

Market Overview

European markets started the week under pressure from the Dubai debt crisis, which served to dampen appetite for risk assets. However, with low expectations of systemic risk, markets resumed their upward trajectory for much of the rest of the week, ending over 2.5% higher. Economic news-flow was mixed, with a better growth outlook for Germany and an acceleration in Chinese manufacturing countered by contraction in the US service industry. However, Friday's unexpectedly good US unemployment news served to accelerate market gains into the weekend. In the corporate sector, banks faced increasing headwinds, with both the International Monetary Fund and the German Chancellor expressing concerns that further write-downs will be needed. Concerns over bank exposures to Dubai, especially with regard to UK names, also held that part of the sector back. However, gains on Friday left the sector 2.7% stronger for the week. The technology sector was the week's worst performer, falling 0.8% on a muted 2010 outlook from handset maker Nokia (NOK). Having lagged the wider market over the last 8 months, the chemical space was the week's best performer, gaining 3.6%. Upside was driven by positive comments on the outlook for the fertilizer and crop science segments by industry major Monsanto (MON), as well as a rising demand profile. Having fallen the previous week, basic resources resumed gains, rising by 2% over the week, despite falling metal prices acting as a drag later in the week. By the week's close, the DJ STOXX 600 had posted gains of 2.7% on the week, led by the Dutch (+3.75%) and French (+3.36%) markets.

Currencies

Sterling was little changed on the week versus both the dollar and the euro. Sterling initially weakened after an unexpectedly downbeat UK consumer confidence release, which saw sentiment dropping for the first time in 10 months. However, the currency pared losses late-on in the week after the pace of contraction in the construction industry slowed and as US non-farm payroll and unemployment numbers came in ahead of expectations, pushing investors back towards riskier assets. The news led to a rally in stock markets and a fall in treasuries, pushing up the yields. By the close on Friday sterling was worth \$1.65 — having been as high as \$1.675 earlier in the day — similar levels to its previous weekly close. Elsewhere, the euro ended the week slightly lower versus the dollar as it continued to struggle to consolidate a position above the \$1.50 level. The euro lost ground following the jobs data from the US, as the news helped to persuade investors that the Federal Reserve will boost its benchmark interest rate from a record low. At Friday's close, a euro traded at \$1.489, having closed the previous week at \$1.496, although it had traded as high as \$1.514 during trading on Thursday, as ECB President Trichet began clearing obstacles to higher interest rates next year.

Commodities

Gold reached a new all-time high (of \$1226/oz during early trade on Thursday) and the rally continued for much of the week. The precious metal has continued to move up as central banks increase their holdings of the physical commodity and as investors become increasingly concerned about the prospects for paper currencies (especially the US dollar). However, the price of bullion slipped late on in the week after better-than-expected US non-farm payroll figures offered a boost to the US currency and pushed investors away from safe-haven asset classes. Gold is seen as a hedge against inflation and an alternative investment to US dollars. The prospect for higher interest rates in the US on the back of a stronger-than-forecast recovery undermines the gold trade on both of those levels. By the close on Friday, the price of gold was trading at \$1176/oz, having closed the previous week at \$1173.

Oil prices initially moved higher after China showed that manufacturing had expanded at its fastest pace in five years, bolstering hopes that demand would increase in the second-largest energy consuming country. However, the release of US employment data on Friday afternoon saw crude prices tumble by \$3 per barrel, leaving oil at \$75.47, compared to a previous weekly close of \$76.05.

Economic Commentary

Eurostat confirmed the flash estimate of a 0.4% increase in euro-area GDP during the third quarter. This represented the first quarter of economic growth since the first quarter of 2008. According to the details, available for the first time, private consumption declined by 0.2% and gross fixed capital formation was down by 0.4%. In contrast, government consumption increased by 0.5%, exports posted a rise of 2.9% and imports rose 2.6% during the quarter. Our economists note that the available purchasing managers indices for October and November suggest that GDP growth will accelerate further. They now expect an increase of 0.8% in the fourth quarter, followed by approximately 0.3% per quarter in 2010.

With an outlook of modest growth and low inflation over the medium term, the European central Bank (ECB) left interest rates unchanged and said that the current policy rate is “*appropriate*.” However, the Governing Council agreed the first small step in terms of the removal of liquidity measures, moving further than the market — and our economists— expected. The ECB will end the 12 month long-term refinancing operations beyond December and will add a variable spread on top of the main refinancing rate. However, it will ensure that the unlimited funding facility for all open market operations will be available at least until April 2010. President Trichet highlighted that these measures are not intended to lead to a significantly tighter monetary stance near-term.

German unemployment claims fell by 7,000 in November, on a seasonally adjusted basis, beating consensus expectations for a 5,000 rise. However, our economists note that this fifth consecutive fall in unemployment was partly driven by a redefinition of unemployment statistics and partly thanks to subsidized short-shift working schemes, which are likely to continue to limit the increase in unemployment. The unemployment ratio edged down from upwardly revised 8.2% in October to 8.1% in November.

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