Produced by the Economic Research Unit
May 2012

Bank of Ireland Global Markets

# TheBulletin

A monthly analysis of international and Irish markets

## Euro rates at fresh lows

- 2-year rates below 1%
- Euro / dollar likely to fall

Market interest rates in the euro area are currently at fresh historical lows following further declines in recent weeks; 2 year swap rates are now below 1% and the 5-year equivalent has slipped below 1.4%. The interest rate available on German bonds, deemed the safest home for euro funds, is lower still, with 2-year yields falling below 0.1%, while overnight interest rates in the money market are down around 0.3%.

One factor is the ECB, with the supply of over €1,000bn in 3-year funds to the market testimony to the central bank's desire to avoid a credit crunch. The demand for loans is unusually weak however, in turn reflecting the limp nature of economic activity across the euro area; GDP contracted by 0.3% in the final quarter of 2011, and the available indicators imply that GDP fell again in the first quarter of 2012, so indicating that the euro area has accompanied the UK into another recession. Moreover, the consensus does not envisage a rapid or strong turnaround, with another decline in GDP projected for the second quarter followed by a flat reading in Q3 and a modest advance in the final quarter of the year.

Interest rates are very low in most of the major economies of course, and expected to remain there for some time - the US Federal Reserve has stated that it expects rates to stay at the current exceptional levels until end-2014. The ECB has not made any such forward-looking statements but the market is also expecting euro rates to stay low over a similar timeframe.

These market rates are not effective rates for many banks across the euro area however, as they have to pay a high credit premium to attract market funds, if indeed they can access the wholesale markets. Retail rates are often much higher, therefore than these market rates imply. Furthermore, some loan rates are directly linked to the ECB's repo rate, including the majority of mortgage loans in Ireland, so to benefit such borrowers need to see a further cut in official ECB rates. That may occur, but the ECB may also take the view that market rates are low enough, and that a repo cut may not have much market impact. In a broader context, euro rates have also fallen relative to sterling and dollar rates which may help explain the single currency's recent depreciation against the former to below 82 pence. One puzzle though is the euro's resilience against the dollar, as the interest rate differential points to a foreign exchange rate of around $1.25, and we expect the euro to weaken over the coming month.

***Dr. Dan McLaughlin***



### Bank of Ireland estimates

— Exchange rates
— Official interest rates
— Five-year swap rates
— GDP and inflation

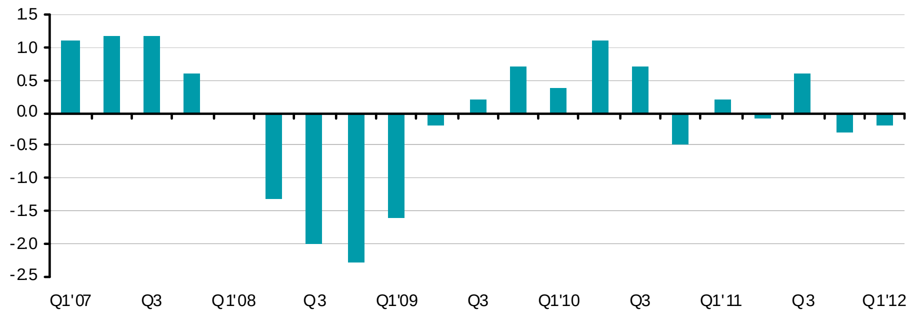
United Kingdom

# Economy in recession

**A further contraction in GDP in first quarter…**

The UK economy contracted for a second consecutive quarter in Q1 according to preliminary estimates, with real GDP falling by 0.2% following a decline of 0.3% in the final quarter of 2011, and is therefore in recession again based on the technical definition of the latter (two consecutive quarters of negative GDP growth). In truth though, following a relatively strong rebound in activity through 2010, the economy has been essentially flat-lining since the beginning of 2011 – the level of GDP in the first quarter of 2012 was only marginally higher than at end-2010. In terms of the composition of GDP in Q1, the construction sector weighed heavily, with a 3% fall in output accounting for most of the 0.2% decline in GDP. However manufacturing output also fell, although the 0.1% decline was a good deal less than the 0.7% fall in Q4, while the services sector, which accounts for over 75% of economic activity, grew by only 0.1%, just offsetting a 0.1% fall in Q4

**UK GDP: % Chg quarter-on-quarter**




**…somewhat at odds with survey data…**

The first quarter GDP outturn, though, was somewhat at odds with some of the available survey data, notably the Purchasing Managers' measures of activity. The manufacturing PMI, for example, moved back above the 50 expansion-contraction threshold in January and remained there through March, which suggested output in the sector might have risen in Q1 rather than falling as reported in the GDP data. More puzzlingly, the services sector PMI averaged 55 in Q1, up from 52.5 in Q4 and the highest calendar quarter reading since the second quarter of 2010. Yet services sector output barely rose in the first quarter according to the official measure.

**…while inflation proving 'stickier' than thought.**

The Bank of England does place some weight on the survey data when assessing economic conditions, so it will not take the Q1 GDP reading fully at face value. Indeed according to the minutes of the April monetary policy meeting, the Bank believes the economy is "likely to be expanding, albeit only modestly, in the first half of the year". Adding to the Bank's dilemma is uncertainty about the outlook for inflation. While inflation has fallen sharply since September, when it peaked at 5.2%, it has remained at around 3.5% since January, and according to the minutes "there is now a risk that inflation would fall more slowly" than previously assumed and hence "a greater chance that above target inflation would persist in the medium-term". If the Bank believes the economy is growing moderately, and with inflation proving somewhat 'stickier' than assumed, then it follows that it is likely to refrain – for now – from announcing further QE when the current additional £50bn in bond purchases is completed this month. This appears to be the view of the markets, which is reflected in the rise in sterling against both the euro and the dollar over the past month or so. The need for further QE at some point cannot be ruled out though, and so sterling may struggle to add to its recent gains.

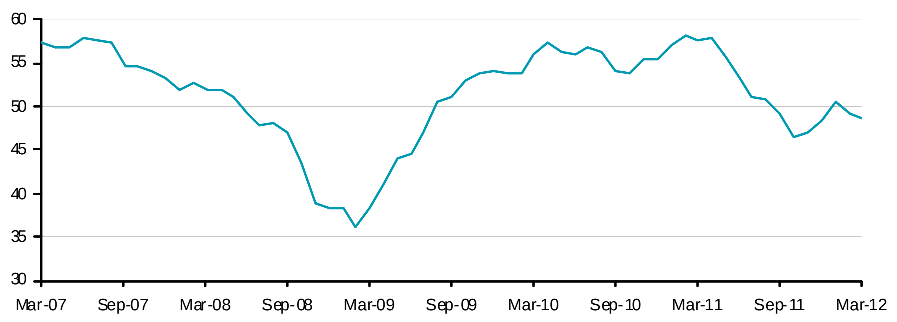
Europe

# Euro area economy still contracting

**Economic conditions deteriorating…**

Economic conditions in the Euro area appear to be deteriorating. Following a fall in real GDP of 0.3% in the final quarter of 2011, it had looked, based on survey data, as if the economy was stabilising albeit at a low level of activity. However the survey data have deteriorated again and point to the possibility of a further decline in GDP in both the first and second quarter of this year. In particular, the Purchasing Managers measures of activity in the manufacturing and services sectors, after rising from the lows of late last year, have both turned down over the past couple of months, and hence the 'composite' index, which combines the two into a single measure of activity, has fallen back close to the level that prevailed in December, when the debt crisis was raging. At a reading of 48.7 in March, below the 50 expansion threshold, the composite index is consistent with falling GDP in the zone. There has also been a renewed slowdown, from already subdued levels, in the rate of growth of lending to the private sector, to both households and non-financial corporations, which will be a worry for the ECB given the massive liquidity provision to the banking system via its 3-year long-tern refinancing operations (LTROs).

Euro Area 'Composite' PMI (50 = expansion-contraction threshold)




**…and ECB softens its rhetoric…**

The ECB has already softened its rhetoric in response to the deterioration in the economic data and amid a resurfacing of tensions in sovereign debt markets, notably in Spain but also Italy. Political developments in France (the strong showing of Hollande, the Socialist candidate, in the first round of the presidential election) and the Netherlands (the collapse of the government amid differences on reducing the budget deficit) have added to what the ECB says is the very 'high uncertainty' prevailing at present. As a result of this uncertainty, the Bank has also said it is too early to contemplate an exit from its current accommodative monetary policy and has not ruled out re-activating is bond purchases programme (SMP) to address the recent rise peripheral yields. The latter remain well off the lows seen earlier this year, although they are still well below the levels that prevailed late last year when the crisis was at its zenith.

**…while market interest rates fall.**

In line with the deterioration in economic conditions and the renewed pressure on peripherals, German government bond yields have fallen over the past month, in the case of 2-year yields to a record low of less than 0.1%. Swap rates have followed suit, with the 2-year rate now below 1%, also a record low. Euro swap rates have also fallen relative to UK and US rates, which one would expect to see reflected in a fall in the euro vis-à-vis sterling and the dollar. The single currency has fallen against sterling, but has remained relatively resilient against the dollar. The latter might not last however, and we still expected to see the euro head lower against the US currency, down to $1.30 and below, from over $1.32 currently.

United States

# Consumer spending drives growth in Q1

**Economy expands again…**

The economy expanded further in the first quarter of 2012, with real GDP increasing by 0.5% or an annualized rate of growth of 2.2%. This followed an increase in GDP of 0.8% (3% annualized) in the final quarter of 2011 and was the eleventh consecutive quarter of expansion since the recession ended in the middle of 2009. The level of GDP is now just over 1% above its pre-recession peak in the final quarter of 2007, though the pace of growth of around 2.5% annually during the recovery has lagged the economy's pre-recession trend rate of growth of close to 3% a year. Consumer spending – which accounts for over 70% of GDP – picked up in the first quarter, increasing in real terms by about 0.7% (2.9% annualized) despite a notable rise in gasoline prices, with the negative effect of the latter on households purchasing power offset by a decline in the saving ratio. Business investment also increased further in Q1, though at a slower pace than in previous quarters, while the positive impact on GDP of a near 5% rise in residential construction was offset by a 3% fall in non-residential construction activity. A big drag on growth again in Q1 was a further fall in government spending, led by a decline in Federal defense spending, which knocked 0.6% points off GDP in the quarter.

**…and Fed revises up 2012 growth forecast…**

The Fed revised up its forecasts for growth in 2012 at its latest meeting in April and now expects the economy to expand by 2.7% in the twelve months to the end of this year (from 2.5% previously), though it expects growth in 2013 and 2014 to be slightly lower than previously forecast at just over 3% a year on average (down from 3.3%). Inflation this year – at 2% – is also expected to be higher that previously forecast (1.6%), though it is projected to be in line with, or slightly below, the 2% target in 2013-2014. The unemployment rate, which will be an important variable in determining the evolution of monetary policy, is expected to fall to 8% by the end of this year, from 8.2% currently (and a previous forecast of 8.4%), and to decline further to 7.5% by the end of 2013 and to 7% by end-2014 (about 0.25% points and 0.1% points lower respectively than previously forecast).

**….but no change in policy stance…**

Notwithstanding this forecast decline in the unemployment rate, it is still expected to be well above what the Fed considers to be the economy's 'normal' rate of unemployment, which is somewhere between 5.2% and 6% according to its latest estimates. Largely on account of this, the statement released after the latest meeting reiterated that exceptionally low levels for the federal funds rate are likely to be warranted "at least through late 2014". That said, there is a diversity of opinion as to when interest rates should be raised. According to members' latest projections for the appropriate timing of a rate hike, 3 believe this should occur this year while another 3 believe rates should be raised in 2013. However, 7 members believe rates should not be raised until 2014, while another 4 think any move should be delayed until 2015. As regards the appropriate level of interest rates at the end of 2014, the average of the members' individual projections is 1.25%, which is about 25bps higher than the average of members' January forecasts and compares to the current target range for the federal funds rate of 0% to 0.25%.

**…and dollar loses some ground.**

The past month has seen a renewed decline in US government bond yields, with the benchmark 10-year yield back below 2% from around 2.30% in early April. The fall in yields partly reflects some weaker than expected data, notably a smaller than forecast rise in employment in March (of 120k, well below the average monthly gain of almost 250k from December through February) as well as a 'flight to quality' as tensions in euro area sovereign bond markets resurfaced. The dollar lost some ground during April, falling by around 1% on a trade weighted basis including a decline of almost 4% against the Japanese yen. It has been relatively stable against the euro over the past month though, with EUR/$ trading (for the most part) in a range of around $1.31 to $1.33. The respective prospects for the US and Euro area economies – continued growth in the former, further contraction near-term in the latter – suggests to us that the dollar should strengthen against the single currency.

Swap Rates

# 5-year euro rate below 1.5%

**Euro rates fall to new lows…**

The ECB has flooded the interbank market with liquidity and that combined with weak loan demand has prompted a collapse in short-term rates. Overnight cash is now down to around 30 basis points and is trading lower still six-month forward. The expectation that the ECB is unlikely to tighten policy for some time has also helped to push longer-term rates to new cycle lows. 2-year swap rates, for example, are now below 1% and the 5-year equivalent is trading sub 1.50% from 3% a year ago. The ECB was raising rates at that time, remarkable as that now seems, and the combination of a new Bank President and a changed economic outlook has transformed the interest rate environment. The ECB is not the Federal Reserve, however, and has a clear inflation mandate but the current weak state of economic activity and the prospect of a prolonged period of fiscal retrenchment in the euro area implies that rates may well stay low for some time, although expectations are volatile, and stronger Euro data may well prompt some upward moves, albeit not substantial.

**…but UK rates tick up.**

The UK economy is in recession, having recorded a second successive quarterly contraction in GDP, but inflation there is much higher than in the euro area, and has been stubbornly high for some time. Consequently, the Bank of England appears to have ruled out any further QE (the latest vote was 8-1 to maintain the current total) and swap rates there have moved a little higher of late, albeit within a trading range; 5-year rates are around 1.65% from below 1.50%. We doubt if rates will rise sharply, given the economic data, but in the absence of a downside surprise in inflation the recent swap rate lows may also prove to be cycle lows. 5-year dollar rates have been in a broad 1% - 1.40% range since last summer and are unlikely to breakout given the Fed's persistent commitment to keeping rates low until the end of 2014.

**Swap Rates**

| | Euro | | Sterling | | US Dollar | |
|---|---|---|---|---|---|---|
| | End June | End Sept | End June | End Sept | End June | End Sept |
| 2-Year | 1.00 | 1.20 | 1.40 | 1.50 | 0.50 | 0.60 |
| 5-Year | 1.50 | 1.65 | 1.75 | 1.85 | 1.20 | 1.35 |
| 10-Year | 2.20 | 2.25 | 2.50 | 2.60 | 2.10 | 2.25 |

## May

| Date | Europe | United States | UK |
|---|---|---|---|
| 4 | PMI Services Index, PMI Composite Index, Retail Sales | Employment Report | |
| 7 | German Factory Orders | Consumer Credit | RICS Housing Survey |
| 8 | German Industrial Output | | BRC Retail Sales |
| 10 | ECB Monthly Report | Jobless Claims, Trade Balance | MPC Meeting, Industrial Output, Trade Balance |
| 11 | EC Macroeconomic Forecasts | PPI, Consumer Confidence (Michigan) | PPI |
| 14 | Industrial Output | | |
| 15 | GDP (Q1), ZEW Index | CPI, Retail Sales | |
| 16 | CPI ('flash estimate'), Trade Balance | Industrial Output, Housing Starts, Fed minutes | BOE Inflation Report, Labour Market Report |
| 17 | | Jobless Claims, Philly Fed Index, Leading Indicators | CBI Industrial Trends Survey |
| 21 | Construction Output | | Rightmove House Prices |
| 22 | Consumer Confidence | Existing Home Sales | CPI, Public Sector Borrowing |
| 23 | 'Flash' PMI's | New Home Sales | MPC Meeting Minutes |
| 24 | German IFO Index | Jobless Claims, Durable Goods Orders | GDP (Q1, 2nd est.), Index of Services |
| 25 | German CPI | | |
| 28 | | | Nationwide House Prices |
| 29 | | Consumer Confidence (Conference Board) | |
| 30 | M3, Business & Consumer Confidence | Pending Home Sales | Mortgage Approvals, Consumer Confidence |
| 31 | CPI | Jobless Claims, Chicago PMI, GDP (Q1, 2nd est.) | |

Forecasts

# Bank of Ireland estimates

## Exchange Rates

| | Current | End Jun | End Sep | End Dec |
|---|---|---|---|---|
| EUR/USD | 1.32 | 1.27 | 1.27 | 1.27 |
| EUR/GBP | 0.81 | 0.80 | 0.80 | 0.80 |
| USD/JPY | 80 | 80 | 82 | 85 |
| GBP/USD | 1.62 | 1.59 | 1.59 | 1.59 |

Source: Bank of Ireland Global Markets

## Official interest rates

| | Current | End Jun | End Sep | End Dec |
|---|---|---|---|---|
| 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 Jun | End Sep | End Dec |
|---|---|---|---|---|
| US | 1.10 | 1.20 | 1.30 | 1.50 |
| Eurozone | 1.40 | 1.50 | 1.65 | 1.75 |
| UK | 1.68 | 1.75 | 1.85 | 1.85 |

Source: Bank of Ireland Global Markets

## GDP and inflation (annual average)

| | 2011 | | 2012 | |
|---|---|---|---|---|
| | GDP | Inflation | GDP | Inflation |
| US | 1.7 | 3.2 | 2.2 | 2.4 |
| Eurozone | 1.5 | 2.7 | -0.4 | 2.4 |
| UK | 0.7 | 4.5 | 0.6 | 3.0 |

Source: Bank of Ireland Global Markets

## Contact Us

### Economic Research Unit (ERU)

To discuss any aspect of this report, contact your treasury specialist or our Economic Research Unit (ERU):

Chief Economist, Bank of Ireland: Dr. Dan McLaughlin — Tel: +353 (0) 766 244 267

Senior Economist: Michael Crowley — e-mail: eru@boigm.com

Economist: Patrick Mullane

### Contact your treasury specialist

| | |
|---|---|
| Corporate Treasury | 1800 60 70 20 or 1800 30 30 03 |
| Business Banking Treasury | 1800 79 01 53 |
| Institutional Treasury | 1800 60 70 40 |
| Specialised Finance | +353 (0)1 790 0001 |
| UK Sales Team | 0800 039 0038 (within the UK) |
| US Sales Team | +1 203 391 5555 |

### Our Offices

**Dublin**

2 Burlington Plaza, Burlington Road, Dublin 4, Ireland

Tel +353 (0) 766 244 100

**London**

Bow Bells House, 1 Bread Street, London EC4P 4BP, UK

Tel +44 (0)20 3201 6000

**Belfast**

1 Donegall Square South, Belfast, BT1 5LR, UK

Tel +44 (0)28 9032 2778

**Stamford (US)**

300 First Stamford Place, Stamford CT 06902, US

Tel +1 203 869 7111

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