



# **Exchange Rate Outlook** *22nd May 2009*

- **USD undermined as prospects for global recovery build**
- **Euro benefits from general improvement in investor sentiment**
- **Sterling sees yearly highs versus USD on growing market optimism**
- **Yen continues to take its lead from market appetite for risk**

**John Beggs**  
Chief Economist

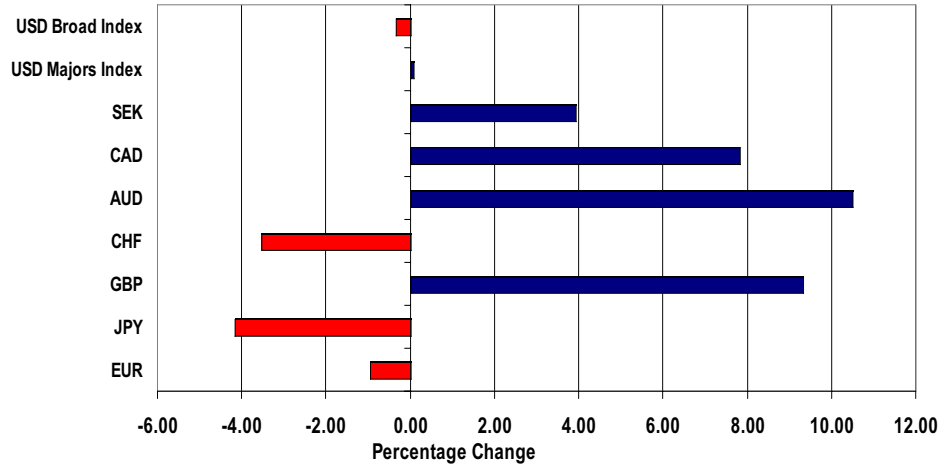
**Geraldine Concagh**  
Senior Economist

**Oliver Mangan**  
Chief Bond Economist

**Jenny Pollock**  
Senior Economist

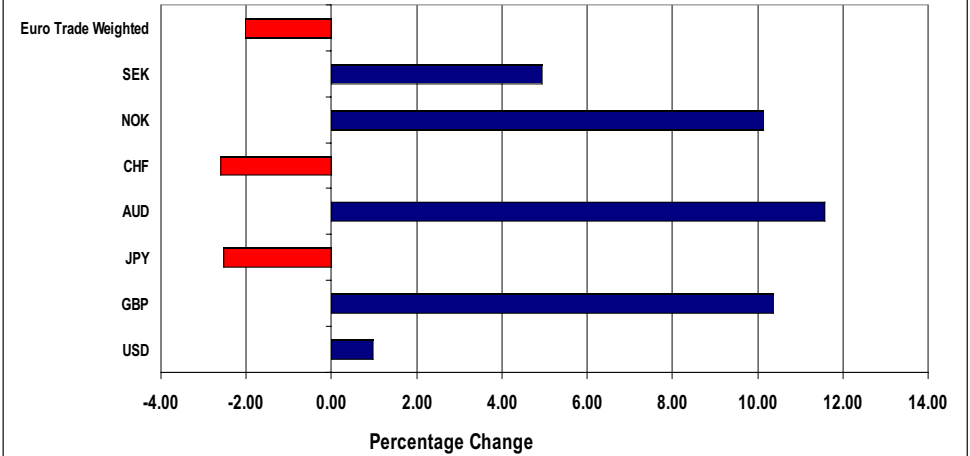
# Key Currency Trends

Performance Versus Dollar & USD Trade Weighted Indices  
2009 Year to Date % Change



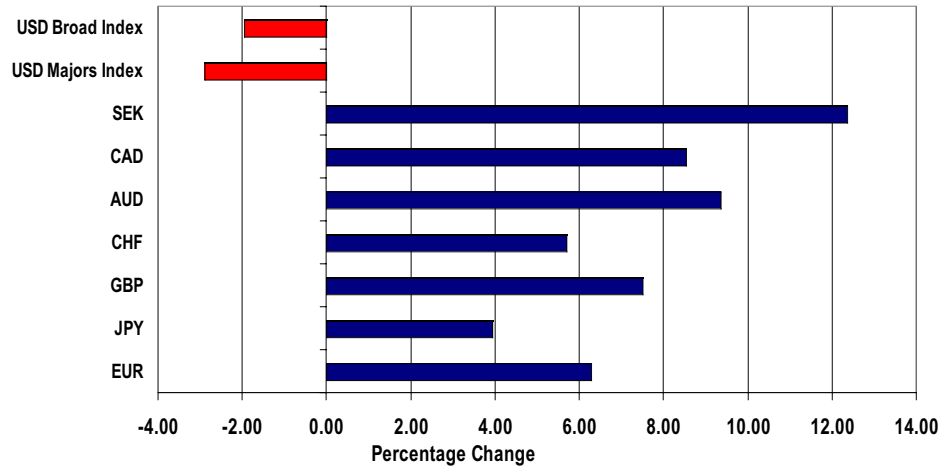
Source: Thomson Datastream

Performance Versus Euro and Euro Trade Weighted Index  
2009 Year to Date % Change



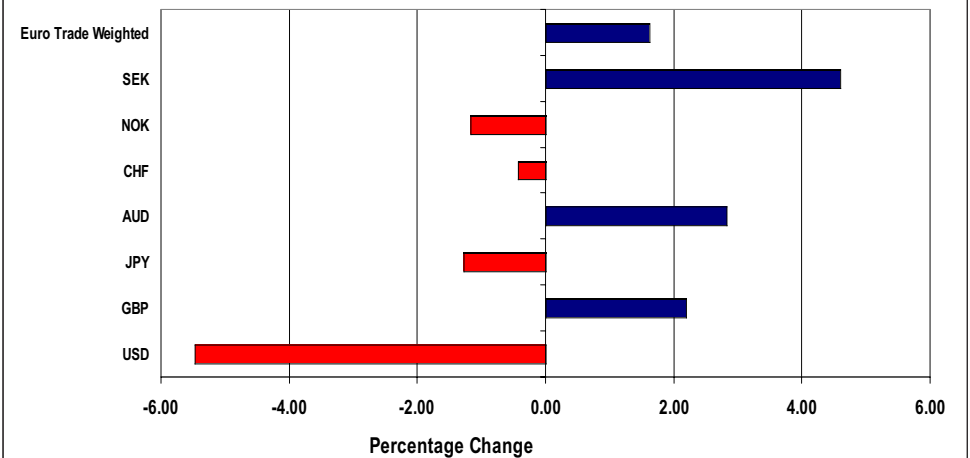
Source: Thomson Datastream

Performance Versus Dollar & USD Trade Weighted Indices  
% Change In Past Month



Source: Thomson Datastream

Performance Versus Euro and Euro Trade Weighted Index  
% Change in Past Month



Source: Thomson Datastream

## Summary of Exchange Rate Forecasts

	<b>Current</b>	<b>Q2-2009</b>	<b>Q3-2009</b>	<b>Q4-2009</b>	<b>Q1-2010</b>
<b>Euro Versus</b>					
<b>USD</b>	1.395	1.35-1.42	1.35-1.42	1.33-1.38	1.30-1.35
<b>GBP</b>	0.880	0.87-0.91	0.85-0.89	0.82-0.87	0.80-0.85
<b>JPY</b>	131.35	125-135	130-140	135-145	135-145
<b>PLN</b>	4.39	4.35	4.10	4.00	4.00
<b>HUF</b>	278.30	280	280	275	275
<b>NOK</b>	8.92	8.80	8.70	8.60	8.60
<b>SEK</b>	10.48	10.50	10.30	10.00	9.80
<b>US Dollar Versus</b>					
<b>JPY</b>	94.18	93-99	95-100	100-105	103-110
<b>GBP</b>	1.584	1.50-1.60	1.64-1.64	1.55-1.65	1.55-1.65
<b>CHF</b>	1.09	1.11	1.10	1.09	1.09
<b>CAD</b>	1.13	1.15	1.15	1.10	1.10
<b>AUD</b>	0.78	0.77	0.77	0.78	0.79
<b>NZD</b>	0.62	0.60	0.60	0.62	0.65
<b>CNY</b>	6.82	6.82	6.80	6.75	6.73
<b>Sterling Versus (mid point of expected trading range)</b>					
<b>JPY</b>	149	149	155	164	171
<b>CAD</b>	1.79	1.79	1.83	1.76	1.77
<b>AUD</b>	2.03	2.02	2.07	2.06	2.03
<b>NZD</b>	2.57	2.59	2.65	2.59	2.47

# Interest Rate Outlook

Central banks across the world have cut official rates aggressively to help ease the crisis that has gripped the world's financial system and counter what is now a very deep global recession. Meanwhile, deflation risks are rising, with inflation close to, or below, zero in many countries. Given a global banking system remains under stress, a very weak global economy and very subdued inflation, we are heading for a prolonged period of very low official interest rates.

## **Fed Rates To Stay Close On 0% For Long Period**

With inflation falling sharply and a deepening recession, the Fed cut US interest rates effectively to zero per cent in December, adopting a 0 - 0.25% target range for the Fed funds rate. As the Fed has become increasingly concerned about the prospect of deflationary forces becoming entrenched and given the very weak economic conditions, the current exceptionally low level of the Fed funds rate is likely to remain in place well into 2010 at least.

Given that official rates are now close to zero, the Fed's focus has shifted to open market operations and other measures, including the purchase of Treasuries and mortgage securities, to help stimulate the economy and the functioning of financial markets.

## **ECB Reduces Rates To 1%**

The ECB cut interest rates by 0.25% to 1.0% at its May policy meeting, bringing the total reduction in official rates in the eurozone to 3.25% since October. An official rate of 1.0% represents an historical low for the eurozone, with rates troughing at 2% in the previous cycle.

As many of the ECB Council members expressed reservations about cutting the repo rate to below 1%, this was expected to represent the trough for eurozone rates. However, ECB President Trichet said after the May meeting that the ECB has not decided that rates could not go any lower. The ECB also announced that it intends to buy €60 billion of covered bonds as part of its credit easing strategy. If the eurozone economy remains in deep recession, further policy easing in the form of lower rates and more asset purchases could be on the cards later in the year.

## **UK Expands Quantitative Easing**

The Bank of England cut its key interest rate by 0.50% to 0.50% at its March meeting. As official rates are now at ultra low levels, the focus has switched to quantitative easing measures. In this regard, the BoE has begun a programme of asset purchases, which includes private sector assets, but is mainly concentrated in buying gilts. It announced after its May meeting that it was increasing the size of its asset purchases by £50 billion to £125 billion. With inflation expected to move well below 2% and stay there, UK monetary policy is set to remain very accommodative.

### US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
<b>Current</b>	0.125	0.72	1.55	1.21	2.45
<b>June '09</b>	0.125	0.70	1.50	1.20	2.40
<b>Sept '09</b>	0.125	0.70	1.50	1.20	2.40
<b>Dec '09</b>	0.125	0.70	1.50	1.20	2.40

\* Swap Forecasts Beyond 1 Year

### Eurozone Interest Rate Forecasts (to end quarter)

	Refi Rate	3 Mth	1 Year	2 Year *	5 Year *
<b>Current</b>	1.00	1.25	1.62	1.70	2.74
<b>June '09</b>	1.00	1.20	1.60	1.70	2.70
<b>Sept '09</b>	1.00	1.15	1.55	1.70	2.70
<b>Dec '09</b>	1.00	1.10	1.50	1.70	2.70

\* Swap Forecasts Beyond 1 Year

### UK Interest Rate Forecasts (to end quarter)

	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
<b>Current</b>	0.50	1.32	1.79	1.87	3.17
<b>June '09</b>	0.50	1.30	1.80	1.85	3.15
<b>Sept '09</b>	0.50	1.25	1.75	1.85	3.15
<b>Dec '09</b>	0.50	1.20	1.70	1.85	3.15

\* Swap Forecasts Beyond 1 Year

# US Dollar

Stock market sentiment continues to be one of the main driving forces in terms of forex flows and against this background the US dollar has weakened versus all majors over the past month, with its broad trade weighted index down 2% over the period. While still retaining its safe haven status, this downward move is a reflection of a pick up in global risk appetite as investors focus on the increasing evidence from leading indicators of "green shoots of recovery". Higher oil prices are also weighing on the US dollar.

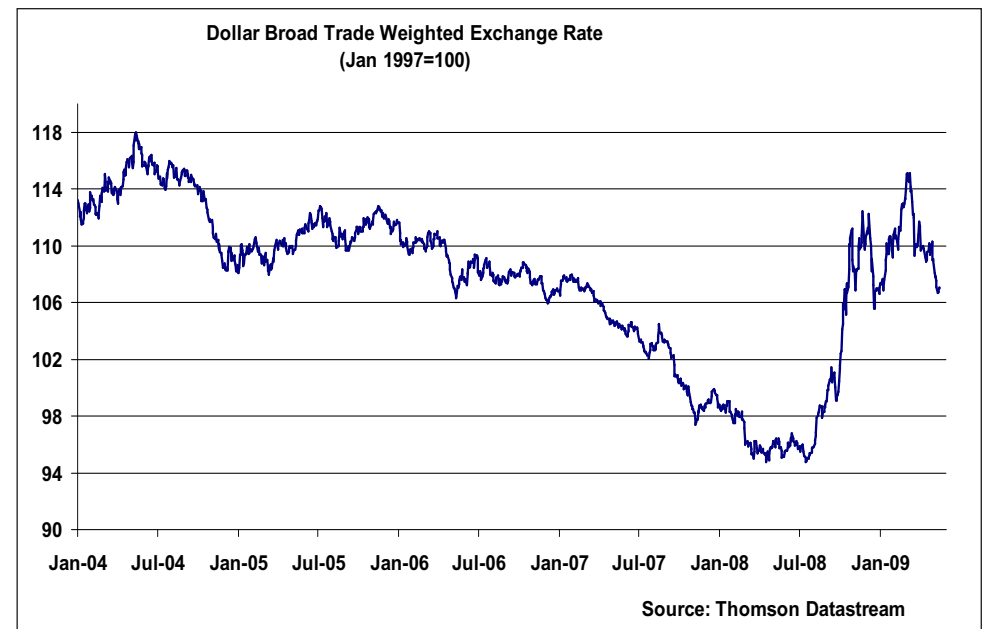
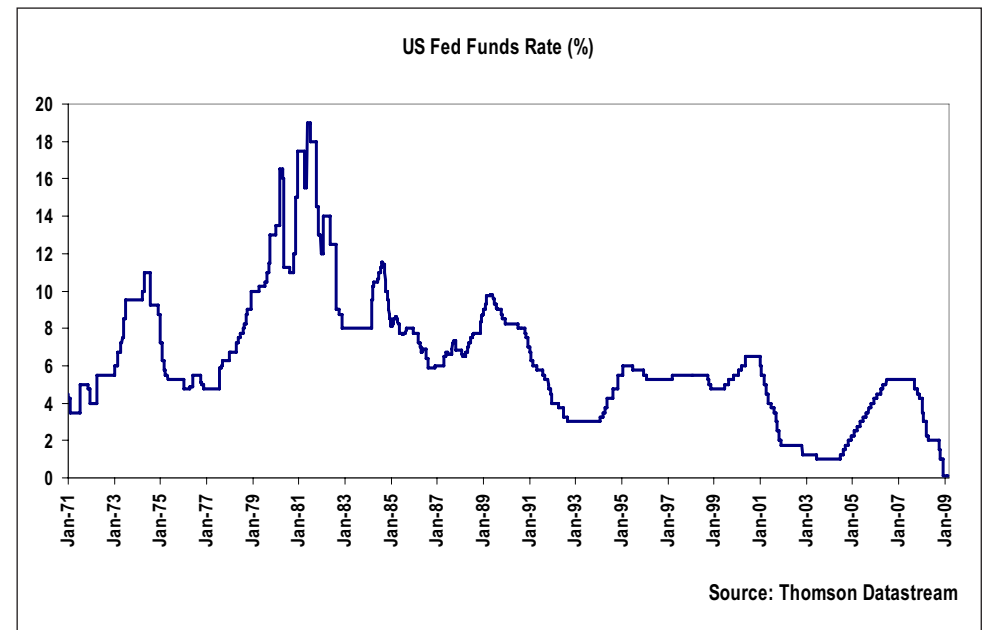
As well as growing optimism that the worst could be over for the financial sector and the world economy, the dollar is also being undermined by the extensive (and potentially inflation generating) quantitative easing activities been undertaken by the Federal Reserve. In March, the FOMC announced that, in addition to large scale purchases of mortgage backed securities, it also planned to buy up to \$300 billion of Treasuries. This is the first time since the 1960's that the central bank has bought Treasuries and the move represents a major expansion of its open market operations.

Given the current negative correlation between the dollar and global equities, the improved sentiment environment could well put further downward pressure on the dollar near term, particularly versus risk sensitive currencies like the euro and sterling. However, stock markets remain fragile and the recent dollar sell off could be quickly unwound if sentiment were to be derailed by any nasty surprises on the data front.

Furthermore, while the perception that global risk is diminishing is negative for the dollar currently, over the longer term we see little prospect for a marked depreciation in the US currency. The US economy is well advanced in terms of the recessionary cycle and is set to move into recovery ahead of the other major economies, with the dollar likely to benefit from any resulting speculation of a tightening in US monetary policy. Meanwhile, the improvement in the US balance of payments position, driven by the marked narrowing in the trade deficit, is also becoming increasingly dollar supportive.

## Key Forecasts

		Q2-2009	Q3-2009	Q4-2009	Q1-2010
<b>US\$/EUR</b>	1.395	1.35-1.42	1.35-1.42	1.33-1.38	1.30-1.35
<b>US\$/GBP</b>	1.585	1.50-1.60	1.64-1.64	1.55-1.65	1.55-1.65
<b>YEN/US\$</b>	94.207	93-99	95-100	100-105	103-110
<b>CHF/US\$</b>	1.090	1.11	1.10	1.09	1.09



# Euro

The euro has been on a gradual uptrend versus the US dollar over recent months, with sentiment underpinned by the prospects of an improvement in global economic conditions and evidence of increasing stability in financial markets rather than any real turnaround in terms of eurozone fundamentals. Indeed, over the past month, the euro has fallen back versus a number of other currencies (including sterling) that have also benefited from the pick up in risk appetite.

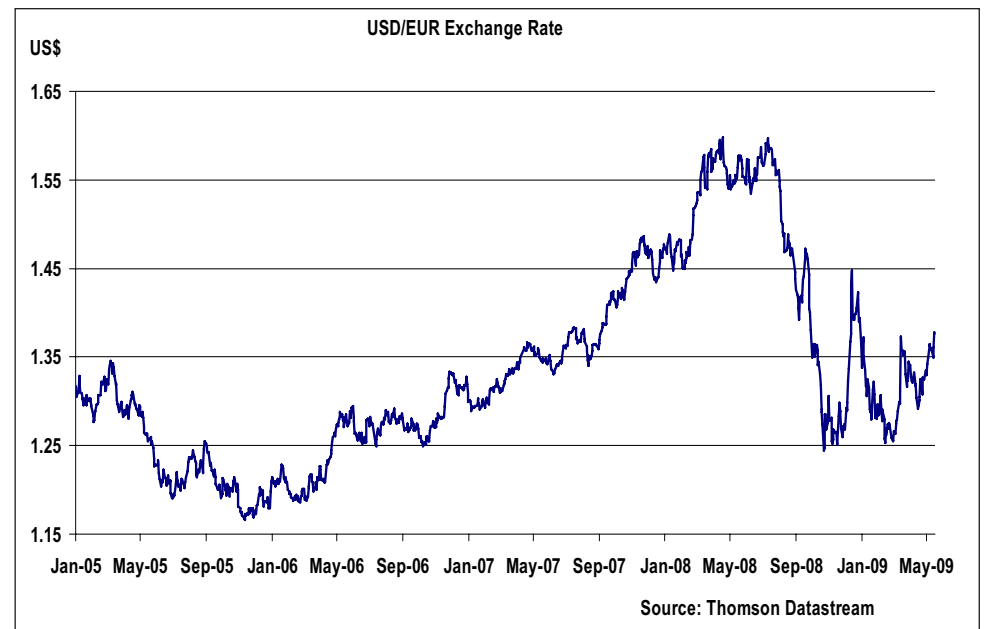
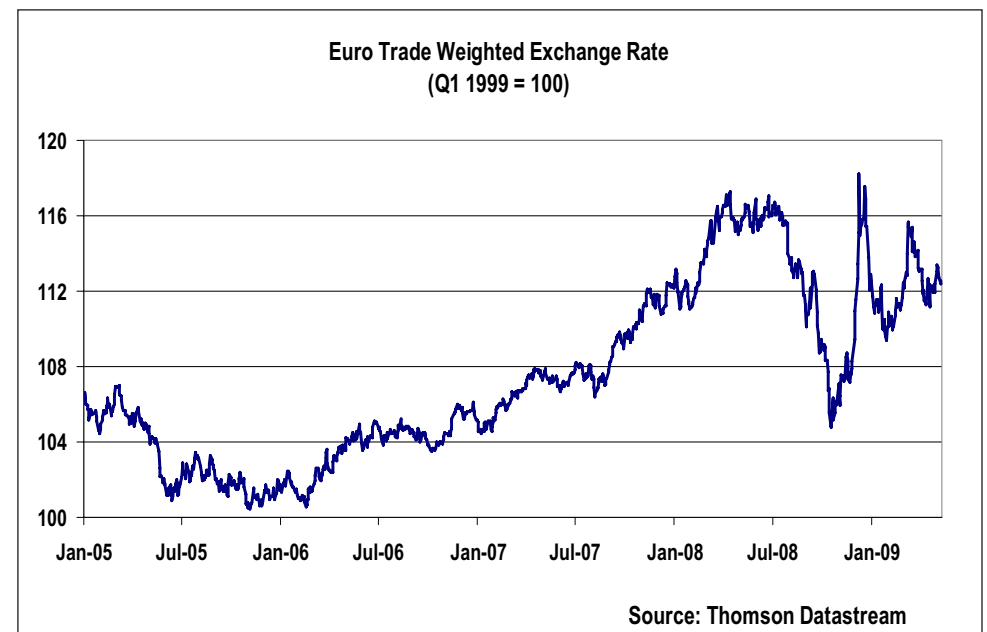
The dollar's position versus the euro has also been undermined by the extensive quantitative easing activities of the US central bank relative to those of the ECB. Although the ECB recently announced its intention to purchase up to €60 billion of euro denominated covered bonds, this sum equates to just 0.6% of eurozone GDP while the Fed plans to buy up assets equalling 12% of US GDP.

With global stock markets trading at four month highs, we expect the euro to remain relatively firm versus the dollar over the near term. Indeed, any further extension of equity market gains could see a move above \$1.40. At the same time, however, stock markets remain fragile and recent gains could be quickly unwound if sentiment were to be derailed by any nasty surprises on the data front. The euro's rally could also be tempered by the prospect of a further interest rate cut from the ECB. Given the marked deterioration in public finance positions right across Europe, country risk also remains a negative factor for the euro, as well as concerns about the eurozone's exposure to Eastern European banks and companies that may go into default.

The euro hit lifetime highs of Stg0.9803p versus sterling in late 2008. Increasing evidence that the eurozone, like the UK, is facing huge economic challenges has since taken it well off this level, with a low of Stg0.8640 seen in early February. Although sterling's recovery was undermined by the BoE's decision to engage in quantitative easing upside for the euro appears increasingly limited at Stg0.91/92p.

## Key Forecasts

		Q2-2009	Q3-2009	Q4-2009	Q1-2010
US\$/EUR	1.395	1.35-1.42	1.35-1.42	1.33-1.38	1.30-1.35
GBP/EUR	0.880	0.87-0.91	0.85-0.89	0.82-0.87	0.80-0.85
YEN/EUR	131.36	125-135	130-140	135-145	135-145
PLN/EUR	4.384	4.35	4.10	4.00	4.00



# Sterling

Once of the worst hit currencies since the start of the credit crunch, sterling suffered a marked depreciation last year, with a period of intense selling resulting in a fall to lifetime lows of Stg0.9803 versus the single currency in late 2008. Multi year lows were also seen versus the dollar and yen as a whole host of factors, including the prospect of the worst UK recession in decades weighed. More recent times, however, have seen a distinct improvement in its position versus other majors with markets considering the sell off was overdone.

Indeed, over recent days we have seen a move to yearly highs versus the US dollar as sterling benefits from a general rise in investor risk appetite and a growing belief that the 1.9% contraction in the UK economy in Q1 of this year should prove to be the low point of the recessionary cycle. Given this improved market sentiment, sterling is now well off its earlier lows and we expect the GBP/USD rate to remain relatively firm in the near term. However, upside beyond \$1.60 could prove difficult near term given that the outlook for the UK economy still remains bleak and that the BoE will continue its extra loose monetary policy stance.

Given that sterling is now a risk sensitive currency, movements on world stock markets will also play a key role in terms of any further moves to the upside. Versus the euro, sterling is up about 10% year to date and we anticipate a Stg0.87-0.91p range for the short to medium term, with downside pressures here contained by the fact that the eurozone itself is also battling with recessionary conditions and ultra low interest rates.

Despite recent moves, sterling still has some way to go relative to historical levels and remains undervalued. Thus, we anticipate further appreciation over the medium term. Volatility, however, is likely to remain high, reflecting underlying concerns about the domestic economy, in particular the long term implications of the Bank of England's quantitative easing policy and the marked deterioration in the UK's public finances.

## Key Forecasts

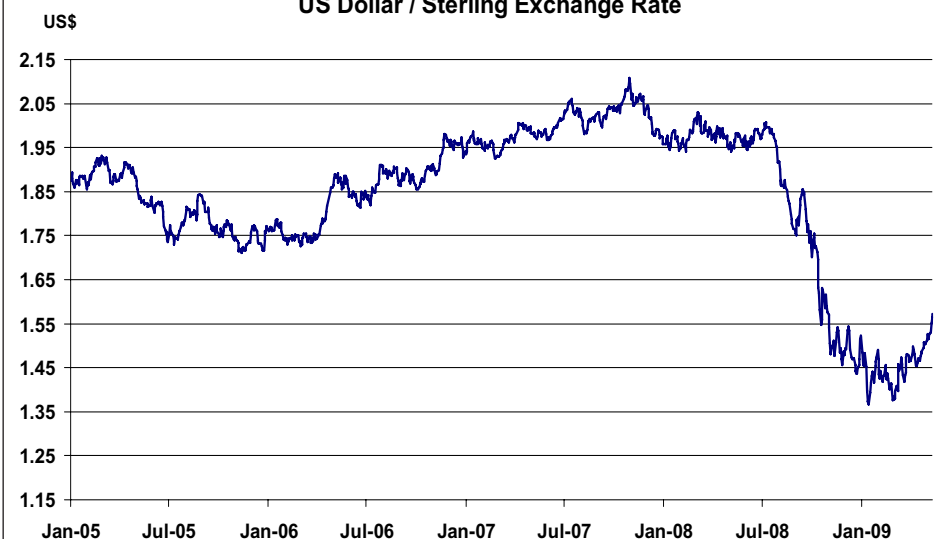
		Q2-2009	Q3-2009	Q4-2009	Q1-2010
<b>GBP/EUR</b>	0.880	0.87-0.91	0.85-0.89	0.82-0.87	0.80-0.85
<b>US\$/GBP</b>	1.585	1.50-1.60	1.64-1.64	1.55-1.65	1.55-1.65
<b>YEN/GBP</b>	149.24	149	155	164	171
<b>CAD/GBP</b>	1.792	1.79	1.83	1.76	1.77

Synthetic Sterling/Euro Exchange Rate (1990-2009)



Source: Thomson Datastream

US Dollar / Sterling Exchange Rate



Source: Thomson Datastream

# Japanese Yen

In an environment of global deleveraging and heightened risk aversion, the yen appreciated markedly over the course of 2008 and in early 2009. Indeed, it proved to be one of the best performing currencies of last year as it appreciated rapidly on the back of a reversal of risky carry trade position and a flight to safe haven assets. Its perceived safe haven status was boosted by the fact that Japan has a relatively healthy banking sector. Furthermore, Japan's current account surplus also made the yen an attractive investment choice in the then volatile and uncertain environment.

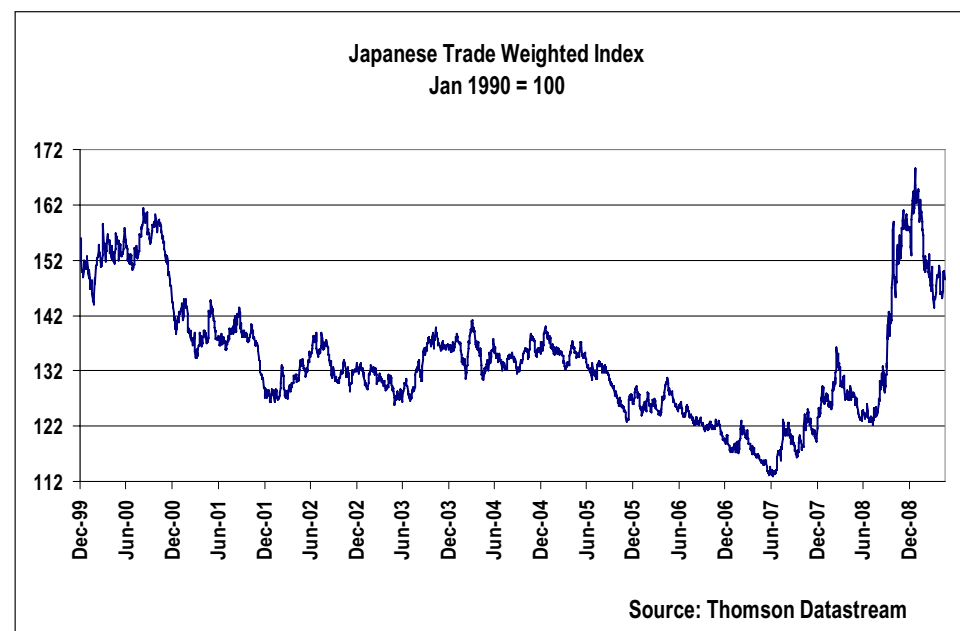
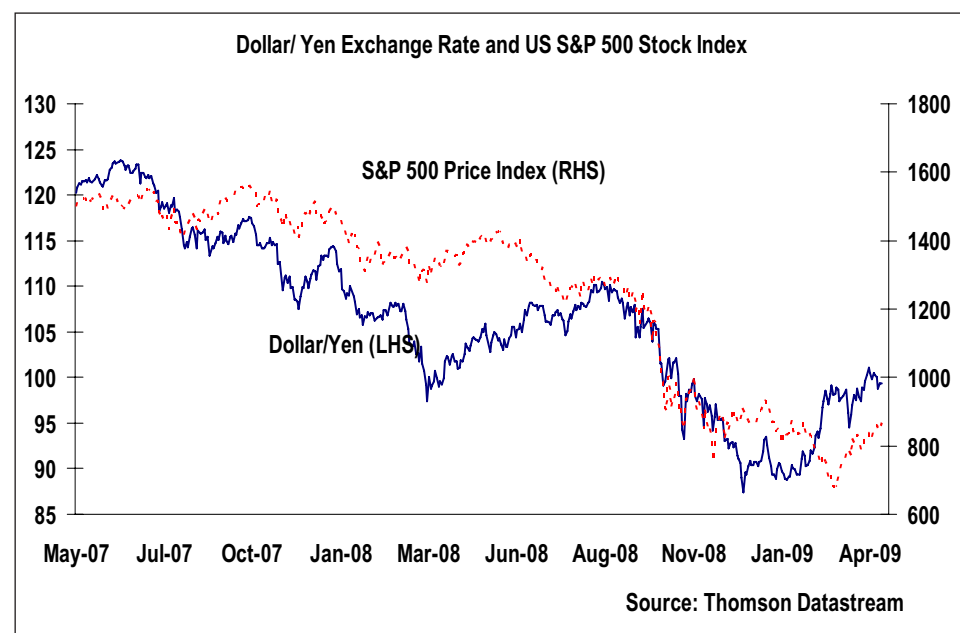
Sentiment toward the yen has since soured as markets focus on the fragile state of the Japanese economy. It has suffered the sharpest downturn of all the major economies, as its heavily industrialised export sector is hit hard by the downturn in global demand, as well as the overvalued position of the yen. After contracting by 3.8% in Q4-2008, the downturn intensified in Q1, with GDP shrinking by 4.0% over the quarter or an annualised rate of 15.2%. Japan's healthy current account surplus has thus vanished and external imbalances are now a negative for the yen.

Thus, from lows of Y87.15 seen in late January, the dollar has firmly held a Y94-100 range over recent months, despite much volatility and a pick up in market sentiment. Even if market sentiment improves further, any yen rebound is likely to be limited given the poor fundamental outlook for the economy. Meanwhile, the euro also continues to trade well off its lows. We anticipate a Y125-135 range for now, though the euro's own upside could be limited given the weak outlook for the eurozone economy.

Over the longer term, we expect the yen to retreat further from its current overvalued positions versus other majors, as reflected in our forecasts. The outlook for Japan is bleak indeed, with official interest rates now back near zero, the economy deep in recession, with business and consumer confidence at low levels and the marked appreciation in the yen continuing to hit export demand.

## Key Forecasts

		Q2-2009	Q3-2009	Q4-2009	Q1-2010
<b>YEN/US\$</b>	94.18	93-99	95-100	100-105	103-110
<b>YEN/EUR</b>	131.36	125-135	130-140	135-145	135-145
<b>YEN/GBP</b>	149.22	149	155	164	171



# Key Events/Diary

## **Week 1 (25th - 29th May)**

May 26th	US	Consumer Confidence (May)
May 27th	US	Existing Home Sales (April)
May 28th	US	Durable Goods (April)
	US	New Home Sales (April)
May 29th	Eurozone	Flash HICP (May)
	Eurozone	EU Business & Consumer Confidence (April)
	Eurozone	M3 Money Supply (April)
	Eurozone	Unemployment (April)
	US	Q1 GDP - 2nd Estimate

## **Week 2 (1st - 5th June)**

June 1	Ezone/US/UK	Manufacturing ISM/Markit PMIs (May)
	US	Personal Income and Consumption (April)
June 3	Ezone/US/UK	Services ISM/Markit PMIs (May)
	UK	Bank of England Policy Announcement
	Eurozone	ECB Policy Announcement & Press Conference
June 5	US	Non-Farm Payrolls (May)

## **Week 3 (8th - 12th June)**

June 10th	UK	Industrial Production & Manf Output (April)
	UK	International Trade (April)
	US	International Trade (April)
June 11th	Japan	Q1 GDP - 2nd Estimate
	US	Retail Sales (May)
	US	Business Inventories (April)
	US	TICs Report (April)
June 12th	US	Michigan Sentiment Survey - Preliminary (June)

## **Week 4 (15th - 19th June)**

June 16th	UK	CPI (May)
	Eurozone	German ZEW Index (June)
	US	Industrial Production and Capacity Utilisation (May)
June 17th	UK	Unemployment (May)
	US	CPI (May)
June 18th	UK	Retail Sales (May)
	US	Philly Fed Activity Index (June)

All forecasts prepared by AIB's ERU.

Current (at time of writing) interest rates and exchange rates quoted in this document are sourced from Reuters.  
The information in the Key Events/Diary is from publicly available sources.

Charts based on daily closing rates as provided by Thomson Datastream.

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