



The Bulletin

A monthly analysis of international and Irish markets

The Global recession is probably over

- Asia first to recover
- Uncertainty remains over shape of upturn

The 'Great Global Recession' appears to be over. The expectation of a recovery some time this year has been driving equity and commodity markets since the spring, but in the event the turning point has come earlier than many expected. It is now evident that a number of key Asian economies recorded positive growth in the second quarter, including China, Japan, Singapore and Hong Kong, and that the pace of contraction in the larger Western economies slowed considerably in Q2, with most now generally expected to record positive growth in the current quarter. On that basis, the global economy probably bottomed around June, and it is not surprising that forecasts for 2009 and 2010 are being revised up - the IMF now believes that the global economy will expand by 2.5% next year, against a 1.9% forecast published in April, and the consensus view is higher still, at over 3%.

The outlook for the US economy has also changed for the better. GDP there contracted by 0.25% in the second quarter, but total spending actually rose marginally, offset by a large fall in inventories as firms cut production in order to shift unsold output. The latter negative influence is likely to be substantially lower in the third quarter, and the consensus view is that US GDP will grow by at least 0.5%. The US housing market also appears to have stabilised and residential construction will represent a much smaller drag on activity in the second half of 2009 before turning positive next year.

In contrast, France and Germany did record positive growth in the second quarter, signalling an end to recession in the euro's largest economies, but the euro area as a whole did contract marginally. The most recent indicators do point to a broader European upturn in Q3, nonetheless, helped by a recovery in export markets.

The financial markets are now focusing on the likely shape of this global recovery and the implication for monetary policy. Some believe that the impaired nature of the global banking sector will dampen growth for some time, or even result in a fresh contraction (a 'W' recovery) while others argue that the scale of the international monetary and fiscal stimulus is such that a rapid and sustained upturn is possible (a 'V' recovery). Time will tell which proves more accurate but it is clear that the loss of output in this cycle has been unusually large, which implies that inflation is unlikely to be a problem any time soon. That being the case, Central banks are unlikely to rush to raise rates and it may be of comfort to borrowers that when rates do rise it will be in an environment in which policy makers are confident that an upturn is well and truly established.

Dr. Dan McLaughlin

United Kingdom Page 2

Bank of England extends QE program

Europe Page 3

Euro Area showing signs of recovery

United States Page 4

Economic growth to turn positive in Q3

Economic Diary Page 6

Forecasts Page 7

Bank of Ireland estimates

- Exchange rates
- Official interest rates
- Five-year swap rates
- GDP and inflation

Contacts Page 8

United Kingdom

Bank of England extends QE program

The Bank of England expands asset purchases by £50bn to £175bn ...

The Bank of England surprised the market when they decided to extend their asset purchase scheme at the MPC meeting at the beginning of August. The Bank had been expected to stay on hold at £125bn or, at most, use the last £25bn of its original authorisation of £150bn. Instead, they decided to request permission from the Chancellor to extend the program by a further £25bn to bring the total planned purchases to £175bn. This brings the total spend to about 12.5% of projected 2009 GDP, which is greater in nominal terms than the estimated output gap caused by recession. The move was surprising as all the macroeconomic data seemed to be pointing to the economy performing slightly better than expected and the recession ending in Q2 with weak growth in Q3. The Q2 GDP data was a little disappointing coming in at -0.8% for the quarter. The MPC pointed to this in their statement saying “the recession appears to have been deeper than previously thought. GDP fell further in the second quarter of 2009”. However, the more recent future looking indicators in the past couple of months have, for the most part, surprised to the upside. Nothing has materially changed, for the worst, since the MPC decided to put QE on hold at £125bn in June. The decision contrasted with previous statements by MPC members in the run up to the meeting, who hinted at going on hold and putting QE to one side unless risks materialised later on in the year.

...as they saw a “real downside risk” to inflation...

The following week, the Bank of England published their Quarterly Inflation Report. In it, the Bank forecasts that inflation will be around the 2% inflation target at the end of the two year horizon if the base rate is kept at 0.5% and asset purchases total £175bn. However, if interest rates rise in line with market expectations (base rate at 3.6% by Q3'11) then inflation would be significantly under the target in two years. These projections would indicate that the Bank will not increase the base rate as aggressively as the market is pricing in as the MPC still see quite a substantial risk of inflation undershooting the target. King said in the press conference that it's “more likely than not” that inflation will be below 1% this year and stay below the 2% target until the end of 2012. On the basis of King's dovish statements and the downside risks to inflation in the August report, we could not rule out the MPC expanding the QE scheme beyond £175bn later on in the year. When asked to explain the MPC's decision to raise assets purchases from £125bn to £175bn, King simply said that there was real downside risks to inflation and was sensible to do so to avoid a longer period of below target inflation. Asked if £175bn was the correct amount he added “I am never convinced that any amount of QE is exactly right”. Regarding GDP growth, King said while the upturn in short term indicators was welcome but the UK faced a slow and protracted recovery and would be in a “difficult position” for some years. He said the important thing to take from their report was that while positive annual GDP rates are expected from 2010 onwards, it was important to remember how much the level of GDP has fallen. This fall has opened up a large degree of spare capacity in the economy and it will take a long time to use up all this excess capacity. The amount of spare capacity is greater than the MPC had previously estimated due to downward revisions to growth from Q4' 2008 backwards. The degree of spare capacity is the biggest downside risk to inflation and in human terms means high and rising unemployment.

...but at the moment inflation remains stubbornly above expectations.

Later on in the month, the minutes of the MPC meeting revealed that “All members agreed that substantial further asset purchases were needed over the next three months” but that 3 members (including Governor King) of the 9 member committee wanted to expand QE by £75bn rather than the £50bn expansion that was decided. The argument for a larger expansion of the bond purchases was that “insufficient stimulatory monetary policy” would harm confidence in the recovery. The risks of “another large stimulus might be less than the possible costs of acting too cautiously,” and the policy could be reversed if found to be “overly expansive,” the minutes said. Just prior to the release of the minutes, inflation data showed that the annual rate of CPI inflation came in higher than expected at 1.8% in July, unchanged from June, as prices were flat on the month. Worryingly for the BoE, annual core price inflation increased from 1.6% in June to 1.8% in July, when a drop was expected. UK inflation remains very sticky and much higher than inflation in the US and EA.

Europe

Euro Area showing signs of recovery

ECB's outlook unchanged in August...

At their meeting at the start of August, the ECB kept rates on hold. President Trichet did not have any surprises in his press conference with the message virtually unchanged from July. He maintained that rates were “appropriate” at this time and that the Governing Council (GC) “did not discuss” whether this was the lowest level for rates. He said that the ECB had planned exit strategies for when the time came and their credibility was “very very strong” on this point as they had previously raised rates when it was not easy to do so, such as in '08. Moreover the GC would not have a public debate before they acted. Trichet added that he never said that the GC would first unwind all non-conventional measure before raising rates and they would exit using the appropriate tools, whatever they may be. On the macroeconomic outlook, he said the economy will remain weak in 2009 and, after a phase of stabilization, a gradual recovery to positive quarterly growth rates is expected next year. He would not confirm one way or the other if the economy was performing better than previously expected. He said that he was not in a position to give an updated view on the outlook without the ECB's updated staff forecasts, which are due this month. Trichet did say that he did not see a huge change from the previous forecasts but he did not exclude an improvement in the outlook. He stated that while there was still huge uncertainty in the economic environment, he saw the global recession bottoming out but didn't exclude a “bumpy road” for the recovery. The GC believes the current period of negative inflation will be short lived and there will be a return to positive rates of inflation later on in the year.

...but there are indications of a recovery in Q3...

However, the data since that meeting has surprised to the upside and the economy may be recovering faster than the ECB had anticipated. There are continuing signs that the Euro Area economy is stabilising and may be heading for an expansion in Q3. The PMI's for manufacturing and services both increased in August. Manufacturing rose to 47.9 from 46.3 in July while Services increased to 49.5 from 45.7. The composite PMI reached exactly 50.0 in August, meaning the Euro Area is right on the cusp of moving back into expansionary territory. Other data has also been supportive of an economy on the brink of a recovery. Industrial new orders increased by 3.1% in June, the biggest gain in 19 months.

...after Germany and France both grew in Q2...

While Euro Area GDP contracted in Q2, it did so just marginally – by 0.1% - when a fall of ½% was expected. Even more encouragingly the biggest economies in the Euro Area, Germany and France, both registered small expansions in their output in Q2. French GDP grew by 0.3% in the quarter, while German GDP also expanded by 0.3%. If we look at Germany more closely we see personal consumption rose by 0.7% while Government expenditure also rose. Exports contributed positively to growth despite falling by 1.2% as imports fell by more (5.1%). The relatively strong growth in consumption is a good sign that the recovery in Germany can be, at least partly, driven internally and will not be totally reliant on a pick up in the global economy to drive growth. Future looking confidence indicators in Germany are also rising, with the IFO expectations index increasing to 95 in August from 92 in June, the highest it's been since April of last year. The ZEW index of German business confidence had earlier contributed to the more upbeat European tone, making a new cycle high of 56.1 from 39.5 in July and a cycle low of -63.9 thirteen months earlier.

...but the monetary tightening remains some way off.

Trichet and other Governing Council member have welcomed the improvement in forward looking indicators but remain very cautious about the sustainability and strength of any recovery. In late August, Trichet himself said that “we see some signs confirming that the real economy is starting to get out of the period of free fall” but he reiterated that this “does not mean at all that we do not have a very bumpy road ahead of us”. Despite the fact economic activity is turning around slightly faster than expected, it will not change the ECB view of when to start tightening monetary policy. Central banks, historically, try to wait until a recovery is well established before raising interest rates. We don't see the ECB raising rates until the second half of 2010.

United States

Economic Growth to turn positive in Q3

Economy contracts more slowly in Q2...

The US economy contracted at an annualised rate of just 1% in the second quarter of this year, a much smaller rate of decline than the 6.4% fall in GDP recorded in the three months to March, which in turn followed a 5.4% fall in the final quarter of 2008. While consumer spending fell (albeit marginally) again in Q2, after rising modestly in the first quarter, there was a notable deceleration in the rate of decline in private investment spending, while government spending rebounded after falling over the opening three months of the year. Net exports (exports minus imports) made another sizeable positive contribution to GDP in the second quarter, while the drag on the economy from 'de-stocking' was smaller than in the opening quarter of the year.

...with return to positive growth likely in Q3...

Given the outturn for the second quarter, and taking into account the available indicator data for the period since June, it seems as if the recession, which began in December 2007 according to the National Bureau of Economic Research, may have come to an end. The Federal Reserve acknowledged this in the statement published after its mid-August meeting when it said that the "information received since (it) met in June suggests that economic activity is leveling out". It noted that "household spending has continued to show signs of stabilising", while businesses, though "still cutting back on fixed investment and staffing", are making progress in "bringing inventory stocks into better alignment with sales". While the Fed expects economic activity "to remain weak for a time, it said it still "continues to anticipate that policy actions to stabilise financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to a...resumption of sustainable economic growth".

...helped by inventory re-build...

The recent period of 'de-stocking', which has exerted a significant drag on the economy (knocking 1.5% points on average off GDP in each of the three quarters to Q2), seems to be giving way now to a period of stock re-building, judging by the latest ISM survey of manufacturing. This shows the production component of the survey running significantly above the 50 expansion-contraction level in August – it rose to 57.9 from 52.5 in June (and 46.0 in May) – which is consistent with rising output in this sector, and which in turn reflects a rise in new orders as businesses seek to re-build stocks. Indeed the official data on manufacturing show manufacturing output rose by 1% in July, the first rise in output since October of last year.

There are also indications, from the latest data on capital goods output and orders, that the pace of decline in business investment, which slowed notably in Q2, has moderated further in the current quarter (Q3), while residential investment, which also fell more slowly in Q2, is likely to post an even smaller decline this quarter with a return to growth in this category of investment now likely to occur in the final quarter of the year based on the rising trend in new housing starts over the past few months. In relation to consumer spending, by far the biggest component of overall spending in the economy, accounting for more than 70% of GDP, the indications are that it will rebound to some extent in Q3, helped by a recovery in auto sales.

...though Fed cautious about nature of any recovery...

The Fed remains cautious about the nature of the prospective recovery, however. It expects any upturn to be gradual, at least in its initial stages, as it thinks consumer spending will be constrained by a number of factors, including ongoing job losses, sluggish income growth, and tight credit conditions. Partly as a result, it expects the degree of slack in the economy to remain substantial even as activity picks up, hence it expects inflation to "remain subdued for some time".

...and so expects to keep rates low for "extended period".

Given its outlook for inflation, the Fed said at its August meeting that it would maintain the target range for the federal funds rate at 0 to 1/4 percent and reiterated that it "continues to anticipate that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period". It also said it would continue purchasing mortgage-backed securities (up to \$1.25 trillion) and Treasury securities (up to \$300bn) though in relation to the latter it said it would slow the pace of these purchases and now "anticipates that the full amount will be purchased by the end of October".

The prospect of official interest rates remaining low for an "extended period", as reiterated by the Fed, has resulted in a renewed decline in government bond yields since the August meeting, with the yield on the benchmark 10-year falling by over 30bps to around 3.5%. In our August bulletin, we argued that 10-year yields "are likely to trade in a range of (broadly) 3.5% to 4% over the remainder of 2009, and possibly into early 2010 as well", given the outlook for the economy and monetary policy, and this remains our view. In relation to the dollar, it has traded in a range of 1.40 to 1.44 against the euro over the past month or so, a little weaker than the 1.38 to 1.42 range that had prevailed in July. The Euro Area economy appears to have bottomed sooner than many expected, which has given a boost to the single currency. However, most forecasts still point to a stronger recovery in the US than in the Euro Area, which we think will ultimately benefit the dollar.

Economic Diary

September

	Europe	UK	US
1	PMI Manufacturing, Unemployment data, German Retail Sales	Mortgage Approvals, PMI Manufacturing	ISM Manufacturing, Pending Home Sales
2	Q2 GDP, PPI's		Factory Orders, FOMC minutes
3	PMI Services, Retail Sales, ECB meeting	PMI Services	ISM Non-manufacturing
4			Nonfarm Payrolls
7	German Factory Orders		
8	German Industrial Production	RICS House Price Balance, Industrial Production	
9		Consumer Confidence	Fed's Beige Book
10	French Industrial Production	Bank of England Meeting	
11		PPI's	U. of Michigan Confidence
14	Industrial production, EU Commission Forecasts		
15	ZEW surveys	Inflation data	PPI's, Retail Sales
16	Inflation data	Unemployment	Inflation Data, Industrial Production
17		Retail Sales	Housing Starts, Philly Fed
21		Rightmove house prices	
23	Industrial new orders, French Consumer Spending	Bank of England Minutes	FOMC minutes
24	German IFO's		Existing Home Sales
25			Durable Goods Orders, New Home Sales

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Sep	End Dec	End Mar
EUR/USD	1.43	1.38	1.35	1.30
EUR/GBP	0.88	0.85	0.85	0.80
USD/JPY	93	95	100	100
GBP/USD	1.62	1.62	1.59	1.62

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End Sep	End Dec	End Mar
USD	0-0.25	0-0.25	0-0.25	0-0.25
EUR	1.00	1.00	1.00	1.00
GBP	0.50	0.50	0.50	0.50

Source: Bank of Ireland Global Markets

Swap rates: 5 year

	Current	End Sep	End Dec	End Mar
US	2.75	2.75	2.75	3.00
Eurozone	2.75	2.60	2.60	2.75
UK	3.35	3.50	3.50	3.75

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2009		2010	
	GDP	Inflation	GDP	Inflation
US	-2.6	-0.5	2.3	2.0
Eurozone	-4.0	0.3	0.9	1.1
UK	-4.4	2.0	1.3	1.8

Source: Bank of Ireland Global Markets

Contacts

Bank of Ireland Global Markets

www.boi.ie/globalmarkets

Chief Executive: Austin Jennings
 Head of Global Customer Business: Deirdre Flannery

Colvill House, Talbot Street, Dublin 1, Ireland
 Fax: +353 1 799 3035 Tel: +353 1 799 3000
 e-mail: info@boigm.com

Economic Research Unit (ERU)

Chief Economist, Bank of Ireland: Dr. Dan McLaughlin
 Senior Economist: Michael Crowley
 Economist: Patrick Mullane

Tel: +353 1 609 3341
 e-mail: eru@boigm.com
 Listen to Daily Commentary on Freephone: 1800 60 70 60

Corporate & Institutional Sales

Freephone 1800 30 30 03

Retail Sales

Freephone 1800 790 153

Deputy Head of Customer Group: John Moclair
 Head of Corporate Sales: Liam Connolly +353 1 790 0000
 Head of Customer Group Funding: Paul Shanley +353 1 609 3212
 Institutions: Gavin Rylands 1800 60 70 40
 Property & Specialised Finance: Ed Preston +353 1 609 3277
 Corporate Relationship Manager: Eamon McManamy +353 1 609 3215

Head of Retail Sales & Customer Group Operations: Aine McCleary
 Business Development & Sales Management: Adrienne McNally
 Business Banking Sales: Leslie Cosgrave 1800 790 153
 Branch Sales: Michelle O'Meara +353 1 609 4330
 Dealer Assistants: Osna O'Connor +353 1 609 3509

Global Markets United Kingdom (UK)

Managing Director: Peter Goshawk
 Chief Dealer: Liam Whelan
 Head of Business Development: Duncan Wilson
 Head of London Treasury Sales: Sandra Perry

P.O. Box 62929, Bow Bells House, 1 Bread Street., London EC4P 4BF
 Tel: +44 (0) 20 7429 9111
 GB Treasury Sales Team Freephone: 0800 039 0038
 Tel: +44 (0) 7429 9121; Treasury Sales Team: 0800 776 616

Global Markets United States (US)

Head of US: Darsh Mariyappa
 Head of US Business Development: Joe Connolly
 Head of US Sales: Garreth Boyle

300 First Stamford Place, Stamford, CT 06902, US
 Tel: +1 203 391 5555
 Fax: +1 203 391 5901

Global Products Team

Global Head of Structured Business: Brian Vaughan
 Head of Structured Products Distribution: Barry McLoughlin

Tel: +353 1 790 0040
 Tel: +353 1 790 0400

Marketing

Head of Marketing: Andrew Hearnden

Tel: +353 1 609 3302

Market data supplied by Reuters

Disclaimer

Produced by the Economic Research Unit at Bank of Ireland Global Markets ("GM"). Bank of Ireland incorporated in Ireland with limited liability. Bank of Ireland is regulated by the Financial Regulator. In the UK, Bank of Ireland is authorised by the Irish Financial Regulator and authorised and subject to limited regulation by the Financial Services Authority. Details about the extent of our authorisation and regulation by the Financial Services Authority are available from us on request. This document is for information purposes only and GM is not soliciting any action based upon it. GM believes any information contained herein to be materially accurate but GM does not warrant its accuracy or completeness and this information should not be relied upon for any purpose. No prices or rates mentioned are bids or offers by GM to purchase or sell any currencies, securities or financial instruments. Except as otherwise may be specifically agreed, GM has not acted nor will act as a fiduciary, financial or investment adviser with respect to any derivative transaction that it has executed or will execute. Any investment, trading and hedging decision of a party will be based on its own judgement and not upon any view expressed by GM. This document does not address all risks related to the transactions described. You should obtain independent professional advice before making any investment decision. Any expressions of opinion reflect current opinions as at 1st September 2009. This publication is based on information available before this date. For private circulation only. This document is property of GM. The content may not be reproduced, either in whole or in part, without the express written consent of a suitably authorised member of GM staff.