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Bank of Ireland Global Markets

TheBulletin

A monthly analysis of international and Irish markets

Dollar falls as Fed changes tack

- Inflation now seen as too low in US
- ECB revises up growth forecasts

The US recovery is now over a year old but the pace of growth slowed in the second quarter, raising concerns for both investors and the Federal Reserve. Firms are still creating jobs in the US but not in sufficient numbers to make an appreciable dent in the unemployment rate, which has fallen at a glacial pace from 10.1% to the current 9.6%.

Unlike other central banks the Fed's mandate includes the maintenance of full employment and so the expectation has grown that they will increase their buying of Government bonds in an effort to push long term notes down further – additional quantitative easing in other words, or QE2 for short. The most recent Fed statement flagged this possibility but also included the belief that inflation is now too low in the US. Consequently, we now have two possible triggers for QE2 – a further period of sluggish growth or a series of weak inflation readings.

The market now also believes that the US will not start to raise rates till the spring of 2012 and this and the chance of QE2 has pushed longer term notes down to new lows – 2 year rates are now around 0.6%, for example, and this has put downward pressure on the US dollar.

A number of the US's trading partners are not prepared to see their currencies rise against the dollar, including Japan and China, but the euro area has no such policy. Moreover, economic activity surprised to the upside in Europe over the summer months and the ECB has revised up its forecasts of GDP and inflation for this year and next.

Consequently 2-year euro rates have risen to around 1.5% or 0.85% above dollar rates from a flat spread in late May. The net impact is that the euro has risen sharply against the US dollar, and we are revising our FX forecasts to take account of the new Fed policy on inflation. We now expect the euro to end the year around $1.35 with an upside risk although it is likely to fall back somewhat near term as it is very over-bought.

Dr. Dan McLaughlin

United Kingdom

MPC edges toward further quantitative easing

MPC considers more QE…

The MPC once again stood pat in September but there are increasing signs that further quantitative easing measures are being considered. We have seen from previous meetings that there is a wide range of views within the Committee. These range from Andrew Sentance, who has dissented at the past four consecutive meetings - voting for a 25bps increase on each occasion - to Posen who has said he thinks that further monetary easing should be undertaken and even that central bank-financed fiscal stimulus – which effectively is monetising part of the deficit – may be warranted if further quantitative easing is ineffective. The latest evidence suggest the economy has slowed from its relatively rapid pace in Q2, when real GDP rose by 1.2% from the first quarter, with the National Institute in the UK estimating growth moderated to 0.7% in the three months to August. The latter is still reasonably robust, and is broadly in line with the UK economy's longer-run trend rate of growth. However, the MPC is still likely to be concerned about the possibility of growth slowing further over the coming months, though it has to balance that against a situation where inflation remains elevated (although the Bank predicts it will ease to below the target of 2% in the medium term). The minutes of the September meeting cast further light into the debate. They showed the committee once again voted 8-1 to keep policy unchanged with Sentance as the lone dissenter. However, some amongst the eight believed "*the probability that further action* (i.e. additional asset purchases) *would become necessary to stimulate the economy and keep inflation on track to hit the target in the medium term had increased*". King has continually signalled that the MPC is prepared to act if further stimulus is deemed necessary. The signals coming from MPC members, bar Sentance, are now increasingly dovish. For the moment, the Committee is still in a wait and see mode and may be watching for a move from their contemporaries in the Fed, but the dovish nature of the minutes indicates they are keeping the door firmly open on the possibility of more asset purchases (QE).

…but, as usual, inflation surprises to the upside…

However, the fly in the ointment continues to be the stickiness of inflation. Once again, inflation data disappointed with the annual increase in the CPI unchanged at 3.1% in August when a small decrease was expected. The annual CPI rate did not drop due to a stronger than expected 0.5% increase in the index between July and August. This was down to a sharp rise in transport and clothing and footwear sub indices, which in turn were due to a rise in air fares and price increases across a range of clothing and footwear products. While this was a small disappointment, it should be noted that the Bank of England – in its August Inflation Report – said they did not expect any sizable drop in inflation between now and Q2 of next year with inflation expected to average 3% this quarter, and 3% in Q1'11 before dropping to 2.8% in Q2 of next year. While the Bank of England continues to maintain that the output gap will reduce inflation in the medium term, in the short term they could be arguing for further monetary easing at a time when growth is robust and inflation is well over the 2% target. Conventional wisdom suggests this would only further add to inflationary pressures but the full impact of QE takes some time to work its way into the real economy. Further QE measures now may well start to affect the real economy more than 12 months from now when the pace of inflation is expected to be declining.

…and Sterling loses ground vs. the Euro.

The increasing possibility that further QE will be announced has weakened Sterling over the past month. It hit a recent high of just below £0.82 to the Euro in late August but since that time has fallen to over £0.86. Sterling has been on a long term appreciation trend against the single currency for most of the past year, rising from just under £0.94 last October to a high of just under £0.81 in June. We think that the growth prospects for the UK are slightly stronger than in the EU and that Sterling will resume a long run appreciation path in the near future. However, the cross is bound to be volatile in the short term as the MPC hints at future measures and we don't rule out a further decline for Sterling against the Euro in the short term. In cable, Sterling has gained against the Greenback in the past month, rising to about $1.57 from under $1.54 at the start of September. The reason is that resuming monetary easing is also possibly on the Fed's agenda and this has depressed the dollar against most major currencies.

Europe

Peripherals under pressure

Ireland under pressure…

It's been another turbulent month for the European debt markets. Once again, concern over sovereign defaults has reared its head and put Euro area peripherals under further pressure. Irish yields have been under particular pressure with the yield on 10 year bonds rising from about 5.7% at the start of the month to close to 7% at times. The pressure on Irish yields is coming from the question mark over how much the final bill will be for State support to the banking sector. The underlying fundamentals of the economy and the public finances have not changed dramatically in the past month, so this open ended exposure for the sovereign did seem to be a key factor. There is more clarity over the Irish situation after the Central Bank completed their stress tests at the end of the month. This means that the bill for Anglo Irish and Irish Nationwide will be approximately €35bn of which over €25bn has already been provided. The next step will be for Ireland to renew its commitment to fiscal consolidation in Budget 2011.

...peripheral bond yield rise and rise…

Ireland is not alone and there are concerns for other peripheral debt markets. Portuguese yields have closely tracked Ireland's higher as it emerged that the Government's underlying deficit position does not seem to be improving. Spanish and Italian 10 year yields have also risen from the start of the month but it has to be said not on the same scale as the increase in Irish and Portuguese yields. In the meantime, diminishing risk appetite has meant that the bund rally has been more or less maintained this month, with 10 year bund yields at around 2.2%, which is only about 10bps away from record low yields. It remains to be seen if the situation will require any country to tap the European Financial Stability Fund (EFSF), or if the other peripherals will be able to get through the current turbulence. It is unlikely that the EFSF will be needed and with some clarity on the banking sector in Ireland as well as renewed austerity commitments from most peripherals in upcoming budgetary process for 2011, peripheral yields may start to ease back over the medium term.

…and so does the Euro.

The possibility of the Federal Reserve resuming quantitative easing measures has caused the Euro to sharply appreciate. The single currency jumped from around $1.26 at the start of the month to well over $1.36 at end September. The Euro has also been helped by the continued strength of Euro area data, particularly strong confidence data, which points to robust growth in the Euro area in the 3rd quarter of this year. The consensus forecast is still for growth to slow in the final quarter of the year and into 2011, but for now we don't rule out the Euro going higher in the short term. There is a significant upside risk for the Euro against the dollar should – as is increasingly likely – the Fed announces further quantitative easing at their November meeting. Over the longer term into next year, we see the Euro resuming a downward path vs. the Greenback (that was evident in the first half of 2010) as both economies experience slowdowns in their recoveries.

United States

Fed ready to act, if necessary, to support the recovery

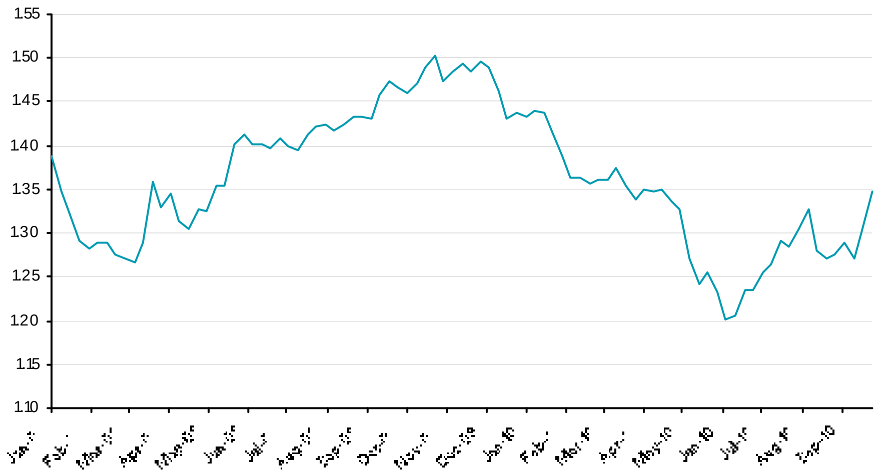
Dollar falls sharply against the euro…

Having risen sharply from $1.51 to $1.19 between the end of 2009 and the middle of 2010, the dollar has since lost substantial ground against the euro, trading down to $1.36 at the end of September. The earlier rise in the dollar reflected the combination of a pick-up in GDP growth in the US relative to that in the Euro area in the opening months of this year and, then, the eruption, and subsequent intensification, of the sovereign debt crisis in the latter over the period from April to June. Similarly, the rebound in EUR/$ since June reflects a moderation in the pace of economic growth in the US relative to earlier in the year, at the same time as activity in the Euro Area has picked up and has been firmer than many analysts thought likely at the height of the sovereign debt crisis. Concerns about the latter have not gone away and have weighed on the single currency intermittently since June (notably in August), but they have not been sufficient to prevent the single currency strengthening overall during this period.

….as Fed considers further monetary stimulus….

Ironically enough, the most recent data suggest that activity in the US may be starting to pick up again and activity in the Euro area beginning to moderate, though that has not arrested or reversed the dollar's fall. This largely reflects the respective positions (or prospective positions) of the Fed and the ECB. While the former has said that it is ready to provide further monetary stimulus if necessary to support the economic recovery in the US, the ECB is likely (given its past record) to be much slower, if at all, in indicating that it is prepared to do the same for the Euro area economy. Almost by default then, the euro may extend its recent gains in the short-term, all the more so as it has managed to breach $1.3510, which represented the 50% retracement of the single currency's fall from $1.51 to $1.19 over the first half of this year.

Euro/Dollar Exchange Rate



…amid slower growth…

In the statement published after its September 21 monetary policy meeting, the Fed said that "the pace of recovery in output and employment has slowed in recent months", as consumer spending remains constrained by high unemployment and modest income growth (because employers are reluctant to add to payrolls), business investment (in equipment and software) moderates from its rapid pace of growth earlier this year, and housing activity remains at "a depressed level". Looking ahead, the Fed said it expects the economic recovery to continue albeit at a modest pace in the near-term.

…and falling inflation.

In relation to inflation, the Fed said underlying inflation is "currently at levels somewhat below those the Committee judges most consistent…with its mandate to promote maximum employment and price stability". The latter is defined by the Fed as an increase in prices, over time, of between 1.7% and 2% a year. Over the period May to July, core consumer prices rose at an annualised rate of just over 1%, lower that the inflation rate the Fed would like to see on a sustained basis. However, the Fed said that while inflation is likely to remain subdued for some time, it does expect it to "rise to levels the Committee considers consistent with its mandate".

While bond yields head lower…

Given this outlook – for a modest recovery coupled with subdued inflation – the Fed reiterated that exceptionally low levels for the federal funds rate (currently 0.0% to 0.25%) are "likely to be warranted for an extended period". However, the Fed added that it is "prepared to provide additional accommodation *if needed* to support the economic recovery and to return inflation, over time, to levels consistent with its mandate". This preparedness to provide further stimulus elicited a marked response in markets. In addition to a large decline in the dollar, government bond yields also fell sharply, with the benchmark 10-year yield dropping by around 20bps to 2.5%.

…as market thinks additional QE very likely at Nov 2 meeting….

In truth, the September 21 statement more or less repeated what chairman, Ben Bernanke, had said in a speech on August 27, that the Fed is "prepared to provide additional monetary accommodation through unconventional measures if it proves necessary, *especially if the outlook were to deteriorate significantly*". The part in italics did not appear in the statement, though presumably it still applies. The data in September have generally been better than expected, and certainly better than over the June-August period. That said, the market seems to believe that additional monetary accommodation, and more precisely further 'quantitative easing" (QE), or asset purchases, is very likely, given the fall in bond yields that has followed the September 21 statement.

…but data between now and then could be decisive.

The Fed meets again on November 2-3, and many analysts think that is the likely date for it to announce additional QE (whether the proximity of the meeting to the mid-term elections creates a difficulty for the Fed remains to be seen). Certainly, market speculation regarding the possibility of such an announcement will be rife approaching the meeting and the dollar may well fall further in such an environment, with $1.40 to the euro a reasonable target now that $1.35 has been breached. One difficulty in assessing the likelihood of any action is trying to interpret what is meant by a significant deterioration in the economic outlook. If it means a further slowdown in growth, then the latest data, which point to some pick up in activity, would suggest there is no need for further QE. If it means continued economic growth but at a pace likely to be insufficient to bring down unemployment and prevent a further decline in inflation - something less than 2.5% perhaps - then the Fed may well act. In his August 27 speech, Bernanke said that the Committee "has not agreed on specific criteria or triggers for further action". Perhaps the Committee has still not come to any agreement. Perhaps the economic data between now and November will help to decide matters. We will have to wait and see.

Economic Diary

October

	Euro Areas	United Kingdom	United States
1	PMI Manufacturing, Unemployment, German Retail Sales	PMI Manufacturing	Personal Income & Spending, U of Michigan Confidence, ISM Manufacturing
4	PPI's		Factory Orders, Pending Home Sales
5	PMI Services, Retail Sales	PMI Services	ISM Non-manufacturing
6	2Q GDP, German Factory Orders		ADP Employment change
7	ECB Meeting, German Ind. Production	BOE meeting, Industrial Production	
8		PPI's	Non Farm Payrolls, Unemployment
12		Inflation data, RICS House Price Balance	Minutes of FOMC
13	Industrial Production	Unemployment data	
14			PPI's
15	Inflation data	Consumer Confidence	Inflation data, Retail Sales, U of Michigan Confidence
18			Industrial Production
19	ZEW surveys		Housing starts
20		Bank of England minutes	Beige Book
21	Consumer confidence	Retail Sales	Leading Indicators, Philly Fed
22	IFO Surveys		
25	Industrial New Orders		Existing Home Sales
26		3Q GDP, Nationwide House Prices	Case/Shiller Home prices, Consumer confidence
27			Durable Goods Orders, New Home Sales

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Dec	End Mar	End Jun
EUR/USD	1.37	1.35	1.35	1.30
EUR/GBP	0.86	0.85	0.84	0.83
USD/JPY	83.4	85	85	90
GBP/USD	1.58	1.59	1.59	1.57

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	1.0	1.0	1.0
GBP	0.50	0.5	0.5	0.5

Source: Bank of Ireland Global Markets

Swap rates: 5 year

	Current	End Dec	End Mar	End Jun
US	1.50	1.50	1.50	1.75
Eurozone	2.00	2.00	2.25	2.50
UK	2.05	2.15	2.35	2.65

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2010		2011	
	GDP	Inflation	GDP	Inflation
US	2.7	1.6	2.5	1.5
Eurozone	1.6	1.5	1.4	1.6
UK	1.6	3.1	1.9	2.6

Source: Bank of Ireland Global Markets

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Market data supplied by Thomson Reuters