



The Bulletin

A monthly analysis of international and Irish markets

Germany leads euro area recovery

- The euro area recession is over
- But the ECB is not yet ready to raise rates

A few months ago we noted that the global economy probably emerged from recession in the early summer, with Asia recovering earlier than the rest of the world. Since then the data has confirmed that most of the major Western economies returned to growth in the third quarter, with the euro area as a whole expanding by 0.4% and the US by 0.7%. The latter is significant from an Irish perspective, given the trade and multinational links between the two countries, but the performance of the euro area is of additional importance as it will determine ECB policy and hence interest rates for the Irish economy.

A number of euro countries, including Ireland, have yet to report third quarter GDP figures and of those that did not all returned to positive growth, with Spain, Cyprus and Greece still in recession. France and Italy did pick up, however, as did Germany, and the three together account for some two-thirds of euro GDP.

Of the largest economies, Germany, has proved the stronger of late, recovering in the second quarter and then growing by 0.7% in Q3, and as such the driver of the euro area upturn. Business spending on machinery and equipment has led the German recovery, with companies also re-building inventories in anticipation of higher demand in the future. Construction too has picked up, but all this has yet to feed through to the consumer – personal consumption had risen in the second quarter in response to a fiscal incentive on car purchase but fell back in Q3, declining by 0.9% in the quarter. The labour market has also benefited from a number of other fiscal initiatives by the Federal Government, and as a result the rise in unemployment has been relatively mild; the unemployment rate stands at 8.1%, having fallen marginally in recent months, and compares with a cycle low of 7.6%.

Despite the upturn the loss of output in Germany has been substantial and GDP is still 4.8% below the level a year earlier. Consequently, it will take some time for the Federal Republic to recover this lost output, and by extension for the euro zone as a whole. This implied level of spare capacity argues against any immediate inflation risk, and for the moment the ECB appears content to leave interest rates at the historic low level of 1% despite the recovery in euro area output. The Bank has also flooded the wholesale money markets with cash and it is in that area that some change is afoot, with December probably seeing the announcement of a reduction in the amount of ECB monetary support. This would mark a turning point of sorts in the cycle but the ECB is not yet ready to go further and signal higher interest rates.

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United Kingdom

MPC increase QE to £200bn and have an “open mind” to further expansion

Bank of England increase QE ...

The Bank of England MPC announced after their meeting at the start of November that the base rate would be kept at 0.5% but that the asset purchase scheme would be increased from a total of £175bn to £200bn. We felt beforehand that the choice to expand by £25bn or go on hold was finely balanced and the decision to extend is not totally unexpected. The move to expand again was no doubt easier to justify due to the continuing contraction in the 3rd quarter. However, the statement did say that a “number of indicators of spending and confidence...suggest that a pickup in economic activity may soon be evident”. The statement went on to outline that two opposing sets of forces are determining the medium term outlook as the considerable level of stimulus is fighting against limited credit availability and depressed spending. In conclusion, the MPC felt “the prospect is for a slow recovery in the level of economic activity, so that a substantial margin of underutilised resources persists”. There was a somewhat muted response by the market following the expansion of QE, hinting that the market had priced in an increase of £50bn in the program.

...and has an “open mind” to increase the scheme further...

The Bank of England published their Quarterly Inflation Report a week after the MPC meeting. They assumed in their forecasts that the base rate follows a path implied by current market interest rates and that QE would stop at £200bn. Under this scenario, the growth forecasts were revised slightly upwards from the August report. However Governor King, once again, said that growth rates were not the key indicator for the MPC at the moment, as the level of GDP showed “the big picture”. The level of GDP in the medium term will be much lower than the level that it would have been had GDP growth continued along its trend line from 2007. A large output gap has emerged and the existence of this gap is why the MPC initiated and expanded an asset purchase scheme. There will be a need for accommodative interest rate policies for some time yet if the BoE hopes the economy can close some of this gap. On inflation, the Report said the outlook is “highly uncertain, with risks in either direction...the Committee judges that inflation is, on balance, more likely to be below the target than above it for most of the forecast period, though by the end the risks are broadly balanced”. Inflation is expected to be just below its target level at the end of the two year horizon. In the press conference, King said the MPC has “a completely open mind as to whether to do more asset purchases or not”. He added that Sterling’s depreciation over the past two years will help smooth a rebalancing in the UK economy away from domestic demand and towards exports.

..but the MPC is not united in their view.

The following week, the minutes for the MPC meeting revealed an unusual 7-1-1 split in the vote to decide to expand the asset purchase scheme. One member, David Miles voted to increase the program by £40bn while another, Spencer Dale, voted not to increase the program at all. Interestingly, the minutes noted that extending QE this month would bring “inflation back to target more quickly than otherwise” and would “bring forward the point at which the extraordinary degree of stimulus could begin to be withdrawn”. While King has said that the MPC may consider further expansion of QE, the minutes make clear that such a decision will not be considered before February. There is clearly an ongoing debate in the MPC over what policy actions are needed now, and some members have diverse views on what actions are needed currently. Regardless of this, we feel the MPC is still a long way from thinking conditions are suitable for tightening monetary policy. We don’t see any increase in the base rate until the second half of next year.

Europe

Europe exits recession in Q3

ECB begins to plan exit strategy...

The ECB kept its main refinancing rate on hold last month, and once again described the current level of 1% as “appropriate”. Its outlook for the economy was slightly more upbeat than the previous month and Trichet indicated that the Governing Council is planning its exit strategy for the removal of its “non-standard” liquidity measures. On the outlook, Trichet said the “indicators continue to signal an improvement in...activity in the second half of this year”, noting that the economy should benefit from fiscal and monetary stimulus, the inventory cycle and a pickup in exports. At the same time though, he said the recovery was likely to be “gradual” and, therefore, that price and cost developments were likely to remain subdued over the policy relevant horizon, a signal that the ECB is in no hurry to raise interest rates. However, regarding the non-standard liquidity measures put in place in response to the economic and financial crisis, Trichet said that “not all our...measures will be needed to the same extent as in the past”. The market does not expect the ECB to extend its program of unlimited 12 months loans to banks past the December offering, and Trichet said he would “say nothing to dispel this present sentiment”, adding that the ECB “will make sure that the extraordinary liquidity measures taken are phased out in a timely and gradual fashion and that the liquidity provided is absorbed in order to counter effectively any threat to price stability.” Although the ECB is preparing to withdraw some of the abundant liquidity it has provided to markets, it does not follow that it will seek to immediately enter into a period of rate hikes.

...as Euro area returns to growth...

The Euro Area economy returned to growth in the third quarter after more than a year of contraction, with real GDP rising by 0.4% (from Q2), slightly less than the 0.5% increase expected by the market and about half the pace of increase recorded in the US economy, which also returned to growth in Q3. The three largest economies, Germany, France and Italy, as well as the Netherlands, all expanded in Q3, with Germany and France each recording a second consecutive quarter of positive growth. On the other hand, among the other large economies, Spain recorded a sixth consecutive quarterly decline in GDP, though the pace of decline slowed notably to 0.3% from over 1% in the second quarter.

...but interest rate increases are a long way off yet...

Year over year growth is still highly negative with GDP falling 4.1% in the year to Q2. The increase in GDP in the third quarter has to be seen in the context of the almost 5% peak to trough decline that occurred during the recession, which shows there is a substantial amount of ground still to be made up to get back to pre-recession levels of output. The degree of spare capacity in the economy is likely to keep inflation subdued, something the ECB itself acknowledges even as these GDP data confirm its view that the Euro Area economy is now embarked on a “gradual” recovery, and which means it is likely to keep interest rates at 1% for some time yet. We think the ECB will ultimately begin to raise its key rate late in 2010 back towards more normal levels, which is somewhere in the region of 4%

...and euro appreciation threatens exports.

The strength of the dollar is a threat to the recovery in Europe. The dollar has depreciated by over 16% against the Euro since March. The Euro is now touching off the \$1.50 level that has previously sparked concerned statements from policy makers on both sides of the Atlantic. While the ECB and the Fed agree that a “strong dollar” policy is in the best interests of the global economy, there is little sign they are prepared to actively intervene in the currency markets at this time.

United States

Fed revises up 2010 growth forecast

Q3 GDP growth revised lower...

The US economy did not rebound quite as strongly in the third quarter as previously estimated, according to data published in late November, with annualised GDP growth in the three months to September revised down from 3.5% to 2.8%, the latter broadly in line with the economy's long-run trend rate of growth. Almost all of the downward revision was due to a slower pace of final demand growth than initially thought, with consumer spending, investment and net exports all weaker than first estimated. The economy is almost certain to expand again in Q4, though we do not have enough 'hard' information yet to gauge how robust the pace of growth will be. There is a risk however, that it will be somewhat lower than in Q3, partly due to the likelihood that consumer spending will increase more slowly than in Q3, when it grew by 2.8% boosted by the government's auto incentive scheme.

...but Fed ups its 2010 forecast...

Looking further ahead, the Fed in its latest macroeconomic projection expects the economy to grow by 3% (the mid-point of a 2.5-3.5% range) in the year to the fourth quarter of 2010, up from its June projection of 2.7%. The unemployment rate is expected to fall to 9.5% by the end of next year (9.7% previously projected) from an expected 10% in the final quarter of this year, though the latter looks a little low given that the unemployment stood at 10.2% in October according to the latest published data. Most importantly perhaps, the Fed left its projection for core inflation in both 2010 and 2011 unchanged from its June forecast of 1.3%, which is well below its implicit "target" of close to 2%.

...though it expects inflation to be subdued...

While some Fed members see some upside risk to inflation from the huge monetary and fiscal stimulus that is being imparted into the economy, most members expect inflation to remain subdued, hence the Fed's ongoing view that "economic conditions are likely to warrant an exceptionally low level" of the federal funds rate for an extended period". The Fed has outlined explicitly what these economic conditions are - in addition to subdued inflation trends, they include low levels of resource utilization and stable inflation expectations - and has warned that any significant changes in these conditions would change the outlook for monetary policy as well. For now though, the Fed believes low rates will be needed for some time.

...and interest rates to remain low...

The Fed's continuing insistence that exceptionally low levels of the federal funds rate are likely to remain in place for the foreseeable future has driven market interest rates down. Government bond yields have fallen steadily over the past month, with the 2-year yield currently trading just above its cycle low of 0.65% set back in December 2008 when the Fed cut the fed funds rate to virtually zero. The yield on the benchmark 10-year bond has fallen by about 20bps since the end of October and at around 3.20% is some 75bps off its summer highs. Similarly, swap rates have fallen by about 20bps since the end of October, with the 2-year rate currently trading at a cycle low of just over 1% and the 5-year rate, at a little less than 2.50%, now just 50bps above its cycle low set back in January, having been around 150bps higher as recently as August. We doubt that swap rates will fall much further from these levels, but in any case we expect them to rise gradually over the course of 2010 as the economic recovery continues and the market increasingly anticipates the Fed beginning to move its key rate back up towards more normal levels.

...which is weighing on the dollar.

The dollar is currently trading just shy of \$1.51 to the euro, from about \$1.48 at the end of October, though in the early part of November the US currency traded up to \$1.46. This movement in EUR/\$ broadly matches developments in the equity markets, which having sold off in late October and early November recovered over the remainder of the month, setting new 2009 highs (in the case of US markets) in the process. Equity markets are likely to continue to exert an influence on EUR/\$ in the short-term, though the most we can say in this regard is that, at current levels (some 65% off their March lows), stocks already seem to incorporate a lot of good news about the economic outlook.

As mentioned in October's issue of *The Bulletin*, policy makers have become more vociferous on the dollar following its recent decline, with the chairman of the Fed, Ben Bernanke, the latest to address the topic. That in itself is interesting, as the Fed rarely discusses the dollar – it usually leaves comments on the currency to the Treasury. Bernanke stated that the Fed was monitoring currency markets closely, and that monetary policy will be conducted in such a way as to 'help ensure that the dollar is strong'. The Fed is currently maintaining a very accommodative monetary policy geared towards fostering a sustainable economic recovery, which we think ultimately will support the dollar, but the associated very low level of interest rates weighs on the dollar in the short-term. Given that momentum is against the currency, a further fall in the dollar in the run-up to year end cannot be ruled out, though further ahead we expect it to trade in a range of \$1.40-1.50 to the euro through 2010.

Economic Diary

December			
	Europe	United Kingdom	United States
1	PMI Manufacturing, Unemployment, German Retail Sales	Nationwide House Prices, PMI Manufacturing	ISM Manufacturing, Pending Home Sales
2	PPI's		Fed's Beige Book
3	ECB Meeting, PMI Services, Retail Sales, Euro area GDP	PMI Services	ISM Non Manufacturing
4			Non Farm Payrolls, Unemployment, Factory Orders
8	German Industrial Production	RIS House Price Balance, Industrial Production	
9		Pre Budget Report, Consumer Confidence	
10	French Industrial Production	Bank of England Meeting	
11		PPI's	Retail Sales, University of Michigan Confidence
14	Industrial Production		
15	ZEW survey	Inflation Data	PPI's, Industrial Production
16	Inflation Data	Unemployment	Inflation Data, Housing Starts, FOMC Meeting
17		Retail Sales	Philly Fed
18	German IFO surveys		
22		3q GDP, Bank of England Minutes	3Q GDP, Existing Home Sales
23	Industrial New Orders, French Consumer Spending		Personal Income and Spending, University of Michigan Confidence, New Home Sales
24			Durable Goods Orders

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Dec	End Mar	End Jun
EUR/USD	1.5051	1.45	1.45	1.40
EUR/GBP	0.9125	0.88	0.85	0.83
USD/JPY	86.30	90	100	105
GBP/USD	1.6488	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	2.40	2.60	3.00	3.25
Eurozone	2.75	2.75	2.90	3.10
UK	3.05	3.35	3.75	3.90

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2009		2010	
	GDP	Inflation	GDP	Inflation
US	-2.4	-0.4	2.6	2.0
Eurozone	-4.0	0.3	1.1	1.3
UK	-4.7	2.0	1.3	2.0

Source: Bank of Ireland Global Markets

Contacts

Bank of Ireland Global Markets

www.boi.ie/globalmarkets

Chief Executive: Austin Jennings
Head of Global Customer Group: 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

Retail Sales

Freephone 1800 790 153

Deputy Head of Customer Group: John Moclair
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

Head of Retail Sales & Customer Group Operations: Aine McCleary
Business Development & Sales Management: Adrienne McNally
Business Banking Sales: Leslie Cosgrave 1800 790 153
Branch Sales: Michelle O'Meara +353 1 609 4330
Dealer Assistants: Osna O'Connor +353 1 609 3509

Global Markets United Kingdom (UK)

Head of Global Markets London: Liam Whelan
Head of Business Development: Duncan Wilson
Head of London Treasury Sales: Sandra Perry

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
Head of Structured Products Distribution: Barry McLoughlin

Tel: +353 1 790 0040
Tel: +353 1 790 0400

Marketing

Head of Marketing: Andrew Hearnden

Tel: +353 1 609 3302

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