



European Weekly Focus

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QUOTE OF
THE WEEK

"Recent information indicates that the outlook for economic activity has weakened further...Financial markets remain under considerable stress, and the tightening of credit conditions and the deepening of the housing contraction are likely to weigh on economic growth over the next few quarters". **FOMC Statement, 18th March**

Change in trend or simple correction?

European verbal intervention has gained momentum of late, with ECB's Quaden going as far as stressing that 'The volatility and the recent moves on the foreign exchange markets have been excessive'. It has certainly been another very volatile week for the Foreign Exchange market last week, with eur/dlr swinging from a high 1.5904 last Monday, back below the 1.54 mark by Friday. At this point, the challenge consists in assessing whether the moves observed on eur/dlr late last week marked the beginning of a reversal in trend or whether this was just a long due correction. **Here, we identify what we see as likely to trigger a sustainable change in fortunes for the greenback and we conclude that calling on a change in trend may be a touch premature at this point.**

1) Better news from the US economy: unlikely for the foreseeable future

Above all, this is a dollar weakness story so that a sustainable reversal in eur/dlr should come in a context of a recovering US dollar **triggered by improving economic news from the other side of the Atlantic**. We believe that this is not likely to happen for the foreseeable future, with **the US economy already in recession** and unlikely to show signs of improvement before later this year - as past rate cuts and fiscal stimulus feed through. **In the meantime, it could get worse before it gets better on the economic front**, with a combined rising unemployment, depressed housing sector, deteriorating consumer/retail sectors and recession forces at the manufacturing gate all likely to keep GDP growth in negative territory. We expect a negative GDP growth performance both in Q1 and Q2.

2) End in financial/banking crisis: highly difficult to predict but it will take a while to restore full confidence

One may hope that the Bear Stearns debacle marked the low in the current financial market crisis, but the risk is that the market has to digest fresh subprime related write-downs over the next couple of weeks/months while the credit crunch persists: the lack of **market liquidity could persist as being a central problem for some time to come**. Bearing this in mind, it is difficult to contemplate a near-term and **sustainable** dollar recovery triggered by a sudden bullish mood in the financial/banking communities.

3) A worsening Eurozone environment: not just yet

We do not subscribe to the decoupling story over the long-term, but we believe that the Eurozone economy is much better positioned to absorb a US recession than it has been in the past (as domestic demand is more solid and as soaring extra Eurozone exports to emerging Europe help offset the weakening trend to the US). However, the longer and deeper the US recession, the greater the downside risks for the Eurozone economy. Furthermore, **the Eurozone has not been spared from the credit crunch of the past few months** and with time, this will feed through onto the real economy. The soaring inflation environment and associated decline in real income growth will also come across as a drag to GDP growth. It has been 'so far so good' for Euroland, but **we expect GDP growth to decelerate throughout 2008**, with a sub-trend growth environment likely to emerge and its **disinflationary effects likely to open the door for a plausible ECB rate cut**. ECB rate cuts would most likely contribute to a more bearish eur/dlr outlook, but **this is unlikely to happen until Q4, at the earliest**.

4) A coordinated Fx Intervention: unlikely for now, but never say never

When it comes to dollar weakness, it is tempting to argue that in a US recession environment, a weak dollar is probably welcome by the US authorities as it smoothens recession forces via the export sector. This is probably true up to the point where **the dollar weakness becomes a dollar crisis, entailing higher US bond yields and generating generalized distrust towards US assets**. **We are not there just yet**. Meanwhile, the European authorities will most likely step up on the verbal intervention at the 1.60 level and the Japanese MoF has already acknowledged that it stands ready to cooperate on the intervention front. Overall, given the current market predicament and the many issues that have to be dealt with, it could be argued that Fx intervention could do more harm than good. **While not our central scenario at this stage, we would not completely rule out Fx intervention** and if anything; tactically, the recent eur/dlr downward correction would set an excellent background for a successful coordinated Fx intervention...

The recent dollar correction was long due, but the greenback remains at risk in the near-term: for now, doom and gloom US economic/financial news risk persevering, while a worsening Eurozone economic profile may not materialize just yet. In fact, a coordinated Fx intervention is what would be most likely to trigger a sustainable change in trend in eur/dlr. No one really believes in the intervention story at this stage, but it is certainly something worth bearing in mind.

Audrey Childe-Freeman, Senior European Economist



This Week in the EUROZONE

Weekly Market Barometer	Latest Trading Level (as at 14.00 GMT on Mar 21)	Near-Term Outlook *	Medium-Term Outlook *
Eur/Dlr	1.5413	Neutral	Positive
Euribor (Jun 2008 contract)	95.640	Small Negative	Neutral
Bunds (Jun 2008 contract)	117.59	Small Negative	Small Negative

* Near-Term = 1 week ahead
* Medium-Term = 1 month ahead

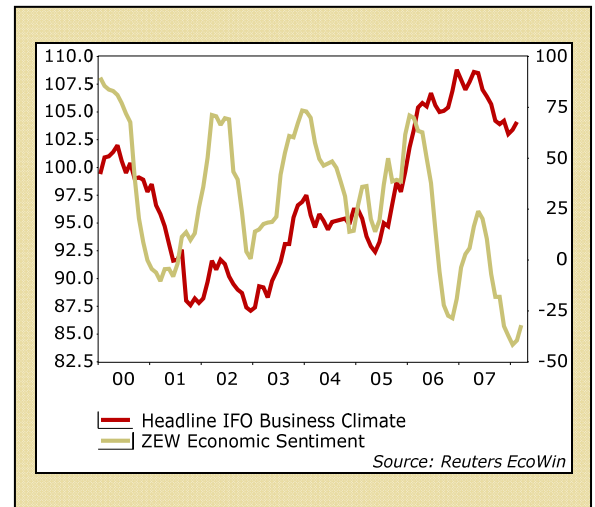
German March IFO (Wednesday)

The German IFO surpassed expectations and reported its second consecutive monthly rise in February, despite the continued financial market turmoil. If anything, the impact stemming from the financial market crises on the ZEW index (a barometer of investor confidence) is likely to be greater than the impact on the IFO (which surveys companies from a wider range of sectors), which so far has held on extremely well. The strong positive correlation between the headline IFO index and German/Eurozone GDP growth suggests that continued solid growth should be anticipated in the near future.

With rising oil prices and a surging euro (heading closer to the \$1.60 level), we may expect business confidence to weaken in March, however **the still resilient German economy** (see Germany's manufacturing PMI rising in March) **could help offset such negative news – the headline IFO index is expected little changed at 103.9 from 104.1 previously.**

Jodie Tiller

German IFO and ZEW



NO OTHER MAJOR EUROZONE DATA DUE THIS WEEK



This Week in the UK

Weekly Market Barometer	Latest Trading Level (as at 14.00 GMT on Mar 21)	Near-Term Outlook *	Medium-Term Outlook *
Cable	1.9818	Neutral	Positive
S-Sterling (Jun 2008 contract)	94.510	Small Negative	Positive
Gilts (Jun 2008 contract)	111.87	Negative	Small Positive

* Near-Term = 1 week ahead
* Medium-Term = 1 month ahead

March Nationwide House Prices (Friday)

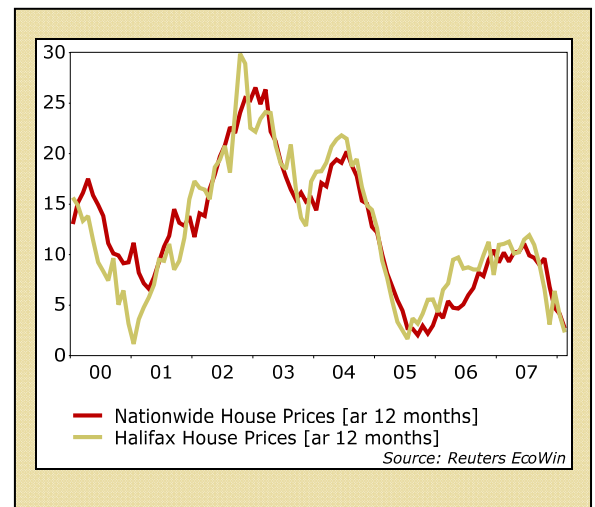
It is clear that the UK housing market is going through a slowdown – **declining forward looking mortgage approvals highlight the risk to see a further deceleration in mortgage lending in the months ahead while house price inflation continues to ease.**

At a time of tight credit conditions, the fact that the Bank of England’s past two interest rates cuts are having no or very little impact on fixed rate mortgages – with a recent report suggesting that many people coming off of fixed rate mortgages in the next few months could face anything between £30 and £300 a month more in mortgage repayments – is also worrying.

Nationwide house prices are expected to continue the softening seen in recent months, and report a 0.4% m/m decline in March, coming after the 0.5% drop in February and corresponding to a yearly rate at 2.0% vs 2.7% (just over a 2yr low). Note that Rightmove also release their March house prices this week.

Jodie Tiller

Nationwide & Halifax House Prices (% , y/y)



Final Q4 GDP (Friday)

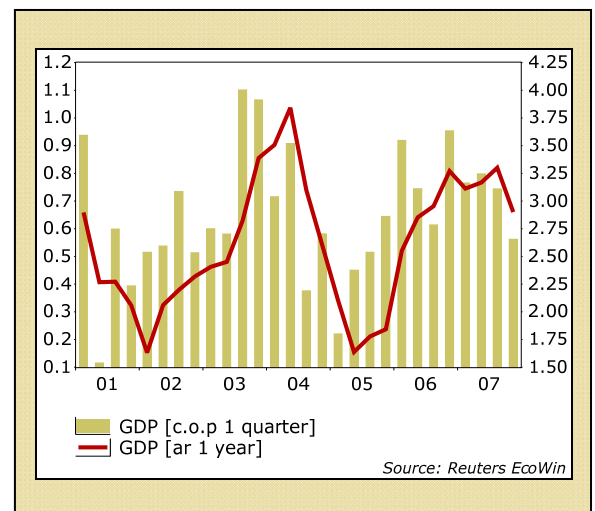
The GDP report this week (final reading) is likely to confirm that **the UK economy continued to expand at a solid but slower +0.6% q/q pace in the final quarter of last year** (down from the +0.7% pace in Q3 and from +0.8% q/q in Q2). **The corresponding yearly rate** is also unlikely to be subject to any major revisions, and instead remain **at 2.9%** (first release), a low not seen since Q206.

Growth in the final quarter was underpinned by strength from the service sector, albeit it a slower pace than in the past (see total services industries output expected at +0.7% q/q vs +0.8% q/q in Q3), while the industrial sector also contributed positively to growth (total production output seen at +0.3% q/q vs flat previously). That pattern could be set for a change as the contribution to growth from **the service sector is anticipated to slow as the consumer sector cannot hold onto to previous levels for much longer in light of the numerous negative effects prevailing at present.**

Even if last week’s February retail sales report confirmed that there is still life in the UK consumer sector, *for now*. Q4 GDP is old news now, what is more important is to see how the economy fared as we started 2008 - 2008 will be a different story to 2007 and likely to evolve at the lower end of the Chancellor’s GDP forecast range.

Jodie Tiller

GDP (% , q/q and y/y)





This Week in the US

Weekly Market Barometer	Latest Trading Level (as at 14.00 GMT on Mar 21)	Near-Term Outlook *	Medium-Term Outlook *
Dir/Yen	99.495	Neutral	Negative
Eurodollars (Jun 2008 contract)	97.790	Small Negative	Positive
US Treasuries (Long Bond)	119-26	Negative	Small Positive

* Near-Term = 1 week ahead
* Medium-Term = 1 month ahead

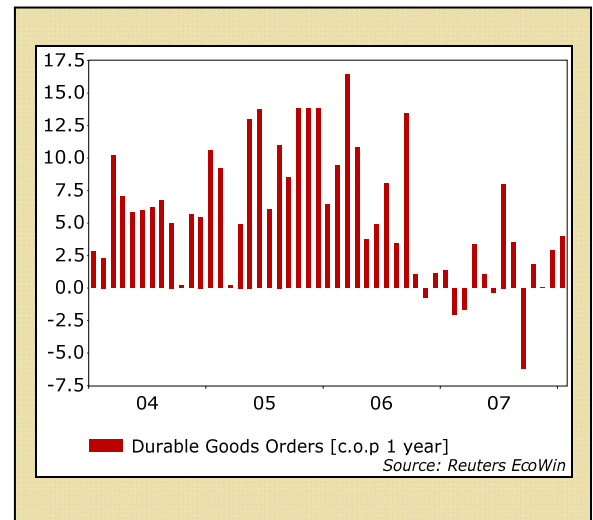
February Durable Goods (Wednesday)

A large increase in the volatile commercial aircraft category should help headline durable goods orders bounce back from a very deep decline in January. Still, the other components of this release are likely to continue to drag down the ex transportation number, although, as always, the one wildcard is defense. Unlike the 2001 US recession, this current downturn is being driven by consumers and not business spending. Yet, it is clear that despite the increase in foreign demand for American made goods due to strong global growth and a weak greenback, no sector of the US economy is completely immune from the current economic slowdown. The most important detail of this report is new orders for non-defense capital goods excluding aircraft, which are a good proxy for capital spending. Although this category is still up for year-to-date, it should follow Jan's lead and continue to drop in Feb and over the months to come.

The outlook for the US economy over the first two-quarters of 2008 is looking increasingly negative. Although capital spending should still be a net a contributor to real GDP over this time period, it appears that its impact is waning as the manufacturing sector continues to struggle from ongoing structural changes and a more sluggish domestic environment.

Meny Grauman

Durable Goods (% , y/y)



This Week in Japan

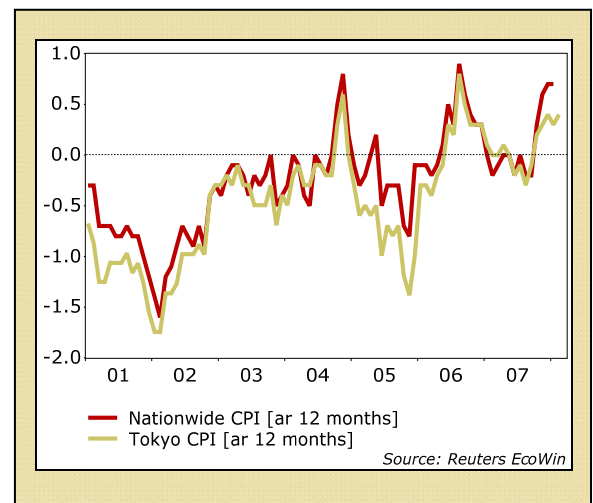
Headline inflation in Japan has been edging higher over recent months, albeit remaining relatively subdued in a global context. As for the prospects for March, Tokyo inflation is likely to edge marginally higher, to +0.5% y/y from +0.4% y/y, while the National measure is anticipated to rise to around +0.9% y/y in February from +0.7% previously.

The news from the retail sector could be a little brighter than what we have become accustomed to, with the y/y rate of retail trade seen rising to +3% in February from 1.3% previously. Meanwhile perhaps a relief to see the jobless rate remaining unchanged at 3.8% in February, but the jobs to applicant ratio is expected to edge lower, to +0.97 from +0.98.

The merchandise trade balance is expected to jump back into a strong surplus position in February after dropping notably in January.

Data may take a back seat this week as the market looks instead to any developments in the BoJ Governor fiasco, as Shirakawa takes the helm (in an acting capacity) until a new Governor is found and agreed upon. **Jodie Tiller**

CPI (% , y/y)



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