

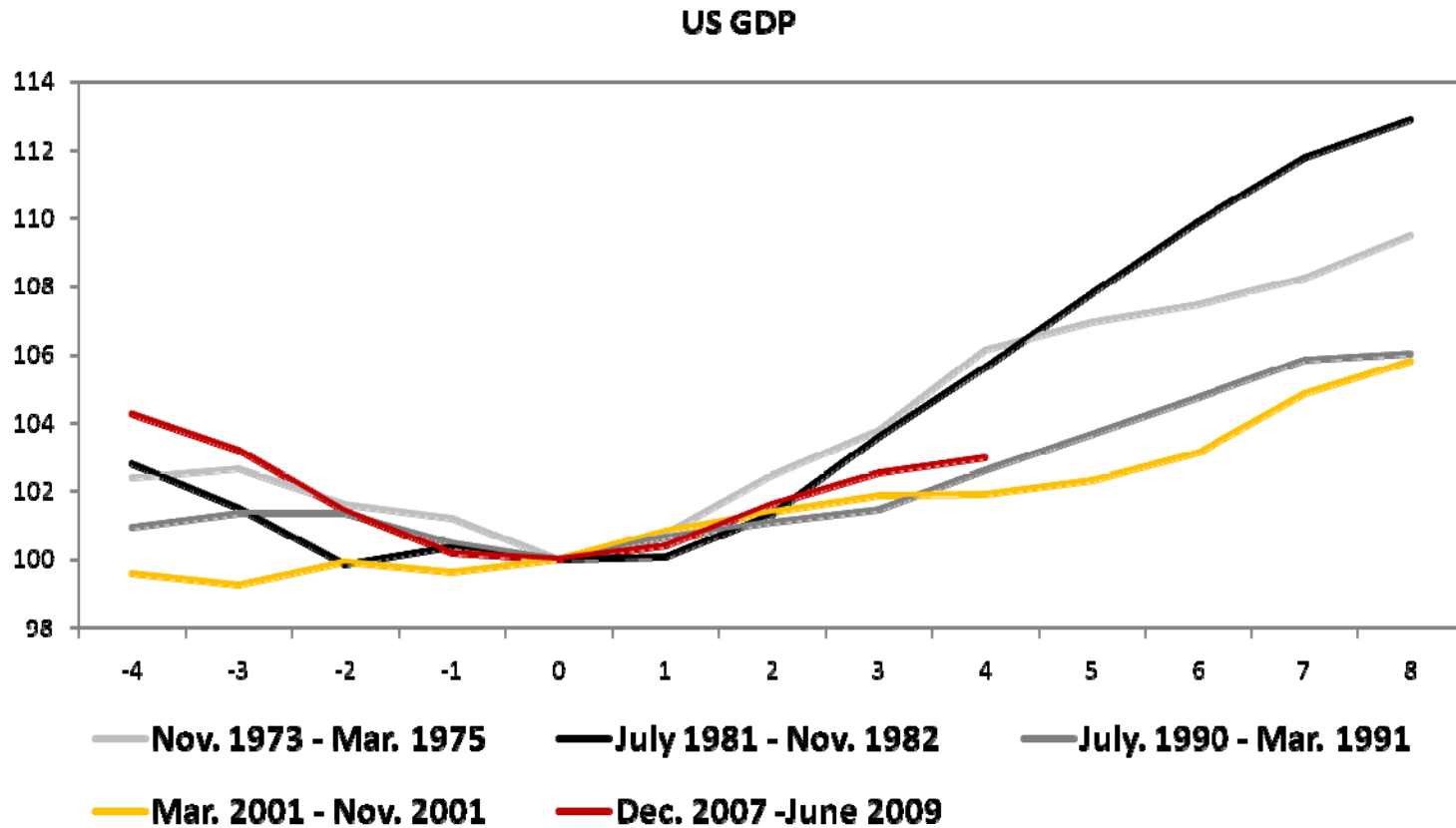
VAKIFBANK GLOBAL ECONOMY WEEKLY

EU debt crises will determine the
success of FED's QE2



T. Vakıflar Bankası T.A.O

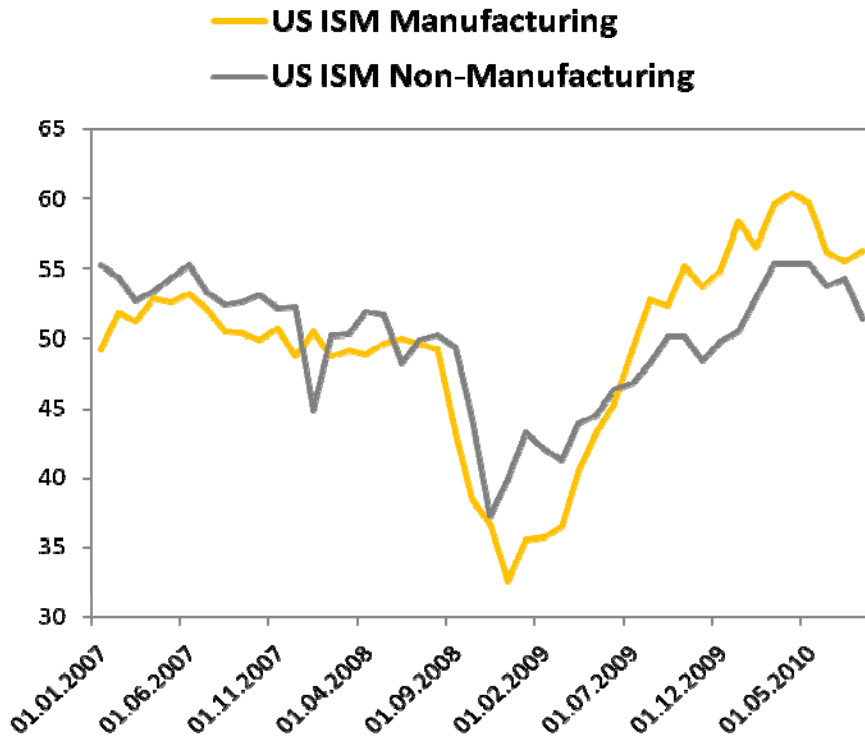
US growth performance supports our “U shaped” recovery forecast



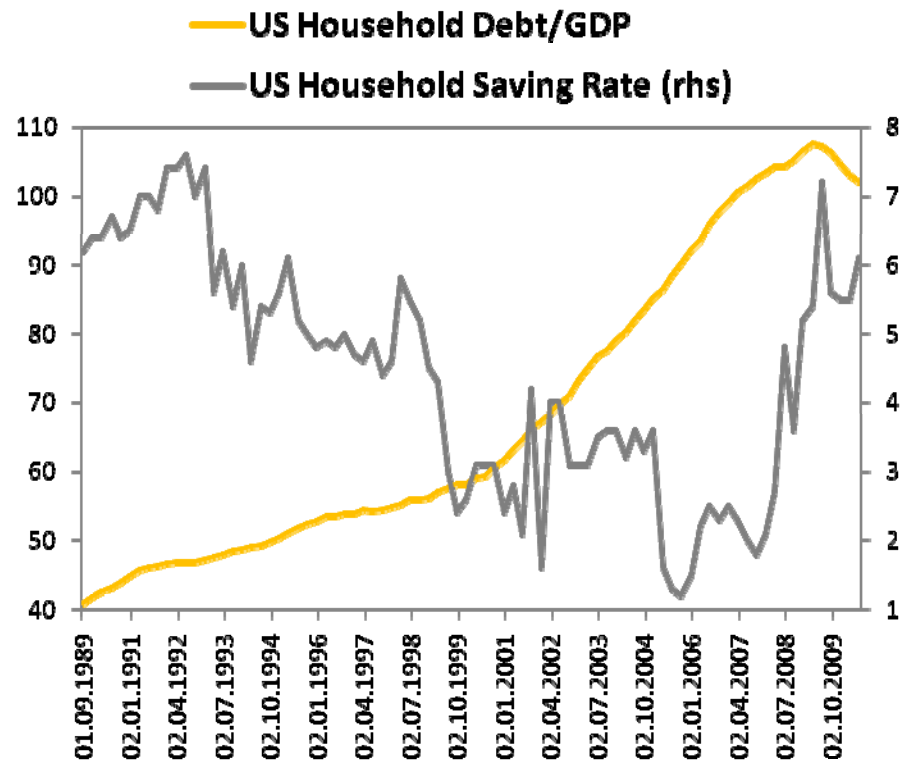
End dates of recessions are taken as zero
 Source: Bloomberg

The second quarter growth and third quarter leading activity data support our view that the recovery is “U shaped”. Market opinion also seems to be converging this scenario.

US corporate and household sectors still face some struggles



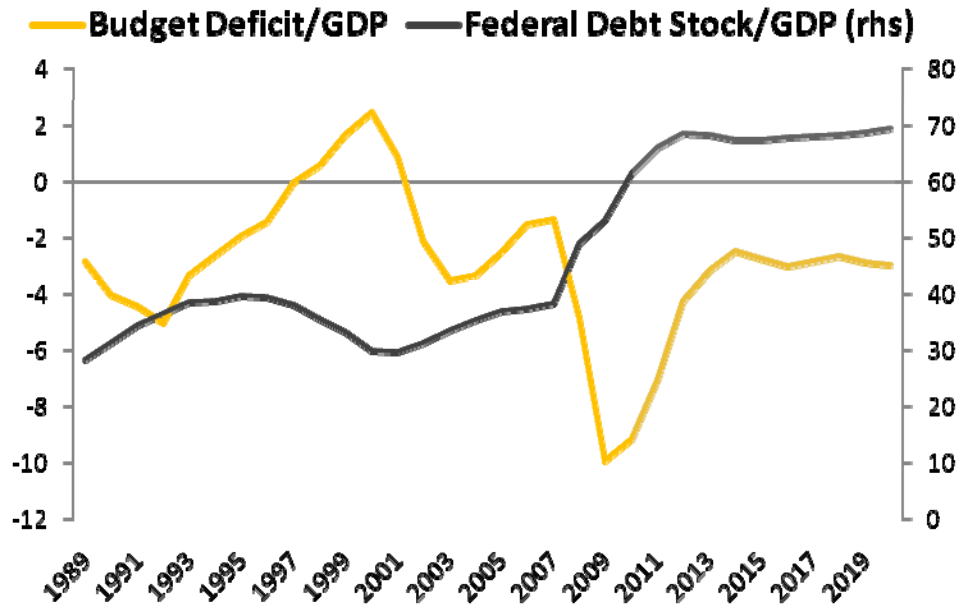
Source: Bloomberg



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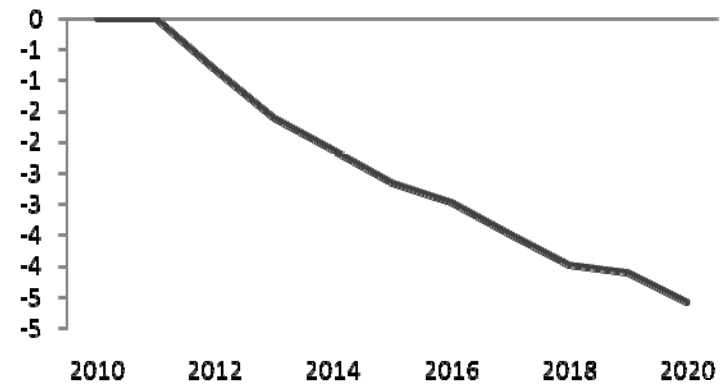
The slow pace of stock accumulation together with high unemployment and weak total demand is concerning. The high level of household debt is an important drag on consumption led growth. Also the household saving rate which is about 6% is another concern and showing that the inflationary pressures might be lower for an extended period than estimated.

Fiscal burden will continue to hang over the US economy for the next decade



Source: Bloomberg, Congressional Budget Office

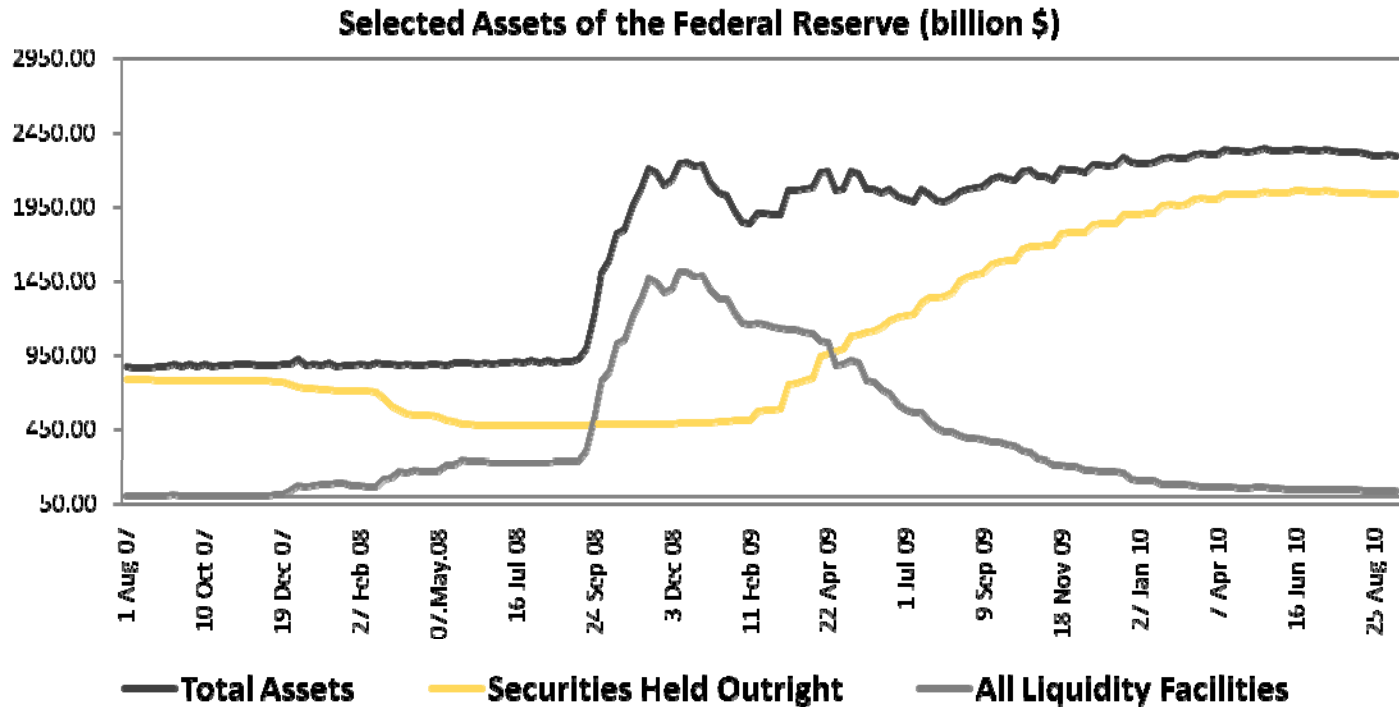
Effect of Crowding Out on Real GDP (%)



Source: Congressional Budget Office

In this slow growth environment, there's little scope for additional fiscal measures, because of the higher levels of budget deficit and debt stock. According to the estimations of The Congressional Budget Office (CBO) the US budget deficit will be around 7% in 2011 and will hardly converge to 3% in the next 9 years. And the debt to GDP ratio is estimated to be around 67% on average during the next 10 years. Also, CBO calculates a considerable crowding out effect on real GDP for this period due to above mentioned fiscal imbalances.

Monetary policy seems to be the easier option for additional stimulus



Source: FED

Total assets of the FED jumped above 2 trillion dollars after the Lehman Brothers bankruptcy in October 2008 with the Quantitative Easing (QE) policy. FED started increasing the purchases of US Treasury securities in the first quarter of 2009 and gave a pause in the 1st quarter of this year. After the September 2010 meeting, the general market expectation is that the FED will restart QE in November and buy treasuries up to an amount of 1 trillion dollars.

What is Quantitative Easing?

What is Quantitative Easing?

Quantitative Easing can be described as increasing the money supply without limit, when further interest rate cuts are not possible.

How is Quantitative Easing applied?

Central banks buy financial assets through open market operations and inject liquidity to the markets.

It is expected that commercial banks increase the credit supply and via credit mechanism the economic recovery is enhanced.

Risks

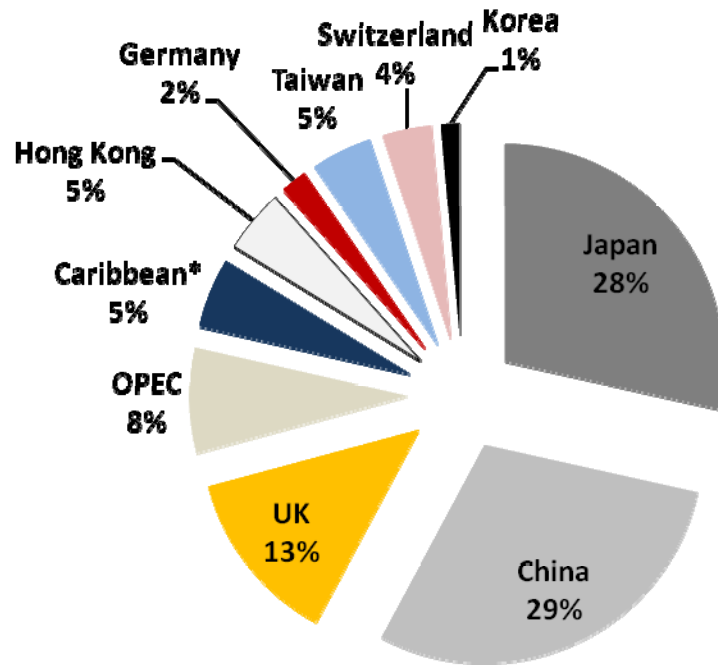
Because of high liquidity monetary authorities could lose control of inflation expectations.

History

It was used in Japan for the first time in the early 2000s to fight deflation. At that time, interest rates were zero and BOJ supplied money to banks to ease private borrowing. In the recent financial crises QE policy is used by FED and Bank of England after the collapse of Lehman Brothers.

Foreign ownership of US Treasuries is very high

Foreign holdings of US Treasury Securities



Caribbean: Bahamas, Bermuda, Cayman Islands, Netherlands Antilles, Panama
Source: FED

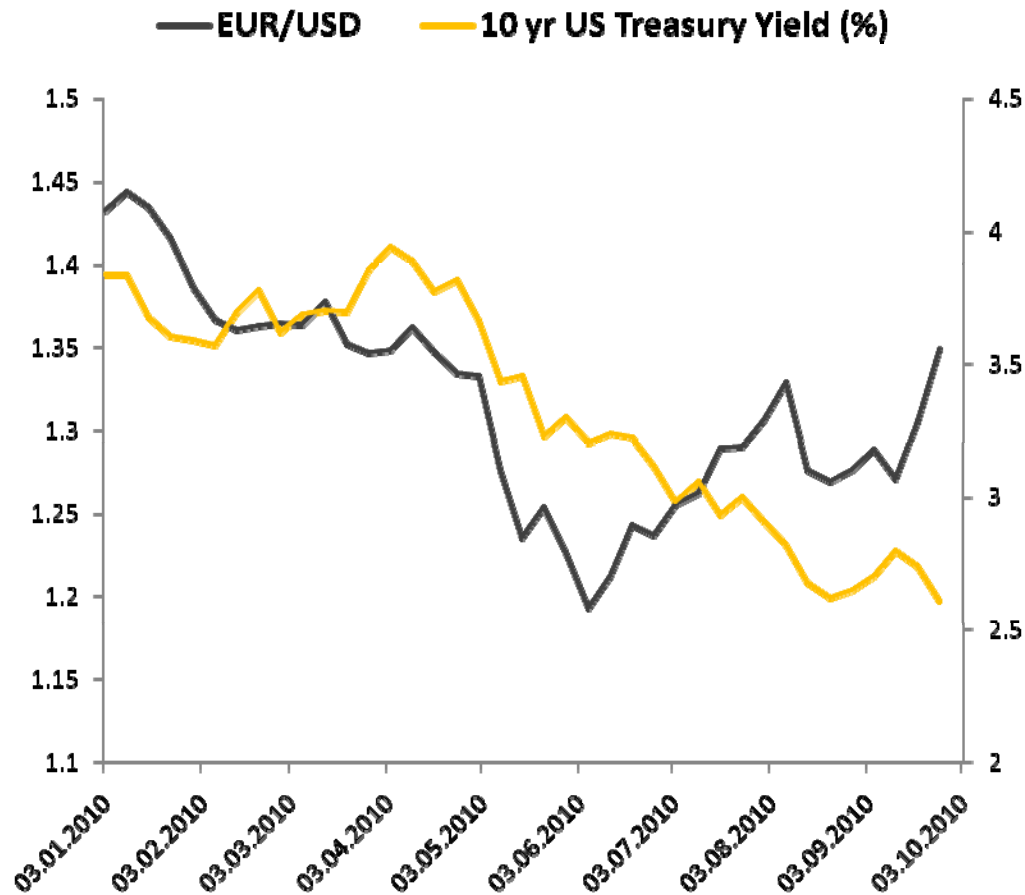
Foreign investors hold:

- ✓ About 47% of US Treasuries
- ✓ 20% of US corporate bonds
- ✓ 12% of US stocks

And, the major holders of US treasuries are Asian countries with around 50% share.

Under these circumstances the high exposure of foreign investors to US securities makes them sensitive to the value of US dollar. And this creates the biggest obstacle for the success of quantitative easing.

Close relation between Quantitative Easing and Dollar value is highly important



Source: Bloomberg

- ✓ We have seen that even the talks of quantitative easing has increased the EUR/USD to 1.34.
- ✓ With the dollar loosing ground very quickly the demand for US treasuries won't be that strong.
- ✓ This might limit the succes of QE2.
- ✓ We think that, for international investors it is important not to disregard the currency risk.

We think that the success of QE2 is highly dependant on European debt crisis

- ✔ Foreign investors do not want to have a high currency risk.
- ✔ We believe that EU debt crises will limit the weakness in dollar and support the success of QE2.
- ✔ Decrease in the value of other currencies against dollar is also important.
- ✔ In this context the intervention of Bank of Japan (BOJ) in order to prevent the appreciation in yen is supportive for US treasuries.
- ✔ Even under the scenario of continued EU debt crises and intervention of BOJ, we think 10 yr US treasury yields will only come down by 25 bps with 1 trillion dollars of QE2.

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