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Bank of Ireland
Global Markets

TheBulletin

A monthly analysis of international and Irish markets

Currency weakness appropriate for Euro Area

- The euro falls to 4-year low against Dollar
- The currency realignment will support euro growth
- The euro is now nearer fair value

The euro has fallen steadily on the foreign exchange markets in the year to date, declining by 8% on average against the other major currencies with half the depreciation recorded in the month of May. The single currency's fall against the US dollar has been more pronounced, at 15%, taking the euro to below $1.22 on occasion and as such back to levels last seen in 2006 and a far cry from the high of $1.60 recorded two years ago.

The speed of the recent fall appears to have unnerved some European policy-makers but the decline in the euro is appropriate given recent economic developments. The eurozone economy grew by just 0.2% in the six months to end-March, against 0.7% in the UK and 2.2% in the US. This wide divergence in relative economic performance has resulted in a substantial shift in interest rate expectations in favour of the dollar. Two-year interest rates in euro, for example, are trading at 1.35% and as such very close to US rates (1.25%) whereas the differential in favour of the euro was 0.75% six months ago. In other words investors are no longer receiving a significant interest rate premium to hold euros over dollars and that has hit the single currency.

The risk of a Greek debt default and the political confusion surrounding the subsequent bail-out has also hit confidence in the euro, of course, but in the absence of that development the single currency would probably have fallen anyway given its mediocre growth performance. Any change in the euro's external value is neither good nor bad as it represents a transfer between consumers and producers – a fall in the euro reduces the spending power of consumers, including those in Ireland, but represents a potential benefit for producers selling into dollar markets. Euro growth should therefore now benefit from the currency's fall as it may boost exports and it should also be noted that the euro is still far from being cheap - most studies put the 'fair value' for the euro/dollar rate at around $1.20 at most, (coincidentally its average value over the past decade) implying that it has been significantly overvalued for the last few years.

We had anticipated a euro/dollar fall to around $1.30 and we now expect the currency to trade in a $1.20 to $1.25 range with the risks to the downside, although speculative traders have sold the euro to an unusually large degree, which means that they have to buy the currency at some stage, which offers the best short term support.

Dr. Dan McLaughlin

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United Kingdom

Inflation becoming a problem

New Government starts down the fiscal consolidation path…

With a new Government in place following the election, the Conservative/Liberal Democrat administration wasted no time in starting fiscal consolidation plans. They immediately decided that a new budget would be announced on the 22nd of June and then outlined some spending cuts starting immediately. The new Chancellor, George Osbourne, detailed initial cuts of £6.25bn this year, but £500m of that will be put into other areas with the rest deficit reduction. The deficit was forecast to be £156bn before these measures in 2010 so £6bn in cuts represents a less than 4% cut in the deficit, or about 0.4% of GDP with the deficit currently forecast at around 12% of GDP. The Government said they found the savings through eliminating low value programs and reducing inefficiencies. Amongst the announcements was a civil service recruitment freeze, cuts in consultancy and government travel costs and renegotiations with major Government suppliers. However, this is the easy "fat" to trim from expenditure, the new budget will be a lot harder to put together, given the scale of the deficit, and fiscal correction measures are going to get a lot tougher from now on. You have to start somewhere and with a new Government in place, the market now expects serious actions to be taken to correct the imbalance in the public finances. The markets have welcomed the new Government's initial efforts with Sterling rising against the Euro from £0.87 at end April to around £0.83 by end May. This is partly due to the problems in the Euro area, but we see Sterling continuing to gain as the Government gets serious about correcting the fiscal deficit and the UK's economic recovery outpaces that of the Euro Area.

…and MPC starts to get a little worried over the inflation situation.

The Bank of England published its quarterly inflation report in early May. The report now assumes that inflation will be higher in the near term and stay above target in 2010. It will then fall sharply as a consequence of the output gap and is forecast to be below 2% in 2 years even if rates stay at 0.5%. The economic recovery is expected to be sustained with growth reaching 3.5% by 2012. The report said the "recovery in economic activity is likely to further strengthen" but downside risks "have increased somewhat reflecting in particular heightened market concerns about the prospects for fiscal consolidation in a range of countries". Governor King also said that he was very pleased with the new Government's "clear and binding" commitments to accelerate the pace of budget deficit reduction. He said the "eventual nature and pace of the consolidation are uncertain" and will need to be sensitive to sustaining financial market confidence. King said it was imperative that the UK's fiscal issues were tackled sooner rather than later.

On monetary policy, King said that raising rates now would not be appropriate and that the MPC "certainly hasn't ruled out" making further asset purchases. Inflation rose to an annual rate of 3.7% in April, up from 3.4% in March. This prompted yet another letter from King to the Chancellor of the Exchequer. It stated that the rise in inflation was largely due to three factors; higher oil prices; higher VAT rate; and the sharp depreciation of sterling in '07/'08. These factors are masking the downward pressure on inflation from the substantial output gap in the economy. There was nothing new in that review of the situation, which was largely unchanged from the February letter's explanation. However, there was somewhat of a change in tone when it came to the section of the letter detailing when the MPC expects inflation to return to target. In the latest letter, the Governor said that while the MPC expects inflation to fall back, it has been somewhat higher than expected over the past year and the Committee is conscious that the pace and extent of the prospective fall are highly uncertain. This highlights concerns about inflation which were not in the previous February letter. The minutes of the last MPC meeting confirm that inflation is starting to become a worry. They stated that, "while the committee central view remained that the substantial margin of spare capacity would continue to bear down on inflation, the extent to which inflation would moderate was highly uncertain". Members were split on whether the risks to inflation were to the upside or downside at the moment, with several members making a case for each scenario at the meeting. This so called "temporary" spike in inflation is lasting a long time. We can manipulate the data to take out effects such as the VAT changes and currency movements. This probably does more accurately reflect the real inflation environment at the moment but the fact remains that the focus of MPC policy making is the headline CPI rate and that has averaged 3.0% since January of 2008. The MPC needs to see this headline rate fall over the next year or inflation expectations could rise significantly.

Europe tries to stem debt crisis

Support package stops rising debt yields…

May has been an eventful month for the Euro area. A major debt support package for EA countries was launched and this successfully stemmed the rapid rise in peripherals yields that we saw in April. However, the crisis has not yet gone away and the market remains very jittery about the prospects for certain member states and are even more concerned that the current crisis will spill over into the financial sector and reignite a crisis in European banks. After an extraordinary first week of May in the markets, the EU authorities, finally, seemed to grasp the seriousness of the crisis and announced a major support package over the weekend of the 8/9 May. The previous week, risk aversion drove equities and peripheral bond prices lower; German 2-year bond yields fell to 0.5%, while Greek 2 year yields rose to over 12%. On the currency markets, the euro suffered further losses against the greenback, the single currency trading down to around $1.25. Amid that turmoil, EU leaders met over that weekend to try to end the sovereign debt crisis and support the single currency. An agreement was announced overnight on Sunday, with 3 distinct elements. Firstly, EU Governments would create a fund for struggling member states of up to €440bn in loans or guarantees, with another €60bn coming from existing EU funds and an additional €250bn from the IMF. Secondly, in order to head off any potential credit crisis in the financial system, the ECB reactivated unlimited fixed rate offerings of 3 and 6 months loans to banks and restored swap lines with Federal Reserve. Finally, the ECB announced that it will purchase public and private debt to "ensure depth and liquidity" in a dysfunctional market. The program aims to address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism.

…but market awaits fiscal consolidation…

The package eased the panic in the bond market with yields on all the peripherals coming in sharply. Irish 10 year yields came in by over 100bps after the announcement. However, the concerns over sovereigns have not gone away. May has seen several EA member states commit to additional austerity measures in order to assuage market fears and accelerate consolidation plans. Portugal cut some public sector wages and increased sales and income taxes, which should reduce the budget deficit to under 5% of GDP next year from over 7% this year. Spain cut public sector wages, froze pensions and plans a new wealth tax – in total these measures will cut the deficit to about 6% in 2011 from over 11% in 2009. Italy announced a public service pay freeze and a crackdown on tax evasion plus other measures which will shave up to 1.6% of GDP off the deficit. Ireland, of course, started implementing austerity measures long before now. Over the past two years, Ireland has announced and implemented consolidation measures amounting to almost 7.5% of GDP. These included public sector wage cuts and income levies. Still, markets are jittery about the prospects for the peripherals and an atmosphere of fear of contagion risk from Greece remains.

…as Euro dips to 4 year low vs the dollar.

The euro has come under huge pressure since the start of the debt crisis. It has dropped to 4 year lows of under $1.22 in recent weeks from over $1.35 at the start of April. In the short term, it remains under pressure but we think it may be somewhat oversold at the moment. As the situation becomes clearer regarding the EA support package and the deficit reduction measures being undertaken by peripheral member states, the euro may bounce in the short term. The weaker euro should provide a boost to exports and offset some of the weakness in EA domestic economies. The austerity measures being implemented by governments will hold back domestic demand and consequently growth will be weak in the medium term. This will compare to much stronger growth in the US over the next few years. In this scenario, we see the Euro trading in a $1.20 to $1.25 range for the rest of the year. However, there remains significant risk to this outlook, should the sovereign debt crisis accelerate again or spill over into the European financial sector. We don't think the crisis will be enough to push the global economy back into recession, and it should not even push the EA into recession, but cutting deficits will hold back growth in Europe for the next several years.

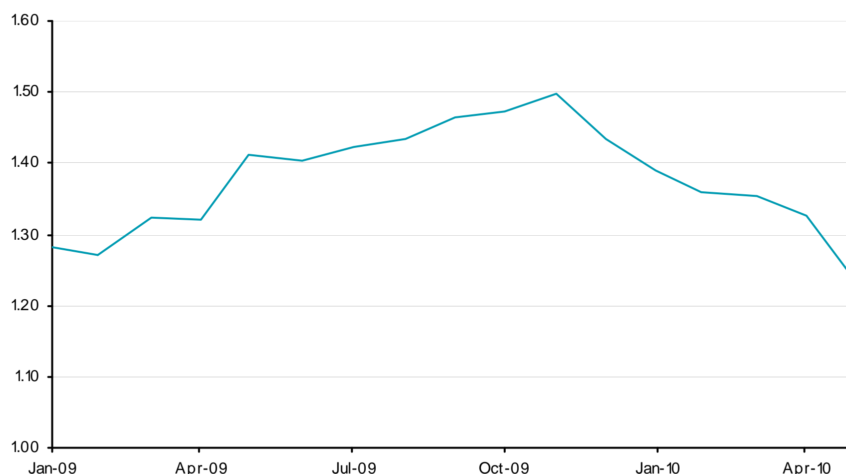
United States

Recovery still on track

Stocks fall, bonds rally…

The effects of the Euro Area sovereign debt crisis spilt over into US markets during the past month. Stocks fell, with the S&P losing about 8% notwithstanding some recovery late in the month, while a flight to safety pushed the yields on government bonds sharply lower, with 2-year yields declining by around 20bsp to 0.77% and the benchmark 10-year bond yield falling by almost 40bps to under 3.3%. Swap rates were somewhat mixed on the month however, with rates in the 2-year ending slightly *higher* but those from 3-years out ending *lower*. The decline in rates - of around 7bps in the 3- to 5-year area and 15-20bps in the 7- to 10-year area - was modest enough, however, in comparison to the fall in government bond yields, and so spreads over the latter widened out noticeably. The dollar strengthened further against the euro, gaining almost 8% (to bring its gains since the start of this year to over 14%), and also appreciated against most of the other major currencies except the yen.

Dollar Exchange Rate versus Euro



…as Europe's debt crisis raises concerns about growth…

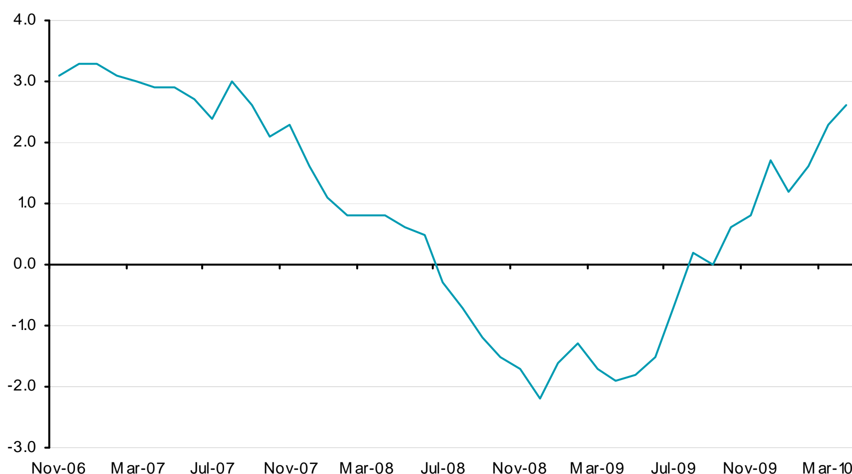
Investors concerns seem to have broadened out to encompass worries that the debt crisis will de-rail the economic recovery currently in train, in the US and indeed globally. In a recent speech, Fed Governor Daniel Tarullo, identified the channels through which the "financial turmoil" in Europe might *potentially* affect the US economy. One was by weakening the asset quality and capital positions of US financial institutions due to their exposure to peripheral European sovereign debt (though this exposure is relatively small). Related to this, a "heightening of financial stresses in Europe" could be transmitted to financial markets globally, resulting in a rise in funding costs and a liquidity shortage for some institutions. In these conditions, US banks and other institutions "might be forced to pull back their lending" at a time when "they have only recently ceased tightening lending standards". Another channel through which the crisis could affect the US economy is by reducing trade, as collectively Europe accounts for about a quarter of US merchandise exports, with the impact on growth depending in turn on the impact of the crisis on growth in Europe. According to Tarullo, a "moderate economic slowdown across Europe" would have a "discernible but modest" effect on the US, but a "deeper contraction in Europe associated with sharp financial dislocation would have the potential to stall the recovery of the entire global economy", with far more serious consequences for US economic growth.

It may be that the actions taken by the EU/IMF/ECB, together with the fiscal consolidation measures announced by peripheral sovereign governments, will ultimately prove sufficient to contain the crisis and prevent greater financial dislocation, in which case the impact on the European economy, and by extension the US and global economies, should be modest enough. Most forecasts, at this juncture at least, envisage such a scenario; both the IMF and OECD are forecasting global growth this year and next broadly in line with its long-run average (of around 4%), with US growth expected to average around 3% over these two years.

…but recovery still on track…

According to the final GDP estimate published late last month, the economy grew by 0.8%, or at an annual rate of 3%, in the first quarter of 2010. This marked a third consecutive quarter of positive growth, during which time GDP rose by a cumulative 2.7%, and the indications are that the current quarter (Q2) will be a fourth. Both consumer spending and business investment in equipment and software made positive contributions to growth in the first quarter and are likely to have done so again in the current quarter. While consumer spending was unchanged in April from March, according to the latest available monthly data, it was still more than 2% (at an annual rate) above its average level in Q1, while the latest data on capital goods orders and shipments suggest business investment will increase at a double-digit pace again in Q2 (after rising by 12.7% in Q1). The current consensus forecast is for GDP to increase by 0.8% in the second quarter, which if achieved would leave the *level* of GDP just a little shy of its pre-recession peak in the second quarter of 2008.Importantly, in terms of the sustainability of the recovery, employment is recovering, with private payrolls over the February-April period increasing by an average of 156k a month, including a gain of over 230k in April. This increase in employment boosts disposable incomes and helps to offset the negative impact on the latter from the expiry of some of the government's 'fiscal stimulus' measures.

Real Consumer Spending, % Change Year-over-Year



…though Fed interest rate stance still unchanged.

While acknowledging the pick up in economic activity, there is still no sign that the Fed is preparing to depart anytime soon from its existing monetary policy stance, that exceptionally low interest rates are likely to be warranted for an extended period. Indeed, what signals there have been from Fed officials indicate that recent developments in the Euro Area may *delay* even further the timing of any hike in policy rates. Nevertheless, if the fall-out from the debt crisis is relatively contained, then we are still likely to see government bond yields back up from current levels over the second half of this year, which will put some with some upward pressure on swap rates as well, as the 'flight to safety' trade is reversed and the focus returns to the on-going recovery in the economy.

June

	Europe	United Kingdom	United States
1	PMI Manufacturing, German Retail Sales	PMI Manufacturing	ISM Manufacturing
2	PPI's		Pending Home Sales
3	PMI Services, Retail Sales	Nationwide House Prices, PMI's Services	ADP Employment Change, Factory Orders, ISM Non-Manufacturing
4	Q1 GDP		Nonfarm Payrolls, Unemployment
7	German Factory Orders		
8	German Industrial Production		
9		Consumer Confidence	Fed's Beige Book
10	ECB Meeting	Bank of England Meeting	
11		PPI's, Industrial Production	Retail Sales,Uni of Michigan Confidence
14	Industrial Production		
15	ZEW Survey	Inflation data	
16	Inflation data	Unemployment data	PPI's, Housing Starts, Industrial Production
17		Retail Sales	Inflation data, Philly Fed, Leading Indicators
21	PMI Surveys	Rightmove House Prices	
22	Consumer Confidence, IFO surveys	UK Budget	Existing Home Sales, House Prices
23		Bank of England minutes	FOMC Meeting, New Home Sales
24	Industrial New Orders		Duarable Goods Orders
25			Q1 GDP

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Jun	End Sep	End Dec
EUR/USD	1.22	1.20	1.20	1.20
EUR/GBP	0.83	0.84	0.83	0.80
USD/JPY	92	94	100	100
GBP/USD	1.45	1.43	1.45	1.50

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	0.75
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 Jun	End Sep	End Dec
US	2.42	2.70	3.50	3.75
Eurozone	2.12	2.30	2.60	2.75
UK	2.60	2.85	3.25	3.50

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2010		2011	
	GDP	Inflation	GDP	Inflation
US	3.0	2.0	3.0	1.9
Eurozone	1.1	1.2	1.5	1.5
UK	1.2	2.5	2.5	1.7

Source: Bank of Ireland Global Markets

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Market data supplied by Reuters

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