



The Bulletin

A monthly analysis of international and Irish markets

Oil the key driver of rate outlook

- Higher energy and food prices have boosted headline inflation
- And ECB ready to hike despite economic slowdown

Last September inflation in the euro area was 2.1%, having climbed above the ECB's target for the first time in a year. Energy, which accounts for some 10% of the total price index, had risen by 3% over the previous twelve months, but since then the annual inflation rate in energy has surged to 13.7%. Food prices (accounting for some 16% of the index) have also risen sharply, from an annual rate of 2.4% to 6.4%, and these two categories have been the key drivers in pulling the euro zone annual inflation rate up to the current 3.7%.

This acceleration has proved a move too far for some members of the ECB Governing Council, and it seems that the Bank is set to raise rates by a quarter of a percent in July, contrary to our and most of the market's expectation that the next move would be down. Indeed, the market has now switched to fully pricing in a half point rise in rates by year-end. Higher rates will not affect inflation in the short-term, but the rationale is that it will help to anchor inflation expectations and convince firms and households that the ECB will do all it can to bring inflation back to the target. The proposed rate-rise occurs against a backdrop of slowing economic activity, (the latest PMI index implies that the euro zone had negative growth in June), which should eventually lead to a fall in inflation, but the ECB Governing Council appears unwilling to wait for this to happen.

In truth, consumer's expectations of inflation probably owe more to their recent experience of inflation, particularly high frequency purchases such as food and energy, than to Central Bank monetary policy. In that sense the near-term path of oil prices will prove decisive in determining headline inflation, expectations and hence ECB policy. Crude oil has risen by over 35% in the past few months, having doubled in 2007 in dollar terms, and if it stabilises at current levels inflation in the euro area is likely to fall steadily from September, helped by positive base effects from food, albeit with a strong risk that it creeps higher near-term. Should this scenario unfold, or if oil prices fall, the ECB may limit its tightening to a quarter point. A further acceleration in oil prices and further spike in headline inflation may mean even tighter policy, however, even though the resultant slowdown would be such that the ECB would probably end up cutting rates aggressively in 2009. The short term outlook is therefore unclear, but with rates now unlikely to fall this year as we expected the euro may end the year around \$1.50 instead of the \$1.40 we had forecast.

Dr. Dan McLaughlin.

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UK

Market expects Bank of England to raise rates

Inflation accelerates further...

Having raised interest rates every couple of months between December and April, the Bank of England held the Bank Rate steady at 5% in June, against the background of a further acceleration in inflation. Indeed, given the latter and a rise in measures of expected inflation over the short-term, the June meeting discussed whether an immediate *increase* in interest rates was warranted, with some members deeming that a pre-emptive increase would be appropriate if there was a serious threat to expectations of inflation over the medium term.

...but growth still slowing...

In the event, the Bank decided against raising interest rates, for a number of reasons. One was that measures of expected inflation over the medium-term remained 'anchored' to the 2% target, so a rate hike was not required to stabilise inflation expectations. Secondly, the implications of higher inflation in the short-term for the medium-term outlook were unclear, as there was still a risk of a sharper than expected slowdown in the economy which could drag inflation *below* its target in the medium-term.

In his letter to the Chancellor following the release of the latest CPI data (which showed inflation at 3.3% in May, more than 1% point away from the target and hence requiring an explanation), the Governor of the Bank of England, Mervyn King, reiterated that it faces a balancing act between two risks. On the one hand, the risk that the period of above-target inflation could persist for longer than desired, and on the other the risk that the downturn in the economy could be so sharp that inflation ultimately undershoots its target. According to King, because of the first risk, the Bank had not responded more aggressively to signs that the economy is slowing, but because of the second the Bank has still reduced interest rates at a time when inflation is above target.

...so we expect BOE to keep rates steady.

While King has said that it is 'impossible to judge' what level of interest rates will ultimately be needed to bring inflation back to its target, we do not expect the Bank to raise rates this year, though the market is currently pricing in a cumulative increase of almost 50bps between now and end-December. After a further rise in the near-term, the Bank expects inflation to peak around the end of this year and then to return to the 2% target within the normal forecast horizon of around two years, as slower growth and a weakening labour market dampen inflationary pressures. It has also said that it would be undesirable to bring inflation back to target any sooner than this, as it would result in 'unnecessary volatility in output and employment in the economy'. This suggests to us that maintaining interest rates at 5% is the appropriate policy stance for now.

Sterling has remained in a range of 78-80p against the euro for the past couple of months. While the ECB is expected to raise interest rates in July, this is probably already in the euro/sterling price. The market expects the ECB to raise rates further over the remainder of 2008, though the market expects rate hikes in the UK too. We don't expect hikes in either (beyond the almost certain ECB increase next month), and so think euro/sterling will remain in the range of 78-80p for the remainder of the year. We expect interest rates in both economies to fall in 2009, though we think ECB rate cuts will weigh more on the euro than similar moves by the Bank of England will weigh on sterling, given that the latter has already fallen sharply against the single currency. Hence we expect to see sterling strengthen gradually through next year.

Europe

ECB not planning series of rate hikes

ECB warns of possible rate rise in July...

...but says not planning series of hikes...

The ECB kept interest rates unchanged at 4% in June but warned that the risks to inflation over the medium term had increased further. In the light of this, the ECB said it was in a 'state of heightened alertness', which its President, Jean-Claude Trichet, explained meant that a 'small' increase in interest rates at its July meeting was 'possible...though not certain' in order to 'secure a firm anchoring of medium and long-term inflation expectations'. The market duly proceeded to price in a quarter point increase in rates next month, as well as a further 50bps over the following 6-9months. Fixed rates rose sharply as a result, and are now up 40bps higher than a month ago. Clearly unhappy with the market reaction, the ECB subsequently went out of its way to insist that a rate hike in July would not mark the beginning of a renewed tightening of monetary policy, with numerous members, including Trichet himself, saying the Bank was not planning a series of rate hikes. How the ECB can be certain that just one small increase in interest rates is all that is needed (if it is needed at all) to achieve its objective is unclear to us, but in any case the market is not yet fully persuaded and still sees at least a further 25bps increase on top of the almost certain hike in July. It seems the market wants to wait and see what the ECB does and – much more importantly – says at next month's meeting before it is willing to accept its assurances on the path for official interest rates.

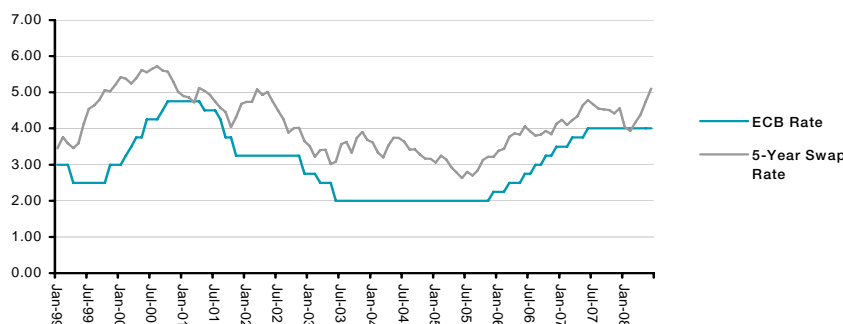
We expect the ECB to raise rates by 25bps in July – having led the public and the markets all the way up to the top of the hill this month, it is unlikely to lead us all the way down again next month. However, we think it will be a case of 'one and done' with this quarter point move. While inflation is likely to rise somewhat further (from the current 3.7%) in the near term, we expect it to start falling – possibly sharply – from this autumn. Sizeable increases in food & energy prices last autumn are unlikely to be repeated this year, which will push inflation lower. Moreover, the latest survey data point to a notable slowdown in economic growth, with the last Purchasing Managers indices falling below the 50 expansion-contraction threshold in June. The ECB acknowledges that the economy is slowing but expects the pace of growth to pick up again latest this year. We find it hard to see how, given that it is tightening monetary policy and considering the extent of the rise in the euro – around 10% over the past year.

Fixed rates to fall back again.

Fixed rates are currently trading not far below their highest levels since 1999, which was in May 2001 when the ECB rate was 4.75%. Given our expectation that official rates won't rise beyond 4.25%, we see room for fixed rates to come down again over the remainder of this year, with a fall of 40-50bps possible by year-end. If ECB rates head lower in 2009, as we expect, then clearly fixed rates will fall further. While we don't

expect the ECB to raise rates beyond July, nor do we expect the Fed to raise rates this year either, so we think the Euro/\$ exchange rate will trade in a range of 1.50 to 1.55 over the balance of 2008. We do, though, expect the Fed to raise rates next year, which will see the dollar strengthen notably against the single currency.

Swap Rate



 United States

Fed balances growth, inflation risks

Fed still sees downside risks to growth...

The Fed left interest rates unchanged at its June 24/25 meeting, as universally expected, though the accompanying statement did confirm a shift in its position since the previous meeting in April. In a speech on June 9, the Fed Chairman, Ben Bernanke, said the 'risk that the economy has entered a substantial downturn appears to have diminished' and the statement duly noted that 'the downside risks to growth...appear to have diminished somewhat'. Risks to growth still remain though, and are largely related to the ongoing contraction in the housing market and high energy prices.

...but says upside risks to inflation have risen...

In the same speech, Bernanke also noted that inflation remains high due largely to the sharp increases in the prices of globally trade commodities, but said that, to date at least, the 'pass through of high raw materials prices to the prices of most other products and domestic labour costs has been limited, in part because of softening domestic demand'. Nevertheless, he said that 'the latest round of increases in energy prices has added to the upside risks to inflation and inflation expectations' and warned that the Fed would 'strongly resist any erosion of longer-term inflation expectations'. It was no surprise, then, that its latest policy statement noted that the 'upside risks to inflation and inflation expectations have increased'.

In response to the shift in the Fed position, the market initially priced in a quite aggressive rise in interest rates over the remainder of 2008, expecting a cumulative increase of 75bps in the fed funds rate by the end of the year starting with a quarter point move in August/September, which propelled fixed rates sharply higher. However, the Fed subsequently let it be known (through the press) that the market was pricing in too many rate hikes too soon and consequently the market scaled back expectations regarding the degree of tightening this year. It pared them back further following the Fed meeting and is now only pricing in a full 25bps increase by October with a high, though not 100%, probability attached to a further quarter point increase by the end of the year.

...so interest rates to remain on hold.

While we expect the next move in official interest rates to be up, we don't expect this to happen until 2009. Economic growth is likely to remain subdued for some time yet, with any near-term boost from the government's 'fiscal stimulus' likely to be temporary, as a number of negative influences weigh on activity, including a further contraction in housing output, falling employment and slowing income growth, depressed levels of consumer confidence and tight credit conditions. Meanwhile, as the Fed noted in its policy statement, inflation is likely to fall later this year and next, as food and energy price inflation moderates and core inflation remains contained amid increasing slack in the economy.

Fixed rates have come off the recent highs as the market has pared back expectations for Fed tightening this year, with 5-year rates almost 30bps lower over the past couple of weeks. Since we don't expect the Fed to raise official rates this year, we see scope for fixed rates to fall further between now and year-end. However, any fall will be limited, given the prospect for official rate hikes in 2009. The latter should lead to a notable strengthening of the dollar in 2009, though we see it trading, for the most part, in a range of 1.50-1.55 against the euro over the remainder of this year.

Swap Rates

Swap rates rise, but off peak

Earlier in the year the consensus market view was that the downside risks to growth across the major economies, exacerbated by the credit crunch, would dominate central bank thinking, prompting an easing of monetary policy. This helped to push swap rates down, with 2-year euro rates trading at a low of 3.75% and US swaps at just over 2%. The past few months has seen an about-turn, however, prompted by an acceleration in headline inflation rates and a change in central bank rhetoric. The latter was most pronounced from the ECB, which in June stunned the market by flagging that rates would probably rise by a quarter point in July, despite the fact that interbank rates remain extremely elevated and economic activity is slowing. The result was a rapid re-pricing of period rates, with three quarter point rate rises discounted at one point. Swap rates also soared, leaving 2-year rates at a high of 5.50% at one stage, and 5-year yields at 5.20%.

The ECB appears unhappy with this scale of implied monetary tightening, and a number of Council members have signaled that the Bank only intends to move by a quarter point. Policy must surely be data dependent, of course, so these protestations are conditional one suspects, and the market is still fully pricing in two rate increases by year-end. Swap rates have rallied, nonetheless, helped by data implying a marked weakening of the euro economy in June, and we expect 2-year swaps to fall back to round 5% near term. If rates do indeed peak at 4.25% a more substantial rally is in prospect but for now uncertainty about oil prices and the near term inflation outlook may prevent that.

The UK market is also pricing in two rate hikes over the next few months but in this case the Bank of England has not signaled an intention to tighten policy. Indeed, the Governor reiterated again of late that any move to bring inflation back to the target 2% quickly risks unnecessary volatility in output and employment. The Bank now expects inflation to peak around 4% later in the year before falling back in 2009 and for the moment appears willing to see if this scenario unfolds. Again, swap rates may have peaked and we expect 5-year rates to fall from the current 6.15% to around 5.50% over the next few months.

Finally, 5-year US dollar swaps have risen sharply in anticipation that the Fed will start to tighten policy over the next few months. We doubt this as the short term economic outlook still looks uncertain, although higher oil prices remains a key risk, as in the other markets. We expect 5-year rates to remain in a 4.25%-4.5% range near term.

	Euro		Sterling		Dollar	
	Sept-08	Dec-08	Sept-08	Dec-08	Sept-08	Dec-08
2-Year	4.75	4.50	5.75	5.50	3.50	3.50
5-Year	4.50	4.25	5.50	5.25	4.25	4.25
10-Year	4.50	4.25	5.25	5.25	4.50	4.50

Economic Diary

July

July	Euro zone	United States	UK
1	PMI Manufacturing		Nationwide House Prices
2	PPI	Factory Orders	PMI Manufacturing
3	PMI Services, Retail Sales, ECB Meeting	Payrolls	BoE Credit Conditions Survey, PMI Services
4	German Factory Orders		
7	German Industrial Production		Industrial Production, DCLG House Prices
8		Pending Home Sales	
9	Final 1Q GDP		Nationwide Consumer Confidence, Trade Balance
10	ECB July Monthly Report, French Industrial Production		MPC Meeting
11		Trade Balance, U. of Michigan Confidence	
14	Industrial Production		
15	ZEW Surveys	PPI, Retail Sales, Empire Manufacturing, Business Inventories,	RICS House Price Balance, Inflation data
16	Euro zone, German and French Inflation	CPI, Industrial Production, Housing Starts & Permits, Philly Fed	Unemployment and Earnings
17			
18	Trade Balance, German PPI		M4 Money Supply
21			Rightmove House Prices
22		Richmond Fed	
23	French Consumer Spending	Fed's Beige Book	Bank of England Minutes
24			Retail Sales
25		Durable Goods	2Q GDP Estimate

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Sep	End Dec	End Mar
EUR/USD	1.5774	1.55	1.50	1.45
EUR/GBP	0.7940	0.79	0.78	0.75
USD/JPY	106.19	108	110	110
GBP/USD	1.9864	1.96	1.92	1.93

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End Sep	End Dec	End Mar
USD	2.00	2.00	2.00	2.25
EUR	4.00	4.25	4.25	4.00
GBP	5.00	5.00	5.00	4.75

Source: Bank of Ireland Global Markets

Swap rates: 5 year

	Current	End Sep	End Dec	End Mar
US	4.32	4.25	4.25	4.50
Eurozone	5.00	4.50	4.25	4.25
UK	6.10	5.50	5.25	5.25

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2008		2009	
	GDP	Inflation	GDP	Inflation
US	1.3	3.8	1.9	2.5
Eurozone	1.6	3.3	1.5	2.4
UK	1.7	2.8	1.6	2.2

Source: Bank of Ireland Global Markets

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Market data supplied by Reuters

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