Produced by the Economic Research Unit
September 2012

Bank of Ireland Global Markets

TheBulletin

A monthly analysis of international and Irish markets

September may be significant month for the euro

- Euro has rallied of late
- Event risks abound near term

The euro has rallied over the past month against most of the major currencies, including sterling and the US dollar, supported by the belief that the ECB will resume the purchase of sovereign debt, an expectation that has taken some of the tension out of euro bond markets. Yet September carries a number of substantial event risks, many with the potential to re-ignite investor concern about the future of the single currency, so it promises to potentially be a very significant month for the markets in general and the euro in particular.

The most important event is the decision by the German Constitutional Court on the ESM and the Stability Treaty, scheduled for the 12th, as German and hence European policy has been in limbo awaiting that ruling. Most observers doubt that the Court will reject the ESM, hence destroying the permanent firewall in the euro area, but some expect that the Judges could impose restrictions and constraints on German participation. The Netherlands has also yet to ratify the Stability Treaty and holds a General Election on the same day and that has the potential to throw up an anti-austerity Government and the prospect of a Dutch referendum on the Treaty.

Spain and more specifically the capital needs of the Spanish banks was a key market concern and September is also likely to see a decision by the new Government there on how much it will seek in support from the EU and whether that request will extend beyond the banking sector and include the State. The ESM can directly support banks but only if a single banking supervisor is in place, and the European Commission is scheduled to unveil any progress on that issue on the 11th, including its thoughts on a Banking union.

The ECB proposal to buy short-dated sovereign debt is conditional on purchases by the EFSF/ESM so any problems with the latter will in turn impact the Bank's plans to support bond markets under stress. The details of that, including the issue of ECB seniority to other bond holders, have yet to be unveiled and the market's expectation regarding more clarity on these issues at the upcoming ECB meeting may be disappointed. That meeting could well resort to more conventional monetary policy measures, however, including another cut in the repo rate, or at least the flagging of that prospect.

Finally September may also see Greece again in the spotlight as euro policy makers have chosen to await the next Troika report before making any decisions. Germany appears to have ruled out any fresh loans so the issue of a Greek exit from the zone is also likely to re-appear adding another risk to what could prove a very eventful period.

Dr. Dan McLaughlin.

United Kingdom

Outlook points to further monetary stimulus

Inflation Report implies need for policy action…

The Bank of England (BoE) is currently engaged in buying an additional £50bn of Gilts in order to bring the total amount of purchases up to the target of £375bn by the end of October. That decision, taken by the MPC in early July, was not unanimous but the economic outlook as portrayed in the August Inflation Report implies that a further policy stimulus may well be required given the outlook for economic activity. The Bank still expects GDP to pick up later this year but has become more pessimistic about the economy's potential growth and now forecasts annual growth of 2.1% in 2014, against 2.6% forecast just three months earlier. This projection includes the impact of the additional QE and makes allowance for the new Funding for Lending Scheme (FLS), designed to boost credit to the real economy. The annual inflation rate in two years time is expected to be at 1.6% on unchanged policies, which implies that some additional stimulus is required to bring inflation up to the 2% target.

Any projections made in the current financial and economic environment are subject to more caveats than usual but the markets are expecting the BoE to announce another round of monetary easing in the next few months. The nature of that easing is debated however, and the futures market is effectively discounting a quarter point cut in the Bank rate, which would take it to 0.25%. The arguments for and against such a move have been discussed at recent MPC meetings, although not at the August gathering, and Governor King has stated that a cut would not have a significant impact and would cause problems for the banking sector, so he at least does not seem to favour that option.

…and further QE likely rather than rate cut…

The BoE has also published research supporting the view that QE has had a very significant impact on the economy, arguing that the first £200bn of purchases may have boosted GDP by up to 2%, so a further round of QE may indeed prove to be more likely than a rate cut. The MPC may want to wait a few months though, to monitor the impact of the FLS and to see how the euro sovereign and banking issues unfold, as it sees the outlook for the euro zone as a key risk to the prospects of an upturn in the UK economy.

…Budget shortfall now likely.

The recession also appears to be finally impacting the UK's fiscal position. The current Budget was predicated on 0.8% GDP growth in 2012 but the consensus now expects the economy to contract by 0.2% following the second quarter data. The initial 0.7% fall in GDP was revised up, to -0.5%, following revisions to industrial production and construction and a rebound is likely in Q3, but annual growth was also -0.5% so even a strong recovery in the second half of the year will still leave growth for 2012 flat at best, and it would therefore be surprising if the 2012/2013 deficit emerged around the £92bn target, particularly as the deficit is running above last year's total. This in turn would pose a problem for the UK government – should it allow the deficit reduction programme to slip behind target or should it adjust spending on taxation to keep it on track?

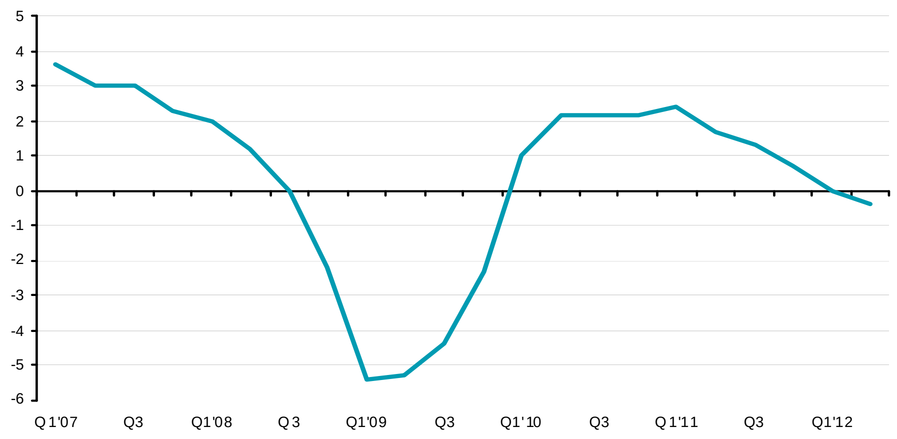
Europe

Euro area economy contracts in Q2

Euro area economy contracts in Q2…

The euro area economy contracted in the second quarter, with real GDP falling by 0.2% from the first quarter; over the year to the second quarter the economy contracted by 0.4%, having expanded by 1.7% over the previous twelve months. There is little respite in prospect for the zone, as the available indicator data, notably the Purchasing Managers measures of activity in the manufacturing and services sectors, point to another fall in GDP in the current quarter (Q3). The unemployment rate has risen sharply as the economy has slowed and stood at 11.2% in June, more than a percentage point higher than in June 2011. The inflation rate has fallen during the course of 2012, to 2.4% in July from 3% at the end of last year.

Euro area GDP: % Chg year-on-year



…and ECB may cut interest rates again…

The ECB left interest rates unchanged in August, having cut both the main refinancing rate and the deposit rate by 25bps, to 0.75% and 0% respectively, at the July meeting. The weakening economy certainly leaves scope for the ECB to cut the main refinancing rate again, though whether this comes as soon as the September 6 meeting remains to be seen. We think the October meeting is the more likely date for such a move. The ECB has also said it may intervene in the government bond markets to reduce the excessively high risk premia on some countries' yields, though this is conditional on a country formally requesting financial assistance and euro area governments being ready to activate the EFSF/ESM in the bond market. The German constitutional court is due to give a ruling on the ESM on September 12, and the indications from European officials are that Spain is unlikely to formally request help before the September 14 meeting of euro area finance ministers. Hence any intervention in the bond markets is only likely to come from mid-September onwards.

…while prospect of bond buying has lowered peripheral yields.

The prospect of bond buying has, though, contributed to a further fall in peripheral yields since the August 2 ECB meeting. Spanish 2- and 10-year yields have fallen by 130bps and 35bps respectively over this period, with the much larger decline in 2-year yields not surprising as the ECB has said any bond buying will be concentrated at the 'short end of the curve'. Risk aversion generally has receded, with European equity markets up more than 4% since early August and the euro strengthening further against the dollar to around $1.25 from $1.23. Any announcement and commencement of actual bond buying by the ECB and EFSF/ESM would see peripheral yields fall further, while the euro would probably extend its gains against the dollar on the foreign exchange markets. Whether the single currency could sustain any gains is questionable however. The euro area economy is contracting with little respite in prospect in the short-term, while the US economy is at least growing albeit moderately. The ECB may cut rates again, but the Fed has indicated that it may also ease monetary policy, which could limit any upside for the dollar. On balance, we still think a trading range of $1.20 -$1.25 may prevail for a while yet.

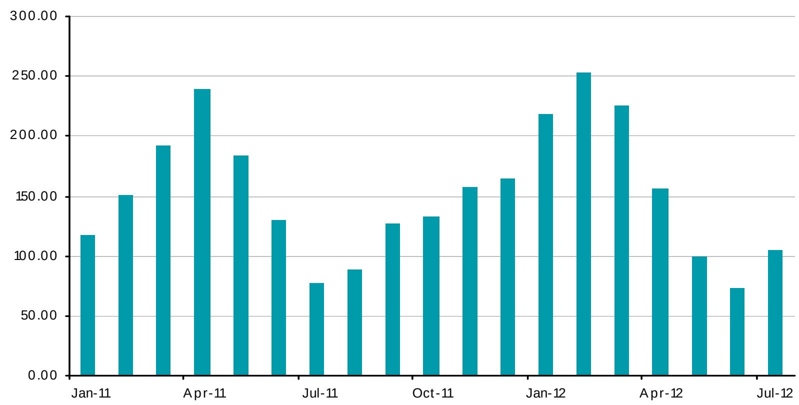
United States

Fed signals further policy easing

Some signs growth picking up again…

The US economy expanded by 0.4% in the second quarter, after growing by 0.5% in Q1, according to the second estimate of GDP published in late August, though available indicator data point to a possible re-acceleration in the pace of growth in the current quarter (Q3). Retail sales rose for the first month in four in July to leave spending 0.3% above the level in the second quarter (spending *fell* by about 0.2% in Q2 from Q1); manufacturing output rose by 0.5% for a second consecutive month in July to leave the *level* of output 0.7% above that in Q2 (output rose by just 0.3% in the second quarter); total employment in the economy increased by 163k in July, more than double the average monthly increase of 75k in the second quarter, while the level of new jobless claimants recently points to the possibility of another sizeable gain in August. On the minus side though, orders for capital goods fell again in July, signaling a possible deceleration in the pace of business investment from the second quarter.

US Employment (Monthly Change, 000s, 3mma)



…Fed keeps policy on hold in August…

Having announced an easing of monetary policy in June – a $267bn extension of 'Operation Twist' to the end of this year – the Fed kept the stance of monetary policy unchanged at the July 31st – August 1st meeting, though it said it "will provide further accommodation as needed to promote a stronger economic recovery". The minutes of the meeting revealed that 'many members' judged that additional monetary easing would likely be warranted 'fairly soon' unless incoming information pointed to a 'substantial and sustainable strengthening in the pace of the economic recovery'. As noted above, the data released since the meeting have pointed to some re-acceleration in economic activity, though one could not describe it as substantial let alone sustainable (the latest 'consensus' forecast is for an increase in GDP of around 0.5% in Q3). There are some important data due before the Fed's next meeting on September 12/13, but they are unlikely to settle the matter either.

….but further easing likely…

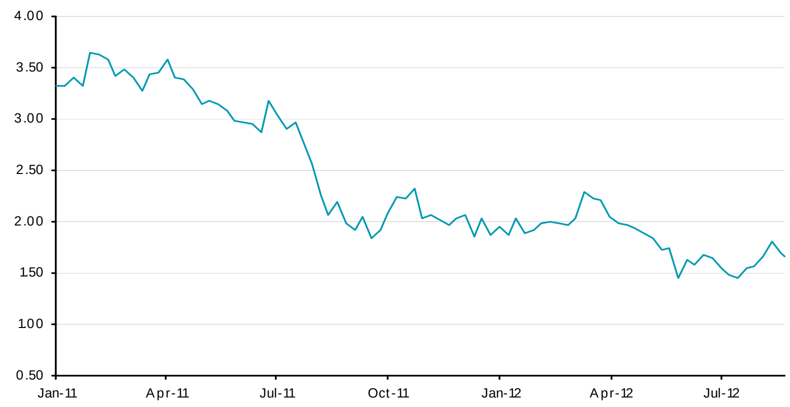
Some further monetary easing, then, is likely to be announced in September, though the question is what form it might take. The Fed discussed a number of options at the August meeting. One was to extend the period over which it expects to keep interest rates at (effectively) zero percent to beyond the current 'late 2014' date, which the Fed said could be 'particularly effective if done in conjunction with a statement indicating that a highly accommodative stance of monetary policy was likely to be maintained even as the recovery progressed'. Such a commitment to keep official interest rates low for longer would tend to exert downward pressure on market interest rates and, thus, provide support to the economy.

Fed members also 'exchanged views on the likely benefits and costs' of a third round of 'quantitative easing' (QE3), or asset purchases, which 'many' members believed could also support the economy by "putting downward pressure on longer-term interest rates and by contributing to easier financial conditions more broadly". However, 'several' members believed that another round of asset purchases, which would increase the size of the Fed's balance sheet even further, might make 'normalizing' the balance sheet even more difficult 'when the time eventually comes to removing policy accommodation'.

…perhaps extending forward guidance on interest rates…

The minutes also revealed that 'many members expressed support for extending the…forward guidance' on interest rates at the August meeting but 'agreed to defer a decision on this matter until the September meeting in order to consider such an adjustment in the context of updates…to economic projections and the…further consideration of policy options". It seems, then, that the Fed will, at the very least, announce an extension of the forward guidance on interest rates at next month's meeting. The question is, will it go even further than this and also announce a third round of QE? Some more positive data between now and the September meeting, particularly in relation to the labour market, might prompt the Fed to eschew further QE. Also, political considerations ahead of the November presidential election might also play a role. The Republican candidate, Mitt Romney, has said QE2 hasn't worked and believes QE3 wouldn't work either.

US Government 10-year bond yield



…dollar off its mid-summer highs.

The generally better than expected economic data over the past month or so, together with some reversal of the 'risk aversion' trades in markets, has contributed to a back up in government bond yields. The yield on the benchmark 10-year yield rose by more than 40bps - from 1.4% to almost 1.85% - between late July and mid-August, though the signal from the Fed minutes of further policy easing has since seen yields reverse almost half this move higher (the 10-year is currently around 1.65%). Similarly, the dollar has lost ground to the euro over the past four to five weeks, first as the 'risk aversion' trades were unwound and, then. as the prospect of further Fed easing weighed on the US currency. An announcement of additional easing at the Sept 12/13 meeting, and possible ECB intervention to alleviate tensions in certain 'peripheral' bond markets sometime from mid-September on, could push the dollar lower against the single currency. However, the ECB may also cut euro interest rates further, which could weigh on the single currency, while the US economy looks certain to outperform its euro zone counterpart over the coming months. Overall, we expect the dollar to trade in a range of $1.20-$1.25 to the euro in the period ahead.

Economic Diary - September

	Euro Zone	United States	United Kingdom
5	Services PMI, Retail Sales	Unit Labour Costs (Q2)	PMI Services
6	ECB Meeting, GDP (Q2, 2nd est.)	Jobless Claims, ADP Employment	BOE Meeting
7	German Industrial Output	'Non-Farm Payrolls', ISM Non-Manufacturing Index	Industrial Output, Producer Prices
10		Consumer Credit	RICS Housing Survey
11		Trade Balance, NFIB Small Business Optimism Index	Trade Balance
12	Industrial Output	Fed two-day meeting, Import Prices	Labour Market Report
13	Labour Costs	Fed statement, Producer Prices, Jobless Claims	
14	CPI, Employment	CPI, Retail Sales, Industrial Production, Consumer Confidence	
17	Trade Balance	Empire Manufacturing Index	Rightmove House Prices
18	German ZEW Index	BOP Current A/C, NAHB Housing Market Index	CPI
19	Construction Output	Housing Starts & Permits, Existing Home Sales	BOE Meeting minutes
20	Consumer Confidence	Jobless Claims, Philly Fed Index, Leading Indicators	Retail Sales
21			Public Finances
24	'Flash' PMIs, German IFO Index		Nationwide House Prices
25		Consumer Confidence, S&P CaseSchiller House Prices	
26		New Home Sales	
27	M3, Business & Consumer Confidence	Jobless Claims, GDP (Q2, final), Durable Goods Orders	GDP (Q2, final), BOP Current A/C
28	'Flash' CPI	Personal Income & Spending, Chicago PMI	Index of Services

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Sep	End Dec	End Mar
EUR/USD	1.25	1.20	1.20	1.25
EUR/GBP	0.79	0.80	0.80	0.80
USD/JPY	78.6	80	82	85
GBP/USD	1.58	1.50	1.50	1.56

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End Sep	End Dec	End Mar
USD	0-0.25	0.25	0-0.25	0-0.25
EUR	0.75	0.75	0.5	0.5
GBP	0.50	0.5	0.5	0.5

Source: Bank of Ireland Global Markets

Swap rates: 5 year

	Current	End Sep	End Dec	End Mar
US	0.85	1.0	1.0	1.25
Eurozone	0.95	1.0	1.0	1.25
UK	1.05	1.10	1.10	1.30

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2012		2013	
	GDP	Inflation	GDP	Inflation
US	2.2	2.0	2.2	2.0
Eurozone	-0.4	2.4	0.5	1.6
UK	0.0	2.6	1.5	1.8

Source: Bank of Ireland Global Markets

Contact Us

Economic Research Unit (ERU)

To discuss any aspect of this report, contact your treasury specialist or our Economic Research UNIT (ERU):

Chief Economist, Bank of Ireland: Dr. Dan McLaughlin — Tel: +353 (0) 766 244 267

Senior Economist: Michael Crowley — e-mail: eru@boigm.com

Economist: Patrick Mullane

Contact your treasury specialist

Corporate Treasury	1800 60 70 20 or 1800 30 30 03
Business Banking Treasury	1800 79 01 53
Institutional Treasury	1800 60 70 40
Specialised Finance	+353 (0)1 790 0001
UK Sales Team	0800 039 0038 (within the UK)
US Sales Team	+1 203 391 5555

Our Offices

Dublin

2 Burlington Plaza, Burlington Road, Dublin 4, Ireland

Tel +353 (0) 766 244 100

London

Bow Bells House, 1 Bread Street, London EC4P 4BP, UK

Tel +44 (0)20 3201 6000

Belfast

1 Donegall Square South, Belfast, BT1 5LR, UK

Tel +44 (0)28 9032 2778

Stamford (US)

300 First Stamford Place, Stamford CT 06902, US

Tel +1 203 869 7111

Keep in touch with the markets, visit www.treasuryspecialists.com

Market data supplied by Thomson Reuters