

UOB Economics Projections	2008	2009	2010F	2011F
GDP	0.6	-4.1	1.2	1.5
CPI (average, y/y)	3.3	0.3	1.2	1.5
Unemployment rate (%)	7.6	9.4	10.2	10.4
Current account (% of GDP)	-5.0	-2.6	-0.5	-0.3

- *Sovereign debt will continue to be the headline issue for the rest of this year.....*
- *With the interest rate environment and the potential tensions threatening to weaken the raison d'être of the European Union (EU) as an entity, all do not seem so rosy for the Euro. Our end-quarter target for EUR/USD is at 1.360.*
- *The European Central Bank (ECB) will probably take the cue from other central banks, notably the Federal Reserve in hiking interest rates. Highly plausible that it may be a laggard in moving interest rates, we have pushed our forecast for a rate hike only in 2011.*

How Far Will it Spread?

Whilst the year 2010 marks the 11th anniversary of the EU, events of late with regards to Greece, Portugal and some of the Eurozone nations had cast the European Union into some sort of negative publicity. Skeptics of the EU had long cast doubts on the efficacy and long term sustainability of the super bloc and the handling of the Greece affair only served to lend credence to this particular group.

A potential fragmentation and disintegration of the EU might seem like a far-fetched notion and would certainly have far-reaching ramifications. Faced with mounting electoral pressures in their home countries, respective leaders were inadvertently forced to put their interests ahead of the EU. This was best exemplified by the apparent rift between the German Chancellor Angela Merkel and her Finance Minister on the decision as to whether there should be a bailout for Greece.

There will be pressure on leaders of the 16-nation common currency bloc to offer rescue packages for its ailing weaker members i.e. the PIIGS (referring to Portugal, Italy, Ireland, Greece and Spain). However, the long drawn saga and the disagreements in agreeing an eventual solution for Greece (with the IMF intervention) had cast doubts whether the EU can sustain another "Greece-like event".

Furthermore, Portugal's sovereign credit rating was recently downgraded by Fitch Ratings by one notch to AA-, citing budgetary underperformance in 2009 and warning that a similar outcome this year and next could cause

another downgrade. And with unemployment in Spain at an elevated level of more than 18.0%, all do not seem well for the southern European economies at the moment.

With this backdrop in mind and the widening fissures within the EU, it is vital that we consider the developments within the FX and interest rate space.

Sovereign Debt Issues

Will Continue to Play Havoc with the Euro

From March 2009, EUR/USD was on a sharp appreciating trend as the market crisis struck the US hard and the greenback was sold off rapidly. However, in recent months, there seems to be a reversal of roles as the EUR/USD had taken a severe battering, coming off a high of 1.5144 on November 25, 2009 to a low of 1.3268 on March 25, 2010.

No doubt, the sovereign default crisis surrounding Greece and the inability of the EU as a bloc to come in unison to agree on a rescue package weighed heavily on the EUR/USD. The initial hubris of not allowing the intervention of the IMF to the eventual concession of allowing IMF aid did not give much confidence to market players in the strength of the Euro. EUR/USD bears will find greater comfort in this apparent lack of unity and strength within the bloc to set up greater shorts into the coming months as there may potentially be more examples of Greece in the horizon.

In addition, the perceived tardiness of the ECB in enacting monetary policy changes will also serve to undermine the Euro in the coming months as the market position itself

Eurozone

towards exit strategies by the other central banks. All in all, with the interest rate environment and the potential tensions threatening to weaken or (in the worst case scenario), break down the *raison d'être* of the EU as an entity, all do not seem so rosy for the 16-nation currency. Our end-quarter target for EUR/USD is at 1.360.

Pushing Our Forecast of an Interest Rate Hike Only in 2011

Unlike their American counterparts, the ECB dragged their feet in easing monetary policy and pump priming the economy with fiscal stimulus. As a matter of fact, the ECB reacted, only after all the central banks, in slashing the interest rates to 1.0%.

16 months after the crisis, the economy has witnessed signs of recovery with key leading and lagging indicators pointing to an avoidance of the double-dip scenario and improvement in sentiment. Yet, greater attention needs to be paid on a potential sovereign default crisis that may grip the whole Eurozone like a pack of dominoes. Credit Default Swap spreads had been escalating through the roof as market participants increased their bets that the "PIIGS" economies will be unable to service their outstanding sovereign debt and go into default. Besides the meteoric spike in CDS spreads of the "PIIGS", another worrying trend

seen is the tightening of the swap spreads into negative territory in the European economies. On one hand, this may be caused by potential spread widening players cutting their positions. On the other, it can be explained also by the fact that there is a general lack of confidence in holding sovereign debts, pushing government benchmark yields higher. Negative swap spreads, especially in the longer end of the curve, indeed poses a worrying trend about the general confidence in sovereigns' abilities to borrow and service their outstanding debts. For the next few months ahead, Europe stands on the precipice of a political mess that will weigh heavily on the credit market.

Whilst market participants had been calling for central banks to gradually remove the stimulus and begin the tightening process to drain the excess liquidity from the system; given the bureaucratic nature of the ECB setup, we envisage that there will not be any reversal of roles (this time as well), and the ECB will probably take the cue from other central banks – notably the Fed – in hiking interest rates. In addition, given their slower recovery vis-à-vis the US and the mounting problems with the southern members, this scenario is highly plausible. We are now calling for a rate hike only in 2011.