

1 September 2000

# Global FX Outlook & Strategy

## A Fortnightly Review

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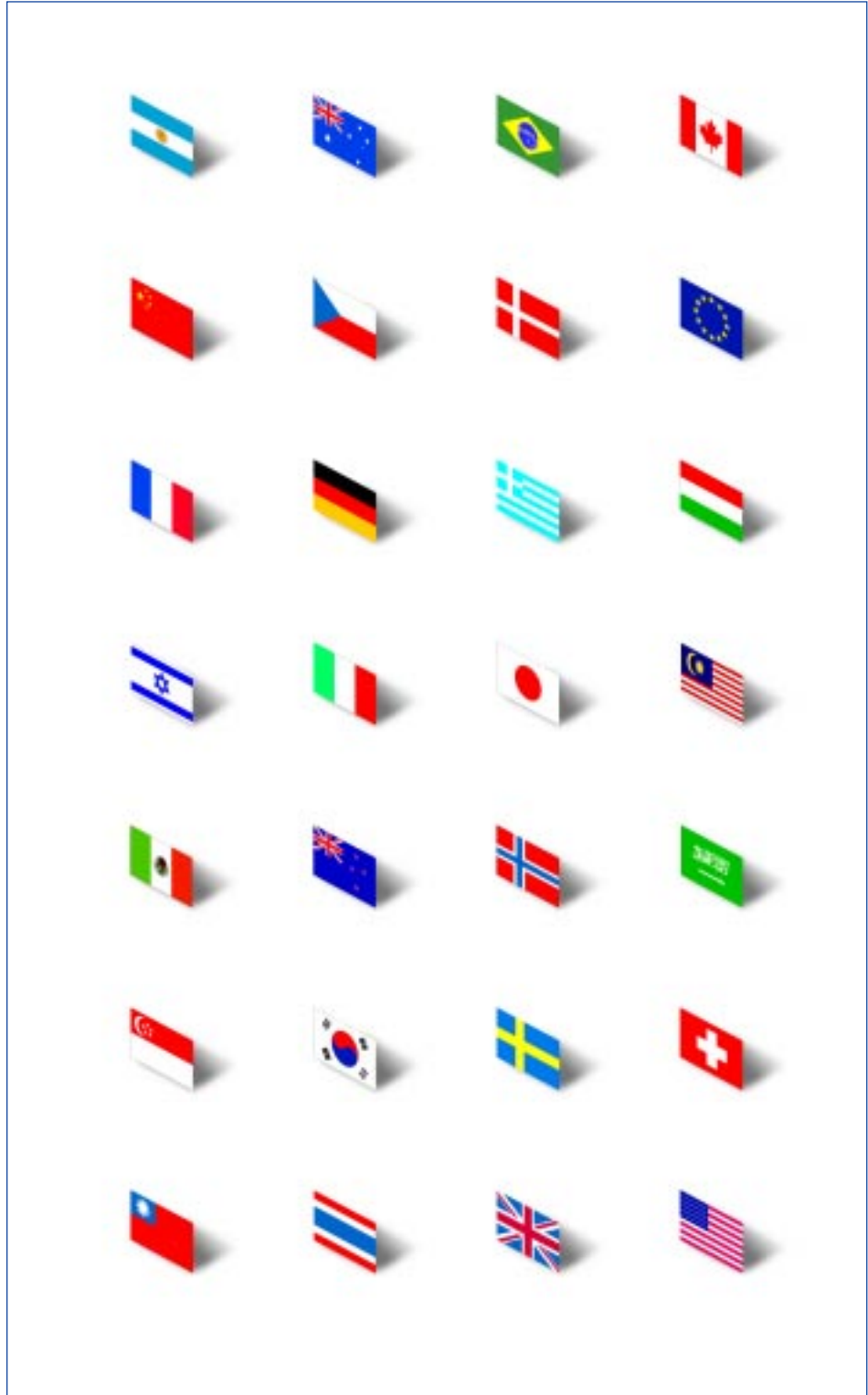
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**Michael R. Rosenberg**  
Head of Global FX Research

**David Folkerts-Landau**  
Managing Director, Head of Global Markets Research



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## Deutsche Bank Foreign Exchange Research

**Michael Rosenberg****New York**

Robert Lawrie  
Tim Moloney  
Marcelo Salomon  
Grace Truong

**London**

Michael Lewis  
Paul Meggyesi

**Sydney**

Richard Yetsenga

**Tokyo**

Kenneth Landon

## Sources:

Datastream International, Inc. is the source of the majority of data used in the charts and tables in this publication. Some emerging-market exchange rates and interest rates are from Reuters. Other sources are noted individually.

The *OECD Economic Outlook* and national accounts data are the sources for historical data in the annual economic tables.

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## Summary & Key Investment Themes

### Summary of This Week's Overview Article

The U.S. dollar's remarkable 5½-year run continues apace. We have long argued that the dollar's rise reflects an upward revision in the dollar's real long-run equilibrium value, which can be traced in large part to continual, stronger-than-expected gains in U.S. productivity growth.

While U.S. domestic economic fundamentals would, everything else being equal, warrant an overweight allocation to the dollar, there are several reasons why fund managers are likely to shy away from such a strategy. According to behavioral finance studies, investors may interpret new information as representing only a temporary shift in the dollar's favor, even if the new information actually represents a permanent shift in the U.S. economic setting.

There will undoubtedly be a limit on just how long U.S. economic data can continue to surprise on the upside. If and when the U.S. economy reaches that limit, the dollar could then become vulnerable, particularly against currencies that are now significantly undervalued on a PPP basis versus the U.S. dollar.

Dollar-based equity fund managers with significant exposure to Japan should consider hedging their yen exposure, since the premium earned by selling yen forward could represent a significant incremental source of total return. For yen-based investors, a high hedge-ratio strategy has been an underperforming strategy for the past 5½ years.

### Industrialized Countries

#### U.S. Dollar

We are long-term dollar bulls. The dollar is the apparent beneficiary of the U.S. leadership role in the information technology, which has raised the speed limit on U.S. potential output and the sustainable current-account deficit, and made U.S. asset all the more attractive.

#### Euro

The compression in the two-year U.S./German interest-rate spread has encouraged net bond inflows into the euro area. But European corporates continue to express their optimism towards the U.S. economy via ongoing acquisition activity, thus maintaining adverse foreign direct investment trends for the euro. The markets next focus will be the Deutsche Telekom/Voicestrem deal, which should maintain near-term downward pressure on the euro as the all time low of 0.8845 beckons.

#### Japanese Yen

Japan's unique tight monetary/loose fiscal policy mix has supported the yen over past years. Japan's massive debt build up and wavering financial health will be a long-term drag on the yen.

#### British Pound

We maintain our view that interest rates have yet to peak in this cycle. Allowing for at least one more rate rise by year-end, we continue to look for a peak of 6.5% and a rise in cable above \$/£ 1.50 once more in coming months.

#### Dollar-Bloc

The C\$ has managed to hold its ground against the US\$, buoyed by M&A activity and growing appreciation for the size of equity inflows making their way into Canada. The A\$ has also recovered following its steep fall just before the recent FOMC meeting. Stronger domestic data, better-than-expected trade numbers, and rising commodity prices have helped offset the impact of a weaker Euro on A\$ sentiment. The A\$/NZ\$ crossrate has moved to its highest level this cycle and should see further gains over coming months.

#### Swiss Franc

M&A outflows have again short circuited a rebound in the Swiss franc. Comments from the Swiss National Bank that the Swiss rate cycle is close to a peak also detracted from sentiment. The franc continues to trade within a 1.54-1.57 range against the euro. The next key event will be the SNB policy meeting on September 13.

### Emerging-Market Currencies

While liquidity continues to be the overriding issue for emerging-market currencies, the overall picture has remained quite positive. As the U.S. and global economy stabilizes, domestic fundamentals in each particular economy takes center stage as being the driver of exchange-rate movements. In Latin America, early signs of an improving economic environment coming from Argentina may mark the so much awaited rebound in sentiment. Lower inflation risks and encouraging growth prospects in Emerging Europe have been supportive of currency gains, especially the Czech koruna and the Hungarian forint. Meanwhile in Asia, we expect political developments to be of particular importance in Indonesia, Thailand, and the Philippines.

# Currency Forecasts

| Industrialized Countries   |              |         |         |          |      |
|----------------------------|--------------|---------|---------|----------|------|
| Currency                   | Spot Rate    | in 3 mo | in 6 mo | in 12 mo |      |
| <b>US\$ Exchange Rates</b> |              |         |         |          |      |
| Euro                       | US\$/Euro    | 0.8934  | 1.00    | 1.05     | 1.05 |
|                            | (Fwd. Rates) | --      | 0.90    | 0.90     | 0.91 |
| Japan                      | ¥/US\$       | 106.53  | 112     | 115      | 120  |
|                            | (Fwd. Rates) | --      | 105     | 103      | 100  |
| U.K.                       | US\$/£       | 1.4554  | 1.54    | 1.54     | 1.55 |
|                            | (Fwd. Rates) | --      | 1.46    | 1.46     | 1.46 |
| Canada                     | C\$/US\$     | 1.4780  | 1.46    | 1.44     | 1.36 |
|                            | (Fwd. Rates) | --      | 1.47    | 1.47     | 1.47 |
| Australia                  | US\$/A\$     | 0.5719  | 0.59    | 0.60     | 0.63 |
|                            | (Fwd. Rates) | --      | 0.57    | 0.57     | 0.57 |
| N.Z.                       | US\$/NZ\$    | 0.4281  | 0.47    | 0.48     | 0.51 |
|                            | (Fwd. Rates) | --      | 0.43    | 0.43     | 0.43 |
| Switzerland                | Sfr/US\$     | 1.7341  | 1.56    | 1.48     | 1.48 |
|                            | (Fwd. Rates) | --      | 1.72    | 1.71     | 1.68 |

| Euro Cross Rates |              |        |      |      |      |
|------------------|--------------|--------|------|------|------|
| Japan            | ¥/Euro       | 95.17  | 112  | 121  | 126  |
|                  | (Fwd. Rates) | --     | 94   | 93   | 91   |
| U.K.             | £/Euro       | 0.6139 | 0.65 | 0.68 | 0.68 |
|                  | (Fwd. Rates) | --     | 0.62 | 0.62 | 0.62 |
| Switzerland      | Sfr/Euro     | 1.5492 | 1.56 | 1.55 | 1.55 |
|                  | (Fwd. Rates) | --     | 1.54 | 1.54 | 1.53 |
| Denmark          | Dkr/Euro     | 7.4548 | 7.46 | 7.46 | 7.46 |
|                  | (Fwd. Rates) | --     | 7.47 | 7.48 | 7.50 |
| Norway           | Nkr/Euro     | 8.0730 | 8.35 | 8.40 | 8.40 |
|                  | (Fwd. Rates) | --     | 8.12 | 8.16 | 8.24 |
| Sweden           | Skr/Euro     | 8.4195 | 8.50 | 8.50 | 8.50 |
|                  | (Fwd. Rates) | --     | 8.40 | 8.38 | 8.37 |
| Greece           | Gdr/Euro     | 337.63 | 339  | 341  | 341  |
|                  | (Fwd. Rates) | --     | 340  | 341  | 341  |

| Emerging Europe |              |         |            |            |            |
|-----------------|--------------|---------|------------|------------|------------|
| Currency        | Spot Rate    | in 3 mo | in 6 mo    | in 12 mo   |            |
| Czech Rep.      | Koruna/Euro  | 35.36   | 36.50      | 37.50      | 38.00      |
|                 | (Fwd. Rates) | --      | 35.40      | 35.41      | 35.49      |
| Hungary         | Forint/Euro  | 261.22  | <b>263</b> | 264        | 267        |
|                 | (Fwd. Rates) | --      | 265        | 268        | 274        |
| Poland          | Zloty/US\$   | 4.38    | 4.45       | 4.45       | 4.45       |
|                 | (Fwd. Rates) | --      | 4.52       | 4.65       | 4.89       |
| Russia          | Ruble/US\$   | 27.78   | 27.20      | 27.20      | 28.20      |
|                 | (Fwd. Rates) | --      | -          | -          | -          |
| Turkey          | Lira/US\$ *  | 652.050 | <b>655</b> | <b>654</b> | <b>688</b> |
|                 | (Fwd. Rates) | --      | 687        | 723        | 805        |

| Asia        |               |         |         |          |       |
|-------------|---------------|---------|---------|----------|-------|
| Currency    | Spot Rate     | in 3 mo | in 6 mo | in 12 mo |       |
| China       | Renminbi/US\$ | 8.28    | 8.30    | 8.50     | 9.10  |
|             | (Fwd. Rates)  | --      | 8.29    | 8.30     | 8.37  |
| Hong Kong   | HK\$/US\$     | 7.80    | 7.80    | 7.80     | 7.80  |
|             | (Fwd. Rates)  | --      | 7.79    | 7.79     | 7.78  |
| Indonesia   | Rupiah/US\$   | 8360    | 9650    | 10000    | 10500 |
|             | (Fwd. Rates)  | --      | 8400    | 8520     | 8770  |
| Malaysia    | Ringgit/US\$  | 3.80    | 3.80    | 3.80     | 3.80  |
|             | (Fwd. Rates)  | --      | 3.77    | 3.74     | 3.69  |
| Philippines | Peso/US\$     | 45.10   | 45.00   | 46.00    | 47.30 |
|             | (Fwd. Rates)  | --      | 46.20   | 46.90    | 48.10 |
| Singapore   | S\$/US\$      | 1.72    | 1.73    | 1.70     | 1.68  |
|             | (Fwd. Rates)  | --      | 1.70    | 1.69     | 1.65  |
| South Korea | Won/US\$      | 1109    | 1105    | 1090     | 1050  |
|             | (Fwd. Rates)  | --      | 1109    | 1110     | 1111  |
| Taiwan      | NT\$/US\$     | 31.07   | 31.00   | 32.00    | 34.00 |
|             | (Fwd. Rates)  | --      | 31.10   | 31.10    | 30.80 |
| Thailand    | Baht/US\$     | 40.98   | 40.80   | 42.00    | 44.00 |
|             | (Fwd. Rates)  | --      | 40.70   | 40.60    | 40.50 |

| Latin America |              |         |             |             |              |
|---------------|--------------|---------|-------------|-------------|--------------|
| Currency      | Spot Rate    | in 3 mo | in 6 mo     | in 12 mo    |              |
| Argentina     | Peso/US\$    | 1.00    | 1.00        | 1.00        | 1.00         |
|               | (Fwd. Rates) | --      | 1.00        | 1.01        | 1.04         |
| Brazil        | Real/US\$    | 1.83    | <b>1.88</b> | <b>1.88</b> | <b>1.88</b>  |
|               | (Fwd. Rates) | --      | 1.87        | 1.90        | 1.97         |
| Chile         | Peso/US\$    | 564.55  | <b>550</b>  | <b>540</b>  | <b>535</b>   |
|               | (Fwd. Rates) | --      | 565         | 568         | 578          |
| Colombia      | Peso/US\$    | 2208.00 | <b>2200</b> | <b>2222</b> | <b>2289</b>  |
|               | (Fwd. Rates) | --      | 2250        | 2290        | 2425         |
| Mexico        | Peso/US\$    | 9.21    | <b>9.35</b> | <b>9.55</b> | <b>10.00</b> |
|               | (Fwd. Rates) | --      | 9.43        | 9.65        | 10.09        |
| Venezuela     | Bolivar/US\$ | 689.25  | <b>711</b>  | <b>732</b>  | <b>777</b>   |
|               | (Fwd. Rates) | --      | 701         | 721         | 763          |

| Middle East / Africa |              |         |             |             |             |
|----------------------|--------------|---------|-------------|-------------|-------------|
| Currency             | Spot Rate    | in 3 mo | in 6 mo     | in 12 mo    |             |
| Israel               | Shekel/US\$  | 4.01    | <b>4.12</b> | 4.30        | 4.40        |
|                      | (Fwd. Rates) | --      | 4.02        | 4.03        | 4.06        |
| South Africa         | Rand/US\$    | 6.96    | <b>6.63</b> | <b>6.67</b> | <b>7.11</b> |
|                      | (Fwd. Rates) | --      | 7.03        | 7.09        | 7.21        |

Source: Datastream, Reuters, DB forecasts.  
 \* Turkish Lira exchange rates are divided by 1000.  
 Forecasts highlighted in **blue** indicate a change in levels.  
 Forecasts highlighted in **bold** indicate a change in direction.



## FX Strategy: Projected Total Return Analysis

Based on our projections of exchange-rate trends over the next six months, we strongly favor overweight positions in the continental European currencies. The Japanese yen ranks at the bottom of our list of industrialized-country currencies.

Our total-return indicators are favoring positions in the Hungarian forint and the Czech koruna as stronger

growth and the lack of inflationary fears boost their values. Meanwhile in Indonesia, despite the high short-term interest rates (13.5%), the worsening political outlook should continue to drive the currency down dragging total returns to below -10% over the next six months.

### Projected Six-Month Total Returns for Industrialized Countries (in U.S. Dollar Terms)

| Rank | Currency          | Latest Spot Rate | Six-Month Forecast Spot Rate | Projected Currency Return | Money Market Rate | Expected Six-month Total Return | Strategy Relative to Benchmark |
|------|-------------------|------------------|------------------------------|---------------------------|-------------------|---------------------------------|--------------------------------|
| 1    | Greek Drachma     | 378              | 325                          | 16.4                      | 8.7               | 21.4                            | Overweight                     |
| 2    | Danish Krone      | 8.34             | 7.10                         | 17.4                      | 5.7               | 20.8                            | Overweight                     |
| 3    | Euro              | 0.89             | 1.05                         | 17.5                      | 4.8               | 20.4                            | Overweight                     |
| 4    | Swiss Franc       | 1.73             | 1.48                         | 17.5                      | 3.4               | 19.5                            | Overweight                     |
| 5    | Swedish Krona     | 9.42             | 8.10                         | 16.4                      | 4.0               | 18.8                            | Overweight                     |
| 6    | Norwegian Krone   | 9.04             | 8.00                         | 13.0                      | 7.1               | 16.9                            | Overweight                     |
| 7    | N.Z. Dollar       | 0.43             | 0.48                         | 12.1                      | 6.6               | 15.8                            | Neutral                        |
| 8    | U.K. Pound        | 1.46             | 1.54                         | 5.8                       | 6.2               | 9.1                             | Neutral                        |
| 9    | Australian Dollar | 0.57             | 0.60                         | 4.9                       | 6.4               | 8.3                             | Neutral                        |
| 10   | Canadian Dollar   | 1.48             | 1.44                         | 2.6                       | 5.8               | 5.6                             | Neutral                        |
| 11   | U.S. Dollar       | --               | --                           | 0.0                       | 6.6               | 3.3                             | Neutral                        |
| 12   | Japanese Yen      | 107              | 115                          | -7.4                      | 0.4               | -7.2                            | Underweight                    |

### Projected Six-Month Total Returns in Emerging Markets (in U.S. Dollar Terms)

| Rank | Currency     | Latest Spot Rate | Six-Month Forecast Spot Rate | Projected Currency Return | Short-Term Interest Rate | Expected Six-month Total Return | Strategy—Relative to Benchmark |
|------|--------------|------------------|------------------------------|---------------------------|--------------------------|---------------------------------|--------------------------------|
| 1    | Hungary      | 292              | 251                          | 16.3                      | 10.7                     | 22.5                            | Overweight                     |
| 2    | Turkey       | 652              | 654                          | -0.3                      | 33.2                     | 16.3                            | Neutral                        |
| 3    | Czech Rep.   | 39.58            | 35.71                        | 10.8                      | 5.3                      | 13.8                            | Overweight                     |
| 4    | South Africa | 6.96             | 6.67                         | 4.3                       | 9.9                      | 9.5                             | Neutral                        |
| 5    | Poland       | 4.38             | 4.45                         | -1.5                      | 19.8                     | 8.2                             | Neutral                        |
| 6    | Chile        | 565              | 540                          | 4.5                       | 5.8                      | 7.6                             | Neutral                        |
| 7    | Colombia     | 2208             | 2222                         | -0.6                      | 12.4                     | 5.5                             | Neutral                        |
| 8    | Argentina    | 1.00             | 1.00                         | -0.0                      | 11.0                     | 5.5                             | Neutral                        |
| 9    | Korea        | 1109             | 1090                         | 1.7                       | 7.4                      | 5.5                             | Neutral                        |
| 10   | Brazil       | 1.83             | 1.88                         | -2.8                      | 16.0                     | 4.9                             | Neutral                        |
| 11   | Singapore    | 1.72             | 1.70                         | 1.4                       | 6.8                      | 4.8                             | Neutral                        |
| 12   | Mexico       | 9.21             | 9.55                         | -3.5                      | 16.1                     | 4.3                             | Neutral                        |
| 13   | Hong Kong    | 7.80             | 7.80                         | 0.0                       | 6.8                      | 3.4                             | Neutral                        |
| 14   | Philippines  | 45.10            | 46.00                        | -2.0                      | 10.5                     | 3.2                             | Underweight                    |
| 15   | Malaysia     | 3.80             | 3.80                         | 0.0                       | 3.5                      | 1.8                             | Underweight                    |
| 16   | Venezuela    | 689              | 732                          | -5.8                      | 15.2                     | 1.3                             | Underweight                    |
| 17   | China        | 8.28             | 8.50                         | -2.6                      | 5.9                      | 0.2                             | Underweight                    |
| 18   | Taiwan       | 31.07            | 32.00                        | -2.9                      | 5.8                      | -0.1                            | Underweight                    |
| 19   | Thailand     | 40.98            | 42.00                        | -2.4                      | 3.4                      | -0.8                            | Underweight                    |
| 20   | Israel       | 4.01             | 4.30                         | -6.8                      | 9.0                      | -2.6                            | Underweight                    |
| 21   | Indonesia    | 8360             | 10000                        | -16.4                     | 13.5                     | -10.8                           | Underweight                    |

## Overview

The U.S. dollar's remarkable run to new higher highs continues apace. As shown in Figure 1, the trade-weighted dollar has been on a rising trend for the past 5½ years and has recently risen to another new cyclical high. The dollar's long-term appreciation appears even more impressive when we exclude the yen. As shown in Figure 2, a U.S. dollar trade-weighted index that excludes the yen has been rising for eight years, and has recently moved to a new high for this cycle. We have long argued that the dollar's rise reflects an upward revision in the dollar's real long-run equilibrium value, which can be traced in large part to the continual stronger-than-expected gains in U.S. productivity growth.

In determining whether to maintain overweight or underweight exposures to the dollar in the future, fund managers need to weigh a number of competing factors. On the positive side, the continual underlying strength of the U.S. economy should, everything else being equal, encourage investors to maintain an overweight position in the U.S. dollar. If anything, the already bright U.S. economic outlook could get even brighter in the year ahead. Some senior Federal Reserve officials believe that the speed limit at which the U.S. economy can safely grow without igniting inflation may now be as high as 5.0% per annum. The dollar could also get a lift from the recent solid gains in U.S. export growth. As shown in Figure 3, U.S. goods exports are now rising at a very rapid 19.4% year/year clip. Much of the recent gain in U.S. exports is in the capital goods sector, particularly computers and semi-conductors. This would suggest that the boom in U.S. information technology spending over the past few years is finally beginning to pay off.

The dollar might also gain ground if the U.S. fiscal/monetary policy mix shifts toward greater fiscal stimulus and greater monetary restraint following the November 2000 U.S. Presidential election. It is widely felt that whether Texas Governor Bush or Vice President Gore is elected the next President, the U.S. fiscal stance looks set to become more expansive in the coming years. With the U.S. economy already white hot, a more expansive fiscal stance would place greater pressure on the Federal Reserve to tighten its grip on the monetary reins. If the fiscal stance is indeed eased and the monetary stance tightened, the resulting policy mix should drive U.S. real interest rates higher, thereby lending additional support to the dollar.

Figure 1

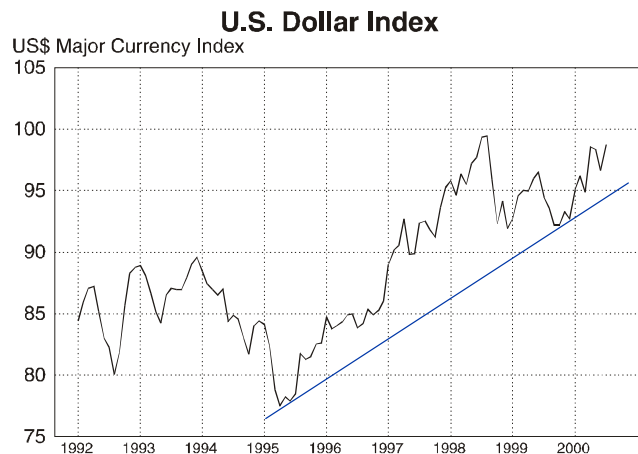


Figure 2

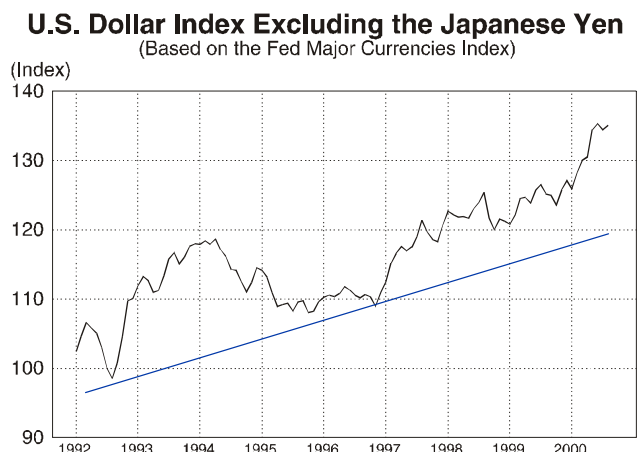
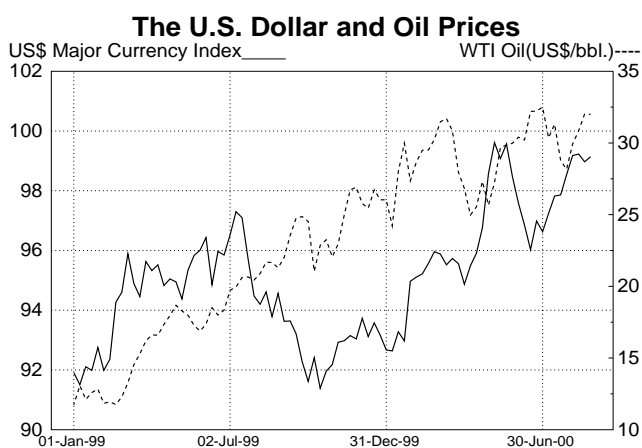


Figure 3



Figure 4

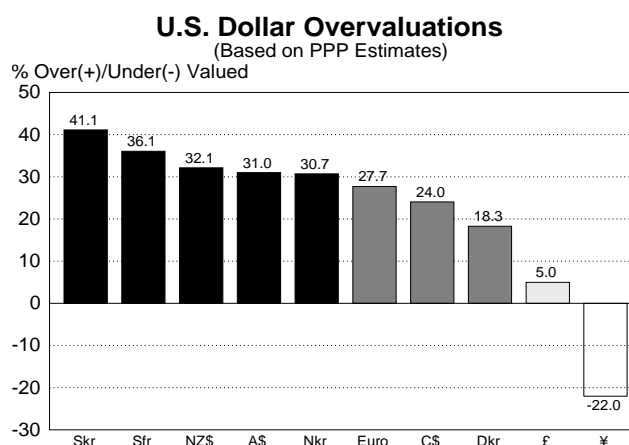


One additional factor in the dollar's favor in the months ahead would be a further rise in the price of oil. As we have pointed out in recent reports, econometric studies by both the Bundesbank and the Bank of Canada have found that sustained increases in energy prices have tended to boost the U.S. dollar's value. Indeed, it may be the case that part of the past year's gains in the dollar's value could be attributed to the sharp hike in oil prices (see Figure 4). With oil inventories presently lean, capacity constraints holding back output in several leading oil producing nations, overall global demand strong, and upcoming seasonal pressures likely to boost the demand for oil, there is a risk that oil prices might move still higher in the months ahead. If so, this could help push the dollar higher.

While U.S. domestic economic fundamentals would, everything else being equal, warrant an overweight allocation to the dollar, there are several reasons why fund managers are likely to shy away from such a strategy. First, the dollar's appreciation over the past 5½-8 years has pushed the dollar into significantly overvalued territory on a purchasing power parity basis. As shown in Figure 5, our estimates suggest that the dollar is overvalued by 30%-40% versus the Swedish krona, New Zealand dollar, Australian dollar, and Norwegian krone. Against the euro, Canadian dollar, and Danish krone, the dollar is overvalued by 20%-30%. Such large dollar overvaluations will make investors reluctant to carry heavily overweight dollar positions.

In addition, concern over the mammoth size of the U.S. current-account deficit is likely to make investors wary of having aggressively overweight dollar exposures. Concern was expressed once again at the Federal Reserve Bank of Kansas City's Jackson Hole, Wyoming conference that the dollar could face a hard landing if foreign investors, concerned about the potential difficulties of financing the mammoth U.S. current-account deficit, decided to exit the U.S. all at once.

Figure 5

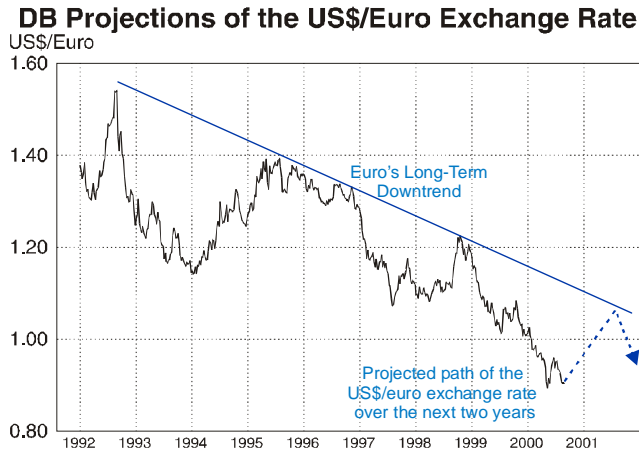


Behavioral finance theory may also shed some light as to why investors might be reluctant to aggressively overweight the dollar. (For a highly readable introductory survey to behavioral finance theory, we recommend *Beyond Greed and Fear*, by Hersh Shefrin, Harvard Business School Press, 2000.) According to behavioral finance studies, investors have been found to have a mean-reverting bias when they view financial market trends.

For example, if new information reaches the market that helps drive the dollar higher, the market will initially tend to interpret that new information as representing a "temporary" favorable shift in the fundamental setting, even if the new information actually represents a "permanent" favorable shift. Viewing new information as a temporary and not as a permanent change to the fundamental setting, investors will tend to expect increases in the dollar's value induced by the new information to be temporary as well. Therefore, they will expect both the dollar and the change in economic setting to eventually reverse, i.e., the dollar would be expected to revert to its mean value once the perceived temporary shift in the fundamental setting is unwound.

The mistake investors seem to make is to interpret new information on the U.S. economy as representing a temporary shift in the economic setting when, in fact, it may reflect a permanent shift. This creates a situation where investors will repeatedly be surprised by favorable developments in the U.S. economy. With positive U.S. surprises followed by more positive U.S. surprises, investors will repeatedly get caught leaning the wrong way. And while the steady stream of positive U.S. surprises forces investors to steadily revise upward their "estimate" of the dollar's long-run equilibrium level, those estimates repeatedly fall short of the dollar's "true" long-run equilibrium level because investors tend to "learn" only slowly.

Figure 6

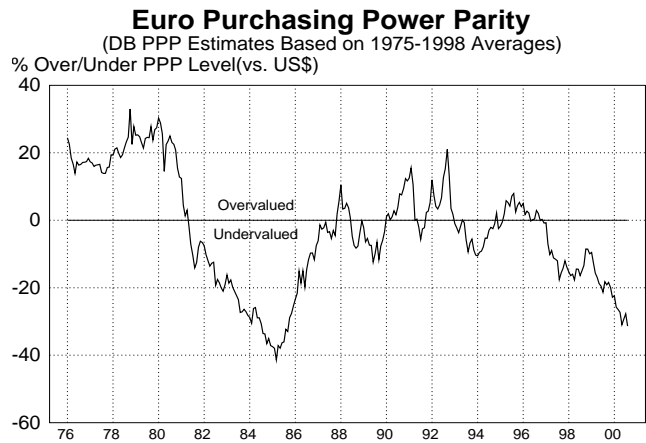


In all likelihood, investors' expectations will continue to be anchored to purchasing power parity valuation criteria and to slowly adapting notions of fair value for the dollar. As such, global investors will likely shy away from holding onto aggressively overweight dollar positions.

Investors are not the only party guilty of mean reversion thinking. Currency strategists are equally guilty. Indeed, our own forecast for the U.S. dollar/euro exchange rate has called for a mean-reverting rebound of the euro to its longer-term downtrend line shown in Figure 6. On PPP grounds (see Figure 7), relative unemployment-rate considerations (see Figure 8), and interest-rate differential trends (see Figure 9), a case could be made that the euro should be poised to experience at least a medium-term rebound.

The reason that the euro has so far failed to rise against the dollar probably has less to do with weak Euroland fundamentals and more to do with strong U.S. funda-

Figure 7



mentals. In fact, the dollar is strong versus most major currencies, not just the euro. And with the seemingly endless capacity of the U.S. economic data to surprise on the upside—it was recently reported that U.S. capital spending on technology rose by nearly 30% on a year/year basis (see Figure 10) and that U.S. productivity surged by 5.1% year/year (see Figure 11), the strongest productivity gain in 17 years—this has led to comparable upside surprises for the dollar as well.

However, one note of caution is warranted here. There will undoubtedly be a limit on just how long U.S. economic data can continue to surprise on the upside. If and when the U.S. economy reaches that limit, the dollar could then become vulnerable, particularly against the currencies that are now significantly undervalued on a PPP basis versus the U.S. dollar.

Figure 8

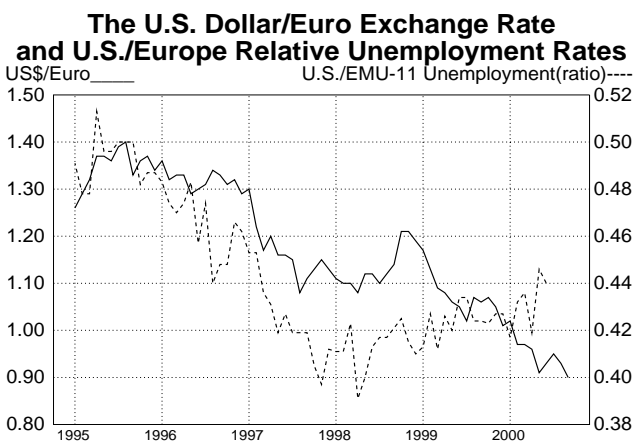


Figure 9

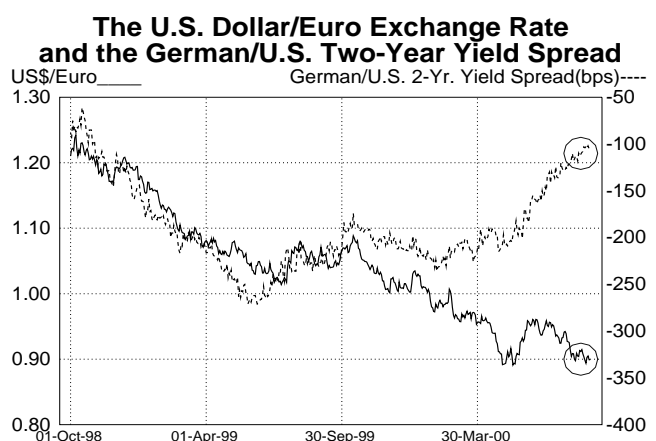


Figure 10

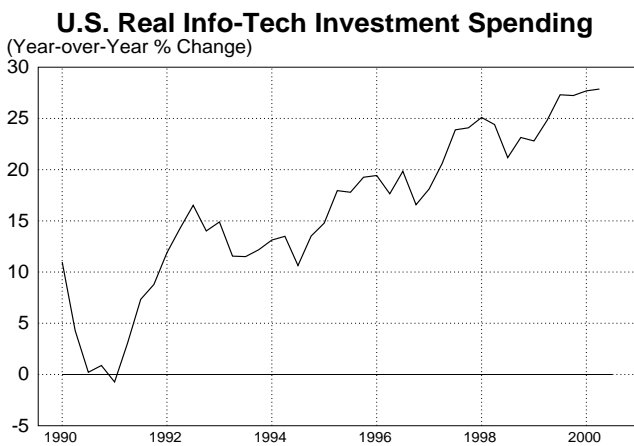


Figure 11



Turning our attention to the Japanese yen, the behavior of the yen continues to frustrate both yen bulls and bears alike. The yen has been the only major industrial currency that has not weakened on a trend basis versus the U.S. dollar in the past couple of years. We have long argued that the yen has been firm over this period because Japan's unique expansive-fiscal/tight-monetary policy mix has helped drive real interest rates higher in Japan relative to real U.S. rates. As shown in Figure 12, the dollar's decline versus the yen since 1998 can be traced to the narrowing trend in U.S./Japanese real interest-rate differentials. Japanese real interest rates have risen on a trend basis in the past 2-3 years largely because the pace of Japanese deflation has intensified. Indeed, as shown in Figure 13, the year/year decline in the Tokyo CPI amounted to -1.3% in August, which is close to a record year/year decline.

Although the yen has been firm versus the U.S. dollar, the real question we need to be asking is how have long yen positions performed relative to long dollar positions? The yen could trade with an upward bias, but this does not necessarily imply that long yen positions will outperform long U.S. dollar positions. For example, the U.S./Japanese short-term yield spread presently stands at 625-650 basis points. The yen would need to appreciate by more than 6.25%-6.50% per annum versus the dollar in order for long yen positions to outperform long dollar positions. The evidence suggests that those periods when long yen positions have outperformed long dollar positions have been few and far between in the past 5½ years.

Figure 12

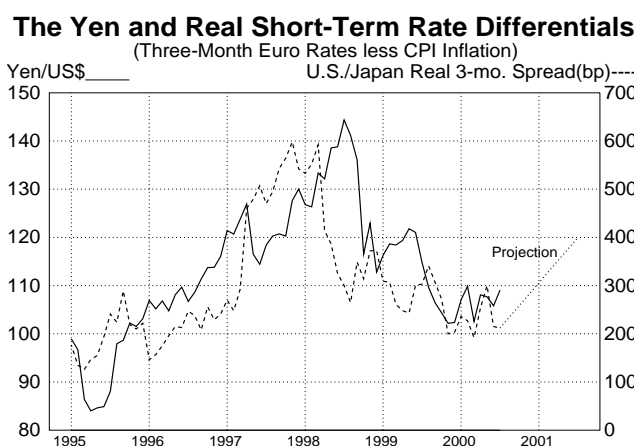


Figure 13

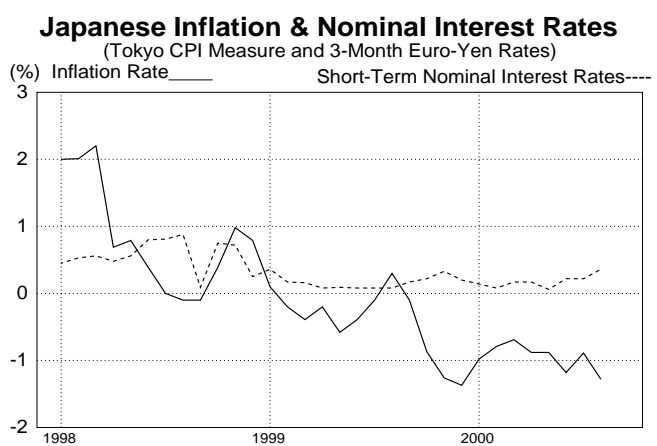


Figure 14 illustrates the excess return that could have been earned on long dollar positions relative to long yen positions since April 1995. Between April 1995 and August 1998 the dollar trended higher versus the yen while short-term yield spreads between the U.S. and Japan averaged around 500 basis points in favor of the U.S. As a result, substantial excess returns could have been earned by taking on long dollar/short yen positions. It was during this period that the infamous yen carry trade was so popular among leveraged investors.

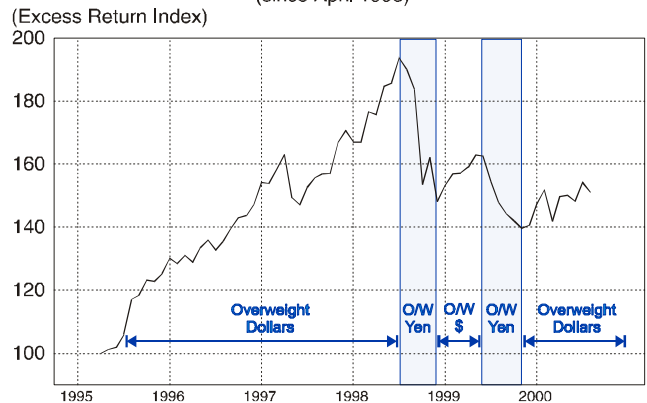
The unwinding of the yen carry trade in September-October 1998 created a brief window where excess returns were available on long yen/short dollar positions. But following the unwinding of the yen carry trade, long dollar/short yen positions once again became the stronger performer. Between November 1998 and June 1999, excess returns could have been earned on long dollar positions, partly generated from the modest rise in the dollar's value at that time, and partly from the attractive yield pickup that long dollar positions offered.

Another brief window opened up for long yen/short dollars between July and September 1999 as the yen strengthened more than the adverse yield spread. But since September 1999, a relatively stable yen along with a rather wide U.S./Japanese yield spread has created an environment where long dollar/short yen positions have once again become the stronger performer.

What this exercise demonstrates is that when comparing investment positions in dollars and yen, we need to take account of both the expected currency move plus the relatively wide yield gap between the U.S. and Japan. What does all of this imply for global fund managers? In terms of setting currency exposure, investors should prefer to be overweight dollars relative to the yen if (1) the dollar is expected to gain ground on the yen, (2) the dollar is expected to be range-bound versus the yen, or (3) the dollar is expected to lose ground to the yen by less than the 625-650 basis point yield spread. The only reason to adopt a medium-term/long-term overweight core position in the yen is if one expects the yen to materially strengthen by more than 6.25%-6.50% versus the U.S. dollar on a per annum basis.

Figure 14

**Excess Return of Long-US\$/Short-Yen Positions**  
(since April 1995)



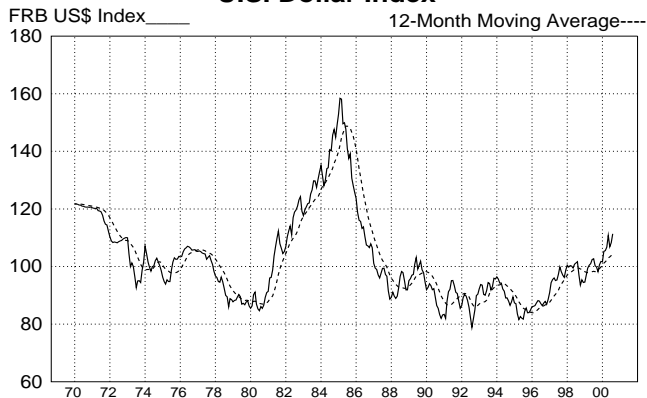
For equity fund managers, this would suggest that dollar-based investors with significant exposure to the Japanese equity market should consider hedging their yen exposure, since the premium earned by selling yen forward could represent a significant incremental source of total return. The opportunity cost associated with this hedging strategy is the risk that the yen strengthens by more than the U.S./Japanese yield spread, a risk to which we would assign only a small probability. The opposite strategy would be recommended for yen-based investors with significant exposure to the U.S. equity market. Such investors should be unhedged because of the significant costs associated with selling dollars forward at a large discount. The risk to such a strategy is that the dollar falls by more than the forward discount.

This discussion has important implications for the hedging activities of Japanese investors. Japanese investors have tended to be highly risk averse and have therefore maintained high hedge ratios on their overseas investments. However, as Figure 14 implies, a high hedge ratio strategy has been an underperforming strategy for the past 5½ years.

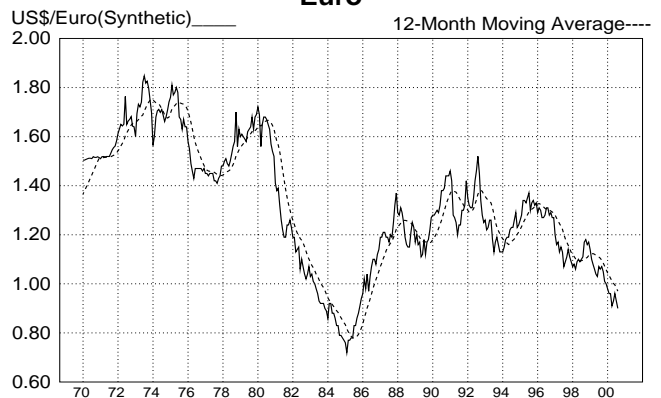
**Michael R. Rosenberg** New York, (1) (212) 469-4776  
[michael.rosenberg@db.com](mailto:michael.rosenberg@db.com)

# The Dollar's Long-Run Exchange-Rate Trends

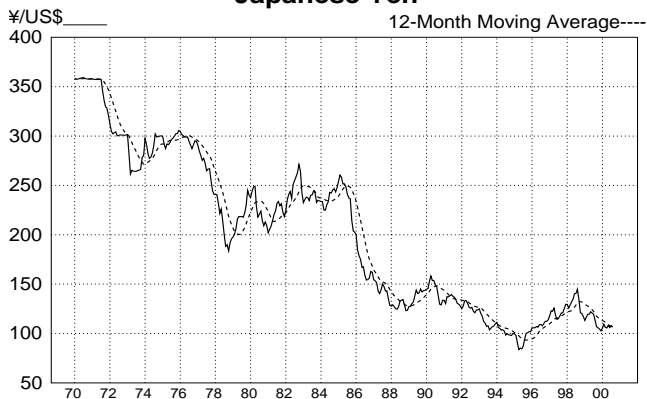
**U.S. Dollar Index**



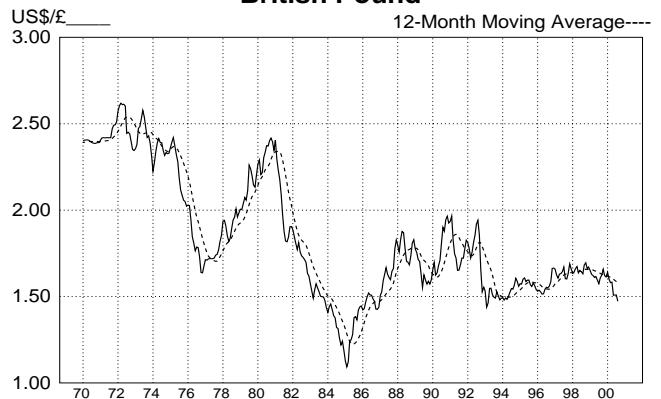
**Euro**



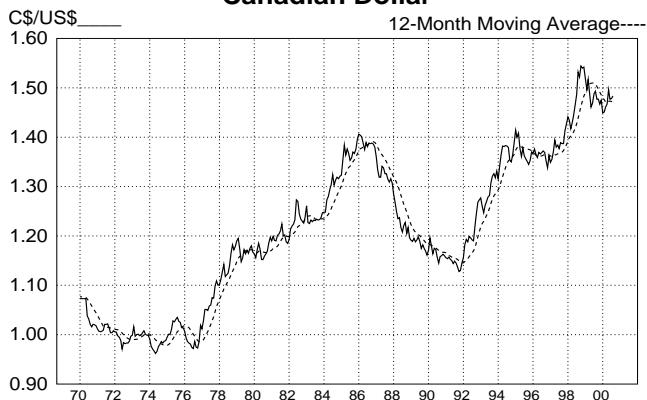
**Japanese Yen**



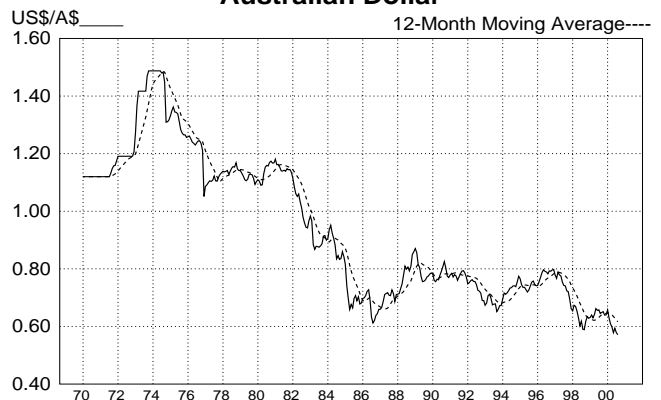
**British Pound**



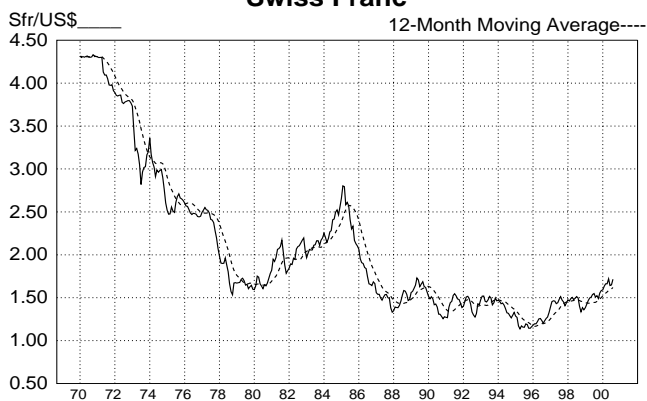
**Canadian Dollar**



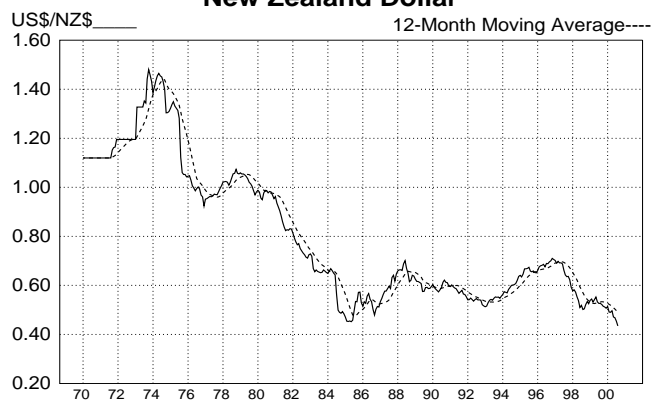
**Australian Dollar**



**Swiss Franc**



**New Zealand Dollar**



## A Behavioral Perspective

### The Euro (versus the U.S. Dollar)

(Latest: US\$/€ 0.8910)

#### **The return of the old behaviour means a return of the old risks.**

A month is a long time in the financial markets. Just four weeks ago we commended medium-term position-takers for their money management discipline. We noted how their willingness to cut losses on long positions, something they were loath to do last year, had nipped a potential downtrend in the bud.

Then, suddenly, over the month of August it seems that the old biases are back. Whilst the currency has barely moved, bullish opinion has skyrocketed. In terms of our Euro Sentiment Index, optimism in a three-month horizon has almost doubled over the course of the month. Even allowing for the usual self-encouragement that bulls feed themselves, this time in the form of a frenzy surrounding the foreign-exchange impact of the auction for 3G mobile phone licenses, it is difficult to justify the widespread conviction in higher prices.

The discussion surrounding the UMTS licenses—supposedly a key fundamental factor—vanished 24-hours after the bidding came to a close, but bullishness, nevertheless, continued to rise. Only the euro's proximity to its historical low could explain the overwhelming desire to hold them. Clearly, discipline is much easier when it doesn't involve selling at the lows.

The return of the old behaviour means a return of the old risks. It was precisely the reluctance of medium-term longs to square their positions that resulted in the drawn-out downtrend in 1999. Once again, we must prepare ourselves for a plunge to new depths.

The exposures are probably not as great as last year, thanks to the Spring rally to 0.9700, which allowed some to escape, so the decline need not be interminable. First, we should reckon with a move to 0.8750. Stop-losses on a grander scale will probably be triggered only below there. Then we would see a slide to 0.8360/80. A powerful rebound is difficult to imagine. For the recent longs a return just to breakeven would be a welcome sight. For the many bulls that came on board over the month of August, this point is near 0.9090, thus the euro will have difficulty in overtaking even this. To argue with any kind of stabilisation, an eventual recovery would have to go beyond 0.9290.

### The Japanese Yen (versus the U.S. Dollar)

(Latest: ¥/€ 106.20)

#### **The risk is too great to wait for further downside confirmation.**

The first half of August was untypically quiet for the dollar. The apparent lack of activity must have hidden much position adjustment because, in the last two weeks, it has embarked on a downward path with determination. We had anticipated another 2%-3% of upside before the U.S. dollar took its inevitable plunge. But, as it turned out, it violated immediately our critical downside point and is now on a course to undercut the January low and revisit prices not seen since 1995 (95.40).

The U.S. dollar is still within a multi-month consolidation and the lower border at 103.50/75 could yet provide some support. We believe, however, that it would be impudent to wait for further downside confirmation. So, at the risk of seeing it pull back to above 109.75 and into neutral territory again, we prefer to prepare now for the worst. Even were a stabilisation to be attained, the best to be hoped for is the same as last month—an advance to the 112.80/113.40 zone before lower again.

### The Japanese Yen/Euro Crossrate

(Latest: ¥/€ 0.9460)

#### **The investment in a losing course of action goes beyond being right or wrong.**

Even three months after the other major euro-crosses had achieved a stabilisation, the euro/yen had done nothing to alter its medium-term downtrend. The long-suffering cross has borne the weight of the contrary positioning in the yen as much as in the euro. The size and the distribution of the non-performing positions in this market must now be enormous. And the rebounds, which over the last 12-months have become smaller and smaller, have systematically denied a breakeven exit for bulls that have been accumulating euros since the start of 1999

As we write, long position holders are once again faced with a new historical low. It's difficult to imagine that the behaviour will change however. The investment in the losing course of action has long since gone beyond the simple fact of being right or wrong. Thus, after a quick decline to 91.40, one must expect the trend to slow again as renewed accumulation kicks in. A fresh consolidation may then develop around this lower level. One cannot predict when a final capitulation may unfold. To be honest, we had thought that it would come a long time ago. But, a long-squeeze at this time could see the cross attain very quickly the level 83.90. The stabilisation point has again drawn a little closer but at 103.00 (strong), it is too distant to be relevant. Much earlier hurdles, in particular at 99.30 must be cleared before this would again come into play.



## The Euro (versus the British Pound)

(Latest: £/€ 0.6155)

### Oscillation around the current entry prices makes euro unpredictable

We were surprised to see the euro gather a little downside pace last month. Although it undercut, albeit marginally, our 0.6040 support (apologies), the price action still seems to be part of the same base-building process that we identified one month earlier. As a result, were it to overtake 0.6185, we would again be willing to bet on rising prices. Initially we would look for gains to 0.6320 whilst secretly preparing for an advance to as high as 0.6655.

Further weakness from here, especially to below 0.5970, would be a damaging sign. A lack of good support in this region could condemn the cross to a return to the May lows. Bear in mind that there is no positional bias in this market. The majority of the current medium-term positions is relatively recent (2-4 months) and will have entry prices near current levels. A flexible approach is recommended for what could prove to be a volatile future.

## The Australian Dollar (versus the U.S. Dollar)

(Latest: US\$/A\$ 0.5900)

### The NZD was implicated in the unwinding of AUD positions

Although the attention was focussed on its New Zealand cousin over the last few weeks, the A\$ nevertheless recorded some sizeable price moves of its own. In one week it lost over 4%, with most of this taking place over just two days! The behaviour of the A\$/NZ\$ cross rate seemed to confirm last month's suspicion that many had hedged their short-A\$ risk through the NZ dollar—a decision that subsequently proved unwise. The spike to a new year high that materialised in that cross did not help our A\$ view, however, as we were rather expecting modest gains.

The above evaluation means that medium-term players are now largely square, thus the idea that the market is capable of a further huge squeeze has to be set aside. Of course, short-term dip buyers will be attracted by the market's proximity to its May low. However, even were these to be squeezed out (this will most likely be the case), the downside pressure would not be too great. One should expect 0.5605/10, but probably not more. The upside objective on these longs will not be too ambitious. Already, in the zone 0.5775/95, many will be coaxed onto the offer. The A\$ would need to rally to beyond 0.6120 (strong), however, to regain any credibility.

**Herman Brodie**

[herman.brodie@db.com](mailto:herman.brodie@db.com)

Frankfurt, (49-69) 910-35093

# Market Sentiment

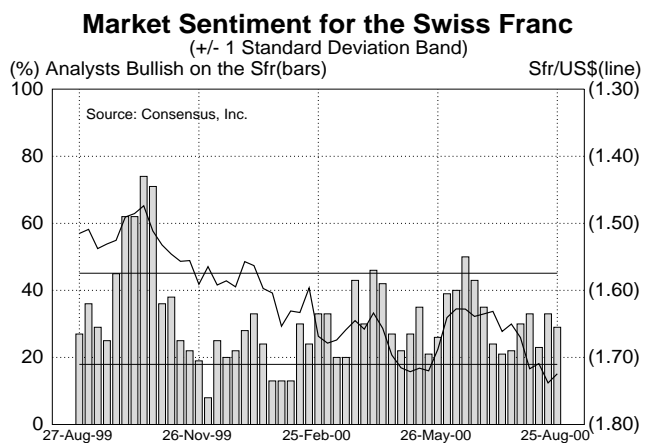
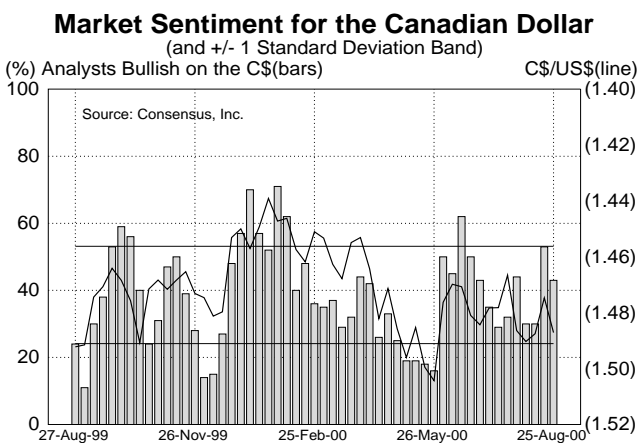
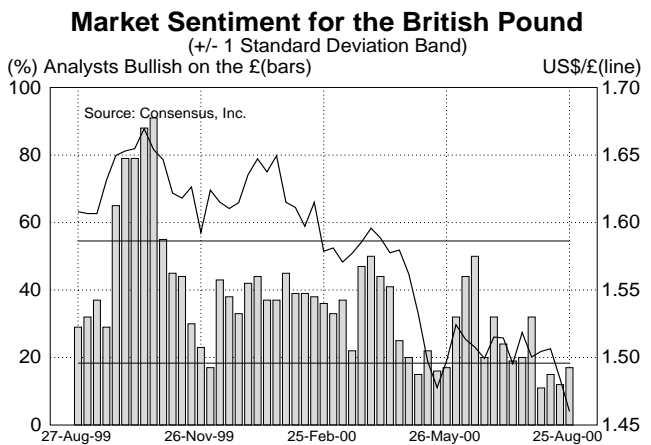
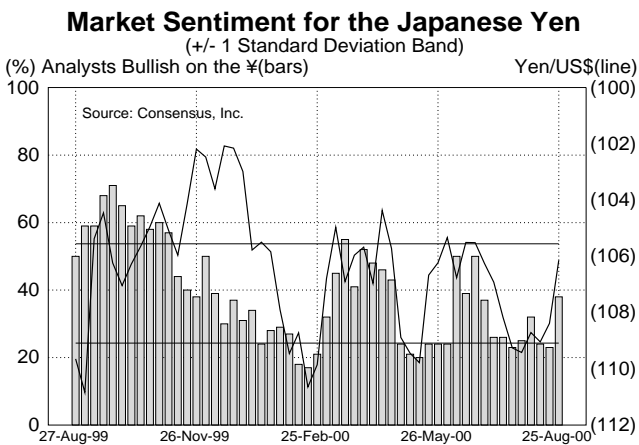
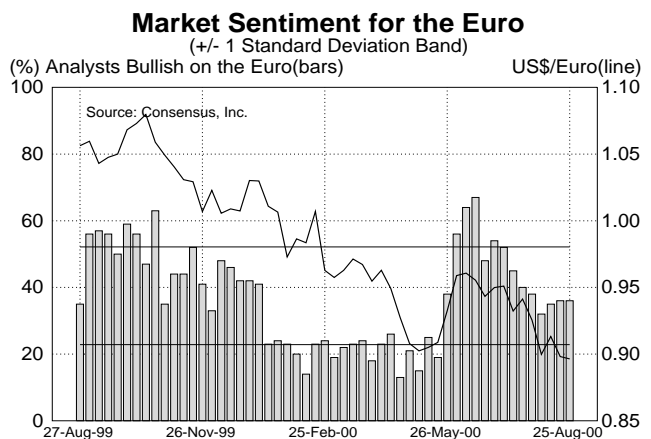
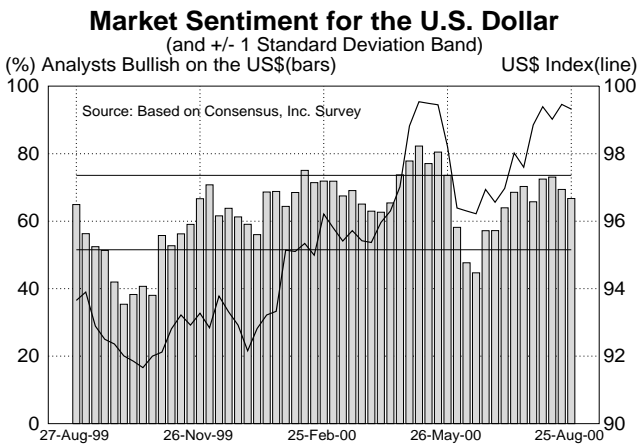
Consensus Inc. survey reveals that sentiment for the Japanese yen reached a two-month high last week, rallying up to 38% after remarks by a government official that the Bank of Japan may allow the yen to strengthen in the coming months. While there was an across-the-board decline in sentiment for all the other major currencies last week, euro sentiment has remained firmly intact at the 36% level, and for the most part, unchanged since the beginning of August.

(By permission of Consensus, Inc., *Consensus, National Futures and Financial Weekly*, [www.consensus-inc.com](http://www.consensus-inc.com))

Sentiment readings for the U.S. dollar show that bullishness for the dollar has fallen slightly to 67% this week. As well, bullishness opinions on the Canadian dollar and Swiss franc have declined respectively to 43% and 29%. Although market sentiment for the British pound is moving up a few notches to 17% this week, the pound's sentiment readings have remained in over-sold territory by and large for the past month.

**Grace Truong**  
[grace.truong@db.com](mailto:grace.truong@db.com)

New York, (212) 469-7201



## Upcoming Events

| Month              | Day      | Code  | Event   |
|--------------------|----------|---|---|
| <b>September</b>   | 6-7      | UK  | Bank of England Monetary Policy Committee meeting.  |
|                    | 7        | Sweden  | Central bank executive board monetary policy meeting.   |
|                    |          | Japan   | BoJ Policy Board chairman Shinotsuka speaks on issues for the Japanese economy.                             |
|                    | 9-10     | EU  | European Union finance ministers hold informal meeting.   |
|                    | 10       | US  | Treasury Secretary Summers attends National Association for Business Economics meeting.                     |
|                    |          | OPEC  | Oil ministers from OPEC meet ahead of Sept.28-30 summit in Venezuela.                                       |
|                    | 11       | World   | International Energy Agency releases its monthly oil market report.   |
|                    | 12       | EU  | European Parliament Economic & Monetary Affairs Committee hears ECB President Duisenberg.                   |
|                    |          | UK/Swiz.  | BoE Governor George address British-Swiss Chamber of Commerce.  |
|                    | 14       | Japan   | Bank of Japan policy board meeting.   |
|                    |          | ECB   | European Central Bank governing council meets to set interest rates.  |
|                    |          | UK  | London Stock Exchange shareholders to vote on proposed merger with Deutsche Boerse.                         |
|                    | 18       | US  | Fed Chairman Greenspan to speak about regulatory issues at American Bankers Association.                    |
|                    | 19       | UK  | Bank of England holds gold sales auction of 25 tons of gold (third in series of six sales by BoE).          |
|                    |          | IMF   | IMF releases its World Economic Outlook on prospects in IMF member states.                                  |
|                    |          | Japan   | Bank of Japan announces monthly economic report.  |
|                    | 20       | US  | Federal Reserve issues Beige Book economic summary.   |
|                    |          | Norway  | Norwegian Central Bank to announce interest rate decision after Executive Board Meeting.                    |
|                    | 21       | Sweden  | Central bank executive board monetary policy meeting.   |
|                    |          | EU/Brazil   | Third Mercosur-EU Business Forum.   |
|                    | 22       |   | Formal start of Euronext bourse, formed from the merger of the Amsterdam, Brussels and Paris Stock markets. |
|                    | 26-28    | World   | World Bank and IMF 55th annual meetings.  |
|                    | 28       | Denmark   | Danish referendum on joining the euro currency.   |
|                    |          | Sweden  | Central bank executive board monetary policy meeting.   |
|                    |          | Germany   | Bundesbank conference.  |
|                    | 29       | EU  | European Union finance ministers meet.  |
|                    | 28-30    | OPEC  | OPEC summit.  |
| <b>October</b>     | 2        | EU/US   | European Union-U.S. ministerial meeting.  |
|                    | 3        | US  | Policy-making Federal Open Market Committee meets.  |
|                    |          | US  | First presidential debate prior to the US presidential election on November 7.                              |
|                    |          | Japan   | BoJ Tankan Report.  |
|                    | 4        | Sweden  | Riksbank executive board monetary policy meeting.   |
|                    | 4-5      | UK  | Bank of England Monetary Policy Committee meeting.  |
|                    | 4-7      | ASEAN   | Economic ministers from ASEAN nations meet.   |
|                    | 5        | ECB   | ECB Governing Council announces interest rate decision.   |
|                    | 9        | Sweden  | Riksbank executive board monetary policy meeting.   |
|                    | 10       | Sweden  | Riksbank publishes quarterly inflation report.  |
|                    | 11       | US  | Second presidential debate prior to the US presidential election on November 7.                             |
|                    | 16       | US  | Fed Chairman Greenspan speaks via satellite at 2000 Financial Markets Conference.                           |
|                    | 17       | EU  | European Union finance ministers meet.  |
|                    |          | US  | Third presidential debate prior to the US presidential election on November 7.                              |
|                    | 19       | ECB   | European Central Bank council of governors holds meetings.  |
|                    |          | Sweden  | Central bank executive board monetary policy meeting.   |
| 19-21              | EU       | Asian and European Union Economic Ministers conference. |   |
| 21                 | EU/Asean | European Union-ASEAN ministerial meeting.               |   |
| 26                 | Sweden   | Central bank executive board monetary policy meeting.   |   |
| 30                 | EU       | European Union-Russia summit.                           |   |
| <b>November</b>    | 1        | US  | Federal Reserve issues Beige Book economic summary.   |
|                    | 9        | Sweden  | Central bank executive board monetary policy meeting.   |
|                    | 15       | US  | Policy-making Federal Open Market Committee meeting.  |
|                    | 23       | Sweden  | Central bank executive board monetary policy meeting.   |
|                    | 23-24    | EU  | European Union budget ministers meet.   |
|                    | 27-28    | EU  | European Union finance ministers meet.  |
|                    | 30       | Sweden  | Central bank executive board monetary policy meeting.   |
|                    | na       | UK  | Bank of England holds gold sales auction of 25 tons of gold (fourth in a series of six sales).              |
| <b>December</b>    | 6        | US  | Federal Reserve issues Beige Book economic summary.   |
|                    |          | Sweden  | Riksbank executive board monetary policy meeting.   |
|                    | 7        | Sweden  | Riksbank publishes quarterly inflation report.  |
|                    | 7-8      | EU  | Summit of European Union heads of state and government.   |
|                    | 18       | EU  | European finance ministers meet.  |
|                    |          | EU/US   | European Union-U.S. summit.   |
|                    | US       | Policy-making Federal Open Market Committee meeting.    |   |
| <b>Janury 2001</b> | 1        | EU  | Sweden assumes presidency of the European Union.  |
|                    | na       | UK  | Bank of England holds gold sales auction of 25 tons of gold (fifth in a series of six sales).               |
| <b>March</b>       | na       | UK  | Bank of England holds gold sales auction of 25 tons of gold (last in a series of six sales).                |
| <b>April</b>       | 20-22    | EU  | European Union finance ministers' meeting.  |

## U.S. Dollar

We are moderating our interest-rate outlook once again. Even though recent economic indicators were close to or exceeded our expectations and seem to suggest a 25 basis-point increase in rates from the Fed in November once the Presidential election is out of the way, labor productivity growth has been able to keep core inflation in check. That could keep the Fed on the sidelines for the rest of the year and, as a result, 10-year yields should remain below 6% by year-end.

With only one month of third-quarter data under our belts, we are still carrying our forecast of 4%-plus U.S. growth. August retail sales appear sluggish and point to only a modest acceleration in consumer spending growth from the 3% pace of last quarter, but investment demand should remain strong and inventory demands appear manageable. Furthermore, a much less aggressive Fed means that financial conditions are much more supportive of growth, which has led us to raise our GDP forecast for next year by 0.4% to 4.0%.

The near-term inflation outlook has improved. The impressive productivity gains have not been matched (yet) by compensation gains and this has helped stabilize core inflation at 2.5% (after its 0.5% rise earlier this year). But we think that compensation growth will eventually catch up to productivity gains, although the risks of higher inflation appear to have been delayed to next year because of the continuing "productivity miracle."

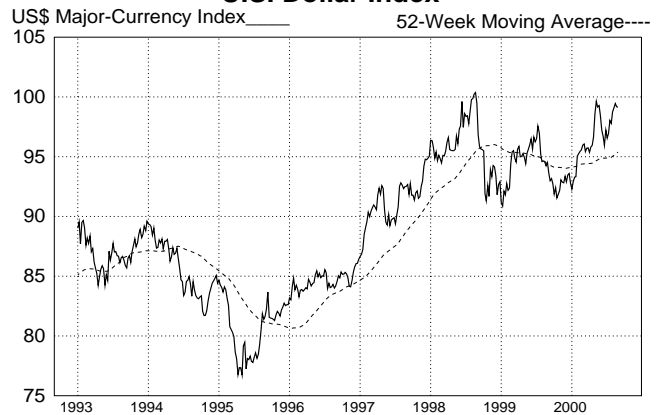
Demand for oil has fallen short of expectations and supply has shown signs of life, but crude oil and oil product prices have rebounded in the last few weeks nonetheless. The price pressures are due to disappointing inventory figures, and there is increasing risk of another spike in home heating oil prices this winter even if crude prices were to ease.

While the majority of G-7 central banks appear poised to maintain, or even pick up, the pace of monetary stringency, investors are increasingly convinced that the Fed is done hiking rates this year. The Fed has now avoided lifting rates at its past two meetings and has not hinted that investor thinking is wrong, at least in the very near term. The market's assumption is that the Fed may be able to stomach growth rates as high as 5% without raising rates, so long as the wage and price inflation figures do not accelerate.

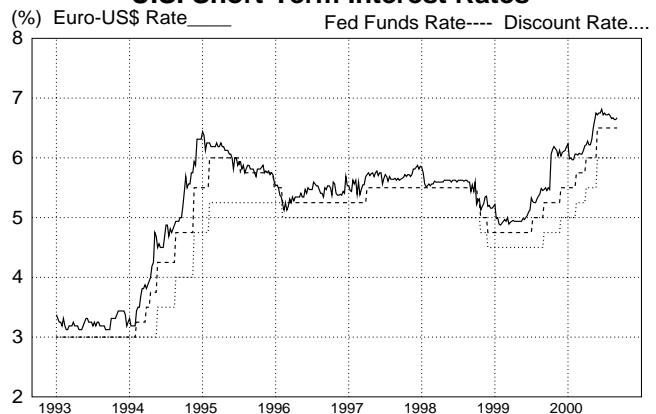
Next year is another question. Stimulative financial conditions, prospective cuts in taxes and increased Federal spending, and higher oil and labor costs point to higher rates sometime next year. So the Fed's interest-rate cycle may be extremely elongated this time.

**M. Cary Leahey** New York, (212) 469-7579  
[cary.leahey@db.com](mailto:cary.leahey@db.com)

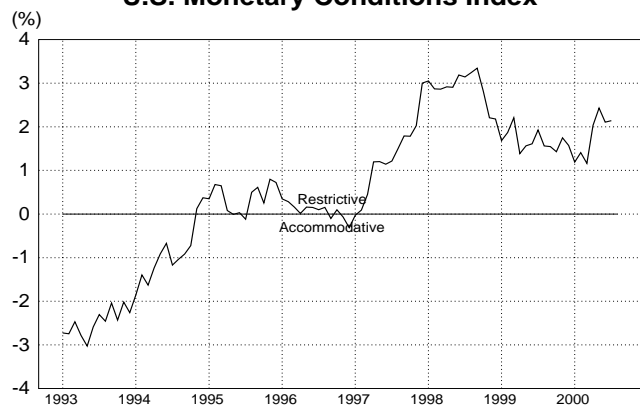
### U.S. Dollar Index



### U.S. Short-Term Interest Rates



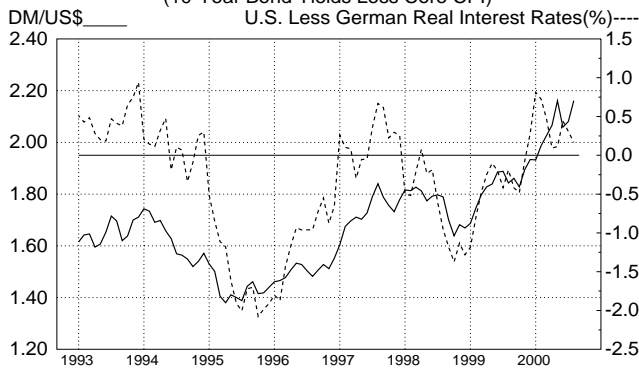
### U.S. Monetary Conditions Index



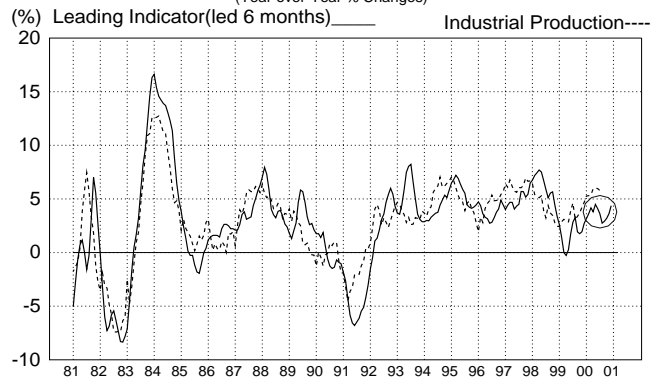
### U.S. Bond Market Trends

|  | Latest | High | 52-Week Low | Average | Z-Score |
|--|--------|------|-------------|---------|---------|
| <b>Yield Curve (%)</b>                   |        |      |             |         |         |
| 3-mo. T-Bill                             | 6.31   | 6.31 | 4.78        | 5.62    | 1.59    |
| 2-year                                   | 6.25   | 6.85 | 5.60        | 6.25    | 0.02    |
| 5-year                                   | 6.06   | 6.78 | 5.75        | 6.26    | -0.67   |
| 10-year                                  | 5.96   | 6.75 | 5.86        | 6.19    | -0.96   |
| 30-year                                  | 5.75   | 6.75 | 5.71        | 6.11    | -1.43   |
| <b>Credit Spreads (basis points)</b>     |        |      |             |         |         |
| CP/T-Bill                                | 17     | 104  | 0           | 34      | -0.65   |
| AAA/Trsy                                 | 161    | 174  | 99          | 143     | 0.92    |
| BAA/Trsy                                 | 232    | 255  | 158         | 216     | 0.57    |
| 10-yr. Swap                              | 113    | 139  | 73          | 106     | 0.37    |
| <b>Yield Curve Trends (basis points)</b> |        |      |             |         |         |
| 2-yr./3-mo.                              | -6     | 107  | -12         | 63      | -2.40   |
| 10-yr./3-mo.                             | -35    | 138  | -36         | 57      | -1.95   |
| 10-yr./2-yr.                             | -30    | 31   | -46         | -5      | -0.90   |

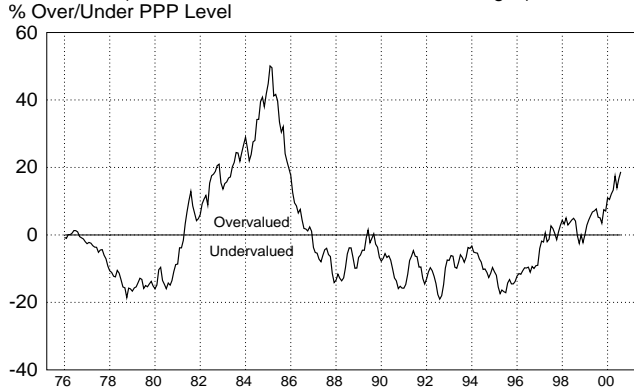
### DM/US\$ Exchange Rate and U.S./German Real Interest-Rate Differentials



### U.S. Leading Indicator & Industrial Production



### U.S. Dollar Purchasing Power Parity



### U.S. Equity Market



#### U.S. Monthly Economic Data

| Economic Indicator    | Units         | Aug 1999 | Sep 1999 | Oct 1999 | Nov 1999 | Dec 1999 | Jan 2000 | Feb 2000 | Mar 2000 | Apr 2000 | May 2000 | Jun 2000 | Jul 2000 |
|-----------------------|---------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| Consumer Prices       | (yoy % chg)   | 2.3      | 2.6      | 2.6      | 2.6      | 2.7      | 2.7      | 3.2      | 3.7      | 3.0      | 3.1      | 3.7      | 3.5      |
| Producer Prices       | (yoy % chg)   | 2.3      | 3.1      | 2.8      | 3.1      | 2.9      | 2.5      | 4.0      | 4.4      | 3.9      | 3.9      | 4.3      | 4.1      |
| Unemployment          | (%)           | 4.2      | 4.2      | 4.1      | 4.1      | 4.1      | 4.0      | 4.1      | 4.1      | 3.9      | 4.1      | 4.0      | 4.0      |
| Employment            | (mom chg 000) | 159      | 208      | 258      | 265      | 250      | 349      | 95       | 527      | 410      | 171      | 30       | -108     |
| Avg. Hourly Earnings  | (yoy % chg)   | 3.5      | 3.7      | 3.6      | 3.6      | 3.5      | 3.5      | 3.7      | 3.7      | 3.8      | 3.6      | 3.6      | 3.7      |
| Industrial Production | (yoy % chg)   | 3.1      | 3.4      | 3.7      | 4.2      | 4.7      | 5.3      | 5.3      | 5.4      | 5.9      | 6.0      | 6.0      | 5.8      |
| Durable Goods Orders  | (yoy % chg)   | 9.0      | 6.0      | 7.4      | 8.3      | 11.6     | 6.1      | 8.5      | 9.9      | 6.1      | 12.6     | 23.0     | 3.4      |
| NAPM                  | (index)       | 54.4     | 57.3     | 56.9     | 57.1     | 56.8     | 56.3     | 56.9     | 55.8     | 54.9     | 53.2     | 51.8     | 51.8     |
| Inventory/Sales       | (ratio)       | 1.28     | 1.30     | 1.30     | 1.29     | 1.28     | 1.28     | 1.28     | 1.26     | 1.28     | 1.26     | 1.25     | -        |
| Personal Income       | (yoy % chg)   | 5.2      | 5.0      | 5.8      | 5.3      | 5.7      | 6.1      | 6.1      | 6.6      | 6.7      | 6.7      | 6.2      | 6.3      |
| Housing Starts        | (yoy % chg)   | 2.7      | 2.9      | -4.6     | 0.2      | -1.3     | -3.3     | 4.8      | -6.2     | 5.8      | -3.5     | 0.1      | -11.3    |
| M2                    | (yoy % chg)   | 7.7      | 7.1      | 6.5      | 6.0      | 5.9      | 5.8      | 5.5      | 5.9      | 6.2      | 5.6      | 5.5      | 5.3      |
| Trade Balance         | (US\$ bn sa)  | -23.9    | -24.0    | -24.9    | -25.7    | -25.7    | -27.4    | -28.1    | -30.6    | -30.5    | -30.3    | -30.6    | -        |
| Gov't Surplus/Deficit | (US\$ bn)     | 103.7    | 124.4    | 130.1    | 120.1    | 158.3    | 149.9    | 150.5    | 137.6    | 183.6    | 204.0    | 206.3    | 236.2    |

#### U.S. Annual Economic Data

| Economic Indicator | Units       | 1990  | 1991  | 1992  | 1993  | 1994   | 1995   | 1996   | 1997   | 1998   | 1999   | 2000f  | 2001f  |
|--------------------|-------------|-------|-------|-------|-------|--------|--------|--------|--------|--------|--------|--------|--------|
| Real GDP           | (yoy % chg) | 1.8   | -0.5  | 3.1   | 2.7   | 4.0    | 2.7    | 3.6    | 4.4    | 4.4    | 4.2    | 5.4    | 4.0    |
| Unemployment Rate  | (%)         | 5.6   | 6.9   | 7.5   | 6.9   | 6.1    | 5.6    | 5.4    | 4.9    | 4.5    | 4.2    | 4.0    | 4.0    |
| Consumer Prices    | (yoy % chg) | 5.4   | 4.2   | 3.0   | 3.0   | 2.6    | 2.8    | 2.9    | 2.3    | 1.6    | 2.2    | 3.2    | 2.6    |
| Trade Balance      | (US\$ bn)   | -78.9 | -28.3 | -35.7 | -68.9 | -97.0  | -95.9  | -102.1 | -105.9 | -166.9 | -265.0 | -340.0 | -375.0 |
| Current Acc't Bal. | (US\$ bn)   | -77.0 | 6.6   | -47.7 | -82.7 | -118.6 | -109.5 | -123.3 | -140.5 | -217.1 | -331.5 | -400.0 | -440.0 |
|                    | (% of GDP)  | -1.3  | 0.1   | -0.8  | -1.2  | -1.7   | -1.5   | -1.6   | -1.7   | -2.5   | -3.6   | -4.0   | -4.0   |
| Budget Balance     | (% of GDP)  | -2.9  | -3.7  | -4.8  | -4.1  | -2.9   | -2.4   | -1.5   | -0.3   | 0.8    | 1.3    | 1.7    | 2.2    |

Sources: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

# Euro

At the moment, it seems very likely that the euro will break below its all-time low of 0.8845 versus the U.S. dollar set last May. Despite aggressive tightening in ECB monetary policy over the past 12 months and the compression in European/U.S. interest-rate spreads, and in spite of net bond inflows into the euro area, the euro has been unable to make any headway.

The euro continues to be exposed to the dollar's broad-based strength, powered by the surge in U.S. growth and productivity trends over the past 18 months. Indeed, European corporates' optimism towards the U.S. economy—and in particular, the new-economy sectors such as information technology, telecommunications and media—as expressed via their ongoing acquisition activity, should maintain adverse foreign direct investment trends for the European single currency.

Currency markets also continue to prefer the more growth strategy of the U.S. Federal Reserve. The ECB has tightened policy 200 basis points since the middle of last year compared with 175 by the Fed. And leading indicators in Germany, Italy, and Belgium have all peaked in the past few months, which maintains the belief that Euroland will never be able to sustain growth rates above those in the U.S. at any point in the near future. The ECB's primary concern continues to be the inflationary implications of the rising oil price and the 20% decline in the euro since the beginning of last year.

Financial markets continue to downplay the risk towards foreign-exchange intervention, which in Euroland lies in the hands of the Economic and Financial Committee. The EFC is comprised of the 11 Eurozone Finance Ministers and officials from the ECB and the national central banks of the Eurosystem. The next focus for the market will be the weekend Ecofin meeting September 8-10 and whether—like in May when the euro was close to current levels—the Euro11 will issue another statement expressing their "common concern" towards the exchange rate.

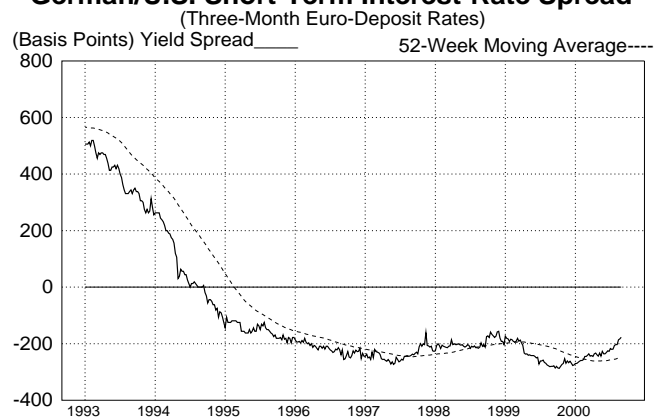
Any decision to intervene would then need to be ratified by the ECB President and the chair of the Euro 11, currently held by the French Finance Minister Laurent Fabius. Concerns continued to be voiced in the EFC that without direct U.S. support, any intervention is likely to fail. Since the Fed is unlikely to follow the course of driving the dollar lower in an environment of super-strong domestic growth, there appears to be little chance of the U.S. Federal Reserve accepting any request from the ECB to intervene. In addition, unlike in 1985, when the U.S. dollar was significantly overvalued, there are currently no calls from U.S. industry to drive the dollar lower. Not until U.S. growth slows will there be any pressure from either the private or public sectors to shift U.S. policy towards the dollar or to rescue the euro.

**Michael Lewis** London, (44-020) 7545-2166  
[michael.lewis@db.com](mailto:michael.lewis@db.com)

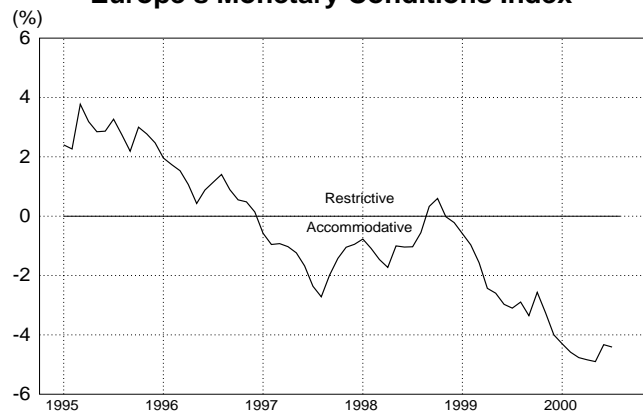
## U.S. Dollar/Euro Exchange Rate



## German/U.S. Short-Term Interest-Rate Spread

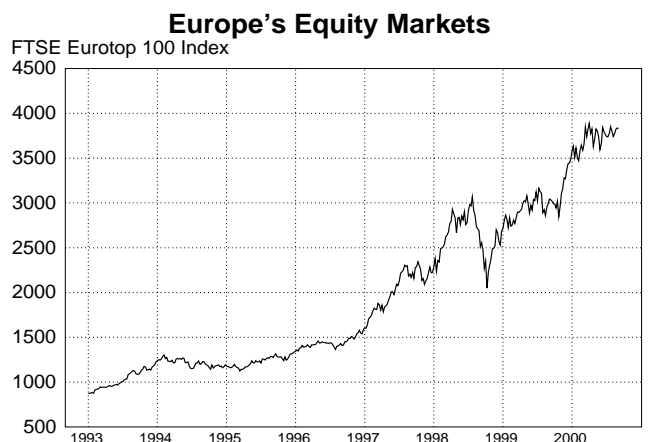
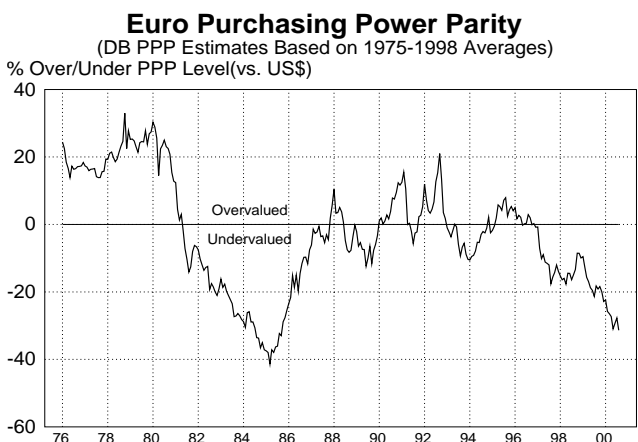
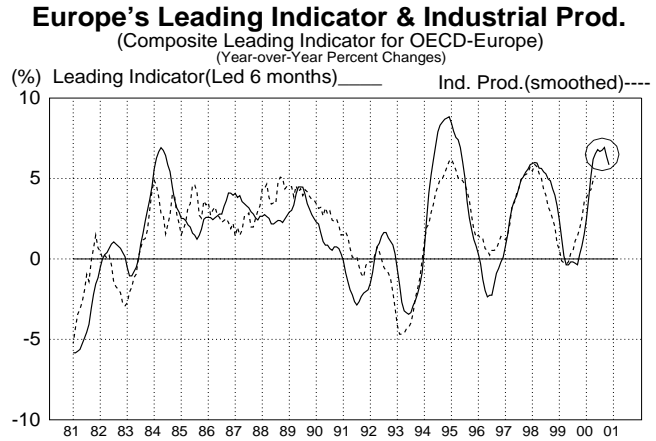
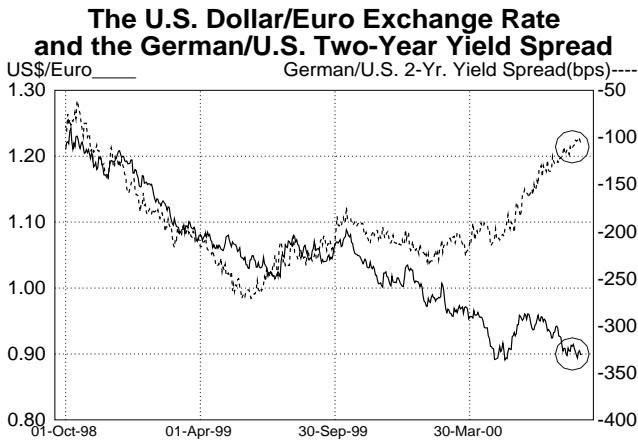


## Europe's Monetary Conditions Index



## German Government Bond Market Trends

|   | Latest | High | 52-Week Low | Average | Z-Score |
|---|--------|------|-------------|---------|---------|
| <b>Yield Curve (%)</b>                      |        |      |             |         |         |
| 3-month                                     | 4.92   | 4.92 | 2.66        | 3.79    | 1.85    |
| 2-year                                      | 5.23   | 5.26 | 3.40        | 4.39    | 1.66    |
| 5-year                                      | 5.25   | 5.25 | 4.26        | 4.87    | 1.41    |
| 10-year                                     | 5.26   | 5.61 | 4.87        | 5.25    | 0.05    |
| <b>Yield Spread vs. U.S. (basis points)</b> |        |      |             |         |         |
| 3-month                                     | -167   | -167 | -288        | -247    | 2.78    |
| 2-year                                      | -102   | -97  | -229        | -185    | 2.30    |
| 10-year                                     | -69    | -66  | -118        | -94     | 1.67    |
| <b>Yield Curve Trends (basis points)</b>    |        |      |             |         |         |
| 2-yr./3-mo.                                 | 31     | 104  | 29          | 61      | -1.50   |
| 10-yr./3-mo.                                | 34     | 244  | 34          | 146     | -1.81   |
| 10-yr./2-yr.                                | 3      | 158  | -2          | 86      | -1.74   |



**Euroland's Monthly Economic Data**

| Economic Indicator    | Units       | Aug 1999 | Sep 1999 | Oct 1999 | Nov 1999 | Dec 1999 | Jan 2000 | Feb 2000 | Mar 2000 | Apr 2000 | May 2000 | Jun 2000 | Jul 2000 |
|-----------------------|-------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| Consumer Prices       | (yoy % chg) | 1.2      | 1.2      | 1.4      | 1.5      | 1.7      | 1.9      | 2.0      | 2.1      | 1.9      | 1.9      | 2.4      | 2.4      |
| Consumer Prices       | (mom % chg) | 0.1      | 0.1      | 0.1      | 0.1      | 0.4      | -0.1     | 0.4      | 0.4      | 0.1      | 0.1      | 0.4      | 0.0      |
| Producer Prices       | (yoy % chg) | 0.9      | 1.4      | 2.0      | 2.6      | 3.4      | 4.0      | 4.6      | 5.0      | 4.6      | 5.2      | 5.5      | -        |
| Unemployment Rate     | (%)         | 9.9      | 9.9      | 9.7      | 9.6      | 9.6      | 9.6      | 9.5      | 9.4      | 9.3      | 9.2      | 9.1      | -        |
| Industrial Production | (yoy % chg) | 2.4      | 2.5      | 3.2      | 4.0      | 4.6      | 4.1      | 5.1      | 5.6      | 6.3      | 6.8      | -        | -        |
| M2                    | (yoy % chg) | 7.0      | 7.0      | 7.1      | 6.6      | 5.5      | 4.6      | 5.6      | 5.3      | 5.8      | 4.9      | 4.3      | 4.0      |
| M3                    | (yoy % chg) | 5.9      | 6.6      | 6.4      | 6.9      | 7.2      | 6.3      | 7.1      | 7.6      | 8.7      | 7.8      | 7.2      | 7.3      |
| Consumer Confidence   | (index)     | -4.0     | -4.0     | -2.0     | -1.0     | -1.0     | -1.0     | 0.0      | 0.0      | 0.0      | 1.0      | -1.0     | 0.0      |
| Economic Sentiment    | (index)     | 102.2    | 102.4    | 103.0    | 102.9    | 103.1    | 103.5    | 103.8    | 104.0    | 104.0    | 104.0    | 104.0    | 104.0    |
| Trade Balance         | (Euro bn)   | 3.0      | 1.7      | 7.3      | 3.7      | 3.1      | -5.0     | -0.1     | 3.2      | 0.1      | 0.1      | -        | -        |

**Euroland's Annual Economic Data**

| Economic Indicator | Units       | 1990 | 1991  | 1992  | 1993 | 1994 | 1995 | 1996 | 1997  | 1998  | 1999  | 2000f | 2001f |
|--------------------|-------------|------|-------|-------|------|------|------|------|-------|-------|-------|-------|-------|
| Real GDP           | (yoy % chg) | 3.6  | 4.6   | 1.3   | -1.0 | 2.7  | 2.2  | 1.6  | 2.3   | 2.7   | 2.3   | 3.6   | 3.6   |
| Unemployment Rate  | (%)         | 8.6  | 8.7   | 9.6   | 11.3 | 12.2 | 11.9 | 12.3 | 11.6  | 10.9  | 10.0  | 9.2   | 8.1   |
| Consumer Prices    | (yoy % chg) | 4.3  | 4.5   | 4.5   | 3.7  | 3.0  | 2.9  | 2.4  | 1.6   | 1.1   | 1.1   | 2.2   | 1.9   |
| Trade Balance      | (Euro bn)   | na   | na    | na    | na   | na   | na   | na   | 143.0 | 133.6 | 113.3 | 116.3 | 130.7 |
| Current Acc't Bal. | (Euro bn)   | na   | -49.1 | -43.7 | 20.3 | 19.0 | 41.0 | 71.1 | 98.0  | 76.9  | 36.4  | 45.4  | 55.7  |
|                    | (% of GDP)  | na   | -1.1  | -1.0  | 0.4  | 0.3  | 0.8  | 1.2  | 1.8   | 1.3   | 0.6   | 0.5   | 0.6   |
| Budget Balance     | (% of GDP)  | -4.2 | -4.6  | -4.6  | -5.5 | -5.0 | -4.8 | -4.1 | -2.6  | -2.0  | -1.5  | 0.7   | -0.1  |

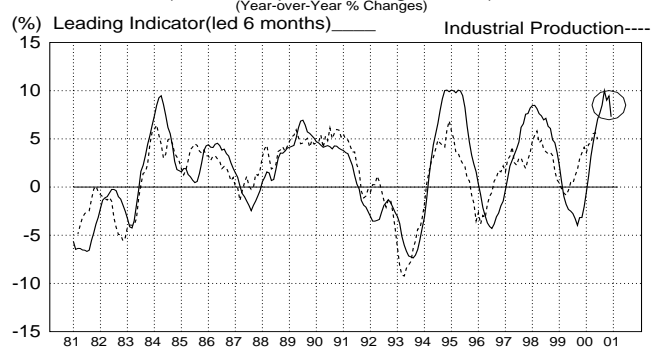
Sources: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

# Germany

## Germany's Equity Market



## Germany's Leading Indicator & Industrial Prod. (OECD Composite Leading Indicator)



## Germany's Monthly Economic Data

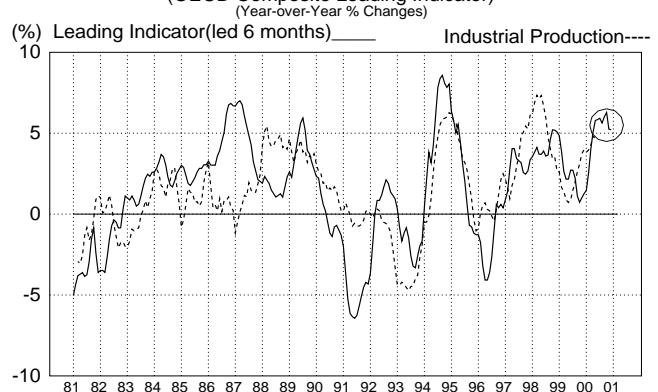
| Economic Indicator    | Units       | Aug 1999 | Sep 1999 | Oct 1999 | Nov 1999 | Dec 1999 | Jan 2000 | Feb 2000 | Mar 2000 | Apr 2000 | May 2000 | Jun 2000 | Jul 2000 |
|-----------------------|-------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| Consumer Prices       | (yoy % chg) | 0.7      | 0.7      | 0.8      | 1.0      | 1.2      | 1.6      | 1.8      | 1.9      | 1.5      | 1.4      | 1.9      | 1.9      |
| Producer Prices       | (yoy % chg) | -0.7     | -0.5     | 0.2      | 0.7      | 1.1      | 2.0      | 2.4      | 2.4      | 2.1      | 2.7      | 2.9      | 3.3      |
| Unemployment Rate     | (%)         | 10.5     | 10.5     | 10.5     | 10.4     | 10.2     | 10.1     | 10.0     | 10.1     | 9.6      | 9.6      | 9.6      | 9.5      |
| Industrial Production | (yoy % chg) | 2.5      | 2.9      | 3.3      | 4.4      | 4.7      | 1.7      | 7.0      | 4.8      | 4.7      | 7.4      | 2.8      | -        |
| Retail Sales          | (yoy % chg) | 0.6      | -2.0     | 3.5      | -1.9     | -0.3     | -0.6     | 1.7      | -4.0     | 6.1      | 3.4      | 1.0      | -        |
| Domestic Orders       | (yoy % chg) | 4.2      | 0.7      | 6.9      | 7.5      | 6.7      | 1.6      | 10.4     | 6.6      | 10.4     | 11.9     | 7.6      | -        |
| Foreign Orders        | (yoy % chg) | 18.3     | 12.6     | 12.2     | 21.2     | 13.4     | 14.0     | 15.9     | 24.2     | 18.3     | 21.1     | 21.1     | -        |
| Consumer Confidence   | (index)     | -5.0     | -7.0     | -6.0     | -6.0     | -4.0     | -3.0     | -1.0     | -2.0     | -2.0     | 2.0      | -1.0     | -2.0     |
| Business Sentiment    | (index)     | 95.3     | 95.3     | 96.0     | 98.8     | 99.6     | 100.2    | 100.9    | 100.5    | 101.2    | 102.0    | 100.4    | 99.1     |

# France

## France's Equity Market



## France's Leading Indicator & Industrial Prod. (OECD Composite Leading Indicator)



## France's Monthly Economic Data

| Economic Indicator    | Units       | Aug 1999 | Sep 1999 | Oct 1999 | Nov 1999 | Dec 1999 | Jan 2000 | Feb 2000 | Mar 2000 | Apr 2000 | May 2000 | Jun 2000 | Jul 2000 |
|-----------------------|-------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| Consumer Prices       | (yoy % chg) | 0.5      | 0.7      | 0.8      | 0.9      | 1.3      | 1.6      | 1.4      | 1.5      | 1.3      | 1.5      | 1.7      | 1.7      |
| Producer Prices       | (yoy % chg) | -1.4     | -0.7     | 0.4      | 0.8      | 1.3      | 2.3      | 3.0      | 3.4      | 4.3      | 4.7      | 5.0      | -        |
| Unemployment Rate     | (%)         | 11.3     | 11.1     | 11.0     | 10.9     | 10.6     | 10.5     | 10.2     | 10.0     | 9.9      | 9.8      | 9.6      | -        |
| Industrial Production | (yoy % chg) | 2.4      | 3.2      | 3.7      | 4.3      | 3.9      | 3.3      | 4.7      | 4.9      | 4.8      | 4.6      | -        | -        |
| Retail Sales          | (yoy % chg) | 4        | 4        | 8        | 6        | 5        | -        | -        | -        | -        | -        | -        | -        |
| Household Confidence  | (index)     | -7       | -6       | -4       | 0        | -2       | -2       | -2       | -1       | 2        | 1        | 2        | 3        |
| Business Confidence   | (index)     | -5       | -4       | -6       | 0        | -5       | -5       | -3       | -3       | -10      | -4       | 4        | -2       |

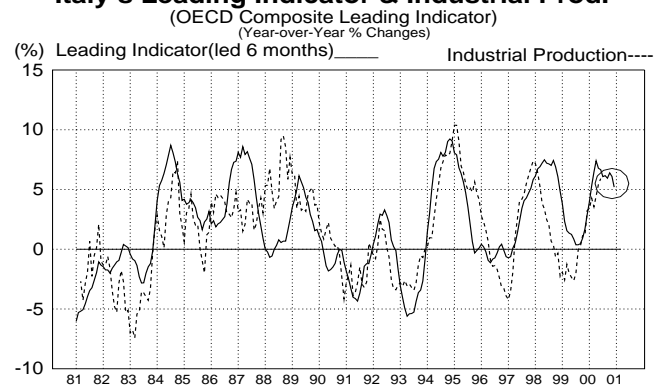
Source: Datastream

# Italy

## Italy's Equity Market



## Italy's Leading Indicator & Industrial Prod.



## Italy's Monthly Economic Data

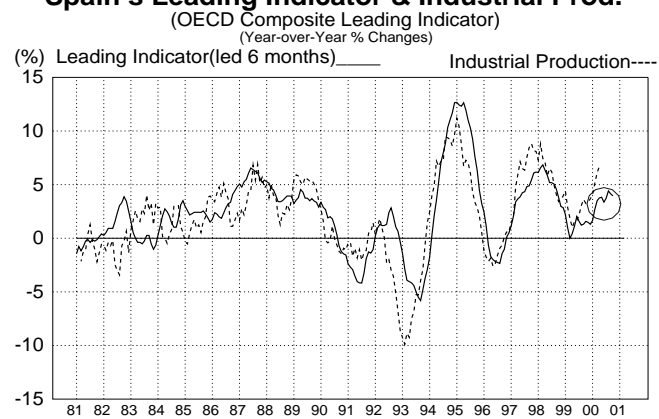
| Economic Indicator    | Units       | Aug 1999 | Sep 1999 | Oct 1999 | Nov 1999 | Dec 1999 | Jan 2000 | Feb 2000 | Mar 2000 | Apr 2000 | May 2000 | Jun 2000 | Jul 2000 |
|-----------------------|-------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| Consumer Prices       | (yoy % chg) | 1.7      | 1.8      | 2.0      | 2.0      | 2.1      | 2.2      | 2.4      | 2.5      | 2.3      | 2.5      | 2.7      | 2.6      |
| Unemployment Rate     | (%)         | -        | 11.1     | -        | -        | 11.1     | -        | -        | 11.4     | -        | -        | 10.8     | -        |
| Industrial Production | (yoy % chg) | 10.3     | -0.4     | -1.1     | 3.0      | 8.5      | 4.1      | 8.0      | 4.1      | -4.2     | 10.9     | 4.7      | -        |
| Hourly Wages          | (yoy % chg) | 1.9      | 2.1      | 2.0      | 1.9      | 2.0      | 2.1      | 2.1      | 2.1      | 2.1      | 2.3      | 1.8      | -        |
| Retail Sales          | (yoy % chg) | 0.9      | 2.8      | 3.2      | 5.5      | 2.9      | 1.2      | 2.1      | -0.4     | 1.2      | 2.4      | -        | -        |
| Household Confidence  | (index)     | 118.7    | 115.8    | 117.1    | 115.4    | 115.9    | 121.7    | 117.9    | 117.9    | 118.7    | 115.9    | 119.1    | 123.0    |
| Business Confidence   | (index)     | 88       | 89       | 85       | 87       | 88       | 91       | 89       | 90       | 90       | 89       | -        | -        |

# Spain

## Spain's Equity Market



## Spain's Leading Indicator & Industrial Prod.



## Spain's Monthly Economic Data

| Economic Indicator    | Units       | Aug 1999 | Sep 1999 | Oct 1999 | Nov 1999 | Dec 1999 | Jan 2000 | Feb 2000 | Mar 2000 | Apr 2000 | May 2000 | Jun 2000 | Jul 2000 |
|-----------------------|-------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| Consumer Prices       | (yoy % chg) | 2.3      | 2.5      | 2.4      | 2.7      | 2.8      | 2.9      | 3.0      | 3.0      | 3.0      | 3.2      | 3.5      | 3.7      |
| Producer Prices       | (yoy % chg) | 1.4      | 2.4      | 2.7      | 3.1      | 3.8      | 4.5      | 5.1      | 5.7      | 5.7      | 5.8      | 5.8      | -        |
| Unemployment Rate     | (%)         | 15.7     | 15.6     | 15.1     | 15.1     | 15.2     | 15.1     | 15.1     | 14.8     | 14.6     | 14.4     | 14.1     | -        |
| Industrial Production | (yoy % chg) | 6.0      | 4.2      | -0.2     | 5.2      | 5.4      | 5.0      | 9.9      | 10.2     | -0.1     | 9.5      | -        | -        |
| Household Confidence  | (index)     | 7        | 8        | 11       | 11       | 8        | 8        | 10       | 11       | 10       | 8        | 8        | 9        |
| Business Confidence   | (index)     | -5       | -4       | -6       | 0        | -5       | -5       | -3       | -3       | -10      | -4       | 4        | -2       |

Source: Datastream

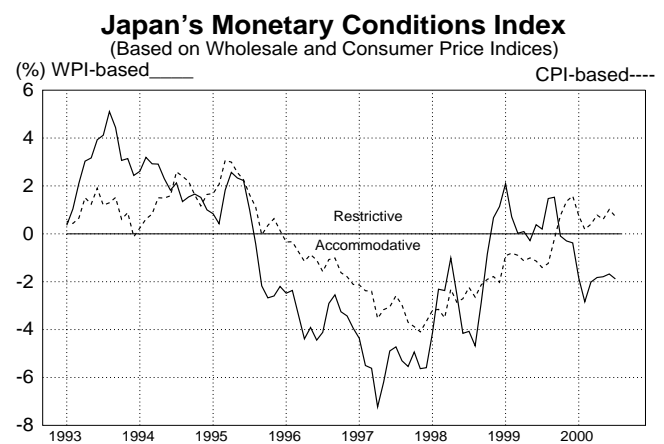
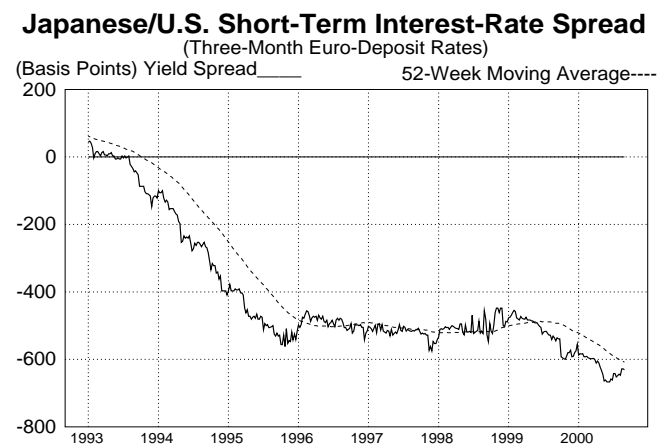
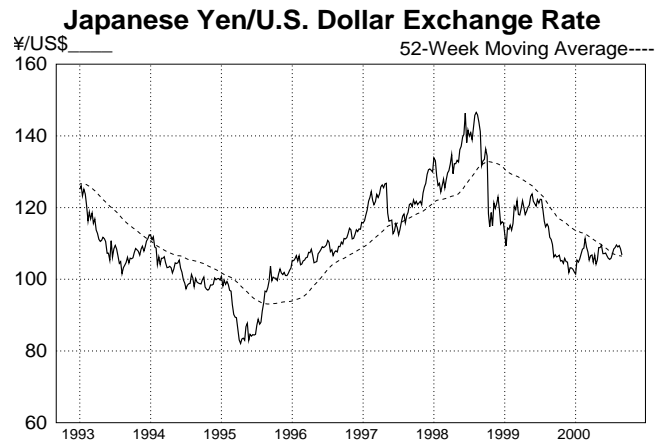
# Japanese Yen

Reports over the past week have painted a sketchy picture of the Japanese economy. The employment situation improved slightly with the job-to-applicant ratio edging higher to 0.60 in July from 0.59 in June. But the supply-side of the economy—the very area that the Bank of Japan (BoJ) pointed to justify its recent rate hike—showed signs of a slowdown. More specifically, industrial production fell by a surprising 0.7% month/month in July, which confounded market expectations of a small rise. Meanwhile, consumption-side reports continued to show an economy on a downward path. Household spending fell by 3.6% year/year in July and large-scale retail sales were off 4.9% from year-ago levels. Granted, neither report is considered to be an accurate reflection of consumption in Japan. But even so, the trend in the series has not improved at all. Taking a snapshot of the July numbers, one would have to wonder what drove the BoJ to hike rates when they did.

The yen has strengthened in recent weeks despite the downbeat economic numbers and despite the fact that the BoJ made the first rate hike in 10 years. The general assumption in the market is that the yen should appreciate if the BoJ hikes rates. And indeed, the yen strengthened sharply from ¥/US\$ 108.65 at the time of the August 17th rate hike to near ¥/US\$ 106.0 recently. Longer-term investors should not be misled by either the short-term price action or the general assumption. The historical record clearly shows that rate hikes by the BoJ—and the secession of rate hikes by the Fed—are an unambiguously negative factor for the yen. To wit, the exchange rate moved inversely with the Fed funds/Japanese overnight rate spread in 19 out of the last 28 years. Cyclical trends can take time to develop, but a significant factor has moved in the favor of the dollar in recent weeks.

Finally, the price of Brent crude oil surged to a new cyclical high this past week above \$34 a barrel. The conventional wisdom is that higher oil prices are bad for the yen and good for the dollar because Japan imports just about all of its oil. As noted in previous issues, however, the correlation between the yearly moves in the yen and Brent oil was an insignificant 0.09 from the early-1980s to the late-1990s. In other words, there is no discernible pattern between movement in the oil prices and movement in the yen on a contemporaneous year-over-year basis. But one pattern that does support the conventional wisdom is that changes in the price of oil in year one are negatively correlated (0.42) with changes in the yen in year two. This relationship held in 10 out of the last 16 years, and in each of the last six years. Therefore, the sharp 50% rise in the price of oil over the past year suggests that the dollar will find good support versus the yen over the coming 12 months.

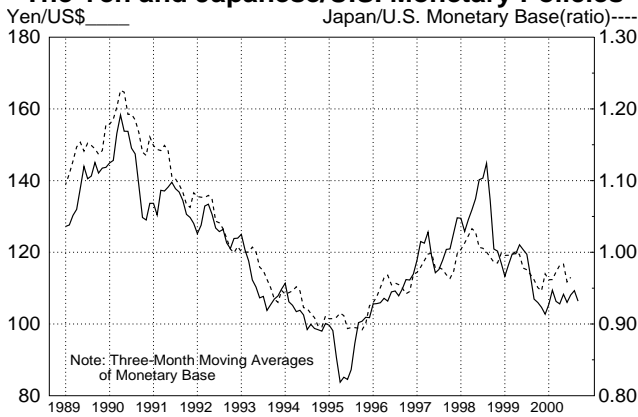
**Kenneth Landon** Tokyo (81-3) 5401-6518  
[kenneth.landon@db.com](mailto:kenneth.landon@db.com)



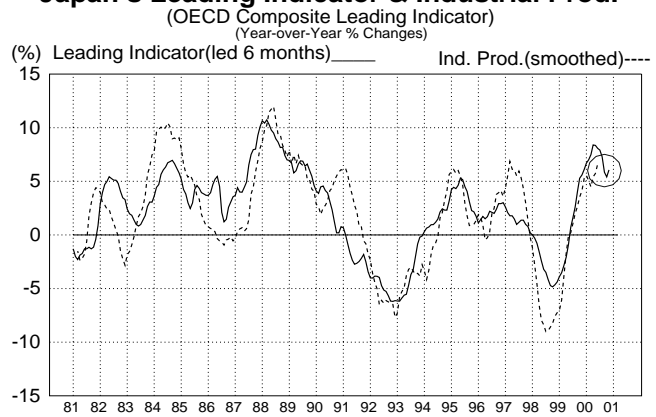
## Japanese Bond Market Trends

|   | Latest | High | 52-Week Low | Average | Z-Score |
|---|--------|------|-------------|---------|---------|
| <b>Yield Curve (%)</b>                      |        |      |             |         |         |
| 3-month                                     | 0.36   | 0.55 | 0.05        | 0.18    | 1.67    |
| 2-year                                      | 0.74   | 0.74 | 0.32        | 0.49    | 2.70    |
| 5-year                                      | 1.36   | 1.36 | 0.81        | 1.11    | 2.16    |
| 10-year                                     | 1.92   | 1.92 | 1.53        | 1.76    | 2.14    |
| <b>Yield Spread vs. U.S. (basis points)</b> |        |      |             |         |         |
| 3-month                                     | -623   | -534 | -673        | -607    | -0.46   |
| 2-year                                      | -551   | -523 | -637        | -575    | 0.80    |
| 10-year                                     | -403   | -403 | -509        | -443    | 1.45    |
| <b>Yield Curve Trends (basis points)</b>    |        |      |             |         |         |
| 2-yr./3-mo.                                 | 38     | 53   | 3           | 31      | 0.65    |
| 10-yr./3-mo.                                | 156    | 182  | 117         | 158     | -0.11   |
| 10-yr./2-yr.                                | 118    | 155  | 107         | 127     | -0.82   |

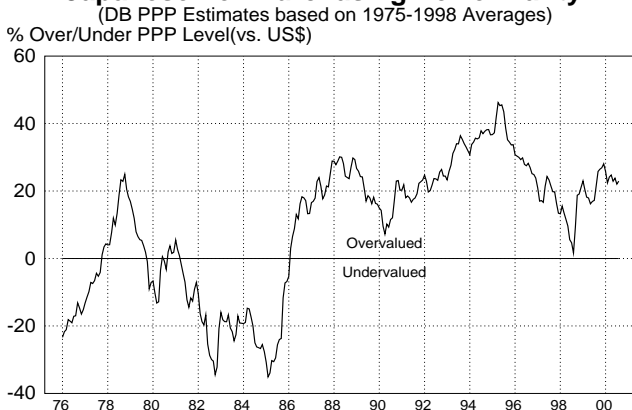
### The Yen and Japanese/U.S. Monetary Policies



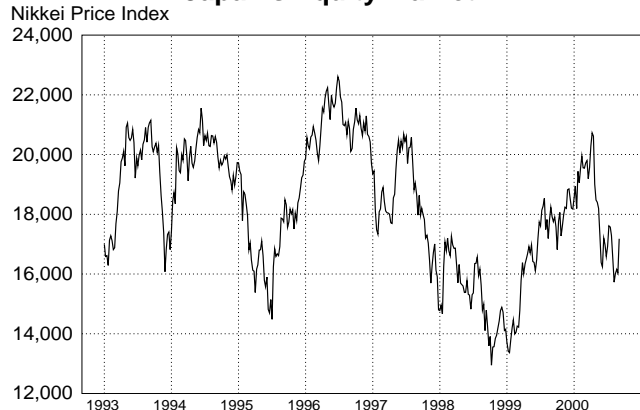
### Japan's Leading Indicator & Industrial Prod.



### Japanese Yen Purchasing Power Parity



### Japan's Equity Market



## Japan's Monthly Economic Data

| Economic Indicator     | Units          | Aug 1999 | Sep 1999 | Oct 1999 | Nov 1999 | Dec 1999 | Jan 2000 | Feb 2000 | Mar 2000 | Apr 2000 | May 2000 | Jun 2000 | Jul 2000 |
|------------------------|----------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| Consumer Prices        | (yoy % chg)    | 0.3      | -0.2     | -0.7     | -1.2     | -1.1     | -0.9     | -0.6     | -0.5     | -0.8     | -0.7     | -0.7     | -0.5     |
| Wholesale Prices       | (yoy % chg)    | -4.5     | -3.9     | -2.1     | -1.7     | -1.5     | -0.5     | 0.1      | -0.4     | -0.4     | -0.6     | -0.6     | -0.4     |
| Unemployment           | (%)            | 4.7      | 4.6      | 4.6      | 4.6      | 4.7      | 4.7      | 4.9      | 4.9      | 4.8      | 4.6      | 4.7      | 4.7      |
| Job Offers/Applicants  | (ratio)        | 0.47     | 0.48     | 0.48     | 0.49     | 0.50     | 0.52     | 0.52     | 0.53     | 0.56     | 0.56     | 0.59     | 0.60     |
| Industrial Production  | (yoy % chg)    | 3.8      | 2.8      | 4.0      | 5.6      | 6.2      | 4.8      | 4.1      | 4.5      | 7.6      | 5.1      | 7.2      | -        |
| New Const. Orders      | (yoy % chg)    | -6.9     | -5.2     | -18.1    | 2.4      | -13.1    | 25.0     | 3.2      | 7.2      | -1.0     | 13.9     | 13.0     | -        |
| Priv. Mach. Orders     | (yoy % chg sa) | -3.8     | -6.7     | 5.4      | -1.4     | 14.9     | 20.3     | 12.9     | 6.0      | 14.1     | 17.8     | 28.4     | -        |
| Inventory/Shipments    | (ratio)        | 100.5    | 100.9    | 100.3    | 98.4     | 99.0     | 100.2    | 97.6     | 100.0    | 101.5    | 100.5    | 98.5     | -        |
| Retail Sales           | (yoy % chg)    | -3.9     | -3.1     | -0.8     | -7.2     | -4.7     | -4.2     | -0.8     | -4.3     | -4.7     | -5.8     | -4.4     | -        |
| Housing Starts         | (yoy % chg)    | 8.5      | 10.5     | -0.6     | 8.1      | -0.8     | 16.8     | 2.4      | -3.6     | 0.1      | -1.1     | -1.2     | -        |
| M2 plus Cert. of Dep.  | (yoy % chg)    | 0.4      | 1.2      | 0.5      | 0.4      | -2.2     | 1.7      | 1.4      | -0.6     | 1.0      | 0.8      | 1.8      | -        |
| International Reserves | (US\$ bn)      | 261.3    | 272.4    | 272.8    | 272.0    | 288.1    | 293.2    | 294.5    | 305.5    | 338.6    | 341.1    | 344.8    | 344.9    |
| Trade Balance          | (¥ bn sa)      | 11.1     | 11.6     | 12.4     | 9.4      | 9.5      | 12.9     | 13.1     | 9.6      | 13.6     | 9.9      | 11.3     | -        |
| Current Account Bal.   | (¥ bn sa)      | 10.5     | 9.0      | 11.2     | 8.5      | 7.3      | 12.8     | 15.3     | 8.5      | 12.8     | 11.2     | 10.8     | -        |

## Japan's Annual Economic Data

| Economic Indicator | Units       | 1990 | 1991 | 1992  | 1993  | 1994  | 1995  | 1996 | 1997  | 1998  | 1999  | 2000f | 2001f |
|--------------------|-------------|------|------|-------|-------|-------|-------|------|-------|-------|-------|-------|-------|
| Real GDP           | (yoy % chg) | 5.1  | 3.8  | 1.0   | 0.3   | 0.6   | 1.5   | 3.9  | 1.4   | -2.5  | 0.2   | 2.3   | 2.2   |
| Unemployment Rate  | (%)         | 2.1  | 2.1  | 2.2   | 2.5   | 2.9   | 3.1   | 3.4  | 3.4   | 4.1   | 4.7   | 4.8   | 5.1   |
| Consumer Prices    | (yoy % chg) | 3.1  | 3.3  | 1.7   | 1.2   | 0.7   | -0.1  | 0.1  | 1.7   | 0.6   | -0.3  | -0.4  | 0.1   |
| Trade Balance      | (US\$ bn)   | 69.4 | 96.1 | 124.5 | 139.3 | 144.1 | 131.2 | 83.6 | 101.6 | 122.8 | 123.3 | 134.9 | 138.4 |
| Current Acc't Bal. | (US\$ bn)   | 44.7 | 68.2 | 112.4 | 131.9 | 130.5 | 110.4 | 65.8 | 94.3  | 121.1 | 106.9 | 122.3 | 124.2 |
|                    | (% of GDP)  | -1.6 | -0.1 | -0.8  | -1.3  | -1.8  | -1.6  | -1.8 | 2.3   | 3.2   | 2.5   | 2.7   | 2.7   |
| Budget Balance     | (% of GDP)  | 2.9  | 2.9  | 1.5   | -1.6  | -2.3  | -3.6  | -4.3 | -3.5  | -7.1  | -9.2  | -7.2  | -7.5  |

Sources: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## British Pound

After managing to keep its head above US\$/£ 1.50 from May until mid-August, sterling has fallen steadily and reached a seven-and-a-half year low of under US\$/£ 1.45 this week. As with all currency movements, the reasons for this move are difficult to discern, but the continued general strength of the dollar is almost certainly one factor (as opposed to sterling weakness per se). This was compounded by continued optimism over U.K. interest rates, with many in the market concluding that the failure of the Monetary Policy Committee (MPC) to tighten policy at the August meeting implied that rates have peaked.

Nonetheless, sterling's latest move seems overdone. The spread between euro-£ and euro-\$ December 2000 contracts has actually continued to narrow and is presently -40 basis points, compared to -70 basis points just over a year ago, the opposite direction to that implied by the currency. The dollar has been rallying against most currencies and, clearly, sterling is no longer an exception to that rule.

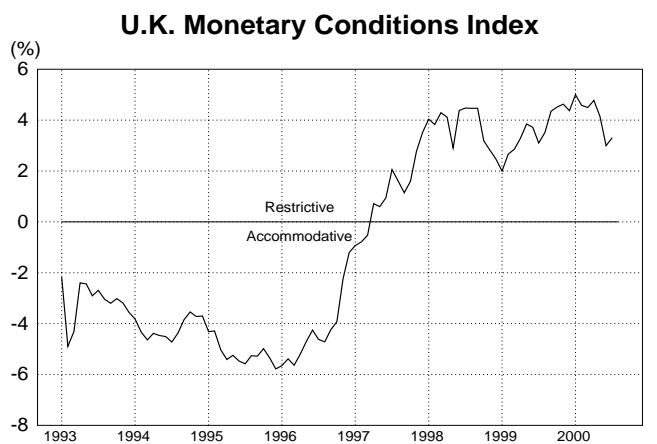
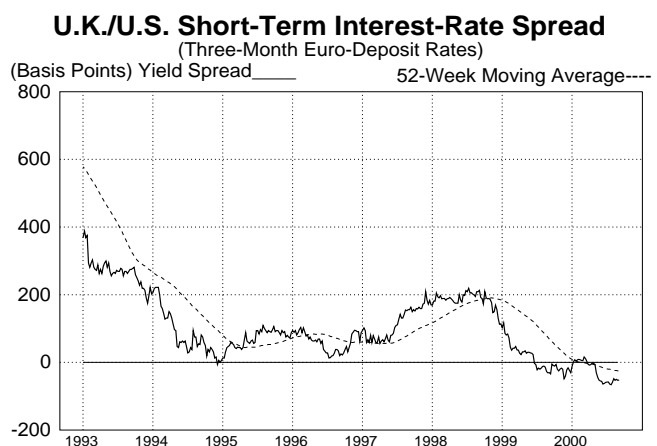
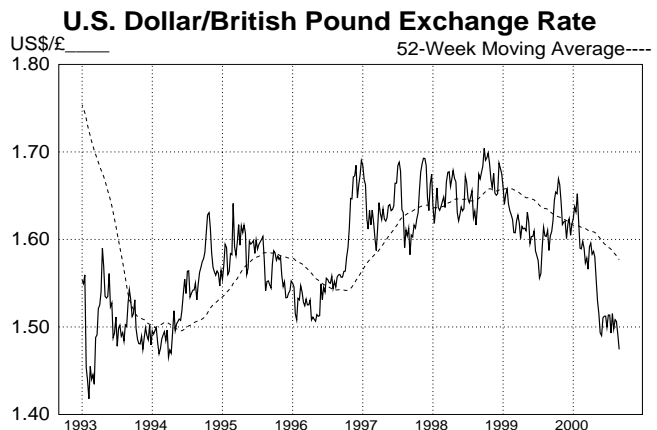
Certainly, the MPC should not react to the fall in the currency. The trade-weighted index—arguably more important than the move in sterling against one currency—is just under 106. This compares to the MPC's starting point of 106.1 in its *Inflation Report* projections and an end-point forecast of 104.6 in 2002. The concern of many members on the MPC would be that a surprise rate hike would push sterling's trade-weighted index higher once more, leading to a "double-whammy" tightening in monetary conditions.

Of more importance for interest-rate considerations is the state of the economy. The data in the past month has been something of a stalemate: the detail on Q2 GDP was broadly encouraging, yet the housing market is slowing and average earnings growth, a key concern of the MPC, has dipped below the 4.5% "comfort" level. As such, we do not believe that the Committee will vote to raise interest rates at the September meeting, although we acknowledge it will be a close call.

That said, we maintain our view that interest rates have yet to peak in this cycle. This is predicated mainly on a belief that strong consumption, driven by high employment and above-trend income growth, will support GDP growth at a level the MPC feels is excessive (note they do not yet agree that labour productivity growth has increased beyond its trend 2%). With this in mind, it is interesting to note that the GfK consumer confidence survey measures expectations on personal finances at an all-time high. Moreover, a euro rebound versus the dollar would also maintain pressure on U.K. interest rates. Allowing for at least one more rate rise by year-end, we look for a rate peak of 6.5% and a rise in cable above US\$/£ 1.50 once more in coming months.

**Ciaran Barr**  
 ciaran.barr@db.com

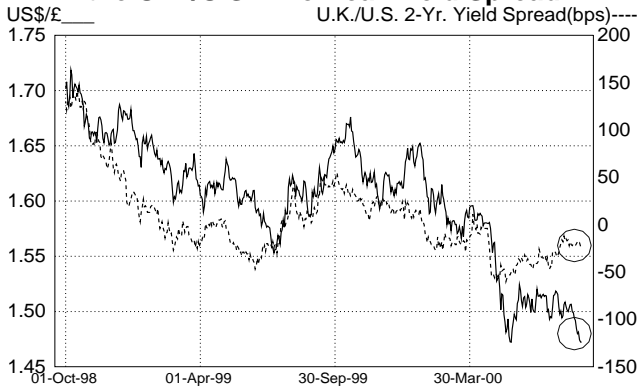
London, (44-20) 7545-2088



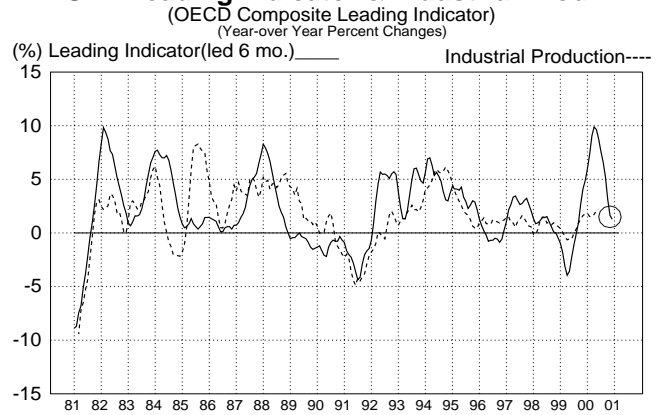
### U.K. Bond Market Trends

|   | Latest | High | 52-Week Low | Average | Z-Score |
|---|--------|------|-------------|---------|---------|
| <b>Yield Curve (%)</b>                      |        |      |             |         |         |
| 3-month                                     | 6.16   | 6.28 | 5.17        | 6.01    | 0.55    |
| 2-year                                      | 6.04   | 6.59 | 5.77        | 6.19    | -0.77   |
| 5-year                                      | 5.78   | 6.42 | 5.58        | 5.93    | -0.69   |
| 10-year                                     | 5.32   | 5.86 | 4.97        | 5.36    | -0.19   |
| <b>Yield Spread vs. U.S. (basis points)</b> |        |      |             |         |         |
| 3-month                                     | -44    | 13   | -64         | -24     | -0.82   |
| 2-year                                      | -21    | 47   | -56         | -6      | -0.53   |
| 10-year                                     | -64    | -23  | -123        | -84     | 0.83    |
| <b>Yield Curve Trends (basis points)</b>    |        |      |             |         |         |
| 2-yr./3-mo.                                 | -11    | 76   | -18         | 17      | -1.17   |
| 10-yr./3-mo.                                | -84    | 27   | -108        | -65     | -0.50   |
| 10-yr./2-yr.                                | -73    | -40  | -113        | -83     | 0.54    |

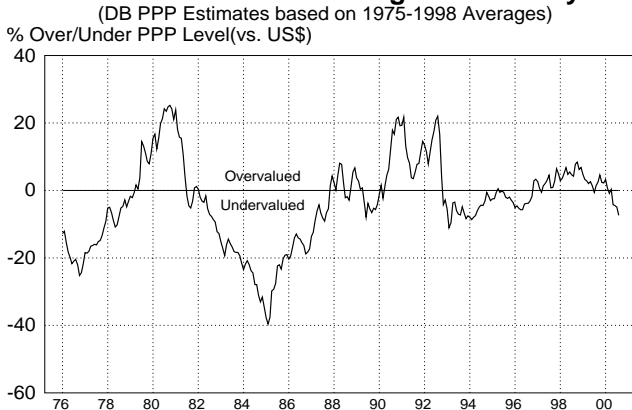
### The US\$/British Pound Exchange Rate and the U.K./U.S. Two-Year Yield Spread



### U.K. Leading Indicator & Industrial Prod.



### British Pound Purchasing Power Parity



### U.K. Equity Market



## U.K. Monthly Economic Data

| Economic Indicator            | Units       | Aug 1999 | Sep 1999 | Oct 1999 | Nov 1999 | Dec 1999 | Jan 2000 | Feb 2000 | Mar 2000 | Apr 2000 | May 2000 | Jun 2000 | Jul 2000 |
|-------------------------------|-------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| Retail Prices                 | (yoy % chg) | 1.1      | 1.1      | 1.2      | 1.4      | 1.8      | 2.0      | 2.3      | 2.6      | 3.0      | 3.1      | 3.3      | 3.3      |
| Core Retail Prices            | (yoy % chg) | 2.1      | 2.1      | 2.2      | 2.2      | 2.2      | 2.1      | 2.2      | 2.0      | 2.0      | 2.0      | 2.3      | 2.2      |
|                               | (mom % chg) | 0.2      | 0.4      | 0.1      | 0.1      | 0.2      | -0.4     | 0.4      | 0.4      | 0.7      | 0.3      | 0.2      | -0.4     |
| Producer Prices               | (yoy % chg) | 1.3      | 1.7      | 1.9      | 2.1      | 2.3      | 2.4      | 2.4      | 2.4      | 2.3      | 2.4      | 2.9      | 2.9      |
| Unemployment                  | (%)         | 4.2      | 4.2      | 4.1      | 4.1      | 4.0      | 4.0      | 4.0      | 3.9      | 3.8      | 3.8      | 3.8      | 3.7      |
| Average Earnings              | (yoy % chg) | 4.9      | 4.7      | 4.9      | 4.9      | 5.5      | 5.9      | 6.0      | 5.7      | 5.1      | 4.6      | 4.1      | -        |
| Industrial Production         | (yoy % chg) | 1.1      | 1.2      | 1.6      | 2.1      | 1.7      | 1.7      | 1.3      | 1.6      | 2.3      | 2.3      | 1.9      | -        |
| CBI Business Optimism (index) |             |          |          | 5        |          |          | 13       |          |          | 9        |          |          | -2       |
| Retail Sales Volume           | (yoy % chg) | 3.5      | 3.6      | 4.7      | 4.2      | 5.5      | 6.2      | 4.6      | 4.5      | 4.8      | 3.6      | 4.5      | 4.0      |
| M0                            | (yoy % chg) | 7.7      | 7.1      | 7.3      | 8.8      | 11.9     | 12.7     | 8.5      | 8.3      | 8.3      | 7.8      | 7.6      | 7.1      |
| M4                            | (yoy % chg) | 4.4      | 3.1      | 3.4      | 3.2      | 3.8      | 3.2      | 3.2      | 5.3      | 4.9      | 5.2      | 6.8      | 6.8      |
| Trade Balance                 | (£ bn sa)   | -1.9     | -1.5     | -2.2     | -2.4     | -2.6     | -2.6     | -2.0     | -1.9     | -2.8     | -2.3     | -2.3     | -        |
| Current Account Bal.          | (£ bn sa)   |          |          | -2.7     |          |          | -1.5     |          |          | -4.0     |          |          | -        |

## U.K. Annual Economic Data

| Economic Indicator | Units       | 1990  | 1991  | 1992  | 1993  | 1994  | 1995  | 1996  | 1997  | 1998  | 1999  | 2000f | 2001f |
|--------------------|-------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Real GDP           | (yoy % chg) | 0.7   | -1.5  | 0.1   | 2.3   | 4.4   | 2.8   | 2.6   | 3.5   | 2.6   | 2.1   | 3.0   | 3.0   |
| Unemployment Rate  | (%)         | 5.7   | 7.9   | 9.6   | 10.2  | 9.2   | 8.0   | 7.2   | 5.5   | 4.7   | 4.3   | 3.8   | 3.5   |
| Consumer Prices    | (yoy % chg) | 8.1   | 6.8   | 4.7   | 3.0   | 2.4   | 2.8   | 2.9   | 2.8   | 2.7   | 2.3   | 2.0   | 2.4   |
| Trade Balance      | (£ bn)      | -18.7 | -10.2 | -13.1 | -13.3 | -11.1 | -11.7 | -13.1 | -11.9 | -20.5 | -26.8 | -30.5 | -36.2 |
| Current Acc't Bal. | (£ bn)      | -19.5 | -8.4  | -10.1 | -10.6 | -1.5  | -3.7  | -0.6  | 6.6   | -0.1  | -11.0 | -17.1 | -21.7 |
|                    | (% of GDP)  | -3.5  | -1.4  | -1.7  | -1.7  | -0.2  | -0.5  | -0.1  | 0.8   | 0.0   | -1.2  | -1.8  | -2.2  |
| Budget Balance     | (% of GDP)  | 0.1   | -2.3  | -5.9  | -7.1  | -5.3  | -4.4  | -3.0  | -0.1  | 0.8   | 1.0   | 3.0   | 0.7   |

Sources: Datastream, OECD, National Accounts Data, Deutsche Bank Forecasts

## Canadian Dollar

During the past month, the Canadian dollar has—unlike many other major currencies—successfully avoided a sharp decline against the U.S. dollar. While the Australian dollar, the Swiss franc, and the euro have slumped and are approaching record lows, the C\$ continues to trade close the center of its medium-term range of C\$/US\$ 1.45 to 1.51 in place since April 2000. With the exception of the yen, the C\$ is the only major currency to keep pace with the U.S. dollar through August, with its relative strength traced to a combination of positive investor sentiment and better-than-expected performance of domestic and external demand.

Investor demand for the C\$ has clearly been supported by the persistent out-performance of the Toronto Stock Exchange against all other stock markets. In addition, the secure environment of a superior core-inflation performance and steady interest-rate expectations, have helped Canadian fixed-income markets to rally convincingly following the May 50 basis-point rate hike.

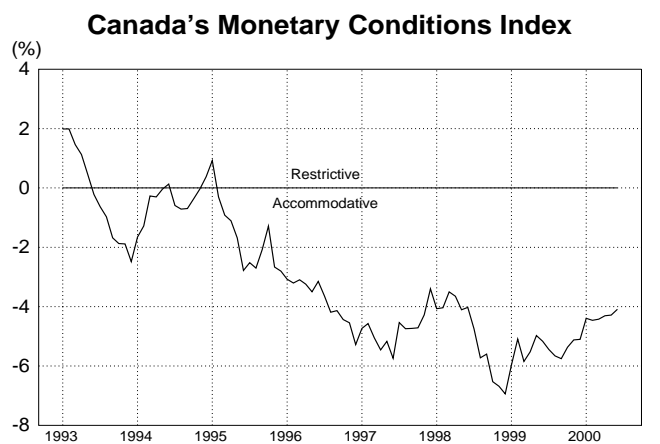
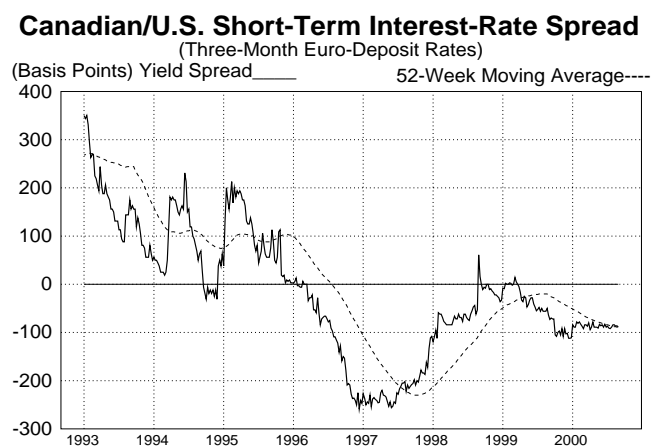
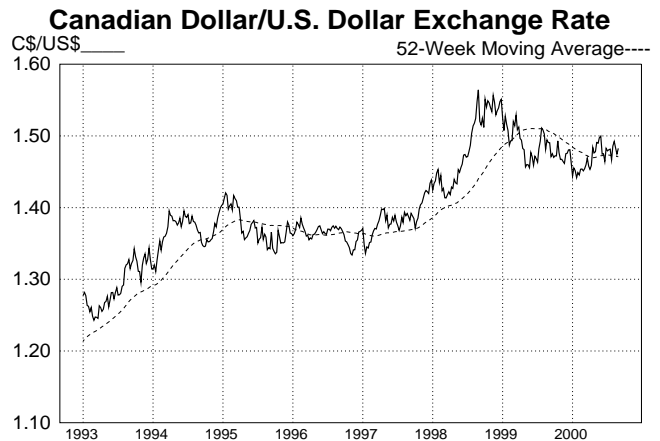
The sharp turnaround in investor sentiment through the summer culminated in a sharp rise in the Consensus Inc. measure of bullish market opinion for the C\$ to 53% by the middle of August, the second highest measure in the past six months. Rising investor confidence in the C\$ has helped to protect the exchange rate from the speculative short selling afflicting a host of other currencies, including the A\$ and NZ\$. As a result, the A\$ reached a record low of 1.1850 against the C\$ during the past week, a year-to-date depreciation of almost 15%.

The recent recovery in investor opinion towards the C\$ has allowed the currency to respond positively to the better-than-expected demand and production second-quarter outcomes, buoyed additionally by the continued strong performance of the external accounts. The continued momentum in demand—which features a strong U.S.-like investment boom—has not gone unnoticed by the money markets, which have taken out the excessive negative spread achieved in early summer. The front December money-market spread to the U.S. has thus narrowed in from a summer high of -112 basis-points to a -90 to -95 basis-point range, further supporting the recent unwinding of excessive C\$ shorts on the IMM.

Unlike the persistent trade and current-account deficits marked by the rest of dollar-bloc and the patchy domestic growth picture painted by recent data in Euroland and the U.K., the Canadian economy shows a healthy balance of robust domestic and foreign demand, mixed with low inflation and rising productivity. With both external and domestic demand signals likely to retain a measure of strength during the second half of the year, our relatively bullish expectation of a gradually appreciating C\$ into 2001 remains intact.

**Peter Frank**  
peter.frank@db.com

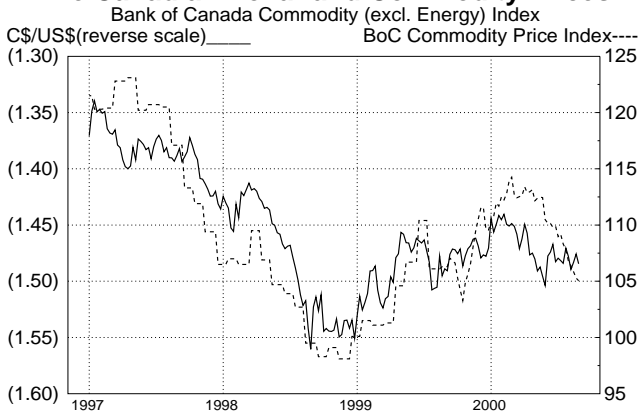
Toronto, (416) 682-8015



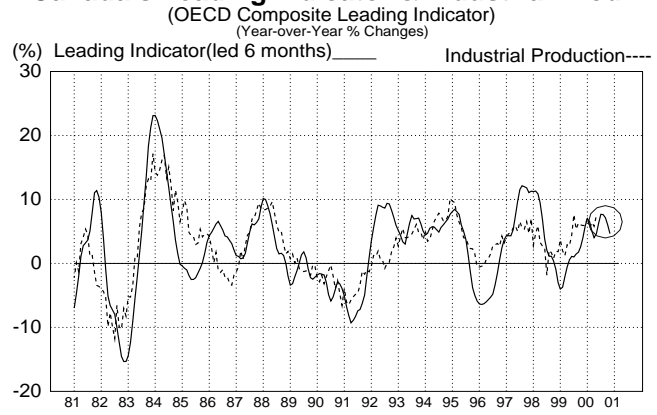
### Canadian Bond Market Trends

|   | Latest | High | 52-Week Low | Average | Z-Score |
|---|--------|------|-------------|---------|---------|
| <b>Yield Curve (%)</b>                      |        |      |             |         |         |
| 3-month                                     | 5.80   | 5.94 | 4.75        | 5.37    | 1.17    |
| 2-year                                      | 5.87   | 6.31 | 5.32        | 5.88    | -0.05   |
| 5-year                                      | 5.88   | 6.48 | 5.59        | 6.05    | -0.69   |
| 10-year                                     | 5.83   | 6.54 | 5.69        | 6.03    | -0.86   |
| <b>Yield Spread vs. U.S. (basis points)</b> |        |      |             |         |         |
| 3-month                                     | -80    | -58  | -109        | -88     | 0.74    |
| 2-year                                      | -38    | 6    | -65         | -37     | -0.10   |
| 10-year                                     | -12    | 10   | -43         | -16     | 0.38    |
| <b>Yield Curve Trends (basis points)</b>    |        |      |             |         |         |
| 2-yr./3-mo.                                 | 7      | 104  | -1          | 50      | -1.46   |
| 10-yr./3-mo.                                | 4      | 147  | -5          | 66      | -1.35   |
| 10-yr./2-yr.                                | -3     | 46   | -15         | 16      | -1.06   |

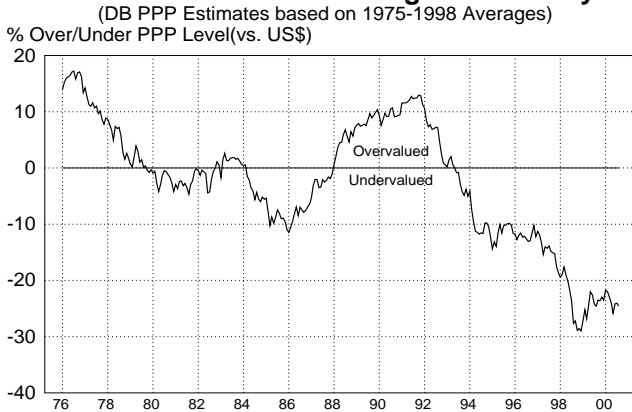
### The Canadian Dollar and Commodity Prices



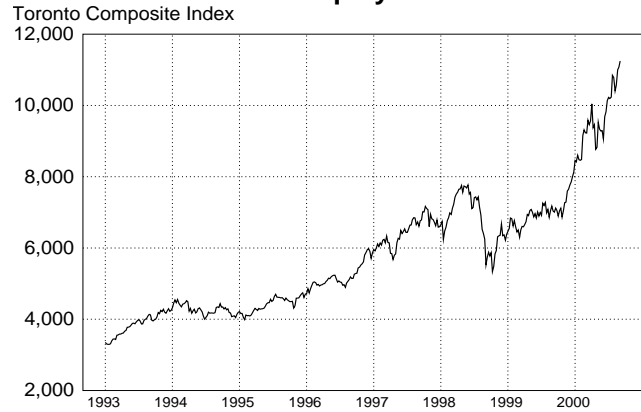
### Canada's Leading Indicator & Industrial Prod.



### Canadian Dollar Purchasing Power Parity



### Canada's Equity Market



## Canada's Monthly Economic Data

| Economic Indicator     | Units         | Aug 1999 | Sep 1999 | Oct 1999 | Nov 1999 | Dec 1999 | Jan 2000 | Feb 2000 | Mar 2000 | Apr 2000 | May 2000 | Jun 2000 | Jul 2000 |
|------------------------|---------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| Consumer Prices        | (yoy % chg)   | 2.1      | 2.6      | 2.3      | 2.2      | 2.6      | 2.3      | 2.7      | 3.0      | 2.1      | 2.4      | 2.9      | 3.0      |
| Producer Prices        | (yoy % chg)   | 2.3      | 3.4      | 2.7      | 2.8      | 4.4      | 4.5      | 6.1      | 5.8      | 5.7      | 5.9      | 5.6      | 4.3      |
| Real GDP               | (yoy % chg)   | 4.6      | 4.8      | 4.6      | 4.9      | 4.8      | 5.1      | 4.2      | 4.8      | 4.3      | 4.8      | -        | -        |
| Unemployment           | (%)           | 7.7      | 7.4      | 7.1      | 6.9      | 6.8      | 6.8      | 6.8      | 6.8      | 6.8      | 6.6      | 6.6      | 6.8      |
| Employment             | (mom chg 000) | 2.1      | 50.0     | 37.3     | 53.8     | 60.1     | 44.3     | 35.7     | 30.3     | 4.8      | 42.3     | -14.1    | -17.3    |
| Avg. Hourly Earnings   | (yoy % chg)   | 0.9      | 1.4      | 0.9      | 1.1      | 1.4      | 2.3      | 2.8      | 2.8      | 2.6      | 2.8      | 2.8      | -        |
| Industrial Production  | (yoy % chg)   | 5.3      | 6.3      | 6.0      | 5.9      | 6.0      | 7.1      | 5.5      | 6.4      | 5.8      | 7.5      | -        | -        |
| Retail Trade           | (yoy % chg)   | 7.8      | 7.1      | 6.5      | 5.9      | 8.8      | 6.9      | 5.3      | 6.7      | 5.8      | 6.4      | 6.3      | -        |
| M2                     | (yoy % chg)   | 3.1      | 3.3      | 3.1      | 3.6      | 5.5      | 5.4      | 5.2      | 5.2      | 6.8      | 5.7      | 7.0      | 7.5      |
| International Reserves | (US\$ bn)     | 25.7     | 26.2     | 26.8     | 28.9     | 28.6     | 29.0     | 29.9     | 31.1     | 30.4     | 29.6     | 30.3     | 30.1     |
| Trade Balance          | (C\$ bn sa)   | 3.7      | 2.9      | 2.6      | 3.5      | 2.7      | 4.3      | 3.7      | 4.3      | 3.2      | 4.0      | 5.0      | -        |
| Current Account Bal.   | (C\$ bn sa)   |          | 0.4      |          |          | -0.3     |          |          | 4.8      |          |          |          |          |
| Gov't Surplus/Deficit  | (C\$ bn)      | 7.6      | 7.5      | 8.0      | 7.3      | 5.5      | 5.9      | 8.3      | 8.8      | 10.1     | 11.5     | 12.3     | -        |

## Canada's Annual Economic Data

| Economic Indicator | Units       | 1990  | 1991  | 1992  | 1993  | 1994  | 1995  | 1996 | 1997  | 1998  | 1999 | 2000F | 2001F |
|--------------------|-------------|-------|-------|-------|-------|-------|-------|------|-------|-------|------|-------|-------|
| Real GDP           | (yoy % chg) | 0.3   | -1.9  | 0.9   | 2.3   | 4.7   | 2.8   | 1.5  | 4.4   | 3.3   | 4.5  | 4.8   | 3.5   |
| Unemployment Rate  | (%)         | 8.2   | 10.4  | 11.3  | 11.2  | 10.4  | 9.5   | 9.7  | 9.0   | 8.3   | 7.6  | 6.6   | 6.3   |
| Consumer Prices    | (yoy % chg) | 4.8   | 5.6   | 1.5   | 1.9   | 0.2   | 2.2   | 1.6  | 1.6   | 1.0   | 1.8  | 2.5   | 2.4   |
| Trade Balance      | (C\$ bn)    | 8.7   | 3.6   | 6.3   | 9.4   | 16.1  | 29.6  | 35.7 | 24.3  | 19.4  | 28.2 | 45.5  | 38.5  |
| Current Acc't Bal. | (C\$ bn)    | -25.2 | -27.0 | -25.9 | -28.7 | -19.7 | -10.0 | 4.7  | -12.9 | -18.4 | -9.5 | 11.0  | 0.0   |
|                    | (% of GDP)  | -3.4  | -3.7  | -3.6  | -3.9  | -2.3  | -0.8  | 0.6  | -1.5  | -1.8  | -0.5 | 1.0   | 0.0   |
| Budget Balance     | (% of GDP)  | -4.5  | -7.2  | -8.0  | -7.5  | -5.5  | -4.3  | -2.0 | -1.8  | -1.7  | 1.6  | 1.7   | 1.5   |

Sources: Datastream, OECD, National Accounts Data, Deutsche Bank Forecasts

## Australian Dollar

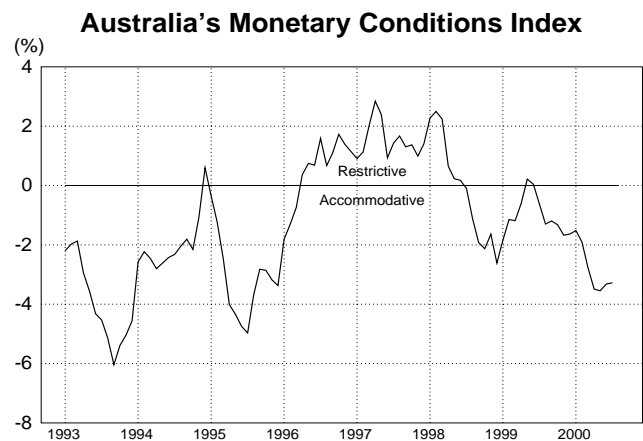
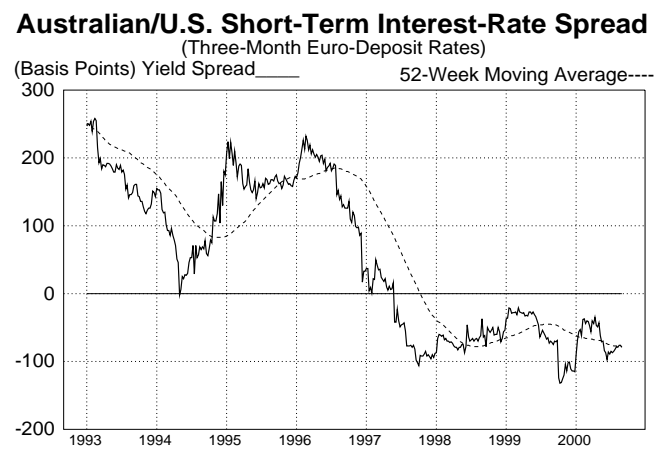
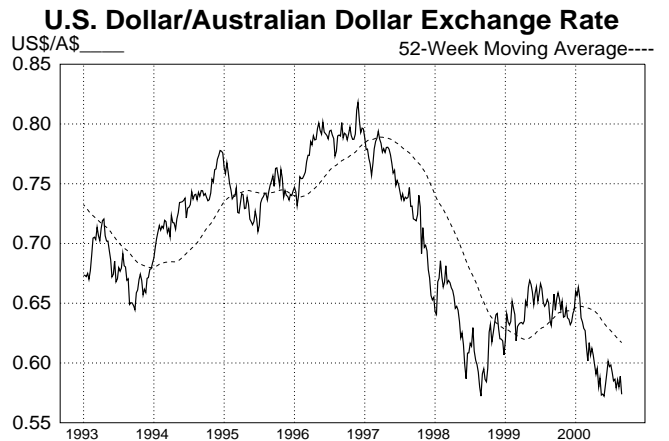
The A\$ has remained within a US\$/A\$ 0.5650-0.6100 range despite some volatile trading in recent times. The data trend in Australia over the past two months has strengthened noticeably, but the A\$ has not been able to take advantage of the improved fundamentals. For instance, employment rose a cycle-high 3.7% in the year to August, consumer sentiment rose 13% over the two months to August, and the NAB business survey reported strong bounces in business confidence in June and July.

The market, however, was slow to respond to the strength in the data and was taken unawares by the Reserve Bank's (RBA) August rate hike. This probably reflects the fact that some traditional demand-side indicators remained weak, and the data was erratic and difficult to interpret because of the introduction of the general sales tax (GST). For example, building approvals fell 18.0% in June, but motor vehicle registrations rose by 55.2% month/month rise in July and there was a 7.7% month/month rise in retail spending in June. We expect the RBA to hike rates twice more this calendar year, with perhaps one more rate hike after that. That suggests a cash rate of 6.75%-7.00%, which is likely to represent the peak of the cycle.

The A\$ has been unable to gain from these positive developments. We suspect that the explanation is simply due to the continued strength of the U.S. economy more than anything. Consensus forecasts for Australian growth have remained unchanged for this year and have been revised slightly lower for 2001, while forecasts for U.S. growth have been revised higher. And any improvements in Australian fundamentals have been overshadowed by further upgrades to the U.S. growth outlook. As has been the case for the past eighteen months, Australia's inability to keep pace with the continued upgrades to the U.S. growth outlook has put downward pressure on the A\$.

Finally, while the Federal Reserve looks willing to give the inflation cycle the benefit of the doubt, the RBA is likely to tighten further in the face of rising inflationary pressure. Although this implies the removal of negative carry on A\$ investments, just as with the euro, the A\$ is likely to progressively diverge from rate spreads as the year progresses. These factors suggest that while the A\$ is still within its established range, a break to the downside remains the key risk.

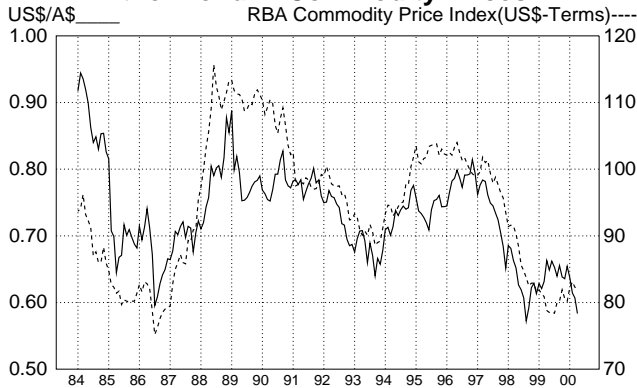
**Richard Yetsenga** Sydney, (61-2) 9258-2130  
[richard.yetsenga@db.com](mailto:richard.yetsenga@db.com)



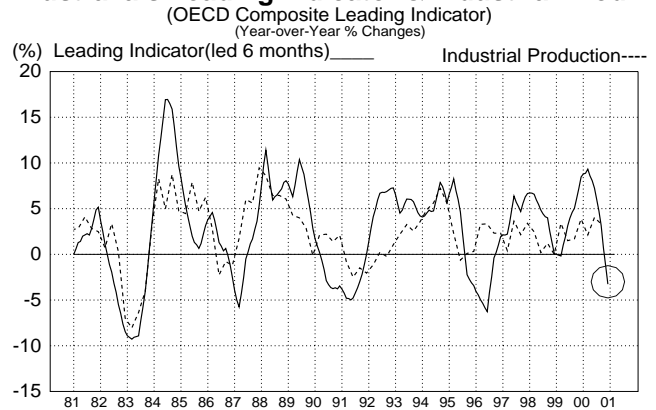
### Australian Bond Market Trends

|   | Latest | High | 52-Week Low | Average | Z-Score |
|---|--------|------|-------------|---------|---------|
| <b>Yield Curve (%)</b>                      |        |      |             |         |         |
| 3-month                                     | 5.88   | 6.05 | 4.75        | 5.48    | 0.91    |
| 2-year                                      | 6.41   | 6.56 | 5.26        | 6.05    | 1.16    |
| 5-year                                      | 6.32   | 7.02 | 5.74        | 6.35    | -0.11   |
| 10-year                                     | 6.26   | 7.21 | 6.04        | 6.50    | -0.74   |
| <b>Yield Spread vs. U.S. (basis points)</b> |        |      |             |         |         |
| 3-month                                     | -71    | -36  | -133        | -77     | 0.22    |
| 2-year                                      | 16     | 17   | -71         | -19     | 1.51    |
| 10-year                                     | 31     | 57   | -9          | 31      | -0.00   |
| <b>Yield Curve Trends (basis points)</b>    |        |      |             |         |         |
| 2-yr./3-mo.                                 | 53     | 118  | -5          | 57      | -0.12   |
| 10-yr./3-mo.                                | 38     | 187  | 21          | 102     | -1.04   |
| 10-yr./2-yr.                                | -15    | 94   | -15         | 45      | -1.95   |

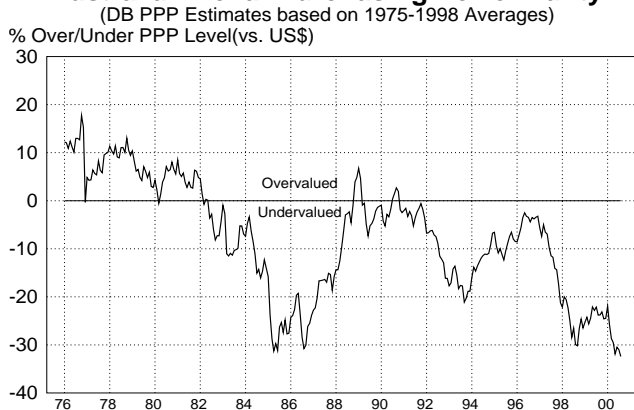
### The Australian Dollar and the Trend in Commodity Prices



### Australia's Leading Indicator & Industrial Prod.



### Australian Dollar Purchasing Power Parity



### Australia's Equity Market



## Australia's Monthly Economic Data

| Economic Indicator     | Units           | Aug 1999 | Sep 1999 | Oct 1999 | Nov 1999 | Dec 1999 | Jan 2000 | Feb 2000 | Mar 2000 | Apr 2000 | May 2000 | Jun 2000 | Jul 2000 |
|------------------------|-----------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| Consumer Prices        | (yoy % chg)     |          | 1.7      |          |          | 1.8      |          |          | 2.8      |          |          | 3.2      |          |
| Mfg Output Prices      | (yoy % chg)     |          | 1.0      |          |          | 3.1      |          |          | 5.6      |          |          | 7.3      |          |
| Commodity Prices       | (yoy % chg)     | -4.4     | -2.8     | -1.2     | -2.8     | -1.72    | 0.2      | 2.2      | 1.2      | 4.4      | 4.7      | 6.1      | 7.0      |
| GDP                    | (yoy % chg, sa) |          | 4.5      |          |          | 4.1      |          |          | 4.3      |          |          | -        |          |
| Unemployment           | (%, sa)         | 7.1      | 7.3      | 7.1      | 6.8      | 7.0      | 6.9      | 6.7      | 6.9      | 6.8      | 6.7      | 6.6      | 6.3      |
| Employment             | (mom chg)       | 31.4     | 8.2      | 42.8     | 1        | 39.5     | -8.9     | 59       | 8.3      | 37.5     | 12.1     | 21.7     | 75.8     |
| Avg. Weekly Earnings   | (yoy % chg)     |          | 2.1      |          |          | 3.0      |          |          | 4.1      |          |          | 4.2      |          |
| Industrial Production  | (yoy % chg)     |          | 1.7      |          |          | 3.9      |          |          | 2.1      |          |          | -        |          |
| Private Sector Credit  | (yoy % chg)     | 10.6     | 10.8     | 11.1     | 11.1     | 11.1     | 10.9     | 11.8     | 11.9     | 11.7     | 12.6     | 13.1     | -        |
| International Reserves | (A\$ bn)        | 23.6     | 23.1     | 29.1     | 32.5     | 33.6     | 30.3     | 29.8     | 27.2     | 26.7     | 23.3     | 27.9     | 28.3     |
| Exports                | (A\$ bn, sa)    | 9.6      | 9.7      | 10.5     | 10.5     | 10.3     | 10.0     | 10.9     | 10.9     | 11.0     | 11.3     | 11.7     | -        |

## Australia's Annual Economic Data

| Economic Indicator      | Units       | 1990  | 1991  | 1992  | 1993  | 1994  | 1995  | 1996  | 1997  | 1998  | 1999  | 2000f | 2001f |
|-------------------------|-------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Real GDP                | (yoy % chg) | 1.9   | -1.0  | 2.4   | 3.8   | 5.2   | 3.8   | 4.4   | 4.1   | 5.0   | 4.4   | 4.3   | 3.4   |
| Unemployment Rate       | (%)         | 7.0   | 9.6   | 10.8  | 10.9  | 9.8   | 8.5   | 8.6   | 8.6   | 8.0   | 7.2   | 6.4   | 5.7   |
| Consumer Prices         | (yoy % chg) | 7.3   | 3.2   | 1.0   | 1.8   | 1.9   | 4.6   | 2.6   | 0.3   | 0.9   | 1.5   | 4.6   | 3.9   |
| Trade Balance           | (A\$ bn)    | 0.5   | 4.5   | 2.2   | -0.1  | -4.4  | -5.7  | -0.8  | 2.3   | -8.3  | -15.2 | -6.7  | -2.3  |
| Current Account Balance | (A\$ bn)    | -20.5 | -14.4 | -15.3 | -14.5 | -23.6 | -26.5 | -20.4 | -17.2 | -28.5 | -34.7 | -28.2 | -26.0 |
|                         | (% of GDP)  | -5.2  | -3.6  | -3.7  | -3.3  | -5.1  | -5.4  | -3.9  | -3.1  | -4.9  | -5.7  | -4.3  | -3.8  |
| Budget Balance          | (% of GDP)  | 1.8   | 0.1   | -2.8  | -4.0  | -3.8  | -2.8  | -2.0  | -0.9  | 0.2   | 0.5   | 0.8   | 0.5   |

Sources: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

# New Zealand Dollar

The NZ\$ continued to hit successive record lows in recent weeks against the U.S. dollar and reached a cyclical low against the A\$. Unlike Australia, New Zealand does not have improving domestic fundamentals to partially offset the improving confidence in the U.S. economy. New Zealand's growth data continues to be disappointing, with the final run of partial activity indicators for the second quarter finally confirming that a negative GDP outcome is in prospect. At the end of 1999 New Zealand, was the strongest growing economy in the dollar-bloc. Expectations for 2000 are now centered on it being the weakest, a dramatic turnaround by any measure.

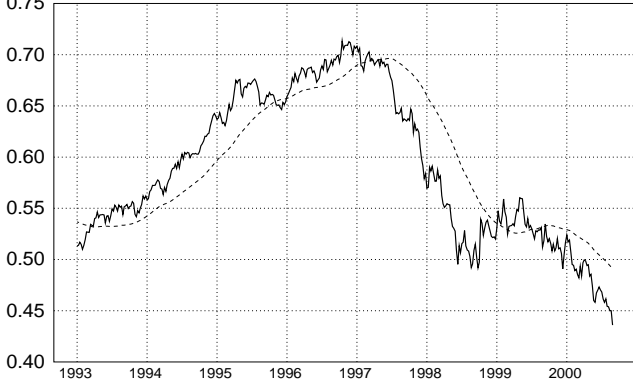
The Reserve Bank (RBNZ), however, surprised the market with a much more dovish assessment of the interest-rate outlook in its recent Monetary Policy Statement (MPS). The apparent increase in weight given to the growth outlook, and diminution of currency-induced inflation concerns, have raised hopes that interest-rate developments may not be as negative for the growth outlook as feared. With many currencies pricing principally off the growth outlook in recent times, this is a positive factor for the NZ\$. Unfortunately, it is unlikely to be positive enough to stem further losses.

**Richard Yetsenga**

Sydney, (61-2) 9258-2130

[richard.yetsenga@db.com](mailto:richard.yetsenga@db.com)

**U.S. Dollar/New Zealand Dollar Exchange Rate**  
US\$/NZ\$ \_\_\_\_\_ 52-Week Moving Average-----



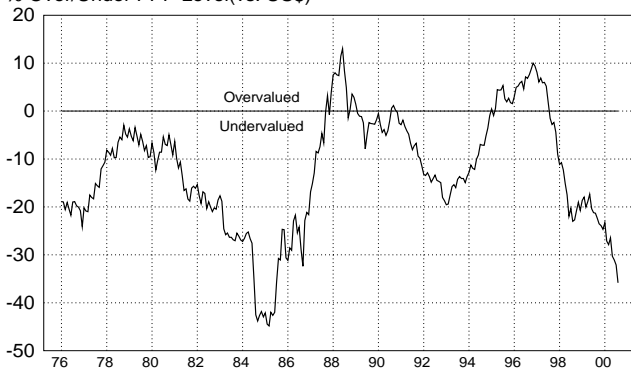
**New Zealand's Equity Market**



**New Zealand Dollar Purchasing Power Parity**

(DB PPP Estimates based on 1975-1998 Averages)

% Over/Under PPP Level(vs. US\$)



**New Zealand Bond Market Trends**

|   | Latest | High | 52-Week Low | Average | Z-Score |
|---|--------|------|-------------|---------|---------|
| <b>Yield Curve (%)</b>                      |        |      |             |         |         |
| 3-month                                     | 6.57   | 6.84 | 4.88        | 5.90    | 0.99    |
| 2-year                                      | 6.88   | 7.20 | 5.59        | 6.70    | 0.46    |
| 5-year                                      | 6.80   | 7.39 | 6.53        | 6.94    | -0.68   |
| 10-year                                     | 6.73   | 7.52 | 6.67        | 7.03    | -1.26   |
| <b>Yield Spread vs. U.S. (basis points)</b> |        |      |             |         |         |
| 3-month                                     | -2     | 15   | -130        | -36     | 0.85    |
| 2-year                                      | 63     | 73   | -1          | 45      | 1.17    |
| 10-year                                     | 78     | 109  | 59          | 83      | -0.44   |
| <b>Yield Curve Trends (basis points)</b>    |        |      |             |         |         |
| 2-yr./3-mo.                                 | 31     | 143  | -8          | 80      | -1.06   |
| 10-yr./3-mo.                                | 16     | 231  | -14         | 113     | -1.20   |
| 10-yr./2-yr.                                | -15    | 114  | -21         | 33      | -1.14   |

**New Zealand's Annual Economic Data**

| Economic Indicator | Units       | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000f | 2001f |
|--------------------|-------------|------|------|------|------|------|------|------|------|------|------|-------|-------|
| Real GDP           | (yoy % chg) | -0.3 | -1.8 | 0.9  | 5.1  | 6.0  | 4.0  | 3.2  | 2.0  | -0.2 | 3.4  | 3.9   | 3.2   |
| Unemployment Rate  | (%)         | 7.7  | 10.3 | 10.3 | 9.5  | 8.1  | 6.3  | 6.1  | 6.6  | 7.5  | 6.3  | 6.5   | 6.4   |
| Consumer Prices    | (yoy % chg) | 6.1  | 2.6  | 1.0  | 1.3  | 1.8  | 3.8  | 2.3  | 1.2  | 1.5  | 1.1  | 2.3   | 2.4   |
| Trade Balance      | (NZ\$ bn)   | 0.2  | 2.3  | 1.6  | 1.6  | 0.9  | -0.6 | -0.5 | 1.2  | 1.6  | -0.8 | 0.1   | 2     |
| Current Acc't Bal. | (NZ\$ bn)   | -2.0 | -1.6 | -1.7 | -1.4 | -2.1 | -3.3 | -3.9 | -6.9 | -5.9 | -8.3 | -8.1  | -6.6  |
|                    | (% of GDP)  | -2.8 | -2.2 | -2.7 | -1.1 | -2.2 | -3.1 | -3.9 | -7.6 | -5.0 | -8.1 | -7.4  | -5.8  |
| Budget Balance     | (% of GDP)  | -4.7 | -3.8 | -3.3 | -0.6 | 3.0  | 3.3  | 2.7  | 2.0  | 2.6  | 1.8  | 0.7   | 1.1   |

Sources: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

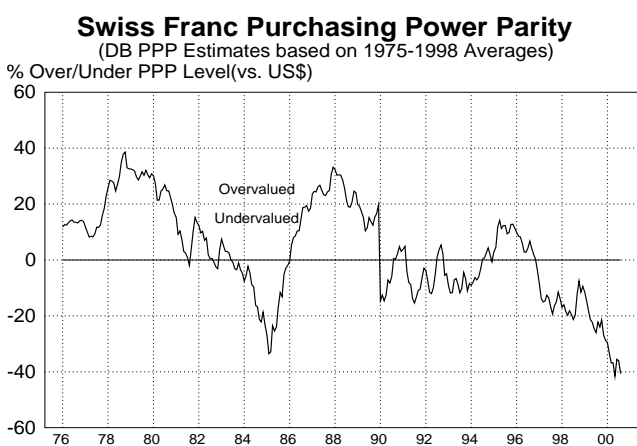
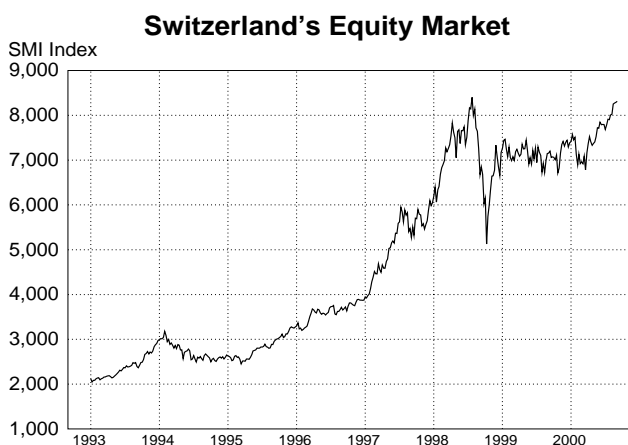
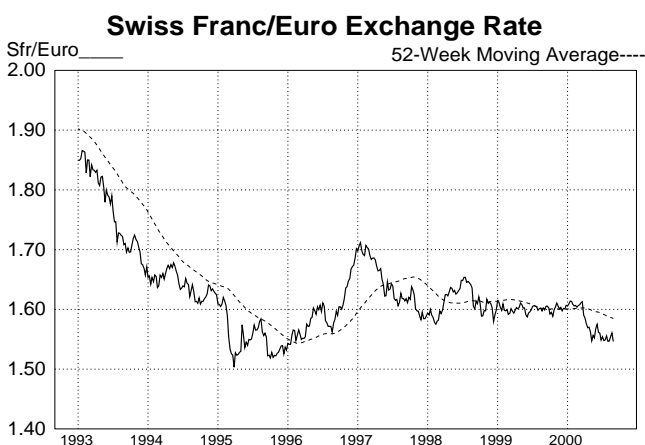
## Swiss Franc

A tight labour market has been a feature of the Swiss economy this year and there are some anecdotes of rising wage pressures. The Swiss Trade Union Federation, an umbrella organisation representing about 10% of the working population, recently said member groups would push for wage rises of between 1.5%-3% above inflation. Such increases are already being targeted within the chemical industry and construction sectors, and the civil service, for example. Even if wage claims fall short of these targets, real wages (which have been stagnant since 1992) look set to rise. Current strength in productivity growth will provide a near-term offset, but if productivity trends were to return to more usual levels, these wage trends would affect the medium-term inflation outlook.

More beneficially, tight labour markets may help defeat an initiative aimed at restricting foreign residents to 18% of the population (from 19.3% currently). A referendum on the issue is set for 24 September. The Government is against the proposal, arguing that it would hurt business and that it would run counter to the bilateral agreements with EU member countries, which include reciprocal freedom of movement for Swiss and EU citizens. Not all parliaments of the EU member states have passed these agreements yet. A recent television poll showed 48% against the proposal (up from 42% a month ago), while those for the proposal were steady at 40%.

**Nick Bennenbroek**  
[nick.bennenbroek@db.com](mailto:nick.bennenbroek@db.com)

London, (44-020) 7545-8738



|  | Latest | High | 52-Week Low | Average | Z-Score |
|--|--------|------|-------------|---------|---------|
| <b>Yield Curve (%)</b>                         |        |      |             |         |         |
| 3-month  | 3.42   | 3.45 | 0.98        | 2.47    | 1.31    |
| 2-year   | 3.71   | 3.78 | 1.99        | 3.07    | 1.17    |
| 5-year   | 3.80   | 3.91 | 2.68        | 3.38    | 1.11    |
| 10-year  | 3.76   | 4.13 | 3.04        | 3.66    | 0.37    |
| <b>Yield Spread vs. Germany (basis points)</b> |        |      |             |         |         |
| 3-month  | -150   | -94  | -169        | -132    | -0.94   |
| 2-year   | -152   | -96  | -190        | -132    | -0.94   |
| 10-year  | -150   | -108 | -202        | -159    | 0.35    |
| <b>Yield Curve Trends (basis points)</b>       |        |      |             |         |         |
| 2-yr./3-mo.                                    | 28     | 126  | 24          | 60      | -1.41   |
| 10-yr./3-mo.                                   | 34     | 213  | 34          | 119     | -1.70   |
| 10-yr./2-yr.                                   | 5      | 118  | 2           | 58      | -1.66   |

### Switzerland's Annual Economic Data

| Economic Indicator | Units       | 1990  | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000f | 2001f |
|--------------------|-------------|-------|------|------|------|------|------|------|------|------|------|-------|-------|
| Real GDP           | (yoy % chg) | 3.7   | -0.8 | -0.1 | -0.5 | 0.5  | 0.6  | 0.0  | 1.7  | 2.1  | 1.7  | 3.0   | 2.7   |
| Unemployment Rate  | (%)         | 0.5   | 1.1  | 2.5  | 4.5  | 4.7  | 4.2  | 4.7  | 5.2  | 3.9  | 2.7  | 1.9   | 1.7   |
| Consumer Prices    | (yoy % chg) | 5.4   | 5.9  | 4.0  | 3.3  | 0.9  | 1.8  | 0.8  | 0.5  | 0.0  | 0.8  | 1.7   | 2.0   |
| Trade Balance      | (Sfr bn)    | -10.0 | -8.5 | -1.4 | 2.4  | 2.2  | 1.0  | 1.1  | -0.5 | -2.2 | -0.2 | -3.3  | -1.6  |
| Current Acc't Bal. | (Sfr bn)    | 12.0  | 15.2 | 21.3 | 28.8 | 23.9 | 25.2 | 27.2 | 37.6 | 34.6 | 44.6 | 44.6  | 45.8  |
|                    | (% of GDP)  | 3.7   | 4.6  | 6.2  | 8.2  | 6.7  | 7.0  | 7.2  | 10.1 | 9.1  | 11.5 | 11.0  | 10.8  |
| Budget Balance     | (% of GDP)  | 1.1   | 2.1  | -3.5 | -3.6 | -2.8 | -1.8 | -1.8 | -2.1 | -0.4 | -1.5 | -0.9  | 0.0   |

Sources: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

# Danish Krone

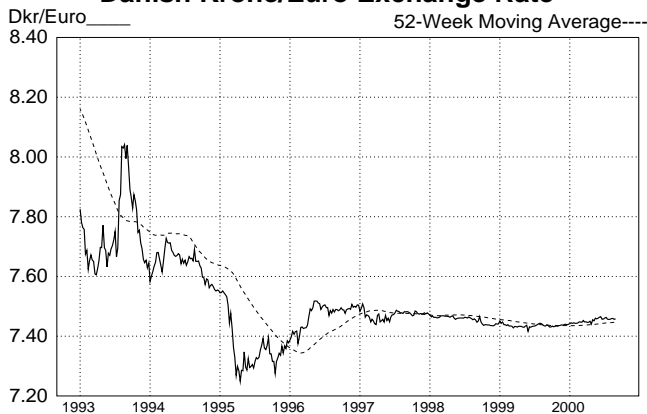
Market focus in Denmark is still firmly on the EMU opinion polls. Since the summer, there has been a small swing back in favour of the 'yes' vote that can be attributed, to some extent, to the government's change in strategy. While it had previously concentrated on the economic benefits of EMU membership, it is now making a concerted effort to address the public's political concerns. This may help to sway some of the doubters, who are worried about the implications of EMU for wider political union and the Danish welfare state. The most recent poll by IFO shows the 'yes' side ahead with 42.4% against 39.4% for the 'no' side. While this is still very close, there does seem to be some change in sentiment.

The krone has remained fairly stable over the last few weeks and the polls will continue to be decisive. We believe there is a more than a 50% chance of a 'yes' vote in the referendum on September 28th, but even if the outcome is negative, the impact on the krone should be limited and short-lived. Economic fundamentals are positive, and inflation is expected to converge with Euroland since the Danish economy is growing relatively slower. In addition, investor positions in the Danish market are not what they were in 1998, in particular leveraged positions are more limited.

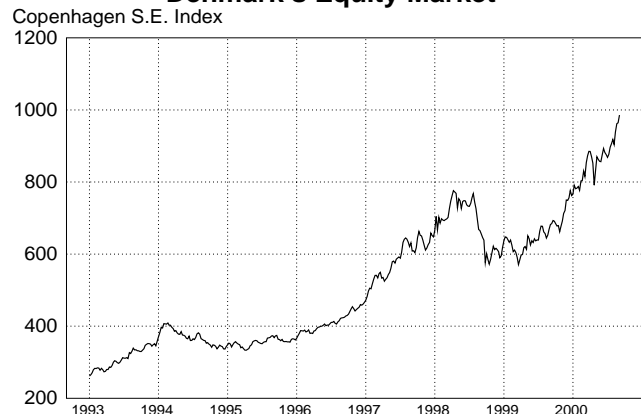
**Stephanie Pfeifer**  
stephanie.pfeifer@db.com

London, (44-020) 7545-2086

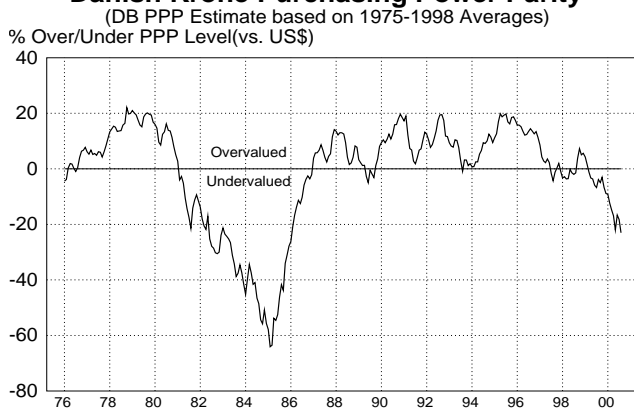
**Danish Krone/Euro Exchange Rate**



**Denmark's Equity Market**



**Danish Krone Purchasing Power Parity**



**Danish Bond Market Trends**

|  | Latest | High | 52-Week Low | Average | Z-Score |
|--|--------|------|-------------|---------|---------|
| <b>Yield Curve (%)</b>                         |        |      |             |         |         |
| 3-month  | 5.58   | 5.86 | 3.02        | 4.25    | 1.63    |
| 2-year   | 5.87   | 5.91 | 3.88        | 5.07    | 1.45    |
| 5-year   | 5.73   | 5.90 | 4.82        | 5.41    | 1.06    |
| 10-year  | 5.67   | 5.94 | 5.28        | 5.66    | 0.04    |
| <b>Yield Spread vs. Germany (basis points)</b> |        |      |             |         |         |
| 3-month  | 66     | 136  | 9           | 46      | 0.71    |
| 2-year   | 64     | 90   | 43          | 67      | -0.37   |
| 10-year  | 41     | 52   | 29          | 41      | -0.04   |
| <b>Yield Curve Trends (basis points)</b>       |        |      |             |         |         |
| 2-yr./3-mo.                                    | 29     | 131  | 5           | 82      | -1.59   |
| 10-yr./3-mo.                                   | 9      | 257  | -10         | 141     | -1.66   |
| 10-yr./2-yr.                                   | -20    | 155  | -28         | 59      | -1.55   |

**Denmark's Annual Economic Data**

| Economic Indicator | Units       | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998  | 1999 | 2000f | 2001f |
|--------------------|-------------|------|------|------|------|------|------|------|------|-------|------|-------|-------|
| Real GDP           | (yoy % chg) | 1.2  | 1.4  | 1.3  | 0.8  | 5.8  | 3.2  | 3.2  | 3.1  | 2.5   | 1.7  | 2.2   | 2.3   |
| Unemployment Rate  | (%)         | 9.4  | 10.3 | 11.0 | 12.1 | 12.0 | 10.1 | 8.7  | 7.9  | 6.6   | 5.7  | 5.3   | 5.3   |
| Consumer Prices    | (yoy % chg) | 2.6  | 2.4  | 2.1  | 1.3  | 2.0  | 2.1  | 2.1  | 2.2  | 1.9   | 2.5  | 3.0   | 2.4   |
| Trade Balance      | (Dkr bn)    | 21.7 | 25.2 | 41.9 | 49.7 | 45.6 | 36.6 | 43.7 | 26.5 | 13.7  | 30.3 | 40.0  | 42.0  |
| Current Acc't Bal. | (Dkr bn)    | 8.2  | 13.0 | 24.5 | 30.4 | 17.0 | 10.2 | 16.4 | 6.1  | -12.9 | 15.3 | 18.3  | 20.4  |
|                    | (% of GDP)  | 1.0  | 1.5  | 2.8  | 3.5  | 2.1  | 1.1  | 1.7  | 0.5  | -1.1  | 1.3  | 1.4   | 1.5   |
| Budget Balance     | (% of GDP)  | -1.0 | -2.4 | -2.2 | -2.8 | -2.6 | -2.2 | -0.9 | 0.4  | 1.1   | 3.0  | 2.2   | 2.4   |

Sources: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Norwegian Krone

Norges Bank surprised the markets again with a 50 basis-point rate hike at its board meeting in August. But the Bank also suggested that the peak in rates is near, saying that the 1.25% rate increase since the start of the year represents a substantial step in the adjustment of the interest rate. The interest-rate differential with Euroland is therefore expected to move against the krone, with Norges Bank near the end of its rate cycle while the ECB still has some way to go.

If there are any further rate increases, they are likely to depend on the government's budget, which is due for release in October. Some renewed krone volatility is therefore possible in the run-up to the budget

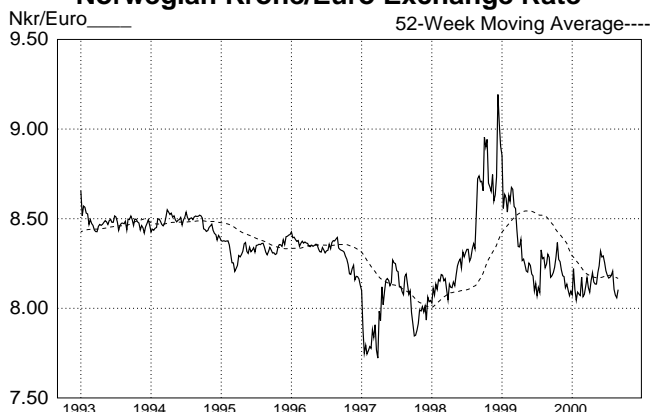
presentation on October 4th. The decision by the government to delay the sale of shares in Christiania Bank is also seen as being negative for the krone.

On the other hand, the strength of the oil price is likely to have had some positive impact on the krone, which has strengthened to a level around Nkr/€ 8.08. Nevertheless, the relationship is no longer as strong as it was before 1999, and we would be more cautious in expecting a strong appreciation of the krone if oil prices were to move higher.

**Stephanie Pfeifer**  
stephanie.pfeifer@db.com

London, (44-020) 7545-2086

**Norwegian Krone/Euro Exchange Rate**

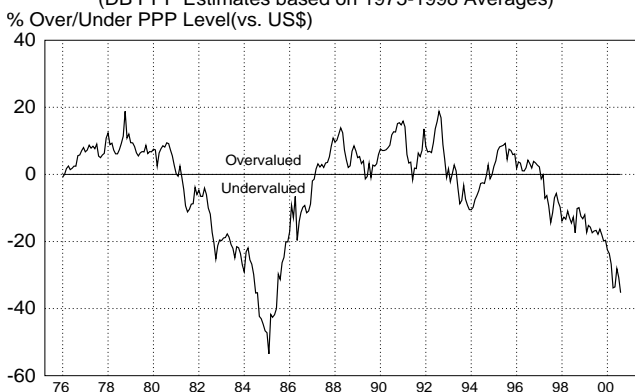


**Norway's Equity Market**



**Norwegian Krone Purchasing Power Parity**

(DB PPP Estimates based on 1975-1998 Averages)



**Norwegian Bond Market Trends**

|  | Latest | High | 52-Week Low | Average | Z-Score |
|--|--------|------|-------------|---------|---------|
| <b>Yield Curve (%)</b>                         |        |      |             |         |         |
| 3-month  | 7.05   | 7.07 | 5.72        | 6.21    | 2.01    |
| 2-year   | 7.22   | 7.30 | 5.58        | 6.33    | 1.60    |
| 5-year   | 6.63   | 6.66 | 5.70        | 6.20    | 1.56    |
| 10-year  | 6.30   | 6.46 | 5.87        | 6.17    | 0.95    |
| <b>Yield Spread vs. Germany (basis points)</b> |        |      |             |         |         |
| 3-month  | 213    | 324  | 196         | 242     | -0.90   |
| 2-year   | 200    | 225  | 156         | 193     | 0.37    |
| 10-year  | 104    | 104  | 76          | 92      | 1.56    |
| <b>Yield Curve Trends (basis points)</b>       |        |      |             |         |         |
| 2-yr./3-mo.                                    | 17     | 49   | -57         | 12      | 0.19    |
| 10-yr./3-mo.                                   | -75    | 68   | -90         | -4      | -1.68   |
| 10-yr./2-yr.                                   | -93    | 56   | -115        | -16     | -1.41   |

**Norway's Annual Economic Data**

| Economic Indicator | Units       | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998  | 1999 | 2000f | 2001f |
|--------------------|-------------|------|------|------|------|------|------|------|------|-------|------|-------|-------|
| Real GDP           | (yoy % chg) | 2.0  | 3.1  | 3.3  | 2.7  | 5.5  | 3.8  | 5.5  | 3.4  | 2.0   | 0.9  | 3.4   | 2.7   |
| Unemployment Rate  | (%)         | 5.2  | 5.5  | 5.9  | 6.0  | 5.4  | 4.9  | 4.8  | 4.1  | 3.2   | 3.2  | 3.5   | 3.5   |
| Consumer Prices    | (yoy % chg) | 4.1  | 3.4  | 2.3  | 2.3  | 1.4  | 2.5  | 1.3  | 2.5  | 2.3   | 2.3  | 3.0   | 2.2   |
| Trade Balance      | (Nkr bn)    | 0.0  | 0.0  | 51.5 | 48.7 | 47.9 | 50.3 | 79.2 | 96.0 | 31.4  | 91.4 | 180.0 | 173.0 |
| Current Acc't Bal. | (Nkr bn)    | 24.1 | 33.1 | 27.8 | 25.0 | 26.4 | 30.9 | 68.6 | 56.8 | -16.2 | 43.5 | 140.0 | 133.0 |
|                    | (% of GDP)  | 3.2  | 4.3  | 2.3  | 1.8  | 3.0  | 3.3  | 6.7  | 5.6  | -1.5  | 3.7  | 11.1  | 10.0  |
| Budget Balance     | (% of GDP)  | 2.6  | 0.1  | -1.7 | -1.4 | 0.4  | 3.5  | 6.5  | 7.5  | 3.9   | 4.8  | 12.3  | 10.5  |

Sources: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

# Swedish Krona

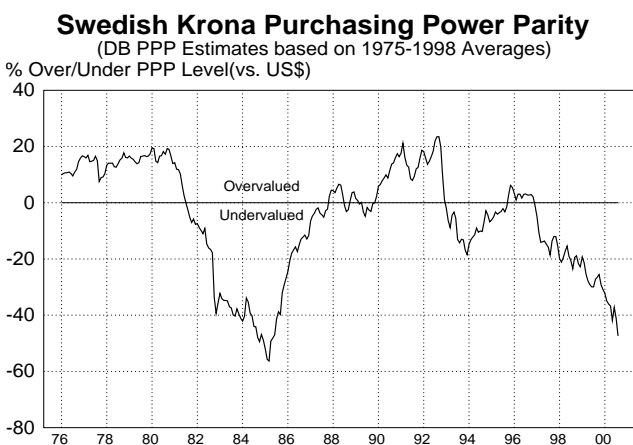
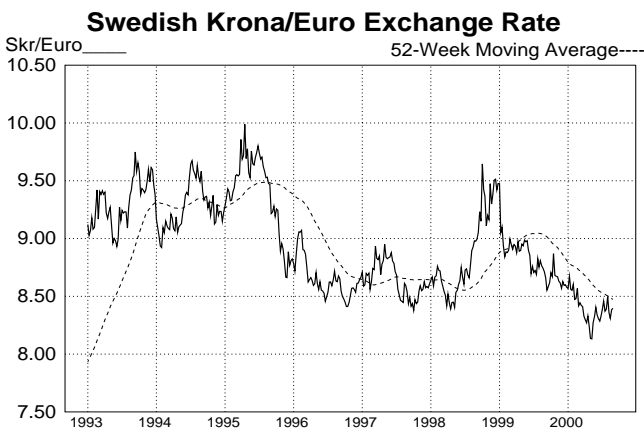
The Riksbank left the repo rate unchanged at its board meeting on August 16th. Positive inflation data made it difficult to hike rates despite continued signs that domestic demand is strong. The market is now looking for only a 25 basis-point interest-rate increase when the Bank presents its third-quarter Inflation Report in October. With the underlying inflation rate still well below the Riksbank's 2% inflation target (the annual rate fell to 1.2% in July), it would be difficult for the Bank to justify a larger rate increase. Therefore, at least over the short term, the interest-rate differential should move further in favour of the euro.

The budget, which is due to be presented on September 20th, will be important for future Riksbank policy. The

outcome of the Danish referendum could also have some limited impact on the krona. Opinion polls show that in the event of a 'yes' vote in Denmark, a substantial number of EMU opponents in Sweden would change their stance, giving the 'yes' side a majority. Currently, the 'no' side has a lead of around seven percentage points in Sweden. On the other hand, if the Danes vote 'no' to EMU in September, the opposition to Swedish membership is likely to be strengthened because the more countries remain 'EMU-outs', the more acceptable this will be.

**Stephanie Pfeifer**  
stephanie.pfeifer@db.com

London, (44-020) 7545-2086



## Swedish Bond Market Trends

|  | Latest | High | 52-Week Low | Average | Z-Score |
|--|--------|------|-------------|---------|---------|
| <b>Yield Curve (%)</b>                         |        |      |             |         |         |
| 3-month  | 4.03   | 4.23 | 3.15        | 3.89    | 0.47    |
| 2-year   | 4.81   | 5.40 | 4.35        | 4.87    | -0.24   |
| 5-year   | 5.23   | 5.83 | 4.92        | 5.36    | -0.64   |
| 10-year  | 5.34   | 6.06 | 4.96        | 5.53    | -0.71   |
| <b>Yield Spread vs. Germany (basis points)</b> |        |      |             |         |         |
| 3-month  | -89    | 65   | -89         | 10      | -2.41   |
| 2-year   | -42    | 106  | -42         | 48      | -2.27   |
| 10-year  | 7      | 67   | -33         | 28      | -0.84   |
| <b>Yield Curve Trends (basis points)</b>       |        |      |             |         |         |
| 2-yr./3-mo.                                    | 78     | 140  | 67          | 99      | -1.18   |
| 10-yr./3-mo.                                   | 131    | 261  | 97          | 165     | -0.69   |
| 10-yr./2-yr.                                   | 53     | 132  | 4           | 66      | -0.34   |

## Sweden's Annual Economic Data

| Economic Indicator | Units       | 1990  | 1991  | 1992  | 1993  | 1994  | 1995  | 1996  | 1997  | 1998  | 1999  | 2000f | 2001f |
|--------------------|-------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Real GDP           | (yoy % chg) | 1.4   | -1.1  | -1.4  | -2.2  | 3.3   | 3.9   | 1.3   | 1.8   | 3.0   | 3.8   | 4.5   | 3.8   |
| Unemployment Rate  | (%)         | 1.6   | 3.0   | 5.3   | 8.2   | 7.9   | 7.7   | 8.1   | 8.0   | 6.5   | 5.6   | 4.7   | 4.3   |
| Consumer Prices    | (yoy % chg) | 10.4  | 9.7   | 2.6   | 4.7   | 2.4   | 2.9   | 0.8   | 0.9   | 0.4   | 0.3   | 1.7   | 2.0   |
| Trade Balance      | (Skr bn)    | 14.8  | 30.6  | 36.5  | 56.7  | 72.1  | 114.8 | 124.8 | 131.7 | 131.4 | 135.0 | 146.0 | 162.0 |
| Current Acc't Bal. | (Skr bn)    | -39.0 | -28.8 | -43.6 | -24.3 | 12.6  | 39.3  | 43.6  | 50.7  | 55.3  | 49.0  | 51.0  | 67.0  |
|                    | (% of GDP)  | -2.7  | -2.0  | -3.5  | -2.2  | 0.4   | 2.1   | 2.3   | 2.9   | 2.9   | 2.5   | 2.4   | 3.0   |
| Budget Balance     | (% of GDP)  | 4.2   | -1.1  | -7.8  | -12.3 | -10.3 | -7.0  | -3.5  | -0.7  | 2.3   | 2.0   | 2.5   | 3.0   |

Sources: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

# Greek Drachma

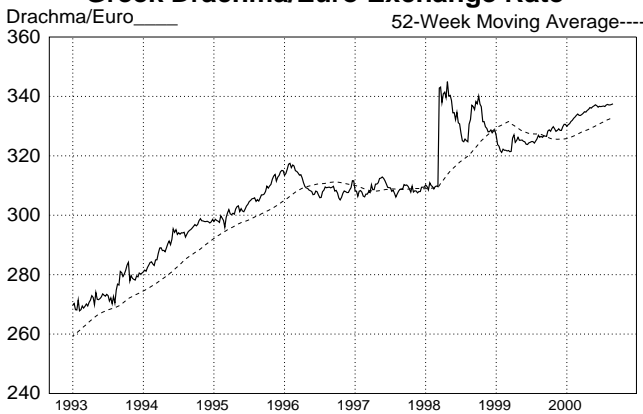
Following the formal ratification of Greece's application to join EMU, the emphasis has begun to shift towards implementing long-awaited structural economic reforms and making progress towards long-term macroeconomic stability. Moody's Investors Service noted that, "reforms of the labour and product markets will be crucial if the Greek economy is to improve its competitiveness and wean itself from EU financial support". Indeed, at over 10%, Greece's unemployment rate (on the ILO measure) is the third highest among EU countries, with the employment rate languishing at only 57.3%. In fact, the number of registered unemployed has risen by some 140,000 since 1995 to over 325,000 in 1999.

The government has resumed deliberations over the best approach to increasing flexibility and employment in the market. That said, we should not ignore what has already been achieved in the labour market; in particular, productivity has improved dramatically during the 1990s, growing on average by 1.4% between 1994 and 1998 compared to only 0.1% between 1981 and 1993 according to the Ministry of National Economy and Finance. In fact, the government's economic think tank has recently suggested that a productivity growth rate of 3.5% is attainable combined with annual employment growth of 2%.

**George Buckley**  
[george.buckley@db.com](mailto:george.buckley@db.com)

London, (44-020) 7545-1372

**Greek Drachma/Euro Exchange Rate**

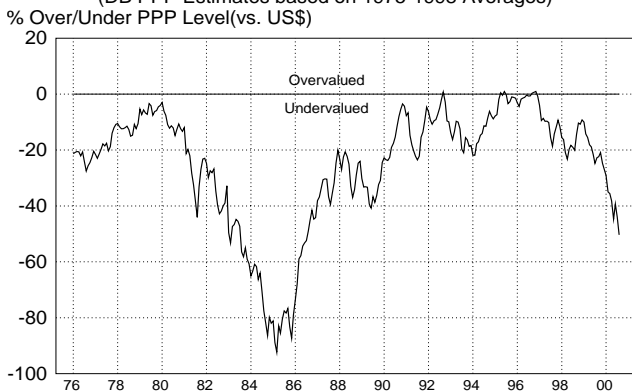


**Greece's Equity Market**



**Greek Drachma Purchasing Power Parity**

(DB PPP Estimates based on 1975-1998 Averages)



**Greek Bond Market Trends**

|  | Latest | High  | 52-Week Low | Average | Z-Score |
|--|--------|-------|-------------|---------|---------|
| <b>Yield Curve (%)</b>                         |        |       |             |         |         |
| 3-month  | 7.93   | 11.05 | 7.80        | 8.95    | -1.12   |
| 3-year   | 6.14   | 7.74  | 5.86        | 6.46    | -0.69   |
| 4-year   | 6.12   | 7.64  | 5.86        | 6.41    | -0.68   |
| 10-year  | 6.51   | 7.49  | 6.23        | 6.66    | -0.70   |
| <b>Yield Spread vs. Germany (basis points)</b> |        |       |             |         |         |
| 3-month  | 301    | 760   | 301         | 516     | -1.51   |
| 3-year   | 91     | 369   | 91          | 207     | -1.30   |
| 10-year  | 124    | 207   | 104         | 141     | -0.61   |
| <b>Yield Curve Trends (basis points)</b>       |        |       |             |         |         |
| 2-yr./3-mo.                                    | -179   | -171  | -410        | -248    | 1.28    |
| 10-yr./3-mo.                                   | -142   | -127  | -442        | -229    | 1.08    |
| 10-yr./3-yr.                                   | 37     | 73    | -42         | 20      | 0.54    |

**Greece's Annual Economic Data**

| Economic Indicator | Units       | 1990  | 1991  | 1992  | 1993  | 1994  | 1995  | 1996  | 1997  | 1998  | 1999  | 2000f | 2001f |
|--------------------|-------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Real GDP           | (yoy % chg) | 0.0   | 3.1   | 0.7   | -1.6  | 2.0   | 2.1   | 2.4   | 3.4   | 3.7   | 3.5   | 3.8   | 4.0   |
| Unemployment Rate  | (%)         | 7.0   | 7.7   | 8.7   | 9.7   | 9.6   | 9.1   | 9.8   | 9.7   | 10.9  | 10.5  | 10.1  | 9.8   |
| Consumer Prices    | (yoy % chg) | 20.4  | 19.5  | 15.9  | 14.4  | 10.7  | 8.9   | 8.2   | 5.5   | 4.8   | 2.6   | 2.7   | 3.0   |
| Trade Balance      | (US\$ bn)   | -12.0 | -12.5 | -13.1 | -12.3 | -11.8 | -14.3 | -16.5 | -16.2 | -16.1 | -16.4 | -18.2 | -21.0 |
| Current Acc't Bal. | (US\$ bn)   | -3.9  | -3.4  | -2.0  | -2.4  | -0.5  | -1.1  | -3.0  | -2.8  | -2.3  | -1.7  | -2.6  | -3.5  |
|                    | (% of GDP)  | -4.7  | -3.8  | -2.0  | -2.6  | -0.5  | -0.9  | -2.4  | -2.3  | -1.9  | -1.3  | -1.8  | -2.5  |
| Budget Balance     | (% of GDP)  | -16.1 | -11.5 | -12.8 | -13.8 | -10.0 | -10.2 | -7.4  | -3.9  | -2.5  | -1.7  | -1.0  | -0.5  |

Sources: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Exchange-Rate Trends in Emerging Markets

### Asia

The combination of a traditionally quiet August month and central bank intervention has resulted in a period of relative calm within Asian currency markets. Most Asian currencies are now trading above the lows reached in July and investor focus is now on domestic political and economic developments.

Political developments in **Indonesia** have assisted a rally in South East Asian currencies. The People's Consultative Assembly meetings in August affirmed President Abdurrahman Wahid's control on power. The various factions that make up Indonesia's political establishment succeeded in reducing political risk, which assisted in a 13% rally in the rupiah. However, the key problems, including underlying political friction, remain. Consequently, we think that the rupiah is likely to continue to decline over coming months as the political outlook deteriorates and the economic situation remains fragile.

Political concerns have now refocused on **Thailand** and the Philippines. It appears increasingly likely that the Thai Democratic Party lead by PM Chuan Leepai may lose power to the populist Thai Rak Thai party at the November election. The combination of a weakening fundamental outlook, rising oil prices and uncertainty regarding Thai Rak Thai are encouraging investors to enter short baht positions. In addition, Thai corporates who have underlying U.S. dollar exposures are bringing forward their U.S. dollar purchases. At this stage we believe that investor positioning and sentiment is short baht, supporting further range trading. We would look to build baht positions below THB/USD 40.60.

Events in the **Philippines** are no more encouraging. The Philippine Government faces problems in financing an ever-widening budget deficit while official reserves remain below IMF targets. Despite the release of hostages, the Muslim insurgency in the southern province of Mindanao remains a key concern for investors. Currently we recommend investors sell the peso three-month forward.

Political concerns are also affecting North Asian currencies. The Bank of **Korea** has been active in preventing the Korean won from appreciating above KRW/USD 1113 in recent weeks. The lack of risk-taking ability promoted inter-bank traders to refuse to take positions in the currency in protest against the central bank. Consequently, large end-of-month corporate remittances have pushed the Korean won to a high of KRW/USD 1108. Notwithstanding the impact of rising oil prices (South Korea ran an oil trade deficit of 3% of GDP in 1999) we remain of the view that the won should appreciate over coming months as inflationary pressures in South Korea continue to grow.

The outlook in **Taiwan** continues to deteriorate. The Taiwanese economy is increasingly fragmented between an information technology sector struggling to meet demand and more traditional industries suffering from weak demand and financial fragility. Economic statistics in Taiwan continue to disappoint. Almost every recent key economic release including GDP, CPI, the trade balance, and the money supply have fallen well below expectations. The Taiwanese stock market continues to weaken, supported by government intervention, which is also preventing the currency from depreciating. In the August 11 Emerging Markets Weekly we recommended investors and corporate treasurers wishing to hedge enter a three-month USD/TWD risk reversal. Entry via a zero cost structure with a spot rate of 31.05 and a 25% delta would have an upside strike at 31.25 (TWD put) and 30.70 (TWD call). We believe that this structure offers favourable risk/reward characteristics as well as opening the possibility of leverage within the trade.

**Peter Redward**

Singapore, (65) 883 1680

[peter.redwardn@db.com](mailto:peter.redwardn@db.com)

### Latin America

Latin local markets had mixed reactions to the improved outlook for U.S. interest rates. Over the next few months, we expect the U.S. interest-rate outlook will remain the primary driver of relative performance in the region's currencies. If the market continues to expect the Fed to remain on hold, then domestic factors should play an increasingly important role. For instance, the seasonal upswing in the region's current-account deficits in the run-up to the Christmas season may be a common story in the major currencies. We expect this to be especially true in Mexico and Brazil where there has been a healthy recovery in domestic demand.

Predicting the demise of the **Mexican peso** will likely become a growth industry in the latter part of this year. But so far, the peso has resisted all analysis and broken to new highs against the dollar on strong investor positioning. We have seen a worrisome trend emerging over the last few weeks, though, where speculative investors have been selling the dollar with little regard to the peso's real appreciation. Mexico's local markets, still offering hefty double-digit yields on the peso forward curve, have been a lightning rod for hedge funds and dedicated EM investors who need to search farther afield for high-yielding instruments. While other EM local markets, including Brazil and Turkey, can offer similar returns, Mexico enjoys the advantage of a much better risk profile in the eyes of foreign investors.

Corporates have been fairly steady buyers of the dollar through the rally. One must remember that although

the trade deficit appears fairly well under control, it has been helped immensely by higher oil prices and the growth of U.S. demand. But higher oil prices do not necessarily show up in the peso market because Pemex sells its dollar inflows directly to the Central Bank. The non-oil trade deficit is thus considerably higher than levels this time last year, which creates a fairly consistent bid for the dollar from corporate importers. We therefore expect the technical position to continue to worsen in the short term, with the divergence between speculative dollar selling and corporate buying continuing to widen. Such a trend should ultimately cause the spot to jump to weaker levels, but we would only expect a trend reversal after the spot rate has tested the MXN/USD 9.15 level again.

The first signs of improving economic activity in **Argentina** may have helped revive the peso last week. The release of FIEL's industrial activity index confirms that the economy may have finally re-entered positive growth territory. While there is still a long way to go until a recovery trend can be depicted, these first signs are crucial to foster a rebound in sentiment. Also adding to a more positive near-term outlook were the statements delivered by the business community in support of the government.

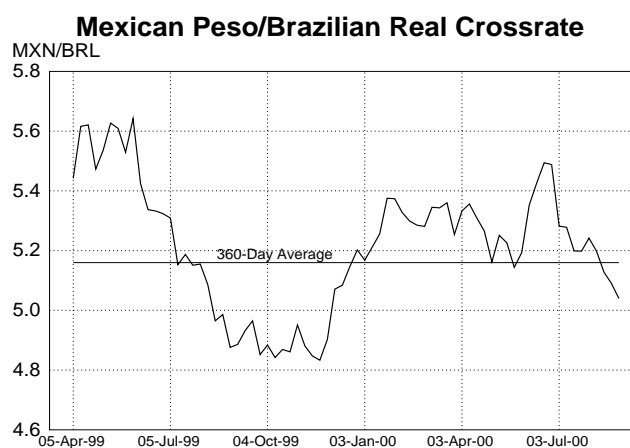
Argentina can only grow itself out of the vicious cycle of worsening fiscal balances leading to dampening sentiment and growth, which in turn feeds back through a decreasing tax base. And in order to exorcise any ghosts with respect to solvency or liquidity, such growth levels have to emerge quickly and robustly. Meanwhile, the country will remain vulnerable to external shocks and domestic disappointments.

**Chile's** central bank's decision to cut rates on Monday evening may be supportive of the peso in the long run, but in the near-term we remain negative on the currency. Negative portfolio flows have been one of the primary factors behind the peso's weakness this year, and with lower interest-rate differentials, local pension funds have an even higher incentive to hold foreign assets. Pension funds are currently holding less than the maximum allowed under central-bank regulations, so the peso could see some short-term weakness as pension funds increase their foreign holdings.

On a longer-term basis, better growth prospects may boost the excess demand for pesos and offset some of the initial weakening. However, the relatively illiquid Chilean stock market remains an obstacle for higher holdings of foreign equity investors. Inflation remains subdued, so we believe the central bank will favour growth via higher exports at the expense of a weaker nominal peso. We look for the peso to remain above CLP/USD 550 for the next 2-4 weeks.

After two weeks of gradual weakness in the **Brazilian real**, we suspect the sell-off will come to an end as dol-

Figure 1



lar shorts take profits and close out their positions. This trend comes at a time when we are increasingly worried about the Mexican peso, and we believe the **BRL/MXN crossrate** is approaching a near-term low. The cross trade can be an attractive way to take advantage of a temporary lack of correlation in two assets that are traditionally positively correlated.

We last highlighted the cross in the months before the Mexican presidential election, a time when the crossrate was at a temporary low (see Figure 1). The cross is currently even lower than the pre-election levels and is approaching the lows seen a year ago when the real was suffering the effects of high seasonal inflation. While we would hesitate to put on a long-real/short-peso trade immediately—the peso could still break below the MXN/USD 9.15, and real may still test the BRL/USD 1.850—we suggest investors begin to track the cross, waiting for the appropriate entry point.

The cross is now at MXN/BRL 5.032. We would look to put on long-BRL/short-MXN positions at a level just under MXN/BRL 5.00. Should the real continue to depreciate to BRL/USD 1.840 and peso continue to appreciate to MXN/USD 9.150, the cross would be at MXN/BRL 4.972, which we would consider an attractive entry point since we expect the cross to revert to its 360-day average of MXN/BRL 5.16 over the next 1-3 months.

The trade offers slightly positive carry if investors put on a one-month trade, and is flat to slightly negative if the trade is put on at a 2-3 month horizon. The trade is particularly attractive for investors who would like to be short dollars/long real but who would prefer not to have completely naked Latin local markets risk. It is attractive as well as for those who would like to be long dollars/short peso, but who would prefer not to have to pay the high negative carry of the trade.

**Christian Stracke**  
christian.stracke@db.com

New York, (212) 469-2788

**Marcelo Salomon**  
marcelo.salomo@db.com

New York, (212) 469-3628

# Emerging-Market Exchange-Rate Regimes, Capital Controls, and Credit Ratings

|                    | Currency           | Exchange Rate Regime   | Capital Controls  | Credit Ratings (Moody's/S&P) |                     |
|--------------------|--------------------|--|---|------------------------------|---------------------|
|                    |                    |  |   | Rating                       | Outlook             |
| Asia-Pacific       | Chinese Renminbi   | Essentially fixed at 8.28 R/US\$   | Full current account convertibility, capital account transactions are tightly controlled by the State Administration of Foreign Exchange. FDI approved on a case-by-case basis, non-residents are restricted from most internal capital markets                     | A3 / BBB                     | Stable / Stable     |
|                    | Hong Kong Dollar   | Depreciating to a fixed rate of 7.8 HK\$/US\$ by mid-2000  | Full current and capital account convertibility   | A3 / A                       | Stable / Stable     |
|                    | Indonesian Rupiah  | Float  | Full current and capital account convertibility   | B3 / SD                      | Stable / N.R.       |
|                    | Malaysian Ringgit  | Fixed at 3.8 R/US\$  | Extensive restrictions on both current and capital account transactions   | Baa3 / BBB                   | Positive / Stable   |
|                    | Philippines Peso   | Float  | Full current account convertibility, capital account transactions essentially unrestricted  | Ba1 / BB+                    | Stable / Stable     |
|                    | Singapore Dollar   | Managed Float  | Full current and capital account convertibility   | Aa1 / AAA                    | Stable / Stable     |
|                    | South Korean Won   | Float  | Full current and capital account convertibility for non-residents   | Baa2 / BBB                   | Stable / Positive   |
|                    | Taiwanese Dollar   | Managed Float  | Full current account convertibility, extensive controls over FDI and portfolio investment. Financial authorities also use informal tactics to implement exchange controls   | Aa3 / AA+                    | Stable / Stable     |
|                    | Thai Baht          | Float  | Full current account convertibility. Portfolio outflows still tightly monitored to discourage speculation, the Bank of Thailand must approve foreign exchange transactions greater than US\$5,000   | Baa3 / BBB-                  | Positive / Stable   |
| Latin America      | Argentine Peso     | Currency board, pegged to US\$ at par  | Full current and capital account convertibility   | B1 / BB                      | Stable / Stable     |
|                    | Brazilian Real     | Float  | Current account transactions are generally unrestricted, FDI and portfolio flows are subject to minor restrictions. The central bank must authorize, directly or indirectly, most foreign exchange transactions   | B2 / B+                      | Stable / Positive   |
|                    | Chilean Peso       | Float  | Full current account convertibility, 15% capital-gains tax on all foreign investment  | Baa1 / A-                    | Stable / Stable     |
|                    | Colombian Peso     | Float  | Full current account convertibility, inward capital flows are subject to a non-interest bearing deposit requirement of 10% of the total investment for 6 months. Portfolio investment must be made through foreign capital investment funds                         | Ba2 / BB                     | Stable / Negative   |
|                    | Mexican Peso       | Float  | Full current and capital account convertibility   | Baa3 / BB+                   | Stable / Positive   |
|                    | Venezuelan Bolivar | Currency bands of 7.5% on each side of crawling midpoint that rises by VEB0.34 per day.  | Full current and capital account convertibility   | B2 / B                       | Stable / Stable     |
| Eastern Europe     | Czech Koruna       | Float  | Full current account convertibility, capital account transactions for non-residents are generally unrestricted. Companies borrowing abroad require a license and are typically limited to long term loans   | Baa1 / A-                    | Stable / Stable     |
|                    | Hungarian Forint   | Currency bands set 2.25% above and below the central rate determined by a crawling peg to the euro.  | Full current account convertibility. Capital account restrictions include central bank approval for portfolio investments on a case-by-case basis and the prohibition of non-residents from purchasing short-term government securities                             | Baa1 / BBB+                  | Stable / Positive   |
|                    | Polish Zloty       | Currency bands set 15% above and below the central rate determined by a crawling peg to a basket of the Euro (55%) and the US dollar (45%) | Full current account convertibility, capital account transactions not involving real estate are unrestricted  | Baa1 / BBB+                  | Stable / Stable     |
|                    | Russian Ruble      | Managed Float  | Full current account convertibility, but there is a 1% tax on purchases of hard currency. FDI and portfolio investment generally allowed, subject to major changes in policy regime. For instance, repatriation of capital invested in GKO/OFZs is still restricted | B3 / SD                      | Stable / NR         |
| Africa/Middle East | Turkish Lira       | Managed float versus Euro and US dollar, based on a basket of 1USD + 0.77EUR.  | Full current and capital account convertibility   | B1 / B+                      | Stable / Positive   |
|                    | Israeli Shekel     | Asymmetric currency bands with central rate determined by a trade weighted basket of five major currencies                                 | Full current and capital account convertibility. Derivatives transactions involving non-residents are restricted to maturities less than one-month  | A3 / A-                      | Positive / Positive |
|                    | South African Rand | Float  | Full current and capital account convertibility for non-residents   | Baa3 / BBB-                  | Stable / Stable     |

Sources: EIU, IMF, Moody's, and S&P



## Emerging-Market Currency Strategies

### Immediate Currency Strategies within Longer-Term

| Currency           | Longer-Term Strategy | Recent Developments   | Immediate Strategy |
|--------------------|----------------------|---|--------------------|
| Indonesian Rupiah  | Underweight          | Political uncertainty as to the success of the new cabinet will continue to drive the currency in the near term.  | Trading Sell       |
| Philippine Peso    | Neutral              | Expect the peso to trend down as the weakening growth trend of domestic demand should limit the prospects of interest rate hikes.   | Neutral            |
| Singapore Dollar   | Accumulate           | Expect a near-term appreciation. The monetary authority will likely sanction some tightening of policy via stronger currency as short-term rates track the U.S. markets closely.  | Accumulate         |
| South Korean Won   | Neutral              | Expect the won to trade with a slight negative bias as higher oil prices continues to bite into a larger share of Korea's current-account surplus.  | Neutral            |
| Argentine Peso     | Neutral              | Positive sentiment with respect to Latin American markets has helped improve the Argentine outlook. Growth continues to be the main risk, and until signs of a solid recovery becomes evident, the currency, via non-deliverable forwards, will remain vulnerable to both external shocks and domestic disappointments. | Neutral            |
| Brazilian Real     | Neutral              | The healthy pace of foreign inflows and a positive growth outlook should keep the real below the BRL/US\$ 1.84 level in the short-term. Inflationary jitters could force some weakening pressure.   | Neutral            |
| Chilean Peso       | Neutral              | Expect the weakening trend to continue since growth appears to remain softer than expected. While the last interest-rate cut should help the peso in the long run, in the short run steeper short-term outflows are likely to keep the currency under pressure.   | Neutral            |
| Mexican Peso       | Accumulate           | Higher oil prices and robust growth in U.S. demand should keep the peso well bid in the near term, while worsening technical positions may cause some short-run volatility.   | Neutral            |
| Czech Koruna       | Neutral              | The koruna should remain stable in the near-term despite the stronger-than-expected rise in July's trade deficit. We continue to expect no change in monetary policy.   | Neutral            |
| Polish Zloty       | Neutral              | While inflation persistence appears to be intensifying, expect the currency to remain flat over the next three months. Risk of interest-rate hikes may strengthen the zloty in the near term.   | Neutral            |
| South African Rand | Accumulate           | Expect the rand to appreciate further as supply shocks continue to unwind and net-exports remain supportive of better growth.   | Neutral            |

| Action          | Explanation  |
|-----------------|--|
| EM Trading Buy  | We expect a 5% or more appreciation within a one-month horizon and think that now is the time to go long this currency.                      |
| EM Accumulate   | We recommend increasing exposure at appropriate opportunities.   |
| EM Neutral      | We do not have a strong short-term directional view on this currency and expect the currency to trade within a 5% range over the next month. |
| EM Reduce       | We recommend decreasing exposure at appropriate opportunities.   |
| EM Trading Sell | We expect a 5% or more depreciation within a one-month horizon and think that now is the time to go short this currency.                     |

## Chinese Renminbi

Most indicators now suggest that both consumption and investment demand are growing strongly. Data released by the State Statistical Bureau show that retail sales rose by 9.1% in July, somewhat weaker than the rates seen in the first half but still very high. Fixed asset investment also rose by a robust 14.8% during the month. Expanding domestic demand is also beginning to feed imports and prices. Exports growth was strong at 24% in July, but imports rose by 40% during the month. (Note that import growth is strong even after accounting for high oil prices). The latest consumer price data hint that pricing power is gradually returning. CPI inflation remained steady at 0.5% in July—the third straight month of positive inflation.

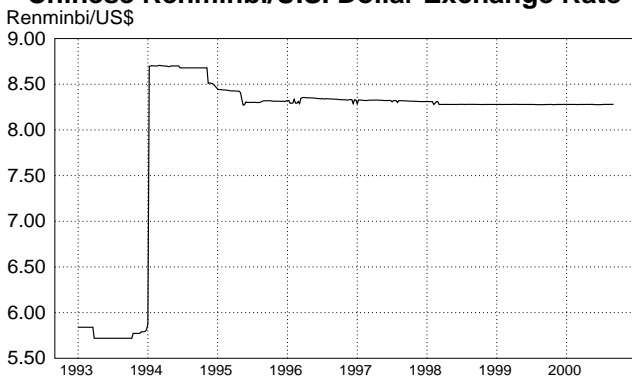
Meanwhile, contracted foreign direct investment rose 20.2% in July to US\$3.47 billion. Pledged investments have been rising strongly this year—up 24% in the first seven months. This is probably a reflection of renewed interest in the economy in view of imminent entry to the WTO. However, actual inflows have continued to fall—down 6.6% in July and 7.4% in the first seven months of 2000. It is possible that this is due to the lag caused by investors waiting to see the final form of WTO trade agreements.

Notwithstanding the cyclical upturn discussed above, unemployment appears to be worsening and we feel that the need to keep monetary policy expansionary will eventually force a change in currency regime (likely mid-2001).

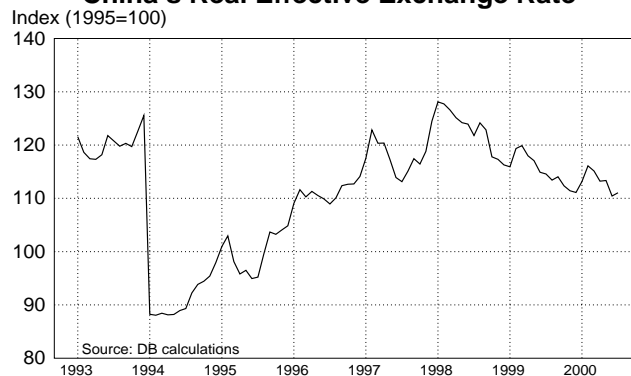
**Sanjeev Sanyal**  
sanjeev.sanyal@db.com

Singapore, (65) 423-5925

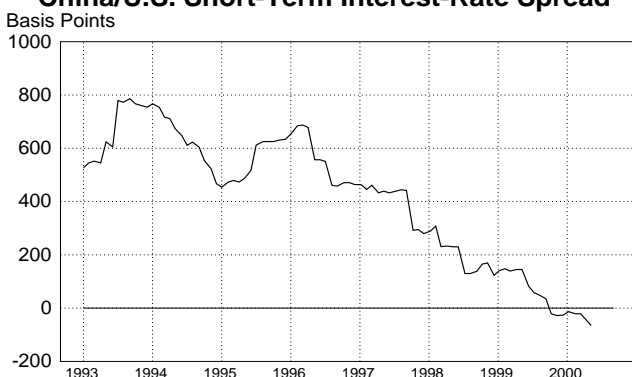
**Chinese Renminbi/U.S. Dollar Exchange Rate**



**China's Real Effective Exchange Rate**



**China/U.S. Short-Term Interest-Rate Spread**



**China's Stock Market**



### China's Annual Economic Data

|                   |             | 1994 | 1995 | 1996  | 1997  | 1998 | 1999  | 2000f | 2001f |
|-------------------|-------------|------|------|-------|-------|------|-------|-------|-------|
| Real GDP          | (yoy % chg) | 12.6 | 10.5 | 9.6   | 8.8   | 7.9  | 7.1   | 7.7   | 7     |
| Consumer Prices   | (yoy % chg) | 24.1 | 17.1 | 8.3   | 2.8   | -0.8 | -1.6  | 0.8   | 2.0   |
| Current Acc't Bal | (% of GDP)  | 1.3  | 0.2  | 0.9   | 3.3   | 3.1  | 1.6   | 2.4   | 1.9   |
| FX Reserves       | (US\$ bn)   | 57.8 | 80.3 | 111.7 | 146.4 | 145  | 154.7 | 163.9 | 175.2 |
| Budget Balance    | (% of GDP)  | -1.2 | -1   | -0.7  | -0.8  | -1.2 | -2.2  | -3.4  | -3.5  |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

# Hong Kong Dollar

Hong Kong's GDP grew at a double-digit pace in the second quarter, rising 10.8% after 14.3% growth in Q1. The strong second-quarter number makes Hong Kong the fastest growing economy in the region in the first half of the year. With the release of the numbers, the government raised its full-year GDP forecast from 6% to 8.5%, which is also our forecast. Growth was above our expectation of a 9.6% gain, but not by enough to cause us to revise our forecast.

July trade data were also released, giving the first indication of what to expect in the second half of the year. The numbers point to what we have been warning of for some time—namely, that export growth will slow quickly in the coming quarters and the trade balance will dete-

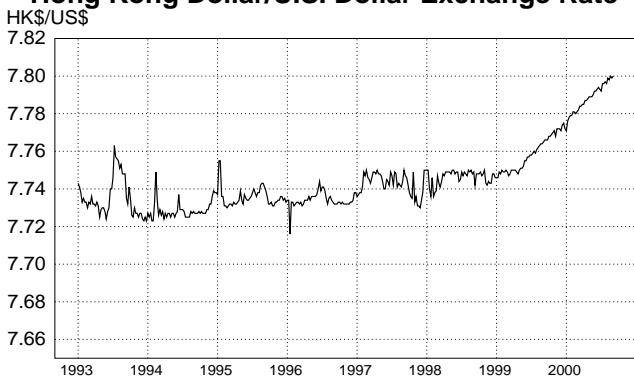
riorate. Export growth slowed to 9.6% in July from 14.5% in June while imports rose by 11.6% during the month causing the trade deficit to widen to HK\$8.1 billion from HK\$6.3 billion in June.

For now a large services surplus and capital inflows are more than compensating for the deterioration of the trade balance, keeping foreign-exchange reserves on the rise and liquidity ample. However, a continuation of this trend will likely reduce domestic liquidity and eventually remove the current Hong Kong dollar interest-rate discount to the U.S. dollar.

**Nicholas Brooks**  
nicholas.brooks@db.com

Hong Kong, (852) 2203-6184

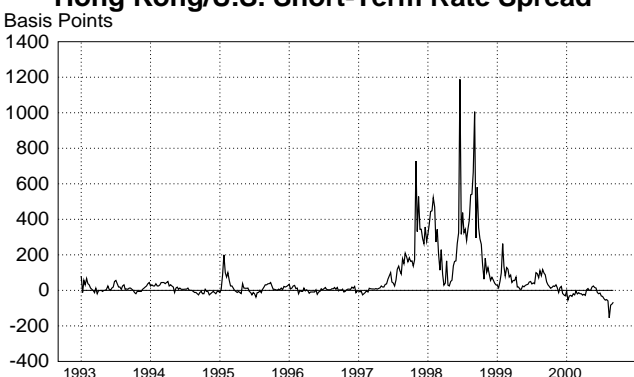
**Hong Kong Dollar/U.S. Dollar Exchange Rate**



**Hong Kong's Real Effective Exchange Rate**



**Hong Kong/U.S. Short-Term Rate Spread**



**Hong Kong's Stock Market**



## Hong Kong's Annual Economic Data

|                   |             | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000f | 2001f |
|-------------------|-------------|------|------|------|------|------|------|-------|-------|
| Real GDP          | (yoy % chg) | 5.4  | 3.9  | 4.5  | 5.0  | -5.1 | 3.0  | 8.5   | 5.0   |
| Consumer Prices   | (yoy % chg) | 9.6  | 7.2  | 6.6  | 5.8  | 2.6  | -3.2 | -2.6  | 2.0   |
| Current Acc't Bal | (% of GDP)  | 1.2  | -4.3 | -1.4 | -3.5 | 0.4  | 5.8  | 0.7   | -0.6  |
| FX Reserves       | (US\$ bn)   | 49.3 | 55.4 | 63.4 | 92.8 | 89.6 | 96.3 | 97.1  | 102.0 |
| Budget Balance    | (% of GDP)  | 1.9  | 1.0  | -0.3 | 1.9  | -1.8 | -0.1 | -0.5  | 0.0   |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Indonesian Rupiah

Market participants were even more disappointed by President Wahid's cabinet reshuffle than we had anticipated. A seemingly rushed announcement (most likely to pre-empt efforts by his opponents to force last-minute changes) and the absence of VP Megawati immediately raised suspicions about the outcome. Indeed, the new cabinet is heavily populated by close allies of the Wahid's and Golkar and PDI-P representation in the cabinet has been diminished significantly.

Wahid's decision to forge ahead with a cabinet of his own choosing means that the presidential/parliamentary debate over the form of government in Indonesia will

probably heat up. Already there have been complaints that Wahid has reneged on an agreement with parliament to hand over substantial control to Megawati. Having a more cohesive cabinet could mean that once they warm to the task, ministers will adopt and implement sounder, more consistent policies with the full backing of the President. It also probably means heightened conflict with Parliament and more talk of impeachment as members of that body try to regain the upper hand. Political risk looks to increase, and that will continue to drive the currency.

**Nicholas Brooks**

Hong Kong, (852) 2203-6184

[nicholas.brooks@db.com](mailto:nicholas.brooks@db.com)

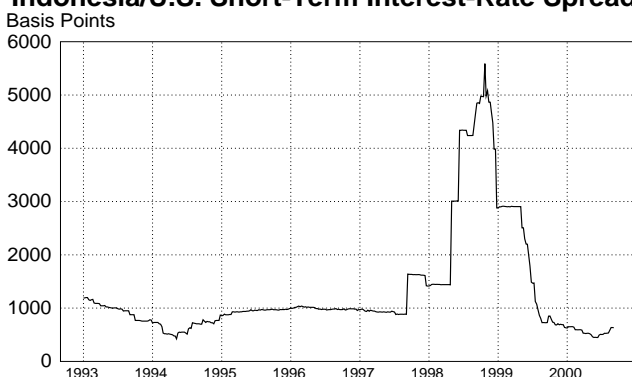
**Indonesian Rupiah/U.S. Dollar Exchange Rate**



**Indonesia's Real Effective Exchange Rate**



**Indonesia/U.S. Short-Term Interest-Rate Spread**



**Indonesia's Stock Market**



### Indonesia's Annual Economic Data

|                   |             | 1994 | 1995 | 1996 | 1997 | 1998  | 1999 | 2000f | 2001f |
|-------------------|-------------|------|------|------|------|-------|------|-------|-------|
| Real GDP          | (yoy % chg) | 7.5  | 8.2  | 7.8  | 4.7  | -13.2 | 0.3  | 5.0   | 4.5   |
| Consumer Prices   | (yoy % chg) | 8.5  | 9.4  | 7.9  | 6.2  | 58.4  | 20.5 | 3.2   | 6.0   |
| Current Acc't Bal | (% of GDP)  | -1.7 | -3.4 | -3.4 | -2.4 | 4.1   | 4.0  | 6.7   | 4.7   |
| FX Reserves       | (US\$ bn)   | 13.2 | 14.7 | 19.1 | 17.4 | 14.0  | 27.3 | 30.5  | 33.5  |
| Budget Balance    | (% of GDP)  | -5.6 | -0.9 | 0.4  | -0.7 | -9.4  | -5.2 | -5.0  | -4.0  |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Malaysian Ringgit

Second-quarter growth was slightly faster than our forecast at 8.8%, down from 11.9% in the first quarter. The strength of private sector investment (up 26%) was the main reason for the difference in forecasts. As in Korea, the Malaysian economy is currently being powered by an investment boom—in large part, it appears, aimed at increasing electronics output. Private consumption was also strong, as expected, rising 14% over the previous year, bringing the level of real consumption solidly in line with pre-crisis spending.

We expect second-half annual growth will slow sharply to 6% from the first half's 10.3%—implying essentially flat seasonally adjusted quarterly growth. July monetary statistics show that broad and narrow money supply

continued the slowing trend that started at the beginning of the year. Part of the reason for the slowdown has been the decline in net foreign-exchange reserves, which is acting as a drag on base-money growth that is not being fully offset by domestic monetary policy. If reserves continue to fall it will become increasingly necessary for Bank Negara to pursue a more expansionary monetary policy if it hopes to support growth. Because of the inherent contradiction between a fixed exchange rate and an independent monetary policy, this will eventually force the authorities to consider allowing the exchange rate to weaken. Our view is this is unlikely to occur until the second half of next year.

**Nicholas Brooks**

Hong Kong, (852) 2203-6184

[nicholas.brooks@db.com](mailto:nicholas.brooks@db.com)

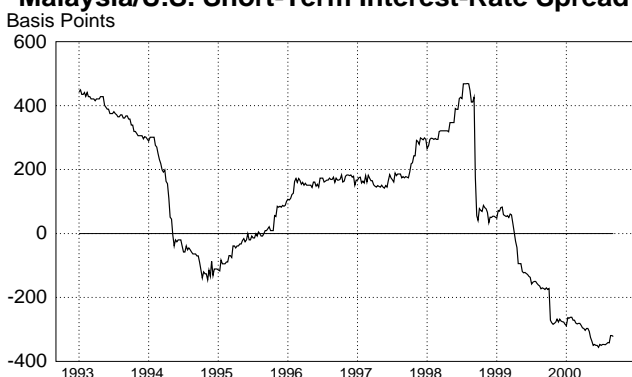
**Malaysian Ringgit/U.S. Dollar Exchange Rate**



**Malaysia's Real Effective Exchange Rate**



**Malaysia/U.S. Short-Term Interest-Rate Spread**



**Malaysia's Stock Market**



### Malaysia's Annual Economic Data

|                   |             | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000f | 2001f |
|-------------------|-------------|------|------|------|------|------|------|-------|-------|
| Real GDP          | (yoy % chg) | 9.2  | 9.8  | 10.0 | 7.3  | -7.4 | 5.6  | 8.0   | 4.0   |
| Consumer Prices   | (yoy % chg) | 3.2  | 3.2  | 3.3  | 2.4  | 5.3  | 2.7  | 1.5   | 2.3   |
| Current Acc't Bal | (% of GDP)  | -7.8 | -9.9 | -4.9 | -5.1 | 12.9 | 16   | 11.1  | 8.7   |
| FX Reserves       | (US\$ bn)   | 26.3 | 24.7 | 27.9 | 21.6 | 26.2 | 30.9 | 35.6  | 38.3  |
| Budget Balance    | (% of GDP)  | -3.5 | -3.2 | 0.7  | 2.4  | -1.8 | -3.2 | -3.2  | -2.8  |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Philippine Peso

Philippines second-quarter GDP rose by 4.5%, well above our as well as market expectations of a rise of around 3.5%. While the headline number was better than expected, the underlying trend remains extremely weak. A breakdown of the real expenditure figures shows that during the quarter, domestic demand growth (excluding stocks) actually slowed sharply to 1.5% from 2.8% in the first quarter due to a sharp decline in construction spending and slowing investment in durable equipment. Private consumption growth remained flat at 3.2%. The reason the headline GDP growth number rose above expectations was a surprisingly large contribution to growth from net exports of goods and services. The boost to growth from net exports was not due to a strong pickup in exports, but because of a sharp fall in imports.

In our view, the growth trend of domestic demand gives a better indication of the health of the economy than the headline number. It is unlikely that the boost from the rise in net exports is sustainable, and tax revenues (and therefore the fiscal outlook) are far more dependent on domestic demand than on agricultural output or net exports. Therefore, while the headline GDP figure on first appearances appears positive, the weakness of domestic demand will continue to limit the central bank's (BSP) inclination to raise interest rates and will continue to pressure the fiscal accounts with negative implications for the peso.

**Nicholas Brooks**  
[nicholas.brooks@db.com](mailto:nicholas.brooks@db.com)

Hong Kong, (852) 2203-6184

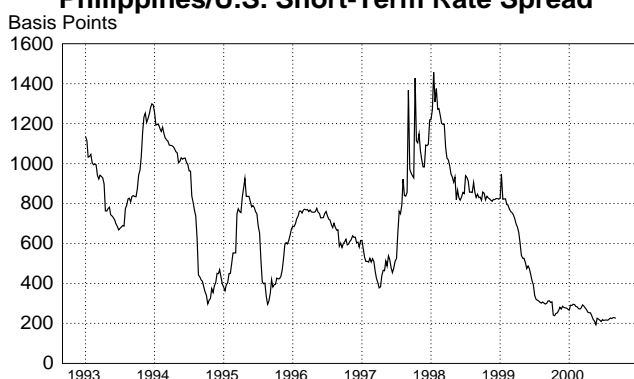
**Philippines Peso/U.S. Dollar Exchange Rate**



**Philippines' Real Effective Exchange Rate**



**Philippines/U.S. Short-Term Rate Spread**



**Philippines' Stock Market**



### Philippines' Annual Economic Data

|                   |             | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000f | 2001f |
|-------------------|-------------|------|------|------|------|------|------|-------|-------|
| Real GDP          | (yoy % chg) | 4.4  | 4.7  | 5.8  | 5.1  | -0.6 | 3.3  | 2.5   | 3.0   |
| Consumer Prices   | (yoy % chg) | 7.1  | 10.9 | 5.2  | 4.7  | 9.8  | 6.7  | 5.5   | 5.0   |
| Current Acc't Bal | (% of GDP)  | -4.6 | -4.5 | -4.8 | -4.7 | 2.0  | 9.0  | 8.0   | 8.0   |
| FX Reserves       | (US\$ bn)   | 7.1  | 7.8  | 11.3 | 8.7  | 10.9 | 14.9 | 15.3  | 17.2  |
| Budget Balance    | (% of GDP)  | 2.2  | 1.4  | 0.3  | 0.1  | -3.3 | -3.7 | -3.1  | -3.0  |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Singapore Dollar

The Consumer Price Index rose somewhat above expectations to 1.2% in July, compared to 0.8% in June. A combination of factors is driving prices higher in most categories (except food and clothing). High international energy prices and changes in administered rates (such as water tariffs) have played a role, but rapid economic expansion is also beginning to feed inflation.

Unit labor costs also appear to be rising (although the unemployment rate remains high due to a structural skill mismatch). These trends are likely to support the current Monetary Authority of Singapore (MAS) strategy of

gradual tightening through appreciation of the trade-weighted exchange rate. However, we do not expect the MAS to introduce any strong measures in the near future. The inflation rate is well within bearable limits and the trade-weighted exchange rate has already appreciated significantly in recent weeks. Interest rates will continue to be driven by global liquidity and with our flat U.S. rate forecast implies only a 25 basis-point increase in Singaporean rates by the end of the year.

**Nicholas Brooks**

Hong Kong, (852) 2203-6184

[nicholas.brooks@db.com](mailto:nicholas.brooks@db.com)

**Singapore Dollar/U.S. Dollar Exchange Rate**



**Singapore's Real Effective Exchange Rate**



**Singapore/U.S. Short-Term Interest-Rate Spread**



**Singapore's Stock Market**



### Singapore's Annual Economic Data

|                   |             | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000f | 2001f |
|-------------------|-------------|------|------|------|------|------|------|-------|-------|
| Real GDP          | (yoy % chg) | 11.2 | 8.5  | 7.5  | 8.0  | 0.4  | 5.4  | 7.3   | 5.0   |
| Consumer Prices   | (yoy % chg) | 3.1  | 1.7  | 1.4  | 2.0  | -0.3 | 0.4  | 1.2   | 2.3   |
| Current Acc't Bal | (% of GDP)  | 16.4 | 17.3 | 15.9 | 15.6 | 23.9 | 24.7 | 19.7  | 15.9  |
| FX Reserves       | (US\$ bn)   | 58.3 | 68.8 | 77.0 | 71.4 | 75.0 | 77.2 | 81.8  | 85.7  |
| Budget Balance    | (% of GDP)  | 84.0 | 7.6  | 6.7  | 4.3  | -0.3 | 2.2  | 1.6   | 2.1   |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## South Korean Won

We continue to expect Korea to run a current-account surplus equivalent to around 1.1% of GDP this year. Together with a large capital-account surplus, that should keep the balance of payments well supported and keep the Korean won on an appreciating trend.

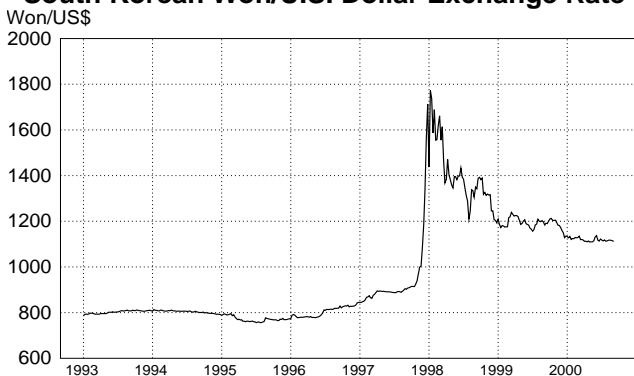
Korea's capital-account surplus rose to US\$1.1 billion from US\$830 million in June, which partially offset the sharp drop in the current-account surplus in July to US\$810 million, well below the US\$1.46 billion surplus in June and our expectations. The main reason for the decline in the current-account surplus was a sharp fall in the mer-

chandise-trade surplus following a rebound the previous two months. The combined services and income accounts actually improved.

The primary cause for the decline in the merchandise surplus has been a surge in imports (up 39.9% during the month) partly because of the rise in the cost of oil imports and also because strong demand for component imports and investment goods. Export growth in fact accelerated during the month to 23.1% from 19% in June.

**Nicholas Brooks** Hong Kong, (852) 2203-6184  
[nicholas.brooks@db.com](mailto:nicholas.brooks@db.com)

**South Korean Won/U.S. Dollar Exchange Rate**



**South Korea's Real Effective Exchange Rate**



**S. Korea/U.S. Short-Term Interest-Rate Spread**



**South Korea's Stock Market**



### South Korea's Annual Economic Data

|                   |             | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000f | 2001f |
|-------------------|-------------|------|------|------|------|------|------|-------|-------|
| Real GDP          | (yoy % chg) | 8.3  | 8.9  | 6.8  | 5.0  | -6.7 | 10.7 | 9.0   | 5.2   |
| Consumer Prices   | (yoy % chg) | 6.2  | 4.5  | 5.0  | 4.4  | 7.5  | 0.8  | 2.0   | 3.2   |
| Current Acc't Bal | (% of GDP)  | -1.2 | -2.0 | -4.9 | -2.0 | 12.5 | 6.1  | 1.6   | 1.1   |
| FX Reserves       | (US\$ bn)   | 25.7 | 32.7 | 33.3 | 20.4 | 52.0 | 74.1 | 85.0  | 89.5  |
| Budget Balance    | (% of GDP)  | 0.5  | 0.5  | 0.0  | 0.0  | -5.6 | -5.0 | -4.3  | -2.0  |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Taiwanese Dollar

Manufacturing output growth slowed to 7% in July, from 9.7% in June, however on a three-month moving-average basis, growth has stabilized at about 8%-9% (8.6% in July). Output of electronics products fell 2.2% on a seasonally adjusted monthly basis, but this comes after two very good months. With annual output growth in this sector still running well above 20%, one month's decline should not be a cause for concern. However, the leading economic indicator index fell to 103.2 in July from 103.8 in June, the lowest level in 10 months. Meanwhile the coincident composite index fell for the third consecutive month.

The numbers support what other data of recent months has been indicating, namely, that the underlying Taiwan economy remains extremely weak once the strong performance of the technology sector is excluded. The policy implications are clear; the central bank needs to maintain a low interest-rate policy and allow the currency to depreciate further. think the exchange rate will depreciate to NTD/USD 34 over the next 12 months and that three-month rates to fall another 50 basis point.

**Nicholas Brooks** Hong Kong, (852) 2203-6184  
[nicholas.brooks@db.com](mailto:nicholas.brooks@db.com)

**New Taiwan Dollar/U.S. Dollar Exchange Rate**



**Taiwan's Real Effective Exchange Rate**



**Taiwan/U.S. Short-Term Interest-Rate Spread**



**Taiwan's Stock Market**



### Taiwan's Annual Economic Data

|                   |             | 1994 | 1995 | 1996 | 1997 | 1998 | 1999  | 2000f | 2001f |
|-------------------|-------------|------|------|------|------|------|-------|-------|-------|
| Real GDP          | (yoy % chg) | 7.1  | 6.4  | 6.1  | 6.7  | 4.6  | 5.7   | 5.0   | 4.5   |
| Consumer Prices   | (yoy % chg) | 4.1  | 3.7  | 3.1  | 0.9  | 1.7  | 0.2   | 1.2   | 1.8   |
| Current Acc't Bal | (% of GDP)  | 2.7  | 2.1  | 4.0  | 2.7  | 1.3  | 2.0   | 1.1   | 0.5   |
| FX Reserves       | (US\$ bn)   | 92.4 | 90.3 | 88.0 | 8.5  | 90.3 | 106.2 | 113.3 | 115.7 |
| Budget Balance    | (% of GDP)  | -5.7 | -7.4 | -7.4 | -6.3 | 0.2  | -4.9  | -1.4  | -0.5  |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Thai Baht

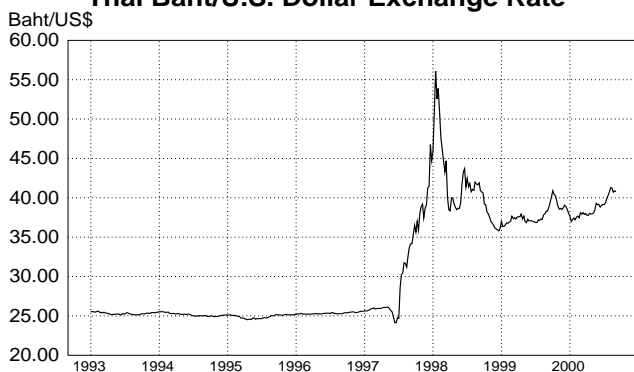
The lowering of Thailand's weightings in key regional equity indices is a reminder of that market's declining importance for most investors, and the weakening economic outlook makes it even less likely that foreign capital will return soon. Late in the day, the government has eased restrictions on banks' capital regulations, allowing them to issue upper Tier II (interest deferred) subordinated debt. This rule change comes as the government announced that non-performing loans held by the domestic banks fell to 34.9% in July from 35.1% in June.

Such painfully slow progress in resolving bad loans (even though the private banks have in most cases set aside more than the minimum required provisions against

losses) is an important source of declining sentiment. That declining sentiment shows up clearly in the declining level of the real composite consumption index. Similarly, real manufacturing output has tapered off. The growth that banks (and borrowers) had hoped would ease the way for debt restructuring (or a return to solvency) seems to be slipping away. Investors (and creditors) will likely continue to be wary of making new commitments to Thailand. Capital flows are expected to continue to put enough pressure on the currency to perpetuate the gradual depreciation in the baht.

**Nicholas Brooks** Hong Kong, (852) 2203-6184  
[nicholas.brooks@db.com](mailto:nicholas.brooks@db.com)

**Thai Baht/U.S. Dollar Exchange Rate**



**Thailand's Real Effective Exchange Rate**



**Thailand/U.S. Short-Term Interest-Rate Spread**



**Thailand's Stock Market**



### Thailand's Annual Economic Data

|                   |             | 1994 | 1995 | 1996 | 1997 | 1998  | 1999 | 2000f | 2001f |
|-------------------|-------------|------|------|------|------|-------|------|-------|-------|
| Real GDP          | (yoy % chg) | 9.0  | 8.9  | 5.9  | -1.7 | -10.2 | 4.2  | 5.0   | 4.0   |
| Consumer Prices   | (yoy % chg) | 5.1  | 5.8  | 5.8  | 5.6  | 8.1   | 0.3  | 1.6   | 2.5   |
| Current Acc't Bal | (% of GDP)  | -5.6 | -8.0 | -8.1 | -0.8 | 12.7  | 12.8 | 6.2   | 4.6   |
| FX Reserves       | (US\$ bn)   | 30.3 | 36.9 | 38.7 | 9.0  | 22.9  | 34.8 | 32.5  | 41.9  |
| Budget Balance    | (% of GDP)  | 2.8  | 3.2  | 0.7  | -0.6 | -5.2  | -5.2 | -5.3  | -4.2  |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Argentine Peso

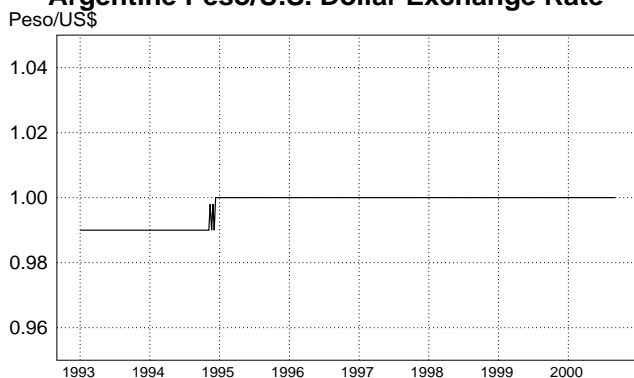
After a significant sell-off a couple of weeks ago, mostly confirming our warning calls about peso assets, the forward market settled down in recent days. Peso spreads, however, have remained around 50 basis points wider than before the sell-off, with the 1-year spread trading now at 370 basis-points level. For the coming days, we remain cautious about peso non-deliverable forwards (NDF) although we do not rule out a further tightening in the peso spread.

Peso forwards still offer a relatively cheap hedge against the still vulnerable economic situation in Argentina. This notwithstanding, it is worth highlighting that there has been a slight improvement in Argentina's outlook in recent days. Minister Machinea emerged fortified after what seemed to be a difficult period as the President and lead-

ers of the ruling alliance reinforced their backing to the current policy track. More importantly, the business community's expression of support for the Minister and his policies for the first time since the new administration took office could have a significant effect on local confidence going forward. In the meantime, additional economic data confirmed that July was the first positive month in terms of economic activity after a few months in the red. These results however, do not yet confirm a sustained upward path over the next few months. On the downside this week, the Senate bribery scandal is likely to further complicate the political situation and paralyze the working of Congress

**Gustavo Cañonero** Buenos Aires, (54-114) 590-2848  
[gustavo.canonero@db.com](mailto:gustavo.canonero@db.com)

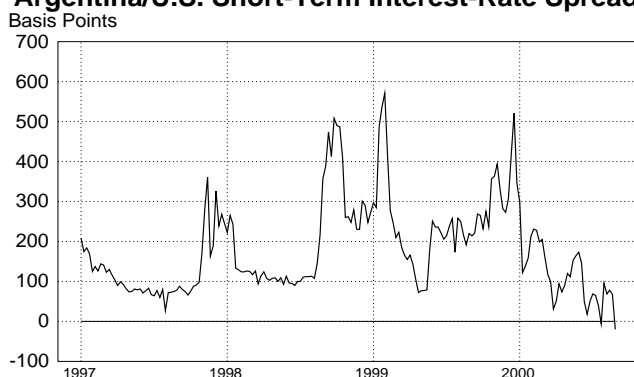
**Argentine Peso/U.S. Dollar Exchange Rate**



**Argentina's Real Effective Exchange Rate**



**Argentina/U.S. Short-Term Interest-Rate Spread**



**Argentina's Stock Market**



### Argentina's Annual Economic Data

|                   |             | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000f | 2001f |
|-------------------|-------------|------|------|------|------|------|------|-------|-------|
| Real GDP          | (yoy % chg) | 8.0  | -4.0 | 4.8  | 8.6  | 3.9  | -3.0 | 2.2   | 3.4   |
| Consumer Prices   | (yoy % chg) | 3.9  | 1.6  | 0.1  | 0.3  | 0.9  | -2.1 | 0.0   | 1.0   |
| Current Acc't Bal | (% of GDP)  | -3.6 | -1.0 | -1.3 | -3.7 | -4.9 | -4.3 | -4.4  | -4.4  |
| FX Reserves       | (US\$ bn)   | 16.0 | 16.0 | 19.7 | 22.4 | 23.9 | 26.4 | 24.0  | 25.0  |
| Budget Balance    | (% of GDP)  | 0.4  | 0.9  | 2.0  | -1.8 | -1.6 | -2.6 | -1.6  | -1.3  |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

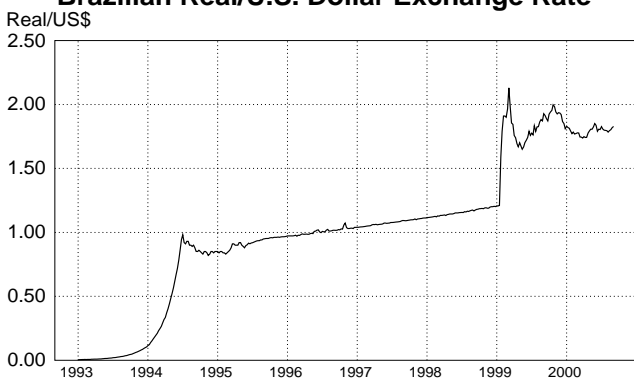
## Brazilian Real

Brazilian markets were affected by higher-than-expected inflation numbers in July and August. Inflation was caused mainly by increases in administered prices such as fuel and electricity, as well as by a sharp hike in agricultural prices due to seasonal factors and adverse climatic conditions. Although inflation is expected to recede in the fourth quarter as these supply shocks taper off, annual inflation will likely exceed this year's 6% target by a small margin. Moreover, the authorities must now worry about next year's 4% target, which totally justifies their decision to keep the overnight interest rate unchanged at 16.5% at the August meeting of the monetary policy committee. The Central Bank should not ease monetary policy again before the future inflation trend becomes clearer.

Regardless of inflation pressures, the economic outlook remains quite positive and Moody's even put Brazil on watchlist for a possible ratings upgrade. Economic activity is recovering fast, the public sector posted a primary surplus BRL7.6 billion above the IMF target in the first semester and the balance of payments continues to benefit from a large inflow of foreign direct investment (which reached US\$17.8 billion in the first seven months of the year), which is helping to keep the exchange rate fairly stable.

**José Carlos de Faria** São Paulo, (55-11) 5189-5185  
[jose.faria@db.com](mailto:jose.faria@db.com)

**Brazilian Real/U.S. Dollar Exchange Rate**



**Brazil's Real Effective Exchange Rate**



**Brazil/U.S. Short-Term Interest-Rate Spread**



**Brazil's Stock Market**



### Brazil's Annual Economic Data

|                   |             | 1994   | 1995 | 1996 | 1997 | 1998 | 1999  | 2000f | 2001f |
|-------------------|-------------|--------|------|------|------|------|-------|-------|-------|
| Real GDP          | (yoy % chg) | 5.9    | 4.2  | 2.8  | 3.2  | -0.1 | 1.0   | 3.6   | 4.5   |
| Consumer Prices   | (yoy % chg) | 1112.9 | 22.0 | 9.1  | 5.2  | 1.7  | 8.9   | 6.1   | 4.7   |
| Current Acc't Bal | (% of GDP)  | -0.3   | -2.5 | -3.1 | -4.2 | -4.3 | -4.5  | -3.9  | -3.4  |
| FX Reserves       | (US\$ bn)   | 37.1   | 51.8 | 60.0 | 52.2 | 44.6 | 36.3  | 29.6  | 29.5  |
| Budget Balance    | (% of GDP)  | -26.1  | -7.1 | -6.1 | -6.2 | -8.1 | -10.0 | -3.5  | -2.3  |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Chilean Peso

It is our view that the peso has depreciated more than necessary on a medium-term basis. Nevertheless, the currency remains vulnerable in the short-run should the economy fail to gather steam. Recent economic data underscores our concern. The unemployment rate rose to 10.2% in July from 9.4% a month ago, and industrial production growth rate was down from the previous month. In a surprising move on Monday, the central bank lowered its reference rate by 50 basis points, reflecting the authorities' concern about the economic situation. Consequently, the peso slid by more than 10 pesos per dollar, almost reaching 560 this week.

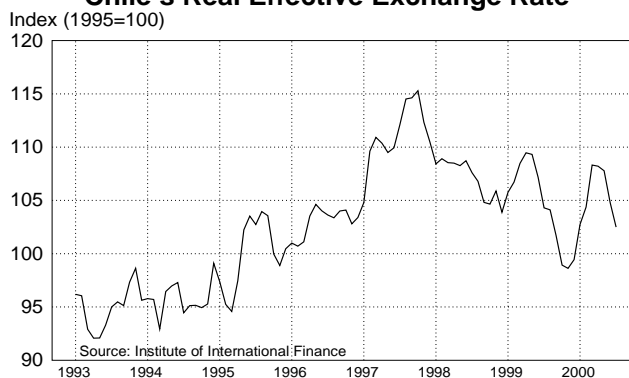
The peso outlook in the very short term remains a difficult call. Given the lack of reaction in consumer demand, particularly in investment spending so far this year, the prospects for activity to rebound in the next few weeks does not appear too encouraging. As we said before, we believe that Chile's slower economic recovery than in the past mostly reflects the effects left by the real shocks and the policy response in 1998-1999. On this basis, a stronger economic rebound is just a question of time. In the meantime, however, the lack of reaction from local spending will require a weaker peso to do most of the job of reactivating aggregate demand.

**Gustavo Cañero** Buenos Aires, (54-114) 590-2848  
gustavo.canonero@db.com

### Chilean Peso/U.S. Dollar Exchange Rate



### Chile's Real Effective Exchange Rate



### Chile/U.S. Short-Term Interest-Rate Spread



### Chile's Stock Market



### Chile's Annual Economic Data

|                   |             | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000f | 2001f |
|-------------------|-------------|------|------|------|------|------|------|-------|-------|
| Real GDP          | (yoy % chg) | 5.7  | 10.6 | 7.4  | 7.1  | 3.4  | -1.1 | 5.6   | 6.5   |
| Consumer Prices   | (yoy % chg) | 8.9  | 8.2  | 6.6  | 6.0  | 4.7  | 2.3  | 4.4   | 4.0   |
| Current Acc't Bal | (% of GDP)  | -3.1 | -2.1 | -5.5 | -5.3 | -5.7 | -0.1 | -2.3  | -3.0  |
| FX Reserves       | (US\$ bn)   | 13.7 | 14.8 | 15.5 | 17.8 | 15.4 | 14.6 | 15.0  | 17.0  |
| Budget Balance    | (% of GDP)  | 1.3  | 3.1  | 1.4  | 0.1  | 0.4  | -1.3 | -0.5  | 1.0   |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Colombian Peso

The peso has depreciated 1% since the middle of August, after trading around COP/US\$ 2180 since early July. The main trigger of the depreciation has been the market's impression that increasing the transactions tax is most likely among the tax measures being studied by the government.

The new finance minister, Juan Manuel Santos, announced at the end of July that the new target for the tax reform would now call for an additional COP2.0 billion in taxes. However, by mid-August, the government again indicated that further tax reforms were needed. An in-

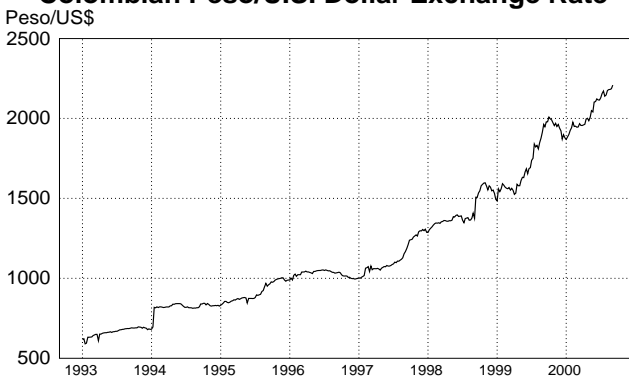
crease in the transactions tax, while technically inefficient, seems to be easier to approve in Congress than other tax hikes.

Looking forward, the government may be expecting inflows from privatization and by the issuance of external bonds. These capital flows could total between US\$1.0-1.4 billion for the remainder of the year. Based on those expected inflows, we do not expect the peso to depreciate much beyond current levels.

**Piero Ghezzi**  
piero.ghezzi@db.com

New York, (212) 469-7355

**Colombian Peso/U.S. Dollar Exchange Rate**



**Colombia's Real Effective Exchange Rate**



**Colombia/U.S. Short-Term Interest-Rate Spread**



**Colombia's Stock Market**



### Colombia's Annual Economic Data

|                   |             | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000f | 2001f |
|-------------------|-------------|------|------|------|------|------|------|-------|-------|
| Real GDP          | (yoy % chg) | 5.8  | 5.9  | 2.0  | 3.3  | 0.4  | -4.5 | 3.1   | 2.5   |
| Consumer Prices   | (yoy % chg) | 22.6 | 19.5 | 21.6 | 17.7 | 16.7 | 9.2  | 10.3  | 9.4   |
| Current Acc't Bal | (% of GDP)  | -4.4 | -6.2 | -5.8 | -5.8 | -5.3 | -1.0 | -2.6  | -2.7  |
| FX Reserves       | (US\$ bn)   | 7.9  | 8.2  | 9.7  | 9.6  | 8.7  | 10.6 | 12.4  | 13.8  |
| Budget Balance    | (% of GDP)  | -0.1 | 0.4  | 1.9  | -3.8 | -3.3 | -6.0 | -3.2  | -3.2  |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Mexican Peso

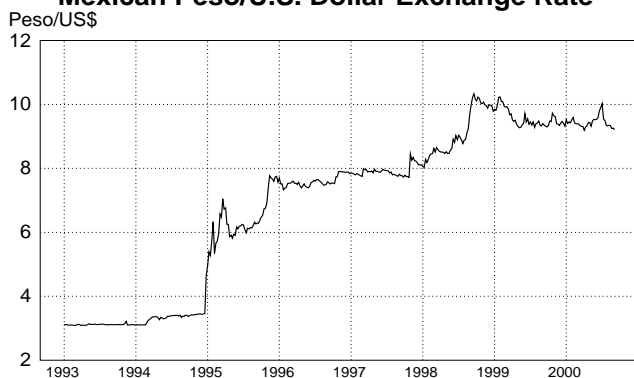
A sequence of recent events in Mexico has further boosted the outlook for the country, and at the same time, reinforced peso strength. First, the election for the Governor of Chiapas last week passed uneventfully. Second, unemployment and retail sales figures in June further confirmed a rapid growth pace. Third, July's trade deficit, which fell below June's deficit, reflects the significant mitigating effect of U.S. growth and high oil prices on Mexico's external accounts. Fourth, the mid-month CPI report continued to point to a declining inflation path.

All of the above indicators are consistent with our view that Mexico is on a solid growth path for the next few months. This bright economic outlook is not free of risks,

however. Inflation pressures could soon increase, while long-standing strength in external demand and oil prices could fall off. A combination of events could set the stage for a major swing in the exchange rate, seriously complicating the central bank's goals for reducing inflation. For now, the short-term outlook for external conditions, accompanied by capital inflows, will likely lend support to a relatively strong currency and low inflation. Indeed, a continuation of this scenario may accelerate the current deflationary process, feeding back into lower-than-expected equilibrium for nominal variables.

**Gustavo Cañonero** Buenos Aires, (54-114) 590-2848  
gustavo.canonero@db.com

### Mexican Peso/U.S. Dollar Exchange Rate



### Mexico's Real Effective Exchange Rate



### Mexico/U.S. Short-Term Interest-Rate Spread



### Mexico's Stock Market



### Mexico's Annual Economic Data

|                   |             | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000f | 2001f |
|-------------------|-------------|------|------|------|------|------|------|-------|-------|
| Real GDP          | (yoy % chg) | 4.4  | -6.2 | 5.2  | 6.8  | 4.8  | 3.7  | 5.8   | 5.0   |
| Consumer Prices   | (yoy % chg) | 7.0  | 52.0 | 27.2 | 15.7 | 18.6 | 12.4 | 8.9   | 6.6   |
| Current Acc't Bal | (% of GDP)  | -7.1 | -0.6 | -0.7 | -1.8 | -3.8 | -2.9 | -3.8  | -4.0  |
| FX Reserves       | (US\$ bn)   | 6.5  | 17.0 | 19.5 | 30.0 | 29.3 | 31.4 | 37.2  | 39.2  |
| Budget Balance    | (% of GDP)  | 0.1  | 0.0  | 0.0  | -0.8 | -1.3 | -1.2 | -1.0  | -1.0  |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Venezuelan Bolivar

As expected, the bolivar has remained stable despite an earlier announcement that the government had requested the central bank to transfer VEB1.95 trillion (US\$2.8 billion) to fund expenditures. The money is to be taken from a reserve account in the central bank balance sheet.

According to international convention, the central bank generates an artificial account to offset the domestic currency effects of the currency depreciation on international reserves. The government has decided to take the resources accumulated in that reserve account. Since the account is artificial, the central bank will actually need to issue the VEB1.95 trillion to satisfy government requirements. Those resources represent 43.3% of the monetary base. This is an inorganic monetary expansion in the old Latin American style and one of the most

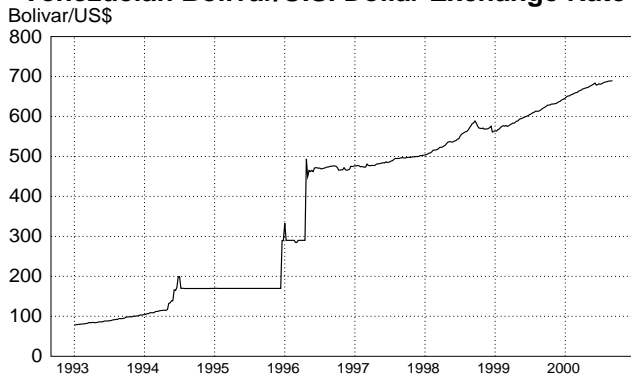
unfortunate moves of this administration.

Our impression is that even if those monetary-base increases were immediate, the effect on the exchange rate would not be sizable. Under a de facto crawling-peg system as in the case of Venezuela, it is more likely to be reflected in capital outflows. The reason being that the Central Bank still has full control of exchange-rate movements. Even after accounting for the impact of current monetization, international reserves cover 1.9 times the monetary base and more than 66% of M2. In addition, oil prices remain supportive of those flows. Looking forward, we maintain our view that the government will be able to keep control of the exchange-rate path.

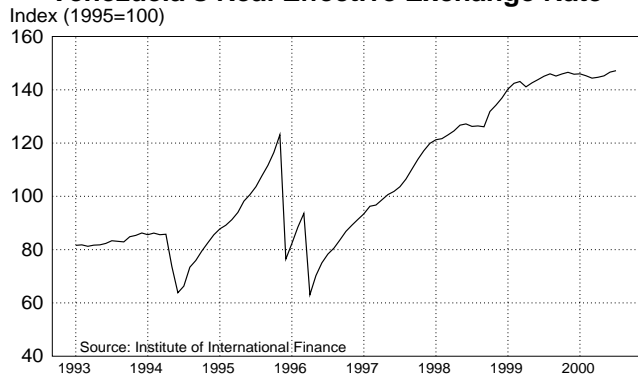
**Piero Ghezzi**  
[piero.ghezzi@db.com](mailto:piero.ghezzi@db.com)

New York, (212) 469-7355

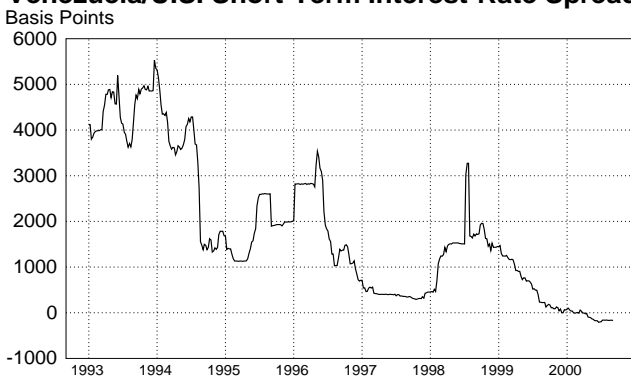
### Venezuelan Bolivar/U.S. Dollar Exchange Rate



### Venezuela's Real Effective Exchange Rate



### Venezuela/U.S. Short-Term Interest-Rate Spread



### Venezuela's Stock Market



### Venezuela's Annual Economic Data

|                   |             | 1994 | 1995 | 1996  | 1997 | 1998 | 1999 | 2000f | 2001f |
|-------------------|-------------|------|------|-------|------|------|------|-------|-------|
| Real GDP          | (yoy % chg) | -2.3 | 3.7  | -0.4  | 5.1  | -0.1 | -7.2 | 3.1   | 2     |
| Consumer Prices   | (yoy % chg) | 70.8 | 56.6 | 103.2 | 37.6 | 29.9 | 20   | 13.4  | 12.7  |
| Current Acc't Bal | (% of GDP)  | 4.4  | 2.8  | 12.4  | 6.8  | -2.7 | 5.4  | 11.7  | 7.1   |
| FX Reserves       | (US\$ bn)   | 12.5 | 10.7 | 16.2  | 18.2 | 14.9 | 15.2 | 21.2  | 22.3  |
| Budget Balance    | (% of GDP)  | 15.4 | 5.8  | -7.4  | 1.9  | -3.1 | -1.8 | -1.9  | -2.9  |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Czech Koruna

The koruna strengthened significantly during the early part of August, as economic indicators showed the recovery gathering pace while inflationary pressures remain subdued. With the Czech National Bank sitting on the sidelines and fears of foreign-exchange intervention gradually receding, the koruna reached an 18-month high of CZK/EUR35.26 in early August.

The trade deficit widened well beyond expectations in July, to €380 million from €250 million in June. Export growth remained fairly strong at 13.7% year/year in euro terms, thanks to EU demand for manufactured goods. But with import growth of 21.9% year/year in euro terms, the trade deficit for the first seven months reached €1.5 billion. High oil prices and the strong U.S. dollar again played a key role, but import demand might be strength-

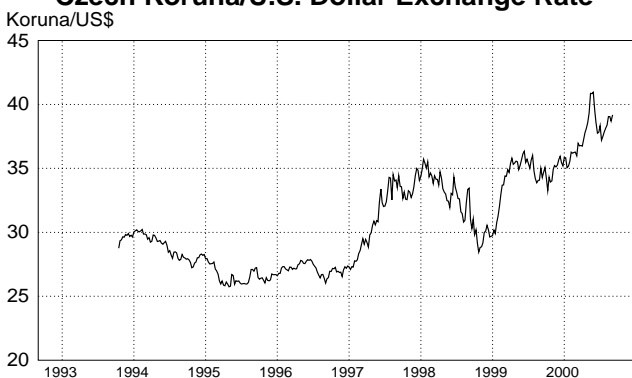
ening across the board as growth picks up. The trade deficit does not, at this stage, generate concerns for the current account or the koruna. Partly reflecting the weakness of the euro, the koruna remains strong at CZK/EUR 35.35.

The government has resumed its debate of the 2001 budget and, given political difficulties, we could see some relaxation in the implied fiscal stance if not on the official deficit target. Together with ongoing tensions on the new central bank law draft, this could cause some koruna weakening. With no evidence of inflationary pressures so far, we expect interest rates to remain on hold for the time being.

**Marco Annunziata**  
marco.annunziata@db.com

London, (44) 20 7545-5506

**Czech Koruna/U.S. Dollar Exchange Rate**



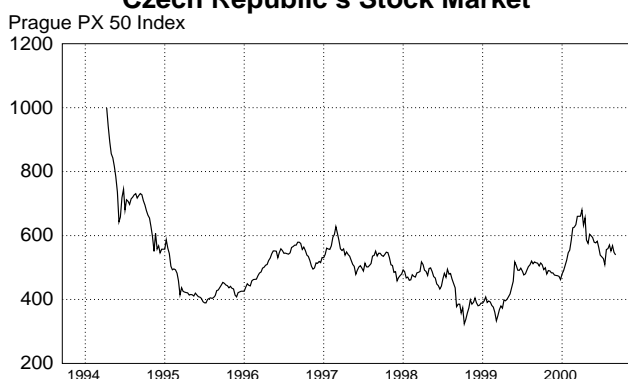
**Czech Republic's Real Effective Exchange Rate**



**Czech Republic/U.S. Short-Term Rate Spread**



**Czech Republic's Stock Market**



### Czech Republic's Annual Economic Data

|                   |             | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000f | 2001f |
|-------------------|-------------|------|------|------|------|------|------|-------|-------|
| Real GDP          | (yoy % chg) | 3.2  | 5.9  | 4.8  | -1.0 | -2.3 | -0.2 | 2.0   | 2.8   |
| Consumer Prices   | (yoy % chg) | 9.7  | 7.9  | 8.6  | 10.0 | 6.8  | 2.6  | 4.5   | 6.0   |
| Current Acc't Bal | (% of GDP)  | -2.0 | -2.7 | -7.4 | -6.1 | -2.4 | -2.0 | -3.3  | -2.9  |
| FX Reserves       | (US\$ bn)   | 7.0  | 14.7 | 12.4 | 9.8  | 12.6 | 12.9 | 13.5  | ..    |
| Budget Balance    | (% of GDP)  | ...  | 0.5  | -0.1 | -1.0 | -1.6 | -3.0 | -3.3  | -3.0  |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Hungarian Forint

The forint remains firmly near the top of its intervention band, and is supported by strong economic fundamentals, which show little signs of overheating. The exchange rate was not even affected by the unexpectedly strong July CPI reading, which jumped to 9.6% year/year from 9.1% year/year in June. The CPI jump was due to a 3.3% month/month hike in food prices that is likely to start disappearing in the autumn. This implies that both core inflation and headline inflation should continue to decline.

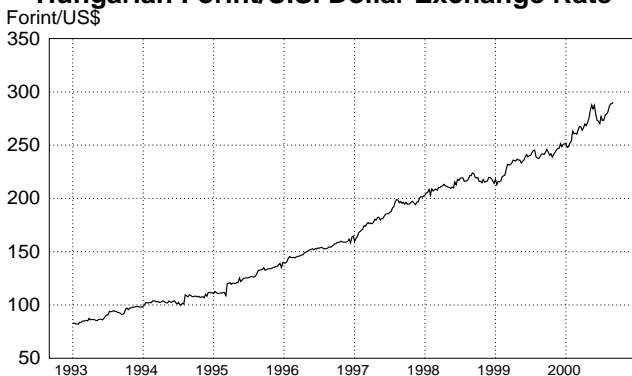
In view of Hungary's strong economic fundamentals, we expect the forint to remain on the strong side of the band for the rest of the year. The prospect of falling infla-

tion with little signs of the economy overheating still leaves room for some 50 basis-point interest rate cuts in the remainder of the year. As for the timing of the next cut in the devaluator rate (currently 0.3% a month), we expect the National Bank of Hungary to wait until after two more monthly CPI releases prior to making their decision. However, postponing such a move until early next year could be considered as contributing to inflation. Thus, a cut in the devaluator could still take place this year.

**Natalia Gurushina**  
natalia.n.gurushina@db.com

London, (44) 20 7547-3304

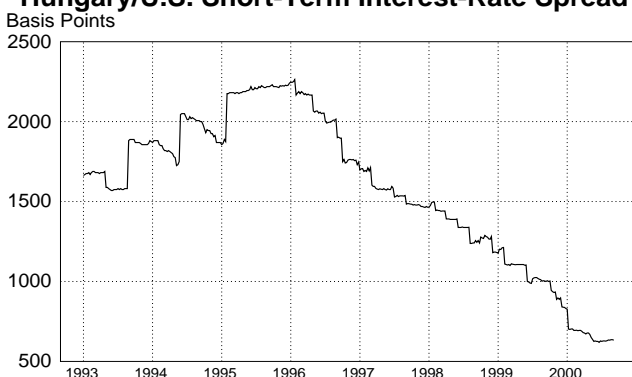
**Hungarian Forint/U.S. Dollar Exchange Rate**



**Hungary's Real Effective Exchange Rate**



**Hungary/U.S. Short-Term Interest-Rate Spread**



**Hungary's Stock Market**



### Hungary's Annual Economic Data

|                   |             | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000f | 2001f |
|-------------------|-------------|------|------|------|------|------|------|-------|-------|
| Real GDP          | (yoy % chg) | 2.9  | 1.5  | 1.3  | 4.6  | 4.9  | 4.5  | 5.3   | 5.4   |
| Consumer Prices   | (yoy % chg) | 21.2 | 28.3 | 19.8 | 18.4 | 10.3 | 11.2 | 7.5   | 6.2   |
| Current Acc't Bal | (% of GDP)  | -9.4 | -5.4 | -3.8 | -2.1 | -4.8 | -4.1 | -3.7  | -3.7  |
| FX Reserves       | (US\$ bn)   | 6.8  | 12.0 | 9.8  | 8.4  | 9.3  | 11.0 | 12.0  | 13.0  |
| Budget Balance    | (% of GDP)  | -7.7 | -4.0 | -3.0 | -4.8 | -4.6 | -3.9 | -3.5  | -3.5  |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Polish Zloty

Expectations of TPSA privatization inflows continued to underpin the zloty throughout the month. The July CPI figure released on 16 August led to expectations of a sizeable rate hike by end-month, and the zloty strengthened to PLZ/US\$ 4.31 by 18 August. Subsequent data releases, however, showed no signs of overheating pressures, and with food prices falling in the first half of August (by 0.7% month/month) expectations of a rate hike were scaled back. The zloty has since retreated to PLZ/US\$ 4.38.

Domestic demand is slowing down, and as exogenous price pressures start to peter out, we expect inflation to edge down in August and to decline more sharply over the remainder of the year. Nevertheless, it should remain significantly above the NBP's 2000 target.

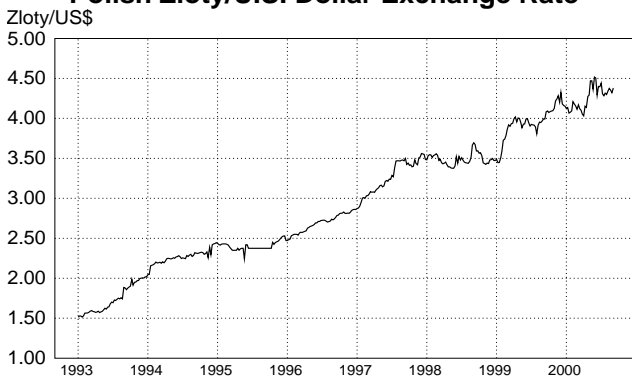
Privatization inflows should continue to support the zloty even after the TPSA funds stop flowing in by end-September. The debate on the 2001 budget, however, should cause some increase in foreign-exchange volatility, and the zloty is likely to weaken somewhat to PLZ/US\$ 4.40-4.45 by year-end. The Ministry of Finance has indicated that the assumptions underlying the budget might need to be revised, upping the inflation forecast and reducing the real GDP growth forecast. Finance Minister Bauc has assured that the 2001 deficit target will remain unchanged. Given the difficult political situation and the upcoming presidential elections, however, there is a risk of a de facto loosening of fiscal policy.

**Marco Annunziata**

[marco.annunziata@db.com](mailto:marco.annunziata@db.com)

London, (44) 20 7545-5506

### Polish Zloty/U.S. Dollar Exchange Rate



### Poland's Real Effective Exchange Rate



### Poland/U.S. Short-Term Interest-Rate Spread



### Poland's Stock Market



### Poland's Annual Economic Data

|                   |             | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000f | 2001f |
|-------------------|-------------|------|------|------|------|------|------|-------|-------|
| Real GDP          | (yoy % chg) | 5.2  | 7.0  | 7.0  | 6.8  | 4.8  | 4.1  | 5.0   | 5.0   |
| Consumer Prices   | (yoy % chg) | 29.5 | 21.6 | 18.7 | 13.2 | 8.6  | 9.8  | 8.5   | 5.4   |
| Current Acc't Bal | (% of GDP)  | 1.0  | 0.7  | -1.0 | -3.0 | -4.3 | -7.6 | -7.3  | -6.8  |
| FX Reserves       | (US\$ bn)   | 6.0  | 15.0 | 17.7 | 20.3 | 26.3 | 25.5 | 26.0  | -     |
| Budget Balance    | (% of GDP)  | -3.0 | -2.4 | -3.2 | -2.6 | -2.7 | -3.7 | -2.5  | -2.0  |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Russian Ruble

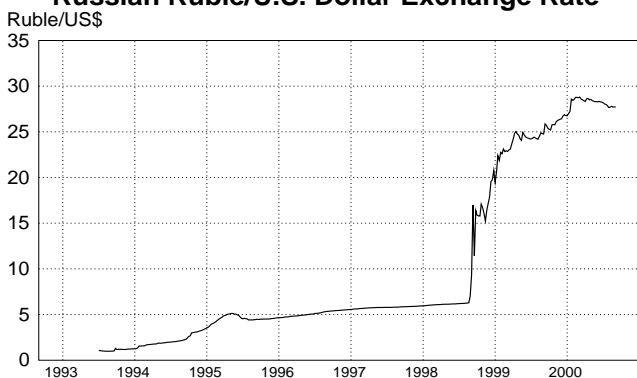
The ruble remained largely stable at RUB/US\$ 27.7 in the past two weeks. However, the Central Bank of Russia (CRB) had to buy rubles for the first time since February 2000, which led to a US\$200 million decline in reserves to US\$23.4 billion. The pressure on the ruble could have been caused by two factors. First, there may have been some (lagged) decline in receipts from crude oil exports due to seasonal factors and also reflecting lower oil prices in the second quarter. The second possible factor is related to banks' ruble liquidity at the CBR's direct deposit facility. Since a significant proportion of these funds is very short-term, any deterioration in market sentiment can lead to their withdrawal from the CBR and to a resulting rise in foreign-exchange purchases. Notwithstanding the recent small decline, we expect reserves to continue increasing this year, albeit at a slower pace than in

the first half of the year, and the ruble to appreciate to RUB/US\$ 27 by year-end.

Liquidity management of the large balance of payments inflows remains the key challenge for the monetary authorities, especially as the pace of disinflation slows down due to recovering domestic demand, higher oil prices, and price liberalization. To alleviate the pressure, the government will have to step up the conversion of the securities portfolio of the central bank into a marketable portfolio, either by repaying the debt or by swapping it into marketable debt. This would reduce sterilization costs and allow more active open-market operations.

**Marcel Cassard** London, (44) 20 7545-9913  
[marcel.cassard@db.com](mailto:marcel.cassard@db.com)  
**Natalia Gurushina** London, (44) 20 7547-3304  
[natalia.n.gurushina@db.com](mailto:natalia.n.gurushina@db.com)

**Russian Ruble/U.S. Dollar Exchange Rate**



**Russia's Real Effective Exchange Rate**



**Russia/U.S. Short-Term Interest-Rate Spread**



**Russia's Stock Market**



### Russia's Annual Economic Data

|                   |             | 1994  | 1995 | 1996 | 1997 | 1998 | 1999 | 2000f | 2001f |
|-------------------|-------------|-------|------|------|------|------|------|-------|-------|
| Real GDP          | (yoy % chg) | -12.6 | -4.0 | -3.5 | 0.9  | -4.9 | 3.2  | 6.5   | 4.0   |
| Consumer Prices   | (yoy % chg) | 215.0 | 96.4 | 21.0 | 11.8 | 84.4 | 36.7 | 19.5  | 11.0  |
| Current Acc't Bal | (% of GDP)  | 0.3   | 1.1  | 2.8  | 1.1  | 0.8  | 13.8 | 14.6  | 11.5  |
| FX Reserves       | (US\$ bn)   | 7.2   | 18.0 | 15.3 | 17.8 | 12.2 | 12.5 | 25.0  | 25.0  |
| Budget Balance    | (% of GDP)  | -     | -5.4 | -7.9 | -7.0 | -5.0 | -1.7 | 1.0   | 0.0   |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Turkish Lira

The monthly depreciation of the lira was in line with the 1.3% program target, which will decline to 1.0%, 0.9% and 0.85% per month in the next three quarters. Foreign-exchange reserves remained stagnant during August at US\$24.5 billion, as well as the central bank's net foreign-exchange position at US\$7.5 billion. While foreign-exchange inflows were limited, Turkish private-sector banks continued to receive syndicated loans in August, increasing the year-to-date amount to more than US\$3.8 billion. July inflation data was mixed—wholesale prices rose by 1% month/month against a CPI rise of 2.2%. We expect August wholesale inflation to be relatively tame at 1.3%, but consumer prices to rise at 2.1%.

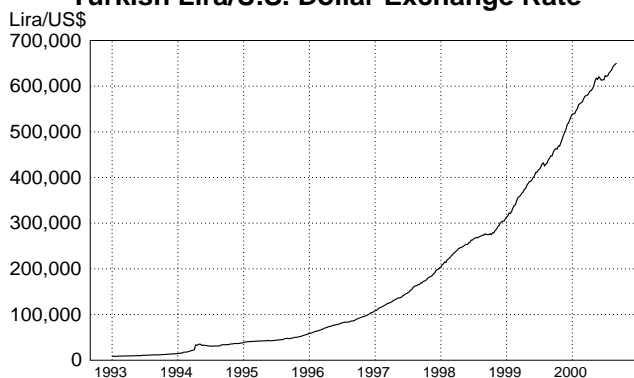
The current-account deficit reached US\$4.5 billion during the January-May period. Over the same period last year,

the current account registered a surplus of US\$431 million. Exports rose by 9% year/year in the first five months of the year, including the shuttle trade that expanded by 46% year/year. Most strikingly, tourism revenues displayed an excellent performance by rising 42% year/year during January-April and we expect the improvement to escalate further in the coming months. Despite the deterioration of the current account, we still believe that there is little need for worry about the exchange-rate framework. However, as all economic indicators point to a fast pickup in economic activity and domestic demand, the government will have to take fiscal measures to slow the deterioration in the current-account deficit.

**Tevfik Aksoy**  
tevfik.aksoy@db.com

Istanbul, 90 212 265-0268

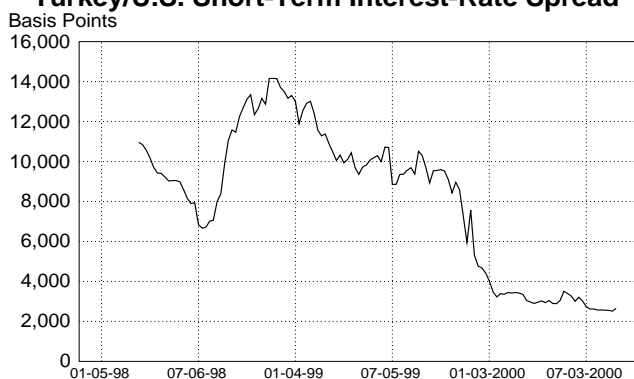
**Turkish Lira/U.S. Dollar Exchange Rate**



**Turkey's Real Effective Exchange Rate**



**Turkey/U.S. Short-Term Interest-Rate Spread**



**Turkey's Stock Market**



### Turkey's Annual Economic Data

|                   |             | 1994  | 1995 | 1996 | 1997 | 1998 | 1999  | 2000f | 2001f |
|-------------------|-------------|-------|------|------|------|------|-------|-------|-------|
| Real GDP          | (yoy % chg) | -5.5  | 7.2  | 7.1  | 8.3  | 3.8  | -6.1  | 5.0   | 5.0   |
| Consumer Prices   | (yoy % chg) | 125.4 | 78.9 | 79.8 | 99.1 | 69.7 | 68.8  | 34.5  | 20.0  |
| Current Acc't Bal | (% of GDP)  | 2.0   | -1.4 | -1.3 | -1.4 | 0.9  | -0.7  | -4.0  | -3.6  |
| FX Reserves       | (US\$ bn)   | 8.6   | 13.9 | 16.5 | 18.7 | 19.8 | 23.2  | 26.0  | -     |
| Budget Balance    | (% of GDP)  | -7.9  | -5.4 | -8.9 | -7.4 | -7.1 | -11.5 | -11.0 | -6.2  |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## South African Rand

At the time of writing, the rand is at its best trade-weighted value in the past four months. Some of this highlights the rand's response to a weaker euro and sterling, which make up 50.6% of the rand's trade weighted index. It also reflects the technical benefit to the trade-weighted index of the 24% ZWD devaluation by the Reserve Bank of Zimbabwe on 1 August (a 2.27% TWI weighting). As a confidence indicator, the current trade-weighted index value suggests that the full extent of Zimbabwe-contagion has now been priced out of the exchange rate, given that the onset of this problem for South Africa's foreign-exchange market was the start of May. This conclusion is also evident in a strong return of portfolio investor flows. At the height of "Zimbabwe-contagion", quarterly capital outflows reached a nadir of US\$2 billion but have since recovered to a positive US\$1 bil-

lion inflow. These flows also show the benefits akin to other emerging markets from the Fed's August policy action as well as government's elaboration of its privatisation intentions over the next three years on 10 August.

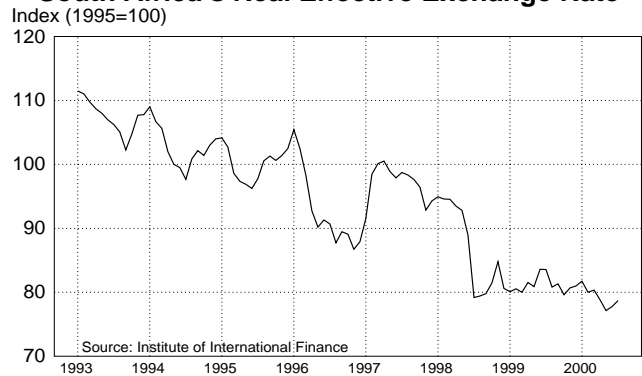
The rand has simultaneously been underpinned by an improving current-account profile, posting a modest second quarter US\$800 million surplus. In part, this has been due to the negative impact on business confidence from financial market volatility during the quarter, resulting in postponed import decisions. Meanwhile, exports—led by booming platinum revenues—have continued to perform exceptionally well, even given the negative impact of this year's oil price shock for South Africa.

**Gordon Smith** Johannesburg, (27-11) 322-6711  
[gordon.smith@db.com](mailto:gordon.smith@db.com)

**South African Rand/U.S. Dollar Exchange Rate**



**South Africa's Real Effective Exchange Rate**



**S. Africa/U.S. Short-Term Interest-Rate Spread**



**South Africa's Stock Market**



### South Africa's Annual Economic Data

|                   |             | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000f | 2001f |
|-------------------|-------------|------|------|------|------|------|------|-------|-------|
| Real GDP          | (yoy % chg) | 2.7  | 3.4  | 3.2  | 1.7  | 0.5  | 1.2  | 3.0   | 3.5   |
| Consumer Prices   | (yoy % chg) | 9.9  | 6.9  | 9.4  | 6.1  | 9.0  | 2.2  | 7.0   | 4.6   |
| Current Acc't Bal | (% of GDP)  | -0.3 | -2.0 | -1.3 | -1.5 | -1.6 | -0.4 | -1.2  | -1.7  |
| FX Reserves       | (US\$ bn)   | 3.3  | 4.5  | 2.3  | 4.8  | 5.4  | 7.4  | -     | -     |
| Budget Balance    | (% of GDP)  | 10.4 | 6.0  | 5.5  | 6.3  | -2.9 | -2.4 | -2.6  | -2.5  |

Source: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

## Israeli Shekel

The shekel's ongoing appreciation (it went from NIS/USD 4.085 to 4.02 in August) puts it only 2% from the strong limit of Israel's crawling currency band. The shekel has been supported by Israel's strong macroeconomic fundamentals and its appreciation has occurred despite a substantial and persistent narrowing of the interest-rate differential between Israel and developed countries.

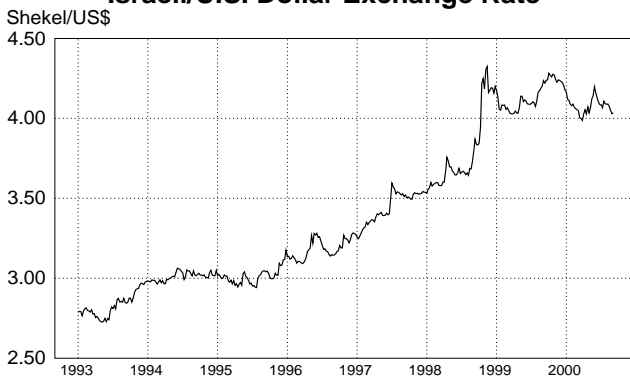
The central bank is pressing to abolish the currency band and to adopt a free float of the shekel, thus sidestepping the immediate need to intervene in the foreign-exchange market to protect the band. But the government is balking, wanting to protect Israeli exporters from further nominal strengthening of the shekel. A compromise is therefore expected in the form of a reduction of the slope of the strong limit of the band being reduced from its cur-

rent rate of 2% per year to 0%. While this will buy the central bank some time, the move towards a greater degree of flexibility seems inevitable and eventually the band will be abolished.

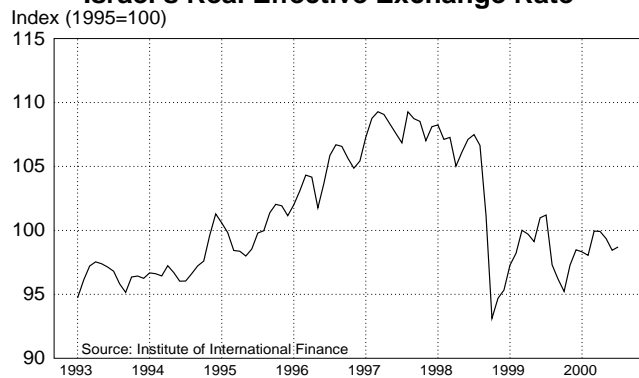
Near term, the possibility of changes in the band seems to have contributed to the pace of shekel appreciation to the band's strong limit. Towards the end of the year, however, we expect some weakening of the shekel to NIS/USD 4.10-4.15 due to further reductions of the Bank of Israel's key interest rate, an increase of interest rates in Europe and perhaps in the U.S., and a renewal of domestic political tensions after the Knesset (the parliament) returns from its summer recess in late October.

**Leonardo Leiderman** New York, (1) 212 469-5894  
[leonardo.leiderman@db.com](mailto:leonardo.leiderman@db.com)

**Israeli/U.S. Dollar Exchange Rate**



**Israel's Real Effective Exchange Rate**



**Israel/U.S. Short-Term Interest-Rate Spread**



**Israel's Stock Market**



### Israel's Annual Economic Data

| Economic Indicator | Units       | 1990 | 1991 | 1992 | 1993 | 1994 | 1995  | 1996  | 1997 | 1998 | 1999 | 2000f | 2001f |
|--------------------|-------------|------|------|------|------|------|-------|-------|------|------|------|-------|-------|
| Real GDP           | (yoy % chg) | 6.4  | 6.3  | 6.6  | 3.5  | 6.8  | 6.2   | 4.6   | 4.4  | 2.2  | 2.2  | 5.2   | 5.0   |
| Unemployment Rate  | (%)         | 9.5  | 10.4 | 11.2 | 10.3 | 7.9  | 7.0   | 6.6   | 7.7  | 8.6  | 8.9  | 8.7   | 8.1   |
| Consumer Prices    | (yoy % chg) | 17.6 | 18.1 | 9.4  | 11.2 | 14.5 | 8.1   | 10.6  | 7.0  | 8.6  | 1.3  | 1.8   | 3.2   |
| Trade Balance      | (US\$ bn)   | -3.5 | -5.5 | -6.1 | -6.1 | -7.3 | -10.1 | -10.3 | -7.8 | -5.7 | -7.1 | -6.5  | -6.4  |
| Current Acc't Bal. | (US\$ bn)   | 0.2  | -1.3 | -1.0 | -2.6 | -3.4 | -5.2  | -5.4  | -3.7 | -1.0 | -1.9 | -1.7  | -2.6  |
|                    | (% of GDP)  | 0.3  | -2.2 | -1.5 | -3.9 | -4.5 | -6.0  | -5.7  | -3.7 | -1.0 | -1.9 | -1.5  | -2.2  |
| Budget Balance     | (% of GDP)  | -3.7 | -4.0 | -4.1 | -3.5 | -2.3 | -4.1  | -3.8  | -2.7 | -2.4 | -2.2 | -0.8  | -1.5  |
| FX Reserves        | (US\$ bn)   | -    | -    | -    | -    | 6.8  | 8.2   | 11.4  | 20.3 | 22.7 | 22.5 | 23.1  | 23.5  |

Sources: Datastream, OECD, National Accounts Data, Deutsche Bank forecasts

# Central Bank Monitor

## Taylor Rules

A simple and meaningful way to gauge the appropriateness of current monetary policy is through the use of the Taylor Rule. The Taylor Rule relates short-term policy-rate settings to changes in inflation relative to central-bank inflation targets and to changes in output gaps. A simple version can be expressed as:

$$\text{Short-Term Policy Rate} = r^* + i + w_1 * y + w_2 * i_g$$

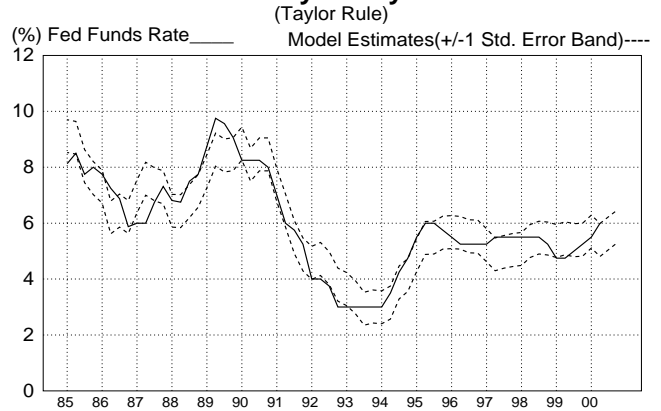
where:

- $r^*$  is the equilibrium real short-term interest rate,
- $i$  is inflation rate over the previous year,
- $y$  is the percentage gap between actual and potential real GDP,
- $i_g$  is the percent deviation of inflation from its targeted level,
- $w_1, w_2$  represent the relative weights placed on output and inflation, respectively.

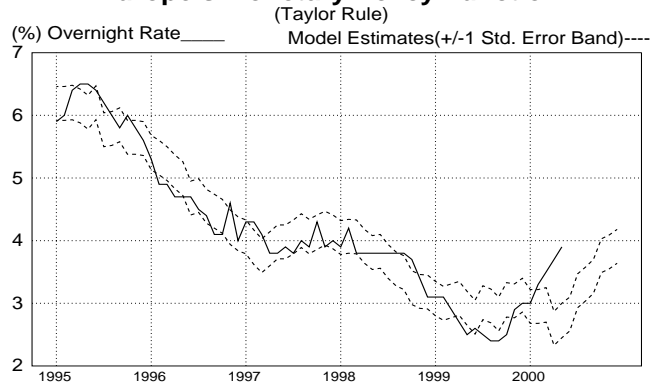
This form of the Taylor Rule assumes that monetary policy is set to attain an equilibrium interest rate consistent with non-inflationary growth. The Taylor Rule specifies a monetary-policy rule that tightens policy when output rises above non-inflationary levels and inflation is rising relative to target.

For each country, we estimate equilibrium short-term interest rates and weights that best reflect the historical response of monetary authorities to changes in economic fundamentals.

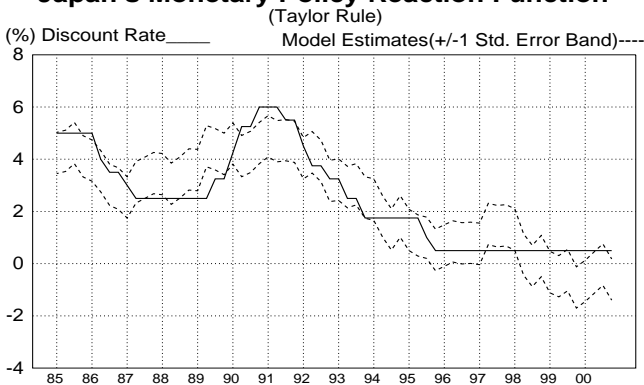
## U.S. Monetary Policy Function



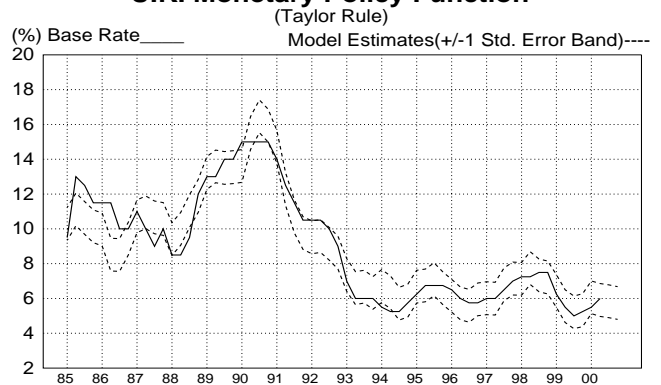
## Europe's Monetary Policy Function



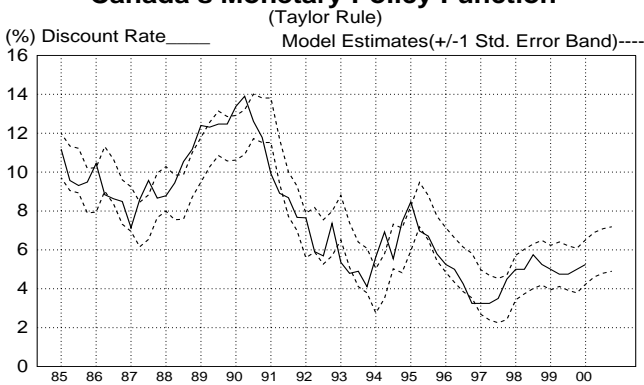
## Japan's Monetary Policy Reaction Function



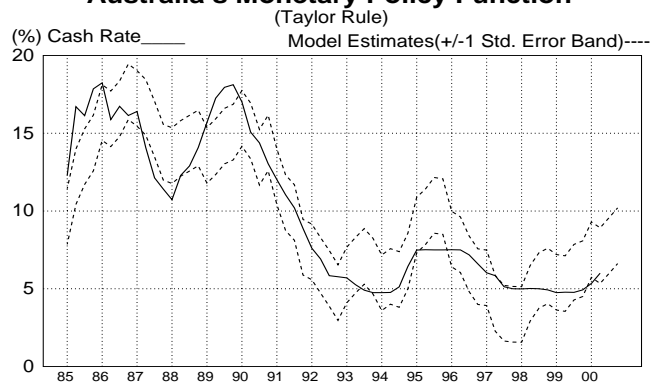
## U.K. Monetary Policy Function



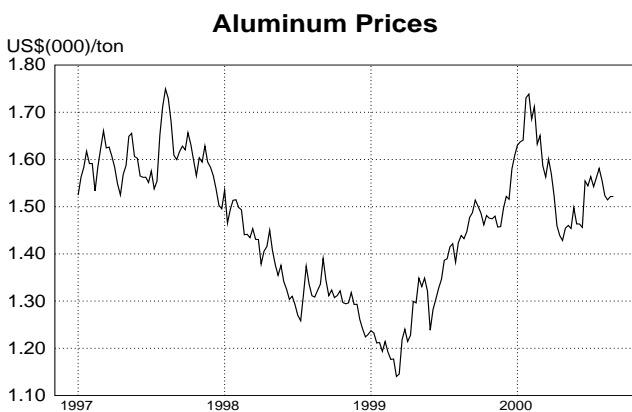
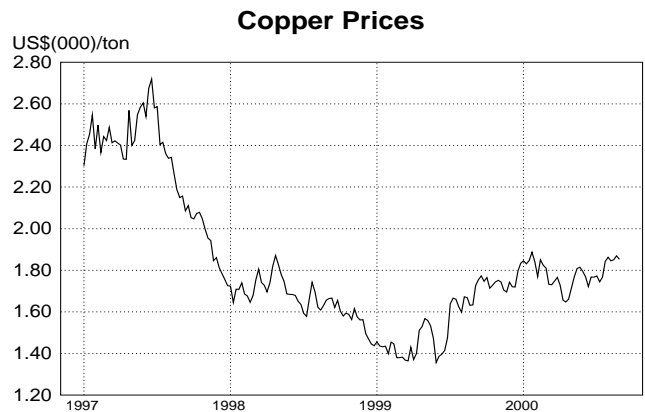
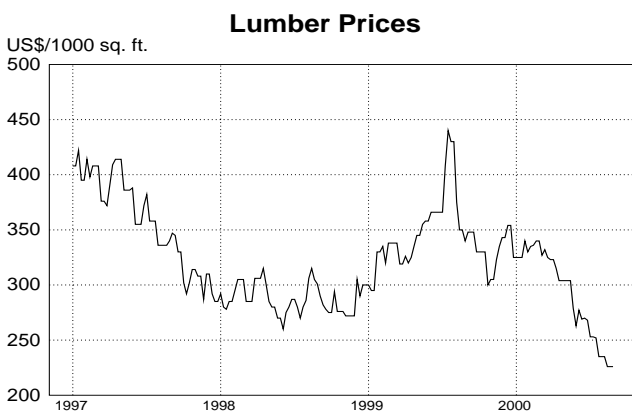
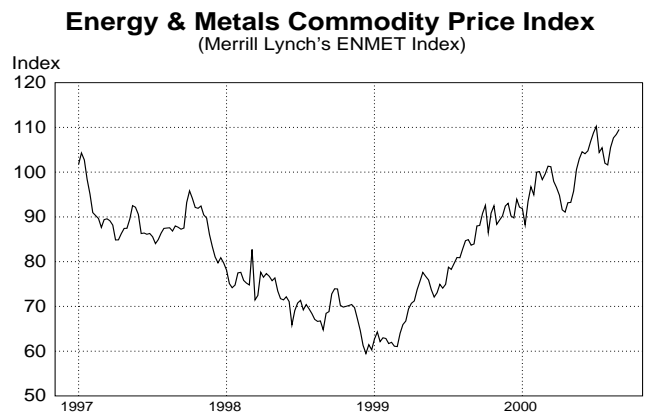
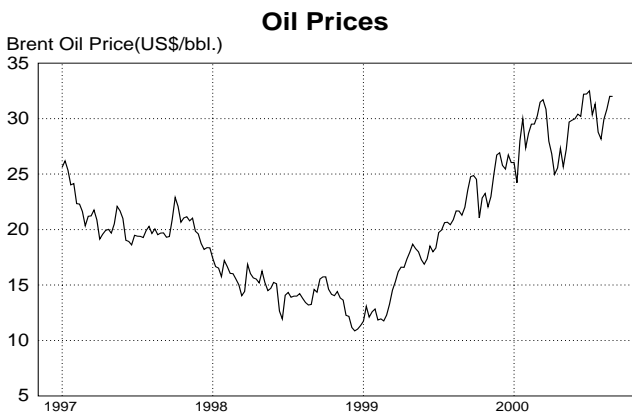
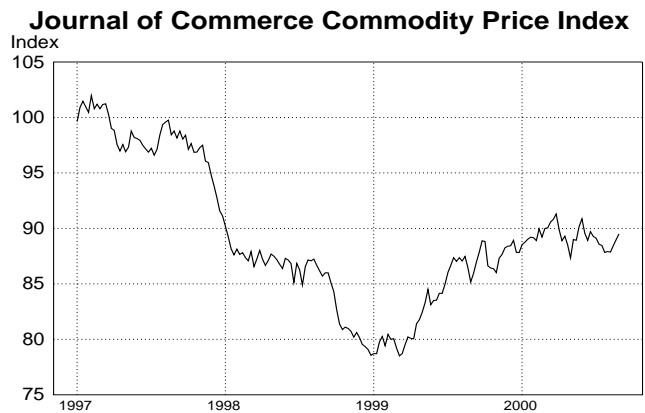
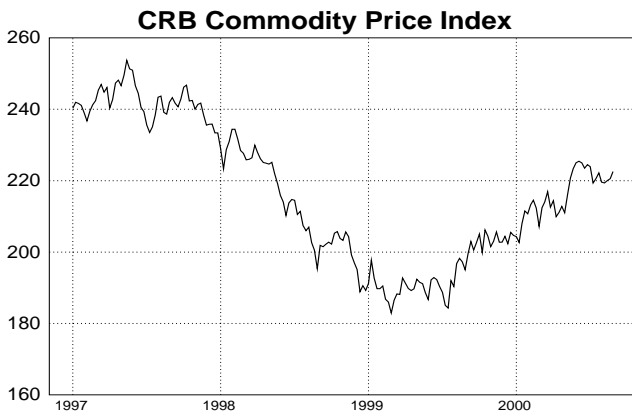
## Canada's Monetary Policy Function



## Australia's Monetary Policy Function



# Commodity Price Monitor



# Money-Market Rate Spreads

## Yield Pickup of Three-Month Foreign Money-Market Rates over Domestic Rates

|                    |                    | Three-Month Foreign Money-Market Rates |      |       |       |        |           |       |        |        |        |        |
|--------------------|--------------------|--|------|-------|-------|--------|-----------|-------|--------|--------|--------|--------|
|                    |                    | U.S.                                   | Euro | Japan | U.K.  | Canada | Australia | N.Z.  | Switz. | Norway | Sweden | Greece |
| <b>US</b>          | Latest             | -                                      | -175 | -622  | -45   | -84    | -21       | -7    | -325   | 41     | -261   | 129    |
|                    | Yield Pickup (bps) |  |      |       |       |        |           |       |        |        |        |        |
|                    | High               | -                                      | -173 | -534  | 13    | -58    | -21       | 15    | -317   | 48     | -186   | 505    |
|                    | Low                | -                                      | -288 | -673  | -64   | -109   | -123      | -130  | -445   | -43    | -281   | 114    |
|                    | Euro-\$ Rate       |  |      |       |       |        |           |       |        |        |        |        |
|                    | Avg                | -                                      | -247 | -607  | -24   | -88    | -58       | -36   | -378   | -4     | -237   | 269    |
|                    | Z-Score            | -                                      | 2.54 | -0.42 | -0.88 | 0.33   | 1.78      | 0.73  | 1.36   | 1.77   | -1.05  | -1.18  |
| <b>Euros</b>       | Latest             | 175                                    | -    | -447  | 130   | 91     | 154       | 168   | -150   | 216    | -86    | 304    |
|                    | Yield Pickup (bps) |  |      |       |       |        |           |       |        |        |        |        |
|                    | High               | 288                                    | -    | -258  | 284   | 222    | 234       | 245   | -94    | 324    | 65     | 760    |
|                    | Low                | 173                                    | -    | -447  | 130   | 91     | 147       | 148   | -169   | 196    | -86    | 304    |
|                    | Euro Rate          |  |      |       |       |        |           |       |        |        |        |        |
|                    | Avg                | 247                                    | -    | -360  | 223   | 159    | 189       | 211   | -132   | 242    | 10     | 516    |
|                    | Z-Score            | -2.54                                  | -    | -1.46 | -2.03 | -2.39  | -1.45     | -1.78 | -0.94  | -0.80  | -2.35  | -1.49  |
| <b>Japan</b>       | Latest             | 622                                    | 447  | -     | 577   | 538    | 601       | 615   | 297    | 663    | 361    | 751    |
|                    | Yield Pickup (bps) |  |      |       |       |        |           |       |        |        |        |        |
|                    | High               | 673                                    | 447  | -     | 620   | 581    | 623       | 670   | 323    | 671    | 415    | 1082   |
|                    | Low                | 534                                    | 258  | -     | 508   | 467    | 470       | 469   | 89     | 530    | 305    | 751    |
|                    | Euro-¥ Rate        |  |      |       |       |        |           |       |        |        |        |        |
|                    | Avg                | 607                                    | 360  | -     | 583   | 519    | 549       | 571   | 228    | 603    | 370    | 876    |
|                    | Z-Score            | 0.42                                   | 1.46 | -     | -0.22 | 0.51   | 1.17      | 0.64  | 0.96   | 1.52   | -0.30  | -1.39  |
| <b>U.K.</b>        | Latest             | 45                                     | -130 | -577  | -     | -39    | 24        | 38    | -280   | 86     | -216   | 174    |
|                    | Yield Pickup (bps) |  |      |       |       |        |           |       |        |        |        |        |
|                    | High               | 64                                     | -130 | -508  | -     | -20    | 24        | 70    | -266   | 91     | -187   | 532    |
|                    | Low                | -13                                    | -284 | -620  | -     | -103   | -113      | -119  | -433   | -40    | -243   | 161    |
|                    | Euro-£ Rate        |  |      |       |       |        |           |       |        |        |        |        |
|                    | Avg                | 24                                     | -223 | -583  | -     | -64    | -34       | -12   | -354   | 20     | -212   | 293    |
|                    | Z-Score            | 0.88                                   | 2.03 | 0.22  | -     | 0.95   | 1.91      | 0.95  | 1.38   | 1.67   | -0.25  | -1.08  |
| <b>Canada</b>      | Latest             | 84                                     | -91  | -538  | 39    | -      | 63        | 77    | -241   | 125    | -177   | 213    |
|                    | Yield Pickup (bps) |  |      |       |       |        |           |       |        |        |        |        |
|                    | High               | 109                                    | -91  | -467  | 103   | -      | 63        | 101   | -239   | 128    | -103   | 608    |
|                    | Low                | 58                                     | -222 | -581  | 20    | -      | -34       | -41   | -384   | 46     | -198   | 200    |
|                    | Euro-C\$ Rate      |  |      |       |       |        |           |       |        |        |        |        |
|                    | Avg                | 88                                     | -159 | -519  | 64    | -      | 30        | 52    | -290   | 84     | -149   | 357    |
|                    | Z-Score            | -0.33                                  | 2.39 | -0.51 | -0.95 | -      | 1.83      | 0.70  | 1.26   | 1.78   | -1.19  | -1.19  |
| <b>Australia</b>   | Latest             | 21                                     | -154 | -601  | -24   | -63    | -         | 14    | -304   | 62     | -240   | 150    |
|                    | Yield Pickup (bps) |  |      |       |       |        |           |       |        |        |        |        |
|                    | High               | 123                                    | -147 | -470  | 113   | 34     | -         | 78    | -261   | 142    | -114   | 574    |
|                    | Low                | 21                                     | -234 | -623  | -24   | -63    | -         | -29   | -389   | 9      | -240   | 150    |
|                    | Euro-A\$ Rate      |  |      |       |       |        |           |       |        |        |        |        |
|                    | Avg                | 58                                     | -189 | -549  | 34    | -30    | -         | 22    | -320   | 54     | -179   | 327    |
|                    | Z-Score            | -1.78                                  | 1.45 | -1.17 | -1.91 | -1.83  | -         | -0.32 | 0.45   | 0.24   | -2.21  | -1.36  |
| <b>N.Z.</b>        | Latest             | 7                                      | -168 | -615  | -38   | -77    | -14       | -     | -318   | 48     | -254   | 136    |
|                    | Yield Pickup (bps) |  |      |       |       |        |           |       |        |        |        |        |
|                    | High               | 130                                    | -148 | -469  | 119   | 41     | 29        | -     | -259   | 149    | -108   | 574    |
|                    | Low                | -15                                    | -245 | -670  | -70   | -101   | -78       | -     | -395   | -40    | -287   | 109    |
|                    | Euro-NZ\$ Rate     |  |      |       |       |        |           |       |        |        |        |        |
|                    | Avg                | 36                                     | -211 | -571  | 12    | -52    | -22       | -     | -343   | 31     | -201   | 305    |
|                    | Z-Score            | -0.73                                  | 1.78 | -0.64 | -0.95 | -0.70  | 0.32      | -     | 0.90   | 0.35   | -1.13  | -1.11  |
| <b>Switzerland</b> | Latest             | 325                                    | 150  | -297  | 280   | 241    | 304       | 318   | -      | 366    | 64     | 454    |
|                    | Yield Pickup (bps) |  |      |       |       |        |           |       |        |        |        |        |
|                    | High               | 445                                    | 169  | -89   | 433   | 384    | 389       | 395   | -      | 489    | 216    | 905    |
|                    | Low                | 317                                    | 94   | -323  | 266   | 239    | 261       | 259   | -      | 314    | 64     | 439    |
|                    | Euro-Sfr Rate      |  |      |       |       |        |           |       |        |        |        |        |
|                    | Avg                | 378                                    | 132  | -228  | 354   | 290    | 320       | 343   | -      | 374    | 142    | 648    |
|                    | Z-Score            | -1.36                                  | 0.94 | -0.96 | -1.38 | -1.26  | -0.45     | -0.90 | -      | -0.18  | -1.63  | -1.27  |
| <b>Norway</b>      | Latest             | -41                                    | -216 | -663  | -86   | -125   | -62       | -48   | -366   | -      | -302   | 88     |
|                    | Yield Pickup (bps) |  |      |       |       |        |           |       |        |        |        |        |
|                    | High               | 43                                     | -196 | -530  | 40    | -46    | -9        | 40    | -314   | -      | -163   | 493    |
|                    | Low                | -48                                    | -324 | -671  | -91   | -128   | -142      | -149  | -489   | -      | -302   | 85     |
|                    | Euro-Nkr Rate      |  |      |       |       |        |           |       |        |        |        |        |
|                    | Avg                | 4                                      | -242 | -603  | -20   | -84    | -54       | -31   | -374   | -      | -232   | 274    |
|                    | Z-Score            | -1.77                                  | 0.80 | -1.52 | -1.67 | -1.78  | -0.24     | -0.35 | 0.18   | -      | -1.89  | -1.58  |
| <b>Sweden</b>      | Latest             | 261                                    | 86   | -361  | 216   | 177    | 240       | 254   | -64    | 302    | -      | 390    |
|                    | Yield Pickup (bps) |  |      |       |       |        |           |       |        |        |        |        |
|                    | High               | 281                                    | 86   | -305  | 243   | 198    | 240       | 287   | -64    | 302    | -      | 735    |
|                    | Low                | 186                                    | -65  | -415  | 187   | 103    | 114       | 108   | -216   | 163    | -      | 360    |
|                    | Euro-Skr Rate      |  |      |       |       |        |           |       |        |        |        |        |
|                    | Avg                | 237                                    | -10  | -370  | 212   | 149    | 179       | 201   | -142   | 232    | -      | 506    |
|                    | Z-Score            | 1.05                                   | 2.35 | 0.30  | 0.25  | 1.19   | 2.21      | 1.13  | 1.63   | 1.89   | -      | -1.01  |
| <b>Greece</b>      | Latest             | -129                                   | -304 | -751  | -174  | -213   | -150      | -136  | -454   | -88    | -390   | -      |
|                    | Yield Pickup (bps) |  |      |       |       |        |           |       |        |        |        |        |
|                    | High               | -114                                   | -304 | -751  | -161  | -200   | -150      | -109  | -439   | -85    | -360   | -      |
|                    | Low                | -505                                   | -760 | -1082 | -532  | -608   | -574      | -574  | -905   | -493   | -735   | -      |
|                    | Euro-Gdr Rate      |  |      |       |       |        |           |       |        |        |        |        |
|                    | Avg                | -269                                   | -516 | -876  | -293  | -357   | -327      | -305  | -648   | -274   | -506   | -      |
|                    | Z-Score            | 1.18                                   | 1.49 | 1.39  | 1.08  | 1.19   | 1.36      | 1.11  | 1.27   | 1.58   | 1.01   | -      |

Notes: Averages, highs, and lows are based on weekly data for the past year. A Z-score is the number of standard deviations that the latest observation lies away from its average. Yield spreads with Z-scores greater than 1.96 are considered to be significantly different from their 52-week averages.



# Bond-Market Yield Spreads: 10-Year Bonds

## Yield Pickup of 10-Year Foreign Bonds over Domestic Bonds

|                    |                    | 10-Year Foreign Bonds |       |       |       |        |           |       |        |        |        |        |
|--------------------|--------------------|-----------------------|-------|-------|-------|--------|-----------|-------|--------|--------|--------|--------|
|                    |                    | U.S.                  | Euro  | Japan | U.K.  | Canada | Australia | N.Z.  | Switz. | Norway | Sweden | Greece |
| <b>U.S.</b>        | Latest             | -                     | -49   | -403  | -64   | -12    | 31        | 78    | -220   | 34     | -62    | 55     |
|                    | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                    | High               | -                     | -48   | -403  | -23   | 10     | 57        | 109   | -193   | 34     | -15    | 132    |
|                    | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
|                    | Low                | -                     | -103  | -509  | -123  | -43    | -9        | 59    | -316   | -35    | -135   | -10    |
| U.S. Treasuries    | Avg                | -                     | -79   | -443  | -84   | -16    | 31        | 83    | -253   | -2     | -66    | 47     |
|                    | Z-Score            | -                     | 1.94  | 1.45  | 0.83  | 0.38   | -0.00     | -0.44 | 1.00   | 1.94   | 0.14   | 0.25   |
| <b>Euro</b>        | Latest             | 49                    | -     | -355  | -15   | 36     | 79        | 126   | -171   | 83     | -13    | 104    |
|                    | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                    | High               | 103                   | -     | -311  | 45    | 97     | 154       | 199   | -128   | 91     | 53     | 194    |
|                    | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
|                    | Low                | 48                    | -     | -407  | -30   | 34     | 64        | 124   | -216   | 64     | -49    | 89     |
| Euro Bonds         | Avg                | 79                    | -     | -364  | -5    | 63     | 110       | 162   | -175   | 76     | 13     | 125    |
|                    | Z-Score            | -1.94                 | -     | 0.46  | -0.56 | -1.64  | -1.15     | -1.79 | 0.15   | 0.89   | -0.99  | -0.81  |
| <b>Japan</b>       | Latest             | 403                   | 355   | -     | 339   | 391    | 434       | 481   | 184    | 437    | 341    | 458    |
|                    | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                    | High               | 509                   | 407   | -     | 416   | 489    | 560       | 584   | 245    | 475    | 434    | 581    |
|                    | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
|                    | Low                | 403                   | 311   | -     | 319   | 378    | 434       | 481   | 112    | 396    | 322    | 445    |
| Japanese Bonds     | Avg                | 443                   | 364   | -     | 360   | 427    | 474       | 526   | 190    | 441    | 377    | 490    |
|                    | Z-Score            | -1.45                 | -0.46 | -     | -0.84 | -1.37  | -1.20     | -1.78 | -0.20  | -0.19  | -1.24  | -1.32  |
| <b>U.K.</b>        | Latest             | 64                    | 15    | -339  | -     | 52     | 95        | 141   | -156   | 98     | 2      | 119    |
|                    | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                    | High               | 123                   | 30    | -319  | -     | 102    | 159       | 198   | -112   | 109    | 45     | 191    |
|                    | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
|                    | Low                | 23                    | -45   | -416  | -     | 7      | 52        | 109   | -242   | 45     | -24    | 78     |
| U.K. Gilts         | Avg                | 84                    | 5     | -360  | -     | 68     | 114       | 167   | -170   | 81     | 18     | 130    |
|                    | Z-Score            | -0.83                 | 0.56  | 0.84  | -     | -0.73  | -0.79     | -1.25 | 0.37   | 1.02   | -1.01  | -0.55  |
| <b>Canada</b>      | Latest             | 12                    | -36   | -391  | -52   | -      | 43        | 90    | -208   | 46     | -50    | 67     |
|                    | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                    | High               | 43                    | -34   | -378  | -7    | -      | 72        | 130   | -183   | 46     | 2      | 127    |
|                    | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
|                    | Low                | -10                   | -97   | -489  | -102  | -      | 15        | 75    | -295   | -17    | -115   | 11     |
| Canadian Bonds     | Avg                | 16                    | -63   | -427  | -68   | -      | 47        | 99    | -238   | 14     | -50    | 62     |
|                    | Z-Score            | -0.38                 | 1.64  | 1.37  | 0.73  | -      | -0.24     | -0.86 | 0.87   | 1.85   | 0.01   | 0.16   |
| <b>Australia</b>   | Latest             | -31                   | -79   | -434  | -95   | -43    | -         | 47    | -251   | 3      | -93    | 24     |
|                    | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                    | High               | 9                     | -64   | -434  | -52   | -15    | -         | 78    | -212   | 13     | -49    | 77     |
|                    | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
|                    | Low                | -57                   | -154  | -560  | -159  | -72    | -         | 23    | -359   | -87    | -136   | -57    |
| Australian Bonds   | Avg                | -31                   | -110  | -474  | -114  | -47    | -         | 52    | -284   | -33    | -97    | 16     |
|                    | Z-Score            | 0.00                  | 1.15  | 1.20  | 0.79  | 0.24   | -         | -0.46 | 0.72   | 1.32   | 0.19   | 0.24   |
| <b>N.Z.</b>        | Latest             | -78                   | -126  | -481  | -141  | -90    | -47       | -     | -297   | -43    | -140   | -23    |
|                    | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                    | High               | -59                   | -124  | -481  | -109  | -75    | -23       | -     | -275   | -43    | -106   | 31     |
|                    | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
|                    | Low                | -109                  | -199  | -584  | -198  | -130   | -78       | -     | -398   | -119   | -204   | -91    |
| N.Z. Bonds         | Avg                | -83                   | -162  | -526  | -167  | -99    | -52       | -     | -337   | -86    | -149   | -37    |
|                    | Z-Score            | 0.44                  | 1.79  | 1.78  | 1.25  | 0.86   | 0.46      | -     | 1.00   | 2.01   | 0.47   | 0.49   |
| <b>Switzerland</b> | Latest             | 220                   | 171   | -184  | 156   | 208    | 251       | 297   | -      | 254    | 158    | 275    |
|                    | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                    | High               | 316                   | 216   | -112  | 242   | 295    | 359       | 398   | -      | 291    | 260    | 392    |
|                    | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
|                    | Low                | 193                   | 128   | -245  | 112   | 183    | 212       | 275   | -      | 205    | 99     | 245    |
| Swiss Bonds        | Avg                | 253                   | 175   | -190  | 170   | 238    | 284       | 337   | -      | 251    | 188    | 300    |
|                    | Z-Score            | -1.00                 | -0.15 | 0.20  | -0.37 | -0.87  | -0.72     | -1.00 | -      | 0.11   | -0.62  | -0.63  |
| <b>Norway</b>      | Latest             | -34                   | -83   | -437  | -98   | -46    | -3        | 43    | -254   | -      | -96    | 21     |
|                    | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                    | High               | 35                    | -64   | -396  | -45   | 17     | 87        | 119   | -205   | -      | -31    | 112    |
|                    | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
|                    | Low                | -34                   | -91   | -475  | -109  | -46    | -13       | 43    | -291   | -      | -118   | 19     |
| Norwegian Bonds    | Avg                | 2                     | -76   | -441  | -81   | -14    | 33        | 86    | -251   | -      | -64    | 49     |
|                    | Z-Score            | -1.94                 | -0.89 | 0.19  | -1.02 | -1.85  | -1.32     | -2.01 | -0.11  | -      | -1.33  | -1.21  |
| <b>Sweden</b>      | Latest             | 62                    | 13    | -341  | -2    | 50     | 93        | 140   | -158   | 96     | -      | 117    |
|                    | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                    | High               | 135                   | 49    | -322  | 24    | 115    | 136       | 204   | -99    | 118    | -      | 161    |
|                    | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
|                    | Low                | 15                    | -53   | -434  | -45   | -2     | 49        | 106   | -260   | 31     | -      | 62     |
| Swedish Bonds      | Avg                | 66                    | -13   | -377  | -18   | 50     | 97        | 149   | -188   | 64     | -      | 112    |
|                    | Z-Score            | -0.14                 | 0.99  | 1.24  | 1.01  | -0.01  | -0.19     | -0.47 | 0.62   | 1.33   | -      | 0.19   |
| <b>Greece</b>      | Latest             | -55                   | -104  | -458  | -119  | -67    | -24       | 23    | -275   | -21    | -117   | -      |
|                    | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                    | High               | 10                    | -89   | -445  | -78   | -11    | 57        | 91    | -245   | -19    | -62    | -      |
|                    | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
|                    | Low                | -132                  | -194  | -581  | -191  | -127   | -77       | -31   | -392   | -112   | -161   | -      |
| Greek Bonds        | Avg                | -47                   | -125  | -490  | -130  | -62    | -16       | 37    | -300   | -49    | -112   | -      |
|                    | Z-Score            | -0.25                 | 0.81  | 1.32  | 0.55  | -0.16  | -0.24     | -0.49 | 0.63   | 1.21   | -0.19  | -      |

Notes: Averages, highs, and lows are based on weekly data for the past year. A Z-score is the number of standard deviations that the latest observation lies away from its average. Yield spreads with Z-scores greater than 1.96 are considered to be significantly different from their 52-week averages.

# Currency-Hedged Bonds

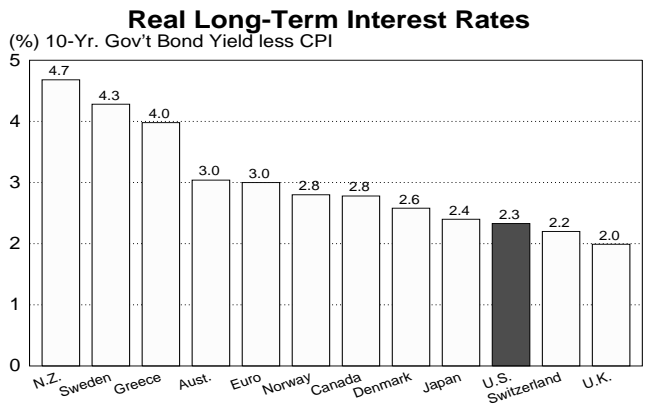
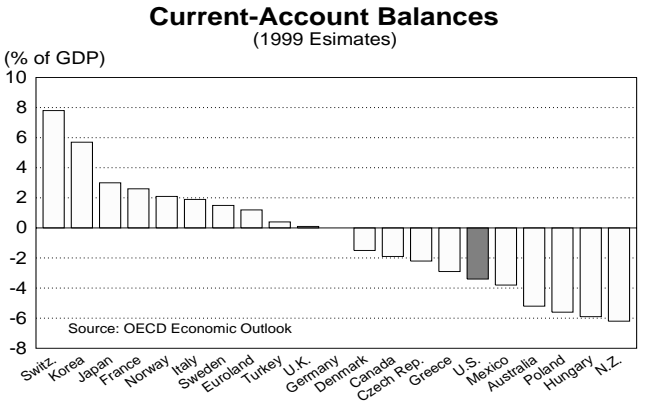
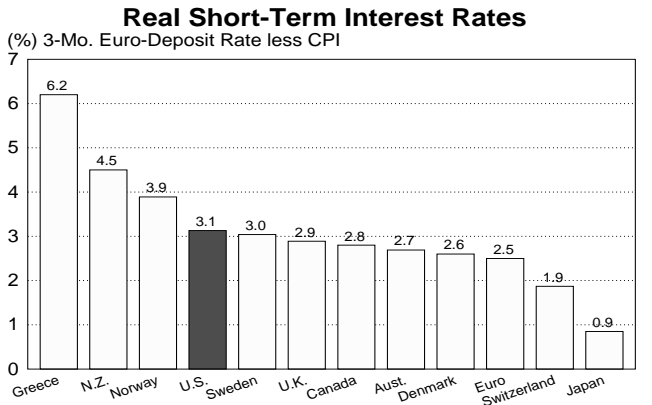
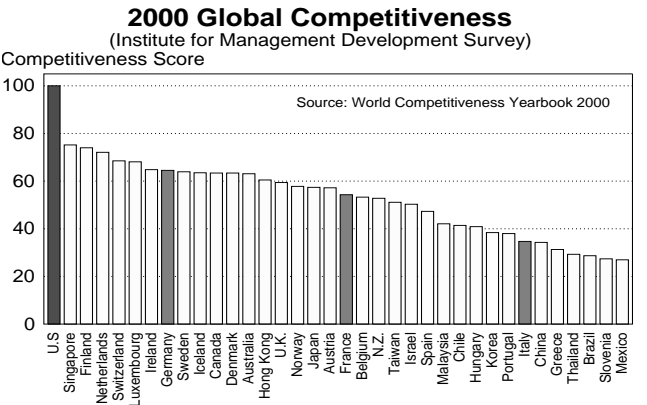
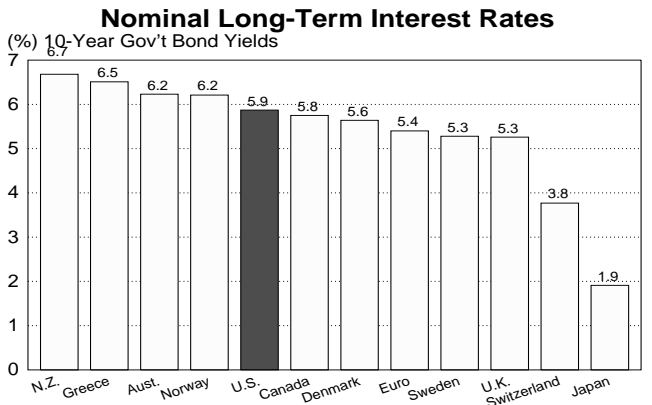
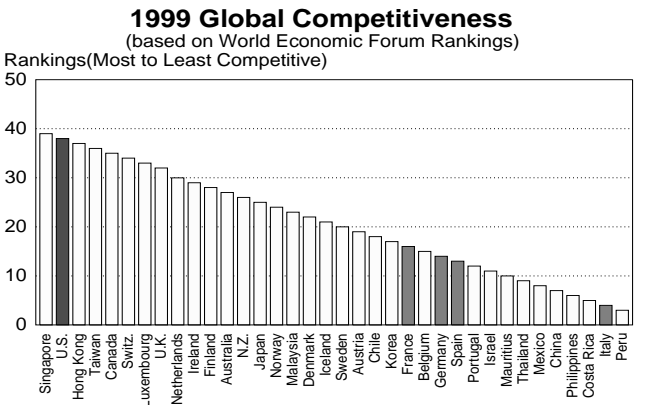
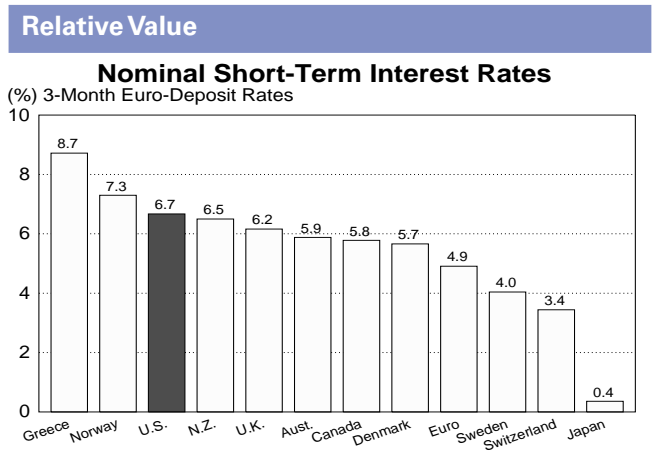
## Yield Pickup of Hedged 10-Year Foreign Bonds over Domestic Bonds

|                         |                    | 10-Year Foreign Bonds |       |       |       |        |           |       |        |        |        |        |
|-------------------------|--------------------|-----------------------|-------|-------|-------|--------|-----------|-------|--------|--------|--------|--------|
|                         |                    | U.S.                  | Euro  | Japan | U.K.  | Canada | Australia | N.Z.  | Switz. | Norway | Sweden | Greece |
| <b>Hedged into US\$</b> | Latest             | -                     | 126   | 219   | -18   | 72     | 52        | 85    | 105    | -7     | 199    | -74    |
|                         | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                         | High               | -                     | 218   | 229   | 6     | 111    | 179       | 231   | 169    | 36     | 239    | -61    |
|                         | Low                | -                     | 125   | 77    | -122  | 27     | 45        | 56    | 60     | -60    | 114    | -437   |
|                         | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
| U.S. Treasuries         | Avg                | -                     | 168   | 164   | -59   | 72     | 89        | 119   | 125    | 2      | 171    | -223   |
| (3-mo. roll)            | Z-Score            | -                     | -1.79 | 1.29  | 1.23  | 0.01   | -1.18     | -0.70 | -0.84  | -0.52  | 0.97   | 1.38   |
| <b>Hedged into €</b>    | Latest             | -126                  | -     | 92    | -145  | -54    | -75       | -42   | -21    | -133   | 73     | -200   |
|                         | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                         | High               | -125                  | -     | 92    | -141  | -54    | -38       | 17    | 4      | -127   | 73     | -195   |
|                         | Low                | -218                  | -     | -93   | -285  | -165   | -130      | -109  | -107   | -239   | -48    | -604   |
|                         | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
| Euro Bonds              | Avg                | -168                  | -     | -4    | -227  | -96    | -79       | -49   | -43    | -166   | 3      | -391   |
| (3-mo. roll)            | Z-Score            | 1.79                  | -     | 1.68  | 2.20  | 1.61   | 0.20      | 0.22  | 0.99   | 1.12   | 2.63   | 1.52   |
| <b>Hedged into ¥</b>    | Latest             | -219                  | -92   | -     | -237  | -146   | -167      | -134  | -113   | -225   | -20    | -293   |
|                         | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                         | High               | -77                   | 93    | -     | -140  | -9     | 29        | 81    | 43     | -87    | 82     | -280   |
|                         | Low                | -229                  | -92   | -     | -278  | -164   | -172      | -163  | -115   | -234   | -65    | -597   |
|                         | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
| Japanese Bonds          | Avg                | -164                  | 4     | -     | -223  | -92    | -75       | -45   | -39    | -162   | 7      | -386   |
| (3-mo. roll)            | Z-Score            | -1.29                 | -1.68 | -     | -0.39 | -1.20  | -1.45     | -1.11 | -1.58  | -1.57  | -0.54  | 1.16   |
| <b>Hedged into £</b>    | Latest             | 18                    | 145   | 237   | -     | 91     | 70        | 103   | 124    | 12     | 218    | -55    |
|                         | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                         | High               | 122                   | 285   | 278   | -     | 188    | 223       | 266   | 241    | 129    | 280    | -28    |
|                         | Low                | -6                    | 141   | 140   | -     | 64     | 70        | 83    | 124    | -14    | 190    | -382   |
|                         | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
| U.K. Gilts              | Avg                | 59                    | 227   | 223   | -     | 131    | 148       | 178   | 184    | 61     | 230    | -163   |
| (3-mo. roll)            | Z-Score            | -1.23                 | -2.20 | 0.39  | -     | -1.12  | -1.78     | -1.32 | -2.06  | -1.27  | -0.58  | 1.03   |
| <b>Hedged into C\$</b>  | Latest             | -72                   | 54    | 146   | -91   | -      | -20       | 12    | 33     | -79    | 127    | -146   |
|                         | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                         | High               | -27                   | 165   | 164   | -64   | -      | 84        | 137   | 125    | -35    | 165    | -130   |
|                         | Low                | -111                  | 54    | 9     | -188  | -      | -22       | -11   | -8     | -123   | 53     | -547   |
|                         | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
| Canadian Bonds          | Avg                | -72                   | 96    | 92    | -131  | -      | 17        | 47    | 53     | -70    | 99     | -295   |
| (3-mo. roll)            | Z-Score            | -0.01                 | -1.61 | 1.20  | 1.12  | -      | -1.52     | -0.82 | -0.74  | -0.44  | 1.03   | 1.30   |
| <b>Hedged into A\$</b>  | Latest             | -52                   | 75    | 167   | -70   | 20     | -         | 33    | 53     | -59    | 147    | -126   |
|                         | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                         | High               | -45                   | 130   | 172   | -70   | 22     | -         | 70    | 100    | -29    | 147    | -120   |
|                         | Low                | -179                  | 38    | -29   | -223  | -84    | -         | -15   | -50    | -177   | 29     | -563   |
|                         | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
| Australian Bonds        | Avg                | -89                   | 79    | 75    | -148  | -17    | -         | 30    | 36     | -87    | 82     | -312   |
| (3-mo. roll)            | Z-Score            | 1.18                  | -0.20 | 1.45  | 1.78  | 1.52   | -         | 0.12  | 0.55   | 0.76   | 2.28   | 1.41   |
| <b>Hedged into NZ\$</b> | Latest             | -85                   | 42    | 134   | -103  | -12    | -33       | -     | 21     | -91    | 114    | -159   |
|                         | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                         | High               | -56                   | 109   | 163   | -83   | 11     | 15        | -     | 86     | -43    | 128    | -128   |
|                         | Low                | -231                  | -17   | -81   | -266  | -137   | -70       | -     | -102   | -230   | -10    | -613   |
|                         | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
| N.Z. Bonds              | Avg                | -119                  | 49    | 45    | -178  | -47    | -30       | -     | 6      | -117   | 52     | -342   |
| (3-mo. roll)            | Z-Score            | 0.70                  | -0.22 | 1.11  | 1.32  | 0.82   | -0.12     | -     | 0.34   | 0.47   | 1.59   | 1.22   |
| <b>Hedged into Sfr</b>  | Latest             | -105                  | 21    | 113   | -124  | -33    | -53       | -21   | -      | -112   | 94     | -179   |
|                         | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                         | High               | -60                   | 107   | 115   | -124  | 8      | 50        | 102   | -      | -60    | 94     | -177   |
|                         | Low                | -169                  | -4    | -43   | -241  | -125   | -100      | -86   | -      | -203   | -20    | -571   |
|                         | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
| Swiss Bonds             | Avg                | -125                  | 43    | 39    | -184  | -53    | -36       | -6    | -      | -123   | 46     | -348   |
| (3-mo. roll)            | Z-Score            | 0.84                  | -0.99 | 1.58  | 2.06  | 0.74   | -0.55     | -0.34 | -      | 0.37   | 2.14   | 1.42   |
| <b>Hedged into Nkr</b>  | Latest             | 7                     | 133   | 225   | -12   | 79     | 59        | 91    | 112    | -      | 206    | -67    |
|                         | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                         | High               | 60                    | 239   | 234   | 14    | 123    | 177       | 230   | 203    | -      | 238    | -48    |
|                         | Low                | -36                   | 127   | 87    | -129  | 35     | 29        | 43    | 60     | -      | 101    | -425   |
|                         | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
| Norwegian Bonds         | Avg                | -2                    | 166   | 162   | -61   | 70     | 87        | 117   | 123    | -      | 169    | -225   |
| (3-mo. roll)            | Z-Score            | 0.52                  | -1.12 | 1.57  | 1.27  | 0.44   | -0.76     | -0.47 | -0.37  | -      | 1.01   | 1.51   |
| <b>Hedged into Skr</b>  | Latest             | -199                  | -73   | 20    | -218  | -127   | -147      | -114  | -94    | -206   | -      | -273   |
|                         | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                         | High               | -114                  | 48    | 65    | -190  | -53    | -29       | 10    | 20     | -101   | -      | -235   |
|                         | Low                | -239                  | -73   | -82   | -280  | -165   | -147      | -128  | -94    | -238   | -      | -619   |
|                         | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
| Swedish Bonds           | Avg                | -171                  | -3    | -7    | -230  | -99    | -82       | -52   | -46    | -169   | -      | -393   |
| (3-mo. roll)            | Z-Score            | -0.97                 | -2.63 | 0.54  | 0.58  | -1.03  | -2.28     | -1.59 | -2.14  | -1.01  | -      | 1.01   |
| <b>Hedged into Gdr</b>  | Latest             | 74                    | 200   | 293   | 55    | 146    | 126       | 159   | 179    | 67     | 273    | -      |
|                         | Yield Pickup (bps) |                       |       |       |       |        |           |       |        |        |        |        |
|                         | High               | 437                   | 604   | 597   | 382   | 547    | 563       | 613   | 571    | 425    | 619    | -      |
|                         | Low                | 61                    | 195   | 280   | 28    | 130    | 120       | 128   | 177    | 48     | 235    | -      |
|                         | over 10-Year       |                       |       |       |       |        |           |       |        |        |        |        |
| Greek Bonds             | Avg                | 223                   | 391   | 386   | 163   | 295    | 312       | 342   | 348    | 225    | 393    | -      |
| (3-mo. roll)            | Z-Score            | -1.38                 | -1.52 | -1.16 | -1.03 | -1.30  | -1.41     | -1.22 | -1.42  | -1.51  | -1.01  | -      |

Notes: Three-month rolling hedges. Averages, highs, and lows are based on weekly data for the past year. A Z-score is the number of standard deviations that the latest observation lies away from its average. Yield spreads with Z-scores greater than 1.96 are considered to be significantly different from their 52-week averages.

# Indicators of Competitiveness and Relative Value

| Competitiveness                         |                  |              |                     |
|---|------------------|--------------|---------------------|
| Purchasing Power Parity (PPP) Estimates |                  |              |                     |
| Currency (vs. US\$)                     | Latest Spot Rate | PPP Estimate | % Over/Under-Valued |
| Greek Drachma                           | 358.36           | 248.88       | -44.0               |
| Swedish Krona                           | 8.95             | 6.34         | -41.1               |
| Swiss Franc                             | 1.65             | 1.21         | -36.1               |
| N.Z. Dollar                             | 0.46             | 0.68         | -32.1               |
| Australian Dollar                       | 0.59             | 0.85         | -31.0               |
| Norwegian Krone                         | 8.72             | 6.67         | -30.7               |
| Euro                                    | 0.95             | 1.32         | -27.7               |
| Canadian Dollar                         | 1.48             | 1.19         | -24.0               |
| Danish Krone                            | 7.94             | 6.71         | -18.3               |
| Deutsche Mark                           | 2.08             | 1.76         | -18.2               |
| British Pound                           | 1.51             | 1.59         | -5.0                |
| US\$ Index                              | 109.61           | 93.91        | 16.7                |
| Japanese Yen                            | 108.11           | 138.67       | 22.0                |



## Main Offices

### London

Winchester House  
1 Great Winchester Street  
London EC2N 2DB  
United Kingdom  
Tel: +44 20 7545 8000

### Frankfurt

Grosse Gallusstrasse 10-14  
60311 Frankfurt  
Germany  
Tel: +49 69 9100-0

### New York

31 West 52<sup>nd</sup> Street  
New York, NY 10019  
United States of America  
Tel: +1 212 469 5000

### Hong Kong

55/F, New World Tower  
2 Queen's Road, Central  
Hong Kong  
Tel: +852 2203 8888

### Sydney

Grosvenor Place  
Level 18, 225 George Street  
Sydney NSW 2000  
Australia  
Tel: +61 2 9258 1661

### Singapore

5 Temasek Boulevard  
#08-01 Suntec Tower Five  
Singapore 038985  
Tel: +65 224 4677

### Tokyo

12-1, Toranomon 3-chome  
Minato-ku, Tokyo 105  
Japan  
Tel: +81 3 5401 1986

## Global Markets Research

### David Folkerts-Landau

Managing Director, Global Head of Research (Tel: +44 20 754 55502)

**Peter Garber**, Global Strategist

(Tel: +1 212 469 5466)

### Credit Research

**Simon Adamson**, Co-head, European High Grade Credit Research (Tel: +44 20 754 58715)

**David Bitterman**, Co-head, US High Yield Credit Research (Tel: +1 212 469 2599)

**Mark Girolamo**, Co-head, US High Grade Credit Research (Tel: +1 212 469 5403)

**Anja King**, Co-head, European High Grade Credit Research (Tel: +44 20 754 59260)

**Paul Tice**, Co-head, US High Grade Credit Research (Tel: +1 212 469 2776)

**Andrew W. Van Houten**, Co-head, US High Yield Credit Research (Tel: +1 212 469 2777)

### Economic Research

**Peter Hooper**, Co-head, Global Economics/Chief US Economist (Tel: +1 212 469 7352)

**Stuart Parkinson**, Co-head, Global Economics (Tel: +44 20 754 57303)

**Leonardo Leiderman**, Head of Latin American Research (Tel: +1 212 469 5894)

**Marcel Cassard**, Chief Economist, EM Europe, M. East & Africa (Tel: +44 20 754 55507)

**Michael Spencer**, Chief Economist, Asia (Tel: +852 2203 8305)

### Fixed Income and Relative Value Research

**David Knott**, Global Head (Tel: +44 20 754 54017)

**Peter Petas**, Chief Emerging Markets Strategist (Tel: +1 212 469 5414)

### Foreign Exchange Research

**Michael Rosenberg**, Global Head (Tel: +1 212 469 4776)

### Indices

**Fergus Lynch**, Head of Index Development (Tel: +44 20 754 58765)

### Securitisation Research

**Karen Weaver**, Global Head (Tel: +1 212 469 3125)

Deutsche Bank



Global Markets

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### Publication Address:

Deutsche Bank AG London  
Winchester House  
1 Great Winchester Street  
London EC2N 2DB

### Internet:

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