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Bank of Ireland
Global Markets

TheBulletin

A monthly analysis of international and Irish markets

Central Banks called into action - again

- Economic activity weakening
- Prompting monetary policy easing

Markets have been expecting yet further central bank action across the major economies in response to poor economic data. Economic activity in the US remains relatively weak and employment growth has slowed. The UK is again in recession and the economy has been essentially flat now for eighteen months. The euro area economy managed to avoid a second consecutive quarter of negative growth in Q1 but GDP looks almost certain to have fallen again in the second quarter.

Given the extraordinary policy actions taken by central banks over the past number of years – including reductions in interest rates to historically low levels and large-scale quantitative easing and liquidity provision – the continuing poor performance of these economies raises questions about whether the policies have 'worked' and, moreover, whether further action will have any effect. The central banks' answer to the first is, generally, that conditions would be much worse in the absence of these actions and, in the case of the Fed and the Bank of England at least, their answer to the second is that further action can support their economies.

Hence the Fed has decided to extend 'Operation Twist' to the end of this year. It will buy a further $267bn of longer-dated government bonds, on top of the $400bn purchased since last September, which it says "should put downward pressure on longer term interest rates and help to make broader financial conditions more accommodative". The Bank of England has indicated it will almost certainly announce a further round of 'quantitative easing" at the July meeting, with additional government bond purchases of at least £50bn likely, on top of the £325bn purchased to date. It has already announced a new initiative - a 'Funding for Lending' scheme - jointly with the Treasury, whereby the latter will guarantee loans from the Bank to the banking sector at below market interest rates in an effort to boost credit growth.

The ECB cut its main interest rate twice late last year, to 1%, though this is still above policy rates in the US (near 0%) and the UK (0.5%). It has also provided substantial liquidity to the banking sector, via two 3-year funding operations, which it says has helped avert a more serious credit contraction in the zone and which has had the effect of pushing short-term market interest rates well below 1%. While a further reduction in the policy rate may not have much impact on market rates, 'a few' ECB members still favoured a cut at the June meeting. President Draghi has also cited significantly increased downside risks to the economy. A rate reduction - probably 25bps - now seems likely in July.

Michael Crowley

Bank of Ireland estimates

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

United Kingdom

BoE to reactivate asset purchase scheme

Kings indicates further monetary easing on the way…

It has been an illuminating month regarding the Bank of England's intentions as we have gotten several strong signals that further monetary easing – in the shape of increased asset purchases – is now on the immediate agenda. It started with Governor King's annual Mansion House speech, in which he said the 'case for further monetary easing is growing' as the economic outlook deteriorates amid the increasing downside risks from the crisis in the Euro area. He noted that, since the last inflation report in May, conditions in the UK have deteriorated with 'weakening business surveys, a downward revision to measured output, and further slowing in economies overseas'. He pointed to problems created by the euro crisis, such as higher funding costs for UK banks and a 'black cloud' of uncertainty. King said further monetary easing could alleviate some of this pressure and, in his view, this was not 'pushing on a string' as the creation of money by the Bank of England has prevented an 'extremely damaging contraction' in the money supply.

King also said "today's exceptional circumstances create a case for a temporary bank funding scheme to bridge to calmer times" and announced that the Bank of England and the Treasury are working together on a "funding for lending" scheme that would "provide funding to banks for an extended period of several years, at rates below current market rates and linked to the performance of banks in sustaining or expanding their lending to the UK non-financial sector".

…and minutes indicate decision coming in July

The minutes of the June MPC meeting, which were published a week after King's speech, showed the committee voted 5-4 to keep the asset purchases total at £325bn, with 3 members – Governor King, Miles and Posen – voting for an additional £50bn of purchases and another, Fisher, voting for a £25bn increase. The key point from the minutes was that most members 'judged that some further economic stimulus was either warranted immediately or would probably become warranted in order to meet the inflation target'. In appraising what monetary stimulus action would be appropriate, the Committee felt, at the present time, that a 'reduction in the bank rate would not have any advantages over an expansion of asset purchases'.

In the conclusion, most members acknowledged that 'further stimulus was likely to become warranted at some point' and only held off judging on any further monetary stimulus at that time (in early June) due to several key events in the Euro Area (i.e. the Greek elections and the end of June EU summit). The economic situation in the EA does not appear to have improved dramatically since that time, so all the signals now point to the MPC authorising an additional £50bn of asset purchases at their July meeting (£25bn would underwhelm markets). In addition, one of the members who voted to stay on hold in June, Weale, said in a subsequent speech that he saw 'appreciably more room for further monetary stimulus'. His vote at the July meeting would be enough to tip the balance in favour of further asset purchases, which now look a virtual certainty. This has already been 'priced in', with 2 year swap rates falling 25bps in the last to week of June to under 1%.

Europe

Europe reacts to deepening crisis

ECB to cut interest rates again…

In the run up to the ECB meeting last month there had been some speculation that the Central Bank would surprise markets and cut interest rates as the debt crisis intensified. Surprise rate cuts are not really in the ECB's DNA however – it prefers to flag any change in policy - so it duly left the main interest rate at 1%. However, Draghi's comments in the press conference after the meeting have left the door wide open for a cut in rates, possibly as soon as July. The Bank kept its updated forecasts for growth and inflation in 2012 and 2013 largely unchanged from those made in March, but Draghi acknowledged that the data published since the cut-off date for the latest forecasts (May 24th) had deteriorated and he spoke of 'heightened uncertainty weighing on confidence and sentiment, giving rise to increased downside risks'. This sort of language came before the rate cuts of late last year and indicates that a rate reduction is being considered.

Indeed, Draghi said that 'a few' members wanted to cut rates in June, which tells us not only that some members are actively advocating cuts but also that the 1% level that the ECB has stuck to is no longer an issue and that members are considering moving below it. This all points towards further policy accommodation, and with Draghi ruling out another LTRO (for now) it points toward a rate cut in the near future. In addition, since the June meeting, several ECB members have hinted at an openness to cut rates and move below that 1% threshold. Not least of which has been Peter Praet, the ECB defacto chief economist, who said that 'there is no doctrine that interest rates cannot fall below 1.0 percent…they (rate cuts) are justified if they contribute to guaranteeing price stability in the medium term'. Taking all of this into account we now expect the ECB to cut the main refinancing rate by 25bps at the July meeting.

…while EU summit authorises further crisis measures

While the ECB contemplated further action, the situation in the Euro area continued to deteriorate over the past month. A 'Greece exit' crisis has been avoided, for now, following the election of a pro-EU Government in the rerun elections on June 16th, and the country has been moved from the front of the crisis storm. In its place has come Spain, and to a lesser extent Italy, as their yields continued to rise. Spain has had to go to the EU for official funding to recapitalise its banks, with the EFSF/ESM to provide up to €100bn. While that development intensified the crisis once more, there was some better news at the end of the month. Measures taken at the European Council summit exceeded market expectations (for once) and have taken some pressure off the peripherals. Firstly, EU leaders agreed a growth package which will boost investment by up to €120bn through the European Investment Bank and unused structural funds. However, it appears the Italian Government made it clear it would not agree to any growth package or, in fact, any deal, policy or 'roadmap', unless there was agreement on immediate initiatives to help lower Italian debt yields. Italy's veto threat proved to be a catalyst, with the summit ultimately agreeing on some of the more contentious issues.

Firstly, a single EU-wide bank supervisory authority will be established, involving the ECB, and once this is in place then the ESM would be allowed to recapitalise banks directly. This is an important concession, which has long been sought by under-pressure peripherals. Specific mention was made of Ireland with agreement that the Eurogroup 'will examine the situation of the Irish financial sector with the view of further improving the sustainability of the well-performing adjustment programme'. We have to see how this plays out but it hopefully will ultimately prove to be positive in reducing the share of Ireland's debt related to the banking sector. The Council also agreed to scrap the seniority of the financial support to Spain's banks from the EU rescue funds. Finally, the Council agreed to use the rescue funds in a 'flexible and efficient manner in order to stabilise markets' indicating a willingness to use the funds more proactively. Markets have, so far, responded very positively to that deal with 10-yields on Spanish, Italian Irish bonds falling about 60bps, 50bps and 75bps respectively in the days after the summit.

United States

Fed 'twists' some more

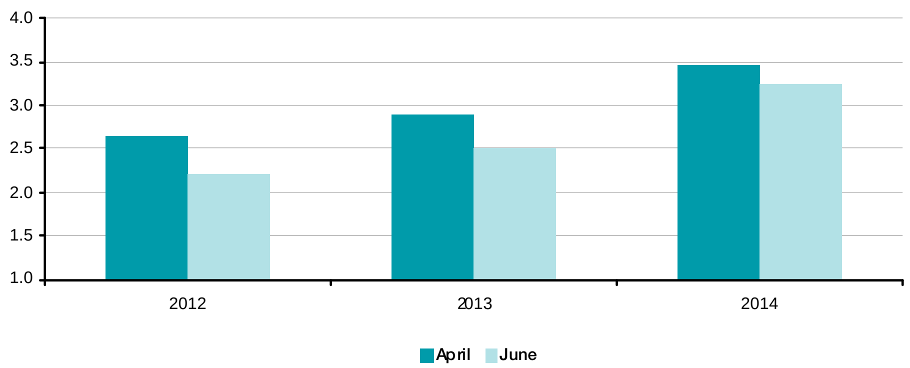
Weak data...

Following its policy meeting in late June the Fed said the US economy has been 'expanding moderately this year', though it noted that growth in employment 'has slowed in recent months'. It also said that consumer spending 'appears to be rising at a somewhat slower pace than earlier in the year'. On the other hand, business investment has 'continued to advance', while the housing sector has 'improved' albeit the level of activity remains low.

...prompts Fed to revise down growth forecasts...

On the back of these developments, the Fed has revised *down* its forecast for growth this year and the following couple of years, though the pace of growth is still expected to pick up over this period. Consequently, the Fed has also revised *up* its forecast for the unemployment rate for each of the years 2012-2014, although the unemployment rate is still expected to fall gradually over this period. In terms of the specifics, the Fed expects GDP growth in both 2012 and 2013 to be about half a percentage point lower, at 2.2% and 2.5% respectively, than forecast in April, while growth in 2014 is now expected to be about a quarter of a percentage point lower at 3.25%. As noted, this is still sufficient to keep the unemployment rate on a downward trend, although it is now expected to be about a quarter percentage point *higher* than previously forecast in each of three years to 2014, at 8.1%, 7.8% and 7.4% respectively. Inflation, meanwhile, is forecast to average 1.7% a year over the period 2012-2014, which is *below* the Fed's recently announced 2% target for inflation over the medium-term.

Fed forecasts for US GDP growth

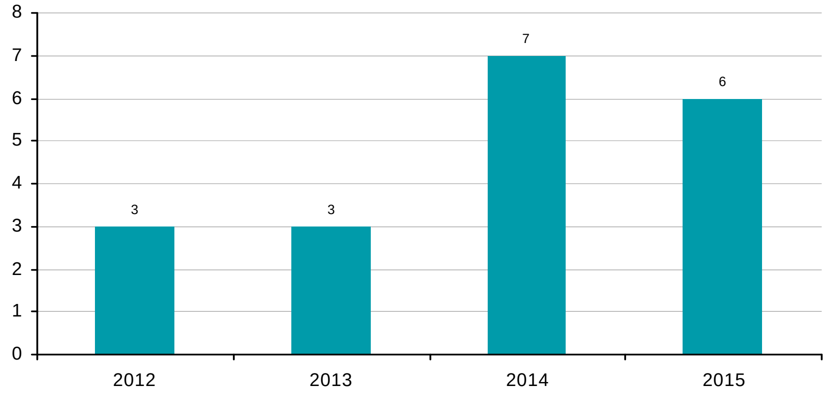


With inflation expected to be *below* target, and the unemployment rate projected to remain well *above* what is considered to be consistent with a 'fully employed' economy (around 5.5%), the Fed, not surprisingly, reiterated that exceptionally low interest rates "are likely to be warranted until at least late 2014". This is reflected in Fed members' latest assessment of the appropriate timing of a first increase in the federal funds rate, with 13 of the 19 members citing 2014 (7) or 2015 (6) as the appropriate time for a rate increase. A small number – 6 – believe interest rates should be raised before 2014, with 3 saying such a move would be appropriate this year.

...and to extend 'Operation Twist'...

However, in advance of the meeting, markets had speculated that the Fed would go beyond simply reiterating that low interest rates are warranted for some time yet and also announce some additional stimulus for the economy. The options appeared to be between prolonging the Maturity Extension Programme – aka 'Operation Twist' – which was due to expire in June, or another round of outright asset purchases (QE3), be it purchases of government bonds or purchases of mortgage-backed securities (MBS), or some combination of both. In the end, the Fed decided to extend 'Operation Twist', saying it would purchase a further $267bn of longer-dated government bonds between now and the end of this year, funded by the proceeds of the sale of an equivalent amount of shorter-dated government bonds (bonds with a maturity of 3 years or less). According to the Fed, the continuation of Operation Twist 'should put downward pressure on longer-term interest rates and help make broader financial conditions more accommodative", and in this way provide some further stimulus to the economy.

Appropriate timing of first interest rate increase (no. of Fed members)



...leaves door open for further action...

Given expectations for some policy response at the June meeting, the Fed probably did the minimum it had to do in order not to disappoint markets. It also left the door open to some further policy action – probably outright QE- if that is needed. That said, all things considered, the extension of Operation Twist seems a proportionate response to the recent slowdown in activity, which may not prove to be quite as sharp as the one that occurred over the first half of 2011, when consumer spending for example almost ground to a halt. Despite some softening recently, consumer spending should still increase at an annualised rate of around 2% in Q2, down from 2.5% in Q1 but still better than the 0.4% increase in the same quarter in 2011. While employment increased by an average of just over 70k a month in April and May, well down from 225k a month in Q1, the Fed believes the slowdown may be exaggerated (partly because of difficulty seasonally adjusting the data). In any case, if the pattern in 2011 is any guide - a similar slowdown in employment growth in the middle months of last year gave way to a reasonably strong re-acceleration into year-end – then we should see employment pick up again later this year.

The combination of poor data and expectations for a Fed response contributed to some weakening of the dollar, which fell from a high of around $1.2360 to the euro at end-May to just over $1.27 by mid-June. However, growing speculation that the ECB will cut interest rates contributed to a renewed fall in EUR/$ to sub $1.25, before developments at the end-month EU Summit saw the single currency strengthen again. The latter may prove short-lived however, and we would not be surprised to see the euro lose ground again over the coming weeks.

July

Date	Europe	United Kingdom	United States
2	PMI Manufacturing, Unemployment	PMI Manufacturing	PMI, ISM Manufacturing
3	PPI's	Mortgage Approvals	Factory Orders
4	PMI Services, Retail Sales	PMI Serives	
5	ECB Meeting, German Factory Orders	Bank of England Meeting	ADP Employment Change, ISM Non-Manufacturing, Initial Jobless Claims
6	German Industrial Production	PPI's	Payrolls & Unemployment
10		RICS House Price Balance, Industrial Production	NFIB Small Business Optimism
11			FOMC Minutes
12	Industrial Production		Initial Jobless Claims
13			PPI's, University of Michigan Confidence
16	Inflation data		Empire Manufacturing, Retail Sales
17	ZEW Survey	ONS House Prices, Inflation Data	Inflation Data, Industrial Production, Beige Book
18		Bank of England Minutes, Unemployment & Earning Data	Housing Starts
19		Retail Sales	Initial Jobless Claims, Philly Fed, Existing Home Sales, Leading Indicators
23	Consumer Confidence		
24	Advance PMI's		Advance PMI, House Prices
25	IFO Surveys	2Q GDP, Index of Services	New Home Sales
26			Durable Goods Orders, Initial Jobless Claims, Pending Home Sales
27			Q2 GDP, University of Michigan Confidence
30	Confidence Data, German Retail Sales	Mortgage Approvals	
31	CPI estimate		Personal Income & Spending, Chicago PMI, Consumer Confidence, S&P/CaseShiller Home Prices

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Sep	End Dec	End Mar
EUR/USD	1.25	1.20	1.20	1.25
EUR/GBP	0.80	0.80	0.80	0.80
USD/JPY	80	82	85	90
GBP/USD	1.57	1.50	1.50	1.56

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	0.75	0.75	0.75
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	0.93	1.00	1.25	1.25
Eurozone	1.25	1.25	1.25	1.25
UK	1.23	1.25	1.30	1.30

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2011		2012	
	GDP	Inflation	GDP	Inflation
US	1.7	3.2	2.2	2.2
Eurozone	1.5	2.7	-0.4	2.4
UK	0.7	4.5	0.2	2.8

Source: Bank of Ireland Global Markets

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