



The Bulletin

A monthly analysis of international and Irish markets

Euro falls against Sterling and US Dollar

- Euro may fall to 84 pence sterling
- Resurgent dollar to put further pressure on euro

The euro has had a bad winter, having fallen substantially against the other major currencies over the past two months. From an Irish perspective the key change has been the decline against sterling and the US dollar as the euro's strength against these currencies, notably the former, has had a significant influence on the economy over recent years, putting downward pressure on prices and employment.

Three years ago a euro bought under 66 pence sterling but by December 2008 the slide in the UK currency had brought that figure to 98 pence. A currency appreciation boosts the purchasing power of consumers, either directly in this case for anyone crossing the border into Northern Ireland, or indirectly via lower import costs, although this impact can be diluted depending on the trend in retail margins. For exporters, however, it usually results in either a squeeze on profit margins or a decline in demand, with negative knock-on effects for employment, and the UK market represents a much higher export share for Irish indigenous firms than the 16% figure derived from the aggregate export data.

Most studies show that sterling is substantially undervalued against the euro, with 75 pence seen as around 'fair' value, and we have argued that sterling is likely to appreciate from recent lows against the single currency over time. The decline in the euro sterling rate of late has seen it trade below 87 pence and although a short term euro rally is possible we still feel that the 84 pence lows of last June are likely to be revisited by mid-year.

The euro has also fallen against the dollar, although again the current level (around \$1.39) is still substantially above the \$1.15 - \$1.20 range seen as fair value. The dollar's appreciation, which has been broadly based, may in part be due to the relative good performance of the US economy of late, with GDP in the final quarter of 2009 rising by 1.4%, compared with just 0.2% estimated in the euro area. The perception that continental Europe is underperforming the US is also evident in longer term interest rates, with the yield on 10 year US bonds rising sharply relative to German bonds over the past two months. Investor concerns about the fiscal deficits of some of the euro's peripheral economies, notably Greece, have also played a part as has market positioning, with speculative traders now selling the euro against the dollar from being buyers of the euro for most of 2009. We believe that relative economic performance is a strong driver of currencies so, in the absence of an acceleration in euro growth relative to the US, the euro may remain under downward pressure against a resurgent US dollar; we have cut our forecast for end-March to \$1.35 from \$1.40.

Dr. Dan McLaughlin

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United Kingdom

UK inches out of recession**Inflation surprises to the upside once again...**

We have had some surprises in UK data this month starting with the inflation data for December. Annual CPI inflation came in at 2.9% - beating the consensus forecast of a gain of 2.6% - following an increase of 1.9% in November. The MPC had said they expected that the rate of inflation would exceed 3% in the first couple of months of this year but the rapid pace of the move towards 3% in the latter half of 2009 may not have been anticipated by them. However, Bank of England Governor Mervyn King said, after the release of the inflation data, that "The continuing pass-through of the earlier significant depreciation of sterling, while part of the necessary rebalancing of our economy, is offsetting to some extent the downward pressure on inflation from the large amount of spare capacity. And the rise in VAT back to 17.5% means that CPI inflation is likely to rise to over 3% for a while, or even higher for even longer were energy prices or indirect taxes to increase further. Although such price level effects do not constitute a continuing source of inflation, and hence should be temporary, they remain in the official measure of inflation for a full year. Provided monetary growth remains well under control – and remember that at present it is undesirably low – inflation should return to target in the medium term". The strong uptick in inflation has increased speculation that the UK economy may not be as weak as the MPC believe and this may lead to a tightening of monetary policy sooner than expected.

...as economy expands just marginally in Q4...

However, countering the argument that the UK economy is recovering strongly is the actual national accounts data which continues to show disappointing activity. Following a contraction of 0.2% in Q3, when an expansion was widely expected, Q4 UK GDP data, once again, came in weaker than expected. The consensus forecast was for a return to growth of about 0.4% but the actual figure came in at just 0.1%. Services, which make up about 75% of GDP, expanded by 0.1% while industrial production grew by 0.1% also. The construction sector was flat. The economy declined by 3.2% year-over-year. Last quarter's expansion follows 6 consecutive quarters of negative growth where the peak to trough fall in output was about 6%. Governor King said recently that the economy is in the "early stages of recovery" and the UK faces "a long period of healing". Output is about 10% below the level it should be at in the absence of the financial crisis. It seems that this is the size of the output gap in the MPC's thinking and explains why they seem to be convinced that there will be little inflation pressure in the medium term. The UK seems to be enduring a period of inflation surprising to the upside and growth surprising to the downside, and that is not a good economic recipe for a sustainable recovery. However, the argument can be made that inflation is only temporarily above target at the moment and will fall back later on in the year once base effects drop out. The current combination of above target inflation and stabilization in the economy may prompt the MPC to conclude that February may be the right time to pause their asset purchase scheme. They could go on hold this month and wait and see how growth and inflation evolves over the next couple of quarters before deciding if more QE is needed.

...but Sterling gains on the Euro.

Sterling has appreciated sharply against the Euro again the middle of January. The UK currency had a fillip from the strong inflation numbers and moved from over £0.90 to the single currency to around £0.8650 in a little more than a week's worth of trading. Its appreciation was halted somewhat after Q4 GDP data was weaker than expected but it remains around £0.87 at the end of the month. Sterling's gains were also due, in part, to the current negative sentiment towards the Euro area due to worries over the Greek public finances amongst others. This meant that Sterling did not do as well against the dollar as compared to the Euro last month. Sterling improved to \$1.60 by the end of January having traded as low as \$1.64 in mid month; however it was trading at under \$1.59 at the end of December so it ends the first month of the year more or less as it started.

Europe

Euro slides against the dollar despite economic recovery

Hard data points to weak recovery...

In the Euro area, the PMI data continues to be favourable but the hard data is not backing up the survey data with evidence of a strengthening recovery. The survey data is, however, more timely than the hard data which is going back several months. The Euro Area economy emerged from recession in the third quarter of last year, with real GDP increasing by 0.4%, though the composition of growth in that quarter together with the available 'hard' data such as weaker than hoped industrial production and retail sales, cast some doubt on the momentum of the recovery in the final quarter. The increase in GDP in the third quarter was more than fully accounted for by inventories, which contributed 0.5% points to the 0.4% growth over the three months to September. In contrast, domestic demand (consumer spending, government spending and investment) made a negative contribution to growth, with both consumer spending and investment falling and only government spending posting an increase. Domestic demand may have remained weak in Q4, with retail sales for example falling for a third month in four in November to leave sales over the October-November period running about 0.8% below their Q3 level. Similarly, both orders and output in industry fell in October, and the level of output in the month was unchanged from its level in Q3 (when it rose by 2% from Q2). It is still likely that output will rise further reflecting a turn in the inventory cycle but any boost to growth from this source will prove temporary in the absence of a sustained pick up in domestic demand. As mentioned, the survey data, which are admittedly timelier than the hard data, continues to be favourable. The Purchasing Managers indices of activity in the manufacturing and services sectors both rose further into year-end (falling back marginally in January) but even here they indicate that the pace of growth in the economy is still somewhat below its long-run trend rate and so not strong enough at this stage to prevent a further rise in unemployment or to create any inflationary pressures.

...as Euro declines against major currencies.

The Euro has made a significant downward move over the past two months. Initially, at the start of December, the move in EUR/USD was due to a more optimistic outlook for the dollar which was kicked off by strong US employment data for November. This showed that job losses in the US were just -11k (later revised up to +4k). This proved to be the catalyst for sharp move upwards by the dollar which saw it come in from over \$1.50 on December 1st to the Euro up to \$1.43 by the end of the year. The Euro bounced a little off these levels in January, getting up to \$1.45 by mid month. However, the generally negative sentiment towards the Euro area - stemming from concerns over the public finances in some member states, notably Greece, - has weighted down on the single currency during the back end of the month. The size of the Greek deficit this year (about 12%) is worrying and it is compounded by the current size of the national debt already (estimated to be about 110% of GDP) and scepticism that the Greeks have a viable plan to reduce their deficit. ECB members have said that any chance of Greece leaving the Euro area is absurd but Trichet himself has said "No Government, no State must or can expect from us any special treatment. We have our own rules and we will apply our own rules without special treatment of any kind." Trichet went on to say that "Some governments, one in particular, have very difficult decisions to take. The problem is not that help than can be given the problem is to take appropriate decisions". He dismissed out of hand that the issues Greece was having would lead to any instability in the Euro system itself. He said Greece was a challenge that you can have in a single market with a single currency but it had to be placed in perspective as the Greek economy was only between 2.5% and 3% of total Euro area GDP. The respective performance of the euro zone and US economies is also hurting the euro against the dollar; GDP in the US grew by 1.4% in the final quarter of last year, against a likely 0.2% advance in Europe. The Euro was trading at around \$1.39 at the end of January, its lowest level since last July.

United States

Dollar stages a recovery

Dollar stages a rally as US yields rise...

Having fallen to a 2009 low of around \$1.51 to the euro in late November, the dollar has rebounded strongly since to trade at around \$1.39 currently, a rise of around 9%. The dollar has also made some modest gains against other currencies over this period, though its appreciation against the single currency has been by far the most pronounced. In seeking to explain the dollar's rise against the euro, it is useful to look at what has happened to US and euro government bond yields since late November. In the case of the US, 10-year yields have risen by over 40bps over this period, while euro 10-year yields are broadly unchanged; in the case of 2-year yields, those in the US have risen by almost 20bps while euro yields have *fallen* by around 15bps. So, US yields have risen by between 35-40bps *relative* to their euro equivalents since late last year. In other words, market interest rate differentials have moved (increased) in favour of the dollar over this period.

...reflecting strengthening economy...

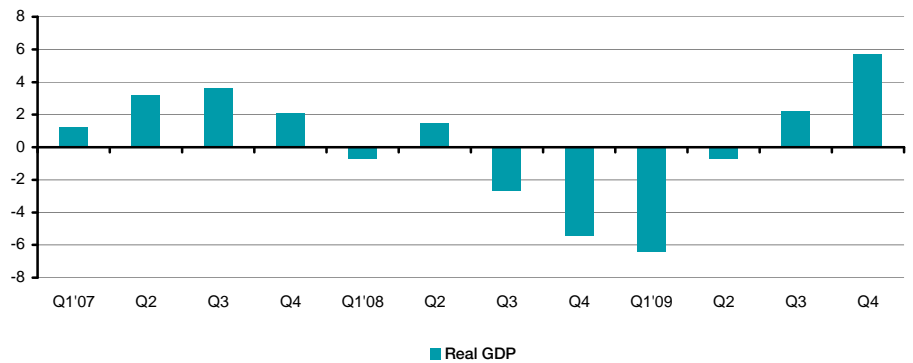
This rise in US yields relative to those in the euro area is, in turn, related to the relative performance of the respective economies. Currently, the signs are that the US economy is emerging more strongly from the recession than its euro area counterpart. While the pace of recovery in the US stepped up a gear in the final months of 2009, with GDP rising 1.4% (or 5.7% at an annualised rate) in Q4, after increasing by 0.6% (2.2%) in the third quarter, there are some signs (although the evidence overall is not conclusive) that the recovery in the euro area has lost some momentum i.e. the economy is still expanding but the pace of GDP growth may have eased a bit from the 0.4% rate recorded in Q3.

...though Fed not in hurry yet to raise interest rates.

Admittedly, the Fed, notwithstanding the pick up in activity, appears to be in no hurry yet to raise official interest rates. However, the more sustainable the recovery becomes the more the market will anticipate an eventual increase in official rates, which will push bond yields higher. Based on the analysis outlined above, the impact of this on the euro/dollar exchange rate will also depend on what happens to euro yields, which in turn will be a function of the euro area recovery and expectations regarding ECB policy. In short, we expect the euro zone recovery to lag that in the US and the ECB to lag the Fed in terms of raising official interest rates, therefore we see US yields rising further relative to euro yields over the coming months and hence we see the dollar strengthening further through 2010.

In the statement published after its meeting in late January, the Fed struck a relatively upbeat note on the economy. It said that "activity has continued to strengthen" amid a moderate rate of expansion in consumer spending and a pick-up in business investment, and that the "deterioration in the labour market is abating". Interestingly, the Fed also said that, while bank lending "continues to contract", financial market conditions "remain supportive of economic growth". It would seem, then, that the Fed does not see the weakness of lending preventing continued growth in the economy, although it does expect that the pace of growth will remain "moderate" for a time and hence not sufficient to make much inroad into the "substantial resource slack" that exists. The latter in turn means, according to the Fed, that inflation is likely to remain subdued for some time; therefore it reiterated in its statement that exceptionally low levels of the fed funds rate are likely to be warranted for "an extended period". There was, however, one dissension to this, with Thomas Hoenig, president of the Atlanta Fed, believing instead that economic and financial conditions had improved sufficiently to drop the "extended period" language. The Fed also said it would complete its \$1.25 trillion asset (MBS) purchase programme by the end of the first quarter, as previously announced.

US Real GDP (% quarterly change, annualised)



GDP growth accelerates in Q4.

As mentioned above, the pace of growth picked up noticeably in the final three months of 2009. Businesses ran down stocks at a much slower pace than in Q3, which contributed significantly to growth in Q4, accounting for 3.4% points of the 5.7% (annualised) increase in GDP. Any such boost to growth would prove temporary in the absence of a pick up in final demand in the economy, but here the signs are positive. Final demand (= GDP *minus* inventories) actually recovered in the second quarter of 2009 after a number of quarters of decline and strengthened further in Q3, increasing by 1.5% at an annualised rate. The pace of final demand growth accelerated again in the final quarter of the year to 2.2%, albeit this is still below its long-run trend rate of 2.6%. The pick up in demand is mirrored on the output side of the economy, with industrial output rising again in the fourth quarter and the available survey data pointing to a further rise in the opening months of the year. Consistent with the pick up in economic activity, the pace of job losses has slowed sharply in recent months, while the unemployment rate seems close to peaking (in the vicinity of 10%) if it has not already done so. However, we would need to see a further, sustained, pick up in final demand growth to above its long-run trend rate in order for the unemployment rate to start coming down.

Economic Diary

February

	Europe	United Kingdom	United States
1	PMI Manufacturing	PMI Manufacturing, M4 Money Supply	ISM Manufacturing, Personal Income and Spending
2	PPI's, German Retail Sales	PMI Construction	Pending Home Sales
3	PMI Services, Retail Sales	PMI Services	ISM Non-manufacturing, ADP Employment change
4	ECB Meeting, German Factory Orders	BoE Meeting	Factory Orders
5	German Industrial Production	PPI's	Non farm payrolls, unemployment
9		RICS House Prices	
10	French Industrial Production	BoE Quarterly Inflation report, Industrial Production	
11			Retail Sales, Business Inventories
12	4Q GDP, Industrial Production		U. of Michigan Confidence
15		Rightmove House Prices	
16	Zew Surveys	Inflation data	
17		Bank of England minutes, Employment data	Industrial Production, FOMC minutes, Housing starts, Building permits
18	Consumer Confidence	M4 money supply	PPI's, Philly Fed
19		Retail Sales	Inflation data
23	IFO Surveys, French Consumer Spending	Nationwide House Prices	S&P CaseShiller Home Prices, Consumer Confidence
24	Industrial New Orders, PMI's,		New Home Sales
25			Durable Goods Orders, House Prices
26	Inflation data	2nd estimate 4Q GDP	2nd estimate 4Q GDP, Chicago PMI, Existing Home Sales

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Mar	End Jun	End Sep
EUR/USD	1.39	1.35	1.30	1.30
EUR/GBP	0.87	0.85	0.83	0.80
USD/JPY	90	95	100	100
GBP/USD	1.59	1.59	1.57	1.63

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	2.68	3.00	3.25	3.50
Eurozone	2.60	2.80	3.00	3.40
UK	3.15	3.35	3.75	4.00

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2010		2011	
	GDP	Inflation	GDP	Inflation
US	2.70	2.1	2.90	2.1
Eurozone	1.20	1.3	1.50	1.4
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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