

# Macroeconomic Outlook

Research Department

December 2007

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## 2008 outlook: problems coming to a head

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**Declining growth forecasts, but increasing inflation estimates**

The financial crisis that erupted in the summer has lent increasing authority to the forecasts of a slowdown in global economic growth already factored into our outlook. The risk premium priced into interbank rates shows no sign of receding, which implies tighter interest rate conditions in the Euro area, and broadly unchanged conditions in the United States; the tightening is magnified by corporate spreads at higher levels than at start-2007, by the slide in the equity indices, and also by the need for banks to protect capital eroded by portfolio write-downs and the difficulties in easing pressure on assets via securitisations. Another aspect of the forecast that has been reinforced by the events of recent months is the support afforded by the emerging economies, as is apparent this year: between 2007 and 2008 economic growth will slow from 2.5% to 2.1% in the industrialised nations, and relatively less, from 6.5% to 6.1%, in the developing countries. In truth the financial systems of the main emerging economies have not been significantly affected by the crisis; in addition, domestic demand should help attenuate a slowdown in global demand that does not involve a decline in US imports, which usually only happens during recessions. This means that the slowdown in global growth will be relatively modest, probably around 4-5 tenths of a point, and the rate of expansion will remain high (*too high in some respects*) relative to the historical average. Thus, in the baseline scenario general conditions remain conducive to growth in commodities demand, which in turn helps to keep down spare capacity margins in the oil sector. This promotes growth in average oil prices, which are expected to be 11% higher than in 2007 – but below the November highs (see page 6).

### Economic growth by region

	2004	2005	2006	2007	2008	2009
<b>USA</b>	3.6	3.1	2.9	2.2	1.8	2.6
<b>Japan</b>	2.7	1.9	2.4	1.8	1.4	1.7
<b>Eurozone</b>	1.8	1.6	2.9	2.6	2.0	2.2
<b>Eastern Europe</b>	6.8	5.7	6.9	6.7	6.0	5.4
<b>Latin America</b>	6.1	4.5	5.4	5.3	4.4	4.0
<b>OPEC</b>	7.9	7.8	6.1	5.8	5.2	4.9
<b>East Asia</b>	8.1	7.8	7.9	9.2	8.1	7.3
<b>Africa</b>	4.9	4.6	5.7	5.8	5.4	4.9
<b>World growth</b>	4.9	4.4	5.2	5.2	4.7	4.6

Average percentage changes over year ahead. Source: Intesa Sanpaolo

**Uncertainty is still strong, and affecting different sectors**

On the other hand, the clouds on the horizon have by no means dissipated. The situation in the coming months will be marked by a turbulent mix of financial tensions, monetary easing and measures to shore up market liquidity, against the backdrop of a slowdown in economic activity already well under way and higher than expected inflationary pressures. Further complicating the picture, the freezing up of the interbank market and the need for banks to protect their capital makes the timing and intensity of the transmission of monetary policy impulses uncertain, with variable effects depending on the level of bad loans on bank balance sheets and also on local institutional situations (for example, average rates on loans in the United States have reacted to the rate cut far more than might have been imagined). It is by no means a given fact that the surprises will be exclusively negative in the coming months. The central banks in the regions most affected by the repercussions of the crisis have taken aggressive action, based on such massive injections of liquidity as to saturate the system and directly satisfy all banking players, thereby leapfrogging the jammed mechanism of the money market. In these circumstances, which help the most exposed

institutions to deleverage, it is extremely hard to imagine that banks will experience a liquidity crisis; if anything, one may well ask whether those banks which in the past have managed risk more wisely are not being unduly penalised. The markets price in a partial reduction in risk premiums on the money markets in the first half of 2008, but the actual prospect of this depends on the crisis of confidence being overcome, and therefore on the acquisition of certainties regarding the size of the individual problems of the lending institutions participating in the market.

As is clear from the forecasting charts, and without prejudice to what we said regarding a less pronounced slowdown in the emerging countries, we do not believe there will be a genuine decoupling of regional growth rates. Aside from the transmission of the US economic slowdown, which has been magnified by exchange rate movements, global factors are at work (spike in commodities prices, financial crisis), operating in tandem with local factors (for example, the investment cycle in the Euro area). 2008 will be a period in which Euro area growth eases towards the lower levels currently being recorded in the United States, with potentially negative implications for the level of the Euro/US Dollar cross.

Inflation will continue to be buoyed by the spike in commodities prices. The price increase estimates for 2008 have been revised up since September in all the main regions. The level of expected inflation may be an obstacle to monetary easing in the Euro area. But talk of stagflation seems overdone for more than one reason: first, the slowdown in growth to below trend should ease endogenous price pressures over time; second, the repercussions of the hike in fuel prices on inflation expectations remain relatively moderate; third, the ability of the energy price hikes to drive up inflation in other sectors is limited and transitory.

#### Commodity price projections

	2004	2005	2006	2007	2008	2009
<b>Oil price; Brent crude spot\$/barrel</b>	38.3	54.4	65.4	72.5	80.3	75.5
	+32.7	+42.1	+20.1	+10.9	+10.7	-3.7
<b>Non-fuel commodities price index</b>	122.5	135.1	173.5	200.9	198.0	189.7
	+18.5	+10.3	+28.4	+15.8	-1.4	-3.7
<b>World price of metals</b>	134.0	169.3	265.1	330.1	313.2	269.6
	+36.2	+26.4	+56.5	+24.5	-5.1	-13.9
<b>Agricultural raw materials world price</b>	105.9	107.6	118.4	130.0	136.6	136.3
	+5.5	+1.6	+10.1	+9.8	+5.1	+3.1

Levels and average annual rate of change. Source: Intesa Sanpaolo

#### Outlook by area in brief

##### United States

The central forecast for the US economy, despite the many negative shocks it has incurred, is still that of a **relatively soft landing**, with growth expected to be just under 2% in 2008 (new forecast: **1.8% for 2008**). The negative effect of the oil price and the tightening of credit conditions, added to the correction in the residential real estate sector, should be offset by dollar depreciation and Fed rate cuts. However, this scenario is surrounded by **downside risks to growth**, concentrated in the possible (and still extremely uncertain) effects of the financial crisis on bank balance sheets, on the equity market, and on re-intermediation in several segments of the credit sector. Since the Fed will continue to assign priority to the risks to growth and the financial system over the price risks in the short term, we believe the maintenance of growth close to 2% in 2008 is accompanied by **upside risks to inflation in the next two years**. The Fed should cut rates twice more in first quarter 2008, taking Fed funds to 3.75%: this

forecast is highly uncertain and depends in part on how the liquidity crisis evolves and also on the trend in spreads and market rates.

### **Euro area**

For the Euro area our central forecast is for GDP growth of 2% in 2008 vs. 2.6% in 2007, broadly unchanged from the September estimates (2.1%). The outlook assumes growth of 0.4% qoq in GDP in 4Q07, slowing from 0.7% qoq in the summer months. We still believe that a slowdown significantly below trend is unlikely since the domestic fundamentals remain solid. However, we think that in the last three months the risks have increased in light of the ongoing turmoil on the financial markets and more widespread pessimism over US and international economic growth. Overall, we put the downside risks to growth at around 0.5%. The greatest threat still stems from the financial crisis which, according to our simulations, might hit investment spending particularly hard. Given the lower exposure to debt among European households compared with their US counterparts, and given the absence of widespread overvaluation of the real estate system, we believe the consequences for household consumption are limited (with some differences within the Euro area). Support to growth might come from fiscal policy, which will be generally accommodating in all the main countries. The inflationary dynamic will continue to average 2.5%. Although we believe that the rise in consumer prices seen at end-2007 (3.1% yoy in November) is a blip, the risks to price stability in the medium term are still on the upside since second-round effects cannot be ruled out.

The ECB has taken aggressive action to rectify the anomalies on the markets and will continue to do so until the situation normalises. However, we believe that official interest rates will remain unchanged at 4% throughout 2008, since the macroeconomic outlook for the Euro area and the absence of systemic imbalances like those in the USA do not justify an “insurance” type cut such as those implemented by the Fed and BoE. With an explicit price stability mandate in the medium term, the ECB is less trapped than other central banks between the Scylla of “subdued growth” and the Charybdis of “high inflation”. If and only if clear signs were to materialise that Euro area growth will remain below trend in the second half of 2008 might the ECB consider relaxing monetary policy

### **Japan**

In 2008 the Japanese economy will experience the effects of the two main factors in the 2008 global outlook: **growth slowing, albeit not dramatically, and inflation rising**. As with the global economy, in Japan too the slowdown in growth should be contained both in duration and extent, thanks to the support afforded by the growth in the major emerging economies and accommodating monetary conditions. Financial conditions in Japan remain accommodating, and will be increasingly relaxed in 2008, owing to the expected fall in real interest rates generated by the rise in prices and the slowness with which the BoJ normalises monetary policy. We forecast growth around trend again in 2008, positive inflation and two more rate hikes by the BoJ, in the middle and at the end of the year.

### **China**

The Chinese economy will continue to be driven by domestic demand in 2008, with limited effects from the restrictive measures on overall growth.

## **Outlook for the markets**

### **Bond markets**

In terms of direction, our forecast for the UST curve conforms to the view of a “V-shaped” cycle in 2008, with a low-point coming in the first six months. This forecast presents downside risks connected with the possibility of a prolonged period of subdued growth. An “L-shaped” cycle might generate marked bull steepening on the curves, even from the current levels.

On the European curve, the underlying tendency in 2008 is upward. In the first half it will be mainly the link with the U.S. Treasuries curve that drives directional

movements, whereas in the middle part of the year a more dovish ECB, coupled with a slowdown in growth and inflation, should allow a partial decoupling.

In terms of slope, we still see promise in steepening positions on the 2/10Y or 2/5Y segments of the USD curve, whereas on the Euro curves we believe the opening of steepening positions is premature and too risky in the short term vs. long duration positions at the short end. In short term, our preference for long positions at the short end of the European curve is accompanied by a preference for 10/30Y steepening positions.

***Forex markets***

We believe the Dollar's weakness vs. the Euro is nearly over, whereas downside remains vs. the Asian currencies. The Dollar will in any case stabilise at weaker levels than in past years. The Euro is expected to fall vs. the greenback and the Yen. Sterling will be penalised by the loosening of monetary policy.

***Stock markets***

In terms of valuations, the US and European stock markets look attractive, but the threats hanging over the United States and the financial system in terms of recession risk and impact of the subprime mortgage crisis counsel caution for the time being. The current modest underweighting of US equities, justified by the economic and financial risks, might however be gradually removed over the coming months and be turned into an overweighting. We view the state of the European market as relatively more solid.

### A fruitless game of catch-up

A violent bout of profit taking has brought down oil prices by between 10% (Light Crude) and 7% (Brent) from the 23 November highs. The level of net speculative positions has been cut drastically, while signs of positions being rebuilt around USD 90 have so far proved insufficient to ensure stabilisation. As with the whole of the latest upsurge, it would be self-serving to use changes in the market fundamentals (greater pessimism over US growth? expectations of an increase in OPEC output?) to justify the reversal: quite simply, we have seen the natural termination of a period of speculative overshooting.

Now that the charts are starting to show some peaks and troughs rather than pointing only upward, we can once again analyse the market's prospects more coolly.

#### Short-term forecasts

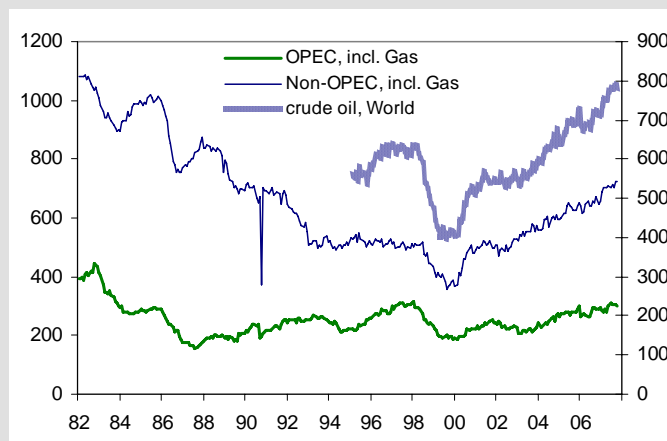
In the short term the downward correction in prices is not necessarily over. Prices remain well above the value estimated by the forecasting model for the current and the next quarter. In addition, the graphical analyses currently show a weak outlook, with risks of a fall in the WTI below USD 87.2 with subsequent targets at USD 83-84. However, at these levels the downward signal given by the fundamental model would be extinguished and the foundations might be created for a resumption of the uptrend.

In support of prices:

- a level of inventories well below 2006, albeit in line with the historical average;
- the perception that Opec has little flexibility in managing the market, with only Saudi Arabia able to move production, and that in any case it does not intend to promote significant inventory accumulation in the consumer countries;
- the geopolitical risk, the usual flashpoints being Iraq, Iran, Venezuela and Nigeria;
- ongoing investor interest in commodities, whose uptrend is seen as structural rather than cyclical.

Whilst not new, these issues can still trigger expectations of a rise in prices. The two main downside risks are connected with a possible recession in the United States, which might impact on crude oil demand in Asia too, and the weather factor (for example, a milder than expected winter in the northern hemisphere).

#### Robust expansion in extraction activity under way



Source: Baker Hughes, Rig Counts.

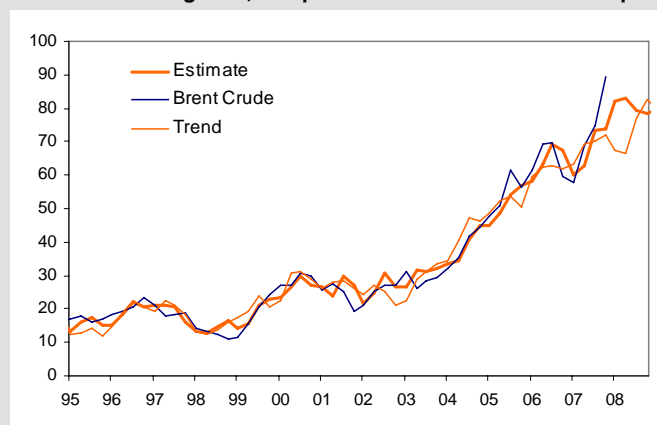
### Growing doubts over long-term equilibrium

The first element to consider stems from the IEA's World Energy Outlook update. The IEA's scenario out to 2030 incorporates growth in oil demand of 1.3% p.a. (1.7% in the decade 2005-15), below that envisaged for total primary energy demand. Around three-quarters of the increase (25M bbl/day out of a total of 32M) comes from developing countries, and 42% from just China (+3.6% yoy avg.) and India. It will not go unnoticed that the outlook assumes a significant slowdown in oil demand over the coming decades, despite assuming an oil price of around USD 60 at constant 2006 Dollars, i.e. nominal price growth of around 2% p.a. which would take the price to USD 100 nominal only after 2030. Implicitly, it is assumed that the maturing of the Chinese and Indian economies will slow economic growth and energy demand to an even greater degree.

According to the IEA, in the baseline scenario supply-side growth (including oil sands and NGL) would be sufficient to satisfy the growth in demand expected through to 2030, despite the misgivings of advocates of peak oil. In recent years there has been a boom in investments in exploration and development, which doubled between 2000 and 2005. The increase in capacity out to 2012 is estimated at 25M bbl/day, of which 11.4M in OPEC countries, based on the expansion projects indicated by the organisation itself, while a further 12.5M bbl/day should be added between 2012 and 2015; of this total 37.5M bbl/day, no less than 14M will offset the fall in production at fields now being exploited, assumed to be 3.7% per annum. But there are four caveats:

1. rates of production decline might be greater than expected. The IEA estimates that a default error of 0.5% would be sufficient to cancel out the entire residual capacity margin by 2015.
2. the expansion of demand might surprise on the upside. Assuming more robust growth in demand from the developing countries (3.3% yoy instead of 2.6%), the IEA estimates annual average growth in oil demand of 1.5%: the projection for 2030 is thus 120M bbl/day, 3.6M more than in the baseline scenario. A significant increase in prices vs. the baseline scenario (+21% average, +40% in 2030) is necessary to attract investments (USD 392Bn constant cumulative, in addition to the USD 5360Bn required in the more moderate growth scenario) and to produce more rapid growth in the production of oil from non-conventional sources, including coal-to-liquid conversion, and to keep the market in balance.
3. the start-up of projects might be more prone to delays than in the past.
4. by contrast, assuming that the much higher current prices persist, this would imply long-term growth in demand below that envisaged in the baseline scenario, and greater incentives to invest in the expansion of production capacity. Owing to the low level of short-term elasticity to prices, demand has so far absorbed only some of the effects of the spikes seen in recent years.

#### With overshooting over, an upward trend remains for the oil price



Source: Intesa Sanpaolo. The trend estimate reports the output of the long-term component only.

The conclusion is that expansion plans for the period over which we have visibility will keep the residual capacity margin relatively low and will therefore expose the market to the recurring risk of price spikes. The perception that supply might not keep up with demand will continue to influence the markets. Together with the fall in the confirmed reserves/production ratio, this factor justifies a steeper uptrend in the oil price than that used by the IEA, and creates the conditions for high price volatility. Thus, for policymakers there would be excellent reasons, even leaving aside the local and global environmental impact, to promote a decline in oil product consumption.

To what extent may the scaling back of oil be helped by the international price dynamic alone? Our baseline scenario envisages prices over USD 80 in 2008, topping USD 100 (nominal) in 2010. In the model, a permanent increase of 10% in prices implies a contraction in demand at regime of 0.5M bbl/day, with linear effects. In practice, however, the persistent overshooting of critical thresholds might result in non-linear effects, connected with strategic decisions that accelerate technological replacement and increase the long-term elasticity of oil demand to the movement in prices. The estimates of the IEA indicate a long-term elasticity of fuel demand to the crude oil price of 15%, such that a doubling of the oil price would lead to a decline in demand relative to the baseline of 15%, approximately equivalent to the cancellation of the growth expected in the following ten years. Accordingly, the rise in fossil fuel prices alone might prove insufficient to produce a sufficiently rapid stabilisation of human emissions of CO<sub>2</sub> without the contribution of specific public actions.

In electricity production, the spike in the oil price would also drive up natural gas prices and would increase the pressure to switch to renewables, nuclear and coal, whilst also delivering benefits on the energy security front. In the IEA's scenario of high growth levels, coal consumption in 2030 is 12% higher than in the baseline scenario. However, the growth of coal as a primary energy source has grave repercussions on the volume of human CO<sub>2</sub> emissions: in the same scenario total CO<sub>2</sub> emissions grow 68% from 2005, vs. 57% in the baseline scenario, which also projects a growing role for coal as a primary energy source. Moreover, the costs of coal capture and storage technologies (CCS, CO<sub>2</sub> capture and storage) at the new coal-powered power stations are estimated by the IEA at around USD 50 per ton of CO<sub>2</sub>, well above the current market prices for emission quotas on the European market, and voluntary adoption on a large-scale is therefore unlikely without public intervention.

With regard to transportation, given the scant weight of fuel consumption within household incomes and the secondary role it plays in vehicle purchasing decisions compared with other parameters, it is doubtful whether a reduction in consumption per km based on the average vehicle fleet (achieved by imposing energy efficiency standards, the large-scale adoption of hybrid vehicles, or other measures) is possible without intervention by the regulator. The rise in the oil price and the political decisions taken to contain CO<sub>2</sub> emissions also support the growth in biofuels, which to some governments seems the most attractive alternative in order to avoid the politically fraught option of energy saving. With the existing technologies, the saving in terms of CO<sub>2</sub> emissions is estimated at ranging from a minimum of 13% for corn-based fuel (the option adopted by the United States), to a maximum of 90% for Brazilian sugar cane, via the 40-60% for sugar-beet proposed in Europe. But, unfortunately, the development of biofuels may carry environmental costs of another order: the production of corn and sugar-beet requires quality farmland and entails the intensive use of chemicals in the form of fertilisers and pesticides, while the increased landmass given over to sugar cane crops may accelerate deforestation in tropical regions. In addition, although the proportion of arable land given over to biofuel production is just 1%, there are already cases where this crop is competing with food production, driving up grain costs. It is therefore unlikely that there will be rapid replacement of crude oil with biofuels in the coming years. Overall, the IEA projects a biofuel percentage of between 4% and 7% in 2030, which is still enough to create upward pressures on farm commodities prices as well.

*(Luca Mezzomo)*

## United States: growth slows while inflation accelerates

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Despite the many negative shocks experienced by the US economy, the central scenario remains one of a relatively soft landing, with growth seen at just below 2% in 2008 (our new forecast puts the figure at 1.8%). The negative impact of oil prices and the credit crunch, coupled with the downturn in the residential housing market, are likely to be counterbalanced by the decline in the dollar and interest rate cuts by the Federal Reserve. However, the outlook is dimmed by downside risks to growth, relating to the potential (and still very uncertain) effects of the financial crisis on banks' balance sheets, the equity market and interbank lending in some parts of the credit sector. Since the Fed is still more worried about the risks to growth and the financial system than risks to prices in the short term, we believe that growth at around 2% in 2008 will be accompanied by upside risks to inflation over the next two years.

Concerns over an inflation rate that will be uncomfortably high for the central banks in the medium term will be the pressing issue for next year. Monetary authorities will no longer be able to indulge in the same unrestrainedly expansive policies introduced by the Fed when it last faced with recession in 2001. This year it seems very clear that the central banks' main dilemma – that is, how to steer a middle path between stabilising growth and curbing inflation – has returned to the fore, after a period in the background due to the early effects of globalisation and the arrival on the markets of emerging countries. At this stage in the cycle, the safety net to growth provided by the expansion of the biggest emerging markets comes at a cost for the industrialised nations – that of upward pressures on energy and agricultural commodities. In the very near term, it is evident that the priority of central banks in general, and the Fed especially, is to kick-start the movement of liquidity, bringing money market rates back to their target rates and returning spreads to normal levels. For the Fed in particular, the combination of the credit crunch and excess supply of residential real estate has triggered an additional risk factor: that of falling house prices. Amid fears of a downward spiral in property values, fuelled by an increase in foreclosures, the Fed will have to loosen the monetary reins further over the next few months. However, once this emergency has been dealt with and a potential recession averted, inflation will become the main issue.

### Forecasts – United States

	2006	2007	2008	2007				2008			
				1	2	3	4	1	2	3	4
GDP (1996 US\$,y/y)	2.9	2.2	1.8	1.5	1.9	2.8	2.5	2.6	2.0	1.1	1.4
q/q annual rate				0.6	3.8	4.9	0.8	0.9	1.3	1.4	1.9
Private consumption	3.1	2.8	1.6	3.7	1.4	2.8	1.1	1.6	1.5	1.8	1.9
Fixed investment - nonresid.	6.6	4.7	5.8	2.1	11.0	9.3	5.9	5.6	4.2	3.1	4.1
Fixed investment - residential	-4.6	-16.4	-10.7	-16.3	-11.8	-20.5	-17.5	-10.5	-5.1	-1.9	-1.3
Government consumption	1.8	1.9	1.5	-0.5	4.1	3.8	0.2	1.2	1.3	1.2	1.2
Export	8.4	8.0	7.0	1.1	7.5	19.1	4.7	5.0	5.2	6.0	7.4
Import	5.9	2.3	3.7	3.9	-2.7	4.4	4.3	3.7	4.0	4.6	4.3
Stockbuilding (% contrib. to GDP)	0.1	-0.2	0.0	-0.2	0.0	0.2	0.1	-0.1	-0.1	-0.1	-0.1
Current account (% of GDP)	-6.2	-5.5	-5.2	-5.9	-5.6	-5.2	-5.7	-5.5	-5.4	-5.2	-5.1
Federal Deficit (% of GDP)	-2.1	-2.0	-2.5								
Gov. Debt (% of GDP)	62.2	62.6	64.4								
CPI (y/y)	3.2	2.8	2.6	2.4	2.7	2.4	3.7	3.3	2.4	2.4	2.1
Industrial production	4.0	2.1	1.3	1.1	3.6	4.3	0.5	1.6	0.6	-0.2	0.2
Unemployment (%)	4.6	4.6	5.0	4.5	4.5	4.6	4.7	4.8	4.9	5.1	5.1
Fed Funds	4.96	5.03	3.82	5.26	5.25	5.07	4.53	4.04	3.75	3.75	3.75
Effective exch.rate (1990=100)	82.5	77.9	75.5	81.9	79.3	77.0	73.3	73.6	74.9	76.2	77.1

Percentage annualised growth rates over previous period, if not otherwise specified.

## 1. Opposing shocks: dollar and Fed ward off recession

In the past few quarters, the US economy has suffered a number of shocks that have had opposite effects. In addition, the breakdown in the credit market coupled with the fall in house prices are unprecedented events, making it difficult to make forecasts. As a result, assessing the future impact of these shocks is particularly problematic. On the monetary policy front too, this situation is different from the past, since to tackle the problems the Fed has acted pre-emptively. This, plus the fact that interest rate cuts have been rendered less effective by the problems on the financial markets and the ongoing credit crunch, makes it difficult to evaluate the impact of monetary policy.

To calculate the effects of each individual shock on growth and inflation, we used an OEF model to simulate the impact of the dollar's depreciation, the fall in house prices and the rise in the price of oil, considering unchanged monetary policy. The simulation shows that the biggest impact on growth comes from the fall in the effective exchange rate, as can be seen from the table below. Using the results of a recent study by Mishkin<sup>1</sup> to evaluate the effects of the house price shock however, we can see a negative impact on GDP, which counteracts the effects of the declining dollar.

The simulation reveals that the falling effective exchange rate has a 10% effect on growth (the same as that actually observed since the start of this year), falling house prices (measured by the OFHEO index) 5% and the rising oil price 10%.

### Effects of each shock considering unchanged monetary policy

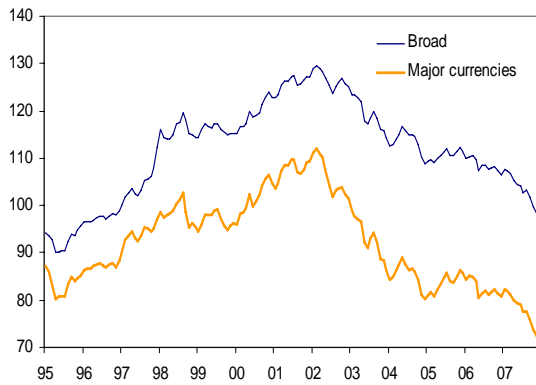
	Effective exchange rate			House prices			Oil		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
<b>GDP</b>	0.7	1.13	0.6	-0.1	-0.37	-0.4	0	-0.1	-0.1
<b>CPI</b>	0.3	1.3	2.5	0	0	-0.2	0.3	0.7	0.9
<b>Consumption</b>	0.1	0.5	0.4	-0.1	-0.4	-0.4	-0.1	-0.2	-0.3

Source: Intesa Sanpaolo

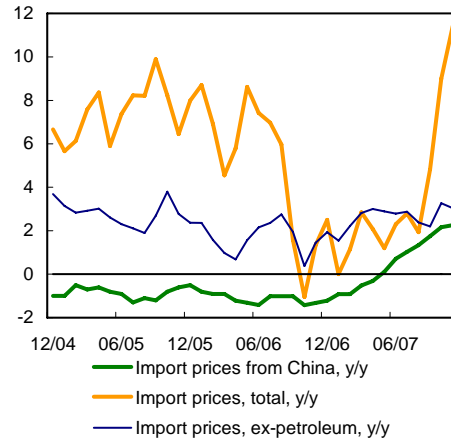
**a) Exchange rates** – the results of the simulation are not much different from those obtained by the Fed using the FRB/US model. In the Fed's simulation, a **permanent decrease** of about 10% in the real effective exchange rate has a positive impact of 0.4% in the first year, 1.2% in the second year and 1.3% in the third. According to the **OEF model**, a 10% fall in the effective exchange rate, with interest rates remaining constant, raises GDP by 0.7% in the first year and 1.13% in the second. The effect on inflation is also very marked, as the second line of the table above shows.

<sup>1</sup> F. Mishkin, *Housing and the Monetary Transmission Mechanism*, FRB Working Paper 2007-40, August 2007

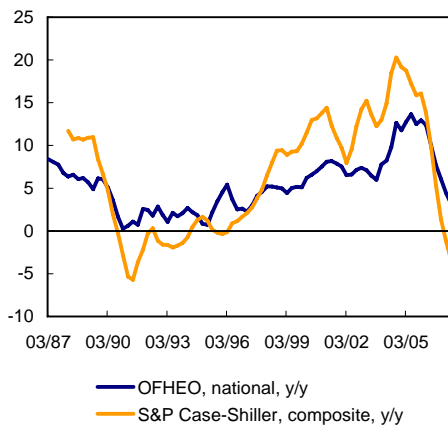
**Dollar: effective exchange rate**



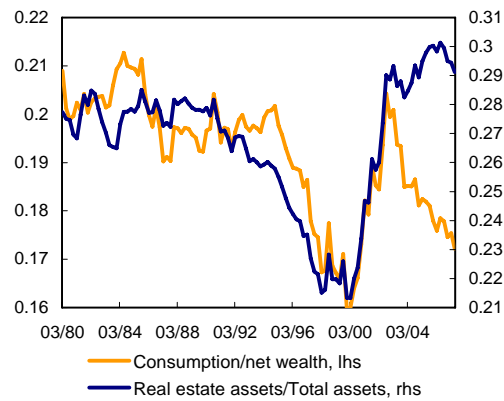
**Import prices**



**House prices**



**Even a further fall in house prices would not wipe out consumer spending growth**



Source: *Ecowin*

**b) House prices** – The impact of falling house prices in the simulation is very strong. A fall of 5% in the OFHEO national index of house prices has never been recorded, but as the graph shows, a hypothetical 5% decline in the index would be consistent with a further drop in the S&P Case-Shiller composite index, one that is much sharper than anything ever observed in the past. The impact of falling house prices is small, since all the wealth effects are diluted over time. It is possible that the model does not capture all the transmission mechanisms via which a house price shock acts. In the FRB model, the impact on GDP of a 20% fall in real house prices as measured by the S&P Case-Shiller index – that is, a slightly bigger shock than the one modelled by us – is around -0.5 pp after three years. Mishkin’s study extends the FRB/US model to make a more accurate assessment of a real estate shock. It shows that, with a larger number of active transmission channels, falling house prices have an impact that is about three times greater than that obtained using the FRB model. However, the analysis also reveals that **pre-emptive interest rate moves neutralise most of the effect on GDP**.

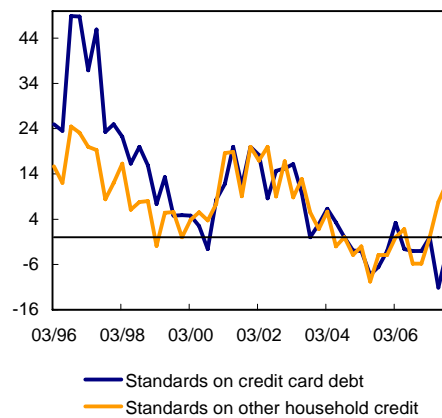
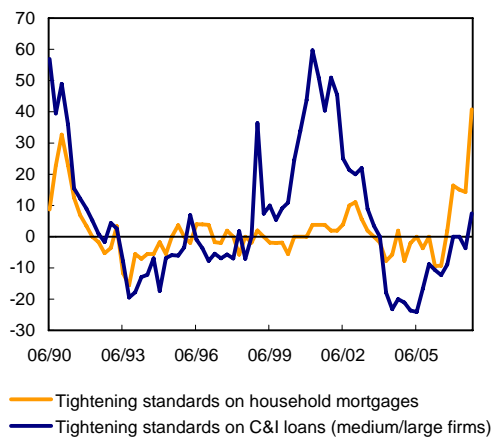
**c) Oil price** – Again according to the Fed’s model, a permanent increase of USD 10 in the **price of oil** trims growth by 0.2% in the first year, 0.4% in the second and 0.2% overall at the end of the third year, in a scenario of unchanged interest rates. According to the OEF simulation, however, a 10% rise in the oil price would

have only a limited effect, since with policy rates unchanged, real rates correct downwards.

**d) Credit crunch** – It is more difficult to simulate this shock, which has hit the financial markets in recent months. The evidence emerging from the Fed's survey of Senior Loan Officers confirms the sharp rise in interest rates charged to both households and companies since the third quarter. Nonetheless, business surveys do not indicate any particular intensification in the credit crunch so far: the NFIB survey for October, for example, found that companies were having no difficulty in obtaining finance.

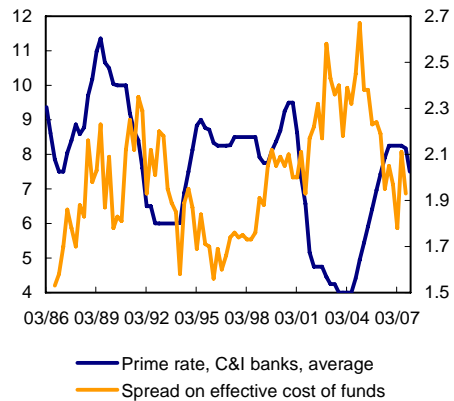
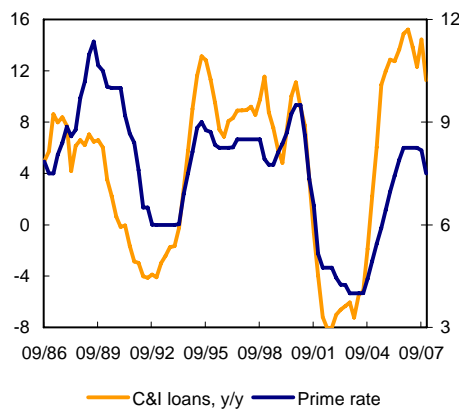
**Senior Loan Officer Survey: tighter conditions...**

**... especially for households**



**Banks plan to increase spreads on rates charged...**

**...but the cut in policy rates cancels out much of these increases**

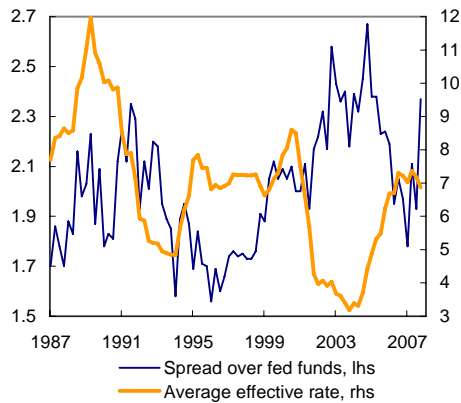


Source: *Ecwin*

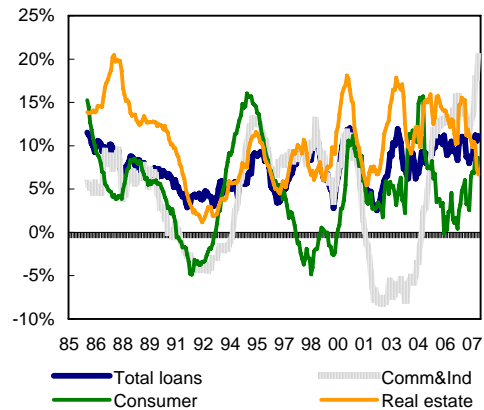
As regards interest rates charged by banks, the Survey of Term Business Lending conducted on a sample of banks between 5 and 9 November and published by the Fed in mid-December, makes reassuring reading: **the monetary policy transmission mechanism has not jammed**, although liquidity is not reaching operators on the non-banking financial markets. The survey reveals that 1) rates on industrial and commercial loans to all types of borrower (i.e. prime and subprime, large and small, in various sectors) have fallen broadly in line with official interest rates; 2) the widening in spreads shown in the Senior Loan Officers survey is fairly moderate, and less marked so far than during recessions. This is shown in the charts below. The trend in industrial and commercial loans, which has accelerated since the summer, is due to banks' bringing loans

previously converted into asset-backed securities back onto their balance sheets after the ABS were not rolled over. Over the next few months, banks may start rationing credit, with a view to topping up their falling capital ratios. However, surveys show that companies are having no problem in obtaining finance to date. In addition, the NFIB's December survey indicates that the availability of credit, the level of interest rates and expectations about credit conditions for the next three months are improving, after a deterioration in the summer.

**Rates on industrial and commercial loans**



**Industrial and commercial loans rise sharply, while mortgage lending falls**



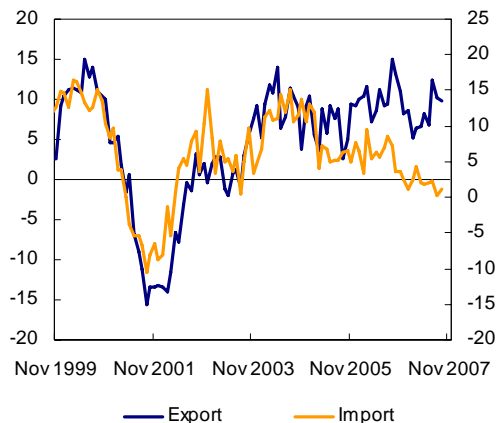
Source: *Ecwin*

As regards the credit crunch for **households**, which is certainly more of an issue given problems with mortgages and the sharp rise in arrears and defaults, we can see that mortgage lending is expected to slow (see chart above), while non-revolving credit is also falling. Nonetheless, according to figures from Bankrate.com, rates have fallen on all types of existing loan, in response to the looser monetary policy.

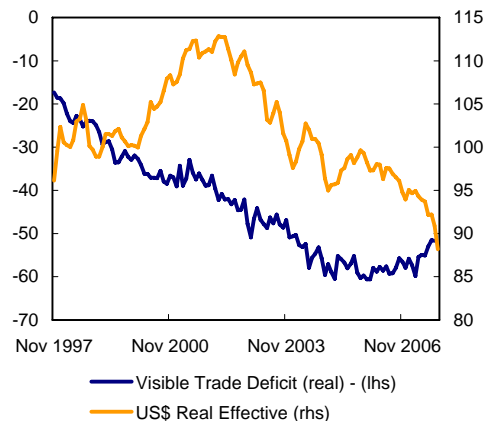
**2. Outlook for 2008**

The outlook for 2008 has **one main theme**: the expected slowdown in **consumer spending growth**. The **main risk** is that such a slowdown could cause a sharp drop in investment and employment, and thus trigger a **recession**. Based on current data and the effects of the shocks described in the previous section of this report, however, we are standing by our central scenario of a slowdown with no disastrous side effects. In particular, we do not see unemployment rising significantly: the figure should stand at around 5% by mid-2008.

**Exports will lend a hand again in 2008...**



**...and help reduce international imbalances**



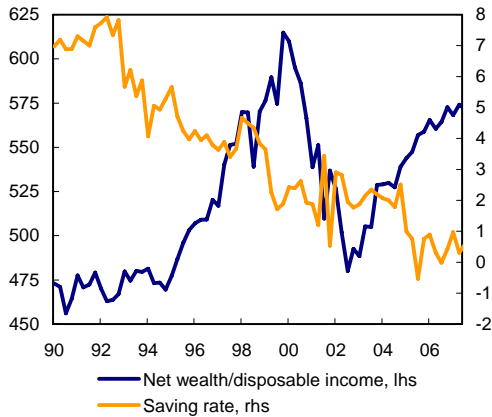
Source: Datastream

**Net exports** will again be a key driver of demand: our effective exchange rate forecasts for the dollar see it falling a little further in 1Q08, and then stabilising. Next year, in the run-up to the elections, additional support may come from **public spending**, as the US trade deficit narrows and the government responds to the subprime mortgage crisis with indirect support measures.

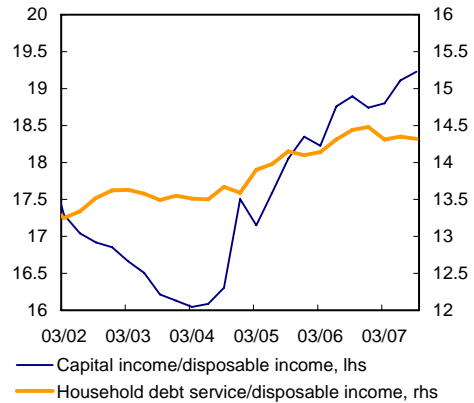
Although **consumer spending** is likely to slow sharply in the wake of the problems caused by the credit crunch, it will receive fundamental support from rising wages and investment income: these should offset the negative effects of flat – and in some important regions such as the south-eastern and western US – falling real estate wealth. Barring a stock market collapse, net wealth as a percentage of disposable income remains high, while investment income/disposable income is higher than debt servicing costs/disposable income on average.

The most recent figures on household spending were less negative than had been expected, despite the strong headwinds (petrol prices, credit crunch, inflation, foreclosures) that could have hampered consumption. Retail sales went up in November, even in real terms, while the revised figure for October indicates that consumer spending may have risen slightly in that month. Despite these positive indications, however, our scenario incorporates the risk of a fairly sharp downturn in consumer spending growth to 1.6% next year, which is reflected in a significant upturn in savings growth to 1.3-1.4%. The upwards trend in savings will not last long in view of demographic changes, as baby boomers increasingly go into retirement.

**High net wealth/disposable income**



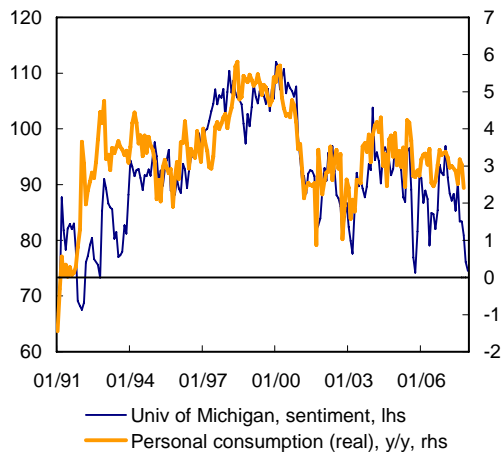
**Investment income is higher than debt servicing costs**



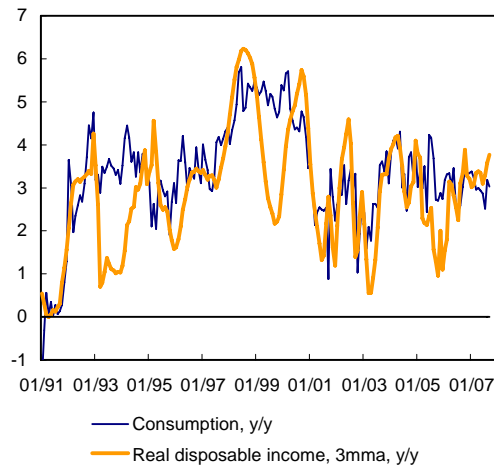
Source: *Ecowin*

**Employment growth** is slowing, but, as the Fed has been highlighting for some time, not enough to cause a sharp correction in the job market. The trend began to slow this year, although the estimated employment growth required to keep unemployment stable has fallen to around 100,000 jobs, according to the Fed. With companies not facing an out-and-out credit crunch, investment and employment growth lower than in the previous cycle so far, and the global economic situation still favourable, the current cyclical conditions are in keeping with a prolonged correction, but not necessarily a recession. With potential growth down to an estimated 2.5-2.6%, according to the Fed, a decline in effective growth to just under 2% will not generate enough excess resources to exert downward pressures on inflation. This is a key element in the monetary policy strategy of the Fed, which is afraid of overdoing the monetary stimulus against a backdrop of upside inflationary risks, both domestic and international.

**Household confidence has hit a low, but this is not always a good proxy for consumption**



**In 2008, consumer spending will slow to make way for an upturn in savings**



Source: *Ecowin*

Domestic demand will slow even further next year, with a (decreasingly) negative contribution from **residential building**. The downturn in the housing market is not over yet, and will continue to erode growth in 2008. The stock of unsold houses indicates that even if sales were to stabilise in 1Q08, spending on residential

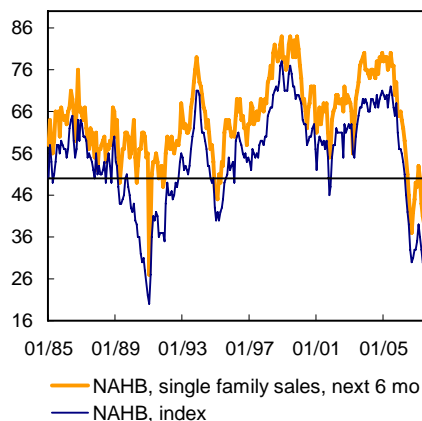
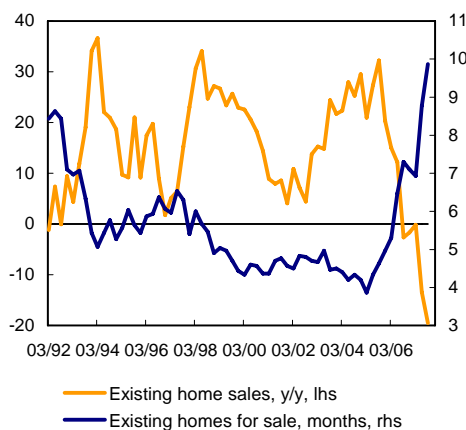
building would not return into positive territory until the start of 2009. In the next few weeks, the Fed and Congress will announce measures to support households struggling with mortgage payments.

The Fed's **Board of Governors** has proposed new regulations for the mortgage market. The proposals, approved recently by the Board, are a late response to the problems, and are the result of an analysis carried out by the Fed in the past six months. They offer a clear set of guidelines that cover a range of issues including the types of mortgage that can be provided, the documentation required and early repayment penalties. The aim is to remove the excesses that led to the recent disaster, without however over-regulating the sector or completely killing off the subprime mortgage market, which in the past decade has played an important role in giving previously excluded households access to credit. Nonetheless, as Randall S Kroszner stated, and as was obvious to external observers, in some cases people had obtained mortgages that they could not pay off. The proposals also include a ban on offering mortgages to borrowers without adequate supporting documentation. Meanwhile, **Congress** is debating much tighter regulations. The Fed's proposal will remain open for three months for feedback, and then will come into effect with possible amendments. It is unclear how far the new regulations will help resolve the current problems, given that many of the proposals relate to types of mortgage that are hardly ever offered now. One positive effect could be a reduction in or ban on the early repayment penalties applied by banks.

Official measures by the authorities have been accompanied by moral pressure on the banks. On 18 December, in an initiative co-ordinated by the Boston Fed, New England's five biggest banks announced that they had earmarked about USD 100 million to refinance subprime mortgages and convert them into fixed-rate loans. Bank of America stated that it will participate in the scheme, but has not yet announced how much it will set aside. Congress is debating changes to the Federal Housing Administration's operating procedures which would allow more mortgages to be refinanced by providing guarantees to banks.

**The stock of unsold houses means the downturn in residential building will continue until 2009**

**Builders are starting to give weak signals of stabilising confidence**



Source: *Ecwin*

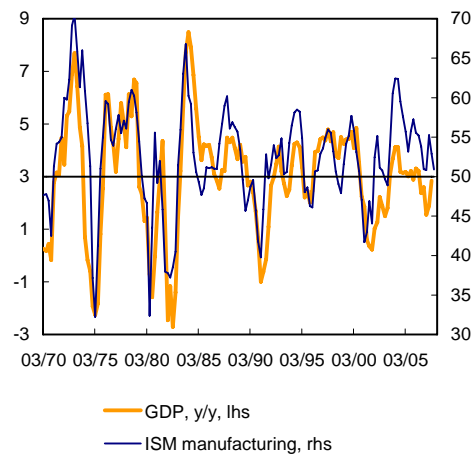
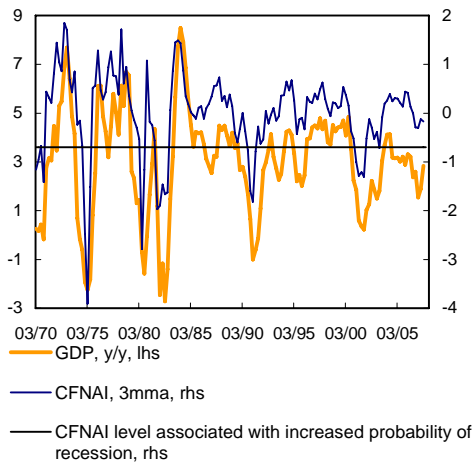
The key to next year's scenario – as in any period of sharply slowing growth – is **non-residential investment** and forecast demand from companies. November surveys indicated a significant downwards revision of six-month expectations, but

these may have stabilised in December. In the Empire State survey, the first indicator for December, the six-month diffusion index shows a modest improvement. The figure plummeted from 50.5 in October to 30.5 in November, but in December expectations have improved slightly to 32.4, while the index showing expectations of capital expenditure has gone up from 19.05 to 23.75.

Orders data are uncertain, but industrial output figures are weaker for consumer goods than investment goods. The orders component of the ISM index for November stood at 52.8, from 52.5 in October, stabilising in an area consistent with modest but positive growth. Unfilled orders fell sharply, however; the index has been below 50 for two months, indicating expected weakness in the next quarter. One positive factor remains orders from abroad, which have taken the gap between foreign and domestic orders to its widest point since over 20 years ago, when the balance of trade was practically zero.

**Chicago Fed index indicates below-trend growth, but not recession...**

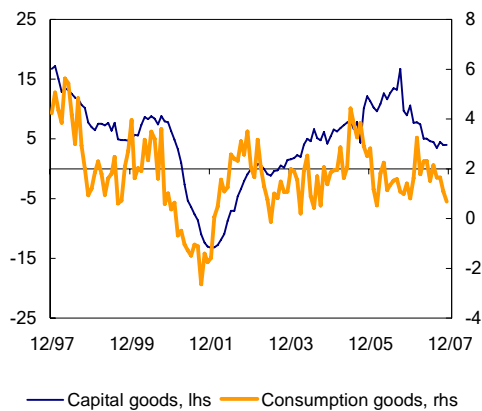
**...in line with indications from the ISM survey**



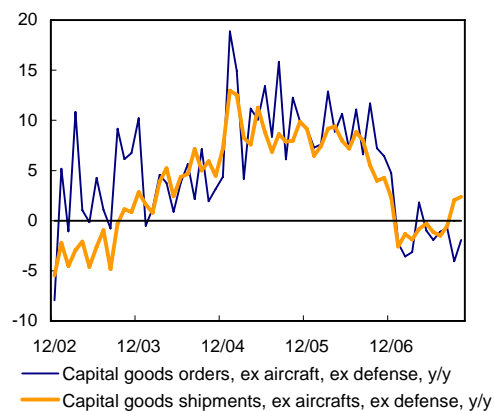
Source: *Ecowin*

In the next quarter **investment growth** will be low but positive, and in light of easing lending conditions caused by cuts in official interest rates, we believe that non-residential investment will keep growing in 2008, and will make a positive contribution to (still weak) domestic demand. The risks are obviously to the downside, however.

**Industrial output: investment goods hold firm, consumer goods fall**



**Durable goods orders are uncertain, but deliveries improve**



Source: Datastream

As we mentioned in the introductory section, however, there are two negative factors weighing on the outlook: weak growth and high inflation. Either or both of these could get worse, with growth falling and inflation rising. Not only has the **inflation** trend gathered huge momentum, hitting 4.3% yoy in November, but it is also coming under pressure from the weak dollar, rising commodities prices and falling profit margins, which are increasingly prompting companies to announce price hikes.

The **most recent inflation figures, released in November, are not encouraging. Producer prices** rose by 3.2% mom for the headline index and 0.4% mom for the core figure, much more than expected. The sharp jump in factory gate prices was due to the rise in petrol prices (+34.8% mom) and auto prices (+0.6% mom). The core figure stripping out auto prices went up by only 0.1% mom, but prices of core intermediate goods indicate a significant increase in inflationary pressures, rising 1% mom. The **CPI** surprised to the upside, rising by 0.796% mom, and by 4.3% yoy, from 3.5% in October. The core CPI also went up by more than expected, posting an increase of 0.275% mom and 2.3% yoy, from 2.2% in October. The energy component of the index registered an increase of 5.7% mom, driven by a 9.3% mom (37.1% yoy) rise in petrol prices. Food prices went up by 0.3% mom and 4.8% yoy, while clothing prices jumped by 0.8% mom. Services rose in line with trend (+0.3% mom, 3.4% yoy). The rise in healthcare costs was 0.4% mom in November, from 0.6% in October. In the housing sector, owner's equivalent rent went up 0.3% mom, from 0.2% the previous month, while effective rents increased by 0.4%. The acceleration in core inflation is not a blip confined to just one sector, but is spread across several sectors. More importantly, it has been partly driven by rents, the item that had made the biggest contribution to the slowdown in inflation in the middle of the year. The acceleration in healthcare prices (about 5% yoy) is another worrying factor.

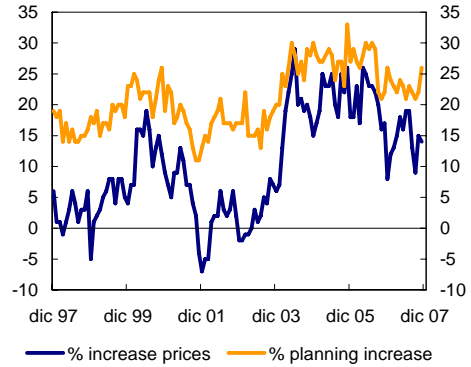
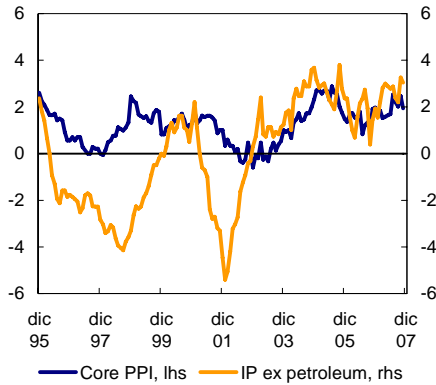
In **2008**, the base effect caused by a positive end to 2007 will weigh on the year-on-year figure, and is likely to put **average headline inflation** at a high **2.6% or so**, despite falling oil prices in 1Q. **Core inflation will remain above 2%, settling at about 2.2-2.3%**, assuming a fairly favourable monthly trend of not more than 0.2%. However, this forecast could be affected by the risk that rents will continue to rise at the same rate as the past two months, and wipe out the decline registered in 2Q and 3Q. It seems clear that once the worst of the economic

slowdown is over, the inflation trend will once more become the key issue for monetary policy.

The risk of **stagflation, 21st-century style**, has made the central banks concerned that the Phillips curve is structurally flatter, and that even a severe slowdown in domestic economic growth will not be enough to push down core prices. However, the weakness of domestic demand, coupled with international competition, will help curb upward pressure on prices.

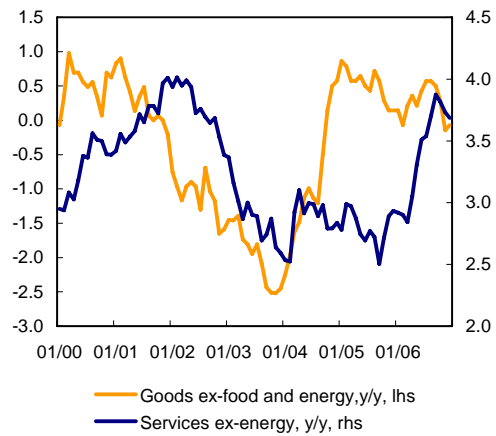
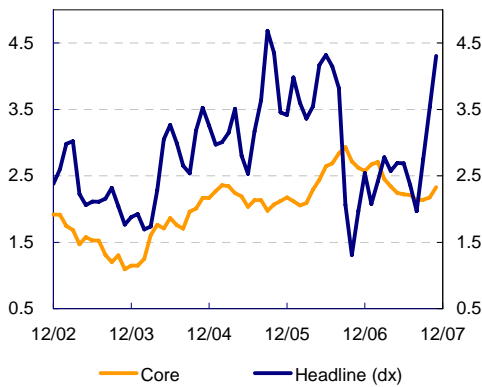
**Producer prices: the world has changed since the end of the 1990s!**

**NFIB survey: small companies plan to raise prices**



**Inflation is rising...**

**...but not just because of energy**



Source: Datastream, Ecowin

## Fed faces growth/inflation tradeoff, again

The key issue that emerged from the FOMC's December press release was uncertainty over the economic outlook. The Fed is keeping **separate channels of communication for the two issues of macroeconomics and the financial markets**, making its monetary policy announcements in the press releases that follow the FOMC's meetings, and those for measures affecting the markets elsewhere. The press release setting out the new measures adopted jointly with other central banks to ease the liquidity crisis was issued separately, and highlights the Fed's wish to intervene actively to help prevent a systemic crisis in the banking sector. As for the macroeconomic outlook, the Fed's concerns about growth clearly intensified in December, as the FOMC noted that the housing market downturn and the credit crunch are trickling down to the rest of the economy. Once again, the press release made no explicit mention of the likely direction of interest rates. **The Intesa Sanpaolo forecast for 2008 incorporates another two cuts in the Fed funds rate** in the first quarter, in response to weak demand.

### 1. No guidance on interest rates after December's FOMC meeting

The FOMC's December meeting ended with a **25bp rate cut** and the removal from the press release of the reference to "balanced" risks that had been introduced in October, after one month of suspended judgment. The markets had been expecting a cut of 50 bps, and an increase in the duration of the discount window from the 30 days set in August to up to 90 days. As regards the current tensions and imbalances on the money market, the Fed has opted to use other communication channels to announce measures to tackle the ongoing liquidity crisis (see next section).

The vote was not unanimous: nine representatives were in favour of a 25 bp rate cut, while Eric S Rosengren of the Boston Fed wanted a 50 bp reduction. Thomas M Hoenig of the Kansas City Fed, who in October wanted to keep rates on hold (they were cut by 25 bps), voted with the majority. The quarter-point cut was requested by seven out of the 12 regional Fed chairmen. It is likely that once the meeting minutes are released, they will contain a variety of opinions, with some chairmen wanting a bigger cut and some others perhaps wanting none at all. The Boston, San Francisco, Dallas, Kansas City and Minneapolis Feds did not request a 25 bp cut. The first two most likely wanted a half-point reduction, while Kansas City, Dallas and Minneapolis may possibly have voted to keep rates on hold.

Looking at the press release, it is clear that **concern over the growth outlook** is mounting. In its assessment of the macroeconomic data, the release states that growth is slowing, "reflecting the intensification of the housing correction and some softening in business and consumer spending". The announcement also states that tensions on the financial markets have started rising again recently. The key point in the assessment is that the impact of the housing correction has started, for the first time, to trickle down to other sectors of the economy.

There were no new developments on the **inflation** front, and the Fed's assessment of the situation and the risks is broadly unchanged. The press release states that "elevated energy and commodity prices, among other factors, may put upward pressure on inflation". The differences from the assessment made in October are few, and reflect the fact that inflationary fears are taking a back seat for the moment. The concluding paragraph no longer states that the risks are broadly balanced. In October, the Committee was of the view that "the upside risks to inflation roughly balance the downside risks to growth". By December, however, it was asserting that "recent developments, including the

deterioration in financial market conditions, have increased the uncertainty surrounding the outlook for economic growth and inflation”.

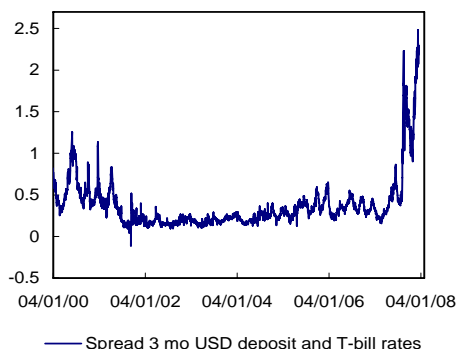
## 2. Measures to curb the liquidity crisis

The Fed has announced new measures to tackle the ongoing liquidity crisis, in a joint intervention with the Bank of Canada, the Bank of England, the ECB and the Swiss National Bank.

At domestic level, the **Fed has launched a new temporary loan refinancing scheme** via the Term Auction Facility (TAF). Under the scheme, the Fed will auction short-term funding to banks with solid balance sheets, backed by a wide range of allocable securities (as indicated by the terms of the primary credit discount window). In this way, the refinancing will be aimed at a larger number of banks, backed by a wider range of guarantees, as already happens in the Euro zone with the ECB’s open market operations. Each auction will be for a set amount, and at a variable rate with a predetermined minimum. The first auction, of USD 20Bn, was scheduled for 17 December, with settlement date on 20 December, a 28 day duration and expiry on 17 January. The second, again of USD 20Bn, was scheduled for 20 December, with settlement date on 27 December and expiry on 31 January (duration: 35 days). Further auctions have already been set for 14 and 28 January, and the amount will be decided on the basis of the financial markets’ performance. The Fed may schedule more auctions at a later date, depending on market conditions. If the scheme proves successful, the bank could decide to launch a permanent series of auctions at the discount window. With the TAF, the bottlenecks on the US interbank market may be eased to some extent, providing liquidity to those banks that need funds, are not primary dealers and do not want to be identified as operators in difficulty by using the discount window. However, the experience in Europe suggests that this is not sufficient to ensure a reduction in interbank rates against the overnight rate, and thus strengthen the transmission of monetary policy. Even Yves Mersch, a member of the ECB’s Governing Council, doubts that the move is enough to remove the causes of the problem, which include a crisis of confidence among the banks.

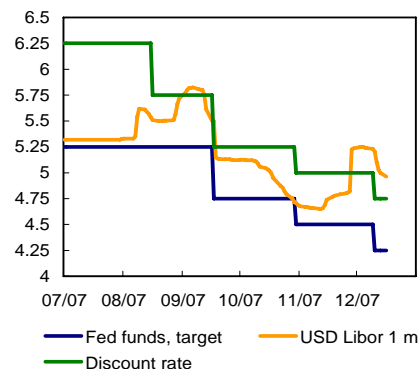
In addition to setting up the TAF, the Fed has announced that, **in agreement with the BoE, the ECB, the Bank of Canada and the SNB, the Board has authorised** swap lines with the ECB and the SNB, for a total of USD 20Bn and USD 4Bn respectively, to be used in the two European banks’ areas of jurisdiction. These lines have been approved for a period of six months, and are aimed at compensating for the closure of other dollar funding channels available to European banks.

Confidence crisis pushes spreads sky-high



Source: Ecowin

Monetary policy ineffective on money market rates



## Forecasts

Uncertainty has been the key factor highlighted by the Fed in recent months. In addition to uncertainty caused by the liquidity crisis on the markets, the increasingly fine line between price stability and sustainable growth means the Fed is reluctant to commit itself to statements that could send the markets in one clear direction or the other. In a recent speech, Charles I Plosser of the Philadelphia Fed stated that an evaluation of inflationary and growth risks could be misleading, especially during periods of uncertainty.

The Fed appears to be cautious in assessing the macroeconomic outlook, given the intensifying credit crunch. Although it has stated that the weakness is filtering through to companies and consumers, it has not indicated that downside risks to growth are more important than inflationary risks, an obvious fact during a financial crisis. Since September, the Fed has given up providing guidance to the markets, and is playing it by ear. This creates the risk that it will confirm market expectations, as happened in October and December, despite William Poole's assertion that chaos would ensue if the Fed were to follow the markets.

Monetary policy forecasts are hampered by the twofold uncertainty caused by both the situation itself and a lack of transparent guidance from the Fed. While it has clearly underlined the uncertainty of the outlook, the bank has nonetheless produced forecasts, although they cover very wide confidence intervals. In its latest press release, the Fed has made no comparison between its latest forecasts based on new data and those made in October. We will have to wait until the meeting minutes are released in early January to get a more exact picture of the views of the meeting attendees, and on the consensus reached by the Committee (if indeed there was one).

In the meantime, we can interpret the lack of information in December's press release in two ways. One possibility is that there is so much uncertainty, especially about the consequences of the liquidity crisis and developments on the credit markets, that the Fed wants to wait until early 2008 before assessing whether the current problems are a long-term issue or whether they are due to the closure of the financial year. A reduction in pressure on the market would reduce the necessity for further rate cuts, and could make a significant degree of monetary easing more risky. Alternatively, the impact of the growing uncertainty may have caused a significant divergence of opinions within the Committee, making it difficult for them to formulate a precise view, and leading to a vague statement on policy that is less than optimal during periods of widespread market uncertainty.

Our forecast of another two cuts in the Fed funds rate is based on our expectation that, as it did under Alan Greenspan, the Fed under Ben Bernanke will continue to decide on the basis of a cost-benefit analysis. Events with a low probability but a high potential cost could in the short term cause the Fed to make policy decisions that deviate from what would be expected in a more benign central scenario. The key issue is the expected cost, rather than the probability of the event itself.

A long-term freeze in the credit markets, for whatever reason, appears sufficient on its own to justify monetary stimulus measures notwithstanding the inflationary risk. However, further interest rate cuts would be justified only by clear signs that the economy was entering a recession. The risks of inflation, coupled with strong global growth, place the Fed in a very different situation from that of 2001. A rate cut in January is seen as certain and if, as is likely, the data and market rates continue their current trend next month, another cut in March is the most likely scenario, which would take the Fed funds rate to 3.75%. If the US avoids a recession, inflationary pressures will cause the Fed to review its priorities again.

## Euro zone: gradual slowdown confirmed, risks on the upping; ECB: in defense of price stability

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■ Our central scenario sees Euro zone GDP growth at 2% in 2008 (2.6% in 2007), which is broadly unchanged from September's estimate of 2.1%. This scenario assumes growth of 0.4% qoq in 4Q07, down from 0.8% in 3Q. A slowdown substantially below potential is still unlikely in our view, as fundamentals remain solid. However, we think that the risks have increased in the last three months in light of the serious financial market anomalies and more widespread pessimism on the US and international economies.

■ Overall, we quantify the risks to the downside for growth at around 0.5%. The financial crisis poses the greatest risk, and could particularly affect capital investment, according to our simulations.

■ Given that European households are less exposed to debt than their US counterparts and there is no widespread overvaluation of real estate, we believe the impact on household consumption in Europe will be limited (with some variations within the Euro zone). Support for growth could come from fiscal policy, which will have an expansive bias in all the main countries.

■ Inflation will be 2.5% on average. Although the rise in consumer prices seen at end-2007 (3.1% yoy in November) are considered temporary, the risks to price stability in the medium term are still to the upside, as second-round effects cannot be ruled out.

■ The ECB has intervened aggressively to address market anomalies and will continue to do so until the situation normalises. However, we think policy rates will remain on hold at 4% for the whole of 2008, since the Euro zone macro scenario and the absence of US-style systemic imbalances do not justify a cut for 'insurance' purposes as implemented by the Fed and Bank of England.

■ With an explicit mandate to stabilise prices in the medium term, the ECB is less torn than the Fed or Bank of England between the risk of "low growth" and "high inflation". If, and only if, there are clear signs that Euro zone growth will be below potential also in the second half of 2008, the ECB might then consider easing monetary policy.

### Area euro - Forecasts

	2006	2007	2008	2007				2008			
				1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	2.9	2.6	2.0	3.2	2.5	2.7	2.2	1.8	2.0	2.0	2.3
- q/q change				0.8	0.3	0.7	0.4	0.3	0.5	0.7	0.7
Private consumption	1.9	1.4	1.9	0.0	0.6	0.5	0.2	0.6	0.4	0.6	0.6
Fixed investment	5.2	4.8	2.9	1.8	0.0	0.9	0.8	1.0	0.2	1.0	0.9
Government consumption	1.9	2.0	1.4	0.9	0.2	0.6	0.2	0.4	0.3	0.4	0.4
Export	8.0	6.3	5.0	0.9	0.8	2.5	1.2	0.8	1.1	1.2	1.4
Import	7.6	5.8	5.2	1.4	0.1	2.7	2.0	0.7	0.5	1.3	1.9
Stockbuilding (% contrib. to GDP)	0.1	0.1	0.0	0.4	-0.4	0.2	0.4	-0.3	-0.1	0.1	0.2
Current account (% of GDP)	-0.2	0.2	-0.3	0.4	0.3	0.4	-0.2	-0.6	-0.5	0.2	-0.2
Deficit (% of GDP)	-1.6	-1.0	-1.1								
Debt (% of GDP)	68.1	66.9	65.7								
CPI (y/y)	2.2	2.1	2.5	1.9	1.9	1.9	2.9	2.9	2.6	2.7	2.4
Industrial production (y/y)	4.0	3.4	2.6	1.0	0.5	1.5	0.2	0.2	0.7	1.1	1.0
Unemployment (%)	8.2	7.4	7.1	7.6	7.5	7.4	7.2	7.1	7.1	7.0	7.0
3-month Euribor	3.08	4.27	4.32	3.82	4.07	4.50	4.70	4.65	4.35	4.15	4.15
EUR/USD	1.26	1.37	1.41	1.31	1.35	1.37	1.45	1.47	1.43	1.39	1.37

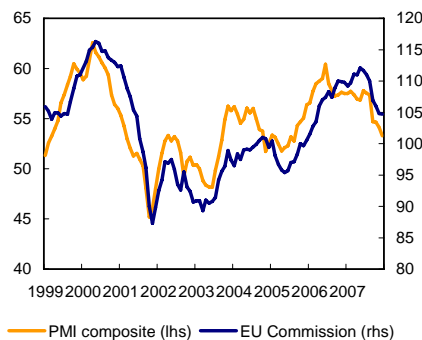
Percentage annualised growth rates over previous period, if not otherwise specified.

**We confirm a soft landing as our main case scenario for 2008**

**We expect a slowdown for the Euro zone economy in 2008 as a result of weaker investment and exports, though consumption should hold up.**

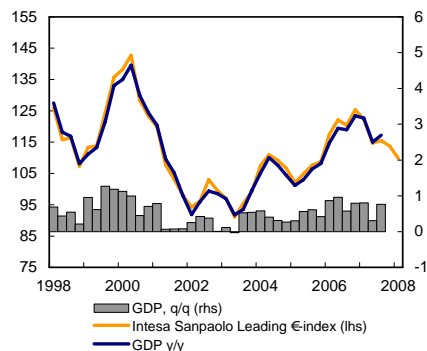
Investment, which has been driving the economy for the last two years (exceeding, as a proportion of GDP, the previous highs recorded in 2000), is set to slow to 2.9% in 2008, from the 4.8% estimated for 2007. We project a reduction in corporate capex given tighter funding conditions and thinner margins, but not a collapse. The same is in store for exports, which after slowing in 2007 (to 6.3%, from 8%), will fall further next year (our estimate: 5%), due to a combination of lower US growth and healthy demand from emerging countries. Consumption, meanwhile, should pick up, to 1.9% from 1.4% in 2007, helped by a favourable comparison with the start of 2007 (when a VAT increase took effect in Germany) and the employment gains of recent years.

**Confidence is falling though levels remain high**



Source: NTC Research, European Commission

**€index puts yoy growth at 2%**



Source: NTC Research, IFO, ISM, European Commission and Intesa Sanpaolo chart

### Weaknesses outweigh strengths

In recent months, analysts have generally revised down their Euro zone growth forecasts for 2008 to 1.9%, from 2.2% in September. **Our estimate is 2%** (a level consistent with the latest Intesa Sanpaolo €-index—a leading indicator), **broadly unchanged from September (2.1%), though we recognise that our base scenario is subject to risks, mostly to the downside.**

At the current stage of the cycle, the Euro zone economy is enjoying a number of plus relative to other countries: 1) confidence indicators, while slowing, remain at expansive levels; 2) fundamentals seem solid and there appear to be no imbalances comparable to those in the US—exposure to subprime assets and commercial paper is limited, consumers are less indebted and the overvaluation of real estate is confined to certain countries (e.g. Spain; see Focus); 3) the European economy is in a less mature phase than the US economy, especially as regards the labour market—unemployment is still falling, which should prevent a collapse in consumption (in fact, consumption is expected to accelerate in 2008); 4) economic policies will provide support as the fiscal policy bias will be moderately expansive (all the main countries will see a slight deterioration in the public finances) and this phase of monetary policy tightening seems to have come to an end, at the very least. The risks, meanwhile, relate to: 1) the slowdown in global demand and US demand in particular; 2) the rise in the effective exchange rate (just over 5% in 2007); 3) higher commodity and energy prices; 4) the financial crisis, which has exacerbated money market anomalies in recent weeks (as evidenced by widening credit spreads and rise in the 3-month Euribor above 5%). We think the risks to our growth scenario are currently to the downside. Below, we attempt to quantify these risks.

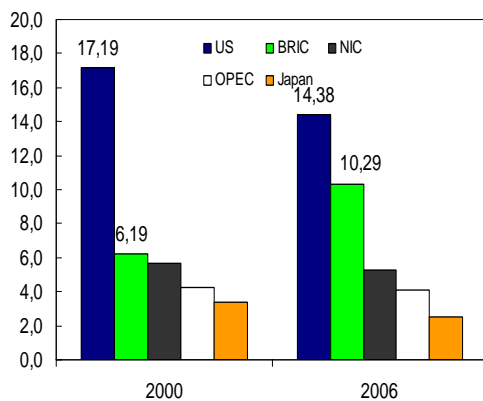
### Commercial ties with the US are less strong than in the past...

**The European economy seems to be less dependent on the US economy than in the past, in that emerging countries now account for a growing proportion of exports, and the US a declining proportion.**

In the last few years, Euro zone trade flows have shifted towards regions such as Asia and the other emerging economies, whose demand for capital goods in particular is of a more structural than cyclical nature, and therefore less sensitive to the euro-dollar exchange rate. A glance at Euro zone exports by product type and geographical destination confirms this.

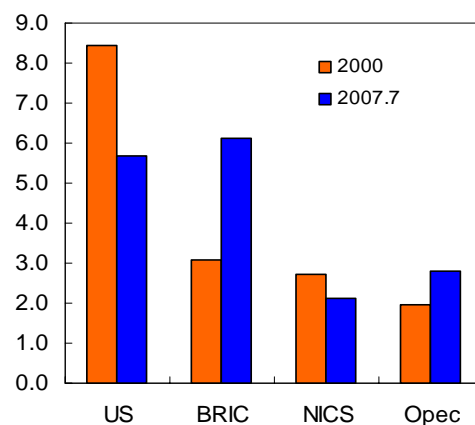
The main destinations for exports outside the Euro zone, excluding EFTA members, which account for around 44%, are still the US, followed by the BRIC countries, the dynamic Asian economies and OPEC countries. However, the US market is not as important as it was in 2000, while the BRIC countries have risen in importance. This trend is particularly marked for Germany.

**Extra-EU exports to main trading partners excluding EFTA members**



Source: Eurostat

**Machinery as a proportion of total exports by geographical destination**



Source: Eurostat

Exports of machinery and manufactured goods represented 45% and 16% of total extra-EU12 exports in July, broadly unchanged versus 2000. Germany's exports of machinery account for around 40% of all extra-EU exports, and 55% of German exports.

### ...but, after decoupling did not materialise in 2007, the Euro zone is moving towards convergence with the US

However, notwithstanding the greater trade flows to the BRIC and OPEC countries, the manufacturing sector may suffer as a result of the rise in the effective exchange rate. A recent ECB working paper (No. 796, August 2007), confirms that the higher the proportion of production exported (irrespective of destination), the greater the impact of the rise in the effective exchange rate on sectoral activity, and that the biggest impact will be on the manufacturing sector. The effect of a 1% rise in the effective exchange rate is -0.2% after around two years, with peaks of -0.75% for the production of machinery. Thus we cannot rule out risks of a more severe contraction in manufacturing activity in the next few months, especially if the euro does not retreat from its recent highs, as per our estimates.

In general, analysing the impact of the US slowdown on the Euro zone by looking at trade flows alone would only tell us part of the story. Recent ECB and IMF reports show that: 1) the US economic cycle is ahead of that of other regions

(except emerging countries in Asia); 2) a high degree of financial integration means the impact will be much bigger than if only the trade channel was involved—a 1% reduction in US GDP would reduce Euro zone growth by 0.3% instead of 0.1%; 3) the spillover tends to be closer in time and greater in degree in the event of a negative shock. We have revised down our US growth forecast for 2008 to 1.8%, from 2.2%. Essentially, the gap between Euro zone and US GDP is set to narrow, by our estimates, from four-tenths to two-tenths of a point. We see further risks to the downside of around five-tenths of a point (a broadly recessionary scenario) for US growth in 2008, and if these materialise, Euro zone growth would be two- or three-tenths of a point lower at around 1.5-2%.

#### The rise in the exchange rate will weigh on growth until mid-2008

The effective exchange rate has risen by more than 5% since the end of 2006. Using the Oxford Economic Forecasting model, we simulated the repercussions of the long-term effects of a 5% shock for the effective exchange rate on Euro zone growth, with no action from the monetary policy authorities. The model points up a maximum impact of around seven-tenths of a point after eight quarters. This result was similar to the findings of a recent ECB study using the INSEE quarterly model (see Table 1). The maximum impact normally occurs after two quarters from the shock, and therefore a high proportion of the rise in the euro will have impacted on growth in 2007. Assuming that the exchange rate stays at mid-December levels, **the increases already observed will dampen GDP growth by a further two-tenths of a point or so until the beginning of spring**. The impact included in our current forecasts is slightly lower.

**Table 1 - Impact of a 5% increase in the effective exchange rate on:**

Years after the shock	IPC <sup>1)</sup>		Real GDP growth <sup>2)</sup>	
	Year 1	Year 2	Year 1	Year 2
<b>Quarterly models</b>				
ECB	-0.5	-0.7	-0.5	-0.7
OEF	-0.3	-0.9	-0.4	-0.7
INSEE MZE 3	-0.9	-1.3	-0.5	-0.6

1) Harmonised consumer price index 2) Cumulative impact at the end of the simulation period

Sources: ECB: "The impact of exchange rate shocks on sectoral activity and prices in the euro area", Working Paper No. 796, August 2007"

Oxford Economic Forecasting

INSEE Macroeconomic model MZE – 2003

A further rise of 3.5% in the effective exchange rate from current levels at the start of 2008 would rein in quarterly GDP growth by a further two-tenths of a point in the first half of 2008, to 0.3%, versus our forecast of 0.45% qoq. The year-on-year figure would be 1.7%, and the 2008 average would fall to 1.8%. We therefore measure the potential risk from exchange rates at around two-tenths of a point.

#### Higher crude prices will have less of an impact on growth than in the past

We now assess the risks to growth of the increase in oil prices in 2007. In US dollar terms, the increases total almost 50%, or 36% in euro. The impact on GDP of a 50% rise in the crude price after two years from the time of the shock varies between -0.3% and -0.8%, depending on the model used. The impact on inflation is in the +0.5-2.6% range (see Table 2).

**Table 2 – Impact of a 50% increase in the price of oil on:**

Years after the shock	Inflation <sup>1)</sup>		Real GDP growth	
	Year 1	Year 2	Year 1	Year 2
<b>Quarterly models</b>				
ECB	0.5	0.4	-0.1	-0.2
ECB QUEST	0.4	0.1	-0.6	-0.2
INSEE MZE 3	1.2	0.2	-0.3	-0.2
<b>Yearly models</b>				
IMF Multimod	1.6	1.1	-0.1	-0.3
OECD Interlink	0.6	0.2	-0.4	0.2

1) Change in harmonised consumer price index for ECB AWM, change in national consumer price index for the other models.

Sources: ECB AWM: Dieppe, A. and J. Henry (2004), "The euro area viewed as a single economy: how does it respond to shocks?", *Economic Modelling* 21, 833-875. EC QUEST.

European Commission (2004), "How vulnerable is the euro area economy to higher oil prices?" NIESR Discussion paper.

OECD Working Paper No. 306 OECD Interlink: Dalsgaard, T., C. André and P. Richardson (2001), "Standard shocks in the OECD Interlink Model".

IMF Multimod: Hunt, B., P. Isard and D. Laxton (2001), "The macroeconomic effects of higher oil prices"

INSEE Macroeconomic model MZE – 2003

The impact of higher crude prices on GDP growth in the last two years has been reasonably contained. One possible explanation is that in recent years globalisation has had a disinflationary effect on the price of other imported goods, partly offsetting the increase in energy prices. However, the limiting effect of globalisation now seems to be diminishing: the increase in commodities prices is more than offsetting the drop in prices of manufactured goods. **It is therefore possible that higher energy prices are having a greater impact on growth, which could become more acute if we see further spikes in the short term.**

#### Effects of the financial crisis pose biggest risk

The main risk factors facing the Euro zone include the tighter financing conditions continuing for the foreseeable future, and a further and more substantial repricing of risk premiums. Unfortunately, the repercussions of a credit crunch-type shock on the real economy are difficult to quantify.

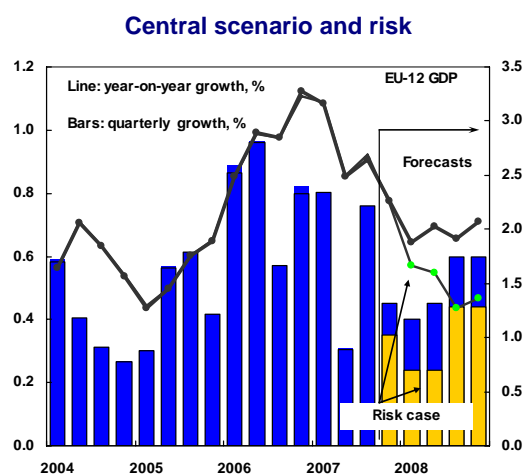
Clearly, **the risk of a severe impact is lower than in the US, given the limited exposure of the banking system and households** and the smaller number of areas where real estate is overvalued (Spain is an example of this; see Focus).

With the aim of gauging the macroeconomic impact of the crisis, we used the Oxford Economic Forecasting model to simulate a scenario whereby the spread between the 3-month Euribor and the refi rate, which is close to 100bps at present, remains at these current, historically abnormal levels, instead of "normalising" (towards 10-15bps), as in our base scenario. The results of this simulation put 2008 growth at 0.2% lower than in our base scenario. In line with the theoretical conclusions, the impact is expected to be greater on investment (-0.3%) than on consumption (-0.2%). Given that the simulation probably underestimates the impact of the crisis (as it doesn't include a widening of credit spreads, and tightening of bank lending conditions is difficult to quantify), **the macroeconomic impact of a continuation of the crisis would be quantifiable at 0.2-0.3% of GDP.**

### The risk scenario points up growth at 1.5%

Overall, taking into the factors described and quantified above, we calculate the risks to the downside for our central scenario at around five-tenths of a point. If this is the case, in the first half of 2008 GDP growth would slow to around 1.5%. In this scenario, domestic pressures on consumer prices in the second half of 2008 would dissipate, and the ECB could consider easing monetary policy.

Substantial uncertainty remains over GDP growth prospects for the second half of 2008 and the start of 2009. These will largely depend on what happens in the US. If the problems in the US economy are accounted for over the course of next year, it would be reasonable to assume a return to above-trend growth there at the end of 2008, a smoothing of market imbalances and a recovery in the international economy. In this case, we could also see **European growth picking up more strongly between the end of 2008 and start of 2009**, introducing risks to the upside to the forecast of flat interest rates, including in the second half of 2008.



Source: Eurostat and Intesa Sanpaolo

### Inflation above target until late 2008

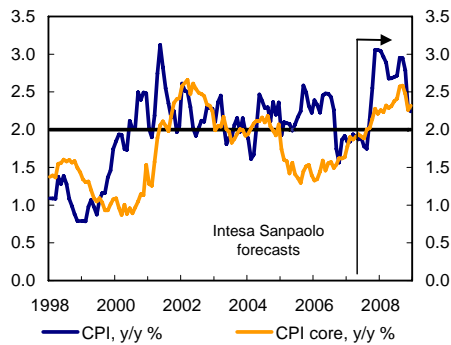
In November, Euro zone inflation shot up to 3.1% yoy, from 1.7% yoy at the end of August. The acceleration was chiefly due to soaring energy and food prices, together with an unfavourable comparison base (Fig. 7).

**The unexpected surge in the last few months of 2007 has taken the 2008 inflation forecast to 2.5%, versus 2.1% previously (Fig. 6).** The latest survey from Consensus Forecasts (early December) puts 2008 inflation at 2.3%, versus 2.0% in September.

#### External pressures remain a risk factor for the 2008 inflation scenario.

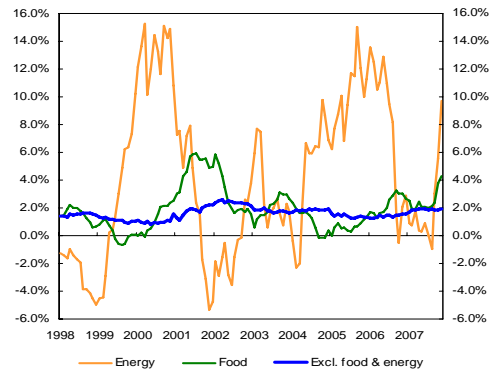
Our forecasts incorporate a gradual fall in the oil price towards USD 81 per barrel, and a reduction in the effective exchange rate of between 3% and 5%, and therefore see a lowering of pressure from energy prices.

**Headline inflation around 3% in mid-2008**



Source: Eurostat and Intesa Sanpaolo forecasts

**The increase is chiefly due to energy and food price rises**

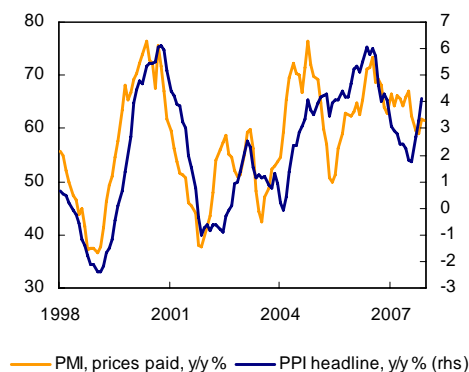


Source: Eurostat

**The risks posed by external pressures are set out below.**

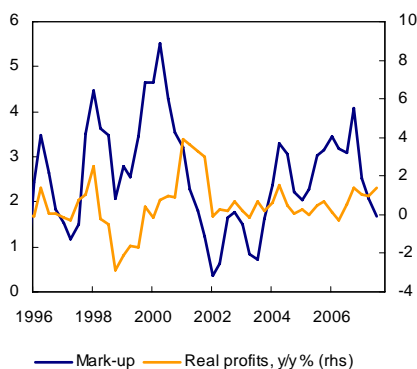
1. **The crude price could show resilience at around USD 90**, and this—with exchange rates assumptions unchanged—would be sufficient to leave headline inflation at 2.6%.
2. **It is also possible that past commodity price hikes will only partly feed through to final prices. Until now, the strong exchange rate has acted as a limiting factor.** However, unless the currency strengthens further, we could see greater pressures from imports. There has been some indication of this as German import prices have soared (3.2% yoy, from 0.2% yoy previously).
3. **Further up the production chain, the PMI of prices paid has signalled fresh price rises in the last three months.** It will be difficult for companies to digest further price rises as **mark-ups were almost wiped out in the summer months (Fig. 9).**
4. **The disinflationary pressures of globalisation have already been absorbed by industrialised countries.**

**Renewed pressures further up the production chain...**



Source: Eurostat and NTC research

**... will be difficult for companies to absorb**



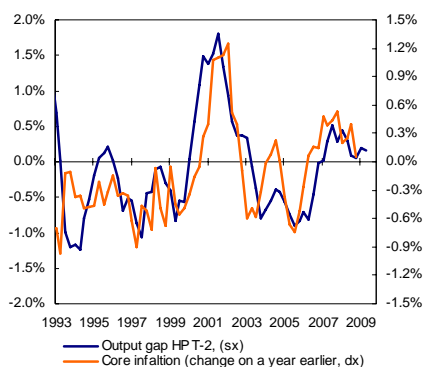
Source: Eurostat

**Our growth scenario is scarcely one-tenth of a point weaker than three months ago, and therefore insufficient to limit the constraints on production capacity that have accumulated over the last two years of above-potential growth.** By our estimates, the output gap should remain in positive territory next year too, continuing to exert pressure on the underlying consumer price trends (Fig. 10). If only the risks to the downside for growth materialise, sending GDP growth down towards 1.5% for almost the whole of 2008, the output gap would return to marginally negative territory between June and October.

**Further risks to price stability will come from the labour market.** If unemployment in Europe, especially Germany, continues to fall, and productivity levels remain strong, we cannot rule out the appearance of more aggressive wage demands. The slowdown in productivity in this mature stage of the cycle has already caused unit labour costs to increase.

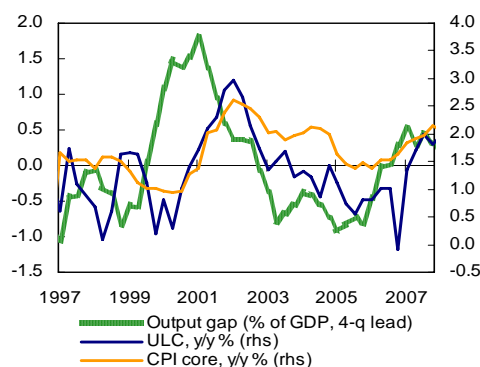
**The contribution of administered prices, which added around 0.4-0.5% to consumer prices in 2007, will continue to diminish next year, however.**

**The output gap will continue to exert inflationary pressure**



Source: Eurostat and Intesa Sanpaolo elaborations

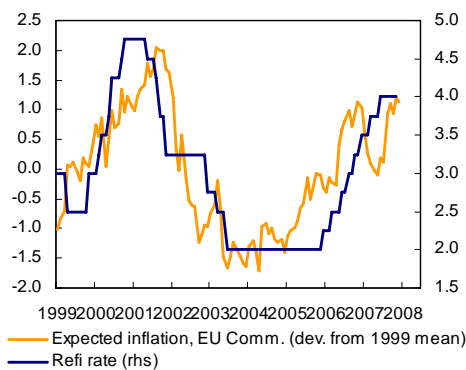
**Unit labour costs have already risen**



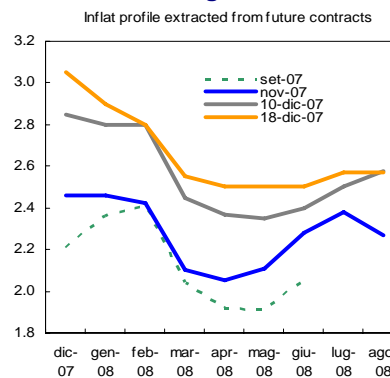
Source: Eurostat

**As several members of the ECB's Governing Council have reiterated, if inflation remains above the target level for a prolonged period, this could lead to inflation expectations being revised up.**

**Consumers' expectations on prices increased substantially in the last two – three months (Fig. 12).** Breakeven inflation has shot up beyond 2% since the end of August, but the inflation expectations extrapolated from linkers could be distorted by the general increase in risk premiums across all asset classes. We should therefore look at the inflation profile implicit in **futures contracts**. **As shown in the chart below, implicit inflation for 2008 increased between the start of November and December. Yet, markets have upped expectation mainly for the final months of 2007 early 2008, while the profile for the second part of 2008 have remained broadly stable relatively to September.**

**Consumer expectations increase**

Source: Eurostat and Intesa Sanpaolo forecasts

**The market sees higher inflation in 2008**

Source: Reuters and Intesa Sanpaolo elaborations

**ECB: keeping a close eye on price stability**

With an explicit mandate to stabilise prices in the medium term, the ECB is less torn than the Fed or Bank of England between “stagnation” or “inflation”.

**Interest rates will most likely remain on hold at 4% for the whole of 2008.**

**The ECB's December forecast does not diverge from the consensus, nor from our latest estimates.** In light of the latest developments (including the market anomalies), the ECB reckons growth will moderate in 4Q from the comfortably above-potential level of 3Q (+0.7% qoq, 2.6% yoy). December's ECB staff forecasts put Euro zone growth in 2008 in the 1.5-2.5% range, from 1.8-2.8% previously. The mid-point moves from 2.3% in September, to 2.0%, in line with the latest consensus projections and our central scenario. More importantly for the monetary policy decision-makers, growth estimates for 2009 are in the 1.6-2.9% range, i.e. more or less in line with potential.

**Given that the macroeconomic backdrop continues to be solid, the ECB's focus remains firmly on price stability and medium-term risks.** The surge in inflation beyond 3% in the wake of the spike in commodities prices is seen as a temporary phenomenon, but one that will still be a factor in consumer prices staying above target for longer than expected. Inflation estimates for December are in the 2.0-3.0% range, so the mid-point is 2.5%. In 2009, inflation is expected to return to the target level (1.2-2.4%), assuming—as emphasised by Jean-Claude Trichet—that there are no second-round effects and that the pressures from production capacity do not affect pay negotiations. It should also be borne in mind that the ECB's medium-term inflation estimates are generally on the low side since they cannot take account of increases in administered prices on a two-year horizon.

The financial market anomalies are clearly a concern for the ECB, and increase the risks to the downside for our central growth scenario. However, the ECB has confirmed that the markets need a massive injection of liquidity to get moving again. With its extraordinary refinancing move of 18 December, the ECB injected EUR 348.6Bn into the system, at the rate of 4.21%—requested, it said, by 390 banks. This sum is approximately double the amount the ECB thought necessary at the time for normal operations to resume. The transaction led to a fall in money market rates, with the 2-week Libor down from 4.94% on Monday 17 December to 4.4%.

We do not think the ECB will want to intervene with a rate cut (as the Fed and Bank of England have done) to provide “insurance” for growth, in light of fresh nervousness on the markets and a further increase in the preference for liquidity

seen in recent weeks. Given the lower exposure of European households compared with those in the US and UK, together with the general lack of an overvalued real estate market, there are no key factors implying a more pessimistic revision of the macro scenario and risks to price stability—and therefore, monetary policy.

It is worth remembering that at the start of the rate-raising cycle in late 2005, the ECB had left rates neutral and non-restrictive.

**If the risks to the downside for growth materialise in the first half of 2008, leaving GDP at the lower limit of the ECB staff forecasts for the whole of 2008, the bank may consider easing monetary policy.** In this case the pressure from production capacity on consumer prices in 2009 would fall away.

Conversely, if the US and international situation normalised to a greater extent than the markets expect, Euro zone growth could recover more rapidly than envisaged in the second half, introducing risks that the ECB will raise rates.

**Table 3 - Key macroeconomic forecasts: ECB versus the consensus and Intesa Sanpaolo**

Macroeconomic projections							
	Year	ECB		Consensus (Dec 07)		Intesa Sanpaolo	
		HICP	GDP	HICP	GDP	HICP	GDP
June 2007	2007	2.0	2.6	2.0	2.7	2.1	2.9
September 2007	2007	2.0	2.5	2.0	2.6	2.1	2.6
<b>December 2007</b>	<b>2007</b>	<b>2.1</b>	<b>2.6</b>	<b>2.0</b>	<b>2.6</b>	<b>2.1</b>	<b>2.6</b>
June 2007	2008	2.0	2.3	1.9	2.2	2.0	2.4
September 2007	2008	2.0	2.3	2.0	2.2	2.2	2.3
<b>December 2007</b>	<b>2008</b>	<b>2.0</b>	<b>2.0</b>	<b>2.3</b>	<b>1.9</b>	<b>2.3</b>	<b>2.0</b>
<b>December 2007</b>	<b>2009</b>	<b>1.8</b>	<b>2.1</b>				

Source: ECB, consensus and Intesa Sanpaolo

But there is a reason, of a regulatory nature, why the ECB will want to avoid cutting its policy rate—money supply growth. The ECB recognises the importance of financial aggregates in determining monetary policy. It is possible that the de facto restriction put in place by the markets in recent months triggers a sharp slowdown in lending, but for the moment M3 growth continues to advance buoyantly. If the market anomalies recede in three months' time, the liquidity pumped in by the central banks could push up consumer prices, and the task of countering this would have to begin again.

## Germany: heading for more balanced growth

Anna Grimaldi

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**After about ten years of below-average growth, the German economy resumed its role as the Euro zone's main driver in late 2005.** Far-reaching reforms that began at the end of the 1990s and culminated in the Hartz law of 2003 have helped kick-start the country's competitiveness. In light of the transformation of the past seven years, the Bundesbank has revised its potential growth estimates from 1.5% to 1.5-1.75%.

The reform process – especially widespread wage moderation and the outsourcing abroad of the most labour-intensive parts of the production process – together with German industry's manufacturing specialisation, have led to a sharp upturn in exports in the past two and a half years. Capital spending has accelerated in order to deal with limits on manufacturing capacity. Spending on construction, which between 1995 and 2005 trimmed an average of 0.3% per year off GDP growth, has once again begun to make a positive contribution. Household consumption was again the weakest link in 2007, due partly to the VAT hike at the start of the year.

In 2008, growth could be hampered by more restrictive financial conditions and uncertainty over the international outlook. However, the improvement in the fundamentals seen in recent years should enable the German economy to keep growing above trend and in line with the Euro zone average of 1.9-2.0%. It should also beat France (1.8%) and Italy (1.2%). We expect a slowdown in exports, although manufacturing specialisation and the concentration of German trade flows towards Asia and east Europe should help them remain resilient (+6.9%, after a rise of 8.2% in 2007). Conversely, we forecast that domestic demand will be strong and become more balanced. In the first half of the year, there could be a slowdown in expenditure on machinery due to tighter fiscal regulation of depreciation, although this will be counteracted from 2Q by the positive effect on company earnings of a lower corporate income tax rate. Consumer spending should pick up in 2008 even without the favourable base effect caused by the VAT hike in early 2007. We forecast an average rise of 0.4% qoq, from the 0.1% qoq registered in the past five years. Disposable income is likely to grow at a better rate since the employment trend is still strong. We can therefore reasonably expect to see wage growth pick up after years in negative territory. However, propensity to consume remains historically low because income distribution has shifted towards sections of the population that prefer to save, while the level of precautionary saving<sup>2</sup> has also increased.

**On the supply side, we expect German industry to be more resilient than the European average.** The construction sector is set to grow more slowly than in the past two years, however, judging by data on orders and building permits.

**After the jump to above the Euro zone average in 2007 due to the VAT hike, inflation is forecast to ease back during 2008.** The recent sharp rise in commodities prices was only partly counterbalanced by the strong euro, as can be seen by the sharp jump in import prices in October, and will therefore help keep the annual inflation rate above 2% until October 2008. Further pressures could come from wages.

**Looking now at public finances, we expect Germany to register a budget surplus in 2007.** Revenue growth exceeded even the most optimistic forecasts, while spending remained largely in line with the projections set out in the budget,

<sup>2</sup> Deutsche Bundesbank, "Private consumption in Germany since reunification", *Monthly Bulletin*, September 2007.

at less than 1%. We expect a slight deficit of 0.2% of GDP in 2008, since the reform of corporate income tax will trim the public finances by at least 0.3% of GDP, while growth in tax income on company earnings may ease back slightly next year. In addition, the wage agreement for federal and local public sector workers expires at the end of this year, and after two years of zero nominal salary growth, the unions are likely to demand wage rises in line with those agreed for employees of the Länder (2.5% until 2008).

The main **risk** is still of a **credit crunch**, but in this case too we think that the **German economy is more capable than its Euro zone peers of absorbing tighter financial conditions**. Companies' balance sheets are very solid, given strong earnings growth over the past 18 months and the limited use of debt to finance investment. Household debt has remained largely stable over the past ten years, standing at 68.3% of GDP compared with 63.5% in 1996, whereas it has grown sharply in the rest of the Euro zone, to 61% of GDP, from 45% in 1996. Moreover, most household debt is indexed to long-term interest rates, which have fallen significantly over the past five months and are expected to rise only slightly now.

**Further risks to the German economy lie in the fact that the far-reaching reform process appears to have passed its peak**. Now there is talk of a minimum wage, something never before seen in Germany. The era of sharp wage deflation, one of the main contributors to Germany's improved competitiveness, has almost certainly come to an end, and the demand for a minimum wage could be bad news for future trends.

#### Germany – forecasts

	2006	2007	2008	2007				2008			
				1	2	3	4	1	2	3	4
GDP (1995 prices, y/y)	3.1	2.7	1.9	3.6	2.5	2.5	2.0	1.8	1.9	1.8	1.9
- q/q change				0.5	0.3	0.7	0.5	0.3	0.4	0.5	0.6
Private consumption	1.1	-0.2	1.9	-2.0	0.8	0.5	0.3	0.5	0.5	0.6	0.6
Fixed investment	7.0	5.3	2.9	2.1	-1.2	0.6	1.1	0.8	0.8	1.0	0.8
Government consumption	0.9	2.0	0.8	1.8	0.0	0.0	0.3	0.3	0.3	0.3	0.3
Export	12.9	8.3	5.8	-0.3	0.8	3.1	1.1	1.0	1.3	1.5	1.7
Import	11.5	7.0	8.4	2.3	-1.8	3.9	4.0	1.8	0.0	2.4	2.6
Stockbuilding (% contrib. to G)	-0.2	0.4	0.8	2.0	-1.1	0.4	1.3	0.2	-0.7	0.3	0.4
Current account (% of GDP)	4.9	6.0	4.6	6.3	5.9	6.2	5.6	5.3	4.3	4.2	4.7
Deficit (% of GDP)	-1.6	0.0	-0.3								
Debt (% of GDP)	68.7	65.6	63.7								
CPI (y/y)	1.8	2.3	2.4	1.9	2.0	2.2	3.2	2.7	2.4	2.5	1.9
Industrial production (y/y)	6.0	5.8	3.8	1.8	0.3	2.1	0.8	-0.1	1.1	2.1	1.3
Unemployment (%)	10.8	9.0	8.1	9.4	9.2	8.9	8.6	8.4	8.2	8.0	7.9

Percentage variations over previous period, if not otherwise specified.

## France: support from domestic demand

Paolo Mameli

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Following its underperformance in the last two years, when economic growth in France trailed the entire Euro zone by more than half a point, France will reduce the gap with the Euro zone in 2008. We expect only a slight slowdown to 1.8% in 2008, from 1.9% in 2007. Domestic demand will be the driving force for the economy. Consumer spending will, in fact, accelerate to 2.2%, in line with disposable income, which will benefit from both the improvement in employment (+1.7% yoy in 3Q, at their highest levels since 2001), and the tax cuts introduced by the TEPA law (Law on employment, labour and purchasing power). Specifically, higher tax credits allowed on mortgage loan interest will soften the impact of rising house prices and tighter lending conditions. Fiscal policy will thus stimulate growth: we estimate a deficit of 2.9% of GDP in 2008 (from 2.4% in 2007), following lower growth and the expansive measures, equivalent to 0.2% of GDP, contained in the above law. Conversely, household spending will be prevented from accelerating too sharply by rising inflation, which is squeezing real salaries growth, and by the fact that continuing high unemployment levels will keep wage growth in check.

Turning to companies—the weakest link in the French production system over the last few years—more encouraging signs than forecast recently are beginning to emerge, with business confidence indices and industrial activity indicators outperforming those of other Euro zone countries. Given that the level of capacity utilisation is above the historical average and that many companies need to renew their plant and equipment, the cycle of investment cannot be considered at an end. However, although investment remained robust at 3.7% this year (4.1% in 2007 and 5.1% in 2006), we estimate that it will slow in 2008 to 2.4% following the deterioration in profitability due to higher energy prices and a less favourable global economy. We estimate that exports could continue to make a negative contribution to growth, given that the productive and geographical mix of French exports is not particularly advantageous in the current phase of economic growth.

Inflation rose sharply recently, reaching 2.4% in November, its highest level for more than three years and double that of three months ago. We estimate that prices could rise further, peaking at 2.7% next spring, with an annual average of 2.2% in 2008, up from 1.5% in 2007.

### France - Forecasts

	2006	2007	2008	2007				2008			
				1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	2.2	1.9	1.8	1.9	1.4	2.1	2.0	1.8	1.9	1.6	1.8
- q/q change				0.6	0.3	0.7	0.4	0.3	0.4	0.4	0.5
Private consumption	2.2	1.9	2.2	0.5	0.6	0.7	0.4	0.6	0.5	0.6	0.6
Fixed investment	4.1	3.7	2.4	1.2	0.4	0.6	0.4	0.3	0.8	1.0	1.0
Government consumption	1.6	1.5	1.3	0.3	0.5	0.3	0.3	0.3	0.3	0.3	0.3
Export	6.3	3.5	2.8	1.5	0.7	1.7	0.9	-0.2	0.4	1.1	1.6
Import	7.1	4.4	2.5	0.9	1.8	1.4	1.1	-0.7	1.3	0.0	1.4
Stockbuilding (% contrib. to GDP)	0.1	0.0	-0.3	-0.2	0.2	0.0	0.1	-0.3	0.2	-0.5	-0.1
Current account (% of GDP)	-1.3	-1.2	-1.6	-0.8	-1.1	-1.3	-1.8	-2.1	-1.5	-1.2	-1.5
Deficit (% of GDP)	-2.5	-2.4	-2.9								
Debt (% of GDP)	65.1	64.9	65.4								
CPI (y/y)	1.7	1.5	2.2	1.5	1.3	1.2	1.5	1.8	2.1	2.3	2.2
Industrial production	0.9	1.3	1.5	0.9	0.1	1.1	-0.1	0.2	0.5	0.5	0.5
Unemployment (%)	9.0	8.1	7.7	8.4	8.1	7.9	7.8	7.7	7.7	7.8	7.7

Percentage variations over previous period, if not otherwise specified.

## Italy: towards a sharp slowdown

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Recent trends in the Italian economy show that at the moment there is no solid base of growth, with downside risks weighing on all the major components of GDP.

Industrial activity is unequivocally slowing, a trend which has been confirmed by the most recent figures. In addition to the combination of higher commodities prices and weakening demand, industrial companies also had to deal with the chaos caused by transport workers' industrial action (estimates by *Federdistribuzione* put total damage at around EUR 2 billion). Even services, which had shored up the economy in the first half of the year, started to show signs of a slowdown, as seen in the confidence indices of sector companies. We cannot even expect robust support from the building sector: following its recovery in summer, investment in building could start slowing again in the wake of interest rate rises, which restrict access to mortgages, and signs of weakening demand.

Not only are there no encouraging signs emerging from companies, risks to household spending are also rising. Disposable income is increasing only modestly, and the return of inflation has curbed spending capacity in real terms. Moreover, the latest interest rate rise on the inter-bank market will further increase debt servicing costs.

If domestic demand is fragile, foreign demand is certainly not in a position to act as a driver, given the weak global economy, which in 2008 will see growth no higher than 2% in all the main advanced countries. On the other hand, the solid performances of emerging countries could prevent exports from slowing further following the decline noted in 2007.

The only support factors in this phase appear to be: 1) the resilience of employment; 2) the moderately expansive tone of fiscal policy and 3) Italy's lower exposure to credit crunch risks compared to other countries, given its low level of household debt.

In summary, we estimate average GDP growth of 1.2% (from 1.7% previously) for 2008. We therefore revise our estimates down by one-tenth of a percentage point.

As regards inflation, we believe that the recent upsurge in prices cannot be considered at an end, as international commodities prices are still high, and further price increases are expected on 1 January following those that occurred in October. We think that the national consumer price index could hit its highest point, of 2.6%, in January, in tandem with the new price rises. Inflationary pressures are not likely to ease substantially until the end of 2008. Average consumer prices will rise to 2.4% in 2008, compared to 1.8% in 2007.

The greatest risk to the Italian economy today—over and above the effects of the financial crisis, to which Italy has only been slightly exposed—is that attached to the resilience of exports, against a backdrop of slowing global demand and a strong euro. Using the OEF econometric model, we estimated the effects on Italy's economic growth of a 9% rise of the euro against the dollar, as happened in 2007, over the long term, assuming that the euro/dollar exchange rate remains at current levels (1.44 at 19/12/2007), rather than falling back from this peak as in our base scenario (and the consensus). This exercise shows that such a rise (if long term) could lead, all other things being equal, to a reduction in GDP growth of 0.6% on average for the forecast horizon (five years). In our view, the model overestimates this impact in that the long-term equation estimates also includes the pre-euro period, which for a number of reasons cannot be compared satisfactorily to the current scenario, and does not take into account recent growth in the proportion of exports to Asian countries. However, that would indicate that

the greatest risk to the Italian economy, above and beyond the effects of the financial crisis, is clearly the risk relating to the resilience of exports. Note too, that any easing action by the ECB in response to slower growth would reduce the impact to 0.4%. A simulation conducted using the econometric model of the Confindustria Research Centre estimates that a long-term rise of the euro against the dollar of 10% would have a negative impact on GDP of 0.2% per year. Assuming a monetary policy move, the impact is more likely to be around 0.3%. Running simulations using simultaneous equation models also helps to identify the effects on various demand components. It emerges that the greatest risks are attached to exports, which are directly hit by the loss of competitiveness of Italian products, and investment, which would reflect the drop in aggregate demand and the downgrading of growth and earnings prospects. Companies' spending on machinery, equipment and transport would suffer, while investment in construction should not diverge from the base scenario. Euro appreciation would boost consumption in the first year, by reducing the price of imported goods, but the effects would be negative thereafter.

#### Italy - Forecasts

	2006	2007	2008	2007				2008			
				1	2	3	4	1	2	3	4
GDP (constant prices)	1.9	1.7	1.2	2.4	1.8	1.9	0.9	0.9	1.2	1.2	1.4
- q/q change				0.3	0.1	0.4	0.1	0.3	0.4	0.4	0.3
Private consumption	1.5	1.9	1.4	0.7	0.5	0.2	0.2	0.4	0.4	0.5	0.4
Fixed investment	2.4	2.9	2.0	0.6	0.2	1.5	0.1	0.5	0.4	0.4	0.5
Government consumption	-0.3	0.2	1.0	0.0	-0.1	0.2	0.2	0.3	0.3	0.3	0.3
Export	5.5	2.4	2.5	0.2	-1.4	0.9	1.0	0.5	1.0	0.3	1.0
Import	4.5	2.4	2.9	-1.2	-0.2	2.4	0.6	0.0	0.6	0.8	1.9
Stockbuilding (% contrib. to GDP)	0.4	0.0	-0.2	-0.6	0.0	0.3	-0.2	-0.2	-0.1	0.1	0.2
Current account (% of GDP)	-2.6	-2.3	-2.6	-3.3	-2.4	-0.9	-2.9	-4.0	-2.9	-1.0	-2.6
Deficit (% of GDP)	-4.4	-2.4	-2.3								
Debt (% of GDP)	106.8	104.5	103.0								
CPI (y/y)	2.1	1.8	2.4	2.0	1.9	1.7	2.4	2.5	2.4	2.5	2.1
Industrial production	2.6	0.5	0.7	-0.7	-0.4	0.6	-0.3	0.5	-0.2	0.4	0.7
Unemployment (%)	6.8	6.0	6.1	6.2	6.0	5.9	6.0	6.0	6.0	6.1	6.1

Percentage variations over previous period, if not otherwise specified.

## FOCUS - Spain: heading for the big test

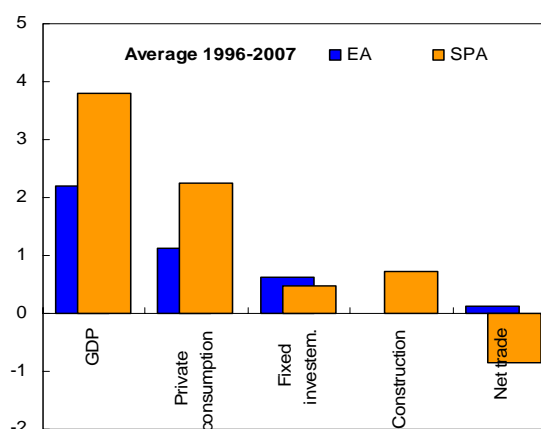
### Growth has outpaced the Euro area average for ten years, but the excesses carry a cost

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Since 1995 Spain's growth has outstripped the Euro area average by 1.5 points and has been almost half a point above trend, estimated at 3.5%<sup>3</sup>. This surprising performance is clearly due in part to a process of catching-up, accelerated by the fall in interest rates that followed Monetary Union, which acted as a spur to domestic demand and particular to spending on consumption and construction. The weight of residential investments as a proportion of GDP has almost doubled in the last ten years to 7% of GDP in 2007, whereas in Europe the figure is around 4.5%. By contrast, the contribution of corporate sector investments has been below the European average (see the chart below).

#### What is behind Spain's surprising outperformance?



Source: Eurostat and Intesa Sanpaolo research

#### Trade deficit at 7,8% of GDP a threat to future income flows

Against the exuberance of domestic demand, the unsatisfactory trend in labour productivity and total factor productivity, coupled with the robust growth in wages, has resulted in a significant loss of competitiveness and impacted on outgoing trade flows, generating a trade deficit of around 7,8%. In itself the trade deficit is not worrying since membership of the European Union isolates Spain from the exchange rate risk. However, the accumulation of debt might affect future income flows and thus penalise the trend in domestic demand in the medium term.

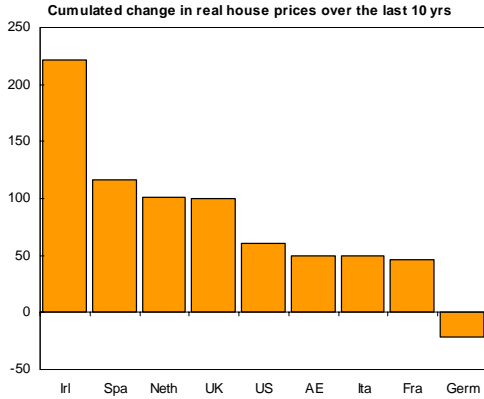
#### House prices rising steadily since 1997

The falling cost of debt and demographic trends in the second half of the 1990s triggered a boom in housing demand. Property prices rose by an average of 8% yoy per annum between 1997 and 2005. In the last two years prices have slowed, easing to 6.7% yoy in 2006 and to 3.0% this year. In spite of this, the cumulative rise in the last ten years has been 120%, second only to Ireland among the industrialised nations. A prolonged period of sustained growth in house prices inevitably raises fears of overvaluation and/or a speculative bubble. A reversal in the trend in house prices may have serious consequences vis-à-vis household

<sup>3</sup> See Bank of Spain July Bulletin.

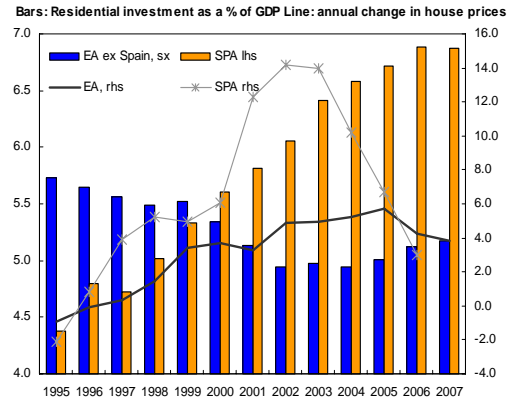
consumption and investment decisions via the wealth effect. Home ownership is the main asset of households in Europe and especially in Spain, where real estate wealth amounts to around 900% of disposable income vs. 455% in 1999.

**Behind Ireland, Spain has seen house prices rocket in the last ten years**



Source: OECD, ECB and Bank of Spain

**...which accounts for the robust growth in residential investments as a proportion of GDP vs. the Euro area average**



Source: Eurostat, ECB and INE

**Household debt now at UK/US levels**

A change in interest rates may have serious repercussions on consumer spending, especially when household leverage is variable rate. To meet the growing debt burden, households might sell their property assets, thus triggering a price correction which in turn would have a further negative effect on consumption. In Spain, debt is now around UK levels and accounted for 136% of disposable income in 2Q07. The Bank of Spain estimates that around 80% of real estate leverage is indexed to short-term rates.

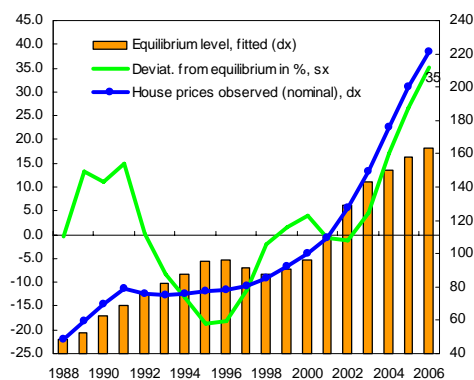
**The crisis on the markets and the uncertainty over the macroeconomic outlook might prove fatal. Will Spanish households and the Spanish economy overcome this test?**

It is thus clear to see why there have been fears for several years now of a sharp correction in the real estate sector, and consequently in the Spanish economy. So far the Cassandras have been wrong, but 2008 might bring a major test. The financial crisis has driven the three-month Euribor to almost 5%, around 80bps above the start of June level. The international outlook remains uncertain and the risk of a slowdown in the Euro area to well below trend is not negligible. A lethal combination could thus be triggered of sudden and excessive growth in the debt burden and an economic slowdown. Will households and the economy hold up? We have sought to assess the size of the overvaluation of the Spanish real estate sector and the financial ability of households to respond to the crisis.

Accurately assessing the extent to which house price inflation is explained by the characteristics of an economy is not an easy task, and is moreover hampered by the availability and comparability of the data over time.

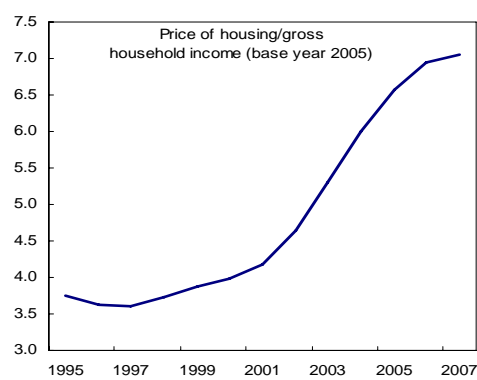
A simple equation<sup>4</sup> setting house prices in relation to the trend in the income of the population aged over 25 and a measure of the return on alternative investments suggests that house prices (nominal) are around 35% off their equilibrium value. Our valuation, despite being more approximate, does not differ significantly from the conclusions of the numerous papers published by the Bank of Spain, as summarised in the July 2006 Bulletin<sup>5</sup>. **The Bank of Spain paper concluded that house prices were overvalued by between 24% and 32%. The available studies, whilst recognising a deviation in the level of prices from the fundamentals seem to find no evidence of a speculative bubble** since the short/medium-term movements in house prices did not differ significantly from the adjustment towards equilibrium suggested by the empirical estimates.

**Our estimates suggest house prices are around 35% overvalued**



Source: Bank of Spain and INE

**Houses increasingly expensive in relation to income**



Source: Bank of Spain and INE

The sharp growth in house prices above the equilibrium value since the second half of the 1990s is due in part to the period of undervaluation that characterised the first half of the decade. In the absence of speculative phenomena, there is less likely to be a sharp reversal in house prices. However, the prolonged growth in house prices might trigger speculative behaviour. But this does not seem to be the case, since in the last 16 months there has been a relatively gradual slowdown in house price growth, to 6.7% in 2006 and to around 4% yoy in the first half of 2007. House price cooling coupled with a rise in interest rates may have major implications for the economy via the wealth effect. Specifically, the sharp rise in Spanish household debt (135% of disposable income in September 2007 vs. 52% in 1999) and the growing proportion of variable rate mortgages might magnify the downturn in consumption in response to a rise in interest rates and

<sup>4</sup> We have estimated the following long-term equation:  $\text{Log\_real house prices} = 11.4 + 1.24 \cdot \text{log income / population } >25\text{years} - 0.29 \cdot \text{log\_stock price index}$ . The equation is estimated over the period 1988 – 2006. The house price figures up to 1996 are extrapolated on the basis of the average price per square metre of vacant properties at least one year old. For the period 1996-2006 we have used Bank of Spain data. The prices are deflated using the harmonised index of consumer prices. The return on alternative investments is given by the share price index from the IMF. The population aged over-25 is available from 1996. For the period 1988 – 1996 the data are obtained from the total population growth rate. We tested the steadiness of the residuals and find weak evidence of cointegration; however, the lagged value of the residuals helps explain the short-term movements in house prices. Note that the coefficient on income from the estimated equation is higher than one. One possible explanation is that per capita income captures demographic and institutional factors that acquired greater importance in the second half of the 1990s.

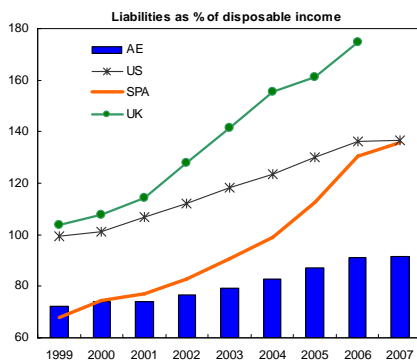
<sup>5</sup> J. Ayuso & F. Restoy “House prices in Spain: Is the evidence of overvaluation robust?” Bank of Spain Economic Bulletin, July 2006.

the movement in house prices. Based on the latest Bank of Spain indications, house prices are now seven times higher than incomes (Fig.5). Accordingly, it is worth looking at the financial health of households.

### Spanish households relatively affluent, but only thanks to the rise in real estate values

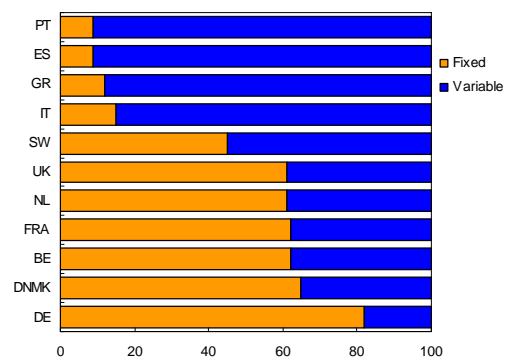
As debt has increased, so too has wealth, climbing to almost 1100% of disposable income from 655% in 1999. This increase is basically due to the growth in property wealth from 650% of income in 1999 to 920% in 2007. Financial wealth on the other hand has fallen sharply, slipping from 193% of income in 1999 to 153% in 2007, as households have reduced their positions in shares.

#### Debt has risen to “UK/US” levels



Source: Bank of Spain and INE

#### ...moreover, it is variable rate



Source: Bank of Spain and INE

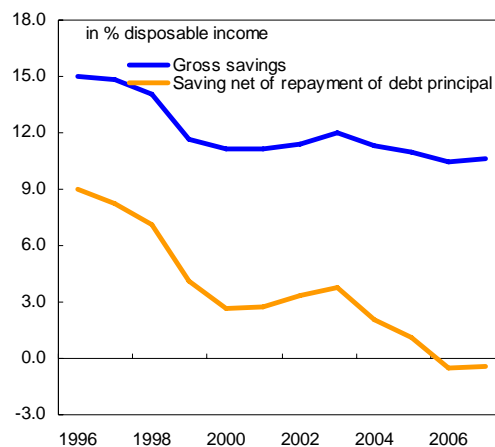
**Overall, net wealth remains high, but for this to boost spending the financial and/or real estate assets must be converted into cash. As interest rates rise, the growth in current financial charges is immediate and depends on the proportion of variable-rate debt.**

According to the European Mortgage Federation, around 80% of mortgages in Spain were variable rate in 2006. Between June and September, the average interest rate on mortgage debt rose by 23bps, i.e. by 5.4% and, according to our calculations, might have topped 6% average in the last three months. Following a sharp fall in interest rates to 3.4% between 2001 and end-2005, mortgage rates rose to 5.6% in August this year. In the latest credit survey conducted by the Bank of Spain, lending institutions said their standards were tighter in October and expected more stringent conditions in the coming months owing to the difficulties in securing funds on the interbank market. According to our calculations, average interest rates on debt might have risen to 6% avg. in the last three months. How households manage to digest these tougher financial conditions crucially depends on the saving rate netted of the debt burden.

**The saving rate netted of the debt burden is negative and might deteriorate should banks tighten lending standards in response to the crisis.**

We have therefore looked at the trend in the saving rate (including the interest expense) less the portion of debt that has to be repaid every year. Using Bank of Spain data, we note that the saving rate has remained steady in recent months at 10.5% of disposable income but, deducting the debt burden, the financial position of Spanish households looks far less secure since the net saving percentage is now negative. The hope is that the turmoil on the money market will gradually subside in the first half of 2008, bringing short-term rates more into line with policy rates.

### Spanish households no longer have savings on which to draw in the event of further rises in interest rates



Source: Bank of Spain and Intesa Sanpaolo calculations

However, a period of more restrictive financial conditions cannot be ruled out since, based on the latest credit survey conducted by the Bank of Spain, banks say they intend to introduce stricter lending standards. How much more stringent conditions become in the coming months depends on bank exposure. An analysis of the financial position of lending institutions suggests that the impact of the crisis should be limited.

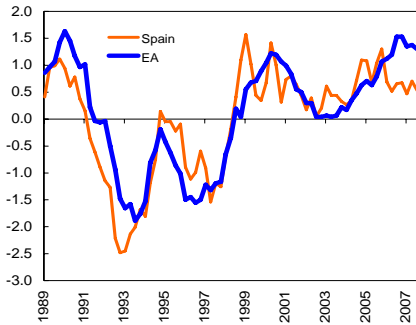
#### Is the banking system at risk?

In its last Bulletin (October 2007), the Bank of Spain estimated that the direct and indirect exposure of Spanish banks to subprime mortgages was negligible and, at the same time, found no evidence of financial commitments via conduits and/or SIVs. It is undeniably true that the difficulty in securing short-term funding on the interbank market poses a threat to Spanish banks which have made extensive use of this funding channel in recent years, as growth in lending has constantly outstripped growth in funding. However, based on the June 2007 figures, **banks seem to have used mainly medium/long-term instruments (25% of assets) rather than short-term instruments on the interbank market (6%) and commercial papers (3%). Moreover, around 77% of short-term funding on the interbank market involves foreign banks and accounts for just 7% of lending to households.** The Spanish banking market is characterised by good asset quality, delivering high returns and solvency standards. There is no subprime market. Loans to households in arrears are for now only slightly up and the Bank of Spain indicates a high level of provisioning against doubtful loans. Spanish banks have not used securitisations as a way to take the credit risk off balance sheet. Therefore, the financial position of banks should enable them to continue securing funds on the markets once the worst of the crisis is over. However, the need to secure funding on the market was already down even before the summer, since the hike in rates had reduced the demand for leverage, thus narrowing the gap between funding and loans.

**Residential investments heading for a gradual correction**

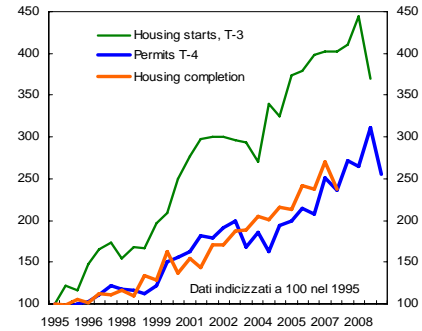
In conclusion, our analysis suggests a further cooling of residential property prices, but this should be gradual and have a limited impact on consumer spending, since the tightening of financial conditions via increases in rates should peak at the start of 2008.

**Confidence in residential construction has been falling since end-2005**



Source: EU Commission

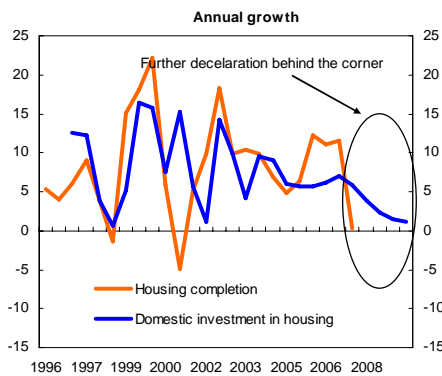
**Building permits and housing starts signal a reversal**



Source: Bank of Spain and INE

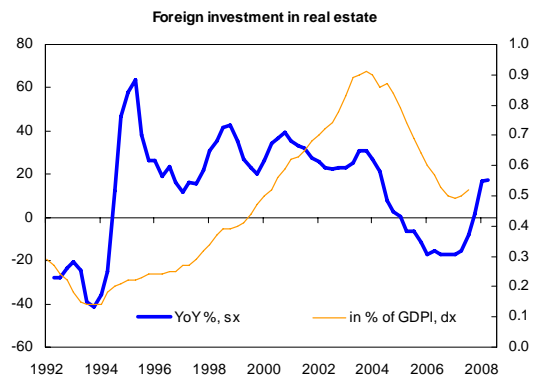
The implications for residential investments are for a “gentle slowdown” rather than a collapse. The confidence indicators have suggested a decline in sentiment since end-2005, but for now there have been no alarm signals on the real data front. The national accounting figures so far show a gradual slowdown in house building to 2.9% yoy in 3Q07, vs. 7.8% yoy at the start of 2006. Foreign investments in properties in the last four quarters have started rising again, helping to keep the year-on-year dynamic at a reasonable level. The trend might intensify over the coming months since building permits and housing starts were down sharply in the summer. Our central forecast is for growth in residential investments to 0,3% in year-on-year average terms in 2008, vs. an estimated 3.0% in 2007.

**The real estate market has already slowed in 2007. We expect a “gentle slowdown” over the next two years**



Source: Bank of Spain and INE

**Foreign investments are back, but will they stay?**



Source: Bank of Spain

### **Fiscal policy may provide an important buffer**

Even assuming a sharper slowdown than is envisaged in our central forecast should banks apply tighter standards for longer, we still see a sharp downturn in the Spanish economy as unlikely. The buffer for the economy might come from fiscal policy. In 2007, the budget will probably show a year-end surplus of just under 2%. Debt as a proportion of GDP will fall to 36% from 39.7% in 2006. Next year, the Finance Act projects a surplus of 1.3%, almost double the last update to the Stability and Growth Programme. To counter a collapse in residential investments, the government might bring forward several public works projects planned for the next ten years, and could even cut income taxes to bolster the purchasing power of households and businesses. We therefore take the view that the Spanish economy will cope reasonably well with the combination of high interest rates, more subdued growth and uncertainty over the international outlook.

### **Short term rates at around 5% are not restrictive for the Spanish economy**

Whilst we acknowledge that monetary conditions have turned far more restrictive since mid August, one should bear in mind that short-term rates at around 5% (3 mths Libor fixing hovered at around 4,90 in the first two weeks of December) are still expansionary for Spain, given that trend growth is estimated at around 3,5\$% and inflation is still hovering just under 3%.

Thus, we stand by our forecast of a slowdown in growth below trend in 2008 (2.5% vs. an estimated 3.8% in 2007); the risks are arguably still on the downside but, in light of our analysis, we see a full-blown recession as unlikely.

## United Kingdom: the monetary easing cycle is beginning

Asmara Jamaleh

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**Deteriorating conditions on the financial markets** (further rise in monetary market rates) **and the credit crunch have prompted the Bank of England to cut rates earlier than expected**, in December, from 5.75% to 5.50%. We expect two further cuts between the first and second quarter of 2008, bringing down the base rate to 5.00%. The financial market crisis is effectively also reaping effects on the real economy, both as a result of the direct impact on the financial services sector, and through the real estate channel. **Housing prices have already started to drop** and a further correction is very likely in the months ahead. In our estimation, **an additional 2.5% decline could subtract up to 0.5% from growth**, as a result of slower consumer spending induced by decreasing real estate wealth effect. While a slowdown in domestic demand was already expected before the August crisis broke out, the latter has amplified it on the downside.

**Early commencement of the monetary easing cycle should in any case prevent the economy from slowing sharply.** Estimated growth in 2007 is still high, at 3.1%, thanks to an excellent and stronger-than-expected performance in the third quarter of the year. The rate of growth in 2008, on the other hand, is expected to drop to 2.2%, just below the potential rate, depressed by both declining investments and consumer spending. The former are feeling the effects of both the past exchange rate trend and of distortion on interest rates, on the rise since August. Consumer spending growth is estimated to slow from 1.0% q/q to 0.6% only in 4Q07, thanks to the resilient labour, but should then decelerate more rapidly in the opening months of 2008, touching a low and subsequently bouncing back thanks to expected interest rate cuts.

**Slower growth and declining rates should weaken the pound sterling** both against the US dollar and the euro, which in turn should at last allow foreign trade to resume making a moderately positive contribution to growth. Due to imported inflation, the **price trend will continue to prove resilient**, also supported by rather tight conditions on the labour market, where unemployment has been declining uninterruptedly for a year, and wages started rising again in the 3Q07. **The inflation rate should ease back in line with the targeted rate only towards the end of 2008**, making a decline in interest rates below the forecast 5.0% mark unlikely.

### United Kingdom – Forecasts

	2006	2007	2008	2007				2008			
				1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	2.8	3.1	2.1	3.1	3.1	3.2	2.9	2.4	2.1	1.9	2.1
- q/q change				0.8	0.8	0.7	0.5	0.3	0.5	0.5	0.8
Private consumption	2.0	3.2	2.3	0.7	0.8	1.0	0.6	0.3	0.4	0.6	0.7
Fixed investment	8.2	5.5	1.2	1.1	-0.9	1.6	0.2	0.1	0.2	0.2	0.7
Government consumption	2.1	1.7	2.4	0.5	0.3	0.3	0.8	0.6	0.6	0.6	0.6
Export	10.3	-4.1	4.7	0.2	0.2	2.7	1.8	0.8	0.6	0.6	1.1
Import	9.8	-2.1	3.7	1.1	-0.4	3.9	1.1	0.3	0.3	0.4	0.9
Stockbuilding (% contrib. to C)	-0.2	0.2	-0.2	0.3	0.2	0.3	-0.2	-0.2	0.0	-0.1	0.0
Current account (% of GDP)	-3.2	-3.1	-3.2	-3.2	-2.7	-3.4	-3.4	-3.3	-3.2	-3.2	-3.1
Deficit (% of GDP)	-2.7	-2.5	-3.1								
Debt (% of GDP)	43.9	43.8	44.8								
RPIX (y/y)	2.9	3.2	2.7	3.7	3.4	2.7	3.1	2.9	2.7	2.8	2.5
Industrial production	0.0	0.4	0.7	-0.1	0.7	0.0	0.1	0.2	0.1	0.2	0.4
Unemployment (%)	2.9	2.7	2.6	2.8	2.7	2.6	2.5	2.5	2.6	2.7	2.7
3m GBP Libor	4.80	5.97	5.45	5.49	5.72	6.30	6.38	6.00	5.50	5.20	5.10
Long Gilt	4.50	5.02	4.75	4.86	5.21	5.18	4.83	4.70	4.60	4.80	4.90
GBP/USD	1.84	2.00	1.96	1.95	1.99	2.02	2.05	2.03	1.98	1.93	1.91
Effective exch.rate (1990=10)	101.2	103.5	98.7	104.6	104.1	104.1	101.3	99.1	98.8	98.3	98.4

Percentage variations over previous period, if not otherwise specified.

## Asia

### Japan: moving forward slowly

Giovanna Mossetti

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The Japanese economy in 2008 will follow the other industrialised economies on the path that leads to 21<sup>st</sup>-century style stagflation, revised and adjusted for the effects of globalisation: slightly lower growth, slightly higher inflation. Japan's growth will therefore be around potential, while prices will rise due to the normalisation of domestic demand combined with pressure on prices from energy and agricultural commodities.

The Japanese economy in 2008 will suffer the effects of the two main factors in the global scenario: **slowing growth, albeit not dramatically, and rising inflation**. As in the global economy, the slowdown in Japan's growth is not likely to be extensive or prolonged, as it will be supported by the growth of the large emerging economies and expansive monetary conditions. Financial conditions in Japan remain accommodative and will be increasingly so in 2008 if real rates fall as expected due to higher prices and the slow speed at which the BoJ normalises monetary policy. Moreover, the turbulence on the financial markets has so far had a restrictive effect on Japan, and has generally only caused the currency to appreciate. Although it would seem an ideal goal for Japan to come out of deflation, inflation will be due more to higher commodities prices than an increase in companies' pricing power.

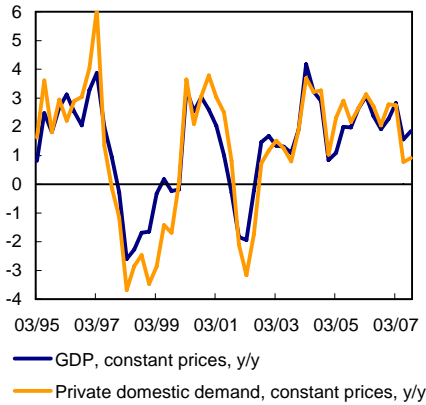
The Japanese economy is subject to downside "global" risks stemming from 1) the continuing credit crisis and possible contagion to the Japanese financial system, which so far has remained relatively immune to the market turbulence; and 2) a deterioration in the US economy. On the domestic front, the Japanese economy is subject to two idiosyncratic risks. A risk factor to domestic demand in 2008 is the trend in **labour income**: if salaries do not adjust to keep pace with rising inflation, private consumption could act as a drain on growth in the second half of 2008. The other idiosyncratic risk factor for the Japanese economy is the correction of the **residential housing sector**, which is contributing significantly to the growth slowdown in 2H07, with repercussions lasting at least until 1Q08. Current projections see a return of investment in the sector to positive growth rates from 2Q08.

**Third-quarter growth** was revised downwards to 1.5% qoq ann., from the previous estimate of 2.6%. The downwards revision essentially affected domestic demand growth, which fell from the previous estimate of +0.8% qoq ann., to -0.4% qoq ann., mainly due to the significant revision of private **non-residential investment spending**, which rose 4.7% qoq ann. from the previous estimate of 6.1%. **Residential investment** continued to act as a sharp brake on overall growth, falling by 27.9% qoq ann., and making a negative contribution of 1.2% to growth. Consumer spending remained modest but positive, rising by 1.2% qoq ann., slowing from its average growth rate of 1.6% in the first half. As regards net exports, the revision showed more modest growth of exports (+11%, from +17%), which is more than offset by the sharp downwards revision of imports (-0.8% qoq ann., from the previous estimate of +8.2%). The contribution of net exports therefore rose to 2.0%. The revised estimates also reduced second-quarter growth from -1.6% qoq ann. to -1.8%, and increased the estimate for 1Q growth to 3.3%.

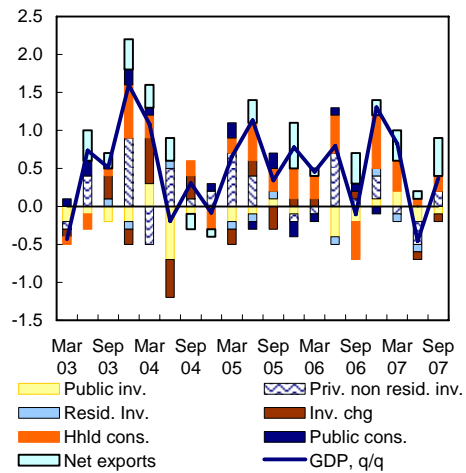
The revision of the third-quarter figures stresses an important point for the economy in 2008: **domestic demand has been curbed recently by various factors** - some temporary, others potentially longer-lasting - **and growth in 2H07 was again boosted by external demand, which remains solid** despite the

appreciation of the currency. The central scenario is that the factors curbing domestic demand growth at end-2007 are, however, favourable for 2008 (residential investment picking up), making expected growth next year less dependent on the performance of net exports.

**Exports save the day!**



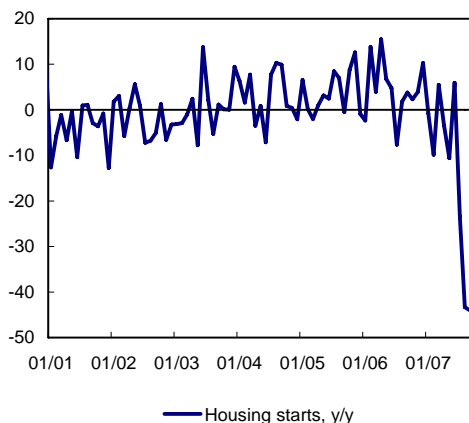
**Residential investment and inventories curb GDP**



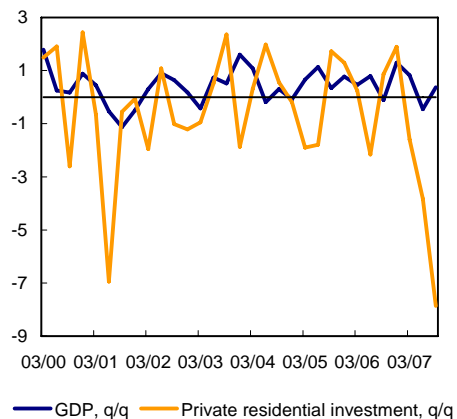
Source: Ecwin

Orders and deliveries relating to **non-residential investment** are again fairly positive and in keeping with the investment trend seen in the third and fourth quarters. October orders surprised to the upside, rising 12.7% mom, leading us to expect a positive fourth quarter even if this were to be followed by another slowdown. **Industrial output** grew by 1.7% mom in October following its fall of 1.4% in September, in line with expectations. Production plans for November are negative (-1.7% mom), and will recover in December (+3.2% mom). Output is driven by exports to Asia and the hi-tech sector. Output in the rest of the quarter looks likely to be less exceptional than that included in companies' plans due to weakening foreign demand, the effects of the downturn in the construction sector and the need to reduce inventories.

**Housing starts plummet...**



**...and residential investment spending collapses**



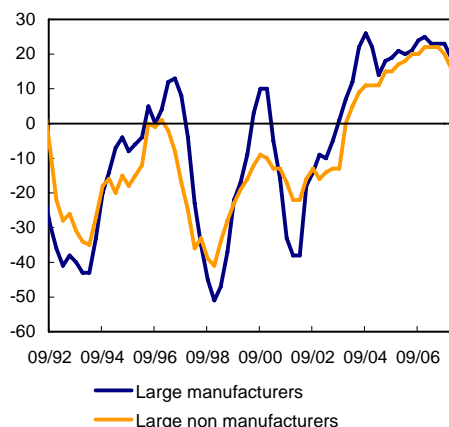
Source: Ecwin

**Residential investment** will close out the year with a slump of nearly 30% qoq ann., on the heels of its 24% fall in 3Q. Despite this, the figures for new housing

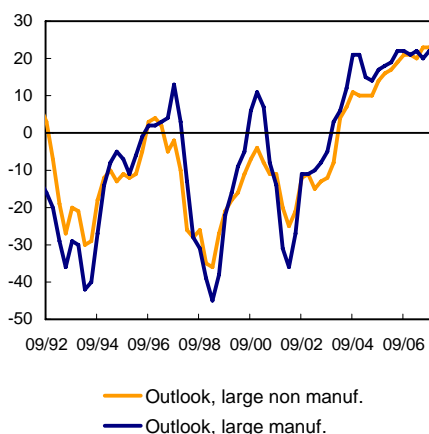
starts show that there could be light at the end of the tunnel: although new starts fell by 35% yoy (and by 44% in September), if looked at on a monthly basis, a turning point has at last been reached, with an increase of 18.1% mom. In October the government eased restrictions on building standards and construction materials, putting an end to the crash that started in the spring. The residential housing sector made a contribution of -1% in 3Q and is set to remain firmly in negative territory in 4Q.

The December **Tankan** survey indicates a less exceptional scenario over the next few quarters but one that is still in keeping with near-potential growth. The **Tankan** survey showed a decline by the coincident and three-month indices that was greater than expected by the consensus. The index for **large manufacturing companies fell to 19** from 23 in September, in line with September's expectations index. The fall in the indices affected a large number of sectors. Expectations for the next quarter fell from 19 to 15. Indications from the Tankan report do not confirm the recovery of the Reuters Tankan (manufacturing) and PMI indices, which had improved in November following sharp falls in September and October: the Reuters Tankan showed signs that expectations would decline further over the next few months. For **large non-manufacturing companies, the Tankan fell from 20 in September to 16**. The expectations index slid from 21 in September to 15. The Reuters Tankan for large non-manufacturing companies had declined sharply in November, tumbling from 19 to 9. The fall, however, was mitigated by signs of recovery in expectations for the next three months. A positive glimmer is emerging from the surveys of small and medium-sized manufacturing companies, whose coincident index rose from +1 to +2. Despite this, the three-month indices for SMEs also fell.

**Tankan: indices decline, but remain at high levels**



**Expectations indicate modest slowdown**



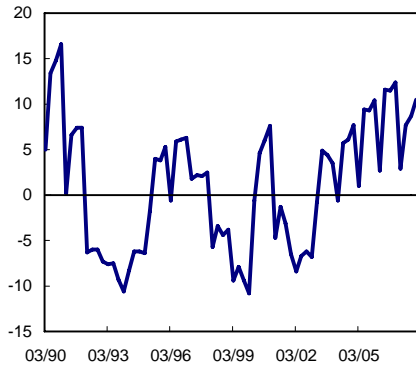
Source: Ecwin

**Investment plans** for the current financial year show an upwards revision to 10.5% (10.8% for manufacturing and 10.2% for non-manufacturing companies), from 8.7% in 3Q. The exchange rate assumed in the outlook for companies for the second half of the financial year 2007 is 116.7 Y/\$, compared to previous forecasts of a slightly stronger currency (113.8 for 2H07). The survey confirms the high rate of capacity utilisation, although this is likely to ease in the next quarter. On the earnings front, profitability is increasing for large companies but falling for SMEs.

Diffusion indices for **employment** show a slight fall in keeping with the rise in the unemployment rate in the last few months from its recent low of 3.6% to 4%. Lastly, **price indices** show rising pressure from input prices together with a rise in

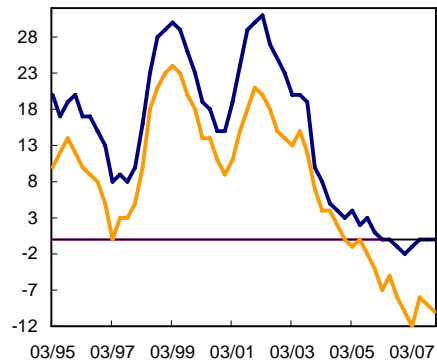
the output price index, confirming the central bank's expectations of a gradual return to non-deflationary price policies. The survey confirms that the Japanese economy is likely to see the pace of growth slow in the fourth quarter and early 2008. However, indications are in line with growth staying close to potential, estimated at 1.5-2%.

**Investment plans still rising...**



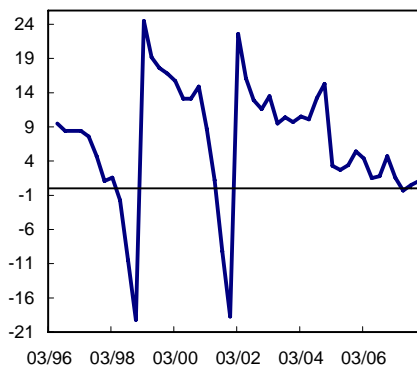
— Capex plans, large firms, y/y, fiscal year

**...to cover the full use of resources**



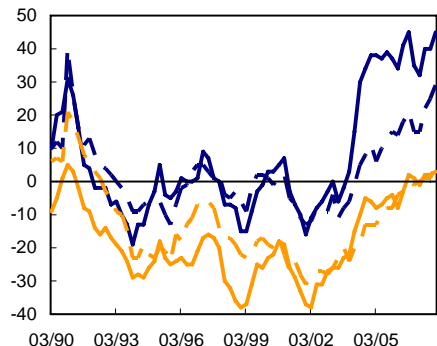
— Excess production capacity  
— Employment conditions (<0 indicates tight labor mkt)

**Earnings slightly positive**



— Profits (expected), fiscal year, y/y

**Price pressures: deflation is really over**



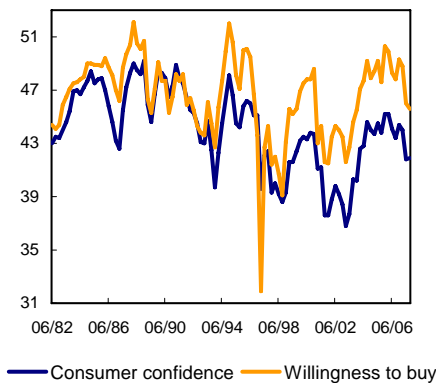
— Input, manuf.      — Input, non manuf.  
— Output, manuf.      — Output, non manuf.

Source: Ecwin

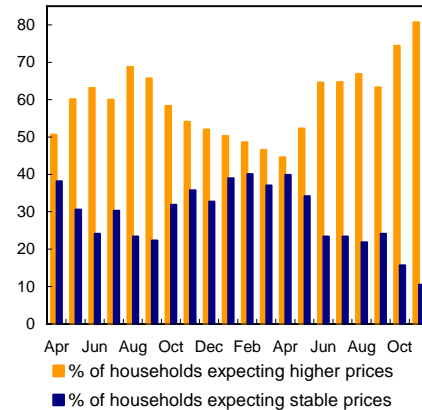
The **unemployment rate** remained stable at 4% in October, while the jobs/applicant ratio fell from 1.05 to 1.02. The number of people in employment rose by 0.3% mom, but fell slightly yoy. A few signs of weakness are emerging in some sectors. The outlook for consumer spending is crucially dependent on the labour market trend: constant employment growth in the last two-three years, together with the continuing fall in the rate of unemployment, has driven consumer spending onto a positive path of around 1.5-2%. The outlook for next year is for unemployment to dip to 3.6%, in keeping with unchanged positive growth in the number of people in employment, although this is likely to be weaker than that seen in recent years, as the ageing population causes the workforce to reduce. **Household spending** went up by 0.6% yoy in October, in line with expectations, after a strong showing in September. The change in real terms was 0.6% on a monthly basis, which confirms our forecast of modest growth in consumer spending at the end of the year. In 2008, consumer spending is forecast to grow at around 1.6%, in line with 2007 levels.

**Consumer confidence** fell continually in the second half, due partly to internal policy issues and partly to a perceived diminution in the purchasing power of salaries in the face of price rise expectations. Looking at household confidence surveys, which show a sharp fall in spring, it can be seen that the percentage of households expecting positive inflation in the next 12 months climbed steadily, reaching 80.7% in November 2007, the highest since the series began (2004). Risks to consumer spending could come from rising inflation in the first half of the year.

**Household confidence falling....**



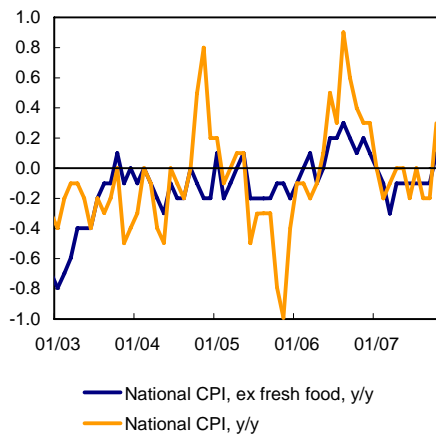
**...partly due to expectations of higher prices**



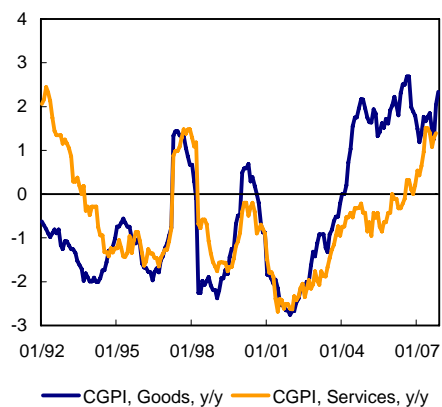
Source: Ecwin, Cabinet Office

Inflation increased to 0.3% yoy in October for the national index, from -0.2% yoy in September, which was also more than that indicated by the Tokyo index (+0.1% yoy) published the previous month, and by rising petrol prices. Inflation ex fresh foods rose by 0.1% yoy in October, while the year-on-year variation in inflation excluding food and energy remained unchanged at -0.3%. In 2008, upward pressures on commodities are expected to combine with rising services prices, to finally “normalise” consumer prices.

**Positive inflation: mainly energy at the moment...**



**...but pressures on services prices are rising**



Source: Ecwin

## Conclusion

All the available information points to the fact that Japanese growth is slowing, but not markedly so. Domestic demand is likely to remain the main growth factor in 2008, with consumer spending broadly in line with that seen in 2007 (around 1.5%): non-residential private investment will still be positive, rising by around 2-2.5%, accompanied by a pick-up in residential investment in the second quarter of 2008. The price outlook shows that inflation will clearly return to positive territory due to the combined effects of rising commodities prices and a slight improvement in companies' pricing power. Consequently, rate normalisation is the most likely scenario for the BoJ, although there is unlikely to be any scope for a fresh interest rate rise before the end of 2Q08.

## Japan – Forecasts

	2006	2007	2008	2007				2008			
				1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	2.4	1.8	1.4	2.8	1.6	2.0	0.9	0.5	1.6	1.6	1.8
q/q annual rate				3.3	-1.8	1.5	0.8	1.4	2.7	1.6	1.6
Private consumption	2.0	1.6	1.6	2.6	0.8	1.2	1.2	1.8	1.9	2.0	2.1
FI - private nonresidential	4.3	1.9	2.6	-1.6	-6.7	4.6	4.3	1.9	2.5	3.8	4.7
FI - private residential	0.9	-8.4	-11.1	-6.2	-14.5	-27.9	-23.5	-7.7	1.5	1.8	2.3
Government investment	-8.5	-1.8	0.0	21.0	-17.1	-9.0	12.6	0.3	0.3	0.4	0.4
Government consumption	-0.4	0.6	1.2	0.7	1.1	0.7	1.2	1.3	1.3	1.3	1.3
Export	9.6	7.8	4.4	13.3	3.9	11.0	5.5	3.2	2.7	2.6	3.0
Import	4.2	1.6	4.7	3.9	2.8	-0.8	4.0	5.2	6.1	7.3	8.3
Stockbuilding (% contrib. to GDP)	0.2	-0.1	0.0	0.0	-0.1	-0.1	-0.2	0.0	0.3	0.0	0.0
Current account (% of GDP)	3.9	4.7	4.6	4.4	5.0	4.8	4.4	4.6	4.8	4.7	4.6
Deficit (% of GDP)	-6.5	-6.2	-5.9								
Debt (% of GDP)	163.5	163.3	167.3								
CPI (y/y)	0.2	0.0	0.3	-0.1	-0.1	-0.1	0.2	0.5	0.2	0.1	0.1
Industrial production	4.5	2.6	1.8	-4.8	0.5	9.4	0.6	0.4	0.7	1.4	1.8
Unemployment (%)	4.1	3.8	3.6	4.0	3.8	3.8	3.7	3.6	3.6	3.6	3.6
3-month CD rate	0.33	0.71	1.09	0.64	0.64	0.79	0.78	0.90	1.00	1.15	1.30
10-year rate	1.76	1.76	1.99	1.65	1.87	1.68	1.85	1.91	1.95	2.00	2.11
JPY/USD	116.4	117.8	108.5	119.4	120.8	117.7	113.2	110.8	109.0	107.5	106.5
Effective exch.rate (1990=100)	124.6	118.4	127.5	119.2	116.2	118.1	120.3	122.7	126.2	129.4	131.6

Percentage annualised growth rate over previous period, if not otherwise specified.

## China: no major slowdown in sight

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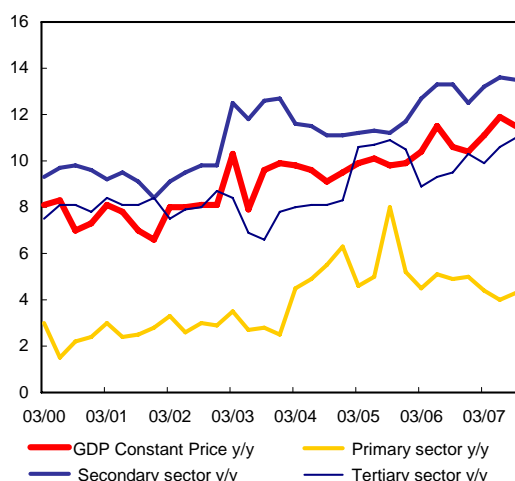
Chinese growth is still thriving, despite five interest rate hikes and ten compulsory reserve coefficient adjustments.

GDP grew by 11.5% y/y in 3Q07, falling only slightly short of the 2Q07 rate, and **investments were once again the main driver of growth**. Despite the measures put in place to slow their trend, fixed investments increased by 26.4% y/y in 3Q07, and by 26.9% y/y in the first ten months of 2007. At the end of 2006 they accounted for 42.5% of GDP, as opposed to the 36.2% share accounted for by private consumption, and according to the National Bureau of Statistics, in the first nine months of 2007 the breakdown remained broadly unchanged.

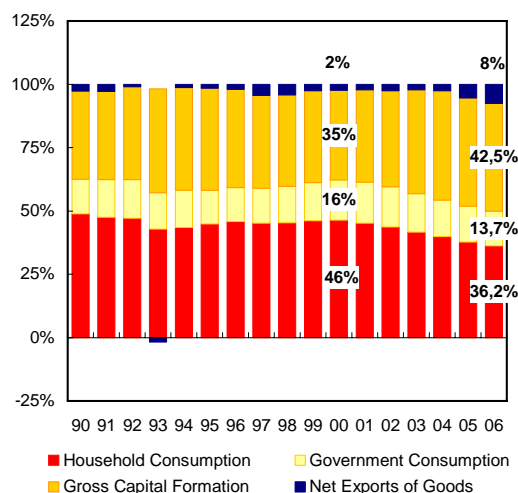
The share of private consumption in China's GDP has dropped progressively over the past few years, from 46% in 2000 to 36% in 2006. The weight of investments, on the other hand, has increased from 35% to 43%. In 2006, in the major industrialised countries private consumption accounted for shares of GDP ranging from around 55% in France to a high of 70% in the United States. The rate was 57% in Japan and just over 50% in South Korea. While it is plausible that in an initial phase of infrastructure building investments may account for an important share of a country's GDP, other Asian economies, such as Vietnam (private consumption 64% of GDP at the end of 2006) and India (private consumption 57% of GDP at the end of 2006), show a more balanced distribution of growth.

**A rebalancing of growth and employment to the advantage of higher-added-value and technology-content productions, as well as to services, may support wages and, as a result, end consumption**, which still have an ample growth margin. Combined with a reduction in industrial investments, this will be a priority target for the Chinese government and central bank over the next few years, as clearly stated on occasion of the 17<sup>th</sup> five-yearly National Congress of the Communist Party, held in mid-October 2007. The Congress confirmed that economic growth remains a priority for the government, with the aim of quadrupling per capita GDP compared to 2000 levels by 2020, while attempting to alleviate rural poverty and strengthen environmental protection measures.

GDP y/y: no sign of a slowdown for the time being



GDP breakdown: ample rebalancing margin

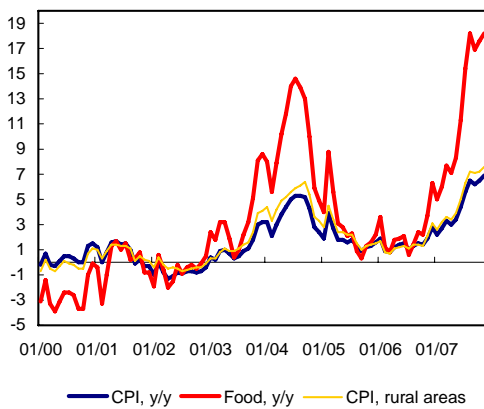


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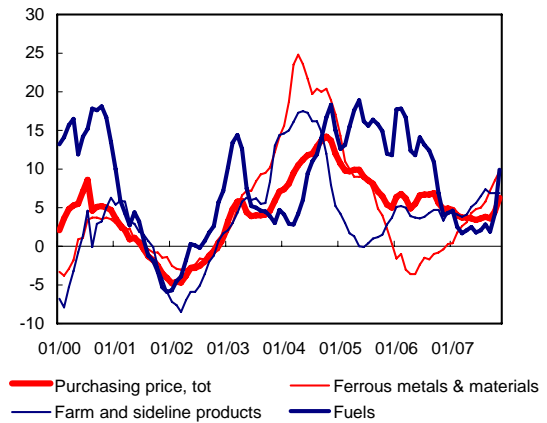
The authorities will therefore focus their efforts on preventing the economy from overheating, an obvious risk when considering the startlingly strong stock market and real estate market trends, curbing the trend of inflation, which is now

becoming a more serious concern for the central bank. According to the media reports, in a recent closed-door meeting, the PBOC has resolved to adopt a **more restrictive monetary policy stance**, coordinating its action on rates and forex policy with administrative measures, to “prevent overheating and excessive inflation”. On December 20th the PBOC decided to raise rates for the sixth time, with an increase of 27 bps on 1 year deposit rates and of 18 bps on 1 year lending rates. In the statement the PBOC said that inflation has been at its highest level since 1999 and that a higher increase of deposit rates should lead investors to leave more money in bank deposits after years in which they concentrate in housing and equity markets, given their vertiginous price rise. However, as long as the exchange rate will not be allowed to fluctuate freely, the central bank will find it hard to make full use of the interest rate lever without attracting strong capital inflows. All the more so in light of the gradual liberalisation of the financial sector. Therefore, we believe the PBOC’s declaration of intent is simply in line with the rhetoric of the past, and does not represent a true change in direction. If inflation gradually fades in 2008 interest rate hikes will be marginal and the **PBOC will continue to resort primarily to administrative credit restriction measures**.

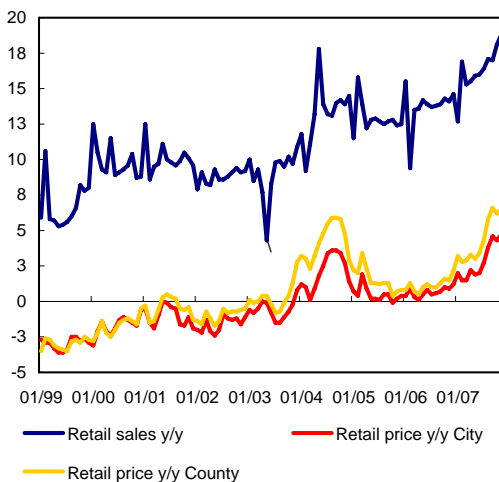
**Inflation on the rise, driven by food prices...**



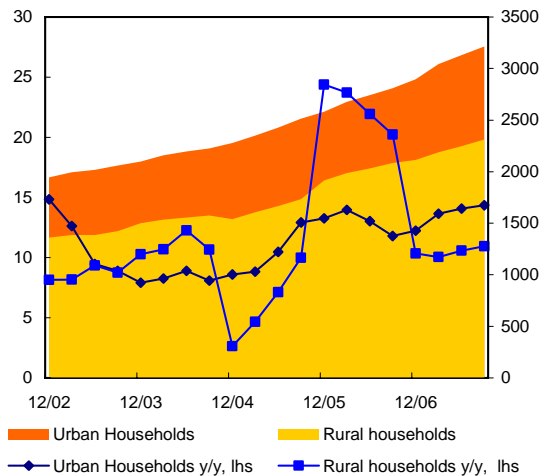
**... and higher commodity costs**



**Retail sales still increasing**



**But inflation is limiting real income growth in rural areas**

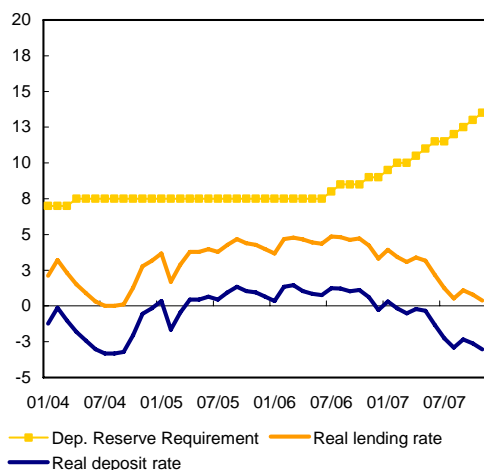


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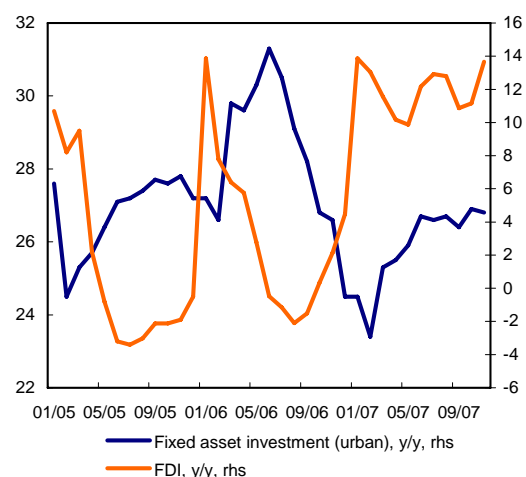
In November, consumer price **inflation** rose further, to 6.9% from 6.5% in October, reaching levels last touched in 1996. The increase was mostly driven by food prices, on the rise at rates in excess of 15% for four consecutive months. The 18.2% November increase was due to a price surges of 28.6% for vegetables, 38.5% for meat, and 35% for edible oils. In November core inflation also leapt upward, by 1.4% y/y, after recording average increases of 1% for a full year. However, this cannot be fully ascribed to food prices, as commodities and fuel also played a role, as testified to by the trend of production input prices. Indeed, in November the government approved a 10% rise in fuel prices.

Nonetheless, the **food component** accounts for one-third of the CPI basket, and in a country in which income remains low for the majority of the population, a sharp rise in food prices is bound to reap negative effects on consumer spending, especially in rural regions. The monthly rise in inflation in these regions, consistently higher than recorded in urban areas in recent months (7.6% y/y in November vs. 6.6%), is causing strong malcontent among the population, and is of great concern to the authorities, which fear the risk of social protest breaking out.

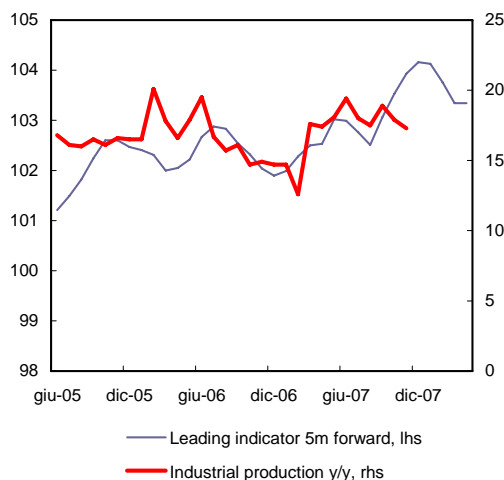
**Real rates (overall CPI) on the decline despite monetary tightening...**



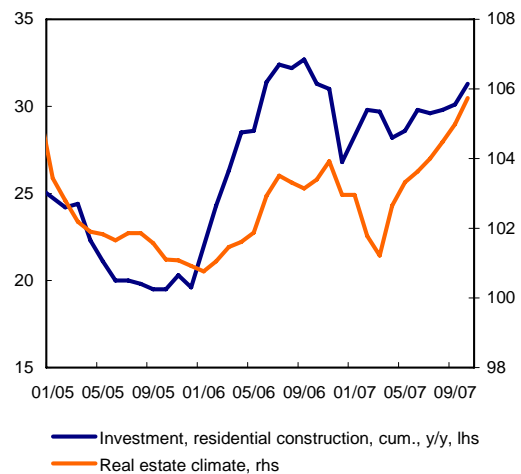
**...to the advantage of fixed investments**



**Industrial production is still strong ...**



**...as is the real estate market**



Source: Ecowin

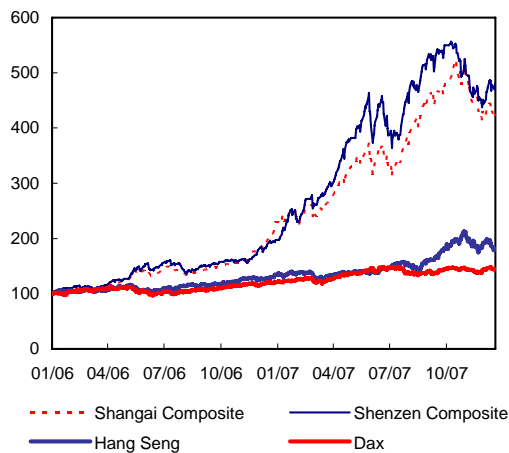
Higher inflation has contributed to keeping **real rates** (deflated by the overall CPI) on the decline, compressing lending rates to levels around 200bps lower than in August, despite the interest rate hikes carried out. Therefore, real rates went against the trend outlined by other restrictive measures, such as the required deposit reserve ratio increase, to 14.5% as of the end of the year. Fixed investments have kept growing at a brisk pace, rising by 26.8% in the first 11 months of 2007 compared to the same period the previous year. Industrial production has also kept increasing, albeit at slightly slower rates (17.3% in November) compared to the September peak (+18.9%), as a result of the abolishment of a number of tax breaks and export subsidies in some industrial sectors, which had been put in place in the summer. However, the trends of the PMI and leading indicator are not pointing to further declines. Similar observations can be made on the real estate market, which is still surprising on the upside, further fuelled in urban areas by the recent introduction of the new law on private property<sup>6</sup>.

The decline in real rates, combined with the rise in monetary aggregates, is one of the causes behind the **strong liquidity flows addressed to the stock market**. The trend of the Shanghai Composite index, which increased fourfold in just over two years, clearly outlines the risk of a speculative bubble. Following the resurgence of the subprime mortgages crisis, the index has traced back by around 20% from its peak in mid-October 2007 to its trough in mid-December, although it has gained 96% in 2007. Listed shares still account for a small portion of total financial wealth in China, and residents are not permitted, if not experimentally in some areas, to acquire listed shares outside the country. However, the exposure of companies and Qualified Foreign Institutional Investors (QFII) on the domestic market, and of Qualified Domestic Institutional Investors (QDII) on foreign markets, in a context of international contagion, may make the macroeconomic effect of a further sharp decline in the stock market index a problem to be reckoned with. All the more so if a large share of corporate earnings derives from stock market investments, as reported by the press.

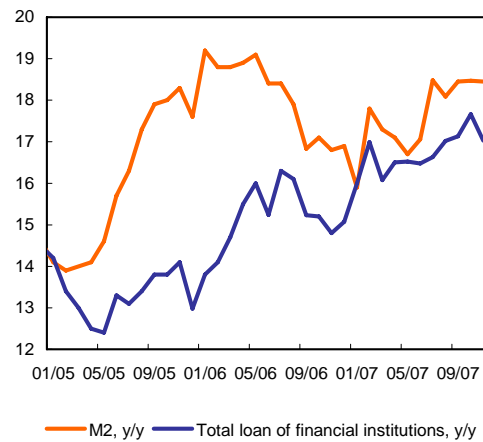
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<sup>6</sup> On 1 October, the government introduced a law approved in March 2007, which defines property rights in the People's Republic of China. Three types of property are provided for: state, collective and private. The law represents an important step forward from the rather generic definitions contained in an addition to the constitution made in 2003. However, the law will benefit most China's metropolitan areas and the emerging urban middle class, as agricultural land property will remain exclusive to the state. In rural areas, farmers hold land exclusively in usufruct, and cannot use it as a guarantee to obtain loans. Furthermore, the new law does not define rights in case of expropriation, despite the large-scale expropriations executed in recent years and of the resulting disputes over property, which have become a major cause of social unrest.

**Very high growth rates for the Chinese stock market...**



**...also thanks to abundant liquidity**

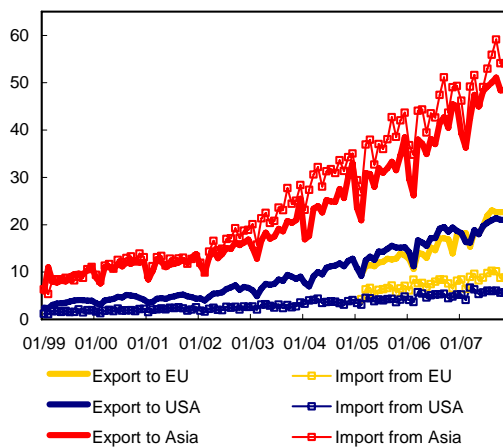


Source: Ecwin

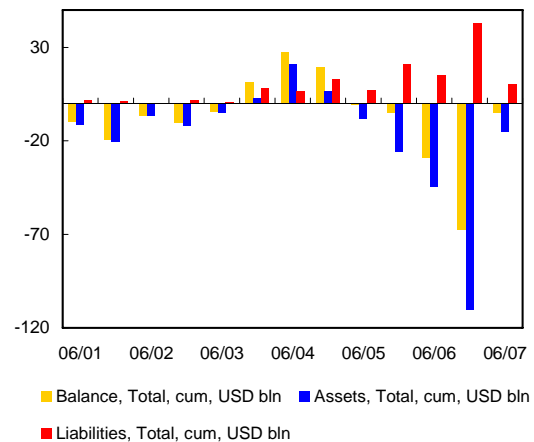
**The contribution of foreign trade will remain positive.** In particular, trade with the EU has intensified to the point that, as of July 2007, the total worth of exports has exceeded that of goods directed to the United States, although the trade balance remains slightly lower. The major export category among manufactured products is composed of office and telecom equipment which accounted for 25% of China exports in 2006. Clothing and textiles export share though decreasing still account for roughly 15% of exports (14.9% in 2006 vs 21.4% in 2000) and the export mix will continue to change to the advantage of higher-added-value and technology-content products. A strong economic slowdown in the US or Europe are likely to negatively impact the main export category, while textiles look less vulnerable<sup>7</sup>. Any protectionist measures dictated by disputes underway at the WTO level on product counterfeiting and intellectual rights will undoubtedly weigh, although, with the United States at least, significant steps forward were made on this front on occasion of the latest US-China Strategic Economic Dialogue (SED) held in mid-December. China also undertook to promote **greater liberalisation of the financial sector**, allowing foreign companies and banks in China to issue securities denominated in yuan, and Chinese mutual funds to invest in US stock markets. The roof on QFII investments in the Chinese stock market has been raised from USD 10 bn to USD 30 bn.

<sup>7</sup> Restrictions on the imports of 10 textile and clothing products from China, introduced in mid-2005 by the EU following an agreement to limit the annual growth rate to between 8% and 12.5%, expired at the end of December 2007, to the advantage of this business line.

### Intra-Asia trade is preponderant, and trade with the EU is increasing (data in USD bn)



### The gradual easing of restrictions on the circulation of capitals has increased portfolio outflows



Source: Ecwin

A number of memorandums of understanding were also signed on product safety issues, with food products at the fore, but also covering energy efficiency and safety, and environmental issues. Although both countries are coming under heavy fire for their scepticism with regards to climate change and the measures which should be adopted to face the problem, as recently proven in Bali, **important memorandums of understanding have also been signed on environmental issues.** China and the United States have agreed to reduce the sulphur content in fuels, and to create a national platform for the exchange of NO<sub>2</sub> permits (nitrogen dioxide, the main cause of acid rain), already active in the US. Furthermore, the two countries have also pledged to present a plan to the WTO in 2008, aimed at eliminating tariff and non-tariff barriers on environmental goods and services, and to cooperate on the transfer of water-management technology. The outcome of the summit with the European Commission in mid-November, focused on product counterfeiting, was the creation of a mechanism similar to SED, the first meeting of which will be held in March 2008.

The huge inflow of foreign currency resulting from the trade surplus has fuelled pressures calling for an appreciation of the yuan and complicated liquidity management. In order to balance current account trends, **the authorities have eased restrictions on capital outflows, not only for QDII.** A pilot project has been initiated allowing Chinese citizens residing in the Tianjin Binhai area to invest in foreign assets, initially limited to those traded on the Hong Kong stock exchange, and the government is now considering extending permission to the London and New York stock markets. The measures geared to easing restrictions on capital circulation have translated into a substantial increase in outflows in the form of portfolio investments, on the rise from USD 4.93 bn in 2005 to USD 67.5 bn in 2006, more than offsetting the inflow of equity investments (USD 42.9 bn), which virtually doubled in 2006 vs. 2005 as a result of the excellent stock market performance. In 2006, furthermore, net FDI declined as a result of broadly unchanged inflows compared to 2005 (USD 78.1 bn vs. USD 79.12 bn), and an increase in outflows (USD 17.8 bn). This trend could also continue in 2008, in line with the implementation of measures geared to increasing the liberalisation of the financial sector.

## China – Forecasts

		2004	2005	2006	2007	2008	2009
GDP (constant prices)	y/y	10.1	10.4	11.1	11.5	11.0	8.9
Consumer spending	y/y	8.1	9.6	10.8	10.7	11.8	11.5
Fixed Investment	y/y	20.1	20.0	19.9	21.4	19.1	12.0
Public consumption	y/y	8.3	12.7	12.2	9.5	8.7	7.8
Exports	y/y	22.8	20.3	21.2	18.5	17.2	13.5
(foreign demand index)	y/y	12.3	8.9	8.4	5.7	5.9	7.5
Imports	y/y	21.7	7.0	11.1	13.0	14.1	16.3
Industrial output	y/y	11.1	11.7	13.0	13.5	12.6	8.9
Unemployment rate	%	4.2	4.2	4.2	4.1	4.0	4.0
Inflation (CPI)	y/y	3.9	1.8	1.5	4.7	3.1	1.4
Short-term interest rate	%	5.4	5.6	5.9	6.7	7.3	6.4
USD/CNY (average)		8.28	8.19	7.97	7.61	7.23	6.84
	y/y		-1%	-3%	-5%	-5%	-5%
USD/CNY (eop)		8.3	8.1	7.9	7.4	7.1	6.7
EUR/CNY (eop)		10.6	9.7	10.0	10.6	10.4	8.9

Source: Intesa Sanpaolo

**Conclusions.** The monetary authorities and the government will continue to put in place measures aimed at rebalancing growth to the advantage of a stronger contribution of domestic demand. The scenario in 2008 will not change much compared to 2007 in terms of the growth rate, which will remain at around 11% or just below. However, we expect a slight change in the mix to the advantage of consumption. Fixed investments should drop from 21.4% to 19.1%, after booming in 2007. The effects of the Olympic Games have probably already been incorporated in 2007, and the credit growth rate should continue to be curbed by the ongoing adoption of dedicated measures. Inflation should begin to drop as of the early months of the year, barring further unexpected upswings in energy and fuel prices, also thanks to a favourable base effect, which could compress the average rate to 3.15% in 2008 vs. 4.7% in 2007. In any case, we expect the Olympics to contribute in part to fuelling consumption, together with the estimated drop in inflation and any expansive fiscal policies put in place to support income in rural regions of the country. Consumer spending should therefore increase at a rate of 11.8% in 2008, from 10.7% in 2007, supporting stronger import growth compared to 2007.

## Forex markets - 2007 an “unfortunate” year for the Dollar, 2008 should be better.

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**2007 was very negative for the dollar, because of a combination of unfavourable factors. 2008 should be a little better**

**DOLLAR** – 2007 was a very negative year for the Dollar, since the main variables affecting its performance all turned for the worse: (1) domestic interest rates, after a long period of stability, started to fall; (2) oil and commodities prices rose sharply, further magnifying flows to commodity currencies which frequently are also high yielding currencies; (3) the subprime crisis, which erupted in August, exacerbated the pre-existing negative factors, and also triggered a wave of volatility and risk aversion that dampened the appetite for high yielding currencies and favoured low yielding currencies (Yen), albeit with a negative final net effect on the Dollar due in part to the concurrent correction in the stock markets.

The situation should change in 2008: (1) the fall in US rates should not persist beyond the first quarter; (2) at the same time, commodities prices should gradually start to soften, whilst remaining relatively high; (3) some of the effects of the subprime crisis should dissipate, confining the period of greatest volatility to the first few months of the year.

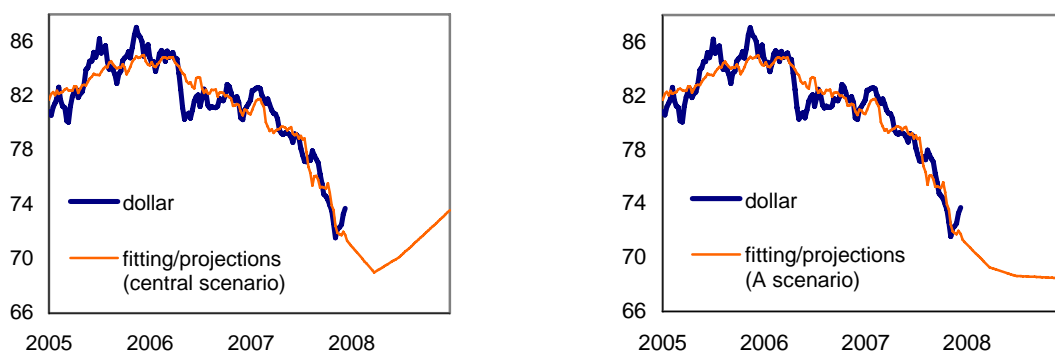
In order to assess the combined effect of these variables on the greenback in 2008, we have estimated a model for the Dollar’s effective nominal exchange rate (major currencies) as a function of: (1) domestic rates and foreign rates (EUR rates and AUD rates, the latter representative of high yielding currencies); (2) commodities (composite index); (3) equity volatility (VIX index), as an indicator of risk aversion. Under the above-mentioned assumptions, our central forecast is that the Dollar might weaken further in the first quarter, by around 3%, but it should then recover gradually and end 2008 slightly up (around 3% vs. the start of the year).

**Projections of expected dollar change by the end of 2008 under alternative scenarios**

central scenario	(A) scenario quasi recession in the USA only	(B) scenario "global" recession	(C) scenario positive shock for the US economy
+3.2%	-3.5%	-0.7%	+3.7%

Source: Intesa Sanpaolo

**Simulation of alternative scenarios for the effective dollar exchange rate/1**

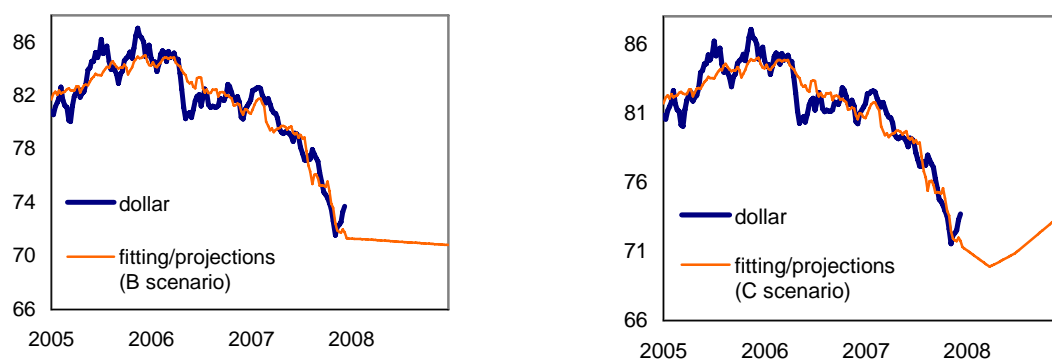


Source: Intesa Sanpaolo

**The downside for the dollar should be limited, even assuming alternative unfavourable scenarios**

However, since the risks might once again tend towards the downside, we have assumed two alternative and adverse scenarios in order to quantify the downside more accurately: scenario (A) is a quasi-recession in the USA, although the crisis does not propagate its negative effects abroad (in this case the Fed would cut rates four/five times in 2008); scenario (B) is a “global” recession, with a recession in the USA spreading its negative effects abroad. In both cases the weakening of the Dollar would extend into 2008 but would be very modest in size.

**Simulation of alternative scenarios for the effective dollar exchange rate/2**



Source: Intesa Sanpaolo

In scenario (A) which is the most adverse in that it assumes a quasi-recession confined to the United States, thus implying a decoupling from the rest of the world, the total depreciation in 2008 would amount to 3.5% (see table), which is modest in absolute terms and around one-third of that recorded in 2007. In scenario (B), which envisages a recession in the USA but a deterioration in the macroeconomic situation in the rest of the world, it would not be just the Dollar that felt the consequences, since the other currencies would also weaken in response to a sharp economic slowdown. In this case the Dollar's final depreciation would be almost zero (-0.7%). **In conclusion**, even taking account of the risks associated with adverse alternative scenarios, **the scope for Dollar depreciation should be almost over** and 2008 should be better than 2007.

**The dollar should stabilise at lower levels than those reached in the past years**

**However, one should not be over-optimistic. We have also assumed a third scenario (C) favourable** to the greenback, in which a generic positive shock hits the US economy alone, doing away with the need for any rate cut and actually calling for a rate hike. We do not assume the propagation of the benign effects outside the USA so as to maximise the positive impact on the Dollar. **In this scenario the Dollar would appreciate by around 4% (see table), which is not much in absolute terms and, above all, is very little compared with the 3% resulting from the central scenario (see table).**

This probably reflects the inevitable erosion of the Dollar's supremacy on the foreign exchange market following the diversification of global currency reserves and a gradual reduction in the Dollar portion. This process is mainly under way in Asia, and specifically China: pending full and free fluctuation for the Yuan, the Chinese currency will tend to appreciate further (against the Dollar), and other Asian currencies may do likewise (primarily Yen). Therefore, even when the Dollar, once the most critical phase for the US economy is over, starts to make up ground against the main currencies (Euro, Canadian Dollar, Sterling, high yielding currencies) – at the end of the first quarter in our forecast – it will continue to depreciate against the Asian currencies. This should stabilise the Dollar at lower levels than those seen in past years.

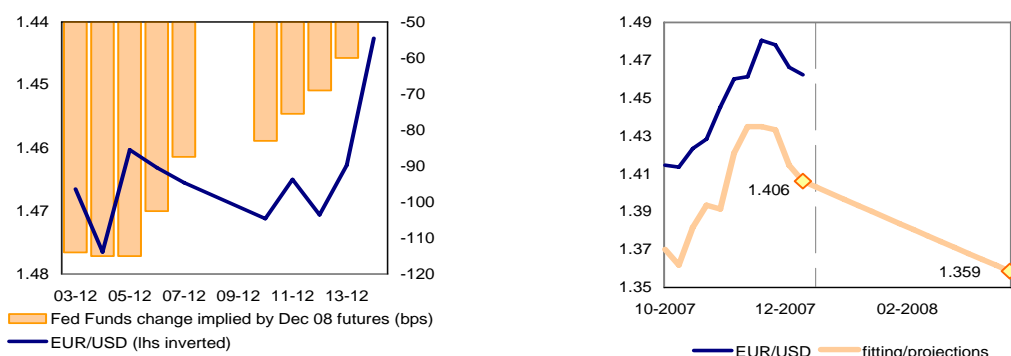
*If China lets the yuan appreciate more quickly, the dollar could recover more easily vs the non-Asian currencies*

One factor which might accelerate the process of adjustment among the main currencies following the excesses of 2007 (excessive Dollar weakness vs. excessive strength in the main non-Asian currencies: Euro, Canadian Dollar, Sterling) is a widening of the Yuan's fluctuation band, currently set at  $\pm 0.5\%$  daily. Recently, the Chinese press reported that the PBoC was considering the option to widen the band from  $\pm 0.5\%$  to  $\pm 0.8\%$ . Such a measure would implicitly signal the willingness of the Chinese authorities to let the Yuan appreciate at around twice the rate allowed in 2007, i.e. roughly 10% vs. 6% in 2007. This would be a major development since, in this case, at end-2008 the Yuan would have appreciated by 20% from July 2005, when it was revalued, and when the estimates going the rounds at that time put the Yuan's undervaluation at around 20-25%. In this case the Chinese currency would be very close to its fair value, and this would enable the other non-Asian currencies to return more closely into line with their fundamentals – since they would no longer have to carry the burden of the Dollar's depreciation as the Dollar could finally depreciate against the "right" currencies, i.e. the Asian ones.

*US interest rates, the key for the euro*

**EURO** – In 2007 the Euro appreciated by around 10% vs. the Dollar, climbing from 1.32 EUR/USD at the start of the year to almost 1.50 (high of 1.4966 on 23 November). From this level it corrected, falling to between 1.45 and 1.40 in mid-December. In recent months, especially in the wake of the subprime crisis, the Euro's main driver has been the interest rate spread between Euro area and USA. Much of the upsurge from 1.35 to almost 1.50 was due to the change in Fed's monetary policy, which after the crisis had to cut rates by 100bps from 5.25% to 4.25% in less than four months. Our forecasts are for two more 25bps cuts, each in first quarter 2008. Market expectations are more aggressive, assigning moderate probability to a third cut, and at the start of December the market went so far as to assign 100% probability to a fourth rate cut. The tendency should be towards a further scaling back of rate cut expectations in the US. Economic growth should bottom out in the fourth quarter of this year and then start to pick up. Inflation, on the other hand, has surprised on the upside and is set to remain quite elevated, limiting the room for manoeuvre (downwards) on rates. The new measures announced by the Fed to counter the liquidity crisis should point in the same direction, since by demonstrating that the channel for dealing with this type of problem is not via rate cuts (beyond certain levels), market expectations of further monetary easing are consequently reduced.

**EUR/USD exchange rate**



Source: Intesa Sanpaolo

According to our estimates of the elasticity of the exchange rate to interest rates, just two cuts in Fed rates, rather than the four previously priced in, justify a "permanent" correction in the Euro of around five figures. The other variable that drives the exchange rate is growth expectations. In 2007 the Euro area economy outperformed the US, growing by around half a percentage point more. Our

**The euro should gradually depreciate towards 1.35 in 2008**

forecasts for next year are around 2.0% for both regions, with the United States stabilising and the Euro area slowing. The expected growth gap would thus narrow from 0.5% to 0.0% and, according to our estimates, this alone would imply a correction of a further five figures in EUR/USD. Assuming that the Euro is in any case overvalued at the current levels vs. the Dollar, it follows that in 2008 the currency should reverse the uptrend that marked the whole of 2007 and return to levels more consistent with the trend in the fundamentals. **Our forecast for 2008** is therefore for **gradual Euro depreciation**, and a return towards **1.35 EUR/USD** on a one-year time horizon.

**A stronger yuan would allow a weaker euro**

**The downside might expand further if China accepted a more rapid appreciation in the Yuan.** Should the PBoC announce a widening of the daily fluctuation band for Yuan, signalling its willingness to accept around twice the appreciation vs. the Dollar in 2008 than was granted in 2007, then according to our estimates the downside for Euro might extend from 1.35 to around 1.31-1.30.

**Risks to the central scenario: a US recession should not favour the euro indefinitely, unless a perfect decoupling occurs**

Aside from developments on the Yuan front, the risks to our central forecast are on the downside, i.e. a more severe slowdown in the US economy. **But should the growth outlook deteriorate to such a point in the United States, the negative repercussions would be even more marked** in the rest of the world too, including in the Euro area. Accordingly, it is by no means a given fact that this would imply a further sharp appreciation in the Euro vs. the Dollar, as happened in 2007; indeed, **once a critical level such as 1.50 EUR/USD has been reached, a correction in the currency would become even more urgent.** Therefore, the forecast of Euro depreciation during 2008 – albeit with flexibility in the ultimate end-point of the correction or the start of the downtrend – should not be undermined.

**Sterling set to weaken further with the BoE cutting rates**

**STERLING** – Like the Euro, **Sterling also appreciated considerably against the Dollar in 2007**, rising from 1.95 GBP/USD at the start of the year to a high of 2.11 in November. However, unlike the Euro, **it has fallen back more rapidly from its high owing to growing expectations of a rate cut in the United Kingdom which in effect prompted the BoE to lower the base rate from 5.75% to 5.50% in December. With two more cuts expected** in the first and second quarter, **the prospect is for further depreciation in Sterling vs. both Dollar** (expected return to 1.89 GBP/USD by end-2008) **and Euro** (downside to 0.75 EUR/GBP at least). Sterling is hampered by the fact that the BoE is still loosening monetary policy, whereas ECB rates should remain on hold. Moreover, the emphasis placed by the ECB on the inflation risk might even prevent the formation of rate cut expectations in the Euro area. In the cross with the Euro, however, Sterling might fall to a low around the middle of the year as expansion peters out. Thereafter, once the BoE ceases cutting rates, the expected upturn in growth and the increase in inflation expectations generated by the rate cuts might help Sterling stage a partial recovery vs. Euro.

**Limited appreciation of the yen vs the dollar, unless China lets the yuan appreciate more quickly**

**YEN** – US rates falling and Japanese rates expected to rise should underpin **further Yen appreciation in 2008.** However, since the expected tightening is limited and rates would remain very low, **the expected firming is limited** (to 106 USD/JPY by year-end). The upside scope would however increase if China let the Yuan appreciate more rapidly. Should the rate of appreciation double vs. 2007, then the Yen's appreciation might also pick up the pace, shifting the final target to 102 USD/JPY. In either case the scope for appreciation should be greater vs. the Euro, owing to the expected depreciation in EUR/USD: in the central forecast EUR/JPY might extend to 145-140, while in the case of more rapid Yuan appreciation it could go as far as 135-130 (considering that the end-point for the Euro would also be lowered from the 1.35 projected in the central forecast to an estimated 1.30 or thereabouts).

## Bond markets

### Direction

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#### USD - Beyond the soft landing

■ **The directionality of the US government market is basically explained by the trend in inflation, the economic cycle, monetary policy and the appetite for risk.**

■ **At the short end of the curve, the alternating dominance of these competing forces might conceal the underlying tendency which we expect to be moderately bullish in the first half of 2008 and bearish in the second half.**

■ **Overall, our forecast conforms to the view of a “V-shaped” cycle in 2008, with a low-point being recorded in the first six months. This scenario presents downside risks connected with the possibility of a prolonged period of stagnation. An “L-shaped” cycle might induce marked bull steepening of the curves, even from the current levels.**

In the United States the market's direction will be decided by the dominance of opposing forces which will cause high volatility and a non-linear and modulated trend in the course of the year. At the short end of the curve, the alternating dominance of these forces over the directionality of the market might conceal the underlying tendency which we see as moderately bullish in the first half of 2008 and bearish in the second half. This seems to be at odds with what was seen in the last two recessions (1990-91 and 2001), which were characterised by marked falls in yields in the final stages of those recession events.

The directionality of the bond market is basically explained by the trend in inflation (current and expected), the economic cycle (gap in growth vs. trend), monetary policy (Fed funds, policy bias and monetary policy expectations) and risk appetite among investors. We expect the first three sets of variables to make a bullish contribution in the first half of 2008. The slowdown in growth has already turned the soft landing into economic stagnation, as recorded by the fall in growth expectations for 2008. In the short term, the contagion of the “building recession” to the rest of the economy and the real effects of the credit tightening triggered by the subprime crisis will continue to exacerbate the macro slowdown highlighted by the ISM surveys. This should translate into a mix of negative data in the coming months and bullish pressure on the market's directionality.

Long-term inflation expectation (5-10 years) as measured by the University of Michigan have fluctuated around 2.9% avg. over the last ten years, a period we may describe as marking the attainment of the Fed's inflation target (in 1998 there was even talk of the United States potentially slipping into deflation, like Japan). In the course of 2005 and 2006, however, there was a slight upward tendency which took values above the period mean, alarming the Fed which feared losing the holy grail of price stability. The effects produced by the economic slowdown and the fall in the oil price should help scale back inflation expectations and considerably cool current inflation in the second half of 2008. This factor should also exert downward pressure on yields and strengthen the movement engendered by the cycle variables.

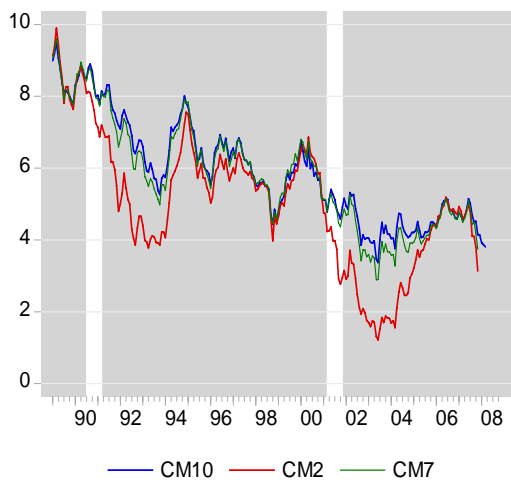
The third set of variables should be bullish as long as the Fed keeps alive significant expectations of a rate cut. Considering the tone of the data in the coming months, it is reasonable to assume that a change in the Fed's bias will not arrive before the second half of 2008. At that time the amount of easing priced in by the market should be reduced, resulting in a steepening of the Dollar strip and

a rise at the short end of the curve. This factor should bolster the upward directional pressure in the second half of the year, helped by the termination of the flight to quality triggered by the liquidity crisis and interbank system confidence.

The final factor that may neutralise the markedly upward movement for the bond market, namely risk appetite, is unfortunately the hardest to predict in terms both of trend and implications. The increased risk aversion among investors has not so far fed through to the premiums priced in by the market owing to the marked flight to quality: the gradual normalisation of these markets should help restore a risk premium and penalise the government bond market.

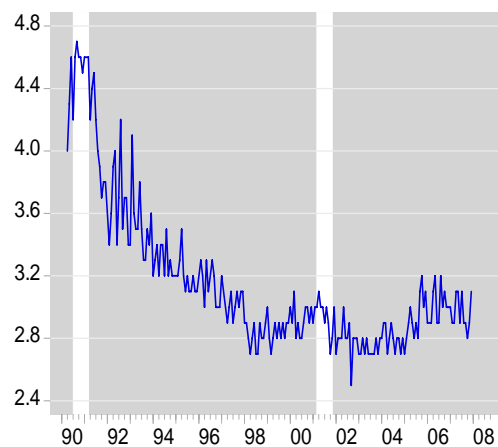
Overall, this scenario conforms to the view of a “V-shaped” cycle in 2008, with a cycle low coming in the first six months, when we assume that the liquidity crisis and the question of financial system confidence should be resolved. While we are broadly in line with the market (*2008 IDEAGlobal Annual Special Survey*) on this second point, the macro growth outlook presents downside risks connected with the possibility of a prolonged period of stagnation. An “L-shaped” cycle might in this case induce marked bull steepening on the curves, even from the current levels. In identifying the predominant directional risk, we have rejected the possibility of stagflation (low growth and high inflation), since we believe that in a slowdown and/or recession, and with high credibility in respect of the monetary policy objectives, the chance of seeing significant second-round effects due to the spike in energy and other commodity prices is quite slim.

**Treasury 10-7-2Y Constant Maturity**



Source: NBER, Federal Reserve and Intesa Sanpaolo calculations

**Long-term inflation expectations (U. Michigan)**



Source: NBER, Bloomberg and Intesa Sanpaolo calculations

### EURO - Waiting for our turn

■ The directionality of the Euro area government bond market is explained, like the UST curve, by inflation, cycle, monetary policy and risk appetite. Added to this is a close correlation with the UST curve.

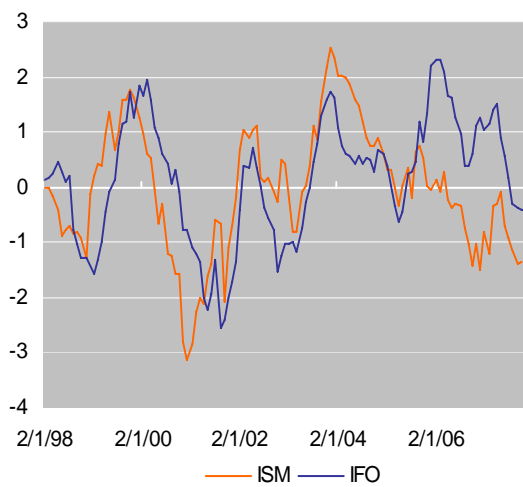
■ The underlying tendency we envisage in 2008 is bullish. In the first half it will be mainly the link with the UST curve that drives directional movements, while in the second half of the year a more dovish tone from the ECB, coupled with a slowdown in growth and inflation, should allow a partial decoupling from the UST curve.

■ As with the UST curve, this scenario presents downside risks connected with the possibility of a prolonged period of US stagnation.

The directionality of the European government market is explained, like the UST curve, by inflation, cycle, monetary policy and risk appetite. Added to this is a close correlation with the UST curve.

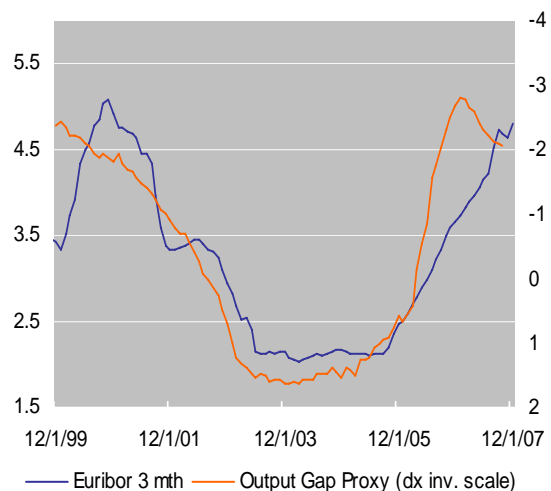
The underlying tendency we expect in 2008 is bullish. In the first half of 2008 the market's direction will be influenced by the fall in US yields rather than by domestic factors. An ECB still on its guard and an economic slowdown which will materialise more fully over the rest of the year will halt the downturn in yields. In the second half of the year, a more dovish tone from the ECB, coupled with a slowdown in growth and inflation, should allow a partial decoupling from the UST curve. The latter's bearish movement should be largely absorbed by domestic factors.

**ISM & IFO Expectation  
(Rebased and Standardized)**



Source: Intesa Sanpaolo based on Datastream data

**ECB's rhetoric taking a more dovish tone**



Source: Intesa Sanpaolo based on Bloomberg data

The very buoyant growth seen in the Euro area in the last two years has ignited intense debate over the possibility of cyclical decoupling from the United States. The expectations component of the IFO, historically closely correlated with the ISM manufacturing index, has seen this link weaken in recent years. The persistence of the IFO at higher levels than the ISM testifies to the arrival of a new player on the global stage, namely emerging Asia. In spite of this, and albeit from different levels, the IFO retains an undeniable link with the ISM and this has very negative implications in terms of growth. Expectations for 2008 have seen a marked deterioration in the consensus estimates. Growth is projected at 1.9% (*Consensus Economics*, December 2007), i.e. below the level compatible with the

stability of the output gap. By contrast, inflation does not seem set to have second-round effects (the hourly labour cost should grow at almost the same rate as in 2007), and this should enable the ECB to relinquish its emphasis on inflation and allow the market to price in 25-50bps of refi rate easing by the end of the year.

As with the UST curve, this scenario presents downside risks connected with the possibility of a US recession. Such an eventuality would reinforce our bullish view of the Euro curve in 2008.

## Curve

### The Fed will push 2/10Y UST spread higher

- **Steepening positions on the Dollar curve will remain profitable until the end of the Fed's monetary easing.**
- **The forecasts obtained using a structural model on the 2/10Y UST indicate a high for the steepening from 94bps spot to 135bps in 2Q08, a target which more than makes up for the negative carry of 17bps six months forward on the benchmarks.**
- **When the monetary policy bias returns to neutral, the 2/10Y curve will start (bear) flattening again, with a target of 120bps at year-end.**
- **On the swap curve, the 2/10Y spread projects steepening to 144bps vs. 74bps spot on a six months horizon.**
- **A hard landing scenario, with the continuation of monetary easing by the Fed through to year-end, takes the target on the 2/10Y to 184bps on cash and to 207bps on swap.**

The Euro and Dollar curves have steepened since the start of the liquidity crisis thanks mainly to the inception of monetary easing by the Fed, compounded by the marked flight to quality into short-term government paper in response to the rise in the risk premium on financial counterparties.

The across-the-board steepening of the corporate curves by credit rating recorded since mid-August in both the United States and Europe has also involved asset swap spreads on government bonds which, as well as widening well above the fair value levels based on the fundamentals, have also flattened: the 2-10Y US Treasury swap spread curve is currently inverted at -24bps, while the swap spread curve on Bund trades at -20bps.

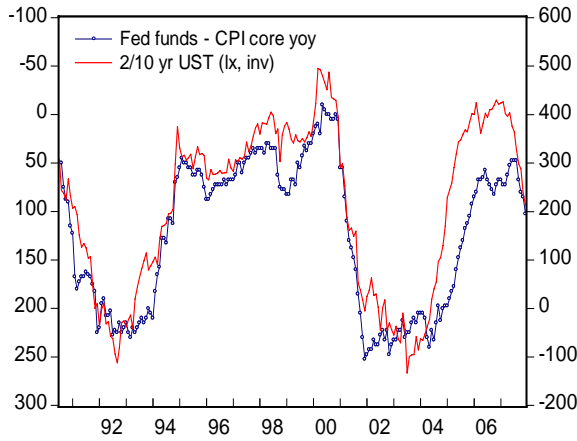
In many cases since mid-August the trend in swap spreads has predominated over the directionality of swap and govies rates and has generated pure decoupling between the slope of the swap curve and the government curve. At times of diminishing tensions on the money market, i.e. falling risk premiums, the steepening of the swap spread curve has been accompanied by a steepening of the swap curve vs. flattening of the govies curve.

This last week, the aggressive injection of liquidity into the system by the main central banks has triggered a flattening of the government curve, notably on the Dollar, which on the 2/10Y has returned to 93bps from a high of 103bps recorded at the start of December. This steepening has been concentrated on the 2/5Y segment, while the 5/10Y spread has remained unchanged.

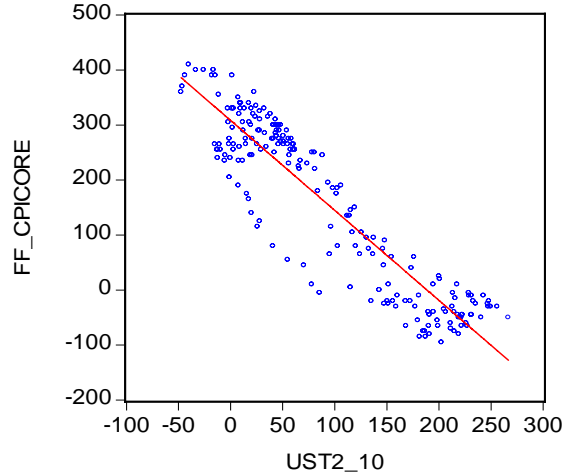
Movements on the Euro curve are stickier. The marked steepening tendency of the Dollar curve has extended to the European curve, where however the ECB's outright refusal to allow scope for expectations of a possible rate cut has so far considerably limited the curve steepening targets. Note too that the bear flattening

of the Euro money market curve has resulted in a sharp increase in the carry paid on steepening positions, on the Euro curve too.

**Close link between 2/10Y US Treasury slope and real Fed funds**



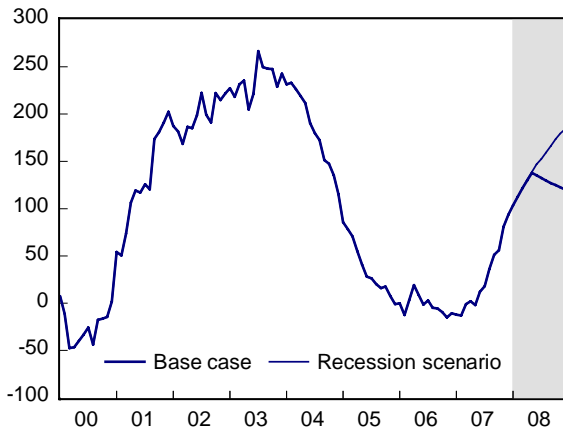
Source: Intesa Sanpaolo based on Bloomberg data



Source: Intesa Sanpaolo based on Bloomberg data

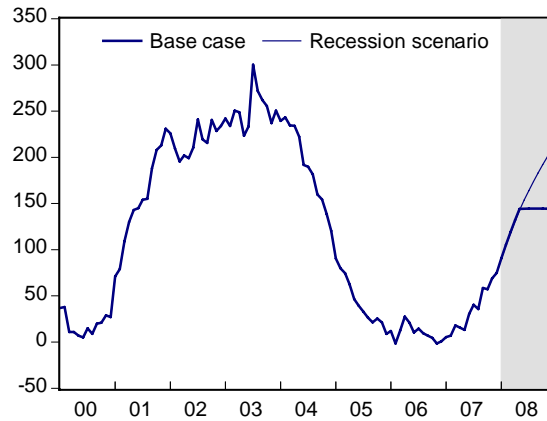
Despite the recent flattening, we still prefer steepening positions over directional positions on the Dollar curve (see Direction section). Dollar steepening will remain profitable until the Fed's monetary easing is over. In order to calculate the targets on the 2/10Y UST spread we have updated a structural model using monthly data over the period January 1990-October 2007, which includes four Fed monetary easing episodes/cycles.

**Forecasts for 2/10Y US Treasury (bps)**



Source: Intesa Sanpaolo based on Bloomberg data

**Forecasts for 2/10Y Swap USD (bps)**



Source: Intesa Sanpaolo based on Bloomberg data

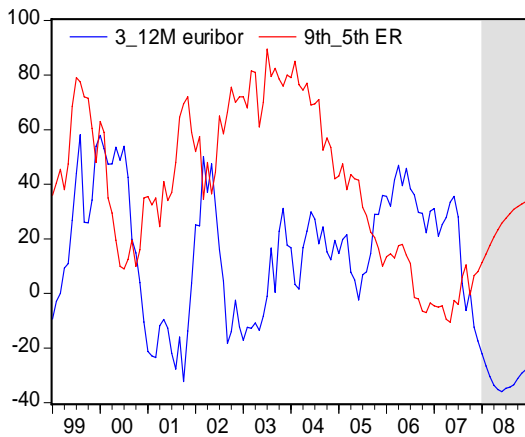
The exogenous variables we use in estimating the 2/10Y UST spread are real Fed funds (with core CPI lagged by one period) and the Fed's bias. As an alternative, we estimate the spread using a cycle variable (ISM or the Chicago Fed's activity index or CFNAI), the spread between inflation expectations 5Y and 1Y forward as measured by the University of Michigan, and the Fed's bias.

The forecast for the spread in 2008 is made using a path for Fed funds in line with market expectations and a Fed bias that becomes neutral at the end of the monetary easing cycle. The curve's current slope is not far off the fair value level estimated for December (94 spot vs. 91 fitted).

The results obtained indicate a continuation of the steepening to a high of 137bps in May '08, followed by moderate flattening taking the spread to 120bps at the end of 2008, which is still above the current level. In an alternative risk scenario (assigned more than minimal probability) of a hard landing prompting the Fed to extend the rate cutting cycle taking real rates close to zero at year-end, the 2/10Y spread rises to 166bps in September '08 and to 184bps in December '08.

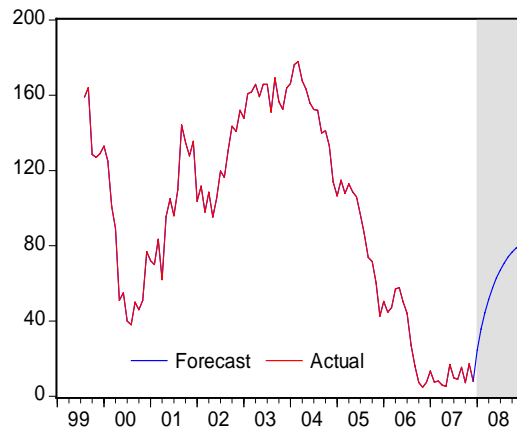
On the USD swap curve, the forecasts for 2008 based on the two scenarios indicate a steepening from 75bps spot to 144bps in 2Q08 and, in the recession scenario a year-end target of 207bps vs. a spread steady in the area 145bps in the baseline scenario. The carry six months forward on the swap curve gives a position breakeven of 93bps.

**Euribor money market spreads, spot and future**



Source: Intesa Sanpaolo based on Bloomberg data

**Forecasts for 2/10Y Euro swap (bps)**



Source: Intesa Sanpaolo based on Bloomberg data

### Ultralong steepening on the European curve

■ In spite of the attractive targets obtained on the 2/10Y steepening of the Euro curves, we believe the opening of steepening positions is premature and more risky in the short term than outright long duration positions at the short end.

■ In the short term, our preference for long positions at the short end of the European curve is accompanied by a preference for 10/30Y Euro steepening positions.

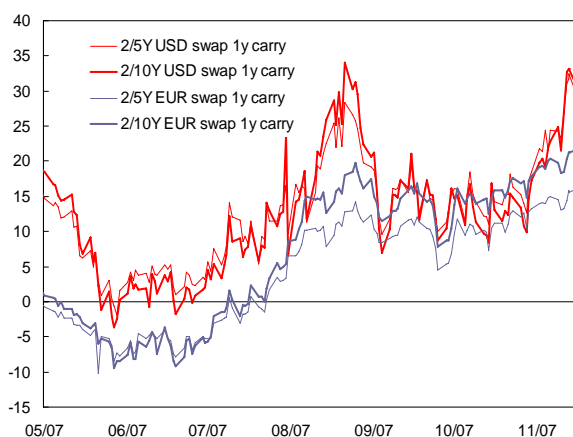
On the European curve, as discussed above in more detail, the deterioration in the growth outlook, which will be accompanied in the new year by a fall in inflation in trend terms, may trigger a flattening of the Euribor strip on maturities between the second half of 2008 and the start of 2009. At the same time, it is reasonable to expect a steepening on maturities one year forward (we use the Euribor 3 months future spread between ninth and fifth contract ED9\_5). This prospect will in the medium term also trigger a steepening movement on the Euro curves, although the steepening targets will crucially depend on the central bank's stance.

A model based on a money market curve dynamic consistent with rate cut expectations in the second half of 2008 and the Euro area composite PMI indicates a 2/10Y steepening target on the Euro swap curve of 62bps and 67bps on the govies curve; the targets rise to 80bps and 87 bps respectively on the swap and govies curves on a year-end time horizon.

In spite of the attractive targets obtained on the 2/10Y steepening of the Euro curves, we believe the opening of steepening positions is premature and more risky in the short term than outright long duration positions at the short end. The reasons underpinning this conclusion are diverse:

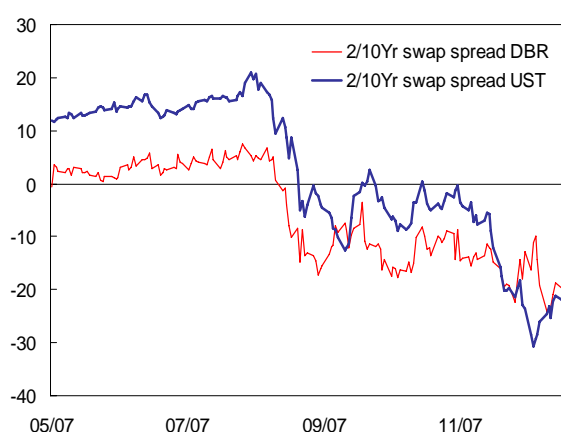
1. the acceleration of the steepening on the 2/10Y will depend on a steepening of the 2/5Y segment, which will continue to be affected by the ECB's wording. In the immediate term, inflation above the 2% target and the ECB's determination to completely separate liquidity creation intervention from the monetary policy stance will ensure the dynamic in the slope of the European curve remains sticky.

Swap curve steepening one year forward



Source: Intesa Sanpaolo based on Bloomberg data

2/10Y swap spread curve heavily inverted



Source: Intesa Sanpaolo based on Bloomberg data

2. the carry paid on Euro steepening has increased considerably since the start of the liquidity crisis and makes the timing of the opening of curve strategies

crucial. On a three-month horizon, the carry on the 2/10Y Euro swap curve is 9bps and rises to 18bps six months forward.

- the steepening on the govies curve might be held back by the tightening of swap spreads and especially by the disinversion of the swap spread curve on the 2/10Y segment.

In the short term, our preference for long positions at the short end of the European curve is accompanied by a preference for 10/30Y Euro steepening positions.

The 10/30Y spread on the European curve both swap and govies has resumed a markedly directional dynamic since the summer, with the start of the bullish movement involving the short end of the European curve. On the German govies curve, the 10/30Y spread rose from lows of 15bps to a high of 45bps at end-November, before flattening again (27.5bps spot) this last month in keeping with the above-4% return on the Schatz.

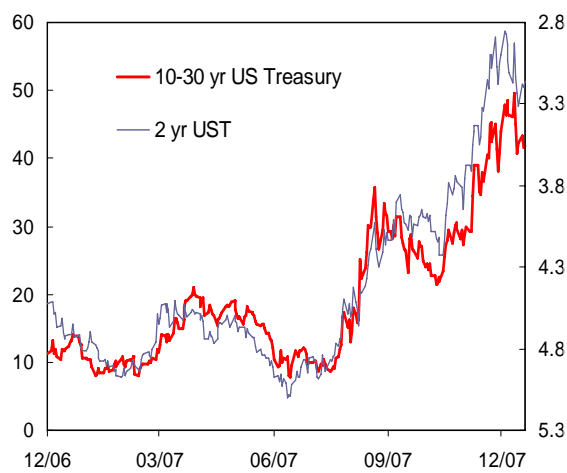
On the dollar curve, the trend in the 10/30Y spread has been extremely directional, even in the period preceding the summer liquidity crisis. As shown in the chart below right, in the course of 2007 the 10/30Y US Treasury spread has shown a close correlation with 2Y yields. The behaviour of the 10/30Y spread on the Dollar curve seems to have considerably affected the spread's dynamic on the European curve in the first half of the year, when the short end of the Euro and Dollar curves showed a marked decoupling.

**Steepening 10/30Y Bund vs. 2Y yield**



Source: Intesa Sanpaolo based on Bloomberg data

**Steepening 10/30Y US Treasury vs. 2Y yield**



Source: Intesa Sanpaolo based on Bloomberg data

Whereas on the Dollar curve the trend in the 10/30Y spread is well explained by the relationship with 2Y rates, on the Euro curve the best estimate for the 10/30Y spread also requires the inclusion of USD 2Y rates as exogenous variable. The estimate of the 10/30Y govies spread on the sample in the last three years gives a fair value for the spread of 37bps vs. 27bps spot, while the estimate on the sample covering the last year gives a fair value of 36bps. Looking forward, the fall at the short end of the European curve sets a target for 10/30Y govies steepening of 48bps.

## Equity markets and portfolio strategy

US market: 2008 EPS estimates deteriorating, while valuations stay interesting.

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**MARKET TRENDS.** In the closing weeks of the year, equity market volatility remained high around the world, and in particular in the United States, in the wake of intense and often contradictory news flows on the subprime mortgages issue and on the US macroeconomic picture. After having gained 5.3% between 20 November and 10 December, the S&P500 index dropped 2.6% in the following session, in the wake of the statements made by the Fed on occasion of the FOMC, on the haziness of the current conjuncture and the resulting difficulty in interpreting data and assessing recession and/or inflation risks. On 12 December, concerted action on the part the main central banks, aimed at guaranteeing the necessary liquidity to the financial system, and easing the credit crunch on the monetary market, offered renewed support to prices; however, optimism was short-lived, and uncertainty soon returned, due to the banking system's wariness and to persistently high short-term and very short-term Interbank rates.

Three main issues will be on the floor in 2008:

- developments of the subprime crisis and impact on bank balance sheets and the economy at large;
- employment trends and consumer spending resilience;
- inflation pressures, both domestic and imported from China.

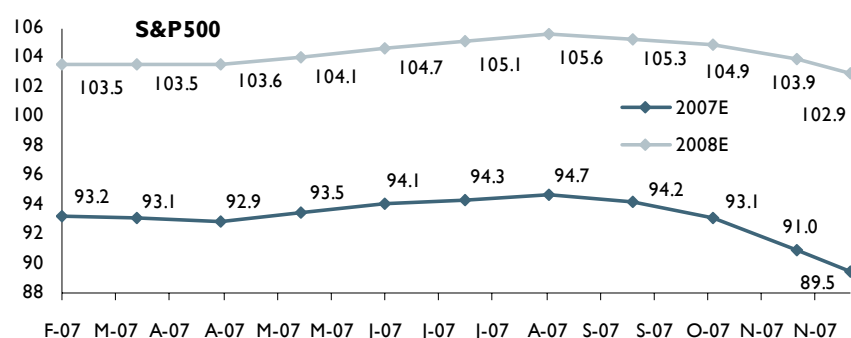
Total losses incurred by the banking system as a result of the subprime mortgages crisis are still hard to quantify; however, negative impacts are likely to be felt in 4Q07 and into 1Q08, gradually waning over the following quarters, and with some improvement already becoming evident as of 2H08. Furthermore, financial institutions could charge provisions to 2007 balance sheets, in order not to weigh down 2008 accounts, and to benefit from a positive base effect in the new year. In any case, as long as banks hold back from fully disclosing their exposure to subprime mortgages, monetary market rates will remain under pressure, regardless of central bank interventions. The employment trend is still sound, and retail sales data continue to indicate resilient consumption: while some tension on the labour market cannot be ruled out, there is still no sign of a systemic crisis on the job market. Lastly, inflation pressures represent a danger for the economy as they limit the Fed's margin of action on Fed Funds.

**VALUATIONS.** In terms of valuations, the US equity market retains its appeal, despite the threats posed by the risk of a recession and the impact of the subprime mortgages crisis. While 2008 EPS estimates have deteriorated (see chart), dropping in mid December to USD 102.9 from USD 103.9 in November, the main indicators measuring the health of the market in a historical perspective are encouraging: the P/E of 14.4x is still well off its long-term average (20.4x), as is the PEG of 1.47 (long-term average of 1.61), with an implied risk premium of 5.3% (long-term average of 4.0%), and an IMTG of 3.9% (average: 9.5%).

**S&P500 valuation ratios**

	10-Dec-07	Nov-07	1997-2006 average
2008E EPS (USD)	102.9	103.9	
2008E EPS growth (%)	15.3	14.4	
2007-09E EPS CAGR (%)	9.8	10.1	
2008E P/E (x)	14.4	14.0	20.4
PEG (07-09 CAGR)	1.47	1.39	1.61
EYR	0.60	0.58	0.95
Risk premium <sup>8</sup> (%)	NA	5.3	4.0
IMTG <sup>9</sup> (%)	NA	3.9	9.5

Source: Intesa Sanpaolo on IBES data

**S&P500: trend of 2007 and 2008 EPS estimates.**


Source: Intesa Sanpaolo

While leaving unchanged our stance on the hypothesis of the US economy recession entering a recession, we have run a sensitivity analysis to capture the effects on valuations of a sudden deterioration in corporate earnings growth expectations, tied to a downturn in financial, real estate, employment, and household consumption trends. Our first hypothesis considers a 10% decline in estimated 2008 EPS (from USD 102.9 to USD 92.6), equivalent to an annual growth of 3.5% in 2008 vs. 2007, compared to 15.3% at present. Based on this hypothesis, the S&P500 index seems capable of absorbing the downward revision of market consensus, as appealing valuations act as a significant buffer to absorb any disappointment on the side of corporate delivery: value indicators continue to prove appealing, remaining comfortably off long-term averages. The second simulation identifies the level at which US equity would begin to appear

<sup>8</sup> In order to calculate the equity risk implied by current valuations, we have run a 3-stage dividend discount model, which compares stock quotations to expected future dividend flows, discounted by the required return on shares. The model uses EPS growth estimates for the first nine years, assuming fixed-rate earnings growth from the tenth year onwards, in line with the nominal GDP growth rate and at like-for-like conditions. More in detail, the model assumes that earnings will grow in line with IBES EPS growth estimates over the first three years. Between the fourth and ninth year, EPS growth rates are based on medium-term IBES forecasts, and on the GDP's long-term growth rate. See "Banca IMI's Risk Premium Model: applications and methodology", 10 April 2003.

<sup>9</sup> In order to calculate Implied Medium Term Growth (IMTG), we have run a 3-stage dividend discount model, which compares sector P/E ratios to expected future earnings flows, discounted by the required rate of return on shares. The main assumptions incorporated into the formula are: a long-term payout ratio of 60%; a rate of discount for each "t" period, resulting from the sum of the specific sector's equity risk premium and the expected interest rate in the "t" period, as implied by the current bond yields curve; a sector-specific risk premium, resulting from the market risk premium and the sector's Beta. See "Banca IMI's IMTG model: New applications, review of methodology", 4 November 2002.

expensive: a drop of around 29% from the current EPS estimate (from USD 102.9 to USD 73.1) would be necessary, with a resulting decline in aggregate earnings of 18.3%, for the main ratios to indicate valuations ranging from the fair value level to overvaluation. The table below summarises the findings of our sensitivity analysis.

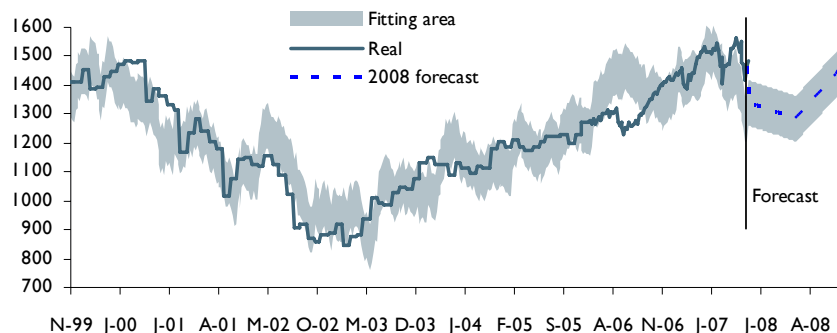
#### S&P500 – Analysis of sensitivity to earnings expectations changes.

	Current	-10% EPS 08	-29% EPS 08	1997-2006 Avg.
2008E EPS (USD)	102.9	92.6	73.1	
2008E EPS growth (%)	15.3	3.5	-18.3	
2007-09E EPS CAGR (%)	9.8	5.9	-2.1	
2008E P/E (x)	14.4	16.0	20.3	20.4
PEG (con 07-09 CAGR)	1.47	2.71	NM	1.61
EYR	0.60	0.69	0.87	0.95
Risk premium (%)	5.3	5.1	4.1	4.0
IMTG (%)	3.9	5.4	9.5	9.5

Source: Intesa Sanpaolo

Having found that the US market can count on a sizeable buffer to absorb bad news on the earnings front, we then ran our econometric model moving from the hypothesis of a 10% decline in estimated earnings in 1H08, followed by recovery in the second half of the year at a rate equal to that tying GDP growth to corporate earnings growth, based on our forecasts. Assuming growth rates of 2.1% y/y in 3Q08, and 2.0% y/y in 4Q08, earnings growth over the six months considered should amount to around 4.3%. All other conditions are assumed to be equal, and therefore the analysis implies virtually stable 2Y rates. The model yielded the following results.

#### S&P500: valuation assuming EPS -10% in 1H08, +4.3% in 2H08



Source: Intesa Sanpaolo

As shown by the dotted line and by the chart's valuation band, even making conservative assumptions in terms of the earnings trend for Corporate America, the US equity market does not appear demanding on a 12-month time horizon; once the current phase of turmoil is over, US equity could therefore offer an excellent investment opportunity already as of the second or third quarter of 2008, when total exposure to subprime mortgages may finally have been disclosed, and when macro data may lead to a waning of recession fears. Our current slight underweighting of US equity may gradually be removed over the coming months, eventually leading up to an overweighting of this asset class.

## European market: 2008 EPS estimates stable, upside potential following a range-trading phase.

**MARKET TRENDS.** Between 20 November and 12 December, the Euro Stoxx index rose by 4.3%, driven by the BOE's interest rate cut, expectations for similar action by the Fed, and the US government's decision to support households facing hardships in paying back mortgages. A sudden trend reversal followed, due to the disappointing outcome of the joint intervention of central banks, and to resurging fears of an economic slowdown induced by the subprime crisis, against the background of a complex inflation picture. Nonetheless, prospects for equity in 2008 seem more interesting in Europe than in the United States, in terms not only of valuations, but also of earnings resilience and greater defensiveness in the event of a sharp economic slowdown in the US.

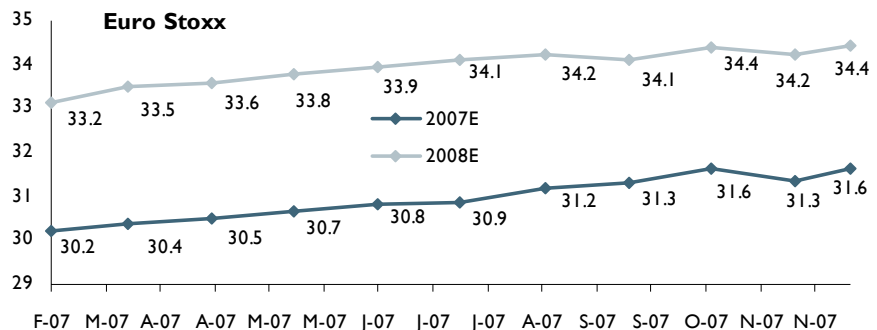
The main issues at play in 2008 will be:

- the lag of the Eurozone's economic cycle compared to the American (more solid growth in 4Q07 and 1Q08);
- a EUR/USD rate downtrend seems to have begun, with the dollar making up ground against the single European currency;
- inflation, both domestic and imported from Asia, may pose the most serious risk in 2008;
- lower exposure to subprime mortgages compared to the US markets.

The Eurozone economic cycle lags the United States' by a few quarters, and this means that EMU countries are set to benefit from a period of stronger growth, with a positive fallout on the European equity market, also favoured by the financial system's lower exposure to derivatives tied to subprime mortgages. Furthermore, should the euro keep depreciating vs. the US dollar, European exports would benefit, supporting corporate results. An element of uncertainty will be the Inflation rate, which represents a danger also in Europe, as the ECB, structurally focused on curbing price tensions, will probably prove less flexible than the Fed in leveraging monetary policy to support growth.

**VALUATIONS.** As at 10 December, Euro Stoxx valuations were up slightly compared to November, thanks to higher expected earnings, with 2008 EPS estimated at EUR 34.4 from EUR 34.2 previously.

**Euro Stoxx: trend of 2007 and 2008 EPS estimates**



Source: IBES

The comparison with bond yields, on the other hand, has worsened (EYR of 0.51 vs. 0.49 in November), although shares are still significantly more appealing than bonds (long-term EYR average of 0.79). The deterioration in growth estimates for

both 2008 and CAGR 2007-09, despite improved 2008 EPS estimates, is due to the fact that 2007 EPS estimates also rose, from EUR 31.3 on 20 November to EUR 31.6 on 10 November (a proportionally stronger rise). While slight, the improvement in valuations is all the more significant as it materialised as prices also rose slightly (Euro Stoxx performance +1.3% between 22 November and 6 December, dates on which IBES consensus estimates were updated).

#### Euro Stoxx valuation ratios

	10-Dec-07	Nov-07	1997-2006 average
2008E EPS (EUR)	34.4	34.2	
2008E EPS growth (%)	8.8	9.2	
2007-09E EPS CAGR (%)	10.4	10.6	
2008E P/E (x)	11.9	12.0	18.9
PEG (con 07-09 CAGR)	1.15	1.13	1.47
EYR	0.51	0.49	0.79
Risk premium (%)	NA	5.6	4.1
IMTG (%)	NA	-0.5	4.1

Source: Intesa Sanpaolo on IBES data

We ran a sensitivity analysis also on the European index to estimate the impact on valuations of a potential downward revision of earnings estimates. The usual assumption of a 10% decline from current 2008 EPS estimates indicates that the European equity market is still capable of yielding value, even in the event of estimated earnings growth in 2008 dropping to zero or turning slightly negative.

#### Euro Stoxx – Analysis of sensitivity to earnings expectations changes

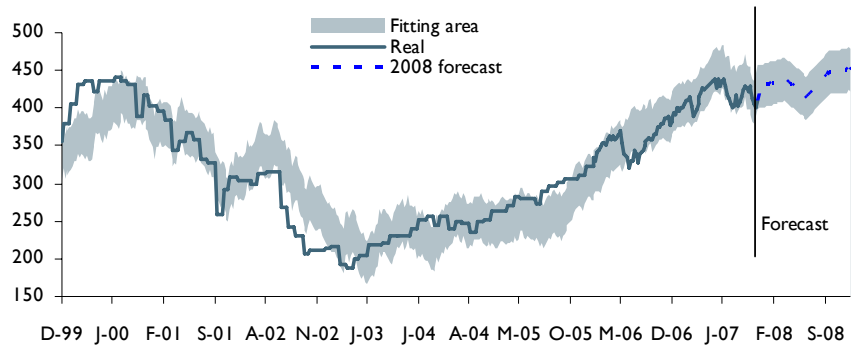
	Current	-10% EPS 08	-25% EPS 08	1997-2006 Avg.
2008E EPS (EUR)	34.4	31.0	25.8	
2008E EPS growth (%)	8.8	-2.1	-18.4	
2007-09E EPS CAGR (%)	10.4	6.6	0.3	
2008E P/E (x)	11.9	13.2	15.9	18.9
PEG (con 07-09 CAGR)	1.15	2.01	NM	1.47
EYR	0.51	0.57	0.68	0.79
Risk premium (%)	5.6	5.0	3.6	4.1
IMTG (%)	-0.5	1.1	4.3	4.1

Source: Intesa Sanpaolo on IBES data

Our models also indicates the presence of a rather substantial buffer for the Euro Stoxx to absorb disappointing EPS growth: for valuations to turn expensive based on long-term averages, 2008 EPS estimates would have to be cut by a hefty 24-25%.

Our econometric model yields similar results: assuming that between the first and second quarter of 2008 EPS growth remains stable, or accelerates by around 3.1% from current levels (with a GDP growth rate of 1.7% in 1Q08, given the lag between the European and the US economic cycles), with EPS subsequently declining by 10% between 1Q and 2Q08, the market would still be close to its fair value, based on year-end 2007 values. Lastly, in the second half of 2008, we have assumed estimated EPS growth to bounce back by 9.3% vs. the end of 2007, in line with estimated GDP over the last two quarters of the year, of 2% y/y. All other conditions are assumed to be equal, and therefore the analysis implies virtually consistent 2Y rates. The results yielded by the model are summarised in the chart below.

**Euro Stoxx: valuation assuming EPS +3.1% in 1Q, -10% in 2Q, and +9.3% in 3-4Q**

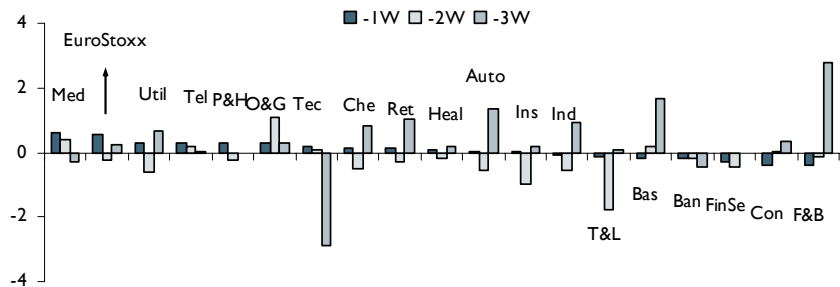


Source: Intesa Sanpaolo

In light of the above considerations, the European equity market looks more appealing than the American, especially on a three month horizon. In the longer period (6-9 months), on the other hand, corrections may occur, albeit not particularly sharp and followed by rapid recoveries.

**EUROSTOXX SECTOR ANALYSIS AND SECTOR ALLOCATION.** Based on the updates of IBES consensus estimates on 2008 EPS growth, the sectors which have scored upgrades over three consecutive weeks are the Oil & Gas and Telecom sectors, whereas Banks and Financial services incurred consecutive EPS estimate downgrades over the past three weeks. The aggregate Euro Stoxx index recorded a slight rise in 2008 EPS estimates in the past week.

**Revision of IBES consensus EPS estimates over the past three weeks**



Source: Datastream, IBES

**SECTOR STRATEGY.** Between 20 November and 14 December, our sector portfolio performed broadly in line with the benchmark, achieving only a marginally higher return (0.05%). The choices made in the Chemicals, Technology, Travel & Leisure, and Utility sectors were rewarding, whereas underweighting of the Healthcare, Financial Services, and Insurance sectors was penalising.

Looking ahead to 2008, sector allocation will prove rather complex, given the high volatility and uncertainty recorded in the closing weeks of the year.

We still suggest overweighting the **Technology** and **Telecom** sectors, as the former is exposed to Asian growth and less tied to the US domestic cycle, and the latter may be set to yield new value following recent restructuring and strategic investments, in addition to its typically high dividend yield. Dividend yield is also a

plus for the **Utility** sector, which thanks to its defensive characteristics, may also score positive performances in 2008. This month we have upgraded the **Oil & Gas** and **Healthcare** sectors. The energy sector, as well as being at the fore of the current growth phase in Asia, is benefiting from inflation tensions and solid pricing power. Demand in the sector is also supported by exuberant growth in China and India, destined to continue in the years ahead. Pricing power is also good in the Healthcare sector, which may well outperform the market in the current phase, despite the competition of generic drugs, thanks to its defensive features and appealing dividend yield.

We have upgraded the **Basic Resources** and **Insurance** sectors from underweight to market weight, due respectively to strong support offered by Asian demand and positive longer-term prospects, and to the lower-than-expected impact of the subprime crisis on the balance sheets of European insurance companies. Following the excellent performances achieved, we have brought the **Chemicals** sector back, now fairly valued, down to market weight.

Lastly, we have downgraded the **Travel & Leisure** and **Retail** sectors to underweight, as consumer spending may suffer somewhat due to weak demand in the United States and rising inflation pressures in Europe. Furthermore, even barring further rises, the price of oil may in any case stay high, eroding airline company margins.

Our optimiser succeeded in identifying a portfolio weight vector combination capable of generating higher expected return vs. the benchmark on a one-month horizon (0.44% vs. 0.35%), and with lower volatility (1.91% vs. 1.94%). In the current phase of uncertainty, overall portfolio volatility control is of greater concern than achieving higher expected yields.

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#### OVERWEIGHT

Oil & Gas ↑	<b>Tailwinds:</b> defensive sector with good pricing power in the current phase characterised by inflation tensions; strong demand for offshore services; oil processing margins close to historical peaks; oil extraction companies benefiting from high oil quotations. <b>Headwinds:</b> high exploration costs; refining margins under pressure due to high production costs; earnings and revenues highly exposed to volatile factors such as exchange rates and OPEC policies.
Technology	<b>Tailwinds:</b> estimated EPS momentum has improved; operating margins expected to rise for chip manufacturers; the launch of new products should positively impact the sales of consumer electronics companies. <b>Headwinds:</b> operating profitability is expected to decline for some software producers and technological equipment manufacturers; pressures on margins; sector vulnerable to economic slowdowns; average mobile phone retail prices are still dropping.
Telecom	<b>Tailwinds:</b> appeal tied to increasing M&A activity, on the back of strong cash generation and debt reduction; good 3Q07 results, generally higher than expected; cost containment and operating rationalisation; in addition to posting strong 3Q results, Vodafone upgraded guidance on 2007 and 2008, driven by Eastern Europe, India and Turkey; Telefonica reported increases in broad band services subscribers. <b>Headwinds:</b> profitability still low in new high-speed services; strong competition in the wireline business; difficulties in refinancing debt.
Healthcare ↑	<b>Tailwinds:</b> appreciation of the US dollar is a supportive factor; defensive sector; patent expiration and increasing popularity of generic drugs offset in part by the production of new drugs and by the acquisition of small generic drug producers by major players. <b>Headwinds:</b> revenues under pressure due to competition from generic drugs; R&D costs are high; limited number of new products in the pipeline.
Utility	<b>Tailwinds:</b> increase in expected earnings this year, thanks to the higher cost of energy; earnings from commodity trading on the rise; appeal tied to the consolidation process under way; defensive features tied to earnings flows; high dividend yield. <b>Headwinds:</b> dry weather forecasts may negatively impact cheaper power generation from renewable sources; sector sensitive to oil price volatility; earnings subject to regulatory pressures.

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**MARKET NEUTRAL**

Autos	<b>Tailwinds:</b> appeal tied to M&A activity; some turnaround stories; margin for further rationalisation and cost containment; dividend distribution and share buybacks. <b>Headwinds:</b> negative forex effect; commodity prices on the rise; pricing power still weak due to persisting excess production capacity; margins under pressure due to the cost of new production start-ups.
Banks	<b>Tailwinds:</b> strong credit trend on domestic markets and in South-Eastern Europe; further margin for cost cutting and operating rationalisation. <b>Headwinds:</b> 3Q results impacted by provisions and losses tied to the subprime mortgages crisis; likely significant decline in revenues and earnings generated by activity on the capital markets; high risk profile.
Basic Resources ↑	<b>Tailwinds:</b> one of the most interesting sectors in a medium-to-long-term perspective; demand drivers such as urbanisation, infrastructures and commodity and energy source exploration still in place; further EPS estimate upgrades likely; high sales prices. <b>Headwinds:</b> high unprocessed commodity and energy prices; volatile metal prices; lacklustre outlook in the paper sector, given negative sales expectations and the rising cost of wood pulp.
Chemicals ↓	<b>Tailwinds:</b> strong demand and high prices in the fine chemicals segment; M&A appeal; margin for improvement in terms of profitability, restructuring and rationalisation of operations. <b>Headwinds:</b> valuations in line with fair value; basic chemicals sensitive to oil price volatility; high oil prices impacting production costs; sensitive to economic cycle downturns; margins under pressure due to antipollution regulations and competition from low-cost countries.
Food & Beverages	<b>Tailwinds:</b> strong demand in emerging markets (Asia-Pacific, Africa, Central/Eastern Europe); appealing valuations; opportunities tied to some M&A stories. <b>Headwinds:</b> margins forecast to contract due to rising commodity prices and competition from unbranded products; 3Q07 results of some companies (beer producers first among them) impacted by adverse weather conditions; sector sensitive to the forex market.
Industrial G&S	<b>Tailwinds:</b> rise in new orders and better visibility on future activity; demand for investments resilient; Chinese demand still particularly strong. <b>Headwinds:</b> margins under strong pressures in the highly competitive industrial services segment; sales trend forecast to slow in some European markets; sector sensitive to the economic cycle and penalised by the forex market trend.
Insurance ↑	<b>Tailwinds:</b> exposure to subprime mortgages smaller than initially feared; strong growth in the Life and Health insurance segments; favourable prospects for the insurance business in fast-growing emerging economies; upward EPS estimate revisions. <b>Headwinds:</b> sector vulnerable to financial market volatility; slowdown in the non-Life segment; combined ratio on the rise following recent claims tied to weather-related damages (tornados, storms, floods).
Media	<b>Tailwinds:</b> advertising spending in Western Europe should grow at higher rates than in the USA in 2007 for the first time in many years, fuelled by increasing demand in Germany and the United Kingdom; growth driven by online products; important sporting events (Olympics, soccer Euro 2008) e political events (presidential elections in the United States) should support advertising spending growth in 2008. <b>Headwinds:</b> some innovative activities will imply high start-up costs and limited visibility; weak advertising income growth in the US; negative forex effect.

**UNDERWEIGHT**

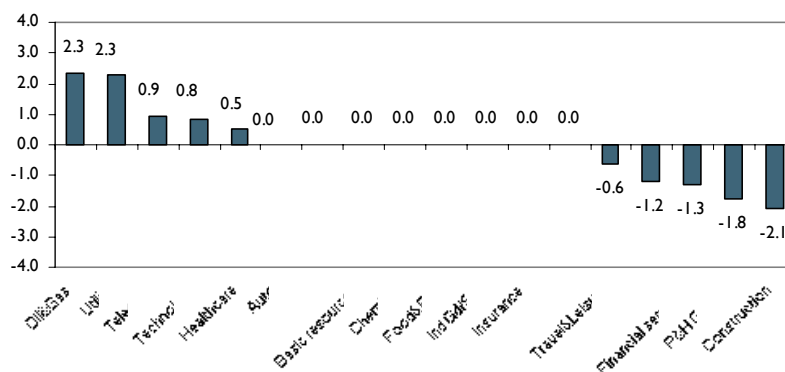
Construction and Material	<b>Tailwinds:</b> strong sales of cement and clinker in emerging countries; some leading sector companies reported strong 3Q07 results thanks to revenues generated in Asia (China and India). <b>Headwinds:</b> high exposure to the real estate market; signs of a slowdown in fast-growing European countries, such as Spain; building materials vulnerable to energy cost and forex trends.
Financial Services	<b>Tailwinds:</b> not particularly demanding valuations. <b>Headwinds:</b> high risk profile: holding companies very sensitive to equity quotations volatility; risk of further negative repercussions on real estate companies in the event of deteriorating market conditions; the impact of the subprime mortgages crisis on the sector may not be over.
Personal & Household Goods	<b>Tailwinds:</b> strong growth prospects in emerging economies; ample margin for M&A activity intensification, especially in the luxury goods sector; good chance of share buybacks and generous dividend, benefiting quotations. <b>Headwinds:</b> cyclical sector, greatly exposed to the risk of an economic slowdown; exposure to the forex market, and in particular to the more volatile Asian currencies and the US dollar.
Retail ↓	<b>Tailwinds:</b> solid growth in Eastern Europe and Asia; defensive sector; several opportunities tied to M&A activity; strong cash-generating capacity, interesting in view of potential LBOs and private equity funds. <b>Headwinds:</b> sector sales and margins negatively impacted by inflation pressures; highly competitive market conditions in Western Europe (presence of discount chain stores); slow growth in sales and discount, necessary to safeguard market shares; sector penalised by the economic cycle and forex effects.
Travel & Leisure ↓	<b>Tailwinds:</b> appeal tied to M&A activity; some defensive features (leisure services); reduction in the number of flights operated by Ryanair, with savings on airport services costs to the advantage of profitability. <b>Headwinds:</b> sector sales and margins impacted negatively by inflation pressures; fuel costs on the rise; downward pressures on airline tickets, due to competition from low-cost companies; sentiment on the sector tied to volatile factors (oil prices, terrorist attacks).

## European equity sector allocation (one-month horizon)

%	Benchmark	Optimal	Delta
Auto	5.0	<b>5.0</b>	0.0
Bank	19.5	<b>19.5</b>	0.0
Basic resources	2.2	<b>2.2</b>	0.0
Chemical	4.8	<b>4.8</b>	0.0
Construction	4.1	<b>2.1</b>	-2.1
Food&Bev	3.5	<b>3.5</b>	0.0
Financial services	2.6	<b>1.3</b>	-1.3
Healthcare	3.1	<b>3.6</b>	0.5
Ind Gd/Srv	8.0	<b>8.0</b>	0.0
Insurance	7.8	<b>7.8</b>	0.0
Media	2.5	<b>2.5</b>	0.0
Oil&Gas	6.7	<b>9.0</b>	2.3
P&H Goods	3.5	<b>1.8</b>	-1.8
Retail	2.4	<b>1.2</b>	-1.2
Technology	5.3	<b>6.2</b>	0.8
Telecom	7.4	<b>8.3</b>	0.9
Travel&Leisure	1.2	<b>0.6</b>	-0.6
Utility	10.5	<b>12.8</b>	2.3
	<b>100.00</b>	<b>100.00</b>	
<b>Expected Return:</b>	0.35%	<b>0.44%</b>	
<b>Volatility:</b>	1.94%	<b>1.91%</b>	
<b>Absolute Portf. VAR (95%):</b>	-3.19%	<b>-3.15%</b>	
<b>Sharpe Ratio:</b>	0.18	<b>0.23</b>	
<b>Tracking Error:</b>		<b>0.08%</b>	
<b>Information Ratio:</b>		<b>1.17</b>	
<b>Relative Portf. VAR (95%):</b>		<b>-0.13%</b>	

Source: Intesa Sanpaolo elaborations

## Sector over/underweighting (portfolio weight-benchmark delta)



Source: Intesa Sanpaolo elaborations

Japanese market: prospects not particularly dynamic, valuations close to fair value.

**TRENDS AND MARKET VIEW.** The Nikkei index traced the S&P500's trend, gaining 5.5% between 20 November and 11 December, and subsequently sliding by more than 3% following the statements made by the Fed and the market's cooling optimism with regards to the effectiveness of the central banks' concerted action in support of Interbank liquidity. Early in December, gains on the Japanese markets were driven by positive prospects for steel producers and by the rebound of the construction sector; a correction followed, led by the declining banking and financial share quotations. The Tankan index lost ground in 4Q, falling short of market expectations, although large manufacturing companies reported a 10.5% increase in capex, vs. a previous rise of 8.7%.

**VALUATIONS.** Looking ahead to 2008, valuations on the Japanese market do not seem to be particularly demanding, and almost all the main indicators are still well off their long-term averages. However, 2008 EPS estimates are deteriorating, down from JPY 103.1 at the end of November to JPY 102.1 on 10 December. Despite the fact that the macro picture is not negative, this trend could accentuate over the coming months, as a result of slowing growth in the United States, with negative repercussions on exports, domestic problems tied to the real estate market, modest wages growth, and the risk of an appreciation of the yen against the US dollar further holding back exports, in addition to prompting an unwinding of carry trades. On the other hand, the Japanese market should be supported by exports to China, which have been growing for many quarters now. Lastly, the strong bind between US and Japanese equity market trends should also be considered.

#### Japan Topix valuation ratios

	10-Dec-07	Nov-07	1997-2006 average
2008E EPS (JPY)	102.1	103.1	
2008E EPS growth (%)	9.7	9.1	
2007-09E EPS CAGR (%)	12.1	12.2	
2008E P/E (x)	14.9	14.1	34.3
PEG	1.23	1.16	1.53
EYR	0.23	0.21	0.44
Risk premium (%)	ND	7.1	5.2
IMTG (%)	ND	0.5	4.3

Source: Intesa Sanpaolo on IBES data

An analysis of the sensitivity of valuations to expected earnings trends on the Topix index shows that the Japanese market is also capable of reacting to potential downward revisions, although buffers a smaller than on the US market. A 10% decline in 2008 EPS estimates would in fact suffice to place growth in percentage terms under pressure (from 9.7% to -1.2%), pushing the PEG ratio up from 1.23 to 2.01, above its long-term average (1.53), with valuations hard-pressed to support such a modest earnings growth rate. A 20-23% decline in 2008 EPS estimates would place the Topix index on the dividing line between the fair value and overvaluation areas, in a long-term valuation approach.

#### Topix – Analysis of sensitivity to earnings expectations changes.

	Current	-10% EPS 08	-23% EPS 08	1997-2006 Avg.
2008E EPS (JPY)	102.1	91.8	78.6	
2008E EPS growth (%)	9.7	-1.2	-15.5	
2007-09E EPS CAGR (%)	12.1	8.2	2.7	
2008E P/E (x)	14.9	16.5	19.3	34.3
PEG	1.23	2.01	7.04	1.53
EYR	0.23	0.26	0.30	0.44
Risk premium (%)	7.1	6.4	5.2	5.2
IMTG (%)	0.5	3.3	9.5	4.3

Source: Intesa Sanpaolo on IBES data

It is still hard to forecast the trend of domestic consumption in the short and medium-term, still weak at present and penalised by the low spending power of wages. Given the domestic hardships and the less defensive nature of the equity Japanese market in the event of EPS estimate downgrades, our view on this market is Neutral, despite the undemanding valuations.

## Chinese market: 2008 may be the year of convergence between prices and valuations

**TRENDS, VALUATIONS AND MARKET VIEW.** Despite the recent decline of the Chinese equity market (Shanghai A Index -21.2% from the peak of 16 October to the low touched on 28 November, IBES China Index -16.9% between 16 October and 3 December), valuations remain expensive, although they are now closing in on fair value levels. In particular, the risk premium and IMTG seem to be broadly in line with average long-term historical data, and despite a deteriorating international picture, in the US especially, EPS estimates keep growing. As anticipated in recent months, 2008 should also see the continuation of the realignment trend of prices and valuations, with the former declining and corporate earnings growth expectations rising (or holding out). The real downside risk weighing on the powerful drive of the Chinese economy in 2008 may be inflation, which is growing at a brisk pace, as proven by numerous indicators (CPI +6.9% in November vs. 6.5% in October). However, price increases are mostly fuelled by soaring domestic demand and by large exports, helped by a pegged exchange rate vs. the US dollar: demand-driven inflation in a fast-growing economy does not pose a serious problem, for the time being.

### IBES CHINA Index valuation ratios

	10-Dec-07	Nov-07	1997-2006 average
2008E EPS (Yuan)	0.594	0.585	
2008E EPS growth (%)	31.7	30.9	
2007-09E EPS CAGR (%)	33.4	33.0	
2008E P/E (x)	23.5	23.8	12.8
PEG	0.70	0.93	1.13
EYR	1.06	1.11	0.74
Risk premium (%)	NA	8.9	6.7
IMTG (%)	NA	19.3	19.8

Source: Intesa Sanpaolo on IBES data

Our sensitivity analysis run on the Chinese equity market (see table below), indicates a total lack of buffers capable of absorbing a potential deterioration in expectations on the sustainability of current earnings growth rates: as the market is already expensive, any deterioration in prospected earnings would further impact valuations, triggering an even faster decline in quotations.

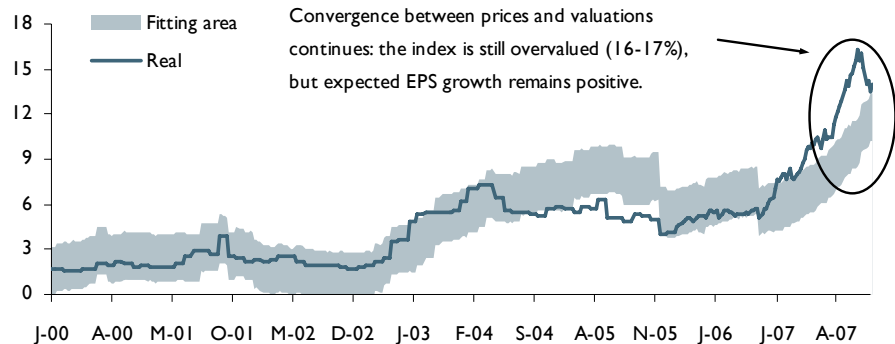
### IBES China – Analysis of sensitivity to earnings expectations changes

	Current	-10% EPS 08	1997-2006 Avg.
2008E EPS (USD)	0.594	0.535	
2008E EPS growth (%)	31.7	18.5	
2007-09E EPS CAGR (%)	33.4	28.8	
2008E P/E (x)	23.5	26.1	12.8
PEG	0.70	0.91	1.13
EYR	1.06	1.18	0.74
Risk premium (%)	8.9	7.2	6.7
IMTG (%)	19.3	20.9	19.8

Source: Intesa Sanpaolo on IBES data

The convergence between prices and valuations, as identified by an econometric model estimating the fair value of the Chinese equity market, is illustrated in the chart below: 2008 may well be the year in which the fitting area and the line representing the index will meet again.

### China – Valuation model



Source: Intesa Sanpaolo

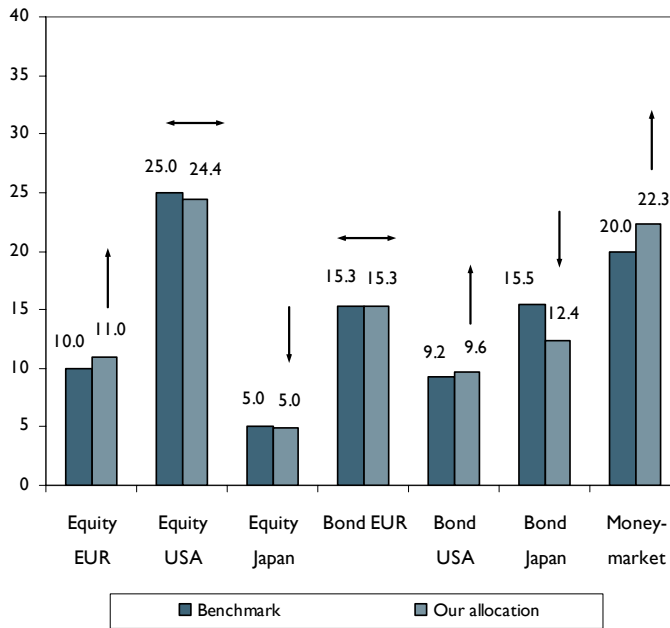
**Market portfolio:** while waiting for the current phase of volatility to end, preference for euro equity, US bonds, and money market.

**ASSET ALLOCATION MODEL<sup>10</sup>.** Between 20 November and 14 December, our asset allocation model outperformed the benchmark, achieving better results in all asset classes except US equity, which we had underweighted. This month, prompted by our positive long-term view, balanced in part by a more cautious short-term view, we have opted to slightly increase exposure to European equity, more interesting than the US equity in terms of valuations and earnings growth defensiveness, while reducing exposure to Japanese equity. As regards bonds, we have further reduced exposure to the Japanese market, while overweighting US bonds (9.6% vs. the 9.2% benchmark). Lastly, we have increased the weight of the monetary market component.

Therefore, in our portfolio Euro equity, US bonds, and the monetary market are overweighted; US equity and Japanese bonds are underweighted; Japanese equity and Euro bonds are in line with market weight.

<sup>10</sup> The asset allocation process is governed by a bound optimisation model based on the Var-Cov matrix of the asset classes considered, and on expected returns modified by the market view (Black-Litterman approach). For the equity component, as well as on scenario indications, the overall view is also based on four quantitative indicators (Risk Premium, IMTG, EYR and 12M fwd. EPS momentum), calculated taking a mean-variance approach, in combination with fundamentals-based valuations. For the bond component, expected returns are based on our estimates applying the modified duration and convexity principle. Bounds on optimisation are expressed in terms of an upper limit on relative Value At Risk, and of a +/-20% difference compared to benchmark weights for each asset class. The benchmark reflects market capitalisations.

**Tactical asset allocation: medium-risk model portfolio**

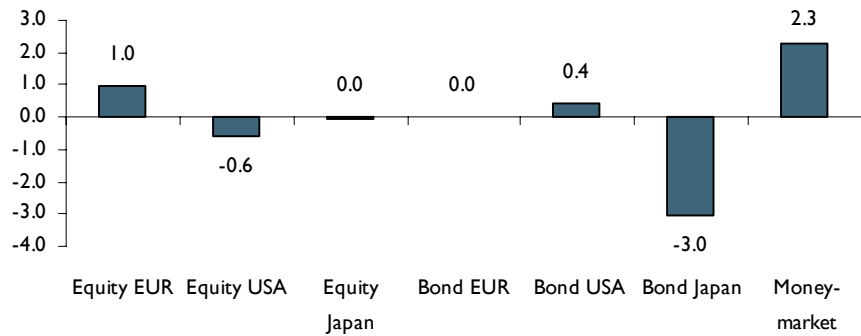


Note: the arrows indicate an increase/decrease vs. previous exposure.

Source: Intesa Sanpaolo elaborations

The chart below illustrates the delta of the various asset classes vs. benchmark weights.

**Tactical asset allocation: difference between portfolio and benchmark**



Source: Intesa Sanpaolo elaborations

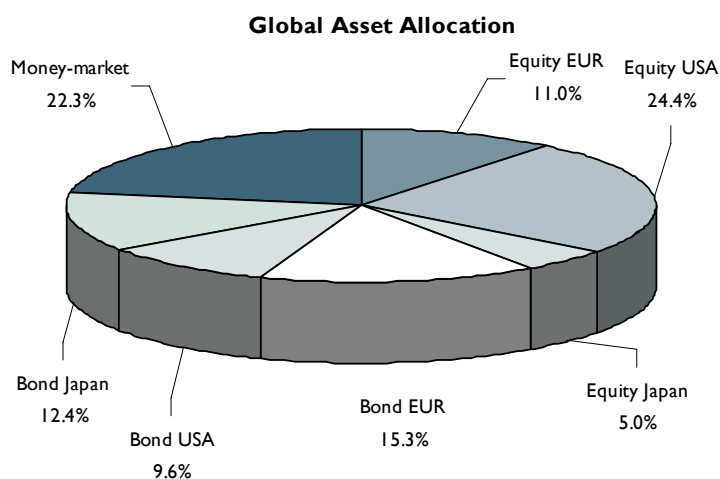
The main portfolio variables and indicators obtained through the optimisation process are summarised in the table below.

**Medium-risk portfolio (3-month horizon)**

	<b>BNCHMK</b>	<b>OPTIMAL</b>	<b>DELTA</b>
Equity	40.00	<b>40.34</b>	0.34
Bond	40.00	<b>37.39</b>	-2.61
Money-market	20.00	<b>22.27</b>	2.27
	<b>100.00</b>	<b>100.00</b>	
EUR	45.32	<b>48.57</b>	3.26
USD	34.20	<b>34.03</b>	-0.17
JPY	20.48	<b>17.40</b>	2.27
	<b>100.00</b>	<b>100.00</b>	
<b>Expected return:</b>	<b>1.57%</b>	<b>1.65%</b>	
<b>Volatility:</b>	<b>2.76%</b>	<b>2.79%</b>	
<b>Absolute VAR (95%):</b>	<b>-4.55%</b>	<b>-4.59%</b>	
<b>Sharpe ratio:</b>	<b>0.57</b>	<b>0.59</b>	
<b>Tracking error:</b>		<b>0.08%</b>	
<b>Information ratio:</b>		<b>1.00</b>	
<b>Relative portfolio VAR (95%):</b>		<b>-0.13%</b>	

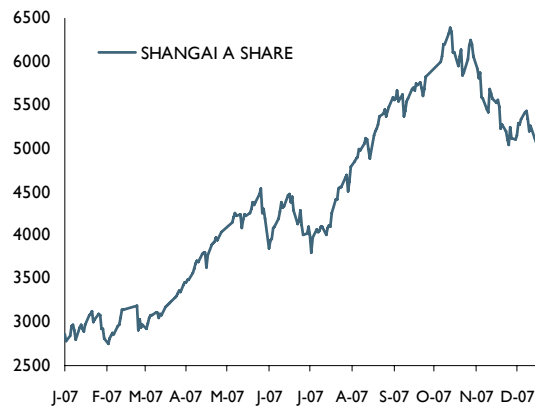
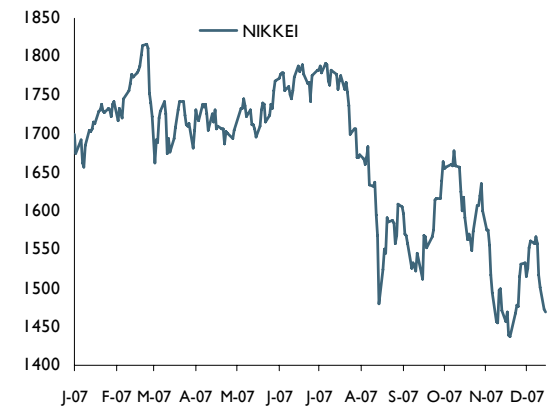
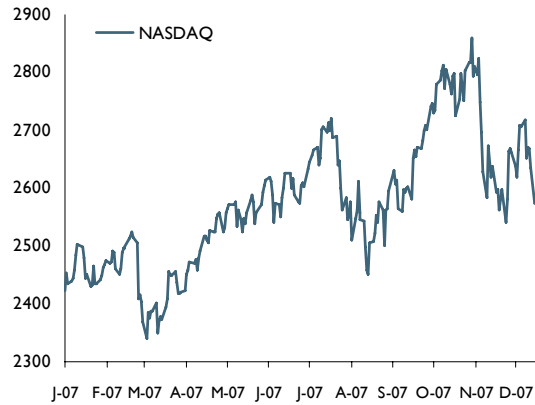
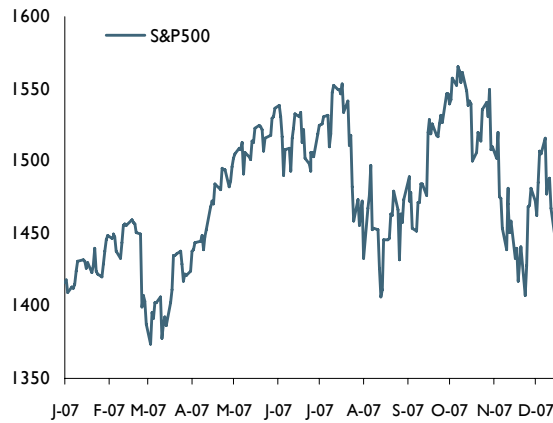
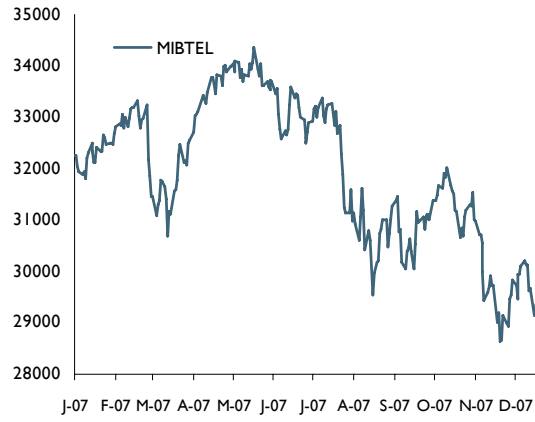
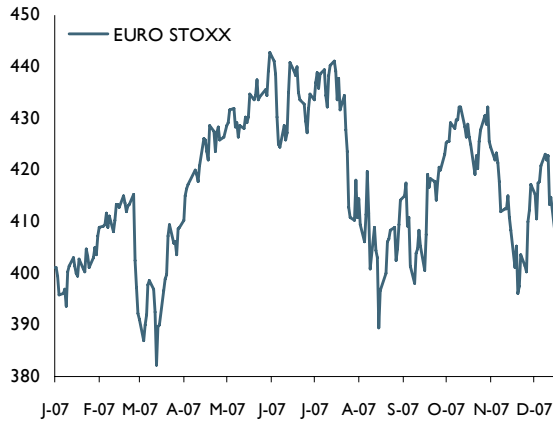
Source: Intesa Sanpaolo elaborations

**Tactical asset allocation: medium-risk model portfolio**



Source: Intesa Sanpaolo elaborations

## Trends of the main world stock markets



Source: Bloomberg

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## APPENDIX 1

### ANALYST CERTIFICATION

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- (1) The views expressed on companies mentioned herein accurately reflect independent, fair and balanced personal views;
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