

Merkel's Victory Paves Way for Political Continuity

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Summary

German election – Chancellor Merkel's centre-right CDU/CSU party obtained 41.5% of votes, the highest share of any party in a German election since 1990, likely leaving it just five seats short of an overall majority. Comment: The stronger-than-expected performance of Merkel's centre-right CDU/CSU is clearly a vote for continuity for Merkel's leadership, including in the Eurozone crisis. It is in contrast to the broader Eurozone trend of anti-incumbent sentiment and greater support for small parties. A Grand Coalition between Merkel's party and the center-left SPD – our base case scenario – is still the most likely outcome.

SPD to debate Grand Coalition and leadership, with the party executive meeting this morning, the newly-formed SPD parliamentary group on Tuesday, and a party convention scheduled for Friday

ECB's Liikanen on monetary policy support – the ECB would be “ready to act if needed.” Comment: it is not obvious at this stage that the reduction in excess liquidity is sufficient to prompt the ECB into action, especially with money market rates having declined in the aftermath of the Fed's no tapering announcement.

ECB speakers on banking union – ECB's Mersch re-iterated that the ECB would not start bank balance-sheet reviews until governments agree on emergency backstops. Liikanen calls for a resolution mechanism similar to the US's FDIC with a “well-defined mandate” and funded by banks.

France – President Hollande's approval ratings hit new lows, falling by five points to 23% in September, according to an IFOP poll.

Italy – FinMin Saccomanni threatens to resign if VAT rate hike is blocked and coalition parties do not cooperate to keep 2013 fiscal deficit below the 3% of GDP target. Saccomanni said he does not want to put his reputation at risk because parties are acting exclusively for electoral purposes, in view of possible early elections in spring 2014.

Spain – public services to be “de-indexed” from CPI inflation, in a move which would help in taming price pressures and making inflation more sensitive to the economic cycle.

Moody's says 2014 Dutch budget plans are credit negative, saying the budget is “pro-cyclical and [...] that these spending cuts will hurt private consumption and overall economic growth, making them credit negative.”

Belgium targets a 2014 deficit of 2.25% of GDP, a structural deficit of 1.2%.

Greece – state's real estate assets possible collateral for a new loan.

Greece close to achieve a primary budget surplus in 2013, opening the way for further debt relieving measures, FinMin said.

Euro Area flash composite PMI for Sep – Up again, encouraging for 4Q.

23 September 2013

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Economics

Western Europe

Industrialised G7 Countries

Recent Research

German Elections — Big Merkel Win, Grand Coalition Government Most Likely

Very strong result for Chancellor Merkel's CDU/CSU party paves way for policy continuity. Chancellor Merkel's center-right CDU/CSU party obtained 41.5% of the votes, highest share of any party in a German election since 1990. According to the preliminary official result, it will have 311 out of 630 seats in the Bundestag (Lower House of parliament), leaving it just five seats short of an overall parliamentary majority. The stronger-than-expected performance for Merkel's center-right CDU/CSU is clearly a vote for continuity for Merkel's leadership, including in the Eurozone crisis.

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Euro Economics Weekly — Housing Not Yet Turning Around

Recent data suggest that house prices are rising again in Ireland, still rising in Germany and perhaps falling less fast

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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German industry urges energy reform, according to FAZ survey.

Today's News in Detail

German election: Very strong result for Chancellor Merkel's CDU/CSU party paves way for policy continuity. Chancellor Merkel's center-right CDU/CSU party obtained 41.5% of the votes, the highest share of any party in a German election since 1990. According to the preliminary official result, it will have 311 out of 630 seats in the Bundestag (Lower House of parliament), leaving it just five seats short of an overall parliamentary majority. The centre-left SPD came second with 25.7% of the vote and 192 seats. While the SPD gained 2.7pp more votes than in 2009, it was still its second-worst election result since WWII. The Left Party came third (8.6% of votes/64 seats) and the Green Party fourth (8.4%/63). The liberal FDP, the junior party in the current government, at 4.8% of votes fell short of the 5% needed to enter parliament for the first time since 1949, against our expectations. The euro-sceptic AfD also narrowly missed the 5% threshold. Comment: The stronger-than-expected performance of Merkel's centre-right CDU/CSU is clearly a vote for continuity for Merkel's leadership, including in the Eurozone crisis. It is in contrast to the broader Eurozone trend of anti-incumbent sentiment and greater support for small parties, though the showing from the eurosceptic AfD suggests that the nascent protest party could eventually build on its initial performance and challenge other small rivals. A Grand Coalition between Merkel's party and the center-left SPD – our base case scenario – is still the most likely outcome. A CDU/CSU-Green alliance is possible, while a SPD-Green-Left coalition cannot be ruled out yet (the possibility of a CDU/CSU-Left coalition is only theoretical). Coalition negotiations could take weeks to finalise, involving horse-trading between the two parties for key posts (one question is whether the junior coalition partner would demand the Finance Ministry). Eurozone policies are unlikely to change substantially under any of these scenarios, a key assumption of our pre-election scenarios. The SPD will hold a party convention on Friday to discuss its next steps. Final election results will not be available for weeks and the German Constitutional Court could issue its final ruling on the OMT at any point over the next weeks or months. Overall, the election outcome should be interpreted fairly positively: a Grand Coalition would have large parliamentary majorities in both houses of parliament and the euro-sceptic AfD has narrowly failed to enter parliament. However, coalition negotiations are likely to be lengthy and quite tricky, which could disconcert markets in the near-term, particularly in the case of possible coalition talks between SPD, Greens and Left. A Grand Coalition may also become unstable in the long-run, as the SPD will likely try to avoid the same fate as in 2005-09 when it lost substantial voter support following its participation in a Merkel-led Grand Coalition government. For more details, see [*Big Merkel Win, Grand Coalition Government Most*](#) this morning and [*Four More Years – A Multi-Asset View*](#).

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SPD to debate Grand Coalition and leadership. Ahead of likely coalition talks with Chancellor Merkel's CDU/CSU party, the SPD is beginning to consider its options, as *Spiegel Online* reports. The SPD party executive meets this morning, the newly-formed SPD parliamentary group on Tuesday, and a party convention is scheduled for Friday. A spokesman for the left wing of the party said that the SPD should “*keep the door open to other parties*”, implying that a Left coalition of SPD/Green/Left could be an option. The SPD prime minister in the state of North Rhine-Westphalia noted that the “*SPD had experience with Grand Coalitions and these were not particularly positive*”, while the leader of the youth organisation of the SPD said that the central projects of the SPD would likely not stand much

than before in Spain, while euro area housing investment grew in Q2 for the first time since Q1 2011. These data have fed some optimism that the housing cycle is about to turn in the euro area (EA) and play its part in the EA recovery. We think that such hopes are probably premature.

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UK Economics Weekly — Change to Rate View

We are significantly changing our UK interest rate forecasts, advancing the first rate hike from 2017 to 2015. These revisions reflect two main factors: first, we are again revising up our growth forecasts, and now expect growth of 1.4% this year, 3.0% in 2014 and 3.1% in 2015 (versus 1.1%, 2.1% and 2.7% respectively last month); second, we now believe that productivity will rebound more slowly than we previously expected, partly because of continued declines in the cost of labour.

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Norway — Stable Rates, Easing Bias Removed And Earlier Rate Hike

As widely expected, we saw something of a U-turn from Norges Bank; after being extremely dovish at previous meetings, the Bank has now turned more hawkish; the Bank left the key policy rate unchanged at 1.50%, and lifted its conditional interest rate path in the new Monetary Policy Report (by up to 23bp for 2014), completely removing the Bank's near-term easing bias at the same time as indicating an earlier initial rate hike.

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UK — Retail Sales Fall Back, Trend Remains Solid

Retail sales volumes fell 0.9% MoM in August, nearly reversing the 1.2% rise in July. We suspect that the MoM swings in retail sales volumes are still being affected by unusual weather variations. Even with these figures, the trend in retail sales remains solid, with the average level of retail sales volumes in July-August 1.5% above the Q2 average. This is consistent with other

chance of being implemented in a Grand Coalition. *Spiegel Online* suggests that if the SPD joined the CDU/CSU in a Grand Coalition, it could expect to have six ministries under its leadership. SPD Chancellor candidate Steinbrück said that he would still be prepared to take responsibility for the SPD in the future, but also confirmed that he would not be available as a minister in a Grand Coalition government led by Ms Merkel.

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ECB's Liikanen on monetary policy support – ECB Governing Council member Erkki Liikanen gave an interview to *Corriere della Sera* in which, responding to a question on whether the central bank is planning a new LTRO, he noted that the ECB would be “ready to act if needed.” Mr. Liikanen indicated that money-market volatility has declined, and that ECB predictability has increased since forward guidance in July. Comment: it is not obvious at this stage that the reduction in excess liquidity is sufficient to prompt the ECB into action, especially with money market rates having declined in the aftermath of the Fed's no tapering announcement.

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ECB speakers on banking union – ECB Executive Board member Yves Mersch re-iterated in an interview with *Handelsblatt* that the ECB would not start bank balance-sheet reviews until governments agree on emergency backstops, given the risk that “the review could catapult us back into a crisis if the financing isn't clarified beforehand.” ECB Governing Council member Erkki Liikanen called on Europe to introduce a resolution mechanism similar to the US's FDIC with a “well-defined mandate”, funded by banks, suggesting that the resolution mechanism authority would work together with Single Supervisory Mechanism (SSM). Talking about the possible recapitalisation needs of the euro area banking system, he hoped that recapitalization will happen through the private sector, but warned that government might also have to get involved after the asset quality review is completed. Comment: the ECB is putting pressure on politicians to deliver on their promise to have a fully-fledged ESM direct bank recapitalisation framework in place by December. Although €50bn was set aside for this scheme, a final agreement remains to be reached between euro area member states.

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France: President Hollande's approval ratings hit new lows – an IFOP poll for weekly newspaper *Le Journal du Dimanche* showed that President Hollande's approval rating fell by five points to 23% in September, closing in on the 22% record low held by former Socialist President Mitterrand in 1991. The poll also showed Hollande's ratings among supporters of the Green party had slid by 19 points since last month, a sign of growing tensions between Hollande's Socialists and their Green allies in government. Comment: While popularity ratings appear to be disconnected from economic performance, the very low level of confidence in both the President and the government suggests that the rebound in business and household confidence seen since the late spring will likely be limited, constraining the recovery in economic activity.

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Italy – FinMin Saccomanni threatens to resign if VAT rate hike is blocked. The former central banker Fabrizio Saccomanni said in a newspaper interview with *Il Corriere* that he is ready to quit if coalition parties do not cooperate to find an agreement on the 2014 budget and both work to keep the fiscal deficit below the 3% of GDP target by the end of this year. The major issue of debate on fiscal policy has recently been the planned VAT rate hike, due to start on 1 Oct, which the centre-right PdL party vehemently calls to be cancelled. PD members, including party leader Guglielmo Epifani, have also supported the idea of at least postponing the hike. The increase in the standard VAT rate, from 21% to 22%,

signs of fairly strong GDP growth in Q3.
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UK — MPC Minutes – No Rate Protest

The MPC minutes show a 9-0 vote for no change in either Bank Rate or QE, and no MPC members judged that any of the knockouts in the guidance framework have been triggered. The MPC judge that growth prospects are at least as good as expected in the August Inflation Report. Partly in light of the improvement in growth prospects, the MPC do not make any serious protest at the rise in market rates.

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Sweden — Expansionary 2014 Budget, Provides Big Boost to Households

There were no surprises in today's 2014 budget as the government had unveiled all the budget measures over the last two-three weeks. As expected, the government plans to ease fiscal policy further in the election year 2014, and the reforms are turning more voter-friendly compared to the structurally-oriented easing this year. Total unfunded easing next year is estimated at SEK 24.2bn (corresponding to 0.7% of GDP) with the majority part directed towards households (SEK 20.6bn).

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Scandi Economics Update —

Sweden — Politics.

Sweden — Data preview. Most important data releases this week are September manufacturing and consumer confidence from the National Institute of Economic Research (Wed), followed by August household lending (Thu) and August retail sales (Fri).

Norway — Norwegian opposition parties continue talks on forming government — Data preview. LFS (Wed) and registered labour market data (Fri).

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has already been postponed from last July and is estimated to be worth some €1bn of revenue in the last three months of 2013. Last week the government unveiled the updated macroeconomic scenario, foreseeing the budget deficit at 3.1% of GDP by year-end. Mr Saccomanni made clear in the interview that he does not intend to put his reputation at risk by letting the fiscal deficit exceed the 3%-of-GDP target because political forces are acting exclusively for electoral reasons, considering possible early elections in spring 2014. Separately, the date for the centre-left primary elections for party leadership has been set for 8 December. Comment: tensions within the governing coalition persist, even after they seemed to have overcome, at least temporarily, the problem of how to deal with Silvio Berlusconi's impeachment. The debate around the VAT rate hike seems to be purely political, with each of the two main governing parties trying to take advantage of the other by calling for fewer taxes (without proposing any realistic financial coverage, in our view). Although early elections are unlikely in the short term, both parties are definitely positioning themselves for possible early elections to be held in 2014.

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Spain – public services to be “de-indexed” from CPI inflation. According to *El Economista*, the Spanish government will table a draft law this week which sets a new mechanism to update regulated prices (that is prices for public services like public transport, water supply or postal services), de-linking them from past CPI inflation and linking them to costs. The measure is meant to come into force on 1 January 2014, when the prices of most regulated public services are normally updated using the previous year's CPI inflation. Comment: if introduced, the measure will help to tame price pressures also from the side of regulated prices – a substantial share of the overall CPI basket. Reducing the level of indexation in the economy would make inflation more sensitive to the economic cycle and hence, in the current phase, help reduce it further.

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Moody's says 2014 Dutch budget plans are credit negative – Moody's indicated on Monday that while the Dutch government's additional cuts demonstrate a commitment to fiscal consolidation, it stressed that the budget is *“pro-cyclical and [...] project that these spending cuts will hurt private consumption and overall economic growth, making them credit negative.”* Moody's trimmed its 2014 budget deficit forecast from 0.6% to 0.4% expecting that the proposed tax adjustments will further weaken households' purchasing power for the fifth consecutive year. Comment: Moody's concurs with the Dutch government's independent forecasting board CPB that the 2014 budget deficit will likely exceed the 3% target. We continue to believe that the Aaa/AAA Dutch sovereign rating will be lowered by a notch to Aa1 and AA+ in the coming years, given the underperformance of economic activity compared to its Aaa/AAA-rated peers.

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Belgium budget plans – Belgium's budget minister Olivier Chastel indicated on Friday after the cabinet meeting that the government had found an additional €218mn of saving, expressing confidence that the government would *“keep to our objective of 2.5% of GDP for 2013”*. Dow Jones newswires reported that Belgium was aiming to submit its 2014 budget plans to the European Commission on Saturday. The 2014 budget targets are for a nominal deficit of 2.25% of GDP and a structural deficit of 1.2% of GDP. Comment: Belgium is being monitored very closely by the European Commission and talks on the 2014 budget are continuing ahead of the formal deadline of October 15 for the submission of budgetary plans.

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Greece to achieve a primary budget surplus. Greek FinMin Yannis Stournaras

said on Sunday that the government and the international lenders represented by the troika are close to agreeing that Greece will be able to reach a small primary budget surplus in 2013, opening the way for another round of debt relief to be granted on Greek public debt. Reuters reports that the troika may also revise upward their 2013 GDP forecasts from -4.2% to -3.8%. Comment: depending on how the transfer of ECB/Eurosystem profits on Greek bonds (€2.7bn, or 1.5% of GDP) from other eurozone countries to Greece is accounted for, Greece may indeed be able to achieve a primary surplus in 2013. This would open the door for a discussion on further debt relief, as European lenders have promised Greece. But we doubt this would end up with an outright haircut on the official loans – in our view the only way the Greek public debt can be made sustainable.

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Greece – state real estate assets possibly to be used as collateral for a new loan. *Ekathimerini* reports that the government is considering the possibility of using real estate assets owned by the Greek state as collateral for a new loan to cover its funding gap for 2014 and 2015. The plan would be to convey the assets into a vehicle (co-managed by Greece and European lenders) which would be able to issue collateralised debt securities; these securities would be financed by the ESM or potentially also by private investors. Comment: with the much-delayed privatisation process, real estate assets are now being considered to be used at least as collateral to help Greece in filling its funding gap. Aside from privatisations, the resources Greece could put on the table to cover the budget shortfall have become very limited, given the massive fiscal tightening already put in place in the past three years. But the willingness of other European countries to continue funding the Greek government – the financial sustainability of which is still very dubious, in our view – has also diminished significantly, leaving the coverage of the budget shortfall in 2014-15 still undecided.

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Euro Area flash composite PMI for September – Up again, encouraging for 4Q. The euro area composite flash PMI surprised to the upside in September, with a 0.6-point gain marking the fifth successive monthly increase. This survey marks the fastest rate of expansion in private sector activity since June 2011. This survey suggests that economic activity is accelerating slightly at the end of the third quarter, and with incoming orders improving, the uptrend will likely be confirmed, underpinning a positive (and most likely higher) 4Q GDP. The uptrend is consistent with the ECB's view of a gradual recovery, requiring the re-iteration of forward guidance to anchor short-end money market rates. The **euro area composite PMI rose by 0.6 point to 52.1** (highest since June 2011), comfortably exceeding the 51.8 consensus forecast. The services PMI jumped by 1.4 point in September with employment rising by 1.5 point to 50 (highest since Dec-11). The manufacturing PMI fell by 0.3 point to 51.1. The **German composite PMI rose by 0.3 point to 53.8 in September**, its highest reading since January 2012, and a fifth successive monthly gain. The services PMI rose by 1.3 point to 54.4, exceeding the 53.0 consensus forecast, but the manufacturing PMI fell by 0.9 point to 51.3 (Mkt. 52.2). Markit noted that staffing levels across the private sector grew at the fastest pace since March 2012. The **French composite PMI rose by 1.4 point to 50.2 in September**, exceeding the 50 threshold for the first time since February 2012. The services PMI also rose by 1.8 point to a 20-month high of 50.7 (Mkt. 49.6), while the manufacturing PMI fell by 0.2 point to 49.5 (Mkt. 50.1). Markit noted that the flow of new manufacturing orders grew for the first time since June 2011, with demand from abroad particularly strong.

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German industry urges energy reform. FAZ reports that in a survey of executives of large German industrial firms it carried out, these executives called for urgent energy reforms, noting that for some industrial energy users the

current arrangements were already threatening their existence. Another executive noted that a further increase in electricity prices would inevitably lead to the loss of jobs and of industrial production, while yet another thought that a “*creeping de-industrialization*” was possible.

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Latest Issues of Sovereign Debt Crisis Update

Germany – Final Days for Campaigning

Ahead of German election on Sunday, latest polls suggest slightly greater chance of Grand Coalition. ECB's Liikanen reiterates forward guidance. Possible news today on ECB's Asset Quality Review. New EU rules on structural deficits. EC estimates of VAT revenue shortfalls. Italy to re-enter excessive deficit procedure if 3% target not met. S&P affirms Belgium's rating. ECB's Asmussen upbeat on Greek progress. Unemployment down in Slovakia. Slovenia's central govt deficit slightly better in Aug.

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S&P Puts Portugal on Negative Credit Watch

S&P puts Portugal on negative credit watch. Berlusconi to remain leader of Italy's PdL party even if ousted from parliament. Italy's 2013 government deficit likely to exceed 3% of GDP even with VAT hike, government source tells Reuters. Italian govt to announce privatisation plans before October. Spain's nonperforming loans rise in July. Germany's FDP wants to get rid of ESM. FM Schaeuble and deputy FM Roesler criticise AfD. German industry proposes energy reform.

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Italy: Risk of Political Crisis Recedes Ahead of Senate Vote

Berlusconi's TV speech today will reportedly not pull the plug on the governing coalition. EC's Rehn criticises Italian fiscal policy decisions. EC's Rehn says Spain has high chances to exit bank bailout programme at year-end. Greece's PM rejects new austerity. ECB monitoring excess liquidity closely. ECB's Praet and Nowotny on upcoming AQR. Cyprus: possible end to capital controls in Jan 2014. Dutch 2014 Budget. German Election: SPD debates post-election course, many voters still undecided

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Portugal May Seek A Precautionary Credit Line

Portugal may seek a precautionary credit line at end of current financial assistance programme. IMF approves next tranche of Cypriot programme. Italy's PM Letta says scrapping planned VAT hike is very difficult. Spain's pension reform expected to bring savings of 3.3% of GDP. Spain's Jan-Jul government deficit reaches 5.27% of GDP. German industry calls for credible bank resolution regime. German regions struggle with rising interest costs. German polling institute obtains injunction against AfD

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Crucial Week for Italian Government Once Again

Italy's Senate committee holds a crucial Berlusconi vote on Wed. Eurogroup's Dijsselbloem sees no delay on SRM. CSU wins absolute majority in Bavarian election. ECB's Praet on money market rates. Eurogroup rejects fiscal relaxation for Portugal. Spain must extend bailout programme if deficit target missed, says EC. Spain's Rajoy offers Catalonia talks but no independence vote. Spanish govt approves pension reform. Germany's AfD gains some momentum in polls. French GDP growth and 2014 budget.

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Macroeconomic Forecasts

European Economic Forecast Highlights — August 2013

Western Europe

This companion to Global Economic Outlook and Strategy - August 2013 contains detailed quarterly forecasts for the main European countries to end 2014. Tables 20-21 give annual forecasts to 2017 for growth, inflation, short-term interest rates, current balance, fiscal balance and government debt. Table 22 shows the change in our forecasts from last month. Figures 23-25 compare current forecasts for each country.

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Global Economic Outlook and Strategy — August 2013

Global, Pan Asia, GEMS, Americas, EMEA, Asia, Australia

We cut 0.1% off our 2013 global growth forecast this month (to 2.4%), but lift our 2014 forecast by 0.1% to 3.2%. We highlight four key issues that will shape the economic and market outlook in coming months: Fed tapering, Japan's consumption tax hike choices, the EM slowdown, plus renewed focus on issues of longterm fiscal sustainability in various EMU periphery countries. We pencil in the first Fed hike for 2015, with an even longer period of ultra-low rates likely from the ECB, BoJ and BoE.

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Appendix A-1

Analyst Certification

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