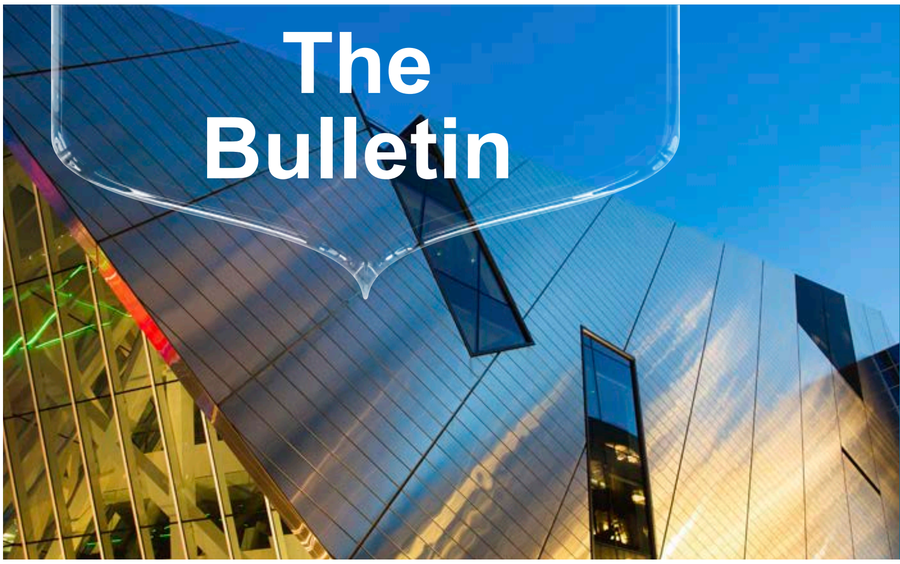
Bank of Ireland

Economic Research Unit



June 2015

Bond markets remain volatile

Overview Bond yields have risen further over the past month amid on-going volatility in markets. Germany continues to lead the way with 10-year yields increasing by around 20bps to 0.9%, having traded above 1% at one stage. The ECB President, Mario Draghi, has said the rise in yields partly reflects the improved outlook for the Euro area economy and higher inflation expectations, while also noting that 'we should get used' to periods of increased volatility. The ECB has indicated that it will not attempt to counter the volatility in markets, but it has reiterated that it will continue bond purchases (QE) until at least September 2016 and longer if necessary, and that its key interest rates will remain low for an extended period of time. Bond yields in the US have also risen recently. However, while the increase in 10-year yields has lagged the rise in equivalent German yields, 2-year yields have risen by more than German 2-year yields (which still remain in negative territory). The latter reflects the prospect of the Fed raising interest rates over the coming months, as the US economy rebounds from a weak first quarter and amid a continuing improvement in the labour market.

Euro area inflation rises again

UK growth picking up

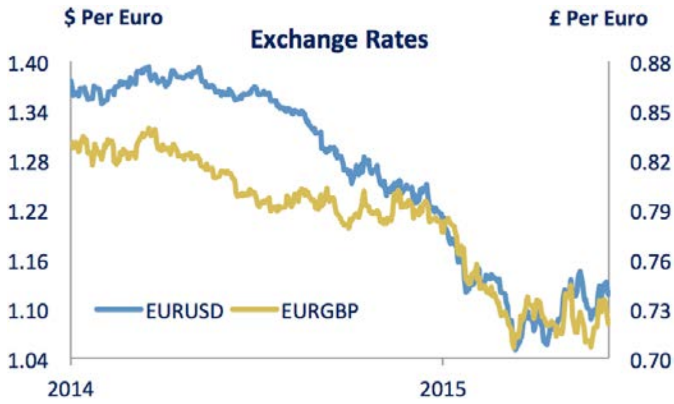
US economy rebounding

Diary	Euro Area	UK	US
Central Bank Meetings	Jul 16	Jul 9	Jun 17
GDP	Aug 14	Jun 30	Jun 24
Inflation	Jun 30	Jun 16	Jun 18
Labour Market	Jun 30	Jun 17	Jul 2

Forecasts	End Jun 2015	End Sep 2015	End Dec 2015	End Mar 2016
Exchange Rates				
€/$	1.11	1.06	1.03	1.03
€/£	0.72	0.71	0.70	0.70
£/$	1.54	1.51	1.47	1.47
Swap Rates (5 year)				
Euro Area	0.50	0.60	0.70	0.80
UK	1.65	1.80	2.00	2.30
US	1.90	2.10	2.30	2.60

Euro Area inflation rises again

GDP grew by 0.4% q-o-q in Q1 driven by a strengthening of investment, which rose for a third quarter running, and a fifth consecutive quarterly increase in consumer spending. The composite PMI in April-May was in line with its level in Q1 at just under 54, suggesting GDP growth is being maintained at around a 0.4% pace in Q2. Annual inflation rose to 0.3% in May from 0% in April and January's low of -0.6%. Bond markets remain volatile with yields still on an upward trend. German 10-year yields have risen by a further 20bps over the past month to around 0.9%. The ECB has said it does not intend to 'counter' the volatility in markets but has reiterated that QE will continue until September 2016 at least, and that its key interest rates 'will remain low for an extended period of time'. The euro has fallen from its recent highs against the dollar and is currently trading at just under $1.12. The Greek government and its creditors have yet to reach an agreement, with the current financial aid programme expring at the end of June.



UK growth picking up

Having eased to 0.3% q-o-q in Q1, the pace of economic growth is picking up again based on the available indicator data. Industrial output and retail sales rose in April with both running well ahead of Q1, while the composite PMI stood at just over 57 in April-May, in line with the average reading over the previous 6-9 months. Employment rose further in Q1 and the unemployment rate fell to a 7-year low of 5.5%, while annual earnings (excluding bonuses) grew at the fastest pace (2.2%) since mid-2011. The Bank of England expects inflation, which fell to -0.1% in April, to 'pick up notably' towards the end of the year, and has indicated that a first increase in interest rates might be appropriate in H1 2016. Government 10-year bond yields have risen over the past two months, though the increase (c.50bps) has lagged the rise in German yields (c.80bps). Sterling has remained in a range of 70.5p to 74.5p against the euro over the past 3 months and is currently trading at around 72p.

US economy rebounding

Growth in Q1 was revised to -0.2% q-o-q, from flat, in the second GDP release, with net exports making a more negative contribution than initially estimated. However the contraction in the economy was at least partly due to transitory factors, and activity has rebounded in Q2. Retail sales increased for a third consecutive month in May, while the ISM manufacturing index rose last month to its highest level since the end of last year. Employment also strengthened in May, increasing by 280k after a gain of 221k in April and an increase of just 119k in March, and annual earnings rose at the fastest pace (2.3%) since July 2011. Annual headline PCE inflation remains subdued at 0.1%, though the core rate is higher at 1.2%. Government bond yields have risen further over the past month with both 2- and 10-year yields increasing by about 20bps. The Fed is not expected to raise interest rates at this month's meeting but a hike in September is a live possibility.

Contact us at:

economics@boi.com

Dr. Loretta O'Sullivan
Chief Economist
+353 (0) 766 244 267

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