Produced by the Economic Research Unit
September 2011

Bank of Ireland
Global Markets

TheBulletin

A monthly analysis of international and Irish markets

Investors reassess Irish debt risk

- Significant fall in Irish bond yields
- Debt ratio may now peak at level lower than projected
- Bank recapitalisation cost State less than feared

August proved a turbulent month for financial markets across the globe. Investors pared risk in the face of a slowdown in global growth, notably in the major Western economies, and further uncertainty regarding sovereign debt in the euro area. Ireland proved an exception however, with strong foreign buying helping to push Irish sovereign bond yields sharply lower, both in absolute terms and relative to the rest of the euro area.

The yield on 2-year bonds is currently trading around 8%, having reached 22% in late July, and the 10-year benchmark yield is under 8.5% from 14%. The latter move has taken the spread over Germany to 650 basis points, from over 1100. Moreover, Irish 10-year yields are now well below that of Portugal, the other recipient of funds from the EFSF, having traded well above for most of the year.

A number of factors lie behind this implied reassessment of Irish risk by investors: the monthly exchequer returns continue to show the Budget deficit to be broadly on target, the interest rate on borrowings from the EU will now be lower than originally agreed and the cost to the State of the latest round of bank recapitalisations has been lower than generally expected. Some €35bn of Ireland's €85bn package agreed with the troika last November was earmarked for the banks but in the event €24bn was required; the State has injected around €17bn with the balance coming from private sector burden sharing or equity injection. The net result is that the sovereign debt ratio may peak at lower levels than many projected, and the NTMA has stated that it now expects the exchequer to be funded to the end of 2013.

Sentiment can swing sharply of course, and Irish yields have risen this week amid general risk aversion. The Minister for Finance has also stated that the risks to economic growth are on the downside. We share the current consensus view that the economy will show marginally positive growth this year but the available data still implies that any growth will be driven by the external sector, as domestic demand still appears to be very weak with consumer spending clearly in the doldrums. That dichotomy highlights that Ireland needs the current softness in global growth to be temporary rather than the precursor of a sharper downturn.

Dr. Dan McLaughlin.

United Kingdom

Bank of England may restart QE

Inflation report points to slowing growth…

There have been a number of publications from the Bank of England over the past month which indicate that a further round of asset purchases may be seriously considered by the MPC in the coming meetings. Firstly, the Bank published its latest quarterly inflation report at the beginning of August. The Bank revised down its forecast for GDP growth in the UK over the next couple of years and expects inflation to fall back to slightly below its 2% target in two years time, with these forecasts conditioned on the assumption that interest rates rise modestly from the current level of 0.5% over the period and that the stock of asset purchases (QE) remains at £200bn. Governor King cited the risks to the UK economy as coming from external sources and “intensifying” by the day. According to King, the Euro area debt crisis is the biggest risk to the economic outlook but he said there is “no reason” why the Bank should increase stimulus right now though he made it clear that the Bank would consider further asset purchases if it was deemed necessary.

…as King warns of market turmoil…

Secondly, Governor King had to send yet another letter of explanation to the Chancellor after July’s CPI inflation print of 4.4%, because another three months have passed since the last letter and inflation remains far above the target level. King identified the usual suspects for the elevated level of inflation: the increase in the standard rate of VAT to 20%, and past increases in global energy and import prices. Interestingly, King also sounded some warnings regarding the market volatility since the August meeting of the MPC, with the letter noting that “there have been significant movements in financial asset and energy prices since the time of that meeting….and the MPC will… consider their implications for the inflation outlook at its meeting in September.” The letter also notes that there are downside risks to growth with “Recent developments in world stock markets and in the euro area are of particular concern.”

…and MPC votes unanimously to keep rates on hold.

Thirdly – and most importantly - that more dovish tone continued when the minutes from that August MPC meeting were published. Those minutes showed that the Committee voted 9-0 to keep rates on hold as the two dissenting members (Dale and Weale) who had been voting for a hike changed their votes. This was not totally unexpected given that data has been somewhat softer over the recent months and points to a weaker growth outlook for the UK. While just one member (Posen) at the moment continues to vote for an increase in asset purchases, the minutes did note that “Some members considered whether there was a case for increasing the degree of monetary stimulus by undertaking a further programme of asset purchases. Those members concluded that the case was not yet strong enough, particularly in light of the lower path for Bank Rate now implied by financial markets. Further asset purchases might nonetheless become warranted were some of the downside risks to materialise". It is thought that while just one member voted for more QE last time out there are a number of members, including the Governor, who may be close to switching their vote to support more asset purchases. If the events since the last meeting is any determinant then the chances of more QE are rising as both the hard data and soft survey data are indicating a slowdown in growth.

ECB changing course?

ECB may alter policy stance…

Since the start of this year the ECB has said the risks to inflation in the Euro area are on the upside, hence justifying the two 25bps increases in official rates in April and July. However, it now seems set to change its assessment of the risks to inflation in light of a recent slowdown in growth and the more uncertain outlook for the economy. At a hearing of the Committee on Economic and Monetary Affairs of the European Parliament, ECB President, Jean-Claude Trichet, said the "risks to the medium-term outlook for price developments are under study in the context of the ECB staff projections that will be released early September". Those projections may show a downward revision to the growth forecasts for this year and next, in light of "weakened economic prospects" in the United States and the "recently re-emerged tensions in financial markets". If this is indeed the case, then at the very least the ECB should shift to a neutral assessment of the risks to inflation (i.e. the upside and downside risks are balanced) which in turn means at the very least the ECB will now put interest rates on hold. The market, though, is pricing in a cut in interest rates over the next few months. With the Fed having promised to keep rates unchanged to 2013 and some initial signs that the BoE may restart QE, a rate cut by the ECB would certainly not be out of kilter with other central banks policies.

…as data points to slowdown in growth…

The data from Europe over the past month has been poor, with the hard data showing a weak quarter in Q2 with the survey data pointing to continuing weak growth in Q3. German GDP data showed that growth nearly stalled in Q2 rising by just 0.1%. Imports rose more than exports in the quarter which meant that net exports impacted negatively on GDP growth. Private consumption and construction were also weak and pulled down growth. On the positive side, business investment did rise. Germany had been outperforming the rest of Europe and had been the driver of growth in the Euro area as a whole. This weak quarter had a knock on effect for Euro Area Q2 GDP which rose by just 0.2% down from a growth rate of 0.8% in Q1. The data paints a picture of weakening consumer demand and slowing export growth throughout the Euro area. The PMI's up to this point in Q3 certainly confirm a poor growth outlook with the manufacturing PMI in August slipping below 50 for the first time since September '09 and indicating the sector may be contracting in the face of weakening global demand. The services PMI has also fallen in the past number of months but has managed, so far, to stay above the key 50 expansionary reading. The outlook for Q3 is not good on these measures with the composite PMI averaging 50.9 in the first two months of Q3 compared to an average reading of 55.6 in Q2. The risks are to the downside for growth in the Euro area with the global recovery slowing and further austerity measures due to be implemented by most Member States so the picture doesn't look too good for growth in the second half.

…and peripherals still need support.

With the deal to expand the powers of the EFSF yet to be formally ratified by all EA parliaments it was left to the ECB to intervene in the bond markets to support peripherals. The ECB was forced to restart its Securities Market Program (SMP) after yields on Spanish and Italian debt climbed, with 10-year yields getting above 6% in early August for both of those countries. The renewed buying by the SMP has been relatively successful with the 10-yields on Spanish and Italian debt quickly falling to around 5% for most of August. The ECB spent approximately €55bn purchasing sovereign debt in the first 4 weeks of the restarted program but yields on Italian and Spanish debt have begun to creep upwards again at the start of September implying that the ECB may have to step up the level of purchases in the coming weeks if the situation deteriorates. The decision by the ECB to restart the SMP was not unanimous and it remains to be seen if the ECB will continue the program if and when the EFSF is given the powers to purchase bonds itself. One notable out performer of the peripherals this month has been Ireland which has seen 10-year yields fall by over 5% to under 8.5% at times, due to renewed confidence by real money investors in Irish debt.

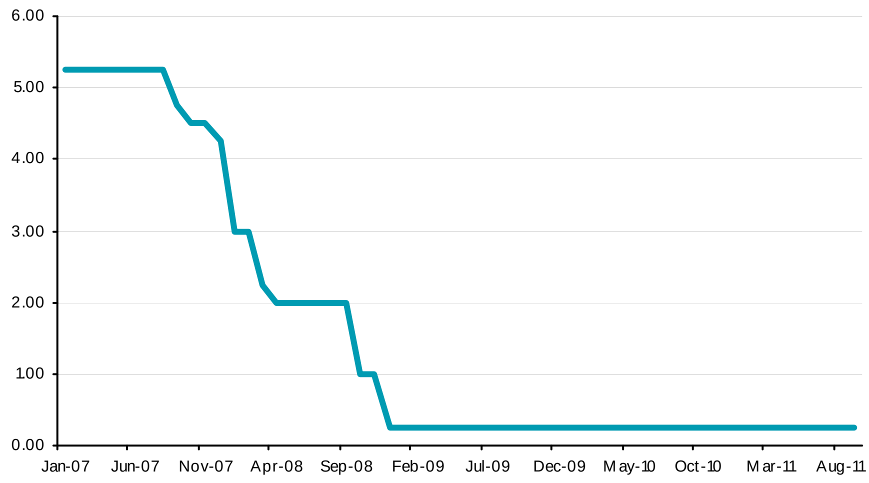
United States

Fed responds to slowdown in growth

Fed sees slower recovery…

At its monetary policy meeting in August the Fed said that economic growth so far this year had been considerably slower than expected, noting that the unemployment rate had moved up, household spending had flattened out, and the housing sector remained depressed. It also said that temporary factors, including the damping effects of higher energy and food prices on consumer purchasing power and spending and supply chain disruptions associated with the earthquake/tsunami in Japan earlier this year, appeared to account for *only some* of the recent weakness in economic activity. Hence, while it still expected activity to pick up again over the second half of this year, it forecast a somewhat slower recovery than previously projected and said the unemployment rate would decline only gradually over the coming quarters.

Federal Funds Rate (%)



….and expects to keep rates low at least through mid-2013…

In light of the deterioration in the economic outlook, most Fed members agreed that a 'response' was warranted at the August meeting, saying that monetary policy could contribute to supporting the recovery. They believed that a shift towards a more accommodative policy could be achieved by strengthening the forward guidance regarding the federal funds rate, specifically by being more explicit about the period over which the central bank expected the federal funds rate to remain exceptionally low. Hence it said that *"economic conditions…are likely to warrant exceptionally low levels of the federal funds rate at least through mid-2013*", which replaced the language used in previous statements that exceptionally low levels of the federal funds rate are likely to be warranted for an extended period (though three members voted against this change in language). The Fed chairman, Ben Bernanke, elaborated on this shift in policy in a subsequent speech, saying that, in what the Fed judges to be the most likely scenario for the economy in the medium term, the target for the federal funds rate would be held at its *current* low levels (of 0%to 0.25%) for at least two more years.

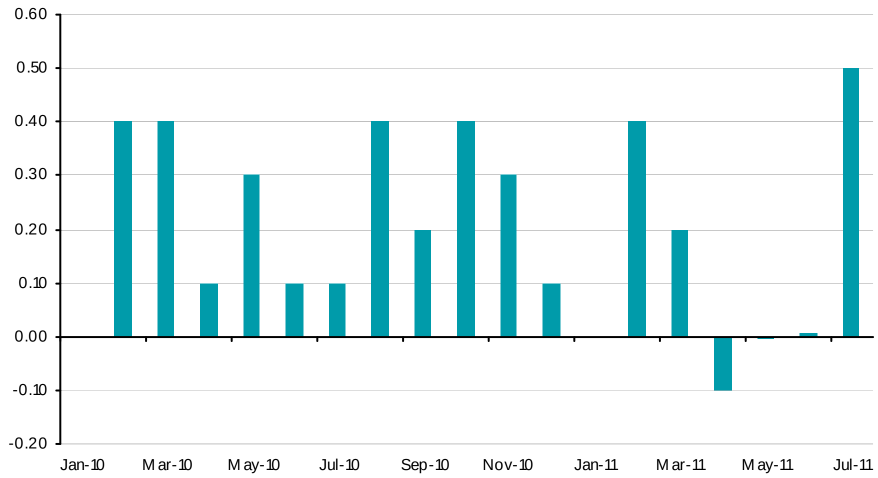
…prompting a fall in bond yields…

The more explicit guidance on interest rates provided by the Fed has contributed to an easing in monetary conditions and hence a more accommodative policy stance. Government bond yields have fallen since the August 9 meeting, with 2-year yields about 10bps lower at sub 0.2% and 10-year yields about 30bps lower at sub 2% (an all-time low), bringing the cumulative decline in the latter to a full percentage point over the past couple of months.

...and says further tools available to support recovery.

The Fed has also said that, in addition to refining its forward guidance on interest rates, it has *"a range of other tools that could be used to provide additional monetary stimulus"* to the economy and has scheduled its September meeting for two days (the 20th and 21st) instead of one to allow for a fuller discussion. Amongst these tools are: additional securities purchases (i.e. further QE), which could be used to provide more accommodation by lowering longer-term interest rates; increasing the average maturity of the Fed's existing securities holdings by selling securities with relatively short remaining maturities and purchasing securities with relatively long remaining maturities (which could have a similar effect on longer-term interest rates without boosting the size of the Fed balance sheet); and reducing the interest rate paid on commercial banks excess reserve balances at the Fed. However, a few Fed members believe that *none* of these tools would do much to promote a faster recovery.

Real Consumer Spending, % chg month-on-month



Consumer spending bounces back in July...

Financial markets have been particularly volatile since early August, with fears of a double-dip recession in the US, a downgrade to its credit rating and an intensification of the Euro area debt crisis contributing to a sharp fall in stocks. The S&P 500, though off its worst levels, is about 10% lower than at the end of July. All of this has also taken its toll on consumer confidence, which according to the Conference Board measure fell in August to its lowest level since the collapse of Lehman's in late 2008. However, the hard data published over the past month or so would tend to support the Fed view that economic activity is likely to pick up over the second half of the year. Most noteworthy perhaps was a rebound in consumer expenditure in July, with the 0.5% gain in real terms leaving spending on track to increase at a 1.5% to 2% annualized rate in the third quarter, up from just 0.4% in Q2. In addition, business investment in equipment and software – one of the bright spots in the recovery to date – looks on course to make another positive contribution to overall growth in Q3.

...though labour market remains weak.

The labour market remains weak however. The latest payrolls report showed employment was flat in August, although when allowance is made for striking workers in the telecommunications sector there was an underlying increase of around 45k, leaving the average monthly gain in total employment over the June-August period at (an admittedly still subdued) 50k, or around 100k a month in terms of the gain in private sector employment. The report heightened expectations that the Fed will announce further monetary stimulus at its September meeting. Ordinarily this might be expected to result in the dollar weakening against the euro, though this may not be the case this time. For a start, the market is also speculating that the ECB might have to ease monetary policy (by cutting interest rates), while the on-going debt crisis in the Euro area is likely to continue weighing on the single currency.

Economic Diary – September

	Europe	United Kingdom	United States
1	PMI Manufacturing	Nationwide House Prices, PMI Manufacturing	Initial Jobless Claims, ISM Manufacturing
2	PPI's		Payrolls, Unemployment
5	PMI Services, Retail Sales	PMI Services	
6	Q2 GDP, German Factory Orders		ISM Non-Manufacturing
7	German Industrial Production	Industrial Production	Fed's Beige Book
8	ECB Meeting	BoE Meeting	Initial Jobless Claims
9		PPI's	
12		Consumer Confidence	
13		RICS House Price Balance, Inflation Data	NFIB Small Business Optimism
14	Industrial Production	Employment data	PPI's, Retail Sales
15	Inflation data, Employment data	Retail Sales	Inflation Data, Empire Manufacturing, Initial Jobless Claims, Industrial Production, Philly Fed
16			University of Michigan Confidence
19		Rightmove House Prices	
20	Zew Survey		Housing Starts
21		Bank of England Minutes	FOMC meeting, Existing Home Sales
22	Industrial New Orders, Consumer Confidence		Initial Jobless Claims, Leading Indicators, House Price Index
26	IFO Survey, German Retail Sales		New Home Sales
27			S&P Case Shiller, Consumer Confidence
28			Durable Goods Orders
29	Confidence data		Q2 GDP, Initial Jobless Claims, Pending Home Sales
30	HICP estimate, Unemployment		Personal Income & Spending, Chicago PMI

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Sept	End Dec	End Mar
EUR/USD	1.41	1.40	1.40	1.40
EUR/GBP	0.88	0.88	0.88	0.88
USD/JPY	77.3	0.80	0.85	0.90
GBP/USD	1.61	1.59	1.54	1.54

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End Sept	End Dec	End Mar
USD	0-0.25	0-0.25	0-0.25	0.02
EUR	1.50	1.50	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 Sep	End Dec	End Mar
US	1.18	1.25	1.25	1.35
Eurozone	2.00	2.00	2.00	2.00
UK	1.75	1.75	1.75	2.00

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2011		2012	
	GDP	Inflation	GDP	Inflation
US	1.8	3.0	2.5	2.0
Eurozone	1.8	2.5	1.5	2.0
UK	1.2	4.2	1.8	2.3

Source: Bank of Ireland Global Markets

Contacts

Bank of Ireland Global Markets
www.boi.ie/globalmarkets

Chief Executive: Austin Jennings
Head of Global Customer Business: Kevin Twomey

Colvill House, Talbot Street, Dublin 1, Ireland
Fax: +353 1 799 3035 Tel: +353 1 799 3000
e-mail: info@boigm.com

Economic Research Unit (ERU)

Chief Economist, Bank of Ireland: Dr. Dan McLaughlin
Senior Economist: Michael Crowley
Economist: Patrick Mullane

Tel: +353 1 609 3341
e-mail: eru@boigm.com
Listen to Daily Commentary on Freephone: 1800 60 70 60

Corporate & Institutional Sales — Freephone 1800 30 30 03

Head of Corporate & Institutional Sales: Aine McCleary	
Head of Corporate Sales: Liam Connolly	+353 1 790 0000
Head of Customer Group Funding: Paul Shanley	+353 1 609 3212
Institutions: Gavin Rylands	1800 60 70 40
Property & Specialised Finance: Ed Preston	+353 1 609 3277
Corporate Relationship Manager: Eamon McManamy	+353 1 609 3215

Retail Sales — Freephone 1800 790 153

Deputy Head Global Customer Group, Head of Retail Sales & Customer Group Operations: John Moclair
Business Development & Sales Management: Adrienne McNally
Head of Customer Group Operations: Osna O' Connor
Business Banking Sales: Leslie Cosgrave

Global Markets United Kingdom (UK)

Head of UK: Liam Whelan	0044 207 4299 111
Head of Specialised Treasury: Mark Doody	0044 207 4299 103
Head of Corporate Sales: Kai Fisher	0044 207 4299 109
Business Banking Sales: Sandra Perry	0044 207 4299 121

P.O. Box 62929, Bow Bells House, 1 Bread Street, London EC4P 4BF
Tel: +44 (0) 20 7429 9111
GB Treasury Sales Team Freephone: 0800 039 0038
Tel: +44 (0) 7429 9121; Treasury Sales Team: 0800 776 616

Global Markets United States (US)

Head of US: Darsh Mariyappa
Head of US Business Development: Joe Connolly
Head of US Sales: Garreth Boyle

300 First Stamford Place, Stamford, CT 06902, US
Tel: +1 203 391 5555
Fax: +1 203 391 5901

Global Products Team

Global Head of Structured Business: Brian Vaughan — Tel: +353 1 790 0040
Head of Structured Products Distribution: Barry McLoughlin — Tel: +353 1 790 0400

Marketing

Head of Marketing: Andrew Hearnden — Tel: +353 1 609 3302

Market data supplied by Thomson Reuters