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TheBulletin

A monthly analysis of international and Irish markets

Dollar finds some support

- The dollar has suffered amid a global recovery
- But looks cheap on fundamentals

The US dollar has recovered some ground over the past few weeks following a pronounced depreciation since the spring. The US currency fell by an average 16% against the major currencies from its March high, with the New Zealand and Australian dollars rising by over 45% against the greenback over that period. The euro appreciated by 20%, rising from $1.25 to a high of $1.50 before falling back a little of late.

The factors driving currencies vary over time, making it difficult to disentangle short term speculatively-driven moves from more fundamental forces. In the dollar's case, for example, traders have built up a significant short position in the currency against the euro, which ultimately will be covered, so eventually boosting dollar demand. The US currency certainly looks cheap against the euro in terms of purchasing power parity (PPP), a theory which posits that currencies adjust to reflect relative inflation differentials, with countries experiencing high inflation likely to see their currencies decline. Estimates of PPP vary but the OECD put the euro/dollar PPP at $1.18 implying a very significant overvaluation of the euro. A simple version of PPP, the Big Mac index, which uses the respective price of that meal across countries, points to an even lower euro/dollar PPP, of $1.05, although history suggests that currencies can depart from PPP for long periods.

Proponents of a weak dollar often argued in the past that the scale of the US balance of payments deficit was dollar negative, although funding that deficit was never a big issue for the US. Moreover, the US BoP deficit has fallen sharply this year, to under 3% of GDP from 6% in 2006, yet the dollar is weaker now than it was then.

Short-term interest rates in the US are lower than most other countries, of course, and this may be a factor hurting the dollar, but a bigger influence appears to be market appetite for risk. The dollar's appreciation in the second half of 2008 (the euro/dollar rate fell from $1.60 to $1.25) was driven by risk aversion, it is argued, with investors seeking the perceived safety of US government bonds amid plunging equity markets. The dollar subsequently suffered as investors shifted back to riskier assets this year in anticipation of a global recovery. The dollar is negatively correlated with the US equity market, at present, falling if the S&P rises, lending support to the risk aversion view.

On that basis a dollar rally would be inconsistent with a further rise in equity markets but we suspect that the performance of the US economy and expectations about Fed monetary tightening will become more significant drivers of the US currency, particularly given the return to positive growth in the third quarter. Ultimately, currencies tend to reflect relative economic performance and it is not clear to us that the outlook for the US economy is worse than for the euro economy. Consequently, we still expect the euro/dollar to trade in a broad $1.40 to $1.50 range over the next six months.

Dr. Dan McLaughlin.

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United Kingdom

Tough call for MPC after unexpected fall in output in Q3

Sterling fluctuates as markets speculate about the future of QE…

Sterling has had quite a volatile month. It has depreciated rapidly against the euro, falling from £0.91 at the start of October to over £0.94 at times during mid-month. This was a six month high for the euro against the UK currency. Sterling fell on speculation that the MPC would further expand QE at their meeting in November. However, the release of the MPC minutes arrested the fall of Sterling and turned it around. The Committee, as expected, voted 9-0 to maintain the asset purchase scheme as it was. The minutes noted there were differences of opinion to the balance of risks to the medium term inflation outlook. However "all committee members agreed that recent developments were not sufficiently compelling to justify revising the target level of asset purchases …or change the level of Bank rate". The committee would asses the medium term outlook for activity and inflation more fully at the next meeting when they get the latest Inflation Report. This unanimous decision indicated that the chances were increasing that the Bank of England would finish the asset purchase scheme this month and put the programme on indefinite hold at their November meeting. Sterling was further strengthened after comments by the MPC's Fisher that the program may pause in November. MPC member Charles Bean backed up these comments saying that "quantitative easing is having the expected effects on the economy" and hinted that the program should be put on indefinite hold in November. Bean and Fisher voted for expanding QE by £50bn in August rather than a £75bn expansion that a minority of MPC members favoured.

…and Q3 GDP surprises to the downside…

However, the outlook has become less clear after the release of Q3 GDP data in late October. The macroeconomic data from the UK has been getting consistently stronger since the start of the summer. The service sector PMI has been above 50 since May and stood at 55.3 in September. The manufacturing PMI has also improved over the summer months and averaged 49.8 in the 3rd quarter indicating just a tiny contraction in the sector. The consumption side has held up reasonably well with retail sales growing in 5 of the past 6 months. Industrial production has disappointed - although it showed expansions in 3 of the 4 months to July – falling sharply in August, dropping by 2.5% on the month matching the monthly fall in January during the trough of the economic contraction. Apart from this the other indicators were pointing towards GDP growth in the third quarter with conditions in the labour and housing markets also appearing to improve. However, contrary to all of these indicators, GDP surprised to the downside registering a contraction of 0.4% quarter on quarter, when the consensus was for an expansion of 0.2%. The economy has shrunk for 6 consecutive quarters and it is now the longest recession on record. The service sector fell by 0.2% on the quarter, the industrial sector fell 0.7%, while the construction sector lost 1.1% on the quarter. This result was very disappointing due to huge amount of stimulus currently supporting the economy. The downturn still appears broad based and there is no one sector that is expanding. The Q3 outturn seems to echo the warning of BOE Governor King who has repeatedly said that the return to growth will not be smooth and painless.

…leaving the door open to a further expansion of QE.

Sterling fell sharply after that GDP data; it lost most of the gains it had made on the Euro since mid-month. It dropped from close to £0.90 against the single currency down to over £0.92 in the aftermath but it recovered to under £0.90 by the end of the month. The GDP outturn is adding to the argument for a further expansion to the asset purchase scheme. Up until then, the signs had been pointing towards pausing the scheme in November. However, each contraction in economic activity now is further enlarging the output gap and increasing the deflationary risk to the UK. This is the key point that King made when justifying the expansion of the asset plan in August from £125bn to £175bn. We think the probability is weighted towards suspending the asset purchase scheme in November but the weakness of 3rd quarter GDP means a further expansion could not be ruled out.

Europe

Economic recovery appears on track

ECB hold steady in October with outlook unchanged…

The ECB kept the main refinancing rate on hold at 1% at their October meeting. Trichet once again said that "rates are appropriate" and gave no hint that the ECB's medium term strategy was changing. On inflation, he said that the Governing Council's outlook had not changed and they considered the delivery of price stability to be essential and in that regard "the very solid anchoring of inflation expectations has helped us to avoid the materialization of deflationary risks. We had a much more solid anchoring, which prohibited the collapse of inflation expectations. We were considerably helped by the fact that there was no dramatic adjustment of inflation expectations downward. It is of course key for recovery." He struck a cautious note when talking about the economic outlook although he acknowledged the recent upturn in economic indicators. He said "we have ahead of us a bumpy road even if we are out of this period of freefall". He said the Governing Council had to remain cautious and prudent due to the high level of uncertainty despite the "signs of stabilisation". The role of policy makers at this time is to "anchor confidence, consolidate confidence" as it had evaporated. All in all, the message was steady as she goes from the ECB. They will not be in a hurry to raise rates anytime soon and the economy seems to be evolving in line with their thinking at this time, perhaps with the recovery starting a little ahead of schedule.

…despite increasing signs that economic growth will return before the end of '09…

On that note, the evidence is that Euro area economy will emerge from recession before the end of the year. The Purchasing Managers indices (PMIs) of activity in the euro area manufacturing and services sectors both bottomed in February of this year and have risen steadily since. They both advanced further in October according to the 'flash' readings, with the services index rising to 52.3 from 50.9 in September and the manufacturing index rising to 50.7 from 49.3. Based on the recent trend in the indices, it looks like the economy, at the least, stopped contracting in Q3 (following a decline of 0.2% in real GDP in Q2) and will expand in the current quarter, with a rise in real GDP of 0.3% to 0.4% possible assuming the current level of the PMIs is sustained through to December (they may well rise further, of course). So, after a downturn lasting 15 months, the economy seems now to be embarked on a recovery, though there is a lot of ground to be made up given that the fall in GDP in the downturn was over 5% from peak to trough.

…but euro strength remains a concern.

In his press conference this month, Trichet highlighted that events in the FX market were of concern to the ECB. He acknowledged the depreciation of the dollar is not helpful to the global recovery saying "Excess volatility and disorderly movement in exchange rates has negative implications for economic and monetary stability." He supported a strong dollar policy and said the statement of the US authorities on this policy "was extremely important in the present circumstances". These statements from Trichet and similar statements from Bernanke seem to have capped the euro's appreciation at $1.50. The continued strength of the Euro is dampening the prospects of euro area export gains as the global economy recovers. Despite policy makers statements they seem reluctant to intervene to strengthen the dollar. This correction will be left to the market where we think the dollar will appreciate – slowly – over the next year. European equities had an up and down month with the Eurostoxx hitting a yearly high on the 14th. However, it declined into the back end of the month leaving it at close to September's closing level by the end of October. Bond prices have also fallen with 10 year yields rising about 15bps from the start of the month leaving them at around 3.3%.

United States

Economy emerges from recession in Q3

GDP rises in Q3…

After contracting for four consecutive quarters the economy expanded in the third quarter, with real GDP rising at an annual rate of 3.5% following a decline of 0.7% in Q2. Consumer spending rebounded in the quarter, increasing by 3.4%, spurred by the government's 'cash for clunkers' scheme which boosted auto sales. Investment spending rose too, albeit modestly so, with a decline in non-residential construction offset by increases in both business equipment & software spending and residential construction, the latter marking the first increase in more than three years. *Net exports* (exports minus imports) made a negative contribution to GDP, the first in nine quarters bar one, as imports grew more quickly than exports, while inventories made a positive contribution via a slower rate of inventory liquidation than in Q2. Most forecasts see the economy expanding further over the coming quarters, albeit at a slower rate than in Q3.

…but Fed cautious about recovery…

At its September 22nd meeting, Fed members agreed that "economic activity had picked up following its severe downturn" and that a "recovery was under way"; indeed, members "revised up their projections for the second half of 2009 and for subsequent years". A number of factors were expected to support growth. These included the improvement in financial market conditions in recent months; the progress made by businesses in bringing inventories into better alignment with sales, which should lead to a further increase in production in many sectors; a recovery in the housing market amid a recent increase in activity and prices; and an improvement in the outlook for growth abroad. At the same time however, members thought that the "recovery was likely to be quite restrained", as credit conditions remain tight, consumers cautious in spending, and business cautious in hiring and investing.

…so interest rates to remain low.

While the "economy was projected to expand over the remainder of 2009 and during 2010", the Fed believed this was "unlikely to reduce the unemployment rate appreciably" and therefore the "substantial" slack in the labor market could lead to "subdued and potentially declining wage and price inflation". Because of this, the Fed judged that the "costs of growth turning out to be weaker than anticipated could be relatively high" and, accordingly, agreed that it was "appropriate to maintain its target range for the federal funds rate at 0 to 1/4 percent and to reiterate its view that economic conditions were likely to warrant an exceptionally low level of the federal funds rate for an extended period". There has been some chatter in the market lately that the Fed might water down this (conditional) commitment to keep rates low for a protracted period at its meeting on November 3rd/4th, but we don't believe this will be the case.

Government bond yields have risen over the past month, though they still remain comfortably within the ranges that have prevailed for the past six months. Swap rates remain range bound as well with the 5-year rate – at 2.75% - currently trading in the lower half of the 2.4% to 3.4% range in place since May (the range has been tighter – 2.5% to 2.9% – over the past couple of months). We expect swap rates to rise gradually over the coming months, in the case of the 5-year to around 3% by spring next year.

Dollar to trade in $1.40 – $1.50 range to the Euro.

October was a month of two halves for the dollar, at least against the euro. It fell from $1.46 to over $1.50 by the middle of the month, as equity markets advanced further, but then rose to around $1.48 as stocks retreated. Interestingly, once the dollar fell to around $1.50, it prompted some expressions of concern from US and European policy markers alike, so EUR/$ may find it hard to sustain a move above this level, even if stocks were to move higher again. In any case, we suspect that the performance of the US economy and expectations about Fed monetary tightening will become more significant drivers of the dollar, particularly given the return to positive economic growth in the third quarter. Currencies tend to reflect relative economic performance and it is not clear that the outlook for the US economy is worse than for the euro economy. Indeed, it may be better. Hence we expect EUR/$ to trade in a broad $1.40-$1.50 range over the coming months.

Range bound

Swap spreads have fallen from extreme levels…

Swap rates normally trade at a premium to Government bond yields with the size of that premium reflecting the fact that the counterparty to the trade is a bank and not a sovereign state. The premium, or swap spread, soared in the autumn of 2008, following the collapse of Lehman Brothers, but the past year has seen a substantial decline in swap spreads to more normal levels: the 5-year swap spread in US dollars has fallen to under 40 basis points from a high of 120, while the euro equivalent has declined to 35bp from 95bp. Sterling swap spreads have also fallen, from over 100bp over the past year to 55bp, but have risen from the lows probably reflecting the impact of the quantitative easing (QE) programme, which has driven government bond yields lower than would otherwise be the case.

Swap rates are therefore likely to be largely driven by bond yields in the near future and in turn these are strongly influenced by interest rate expectations, with the market currently projecting the onset of monetary tightening in the major economies in 2010.

…and swap rates now largely influenced by rate expectations…

In euros, for example, 3-month money in the futures market is trading at 1.95% for December 2010, against a current rate of under 0.6%, and at 3.32% for December 2012. These forward rates are volatile, of course, depending on ECB rhetoric and the flow of data, but have moved in a relatively narrow range in the past two months. Consequently, 5-year swap rates in euros have also traded in a relatively narrow range around 2.75%, our end-year target. The euro area recession is probably over but the ECB is unsure about the pace and durability of the recovery, and as such is not signalling the likelihood of any imminent tightening of policy. On that basis we still expect 5-year euro swap rates to trade around 2.75% over the next few months, before rising to around 3% in the first half of 2010.

Similarly in US dollars, the 5-year swap has traded in a narrow range over the past two months, this time around 2.70%. The US economy has emerged from recession judging from the third quarter GDP data but the Fed has said it will keep rates low for an 'extended period'. This rhetoric may well change in the months ahead, of course, and we still expect 5-year dollar swap rates to rise to 3.0% by the spring of 2010.

…although QE a factor in the UK.

In contrast to the other major markets, sterling swap rates have been significantly influenced by market expectations about the quantity of bonds to be purchased by the Bank of England, and sentiment in this regard has ebbed and flowed. The surprise fall in third quarter GDP has put the scale of QE back on the table and the upcoming MPC decision on that is a close call. On a longer time frame, however, we still feel that UK swap rates will rise and expect 5-year swaps to move up to 3.75% by the spring.

	Euro		Sterling		Dollar	
	End-Dec	End-March	End-Dec	End-March	End-Dec	End-March
2-year	1.85	2.25	2.00	2.25	1.35	1.60
5-year	2.75	2.90	3.50	3.75	2.75	3.00
10-year	3.60	3.80	4.00	4.25	3.65	3.90

Economic Diary

November

	Europe	United Kingdom	United States
1			
2	PMI Manufacturing	PMI Manufacturing	ISM Manufacturing, Pending Home Sales
3			Factory Orders
4	PMI Services, PPI's	PMI Services	ISM Non Manufacturing, FOMC meeting
5	Retail Sales, ECB meeting	Industrial Production, BOE Meeting	
6	German Factory Orders	PPI's	Non-farm payrolls, Unemployment rate
9	German Industrial Production		
10	ZEW Survey, French Industrial Production	RICS House Price Balance	
11		Unemployment, Bank of England Quarterly Inflation Report	
12	Industrial Production		
13	CPI, 3Q GDP, French & German 3Q GDP		University of Michigan Confidence
14			Retail Sales
17		CPI	PPI's, Industrial Production
18		Bank of England minutes	CPI, Housing Starts
19		Retail Sales	Philly Fed
22	Flash PMI's		
23		Nationwide House prices	Existing Home Sales
24	Industrial New Orders, French Consumer Spending, German IFO		3Q GDP, CaseShiller Home Prices, Consumer Confidence
25		3Q GDP	Personal Income and Spending, Durable Goods Orders, New Home Sales, Minutes of FOMC

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Dec	End Mar	End Jun
EUR/USD	1.480	1.45	1.45	1.40
EUR/GBP	0.8950	0.88	0.85	0.83
USD/JPY	90.95	95	100	105
GBP/USD	1.65	1.65	1.70	1.69

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End Dec	End Mar	End Jun
USD	0-0.25	0-0.25	0-0.25	0-0.25
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 Dec	End Mar	End Jun
US	2.74	2.75	3.00	3.25
Eurozone	2.81	2.75	2.90	3.10
UK	3.30	3.50	3.75	3.90

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2009		2010	
	GDP	Inflation	GDP	Inflation
US	-2.5	-0.5	2.6	2.0
Eurozone	-4.0	0.3	1.0	1.1
UK	-4.7	2.0	1.3	1.8

Source: Bank of Ireland Global Markets

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