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# the bulletin

Research • Analysis • Commentary

## ECB Out of Step

The US market is pricing in substantial rate cuts...

...but the euro market is not.

The picture portrayed by market prices at the moment is an oddly disjointed one; the US market is effectively pricing in a recession, yet oil prices are close to \$100. Closer to home, the ECB remains concerned about upside risks to inflation, implying that some council members favour an increase in interest rates, yet is clearly worried about the liquidity squeeze in money markets, and has pledged to inject more cash in to the system. We suspect that a more consistent picture will emerge in the coming months, but if so, it implies some sharp market moves, as these inconsistencies are ironed out.

In the US, the market has been pricing in lower rates for some time now, an expectation which has undermined the dollar, but November saw a marked acceleration of this trend; the September Fed Funds contract is under 3.50%, or more than 100bp below the current rate. This implies a recessionary or near recessionary environment, which is neither supported by the data nor Fed rhetoric. The former certainly points to further weakness in the housing market but not to a broader-based slowdown, at least for the moment. The Fed also expects the housing market to remain a drag on activity for some time, but forecasts US growth of around 2% in 2008, albeit with downside risks. The implication is that those downside risks will have to materialise to validate the current market expectation, as the Fed's forecast is more consistent with a rate of 4%, or so.

The sell-off in equity markets, led by bank shares, is also illustrative of this market

expectation of an economic slowdown, yet commodity prices in the aggregate have risen sharply over the past two months, including oil. Again, this appears inconsistent, and we suspect that the oil price increase, in particular, is speculatively driven and could unwind sharply, just as it did in the latter months of 2006, when crude prices fell from \$75 to \$50.

The economic data has softened appreciably in the euro area, where there has been a notable decline in sentiment and confidence indices such as the PMI's and the Ifo. This, and the rise in interbank rates, has prompted the ECB to acknowledge that there are now downside risks to growth, but it still feels that these are matched by upside risks to inflation. Consequently, the market is not fully pricing in any rate cuts in the first half of 2008, despite the trends seen in other interest rate markets. Indeed, the Bank of England has done a complete about-turn, and is now effectively signalling that UK rates may fall by up to 75bps over the next eighteen months. The ECB is therefore the 'odd man out' and we still expect a change in tune from Frankfurt over the coming weeks, with the Bank expressing more concern about downside risks to growth and hence indicating that the next rate move will be down. If so, that would also cap the euro's advance, both against sterling and the US dollar.

**Dr. Dan McLaughlin**  
30th November, 2007

## Interest rates headed lower

MPC projections show inflation to undershoot target...

...unless interest rates are cut...

...so MPC move next month very possible.

In its November Inflation Report, the Bank of England said that, with interest rates maintained at the current level of 5.75%, economic growth would slow sharply and inflation would undershoot its target of 2% in two years time, which it should be noted is no more acceptable to the MPC than an overshoot of the inflation target. On the other hand, predicated on the path for the Bank Rate implied by market expectations as of early November - 5.5% in Q1 2008, 5.3% in Q3 and 5.2% in early 2009 - GDP economic growth is projected to fall back quite sharply over the next year before picking up again thereafter, while inflation is forecast to be on target in two years time.

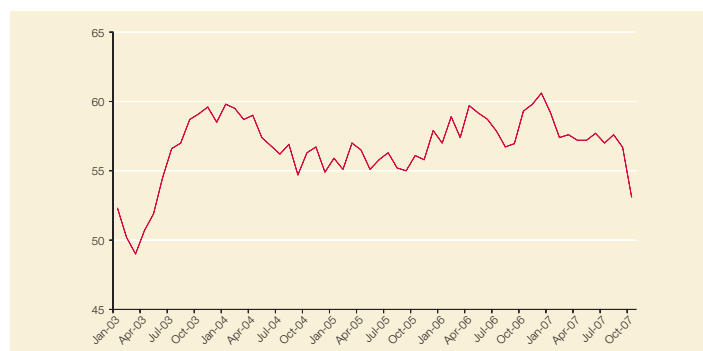
The implication of the Inflation Report would seem to be clear therefore - the MPC needs to lower interest rates to meet its inflation objective. However, the publication of the minutes of its November meeting has clouded the issue somewhat - just two members voted for a (25bps) cut in rates with the remaining seven preferring to keep them unchanged at 5.75%. Amongst the arguments to keep rates steady were: uncertainty about the extent to which the economy is slowing; related to this, limited evidence, to date, of significant effects on household or business activity from the recent tightening of credit conditions; and upside risks to inflation from recent increases in oil and commodity prices. The two dissenting members, on the other hand, argued that earlier increases in interest rates were now having an impact on the commercial property and housing markets and there was evidence of some slowing in economic activity generally. They also argued that the

central projection in the November Inflation Report showed a sharp slowing of growth, even with lower interest rates over the next year, so why wait before cutting them and thus risk an even sharper slowdown in activity.

The projections in the Inflation Report are the key to the outlook in our view, which is why we think there is a very good chance the MPC will cut rates by 25bps at the December meeting, particularly as financial conditions have worsened since it last met, with equities lower and sterling inter-bank rates higher. Moreover, GDP growth in Q3 was not quite as strong as originally reported, being revised down to 0.7%, and survey data point to a quite pronounced slowdown in the current quarter, while there are even clearer signs now that activity in the housing market is easing.

The Inflation Report has prompted a change in market sentiment regarding interest rates, with a 25bps cut expected by January at the very latest to be followed by a further quarter point reduction by early spring. This in turn has prompted a notable decline in sterling against the euro, with the UK unit falling to a five year low of 72.16p in November. The range since the single currency was launched in 1999 is around 57p to 72.5p, so there is clearly a risk that sterling will break out of this range in the near-term. Looking ahead to 2008 however, we expect sterling to strengthen against the euro. As the market prices in lower euro interest rates, which we expect it will, this will take its toll on the single currency, so we see euro/sterling falling back towards 68p through the course of next year.

### CIPS Index of Services Sector Activity



# euro zone

## ECB gets the hump

Recent inflation rise worries ECB...

...but likely to prove temporary...

...particularly as growth slowing...

...which ultimately will lead to cut in rates.

The ECB left its key interest rate unchanged at 4% in November, though the Governing Council still believes that there are upside risks to inflation in the medium term, stemming from oil and food prices, and the possibility of a pick up in wage growth. At the same time however, the ECB acknowledges that there are downside risks to economic growth, in part reflecting *'the potential for a broader impact from the ongoing reappraisal of risks in financial markets on confidence and financing conditions'*. The latter warrants *'a thorough examination of additional information before drawing conclusions for monetary policy'*. Overall then, while the ECB says it *'stands ready to counter upside risks to price stability'*, which implies that it could raise interest rates further, it is unlikely to do so given the downside risks to growth, particularly as the latter have, if anything, risen further since the ECB last met.

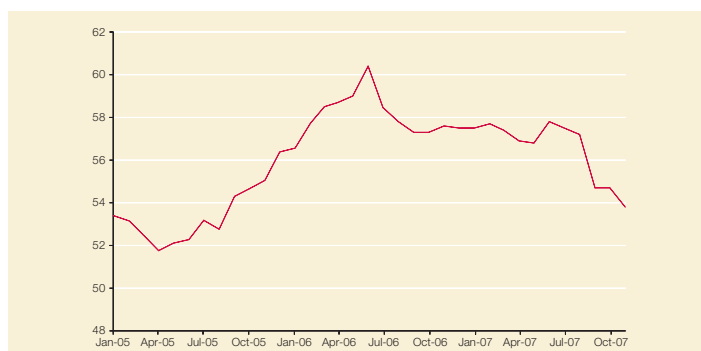
Inflation has risen sharply over the past few months, from 1.7% in August to 2.6% in October, and it is likely to rise further, to close to 3%, in November. This is largely due to the impact of the sharp rise in the oil price recently, which has fed through into higher energy costs, and has been exacerbated by the fact that energy costs were falling around this time last year. The ECB believes that what it calls this *'hump'* in inflation will prove temporary, and that inflation will moderate again in the course of 2008, assuming there are no *'second-round effects'* from the initial spike in inflation, and in particular as long as there are no increases in wage rates to compensate for what is a temporary increase in inflation. Wage inflation has remained relatively subdued, notwithstanding the tightening of the labour market over the past couple of years. Now that the pace of economic

growth is slowing, it is unlikely that second-round effects will emerge.

Though real GDP increased by 0.7% in Q3 after a 0.3% gain in Q2, it is clear that growth peaked in the final quarter of 2006, with the annual rate slowing from 3.3% in the last three months of last year to 2.6% in the three months to September. The available indicator data point to a further slowdown in the final quarter of this year. In particular, the Purchasing Managers composite index of activity across the manufacturing and services sectors has fallen in recent months and currently points to an increase in GDP of about 0.4% in Q4, which would imply a further deceleration in the year-over-year rate to 2.2%. Given past increases in official rates, the tightening of monetary and credit conditions on account of recent financial market conditions, and taking into account the appreciation of the euro, growth is likely to slow further in 2008. This, we believe, will prompt the ECB to cut interest rates by at least 50bps next year, beginning some time in late spring or early summer

Government bonds yields have fallen sharply over the past month and are now trading through the current level of official rates of 4% out to the 10-year segment of the curve. Some of this reflects the fact that the market has priced out any further increase in official rates, but much of it reflects a flight to the safety of government bonds in volatile markets. Swap rates have also fallen, though not as sharply and they still remain above the 4% level. The market is only tentatively pricing in the possibility of any cut in ECB rates next year. If and when it prices in a much greater likelihood of lower official rates, swap rates will fall further while the euro, which has risen to almost \$1.50, will lose ground to the US currency.

## Purchasing Managers Composite Index



## Fed to cut again in December

Bond yields fall sharply...

...as market expects Fed to cut rates again soon...

Government bond yields have fallen sharply over the past month, with the 2-year down about 80bps to just over 3% and 10-year yields falling by around 50bps to just under 4% over this period. Swap rates have also fallen, though by less than bond yields, (so swap spreads have widened out). This is particularly so in the case of the 2-year swap rate which has fallen by about 45bps (to just over 4%), while the 10-year swap rate is about 35bps lower (at around 4.7%).

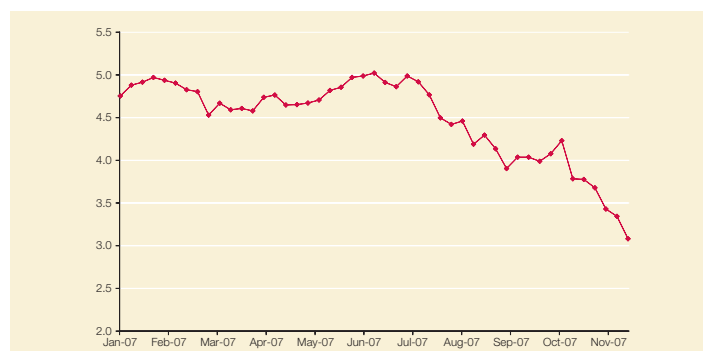
These developments have occurred against the backdrop of a sharp decline in equity markets - the S&P 500 has fallen by 8% since the end of October, led by financial stocks - and renewed tensions in money markets - three-month rates have risen by almost 20bps over the past month - which has resulted in a flight to the safety of government bonds (evident in the particularly sharp fall in 2-year yields) and led the market to price in a substantial cut in official rates (which has reinforced the fall in yields). The latter has undermined the dollar, which has fallen further against the euro over the past month.

The market expects the Fed to cut interest rates to 3.25-3.5% over the

next twelve months, with another 25bps reduction at the December 11th meeting almost fully priced in at this juncture. In the statement issued following its 25bps rate cut at the October meeting, the Fed noted that, after *'this latest action, the upside risks to inflation roughly balance the downside risks to growth'*. This adoption of an effectively neutral stance on interest rates, while certainly not ruling out a further cut, seemed to cast doubt on whether it might lower them again as soon as the next meeting on December 11th. Much of the Fed's public commentary since the meeting had also, by and large, reinforced the message that the current stance of policy was appropriate and balanced the upside risks to inflation (from, amongst others, high oil and commodity prices) on the one hand and the downside risks to growth (related to housing and tighter credit conditions) on the other.

However, in a potentially significant speech at the end of November, the Fed Vice-Chairman, Donald Kohn, focused heavily on the *'increased (market) turbulence of recent weeks (which) partly reversed some of the improvement in market functioning over the late part of September and in October'*, noting that *'heightened*

Government 2-Year Bond Yield



concerns about larger losses at financial institutions now reflected in various markets have depressed equity prices and could induce more intermediaries to adopt a more defensive posture in granting credit, not only for house purchases, but for other uses as well'. In this vein, he warned that 'should the elevated turbulence persist, it would increase the possibility of further tightening in financial conditions for households and businesses'.

The Fed Vice-Chairman also outlined the central bank's approach to setting monetary policy when operating under a higher than normal degree of uncertainty. Under such circumstances, Kohn said, the 'potential actions (the Fed) discusses have the character of 'buying insurance' or managing risk - that is, weighing the possibility of especially adverse outcomes... the nature of financial market upsets is that they substantially increase the risk of such especially adverse outcomes while possibly having limited effects on the most likely path for the economy'.

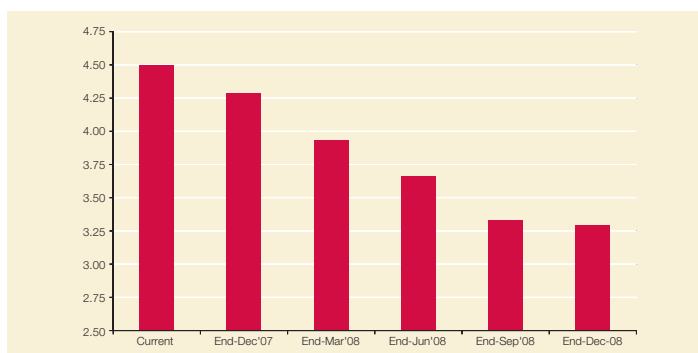
The Fed outlined its view of the most likely path for the economy when it published its latest projections in November. It sees economic growth slowing to between 1.8% and 2.5% in the year to the fourth quarter of 2008,

which is a downward revision of 0.5% from its July forecast, before picking up to between 2.3% and 2.7% in 2009, while core inflation is seen around 1.8% in each of the next two years. These projections are predicated on 'an appropriate path for monetary policy', though unfortunately we do not know what interest rate this means (because the Fed does not tell us). However we suspect that the forecasts are consistent with a fed funds rate of about 4%, 50bps lower than the current level. Hence we expect the Fed to cut rates by 25bps on December 11th and by a further 25bps in the first quarter of next year.

Growth would have to be considerably weaker than the Fed is projecting (and what we think is likely, which is a real GDP increase of around 2% over the next year) to justify the current market expectation that rates will fall to as low as 3.25-3.5% in 2008. If it is not, and given what is priced in, then there is clearly a risk that bond yields particularly, but also swap rates, may begin to back up again in 2008. For the same reason, the dollar should also strengthen if policy is not eased as much as the market thinks, particularly so if the market also begins to price in lower Euro Area interest rates.

...though ultimately they may not fall as much as market is pricing in.

### Fed Funds Rate - Market Expectations



# forecasts

## Exchange Rates

	Current	End-Dec 2007	End-Mar 2008	End-Jun 2008
EUR / USD	1.47	1.45	1.36	1.34
EUR / GBP	0.71	0.70	0.70	0.69
USD / JPY	110	115	115	115
GBP / USD	2.07	2.07	1.94	1.94

## Official Interest Rates

	Current	End-Dec 2007	End-Mar 2008	End-Jun 2008
Fed Funds	4.50	4.25	4.00	4.00
ECB	4.00	4.00	4.00	3.75
UK	5.75	5.50	5.25	5.25

## Swap Rates: 5-year

	Current	End-Dec 2007	End-Mar 2008	End-Jun 2008
US	4.25	4.25	4.35	4.35
Euro Zone	4.40	4.40	4.25	4.00
UK	5.35	5.25	5.10	5.00

## GDP and Inflation (%, annual average)

	2007		2008	
	GDP	Inflation	GDP	Inflation
US	2.0	2.6	2.0	2.0
Eurozone	2.6	2.1	2.0	1.9
UK	3.1	2.3	2.2	2.0

# economic diary

Dec

Date	Eurozone	United States	United Kingdom
3	PMI Manufacturing Index, Unemployment Rate	ISM Manufacturing Index, Auto Sales	CIPS Manufacturing Index
4	PPI		CIPS Construction Index, BRC Retail Sales Monitor
5	PMI Services Index, Retail Sales	ISM Non-Manufacturing Index, Factory Orders, ADP Report	CIPS Services Index
6	ECB Rate Announcement, German Factory Orders	Jobless Claims	MPC Rate Announcement, Industrial Output
7	German Industrial Output	Employment Report, Consumer Confidence	
10	French Industrial Output, Italian Industrial Output	Pending Home Sales	PPI, Rightmove House Prices
11	German ZEW Index	Fed Rate Announcement	Visible Trade
12	Industrial Output, Employment (Q3)	Trade Balance, Import Prices	Labour Market Stats.
13	ECB Monthly Report, Labour Costs, French CPI	Retail Sales, PPI, Jobless Claims	RICS Housing Survey
14	CPI, New Car Regs.	CPI, Industrial Output	
17		Current Account, TIC Report, Empire Index, NAHB Index	
18	Trade Balance	Housing Starts & Permits	CPI, MPC Meeting Minutes
19	German Ifo Index, Construction Output		Business Investment, CBI Retail Sales Survey
20	Flash PMIs	Jobless Claims, Philly Fed Index, GDP (Q3, final)	GDP (Q3, final), M4
21	Current Account	Personal Income & Spending	Retail Sales

## 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

# contact



## Bank of Ireland Global Markets

Colvill House, Talbot Street, Dublin 1, Ireland

Tel: +353 1 799 3000

Fax: +353 1 799 3035

e-mail: [info@boigm.com](mailto:info@boigm.com)

[www.boi.ie/globalmarkets](http://www.boi.ie/globalmarkets)

Chief Executive - Austin Jennings

Head of Global Customer Business - Deirdre Flannery

---

## Economic Research Unit (ERU)

Tel: +353 1 609 3341

e-mail: [eru@boigm.com](mailto:eru@boigm.com)

Listen to Daily Commentary on Freephone: 1800 60 70 60

Chief Economist, Bank of Ireland - Dr. Dan McLaughlin

Senior Economist - Michael Crowley

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## Corporate & Institutional Sales

Freephone: 1800 30 30 03 (Corporate)

Tel: +353 1 790 0000

Freephone: 1800 60 70 40 (Institutional)

Tel: +353 1 670 2652

Tel: +353 1 609 3277 (Property)

Deputy Head of Customer Group - John Moclair

Corporate - Paul Shanley

Institutions - Gavin Rylands

Property & Specialised Finance - Ed Preston

Corporate Banking Relationship Manager - Eamon McManamy

---

## Business Banking & Retail Sales

Freephone: 1800 790 153

Tel: +353 1 609 4343/4300

Tel: +353 1 609 4330 (branch sales team)

Head of Retail Sales & Customer Group Operations - Aine McCleary

Business Banking Sales - Leslie Cosgrave

Branch Sales - Liam Connolly

Customer Service - Osna O'Connor

---

## Global Markets United Kingdom (UK)

Eastcheap Court, 11 Philpot Lane, London EC3M 8BA

Tel: +44 (0) 20 7560 8600

[www.boigm.co.uk](http://www.boigm.co.uk)

Managing Director - Peter Goshawk

Chief Dealer - Liam Whelan

Head of Business Development - Duncan Wilson

Team Heads - Tom Turney, Kai Fisher, Mark Doody, Jacqueline Mathieson, Andrew Law

---

## Corporate Treasury Team

Freephone: 0800 039 0038

---

## Treasury Team (Regional)

Freephone: 0800 169 5415

---

## Global Markets United States (US)

300 First Stamford Place

Stamford, CT 06902

Tel: +1 203 391 5555

Fax: +1 203 391 5901

Head of US - Darsh Mariyappa

Head of US Corporate Sales - Joe Connolly

Team Heads, Customer Group - Garreth Boyle, Mike McGuinness, Flavio Paparella, Breda Ryan

Team Heads, Trading Group - Derek Doody, Jose Ruiz

---

## Global Products Team

Tel: +353 1 790 0040

Global Head of Structured Business - Brian Vaughan

---

## Marketing Department

Tel: +353 1 6093302

Head of Marketing - Damien Daly

Team Heads - Patrick O'Sullivan, Andrew Hearnden,

Mairead Magill, Suzanne McGann, Eva Koenig

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