



The Bulletin

A monthly analysis of international and Irish markets

Risk premium on Irish debt eases

- The NTMA has funded 90% of the annual target
- And core deficit may undershoot target

There is much debate internationally amongst economists, central bankers and politicians on the appropriate stance of fiscal policy at this juncture – should governments attempt to bolster the recovery by running higher deficits for longer, or would it be better to reduce State borrowing more quickly. The main case against higher budget deficits in general is that they risk pushing up the cost of borrowing for the State and therefore for the private sector as well. This tends not to be an issue for large economies but for small economies like Ireland the interest rate argument tends to prevail, particularly as Irish savers prefer bank deposits or investments in property and equities rather than lending money to the Government. This leaves the Government very dependent on foreign investors to fund any deficit and hence vulnerable to any rise in the perceived risk of buying Irish debt.

As a case in point, the Irish Government has just announced revised capital spending plans which envisage lower outlays than projected a few years ago, citing budget constraints as a key factor in that decision. For some, the reduction is a missed opportunity to provide additional stimulus to the economy, whereas a sharper cut might bring the projected deficits down to the 3% target in a shorter timeframe.

The perceived risk of holding Irish debt, as measured by the cost of insuring against a default, soared after the nationalisation of Anglo Irish Bank to around 4% a year from 0.5% six months earlier, before falling back to 1.5% and under by last autumn. The prospect of a Greek default and the ensuing turmoil in euro bond markets over recent months pushed the cost up again, to over 2.8%, but it has fallen back in the last few weeks to around 2.2%. Similarly, Irish bond yields have fallen relative to Germany, to a 10-year spread of 2.4% from 3% a month ago.

Despite this turbulence, the NTMA has raised over €18bn in the year to date from debt issuance, against a €20bn target for the year. Moreover, the average cost of that borrowing, at 4.57%, is actually marginally lower than the average in 2009, thanks to the fall in long term rates internationally. Consequently, it is likely that the cost of servicing the national debt this year may be lower than expected in the 2010 Budget. In addition, the Central Bank has run a higher surplus in the first half of the year than projected for the full year, and capital spending is massively behind target, implying an undershoot there. Consequently, we feel there is a good chance that this year's deficit may undershoot the target (excluding any capital for the Irish banking sector) and that view takes no account of the fees paid by banks for the 2010 deposit guarantee, which may reach €1bn.

Dr. Dan McLaughlin

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United Kingdom

Pace of UK recovery quickens

Economy surges by 1.1% in Q2....

The UK economy grew by 1.1% in real GDP terms in Q2, much faster than the consensus forecast. This is the fastest expansion in a quarter in four years and comes after a 0.3% expansion in Q1. The annual rate of growth stood at 1.6% in Q2. The services sector, which makes up about three-quarters of the UK economy grew by 0.9% in the quarter and manufacturing expanded by 1.6%. There was a huge upside surprise in construction which increased by 6.6%, which is only the 2nd quarter since 2008 that the sector has not contracted. The strength of the UK recovery at the moment may fuel further debate at the MPC where one member believes that growth at the moment justifies a base rate increase while others see some arguments that inflation may not come back to target soon.

...as Sentance continues to call for a hike...

Sentance was again the lone dissenter in July voting for a 25bps hike in a 7-1 split. The latest set of minutes pointed to some debate already going on within the MPC. According to the minutes "The Committee considered arguments in favour of a modest easing in the stance of monetary policy. The softening in the medium term outlook for GDP growth over recent months would put further downwards pressure on inflation, once the impact of temporary factors had waned. Pay growth had remained subdued and there was little sign of a material pickup in medium-term inflation expectations" while on the other hand there were also arguments in favour of a modest tightening in the stance of monetary policy. Inflation was likely to remain above target for some months and there was a risk that medium-term inflation expectations would rise. "The resilience of inflation over recent months had suggested that the downward impact of spare capacity could be weaker than expected and this created uncertainty around the extent to which inflation would fall back in the future. Demand growth had bounced back internationally, although the geographical distribution remained uneven. The average growth rate of the main measures of UK nominal demand in recent quarters had been around or above historical rates". The word 'uncertain' is prominent throughout the July MPC minutes. The Committee thought that growth may be slightly weaker than previously thought but that inflation was also likely to be higher in 2010 than envisaged in the May inflation Report. Spencer Dale may also be starting to lean towards the view that inflation will remain elevated but it would have been very surprising if he had voted for a rate hike this month. He said after the minutes were released that huge monetary stimulus remains and he saw inflation above target at year end, however he added that the growth outlook had deteriorated recently. Sentance said before the July meeting that events such as the budget had not changed his overall view so his vote for a hike was expected, and he could be a lone voice for a while yet. At the Treasury Committee at the end of the month, King repeated that the MPC had "room" to move in either policy direction and would do so if needed.

...with no end in sight for high inflation rates.

For the members of the MPC who are worried about the upside risks to inflation, the current stickiness of high inflation is increasing their concerns. UK CPI inflation fell to an annual rate of 3.2% in June from 3.4% in May while the annual core rate rose to 3.1% from 2.9% in the same period. The biggest effect on both the headline and core rate continues to be the base effect from the increase in VAT at the start of the year, which is contributing about 1.5% to the headline rate at the moment. The annual inflation rate excluding indirect taxes fell to 1.6% in June from 1.7% in the previous month. The headline rate of inflation bottomed at 1.1% in September'09 but has now been above 3% since the start of this year. If we remove the effect of indirect taxes then the annual inflation rate has fallen from 2.2% in September '09 to 1.6% last month. The underlying inflation environment in the UK appears to be subdued but the high headline rate risks pushing up inflation expectations as headline inflation has been above target for most of the past 2 years. The headline rate will continue to be boosted by VAT increases until the end of 2011 as the Chancellor's decision to increase the VAT rate by another 2.5% from January 2011 mean that an increased VAT rate will continue to make a significant contribution to headline inflation for all of next year as well.

Europe

Euro above \$1.30 as data shows strong recovery in Q2

Euro moves above \$1.30...

The Euro has surged against the Dollar over the past month. The single currency had been under severe pressure in the early summer due to the fallout from the euro debt crisis, hitting a 4 year low of \$1.19 in early June. However, it has made a comeback and had gained about 6.5% against the dollar over the course of July, moving up from \$1.22 at the start of the month to over \$1.30 by the last week of the month. It has also gained against other currencies, including Sterling and the Yen. Part of the boost to the Euro came from positive macro data this month, which, for the main part, came in ahead of expectations and indicates the recovery should strengthen in the short term. PMI readings for July for the euro area were healthier than expected; Services rose to 55.8 while Manufacturing was up to 56.7. Both of those readings were slightly higher than the consensus forecast and having been showing expansions for 10 consecutive months. Industrial new orders in the euro area in May were also much higher than expected. Orders rose by 3.8% following a 0.6% gain in April - a marginal fall in orders in May had been expected. Industrial production rose by 0.9% in May while retail sales gained 0.2% in the same month. The German IFO index also surged in July, up to 106.2 from 101.8. That's just a few points off the 2006 high for the index. Other confidence indicators were also showing increasingly positive sentiment towards economic conditions at the moment. The Euro has also been helped by some weaker than expected US data which indicates that the US recovery is proceeding but may not be as robust as previously thought. All of these points to stronger growth in the short term for the Euro area, however, the pace of growth should slow towards the back end of the year as austerity measures start to kick in across the currency zone's members.

...as ECB says very little...

The ECB meetings in July and August produced no surprises. The Bank still sees a gradual albeit uneven economic recovery ahead accompanied by moderate inflation; hence it continues to believe the current level of interest rates of 1% remains appropriate. At the post-meeting press conferences, most of the questions asked related to the ECB's bond purchases, liquidity conditions in the market, and the EU banking sector stress tests. As regards bond purchases, Trichet said the functioning of government bond markets had improved since the ECB began to intervene in early May and noted that the amount of bonds purchased has progressively reduced in recent weeks, though he was careful not to say the purchases would end anytime soon. In relation to liquidity conditions, Trichet said the recent rise in money market rates was a consequence of the reduction in excess liquidity which the banking system itself had determined and should not in any way be interpreted as signalling a change in the Bank's monetary policy stance, which as mentioned above remains appropriate.

...and Banks pass Stress Tests.

The Bank Stress Tests results, released on the 23rd of July, contained few surprises. Only 7 of the 91 banks tested (5 Spanish, 1 Greek, 1 German) failed, with regulators recommending that circa. €3.5bn of capital is raised to bring those banks into line. The tests have been criticized as being too easy on banks, but despite the concerns that the tests were not rigorous enough the markets responded well to the results. In the following week, the Euro pushed on to over \$1.30 against the dollar while European equities indices also gained, with most financial stocks doing well. Peripheral bond yields fell with the yield premium over equivalent German Bunds falling sharply. Irish ten year yields fell to under 5% for the first time since early June with about 50bps from mid-month to the end of the month. The yield premium over 10 year bunds fell about 60bps in the same time frame. The stress tests themselves are welcome as they restore some confidence in euro financials - and by implication euro sovereigns - but they are probably not the silver bullets to assuage all market concerns.

United States

Lower US rates hurt the dollar

US rates have fallen ...

Market rates in the US have fallen steadily since April and reached new lows for the year in early August. The benchmark 10-year Treasury yield declined from 4% to under 2.9%, having oscillated around 3% in the past few weeks, with the 2-year equivalent moving from 1.2% to under 0.5%. Expectations on the scale and timing of monetary tightening by the Fed also shifted, with the Fed funds rate not expected to move up to 0.5% from the current 0.25% until late 2011.

Swap rates also fell; 2-year rates traded below 0.7% from 1.25% in late May and 5-year rates dropped below 2%. This was in contrast to the trend in euro rates, and as a consequence the interest rate spread between the two currencies widened appreciably; 2-year swap rates in euros for example, were trading flat to dollar rates in late June but are currently trading 70 basis points over dollars. The diminished relative value of holding dollars has hurt the US currency and is one factor in the euro's recent advance, from under \$1.20 to over \$1.30.

The fall in US yields was partly due to a flight to quality from falling equities in the second quarter. The flow of economic data from the US has also been on the softer side of expectations, however, prompting concerns about the pace of the economic recovery.

... on the back of weaker data ...

The housing market, in particular, has seen a marked slowdown following the expiry of a buyers tax credit in April – house sales plunged in May and housing starts have fallen back. The limp recovery in the labour market is another factor affecting investor sentiment, with the pace of private sector jobs growth slowing in recent months. The result has been a slow fall in the unemployment rate, which at 9.5% is very high by US standards. Conditions in the labour market are also a significant concern for consumers, putting significant downward pressure on confidence indices – the Conference Board measure fell to 50.4 in July from 62.7 in May and the three-month moving average has been stuck in a 50-60 range for a year now.

The Federal Reserve acknowledged the disappointing nature of the incoming data at its meeting in late June, and the FOMC revised down its forecast for economic growth for this year and next. A more cautious view was also expounded by Fed Chairman Bernanke in his semi-annual testimony to Congress, when he noted that the economic outlook was 'unusually uncertain'.

...GDP slowed in Q2...

The second quarter GDP data confirmed the slowdown, with growth easing from a revised annual pace of 3.7% in Q1 to 2.4%. Sluggish consumption was a prime factor, with households boosting savings and curbing discretionary outlays: the savings ratio rose to 6.2% (the recent savings data was also revised higher) and consumer spending grew at a 1.6% annualised pace, from 1.9% in the first quarter. Households bought more cars, but spending on other durables slowed. In contrast, the US corporate sector increased its spending sharply, with investment in machinery and equipment increasing by 21.9%, following a 20.4% increase in Q1. Residential investment also rose substantially, as did Federal Government spending, but this boost to domestic demand also resulted in a very strong increase in imports (28.8%) which outstripped export growth (10.3%).

As a result, this negative impact from the external sectors reduced growth by 2.8 percentage points, although GDP was boosted by a further increase in inventories, which added 1% to growth.

... market may have overreacted.

The Fed still expects the economy to grow at a modest pace, nonetheless, and for unemployment to continue to fall, so the market may have over-reacted to the recent run of data; the consensus still sees the US expanding by 3% this year and next. The earnings season has also produced results that in general have beaten expectations, with some blow-out figures from the tech giants with a global franchise. Consequently, we feel that there is not sufficient evidence to warrant predictions of a 'double-dip' in the US, and that the economy is still likely to deliver reasonable growth this year. Nevertheless, the relative out-performance of the euro area against the US on the data front, and the relative interest rates advantage for the single currency implies that the recent dollar fall against the euro will not be reversed quickly in the absence of a general bout of risk aversion, and we therefore feel the euro dollar rate will be somewhat stronger than we envisaged over the next few months.

Economic Diary

August

	Europe	United States	United Kingdom
2	PMI Manufacturing	ISM Manufacturing	PMI Manufacturing
3	PPI's	Personal Income and Spending, Factory Orders, Pending Home Sales	
4	PMI Services, Retail Sales	ADP Employment Change, ISM Non-Manufacturing	PMI Services
5	ECB Meeting, German Factory Orders		BoE Meeting
6	German Industrial Production	Non Farm Payrolls, Unemployment	PPI's, Industrial Production
9			Nationwide Consumer Confidence
10		FOMC Rate Decision	RICS House Price Balance
11			Unemployment Data, Inflation Report
12	Industrial Production		
13	Q2 GDP	Inflation Data, Retail Sales, Uni. of Michigan Confidence	
16	Inflation Data		
17	ZEW Surveys	PPI's, Housing Starts, Industrial Production	Inflation Data
18			Bank of England Minutes
19		Philly Fed, Leading Indicators	
20			Retail Sales
23	Consumer Confidence		
24	Industrial New Orders	Existing Home Sales	
25	IFO Surveys	Durable Goods Orders, New Home Sales	Nationwide House Prices
27		Q2 GDP	Q2 GDP

Forecasts

Bank of Ireland forecasts

Exchange Rates

	Current	End Sep	End Dec	End Mar
EUR/USD	1.33	1.28	1.25	1.20
EUR/GBP	0.83	0.82	0.80	0.78
USD/JPY	86	88	90	100
GBP/USD	1.60	1.56	1.56	1.54

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End Sep	End Dec	End Mar
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 Sep	End Dec	End Mar
US	1.70	2.00	2.50	3.00
Eurozone	2.05	2.25	2.50	3.00
UK	2.40	2.75	3.00	3.50

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2010		2011	
	GDP	Inflation	GDP	Inflation
US	3.0	2.0	3.0	1.9
Eurozone	1.1	1.5	1.4	1.6
UK	1.3	3.1	2.2	2.5

Source: Bank of Ireland Global Markets

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Market data supplied by Thomson Reuters

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