

Irish Economy

Q3 2014 Health Check

Moving up a gear

Domestic demand strengthens further

Ireland's cyclical recovery has recently gained momentum, leading to an upgrade to our economic forecasts. Stronger domestic demand trends, a rebound in exports and favourable statistical revisions all contribute to our improved estimates. Our preferred indicator - domestic demand - is expected to grow by 2.9% in 2014 and 3.1% in 2015.

No new austerity measures required to hit 3% of GDP deficit target

We believe that the government can reach the hallowed ground of a sub-3% of GDP budget deficit in 2015 with no net additional austerity measures. Already announced water charges will bring in €500m, leaving scope for the government to focus on measures that improve medium-term growth capacity, including a reduction in the income tax burden and the reversal of some of the capital spending cuts of recent years. The fiscal position would also benefit from refinancing €20bn of IMF loans over the coming years, saving c.€400m per annum (0.2% of GDP) in interest costs. The NTMA should do this by selling debt beyond its traditional 10 year time frame, thus taking advantage of record low market interest rates.

Price squeeze in property market to continue

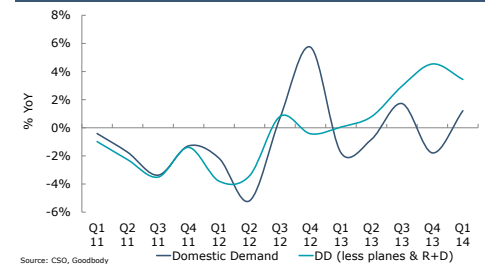
Supply shortages are the key driver of the recent acceleration in both residential and commercial property prices. While there are signs that construction activity is rebounding, supply will continue to be a problem, thus pushing prices higher. Prices are still cheap in an historical context, but an increase in supply is necessary to declare the recovery a quality one.

Economic Indicators				
Growth Components	2013	2014f	2015f	2016f
Consumption	-0.8%	1.4%	1.7%	1.9%
Government	1.4%	-0.4%	-0.5%	0.4%
Investment	-2.4%	10.9%	10.2%	8.4%
Domestic Demand	-0.7%	2.9%	3.1%	3.1%
Exports	1.1%	4.7%	4.0%	3.6%
Imports	0.6%	4.6%	3.4%	3.3%
GDP	0.2%	3.5%	3.6%	3.4%
GNP	3.2%	3.8%	3.6%	3.4%
Prices				
Consumer Price Inflation	0.5%	0.5%	1.4%	1.5%
House Price Inflation (end-year)	6.4%	11.9%	7.6%	6.7%
Wage Inflation (GBS)	-0.7%	1.0%	1.5%	1.5%
Fiscal				
GGB / GDP	-6.7%	-3.7%	-2.5%	-1.5%
Debt/GDP	116%	114%	110%	106%
Consumer Profile				
Employment Growth (end year)	3.2%	2.0%	2.5%	1.5%
Unemployment Rate (end-year)	12.2%	10.7%	9.2%	8.5%
Exchange Rates (Avg for the year)				
€/£	1.33	1.34	1.27	1.25
€/€	0.85	0.80	0.80	0.81

Economic Research

19 Aug 2014

Domestic demand (headline & core)

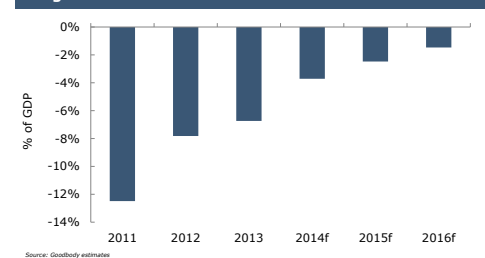


Growth forecast changes

	2014		2015		2016
	Old	New	Old	New	
Consumption	1.3%	1.4%	1.6%	1.7%	1.9%
Government	-1.5%	-0.4%	-1.1%	-0.5%	0.4%
Investment	13.6%	10.9%	11.7%	10.2%	8.4%
Dom Demand	2.5%	2.9%	2.7%	3.1%	3.1%
Exports	3.4%	4.7%	3.8%	4.0%	3.6%
Imports	3.4%	4.6%	3.4%	3.4%	3.3%
GDP	2.6%	3.5%	3.1%	3.6%	3.4%
GNP	3.1%	3.8%	3.1%	3.6%	3.4%

Source: Goodbody

Budget deficit to fall below 3% of GDP in 2015



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DOMESTIC MACRO DATA

	2012a	2013a	2014f	2015f	2016f
Growth Components					
Consumption	-1.2%	-0.8%	1.4%	1.7%	1.9%
Government	-2.1%	1.4%	-0.4%	-0.5%	0.4%
Investment	5.0%	-2.4%	10.9%	10.2%	8.4%
Domestic Demand	-0.2%	-0.7%	2.9%	3.1%	3.1%
Exports	4.7%	1.1%	4.7%	4.0%	3.6%
Imports	6.9%	0.6%	4.6%	3.4%	3.3%
GDP	-0.3%	0.2%	3.5%	3.6%	3.4%
GNP	1.9%	3.2%	3.8%	3.6%	3.4%

Housing Statistics

Completions	8,488	8,301	10,600	12,993	15,253
Average House Price (€k)	167,860	178,575	199,882	215,095	229,453
House Price Inflation (end-year)	-4.5%	6.4%	11.9%	7.6%	6.7%
Mortgage Credit Growth (end-year)	-2.9%	-3.3%	-2.0%	-1.2%	-0.2%

Prices

Consumer Price Inflation	1.7%	0.5%	0.5%	1.4%	1.5%
Wage Inflation (GBS)	0.5%	-0.7%	1.0%	1.5%	1.5%

Fiscal

Exchequer Balance	-14,823	-12,528	-8,149	-5,602	-3,855
Exchequer Balance / GNP	-10.4%	-8.4%	-5.2%	-3.4%	-2.2%
General Government Balance	-13,511	-11,778	-6,778	-4,762	-2,920
GGB/GDP	-7.8%	-6.7%	-3.7%	-2.5%	-1.5%
GGB/GDP - ex banking costs	-7.8%	-6.2%	-3.7%	-2.5%	-1.5%
Debt/GDP	111%	116%	114%	110%	106%

Consumer Profile

Employment Growth (end year)	-0.1%	3.2%	2.0%	2.5%	1.5%
Employment Growth (Full-year average)	-0.6%	2.4%	2.1%	2.6%	1.9%
Unemployment Rate (end-year)	14.2%	12.2%	10.7%	9.2%	8.5%
Debt/Disp. Income	210%	196%	184%	176%	170%

Interest Rates (At year end)

ECB	0.75%	0.25%	0.15%	0.15%	0.15%
BoE	0.50%	0.50%	0.75%	1.75%	2.50%
Fed	0.25%	0.25%	0.25%	0.75%	1.75%

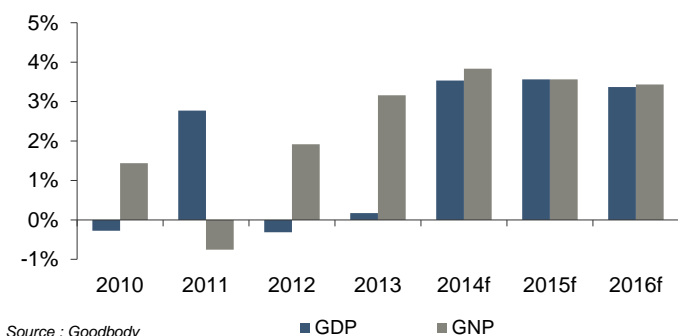
Trade

Current Account (€m)	2,700	7,638	8,965	10,932	12,259
CA as a % of GDP	1.6%	4.4%	4.9%	5.7%	6.1%

Exchange Rates (Average for the year)

€/£	1.29	1.33	1.34	1.27	1.25
€/€	0.81	0.85	0.80	0.80	0.81

Irish economic growth



SOVEREIGN ANALYSIS

	2012a	2013a	2014f	2015f
Debt/GDP				
Austria	74%	75%	80%	79%
Belgium	101%	102%	102%	102%
Cyprus	87%	112%	122%	126%
Finland	54%	57%	60%	61%
France	91%	94%	96%	97%
Germany	81%	78%	76%	74%
Greece	157%	175%	177%	172%
Ireland	111%	116%	114%	110%
Italy	127%	133%	135%	134%
Luxembourg	22%	23%	23%	26%
Malta	71%	73%	73%	71%
Netherlands	71%	74%	74%	73%
Portugal	124%	129%	127%	125%
Slovakia	53%	55%	56%	58%
Slovenia	54%	72%	80%	81%
Spain	86%	94%	100%	104%
Eurozone avg.	93%	95%	96%	95%

GGB/GDP

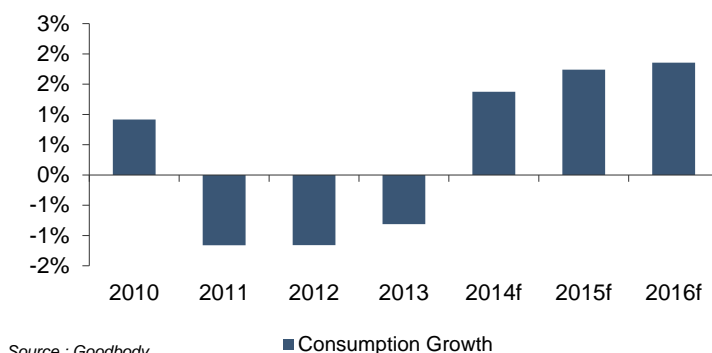
Austria	-2.5%	-1.7%	-2.1%	-1.8%
Belgium	-4.1%	-2.6%	-2.6%	-2.8%
Cyprus	-6.3%	-5.5%	-5.8%	-6.1%
Finland	-1.8%	-2.1%	-2.3%	-1.3%
France	-4.9%	-4.3%	-3.9%	-3.4%
Germany	0.1%	-	-	-0.1%
Greece	-8.9%	-12.7%	-1.6%	-1.0%
Ireland	-7.8%	-6.7%	-3.7%	-2.5%
Italy	-3.0%	-3.0%	-2.6%	-2.2%
Luxembourg	-	0.1%	-0.2%	-1.4%
Malta	-3.3%	-2.8%	-2.5%	-2.5%
Netherlands	-4.1%	-2.5%	-2.8%	-1.8%
Portugal	-6.4%	-4.9%	-4.0%	-2.5%
Slovakia	-4.0%	-14.7%	-4.3%	-3.1%
Slovenia	-4.0%	-14.7%	-4.3%	-3.1%
Spain	-10.6%	-7.1%	-5.6%	-6.1%
Eurozone avg.	-3.7%	-3.1%	-2.6%	-2.5%

10Y Spread to Germany

	2010a	2011a	2012a	2013a	Current
Austria	39.27	113.75	43.74	32.00	26.23
Finland	17.83	45.76	19.26	17.73	17.88
France	37.28	131.06	56.37	43.40	38.40
Netherlands	15.79	35.29	17.05	29.60	18.70
Belgium	98.10	221.53	73.31	62.00	37.90
Spain	249.56	324.52	392.10	223.80	148.30
Italy	183.70	513.69	313.40	216.40	163.30
Portugal	365.36	1,096.01	554.13	417.20	251.48
Greece	938.86	2,986.98	892.10	632.10	495.70
Ireland	605.29	642.69	n/a	148.90	106.92

Source: FactSet & European Commission

Consumption Growth



Key themes

Recovery is gaining steam

The Irish economic recovery has gained momentum over recent months. A host of indicators, including the PMIs, GDP data, business surveys, bank lending surveys and retail spending have all suggested that the recovery is strengthening and becoming more broad-based. We now expect GDP growth of c.3.5% per annum over the next three years.

Recent data revisions have been helpful

GDP and GNP statistics often give a volatile and distorted picture of Irish economic momentum, mainly as a result of the large multinational presence in Ireland. New statistical methodologies (ESA 2010) recently added to this confusion, with large upgrades to the value of GDP and GNP, mainly as a result of the inclusion of R&D in investment spending for the first time. There were two benefits from the recent revisions to the National Accounts for Ireland. Firstly, the previously reported negative carryover from Q4 2013 is no longer an issue for 2014. Secondly, the higher levels of GDP have a notable impact on the debt/deficit ratios.

Deficit to fall below 3% even without further austerity measures

Aided by these statistical issues and better than expected government revenues, the budget deficit is now expected to come in well below expectations in 2014. The revenue overshoot amounts to €1bn in the first seven months of the year and we expect it to grow to c.1% of GDP for the full-year. This will result in a budget deficit of 3.7% of GDP. On this basis, the achievement of a sub-3% of GDP deficit in 2015 can be achieved without the need for further austerity measures.

Budget 2015 can be used for growth-enhancing measures

Our preference is for the government, instead of abandoning fiscal discipline, to implement measures that will increase the medium-term potential of the economy. These should include: (i) a widening in the income tax bands; (ii) a reduction in the higher rate of tax, which, including the universal social charge, is one of the highest in the EU, and; (iii) a refocusing on capital expenditure, which has collapsed over recent years and remains at its lowest since the late 1980s as a percentage of GDP.

Opportunity to refinance IMF loans

The IMF recently gave its support for an early repayment of its loans to Ireland. While this is subject to agreement with its EU partners, there are significant savings to be made by such a measure, given that the debt currently attracts an interest rate of 4.99%. Our preference would be for the NTMA to go beyond its traditional 10-year time frame in refinancing these loans in the market with interest savings of c.€400m per annum a possibility.

Drivers of consumption bode well for a resumption of spending

The consumer spending environment has shown signs of improving over the first half of 2014, with the underlying drivers, particularly in disposable income and the labour market, trending positively. Retail sales and VAT trends are also showing momentum and the prospect of positive news on the fiscal side gives further support. However, the high debt levels of households will act as a headwind and consumption growth over the next three years will be modest.

Supply shortages will continue to support house prices

Despite signs of a recovery in house building, with both commencement and completions data showing impressive growth rates, they are coming from a very low base and in absolute terms remain too low to meet projected demand. This has not only seen a strong recovery in house price growth in Dublin where the shortage is most acute, but house prices outside the capital have also stabilised. Low stock for sale and rent is also supporting both prices and rental growth.

Irish Economy – Moving up a gear

The Irish economy is now in the midst of a cyclical recovery that is being led by strong growth in investment spending. This rate of expansion and the momentum seen in the PMI surveys through the first quarter of the year have surprised to the upside, giving us the ammunition to raise our economic growth forecasts once again in this *Health Check*. This continues a long run of positive upgrades.

We now forecast that the Irish economy will grow by over 3% on average over the 2014-2016 period. The expansion is becoming increasingly broad-based, with domestic demand to make a contribution this year for the first time since 2007. Our investment-led growth thesis is playing out as we expected, with particular dynamism in construction and in machinery and equipment investment. We expect this trend to continue.

The fate of the Irish consumer is more uncertain given the contrasting fortunes across different geographies, professions and generations, but the latest evidence suggests that a modest recovery is now in train. The improvement in the labour market is the biggest contributor to this, but consumer confidence has also been rising, while disposable income has finally stabilised. One wouldn't get too carried away, but modest expansion is now likely over the period to 2016.

On the external side, the latest data suggests that the worst effects of the patent cliff may be behind us. While we are loathe to make a conclusive call on this issue, goods exports did bounce back in the first quarter of the year, while services exports continued their positive performance. After a poor 2013, net exports will once again make a positive contribution in 2014.

While the positive economic momentum has been undoubtedly positive, Ireland has had a few favourable statistical "bounces of the ball" that have meant that both the drag from the fall in output in Q4 2013 is not now nearly as pronounced, while upward revisions to GDP has helped the aesthetics of Ireland's debt and deficit ratios.

While some may consider this latter issue nothing more than statistical gimmickry, it is important in the context of the commitments made to the Troika and the European Commission. These commitments stated that Ireland would achieve a budget deficit of less than 3% of GDP in 2015. Owing to these upward revisions and also more buoyant tax revenue, we now believe that the government can easily reach this target without any additional austerity measures.

Given the austerity fatigue among the electorate and the proximity of the next General Election, it would be easy to use this opportunity to loosen the purse strings and abandon fiscal prudence. We don't see any major cause for concern at this stage but there have been some indications that pressures on pay in particular may emerge once again. On top of this, there is the medium-term aging-related expenditures, while "one-off" revenues such as the pension levy and the fees emanating from the banking system will roll off over the coming years. In short, with debt levels still high and a deficit still in place, discipline must remain. The upcoming review of expenditure will be important in this regard.

Despite this, we believe the upcoming Budget can be used to focus on a number of areas that will benefit the medium-term growth potential of the Irish economy. With water charges set to bring in close to €500m per annum, there is some leeway to: (i) widen the income tax bands, thus taking workers out of the higher tax bracket; (ii) decrease the higher rate of tax (one of the highest in Europe); (iii) refocus on capital infrastructure projects, where spending has collapsed over recent years. These will be small measures on their own, but they are the start of the removal of some emergency measures of recent years.

Latest developments

Irish economic data is notoriously volatile, but gauging the true underlying trajectory of the Irish economy over recent years has been especially difficult for a number of reasons:

- GDP trends have been heavily affected by the slowdown in export growth as a result of the “patent cliff” issues in the pharmaceutical sector;
- Statistical noise regarding the activities of certain multinational companies in Ireland, particularly in the large software sector;
- Domestic demand has been dragged down due to a significant fall in aircraft investment;
- Recent changes to the methodology of calculating GDP have added a new, and rather volatile, component to GDP in the form of expenditure on R&D.

For these reasons, one has to look at a broader set of economic variables when assessing how the Irish economy is faring. The bottom line from this analysis is that the Irish economic recovery is gathering pace, with a significant contribution from domestic demand and, in particular, investment spending.

Our new economic forecasts are contained in the table below. We now expect domestic demand to grow by c.3.5% for the next three years. Investment will be the fastest growing component of the Irish economy by far, but it must be remembered that the investment/GDP ratio is coming from unsustainably low levels. Even allowing for the rapid growth forecast over the coming years, the ratio will only rise to 10% of GNP, relative to its long-term average of 17% of GNP.

Consumer indicators have been notably more positive in 2014 and include strong employment growth, higher confidence levels, a recovery in retail sales and signs of improvement in disposable income. We predict growth in consumer spending in 2014 of 1.4%, picking up to 1.9% in 2016. While this growth appears modest given the employment prospects in particular, continued deleveraging and the impact of cumulative austerity measures over recent years are the major reasons for our ongoing conservatism in relation to the Irish consumer.

We continue to urge caution when looking at the GDP and GNP variables for a number of reasons, mainly related to the effect that the large multi-national presence can have on the Irish economy (patent cliff, profit flows, intellectual property). Nevertheless, on our forecasts, we now believe Ireland will remain one of the fastest growing economies in the euro area over the next three years.

Irish growth forecasts					
	2012	2013	2014f	2015f	2016f
Consumption	-1.2%	-0.8%	1.4%	1.7%	1.9%
Government	-2.1%	1.4%	-0.4%	-0.5%	0.4%
Investment	5.0%	-2.4%	10.9%	10.2%	8.4%
Dom Demand	-0.2%	-0.7%	2.9%	3.1%	3.1%
Exports	4.7%	1.1%	4.7%	4.0%	3.6%
Imports	6.9%	0.6%	4.6%	3.4%	3.3%
GDP	-0.3%	0.2%	3.5%	3.6%	3.4%
GNP	1.9%	3.2%	3.8%	3.6%	3.4%

Source: CSO, Goodbody

Revisions & methodology changes in the Irish data

The Central Statistics Office (CSO) recently introduced changes to the methodology of calculating GDP. This is in line with a move by all European countries to take on board agreed statistical conventions in the ESA2010 guidelines. While there are 25 changes in the new methodology in total, the most material changes relate to the introduction of two additional components:

R&D: R&D expenditure is now included as part of investment in the National Accounts. This added 4% to GDP alone.

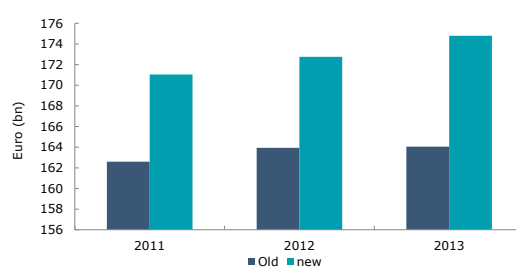
Illegal economic activities: New estimates for “illegal but mutually agreed” transactions have added 0.7% to GDP.

Major components to change in GDP

	2011	2012	2013
GDP (previous estimate)	162,600	163,938	164,050
Research & Development	6,842	6,910	7,166
% of GDP	4.0%	4.0%	4.1%
Illegal economic activity	1,232	1,209	1,258
% of GDP	0.72%	0.70%	0.72%
GDP (new estimate)	171,042	172,755	174,791

Source: CSO, Goodbody

GDP revisions

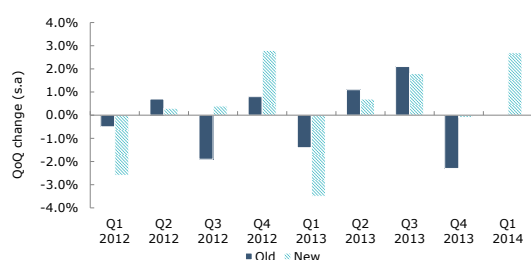


Source: CSO

These revisions tell us nothing about the momentum in the Irish economy, but they are very beneficial to the government debt and deficit ratios (which we deal with later). The quarterly growth profile does contain some important revisions, most notably for Q4 2013, where a 2.3% drop initially reported has been revised to a decline of just 0.1%. The previously reported contraction created a large negative carryover into 2014, but this is no longer an issue.

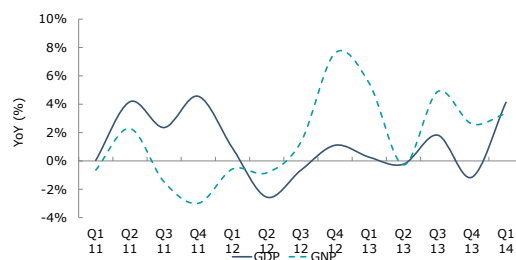
GDP also experienced a large increase of 2.7% qoq on a seasonally-adjusted basis in Q1, meaning that even a flat quarterly profile for the remainder of the year would result in a 3.7% increase for the full-year. However, due to the volatility of the data and the incidence of revision, we prefer to look at the data on an annual basis. In Q1, there was broad-based growth in all expenditure components, leading to a 4.1% yoy increase in GDP and a 3.4% yoy increase in GNP.

Large Q4 2013 drop in GDP revised away...



Source: CSO

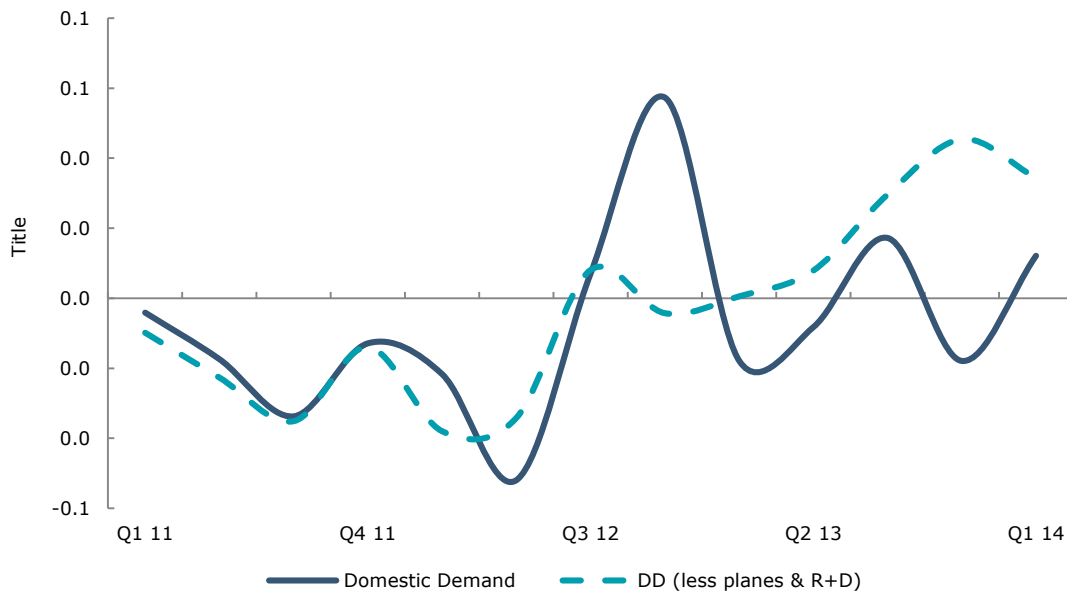
...while annual growth bounced in Q1 2014



Source: CSO

On both metrics, it is difficult to discern an underlying trend. Analysis of a broader set of indicators is required. Our preferred measure of activity in the Irish economy has always been domestic demand. We excluded the volatile aircraft component from the comparisons in the past and we now do the same for the R&D component due to the volatility in the data series on a quarterly basis. The chart on the next page shows how this “core” element of domestic demand has strengthened significantly over recent quarters. In Q1, core domestic demand grew by 3.4% yoy.

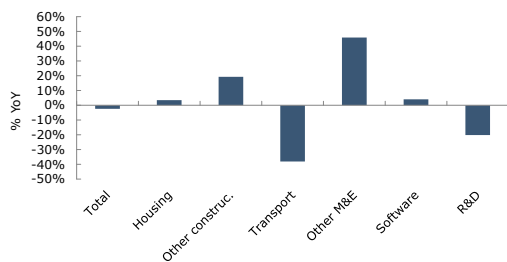
Domestic demand growth has strengthened significantly in recent quarters



Source: Goodbody, CSO

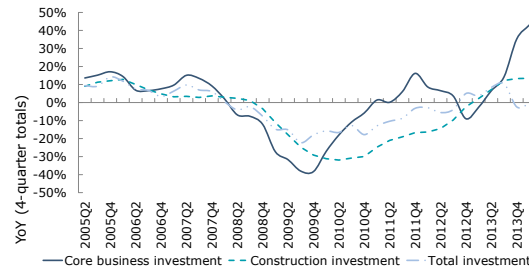
The recovery in domestic demand continues to be led by a strong rebound in investment spending. The chart below shows that very strong growth of 50% yoy occurred in machinery and equipment investment last year, while there was also an impressive bounce in other construction activity. R&D spending fell by 20% but this tends to be a very volatile component, even on an annual basis. More recent indicators suggest that this trend remains in train. The chart below shows the surge in business investment spending over the past four quarters, while surveys from employers' groups and from the bank lending survey indicates that further strength is likely in the coming quarters.

Investment spending by type - 2013



Source: CSO

Business investment has surged



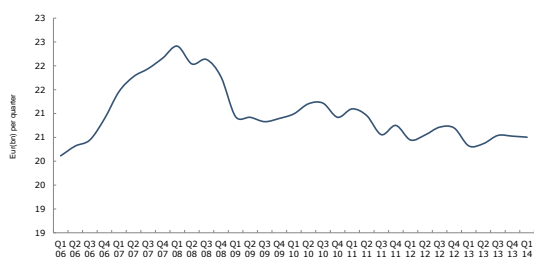
Source: CSO

Consumers show signs of life

While the opening quarter of 2014 saw consumption grow only modestly (0.2% yoy), broader indicators give us confidence that consumption will grow this year for the first time since 2011.

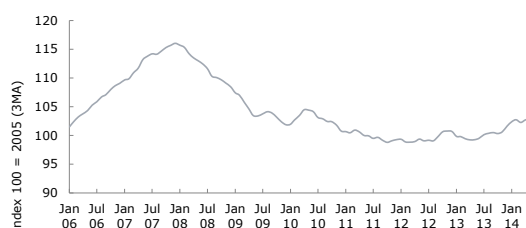
Since it troughed in Q1 2013, consumer spending is up less than 1% and remains 8.5% below the Q1 2008 peak. Core retail sales troughed earlier (Q2 2012) but displayed equally modest recovery trends, with volumes only rising by 1% between then and the end of Q2 2013. Since then the improvement has gathered pace, with volumes increasing by 2.5% yoy in H2 2013. This trend has continued into 2014 with core retail sales volumes up by 4% yoy in Q2 2014, highlighting the improving consumer spending environment. However, core sales remain 11% below peak 2007 levels.

Consumer spending has stabilised



Source: CSO

Core retail sales volumes are recovering



Source: CSO

Underlying drivers are positive

Our Consumer Checklist (below) summarises twelve underlying drivers of consumption. Of these, nine are trending positively.

Irish consumer checklist								
	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	Trend
Consumption (yoy)	0.1%	-0.8%	-1.2%	-0.7%	-0.6%	0.2%		Positive
Retail Sales 3MA (yoy)	0.7%	-1.3%	-0.4%	2.9%	1.5%	7.6%	5.4%	Positive
Savings ratio (SA)	10.2%	9.7%	10.1%	10.7%	12.5%	12.7%		Neutral
New credit card spending (yoy)	-1.2%	-8.3%	-5.3%	-6.6%	-6.1%	-1.0%	-5.4%	Negative
Employment (yoy)	-0.1%	1.2%	2.0%	3.1%	3.2%	2.4%		Positive
Unemployment (yoy)	-5.4%	-9.5%	-7.3%	-12.9%	-13.4%	-11.9%		Positive
Average weekly earnings (yoy)	-0.8%	-0.6%	0.4%	-2.1%	-0.4%	-0.4%		Negative
Disposable Income 4Q (yoy)	-1.0%	-1.6%	-1.4%	0.4%	3.2%	3.7%		Positive
Core Inflation (yoy)	0.0%	0.5%	0.5%	0.3%	0.7%	0.5%	0.7%	Positive
Interest Burden	8.1%	8.3%	8.4%	8.2%	7.7%	7.8%	7.3%	Positive
VAT 3MA (yoy)	9.5%	0.2%	-0.9%	5.2%	0.7%	2.0%	16.6%	Positive
Consumer Confidence 3MA	58.2	61.2	63.6	69.4	75.7	84.4	82.6	Positive

Source: CSO, Central Bank, Bloomberg, Goodbody

The labour market has provided the most important indicator of better consumer spending fundamentals. Following five quarters of strong growth, employment grew by a more modest 0.1% in the first three months of 2014. On an annual basis employment grew by an impressive 2.2%, driven by full time employment as employers signal their increasing confidence in the recovery. This has led to a sustained fall in unemployment (from a peak of 15.1% to its current level of 12%) and has seen consumer confidence soar to its highest level since 2007.

Labour market forecasts

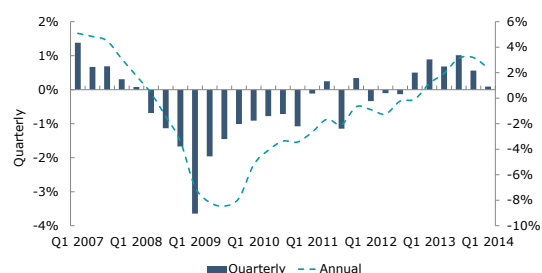
	2010	2011	2012	2013	2014f	2015f	2016f
Employed (Q4)	1,857	1,844	1,843	1,901	1,940	1,988	2,017
% yoy	-3.4%	-0.7%	-0.1%	3.2%	2.0%	2.5%	1.5%
% yoy (4 Q average)	-4.0%	-1.8%	-0.6%	2.4%	2.1%	2.6%	1.9%
Unemployment rate (Q4)	14.7%	14.9%	14.2%	12.2%	10.7%	9.2%	8.5%
Wage growth	-1.9%	-0.5%	0.5%	-0.7%	1.0%	1.5%	1.5%

Source: CSO & Goodbody

Despite improving labour market dynamics, average earnings continue to contract. We find this difficult to reconcile with the wider information in the labour market but may partly be due to a mix-effect of higher earning workers leaving the workforce to be replaced by lower earning workers.

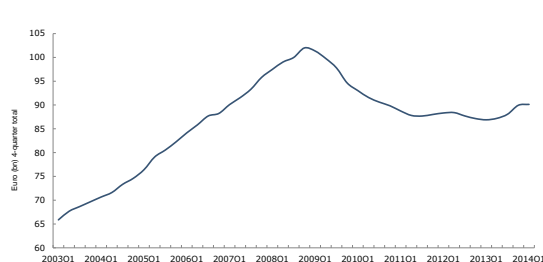
Disposable income, as measured by the Institutional Sector Non-Financial Accounts, has been rising annually since Q3 2013 and in Q1 grew by c.4% yoy. This, in turn, was driven by a 6.8% yoy increase in Compensation (somewhat offset by a 6% increase in Taxes and Benefits). It is worth noting that disposable income remains 10% below the 2008 peak although a further rise in employment, coupled with an easing in austerity, will help to support the positive income trends. In addition, anecdotal evidence from recruitment companies and industry bodies suggests that wage increases are beginning to filter through, particularly in sectors where there are skills shortages like accounting & finance and IT & languages.

Employment has been growing strongly



Source: CSO

Disposable income also rising

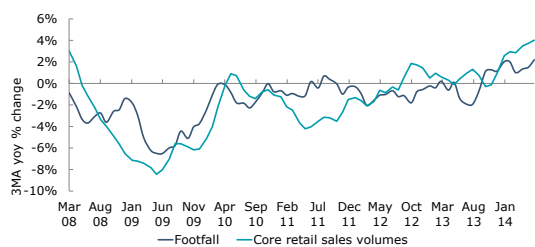


Source: CSO

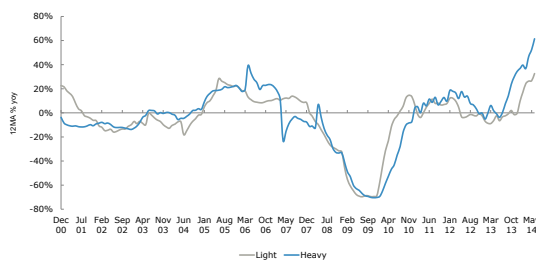
In conjunction with rising disposable income, discretionary spending is getting a boost from the fall in the interest burden over the past twelve months, given the fall in ECB rates (50% of mortgages are on a tracker rate). The savings ratio remains elevated but stable suggesting that precautionary savings is not increasing. In addition, this gives spending headroom which can translate into consumption as consumer confidence rises.

Alternative indicators of a modest consumer recovery

In addition to the key data described above, there are other indications that the consumer is on an improving trend. For example, statistics produced by Experian show that retail footfall is regaining momentum. Following dramatic falls since 2007, mirrored by a weak performance in core retail sales, footfall troughed in April 2013. Since then it has increased by 11% and is back at 2011 levels. While it remains c.10% lower than 2007, it has been accelerating since the start of 2014.

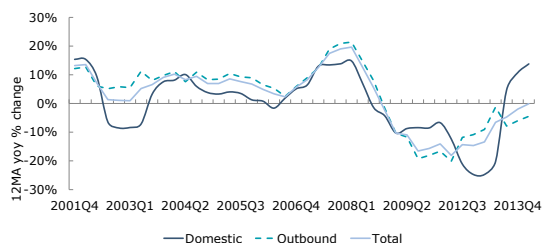
Footfall has been increasing since April 2013

Source: Experian

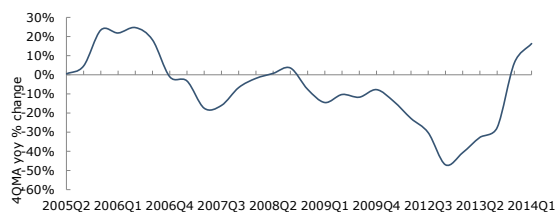
Goods vehicles registrations rise

Source: SIMI

Consumers also appear to be showing confidence by taking more holidays. Following three years of annual falls, the number of holidays taken by Irish consumers (measured in nights) stabilised in Q12014. This was driven by a 14% yoy increase in holidays taken domestically and a slowdown in the pace of decline of holidays taken abroad (-4% yoy). While “The Gathering” tourist initiative in 2013 may have encouraged more people to take holidays domestically, underlying trends have stabilised.

Number of holidays taken is recovering

Source: CSO

Business travel domestically is rising

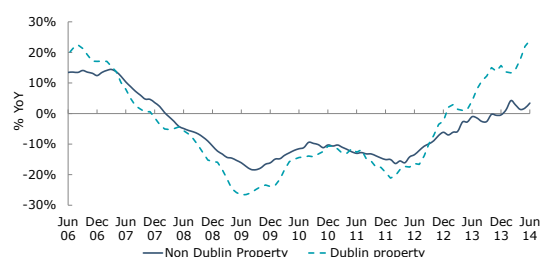
Source: CSO

With the majority of the underlying indicators pointing to an increase in activity in the domestic economy in general, and the consumer in particular the short term outlook is positive. We continue to forecast that consumption will contribute positively to economic growth for the first time in 4 years in 2014. The smaller than anticipated fiscal adjustment in 2015 will also give support. However, we remain cautious given the high levels of household debt (total liabilities are 193% of disposable income) and the associated deleveraging which will continue to act as a headwind and consumption growth will be modest.

Supply constraints continue to support house price and rental growth

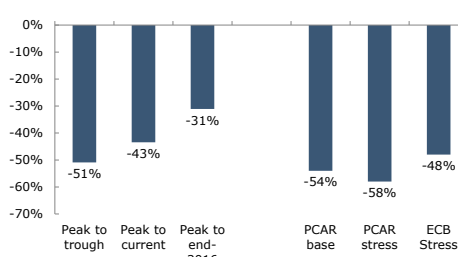
House price growth continues to outpace expectations. At a national level prices rose by 5% in the first half of the year and by 12.5% yoy. In line with previous trends, increases are being driven by Dublin where prices are up 9% ytd and 24% yoy. However, the recovery has become broader based with prices outside of Dublin prices rising since the start of 2014, and in June were 3.4% yoy higher. House prices have now reversed some of the peak to trough decline experienced during the housing market collapse and are currently 43% lower than peak levels. This is now well within the PCAR base (54%) and stress (58%) case scenarios which informed the capital requirements of the banks in 2011. Some of the banks have already adjusted their own assumption towards the new declines but with house prices set to continue to rise there is scope for further adjustment. On our forecasts, the decline from the peak by the end of 2016 (timeline for upcoming ECB stress tests) will be 31%.

Prices growing nationally...



Source: CSO

...with price falls within stressed parameters



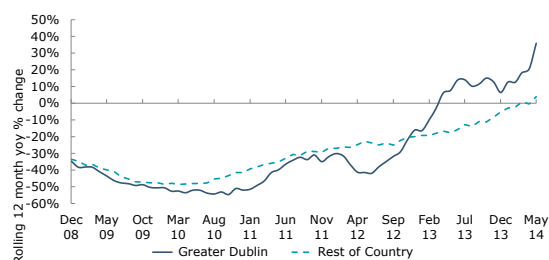
Source: CSO, Central Bank, ECB, Goodbody

Supply constraints remain the biggest driver of prices and despite signs of a recovery in house building, show little signs of abating in the short term. While both commencement and completions data are showing impressive growth rates in 2014 they are coming from a very low base and in absolute terms remain too low to meet projected demand.

Increases in house building remain insufficient to address supply shortages

Housing completions fell for the seventh consecutive year, to 8,300, in 2013. We estimate that between 2011 and 2016, 10,000 completions per annum are required, all in the Greater Dublin Area (GDA). Between 2011 and 2013 completions averaged just 9,100 per annum, with only 2,400 of these in the GDA. This has exacerbated the shortage of housing in the capital and translated into the squeeze on prices and rents over the past year. 2014 has seen a pick-up in completions and in the twelve months to the end of May, completions nationally amounted to 9,200 (+13% yoy) on a rolling 12 month basis, still well short of our medium-term estimates of c.30,000 units pa.

Completions are growing strongly...



Source: Department of the Environment

...but remain at low levels



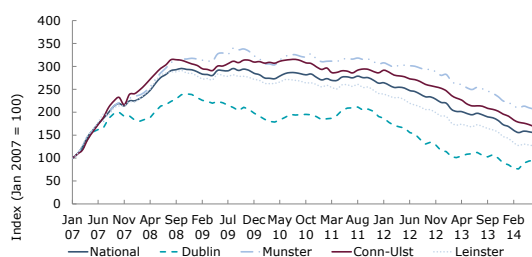
Source: Department of the Environment

Housing commencements are now indicating rapid growth from a very low base. Official data is available to February at this stage, but it shows there was a surge of activity ahead of the introduction of new building standards at the beginning of March 2014; in the twelve months to end-February 2014, commencements grew 120% compared to a year earlier. These growth rates will ease over the coming months, but in absolute terms there was 5,200 commencements nationally in the opening two months of 2014, which is already 11% ahead of the 4,200 seen over the whole of 2013. The GDA has seen 2,100 commencements in the opening two months of 2014, already 43% higher than seen in all of 2013. Notwithstanding the distortions being created by the changes to the building code, there is clearly momentum in the house building sector. However, it is not yet sufficient to meet projected demand and, given the time lag between commencements and completions, indicates that supply shortages will remain a feature.

Low stock for sale and rent is also supportive of prices

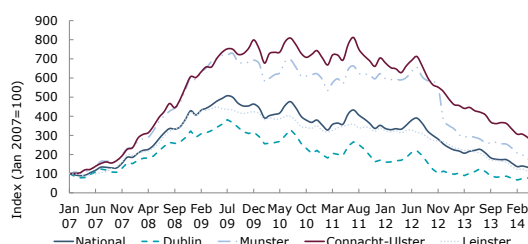
In addition to the shortage of housing, the stock available for either sale or rent is at or close to record lows and falling. According to daft.ie, there were 33,000 properties listed for sale nationally in June. This is 20% lower on an annual basis and almost half of that seen at the peak in Q4 2008. It is also only 1.7% of total housing stock which compares unfavourably to the average of 2.8% seen since 2007. Of the properties listed for sale only 9% are in Dublin, with Munster accounting for the most at 32%. Dublin stock for sale levels have been below 3,000 since November 2013, which means that only 0.5% of the existing housing stock is on the market (average since 2007 is 1.1%).

Housing stock for sale remains low



Source: Daft.ie, Goodbody

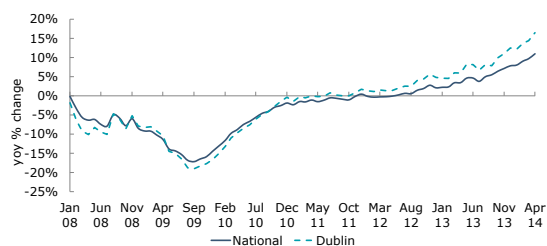
Rental stock is also close to record lows



Source: Daft.ie, Goodbody

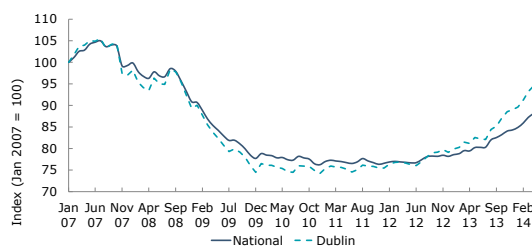
Properties available for rent also remain at low levels. According to daft.ie there were 6,500 properties available to rent in May, 75% below the 2009 peak. In Dublin, the stock of rental properties has, in the main, been falling at double digit rates since February 2010 and stood at 1,600 in June, just 0.3% of the total housing stock. This is 80% below peak levels and further highlights the squeeze on housing supply in the capital.

Rental are showing double digit increases



Source: Daft.ie, Goodbody

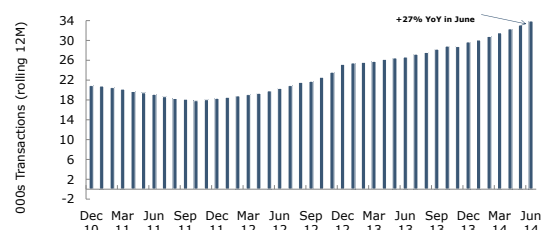
Rent indices have been recovering since 2012



Source: Daft.ie, Goodbody

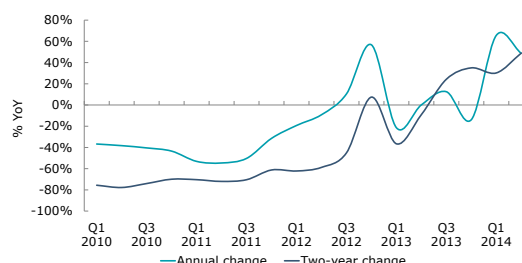
While supply side factors are most important in the price developments, there have been some more positive signs of late on the demand side. Property transactions grew by 27% yoy in June on a rolling 12 month basis. Gross mortgage lending is also picking up, with the volume of drawdowns up by 49% yoy in Q2, with strength being seen across the board. Trends are indeed positive, but with cash still representing 50% of housing transactions, mortgage lending is anticipated to be half of a "normal" level in 2014 (€3.8bn) and with new supply levels well below medium-term demand, we are not yet at the stage that we can declare that a fully functioning housing market is in situ.

Transactions are showing momentum



Source: NPPR

Gross mortgage lending is trending higher



Source: IBF

Key housing metrics & forecasts

	2011	2012	2013	2014f	2015f	2016f
House completions	10,480	8,488	8,301	10,600	12,993	15,253
Average house price (€, end-year)	175,769	167,860	178,575	199,882	215,095	229,453
Price inflation (% YoY, end-year)	-17%	-4%	6%	12%	8%	7%
- Dublin (% YoY, end-year)	-19%	-2%	16%	18%	11%	7%
- Non-Dublin (% YoY, end-year)	-15%	-6%	0%	7%	6%	6%
Gross mortgage lending (€m)	2,463	2,636	2,495	3,753	4,612	5,800
Growth in gross lending	-48%	7%	-5%	50%	23%	26%
Net mortgage lending growth (end -year)	-3.9%	-2.9%	-3.3%	-2.0%	-1.2%	-0.2%
Gross rental yield (end-year)	5.1%	5.5%	5.6%	5.4%	5.2%	5.2%

Source: CSO, DoELG, IBF, Goodbody

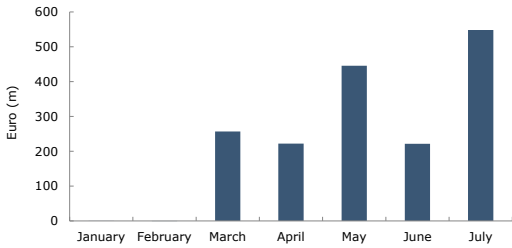
End to fiscal austerity in sight

The road to stability in the public finances has been a long and painful one for Ireland, having implemented €30bn in fiscal austerity measures since mid-2008. However, recent developments suggest that the road is almost at an end, with a sub-3% of GDP deficit in 2015 likely to be reached relatively easily. In the Stability Programme Update in April, the Government laid out its forecast that the budget deficit would fall to 4.8% in 2014. However, a combination of developments has led to us to believe that the deficit will now come in at 3.7% in 2014:

- The upward revision to GDP has meant that the denominator is likely to be some €14bn higher than expected in the SPU. This reduces the deficit by 0.4% of GDP.
- Government revenues have performed significantly better than expectations (€1bn better) in the first seven months of the year. A similar level of outperformance for the remainder of the year would leave revenues c.1% of GDP better than original expectations.
- Although total expenditure is in line with expectations, there has been a large undershoot on interest costs (€301m lower than expectations after seven months) once again. Given the current level of market interest rates and the prospect for a repayment of IMF loans rising, this saving may also be repeated in 2015.

Goodbody Fiscal Forecasts							
	2010	2011	2012	2013	2014f	2015f	2016f
Budget Deficit (% of GDP)	-29.3%	-12.5%	-7.8%	-6.7%	-3.7%	-2.5%	-1.5%
Excluding Banking costs	-10.2%	-8.5%	-7.8%	-6.2%	-3.7%	-2.5%	-1.5%
General Government Debt (% of GDP)	87%	99%	111%	116%	114%	110%	107%
Interest/GDP	2.5%	3.1%	3.6%	4.4%	4.3%	4.2%	3.9%
Primary balance	-7.7%	-5.4%	-4.2%	-1.8%	0.6%	1.7%	2.4%
Average interest rate	3.9%	3.6%	3.7%	4.0%	3.8%	3.9%	3.7%
Assumed interest rate on new debt	5.0%	4.0%	4.0%	4.0%	4.0%	3.0%	3.4%
GDP growth (real)	-0.3%	2.8%	-0.3%	0.2%	3.5%	3.6%	3.4%
GDP growth (nominal)	-1.9%	3.7%	1.0%	1.2%	4.5%	5.0%	4.7%

Source: DoF, Goodbody

Budgetary outturn* (to July 2014)		Tax revenue overshoot has grown	
			
Tax revenues	548		
PRSI	124		
Central Bank	222		
Other	131		
Total revenues	1025		
Gross voted	-23		
Non-voted	363		
Debt interest	-301		
Total expenditure	39		
Total	986		

Source: DoF

* relative to government expectations

Source: DoF

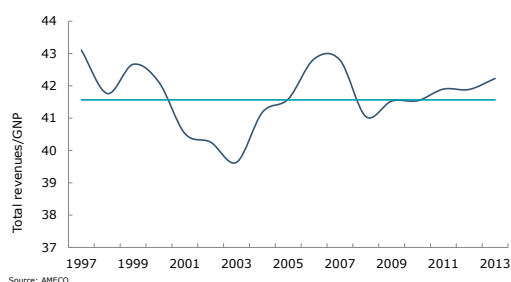
Considerations ahead of Budget 2015

Although there is still uncertainty about the outcome of the budget deficit in 2014, we believe there is sufficient evidence to suggest that no further austerity measures need be implemented in Budget 2015. However, although the sub-3% of GDP budget deficit should be easily achieved, it would be wrong to abandon fiscal prudence ahead of an expected general election in 2016.

Our preference is for the government to use the upcoming budget to refocus on measures that will improve the long-term growth capacity of the Irish economy. On this issue, we would make a number of observations:

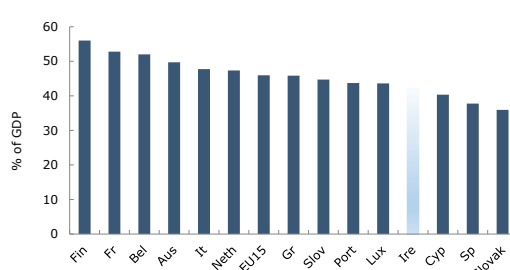
- The chart below shows that total government revenues as a percentage of GDP (GNP for Ireland), while below the European average, are now above their pre-crisis level. Much of this burden has had to be taken by Irish workers on their earnings.

Revenues now ahead of pre-crisis levels...



Source: Goodbody

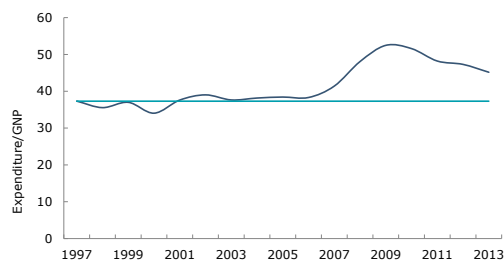
...albeit lower than the European average



Source: AMECO

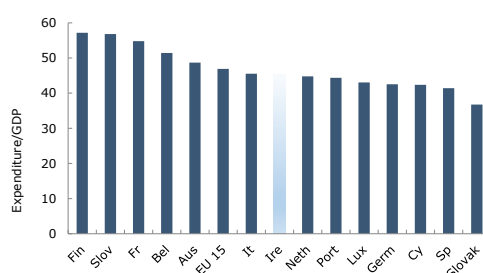
- Expenditure as a percentage of GNP, at 45%, remains well above its pre-crisis level (adjusting for banking costs).

Expenditure still above pre-crisis levels...



Source: Goodbody

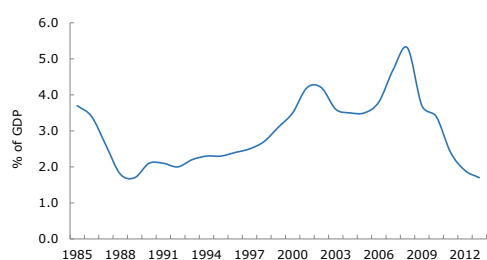
...albeit close to EU average levels



Source: AMECO

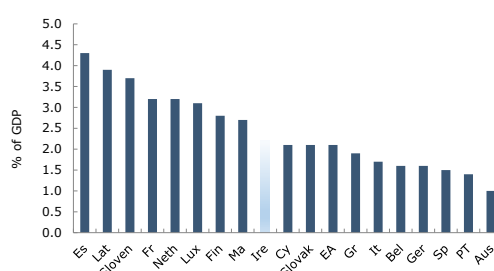
- Capital spending remains substantially below pre-crisis levels and, at 2.3% of GNP, is below the rate of depreciation of the capital stock and at its lowest level relative to GDP since the late 1980s. This is potentially damaging for medium-term growth prospects of the Irish economy.

Capital spending remains unsustainably low



Source: AMECO

Capital spending compared across Europe



Source: AMECO

With these facts in mind, we believe that the government should aim to announce a budget that will continue the sensible policies of recent years, while also supporting growth in the economy, both in the short and medium-term. To do this, we recommend:

- Continue with the introduction of the water charges that are expected to bring in €500m in the full year
- Continue restraint on public sector pay and pensions
- Achieve the proposed savings in the health sector
- Widen the bands by €2000 and decrease the top rate of income tax by 1% to 51% (inclusive of the universal social charge) at a cost of €370m
- Increase the use of PPPs in the provision of infrastructural development.

We noted at the beginning of the year that 2014 will be a pivotal year for Irish debt sustainability given the emergence of a primary budget surplus and a reduction in gross debt levels for the first time since the crisis began. Developments over the opening seven months of the year give us even more confidence that both will prove to be the case, while the upward revisions to the level of GDP has had a meaningful impact on the debt/deficit ratios.

We now estimate that the debt/GDP ratio will fall to 113% this year, down from 116% in 2013. The ratio is expected to then fall to 106% of GDP by the end of 2016. These ratios include cash and other assets. At the end of July, the NTMA note that it held €20.6bn in Exchequer cash. There is also the potential for some further recouping of its investments in the banks next year when it is anticipated that the government will sell off some of its stake in AIB.

This will reduce the cost to the Irish state further. The following table shows the latest estimates for the cost of the Irish banking crisis. In gross terms, the recapitalisation totalled €64.1bn (37% of GDP). This added 25 percentage points to the State's debt/GDP level, with the National Pension Reserve Fund (NPRF) contributing the remaining 12% of GDP.

Since then, the Government has recouped €10.3bn (6% of 2013 GDP) of its outlay, bringing the net cost of recapitalising the banking sector to €53.8bn (31% of 2013 GDP). It was recouped this by way of:

- €6.0bn from sales and redemptions: Aside from the €1.34bn received for the sale of Irish Life, all of the sales proceeds relate to Bank of Ireland. Through the sales of preference shares, equity and cocos, the Government has realised €4.7bn from Bank of Ireland which is equal to the amount that it initially injected. And;
- €4.3bn in fees paid to date by the banking sector for government guarantees.

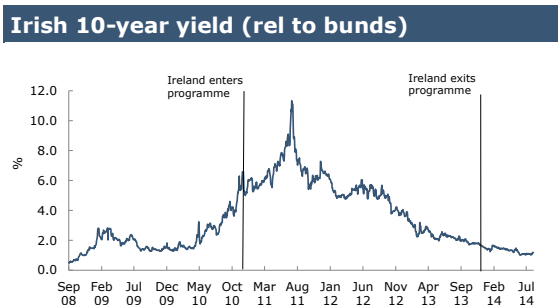
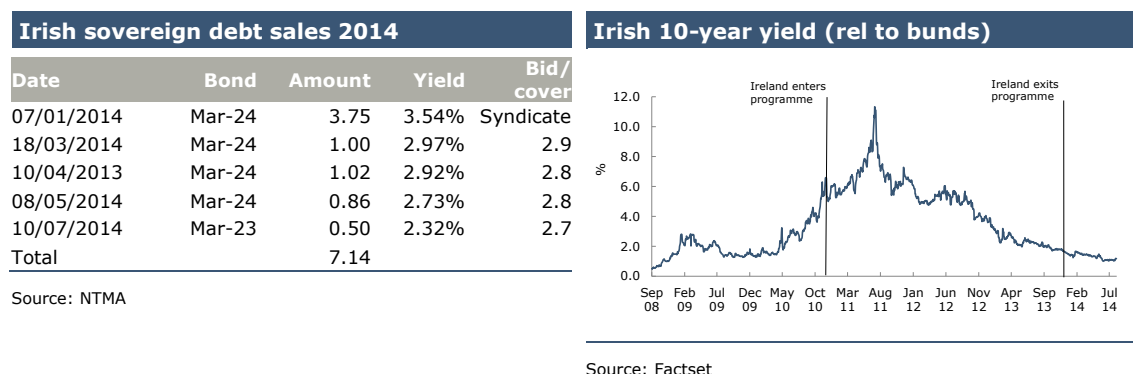
In addition to the realised gains outlined above, the government also holds stakes in the remaining going concern banks valued at €13.2bn (8% of 2013 GDP). This means that the overall net State investment into the Irish banking sector is currently €40.6bn or 23% of 2013 GDP.

Net State investment into Irish banking sector						
	AIB/EBS	BoI*	PTSB	IBRC	Total	% of GDP**
Total recap from State	20.7	4.7	4.0	34.7	64.1	37%
Sales/Redemptions	0.0	4.7	1.3	0.0	6.0	
Fees (ELG etc)	1.7	1.5	0.6	0.5	4.3	
Total Rec'd	1.7	6.1	1.9	0.5	10.3	6%
Net Cost to State	19.0	-1.5	2.1	34.2	53.8	31%
Value of stakes	11.6	1.2	0.4	0	13.2	8%
Overall impact on State	7.4	-2.7	1.7	34.2	40.6	23%
**2013 GDP	*0.27 price 14/08/2014					

Source: Department of Finance, Dail questions, Goodbody

Ireland should take advantage of low market rates to repay IMF loans

While there was some anxiety ahead of Ireland's re-entry to bond markets unaided in 2014, this concern turned out to be unfounded. The NTMA has sold €7.1bn long-term bonds since the beginning of the year, with each successive auction being sold at a lower yield. This has also been accompanied by a successful bill programme.



The NTMA is now within touching distance of its €8bn target for the full year, while, at the same time, has a significant cash buffer going into 2015. Funding requirements also look relatively small for 2015, with only €2.2bn of maturing debt and €5.5bn in Exchequer deficit funding. To this rather low hurdle, we believe that Ireland should target refinancing the majority of the IMF loans by the end of 2016.

There is currently €22.5bn of IMF loans outstanding that is attracting an average interest rate of 4.99%. Finance Minister Michael Noonan recently confirmed that talks are underway that may lead to the permission to repay the bulk of these loans early. As it currently stands, early repayment of any part of the Troika loans automatically triggers the early repayment of an equal amount of the other loans under the Troika programme. Therefore, agreement will be required to alter these rules at a European level, but we believe this will be agreed in the coming months.

Ireland's official loans			Potential funding (incl. IMF loan repayment)			
	Total	Interest rate		2014	2015	2016
IMF	22.5	4.99%	Starting cash balance	18,500	15,500	12,500
EFSM	22.5	3.06%				
EFSF	18.4	2.31%	Exchequer deficit	8,149	5,602	3,855
UK	4.0	1.78%	Maturing private debt	2,746	2,230	8,132
Sweden	0.6	1.34%				
Denmark	0.4	1.33%				
Total	68.4	3.39%				
Source: NTMA			Refinancing of IMF loans	5,000	10,000	5,000
			Change in cash	-3,000	-3,000	-1,000
			Funding target	12,895	14,832	15,987
			End-year cash balance	15,500	12,500	11,500
			Source: NTMA, Dept of Finance, Goodbody			

A refinancing of these loans would bring about significant financial benefits for the Irish state. It would be our preference for the NTMA to move beyond its traditional ten-year horizon as much as possible. Spanish 30-year yield currently stand at 3.75%, so Ireland should be able to fund itself for below 4% at this maturity.

Funding requirements over the period to 2016 are also likely to be reduced by the swapping of the 2016 bond into later maturities. We estimate that an annual saving of c.€400m per annum could be made by way of refinancing of the IMF loans by the end of 2016. To get to this calculation, we have used current Spanish bond yields as a proxy but the scale of savings will of course depend on market rates at the point of refinancing. The table below shows the sensitivity on the interest rate saving to changes in interest rates.

A refinancing such as this would also bring about the benefit of extending the maturity of Ireland's sovereign debt. Such an operation would represent the latest in series of successful actions to enhance debt sustainability by the Irish state.

Interest rate savings on refinancing of IMF loans – a scenario analysis						
		10-yr	15-yr	20-yr	30-yr	Total
Total amount (€m)	20,000					
Rate	4.99%					
Annual interest cost (€m)	998					
Refinancing		7,000	3,000	3,000	7,000	20,000
Assumed yield*		2.20%	3.10%	3.30%	3.70%	3.03%
Annual interest cost (€m)		154	93	99	259	605
Saving relative to current cost						393
Sensitivity						
+/- 10bps (€m)		7.0	3.0	3.0	7.0	20.0

Source: Goodbody

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