Deutsche Bank

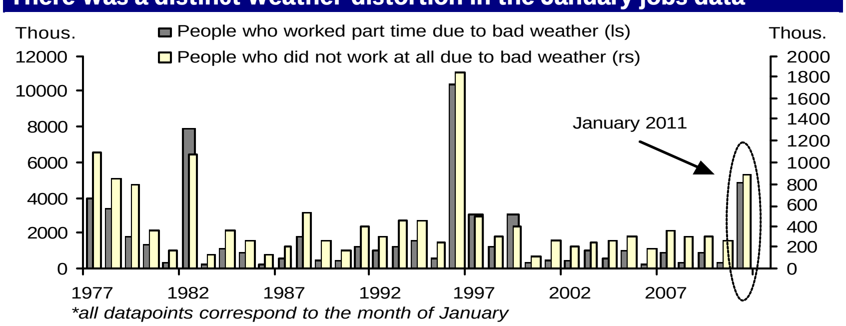
4 February 2011

US Economics Weekly

Labor "green shoots" lurk beneath the snow

- **Overview:** As expected, inclement weather wreaked havoc with the January employment report, depressing both nonfarm payrolls and hours worked. Barring outsized weather disruptions in February, these distortions should reverse and we should see a sizeable payback next month. This is similar to what happened after a major blizzard in 1996. However, the sizeable and unexpected drop in the unemployment rate was legitimate and strongly suggests the economy is operating at an above trend pace this quarter. Consequently, we are in the midst of reviewing upside risks to our 2011 GDP projections. New forecasts will be published in next week's edition of the US Economics Weekly.
- **Banks in the mood to lend:** The Federal Reserve's Senior Loan Officer Survey provides further evidence of ample credit availability. According to the latest results, commercial banks continue to ease standards on commercial and industrial loans to businesses of all sizes. Additionally, lending officers continue to show a strong desire to extend bans to consumers. These two important developments signal a strengthening in the rate of inventory accumulation and the pace of durable goods consumption. The only area where lending conditions are still tight is real estate, but this should not prevent the economy from registering a decent year of above trend real GDP growth.
- **Will the export surge continue?** Exports recovered sharply following the end of the recession in 2009. In fact, the contribution to economic output from this category significantly outpaced the typical recovery, thereby countering some of the weakness from other frequent early-cycle economic engines. While some forecasters are fretting the longevity of the emerging period of above-trend growth, we are less concerned for a couple of reasons: First, we expect consumer spending to accelerate as the labor market firms. Second, business spending should remain robust as corporate cash is deployed for investment. Third, as we highlight in the following commentary, strong foreign demand for US exports will continue to propel industrial production.

There was a distinct weather-distortion in the January jobs data



Source: BLS & DB Global Markets Research

Economics

Table of Contents

Research Team

Joseph LaVorgna
Chief US Economist
212 250-7329
joseph.lavorgna@db.com

Carl Riccadonna
Senior US Economist
212 250-0186
carl.riccadonna@db.com

Brett Ryan
Economist
212 250-6294
brett.ryan@db.com

Forecasts

	2010		2011			
	Q3	Q4	Q1F	Q2F	Q3F	Q4F
Real GDP (% q/q)	2.6	3.2	3.5	3.3	3.3	3.2
Final sales (% q/q)	0.9	7.1	3.7	3.4	3.5	3.3
Private consumption (% q/q)	2.4	4.4	3.5	3.3	3.3	3.3
Core PCE (%y/y)	1.2	0.8	1.0	1.2	1.4	1.8
Unemployment rate	9.6	9.6	***9.0***	***8.8***	***8.8***	***8.8***
Fed funds	0.20	0.20	0.20	0.20	0.20	0.50

Deutsche Bank Securities Inc.

Labor "green shoots" lurk beneath the snow

Summary: *As expected, inclement weather wreaked havoc with the January employment report, depressing both nonfarm payrolls and hours worked. Unless adverse weather disrupts the economy during the February employment survey week, these distortions should reverse; hence we should expect to see a sizeable payback in February payrolls and a rise in the workweek. This is what happed in February 1996 after blizzards across the Northeast dampened the labor market. The sizeable and unexpected drop in the unemployment rate was legitimate and strongly suggests the economy is operating at an above trend pace this quarter. Consequently, we are in the midst of reviewing upside risks to our 2011 GDP projections. New forecasts will be published in next week's edition of the US Economics Weekly.*

Weather effects abound in the data. Nonfarm payrolls rose just 36k in January following modest net downward revisions of -4k to the prior two months; private jobs were marginally higher at +50k. However, the data showed that weather did have a meaningful impact on hiring. The Bureau of Labor Statistics (BLS) reported that the number of people who could not report to work because of bad weather totaled 886k. This is the largest reading since January 1996, when the figure was 1.8 million, and it is more than twice the usual January weather impact of 417k. We conservatively estimate that absent weather effects, nonfarm payrolls would have been about 120k higher in January relative to what was reported.[1] In forecasting February employment, we should add this estimate to what we believe is the underlying pace of nonfarm payroll growth. Assuming an underlying trend of +128k—this was the three-month moving average from October to December—then a 120k weather payback implies a 250k increase in February nonfarm payrolls. Of course, the trend in the labor market might be stronger than the +128k Q4 2010 average because recent data suggest economic momentum is building. For example, the employment components of the manufacturing and non-manufacturing ISM surveys each made record highs last month.

Inclement weather also impacted the nonfarm workweek, which slipped 0.1 to 34.2 hours. According to the BLS, the number of workers who worked part-time because of bad weather totaled 4.9 million, which is the highest reading since January 1996 (10.4 million) and the third highest reading on record dating back to 1977. Consequently, we can expect a bounce-back in hours along with payrolls in next month's report. In January 1996, payrolls were initially reported to be down -201k; the following month they rose +705k. The nonfarm workweek initially had been down -0.7 hours in January 1996 but then rebounded +0.8 hours in February. We expect the workweek to rebound by +0.2 hours. (Incidentally, in income terms this is equivalent to the addition of roughly 600k workers.)

Where is the strength? There were two important pockets of strength in the employment report: The first was manufacturing payrolls, and the second was the unemployment rate. The strength in manufacturing corroborates the aforementioned strength in the ISM survey. Manufacturing payrolls soared by +49k, the largest increase since August 1998, and the factory workweek lengthened 0.1 to 40.5 hours. This caused the index of manufacturing hours worked to rise +0.6%, the largest increase since May 2010. This implies a corresponding increase in manufacturing industrial production. The unemployment rate posted a sizeable -0.4% decline to 9.0% from 9.4% previously. Recall that in December the unemployment rate also declined by -0.4%. The last time the economy experienced a decline of this magnitude over a two-month period was October-November 1958.

There was some confusion among analysts as to what caused the decline, because it initially appeared to be a drop in labor force participation. However, this was not the case after adjusting for population controls which are implemented every January. This means we cannot compare the January levels of household employment and unemployment to December, which is based off of an old population survey. The BLS provides a series on break-adjusted household employment and unemployment, which accounts for the population-control factor, and it showed a 589k increase in employment and a 590k decline in unemployment. Hence, these are solid readings, because the decline in the unemployment rate was due to rising employment, not slackening labor force participation. Conversely, in December we estimated that half of the decline in the rate was due to individuals dropping out of the labor force. Lastly, it is important to note that while inclement weather impacted payrolls, it did not impact the unemployment rate because individuals do not have to be paid during the survey week to be counted as employed in the household survey (contrary to what is the case in the establishment survey).

Joseph A. LaVorgna (212) 250-7329
Carl J. Riccadonna (212) 250-0186

[1] We arrive at this estimate by subtracting 767k from 886k. The former is the 417k January average plus one standard deviation (350k).

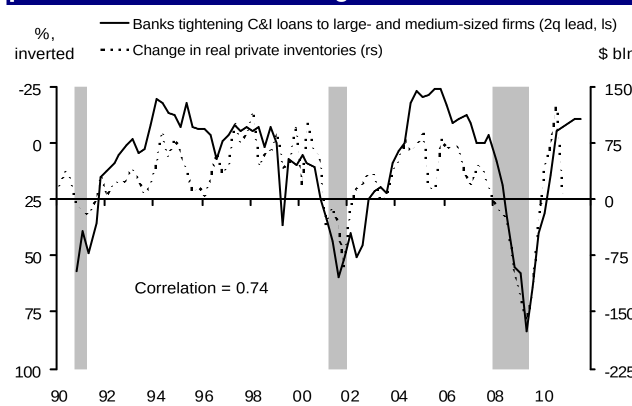
Banks in the mood to lend

Summary: *The Federal Reserve's Senior Loan Officer Survey provides further evidence of ample credit availability. According to the latest results, commercial banks continue to ease standards on commercial and industrial loans to businesses of all sizes. Additionally, lending officers continue to show a strong desire to extend loans to consumers. These two important developments signal a strengthening in the rate of inventory accumulation and the pace of durable goods consumption. The only area where lending conditions are still tight is real estate, but this is not expected to prevent the economy from registering a decent year of above trend real GDP growth.*

Banks are easing lending standards. Every quarter the Fed conducts a nationwide survey of senior loan officers. This is one of the key pieces of information monetary policymakers use to gauge credit availability. In general, a dramatic tightening of lending standards preceded both the onset of recession and the serious credit crunch which ensued, so this survey is a very useful leading indicator of the economy and the financial markets. One of the questions the Fed asks senior loan officers is if they are tightening lending standards on commercial and industrial (C&I) loans, an important component of bank credit that accounted for 35% of the total decline in bank lending in the last recession. According to the Fed's latest survey, the net percentage of commercial banks tightening standards for C&I loans to large- and medium-sized firms in Q1 2011 remained at -10.5% for the second quarter in a row. Technically, the Senior Loan Officer Survey covers the period ending January 2011. This marked the fifth consecutive quarter in which lending standards eased, and it represented the lowest figure since Q2 2006 (-12.3%). The story is basically the same for small firms as well, where lending standards have eased for three straight quarters.

We care about lending standards on C&I loans, because they accurately foreshadow the trend in inventory building as illustrated in the following chart. Lending standards are shown on the left hand axis on an inverted scale with a two quarter lead versus the change in inventories. The reason lending standards tell us something important about inventory building is because the latter is typically funded via C&I loans. Consequently, when lending standards tighten, the pace of inventory building generally slows, and when lending standards ease, the pace of inventory building generally quickens. In fact, the correlation coefficient between the two series is a high 0.74. Based on current C&I lending standards for large- and medium-sized firms, inventory building should strengthen noticeably this quarter and next. Judging from the chart, we estimate that after increasing only $7 billion in Q4 2010, easier lending standards point to inventory building of around $100 billion over the next couple of quarters. This would add nearly three full percentage points to real GDP growth at an annual rate, a significant amount to be sure. Furthermore, the improvement in lending standards has not been limited to just businesses. Senior loan officers are also reporting an increased willingness to lend to consumers. Perhaps this is the most important development thus far in the expansion, because consumers account for 70% of expenditures-based GDP and this category has been a laggard thus far in the cycle.

Significantly easier lending standards on C&I loans point to a dramatic rebuilding of inventories

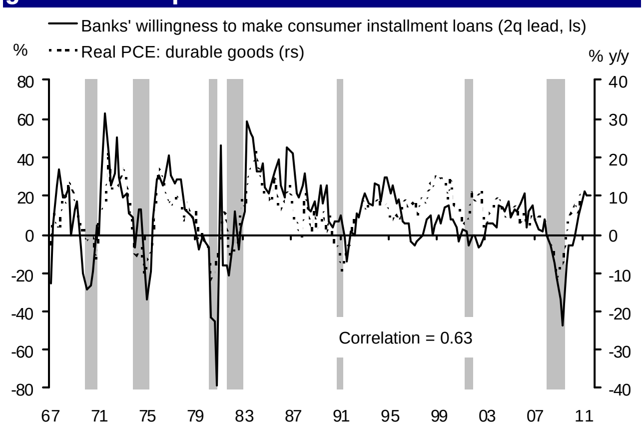


Source: BEA, FRB & DB Global Markets Research

Consumers are gaining access to credit. There are three consumer-related series in the Senior Loan Officer Survey that we use to measure credit availability: 1) commercial banks' willingness to make consumer installment loans, 2) the net percentage of banks tightening lending standards on credit cards and 3) the net percentage of banks tightening lending standards on other consumer loans. Of these three series, our favorite measure is banks' willingness to lend, because it has the longest history and consistently has been an accurate predictor of changes in consumer behavior. Nonetheless, it is imperative to note that all three credit metrics show a substantial easing of lending standards, which minimizes the chance of one particular series sending us a misleading signal. In the current quarter, the net percentage of banks reporting a willingness to lend stood at a very high +20.4% reading, up slightly from +20.0% in Q4 2010 and down from a cyclical peak of +22.6% in Q3 2010. Over the last three quarters, banks' willingness to lend averaged +21.0%, the highest since the three quarters ending Q4 1994 (+25.2%). Additionally, the current reading is more than double the long-term average of the series, further testament to how easy credit conditions have become over the past few quarters. As a result, we should expect to see a sharp improvement in spending on consumer durables going forward.

Easier credit should translate into faster growth. In the chart below, we show banks' willingness to make consumer installment loans versus spending on consumer durables. Spending on consumer durables covers such big ticket items as motor vehicles, household appliances and furniture. Spending on durables is often a leading indicator of the broader trend in consumption. As a general rule, people purchase consumer durables if they have access to credit and if they are reasonably confident in their job and income prospects. Based on banks' willingness to lend, credit availability is ample and points to hefty growth in durable goods spending. We project real durable goods spending to grow over 7% at an annual rate for the next several quarters; this compares to our estimate of 3% to 3.5% growth in overall consumption.

Banks' willingness to lend portends faster durable goods consumption ahead

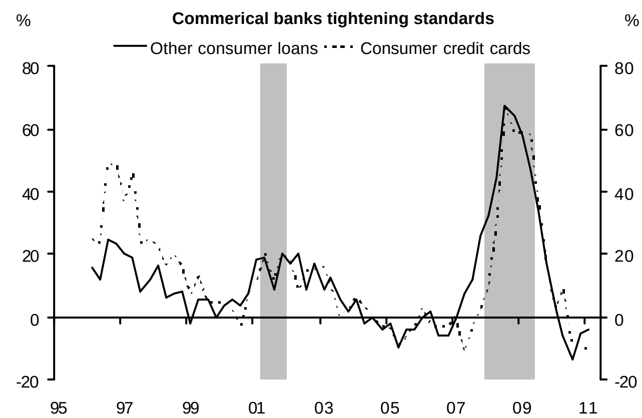


Source: BEA, FRB & DB Global Markets Research

Commercial banks' willingness to make consumer installment loans is also corroborated by the appreciable drop in the net percentage of banks tightening standards on consumer credit cards and other consumer loans. For credit cards, the rate of easing is faster today than at any point in the relatively brief history of the series which only dates back to 1996. This is a dramatic change from Q3 2008 when over 67% of commercial banks were tightening standards on credit cards. At the same time, banks tightening standards on other consumer loans registered a -3.7% reading in Q1 2011, the fourth quarter in a row in which the series declined. The last time this happened was in the period spanning 2004 to 2005.

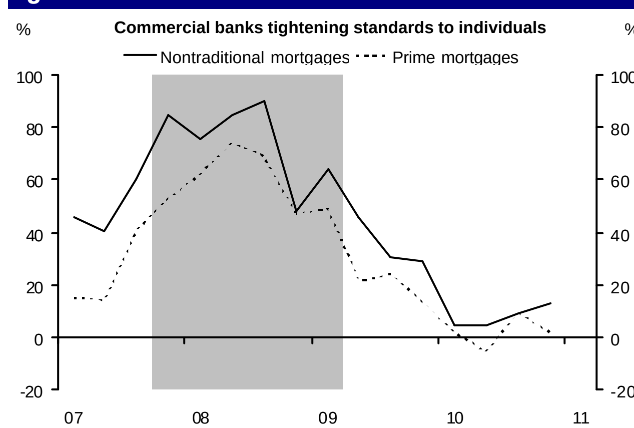
However, some lending constraints still exist. With one exception in Q3 2010, commercial banks are not yet easing lending standards for prime mortgage loans. According to the Fed's figures, +1.9% of banks on net are tightening standards, down from +9.4% in Q4 2010 but above the -5.3% reading seen in Q3 2010. And, lending standards for non-traditional mortgages are actually tightening at a faster rate, up to +13.0% in Q1 2011 compared to +9.5% previously. Therefore, unless banks loosen mortgage underwriting standards, the recovery in residential construction is likely to be slow and uneven. However, at just 2% of GDP, the residential sector is not large enough to hold the economy back from growing well above 3% this year. Lending standards on C&I and consumer loans have meaningfully eased, allowing producers and consumers to more easily transact. This is bullish for growth, especially considering where lending standards were just a couple of years ago.

Commercial banks are easing lending standards on a variety of consumer loans



Source: FRB & DB Global Markets Research

The one area where bank lending standards remain tight is residential real estate



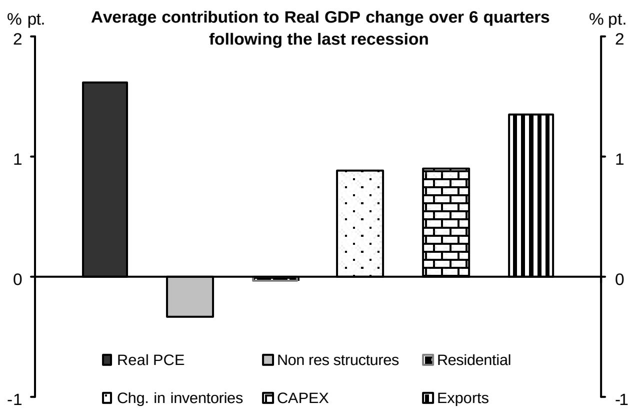
Source: FRB & DB Global Markets Research

Joseph A. LaVorgna (212) 250-7329

Key Economic Themes:

Will the export surge continue?

Figure 1: Exports have been an important driver of GDP growth since the end of the recession

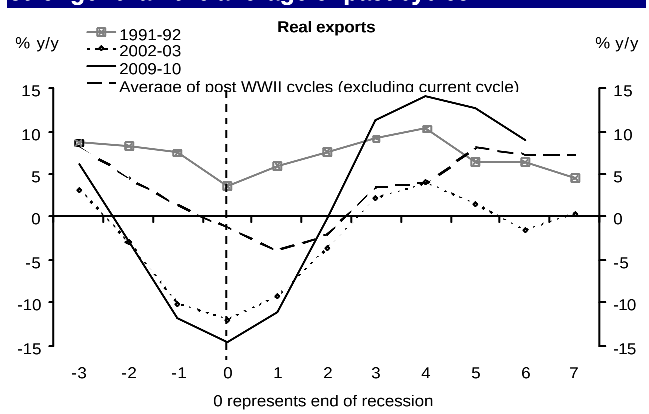


Source: BEA & DB Global Markets Research

Exports recovered sharply following the end of the recession in 2009. In fact, the contribution to economic output from this category significantly outpaced the typical recovery, thereby countering some of the weakness from other frequent early-cycle economic engines, such as residential investment and consumer spending, which demonstrated softer-than-average recovery profiles. While the recent trend in forecast revisions among economists has been skewed toward faster growth in the near term, some forecasters are fretting the longevity of this period of above-trend growth due to factors such as fiscal tightening in 2012 (namely expiring tax cuts) and rising commodity prices (particularly energy). While these factors do pose headwinds for the economy, we are less concerned for a couple of reasons: First, we expect consumer spending to accelerate as the labor market firms. Second, business spending should remain robust as corporate cash is deployed for investment in order to prevent further deterioration of the capital stock. Third, as we highlight in the following commentary, strong foreign demand for US exports will continue to propel industrial production.

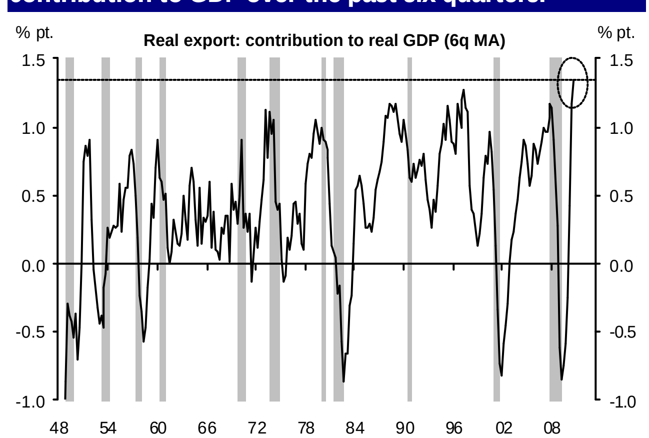
Exporting the way to recovery? Exports have contributed significantly to economic output since the end of the recession. In fact, while exports ordinarily contribute an average of 0.3 percentage points to overall GDP growth in the first six quarters of recovery, the contribution has been much larger at present—roughly 1.4 percentage points. (See chart above.) In fact, it has been a record-breaking performance—the rise in exports has been faster than the comparable six quarter period following any of the previous recessions in the post-WWII era. Furthermore, in terms of the average percentage point contribution to GDP, the past six quarters have been the absolute largest on record—regardless of the stage in the economic cycle. Much (if not all) of the direct impact on GDP from exports will be netted out with imports (recall that imports are subtracted from GDP), particularly since stronger consumption from households and businesses will result in increased demand for imports. Nonetheless, the lift to production from foreign demand will generate employment income, thereby spurring additional consumption. While many analysts, ourselves included, touted accelerating domestic demand as an important kernel of strength in the Q4 GDP figures, foreign demand for domestically produced goods is likely to remain sturdy for the foreseeable future. Hence, exports will continue to be an important contributor to output growth and employment over the medium term.

Figure 2: Export growth has been considerably stronger than the average of past cycles



Source: BEA & DB Global Markets Research

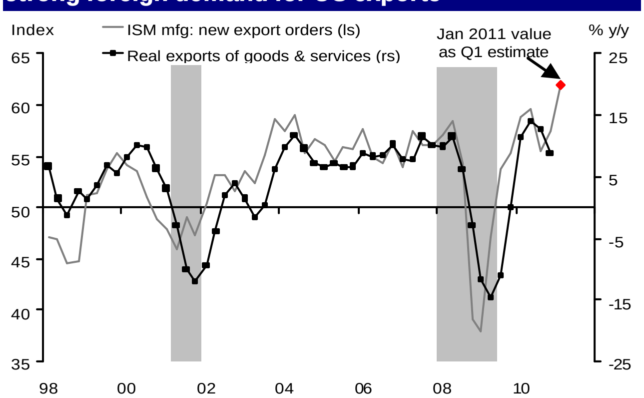
Figure 3: Exports have made an unprecedented contribution to GDP over the past six quarters.



Source: BEA & DB Global Markets Research

Foreign demand is not subsiding. There are two main economic themes supporting our expectation of continued strong export demand—a favorable exchange rate and sturdy global growth. With respect to the first point, the broad trade-weighted dollar continues to depreciate. As of the final week in January, it was less than 0.1% above its post-recession low, although it was nearly 3.5% lower (July 2008) during the height of the financial crisis. The deterioration has occurred against a variety of currencies, including the Japanese yen (-9%), Canadian dollar (-5%), Mexican peso (-5%) and Chinese yuan (-3%). As long as the Fed is perceived to be pursuing a "low for long" strategy regarding interest rates, the trade-weighted dollar is likely to remain in a downtrend—particularly if major trading partners begin to transition toward less accommodative monetary policy stances. As highlighted in the 2011 *World Outlook* [2], global growth is projected to slow moderately this year to a trend-like 3.9% from an estimated 4.7% in 2010. While a slower pace of global expansion could potentially imply a slower rate of growth for US exports, this does not appear to be the case based on a number of proxies for export demand.

Figure 4: ISM new export orders point to continued strong foreign demand for US exports

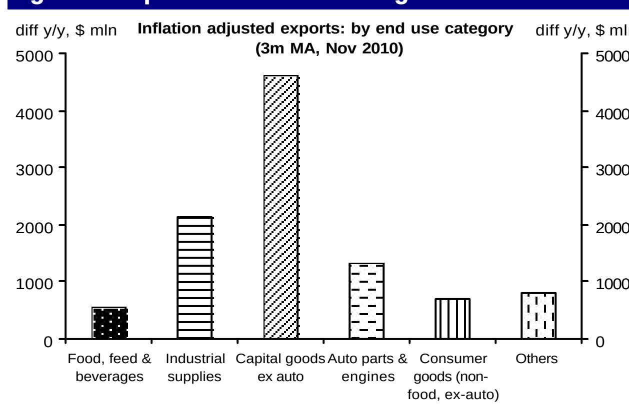


Source: NAPM, BEA & DB Global Markets Research

As the chart above illustrates, the new export orders component of the manufacturing ISM survey is a useful and timely gauge for overall export demand. Over the past 25 years, the correlation between the two series is roughly 75%; it is even higher after accounting for a one quarter lead on the ISM (closer to 90%). As we highlighted earlier in the week, the January ISM was impressive by several accounts—the headline touched a new cyclical high, every single subcomponent rose and employment was the strongest since 1974. New export orders also rose appreciably. They accelerated to 62.0 in January from an average of 57.3 in Q4 2010—this ties May 2010 for the highest reading in over two decades. If the reacceleration in ISM new export orders is sustained, then real exports should continue to increase at least in the high single digits through midyear.

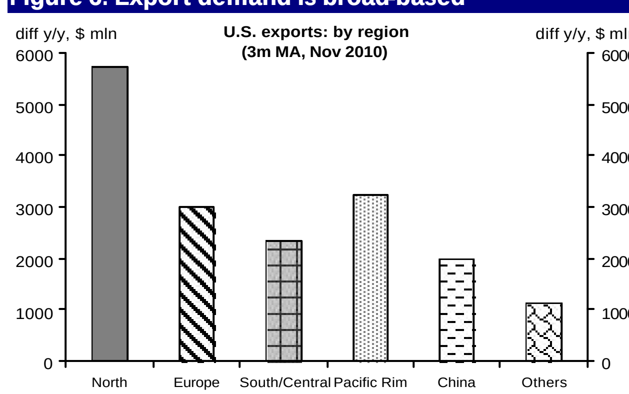
Strength in the numbers We have long cited diffusion as evidence of robustness in various economic series, including international trade. This concept applies to both the range of exports, as well as their destination. We highlight this in the following charts, although the conclusions are similar. The first figure illustrates that every major export category is up significantly over the past twelve months. The fact that demand is particularly strong for high-tech, capital goods bodes well for continued momentum in the manufacturing sector. More broadly, the surge in prices for raw and semi-processed goods (as evidenced in the earlier stages of production in the PPI) also points to burgeoning demand for inputs. Furthermore, the breadth of demand across an array of geographic regions—including North America, Europe and Asia—suggests a relative degree of immunity to temporary, regional disruptions resulting from factors such as geopolitics, weather, etc. While many analysts are focusing on strengthening domestic demand of late, foreign demand should not be ignored—because it will provide a significant addition to GDP growth this year.

Figure 5: Export volumes are rising across the board



Source: Census & DB Global Markets Research

Figure 6: Export demand is broad-based



Source: Census & DB Global Markets Research

Carl J. Riccadonna (212) 250-0186

[2] "Two-Track Recovery" World Outlook December 10, 2010

Data and Events Calendar

Calendar (January 31 – February 25)

Jan-31

Personal Income

8:30 AM	Oct:	Nov:	Dec:
Income	+0.5%	+0.4	+0.4
Consump.	+0.7%	+0.3	+0.7
Core PCE	Unch.	+0.1	Unch.

Chicago PMI

9:45 AM	Nov:	61.9
	Dec:	66.8
	Jan:	68.8

Feb-01

ISM Index

10:00 AM	Nov:	56.6
	Dec:	58.5
	Jan:	60.8

Construction Spending

10:00 AM	Oct:	+0.7%
	Nov:	-0.2
	Dec:	-2.5

Unit motor vehicle sales

Sales:	Cars	Trucks	Total
Nov :	3.8	5.5	12.3 M
Dec :	3.9	5.6	12.5
Jan :	4.0	5.6	12.5

Feb-02

3 Yr Note Announcement

$32B

10 Yr Note Announcement

$24B

30 Yr Bond Announcement

$16B

Feb-03

Initial Claims (wk-end)

8:30AM	Jan15	403k	-44k
	Jan22	457	+54
	Jan29	415	-42

Nonfarm Productivity			**Unit Labor Costs**
8:30AM	2Q10:	-1.8%	+4.9%
	3Q10	+2.4	-0.1
Prelim:	4Q10	+2.6	-0.6

Factory Orders

10:00 AM	Oct:	-0.7%
	Nov:	+1.3
	Dec:	+0.2

Nonmfg. ISM

10:00 AM	Nov:	56.0
	Dec:	57.1
	Jan:	59.4

Fed Chairman Bernanke speaks at National Press Club, Washington, D.C.

12:30PM

Feb-04

Employment

8:30 AM	Nov:	Dec:	Jan:
Payrolls	+93k	+121	+36
UnRate	9.8%	9.4	9.0
Hrly Erngs	Unch.	0.1	+0.4
Workwk	34.2 hrs	34.3	34.2

FORECASTS

Feb-07

Consumer Credit

3:00 PM	Oct:	+$7.0B
	Nov:	+1.3
	Dec:	*+5.0*

Feb-08

3 Yr Note Auction

$32B

Feb-09

10 Yr Note Auction

$24B

Fed Chairman Bernanke testifies before House Budget Committee

Feb-10

Wholesale Inventories

10:00 AM	Oct:	+1.7
	Nov:	-0.2
	Dec:	*+0.8*

30 Yr Bond Auction

$16B

30 Yr Tips Announcement

$9B

Feb-11

International Trade Balance

8:30 AM	Oct:	-$38.4B
	Nov:	-38.3
	Dec:	*-39.5*

Consumer Sentiment

9:55 AM	Dec:	74.5
	Jan:	74.2
Prelim:	*Feb:*	*76.0*

Feb-14

Feb-15

Retail Sales		**Total**	**Ex Autos**
8:30AM	Nov:	+0.8	+1.0%
	Dec:	+0.6	+0.5
	Jan:	*+0.4*	*+0.5*

NY Fed Empire State Survey

8:30AM	Dec:	+9.9
	Jan:	+11.9
	Feb:	*+15.0*

Import Prices

8:30AM	Nov:	+1.5%
	Dec:	+1.1
	Jan:	*+1.2*

Business Inventories

10:00AM	Oct:	+0.8%
	Nov:	+0.2
	Dec:	*+0.4*

NAHB Housing Market Index

10:00AM	Dec:	16
	Jan:	16
	Feb:	*17*

Feb-16

Housing		**Starts**	**Permits**
8:30AM	Nov:	0.553M	0.544M
	Dec:	0.529	0.635
	Jan:	*0.500*	*0.600*

PPI		**Total**	**Core**
8:30AM	Nov:	+0.8%	+0.3%
	Dec:	+1.1	+0.2
	Jan:	*+0.8*	*+0.3*

Industrial Production			**Cap. Util.**
9:15AM	Nov:	+0.3%	75.4%
	Dec:	+0.8	76.0
	Jan:	*+0.6*	*76.6*

FOMC Minutes

2:00 PM

Feb-17

CPI Price		**Total**	**Core**
8:30AM	Nov:	+0.1%	+0.1
	Dec:	+0.5	+0.1
	Jan:	*+0.2*	*+0.1*

Leading Economic Indicators

10:00AM	Nov:	+1.1
	Dec:	+1.0
	Jan:	*+0.6*

Philadelphia Fed

10:00AM	Dec:	+20.8
	Jan:	+19.3
	Feb:	*+22.0*

2 Yr Note Announcement

$35B

5 Yr Note Announcement

$35B

7 Yr Note Announcement

$29B

30 Yr Tips Auction

$9B

Feb-18

Feb-21

Presidents' Day

US Markets Closed

Feb-22

Consumer Confidence

10:00 AM	Dec:	53.3
	Jan:	60.6
	Feb:	*62.0*

2 Yr Note Auction

$35B

Feb-23

Existing Home Sales

10:00 AM	Nov:	4.70	+6.1
	Dec:	5.28	+12.3
	Jan:	*5.40*	*+2.3*

5 Yr Note Auction

$35B

Feb-24

Durable Goods Orders			**ExTrans**
8:30 AM	Nov:	-0.1	+4.5%
	Dec:	-2.5	+0.5
	Jan:	*+2.0*	*Unch.*

New Home Sales

10:00 AM	Nov:	280K	Unch.
	Dec:	329	+17.5
	Jan:	*300*	*-8.8*

7 Yr Note Auction

$29B

Feb-25

Real GDP			**Deflator**
8:30 AM	Q210:	+1.7%	+1.9%
	Q310:	+2.6	+2.1
Adv.	Q410:	+3.2	+0.3
Prelim.	*Q410:*	*+3.2*	*+0.3*

Consumer Sentiment

9:55 AM	Dec:	71.6
	Jan:	74.2
Final:	*Feb:*	*76.0*

Contacts

Name	Title	Telephone	Email	Location
Joseph LaVorgna	Chief US Economist	212-250-7329	joseph.lavorgna@db.com	New York
Carl Riccadonna	Senior US Economist	212-250-0186	carl.riccadonna@db.com	New York
Brett Ryan	Economist	212-250-6294	brett.ryan@db.com	New York
Jennifer Francis	Administrator	212-250-7275	jennifer.francis@db.com	New York

Appendix 1

Important Disclosures

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David Folkerts-Landau
Managing Director
Global Head of Research

Stuart Parkinson
Associate Director
Company Research

Marcel Cassard
Global Head
Fixed Income Research

Europe	Asia-Pacific	Germany	Americas
Guy Ashton Regional Head	Fergus Lynch Regional Head	Andreas Neubauer Regional Head	Steve Pollard Regional Head

Principal Locations

Deutsche Bank AG
London
1 Great Winchester Street
London EC2N 2EQ
Tel: (44) 20 7545 8000

Deutsche Bank AG
New York
60 Wall Street
New York, NY 10005
United States of America
Tel: (1) 212 250-2500

Deutsche Bank AG
Hong Kong
Filiale Hongkong
Intl. Commerce Centre,
1 Austin Road West,Kowloon,
Hong Kong
tel: (852) 2203 8888

Deutsche Securities Inc.
Japan
2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Tel: (81) 3 5156 6770

Deutsche Bank AG
Frankfurt
Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 00

Deutsche Bank AG
Aurora business park
82 bld.2 Sadovnicheskaya street
Moscow, 115035
Russia
Tel: (7) 495 797-5000

Deutsche Bank AG
Singapore
One Raffles Quay
South Tower
Singapore 048583
Tel: (65) 6423 8001

Deutsche Bank AG
Australia
Deutsche Bank Place, Level 16
Corner of Hunter & Phillip Streets
Sydney NSW 2000
Tel: (61) 2 8258 1234

Deutsche Bank Dubai
Dubai International Financial Centre
The Gate, West Wing, Level 3
P.O. Box 504 902
Dubai City
Tel: (971) 4 3611 700

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New York, NY 10005
United States of America
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