NCB CAPITAL MARKETS LIMITED

H2 ECONOMIC UPDATE 2009

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Is the Glass Half Empty or Half Full?

Economic Data in H1 underscores challenges facing the local economy

In the first half of the year (H1), the economic data continued to underscore the challenges facing the domestic economy and were generally in line with our base case projections. The local currency came under pressure, depreciating 10.7%, with much of the depreciation taking place in the first quarter. Further, headwinds from the external environment contributed to missed fiscal targets and adversely impacted the local economy. However, it seems we underestimated the impact that the global downturn would have on domestic production. The local economy contracted by 3.1% in the first quarter a lot worse than the flat outturn we had projected. Deeper contractions are expected in upcoming quarters in light of the decline in bauxite and alumina exports; the sharp drop in remittances; lower tourism revenues and weaker consumer demand. Against this backdrop, the year-to-date performance of the local stock market had done little to improve investor sentiment, with stocks registering an average decline of 8.1%. With the deterioration in the external environment, the largely anticipated downgrade in the country's credit ratings took place in March. The country was also placed on a watch for a further downgrade as the fiscal position and the economic outlook deteriorated. With the downturn in hard currency flows, the resumption of a borrowing relationship with the IMF became more than just verandah talk as the government is already in discussions with the multilateral lending agency with the view to re-establishing a borrowing relationship.

Behind these dark clouds however, there were a few positives. Our base case outlook was predicated on the view that policy makers in the major global economies would be successful in their attempts to avoid a protracted recession. In this regard, the global economy looks set for a modest recovery in H2 with the rebound in its nascent stage in Emerging Market- Asia and signs that the downturn in the US economy may be bottoming. Locally, there has been relative stability in the foreign exchange market since the second quarter (0.29% depreciation in Q2); inflation has moderated and has fallen significantly from peak levels in Q3 2008. In addition, market interest rates have begun trending downwards earlier than we'd projected. Global bond prices have also risen from the lows seen late last year as investor risk appetite rebounded.

Given all these developments, what are the prospects for the local economy in the second half of 2009? Will developments in the economy simply be more of what was seen in H1 – the case for the half empty glass? Or has Jamaica seen the worst of the effects of the global downturn with a more positive outlook for the future – the case of the half full glass?

Output

Downside risks materialize as output contracts sharply in Q1...

The risks to a contraction in output have increased since our review at the start of the year as the scale and breadth of the downturn has become evident. Our best case scenario of flat economic growth has proven to be too optimistic. Against the background of the global recession, local consumer spending, employment and output has contracted sharply. The Planning Institute of Jamaica (PIOJ) reported that the local economy contracted by 3.1% in the first quarter reflecting declines in both the Goods Producing and Services sectors. The mining sector has been particularly hard hit as prices of bauxite and alumina have dropped by more than 50% since the highs seen in July of last year. This has resulted in the closure of some of the major bauxite plants and large scale layoffs. In the services sector, major

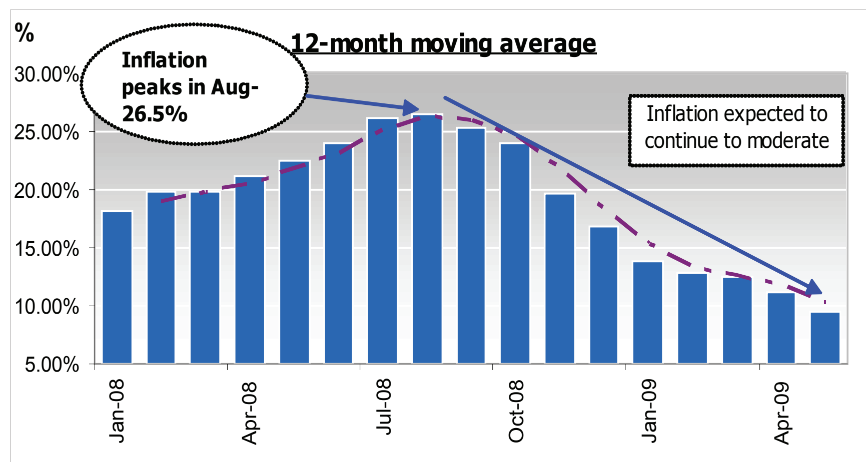
revenue earners such as tourism and remittances have also declined.

Although the global economy has seen some improvement since the beginning of the year, significant risks remain. Unemployment is set to rise in the US through 2009 despite expectations for a modest recovery. Rising unemployment is likely to translate into a slower turnaround for both tourism and remittances. This is expected to further weaken consumption given the large contribution remittances make to private consumption (13.8% of GDP in 2008). Despite a mild recovery in bauxite prices since the lows of February 2009, this is insufficient to offset the high cost of local production. As such, the mining and quarrying sector is expected to continue to lead the downturn in the Goods Producing sector. With greater fiscal inflexibility and additional cuts in capital expenditure, we foresee continued weakness in real GDP. PIOJ's projection is for a contraction in the range of -2.5 and -3.5% for 2009. While green shoots have appeared in the US which suggests a bottoming of the recession, it will take some time before the effects of any recovery filters down through to the domestic economy. In addition, with the government still in damage control mode and no clear plans yet in place to boost domestic production, we believe that the economy is likely to contract in the range of -3.0% to -4.0% in 2009.

Inflation

Inflation: The silver lining

Amidst the grey skies of the contracting economy, inflation has been the silver lining. As expected, the rate of increase in consumer prices continued to moderate helped by the year-on-year decline in oil and other prices. So far this year, 12-month inflation is currently running at 8.9% (June 2009) compared to 24.0% recorded over the same period last year. In line with the drop in commodity prices and the slack in the local and global economies inflation pressures have cooled significantly and have provided consumers with some reprieve.

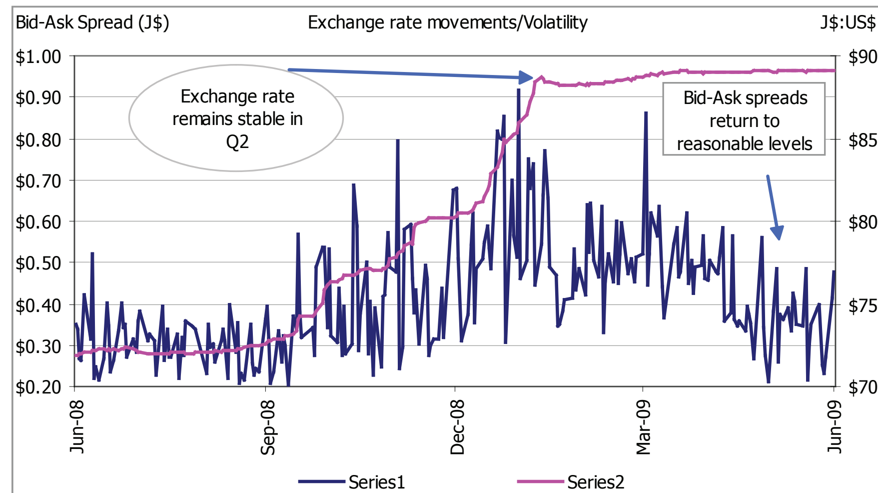


We are maintaining our calendar year inflation forecast of 10-12% for 2009 in light of the recent run up in oil prices and the increases in the SCT on petroleum products and spirits. We anticipate some second round effects on consumer prices from the increase in the SCT on fuel. In addition, consumer prices could be pushed higher if the increase in electricity rates (as high as 26%) now being sought by the local Light & Power Company is approved. However, we are of the view that the impact will be tempered by the slack in the domestic economy which will limit the pricing power of domestic firms. Our base case projection is for inflation at the lower end of this range. However adverse weather conditions during the hurricane season could translate into higher domestic food prices and push inflation towards the higher end of our range.

FX Market Stable in Q2 – Will it hold?

After seeing the J$ depreciate at a fast pace in late 2008, the first six months of the 2009 calendar year can be characterized in two phases. In Q1 the J$ continued to weaken , as low US supplies coupled with high demand continued to put upward pressure of the local currency.

Graph 2



Central Bank forges consensus for exchange rate stability

During the first quarter, the local dollar lost approximately 10.69% to close at $88.82; far exceeding the 0.67% depreciation witnessed in the first three month of last year. Despite no significant improvement in FX supplies, stability returned to the foreign exchange market in Q2 helped with a consensus forged between the BOJ and the major FX dealers. Demand pressures in the market also eased when the central bank opted to supply hard currency directly to government agencies. As stability returned to the foreign exchange market, spreads narrowed relative to the first three months of the year. As such, during the second quarter the local dollar depreciated by a marginal 0.29% pushing the year to date depreciation of the local dollar relative to the US$ to 10.69%.

While the strategies employed by the monetary authorities appear to be working; they do not address the critical issues facing the foreign exchange market and are not sustainable. Among the factors contributing to the reduction in hard currency supplies is the drop in remittance inflows. Inflows fell 17.5% (net 19.6%) in the month of May and have fallen 16.7% year-to-May relative to the same period last year. In addition, revenues from tourism have been falling due to huge discounts being offered as a part of the marketing efforts to prevent a significant falloff in the sector.

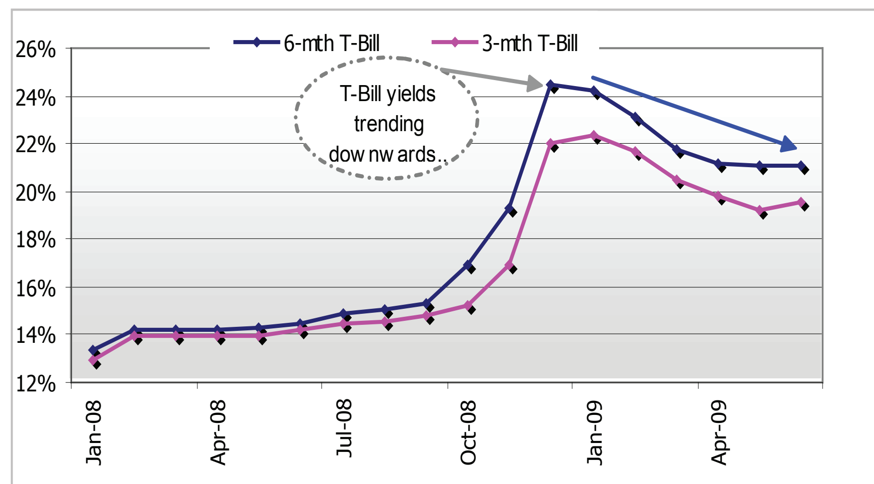
We are of the opinion that we should see some depreciation towards the back end of the 2009 calendar year with the usual seasonal increase in demand coming in the last quarter of the year. However, the outcome of the arrangements that will be made with the IMF will likely play a pivotal role in exchange rate stabilization over the medium term as it would boost the country's net international reserves (June 2009: US$1.6Bn) thus giving the BOJ greater flexibility to address the current supply shortfall and help maintain foreign exchange market stability. As such, we've kept our base case projection of 12-13% depreciation in the local currency for 2009.

Interest Rates...Expect Further declines In H2

Interest rates set to Decline in H2 But ....

While we had anticipated lower interest rates in 2009, the downtrend began sooner than expected. After spiking in response to BOJ rate adjustments in December 2008, market interest rates began to trend slowly downwards helped by the return of foreign exchange market stability in Q2. In stark contrast to the first quarter, the second quarter saw a return of stability to the foreign exchange market helped by of the use of moral suasion by the central bank.

Graph 1



This facilitated a reduction in market interest rates evidenced in the movements in Treasury bill yields. T-bill yields on the 182-day and 91-day issues have both fallen since the beginning of the year by 340 and 243 basis points, respectively. With inflation and inflationary expectations moderating and relative stability restored to the FX market, the Bank of Jamaica (BOJ) pulled its 1 year-Certificate of Deposit (CD) from the market. While the relatively stable exchange rate facilitated the reduction in interest rates, heavy GOJ debt raising activity in the local market kept interest rates from falling at a brisk pace.

Though we are of the belief that interest rates will be trending downwards in the short term, the pace of decline will depend on the outcome of the possible borrowing arrangement between the Government of Jamaica and the International Monetary Fund. If this is to materialize, we could see interest rates declining faster than expected as the reliance on the local economy for funding would be significantly reduced.

Fiscal

Risks of fiscal slippage rise as output and revenues decline...

The deficit for the FY2008/09 came in at 6.8% of GDP, a stark deviation from the revised 5.8% target (initial target: 4.5%). Data released so far for the 2009/10 fiscal year showed that the fiscal picture has already begun to deteriorate due to the significant underperformance of revenues. Based on the data for the period April to May 2009, Central Government recorded a fiscal deficit of J$22.19Bn, or J$2.10Bn above the projected deficit of $20.09Bn. Revenue collection has fallen off track despite the increase in SCT and other recently imposed tax measures. Revenues and Grants came in at J$37.75Bn or J$5.51Bn less than anticipated, pointing to the decline in consumer spending. There was a shortfall in revenues

from GCT and SCT on local goods during the period. SCT on imports and custom duty also came in below projection limiting revenues from international trade as the downturn in the economy resulted in falloff in the demand for imported goods. The revenue shortfall was partially offset by the curtailment of capital and recurrent expenditure.

The historical pattern is for the fiscal balance to outperform projections earlier in the year and gradually deteriorate later in the year. The rapid deterioration in the fiscal picture so early in the year highlights the significant decline in aggregate demand and the challenges that will be faced in meeting the fiscal target. It is likely that the pessimistic outlook on the economy, increased unemployment and further decline in remittances could continue to weaken consumer spending and result in the underperformance of tax revenues. Increased unemployment levels are also likely to lead to a reduction in revenues from PAYE (Income Tax). The situation is also being exacerbated by the virtual disappearance of bauxite revenues.

GOJ in talks with IMF, Expect expenditure cuts as revenues drop...

If central government revenues continue on the current path we see very high risks of fiscal slippage in FY 2009/10. Meeting the fiscal deficit target of 5.5% will prove a mammoth task given the increased downside risks to revenues in the current year. It is in this context as well as the sharp reduction in foreign exchange inflows that the government is exploring a Standby Arrangement with the International Monetary Fund (IMF). Securing a line of credit from the IMF would help to shore up the country's reserves and help fill the void left by the decline in hard currency inflows from remittances and bauxite. It would also help to lower the government's funding costs and assist in reducing the reliance on the domestic market for funding. However, IMF agreements are usually accompanied by stringent conditionalities which have, in the past, included expenditure cuts and increasing interest rates to stabilize the local currency. It should be noted however, that the government is already in cost cutting mode with capital expenditure running significantly behind budget. In addition public sector wages have been frozen and attempts are already been made to reduce the coupon on its investment instruments. That aside, we believe that additional expenditure cuts are in the cards and will be one of the conditions for IMF funds given the deteriorating revenue situation. Although IMF funding should help to stem the bleeding in the economy, there is no clear strategy for growth which is a critical element in the longer term solution to sustainable debt reduction.

GLOBAL BOND MARKET

Globals Rally in Q2 but...

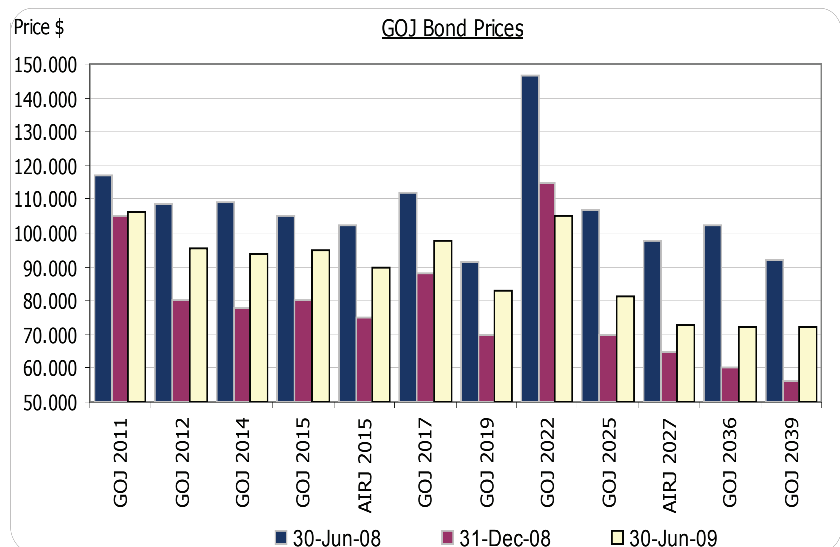
GOJ bond prices continued to fall in the first quarter as several factors both locally and in the wider global markets depressed prices in the first quarter. Low US$ liquidity levels prevented most institutional investors from capitalizing on the attractive yields that resulted from the falloff in prices. In addition, supply was also restricted as bondholders were unwilling to realize capital losses by selling bonds at depressed prices. Individual investors were kept at bay as the downgrade of the country's external credit rating by rating agencies S&P and Moody's (to B- and B2, respectively) reduced the appeal of GOJ hard currency debt. Post the downgrade there was little movement in the bond prices as the downgrade was largely anticipated and had already been priced in.

Helped by monetary and fiscal stimuli and signs of 'green shoots' in the global economy in Q2, risk appetite returned to the financial markets and risky assets delivered a strong performance in the period March to June 2009. Jamaican global bonds along with EM bonds benefited from the rebound in risk

appetite.

Further, US$ liquidity did return to the local market temporarily through the payout of a JPS bond. The funds from the repayment found its way into the bond market as investors bought GOJ globals to replace the hard currency assets and take advantage of the attractive yields. With the exception on the GOJ 2022, which lost a further 8.70% over the 6-month period, GOJ global bonds rallied with gains ranging from a marginal 1% on the GOJ 2011 to 28.57% on the longer end of the curve (2039). Although, the average price appreciation on the GOJ bonds was 14.73%, this was well below the 6-month returns of 42.31% for emerging markets based on the JP Morgan Emerging Market Bond Index.

However, investors have now begun to doubt the strength of the recovery and this has tempered their risk appetite. In addition, with the appreciation seen in the bond prices during the second quarter, there may be limited room for further upside in the short term. Although yields on GOJ global bonds have fallen off, they remain above levels seen this time last year. Additionally, even if liquidity is to return to the local market, the country's macro economic state, which remains under the microscope by ratings agencies, could possibly be the overriding factor that limits the upside potential for prices.



Stock Market

FX gains boost Q1 earnings but economic contraction to be reflected in corporate earnings going forward...

The equities market performed fairly in line with expectations as stock prices continued on their downward trajectory. Investor sentiments waned as the flow of funds to the market continued to be restricted by the high interest rates being offered on fixed income products, tight liquidity conditions and the bleak outlook for corporate earnings. The decline was much more severe in the first quarter when the local currency depreciated significantly and domestic interest rates remained at 2008 levels. However, huge foreign exchange gains boosted corporate earnings triggering a second quarter rally. In addition, indications of lower domestic interest rates became clearer as the BOJ reduced the rate offered on its one year CD. Market interest also started to trend downwards. As such, the Main Index

ended H1 flat, while the Composite and Select Indices fell by 10% and 9.0% respectively.

Given the recent run-up in stock prices post the first quarter earnings releases, there is likely to be retracement in equity prices going forward. The summer period is usually characterized by low market activity and accompanied by a falloff in stock prices. However, in light of the expected contraction in the local economy and the anticipated impact on corporate earnings, equity prices could continue to decline even after the summer period has passed. We maintain, that the impact of the downturn in the economy has not yet been fully reflected in corporate earnings. As such, the effects of the slowdown in business activity and weaker consumer demand are likely to be seen in corporate earnings results for Q2 2009 and beyond. The stability in the local currency since the beginning of the second quarter means that the significant foreign exchange gains which boosted net profit of a number of listed companies in Q1 are unlikely to be repeated. As such, these results should be more reflective of the core business operations. Weaker earnings are expected across all sectors. Although financials could benefit from wider spreads on account of a decline in interest rates, earnings growth rate is expected to weaken in the face of slower growth in their loan portfolio and an increase in non-performing loans. While manufacturing companies should benefit from the moderation in prices, the sector will also be adversely affected by a decline in consumer spending in the face of lower disposable incomes. Retailers are also likely to experience weaker sales growth in the current year. We remain of the view that there will need to be a bottoming of the corporate earnings and clear signs of recovery in corporate profits, before sentiment begins to improve and stocks see any sustained move upwards. That said, the expected retracement in stock prices could provide long term investors with an opportunity to pick up value stocks at a discount.

With most of the major macroeconomic indicators expected to remain negative in the near term it would be easy to view the glass as half full. The outlook for economic output, the government revenue situation as well as the stock market is for continued weakness for much of the second half of the year. On the flipside though, unlike at the beginning of the year, signs of an end to the global contraction have somewhat illuminated these dark clouds. The anticipated mild recovery in global conditions in the second half of year is a positive, though it may take some time for the benefits of any recovery to filter through to the economy. While a relationship with the IMF is not the panacea for the country's inherent problems, funds received from the institution could help to stave off the effects of a significant reduction in revenues and help to meet the short fall in hard currency inflows. An IMF agreement could also help with fiscal discipline and help the government to meet its 2009/10 fiscal targets. Further, the expected continued moderation in the level of inflation as well as the downtrend in interest rates could provide some reprieve for consumer and businesses alike. As such, relative to the beginning of the year, there have been some positive developments implying that the glass may indeed be half full. Although serious challenges remain for local policymakers, foreign exchange market stability, the decline in interest rates and the easing of inflation pressures are all positive developments that have occurred since the start of the year.

Investment strategies for H2

Investment Strategies for H2

Despite the softening in the economy and the financial markets there are good opportunities for investors. The recommendations made are with the view that the economic contraction will deepen going into the second half of the year, the country's fiscal position is likely to weaken considerably; interest rates will continue to trend downwards and the level of inflation will continue to moderate. In this context, we recommend that investors be overweight in fixed income products.

Buy fixed income investments: short to medium term to lock in current high interest rates

GOJ instruments and repos (on the longer end of the curve) should be used to capitalize on the current interest rate environment and the expectation of the decline in rates in the near term.

Limited upside for Capital gains on globals in the short term, but yields on Air J 15 still attractive

The bond prices have recovered significantly from the lows seen in the latter part of 2008. As such, further significant price appreciation is not expected given the deteriorating fiscal position and the weakness in the domestic economy. However, Air J 15s could remain fairly attractive given the amortization feature of the bond as well as the offer yields on this instrument. Investors could also benefit from the fact that this instrument is denominated in US$ which provides currency diversification and a hedge against a depreciation in the J$.

In the local equities market, we continue to see value in stocks for the long term investors. Investors could try to pick up stocks which are currently trading at significant discounts. Financials such as SDBG, SGJ and NCBJ should benefit from a decline in interest rates which should widen spreads and boost earnings. In addition, these stocks are trading close to their one year lows and could provide some long term value. Pan Jam, FJI and GraceKennedy are also attractive buys just before the start of the earnings season as the prices would have fallen off significantly. In addition these stocks continue to trade well below book value.

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