

EXCHANGE RATE MONTHLY

October/November 2004

AIB Global
Treasury
Economic
Research

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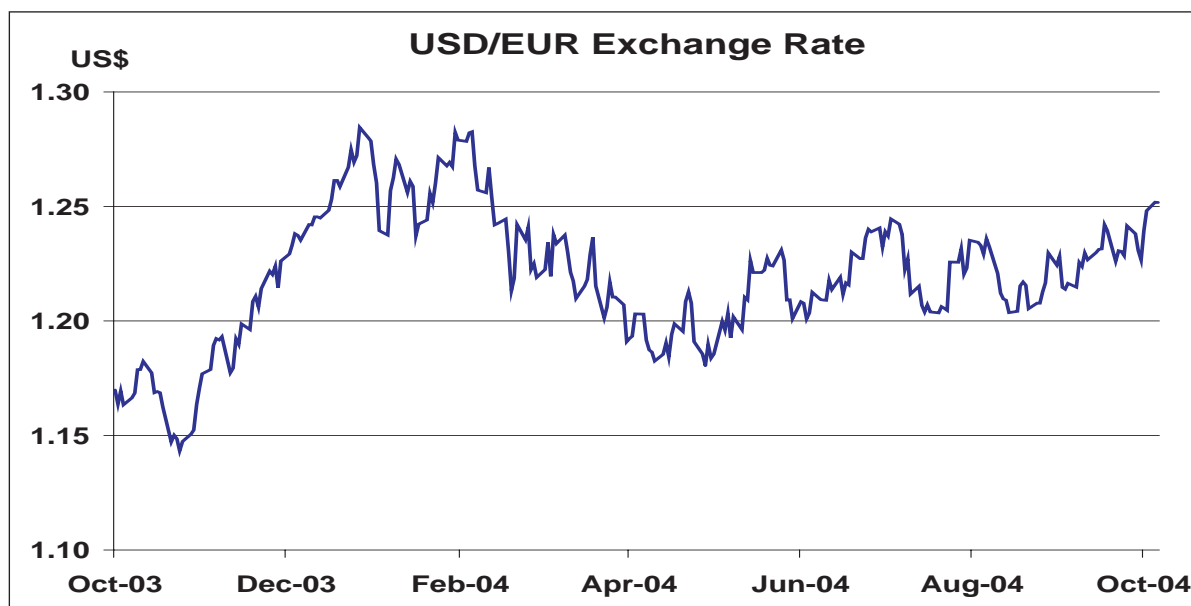
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Dollar Under Pressure on Eve of US Presidential Poll

- We retain our negative bias towards the US dollar as we head into a period of increased political uncertainty with the US Presidential election on 2 November. A more sustained break above \$1.25 is on the cards for the rest of the year.
- A support for the dollar is the lack of attractive major currency alternatives. There are signs that the ECB is increasingly worried about the impact of sustained high oil prices on the euro area's export driven expansion. This could put the ECB on hold until mid-2005.
- Weak economic and housing market data have taken their toll on sterling. The UK currency could continue to suffer versus the euro, moving towards £0.71 in the short term, but should gain against the weakening dollar.



Summary of Forecasts

Latest View

- EUR/USD is establishing a base around \$1.25. It could weaken further towards \$1.30 post the Presidential election.
- Sterling has weakened as we expected. Further falls should be limited from here, especially against the dollar.

Exchange Rates

Euro Versus		Forecast Range Over The Period				
	Range Over the Last Month	Current	Nov-Jan 05	Feb-Apr 05	May-Jul 05	Aug-Oct 05
USD	1.22-1.26	1.2585	1.25-1.30	1.25-1.30	1.23-1.28	1.22-1.27
GBP	0.67-0.70	0.6950	0.68-0.71	0.69-0.71	0.67-0.69	0.66-0.68
JPY	134-138	136.10	137-142	132-137	130-135	130-135
CHF	1.53-1.56	1.5380	1.53	1.53	1.52	1.52
NOK	8.19-8.40	8.245	8.15	8.10	8.05	8.00
SEK	9.02-9.11	9.076	9.05	9.00	8.95	8.90

Dollar Versus		Forecast Range Over The Period				
	Range Over the Last Month	Current	Nov-Jan 05	Feb-Apr 05	May-Jul 05	Aug-Oct 05
JPY	108-112	108.15	107-111	104-109	103-108	105-110
GBP	1.77-1.82	1.8088	1.80-1.85	1.80-1.85	1.82-1.87	1.83-1.88
CHF	1.22-1.27	1.2225	1.20	1.20	1.21	1.22
CAD	1.25-1.29	1.2535	1.24	1.23	1.22	1.21
AUD	0.70-0.74	0.7316	0.75	0.74	0.75	0.76

Official Interest Rates

	Forecast to End Period				
	Current	Dec 04	Mar 05	June 05	Sep 05
Euro Refi Rate	2.00	2.00	2.00	2.25	2.50
US Fed Funds	1.75	2.00	2.25	2.50	2.75
UK Base Rate	4.75	4.75	4.75	5.00	5.00
Japan ODR	0.10	0.10	0.10	0.10	0.10

Growth and Inflation

Y-on-Y% Change	GDP			Inflation		
	2003	2004	2005	2003	2004	2005
US	3.0	4.4	3.5	2.3	2.6	2.5
Eurozone	0.4	1.8	1.9	2.1	2.1	1.9
UK	2.2	3.2	2.7	1.4	1.3	1.6
Japan	2.5	4.1	1.8	-0.2	-0.2	0.0
Ireland	3.7	5.5	5.5	3.5	2.3	2.9

Our View In Brief

- * **Crude oil prices continue to rise, raising fears that the rate of global economic growth could fall significantly in 2005. The IMF believes that the global economy will grow by 5% in 2004. The pace of activity is forecast to slow to about 4% in 2005 but, with oil prices showing little sign of reversing, the outlook for 2005 could be downgraded.**
- * **Geopolitical risks, particularly developments in Iraq, and uncertainty over the outcome of the US Presidential election on 2 November, have dampened consumer and business confidence. These events, along with the winter weather, could see Brent crude oil prices trade within a \$50-55 per barrel range until the second quarter of 2005.**
- * Economic data have in general pointed to only moderate growth in the US and euro economies. It would appear that activity in the UK slowed sharply in the third quarter. We await data on the final quarter of the year. Growth is likely to be slower than in the third quarter. On the inflation front, despite the impact of higher energy prices on headline inflation rates, core or underlying rates have been muted in the major economies.
- * Thus, while central banks may be biased towards reducing the amount of monetary stimulus, there is no need for any hurry. Nevertheless, we expect that the US Fed will raise official rates when the FOMC meets on 10 November. This could be the last increase this year.
- * The ECB has been cautioning about the risks to price stability from second round effects arising from the increase in energy prices. However, in our view these risks are low and inflation should remain well behaved in 2005.
- * **We expect that the ECB will maintain official rates at current levels until mid 2005. By end 2005, we expect that the official refinancing rate could be 2.75%. However, there are currently downside risks to this forecast.**
- * In the UK, it is now expected that the Bank of England will hold official rates at 4.75% over the balance of the year. We see scope for further modest tightening in 2005 if, as we believe, the economy gathers a second wind and there is renewed vigour in the housing market.
- * **The US dollar has weakened on the back of unspectacular economic data and the deterioration in the US trade and current account deficits. We had expected that this would occur. We retain our view that the EUR/USD rate will move further into a \$1.25-1.30 range after the Presidential election. This rate could hold into Q1'05.**
- * Sterling has weakened against the euro as the UK economy showed visible signs of weakness in recent months. However, we believe that the EUR/GBP rate should hold below £0.71 over coming months.
- * **As we do not believe that the UK economy will remain as weak as indicated by recent data, we look for some revival in sterling in 2005 versus the euro. This is our central forecast but, in the event of a significant dollar adjustment, the EUR/GBP rate could move out to £0.72-£0.73.**

20 October 2004

Interest Rate Environment

Fed To Hike Rates Further

- * The Fed is expected to raise the official Fed funds rate by a further 0.25% to 2% when the Federal Open Market Committee (FOMC) meets on 10 November. This will continue the policy of measured rate increases begun in June. However, the Fed may stay on hold at the following FOMC meeting on December 14th, given the short gap since the previous meeting and the nearness of Christmas.
- * Looking to 2005, the Fed is expected to continue to gradually remove more of its monetary stimulus. The Fed funds rate is forecast to reach 3% by end 2005.
- * Longer term rates are expected to rise over the next year as the Fed reduces its monetary stimulus. Assuming moderate economic growth and relatively favourable inflation trends, the rise in 10 year rates should be no more than 0.7% from current levels by end 2005.

ECB On Hold Until Mid-2005

- * The ECB is worried about the possible second round effects of the rise in oil prices. However, with growth slowing, we believe that the risks to inflation are less than feared by the ECB.
- * As a result, our central forecast is that official rates won't rise until mid-2005. By end 2005, we expect the official refinancing rate to have risen by, at most, 0.75% to 2.75%.
- * Looking to longer term rates, the eurozone is likely to follow the general direction of the US market. We see 10 year rates rising by 0.6% over the next year.

Bank of England To Pause

- * With the economy and the housing market slowing and CPI inflation falling to 1.1%, the BoE is likely to leave rates on hold at 4.75% over the balance of 2004.
- * It could still tighten policy somewhat further in 2005 if the economy picks up momentum again and there is renewed upward pressure on house prices. With virtually no spare capacity in the economy, rates could rise to 5.25% by end 2005.

US Interest Rates				
	Current	Nov 04	Dec 04	Dec 05
Fed Funds	1.75	2.00	2.00	3.00
3 Month	2.03	2.15	2.25	3.20
1 Year	2.35	2.50	2.60	3.50
2 Year*	2.85	3.00	3.10	3.90
5 Year*	3.70	3.75	3.80	4.50
10 Year*	4.48	4.50	4.60	5.20
* Swap Forecasts Beyond 1 Year				

Eurozone Interest Rates				
	Current	Nov 04	Dec 04	Dec 05
Refi Rate	2.00	2.00	2.00	2.75
3 Month	2.12	2.12	2.15	3.00
1 Year	2.26	2.25	2.30	3.25
2 Year*	2.58	2.60	2.65	3.50
5 Year*	3.30	3.33	3.37	4.00
10 Year*	4.02	4.05	4.10	4.60
* Swap Forecasts Beyond 1 Year				

UK Interest Rates				
	Current	Nov 04	Dec 04	Dec 05
Repo Rate	4.75	4.75	4.75	5.25
3 Month	4.81	4.80	4.85	5.35
1 Year	4.94	4.95	5.00	5.50
2 Year*	4.99	5.00	5.05	5.50
5 Year*	5.05	5.05	5.10	5.45
10 Year*	5.08	5.10	5.15	5.40
* Swap Forecasts Beyond 1 Year				

Exchange Rate Outlook

KEY ISSUES

- **Dollar Remains Under Pressure:** The US dollar remains under pressure as crude oil prices stay high and in the run-up to the US Presidential election on 2 November. We retain our negative dollar bias.
- **Euro Climbs in Uncertain Conditions:** The euro has climbed against major currencies despite doubts about the outlook for the euro economy as oil prices rise and global growth slows.
- **Sterling Under Pressure as Economy Falters:** Sterling has fallen on weakening UK economy.

Oil and Politics Weigh on US Dollar

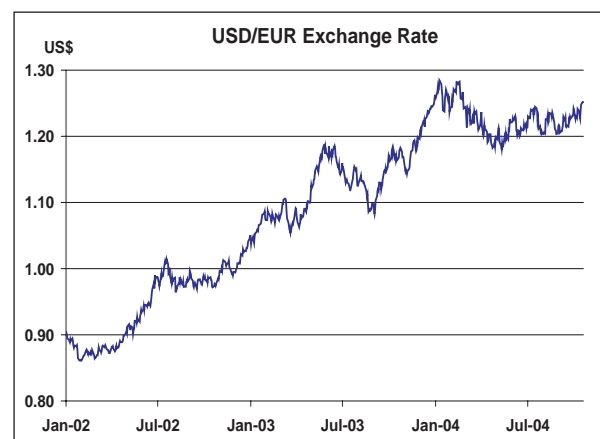
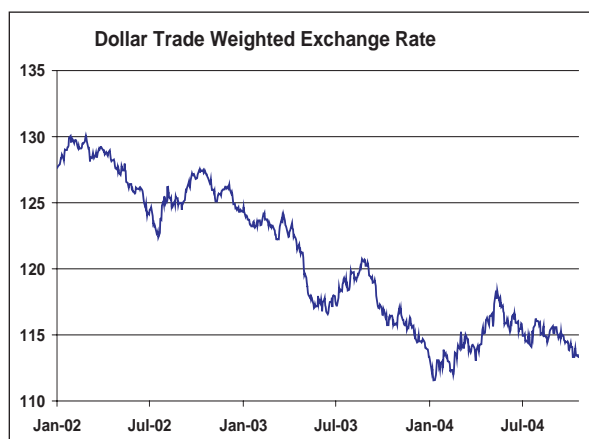
The US dollar has performed much as we had expected over the past month. It traded in the top half of a \$1.20-1.25 range against the euro, breaking out of the top of that range in the past week.

The EUR/USD rate is establishing a base around the \$1.25 level ahead of the Presidential election on 2 November. The outcome of this election is too close to call but the markets are expected to remain nervous irrespective of who wins it. With a large budget deficit, the scope for significant policy changes to boost the US economy is extremely limited. Efforts by either candidate to rein in the deficit are not expected to amount to much in 2005.

Apart from electoral uncertainty, the US currency remains under pressure from a combination of other factors. The tense geopolitical situation is the single biggest drag on the dollar. As we pointed out before, terrorism and military conflict in Iraq has a more significant impact on the dollar than on any other currency. The situation will continue to be a major threat to the dollar.

Higher crude oil prices also play a big part in the dollar's weakness but higher energy prices also adversely affect the Japanese yen. To the extent that higher oil prices also reduce the economic growth prospects of other countries, their currencies will also come under some pressure depending on the market's expectations as to how their respective central banks will respond.

In the case of the euro, it could have gained even further against the dollar but for the fact that the ECB is beginning to reflect on the risks to euro area economic growth from the persistently high price of crude oil. As a result, it now appears less likely that the ECB will raise official rates until mid-2005.



FX Markets Unimpressed by US Economic Performance in 2004

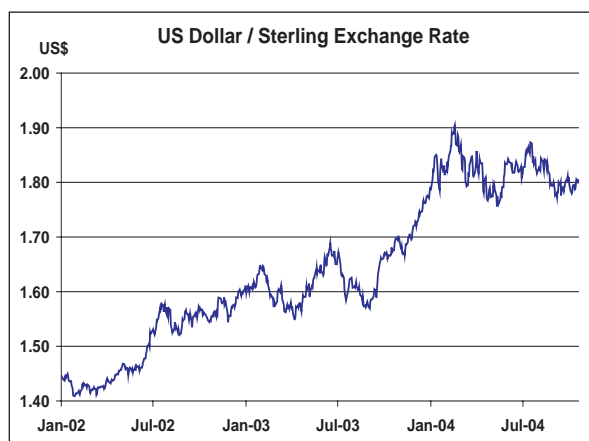
The combined impact of geopolitical and oil price uncertainty has clouded the outlook for the US economy. It is this uncertainty about the speed of future US economic growth which has caused the dollar to slip versus the euro and other currencies. With doubts about the outlook for the US economy come questions as to how fast and far will the US Federal Reserve raise official interest rates.

The US economy grew by 4.5% on an annualised basis in Q1'04. This was followed by a 3.3% increase in Q2'04. Official figures for the third quarter are awaited. However, the economy probably grew by about 4% in that period. This has been a fairly impressive performance but markets have not thought so. The outlook for the final quarter is very uncertain. Growth is likely to be weaker than in Q3'04. Overall, however, the US is expected to grow by about 4.4% in 2004. Because the US economy continues to enjoy a high rate of productivity growth, the expansion of employment has been weaker than in other recovery periods. Nevertheless, US non-farm employment is still rising at a year-on-year rate of close to 1.5%.

The recent US economic performance has probably been weaker than the Fed had anticipated when it embarked on its policy of removing, in a measured way, its monetary stimulus. However, activity should still be strong enough for the Fed to feel able to raise rates again when the FOMC meets on 10 November. We expect another increase of 0.25% in the Fed funds rate, bringing it to 2%. If the Fed were to abstain from acting, the markets would view this as Fed concerns about the economic recovery. The dollar would weaken.

Heading into the final two months of the year liquidity will dry up and exchange rate changes will become more volatile. Hence, as was the case at the end of 2003, we believe that EUR/USD could weaken to the top of a \$1.25-1.30 range. The ECB would be unlikely to express too much concern at such a move but the risk of verbal intervention would probably limit the dollar's decline beyond this level.

The dollar is also at risk from the mounting US trade and current account deficits. Most analysts see a weaker dollar as the way in which this problem will eventually be brought under control. It's impossible to say when this might occur. The dollar is finding support from official and private capital flows out of Asia. This is likely to continue in the short term. There are some other structural factors that may mitigate some of the risks that the deficit, which is equivalent to 5.75% of GDP, poses to the stability of the US currency. This risk will persist into 2005, awaiting the spark that could ignite a significant dollar adjustment.



Sterling Under Pressure as Economic Weakens

Sterling weakened over the past month as the markets reacted to the raft of weaker economic data and the lower than anticipated inflation figures for September, which showed a year-on-year increase in the CPI of 1.1%, well below market expectations. The Bank of England left official interest rates unchanged in October at 4.75% and is now expected to hold them at current levels over the balance of the year.

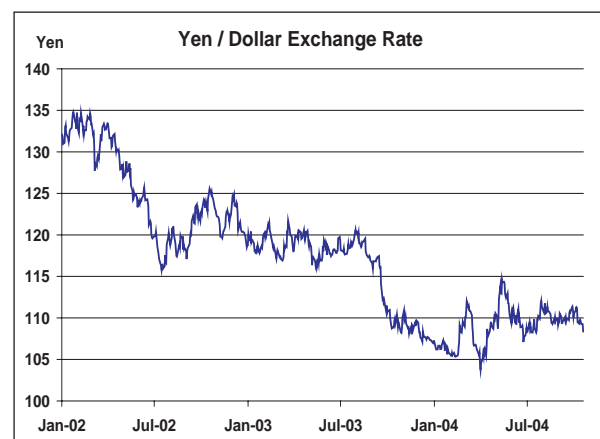
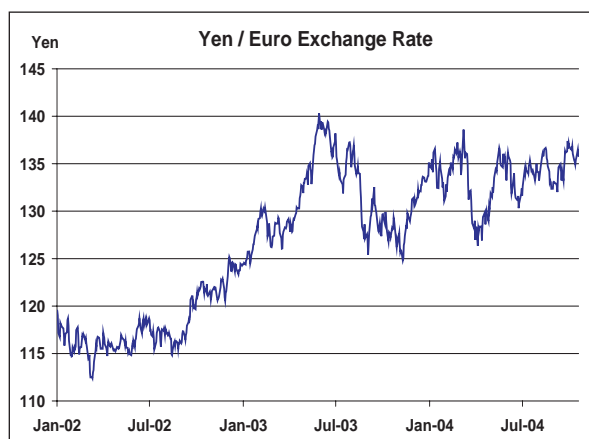
While we feel that the Bank may not be finished, the market now sees rates unchanged in 2005 with an eye on the possibility that official rates may have to be cut at some point next year. This may be an over-reaction to the latest economic and house price data which indicate that the UK is experiencing a sharp slowdown. It is possible that GDP growth in Q3'04 slowed to 0.4% from 0.9% in Q2'04.

Sterling fell to over £0.69 versus the euro and could move above the £0.70 level in the short term. Sterling has gained versus the generally weaker US dollar. However, under circumstances where the dollar fell towards \$1.30 versus the euro, sterling could underperform, pushing the EUR/GBP rate to £0.71 before the end of the year. As we do not believe that the UK economy will remain as weak as indicated by recent data, we look for some revival in sterling in 2005 versus the euro. This is our central forecast but, in the event of a significant dollar adjustment, the EUR/GBP rate could move out to £0.72-£0.73.

Dollar - Yen Rate in Narrow Range

The dollar has weakened against the yen since the start of October but a move much below the Y107 level is doubtful. There is no doubt that with China kicking to touch on a revaluation of the Yuan, the Japanese authorities will be anxious to prevent any sharp dollar depreciation versus the yen.

We see the Y107-Y111 range holding for the USD/YEN rate over the remainder of 2004. This implies a Y137-142 rate for EUR/YEN. Looking further ahead, the USD should weaken versus the yen towards Y105 which would imply a Y132-137 level for the euro-yen rate in the first quarter of 2005, assuming that the EUR/USD rate holds at \$1.30.



KEY MARKET EVENTS

Week 1 <i>(25 - 29 October)</i>	October 25	Eurozone	German Ifo Business Survey (October) This lead indicator of the strength of the German / eurozone economy dipped slightly in September.
	October 26	US	Consumer Confidence (October) Labour market fears plus high oil prices have depressed sentiment in recent months.
	October 29	Eurozone	HICP (October Flash) HICP inflation edged lower to 2.1% in September.
	October 29	US	GDP (Q3 Advance Estimate) Growth to pick up from 3.3% in Q2.
Week 2 <i>(1 - 5 November)</i>	November 1	UK	Manufacturing PMI (October) Sector continues to expand but index fell in September to its lowest level since July 2003.
	November 1	Eurozone	Manufacturing PMI (October) Further expansion in the sector in September but at slower pace than previously.
	November 1	US	Manufacturing ISM (October) Important lead indicator of the US economy. Though index fell in September, it still points to growth in the sector.
	November 2	US	Presidential Election Outcome could be crucial for the dollar.
	November 3	US	Services ISM (October) Services sector growth slowed in September.
	November 3/4	UK	BoE Policy Meeting (2 day) Rates may well be left on hold at this meeting given signs of slowing domestic demand and cooling housing market.
	November 4	Eurozone	ECB Policy Meeting Rates to remain on hold. Comments at press conference of much interest.
	November 5	US	Non-Farm Payrolls (October) A crucial market number. Jobs growth again disappointed in September at just 96,000.
Week 3 <i>(8 - 12 November)</i>	November 10	UK	BoE Inflation Report Report details BoE view on inflation trends which underlie its monetary policy decisions.
	November 10	US	FOMC Policy Meeting Fed Funds rates likely to be raised by 0.25%. Tone of accompanying statement also important.
	November 12	US	Retail Sales (October) Can sales show further growth after a strong September performance?
Week 4 <i>(15 - 19 November)</i>	November 17	UK	November MPC Minutes Strength of support for a rate move at the November meeting important for sterling.
	November 17	US	Consumer Prices (October) Core rate picked up to 2% in September.

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