



# **Exchange Rate Outlook** *21st May 2010*

- **Dollar continues to benefit from market volatility**
- **Euro falls against majors on sovereign risk story**
- **Sterling also suffers versus the dollar on UK concerns**
- **Fragile market sentiment drives the yen higher**

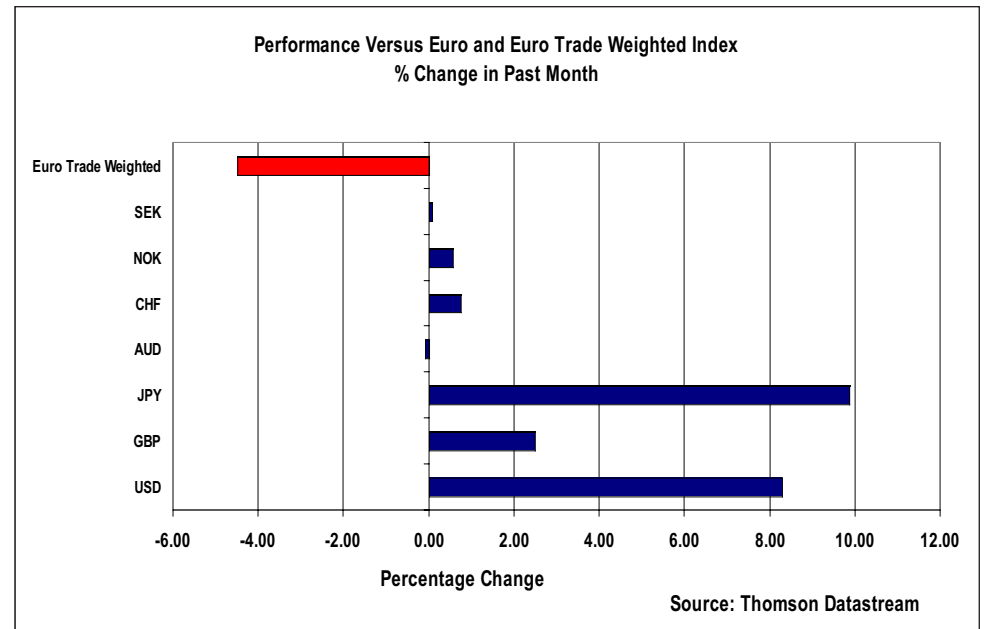
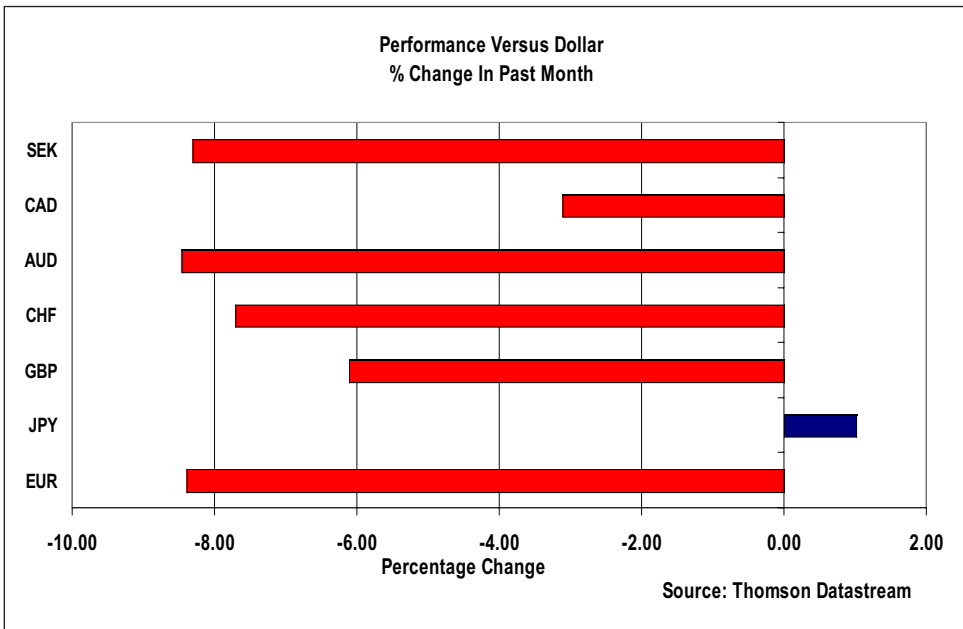
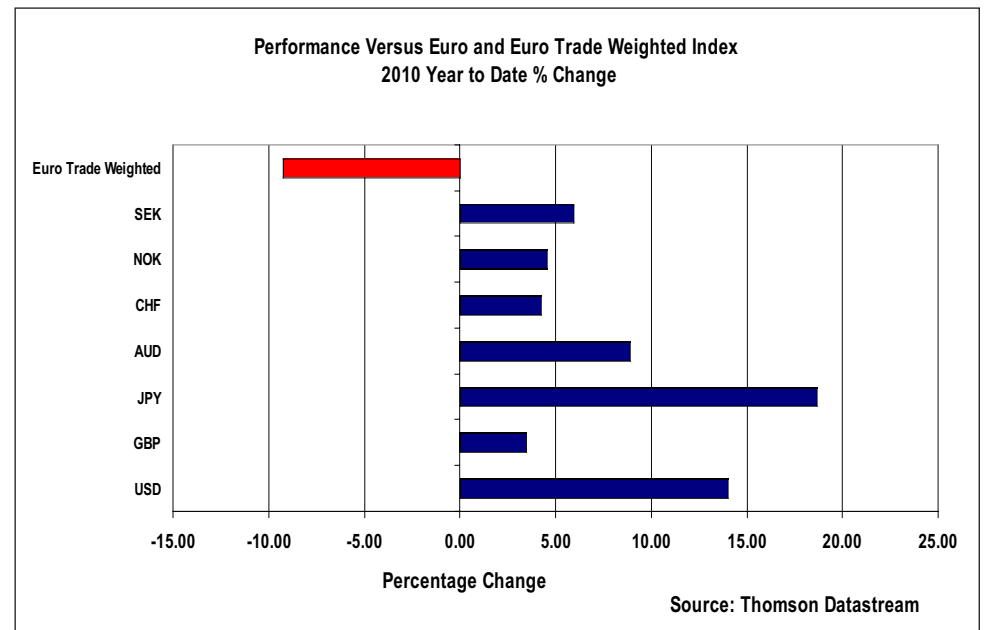
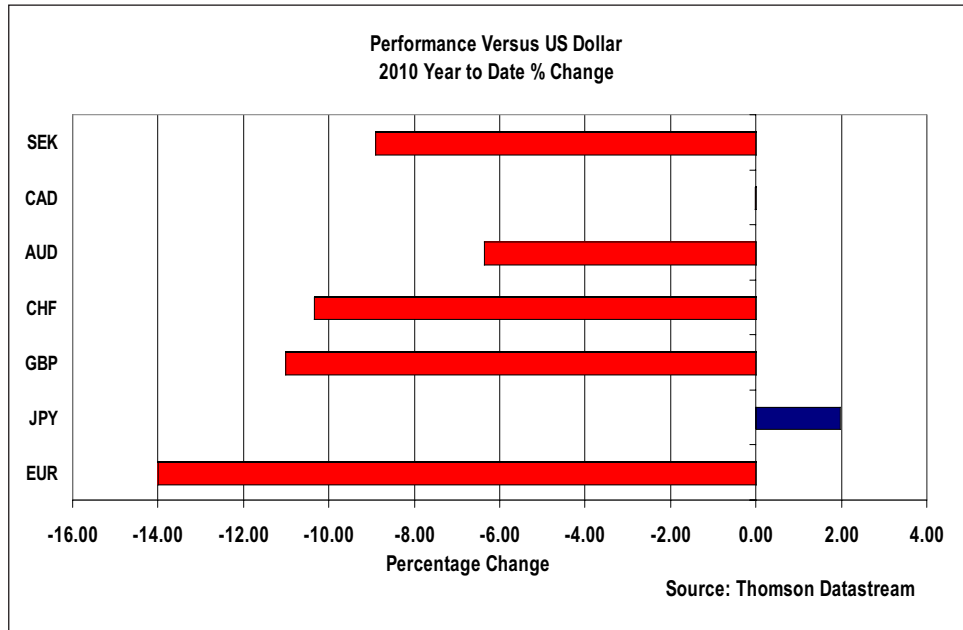
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# Key Currency Trends



# Summary of Exchange Rate Forecasts

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

	<b>Current</b>	<b>Q2-2010</b>	<b>Q3-2010</b>	<b>Q4-2010</b>	<b>Q1-2011</b>
<b>Euro Versus</b>					
<b>USD</b>	1.253	1.16-1.26	1.18-1.27	1.23-1.28	1.25-1.30
<b>GBP</b>	0.870	0.83-0.88	0.84-0.88	0.86-0.89	0.86-0.89
<b>JPY</b>	112.91	108-118	110-120	115-125	125-135
<b>PLN</b>	4.13	4.00	3.85	3.75	3.70
<b>HUF</b>	279.55	270	265	260	260
<b>NOK</b>	8.10	7.95	7.90	7.80	7.70
<b>SEK</b>	9.82	9.65	9.60	9.50	9.40
<b>AUD</b>	1.51	1.42	1.36	1.39	1.43
<b>NZD</b>	1.86	1.78	1.80	1.87	1.90
<b>US Dollar Versus</b>					
<b>JPY</b>	90.08	88-95	92-97	95-100	98-103
<b>GBP</b>	1.440	1.38-1.48	1.40-1.50	1.40-1.50	1.45-1.55
<b>CHF</b>	1.15	1.10	1.07	1.07	1.05
<b>CAD</b>	1.06	1.03	1.03	1.05	1.07
<b>AUD</b>	0.83	0.85	0.90	0.90	0.89
<b>NZD</b>	0.67	0.68	0.68	0.67	0.67
<b>CNY</b>	6.83	6.82	6.81	6.80	6.79
<b>Sterling Versus</b>					
<b>JPY</b>	130	129	135	140	146
<b>CAD</b>	1.53	1.46	1.47	1.51	1.56
<b>AUD</b>	1.73	1.66	1.58	1.59	1.64
<b>NZD</b>	2.14	2.08	2.09	2.14	2.17

# 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 2011.

## **Fed Funds Rates To Stay Close On 0% Until 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%. There are also concerns that the recovery in activity may lose some momentum in H2 2010. Hence, the Fed is unlikely to begin raising the funds rate until early 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, unemployment has risen to 10%, while inflationary pressures are very subdued and the growth in monetary aggregates has turned negative. 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, has 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 has forced it the ECB to reintroduce some of these measures. Given all these negative factors, we do not see the ECB raising rates until Q1 2011 at the earliest.

## **UK Rates Set to Remain Low 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. With UK inflation forecast to be below 2% over the medium term, unemployment high, the economic recovery proving anaemic, and fiscal policy about to be tightened, we do not anticipate any hikes in official rates until Q1 2011 at the earliest.

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

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
<b>Current</b>	0.125	0.50	1.15	1.10	2.25
<b>Jun '10</b>	0.125	0.40	1.15	1.20	2.40
<b>Sept '10</b>	0.125	0.50	1.20	1.40	2.60
<b>Dec '10</b>	0.125	0.70	1.40	1.60	2.80

\* 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	0.64	1.24	1.26	2.08
<b>Jun '10</b>	1.00	0.70	1.30	1.40	2.25
<b>Sept '10</b>	1.00	0.75	1.40	1.50	2.40
<b>Dec '10</b>	1.00	0.80	1.60	1.75	2.70

\* 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	0.70	1.40	1.41	2.46
<b>Jun '10</b>	0.50	0.75	1.45	1.50	2.60
<b>Sept '10</b>	0.50	0.80	1.60	1.70	2.80
<b>Dec '10</b>	0.50	1.00	1.80	2.00	3.20

\* Swap Forecasts Beyond 1 Year

# US Dollar

Volatility on foreign exchange markets continues to be high and looks set to remain so in the near term as the issue of global sovereign risk dominates. Changing market sentiment with regard to the pace of recovery in the world economy and the likely timing of any moves by the main central banks to increase official interest rates from their current very low levels is also adding to the uncertain environment.

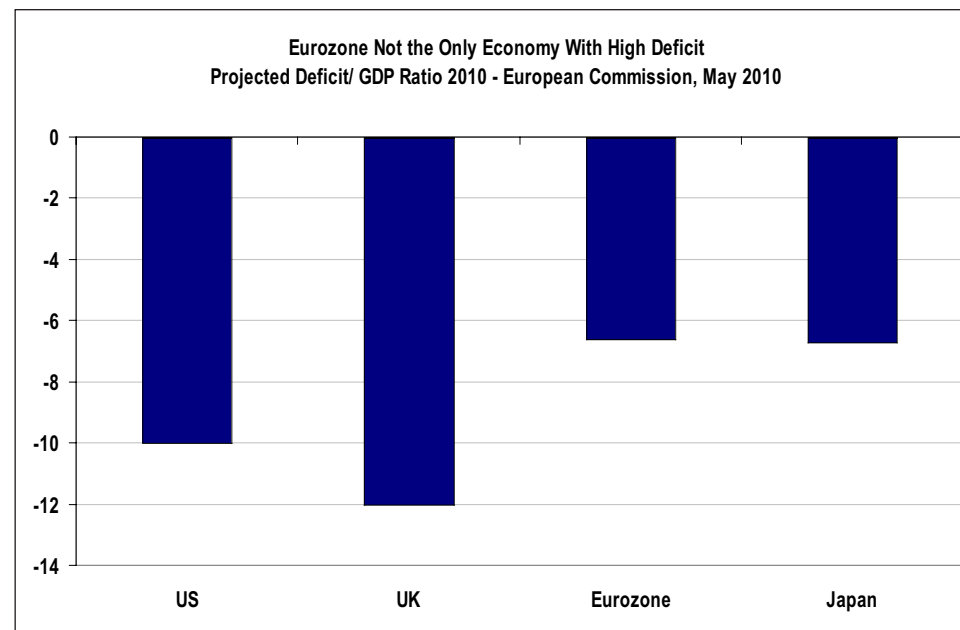
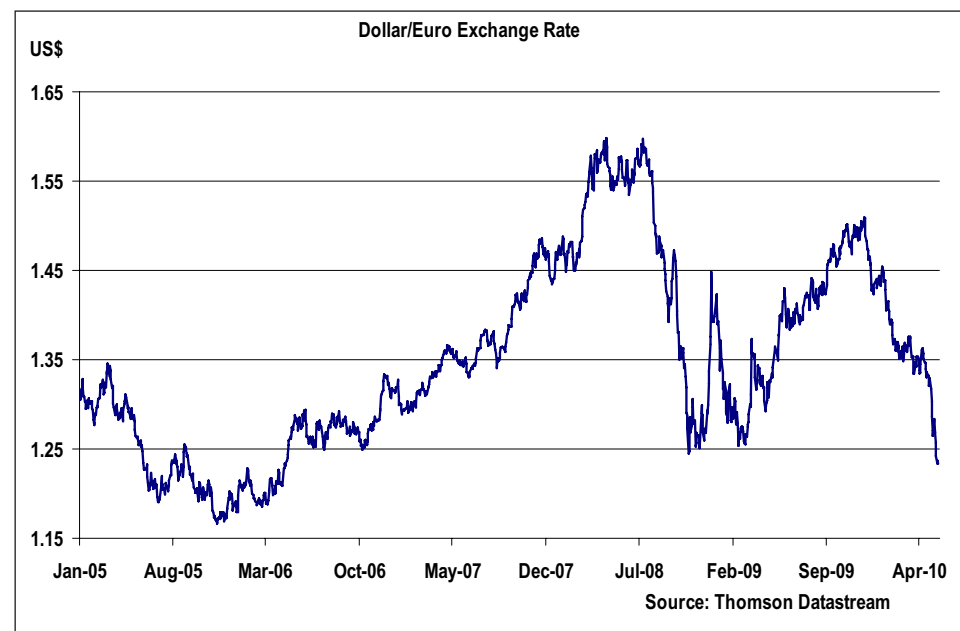
Traditionally a safe haven currency, the dollar is benefiting from this volatility, particularly versus European currencies like the euro and sterling, but it has also gained ground against "high risk" currencies like the AUD. The US public finances are hardly in great shape either but the focus in terms of sovereign risk is on the eurozone and this looks set to remain the case. The news of a €750 bln stand-by facility from the European Union and the IMF provided only short term support for the euro and significant downside risks remain. Indeed, with sentiment clearly against the single currency, we could see a break of \$1.20 in terms of the USD/EUR rate or even lower near term.

As well as general market volatility, the dollar is also taking some underlying support from talk that the Fed will be the first main central banks to increase rates. However, while the economic outlook in the US has improved, there has been little indication from the Fed that it is about to start moving towards a rate hike anytime soon. Thus, the scope for a marked dollar rally on the back of this interest rate story looks limited. Instead, sovereign risk is likely to be the main factor influencing market direction.

This indicates further dollar appreciation near term, though the USD could see some of its gains eroded over the course of the year, particularly if concerns over eurozone risk and market volatility start to ease. Furthermore, the US economy still faces significant headwinds with the current pace of recovery unlikely to be sustained. At the same time, though, the scope for any marked euro recovery should also be restricted by the ongoing evidence of a weak eurozone economic performance, a dovish ECB and sovereign associated risk.

## Key Forecasts

		Q2-2010	Q3-2010	Q4-2010	Q1-2011
<b>US\$/EUR</b>	1.253	1.16-1.26	1.18-1.27	1.23-1.28	1.25-1.30
<b>US\$/GBP</b>	1.440	1.38-1.48	1.40-1.50	1.40-1.50	1.45-1.55
<b>YEN/US\$</b>	90.090	88-95	92-97	95-100	98-103
<b>CHF/US\$</b>	1.149	1.10	1.07	1.07	1.05



Weighed down by concerns about eurozone sovereign risk, the euro remains under pressure versus the USD and is currently trading 14% below where it was at the start of the year. Indeed, with support at a number of key levels giving way, the scale of the euro's decline versus the USD accelerated over recent weeks, with four year lows of \$1.2146 seen on 19th May. This is despite the introduction of measures aimed at stabilising the Greek debt situation, including the announcement of a €750 billion support package from the European Union and the IMF.

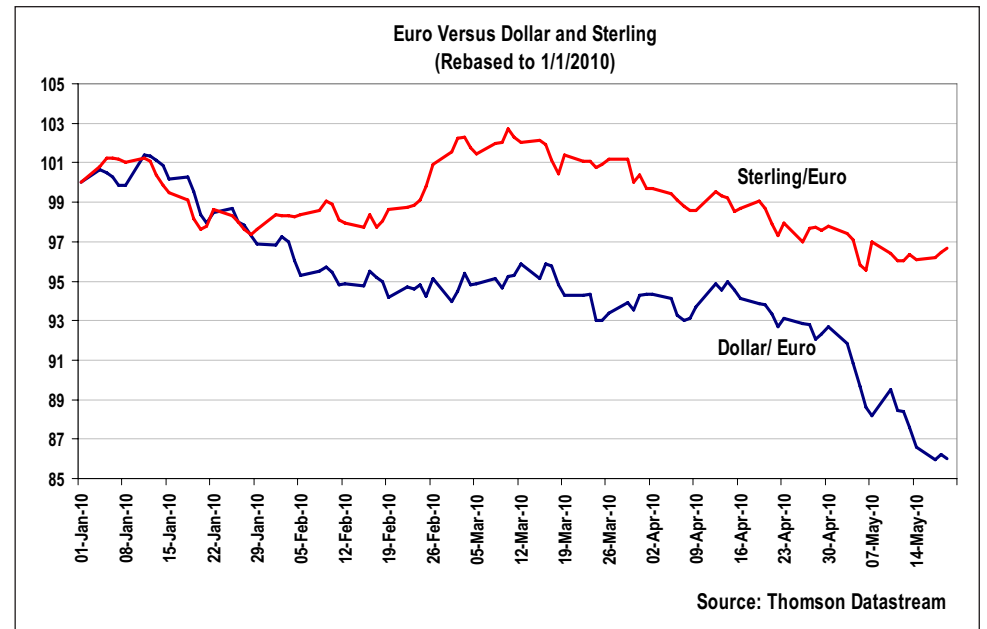
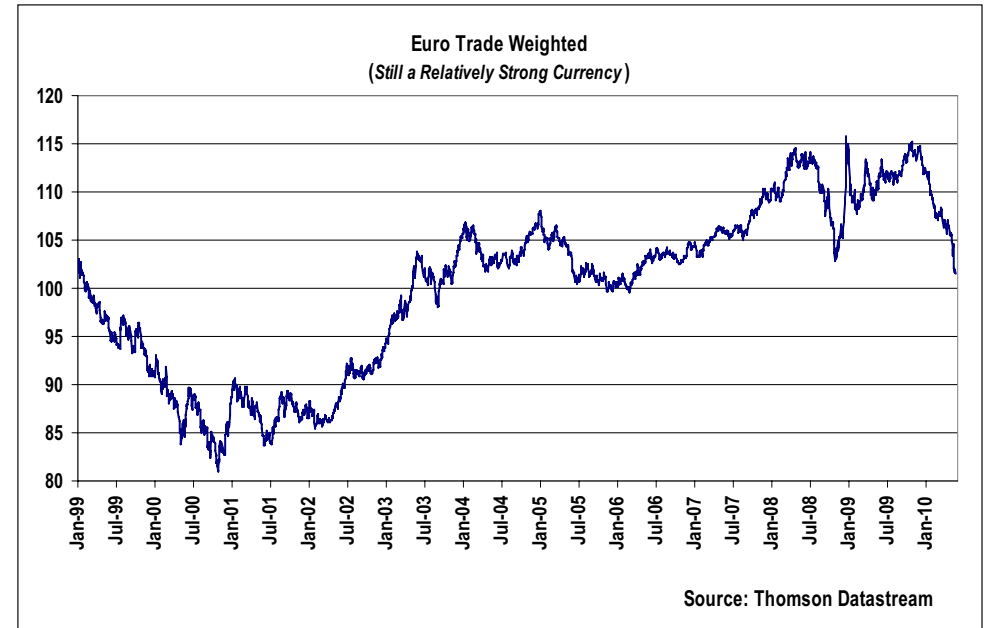
Although currently off these lows, the euro's swift retreat suggests further downside risk, as markets remain fixated on Europe's fiscal policy outlook. There has been some talk of intervention to stem the currency's sharp decline but we would be sceptical of such action at this point given that euro weakness can only be positive for export growth in a region struggling to recover from recession.

Meanwhile, a moderate and uneven eurozone economic recovery, combined with the sovereign debt risk issues, means that the ECB is unlikely to start hiking interest rates soon, a further fact to weigh on the euro. Although still a relatively strong currency (on a trade weighted basis), the euro looks set to remain on the back foot versus the dollar over the coming months with the credibility of the single currency seriously undermined by recent events. We anticipate a \$1.16-1.26 trading range short to medium term, with scope for some modest recovery seen before year end but only if concerns over sovereign associated risk start to ease. Periods of short covering could see some trading outside of the top of this range but a nervous market is expected to sell into any rallies.

Despite its fall against the USD, the euro is holding up reasonably well against sterling, recovering from lows of Stg0.8428p in early May to trade around Stg0.87p. However, this still leaves it 5.7% below March's high of Stg0.9148p. While markets are negative on the euro, they are also wary of the GBP given the UK's own economic challenges. We anticipated a Stg0.83-0.88p range as markets await plans for UK fiscal consolidation.

## Key Forecasts

		Q2-2010	Q3-2010	Q4-2010	Q1-2011
US\$/EUR	1.253	1.16-1.26	1.18-1.27	1.23-1.28	1.25-1.30
GBP/EUR	0.870	0.83-0.88	0.84-0.88	0.86-0.89	0.86-0.89
YEN/EUR	112.87	108-118	110-120	115-125	125-135
PLN/EUR	4.129	4.00	3.85	3.75	3.70



# Sterling

One of the most volatile of the majors during the global financial crisis, sterling remains on its roller coaster ride, particularly versus the dollar. The past month has seen cable trade in a ten cent range as market sentiment with regard to the outlook for the UK economy has ebbed and flowed. Initially supported by better than expected UK data, which helped allay fears that the UK economy may have slipped back into recession in Q1, the GBP fell back to 14 month lows of \$1.4240 as it has tracked the euro lower. Though it has since recovered from these levels, sentiment remains fragile.

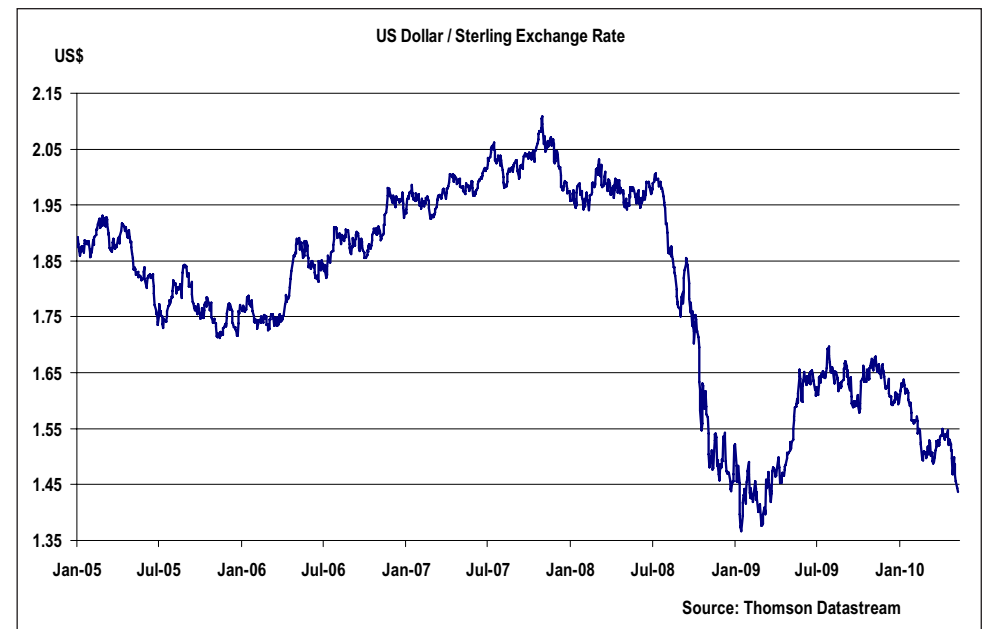
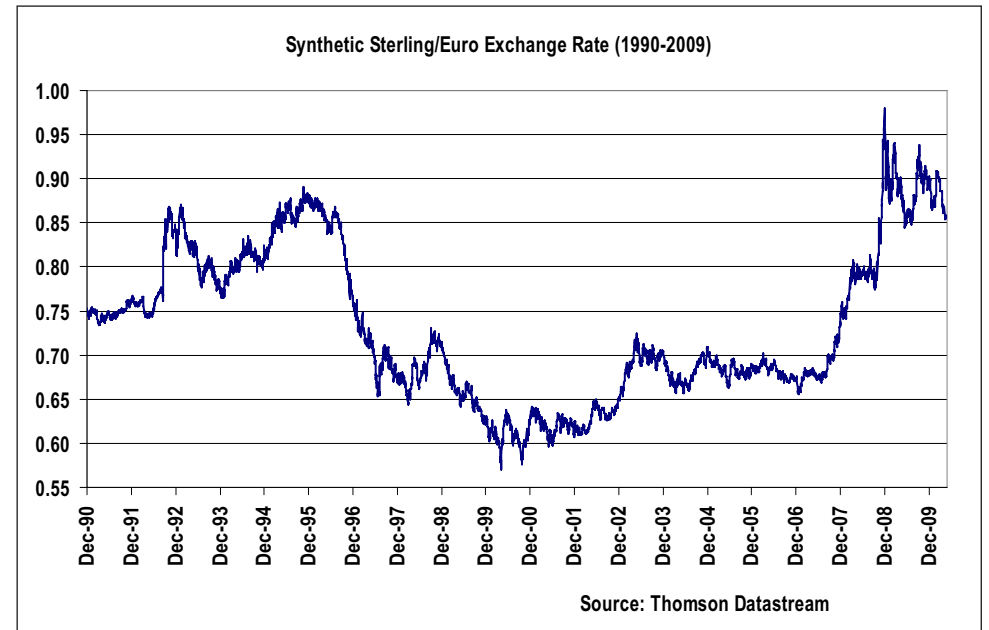
Uncertainty surrounding the formation of a new UK government and concerns about the UK's own fiscal problems also caused investors to sell sterling versus the euro. From yearly highs of Stg0.8428p seen in early May, sterling has fallen back to its current level of around Stg0.87p, though the single currency is still some way off the yearly highs seen in March. We expect trading to be confined to a Stg0.83-0.88p range over the coming weeks, with the dollar/sterling rate likely to be much more volatile.

We expect the dollar/sterling rate to trade in a \$1.38-1.48 range for now, with the GBP likely to be hostage to general market sentiment as well as concerns over the UK's domestic outlook. Notwithstanding the return to growth in Q4, the UK still faces significant headwinds, including high unemployment, as well as the likelihood of a muted upturn in some of the UK's main export markets.

Although the new UK government has already started tackling the problem, it faces a difficult task in reducing a deficit/GDP ratio that is one of the highest in the EU, with fiscal tightening likely to weigh on a fragile UK recovery. This anaemic pace of recovery supports our view that the Bank of England will leave interest rates at ultra low levels for some time to come. Indeed, the central bank recently indicated that it remains open to the prospect of providing further stimulus to the economy should it need it, a fact that could weigh on the GBP. Overall, however, sterling could gain some ground versus the euro near term as the scale of problems in the eurozone appear more daunting.

## Key Forecasts

		Q2-2010	Q3-2010	Q4-2010	Q1-2011
<b>GBP/EUR</b>	0.870	0.83-0.88	0.84-0.88	0.86-0.89	0.86-0.89
<b>US\$/GBP</b>	1.441	1.38-1.48	1.40-1.50	1.40-1.50	1.45-1.55
<b>YEN/GBP</b>	129.83	129	135	140	146
<b>CAD/GBP</b>	1.533	1.46	1.47	1.51	1.56



# 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 overvalued, the JPY is still benefiting from swings in market sentiment, particularly versus the euro as it suffers from sovereign associated risk. Dollar/yen, meanwhile, remains well off 14 year lows of Y84.8 seen late last year, sticking to a relatively tight range of Y88-95 over recent months.

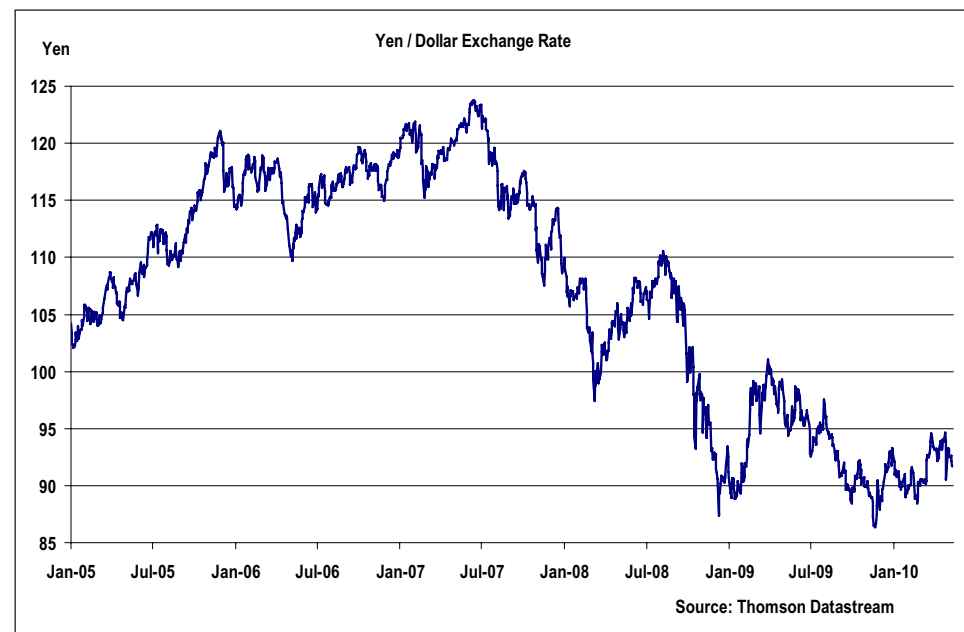
We expect the dollar to continue to hold its own versus the yen, with the improving outlook for the US economy relative to other major economies and the current flight to quality providing support. There are also a number of domestic factors that are likely to weigh on the JPY and which could drive it 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 economy, with a number of vague references made to intervention if necessary over recent times.

Furthermore, the Bank of Japan have extended quantitative easing activities on two occasions since December, which is in contrast to other major central banks who remain very accommodative in terms of official rates but have begun the process of gradually withdrawing non-conventional monetary support measures for the markets. 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 accommodative policy stance anytime soon.

While the dollar could gain ground versus the yen over the year, the euro is likely to struggle to make much headway versus the Japanese currency, particularly in the short to medium term as markets continue to focus on the depth of the eurozone's sovereign debt issues. Back trading below the Y120 level for now, we anticipate a Y108-118 trading range for euro/yen as markets await a more comprehensive and long term resolution to the eurozone's fiscal problems.

## Key Forecasts

		Q2-2010	Q3-2010	Q4-2010	Q1-2011
<b>YEN/US\$</b>	90.11	88-95	92-97	95-100	98-103
<b>YEN/EUR</b>	112.91	108-118	110-120	115-125	125-135
<b>YEN/GBP</b>	129.78	129	135	140	146



# 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 bounced back strongly last year in line with a pick up in global risk appetite. Sentiment was also 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.

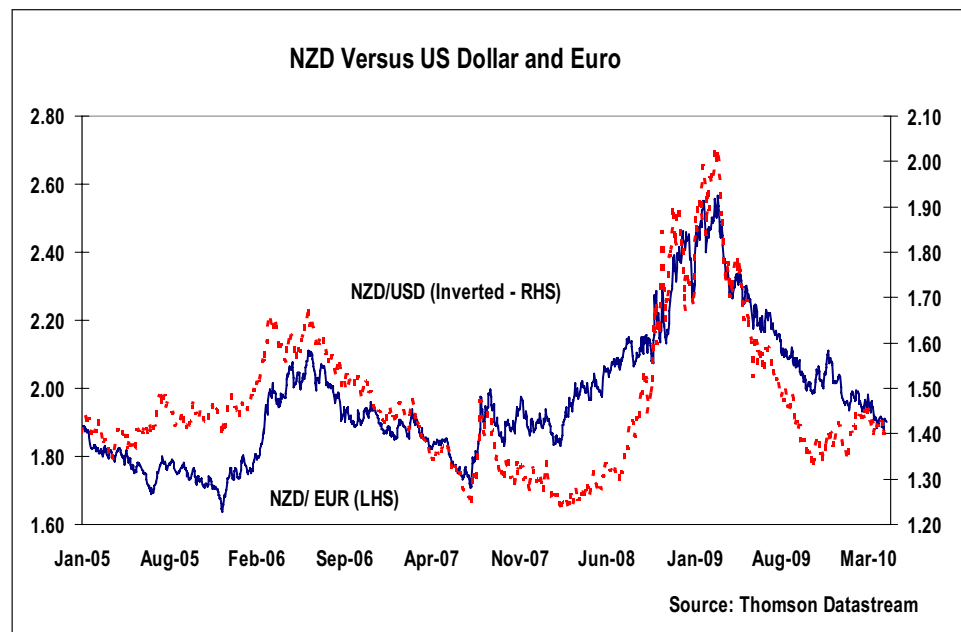
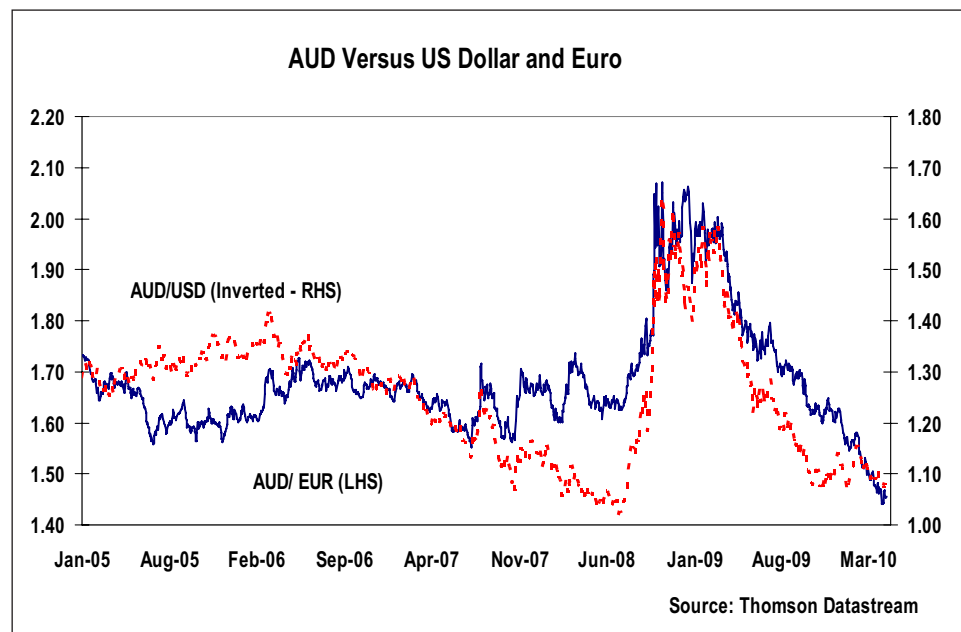
The pair's recovery was further cemented by October's announcement from the Reserve Bank of Australia that, in response to the better than anticipated domestic economic outturn, it was raising interest rates by 0.25% to 3.25%, making it one of the first developed economies to reverse emergency monetary policy action. Rates were increased by a further 0.25% in November and December, opening up a considerable rate differential with other majors.

The opening months of this year saw some fall back from the highs of late 2009, reflecting a rise in risk aversion on concerns about the outlook for the global economy. The AUD was also sold following the surprise decision by the Reserve Bank of Australia to leave rates on hold in January. In doing so, it cited the potentially negative impact of higher mortgage rates at home, as well as tighter policy in China and concerns over sovereign debt abroad.

Although recovering from this, the recent spike in market volatility, reflected in a sell off in stocks and commodities, has put fresh downward pressure on the pair. However, fundamentals suggest that they will remain relatively strong over the coming months, with some talk in the marketplace that the RBA will intervene to correct sharp moves in the currency. Furthermore, interest rates in Australia are now at 4.50%. Although the RBA appears to be done in terms of rate hikes for now, this still leaves them well ahead of the main economies, while the Reserve Bank of New Zealand has indicated that it will start hiking official rates around mid year.

## Key Forecasts

		Q2-2010	Q3-2010	Q4-2010	Q1-2011
<b>AUD/USD</b>	0.831	0.85	0.90	0.90	0.89
<b>NZD/USD</b>	0.675	0.68	0.68	0.67	0.67
<b>AUD/EUR</b>	1.51	1.42	1.36	1.39	1.43
<b>NZD/EUR</b>	1.856	1.78	1.80	1.87	1.90



# Key Events/Diary

## Week 1 (24th-28th May)

May 24th	US	Existing Home Sales (April)
<b>May 25th</b>	<b>UK</b>	<b>Q2 -GDP (Second Estimate)</b>
	US	Consumer Confidence (May)
May 26th	US	Durable Goods (April)
	US	New Home Sales (April)
<b>May 27th</b>	<b>US</b>	<b>Q2 -GDP (Second Estimate)</b>
May 28th	US	Personal Consumption & Expenditure (April)

## Week 2 (31st May - 4th June)

May 31st	Eurozone	EC Business and Sentiment Surveys (May)
	Eurozone	Flash HICP (May)
<b>June 1st</b>	<b>US/UK/Eurozone</b>	<b>Manufacturing ISM/ PMI (May)</b>
<b>June 3rd</b>	<b>US/UK/Eurozone</b>	<b>Services ISM/ PMI (May)</b>
	Eurozone	Retail Sales (April)
	US	ADP Employment Report (May)
<b>June 4th</b>	<b>Eurozone</b>	<b>Q2 -GDP (Second Estimate)</b>
	<b>US</b>	<b>Non-Farm Payrolls (May)</b>

## Week 3 (7th - 11th June)

June 7th	Ireland	Market Holiday
June 9th	UK	External Trade (April)
	Japan	Q2 -GDP (Second Estimate)
<b>June 10th</b>	<b>Eurozone</b>	<b>ECB Announcement &amp; Press Conference</b>
	<b>UK</b>	<b>BoE Rate Announcement</b>
June 11th	UK	Producer Prices (May)
	US	Retail Sales (May)

## Week 4 (14th - 18th June)

June 14th	UK	Industrial Production (April)
<b>June 15th</b>	<b>Eurozone</b>	<b>German ZEW Index (June)</b>
	US	Net Capital Inflows (April)
June 16th	UK	Unemployment (May)
	US	Producer Prices (May)
	US	Industrial Prod & Capacity Utilisation (May)
<b>June 17th</b>	<b>UK</b>	<b>Retail Sales (May)</b>
	<b>US</b>	<b>Consumer Prices (May)</b>

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.

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