

Global recovery is now underway

- Asian-led pick-up in global growth now clearly in train. Closer to home, the recovery dynamic has kicked in in most of Ireland's main trading partners, notably the US and eurozone, though the UK has yet to record positive growth, in GDP terms at least
- Turnaround in growth prospects partly reflects much improved financial conditions, as policy-makers are rewarded for their extraordinary efforts

Momentum is strong so double-dip scenario seems unlikely

- Recovery faces headwinds and risks. However, momentum looks strong and policy remains very supportive so we expect the global recovery to be maintained, with a double-dip scenario an unlikely outcome
- 2010 will likely mark the beginning of the process of interest rate hikes, with the Fed and BoE leading the way in Q3 and ECB following in Q4

80p Eur/Stg forecast pushed out, not abandoned

- Yet more monetary stimulus from the BoE in recent months and disappointing Q3 UK GDP data represented a setback to our previous year-end 80p forecast
- However, we still believe in sterling's ability to recover against the euro and view 80p as a reasonable target by mid-2010

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Global Recovery Takes Hold – Double-dip unlikely

The extraordinary efforts of policy-makers in managing the financial crisis have continued to show important signs of pay-off in recent months. Financial conditions across the markets are much improved, risk aversion has subsided, risk premia and spreads have narrowed considerably and risky assets such as stock markets have rallied strongly, with many markets up over 50% from their early March lows. That is not to suggest that all has suddenly become rosy again in the financial system. Strains are still evident in important areas. Notably, credit conditions remain tight and bank balance sheets remain under pressure reflecting the impact of what has been a particularly severe recession.

However, the better financial market environment has fostered improvement in economic conditions, too. Global recovery is now clearly underway, led by a sharp turnaround in Asia. Notably, growth in China was quick to reaccelerate in Q2 and picked up further in Q3, helped by large-scale stimulus measures.

Closer to home, the summer months marked the end of recession for most of Ireland's main trading partners, many of whom are also now in recovery mode. The US economy had its strongest quarter in two years in Q3, managing a strong 3.5% increase in GDP (in annualised terms). The euro zone is also growing again confirmed by a 0.4% expansion in the September quarter, boosted by a second consecutive quarterly increase in output in Germany and France. Disappointingly, the UK has been something of an outlier, recording an unexpectedly weak 0.4% fall in GDP in Q3, though the turnaround in many other economic indicators in the UK points to an improving trajectory.

As we look forward, a key question is whether sustained recovery takes hold or whether recent indications of improvement peter out and give way to a 'double-dip' scenario. We think the global recovery has legs and expect it to be maintained. Important support in the coming quarters will come from the standard turnaround in the inventory cycle, the strength of momentum behind the improvements in key cyclical indicators and the firm commitment of policymakers to keep huge stimulus in place for as long as necessary.

But to be confident about the sustainability of the recovery, it will be

necessary to see signs of a broadening out of economic improvement beyond areas boosted by transitory but important influences such as stock-rebuilding and policy stimulus. We take some early encouragement in this regard from developments in the US where indications of broad-based improvement have lately become evident.

But a key issue in the debate about sustainability is what will happen to labour markets. In this respect it is vital that the expected increases in output in the quarters ahead translate into an end to worker layoffs and a resumption of hiring. Increased employment is vital to sustained recovery as without it consumer spending prospects will lack the key and fundamental support from rising incomes. For this reason, indicators on labour markets, especially in the US, will be critical in shaping perceptions of recovery in the months ahead.

The recovery does face important headwinds including from ongoing strains in bank balance sheets, and the likelihood of further rises in savings rates in the US and UK as households take stock of the significant hit to wealth over the downturn. And elevated (and still rising) unemployment rates highlight both the risks to sustained increases in consumption as well as the large amounts of spare capacity which have built up as a result of the sharp contraction in output.

In this context, central bankers have remained very cautious about the outlook and hence, up to now, have played down the likelihood of any near-term tightening of monetary policy.

However, if economic conditions continue to improve, it will over time become necessary to make corresponding adjustments to the policy stance. Just as extreme weakness in economies warranted an extreme easing of monetary conditions, a normalisation of the economic environment will necessarily require a corresponding normalisation of monetary settings, including interest rates.

Thus it is our expectation that 2010 will mark the beginning of the process of monetary policy normalisation. This will involve a reduction in special liquidity provision, cessation and some reversal of financial asset purchases (QE) as well as the commencement of a normalisation of the interest rate stance. We expect the Fed and Bank of England to begin raising official interest rates in Q3 and for the ECB to follow suit later in the year. We are pencilling in a 0.50% hike in ECB rates in the final quarter, though it could come sooner if growth recovers more strongly than we expect.

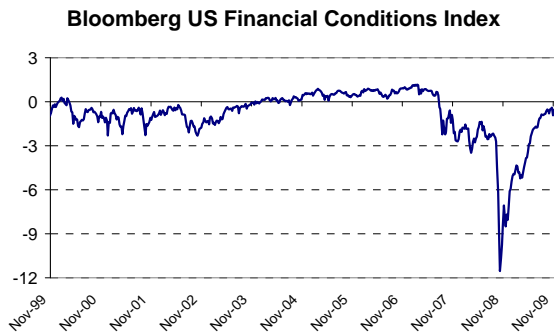
Finally, to the currency markets. Sterling had been trading much better over the summer months and got to as high as 84p to the euro as recently as August. However, an unexpected expansion of the Bank of England's QE programme in August, and the disappointing Q3 GDP number have pulled the UK currency lower again since then. These developments represented a set-back to our 80p end-year forecast, a target which we still think is reasonable, albeit that we have pushed it out to the middle of next

year, predicated on the BoE hiking rates before the ECB. The dollar remains under pressure as its close correlation with market risk appetite remains a prominent theme in the currency arena. Momentum behind the stock market rally looks strong, which means the dollar is likely to continue to weaken. We have a \$1.55 target vs. the euro for the coming months before an eventual turn in the Fed's policy guidance triggers a dollar recovery to around \$1.40 later in the year.

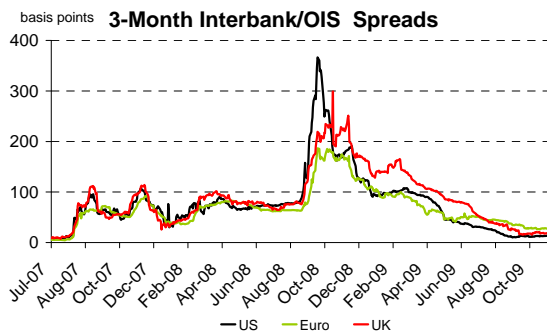
	Forecasts (end period)				
	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
Interest Rates					
Eur					
ECB Refi	1.00	1.00	1.00	1.00	1.50
5yr Swap	2.80	3.00	3.40	3.60	3.70
US					
Fed Funds	0-0.25	0-0.25	0-0.25	1.00	1.50
5yr Swap	2.60	2.90	4.00	4.30	4.50
UK					
Bank Rate	0.50	0.50	0.50	1.00	1.50
5yr Swap	3.40	3.65	4.30	4.50	4.60
Currencies					
EUR/USD	1.52	1.55	1.46	1.40	1.38
EUR/GBP	0.87	0.85	0.80	0.80	0.82
GBP/EUR	1.15	1.18	1.25	1.25	1.22
GBP/USD	1.75	1.82	1.83	1.75	1.68
EUR/JPY	130	135	132	130	130

Recent Financial Market Developments

Payback for policymakers continues...financial conditions across the markets have improved considerably in recent months...



... Spreads in the important interbank money markets are now below pre-Lehman levels ...



Conditions across many areas of the financial markets have continued to improve in recent months. Risk premia in many arenas have fallen, sharply in cases, as investors have become increasingly confident that worst case scenarios for the global economic outlook, as well as for the financial system, will be avoided.

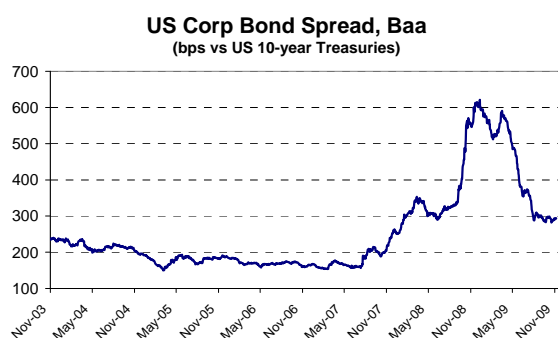
The resolute support of policy-makers has continued to play a key role here of course. At a macro level, the huge amounts of both fiscal and monetary stimulus have significantly lowered the risk of what was a severe recession turning into something much worse. Indeed, as we outline in the sections below, growth has now turned positive in most major economies. At a micro level, huge amounts of extra liquidity and other targeted measures have improved the functioning of and increased activity in many markets.

Notably, spreads in the important interbank money markets have tightened significantly and are back to well below pre-Lehman levels in euros, dollars and sterling. In 3-month euros, for example, the key Euribor-OIS spread has gotten to as low as 0.3%, from a crisis peak of 1.8% and around 0.5% as recently as May. While these spreads are still higher than they were before the crisis hit in the Summer of '07, we confess to being a bit surprised at the extent of spread compression here. We had felt that the post-crisis equilibrium might have resulted in a larger spread of perhaps 0.40%. It remains to be seen what range this spread ultimately settles down in, but for now we note that its relatively low level helps the transmission mechanism between low official interest rates and low market rates.

Spreads in corporate funding markets have also narrowed substantially. Take the difference between yields on investment-grade corporate bonds and those of government bonds in the US, for example; such spreads have tightened enormously from levels last seen in the Great Depression in the 1930s at the height of the crisis. The decline of some 3% in the past few months takes spreads back to levels last seen in late 2007. And large corporates have certainly availed of the better market conditions. The \$800bn of issuance (i.e. fund-raising) in the US soaked up by investors in the first three quarters of this year represents a record level of fund raising and highlights the extent to which risk appetite has picked up.

And stronger risk appetite also remains on display in the performance of global equity markets. Advanced economy markets bottomed in March and have enjoyed a very solid rally since then. Many markets, including the S&P 500 in the US – a bell-weather measure of the asset class - are around 60% higher than the cycle lows at this stage. The reduction in downside macro risks, the turn in the economic cycle, two consecutive much-better than expected earnings seasons and the comfort of very supportive policy settings

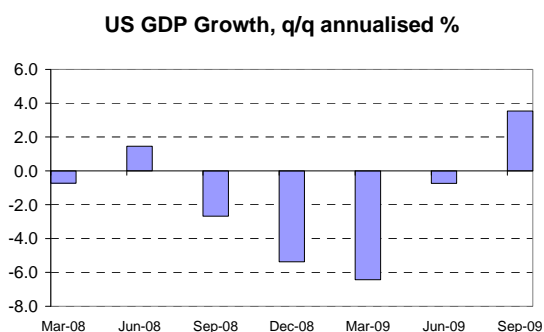
... Lower risk premia are also evident in corporate funding markets



have combined to generate very favourable conditions for equities.

As welcome as all of the above developments have been – and they are telling a story of profound improvement compared to the distress at the peak of the crisis - there are still grounds to be cautious. Importantly, bank balance sheets remain under considerable strain. The latest data from Bloomberg indicate that the global financial system has suffered losses totalling \$1.7 trillion over the current downturn. The improvement in economic conditions, including in housing markets in the US and UK, has to an extent stemmed the risk of extremely large further losses to the system. However, credit conditions remain tight and bank balance sheets remain under pressure reflecting the impact of what has been a particularly severe recession. In this context, further recapitalisation of the global banking system will be required to ensure durable improvement in wider financial system stability prospects.

The US economy returned to growth in Q3, heralding the end of the longest and deepest post-War recession



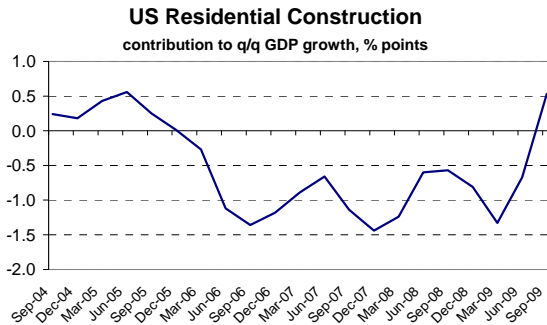
The US Economy and Fed Outlook

The end of the longest and deepest post-War US recession hasn't, as yet, been formally declared. However, the US economy is growing again as confirmed by the 3.5% annualised quarterly growth in third quarter GDP recorded by the latest national accounts data and it looks as if the Summer marked the end of the downturn. We expect that the NBER – the official arbiters of recession dates in the US – will probably judge that recession ended in Q3, possibly July, when it gets around to making its pronouncement which always tends to lag the turn in the cycle itself.

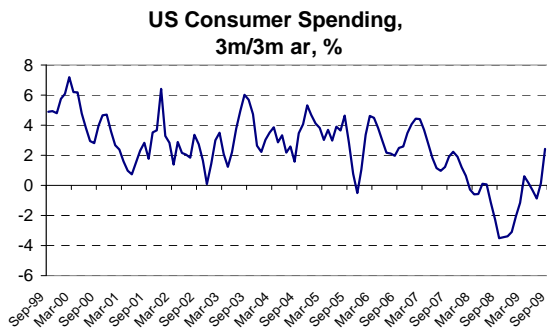
The return to growth has been supported by a pick-up in both business and consumer confidence, a pattern which owes important credit to the successful efforts of policy-makers in avoiding financial and economic meltdown. The stabilisation of financial conditions earlier in the year, and the improvement we have seen since, was associated with the realisation that a depression-type economic scenario was going to be avoided. In turn, this stemmed the panic which had sparked a huge retrenchment in output, production and trade as well as consumer and business spending.

As we noted in our previous Focus, production was slashed way more than was warranted by the fall in final demand which ensued, thus triggering a major liquidation in inventory levels – the largest in modern US economic history in fact. Accelerating inventory liquidation was thus a huge drag on growth as the economy was sliding, alone knocking some 1.4% and 2.4% points off quarterly GDP growth in Q2 and Q1 respectively. But, the panic has subsided, and firms have recognised that the worst case scenario for demand for their output was going to be missed by some distance. Thus, the dynamics of the inventory cycle – the classic

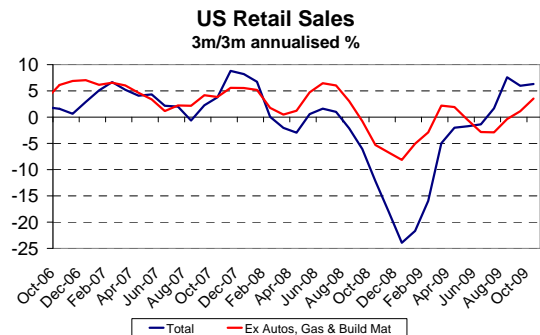
...the quarter also marked the end of a 3 ½ year slump in residential construction...



...while consumer spending is also growing again, helped by the cash-for-clunkers car buying scheme



...but, encouragingly, there is also evidence of a broader pick-up in spending...



driving force behind economic cycles right through history – are in the process of turning decisively in the US. Orders have begun to flow again and a rebound in production levels is clearly underway. Inventories were still being lowered in Q3, but at a much reduced pace compared with Q2, thus making a positive contribution to GDP growth in the last quarter (remember, it's the change in the change of stock levels which impacts on growth).

The effects of stimulus measures were also evident in the Q3 GDP report. Government spending grew by 2.3% and the 'cash-for-clunkers' car buying incentive scheme helped consumer spending growth turn positive.

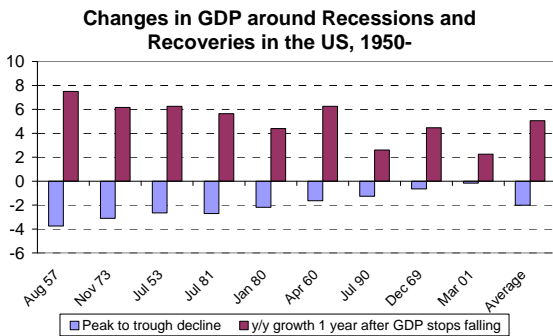
And the housing sector has received a lift from a home-buyer's tax credit offered to those who close on a sale before November. Residential construction has been at the heart of the downturn in the economy; a relentless slump in home-building which began in Q1 '06 dragged growth lower by almost 1%point per quarter over a three and a half-year period. But there's only so far a sector can fall before bottoming and housing starts have now begun to turn up, helped by a somewhat more stable to slightly firmer demand backdrop. Both new and existing home sales stopped falling earlier in the year and have begun to rise in recent months partly reflecting significant improvements in affordability.

So, significantly, the end of the recession in residential construction has meant that it has swung from being a huge and persistent drag on overall economic growth to being a source of support in Q3. A 23% rise in the three months to September boosted Q3 GDP growth by 0.5% - the first such positive contribution since Q4 '05.

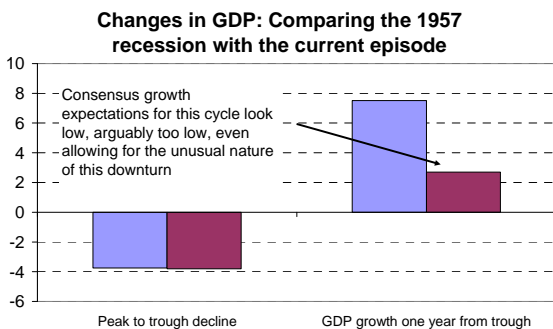
It certainly wasn't all good news in the Q3 GDP report. While overall government spending did rise, that aggregate figure masked a fall in spending at the State and Local Government sector. The financial position of many states in the US is extremely poor and this is a source of weakness that is unlikely to disappear anytime soon. Similarly, recent trends and prospects for non-residential construction don't make for comfortable viewing. Like other areas in the economy, investment here plunged at the height of the crisis. While the 9% drop in Q3 is less eye-popping than the 44% collapse in non-residential investment seen in Q1, the reality is that this sector lags the overall cycle. For example, it only turned down three quarters after the beginning of the recession, and some 2 ½ years after the beginning of the downturn in the residential sector.

The commercial real estate sector is relatively small in a GDP context (only 3% of total GDP). However, its tendency to lag, together with tighter credit conditions facing the sector, leave us of the view that, like State and Government spending, commercial real estate is likely to remain a drag on growth for several quarters ahead.

Historical experience clearly points to the tendency for growth to recover strongly after recessions end...



...and it looks as if the consensus is underestimating the likely strength of the rebound in the current cycle



Special Feature Box: US Recessions and Recovery Patterns in the Post-War Period

The experience of past cycles is a useful starting point in thinking about recovery prospects in the US. The general lessons from history are two-fold. First, the US economy tends to recover strongly from recessions. And second, the deeper is the recession, the more vigorous is the rebound. The average peak-to-trough decline in GDP in the nine US recessions since 1950 is about 2%. But the average increase in output in the year after GDP has stopped falling is of the order of 4.5%. Thus, the trajectory of the economy coming out of recession is typically steeper than it was on the way in. That is, V-shaped recovery is the norm.

Of course, the current cycle is far from 'average'. Indeed, the peak-to-trough decline in GDP in this recession has been 3.8%, the worst downturn in the post-war period, almost double the average decline. But the current cycle doesn't hold that dubious distinction by much; the recession of 1957/58 recorded a 3.7% slump in GDP from peak. But significantly, GDP had risen by 7.5% one year after the end of that recession, highlighting the strength of the 'snap-back' effect once the economy turns.

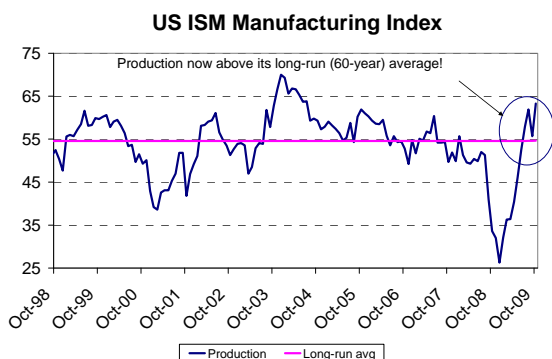
While the output decline in the current cycle may be almost identical to what happened in the late 1950s, we don't expect the US economy to match that cycle in terms of achieving a 7.5% rebound in the year to Q2 next year. Work by the IMF and others suggests that recoveries which follow financial crises tend not to be as strong as average, especially when the crises take place within the context of a synchronised global downturn as has been the case this time.

We think there is a good chance that average annual growth next year will be in excess of 3% vs. the consensus at 2.6% - still somewhat sub-par compared to the 'standard' bounce-back effect observed in prior cycles (thus allowing for current-cycle headwinds) but it does strike us that the risks to the prevailing consensus view lie to the upside.

Our overall sense is of an economy that is now clearly on an improving trajectory with broad-based signs of encouragement in the Q3 GDP numbers. The recovery in Q3 consumer spending wasn't all about car sales; spending outside of autos has begun to show improving trends. Housing is now a positive contributor, and even business capital spending managed a gain, albeit a small one, in Q3 having plunged either side of year-end '08.

Indeed, it is hard not to be struck by the strength of momentum in several reliable indicators of the economy's performance and near-term prospects. The ISM manufacturing survey has recovered really strongly, for example. Its key new orders sub-index has soared from an all-time record low in December last year to above

...the recovery looks to have strong momentum behind it...



its long-run (60-year) average in the ten months since then. A similar pattern is evident in the production index, and this improvement is now beginning to show through in official measures of industrial output which are now turning up. Moreover, the Index of Leading Indicators has enjoyed the strongest run in its 50-year history, with the average monthly rise over the past 6-months clocking at nearly 1%.

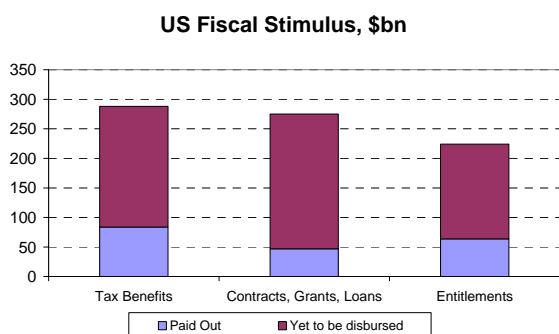
In our view, this means that the chances of a double-dip scenario materialising are relatively low. US growth will have important support in coming quarters from the usual turn-of-cycle dynamics in inventories as the bounce in production continues. Recoveries in auto sales, business spending and housing activity look likely too, from the depressed levels reached in each case at the crisis gripped. Not only have car sales fallen to well below their long-run average level (of about 16 million a year for the past decade), but are now arguably even lower than scrappage rates (the number of cars sent to the scrap heap each year). This is estimated at over 12 million units per year. Even if car sales don't get back to pre-crisis levels for some time, there is still plenty of scope for the sector to contribute meaningfully to growth in the coming year. A return to an annual sales rate of 12.5million, for example, would imply growth of 20% from the October level of 10.45.

Similar observations apply to business spending and housing, which having been slashed to record low levels, have now only one way to go. Again, it is important to distinguish between levels and growth rates. For example, there is no prospect of housing output getting back to pre-crisis levels for the foreseeable future (i.e. years if not decades), but that doesn't prevent some recovery generating positive growth rates, albeit from a very low starting point.

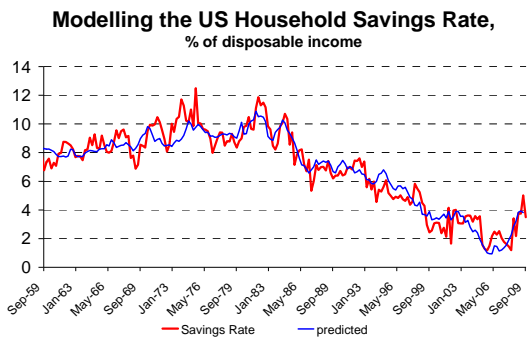
Fiscal stimulus is also set to offer very important support. Despite concerns in some quarters about what happens when fiscal support ends, the reality is that a large majority of the stimulus has, in fact, yet to kick in. As at the end of last month, less than \$200bn, or 25%, of the total \$787bn package had been paid out, leaving a tailwind of some \$600bn coming the economy's way over the next year or so, equivalent to over 4% of a full year's GDP. The \$600bn yet to be disbursed is split roughly \$225 in government contracts, grants and loans, \$205bn in tax measures and \$160bn in benefit entitlements

And of course, monetary policy is also extremely accommodative. The official Fed Funds rate has been at zero (0-0.25%) for eleven months now, and the Fed continues to expand its balance sheet though its various credit and liquidity measures including its enormous purchase programme of financial assets. It has already completed its purchase of \$300bn of government bonds and continues to make steady progress in its near-\$1.4 trillion purchases of mortgage-related assets. On current plans, the latter programme is set to continue until March of next year. While it is exceptionally difficult to know how effective these initiatives have

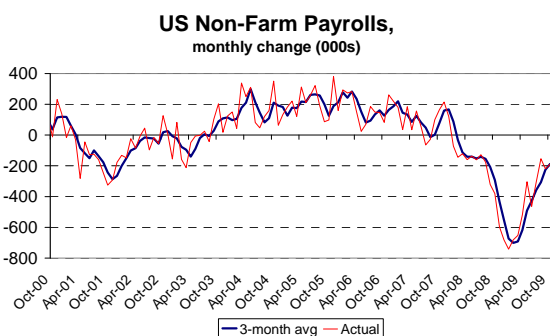
...and there is considerable stimulus still in the pipeline, of the monetary and fiscal varieties...



...the risk of a shift higher in the savings rate is an important one, but so far savings look to be behaving as expected...



The labour market is critical. Payroll trends are improving, but we need to see a return to positive jobs growth in the months ahead...



been, (as we will never know how circumstances would have otherwise evolved) it is fair to point out that 30-year fixed rate mortgage rates (the benchmark product in the US) have fallen by around 1.5% since the asset purchase programme was announced a year ago. The Fed's actions have, in our view, played a key role in stabilising the housing market, and the broader economy.

But as the economy has improved in the past few months, the debate has begun around how and when the Fed will begin to reverse course. With policy set to emergency levels of accommodation at present, changes in the policy stance will, over time, be required as policy-makers develop a greater sense of confidence in the sustainability of the improvements in financial and economic conditions.

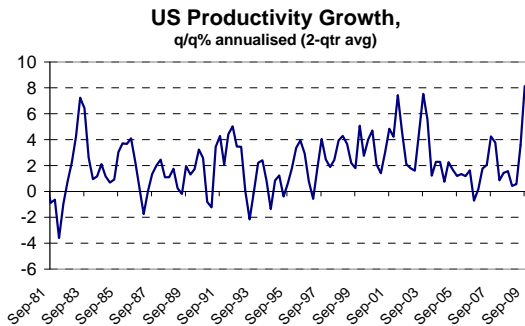
A near-term revival in growth led by an inventory-led rebound in production and a huge amount of stimulus would certainly be welcome, but on its own, is not likely to be enough to trigger a policy response from the Fed. What will be required is evidence that the recovery is developing a pattern of self-sustaining strength. In particular, a key condition that history tells us will most likely have to be met is that the jobs market will have to show definitive signs of improvement. That means going from a situation at present where the economy is continuing to shed jobs to one in which the economy is adding enough employment to get the unemployment rate lower.

The return of net job creation would lift consumer incomes, in turn bolstering consumer spending prospects. As consumer spending picks up the visibility that this brings to final demand should in turn add to business confidence and spending, thus generating the makings of a durable, sustained recovery.

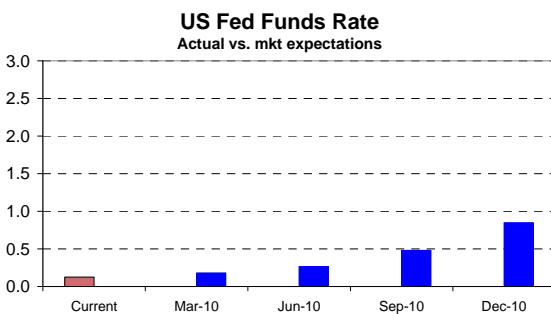
Note, that this scenario does not involve consumer spending acting as a driving force of recovery. That will be difficult if high-on-impossible given the need for household savings rates to increase from the extremely low (and unsustainable) levels reached at the top of the boom. Higher savings dampen spending growth for any given level of income expansion. But note that higher savings does not imply no growth (or even negative growth) in spending, which is where the labour income story ties in. A recovery in jobs will boost incomes and allow some rebuilding of savings, as well as some modest gains in consumer spending.

Our model of the US savings ratio is telling us that savings are doing roughly what one would expect given the changes in wealth i.e. savings don't seem to be showing signs of spiking higher. On the critical issue of the labour market, the monthly payrolls data are showing trend improvement. From a peak level of job losses of 691k per month on average in Q1 of this year, the trend has clearly been moving in the right direction, with the 3-month average standing at about -190k in October – the lowest since August of 2008. Furthermore, the timely and usually reliable weekly initial jobless claims data are also headed in the right direction, also

The recent surge in productivity is unsustainable. If output continues to expand as we expect then jobs growth will follow...



We think the Fed will be tightening by more than is currently priced in



consistent with ongoing improvement.

These indicators will have to continue to improve to validate our scenario of sustained growth into 2010. In particular, we will be looking for payrolls to turn positive in the early months of next year, which is our base case. One important reason for thinking why this is reasonable is that the 4% increase in the output of the non-farm business sector achieved in the third quarter was only possible due to a 9.5% surge in productivity (output per hour worked); hours worked fell at an annualized pace of 5%. In fact, productivity growth has averaged over 8% in the past two quarters, the strongest performance in some 60 years. There are limits to how much extra output firms can get out of a reduced labour input, and we regard such strength in productivity as unsustainable. Thus, if output continues to grow at a reasonable clip in the quarters ahead as we expect, then firms will be forced to take on extra workers.

The Fed continues to convey its view that low rates of resource utilization (e.g. high unemployment) are likely to keep core inflation very much in check – it has fallen to an 8-year low of 1.3% on the Fed’s preferred measure, the core PCE deflator. This means that a change in the Fed’s signaling to the markets will likely require data showing the unemployment rate has peaked and is moving lower. We expect these conditions to be starting to fall into place by around Q1, paving the way for the Fed to drop its “extended period” language from its policy statement by the March or April meetings. In the last cycle, the removal of a similar phrase (back then it was ‘considerable period’) resulted in an actual hike in rates about six months later. That is our base case this time around too, resulting in an expectation for US rates to be headed higher in Q3 and to be back at 1.5% by year end, compared with the market’s current pricing of sub 1% by year end.

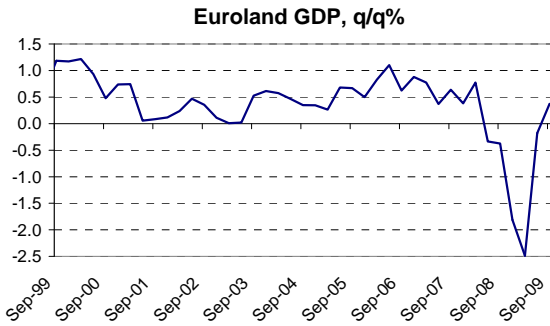
Note that there are risks in both directions around this central view. Some within the Fed, notably Governor Kevin Warsh, have argued that a more aggressive approach might end up being appropriate, arguing that “prudent risk management indicates that policy likely will need to begin normalization before it is obvious that it is necessary, possibly with greater force than is customary”.

But in fairness, that does not appear to be the mainstream view with the core of the Fed’s decision-making apparatus, at this stage at least. Chairman Bernanke and his vice-chairman Donald Kohn – the key players in shaping Fed policy – appear to maintain a more dovish skew to their public comments, hinting at some risk of rates being left lower for longer than our base case calls for.

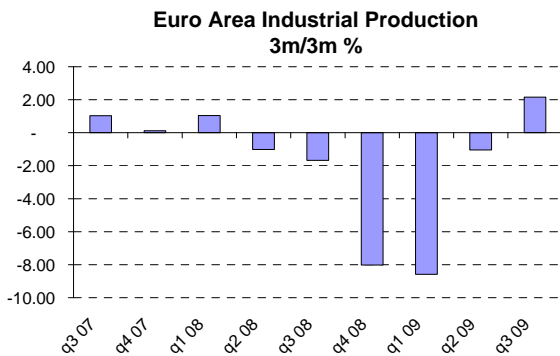
The Euro Area Economy and ECB Outlook

We have been pleasantly surprised by the improvement which has emerged in the euro zone economy in recent months. The German and French economies returned to (admittedly modest) positive

The euro area is now growing again too...



...helped by a rebound in industrial production...



quarterly GDP growth in the second quarter which was earlier than expected, and the euro zone as a whole followed suit a quarter later. An expansion of 0.4%q/q in Q3 brought to an end a five-quarter run of output declines, the worst downturn in the countries that make up the zone in decades.

Country detail behind the Q3 performance indicates that the improvement was broad-based geographically with most countries in the zone for which data are available reporting a positive GDP outturn. Spain was a notable exception, highlighting the ongoing difficulties in countries in which a severe property correction is part of the adjustment (Q3 GDP data for Ireland won't be out for another month or so). A 0.3% decline in Spanish GDP in the September quarter marked the sixth consecutive quarterly contraction, albeit that the pace of decline did ease notably from the average quarterly fall of 1.3% seen in the first half of the year.

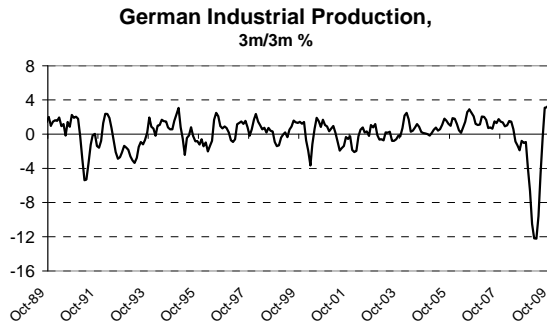
Elsewhere among the major economies that make up the zone, Germany is leading the recovery. Growth there accelerated to 0.7% q/q in Q3 from the 0.3% in Q2. The detailed figures haven't been published as yet, but officials have indicated that exports and investment in equipment and construction were the drivers, with consumption reportedly a drag on growth. France again expanded by 0.3% in the last quarter following a similar increase in Q2, while Italy posted a 0.6% rise in GDP following a 0.5% drop in Q2.

The improved trajectory in quarterly GDP growth in the zone mirrors developments in both the survey and official data in recent months. The closely-followed and reliable PMI surveys indicate that activity in both manufacturing and services bottomed in Q1, and both indices have risen sharply since. Indeed, the results of the PMI surveys have consistently beaten market forecasts over the past six months, highlighting that the growth dynamic which has emerged in the zone has been stronger than people, including ourselves, have been expecting. From record lows earlier in the year for the manufacturing and services indices, both have bounced sharply to get back above the key 50 level in recent months, consistent with rising activity.

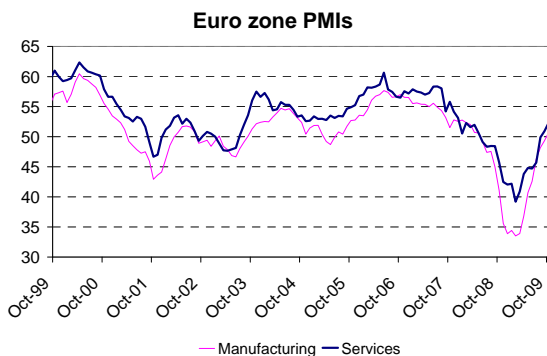
That turnaround is now being reflected in available 'hard' or official data on actual output patterns. Notably, the industrial sector is clearly now back in growth mode, with output up over 2%q/q in Q3, thus making an important contribution to the turnaround in GDP. Of course, industrial output is still considerably lower than where it was a year ago; 13% lower in fact on the latest (September) numbers. But recovery has to start somewhere, and that now finally looks to be happening.

Over and above the pick-up in activity that has already occurred, the euro zone economy looks to have built up quite a bit of momentum. Industrial new orders across the zone have risen some 10% from their April low, suggesting firm support for the near-term outlook. German strength is a sub-plot here, too, with German factory orders up some 19% from the cycle low in Q1.

...German strength is an important theme...



...both the manufacturing and services PMIs are back above 50...



Also, the sheer speed of the turnaround in indicators like the PMI is very striking. Take the composite PMI, for example, an indicator that we place a lot of weight on in tracking the underlying performance of the euro area economy. This combines the output measures of both the manufacturing and services into one pan-economy indicator which tends to give a good, timely steer on the overall growth dynamic. Like many other indicators, the composite PMI hit a record low at the height of the crisis, in this case February of this year. However, in the time since then, the composite PMI has risen by almost 17 index points – more than it has ever done before in any 8-month period since the survey began in 1997. It now stands at its highest level since January 2008 and the October reading of 53 is well ahead of the Q3 average underlining the strong momentum behind this current bout of improvement.

It is against this background that growth forecasts for this year have become less negative in recent months and it looks as if the contraction in 2009 GDP will now come in sub 4% in annual average terms – we are pencilling in -3.9%. The consensus anticipates growth of about 1% next year, but the strength of momentum in the economy at present, combined with the continued signs of global recovery as well the ongoing support from both monetary and fiscal stimulus leaves us favouring a somewhat stronger, if still moderate in absolute terms, outlook of around 1.4%.

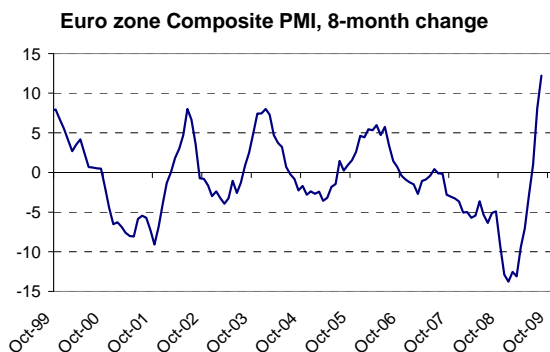
Having published decidedly weak forecasts in both June and September, the upside surprises in the data in recent months have seen the ECB gradually upgrade its assessment of economic prospects. The June Staff Macroeconomic projections envisaged growth of -4.6% this year and another contraction of -0.3% in 2010. The September update eased off on the negativity, but only slightly, revealing an expectation for -4.1% this year and a small 0.2% rise next.

However, as indicated above, these forecasts still look too low and the monthly post-meeting statements by Trichet have begun to acknowledge this. Back in August, the Governing Council's assessment was that the economy was expected to remain "weak" over the remainder of this year. This changed to "showing signs of stabilising" in the September assessment, to "is stabilising" as per the October update while the latest (November) statement noted that an "improvement" in activity is now underway.

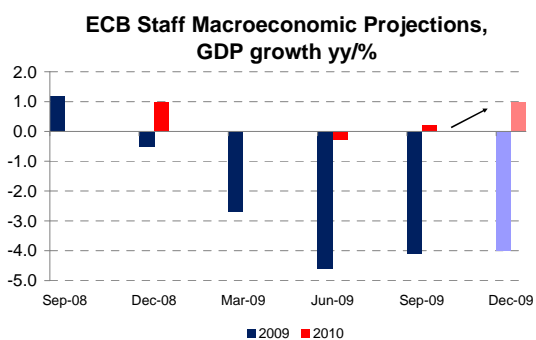
The more positive indications on the economy which are becoming increasingly evident will likely be accompanied by more hawkish soundings from the ECB in the months ahead. We expect this theme to become more prominent through the end of this year and in particular as we move through 2010. Next month's December Staff forecast is certain to show a firmer growth picture and this is likely to result in further incremental changes in ECB rhetoric in a hawkish direction, though we don't expect Trichet to begin any major signalling campaign as early as next month.

Over time, if the recovery is maintained and ECB confidence in its

... the speed and magnitude of the turnaround in the composite PMI is particularly striking...



The ECB has been too pessimistic on growth; December will see a forecast upgrade...



durability increases, then the policy stance, including interest rate policy, will need to move towards more normal settings. As in the US, a key metric in gauging sustainability will be the labour market. A turn lower in the unemployment rate would signal that inroads are being made in reducing spare capacity in the economy, as well as providing an important underpinning for final demand, especially consumer spending, prospects. In the short-term, further increases in the jobless rate seem inevitable as a mere return to positive growth will not prevent unemployment from going higher.

For unemployment to fall, the economy will need to achieve a period of above-trend growth. This will materialise eventually, but the relatively gradual recovery that we pencil in means that unemployment will continue to edge higher well into next year. It currently stands at 9.7%, up from the cycle low of 7.2% last seen in March '08 and we think it is set to rise to between 10.5 and 11% in coming quarters.

This prospect is one important reason not to expect an early rate hike from the ECB. Another related reason is a subdued inflation outlook. Base effects, combined with some upward pressure from recent increases in energy prices, will mean that the HICP measure will retreat from sub-zero (-0.1% y/y) at present to 1% or more within the next few months and to around 1.5% by the second half of next year. But that would still be below the ECB's target of 'close to but below 2', giving some comfort to policy makers that they can be patient, for the time being, in thinking about stimulus withdrawal.

In terms of interest rates, we continue to think that rates will be headed higher by the end of next year. Our view that Q4 will bring the first hike (we anticipate rates will end next year at 1.5%) is based on the thinking that continued, if gradual, improvement in the economy will likely result in growing discomfort within the ECB about the medium to long-term inflationary consequences of having interest rates at what are effectively emergency levels of 1%.

Similar to the US, there are risks in both directions around this central scenario. A disappointing recovery would likely see any hiking deferred until 2011, but correspondingly, the first move could come sooner than we anticipate if the recovery in the economy accelerates more strongly than expected. The composite PMI will be worth keeping a close eye on in this respect. The last ECB hiking cycle began in December 2005 when the latest composite PMI was at 55.1, a mere two points from its current level, so the growth dynamic on this measure is not far from levels which have triggered a policy response in the past.

Indeed, as with the Fed, some members within the ECB are beginning to set out the case for earlier tightening than might ordinarily be considered. Leading ECB hawk and Bundesbank chief Axel Weber recently commented that "We won't wait until employment picks up or unemployment rates fall to tighten. That would certainly be too late. Our monetary policy must be ahead of the curve, not behind". Weber is known for his particularly hawkish

perspective, so such comments need to be taken in that context. But we will be following closely how the view of the Governing Council continues to evolve as the recovery progresses, with inflation expectations likely to play a key role in determining the extent to which the risk of early tightening may materialise.

In the meantime, it looks as if the ECB will soon begin pulling back from its voluminous liquidity provision. Trichet said explicitly at the November press conference that improved conditions in markets means that, in the future, not all of the ECB's large-scale liquidity operations will be required to the same extent as in the past. No details of the first phase of the exit strategy have been communicated, but it seems very likely that one early step in this direction will be a decision not to continue into next year with its lending of unlimited 12-month cash to the banking system.

The UK Economy and MPC Outlook

If incoming GDP data from the euro zone have been a source of pleasant surprise, the same cannot be said about the UK unfortunately.

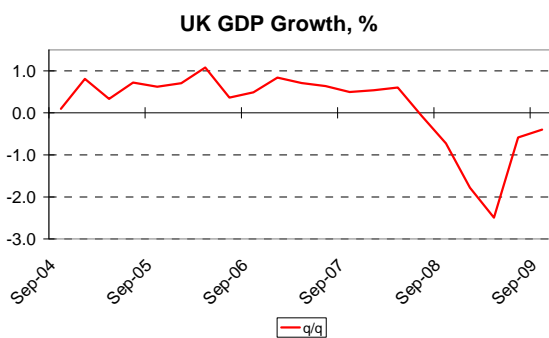
Despite encouraging indications on a number of fronts in the monthly data releases over the summer, the UK economy failed to register the return to positive growth that we, along with virtually all other observers, had expected. The strong improvement in business surveys, along with indications of recovery in housing and resilience in retail spending, had supported firm expectations that the British economy would begin to grow again in Q3.

However, the failure of the all-important services sector to post the improvement which had been signalled by the surveys resulted in a decline in GDP of 0.4% on the quarter. This represented the sixth consecutive quarter of contraction and was a clear set-back for the UK recovery story.

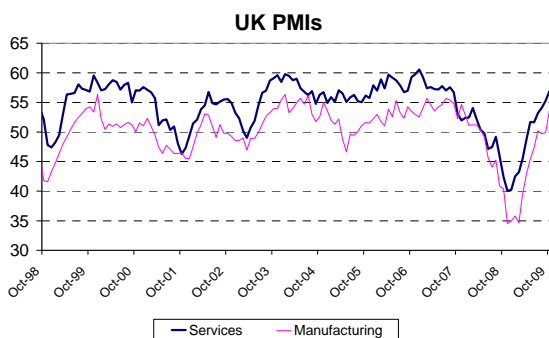
It is important to point out that there can be volatility in the GDP data and that the early national accounts estimates in the UK are often subject to upward revision. So we think that the -0.4% GDP number probably exaggerates the extent of underlying weakness in the UK.

Certainly, the dynamics of the vast majority of business surveys are pointing to an economy whose trajectory is clearly improving. Both the manufacturing and services PMIs have bounced decisively from their record lows reached about a year ago. The October readings of each showed further strong gains, a very encouraging development in terms of near-term prospects. Both indices are now well above the expansion threshold of 50, and both are at their highest level in about two years. And business confidence has picked up smartly on the CBI and BRC measures lately too. So a return to positive output growth in Q4 looks assured based on these

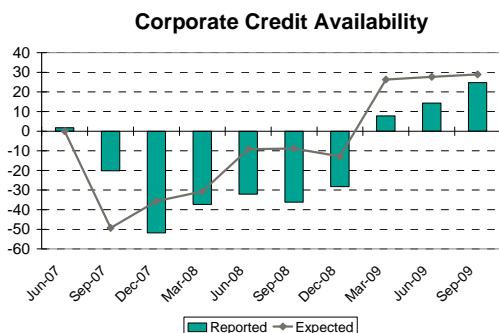
UK Q3 GDP growth numbers were a disappointment, failing to show the expected return to positive quarterly growth...



...but widespread survey evidence clearly points to improvement in activity...



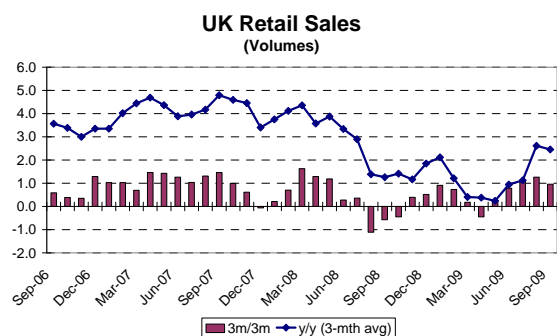
...and there are signs of an easing in credit conditions facing companies...



indicators. As in the US and elsewhere, the inventory cycle is providing a tail wind for output growth at present. In fact, the pace of stock building moderated in Q2, adding some 0.3% points to second quarter growth and is set to continue to act as an important support to output growth in coming quarters.

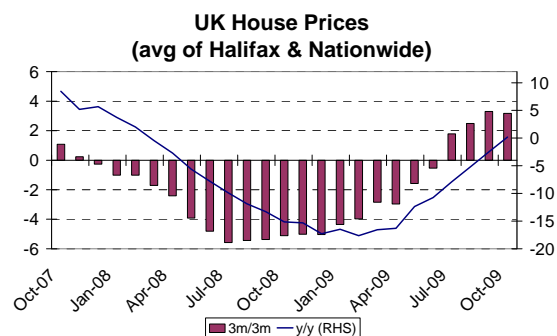
On the demand side, it has certainly been a tumultuous cycle for both consumer and business spending. Falling employment, slower earnings growth, concerns about future income and higher savings have combined to see household expenditure weaken sharply; it has fallen by 3.7% since the recession began to Q2 (the latest quarter for which total spending data are available). The fall-off in business investment has been even sharper at down a massive 18% in the first half of this year. Concerns about the severity of the recession as well as uncertainty about its magnitude and duration have been big drivers here. In both cases an additional headwind has probably been the tighter credit environment which has emerged over the course of the crisis.

...overall consumer spending has been very weak, but retail sales have been resilient...



The Bank's own survey of credit conditions continues to point to less tightening pressure for both firms and households. Nonetheless, this latter factor will likely exert some damping effect on consumer and business spending prospects as we look forward. Surveys have indicated that some households are saving more reflecting concerns about the future availability of credit. Similar caution is probably also at play in the investment decisions of the corporate sector, though the easing of conditions in capital markets (i.e. non-bank credit) has made it easier and cheaper to raise equity and bond finance, at least for larger firms.

...and the housing market looks to have turned...

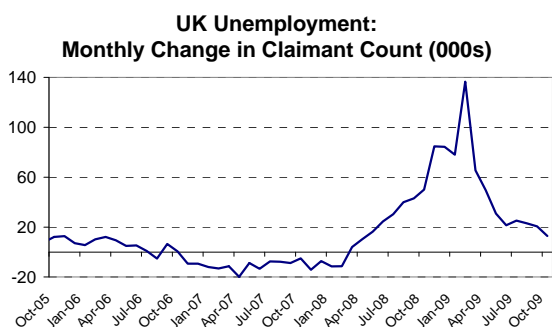


And the poor state of the UK public finances represents another headwind. The budget deficit is estimated at around 12% of GDP for this year and it is widely accepted that corrective measures will be needed to restore order to the situation. This means that the coming large-scale fiscal consolidation will also be a drag on future growth.

But the near-term picture has improved somewhat of late. Business confidence is showing signs of picking up, with surveys of investment intentions turning higher, from very low levels. Consumer confidence is also rising from the extreme lows seen earlier in the year. Indeed, the monthly retail sales numbers have been resilient, posting quarterly growth of 0.8-0.9% in both the June and September quarters while car sales have surged reflecting the scrappage scheme introduced in the summer. And the housing market has also turned; mortgage approvals are at 56,000 per month, still a very low levels historically, but double what it was at the record low in November '08 while house prices are also firming, up around 3% in the three months to October.

But as with the US, a key issue in the UK outlook is the extent to which the increase in output which seems likely based on the momentum in surveys such as the PMIs translates into a better labour market, and hence income environment. Encouragingly,

... signs of an easing in the rate of deterioration in the labour market are encouraging ...



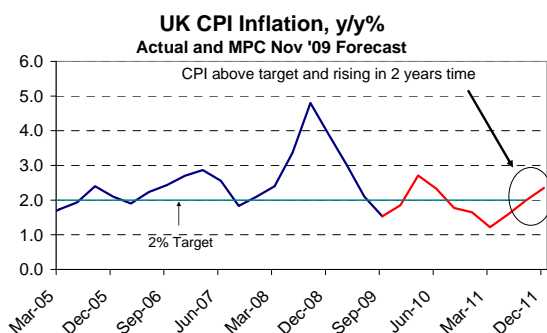
there have been signs that the worst is over for the UK jobs market. The claimant count is still rising, but the monthly increases have eased considerably. February saw an increase of 137,000 – the worst month in nearly 40 years of data – but the trend has turned markedly since then. Consistently lower outturns in recent months culminated in a 13,000 rise in October - the lowest increase in a year and a half.

Similarly, the upward trend in the ILO measure of the unemployment rate looks to have stalled, with the past four readings in a narrowly steady 7.8-7.9% range. This is up from as low as 5.2% in Q2 '08, so it still represents a sharp deterioration in the labour market. While these latest trends are certainly encouraging, it would be wrong to rule out further increases in the jobless rate before growth returns to solid rates. Nonetheless, we are probably within a percentage point of the peak unemployment rate, and it looks as if the UK will avoid the jobless total hitting a double-digit share of the labour force.

Finally on the growth front, UK net export demand should be a positive. Global demand is recovering and sterling's near 25% decline in trade-weighted terms since mid-2007 leaves the UK relatively well-placed to benefit from ongoing improvement in the international environment.

Overall, the resumption of positive growth that we expect in Q4 (we pencil in +0.4%q/q) will be too little too late in terms of preventing a very large decline in GDP in annual average terms. We put this at -4.7% for 2009. However, average growth will turn positive next year in our view and we anticipate GDP expansion of around 1.5%. This improvement reflects the better momentum currently on show, the huge support from policy stimulus (i.e. near-zero interest rates and a QE programme amounting to around 12% of GDP), the better global outlook and sterling's depreciation.

The BoE revised up its CPI projection in its latest forecast round, with inflation clearly above target and rising in two-years time, a signal that the next policy move will be a tightening...



In terms of the outlook for UK monetary policy, the disappointing Q3 GDP numbers have given the Bank of England another opportunity to reinforce its market-leading reputation for pro-active policy making. While Q3 data is at one level somewhat historic at this stage, they do imply that the amount of slack in the economy is that bit larger than had been thought and this argued for more stimulus to address the resulting downside risks in the inflation outlook. This was the context for the Bank to announce a further extension of its asset purchase or (QE) programme in November, with a £25billion increase in the programme's size taking it to £200bn, equivalent to around 12% of UK GDP.

The November Inflation Report showed that the Bank has revised its GDP growth outlook higher reflecting the higher level of financial asset prices including equities, the lower level of sterling, the firmer global backdrop and the extra stimulus provided by the November policy decision. And a stronger growth forecast of course has implications for the inflation outlook. Here, the report shows that CPI inflation based on the assumption of unchanged policy will be

above the BoE's 2% target in two years time. Indeed, it is interesting that despite a severe recession in the UK, headline CPI inflation hasn't and looks like it won't get into negative territory, in contrast to most other regions. The consistent pattern of upside surprises in the UK CPI release lately (it actually picked up to 1.5% from 1.1% in October) is probably a reflection of the impact of sterling's large decline. Significantly in terms of the BoE's latest update, the expected overshoot has been revised up to 2.35% from the 2.17% contained the August report.

On this basis, and assuming the economy evolves in line with the BoE's projections in coming quarters, we view it as quite unlikely that additional policy stimulus will be provided. Thus, we don't expect that total QE asset purchases will exceed their current £200 billion level. Moreover, we regard the publication of a CPI forecast showing an inflation overshoot at the policy horizon as a reasonably clear signal that the next move will be a withdrawal of stimulus in the not too distant future.

We are still broadly comfortable with our view that UK rates will be headed higher by around the middle of next year. Our forecast calls for 0.50% of hiking in each of Q3 and Q4 which would leave Bank rate at 1.5% by the end of next year. The view is, however, importantly predicated on a return to reasonable growth rates (of 0.4% or more) in the coming quarters. If that growth scenario fails to materialise and if the economic recovery falters, then the possible need for extra stimulus would be back on the agenda again, in line with what happened in November.

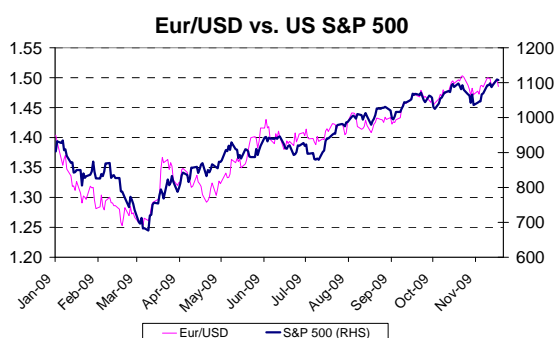
FX Outlook

Eur / USD

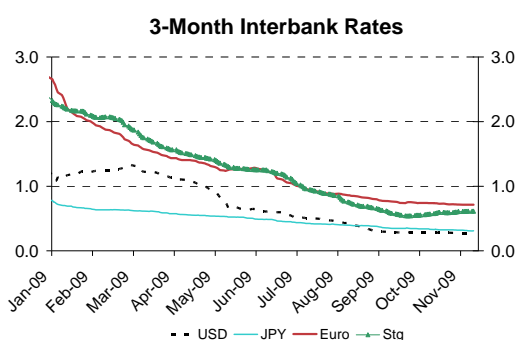
One of the stand-out themes in the currency markets this year has been the strongly negative correlation between the dollar and measures of the performance of risky assets. Within this paradigm, good economic/financial sector/company earnings news has clearly been associated with a weaker dollar, even if such news has, as it frequently has had, its origins in the US itself. Similarly, poor newsflow on the macro/financial environment has tended to go hand in hand with a firmer greenback. Thus, as the graph opposite highlights there has been a very tight correlation between one of the most widely used proxies for risk assets generally, the S&P500 stock market index in the US, and the Eur/USD rate. In particular, the over 60% rally in equities from the low in early March has corresponded closely with a 25% advance, from \$1.25 to \$1.50, for Eur/USD over the same period.

A couple of dynamics have been at play here. Firstly, it partly reflects an unwinding of the post-Lehman surge in demand for dollars. As it began to be clear from around the end of the first quarter that the global economy and financial system had been

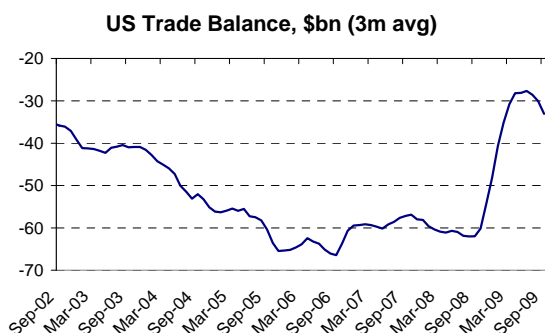
Eur/USD has been very closely correlated with the equity markets this year as buoyant risk appetite has translated into a weaker dollar...



...US interest rates are, very unusually, now lower than all other major currency areas (even yen) which has resulted in rising use of the dollar as a funding currency...



A much narrower trade deficit is helpful from a medium-term perspective...



successfully steered away from collapse by the authorities, the safe-haven grab for dollar assets such as US treasury securities dissipated. Investors had sought the safety of the largest and deepest financial markets in the world at the height of the crisis; but as distress in the system began to ease there was a consequent unwinding of the flight to safety bid for dollars.

Second, as US market interest rates have tumbled in line with the Fed's ultra-easy monetary stance, the dollar has become the funding currency of choice for many investors. With official rates at zero and the Fed apparently willing to continue filling the liquidity punchbowl for an "extended period", the dollar has become a favoured "carry currency". That is, borrowing cheaply in dollars and investing the proceeds in higher-yielding assets has added to the downward pressure on the buck. In this respect, it is highly significant that 3-month USD Libor rates – a benchmark measure of funding costs – have fallen below those of all other major currencies, even yen, in recent months. This has been a rare feature of the investment landscape, last occurring in 1993. And of course, chatter continues to surface from time to time regarding the possible diminution of the dollar's role as the world's premier reserve currency. While we don't envisage any major structural changes in global currency arrangements for the foreseeable future, such noises can and do tend to promote adverse sentiment towards the greenback as such stories get headline coverage.

So with the ongoing buoyancy of market risk appetite finding firm support in improving economic momentum and, for now at least, the comforting noises from policy makers, especially at the Fed, it seems to us that the path of least resistance for the dollar in the months ahead will likely be lower. The mid \$1.50s seems a reasonable target within a three month horizon, though at those type of levels we would expect European policy makers to become vocal in their concern about damaging real economy impacts on this side of the Atlantic. Indeed, we noted with interest Trichet's bout of verbal "intervention-lite" at the October ECB press conference. Asked about his concern over the strength of the euro, he, quite deliberately it seemed to us, reminded the market that "excess volatility and disorderly movements in exchange rates have adverse implications for economic and for financial stability" and that the international authorities will "continue to monitor the exchange markets closely and cooperate as appropriate".

One thing that troubles us somewhat about this view is the extent to which it seems to be so widely held. It appears that many analysts out there share a similar thought process on the near-term outlook. Experience tells us that there is particular scope for sudden reversals in market dynamics when views or positions are 'bunched' in a particular direction. So a risk to our near-term view is that the dollar could buck the expected outlook and snap back.

In any case, beyond the next few months, we anticipate that the dollar will stage a recovery vs. the euro. A considerable narrowing

in the US trade deficit is helpful in developing a constructive dollar view, albeit that concerns about the weak fiscal position provide some counterweight. But importantly, as noted above our base case for the US economy envisages a continuation of recent solid momentum to the point where the Fed begins to acknowledge the unsustainability of current policy settings. We expect the dollar to benefit from a hardening of Fed rhetoric which we expect by around the end of Q1. The prospect of higher US rates and tighter monetary policy should dent the dollar's new found status as funder of choice, will probably curb the stock market rally and see interest rate expectations return as a prominent driver of movements in the dollar. This scenario leaves us favouring a return to \$1.40 later in the year, maybe lower depending on the extent of the shift in Fed policy.

Eur / Stg

Actual changes in, and market expectations for, central bank policy have been very important drivers of Eur/Stg over the last year. Recent news has served to reinforce the market's perception of a dovish, aggressive and very pro-active Bank of England. The August policy meeting resulted in an unexpected further £50 billion dollop of quantitative easing and an additional £25bn was added at the November meeting, taking the total package to £200 billion.

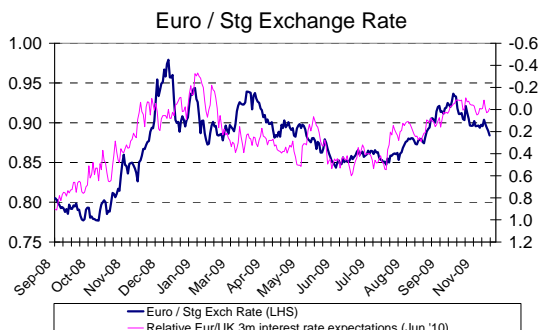
While there has been little prospect of any further stimulus from the ECB for some months now, the BoE's desire to do whatever it takes to deliver UK recovery and avoid an inflation undershoot has again become abundantly clear.

Back in early August, things were looking good for our 80p forecast with Eur/Stg trading as low as 84p at that stage. However our bullish call on sterling vs. the euro has since come under pressure as UK growth has fallen shy of expectations in both absolute terms and relative to a surprisingly strong euro area which has been stronger than we were expecting. This, along with the important BoE actions noted above, has meant that the evolution of interest rate expectations have been a negative for sterling in recent months.

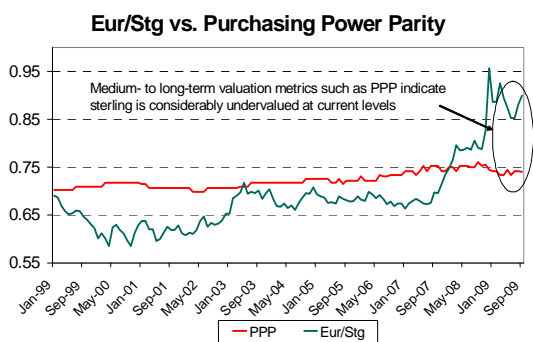
At its weakest recently, sterling fell to about 94p in mid-October. However, as had been the case during previous sell-offs earlier in the year, the market failed to sustain the move beyond such levels – back in January and March the 95p level had proven to be the key resistance point. Thus, if sterling does come under further selling pressure in the period ahead – calls for a move to parity have been heard again lately - we expect that the 94/95p level is unlikely to be breached. Indeed, we would regard any return to such levels as an excellent opportunity to buy sterling as we continue to view the UK currency as undervalued from a medium-term perspective vs. the euro.

In any case, recent price action has seen a modest pull-back to

Monetary policy expectations continue to be a very important driver of Eur/Stg; the BoE's very aggressive approach has again weighed on sterling since the summer...



But medium-term valuations remain supportive of an eventual sterling recovery...



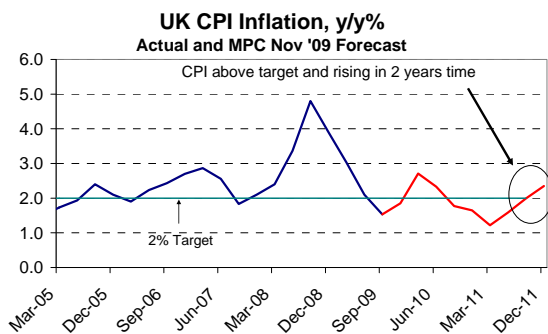
around the 88p level, helped in part by the fact that the recent £25bn QE expansion turned out to be actually below the £50 billion most market analysts had been expecting by the time the meeting had come around.

As we have highlighted previously, some measures of long-term fair value such as Purchasing Power Parity for Eur/Stg put it in the 70-75p range. It doesn't seem reasonable to expect a return to those type of levels for the foreseeable future, and that is certainly not our forecast, nor has it been. But such a large deviation from a notional equilibrium does continue to point to the scope for movement back towards that equilibrium over time.

'Over time' is a key phrase here, as departures from market norms can take time to unwind. But it is also important to keep in mind that large changes can occur very quickly in markets. For example, Eur/Stg went from 98p late last year to around 86p within the space of around six weeks. Similarly, it went from around 95p in mid-March to around 84p within three months. And of course, sterling's recent bout of weakness took it quickly in the opposite direction, from 84 to 94p in just over two months.

Overall, taking on board recent developments we are pushing back the 80p forecast to the middle of next year. We still believe in sterling's ability to recover against the euro. However, given the latest news on the economy and policy fronts it may be asking a bit much for the UK unit to make up all of this ground as quickly as we had previously forecast.

...and a shift in BoE interest rate policy next year will be a catalyst for a lower Eur/Stg rate in our view...



The forecast is tied very closely to the view on interest rate expectations. In other words, we will need to see evidence of stronger growth in the months and quarters ahead in the UK. This will be required to validate our expectation that UK rates will be headed higher by Q3 next year, and should result in a firming of market expectations too, as the eventual turn in the rate cycle moves from the realms of expectation to reality.

The relative timing of the BoE vs. the ECB rate cycles will also have an important bearing of course. There is a risk that the ECB could tighten before the BoE which would be unhelpful from a sterling perspective, but history offers a lot of comfort on this score. The BoE has been ahead of the ECB in every one of the four cyclical turning points in rates since the ECB was formed in 1999 – a fact which underpins just how pre-emptive and proactive the Bank is relative to its Frankfurt-based counterpart.

Finally, the UK fiscal position has weighed on sterling. The weakness in the economy has exposed a large structural budget deficit which will require significant consolidation in the coming years. To date, markets and rating agencies have been less than impressed with existing government plans to tackle the problem.

This risk factor has the potential to swing both ways in terms of its currency impact. If coming fiscal policy updates (the Pre-Budget Report later this month and the Budget proper in March) fail to

convince on the deficit reduction issue, that would hamper sterling's ability to recover as we expect. But given that there seems to be quite a bit of bad news (both economic and fiscal) already in the price, the publication of a credible multi-year plan could foster increased confidence in the UK currency. Maybe Downing Street could take soundings on this front from Merrion Street, given that a huge programme of fiscal correction has already gone from the planning to implementation phase here in Ireland.

GBP / USD

The GBP/USD currency pair has been the foreign exchange market equivalent of an ugly contest. The two most out of favour major currencies have been battling it out with one another for supremacy in a weakest (ugliest) of them all contest in recent months. The result has been that GBP/USD has been moving broadly sideways as weakness in each has effectively eliminated the scope for any major directional trend to emerge. \$1.60-1.70 accounts for the bulk of the price action since late May. Just recently, a more stable slightly resilient sterling has been edging higher against a still-struggling dollar, a combination which has seen GBP/USD creep up towards the upper end of the range at about \$1.68.

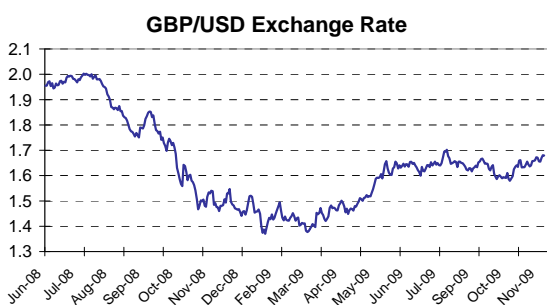
In the coming few months if generalised dollar weakness remains a theme as we expect, then sterling too should be able to continue to benefit. This may well see a break-out of the recent range in GBP/USD. \$1.80 or higher should be possible in this type of environment before the dollar rally that we expect kicks in to take cable back down to its current trading range below the \$1.70 mark.

Eur / JPY

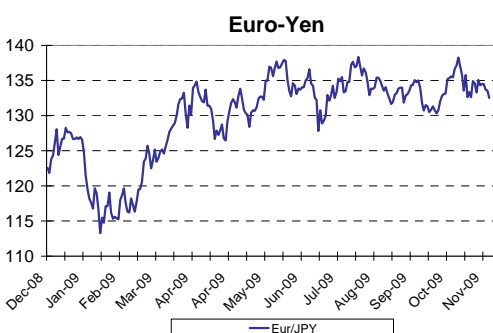
Eur/JPY hasn't been the most exciting of currency pairs lately. The price action has generally been range bound for the past six months or more, with a Y127 to Y138 range applying over the period. There have been the usual gyrations within the range. The election of a new government in Japan brought with it a new finance minister some of whose initial verbiage caused a stir. Early into his tenure, he declared his opposition to intervening in currency markets suggesting that the new administration might favour a more laissez-faire approach to currency management. The implication that there could be more official tolerance of a stronger currency than previously was taken by markets as an invitation to buy the Japanese unit which resulted in Eur/JPY getting to Y130 and lower in late September / early October. The rally triggered some clarifying comments emphasising that if the yen's movements became abnormal or disorderly then the authorities "will consider some action". The backtracking by policy-makers brought about a reversal in the price action and Eur/JPY promptly rose back towards the top of its range.

The Japanese economy is showing signs of recovery, with a

...GBP/USD has been range-bound, though our call for near-term dollar weakness means we favour a move to the upside in coming months...



Eur/JPY has been trading broadly sideways too of late



1.2%/q/q rise in Q3 GDP trumping prevailing market forecasts for a more modest 0.7%. Its location in the heart of Asia – the fastest growing region in the world – and its trade ties with China offers support for the economy in the months ahead. This generates a modest bias for a slightly stronger yen in the period ahead, though we expect the recent ranges to hold for the time being.

Long-term Rates Outlook

As previous editions have highlighted, central bank policy and especially market expectations thereof are very important drivers of long-term swap rates. Thus, the currently extremely accommodative policy stance and the still-dovish public commentary from leading officials has been providing a solid anchor for long-term rates in recent months. Such markets have also been receiving considerable support from the large-scale QE programmes in the US and UK which have had the effect of keeping bond yields and other long-term rates lower than they otherwise would be.

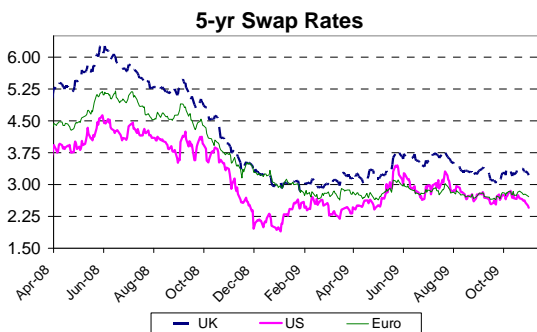
The Fed continues to emphasise that policy will be kept accommodative for an extended period, Trichet takes almost every opportunity to remind us of his cautious and prudent view on the outlook, while the Bank of England has been more dovish again, actually injecting more QE stimulus into the UK economy on two occasions in the past four months, most recently earlier this month.

The major improvement in the money markets has also been supportive. Money market spreads have tightened significantly from levels earlier in the year, as noted in our section on the financial market environment earlier. With the considerable help of the huge amounts of extra liquidity that have been provided by the central banks, this has meant that Libor/Euribor rates have come down significantly despite the fact that there has been no change in official rates in these markets since the ECB cut rates in May. 3-month rates currently stand at between around 0.20% and 0.25% in all three markets and are down by anywhere from 0.25% to 0.50% over the past six months or so. The much lower level of rates at the very front of market yield curves makes the starting point for the calculation of rates further out the curve that bit lower and this has been an additional factor putting downward pressure on long-term rates in recent months.

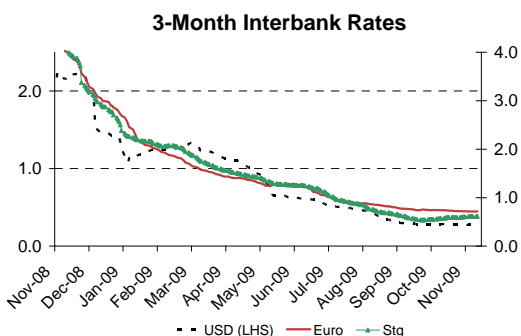
Thus, despite mounting evidence of economic recovery, the policy backdrop has played an important role in keeping long-term rates at extremely low levels historically. Indeed, 5-year swap rates have generally been trading sideways for most of the past half-year. A band between 2.50% and 3.30% summarises the extent of movement in USD and euro rates, while the range in sterling has been slightly higher at 3.10-3.75%.

In terms of the outlook, with policy-makers still cautious there is little

Upward pressure on long-term rates has been largely absent despite clear indications of economic recovery, ...



...with low and falling short-term rates contributing to this pattern...



prospect of any near-term policy tightening. But it is our expectation that 2010 will mark the beginning of the process of monetary policy normalisation. This will involve a reduction in special liquidity provision, cessation and some reversal of financial asset purchases (QE) as well as the commencement of a normalisation of the interest rate stance.

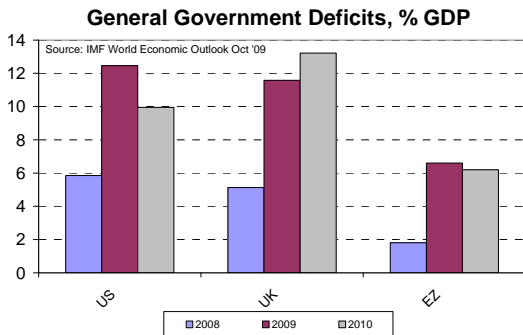
Thus as we move through 2010 we expect long-term rates to come under upward pressure as economies strengthen, central banks get closer to the point of pulling the rate trigger, as market expectations for the future course of policy firm as we anticipate and, in the case of the US and UK, as central banks pull back from and eventually reverse their substantial asset buying programmes.

An additional source of upward pressure comes from very large amount of government bond supply which will need to be issued to fund the substantial budget deficits which confront the US and UK in particular over the coming years. Funding double-digit (as a % of GDP) deficits is likely to get increasingly challenging in the quarters ahead as the central bank bid for government bonds gets withdrawn as QE programmes are halted in the early months of next year. The result is likely to be upward pressure on government bond yields as higher yields become necessary to attract the required level of private sector investor interest.

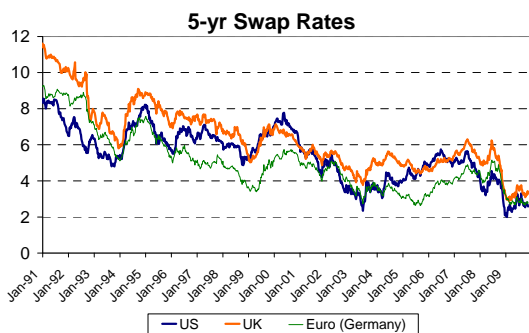
Taking all these factors together, we think that there is considerable upside for long-term USD rates in the months and quarters ahead; perhaps as much as 2% or more for 5-yr swaps on a 12-month horizon, for example, from their present level of approx 2.8%. We also expect sterling rates to come under upward pressure, albeit not quite as much as in USD; we target a rise in 5-yr rates of about 1% on a 12-month view. With the ECB lagging and budget deficits not quite as large in the euro zone, we don't expect the same degree of upward pressure on long-term rates in the euro zone, though we still think they will be following the same broad pattern, especially towards the latter part of next year.

While long-term rates remain at very low levels historically, we expect the landscape to change materially in 2010 – a scenario to which the forward-looking treasurer with interest rate exposure to manage needs to be attuned.

But upward pressure is coming, both from the approaching turn in official rate cycles and very wide budget deficits, notably in the US and UK ...



...current levels continue to represent a strategic opportunity for forward-looking treasurers ...



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