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Bank of Ireland

TheBulletin

A monthly analysis of Global and Irish developments

Fed preparing to raise interest rates

- Employment growth accelerates
- Fall in inflation expected to be 'transitory'
- June rate hike seems likely

The pace of employment growth in the US has picked up noticeably with 'payrolls' increasing by an average of almost 340k a month in November-January, the strongest three-month period of job gains since late 1997. The unemployment rate also continues to trend down and at 5.7% has fallen by around half a percentage point over the past six months.

Given the on-going improvement in the labour market and the fall in the unemployment rate to not far above its estimated sustainable level, the Fed is clearly moving closer to the point at which it will become appropriate to raise interest rates. It has indicated a first hike might come around mid-2015, while the market currently thinks it is more likely to be September/October.

There are certainly reasons why the Fed might be cautious about raising interest rates. One is the subdued increase in wages to date despite the steady decline in the unemployment rate. Another is the fact that inflation has fallen recently (to 0.7%) and is likely to decline further in the short-term. However, in relation to the former, the latest jobs report provided some tentative evidence that earnings growth may be starting to pick up. As for the fall in inflation, this mainly reflects the impact of the collapse in oil prices and so should prove transitory, as the Fed expects.

It is also worth recalling the remarks made by Fed Chair Janet Yellen at the press conference following the last but one monetary policy meeting. While accepting that inflation was likely to fall further in the near-term, she said that, when the Fed starts the process of raising interest rates, it will want to feel reasonably confident that inflation will move up over time. And in this regard, she said "as labour market conditions continue to improve, history suggests…that that's likely to occur".

It might be argued that it will be 'difficult' for the Fed to raise interest rates when so many other central banks are easing monetary policy. However, just as the latter are responding to conditions in their respective economies, the Fed too sets policy primarily with respect to the needs of the US economy. Given the latter's progress to date it is becoming harder to argue that interest rates near zero percent are still appropriate. A June 'lift-off' seems a good bet.

Feature

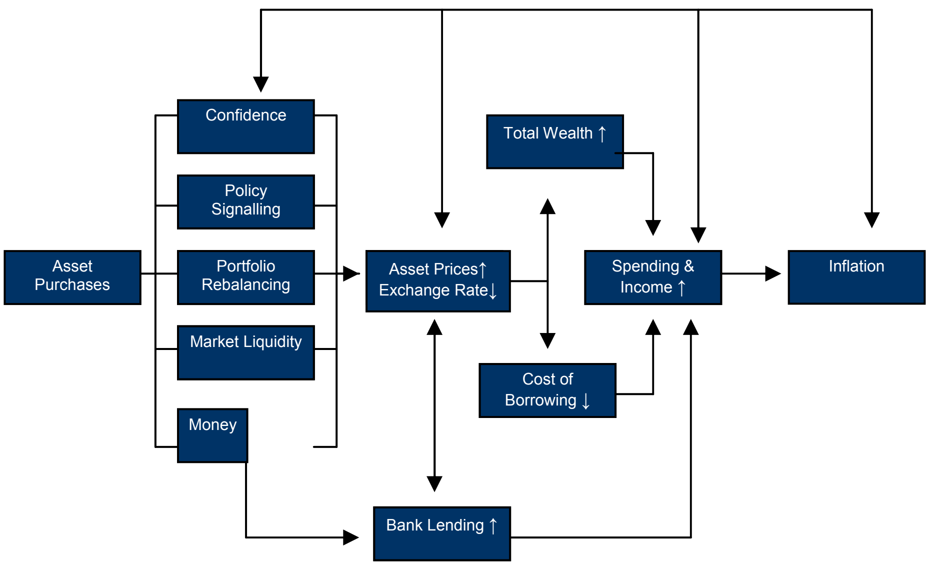
ECB launches expanded asset purchase programme

The ECB announced an ***expanded asset purchase programme*** - full QE effectively - following January's Governing Council meeting. Starting in March**,** the ECB will buy E60bn of assets (public and private) a month. The purchases are intended to be carried out until September 2016 and, according to the ECB, will in any case continue until inflation returns to a path consistent with the inflation target. Taking into account the ABS/covered bonds the ECB has been buying since late last year, the *additional* purchases amount to cE50bn a month, most of which will be government bonds.

The ECB says the expanded asset purchase programme, working primarily through the so-called 'signalling' and 'portfolio balance' channels, will underpin inflation expectations, reinforce its 'forward guidance' on interest rates, and help support spending (investment and consumption) in the economy, which taken together will contribute to a return of inflation towards 2%. By engaging in full QE, the ECB is signalling its determination to return actual inflation to the target of 'below, but close to 2%', which should help to keep *expectations of inflation over the medium term* anchored around the target. It is also signalling that ECB interest rates are likely to remain unchanged for an extended period, which should help to boost lending and spending over time. Moreover, if interest rates are expected to remain low *relative* to elsewhere, the euro exchange rate is likely to remain weak/fall further, so boosting growth through increased exports and contributing to higher inflation through increased import prices. Regarding the 'portfolio balance' channel, ECB purchases raise the price and lower the yield on the assets bought, while the sellers (e.g. institutional investors) rebalance their portfolios by purchasing other assets e.g. corporate bonds and stocks, which raise the price of these assets as well. This lowers the cost of borrowing, and also generates a wealth effect, which in turns leads to increased spending.

Of course, market expectations of full QE had been building steadily *before* last month's announcement, as evidenced by a fall in the yields on government bonds. across Euro area countries. Core government bond yields have fallen further since the announcement (and ahead of the start of the programme), though peripheral yields generally have risen albeit they remain close to record lows. Corporate bond yields have also fallen post the announcement and stocks have rallied, and with the ECB not expected to raise interest rates until late 2018, the euro has lost ground against the dollar and sterling. Meanwhile, market measures of expected inflation over the 5 years starting 5 years hence have stabilised after falling in recent months. For the ECB then, it's seems a case of 'so far so good'.

Stylised QE Transmission Channels



United Kingdom

Growth eases in Q4

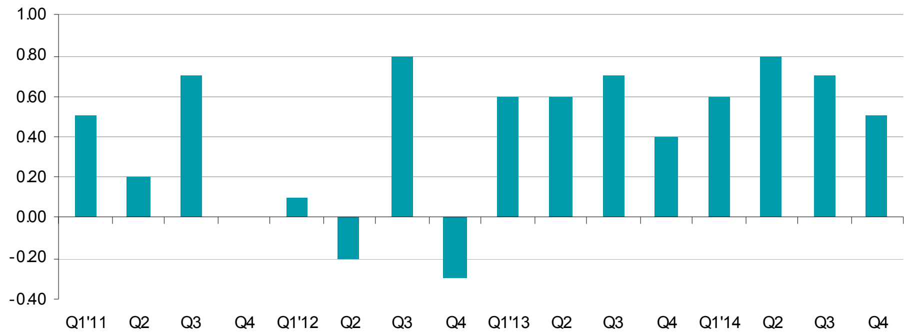
GDP rises 0.5% in Q4…

The pace of economic growth eased in the final quarter of 2014 with GDP increasing by 0.5% after rising by 0.7% in Q3. Industrial production fell, due mainly to a decline in output in the volatile utility sector, as did construction output, having expanded strongly over the previous two quarters. The services sector was again the main driver of growth with output increasing at the same pace (0.8%) as in Q3. For 2014 as a whole, GDP rose by 2.6%, the strongest outturn since 2007.

…similar pace of growth likely in Q1…

The latest survey data suggest GDP growth will be sustained at around 0.5% in the opening quarter of 2015. A recent slowdown in manufacturing activity appears to have run its course – the Purchasing Managers index has risen from its lows of late 2014 – while the services sector is still expanding steadily at the start of this year – the services PMI of 57.2 in January was broadly in line with its average in Q4. Services activity is being supported by strong growth in consumer spending – the volume of retail sales increased by over 2% in the final three months of last year – which in turn is benefiting from rising employment and a pick up in earnings growth.

UK GDP: % Change q-o-q



…inflation falls to 0.5% in December…

An energy price-driven fall in inflation is also boosting consumers' purchasing power. Headline inflation fell to 0.5% in December, a decline of almost 1 percentage point in just two months, and is likely to have fallen further since given the continuing drop in oil prices that occurred through January. Core inflation, which excludes energy and food prices, nudged down in December to 1.3%.

…but Bank of England still sees upside risks to inflation outlook…

The Bank of England's MPC kept interest rates unchanged at 0.5% at this month's meeting. Near-term, the MPC is concerned that the recent but (it believes) temporary fall in headline inflation may contribute to lower pay growth, given that a large proportion of wage claims are settled in the early part of the year. If this were the case, then inflation could persist below target for longer than anticipated. Set against that, though, the Committee believes that, overall, 'the risks to inflation in the medium term might have…shifted to the upside', mainly because of signs that slack in the labour market is being absorbed more quickly than expected, as evidenced by the notable pick up in average earnings growth over the second half of last year. According to its latest forecasts, it expects inflation to average 0.5% this year before rising to 1.8% (just below the 2% target) in 2016.

…interest rate hike possible in H2.

How the labour market evolves will be important in determining when the MPC starts to raise interest rates. The unemployment rate fell to a seven year low of 5.8% in November, a decline of almost 1.5% points from 12 months earlier, and looks set to fall further during the course of 2015. If this is accompanied by a pick up in earnings growth, as the MPC expects, then a rate hike is possible over the second half of this year. This is sooner than the market currently expects and would support sterling on the foreign exchange market, though as we have noted before the impending general election in May is likely to begin acting as a headwind for the currency at some point over the next few months.

Europe

ECB to begin full QE

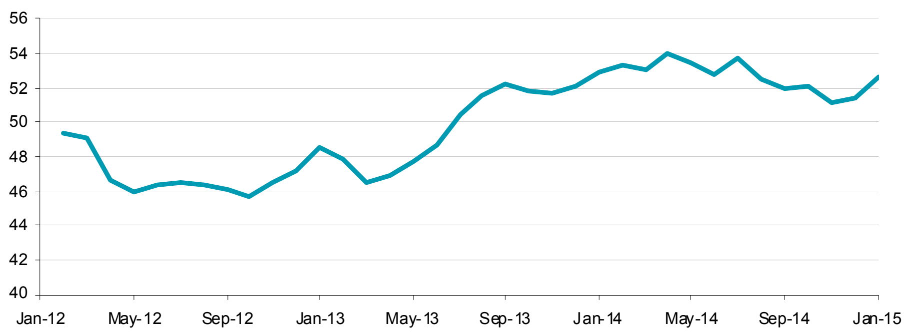
Economy continues to grow at moderate pace…

The latest survey data suggests the economy is continuing to grow at a moderate pace. Both the manufacturing and services PMI rose for a second consecutive month in January and the composite index increased to its highest level in six months. There has also been some improvement in the (less timely) hard data – retail sales, for example, rose by 2.0% year-on-year in Q4, the fastest rate of growth since Q1 2007. The consensus estimates GDP rose by 0.2% in the final quarter of 2014, the same as in Q3, and expects growth of 0.3% in the opening quarter of 2015. The EU Commission, meanwhile, has revised up its forecast for annual GDP growth in 2015 by 0.2% points to 1.3%, reflecting, inter alia the positive impact of lower oil prices, a weaker euro, and ECB QE.

…inflation falls further into negative territory…

The ongoing growth in the economy is contributing to a gradual decline in the unemployment rate, which stood at 11.4% in December (around half a percentage point lower than a year earlier). Inflation fell further into negative territory in January with the annual decline in consumer prices accelerating to -0.6%, a drop of almost 1 percentage point in just two months. Much of the fall was due to sharply lower energy costs, which were down almost 9% year-on-year, reflecting the steep drop in oil prices. However, underlying price pressures also remain subdued, as evidenced by the fall in annual core inflation to 0.6% last month, a new cycle low.

Euro area Composite PMI



…ECB announces expanded asset purchase programme…

The ECB has responded to the continuing low inflation environment by announcing an expanded asset purchase programme (full QE effectively). Starting in March**,** the ECB will buy E60bn of assets (public and private) a month. The purchases are intended to be carried out until September 2016 and, according to the ECB, will in any case continue until inflation returns to a path consistent with the target of 'below, but close to 2%'. Taking into account the cE10bn a month in ABS/covered bonds the ECB has been buying since late last year, the *additional* purchases amount to cE50bn a month, most of which (cE45bn) will be government bonds. Of the *additional* asset purchases, 20% will be subject to risk-sharing across the Eurosystem while the national central banks will retain the risk on the remaining 80%.

…euro likely to fall further

The euro weakened post the QE announcement, falling to a low of just under $1.11 against the dollar (from over $1.16 prior to the announcement) before clawing back some ground. Heightened uncertainty in Greece following the recent general election outcome may weigh on the single currency. Bond yields there have risen post the election though to date there has been limited spill-over to other peripheral markets. In any case, with the Fed on track to raise interest rates relatively soon, EUR/$ is likely to weaken further during the course of 2015.

United States

More moderate growth in Q4

GDP increases by 0.7% in Q4…

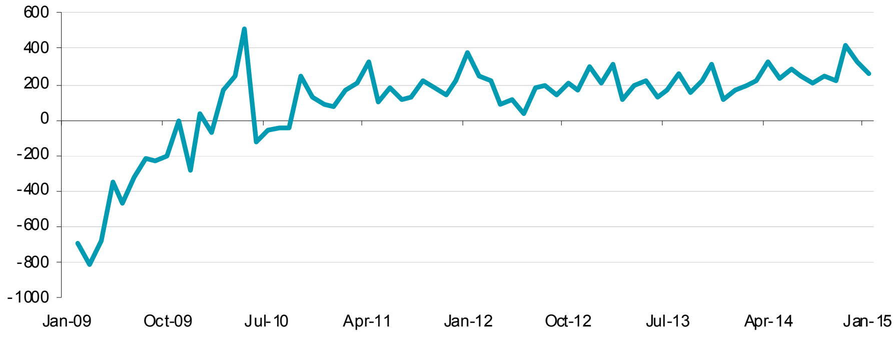
Following very robust activity in the six months to September, the pace of growth moderated in the final quarter of 2014 with GDP increasing by 0.7%. While consumer spending strengthened in the latter period, helped by the boost to households' purchasing power from lower energy costs, investment slowed and both net exports and government consumption made a negative contribution to growth. For 2014 as a whole, annual GDP growth averaged 2.4%, slightly ahead of the 2013 outturn (2.2%).

The available survey data suggests the more moderate pace of growth is being maintained at the start of 2015. The ISM measures of activity in the manufacturing and services sectors have come off the lofty levels of the latter part of last year though both are still running above longer-run average levels. Consumer confidence is rising strongly, reaching a 7-year high in January, which should support consumer spending.

..,labour market improving steadily…

The labour market continues to improve steadily. Employment rose by almost 340k a month over the three months to January and the unemployment rate has fallen to 5.7% from over 7% a year ago. Despite the decline in unemployment, annual earnings growth has remained relatively subdued to date though it did pick up to 2.2% last month from 1.9% in December.

US employment growth (Month Change, 000s, 3-month average)



…Fed believes recent fall in inflation 'transitory'…

In the statement published following January's meeting, the Fed noted the 'solid' pace of economic activity, 'strong job gains', and a continuing decline in the unemployment rate. It also believes the recent fall in inflation (which stood at 0.7% in December) is 'transitory', mainly reflecting the impact of lower energy prices, and it expects a gradual move back up towards the 2 percent target as the labour market improves further.

…and reiterates it can be patient before raising interest rates.

The Fed also reiterated that it can be 'patient' before raising interest rates. Based on the guidance provided by Janet Yellen recently, this means rates are likely to remain unchanged at both the March and April meetings. The following meeting in June is certainly in play as a possible date for 'lift-off', given the continuing strength of the labour market and, also, the relatively stability in oil prices more recently, which means inflation should soon bottom before starting to move back up again.

The market has brought forward the expected timing of the first hike, to around September this year (from November/December previously). Bond yields have risen as a result, to about 2% in the 10-year area. Yields are likely to rise further as the Fed raises rates, which in turn should support the dollar on the foreign exchange market.

Economic Diary – February/March 2015

		Ireland	Europe	United Kingdom	United States
Feb	16				
	17		ZEW Index	CPI, PPI, ONS House Prices	Empire Manufacturing Index
	18		Construction Output	Unemployment & Earnings, BOE minutes	PPI, Housing Starts, Industrial Output, Fed Minutes
	19	CPI	Consumer Confidence		Jobless Claims, Philly Fed Index
	20	Good export and imports	Flash' PMIs	Retail Sales, Public Sector Net Borrowing	
	23			CBI Retail Sales	Existing Home Sales
	24		CPI (Jan, final)		Consumer Confidence House Prices
	25	Residential Property Prices			New Home Sales
	26	Retail Sales	M3, Economic Sentiment Indicator	Consumer Confidence	CPI, Durable Goods, Jobless Claims
	27	QNHS (Q4)*		GDP (Q4, 2nd est) Index of Services	GDP (Q4, 2nd est); Chicago PMI
Mar	2	PMI Manufacturing	'Flash' CPI (Feb) PMI Manufacturing	PMI Manufacturing Mortgage Approvals	PCE Deflator, Personal Spending, ISM Manufacturing
	3	Exchequer Returns	PPI	PMI Construction	
	4	PMI Services Live Register	PMI Services, Retail Sales	PMI Services	ADP Employment, Beige Book
	5			BoE Meeting	Factory Orders, Jobless Claims
	6		GDP (Q4, 2nd est)		Employment Report

* *Released no later than Feb 27*

Forecasts

Bank of Ireland estimates

Exchange Rates

	End Mar '15	End June '15	End Sept '15	End Dec'15
EUR/USD	1.13	1.10	1.08	1.08
EUR/GBP	0.74	0.74	0.72	0.71
USD/JPY	119	120	122	122
GBP/USD	1.53	1.53	1.52	1.52

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	0-0.50	0.75	1.00
EUR	0.05	0.05	0.05	0.05
GBP	0.50	0.50	0.50	0.75

Source: Bank of Ireland Global Markets

Swap rates: 5 year

	En Mar '15	End June '15	End Sept '15	End Dec '15
US	1.70	2.00	2.40	2.80
Eurozone	0.30	0.40	0.80	0.80
UK	1.50	1.70	2.20	2.50

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2014		2015	
	GDP	Inflation	GDP	Inflation
US	2.4	1.6	3.2	0.7
Eurozone	0.8	0.4	1.1	0.1
UK	2.6	1.5	2.6	0.9

Source: Consensus Economics, *Consensus Forecasts*, Jan. 15

Contact Us

Economic Research Unit (ERU)

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

Chief Economist, Bank of Ireland: Dr. Loretta O'Sullivan Tel: +353 (0) 766 244 267

Senior Economist: Michael Crowley Tel: +353 (0) 766 244 268

Senior Economist: Patrick Mullane

Visit: *www.bankofireland.com/economicresearch*

Contact

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

Global Market 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