Economic Prospects: Problems and Promise

September 11, 2012

Peter Hooper, Managing Director
Chief Economist, Deutsche Bank Securities
peter.hooper@db.com
+1 (212) 250-7352

All prices are those current at the end of the previous trading session unless otherwise indicated. Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies. Deutsche Bank does and seeks to do business with companies covered in its research reports. Thus, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision. DISCLOSURES AND ANALYST CERTIFICATIONS ARE LOCATED IN APPENDIX 1. MICA(P) 072/04/2012.
Fed will ease again this week. More QE will exacerbate exit challenges, but economic prospects weak enough to warrant action.

Euro risk is likely to be with us for several more years.

US fiscal uncertainties loom large.

US has potential to be an engine of global growth again.
Fed BSPs pushed real interest rates lower

Source: FRB, Haver Analytics, DB Global Markets Research
US 10y yield running well below business cycle fundamentals

Model:  
10YT = c + 2YT + Business cycle

Coeff.  2.71  0.52  0.01
(76.8) (50.2) (0.6)

Note: t-stats in parentheses

Note: Explanatory variables used in the model are 2y treasury yield and Aruoba-Diebold-Scotti Business Conditions Index

Source: FRB, DB Global Markets Research
Financial conditions still a moderate drag

Euro risk is elevated

Avg. Italy & Spain 10-yr Govt bond spreads rel. to bunds*

* Measured as difference between German 10 year treasury yields and average of (Italy and Spain 10 year treasury yields).

Source: Bbk, BDIT, BDE, Haver Analytics, DB Global Markets Research
Euro risk here to stay for a good while

- Muddle through will persist because of political attachment to euro in core and periphery and high cost of failure/exit.
- Don’t expect a US solution: full fiscal union and euro-bonds not in the Euro area’s foreseeable future.
- Solution that will maximize membership is “conditional assistance,” with ESM doling out assistance and ECB providing lots of liquidity so long as members make needed progress on fiscal and structural reforms (OMT).
- Reforms unpopular, monitoring and enforcing conditions means stress in markets.
- EA is two years into a 5-year adjustment program. Expect substantial fiscal drag and weak growth into 2015.
- EA reforms have further to go, but EA also does not get credit it deserves for progress already made.

Source: DB Global Markets Research
Euro Area fiscal position relatively good

General government deficit as share of GDP

Source: IMF, Haver Analytics, DB Global Markets Research
US fiscal cliff looms

% of GDP

US Federal budget deficit (Aug 2012)

% of GDP

Note: The budget deficit denoted in positive sign whereas surplus in negative

Source: CBO, DB Global Markets Research
Mountain of debt lies beyond the cliff

% of GDP

Source: usgovernmentspending.com, Fiscal Commission, CBO, DB Global Markets Research
US poised to be an engine of global growth

Private fixed investment/GDP at historic low

*Discretionary spending here includes personal consumption expenditure on durable goods and gross domestic private investment.

Source: BEA, Haver Analytics, DB Global Markets Research
Capacity utilization back to historical norm

Industrial capacity utilization

Historical average

Source: FRB, Haver Analytics, DB Global Markets Research

Deutsche Bank
Peter Hooper – September 2012
+1 212-250-7352
peter.hooper@db.com
Excess stock of vacant homes has disappeared

* Includes homes for sale, homes for rent, and homes held off the market for other reasons; excludes seasonal homes and second homes not used a primary residence.

Source: Census, Haver Analytics, DB Global Markets Research
Household deleveraging and asset recovery

Source: FRB, Haver Analytics, DB Global Markets Research
Household balance sheets looking more normal

*Assumption: house prices fall by 2% by end of 2012 and stock rises by approx. 1% each quarter in 2012 on %QoQ basis, Nominal DPI increases by 4.2%

Source: BEA, FRB, Haver Analytics, DB Global Markets Research
Key points

Fed will ease again this week. More QE will exacerbate exit challenges, but economic prospects weak enough to warrant action.

Euro risk is likely to be with us for several more years.

US fiscal uncertainties loom large.

US has potential to be an engine of global growth again, as capital stock utilization rises, HH balance sheets have adjusted.

Source: DB Global Markets Research
Peter Hooper

Managing Director, Chief Economist
Deutsche Bank Securities, Inc.
+1 (212) 250-7352
peter.hooper@db.com

Peter Hooper is currently Managing Director and Chief Economist for Deutsche Bank Securities. He joined Deutsche Bank Securities in the fall of 1999, first as Chief International Economist and shortly thereafter as Chief US Economist. He became Chief Economist and co-head of global economics in 2006. Prior to joining Deutsche Bank, Hooper enjoyed a distinguished 26-year career at the Federal Reserve Board in Washington, D.C. While rising to senior levels of the Fed staff, he held numerous positions, including as an economist on the FOMC and as Deputy Director of the Division of International Finance.

Hooper produces weekly and quarterly publications for Deutsche Bank with a focus on US and global economic developments and Fed policy; he also comments on US and global economic and financial developments in the news media. His US Economics team has been ranked No. 1 in fixed income research by Institutional Investor in 2010 and 2011. Hooper currently serves as a member of the Economic Advisory Panel of the Federal Reserve Bank of New York, a member and former chairman of the Economic Advisory Committee of the American Bankers Association, a founding member of the US Monetary Policy Forum, a member of the Economic Leadership Council for the University of Michigan, and a member of the Forecasts’ Club of New York.

Hooper earned a BA in Economics (cum laude) from Princeton University and an MA and Ph.D. in Economics from University of Michigan. He has published numerous books, journal articles, and reviews on economics and policy analysis.
Appendix 1

Important Disclosures
Additional information available upon request
For disclosures pertaining to recommendations or estimates made on a security mentioned in this report, please see the most recently published company report or visit our global disclosure look-up page on our website at http://gm.db.com/ger/disclosure/DisclosureDirectory.eqsr.

Analyst Certification
The views expressed in this report accurately reflect the personal views of the undersigned lead analyst about the subject issuers and the securities of those issuers. In addition, the undersigned lead analyst has not and will not receive any compensation for providing a specific recommendation or view in this report.

Peter Hooper

Regulatory Disclosures

1. Important Additional Conflict Disclosures
Aside from within this report, important conflict disclosures can also be found at https://gm.db.com/equities under the “Disclosures Lookup” and “Legal” tabs. Investors are strongly encouraged to review this information before investing.

2. Short-Term Trade Ideas
Deutsche Bank equity research analysts sometimes have shorter-term trade ideas (known as SOLAR ideas) that are consistent or inconsistent with Deutsche Bank’s existing longer term ratings. These trade ideas can be found at the SOLAR link at http://gm.db.com.

3. Country-Specific Disclosures

Australia and New Zealand: This research, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act and New Zealand Financial Advisors Act respectively.

Brazil: The views expressed above accurately reflect personal views of the authors about the subject company(ies) and its(their) securities, including in relation to Deutsche Bank. The compensation of the equity research analyst(s) is indirectly affected by revenues deriving from the business and financial transactions of Deutsche Bank. In cases where at least one Brazil based analyst (identified by a phone number starting with +55 country code) has taken part in the preparation of this research report, the Brazil based analyst whose name appears first assumes primary responsibility for its content from a Brazilian regulatory perspective and for its compliance with CVM Instruction # 483.

EU countries: Disclosures relating to our obligations under MiFID can be found at http://www.globalmarkets.db.com/riskdisclosures.

Japan: Disclosures under the Financial Instruments and Exchange Law: Company name - Deutsche Securities Inc. Registration number - Registered as a financial instruments dealer by the Head of the Kanto Local Finance Bureau (Kinsho) No. 117. Member of associations: JSDA, Type II Financial Instruments Firms Association, The Financial Futures Association of Japan, Japan Investment Advisers Association. This report is not meant to solicit the purchase of specific financial instruments or related services. We may charge commissions and fees for certain categories of investment advice, products and services. Recommended investment strategies, products and services carry the risk of losses to principal and other losses as a result of changes in market and/or economic trends, and/or fluctuations in market value. Before deciding on the purchase of financial products and/or services, customers should carefully read the relevant disclosures, prospectuses and other documentation. "Moody's", "Standard & Poor's", and “Fitch” mentioned in this report are not registered credit rating agencies in Japan unless “Japan” or "Nippon" is specifically designated in the name of the entity.

Malaysia: Deutsche Bank AG and/or its affiliate(s) may maintain positions in the securities referred to herein and may from time to time offer those securities for purchase or may have an interest to purchase such securities. Deutsche Bank may engage in transactions in a manner inconsistent with the views discussed herein.

Russia: This information, interpretation and opinions submitted herein are not in the context of, and do not constitute, any appraisal or evaluation activity requiring a license in the Russian Federation.
Risks to Fixed Income Positions

Macroeconomic fluctuations often account for most of the risks associated with exposures to instruments that promise to pay fixed or variable interest rates. For an investor that is long fixed rate instruments (thus receiving these cash flows), increases in interest rates naturally lift the discount factors applied to the expected cash flows and thus cause a loss. The longer the maturity of a certain cash flow and the higher the move in the discount factor, the higher will be the loss. Upside surprises in inflation, fiscal funding needs, and FX depreciation rates are among the most common adverse macroeconomic shocks to receivers. But counterparty exposure, issuer creditworthiness, client segmentation, regulation (including changes in assets holding limits for different types of investors), changes in tax policies, currency convertibility (which may constrain currency conversion, repatriation of profits and/or the liquidation of positions), and settlement issues related to local clearing houses are also important risk factors to be considered. The sensitivity of fixed income instruments to macroeconomic shocks may be mitigated by indexing the contracted cash flows to inflation, to FX depreciation, or to specified interest rates – these are common in emerging markets. It is important to note that the index fixings may -- by construction -- lag or mis-measure the actual move in the underlying variables they are intended to track. The choice of the proper fixing (or metric) is particularly important in swaps markets, where floating coupon rates (i.e., coupons indexed to a typically short-dated interest rate reference index) are exchanged for fixed coupons. It is also important to acknowledge that funding in a currency that differs from the currency in which the coupons to be received are denominated carries FX risk. Naturally, options on swaps (swaptions) also bear the risks typical to options in addition to the risks related to rates movements.
Global Disclaimer

The information and opinions in this report were prepared by Deutsche Bank AG or one of its affiliates (collectively "Deutsche Bank"). The information herein is believed to be reliable and has been obtained from public sources believed to be reliable. Deutsche Bank makes no representation as to the accuracy or completeness of such information.

Deutsche Bank may engage in securities transactions, on a proprietary basis or otherwise, in a manner inconsistent with the view taken in this research report. In addition, others within Deutsche Bank, including strategists and sales staff, may take a view that is inconsistent with that taken in this research report.

Opinions, estimates and projections in this report constitute the current judgement of the author as of the date of this report. They do not necessarily reflect the opinions of Deutsche Bank and are subject to change without notice. Deutsche Bank has no obligation to update, modify or amend this report or to otherwise notify a recipient thereof in the event that any opinion, forecast or estimate set forth herein, changes or subsequently becomes inaccurate. Prices and availability of financial instruments are subject to change without notice. This report is provided for informational purposes only. It is not an offer or a solicitation of an offer to buy or sell any financial instruments or to participate in any particular trading strategy. Target prices are inherently imprecise and a product of the analyst judgement.

As a result of Deutsche Bank's March 2010 acquisition of BHF-Bank AG, a security may be covered by more than one analyst within the Deutsche Bank group. Each of these analysts may use differing methodologies to value the security; as a result, the recommendations may differ and the price targets and estimates of each may vary widely.

In August 2009, Deutsche Bank instituted a new policy whereby analysts may choose not to set or maintain a target price of certain issuers under coverage with a Hold rating. In particular, this will typically occur for "Hold" rated stocks having a market cap smaller than most other companies in its sector or region. We believe that such policy will allow us to make best use of our resources. Please visit our website at http://gm.db.com to determine the target price of any stock.

The financial instruments discussed in this report may not be suitable for all investors and investors must make their own informed investment decisions. Stock transactions can lead to losses as a result of price fluctuations and other factors. If a financial instrument is denominated in a currency other than an investor's currency, a change in exchange rates may adversely affect the investment. Past performance is not necessarily indicative of future results. Deutsche Bank may with respect to securities covered by this report, sell to or buy from customers on a principal basis, and consider this report in deciding to trade on a proprietary basis. Unless governing law provides otherwise, all transactions should be executed through the Deutsche Bank entity in the investor's home jurisdiction. In the U.S. this report is approved and/or distributed by Deutsche Bank Securities Inc., a member of the NYSE, the NASD, NFA and SIPC. In Germany this report is approved and/or communicated by Deutsche Bank AG Frankfurt authorized by the BaFin. In the United Kingdom this report is approved and/or communicated by Deutsche Bank AG London, a member of the London Stock Exchange and regulated by the Financial Services Authority for the conduct of investment business in the UK and authorized by the BaFin. This report is distributed in Hong Kong by Deutsche Bank AG, Hong Kong Branch, in Korea by Deutsche Securities Korea Co. This report is distributed in Singapore by Deutsche Bank AG, Singapore Branch, and recipients in Singapore of this report are to contact Deutsche Bank AG, Singapore Branch in respect of any matters arising from, or in connection with, this report. Where this report is issued or promulgated in Singapore to a person who is not an accredited investor, expert investor or institutional investor (as defined in the applicable Singapore laws and regulations), Deutsche Bank AG, Singapore Branch accepts legal responsibility to such person for the contents of this report. In Japan this report is approved and/or distributed by Deutsche Securities Inc. The information contained in this report does not constitute the provision of investment advice. In Australia, retail clients should obtain a copy of a Product Disclosure Statement (PDS) relating to any financial product referred to in this report and consider the PDS before making any decision about whether to acquire the product. Deutsche Bank AG Johannesburg is incorporated in the Federal Republic of Germany (Branch Register Number in South Africa: 1998/003298/10). Additional information relative to securities, other financial products or issuers discussed in this report is available upon request. This report may not be reproduced, distributed or published by any person for any purpose without Deutsche Bank's prior written consent. Please cite source when quoting.

Copyright © 2012 Deutsche Bank AG