

# Weekly Focus

4-11 January 2008

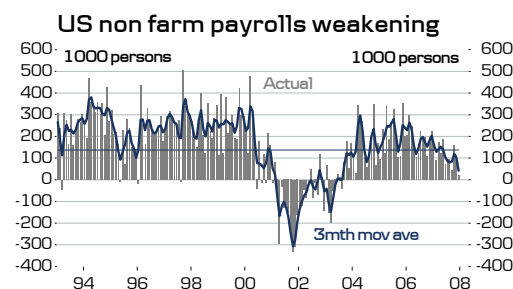
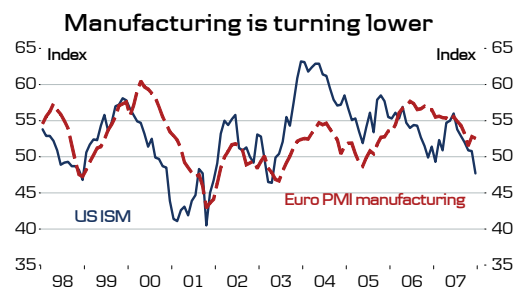
## Rate cuts from the ECB in second half 2008

We have altered our rate forecasts and we now project a longer easing cycle from the Fed and rate cuts of 50bp from the ECB in the second half of 2008. Softer economic data over the last month points to more downside risks to growth in the coming quarters globally. The US will be flirting with recession during the first half and we therefore now forecast the Fed cutting rates by 25bp at every meeting in the first half of 2008. This is a total of 100bp, taking the Fed funds rate to 3.25%.

The decoupling of Euroland will end in 2008, as growth comes increasingly under pressure from a range of sources. Consumption growth has never really got started and is now set to feel the pinch from rising oil and food prices. At the same time, exports are being hurt from a stronger euro and weaker global growth and this is going to weigh on investment activity as well.

The strong decline in US ISM this week points to a quicker deterioration of the global industrial cycle and this will also add to the downward pressure on growth in Euroland. All in all, we therefore think the ECB will come under huge pressure to follow the Fed and the Bank of England and give in to this pressure during the second half of 2008. It will be a close call, though, as inflation is of genuine concern for the ECB, but we do not think it can ignore the scope of the economic slowdown. We thus expect the ECB to cut rates by 25bp at both the September and December meetings.

The further economic weakening and central bank rate cuts will lead to a further decline in global bond yields during 2008.



## Bond yields falling - and likely to fall further



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# Denmark

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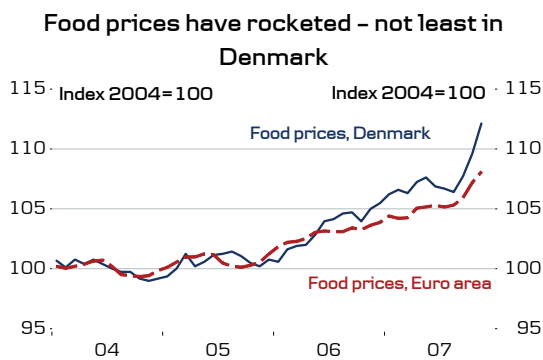
## Labour market steaming ahead

The Danish economy is possibly shifting down a gear, not least because of the housing market slowdown and the low dollar exchange rate, which is putting pressure on Danish competitiveness. However, this is not reflected in the labour market, which is still red hot. The number of unemployed people fell by 3,200 to 78,400 in November, taking the unemployment rate down to as little as 2.8%. This was the first time since 1974 that the unemployment rate dropped below 3%. And, in fact, several industries are short of labour.

It is quite common for a turnaround in the Danish economy to feed through into unemployment with a lag - often three-six months. So, the Danish labour market keeps steaming ahead, and the significant shortage of labour in Denmark might well push unemployment down a little further in coming months.

Low unemployment has sent the rate of wage increases up above rates abroad. And wage rises in Denmark are likely to speed up further this year. While this may hurt Danish competitiveness, the timing is also unfortunate. High wage rises in the late stages of the business cycle may intensify the turnaround in the economy, resulting in a protracted and sharper downturn in GDP growth.

High wage rises may be passed on to prices, fuelling domestic market-driven inflation. However, so far inflation has mainly been driven by external factors. Hence, the jump in the inflation rate from 1.7% in October to 2.5% in November was primarily the result of a hop in food prices, together with rising energy prices. Food price increases are a global phenomenon, but prices have risen more in Denmark than in the Euro-zone. While this might indicate that we have seen most of the effects of the rise in global food prices for now, we expect food prices to edge up further in the week ahead, when the December inflation numbers are released. On the other hand, energy prices have fallen back a little, so we expect the inflation rate to edge down to 2.3%.



### Key events of the week ahead

- Monday: Business confidence indicators.
- Tuesday: Bankruptcies and forced property sales for December. We expect a modest rise in forced sales and a flat trend in bankruptcies.
- Wednesday: Current account and foreign trade numbers. The current account surplus for November is estimated at DKK 4bn.
- Thursday: consumer price index for December. Look for a fall in the inflation rate to 2.3%.
- Friday: Industrial production.

Date	Time	Event	Period	Danske Bank	Consensus	Previous
Mon 07 - 11	-	DKK HICP	m/mly/y			0.8% 2.5%
Mon 07	9:30	DKK Retail sales, volume	m/mly/y			-1.9% 2.3%
Wed 09	9:30	DKK Current account	DKK bn	4.0		4.6
Wed 09	9:30	DKK Trade Balance	DKK bn			1.4
Thu 10	9:30	DKK CPI	m/mly/y		-0.1% 2.3%	0.7% 2.5%
Fri 11	9:30	DKK Industrial production	m/m			3.7%

# Sweden

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## Wage developments becoming increasingly important

Riksbank Governor Stefan Ingves recently authored an article ([available here](#)) in Sweden's largest news paper *Dagens Nyheter* (DN). Although it contains nothing new (compared to the Monetary Policy Update in December), it stands clear that the Riksbank is finding it difficult to weigh strong domestic developments against increasingly worrisome developments in the surrounding world. As you might know, we at Danske Bank find this less problematic - Sweden is a small open economy with an established inflation-targeting regime - further hikes are, according to us, out of the question.

Governor Ingves expressed concerns about the negotiated wages that he must - implicitly - find a tad too high. The rapidly slowing growth, in conjunction with the strong labour market, raises unit labour costs, which might spill over into price hikes. As we have put forward many times, we do not approve of this argument as the labour market is a (naturally) lagging - not a leading, and not even a coincident - indicator of the economic cycle. But Ingves seems to put more emphasis on the wage pressure by itself, stating that wage agreements are (too) high.

This remains to be seen. The data out so far are not as alarming as could be expected given the strong labour market (even the Riksbank has noticed this), but the ridiculously long lags and consistent upwards revisions to wage statistics make this a very uncertain conclusion. The October wage data recently released, which are actually the first somewhat accurate indications of actual wage pressures related to the wage agreements in spring, point to an hourly wage growth below 4% y/y (assuming the NIER's estimate of wage drift and local negotiations in 2008). The Riksbank forecast is 4½% y/y, a notch above our estimated wage growth.

The at least seemingly lower wage outcome is one - albeit not the most important - reason behind our decision to add two 25bp cuts to our forecast for the Riksbank repo rate over the coming 12 months. The pronounced weakening of the global and domestic economy and our firm belief that current high domestic cost pressures will subside in pace with a weaker labour market are of course the most important reason behind our changes.



### Key events of the week ahead

- Industrial data (orders and production) together with the GDP-indicator will be interesting, but probably not sufficient to disturb financial markets.
- On the other hand, the minutes from the Riksbank policy decision in December might prove to be really interesting.

Date	Time	Event	Period	Danske Bank	Consensus	Previous
Wed 09	9:30	SEK Budget Balance	Dec			
Thu 10	9:30	SEK Industrial production	m/mly/y Nov		0.3% 1.3%	-0.3% 1.0%
Thu 10	9:30	SEK Activity index	Index Nov			123.1
Thu 10	9:30	SEK Industrial orders	m/mly/y Nov			-4.4% 6.2%

# Norway

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## Order boom is over

The PMI for December released during the week suggested that manufacturing activity may have peaked in Norway. As we have stressed many times before, Norway is enjoying its first manufacturing-driven economic upswing for almost 30 years. Signs of a slowdown in manufacturing are therefore the first indication of the Norwegian economy peaking.

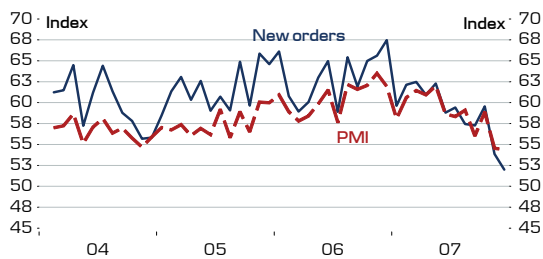
It is primarily a sharp drop in the index for new orders that has made us uncertain about the future of the upswing. Overall, the index suggests that growth in orders received will approach zero in Q1. If this trend continues, Norwegian interest rates will probably also be close to peaking.

Nevertheless, given the continued strong pressure in the labour market and the service sector, we still expect wage growth to be close to 6% this year. There is therefore the prospect of a further interest rate hike from Norges Bank before it goes on hold. The way manufacturing orders are going suggests that any further hikes after that will be unnecessary.

Inflation data for December will be the highlight of the coming week in the Norwegian market. We expect underlying inflation to tick up further to 1.6 y/y in December from 1.5% in November. This is due partly to growth in food prices, which is expected to climb from 1.7% to 2.0%. If our forecast is correct, underlying inflation will rise marginally more than expected by Norges Bank.

Other economic data during the week will probably largely confirm the pressure in the Norwegian economy, as the labour market is tight and private consumption is high. However, keep an eye out for signs of a downturn in manufacturing output.

### Order downturn in PMI



### Key events of the week ahead

- Core inflation is expected to be 1.6% y/y in December.
- AKU unemployment probably fell to 2.5% in October (September-November).
- We expect retail sales to climb 1.0% in November after the drop in October.
- Manufacturing output probably fell by 1.0% in November after the sharp upswing in October.

Date	Time	Event	Period	Danske Bank	Consensus	Previous
Tue 08	10:00	NOK Industrial Production	m/mly/y			1.0% 4.5%
Tue 08	10:00	NOK Manufacturing Production	m/mly/y	-1.0% .	0.2% 4.8%	1.7% 4.6%
Tue 08	10:00	NOK Unemployment s.a. (LFS)	%	2.5	2.5	2.6
Wed 09	10:00	NOK Retail sales, s.a.	m/mly/y	1.0% 7.1%	0.7% 6.3%	-0.3% 6.6%
Thu 10	10:00	NOK Consumer prices	m/mly/y	0.2% 2.1%	0.2% 2.1%	1.6% 1.5%
Thu 10	10:00	NOK Core inflation(CPI-ATE)	m/mly/y	0.1% 1.6%	0.1% 1.6%	0.3% 1.5%

# Euroland and Switzerland

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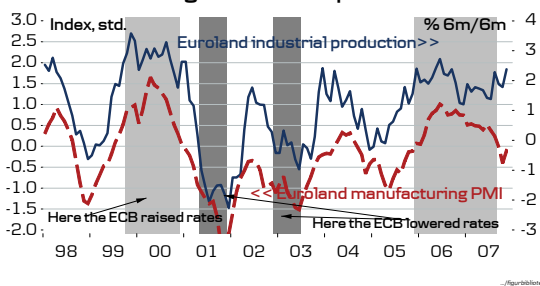
## Which way is manufacturing heading?

The surprisingly sharp fall in the ISM index, which is a broad activity indicator for the US manufacturing sector, has put a big question mark over the robustness of the Euroland economy. We had expected Euro-land manufacturing to remain robust, and maybe even strengthen slightly around New Year. Global manu-facturing outside the US was on the up, and this tends to be reflected in Europe. There were also signs that the stock markets were taking the second round of the credit crisis in November relatively calmly, and European share prices gained slightly in December.

The dip in the ISM index changes the picture somewhat. It means that the weakness we had expected to start to materialise from Q2 in Euroland and persist into H2 will probably now arrive in Q1 instead. Nor-mally a good rule of thumb for the ECB's monetary policy is that it tightens when the manufacturing PMI is above 55, and eases when it falls below 50. The December figure was 52.6, which is close to neutral. But with high inflation and continued strong liquidity growth, it has not taken much for the ECB to tighten any-way. Following the dip in the ISM index, we now need to start keeping an eye on whether this weakness is seriously spreading to Euroland. We reckon that the PMI could fall to just under 50 over the next three to six months, but this does not necessarily mean that the ECB will start to ease monetary policy: inflation is too high for this, and money supply growth too strong.

The coming week will give us an idea of whether Euroland manufacturing is shifting down a gear with the pub-lication of figures for German manufacturing output and orders. Since the summer, these data have been better than suggested by the business confidence indicators, which normally capture developments very well. We expect a slight increase in industrial output and a slight decrease in orders, so the trend will still look healthy, although it is hard to decide whether the trend is now turning, so triggering a real slowdown in the Euroland economy. However, one thing we can conclude is that we will see lower growth in Euroland in the coming quarters, and that this, coupled with the credit crisis, will probably stop the ECB from raising in-terest rates for a long time to come. The focus now needs to be on whether the slowdown will be sufficiently sharp for the ECB to see its way towards easing monetary policy later on in 2008 despite inflation.

Manufacturing could be important for ECB



### Key events of the week ahead

- ECB meeting, where the tone will probably remain hawkish with little softening.
- Confidence indicators from the European Commis-sion, which will doubtless show that growth slowed slightly from November to December.
- German manufacturing output and orders, which will be relatively stable.

Date	Time	Event	Period	Danske Bank	Consensus	Previous
Mon 07	11:00	EUR Euroland PPI	m/mly/y	Dec 0.7% 3.9%	0.7% 3.9%	0.6% 3.3%
Mon 07	11:00	EUR Unemployment	%	Nov 7.1	7.2	7.2
Mon 07	11:00	EUR Consumer confidence	Net balanc	Dec -9	-9	-8
Mon 07	11:00	EUR Economic Confidence	Index	Dec 104	104.0	104.8
Mon 07	11:00	EUR Business confidence	Net balanc	Dec 2	2	3
Tue 08	11:00	EUR Retail sales	m/mly/y	Nov		-0.7% 0.2%
Tue 08	12:00	DEM Manufacturing orders	m/mly/y	Nov -1.0% .	-1.6% .	4.0% 14.0%
Wed 09	8:00	DEM Trade balance	EUR bn	Nov		18.7
Wed 09	11:00	EUR GDP, s.a., final	q/qly/y	3rd quarter	0.7% 2.7%	0.7% 2.7%
Wed 09	12:00	DEM Industrial production	mm/ly/y	Nov 0.3% .	0.5% .	-0.3% 6.0%
Thu 10	8:45	FRF Industrial production	m/mly/y	Nov	-0.5% 3.8%	2.1% 4.0%
Thu 10	13:45	EUR ECB Meeting		4.0%	4.0%	4.0%
Mon 07	7:45	CHF Unemployment	%	Dec	2.8	2.7
Mon 07	7:45	CHF Unemployment s.a.	%	Dec	2.6	2.6

# UK

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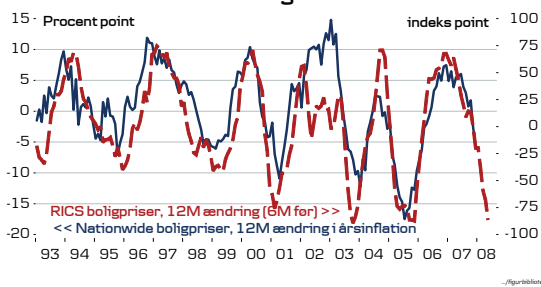
## Fresh BoE rate cut on the way

In recent days it has become clear that the autumn credit crisis is beginning to impact seriously on the UK real economy, and that the outlook has deteriorated. The UK PMI fell to 52.9 in November. This still indicates growth in manufacturing, but the country is also dependent on global manufacturing activity, and the ISM index in the USA released during the week also pointed downwards. Our view is that UK manufacturing is headed for slightly tougher times in 2008. The service industry - not least the financial services sector so important to London - has also encountered numerous setbacks as a result of the financial crisis in recent months.

We have long argued that the credit crunch would impact negatively on the UK housing market, and we got confirmation of this over Christmas. According to Nationwide, house prices fell by 0.5% in December, following on from a drop of 0.8% in November. Prices were still 4.8% up on December 2006, but prospective indicators like the RICS index and the number of mortgage applications point towards an uphill battle for the UK housing market in 2008. The Bank of England published its quarterly Credit Conditions Survey during the week, which found that lenders cut back "materially" on their lending to both homeowners and businesses in Q4, and have plans to restrict lending further. In other words, the UK is in a situation where the availability of credit has been sharply reduced. This could increase the risk of an even stronger downturn in the housing market and the economy in general.

In the light of the very disturbing tone of the Monetary Policy Committee's December meeting, and not least the news that credit conditions have been tightened to the degree to which they have been, we now expect the BoE to follow up with another interest rate cut in the coming week, taking the base rate down to 5.25%. However, we do not believe that this will be the final cut: we anticipate another in February, and further easing in Q2 and Q3. We now expect the base rate to end the year at 4.5%.

RICS indicator suggests fresh weakness in UK housing market



### Key events of the week ahead

- The BoE is expected to cut its key rate by a further 25bp to 5.25%.
- Figures for manufacturing output.

Date	Time	Event	Period	Danske Bank	Consensus	Previous
Mon 07 - 10	-	GBP HBOS House Prices	m/m q/y		-0.5% 4.7%	-1.1% 6.3%
Tue 08	12:00	GBP BRC December Retail Sales Monitor				
Wed 09	1:01	GBP Nationwide Consumer confidence	Index			86
Wed 09	16:30	GBP Leading indicator	m/m			0.2%
Wed 09	16:30	GBP Coincident indicator	m/m			0.1%
Thu 10	10:30	GBP Visible Trade balance	GBP bln.		-7225	-7115
Thu 10	10:30	GBP Trade Balance non-EU	GBP bn			-4416
Thu 10	10:30	GBP Trade balance	GBP bln.		-4300	-4144
Thu 10	13:00	GBP BoE rate announcement	%	5.25	5.50	5.50
Fri 11	10:30	GBP Industrial Production	m/m y/y		0.1% 0.6%	0.4% 1.0%
Fri 11	10:30	GBP Manufacturing production	m/m y/y		0.2% 0.4%	0.3% 0.3%
Sat 12	1:01	GBP NIESR GDP Estimate	%			0.6

# Baltics

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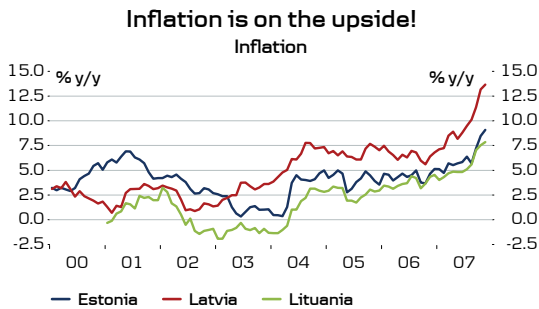
## New year starts with a fresh consumer price rise

The new year in the Baltic states started with higher fuel, energy and alcoholic beverage prices. Lithuania and Estonia increased their excise duties, but to different degrees.

In order to meet the Maastricht criteria as soon as possible, the Estonian authorities decided to raise excise duties on fuel, energy, tobacco and alcoholic beverages, to the required levels. The excise on alcoholic beverages will be raised twice this year: the first time by 10% and the second by almost by 20%. This supports our expectation that CPI in Estonia will rise to double-digit levels - more than 10% y/y.

The increased excise duties on fuel will determine another hike in inflation in Lithuania. The direct effect of higher taxes would not be so big, but the so-called "second round" will add substantial pressure to price levels. In the near future we could expect another jump in food prices and a rise in public transport costs. Lithuanian authorities decided to choose a more gradual adjustment and another raise in excises will come in 2009.

Latvia postponed raising its excise duties for heavy fuel oil because of a transitional period until 1 January, 2010. Therefore, the "only" rise in electricity and heating prices could be expected at the beginning of 2008.



### Key events of the week ahead

- We expect another hike in CPI in all of the Baltic states at the beginning of 2008.
- The real estate market is continuing to ease in Latvia and Estonia.

Date	Time	Event	Period	Danske Bank	Consensus	Previous
Tue 08	8:00	EEK CPI	m/mly/y	Dec	1.4%	9.1%
Wed 09	10:00	LTL CPI	m/mly/y	Dec	1.1%	7.8%
Thu 10	12:00	LVL CPI	m/mly/y	Dec	1.4%	13.7%

# US

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## Bleaker growth outlook and more interest rate cuts

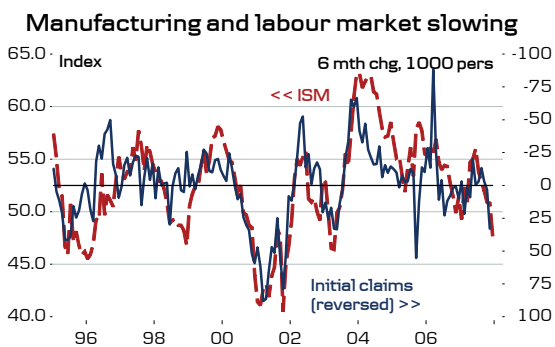
Recent weeks' economic data have painted a bleaker picture of the outlook for the US economy in H1. While it is set to surprise on the upside in Q4 with relatively healthy growth of 1.5%-2.0%, there are now growing signs of a more rapid and broad-based economic slowdown to come.

Firstly, the ISM manufacturing index fell sharply from 50.8 in November to 47.7 in December – a level which indicates an outright drop in output in the manufacturing sector (see *Flash Comment – USA: ISM tumbling below 50*). Viewed in relation to the demand-side fundamentals, the fall in the ISM index was both earlier and stronger than we had anticipated (see *Global Scenarios, December 2007*). Thus our already negative view of growth in early 2008 has become even more pessimistic. While the current level of the ISM index (47.7) does not indicate that the US economy was in recession in December, the risk of this happening at the beginning of 2008 has increased.

Secondly, there are signs that businesses are becoming less interested in hiring new employees. This has emerged partly from the weekly figures for unemployment claims, which crept steadily upwards in the last few months of 2007. Combined with rising energy prices, this more rapid deterioration in the labour market poses a risk to private consumption in H1.

Finally, there are still no convincing signs of stabilisation in the housing market, and the latest sharp drop in sales of new homes suggests that homebuilding will continue its downward spiral in H1.

All in all, the slowdown in H1 looks likely to be more severe than expected. At the same time, the minutes of the last FOMC meeting on 12 December suggest that the Federal Reserve has become more worried about growth (see *Flash Comment – FOMC: Minutes indicate more concern*). Against this backdrop, we are revising our monetary policy forecast and now predict that the Fed will cut the Fed Funds rate by 25bp at each of its meetings in H1, to leave it at 3.25% after the June meeting. We still expect the economy to stabilise in H2, but at a slightly lower level than previously assumed.



### Key events of the week ahead

- The week ahead will bring a whole series of speeches from FOMC members, which will be important in terms of the upcoming monetary policy meeting on 29-30 January.
- It will be important to monitor the weekly figures for unemployment claims in the time ahead to see just how hard a knock the labour market has taken.

Date	Time	Event	Period	Danske Bank	Consensus	Previous
Mon 07	18:40	USD Fed's Lochart (non-voter, neutral) speaks				
Tue 08	14:20	USD Fed's Plosser (non-voter, hawk) speaks				
Tue 08	16:00	USD Pending home sales	m/m	Nov	-0.5%	0.6%
Tue 08	16:50	USD Fed's Rosengren (voter) speaks				
Tue 08	21:00	USD Consumer credit	bn. USD	Nov	8.5	4.7
Wed 09	13:00	USD MBA Mortgage Applications	%			-11.6
Wed 09	15:30	USD Fed's Poole (voter, hawk) speaks				
Thu 10	14:30	USD Initial jobless claims	1000		335	336
Thu 10	19:00	USD Fed's Hoenig (voter, neutral) speaks				
Thu 10	19:00	USD Fed Chairman Bernanke (voter, neutral) speaks				
Fri 11	14:30	USD Trade balance	USD bn	Nov	-59.3	-57.8
Fri 11	14:30	USD Import prices	m/mly/y	Dec	0.0%	2.7% 11.4%
Fri 11	18:45	USD Fed's Mishkin (voter, dove) speaks				
Fri 11	19:00	USD Fed's Rosengren (voter) speaks				
Fri 11	20:00	USD Budget statement	USD bn	Dec	49.1	42.0

# Asia

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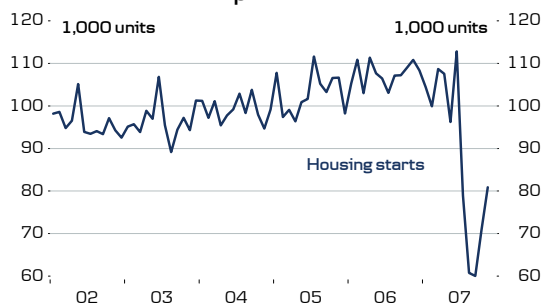
## Japan is not as bad off as feared

A batch of important Japanese indicators released between Christmas and New Year suggests that the Japanese economy is not in such a bad state as one might have feared. As discussed in previous issues of this publication, the weakness in the Japanese economy in recent months has been concentrated in the domestic economy, but there are now clear signs of stabilisation. Firstly, housing starts are recovering from their collapse in the wake of the tightening of building permit requirements (see figure). In fact, housing construction is normalising somewhat faster than we had expected. We still believe that lower housing construction activity will shave almost 0.2% point off quarter-on-quarter GDP growth in Q4 07, but the normalisation of construction now looks likely to boost quarterly growth by 0.2% point and 0.3% point, respectively, in the first two quarters of 2008. Hence, the contribution to growth from normalising housing construction will show up a quarter earlier than we had expected.

Secondly, employment trends have been far more positive than expected. The unemployment rate edged down from 4.0% to 3.8% in November, and employment posted another sharp rise. Employment looks likely to grow by at least 0.3% q/q in Q4 07 after dropping by 0.5% q/q in Q3. Therefore, household real income trends are also beating expectations, hence brightening the outlook for consumer spending a little. As a result, we may have to adjust our expectations for consumer spending upwards – especially for Q4 07, when we have forecast consumer spending to grow at a zero rate.

Thirdly, exports are still in good shape. Numbers released so far suggest exports will grow by just over 2% q/q in Q4 in fixed prices, and the contribution to quarterly growth from exports looks likely to almost match that of Q3 (nearly 0.4% point). This is also slightly better than expected. Continued export strength is the reason behind the still good condition of Japanese industry. However, we expect industrial production to grow only 0.5% q/q in Q4 after jumping 2.2% q/q in Q3. Yet, the positive momentum of industry looks likely to be maintained into Q1 08. Indeed, Japanese manufacturing PMI rose from 50.8 to 52.3 in December, underlining the significantly greater strength of the Japanese economy relative to the US economy at the moment. Given the slightly weakened outlook for the US and Europe, we have postponed the expected next rate hike from the end of Q3 to the end of Q4.

Construction is stabilising faster than expected



### Key events of the week ahead

- China may publish December trade balance data at the end of the coming week. We expect that import growth will again exceed export growth, reflecting that the large Chinese trade surplus may be stabilising.
- No important indicators are due out of Japan in the coming week.

Date	Time	Event	Period	Danske Bank	Consensus	Previous
Thu 10 - 16	-	CNY Trade balance	USD bn	Dec	24.50	26.28
Thu 10	6:00	JPY Leading Economic Index, preliminary	%	Nov	10.0	18.2
Thu 10	6:00	JPY Coincident index, preliminary	%	Nov	33.3	70.0
Fri 11 - 16	4:29	CNY Foreign Exchange Reserves	bn. Usd	Dec	1510.00	1433.61
Fri 11	6:00	JPY Eco watchers survey, current	Index	Dec		38.8
Fri 11	6:00	JPY Eco watchers survey, outlook	Index	Dec		38.8
Fri 11 - 16	8:15	CNY Money supply M2	%	Dec	18.1	18.5

# Foreign Exchange

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## EUR/USD above 1.50, EUR/GBP above 0.75

For some time now we have argued that the course of the US economy would be a source of dollar weakness (see *Will the decline in the USD become disorderly?*, 14 November 2007). We still think it will. The sharp fall in the ISM index of factory activity to 47.7 in the past week testifies to the rapid decline in US manufacturing activity. The wobbles in the US housing market are well known but a slowdown in manufacturing and its ramifications for labour markets might prompt a sharper slowdown in consumer spending than we have seen so far. At Danske Bank, we do not expect the US economy to be heading into a recession, but it will be a close shave, and the coming months will probably see increased concern about the outlook. The Federal Reserve has responded with rate cuts and liquidity auctioning, but we expect the Fed to cut rates aggressively yet again in the coming months (next time on 30 January). Technically, the EUR/USD 1.4810-20 area offers some resistance, but a break should take us up towards the 1.50 level. **We still expect EUR/USD to rise above 1.50 in the first quarter of this year.**

The **pound** has weakened sharply recently – much in line with our expectations (see *FX forecast update*, 4 December 2007), although the weakening has been somewhat more pronounced than we had anticipated. The fall can be explained by a significant shift in expectations for the UK economy, including not least a sharp revision of the assessment of the Bank of England. As discussed elsewhere in this publication, we now expect the BoE to ease by 100bp in 2008, the first time next Thursday. EUR/GBP has long since passed the our forecast of 0.73, but **we believe the pound might weaken further, and we now lift the forecast to 0.7550 during Q1**. This implies a GBP/DKK of 9.88, which, if realised, would be the first time since 1996 that sterling would be trading below DKK 10.

EUR/CHF has been range trading between 1.62 and 1.68 for the past six months (CHF/DKK 4.43 – 4.60). Contrary to what we have seen previously, expectations for monetary policy account only for a modest part of the movement, whereas the market's risk attitude has been decisive. **We generally believe that the trend weakening of the CHF which we saw in the 2005–2007 period is over**, based on our assumptions of increased volatility and reduced risk appetite in 2008. However, our forecast for the coming months is fairly close to the forward rate; hence, we do yet not expect a sharp appreciation of the CHF.

The **Danish central bank** bought DKK 11.9bn worth of kroner in December to halt the rise in EUR/DKK. This was the first intervention by the central bank since September, and is consistent with the bank's policy of preventing a rise above 7.4680 (see *EUR/DKK revisited*, 20 December 2007). We believe the main reason for the DKK's weakening was the heavy pressure on euro-area money markets ahead of the New Year. Since then, EUR/DKK has edged down to 7.4540 as money markets have partly normalised, so there is no longer a need for the Danish central bank to intervene. In our opinion, a unilateral Danish rate rise in defence of the krone would only be needed in the event of a protracted and significant need for intervention (two-three months, DKK 20-30bn accumulated).

# Fixed income

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## New yield forecast – expect lower yields and ECB rate cuts

The ISM index of US business confidence and the US employment report delivered a serious disappointment in the past week, prompting a massive drop in yields. The poor indicators removed any final doubts about a rate cut from the Federal Reserve, which now seems set to cut rates on 30 January. In light of the generally weak US data, we are altering our forecast for the Fed funds rate, and we now expect the Fed to cut rates by 25bp at all four policy meetings in H1 08. There is a risk of further rate cuts in H2 if the US economy, including not least the housing market, fails to recover (see US section).

We are expecting generally weaker indicators out of Euroland, and the markets will probably, at some point, begin to price in rate cuts from the European Central Bank (the ECB). Whether the ECB will deliver is a moot point. We believe the slowdown in growth will be large enough to offset the bank's inflation concerns, and we now expect two rate cuts from the ECB in H2 08.

Given the change in our monetary policy outlook and the revision of our economic outlook, we are also changing our yield forecast. We now expect yields to fall and the yield curves to steepen. The new yield forecast will be discussed in a research note due to be published in the afternoon of Friday 4 January. The detailed discussion of our new forecast will be available on our website. Our new rate and yield estimates are shown in the table at the back of this publication.

We do not expect much in the way of interesting indicators out of the US in the coming week. Hence, attention will probably focus on Europe, where both the Bank of England (the BoE) and the ECB will announce their rate decisions on Thursday. The ECB will no doubt stay on hold, so market participants will focus on the press meeting following the decision. The ECB has, for a long time, maintained a rather hawkish rhetoric, but growing doubts about the course of the economy may prompt it to soften its rhetoric on the growth outlook a bit. On the other hand, inflation risks are still on the upside. All things considered, the ECB will probably stay relatively hawkish, although the markets will be looking for signs of a softening and possibilities for rate cuts. We do not believe that the ECB press meeting will remove the market's perception that the ECB is biding its time and that it will stay on hold for some time to come.

In the edition of Weekly Focus published just before Christmas, we focused on the central bank measures taken to ease the pressure on money markets. Fixing rates have indeed fallen in response to the new measures, but they are still very high.

