



European Weekly Focus

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QUOTE OF THE WEEK *"Business surveys suggest that the margin of spare capacity is relatively limited and that firms are finding it a bit easier to make price increases stick."* **Bank of England Chief Economist Bean, 31st October 2007**

ECB and BoE: wait and see for now, but a different bias

EUROPEAN CENTRAL BANK

BANK OF ENGLAND

Recent Data:

Eurozone Oct CPI (1st est.) +2.6% y/y (vs +2.1% in Sep)
Eurozone Sep M3 MS +11.3% y/y (vs +11.6% y/y in Aug)
Eurozone Sep Unemployment Rate +7.3% (from +7.4% in Aug)
German Oct IFO +103.9 (vs +104.2 in Sep)

Recent Data:

Sep CPI +1.8% y/y (from +1.8% y/y in Aug)
Sep Unemp. down 12.8k (adding to a 4.2k decline in Aug)
Aug Average Earnings +3.7% y/y (from +3.5% in Jul)
Sep Retail Sales +0.6% m/m (vs +0.7% in Aug)

ECB's Recent rhetoric:

"We have got to remain ready to act. We only interrupted the tightening cycle on account of financial market turbulence."
Governing Council member Weber, 22nd October 2007

BoE's Recent rhetoric:

"We [the monetary policy committee] are asking ourselves if things are so different from August and do we actually have to cut rates?" **MPC member Barker, 29th October 2007**

Expected Policy Outcome: Repo rate unchanged, at 4%.

For the fifth consecutive month, we expect **the European Central Bank to maintain its main marginal lending, repo and deposit rates on hold at the November 8 Governing Council Meeting - at 5%, 4% and 3% respectively.**

Recent ECB policy remarks are consistent with a Central Bank that **still has a tightening bias** in place at this stage of the cycle, but given a still relatively unsettled market environment and the limited information on the extent to which this summer's credit crunch is affecting the real economy (not to mention a soaring euro exchange rate), we believe that the European monetary authorities **will opt for a wait and see approach in November.** Recent data/survey evidence from the real economy have reinforced our view that the peak may be behind us in terms of Eurozone activity levels for the current cycle, but the easing in growth comes from a very high base and the medium-term GDP growth outlook remains solid. Notwithstanding a soaring euro, external demand has proven surprisingly resilient of late (this cannot last forever though), conditioning sustained strength in the labour market and solid business investment growth. Meanwhile, the consumer sector remains the weakest link for the Eurozone economy and while consumers have remained hesitant in an above trend growth environment throughout 2006 and into 2007, it is highly unlikely that household consumption will gain sustainable momentum in a weaker growth environment. On the other side of the equation, as captured by the stronger than expected October CPI data, **upside inflation risks persist**, with continued strength in energy and food prices as well as continued tightness in the labour market **of most concern.** **Combined with a stubbornly high monetary growth and associated medium-term upside inflation risks, all this is likely to keep ECB hawks in a vigilant mood.**

A no-change monetary policy outcome seems most likely at this month's Meeting, but the ECB policy bias remains towards **more tightening.** Looking further ahead, **we remain of the view that a stronger euro and softening growth profile mean that the last rate hike scenario may never materialise, but it may take a few more months for ECB officials to abandon their hawkish rhetoric and the risk of a one last rate hike ought not to be totally underestimated.**

Risks:

Probability of unchanged outcome: 75%
Probability of 25bp hike: 20%
Probability of 25bp cut: 5%

Expected Policy Outcome: Base rate on hold, at 5.75%

The case for a **25bp Bank of England rate cut** sooner rather than later remains convincing, but bearing in mind recent policy remarks and considering recent mixed domestic data, we believe that the chance of an actual policy action this week is small. **Indeed, for the fourth consecutive month, expect the MPC to opt for a wait and see approach to monetary policy on November 8th, with a base rate likely on hold, at 5.75%.**

The doves on the MPC will undoubtedly refer to the weaker than expected inflation data of the past few months when pleading for an imminent rate cut: after all, the MPC has an inflation target and with UK CPI back below the Bank's 2% target **for three consecutive months**, there is a little more room for manoeuvre on the interest rate front. The counter argument is that the BoE's 2% inflation target is over a 2 year horizon and the above trend growth environment still prevailing in the UK economy (and consequences for the medium-term inflation outlook) will most likely be referred to when it comes to pledging against a rate cut. Indeed, Q3GDP surprised to the upside again, with a +3.3% annualised growth rate adding to a +3.1% reading in Q2 and confirming an above trend growth environment. This highlighted **reduced spare capacity, something that has been a concern at the BoE in the past.** Notwithstanding a likely slow-down in Q4GDP growth, the strength in Q3GDP was also consistent with an above trend growth performance for 2007 as a whole (close to the 3% mark) and it will most likely leave some on the MPC reluctant to cut interest rates at this stage. The case for a pre-emptive monetary easing exists though, with mounting evidence of a weakening housing sector, an overstretched consumer sector, softer CPI readings and well contained average earnings all backing a rate cut scenario.

We expect the Bank of England to opt for an unchanged monetary policy outcome at this month's Meeting but unlike at the ECB, the bias has to be towards cutting interest rates in the UK.

Risks:

Probability of unchanged outcome: 70%
Probability of 25bp cut: 30%
Probability of 25bp hike: 0%

Audrey Childe-Freeman, Senior European Economist



This Week in the EUROZONE

Weekly Market Barometer	Latest Trading Level (as at 14.00 GMT on Nov 02)	Near-Term Outlook *	Medium-Term Outlook *
Eur/Dlr	1.4476	Neutral	Positive
Euribor (Dec 2007 contract)	93.770	Small Negative	Neutral
Bunds (Dec 2007 contract)	107.83	Small Negative	Small Negative

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

September German Industrial Production (Wednesday)

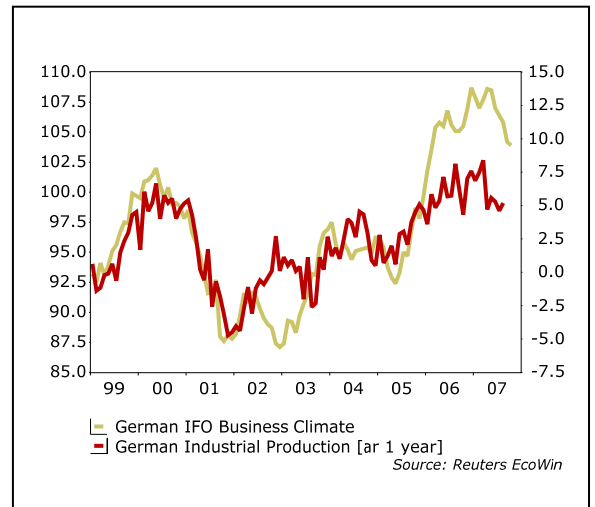
The decline in the surveys in Germany (and the majority of the Eurozone) has not yet translated into softer core data, with activity in both the consumer and industrial sectors remaining in solid territory in September.

The IFO has reported six straight months of decline, but for now the industrial sector remains fairly robust on a historical basis with output rising by 1.7% m/m in August. That run of positive output growth could come to an end in September though, with a -0.4% monthly outturn anticipated, corresponding to a y/y rate unchanged at 5.1%.

Looking further ahead, recent evidence would suggest that the risks to the industrial sector are to the downside, but the German industrial sector is better positioned to absorb a strong euro now than in the past.

Jodie Tiller

German Industrial Production and IFO



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 Nov 02)	Near-Term Outlook *	Medium-Term Outlook *
Cable	2.0832	Neutral	Negative
S-Sterling (Dec 2007 contract)	95.455	Small Negative	Small Positive
Gilts (Dec 2007 contract)	113.90	Neutral	Neutral

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

September Industrial Production (Monday)

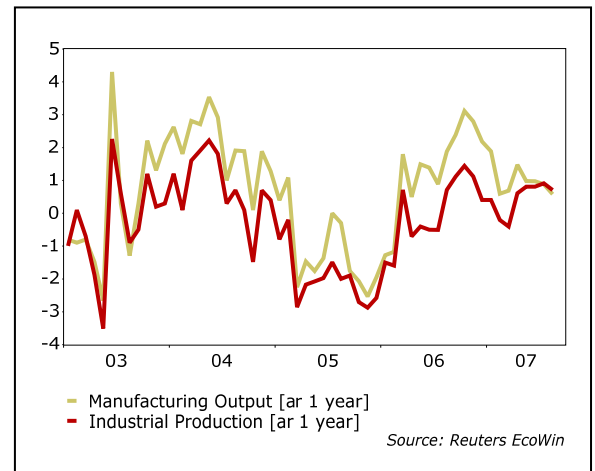
The UK manufacturing PMI remained in expanding territory in October, but the pace of activity decelerated notably, with the headline index edging lower to a December 2006 low of 52.9 from a revised 54.7. The data breakdown highlighted weaker areas in output, new orders and exports (edging closer to expanding 50 level) with all those indices moving lower in October.

As for the prospects for September core industrial production, output is expected to rise by a modest 0.2% adding to the small 0.1% monthly rise posted in August and correspond to a y/y rate at +0.4% from +0.7%.

Looking further ahead, one would have to acknowledge that risks to the industrial sector outlook are tilted to the downside, with the global slowdown and a rising pound both likely to weigh on activity levels in the months ahead, as exporters struggle to stay competitive.

Jodie Tiller

Industrial and Manfg Output (% y/y)



October Services PMI (Monday)

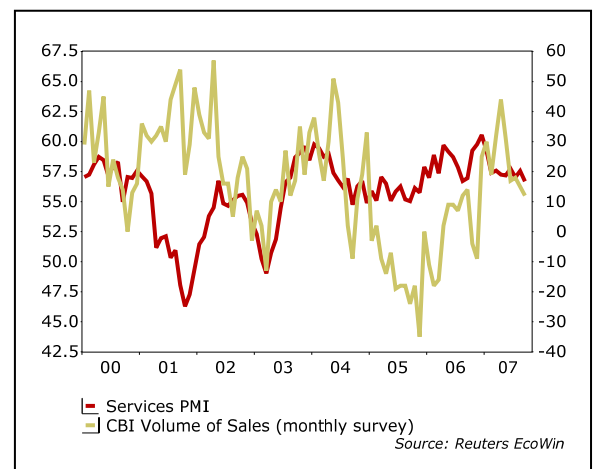
Not that the CBI distributive trades survey (DTS) and services PMI always correlate strongly on a monthly basis, but last week's CBI DTS which confirmed a slowing in the pace of retail sales activity in October (to a November 2006 low) points at a potential softening in the headline services PMI in October.

Up until very recently, we had become accustomed to retail surveys and indeed core data surprising to the upside in the UK, but recent evidence has suggested that higher interest rates, the credit crunch and a weaker housing market might finally be affecting sentiment and spending patterns in the UK.

Expect this week's services PMI to ease to 56.2 in October from 56.7, following other recent anecdotal evidence suggesting a slowdown in the pace of retail activity.

Jodie Tiller

Services PMI and CBI Total Sales Balance





This Week in the US

Weekly Market Barometer	Latest Trading Level (as at 14.00 GMT on Nov 02)	Near-Term Outlook *	Medium-Term Outlook *
Dir/Yen	114.83	Neutral	Neutral
Eurodollars (Dec 2007 contract)	95.250	Neutral	Small Positive
US Treasuries (Long Bond)	111-05	Neutral	Neutral

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

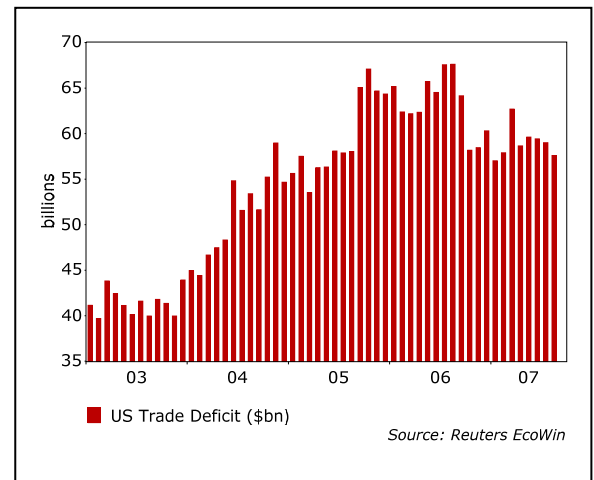
September Trade Balance (Friday)

The US trade deficit for September is expected to be higher than August's \$58bn primarily because import prices would have ramped up with the ascent of oil. A sharp drop in the US\$ may also have pushed up prices for non-petroleum imports, outweighing the negative impacts on the volume of imports Americans bring in. As a result, we expect the trade deficit to widen to \$59.8bn. That would be roughly consistent with what the Commerce Department assumed in its 3.9% "advance" estimate for Q3 GDP growth, and still leaves the quarter with a nearly 1% contribution to growth from real trade.

Our forecasts are in line with the Commerce department's assumptions for September's trade balance, and would therefore not alter the picture for Q3, or our Q4 outlook. While net trade won't be as solid in Q4, we expect trade to continue to contribute to growth over the coming year, as a weak US\$ makes American products more competitive on world growth, and as cooler US consumer spending slows America's import appetite.

Avery Shenfeld and Krishen Rangasamy

Trade Deficit (\$bn)



This Week in Japan

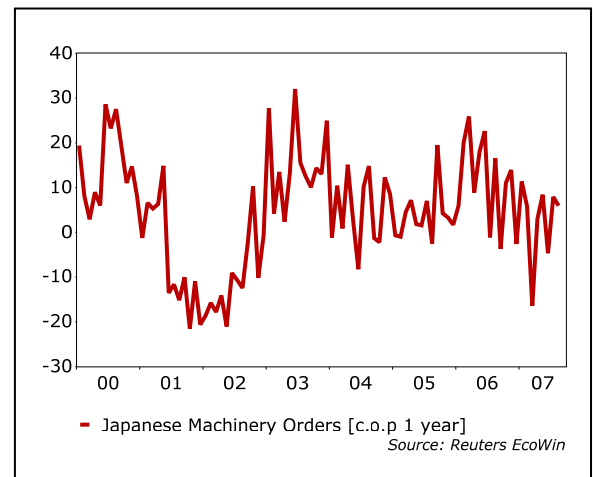
The Japanese calendar is rather light this week with the only likely market moving data to be released on Thursday – in the form of September machinery orders. Whilst known to be a volatile series, those are expected to remain in the red again in September, at -1.8% m/m, adding to the 7.7% plunge in August and since they provide a good proxy for capital spending in Q3, the outlook there looks rather bleak.

Other data on tap this week include the September leading economic index (expected to report a flat outcome representing a deceleration from the 27.3 reading in August), while final September industrial production is likely to remain close to the first estimate of -1.4% m/m – one of the softest IP readings in September from the G7 – but such a level would keep the two-month moving average in positive territory.

Finally, the minutes from the September MPB meeting may be seen as old news since Fukui used last week's post-meeting press conference to update us on the latest views at the BoJ, with the gradual approach to normalizing rates still favoured.

Jodie Tiller

Machinery Orders (% y/y)



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