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Bank of Ireland Global Markets

TheBulletin

A monthly analysis of international and Irish markets

ECB may bring next cut forward

- Manufacturing output in the Euro area has plunged…
- which may prompt earlier ECB action than anticipated.

The past few weeks has seen an increase in market appetite for risk. This is most clearly evident in the equity market with the S&P index rising by over 20% from a new cycle low in early March, outpacing the major European indices and the ISEQ index. Spreads on sovereign debt within the euro area have also narrowed, and the perceived risk of buying Irish and other peripheral euro zone bonds has fallen – the cost of insuring against an Irish debt default over the next five years, for example, has declined to 2.2% from a recent high of 3.8%. Commodity markets, too, have generally rallied, and crude oil looks as if it may have bottomed.

This change in market sentiment has impacted the dollar which in many ways is now the bell weather for risk aversion – the US currency benefited from the bear market on equities in the first two months of the year, and hence has suffered as a result of the recent rally.

Yet the market's enthusiasm that the worst of the global recession may be over sits uneasily with the view of policy-makers, which in general appears to have shifted to a more bearish stance, and some of the most recent data, which has been truly dismal. Take industrial production; German output fell an extraordinary 19.3% in the twelve months to January, while Japan recorded a plunge of 31%. These figures imply that global GDP is likely to have recorded another sharp fall in the first quarter of the year, following a substantial contraction in the fourth quarter of 2008, a prospect which has prompted many forecasters to revise down growth projections for 2009 as a whole. This is particularly true for official forecasters, and agencies such as the World Bank.

Industrial production in the euro zone as a whole also fell sharply in January, to a level over 6% below the fourth quarter average, and some ECB council members have emphasised the downside risks to the Bank's most recent forecast, published early in March. This concern and the low inflation backdrop may also prompt the ECB to bring forward any further monetary easing, and we now expect the Bank to cut the repo rate to 1% at its April 2nd meeting, rather than wait until May, particularly as it coincides with the G20 meeting in London, where the emphasis will be on global policy action to kick-start credit growth and economic activity.

The Euro area followed the US into recession and may well lag in the recovery, which is ultimately positive for the dollar against the single currency. Consequently we feel that the current relationship between the US currency and equity markets will fade, and that the dollar will benefit from any clearer signs that the American economy is beginning to show some signs of life.

Dr. Dan McLaughlin.

Bank of England start quantitative easing

The MPC cut the Bank rate to 0.5% and announce QE program….

The Bank of England lowered interest rates by 50bps at the start of March bringing the Bank rate to a new all-time low of 0.5%. This is likely to be the floor for rates. The statement issued after the decision said the MPC was concerned that a "very low level of Bank Rate could have counter-productive effects on the operation of some financial markets and on the lending capacity of the banking system". The statement also said that this reduction in the base rate would, by itself, still leave a substantial risk of undershooting the 2% CPI inflation target in the medium term. Accordingly, in addition to the reduction in the base rate, the MPC also decided to engage in alternative monetary policies to boost the supply of money and credit. This move had been flagged since the February meeting of the MPC, when the committee decided to request authorisation to engage in quantitative easing – which was duly granted by the Chancellor of the Exchequer. The MPC announced the Bank of England would buy up to £75bn in assets, over the next 3 months, financed by the creation of central bank money. The Chancellor has given approval of purchases of up to £150bn if needed. The MPC intends the majority of the purchases to be in the form of medium and long term UK Government bonds. The MPC will also purchase private sector assets through the Asset Purchase Facility in order to improve the functioning of the credit market. The Chancellor, in his letter of authorisation, said that up to £50bn (of the purchases limit of £150bn) should be used to buy private sector assets. The move is intended to reduce the cost of credit primarily through reducing the yields on UK gilts. Initially, this was successful as the yields on 10 year gilts fell about 60 bps in the first two weeks of the month to under 3%. However, yields have crept back up again to about 3.3% in the last week of March after inflation in February surprised to the upside.

…however, inflation surprises to the upside...

Indeed, the inflation data emerging from the UK this month has somewhat upset the MPC's applecart. The February inflation data showed that annual CPI inflation rose to 3.2% from 3.0% in January. Prices rose by 0.9% in the month. Core CPI rose to an annual rate of 1.6% from 1.3% in January. This outturn is a worry for the MPC which had forecast that inflation would average 2.7% in the first quarter but it has averaged 3.1% in the first two months alone. The inflation rate has been above 3% for the 11th month in a row, prompting a fourth consecutive letter from King to Darling to explain the situation. In the letter, King blames the stubborn elevated rate of inflation on the depreciation of Sterling which has increased that cost of imports and lessened the pass through of lower commodities prices to the consumer. However, he remains confident that the sharp decline in inflation would continue in the coming months due to a reduction in energy prices and the continuing slowdown in activity. The MPC expects inflation to move below target this year although, as illustrated by February's outturn, the profile could be volatile. Interestingly, King does say in the letter that in light of this month's CPI data, the MPC will need to judge to what extent the main upside risk to inflation – the pass through of the exchange rate depreciation to inflation – is crystallising. The last thing the MPC want right now is to have to talk about ways to tackle high inflation – especially just after introducing significant quantitative easing. However, they may have to talk about it, if they wish to anchor inflation expectations if CPI inflation remains significantly above 2% in the next couple of months. In a sign that King sees no more room for expansionary policies, he said in testimony to the Treasury Select Committee that the UK was not in a fiscal position to offer another stimulus package, calling for restraint from the UK Government in April's budget.

…as Sterling depreciates against the Euro.

Sterling depreciated against the Euro over the past month. The initial catalyst for the move downwards appears to have been the announcement of quantitative easing by the Bank of England and the move by the UK Government to take a 75% stake in Lloyds bank, which reignited concerns over the UK banking system and the UK economy as a whole. Sterling has only got weaker against the Euro since then, as the economic data continues to point to weak Q1 in the United Kingdom. Industrial production fell by 2.6% in January and down nearly 12% year-on-year. Retail sales disappointed in February, contracting by 1.9% in the month after 3 consecutive months of expansion. Retail sales have been surprisingly resilient in the UK over the past 6 months but we see them falling in next couple of months. The PMI figures for services and manufacturing in January and February are pointing to sizable contractions in those sectors also. Sterling has fallen from about £0.88 against the Euro at the start of the month to close to £0.94 by the last week in March. We do not see these gains by the Euro as sustainable (due to the weakness of the Euro area economy and further easing moves by the ECB) and see Sterling appreciating against the single currency over the remainder of the year.

Europe

ECB lowers rates to 1.5% and further easing is likely

The ECB cuts rates by 50bps to 1.5%...

The ECB lowered interest rates by 50bps to a record low of 1.5% at the start of the month, noting the severe downturn in economic activity in the euro area and a significant decline in inflation. The ECB has sharply revised downwards its forecasts for GDP growth in 2009 and 2010, to -2.6% and 0.0% respectively from -0.5% and +1% projected in December. Its forecasts for inflation have also been revised sharply downwards. Inflation (running at 1.2% in February) is now forecast to average just 0.4% in 2009 and 1% in 2010 (from 1.4% and 1.8% respectively projected in December); both years' forecasts are well below the ECB target of 'below but close to 2%'. Weaker growth in the economy and resultant margin of spare capacity in the euro area economy will dampen inflation over the next two years. The poor outlook in the ECB's own forecasts suggest that 1.5% is not the floor for interest rates. In the press conference after the meeting, Trichet did not rule out a further 'easing' of monetary policy, saying that 1.5% is not necessarily the floor for rates. Trichet also said that the decision to cut by 50bps was reached by consensus, rather than a unanimous one, which suggests that some members favoured a larger reduction. Trichet also said the ECB is examining options in relation to adopting non-conventional monetary policy measures.

…and is likely to cut to 1% in April and expand non-standard measures...

The ECB timescale at the start of the month was probably to cut interest rates again, if warranted, in May or June. However, the situation has moved on in the past number of weeks and we think the ECB will now cut its key interest rate again at the meeting in April. We also see the ECB expanding its non-standard measures as a form of quantitative easing. The Bank of England and Fed's respective decisions to expand their purchases of Government debt to re-stimulate private sector credit has put the ECB under pressures to pursue similar policies in the Euro Area. The structure of the Euro area makes it difficult for the ECB to copy the Fed or the BoE in buying up Government debt. However, ECB members have strongly indicated that they will pursue other non standard measures – such as increasing the duration of ECB loans to banks. In late March, Trichet said that it was "pretty possible that we would continue to be non conventional through the channel of bank financing. This channel remains for us essential." He repeated that the ECB could cut its benchmark rate from 1.5% but that a zero interest rate was not "appropriate" for the Euro area regardless of what others had done and that Central Banks were not in a "race". The normally super hawkish German member of the ECB, Axel Weber, also made similar comments supportive of Trichet's position. He said "Rates are at 1.5% in the euro area and heading lower. We have room to manoeuvre. We are using the room that we have to manoeuvre." Weber also said that he favoured expanding the ECB's existing program of loans to banks by extending the duration of loans. ECB members Papademos, Orphanides and Liikanen have all made statements indicating they favour a reduction in interest rates and an increase in non-conventional measures. We think that the ECB will follow through on expectations and do both at their April meeting.

…Euro appreciation is not sustainable…

There has been little sign over the past month of any green shoots of recovery in Euro area data. The economic situation has continued to deteriorate, although the pace of decline appears to have slowed somewhat. Industrial production fell by 3.5% in January to bring the annual decline to 17.3%. Retail sales were broadly unchanged in the same month growing by 0.1% in the month (-2.2% in the year). The PMI's for March show that sentiment is increasing slightly but they are still indicating contractions. Manufacturing PMI rose to 34 from 33.5 in February while the services PMI rose to 40.1 from 39.2. Equities in Europe have had a good month with the German DAX index up about 10%. The Euro has been on an upward trend over the past month. It has risen from around £0.88 against Sterling at the start of March to about £0.94 at the end of the month. In the same time period, it has risen from $1.25 to $1.36 against the dollar. The catalyst for the move appears to be weakness in Sterling and Dollar rather than Euro strength. The Euro has appreciated after substantial quantitative easing announcements by the Fed and the BoE during the month. The appreciation of Euro against the currencies of its largest trading partners is significantly hurting the competitiveness of the Euro area at this time. We believe that the gains by the Euro are unsustainable. We think the Euro Area economy will under perform the US economy this year and will lag any US recovery. Furthermore, we think the ECB will have to cut interest rates again and engage in quantitative easing and this will place the Euro under pressure on the FX markets. We see the Euro depreciating against Sterling and the Dollar over the remainder of the year.

United States

Fed ups the ante

Fed expands its balance sheet further…

The Fed may have no room to cut official interest rates any further but it still has the capacity to surprise the markets, as it demonstrated this month following the conclusion of its two-day meeting of March 17/18 when it announced a significant increase in the size of its balance sheet - through amongst other things the purchase of Treasury securities (i.e. government bonds) – to 'promote economic recovery'. The Fed had said in January that it was 'prepared' to purchase Treasury securities, but the market certainly did not expect it to announce at the March meeting that it was about to do so. Hence the huge drop in government bond yields immediately following the announcement, with the yield on the benchmark 10-year bond initially plunging by around 50bps to 2.5% though it since has backed up over 2.7%. The dollar also fell sharply on the foreign exchange markets, weakening by 6 cents to over $1.36 to the euro, before recovering some ground.

…as economy continues to contract…

The Fed in its post-meeting statement noted that the US economy 'continues to contract', with falling employment, declining equity and housing wealth, as well as tight credit conditions weighing on consumer spending, while weaker sales prospects and difficulties in obtaining credit have caused businesses to cut back on investment. The Fed also noted that exports from the US have slumped, as a number of its major trading partners have fallen into recession. While acknowledging that the near-term economic outlook remains weak, the Fed was cautiously optimistic that the policy actions taken to stabilize financial markets and institutions, together with fiscal and monetary stimulus, will eventually contribute to a 'gradual resumption of sustainable economic growth'.

…and will now buy Treasury securities…

In light of the increasing slack in the economy, the Fed saw a risk that inflation could persist for a time below desirable levels, hence it reiterated that economic conditions are likely to warrant exceptionally low interest rates (currently 0-0.25%) for an 'extended period' and announced the further increase in the size of its balance sheet. In addition to the purchases of Treasury securities, amounting to $300bn over the next six months and designed to improve conditions in private credit markets (the Fed hopes that lower Treasury yields will reduce borrowing costs for a range of private borrowers), the Fed also announced that, to 'provide greater support to mortgage lending and housing markets", it would purchase up to an additional $750 billion of agency mortgage-backed securities (MBS), which will bring its total purchases of these securities to $1.25 trillion this year. This led to an immediate fall in mortgage rates, thus extending the trend decline in these rates that began late last year when the Fed first announced its intention to purchase MBS. The Fed also confirmed that it had launched the Term Asset-Backed Securities Loan Facility, which is designed to facilitate the extension of credit to households and small businesses and which is expected to eventually amount to some $1trillion.

…which will cap yields.

As noted above, government bond yields have backed up again having fallen initially on the Fed announcement. Given the scale of the initial fall, it is perhaps not too surprising to see yields rise again somewhat, although it is also worth noting that the proposed size of the Fed purchase of Treasury securities – $300bn – is very small relative to the outstanding stock of government bonds and amounts to just a third or so of the additional supply of bonds that will come into the market to finance the large budget deficit the government will run this year. All other things equal, this extra supply will put downward pressure on bond prices, or upward pressure on bond yields. On the other hand, the fact that the Fed is now a willing buyer of government bonds, and could decide to increase the scale of its purchases if it feels further action is required to try and revive the economy, will tend to exert downward pressure on yields. All told, yields are likely to trade in a relatively narrow range (+/- 20bps) centered around current levels, which in the case of the 10-year bond is about 2.7%.

Swap rates may be near cyclical low

Official rates at or near lows…

Longer dated swap rates are determined by government bond yields and a credit spread, with the former in turn driven by the market's expectation of the likely path of short-term rates over time. Consequently, the decline in 5-year euro swap rates over the past six months, from 4.75% to 2.75% can be largely explained by the deterioration in the euro zone economy, which prompted the ECB to ease monetary policy – the repo rate is currently at 1.5% from a cyclical high of 4.25% last October. The swap spread over government bond yields has also fallen by about 40bps, so it too played a part, but the decisive factor was interest rate expectations.

The market now expects the ECB to cut further, to at least 1%, but we are now clearly approaching the practical limit of official rate reductions in the euro zone. On that basis a marked fall in 5-year swap rates from here would require either a significant reduction in the swap spread over bonds or a market expectation that official interest rates are likely to stay low for longer. Both are possible, particularly the latter, but a sustained move down to 2% is unlikely in our view and the market may even find it difficult to push below 2.50% for any length of time.

…so swap rates unlikely to fall much further.

The sterling market has already reached a floor in terms of official BoE rates (0.5%) and so the issue there is clearly about how long rates are likely to remain at this historically low level. The UK situation also differs from the euro in that the Bank of England is aggressively buying government bonds, which has added further downward pressure on bond yields. The swap spread there has widened, however, to around 75bps so leaving the 5-year swap rate broadly unchanged around 3% and again this may prove to be a cyclical low.

In the US the situation is similar to that of the UK, in that the Federal Reserve has cut rates to near zero, and is buying government bonds, albeit proportionately less than in the UK. The US Central Bank has also said that rates are likely to remain low for an extended period, moreover. Swap rates may have bottomed at the low seen earlier in the year, however, and although we do not anticipate a rapid rise, the market may well trade in a 2.25% to 2.50% range for a while.

	Euro		Sterling		Dollar	
	Jun-09	Sept-09	Jun-09	Sept-09	Jun-09	Sept-09
2-year	2.10	2.10	2.35	2.35	1.50	1.50
5-year	2.50	2.50	2.85	2.85	2.25	2.25
10-year	3.25	3.25	3.50	3.50	2.90	2.90

April

Date	Europe	United Kingdom	United States
1	PMI Manufacturing, Unemployment rate	PMI Manufacturing	ISM Manufacturing
2	ECB Meeting		
3	PMI Services	PMI Services	Non-farm Payrolls, Unemployment Rate, ISM Non-manufacturing
6	PPI's, Retail Sales		
7	4Q GDP	Industrial Production	
8		Consumer Confidence	
9	German Industrial Production	Bank of Engand Meeting, PPI's	
10	French Industrial Production		
14		RICS House Price Balance	PPI's, Retail Sales
15			Inflation data, Industrial Production, Fed's Beige Book
16	Inflation Data, Industrial Production		Philly Fed
17			Uni. of Michigan Confidence
21	ZEW Surveys	Inflation Data	
22		Bank of England Minutes, UK Budget, Unemployment Rate	House Price Index
23		CBI Industrial Trends	
24	German IFO Surveys, French Consumer Spending	1Q GDP, Retail Sales	Durable Goods Orders, New Home Sales

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Jun	End Sep	End Dec
EUR/USD	1.32	1.25	1.25	1.25
EUR/GBP	0.93	0.89	0.85	0.85
USD/JPY	96	95	95	100
GBP/USD	1.41	1.40	1.47	1.47

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End Jun	End Sep	End Dec
USD	0-0.25	0-0.25	0-0.25	0-0.25
EUR	1.50	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 Jun	End Sep	End Dec
US	2.25	2.25	2.25	2.50
Eurozone	2.72	2.50	2.50	2.60
UK	3.08	2.85	2.85	3.00

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2008		2009	
	GDP	Inflation	GDP	Inflation
US	1.1	3.9	-2.5	-0.7
Eurozone	0.7	3.3	-3.0	0.4
UK	0.7	3.6	-3.0	1.0

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

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Corporate & Institutional Sales — Freephone 1800 30 30 03

Deputy Head of Customer Group: John Moclair	
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Head of Customer Group Funding: Paul Shanley	+353 1 609 3212
Institutions: Gavin Rylands	1800 60 70 40
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Corporate Relationship Manager: Eamon McManamy	+353 1 609 3215

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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

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 62969, 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; NI 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 — Tel: +353 1 790 0040

Head of Structured Products Distribution: Barry McLoughlin — Tel: +353 1 790 0400

Marketing

Head of Marketing: Damien Daly — Tel: +353 1 609 3302

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