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NCB CAPITAL MARKETS LIMITED

LOCAL ECONOMIC OUTLOOK 2010

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Living With the IMF: Outlook for 2010

Higher Unemployment in Major Economies Limited Flow Through of Recovery to Jamaica

Having been weakened by the financial crisis in 2008, the global economy began to see a turnaround in 2009. This turnaround started in the second half of 2009 as unprecedented fiscal and monetary stimuli resulted in some of the major economies returning to growth in H2. Growth in the emerging markets, particularly India and China, rose sharply. However, in the major developed markets the recovery occurred at a more measured pace as unemployment rose sharply and this limited the flow through of the recovery to Jamaica. Depressed bauxite production, lower remittances and tourism earnings resulted in softening hard currency flows and a significant revenue shortfall which led to a widening of the fiscal deficit. The hard currency situation was also exacerbated by tighter credit conditions globally which restricted credit to local financial institutions. Significant cost cuts on capital expenditure aimed at reigning in the deficit only served to exacerbate already weak economic conditions. It is within this context that government made the decision to return to a borrowing relationship with the International Monetary Fund (IMF).

Fiscal Deficit and Debt Burden was the Centerpiece of IMF Deal

Living with the IMF in 2010.....

With the fiscal deficit and huge public debt being the centerpiece of the IMF deal, conditionalities have focused on containing expenditure by reducing the size of the public sector, divestment of loss-making public sector entities and reducing debt servicing costs through restructuring of the country's domestic debt. In addition, there has been several tax packages aimed at boosting revenues and shrinking the gap between revenues and expenditure. Cost cutting measures employed in both the public and private sectors will mean employee retrenchment and as such, higher unemployment levels. Inflationary pressures are also expected to heighten, impacted by higher consumption taxes on fuel and rising oil prices. However, the slack in the economy could temper the increase in consumer prices. We anticipate increased pressures on the local currency as J$ interest rates fall significantly. However, with gross reserves bolstered by IMF funds, we expect timely BOJ intervention to cover the supply shortfalls and as such, assuming the passing of the quarterly IMF test, the local currency is expected to remain relatively stable against the USD. Monetary policy has been accommodative for most of 2009 and the Central Bank is expected to keep monetary policy loose throughout 2010. With lower interest rates a critical part of the government's macro economic program, monetary policy is expected to continue to play a critical role in keeping interest rates low to boost economic activity.

JDX Implemented to Save $42Bn in Interest Cost

The Debt Exchange

As part of the conditionality for an IMF agreement, the government implemented the Jamaica Debt Exchange (JDX) program aimed at lowering interest costs and extending the maturity profile of its outstanding debt. The program (which received a take up of 99.2%) affected approximately

J$700Bn of local debt and involves the government swapping outstanding high interest rate bonds for 24 new instruments with lower coupon rates and longer tenures. New J$ instruments will now yield an average 12% down from roughly 28% with US$ rates averaging 7% (down from 9% average). This is expected to result in some $42Bn in interest cost savings (ignoring the impact of losses in income from withholding tax as a consequence of lower interest rates). Variable rate instruments will also be re-priced based on monthly Treasury bonds instead of Treasury bills, implying that rates applicable to variable rate instruments will no longer be market determined. The JDX has effectively forcibly brought interest rates to record lows. The challenge will be maintaining interest rates at these artificial levels even as monetary authorities seek to maintain stability in the local currency. Achieving other targets outlined in the macroeconomic framework may also be at risk. That said, the benefits of lower interest rates could translate into increased economic activity. Economic growth (if any) could come later in the year at pace at or below 0.3%.

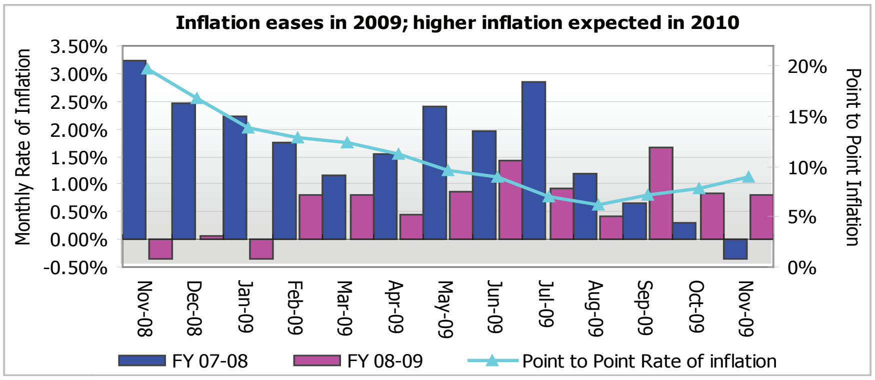
Medium Term Targets Aim for Positive Economic Growth, Single Digit Inflation and Fiscal Deficit in 2010/11

Medium Term Macro Economic Targets					
	2009/10	2010/11	2011/12	2012/13	2013/14
GDP	-3.50%	0.60%	1.90%	1.90%	2.00%
Inflation (Pt to Pt)	12.20%	7.30%	7.00%	6.50%	6.00%
Inflation (Annual)	9.00%	11.20%	7.10%	6.70%	6.30%
NIR (US$Mn)	1,378	1,078	1,325	1,450	1,761
Gross Reserves	2,051	2,151	2,598	2,640	2,579
Fiscal Balance	-10.0%	-6.50%	-4.3%	-2.6%	-0.7%
BOP (Current Ac/GDP)	-9.4%	-8.8%	-6.6%	-5.9%	-5.0%

Inflation

Weak Consumer Demand Tempered Inflationary Impulses in 2009

Weak consumer demand resulting from the downturn in the local economy, coupled with the decline in world commodity prices helped to moderate the pace of increase in consumer prices in the 2009 calendar year. The Consumer Price Index closed at 150.4 which represented a 10.2% increase over the prior year. This is significantly lower than the 16.9% reported over the comparative period in 2008 and in line with the lower end of our 10-12% projection made at the beginning of last year. Fiscal year-to-date inflation rate of 8.8% also came out below the 11.1% registered over the same period in 2008.



Taxes and Expected Resurgence in Commodity Prices Could Increase Inflationary Impulses in 2010

Throughout the calendar year the pace of increase in prices was driven mainly by increases in Alcoholic beverages and tobacco (+23.3%) as a result of the increases in the SCT on spirits and cigarettes by the Government during the 2009/10 fiscal year. In addition, the category of Housing, Water, Electricity, Gas and Other fuels increased 23% against the background of a rebound in global oil prices and the implementation of a Special Consumption tax on gasoline during the year. The moderation in the inflation rate also came against the background of a relatively inactive hurricane season which aided a rebound in the agricultural sector and helped to contain food price increases.

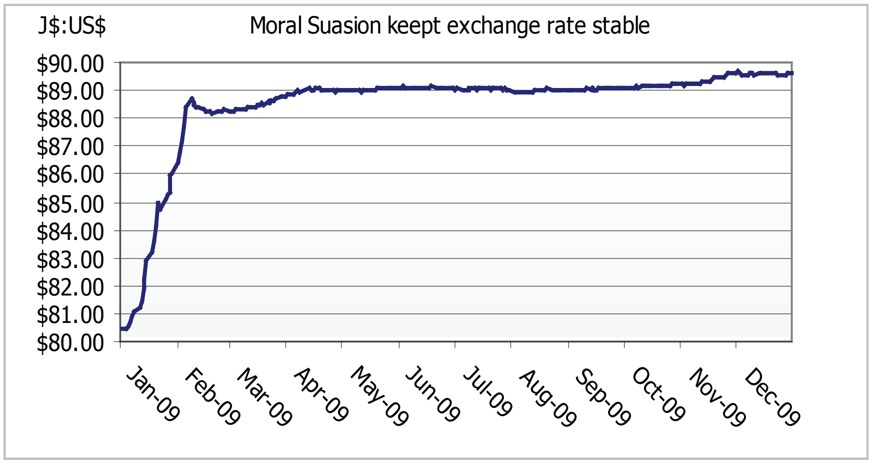
For 2010, our expectation is for higher inflation spurred by 1) recent tax measures by the Government and 2) continued increase in commodity prices on the international market. New taxes on electricity usage and higher taxes on cigarettes came into effect on January 1, 2010. Still, one of the main threats to a significant increase in the rate of inflation is the 15% Ad Valorem tax on fuel. This increase is likely to have spin-off effects on several sectors throughout the economy forcing firms to pass on higher costs to consumers. The situation could be exacerbated by higher oil prices on the international markets as global demand picks up. Expectations are that world oil prices could rise above US$100 per barrel over the next two years. Further, Transport costs could increase when plans to raise bus fares are implemented.

However, mounting job losses and the retrenchment in consumer spending could temper the pace of increase in consumer prices. Of note, there is the risk that adverse weather conditions could negatively impact the agricultural sector, triggering an increase in the prices of produce. Given the susceptibility of the agricultural sector to natural disasters, it will take a complete modernization of the sector to reduce this vulnerability and minimize these weather related external shocks. However, barring any external shock and any further tax increases, we expect inflation for the 2010 calendar year to fall between 12%-14%.

Moral suasion helped to maintain exchange rate stability for most of the year

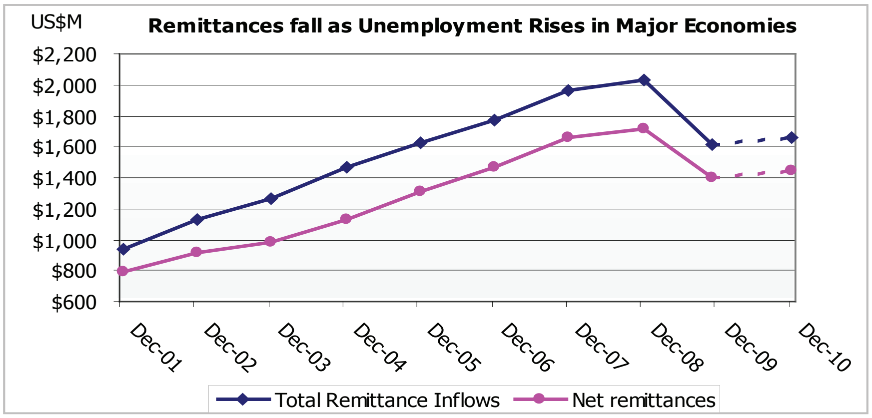
Foreign Exchange Market

The local currency lost 11.35% of its value relative to its major trading counterpart in 2009. Most of the depreciation in the Jamaican dollar occurred in the first quarter of 2009 (10.69%) as the monetary authorities used moral suasion and market intervention to help maintain currency stability for the remainder of the year.



US$ Supplies weakened by Downturn in Major Sources of Hard-Currency

The shortage of US$ supplies on the FX market continued to add to demand and supply imbalances. The country's main foreign exchange earners namely bauxite/alumina exports, remittance and tourism spend all fell sharply during the year as a result of the downturn in the major economies. In addition, the availability of credit to local financial institutions from overseas correspondent banks was severely curtailed against the background of the contraction in global credit. This also served to limit hard currency supplies. Data to December 2009 showed that remittances- an important hard currency earner for Jamaica, fell 11.4%. Although bauxite earnings could remain well below pre-crisis levels in the near to medium term, expectations for an improvement in the global job markets augurs well for some improvement in inflows to the foreign exchange market from remittances as well as the tourism sector in the latter part of the year.

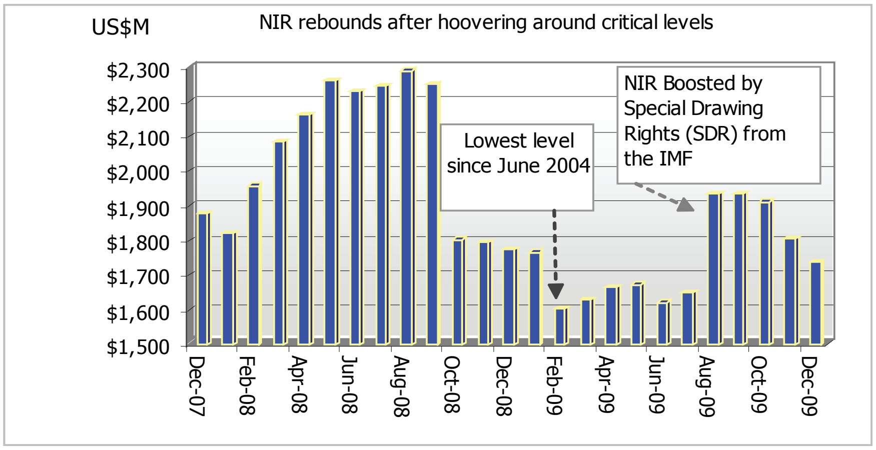


Exchange Rate Stability Poses Main Challenge to Low Interest Rate Regime

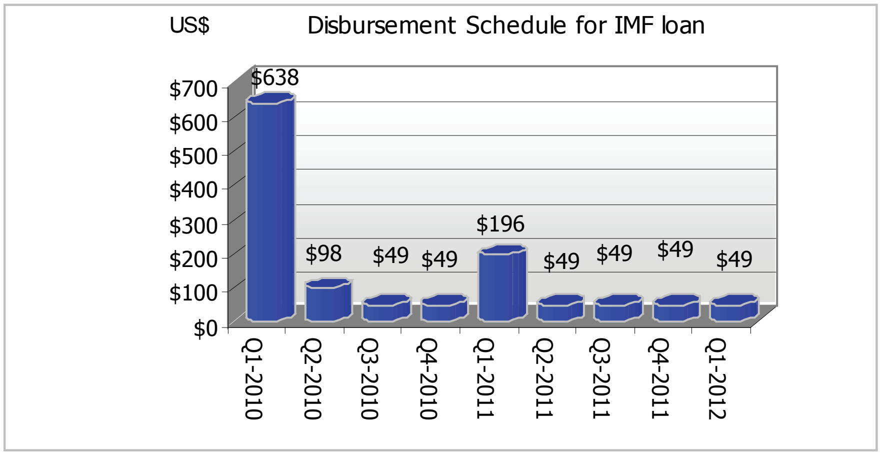
The real challenge for the government will be maintaining currency stability in the short term even with lower J$ interest rates. While US$ rates remain low, there is anticipation that the Fed will start to increase interest rates in

Inflows from Multi-National likely to Ease Pressures in FX Market

the latter part of 2010. This will in effect, reduce the interest rate differential between J$ and US$ assets and put pressure on the local currency. There seems to be heavy reliance on the psychological impact of the increase in gross reserves from the inflow of IMF funds to boost investor confidence and help temper the demand for hard currency. However, this psychological factor will have more of an impact on speculatory purchases rather than day to day demand for purchases of goods and services which currently exists. That said, with Jamaica receiving the first tranche of the IMF funds which is to be used as balance of payment support, pressures in the foreign exchange market could see some abatement. Further, the IMF agreement is expected to unlock some US$1.1Bn from other multi-lateral organizations which should help to alleviate US$ shortage in the short term. With gross reserves at US$2,390Mn, the BOJ has the ability to intervene in the market to shore up US$ supplies in the interim. Barring any exogenous shocks and or the impact of a double dip recession, we anticipate a more stable rate of depreciation in the local currency between 3-4% for the 2010 calendar year.



With the receipt of US$640Mn from the IMF, gross reserves in early February stood at US$2,390Mn or 16.9 weeks of imports.



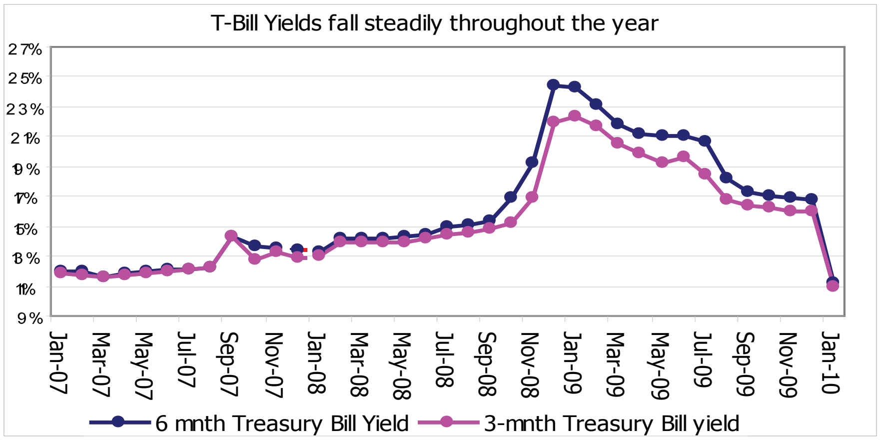
Current NIR supplies could see further improvement providing Jamaica meets the quarterly target outlined in the IMF agreement which will facilitate future disbursement of IMF funds. However, given that BOJ intervention seems to be the preferred tool to defend the local currency in light of lower interest rate regime, the possibility exists for a decline in NIR levels. The recovery in several of the country's key sectors that provide US$ inflows will be necessary for normalcy to return to the foreign exchange market.

Interest rates

2009 Saw Reversal of Interest Rate Policy Direction

Having used tight monetary policy tool to defend the local currency in late 2008, 2009 saw the Bank of Jamaica reversing this policy direction with a gradual reduction in domestic interest rates beginning in the second quarter. The Bank of Jamaica shaved off 133 basis points off its 365-day instrument. Following this, the Central Bank removed the 365-day instrument from the market in June and thereafter increased the pace at which it reduced its rates- with 6 downward adjustments amounting to a cumulative 650 basis points.

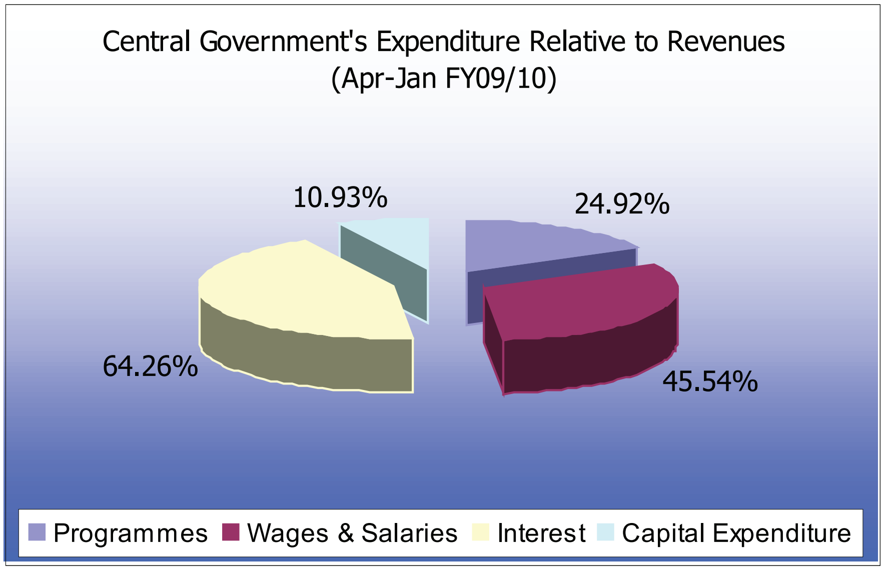
The market followed suit as the benchmark 6-month Treasury Bill fell 746 basis points from its peak in January 2009 to close the year at 16.80%. In a similar fashion, the 3-month Treasury bill yield closed 638 basis points lower to end the year at 15.95%.



JDX Reduced Interest Rates to Historical Lows

The JDX has reduced domestic interest rates to the historical lows of that existed prior to 2008. The government's ability to further reduce or keep interest rates at these levels will depend on the effectiveness of moral suasion as well as the significance of the psychological impact of the increased reserves in maintaining stability in the local currency. This stability could be threatened by the expected reduction in interest rate differential between US$ and J$ investments as the Fed announced intentions to increase US$ rates later this year. Going forward, the BOJ may be reluctant to use the interest rate tool to defend the local currency and as such, current conditions demand rates that will remain attractive to local investors. Inflationary pressures also need to be contained in order to avoid negative real returns that could result in investors demanding an inflation premium. The BOJ has temporarily removed tenors in excess of 30-days from its menu of open market instruments to "allow the market to establish a new yield curve in the post-JDX environment". Investors are expected to take the cue from monetary authorities. With further downward adjustments market rates could fall in the 9-12% range which was for the most part set by the JDX.

Fiscal



Government Attempts to Recoup lost Revenues Through Taxes Following Downturn in External Revenue Sources

In the context of high debt levels and spiraling debt servicing costs, controlling the fiscal deficit has become one of the central areas of focus for the government. The terms of the IMF agreement and pre-conditions have been centered on addressing this issue. The significant reduction in the country's external revenue from bauxite, tourism and remittances has led to the government attempting to recoup some of the lost revenues through several tax increases effected during the fiscal year. Still, the fiscal deficit to GDP ratio has already exceeded the initial target of 5.5% and is expected to end at 10%. This is significantly above the 6.8% recorded last year. Including the rounds of tax increases implemented earlier in the year which is expected to yield an annualized 3.0% of GDP, the government will also be looking to significantly reduce its expenditure through several measures. These include the restructuring of the domestic debt through which it projects savings of $42Bn in interest costs; the rationalization of the public sector and the freezing of public sector wages; and the divestment of non-core entities.

Higher Taxes May Not Yield Desired Increase in Revenues Due to Weakness in Local Economy

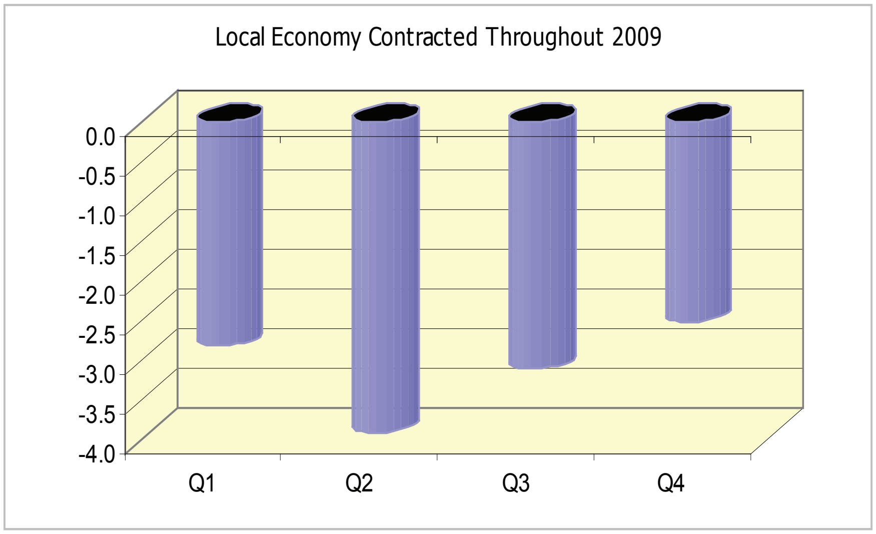
In the 2010/11 fiscal year the deficit target has been set at 6.5% under the macroeconomic programme outlined by the government. Meeting this target will be critical for passing IMF quarterly tests and for continued receipt of IMF funds. While anticipated expenditure cuts should go a far way in reducing the gap between revenues and expenditure, there is the risk that tax packages implemented in the 2009/10 fiscal year will not generate the anticipated revenues against the background of a still very weak domestic economy. While the debt exchange should see the government saving some $42Bn in interest costs, the government could see a sharp fall in PAYE revenues as companies retrench against the background of weaker demand and falling profits and the resultant impact that this will have on employment levels. The recent tax increases could also result in a greater than anticipated retrenchment in consumer spending and lead to a reduction in revenues from taxes on consumption. As such, meeting the 6.5% target for the 2010/11 fiscal year will prove to be another difficult one. That said, the positive outlook for the global market in the latter part of the year could result in a recovery in tourism and remittance revenues.

Ratings Agencies Upgrade Jamaica's Credit Ratings Post JDX

After downgrading the country's external ratings to 'SD', Standards and Poors outlined that the country's debt levels remain high at a projected 140% of GDP in 2010. S&P noted, however, that the interest savings as well as the IMF program should reduce the government's borrowing needs and help manage its fiscal consolidation program. As such, the country's sovereign credit rating was revised upwards to 'B-' on the successful completion of the debt exchange program.

Output

The outlook for global growth improved in late 2009 with the increasing pace of growth in several of the major economies. However, the recovery has largely been a jobless one, particularly in the US. As such the demand for Jamaica's major exports remain weak. The mining sector is yet to recover from the depressed aluminum prices. Tourism and remittance flows also remain weak, further undermining local consumer spending. Against this background the PIOJ estimated that the local economy contracted by 2.8%.



Local Economy Likely to Continue to Contract at Brisk Pace in Early 2010

It is likely that the domestic economy will continue to contract at a brisk pace in the early part of 2010 as job cuts across the public and private sectors should continue to keep domestic demand depressed. Under the IMF Standby Arrangement, the government will have to keep a tight lid on capital expenditure even as it seeks to reduce recurrent expenditure, pointing to the fact that very little government spending will be available to oil the economy. The GOJ debt restructuring exercise is expected to weigh down the finance and insurance segments; while the real estate sector could be adversely impacted by rising unemployment even in the face of lower interest rates.

Outlook to Improve in H2 Barring Adverse Shocks

In H2, the outlook is more positive, however, barring any adverse shocks from hurricanes or other natural disasters. Global unemployment is expected to decline as confidence in the recovery improves. Increased revenues from the tourism sector are also expected in addition to stability in remittance flows. Lower domestic interest rates are also likely to stimulate economic activity and boost demand in the productive sectors. With the possibility of a mild recovery in the latter part of 2010, economic growth is expected to be in the range of -1.0% to +0.3% for the calendar year.

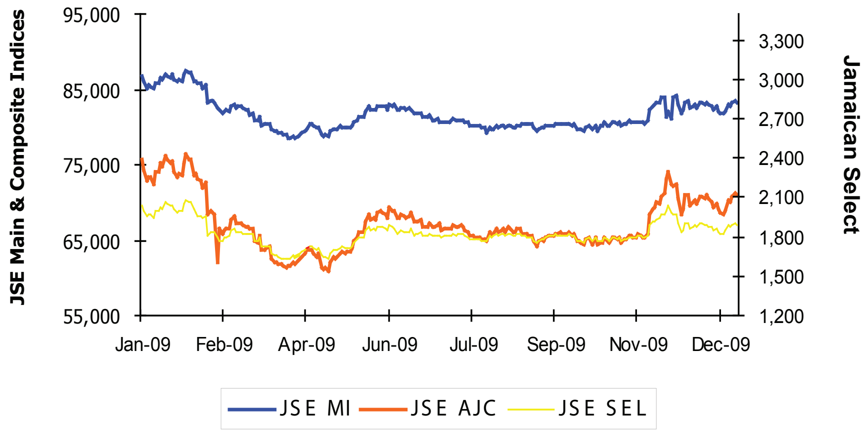
Projected Economic Growth Under Medium Term Macro-Economic Framework					
	2009/10	2010/11	2011/12	2012/13	2013/14
GDP	-3.50%	0.60%	1.90%	1.90%	2.00%

The targets outlined in the macroeconomic framework supports the view that economic growth could remain anemic in the short-term. Stronger growth of 1.9% in the FY2011/12 will depend on how quickly the economy can recover jobs lost in the current recession and eventually lead to increased consumer confidence and spending.

Stock Market

Local Stocks Closed 2009 on the Downside

For the most part, local equities ended the year down in 2009. Stock prices started the year on a downward slide as high interest rates on fixed income investments captured investor interests and led to a drop in stock prices. However, the market reached an inflection point in May as signals of lower interest rates became clearer. Against the backdrop of a more significant rate reduction by the Bank of Jamaica, stock prices appreciated at a faster pace. However, despite a good run in November, the indices were unable to catch up to their 2009 opening levels. The uncertainty relating to the then IMF negotiations and a signing deadline that was extended on several occasions resulted in rising risk aversion and negated much of the benefits of lower interest rates in the final quarter of the year. Local stock prices declined on average by 4.22% as measured by the All Jamaican Composite Index.



Lower Domestic Interest Rates and Investors' Response to Equities

Decline in Risk Appetite, Lower Liquidity Negate Impact of Lower Interest Rates

On the surface, interest rates at the current levels (of roughly 12% on average) should increase the attractiveness of local equities. Earlier, investor sentiment was seemingly negated by other events that occurred in the operating environment. Firstly, risk appetites might have been affected by the decline in asset prices in the wake of the financial crisis as well as the recent GOJ debt exchange exercise. For the latter, investors were asked to accept lower interest rate, longer dated instruments. This not only translates into lower interest income, but also derailed plans which may have been made for anticipated cash flows from these bonds. While adding to investor caution, the extension of maturities means that there will be less liquidity available in the short-term for investment in local equities. There is also the issue of the anticipated adverse impact that weaker consumer spending, higher taxes and the GOJ debt exchange, are likely to have on corporate earnings this year. However as the JDX draws to a close, liquidity levels are likely to improve and interest in the stock market could return.

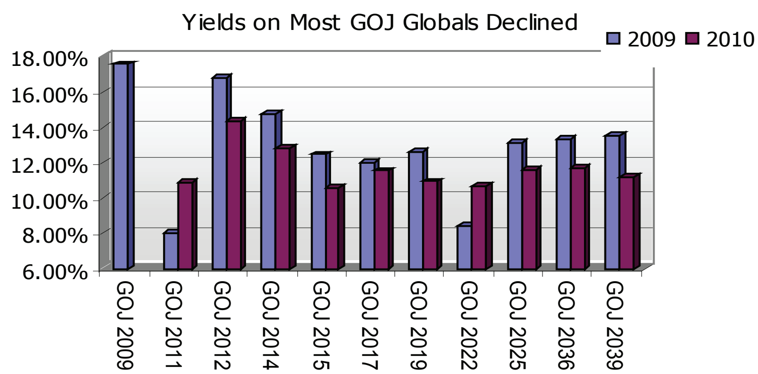
Corporate Profits Set to weaken in 2010

Corporate profits are set to weaken in 2010 given softening consumer spending, higher taxes and the GOJ debt exchange exercise. Financials should see their earnings slow in 2010 as banks and brokerage houses should see a significant decline in interest income due to the debt exchange program. The balance sheets of some companies are likely to come under pressure from the expected decline in fair value reserves as the interest rates on GOJ securities decline and the maturities are extended. Although BOJ is expected to administer the US$1Bn Financial Sector Support Fund (FSSF) to help institutions which experience difficulty due to their support of the exercise, there is the possibility of some consolidation within the sector. The Letter of Intent submitted to the IMF noted that companies which receive support from the fund will be subject to extensive supervision which may include the authorities taking temporary control of the institution, during which time-the rights of shareholders and management will be suspended. As it relates to the loan portfolios of banks, higher unemployment could mean further deterioration in loan quality. On a positive note however, lower interest rates could facilitate strong growth in their loan portfolios later in 2010. The JDX is expected to have a more severe impact on insurance companies. Lower interest rates will mean a significant jump in insurance and annuity liabilities even as investment incomes are drastically reduced. Efficiency will be the order of the day as companies seek to reduce operating costs in order to compete more effectively and remain profitable. Manufacturing companies and retailers should be adversely impacted by the higher taxes as well as the reduction in consumer spending but could also benefit from an anticipated improvement in consumer sentiment later in the year.

Lower Interest Rates, Increased Institutional Demand to Stimulate Equity Market Activity

We do not anticipate any significant improvement in corporate earnings until late 2010. However, the significant decline in interest rates on fixed income products could support price appreciation as investors look to the stock market for higher returns. In addition, the expected increase in unit trust product offerings could increase the demand for local stocks and result in an uptick in stock prices later in the year. That said, the expected decline in corporate earnings could result in volatility in some stock prices and temper the overall performance of local equities.

GOJ Global Bonds



GOJ Global Bond Prices Rose Despite Several Downgrades in 2009

After being severely impacted by the lack of liquidity in the earlier part of 2009, yields on GOJ Global Bonds began to trend downwards towards year end as demand increase and prices rose. Despite several downgrades from rating agencies, most bond issues registered price appreciation. The highest returns were realized at the longer end of the curve in the GOJ 2039's (+22.32%); GOJ 2036's (+18.33%) and GOJ 2025's (+14.29%). The only global bonds to register price declines were the GOJ 2022's and GOJ 2011's which fell 11.20% and 5.71%, respectively.

Yields on GOJ Globals Exceed Current Rates on J$ Instruments

Improvement in global risk appetite has meant improved confidence in risky assets. Having been excluded from the debt exchange program, the global bonds maintained their 'CCC/C' rating from S&P. The completion of the IMF deal has solidified investor confidence and has led to increased demand for GOJ global bonds as Jamaica's fiscal outlook improves. Further lower J$ interest rates means that GOJ bonds which are denominated in US$ have yields comparable with the interest rate currently being offered on J$ instruments. This has increased the demand for GOJ globals even as the supply of these bonds remains limited. Further improvement in bond prices will be driven by the reduction in the country's fiscal deficit and the success of the IMF program. The upgrade from the Ratings Agency upon the completion of the GOJ debt exchange could also support further uptick in GOJ global bond prices.

Conclusion

Living with the IMF and passing the quarterly test set out under the programme are likely to pose its own unique challenges in 2010. The Letter of Intent has outlined a number of targets which the government has set out to meet under its medium term macroeconomic programme. The objectives as well as the time frame in which the government has set out to achieve them will prove challenging. Failure to achieve the targets could result in the country being denied future tranches of critical IMF and other multi-lateral funding.

The government has outlined a medium term macro-economic framework which includes reducing inflation, maintaining a flexible exchange rate and continued efforts to reduce domestic interest rates. This puts the BOJ in a position of pursuing, what we believe, are competing objectives. Higher taxes and pass through effects are likely to cause inflation to rise particularly in the first quarter of 2010. The BOJ will need to keep inflation under control while attempting to bring interest rates down which will require it to keep monetary policy relatively loose. There is also the challenge of maintaining currency stability even as interest rates fall. We note that IMF funds should bolster the NIR and help support currency stability. Nevertheless, there is the need to meet these hurdles and ensure the success of the IMF program as failure of the program could have severe repercussions in the local economy. The risk of a second round of the global recession could intensify the country's challenges in meeting these targets.

We see some positives in 2010. We anticipate that measures implemented at the start of the year and stringent monitoring by the IMF will help to reduce the fiscal deficit in FY20010/11. Further, the expectation of higher global employment coupled with lower domestic interest rates could result in a bottoming of the economy in 2010. In addition, the lower interest rate environment as well as the anticipated increase in unit trust product offerings could help to stimulate stock market activity and result in increased returns for equity investors.

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