



Exchange Rate Outlook *6th August 2010*

- **Dollar under pressure as focus switches to US economic outlook**
- **Euro rallies as sovereign associated risks ease**
- **Sterling recovery continues as UK outlook improves**
- **Market sentiment continues to drive yen**

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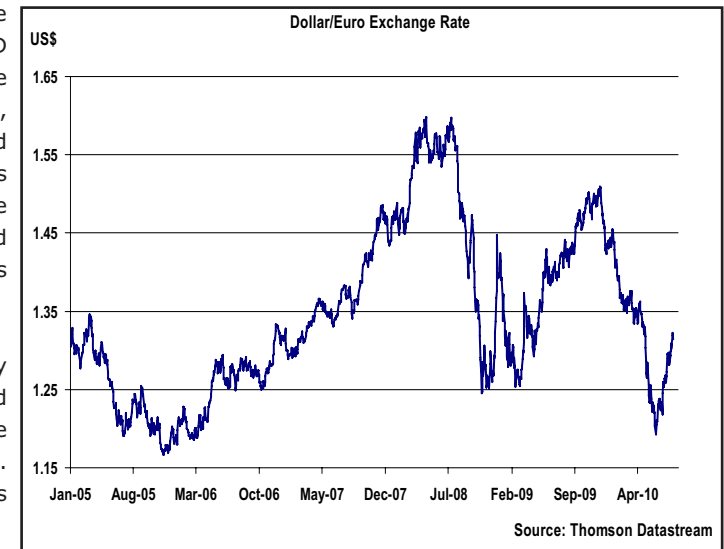
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Market Overview

■ **Recent weeks have seen a complete turnaround in terms of sentiment on forex markets.** The dollar has fallen sharply against other majors, with the euro recovering considerable ground versus the USD as a result. We have gone from a situation where investors were firmly against the euro to one where the dollar is now on the backfoot. So what has changed? A series of key US data releases have disappointed, pointing to weaker growth prospects for the US economy in the second half of this year. This has prompted talk of fresh supportive action from the Federal Reserve and markets have pushed out their expectations for any rate hikes in the US to mid-2011 at the earliest. Meanwhile, some eurozone data releases have surprised on the upside, the ECB appears a little more optimistic in terms of its economic outlook and markets are (for the moment anyway) less concerned about eurozone sovereign risk. Thus, there is less need for a move into safe haven dollars.

■ **In terms of the factors driving our forex forecasts,** it has long been our view that the pace of recovery in the US economy would lose momentum in the second half of this year and that interest rates would remain on hold until into 2011, with this weaker outlook eventually weighing on the USD as it became the general market view. We had also anticipated that the risks associated with the eurozone would ease. However, as nearly always proves to be the case with currency markets, this change in view has materialised more quickly than we had been anticipating.



■ Thus, **we have pulled forward the timing of our predicted recovery in the euro** from this year's lows of \$1.1878 (as seen in early June), as reflected in our revised forecasts. We now anticipate a \$1.28-1.38 trading range near term as compared to last month's \$1.16-1.26 range. Over the longer term, we anticipate a \$1.25-1.35 trading range, which constitutes a modest upward revision from last month's year end forecast of \$1.20-1.30. While dollar/euro tends to dominate in terms of assessing direction on forex markets, movements in dollar/yen should also be closely watched as a key indicator of market sentiment, with investors currently favouring the Japanese currency as a safe haven alternative over the dollar.

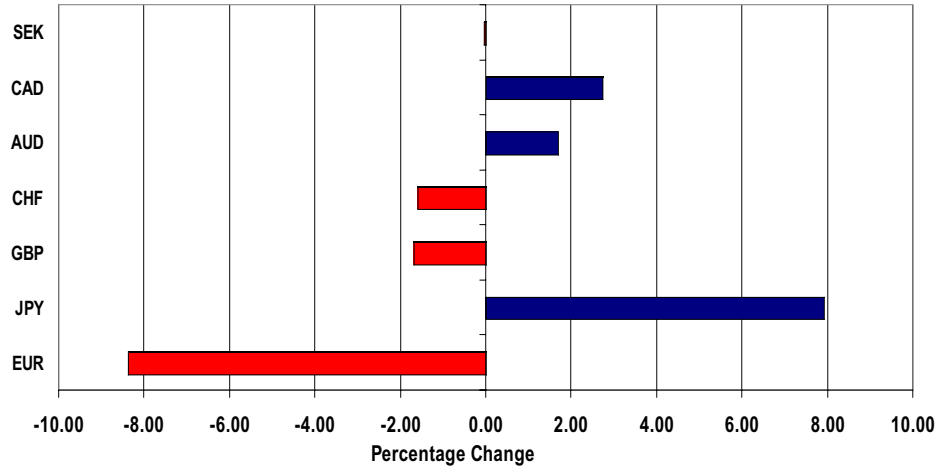
■ **Over recent weeks, speculative players have rushed to cover very short euro positions** as the fiscal/political risk associated with the euro has eased and the deteriorating outlook for the US economy has become the main focus of attention. This normalisation of positions looks to have further to go, suggesting continued downside risks for the dollar near term. However, the direction may not be all one way. The dollar is still the world's number one reserve currency and any fresh spike in risk aversion on the back of concerns about the global economy and financial markets could provide temporary bouts of support for the dollar in an otherwise downward trend.

■ **It is also probably too soon to say that all is well with the eurozone.** Governments still face significant challenges as they look to implement tough fiscal tightening measures, as reflected in the fact that CDS spreads for the non-core economies remain wide. Thus, sovereign associated risk may yet come back to haunt the euro, preventing a marked rally in the USD/EUR rate. Indeed, we cannot rule out a fresh bout of euro selling if we were to see adverse development in this regard over the autumn months. For now, however, it looks to be a dollar selling market.

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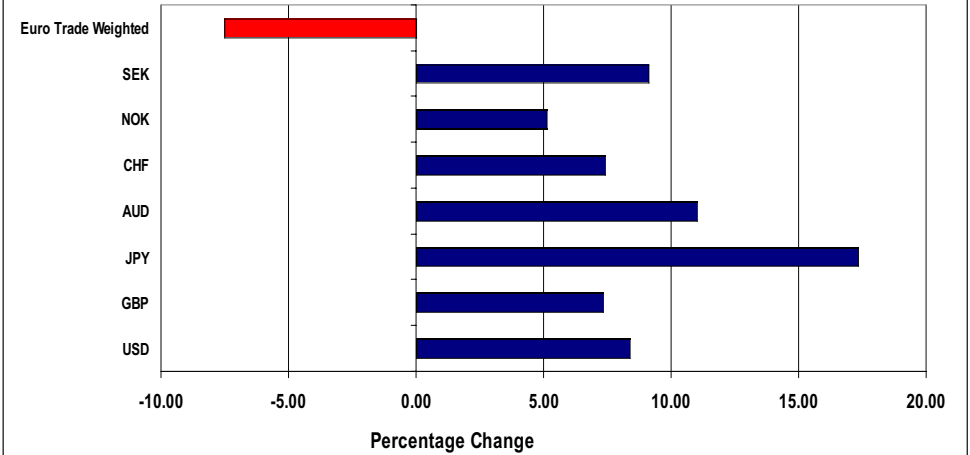
Key Currency Trends

Performance Versus US Dollar
2010 Year to Date % Change



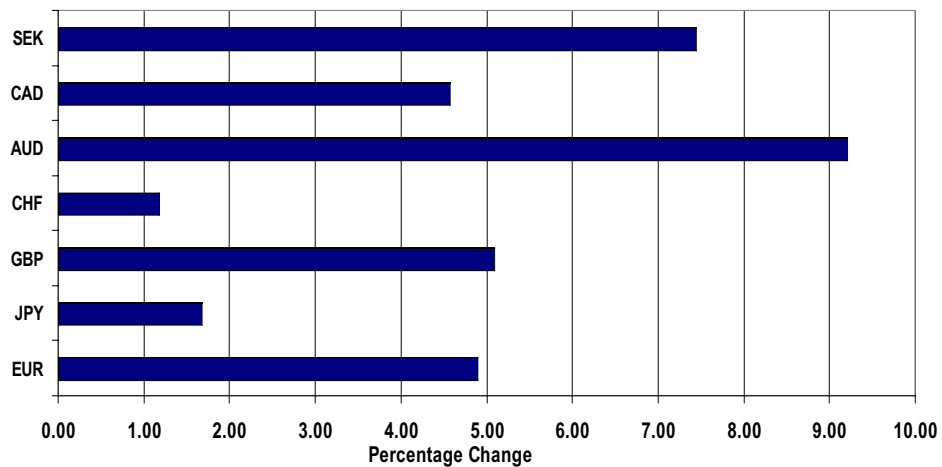
Source: Thomson Datastream

Performance Versus Euro and Euro Trade Weighted Index
2010 Year to Date % Change



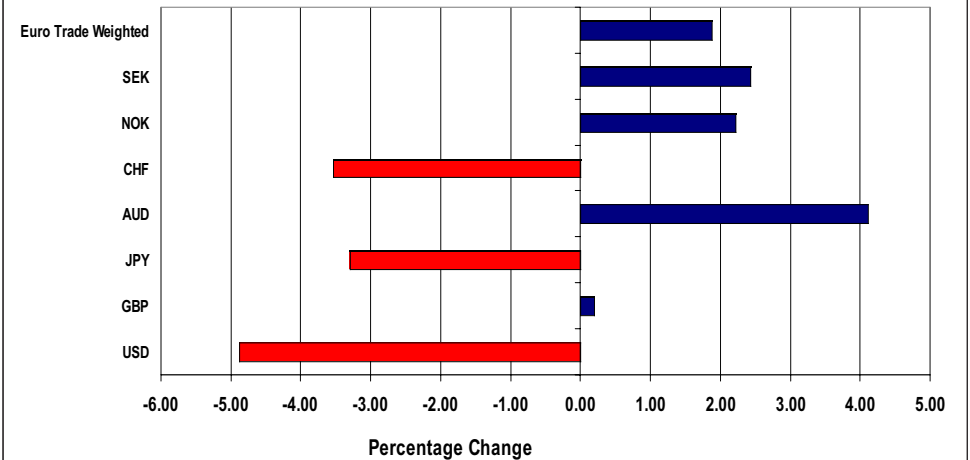
Source: Thomson Datastream

Performance Versus Dollar
% Change In Past Month



Source: Thomson Datastream

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



Source: Thomson Datastream

Summary of Exchange Rate Forecasts

("Spot" Forecasts Represent Mid-Point of Expected Trading Range)

	Current	Q3-2010	Q4-2010	Q1-2011	Q2-2011
Euro Versus					
USD	1.316	1.28-1.35	1.30-1.38	1.28-1.35	1.25-1.33
GBP	0.830	0.81-0.85	0.82-0.86	0.83-0.88	0.83-0.88
JPY	113.15	107-117	107-117	115-125	120-130
PLN	3.99	3.95	3.85	3.75	3.70
HUF	279.55	280	275	270	265
NOK	7.89	7.85	7.80	7.75	7.70
SEK	9.38	9.40	9.35	9.30	9.25
AUD	1.44	1.46	1.49	1.48	1.47
NZD	1.81	1.85	1.89	1.88	1.87
US Dollar Versus					
JPY	85.96	82-88	85-82	90-97	95-102
GBP	1.586	1.53-1.63	1.55-1.65	1.48-1.58	1.45-1.55
CHF	1.05	1.04	1.03	1.05	1.04
CAD	1.01	1.01	1.03	1.05	1.07
AUD	0.91	0.90	0.90	0.89	0.88
NZD	0.73	0.71	0.71	0.70	0.69
CNY	6.77	6.78	6.75	6.73	6.70
Sterling Versus					
JPY	136	135	133	144	149
CAD	1.61	1.60	1.64	1.61	1.61
AUD	1.74	1.76	1.77	1.73	1.71
NZD	2.19	2.23	2.25	2.20	2.19

Interest Rate Outlook

Central banks across the world cut official rates to exceptionally low levels in 2008/09 to help counter what proved to be a very deep global recession, which saw inflation fall close to, or below, zero in many countries. The four main central banks have kept interest rates at these historically low levels to date in 2010 as the pace of recovery from the deep recession has proved to be anaemic in developed economies. Furthermore, the deep recession created a lot of spare capacity, with very high unemployment now the case in most countries. This is helping to keep inflation subdued. These conditions are likely to prevail over the balance of the year so we do not expect the four main central banks to start hiking rates until well into 2011.

Fed Funds Rates to Stay Close On 0% Until Mid-2011

With inflation falling sharply and the economy in deep recession, the Fed cut US interest rates effectively to zero per cent in December 2008, adopting a 0 - 0.25% target range for the Fed funds rate. It also pursued quantitative easing measures. The US moved out of recession in Q3 2009. However, the unemployment rate remains close to 10% and core CPI inflation has fallen to below 1%. Furthermore, the recovery in activity is set to lose some momentum in H2 2010. Hence, the Fed is unlikely to begin raising the funds rate until mid-2011.

ECB Refi Rate Very Much On Hold At 1%

The ECB cut interest rates to a historic low of 1.0% in May 2009. The eurozone economy emerged from recession in Q3 2009 but the pace of recovery has been very slow. Meantime, the unemployment rate has risen to over 10%, while inflationary pressures are very subdued and growth in monetary aggregates is flat. Hence, the ECB has shown no inclination to raise rates and has repeatedly said that the refi rate is at an appropriate level.

The ECB, though, had been gradually withdrawing its non-standard liquidity support measures for the market, in particular fixed-rate, long-term refi operations. However, the difficulties in markets caused by the Greek debt crisis have forced the ECB to reintroduce some of these measures. Given all these negative factors, we do not see the ECB raising rates until mid 2011 at the earliest.

UK Rates Set to Remain Low Well Into 2011

The BoE cut UK interest rates to an historically low level of 0.50% in March 2009, while also employing quantitative easing measures. It has left the door open to do further gilt purchases should they be required down the line. Although UK inflation continues to surprise on the upside, the central bank remains of the view that it will fall below 2% over the medium term. This combined with high unemployment, an anaemic economic recovery and significant fiscal tightening means that we do not anticipate any hikes in official rates until mid 2011 at the earliest.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.125	0.42	1.01	0.73	1.76
Sept '10	0.125	0.45	1.05	0.75	1.80
Dec '10	0.125	0.60	1.20	1.10	2.10
Mar '11	0.125	0.80	1.35	1.40	2.40

* Swap Forecasts Beyond 1 Year

Eurozone Interest Rate Forecasts (to end quarter)

	Refi Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	1.00	0.83	1.39	1.41	2.09
Sept '10	1.00	0.85	1.40	1.45	2.15
Dec '10	1.00	0.85	1.50	1.65	2.40
Mar '11	1.00	0.95	1.70	1.85	2.70

* Swap Forecasts Beyond 1 Year

UK Interest Rate Forecasts (to end quarter)

	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.50	0.74	1.48	1.42	2.41
Sept '10	0.50	0.85	1.50	1.55	2.50
Dec '10	0.50	0.95	1.70	1.80	2.95
Mar '11	0.50	1.10	1.90	2.10	3.30

* Swap Forecasts Beyond 1 Year

US Dollar

We have made significant changes to our near-term USD forecasts reflecting the fact that sentiment has turned decisively against the US currency over recent weeks. Versus the euro, the dollar has fallen by nearly 5% over the past month to its current level of circa \$1.32. We anticipate further falls to \$1.35 and possibly beyond near term, while Y85 may come under pressure versus the yen. The recent retrenchment in the dollar is largely due to a growing level of concern about the outlook for the US economy and the impact that this will have on the path of monetary policy.

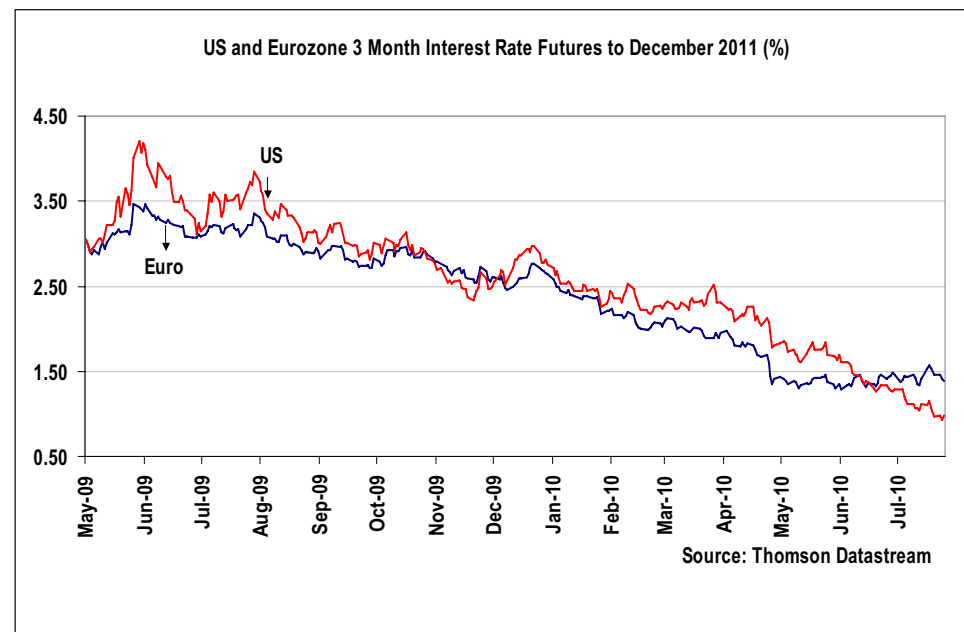
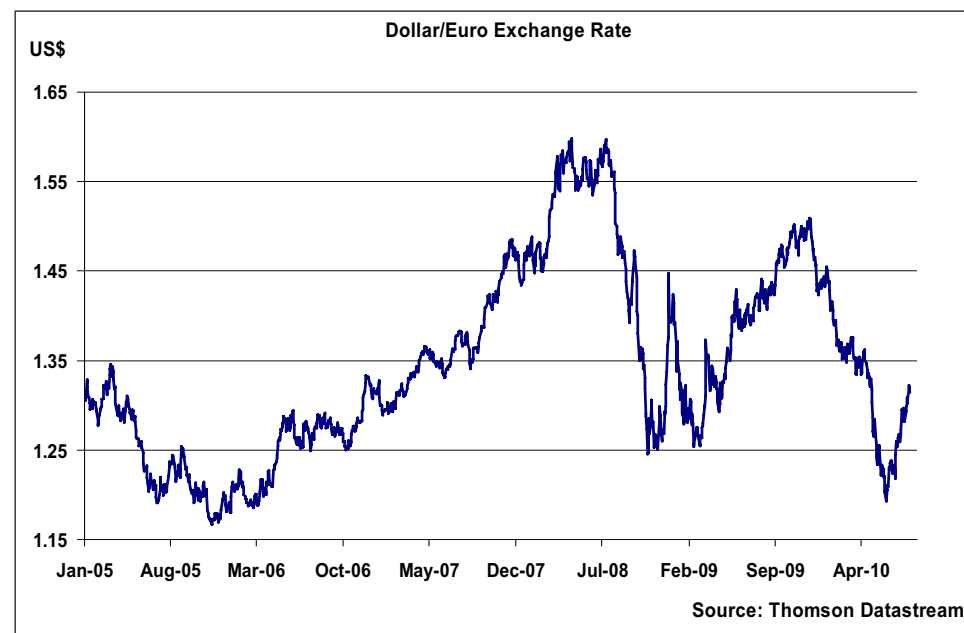
The recession, which began at the end of 2007, ended in Q3 2009 with GDP growing at an average annualised rate of 3.2% in the four quarters to Q2-2010. However, recent US indicators have been generally disappointing. Thus, GDP growth is expected to slow in the second half of the year as support from factors such as stock building and fiscal stimulus fades. Recent communiqués from the Fed point to an economy that faces an unusual degree of uncertainty, with the FOMC indicating that it may need to consider further policy stimulus.

Thus, markets have revised their outlook for US interest rates and now believe that there will not be any increase in the Fed funds rate until mid-2011 at the earliest. It has been our long held view that the US would disappoint in H2. However, this has only begun to hit the dollar of late as concerns over sovereign risk in the eurozone have abated, thus reducing the need for safe haven flows. Broad based dollar weakness looks set to remain a feature of forex markets over the remainder of the summer.

The key factor determining direction is likely to be the extent of the slowdown in the US over the second half of the year and the response, if any, from the Fed. However, general market sentiment also continues to be an important force and any fresh spike in risk aversion could be favourable for the dollar in an otherwise downward trend. Longer term we see the dollar stabilising and even recovering some ground, with growth also likely to remain sub trend in other major economies, keeping rates at very low levels.

Key Forecasts

		Q3-2010	Q4-2010	Q1-2011	Q2-2011
US\$/EUR	1.316	1.28-1.35	1.30-1.38	1.28-1.35	1.25-1.33
US\$/GBP	1.586	1.53-1.63	1.55-1.65	1.48-1.58	1.45-1.55
YEN/US\$	85.974	82-88	85-82	90-97	95-102
CHF/US\$	1.046	1.04	1.03	1.05	1.04



Euro

The euro has staged an impressive recovery versus the dollar over the past month, bouncing back from yearly lows of \$1.1878 in early June to its current level of \$1.32, an appreciation of some 11%. This turnaround, which it should be remembered only leaves the currency back where it was in late April, largely relates to broad based dollar weakness on the back of growing concerns about the prospect of a double dip recession in the US. Markets as a result have pulled back in terms of their expectations for US official interest rates, which look set to remain below those in the eurozone for some time to come.

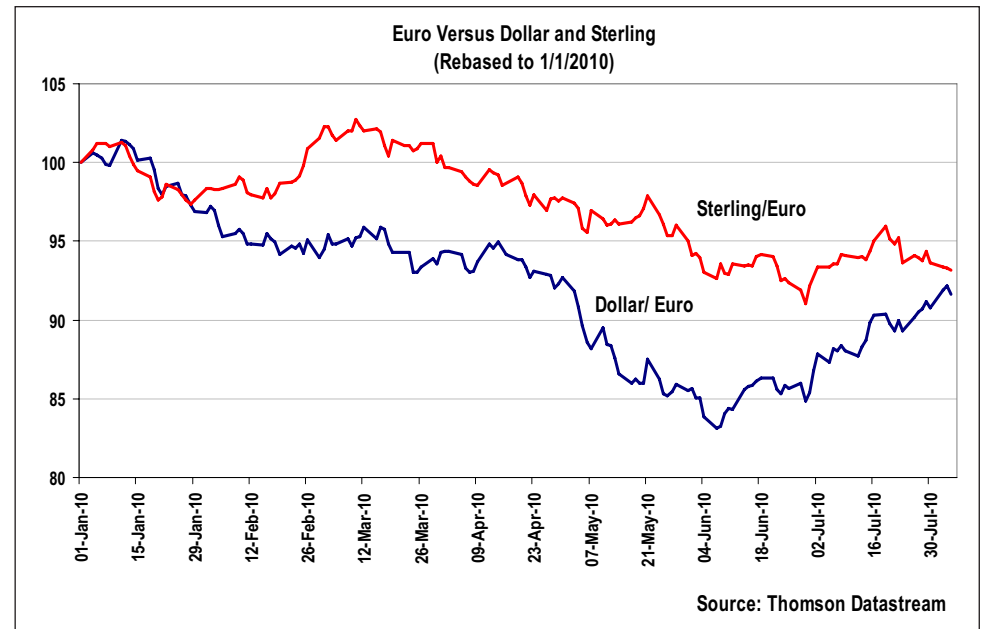
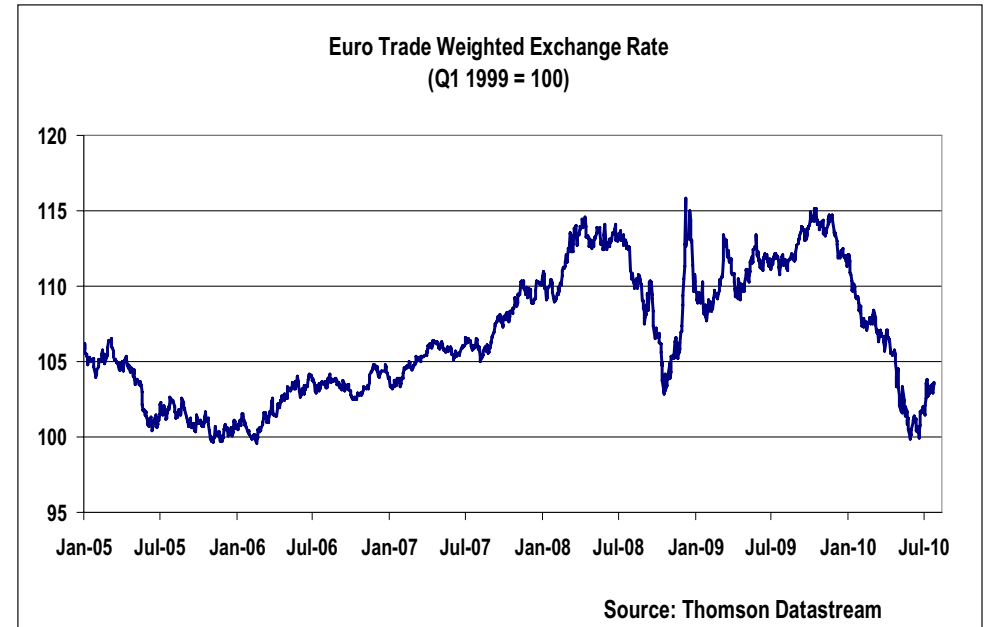
The euro has also benefited to some extent from supportive European developments, including a largely positive (though somewhat sceptical) response to the publication of the banks' stress test results, which has lessened the need to purchase safe haven dollars. There has also been a massive covering of short euro positions as a number of eurozone data releases have surprised on the upside, indicating that growth may not be as anaemic as anticipated in the second half of the year.

With the focus now firmly on the US, the euro looks set for further gains over the coming weeks, that is notwithstanding the prospect of fresh adverse developments in terms of eurozone sovereign risk or the banking system. This could see the euro recover back to the \$1.35 level and possibly beyond versus the USD. However, we do not see the euro returning to its yearly highs of close to \$1.46, with the markets likely to fret about the impact of fiscal tightening on the medium term outlook for the eurozone.

While the euro has rallied versus the dollar, it has struggled to make any headway versus sterling, falling back from highs above Stg0.85p in mid July. The GBP looks set to continue to benefit from political stability now that the election is out of the way, the improved outlook for the UK economy and the fact that upside inflation risks could see the Bank of England move on interest rates ahead of other central banks. We anticipate a Stg0.81-0.85p range over the coming months, with the bias in sterling's favour.

Key Forecasts

		Q3-2010	Q4-2010	Q1-2011	Q2-2011
US\$/EUR	1.316	1.28-1.35	1.30-1.38	1.28-1.35	1.25-1.33
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YEN/EUR	113.17	107-117	107-117	115-125	120-130
PLN/EUR	3.986	3.95	3.85	3.75	3.70



Sterling

Broad based dollar weakness has seen sterling make up considerable ground versus the USD of late, with the GBP/USD currently trading just below the \$1.60 level, well up on its yearly lows of \$1.4232. As well as the general sell off in the dollar, sterling has also benefited from new found political certainty now that the UK election is out of the way and the fact that the new government has outlined a comprehensive programme to get the public finances in order.

Upside surprise in terms of UK inflation data has also raised questions as to the prospect of a move by the BoE away from its current very accommodative stance sooner than markets had been anticipating. At the same time, however, the UK still faces considerable challenges as it seeks to reduce one of the highest deficit/GDP ratios in the EU, with the scale of the fiscal tightening outlined likely to weigh on an already fragile UK recovery. This anaemic upturn is likely to see the BoE leave UK rates on hold, despite increasing signs of unease amongst MPC members about inflation trends. Thus, while sterling could see further gains versus the dollar near term it may find it difficult to extend its gains much beyond the \$1.63/1.65 level.

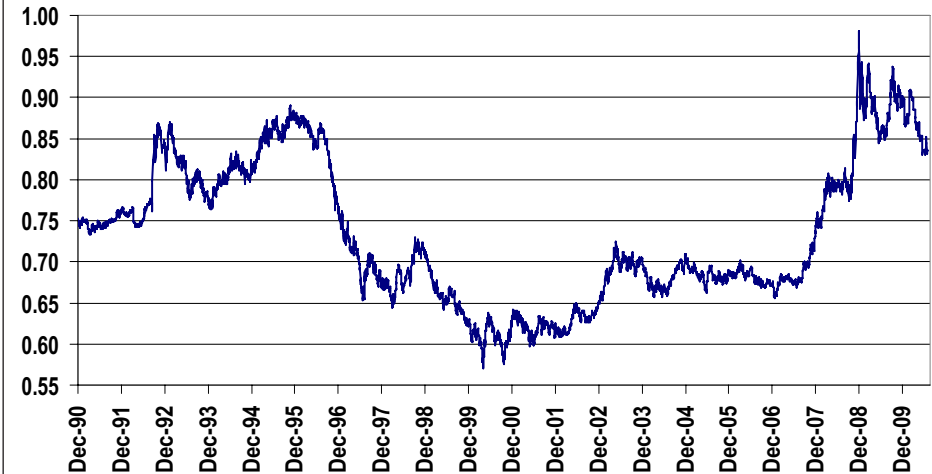
Versus the euro, current trends point to sentiment remaining generally against the single currency given the relative outlooks for the UK and the eurozone. Despite its recent recovery versus the dollar, the market still views the scale of the sovereign debt problems in the eurozone as more daunting than those in the UK. Nonetheless, having reached 18 months highs of Stg0.8211p versus the EUR in mid June, sterling has since eased back to trade in a tight range around Stg0.83p, with much more volatility seen in the GBP/USD rate as markets focus on the US.

We expect sterling to trade in a Stg0.81-0.85p range over the coming weeks, with much of the near term activity likely to remain centred around the Stg0.83p level. Indeed, any further marked appreciation by the GBP could draw negative comments from the UK authorities as they look to rebalance the economy towards the external sector.

Key Forecasts

		Q3-2010	Q4-2010	Q1-2011	Q2-2011
GBP/EUR	0.830	0.81-0.85	0.82-0.86	0.83-0.88	0.83-0.88
US\$/GBP	1.586	1.53-1.63	1.55-1.65	1.48-1.58	1.45-1.55
YEN/GBP	136.35	135	133	144	149
CAD/GBP	1.609	1.60	1.64	1.61	1.61

Synthetic Sterling/Euro Exchange Rate



Source: Thomson Datastream

US Dollar / Sterling Exchange Rate



Source: Thomson Datastream

Japanese Yen

In an environment of global deleveraging and heightened risk aversion, the yen appreciated markedly during the height of the global financial crisis. Indeed, despite being considered overvalued, the JPY continues to benefit from swings in market sentiment, as reflected in its performance versus the euro during the height of the spike in sovereign associated risk. Although the euro is currently off the lows seen earlier in the summer it is likely to struggle to make up much ground versus the Japanese currency, particularly in the short to medium term.

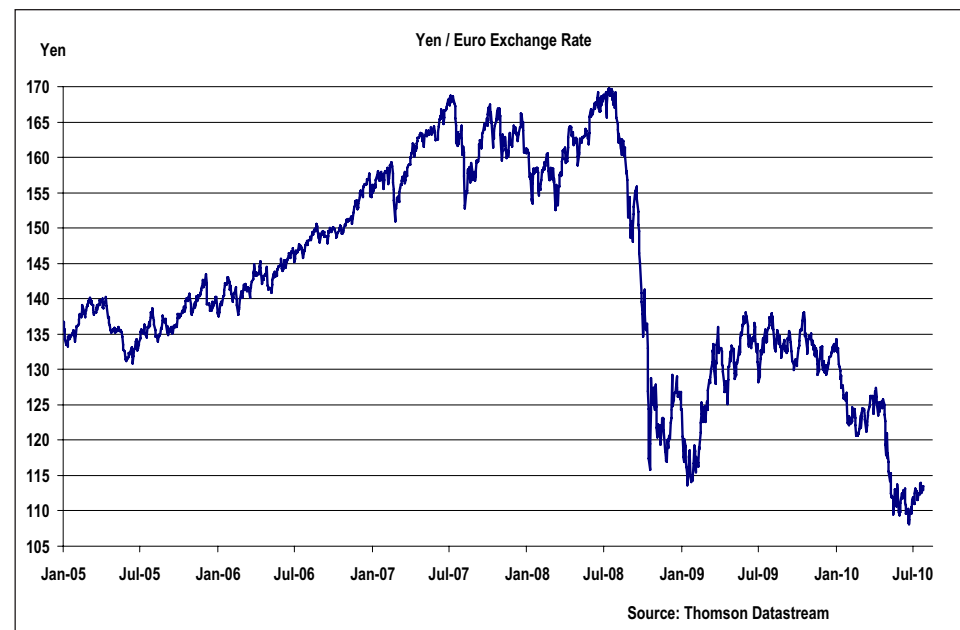
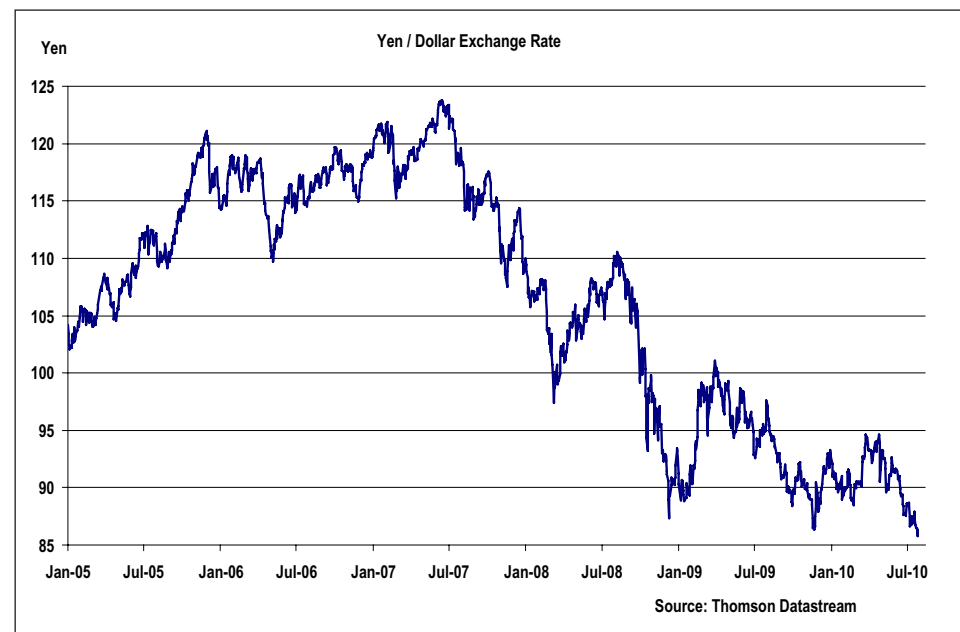
Dollar/yen, meanwhile, spent much of the year to date trading in the Y88-95 range that has prevailed since the dollar recovered from 14 year lows late last year. However, recent events have seen the yen break out of this range, with the dollar now looking to a break of last November's low of Y84.4. With investors favouring the JPY as a safe haven option over the USD, a fall below this could open the way for a slide in the dollar to Y80, a level not seen for 15 years. Markets will be on their guard as Japan's finance minister recently reiterated that he is closely watching currency moves. However, the balance of risk is to dollar weakness for now.

Over the longer term, we expect the dollar to recover ground versus the yen. There are a number of domestic factors that are likely to weigh on the JPY and which could drive it lower versus the USD over the course of the year. The current Japanese regime favours a weaker currency given its impact on the export driven economic recovery, with a number of vague references made to intervention if necessary over recent times.

Furthermore, the Bank of Japan has extended quantitative easing activities on two occasions since December and has effectively resumed a zero interest rate policy as it seeks to fight deflation conditions once again. Although the BoJ recently upgraded its assessment of the domestic economy to reflect some better than forecast economic data, it is not expected to make any changes to its extremely accommodative policy stance anytime soon.

Key Forecasts

		Q3-2010	Q4-2010	Q1-2011	Q2-2011
YEN/US\$	85.96	82-88	85-82	90-97	95-102
YEN/EUR	113.15	107-117	107-117	115-125	120-130
YEN/GBP	136.36	135	133	144	149



Australian Dollar/ New Zealand Dollar

The AUD and NZD came under strong selling pressure during the height of the global financial crisis. However, the pair have since bounced back strongly in line with a pick up in global risk appetite. Sentiment is also being underpinned by rising commodity prices and, particularly in the case of the AUD, a resilient economic performance. Australia proved to be one of a handful of economies that avoided recession, in large part due to the successful implementation of fiscal stimulus measures.

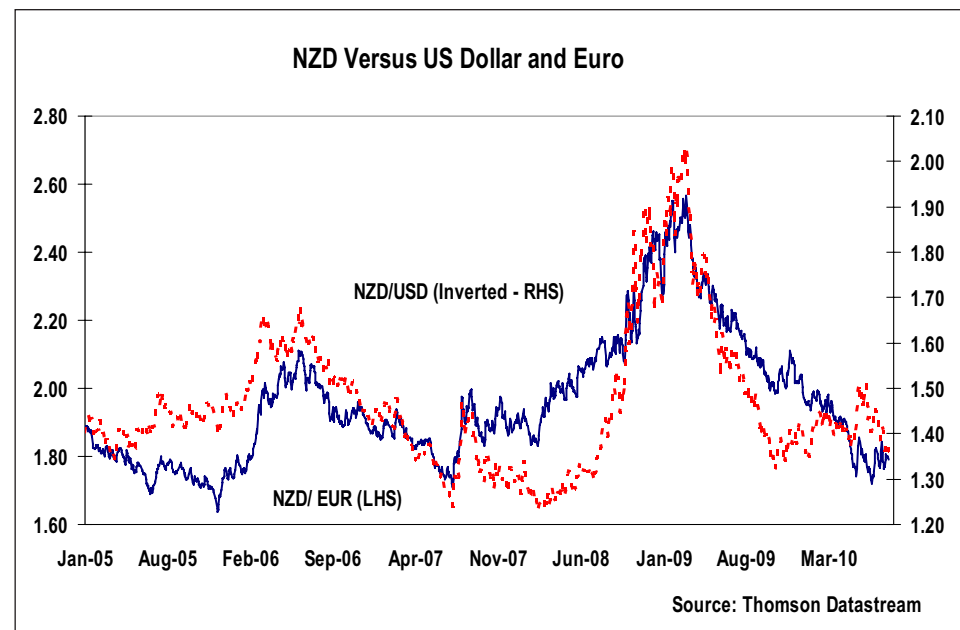
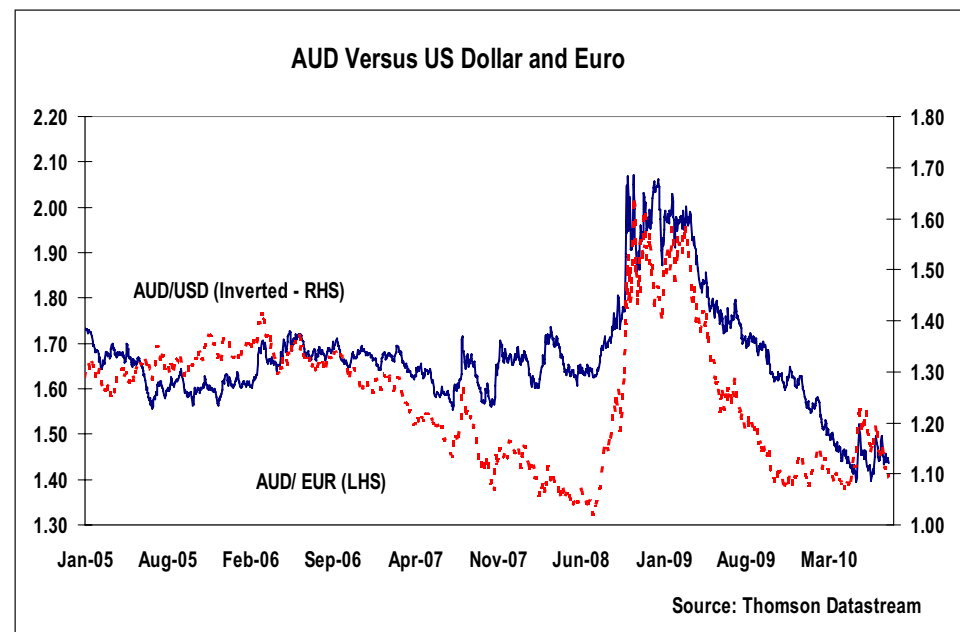
The pair's recovery was further cemented by last October's announcement from the Reserve Bank of Australia (RBA) that, in response to the better than anticipated domestic economic conditions, it was raising interest rates by 0.25% to 3.25%, making it one of the first developed economies to reverse emergency monetary policy action. Rates have since been increased by a further 1.25% to 4.50%, opening up a considerable rate differential with other majors. The Reserve Bank of New Zealand, meanwhile, started increasing rates in June, indicating to markets that further tightening is in the pipeline.

Favourable fundamentals (both economies are showing strong domestic demand conditions) and interest rate differentials should support the pair in the months ahead. There is also the threat of intervention from the RBA to smooth out any major fluctuations in the currency. At the same time, however, branded "high-risk" currencies, both remain subject to volatility on the back of changing investor sentiment, as well as potentially unfavourable moves in commodities.

Indeed, the AUD fell to a 10-month low versus the USD in early summer on the spike in risk aversion on the back of Europe's debt crisis. The NZD also weakened, though not by nearly as much. Both, however, have more than recovered this ground, resuming their upward trend in line with the recent sell off in the USD. Underlying concerns about the global economy and strong signals from the RBA that it is slowing down its pace of tightening now that official rates are back at "average levels" could keep the pair off their highs, but both should remain firm, particularly as carry trades come back into vogue.

Key Forecasts

		Q3-2010	Q4-2010	Q1-2011	Q2-2011
AUD/USD	0.914	0.90	0.90	0.89	0.89
NZD/USD	0.726	0.71	0.71	0.70	0.70
AUD/EUR	1.44	1.46	1.49	1.48	1.48
NZD/EUR	1.813	1.85	1.89	1.88	1.88



Key Events/Diary

Week 1 (9th - 13th August)

Augt 10th	US	FOMC Policy Announcement
Augt 11th	UK	Unemployment (July)
	UK	BoE Quarterly Inflation Report (Q3)
	US	International Trade (June)
Augt 13th	Eurozone	Flash GDP (Q2)
	US	CPI (July)
	US	Retail Sales (July)

Week 2 (16th - 20th August)

Augt 16th	Eurozone	HICP (Final - July)
	US	Net Capital Inflows (June)
Augt 17th	UK	CPI (July)
	Eurozone	German ZEW (August)
	US	Housing Starts and Permits (July)
	US	PPI (July)
	US	Industrial Production (July)
Augt 19th	UK	Retail Sales (July)
	UK	Public Finances (July)

Week 3 (23rd - 27th August)

Augt 23rd	Eurozone	Flash PMIs & Consumer Conf (August)
Augt 24th	US	Existing Home Sales (July)
Augt 25th	Eurozone	German Ifo (August)
	US	New Home Sales (July)
Augt 27th	US	Q2 GDP - 2nd Estimate

Week 4 (30th August - 3rd September)

Augt 30th	UK	Market Holiday
	Eurozone	EC Activity & Sentiment Surveys (August)
	US	Personal Income & Spending (July)
Augt 31st	Eurozone	Flash HICP (August)
	Eurozone	Unemployment (July)
Sept 1st	US/UK/ Eurozone	Manufacturing ISM/PMIs (August)
	US	ADP Employment Report (August)
Sept 2nd	Eurozone	Q2 GDP - 2nd Estimate
	Eurozone	ECB Meeting and Press Conference
Sept 3rd	US/UK/ Eurozone	Services ISM/PMIs (August)

All forecasts prepared by AIB's ERU.

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

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

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