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Global Markets

TheBulletin

A monthly analysis of international and Irish markets

Weaker euro will help

- The euro's fall will benefit the Irish economy
- The implicit punt/sterling rate has been exceptionally high

The evidence from a host of cross-country experiences with fiscal contraction is that it tends to dampen economic growth unless offset by one of two countervailing forces – lower interest rates or a currency depreciation. In the euro zone fiscal deficits have been falling since 2009 but interest rates are already exceptionally low – the repo rate is 1% and short dated money market rates are lower still - so support from that source is unlikely to prove significant, although for some countries, including Ireland, effective rates are higher, reflecting a risk premium, so there is some scope for improvement if a less risk averse environment was to develop.

There are fewer constraints surrounding the currency, however, and a weaker euro might help to boost exports and hence support growth, particularly for these countries that are less dependent on intra-eurozone trade. This is certainly true for Ireland, with only 40% of exports going to euro countries. The US is Ireland's largest single country export market and although exports to the UK are less significant than they were, that market is still very important for Irish indigenous firms and therefore for growth and employment.

Consequently, the fall in the euro over the past year is positive for the Irish economy, particularly the 10% decline against sterling, to around 80 pence. To put that in historical context, Ireland's currency crisis in 1992 was triggered by a rise in the punt/sterling rate to above parity, a rate viewed as unsustainable at the time, yet a year ago the implicit punt/sterling rate was 1.14 and in 2009 was briefly up at 1.24. The weakness of sterling in recent years has been a significant and perhaps understated negative for the Irish economy and so the euro's recent fall is a positive development, even though the effective punt/sterling rate is still around parity. A weaker currency is not a panacea for the woes besetting the euro area as some countries are chronically uncompetitive but it may well help – a currency depreciation is part of the solution rather than the problem.

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United Kingdom

GDP data shows economy in recession

Contrasting data hard to square…

It's unclear from the most recent data exactly how the UK economy is faring at the moment. The official GDP figures have portrayed an economy currently in a recession that could easily last another quarter or more. However, this data contrasts with survey, employment and retail sales data which indicate the economy is in a healthier state and may be on the brink of a recovery. Q1 GDP growth was revised down to -0.3% from an initial estimate of -0.2% and follows a 0.3% fall in Q4 as well. Consumer spending rose by 0.1% in the quarter after a 0.4% gain in Q4, investment fell for a second consecutive quarter, while export growth slowed to 0.1% from 1.6%. On the basis of this data, the economy appears to have contracted quite sharply. However the survey data tells a different story with the PMIs in services and manufacturing consistently posting readings above the 50 level – indicating expansion – through the entire period of Q1 with both indexes averaging higher levels than in Q4. Retail sales rose sharply in March and by 0.8% in the first quarter, while the employment data are also not consistent with an economy in recession. Yet the fact remains that the headline data is very negative and this is the most reliable statistic for activity in the economy. The MPC has said that it attaches a significant weight to the survey data despite the very real possibility that GDP will contract for three consecutive quarters from Q4'11 through Q2'12. The MPC may wish to play down the GDP data right now so as to buy some time and stay on hold while watching how the situation evolves in the short term before committing to further significant amounts of asset purchases. It's noteworthy also that the latest manufacturing PMI showed an unexpectedly sharp drop to well below 50 in the May reading indicating that the situation in that sector is not as healthy as previous readings indicated.

…as inflation report makes clear more QE is an option in reserve.

We are not the only ones having difficulty in determining the true state of the UK economy. The MPC face a policy dilemma now with the latest QE program finished in May but there is a case for more easing as GDP growth is negative currently (and has barely grown over the past year and a half) and there are serious downside risks from the situation in Europe. On the other hand, annual inflation has remained stubbornly high, averaging 3.5% in the first quarter, although it did drop to 3.0% in April. This situation was highlighted in the latest Inflation Report forecasts. Inflation was revised up in the short term but is forecast to fall to 1.6% in two years time. Growth is likely to remain 'subdued' with the report revising down the forecasts for growth over the next 3 years with continuing risks, in the short term at least, to the economy from the situation in Europe. Looking at these forecasts, one might assume with the projected shortfall in inflation that the chance of further quantitative easing has increased. However, Governor King said that such was the uncertainty about the outlook that inflation was judged about as likely to be below as above the 2% target at the end of the forecast period, which he said could be consistent with more QE (more government bond purchases) or less QE (selling government bonds). This supports the consensus view of the MPC holding off on further QE for now but keeping it in reserve should the situation worsen. The debt crisis situation in European continues to threaten but the committee voted 8-1 in May against further monetary easing – although Adam Posen has recently stated he may be considering voting for QE again thus possibly bringing it to 7-2 against in June.

Europe

Debt crisis deepens

Euro falls and economy falters…

It has been another turbulent month for Europe with the debt crisis intensifying once more. The euro has borne the brunt of the turmoil with the single currency falling from over $1.32 to the USD at the end of April to touch off multi year lows of under $1.23 during the first week of June. It was almost inevitable that the euro would suffer at some point as it had held up surprisingly well over the past year despite the ebbs and flows of the debt crisis, but with the US economy performing far better in comparison to the euro area, and with the debt crisis showing no sign of abatement, then a fall in the value of the euro was likely to occur at some point. The fall has been swift and the last time the euro dropped past these levels (in 2010) it ultimately ended up at $1.20, and the euro may well test that level again soon. The euro plight has not been helped by the latest economic data. Although GDP growth in Q1 was flat following a 0.3% contraction in Q4'11 the forward looking data suggests there will be a renewed decline in Q2. The composite PMI fell to 46.0 in May, its lowest reading since the renewed downturn in the EA late last year. The composite PMI has averaged 46.4 so far in Q2, far lower that the 49.6 average reading in Q1 and on the basis of that data we are likely to see another sizable contraction in GDP in Q2.

…with elections and Spain's banks increasing worries…

The catalyst for the latest phase of the debt crisis was the elections in Greece, the deepening banking sector troubles in Spain and, to a lesser extent, the election of Francois Hollande as French President. The inconclusive elections in Greece meant that no government could be formed and new elections will now be held in the middle of June. There is sizable support for anti-EU parties seeking to abandon Greece's rescue deal and unilaterally default on Greece's debt. This would likely mean that Greece would have to leave the euro and this possibility has greatly spooked the markets, putting downward pressure on the euro and upward pressure on peripheral yields. The latest opinion polls show that pro-EU Greek parties maintain a lead but the next set of elections could equally produce no viable government so the instability surrounding Greece could be here for some time yet. Spain's banking sector represents a burgeoning problem for the euro area. Spain had to move in May to take over Bankia, one of the countries largest lenders, in order to recapitalise it. This move provoked more concern in the markets about how much it will ultimately cost to recapitalise Spain's banking sector should property loan losses continue to accumulate. Spanish government 10-year yields rose above 6½%, at times, on fears the costs of recapitalising the banking sector will be too much for the sovereign to bear. Some leaders in Europe have pushed for the ESM to be allowed to directly recapitalise banks in trouble, a move which would alleviate the pressure on Spain. Germany, however, remains firmly opposed to such a policy. However, the German government itself is coming under pressure to change its policy stance. The new French President, Hollande, is pushing for a more growth orientated agenda and for the adoption of more radical policies. These policies may include direct ESM bank recapitalisation and commonly issued euro bonds. Italian Prime Minister Monti has been quoted as saying a 'majority' of euro area members now support the introduction of common euro bonds but Germany is certainly not part of that alliance. These radical measures may still be some way off, but it's clear following the election of Hollande and increasing problems over the past month that common bonds and more liberal uses of rescue funds are now being openly discussed as viable options rather than just theoretical ideas.

…prompting flight to quality.

The net result of the deepening of the debt crisis has been a flight to quality in conjunction with increasing pressure on peripheral yields. German 10-year yields fell about 40bps during May to under 1.2% at times while German 2-year yields turned negative for a time. In contrast, Spain's yields have risen over the past month rising from 5.7% at the end of April to about 6.6% at the end of May, although they have fallen back somewhat in early June. It remains to be seen if Spain can maintain access to credit market should yields rise further. A full blown rescue program for Spain would dwarf the cost of the program for Ireland.

United States

Dollar rises on risk aversion

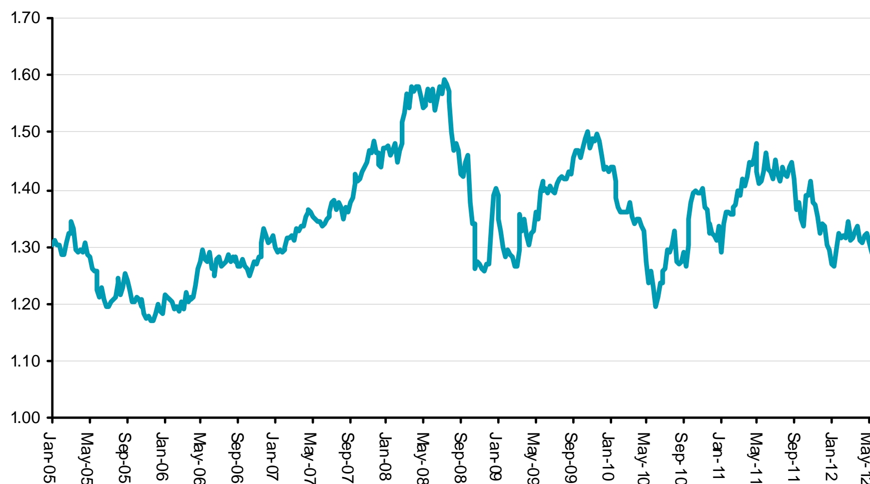
'Flight to safety' prompts a rise in dollar…

The past month or so has seen a fall in stocks, a decline in government bond yields, and a rise in the value of the dollar on the foreign exchange markets. The three main equity indices have shed between 6% and 7% over this period, while the benchmark 10-year government bond yield has fallen by around 30bps to around 1.6%. The dollar has risen in trade-weighted terms by around 3.5% since the end of April, including a 6.5% rise in value against the euro. Underpinning all of these related developments is, of course, the re-intensification of the euro area crisis – the catalyst this time being the economic and banking situation in Spain and the political situation in Greece – which has led to an increase in risk aversion and a 'flight to safety' amongst investors.

…that could be extended in short-term…

While the dollar has risen particularly sharply against the euro over the past month it has been appreciating against the single currency for the best part of a year now, albeit this has been interrupted by periodic bouts of euro strength (see chart below). Currently, the EUR/$ exchange rate, at around $1.25 is 16% below its level – $1.48 – of 12 months ago. In the short-term, and even though the market is exceptionally 'short' the single currency, there is clearly a risk that EUR/$ will fall further ahead of the Greek elections – which are being billed as effectively a vote on EMU membership – on June 17th, with the 2010 low of just under $1.20 an obvious level in this regard. The election result will also have an impact on the exchange rate. If a pro-EU/IMF bailout government can be formed, then the euro is likely to recover some ground. If, however, an anti-bailout government emerges, or if, like following the elections on May 6, a government cannot be put together, then the single currency will remain under pressure, with a move well into sub-$1.20 territory a distinct possibility.

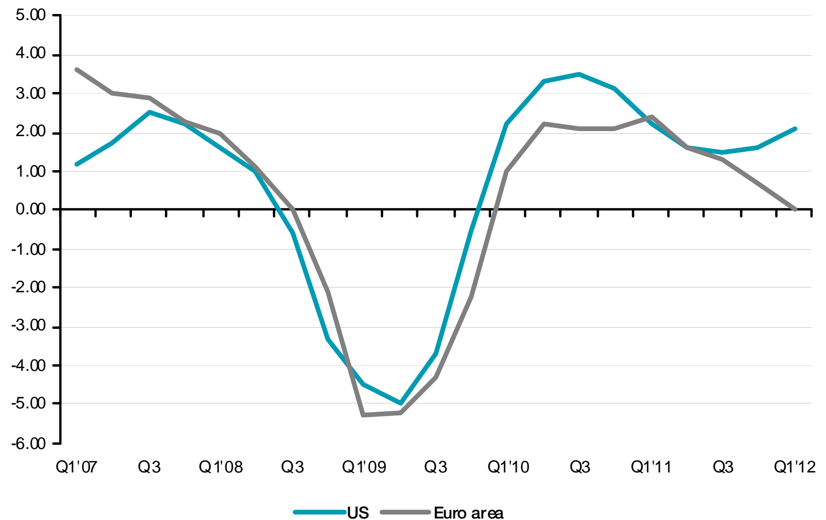
Euro/$ exchange rate



…US economy proving relatively immune to euro crisis…

Notwithstanding the on-going crisis in the euro area, and the renewed downturn in its economy since late last year, the US economy has to date been *relatively* unaffected by these developments. This is partly because the direct trade links between the two economies is relatively small – less than 15% of US goods exports go to the euro area and US exports are in any case a relatively small component (less than 15%) of US GDP. In addition, while US financial markets clearly haven't been immune to events in Europe, they haven't been significantly negatively affected. While stocks have fallen quite sharply in the past month, the S&P 500, for example, is still up more than 4% year to date, in contrast to a fall of over 8% in European markets over this period. The fall in government bond yields, on the other hand, can be viewed as positive for the economy, as it helps to lower private borrowing costs. For example, mortgage rates have fallen to record low levels of around 3.75%, which is helping to spur some activity in the housing market.

GDP: % change year-over-year



...though recovery still gradual...

At the same time, however, the recovery is still proceeding at a relatively gradual pace. Revised 1st quarter GDP data showed the economy grew by 0.5%, or at an annualized rate of just 1.9% over the first three months of 2012. The pace of growth in consumer spending, which accounts for over 70% of GDP, accelerated for the third consecutive quarter, to an annualized rate of 2.7% and so accounted for virtually all of the increase in GDP. Investment rose further, albeit at a slightly slower rate than in the final quarter of last year, while government spending fell quite sharply for a second consecutive quarter, due again to a sizeable fall in national defence spending. As regards the short-term outlook for the economy, growth is likely to continue at a rate close to 2% (on an annualised basis). In particular, consumer spending should be supported by on-going gains in employment, albeit the growth in employment has slowed in recent months from the very strong pace in Q1, and by the recent fall in gasoline prices, which are now almost 8% down from the mid-April peak of around $4 per gallon.

...and Fed keeping policy options open.

The Fed also seems somewhat more reassured that a sustainable recovery is taking hold – according to the minutes of the April monetary policy meeting some members (though not all) had become “more confident about the durability of the recovery” – but its revised macroeconomic projections still point to only moderate growth, and a slow decline in the unemployment rate, in the period ahead. This, though, seems enough to have persuaded a majority of members that further monetary stimulus may not be necessary. One member, William Dudley, summed up the prevailing view: “If we continue to see improvement in the economy, in terms of using up the slack in available resources then it’s hard to argue that we absolutely must do something more in terms of…monetary policy...What's changed for me…is that I'm a little bit more confident that the economy's going to keep growing.. I'm a little bit less worried about a Japanese-style deflation outcome. And that was really the reason that…motivated the need for further monetary policy action”. However, importantly, he also said – and this too is probably the view of the majority of members – that “if downside risks from, say, Europe or the U.S. ‘fiscal cliff’ (on current policy the fiscal stance is set to tighten very sharply next year) were to really intensify, then I think you'd absolutely have to consider further monetary policy moves”.

Economic Diary – June

June

Date	Europe	United Kingdom	United States
1	PMI Manufacturing, Unemployment	PMI Manufacturing	Payrolls, Unemployment, Personal Income & Spending, ISM Manufacturing
4	PPI's		Factory Orders
5	PMI Services, Retail Sales		ISM Non-Manufacturing
6	ECB Meeting, Q1 GDP, German Industrial Production		Fed's Beige Book
7		Bank of England Meeting, PMI Services	Initial Jobless Claims
8		PPI's	
12		Industrial Production	NFIB Small Business Optimism
13	Industrial Production		PPI's, Retail Sales
14	Inflation		Inflation data, Initial Jobless Claims
15			Industrial Production, Empire Manufacturing, University of Michigan Confidence
18		Nationwide Consumer Confidence	
19	ZEW Survey	Inflation data	Housing Starts
20		Bank of England Minutes, Labour market data	FOMC Meeting
21	PMI's, Consumer Confidence, IFO's	Retail Sales	Philly Fed, Initial Jobless Claims, Philly Fed, Existing Home Sales
25		Nationwide House Prices	New Home Sales
26			Consumer Confidence, S&P Case Shiller Home Prices
27			Durable Goods Orders, Pending Home Sales
28		Q1 GDP	Q1 GDP, Initial Jobless Claims
29	CPI estimate		Personal Income & Spending, Chicago PMI
30	German Retail Sales		

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Sep '11	End Dec '11	End Mar '12
EUR/USD	1.25	1.20	1.20	1.25
EUR/GBP	0.81	0.80	0.80	0.80
USD/JPY	79	82	85	90
GBP/USD	1.55	1.50	1.50	1.56

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End Sep '11	End Dec '11	End Mar '12
USD	0-0.25	0-0.25	0-0.25	0-0.25
EUR	1.00	1.0	1.0	1.0
GBP	0.50	0.5	0.5	0.5

Source: Bank of Ireland Global Markets

Swap rates: 5 year

	Current	End Sep '11	End Dec '11	End Mar '12
US	1.00	1.00	1.25	1.25
Eurozone	1.25	1.25	1.25	1.25
UK	1.40	1.40	1.40	1.40

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

		2011		2012
	GDP	Inflation	GDP	Inflation
US	1.7	3.2	2.2	2.4
Eurozone	1.5	2.7	-0.4	2.4
UK	0.7	4.5	0.4	2.8

Source: Bank of Ireland Global Markets

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