Bank of Ireland

Economic Research Unit

March 2015

Euro on back foot

Overview The diverging outlook for monetary policy in the US and the Euro area continues to weigh heavily on the euro/dollar exchange rate. The single currency has fallen further over the past month to around $1.06, its lowest level since 2003. Against the backdrop of a continuing improvement in the labour market in the US – almost 2 million jobs have been added over the past 6 months and the unemployment rate has fallen to 5.5% – the Fed has indicated that it will soon begin considering an increase in interest rates 'on a meeting-by-meeting basis'. This has contributed to a sharp rise in US government bond yields recently, of the order of 55bps in the case of the benchmark 10-year bond. In contrast, the ECB announcement in late January that it would conduct full QE starting this month – sovereign bond purchases began on March 9 – and continuing through to September 2016, has resulted in a fall in yields in the Euro area to record lows. As the Fed raises interest rates, possibly starting in mid-year, bond yields in the US are likely to rise further relative to those in the euro zone, which in turn should be accompanied by a continued strengthening of the dollar against the single currency.

ECB raises growth forecasts

UK unemployment at 7-year low

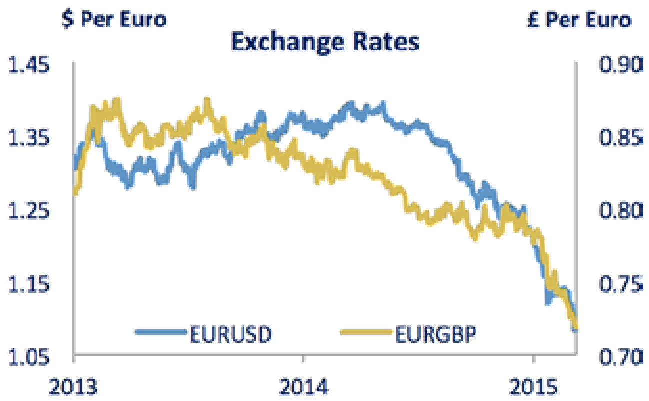
Sharp rise in US bond yields

Forecasts	End Mar 2015	End Jun 2015	End Sept 2015	End Dec 2015
Exchange Rates				
€/$	1.08	1.06	1.05	1.05
€/£	0.71	0.72	0.71	0.70
£/$	1.52	1.47	1.48	1.50
Swap Rates (5 year)				
Euro Area	0.30	0.40	0.60	0.80
UK	1.65	1.80	2.20	2.50
US	1.80	2.00	2.40	2.80

Diary	Euro Area	UK	US
Central Bank Meetings	Apr 15	Apr 9	Mar 18
GDP	May 13	Apr 28	Apr 29
Inflation	Mar 31	Mar 24	Mar 30
Labour Market	Mar 31	Mar 18	Apr 3

ECB raises growth forecasts

The Euro area economy expanded for a 7th consecutive quarter in Q4 with GDP increasing by 0.3% q-o-q. For 2014 as a whole, annual growth averaged 0.9%, following a slight contraction in GDP in 2013. The ECB has revised up its projections for growth in 2015 and 2016 to 1.5% and 1.9% respectively from 1.0% and 1.5% previously, reflecting the favourable impact of lower oil prices and the fall in the euro as well as the expected effect of its policy measures including QE. It is projecting an increase in GDP of more than 2% in 2017. Headline CPI inflation rose to -0.3% in February from -0.6% in January, while the core rate was unchanged at 0.6%. The ECB expects inflation to average 0% this year (revised from 0.7%) before picking up to 1.5% in 2016 and 1.8% in 2017, with the latter broadly in line with the target. The Eurogroup approved a 4-month extension of Greece's programme after the new government provided a 'sufficiently comprehensive' list of proposed reforms, which its partners say should be implemented without delay. The euro has fallen to around $1.06 against the dollar and is trading at a 7-year low of 70p against sterling.



UK unemployment at 7-year low

The pace of activity in the UK economy eased in Q4 with GDP increasing by 0.5% q-o-q (after 0.7% in Q3). The external sector was the main driver of growth, as domestic demand was flat with consumer spending rising but investment falling. The composite PMI was unchanged in February at 56.7, slightly ahead of the Q4 average of 56.2 and consistent with GDP growth of around 0.5% again in Q1. The labour market continues to improve and the unemployment rate has fallen to a 7-year low of 5.7%. Annual weekly earnings growth has picked up to over 2% and is running well ahead of inflation, which fell to 0.3% in January. The Bank of England's MPC kept interest rates unchanged at 0.5% in March. It expects inflation to pick up towards the end of 2015 and says 'it is more likely than not' that rates will 'increase over the next three years'. The market does not expect a first hike until Q1 2016, although the minutes of the February meeting show some MPC members believe 'there could well be a case for an increase' later this year. Sterling has strengthened further against the euro but has fallen back against a generally firmer dollar.

Sharp rise in US bond yields

Growth in the US economy moderated in Q4 as GDP expanded by 0.5% q-o-q having increased by more than 1% in each of the two previous quarters. Consumer spending rose at its strongest pace since Q4 2010, but investment slowed and net exports made a negative contribution to GDP. Employment rose by 295k in February and the unemployment rate fell to 5.5%, more than 1% point lower than a year earlier. Annual PCE inflation has fallen to just 0.2% mainly reflecting the impact of lower energy prices. The decline in inflation has boosted real personal disposable incomes which in January rose at the fastest rate (4.2% year-on-year) since the end of 2012. The Fed kept interest rates unchanged at its January meeting. It says it will 'at some stage' begin considering raising interest rates 'on a meeting-by-meeting basis' but for now can be 'patient', which implies no increase in rates before end-April 2015. Government bond yields have risen over the past month as the market focuses on the start of a rate-hiking cycle with the benchmark 10-year yield about 55bps higher at around 2.15%.

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