

The Best Is Yet to Come

Resilient Growth, Moderate Inflation – Rates Back to Normal – Imbalances Recede

Global Outlook

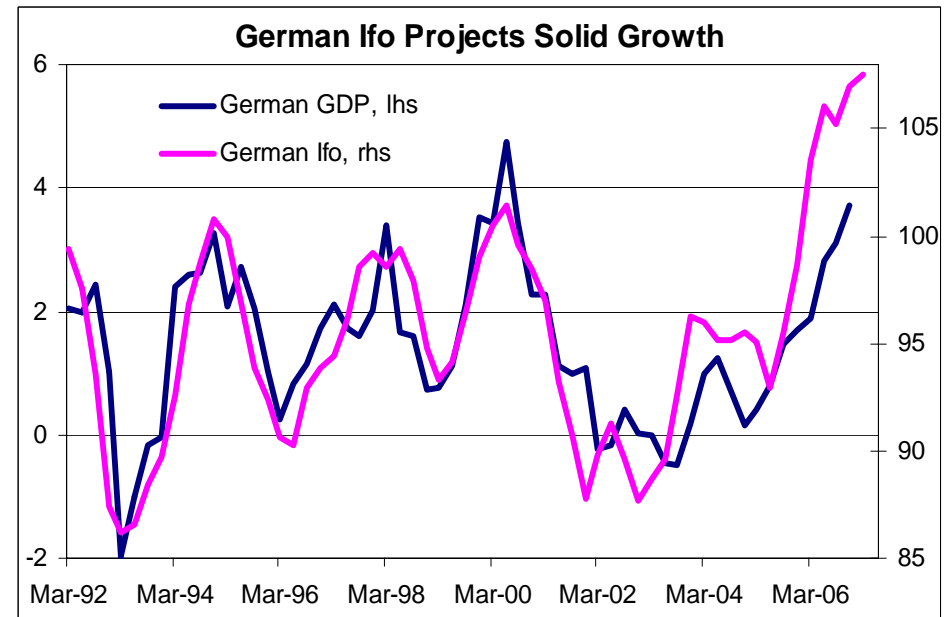
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Yoy change in German GDP, left-hand scale; IFO level, quarterly averages, right-hand scale, advanced by one quarter. Source: Destatis; IFO

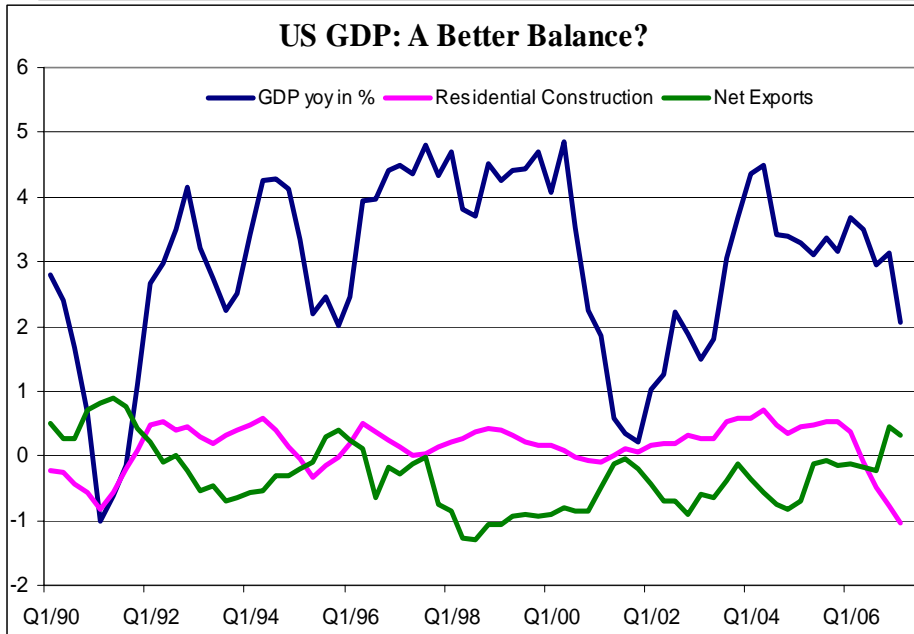
Global Outlook: The Good Times Ain't Over Yet

- ◆ **Global Growth:** *Mid-cycle slowdown now, rebound late 2007 and 2008. It is too early for a global recession. Asia and core Europe have not had their consumption-led boom yet, the typical last stage of a cycle. Boom 2009, recession in 2011?*
- ◆ **The Automatic Stabiliser:** *The end of the oil shock supports consumer incomes.*
- ◆ **Central Banks:** *Modest Fed easing back to neutral 5% in late 2007; ECB to raise rates further to 4.5% and BoJ to 1.25% by mid-2008; BoE likely to peak at 5.5% in May 2007 but return to 5% in late 2008.*
- ◆ **EUR/USD:** *Significant long-term \$ upside as US trade deficit will decline on trend.*
- ◆ **JPY:** *Modest long-term upside vs USD as BoJ raises rates while CNY drifts up.*
- ◆ **GBP:** *£ strength to fade as US economy recovers late 2007 while UK loses steam.*
- ◆ **Bonds:** *Modest updrift in global yields as global economy moves beyond its soft patch and surpluses of oil exporters recede, giving them less funds to buy bonds.*

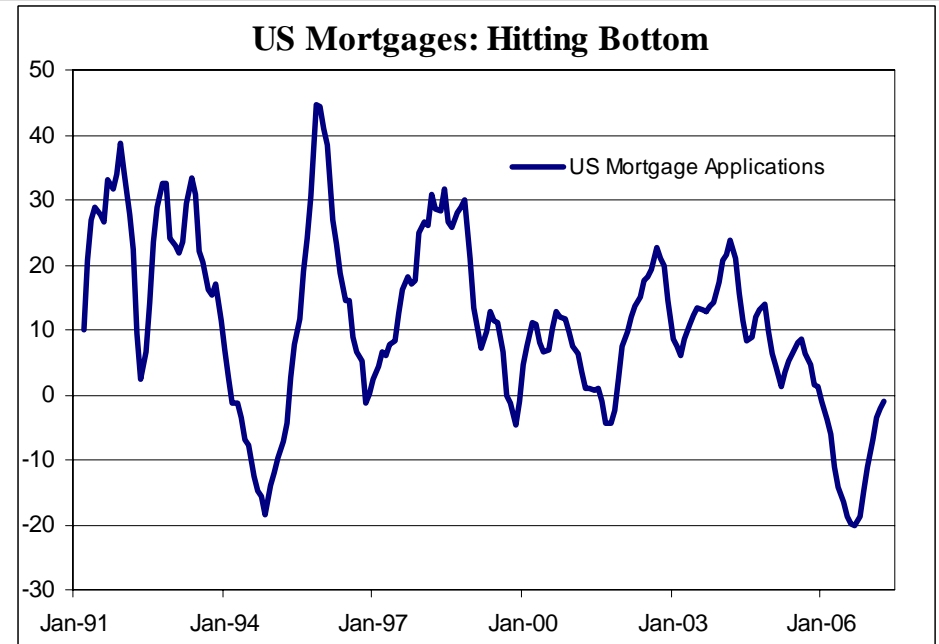
US Economic Outlook

- ◆ *Monetary policy is slightly restrictive. Rising chance that the Fed may remove this restriction as the dip in growth to a pace well below 2% eases inflation concerns.*
- ◆ *Fiscal policy has turned neutral. No major initiatives ahead of the 2008 elections.*
- ◆ *The **USD** is undervalued versus the Euro and Sterling but overvalued versus Asian currencies. Net exports will make a modest positive contribution to US growth, partly offsetting slower growth in private consumption.*
- ◆ *The correction in the most interest sensitive sectors, residential construction and cars, has led to a temporary dip in **business investment**. We look for US growth to return to around 3% in late 2007 after a sub-2% pace until 3Q 2007.*
- ◆ *The worst of the decline in **residential construction** will be over this autumn, subtracting less from GDP in coming quarters than in the last four quarters. The **inventory correction** is also well advanced. However, business investment is declining temporarily in response to less buoyant final demand.*
- ◆ ***Private consumption:** rising employment and robust gains in disposable income mitigate the impact from a likely modest fall in house prices.*

US Real Estate Market – The Great Risk?



Contributions to yoy growth in GDP; in % points. Source: BEA

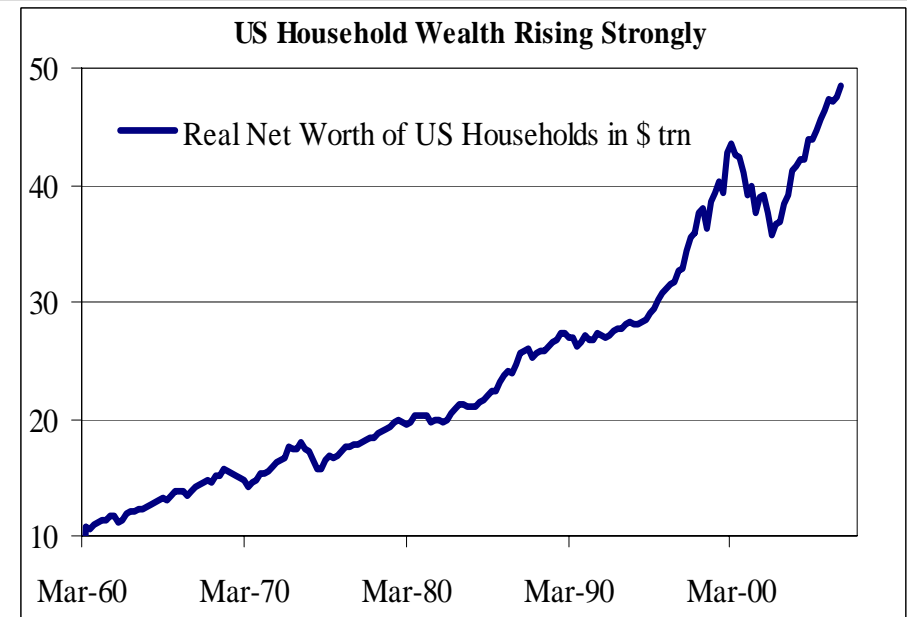
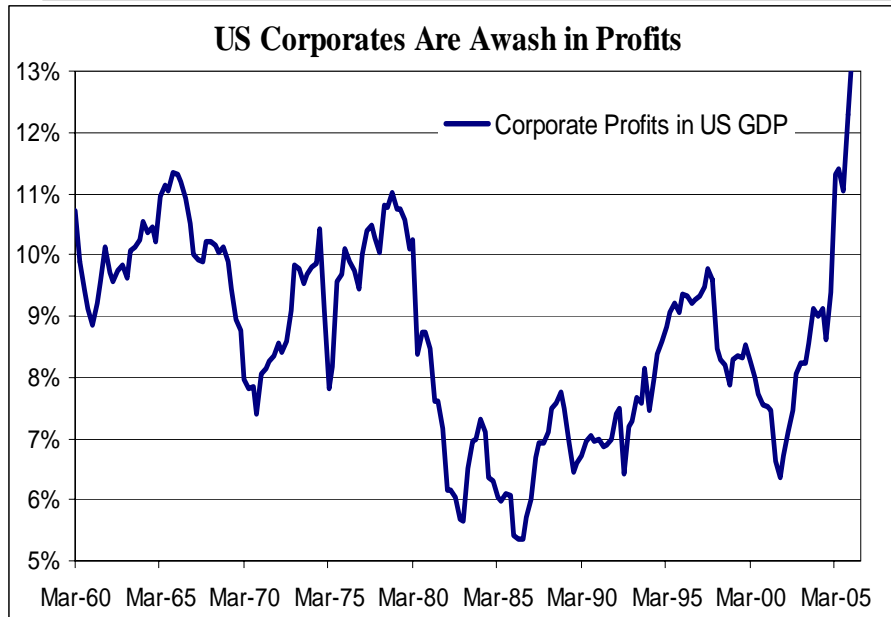


Volume of mortgage applications for home purchases, yoy change in %. Source: MBA.

Luck is still with the US: While residential construction has nosedived, net exports are now supporting growth.

Mortgage statistics suggest that residential construction will likely hit bottom soon. Housing accounts for some 7% of the US economy.

US Corporates and Consumers in Good Financial Health



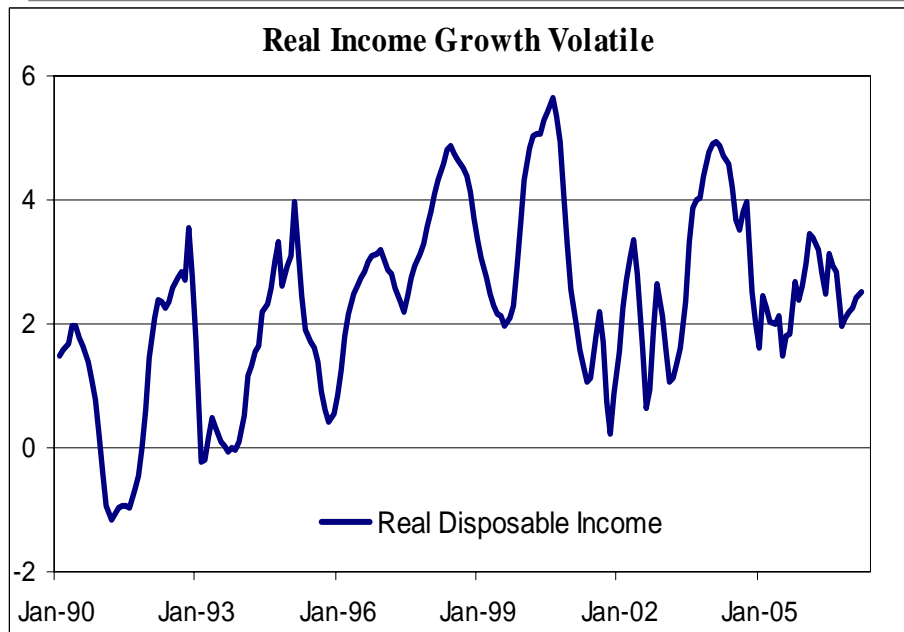
Share of pre-tax profits in US nominal GDP; profits without inventory valuation and capital consumption adjustment. Source: BEA

Assets minus liabilities, adjusted for inflation. Source: Fed

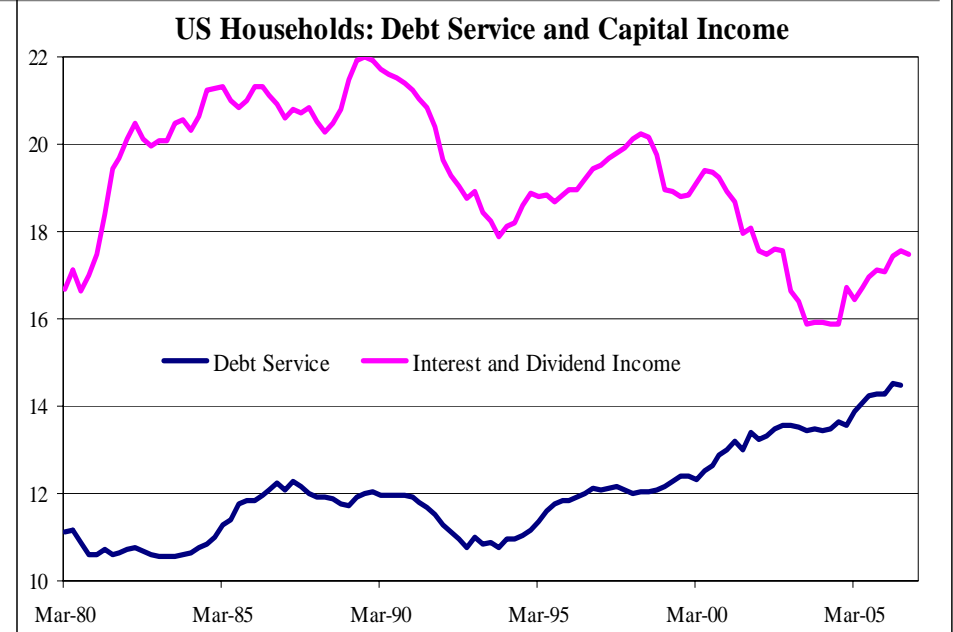
Corporates have used bumper profits to improve their balance sheets. This reduces the downside risks to growth. Corporates do not need to overreact to any temporary dip in demand.

US households are rich – not overindebted. It would take a major collapse in asset values to create widespread debt problems. That looks unlikely. US consumers can stomach a modest fall in average house prices.

US Consumers Not Facing a Debt Problem



Deflated by core CPI. Source: Fed

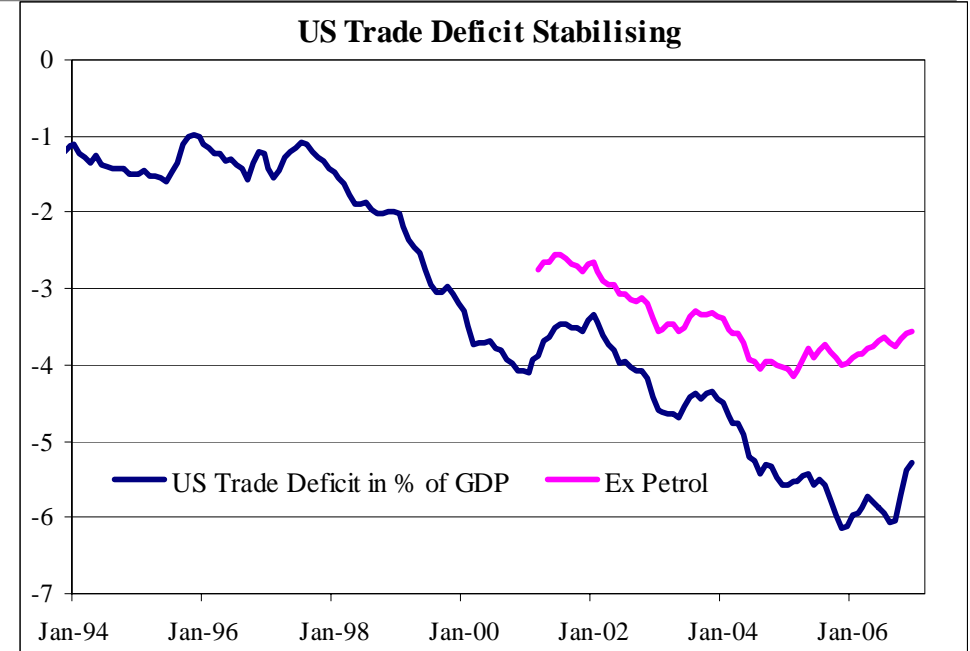
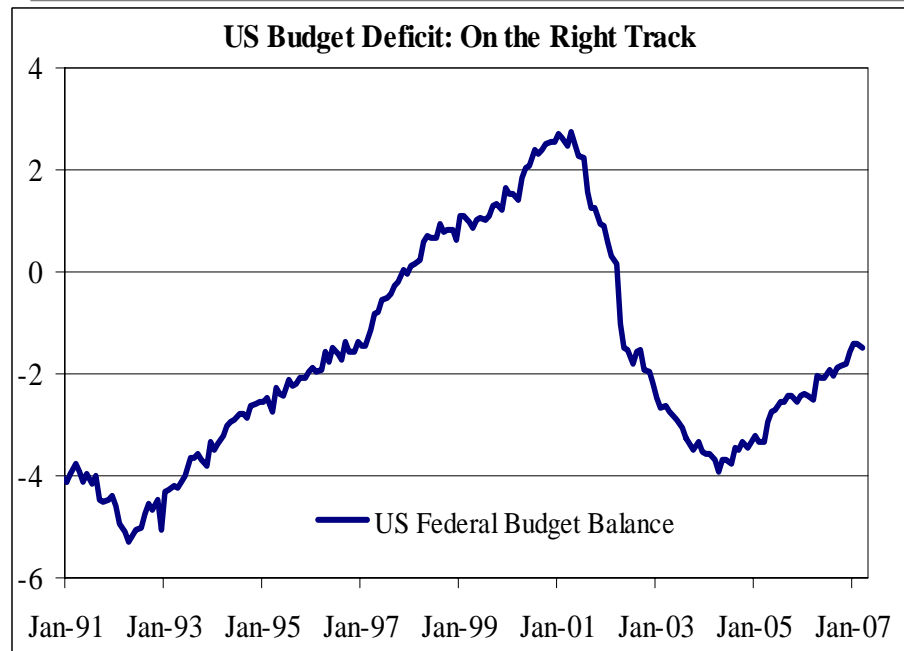


In % of disposable income. Source: Fed

The income of US households is still expanding at a respectable pace of more than 2%, helped by a resilient labour market and strong corporate profits. Going forward, employment growth and core inflation both look set to slow down slightly, leaving real disposable income growth close to its current rate.

US households face a higher debt service burden. However, interest and dividend income has also started to rebound, helping households to service their debt. US households have no problem servicing their debt. Delinquency ratios remain very low.

US: Remember the Twin Deficits?



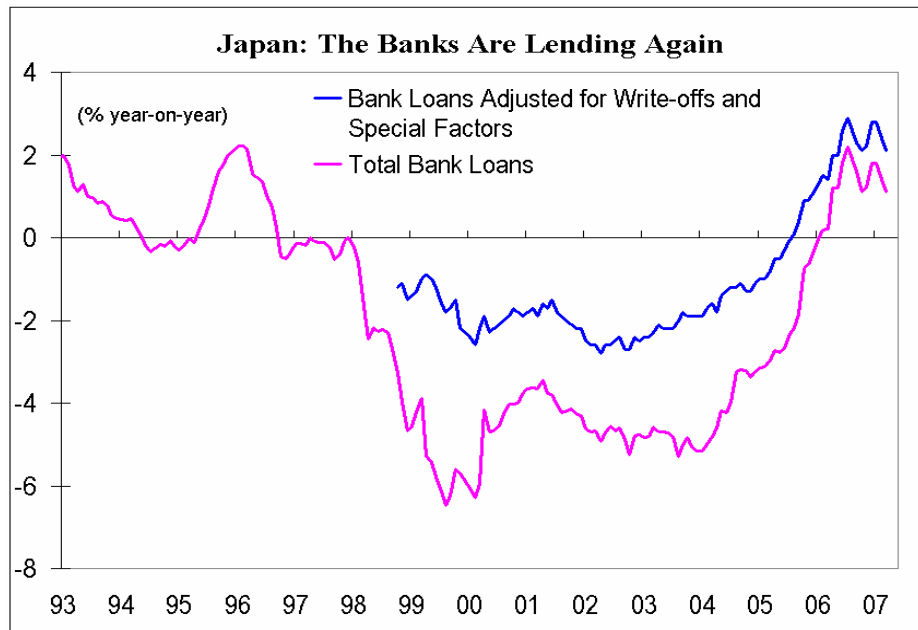
The US fiscal balance has improved significantly, helped by a strong rebound in tax revenues, led by profit and personal income taxes as well as capital gains taxes.

The US trade deficit has stabilised excluding petrol. The headline deficit will likely decline significantly during 2007 due to less elevated oil prices and a slowdown in US domestic demand relative to demand growth elsewhere in the world.

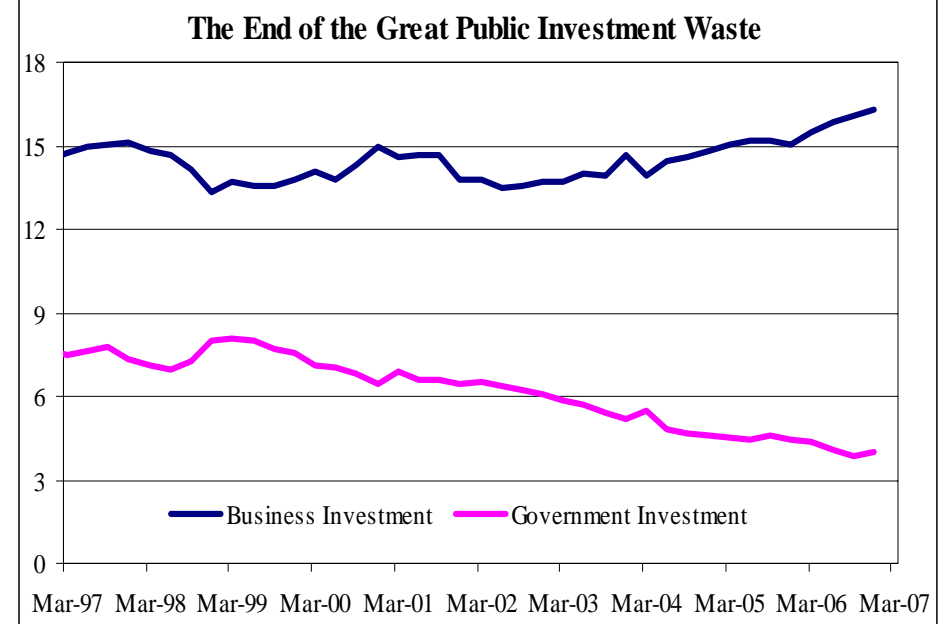
Japanese Outlook

- ◆ *Japan has made major structural progress and has overcome its financial crisis.*
- ◆ *Monetary policy remains stimulative. Subdued consumption growth will likely delay the next 25bp hike to September, followed by 3 rate moves in 2008 to 1.5%.*
- ◆ *Fiscal Policy is slightly restrictive as Japan continues to reduce its – often wasteful – public investment programmes.*
- ◆ *The JPY is undervalued against most major currencies, reflecting the interest rate differential. Japan's proximity to fast-growing Asia means that Japan can rely on buoyant demand for its exports on trend amid some heavy short-term fluctuations.*
- ◆ *Robust business investment bodes well for further gains in employment and a modest updrift in wage income.*
- ◆ *Although core consumer prices are not yet rising, Japan is no longer at risk of falling into a deflationary spiral. Decent GDP growth and other indicators project a slow return to positive inflation rates.*

Japan: A Wobbly Recovery - But Still a Recovery



Yoy change in %. Source: BoJ

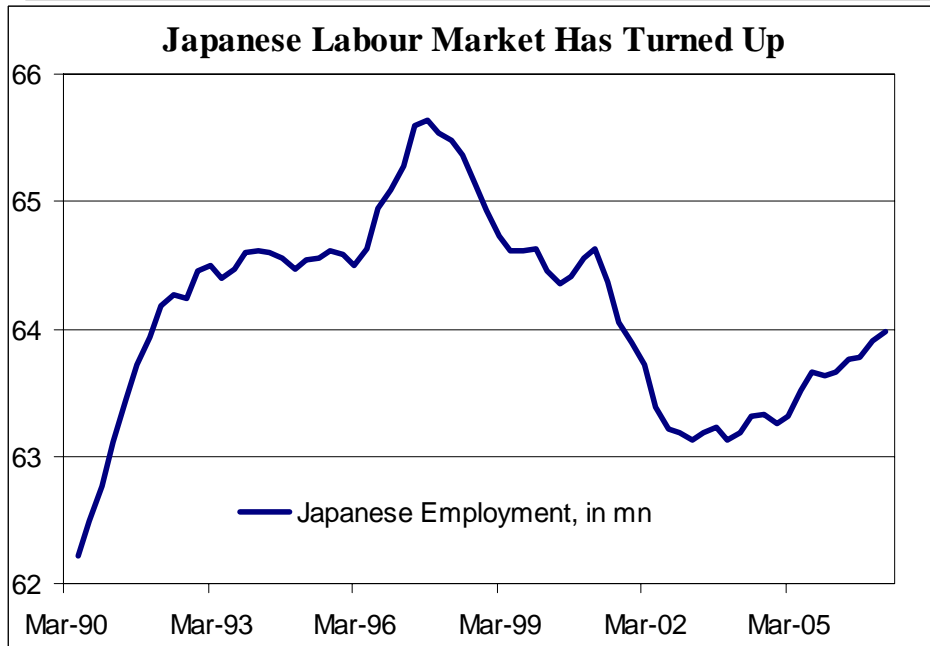


Share in GDP. Source: Bloomberg

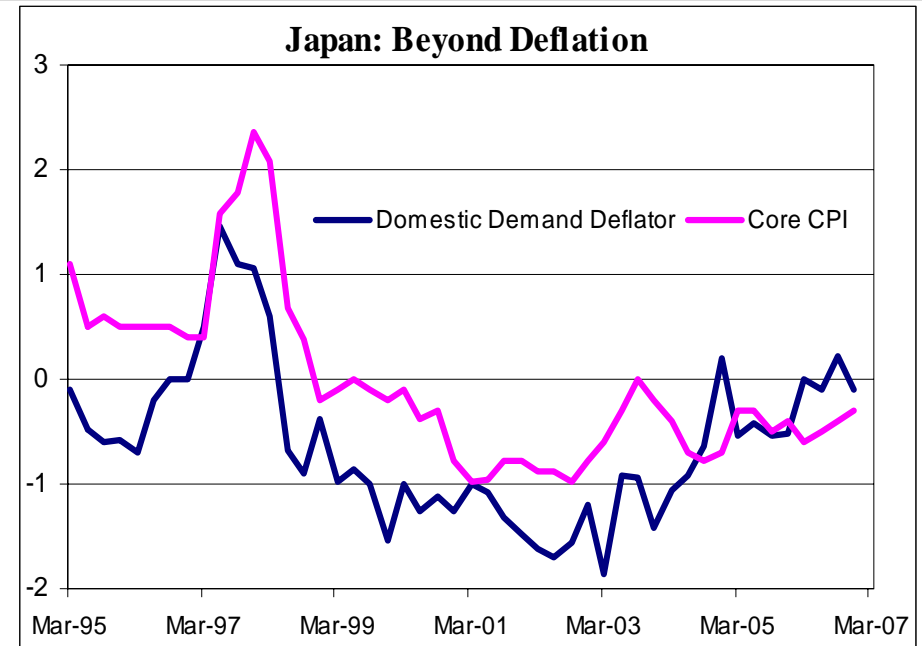
Banks are functioning normally again, having largely sorted out their distressed loans problem.

Export growth is volatile but remains firm overall. Next to fast-growing China, Japan can count on a robust export performance on trend.

Japan: Recovery Well Supported



2-quarter average, in millions. Source: Bloomberg

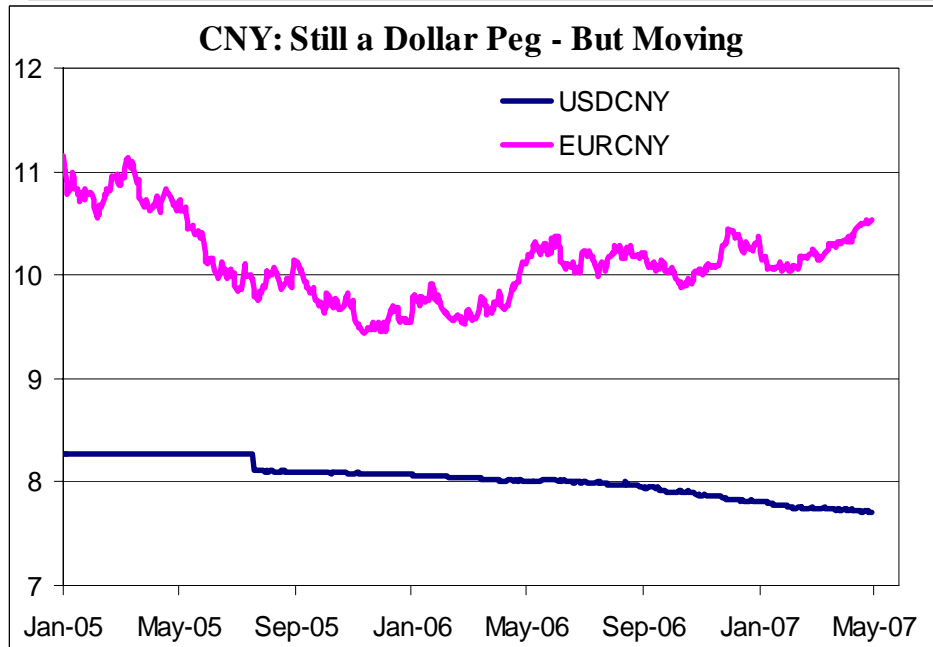


Yoy change in %. Source: Bloomberg

Robust business investment is generating new jobs in Japan.

Deflation is easing on trend.

China: Not in a Hurry to Set the Currency Free



Source: Bloomberg



Yoy change Chinese consumer prices in %. Source: Bloomberg

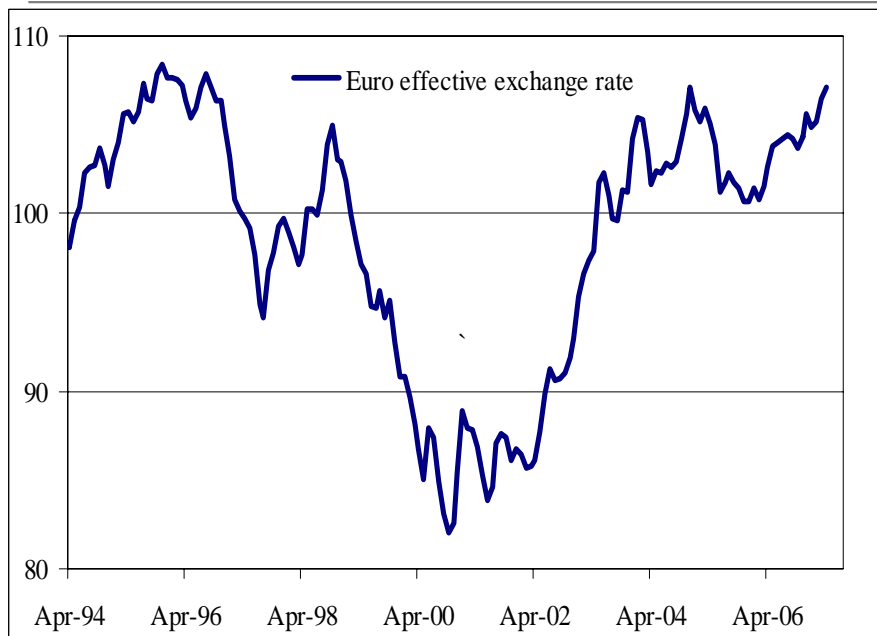
China has slightly increased the pace of appreciation versus the USD.

With low inflation low, China has no urgent domestic reason to accelerate the transition to a more flexible exchange rate arrangement dramatically. We expect a further rise to RMB 7.40 per \$ by the end of 2007. China is using a mix of administrative measures, higher reserve ratios and slightly higher interest rates to rein in its investment boom.

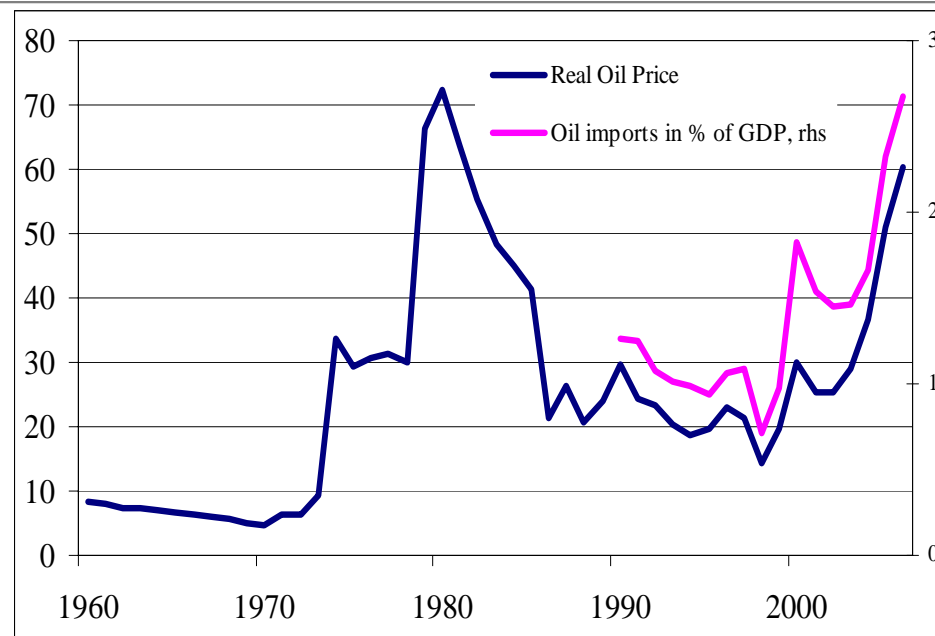
Eurozone Outlook: The Best Is Yet to Come

- ◆ *Monetary policy* has turned roughly neutral in March 2007 and will probably be modestly restrictive by early 2008, in line with a further improvement in employment and some rise in wage inflation.
- ◆ *Fiscal policy* is modestly restrictive in 2007 to the tune of 0.25% of GDP, with German fiscal tightening of €20 bn. Tax cuts in France (€5 bn) are offset by net fiscal tightening of the same magnitude in Italy this year.
- ◆ The **EUR** is overvalued versus the USD and most Asian and other European currencies. However, exporters have largely adjusted to the strong euro. Demand from Asia, Eastern Europe and the oil countries remains strong.
- ◆ The surge in **business investment** bodes well for a stronger advance in employment and wage incomes, which will more than offset the German VAT hike.
- ◆ **GDP growth** will likely moderate in mid-2007 due to the US demand slowdown and the stronger euro. However, growth should strengthen again in late 2007 once the US real estate correction has ended. We look for above-trend growth in 2008.
- ◆ The French elections have improved the reform outlook.

Eurozone: The External Headwinds



Nominal effective exchange rate versus 24 trading partners. Source: ECB

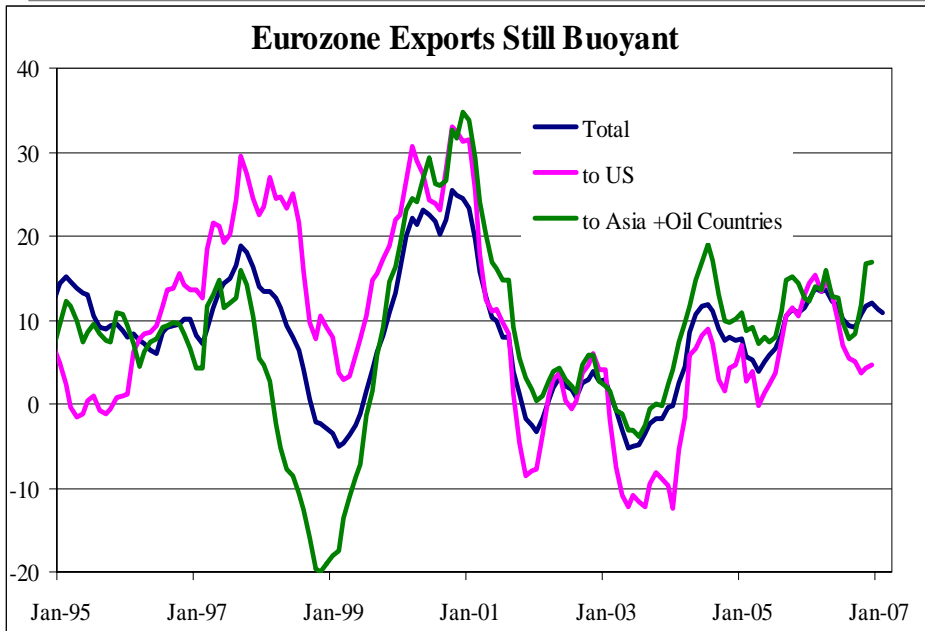


Real oil price in \$ per barrel at 2003 prices; oil imports as share of GDP on left-hand scale. Source: BEA; Bloomberg, ECB

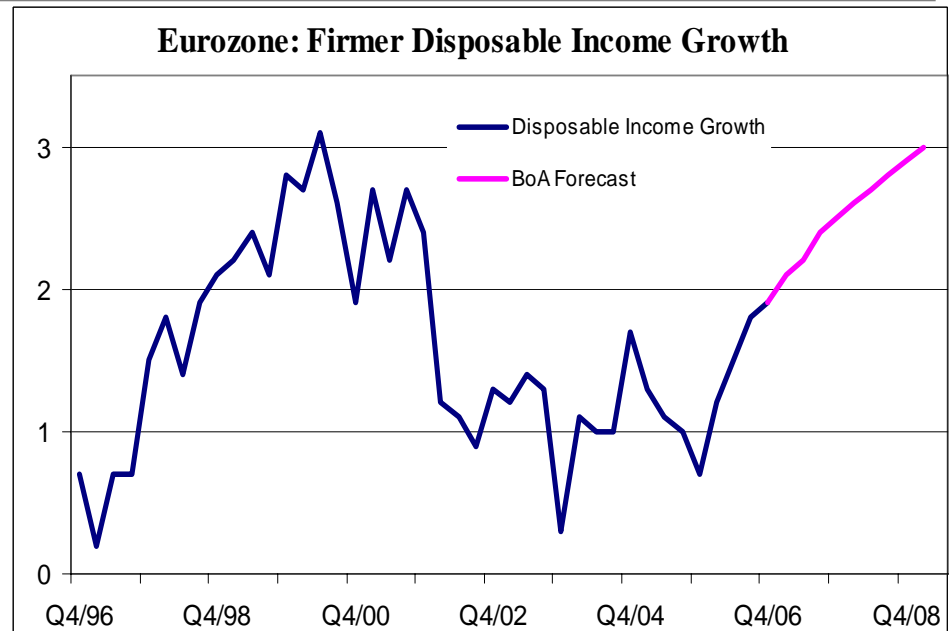
The effective exchange rate remains is close to its previous peaks, and 3.5% above its 2004-06 average. We estimate that this appreciation, if sustained, will shave 0.4% points off economic growth after one year, equivalent to the impact of a 50bp ECB rate hike.

The oil price is now almost 3 times higher than it was in the late 1990s. The oil import bill of the Eurozone has risen by the equivalent of 1.7% of GDP since then. Adding a guess for the impact of higher natural gas prices, the energy shock is probably equivalent to almost 2.5% of Eurozone GDP.

Eurozone: The Tailwinds



Yoy change in %, 3-mo averages, oil countries: OPEC + Russia.
Source: Eurostat

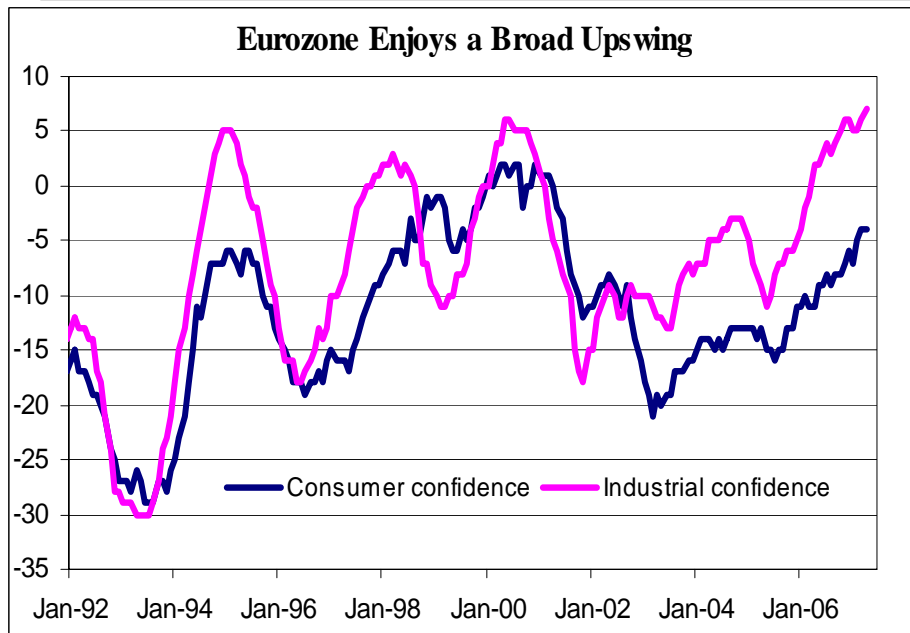


Yoy change in %. Source: OECD; BoA forecasts for 2007-08.

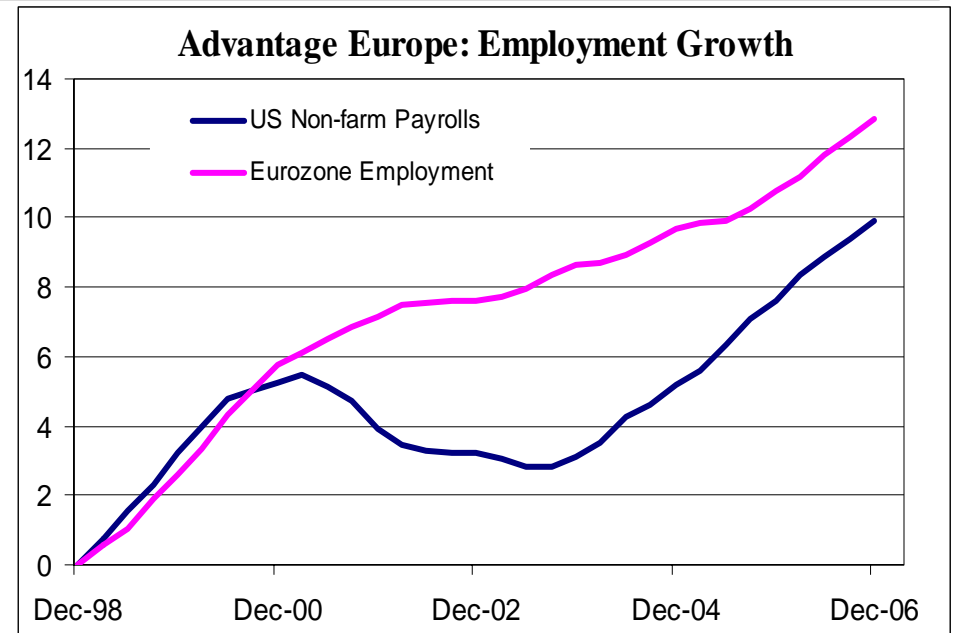
External demand remains strong, despite a recent dip in export growth to the US

Disposable income growth looks set to recover further and could approach its 1999 peak in 2008, helped by rising employment, a modest advance in wage inflation and subdued consumer price inflation.

Eurozone: A Broad-Based Upswing



Source: EU Commission

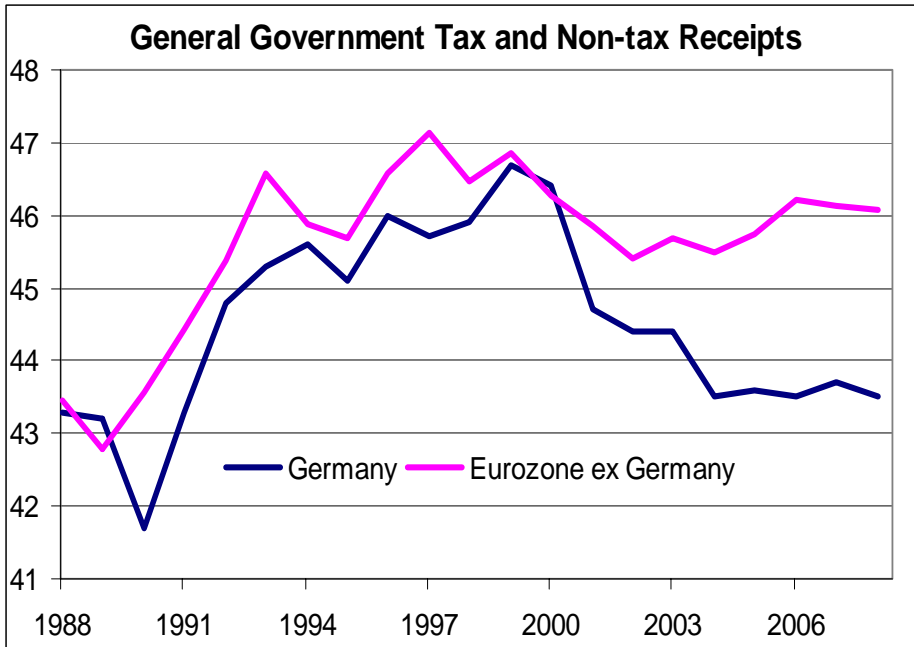


Increase in jobs in millions since the start of EMU. Source: BLS; Eurostat.

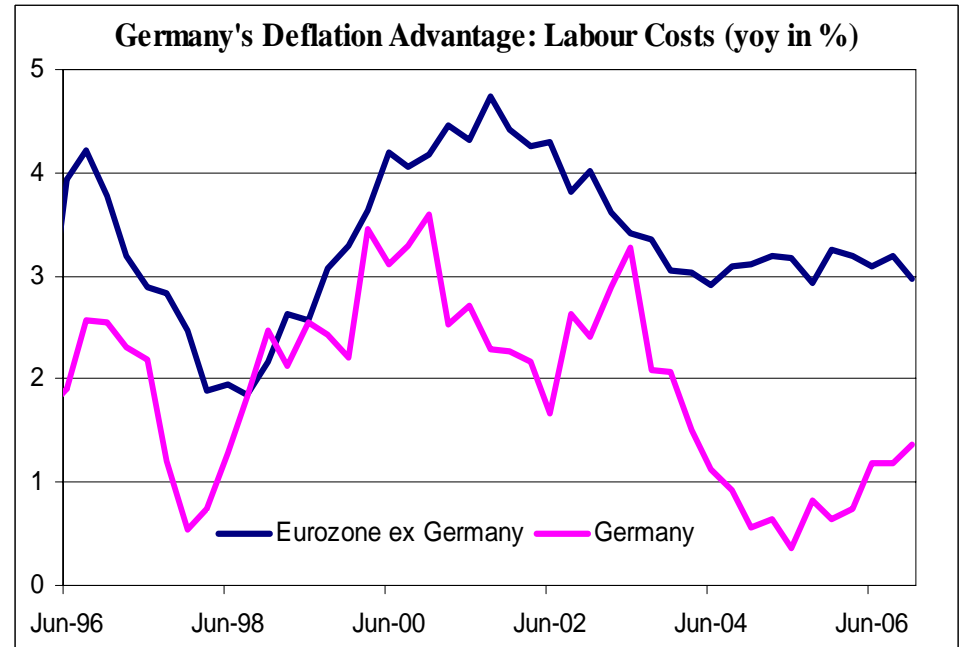
Industrial confidence has surged to new highs despite the mid-2006 spike in petrol prices. Even consumer confidence has recovered, helped by a steady decline in unemployment. Less elevated oil prices now mitigate the downside risks stemming from the US slowdown.

The Eurozone is creating more jobs than the US.

Germany on the Mend



In % of GDP. OECD projections 2005-07. Source: OECD; Bank of America calculations



Yoy change in %. Source: Eurostat

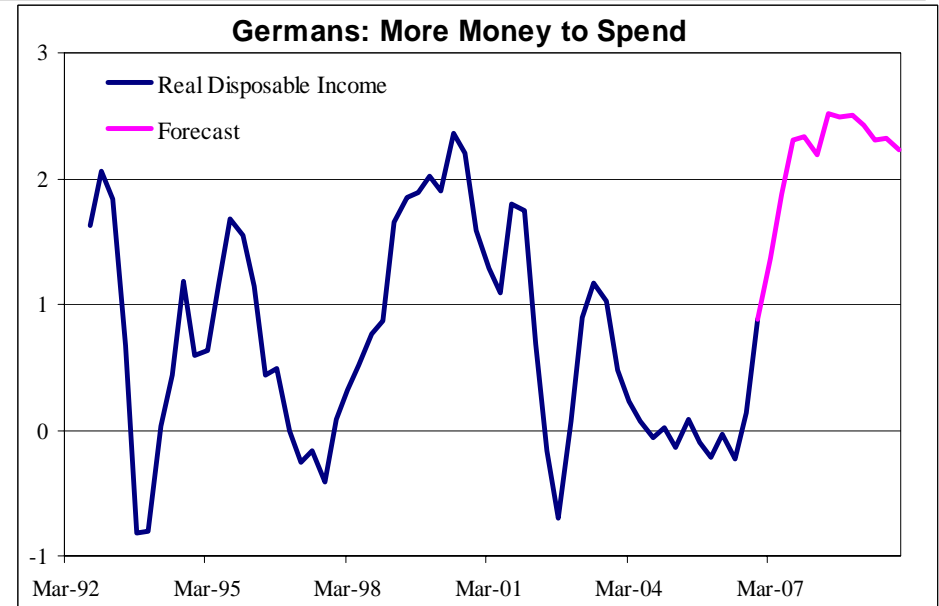
Germany has undone the damage which it inflicted upon itself after unification. Germany has reduced its tax burden significantly since 1999, bringing it back to pre-unification levels. After a wrenching 5-year adjustment crisis, Germany has thus returned to normal.

Germany has regained its cost competitiveness within the Eurozone. Since early 2000, German labour costs have risen by 12%, less than half the cumulative 26.4% increase elsewhere in the Eurozone.

Firmer Labour Market Supports Disposable Income



Core employment subject to payroll taxes. Source: Bundesagentur fuer Arbeit; Bundesbank

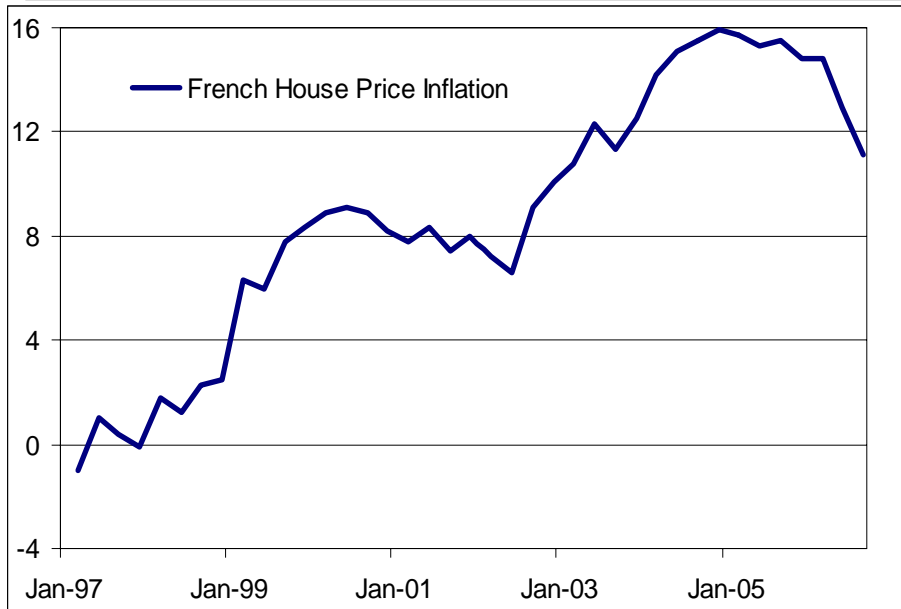


Real disposable income; yoy change in %. Source: Bundesbank; BoA projections

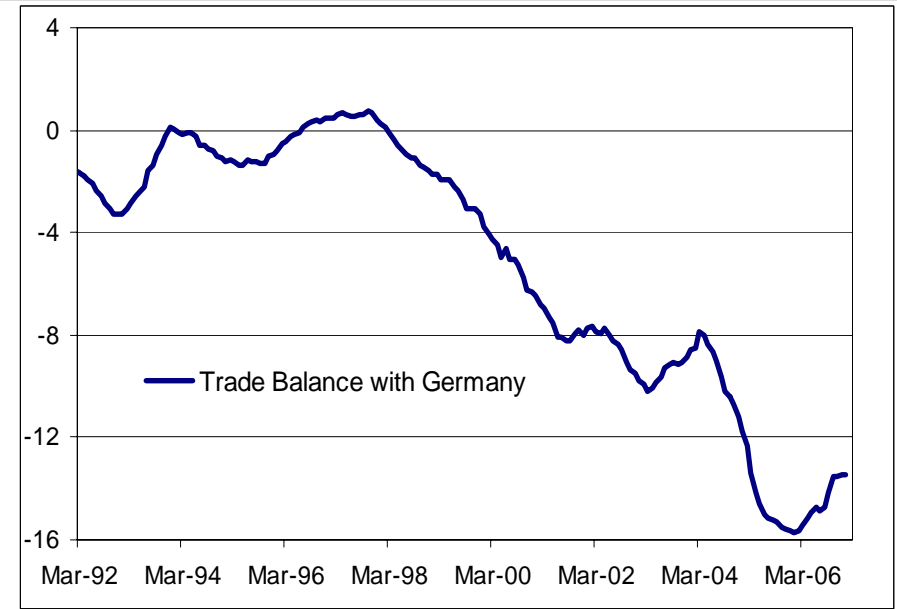
Germany's labour market has improved. Courtesy of wage restraint and recent reforms, core employment is finally rising again. As German domestic demand had started to grow again, it is becoming a more attractive market again for its trading partners.

We expect real disposable income growth to firm significantly in Germany.

France: Changing Gear



Source: Bloomberg

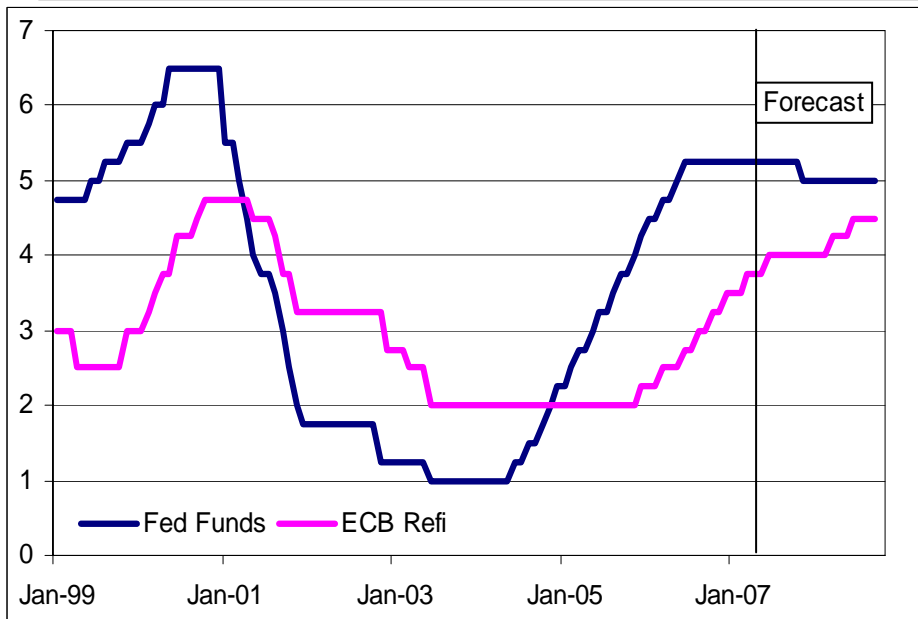


12-month sum; in billion €. Source: Bloomberg

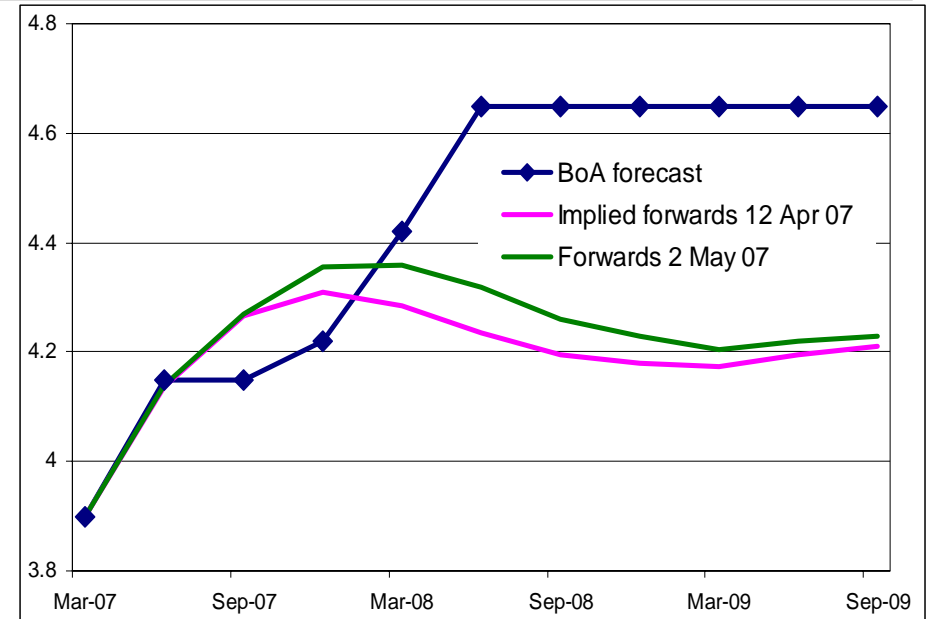
The French real estate market is slowing down.

As Germany is starting to buy again, the French trade deficit with Germany has finally stabilised. This is a general pattern within the Eurozone. While domestic demand is cooling some countries where low ECB rates had stimulated demand in previous years (Spain, Ireland and, to some extent, France), Germany is taking up the slack. The chance to export more to Germany supports growth elsewhere in Europe.

Central Bank Outlook: Fed Steady, ECB Not Done Yet



Source: Fed, ECB; BoA forecasts after December 2006

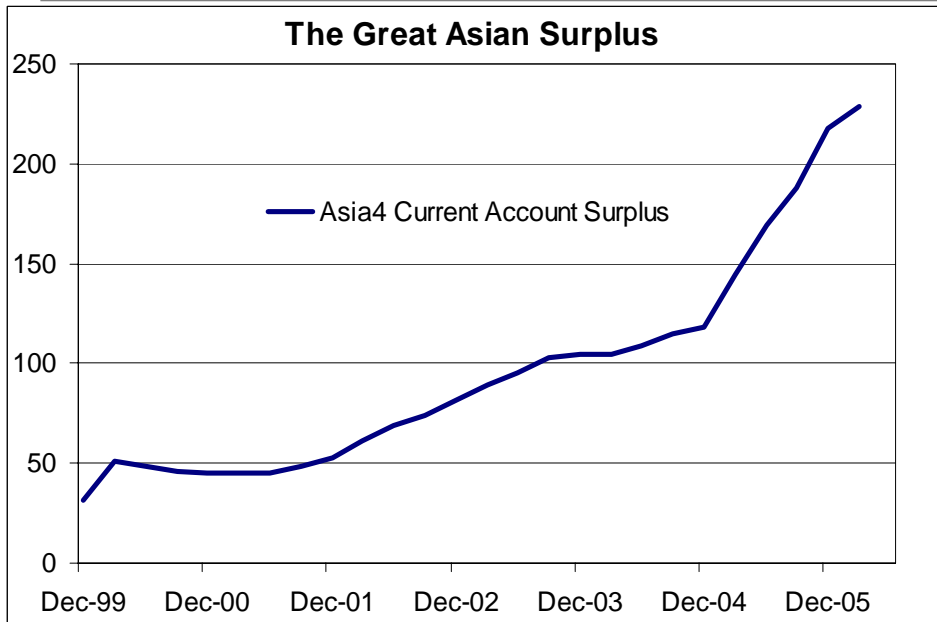


Source: ECB; Bloomberg; BoA forecasts

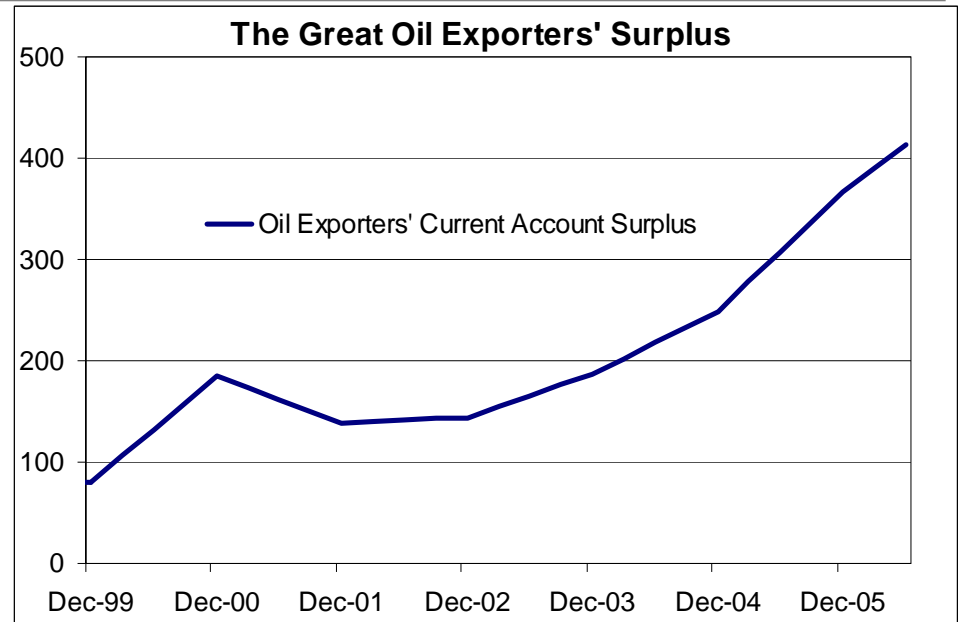
As inflationary pressures ease while the economy rebounds in late 2007 from its current soft patch, the Fed can return from “moderately restrictive” now to a more neutral 5% in late 2007.

Expect the ECB hike to 4.0% in June to be followed by a pause in 2H 2007. We look for two final adjustments to 4.5% in March and June 2008 in response to a less overvalued euro. This risks to the ECB call are on the upside.

Bond Yield Drivers: Global Savings Glut



China, Taiwan, Hong Kong, Singapore, 4-quarter rolling sum, in bn USD.
Source: Haver



Oil exporting countries, 4-quarter rolling sum, in bn USD. Source: IFS; Haver; own estimates for 1H 2006.

Despite strong growth in domestic investment, fast-growing Asia is supplying capital to the world. However, we expect Asian consumer demand to firm over time, reducing the external surpluses.

High oil prices re-distribute purchasing power from consumers with a low savings rate to oil producers with a high savings rate. This “forced saving” adds to the global demand for bonds. Stable or falling oil prices should lead to steeper yield curves.

Global Economic Forecasts

	PPP WEIGHT	USD WEIGHT	GDP % change			Unemployment (%)			CPI % change			Current Account % of GDP			Budget Balance % of GDP		
			2006	2007	2008	2006	2007	2008	2006	2007	2008	2006	2007	2008	2006	2007	2008
WORLD (USD)		100.00	3.9	3.3	3.5												
WORLD (PPP)	100.00		5.2	4.5	4.6												
THE AMERICAS	29.46	36.05	3.5	2.2	3.1												
United States	20.10	28.02	3.3	1.9	3.0	4.6	4.7	4.8	3.2	2.6	2.3	-6.5	-6.0	-5.6	-1.9	-1.1	-0.8
Canada	1.81	2.55	2.7	2.4	3.1	6.3	6.1	6.4	2.0	2.0	2.2	1.7	0.5	0.2	1.0	0.5	0.7
Latin America	7.33	5.38	4.7	4.1	4.2												
Brazil	2.58	1.79	2.9	3.6	3.8	10.0	9.7	9.4	4.2	3.7	4.2	1.1	0.6	0.1	-3.6	-3.0	-2.5
Mexico	1.76	1.73	4.8	3.6	4.2	3.7	3.7	3.6	4.1	3.8	3.5	-0.2	-0.6	-1.1	0.2	0.0	0.0
Argentina	0.87	0.41	8.3	7.1	4.7	10.4	9.7	9.0	10.9	11.1	11.4	3.5	2.0	1.2	4.0	3.0	2.3
Chile	0.32	0.26	4.4	5.3	4.9	8.2	7.8	7.4	3.4	2.5	3.0	3.9	3.2	1.0	7.6	5.8	4.3
EUROPE	26.65	35.35	3.3	3.0	2.9												
Eurozone	14.78	22.40	2.8	2.5	2.5	7.9	7.0	6.6	2.2	1.8	1.8	-0.2	-0.1	-0.1	-1.6	-0.9	-0.6
Germany	4.13	6.28	2.9	2.6	2.5	8.3	6.8	6.2	1.7	1.7	1.2				-1.7	-0.4	0.2
France	3.00	4.78	2.1	2.3	2.3	9.0	8.4	8.2	1.9	1.5	1.9				-2.5	-2.6	-2.3
Italy	2.73	3.97	1.9	1.8	1.8	6.8	6.3	6.1	2.2	1.9	1.7				-4.4	-2.8	-2.6
Other Western Europe	4.48	7.93	3.1	2.8	2.6												
United Kingdom	3.00	5.02	2.8	2.8	2.5	5.4	5.4	5.2	2.3	2.3	2.0	-3.4	-2.1	-1.8	-2.6	-2.4	-2.3
Switzerland	0.39	0.83	2.7	2.2	2.4	3.3	2.9	2.7	1.1	0.3	1.4	17.2	16.5	16.0	0.3	0.5	0.7
Sweden	0.44	0.81	4.7	3.7	3.5	5.3	4.6	4.3	1.4	1.7	2.1	7.4	6.6	6.1	0.5	0.5	0.5
Norway	0.32	0.67	4.6	3.7	2.4	2.6	2.7	3.5	2.3	1.4	2.3	19.6	20.1	15.9	6.0	6.0	6.0
Other Europe	7.09	5.01	6.0	5.4	5.4												
Russia	2.58	1.72	6.5	6.0	5.6	6.9	6.6	6.1	9.7	8.2	7.9	8.5	4.0	2.5	6.3	3.5	2.0
Turkey	0.93	0.82	5.6	4.8	5.5	9.9	9.5	8.6	9.6	7.9	5.4	-7.9	-6.3	-6.0	-0.6	-1.2	-1.5
Poland	0.81	0.68	5.6	5.0	4.5	14.9	14.7	14.3	1.3	2.1	2.8	-2.0	-2.3	-2.7	-3.2	-4.0	-4.5
Czech Republic	0.31	0.28	6.4	5.4	5.2	7.7	7.9	8.0	2.6	2.1	2.6	-4.5	-4.2	-3.6	-3.5	-4.1	-4.4
Hungary	0.28	0.25	3.9	2.6	3.8	7.5	8.4	8.1	4.0	7.2	4.3	-7.5	-6.4	-6.2	-9.5	-7.5	-6.2
ASIA & PACIFIC	37.92	24.29	5.1	4.8	4.6												
Japan	6.41	10.27	2.2	2.4	2.0	4.1	3.9	3.7	0.1	0.0	0.5	3.9	4.7	4.7	-4.9	-4.3	-4.1
China	15.41	5.03	10.5	9.5	9.0	n.a.	n.a.	n.a.	1.4	2.5	3.5	8.5	8.5	9.0	-1.3	-1.3	-1.3
Other Asia	14.43	7.13	6.1	5.6	5.6												
Oceania	1.24	1.86	2.5	3.0	2.9												
Australia	1.03	1.59	2.7	3.4	3.7	4.9	4.6	4.7	3.5	2.2	3.0	-5.4	-5.4	-4.4	2.5	2.0	1.5
New Zealand	0.17	0.24	1.7	3.3	2.3	3.8	3.7	4.1	3.4	2.4	2.5	-9.0	-8.5	-7.6	3.5	2.0	2.0
AFRICA / MID EAST	6.33	4.34	4.7	5.2	4.8												

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