AIB Global Treasury
Economic Research

EXCHANGE RATE MONTHLY

November 2005

Interest Rate Focus Switches to Eurozone

- The familiar dollar/euro range of $1.19-1.25 looks set to hold over the balance of the year, though with a bias towards a stronger euro as markets focus on the possibility of eurozone interest rate hikes.

- Markets are no longer discounting a rate cut in the UK but sterling could still come under renewed pressure if continued weakness in consumer spending data revives hopes of a rate cut.

- The yen has slipped further versus the dollar and euro despite a better Japanese economic outlook. Downward pressure on the yen is expected to remain in place near-term.

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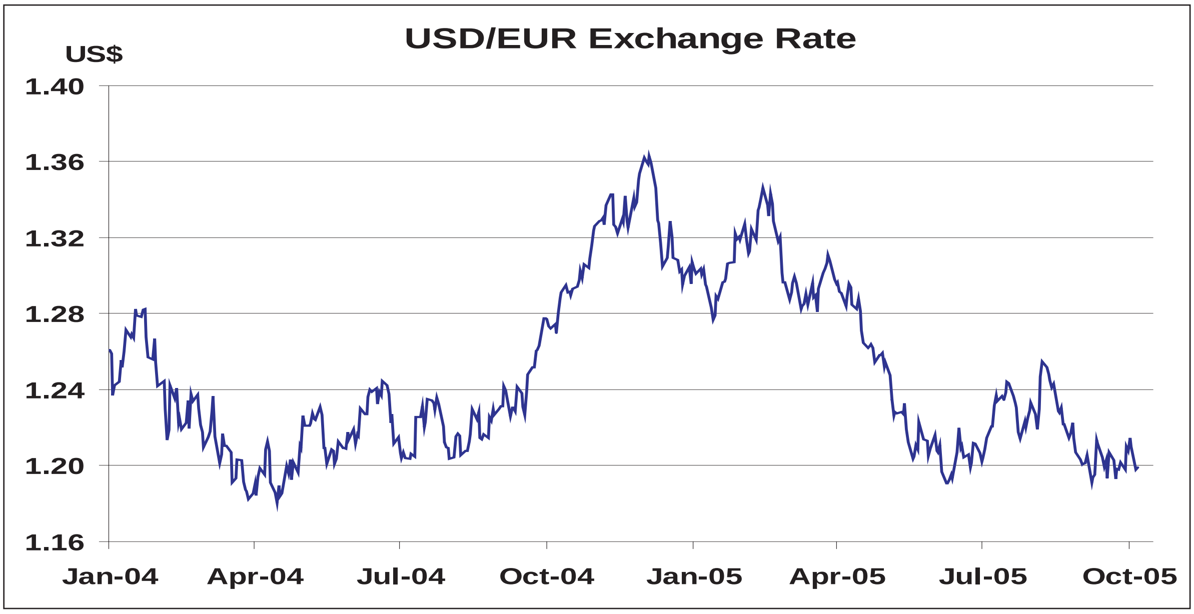

Summary of Forecasts

Exchange Rates

Euro Versus		Forecast Range Over The Period			
	Current	**Q4 - 2005**	**Q1 - 2006**	**Q2 - 2006**	**Q3 - 2006**
USD	1.2007	1.19-1.24	1.19-1.24	1.21-1.26	1.21-1.26
GBP	0.6769	0.67-0.69	0.67-0.69	0.67-0.69	0.67-0.69
JPY	140.40	138-143	137-142	134-135	130-135
PLN	3.9555	4.00	4.05	4.05	4.05

Dollar Versus		Forecast Range Over The Period			
	Current	**Q4 - 2005**	**Q1 - 2006**	**Q2 - 2006**	**Q3 - 2006**
JPY	116.90	113-118	112-117	108-113	105-110
GBP	1.7738	1.75-1.80	1.75-1.80	1.80-1.85	1.80-1.85
CHF	1.2856	1.27	1.27	1.25	1.25
AUD	0.7415	0.75	0.76	0.78	0.78

Official Interest Rates

		Forecast to End Period			
	Current	**Q4 - 2005**	**Q1 - 2006**	**Q2 - 2006**	**Q3 - 2006**
Euro Refi Rate	2.00	2.00	2.00	2.25	2.50
US Fed Funds	4.00	4.25	4.50	4.75	4.75
UK Base Rate	4.50	4.50	4.25	4.25	4.25
Japan ODR	0.10	0.10	0.10	0.10	0.25

Growth and Inflation

		GDP			**Inflation**	
Y-on-Y% Change	**2004**	**2005**	**2006**	**2004**	**2005**	**2006**
US	4.2	3.5	3.5	2.7	3.4	3.0
Eurozone	1.8	1.3	1.7	2.1	2.2	2.1
UK	3.2	1.8	2.4	1.3	2.1	2.0
Japan	2.6	2.3	2.3	-0.2	-0.3	0.2
Ireland	4.5	5.0	5.5	2.2	2.5	3.3

Our View In Brief

* **The US economy grew by an annualised 3.6% in the first three quarters of 2005, indicating that the upswing in activity remains strong. The domestic economy was particularly robust. While the disruption caused by Hurricane Katrina and high energy prices are likely to dampen activity over the balance of the year, the economy should rebound in early 2006 as reconstruction work gets underway. Furthermore, oil prices appear to have stabilised well below their autumn highs. We look for GDP growth to average around 3.5% in 2005 and 2006.**

* The Fed believes that the US economy is on a solid growth path and thus the FOMC looks set to continue raising interest rates into 2006. We expect the Fed funds rate to be at 4.75% by mid 2006. Until recently, markets believed that rates in the US would top out at 3.75% at end 2005, but expectations are now in line with our forecasts.

* **The dollar continues to be supported by the relatively higher level of US rates. However, with the market now speculating about increases in interest rates in the eurozone, $1.19 is proving to be a strong support level for the euro. We expect the $1.19-1.25 range to hold over the balance of the year.**

* GDP growth in the eurozone economy averaged less than 0.4% in the first two quarters of this year. Both consumption and investment were weak, with net trade and government spending the main growth drivers. Indications are that activity picked up some momentum over the course of Q3 and into Q4. The upswing in activity is expected to be maintained into 2006. We anticipate an average GDP growth rate of 1.3% for 2005 and 1.7% for 2006.

* **The ECB has left official interest rates on hold at 2.0% since June 2003. However, all indications are that it is preparing the ground for a rate hike. It has stepped up its anti-inflation rhetoric in view of the marked rise in oil prices, while also stressing the need for strong vigilance in light of ample liquidity and buoyant money and credit growth in the eurozone. At the same time, there is little evidence of any second round inflation effects. Thus, we believe that the ECB may hold off until Q2 of next year before taking any action on rates.**

* The UK economy has been growing below trend since mid-2004. The interest rate cut in August should provide a boost to activity and some recent indicators suggest that growth is beginning to pick up. Nevertheless, GDP growth this year now looks set to average around 1.8%, the first time it has dipped below 2% since the early 1990s. Growth should, however, pick up to 2.4% in 2006.

* The market is no longer discounting any further easing in UK interest rates. We would not, however, rule out further easing in early 2006 if the economy continues to grow below trend over the winter months and headline inflation falls back towards 2%. Sterling has recovered ground as markets pare back expectations for another rate cut. It could, however, come under renewed pressure in the weeks ahead, if consumer spending data fail to support the case for steady rates.

* The Japanese economy recorded its third consecutive quarter of growth in Q2 2005. Economic activity this year has been more evenly balanced, with domestic demand contributing to growth as well as the external sector. There are also signs that deflationary pressures are easing. Interest rates in Japan, however, are expected to remain at ultra low levels until the second half of 2006.

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Interest Rate Environment

Further US Rate Hikes to Come

* As expected, the Fed raised US interest rates by another 0.25% at its policy meeting in November, bringing the Fed funds rate to 4.00%.

* The Fed believes that the US economy is on a solid growth path but that price pressures have picked up. However, longer-term, inflation should remain contained, allowing the Fed to continue to tighten policy at a measured pace.

* Thus, there is little to suggest that US rates are near their peak and we expect the Fed funds rate to be at 4.75% by mid-2006. Long-term rates have moved sharply upwards as markets discount further policy tightening. Yields are likely to rise a bit further in the months ahead, as indicated in our forecasts.

US Interest Rates

	Current	Dec '05	Mar '06	June '06
Fed Funds	4.00	4.25	4.50	4.75
3 Month	4.25	4.45	4.70	4.85
1 Year	4.73	4.90	4.95	5.00
2 Year*	4.86	5.00	5.05	5.10
5 Year*	4.97	5.10	5.15	5.20
10 Year*	5.11	5.20	5.25	5.30

** Swap Forecasts Beyond 1 Year*

ECB to Hike in 2006

* Interest rates in the eurozone have been at 2.0% since June 2003 but recent commentary from the ECB suggests that it is preparing the ground for a rate hike. Growth in monetary aggregates remains strong, while upside inflation risks also prevail.

* However, with the economic recovery still fragile the ECB is unlikely to tighten rates before year end. Furthermore, there is little sign of a pick-up in underlying inflation.

* Thus, we expect eurozone interest rates to remain on hold until Q2-2006. Assuming that the economy does pick up, we anticipate three quarter point rate hikes next year, bringing the refi rate to 2.75% by end 2006.

Eurozone Interest Rates

	Current	Dec '05	Mar '06	June '06
Refi Rate	2.00	2.00	2.00	2.25
3 Month	2.23	2.15	2.25	2.50
1 Year	2.55	2.50	2.60	2.90
2 Year*	2.83	2.80	2.90	3.20
5 Year*	3.18	3.15	3.25	3.50
10 Year*	3.56	3.55	3.65	3.80

** Swap Forecasts Beyond 1 Year*

UK Outlook Remains Finely Balanced

* The Bank of England cut UK interest rates by 0.25% in August, bringing the repo rate to 4.50% but has kept rates on hold since then.

* Expectations for another rate cut before year end have all but died following hawkish comments from the BoE and some better than expected domestic data.

* Consumer spending, however, remains weak. Thus, we believe that there remains a possibility that rates could be cut by another 0.25% early next year, if the economy continues to grow below trend and inflation falls back.

UK Interest Rates

	Current	Dec '05	Mar '06	June '06
Repo Rate	4.50	4.50	4.25	4.25
3 Month	4.52	4.50	4.30	4.30
1 Year	4.62	4.60	4.35	4.40
2 Year*	4.71	4.70	4.50	4.60
5 Year*	4.75	4.75	4.65	4.70
10 Year*	4.74	4.75	4.75	4.80

** Swap Forecasts Beyond 1 Year*

Exchange Rate Outlook

KEY ISSUES

- ***Euro Holds $1.19:*** The euro is finding strong support at the $1.19 level as market attention switches to the likelihood of a move to policy tightening in the eurozone.
- ***But Upside Momentum is Limited:*** We do not envisage a renewed slide in the dollar, however, which should continue to find underlying support in its favourable interest rate differentials.
- ***Sterling Looks to BoE:*** The direction of UK interest rates will be crucial for sterling, with markets keeping a close eye on forthcoming data releases.

Focus Switches to Eurozone Interest Rates

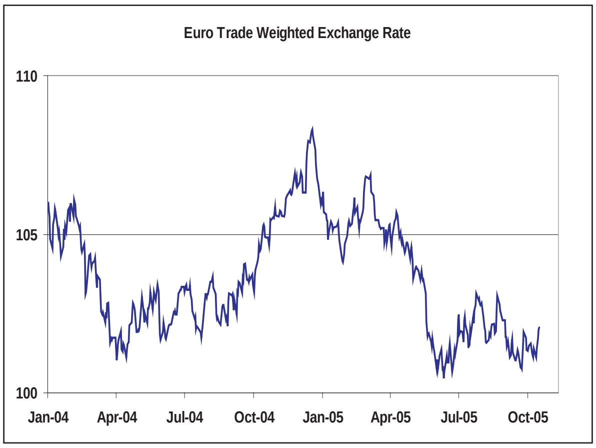
Interest rate expectations continue to be a major driving force for forex markets. However, the focus has switched from the US to the eurozone. Futures markets had been discounting only a small rise in eurozone interest rates to end 2006. Nevertheless, there is mounting speculation that a shift in the ECB's monetary policy stance could come sooner than had been anticipated.

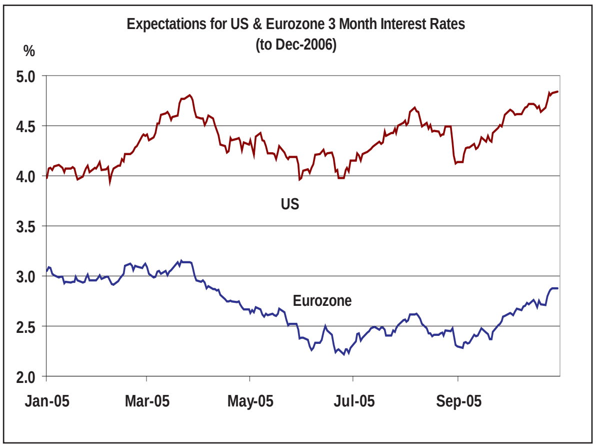
Sentiment and activity data suggest that growth in the eurozone picked up some momentum in Q3. PMI's for October also came in better than expected, with the manufacturing index reaching a 13-month high. National sentiment indicators such as the German Ifo are also picking up.

Meanwhile, inflation is above the ECB's 2% target level, with growth in monetary aggregates also remaining strong. If the PMI's and other surveys continue to strengthen over the course of Q4, then interest rate hikes would, indeed, become increasingly likely in the opening half of next year.

The ECB is stressing the need for strong vigilance against upward pressures on inflation. While there is no evidence yet of any second round effect from the sharp rise in oil prices, the central bank is watching developments closely and, if risks do materialise, then, as council member Bini Smaghi said recently, "action starts". On the basis of recent remarks, the ECB appears to be preparing the ground for a possible move in official interest rates in H1 2006.

Meanwhile, given that the performance of the US economy post the hurricanes has been better than expected and that inflation concerns remain in place, the market is now discounting US interest rates of 4.75% by mid-2006. Not that long ago, the market believed that rates would top out at 3.75% at end 2005.





Although the dollar has found firm support so far this year from favourable rate differentials, it has failed to build up any new momentum on the back of the recent shift upwards in US rate expectations. Against the euro, it has run into stiff resistance at $1.19. This level has held well over the year and continues to represent the bottom of our near-term trading range.

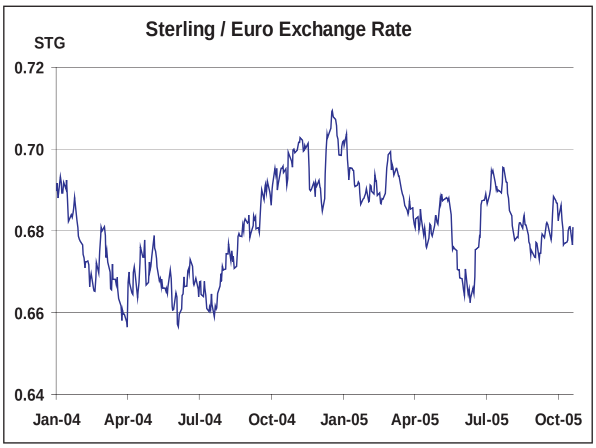
It is interesting to note, as we head into the final months of 2005, that the trading pattern of dollar/euro in the year to date has effectively mirrored that of much of last year. In both 2004 and 2005, the euro rallied in the early months of the year, before losing considerable ground to fall into a $1.19-1.25 range for much of the rest of the year.

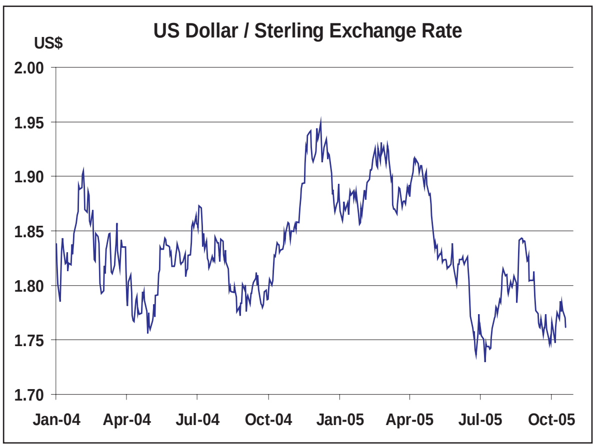
Indeed, this range typifies almost the entirety of the activity in dollar/euro for 13 of the last 22 months. On the basis of recent price activity, we expect this range to hold over the balance of the year and into 2006, though with a slight bias towards euro strength as markets debate the timing of the start of the ECB's tightening cycle. Beyond the 6 month horizon, there could be scope for the euro to break modestly higher if, by then, rates in the US have peaked but those in the eurozone continue to increase.

Upside momentum, however, could prove difficult beyond the $1.25 level. Even if eurozone interest rates do rise as expected over 2006, the dollar could still be carrying an interest rate differential of up to 2% by the end of next year. Furthermore, concerns about US external imbalances have waned as trade and capital inflows data continue to exceed expectations.

The last two net capital inflows data (TICS) reports (July and August) showed net US monthly inflows of some $87.5bn and $91.3bn. This is well in excess of the respective $58bn and $59bn trade deficits recorded for the same months. In addition, the net capital inflows data show that the demand for US assets is not limited to official buying of US Treasuries. Thus, it would appear that, for now at least, the widening interest rate differentials continue to attract sufficient private capital flows into US assets, underpinning the dollar.

The nomination of Ben Bernanke as the new Fed Chairman appears to have clouded the dollar's outlook somewhat, as markets discuss his views on inflation targeting and the possible impact on monetary policy and the currency going forward. While a move to inflation targeting could have far reaching policy implications, we don't envisage that his appointment will have any material impact on the near-term direction of US interest rates, or the dollar.





Sterling's Fortunes Tied to Bank of England

The correlation between changes in UK interest rate expectations (which have swung back and forth over recent months) and moves in sterling remains very high. Thus, sizeable moves upward in UK interest rates over the past month have propelled sterling higher against both the dollar and euro.

Following hawkish comments and the tone of the minutes of the October Bank of England policy meeting plus some better than expected domestic data, the market is no longer discounting a rate cut in the UK and now expects policy to remain on hold until end 2006. Thus, sterling is back trading above the $1.76 level versus the dollar, while also moving back into a Stg67-68p trading range versus the euro.

As long at the market retains this view on UK monetary policy, sterling should find support around current levels. However, there has been much uncertainty surrounding the prospects for UK rates during 2005. Despite the markets' current relaxed view, this uncertainty looks set to remain in place for some months yet, as we wait for the outlook on the economy to become clearer. In our view, there is still a reasonable chance that rates could be cut again.

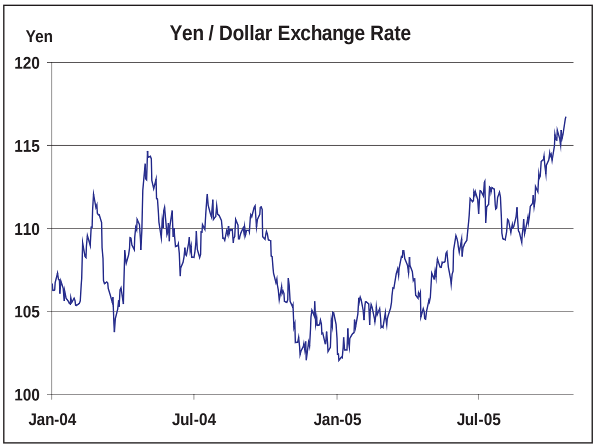
There is little sign as yet that consumer spending has picked up, with sentiment also remaining downbeat. Should the economy continue to grow at a below trend rate and headline inflation ease back towards 2%, a rate cut remains a distinct possibility in early 2006. Thus, sterling could well come under renewed pressure if data force markets to revise, yet again, their expectations for UK interest rates.

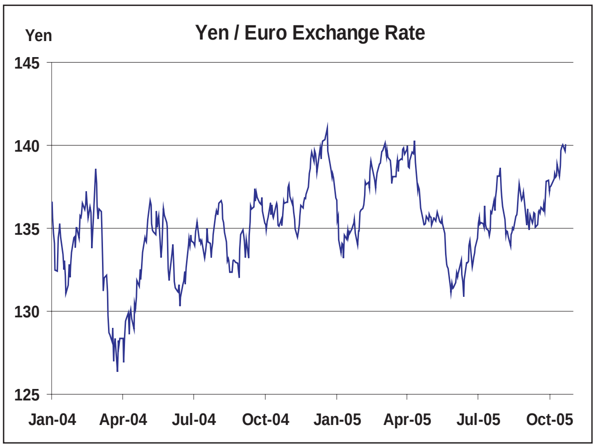
Yen Comes Under Pressure as US Rates Continue to Rise

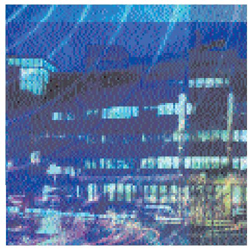
The dollar has been on a steady upward trend versus the yen over the past month, breaking through the Y117 level for the first time in over two years. As well as expectations for higher interest rates in the US, the yen has been hit by strong Japanese demand for higher yielding overseas assets.

With the interest rate differential continuing to move in the dollar's favour, the yen looks set to remain under pressure for the time being. However, with speculators net short yen position at its highest level since 1994, the dollar could become vulnerable to a correction back below the Y116 level before year end.

Furthermore, economic conditions in Japan continue to improve, particularly on the domestic front, which should compensate for any weakness on the export side. Thus, we still see scope for yen appreciation and a move back towards a Y105-110 range over the longer-term.







KEY MARKET EVENTS

Week 1 *(7-11 November)*	**November 7**	**UK**	**Industrial Prod & Manufacturing Output (September)**
	November 10	**Eurozone**	**ECB Monthly Bulletin (November)**
		UK	**BoE Policy Announcement**
		US	**Trade Balance (September)**
	November 11	**JAP**	**Q3 GDP (First Estimate)**
Week 2 *(14-18 November)*	**November 15**	**UK**	**Consumer Prices (October)**
		Eurozone	**Flash GDP (Q3)**
		US	**Producer Prices & Retail Sales (October)**
	November 16	**UK**	**Unemployment (October)**
		Eurozone	**HICP Final (October)**
		UK	**Bank of England Inflation Report (November)**
		US	**Consumer Prices & Net Capital Inflows (October)**
	November 17	**UK**	**Retail Sales (October)**
		US	**Industrial Production & Capacity Utilisation (October)**
Week 3 *(21-25 November)*	**November 22**	**US**	**FOMC Minutes (Nov Meeting)**
	November 23	**UK**	**Minutes of MPC Meeting - 9/10 November**
	November 24	**GER**	**Ifo Business Survey (November)**
Week 4 *(28 Nov-2 Dec)*	**November 29**	**US**	**Consumer Confidence (November)**
	November 30	**Eurozone**	**Business & Consumer Confidence (November)**
		Eurozone	**HICP Flash Estimate (November)**
		US	**Fed Beige Book**
	December 1	**US/UK/Eurozone**	**Manufacturing ISM/PMI's**
		US	**Personal Income & Spending (October)**
		Eurozone	**ECB Policy Announcement & Press Conference**
	December 2	**US**	**Non-Farm Payrolls (November)**

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