

“Living away beyond our means” — Charles Haughey, 1980

The cyclical picture continued to improve in October, with the unemployment rate actually falling (Chart 7) and new orders in both the manufacturing and services PMI reaching 49.7, just shy of the 50 mark which separates contraction from expansion. The NCB PMI growth indicator reached 49.9 in October (Chart B) and it is likely to breach the 50 mark next month. Both the PMI and labour market figures lend evidence to our belief that the economy will return to growth in Q4 of 2009. We expect the national accounts to remain extremely choppy over the next couple of quarters and the economy to fluctuate between quarter-on-quarter growth and contraction. Our forecasts, which were upgraded last month remain unchanged. The forecast is for the economy to contract by -6.7% this year in and -0.3% in 2010 (Appendix 1).

Problems solved! Well not quite. Firstly, emigration and increased participation in education by younger persons likely accounted for some of the fall in unemployment in October. That is not to dismiss the fall in unemployment. The latest available quarterly employment report showed that there was actually an increase in employment in certain sectors in Q2 (Table 1). All-in all the fall in unemployment is unequivocally a positive but it is too early to say that it has peaked.

Secondly, as outlined last month, even when the growth rate of the economy picks up it is likely to take until 2014/2015 for the economy to reach the level of activity that was prevalent in 2007. Unfortunately debt levels remain fixed, and in Ireland they now represent 200% of GDP even when financials are excluded (Chart 34). Lower levels of investment, lower levels of business spending, lower levels of income and a large level of debt are the reasons for caution on employment prospects and the Irish consumer. When this is combined with the structural problems related to the property crash and the banking sector we believe that the rebound in activity will not be as vigorous as suggested by the typical recovery from a recession in the medium-term.

Finally, Ireland is damned if it does and damned if it doesn't when it comes to the public finances. Ireland needs to correct its budget deficit which will have a deflationary effect on the economy but by not addressing the issue now the adjustment will be even greater down the line.

It is often forgotten that the fiscal consolidation effort is a multi-year project. The €4.75bn in savings that needs to be generated in 2010 is just the start. A further €4.6bn, €4bn and €3bn needs to be found in the years 2011, 2012 and 2013 respectively. This equates to approximately 7% of 2009 GDP. These savings will need to be found; year-to-date Ireland has borrowed €28.6bn or approximately 16% of 2009 GDP. Charles Haughey's words of 1980 are once again apt: “As a community we are living away beyond our means. I do not mean that everyone in the community is living too well. Clearly many are not and have barely enough to get by. But taking us all together, we have been living at a rate which is simply not justified by the amount of goods and services we are producing.”

People are shouting foul that they did not cause the problem and never saw any of the benefits of the boom years. Granted, a large part of the blame can be levelled at developers, bank directors, economists, regulators and the Government but the reality is that nearly everyone was complicit. Free education, higher public service pay, lower taxes, no income taxes, increased welfare payments, higher return-on-equity, child benefit increases, larger tax credits etc... all stemmed from an unsustainable property boom. Given the current operating system of Government, if these benefits had not been passed onto the public, the Government would have been voted out office and replaced by the opposition who would have duly obliged the public.

Currently the burden of adjustment is not being shared fairly across the economy. The private sector has seen both large pay cuts and employment cuts. As we have said on numerous occasions upward-only benchmarking is unjustifiable. Costs need to come down right across the entire economy. Public sector service and pay cuts will have a deflationary effect but it would be less deflationary than going after taxes in Budget 2010 and such measures will improve competitiveness. Ultimately this will be beneficial for growth and jobs. The unions, by opposing pay cuts in the public sector, are pulling up the draw bridge and protecting those with jobs to the detriment of the economy and in particular the young. Unemployment for those aged 20-24 was 23.0% at the end of Q2 up 15.2% from Q2 2007. For those aged 25-34 the rate was 13.4% (up 9.0% from Q2 2007). In comparison the rate was 9.9% (up 6.2%), 7.8% (up 4.3%), 6.2% (up 3.5%) and 5.7% (up 4.2%) for those aged 35-44, 45-54, 55-59 and 60-64 respectively.

Taxes are not immune forever though and will have to form a part of future budgets. The suggestion that a third higher marginal tax bracket be imposed is not practical. Only 10% of employees are currently paying tax at the higher level. Furthermore, the Minister for Finance revealed that 50% of all earners are now out of the tax net entirely. The tax base is based on an economy that no longer exists. More people will have to be brought into the tax net in the future whether that is via decreases in tax credits or a property tax.

The cyclical picture is clearly improving but many challenges lie ahead for Ireland.

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Quarterly growth, NCB activity indexes and projections...

- **Broad picture:** The NCB economic activity index improved marginally in August and signaled that underlying activity was still contracting at a -4% annualize rate. The indicator is designed to look at the underlying trend in economic activity and therefore will not be as volatile as the GNP/GDP figures. Our more timely, PMI based, growth indicator also continued rising in August and October (Chart B). The indicator registered 49.9 in October and is close to breaching the 50 mark which signals expansion.
- It now appears likely that the economy will begin growing again in Q4. The GNP and GDP figures will remain extremely choppy as the always do but it is now conceivable that the underlying trend in growth will remain positive. Previously we had envisaged the economy bottoming in H1 2010 and returning to sustainable growth in H2 but with income taxation apparently off the table for Budget 2010 and a rather resilient economy in Q2 it looks like the economy will bottom in H2 2009 (Chart C).

Chart A: NCB Irish Economic Activity Index*, saar%

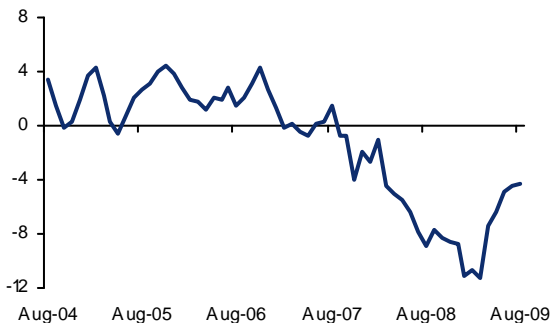


Chart B: NCB PMI growth indicator, >50=growth**

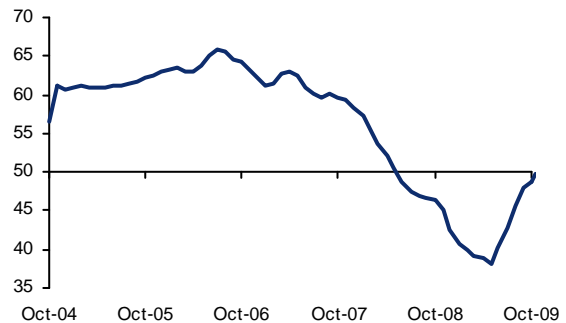
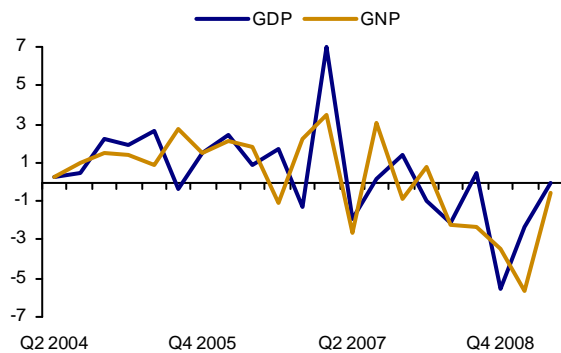


Chart C: Irish GDP, saar €bn



Chart D: Irish q/q% chg in GDP/GNP



Sources: Datastream, CSO, Central Bank of Ireland, NCB, authors' calculations

* The NCB Economic Activity Index is designed to obtain a measure of the underlying trend in economic activity in Ireland. The index is created by manipulating the time series characteristics of the underlying data. The underlying data consists of monthly consumer, housing, industrial, external and financial data.

** The NCB PMI growth indicator is calculated using the NCB manufacturing PMI, the NCB services PMI, the Ulster Bank construction PMI and lagged values of GDP. The indicator was rebased this month so rather than a breach of zero signaling growth the more familiar 50 mark is used as the growth line.

Activity indicators, growth...

- Broad picture:** The PMI readings in October, although continuing to signal contraction, were encouraging. The Manufacturing PMI increased from 46.6 to 48.0, while the services PMI increased from 45.5 to 47.7. The real positive was that overall new orders increased to 49.7 for both the manufacturing and services sectors. New export orders in the services sector actually increased for the second month running. With the current momentum in global economic activity we believe that the manufacturing and services PMIs should breach the 50 mark by the end of 2009. Our PMI growth indicator which is a smoothed indicator based on the PMIs and GDP is likely to breach the 50 next month.

Chart 1: NCB manufacturing PMI

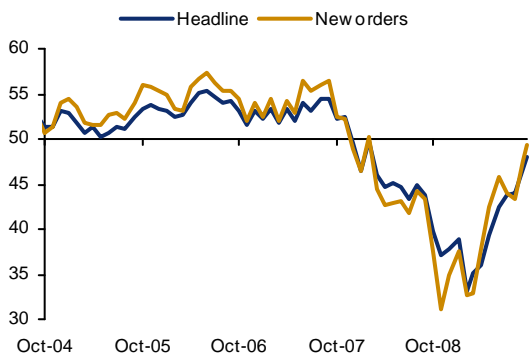


Chart 2: NCB services PMI

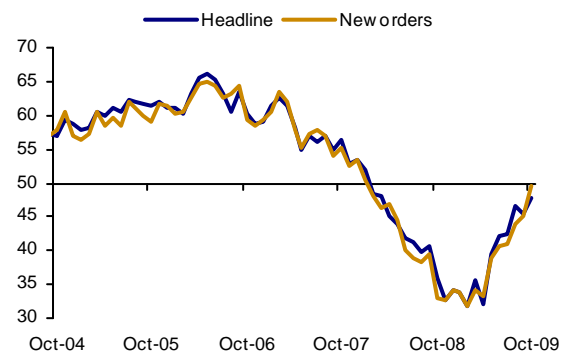


Chart 3: Ulster Bank construction PMI

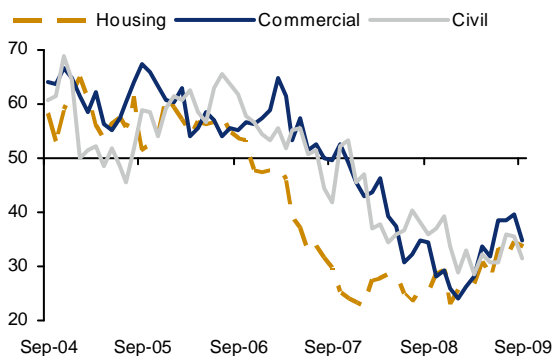


Chart 4: NCB growth indicator, >0 = growth

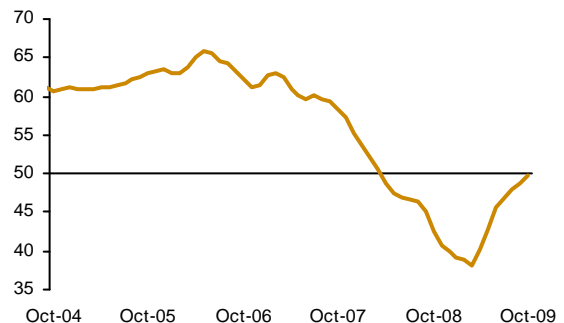


Chart 5: Value €bn and q/q% chg in volume of GNP and GDP

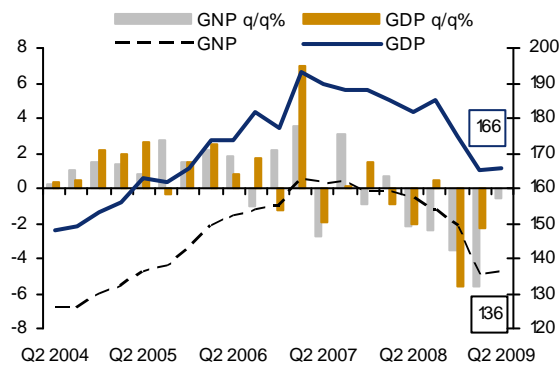
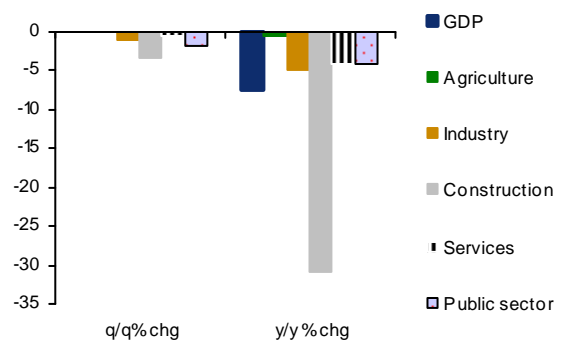


Chart 6: y/y % chg GDP and sector



Consumer and labour market ...

- Broad picture:** The seasonally adjusted live register fell by -3,000 in October. This is the first outright fall in the seasonally adjusted Live Register since September 2006. The seasonally adjusted unemployment rate also fell from 12.6% to 12.5% (Chart 7). Emigration and increased participation in education by younger persons likely accounted for some of the fall in the Live Register. However, it has to be remembered that the quarterly employment report, latest available Q2, showed that there was a marginal increase in hours worked and also part-time employment which can be seen as leading indicators of the employment market. In fact in some sectors there was an increase in employment in Q2 (Table 1). So all-in all the fall in unemployment is unequivocally a positive. It must not be forgotten though that the level of unemployment is still extremely high.
- Note, retail sales fell on an m/m basis in August for the first time since January, while retail sales ex-motors fell for the first time since April:** (Chart 10). Retail sales in July and August were still 3.2% ahead of Q2 but it would be a worry if the August fall was the start of a new trend. To date, price discounting has supported the volume of consumption and we do expect that to continue but there is a danger that energy cost rises hamper that process.

Chart 7: Live register data, sa

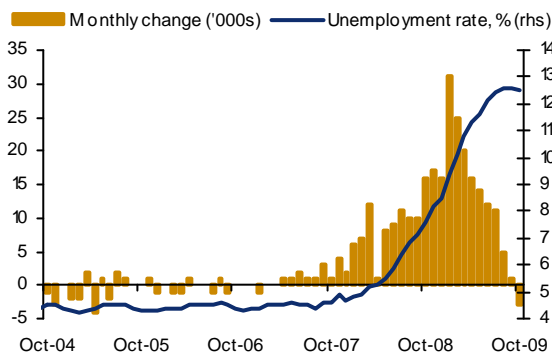


Table 1: Employment by broad sector, '000s

Name	Q2 2009	q/q %chg	y/y a.chg
Agriculture & others	97.8	-2.9%	-23.6
Industry	259.9	-2.8%	-29
Construction	158	-12.9%	-86
Wholesale & retail	279.8	-1.4%	-29.6
Transport & storage	94.2	1.2%	1.7
Hotels & restaurants	119.6	1.2%	-5.6
Business, IT & science	72.2	-0.1%	-18.4
Public, education & health	108.3	1.1%	16.1
Total	102.5	-1.8%	-174.4

Chart 8: Irish inflation, y/y %

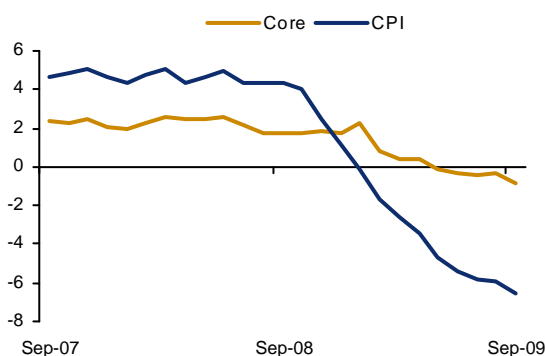


Chart 9: Consumer confidence, 3 month ma

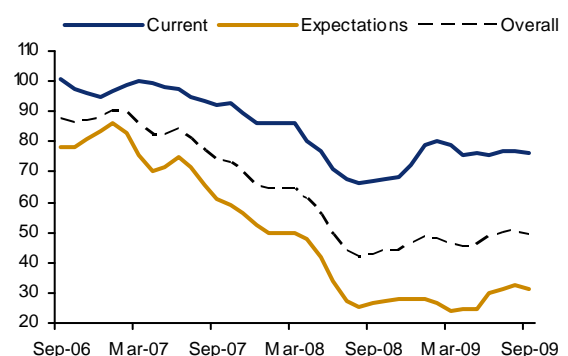


Chart 10: Retail sales ex motors, 3 month ma

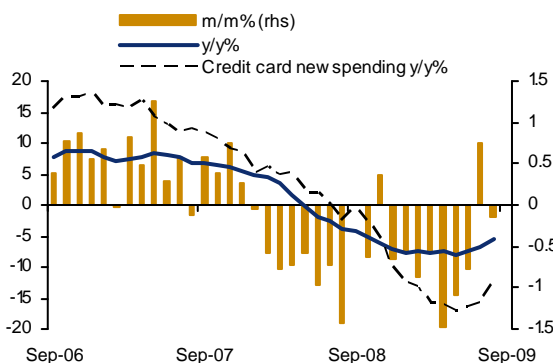
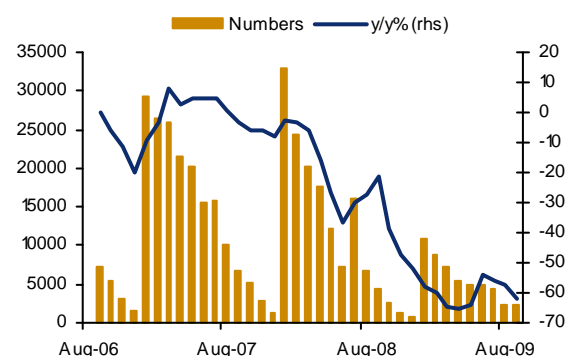


Chart 11: Cars licensed for first time



Housing market ...

- Broad picture:** House prices continued their downward trudge, falling 1.1% m/m in September. The lagging tsb/esri index is now 25% off the peak (Chart 13). Daft asking prices are down 28% from the peak. As a rough rule of thumb, we assume that achieved prices are 5-10% below asking prices putting the actual decline at approximately 35%. According to Daft asking prices in Dublin are 35% of the peak, implying that achieved prices could be between 40-45% off the 2007 peak. Dublin house prices have fallen more, because they rose more during the boom period and also because there are more transactions in the Dublin market than elsewhere, which is helping the market find the bottom. The Dublin and Mid-East (Meath, Kildare, Wicklow) regions are less oversupplied than other parts of the country and as such we expect prices to perform better in those areas than other parts of the country once the bottom has been found.
- Given the oversupply problem in the country, it is not surprising that commencements continue to fall, reaching a seasonally adjusted annualized rate of 7,000 in September. The fall off in commencements, rather than any major uptick in mortgage drawdown's has seen the properties available for sale and rent level off. (Chart 16).

Chart 12: Tsb/ESRI house price index, 3ma chg

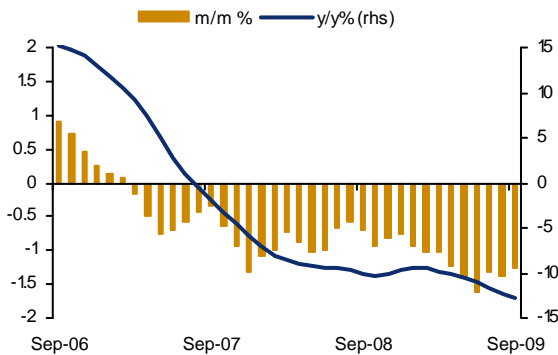


Chart 13: House prices, peak to trough

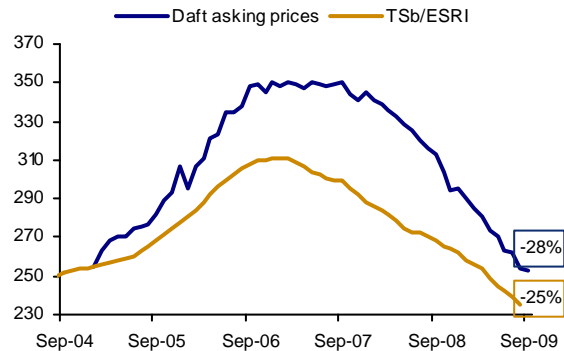


Chart 14: Rate of house building sa annualised, '000's

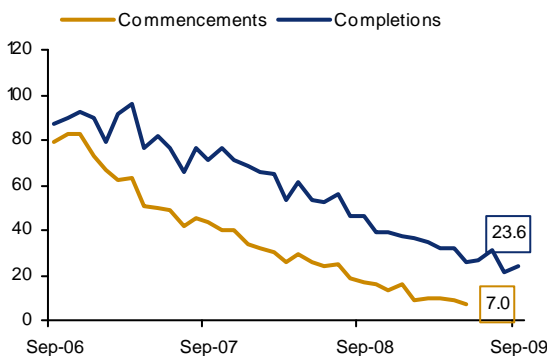


Chart 15: Mortgage drawdowns, monthly rate sa annualised, '000's

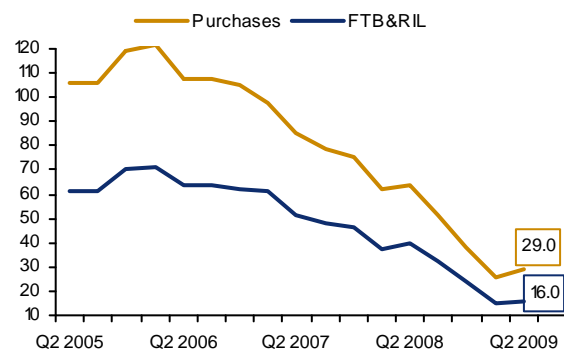


Chart 16: Daft stock of properties

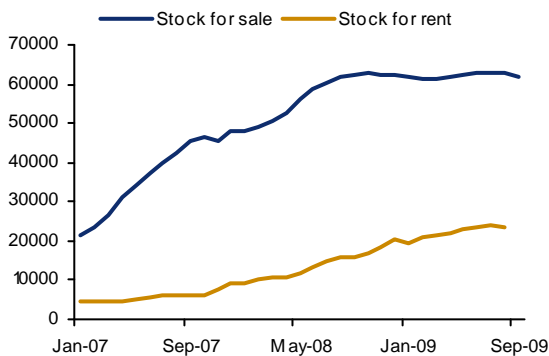
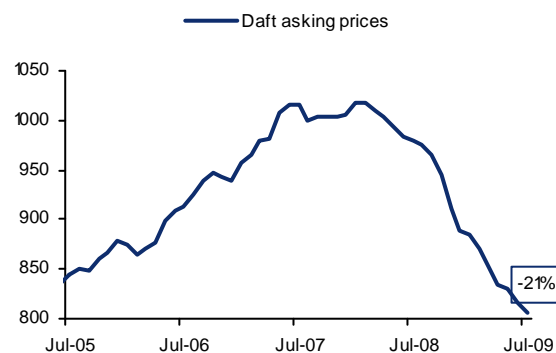


Chart 17: Peak to trough in rental prices



Government finances...

- Broad picture:** In the year to October the exchequer deficit was -€22.7 billion. Voted current expenditure was largely in line with the Government's end of year targets while the much smaller category of voted capital expenditure was ahead of target. The decrease in the price of goods coupled with an underestimation of the level of wage cuts in the economy has left VAT and income tax 6.4% behind the Department of Finance's targets. The tax take in total is €1,074 mn behind the Government's target for the year to October. The shortfall for the full year is now expected to be €2bn, implying a full year exchequer deficit of €26.1bn.
- Note, €28.6bn or approximately 16% of GDP has been borrowed to date in 2009.** The interest payment on this debt is manageable in the current low interest rate environment and this has been taken by some as an excuse to maintain the status quo. Interest rates are not in Ireland's control, although Ireland has a vote in their determination, the reality is that they are determined largely by the performance of the 4 big economies in the Euro area which make up 78% of Euro area GDP. Spain is still reeling, Italy is Italy but France and Germany are beginning to show signs, not only of stabilization but strength. Although we expect rates to remain on hold until the end of H1 2010, the prospect of rate hikes is coming forward. Ireland's Government debt is on an unsustainable path. If the fiscal correction is done properly then the situation will be redeemed. If the correction is only half-hearted and bows to lobbying then higher than expected interest rates will ensure that the debt follows an unsustainable path.

Table 2: Tax take to October 2009, €mn

	€mn	% behind (-) target
Income Tax	9,202	-6.40%
VAT	8,952	-6.40%
Corporation Tax	2,827	9.90%
Excise	3,732	0.70%
Stamps	729	-5.70%
Capital Gains Tax	235	-22.10%
Capital Acquisitions Tax	217	-8.70%
Customs	171	-11.10%
Total	26,096	-4.00%

Table 3: Voted Expenditure, €mn

	€mn	% ahead (+) of target
Current	33,868	+0.3%
Capital	4,958	+8.7%
Total Net Cumulative Voted Spending	38,827	+1.4%

Chart 18: Cumulative government accounts, €mn

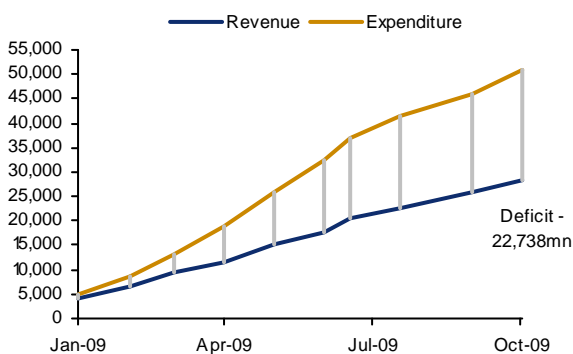


Chart 19: Cumulative borrowing €mn

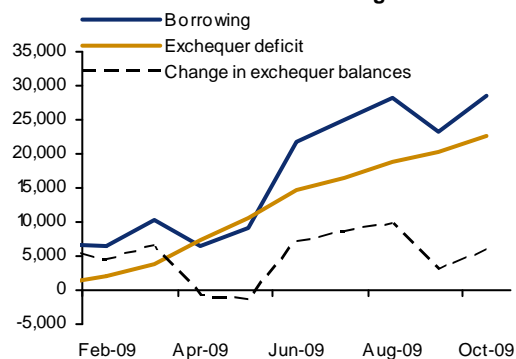


Chart 20: 5 year CDS various countries, bps

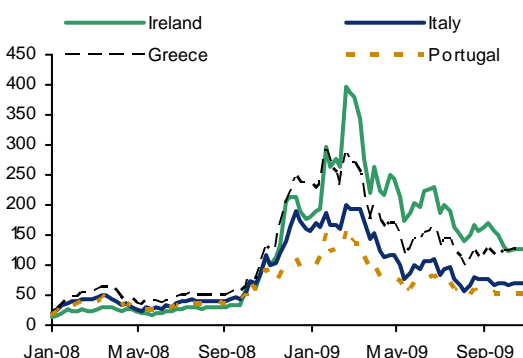
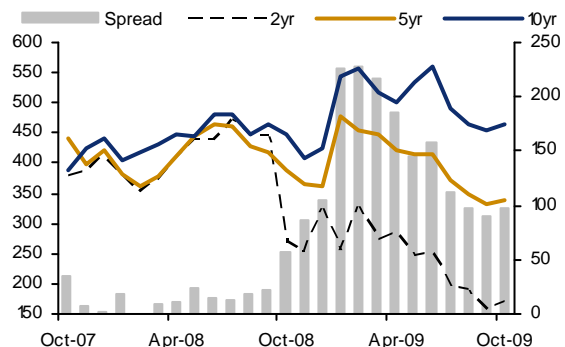


Chart 21: Irish government bonds & spread over German 5 year (rhs), bps



Industrial production and external sector...

- Broad picture on industry: The pace of decline in industrial production continues to moderate. The overall figure however hides the stark dichotomy between the modern sector and all other sectors (Chart 23). The modern sector exports approximately 85% of its produce and it is this sector that is driving exports which increased marginally (0.2% q/q) in Q2 but still continue to fall on a y/y basis (Chart 25).
- Note, the chemical sector is continuing to drive the modern sectors impressive performance. Within the modern sector cyclical sectors such as office machines and electrical equipment are also suffering (Chart 26).
- Sterling has strengthened relative to the euro by 5% over the last number of days but the level (0.90p) still poses serious challenges to the more employment intensive traditional sector. Ireland still remains expensive relative to its trading partners in terms of unit labour costs and any movement in sterling will make Ireland less competitive (Chart 30, overleaf).

Chart 22: Industrial production, 3ma m/m%

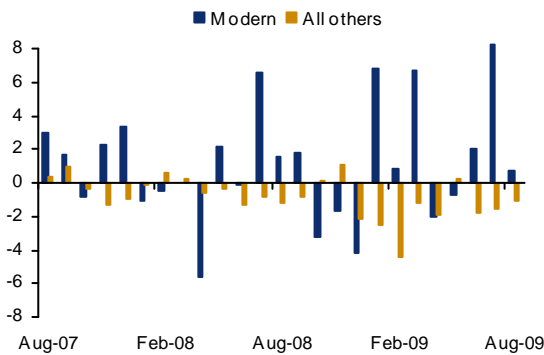


Chart 23: Industrial production, 3ma y/y %

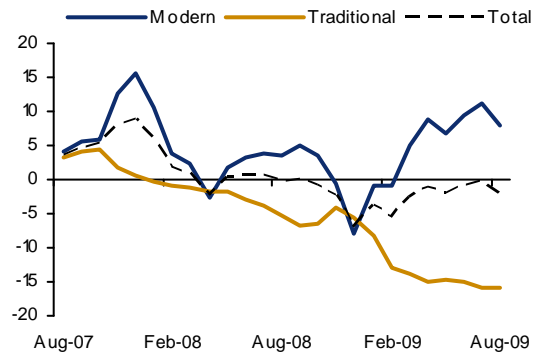


Chart 24: Industrial new orders, 3ma

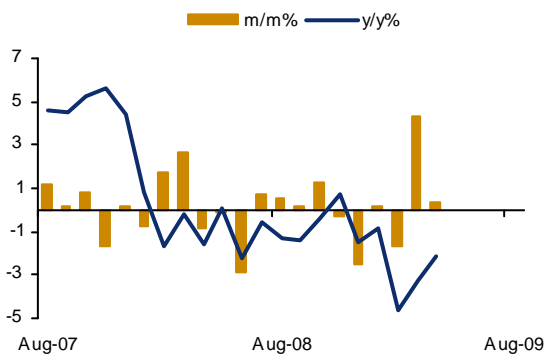


Chart 25: Merchandise exports, volume 3ma

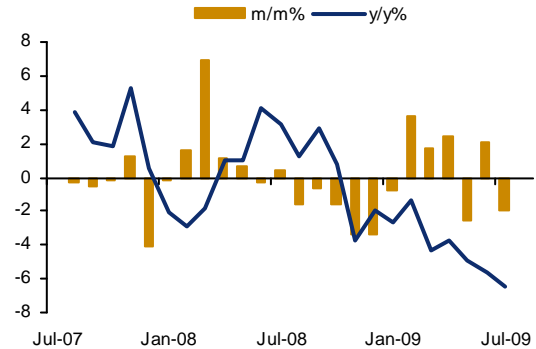


Chart 26: Value of exports by sector, 3ma y/y%

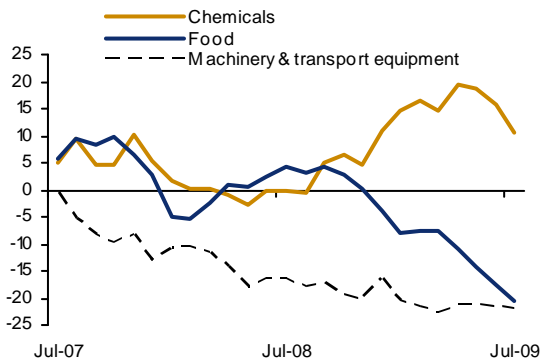
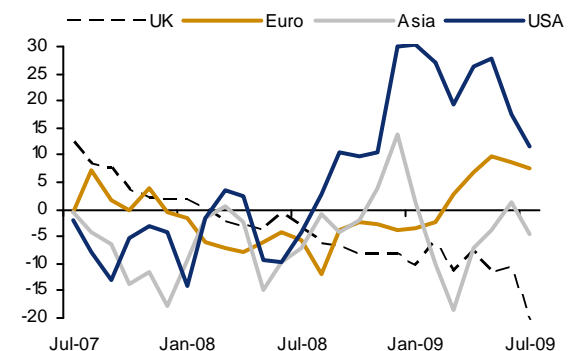


Chart 27: Value of exports to country, 3ma y/y%



External sector continued ...

- Note: Merchandise imports remain weak as services imports remain robust (Chart 28 and 31). The former is driven by a weak domestic economy while the latter is driven by royalties/licenses and miscellaneous business services (advertising, R&D and inter-affiliate management charges) or more simply the “inputs” for multinational firms.
- Broad picture on external sector: The merchandise trade surplus continued to widen as Chemical exports remained robust and merchandise imports remained subdued. On the other hand the services deficit remained wide as services exports struggled (0.2% y/y) in Q2 while services imports boomed. There is never a strict dichotomy between the merchandise balance and the services balance but this is especially so in the case of Ireland as many of the inputs for merchandise exports are services imports of royalties and licenses. Nonetheless the totality of it all, is that the current account deficit narrowed sharply from 6.2% to 2.9% in Q2 2009 (Table 4).

Chart 28: Merchandise imports, volume 3ma

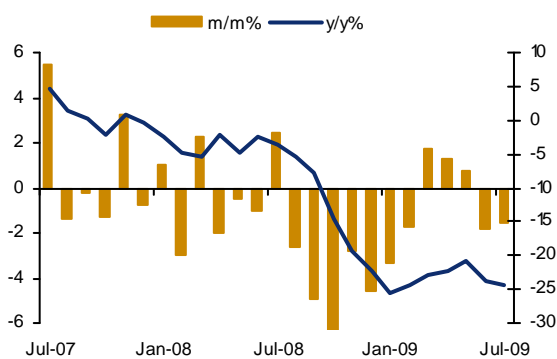


Chart 29: Value of imports by sector, 3ma y/y%

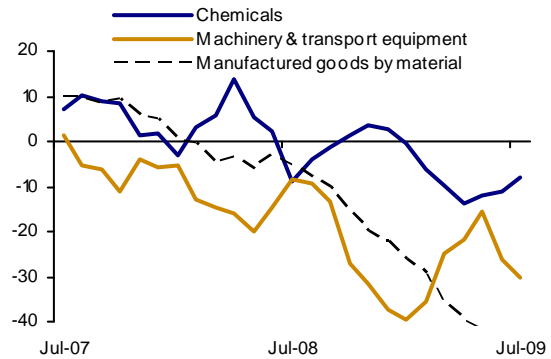


Chart 30: Effective exchange rate, relative to 25 trading partners

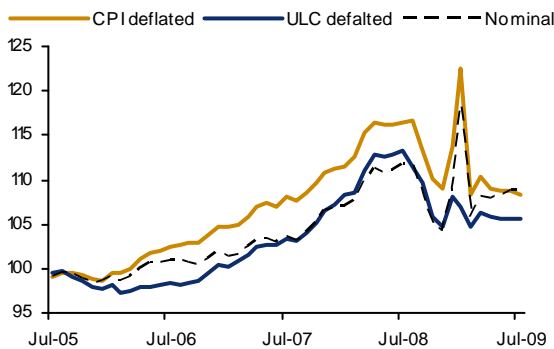


Chart 31: Services volumes, y/y%

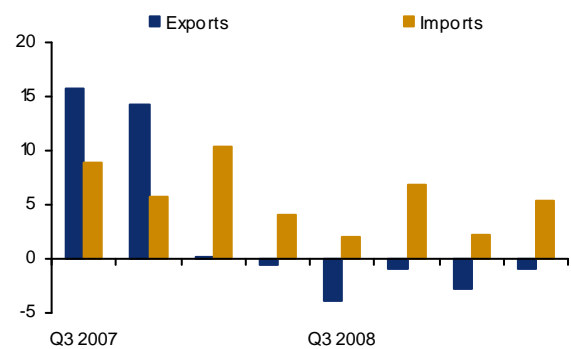
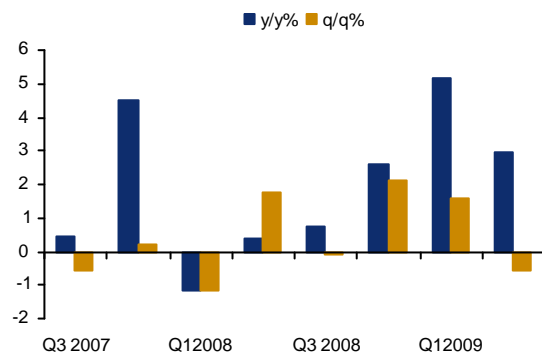


Table 4: Balance of payments

	2008	Q1 '09	Q1 '09
Merchandise exports	81,495	20,536	20,790
Merchandise imports	57,675	12,516	11,474
Merchandise balance	23,819	8,020	9,316
Services exports	69,203	16,049	17,029
Services imports	74,574	18,230	19,156
Services balance	-5,370	-2,180	-2,127
Income balance	-26,770	-7,596	-7,789
Current transfers	-1,115	-784	-604
Current account balance	-9,435	-2,542	-1,204
CA as a % of GDP	-5.1%	-6.2%	-2.9%

Chart 32: Net exports contribution to GDP, %



Private sector credit ...

- **Broad picture:** The pace of credit growth continued to slow as credit growth to a wide range of sectors contracted (Chart 33). Not surprisingly credit extended to the construction sector showed the sharpest contraction (Chart 34).
- **Note:** interest rates for house purchase have appeared to bottomed but demand for mortgages still remains subdued according to the latest bank lending survey (Chart 35 & 36). Similarly, credit standards for mortgages remain tight adding further problems to the demand side of the housing market.
- **Note:** the increase in deposits at retail clearing banks (Chart 37). The increase in deposits reflects both a push by banks to obtain deposits, which they are paying up to gather (Chart 38), and also the increase in the savings rate which we expect to rise towards 11% this year from 4% last year.

Chart 33: Private sector credit, y/y% chg

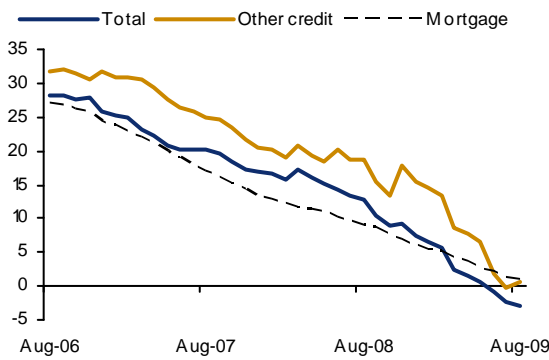


Chart 34: Sector breakdown of credit outstanding, Jun'09

	€mn	y/y% chg
Construction	19,002	-23.0
Wholesale/retail trade	13,236	-3.8
Hotels & restaurants	11,295	-7.8
Real estate & business activities	95,563	0.5
Of which real estate	89,401	1.7
Personal	170,724	-0.1
Of which residential mortgages	148,138	1.9
All others (excludes financials)	24,669	-6.4
Total (excluding financials)	334,486	-2.5

Chart 35: Various interest rates, %

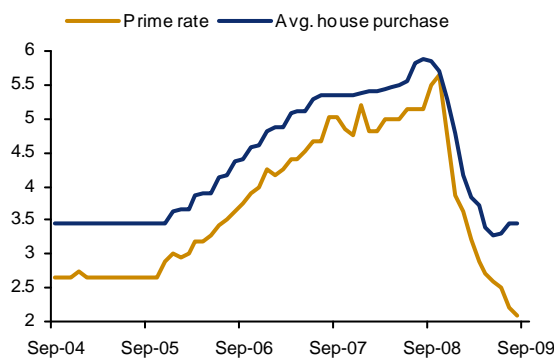


Chart 36: Bank lending survey, credit standards

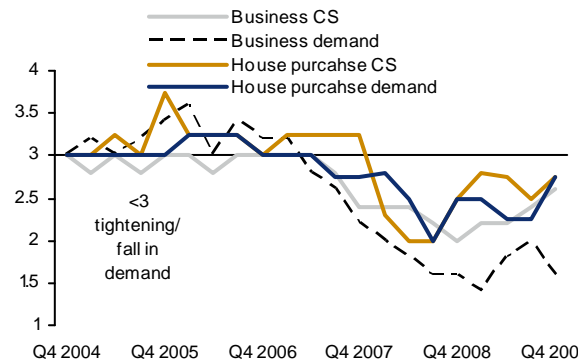


Chart 37: Retail clearing banks

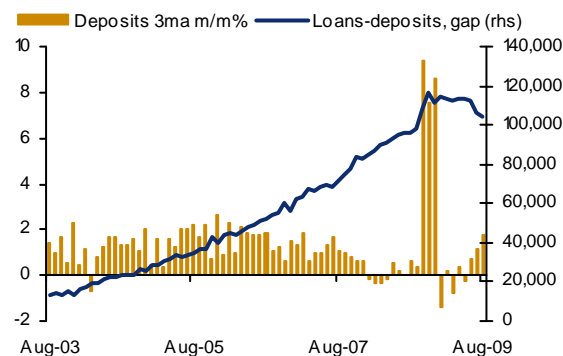
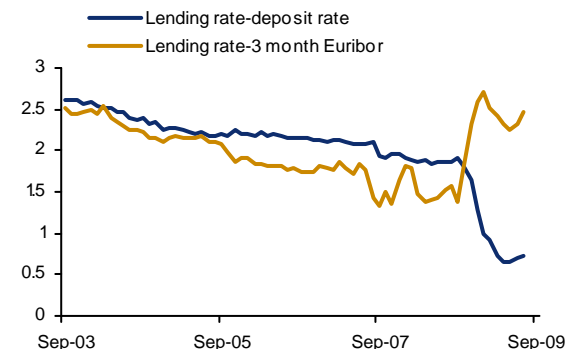


Chart 38: Spread between lending rates and deposit/interbank rates, %



Appendix 1: Annual data and forecasts

y/y% changes unless otherwise stated

	'2006	'2007	'2008	'2009	'2010	'2011	'2012	'2013
GNP	6.3	4.4	-2.8	-8.6	-0.5	2.5	2.6	2.9
GDP	5.4	6.0	-3.0	-6.7	-0.3	2.6	2.8	2.9
Components of GDP								
Consumption	6.6	5.9	-1.0	-7.3	-0.3	2.1	2.7	2.4
Government consumption	5.8	6.9	2.6	-0.4	-2.8	-1.4	-1.0	-0.7
Investment	4.0	2.3	-15.5	-29.4	-11.2	2.1	4.6	5.6
Gross Domestic expenditure				-11.4	-3.3	1.4	2.3	2.3
Exports	5.1	8.6	-1.1	-3.2	2.8	2.9	3.2	3.7
Imports	6.5	5.7	-2.1	-8.0	0.6	1.7	2.7	3.3
Prices								
CPI	3.9	4.9	4.1	-4.3	-1.4	1.5	2.2	1.7
HICP	2.7	2.9	3.1	-1.9	-1.0	1.1	1.8	1.7
Labour market indicators								
Employment	4.1	2.9	-4.0	-7.7	-1.5	1.7	1.5	2.1
Unemployment rate (year avg)	4.4	4.6	6.3	12.2	13.0	12.1	10.9	9.9
Government finances								
Revenue receipts (€ millions)	48,016	49,294	43,022	35,572	37,180	40,139	42,805	45,752
Expenditure outlays (€ millions)	45,751	50,914	55,735	57,132	56,945	58,773	59,403	59,717
Exchequer balance (€ millions)	2,265	-1,619	-12,714	-21,560	-19,765	-18,634	-16,598	-13,965
General government deficit to GDP (%)	2.9	0.5	-6.9	-11.8%	-10.9%	-9.4%	-5.5%	-3.6%
Gross debt to GDP, not including NAMA (%)	27.3	24.7	41.5	61.7%	74.9%	81.8%	84.4%	84.2%
Financial indicators								
Current account deficit (% GDP)	-3.6	-5.3	-5.2	-3.2	-2.1	-1.8	-1.5	-1.3
EUR/GBP (year avg)	0.68	0.68	0.79	0.86	0.86	0.83	0.81	0.80
EUR/USD (year avg)	1.26	1.37	1.47	1.36	1.39	1.41	1.45	1.47

Appendix 2: Quarterly data

Seasonally adjusted q/q% changes unless otherwise stated

Name	Q3 2008	Q4 2008	Q1 2009	Q2 2009	Q3 2009
GNP, saar €bn	153796	148764	134692	135688	
GDP, saar €bn	185344	175156	165276	166116	
GNP	-2.37	-3.5	-5.63	-0.55	
GDP	0.45	-5.55	-2.31	-0.02	
Components of GDP					
Consumption	0.26	-2.27	-5.23	0.51	
Government consumption	-1.01	0.93	0.09	-0.91	
Investment	1.2	-17.7	-13.7	5.7	
Gross Domestic expenditure					
Exports	-0.65	-1.23	-0.72	0.19	
Imports	-0.59	-4.4	-3.06	1.02	
Prices					
CPI	0.5	-0.45	-2.76	-2.1	-2.1
HICP	0.39	-0.17	-1.06	-0.74	-0.74
Labour market indicators					
Employment	-1.43	-1.84	-3.37	-1.83	-1.83
Unemployment rate (period end)	6.8	8.1	10.1	11.6	11.6
Government finances (€ millions)					
Revenue receipts	9582	12593	9433	8284	8284
Expenditure outlays	13338	15902	13154	19272	19272
Exchequer balance	-3756	-3310	-3721	-10988	-10988
Financial indicators					
Current account deficit, % GDP	-6.25	-0.76	-6.15	-2.9	
EUR/GBP, avg	0.8111	0.84875	0.8989	0.86175	0.8815
EUR/USD, avg	1.45895	1.25955	1.25895	1.4157	1.43035
ECB refinancing rate, period end	4.25	3.25	2	1	1

Appendix 3: Monthly data

		July	Aug	Sep	Oct
Activity indicators:					
NCB Economic Activity Index	saar %	-4.2	-4.0		
NCB PMI based Indicator	sa, >0=growth	45.7	47.9	48.7	49.9
NCB Services PMI	sa, >50=growth	42.4	46.7	45.5	47.7
NCB Manufacturing PMI	sa, >50=growth	43.7	44.0	46.6	48
Ulster Bank Construction PMI	sa, >50=growth	37.9	38.8	34.2	
Industrial Production	m/m% chg	7.9	-16.7		
	y/y% chg	6.2	-13.7		
Labour market indicators:					
Live register	Actual numbers	435,700	440,100	419,854	412,407
Live register	sa, monthly change	10500	5300	200	-3000
Unemployment rate	sa, %	12.2	12.6	12.6	12.5
Consumer indicators:					
Consumer confidence	Index	49.5	48.7	49.6	54.2
Retail sales	sa, m/m% chg	1.93	-1.05		
	nsa, m/m% chg	-14.6	-8.8		
CPI	nsa, y/y% chg	-0.78	0.39	-0.39	
	nsa, y/y% chg	-5.86	-5.9	-6.5	
HICP	nsa, m/m% chg	-0.84	0.19	-0.37	
	nsa, y/y% chg	-2.56	-2.37	-3.01	
Housing indicators					
Tsb/esri house prices	nsa, m/m% chg	-1.49	-1.14	-1.49	
	nsa, y/y% chg	-13	-13.1	-13	
Commencements	Actual numbers				
Completions	Actual numbers	2,350	1,630	2,100	
Balance of payments					
Merchandise exports	sa, m/m% chg	-5.23			
	nsa, y/y% chg	-6.2			
Merchandise imports	sa, m/m% chg	-29.1			
	nsa, y/y% chg	-29.8			
Trade balance	sa, € millions	3,248	2,952		
Financial indicators					
Private sector credit	nsa, y/y% chg	-3	-4.26	-5.28	
ISEQ	Month end	2691.41	3036.69	3304.28	2873.07
5 year CDS	Month end, bps	184.035	161.96	133.54	139.775
5 year bond yield	Constant maturity, %	4.0996	3.5242	3.4082	3.3762
Spread over German 5yr	Constant maturity, bps	153.732	104.3949	97.943	96.231

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