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Bank of Ireland

TheBulletin

A monthly analysis of Global and Irish developments

ECB ready to begin government bond purchases

- Euro area inflation falls into negative territory
- Increased risk of inflation remaining 'too low for too long'
- Euro on the back foot

While the ECB refrained from taking any policy action at December's meeting, it said it would, early in 2015, reassess the outlook for inflation in light of 'recent oil price developments'. Oil prices have fallen further in the intervening period and are now down more than 50% since the middle of last year. Annual inflation in the Euro area turned negative in December, mainly due to falling energy costs, and is likely to decline further over the next few months. This is occurring at a time when underlying price pressures are already subdued, partly reflecting weak demand. Hence the ECB has become increasingly concerned that inflation will remain too low for too long.

The ECB has said it is prepared to take further policy action if necessary, which would entail 'altering the size, pace and composition' of its asset purchases. It now looks set to announce, probably at the January meeting, a large-scale expansion of its asset purchases to include government bonds and possibly corporate bonds as well, although any programme is likely to be heavily weighted towards the former. The recent European Court of Justice (ECJ) Opinion on OMT – which it said was 'in principle' compatible with the European Treaty - seems to pave the way for the ECB to conduct government bond purchases.

In contrast to the ECB, the Fed can afford to 'look through' an energy-related fall in inflation given that the US economy is at a much more advanced stage in the cycle than its Euro area counterpart. Indeed, the Fed expects the impact of falling oil prices on inflation to be 'transitory' with the latter expected to move gradually back up towards its 2% target as the labour market continues to improve. Hence, while the Fed says it can be 'patient' before raising interest rates, it also believes it will 'become appropriate' to raise rates 'during this coming year'.

The story on the foreign exchange markets over the second half of last year was the sharp fall in the euro against the dollar. The single currency has continued to slide at the start of this year, as full QE has become increasingly likely, and is now trading at a multi-year low of around $1.16, having ended 2014 at just under $1.24. While we think the euro might bounce on an actual announcement of QE, this would probably prove to be just a temporary reprieve, as rising interest rates in the US are likely to drive the dollar higher generally in 2015.

Growth slowing a little

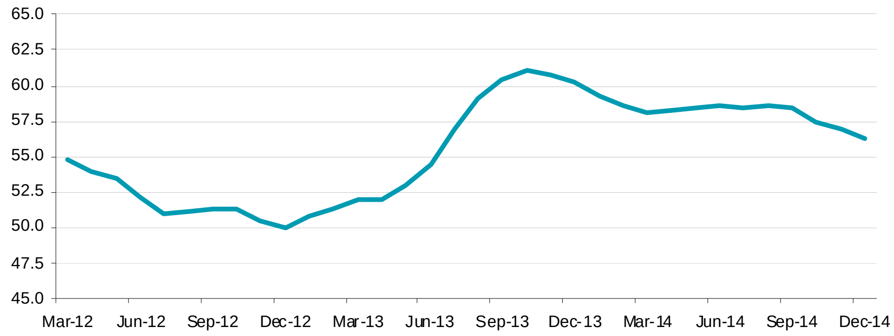
Survey data suggest growth eased in Q4…

The pace of economic growth appears to have eased a little in the final quarter of 2014 judging by the Purchasing Managers survey data. The services PMI fell in Q4 to its lowest level since the second quarter of 2013, while the equivalent index for manufacturing, though largely unchanged in the fourth quarter, remained well off the levels recorded earlier in the year. The composite PMI fell to 56.2 in Q4 (from 58.4 in Q3), which is consistent with quarterly GDP growth of around 0.5-0.6%.

...fall in inflation will support consumer spending…

Consumer spending seems to have been an important driver of growth again in Q4 (having increased for a 13th consecutive quarter in Q3) with the volume of retail sales, increasing by more than 1% over the three months to November. The recent fall in oil prices is providing support to spending via lower inflation – annual inflation fell by almost one percentage point to 0.5% between October and December – and a consequent rise in *real* incomes and hence consumers' purchasing power. Wage growth has also started to pick up as the labour market tightens, with the annual increase in weekly earnings (excluding bonuses) accelerating to 1.6% from 0.6% in mid-June, which will also support spending.

UK Composite PMI (3-month average)



….market expects BOE to keep interest rates on hold until Q2 2016 …

Given the continuing fall in oil prices at the start of 2015, inflation is likely to fall further over the coming months and remain lower for longer than the Bank of England previously anticipated. The Monetary Policy Committee (MPC) kept interest rates unchanged at 0.5% again at this month's meeting and the market does not expect a first hike until late in the second quarter of 2016. This has contributed to a fall in sterling against the dollar – the market still expects the Fed to raise US interest rates in the second half of this year – though the UK currency has strengthened against the euro to around 76p.

…though a first hike could come this year.

Market expectations regarding the timing of a first interest rate increase may be too sanguine, however. The Bank of England Governor, Mark Carney, says he expects the 'normalisation' of rates to begin 'within the foreseeable future'. As noted above, earnings growth has started to pick up and is forecast by the MPC to accelerate during 2015 as the unemployment rate falls towards its sustainable rate (which the MPC estimates to be around 5.5%). If so, then the MPC may raise rates some time over the second half of this year.

If rates do start to rise sooner than the market expects, then there is certainly scope for sterling to strengthen further against the euro. However, the impending general election in the UK (scheduled for May) could prove to be something of a headwind for sterling over the first half of this year with political uncertainty ahead of the vote potentially weighing on the currency.

Europe

ECB set to conduct full-scale QE

Modest growth likely again in Q4…

Euro area GDP rose by 0.2% in Q3, following an increase of 0.1% in the second quarter, as the strongest growth in consumer spending in almost 4 years was partially offset by a decline in investment and a negative contribution from net exports. Economic growth remained weak in the final quarter of 2014 judging by the Purchasing Managers data, with the composite PMI falling to 51.5 from 52.8 in the third quarter. The consensus forecast is for an increase in GDP of just 0.1%.

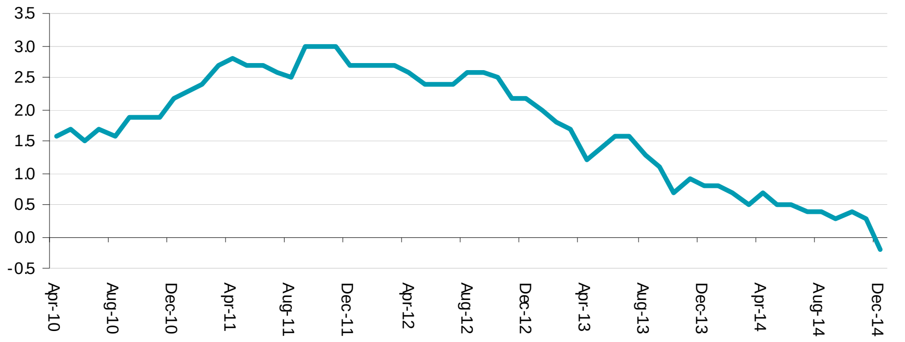
…inflation falls into negative territory…

As in the case of other oil-importing economies, falling energy costs as a result of the decline in crude prices will support household income and spending and so contribute to an on-going economic recovery in the zone. However, they have already pushed annual headline inflation the zone into negative territory (-0.2% in December) and a further decline seems inevitable in the early months of 2015. The core rate (excluding energy and food prices) has remained steady in recent months, however, at 0.7%.

…ECB to 'reassess' the outlook for inflation 'early in 2015'…

While the ECB left policy unchanged at its December meeting, Mario Draghi said the Governing Council would, in early 2015, 'reassess' the 'broader impact of oil price developments on medium-term inflation trends'. The ECB is concerned that a further energy-price driven fall in inflation could lead to 'second-round' price effects (via, say, a reduction in wages) and/or a decline in inflation *expectations,* thus increasing the risk of inflation remaining 'too low for long'.

Euro Area CPI Inflation



…and committed to using additional measures if necessary…

Draghi also said the Governing Council was unanimously committed to using 'additional unconventional instruments' if necessary, which would entail 'altering… the size, pace and composition' of its asset purchases. The ECB is currently purchasing asset-backed securities and covered bonds and, based on members' public comments since the December meeting, seems almost certain to announce an expansion of its asset purchases to include government and/or corporate bonds possibly at its January 22nd meeting.

…euro weakens further on prospect of QE.

The euro has weakened further against the dollar over the past month, as speculation of full QE has increased. The recent decision of the Swiss central bank (SNB) to discontinue the franc-euro ceiling has added to the fall, and the single currency is now trading at $1.16. It has also broken lower against sterling to trade at 76p, its weakest level since 2008. Peripheral bond yields have also fallen on the expectation of ECB buying, even as political uncertainty in Greece ahead of the election on January 25th has led to quite a sharp rise in that country's sovereign bond yields.

Looking ahead, we would not be surprised to see the euro bounce on an actual announcement of QE as short-positions in the currency are closed out and profits booked. Even if this is the case, it may prove to be just a temporary reprieve, as the prospect of rising interest rates in the US and the UK over the second half of this year is likely to contribute to a renewed fall in the euro against both the dollar and sterling.

United States

Fed to be 'patient' before raising interest rates

Economy expands at robust pace in Q3…

The economy grew at a robust pace again in Q3 with GDP increasing by 1.2% following an increase of 1% in Q2, the strongest two-quarter period of expansion in eleven years. Consumer spending picked up further in Q3 and contributed almost 0.6% points to the increase in GDP, while investment again rose at a solid pace with net exports also making a positive contribution to growth for the first time since the final quarter of 2013.

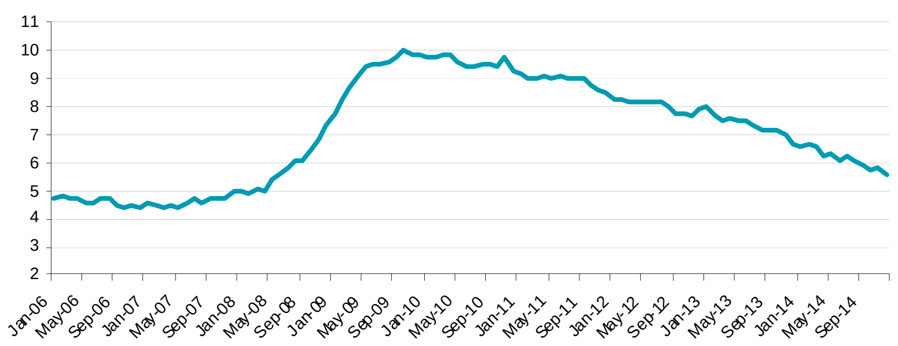
…growth looks to have eased in Q4…

Both the hard and soft (survey) data point to some easing in the pace of growth in the final quarter, which is not surprising given the strength of activity in Q2/Q3, with the consensus expecting an increase in GDP of 0.7%. The ISM survey measure of activity in the manufacturing and services sectors fell back in Q4 but remained above its long-run average. Retail sales rose again in the fourth quarter though at a slower rate than in Q3, while the growth in manufacturing output moderated a little over the three months to November.

…employment ends 2014 on strong note…

The labour market ended the year on a firm noted with employment increasing by 252k in December. This left the average monthly increase in 'payrolls' in 2014 at 246k, up from 194k in 2013 and the strongest year of job growth since 1999. The unemployment rate fell further in December to 5.6%, more than 1% point lower than in December 2013 and not far above the Fed's estimate of the sustainable rate of just under 5.5%. Despite the continuing fall in unemployment, however, earnings growth remained subdued at just 1.7% over the year to December.

US Unemployment Rate (%)



…Fed sees inflation falling in near-term…

In the statement published following its December monetary policy meeting, the Fed noted the continued expansion in economic activity and the further improvement in the labour market. The minutes of the meeting show that members believe the net effect of the recent decline in energy costs – on the back of the fall in oil prices – would be 'positive for economic activity and employment'. Members also anticipated that inflation, which is currently running at just over 1%, was likely to fall in the near term, reflecting the impact of the oil price decline and to a lesser extent the effects of the rise in the dollar on import prices.

…and can be 'patient' before raising interest rates…

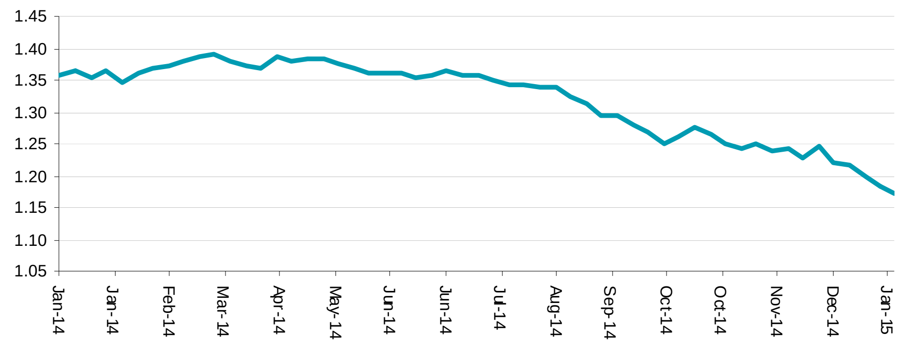
The Fed also updated its forward guidance on interest rates at the December meeting, saying it can be 'patient in beginning to normalise the stance of monetary policy'. However it also added that 'this guidance is consistent with its previous statements that it would be appropriate to keep interest rates unchanged at near zero percent for 'a considerable period'.

…but a first hike still likely this year...

In her post-meeting press conference, Janet Yellen, the Fed Chair, said the updated forward guidance ‘better reflects the Committee’s focus on the economic conditions’ that would make an increase in interest rates appropriate. She said that “employment is rising at a healthy rate and the economy is strengthening”, and while inflation has been running somewhat below the 2% target, the Fed expects the “gap to close gradually over time”. Given this, it therefore will ‘at some point’ become necessary to begin raising interest rates, though she said the Fed can be patient before doing so with no move likely ‘for at least the next two meetings’. The next two meetings cover the period to the end of March, so an increase in interest rates thereafter is possible.

The majority of Fed members believe interest rates should rise this year and a June ‘lift-off’ has been cited by many as a possibility. If the unemployment rate continues to fall at the same pace as over the second half of last year then by mid-2015 or so it will be running *below* the Fed’s estimate of the sustainable rate, so it would seem appropriate to begin raising interest rates around that time.

Euro/Dollar Exchange Rate



…which should support the dollar.

The market does not expect a first increase in interest rates until the fourth quarter of this year, while bond yields have fallen sharply at the start of 2015 as oil prices have fallen and amid increased volatility in equity markets. The dollar has strengthened further, though, to reach a multi-year high against the euro of $1.16. Despite the sizeable gains made since mid-2014, the dollar has scope to rise further given the divergent outlook for Fed and ECB policy.

Economic Diary – January/February 2015

		Ireland	Europe	United Kingdom	United States
Jan	19		Construction Output		
	20		German ZEW Output		
	21			MPC Minutes; Labour market data	Housing Starts
	22		ECB Meeting		Initial Jobless Claims
	23		'Flash' PMIs	Retail Sales	Existing Home Sales
	26				
	27			GDP (Q4); Index of Services	Durable Goods Orders; Consumer Confidence
	28	Retail Sales		Nationwide House Prices	FOMC Meeting
	29		M3, Economic Confidence	CBI Retail Sales Survey	Initial Jobless Claims
	30	Residential Property Prices	'Flash' CPI	Consumer Confidence Mortgage Approvals	GDP (Q3, final); Chicago PMI
Feb	2	PMI Manufacturing	PMI Manufacturing	Manufacturing PMI	Personal Spending; PCE Inflation; ISM Manufacturing
	3	Exchequer Returns	PPI	Construction PMI	Factory Orders
	4	PMI Services	PMI Services, Retail Sales	Services PMI	ISM Non-Manufacturing; ADP Employment
	5			MPC Meeting	Initial Jobless Claims
	6			Trade Balance	Non-Farm Payrolls; Unemployment; Earnings
	9	Car Sales			
	10			Industrial Output	NFIB Small Business Optimism
	11	Industrial Production		BoE Inflation Report; RICS Housing Survey	
	12		Industrial Production		Initial Jobless Claims; Retail Sales
	13		GDP (Q4)		

Forecasts

Bank of Ireland estimates

Exchange Rates

	End Mar'15	End June '15	End Sept '15	End Dec '15
EUR/USD	1.18	1.15	1.13	1.13
EUR/GBP	0.78	0.76	0.75	0.74
USD/JPY	119	120	122	122
GBP/USD	1.51	1.51	1.51	1.53

Source: Bank of Ireland Global Markets

Official interest rates

	End Mar'15	End June '15	End Sept '15	End Dec '15
USD	0-0.25	0-0.25	0.50	0.75
EUR	0.05	0.05	0.05	0.05
GBP	0.50	0.50	0.75	1.00

Source: Bank of Ireland Global Markets

Swap rates: 5 year

	End Mar'15	End June '15	End Sept '15	End Dec '15
US	1.70	2.10	2.50	2.90
Eurozone	0.50	0.60	0.80	1.00
UK	1.50	1.90	2.40	2.70

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2014		2015	
	GDP	Inflation	GDP	Inflation
US	2.2	2.0	3.1	2.1
Eurozone	0.8	0.6	1.3	0.9
UK	3.2	1.6	2.7	1.8

Source:IMF World Economic Outlook

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