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Bank of Ireland
Global Markets

TheBulletin

A monthly analysis of international and Irish markets

Central Banks gloomy on global outlook

- Data at odds with sentiment
- ECB expected to cut rates again

The global economy slowed in the first half of 2011, with annual growth estimated at 3.8% in the second quarter from 4.4% in Q1 and over 5% in 2010. The limited data available for the third quarter implies a similar pace to Q2, although investor sentiment reflects a concern that the pace of expansion has slowed more sharply. Moreover, the rhetoric and actions of the major central banks also reveals fear that next year could see a much sharper slowdown.

In the UK, for example, the Bank of England has announced further asset purchases – in effect more printing of money – in an attempt to counteract what it sees as substantial downside risks to growth, in part stemming from the turbulence engulfing the euro area. The Bank of Canada recently revised down its projections for global and Canadian growth and forecast a mild euro zone recession. In the US the Fed has also revised down growth projections and announced its intention to buy longer dated government bonds in an attempt to keep longer interest rates low. Elsewhere, the Australian central bank has reversed course and cut interest rates, while speculation mounts that the authorities in China may well abandon monetary tightening and embrace monetary easing.

Annual growth in China did slow in the third quarter, to 9.1% from 9.5%, but the quarterly increase was still a strong 2.3%. In the US, the economy picked up in the third quarter, expanding at an annualised 2.5% from 1.3% in Q2, and that pattern was repeated in the UK, with growth there of 0.5% from 0.1% in the second quarter. These figures are at odds with sentiment readings such as consumer confidence, which are generally weak and declining, suggesting a divergence between the hard economic data and sentiment indicators.

There is one major central bank which had not sought to change monetary policy – the ECB. It was curious that other central banks were easing policy in part on fears of a euro area recession, while the euro area's central bank resisted such a move. In cutting rates by a quarter point the ECB is now addressing the clear downside risks to euro growth, and we still expect the repo rate to end the year at 1%.

Dr. Dan McLaughlin.

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United Kingdom

Bank of England restarts QE

Bank of England ups assets purchases…

The Bank of England went on the offensive last month launching another round of QE in the face of slowing growth as well as uncertainty caused by the debt crisis in Europe. The MPC kept rates on hold at 0.5% at the October meeting but increased the asset purchase scheme total to £275bn from £200bn. This was a larger increase than expected as the markets, generally, were expecting an initial £50bn increase to be announced, possibly in October but more likely November. This represents a somewhat aggressive move by the Bank to counter slowing growth. The statement said that the "vulnerabilities associated with the indebtedness of some euro-area sovereigns and banks have resulted in severe strains in bank funding markets and financial markets more generally. These tensions in the world economy threaten the UK recovery". The MPC went on to say that "the squeeze on households' real incomes and the fiscal consolidation are likely to continue to weigh on domestic spending, while the strains in bank funding markets may also inhibit the availability of credit to consumers and businesses". While inflation remains elevated, the MPC do not see this as a barrier to QE as "measures of domestically generated inflation remain contained and inflation is likely to fall back sharply next year as the influence of the factors temporarily raising inflation diminishes and downward pressure from unemployment and spare capacity persists". In that environment the "deterioration in the outlook has made it more likely that inflation will undershoot the 2% target in the medium term. In the light of that shift in the balance of risks, and in order to keep inflation on track to meet the target over the medium term, the Committee judged that it was necessary to inject further monetary stimulus into the economy."

…and indicates they may do more.

Later last month, the minutes of that meeting showed - as more or less expected – that it was a unanimous vote to restart the program. The minutes revealed that the Committee debated adding up to £100bn in additional stimulus before settling on £75bn. They decided that there was no sufficient case for waiting until the new inflation report forecasts which would be available at the next meeting in November and that the arguments to delay action were outweighed by the arguments to act now due to the ongoing EA debt crisis and the slowdown in growth. The minutes noted that "Heightened awareness of the vulnerabilities associated with the indebtedness of several euro-area governments and banks had led to a further deterioration in demand prospects…while the worst risks had not crystallized, the threat of them doing so had resulted in severe strains in bank- funding markets". The MPC judged that recent indicators suggest "that the underlying rate of growth (in the UK) had moderated and would be close to zero in the fourth quarter, substantial downside risks pointed to injecting a larger monetary stimulus than otherwise in order to place to economy in a stronger position were those risks to materialize.". Overall the members described the case to increase QE this month as "compelling". The Committee, even by just discussing doing up to £100bn, clearly is showing that they are prepared to play their hand again if the situation warranted and would increase the total in the asset purchase scheme again if needed. The data for the UK since that meeting has not been encouraging with the manufacturing PMI below 50 well below 50 in October while the Services PMI is hovering just above 50. However, the new round of asset purchases will take about 4 months to complete so for now the Committee will watch how things progress over this period.

Europe

EA debt plans dashed as growth slows

New strategy derailed by Greek referendum proposal…

Europe has been struggling for many months to draw a line under the debt crisis and stop the contagion which threatened to spread the crisis to other member states. Last month EA leaders put a strategy together which was hoped would calm the situation amid signs that economic growth may be slowing to a halt. The EA has agreed a three pronged strategy to deal with the crisis. This encompasses leveraging the EFSF for use as an insurer for issuance of sovereign debt and to use the fund as an investment vehicle for outside investment into EA debt. It is estimated this will give the fund an effective firepower of €1trn to support EA sovereign debt. Next, some Greek debt is to be written down by 50% to make the Greek debt burden sustainable by 2020. Greece has been the source of many of the EA problems and it was hoped that this deal would draw a line under its problems and put the country on a long term path to public finance stability. Finally, EA banks will be required to have a core capital ratio of 9% by the end of June 2012. This aims to strengthen EA banks and the markets perception of them. Banks unable to reach that goal will be required to raise new capital and deleverage to hit the target, if they are unable to do so then sovereign states or the EFSF will provide additional capital. This new strategy had been promised by Chancellor Merkel and President Sarkozy since the start of September and, while it is not wide ranging and the EFSF funding is not as large as some commentators had hoped for, the agreement was well received by the markets which saw equities and the Euro rise and peripherals yields tighten after the deal was announced. However, this boost was short lived as Greece unexpectedly announced that it would hold a referendum on the latest aid package – which would in fact be a de facto referendum on Euro membership - which put the implementation of this strategy on hold and thrown the Euro area into disarray once again. The latest news appears to be that a new government may be formed and the referendum has been scrapped, but the situation remains very fluid. Until the Greek position on the package is clarified we can expect further financial market volatility and continued uncertainty about the support for peripheral member states. The ECB stepped up purchases of peripheral sovereign debt in the days after the referendum announcement in order to calm the situation which may have limited yields on peripheral debt widening once more.

…and ECB cuts rates in face of 'mild recession".

In the background of the ongoing debt crisis is the continuing signs of a sharp slowdown in Euro area growth. PMI survey data for services and manufacturing are both firmly below the 50 expansionary threshold in October. The signs point to the economy having stopped expanding and may now be contracting slightly. The ECB had resisted calls to lower interest rates with the Bank maintaining at the October meeting that rates were appropriate. However, the markets believed that an interest cut would have to come due to the weakness of economic data. We knew rate cuts were on the agenda as ECB President Trichet said at his final press conference that there are 'intensified downside risks' to the economic outlook and dropped the previous reference to monetary policy being accommodative. The Bank also said that the economy is likely to grow at only a "very moderate" pace in Q4. At the November meeting, the Bank decided to cut rates by 0.25% and new chief Mario Draghi said the Bank made the decision due to their observation of "slow growth heading toward a mild recession". In fact, Draghi left the door open to further interest rate cuts by saying that the "main downside risks to inflation relate to the impact of weaker than expected growth in the euro area and globally" (similar to the language in the October statement); however he added a more explicit qualifying statement saying that "if sustained, sluggish economic growth has the potential to reduce medium-term inflationary pressure in the euro area". This could indicate that the governing council continues to have a bias towards more rate cuts especially when you consider that November's cut only removes one of the two interest rate increases from earlier this year.

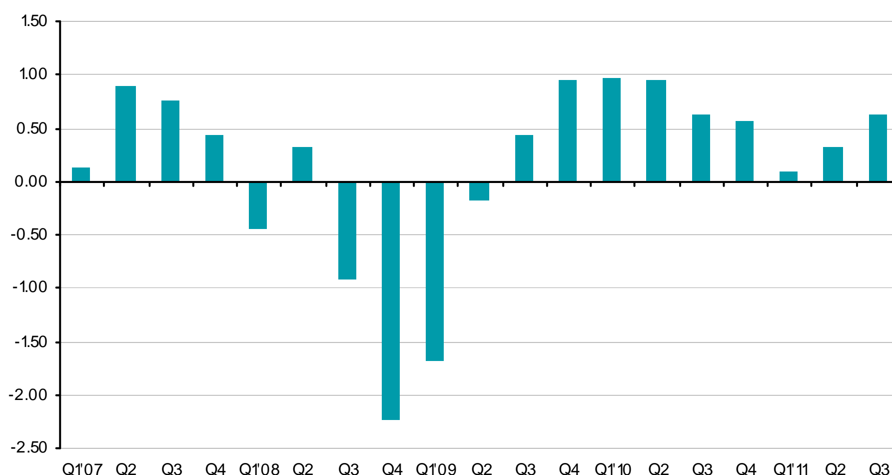
United States

Growth picks up in third quarter

Economy picks up in Q3…

The pace of economic growth picked up in the third quarter according to the latest official data, with real GDP rising by 0.6% (or by 2.5% at an annualised rate) after an increase of 0.3% in Q2 and 0.1% in the first quarter. Indeed excluding the negative impact of a slower pace of inventory building, growth was 0.9%, the strongest outturn since the final quarter of 2010. Consumer spending - which accounts for over 70% of GDP - recovered in Q3, increasing by 0.6% having been essentially flat in the second quarter. Business investment in equipment and software, which has been a notable bright spot in the recovery to date, posted a particularly large gain, increasing by almost 4.5% from Q2 and contributing around 0.3% points to the increase in GDP. Investment in non-residential construction rose further, extending the recovery that commenced in the second quarter of last year, and has now risen by 10% from the trough in early 2010. Residential investment only rose marginally again in the third quarter having bottomed in the first quarter of this year, but at least it is now no longer weighing negatively on growth.

US GDP Growth - % Change quarter-on-quarter



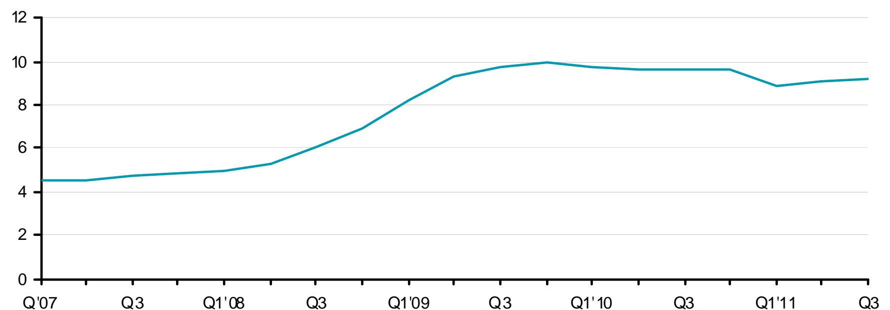
…but unemployment has risen again recently…

The growth of 0.6% in Q3 brought the cumulative increase in GDP over 12 months to 1.6%, down sharply from the 3.5% increase over the year to Q3 2010 and well below the economy's estimated trend, or potential, rate of growth of around 2.5%. The slowdown in growth to below trend has also resulted in a renewed rise in the unemployment rate, which in September stood at 9.1%, up from 8.8% in March (albeit still about 1% point down from the peak of 10.1% in October 2009). This in turn partly reflects a (lagged) slowdown in the pace of job growth, with private sector employment increasing by a little less than 130k a month over the six months to September, down from an increase of almost 170k a month over the six months to March. Notwithstanding the slowdown in the pace of economic growth, inflation has picked up over the past year, with PCE (personal consumption expenditure) inflation accelerating to 2.9% in the year to this September from 1.4% in the year to September 2010. However, much of this was due to the impact of higher energy prices in particular. Core inflation (which excludes energy and food prices) picked up by much less over the same period, to 1.6% from 1.2%. In any case, inflation pressures have eased recently as energy prices have fallen back again; the annualised increase in PCE prices fell to just over 2% in Q3 from almost 3.5% in Q2.

…and Fed revises down growth forecasts…

Though the Fed had expected some pick up in the economy in Q3, as the dampening effect of temporary factors on H1 activity waned, it has still marked down substantially its forecasts for the economy both this year and next. It now expects GDP growth of 1.7% over the year to the final quarter of 2011, down from its June projection of 2.8%, and 2.7% over the year to Q4'12, down from a forecast of 3.5% previously. As a result it now expects the unemployment rate to be higher than previously projected, at 9.1% in Q4'11 and 8.6% in Q4'12, the latter more than half a percentage point higher the forecast in June. Moreover, the unemployment rate is still expected to be between 7.8% and 8.2% in the final quarter of 2013, well above what the Fed considers to be the economy's normal rate of unemployment over the long run. PCE inflation, meanwhile, is expected to decelerate to 1.7% in 2012, from 2.8% this year, and to average around 1.7% as well over the following couple of years.

US Unemployment Rate (%)



…and takes measures to support the recovery…

In response to the recent slowdown in growth and the downgraded prospects for the economy over the next 2-3 years, the Fed has said that interest rates are likely to remain at the current level of effectively zero per cent until *at least* the middle of 2013. The Fed has also commenced 'Operation Twist', buying longer-maturity government bonds and selling short-maturity bonds with the intention of keeping the yields on the former low, thus exerting downward pressure on other longer term interest rates in the economy and thereby supporting the recovery. In the statement published after its latest monetary policy meeting in early November, the Fed warned of 'significant downside risks to the economic outlook, including strains in global financial markets' and said that it is prepared to take further action if necessary to help the economy. This is likely to include another round of 'quantitative easing' (QE3), be it further outright purchases of government bonds or, as in the case of QE1, purchases of mortgage-backed securities (MBS), which would help the housing market –by putting further downward pressure on mortgage rates - as well as supporting the economic recovery generally.

…dollar likely to strengthen.

Having strengthened to a 10-month high of around $1.31 to the euro in early October, the dollar fell back to over $1.40 later in the month amid hopes of progress in dealing with the Euro area debt crisis. However, while the EU leaders' summit of October 26 agreed a framework for addressing the crisis, the lack of detail regarding the main elements of the plan unnerved markets, as did a proposal by the Greek PM to hold a referendum – subsequently taken off the table – on the latest bail-out package for his country, and the dollar recovered some ground again. The ebb and flow of developments in relation to the debt crisis is likely to continue to be the main driver of EUR/$ in the near-term. However, notwithstanding the slowdown in the US economy, it still seems set to outperform its Euro area counterpart, the latest survey data for which points to the risk of an outright decline in GDP in the zone. This in turn suggests the dollar should strengthen against the single currency over the coming months.

Economic Diary - November

	Europe	United States	United Kingdom
1		ISM Manufacturing	Nationwide House Prices, PMI Manufacturing, 3Q GDP estimate
2	PMI Manufacturing	FOMC meeting, ADP employment change	PMI Construction
3	ECB Meeting	Initial Jobless Claims, Factory Orders, ISM Non-Manufacturing	PMI Services
4	PMI Services, PPI's, German Factory Orders	Payrolls, Unemployment	
7	Retail Sales, German Industrial Production		
8		NFIB Small Business Optimism	RICS House Price Balance, Industrial Production
10	EU Commission Forecasts	Initial Jobless Claims	BoE Meeting
11		Uni. of Michigan Confidence	PPI's
14	EA Industrial Production		Consumer Confidence
15	3Q GDP estimates, ZEW Survey	PPI's, Retail Sales, Empire Manufacturing	Inflation Data
16	Inflation data	Inflation Data, Industrial Production	Bank of England Inflation Report, Unemployment Data
17	Consumer Confidence	Initial Jobless Claims, Housing Starts, Philly Fed	Retail Sales
21		Existing Home Sales	
22		3Q GDP Estimate	
23	Industrial New Orders	Minutes of FOMC, Durable Goods Orders, Personal Income & Spending, Initial Jobless Claims	Bank of England Minutes
24	IFO Surveys		3Q GDP 2nd Estimate
25	German Retail Sales		
28		New Home Sales	
29	Confidence Data	S&P CaseShiller Home Prices, Consumer Confidence, House Prices	
30	CPI estimate, Unemployment	Beige Book, ADP Employment Change, Chicago PMI, Pending Home Sales	

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Dec	End Mar	End Jun
EUR/USD	1.38	1.30	1.30	1.30
EUR/GBP	0.86	0.85	0.85	0.85
USD/JPY	78	80	80	85
GBP/USD	1.60	1.53	1.53	1.53

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End Dec	End Mar	End Jun
USD	0-0.25	0-0.25	0-0.25	0-0.25
EUR	1.25	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 Dec	End Mar	End Jun
US	1.25	1.20	1.25	1.35
Eurozone	1.90	1.85	1.85	2.00
UK	1.85	1.75	1.75	2.00

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2011		2012	
	GDP	Inflation	GDP	Inflation
US	1.60	3.00	2.10	2.10
Eurozone	1.60	2.50	0.80	1.80
UK	1.00	4.40	1.50	2.60

Source: Bank of Ireland Global Markets

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Market data supplied by Thomson Reuters

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