

The world at a glance

G10: Risk on related USD weakness to continue near term

We continue to look for near-term USD weakness as rising risk appetite draws capital away from relatively defensive US markets. Euro is expected to continue to trade as a “high beta” currency near term due to the influence of reserve manager demand. Euro demand from these accounts is a derivative of capital inflow into EM. We expect their influence to wane through 2010 and for EUR-USD over-valuation to become a market and political issue.

Within the funding currency group (USD, JPY and CHF), recent JPY strength appears to have been driven by a compression in US over Japan short-term interest rate differentials. The move also appears to have been exaggerated by expectations that the DPJ-led cabinet is likely to be supportive of a stronger JPY. We do not believe this will be the case, given Japan continues to grapple with intense deflation. We look for USD-JPY to turn higher once the Federal Reserve embarks on the process of policy normalization.

Forecasts

We adjust several forecasts in this issue. The downward pressure on USD-JPY has taken us by surprise. While our core view remains JPY-negative, the observed sensitivity to interest rate differentials and on-going Fed commitment to loose monetary policy now makes it unlikely, in our view, that USD-JPY will climb quickly until the second half of 2010. We also adjust the near-term NZD-USD profile to reflect a higher-than-expected sensitivity to rising risk appetite (we were not quite bullish enough), but retain our longer-term concerns. In terms of the European crosses, the only major forecast change is a higher EUR-GBP for the end of 2009, as a result of the unexpected expansion of quantitative easing in the UK. The EUR-CHF and EUR-SEK profiles have been modestly altered to reflect unexpected resilience of the franc during the first part of the global recovery and the lagged economic recovery in Sweden.

Valuation

We update our real effective exchange rate (REER) valuation metric. Compared to longer-term historical averages, EUR and AUD remain the most overvalued by around 17%, while USD and GBP are the most undervalued.

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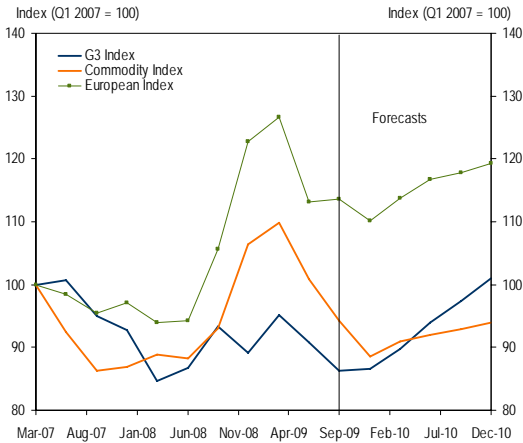
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Chart 1: USD Forecasts against G10



Source: Bank of England, Bloomberg, BofA Merrill Lynch

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We expect USD to continue weakening near term, but to strengthen broadly within G10 in 2010.

Table 1: Relative growth still favorable for USD

	2007	2008	2009F	2010F
US	2.2	0.4	-2.5	3.1
Euro area	3.0	0.6	-3.8	2.0
UK	2.6	0.7	-4.3	1.2
Japan	2.4	-0.7	-5.6	3.5
Canada	2.7	0.4	-2.1	3.2
Australia	4.0	2.3	0.7	2.6
New Zealand	-1.0	0.1	-1.6	2.2
Switzerland	3.3	1.8	-1.4	1.8
Norway	6.2	2.5	-1.1	2.8
Sweden	2.6	-0.4	-4.3	2.3

Source: BofA Merrill Lynch; Forecasts are from [Global Economics Weekly](#), 25 September 2009

USD: weaker now, but stronger later

For USD, the outlook continues to be for a bit more depreciation in the near term, and then appreciation through 2010 against most of G10 (Chart 1). In general, we do not expect to see a substantial pullback in risk appetite over the remainder of the year, and believe that the correlation between positive risk and a weaker USD will continue to hold at the same time. We have used previous rallies in USD to take short positions, and expect that the dollar will soften up against the majors in G10, especially the high-beta commodity and Scandinavian currencies.

Short-term weakness now means future strength

On a long-term macro level, the flip side of further near-term USD weakness, excessive non-USD G10 currency strength, is, in our view, likely to prove unsustainable. Indeed, we have generally characterized foreign currency strength as, to some extent, sowing the seeds of its own destruction, since these countries, which are generally more dependent on trade than the US, feel substantial pain from strength, such that economic conditions take a hit. This is most compelling in currencies such as JPY, where we see dependence on trade and exports as incompatible with continued strength. Moreover, every Dollar Bloc central bank has spoken about the negative impact that the recent strength of their local currencies is having on the growth front, which also links to the fact that their activity outlook is particularly dependent on trade. Most importantly of all, ECB President Trichet has now taken the first step of speaking out in support of a strong USD.

2010 to bring an important correlation break

While previous USD strength had been associated with a negative macro and financials outlook during the crisis, we do not look for a substantial risk pullback or double-dip in the economy to drive our 2010 USD-strengthening view. Our US Economics team is calling for growth of roughly 3-3.5% growth in each quarter through the end of 2010. Instead, our view revolves around a breakdown in the correlation between risk and USD. We think financial flows will ultimately favor the US, rewarding both growth and a robust investing environment. Our US Equity Strategist, David Bianco, is calling for a 12-month S&P 500 target of 1200. While the US recovery we are forecasting is actually historically tame compared to the depth of the recession, it is forecast to be relatively robust across the majors, especially relative to the Euro Area and the UK (Table 1). Consequently, we think USD will benefit as financial market normalization continues through 2010.

A floor for USD: longer-run fundamentals

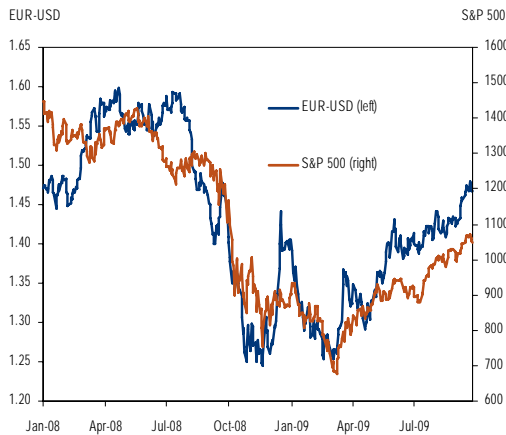
We disagree with calls for a deep secular decline in USD, because, in our view, longer-run fundamentals continue to provide a floor. The US current account deficit has shrunk to a sustainable level and is no longer a knee-jerk reason to believe the USD should fall. Additionally, we do not subscribe to the view that inflation risks will bring the demise of the USD. With the Fed's balance sheet expansion bottled up at the bank level in excess reserves, substantial excess capacity in labor and product markets, inflation expectations contained, and actual total and core inflation at very soft levels, we do not look for USD-debasing inflation as either a base case or a medium-term substantial market risk.

Table 2: USD forecasts

End of	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10
EUR-USD	1.50	1.42	1.36	1.32	1.28
USD-JPY	93	95	100	105	110

Source: BofA Merrill Lynch

Chart 2: EUR has been following risky assets, such as the S&P 500



Source: Bank of England, Bloomberg, BofA Merrill Lynch

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We continue to target an increase of 1.50 for year-end EUR-USD, but a drop to 1.28 for year-end 2010

EUR: gains now, weakness later

The outlook for the EUR is for appreciation over the balance of the year. We keep our target for end 2009 at 1.50. In the near term, we continue to expect the current set of correlations with EUR to play out. The relationship between positive risk sentiment and gains in EUR remains strong, given the link between capital inflows to EM and euro strength created by reserve manager flows. This relationship seems unlikely to shift in the near term, as, although markets have enjoyed some strong moves back toward normalization (Chart 2), we still think there is a considerable way to go in terms of capital flowing from defensive to risky assets.

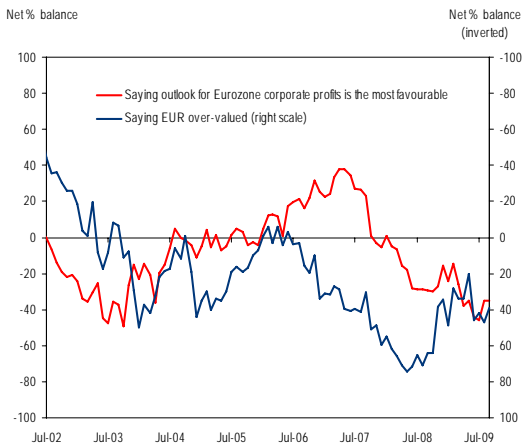
In this context, we still look for the dynamics around emerging market FX reserves to underpin near-term EUR strength. Reserve accumulation has resumed, as the normalization of markets has meant flows into riskier asset classes, including emerging markets. As money continues to move into EM economies, those countries wind up accumulating additional USD as they attempt to slow or resist local currency appreciation. This, in turn, strengthens the reserve manager bid for EUR as they attempt to diversify the fresh inflows. Markets have had momentary pullbacks from USD weakness, but we generally have taken such moves as an opportunity to build up positions, such as long EUR-USD. We expect it is too soon for this correlation to fade.

What goes up must come down: EUR to 1.28 at end-2010

There is some expectation in the markets that the broad EUR strengthening that has taken place since March will continue on a more sustained basis. But, ultimately, we believe that much of the current EUR strength will reverse itself, and we maintain our target of 1.28 for the end of 2010. Even at current levels, EUR feels uncomfortably high for corporations and, from the perspective of fund managers, crimps growth and profits (Chart 3).

Such a strong EUR does, in our view, pose a substantial threat to the nascent recovery. This view seems shared by many European politicians and central bankers, with some open-mouth operations already starting. But, in recalling last year's episode, when EUR surged all the way to 1.60, we can see more grumbling about currency strength in the EUR area and an intensification of attempts by policymakers to at least try and talk the currency down, especially as our current year-end 1.50 target is quite elevated. We believe the reaction to euro overvaluation will become more telling as reserve manager flow diversification demand for euro fades. This can occur either as capital inflows to EM slow or should EM FX rates – especially those in Asia – become more flexible.

Chart 3: Fund managers see EUR as a drag



Source: BofA Merrill Lynch, from the Fund Manager Survey

1.28 is a sizable move, but also back in line with valuations

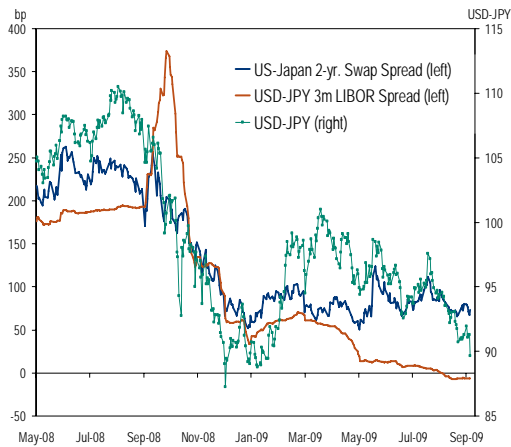
Although 1.28 would be a sizable move, it actually reflects a level that we view as more consistent with fair value on our longer-run valuation metrics. Using our fair value model COMPASS, we calculate that 1.30 would represent a longer-run-type equilibrium point for EUR in terms of generating sustainable capital flows and current account balances. On a real effective exchange rate basis, EUR is roughly 17% overvalued, which would imply EUR-USD toward \$1.20. In summary we think that the current strength in EUR should eventually reverse, and our 2010 target represents our rough estimate of where that longer-run point should fall.

Table 3: EUR forecasts

End of	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10
EUR-USD	1.50	1.42	1.36	1.32	1.28
EUR-JPY	140	135	136	139	141

Source: BofA Merrill Lynch

Chart 4: US-Japan Rate Spreads and USD-JPY

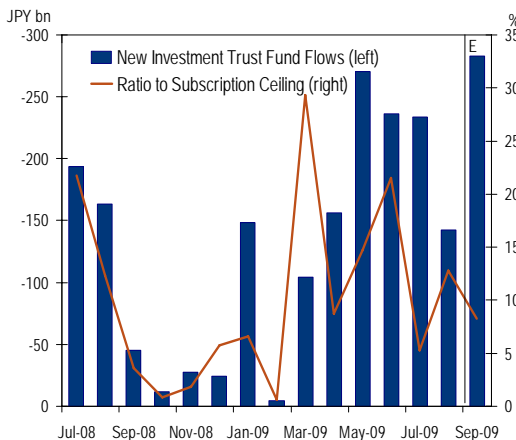


Source: Bloomberg, BofA Merrill Lynch

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Capital outflows should be more than sufficient to recycle Japan's stalling external surplus and foster USD-JPY gains once yield differentials turn supportive.

Chart 5: New Investment Trust Fund (*Toshin*) Flows



Source: Reuters, BofA Merrill Lynch estimate.

JPY: drop over the medium term

The outlook for the JPY is a gradual depreciation despite short-run volatility. Recent USD-JPY gains partly reflected exaggerated speculation of the new Democratic Party of Japan (DPJ) cabinet's support for a strong JPY. As the DPJ's policy initiatives are failing to attract global equity investors, the JPY's recent gains should not be sustainable. At the same time, USD-JPY has not been exempt from broad USD weakness recently. The JPY's status as the most preferred carry trade funding currency has weakened, as cheap USD funding costs have fostered USD carry trades as well. The 3-month USD LIBOR has remained below the 3-month JPY LIBOR since late August (see Chart 4). As a result, a sustainable USD-JPY rally probably requires a widening of US-Japan yield differentials. With the BoJ likely to be on hold for at least year, this is most likely to be triggered by markets reacting to the scaling back in liquidity provision by the Federal Reserve and eventually moving to price in a Fed tightening cycle. As such, a fully fledged USD-JPY rally now seems unlikely until late 2010 and we have revised down our forecast profile.

Japan's external surplus should pick up very slowly

Japan's current account surplus has bottomed, but will probably increase only very slowly in the next several months. The merchandise trade surplus growth stalled in the summer due to the slow improvement of overseas demand and lagged effects of the earlier JPY appreciation. We believe Japanese multinationals' repatriation in response to the April 2009 implementation of the Japanese HIA (a tax cut on repatriation of overseas retained earnings) will remain much smaller (at about JPY1tn in the first year) than portfolio and short-term investment flows, although HIA repatriation flows will probably tend to pick up at the end of each quarter.

DPJ's policy initiatives failing to attract global investors

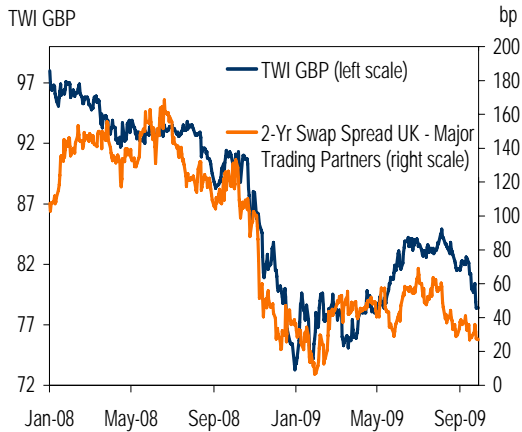
The JPY's recent gains on exaggerated expectations that the DPJ-led cabinet is likely to be supportive for a stronger JPY should not be sustainable. New Finance Minister Hirohisa Fujii probably would like to minimize intervention, but this is essentially the same stance as that for the previous Liberal Democratic Party-led cabinet. Mr. Fujii very clearly stated that the government does not intend to take a strong JPY policy, but that it does not intend to lead the JPY lower either. The DPJ needs to win in the summer 2010 Upper House election, and a sustainable recovery of the export-dependent Japanese economy is a pre-requisite for maintaining popular support. Moreover, the DPJ's domestic policy initiatives are long on near-term household income support measures and short on structural reforms to improve Japan's potential growth. In fact, the DPJ's proposals on more labor market regulations and re-consideration of postal privatization mean a setback in structural reforms. Thus, the DPJ's policies are unlikely to attract global equity investors, and the Merrill Lynch fund manager survey taken after the election already revealed more intentions of underweighting Japanese equities. On the other hand, recent popularity of some emerging market investment trust funds (*toshin*) suggests that Japanese investors should be ready for more diversification into higher-yielding foreign assets (Chart 5).

Table 4: JPY forecasts

End of	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10
USD-JPY	93	95	100	105	110
EUR-JPY	140	135	136	139	141

Source: BofA Merrill Lynch

Chart 6: TWI GBP vs. trade-weighted short-term rate spread



Source: Bank of England, Bloomberg, BofA Merrill Lynch

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GBP is likely to underperform until the BoE signals that monetary easing has ended

GBP: sterling loses its shine

The outlook for sterling between now and the end of the year is negative. The Bank of England surprised the market in early August by announcing a £50bn increase to the size of its quantitative easing (QE) program to £175bn. Furthermore, the minutes from that meeting revealed that three of the nine members of the MPC (including Governor King) had voted for an expansion of the QE program to an even higher level of £200bn. The focus of the MPC appears to have been on the large downward revision to Q2 GDP, which revealed a larger output gap than previously expected and subdued levels of M4 money supply growth (suggesting that QE is not working entirely as planned).

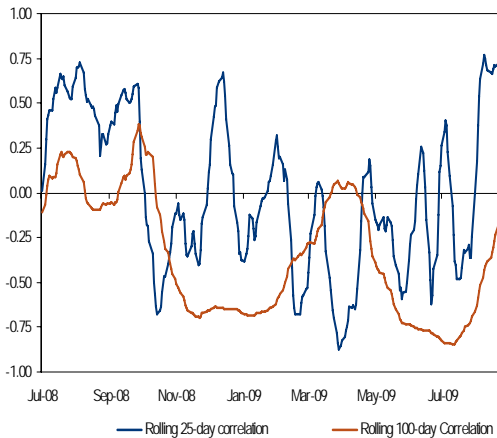
Sterling to underperform until BoE signals an end to easing

The completion of the newly voted for £50bn of purchases will coincide with the November Inflation Report, when the MPC will be able to judge from fresh inflation forecasts if any additional QE would be warranted. BoE Governor King has also mentioned twice the possibility of reducing the rate at which excess reserves are remunerated. This would have a similar effect on money market rates as actually cutting the Bank Rate. To be clear, BofAML economists do not look for the size of the BoE's QE program to be increased, but the risk of such a development has clearly increased. While the ECB and Federal Reserve focus on exit strategies, the BoE remains almost the only central bank in the developed world that continues to contemplate additional easing of monetary policy. In such an environment, sterling is likely to continue to underperform (Chart 6). A clear signal from the central bank that easing has come to an end will probably be required for GBP to stabilize. This should materialize as 2009 winds down.

EUR-GBP forecasts revised upward

In the context of the unexpected expansion of QE, we have revised up our end-2009 EUR-GBP forecast from 0.85 to 0.92. However, we still look for EUR-GBP to correct lower in 2010, ending the year around 0.83. In a trading environment in which there is greater differentiation between liquidity plays and true growth plays, sterling is unlikely to recapture the high beta status that it was granted throughout the first phase of the recovery (Chart 7). Nonetheless, underlying fundamentals, such as a shrinking current account deficit, suggest a sound footing for a sterling recovery once the BoE ends its monetary easing campaign.

Chart 7: Sterling loses its high beta status



Note: Correlations between EUR-GBP and S&P 500

Source: BofA Merrill Lynch

Trade and capital flows to eventually help sterling recover

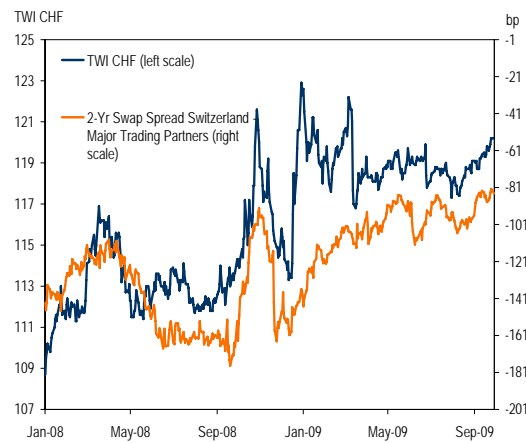
The recession and resultant rebalancing of the UK economy are expected to reduce the current account deficit from -2.1% of GDP in 2009 to -1.4% in 2010. The rebalancing process has already helped the 12-month rolling-sum of the current account deficit and foreign direct investment narrow to -£31.6bn from a trough of -£82.7bn in September 2007. Indeed, the attractiveness of investing in the UK has likely increased as a result of the currency's depreciation. These underlying developments should lay the ground work for sterling appreciation versus EUR in 2010. Our view of USD weakness still leaves us with a rising GBP-USD profile until year-end.

Table 5: GBP forecasts

End of	Q4 09	Q1 10	Q2 10	Q3 10	Q410
EUR-GBP	0.92	0.89	0.87	0.85	0.83
GBP-USD	1.63	1.60	1.56	1.55	1.54

Source: BofA Merrill Lynch

Chart 8: TWI CHF vs. trade-weighted short-term rate spread

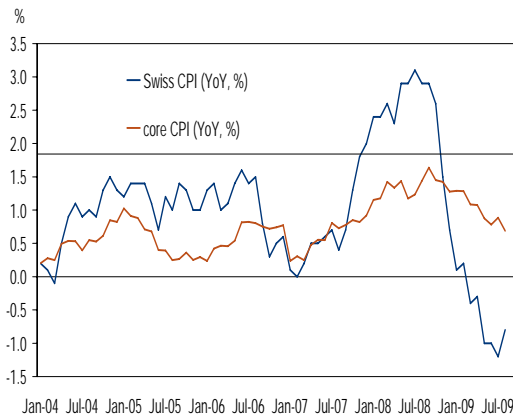


Source: Bank of England, Bloomberg, BofA Merrill Lynch

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As long as deflation looms in Switzerland, the SNB will likely continue to intervene in the FX market, placing a floor of 1.5000 on EUR-CHF.

Chart 9: Deflation risks suggest further intervention



Source: Bloomberg; BofA Merrill Lynch

CHF: steady as she goes

The outlook for EUR-CHF is one of stability. During periods of heightened risk aversion, Switzerland is unable to smoothly recycle its large current account surplus, putting upward pressure on CHF. This move has also been helped by an unwinding of the CHF carry trade in Eastern Europe. CHF appreciation risks exacerbating the serious economic downturn and the resultant potential of deflation in Switzerland. The SNB has responded with a range of unconventional policy measures, including FX intervention, and appears to be defending the area around EUR-CHF 1.5000. However, the exact level and timing of their intervention operations have not been predictable.

Switzerland re-affirms QE club membership

BofAML economists look for the Swiss economy to contract -1.4% this year, with a modest recovery in 2010. The resultant output gap creates a serious risk of deflation. We expect Swiss CPI to fall -0.3% in 2009 and to rise a modest +0.5% in 2010. The SNB has responded by taking its target band for three-month CHF LIBOR down to the effective zero bound (0 to 0.75%) in March 2009 (Chart 8) and reaffirmed as recently on September 17 that it remains ready to provide generous liquidity injections and to purchase CHF bonds to reduce risk premia on long-term private sector debt. The SNB also reiterated that it “will continue to act decisively to prevent any appreciation of the Swiss franc against the euro.”

Carry trade reversal pushes CHF higher

In addition to the large current account surplus (9% of GDP), periodic CHF demand (requiring offsetting SNB intervention) is likely to emerge as part of the global de-leveraging process. From Q1 2003 to Q4 2007, the level of CHF denominated cross-border banking claims of non-Swiss banks rose from about CHF 90bn to CHF 154bn. To put this into context, the cumulative trade surplus in goods totaled a mere CHF 29bn during the same time period. However, the global financial crisis has sharply reversed the CHF funded carry trade, requiring banks in Hungary and Poland to purchase francs to service their liabilities denominated in CHF. The aforementioned level of CHF denominated cross-border banking claims has shown some signs of stabilization over the last two quarters, but it is likely to decline further as the economic deterioration in eastern Europe leads to further write-downs.

SNB to resist further appreciation

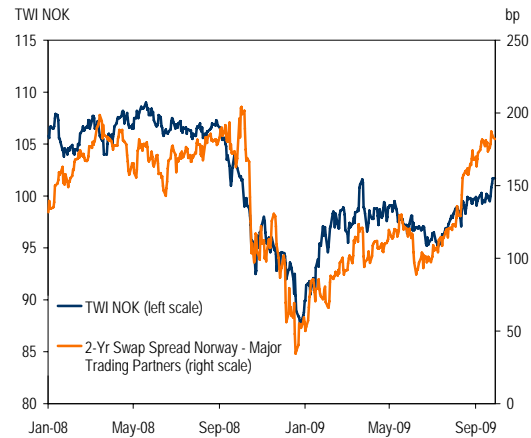
The SNB has been very clear about its intention to avoid additional appreciation of the CHF, and has proved its resolve with EUR 11.7bn in official purchases in Q2 2009. There is no practical limit on the quantity of FX intervention – sterilized or otherwise – that the SNB can undertake given it is accumulating FX reserves in exchange for local currency, as long as inflationary pressures remain subdued (Chart 9). The recent rhetoric from the SNB suggests that it will defend the 1.5000 level. Looking ahead, we expect EUR-CHF to grind higher as the global economy heals, Swiss investor risk appetite recovers and carry trade unwinds are completed. However, we initially underestimated the extent to which CHF would remain supported as financial markets recovered from the low point of March 2009. As a result, we have modestly lowered our forecasted EUR-CHF profile.

Table 6: CHF forecasts

End of	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10
EUR-CHF	1.52	1.53	1.54	1.55	1.56
USD-CHF	1.01	1.08	1.13	1.17	1.22

Source: BofA Merrill Lynch

Chart 10: TWI NOK vs. trade-weighted short-term rate spread

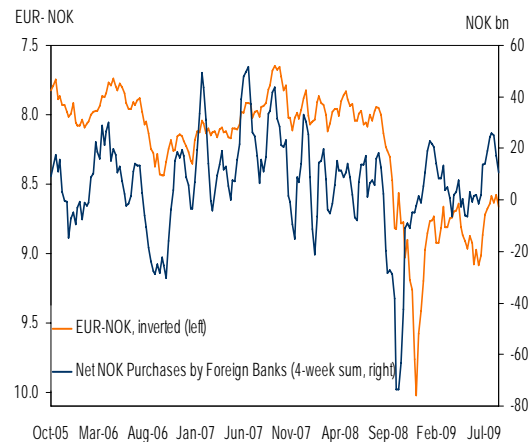


Source: Bank of England, Bloomberg, BofA Merrill Lynch

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The resilience of the Norwegian economy should prove appealing to foreigners, and help EUR-NOK descend to pre-crisis levels.

Chart 11: Foreign inflows to help NOK recover



Source: Bank of England, Bloomberg, BofA Merrill Lynch

NOK: a solid growth play

The future is bright for NOK, as the negative impact of the financial crisis continues to dissipate. The crisis had two major negative effects on NOK. First, liquidity concerns and the correction in commodity prices prompted significant foreign selling of Norwegian equities. Second, the fall in oil prices and the global slowdown dealt a serious blow to the Norwegian economy, leading to sharp interest rate cuts and a reduction in yield support for the currency. Nonetheless, the relative resilience of the Norwegian economy, partly due to the recovery in oil prices, should help NOK appreciate in the months ahead.

Norwegian economy displays relative resilience

BofAML economists look for Norway to experience the least shallow recession amongst the countries of developed Europe (counting the Eurozone as a whole) in 2009 (-1.1%) and for the strongest rebound in 2010 (+2.8%). The growth outlook is being supported by ongoing investment in the oil sector, significant fiscal stimulus, and the resilience of the domestic labor market. As such, the Norges Bank is likely to be the first central bank in the G10 space to hike rates (probably in October), creating yield support for NOK (Chart 10). However, a second source of currency appreciation related to the robust growth outlook in Norway may prove to be more important: international capital flows.

Capital inflows to support NOK

NOK hit new record lows as a result of investors fleeing Scandinavia in favor of more liquid currencies such as EUR and USD during the height of the financial crisis. Foreigners left the Norwegian stock market en masse in late 2008. Statistics Norway reports that foreigners sold NOK 31bn in Norwegian shares in Q4 2008, reducing their ownership of the stock market from 38% to 31%. Foreign demand for NOK (and by extension Norwegian assets) is, by definition, a key driver of the currency. EUR-NOK has maintained a significant relationship throughout the crisis with the level of net NOK purchases by foreign banks, a data series published by the Norges Bank (Chart 11). With these flows strongly influenced by foreign equity purchases, NOK's fate should be closely connected to foreign interest in the Norwegian growth story.

NOK to recover despite shrinking current account surplus

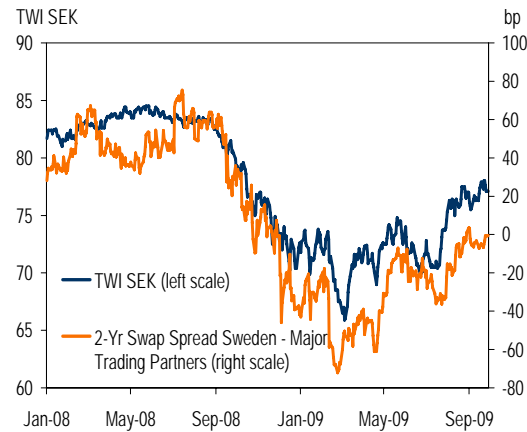
Despite the recent recovery, the decline in oil prices should significantly lower the current account surplus in 2009. However, the Norwegian government aims to avoid creating a form of "Dutch disease" in Norway by recycling the majority of oil proceeds back into global capital markets via the government pension fund, largely mitigating the effect of oil prices on NOK over the medium term. Seventy percent of the proceeds from the trade surplus that accumulated from Q1 1999 (the year during which Norway's terms-of-trade started to show a perceptible increase) to Q2 2008 were transferred to the government pension fund to purchase foreign assets. As such, we do not expect the sharp decline in oil prices from the 2008 highs to have a lasting effect on NOK. However, there is an indirect effect. The recent rebound in oil prices should help boost the economy and provide support for the currency via the yield support channel.

Table 7: NOK forecasts

End of	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10
EUR-NOK	8.20	8.10	8.00	7.90	7.85
USD-NOK	5.47	5.70	5.88	5.98	6.13

Source: BofA Merrill Lynch

Chart 12: TWI SEK vs. trade-weighted short-term rate spread



Source: Bank of England, Bloomberg, BofA Merrill Lynch

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SEK's period of outperformance has probably come to an end with Sweden's growth prospects below many G10 nations

SEK: leaving the fast lane

We maintain a downward bias for EUR-SEK, but the krona's period of significant outperformance has probably come to an end. SEK has been the strongest performer in the G10 space versus EUR and USD over the last three months. However, the currency's appreciation should be viewed as an unwinding of the severe undershoot induced by the financial crisis and not as a rally sparked by the country's growth prospects or near-term tightening from the Riksbank. Looking ahead, the inability of Sweden to recoup in 2010 the GDP declines of 2009 (as we expect for Australia, Canada, New Zealand and Norway) is likely to remove SEK from the camp of outperformance. On a regional basis, we expect SEK to underperform the currency of its resilient neighbor, Norway. Given the relative lag in the Swedish recovery, we have modestly raised the EUR-SEK forecasts.

Riksbank divided on interest rate outlook

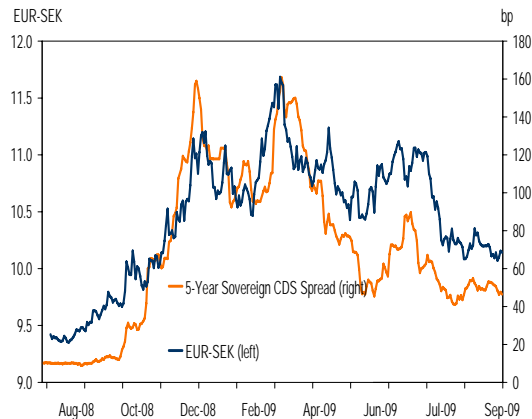
The Swedish economy was hit hard by the global contraction in demand, with 55% of the nation's GDP dependent on the export sector. BofAML economists look for a -4.3% contraction in 2009 and a recovery of +2.3% in 2010. However, the uncertainty surrounding the durability of the recovery has created a significant divergence of views at the Riksbank. The central bank has signaled in its forecasted repo rate path that monetary policy will remain on hold until autumn 2010. The internationally renowned monetary policy expert and Executive Board member Lars Svensson favors additional easing measures. In contrast, his colleagues, Deputy Governors Nyberg and Wickman-Parak, revealed in September that they believe rates will have to be raised earlier than what the Riksbank has presented at its core scenario. With two members of the Executive Board now openly disagreeing with the forecast, a significant SEK sell-off related to a reduction in tightening expectations does not seem likely, despite these expectations potentially being unrealistically elevated (Chart 12).

Sweden and the Baltics

Some market participants still believe that the exposure of the Swedish banking sector to the Baltic nations creates risks for Sweden's sovereign debt rating and, by extension, for the currency. These concerns manifested themselves during the financial crisis through a high correlation between EUR-SEK and the five-year Swedish sovereign CDS spread (Chart 13). Swedish banks have lent heavily in these countries, with the BIS estimating outstanding loans in the region at around SEK75bn, or roughly 18% of Swedish GDP. As a majority of these loans are euro-denominated, a currency devaluation in the Baltics would, therefore, significantly raise the level of non-performing loans of Swedish banks.

However, given the relatively healthy fiscal condition of Sweden, we have long believed that the burden of a potential government bail-out of the banking sector would be manageable, ("[Sweden: wearing a bathing suit?](#)," *FX Spotlight*, 13 March 2009). Furthermore, our emerging markets strategy team thinks that the probability of devaluation in the Baltic region has been considerably reduced. In this context, we do not believe that SEK is vulnerable to significant depreciation induced by the exposure of the Swedish banking sector those eastern European nations.

Chart 13: SEK weakened by fiscal concerns



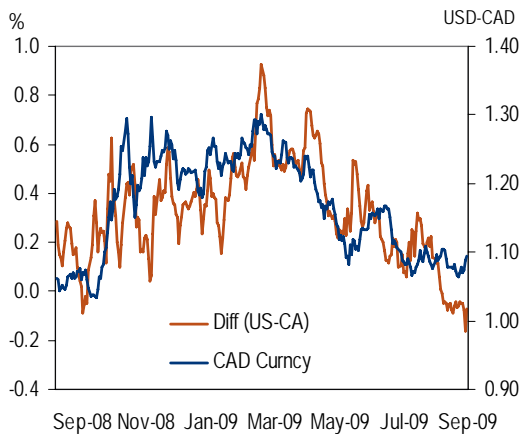
Source: Bank of England, Bloomberg, BofA Merrill Lynch

Table 8: SEK forecasts

End of	Q4 09	Q1 10	Q2 10	Q3 10	Q410
EUR-SEK	10.00	9.95	9.90	9.80	9.75
USD-SEK	6.67	7.01	7.28	7.42	7.62

Source: BofA Merrill Lynch

Chart 14: Spreads favor USD-CAD lower

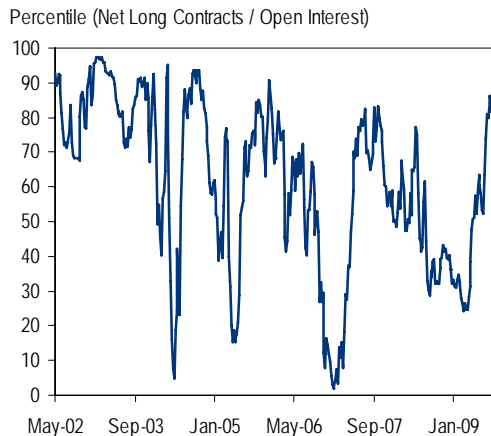


Note: Chart is the 2-year swap rate differential with spot
Source: BofA Merrill Lynch, Bloomberg

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CAD should strengthen over the near term on the back of risk appetite and stronger macro data.

Chart 15: Long CAD positioning historically high



Source: BofA Merrill Lynch, CFTC

CAD: upside still, but limited

The outlook for the CAD is positive for the remainder of the year. We expect risk appetite and inflation pressures to drive USD-CAD lower, with a target of 1.02 for the end of Q4. However, we see CAD retracing against the USD in 2010 on the back of a shift in investor expectations surrounding USD-denominated assets (page 2) and as the Federal Reserve shifts to a tighter policy setting.

Risk supportive of high beta, spreads favor USD-CAD lower

Last week, the VIX closed at 23.08, below the July lows and the lowest the index has been since early September 2008. Our own proprietary index (see [Forex Portfolio Manager, 28 September 2009](#)) is reading 0.36, similar to levels seen at the end of Q1 2007. Clearly, appetite (and positioning) has returned following better fundamentals. With stronger demand returning to economies globally, and data still surprising to the upside, we see additional room for risky/high beta assets to appreciate through year-end.

Spreads have re-opened in favor of CAD strength, with 2-year swap differentials favoring USD-CAD lower (Chart 14), on the back of an improved macro outlook and shrinking output gap. BoC Deputy Governor Longworth has noted that growth in the second half of the year could be stronger than previously thought. Supporting this, our economists' view on Canada is quite bullish, forecasting 4%+ annualized quarterly growth in three of the next four quarters. While we are not forecasting hikes in the policy rate until Q2 2010 (in line with BoC signals), the risks remain to the upside given the acceleration of the outlook. Our house estimate is for a full 125bp of tightening by end-2010.

Bank signals reasonable strength acceptable

The Bank of Canada appears to be becoming less concerned with CAD strength. Since June, they have signaled that the strong CAD remains a risk to the expected recovery in growth; however, recently, the language surrounding this assessment has softened. June's statement read: "If the unprecedentedly rapid rise in the Canadian dollar ... proves persistent, it could *fully offset* these positive factors." In July, the bank retreated to "the higher Canadian dollar, as well as ongoing restructuring in key industrial sectors, is *significantly moderating* the pace of overall growth." September's statement was an even milder "persistent strength in the Canadian dollar *remains a risk* to growth and to the return of inflation to target." Additionally, Deputy Governor Longworth repeated on Wednesday that the bank has no target rate for USD-CAD, signals that we interpret as accepting further downside, so long as it is in an orderly manner.

Risks do exist as long CAD has been popular

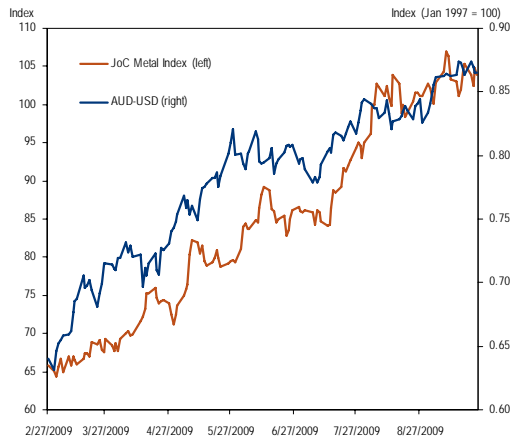
However, risk does exist in positioning. The latest IMM data in Canada shows that the net positioning as a percentage of open interest is the highest it has been since 2007, when CAD last made its run to parity (Chart 15). Although we still forecast further upside to the cross following increased trade and improving growth outlooks, the positioning backdrop is a warning that the probability of a correction higher is increasing. We view this as a risk, and not our base case scenario. We would not expect any positioning-related CAD sell-off to endure for long, and would treat any instances as a buying opportunity.

Table 9: CAD forecasts

End of	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10
USD-CAD	1.02	1.05	1.06	1.07	1.08

Source: BofA Merrill Lynch

Chart 16: Commodities reflect risk appetite



Source: Bloomberg, BofA Merrill Lynch

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We view the AUD as out-performing over the next two quarters as risk appetite and flow drives commodity currencies.

AUD: strengthening nicely

We see AUD-USD increasing from present levels on the back of strong risk appetite, stronger commodities and supported, in part, by an EM-Asian led recovery. We are forecasting 0.90 for Q4 2009 and Q1 2010, and retracing from there. We expect AUD (along with the NZD) to outperform CAD within the dollar bloc.

Stronger fundamentals and financials

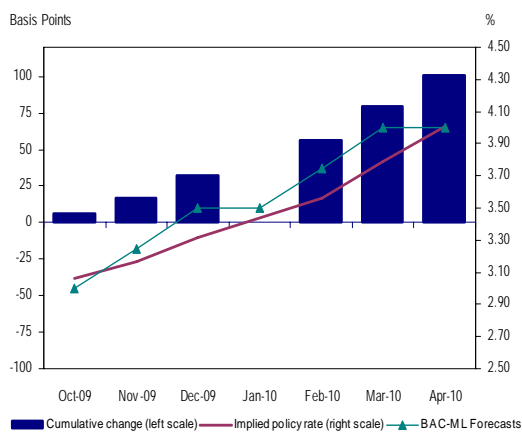
AUD has benefited from the pick-up in risk sentiment and optimism around commodities, as indicated by the gains since March (Chart 16). Such a trend is expected to continue over the coming year, with our commodities strategist forecasting upward paths in energy, industrial and precious metals. This demand would naturally correlate to increased global appetite and be beneficial for the AUD from a trade perspective. What started as a risk appetite play is now well into a cycle with stronger fundamental support in the macro data.

The RBA's semi-annual Financial Stability Review illustrated this last week, which, as expected, was relatively positive. Outside of the financial sectors, sentiment has been improving in households in recent months. Like other countries, the household sector experienced a considerable contraction in net worth when equities prices were falling. However, disposable income has received a significant boost from interest rate reductions and fiscal transfers. The ASX has recovered 45% from its lows in early March. Such factors look attractive on a long-term horizon, as the AU economy enters a growth cycle.

RBA cools tone, positioning stretched

While the RBA is expected to be the second central bank in the G10 (Norges the first) to begin its tightening cycle, the minutes from the September meeting have pared back the short-term rates outlook, with the market nearly pricing out all expectations of a hike in October. As our economist notes, the minutes were much more cautious about China, saying recent Chinese data had been "somewhat mixed" and that "there were some signs that Chinese demand for resources had not continued at the exceptional pace of the June quarter." Such statements are helping to cool some of the fire around AUD, adding volatility as markets push expectations. Currently, the market has priced November or December as the first 25bp hike; our economist is on the more bullish side with his call for the November meeting (Chart 17).

Chart 17: RBA enters it's tightening cycle



Source: Bloomberg, BofA Merrill Lynch

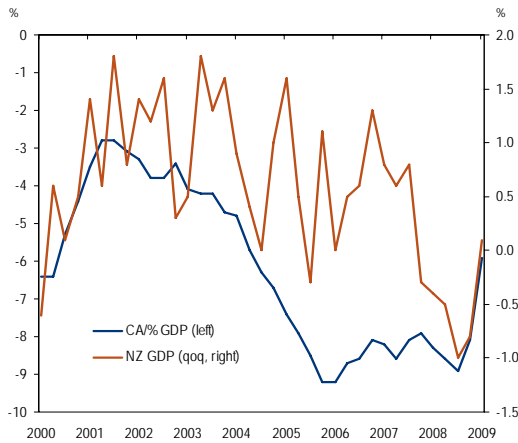
Net positioning (as a percentage of open trailing interest) in CFTC data illustrates how asymmetric markets are now with respect to commodity currencies (see [Forex Portfolio Manager, 28 September 2009, page 5](#)). The trailing average of open interest adjusts for a more realistic comparison of positioning through time, and is at the highest level for the Australian dollar since late 2006/early 2007. Given that positioning can remain stretched for some time we do not immediately take this as signaling a reversal, but this is the primary short-term risk to our bullish forecast.

Table 10: AUD forecasts

End of	Q4 09	Q1 10	Q2 10	Q3 10	Q410
AUD-USD	0.90	0.90	0.88	0.86	0.84

Source: BofA Merrill Lynch

Chart 18: Substantial macro improvement

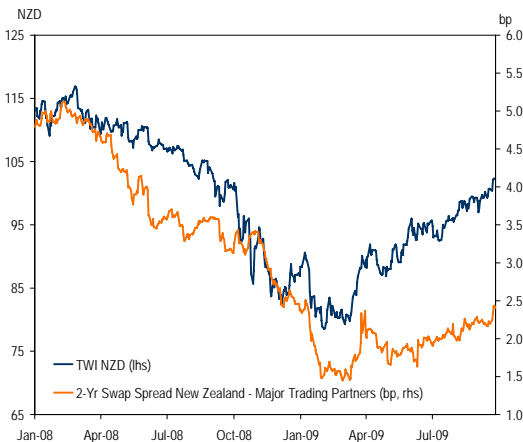


Source: Bloomberg, BofA Merrill Lynch

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We expect a relatively moderate pick-up in NZD for 2009 and retracement in 2010 down to 0.68.

Chart 19: TW NZD a bit strong



Source: Bloomberg, BofA Merrill Lynch

NZD: a strengthening outlook

Our outlook for the NZD is for near-term appreciation. We shift our forecast path upward for NZD as our original forecast underestimated the beta of the NZD with respect to global risk appetite. We now expect NZD-USD at 0.75 by year-end, but decreasing to 0.68 by end-2010. NZD should remain supported over the near term, based on its connection to the Asian cycle, improving terms of trade, high beta nature and recent external improvement.

Upside surprise

Expectations in New Zealand have been improving of late, helped in part by recent data. New Zealand's current account deficit narrowed much more sharply than expected in Q2, actually printing a small surplus, the first since Q1 2003. As a result, the four-quarter deficit narrowed to -5.9% of GDP (consensus -7.4% of GDP) from a downward revised -8.1% of GDP in the prior quarter. Such improvements in the external sector bode well for any currency, and the NZD was no exception, rallying a full percent on this information alone. In addition, quarterly GDP showed growth of 0.1% for Q2 vs. the treasury prediction of -0.4% and consensus of -0.2%. This was the first positive number since Q4 2007 (Chart 18).

These two data points suggest a less negative output gap than the RBNZ must have been assuming when communicating rates would be kept at 2.50% until late 2010. This year, the CA deficit will be much lower than last year's result due to the fall-off in imports and the rapid rise in dairy, meat and forest products, which are staples of the NZ economy. In fact, such demand is having a direct impact on NZD support. Fonterra announced this week the total forecast available for payout for the 2009/10 season increased 55 cents to NZD5.10 per kilogram of milk solids.

A revised outlook

Concern about NZ's twin deficits should be somewhat alleviated by this data (smaller external deficit, prospects for revising down budget deficit projections as % of GDP). The data also increase the risk of an RBNZ rate hike before late 2010. Our economist has now brought forward his call for a first RBNZ hike to April 2010, and now expects the cash target rate to reach 3.75% by December 2010. That is still behind market pricing (4.0% expected), but the focus on a tightening cycle should nevertheless support the NZD over the balance of this year at least.

Long term, we expect the growth in risk appetite to run its course and NZD to fade back toward 0.68 by the end of 2010. On a trade-weighted basis, the NZD has enjoyed strong gains, but this is perhaps larger than can be justified on the basis of developments relative to its trading partners (Chart 19). In our view, the strong tie between New Zealand and the Asian economic picture will by then be fully priced in, and the USD will begin strengthening again – particularly as markets start to focus on the Fed's exit strategy.

Table 11: NZD forecasts

End of	Q4 09	Q1 10	Q2 10	Q3 10	Q410
NZD-USD	0.75	0.74	0.72	0.70	0.68

Source: BofA Merrill Lynch

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- [Is EEMEA's growth model alive? \(19 Jun\)](#)

EMEA: growth outlook supporting FX Growth likely to surprise to the upside

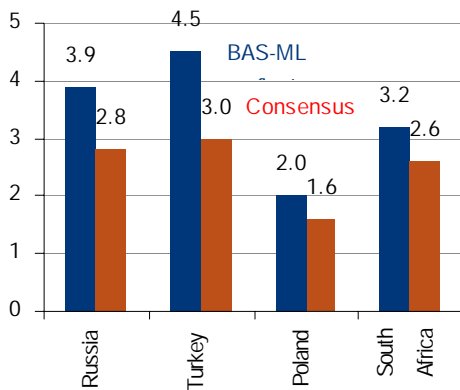
We are bullish on EMEA FX, mainly reflecting an improvement in the growth outlook. The remainder of 2009 will indeed present the regional economies with a sweet spot, in our view, with growth surprising to the upside and inflation remaining contained. The initial phase of the recovery is likely to be V-shaped.

We upgrade Russia's 2010 growth to 3.9% from 2.4%, thus placing all our forecasts for the major markets above consensus (Chart 20). This stronger growth outlook provides support to our FX view that EMEA currencies will likely strengthen further in the period ahead.

Stimulative EM Policy

In EMEA, we expect policies to remain stimulative well into 2011. We expect further easing in most markets, and significant ones in Hungary and Romania. Tightening will also be less pronounced than what is currently priced in, in our view.

Chart 20: We expect substantially higher 2010 GDP growth than the consensus (% yoy, av.)



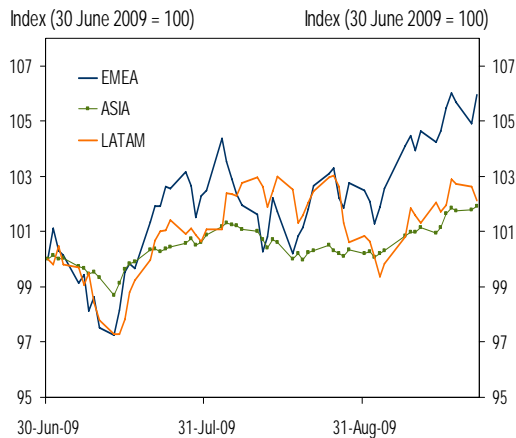
Source: BofA Merrill Lynch, Consensus Economics (August edition)

The exceptions are South Africa and Turkey, where we expect earlier and more tightening than priced, as central banks need to assert their inflation-fighting credibility: in South Africa, because inflation will only temporarily dip into the target range, on our forecast; and, in Turkey, because the CBT will want to preserve the structural break in inflation that resulted from the recession. We believe fiscal policy is likely to become only marginally more restrictive as governments remain unpopular and wary of a double-dip, while financing conditions stay favorable.

FX differentiation going forward

EMEA FX has outperformed other regions the past few weeks, in line with our views. While the current environment is generally supportive of EMEA FX (Chart 21), we believe some differentiation is likely to take place, as currencies are at different stages of the normalization process. This may favor a relative value approach, in our view.

Chart 21: EMEA FX outperforming



Source: BofA Merrill Lynch

Looking at pre-crisis levels, we believe Central Europe FX, which was the hardest-hit during the crisis (with the exception of CZK), has the furthest to go. On this basis, we are bullish on both the HUF and PLN. Currencies such as the ZAR or CZK display relatively less potential from a valuation perspective, but, in the near term, the rand is likely to gain further support from the appetite for risk growth plays despite the mounting risk of central bank intervention. On this basis, we recommend a long PLN-CZK position.

For Russia, in the near term, the broad USD weakness is likely to push USD-RUB lower, but we do not foresee a sharp move of the RUB against the basket until early next year. The pace of appreciation may pick up in 2010, driven by further appetite for risky assets, evidence of stronger global growth recovery and more acceptance on the part of the Central Bank of Russia of a stronger currency. The CBR has already signaled that it would gradually introduce more flexibility in its defense of key RUB levels (against the basket). Overall, it remains clear that the oil price exerts a significant impact on the RUB. We estimate that the correlation coefficient between the RUB and the oil price stands at 0.82, pointing to a very strong relationship between the two. From a longer-term perspective, the RUB is probably one of the most undervalued currencies in the EM FX universe, which makes long RUB a compelling call for investors with a longer-term focus, in our view.

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Latin America: stepping up

On aggregate, we believe EM currencies are undervalued because external imbalances are tame and real effective exchange rates do not seem misaligned. While growth in LatAm is forecasted to reach only 3.3% in 2010, lagging the average for EM by 250bp (Chart 22), this would still imply an acceleration of 500bp, making it one of the sharpest recoveries on record for the region.

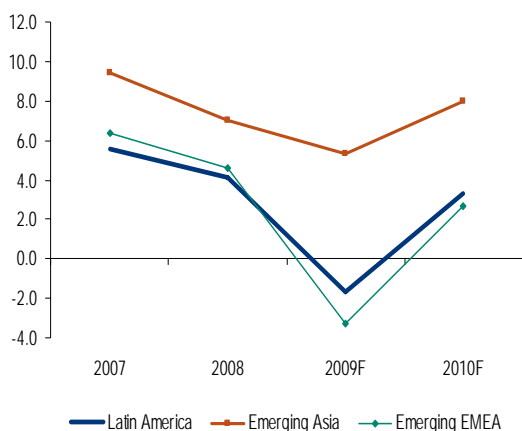
Still, as growth should remain at or below potential in most countries, we believe inflation is unlikely to become an important source of concern anytime soon. In fact, with the exception of Mexico, where higher taxes could push inflation temporarily higher, central banks in Brazil, Chile, Colombia and Peru are all expected to be more dovish than what is currently suggested by markets.

Central banks: tightening bias in Mexico, not yet in Brazil

The permanence of a wide output gap and relatively contained inflation expectations (2010 year-end inflation expectations stand at 4.01%) will allow Banxico to keep the Fondeo rate unchanged at 4.50% for the rest of 2009. However, the government's need to rely on increased taxes and higher public administered prices for revenue purposes will feed inflationary pressures, becoming a critical element weighing on Banxico's balance of risks for 2010. We maintain an estimated Fondeo rate for 2010 year-end at 5.50%. But we now see a bias for the CB to initiate the reversal of the monetary cycle sooner than anticipated.

In contrast, in Brazil, with inflation running significantly below the midpoint of the target and growth decelerating to a level consistent with equilibrium, we do not take a Selic hike next year for granted. In fact, we continue to expect the Selic to remain unchanged at 8.75%. We agree that the risks to this forecast are somewhat skewed to the upside, particularly in H2 2010, when the BCB will already be focusing on 2011. Ultimately, the behavior of inflation expectations for the year will be the judge. We think the verdict could be that we have finally converged to lower interest rates.

Chart 22: Emerging Markets growth

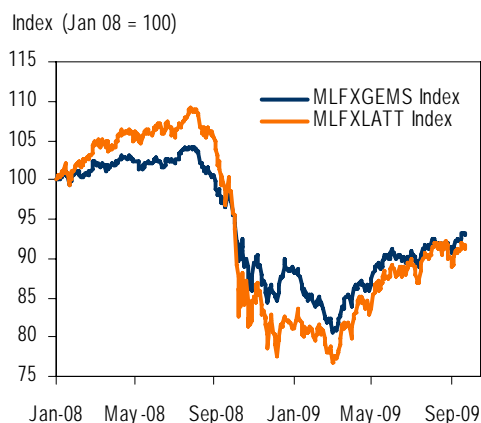


Source: BofA Merrill Lynch

More bullish on LatAm FX going forward

The bullish outlook for commodities and a supportive risk appetite backdrop are likely to support further LatAm FX strength into year-end and 2010 (Chart 23). This will be especially true for those currencies that remain significantly undervalued from a fundamental perspective.

Chart 23: MLFX EM FX and LatAm FX Indices



Source: BofA Merrill Lynch

This is the case with the MXN, where we now envision a faster convergence than previously toward fair value and expect the MXN to close 2009 at 13.25 and trade toward 12.30 by end 2010. The BRL has appreciated even faster than our already bullish expectations. We expect its strong performance to continue and the USD-BRL to close the year at 1.70. However, uncertainty regarding the presidential elections may lead to some BRL weakness in 2010.

We are now more bullish the CLP, as the currency remains far from fair value and our forecasts previously reflected potential BCCh intervention, which proved unnecessary, given improving growth and inflation expectations. Oil price strength has also led us to push back COP and VEF weakness. With all this in mind, we are long the BRL and the MXN in an EM FX basket against G3 FX. We are also long the CLP against the PEN.

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Asia: in the sweet spot

The prevailing environment is good for asset markets. Prospects of stronger growth, low inflation and central banks on hold provide the ideal backdrop for gains in asset markets and also keep bonds from weakening significantly. The macro view supports Asian FX. We are most constructive on Asian FX and think USD-Asia heads lower as it catches up with fundamentals.

Policy tightening in Asia (ex Japan)

Asia (ex Japan) is expected to be the fastest-growing region in the world. Over the next 2-3 quarters, we expect growth to accelerate, inflation to remain below target levels and policy to remain supportive for the economy. In our view, Australia is likely to lead the tightening, followed closely by Korea and India. That said, tightening is expected to be less than what markets appear to be pricing currently. Fiscal policies will continue to be supportive; however, we expect some moderation in deficits in 2010. In the coming months, the big upside to growth is likely to be in the small export-driven economies in the region.

Downward USD-Asia trend to accelerate

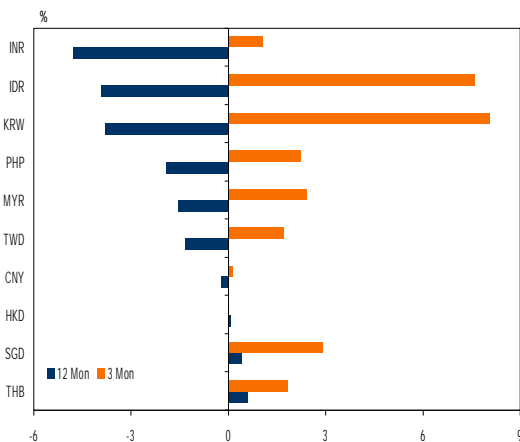
Support for Asian FX appreciation continues to build and we think Asian central banks will relax their grip and permit further appreciation as we head into the last quarter. The latest trigger has been broad USD weakness. Valuations have been attractive for a while, but central banks were absorbing inflows and have dulled appreciation pressures. With reserve accretion running at near the strongest (over a 3m rolling period) pace, it is natural to expect some slowdown, especially when some central banks are considering 'exit strategies.' The positive base effect on inflation is almost over and headline inflation is expected to rise sharply from the lows. FX appreciation could also help stem inflation expectations in this backdrop. Finally, this asset class is also most out of sync with economic fundamentals when one puts the rally in credit, the rally in equities and the sell-off in fixed income into context. Our preferred currencies are the KRW, IDR and INR (Chart 24).

Alignment of factors will pave the way for stronger RMB

During the policy tightening period from 2007 to H1 2008, spot RMB appreciation was evidently a complementary policy tool. Export competitiveness concerns were mitigated as the authorities managed to maintain a non-appreciating RMB NEER (Chart 25). USD trending lower has provided the sufficient condition and, with the bias for monetary tightening likely to increase rather than decrease going forward, we believe it is opportune to price in greater RMB appreciation via the NDFs.

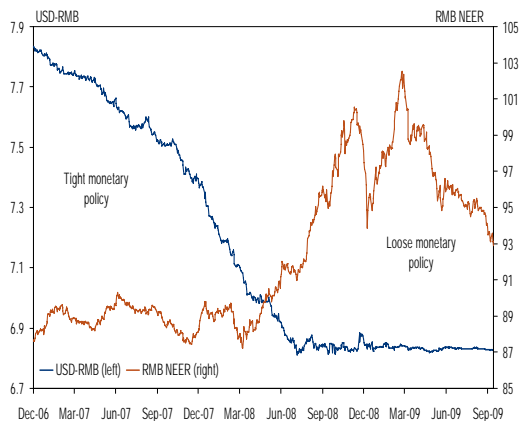
The debate on when the authorities will loosen their grip on the RMB is ongoing, and the main line of arguments we adhere to include the following. First, the current account flows dominate the financial account flows with a high degree of stability, thus, we think current account flows will likely dominate for FX policy considerations. China's capital account remains closed, which restricts the scope of capital flight of hot money inflows. Controls will remain in place and the SAFE chief recently said that it would keep a close watch to prevent any "massive" outflow or "concentrated" inflow of capital. A multi-year move toward capital account liberalization requires a more flexible currency. Second, to keep the RMB stable, the central bank has been an ardent USD buyer and sterilizing these purchases, which comes at a cost, and is still mainly concentrated on US Treasuries holdings. This reluctance will likely increase, in view of the authorities feeling uncertain about the USD's strength.

Chart 24: Asian FX – there is more to go



Note: Asian FX absolute returns against the USD over a 3m and 12m horizon.
Source: Bloomberg, BofA Merrill Lynch

Chart 25: Interplay between RMB and RMB NEER during different policy stances



Source: BofA Merrill Lynch, Bloomberg

G10 Currency overview

Table 12: Our view on select G10 currencies in brief

USD: For USD, the outlook continues to be for a bit more depreciation in the near term, and then appreciation through 2010 against most of G10. In general we do not expect to see a substantial pullback in risk appetite over the remainder of the year, and believe that the correlation between positive risk and a weaker USD will continue to hold at the same time. We disagree with calls for a deep, secular decline in USD because, in our view, longer-run fundamentals continue to provide a floor for the currency, including a substantial reduction in imbalances and a likely disinflationary environment over the next few years.

EUR: The near-term outlook for EUR is for a bit more appreciation for the rest of the year. We keep our target for year-end 2009 EUR-USD at 1.50. The relationship between positive risk sentiment and gains in EUR has really been a force, one that is unlikely to shift in the near term. But such a strong EUR does pose a substantial threat to the nascent recovery. Ultimately we believe that much EUR strength will reverse itself, and we maintain our target of 1.28 for the end of 2010. Although 1.28 would be a sizable move, it actually reflects a level that we view as more consistent with fair value on our longer-run valuation metrics.

JPY: The outlook for the JPY is gradual depreciation despite short-run volatility. Recent USD-JPY gains partly reflected exaggerated speculation of the new Democratic Party of Japan (DPJ) cabinet's support for a strong JPY. As the DPJ's policy initiatives are failing to attract global equity investors, the JPY's recent gains should not be sustainable. But a sustainable USD-JPY rally probably requires not only favorable risk sentiment but also a widening of US-Japan yield differentials, most likely triggered by market expectations of the US Fed's exit policies. The BoJ is not likely to begin a rate hike cycle at least for another year. A full-fledged USD-JPY rise is likely in 2010.

GBP: The outlook for sterling between now and the end of the year is negative. In the context of the unexpected expansion of Quantitative Easing by the Bank of England ("BoE"), we have revised up our end-2009 EUR-GBP forecast from 0.85 to 0.92. However, we still look for EUR-GBP to slide in 2010, ending the year around 0.83. The BoE remains the only central bank in the developed world that continues to contemplate additional easing of monetary policy. In such an environment, sterling is likely to continue to underperform. A clear signal from the central bank that easing has come to an end will probably be required for GBP to stabilize.

CHF: The outlook for EUR-CHF is one of stability. During periods of heightened risk aversion Switzerland is unable to smoothly recycle its large current account surplus, putting upward pressure on CHF. This move has also been helped by an unwinding of the CHF carry trade in Eastern Europe. Franc appreciation risks exacerbating the serious economic downturn and the resultant potential of deflation. The SNB has responded with a range of unconventional policy measures, including FX intervention, and appears to be defending the area around EUR-CHF 1.5000. However, the exact level and timing of their intervention operations have not been predictable.

SEK: We maintain a downward bias for EUR-SEK, but the krona's period of significant outperformance has probably come to an end. SEK has been the strongest performer in the G10 space versus EUR and USD over the last three months. However, the currency's appreciation should be viewed as an unwinding of the severe undershoot induced by the financial crisis and not as a rally sparked by the country's growth prospects or near-term tightening from the Riksbank. On a regional basis, we expect SEK to underperform the currency of its resilient neighbor, Norway.

NOK: The future is bright for NOK as the negative impact of the financial crisis continues to dissipate. The crisis had two major negative effects on NOK. First, liquidity concerns and the correction in commodity prices prompted significant foreign selling of Norwegian equities. Second, the fall in oil prices and the global slowdown dealt a serious blow to the Norwegian economy, leading the Norges Bank to cut interest rates and reducing yield support for the currency. Nonetheless, the relative resilience of the Norwegian economy, partly due to the recovery in oil prices, should help NOK appreciate in the months ahead.

CAD: The outlook for the CAD is positive for the remainder of the year and negative for 2010. We expect risk appetite and inflation pressures to drive USD-CAD lower, with a target of 1.02 for the end of Q4. However, we see CAD retracing against the USD in 2010 on the back of a shift in investors' expectation surrounding USD-denominated assets as well as Federal Reserve credibility.

AUD: We see AUD-USD increasing from present levels on the back of risk appetite, stronger commodities and supported in part by an EM-Asian led recovery. We are forecasting 0.90 end-of-year and Q1 2010, and retracing from there. AUD has benefited from the pick-up in risk sentiment and optimism around commodities, as indicated by the gains since March. Such a trend is expected to continue over the coming year, with our commodities strategist forecasting upward paths in energy, industrial and precious metals alike. What started as a risk appetite play is now well into a cycle with stronger fundamental support in the macro data.

NZD: Our outlook for the NZD is for near-term appreciation followed by weakness in 2010. We shift our forecast path upward for NZD as our original forecast underestimated the beta the NZD would respond with. We now expect NZD-USD 0.75 year-end and decreasing to 0.68 by end-2010. NZD should remain supported over the near term similar to AUD, based on its connection to the Asian cycle, improving terms of trade, high beta nature, recent external improvement and outlook on longer trends.

Source: BofA Merrill Lynch

EM Currency overview

Table 13: Our view on select EM currencies in brief

MXN: We expect MXN weakness over the next few weeks following seasonal pressures. The MXN tends to weaken in Q4 because of a turn in the balance of payments. The trade deficit tends to widen as imports increase and USD remittances decrease into year-end. The perceived real interest rate also tends to drop because actual inflation typically increases toward the end of the year. We think seasonal USD demand should keep USD-MXN from moving significantly lower and expect it to end the quarter at 13.75. However, by year-end the market should rectify some of the MXN undervaluation, and USD-MXN should close 2009 at 13.25.

BRL: Fundamentals remains BRL supportive with a narrowing current account deficit, high nominal and real yields, and robust trade inflows. USD-BRL continues to find strong support around the 1.80-1.81 level with positioning and risk appetite providing driver for near-term movements. Positioning remains slightly short USD with central bank FX data showing local banks were short USD1.1bn as of the end of August, less than the USD1.5bn in July. In September, Brazil has experienced net USD outflows of USD1.7bn, but the central bank continues to intervene in the spot market, purchasing USD0.6bn from 1-11 September.

CLP: Although Chile's terms of trade may still be weaker next year than in 2006-08, copper prices will still be strong enough to keep Chile's terms of trade stronger than in the years prior to 2006. Moreover, high prospects for copper will likely lift the CLP. Indeed, the CLP appreciated nearly 20% from its lows in late October 2008. The high correlation between the CLP and copper (balanced by higher oil expectations) points to a USD-CLP at 500 by the end of next year.

CNY: An alignment of factors will pave the way for stronger RMB. During the policy tightening period from 2007 to H1 2008, spot RMB appreciation was evidently a complementary policy tool. Export competitiveness concerns were mitigated as the authorities managed to maintain a non-appreciating RMB NEER. USD trending lower has provided the sufficient condition and, with the bias for monetary tightening likely to increase rather than decrease going forward, we believe it is opportune to price in greater RMB appreciation via the NDFs.

TWD: The CBC has managed to keep USD-TWD trading within 30-35 range multi-year, and we think that this modus operandi to maintain export competitiveness will persist. However, in our view, the bias is for USD-TWD to trade lower (but still within the range) in the near term, as 1) improved cross-strait relations means enhanced investment/repatriation inflows into Taiwan and 2) TWD remains competitive vis-a-vis its main trade competitors.

SGD: The authorities maintaining policies that continue to be stimulatory or supportive of growth implies that the argument for a change in FX policy to gradual appreciation is still weak for now. All said the SGD NEER has defied our expectation and persistently traded on the stronger end of the NEER band. The currency will likely remain flows-driven toward the end of the year and as interest for carry/yield remains subdued for now. Accordingly, we adjusted our end 2009 USD-SGD forecast lower to 1.42 from 1.46.

KRW: The KRW will likely benefit, as the BoK is expected to be one of the early 'hikers' in Asia. Recent CPI releases support the case for our economists' call for an early rate hike in Q4. In view of that, not only will the won's attractiveness be suitably enhanced from the yield perspective, we also expect some of the monetary tightening to be complemented via currency appreciation. The authorities have recently instilled a more bullish view on the won, projecting the currency to end the year at levels stronger than 1200.

IDR: Moody's upgrade of Indonesia's foreign and local currency sovereign debt ratings to Ba2 from Ba3 should bode well for IDR and IDR assets. The ratings upgrade was attributed to healthy growth prospects and resilience to recession. Portfolio flows have been constructive too, totaling USD190mn this month alone. BI is expected to stay supportive of IDR appreciation as long as it is gradual and orderly. Reserves accumulation has fallen in the last few months, in line with recent BI rhetoric that the central bank prefers not to intervene in the FX market. We maintain a constructive view on IDR and expect further gradual appreciation toward 9,500 by year end.

INR: The recent decline in NEER appears to be tapering off and we think it will be reasonable to expect a recovery going forward as better global and domestic growth prospects next year encourage a more bullish outlook in INR. Export competitiveness issues will likely fade into the background in coming months. The INR is well positioned to gain, as the RBI could be one of the first in Asia to tighten monetary conditions. Inflation trajectory will then hold the key and the momentum at which prices rise and/or get increasingly priced in could eventually be the trigger for USD-INR to move below the previous RBI threshold of 47.0 level.

THB: We expect BoT to actively ward off THB strength. The THB has been tracking the regional currencies rally with more enthusiasm and while the BoT's effort to ward off recent firming trend will be futile, it is not likely to let go of its interventionist stance. Foreigners have been net buyers of local stocks to the tune of USD548mn on MTD basis, fuelling upside pressure on THB though the authorities have been active in mopping up the excess liquidity to temper the unit's gains. Though largely ignored by markets for now, we think the political scene is a latent risk for medium term THB outlook.

HUF: We are bullish on the HUF, as we think the currency will pursue its adjustment after selling off sharply during the crisis. We expect the HUF to appreciate to 262 against the EUR by year-end and continue its strengthening trend into 2010 with EUR-HUF at 245 by the middle of the year. Nonetheless, we weakened our forecast slightly for the near term, as the HUF has not caught up with its peers yet. The HUF should perform well in a pro-risk environment, as Hungary boasts some of the highest rates in the EM space. The central bank has lagged its EM peers in easing policy and is now in the process of catching up, which has benefited the HUF.

TRY: We now forecast the TRY to appreciate moderately over the next few months and end the year at 1.44, and maintain an appreciating trajectory in early 2010. However, mounting concerns about the financing picture may cause the TRY to weaken in Q2, followed by a broadly stable profile at 1.45 until year-end. We are relatively bullish on the TRY, mainly reflecting the recovery of global risk appetite for emerging markets. We also think that the domestic policy environment is supportive of the TRY, with the central bank's policy bias remaining firmly on the dovish side and the government showing efforts to address the medium-term fiscal issues.

PLN: We remain bullish on the PLN in the period ahead and have revised our forecast for the year-end upward. We now forecast the PLN to break through 4.00 against the EUR in coming weeks to close the year at 3.95. The PLN will strengthen further next year with a low of 3.45 for EUR-PLN by the end of next year. Our PLN view reflects an improvement in the country's fundamentals, with risks on economic growth now skewed to the upside.

ZAR: We forecast the rand to close the year at 7.55 against the USD, broadly flat from current levels. We expect the rand to remain broadly stable in the near term, with perhaps a bias for some moderate weakness. However, there is more room for the rand to rally next year when appetite toward risky assets picks up further, at which time we project the USD-ZAR to trough at 7.25 by end-June. From a longer term perspective, we remain concerned about the longer-term overvaluation of the rand.

RUB: We continue to expect RUB strength, and have slightly revised our forecasts for USD-RUB lower to reflect our expectations of generalized USD weakness and a pro-risk environment, as well as the recent run-up in commodity prices. We now forecast the RUB to strengthen to 30.00 against the USD by year-end. In terms of the EUR-USD basket, this implies a rate of 36.75 by year-end, which is broadly stable from current levels. In the near term the broad USD weakness is likely to push USD-RUB lower, but we do not foresee a sharp move of the RUB against the basket until early next year.

Source: BofA Merrill Lynch, [Emerging Markets Monthly, 25 September 2009](#)

Forecasts

Table 14: Quarterly forecasts – G10 currencies

	Spot	Dec '09	Mar '10	Jun '10	Sep '10	Dec '10
G3						
EUR-USD	1.46	1.50	1.42	1.36	1.32	1.28
USD-JPY	90	93	95	100	105	110
EUR-JPY	131	140	135	136	139	141
Dollar Bloc						
USD-CAD	1.09	1.02	1.05	1.06	1.07	1.08
AUD-USD	0.87	0.90	0.90	0.88	0.86	0.84
NZD-USD	0.72	0.75	0.74	0.72	0.70	0.68
Europe						
EUR-GBP	0.92	0.92	0.89	0.87	0.85	0.83
GBP-USD	1.59	1.63	1.60	1.56	1.55	1.54
EUR-CHF	1.51	1.52	1.53	1.54	1.55	1.56
USD-CHF	1.03	1.01	1.08	1.13	1.17	1.22
EUR-SEK	10.20	10.00	9.95	9.90	9.80	9.75
USD-SEK	6.98	6.67	7.01	7.28	7.42	7.62
EUR-NOK	8.52	8.20	8.10	8.00	7.90	7.85
USD-NOK	5.83	5.47	5.70	5.88	5.98	6.13

Note: Forecast as of 29 September 2009. Spot exchange rate as of 28 September 2009. The left of the currency pair is the denominator of the exchange rate. Source: BofA Merrill Lynch

Table 15: Quarterly forecasts – EM currencies

	Spot	Dec '09	Mar '10	Jun '10	Sep '10	Dec '10
Latin America						
USD-BRL	1.79	1.70	1.85	1.70	1.85	1.65
USD-MXN	13.55	13.25	13.15	13.00	12.70	12.30
USD-CLP	543.9	520.0	510.0	530.0	520.0	500.0
USD-COP	1919	2070	2100	2150	2140	2200
USD-ARS	3.85	4.00	4.25	4.35	4.20	4.15
USD-VEF	2.15	2.15	2.70	2.70	2.70	2.70
USD-PEN	2.88	2.80	2.97	2.90	2.80	2.90
Emerging Europe						
EUR-PLN	2.87	3.95	3.85	3.60	3.55	3.45
EUR-HUF	269.3	262.0	255.0	245.0	250.0	255.0
EUR-CZK	25.22	24.75	24.25	24.15	24.10	24.00
USD-UAH	8.42	8.50	8.50	8.50	8.50	8.50
USD-RUB	30.14	30.00	29.44	29.26	27.10	26.64
USD-ZAR	7.42	7.55	7.35	7.25	7.45	7.60
USD-TRY	1.49	1.44	1.42	1.50	1.45	1.45
EUR-RON	4.21	4.12	4.00	3.95	4.00	4.05
USD-EGP	5.51	5.52	5.55	5.60	5.65	5.75
USD-ILS	3.76	3.65	3.50	3.35	3.40	3.40
USD-AED	3.67	3.67	3.67	3.67	3.67	3.67
USD-KWD	0.29	0.29	0.29	0.29	0.29	0.29
USD-SAR	3.75	3.75	3.75	3.75	3.75	3.75
USD-QAR	3.64	3.64	3.64	3.64	3.64	3.64
Asian Bloc						
USD-KRW	1196	1100	1100	1150	1050	1000
USD-TWD	32.47	31.00	31.50	32.00	32.50	33.00
USD-SGD	1.42	1.42	1.43	1.43	1.44	1.45
USD-THB	33.56	33.80	34.00	34.20	34.20	34.50
USD-HKD	7.75	7.80	7.80	7.80	7.80	7.80
USD-CNY	6.83	6.70	6.65	6.60	6.55	6.50
USD-IDR	9725	9500	9400	9300	9200	9200
USD-PHP	47.61	47.50	49.00	50.00	49.00	48.00
USD-MYR	3.48	3.47	3.45	3.40	3.45	3.50
USD-INR	47.99	47.00	45.00	44.00	43.50	43.00

Note: Forecast as of 29 September 2009. Spot exchange rate as of 28 September 2009. The left of the currency pair is the denominator of the exchange rate. Source: BofA Merrill Lynch

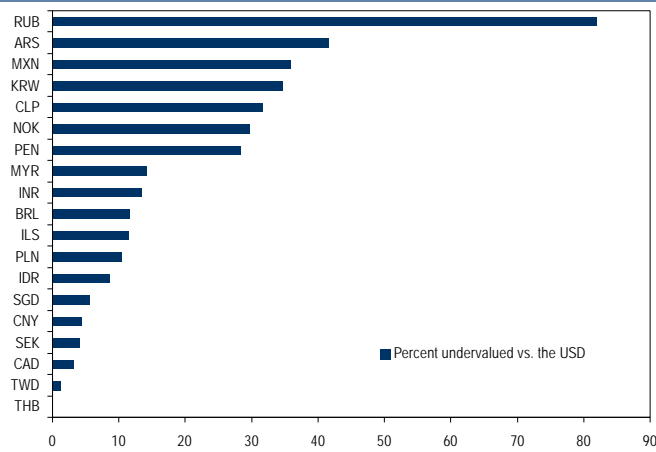
Table 16: Forecasts versus forwards

	Spot	Dec '09		Mar '10		Jun '10		Sep '10		Dec '10		
		Fcst	Fwd	Fcst	Fwd	Fcst	Fwd	Fcst	Fwd	Fcst	Fwd	
G10												
EUR/USD	1.46	1.50	1.46	1.42	1.46	1.36	1.46	1.32	1.46	1.28	1.46	
USD/JPY	90	93	89	95	89	100	89	105	89	110	89	
EUR/JPY	131	140	131	135	131	136	130	139	130	141	130	
USD/CAD	1.09	1.02	1.09	1.05	1.09	1.06	1.09	1.07	1.09	1.08	1.09	
AUD/USD	0.87	0.90	0.87	0.90	0.86	0.88	0.85	0.86	0.84	0.84	0.83	
NZD/USD	0.72	0.75	0.71	0.74	0.71	0.72	0.70	0.70	0.70	0.68	0.69	
EUR/GBP	0.92	0.92	0.92	0.89	0.92	0.87	0.92	0.85	0.92	0.83	0.92	
GBP/USD	1.59	1.63	1.59	1.60	1.59	1.56	1.59	1.55	1.59	1.54	1.59	
EUR/CHF	1.51	1.52	1.51	1.53	1.51	1.54	1.50	1.55	1.50	1.56	1.50	
USD/CHF	1.03	1.01	1.03	1.08	1.03	1.13	1.03	1.17	1.03	1.22	1.02	
EUR/SEK	10.20	10.00	10.18	9.95	10.18	9.90	10.18	9.80	10.18	9.75	10.19	
USD/SEK	6.98	6.67	6.97	7.01	6.96	7.28	6.96	7.42	6.96	7.62	6.97	
EUR/NOK	8.52	8.20	8.54	8.10	8.57	8.00	8.61	7.90	8.65	7.85	8.69	
USD/NOK	5.83	5.47	5.84	5.70	5.87	5.88	5.89	5.98	5.92	6.13	5.94	
Emerging Markets												
USD/BRL	1.79	1.70	1.82	1.85	1.85	1.70	1.88	1.85	1.92	1.65	1.96	
USD/MXN	13.55	13.25	13.69	13.15	13.86	13.00	14.05	12.70	14.24	12.30	14.43	
USD/CLP	543.90	520.00	539	510.00	537	530.00	537	520.00	536	500.00	540	
USD/COP	1919	2070	1940	2100	1962	2150	1987	2140	2016	2200	2052	
USD/ARS	3.85	4.00	3.95	4.25	4.09	4.35	4.22	4.20	4.39	4.15	4.59	
USD/VEF	2.15	2.15	2.15	2.70	2.15	2.70	2.15	2.70	2.15	2.70	2.15	
USD/PEN	2.88	2.80	2.89	2.97	2.89	2.90	2.89	2.80	2.89	2.90	2.92	
EUR/PLN	4.20	3.95	4.22	3.85	4.25	3.60	4.28	3.55	4.30	3.45	4.33	
EUR/HUF	269.3	262.0	273.4	255.0	276.6	245.0	279.4	250.0	282.3	255.0	289.0	
EUR/CZK	25.22	24.75	25.27	24.25	25.34	24.15	25.42	24.10	25.48	24.00	25.54	
USD/UAH	8.42	8.50	9.35	8.50	10.58	8.50	10.45	8.50	11.71	8.50	13.62	
USD/RUB	30.14	30.00	30.81	29.44	31.55	29.26	32.33	27.10	33.03	26.64	33.78	
USD/ZAR	7.42	7.55	7.53	7.35	7.66	7.25	7.79	7.45	7.92	7.60	8.05	
USD/TRY	1.49	1.44	1.52	1.42	1.54	1.50	1.57	1.45	1.60	1.45	1.63	
EUR/RON	4.21	4.12	4.29	4.00	4.37	3.95	4.44	4.00	4.52	4.05	4.59	
USD/EGP	5.51	5.52	5.62	5.55	5.76	5.60	5.90	5.65	6.14	5.75	6.38	
USD/ILS	3.76	3.65	3.76	3.50	3.76	3.35	3.76	3.40	3.77	3.40	3.78	
USD/AED	3.67	3.67	3.674	3.67	3.675	3.67	3.676	3.67	3.676	3.67	3.679	
USD/KWD	0.29	0.29	0.287	0.29	0.287	0.29	0.287	0.29	0.288	0.29	0.288	
USD/SAR	3.75	3.75	3.748	3.75	3.745	3.75	3.743	3.75	3.740	3.75	3.739	
USD/QAR	3.64	3.64	3.642	3.64	3.648	3.64	3.655	3.64	3.666	3.64	3.676	
USD/KRW	1196	1100	1193	1100	1197	1150	1200	1050	1204	1000	1208	
USD/TWD	32.47	31.00	32.16	31.50	31.88	32.00	31.73	32.50	31.48	33.00	31.25	
USD/SGD	1.42	1.42	1.42	1.43	1.42	1.43	1.42	1.44	1.42	1.45	1.42	
USD/THB	33.56	33.80	33.55	34.00	33.58	34.20	33.59	34.20	33.64	34.50	33.55	
USD/HKD	7.75	7.80	7.75	7.80	7.74	7.80	7.74	7.80	7.73	7.80	7.73	
USD/CNY	6.83	6.70	6.81	6.65	6.78	6.60	6.75	6.55	6.72	6.50	6.68	
USD/IDR	9725	9500	9824	9400	9970	9300	10222	9200	10390	9200	10569	
USD/PHP	47.61	47.50	48.01	49.00	48.26	50.00	48.50	49.00	48.89	48.00	49.32	
USD/MYR	3.48	3.47	3.48	3.45	3.49	3.40	3.49	3.45	3.50	3.50	3.49	
USD/INR	47.99	47.00	48.36	45.00	48.69	44.00	48.96	43.50	49.21	43.00	49.53	

Note: Forecast as of 29 September 2009. Spot exchange rate as of 28 September 2009. The left of the currency pair is the denominator of the exchange rate. Source: BofA Merrill Lynch

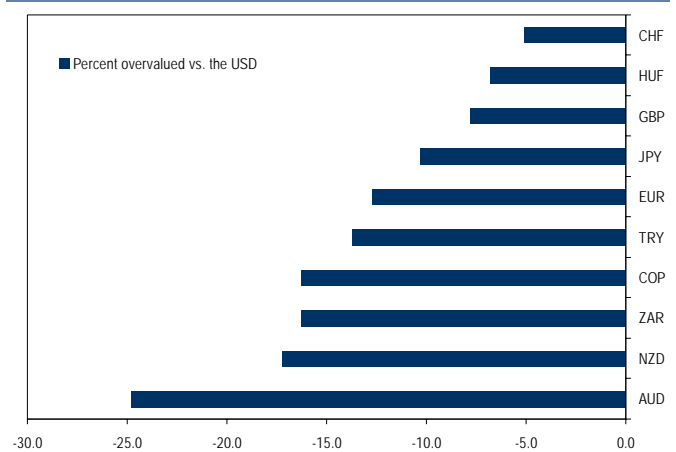
ML FX COMPASS valuation model

Chart 26: Undervalued currencies vs. the USD



Source: BofA Merrill Lynch Research

Chart 27: Overvalued currencies vs. the USD



Source: BofA Merrill Lynch Research

Table 17: G10 medium-term values

	Spot	COMPASS	% difference
EUR-USD	1.46	1.30	-12.8
USD-JPY	90	100	10.3
EUR-JPY	131	130	-1.1
USD-CAD	1.09	1.05	-3.2
AUD-USD	0.87	0.70	-24.8
NZD-USD	0.72	0.61	-17.2
GBP-USD	1.59	1.47	-7.8
EUR-GBP	0.92	0.88	-4.6
USD-CHF	1.03	1.09	5.1
EUR-CHF	1.51	1.41	-7.0
USD-SEK	6.98	6.70	-4.2
EUR-SEK	10.20	8.69	-17.4
USD-NOK	5.83	4.49	-29.8
EUR-NOK	8.52	5.82	-46.4

Note: For more details on current valuation refer to "New FX fair values," FX Weekly, 11 November 2008. The ML FX COMPASS is our fundamental valuation model for G10 FX ("Navigating for currency value – ML FX COMPASS," Global FX Paper #2, 17 March 2003) and 19 countries in the emerging markets ("The emerging magnet: Introducing EM FX COMPASS," Global FX Paper #7, 20 February 2007). More recently we added PEN to COMPASS, increasing the number of emerging markets countries to 20 ("PEN joins COMPASS family," Cause & FX, 26 March 2008). The model helps us identify the gravitational pull of equilibrium exchange rates over longer term horizons.

Source: BofA Merrill Lynch

Table 18: EM medium-term values

	Spot	COMPASS	% difference
LatAm			
USD-ARS	3.85	2.72	-41.6
USD-BRL	1.79	1.60	-11.6
USD-CLP	544	413	-31.7
USD-COP	1919	2291	16.3
USD-MXN	13.55	9.97	-35.9
USD-PEN	2.88	2.25	-28.4
Emerging Asia			
USD-CNY	6.83	6.53	-4.5
USD-INR	47.99	42.27	-13.5
USD-IDR	9725	8953	-8.6
USD-KRW	1196	887	-34.8
USD-MYR	3.48	3.05	-14.2
USD-SGD	1.42	1.34	-5.6
USD-TWD	32.47	32.04	-1.3
USD-THB	33.56	33.53	-0.1
EMEA			
USD-HUF	184	198	6.8
EUR-HUF	269	256	-5.1
USD-ILS	3.76	3.37	-11.5
USD-PLN	2.87	2.60	-10.5
EUR-PLN	4.20	3.37	-24.6
USD-RUB	30.14	16.56	-82.0
USD-ZAR	7.42	8.86	16.3
USD-TRY	1.49	1.73	13.7
EUR-TRY	2.18	2.24	2.7

Source: BofA Merrill Lynch

Long-run valuation metrics

Chart 28: Current COMPASS valuation

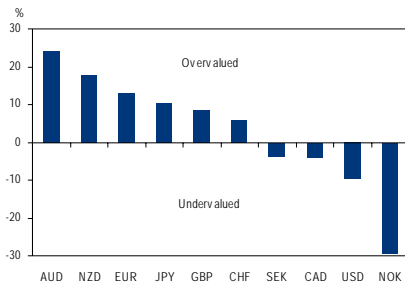


Chart 29: Current REER valuation

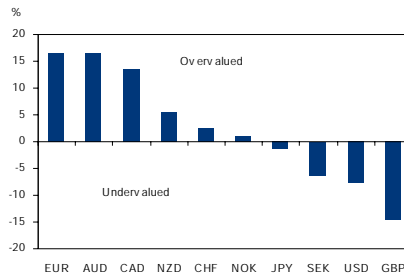


Chart 30: USD over/undervaluation since '03

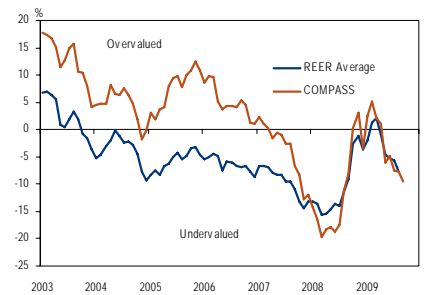


Chart 31: EUR over/undervaluation since '03

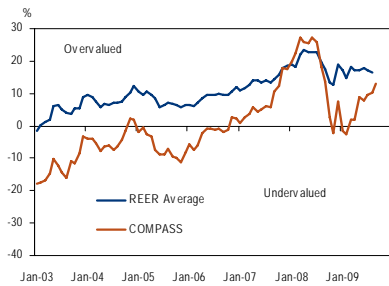


Chart 32: JPY over/undervaluation since '03

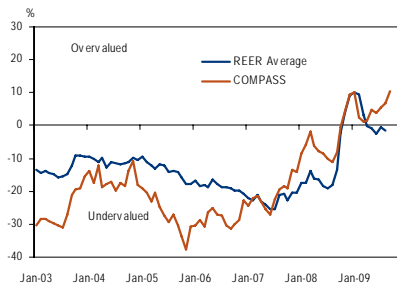


Chart 33: GBP over/undervaluation since '03

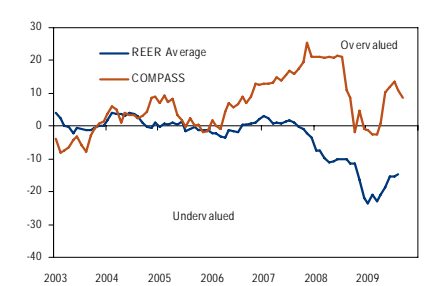


Chart 34: AUD over/undervaluation since '03

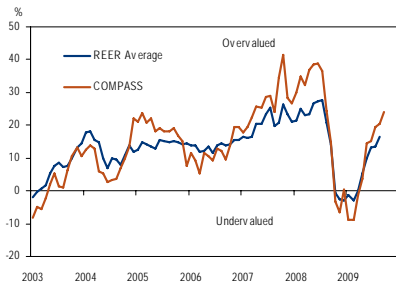


Chart 35: NZD over/undervaluation since '03

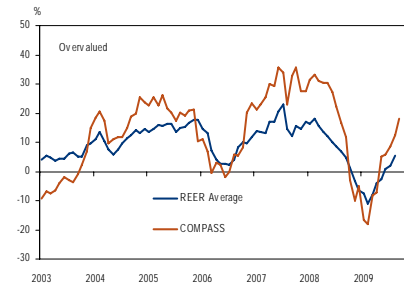


Chart 36: CAD over/undervaluation since '03

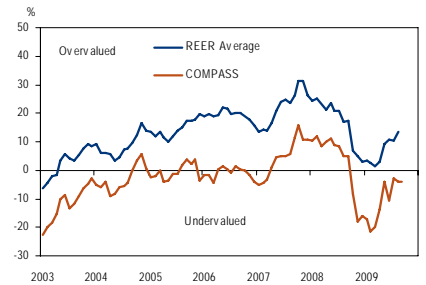


Chart 37: CHF over/undervaluation since '03

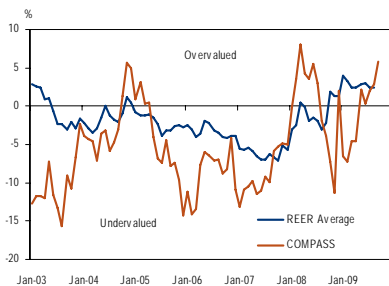


Chart 38: NOK over/undervaluation since '03

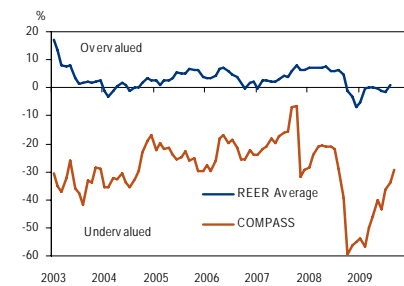
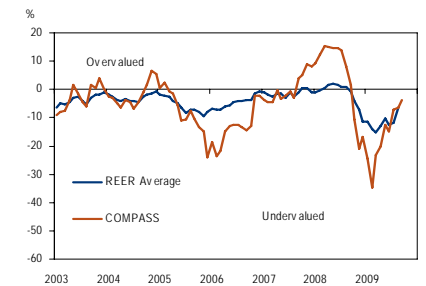


Chart 39: SEK over/undervaluation since '03



Note: The figures show, for each G10 currency, how much they are undervalued or overvalued relative to our COMPASS model, which starts in 2003, or by looking at real effective exchange rates ("REER") from the BIS. For REER we use rolling 10-year averages for comparison. For USD in the COMPASS model, we use DXY weights. Source: BofA Merrill Lynch, Bloomberg, and Bank of International Settlements ("BIS")

Analyst Certification

I, Steven Pearson, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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