Bank of Ireland
Global Markets

APRIL 2008

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the bulletin

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Sterling Woes

Sterling has had an awful six months, falling substantially against most of the other major currencies, including the euro. The latter broke above 71 pence in November, and hence out of the long established trading range, and has powered ahead since then, briefly pausing around 74 pence before establishing a new high of just under 81 pence a week ago.

Sterling's fall has been rapid and severe...

The pace and severity of the move has been surprising (six months ago the consensus forecast for euro/sterling was 70 pence for mid-2008), and begs an explanation. One factor is the differential in interest rates, which has swung against sterling. Last autumn, the UK Bank rate was 5.75% against a repo rate of 4% in the eurozone, but this differential has now narrowed to 1% following three rate reductions by the Bank of England. Moreover, the market now expects euro rates to remain at 4% for the rest of the year, while pricing in another half point cut in the UK, taking the differential in favour of sterling to only half a percentage point.

...but it now looks undervalued.

The consensus growth forecasts for the two economies are similar (around 1.6%) which should not be overly supportive of the euro, but these do imply a more pronounced deceleration in the UK, given that growth there last year was 3%. In addition, the housing market in the UK plays a more significant role in the economy than in the other large European countries, implying greater perceived vulnerability in the current credit crunch climate. The dislocation still evident in the banking sector may also be seen as negative for the City of London and therefore for the UK economy as a whole, implying that sterling is also acting as a bell weather for financial market sentiment. It is also the case that the UK Government's popularity has fallen in the polls and that policies have been introduced which are seen as negative for non-domiciled residents.

Sterling's fall has not raised alarm bells in policy circles as the Bank of England seems to believe that the UK economy needs rebalancing, with resources moving away from consumption and towards exports and investment. All told then, not a recipe for a strong rally in sterling, but it does now appear significantly oversold and undervalued. Consequently, we expect a partial reversal taking it back to 75 pence against the euro in the coming months, although it remains vulnerable to another lurch downward in the credit cycle.

Dr. Dan McLaughlin
April 2008

UK

Scope for lower rates

The Bank of England MPC cut interest rates by another 25bps in April, the third quarter point reduction since December to take the Bank Rate to 5%. The MPC noted in the accompanying statement that credit conditions had tightened and the availability of credit had worsened, while business surveys suggested economic growth had begun to moderate. The statement also said slower growth should help to keep domestic inflationary pressures in check in the medium term, thus justifying the quarter point cut in rates.

MPC weighs downside risks to growth…

The MPC has indicated that it will continue with its relatively cautious approach to lowering rates. One if its members, Charles Bean, who is also the Bank of England Chief Economist, remarked recently that the MPC is currently "walking a tightrope" as it balances two on-going risks to the inflation outlook. On the one hand, there is the risk that the disruption in financial markets could lead to a slowdown in the economy that was "sufficiently sharp" to pull inflation below the target of 2% in the medium term. On the other hand, there is a risk that above-target inflation in the near-term - inflation is currently running at 2.5% and is expected to accelerate to 3% over the next few months - will raise inflation expectations in the economy and thus lead to permanently higher inflation. Up until now at least, the MPC has attached greater weight to the risks associated with a potentially sharp slowdown in growth, hence the three quarters of a percentage point reduction in rates since December.

…and upside risks to inflation…

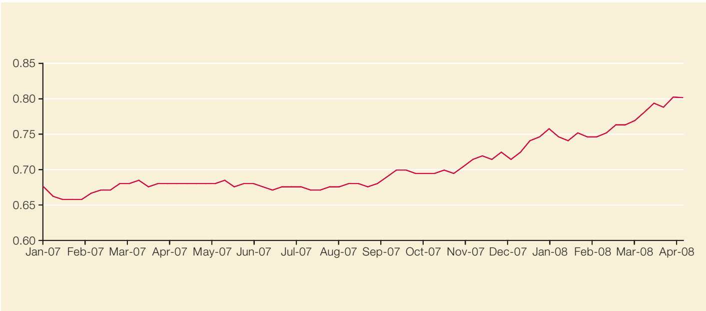
The effects of tighter credit conditions can be seen in the housing market, with mortgage approvals declining by almost 40% in the year to February, according to the Bank of England, and house prices falling in each of the four months through to March, according to the Nationwide. More generally, while it seems the pace of economic growth decelerated only modestly in Q1 - to around 0.5% from 0.6% in Q4 - the indications are that activity will slow more quickly over the remainder of this year. The Bank of England's latest Agents Summary, for example, reports an easing in consumer spending, a fall in business investment intentions, as well as a softening in labour demand.

…but likely to ease further.

Notwithstanding the recent announcement of the Bank of England's Special Liquidity Scheme, which is designed to improve the liquidity position of the banking system and, ultimately, spur lending to the wider economy, interest rates are likely to be cut further, given the expected slowdown in growth and considering the Bank Rate is still relatively high at 5%. Hence, we retain our forecast for a further 50bps cut in rates - to 4.5% - by the end of this year. This should allow swap rates, which have risen quite sharply over the past couple of weeks, to fall back again towards 5% in the coming months. As regards sterling, we see it in a range of about 75-81p over the rest of the year, with a move towards the 75p level requiring some indication from the ECB that it is likely to lower interest rates.

Michael Crowley

Euro/Sterling Exchange Rate



euro zone

No near term rate cut

ECB rhetoric has turned hawkish...

...and we have pushed out the timing of forecast rate cuts.

On St. Patrick's Day the financial markets were discounting a half-point cut in ECB rates by September. Since then, expectations have turned bearish and the current shape of the money market curve implies that traders are no longer projecting any policy easing by the ECB. This, in turn, has offered support to the euro which has risen against most of the other major currencies, and is again flirting with new highs against the US dollar.

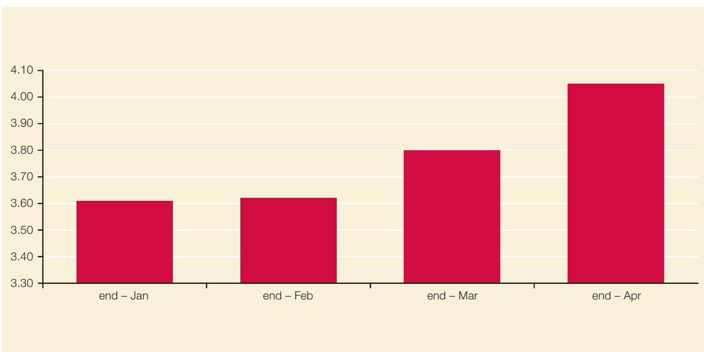
Global rate expectations have changed, too, of course, but a prime factor driving the reappraisal of the euro rate outlook is the rhetoric of the ECB, which has turned more hawkish in the past few weeks. A number of prominent council members have noted downside risks to growth but have emphasised the recent rise in inflation and the risks that this adversely impacts inflation expectations. The Bank still expects inflation to fall back to the 2% target over the next eighteen months, which is why they have kept rates at 4%, but they may be less confident about this happening, given the recent acceleration in headline inflation. Nevertheless, it is an unpleasant surprise to the market to hear the French Central Bank Governor, Noyer, state that the ECB would raise rates if required.

In March the ECB forecast projected average inflation of 2.8% this year, declining to 2.1% in 2009, but the price data has surprised to the upside in the past few months, with a 3.6% annual inflation rate recorded in March. This may actually turn out to be the peak of the cycle, but a sharp deceleration is unlikely in the absence of a fall in oil and food prices. The real economy data has also tended to be on the firm side of expectations, at least in terms of Germany, implying a decent first quarter growth figure in that country.

Yet, the broader euro-wide sentiment indices are still drifting lower and interbank rates remain extraordinarily elevated, which is prompting a tightening of credit standards and an upward creep in retail rates. Consequently, we still expect economic growth to slow in the euro area and for inflation to decelerate which will eventually prompt the ECB to ease in order to prevent a steeper slowdown. The prospects of this happening in the second quarter are now very slim, however, and so we have pushed our rate cut forecasts in to the third and fourth quarters.

Dr. Dan McLaughlin

ECB Repo (Expectations for September 2008)



US

Fed near the end

Some signs of improvement in financial markets...

The rescue of Bear Stearns in mid-March may yet prove to have been a watershed in the credit crisis that erupted in August 2007, as the Fed was seen to be prepared to prevent the collapse of a major banking institution and hence ward off an even greater threat to the US financial system. Equity markets have rallied in the period since and credit markets have improved, while government bond yields have risen recently having fallen sharply in late February/early March on a 'flight to safety' bid.

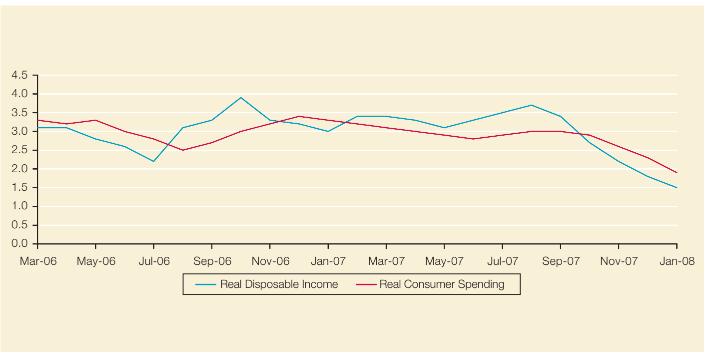
...and rate cut expectations pared back...

Markets have also scaled back expectations regarding further cuts in interest rates - which has also contributed to the rise in bond yields - perhaps indicating a belief that the worst of the credit crisis may be over. That said, tensions certainly remain, as evidenced by the renewed rise in inter-bank interest rates, with 3-month rates having risen by about 40bps since the middle of March. In addition, the effects of the credit crisis, in terms of both the availability and cost of credit, are still working their way through the economy, which certainly does not appear to be out of the woods just yet.

The statement accompanying the Fed rate cut in March (the 75bps reduction took the federal funds rate to 2.25% and brought the cumulative reduction since last September to 300bps) said the "outlook for economic activity has weakened further". It noted that growth in consumer spending had slowed and labour markets had softened, and said financial markets remained "under considerable stress" with the associated tightening of credit conditions "likely to weigh on economic growth over the next few quarters". Indeed the minutes of the meeting showed that many members "thought some contraction in economic activity in the first half of 2008 now appeared likely", with some wary of a "more severe and protracted downturn in activity than currently anticipated".

The pace of economic growth slowed sharply at the end of last year and activity has remained weak since. The effects of the credit squeeze have been most obvious in the residential property market. New housing starts declined by a further 10% in the first quarter, a response to the on-going weakness of demand - the latest data show new home sales fell by another 12% in the three months to February. In line with the continuing fall in output, employment in the construction sector has begun to decline at an accelerated pace, while manufacturing is also shedding jobs, notably in areas closely related to housing. As services sector employment growth has also slowed, the net result is that overall employment has begun to fall, with jobs been shed at a rate of almost 80k a month over the first three months of this year.

Incomes and Spending - % Year-over-Year



...with just another 25bps reduction expected...

...and market now contemplating a rate hike in early '09.

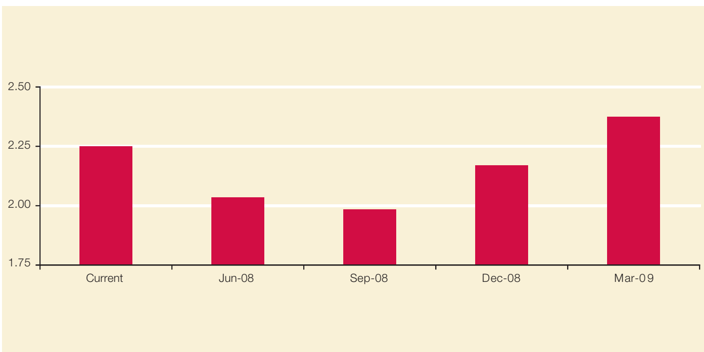
The fall in employment has resulted in a deceleration in income growth and a slowdown in consumer spending, with the latter showing little or no growth in real terms since November last year. However, incomes have also been squeezed by higher inflation recently, which in turn is due largely to higher food and energy price inflation. In addition, consumer spending is facing another headwind from falling house prices, which limits the opportunities for individuals to finance expenditure by extracting equity from their homes.

Partly in light of these headwinds to consumer spending, the Fed believes that "downside risks to (economic) growth remain". Nevertheless, its base case scenario is that, after a weak first half, the economy will pick up over the second half of the year and into 2009, as the effects of past interest rate reductions and the government's fiscal stimulus, as well as some recovery in financial markets and an easing of the downturn in housing activity, start to boost overall activity. Since it believes there are still downside risks to growth, it is reasonable to think the Fed will ease further in the near-term, though the market currently sees only one further cut - of 25bps at the April 29/30 meeting - in this phase of the cycle. Similarly, since the Fed expects activity to pick-up over the second half of the year, if may want to go "on hold" at some stage as it waits to see if the economy is evolving as expected. This, too, is now incorporated into market expectations - the fed funds rate is expected to stay around 2% for much of the remainder of this year though with some chance of a rate hike priced in for the end of 2008/early 2009.

We do expect the Fed to lower rates again, though by 50bps, with the likely 25bps reduction at the April 29/30 meeting to be followed by another quarter point cut to 1.75% at the end of June. We do not, though, expect the Fed to be raising interest rates as early as the end of this year. We think any recovery in the economy is going to be sluggish and so expect interest rates to remain at 1.75% well into 2009. As regards the dollar, and as we have said before, we believe any recovery will partly depend on the ECB lowering interest rates. As discussed elsewhere, we have pushed out the timing of any such easing to the end of Q3, which in turn means any significant reversal in the dollar fortunes is now going to be delayed.

Michael Crowley

Fed Funds Rate: Market Expectations



forecasts

Exchange Rates

	Current	End-June 2008	End-Sept 2008	End-Dec 2008
EUR / USD	1.5730	1.50	1.45	1.40
EUR / GBP	0.7930	0.77	0.75	0.75
USD / JPY	103.5	105	110	110
GBP / USD	1.975	1.95	1.93	1.87

Official Interest Rates

	Current	End-June 2008	End-Sept 2008	End-Dec 2008
Fed Funds	2.25	1.75	1.75	1.75
ECB	4.00	4.00	3.75	3.50
UK	5.00	5.00	4.75	4.50

Swap Rates: 5-year

	Current	End-June 2008	End-Sept 2008	End-Dec 2008
US	3.79	3.50	3.75	3.75
Euro Zone	4.38	4.00	3.75	3.75
UK	5.25	5.00	5.00	5.00

GDP and Inflation (%, annual average)

	2007		2008	
	GDP	Inflation	GDP	Inflation
US	2.2	2.9	1.4	3.6
Eurozone	2.6	2.1	1.6	2.6
UK	3.0	2.3	1.7	2.5

economic diary

May

Date	Eurozone	United States	United Kingdom
1		ISM Manufacturing, Construction Spending, Vehicle Sales, Jobless Claims, Personal Income	PMI Manufacturing
2	PMI Manufacturing, French Producer Prices	Factory Orders, Payroll report, Earnings, RPX Report	
5		ISM Non-Manufacturing	
6	PMI Services, PMI Composite, PPI		HBOS House Prices, PMI Services
7	Retail Salea, German Factory Orders	Productivity & Costs, Consumer Credit	Industrial Ouptut
8	ECB, German Industrial Production	Jobless Claims, Wholesale Inventories	MPC Meeting
9	French Industrial Production	Trade Balance	
11			RICS House Price Balance
12		Monthly Budget Statement	Trade Balance
13		Import Prices, Retail Sales, Business Inventories	CPI, BRC Retail Sales Monitor, House Prices
14	Industrial Production, French CPI	CPI	Employment, Earnings, BoE Inflation Report
15	ECB Monthly Report, CPI, GDP	Jobless Claims, Industrial Production, Empire Index, TIC Report, Capacity Utilisation, Philly Fed., NAHB Housing Report	
16	New Car Registrations, Trade Balance, French Employment	Housing Starts, Building Permits, U. of Michigan Confidence	
19			Rightmove House Prices
20	Construction Output, German ZEW Survey	PPI	
21		Minutes of April 29-30 FOMC Meeting	MPC Meeting Minutes, Public Finances, M4
22		Jobless Claims, House Price Index	Retail Sales
23		Existing Home Sales	Q1 National Accounts

Other publications by ERU include:

- Daily Market Commentary
- Weekly Market Commentary
- the Outlook - trends in the Irish economy
- Bulletin Xtra
- The Irish Property Review - a quarterly analysis of the Irish property market
- UK Review - a quarterly commentary on trends in the UK economy
- Irish Business Review - commentary on current trends in the domestic macroeconomic environment

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