



# **Exchange Rate Outlook** *2nd February 2012*

- **Dollar torn between generally poor risk sentiment and dovish Fed**
- **Euro holds up but still vulnerable as debt crisis continues**
- **GBP in higher range versus euro as UK opts out of latest EU deal**
- **Yen expected to remain strong in uncertain market**

**John Beggs**  
Chief Economist

**Geraldine Concagh**  
Senior Economist

**Oliver Mangan**  
Chief Bond Economist

**Jenny Pollock**  
Senior Economist

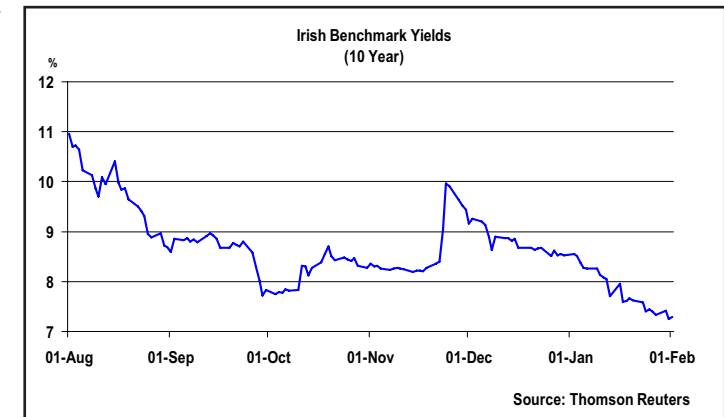
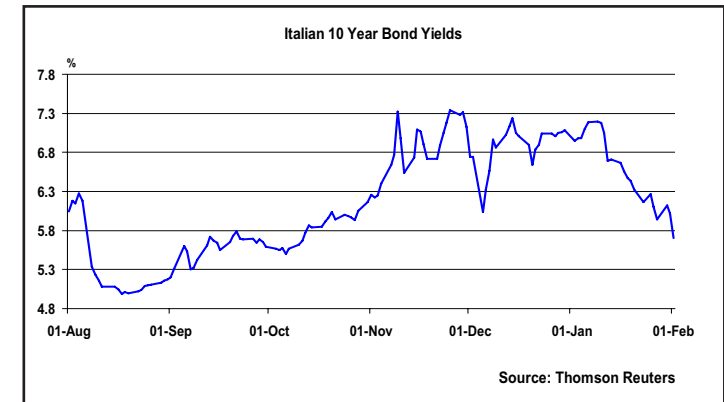
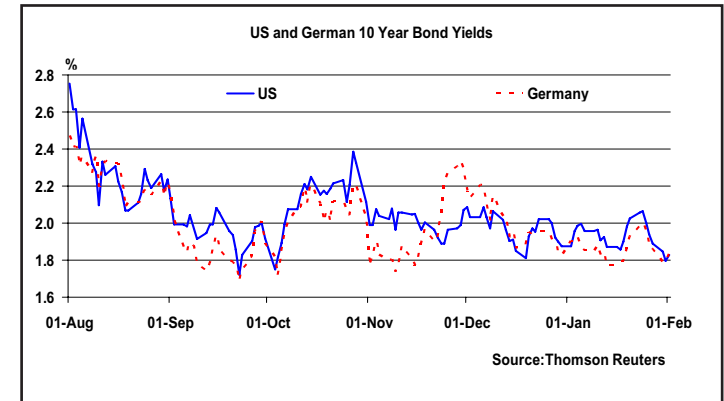
# Summary of Exchange Rate Forecasts

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

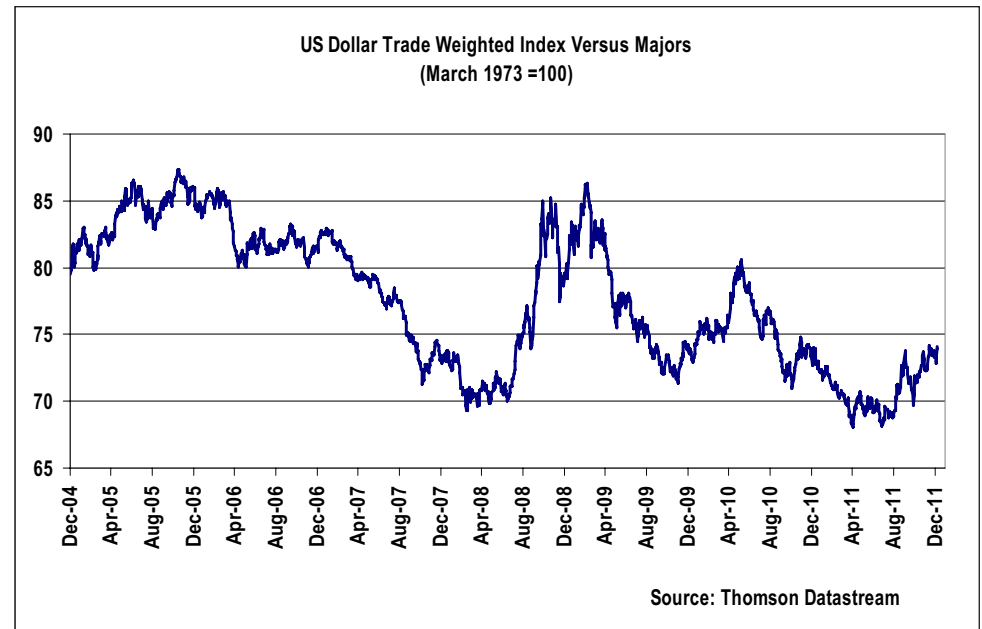
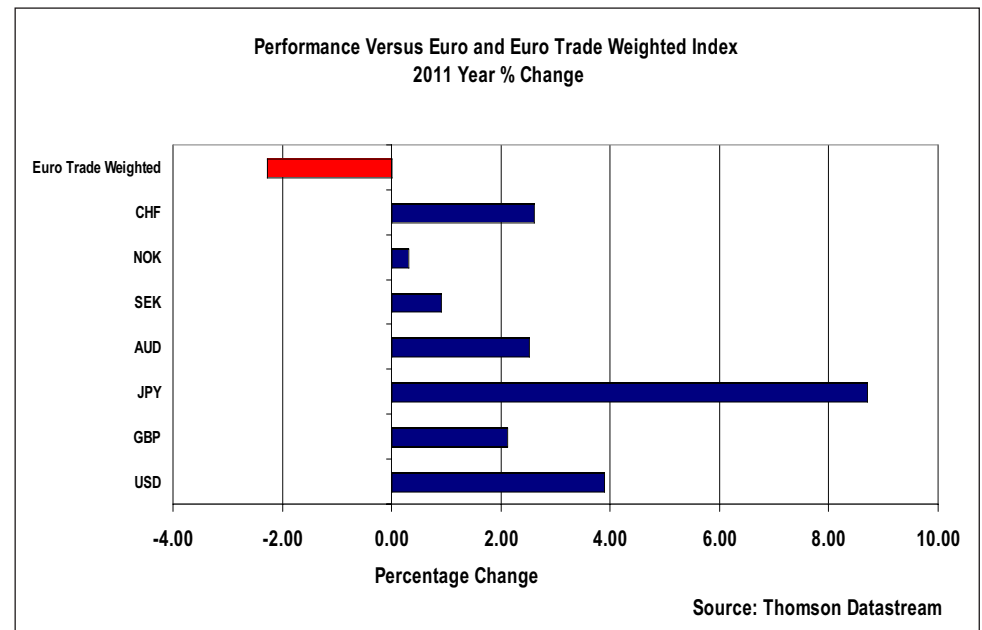
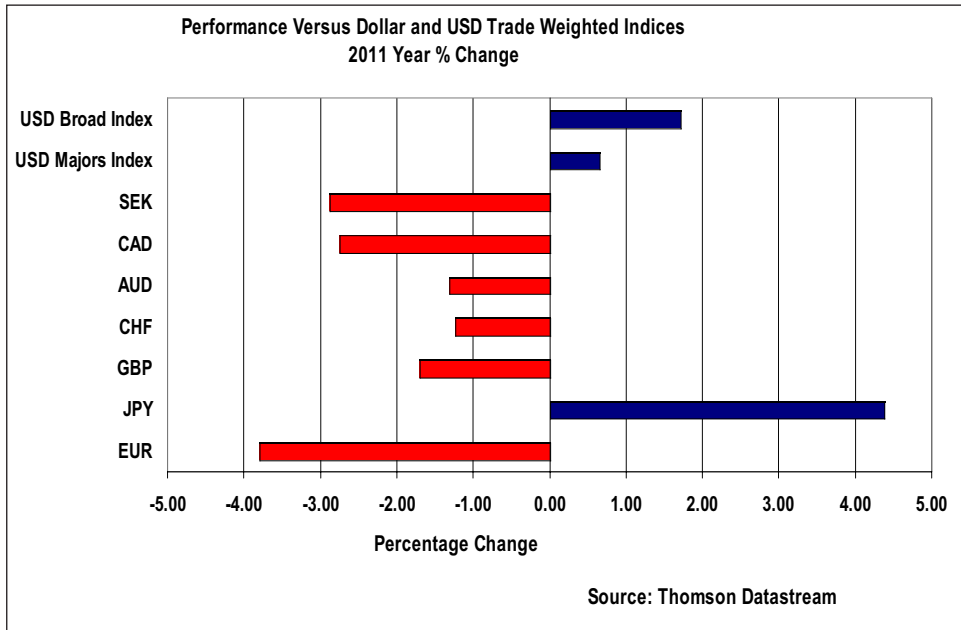
	<b>Current</b>	<b>Q1-2012</b>	<b>Q2-2012</b>	<b>Q3-2012</b>	<b>Q4-2012</b>
<b>Euro Versus</b>					
<b>USD</b>	1.312	1.26-1.33	1.26-1.33	1.28-1.35	1.28-1.35
<b>GBP</b>	0.829	0.82-0.85	0.82-0.85	0.83-0.86	0.83-0.86
<b>JPY</b>	99.83	95-105	95-105	100-110	100-110
<b>PLN</b>	4.20	4.25	4.25	4.20	4.10
<b>HUF</b>	292.18	295	295	290	290
<b>NOK</b>	7.65	7.65	7.60	7.50	7.40
<b>SEK</b>	8.87	8.80	8.75	8.70	8.70
<b>AUD</b>	1.22	1.25	1.25	1.28	1.28
<b>NZD</b>	1.57	1.60	1.60	1.64	1.64
<b>US Dollar Versus</b>					
<b>JPY</b>	76.08	74-80	75-85	76-86	77-87
<b>GBP</b>	1.582	1.50-1.60	1.50-1.60	1.50-1.60	1.50-1.60
<b>CHF</b>	0.92	0.92	0.92	0.94	0.96
<b>CAD</b>	1.00	1.00	1.00	1.02	1.03
<b>AUD</b>	1.07	1.04	1.04	1.03	1.03
<b>NZD</b>	0.83	0.81	0.81	0.80	0.80
<b>CNY</b>	6.30	6.30	6.29	6.28	6.27
<b>Sterling Versus</b>					
<b>JPY</b>	120	120	124	126	128
<b>CAD</b>	1.58	1.56	1.56	1.59	1.60
<b>AUD</b>	1.48	1.50	1.50	1.51	1.51
<b>NZD</b>	1.90	1.92	1.92	1.95	1.95

# Market Overview

- 2012 looks set to be another volatile year for forex markets as Europe's sovereign debt crisis, extremely loose monetary policy across the main economies and an uncertain outlook for the global economy continue to dominate. This would seem to suggest a weaker euro, though the EUR is managing to hold up pretty well as markets await ongoing updates in terms of Europe's plans to tackle the crisis. In the near term, the main focus is the Greek debt restructuring talks (at the time of writing we appear very close to agreement) as well as the recent news of an EU fiscal treaty.
- Given the financial market chaos that a break up of the euro could trigger, we believe that European politicians will eventually arrive at a manageable solution to the region's debt crisis. In the meantime, however, the euro will have to contend with ongoing fears about how medium term financing needs will be catered for, poor eurozone growth prospects, a dovish ECB and the likelihood of further debt downgrades from rating agencies. This leaves the euro vulnerable to downside pressures, though with the market very short the single currency we could see temporary spikes upwards.
- Over the closing weeks of 2011 and into early 2012 we have had a reasonable run of data from the US. This is providing some support for the dollar, which also continues to benefit from its safe haven status. However, there are still many concerns about the US. Fiscal policy is now less supportive and the current account deficit is trending upwards. As well as that, interest rates are at extremely low levels across all maturities. Indeed, the dollar came under some selling pressure after the Fed indicated at its first policy meeting of the year that it is likely to leave rates on hold until well into 2014. At the same time though, in an uncertain global environment, risk sentiment looks set to continue to favour the USD, at least in the short to medium term.
- The annual rate of inflation in the UK fell sharply in December, with a further significant drop anticipated in January data as special factors, including last year's VAT rise, start to fall out of the index. This has intensified speculation that the Bank of England will introduce further quantitative easing measures at its February policy meeting. This is undermining sterling to some extent versus the dollar, though bouts of positive risk sentiment are providing some support.
- Versus the euro sterling should benefit from Europe's ongoing debt problems. The GBP hit 16-month highs in mid January, though it has since come back from these levels as the wave of negative sentiment towards the euro around year end waned. Indeed, despite recent moves, the euro remains relatively high versus the GBP when looked at in a historical context.
- The yen has been a safe haven of choice for some time now, resulting in a marked appreciation versus other majors. Dollar/yen is keeping closely to 2011 yearly highs of Y75.9 (late 2011). Meanwhile, versus the euro, the yen traded at 11-year highs in early January as concerns about eurozone sovereign risk dominated. Despite being overvalued, we expect little change in this strong yen trend near term.

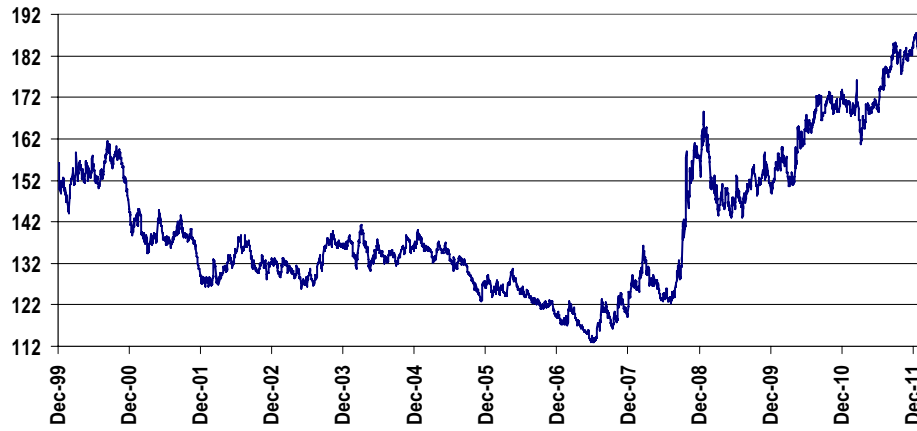


# Key Currency Trends



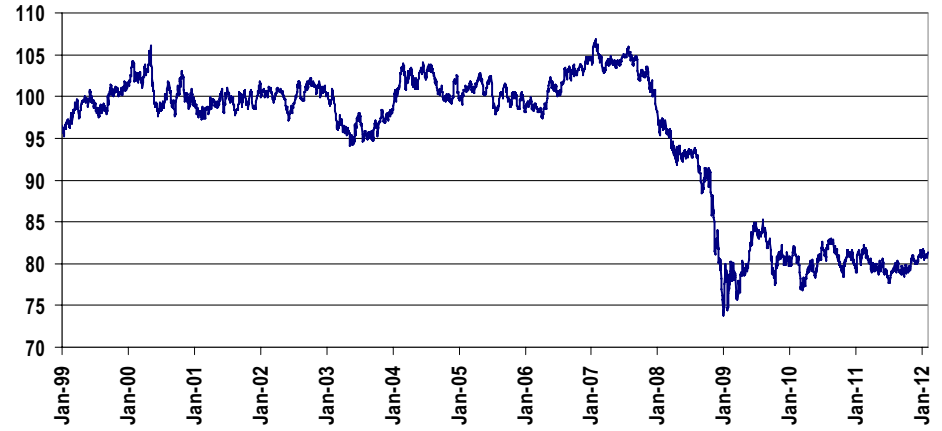
# Key Currency Trends

Japanese Trade Weighted Index  
Jan 1990 = 100



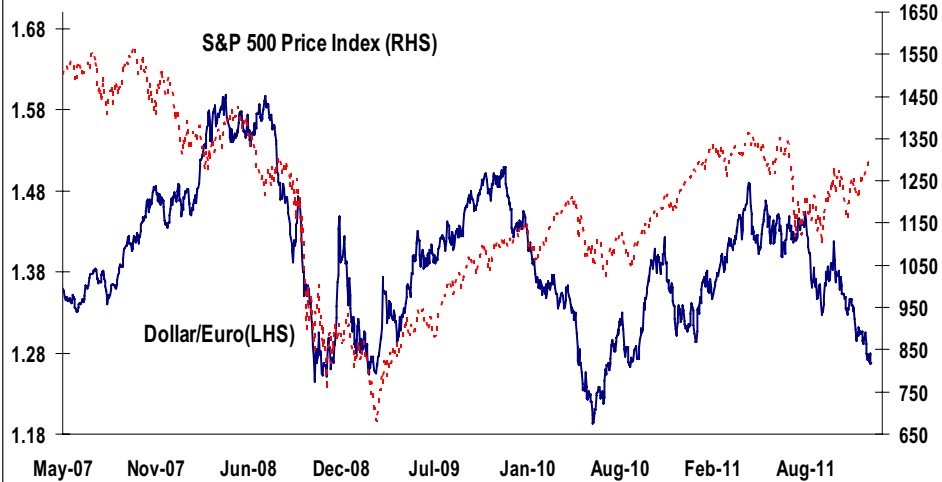
Source: Thomson Datastream

Sterling Trade Weighted Exchange Rate  
Jan 2005 = 100



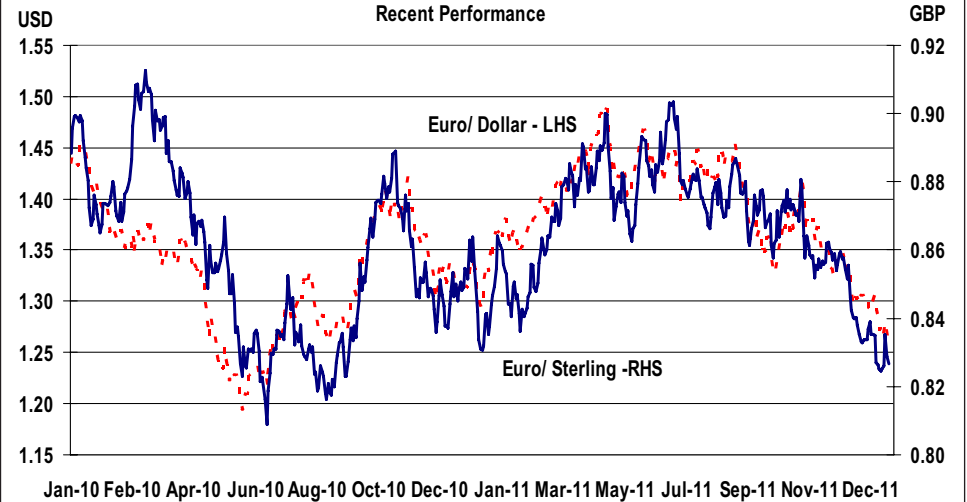
Source: Thomson Datastream

Dollar/ Euro Exchange Rate and US S&P 500 Stock Index



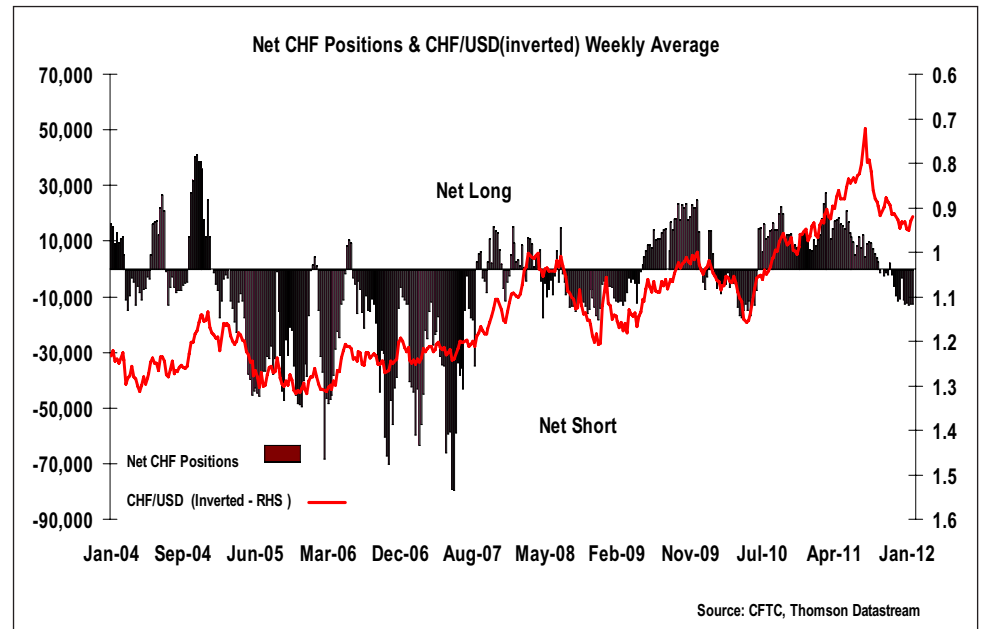
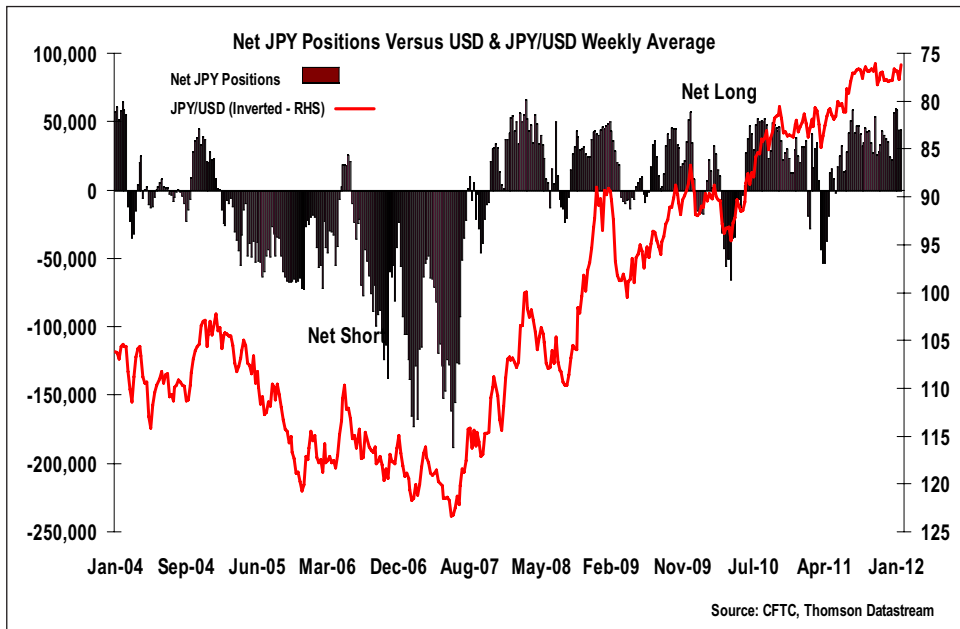
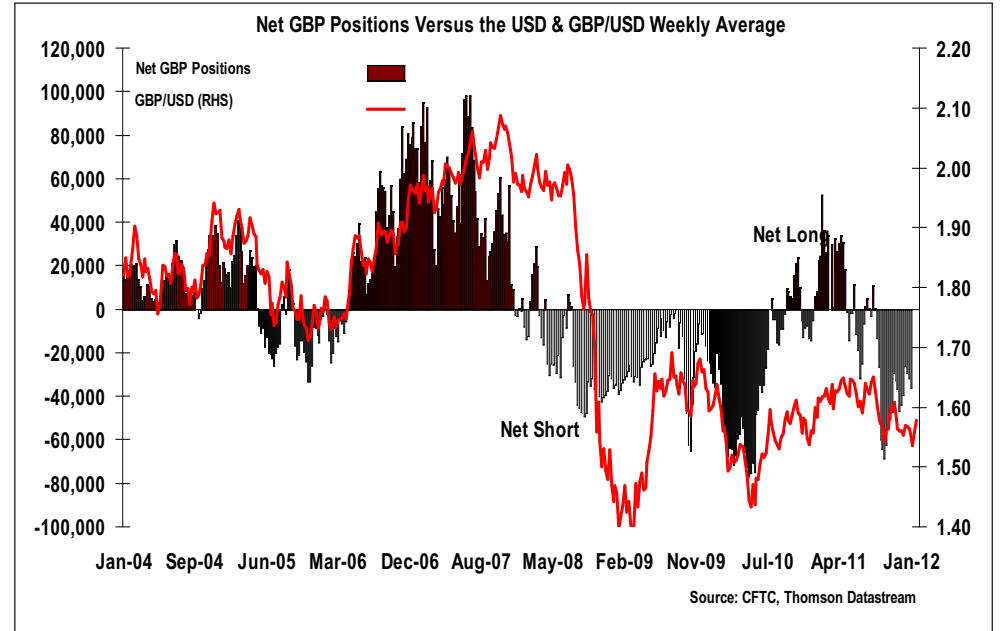
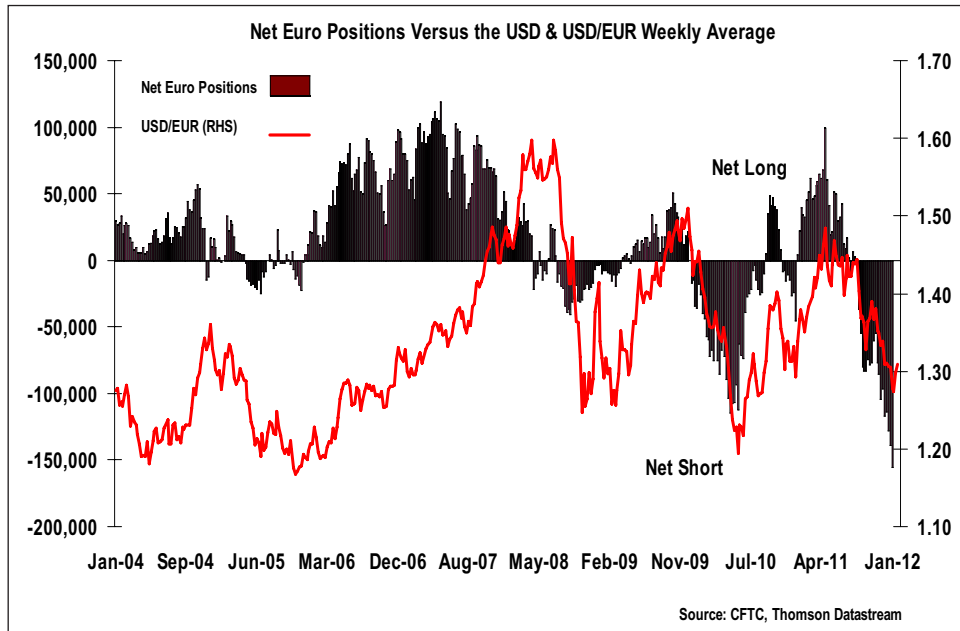
Source: Thomson Datastream

Euro Versus Dollar and Sterling  
Recent Performance



Source: Thomson Datastream

# Commitment of Traders Report - Net Positions Versus the US Dollar



# Interest Rate Outlook

## **First Fed Rate Hike Not Expected Until 2014**

The Federal Reserve has kept its key interest rate at the historically low level target range of 0 - 0.25% since December 2008. Rates are likely to remain on hold for a long time given the subdued pace of economic recovery, the slow progress in bringing down unemployment and with considerable spare capacity in the economy helping to keep underlying inflationary pressures subdued.

At its FOMC meeting in January the Fed indicated that it was unlikely to raise rates until 2014. Even then, the pace of tightening is expected to be slow. Meanwhile, against a backdrop of weak economic data, the Fed introduced some further monetary support measure (Operation Twist) at its September policy meeting. The economy has regained momentum in recent months, though the prospect of further quantitative easing cannot be ruled out.

## **ECB Cuts Rates, Further Move Possible**

The eurozone economy emerged from recession in Q3 2009 but while the pace of recovery was subdued, inflation moved above the ECB's key 2% target level in 2011. In response to this, the ECB raised official interest rates in April and again in July bringing them to 1.50%.

However, a marked weakening in economic conditions and a deepening of the eurozone's debt crisis forced the ECB to cut interest rates by 0.25% at its November 2011 policy meeting. This was followed by a further cut of 0.25% at the December meeting.

The market is pricing in at least one more cut by springtime. In a very uncertain environment this is by no means guaranteed but further weak GDP data could leave the ECB with little option but to cut rates again.

## **BoE Remains in a Dovish Mood**

UK interest rates have been at the historically low level of 0.50% since March 2009. The MPC has also engaged in quantitative easing or asset purchase activities. Indeed, against a weak economic back drop, the MPC announced further QE measures at its policy meeting last October and has left the door open to a further extension of this, with February seen as a likely time to ease again. Meanwhile, rate hikes look to be off the agenda until late 2013 at the earliest.

Inflation in the UK remains high but has at least started to ease back over recent months as once off factors start to fall out of the annual rate. The central bank remains of the view that inflation will fall back to its 2% target over the medium term.

### US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
<b>Current</b>	0.125	0.53	1.09	0.48	0.96
<b>Mar '12</b>	0.125	0.50	1.05	50.00	1.00
<b>Jun '12</b>	0.125	0.50	1.05	0.50	1.00
<b>Sept '12</b>	0.125	0.50	1.00	0.50	1.00

\* Swap Forecasts Beyond 1 Year

### Eurozone Interest Rate Forecasts (to end quarter)

	Refi Rate	3 Mth	1 Year	2 Year *	5 Year *
<b>Current</b>	1.00	1.04	1.71	1.13	1.53
<b>Mar '12</b>	0.75	1.00	1.70	1.10	1.50
<b>Jun '12</b>	0.75	1.00	1.60	1.15	1.55
<b>Sept '12</b>	0.75	1.00	1.50	1.20	1.60

\* Swap Forecasts Beyond 1 Year

### UK Interest Rate Forecasts (to end quarter)

	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
<b>Current</b>	0.50	1.08	1.89	1.22	1.55
<b>Mar '12</b>	0.50	1.50	1.80	1.20	1.50
<b>Jun '12</b>	0.50	1.00	1.75	1.20	1.50
<b>Sept '12</b>	0.50	1.00	1.70	1.20	1.55

\* Swap Forecasts Beyond 1 Year

# US Dollar

Over the closing weeks of 2011 and into 2012 we have had a reasonable run of positive data from the US. There are now clear signs that the economy picked up pace in the final quarter of last year and Q1-2012. There are also growing signs of improvement in the jobs market, with the unemployment rate currently at 8.5%, down from a cyclical high of 10% in late 2009. Meanwhile, the beleaguered housing market seems to have finally turned a corner, with business and consumer confidence also improving.

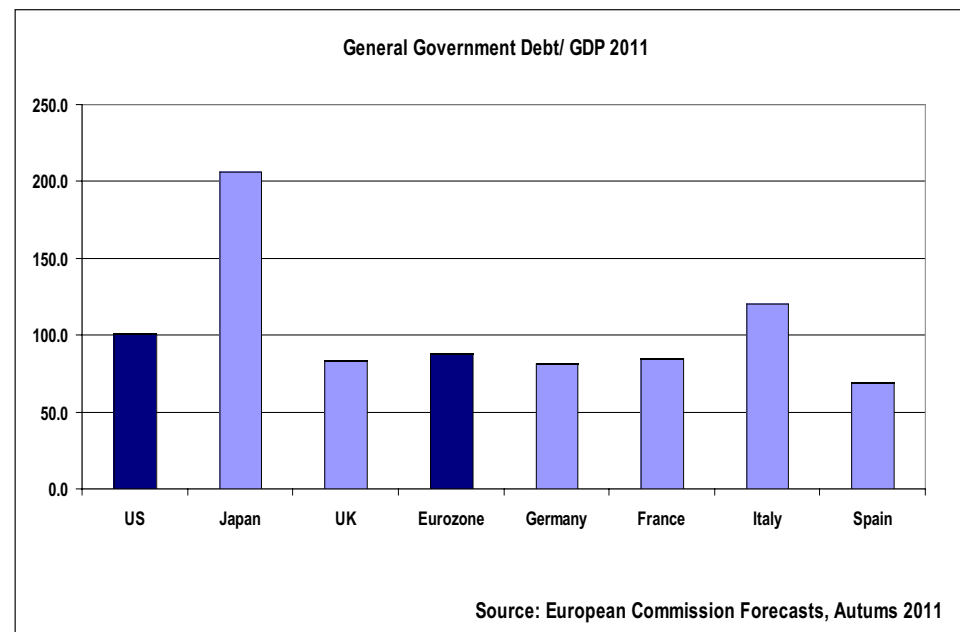
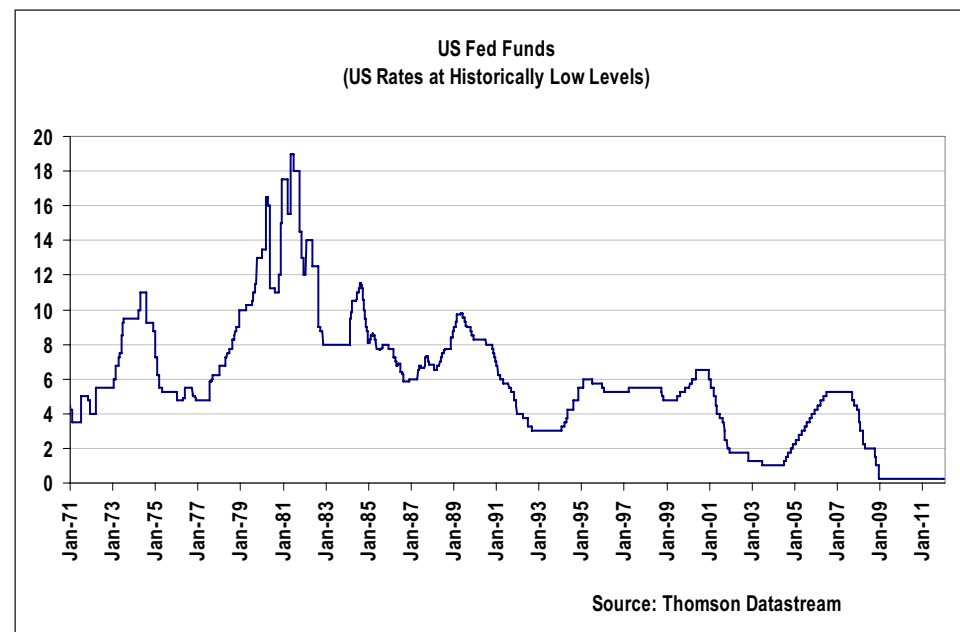
While this is all good news, there are still concerns about the US. Fiscal policy is now less supportive and the current account deficit is trending upwards. As well as that, interest rates are at extremely low levels across all maturities. Furthermore, although most of the focus is on the eurozone right now, the fiscal situation in the US is also a concern. Recent European Commission forecasts show a US debt/GDP level of 101.0% for 2011, compared to a level of 88.0% in the eurozone. Meanwhile, a weak global economy, and fears of recession in Europe, could threaten the pick up in US activity.

Despite all of this though, the dollar remains a key safe haven, with the recent run of positive data providing some support for the USD, particularly versus the euro in an environment of heightened eurozone sovereign risk. The yen is a bigger safe haven, though, and the dollar has struggled to hold up against the JPY despite significant intervention from the Bank of Japan. Further intervention from the BoJ may be seen if the yen continues to push towards fresh highs.

Given the current level of volatility and uncertainty it remains extremely difficult to call the direction of forex markets and the trend will be very much determined by how markets react to ongoing events in Europe, as well as the tone of economic data. Risk sentiment appears to favour the dollar but only to a limited extent. Indeed, upside potential could be restricted by a very dovish Fed, as well as high fiscal and current account deficits. Any signs of a fresh weakening in US economic activity could also pose downside risks for the dollar.

## Key Forecasts

		Q1-2012	Q2-2012	Q3-2012	Q4-2012
<b>US\$/EUR</b>	1.312	1.26-1.33	1.26-1.33	1.28-1.35	1.28-1.35
<b>US\$/GBP</b>	1.582	1.50-1.60	1.50-1.60	1.50-1.60	1.50-1.60
<b>YEN/US\$</b>	76.111	74-80	75-85	76-86	77-87
<b>CHF/US\$</b>	0.918	0.92	0.92	0.94	0.96



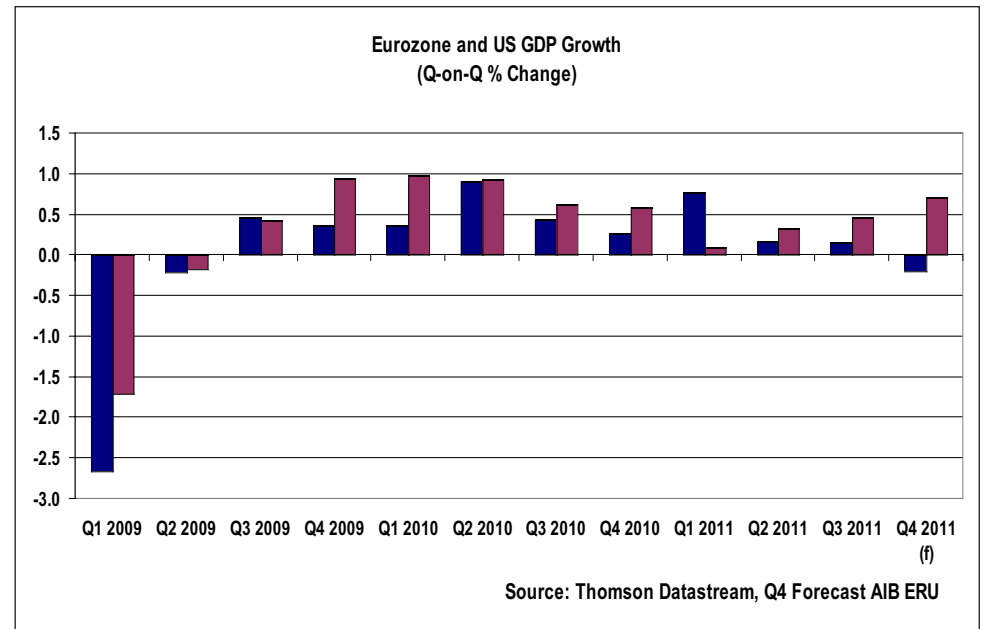
After a year of being buffeted by concerns about eurozone sovereign risk but remaining relatively strong versus other majors, investor sentiment towards the euro ended 2011 on a very poor note. Multi month lows were seen versus the dollar and sterling in early 2012 as markets fretted over eurozone sovereign risk, potential debt downgrades from rating agencies and the likelihood of a return to recession in the eurozone. The euro, however, has since recovered from these levels with the wave of negative sentiment round year end appearing to be overdone. Standard and Poor's did indeed honour its December warning and downgrade its rating of the long term sovereign debt of a number of eurozone member countries. Fitch also announced downgrades.

Surprisingly though, the euro seems to have taken these downgrades in its stride, drawing some support from a general improvement in market sentiment but more specifically from strong demand at a number of recent key eurozone bond auctions and hopes of a Greek debt restructuring deal. This improvement in bond yields (largely due to the ECB's LTRO finding its way back into the market) has likely bought some valuable time for European politicians to sort out a comprehensive solution to the debt crisis. Some upside surprises in terms of eurozone data have also helped. Some forecasters still see a mild recession in the region this year but recent data indicate that the outlook may not be as bad originally feared.

Given the financial market chaos that a break up of the euro could trigger, we believe that European politicians will eventually arrive at a manageable solution to the region's debt crisis. In the meantime, though, despite more recent moves, we believe that the euro will remain vulnerable as it contends with ongoing fears about how medium term financing needs will be catered for, relatively poor eurozone growth prospects and a dovish ECB. A move back towards \$1.25 in dollar/euro cannot be ruled out near term, though we do see scope for the euro recovering some modest ground over the longer term if factors surrounding the debt crisis become less critical. The fact that the markets is so short the euro also leaves scope for temporary bounces.

## Key Forecasts

		Q1-2012	Q2-2012	Q3-2012	Q4-2012
US\$/EUR	1.312	1.26-1.33	1.26-1.33	1.28-1.35	1.28-1.35
GBP/EUR	0.829	0.82-0.85	0.82-0.85	0.83-0.86	0.83-0.86
YEN/EUR	99.84	95-105	95-105	100-110	100-110
PLN/EUR	4.197	4.25	4.25	4.20	4.10



# Sterling

Sterling remains sensitive to UK interest rate expectations, as well as general market appetite for risk. Despite the fact that it has fallen back considerably to 4.2% from its recent peak of 5.2%, the rate of inflation in the UK continues to be substantially above the Bank of England's 2.0% target level. However, the Bank remains of the view that the CPI rate has been boosted by temporary factors while there is no evidence that high inflation has fed through to wages. Meanwhile, the pace of economic recovery remains anaemic at best, with GDP growth expected to be weak into 2012.

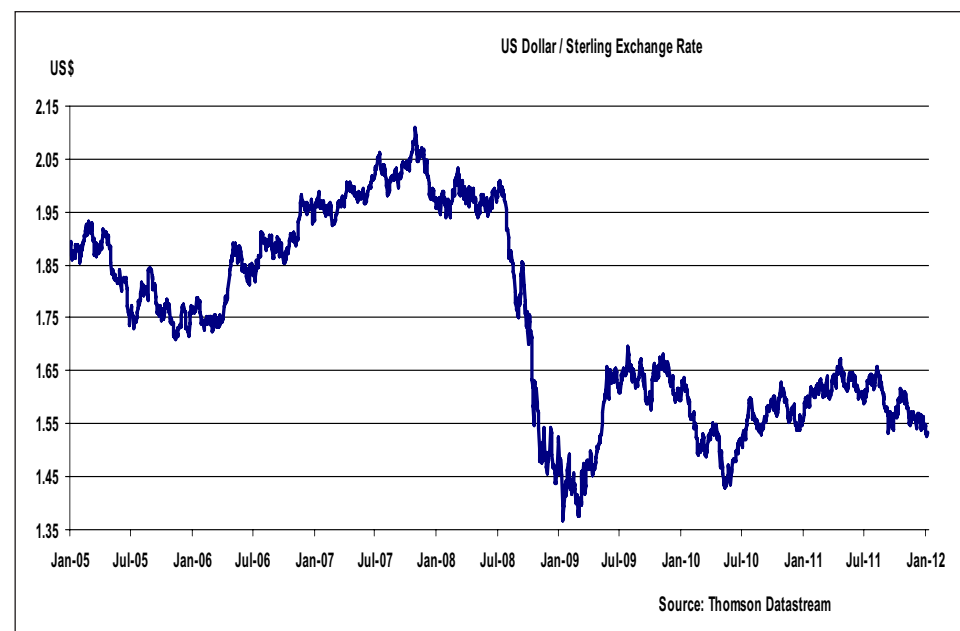
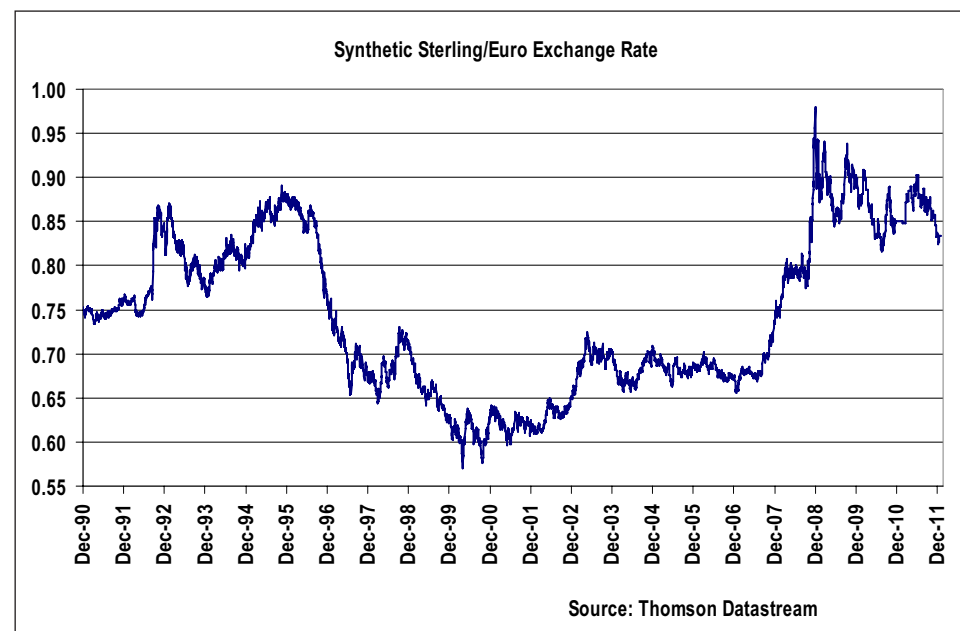
Downside risks on the growth side, as well as heightened financial market risk, saw the BoE announce in October that it was embarking on a fresh round of quantitative easing to the tune of Stg75bln. Further asset purchases could follow possibly in February, while in terms of official rates it could be early 2014 before there is any increase. This dovish policy outlook is likely to weigh on sterling, particularly versus the dollar.

Indeed, given current sentiment and a vulnerable euro, we see little prospect of any substantial gains in sterling versus the USD, with \$1.60 showing key resistance. With GDP growth expected to be sub trend this year and next, the UK economy faces many headwinds, including marked fiscal tightening and high unemployment, as well as the prospect of very low interest rates for some time to come. Thus, there is little to favour sterling versus the dollar near term.

Versus the euro we saw significant moves by sterling of late. Breaking out of familiar ranges, sterling hit 16 month highs of Stg0.8255 in mid January. The euro has since recovered ground and indeed remains relatively strong versus the GBP. However, we could see selling near term if eurozone sovereign risk takes a turn for the worst once again. The decision by the UK to opt out of any new EU Treaty appears to have boosted sterling's safe haven status. Furthermore, while the UK's growth prospects are not great, they are at least better than the eurozone. Versus the euro, we anticipate a Stg0.82-0.85p range over the medium term, though trading could be very choppy.

## Key Forecasts

		Q1-2012	Q2-2012	Q3-2012	Q4-2012
<b>GBP/EUR</b>	0.830	0.82-0.85	0.82-0.85	0.83-0.86	0.83-0.86
<b>US\$/GBP</b>	1.582	1.50-1.60	1.50-1.60	1.50-1.60	1.50-1.60
<b>YEN/GBP</b>	120.36	120	124	126	128
<b>CAD/GBP</b>	1.580	1.56	1.56	1.59	1.60



# Japanese Yen

The Japanese yen continues to benefit from swings in market sentiment given its status as a safe haven of choice. Indeed, the current period of considerable uncertainty surrounding the outlook for the global economy, as well as the ongoing concerns about Europe's debt problems, are keeping the yen closely to yearly highs of ¥75.9 (late 2011) versus the dollar. Meanwhile, versus the euro the yen traded at 11-year highs in early January as concerns about eurozone sovereign risk dominated. Though currently off these highs, we expect little change in this strong yen trend near term.

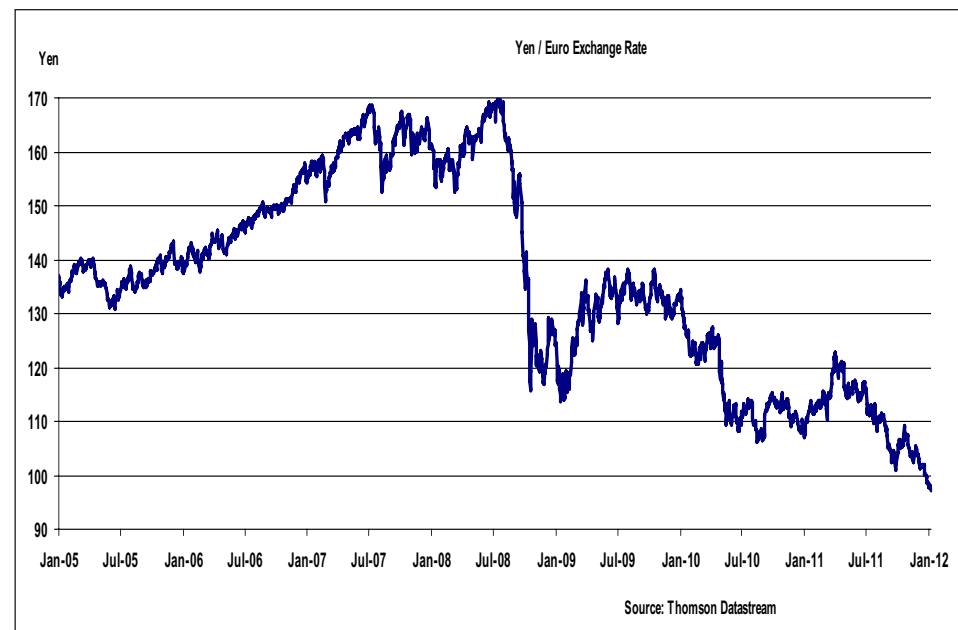
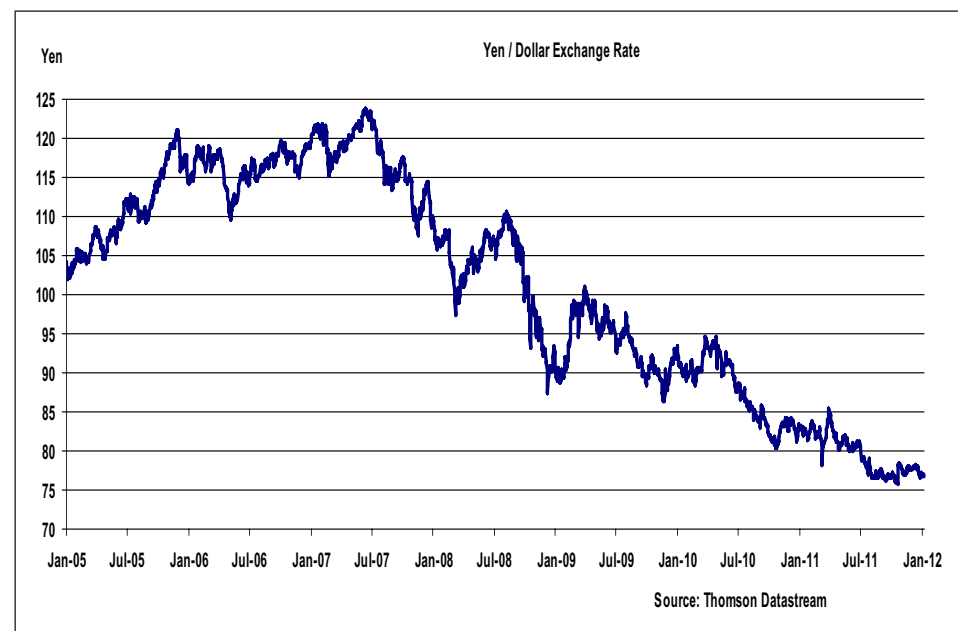
The Bank of Japan continues to express concern about the yen's appreciation and indeed after taking action in March and August, intervened again in late October/early November. Reports suggest that the size of the latest action was more aggressive than that seen earlier in the year but this has done little more than bring some near term stability to the yen. Any fresh sharp movements in the yen could be met with further intervention. However, we do not expect this to have any real impact in terms of weakening the Japanese currency.

The JPY should continue to be supported by risk aversion, a strong external balance and reserve diversification. Recent economic data have also been supportive. After growing by 4.5% in 2010, Japanese GDP growth fell sharply in the first half of 2011 following the March earthquake. However, its recovery has been better than expected, with recent data showing annualised growth of over 4.0% in the three months to September. While this pace of output is likely to ease, the ongoing reconstruction effort following the earthquake should continue to support growth.

Despite this the Bank of Japan is not expected to row back on this ultra accommodative monetary policy stance for some time yet, with rates expected to remain on hold until well into 2014 at least. However, while yield differentials and a weaker global economy (which would impact negatively on Japanese exports) could work against the yen over the longer term, near term we expect that risk sentiment will dominate.

## Key Forecasts

		Q1-2012	Q2-2012	Q3-2012	Q4-2012
<b>YEN/US\$</b>	76.10	74-80	75-85	76-86	77-87
<b>YEN/EUR</b>	99.86	95-105	95-105	100-110	100-110
<b>YEN/GBP</b>	120.39	120	124	126	128



# Australian Dollar/ New Zealand Dollar

The Australian dollar came under downward pressure versus the USD towards the end of 2011, undermined by fears that the global economy could be slipping back into recession. A fall back in commodity prices, as well as interest rate cuts from the Reserve Bank of Australia (RBA) also weighed. To guard against a severe downturn in the economy, the central bank cut interest rates by 0.25% at its policy meetings in November and December. Further policy easing is anticipated in the months ahead.

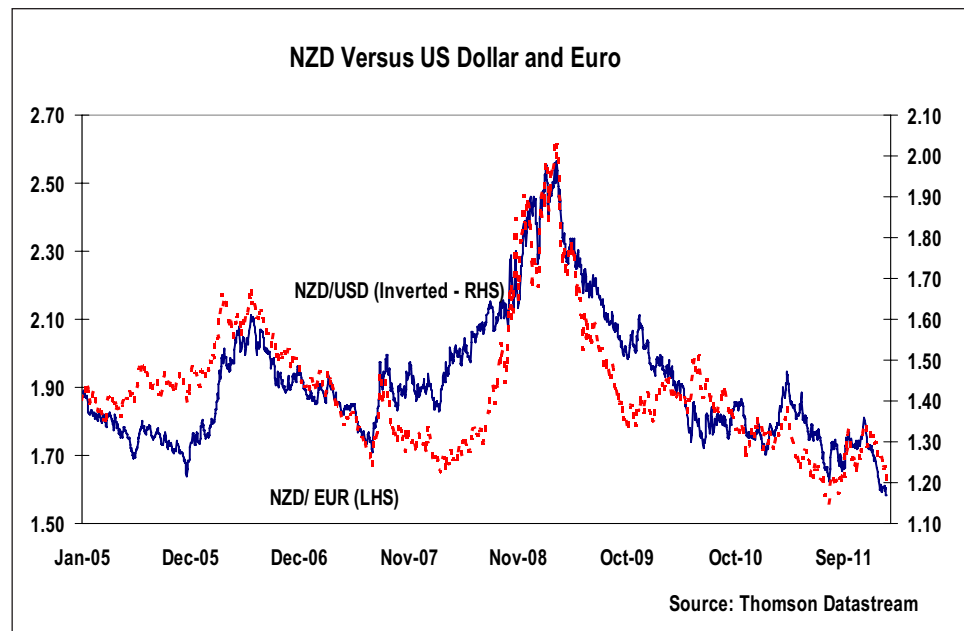
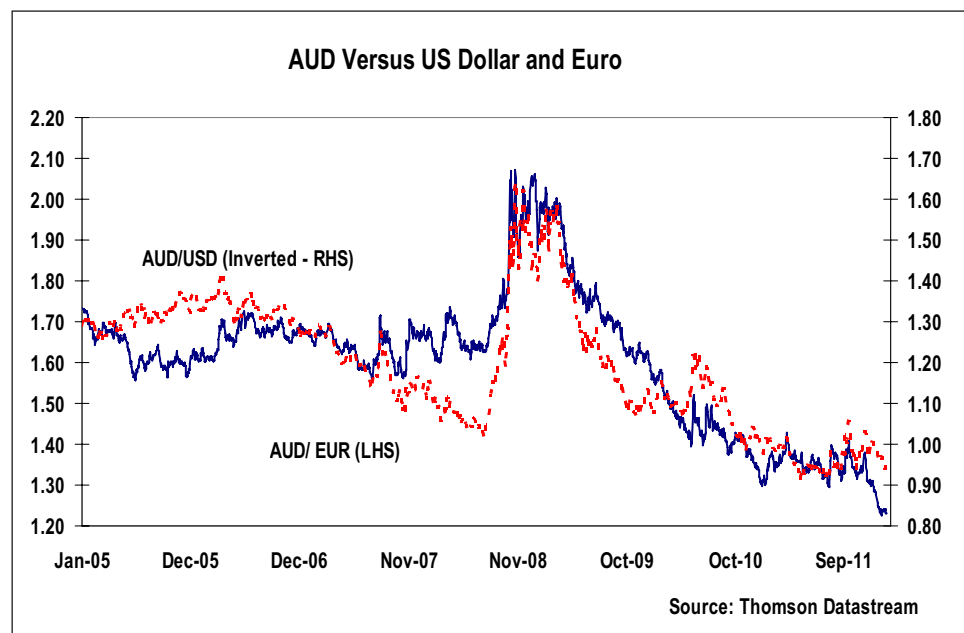
Nonetheless, the currency remains generally strong. Indeed, the AUD has some renewed buoyancy since the start of the year. Hopes for a soft landing in the global economy and in particular China have risen in recent weeks, with data suggesting that the slowdown will not be as severe as originally anticipated. A run of better than expected data from the US has also helped lift sentiment and commodity prices. Meanwhile, despite talk of further action from the RBA, official rates currently stand at 4.25%, which still leaves them well above other those of other majors.

The NZD follows a similar path to the AUD in terms of its movements versus the USD. Thus, it also lost ground before year end. As well as generally higher risk aversion, a recent credit rating downgrade is also likely to have hit sentiment. However, it too remains at elevated levels and should continue to be supported by relatively higher interest rates.

In response to earthquakes in September last year and early this year, interest rates were cut by 0.50% to 2.50% in March, with policy on an extended pause since then. However, the economy is recovering well from the natural disasters and while the renewed slowing in the global economy is likely to impact, GDP prospects for this year and next are pretty favourable. Inflation is also running at its highest level since late 2008. Thus, the market is no longer pricing in interest rates cuts this year and like the AUD the NZD should continue to provide support in its relatively high interest rates. The central bank is expected to resume its tightening schedule in 2013.

## Key Forecasts

		Q1-2012	Q2-2012	Q3-2012	Q4-2012
<b>AUD/USD</b>	1.072	1.04	1.04	1.03	1.03
<b>NZD/USD</b>	0.834	0.81	0.81	0.80	0.80
<b>AUD/EUR</b>	1.22	1.25	1.25	1.28	1.28
<b>NZD/EUR</b>	1.574	1.60	1.60	1.64	1.64



# Key Events/Diary

## Week 1 (6th - 10th February)

Feb 8th	UK	BRC Retail Sales (January)
<b>Feb 9th</b>	<b>Eurozone</b>	<b>ECB Policy Meeting &amp; Press Conference</b>
	<b>UK</b>	<b>BoE Policy Meeting</b>
	UK	Industrial Production (December)
Feb 10th	UK	Producer Prices (January)
	US	Michigan Sentiment Survey (February)

## Week 4 (13th - 17th February)

<b>Feb 13</b>	<b>Japan</b>	<b>Q4 GDP (First Estimate)</b>
<b>Feb 14</b>	<b>UK</b>	<b>Consumer Prices (January)</b>
	US	Retail Sales (January)
<b>Feb 15</b>	<b>Eurozone</b>	<b>German/Eurozone GDP (Q4)</b>
	UK	Unemployment (January)
	<b>UK</b>	<b>BoE Inflation Report</b>
Feb 16	US	Producer Prices (January)
Feb 17	UK	Retail Sales (January)
	US	Consumer Prices (January)

## Week 3 (20th - 24th February)

<b>Feb 22nd</b>	<b>Eurozone</b>	<b>Flash PMI's (February)</b>
	UK	Minutes of BoE Meeting (February)
Feb 23rd	Eurozone	German Ifo Index (February)
	US	House Prices (December)
<b>Feb 24th</b>	<b>UK</b>	<b>Q4 GDP - 2nd Estimate</b>
	US	Consumer Sentiment (February)
	Eurozone	Q4 GDP - Detailed Data

## Week 4 (27th February - 2nd March)

27th Feb	Eurozone	M3 Money Supply (January)
<b>28th Feb</b>	<b>Eurozone</b>	<b>EU Commission Survey (February)</b>
	UK	CBI Distributive Trades Survey (February)
29th Feb	UK	Consumer Confidence (February)
	<b>US</b>	<b>Q4 GDP - 2nd Estimate</b>
<b>1st Mar</b>	<b>US/UK/Eurozone</b>	<b>Manufacturing ISM/PMIs (February)</b>
	US	Personal Income & Spending (January)
	US	Construction Spending (January)

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.

The publication is for information purposes and is not an invitation to deal. The information is believed to be reliable but is not guaranteed. Any expression of opinions are subject to change without notice. This publication is not to be reproduced in whole or in part without prior permission. Allied Irish Banks p.l.c. is regulated by the Central Bank of Ireland.