



The Bulletin

A monthly analysis of international and Irish markets

Interest Rates at cycle low

- The next move in rates is up
- Market may be premature on timing

Central Bank rates across the major economies are at extremely low levels, in many cases unprecedentedly so. In the US the Federal Reserve is maintaining the Fed funds rate in a corridor between zero and 0.25% while in the UK the Bank of England has cut the Bank rate to only 0.5%. Euro zone rates are higher, at 1%, but again the repo rate is also at an historic low.

Interbank rates have also followed official rates down, with 3-month cash in dollars at 0.6% against 1.1% for euros and 1.2% in sterling. These rates are still somewhat higher than might be expected given the historical relationship between market rates and central bank rates, implying that there is still a premium for cash in the interbank markets, but that premium too has fallen of late, and is substantially lower than apparent last autumn, post the Lehman collapse.

Interbank rates may have scope to fall further but official rates are now generally thought to be at a cyclical floor, which means that the next move will be up and it is the timing and scale of such action which is now exercising financial markets. Central Banks themselves seem to be in no rush to tighten monetary policy (or, in the current jargon, to pursue an 'exit strategy'), and the Federal Reserve reiterated at its June meeting that it expects to keep rates 'at exceptionally low levels for an extended period'. Similarly the Bank of England sees significant risks to the economic outlook and is still printing money in order to stimulate activity, although the UK data has generally surprised to the upside of late, implying that a return to positive growth may be at hand. Closer to home, the ECB thinks rates are 'appropriate' now and recently injected €442 one-year cash into the money markets, at a rate of 1%, which is not the action of a Bank set to tighten monetary policy any time soon.

The shape of the economic recovery will ultimately determine the timing of the first move up in interest rates, and so far the international data is generally consistent with a modestly-paced return to positive growth, rather than a surge in activity. Market sentiment in this regard is volatile, nonetheless, and data surprises, such as the much lower level of US job losses seen in May, can prompt a marked change in rate expectations. At the moment, then, the US market is fully priced for a quarter-point rate rise by February 2010, but rates there are still expected to be under 1% in a year's time. In the UK the market is giving a low probability to a rate change before year-end but is fully discounting a move higher by the Bank of England in the spring. Similarly, the euro cash market is currently priced for the first move up by the ECB in March or April, although one should remember that the world economy will have to look a lot better than it does now for these moves to materialise.

Dr. Dan McLaughlin.

United Kingdom Page 2

Economy looks set to start recovery, possibly in Q3

Europe Page 3

ECB cuts forecasts, no sign of recovery until mid '10

United States Page 4

Fed leaves well enough alone

Swap Rates Page 5

Market priced for higher rates

Economic Diary Page 6

Forecasts Page 7

Bank of Ireland estimates

- Exchange rates
- Official interest rates
- Five-year swap rates
- GDP and inflation

Contacts Page 8

United Kingdom

Economy looks set to start recovery, possibly in Q3

Some signs that economy is improving but serious downside risks remain.

The Bank of England met on June 4th and kept the base rate at 0.5%. The Bank did not expand their asset purchase scheme but kept the target total to be purchased at £125bn. The minutes revealed that the members voted unanimously to maintain printing money to fund asset purchases with £80bn already spent. The committee thinks that there are 'tentative' signs that this policy is impacting the monetary aggregates but in general remains cautious on the prospects for an imminent economic recovery. They do accept that the data has improved of late and that the risk of a continued sharp contraction in output in the near term had receded, but feel that the upturn in confidence measures could be fragile and that 'significant risks remained domestically and overseas'. Consequently the MPC concluded that the medium term outlook for growth and inflation had not materially changed from that published in the May Inflation Report. There remains a serious risk to the economy from further turmoil in the financial markets. In the semi-annual financial stability risk report, the BoE said that "Given their leverage and funding positions, banks in the United Kingdom and internationally will remain sensitive to further shocks for some time. If economic recovery were to stall as a result of weak bank lending, losses on assets could rise, further affecting confidence in the banking sector". Mervyn King speaking to the Treasury Select Committee in late June said the recovery from this recession would be "a long hard slog" and that he "feels more uncertain now than ever". Of the Bank's asset purchase plan, he said it "began only three months ago, so there are few indications of its effects...the little evidence we do have, though, seems to be positive". He also added that the depreciation in Sterling over the past would help offset some of the effect of the weak global economy on the UK. Given that there are now tentative signs the economy will start a recovery later on in the year, King said the Bank know what the mechanics were of how to unwind the current stimulus measures but the crucial question remained when should they begin to roll back the measures.

Data indicates service sector growth but inflation remains above BoE expectations.

The data released over the month of June has been quite positive. The PMI services data for May came in at 51.7, over that magic 50 number that indicates that the sector is expanding again. The PMI manufacturing index was also higher in May, up to 45.4 in May from 44 in April. The pace of contraction in activity is slowing sharply and a recovery seems set to take hold in the second half returning the economy to quarterly growth by the end of year, possibly as soon as Q3. Surprisingly, the PMI construction index rose to 45.9 in May from 38.1 in April, the highest level in 13 months. This indicator has moved up very sharply since its low of 27.8 in February. The index is still showing a contraction but a much smaller decline than was expected. Industrial production increased by 0.3% in the month of April, the first monthly increase since February '08. Retail sales did disappoint falling by 0.6% in May but this series has been erratic over the past year with large swings from month to month. The 3-month moving average remained positive in May showing growth of 0.5%. Inflation fell just marginally with the annual CPI rate falling to 2.2% in May from 2.3% in April. Inflation remains stubbornly sticky above the target of 2% and has not slowed as quickly as has been the case in the Euro Area or US. The Bank of England maintains that inflation will fall below the target in the near future and the measures they are taking will ensure price stability in the medium term.

Sterling volatile but appreciates into new 84p to 86p range against Euro.

Sterling has been quite volatile over the past month but ultimately has appreciated against the Euro and the Dollar. During May, the UK currency had gained on the Euro coming in from around £0.90 down to below £0.86. However, Sterling lost ground against the single currency, as well as the dollar, at the start of June due to the political uncertainty over Gordon Brown's Government and the ECB maintaining a hawkish stance at their June meeting indicating no further cuts in the ECB refinancing rates would be forthcoming. Sterling fell to over £0.88 to the Euro and \$1.58 against the Dollar. Once it became clear the political situation was stabilising - for now - the upward trend for Sterling returned. The currency has benefited from the upturn in data over the past couple of months which shows that a potential recovery is on track. Sterling reached a 7 month high of \$0.84 to the Euro and as high as \$1.66 to the Dollar around mid month. Since then Sterling has traded in the £0.84 -£0.86 range to the Euro and \$1.62 to \$1.66 range against the dollar. We think Sterling has room to go higher against both currencies in the months ahead.

Europe

ECB cuts forecasts, no sign of recovery until mid '10**The ECB keeps interest rate at 1%...**

The ECB kept its key interest rate unchanged at 1% on June 4th, as widely expected by the market. It also confirmed that it would proceed with its planned €60bn purchase of covered bonds, although its President, Jean-Claude Trichet would not entertain any discussion regarding whether the ECB might increase the scale of its covered bond purchases or widen the scope of its purchases to include other assets. We noted prior to the meeting that it would be interesting to see if the ECB retained the phrase 'rates are appropriate', which first appeared in the statement following the May meeting, in the statement accompanying this month's decision. In the event, it did, signalling that the ECB plans to keep interest rates at 1% for a while yet. This disappointed the market, which 'priced out' the chances of any further rate cut, in turn prompting a sharp rise in fixed rates – 5-year rates rose by over 20bps to over 3.1% in the aftermath of the meeting, their highest level since last January. Though the ECB revised down sharply its forecast for GDP in 2009, and also lowered its forecast for 2010, its new projections are consistent with the pace of decline in activity slowing over the remainder of 2009 and into early next year with the economy returning to positive (albeit modest) growth from mid-2010 onwards. Moreover, notwithstanding the downward revisions to growth, the ECB left its forecast for inflation next year unchanged at 1%. Though this is well below the ECB target of 'close to but below 2%', it is an average for 2010 as a whole and so is consistent with inflation probably returning to the range of 1.5% to 2% by the end of next year. In that respect, the ECB's current position on monetary policy – of keeping rates at 1% – appears broadly consistent with its inflation forecasts. While the ECB has not specifically ruled out further cuts, it is becoming increasingly likely that 1% will be the trough for the main refinancing rate.

...as hawkish outlook drives up bond yields...

The relatively hawkish stance by Trichet led to an increase in bond yields after the meeting, particularly at the short end. 2 year Bund yields rose to over 1.7%, an increase of over 30bps in the yield on the day before the meeting, as the market moved to price out any further cuts to the ECB rate in the short term. However, yields came back down again in the second half of the month reflecting the sluggishness of the EA economy and continuing weak data. 2 year Bund yields were down to about 1.36% by the end of the month. Fixed rates have also come down with 5 year fixed rates now around 2.9%, the rate they were at before the meeting. Data released during the month disappointed with the PMI's for June more or less stagnating. Services PMI fell marginally to 44.5 from 44.8 in May while manufacturing PMI rose to 42.4 in June from 40.7 in the previous month. This left the composite PMI up just 0.4 in June to 44.4. Industrial production fell by 1.9% in April, a greater fall than expected, leaving the annual decline at 21.6%. Retail sales grew by just 0.2% in April, with the annual decline standing at 2.3%. The pace of economic contraction has slowed sharply in the past few months although it appears any recovery is unlikely before mid 2010.

...but we think they will stay on hold for some time.

ECB President Trichet said, during the month, that the ECB remains vigilant to any sign of renewed turmoil in the financial markets that could further damage the economy. He stated "We are in uncharted waters, and there are still risks of a sudden emergence of unexpected financial turbulence. While there are first signs that the pace of economic weakening is decelerating, we must remain alert". Trichet took the opportunity to remind the markets that he is the spokesman for the ECB implying the differing public views of other ECB members should be discounted in favour of what he, as ECB President, is saying. Notwithstanding this, Bundesbank chief Weber remains a powerful voice on the Governing Council and he remains the member most opposed to any further easing measures. He said the ECB "has used the room for rate reductions that was created by waning inflation risks and a dramatic worsening of the economic situation". He added "additional steps are not necessary at this time". A timely withdrawal of liquidity (at the correct time) is necessary to ensure price stability. Too generous liquidity and low interest rates "promotes the formation of asset-price bubbles". He concluded that it's important not to act too early but if inflation takes hold "it's already too late". Taking everything into consideration, we think the ECB will keep rates on hold for some time and will not increase non-standard measures unless serious downside risks materialise in the second half of the year.

United States

Fed leaves well enough alone

Fed stands pat...

The Fed left well enough alone at its meeting in late June: it kept the federal funds rate at virtually 0%, reiterated that “economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period”, and said it would continue with its current asset purchase programme, which involves buying up to \$1.25trillion of mortgage backed securities (to provide support to the housing market) by the end of this year and up to \$300bn of Treasury securities by the autumn. It also reiterated that it would continue to evaluate the timing and overall amounts of its purchases in light of the evolving economic outlook and conditions in financial markets. On the economy, the Fed noted that “the pace of economic contraction is slowing” and that over time fiscal and monetary stimulus and an improvement in financial conditions will “contribute to a gradual resumption of sustainable economic growth”. On inflation, the Fed said that the substantial slack in the economy (evident in the high and rising rate of unemployment) would dampen cost pressures and so keep inflation “subdued”, notwithstanding the recent rise in energy and other commodity prices. Subsequent to the meeting, the Fed also announced it was extending some of its liquidity programmes through to early 2010, noting that, while financial conditions generally had improved, market functioning “in many areas remains impaired and seems likely to be strained for some time”.

...as downturn eases.

The economy contracted by 5.5% (annualised rate) in Q1, a slightly slower pace of decline than the 5.7% previously estimated. The rise in consumer spending was revised down a little but this was more than offset by net exports, which made a larger positive contribution to GDP in Q1 than initially estimated. In terms of the second quarter, it seems as if the rate of decline slowed, with the consensus looking for GDP to have fallen by 2.0%. It is unlikely that de-stocking (or a run down of inventories) made as large a negative contribution to GDP as it did in Q1 (it accounted for almost half of the overall decline), while the pace of fall in both business and residential housing investment probably slowed from Q1. In relation to the latter, the demand for housing appears to have bottomed, albeit at a low level, which means housing output should bottom by the end of this year. On the other hand, consumer spending looks like, at best, it remained flat in Q2, or may have declined slightly, from Q1. A notable feature has been the pronounced rise in the personal saving ratio, from around 0% at the start of the year to almost 7% currently, which has restrained the growth in consumer spending notwithstanding a rise in disposable incomes due to recent tax cuts. This ‘deleveraging’ in the household sector may also dampen any recovery in economic activity, at least initially.

Bond yields fall.

Having risen to almost 4.0% (some 200bps up from the lows of last December) in early June, the yield on the benchmark 10-year bond has since fallen by around 50bps to 3.5%. Short-dated yields, which had remained in a narrow range over the first five months of 2009, spiked higher in early June – by around 50bps – but they too have fallen back again and have retraced about half of their move higher. The initial rise in yields accompanied signs of some relative improvement in the economy, which prompted the market to ‘price out’ the risk of a protracted economic slump and the associated prospect of deflation. By the same token though, the market had got ahead of itself in pricing in, as it had done in early June, a hike in Fed interest rates as soon as the end of this year. While the bottom of the downturn is in sight, any recovery is likely to be relatively muted and it will take some time for the slack in the economy to be used up. In the meantime, inflation is likely to remain subdued and the Fed (as it has said itself) is likely to have to keep official interest rates at a very low level for some time yet. There may, therefore, be scope for yields to extend their recent decline somewhat further. However, the lows in yields for this cycle are almost certainly behind us. It is worth noting that yields, even at current levels, are still historically very low.

Swap Rates

Market priced for higher rates

Central Bank interest rates across the major economies are unlikely to fall further and therefore the next move will be up. Expectations to that effect have taken hold in the financial markets although sentiment regarding the timing and scale of future monetary tightening is volatile, and fluctuates in response to the economic data.

The scale of job losses in the US, in May, for example, was much lower than expected, prompting a substantial rise in longer-dated government bond yield and swap rates. 3-year swap rates in US dollars, for instance, rose from 2.10% to 2.5% in just a few days, with 5-year rates moving from under 3% to around 3.50%. In euros the 5-year move was less pronounced, albeit with rates above 3% for the first time since early January. In the UK the rise in swap rates started earlier, in May, and 5-year swap rates touched 3.80% at the high, from around 3% in early May.

The market has re-considered however, and swap rates have generally fallen back across the major currencies in the past few weeks, albeit still off the cycle lows. This change in market tone was influenced in part by more mixed data releases, and by the attitude of the major central banks – on balance, policy-makers appear less optimistic than market participants about the near-term outlook, with the impaired nature of the international banking system still causing concern. In euros, 5-year swap rates are around 2.90%, and we expect some further easing in the coming months given that the data at the moment points to only a modest recovery. Despite this the market is essentially pricing in an ECB rate rise by March or April 2010, which may be too early. Nevertheless, 5-year rates may find it hard to push below 2.50% in the absence of a harsh deterioration in the economic data, which we feel is unlikely.

Similarly, for dollars, 5-year rates are unlikely to trade back below 2.50% as long as the data supports the current consensus that the US economy will return to positive growth in the third quarter. In the UK rates of the same maturity may find 3.50% a strong barrier to breach on the down side, although the MPC is still concerned about the risks to growth and unconvinced about the robustness of the signals suggesting that a recovery is at hand.

	Euro		Sterling		Dollar	
	Sept-09	Dec-09	Sept-09	Dec-09	Sept-09	Dec-09
2-year	1.60	1.60	2.10	2.10	1.35	1.35
5-year	2.60	2.60	3.50	3.50	2.75	2.75
10-year	3.50	3.50	4.00	4.00	3.60	3.60

Economic Diary

July

	Europe	UK	US
1	PMI Manufacturing, German Retail Sales	PMI Manufacturing	ISM Manufacturing, Pending Home Sales
2	ECB Meeting, PPI's, Employment data	PMI Construction	Change in Non-farm Payrolls, Unemployment, Factory Orders
3	PMI Services, Retail Sales	PMI Services	
6			ISM Non-manufacturing
7	German Factory Orders	Industrial Production	
8	Q1 GDP (final), German Industrial Production	Nationwide Consumer Confidence	
9		Bank of England Meeting	
10	French Industrial Production	PPI's	University of Michigan Confidence
14	Zew Surveys, Industrial Production	Inflation data, RICS House Price Balance	PPI's, Advance Retail Sales
15	Inflation data	Employment data	Inflation data, Industrial Production, Minutes of FOMC meeting
16			Philly Fed
20		Rightmove House Prices	
21			
22	Industrial New Orders, IFO surveys, French Consumer Spending	Bank of England Minutes, CBI Quarterly Industrial Trends	
23		Retail Sales	Existing Home Sales
24		2Q GDP	
27			New Home Sales

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Sep	End Dec	End Mar
EUR/USD	1.41	1.35	1.35	1.30
EUR/GBP	0.86	0.85	0.85	0.80
USD/JPY	97	95	100	100
GBP/USD	1.64	1.59	1.59	1.62

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End Sep	End Dec	End Mar
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 Sep	End Dec	End Mar
US	2.95	2.75	2.75	3.00
Eurozone	2.88	2.60	2.60	2.75
UK	3.65	3.50	3.50	3.75

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	GDP	2008		2009	
		Inflation	GDP	Inflation	
US	1.1	3.9	-2.8	-0.5	
Eurozone	0.7	3.3	-4.3	0.3	
UK	0.7	3.6	-3.6	1.8	

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: Deirdre Flannery

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)

Managing Director: Peter Goshawk
 Chief Dealer: 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: Damien Daly

Tel: +353 1 609 3302

Market data supplied by Reuters

Disclaimer

Produced by the Economic Research Unit at Bank of Ireland Global Markets ("GM"). Bank of Ireland incorporated in Ireland with limited liability. Bank of Ireland is regulated by the Financial Regulator. In the UK, Bank of Ireland is authorised by the Irish Financial Regulator and authorised and subject to limited regulation by the Financial Services Authority. Details about the extent of our authorisation and regulation by the Financial Services Authority are available from us on request. This document is for information purposes only and GM is not soliciting any action based upon it. GM believes any information contained herein to be materially accurate but GM does not warrant its accuracy or completeness and this information should not be relied upon for any purpose. No prices or rates mentioned are bids or offers by GM to purchase or sell any currencies, securities or financial instruments. Except as otherwise may be specifically agreed, GM has not acted nor will act as a fiduciary, financial or investment adviser with respect to any derivative transaction that it has executed or will execute. Any investment, trading and hedging decision of a party will be based on its own judgement and not upon any view expressed by GM. This document does not address all risks related to the transactions described. You should obtain independent professional advice before making any investment decision. Any expressions of opinion reflect current opinions as at 1st July 2009. This publication is based on information available before this date. For private circulation only. This document is property of GM. The content may not be reproduced, either in whole or in part, without the express written consent of a suitably authorised member of GM staff.