

Eurozone & United Kingdom

UOB Economics Projections - Eurozone	2007	2008	2009F	2010F
GDP	2.7	0.7	-4.1	1.5
CPI (average, y/y)	2.1	3.3	0.3	1.4
Unemployment rate (year-end)	7.5	7.6	10.0	10.5
Current account (% of GDP)	0.4	-1.0	-0.8	-0.7

UOB Economics Projections - United Kingdom	2007	2008	2009F	2010F
GDP	3.0	0.7	-4.5	1.1
CPI (average, y/y)	2.3	3.6	2.1	2.3
Unemployment rate (year-end)	5.4	5.6	8.0	8.6
Current account (% of GDP)	-2.8	0.0	-1.5	-1.7

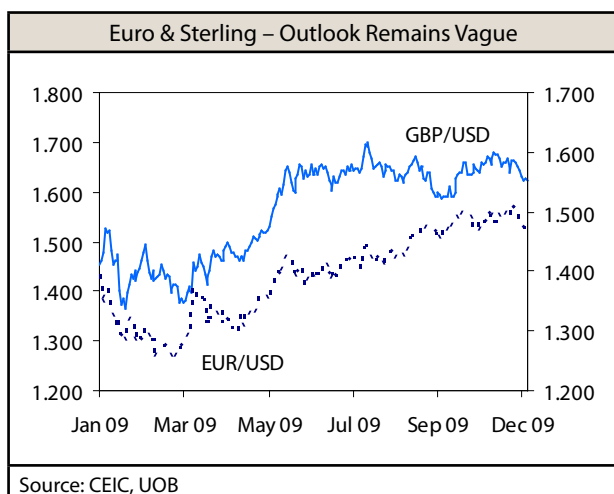
- *Euro and Cable moved sideways for most of the quarter. More recently, however, the dollar has rallied, sending both the currency pairs lower. Going forward, the outlook for the EUR/USD and GBP/USD remains mixed; and market strains globally would further complicate any near-term forecast. In view of recent price movements and our outlook on the US dollar, we have revised our 3-month EUR/USD forecast to 1.500, 6-month forecast to 1.520, and 12-month forecast to 1.450. Similarly, we have revised our 3-month GBP/USD forecast to 1.650, 6-month forecast to 1.660, and 12-month forecast to 1.680.*
- *We maintain our view that the European Central Bank (ECB)'s initial focus will be upon unwinding some of the liquidity measures rather than setting the stage for rate hikes., though we expect that it will lead the G10 nations in moving rates up.*
- *There seems to be nothing so far, to alter our expectations that the Bank of England (BoE) would be the most dovish (out of the G10 nations), leaving rates on hold – in our view – until the fourth quarter next year.*

Euro & Sterling: Outlook Remains Vague

Euro and Cable moved sideways for most of the quarter. EUR/USD had initially climbed from lows of 1.4481 (October 2) to touch highs of 1.5144 on November 25; while GBP/USD had briefly touched highs of 1.6878 on November 16 from lows of 1.5708 attained on October 13. More recently, however, the dollar has rallied, sending both the currency

pairs lower. At the time of writing, EUR/USD and GBP/USD are seen trading around the 1.4400- and 1.6200-levels respectively.

The shift in sentiment was triggered by the US' better-than-expected November employment report released on December 4, when the dollar gained on positive news –something we have not seen in some time. Furthermore, EUR/USD has had a torrid time of late, on concerns about Greece's debt crisis after rating agencies Standard & Poor's and Fitch lowered the country's long-term credit rating. The moves by the agencies were a huge blow to Greece, saddled with high public deficits and debt and had rattled European markets. Greece's public deficit is set to rise to 12.7% of output this year, far above the Eurozone limit of 3.0%. Debt, now at 300 billion euros (442 billion dollars) is also expected to come to 113% of GDP in 2009 against an EU target of 60%. As for the GBP/USD, the pair had been weighed across the quarter, by the dilutive aspects of the Quantitative Easing (QE) program of pumping money into the financial system. We have also witnessed how the trail of comments revolving around the QE program, along with the decisions by the BoE, have caused a substantial



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amount of pressure and volatility in the GBP.

It will be hard not to mention about the greenback as far as these currencies are concerned. We have seen (especially of late) how easily a dollar story could turn into a euro story or vice-versa. Whether or not the dollar's recent behavior is a real shift in the trend or just a correction – given that the lack of liquidity in the market before the year-end could exaggerate fluctuations – is highly debatable. Besides, we believe that gains in the US dollar may not be convincing until there is clear indication of the expected Fed rate hike.

Nevertheless, the US dollar will continue to be a major catalyst and 2010 promises a fair bit of volatility. Needless to say, market strains globally would further complicate any near-term forecast. Peculiar knee-jerk reactions and abrupt position adjustments in other market segments (such as equities, bonds and commodities) could also impact currencies indirectly and unpredictably. In view of recent price movements and our outlook on the US dollar, we have revised our 3-mth EUR/USD forecast to 1.500, 6-mth forecast to 1.520, and 12-mth forecast to 1.450. Similarly, we have revised our 3-mth GBP/USD forecast to 1.650, 6-mth forecast to 1.660, and 12-mth forecast to 1.680.

Eurozone Economy Showing Signs of Improvement

It does seem that the Eurozone economy has gotten past the worst point of the cycle. EU 3Q GDP growth expanded at 0.4% q/q (-4.1% y/y) from a -0.2% q/q (-4.8% y/y). Both French and German 3Q GDP registered expansions of 0.3% and 0.7% respectively. Furthermore, Europe's service and manufacturing industries expanded at the fastest pace in two years in November. The composite index based on a survey of purchasing managers in both industries in the 16-nation euro area increased to 53.7 from 53.0 in October.

Nevertheless, we expect that it is going to be an uneven recovery going into 2010. First and foremost, rising unemployment will undermine consumer spending, and therefore threaten the process of recovery. In a recent survey, it was shown that most Europeans believe the worst of the economic crisis has yet to feed through to the labor market. The poll of more than 30,000 people in 30 countries across Europe was conducted from October 23 through November 18. Europe's jobless rate has risen to 9.8% – the highest since December 1998 – and is forecast by the European commission to increase to 10.7% next year. We are now looking at the unemployment rate to hit 10.4% by the end of 2010, compared to 10.2% previously.

Concerns over sovereign debt burdens have also placed the

Eurozone under new strain. Standard and Poor's lowered Greece's long-term credit rating to BBB-plus from A-minus and warned it could issue a further downgrade unless the government managed to get its finances in order. Fitch has also downgraded Greece to BBB-plus from A-minus. The BBB-plus rating is still considered investment-grade but is below the ECB's standard lending requirements. Greece now ranks the lowest in the Euro region and three steps short of non-investment grade, or junk.

Nevertheless, at the latest ECB meeting on December 3, ECB President Jean Claude Trichet released the ECB's new staff projections. Annual real GDP growth is expected to come in within the range of -4.1% and -3.9% for this year (previous -4.4% and -3.8%), while a range between +0.1% and +1.5 is expected for 2010 and a range of 0.2% and +2.2% is expected in 2011 (previous -0.5% and +0.9%). Meanwhile, annual HICP inflation is expected to come in at 0.3% for this year (previous 0.2% to 0.6%); between 0.9% and 1.7% in 2010 (previous range 0.8% and 1.6%) and between 0.8% and 2.0% in 2011. All said, even as the economy gathers strength, the ECB has signaled that it is in no rush to withdraw unconventional measures.

ECB Outlines its First Exit Strategy Step

Interest rates were kept unchanged at the latest ECB meeting held on December 3 – the refinancing rate at a record low of 1.00%, the marginal lending rate at 1.75% and the deposit rate at 0.25%. At the press conference, ECB President Jean-Claude Trichet highlighted that “the current rates are appropriate”.

The ECB had also decided to continue conducting its main refinancing operations (MROs) as fixed rate tender procedures with full allotment for as long as is needed – and at least until the third maintenance period of 2010 ends on 13 April. This tender procedure will also continue to be used in the special-term refinancing operations with a maturity of one maintenance period, which will continue for at least the first three maintenance periods of 2010, according to the press release.

The Governing Council had also decided that the rate in the last 12-month longer-term refinancing operation, to be allotted on 16 December 2009, will be fixed at the average minimum bid rate of the MROs over the life of this operation. And with regards to longer-term refinancing operations in the first quarter of 2010, the Governing Council has decided to carry out the last six-month longer-term refinancing operation on 31 March 2010. This operation will be carried out using a full allotment fixed rate tender procedure, as will the regular monthly three-month

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longer-term refinancing operations already announced for the first quarter of 2010.

These announcements (which amount to an incipient exit strategy from the ECB's unconventional policy measures due to the crisis) had been partially signaled by Trichet and other ECB officials in recent months. Markets had expected the ECB to leave the rate on its 12-month tender fixed at 1.0%. That would mean that any increase in the benchmark rate next year could prove less effective because banks would have had money at 1.0% through the end of next year. However, the move (of setting the rate on the loans to the average of the benchmark rate over the year) implies that future movements in interest rates will now be reflected in banks' funding costs.

Trichet's comments were a tad more hawkish and we get the sense that the ECB is withdrawing its unconventional policy measures at a slightly faster pace (than our earlier expectations). That said, Trichet acknowledged that "the recovery process is likely to be uneven and that the outlook remains subject to high uncertainty". Cautiously optimistic, we maintain our view that the ECB's initial focus will be upon unwinding some of these liquidity measures rather than setting the stage for rate hikes. Nonetheless, we expect the ECB to lead the G10 nations in increasing interest rates somewhere in the third quarter of 2010.

UK Economy Still Mired in Recession

Unlike the Eurozone and the US – where the economies have already started growing again – growth prospects are much dimmer for the British economy, which is still stuck in a recession dating back to early 2008. Real GDP fell by 0.6% in the second quarter from a contraction of 2.5% in 1Q. Final 3Q GDP numbers which will be rolled out on December 22, is expected to show the economy contracting by 0.3%.

Finance minister Alistair Darling recently announced that the British economy was set to shrink 4.75% this year compared with a previous official estimate of 3.50%. Darling added that government borrowing would reach a bigger-than-expected 178 billion pounds in 2009/10, higher than his previous estimate that the state's public deficit would reach 175 billion pounds during the current fiscal year.

On the same day, Britain had announced a one-off tax on bankers' bonuses, slapping a 50% tax rate on bonuses above 25,000 pounds to recoup cash spent saving the sector. The public finances have been severely stretched by costly banking bailouts, while the recession has ravaged

taxation revenues for the Treasury. It was also announced that the rate of tax levied on income that is used to help fund pensions would be raised, and that pay increases for public sector workers would be capped. Darling also confirmed the government would stick by plans to reverse last year's tax cut on goods and services. The government had cut VAT (value added tax) to 15.0% in December 2008 to help boost consumer spending but will now return as planned to the pre-recession level of 17.5% in January. Relief on property tax (where Britons are currently exempt from paying a tax on property purchases, known as stamp duty, for houses and flats costing less than 175,000 pounds) would also expire at the end of the year.

These measures were taken against a deteriorating fiscal backdrop. The International Monetary Fund had predicted that the UK's government budget deficit could hit 13% of GDP in 2010. Such high deficits are likely to lead to reduced public spending and higher taxes, which would in turn weigh on growth. As such, we have revised lower our GDP forecast for the UK in 2009 to -4.5% from -4.2% earlier, with a view of a positive growth of 1.1% in 2010. Unemployment in the UK is now at 7.8% and we are looking at that number to climb above the 9.0%-mark in 2010.

No Surprises from the BoE

While other countries are considering scaling back emergency life measures, the BoE is still facing a tough call on whether to continue showering money on Britain's troubled economy. Even so, the BoE's decision on December 10 – to hold its key lending rate unchanged at 0.5% and maintain its programme of asset purchases totalling 200 billion pounds – was widely anticipated.

The BoE had slashed its key lending rate to 0.50% in March this year in an attempt to tackle Britain's sharp downturn; and at the same time, had begun its extraordinary policy of pumping billions of pounds worth of newly-created money into the economy. Since then, it has increased the programme thrice – in May, August and the latest being in November, where it expanded the program by 25 billion pounds.

Following the increases (of 50 billion pounds) in May and August, there was speculation that the expansion in November would be of the same amount. However, the expansion by "only" 25 billion pounds coupled with a more upbeat statement was seen boosting the sterling against the dollar. We feel that this could be part of the BoE's interests in preparing markets for a gradual tapering off in QE. Besides, further extensions may run the risk of shaking investor confidence.

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In the December statement, the Bank said that it expects the programme will “take another two months to complete and that “the scale of the programme will be kept under review”. The minutes of the latest two-day meeting will be published on Dec 23. Nonetheless, there seems to be

nothing so far, to alter our expectations that the BoE would be the most dovish (out of the G10 nations), leaving rates on hold – in our view – until the fourth quarter next year. If a move is deemed necessary, the Bank is likely to withdraw the liquidity supplies first before starting to hike rates.

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