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Bank of Ireland
Global Markets

# TheBulletin

A monthly analysis of international and Irish markets

## Oil Matters

- Slower global growth partly due to higher energy prices
- Recent fall in oil prices will boost US more than Europe

The global economy appears to have slowed this year from the buoyant level seen in 2010; annual growth eased to 4.4% in the first quarter and possibly slowed further to around 4% in Q2, from over 5% this time last year. Two specific factors may have been responsible, however, and both may now be unwinding, at least in part.

The first is the impact of the nuclear incident in Japan, which has had a much bigger effect on the international supply chain than perceived at the time, particularly on electronics and autos. The global manufacturing sector has certainly slowed in recent months, but the surprise bounce in US manufacturing in June lends some support to the view that this supply shock may now be dissipating.

A second factor is the price of oil, which rose sharply in the six months to April. The historical evidence shows that global downturns are more often than not a consequence of high energy costs, and rising fuel prices have certainly eaten into household incomes this year. This is particularly so in the US, where the tax on fuel is much lower than in Europe, with the result that any given change in wholesale prices has a greater impact on the retail price.

The corollary is that the recent fall in crude oil prices has had a bigger impact in the US; the price of gasoline has fallen by some 10% in the past six weeks, which may well help to support US consumer spending over the summer months, in the absence of a sharp rebound in crude prices. The wholesale price of fuel, which is priced in dollars, has also fallen in Europe since mid-May, but the impact has been diluted by two factors – the euro is weaker against the US currency, despite a rally of late, and the retail price in most European countries tends to be dominated by the tax component, which in Ireland currently amounts to around 84 cents a litre or some 56% of the total price. Consequently, Irish petrol prices are lower than a month ago but only by around 3 cents, or 2%. This illustrates why the US economy is more sensitive to oil prices than Europe, and may well grow faster than the euro area over the second half of the year. Oil prices are unlikely to fall substantially from here, however, unless the slowdown in global growth proves to be more substantial and prolonged.

*Dr. Dan McLaughlin*

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United Kingdom

# Soft data amid MPC debate about more QE

**Data indicates activity is slowing…**

Industrial production fell by 1.2% in April, which was not unexpected due to one off factors but still suggests that GDP in Q2 may be weak. The extra bank holiday due to the royal wedding and the effects of the Japanese tsunami on manufacturing saw seasonally adjusted manufacturing output fall by 1.5 per cent between March and April. In addition to the effects of the royal wedding bank holiday, we have seen evidence from all over the globe, including the UK, that supply chain disruption from the aftermath of the earthquake in Japan is seriously affecting manufacturing activity, particularly autos and electronics. A number of car manufacturers have provided feedback indicating that the after effects of the tsunami in Japan reduced production levels in April 2011, due to a lack of parts. The transport equipment sub sector fell by 4.1 per cent compared to March 2011, the largest month on month decrease since July 2010. Core retail sales also fell in May – by 1.6% - after a 1.2% gain in April, which once again is put down to a boost from royal wedding. Inflation is eating into real retail sales growth with the three month moving average showing the value of sale increased by 1.4% in May but the volume index increased by just 0.1%. The MPC had foreseen some of these problems and in the May minutes said that "temporary factors, such as the effects of the additional bank holiday associated with the royal wedding and supply chain disruption from the Japanese earthquake and tsunami, were likely to add some volatility to quarterly GDP over the coming quarters". However, the MPC is still expecting a 0.7% rise in Q2 GDP, as per the last Inflation Report, but industrial production in April is now 2% below the Q1 average, so in the absence of a surge in May and June, the Q2 change in industrial production may well be negative, which makes the MPC GDP forecast look optimistic. Added to evidence of softening activity in the latest survey data it points to modest GDP growth this year – the latest consensus forecast is for 1.5% growth.

**…as Bank of England hint more QE might be considered.**

As expected the Bank of England meeting in June concluded with the MPC staying on hold for the 19th consecutive month, keeping the base rate at 0.5% and the asset purchase scheme at £200bn. However, the minutes of the meeting revealed some interesting tweaks in the MPC's thinking. The committee voted 7-2 to keep interest rates on hold with new member Ben Broadbent siding with the majority after he replaced arch hawk Andrew Sentance at this meeting. Adam Posen, once again, voted to increase the asset purchase scheme by £50bn. The minutes were quite dovish with the Committee judging that the likelihood of upside risks to inflation materialising, while substantial, had changed little over the month but that the downside risks to the prospects for medium term inflation had increased over the month with the principal risk coming from lower than forecast demand due to weakening economic prospects. In addition, the minutes noted the current weakness of demand growth was likely to persist for longer than previously thought and that the problems in the Euro Area periphery highlighted the potential for further adverse shocks to demand. This has led to some of the members who voted to keep monetary policy on hold to agree that "it was possible that further asset purchases might become warranted if the downside risks to medium term inflation materialised". This is something that has not appeared in the minutes before and highlights that the initial tightening of policy may be pushed further and further out – the market has now pushed out the timing of the first hike until next May. Further quantitative easing is not on the agenda in the immediate future but its clear that it would become an option should much weaker growth materialise in the near term.

Europe

# ECB to hike again amid Greek woes

**Trichet says ECB in strong vigilance mode…**

The ECB kept its key interest rate unchanged at 1.25% in June but said that 'strong vigilance' is necessary in the context of continuing upside risks to inflation. Thus the ECB 'might' raise interest rates in July, according to Trichet at the post meeting press conference. The Bank, in its latest macroeconomic projections – published at the June meeting - revised up its forecasts for growth and inflation in 2011, to 1.9% and 2.6% respectively, but left largely unchanged its forecasts for 2012, at 1.7% and 1.7% respectively. It is interesting that notwithstanding a significant upward revision to the forecast for 2011 inflation over the past six months – from 1.8% to 2.6% - the forecast for 2012 has been left largely unchanged. This highlights that the recent spike in inflation is due mainly to higher energy costs and is expected by the ECB to be temporary, with no second round effects from the initial rise in headline inflation, which in turn suggests that the ECB will raise rates very gradually over the coming months. However, over the course of the month, several ECB members including chief economist Stark and President Trichet have used the term strong vigilance in speeches and advised that inflation expectations would be anchored. This language makes another 25bps hike in July a virtually certainty. This mirrors the timetable the ECB took during their last hiking cycle when they took a full 3 months between the early increases in the main rate before shorting the period between increases to two months. This time around, however, the market judges that the ECB will ease back on increases over the rest of the year.

**…as Greece continues to cause problems.**

The main issue in June has once again been Greece, rolling around to centre stage once again. It has become increasingly apparent that Greece will not be able to return to the markets next year as was planned under the terms of their original bailout deal. The Greek Government and the troika (ECB/IMF/EA) began discussions on a new aid deal but several members of the EA, most notably Germany, insisted that there would have to be some private sector involvement in the new deal which would involve debt investors agreeing to roll over debt that is maturing in the next couple of years. The EA also refused to sanction the next tranche of aid to Greece under the current deal as the pace of austerity measures implementation had been too slow. If a rollover was forced on holders of Greek debt or Greece did not receive the latest payment of aid then this would lead to a default by the country. This prospect reignited the debt crisis in Europe with peripheral yields widening to new record highs – Greek 2 year yields soared to over 28.6% - and the Euro fell against the dollar down to under $1.41 mid month from nearly $1.47 10 days earlier. However, a solution, for now, appears to have been reached with the Greek Government winning approval from Parliament for a new schedule of austerity measures as demanded by the EU. This allowed the EU to sanction the next payment of funds. In addition, French and German banks – which are the largest holders of Greek debt in Europe – may agree to a rollover of a significant portion of Greek debt which is maturing over the next number of years. This scenario may yet lead to credit agencies declaring that Greece has defaulted, however the rollover would satisfy German demands for some private sector burden sharing. This allows for a new Greek bailout deal to be put in place as the country returning to the bond markets at the end of the current deal appear, at this time, to be an impossibility. The markets reacted well to the likelihood of a new deal for Greece with yields on peripheral yields dropping in the last week of the month from their mid month highs. The Euro also took back some of its losses, rising to $1.45 against the dollar. This is also down to the likelihood of another ECB interest rate increase in July while, at the same time, the Fed remains happy to stand pat. This is likely not the last we have heard of Greece; at best the solution that is emerging can only push the crisis down the road another few quarters as the Greek economy remains in recession and there is little public or political consensus on the scale of austerity measures that have been promised to the EU.

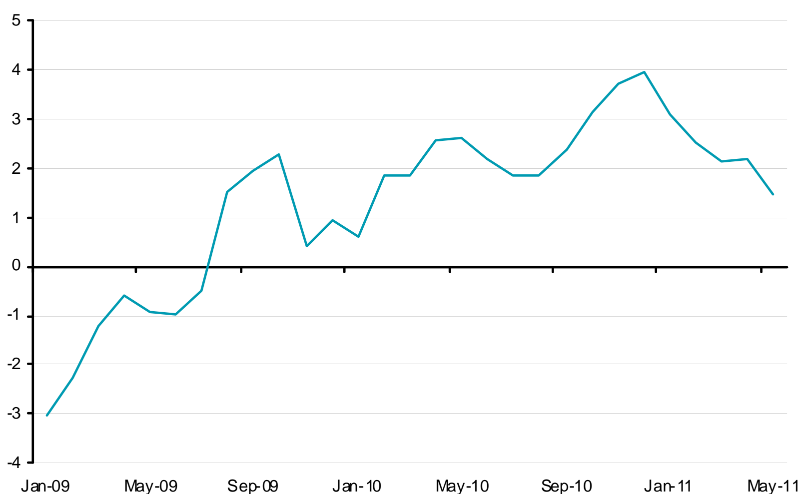
United States

# Sluggish growth continues

**Weak growth again in Q2….**

The period of sluggish economic growth has extended into the second quarter following a below-trend 1.9% increase in real GDP in the first quarter. Consumer spending in particular has remained very subdued having slowed to an annualised rate of growth of 2% in Q1 from 4% in the final quarter of 2010. The sharp rise in energy costs, notably gasoline prices, through to the middle of May has weighed heavily on households' purchasing power, with spending in real terms falling by 0.1% in both April and May. Given its share in GDP, the further slowdown in consumer spending in Q2, to around 1% or less it would seem, will also have weighed on overall economic growth in the quarter, with the consensus currently forecasting another increase in GDP of around 2%. The recent softening in labour market conditions has also had an effect on spending, with employment rising by just 54k in May and the weekly jobless claims data pointing to another modest increase in payrolls in June. The slowdown in spending is also reflected in a moderation in activity in manufacturing, which is evident in both the hard and soft data for the sector.

**Consumer Spending, % chg. 3m/3m (annualised)**




**…though Fed cites temporary factors…**

At its meeting at the end of June, the Fed said the economic recovery is continuing though at a somewhat slower pace than it expected, and that labour market indicators had also been weaker than expected. However, it still thinks the "*slower pace of the recovery reflects in part factors that are likely to be temporary, including the damping effect of higher food and energy prices on consumer purchasing power and spending as well as supply chain disruptions associated with the tragic events in Japan".* At the same time, the Fed also noted that inflation has picked up in recent months, mainly reflecting the higher prices for some commodities and imported goods as well as the supply chain disruptions, though it *"anticipates that inflation will subside…as the effects of past energy and other commodity price increases dissipate."*

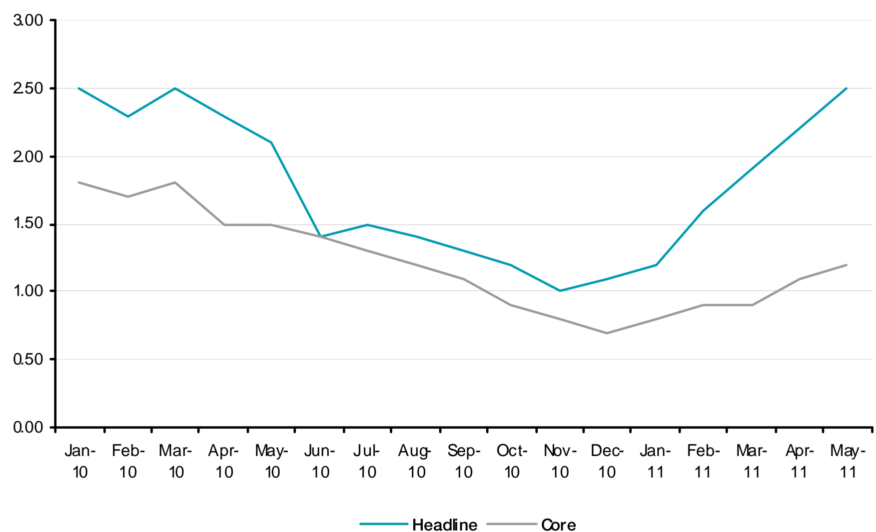
**…but still marks down 2011 and 2012 GDP forecasts…**

In its updated macroeconomic projections, released following the June meeting, the Fed revised *down* its forecasts for GDP growth in 2011 and 2012 relative to those made in April, to 2.8% and 3.5% respectively from 3.2% and 3.9%, and revised *up* its projection for the unemployment rate over this period though it is still expected to decline gradually through the remainder of this year and next (to 8% by end-2012 from over 9% currently). Regarding inflation, the Fed left its forecast for 2011 largely unchanged at 2.4% but revised up slightly its projection for 2012, to 1.8% from 1.6%. Reflecting some pass through from higher headline inflation into core inflation, it revised up its forecasts for the latter in both 2011 and 2012, to 1.7% in each of these two years (from 1.5% and 1.6% respectively).

**…and reiterates low rates warranted for extended period….**

In relation to monetary policy, the Fed reiterated that "*economic conditions…are likely to warrant exceptionally low levels for the federal funds rate for an extended period".* It also said it would complete the purchase of $600bn of longer-term Treasury securities by the end of June as planned and would continue with its existing policy of reinvesting principal payments from its securities holdings (not doing so would result in a contraction in the size of the Fed's balance sheet, which would represent a reduction in the degree of stimulus being provided to the economy). As regards the possibility of QE3, which the market has been speculating upon recently, the Fed chairman, Ben Bernanke, at his post-meeting press conference, gave no indication that the central bank is considering another program of securities purchases in response to the slowdown, though he did say it is an option that is available if necessary. However, Bernanke stressed that the current outlook is significantly different from the one the Fed was facing last August – when QE2 was first mooted – as the economy *"no longer had a deflation risk".*

**Annual PCE Inflation (%)**




**…though additional QE unlikely.**

Nevertheless, Bernanke did admit that the Fed does not have a *"precise read on why this slower pace of growth is persisting".* Hence, if the slowdown were to persist for even longer, or if it was to intensify, then dis-inflationary pressures in the economy would begin to build as the unemployment rate would in all likelihood start to rise again. In that situation, QE3 would be firmly on the agenda. However, there are some reasons to believe that the slowdown will prove temporary and that growth will re-accelerate over the second half of the year. In particular, the oil price has fallen sharply again in recent weeks and gasoline price are 10% off the peak in the middle of May. If this fall is sustained, and obviously if it extends further, consumer spending should pick up again over the next few months. If so, then employment should also pick up again, as uncertainty about the outlook for demand diminishes. It is also worth noting that business investment in plant and machinery has held up well during the recent soft patch in the economy generally.

A re-acceleration in the pace of growth would likely be accompanied by a rise in government bond yields and other market interest rates, including swap rates, particularly as there is plenty of scope for the market to bring forward the expected timing of the first Fed rate hike, which it now does not see until late 2012. A renewed rise in yields should also be accompanied by a further rise in the dollar, which notwithstanding the slowdown in growth is still off its early May lows both against the euro and on a trade-weighted basis.

## Economic Diary - July

## July

| | Europe | United States | United Kingdom |
|---|---|---|---|
| 1 | PMI Manufacturing, Employment data | Uni. Of Michigan Confidence, ISM Manufacturing | PMI Manufacturing |
| 4 | PPI's | | PMI Construction |
| 5 | PMI Services, PMI Composite, Retail Sales | Factory Orders | PMI Services |
| 6 | German Factory Orders | ISM Non-Manufacturing | |
| 7 | ECB Meeting, German Industrial Production | ADP Employment, Initial Jobless Claims | Bank of England Meeting, Industrial Production |
| 8 | | Non Farm Payrolls, Employment Data | PPI's |
| 11 | | | Nationwide Consumer Confidence |
| 12 | | NFIB Small Business Optimism | Inflation Data, RICS House Price Balance |
| 13 | Industrial Production | Minutes of the FOMC | Employment data |
| 14 | Inflation data | PPI's, Retail Sales,Initial Jobless Claims | |
| 15 | | Inflation Data, Industrial Production, Empire Manufacturing, Uni. Of Michigan Confidence | |
| 19 | ZEW Survey | Housing Starts | |
| 20 | Consumer Confidence | Existing Home Sales | Bank of England Minutes |
| 21 | | Initial Jobless Claims, House Price Index, Leading Indicators, Philly Fed | Retail Sales |
| 22 | Industrial New Orders, PMI's, IFO surveys | | |
| 25 | German Retail Sales | | Nationwide House Prices |
| 26 | | CaseShiller Home Prices, Consumer Confidence, New Home Sales | Q2 GDP First Estimate |
| 27 | M3 | Beige Book, Durable Goods | |
| 28 | Confidence Data | Initial Jobless Claims, Pending Home Sales | |
| 29 | HICP estimate | Q2 GDP First Estimate, Chicago PMI | M4 Money Supply |

Forecasts

# Bank of Ireland estimates

## Exchange Rates

| | Current | End Sep | End Dec | End Mar |
|---|---|---|---|---|
| EUR/USD | 1.43 | 1.45 | 1.40 | 1.40 |
| EUR/GBP | 0.90 | 0.90 | 0.90 | 0.90 |
| USD/JPY | 81 | 85 | 90 | 95 |
| GBP/USD | 1.60 | 1.61 | 1.56 | 1.56 |

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 | 1.25 | 1.50 | 1.50 | 1.75 |
| 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 | 2.00 | 2.25 | 2.50 | 2.50 |
| Eurozone | 2.75 | 3.00 | 3.25 | 3.25 |
| UK | 2.40 | 2.50 | 2.75 | 2.75 |

Source: Bank of Ireland Global Markets

## GDP and inflation (annual average)

| | 2011 | | 2012 | |
|---|---|---|---|---|
| | GDP | Inflation | GDP | Inflation |
| US | 2.7 | 3.0 | 3.1 | 2.0 |
| Eurozone | 2.1 | 2.5 | 2.0 | 2.0 |
| UK | 1.4 | 4.2 | 2.0 | 2.3 |

Source: Bank of Ireland Global Markets

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Market data supplied by Thomson Reuters

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