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Bank of Ireland
Global Markets

TheBulletin

A monthly analysis of international and Irish markets

Global growth stronger than expected

- Consensus revising up world outlook
- Irish exports surprising to the upside

The world economy expanded at a faster pace than generally expected last year, growing at an annual pace around 5% in the first three quarters of 2010 before slowing a little in the final months of the year. As a consequence, most forecasters revised up their projections as the year unfolded and the consensus expectation for 2011 has also moved higher – the IMF now expects the global economy to expand by 4.4% this year and by a similar figure in 2012.

The recovery, although stronger than forecast, has been characterised as two-speed, with the developing world, particularly Asia, driving the upturn, and the major developed economies lagging; growth there has been more subdued than in most previous cycles. This pattern is set to continue this year, according to the IMF, although the US is now expected to accelerate – the IMF's 3% forecast is below the consensus. That pace of growth, if it materialises, should be sufficient to precipitate a fall in US unemployment, still stubbornly high at 9.4%, but not at a pace which will prompt a policy response from the US Federal Reserve. Consequently, the market still expects US interest rates to stay at the current abnormal low level around zero until 2012.

Growth in the euro area is expected to be more sluggish, at under 2%, and on that basis it is difficult to see the ECB tightening policy, although the Bank is now concerned that inflation is currently above their 2% target. This largely reflects high food and energy prices, a by-product of the global upturn, and so euro rates are unlikely to rise any time soon, although the market is now pricing in a quarter point increase in the final months of the year.

Inflation is a more pressing concern in the UK where some forecasters expect a 5% CPI reading this month, although in this case the Bank of England believes that the degree of spare capacity is such that inflation will fall back below its 2% target next year. The market is doubtful in that regard and is now priced for two rate increases this year, with the first in the summer months. The UK economy has slowed of late, albeit partially weather related, and this may persuade the Bank of England to sit on its hands for a longer period than the market expects.

The global upturn has also proved a boon for the Irish economy, with buoyant export sales offsetting weak domestic spending and delivering 1.6% GDP growth over the first nine months of 2010. Indeed, the recent monthly data, showing annual merchandise export growth in excess of 17%, implies that the external sector may have ended the past year with great momentum and that the consensus forecast for Irish exports in 2011 is too low. The strength of the global economy has a flip side, however, in that consumer prices in Ireland and elsewhere will face upward pressure from rising energy and food costs, although in the Irish case offset to some degree by downward pressures stemming from weak domestic spending.

Dr. Dan McLaughlin.

United Kingdom

High inflation and low growth gives MPC a dilemma

MPC in a difficult position as inflation is set to remain elevated…

The data released in the first month of the year has put the MPC between a rock and a hard place. Firstly, annual CPI inflation increased to 3.7% in December from 3.3% in November while the consensus forecast was for an annual increase of 3.4%. That made a full calendar year of greater than 3% annual inflation in each month of 2010 and leaves the annual rate for the year as a whole at 3.3%. Over the past couple of years, the Bank's forecasting of inflation has been poor and consistently underestimated inflation. The Bank has said, in a review of its own forecasting record, that the overshoot in inflation relative to its forecasts reflects the impact of higher than assumed energy prices, and some combination of greater than expected upward pressure on inflation from the fall in sterling, a larger than assumed pass through from VAT, and less downward pressure on inflation from weak demand. Despite its forecasting error, the Bank has still been prepared to hold its course through this prolonged period of above-target inflation and keep policy unchanged. The Bank is expecting inflation to increase in the very short term in 2011 and this is making some members more and more concerned about the MPC's credibility. In the minutes of the January MPC, it was stated that the Bank noted the "most likely near-term path of CPI inflation might be higher than the Committee had thought at the time of the November Inflation Report. It appeared likely to rise above 4% in coming months". However, overall they still expect the sizable output gap to bring inflation back to target in the medium term.

…but Q4 GDP contracts…

The second disappointing item of data was first estimate of GDP growth in Q4. The economy contracting by 0.5% when an increase of 0.4% was the consensus forecast. Some slowdown in the pace of growth from the 0.7% quarterly expansion in Q3 was widely expected but the outcome was a shock; there were declines in construction and services sectors in the quarter. The fall in business services sector was the largest negative contributor to growth, over -0.2% in the quarter. The decline in construction contributed virtually the same amount at over -0.2% for the quarter as well. The decline in construction is more understandable after outperforming in Q3 and there has been signs the housing market is slowing. The poor performance of the services sector is more worrying as this sector accounts for about 70% of GDP. The UK's Office for National Statistics estimates that the bad weather in the quarter did have a significant impact on growth, accounting for most of the 0.5% decline, and would have left GDP flat if there had been no disruption. This signals the economy is still on an uneven path to recovery and will have to weather further shrinking consumer confidence as the Government continues its austerity drive. In the aftermath of the GDP release, the market started to price out increases in the base rate with the number of increases this year falling from two, starting in the mid-summer, to one increase, with the tightening cycle starting in the autumn.

..and two members vote for increase in rates.

However in that same week, after the release of the GDP data, the minutes of January's MPC meeting revealed that two members (Sentance & Weale) of the MPC voted for an immediate hike in interest rates at the January meeting, (up from one at the December meeting), six voted for no change and one (Posen) voted for an extension of the Bank's QE programme. The minutes had a slightly more hawkish tone with most members believing that the "risks to inflation in the medium term had probably increased" and there was an explicit discussion on whether to raise interest rates while the decision "was finely balanced". You would imagine that following the poor Q4 result that decision will be less finely balanced next month and weigh clearly on the side of keeping the base rate at 0.50%. Nonetheless, the hawkish tone in the minutes caused the market to price back in the rate increase that it priced out after the GDP release. Governor Mervyn King has been robust in his defence of recent MPC policy and in a speech he said that if the MPC had raised interest rates significantly, inflation "might well have started to fall back this year, but only because the recovery would have been slower, unemployment higher and average earnings rising even more slowly than now". He believes that higher inflation caused by what he considers to be temporary effects - over which the MPC has limited influence - is clearly a price worth paying in order to support the recovery.

Europe

Trichet warns markets of ECB's inflation target credibility

Trichet says ECB will act if necessary to counter inflation threats…

ECB President Trichet's press conference made it an eventful start to 2011 for the ECB. The market had been looking for the Bank of England to start making noises about starting a tightening cycle due to the continued high rates of inflation in the UK. However, in the event, it was the ECB who decided to warn the market that it would not tolerate above target inflation. Trichet moved to reinforce the ECB's position in the face of "short term upward pressure on overall inflation". He reminded the markets that the ECB is prepared to act when necessary and has showed its credibility in that regard in July of 2008 when they hiked rates due to rising inflation despite the ongoing global financial crisis at that time. The ECB's position at this time is that interest rates are 'still appropriate'; there is short-term upward pressure on overall inflation from rising energy prices, but this has not 'so far' affected the assessment of the ECB that inflation will remain in line with its target (just below 2%) over the medium-term. The risks to this medium-term outlook for inflation are 'still broadly balanced', with upside risks relating to developments in energy and non-energy commodity prices balanced by downside risks related to the potential for weaker than expected economic growth; but the risks to inflation could "move to the upside".

…but underlying inflation pressures remain low…

Continuing high and rising commodity prices coupled with stronger than expected economic growth in some of the core areas of the Euro area is a situation which could result in rising inflation related to rising commodity prices leading to second round effects on other prices. However, in the current environment, in which the ECB expects economic growth to slow somewhat, and – more importantly - in which unemployment is very high (at over 10%) and the growth in labour costs very subdued (at less than 1%), any rise in headline inflation due to rising commodity prices is unlikely to have second-round effects and, thus, is likely to prove temporary. We think Trichet is just giving the markets a *very* early warning about the likelihood of raising interest rates. In the ECB's short history they have been prepared to sit and wait with interest rates at low levels until they are sure the time is right to start a tightening cycle. They kept interest rates at 2% for 29 months between July 2003 and November 2005 while the current interest rate has remained at 1% for 20 months to January 2011. We think that interest rates will remain at 1% for some time yet, despite Trichet's lecture on the ECB credibility last month. In fact, the ECB may have felt afterwards that the market somewhat overreacted to Trichet's comments. Some ECB members came out in the weeks after the meeting to tone down Trichet's warning. Cypriot ECB member Orphinides said the measures of underlying inflation remained rather low and that "sometimes there is an overreaction to the underlying message" and that he sees no need for interest rate increases anytime soon.

…however his comments boost the Euro and market interest rates.

The market did react strongly to Trichet's press conference. There was a sharp rise in market interest rates with 2-year swap rates rising by about 50bps from the start of the year to over 2% by the end of January, the highest level in about 18 months. As well as increasing in absolute terms, euro interest rates have also risen relative to those in the US and UK which in turn has contributed to the rise in the euro against both the dollar and sterling. The Euro rose from under $1.30 in the days preceding the meeting to approach $1.38 by the end of the month; that's the cross's highest level since early November in the aftermath of the Federal Reserve announcing more quantitative easing. The rise in Euro market interest rates since September is now very sizeable – 2-year swaps are about 80bps higher – and it would not be too surprising to see rates consolidate around these higher levels for a while now.

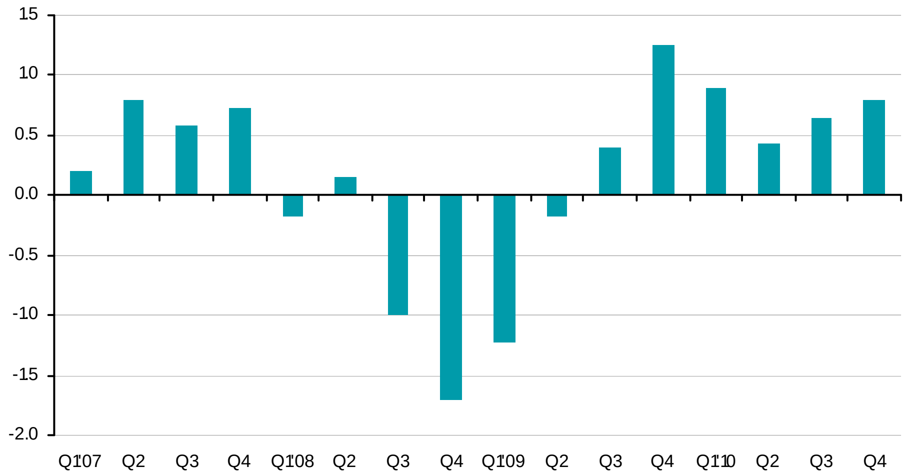
United States

Economic growth accelerates in final quarter of 2010

GDP growth accelerates in Q4…

The pace of economic growth accelerated further in the final quarter of 2010, with real GDP rising by 0.8% (or at an annualized rate of 3.2%) after increasing by 0.6% in the third quarter. Consumer spending picked up notably in the final three months of last year, rising by 1.1%, almost double the increase in Q3. Growth in business investment in equipment and software slowed from the third quarter, though non-residential building investment rose marginally having declined for nine consecutive quarters, and residential building investment rebounded somewhat after falling sharply in Q3, while government spending slipped back after rising quite strongly in both the second and third quarters. A slower pace of inventory building than in Q3 exerted a significant drag on growth in the fourth quarter, knocking 0.9% points off GDP, though this was almost fully offset by a large positive contribution from net exports, which added 0.8% points to GDP. Final domestic demand, which comprises consumer spending, investment and government consumption, rose by 0.9% the final quarter, after increasing by 0.7% in Q3.

Real GDP: % Change Quarter-on-Quarter



…but no meaningful fall in unemployment rate…

The cumulative increase in GDP over the four quarters to Q4'10 was 2.8%, a clear improvement from the 0.2% increase over the previous twelve month period and a pace of expansion broadly in line with the economy's pre-financial crisis trend rate of growth. This was accompanied by an increase in private sector employment, which rose by 1.3% in the year to December, following a decline of more than 4% over the year to December 2009. This pace of employment growth, which equated to an increase in private payrolls of around 112k a month, was not sufficient, however, to make any meaningful dent in the unemployment rate, which ended 2010 at 9.4%, down from 9.9% at the end of 2009, with some of this fall accounted for by a decline in the number of people actually participating in the labour force.

…and core inflation still trending lower…

Even as the pace of economic growth has picked up, inflationary pressures have remained subdued, reflecting the large margin of spare capacity that still exists in the economy (one indicator of which is the unemployment rate, which is some 3.5% to 4% points above its long-run average). As a result, the core PCE deflator – which is the Federal Reserve's preferred measure of underlying inflation – rose by just 0.7% over the year to December, more than a full percentage point lower than the increase recorded over the twelve months to December 2009 and almost 2% points below the peak increase of 2.6% in the year to July 2008. Moreover, underlying inflation on this measure was only 0.4% at an annualised rate in the final three months of last year.

…so Fed maintains accommodative monetary policy stance…

This combination of stubbornly high unemployment and declining underlying inflation underpins the Federal Reserve's continuing accommodative monetary policy stance, notwithstanding the pick up in economic growth. At its most recent meeting on January 26, the Fed acknowledged the continuing economic recovery but reiterated that progress towards its dual objectives of "maximum employment" and "price stability" – which effectively means an unemployment rate closer to 6% and inflation closer to 2% – has been "disappointingly slow". Consequently, it also reiterated that "exceptionally low levels for the federal funds rate", which is currently confined to a target range of 0 to ¼ percent, are likely to be warranted for an "extended period", and said it intends to continue with its purchase of $600bn of longer-term Treasury securities (i.e. QE2), which it commenced last November and plans to complete by the end of the second quarter of 2011.

US Government 10-Year Bond Yield (%)

…while bond yields range trading after spiking in late 2010…

Market expectations that the Fed would announce QE2 had driven government bond yields sharply lower in the run-up to the actual announcement in November, with the yield on the benchmark 10-year bond falling to below 2.4% from around 3% just three months earlier. However, yields rose quite sharply again subsequent to the announcement and by late December were trading almost 100bps higher at close to 3.5%, while the period since has seen yields trade in a range of, broadly, 3.25% to 3.5%. The renewed rise in yields in November/December was in response to increasing indications that economic growth had picked up in the final months of 2010 and which were confirmed by the Q4 GDP data. The broad stability in yields since the end of 2010 suggests markets are now awaiting indications about the pace of growth in early 2011 and the implications for employment in the economy. If growth looks like it is slowing from its Q4 pace to a below trend rate again, then bond yields are likely to break out of the recent range to the downside. If, as seems more likely, growth at least maintains its Q4 pace into 2011, and possibly accelerates, and employment growth picks up, then bond yields are likely to rise and trade in a new higher range of 3.75-4.25% during the course of 2011.

...and dollar loses some ground to the euro.

As well as rising in absolute terms during November/December, US bond yields also rose relative to core (e.g. German) yields in the Euro area, thus contributing to a rise in the dollar against the euro, with the single currency further pressured by sovereign debt concerns in the zone. The latter have eased somewhat recently, thus helping the single currency, but, more importantly, euro yields have risen relative to US yields and the euro has recovered to around $1.36 to the dollar. However, looking ahead, we continue to expect economic growth in the US to outpace that in the Euro area in 2011 and, accordingly, we expect US bond yields to rise again relative to euro yields, which we expect in turn will contribute to a renewed rise in the dollar against the single currency during the course of this year.

Economic Diary - February

	Euro Area	United Kingdom	United States
1	PMI Manufacturing, Unemployment	Nationwide House Prices, PMI Manufacturing	ISM Manufacturing
2	PPI's		ADP Employment change
3	PMI Services, Retail Sales, ECB Meeting	PMI Services	ISM non-manufacturing, Factory orders
4			Payrolls, Unemployment
7	German Factory Orders		
8	German Industrial Production		
10		Industrial Production, BoE meeting	
11		PPI's	
14	Industrial Production		
15	Q4 GDP, ZEW surveys	Inflation data	Empire Manufacturing, Retail Sales
16		Employment data, BoE Inflation Report	Housing Starts, PPI's, Industrial Production
17			Inflation data, Philly Fed, Leading Indicators
18		Retail Sales	
21	IFO Surveys		
22			Consumer Confidence, Case Shiller Home Prices
23	Industrial New Orders	BoE Minutes	Existing Home Sales
24	Consumer Confidence		Durable Goods Orders, New Home Sales
25		Q4 GDP	Q4 GDP, U. of Michigan Confidence
28	Inflation data		Personal Income & Spending, Chicago PMI, Pending Home Sales

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Mar	End Jun	End Sep
EUR/USD	1.36	1.30	1.25	1.25
EUR/GBP	0.84	0.84	0.83	0.83
USD/JPY	81.7	85	90	95
GBP/USD	1.62	1.55	1.51	1.51

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End Mar	End Jun	End Sep
USD	0-0.25	0-0.25	0-0.25	0-0.25
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 Mar	End Jun	End Sep
US	2.40	2.35	2.50	2.85
Eurozone	2.85	2.75	2.75	3.00
UK	3.05	2.85	2.85	3.00

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2010		2011	
	GDP	Inflation	GDP	Inflation
US	2.9	1.6	3.1	1.7
Eurozone	1.7	1.6	1.6	1.9
UK	1.6	3.3	1.9	3.5

Source: Bank of Ireland Global Markets

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Market data supplied by Thomson Reuters