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Bank of Ireland
Global Markets

TheBulletin

A monthly analysis of international and Irish markets

Interest rate expectations support Euro

- Market priced for series of ECB moves
- Expected timing of US rate rise may move forward

The euro had a strong first quarter, appreciating against all the major currencies and effectively reversing the fall seen over the final three months of last year. From an Irish perspective, the most significant moves were against the US dollar and sterling; the single currency has rallied from under $1.30 to over $1.42 against the former and from 83 pence to 88 pence against the latter.

The euro's decline in late-2010 was attributed to investor concerns about the risks of default on sovereign and bank debt within the euro area, and those concerns are still evident; 10-year yields on Greek debt are still over 12%, the Irish equivalent has moved to around 9.5% and the market is now focussed on Portugal, with yields now above 8%. The EU has agreed to boost the spending power of the main existing support mechanism, the EFSF, but the additional funding required is not yet forthcoming, and is unlikely to be sorted until mid-year, so there are still some issues to be resolved.

Yet the euro has risen despite these headwinds, and that appreciation is due to two factors. The first is the interest rate outlook – the ECB has signalled that it is likely to raise rates soon, probably this month, and the market is now expecting a series of rate increases over the next year. In contrast, the market does not expect the US to raise interest rates until March 2012, and this divergence in expectation is very supportive of the euro; an investor buying a 2-year German bond receives 1.8% per annum, against just 0.8% in the US. Similarly, the interest rate differential relative to sterling is also positive, at 0.5%. Secondly, market positioning has switched sharply in recent months – traders sold the euro aggressively till mid-January, but have now built up substantial long positions in the euro and have sold dollars, and this has also supported the single currency.

The implication is that a rally in the dollar against the euro is unlikely unless US interest rate expectations change, and these in turn are most likely to be affected by the trend in US employment – the pick-up in the pace of job creation may well prompt the market to bring forward the expected timing of a US rate rise. We suspect this will indeed occur, and as such expect a near-term pull-back for the euro/dollar rate.

Dr. Dan McLaughlin.

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United Kingdom

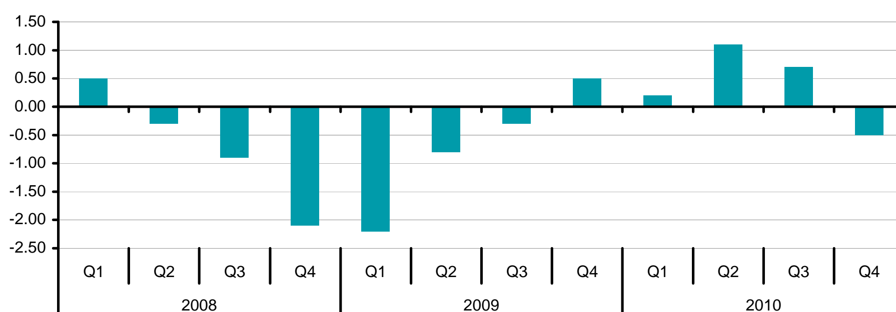
MPC on hold despite divisions

MPC divided but unchanged for now as committee awaits Q1 growth data …

The Bank of England MPC decided to keep interest rates unchanged at March's meeting, largely as expected, however that is not to say that the MPC is united about the way forward. The minutes from that meeting made interesting reading; 3 out of the 9 members for the second consecutive month voted for an interest rate increase. The majority of the committee felt that there was 'merit in waiting to see' how the recent oil price increases played out and how the trend in household spending and confidence evolved. While there was much talk of the importance of inflation expectations the MPC also noted that 'It was unlikely that any increase in inflation expectations would lead to a sustained increase in inflation itself without also being associated with a pickup in wage growth'. MPC member Sentance, who has voted for an interest rate increase consistently since last June, has warned that CPI inflation may well exceed 5% later on this year and the MPC's failure to raise rates now risks the necessity of much sharper moves later on which could destabilise the economy. He has also stated however, that if growth turned out to be materially weaker that he anticipated or medium term inflation pressures eases, then he would "reverse my decision". As regards the indicators of growth, those covering the first months of the year so far do suggest the economy has recovered from its Q4 weakness, though we won't know the extent of the rebound until the Q1 GDP report is published towards the end of April. The manufacturing, services and construction PMI's are all showing strong expansions in their respective sectors in the latest readings. Other data has also been broadly positive; The UK service index rose by 1.3% in January, more than reversing the 1.1% fall in December. It this was unchanged in February and March it would increase by 0.6% in Q1 following a 0.6% fall in Q4. UK industrial output in January was 1.1% above its average level in Q4, if this was also the outcome for Q1 (and services grew by 0.6% increase in Q1) the industry and services together would contribute approx. 0.6% points to GDP growth with construction adding 0.1% or 0.2% more at least. Further out from Q1, growth may moderate somewhat as evidenced by March's manufacturing PMI which fell to a five month low of 57.1 from 60.9 in February. Perhaps MPC members will wait until they see the Q1 national accounts before deciding if a rate increase is warranted, making the May meeting the first likely date for a move if there is to be one.

…but inflation outturns do little to ease hawk's concerns.

Quarterly UK real GDP Growth



The inflation data for February was once again higher than the consensus forecast. Annual CPI inflation was 4.4% in February up from 4.0% in January against a consensus forecast of 4.2%. While the major impacts on the headline rate are from energy price increases, food price rises and the VAT increase, it is noteworthy that the underlying level of inflation is also picking up. In January, if we remove energy, food and indirect taxes from the index then underlying annual CPI inflation would have been about 1.4% but this figure rose to approximately 1.8% last month. Also noteworthy is the fact that all 12 groups within the CPI are contributing to inflation on an annual basis and 8 of the 12 groups are contributing positively on a monthly basis with the other groups (showing small negative or unchanged monthly price changes) affecting the headline rate only very marginally. This suggests that inflation increases are becoming broad based and that the Bank of England's view about temporary spikes in inflation associated with one or two factors is becoming less credible.

Europe

ECB set to raise interest rates

ECB warns the market that monetary policy must be tightened…

The ECB surprised the market completely at their March meeting when President Trichet concluded that the risks to inflation "are on the upside", but also said that "strong vigilance is warranted with a view to containing" these upside inflation risks. In the past the use of the words "strong vigilance" has been a signal that an increase in interest rates is imminent, and at the post meeting press conference Trichet said a hike in rates at the April meeting was "possible" although "not certain". Most if not all of the information coming from ECB members has confirmed the likelihood that a rate rise is coming. Slovakian ECB member, Makuch, said an increase at the April meeting is "highly probable", while Executive Board member, Bini Smaghi, said rates would be raised in a "gradual way". This view was echoed by the ECB Chief Economist, Stark, who said it is time to normalise interest rates "step by step", adding that "we cannot keep the rate at this level (1%) for a long time". Indeed, Stark said that, since the ECB had cut interest rates aggressively during the economic and financial crisis in response to downside risks to inflation, it had to act symmetrically and raise rates given there are now upside risks to inflation. Moreover, Stark said the ECB had to be seen to act to preserve its credibility and prevent a significant increase in long-term interest rates which would occur if investors demanded a higher inflation-risk premium. It's worth noting that the message conveyed by Stark differs from Trichet's view at the time of the March meeting who indicated that a hike in April – if it came – was not the start of a series of hikes. Nonetheless over the course of March we have seen the market price in a 25bps increase this month and another 50bps by the end of year. The EA estimate of annual inflation in March came in higher than expected, rising to an annual rate of 2.6% from 2.4% in February. Those inflation numbers probably strengthens the view of the ECB that inflation is becoming a problem and copper fastens an increase in official rates at April's meeting.

…as Euro Area political difficulties fail to halt Euro advance.

The ECB's rhetoric has inspired a Euro rally, seeing the single currency rise to $1.42 in March from $1.38 before last month's meeting. The Euro ended the month over $1.41, holding up well despite the continued uncertainly in Europe over what to do next in regards to the debt crisis. Last month saw the EU fail to agree new measures to deal with debt problems at its Head of Government summit on March 25. There was little political will in evidence and they failed to even agree how the new ESM facility would be funded from 2013. March also saw the German ruling party lose a key regional election which many commentators blamed on voters views of German contributions to bailout funds and makes it more difficult for Germany to agree to costly potential solutions to the crisis. The Portuguese Government fell over proposed austerity measures as the country moves closer to becoming the third Euro area nation to seek outside help to finance the State. Portuguese 10 year yields have soared to well over 8% from under 7% at the beginning of February while a number of ratings agencies have downgraded the sovereign over the past couple of weeks. The new Irish Government continues to press the EU to renegotiate the November bailout deal. Finance Minister Noonan said the Government would live within the parameters of the EU/IMF deal but they would like to change elements of it subject to negotiation and the Government accepted the broad outline of the consolidation needed. He also said the Government accepted the ECB's objection to imposing burden sharing on senior bondholders. The debates in Europe over debt issues are far from resolved and one can expect more of the same in the months ahead. However, in better news, Spain seems to be pulling away from the peripherals. At the start of the year, Spanish 10 year yields were about 5.4% while Portuguese 10 year yields were trading at about 6.6%. However since that time Portuguese 10 year yields have risen to 8.5% while Spanish 10 year debt yield have fallen about 20bps. Spain has implemented some of its own austerity measures and has moved to head off any concern over its banks. For now, the market believes that Spain will be successful in its effort to control its public finances.

United States

Fed 'exit strategy' on the agenda

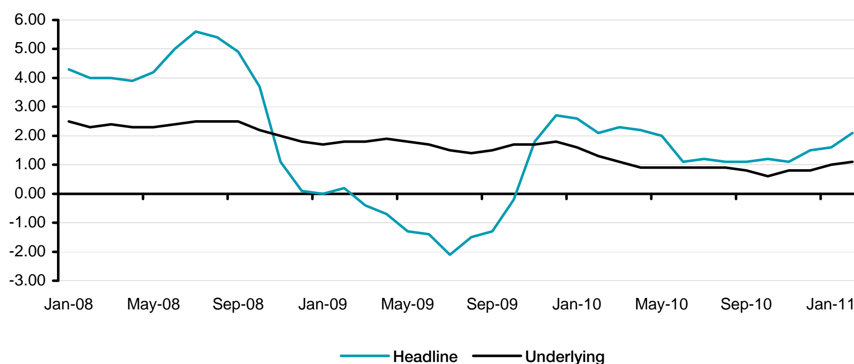
Fed more upbeat on economy…

The Fed conveyed a relatively upbeat assessment of the economy following its monetary policy meeting in mid-March, noting the *"recovery is on a firmer footing"* and that *"conditions in the labor market appear to be improving gradually".* It also said that both *"household spending and business investment in equipment and software continue to expand* ", though it admitted the housing sector remains depressed and that investment in non-residential structures remains weak. This assessment of economic conditions represented a notable upgrade from the one presented after the January meeting, when the Fed said the recovery was continuing though not at a pace sufficient to bring about a significant improvement in the labor market.

…though still relaxed about inflation…

In relation to inflation, the Fed said recent increases in the prices of energy and other commodities - the oil price (West Texas Intermediate) rose by 12% between the January and March meetings and has risen by a further 11% since – were putting upward pressure on the headline rate of inflation. However, it also said it expected these effects to be *"transitory"* (though it assured that it would closely monitor the evolution of inflation and inflation expectations) and noted that measures of underlying inflation (i.e. excluding energy and food prices) *"have been subdued".*

US Inflation (%)



…and maintains its accommodative policy stance…

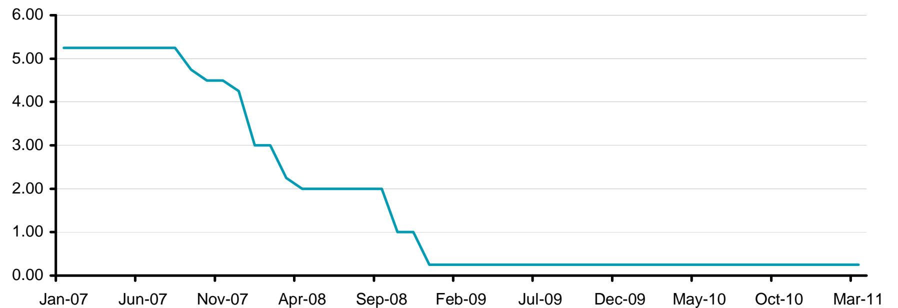
As regards its monetary policy stance, the Fed decided, given the unemployment rate remained *"elevated"* and underlying inflation was *"somewhat low"* (at around 1%), to continue with its $600bn asset purchases program (due to be completed by the end of June) and to keep the target range for the federal funds rate at 0 to ¼ per cent. It also reiterated that economic conditions *were "likely to warrant exceptionally low levels of the federal funds rate for an extended period".*

…though talk turns to an "exit strategy"…

Notwithstanding the position adopted at the March meeting, a number of Fed members since then have spoken on the subject of an "exit strategy" from the central bank's current highly accommodative monetary policy stance. Perhaps this is not too surprising, considering the improvement in economic conditions and the general view now prevailing at the Fed that a self-sustaining recovery in private demand is taking hold. In tandem with the latter, there also now seems to be a widely shared view that further monetary stimulus will not be necessary following the completion of the $600bn asset purchases program (so-called QE2) at the end of June (and indeed one member has said the Fed might yet pull up slightly short of $600bn). Given this, the question then naturally turns to the "exit strategy", and *when* and *how* to start withdrawing the extraordinary stimulus that has been injected into the economy over the past couple of years or so through a combination of zero interest rates and QE1 (which involved asset purchases totaling $1.75trillion) and QE2. In relation to the "how", the decision to be made will be whether to begin raising interest rates first and then proceed to selling assets purchased under QE1 and QE2 at some point thereafter, or vice versa, or to do both *concurrently.* In relation to the "when", views on this differ. One member believes the Fed should have already raised interest rates by now, while some have said the Fed cannot wait "too long" beyond the completion of Q2 in June before starting to withdraw stimulus.

Other members, however, have said the Fed should not be in any hurry to reverse policy post June.

Federal Funds Rate (%)



...prompting a rise in bond yields.

Despite this disagreement, from the markets' perspective the significant thing is that the exit strategy is now on the Fed's agenda (or, strictly speaking, *back* on the Fed's agenda – around this time last year there was also plenty of discussion about an exit strategy but that dissipated as, first, the sovereign debt crisis in the Euro area erupted, followed by a sharp slowing in the US economy). The result is that government bond yields have started to rise again, with 2 and 10-year yields up about 25bps and 30bps respectively since around the time of the mid-March meeting, while the dollar's trade-weighted exchange rate has firmed, albeit very modestly so, and from historic lows. However, the dollar has fallen further against the euro, with the latter buoyed by the prospect of a near-time ECB interest rate increase.

Scope for market to price in earlier Fed rate hike.

Currently, the market is not pricing in a first full 25bps interest rate hike by the Fed until March 2012. It is worth noting, though, that this is three months earlier than was the case just a couple of weeks ago. Moreover, we think there is scope for the market to bring forward the expected timing of a hike some more, particularly given the clear improvement that is now occurring in the labour market. The pace of employment growth has accelerated, with private payrolls increasing by 188k a month in the first quarter of 2011 (including increases north of 200k in both February and March) from 146k a month in the final quarter of 2010. The unemployment rate has also fallen sharply - by a full percentage point to 8.8% between November and March, with more than half of this decline taking place over the first three months of this year - and is now almost 1.5% points below its peak in late 2009. In past recoveries from recession, a fall in the unemployment rate of this magnitude would have already triggered an increase in interest rates. However, as the Fed has said, unemployment still remains elevated notwithstanding the recent fall. Nevertheless, a continuing decline over the coming months would certainly prompt the market to price in an earlier than currently expected rate hike, something that would put further upward pressure on government bond yields while also supporting the dollar on the exchanges.

Economic Diary - April

	Euro Area	United States	United Kingdom
1	PMI Manufacturing, Unemployment	Payrolls, Unemployment, ISM Manufacturing	PMI Manufacturing
4	PPI's		PMI Construction
5	PMI Services,Retail Sales	ISM Non-Manufacturing, FOMC Minutes	PMI Services
6	Q4 Final GDP, German Factory Orders		Industrial Production, NIESR GDP Estimate
7	ECB meeting, German Industrial Production	Jobless Claims	BoE Meeting
8			PPI's
11			Consumer Confidence
12	ZEW Surveys	NFIB Small Business, Trade Data	RICS House Price Balance, DCLG House Price, Trade Data, Inflation Data
13	Industrial Production	Retail Sales, Beige Book	Unemployment, Earnings Data
14		Jobless Claims, PPI	
15	Inflation Data, Trade data	Inflation Data, Industrial Production, U. of Michigan Confidence	
18	Consumer Confidence		Rightmove House Prices
19		Housing Starts	
20		Existing Home Sales	Bank of England Minutes, Public Finances
21	IFO Surveys	Jobless Claims, Leading Indicators, Philly Fed	Retail Sales
25		New Home Sales	
26		CaseShiller Home Prices, Consumer Confidence	Nationwide House Prices
27	Industrial New Orders, German CPI	Durable Goods, FOMC meeting	Q1 GDP
28	German Unemployment	Q1 GDP, Pending Home Sales, Jobless Claims	
29	Confidence Data, M3	PCE, Personal Income & Spending, Chicago PMI	
30			

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End June	End Sept	End Dec
EUR/USD	1.42	1.40	1.35	1.35
EUR/GBP	0.88	0.88	0.86	0.85
USD/JPY	84	90	95	100
GBP/USD	1.61	1.59	1.57	1.59

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End June	End Sept	End Dec
USD	0-0.25	0-0.25	0-0.25	0-0.25
EUR	1.00	1.25	1.50	1.50
GBP	0.50	0.50	0.50	0.75

Source: Bank of Ireland Global Markets

Swap rates: 5 year

	Current	End June	End Sept	End Dec
US	2.40	2.75	3.00	3.25
Eurozone	3.10	3.00	3.25	3.50
UK	3.00	3.00	3.25	3.35

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2011		2012	
	GDP	Inflation	GDP	Inflation
US	3.1	2.3	3.1	1.9
Eurozone	1.7	2.3	1.7	2.0
UK	1.7	4.0	2.1	2.1

Source: Bank of Ireland Global Markets

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Market data supplied by Thomson Reuters

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