Deflation vs. Inflation: The Battle Rages On

Fixed Income Strategy | Global
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RESEARCH

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US TIPS: We remain positive on longer maturity TIPS BE's for longer horizon investors. The recent narrowing in BE's provides an opportunity to re-add to long BE positions that we had recommended scaling back on last week.

European IL: We remain short Euro breakevens but see short term risk from oil prices and therefore prefer to sell inflation forward. We analyse cross-country breakeven spreads and recommend selling BTPei35 breakevens against OATei32. The real German government curve looks too flat in the 5-8 year sector compared to France.

JGBi: The rally in JGB inflation linkers has stalled since April. We believe further weakness should provide a selective buying opportunity.

EM IL: the only long duration left

Exposure to inflation-linked instruments remains important in our overall exposure in EM local debt markets. What we have seen in recent weeks is that exposure to real rates is now the best way to express a long duration view. This is because most central banks have now come close to the end of the easing cycle, which means there is little upside at this stage for a plain long duration position. On this basis, we continue to hold recommendations of a long Turkey Feb. 2012 CPI-linker bond and a long Brazil NTN-B 2015 IPCA-linked bond in our portfolio.

Commodities: A very fast increase in oil prices in the coming months could put the embryonic economic recovery at risk. How high could oil go near-term? In OECD economies, our economists believe that $70-80/bbl oil could start to pose a risk to the recovery, while the risks to EM growth would come in at $90-100/bbl.

US economics: Headline CPI came in significantly below expectations with a 0.1% M/M increase in May. Most forecasters missed the tepid rise in energy which benefited from an aggressive seasonal factor to the downside. Core prices were in-line with a 0.1% M/M gain taking the annual rate to 1.8% versus 1.9% in April.

Euro area economics: Inflation hit a record low of 0.0% in May. While downside risks dominate in the summer, positive headlines rates are seen before year-end.

UK economics: CPI inflation fell a little further in May, and is expected to continue falling to a trough in September.

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US TIPS

Opportunity to Scale Back up Long TIPS BE Positions

With more than 30 bp narrowing of 10-yr TIPS Breakevens (BE's) over the last week (from about 208 bp on 6/10/09 close to about 176 bp on 6/17/09 close), we recommend slowly re-adding to our core long BE positions. In the TIPS section of the May 29 and June 11 editions of the Global Rates Focus, we had finally recommended taking a few chips off the table from the long BE positions that we had been recommending since late last year. We felt it would be wise to slightly scale down long BE positions given the massive run-up in BE's that had occurred, even though we still believed (and still do) that longer term BE's are still headed higher. For those accounts that did take a few chips off the table, we recommend slowly scaling back up long BE positions.

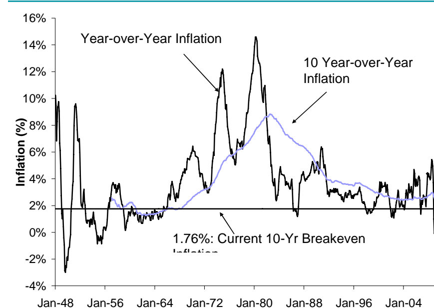
Nominal yields, and along with them TIPS BE's, had just risen too far too fast in recent weeks (up until mid-last week). Some of the rise in BE's was due to less market fears of deflation and greater focus on the increasing risks of inflation down the road in combination with an increasing focus on the continued massive deficits and Treasury supply. But the massive rapid rise in nominal yields and thus in BE's was also due to forced duration selling as the mortgage universe extended as yields rose and dealers selling to delta hedge against puts/payers that they were short (see "July 2003 Style Market Move Creates Opportunities", Global Rates Focus, 6/5/09 for a more detailed explanation).

Over the last week, though, nominal yields and BE's have come back down substantially. The weaker than expected CPI print contributed to the narrowing in BE's yesterday. But BE's narrowed by more than could be attributed just to the carry difference between the total CPI NSA print that the market was anticipating and the actual print. This has provided an opportunity to scale back up long TIPS BE positions at better levels.

Longer maturity BE's should be substantially higher, in our view

10-yr B/Es are still relatively low in comparison to both historical YOY and 10-YOY inflation (Chart 1). The long term risks to inflation, in our opinion, are considerably skewed to the upside versus current levels. As we have re-iterated many times, once the velocity of money begins to increase again, unless the Fed quickly drains massive amounts of money out of the system, which will be difficult both operationally and politically, substantial inflation is a likely scenario. Even if massive inflation is not the most likely scenario, it is certainly a risk. For this reason, a much higher inflationary risk premium (for the risk of a "tail" outcome of the distribution) should also be priced into BE's.

Figure 1: 10yr BE vs 10yr Historical YoY Inflation



Source: BAS-ML

Positive TIPS carry continues on back of surge in energy prices for now

As expected, TIPS positive carry will continue through July. Despite the relatively tame headline total and core CPI SA prints of +0.1% (MoM), May total CPI NSA, which is what TIPS are indexed to, was up +0.3% (MoM) on the surge in gasoline pump prices and seasonal factors. With gasoline pump prices up significantly again in June so far from May levels, we expect a strong June total CPI NSA print next month, and thus that TIPS positive carry should continue through August also. Once we get into the CPI prints for the second half of the 2009 calendar year (July through December CPI prints), though, seasonal factors will begin to work against TIPS carry (Sep '09 through Feb '10 carry, due to the lagged nature of TIPS inflation accretion). This is one negative for long TIPS BE's positions, but the impact is much greater on front end TIPS than on longer maturity TIPS.

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Table 1: Rate of return on TIPS under various annual inflation/deflation scenarios if held to maturity

	TII 4.25 1/10	TII .875 4/10	TII 3.5 1/11	TII 2.375 4/11	TII 3.375 1/12	TII 2 4/12	TII 3 7/12	TII 0.625 4/13	TII 1.875 7/13	TII 2 1/14	TII 1.25 4/14	TII 2 7/14	TII 1.625 1/15	TII 1.875 7/15	TII 2 1/16
5.0%	5.030%	5.324%	5.121%	5.342%	5.616%	5.656%	5.798%	5.855%	6.089%	6.364%	6.139%	6.414%	6.635%	6.649%	6.754%
4.0%	4.254%	4.484%	4.217%	4.425%	4.681%	4.716%	4.855%	4.902%	5.135%	5.405%	5.179%	5.453%	5.670%	5.682%	5.785%
3.0%	3.473%	3.638%	3.308%	3.504%	3.742%	3.772%	3.907%	3.945%	4.175%	4.442%	4.215%	4.487%	4.701%	4.711%	4.813%
2.0%	2.688%	2.788%	2.395%	2.579%	2.797%	2.822%	2.954%	2.984%	3.212%	3.473%	3.246%	3.516%	3.726%	3.735%	3.835%
1.0%	1.898%	1.933%	1.476%	1.648%	1.848%	1.868%	1.996%	2.017%	2.243%	2.500%	2.272%	2.540%	2.747%	2.755%	2.852%
0.0%	1.104%	1.074%	0.553%	0.713%	0.894%	0.908%	1.034%	1.045%	1.269%	1.522%	1.293%	1.559%	1.763%	1.769%	1.865%
-1.0%	0.305%	0.209%	-0.376%	-0.228%	-0.066%	-0.056%	0.066%	0.729%	0.290%	0.539%	1.051%	0.574%	0.774%	0.778%	0.872%
-2.0%	-0.499%	-0.661%	-1.309%	-1.173%	-1.030%	-0.951%	-0.906%	0.716%	-0.693%	-0.449%	1.020%	-0.417%	-0.220%	0.177%	0.667%
-3.0%	-1.308%	-1.535%	-2.248%	-2.124%	-1.999%	-0.982%	-1.884%	0.704%	-1.682%	-1.442%	0.990%	-0.956%	-0.320%	0.120%	0.603%
-4.0%	-2.122%	-2.415%	-3.191%	-3.080%	-2.974%	-1.012%	-2.867%	0.692%	-2.462%	-1.707%	0.961%	-1.007%	-0.366%	0.065%	0.541%
-5.0%	-2.941%	-3.300%	-4.140%	-3.365%	-3.954%	-1.042%	-3.855%	0.680%	-2.502%	-1.753%	0.932%	-1.057%	-0.410%	0.011%	0.481%

	TII 2.5 7/16	TII 2.375 1/17	TII 2.625 7/17	TII 1.625 1/18	TII 1.375 7/18	TII 2.125 1/19	TII 2.375 1/25	TII 2 1/26	TII 2.375 1/27	TII 1.75 1/28	TII 3.625 4/28	TII 2.5 1/29	TII 3.875 4/29	TII 3.375 4/32
5.0%	6.776%	6.820%	6.811%	6.835%	6.840%	6.844%	7.439%	7.420%	7.410%	7.401%	7.471%	7.380%	7.482%	7.217%
4.0%	5.806%	5.850%	5.840%	5.862%	5.866%	5.870%	6.458%	6.438%	6.428%	6.419%	6.489%	6.398%	6.500%	6.235%
3.0%	4.833%	4.874%	4.864%	4.885%	4.888%	4.891%	5.472%	5.452%	5.441%	5.431%	5.502%	5.411%	5.513%	5.248%
2.0%	3.854%	3.894%	3.883%	3.902%	3.905%	3.907%	4.481%	4.460%	4.450%	4.439%	4.510%	4.419%	4.521%	4.256%
1.0%	2.870%	2.909%	2.897%	2.915%	2.916%	2.919%	3.485%	3.464%	3.453%	3.442%	3.514%	3.422%	3.524%	3.259%
0.0%	1.881%	1.919%	1.906%	1.923%	2.010%	1.963%	2.485%	2.463%	2.452%	2.440%	2.512%	2.435%	2.522%	2.258%
-1.0%	1.051%	1.120%	1.453%	1.628%	1.948%	1.865%	1.634%	1.920%	1.986%	2.190%	1.505%	2.220%	1.515%	1.377%
-2.0%	0.965%	1.033%	1.354%	1.561%	1.888%	1.772%	1.465%	1.771%	1.808%	2.048%	0.870%	2.025%	0.977%	1.080%
-3.0%	0.882%	0.949%	1.259%	1.497%	1.832%	1.684%	1.310%	1.635%	1.646%	1.921%	0.603%	1.850%	0.691%	0.815%
-4.0%	0.802%	0.868%	1.167%	1.436%	1.778%	1.600%	1.167%	1.511%	1.498%	1.805%	0.361%	1.692%	0.432%	0.579%
-5.0%	0.725%	0.791%	1.080%	1.377%	1.727%	1.521%	1.036%	1.397%	1.364%	1.701%	0.141%	1.549%	0.198%	0.369%

Source: BAS-ML

please see J. Shatz, Inflation Strategist, 11/25/08 for an explanation of our rate of return tables

June 24 FOMC meeting

The Fed will likely attempt to convince the market of three major themes at the FOMC meeting, in our view, with the ultimate goal of keeping interest rates down across the curve.

1. They will keep the Funds rate low for a considerable period
2. They do not plan to "monetize the debt"
3. They have a credible exit strategy

The first point is focused on keeping short term rates low while the other two points are focused on keeping down future inflation expectations and thus preventing longer maturity yields from rising rapidly.

They will try to convince the market that they are not going to monetize the debt and that they have a credible exit strategy to remove excess reserves from the system when it becomes necessary. The goal of this is to keep down inflation expectations and thus longer maturity yields. In our view, they are already monetizing the debt substantially (even if they leave the size of the securities purchase program unchanged as we expect)! The Fed does have many options to drain reserves from the system, such as asset sales, reverse repos, SFP bills/Fed debt, increasing reserve requirements, and increasing interest paid on reserves, but each method has its problems, in our opinion (please see M. Cloherty, "Can we get there from here?", Global Rates Focus, 6/11/09 for a detailed discussion). We believe it will be very difficult both operationally and politically to quickly drains massive amounts of money out of the system. Thus, we believe that substantial inflation at some point down the road is a major risk and that TIPS BE's should be significantly wider. (see J. Shatz "Likely Messages of the June 24 FOMC Meeting", Global Rates Focus, 6/18/09 for a more detailed discussion of the upcoming June 24 FOMC meeting)

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Table 2: Rate of return on TIPS minus that of similar maturity nominal Treasuries under various annual inflation/deflation scenarios if held to maturity

	TII 4.25 1/10	TII .875 4/10	TII 3.5 1/11	TII 2.375 4/11	TII 3.375 1/12	TII 2 4/12	TII 3 7/12	TII 0.625 4/13	TII 1.875 7/13	TII 2 1/14	TII 1.25 4/14	TII 2 7/14	TII 1.625 1/15	TII 1.875 7/15	TII 2 1/16
5.0%	4.684%	4.879%	4.170%	4.213%	4.173%	4.051%	4.008%	3.742%	3.785%	3.862%	3.489%	3.701%	3.712%	3.574%	3.610%
4.0%	3.908%	4.038%	3.265%	3.297%	3.238%	3.111%	3.065%	2.789%	2.831%	2.904%	2.529%	2.739%	2.747%	2.608%	2.642%
3.0%	3.127%	3.193%	2.356%	2.376%	2.298%	2.166%	2.117%	1.832%	1.872%	1.940%	1.565%	1.773%	1.778%	1.637%	1.669%
2.0%	2.342%	2.343%	1.443%	1.450%	1.354%	1.217%	1.164%	0.871%	0.908%	0.972%	0.596%	0.802%	0.804%	0.661%	0.691%
1.0%	1.553%	1.488%	0.524%	0.520%	0.405%	0.262%	0.206%	-0.096%	-0.061%	-0.001%	-0.378%	-0.174%	-0.175%	-0.319%	-0.292%
0.0%	0.758%	0.628%	-0.399%	-0.416%	-0.549%	-0.697%	-0.756%	-1.068%	-1.035%	-0.979%	-1.357%	-1.154%	-1.159%	-1.305%	-1.279%
-1.0%	-0.041%	-0.237%	-1.327%	-1.356%	-1.509%	-1.661%	-1.724%	-1.384%	-2.013%	-1.962%	-1.599%	-2.140%	-2.148%	-2.296%	-2.272%
-2.0%	-0.845%	-1.106%	-2.261%	-2.302%	-2.473%	-2.557%	-2.696%	-1.397%	-2.997%	-2.950%	-1.630%	-3.131%	-3.143%	-2.897%	-2.477%
-3.0%	-1.654%	-1.981%	-3.199%	-3.252%	-3.442%	-2.587%	-3.674%	-1.409%	-3.986%	-3.944%	-1.660%	-3.670%	-3.243%	-2.954%	-2.541%
-4.0%	-2.468%	-2.861%	-4.143%	-4.208%	-4.417%	-2.617%	-4.657%	-1.421%	-4.766%	-4.208%	-1.689%	-3.721%	-3.288%	-3.010%	-2.603%
-5.0%	-3.287%	-3.746%	-5.092%	-4.494%	-5.397%	-2.647%	-5.646%	-1.433%	-4.806%	-4.255%	-1.718%	-3.771%	-3.333%	-3.063%	-2.663%

	TII 2.5 7/16	TII 2.375 1/17	TII 2.625 7/17	TII 1.625 1/18	TII 1.375 7/18	TII 2.125 1/19	TII 2.375 1/25	TII 2 1/26	TII 2.375 1/27	TII 1.75 1/28	TII 3.625 4/28	TII 2.5 1/29	TII 3.875 4/29	TII 3.375 4/32
5.0%	3.462%	3.433%	3.335%	3.297%	3.229%	3.203%	3.125%	3.019%	2.994%	2.973%	3.043%	2.946%	3.048%	2.769%
4.0%	2.493%	2.462%	2.364%	2.325%	2.256%	2.229%	2.144%	2.037%	2.012%	1.990%	2.061%	1.963%	2.065%	1.786%
3.0%	1.519%	1.487%	1.388%	1.347%	1.277%	1.250%	1.158%	1.050%	1.025%	1.003%	1.074%	0.976%	1.078%	0.799%
2.0%	0.540%	0.507%	0.407%	0.365%	0.294%	0.266%	0.167%	0.059%	0.034%	0.011%	0.082%	-0.016%	0.086%	-0.192%
1.0%	-0.443%	-0.478%	-0.579%	-0.623%	-0.694%	-0.722%	-0.829%	-0.937%	-0.963%	-0.986%	-0.915%	-1.013%	-0.911%	-1.189%
0.0%	-1.432%	-1.468%	-1.570%	-1.615%	-1.601%	-1.678%	-1.830%	-1.939%	-1.964%	-1.989%	-1.916%	-1.999%	-1.913%	-2.191%
-1.0%	-2.262%	-2.268%	-2.023%	-1.910%	-1.663%	-1.776%	-2.680%	-2.481%	-2.430%	-2.239%	-2.923%	-2.215%	-2.920%	-3.071%
-2.0%	-2.348%	-2.355%	-2.122%	-1.977%	-1.723%	-1.869%	-2.849%	-2.630%	-2.608%	-2.380%	-3.559%	-2.409%	-3.458%	-3.368%
-3.0%	-2.431%	-2.439%	-2.218%	-2.041%	-1.779%	-1.957%	-3.004%	-2.766%	-2.770%	-2.508%	-3.825%	-2.585%	-3.744%	-3.634%
-4.0%	-2.511%	-2.519%	-2.309%	-2.102%	-1.833%	-2.041%	-3.147%	-2.890%	-2.918%	-2.623%	-4.067%	-2.743%	-4.003%	-3.870%
-5.0%	-2.588%	-2.597%	-2.396%	-2.160%	-1.884%	-2.120%	-3.278%	-3.004%	-3.052%	-2.728%	-4.287%	-2.885%	-4.237%	-4.079%

Source: BAS-ML

please see J. Shatz, Inflation Strategist, 11/25/08 for an explanation of our rate of return tables

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Table 3: Forward breakeven calculator for TIPS vs nominals from 06/19/09 out to 08/01/09

Cpn/mat	Yield	Fwd yld	Fwd - spot Yld chg (bp)	Cpn/mat	Yield	Fwd yld	Fwd - spot Yld chg (bp)	Spot B/E	Forward B/E	B/E protection
4.25% 1/15/10	0.416%	1.331%	91.59	2.125% 1/31/10	0.346%	0.388%	4.22	-0.070%	-0.943%	87.37
0.875% 4/15/10	0.598%	1.212%	61.38	4% 4/15/10	0.446%	0.492%	4.61	-0.153%	-0.720%	56.77
3.5% 1/15/11	0.299%	0.579%	27.96	4.25% 1/15/11	0.952%	1.017%	6.56	0.653%	0.439%	21.41
2.375% 4/15/11	0.495%	0.745%	25.05	4.875% 4/30/11	1.128%	1.195%	6.66	0.633%	0.450%	18.39
3.375% 1/15/12	0.736%	0.926%	19.02	4.875% 2/15/12	1.443%	1.507%	6.38	0.707%	0.581%	12.64
2% 4/15/12	0.766%	0.938%	17.16	4.5% 4/30/12	1.605%	1.670%	6.47	0.839%	0.732%	10.69
3% 7/15/12	0.901%	1.067%	16.57	4.375% 8/15/12	1.790%	1.859%	6.90	0.889%	0.792%	9.66
0.625% 4/15/13	0.942%	1.071%	12.90	3.125% 4/30/13	2.113%	2.178%	6.50	1.171%	1.107%	6.40
1.875% 7/15/13	1.170%	1.301%	13.14	4.25% 8/15/13	2.304%	2.373%	6.95	1.134%	1.072%	6.18
2% 1/15/14	1.433%	1.558%	12.49	4% 2/15/14	2.501%	2.569%	6.73	1.068%	1.011%	5.76
1.25% 4/15/14	1.210%	1.320%	11.03	1.875% 4/30/14	2.650%	2.714%	6.42	1.440%	1.394%	4.62
2% 7/15/14	1.478%	1.592%	11.40	4.25% 8/15/14	2.714%	2.781%	6.72	1.235%	1.189%	4.68
1.625% 1/15/15	1.690%	1.798%	10.80	4% 2/15/15	2.922%	2.989%	6.65	1.233%	1.191%	4.16
1.875% 7/15/15	1.701%	1.801%	10.03	4.25% 8/15/15	3.074%	3.140%	6.54	1.373%	1.338%	3.49
2% 1/15/16	1.801%	1.896%	9.52	4.5% 2/15/16	3.144%	3.207%	6.28	1.343%	1.310%	3.24
2.5% 7/15/16	1.821%	1.912%	9.07	4.875% 8/15/16	3.313%	3.377%	6.34	1.492%	1.465%	2.73
2.375% 1/15/17	1.863%	1.948%	8.53	4.625% 2/15/17	3.388%	3.448%	6.04	1.525%	1.500%	2.49
2.625% 7/15/17	1.853%	1.933%	8.09	4.75% 8/15/17	3.476%	3.535%	5.91	1.624%	1.602%	2.18
1.625% 1/15/18	1.874%	1.948%	7.42	3.5% 2/15/18	3.538%	3.593%	5.50	1.664%	1.645%	1.92
1.375% 7/15/18	1.877%	1.947%	6.97	4% 8/15/18	3.611%	3.665%	5.45	1.734%	1.718%	1.52
2.125% 1/15/19	1.880%	1.949%	6.89	2.75% 2/15/19	3.641%	3.691%	5.02	1.761%	1.742%	1.87
2.375% 1/15/25	2.454%	2.505%	5.08	7.625% 2/15/25	4.314%	4.363%	4.94	1.860%	1.858%	0.14
2% 1/15/26	2.435%	2.482%	4.69	6% 2/15/26	4.401%	4.448%	4.62	1.967%	1.966%	0.07
2.375% 1/15/27	2.424%	2.470%	4.57	6.625% 2/15/27	4.416%	4.462%	4.55	1.992%	1.992%	0.01
1.75% 1/15/28	2.415%	2.457%	4.18	6.125% 11/15/27	4.429%	4.471%	4.25	2.014%	2.014%	-0.07
3.625% 4/15/28	2.484%	2.531%	4.68	6.125% 11/15/27	4.429%	4.471%	4.25	1.944%	1.940%	0.44
2.5% 1/15/29	2.394%	2.436%	4.20	5.25% 2/15/29	4.435%	4.475%	4.07	2.040%	2.039%	0.13
3.875% 4/15/29	2.495%	2.541%	4.57	5.25% 2/15/29	4.435%	4.475%	4.07	1.940%	1.935%	0.50
3.375% 4/15/32	2.234%	2.272%	3.79	5.375% 2/15/31	4.449%	4.487%	3.87	2.214%	2.215%	-0.09

Source: Banc Of America Securities - Merrill Lynch

RM

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European IL

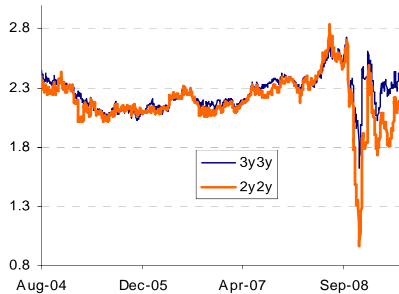
Still short Euro breakevens, but see oil driven risk

In the short term, rising commodity prices may continue to drive European breakeven rates higher, but we still expect European inflation will be lower for longer than the market has currently priced in. **For this reason we prefer to sell forward European inflation which remains at elevated levels and is relatively immune to short term oil price fluctuations.**

Despite the turn around in leading indicators, there has so far been little sign of improvement in the European real economic data. European inflation for May was 0.0% yoy the lowest print in decades and has now come in below consensus for four months in a row (consensus for the flash estimate and provisional German estimates). Given the weakness of the European labour market and low level of capacity utilisation, we don't expect inflation to turn around quickly when the economy does eventually start to recover. We believe this is particularly true in Europe where the risk of a sharp increase in inflation is less than in the UK or the US because of the limited scale of both the fiscal stimulus and quantitative easing measures.

With oil priced in Euros having increased 59% since the start of the year, short maturity breakeven rates have risen sharply. The BAS-ML commodity strategist team believes that OPEC would probably increase production if oil reaches $80/barrel, but a spike in oil prices is clearly a risk to short breakeven positions. European forward inflation rates on the other hand have remained relatively stable (Chart 1). With 3y3y rates currently at 2.38% and 2y2y rates at 2.15% (both well above the ECB's target of 2.0%) we still believe these rates are a sell.

Chart 1: European forward inflation rates remain at elevated levels



Source: Banc of America Securities - Merrill Lynch

Trading cross-country European breakeven spreads

We think there are currently some interesting opportunities trading cross country European breakeven spreads. France, Germany, Italy and Greece all issue IL bonds linked to the same European index and there are therefore a number of potential permutations to consider. To minimise the impact of curve slope, we restrict the comparison to breakeven rates on bonds with adjacent maturities. Because a breakeven position has little net credit exposure to the issuer country, we don't believe cross-country breakeven spreads of bonds with similar maturities should trade away from zero for extended periods.

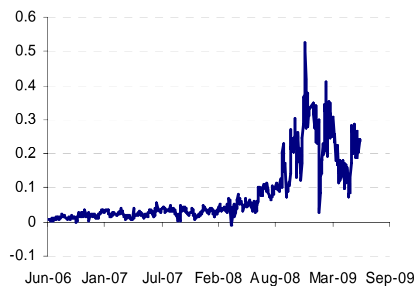
Figure 2: European government breakeven spreads (residual over historic periods shaded by percentile)

	Spread	1m	3m	6m	1y	3y
BTANei 10						
BTPei 10	-5.4	10.1	12.3	14.1	7.9	0.4
OATei 12	42.9	13.9	25.0	15.9	23.0	37.1
BTPei 12	-14.7	5.6	6.7	-5.0	-10.9	-12.1
OBLi 13	-7.8	1.2	2.8	8.5	9.8	8.2
BTPei 14	37.1	-13.0	-10.8	-20.2	-8.8	4.2
OATei 15	10.4	6.6	3.4	2.8	8.7	9.2
DBRei 16	-10.7	-8.6	-5.0	-4.6	-3.2	-2.8
BTPei 17	-10.3	3.5	5.3	2.7	-8.2	-13.5
BTPei 19	40.3	-4.4	-8.6	-4.8	10.0	10.9
OATei 20	30.3	5.2	-0.8	-0.4	6.3	7.0
BTPei 23	-15.0	1.2	9.3	8.5	1.6	-4.0
GGBei 25	-17.5	-6.6	16.6	13.3	-2.8	-6.9
GGBei 30	26.1	10.6	9.0	8.1	10.4	10.6
OATei 32	7.9	-10.3	-39.4	-35.8	-15.5	-1.5
BTPei 35	23.9	0.4	5.4	1.3	5.0	15.8
OATei 40	-20.7	1.4	-2.8	2.0	-2.3	-12.0

Source: Banc of America Securities - Merrill Lynch

Figure 2 shows the spreads between breakeven rates of European linked bonds along with the residual of the spread over different periods. For example the breakeven rate of BTPei35 is 23.9bp above that of OATei32 and this is 0.4bp above the 1m average, 5.4bp above the 3m average. Although there is a three year difference in maturity between these two issues, at such a long maturity this should have a limited impact and historically the spread has traded close to flat. The 3-year average of the spread is 8.1bp and it is now trading 15.8bp above this (Chart 2). We believe there are no fundamental reasons for this spread to have blown out and that it was due to market inefficiencies which are fading as risk appetite and a willingness to trade mis-pricings returns to the market.

Chart 2: BTPei35-OATei32 breakeven spread is trading 15.8bp above the 3y average



Source: Banc of America Securities - Merrill Lynch

Although there are several approximations in this simple analysis, we think it illustrates some interesting points and identifies some genuine opportunities. Historically these spreads have traded tightly around zero. Since Q308 they have been volatile, but continue to average around zero. There are no obvious systematic relationships between the issuers in general.

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Two weeks ago we recommended buying BTPei12 breakevens against OATei12 at a spread of -30.2bp. The spread has since reverted towards fair value and has made 15.5bp. The spread is currently at -14.7bp and should have further to go.

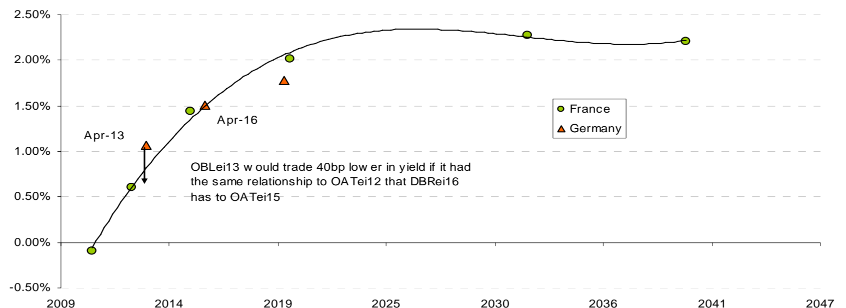
The German real curve looks too flat compared to France

Despite the recent reversion, we think the German real curve is still too flat compared to France in the 5 to 8 year sector. OBLei 13 looks cheap on the curve at a real yield of 1.07% compared to DBRei16 at 1.50%. The slope of 43bp for exactly three years of curve is in sharp contrast to the slope between OATei12 and OATei15 which also have a maturity difference of exactly three years but a yield differential of 84bp (Chart 4). The history of the box can be seen in Chart 3 which shows that the current level of 41bp is close to a record high. We first recommended this trade on 4 June at a spread of 56bp, but we believe it has further to go. The z-spread differentials show the same pattern which is to be expected given the close maturities and offsetting seasonals.

Chart 3: OATei15-OATei12) minus (DBRei16-OBLei13) real yield spread

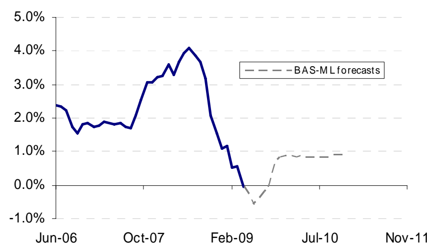
Source: Banc of America Securities - Merrill Lynch

Chart 4: Term structure of France and Germany real rates – OBLei 13 looks cheap on the curve



Source: Banc of America Securities - Merrill Lynch

Chart 5: European HICPXT history and forecasts – BAS-ML expect CPI to trough in July 2009



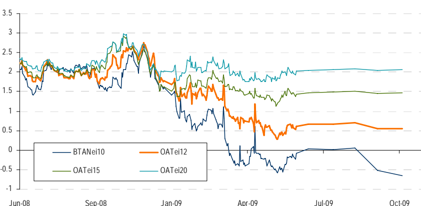
Source: Banc of America Securities - Merrill Lynch

However, it's worth noting that the French nominal curve is also considerably steeper than the German nominal curve and so in terms of breakeven spreads the distinction between the slopes in the two countries is more limited and shows the German breakeven curve is about 11bp steeper than that of France in this sector.

Eurozone CPI print confirms flat European carry in July

The release of the May European inflation data on Tuesday confirmed that carry on European IL bonds will be close to flat during July. The index print of 108.1 (-0.04% yoy, +0.06% mom) was in-line with consensus and the lowest annual rate since the series began. The BAS-ML economics group continues to expect that European CPI will trough at around -0.6% in July before reverting back towards 1% by the end of the year (Chart 5).

Chart 6: French European IL bond real yields and projected forwards based on BAS-ML forecasts for inflation prints to August 2009



Source: Banc of America Securities - Merrill Lynch

Based on these forecasts we project that European IL carry will remain close to flat in August before turning sharply negative in September and will then remain negative into the end of the year. This can be seen in Chart 6 which shows the real yield history for French European IL bonds and the projected forward yields based on index forecasts. During periods of negative indexation, real yields move systematically lower as real prices rises to compensate for the low index prints. Negative indexation has a bull steepening effect on the real curve as short maturity bonds are more sensitive to the indexation effect.

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JGB-i:
Cherry-picking opportunities

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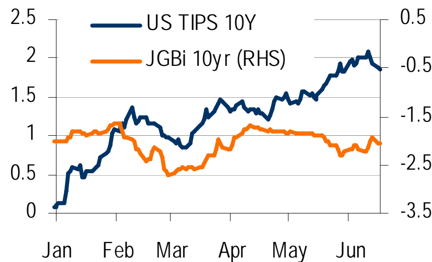
The rally in JGB inflation linkers has stalled since April. Apart from the lingering deflation concerns, market pressure for Japanese banks to strengthen their capital may have discouraged the banks from holding JGB-i, which are less liquid than the nominal bonds. We believe further weakness should provide a good selective buying opportunity.

The only linkers that underperformed nominal bonds

In the wake of surging commodity prices and weakening US$, inflation fears led to a surge of breakeven inflation globally. The BEI of JGBi, however, stands out as the only one that has declined in the last two months. For example, while the 10yr US TIPS outperformed UST by over 50bp from April, the 10yr JGBi underperformed JGB by over 20bp. The downward surprise of May Tokyo CPI, due to fuel, light and water price cuts, dampened hopes that price increases in imported raw materials will quickly trickle down to consumer goods. The CPI ex-fresh food index may decline in the coming month, which may result in a slightly negative carry for BEI. The real yield, however, has surged above 3% again, which cannot be justified by the subdued GDP outlook especially in the medium term.

Figure 3: BEI of US, AU, UK and JP



Source: Bloomberg, BAS_ML

The JGB-i No.4 is particularly interesting. It has one of the highest real yields at 3.12%, but its relatively small outstanding amount and its low base index argue for the opposite. The JGB-i No.4 has the lowest base index among all the JGBi, which protects it from the risk of losing the principal value during deflation. The recent speculation for switching to principal-protected linkers may have driven up the prices of other linkers, but left the No.4 relatively cheap. As the speculation subsides, the No.4 should outperform other linkers. Its small outstanding amount at ¥389bn vs. the average at ¥513bn should facilitate its absorption at the MoF buyback auction, which had reduced the total outstanding amount by ¥2.2tn since last year to ¥8.2tn. The buyback will continue to serve as the fundamental support for linkers.

Table 4: JGBi

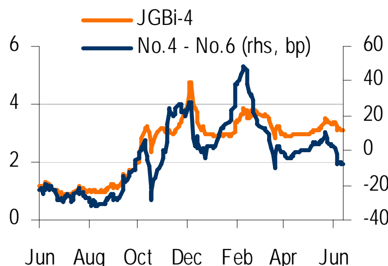
Name	Maturity	Base index	Real yield (bp)	BEI (bp)	Outstanding(bn)
JGBi-1	3/14	99.9963	238	157	99.8
JGBi-2	6/14	99.4872	277	191	172.7
JGBi-3	12/14	99.9963	296	205	370.2
JGBi-4	6/15	99.1817	312	214	389.2
JGBi-5	9/15	99.5890	300	197	408.8
JGBi-6	12/15	99.8945	301	196	424.1
JGBi-7	3/16	99.8945	299	191	365.9
JGBi-8	6/16	99.6909	314	202	810.5
JGBi-9	9/16	100.2000	303	185	426.7
JGBi-10	12/16	100.4000	305	182	774.7
JGBi-11	3/17	100.1000	309	183	383.8
JGBi-12	6/17	99.6000	316	186	945.8
JGBi-13	9/17	100.1000	312	180	357.6
JGBi-14	12/17	100.3000	312	176	918.3
JGBi-15	3/18	100.9000	310	172	461.6
JGBi-16	6/18	100.8000	308	168	914

Source: BAS_ML

Deteriorating sentiment provides opportunity

The recent buyback auction results showed a deterioration of sentiment on the JGBi. The best price spread has been consistently negative since late April as dealers were eager to sell the bonds to the MoF. Japanese banks have been under market pressure to reinforce their core Tier 1 capital. The increased capital requirements may have discouraged the banks from holding the JGBi, which are less liquid than the nominal JGB. The US plan to give the Fed power to address systemic risk by toughening capital requirements for banks would further increase the pressure on its overseas counterparties. Moreover, as CPI ex-freshfood is likely to dip to -2% YoY in the short term, the deflation concerns may depress the JGBi prices again. We believe sentiment would improve gradually as the value is rediscovered. Any further decline should create an excellent opportunity to cherry-pick the bonds.

Figure 4: Real yield and real yield difference

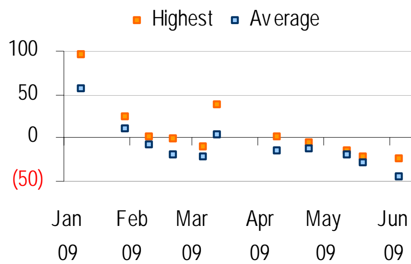


Source: BAS_ML

Consumption tax talk shelved for now

The government's recent analysis published early this month showed in order to achieve fiscal surplus by 2019, a consumption tax hike from 5% currently to 12% will be required. However, a recent poll showed that support for the ruling Liberal Democrat Party is dwindling, despite its fiscal stimulus. Three big municipality

Figure 5: The highest and average prices in the MoF buyback auctions (sen)



Source: MoF, BAS_ML

election wins by the opposite Democratic Party in the past two months have put pressure on the government to shelve talk on the consumption tax hike ahead of the general election. We believe, though shelved, consumption tax hike talk is likely to resume no matter who wins the election. The government debt is very likely to escalate to over 200% GDP by 2010 due to the current fiscal stimulus. Decisions have to be made as early as next year and options will be limited in order to keep the deficit contained beyond 2010. As the maturity of the No.4 is only 6yr, for every 1% hike in consumption tax, the real yield could be shaved by as much as 16.7bp for No.4 (100bp/6 = 16.7bp), while the impact on the 10yr JGBi is at most 10bp. Furthermore, the nominal carry and roll at 6yr is the highest, which should provide a cushion for potential negative inflation carry. We suggest investors to buy No.4 on dips, or hedge it with the sale of No.16.

EM IL: the only long duration left

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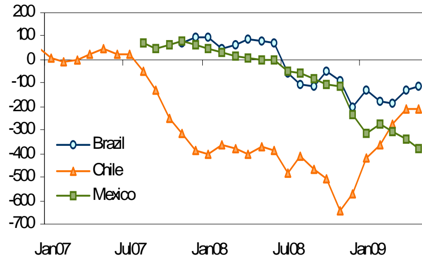
Exposure to inflation-linked instruments remains important in our overall exposure in EM local debt markets. What we have seen in recent weeks is that exposure to real rates is now the best way to express a long duration view. This is because most central banks have now come close to the end of the easing cycle, which means there is little upside at this stage for a plain long duration position. We indeed recently exited our long nominal yield position in Brazil and entered a payer position in Turkey.

Against this backdrop, we retain recommendations of a long Turkey Feb. 2012 CPI-linker bond and a long Brazil NTN-B 2015 in our portfolio, as we believe that there is more room for the real rates to adjust downward over the medium term.

The table below shows that inflation risk premium is negative in most of EM, as well as the 1-year z-score. The ongoing decline in inflation expectations will also help for inflation risk-premium to become less negative.

Chart 7: Inflation risk premium (bp)



Source: Bloomberg, Banc of America Securities - Merrill Lynch calculations.
Note: The inflation risk premium is the difference between nominal yields and real yields plus inflation forecast. Inflation forecasts are based on the data from Consensus Forecast.

Chart 8: Real yield (%) vs TIPS + sovereign bond Treasury spread

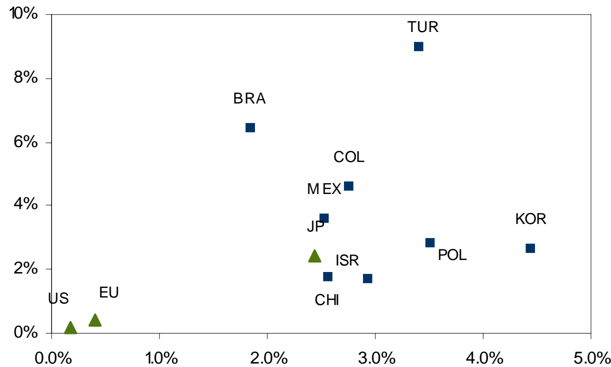
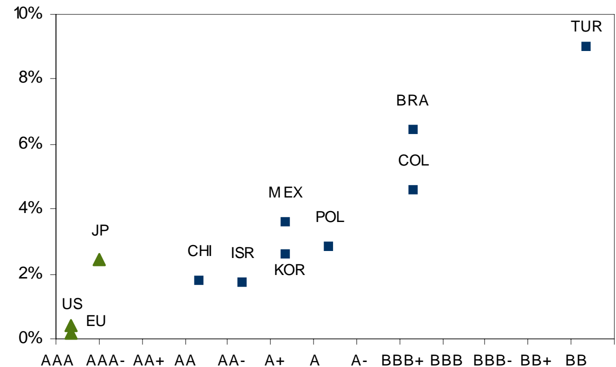


Chart 9: Real yield (%) vs local debt rating



Note: The chart on the left shows the relationship between TIPS plus the corresponding spread in US$ bonds for each country, against real yields. The charts on the right depict real interest rates against the credit rating for selected countries. The countries picked are those where investors can trade liquid CPI-linked fixed income instruments (at least US$1mn each trade).
Source: Bloomberg, Banc of America Securities-Merrill Lynch

Table 5: Real interest rate instruments and valuation

Country	Instrument	Real maturity	Real yield (%)	Instrument	Nominal maturity	Nominal yield (%)	YoY actual inflation	'09 inflation forecast	Risk prem. vs YoY CPI	Risk prem. vs '09 forecast	USD instrument	Treasury spread (bp)	Rating (M/S&P)
Argentina	Pre 08	Mar-10	16.27	NDF	Jun-11	29.47	5.50	6.30	769	689			WR/B-
	Boden 14	Sep-14	33.13	-	-	-	5.50	6.30	-	-	Boden '15s	2177	WR/B-
	Discount ARS	Dec-33	17.96	-	-	-	5.50	6.30	-	-	Discount USD	0	WR/B-
Brazil	NTN-B (IPCA)	Aug-12	6.48	BM&F Future	Jan-12	11.27	5.20	4.45	-41	35	Brazil '12s	167	Ba1/BBB+
	NTN-B (IPCA)	May-15	6.73	BM&F Future	Jan-15	12.37	5.20	4.45	44	120	Brazil '15s	257	Ba1/BBB+
Chile	5y UF Swap	Jun-14	1.78	Fixed vs Camara	Jun-14	4.65	3.00	2.85	-13	2	Chile '13s	98	A1/AA
	10y UF Swap	Jun-19	2.08	Fixed vs Camara	Jun-19	5.42	3.00	2.85	35	50			A1/AA
Colombia	TES (UVR)	Mar-13	4.59	TES	Nov-13	8.19	4.77	5.10	-117	-150	Colombia '14s	258	Baa3/BBB+
Mexico	MUDI 5y	Jun-14	3.61	MBONOS	Jun-13	6.35	5.98	4.05	-324	-131	Mexico '14s	235	Baa1/A+
	MUDI 10y	Jun-19	4.00	MBONOS	Dec-17	8.14	5.98	4.05	-184	9	Mexico '19s	229	Baa1/A+
Israel	Galil	Aug-11	-0.38	Shahar	Apr-11	2.20	2.80	1.30	-23	128	Israel '10s	-13	A1/AA-
	Galil	Oct-14	1.74	Shahar	Mar-14	4.24	2.80	1.30	-30	120	Israel '16s	136	A1/AA-
Poland	POLGB	Aug-16	2.84	POLGB	Oct-15	6.33	3.60	2.40	-12	108	Poland '15s	193	A2/A
Turkey	TGB	Feb-12	9.00	TGB	Mar-12	13.99	5.24	6.15	-25	-116	Turkey '12s	322	Ba3/BB
South Korea	KTBI	Mar-17	2.64	NDF	Sep-16	5.23	2.74	2.65	-15	-6	South Korea '13s	286	A2/A+
US	TIPS	Jan-11	0.18	T	Jan-11	2.71	-0.70	-0.55	324	309			Aaa/AAA
	TIPS	Jul-15	1.58	T	Nov-15	3.73	-0.70	-0.55	285	270			Aaa/AAA
EU	FRTR3	Jul-11	0.41	FRTR4	Apr-11	1.56	0.60	1.00	56	16			Aaa/AAA
	FRTR3	Jul-13	0.80	FRTR4	Apr-13	2.58	0.60	1.00	118	78			Aaa/AAA
Japan	JGBI	Mar-14	2.44	JGB	Mar-14	0.83	-0.10	0.90	-151	-251			Aa2/AA

Note: The table shows for each market the benchmark CPI-linked bond or swap and the corresponding instrument in nominal yield terms. The column titled inflation risk premium is a simple calculation of the differential between nominal yield and real yields plus the inflation forecast. Inflation forecast figures are based on the data from Consensus Forecast.
Source: Bloomberg, Banc of America Securities-Merrill Lynch

RM

How high can oil go near-term?

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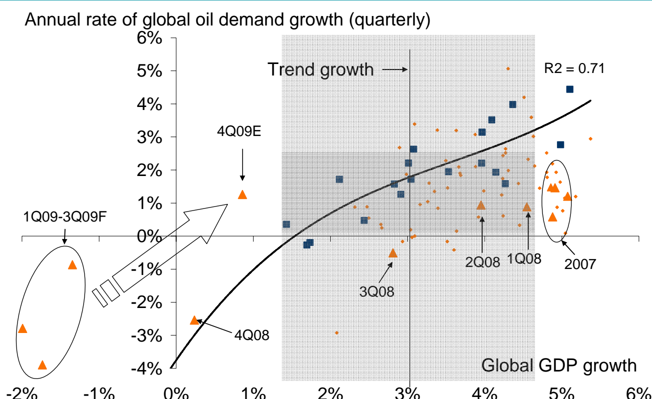
Is oil a "green shoot" or a risk to the embryonic recovery?

Commodity prices have rallied tremendously from their February lows, leading some to argue that rising commodity prices are a sign of the incipient economic recovery. In a way, the recent sharp liquidity increases by OECD and EM central banks are contributing to fuel a strong rebound in EM equity and commodity prices. However, a very fast increase in oil prices in the coming months could also put the embryonic economic recovery at risk. How high could oil go near-term? In OECD economies, our economists believe that $70-80/bbl oil could start to pose a risk to the recovery, while the risks to EM growth would come in at $90-100/bbl.

Small changes in GDP can have a big impact on oil demand

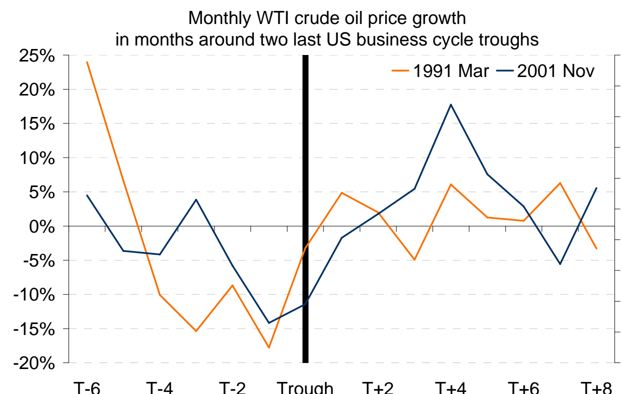
Of course, a stronger economy can also support higher oil prices, so the relationship between oil and the economy works both ways. More importantly, our analysis suggests that the link between oil demand and global GDP is not linear. In fact, small improvements in GDP can result in significant improvements in oil demand, when GDP is either very low or very high relative to trend (Chart 6). Consequently, an upturn in economic activity around the world, even if modest, could have a very significant impact on oil demand. In turn, given that oil supply is semi-fixed in the short-run, any improvement in demand conditions quickly translates into higher prices (Chart 7).

Figure 6: Small improvements in GDP can result in significant improvements in oil demand when GDP is very low



Source: IEA, IMF, Banc of America Securities-Merrill Lynch Commodity Research

Figure 7: Given oil supply is semi-fixed in the short-run, improving demand conditions quickly translates into higher prices



Source: Bloomberg, Banc of America Securities-Merrill Lynch Commodity Research

Fortunately, there is plenty of spare capacity in energy

Of course, petroleum inventories are very high, OPEC has plenty of spare crude production capacity and refining is no longer the bottleneck that it was. The recent output disruption in Nigeria—where production is reportedly down to 1.2 million b/d at present from an average of 1.8 million b/d in the last six months—is contributing to push oil prices higher in the near-term. But spare OPEC capacity still stands at 6 million b/d, and we believe key members would step in to increase output should WTI crude oil prices breach the $80/bbl mark in the coming months.

Meanwhile, fundamentals in OECD economies look frail…

While capital flows continue to chase a potential surge in profits in EM, economic conditions in OECD countries remain rather dire. In the US, oil demand looks very

frail, averaging 1.7 million b/d below last year in the last 3 months. In particular, demand for higher sulphur distillates has collapsed, while gasoline demand is only down modestly year-on-year after a sharp decline last year. Similarly, oil demand in OECD Europe also looks rather weak once we account for German heating oil restocking. Meanwhile, demand has nosedived in Asia Pacific OECD as a result of the dramatic contraction in Japanese industrial activity.

...although we expect a sequential improvement in 2H09

Net, we see an improvement in OECD petroleum product demand in 2H09, as economic activity should move into positive territory on a sequential basis. In contrast to the IEA, our view is that oil demand in OECD economies in 4Q09 will be markedly above oil demand in 4Q08. In addition, EM oil demand should improve over the coming months with the global economy on a recovery path. While the sequential improvement in global oil demand should be modest, we struggle with the idea that the 4Q09-1Q10 period will see a lower absolute level of oil demand than the trough of the business cycle in 4Q08-1Q09.

EM demand has bounced back, but it is also relatively weak

So far, much of the rising appetite for risky assets is just a function of improving business surveys and a change in the second derivative of growth. When looking at the actual economic data, only a number of EMs have shown an improvement in car sales in the recent months. For instance, China saw an increase in car sales of 7.5% YoY in 1Q09, while India experienced a 38% reduction in vehicle purchases in 1Q09. Similarly, electricity generation data across a number of EMs is still very weak (Chart 17), with China posting –3.6% YoY, Brazil showing a –3.7% YoY figure, and India experiencing a 6% expansion in April.

Petroleum inventories could draw in 2H09...

With global demand improving modestly and oil supply still constrained by OPEC, oil inventories in OECD economies could draw over the coming months, in our view. On our estimates, crude oil inventories in the United States could draw from 369 million barrels at present to 325 million by the end of the year. Similarly, European crude oil stocks could draw from 347 to 330 million barrels over the same period.

...further exacerbating the upside risks to oil prices...

In our opinion, a sequential improvement in global oil demand on the back of expansive fiscal and monetary policies, coupled with continued restrictions on OPEC output and an outright decline in non-OPEC supply could ultimately put further upward pressure on oil prices. How far will oil prices go before OPEC members start to increase supply again? In our view, any large reversal in OPEC policy or a change in the evolving demand trend is unlikely before WTI or Brent crude oil prices hit $80/bbl.

... potentially resulting in a flatter curve

Historically, front-to-third month timespreads have led inventory draws, as differentials across contract months reflect the marginal cost of storage in a commodity market. In turn, as we still expect fundamental supply and demand conditions to lead to oil inventory draws over the coming months, we believe WTI front-to-third month timespreads should continue to tighten. This shifting dynamic in the front-end of the crude oil curve, coupled with increasing risks to the long-term oil supply/demand balance could potentially result in a flatter curve by the end of the year.

RM

US Economics

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Energy prices weaker than most expected in May

Overall CPI came in significantly lighter than expectations (0.3% M/M) in May at 0.1% M/M but higher than BAS-ML estimates (-0.1% M/M). The key miss for most was very tepid 0.2% gain in energy prices, where a strong gain in gasoline prices was offset by declines in fuel oil, electricity, and natural gas as well as a strong seasonal factor (unadjusted energy prices rose 4.0% M/M). Food prices posted a decline for the fourth straight month, down 0.2% M/M, where the lagged effects of a stronger US$, weak demand and lower commodity prices appear to be taking hold.

Core prices in-line with underlying weakness

Core CPI rose a modest 0.1% M/M with increases led by new and used cars (the former due for reversal in upcoming months), medical care services, drugs, and tuition costs. Helping to offset these gains were declines in tobacco products (a reversal following record tax hikes in the prior two months that alone added 0.1 ppts to the headline and core in each month), clothing, airfares, personal care products, and services. Both rent and owners equivalent rent - categories which together account for 30% of the core CPI - posted modest increases of 0.1% M/M each.

Largest annual drop in headline CPI since 1955

Relative to year-ago levels, overall prices headed further into negative terrain, down 1.3% for the largest decline since April 1955. Looking ahead, easy energy comparisons versus a year ago should be a key factor in leading the overall CPI lower. After peaking at 6.1% Y/Y in October 2008, food prices eased to 2.7% Y/Y in May and will also be a tailwind for the headline going forward. By 3Q, we anticipate overall CPI to fall more than 2.0% Y/Y before heading back into positive terrain by the end of the year.

Moderation in core to continue

Core prices eased to 1.8% Y/Y from 1.9% Y/Y in April and are down from the nearby peak of 2.5% in August 2008. Over the remainder of the year, the core CPI is expected to moderate further, heading toward 1.2% by 3Q, with depressed demand and more competitive pricing for a broad array of consumer categories expected as tailwinds. Thereafter, we anticipate prices to drift up only slightly, ending the year at around 1.4% Y/Y.

Table 6: US Inflation Outlook

	Total CPI					Core CPI			
	NSA			SA		NSA		SA	
	Level	m/m	y/y	m/m	y/y	m/m	y/y	m/m	y/y
2009: Jan	211.143	0.44	0.0	0.28	-0.2	0.29	1.7	0.18	1.7
2009: Feb	212.193	0.50	0.2	0.39	0.1	0.45	1.8	0.19	1.8
2009: Mar	212.709	0.24	-0.4	-0.14	-0.4	0.44	1.8	0.17	1.8
2009: Apr	213.240	0.25	-0.7	-0.02	-0.6	0.23	1.9	0.25	1.9
2009: May	213.856	0.29	-1.3	0.10	-1.0	-0.01	1.8	0.14	1.8
2009: Jun	215.204	0.63	-1.7	0.27	-1.7	-0.13	1.5	-0.02	1.5
2009: Jul	215.548	0.16	-2.0	0.36	-2.0	0.00	1.3	0.04	1.3
2009: Aug	215.414	-0.06	-1.7	0.32	-1.7	0.09	1.2	0.06	1.2
2009: Sep	215.668	0.12	-1.4	0.30	-1.4	0.23	1.2	0.16	1.2
2009: Oct	215.885	0.10	-0.3	0.30	-0.3	0.15	1.3	0.07	1.3
2009: Nov	215.704	-0.08	1.5	0.16	1.5	-0.15	1.3	0.05	1.3
2009: Dec	215.471	-0.11	2.5	0.14	2.5	-0.23	1.4	0.05	1.4

NSA: Not seasonally adjusted, SA: seasonally adjusted. M/M is monthly percent change, Y/Y is year-over-year percent change.

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Euro area Economics

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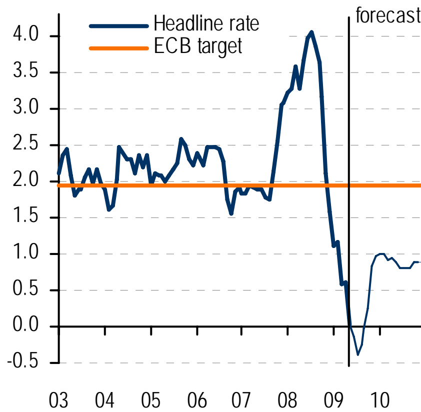
Chart 10: Euro-area HICP inflation (% YoY)



Source: Eurostat, Banc of America Securities – Merrill Lynch

Inflation at record low of 0.0% YoY

The euro-area headline inflation rate fell from 0.6% in April to 0.0% YoY in May matching the consensus forecast of an unrevised flash HICP estimate. Note that, at the margin, ex-tobacco inflation (-0.04% YoY) broke into negative territory for the first time. The main surprise was the 0.1% MoM increase compared to market expectations of a 0.0% reading. The highest monthly rates were found in transport (0.5%, driven by fuels) and communications (0.3%), while the lowest were in recreation and culture (-0.4%, due to package holidays).

Price pressures are diminishing across many sectors

Base effects played an important part again in the behaviour of headline inflation. Although energy prices rose 0.4% MoM in May, the headline annual rate tumbled from -8.8% in April to -11.6% YoY, contributing almost half of the 0.6ppt decline in the overall HICP rate. Disinflation in the housing segment contributed -0.15ppt, with the remaining 0.2ppt equally split between recreation & culture and food.

Very gradual downtrend in core inflation

Of the numerous gauges of core inflation on the Eurostat press release, the main ones are the ex-energy, food, alcohol and tobacco measure (71.1% of the HICP index) and the ex-energy and unprocessed food measure (83%). Both moderated to 1.5% YoY in May from 1.8% and 1.7% respectively, a touch lower than the 1.6% consensus forecast. Underlying price pressures remain on a modest downtrend, reflecting the lagged impact of a severe recession. With core inflation still averaging 1.6% in April and May, we see no reason to worry about deflation.

Fading negative contributions from energy prices

Based on the behaviour of oil prices and EUR/USD in June so far, the decline in energy prices could be slightly less pronounced than the -11.6% YoY May reading. However, we expect the disinflationary trend evident in other less volatile component to persist, driving the HICP reading to -0.1% YoY in June.

Downside risks dominate in the short-term

Downside risks dominate in the short-term, in our view. Indeed, surveys are unequivocal about price expectations being close to record lows, reflecting some imbalance between (excess) supply and (a shortage of) demand. Hence, we expect the ECB to err on the side of keeping rates low for the foreseeable future.

Lower inflation is a welcome boost to purchasing power

Inflationary pressures are non-existent at the consumer level. This is a 360° turnaround from May 2008 when the headline rate stood at 3.67%, on its way to an all-time high of 4.05% in July. Purchasing power gains are mitigating the contraction in consumer spending against a backdrop of widespread job losses. We forecast that headline inflation will stay return to around 1.0% by year-end.

Table 7: Euro-area ex-tobacco HICP (nsa)

	index	% MoM	% YoY
Jan-08	**105.67**	**-0.4**	**3.2**
Feb-08	**106.04**	**0.3**	**3.2**
Mar-08	**107.11**	**1.0**	**3.6**
Apr-08	**107.46**	**0.4**	**3.3**
May-08	**108.14**	**0.6**	**3.6**
Jun-08	**108.54**	**0.5**	**4.0**
Jul-08	**108.38**	**-0.2**	**4.0**
Aug-08	**108.22**	**-0.2**	**3.8**
Sep-08	**108.42**	**0.2**	**3.6**
Oct-08	**108.45**	**0.1**	**3.2**
Nov-08	**107.90**	**-0.6**	**2.1**
Dec-08	**107.75**	**-0.1**	**1.6**
Jan-09	**106.82**	**-0.9**	**1.0**
Feb-09	**107.26**	**0.5**	**1.2**
Mar-09	**107.66**	**0.4**	**0.6**
Apr-09	**108.04**	**0.3**	**0.5**
May-09	**108.10**	**0.0**	**0.0**
Jun-09	108.32	0.2	-0.3
Jul-09	107.88	-0.4	-0.5
Aug-09	107.88	0.0	-0.3
Sep-09	108.32	0.4	-0.1
Oct-09	108.65	0.3	0.1
Nov-09	108.76	0.1	0.8
Dec-09	108.76	0.0	0.9
Jan-10	107.87	-0.8	1.0
Feb-10	108.31	0.4	0.9
Mar-10	108.65	0.3	0.9
Apr-10	109.09	0.4	1.0
May-10	109.09	0.0	0.9
Jun-10	109.20	0.1	0.8
Jul-10	108.76	-0.4	0.8
Aug-10	108.76	0.0	0.8
Sep-10	109.20	0.4	0.8
Oct-10	109.65	0.4	0.9
Nov-10	109.76	0.1	0.9
Dec-10	109.76	0.0	0.9

Source: Eurostat, Banc of America Securities – Merrill Lynch
Figures in bold are actual, others are BAS-ML forecasts

Table 8: Euro-area inflation forecasts (% YoY)

	2008	2009		2010	
		BAS-ML	Consensus	BAS-ML	Consensus
Euro area	3.3	0.4	0.4	0.9	1.2
Germany	2.6	0.2	0.3	0.7	0.9
France	2.8	0.0	0.1	0.8	1.1
Italy	3.3	0.3	0.8	0.7	1.5
Spain	4.1	-0.5	-0.1	1.1	1.2

Source: Eurostat, Consensus Economics, Banc of America Securities - Merrill Lynch; figures based on national CPI indices, except for the euro-area aggregate which is the HICP measure.

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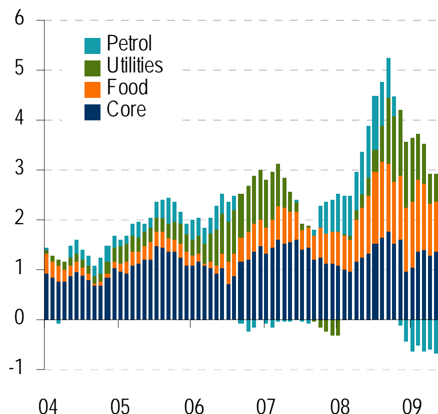
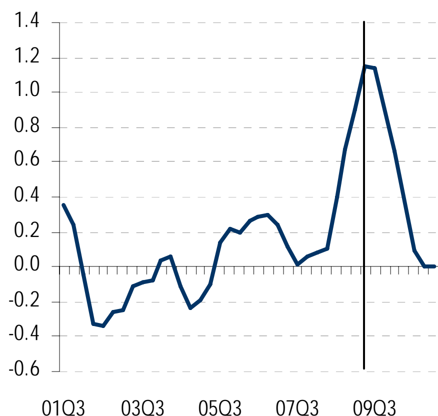
Chart 11: Contributions to CPI inflation (pps)



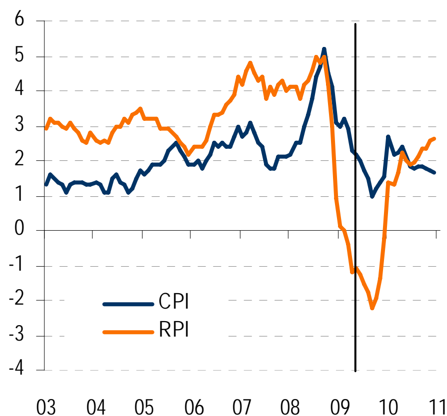
Source: ONS, BAS-ML

Chart 12: Import pressures on inflation (pps)



Source: BAS-ML

Chart 13: Inflation forecasts (% YoY)



Source: ONS, BAS-ML

UK Economics

Downward trend continues

CPI inflation fell from 2.3% in April to 2.2% in May. Continuing the decline from a peak of 5.2% in September 2008, inflation in May was nevertheless a little above the median market expectation of 2.0%; though economists' expectations were very evenly split between 1.9%, 2.0% and 2.1% respectively. Despite rising moderately over the month, petrol prices contributed around 0.1pps to the slowing in CPI inflation, as a larger price rise last year dropped out of the annual comparison (Chart 11). Utility prices accounted for around another 0.05pps of the slowing, as Centrica cut electricity prices by around 10%, having cut gas prices a similar amount back in February (Centrica has a market share of around 44% for gas, and 22% for electricity). Food prices also contributed a similar amount, though that was largely offset by rises in alcohol and tobacco prices, in response to excise duty increases in the Budget.

Imported pressures waning, slack in the economy widening

Core CPI inflation ticked up from 1.5% to 1.6% in May. After the sizeable upside surprises in early 2009, CPI inflation has nevertheless been much closer to expectations more recently. We had noted before how, all else equal, the circa 25% depreciation of sterling between mid-07 and early-09 might continue pushing up on CPI inflation through this year. However, after the circa 8% appreciation of the exchange rate over the last few months, both trade and producer price data now show imported price pressures waning at the early stages of the supply chain, which may dampen that pass-through somewhat (Chart 12).

Evidence has suggested that activity in the economy may have been broadly flat in recent weeks - a significant improvement from the sharp falls in 08Q3-09Q1. However, inventories might have played a significant role in that rebound (a boost which was highly likely at some point, though the precise timing was uncertain), thus auguring relatively little for the potential longevity and fortitude of growth over the next few quarters. Indeed, not least as the household sector rebalances significantly, we expect the recovery to remain muted. Thus, we expect widening spare capacity in the economy to pull down on underlying inflation over the next few quarters, increasingly dominating the pressures from weaker sterling. In turn, while the near-term inflation outlook is strongly driven by utility, food, petrol and VAT effects, over the medium-term we expect inflation to remain subdued, compared with the MPC's projections of a moderate strengthening.

Another decline in June expected

Heavily influenced by a very strong rise in food prices last year dropping out of the annual comparison, we expect CPI inflation to fall back to 2.0% in June. And thereafter, as downward pressures from food, utility and core prices more than offset upward pressures from petrol prices, we expect CPI inflation to continue falling through to a trough in September (Chart 13). The MPC have a somewhat lower near-term inflation outlook however, expecting a trough of around 0.4% in Q4. Thus, while May was the first interval in over a year that an open letter from Mervyn King to the Chancellor was not required (due every 3 months if inflation remains outside the 1-3% range), there may well be another one - but this time on the downside – in the autumn.

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Merrill Lynch Inflation-Linked Indices

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Concern over future inflation was clearly reflected in the relative performance of IL indices vs. their nominal counterparts. Not only did Greece have the best return in May, it was over three times better than that of the next-best performer. Then again, Greece is still making up for large losses the prior year. The only IL index with a low – both in absolute and relative terms – was Japan.

Table 9: Inflation-Linked Index Returns by Country

		Local Total Return		Return vs Nominals	
Global Inflation-Linked Indices	Ticker	Month	YTD	Month	YTD
Canada	G0CI	0.796	2.460	3.121	8.601
France	G0FI	0.167	2.370	2.399	5.700
Germany	G0DI	0.779	2.435	1.955	3.078
Greece	GGRI	6.394	11.633	11.243	21.252
Italy	G0II	1.376	5.502	3.729	8.950
Japan	G0YI	-1.934	-2.690	-1.610	-1.208
Mexico	GMXI	-1.392	2.893	0.012	0.701
Sweden	G0WI	-1.951	-1.953	1.893	8.025
UK	G0LI	1.511	-0.665	2.736	3.440
US	G0QI	1.818	4.217	3.406	10.719
Global Inflation-Linked	W0GI	1.102	2.471	2.810	7.224
Additional Inflation-Linked Indices					
Australia	G0TI	-2.867	-1.694	1.136	4.106
New Zealand	G0ZI	-0.559	3.693	1.371	6.888
Poland	G0PI	3.193	9.543	3.546	14.264
South Africa	GSAI	0.935	5.753	1.369	13.094
Turkey	GTRI	4.837	20.769	2.980	4.254

Source: Merrill Lynch Global Index System

The U.S. share of the Global IL index decreased by nearly 1.5% thanks to a rebound in many currencies relative to the U.S. dollar in May. The U.S. TIPS weight is now at 37.5%, and the lowest reading over the past ten years is 35.0%.

Table 10: Global Government Inflation-Linked Index Structure

	31-May-09				Change vs Prior Month			
Global Inflation-Linked Indices	Issues	Mkt Val (USD MM)	Real Yield	Effective Mod Dur	Issues	Mkt Val (USD MM)	Real Yield	Effective Mod Dur
Canada	5	36,261	2.04	15.46	0	2,595	-0.05	0.13
France	11	211,232	1.26	7.52	0	16,015	-0.07	0.01
Germany	2	33,920	1.21	5.30	0	2,411	-0.07	-0.05
Greece	2	20,185	3.57	13.81	0	2,424	-0.41	0.40
Italy	7	128,467	1.82	7.79	0	9,870	-0.12	0.10
Japan	14	73,929	3.51	7.12	-1	-3,728	0.43	-0.03
Mexico	10	26,779	3.57	7.48	0	1,564	0.16	-0.24
Sweden	4	30,490	1.71	8.72	0	1,317	0.24	-0.18
UK	14	289,604	1.02	13.10	0	29,700	-0.12	0.08
US	27	509,413	1.59	7.90	0	9,093	-0.21	0.00
Global Inflation-Linked	96	1,360,280	1.62	9.13	-1	71,262	-0.12	0.10
Additional Inflation-Linked Indices								
Australia	3	7,502	2.99	5.85	0	346	0.47	-0.13
New Zealand	1	1,397	3.58	5.80	0	136	0.16	-0.03
Poland	1	3,027	4.48	5.90	0	223	-0.33	-0.07
South Africa	4	13,896	2.42	8.09	0	981	0.09	-0.07
Turkey	2	11,205	8.83	2.65	0	844	-0.98	-0.04

Note: Modified durations are calculated using an assumed 1.0 real yield beta.

Source: Merrill Lynch Global Index System

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