditions has eased substantially at the margin and that bank credit is flowing.

Data from Japan also had a more upbeat tone. On Friday, we raised our 4Q GDP growth estimate to 3% from 2.5% in response to the strength of capital goods shipments. December export volume also advanced strongly, as did IP, with manufacturers anticipating additional output increases in the current quarter. The labour market also continues to firm. That said, the latest reports suggest that consumer spending contracted in December for a second month in a row. Both consumption and public works are likely to come under pressure in coming months due to the loss of fiscal stimulus. Moreover, business surveys are sending a message of subdued economic activity apart from the large, export-oriented manufacturers.

JPMorgan Chase Bank, New York
Bruce Kasman (1-212) 834-5515
bruce.c.kasman@jpmorgan.com
David Hensley (1-212) 834-5516
david.hensley@jpmorgan.com

Policy rate fundamentals as of 4Q10 (J.P. Morgan fcst)



Central banks are dropping wall of worry

The latest message from the central banks is that they are becoming more comfortable with the global expansion. At the same time, the recession has left a fragmented macroeconomic backdrop in its wake, resulting in a disparate range of policy signals.

In last week's policy statement, the FOMC remained firmly committed to a "low-for-long" policy in response to substantial resource slack even as it acknowledged economic activity is strengthening. Moreover, ongoing financial market improvements are keeping the Fed on track to wind down several of its extraordinary liquidity-providing measures. Not surprisingly, the Bank of Japan also stayed on hold last week on the heels of extending its QE program in December. However, the Bank appears to be particularly sensitive to further strengthening of the yen and its impact on deflation and business sentiment. If our FX call for a move down in USD/JPY to 82 by midyear is right, this would trigger further QE measures.

At this week's Bank of England monetary policy meeting, we look for the MPC to vote against further gilt purchases, with an inflation report in two weeks that points toward a modest tightening in policy later in the year. Last week's disappointing 4Q09 GDP report in the UK, however, is challenging our call for the BoE to hike in 3Q10. By contrast, the strong economic activity and inflation data out of Australia will lead to a fourth 25bp hike at this week's RBA meeting.

In the EM, the range of macroeconomic backdrops is the largest, and so also are the policy signals. Throughout much of CEE, large negative output gaps and moderate rates of inflation are keeping central banks in easing modes. The National Bank of Hungary eased 25bp last week and considered easing 50bp. We maintain the NBH will ease another 50bp by the end of this quarter. We also expect a 25bp cut in Romania. The National Bank of Poland stayed on hold last week and maintained its more neutral stance, while the Central Bank of Russia is noting the potential for upside inflation risks despite considerable economic slack.

In Latin America, Mexico stands out with the most underlying disinflationary pressure. Despite a sharp tax-induced jump in inflation, Banxico last week stressed in its inflation report that it would fade the direct inflationary impact of one-off price increases. By contrast, the COPOM in Brazil left rates on hold last week but left the door open for a March rate hike in response to firming resource utilization. Indeed, both actual and expected inflation are now above the COPOM's target.

EM Asia is already running monetary policy that is arguably too loose given its cyclical position. It is thus not surprising to see central banks in the region broadly moving toward tightening policy. Last week, the Reserve Bank of India joined the PBoC in tightening. The RBI cited robust growth and creeping core inflation in raising the reserve requirement 75bp in two stages. Consistent with the shift in stance, the central bank raised both its GDP and inflation projections. It also hinted at future rate hikes once the reserve requirement increases normalized liquidity conditions. The BSP in the Philippines left its main policy rate on hold but did raise its discount rate, and Bank Negara Malaysia also stayed on hold but did appear more confident on growth.

JPMorgan Securities Ltd., London
Jan Loeys (44-20) 7325-5473
jan.loeys@jpmorgan.com
John Normand (44-20) 7325-5222
john.normand@jpmorgan.com

J.P.Morgan

JPMorgan View - Global Markets

Only a correction, but it is not over; going short risk

- **Asset allocation:** Go tactically short risky markets on a combination of mixed economic data, rising fiscal policy risk, overweight positions, and negative momentum in flows.
- **Economics:** We downgrade the risk bias on our growth forecasts from upside to neutral. Weakness comes from US jobs and housing, and EU and Japanese domestic demand.
- **Fixed income:** Stay short duration. It is too early to jump back into the intra-EMU convergence trade.
- **Equities:** Position squaring benefits underowned sectors—Financials and Japan—but hurts crowded positions—commodity and cyclical sectors, EM.
- **Credit:** Move to a tactical short in US and EU HG credit spreads.
- **FX:** We lower our EUR/USD forecast to 1.48 in June.
- **Alternatives:** Take profits on short crude oil position.

Riskier asset classes—equities, credit, commodities, and EM—are continuing to **slide down in an orderly fashion** as market participants take profits on mixed economic news and rising policy risks. Bonds are up slightly.

We consider the recent sell-off to be **largely a correction in a medium-term bull market in risky assets**, but nevertheless a correction that is **probably not over** and could easily last another month. We thus **retain bullish medium-term forecasts for all risky assets, and bearish ones for government bonds, while advising a tactical short on the riskier asset classes.** In our *GMOS* model portfolio, we reverse our long equities versus bonds position.

The medium-term case for risky assets is based on **a solid global economic recovery and on good value**, especially in equities. Our forecasts continue to project a 3.5% growth pace for the world economy this year, driven by strong corporate profits, a massive inventory cycle, and supportive asset markets and economic policies. With cash continuing to yield almost no return and government bonds backing up gently, investors will likely be forced to move further into equities and better-yielding corporate and EM debt markets.

Forecasts are not guarantees, though. Positioning on near-term data flow, risk biases, momentum, and positions—unappealing as it feels at times—has been a safer and more profitable strategy than sticking to medium-term forecasts.

Our near-term bearishness is driven by a **series of minor challenges, if not pinpricks** to the outlook, none of which are decisive, but in combination are exerting enough pressure to induce position squaring by market participants, including us. We focus on four such challenges: (1) activity data are coming in modestly weaker than hoped, and our economists have thus downgraded the risk bias on their growth forecasts from upside to neutral; (2) the risk of fiscal and regulatory policy errors has risen; (3) investors started the year heavily overweight equities and credit; and (4) the momentum in flows has turned negative. We comment briefly on each.

Economic activity data for the world as a whole remain broadly consistent with our forecasts for this year, but there are a number of disappointments that force us to **fade upside risks, without yet pushing us to signal downside growth risks**. Most prominent among the weaker data points over the past month have been **US jobs** (payrolls and claims), **US housing**, and **domestic demand in Europe and Japan.** Global trade, manufacturing, and domestic demand in emerging economies are strong and have been beating our hopes.

At the most basic level, we have been long risky assets because we judged that market risk premia were larger than the risks being purchased. The two types of risks we have been monitoring most closely are **premature policy tightening and unfinished delevering**. We remain impressed and trustful of monetary policymaking. Tightening moves in China are measured and aimed at extending the growth cycle. This is not a real threat to risky markets. We are more fearful of premature fiscal tightening. The sell-off in **Greek** government bonds is by itself not a threat to Europe's economy. But the pressure on Greece and other European countries to protect against the new bond vigilantes by hiking taxes and cutting spending before the economy has recovered is a clear threat. In the **US**, the proposed new taxes and regulations on banks should not destroy the recovery, but risk being widened to profit-rich corporates on which we rely to fuel the expansion.

Weaker economic data and increased policy risks would not do great damage to risky markets if real money investors had not started the year with **near-record longs in equities and credit.** Hedge funds have been a lot more cautious, with the exposure to equities only halfway between the peak highs and lows of the past seven years. The momentum in fund flows into equities, EM, and HY has turned negative (see this week's and last week's *Flows & Liquidity*). Overall, active investors remain significantly long risk.

Fixed income

Bond markets were broadly unchanged last week despite the continued weakening of risky markets. Bond managers have been close to flat duration in Europe and were modestly short in the US, thus not inducing the same position squaring seen in equities and credit. **We stay short duration**, on the basis of value and the likelihood that falling demand from QE and bank portfolios creates an unfavourable supply demand imbalance for bonds.

All focus has been on the carnage in **Greek** government bonds, where the 10-year widened 1%-pt to over 4%-pts over Bunds, before settling at 3.7%-pts today. Rumours and counter-rumours unsettled investors. Our view is that there is sufficient interest in Europe to prevent a restructuring of Greek debt. But the path to redemption will be long and uneven. Help comes to those who help themselves: Potential help to Greece, from inside or outside Europe, will want the government to first show stronger commitment and action to reduce its deficit. Investors with overweight positions have less patience and a shorter time horizon than a democratic political system like Greece can meet, creating a risk presumption toward wider spreads before eventual tightening. It is too early to jump back into the intra-EMU convergence trade.

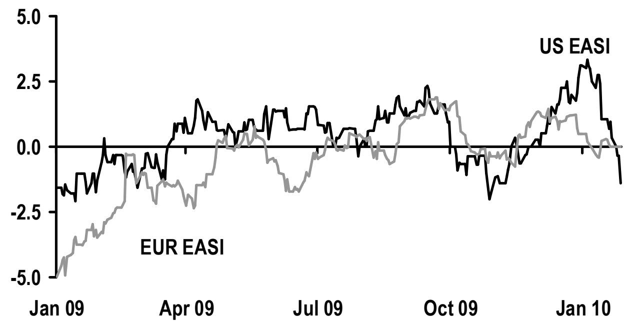
Equities

Equities were down for a third straight week as mixed economic data and uncertainty continue to dominate a strong earnings reporting season. The 4Q US EPS is on track to beat the bottom-up consensus at the beginning of the reporting season by close to 10%. Despite positive earnings news and a bullish medium-term view, we feel forced to **turn defensive near term** as position squaring is probably not over.

This **position squaring** benefits underowned sectors, such as Financials and Japan. It is negative for crowded trades, i.e., commodity and cyclical sectors and EM. Within EM, position squaring is negative for Russia and Mexico, the highest consensus overweights, and positive for Israel and Taiwan, the highest underweights.

Japan is also benefiting from strong foreign investor buying. Foreign investors have been buying Japanese equities for nine straight weeks at the strongest pace in three years. Buying of Japanese equities by foreign investors tends to correlate well with the relative performance of Japanese equities versus global equities. To the extent that these strong foreign inflows continue, Japanese equities should continue to outperform.

US and Europe Economic Activity Surprise Index



With equity markets in the red this month, does the January effect mean that investors should write off the rest of the year? As highlighted before, the answer is "no." The **January effect** has only worked in the past in the case of a positive January return. Based on S&P 500 data since 1945, a positive return in January was followed by a positive return for the remaining 11 months with a probability of 85%. However, a negative return in January was followed by a negative return for the remaining 11 months with a probability of only 45%.

Credit

Credit spreads continue to widen, especially in CDS indices. For cash bonds, most of the spread compression since the start of the year has been erased, with HG spreads back up to 2009 year-end levels. For the higher-spread sectors of EM and HY, spreads are now 20bp above 2009 year-end levels. With heightened uncertainty in the markets, we **turn tactically short in HG** credit spreads but retain a medium-term bullish view. The fiscal challenges for Greece and other small European countries renewed fears of a potential sovereign credit event and contagion within the Euro area. The latest data are showing an increase in iTraxx SovX positions, suggesting that macro hedge funds are increasing their shorts in Western European sovereign risk.

Given the lack of clarity on future financial industry regulations, we expect **HG bond spreads to rise modestly in the near term**. Both retail and institutional investors are slowing their purchases of HG bonds. Over the medium term, HG bond spreads remain attractive relative to historical levels

JPMorgan Securities Ltd., London
Jan Loeys (44-20) 7325-5473
jan.loeys@jpmorgan.com
John Normand (44-20) 7325-5222
john.normand@jpmorgan.com

and are supported by improving credit fundamentals, as evident in reported 4Q earnings. By the end of this year, HG spreads are expected to tighten to the unchanged target of 125bp versus the current spread of 154bp.

Despite the spread widening in **HY**, high yield bonds have continued to outperform equities year-to-date. The high coupons and large spread tightening potential led us to overweight HY bonds versus equities since mid-2009. This trade has done very well since then, and the high coupons should continue to provide a cushion during market sell-offs while default risks fall.

Foreign exchange

We were too optimistic on risky markets and too complacent on Euro area sovereign risk when we issued the *2010 Outlook* in November. The first half of 2010 was supposed to be ideal for cyclical assets through low/stable rates and strong global growth. Sovereign risk has always been on the radar, but more for the UK and US than for peripheral Europe. We assumed financing small states was manageable, that deep recessions in those countries was inevitable, but that the spillover to the region would be minimal if only small countries contracted. Clearly we were wrong. Accordingly, we **mark down the EUR/USD peak to 1.48 in June**, which assumes Greece secures cheaper liquidity and the risk premium built into the euro is reversed. There is no change to the EUR/GBP forecast, but obviously altering the EUR/USD profile lowers GBP/USD as well. We also mark down the commodity currencies by roughly 2%-4% through the end of 2010 to reflect last month’s deleveraging. There is no change to the view that these currencies will rally back as the conditions we set out earlier on Greece, China, the US, and positioning are borne out.

Alternatives

Commodities finished last week 2% lower, as financial markets reacted negatively to the crisis in Greece and the effect of policy tightening in China. Industrial metals lost the most with lead and zinc down around 9%. We stay with a positive medium-term outlook for the base metals sector as re-stocking in the manufacturing sector will be a positive force in coming quarters. We continue to favour copper. We advise **keeping risk low**, however, due to the still turbulent near-term outlook for risky markets.

Ten-year Government bond yields

	Current	Mar 10	Jun 10	Sep 10	Dec 10
United States	3.62	3.90	4.10	4.25	4.50
Euro area	3.20	3.30	3.35	3.50	3.65
United Kingdom	3.91	3.90	4.10	4.25	4.50
Japan	1.32	1.30	1.40	1.50	1.55
GBI-EM	7.21				7.90

Credit markets

	Current	YTD Return
US high grade (bp over UST)	162	1.7%
Euro high grade (bp over Euro gov)	154	0.7%
USD high yield (bp vs. UST)	669	1.4%
Euro high yield (bp over Euro gov)	653	3.3%
EMBIG (bp vs. UST)	320	0.3%
EM Corporates (bp vs. UST)	353	1.2%

Foreign exchange

	Current	Mar 10	Jun 10	Sep 10	Dec 10
EUR/USD	1.39	1.45	1.48	1.45	1.40
USD/JPY	90.5	85	82	85	89
GBP/USD	1.60	1.54	1.59	1.58	1.56

Commodities - quarterly average

	Current	10Q1	10Q2	10Q3	10Q4
WTI ($/bbl)	73	72	76	80	85
Gold ($/oz)	1082	1250	1400	1300	1200
Copper($/m ton)	6876	7350	8000	6800	6250
Corn ($/Bu)	3.59	3.85	4.05	3.95	3.90

Source: J.P. Morgan, Bloomberg, Datastream

Crude oil is now hovering around $74. Even though market conditions have worsened, we believe that oil fundamentals will keep improving in coming quarters. We believe that world oil balances are tightening faster than consensus. While there is still data uncertainty regarding both the strength of Chinese demand and estimates of floating storage, recent data show that onshore stocks are drawing sharply. The oil inventory surplus should erode further in 1Q10, increasing the risks of a crude oil price spike and a move into backwardation in 2Q. We **take profits on our short in crude oil, but wait before reversing to a long position**. Prices should remain in a range near term, but are likely near the bottom of the range now.

JPMorgan Chase Bank, New York
David Hensley (1-212) 834-5516
david.hensley@jpmorgan.com
Carlton Strong (1-212) 834-5612
carlton.m.strong@jpmorgan.com

Global Economic Outlook Summary

	Real GDP % over a year ago			Real GDP % over previous period, saar							Consumer prices % over a year ago			
	2009	2010	2011	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10	1Q11	4Q09	2Q10	4Q10	2Q11
The Americas														
United States	-2.4	3.5	3.1	2.2	5.7	3.0	4.0	4.0	3.5	2.5	1.5	2.8	1.4	0.9
Canada	-2.6	2.7	3.4	0.4	3.0	4.5	2.5	3.5	4.0	4.0	0.9	1.5	1.7	1.9
Latin America	-3.2	4.2	3.4	6.3	5.1	4.0	3.9	3.9	3.1	3.1	5.5	6.8	7.4	7.0
Argentina	-4.0	4.0	3.0	0.2	1.0	8.0	8.0	3.0	3.0	2.0	6.5	8.0	9.0	10.0
Brazil	0.1	6.2	4.0	5.1	7.7	6.3	5.0	5.1	4.0	3.8	4.2	4.5	4.7	4.7
Chile	-1.7	5.0	5.0	4.6	8.0	6.0	5.0	3.0	4.0	6.0	-1.8	2.0	2.6	2.9
Colombia	0.3	3.0	4.1	0.9	3.7	3.0	3.5	3.7	4.0	4.2	2.4	3.9	4.3	3.9
Ecuador	-1.0	2.0	3.0	-2.0	0.0	3.0	3.5	4.0	4.5	3.0	3.8	3.8	4.2	3.8
Mexico	-7.0	3.5	2.5	12.2	4.0	2.3	3.4	1.4	2.2	2.2	4.6	4.5	5.1	4.5
Peru	1.0	5.5	6.0	9.3	12.9	3.0	3.5	4.0	5.0	6.0	0.4	1.5	2.0	2.2
Venezuela	-2.9	-1.5	2.5	-7.8	-0.5	-4.0	-5.0	15.0	1.0	1.5	28.1	41.4	43.2	39.1
Asia/Pacific														
Japan	**-5.2 ↑**	**2.0 ↑**	1.9	1.3	**3.0 ↑**	1.8	1.5	2.0	2.2	1.8	-2.0	**-1.9 ↑**	-1.2	**-0.1 ↑**
Australia	0.9	3.0	3.5	0.8	2.5	3.3	3.8	4.2	3.9	3.1	2.2	2.6	2.6	3.0
New Zealand	-1.6	2.5	3.2	0.8	2.2	3.6	3.0	2.9	2.6	2.9	2.0	1.8	1.8	2.3
Asia ex Japan	4.3	7.7	7.2	10.0	**5.9 ↓**	7.6	7.2	7.2	6.8	6.9	2.7	4.5	3.8	3.2
China	8.6	10.0	9.4	10.3	10.0	9.8	9.4	9.5	9.0	9.1	0.7	3.2	3.1	2.4
Hong Kong	-3.3	4.5	4.1	1.6	5.0	4.2	4.0	3.8	3.5	4.2	1.4	2.4	2.3	1.9
India	6.8	7.8	8.3	11.6	1.8	10.4	8.1	7.0	8.7	7.9	12.2	11.9	6.2	5.5
Indonesia	4.4	5.5	6.0	5.3	5.0	6.0	4.0	8.5	5.0	6.0	2.6	5.3	6.3	4.9
Korea	0.2	**5.3 ↓**	4.1	13.6	**0.7 ↓**	3.6	4.2	4.2	3.5	4.0	2.4	3.1	3.6	3.4
Malaysia	-2.4	5.0	5.1	9.4	4.5	1.6	5.3	5.7	5.3	4.9	-0.5	1.7	2.4	2.4
Philippines	**0.9 ↓**	5.0	4.3	**3.1 ↓**	**3.5 ↓**	6.0	5.0	3.5	4.0	4.5	3.0	4.1	4.7	4.9
Singapore	-2.2	6.5	5.0	14.2	-6.8	11.2	7.0	4.9	4.9	4.1	-0.4	3.4	2.9	2.1
Taiwan	**-2.9 ↑**	**6.3 ↑**	4.8	8.3	**8.0 ↑**	**4.2 ↑**	5.0	4.6	**3.8 ↑**	4.8	**-1.2 ↑**	0.9	2.0	1.8
Thailand	-2.9	5.5	5.0	5.5	5.3	4.9	5.7	5.3	5.3	4.1	1.9	5.5	4.4	3.0
Africa/Middle East														
Israel	0.0	3.0	4.5	2.9	2.5	3.0	3.5	3.5	4.0	4.0	3.6	3.4	3.3	3.1
South Africa	-1.9	3.0	3.5	0.9	3.4	4.1	3.8	3.6	4.1	3.3	6.0	4.5	5.4	5.8
Europe														
Euro area	-3.9	1.9	2.1	1.7	1.2	2.5	2.5	2.5	2.0	2.0	0.4	1.3	1.3	0.8
Germany	-4.9	2.0	2.2	2.9	0.0	2.5	2.5	2.5	2.5	2.0	0.5	0.9	1.3	1.3
France	-2.2	2.2	2.2	1.0	2.5	2.5	2.5	2.5	2.5	2.0	0.6	1.4	0.9	0.9
Italy	-4.7	1.7	1.7	2.3	1.5	2.0	2.0	2.0	2.0	1.5	0.7	1.1	1.1	1.1
Norway	-1.1	2.8	2.8	2.0	3.0	3.0	3.0	3.0	2.8	2.8	1.4	1.9	1.2	1.2
Sweden	-4.4	2.4	3.0	0.7	1.0	3.5	3.5	3.0	3.0	3.0	-0.4	1.1	0.9	1.8
Switzerland	-1.5	2.2	2.8	1.2	2.3	2.5	2.8	3.0	3.0	2.8	-0.1	0.9	0.7	0.8
United Kingdom	-4.8	**1.4 ↓**	3.1	-0.6	**0.4 ↓**	2.0	2.5	2.8	3.5	2.8	**2.1 ↓**	**2.2 ↓**	1.4	1.9
Emerging Europe	-5.4	**4.2 ↑**	4.8	3.9	**5.7 ↑**	**4.0 ↑**	**3.5 ↑**	3.3	**3.8 ↑**	4.4	**6.1 ↓**	5.1	**5.2 ↑**	5.0
Bulgaria	-5.8	-1.5	4.5	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	-4.0	2.5	4.0	3.3	**3.5 ↓**	**3.0 ↑**	**2.5 ↑**	2.0	**2.0 ↓**	3.5	**0.4 ↓**	**1.4 ↓**	3.2	3.0
Hungary	-6.5	1.0	4.0	-6.9	2.5	3.0	3.0	3.0	3.0	4.0	5.2	3.8	2.8	2.8
Poland	1.6	3.5	4.2	2.0	4.0	3.5	3.5	3.0	3.0	4.0	3.3	2.0	2.5	2.5
Romania	-6.0	2.0	5.0	...	...	...	...	...	...	...	4.7	5.5	6.5	6.2
Russia	-8.5	**5.5 ↑**	5.0	7.9	**8.0 ↑**	**5.0 ↑**	4.0	4.0	**5.0 ↑**	5.0	**9.2 ↓**	**6.7 ↑**	**7.2 ↑**	6.9
Turkey	-5.7	5.0	5.5	...	...	...	...	...	...	...	5.5	6.7	5.1	4.9
Global	-2.5	3.3	3.3	2.9	3.8	**3.4 ↑**	3.5	3.6	3.4	3.0	1.3	2.2	1.8	1.6
Developed markets	-3.4	2.6	2.6	1.6	**3.3 ↓**	2.7	3.0	3.1	2.9	2.3	0.6	1.5	1.0	**0.9 ↑**
Emerging markets	0.7	6.1	5.7	7.8	**5.5 ↓**	**6.0 ↑**	5.6	5.6	5.3	5.5	4.0	5.1	**4.9 ↑**	4.3

J.P. Morgan Chase Bank, New York
David Hensley (1-212) 834-5516
david.hensley@jpmorgan.com
Sam Conway (1-212) 834-9123
samuel.e.conway@jpmorgan.com

Global Central Bank Watch

	Official interest rate	Current	Change from Aug '07 (bp)	Last change	Next meeting	Forecast next change	Mar 10	Jun 10	Sep 10	Dec 10	Jun 11
Global	GDP-weighted average	1.30	-337				1.31	1.36	1.45	1.53	2.00
excluding US	GDP-weighted average	1.85	-251				1.87	1.94	2.08	2.19	2.71
Developed	GDP-weighted average	0.50	-361				0.51	0.52	0.56	0.61	1.05
Emerging	GDP-weighted average	4.48	-239				4.50	4.71	5.01	5.23	5.77
Latin America	GDP-weighted average	5.72	-321				5.91	6.41	7.10	7.36	8.32
CEEMEA	GDP-weighted average	4.52	-234				4.35	4.23	4.53	4.79	5.23
EM Asia	GDP-weighted average	4.00	-210				4.04	4.25	4.42	4.60	5.02
The Americas	GDP-weighted average	0.75	-484				0.77	0.82	0.93	0.99	1.44
United States	Federal funds rate	0.125	-512.5	16 Dec 08 (-87.5bp)	16 Mar 10	2Q 11 (+25bp)	0.125	0.125	0.125	0.125	0.50
Canada	Overnight funding rate	0.25	-400	21 Apr 09 (-25bp)	2 Mar 10	20 Jul 10 (+25bp)	0.25	0.25	0.75	1.25	1.75
Brazil	SELIC overnight rate	8.75	-325	22 Jul 09 (-50bp)	17 Mar 10	Mar 10 (+50bp)	9.25	10.25	11.25	11.75	11.75
Mexico	Repo rate	4.50	-270	17 Jul 09 (-25bp)	19 Feb 10	Jun 10 (+25bp)	4.50	4.75	5.25	5.25	6.75
Chile	Discount rate	0.50	-450	9 Jul 09 (-25bp)	11 Feb 10	3Q 10 (+25bp)	0.50	0.50	1.25	2.00	3.50
Colombia	Repo rate	3.50	-550	23 Nov 09 (-50bp)	26 Feb 10	1Q 11 (+50bp)	3.50	3.50	3.50	3.50	5.50
Peru	Reference rate	1.25	-325	6 Aug 09 (-75bp)	4 Feb 10	Jul 10 (+25bp)	1.25	1.25	2.00	2.75	4.25
Europe/Africa	GDP-weighted average	1.33	-320				1.31	1.30	1.38	1.46	2.12
Euro area	Refi rate	1.00	-300	7 May 09 (-25bp)	4 Feb 10	1Q 11 (+25bp)	1.00	1.00	1.00	1.00	1.75
United Kingdom	Repo rate	0.50	-500	5 Mar 09 (-50bp)	4 Feb 10	Aug 10 (+25bp)	0.50	0.50	0.75	1.00	1.50
Sweden	Repo rate	0.25	-325	2 Jul 09 (-25bp)	10 Feb 10	1Q 11 (+25bp)	0.25	0.25	0.25	0.25	0.75
Norway	Deposit rate	1.75	-275	16 Dec 09 (+25bp)	3 Feb 10	24 Mar 10 (+25bp)	2.00	2.25	2.50	2.50	3.25
Czech Republic	2-week repo rate	1.00	-175	16 Dec 09 (-25bp)	4 Feb 10	3Q 10 (+25bp)	1.00	1.00	1.50	2.25	3.00
Hungary	2-week deposit rate	**6.00**	-175	**25 Jan 10 (-25bp)**	22 Feb 10	**22 Feb 10 (-25bp)**	5.50	5.50	5.50	5.50	5.50
Israel	Base rate	1.25	-275	28 Dec 09 (+25bp)	22 Feb 10	**22 Feb 10 (+25bp)**	**1.75**	**2.50**	**3.50**	4.00	4.00
Poland	7-day intervention rate	3.50	-100	24 Jun 09 (-25bp)	24 Feb 10	3Q 10 (+25bp)	3.50	3.50	3.75	4.00	5.00
Romania	Base rate	7.50	50	5 Jan 10 (-50bp)	3 Feb 10	3 Feb 10 (-25bp)	7.00	6.50	6.00	6.00	7.00
Russia	1-week deposit rate	4.00	100	28 Dec 09 (-25bp)	Feb 10	Feb 10 (-25bp)	3.50	3.00	3.00	3.00	3.50
South Africa	Repo rate	7.00	-250	13 Aug 09 (-50bp)	25 Mar 10	4Q 10 (+50bp)	7.00	7.00	7.00	7.50	8.50
Switzerland	3-month Swiss Libor	0.25	-225	12 Mar 09 (-25bp)	Mar 10	Sep 10 (+25bp)	0.25	0.25	0.50	0.75	1.25
Turkey	Overnight borrowing rate	6.50	-1100	19 Nov 09 (-25bp)	16 Feb 10	3Q 10 (+50bp)	6.50	6.50	7.50	8.00	7.50
Asia/Pacific	GDP-weighted average	2.09	-135				2.12	2.25	2.35	2.45	2.67
Australia	Cash rate	3.75	-250	1 Dec 09 (+25bp)	2 Feb 10	2 Feb 10 (+25bp)	4.00	4.50	4.75	5.00	5.50
New Zealand	Cash rate	2.50	-550	30 Apr 09 (-50bp)	10 Mar 10	**29 Apr 10 (+25bp)**	**2.50**	**3.00**	3.50	4.00	4.75
Japan	Overnight call rate	0.10	-43	19 Dec 08 (-20bp)	17 Feb 10	4Q 11 (+15bp)	0.10	0.10	0.10	0.10	0.10
Hong Kong	Discount window base	0.50	-625	17 Dec 08 (-100bp)	17 Mar 10	2Q 11 (+25bp)	0.50	0.50	0.50	0.50	1.00
China	1-year working capital	5.31	-126	22 Dec 08 (-27bp)	1Q 10	2Q 10 (+27bp)	5.31	5.58	5.85	6.12	6.39
Korea	Base rate	2.00	-250	12 Feb 09 (-50bp)	11 Feb 10	Mar 10 (+25bp)	2.25	2.25	2.25	2.50	3.00
Indonesia	BI rate	6.50	-200	5 Aug 09 (-25bp)	4 Feb 10	4Q 11 (-25bp)	6.50	6.50	6.50	6.50	6.50
India	Repo rate	4.75	-300	21 Apr 09 (-25bp)	Apr 10	**Apr 10 (+25bp)**	**4.75**	5.25	5.50	5.50	6.50
Malaysia	Overnight policy rate	2.00	-150	24 Feb 09 (-50bp)	4 Mar 10	**13 May 10 (+25bp)**	2.00	**2.25**	**2.50**	2.50	3.00
Philippines	Reverse repo rate	4.00	-350	9 Jul 09 (-25bp)	11 Mar 10	2Q 10 (+25bp)	4.00	4.25	4.75	5.00	5.00
Thailand	1-day repo rate	1.25	-200	8 Apr 09 (-25bp)	10 Mar 10	**2 Jun 10 (+25bp)**	1.25	**1.50**	1.50	1.75	**2.25**
Taiwan	Official discount rate	1.25	-188	18 Feb 09 (-25bp)	1Q 10	4Q 10 (+12.5bp)	1.25	1.25	1.25	1.375	1.625

Bold denotes move since last GDW and forecast changes. Underline denotes policy meeting during upcoming week.

JPMorgan Australia Ltd., Sydney
Stephen Walters (61-2) 9220-1599
stephen.b.walters@jpmorgan.com

Economic forecasts - Australia

Australia: economic projections *percentage change over previous period, seasonally adjusted annual rates, ur*

				2009			2010				2011			
	2009	2010	2011	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Chain volume GDP	0.9	3.0	3.5	2.6	0.8	2.5	3.3	3.8	4.2	3.9	3.1	3.8	3.0	3.1
Private consumption	1.5	2.3	1.7	2.9	2.6	1.6	2.4	2.4	2.4	1.6	1.6	1.6	1.2	2.0
Construction investment	-0.7	3.9	5.5	-2.7	1.9	0.4	7.6	4.4	6.5	4.3	5.1	5.8	6.7	6.8
Equipment investment	-7.6	2.0	7.1	7.9	-15.5	-4.2	6.3	8.5	8.5	6.3	7.8	4.3	8.7	8.7
Public investment	0.9	11.6	13.6	10.7	27.1	7.7	7.1	10.6	15.4	10.4	12.3	14.3	16.5	19.0
Government consumption	2.3	3.5	3.1	4.0	2.8	2.5	3.9	4.1	3.9	3.8	1.9	3.8	3.8	0.4
Exports of goods & services	1.8	5.3	5.1	3.2	-8.7	14.8	5.1	8.2	3.2	7.4	4.1	4.1	4.1	8.2
Imports of goods & services	-8.5	8.2	5.5	2.8	25.2	-2.0	12.6	8.2	4.9	4.1	4.1	4.1	8.2	12.6
Contributions to GDP growth:														
Inventories	-1.1	-1.0	-0.1	0.8	3.2	-7.9	0.7	-0.1	0.0	-0.1	-0.2	0.1	-0.2	-0.1
Net trade	2.3	-0.6	-0.1	0.1	-6.3	3.2	-1.5	-0.1	-0.4	0.6	0.0	0.0	-0.9	-1.0
GDP deflator (%oya)	-0.3	0.8	2.4	0.7	-3.0	-3.3	-1.5	1.2	1.7	2.0	2.2	2.4	2.5	2.5
Consumer prices (%oya)	1.8	2.4	2.8	1.5	1.3	2.2	2.5	2.4	2.2	2.4	2.6	2.9	2.8	2.8
Producer prices (%oya)	-4.9	0.3	3.5	-6.4	-7.2	-4.7	-0.9	0.7	0.4	1.0	2.5	3.5	4.0	4.0
Trade balance (A$ bil, sa)	-4.4	-15.8	-17.3	-0.9	-4.8	-2.9	-3.8	-3.9	-4.2	-3.8	-3.9	-3.9	-4.5	-5.1
Current account (A$ bil, sa)	-67.0	-62.6	-67.3	-13.1	-16.2	-14.0	-15.3	-15.5	-16.0	-15.7	-15.9	-16.2	-17.1	-18.1
as % of GDP	-6.2	-4.8	-4.9	-4.2	-5.2	-4.5	-4.8	-4.8	-4.9	-4.7	-4.7	-4.7	-4.9	-5.1
3m eurodeposit rate (%)*	6.0	4.9	5.4	3.5	3.4	4.1	4.4	4.8	5.0	5.4	5.4	5.4	5.4	5.4
10-year bond yield (%)*	5.6	5.9	6.0	5.5	5.1	5.8	5.8	5.9	6.0	6.0	6.0	6.0	6.0	6.0
US$/A$*	0.75	0.98	0.92	0.82	0.88	0.91	0.94	1.00	0.99	0.98	0.98	0.95	0.90	0.85
Commonwealth budget (FY, A$ bil)	-27.0	-43.0	-29.0											
as % of GDP	-2.2	-3.3	-2.1											
Unemployment rate	5.6	5.7	4.9	5.7	5.8	5.5	5.7	5.8	5.6	5.4	5.3	5.0	4.8	4.5
Industrial production	-5.6	1.3	1.5	2.9	5.0	3.0	1.0	0.0	-1.0	-2.0	0.0	1.0	2.0	3.0

*All financial variables are period averages

Australia - summary of main macro views

- The Australian economy has powered out of the global downturn largely unscathed; it is one of the few economies to **avoid back-to-back falls in GDP**. Growth will accelerate this year and again 2011.
- B**usiness investment** will be broadly unchanged at elevated levels in the year to June now that firms have upgraded their spending plans. The longer term outlook has brightened significantly, with mining leading the way.
- On **housing**, with the expanded first home owners' grant now having expired and price caps on the basic grant in place, house price growth should cool, particularly at the low and middle-end of the price spectrum.
- The **consumer** has remained remarkably resilient in the absence of further fiscal support from the government. Consumer confidence has returned to pre-crisis highs even in the wake of the RBA's three rate hikes.
- **Export volumes** have held up owing mainly to firm demand from Asia, but the terms of trade has tumbled.This decline looks set to reverse, though, in 2010.
- The **RBA** is the only central bank in the G20 to have tightened monetary policy. We expect another 25bp rate hike this week and a cash rate of at least 5% by the end of the year.
- Having front-loaded the **policy support**, the government now is winding back the fiscal stimulus. Indeed, fiscal policy will be a drag on the economy in 2010, despite the looming federal election.

Economic forecasts - New Zealand

New Zealand: economic projections *percentage change over previous period, seas. adjusted annual rates, unless stated*

				2009			2010				2011			
	2009	2010	2011	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP (1995-96 prices)	-1.6	2.5	3.2	0.9	0.8	2.2	3.6	3.0	2.9	2.6	2.9	4.6	3.2	2.6
Private consumption	-0.9	0.8	0.6	1.5	3.0	0.2	0.4	0.8	0.2	0.6	0.7	0.5	0.9	0.6
Fixed Investment	-12.9	-1.6	3.9	-2.8	-6.0	-7.7	-2.0	3.7	3.0	4.3	2.2	4.1	6.0	7.4
Residential construction	-20.4	-3.7	4.3	-8.7	-18.6	-6.0	-2.0	2.0	3.2	6.0	3.2	4.8	6.0	4.0
Other fixed investment	-11.4	-1.3	3.9	-1.6	-3	-8.0	-2.0	4.0	3.0	4.0	2.0	4.0	6.0	8.0
Inventory change (NZ$ bil, saar)	-2.6	-0.6	0.0	-1.0	-0.7	-0.6	-0.3	-0.2	-0.1	0.1	0.0	0.0	0.0	0.0
Government spending	1.1	0.5	0.6	-5.8	1.5	0.9	0.8	0.8	0.8	0.8	0.4	0.8	0.0	0.2
Exports of goods & services	0.9	8.4	11.0	20.0	0.1	11.0	8.0	10.0	8.0	5.0	12.0	16.0	15.0	10.0
Imports of goods & services	-16.4	5.9	6.8	-9.3	2.7	7.0	8.0	9.0	6.0	7.0	5.0	6.5	12.0	4.0
Contributions to GDP growth:														
Domestic final sales	-5.2	0.2	1.3	0.8	-1.6	-0.8	-0.1	1.4	1.0	1.4	1.0	1.4	2.0	0.4
Inventories	-3.0	1.6	0.4	-8.6	3.2	1.8	3.7	1.2	1.2	1.8	-0.5	-0.1	0.0	0.0
Net trade	6.6	0.8	1.5	9.4	-0.8	1.2	0.0	0.3	0.7	-0.6	2.3	3.2	1.2	2.2
GDP deflator (%oya)	2.1	2.0	2.2	2.0	2.9	0.9	0.7	2.0	2.6	2.8	2.8	2.4	1.9	1.6
Consumer prices	2.1	2.3	2.4	2.3	5.3	-0.7	2.2	2.1	1.9	2.8	2.7	2.6	2.1	1.9
%oya	2.1	2.0	2.4	1.9	1.7	2.0	2.2	2.2	1.4	2.3	2.4	2.5	2.6	2.3
Trade balance (NZ$ bil, sa)	1.3	-6.3	-8.5	0.8	0.7	-1.1	-1.4	-1.5	-1.7	-1.7	-1.8	-2.0	-2.3	-2.4
Current account (NZ$ bil, sa)	-4.2	-9.8	-17.1	-0.4	0.3	-2.0	-1.2	-2.2	-2.5	-3.9	-4.2	-5.2	-4.3	-3.4
as % of GDP	-2.3	-6.8	-7.4	-0.9	0.8	-4.4	-4.7	-5.3	-8.2	-8.7	-8.8	-6.8	-7.1	-6.9
Yield on 90-day bank bill (%)*	3.0	2.9	3.3	2.8	2.8	2.8	3.0	3.1	2.8	2.8	3.0	3.1	3.4	3.6
10-year bond yield (%)*	5.5	5.9	6.0	5.7	5.7	5.9	6.0	6.0	5.7	5.8	6.0	6.0	6.1	6.1
US$/NZ$*	0.64	0.75	0.70	0.60	0.68	0.73	0.73	0.76	0.75	0.74	0.72	0.70	0.70	0.68
Commonwealth budget (NZ$ bil)	-8.1	-8.3	-8.0											
as % of GDP	-4.5	-4.4	-4.0											
Unemployment rate	6.1	7.4	7.0	6.0	6.5	6.8	7.1	7.4	7.5	7.4	7.2	7.2	6.9	6.7

*All financial variables are period averages

New Zealand - summary of main macro views

- The **New Zealand economy expanded a mere 0.2%q/q in 3Q**, the same rate as in the previous three months. The third-quarter result marked the second straight quarter of expansion following five quarters of GDP declines.
- **Business confidence** has improved markedly. This mainly owes to continued improvement in economic conditions in Australia and New Zealand's other major trading partners in Asia.
- Even though firms are becoming more upbeat, **investment** will remain a drag on GDP growth this year; this, of course, has negative implications for the employment outlook.
- Rising **unemployment** and soft wage growth will continue to squeeze households' incomes, curbing the recovery in private consumption.
- **The RBNZ will begin tightening policy in April.** With tighter monetary conditions doing some of the heavy lifting for the RBNZ, we expect the first rate hike will be "only" 25bp.
- **Inflation** fell in the final three months of 2009, with headline CPI slipping 0.2%q/q. Medium term inflation pressures are, however, a concern, given diminishing excess capacity and firms' intentions to raise domestic prices.

JPMorgan Australia Ltd., Sydney
Stephen Walters (61-2) 9220-1599
stephen.b.walters@jpmorgan.com
Helen Kevans (61-2) 9220-3250
helen.e.kevans@jpmorgan.com

Australia and New Zealand economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
1 Feb **Australia:** ANZ job ads Jan House price index (11:30 am) 4Q 5.5 %q/q *Holiday New Zealand*	**2 Feb** **Australia:** RBA cash target (2:30 pm) Feb 25bp hike expected NAB bus. Confidence (11: 30 am) Dec 15 %bal, sa	**3 Feb** **Australia:** Trade balance (12:30 am) Dec -1500 A$ mn	**4 Feb** **Australia:** Building approvals (11:30 am) Dec -1.5%m/m, sa Retail sales (11:30am) Dec 0.2%m/m, sa Retail trade ex inflation 4Q 1.9%q/q **New Zealand:** Visitor arrivals (10:45 am) Dec Unemployment rate (10:45 am) 4Q 7.2%, sa	**5 Feb**
8 Feb **New Zealand:** QV house price Jan	**9 Feb** **Australia:** NAB bus. Confidence (11: 30 am) Jan	**10 Feb** **Australia:** Westpac consumer confidence (10: 30 am) Feb Housing finance approvals Dec	**11 Feb** **Australia:** Unemployment rate (11:00 am) Jan **New Zealand:** Business NZ PMI Jan	**12 Feb** **New Zealand:** Retail sales (10:45 am) Dec
15 Feb	**16 Feb** **Australia:** Westpac leading index (11: 30 am) Dec **New Zealand:** PPI (10:45 am) 4Q	**17 Feb** **Australia:** Westpac leading index (11: 30 am) Dec	**18 Feb**	**19 Feb** **New Zealand:** Credit card spending (2:00 pm) Jan
22 Feb **Australia:** New motor vehicle sales (10: 30 am) Jan	**23 Feb**	**24 Feb** **Australia:** Wage cost index (10:30 am) 4Q	**25 Feb** **Australia:** Pvt. capital exp. (10:30 am) 4Q Construction work done (10:30 am) 4Q **New Zealand:** NBNZ business confidence (2: 00 pm) Feb	**26 Feb** **Australia:** Pvt. Sector credit (11:30 am) Jan **New Zealand:** Building permits (10:45 am) Jan Trade balance (10:45 am) Jan

Global Data Diary

Week / Weekend	Monday	Tuesday	Wednesday	Thursday	Friday
1 - 5 February	**1 February**	**2 February**	**3 February**	**4 February**	**5 February**
United Kingdom • Halifax HPI (Jan)	**China:** PMI mfg (Jan) **Euro area:** PMI mfg final (Jan) **Japan:** Auto regs (Jan) **Korea** • CPI, Trade balance (Jan) **United Kingdom** • PMI mfg (Jan) **United States** • Construction spend (Dec) • ISM mfg (Jan) • Personal income (Dec)	**Australia** • RBA mtg (+25bp) **Brazil** • IP (Dec) **Germany:** Retail sales (Dec) **United States** • LV sales (Jan) • Pending home sales (Dec)	**Euro area** • PMI services final (Jan) • Retail sales (Dec) **Japan** • PMI services (Jan) **Norway** • Norges bank mtg (NC) **Romania** • NBR mtg (-25bp) **Turkey:** CPI (Jan) **United Kingdom** • PMI services (Jan) **United States** • ADP employment (Jan) • ISM nonmfg (Jan)	**Australia:** Retail (Dec) **Brazil:** Auto report **Czech Rep:** CNB mtg (NC) **Euro area:** ECB mtg (NC) **Germany:** Mfg orders (Dec) **Indonesia:** BI mtg (NC) **Peru:** BCRP mtg (NC) **United Kingdom** • New car regs (Jan) • BoE mtg (NC) **United States** • Factory orders (Dec) • Prod and costs prel (4Q)	**Brazil** • IPCA (Jan) **Canada** • Employment (Jan) **Germany** • IP (Dec) **Russia** • CPI (Dec) **Taiwan** • CPI (Jan) **United States** • Consumer credit (Dec) • Employment report (Jan)
8 - 12 February	**8 February**	**9 February**	**10 February**	**11 February**	**12 February**
China • Money supply (Jan) **Japan** • Cabinet Office private consumption (Dec)	**Japan** • Econ watch survey (Jan) **Taiwan** • Trade balance (Jan)	**Germany** • CPI final (Jan) **Mexico** • CPI (Jan) **United Kingdom** • Trade balance (Dec) **United States** • JOLTS (Dec) • Wholesale trade (Dec)	**China** • Trade balance (Jan) **Japan** • Machinery orders (Dec) **United States** • International trade (Dec)	**Chile** • BCCh mtg (NC) **Korea** • BoK mtg (NC) **Sweden** • Riksbank mtg (NC) **United States** • Business inventories (Dec) • Retail sales (Jan)	**Euro area** • GDP flash (4Q) • IP (Jan) **United States** • Consumer sent (Feb)

Economic Research, Emerging Markets Research and Global FX Strategy at JPMorgan

Global Economics

Chief Economist
Bruce Kasman, New York (1-212) 834-5515

Economics: Global

David Hensley (1-212) 834-5516
Joseph Lupton (1-212) 834-5735
Sam Conway (1-212) 834-9123

Data and Forecast Systems

Carlton Strong (1-212) 834-5612
Donald Martis (1-212) 834-5667
Silvana Dimino (1-212) 834-5684

Economics: United States and Canada

United States

Robert Mellman, New York (1-212) 834-5517
Michael Feroli (1-212) 834-5523
Abiel Reinhart (1-212) 834-5614

Canada

Sandy Batten, New York (1-212) 834-9645

Economics: Latin America

Brazil

Fabio Hashizume, São Paulo (55-11) 3048-3634
Julio Callegari, São Paulo (55-11) 3048-3369

Colombia, Ecuador, Venezuela, Peru

Luis Oganes, New York (1-212) 834-4326
Benjamin Ramsey, New York (1-212) 834-4308
Julio Callegari, São Paulo (55-11) 3048-3369

Argentina, Chile
Vladimir Werning, New York (1-212) 834-8144
Mexico
Alfredo Thorne, Mexico City (525) 540-9558

Economics: Asia/Pacific

Head of Japan
Masaaki Kanno, Tokyo (81-3) 6736-1166
Japan

Masamichi Adachi, Tokyo (81-3) 6736-1172
Miwako Nakamura, Tokyo (81-3) 6736-1167

Australia, New Zealand

Stephen Walters, Sydney (61-2) 9220 -1599
Helen Kevans (61-2) 9220-3250

Emerging Markets Research

Head of Emerging Markets Research
Joyce Chang (1-212) 834-4203
Head of Emerging Asia Economic Research
David G. Fernandez, Singapore, (65) 6882-2461

Greater China

Frank Gong, Hong Kong (852) 2800-7006
Qian Wang, Hong Kong (852) 2800-7009

Korea
Jiwon Lim, Seoul (822) 758-5509
James Lee, Seoul (822) 758-5512

India
Jahangir Aziz, Mumbai (91-22) 6639-8033
Gunjan Gulati, Mumbai (91-22) 6639-3125

Indonesia, Malaysia, Philippines, Singapore, Thailand

Matt Hildebrandt (65) 6882-2253

Emerging Markets FX Strategy
Claudio Piron (65) 6882-2218
Yen Ping Ho (65) 6882-2216

Economics: Europe/Africa

Head of Western Europe
David Mackie, London (44-20) 7325-5040

United Kingdom, Switzerland

Malcolm Barr, London (44-20) 7777-1080
Allan Monks, London (44-20) 7777-1188

Euro area

Marta Bastoni, London (44-20) 7325-9114
Greg Fuzesi London (44-20) 7777-4792

Scandinavia

Nicola Mai, London (44-20) 7777-3467

Czech Republic, Hungary, Poland, Slovakia

Nora Szentivanyi, London (44-20) 7777-3981
Miroslav Plohjar, London (44-20) 7325-0745

CEEMEA

Michael Marrese, New York (1-212) 834-4876
Eva Sanchez, New York (1-212) 834-8217

Turkey, Bulgaria, the Baltics

Yarkin Cebeci, Istanbul (90-212) 326-8590

Russia, Ukraine, Bulgaria, Kazakhstan

Nina Chebotareva, Moscow (7-095) 937-7321
Anatoliy Shal (7-495) 937-7321

Africa
Graham Stock (44-20) 7777-3430
Sonja Keller (27-11) 507-0376

Global FX Strategy

Global Head
John Normand (44-20) 7325-5222

Global FX Strategy, New York

Gabriel De Kock (1-212) 834-4254
Kenneth Landon (1-212) 834-2391
Arindam Sandilya (1-212) 834-2304

FX & Commodity Technical Strategy
Niall O'Connor (1-212) 834-5108

Global FX Strategy, London

Paul Meggyesi (44-20) 7859-6714
Kamal Sharma (44-20) 7777-1729
Talis Bauer (44-20) 7777-5276

Emerging Markets FX Strategy
Robert Beange (44-20) 7777-3246

Global FX Strategy: Asia

Tohru Sasaki (81-3) 5570-7717
Junya Tanase (81-3) 5570-7718

Commodity Strategy

Head of Commodites Research
Lawrence Eagles (1-212) 834-8107
Global Energy Strategy
Scott Speaker (1-212) 834-3878
Shikha Chaturvedi (1-212) 834-3245
Mark Gravener (1-212) 834-3089
Sung Yoo (1-212) 834-7045
Kristi Jones (1-212) 834-2835

Global Metals Strategy
Michael Jansen (44-20) 7325-5882

Agricultural Commodity Strategy
Lewis Hagedorn (1-312) 325-6409

Commodity Index Research
Jennie Byun (44-20) 7777-0070