

EUR - USD

Currency analysis

13 January 2010

Economic forecasts

	2008	2009e	2010f	2011f
GDP, % yoy	0.4	-2.5	2.5	1.5
CPI, % yoy	3.8	-0.5	1.5	1.2
Core inflation, % yoy	2.3	1.7	0.7	0.8
Unemployment rate	5.8	9.5	10.2	9.6
Employment growth, % yoy	-0.4	-3.7	0.0	0.6
Current account*	-4.9	-3.0	-2.5	-3.5
Ø EUR/USD	1.47	1.40	1.44	1.40

* in % of GDP

Source: Thomson Reuters, Raiffeisen RESEARCH

US forecasts

	current	Mar-10	Jun-10	Dec-10
EUR/USD	1.445	1.45	1.50	1.37
USD Fed Funds	0.1%	0.1%	0.1%	0.5%
USD 3M LIBOR	0.3%	0.3%	0.3%	0.8%
USD 10y yield	3.85%	3.5%	3.5%	4.1%

* in % of GDP

Source: Thomson Reuters, Raiffeisen RESEARCH

Technical analysis

Initially, the rate should remain in a range between 1.4230 to 1.4620. If EUR/USD drops below the 200-day average (currently: 1.4230), then a further decline to 1.3750 may occur.

USD per EUR



Source: Thomson Reuters, Raiffeisen RESEARCH

Analyst

Valentin Hofstätter, CFA

valentin.hofstaetter@raiffeisenresearch.at

Technical analysis

Klemens Hrovath, CEFA

klemens.hrovath@raiffeisenresearch.at

Highlights

- As forecast for quite some time, EUR/USD hit a **new high for the year in Q4 2009**, at (just over) **1.50**.
- With the **strong downward correction in December 2009**, however, there are good chances that the appreciation trend seen since March 2009 has mostly come to an end.
- **Over a 12-month horizon**, we still expect **USD strengthening versus EUR**, mainly due to US interest rate hikes towards end-2010. With these hikes, EUR/USD 1.35 may easily come into range.
- In light of the sharp correction in December (and the corresponding lower starting levels), new highs for EUR/USD in H1 2010 are unrealistic, in contrast to our original forecast. Consequently, we significantly lowered our 2010 forecasts for EUR/USD several weeks ago (cf. our publications Focus FX and Weekly Market Outlook).
- Over the **short term**, there continues to be a considerable **risk that the downward correction in Q1 will test the 1.40 mark**, because the market's interest rate expectations may temporarily increase in the months ahead.
- Nevertheless, we feel that **these aggressive expectations of US rate increases will finally prove to be premature** (cf. our publication on the outlook for US interest rates from 11 January), and that **EUR/USD will climb back to around 1.50 again by mid-2010, as the market prices out early US rate hikes**.
- With this in mind, we do not issue any short-term recommendation at the current level (over the short run, the upside and downside risks appear balanced), but we would subsequently view any renewed declines in EUR/USD towards 1.40 as a good opportunity for buying with an eye to mid-2010.

Introduction

As forecast for quite some time, EUR/USD hit a new high for the year in Q4 2009, at (just over) 1.50.

Nevertheless, after the strong downward correction in December 2009 – which was stronger than we presumed in our weekly publication in early December – it appears highly likely that the appreciation trend seen since March 2009 has mostly come to an end.

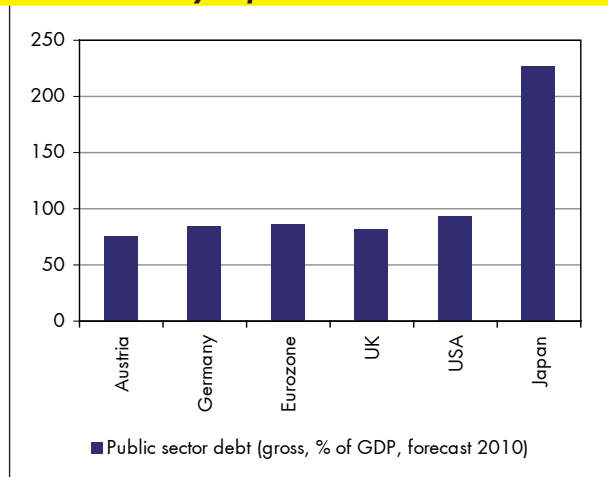
While we expect that EUR/USD will test 1.50 by mid-2010 again, after the sharp correction in December (and the corresponding lower starting levels), new highs for EUR/USD in H1 2010 will not be possible, in contrast to our original forecast. Consequently, we significantly lowered our EUR/USD prognosis for 2010 several weeks ago.

Looking at the **big picture**, in our view **EUR/USD is forming a peak** (and conversely, USD is bottoming out), with this process expected to continue for some time in 2010. The sharp rebound in USD in recent weeks is a good example of why we were not and are not willing to believe that the weakness of the US dollar would continue indefinitely (let alone expecting a total collapse of the dollar).

No collapse for USD in the foreseeable future

Granted, the USA is struggling with numerous, very serious problems, which are well known. But the old traditional, liquid currencies – which are also used to a notable extent as FX reserves (EUR, JPY, GBP) – are also not in much better shape, and in certain respects (e.g. public debt or growth prospects) are actually even in worse positions.

Debt: Not only a problem in the USA

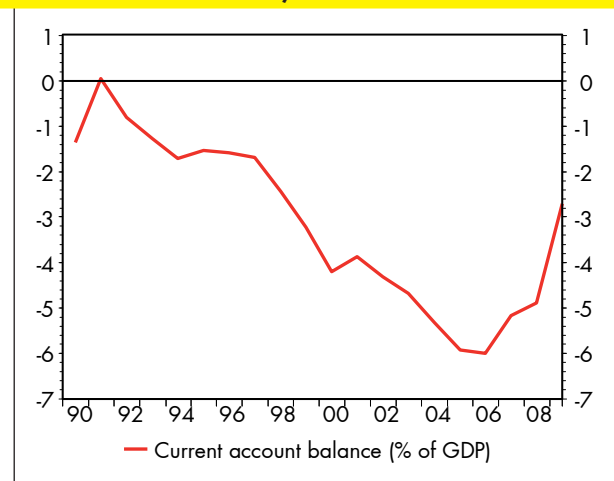


Source: Thomson Reuters, Raiffeisen RESEARCH

Although **USD's role as a leading currency is waning** and its share in international reserves has been falling for many years, as long as important countries such as China wish to prevent a significant appreciation of their own currencies versus the dollar (based on foreign trade considerations), they will have to keep buying USD, which is exactly what has happened in recent quarters and months. As a result, **the Damocles sword of major USD selling by foreign central banks will** continue to hang over the US currency in 2010, but it does **not** appear very likely that this sword will **come plunging down**, neither in 2010 nor in 2011.

Even the **US current account deficit**, which has been a constant thorn in the side of USD, has **improved significantly** during the recession (as well as due to the massive depreciation of USD in recent years).

2009 sees lowest C/A deficit since 1998



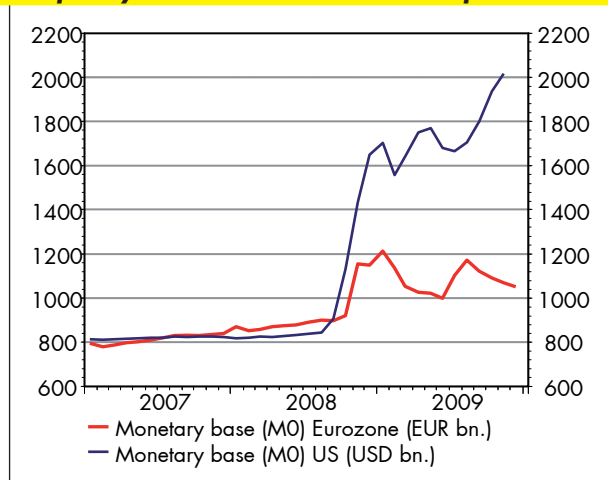
Source: Thomson Reuters, Raiffeisen RESEARCH

Although the C/A deficit is likely to rise again in line with a revival in US economic activity (stronger US growth = stronger US imports), the worst is appear to be past, as it is set to reach 2.9% of GDP in 2010 (after 2.7% in 2009, but down from a peak of 6% in 2006). The recipe for reducing the USA's trade imbalances has been clear for quite a long time: lower-than-average growth in US consumption (= weaker imports) and higher savings by households in order to consolidate their debt situation (along with a weaker USD), in conjunction with continued very strong growth in the Emerging Markets. Now this scenario is beginning to play out (at least in part).

As a result, the **main problem for USD is the USA's significantly more inflationary monetary policy** compared to the euro area, along with the risk and worries in the market that the US central bank may allow for more inflation and indeed may even wish to provoke inflation.

This serious problem was also one of the main reasons why we had projected significant depreciation of USD versus EUR (as well) in 2009.¹ This issue continues to be acute.

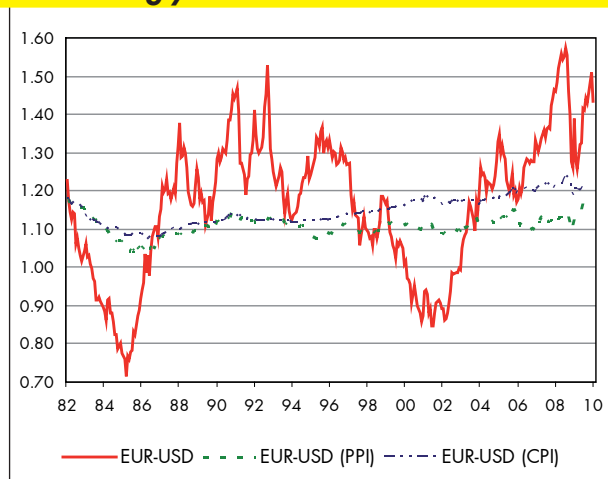
US policy remains much more expansive



Source: Thomson Reuters, Raiffeisen RESEARCH

On the other hand, market participants are well aware of this problem and hence this aspect has been priced in (or at least it was priced in at a rate of EUR/USD 1.50), as it was one of the main factors that drove the depreciation of the US currency to 1.50 in 2009.

USD strongly undervalued



Source: Thomson Reuters, Raiffeisen RESEARCH

At this level, the US dollar was already strongly undervalued versus EUR, as is reflected by purchasing power parity:

Even at the current exchange rate of EUR/USD 1.44, the dollar is still significantly undervalued looking at the development of prices in the USA and the euro

¹ The other important reason was depreciation pressure on USD from carry trades and the general rise in risk appetite on the international financial markets.

area (i.e. the concept of purchasing power parity). As the chart above shows, a fundamentally "fair" value for EUR/USD would currently be around 1.20 (with minor differences depending on whether the CPI or the PPI is taken as a basis for measuring inflation).

Nevertheless, over a period of 6 or 12 months this is not a reason for appreciation of USD, and, in its own right, this will not be able to prevent the dollar from temporarily weakening even more, if other stronger factors push the dollar towards depreciation. At any rate, however, it is one of the reasons that USD is not expected to weaken even more over a long-term horizon (> 12 months), as soon as US monetary policy normalises somewhat.

US monetary policy outlook is the decisive factor

In our view, the decisive factor for EUR/USD is and will continue to be how monetary policy proceeds in the USA compared to the euro area.

In the euro area, the ECB has already presented a fairly clear outline of its intentions, and there are little grounds for concern that the ECB may risk too much inflation.

ECB monetary policy in 2010*

The **ECB's measures to wind up its expansive policies** are already known with a considerable degree of detail. Initially, the ECB will **shorten the maturities of its credits** to commercial banks. Accordingly, in Q2 2010 only credits with the previously usual maturity of one week (= main refinancing operation) and three months (= long-term refinancing operation) will be available. Sooner or later, most of the outstanding volume should be issued via the main refinancing operation again. Recently, this operation only accounted for less than 10% of the total volume.

Since the onset of the financial crisis, the ECB has expanded its lending to commercial banks by around EUR 450 bn, with the outstanding volume rising to EUR 720 bn recently. Through to the end of Q1 2010, the ECB will ensure full allocation in its monetary policy operations, and hence there will be no active measures to **withdraw liquidity**. In our opinion, in the second half of 2010, the central bank will once again take the reins and begin to steer liquidity, ending its full allocation and moving away from fixed rates to return to the normal tender system. We expect to see this occur with the main refinancing operation in H1 and with the long-term refinancing operation as early as in the course of Q2.

In our view, **increases in interest rates** will be the **last step in the process of exiting the enhanced credit measures**. It will probably take until Q4 2010 before the central bank begins to adjust its key interest rates higher, away from the crisis levels. We expect to see the key rate raised by 50 basis points.

* For more on the ECB's monetary policy, please refer to our Eurozone Interest Rate Outlook published on 4 December and our quarterly "Global Strategy" publication.

Accordingly, the decisive factor and the greatest source of uncertainty for EUR/USD will likely be **US monetary policy**.

In the event that the USA decides to pursue an inflationary policy² in 2010 and the following years (and this is a scenario which many people fear may play out), the weakness of the US dollar seen in recent years would continue with a vengeance. As the ECB would not follow the lead of the USA in this regard, new all-time highs above EUR/USD 1.60 would be inevitable (generating grave problems for euro area exports and GDP growth). This is the main risk to our long-term EUR/USD forecast.

On the other hand, if the US central bank (also) begins to wind up its extremely expansive monetary policy in a timely manner and then also moves to raise interest rates, it will thus demonstrate that it actually takes its mandate of ensuing price stability seriously, and this will support USD.

But because there is currently no pressing need to adopt such a restrictive monetary policy, opinions will continue to differ on this point. In the end, it is thus a matter of faith as to whether the US central bank will actually move to tighten its monetary policy in the future, as it has announced.

² Specifically: the ongoing extremely strong growth in monetary aggregates and low interest rates, even during a period when strong credit and economic growth would also necessitate a more restrictive monetary policy. I.e. intentionally failing to react to a sharp increase in inflationary pressure. Higher inflation rates would be the result. The market, on the other hand, would almost certainly not wait for these uncomfortably high rates of inflation to materialise and would discount the outcome of this kind of policy approach.

US Fed's Exit Strategy *

Similar to the ECB, the Fed has also announced the first steps in exiting its extremely expansive monetary policy. The most important measures to avert the crisis and an overview of the current status of these measures is presented in the table below.

Measures by the Fed

Measures by the Fed	Current status
■ USD 300 bn for purchases of US government bonds	Completed in Oct 2009
■ Extension of the maximum availability of funds via the discount window from 1 to 90 days	Reduction of the max. availability period to 28 days from 14 Jan 2010
■ Various programmes for providing central bank funds against collateral (TSLF, PDCF, AMLF, CPFF)	Measures to be ended on 1 Feb 2010
■ Foreign currency swaps with other central banks	Measure to be ended on 1 Feb 2010
■ Programme for the provision of central bank money for commercial banks with good credit ratings against collateral (TAF)	Measure to be ended in spring 2010
■ Another USD 175 bn for purchases of bonds from quasi-government mortgage financing companies (e.g. Fannie Mae, Freddie Mac)	Status as of Nov 2009: USD 142 bn
■ USD 1,250 bn for purchases of MBS (mortgage-backed securities)	Status as of Nov 2009: USD 774 bn, runs out at the end of March
■ USD 1,000 bn in lines of refinancing for private purchasers of ABS (asset-backed securities) in the fields of automobile loans, credit card debts, etc. (TALF)	Measures come to an end on 31 Mar and 30 Jun 2010
■ Reduction of the difference between the discount rate and the key rate from 100bp to 25bp	Prognosis: increase towards the old difference sometime during 2010
■ Rate cut in December 2008 to a record-setting low – corridor of 0.0 to 0.25%	Prognosis: First rate increase towards end-2010

* For more information on the US Fed's monetary policy, please refer to our publication *US Economic and Interest Rate Outlook* published on 29 December and our quarterly "Global Strategy" publication.

While we do expect that compared to the ECB the US central bank will not be so strict about price stability in the future, it will also not pursue an explicitly inflationary policy. Growth in the volume of US central bank money should taper off in 2010, practically all of the liquidity measures taken because of the crisis will run out as announced, and interest rates will be raised in due time, as soon as the economic recovery has stabilised (particularly on the labour market).

If, as we expect, the US central bank raises interest rates after the end of 2010, this should counter worries about the bank pursuing an inflationary policy

and help support the US dollar. This scenario forms the basis for our EUR/USD forecast.

EUR/USD to remain very volatile over the short and medium term

Until then, however, some time will pass and over the next twelve months the market's expectations about US interest rates, which are a very critical factor for EUR/USD, should fluctuate intensely, resulting in (more) extreme swings in the EUR/USD exchange rate.³

One very good example of this was the sharp downward correction seen in the first half of December, as the low point in this movement of 1.422 on 22 December was significantly below our correction target of 1.44/45 from our publication on 7 December. Originally, this move started out as USD strengthening (in reaction to the much better US labour market data from 4 December, the market began to speculate about a quicker return to rate hikes in the USA), but this was then followed by a healthy dose of EUR weakening as well. This in turn was triggered by the market jitters about the Greek budget and the related rating downgrades.

Our outlook: the bleak budget prospects for some euro-area members (not just Greece) and more downgrades will continue in the quarters to come. Hence, the euro will not enjoy any support on this account. Nonetheless, it is highly unlikely that any defaults on payments will occur in the years ahead, and thus the market's panic towards year-end consequently seems a bit exaggerated to us.⁴

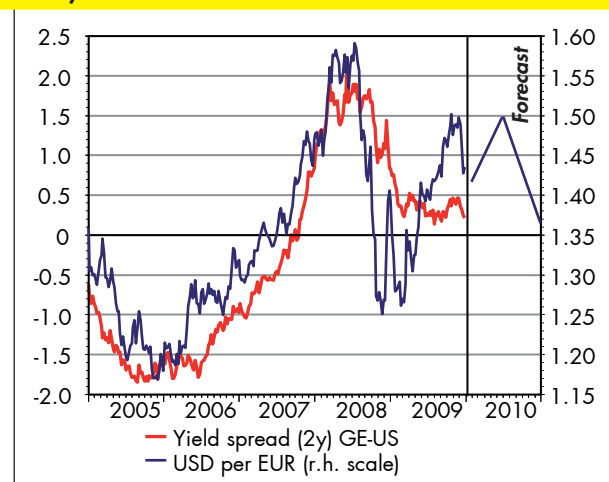
In our opinion, the abovementioned development of the market's US rate expectations will prove to be a more important factor for the evolution of EUR/USD. Right now, the rate market is pricing in the first increase in US interest rates for August 2010. It is possible that US interest rate expectations will rise somewhat more in Q1 2010 and that EUR/USD may come under some temporary pressure, due to the foreseeable improvement in the US labour market (including significant job creation as early as Q1) in the months to come and the temporary rise in US inflation towards 3% due to the base effect.

After the major drop in December, EUR/USD started into a countermove shortly before Christmas, and this has left the rate ranging between 1.42 and 1.44 since. It would quite realistic for this brief recovery to continue to around 1.46. Nevertheless, following any such movement, EUR/USD will be vulnerable to a setback again. Expectations of rising US interest rates would maintain substantial depreciation pressure on EUR/USD in Q1 2010. Consequently, **EUR/USD could easily still test 1.40 in the first quarter.**⁵

In light of the strong correction in December (and the ensuing lower starting levels), new highs of around 1.55 for EUR/USD in H1 2010 (in line with the original forecast) will thus no longer be within reach, and accordingly we substantially lowered our EUR/USD forecasts for 2010 several weeks again (cf. our publications "Focus FX" and "Weekly Market Outlook").

Nevertheless, we feel that these **aggressive expectations of US rate increases will finally prove to be premature** (cf. our publication on US interest rate prospects from 30 December), and that **EUR/USD will climb back to around 1.50 again by mid-2010, as the market prices out US rate hikes.** With this in mind, we do not issue any short-term recommendation at the current level (over the short run, the upside and downside risks appear balanced), but we would subsequently view any renewed declines in EUR/USD towards 1.40 as a good opportunity for buying with an eye to mid-2010.

EUR/USD forecast



Source: Thomson Reuters, Raiffeisen RESEARCH

³ In the last six months alone – a period falling after the end of the worst part of the financial crisis – the range of fluctuation for EUR/USD was 1.38 to (almost) 1.52. The coming six months will likely be marked by a development which is equally as volatile.

⁴ For more details on our assessment of Greece, please refer to our special publication on that country dated 11 December.

⁵ Over the short term, a correction on the equity market (which is what we expect to transpire in H1 2010) would probably result in a temporary appreciation of USD (as carry trades are wound up), in a pattern that has been seen for more than a year now. This impact, however, would not be lasting, and as we still can ascertain the exact timing of this kind of setback on the equity market, we have opted not to take this factor into consideration in formulating our quarterly forecasts.

In the end, it is **only a matter of time before interest rates are raised in the USA**, as was discussed above. We continue to hold the opinion that **USD will rebound strongly when rates are raised in the USA** (hikes will also make it clear that the US central bank is not interested in pursuing a reckless inflationary policy). The developments seen in recent weeks (once again) underline just how intensely USD reacts to changes in expectations about interest rates. We believe that the upward cycle in US interest rates will begin towards the end of 2010, and accordingly for this period we anticipate (as we did in the past as well) a sharp decline in the EUR/USD rate (appreciation of USD). Depending on how quickly rates are raised, this move could easily go well lower than 1.40. With these rate hikes, EUR/USD 1.35 may come into range.

Note: A brief, up-to-date report on the USD and key developments affecting this currency can also be found in our publication "Weekly Market Outlook" (released every Friday) and in our weekly currency overview "Focus FX" (released every Tuesday), as well as in reports published on an ad-hoc basis. Your Raiffeisen customer service representative will be more than happy to provide you with these publications if you wish.

Appendix

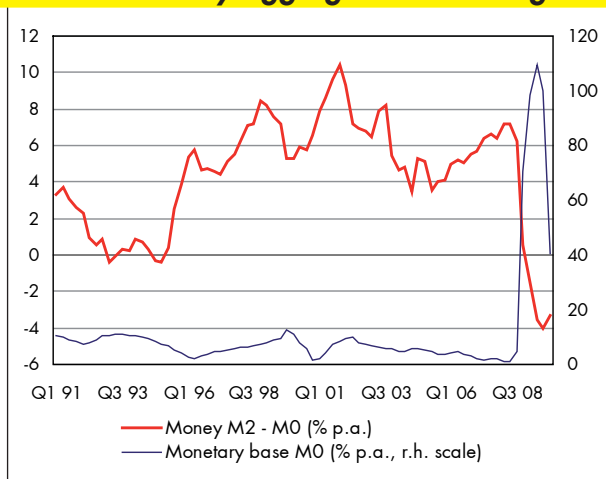
US monetary policy

No hyperinflation for the USA

In our opinion, the large-scale increase in central bank money supply does not entail inflationary risks, and will not in 2010 and 2011 either (yet).

Although the amount of central bank money (M0) provided to the financial system by the Fed is currently still rising at around 40% yoy,¹ the rate of growth has fallen by more than one-half from its peak level. The pace of growth for the M0 monetary aggregate will continue to taper off in the months to come as well. For example, the US central bank has now completed about two-thirds of its planned bond purchases. The purchases of US government bonds for over USD 300 bn were finished in October. Acquisition of government-guaranteed bonds from the real estate financing companies Freddie Mac and Fannie Mae and mortgage-backed securities from these institutions should be finished in the first quarter of 2010. Presently, USD 500 bn is still available for such purchases. After this, growth in central bank money supply should settle in at just over 0%. It is also possible that the growth rate will be negative at times.

Broad monetary aggregate contracting



Source: Thomson Reuters, Raiffeisen RESEARCH

The strong expansion in the volume of central bank money has not yet had any impact on the broader money supply available to the economy (M2): while a superficial look would indicate that the Fed is achieving some success here already (M2 is currently growing at a rate of just over 4% yoy), a closer

inspection reveals that this is only the effect of the strong growth in central bank money. If one subtracts this M0 aggregate from the broader monetary aggregate M2, it is clear that the remaining money supply in the broader economy is actually declining right now! For the period from October to December, this decline will likely amount to over 3% yoy. The currently diametrically opposed developments in central bank money supply and the broader monetary aggregate can be explained with the process of money creation: as a first step, the central bank provides commercial banks with central bank money.² But most of the growth in broader monetary aggregates (M2, M3) occurs via the process of credit creation within the financial system, and the central bank has no direct influence over this, as it can only directly influence the level of interest rates and the minimum reserve regulations.

If this **credit creation process is dysfunctional** (as is currently the case in most of the industrialised countries and was the case in Japan in the 1990s), lending begins to decline (stagnation or contraction in credit aggregates, deleveraging) and the broader monetary aggregates also begin to shrink. This is precisely what is happening right now in the USA (and in the euro area as well). It is also exactly the same reason that the economy and money supply growth in Japan stagnated for more than a decade in the 1990s, as the volume of lending steadily declined and the country was sucked into a deflationary spiral, despite massive growth in the amount of central bank money and interest rates at zero. It was due to this frightening example that the USA moved as quickly as possible to recapitalise the banking system (so that the process of credit creation can get underway again), and why the central bank is trying to arrest the decline in the broader monetary aggregates by pumping in enormous amounts of central bank money.³ Because for a central bank the most dangerous scenario is clearly when the economy slips into a deflationary spiral, as the central bank has almost no way of responding. Central banks essentially have no tools which are suitable for combating deflation. Accordingly, in line with the approach taken by the US Fed, central banks generally attempt to ward off deflationary tendencies by providing even more central bank money, in order to avoid suffering the same fate that befell Japan.

¹ This strong increase is the direct result of purchases of securities by the central bank and the generous lending by the Fed to the commercial banks, which are both factors that boost the supply of central bank money (M0) to the financial system.

² Usually in the form of short-term lines of credit and collateralised credits, but also by the central bank purchasing securities, e.g. government bonds.
³ A deflationary spiral similar to that seen in Japan is also still very unlikely in the USA because the USA reacted much more rapidly and aggressively to address the problems compared with Japan back then.

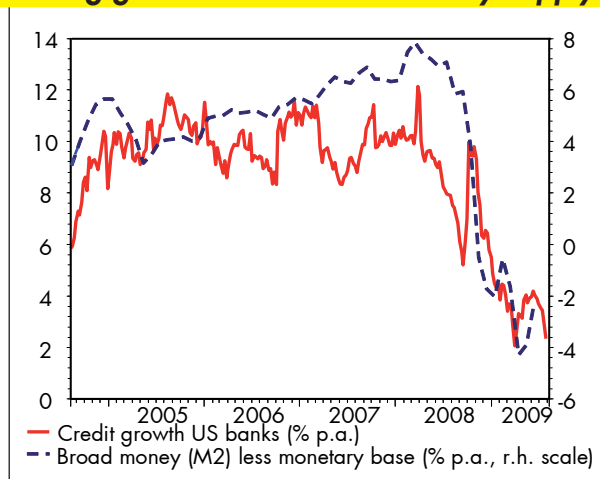
Compared to deflation, the Fed views the resulting inflationary risks in the coming years as minor. Right now, however, the central bank's measures are only compensating for the decline in liquidity in the financial system, which stems from deleveraging (due to deleveraging, liquidity is effectively "annihilated" and money supply is reduced). Furthermore, the central bank cannot force banks to lend by giving them more central bank money: if the banks have too little equity capital (write-downs!) for new lending, or if there is a lack of demand for new loans despite interest rates being at zero (recession!), this **money remains "stuck" in the banking system**, i.e. commercial banks either deposit it with the central bank or hoard it in other forms as a liquidity reserve (e.g. government bonds). As a result, this money never reaches the real economy.

The US central bank will only start to risk inflation **as soon as the financial system has stabilised**, the economy is humming and credit begins to flow again: then **central banks will have to act in a timely manner to reduce the generous supply of central bank money**, which is currently stuck in the banking system and is thus not having an inflationary impact, before this money seeps into the broader economy and rapidly pushes inflation rates higher. But in view of the massive underutilisation of capacities in the overall economy it will be a long time before this is the case.

We share the market's concerns that the US central bank will move more slowly than the European Central Bank and, if in doubt, will prefer to err on the side of slightly more inflation than the ECB. It was precisely these concerns that weighed heavily on USD in 2009 and they were also the most important factor behind our aggressive EUR/USD forecast for 2009. But we do not believe that the US central bank will completely lose track of its inflation targets,⁴ and tolerate high inflation rates in the United States (e.g. over 5% yoy).

⁴ Essentially, the Fed is targeting core inflation of less than 2.0% yoy, even though – in contrast to the ECB – the Fed does not explicitly state this inflation target. In addition to this target, the Fed's also has goals related to higher employment and low long-term interest rates.

Fading growth in credit and money supply



Source: Thomson Reuters, Raiffeisen RESEARCH

From a **technical perspective**, it is **not a problem** to withdraw the measures and thus to siphon off the surplus liquidity, as US Fed chief Bernanke has often stressed.

Short-term credits to the banking system (which increase available money supply) are no longer renewed (or no longer needed by the banks taking out the credits) and then expire after a few weeks or months, which thus reduces money supply. In part, this phenomenon can already be observed in the USA. The reason? As the banking system stabilises and the situation on the interbank market improves, banks are no longer taking out as much credit with the Fed, old Fed credits are maturing and are only partially replaced, and hence the overall volume is shrinking. For some kinds of credit instruments, borrowing from the Fed has already fallen to zero.

The **securities purchased** by the Fed (mainly government bonds and mortgage bonds in the USA) **can be sold** on the financial markets again and thus also reduce the volume of central bank money. **In practice**, however, this can lead to problems, because with the sale of large volumes of these bonds⁵ the central bank risks triggering a strong increase in market yields on these instruments, with a negative impact on the economy. The central bank in the USA is quite aware of this. Consequently, it has recently been fairly clear in indicating that the sale of these securities will not be a central element in the central bank's exit strategy.

On the contrary, a large portion of these bonds will likely be **held to maturity** by the Fed (more than 10 years in the case of many mortgage bonds!). In order to lower the liquidity left in the market, other measures are planned, including repo transactions (short-term

⁵ Essentially, the US central bank is planning on buying up around 6% of the government bond market and 25% of the mortgage bond market.

sale of securities with an obligation to repurchase) and in particular an **increase in commercial banks' deposits with the central bank (via more attractive interest rates)**.

The idea behind this is that the Fed has increased the money supply (liquidity) available to the commercial banks (and thus available to the broader economy) by the purchase of these securities (the same occurs when the central bank extends a credit to a commercial bank). If, in a second step, the central bank is able to prompt commercial banks to deposit these liquid funds at the central bank, then these funds are withdrawn from the economy. The effect is equivalent to the central bank selling the securities, without the central bank having to part with these instruments.⁶

⁶ For fine tuning, the Fed naturally also has other instruments at its disposal, such as short-term (reverse) repo transactions.

EUR - USD

Acknowledgements

This report was completed on 13 January 2010
Cut-off for data: xx January 2010

Editor

Raiffeisen RESEARCH GmbH
A-1030 Vienna, Am Stadtpark 9
Tel: +43 1 717 07-1521

Head:

Peter Brezinschek (1517)

EEconomics, Fixed Income, FX:

Valentin Hofstätter (Head, 1685), Jörg Angelé (1687), Walter Demel (1526), Wolfgang Ernst (1500), Ingo Jungwirth (2139), Marcin Kopaczynski (1423), Julia Neudorfer (5842), Andreas Schwabe (1389), Gintaras Shlizhyus (1343), Gottfried Steindl (1523), Martin Stelzeneder (1614)

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Stocks:

Helge Rechberger (Head, 1533), Aaron Alber (1513), Christian Hinterwallner (1633), Jörn Lange (2169), Hannes Loacker (1885), Richard Malzer (5935), Johannes Mattner (1463), Christine Nowak (1625), Leopold Salcher (2176), Andreas Schiller (1358), Connie Schümann (2178), Magdalena Wasowicz (2169)

Quant Research/Emerging Markets:

Veronika Lammer (Head, 3741), Lydia Kranner (1609), Nina Kucic (1635), Christian Link (1355), Andreas Reschreiter (1683), Josef Wolfesberger (1529)

Technical analysis:

Klemens Hrovath (1421), Robert Schittler (1537)

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