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Bank of Ireland

TheBulletin

A monthly analysis of Global and Irish developments

ECB ready to act again

- ECB lowers inflation forecast
- Likely to begin full QE early next year
- Fed focuses on when to raise interest rates

The recovery in the Euro area economy has lost momentum and the ECB has lowered its projections for growth over the next couple of years. It has also lowered its forecasts for inflation, which is expected to remain well below target in 2015 and 2016 at 0.7% and 1.3% respectively. As the ECB acknowledges, the risks to the inflation outlook are on the downside given the accelerated decline in the oil price over the past few weeks.

In a speech in November, Mario Draghi said it is essential to 'raise inflation and inflation expectations as quickly as possible', prompting speculation that the ECB would act at this month's meeting. In the event, policy was kept on hold but Draghi said the Governing Council would 'reassess' the outlook for inflation 'early next year'. ECB staff have also 'stepped up' preparation of measures which, if needed, could be implemented 'in a timely manner'.

It now seems increasingly likely that further policy action will be announced early in 2015, perhaps as soon as the January 22 meeting. This will probably see the ECB conduct a broad-based asset buying programme – full QE effectively – including the purchase of government bonds. Such a prospect is weighing on the euro, which fell to a fresh 2014 low of $1.2250 against the dollar earlier this month.

In contrast to the situation in the Euro area, economic activity in the US remains relatively strong and employment growth has accelerated. The unemployment rate has declined steadily and is now more than 1% point lower than a year ago. The fall in oil prices will push inflation lower in the near-term but Fed members have emphasised the boost to consumer spending from lower energy costs.

Having ended QE, the Fed's focus is now on when to raise interest rates. In this regard, Vice-Chair Fischer has said that 'if the labour market continues to strengthen…then the natural thing is to get the interest rate up', adding that zero percent is 'far from the natural place' for rates.

Remarkably, it is more than 10 years since the Fed last commenced an interest rate-hiking cycle (June 2004). It is more than 8 years since it last raised interest rates. The next hiking cycle could begin around the middle of 2015. Ahead of this the dollar has risen on a trade-weighted basis to its highest level since early 2006, having strengthened by 11% in 2014. Further gains seem likely next year.

Feature

Financial market conditions in the Euro area

Financial conditions in the Euro area have improved considerably across interbank, bond and equity markets since the recent crisis. This has been a necessary condition for a pick up in economic activity, but a stronger recovery requires support from investment.

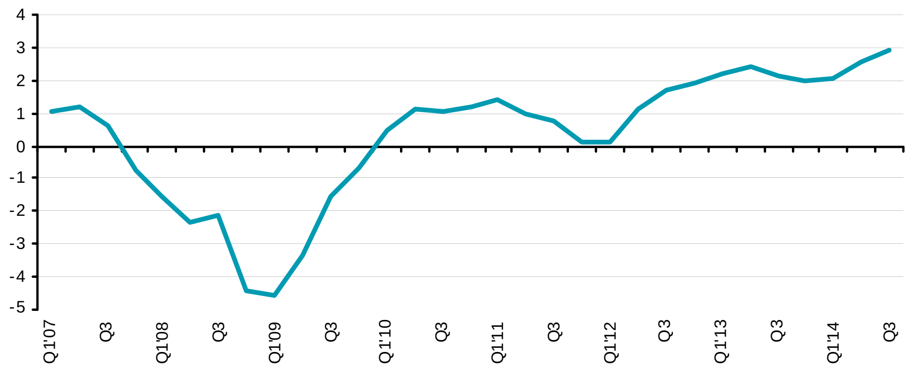
Interbank interest rates have fallen over the past few years as the ECB has cut policy rates and provided unlimited liquidity to banks, and spreads have returned to more normal levels. Banks' access to funds has improved albeit mainly in the secured interbank market. Activity in the unsecured market has picked up in 2014 but remains well below the levels prevailing prior to the financial crisis. The reduced cost and improved access to funds has contributed to an easing in Euro area banks' lending standards. There has also been some improvement in the demand for credit but it remains weak and lending continues to contract on an annual basis although the pace of decline has slowed.

Government bond yields have fallen sharply since ECB President, Mario Draghi, promised in July 2012 'to do whatever it takes to preserve the euro'. This led to a new programme, Outright Monetary Transactions (OMT), under which the ECB committed to buy, subject to certain conditions, the sovereign debt of a 'stressed' country in the euro area in unlimited size. Although the programme has never been activated, it proved to be the catalyst for a fall in sovereign debt yields and a contraction in spreads. Measures taken at a national level as well as further policy actions by the ECB, including engaging in outright asset purchases, which may be broadened to include the purchase of government bonds, have contributed to a continuing decline in sovereign yields to record lows. Renewed political uncertainly in Greece has prompted a spike in government bond yields there lately, but the spillover to other euro area countries has been limited to date.

Corporate bond yields have also fallen and spreads over core government bond yields have narrowed significantly. A 'search for yield' amongst investors has been an important contributory factor, while the possibility of the ECB buying corporate bonds under an expanded asset purchases programme has reinforced the decline in yields and contraction in spreads. Having fallen by over 60%, as measured by the EURO STOXX index, between mid-2007 and early 2009, Euro area equity markets have rebounded strongly, though in aggregate they still remain below pre-crisis peaks. They have also lagged US and Japanese markets, both of which have benefited from QE in their respective economies.

While financial conditions have improved, as captured for example by the OECD's indicator, risks remain. A withdrawal of the current very accommodative global monetary policy could test markets. In addition, there is still some fragmentation in conditions across euro area countries and the economic recovery in the zone remains weak and subject to downside risks, which could result in a reversal in investors appetite for risk.

OECD Financial Conditions Index – Euro Area



United Kingdom

Rate hike delayed

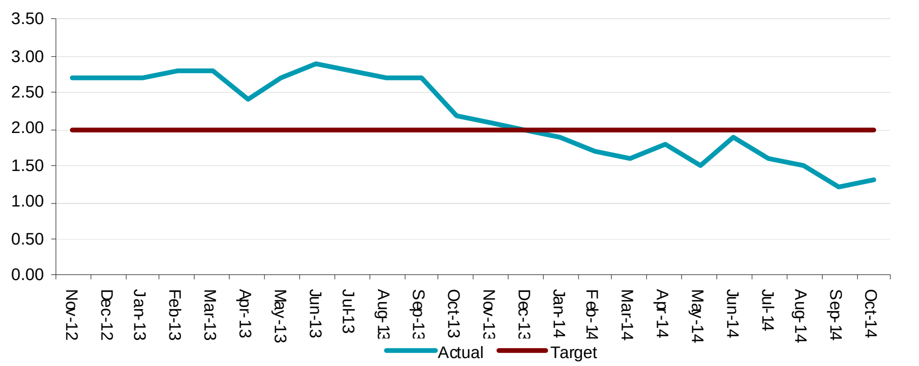
Consumer spending drives growth in Q3…

The second GDP estimate showed the economy grew by 0.7% in Q3 driven by an increase in consumer spending, which rose for a 13th consecutive quarter. Business investment declined, though this followed a strong increase over the previous 12 months, and may also prove temporary as surveys point to investment increasing over the coming months. Exports fell again in Q3, reflecting on-going weak demand in the Euro area, and net exports made a negative contribution to GDP. The pace of economic growth may moderate a little in the final quarter of the year judging by the latest Purchasing Managers' data, with the composite index of activity averaging 56.7 in Oct-Nov from 58.5 in Q3. The consensus expects an increase in GDP of 0.6%, which would leave the annual rate of growth in Q4 - and for 2014 as a whole - at 3%.

Bank of England lowers inflation forecasts…

The Bank of England (BoE) published updated macroeconomic projections in its November *Inflation Report*. The forecasts for GDP growth in 2015 and 2016 were little changed from those published in the August report at 2.9% and 2.6% respectively, while the unemployment rate is projected to fall to 5.4% by the end of next year (from 6% currently) and 5.3% by end-2016, again little changed from August. The Bank has lowered its forecasts for CPI inflation quite substantially, however, reflecting lower actual outturns recently and weaker prices pressures - partly related to falling commodity prices – than previously expected. Inflation is projected to average 1.2% in the final quarter of this year and 1.4% in the final quarter of 2015 (down from the previous forecast of 1.9% and 1.7% respectively), rising to 1.8% by the end of 2016.

UK CPI Inflation (%)



First interest rate hike could be delayed

The MPC kept interest rates unchanged in December. The BOE Governor Mark Carney says the focus of the Committee's discussions is on the 'timing and extent' of interest rates increases. Two members again voted for a 25bps hike at the November meeting, the latest for which minutes are available, citing the continuing fall in the unemployment rate and hence the possibility that 'wage growth might pick up sharply'. For the majority of MPC members, the revised outlook for inflation justified keeping interest rates on hold, and perhaps for longer than seemed likely a relatively short time ago. However, there is a 'material spread of views' amongst these members regarding the risks to the outlook. For some, there is a risk that growth could soften by more than anticipated and hence that inflation might persist well below the 2% target for longer than expected, in which case it would be appropriate to keep interest rates unchanged for some considerable time. For others, the risk is that slack in the labour market is eliminated more quickly than expected, which could result in inflation rising more quickly to, and ultimately overshooting, the 2% target, thus necessitating an increase in interest rates sooner rather than later.

…but may come sooner than the market currently expects.

The market expects a first rate hike in the first quarter of 2016, suggesting it thinks inflation may persist well below target for quite a prolonged period of time. However if, as seems likely, the unemployment rate falls further during 2015, then a majority of members may vote for a first rate increase well before the market currently expects. If so, there is scope for sterling to strengthen, particularly against the euro.

Europe

ECB lowers inflation forecasts

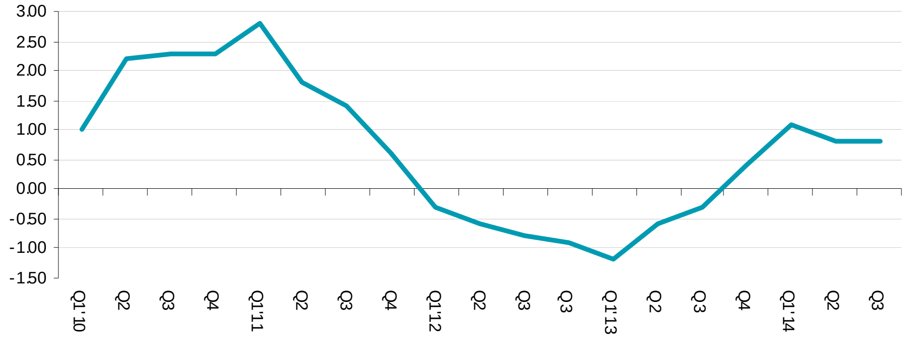
Modest growth again in Q3…

The Euro area economy grew by 0.2% in the third quarter, having expanded by 0.1% in Q2. Consumer spending has picked up during the course of 2014 and posted a sixth consecutive increase in Q3, which helped to offset another fall in investment and a negative contribution from net exports. The latest survey data suggests GDP growth will also be subdued in the final quarter with the Purchasing Managers composite index of activity falling to 51.1 in November, from almost 53 in Q3.

…ECB revises down GDP and inflation forecasts…

The economic recovery to date has been weaker than the ECB expected and hence it has revised down forecasts for growth and inflation quite significantly. GDP is now projected to increase by 1.0% and 1.5% in 2015 and 2016 respectively, compared to 1.6% and 1.9% forecast in September. Inflation is expected to average 0.7% and 1.3% in these two years respectively, down from 1.1% and 1.4% previously. The inflation forecasts assume, amongst other things, an oil price (Brent crude) of about $85 in 2015. Based on an alternative scenario in which the oil price averages around $73 a barrel, then according to ECB staff estimates inflation next year would be 0.4% points *lower* at 0.3% and 0.1% point lower in 2016. A lower oil prices would also boost GDP growth, by about 0.1% point in both 2015 and 2016.

Annual GDP Growth (%)



The ECB is concerned that persistently low inflation could pull down expectations of inflation over the medium-term. As Mario Draghi said following this month's ECB Governing Council meeting, 'taking into account the current environment of very low rates of inflation, it will be important to assess the broader impact of recent oil price developments on…inflation trends and to avoid spillovers to inflation expectations'.

…full QE likely to be announced early next year…

While the ECB kept policy on hold this month, the Governing Council will 'reassess' the outlook for inflation 'early next year'. Bank staff has also 'stepped up' preparation of further policy measures that can be implemented in a timely manner. If the ECB does decide to act early next year, as appears increasingly likely, then according to Draghi it will involve 'altering the size, pace and composition' of its asset purchases. The ECB is currently purchasing asset-backed securities and covered bonds. It may be set to broaden its purchases to include sovereign and/or corporate bonds – i.e. full QE – as it attempts to increase the size of its balance sheet by around 1trillion euro. It may also be more likely to do full QE given the relatively low take up of its second TLTRO offering this month - the ECB allotted E130bn to banks, towards the lower end of market estimates.

…euro falls to fresh lows against dollar.

The prospect of QE is weighing on the euro. It fell to a 2014 low of around $1.2250 against the dollar in early December, bringing its decline since the start of the year to almost 11%. The single currency has been more stable recently against sterling, trading in a range of 78-80p since September, but it's still down around 5% since the beginning of 2014. The likelihood of QE has also contributed to a decline on sovereign bonds yields. Increased political uncertainty has led in a spike in Greek yields lately but there has been limited spillover to date to other euro area countries.

United States

Employment growth pick ups

Strong growth being sustained in Q4…

The economy grew by 1% in the third quarter, slightly stronger than initially estimated. Consumer spending and investment were both revised higher, which helped to offset a smaller but still positive contribution from net exports. Growth is being sustained at a relatively robust pace into year-end judging from the latest survey evidence. In particular, the closely followed ISM index of manufacturing activity remained close to a near 4-year high in November at 58.7, while the equivalent index of activity in the non-manufacturing (mainly services) sector rose to a near 9-year high of 59.3. Similarly, the latest Fed Beige Book struck an optimistic note, saying consumer spending is ‘advancing’ and manufacturing activity ‘strengthening’ across most of the 13 Fed Districts.

…employment gains accelerating…

Employment growth has also strengthened into year-end. The numbers in work rose by 321k in November - the largest gain since early 2011 - to bring the average monthly increase in Q4 to date to 282k, up from 239k in Q3. The unemployment rate was unchanged in November at 5.8% but continues to trend lower – it has fallen by more than 1% point over the past year – while average hourly earnings rose by 0.4%, the strongest month-on-month increase in more than 15 months. Meanwhile, inflation on the Fed’s preferred measure (the personal consumption deflator) dipped to 1.4% in October, though the core rate, which excludes energy and food prices, nudged up to 1.6%.

…muted market reaction to end of QE…

US Trade-Weighted Exchange Rate

The Fed’s decision to end QE following its end-October meeting had been well telegraphed and hence the market reaction has been quite sanguine. Indeed, equity markets have advanced further with the S&P 500 up about 1%, while longer-dated government bonds are trading trade close to the lows of the year. Shorter-dated yields have risen, however, as the prospect of a first increase in interest comes into focus with 2-year yields trading up to the highest level in more than 3 years following the release of the November employment report.

…Fed focusing on when to raise rates…

The Fed said after the October meeting that it is likely interest rates will remain unchanged for a ‘considerable period’ after the end of QE. However, it strongly qualified this by insisting that the timing of any increase in rates is very much data-dependent. Indeed, given the on-going improvement in the labour market, it may be that the Fed will soon drop the considerable period language, perhaps at its December 16 meeting. In this regard, comments by the Fed Vice-Chair Stanley Fischer in a recent Wall Street Journal interview were significant. He said that ‘if the unemployment rate continues to decline, if the labour market continues to strengthen…then the natural thing is to get the interest rate up’ adding that 0% is far from the ‘natural place’ for interest rates.

…mid-2015 lift off is possible.

The market has also started to bring forward the time when it expects interest rates to rise and is now pricing in a first hike by September 2015 at the latest. It could be earlier than this, though, as quite a number of Fed members have suggested that a ‘lift-off’ for rates around the middle of next year might be appropriate. But in any case, the prospect of interest rates rising is underpinning the dollar, which has on a trade-weighted basis has risen to its highest level since 2006.

Economic Diary – December '14/January '15

	Ireland	Europe	United Kingdom	United States
Dec 11	Q3 GDP, BoP, Inflation Data		RICS House Price Balance	Retail Sales, Initial Jobless Claims
12		Industrial Production, Employment		University of Michigan Confidence
15			Rightmove House Prices	Empire Manufacturing, Industrial Production
16		Flash PMI's, ZEW Surveys	Inflation Data	Housing Starts
17		Inflation Data	Bank of England Minutes, Unemployment, Earnings	Inflation Data Fed Meeting
18		IFO Surveys	Retail Sales	Initial Jobless Claims, Philly Fed, Leading Index
22		Consumer Confidence		Existing Home Sales
23			Q3 GDP (Final) Index of Services	Durable Goods Orders, Q3 GDP (Final), University of Michigan Confidence, New Home Sales, Personal Income and Spending Initial Jobless Claims
24	Property Prices			
29		German Retail Sales	Nationwide House Prices	
30				CaseShiller Home Prices, Consumer Confidence
31	Retail Sales			Initial Jobless claims, Chicago PMI, Pending Home Sales
Jan 2	Live Register, PMI Manufacturing	PMI Manufacturing	Mortgage Approvals PMI Manufacturing	ISM Manufacturing
5	Exchequer Returns		PMI Construction	
6	PMI Services	PMI Services	PMI Services	Factory Orders, ISM Non-Manufacturing
7		Unemployment, 'Flash' Inflation		FOMC Minutes, ADP Employment
8		Retail Sales, Confidence Indicators, German Factory Orders	Bank of England Meeting	Initial Jobless Claims
9	Inflation Data, Construction PMI	German Industrial Production	Industrial Production, NIESR Estimate	Non-Farm Payrolls, Unemployment

Bank of Ireland estimates

Exchange Rates

	End Mar'15	End June '15	End Sept '15	End Dec '15
EUR/USD	1.22	1.21	1.20	1.20
EUR/GBP	0.78	0.76	0.75	0.74
USD/JPY	120	120	122	122
GBP/USD	1.56	1.59	1.60	1.62

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	2.15	2.50	2.80	3.10
Eurozone	0.60	0.70	0.90	1.10
UK	1.90	2.30	2.60	2.90

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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