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Bank of Ireland
Global Markets

TheBulletin

A monthly analysis of international and Irish markets

The Property Cycle

- Prices are rising again in the US and UK
- Irish commercial property may have bottomed

The international property cycle appears to have turned following the precipitous falls seen over recent years. Residential and commercial property prices have started to rise again in many countries (over half of the 20 residential markets monitored by *'The Economist'* are showing annual gains) although the pattern is by no means uniform, with Europe lagging and Asia leading in the cycle.

The UK is an exception in Europe, with clear evidence that an upturn is underway. Residential house prices bottomed in the first quarter of 2009 according to the Nationwide index, having fallen by 19% from the peak, and have risen by over 11% since then because demand has stabilised against a backdrop of limited supply. The UK commercial property market also hit bottom in 2009, this time in the second quarter according to the IPD index, and capital values subsequently rose by over 10% in the second half of the year with further gains evident in the early months of 2010. Commercial values are still substantially below the peak (the peak to trough fall was 42%) but it appears that the combination of extremely low funding costs and yields approaching 8% tempted investors back into the market. The picture in the US is less clear-cut, as the residential market there has been strongly affected by a series of fiscal incentives, resulting in a high degree of volatility in the monthly data. Nonetheless, the most widely quoted price index, covering 20 major cities, bottomed in the second quarter of 2009, having declined by 32% from the peak, and has risen 4% since then, although some cities are still seeing falling prices. Housing affordability in the US has never been better, which is boosting demand; new home sales have risen by 24% in the past year, with existing home sales up 16%. Commercial property also appears to have hit bottom according to Moody's index, with price rises in the three months to January, although February did see a marginal fall.

The commercial property market in Ireland also appears to have reached a turning point; the IPD showed a marginal positive return in the first quarter, the first in two years. Capital values fell again in the quarter, it has to be said, by 1.8%, bringing the decline from the peak to over 56% but the trend implies that capital values may have stopped falling in the current quarter. The news on the Irish residential market is less positive however, as all the published data still points to a decline, with the most widely quoted permanent-tsb/ESRI index recording a 4.8% fall in the first three months of the year. An alternative, the Daft.ie measure of asking prices recorded a 3.8% fall in the three months to March with the CSO on private sector rents also showing further declines in the first quarter, albeit at a much slower pace than a year earlier.

Dr. Dan McLaughlin

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United Kingdom

Q1 growth disappoints but economy still in recovery

Election finally kicks off in the UK…

The polls consistently indicate that a hung parliament is a strong possibility, following the General Election, and that is the last thing that the markets want at this time. The Government budget deficit lies at around 12% of GDP and the current Government has not laid out any detailed plans on how to reduce this although they have published a timeline for cutting it to below 3%. The next Government, regardless of its make up, will have some tough decisions to make and the larger the majority the more likely it is that the tough decisions will be made. Sterling has been somewhat volatile in this situation, as you would expect. It got a boost in early April when the election was called but fell back somewhat against the Euro mid month. However, it has shrugged off the increasing uncertainty over the composition of the next parliament to gain in the last 10 days of the month and now finds itself in the first week of May higher against the Euro than when the election was called. The reality of a hung parliament, if that is the result, would put some short term downward pressure on Sterling as the parties decided who was to be in the next Government.

…as Q1 reports growth of just 0.2%…

The initial estimate of Q1 GDP disappointed, reporting growth of 0.2% over the last quarter of 2009. The consensus forecast was for growth of 0.4% and the PMI indicators and others had pointed to a much stronger growth rate. This illustrates that the economy remains in a weak position and the minutes from the latest BoE meeting show that this result may not have come as a surprise to them. The minutes said that "Several erratic factors were likely to have influenced GDP growth around the turn of the year: the restoration in January of the standard rate of VAT to 17½%; the snowy weather; and the declining impact (and ultimate expiry in March) of the vehicle scrappage scheme. Together, these factors were likely to have boosted measured output growth a little in the fourth quarter of 2009, and would probably depress it to some extent in the first quarter of 2010. Looking through those temporary factors, the activity data of the past few months has been consistent with the Committee's central expectation of a gradual recovery in activity. That is somewhat reassuring. The recent pickup in growth, and strength of some of the business surveys and indicators of spending pointed towards underlying activity growth in the first half of 2010 that was only a little below its historical average rate". At the meeting, members felt that the downside risks to the economy had diminished given more favourable economic data recently, while some expressed concern about an upward drift in some market measures of inflation expectations, though in the end all 9 members voted to keep interest rates at 0.5% and to maintain the asset purchase programme at Stg200bn.

…and inflation increases to 3.4%.

UK CPI inflation surprised somewhat to the upside in March, registering an annual increase of 3.4%, after rising at an annual rate of 3.0% in February. The consensus forecast was for a 3.1% increase in March. While commodity price increases are having an effect the main reason behind this current level high of headline inflation is a large base effect impact from the reimposition of the 17.5% VAT rate at the start of the year. The base effects from this VAT change will last for 12 months before it drops out of the index. Looking at the CPI ex indirect taxes, which is probably more reflective of the price pressures in the economy at this time, we can see that the change in VAT added 1.6 percentage points to inflation in March and the CPI ex taxes measure stood at an annual rate of 1.8% last month, down from 4.3% in March of last year. The MPC's view is that the current above target inflation rate is temporary and King has used the 'temporary/ and or special factors' argument in all his letters to the Chancellor. The MPC believes that the output gap is very large and this will eventually put downward pressure on inflation, as indeed it appears to be doing in the euro area and the US. However, it's difficult to get across a message about price pressures been held down by a sizable output gap when the Governor has to write letters to explain the headline rate. There is also difficulty in measuring the exact size of the output gap and the potential that the current temporary increase in inflation could lead to an increase in inflation expectations. However, the MPC can point to the fact that inflation is still largely in line with the Bank's forecasts. The weaker than expected Q1 GDP outturn is indicative of an economy with little real price pressures. Currently, inflation in Q1 came in just slightly ahead of the BoE's target but the BoE expects it to drop in the coming quarters down to 1.1% by Q1 of next year.

Europe

Greek problems threaten to infect other euro area member states

Greece finally asks for help but turmoil continues…

Once again this month, Greece dominates the headlines. The country has been flirting with disaster for a couple of months as its debt yields rose and rose and the market continued to question the soundness of its public finance. The EA and IMF had to promise financial aid last month should the worse come to the worse for Greece. We had plenty of confusion along the way, with the deal first excluding then including the IMF. Yet, there were some false dawns as the markets digested the promises of aid to Greece but, each time, some setback would send the Hellenic Republic's yields rising again. Finally, Greece bowed to the inevitable and formally requested funds from the financial aid plan on April 23rd. At that time, Greek 2 year bonds were almost 11% while 10 year yields were near 9%. Any disbursement of aid must be unanimously approved by all of the euro area governments, some of whom need parliamentary approval to participate in the loan program. The German Government demanded reassurances from Greece on an IMF approved multi year program of cuts and said the granting the aid was not a certainty. This delay proved to be a catalyst that sent Greek yields soaring as other peripherals yields also rose rapidly, plunging the Euro area into a debt crisis as the markets feared a contagion effect from a Greek default. Greek 2 year yields rose to around 19% while equivalent bund yields were trading at well under 1%. 10 year Greek debt yields rose back to over 11% while Portuguese 10 year yields went out by over 100bps in a week to 5.75% and Irish 10 year yields went out by 75bps to over 5.25% in the same time frame. Over the first weekend in May, the Euro Area/IMF and Greece agreed a program of austerity cuts for the country that will hopefully reduce the Greek deficit to less than 3% of GDP by the end of 2014 from around 12% currently. The Greeks will seek to cut up to EUR30bn off the annual budget in that time, in return for a bailout of EUR110bn of loans over 3 years. This would provide Greece with funding for the next three years and take them out of the market while they attempt to correct their public finances. The IMF will provide about EUR30bn of loans with the rest coming from other Euro area members in proportion to their shareholding in the ECB. This agreement should bring some stability to the situation but much uncertainty remains. The cuts will be difficult to achieve and Greece is beset with social and industrial upset over current and proposed budget cuts. While the agreement provides some breathing room for Greece and the Euro area, there is still a long way to go in order to correct the situation, with more volatility in store for Greece and other peripherals in the short term.

….as Euro comes under pressure…

The Greek saga has weighted down heavily on the Euro. It fell from $1.38 in mid March to $1.33 before rallying briefly to back over $1.37 in mid April. However, the respite was brief and the growing uncertainly at the back end of the month sent the Euro down to under $1.29 in early May for the first time in 12 months. Our view is that, regardless of the Greek situation, the trend of the Euro is downward as the US recovery continues to outpace the more tepid Euro area recovery.

…and modest recovery continues.

Revised 4th quarter GDP for the Euro area showed that activity was unchanged in the quarter compared to an initial estimate of an expansion of 0.1%. The revision is somewhat of a surprise as if anything it was more likely that growth would be revised upwards as other data had been indicating a stronger performance. In the national accounts, industry was showed to have contracted by 0.1% in the quarter contradicting industrial production data which was positive in every month of the quarter and indicated an expansion of about 2% q on q. Amongst the expenditure component of growth household consumption was flat in the quarter while government declined by 0.1%, investment fell by 1.3% but exports were up by 1.9% beating a gain in imports of 1.3%. The main reason for the revision was the fall in investment which was greater than initially estimated. The EA most likely performed better in the first quarter of this year although growth is widely expected to be positive but weak with growth accelerating throughout the year. The latest purchasing managers' surveys showed that activity in the Euro Area manufacturing and services sectors rose further in April. Based on the recent trend in these surveys, it looks as if the economy expanded by an average of about 0.5% a quarter over the first two quarters of 2010. Welcome and all as this would be, it would still leave the level of GDP in Q2 almost 4% below its pre-recession peak, indicating just how deep the recent downturn was in the Euro Area, while it will take a further, sustained period of reasonably strong growth to reduce the gap further. In the meantime, such a large margin of spare capacity in the economy should keep inflationary pressures subdued, which in turn means the ECB should be in no hurry at all to raise interest rates.

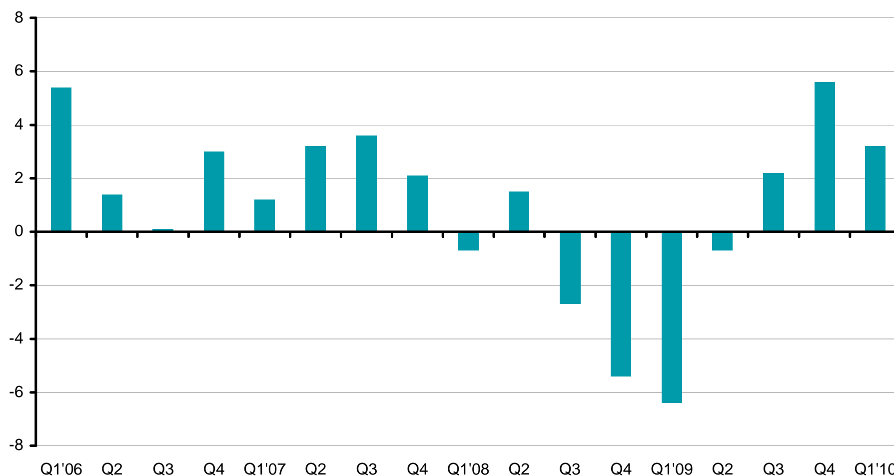
United States

Economy expands again in first quarter of 2010

Economy expands for third consecutive quarter in Q1…

Having grown at annual rates of 2.2% and 5.6% in the third and fourth quarters of 2009 respectively, the economy expanded again in the first quarter of 2010, with real GDP increasing by 3.2%. Consumer spending re-accelerated in the opening quarter of the year, increasing by 3.6% after a relatively modest gain of 1.6% in Q4, while business investment in equipment and software posted another solid rise, increasing by 13.4% after growth of 19% in the final quarter of 2009. Residential investment fell – by almost 11% – following two consecutive quarters of positive growth, while non-residential investment declined for a seventh consecutive quarter. Exports grew again in Q1 – by almost 5.5% – reflecting the recovery in the global economy, though imports rose more quickly – by almost 9% – with the result that *net* exports actually made a negative contribution of 0.6% points to overall GDP growth in Q1. Inventories made a sizeable positive contribution of 1.6% points to growth, as businesses re-built stocks in the quarter. Excluding inventories, real final sales – or final demand in the economy – increased by 1.6% in Q1, in line with the growth of 1.5% and 1.7% recorded in the final two quarters of last year respectively.

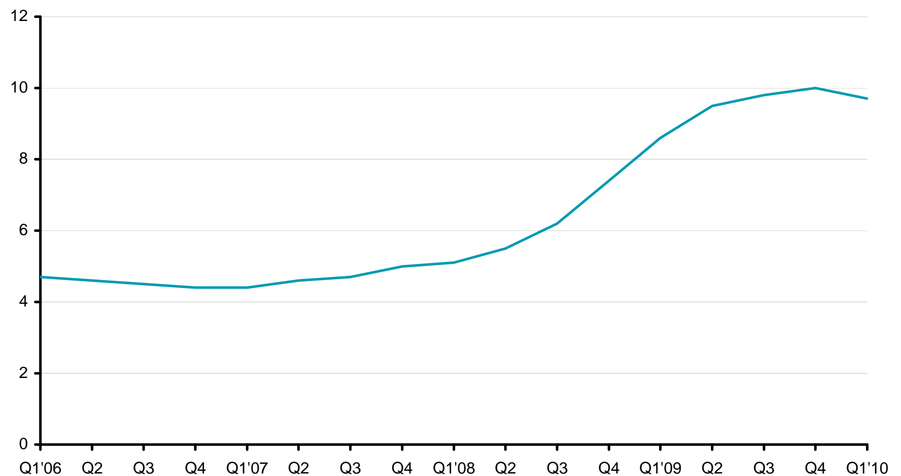
GDP, % change quarter-on-quarter (at annual rate)



…but still a lot of spare capacity…

Following a third consecutive quarter of positive growth, the *level* of real GDP in Q1 was 2.7% above its recession low in the second quarter of 2009, thus reversing almost three-quarters of its 3.8% peak (Q2'08) to trough decline. Based on the consensus forecast for growth over the remainder of this year, the economy – measured by GDP – will be almost back at its pre-recession peak as soon as this current quarter (Q2) and will be some 1% above it by the final quarter of this year. However, the level of GDP is still some distance below where it would be if the downturn had not occurred and the economy had continued to grow at a rate broadly in line with its long- run trend rate. In other words, notwithstanding the recent recovery, there is still a good deal of spare capacity, or 'slack', in the economy. This is evident in the current high rate of unemployment of almost 10%, which is around 4% points above its historical average rate of just under 6% , and in the current low capacity use rate in industry, which at around 73% is some 7% points below its long run average.

Unemployment Rate (%)



…which is keeping inflation low…

This spare capacity means cost and prices pressures in the economy are very subdued. In the labour market, for example, the annual rate of growth in hourly earnings has fallen to 2.1% (March) from over 4% pre the recession. This deceleration in earnings, together with an acceleration in the growth of labor productivity (or output per hour worked) has contributed to an outright fall in whole-economy unit labor costs, with the latter running almost 5% below year earlier levels at the end of 2009. Partly because of this, consumer prices are rising very modestly, with the annual rate of core inflation (i.e. excluding food and energy prices) running at just 1.1% in March, down from 2.5% pre-recession and its lowest level since late 2003. The spare capacity will diminish as the economy continues to expand and so the downward pressure on inflation will eventually ease and, ultimately, reverse, though at present the degree of slack is such that inflation is likely to remain moderate for some time yet.

…and bond yields relatively stable.

It is largely for this reason that the Fed believes, as it reiterated at its end-April meeting, that "exceptionally low levels of the federal funds rate are likely to be warranted for an extended period". It has stated, though, that this expectation for policy is "explicitly contingent on the evolution of the economy rather than on the passage of any fixed amount of calendar time" and hence it would not be prevented from raising interest rates promptly if "the evidence suggested that economic activity was accelerating markedly or underlying inflation was rising notably". As of now, however, it anticipates that economic conditions, including low rates of resource use, subdued inflation and stable inflation expectations warrants maintaining very low interest rates. This stance has helped to keep market interest rates largely range bound recently, even as the economy has clearly picked up. In the case of government bonds, 2-year yields at around 0.9% are trading close to the middle of the 0.7% to 1.2% range they have been in for the best part of a year now, while the benchmark 10-year yield, at around 3.6%, is also trading comfortably within the 3.2% to 4% range that has prevailed over the same period. However, 2-year yields have risen further *relative* to their euro (i.e. German) equivalents over the past month, with the 'spread' widening out by a further 20bps or so. This partly reflects a flight to the safety of German bonds amid the sovereign debt crisis in Greece, which has pushed German yields lower over the past month, but nevertheless the widening out of the spread has supported the dollar, which has risen to around $1.28 to the euro from $1.35 at the end of March. Further dollar gains are likely, reflecting the stronger economic recovery in the US relative to the Euro Area, while the perceived "bail-out" of Greece may also undermine the single currency for a time.

May

	Europe	United Kingdom	United States
3	PMI Manufacturing		Personal Income & Spending, ISM Manufacturing
4	PPI's, German Retail Sales	PMI Manufacturing	Factory Orders, Pending Home Sales
5	PMI Services, Retail Sales		ADP Employment Change, ISM Non Manufacturing
6	ECB Meeting	PMI Services	
7	German Industrial Production	PPI's	Non farm payrolls, Unemployment
10		BoE Meeting	
11		RICS House Price Balance, Industrial Production	
12	Industrial Production, Q1 GDP	BoE Quarterly Inflation Report, Unemployment	
13		Consumer Confidence	
14			Advance Retail Sales, Industrial Production, Uni. Of Michigan Confidence
17		Rightmove House Prices	
18	Inflation data, ZEW survey	Inflation data	PPI's, Housing Starts
19		BoE Minutes	Inflation data, FOMC minutes
20	Consumer Confidence	Retail Sales	Philly Fed, Leading indicators
21	German IFO surveys		
24		Nationwide House Prices	Existing Home Sales
25	Industrial New Orders	Q1 GDP	CaseShiller Home Prices, Consumer Prices
26			Durable Goods, New Home Sales
27			Q1 GDP

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Jun	End Sep	End Dec
EUR/USD	1.27	1.30	1.30	1.30
EUR/GBP	0.85	0.85	0.83	0.80
USD/JPY	93.5	100	100	100
GBP/USD	1.50	1.53	1.57	1.62

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	0.75
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 Jun	End Sep	End Dec
US	2.55	3.00	3.50	3.75
Eurozone	2.20	2.50	2.60	2.75
UK	2.85	3.05	3.25	3.50

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2010		2011	
	GDP	Inflation	GDP	Inflation
US	3.0	2.0	3.0	1.9
Eurozone	1.1	1.2	1.5	1.5
UK	1.2	2.5	2.5	1.7

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: Kevin Twomey

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

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

Retail Sales — Freephone 1800 790 153

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

Global Markets United Kingdom (UK)

Head of UK: 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 — Tel: +353 1 790 0040
Head of Structured Products Distribution: Barry McLoughlin — Tel: +353 1 790 0400

Marketing

Head of Marketing: Andrew Hearnden — Tel: +353 1 609 3302

Market data supplied by Reuters

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