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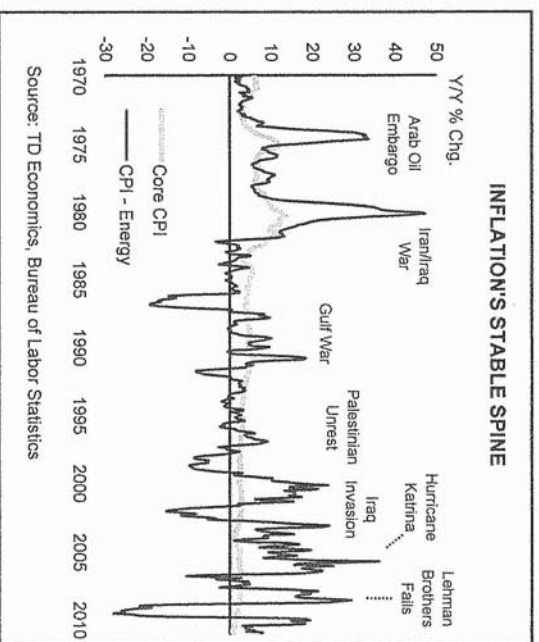
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 Rates & Foreign
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HIGHLIGHTS

- The rise in the price of oil triggered by geopolitical developments poses yet another headwind to both the recovery in financial markets and the global economy.
- Each economy will need to customize their response to higher energy prices which raises the risk for a policy error in an already complicated environment.
- The publication also includes quarterly interest rate and exchange rate forecasts for the U.S., Canada, U.K., Australia, and New Zealand, and also offers additional exchange rate forecasts for the Japanese yen, the euro, and the Swiss franc.

THE LINE IN THE SAND: DISTINGUISHING BETWEEN GOOD AND BAD INFLATION

The global economy is approaching the end of the first quarter of 2011 with significant momentum. With activity measures showing rates of growth not seen for almost five years, forecasters have responded by revising their expectations for economic output higher. Against this backdrop, the likelihood of deflation has become increasingly remote and instead the balance of risk to the forecast has shifted towards higher inflation. But the magnitude of the forecast revisions to both growth and inflation also reflects a fine balance that is ultimately influenced by more than economics. The concurrent rise in geopolitical tensions in the Middle East and North Africa (MENA) and in the price of oil has increased the pressure on policymakers who must



primarily limit its impact on inflation but also guard against the risk it poses to economic growth. The tragic earthquake in Japan has helped to diminish the magnitude of the shock—although the larger fall in crude occurred several days earlier—but events in MENA continue to cast a long shadow over energy markets. By contrast, rising inflation caused by the steady absorption of the resources that had lain idle during the recession is a much better problem for central banks to have. So once again, the financial system is now more exposed to a policy surprise or error than it is to a financial surprise, and the scale of the macro-driven volatility could be significant if realized.

From Each According to His Ability to Fight Inflation, To Each According to His Willingness to Fight Inflation

Just as all politics is local, so too is the impact of the jump in the price of crude oil, and ultimately the response of policymakers. The challenge is most pressing for emerging market economies, where oil is just the latest in a long string of inflationary shocks that speak to a level of monetary accommodation utterly at odds with conditions in the wider economy. A reluctance to accept a stronger currency—instead a combination of intervention and capital controls remain the preferred options—in the face of accelerating foreign demand only adds to the risk of higher inflation. The tentative steps taken by Brazil, Chile,

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