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Bank of Ireland Global Markets

TheBulletin

A monthly analysis of international and Irish markets

Ireland's Sovereign Debt

- IMF monitors net debt, not gross debt
- Ireland's gross debt ratio set to rise further

Ireland's gross national debt stood at €110bn at the end of 2010, with €90bn in the form of government bonds. The net figure, which takes off cash balances, was €93bn, and it is this figure, further adjusted for liquid assets held by the National Pension Fund, which the IMF monitors as part of the current Irish Programme. The EU prefers a broader definition of sovereign debt, however, called General Government debt, and on that measure the Irish figure amounted to €148bn or 96% of GDP, with the difference largely due to the €31bn promissory notes for the state-owned banks. Ireland's debt ratio on that definition is now above the Euro norm (85%) but not dramatically so, as most countries have seen a substantial increase in debt – Germany's ratio has risen from 65% to 83% in the past four years.

Ireland's debt ratio is set to rise further, however, and recent developments mean that the debt burden may now peak at a higher level than previously projected, as outlined in a revised Stability programme published recently by the Department of Finance. The Department had expected the debt ratio to rise to 99% this year and to peak at 103% in 2013, but now forecasts 111%, rising to a peak of 118%. In cash terms the debt total is forecast to end the year at €173bn, or €25bn higher than 2010, reflecting the Budget deficit and some €10bn to cover the costs of additional bank recapitalisations.

The interest rate on the debt is also expected to be higher than initially projected and another factor underlying the change in forecast relates to the economy – the level of GDP over the next few years is now expected to be lower than previously thought, and forecasts for real economic growth have also been revised down for this year and next. The Department has halved its 2011 growth forecast to 0.8% (and as such now similar to our own 0.5%) and expects 2.5% next year, from an original 3.2%. The net result is that the General Government deficit this year is now expected to be higher than projected last December, at 10% of GDP, instead of 9.4%, with the 2012 deficit also revised up, to 8.6% from 7.3%. The latter still incorporates the €3.6bn fiscal adjustment originally envisaged so for the moment the divergence from the original plan is not producing any additional policy measures, with the deficit falling below 3% of GDP in 2015 rather than 2014. The Government has also announced its intention to produce a Jobs Initiative package later this month, but this will be budgetary neutral according to the Stability Programme update.

Dr. Dan McLaughlin.

United Kingdom

Tightening cycle put off after Q1 data

MPC staying on hold…

The MPC decided to stay on hold, once again, at their May meeting. Earlier this year, the May meeting had been pinpointed as one of the potential times that a hiking cycle could begin. However, the data received during the first quarter has pushed back the timing of any monetary tightening and the market is now not pricing in an increase in interest rates until 2012. To begin with, UK CPI inflation data surprised to the downside. The annual CPI rate fell to 4.0% in March from 4.4% in February, the first time the annual rate of inflation has fallen since last June. The fall in the price of food was the most significant contributor to the decline in the annual rate, contributing 0.2% points or half of the 0.4% points change from the annual rate in February. This unexpected decline in the rate of inflation means the Q1 average is 4.1%- exactly in line with the Bank of England's last inflation report forecast. It also means that while the inflation rate could creep up in the coming months the likelihood of it hitting 5%, as was feared by some MPC members, is now reduced. March's inflation outturn also takes some tension out of the next couple of MPC meetings. The members of the committee who favour staying on hold are likely to be somewhat relieved by this latest data and it takes some wind out of the sails of the hawkish members.

…after weaker inflation data and modest growth in Q1…

On the growth side of the equation, GDP in the first quarter advanced by a modest 0.5%.This reversed the 0.5% contraction recorded in Q4 last year. Services sector output rose by 0.9% in Q1, slightly above its longer-run trend rate of growth, while manufacturing output rose by 1.1%, again above its long-run trend. However, industrial output overall rose by only 0.4%, due to a fall of 3.5% in the utilities sector, and the construction sector fell sharply, by 4.7%. The MPC had warned about these factors depressing GDP stating previously that "indicators of output in the manufacturing and services sectors pointed to reasonably healthy growth…first-quarter GDP growth was likely to be pushed down…by the impact of large falls in energy and construction output that were unlikely to be repeated". While these negative factors suppressed growth in Q1 it could bode well for the future as underlying growth in the economy was probably somewhat healthier than the headline figures suggest. However, there are also significant risks to the downside as personal consumption and government spending could be hampered by negative growth in real earnings and sharp fiscal austerity measures in the coming quarters. The PMI data in the first month of Q2 pointed a softening of the expansion in both services and manufacturing and indicates the domestic economy recovery may be losing some momentum.

…as market pushes out first hike to 2012.

The market has now totally discounted the possibility of a rate increase this year and is pushing out the timing of the first interest rate increase into 2012. However, while GDP growth was modest in Q1, the rate of inflation does still remain 2% points above the Bank of England target rate so while this data does remove some of the pressure on the MPC to start monetary tightening immediately, it is unlikely to assuage any of the 3 dissenting hawk's view that rates need to rise. In fact, arch hawk Sentance, who has consistently been voting for a rate increase for some time, believes the slowdown in inflation may be short-lived, and also dismissed the significance of the growth data in Q1, and said the weakness of the pound would push up inflation towards 5% in the near term. The pound has fallen recently on the wider interest rate differential between the Euro area and UK interest rates. Sterling has fallen to it lowest level in over a year to the Euro, over £0.90 from under £0.85 in February. Sentence, who is due to end his term in the MPC this month, has said he believes that there is further upward pressure to come on inflation as the UK is being affected by more imported inflation than it would have if the pound was a bit stronger and therefore that will reinforce the squeeze on consumer spending. In advance of the May meeting, he said that he had not seen anything since the April meeting that would change his basic position that there should be a gradual increase in rates. However, it seems that the hawks are likely to be in the minority for some time as, for the majority of the committee, the Q1 data vindicates the view that now is not the time to raise rates.

Europe

July may see next rate increase

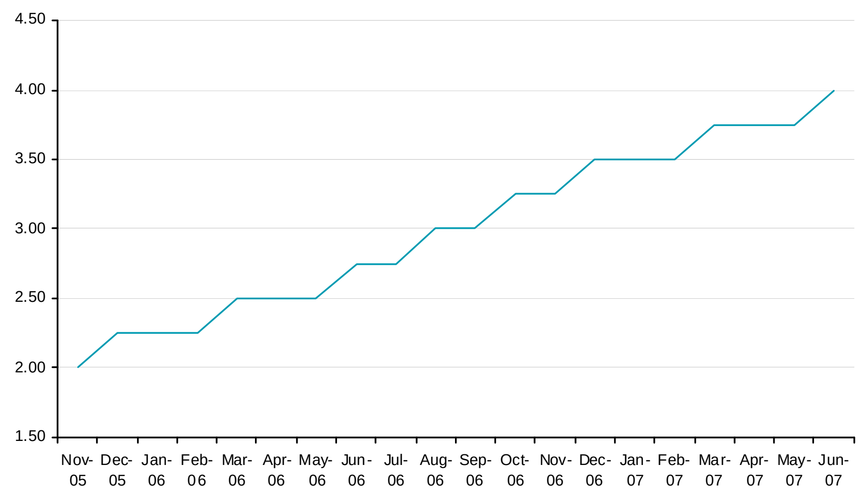
ECB raise interest rates to 1.25% in April…

The ECB, as expected, hiked their main interest rate by 25bps at their April meeting. In many ways, this was a non event as the move was widely flagged since the March meeting and ECB President Trichet's rhetoric in the April press conference was only moderately hawkish as the market was also expecting. Trichet said the ''adjustment of the current very accommodative monetary policy stance is warranted in the light of upside risks to price stability'' while ''monetary analysis indicates that the underlying pace of monetary expansion is still moderate, monetary liquidity remains ample and may facilitate the accommodation of price pressures''. Anchoring inflation expectations is a ''prerequisite for monetary policy to contribute to economic growth in the euro area. At the same time, interest rates across the entire maturity spectrum remain low. Thus, the stance of monetary policy remains accommodative and thereby continues to lend considerable support to economic activity and job creation. Recent economic data confirm that the underlying momentum of economic activity continues to be positive, with uncertainty remaining elevated''. This type of statement is very much in line with what we were expecting; indeed it's probably what you would expect the ECB to say at the start of any tightening cycle. What the market was looking for was an indication of when the next hike may be coming. Trichet said the Governing Council ''did not decide it was the first in a series of interest rate increases, as you know from our own doctrine that we always do what is necessary to deliver price stability over the medium term''.

…next move likely in July…

Of course, saying they did not decide it was a start of a series of hikes is not the same thing as saying it is not the start of a series of hikes. Trichet included in his April statement that the ECB will continue to "monitor very closely" all developments with respect to upside risks to price stability. Use of the phrase "monitor very closely" has, in the past, come two to three months before an interest rate increase. The ECB does not commit to pre announced increases but the language used at both April and May press conferences certainly points to another increase in rates, possibly in July. At the May meeting, where the ECB stayed on hold at 1.25%, Trichet repeated much of what was said in the previous month including the phrase 'monitor very closely' indicating they would stay on hold again in June but another increase in July is possible. Most statements from ECB members in the two months since the ECB indicated in March that a hike was coming have made it clear that rates are going to normalise. While there is no specific timeline in place, it is also clear that the "normalisation" would proceed in an orderly fashion so Trichet's indication in the April and May press conferences that another hike is coming in the near future is really not unexpected and the market has already been pricing in several interest rate increases in this calendar year. During the last hiking cycle, the ECB increased rates by 25bps every 2 to 3 months. The Euro has increased sharply since February as not only is the market pricing in further Euro area interest rate increases, it is pricing out the possibility of interest rate hikes in 2011 in both the US and UK. The wider interest rate differential opening up between the Euro and the Dollar and Sterling has pushed the single currency to fresh annual highs of $1.49 and 90p respectively.

Last ECB tightening cycle starting December 2005



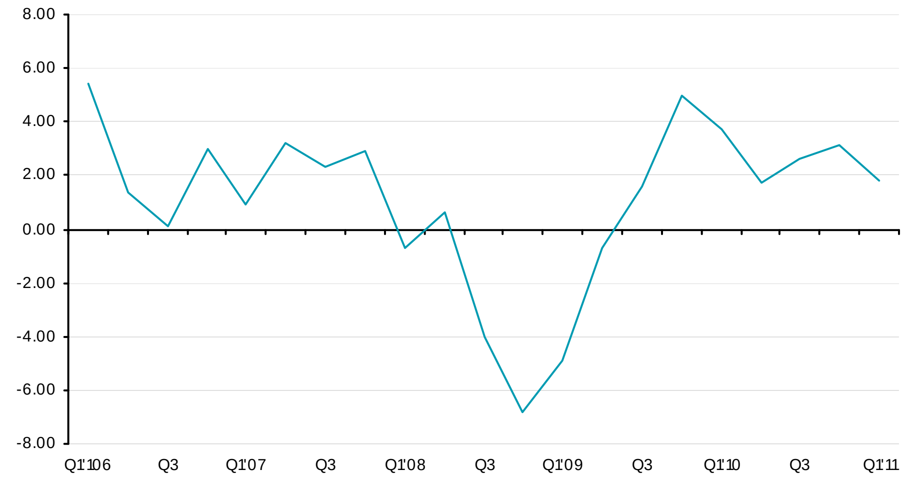
United States

Growth slows in the first quarter

Growth slowdown in Q1…

Economic growth slowed in the first quarter of this year, according to data published in late April, with GDP rising by 1.8% at an annual rate after increasing by 3.1% in the final quarter of 2010. *Real* consumer spending growth moderated to 2.7% from 4%, as rising gasoline prices dampened spending on other good and services. There has been no respite from rising gasoline prices at the start of the second quarter, with April seeing a further increase which will impact on households' purchasing power. Still, the increase in spending in Q1 was broadly in line with its historical trend rate of growth, with this relative resilience in the face of rising energy costs attributable to an improvement in labour market conditions. Amongst the other components of GDP, business investment on equipment and software picked up from the final quarter of 2010, but both residential and non-residential construction fell. The fall in construction activity was partly bad weather-related however, so there may be some positive payback for this in Q2. Government spending also fell in Q1, though there was a particularly large decline in Federal defense spending which may not be repeated.

US GDP Growth (%, annual rate)



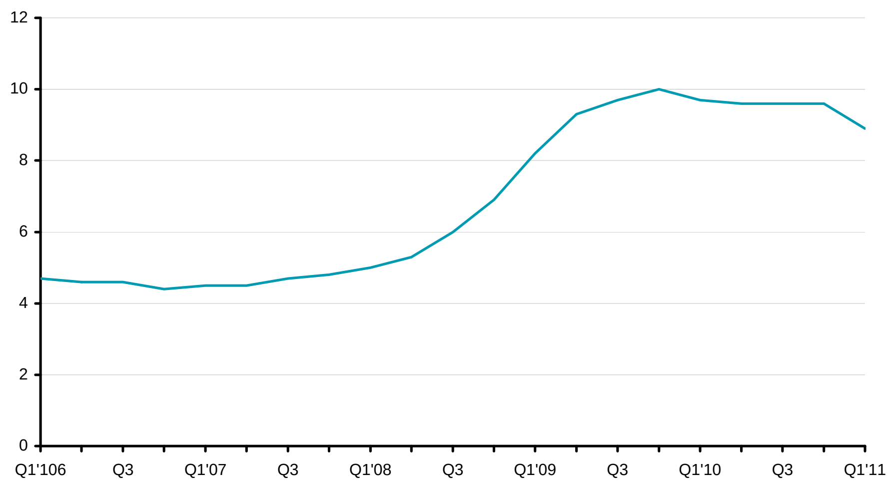
…may prove temporary…

We think the first quarter moderation in economic activity will prove temporary, with growth likely to rebound to a 3%-plus pace in Q2. In addition to the exceptional factors that depressed growth in Q1, it is noteworthy that labour market conditions improved in the first three months of the year *notwithstanding* the slower pace of economic activity. Private sector employment increased by an average of 188k a month, up from 146k a month in the final three months of 2010, while the unemployment rate fell to 8.9% from 9.6%. Moreover, the Purchasing Managers indices of activity in the manufacturing and services sectors both *rose* further in Q1 and in April remained at levels that, combined, would be consistent with slightly above-trend GDP growth.

…but Fed says exceptionally low interest rates still warranted…

April's Fed meeting marked a new departure for the central bank in terms of how it communicates with the public and the markets, as for the first time ever its chairman held a press conference following the meeting. However, the message regarding the outlook for monetary policy was unchanged from what had gone before. The Fed said the economic recovery is *'proceeding at a moderate pace'* and that '*conditions in the labour market are improving gradually'*, while inflation '*has picked up in recent months'* largely due to rising commodity prices. However, the Fed expects this rise in 'headline' inflation to be transitory and, with underlying inflation (i.e. excluding energy and food prices) still somewhat low and the unemployment rate still high relative to the levels it would like to see prevail over the medium-term, again said that *'exceptionally low levels of the federal funds rate are likely to be warranted for an extended period'.* The Fed also said it would complete its $600bn asset purchases program (QE2) by end June as planned and continue to re-invest the proceeds of maturing mortgage backed securities (purchased under QE1) in US government bonds. The latter means that, even though the Fed will no longer purchase government bonds post June, it will *maintain* the size of its balance sheet constant and hence keep in place the extraordinary degree of stimulus injected into the economy over the past 2.5 years.

US Unemployment Rate (%)



...as unemployment still too high and underlying inflation too low...

In its updated macroeconomic projections, which were presented at the April press conference, the Fed revised down its forecast for GDP growth in 2011 to 3.2% from 3.7% previously, mainly because of the weak Q1 outturn, but left its projections for 2012 and 2013 largely unchanged at just shy of 4% in each of these two years. It also revised *down* its forecast for the unemployment rate this year, to 8.6% from 8.9%, reflecting the sharp decline in the first quarter. While the Fed expects the unemployment rate to fall further in 2012 and 2013, it is still projected to be around 7% at the end of this period, which is *above* the 5.5% rate the central bank believes is consistent with a 'fully employed' economy. Meanwhile, headline inflation is expected to average 2.5% this year, up from 1.7% in 2010 (though underlying inflation is expected to be about 1% point lower at 1.5%), but is forecast to fall back to 1.6% in 2012 and to average 1.7% in 2013, the latter at the bottom end of the 1.7% to 2% range the Fed believes is consistent with price stability over time.

...contributing to a further fall in the dollar.

In response to the Q1 growth slowdown and the monetary policy 'guidance' from the Fed, the market has *pushed back out* the timing of the *expected* first increase in the federal funds rate to June 2012 (from early 2012 previously). This has resulted in a fall in government bond yields and other market interest rates since early April and a sharp decline in the value of the dollar, both on a trade-weighted basis (by more than 3%) and against the euro (almost 5%). Though the ECB raised interest rates last month, market expectations regarding the likely path of ECB rates in 2011 have *not* changed much at all from those that prevailed immediately prior to the meeting. Hence the move higher in EUR/$ is largely attributable to the change in market expectations regarding US interest rates. It follows that for the dollar to recover ground against the single currency there needs to be another shift in US rate expectations i.e. the market needs to price in an earlier Fed rate hike(s) than is the case currently. A rebound in economic growth accompanied by further gains in employment and a continuing decline in the unemployment rate is probably necessary to bring this about. We think this is what will unfold and hence we think the dollar will strengthen gradually towards $1.40 over the remainder of this year, though in the near-term the trading range for EUR/$ is likely to be $1.45 to $1.50.

May

	Europe	United States	United Kingdom
2	PMI Manufacturing	ISM Manufacturing	
3	PPI's	Factory Orders	PMI Manufacturing
4	PMI Services, Retail Sales	ADP Employment, ISM Non Manufacturing	Nationwide House Prices. PMI Construction, Money Supply Data
5	ECB meeting, German Factory Orders	Jobless Claims	PMI Services, BoE MPC meeting
6	German Industrial Production	Payrolls, Unemployment	PPI's
10		NFIB Small Business	RICS House Price Balance
11			BoE Inflation Report
12	Industrial Production	Jobless Claims, PPI's, Retail Sales	Industrial Production, NIESR GDP estimate
13	Q1 GDP	Inflation Data, U. of Michigan Confidence	
16	Inflation data		
17	ZEW Survey	Housing Starts, Industrial Production	Inflation data
18		FOMC Minutes	Bank of England Minutes, Unemployment
19		Jobless Claims, Existing Home Sales, Philly Fed, Leading Indicators	Retail Sales
24	Industrial New Orders, IFO Surveys	New Home Sales	
25		Durable Goods, House Price Index	Q1 GDP
26		Q1 GDP, Jobless Claims	
27	M3 Data, Confidence Data	Personal Income & Spending, U. of Michigan Confidence, Pending Home Sales	
31	Inflation Flash Estimate	Chicago PMI, Consumer Confidence, S&P CaseShiller Home Prices	

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Jun	End Sep	End Dec
EUR/USD	1.47	1.47	1.45	1.40
EUR/GBP	0.89	0.89	0.87	0.85
USD/JPY	80	80	85	90
GBP/USD	1.64	1.64	1.66	1.65

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	0-0.25
EUR	1.25	1.25	1.50	1.50
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	2.10	2.25	2.50	3.00
Eurozone	3.00	3.00	3.25	3.25
UK	2.65	2.75	3.00	3.25

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2011		2012	
	GDP	Inflation	GDP	Inflation
US	3.1	2.3	3.1	1.9
Eurozone	1.7	2.5	1.7	2.0
UK	1.6	4.0	2.7	2.1

Source: Bank of Ireland Global Markets

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Market data supplied by Thomson Reuters