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Bank of Ireland Global Markets

TheBulletin

A monthly analysis of international and Irish markets

Dollar main beneficiary of market turmoil

- Flight to quality boosts Dollar
- Euro not weak across the board
- 50bp ECB rate cut likely near term

The recent pronounced deceleration in growth across the major economies, allied to the ongoing concerns about a Greek sovereign debt default, have prompted investors to cut back on risk and fuelled a high degree of volatility in financial markets. The Swiss franc normally benefits from such an environment but it has fallen sharply, following the decision by the Swiss authorities to set a ceiling for the currency against the euro, in order to prevent further appreciation and hence further damage to Swiss competitiveness.

This has left the Japanese yen and the US dollar as the winners in the currency markets over the past month, with the latter outperforming all the major currencies despite the Fed's commitment to keeping rates extremely low for the next two years and in the wake of an S & P downgrade. The recent US data has also generally been better than expected, indicating that growth in the third quarter probably accelerated relative to Q2, although it is unlikely to be strong enough to precipitate a significant increase in US employment.

The euro has fallen sharply against the dollar, to around €1.32 from €1.45 in early September, but despite the turmoil in the euro sovereign debt markets, the single currency has not fallen precipitously against the other major currencies. It has drifted lower against sterling, to below 86 pence, but has risen against the Swiss franc, the 'commodity currencies' and most emerging market currencies with the result that its trade-weighted index is still above its level at the end of 2010.

The euro's appreciation in the first half of 2011 was due to the ECB's hawkish monetary policy stance but that has now changed and we would not be surprised to see the repo rate cut from the current 1.50% back to 1% in the near term. That expectation has put downward pressure on the euro and in our view it is relative interest rates which have driven the currency rather than the sovereign debt issue. On that basis lower ECB rates may well keep the euro nearer $1.30 than $1.40 in the near term and our FX model also projects a lower euro/sterling rate of 85 pence.

Dr. Dan McLaughlin.

United Kingdom

MPC look set to increase asset purchases

Economic outlook continues to weaken…

The data continues to indicate that the economy is slowing; inflation, austerity measures, and weakening export demand have eaten into real growth rates. The services PMI was disappointing, dropped to 51.1 in August from 55.4 in July. Some of that could be put down to the riots in August but the underlying trend is quite negative. The manufacturing PMI is already below 50, so the composite PMI is at a 26 month low. The retail sales data for August continues to point to weakening consumer sentiment. Core retail sales (ex auto fuel) fell by 0.2% to leave the annual decline at 0.1%. This consumer retrenchment is not really a surprise given that household income growth cannot keep up with the rate of inflation. The volume level of retail sales is less than 0.2% above the average level in Q2 – indicating that there may be little contribution to growth in the 3rd quarter from the consumer. Industrial production fell in July, leaving the annual decline at 0.7% and indicating weakness in the manufacturing sector of the economy also. UK CPI inflation rose to an annual rate of 4.5% in August, just marginally up from the annual rate of 4.4% in July. There is unlikely to be any quick fall in the rate of inflation in the short term despite weaker growth in the economy. The annual rate of inflation is likely to rise even further in the coming months due to increases in utility prices. However, the BoE still sees the inflation rate slightly below the 2% target in two years time, so an increase in the short-term would not be enough to dissuade the MPC from increasing monetary accommodation if data shows the economy is slowing further. BoE 'dove' Adam Posen said, during the month, that he saw very few downsides now to the BoE increasing its asset purchases. Posen has been voting for a £50bn increase in asset purchases but said while the Bank should start with that size increase it would ultimately have to do up to £100bn more in purchases. He said if the Bank does not ''undertake simulative policy that the outlook calls for, then our economies and our people will suffer avoidable and potentially lasting damage''.

…as MPC look to increase asset purchases.

We had thought that the MPC would stay on hold in September but that some members would join Posen in calling for more asset purchases. The reality was slightly different with the minutes of the September MPC revealing that the vote remained the same as the previous month with 8 members voting to stay on hold while Posen continued to vote for further asset purchases. However, there was a notable change in tone in the body of the minutes and it's now clear that the MPC is on the verge of conducting further quantitative easing, possibly as soon as October. The minutes noted that recent indicators pointed to "materially weaker growth in the second half of this year than assumed in the August Inflation Report" and said that members "reviewed the range of possible policy actions available…to loosen monetary conditions were that judged appropriate". For most members, further asset purchases were the preferred option at this juncture, and they believed it was "increasingly probable that further asset purchases…would become warranted at some point". This is the key point in the minutes and is as clear a signal as a central bank could give that a policy change is in the offing. The question now is the scale and timing of the purchases. The continuing financial market upheaval and the weak data regarding the macroeconomic outlook means that there is an increasing possibility that the announcement will come at October's meeting with an additional £50bn of purchase authorised, in line with what Posen has been calling for.

Euro area

Europe in crisis

ECB searches for reverse gear…

It has been another tumultuous period for Europe. The ECB, at the start of the month, reversed their rhetoric and it now looks like interest rate cuts may be on the agenda. The debt crisis has reached another tipping point with Greek issues once again coming to the forefront as global leaders worry the crisis in Europe is destabilising the world economy. Meanwhile, the soft data from the Euro area continues to point to a further slowing in the pace of growth amid concerns that the region could be slipping into another recession. The September PMI readings were weaker than expected with manufacturing falling to 48.4 from 49 in August, while services fell sharply to 49.1 from 51.5. This left the composite PMI in September at 49.2 from 50.7; this is the first time since 2009 that the composite PMI has indicated a contraction in activity. The continuing weakness of the data is behind the ECB's reversal of policy at the start of the month. The ECB had been saying there were upside risks to the medium term outlook for Euro area inflation, hence justifying the two quarter point increases earlier this year. However, in August, its President, Jean-Claude Trichet, said the risks to inflation were 'under study' in the context of the Governing Council's September monetary policy meeting. This meant the ECB was shifting to a neutral assessment of the risks to inflation meaning the bank was about to, the very least, put interest rates on hold. In the event, after the ECB meeting, Trichet said that "the risks to the medium-term outlook for price developments (are) broadly balanced". However, the ECB also said the downside risks to Euro area economic growth had 'intensified'. Now, if the downside risks to growth materialise, it would mean that downside risks to inflation would then dominate (weaker than expected growth would imply weaker than expected inflation), in turn meaning the ECB should cut interest rates. Unusually, the central bank said "a very thorough analysis of all incoming data and developments over the period ahead is warranted", which signals a high degree of concern about the economic outlook, and might signal that the ECB is preparing the ground for a cut in interest rates. Moreover, the ECB stated explicitly that inflation should fall below 2% in 2012, thereby removing any obstacle to lowering interest rates, particularly in the context of downwardly revised forecasts for economic growth both this year and next.

…and rate cut looks highly likely.

Over the rest of the month the situation regarding the debt crisis has got considerably worse, with widespread concerns that the crisis will spread to Euro area banks against a higher probability of a Greece default. These concerns combined with the weaker data pointing to slower growth caused a fall in equities on both sides of the Atlantic with French banks in particular coming under scrutiny. There has also been a flight to quality with 10-year bund yields down to records lows. Peripheral debt has come under pressure but ECB purchases have, for the most time, limited the rise in peripheral yields over the month, with the notable exception of Greece. The concerns over Europe has contributed to a significant weakening of the Euro against the Dollar, falling to around $1.33 by month end from over $1.44 at the end of August. Given the turmoil in Europe over the past month, the Euro has actually held up well and may even get a boost if Euro leaders come up with credible solutions to the crisis. It remains to be seen what exactly the next stage for Europe is. The thorny issue of Greece will have to be tackled, either to proceed with further bailouts or to let the country default in an orderly manner while protecting creditor banks; either option will carry significant costs and the danger of further contagion to EU Member States and/or their banks. The reforms of the EFSF agreed in late July are still not fully ratified but may now be inadequate to deal with the escalating crisis. There remains opposition to many suggested solutions such as common Eurobonds or leveraging the EFSF. There may be discussions going on behind the scenes on solutions but it's not clear yet what form they may take. In the meantime, the focus is back on the ECB to ease policy to help the economy. While these other major central banks have really exhausted the interest rate cut route, the ECB's interest rates increases earlier this year – which now look very premature - does give them the room to cut rates now. The financial turmoil must be increasing the probability that the ECB will bring the rate cut forward – maybe as soon as the next meeting in October – and to increase the scale of the cut from 25bps to 50bps.

United States

Fed 'twists again'

Fed responds to growth slowdown…

In response to a slowdown in growth during 2011 and related downgraded forecasts for the economy, together with 'significant risks to the outlook', the Fed has attempted to loosen monetary and financial conditions in order to 'support the recovery'. At its August meeting it announced that economic conditions are likely to warrant exceptionally low levels for the federal funds rate 'at least through mid-2013', thus providing much more explicit guidance regarding the period over which rates are likely to remain at the current level (of effectively zero percent) than was the case with its previous statements that rates were likely to remain low for an 'extended period'. It also said it would consider the other policy tools available to it to promote stronger recovery at the September meeting and was prepared to employ these tools as appropriate. This led to heightened speculation in the market that the Fed would announce further stimulus, with 'Operation Twist', whereby the Fed would sell Treasury (i.e. government) securities with short remaining maturities and buy Treasury securities with longer remaining maturities, the tool considered most likely to be deployed (the Fed conducted a similar policy in 1961).

…by announcing 'Operation Twist.'

The September meeting duly delivered 'Twist', with the Fed announcing that, over the period to the end of June 2012, it would purchase $400bn of securities with remaining maturities of 6 years to 30 years and sell an equal amount of securities with remaining maturities of 3 years or less. According to the Fed, this is expected to put downward pressure on longer-term interest rates, which in turn will 'contribute to a broad easing in financial conditions' and thus 'provide additional stimulus' to support the economy. It also said it expected any rise in the yields on short-term securities from the sale of these securities to be small, given its commitment to keep the federal funds rate exceptionally low until at least mid-2013. In addition to 'Operation Twist', and in order to support conditions in mortgage markets, the Fed also said it would re-invest the proceeds of maturing mortgage-backed securities (purchased under its first 'quantitative easing' program) in mortgage–backed securities (up to now it had re-invested in Treasury securities), thus putting downward pressure on mortgage rates.

Bond yields have fallen…

Longer-term government bond yields, which had fallen as markets anticipated a Fed response to the slowdown in growth, have declined further since early August. The benchmark 10-year bond yield is down around 45bps to 1.85%, though it had been as low as 1.70%. Meanwhile, 2-year yields are largely unchanged from early August, although they too had fallen sharply in anticipation of Fed action. Swap rates have followed a similar pattern as government bond yields, with short-dated swaps (2- and 3-year) broadly unchanged from early August (albeit well down on earlier in the year) and longer-date rates lower (the 5-year, for example is about 25bps lower at just over 1.20%).

…though the dollar has risen.

The dollar might have been expected to come under considerable downward pressure as the Fed eased policy further, but it has actually risen by almost 4.5% on a trade-weighted basis over the past couple of months and has strengthened from around $1.45 to $1.33 against euro over the same period. Expectations that other central banks will also ease monetary policy in response to slowing growth have also built up, hence limiting any downside for the dollar, which has also benefited from a 'flight to safety' as the Euro area debt crisis has intensified. The latter, of course, has weighed heavily on the single currency, which might recover some ground if the authorities can eventually agree on a more robust response, involving inter alia, a leveraging of the EFSF and a re-capitalisation of European banks. In the meantime though, the euro is likely to remain under pressure.

Swap Rates

New cycle lows

The global economy has slowed this year, with the deceleration most pronounced in the major developed economies. That perception, and the risk of a slide into recession, has undermined investor confidence, with the ongoing uncertainty about a possible Greek sovereign debt default adding to risk aversion and market volatility. The resulting flight to quality has pushed swap rates to extremely low levels and the major central banks have also responded.

ECB likely to cut rates…

The ECB has recommenced the purchase of sovereign debt in the secondary market and is again injecting huge sums into the euro money market. Moreover, at its September meeting the Bank announced a policy u-turn, effectively adopting a bias to ease and abandoned its bias to tighten, having already raised rates by 50bp since April. As a consequence we now expect the ECB to cut rates by up to 50bp over the next few months, taking the repo rate back to 1%.

The market had been anticipating such a move but has become less convinced of late, particularly in the wake of a sharp rise in inflation in September. Consequently euro swap rates have risen from the recent lows, albeit modestly, but we do expect rates to stay around current levels for some time, implying 5-year rates at 2% or below and 2-year rates around 1.50%.

…with sterling and dollar swap rates also likely to stay low.

Sterling swap rates have also ticked up a little from the recent lows but again we do not expect this to continue. The latest MPC minutes reveal a committee worried about downside risks to growth and debating a range of further policy options, including a cut in the Bank rate. We don't expect this to materialise but a further round of Quantitative Easing looks very likely over the next few months.

In the US the Fed has stated that it is likely to keep rates at the current extremely low levels until mid-2013 and this has helped to anchor swap rates. In addition the Fed is now going to sell €400bn of its holdings of short-dated treasuries in order to purchase longer dated maturities in an effort to push longer term rates down further. This is likely to keep 5 and 10-year rates down in the near-term although ultimately rates will follow the economy so any pick-up in activity may well lead to higher longer term rates, regardless of 'Operation Twist'.

Swap Rates

	Euro		Sterling		US Dollar	
	End Dec	End March	End Dec	End March	End Dec	End March
2-Year	1.25	1.50	1.25	1.25	0.50	0.60
5-Year	1.85	2.00	1.75	1.75	1.20	1.35
10-Year	2.35	2.50	2.50	2.50	2.00	2.10

Economic Diary – October

	Europe	United Kingdom	United States
3	PMI Manufacturing	PMI Manufacturing	ISM Manufacturing
4	PPI's	PMI Construction	Factory Orders
5	PMI Services, Retail Sales	PMI Services, Q2 GDP Est	ISM Non-Manufacturing, ADP Employment Change
6	ECB Meeting, German Factory Orders	Bank of England Meeting	Initial Jobless Claims
7	German Industrial Production	PPI's	Non-Farm Payrolls, Unemployment
10		Industrial Production, RICS House Price Balance, NIESR GDP estimate	
11		Consumer Confidence	FOMC Minutes, NFIB Small Business
12	Industrial Production	Employment Data	
13			Initial Jobless Claims
14	Inflation Data		Retail Sales, University of Michigan Confidence
17			Industrial Production, Empire Manufacturing
18	ZEW Survey	Inflation Data	PPI's
19		Bank of England Minutes	Beige Book, Inflation Data, Housing Starts
20	Consumer Confidence	Retail Sales	Initial Jobless Claims, Leading Indicators, Philly Fed, Existing Home Sales
21	IFO Surveys		
24	Industrial New Orders		Chicago Fed Nat Activity Index
25		Q3 GDP Initial Estimate	Case-Shiller Home Prices, Consumer Confidence
26	German Retail Sales		Durable Goods Orders, New Home Sales
27	Confidence Data		Q3 GDP Initial Estimate, Initial Jobless Claims, Pending Home Sales
28			Personal Income & Spending, PCE
31	CPI estimate, Unemployment	Nationwide House Prices, Money Supply, Mortgage App	Chicago PMI

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Dec	End Mar	End June
EUR/USD	1.32	1.30	1.30	1.30
EUR/GBP	0.86	0.85	0.85	0.85
USD/JPY	77	80	80	85
GBP/USD	1.54	1.53	1.53	1.53

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End Dec	End Mar	End June
USD	0-0.25	0-0.25	0-0.25	0-0.25
EUR	1.50	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 June
US	1.20	1.20	1.35	1.50
Eurozone	1.90	1.85	2.00	2.10
UK	1.70	1.75	1.75	2.10

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2011		2012	
	GDP	Inflation	GDP	Inflation
US	1.60	3.00	2.20	2.10
Eurozone	1.60	2.50	1.00	1.80
UK	1.20	4.40	1.70	2.60

Source: Bank of Ireland Global Markets

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Market data supplied by Thomson Reuters