



The Bulletin

A monthly analysis of international and Irish markets

Market prices earlier ECB cut

- The market turbulence has affected interest rate expectations
- Weak European data an additional factor in ECB rate outlook

September certainly proved to be an extraordinary month in terms of market turbulence, culminating in the demise of the US investment banking model and the prospect of a \$700bn treasury fund to buy impaired assets from the US banking sector. Volatility has soared in recent weeks and the interbank market ground to a virtual halt at one stage, particularly in dollars, with institutions prepared to lend the US Government cash for three months at zero interest rather than lend into the market.

Central Banks responded by injecting huge amounts of additional cash into the system, although at the time of writing uncertainty remains high as all await the final shape and contours of Hank Paulson's proposed fund.

Amid the turbulence it was interesting that the Federal Reserve chose to leave rates unchanged at 2%, reiterating its central view that economic activity will pick up in 2009, although acknowledging that risks abound. Nevertheless, the market is now pricing in a quarter point cut in US rates over the next few months, albeit having pushed back rate cut expectations in the past week or so.

The ECB contends that the credit crunch has had no discernable impact on activity or bank lending, but the market has now brought forward the timing of the first expected ECB rate cut; December is now fully priced for a quarter point easing, to 4%. Developments in the US and the turbulence in financial markets no doubt played a part in this change, but it is also grounded in the recent European economic data, which has consistently surprised to the downside. The eurozone PMI, for example, fell to a new cycle low of 47.0 in September, on provisional data, which was the weakest since late 2001 and implies that growth in the second half of the year may be stagnant at best. The slowdown has been very pronounced in Germany, as picked up by the IFO survey of business confidence, which was also well below expectations in September, again falling to a new cycle low. Indeed, the last time the IFO was at the current level was in mid-2005, with a repo rate of 2%.

The ECB is still concerned about inflation, of course, but the outlook for that has also changed, given the fall in oil prices; the annual euro area inflation rate may now decline to 3% or so by end-year and to under 2.5% by the Spring of 2009 in the absence of a fresh spike in commodity prices. It will therefore be interesting to note any change in ECB rhetoric in the coming weeks, and any change to a more dovish tone would only fuel the current rate cut sentiment.

Dr. Dan McLaughlin

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United Kingdom

UK economy stagnates in Q2, heads for contraction in Q3

UK economy slows to a stop in 2Q...

Revised UK GDP for Q2 showed the economy stagnated in the three months to June. The weakness was due to falls in investment, down 5.3%, and household consumption, down 0.1%. Balancing out these declines was an increase in government consumption, up 0.4%, and a bigger contribution from net exports – they fell by 0.5% but imports declined in the same period by 1.4%.

...and the situation continues to deteriorate...

The UK economy has shown further signs of deterioration in the past month. The CIPS Survey of Purchasing Managers showed that the manufacturing, services and construction sectors are all continuing to contract. All 3 surveys had readings below 50 in August, although the pace of contraction is slowing. Industrial production fell for the third consecutive month in July, by 0.4% to bring the annual decline to 1.9%. Unemployment rose to 5.5%, and house prices continue to decline across a range of measures with the HBOS index showing an annual decline of nearly 11% in August. The latest retail sales did show a monthly increase of 1.2% in August, however this index has been volatile all year and the quarterly average shows overall sales declining, on average, from Q1 to Q2 with a further decline in Q3 more than likely. CPI inflation hit a new record high of 4.7% in August with a forecast peak of about 5% predicted in the near future. At this point it is very difficult to see any silver lining in the short term for UK economy, which could move into recession in the third quarter.

...but the Bank of England is still in holding mode...

The Bank of England published the minutes of its MPC meeting on the 3-4 September. The minutes revealed that the committee believed that output indicators were broadly consistent with its growth outlook in the Bank's August projections with GDP in Q2 a little lower than expected. Domestic demand has fallen sharply and developments in the financial markets would keep credit tight for longer than expected at the start of the summer. The depreciation of sterling increased the upside risk to inflation through import prices but would help export growth, though this growth potential would be limited by the slowdown in the euro area. While CPI inflation had risen sharply long term inflation expectations were reassuringly steady. While a case could be made for a rate increase, the upside risk of increasing inflation expectations was balanced by downside risks to inflation from slackening demand. The case for a rate cut was due the slowdown in demand and stress in the financial sector. However, a cut could undermine the Committee's determination in reducing inflation to target. The Committee voted 8-1 to keep the rate unchanged at 5.00%, with one member (Blanchflower) voting for a 50bps cut.

...however the question is now when not if they will cut.

Facing unprecedented turmoil in the financial markets this month, the Bank of England has announced that it would extend its special liquidity scheme past its original October deadline in order to continue to push liquidity into the market. It has also acted in co-ordination with the Federal Reserve to make dollar funding available to banks to avoid any more failures in the banking system. However, the problem still remains what to do with interest rates. The current crisis is causing problems for the UK economy but the fact is that the underlying fundamentals in the UK economy are weak and activity is slowing down sharply. Regardless of the situation in the financial markets the UK economy is heading for a recession. The most recent data suggests that it should be a matter of when not if the Bank of England will begin rate cuts. David Blanchflower has been more than vocal in calling for immediate rate cuts to stimulate activity but the rest of the MPC appear to be in holding mood. The reason for this is that inflation continues to hit new highs every month – despite the fact that oil prices have come down by about 30% since July – and the MPC is hesitant to cut when inflation is so far away from target. The financial market conditions and the rapidly slowing economy are increasing the probability that Bank will have to act and we now think that a rate cut this year is highly likely.

Europe

Euro Area economy slows notably**Europe not immune to developments in US...**

European markets have not been immune to recent developments in the US financial sector. Government bond yields, notably at the short-end of the curve, have fallen amid a flight to quality and away from risky assets such as equities, particularly financial stocks. Swap rates, however, are unchanged to higher now than at the start of the month, despite lower government bond yields, with the widening out of the spread between the two indicative of increased risk aversion in markets. Interbank rates have increased over the past month – the 1-month rate by about 40bps, the 3-month rate by about 10bps – amid an increase in demand for liquidity, but which nevertheless implies a tightening of monetary conditions in the economy at a time when growth has slowed sharply. The ECB has stepped up its provision of liquidity to markets in recent weeks, though it continues to emphasise the separation of its responsibilities in this regard from its conduct of monetary policy and the setting of official interest rates, which is geared solely towards achieving low and stable inflation over the medium term.

...with economy slowing...

The economy contracted in the second quarter, by 0.2%, with both consumer spending and investment declining from Q1, while the hard data covering the period since have been uniformly weak. Retail sales fell again in July, which raises the risk that overall consumer spending will decline again in the third quarter, while industrial output seems almost certain to post another fall over the same period amid a continuing decline in orders, the latter partly reflecting slower global demand. The more timely survey data, notably the Purchasing Managers indices of activity in the manufacturing and services sector which are both running below the 50 level, also suggest the economy is stagnant, with Germany in particular having slowed rapidly in recent months. Moreover, the growth in credit to the private sector, which is a particular focus of the ECB, has now begun to moderate noticeably, with the annual rate of increase slowing to 8.8% in August, from 9.4% in July and almost 11% as recently as March of this year. This partly reflects the general slowdown in the economy, but it is also a function of tightening lending standards and less ready availability of credit.

...and inflation now starting to fall.

Having accelerated sharply over the second half of 2007 and the first half of 2008, from 1.7% to 4.0%, largely reflecting higher energy and food prices, it now looks as if inflation has peaked. It fell, albeit modestly, to 3.8% in August, with the annual of increase in both energy and food prices both falling back from July. The latter is likely to continue over the closing months of this year and into 2009 given the falls in the oil price and world food prices over the past few months, and the overall inflation rate could well be back below 3% at the beginning of next year.

In its latest macroeconomic projections published in September, the ECB revised down its forecasts for GDP growth in both 2008 and 2009, to 1.4% and 1.2% respectively from 1.8% and 1.5% in its June projections. It also said the risks around these revised forecasts are to the downside, partly because of the 'potential for financial market tensions to affect the real economy more than currently foreseen'. At the same time, however, the ECB revised up its forecasts for inflation this year and next, to 3.5% and 2.6% respectively from 3.4% and 2.4% in June

We still expect ECB to lower interest rates in Q1'09.

The ECB reiterated at its September meeting, at which it kept interest rates unchanged at 4.25%, that the 'current monetary policy stance' will contribute to its objective of achieving low and stable over the medium-term, though it again warned that there are upside risks to the inflation outlook. Notwithstanding this, the market is pricing in a high probability of a 25bps cut in interest rates by December and is fully priced for such a move by February. At the start of September the market saw no chance at all of a rate cut by year-end, with the shift in expectations in the meantime reflecting the signs of a sharper than expected slowdown in the economy, as well as the renewed turmoil in financial markets. The latter may ease to some degree, though we continue to expect the ECB to begin lowering interest rates in the first quarter of next year, which we in turn expect to be accompanied by a falling value for the euro against the dollar.

United States

Renewed turmoil in financial markets**Turmoil in
financial markets...**

Turmoil returned to financial markets with a vengeance in the latter part of September. While the effective nationalisation of the two mortgage giants, Fannie Mae and Freddie Mac, earlier in the month might have been expected to calm what were then jittery markets, the failure of investment bank Lehman Brothers, which filed for bankruptcy, and the difficulties at the insurance company, AIG, which ultimately had to be 'bailed out' with an \$85bn loan from the Fed, led to acute stress in markets and a rise in risk aversion, the latter perhaps best captured by fact that investors were prepared to lend the US government cash for three months at around zero interest. Government bond yields, particularly at the short-end, plunged amid this 'flight to quality' and away from risky assets such as equities, which fell sharply. There was also a scramble for liquidity, resulting in a rise in interbank rates, particularly dollar rates, which prompted massive, co-ordinated, central bank action to inject funds into the system.

**...prompts \$700bn rescue
package for
banking sector.**

Amid this turmoil, and in an attempt to directly address the source of the difficulties in the financial system, namely the 'toxic' assets on banks' balance sheets, the US Treasury announced it was seeking authority from Congress to issue up to \$700bn in Treasury securities to finance the purchase of 'troubled assets from financial institutions in order to promote market stability... (and) restore the strength of our financial system so it can again finance economic growth'. Equity markets initially greeted the announcement euphorically, with stocks rallying by around 11% in a little over one trading session, though the dollar fell on the currency markets amid concern about the potential impact on the US budget deficit, which is already sizeable and expected to amount to over \$400bn, or just over 4% of GDP, this year. However, equity markets gave up some of these gains again subsequently, amid uncertainty about the details of the Treasury proposal, such as at what price it will buy distressed assets from banks and indeed whether it will be passed through Congress.

Economy rebounds in Q2...

While the Treasury's rescue package, if implemented, may restore some stability to financial markets, it will still take time for the economy to return to normal rates of growth. Indeed, to the extent that recent market developments result in even tighter financial/credit conditions, there is a risk that the economy weakens even further. That said, the economy rebounded strongly in the second quarter, according to the latest national accounts, with real GDP increasing at an annualised rate of 3.3%. This was due almost entirely to net exports, which contributed 3% points of the overall increase in GDP. Domestic demand, on the other hand, was very weak, and remains so, suggesting the pace of overall economic growth has slowed from Q2.

...but set to weaken again.

In particular, consumer spending fell in real terms again in July while retail sales (which account for about 50% of total consumer spending) posted another decline in August, all of which points to little or no growth in this major component of GDP in Q3. The recent fall in oil prices and the associated decline in energy costs will provide some boost to households' purchasing power, but there are significant headwinds to spending, most notably from a weakening labour market. Employment continues to fall and the unemployment rate rises, while earnings growth is moderating, which will dampen consumer spending. Though there are indications that the decline in house sales may be bottoming (whether or not the renewed turmoil in financial markets results in another lurch lower in sales remains to be seen, however), housing output is set to contract for some time yet, and thus will continue to act as a drag on economic growth. On a more positive note, the decline in energy costs, coupled with a continuing period of sub-trend growth, means that inflation is likely to moderate over the remainder of this year and into 2009.

**Fed keeps interest
rates at 2%...**

Amid the turmoil in financial markets, the Fed chose to leave interest rates unchanged at 2% when it met on September 16, though there was plenty of speculation that it might lower them in response to market developments. Given we know now that, as it met,

decisions were also been taken to, amongst other things, rescue AIG with a \$85bn loan and inject liquidity into the markets, it is perhaps not too surprising that the Fed chose to leave official interest rates steady at that time. The Fed did acknowledge in its accompanying policy statement that strains in financial markets had increased significantly, and said that 'economic growth appears to have slowed recently' and was likely to remain sluggish over the next few quarters. It also noted that inflation 'has been high', but reiterated that it expects it to 'moderate later this year and next year'. Significantly, it dropped any reference to inflation expectations, which had been a particular concern of the Fed and which in previous statements had been described as 'elevated' on some measures. Inflation expectations have actually fallen recently, probably reflecting the fall in the oil price and energy costs more generally. Notwithstanding this however, the Fed reiterated that the upside risks to inflation are still of significant concern, as are the downside risks to growth, indicating that, at that time at least, the Fed still had a neutral stance on interest rates.

...and we now see rates on hold through mid-2009.

The market is now fully priced for a 25bps cut in official interest rates by November. Whether the Fed does cut rates remains to be seen, however. On the one hand, the Fed may feel that, if passed through Congress, the bank rescue package will, ultimately, enable banks to expand credit again and hence boost economic growth, thus obviating the need to lower interest rates any further from the already very low level of 2%. On the other hand, if the Fed believes that the renewed turmoil in markets may result in weaker economic than previously expected, with any benefit from the bank rescue package likely to take time to feed through into the real economy, then it may believe it prudent to lower rates. In any case, at the very least, it seems to us that interest rates will now remain at 2% for longer than we had expected – previously we had penciled in a rate hike in the first quarter of next year – and so see no change through to mid-2009 at least. Hence we see longer-term (5-year) fixed rates, which are now marginally higher than at the beginning of September, having been 50bps lower at one stage during the month, trading within a range of 4-4.25% over the coming months.

Dollar expected to resume upward move.

Having strengthened from 1.60 to 1.39 against the euro between mid-July and mid-September, the dollar has since lost some ground against the single currency. The latter is not too surprising, as even in normal times, and taking into account the nature of the currency markets, one would have expected some retracement of the dollar's previous large move. This is what we have seen over the past couple of weeks, though granted the dollar's sell-off accelerated after the announcement of \$700bn bank rescue package, which could potentially add to the already large US budget deficit and as such could be seen as bad for the dollar. However, we are inclined to think the dollar will resume its upward move over the remainder of this year and into 2009, partly because the rescue package may ultimately be viewed by the market as good for the economy and hence good for the currency, but more fundamentally because we think the likelihood (inevitability?) of lower interest rates in the euro area will drag down the single currency against the dollar.

Economic Diary

October

Date	Eurozone	United States	United Kingdom
1	PMI Manufacturing, Unemployment	ISM Manufacturing	Manufacturing PMI
2	PPI, ECB Interest Rate Announcement	Factory Orders	Nationwide House Prices
3	PMI Services, Retail Sales	Non-Farm payrolls, unemployment, ISM Non-Manufacturing	Services PMI
6			Industrial Production
7		FOMC Minutes	NIESR GDP estimate
8	Euro Area 2Q GDP, German Industrial Production		Nationwide Consumer Confidence
9			BoE Interest Rate Announcement
10	French Industrial Production		
13			PPI's
14	ZEW Surveys, Industrial Production, French CPI		Inflation data, RICS House Price Balance
15	Inflation Data	PPI, Retail Sales, Beige Book	Unemployment and Earnings
16		CPI, Industrial Production, Philly Fed	
17		Housing Starts, Uni. Of Mich Confidence	
20			Rightmove House Prices
22			Bank of England Minutes
23	German IFO surveys		Retail Sales
24	French PMI's	Existing and New Home Sales	3Q GDP

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Dec	End Mar '09	End Jun
EUR/USD	1.46	1.40	1.35	1.35
EUR/GBP	0.79	0.78	0.75	0.75
USD/JPY	105	110	115	115
GBP/USD	1.94	1.79	1.80	1.80

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End Dec	End Mar '09	End Jun
USD	2.0	2.0	2.00	2.00
EUR	4.25	4.25	4.00	3.75
GBP	5.00	4.75	4.50	4.25

Source: Bank of Ireland Global Markets

Swap rates: 5 year

	Current	End Dec	End Mar '09	End Jun
US	4.15	4.00	4.25	4.25
Eurozone	4.79	4.25	4.25	4.00
UK	5.35	5.00	4.75	4.50

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2008		2009	
	GDP	Inflation	GDP	Inflation
US	1.8	4.5	1.5	2.6
Eurozone	1.2	3.5	1.0	2.5
UK	1.2	3.8	0.9	2.6

Source: Bank of Ireland Global Markets

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Market data supplied by Reuters

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