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Bank of Ireland
Global Markets

Weekly Commentary

12 February 2010

Economic Research Unit: (01) 609 4613

Themes from the week

– **Euro /dollar at 9-month low, Greece still unsettling markets**

Headlines for the week ahead

– **Inflation in UK and US, BOE and FOMC minutes.**

European Peripheral bond markets outperform

A volatile week in financial markets, largely driven by expectations about EU support for Greece, although China's decision on Friday to tighten monetary policy provided an additional catalyst. The Greek bond market saw a substantial fall in yields and the other peripheral euro markets also saw spreads narrow against Germany; for 10-year maturities the figure was 66bp for Greece, followed by 39bp for Portugal and 20bp for Spain. Ireland also did relatively well on the week, with the 10-year spread converging by 26bp, taking it back under 150bp ahead of the coming bond auction on Tuesday.

The EU issued a statement saying that euro members will take 'determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole' and said the EU 'fully support the efforts of the Greek government and their commitment to do what is necessary ' to meet the terms of its stability programme. The Commission will closely monitor Greece's progress in this regard and 'will propose necessary additional measures, drawing on the expertise of the IMF'.

Greece has not asked for any financial support, and the market may well remain willing to fund the Greek deficit but if not, the EU statement implies official financial support will be forthcoming. This begs a number of questions, however, as to the form that might take, and, crucially, who would pick up the tab.

The ECB cannot lend directly to Euro governments and one suggestion was that the EU might provide a lending facility to be drawn down if needed. This in effect, would mean the creation of a second ECB, acting as lender of last resort, with all that implies for the current system. A direct loan from all the other Euro states, or Germany and France alone, is another option, as is the purchase of Greek bonds by Euro governments or their state–owned banks. Either way, the effect is that German, French and other European taxpayers would be stumping up the funds that Greek taxpayers are unwilling to pay. A hard sell politically then, and hardly a positive one for the euro, which fell to a 9- month low below $1.36 during the week, with every prospect of further declines particularly given the anaemic performance of the euro economy relative to the US.

Dan McLaughlin

Data section contents (changes on the week)

Highlights for the week ahead

		Prev	Fcst	Cons
Tues	IRL Bond auction			
	UK CPI	2.9%		3.6%
	Ger ZEW	47.2		41.0
Wed	BOE Minutes			
	UK Unemployment rate	7.8%		7.8%
	FOMC minutes			
	US Housing Starts	557k		580k
	US Industrial Production	0.6%		0.7%
Thurs	US Philly Fed	15.2		17.0
	US leading Indicators	1.1%		0.5%
Fri	Euro PMI	53.7		53.5
	US CPI	2.7%		2.8%

Spot rates

More details in data section

EUR/GBP	↓	0.8681	**EUR/CHF**	↓	1.4649
EUR/USD	↓	1.3556	**EUR/JPY**	↑	122.09
GBP/USD	↓	1.5614	**EUR/CAD**	↓	1.4298
EUR/SEK	↓	9.9233	**EUR/PLN**	↓	4.0273
EUR/NOK	↓	8.0810	**EUR/ZAR**	↓	10.4349
EUR/HUF			**EUR/CZK**	↓	26.047

Long term rates

More details in data section

	2 year	3 year	5 year	7 year	10 year	15 year	20 year
EUR	1.63	2.02	2.62	3.05	3.47	3.85	3.95
GBP	1.69	2.29	3.12	3.59	3.99	4.33	4.37
USD	1.18	1.82	2.72	3.32	3.84	4.30	4.46

Official rates

More details in data section

	Current	Q1''10		Q2'10		Q4'10	
		Fcst	Cons	Fcst	Cons	Fcst	Cons
EUR	1.00	1.00	1.00	1.00	1.00	1.00	1.50
GBP	0.50	0.50	0.50	0.50	0.50	0.75	0.75
USD	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0.75	0.75

Recent research

See all recent research (www.boi.ie/eru)

See most recent versions of:

The Bulletin (monthly analysis of international and Irish markets)

UK View (quarterly analysis of trends in the UK economy)

The Outlook (quarterly analysis of trends in the Irish economy)

Irish Property Review (quarterly analysis of Irish property trends)

Irish Business Review (quarterly research, analysis and commentary)

All rates quoted are indicative market rates

Data section contents

Europe

EU leaders support Greece – but where's the beef?

EU leaders this week said they fully supported the efforts of Greece to reduce its budget deficit in 2010 and over the following years and called on it to implement the measures to do so in a "rigorous and determined manner". They also said they would "take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole". However, this seeming pledge to provide financial support to Greece if necessary (although the Greek government said that it did not request any financial support) was not backed up by any concrete details regarding what shape or form that support might take. There were, though, some suggestions emanating from EU officials that European finance ministers would take up this issue again when they meet early next week and put "meat on the bone" then. Perhaps as a result of this, the markets initially reacted sanguinely enough to the EU leaders' announcement, despite the absence of detail. The euro did lose some ground at first trading down to around $1.36 to the dollar, before recovering to $1.37. However the markets did appear to have second thoughts later, with the single currency renewing its slide to trade at a 9-month low of around $1.3550. Poor euro area GDP also weighed on the single currency. The Italian economy contracted in the final quarter of 2009 while its German counterpart stagnated over the same period. The French economy did expand further in Q4, but overall Euro Area GDP growth slowed to 0.1% from 0.4% in Q3. This is an annualised rate of growth of 0.4%, which compares pretty unfavorably with the 5.7% pace of growth recorded in the US economy in the final three months of 2009.

Ireland

CPI inflation increases to annual rate of -3.9% in January

Consumer prices in Ireland, as measured by the CPI, normally fall in January for seasonal reasons, reflecting the impact of the 'winter sales'. This duly occurred in January 2010 but rising energy costs provided a partial offset, reflecting the impact of higher excise duty on fuel. The latter added 0.3% to the overall change in the CPI on the month, so reducing the total fall to 0.6%. The Budget, delivered in December, had also cut excise duty on alcohol, and drink prices in restaurants and bars fell by around 2%, providing some additional downward pressure on prices. VAT was also cut in January, albeit marginally from 21.5% to 21%, but this does not appear to have had a material influence. The sales impact was also at work twelve months earlier, but the January 2009 figure was also flattered by a fall in energy costs and substantial decline in mortgage interest, with the result that prices fell by 1.7% on the month. Consequently, these base effects had a huge impact on the annual inflation figure in January this year, with the rate of deflation slowing to -3.9% from -5.0% in December. Prices also fell on the HICP index, the standard EU measure of inflation, by 0.7%, although this time the base effects were modest as mortgage interest is not included in this index; the annual inflation rate was -2.4% from -2.6% in December. This leaves Ireland at odds with the euro norm, as inflation turned positive again in the eurozone in November, and the 'flash' reading for December was +1%.

United Kingdom

Bank of England revises down inflation and growth outlook

The Bank of England's February Quarterly Inflation Report revised down the outlook for both inflation and growth from the forecasts in the November report. Over the forecast horizon, the Bank now expect inflation to be below target in 2 years if rates are left unchanged at 0.5% and the asset purchase scheme was left at £200bn. King said that "Spare capacity will press down on inflation in the medium term. It is more likely than not that inflation will be below target for much of the forecast period, but the risks are broadly balanced by the end." The report indicates that the MPC will be in no hurry to raise interest rates this year. They forecast that inflation would be around 1.2% in two years time if the MPC were to increase the base rate in line with market expectations. In fact, not only are interest rates increases this year becoming more unlikely, Governor King opened the door for more quantitative easing saying that "It is far too soon to conclude that no more purchases will be needed". GDP growth rates were also revised downwards compared to November's report. However, the rate of growth in 2011 and 2012 is still expected to be above the long term average for the economy and should growing at an annual rate of 3.2% by the end of 2011 if interest rates rise in accordance with market expectations. The report said that "while most likely path for growth is somewhat weaker, some of the downside risks are smaller than in November." Sterling sold off after the release of the report rising to over £0.88 against the Euro, however the concerns over Greece late on in the week pushing the Euro down and Sterling rose to £0.86 to the single currency by Friday.

United States

Dollar strengthens further

US equity markets steadied this week having lost ground over the previous three weeks or so - stocks had fallen by around 7% between mid-January and early February - with the main indices unchanged from last Friday. This put some upward pressure on government bond yields, which was compounded by a series of relatively poor Treasury auctions, with the yield on the benchmark 10-year bond rising by more than 10bps. The dollar gained further ground against the euro, though it was something of a week of two halves with trading dominated by events surrounding the fiscal position in Greece and the question of EU financial support to the country. The US currency fell to around $1.38 over the first half of the week, on the expectation that some form of financial help to Greece would be announced at the EU leaders meeting on Thursday, but strengthened to a 9-month high of almost $1.3550 late in the week as the meeting produced nothing in terms of the detail of any such support. Of course, the evidence which has accumulated over the past number of weeks pointing to the US economy outperforming its euro area counterpart - and confirmed in the fourth quarter GDP data for the respective economies – has also contributed to the dollar's gains against the single currency, which now stand at around 11% since the former reached its low point (of $1.51) in late November. This week saw some further good economic numbers out of the US, including a larger than expected fall in new jobless claims last week and a stronger than expect rise in retail sales in January. In relation to the latter, January saw a gain of 0.5% in nominal terms to leave sales running more than 1% above their average level in the final quarter of 2009, indicating consumer spending is on track to make another important positive contribution to GDP growth in the first quarter of 2010.

Japan

Pace of economic recovery expected to improve in Q4

The national account data we get for Japan next week will probably show that the economy grew at the fastest pace since early 2008. The consensus forecast is for quarterly growth of around 0.9% following growth of just 0.3% in Q3. The source of the return to strong growth is easy to identify. Surging exports caused by rising global demand (and in particular, the rise in demand from other Asian countries) has fueled the increase in activity in the economy. Towards the end of 2009, China overtook the US as Japanese largest export destination. However, the boom in external demand is not feeding into the domestic economy where demand remains weak. Consumer spending has been supported by Government stimulus measures, but those effects are beginning to wane. Consumer spending is estimated to have slowed to 0.3% in Q4 from 0.9% in Q3. Recently, Bank of Japan chief economist, Kazuo Momma, said that there is a long way to go before domestic demand will be able to drive the economy without fiscal stimulus.

Data section – changes on the week

Spot and forward rates

Change on the week

EUR/GBP

			Change
Spot	↓	0.8681	*-0.63%*
1M		1	
3M		4	
6M		5	
12M		2	

EUR/USD

			Change
Spot	↓	1.3556	*-0.78%*
1M		-1	
3M		-3	
6M		-8	
12M		-20	

GBP/USD

			Change
Spot	↓	1.5614	*-0.12%*
1M		-4	
3M		-10	
6M		-20	
12M		-35	

World forex rates

Change on the week

EUR currency pairs

			Change
EUR/CAD	↓	1.4298	*-2.04%*
EUR/AUD	↓	1.5376	*-2.37%*
EUR/NZD	↓	1.9567	*-1.56%*
EUR/CHF	↓	1.4649	*-0.08%*
EUR/JPY	↑	122.09	*0.01%*
EUR/SEK	↓	9.9233	*-2.55%*
EUR/NOK	↓	8.0810	*-1.27%*
EUR/HUF	↓	270.97	*-1.11%*
EUR/PLN	↓	4.0273	*-1.61%*
EUR/ZAR	↓	10.4349	*-1.46%*
EUR/CZK	↓	26.047	*-0.39%*

USD currency pairs

			Change
USD/CAD	↓	1.0546	*-1.30%*
USD/AUD	↓	1.1346	*-1.59%*
USD/NZD	↓	1.4438	*-0.75%*
USD/CHF	↑	1.0804	*0.68%*
USD/JPY	↑	90.08	*0.84%*
USD/CNY	↑	6.8326	*0.07%*
USD/MXN	↓	13.0145	*-0.98%*
USD/SGD	↓	1.4150	*-0.38%*
USD/BRL	↓	1.8643	*-0.89%*
USD/THB	↑	33.18	*0.06%*
USD/ZAR	↓	7.6990	*-0.45%*

GBP currency pairs

			Change
GBP/CAD	↓	1.6468	*-1.48%*
GBP/AUD	↓	1.7711	*-1.65%*
GBP/NZD	↓	2.2538	*-0.83%*
GBP/CHF	↑	1.6872	*0.57%*
GBP/JPY	↑	140.68	*0.70%*
GBP/SGD	↓	2.2089	*-0.55%*
GBP/MYR	↓	5.3381	*-0.83%*
GBP/NOK	↓	9.3061	*-0.59%*
GBP/HKD	↓	12.1322	*-0.13%*
GBP/SEK	↓	11.4340	*-1.86%*
GBP/DKK	↑	8.5731	*0.64%*
GBP/ZAR	↓	11.9464	*-1.20%*

Money market rates

Change on the Week

	Base	O'night	1 week	2 week	1 M	2 M	3 M	6 M	9 M	12 M
EUR	1.00	↓ 0.24	↑ 0.31	↑ 0.32	↑ 0.37	↑ 0.43	↑ 0.53	↓ 0.79	– 0.96	↑ 1.11
GBP	0.50	↑ 0.40	↓ 0.40	↓ 0.43	↑ 0.41	↓ 0.43	– 0.48	↓ 0.67	↓ 0.85	↓ 1.05
USD	0-0.25	↓ 0.15	↓ 0.22	↓ 0.22	↑ 0.26	– 0.27	↓ 0.29	↓ 0.47	↑ 0.73	↑ 0.84

Long term rates

Change on the Week

		2 year	*Chng*		5 year	*Chng*		7 year	*Chng*		10 year	*Chng*
EUR	–	1.63	*0.00*	↑	2.62	*0.05*	↑	3.05	*0.07*	↑	3.47	*0.09*
GBP	↑	1.69	*0.01*	–	3.12	*0.00*	↑	3.59	*0.01*	↑	3.99	*0.02*
USD	↑	1.18	*0.06*	↑	2.72	*0.10*	↑	3.32	*0.11*	↑	3.84	*0.13*

Government bond yields (YTM)

Change on the Week

		2 year	*Chng*		5 year	*Chng*		10 year	*Chng*		30 year	*Chng*
Ireland	↑	1.71	*0.77*	–	2.95	*0.00*	↓	4.54	*-0.03*			
Germany	↑	1.01	*0.03*	↑	2.24	*0.09*	↑	3.20	*0.09*	↑	3.92	*0.10*
US	↑	0.84	*0.08*	↑	2.34	*0.10*	↑	3.70	*0.13*	↑	4.66	*0.13*
UK	↓	0.72	*-0.46*	↓	2.73	*-0.16*	↑	4.00	*0.12*	↑	4.54	*0.15*

Prime Rate

Bank of Ireland prime rate	1.03

Equity indices

Change on the Week

			Change
ISEQ	↑	2892	*0.08%*
DOW Jones	↑	10144	*1.32%*
S&P 500	↑	1078	*1.15%*
SMI	↑	6403	*2.22%*
Nasdaq	↑	2177	*1.69%*
FTSE 100	↑	5151	*1.78%*
Eurostoxx 50	↑	2678	*1.74%*
Nikkei	–	10092	–

Commodities

Change on the Week

			Change
Brent	↑	72.76	*4.56%*
WTI Cushing	↑	73.80	*3.67%*
Gold	↑	1080.95	*1.50%*
Wheat	↑	483.25	*2.11%*
Emissions Allowance			

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