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Europe Weekly Outlook



- **Concerns impacting European markets ease - euro gains ground**
- **Industrial activity gaining ground across Europe**
- **Switzerland on a moderate, sustainable growth path; interest rates on hold**
- **Icelandic referendum rejects Icesave agreement with the UK and the Netherlands**
- **Turkey and the IMF halt loan talks as unnecessary**

Concerns impacting European markets ease - euro appreciates

European financial markets are stabilizing following several weeks of Greece-related turbulence. Easing concerns regarding Greece's fiscal crisis have allowed the euro (EUR) to appreciate on the week to US\$1.376 at the time of writing, 1.0% higher from last Friday. While the ongoing fiscal consolidation by weaker European Union members will continue to be closely followed by market participants, and periods of volatility may occur, we expect the EUR to gain some of the recently lost ground in the months ahead and climb back to US\$1.45 by the end of the year. Major European equity securities markets are heading higher for a second consecutive week, with the French CAC40, British FTSE100 and German DAX up by 0.4%-1.2% on the week. European debt markets reflect an easing in investor concerns. The yield spread between the Greek and German 10-year benchmark bonds has stabilized at around 300 basis points (bps) - a marked improvement from the recent high of 394 bps at end-January. The yield on the 10-year German bund has remained virtually unchanged on the week at 3.16%, 55 bps below comparable US Treasuries.

Industrial activity gaining ground across Europe

Industrial activity across the euro zone is on the mend. For the region as a whole, production rose 1.7% m/m in January, though at the national level there were significant differences in performance. Although German industrial output rose a relatively muted 0.6% m/m in January alongside a 6.3% m/m drop in export receipts (the first setback in five months), we are still positive about recent developments - production was above year-earlier levels for the first time since mid-2008 - and prospects. Taking into account the substantial revision in the December IP figure to -1.0% m/m from -2.6%, the January index was more than a full percentage point higher than would have been the case had the monthly gain matched consensus of just over 1% and the December contraction been left at the original figure. It is also worth noting that the January output numbers were depressed by disruptive weather conditions, which drove construction activity down 14.3% m/m and that factory orders over the past three months have jumped 5½%, with positive implications for industrial activity in the months ahead.

The inclement January weather makes the output gains in Italy and France - with sectoral increases of 2.6% m/m and 1.6%, respectively - even more impressive, and we remain confident in further, more modest advances. In France, for example, although confidence among manufacturers sector weakened slightly in February, this follows an extended strings in advances that pushed sentiment into mildly positive territory. We expect some renewed gains in the months ahead as the auto sector recovers from the shock of the conclusion of the government's 'clunker' programme and as French exports continue to strengthen; foreign sales rose 2.7% m/m in January, reaching a 13-month high of €30.2 billion.

Outside the euro zone, UK industrial output slipped for only the second time in the past eight months in January, dipping 0.5% m/m. While it should be noted that the 13.4% slump in industrial activity



over the past two years has been less severe than in Italy (-18.2%) or Germany (-16.8%), an even more significant gap in performance might have been expected in view of the near-30% weakening in the value of the pound vis-à-vis the euro in just over three years. Thus, the UK's most recent trade figures offer a mixed reading. Exports (in sterling terms) slipped back to a 4-month low of £19.45 billion in January; however, the marginal contraction in imports to £27.44 billion, suggests a certain resilience in domestic spending. Admittedly, the severe weather conditions in January had a marked disruptive impact on the flow of goods into and out of the UK. Taken at face value, however, the widening of the trade deficit to £8.0 billion - the largest gap in almost a year and a half - shows that the necessary rebalancing of the economy toward reduced dependence on foreign savings (i.e. a smaller current account deficit) still has some distance to go. Elsewhere, Sweden's industrial prospects are beginning to brighten, as a 1.6% rise in production was accompanied by a 3.7% jump in new orders, the fourth advance in five months.

Switzerland on a moderate, sustainable growth path; interest rates on hold

With inflationary pressures largely absent and the Swiss National Bank (SNB) committed to "act decisively to prevent an excessive appreciation of the Swiss franc against the euro" - the exchange rate has been hovering near 1.46 per euro (1.459 at the time of writing) compared with a 2009 average of 1.510 - Swiss interest rates remain on hold. The SNB's policy committee opted to leave the benchmark interest rate target at 0.25% following its quarterly meeting on March 11th (the full policy statement can be found on the SNB website: <http://www.snb.ch/en>). We do not anticipate a rate change until September, with some possibility that the adjustment might be delayed to December despite the steady stream of positive news that is setting the stage for economic growth of 1.5% in 2010, according to SNB projections. Retail sales volumes (excluding fuel) rose 0.7% m/m in January following a 2.6% advance the previous month. However, we expect overall consumer spending growth to moderate, constrained by relatively soft employment conditions; the jobless rate was unchanged at 4.1% in February; it has been stuck at or above 4.0% since August 2009. Moreover, while inflation remains very subdued - the 0.1% m/m rise in the CPI in February (0.9% y/y) followed two consecutive monthly declines - the SNB anticipates that it will approach 3% by end-2012, in the event that the benchmark interest rate is left unchanged.

Icelandic referendum rejects an Icesave agreement with the UK and the Netherlands

The aftershocks of Iceland's banking sector collapse continue. In a public referendum on March 6th, Icelanders voted overwhelmingly against the so-called Icesave bill that was vetoed by the president in early-January. The bill would have provided for payments of almost €4 billion (equivalent to 45% of the nation's GDP) to compensate the governments of the United Kingdom and the Netherlands for Icesave depositor losses stemming from the bank's failure in the midst of the global financial crisis. As the previous bill is now outdated, the Icelandic authorities are trying to reach a new agreement with the British and Dutch governments that would involve lower interest costs on the loans. A speedy solution to the depositor accord would allow the country to focus on economic recovery after output declined by 6.5% in 2009. The dispute not only strains Iceland's foreign relations, but also puts downward pressure on the country's sovereign credit ratings and endangers the its economic program; new funding from Iceland's Nordic peers is dependent on a resolution of the Icesave matter. Moreover, political instability may be on the rise as the issue puts the cohesion of the fragile coalition government at risk. Despite the ongoing turmoil, the Icelandic krona - which is protected by capital controls - has appreciated against the US dollar by 1.6% over the past week to 125.7.

Turkey and the IMF halt loan talks as unnecessary

Negotiations between the Turkish government and the International Monetary Fund (IMF) regarding a Stand-By loan arrangement have come to an end by a joint decision. The talks had been under way for nearly two years, being delayed by disagreements about fiscal policy and structural reforms. According to the Office of the Prime Minister, Premier Recep Tayyip Erdogan assesses that after proving resilient to the global financial market turmoil, "Turkey is now standing on its own feet and doesn't need a new standby deal with the Fund". Nevertheless, the relationship between Turkey and the IMF continues on a routine basis, with an IMF mission planned for early May as part of the 2010 Article IV consultation process; these discussions are conducted regularly in an annual cycle with all Fund member countries. The Turkish economy is recovering following a deep retrenchment in Europe and at home. Output is expected to expand by 3½% in 2010 following a near-6% decline in 2009. Markets were indifferent to the end of the IMF talks; the Turkish lira is trading at 1.53 per US dollar, 0.7% higher on the week.

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