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UOB Economics Projections: Eurozone	2007	2008	2009F	2010F
GDP	2.7	0.7	-4.1	1.8
CPI	2.1	3.3	0.3	1.4
Unemployment Rate (%)	7.5	7.6	9.4	10.2
Current account (% of GDP)	0.4	-1.0	-1.4	-1.1

UOB Economics Projections: UK	2007	2008	2009F	2010F
GDP	3.0	0.7	-4.2	1.1
CPI	2.3	3.6	1.7	1.9
Unemployment Rate (%)	5.4	5.6	7.9	9.1
Current account (% of GDP)	-2.8	0.0	-2.1	-1.8

Dollar weakness permeating in the backdrop has been of benefit to the Euro and the Cable in the last quarter. Though recent price action suggests that both the GBP/USD and EUR/USD should see a modest climb ahead, any doubt about the sustainability of the recovery could still see the dollar clawing back on its losses.

Going forward, we think that as much as support in the major higher-yielding currencies remains, the EUR/USD and GBP/USD could maintain a weaker bias than the AUD/USD and NZD/USD on the back of softer economic outlooks in the UK and Eurozone.

Part of the improvements in economic conditions in the Eurozone is attributed to policy-driven measures. However, the "growth" story is still very much in the midst especially with the expiration of government stimulus packages. We expect the ECB to keep the refi rate at its current level and will only hike rates – at the earliest – during the second half of next year, under clearer optimistic economic conditions.

Over in the UK, while there may be signs that the economy may be turning around, concerns that the recovery will lag behind that of the Eurozone have remained in the backdrop. We expect that interest rates will be maintained at current levels for some time and the BoE will only begin hiking rates during the latter part of 2010, in line with the ECB.

The rally in equities since March this year and the revival in risk-taking led markets to buying higher-yielding assets. As such, dollar weakness, which has been permeating in the backdrop, has been of benefit to the Euro and the Cable. EUR/USD traded at a low of 1.3833 at the beginning of this quarter but has since moved steadily upwards surging to as high as 1.4844 on 23 September.

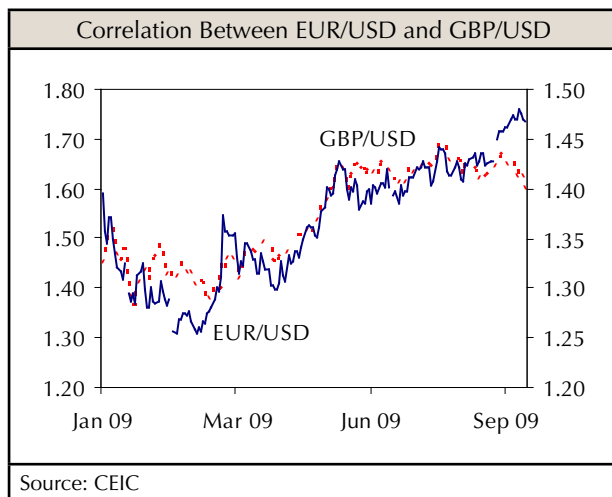
Compared to the EUR/USD, the GBP/USD traded in a more subdued range across the quarter. The pair enjoyed an upward trajectory in the early part of Q3, climbing steadily from lows of 1.5985 on 8 July to 1.7043-highs on 5 August - the highest level attained in the entire quarter. However, the pair tumbled to give back most of its gains following the BoE's decision to increase the size of

asset purchase program by 50 billion pounds to a total of 175 billion pounds on the 6 August. The move took markets by surprise, knee-jerking the GBP/USD and sending it on a downward trajectory thereafter.

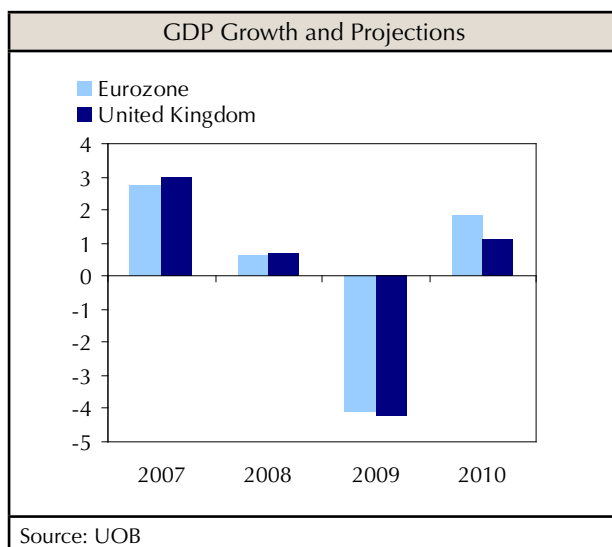
Concerns of the widening UK budget deficit have also pressured the GBP/USD. International ratings agency S&P downgraded its outlook on the UK economy on 21 May to "negative" from "stable" because of the country's "deteriorating public finances". Latest figures show that Britain's budget deficit widened to a record 16 billion pounds in August, 6 billion pounds worse than in the same month last year. The figures have poured in more worries that Chancellor Alistair Darling's budget forecast of a full-year deficit of 175 billion pounds is likely to be

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exceeded as rising unemployment and tumbling tax receipts take a heavy toll on public finances. As such, public sector debt will continue to remain at the top of the government agenda and much remains to be seen on Darling's upcoming pre-budget report in November, in which he is expected to outline a programme to reduce the deficit over the coming years.



Though recent price action suggests that both the EUR/USD and GBP/USD should see a modest climb ahead, any doubt about the sustainability of the recovery could still see the USD clawing back on its losses. Going forward, we think that as much as support in the major high-yielding currencies remains, the EUR/USD and GBP/USD could maintain a weaker bias than the AUD/USD and NZD/USD on the back of softer economic outlooks in the UK and Eurozone. As such, we are looking at both



the EUR/USD and the GBP/USD to continue trading in their familiar ranges. We look for the EUR/USD trading comfortably around 1.470 and the GBP/USD trading just above the 1.600-level by the end of the fourth quarter.

Economic Weakness in the Eurozone Lurks

Following the surprise growth in Germany and France, Eurozone GDP fell by only 0.1% in Q2 2009 from a decline of 2.5% in the first quarter. Real GDP in Germany expanded by 0.3% in the second quarter of 2009 from a contraction of 3.5% q/q previously. The French economy also expanded 0.3% in the latest quarter, compared to a decline of 1.4% q/q in the first quarter. ECB President Jean Claude Trichet, at the latest ECB meeting on 3 September, rolled out an upbeat outlook for global economic growth. He stressed however, the need for caution, and warned that the road to recovery could be less straightforward.

Indeed, economic activity in the coming months is projected to remain weak. Even as markets seem to be switching their focus on the withdrawal of packages and government bailouts for banks (after recent data showing that France and Germany are out of recession), we are aware that part of these improvements in economic conditions in the Eurozone are attributed to policy-driven measures. The "growth" story is still very much in the midst especially with the expiration of government stimulus packages. Besides, we expect to see further deterioration in the labour market as companies are still conservative in hiring as they continue to seek for cost-saving measures. Unemployment in the Eurozone is now at 9.5% and we are looking at that number to climb above the 10.0%-mark in 2010.

Nevertheless, we do expect to see the Eurozone benefiting from the recent German Federal Election held on 27 September at which Chancellor Angela Merkel won re-election with enough support to govern with the pro-business Free Democrats. Many are reportedly expecting Merkel to put a distinctive German stamp on European policies during her term (from fiscal discipline and climate change to the institutional changes that would be introduced if the EU's Lisbon treaty came into effect next year as planned). She has already promised swift income tax cuts and a reform of corporate and inheritance tax. Speaking a day after her victory, Merkel said she would be pushing forward business-friendly tax policies that she had not managed to implement as head of a grand coalition with her rival Social Democrats.

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ECB Stays on Hold in September at 1.00%

On monetary policy, the ECB held its main refi rate steady at 1.00% at its latest meeting. The interest rates on the marginal lending facility and the deposit facility were also unchanged at 1.75% and 0.25% respectively. The ECB also decided that the rate for the twelve-month longer-term refinancing operation to be allotted on 30 September 2009 will be the prevailing rate on the main refinancing operations.

The main focus, however, was on Trichet's press conference. He said that "current rates remain appropriate taking into account all the information and analysis since the last meeting". He stressed that "it's not time to consider so-called exit strategies or the unwinding of exceptional measures taken by the ECB and other central banks to spur economic activity". More recent comments by Trichet about the appropriate timing of unwinding emergency measures were made to the European Parliament on 28 September. He reiterated that "it is not the time to exit" but stressed that "at some point in time an exit strategy will have to be implemented" and that "the ECB has an exit strategy and stands ready to put it into action when the time comes".

The latest forecasts for growth and inflation were also unveiled at the September meeting. The overall outlook was revised higher – average annual real GDP growth is expected to range between -4.4% and -3.8% in 2009 and between -0.5% and +0.9% in 2010 – though the midpoint of a range for 2009 still had the 16-nation economy contracting by 4.1%. Inflation is now expected to come in at 0.4% this year and 1.2% in 2010, a slight hike from June estimates but still well below the ECB's medium-term target of 2.0%.

That said, given that economic activity is likely to remain weak for some time and with the soft outlook on employment, we expect the ECB to keep the refi rate at its current level and will only hike rates – at the earliest – during the second half of next year, under clearer signs of an economic recovery.

Economic Activity in the UK Appears to Have Bottomed but Remains Soft

Over in the UK, latest economic data showed that real GDP contracted by 0.7% q/q in the second quarter, compared to a decline of 2.4% q/q in the first three months of this year. While there may be signs that the economy may be turning around, concerns that the UK recovery will lag behind that of the Eurozone have remained in

the backdrop. So far, there has not been strong evidence of stabilization in Britain's main export markets. Furthermore, the unemployment rate climbed to a high of 7.8% in June, with the number of unemployed rising towards the three-million-mark. Our expectation is for the unemployment rate to rise above 9.0% in 2010.

Nonetheless, the responses to the measures taken by the central bank have been moderately encouraging so far. The National Institute of Economic and Social Research (whose clients include the central bank and the Treasury) said in the beginning of September that the recession probably ended in May. According to reports, house prices in the UK rose by 0.8% in August, while a survey of services companies showed the fastest pace of expansion in almost two years. Furthermore, signs that the economy may be returning to growth helped push the UK's benchmark FTSE-100 index above the 5,000-mark for the first time in almost a year on 9 September.

BoE Leaves Repo Rate Unchanged at 0.5%; Keeps Asset Purchase Plan at 175 Billion Pounds

The BoE held its key lending rate unchanged at 0.5% and maintained its programme of asset purchases totalling 175 billion pounds in September. The Bank, in its statement, said that it expects the programme will complete in November though it highlighted that "the scale of the programme will be kept under review".

Albeit signs that Britain may soon follow France and Germany out of the recession, Governor Mervyn King's actions at the BoE's meeting in August suggested that he was less optimistic on the country's recovery prospects. King had wanted the Bank to increase its so-called quantitative easing (QE) programme by 75 billion pounds. However, his plan did not go through as the nine-member Monetary Policy Committee voted instead, to increase QE by 50 billion pounds to a total of 175 billion pounds.

The QE programme of asset purchases was launched in March this year – the same time where the Bank slashed rates to their current record-low of 0.5% – with an aim to boost nominal spending to ensure that it is consistent with meeting the inflation target in the medium term. While it may be too early to assess the full effect of the asset purchase programme, there have been promising signs so far that ramping up its QE policy has had some positive impacts. The BoE, in the minutes of the August meeting, said that there was "a large reduction in the spread between government bond yields and OIS rates". The Bank also said that "corporate bond spreads had

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fallen, growth issuance had been strong, and the rate at which the Bank had been acquiring corporate bonds had slowed, consistent with the pickup in private investor demand”.

All in all, given that unemployment is still rising and

households are still keeping a firm grip on their spending, there is substantial doubt over the extent to which the recovery would be sustained. Our expectation is that rates will be maintained at current levels for some time. The rate hike process will only begin during the latter part of 2010, in line with the ECB.

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