

## Global economy in severe recession, but US growth set to improve later this year

- Every major economy faces sharp declines in GDP of 1-2.5% in '09
- But US growth is set to turn positive by the end of the year, helped by the enormous \$800bn-plus Obama stimulus package and the 'do-whatever-it-takes' approach of the Bernanke Fed

## Relief on the way for exporters as euro expected to fall

- Early-year weakness for the euro has brought some relief to Irish exporters and we expect further declines against both sterling and the dollar
- We have a near-term target of \$1.15 for Eur/USD and an end-year forecast of 80p for Eur/Stg

## Large declines in long-term rates provide excellent hedging opportunity

- The major central banks have been cutting rates aggressively, and both the Bank of England and ECB are set to take rates down to new record levels, of 0.75% and 1.50% respectively
- Long-term borrowing costs have fallen sharply across all markets in tandem with the huge falls in official rates
- We strongly encourage companies to avail of the opportunity afforded by the current environment to hedge any long-term debt at very attractive levels

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## Summary

The global economy is experiencing a severe and synchronised downturn which is being led by pronounced weakness in the world's major economies. The G7 block faces its first year of contraction since 1982 as every major advanced economy faces significant declines (of around 1-2.5%) in output this year – an extremely unusual pattern of pervasive weakness.

The US is facing its longest, though most definitely not its deepest, recession since the Great Depression of the 1930s. Exceptionally poor momentum, very weak confidence and dwindling order books leave the euro area economy poised to contract by as much as 2% in 2009 which would represent the weakest year for the countries that make up the zone since the 1930s. The UK, too, is looking at a brutal slump with a decline in real GDP of over 2% on the cards – the worst year for the UK since 1980.

One upside to a much weaker global economy is much lower commodity prices. Oil prices, for example, have fallen by more than \$100 from last year's peak to around \$45pb at present. This provides the dual benefit of providing a direct and badly needed boost to household and firm discretionary spending power, and also contributes to a vastly improved inflation outlook, thus giving the central banks plenty of scope to use monetary stimulus to arrest the economic decline.

The Fed has, for the first time in its history, taken its policy rate down to effectively zero and has now switched its focus to using a whole host of novel alternative measures to further boost the ailing US economy and financial system. The Bank of England's recent actions have also been bold, decisive and very aggressive. Its Bank Rate has been lowered by 3.5% in just over three months, action which leaves official rates at 1.5% - a level never before seen in over 300 years of monetary history in the UK.

The ECB is lagging behind the other main central banks in terms of its policy response. Its 2.25% cumulative reduction in rates so far this cycle is less than half that introduced by both the Fed and the BoE. Nonetheless, it is cutting rates faster than it ever has before and its cut last week to 2% has taken rates to as low as they have ever been in the institution's 10-year history.

It's not just on the monetary front that the US is leading the way. New US President Obama has a strong mandate, has assembled a heavy-hitting economics team and looks set to inject an enormous

fiscal stimulus on an unprecedented scale (of the order of \$800bn-plus) into the US which will provide considerable support to the economy and financial system there over the next two years. Fiscal policy has also turned very supportive in the UK, albeit not quite to the same extent. Meanwhile, in the euro area attempts at fiscal stimulus have been hampered by both institutional and philosophical difficulties. The authorities have struggled to put together a package that is either co-ordinated or meaningful, though the most recent indications have been more encouraging and suggest that Germany will now in fact proceed with a stimulus package (of the order of 1.5% of GDP).

The Obama fiscal plan, the 'do-whatever-it-takes' mentality at the Bernanke Fed, lower oil prices and a housing correction that can't and won't last forever, lead us to believe that the US economy will show signs of stabilising later in the year, and we pencil in a return to positive, if still below-par, growth rates by the end of the year. We also take encouragement from some thawing of conditions in credit and funding markets of late. International money markets have been showing heartening signs of improvement while US mortgage rates have fallen significantly in the past couple of months. However, events of recent days highlight that strains in the international banking system remain a major concern.

The UK and euro area will eventually follow the US out of recession, but likely in that order - reflecting the relative policy responses in the two economies. In the meantime, interest rates are likely to be lowered to yet more record lows of 0.75% and 1.5% respectively, with a risk of rates going even lower in both cases.

From a treasurer's perspective, we highlight that long-term borrowing costs have fallen sharply across all markets in tandem with the aggressive lowering of official rates by the central banks. In many cases, notably in the UK and US, rates are currently at record lows. 10-year dollar rates at around 2.5% stand out as exceptionally good value. While long-term rates may end up falling a bit more in the short term, we strongly urge those with long-term debt to use this window of opportunity to hedge any interest rate exposure at levels which are at or close to record lows. 5- and 10-year rates in euros and sterling at around 3% and 3.5% respectively represent the type of opportunity that rarely presents itself.

On the currency markets, we expect better news for Irish exporters to the UK this year following sterling's unprecedented and unwelcome 35% collapse against the euro last year. Greater focus on euro area rather than UK economic weakness this year provides scope for the Eur/Stg rate to continue to move lower in 2009. We target 80p by the end of the year, a move that would also be consistent with the market rewarding the policy-activism of the UK authorities both in absolute terms and relative to the euro zone. We also forecast more weakness for the euro against the dollar, in the short term at least, with a \$1.15 target for the months ahead, though the greenback may find it difficult to sustain those levels later in the year.

**Forecasts (end period)****Current      Mar-09      Jun-09      Sep-09      Dec-09****Interest Rates****Eur**

ECB Refi	2.00	1.50	1.50	1.50	1.50
5yr Swap	2.95	2.75	3.15	3.4	3.6

**US**

Fed Funds	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25
5yr Swap	2.0	2.0	2.75	3.0	3.25

**UK**

Bank Rate	1.50	0.75	0.75	0.75	0.75
5yr Swap	2.95	2.8	3.25	3.6	3.85

**Currencies**

EUR/USD	1.295	1.15	1.20	1.25	1.30
EUR/GBP	0.925	0.87	0.85	0.82	0.80
GBP/EUR	1.08	1.15	1.22	1.25	1.28
GBP/USD	1.40	1.32	1.41	1.52	1.63
EUR/JPY	116	113	120	125	130

## Recent Financial Market Developments

Global capital markets had been going through the most tumultuous period in living memory just prior to our last Focus. Barometers of risk aversion and volatility across a host of markets had soared to never-before-seen levels, amid extraordinary stresses in the global financial system.

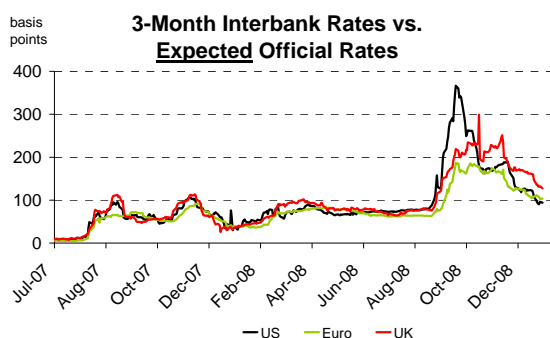
Three months on and the news is somewhat more positive. Or perhaps a better way to put it would be less negative. Many markets remain under considerable strain, and conditions across the system are certainly nowhere near what we might have referred to as 'normal' two years ago. But there are important indications of improvement in a number of key areas of the system.

Notably, money market conditions have finally begun to show signs of reduced stress. This is especially in dollar markets which had been under exceptional pressure a few months ago, as captured by a USD 3-month Libor-OIS spread which had ballooned out to 3.7% at one point in October (recall from our last quarterly that this spread would typically have been of the order of 0.05-0.10% pre-crisis). But we have since seen a sustained narrowing of spreads to the tune of over 2.7%. The latest reading on the spread is actually now below 1% - levels last seen just prior to the Lehman bankruptcy. Euro and sterling spreads have also been moving in the right direction lately, also currently standing at four-month lows.

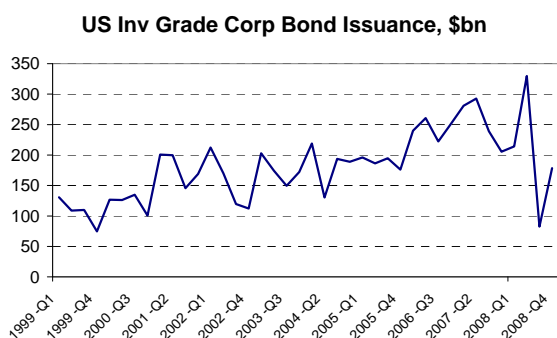
The importance of this is that these moves in the interbank market (which ultimately determines the cost of funds to final borrowers) are now adding to rather than reducing the impact of the reductions in official interest rates announced by the central banks. Take the dollar market. At the peak in spreads around October 10th, the official Fed Funds rate stood at 1.5% but 3-month interbank rates were at over 4.8%. Since then the Fed have cut rates by 1.375% (taking the mid-point of the current 0-0.25% Fed funds target), whereas 3-month rates have tumbled by almost 3.7%. Similarly, over the same period the ECB has lowered official rates in the euro zone by 1.75% but 3-m Euribor has fallen much more sharply, by almost a full 3%, as the previous extreme spread widening has been partially reversed. Likewise in sterling, 3-month interbank rates have tumbled by more than 4% vs. the 3% drop in Bank Rate over the period. Thus, whereas up to mid October the persistent widening of money market spreads was frustrating attempts by the central banks to engineer easier financial conditions, developments since then have seen a welcome reversal of this pattern.

Another example of improved functioning of credit and funding markets is recent developments in the corporate bond market in the US, the market in which large firms can raise funds directly in the capital markets by issuing bonds yielding a specified return to investors. This market completely shut in the aftermath of the Lehman collapse, depriving sound US companies of access to a very important avenue of funding. The level of funds raised in Q3 of last year at \$83bn was the lowest in any quarter in at least 10

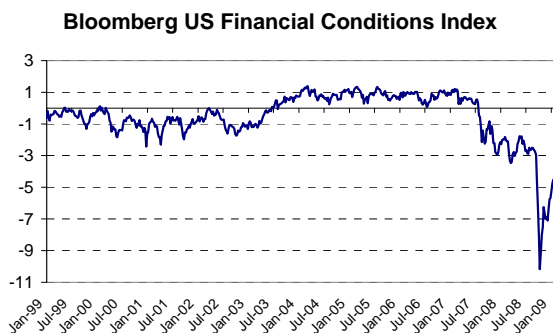
### Conditions in interbank money market have improved considerably (albeit that they are still far from 'normal')...



### ... and US corporate bond issuance has picked up again having collapsed in Q3...



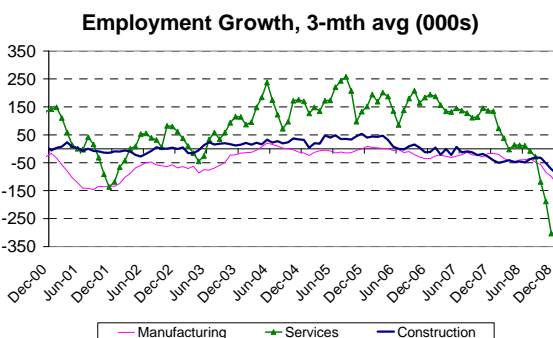
**... Overall financial conditions in the US are recovering from extreme lows...**



years, representing a collapse from the record levels of \$330bn seen in the second quarter (as an aside, evidence of firms being able to raise record amounts of such funding as recently as last Summer is clearly not consistent with a widespread genuine credit crunch being in place at that time). But encouragingly, the aggregate sums raised in the final quarter did recover considerably to around \$180bn – not far from the average quarterly level seen as recently as 2005. Moreover, the early part of 2009 has seen robust levels of activity, with an impressive \$68bn raised in the first three weeks of the year alone, suggesting that, whatever about constraints on new bank lending, this important credit channel is functioning once again, albeit at pricing levels that are considerably higher than previous norms.

Financial information provider Bloomberg calculates a summary measure of US financial conditions, which is compiled from an aggregation of a host of indicators across money, bond and equity markets. The graph across highlights the extent of improvement seen since October (a good deal of which reflects the progress in stabilising money markets discussed above). While conditions clearly remain unusually tight by the standards of experience prior to the current episode, we are heartened by the fact that the situation is moving in the right direction. This suggests that the extraordinary measures taken by global policy-makers are finally enjoying some payback, though the intensification of strains in the international banking system in recent weeks underlines the need for policy-makers to remain pro-active, creative and flexible in dealing with ongoing challenges.

**Weakness in the US jobs market has intensified dramatically in recent months...**



**The US Economy and Fed Outlook**

As noted in previous editions, the US was experiencing a relatively mild downturn until late Summer last year. In the year to August for example, the average pace of job shedding was around 80,000 per month, well below the 200,000-plus typically (e.g. in the 2001 downturn) seen in a recessionary environment. But things took a severe turn for the worse in September as the extraordinary escalation in financial system stress in the aftermath of the Lehman Brothers collapse acted as a serious jolt to confidence and activity, not just in financial markets but also in the real economy.

The average number of jobs lost in Q4 was 510,000, with the 583,000 decline recorded in November marking the worst month in 34 years. Furthermore, the breakdown reveals weakness that is not just deep but also broad-based. The US labour market is now shedding jobs across all sectors from construction to manufacturing to services – a pattern that is very much consistent with the signals from other data (both official and survey) on the economy's recent performance.

We know that in real GDP terms the economy shrank at an annualised pace of 0.5% in the third quarter of last year. But it is abundantly clear from the above that a much more severe contraction was experienced in the three months to December. We

don't have the official Q4 GDP estimate yet, but available data are pointing to a decline of around 5% - which would be the worst quarter since the recession of the early 1980s.

Every component of GDP (bar government spending) looks set to contribute to this dire performance. Business confidence has taken a hammering which, combined with the surge in uncertainty in the current environment, is being reflected in reduced capital spending. Exports are falling sharply in the face of a sharp downturn in international trade volumes reflecting the synchronised nature of the global downturn. Construction has weakened further following yet another lurch lower in residential activity late last year and clear signs of emerging weakness in the non-residential sector.

Meanwhile, consumer spending likely posted another quarter of much reduced expenditure. Household incomes have come under very strong downward pressure in the face of far fewer jobs and decelerating wage growth while the level of wealth destruction facing US households is on a scale never seen in the post-WWII period. Data for the year to September '08 (latest available) show a staggering \$7,000bn wiped off aggregate household net worth, and the huge falls in stock prices seen at the end of last year as well as the continued declines in home prices means that wealth likely came under even greater pressure in the final quarter. Overall, consumer spending growth is on track to record a second consecutive quarter of 3.5-4% contraction in Q4 – the worst half-year for the US consumer since the early 1980s.

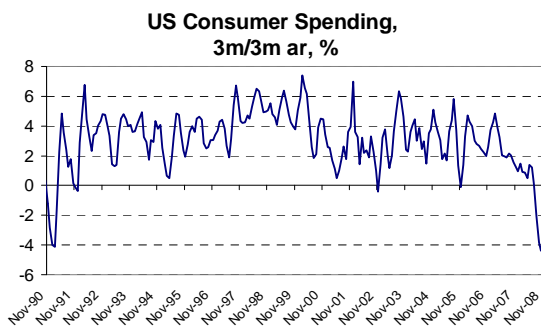
The problem facing the US economy in the very short term is that it is very difficult to see anything other than a continuation of large-scale weakness. Negative momentum, depressed confidence and the significant headwinds described above mean that the economy is likely to continue to contract at a sharp pace in the first quarter, possibly to the tune of around 4-5% again.

But beyond that we are of the view that the economy may well be able to show signs of stabilising and return to positive growth later in the year. Four considerations underpin this assessment.

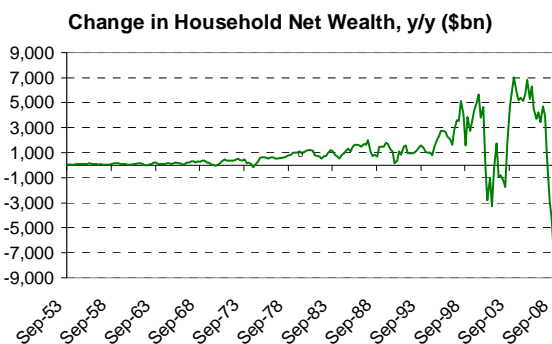
First, while the scale of the shock facing the economy is in many ways unprecedented, so too is the scale of the policy response – a theme we highlighted in our last Focus.

To take monetary/financial policy first, the Fed has for the first time in its history reduced official interest rates to effectively zero, announcing in December a 0-0.25% range for its Fed funds target. But in recognition of the severity of the problems, the Fed is going way beyond its traditional tool of setting a level for official rates. For one thing, it is using communication as a tool to guide market expectations about the intentions of policy makers: the December policy statement also announced the Fed's intention to keep rates at a very low level 'for some time', an attempt at managing market expectations about the future course of policy to help engineer easier financial conditions in the present time. Second, as well as remaining extremely active in supplying huge amounts of extra

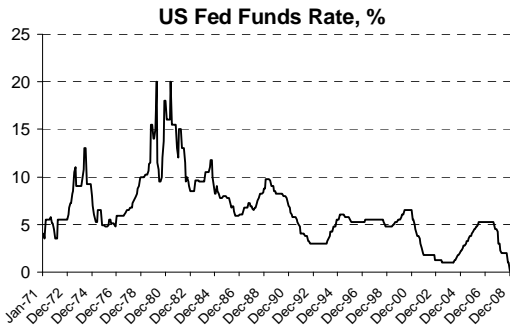
**...Which is now weighing heavily on consumer spending...**



**...as is an unprecedented decline in household wealth...**

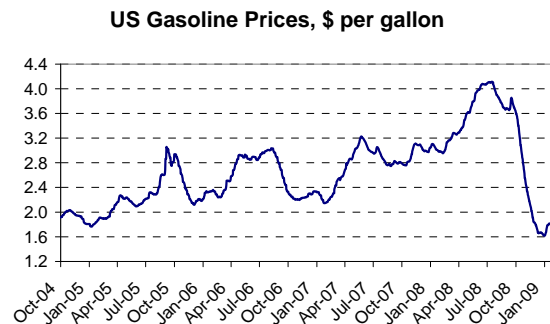


**The ultra-aggressive Bernanke Fed has taken official rates down to effectively zero...**



liquidity to money markets, it is now vigorously engaged in targeting many other areas of the credit and funding arenas. For example, it is now buying large quantities of Mortgage-Backed Securities (MBS) and other housing-related assets in an attempt to get borrowing costs for final borrowers down. It has also said that it is considering purchases of US government bonds (Treasury) a move which if implemented would exert further strong downward pressure on risk-free long-term rates. Indeed, the announcement itself that such an option is under consideration has already supported a move to historic lows in government yields, with the 10-year hitting a 50-year low of just over 2% late last year. These measures are without precedent in financial history and are an indication of both the seriousness of the current problems and the extraordinary lengths to which the Fed is prepared to go to address them. A sentence from the December FOMC statement summarizes the Fed's resolve: "The Federal Reserve will employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability". And importantly, the Fed now seems to be enjoying some well-earned payback for its unprecedented efforts as noted in the section above on the financial market environment with spreads in money, credit and mortgage markets now retreating from recent highs.

**Huge declines in energy costs also provide support...**

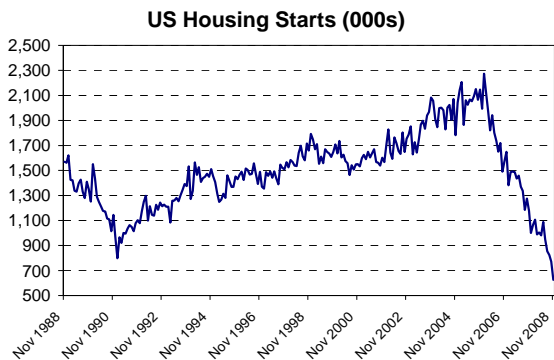


Moreover, the economy is set to benefit from an enormous package of fiscal stimulus. Incoming President Obama has assembled a very solid team to run his economic policy, a team which includes former head of the New York Fed Timothy Geithner as well as former Fed Chairman Paul Volcker. The team looks to have an acute understanding of the severity of the situation and has been busy putting together a huge stimulus package. Precise details are not yet available but the total package looks set to amount to a massive \$800bn-plus, or some 5.5% of GDP. It will likely include a combination of lower taxes and increased spending, with the latter expected to include extra expenditure on infrastructure investment, unemployment assistance and support for home-owners as well as further measures to support the banking system. It will more than likely be a number of months before any such stimulus kicks in (as final details will need to be decided upon and agreed by Congress), but it offers the promise of considerable support to the economy in the second half of this year and into 2010, with some estimates suggesting that by the end of 2010 the level of GDP will be 4% higher than otherwise would be the case. Even if such estimates prove to be on the optimistic side, there is no doubt that large-scale support for the economy is coming from the Federal government.

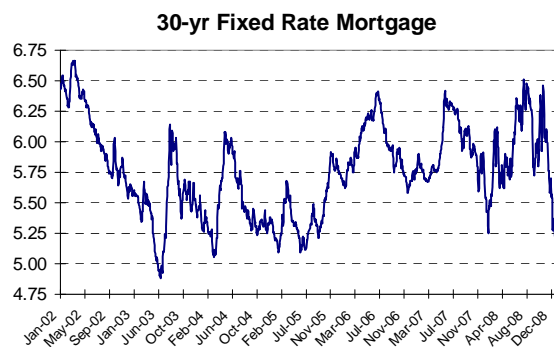
It is hard not to be impressed with the US authorities' determination to do whatever it takes to stabilise the situation. We believe that the measures being implemented and those that look set to be introduced will yield meaningful results in terms of supporting the economy and effecting a further gradual thawing in money and credit markets', with the important caveat that improvement on both fronts is not likely to be even or dramatic.

Second, one benefit of the pronounced weakness in global activity is the significant relief it has brought in the form of lower commodity

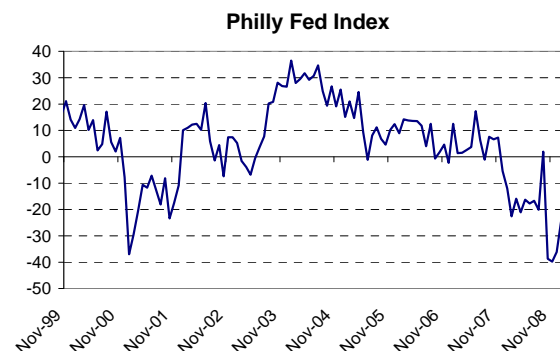
**The correction in housing construction is closer to the end than the beginning...**



**... recent large declines in mortgage rates are very helpful...**



**Is the rate of deterioration in US activity beginning to wane?**



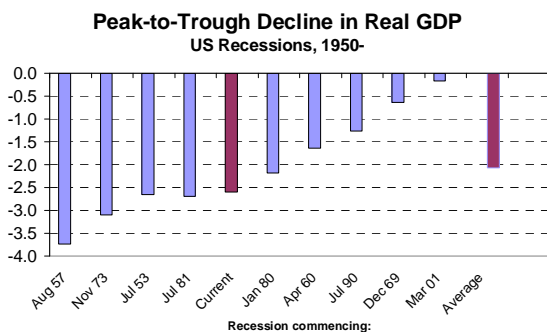
prices. Oil prices in particular have fallen sharply from their \$147 per barrel peak in July (in Brent crude terms) to trade around \$45pb at present. Prices averaged about \$100pb in 2008 but look current futures pricing points to a possible average of about \$50pb for the coming year, or about 50% lower than that in 2009. This substantial decline brings with it a direct boost to discretionary spending power for both households and firms. The large drop in gasoline prices since the Summer is a visible metric on this front, with prices at the pump plunging from a high of over \$4per gallon to as low as \$1.60 last month. In fact, the November reading on total consumer spending provided evidence of such support with a huge 1.1% monthly decline in consumer prices spurring a 0.6% m/m increase in real (i.e. inflation adjusted) spending – the strongest month in some two years. Clearly, the consumer is facing substantial headwinds from other sources as discussed above, so lower energy prices are not a magic bullet; but they do provide an important source of support nonetheless.

Third, is the observation that housing activity cannot and will not fall forever. Housing starts currently stand a staggering 73% below the early-06 peak and while further declines (possibly large at that) in residential construction seem inevitable in the very short term (reflecting economic and financial conditions), we are certainly closer to the end of the housing adjustment than the beginning. Housing has pulled GDP growth lower to the tune of about 1% point per quarter over the past two years, but this drag is way more likely than not set to fade over the course of the year, perhaps even turning into a small positive for growth by the end of the year if activity recovers modestly from what will be extremely depressed levels. The large-scale declines in mortgage rates seen in recent months (they are now within sight of the all-time lows of under 5% seen in '03) will be an important help in promoting an eventual bottoming out in housing.

Fourth, we are beginning to see some signs (very tentative admittedly) that economic activity may be in the process of bottoming out, albeit at very low levels. Some surveys of activity have actually showed small increases in the past month or two. Notably, both the Empire (New York) and Philly Fed indexes rose in January, the latter posting its second consecutive monthly advance. Obviously, one or two readings of regional activity don't make a national trend. But it was also interesting that the national ISM index of non-manufacturing activity also managed a three-point gain in December. This is not at all to suggest that the economy is poised for an imminent rebound; after all, all of these indicators are still at extremely low levels in historic terms. But these could turn out to be early signals that at least the rate of deterioration in the economy is finally beginning to wane – a small first step towards stabilisation.

Overall, the US economy is set to continue to contract for the next couple of quarters, by perhaps 4-5% annualised in Q1 and a further 1-2% in Q2, before growth nudges back into modestly positive, but still sub-trend, territory (around 1-2%) over the second half.

...the current recession looks set to be worse than average, but not as bad as others since the 1950s, thanks in no small part to the extraordinary efforts of the US authorities



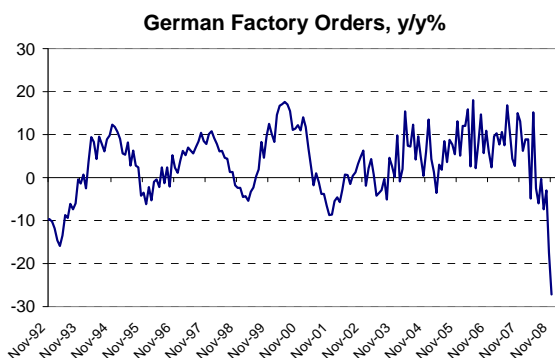
Recovery, when it comes, is unlikely to be strong, not least because of the need for US households to rebuild savings levels from unsustainably low levels. The enormous hit to household wealth discussed above adds to the pressure to repair balance sheets and as we look forward an increasing share of household incomes are likely to be diverted to savings rather than consumption. Indeed, this process looks to have already begun with savings levels already up from near-zero a year ago to almost 3% on the latest numbers (November) – one of the reasons behind recent weakness in consumer spending.

This means the recession is likely to extend until at least the middle of this year. As the NBER, the official arbiters of US recession dating, have now formally declared that the downturn began in December 2007, this would mean that the current downturn is on track to be the longest since the Great Depression of the 1930s. However, with a likely peak-to-trough decline in real GDP of the order of 2.6%, the likely scale of output loss is nowhere near the 27% collapse seen in the 30s.

But the 2.6% peak to trough decline would still, unsurprisingly, be more severe than the average contraction of 2% seen in the nine recessions since the 1950s and would represent the worst downturn since 1981. However, it seems that the current downturn may end up not being the most severe in the post-War period, a tag which may remain with the 1957 recession in which output fell by 3.7%. That the US may end up avoiding a much worse outcome is due in large measure to the extraordinary response of the US authorities.

## The Euro Area Economy and ECB Outlook

Incoming economic news from the euro zone, especially Germany, has been dire



At the time of our October Focus, we had a relatively gloomy forecast for 2009 euro area GDP growth. We were pencilling in average growth for this year at -0.2 % - the first annual contraction in the history of the euro area.

But incoming data are pointing to an economy that is much weaker than we had envisaged at that stage. Indeed, the weakness in the latest numbers on activity in the zone has been alarming. November seems to have been a particularly awful month for activity – a pattern not unique to the euro area as the global environment looks to have lurched lower around then too as the business sector adjusted to the huge shock which hit the financial system. German exports plunged by an astounding 10.8% month on month in November (latest available) – the weakest reading since records began in 1990. And the profound weakness in new factory orders in Germany we identified in October has intensified even further, with new business plummeting by in excess of 6% for each of the two most recent months (October and November). This too is weakness on a multi-decade scale, and the forward-looking nature of the orders data points to additional and considerable downside for output and production in the months ahead. Indeed, an early estimate of German GDP indicates the economy

contracted by 1-5-2% q/q (not annualised) in the three months to December – the weakest quarter since the late 1980s.

But accelerating weakness is far from being solely a German phenomenon. The composite Purchasing Managers Index (PMI) – a reliable guide to the performance of the overall euro area economy in GDP terms – fell to a new all-time low in December and it looks as if the aggregate euro area economy contracted by in excess of 1% in the final quarter. Meanwhile, the labour market continues to deteriorate. The jobless rate is now in a very clear upward trend, with the latest (November) reading standing at 7.8%, up from 7.2% earlier last year.

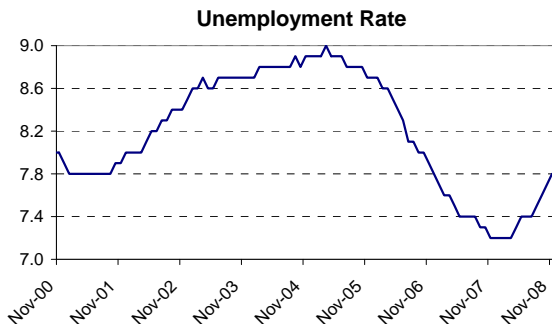
The significant weakness of the numbers in the run in to year end also signal very poor momentum as we move into 2009, though as yet we have no activity data for the current year. Such a weak end to 2008 generates a very weak base from which average growth rates for the coming year will be calculated, so forecasters have been busy marking down their GDP numbers for 2009.

The ongoing correction in property markets continues to weigh on the outlook for construction (both residential and non-residential) while the international nature of the downturn is hitting the euro area hard, both in terms of export activity and also reflecting the common shock to the corporate sector globally. The result is that, in addition to the weakness in construction which is in progress, both exports and capital spending are set to exert a major drag on overall growth this year. On the latter, it is interesting to note that the flow of credit to non-financial corporations (NFCs) is now easing back at an accelerating pace. The latest numbers (November) show the annual rate of credit growth to NFCs at a 2 ½ year low of 11.1%, down from as high as 15% last March. This is in line with our expectation of three months ago, but points to a somewhat greater effect of market turmoil on the credit environment than the ECB has been prepared to concede, until recently at least.

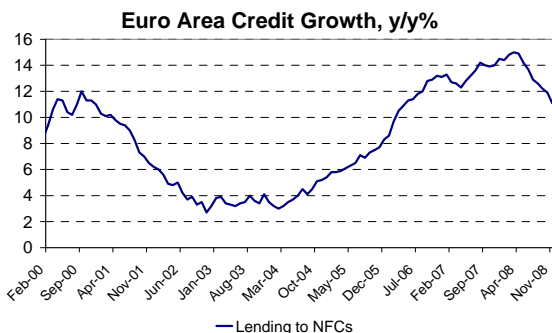
In fairness, the ECB has responded to this accelerated weakness by embarking on an easing cycle unprecedented both in terms of scale and speed. For example, it has now moved on rates in each of the past four consecutive months, a pattern of pro-activity never seen in the ECB's 10-year history. Furthermore, in the period since the first cut in mid-October it has lowered rates by a total of 2.25%, including most recently the 0.50% cut announced at last week's January meeting. At the same stage in the last cutting cycle (in 2001), the ECB had taken rates down by a mere 0.25%. So while we, along with many observers, do find ourselves getting frustrated at times with the ECB's relatively (in comparison with the Fed and BoE) cautious approach, it is worth remembering that the ECB has certainly upped its game in response to the extraordinary circumstances prevailing at present.

Comments from President Trichet at the January press conference made it clear that the Governing Council is aware of, and is taking on board, the fact that the economy is going to be weaker than expected by the December staff forecast. It was clear that the

### ...and the jobs market continues to worsen...



### ...credit growth to corporates is now clearly slowing...



decision to cut by 0.5% this month made allowances for the fact that both incoming information had been weaker than expected and also for the fact that as they looked forward the outlook was now also somewhat poorer.

Nonetheless, our view on growth prospects for this year (we look for a contraction in real GDP of 1.9%) leads us to believe that the ECB has further to go in acknowledging the extent of the downturn facing the euro area economy. We expect the next ECB staff GDP forecast, which will be prepared for consideration at the March meeting, to show a significant downward revision, to something akin to our own current forecast from the -0.5% projected in December.

We thus expect the updated staff projections in March to be used as justification for another 0.50% reduction at that stage. The weakness in the growth environment makes an important contribution to keeping inflation in check, while the sharp declines in oil and other commodity prices is even more immediately helpful. Inflation has already started to fall sharply, currently standing at 1.6% from as high as 4% in July. Annual rates of headline inflation may even dip into negative territory by the middle of this year, leaving average levels close to 1% - well inside the ECB's definition of price stability of below but close to 2%. Thus, in our view rates are destined to get to a new all-time low for the ECB of 1.5%.

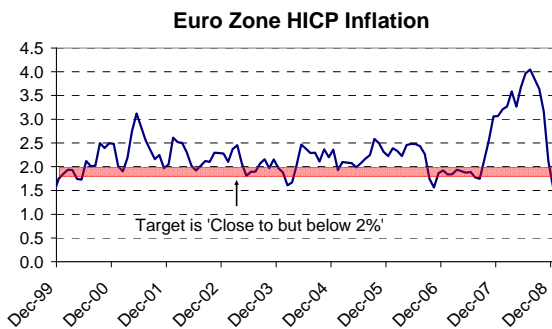
Such is the weakness in the economic environment, both within and beyond the euro area, that we are certainly open to the idea that rates may ultimately end up going even lower, say to 1% or below (see our special box on the ECB's reaction function). However, comments from Trichet at the January press conference repeated his frequently-stated position that it is not the intention of the Council to find itself in a 'liquidity trap' caused by lowering rates to excessively low levels. And he openly acknowledged the ECB's lack of enthusiasm for following US and Japanese rates down to close to zero.

It seems to us that beyond March it is unlikely (though clearly not impossible) that the global and euro area economic environments will still be deteriorating at an accelerating pace. Thus, it is not obvious that incoming news beyond that point will be worse than implied by presumably very low expectations, especially if money and credit markets continue to thaw and if the US economy is perhaps showing some signs of stabilising at that stage. In this context, we note with interest some modest improvement lately in some-forward-looking survey indicators, including the German ZEW which has risen for three months in a row to stand at its highest level since November '07.

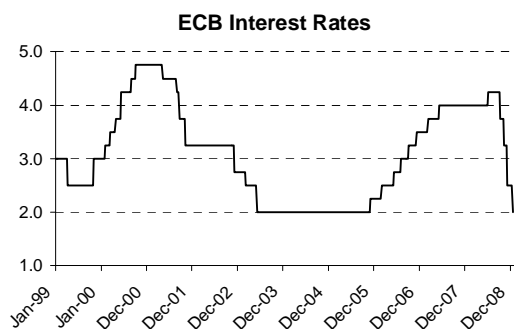
So, while there is a clear risk of further ECB action beyond March, we are inclined to hold back from pencilling in anything more than a move to 1.50% at this stage.

As for recovery prospects in the zone, lower oil prices certainly help and the sharp decline in inflation which is on the cards will boost real household incomes, though unfortunately other things (notably

### ...Inflation is now falling sharply...



### ...and the ECB is slashing rates at an unprecedented pace...



a worsening jobs market) are not equal, so overall spending will still be subdued at best. Any stabilisation in financial sector conditions would certainly be helpful and a pick up in the US is probably necessary to see a euro area upturn. Ultimately, however, the euro area will most likely be following rather than leading the other main economies out of this downturn. This is a scenario that is directly linked to the relatively cautious response of policy makers in the zone, not just on the monetary front, but also on the fiscal side where institutional problems (there is no one single fiscal authority) and cultural differences have hampered efforts at pulling together a response of the magnitude in train elsewhere. However, we do take some encouragement from a re-think in the past couple of weeks by the German government on the merits of a stimulus plan; a package (amounting to some 1.5% of GDP) does now finally look set to be implemented.

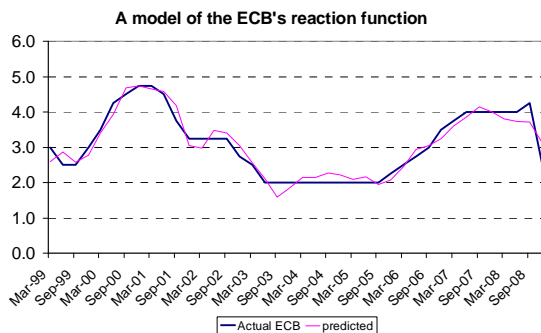
### Special Feature Box: Modelling the ECB official rate

It would be impossible in a short note such as this to do full justice to the complexity of the decision-making processes faced by modern central bankers, including policy-makers at the ECB. However, we have developed a simple little model of the ECB's behaviour which does a reasonably good job of tracking the path of ECB interest rate policy since it was formed in 1999 which we use to shed light on the possible path for interest rates.

Given the time lag between a change in rates and the effect of that change on the economy, modern central banks including the ECB should base their decisions on a forward looking view as to where inflation is going. So, no surprises that we include an inflation forecast variable in our model. The exact measure we use is the expected level of inflation one year into the future, measured by the average of responses to the ECB's quarterly Survey of Professional Forecasters (SPF). We also include a measure of economic growth. Measures of activity should provide extra information on the evolution of underlying inflation pressures (when growth is expected to be strong, so will price pressures be building, and vice versa when growth is weak etc) and should therefore inform the policy choice. Again, we take the expected rate of GDP growth in a year's time measured by average responses to the SPF. (We also add in a third variable, the level of the ECB rate in the prior quarter, partly to allow for the fact that rates tend to move in cycles).

As can be seen in the graph across, this simple model – sometimes referred to as a 'reaction function' to capture the way in which the policy rate tends to react to changes in the macro environment – has done a pretty good job in explaining the ECB's behaviour over the past 10 years. As a brief aside, it helps debunk a couple of myths surrounding the ECB. Firstly, the fact that the variables are forward-looking underlines a very clear forward-looking dimension to the ECB's behaviour (i.e. it, rightly, doesn't set interest rates by looking at the prevailing reading of inflation). Second, the useful inclusion of a growth variable highlights the fact that the ECB, while clearly focussed on achieving an inflation target (of close to but below 2%), does not in fact ignore measures of economic activity in

**We have developed a simple model of the ECB's reaction function. It points to further downside for rates**



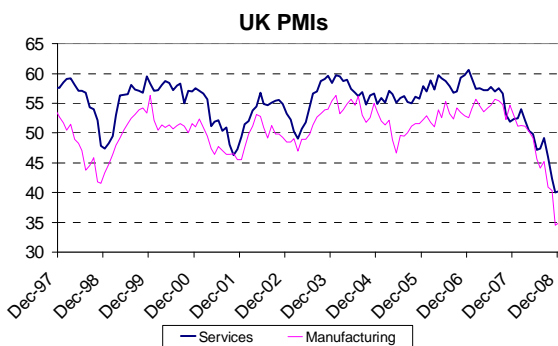
some dogmatic pursuit of price stability. The expected pace of economic growth is an important driver of the medium-term inflation outlook and hence its inclusion here adds explanatory power to the model.

So a natural question to ask is what level of the ECB rate is implied by the current outlook for growth and inflation? Well, the results of the next SPF won't be publicly available until the ECB publishes its February Monthly Bulletin next month. But we can plug in estimates for the variables in the model based on the latest consensus forecasts for GDP growth and HICP inflation to see what it throws up.

Doing so suggests that the current outlook points to a possible ECB rate of 1% or lower. However, please see the section on the euro area economy and ECB outlook for a discussion on why we think that rates may not end up going as low as that. In the context of the model's predictions, it is worth highlighting that the model over-predicted the extent of likely easing at the bottom of the last rate cycle. In other words, this simple reaction function indicated that rates would fall below 2% then, but they clearly didn't - an indication perhaps of ECB caution when rates get down to very low levels.

## The UK Economy and MPC Outlook

### UK activity is weakening sharply...



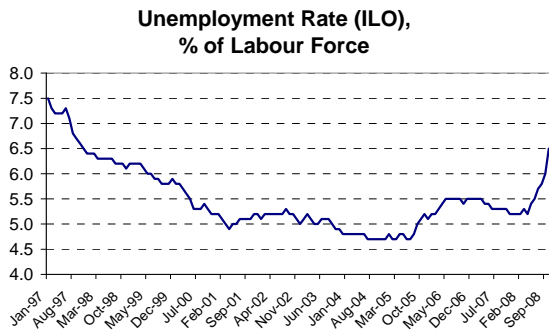
Previous sections have highlighted an intensification of economic weakness in major economies in the final quarter of last year, and the UK is no different. We know that UK economic growth turned negative in the third quarter of 2008 (real GDP fell by 0.3% q/q), the first quarterly contraction since the recession of the early 1990s. But, as with the US and euro area, the performance of the UK economy has taken on a disturbing degree of additional weakness in recent months.

Both the manufacturing and service sector PMIs, which provide a good steer on the economy's underlying dynamic, hit new all-time record lows in the final quarter of last year. Official output data, though less timely, provide clear supporting evidence. Following a shockingly weak 2.3% monthly decline in November, industrial output, for example, is running over 3% lower than Q3 levels.

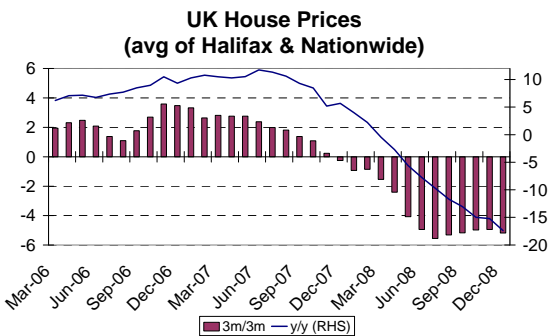
Indeed, we get preliminary national accounts data for the final quarter out later this week. The 1.2% q/q decline in real GDP which we expect would be the weakest quarter since a similar decline was recorded in Q2 1990. Before that you have to go back to 1980 to see anything of comparable weakness. For 2008 as a whole the economy is likely to record a 0.7% expansion in average GDP terms.

With trend growth in the UK of the order of 2.5%, such a performance implies the opening up of a significant amount of spare capacity. And this is becoming increasingly evident in looking at the

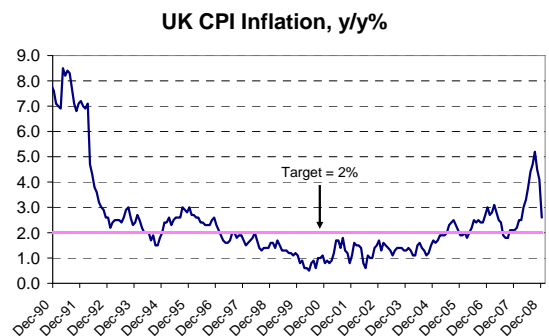
**And the jobless rate is shifting noticeably higher**



**House prices show no sign of bottoming...**



**...but inflation is falling sharply too, and will soon be below target ...**



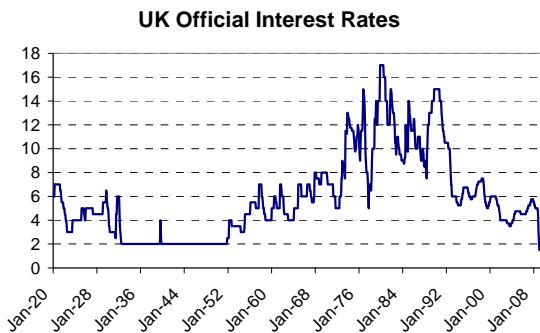
jobs market. The latest numbers show the unemployment rate reached a 9 ½ year high of 6% in October - well up from the lows of 5.2% seen earlier in last year. This deterioration in labour market conditions is doing little to help the ailing housing market, which continues to suffer under the weight of falling employment levels and the continuing tightening of credit conditions. The monthly run-rate on mortgage approvals has hit a new record low of just 27,000, reflecting no doubt the combination of much softer demand as well as supply constraints on new bank lending, and housing starts have continued to fall sharply. Meanwhile, house prices continue their relentless retracement lower and are now 18-20% down on the peak levels seen in the second half of 2007 (on the Nationwide and Halifax measures). Official estimates of retail sales have held up surprisingly well having beaten City forecasts to the upside for the past five consecutive months now. But this pattern is hard to square with gloomy evidence from surveys and anecdotal reports alike.

So the UK, like other major economies, is experiencing weakness of historic proportions. But fortunately that weakness is not being left unchecked by policy-makers. In particular, the Bank of England has responded with an extraordinarily aggressive series of moves on the interest rate front as it became clear that the economy's trajectory was in the process of nose-diving. Since early October, it has cut official rates in the UK by a staggering 3.5%, including a spectacular 1.5% cut in a single move in November. This has taken UK Bank Rate from 5% just over 3 months ago to its present level of just 1.5%. To put this action in context, the current level of rates represents a 300-year low according to BoE records which track official rates all the way back to the late 1600s. So the Bank really is pulling out all the stops here in its attempt to stem the slide in activity and prevent a material undershoot of inflation relative to the 2% target.

Furthermore, the BoE is not alone in its crisis management endeavours. The UK government have embarked on a programme of fiscal stimulus through a combination of tax cuts and additional public spending (totalling over 4% of GDP over two years) and have also introduced a variety of support mechanisms for the banking system including two waves of recapitalisation and measures to improve access to liquidity and funding, all with the objective of getting lending going again. Indeed, formal targets for new lending to businesses and households have now been set for UK banks, as the Government prioritises the need for credit to flow to the real economy.

As we look to the year ahead, such is the weakness in domestic and international demand at present that it is difficult to contemplate anything other than a continuation of very weak activity in the coming months and we pencil in an average decline in GDP this year of 2.2%. We look for further declines in real GDP of 0.5-1.0% in both Q1 and Q2 of this year, as the various forms of stimulus and support, significant as they are, don't kick in quickly enough to reverse the extremely weak momentum which looks set to suppress growth in the short term.

**And the BoE has been phenomenally aggressive in taking UK rates down to never-before seen levels...**



Such an outlook translates into a further build-up of substantial spare capacity in coming quarters. In turn, this will bear down strongly on underlying inflation pressures as firms have less pricing power and workers have less bargaining power. Add in the huge falls in energy and other commodity prices and the 2 ½ p reduction in the VAT rate in the Pre-Budget Report and CPI inflation is set to fall very sharply indeed in coming quarters, possible even dipping into negative territory later in the year (though given the one-off nature of the VAT change this would likely be a short-lived deviation into negative territory). From a position as recently as last month where the BoE Governor has been required to write to the Chancellor explaining why inflation was in excess of 1% above the 2% target, it is highly likely that within six months or so he will be writing to explain why inflation is so far (more than 1%) below the target. How fast things have changed.

This performance is likely to be associated with the need for the Bank of England to do even more on the official rate front and we pencil in a further 0.50% reduction at the February meeting. And further easing is probable beyond next month, though come March it may well be the case that the BoE is starting to take its foot off the gas somewhat. So while we forecast another rate cut at that stage we think it may well be a smaller 0.25% cut, which would take UK rates to 0.75% - their first time ever below the 1% mark.

Indeed, we noticed with interest one noteworthy change in the January policy statement relative to that released after the December rate cut. The Committee chose to insert a new sentence noting “that the recent easing in monetary and fiscal policy, the substantial fall in sterling and the prospective decline in inflation would together provide a considerable stimulus to activity as the year progresses”. We certainly wouldn’t at this stage go as far as to say that the inclusion of this statement represents a deliberate attempt to play down the likelihood of further easing. But the reference to “considerable stimulus” looks to be a conscious attempt at reminding market participants that a huge amount has already been done to provide support for the economy. At some point, policy makers will need to stand back and allow the significant measures already put in place time to work through. We do not at all doubt the BoE’s willingness to do whatever it thinks is necessary and appropriate in the coming months, including the introduction of non-conventional policy measures such as direct asset purchases to improve credit markets, which looks set to be implemented within a matter of weeks. However, this is an interesting reality check of sorts, albeit a subtle one, for a market which has become accustomed to extremely large rate cuts as a matter of course.

## FX Outlook

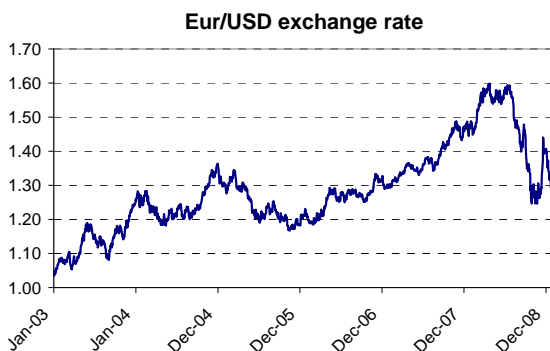
### Eur / USD

Our October call for a late-year dollar sell-off worked out reasonably well. From levels as low as sub-\$1.24 in late October, Eur/USD soared in December, in the end even exceeding our year-end \$1.35 target by closing out 2008 at \$1.3850, getting as high as over \$1.45 in the interim. While some of this move reflected a technical pull-back following the exceptionally large and swift move lower in the months prior, it also had fundamental support from news on the relative stance of monetary policy in the two economies. Following its December meeting, the ECB expressed a surprising degree of reluctance about cutting rates again in January, while in contrast the Fed shifted gears in December in slashing US rates to near-zero and indicating its intention to use all available monetary tools to promote a resumption of growth.

But since then, the ECB has done a u-turn, and ended up cutting rates in January after all. This was in the face of a serious deterioration in euro area economic activity, with a host of indicators suggesting the economy weakened dramatically at the end of last year. Such news has prompted a large sell-off in Eur/USD in recent weeks, taking us to as low as \$1.30 in recent sessions. Heightened downside risks facing the euro area economy is likely to remain a key theme in the months ahead in our view. The ECB has more work to do on the interest rate front, with at least another 0.50% coming in the months ahead while the Fed's ultra-easy policy stance is well discounted, in terms of the near-term currency implications at least. The dollar may also benefit in the short term from an 'Obama-bounce' in confidence as the new administration gets to work on implementing a huge stimulus package as an immediate priority. In contrast, domestic politico-economic considerations are a negative for the euro. The euro area is lagging the US on the fiscal stimulus front, both in terms of timing and scale, though it seems more progress is now finally being made on this front. In addition, pronounced weakness in the economies and public finances of periphery countries within EMU is now weighing on investor sentiment towards the single currency, while there are also rising concerns about the exposure of the euro area to the increasingly vulnerable emerging market economies, especially those in Eastern Europe. Overall, we expect the euro to remain under pressure against the greenback and target \$1.15 in the months ahead which would be a 5-year low for Eur/USD.

While we are positive on the dollar in the short term, we are somewhat more cautious further out. If the US economy stabilises over the coming quarters, investor concern may switch to the medium-term inflation risks associated with the authorities' ultra-aggressive approach to providing stimulus of all forms at present. The Fed's willingness to do whatever it takes to support the economic and financial environment is not in doubt. But careful management of the planned exit strategy from the current uber-easy policy setting, whenever that time comes, will be crucial for the

### Eur/USD sell-off has continued in recent weeks following year-end rally...



Fed in containing long-term inflation expectations. This is especially important in an environment when the need for the US to attract foreign capital is set to reach extreme levels given a still-large current account deficit and as the budget deficit soars to up to \$2 trillion for fiscal year 2009, reflecting the combination of economic weakness and the massive fiscal stimulus. This argues for some reversal of the strength we expect in the short term over the course of the year. Thus, anything around the \$1.15 mark would represent a very good opportunity to sell dollars for those customers with dollar inflows.

## Eur / Stg

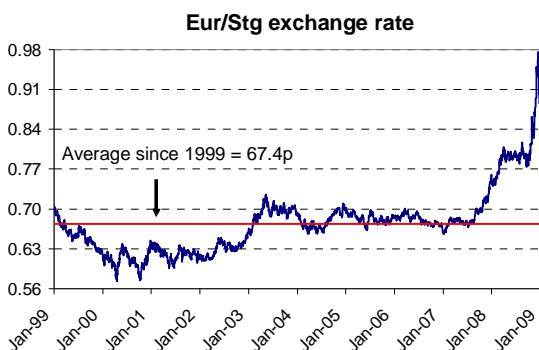
Selling sterling was certainly one of the favoured trades in currency market circles over 2008. A sharply deteriorating UK economy, combined with a Bank of England in hyper-cutting mode gave traders all the excuses they needed to send the UK currency lower. With the ECB adopting a more cautious approach, in relative terms at least, the result was that we hit a succession of all-time highs in Eur/Stg over the back end of last year. Ultimately, a record level of 98p was established in the final trading days of 2008, a move that represented a brutal 33% appreciation of the euro over the year. For those with memories long enough to recall the pain of the early 1990s Irish currency crisis (in which the peak for the old sterling-punt rate was just over £1.10), 98p corresponds to over £1.24 in 'old money'.

The New Year has brought somewhat better news for exporters to the UK, at least in terms of the currency markets. The Eur/Stg rate has corrected significantly lower in early-year trading, getting to as low as sub 89p last week. As noted above, the weakness in the euro zone economy and other vulnerabilities in the zone have come sharply into focus.

The UK economy is certainly not in anything remotely akin to good shape, but a foreign exchange rate is a relative price. Last year, traders were firmly focused on the weakness in the UK and what that means for interest rates there. The price action early this year suggests that escalating weakness in Europe is, rightly in my view, a greater concern. These themes argue for a continuation of the move lower in Eur/Stg over the remainder of this year.

Levels such as we got to at the end of last year represented an overshooting of sterling to the downside, in our view. Note that the average level of the Eur/Stg rate since the euro was introduced is 67.4p. While I am certainly not arguing for a return to sub-70p, a level of 98p represents a 45% deviation from that average. It does seem to me that sterling is undervalued vs. the euro at current levels and that it can recoup some of its recent declines and get back to 80p later this year. Such a move would also be consistent with the market rewarding the policy-activism of the UK authorities both in absolute terms and relative to the euro zone. However, uncertainties abound and markets will likely remain very volatile, so don't expect it to be a straight line move, with the move back up to 93p in recent sessions a case in point. Current levels represent

**Eur/Stg has retreated from its recent all-time high of 98p, but still looks too high to us**



very good value for customers with sterling to buy in our view.

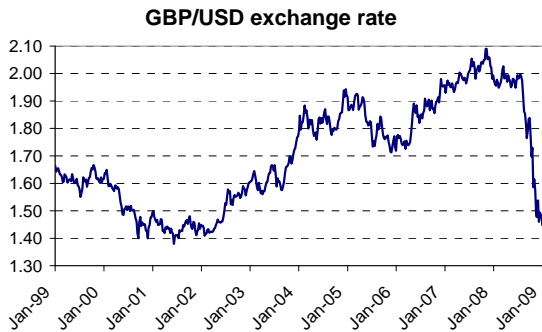
## GBP / USD

GBP/USD has fallen to a 7 ½ year low in the past couple of sessions, as renewed sterling weakness and a stronger dollar have combined to produce a move to below \$1.40 for the first time since mid-2001. As discussed above, we are positive on the dollar in the next few months and we think it is likely to make further gains against sterling as well as the euro. However, as we think that sterling is poised to recover further against the euro, the decline that we are pencilling in in GBP/USD is somewhat smaller than in Eur/USD in percentage terms. The sell-off to \$1.15 which we anticipate in Eur/USD, taken together with a move to 87p in Eur/Stg implies a target of \$1.32 by March, and we may even get there sooner given the momentum behind this latest move lower. This would take sterling to levels last seen in the mid-1980s. But, the UK unit is likely to rebound later in the year, helped by the general dollar weakness which we expect to kick in as well as some independent sterling strength as it recovers from extreme lows against both the euro and the dollar.

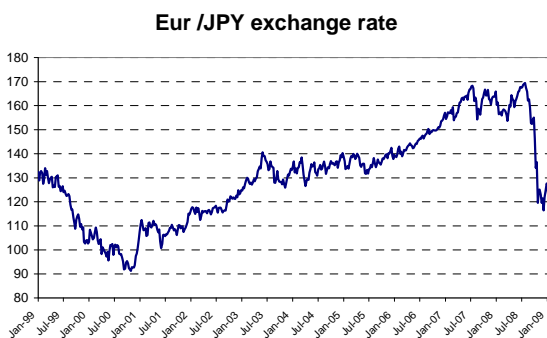
## Eur / JPY

The yen was easily the best-performing main currency in 2008 as its safe-haven status resulted in very large advances (of anywhere from 14-40%) against other majors, gains that were concentrated in the second half of the year as the global financial crisis intensified. The Bank of Japan joined the global cycle of rate cuts in lowering rates by 0.20% in December to take them to a mere 0.10% and the yen experienced some modest weakening for a brief period thereafter. However, at effectively zero rates in Japan can't be cut any further while ECB rates certainly have further to fall. This argues for further yen strength in the short term, especially while economic and financial sector weakness continues to grip globally, and we look for a decline in Eur/JPY to around Y113 – the intra-day low reached in mid-October. But the scope for further yen strength beyond that is probably capped by the lingering threat of intervention from the Bank of Japan, which has expressed concern about the negative economic implications of a strong currency, as has the Ministry of Finance. In addition, if the US economy begins to show signs of stabilising later in the year, risk-aversion inspired buying of yen is likely to diminish, allowing scope for Eur/JPY to head back towards the Y130 level by the end of the year.

**GBP/USD has sunk to a 7 ½ year low; further declines seem inevitable**



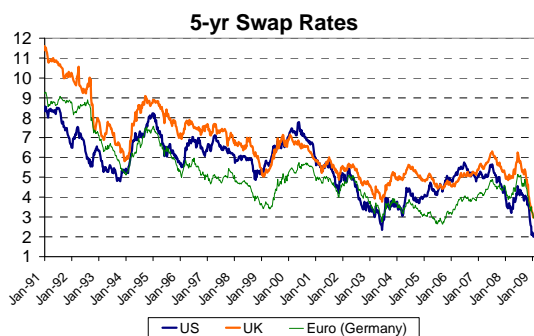
**After its huge rally in recent months, the scope for further large gains for the yen is looking limited ...**



## Long-term Rates Outlook

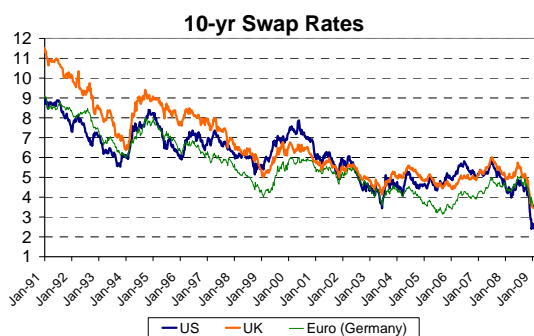
The barrage of seemingly unremitting gloom we have all been exposed to in recent months does, believe it or not, bring with it some excellent opportunities from a treasurer's perspective. In particular, as growth expectations have ratcheted down and as central banks have slashed policy interest rates to record lows in some cases, long-term borrowing costs too have fallen to extraordinarily low levels.

**Five-year rates are at or close to historic lows across the markets...**



Five-year rates, for example, across sterling, dollar and euro markets have tumbled by anywhere between 1.2% and 1.8% since our October Focus. These huge moves have taken rates to exceptionally low levels, especially in the case of dollars and sterling. Five year USD rates, for example now stand at around 2%, some 0.30% lower than the absolute low seen at the bottom of the last rate cycle in 2003. Similarly, equivalent sterling rates now stand at just 3%, some 0.75% lower than the previous low seen in the same cycle. Thus, treasurers with long-term sterling or dollar debt on their books have simply never had better levels of long-term rates at which to hedge such debt. Euro rate markets have not quite reached such historic extremes, but with five-year rates dipping below 3% at present they are only around 0.40% from the lows seen at the bottom of the last downturn.

**...as are rates in the 10-year area. In both cases, current levels offer excellent value from a hedging perspective**



We regard these levels as a strategic opportunity for treasurers to lock in at levels that are very attractive in absolute terms, and that also provide a good deal of protection from the eventuality of rates going higher on a multi-year horizon. In fact, in our view, there may even be better value to be had by considering moving further out the curve, to say the 10-year area. In each market, one can buy an extra five years of protection and certainty for a mere 0.50% or so over and above current five-year rates.

It is worth pointing out that there is widespread agreement among central bankers that part of the reason why the financial system finds itself in the current mess is related to the fact that interest rates were too low for too long in the last interest rate cycle (particularly in the US), with an abundance of easy money ultimately generating and facilitating the subsequent credit and asset market bubble.

Thus, one clear lesson from that period is that once some semblance of normality returns to the economic and financial landscape, it will be both appropriate and necessary to begin to take back the huge amount of stimulus currently being injected into the system. To be clear, I am not arguing that official rates are likely to be raised anytime soon in any of the major economies under discussion. It seems to me that that is unlikely until sometime in 2010. But the reality is that long-term rates will not wait for definitive indications of an imminent turn up in the official rate cycle. In fact, history shows that long-term rates begin to move higher at around the time of the last act of policy easing and very much ahead of any firm indications of recovery. This is perhaps

especially relevant in the current environment in which exploding budget deficits are likely to be the source of upward pressure on long-term bond yields as governments have to issue substantial amounts of bonds to fund high and rising borrowing levels. Furthermore, there may well come a time when investors may begin to fret about the inflationary consequences of the enormous stimulus being thrown at the system at present.

Trying to pick the absolute lows in market interest rate cycles is a mugs game, but experience tells us that the most opportune time to hedge is when gloom is omnipresent and at its most extreme, growth forecasts have been marked down at an accelerating pace and generally when it feels as if there is no way out of the downturn. Tactically, long-term rates may end up falling a bit more from current levels depending on just how bad incoming economic and financial sector news is in the coming weeks and months. However, there is a lot of bad news already in the price in interest rate markets at this stage and we strongly encourage treasurers to adopt a strategic perspective in the present environment and seize the opportunity currently being presented to them. Long-term rates won't stay at such low levels for long if the market begins to sense some shape of stabilisation/recovery in the US and with it the possible end of central bank easing cycles.

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