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TheBulletin

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ECB may not raise rates as quickly as expected

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- Market had discounted prolonged series of rate increases
- Much less aggressive schedule now expected

In April the ECB raised the repo rate from 1% to 1.25% in a well flagged move, and the market responded by anticipating a series of further increases. This view was based on the ECB's actions over two previous tightening cycles, when they tended to raise interest rates every three months, with an occasional two-month interval thrown in. On that basis the market in mid-April was expecting a repo rate of 2.5% by mid-2012 and 3% a year beyond that, implying a steady rise in mortgage costs for Irish borrowers on 'tracker' mortgages, although we felt at that time that the market was pricing in too much.

The market has had second thoughts of late, however, with a much less aggressive ECB rate path now projected; the repo rate is still expected to rise over the next few months to 1.5% but beyond that a rate of 1.75% is now expected by early next year and 2% by end-2012. Nothing is certain, of course, (the ECB 'never pre-commits') but a number of factors have emerged which may mean that this tightening cycle does not pan out like the last one.

Economic growth in the euro area has been a reasonably strong 2.5% over the past year and inflation, at 2.7%, is well above the ECB's 2% target, a combination which has prompted the Bank to view the risks to inflation as being on the upside. Yet the ECB also concedes that there is no evidence that the recent, largely commodity related, increase in prices is either affecting other prices or pushing up inflation expectations. Moreover, the threat of higher rates has helped to boost the euro, which despite a recent fall and persistent concerns about European sovereign debt sustainability is still stronger than it was a year ago. The level of euro GDP is also still some 2% below its peak in late 2007, and the recovery is very uneven across the zone, with Germany well above its long-term trend against modest growth and even contraction elsewhere.

Other markets, including the US and the UK, had seen a marked change in rate expectations earlier in the year, and the recent trend in euro interest rates partly reflects a response to these developments. The ECB's rhetoric itself has also been more balanced, with language implying that rates will rise if necessary but not signaling an aggressive move. The near-term path of oil prices and headline inflation could well prove the decisive factor with any upside surprises prompting tightening but any downside surprises leading to a more elongated tightening cycle than seen in 2005-07, when rates moved from 2% to 4% in eighteen months.

United Kingdom

MPC hold the line as data shows weakening domestic environment

MPC stay divided…

At May's MPC meeting the members voted 6-3, once again, to stay on hold with the usual suspects - Weale, Dale and Sentance – voting for an increase in rates while Posen voted for an £50bn increase in the asset purchase scheme. The minutes said that it was "still too early to know whether the softening in activity was temporary and, notwithstanding the expected unevenness in output growth, the coming months could be revealing about the underlying strength of demand. Even though the overall extent of spare capacity in the economy was uncertain, high unemployment was likely to persist for some time. In time, some withdrawal of stimulus would become necessary. But the May Inflation Report projections implied that this did not need to occur immediately". The minutes noted that "Two of these (dissenting) members regarded the matter (the tightening of policy) as finely balanced and favoured only a small tightening in policy." which could indicate that Weale and Dale may be considering changing their vote. Weale has said in a recent speech that he could see the case for higher interest rates fading if growth turns out to be weaker than expected. This was Andrew Sentance's last MPC meeting, thus reducing those in the hike camp to two. The new member who will replace Sentance, Ben Broadbent, may not join the hawk camp. He said in his testimony to the Treasury Select Committee that "on the broad thrust of policy, I think I would have followed pretty much what the Bank has done". This is certainly not something you would expect a confirmed hawk to say so it's probable that he will join the members voting to stay on hold at his first meeting this month.

…as opinions on inflation remain wide…

In the minutes, the Committee acknowledge that data from the UK had been quite soft, and while the Committee's central judgement was that some pickup in underlying growth was likely during 2011 it was less than the growth projected in the Feb inflation report. On the inflation front, the MPC felt that CPI annual inflation could hit 5% in the coming months but continued to blame the usual suspects – VAT increases, higher import and energy prices – as the root cause of this increase in prices. The minutes note the range of views amongst Committee members over the outlook for inflation was, as in recent months, wider than usual. They all agree that the outlook for growth had weakened in the past three months but they are not agreed on the outlook for inflation; that points to the hawks remaining marginalised for a while yet and the members who are voting to hold the line are strengthened by the relative weakness of the macro data.

..but latest data points to weak consumption and investment in Q1.

The latest economic growth figures showed growth of 0.5% in Q1, and a slowdown in consumer demand and investment as real incomes are squeezed by high inflation rates and austerity measures. Private consumption fell 0.6% in the quarter and follows a 0.3% fall in Q4'10 and a flat reading in the quarter before that. Investment fell sharply by 4.4% in Q1 which is probably, in part at least, due to fall in consumer demand. Government spending rose by 1.0% in the quarter but future austerity measures should cause Government consumption to fall back in the coming quarters. Net trade contributed a positive 1.3% points to GDP growth in the year to Q1'11, having made a negative contribution on average over the 10 years to 2010. Exports, no doubt, have been boosted by a much weaker sterling in the years since 2007 than in the decade before that. The economy appears to be rebalancing away from domestically driven growth and towards exports. However, the fall in consumer spending and investment is a worry. The MPC would like to see the consumer's share of the contribution to economic growth falling but do not like to see actual outright declines in personal consumption. The MPC is likely to be concerned about this weakness in consumer demand and it is one of the reasons the MPC is continuing to stay on hold.

Europe

ECB and Greece put pressure on Euro

Euro suffers sharp fall in May but recovers some ground by end month…

It has certainly been a volatile month for the Euro with the single currency falling sharply in the first half of the month in the aftermath of President Trichet's May press conference. While he said the Bank is 'never pre-committed' and can increase interest rates whenever it "judges it appropriate", he chose to say that the ECB is 'monitoring very closely' all developments regarding inflation, indicating a rate increase in June is unlikely, and not that 'strong vigilance' is required in relation to inflation, which would have indicated an increase in June was almost certain. The market interpreted Trichet's comments as being more dovish than expected and ruled out a June rate rise. The Bank still believes there are upside risks to inflation, however, so a July move still looks likely. The market has priced out more aggressive tightening by the ECB – 2 year swaps have fallen about 30bps since the meeting - and this put downward pressure on the Euro which fell to $1.44 to the dollar after threatening to break $1.50 in the run-up to that ECB meeting. The Euro fell further against most currencies, including the dollar, later on in the month as concerns were once again raised about the public finances in Greece. It has become more likely as the year progressed that Greece will require a further aid deal as it is unlikely that market conditions will have improved sufficiently for Greece to tap the markets next year when its original aid deal runs out. There were markets rumours that Greece would be allowed to restructure or at least reschedule some of its debts which would force burden sharing on some of its private bond holders. This put renewed pressure on the Euro which fell to under $1.40 for a time while Greek 10 year yields soared to record highs of nearly 17%, double the prevailing yield when Greece agreed their first EU/IMF deal last May. However, the Euro revived towards the end of the month as the EU Commission indicated that a deal for Greece would be agreed in June and would not contain any harsh burden sharing terms at this time. Combined with some weaker than expect US data, this lifted the Euro back to around $1.44.

…while Euro area posts strong growth in Q1 driven by Germany.

The Euro area economy grew by 0.8% in the first quarter of 2011, rebounding from a relatively weak end to 2010 when GDP rose by just 0.3% in the final quarter of the year. The average rate of growth of 0.6% over the two quarters was slightly above the economy's trend rate of growth pre the economic/financial crisis and was the backdrop for the recent increase in ECB interest rates. The year-over-year increase in GDP in Q1 was 2.5%, so even allowing for some moderation over the course of this year the annual rate of growth for 2011 as a whole should still average over 2%. The strong Euro Area Q1 outturn was driven by the core member states; German GDP rose by 1.5% in the first quarter, which was stronger than expected. The recovery is becoming broad based in Europe's biggest economy with contributions to growth last quarter from investment, consumer spending and exports. The domestic economy is outperforming expectations as net trade actually made a smaller contribution to growth than domestic demand. Consumer spending is being driven by low unemployment amid a strong recovery from the global recession in 2008. This pace of growth in Germany is expected to dip in the coming quarters but a strong full year's growth of greater than 3% may now be on the cards, which will drive on EA growth as a whole. With the French economy also posting a healthy quarter, up 1% in Q1, this may go some way to justify the interest rate increases the ECB is probably planning. However, this data illustrates that the ECB will have to deal with a two speed Europe that is emerging with the core countries recovering well while the peripherals continue to struggle with weak growth or recession. While interest rate increases may be justified in Germany, they may not be able to be absorbed in Europe's weaker member states.

United States

Growth concerns remain to the fore

Consumer spending slows…

The US economy grew at an annualized rate of 1.8% in the first quarter of this year according to the second estimate of GDP, thus confirming the preliminary estimate published in late April. Consumer spending rose more slowly than previously reported however, by 2.2% rather than 2.7%, though investment spending was revised higher. The slowdown in consumer spending partly represented some moderation from the particularly strong pace of growth – 4% - in the final quarter of last year, but also undoubtedly reflected the impact of a rise in gasoline prices – as a result of the rise in the oil price – which dampened households' income and hence spending. Gasoline prices rose further in April resulting in another modest increase in consumer spending in that month, though they did ease back in May which should have supported spending last month.

…and manufacturing activity moderates…

The slowdown in consumer spending may also be also contributing to the moderation in manufacturing output growth being signaled by surveys of activity in the sector. Manufacturing output actually fell in April, according to the official data, though this was largely due to a sharp fall in auto production, which in turn was due to parts shortages arising from the earthquake in Japan. Still, the surveys suggest the underlying pace of growth in manufacturing is slowing, though it should be noted that this is from a significantly above trend rate recently.

…raising worries about the employment outlook…

Notwithstanding the slowdown in the pace of activity, employment rose strongly over the three months February to April, by an average of just over 230k a month, while the unemployment rate averaged 8.9% over this period, about a half a percentage point lower than over the three months to January. The number of new jobless claimants did rise sharply during the course of April, though this was partially unwound in May according to the data for the first three weeks of the month. However the number of new claimants still remained above 400k, which has raised some concerns that employment growth will slow.

…and driving bond yields lower.

Concerns about the outlook for the economy generally have contributed to a further fall in US government bond yields over the past month; the yield on the benchmark 10-year bond is about 30bps lower than at the end of April and at 2.95% is about 75bps lower than in early February. However, the dollar, which declined steadily between February and April, has risen over the past month, both on a trade-weighted basis and against the euro, in the case of the latter to around $1.45 from $1.48 (though it traded up to a high of $1.40 in late May). Euro (market) interest rates have fallen sharply relative to US rates over the past month as expectations regarding the extent of ECB monetary tightening over the remainder of 2011 have been scaled back, which has weighed on the single currency. The on-going uncertainty surrounding the Euro area debt crisis, particularly in relation to Greece, has contributed to some increase in risk aversion generally which has benefited the dollar more broadly, as evidenced by the rise, albeit modest, in its trade-weighted value over the past month.

Reflecting the slower pace of growth recently, the market has pushed out the timing of a first Fed hike even further over the past month, to September 2012. This could change again, though, if the growth slowdown proves transitory, as the Fed believes it will. As mentioned earlier, consumer spending should pick up again if the recent fall in energy prices is sustained, particularly if employment growth is maintained at a rate broadly similar to recent months. Any such shift in expectations would be accompanied by a renewed rise in US market interest rates, which would lend support to the dollar though the prospect of a further rise in ECB interest rates is likely to limit any gains for the US currency in the near term.

Swap Rates

Lower across the board

Rate expectations have changed…

The past few months has seen a general fall in swap rates across the major currencies, reflecting a change in market expectations about the likely pace and timing of monetary tightening.

In the US, the market has now pushed out the timing of the first expected rate increase by the Fed to September 2012, following a period of disappointing data releases. GDP, for example, slowed in the first quarter, rising by 0.4%, and both the Fed and the consensus have revised down forecasts for growth for the year as a whole. The Fed believes the slowdown was caused by 'transitory' factors and although the unemployment rate has fallen substantially over the past six months, is still well above the historical norm. Core inflation is also low, so that market does not expect the Fed to raise rates any time soon, with the result that 2-year dollar swap rates are back below 0.7% with 5-year rates below 2%.

…first in the US and the UK…

2-year sterling swap rates were trading at 2% in February, amid expectations that the Bank of England would start to tighten policy as early as May, but are now down at 1.5% again, following a market reassessment of the rate outlook. Inflation in the UK is significantly above the 2% target and the Bank of England expects it to reach 5% later this year, but the economy has slowed and the consensus has pulled back its growth forecasts for this year and next. This combination of high inflation and low growth has posed a dilemma for the Bank, and the 9-member MPC is split on the appropriate response although the majority favour keeping rates on hold at 0.5% given the uncertain economic outlook. The market too has now pushed the timing of the first expected UK rate rise into early 2012 with a corresponding fall in swap rates.

…and now in euros.

The ECB has responded to the recent rise in inflation, largely commodity related, by raising rates, although it accepts that at the moment there is no evidence of 'second-round' effects on prices in general. The quarter-point increase in April prompted the market to price in a series of rate rises, with the result that 2-year swaps traded up at 2.5% at times in April and May, from 1.6% at the turn of the year. Rates have fallen again over the past month however, reflecting a combination of less hawkish ECB rhetoric, weaker growth elsewhere and some signs that euro manufacturing output may have passed its peak momentum. Consequently, 2-year swap rates may well remain in a 2%-2.3% range over the coming months.

Swap Rates

	Euro		Sterling		US Dollar	
	End June	End Sept	End June	End Sept	End June	End Sept
2-Year	2.25	2.40	1.50	1.75	0.75	0.90
5-Year	2.85	3.00	2.50	2.75	2.00	2.25
10-Year	3.45	3.60	3.40	3.60	3.15	3.40

Economic Diary - June

	Europe	United States	United Kingdom
1	PMI Manufacturing	ISM Manufacturing, ADP Employment	PMI Manufacturing
2		Initial Jobless Claims, Factory Orders	
3	PMI Services, PMI Composite	Non Farm Payrolls, Employment Data, ISM Non-Manufacturing	PMI Services
6	PPI's		
7	Retail Sales, German Factory Orders		
8	Q1 GDP, German Industrial Production	Beige Book	
9	ECB Meeting	Initial Jobless Claims	Bank of England Meeting
10			Industrial Production, PPI's
13			Nationwide Consumer Confidence
14		NFIB Small Business Optimism, PPI's, Retail Sales	RICS House Price Balance, Inflation data
15	Industrial Production	Inflation Data, Industrial Production	Employment data
16	Inflation data, Employment data	Initial Jobless Claims, Housing Starts, Philly Fed	Retail Sales
17		Uni. Of Michigan Confidence, Leading Indicators	
21	ZEW Survey	Existing Home Sales	
22	Industrial New Orders, Consumer Confidence	FOMC meeting, House Price Index	Bank of England Minutes
23	PMI's	Initial Jobless Claims, New Home Sales	
24	German Retail Sales, IFO surveys	Durable Goods, Q1 GDP	
27		Personal Income & Spending	
28		CaseShiller Home Prices, Consumer Prices	Q1 GDP
29	Confidence Data	Pending Home Sales	
30	M3, HICP estimate	Chicago PMI, Initial Jobless Claims	

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Jun	End Sep	End Dec
EUR/USD	1.46	1.47	1.45	1.40
EUR/GBP	0.89	0.89	0.87	0.85
USD/JPY	80	80	85	90
GBP/USD	1.64	1.64	1.66	1.65

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End Jun	End Sep	End Dec
USD	0-0.25	0-0.25	0-0.25	0-0.25
EUR	1.25	1.25	1.50	1.50
GBP	0.50	0.50	0.50	0.50

Source: Bank of Ireland Global Markets

Swap rates: 5 year

	Current	End Jun	End Sep	End Dec
US	1.90	2.00	2.25	2.50
Eurozone	2.80	2.85	3.00	3.25
UK	2.50	2.50	2.75	3.00

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2011		2012	
	GDP	Inflation	GDP	Inflation
US	2.7	3.0	3.1	2.0
Eurozone	2.1	2.5	2.0	2.0
UK	1.6	4.2	2.0	2.3

Source: Bank of Ireland Global Markets

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