AIB Global Treasury
Economic Research

EXCHANGE RATE MONTHLY

September/October 2005

US Rates Continue to Support Dollar

- The US dollar continues to be supported by Fed action. Despite rising oil prices, the US external imbalances are also stabilising. Thus, the case for any sharp correction in the dollar before year end seems weak.

- Sterling could come under renewed pressure in the weeks ahead if key data in the UK confirm the case for another rate cut.

- The yen's performance has been disappointing given the decisive election result, an improving economy and record equity inflows. However, we continue to anticipate a move toward the Y105 level versus the dollar.

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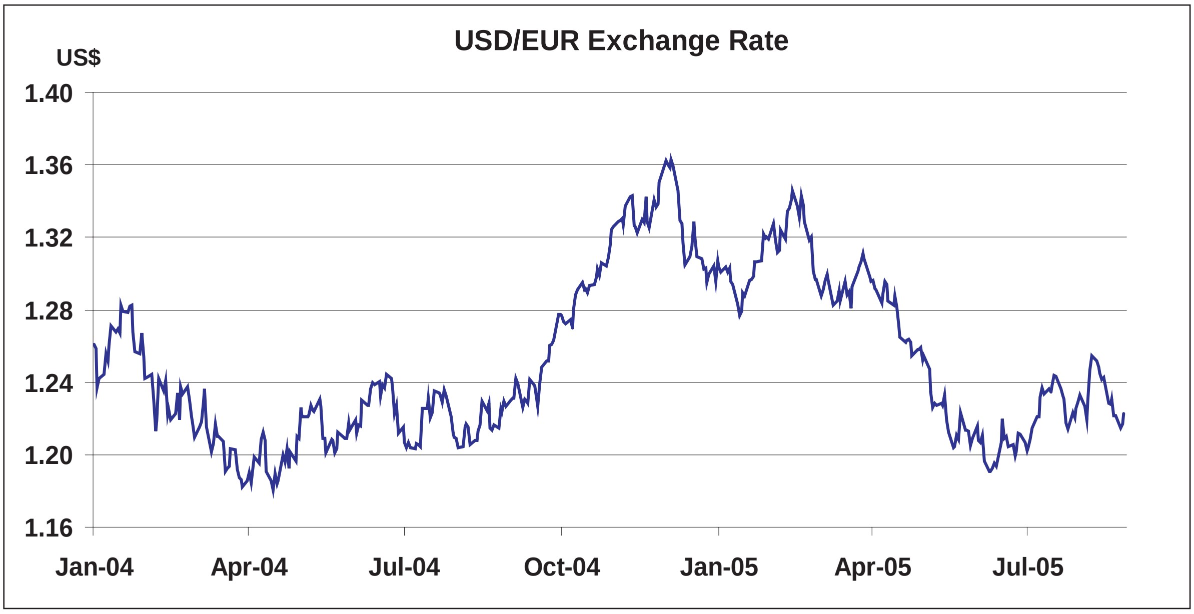

Summary of Forecasts

Exchange Rates

Euro Versus		Forecast Range Over The Period			
	Current	Q4 - 2005	Q1 - 2006	Q2 - 2006	Q3 - 2006
USD	1.2216	1.20-1.25	1.20-1.25	1.22-1.27	1.22-1.27
GBP	0.6755	0.67-0.69	0.67-0.69	0.67-0.69	0.67-0.69
JPY	135.75	130-135	130-135	131-136	131-136
PLN	3.9050	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	111.12	107-112	105-110	103-108	103-108
GBP	1.8084	1.78-1.83	1.78-1.83	1.82-1.87	1.82-1.87
CHF	1.2710	1.27	1.27	1.25	1.25
AUD	0.7690	0.76	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	2.00	2.25
US Fed Funds	3.75	4.00	4.25	4.50	4.50
UK Base Rate	4.50	4.25	4.25	4.25	4.25
Japan ODR	0.10	0.10	0.10	0.10	0.10

Growth and Inflation

	GDP			Inflation		
Y-on-Y% Change	2004	2005	2006	2004	2005	2006
US	4.2	3.5	3.5	2.7	3.3	3.0
Eurozone	1.8	1.3	1.7	2.1	2.2	1.9
UK	3.2	1.9	2.4	1.3	2.1	2.1
Japan	2.6	2.3	2.3	-0.2	-0.3	0.1
Ireland	4.5	5.0	5.5	2.2	2.5	2.7

Our View In Brief

* **Oil prices continue to dominate headlines with prices averaging $53 per barrel year to date, 40% above the average price for 2004. Markets are continuing to monitor data in the main economies for any signs of extended inflationary impacts, while there are still concerns about the longer term negative implications for consumption and investment.**

* **The US economy grew by an annualised 3.5% in H1-2005, indicating that the upswing in activity remains strong. The domestic economy was particularly robust. The disruption caused by Hurricane Katrina and high energy prices are likely to dampen activity over the balance of the year and growth could slip below 3%. The economy, however, should rebound as reconstruction work gets underway. 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 looks set to continue raising interest rates into 2006. We expect the Fed funds rate to be at 4.50% by mid 2006. There may, however, be some pause in the tightening cycle over the balance of the year in response to the impact of Hurricane Katrina and the associated rise in energy prices.

* **The dollar continues to be supported by Fed action, with US rates raised again in September and the FOMC statement indicating that further tightening is in the pipeline. Despite rising oil prices, the US external imbalances are also stabilising. Euro sentiment has also been hit by the indecisive election result in Germany. Thus, the case for any sharp correction in the dollar before year end seems weak.**

* 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. There were some signs of improvement over the summer months but more recent data have disappointed. Thus, we expect just a modest pick-up in activity in H2-2005. The economy, however, should fare better in 2006, with growth expected to average 1.7%, up from 1.3% in 2005.

* **The ECB has maintained the refi rate at 2% since June 2003. It does not want to cut rates further given that they are already at historically low levels. However, subdued economic activity means that there is unlikely to be a rate increase anytime soon. Furthermore, there is little sign of a pick up in underlying inflationary pressures, with the core HICP rate decelerating to 1.4% in recent months, so the ECB can afford to be patient. Hence, we think that the ECB will remain on hold over the balance of the year with rates rising by 0.5% in H2-2006.**

* The UK economy has been growing below trend since mid-2004. The recent interest rate cut should provide a boost to activity and some recent indicators suggest that growth may pick up towards end year. Nevertheless, GDP growth this year now looks set to average around 1.9%, the first time it has dipped below 2% since the early 1990s. Growth should, however, pick up to 2.4% in 2006.

* There is some speculation that the Bank of England could cut UK interest rates again before the year end. The outlook for rates is indeed a finely balanced one and sterling could come under pressure in the weeks ahead if key data do confirm the case for another rate cut.

* The Japanese economy recorded its third consecutive quarter of growth in Q2 2005. Economic growth 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.

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Interest Rate Environment

Further US Rate Hikes to Come

* As expected, the Fed raised US interest rates by a further 0.25% at its policy meeting in September, bringing the Fed funds rate to 3.75%.

* 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.

* The FOMC may hold off on a rate hike at one of its meetings later in the year. However, there is little to suggest that rates are near their peak and we expect Fed funds to be at 4.5% by mid 2006.

US Interest Rates

	Current	Dec '05	Mar '06	June '06
Fed Funds	3.75	4.00	4.25	4.50
3 Month	3.92	4.20	4.40	4.60
1 Year	4.19	4.45	4.65	4.75
2 Year*	4.29	4.60	4.80	4.85
5 Year*	4.39	4.75	4.90	5.00
10 Year*	4.58	4.90	5.00	5.10

** Swap Forecasts Beyond 1 Year*

No Change from ECB Until 2006

* Interest rates in the eurozone have been at 2.0% since June 2003. The ECB has indicated that it does not want to cut rates further given that they are already at historically low levels. Growth in monetary aggregates remains strong, while upside inflation risks also prevail.

* However, the subdued pace of economic growth means that the ECB is unlikely to tighten rates anytime soon. Furthermore, there is little sign of a pick-up in underlying inflation.

* Thus, we expect eurozone interest rates to remain on hold until H2-2006. Assuming that the economy does pick up, we anticipate two quarter point rate hikes later next year, bringing the refi rate to 2.5% by end 2006.

Eurozone Interest Rates

	Current	Dec '05	Mar '06	June '06
Refi Rate	2.00	2.00	2.00	2.00
3 Month	2.17	2.15	2.15	2.20
1 Year	2.16	2.20	2.30	2.60
2 Year*	2.32	2.50	2.70	2.90
5 Year*	2.64	2.85	3.05	3.25
10 Year*	3.12	3.40	3.50	3.60

** 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 kept rates on hold in September.

* Whether there is another rate cut in the UK over the balance of the year is a close call and will depend very much on the strength of upcoming data.

* We believe that there remains a reasonable chance that rates could be cut again by another 0.25%, should data over the coming months prove to be weak. Thereafter, we expect the UK economy to recover next year, suggesting that policy will be on hold for much of 2006.

UK Interest Rates

	Current	Dec '05	Mar '06	June '06
Repo Rate	4.50	4.25	4.25	4.25
3 Month	4.52	4.30	4.30	4.30
1 Year	4.41	4.35	4.35	4.40
2 Year*	4.41	4.40	4.50	4.60
5 Year*	4.42	4.50	4.60	4.70
10 Year*	4.46	4.60	4.70	4.80

** Swap Forecasts Beyond 1 Year*

Exchange Rate Outlook

KEY ISSUES

- ***Euro Loses Momentum Once Again:*** The euro fails to hold summer gains, with the dollar supported by higher US rates and political uncertainty in Germany taking its toll.

- ***Dollar to Get Support from Fed:*** The chief near term risk to the dollar is an end to Fed tightening but while the FOMC could pause later this year we expect the Fed funds rates to be at 4.50% by mid-2006.

- ***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.

Euro Fails to Hold Summer Gains

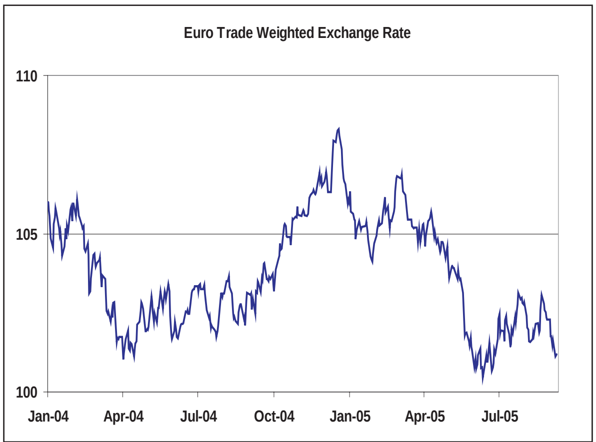
The $1.19-1.25 trading range that has been in place since early summer still prevails and looks set to do so for some time, with the euro trapped between already high US interest rates relative to those in Europe and shifting market expectations regarding the outlook for the US economy and what the Fed will do next.

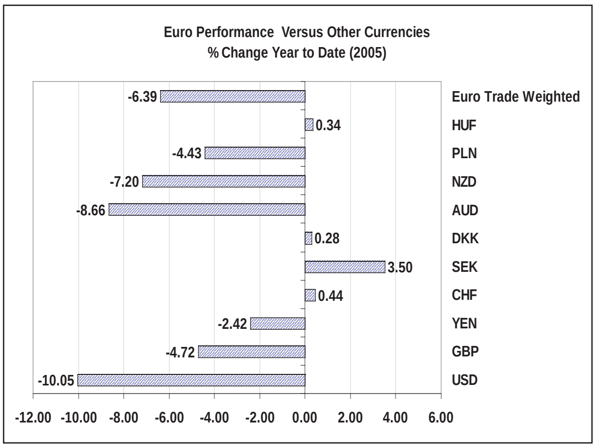
After reaching highs of close to $1.26 in early September the euro has since lost momentum, with dollar/euro falling back towards the $1.22 level. It has also lost ground against sterling. The euro had rallied on concerns that Hurricane Katrina and the associated rise in oil prices would hit the US economy, in particular the consumer, thus forcing the Fed to end its tightening cycle.

However, when it became apparent that the worst fears of the Katrina disaster would not be realised, the dollar rallied in line with rising US money market rates, further evidence that expectations for US monetary policy continue to be a dominant force for forex markets.

The turnabout in euro sentiment also reflects developments in Europe. Eurozone data had been pointing to a pick-up in activity following the very weak performance over the mid-2004 to mid-2005 period, boosting expectations for the economy going forward. However, both the manufacturing and services PMI's slipped back in August, as did the German Ifo index. Consumer spending also remains weak as was evident in the July retail sales report.

The surge in energy prices seems to be impacting on eurozone economic activity, suggesting that it could prove difficult for growth to pick up to any great extent over the second half of the year. Thus, there is little risk of any near term increase in official eurozone interest rates, despite the fact that the ECB has turned more hawkish of late.





Meanwhile, political developments in Germany have also impacted. Instead of a resounding election victory for the reform orientated Angela Merkel, the market is now faced with a stalemate situation that could last for weeks and the risk of a delay in much needed economic and social reforms.

The election result is unlikely to be a dominant force over the longer term but could weigh on the euro until a clear political alliance emerges. The parties will aim to complete talks before the first session of the new parliament, which must take place by October 18.

Compounding the euro's problems is the fact that the US external imbalances are stabilising. Although these were negative factors earlier in the year and structural imbalances still have the potential to derail the dollar, trade and capital flows data have in fact been supportive over recent months.

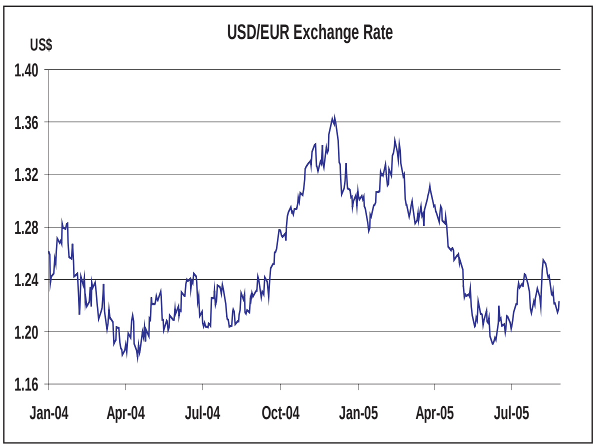
The last two net capital inflows data (TICS) reports (July and August) showed net US inflows of some $81bn and $87bn, well in excess of the $59bn and $57bn trade deficits recorded for the same months. Furthermore, the data show that the demand for US assets is not limited to official buying of US Treasuries. It would appear that the prospect of an ever widening interest rate differential continues to attract sufficient private capital flows into the US.

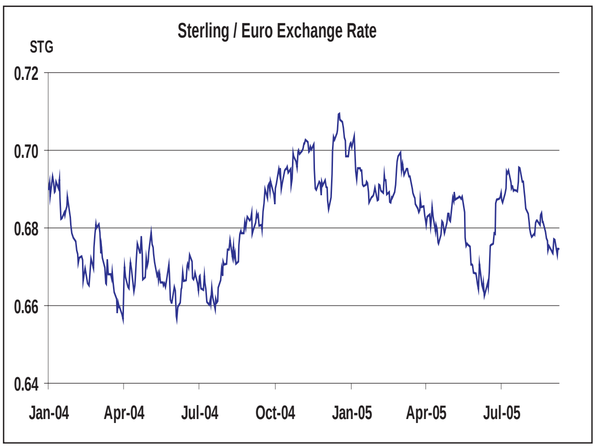
Thus, while the dollar could come under some pressure near-term in response to high oil prices, post Katrina economic data, any potential fall-out from Hurricane Rita and a possible change in tone from the Fed, a sharp correction in the dollar over the coming weeks seems highly unlikely. Indeed, the euro could even re-test the $1.21 level in the short-term, if the political situation in Germany deteriorates.

We also see little scope for a euro recovery much beyond the $1.25 level over the medium term, despite the fact that the support to the dollar from US cyclical factors could wane as markets anticipate the end of the Fed's tightening cycle and the risk that structural forces could once again turn more dollar threatening.

The market currently believes that the Fed will finish its tightening cycle when rates reach 4.25%. However, this is not our view. The US consumer is proving to be remarkably resilient and household spending has remained strong over the summer months, despite continued Fed tightening and high energy prices.

US economic data could indeed prove disappointing over the next couple of months, with activity depressed by the hurricane in the short term. However, there is little spare capacity in the economy and inflationary pressures are building.





Against this background we expect that, notwithstanding the likelihood of some pause in Fed action later this year, further monetary tightening is on the cards and the Fed funds rate will be at 4.5% by mid 2006.

Meanwhile, we expect that official interest rates in the eurozone will remain at 2.0% until Q3 of next year, with a modest tightening to 2.50% seen by year end 2006. If our view on US and eurozone interest rates proves to be correct there seems little prospect of a renewed slide in the US currency over the coming months.

Outlook for Sterling Finely Balanced

Sterling has also fallen back against the dollar of late, driven lower by general dollar strength and renewed UK interest rate cut speculation, mainly as a result of weak retail sales data for August and dovish comments from MPC members.

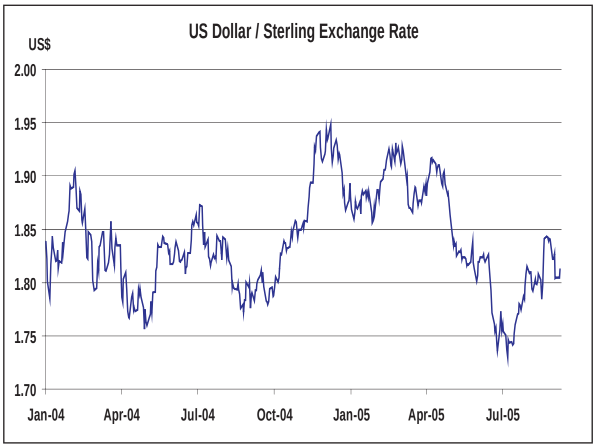
However, UK data are mixed and the outlook for rates is a finely balanced one. Forex markets will continue to closely watch the trend in forthcoming data on the housing market and consumer demand for clues on the likely direction of rates, as well as inflation numbers. Thus, sterling could come under pressure in the weeks ahead if key data do confirm the case for another rate cut. However, it should find support at the $1.78 level.

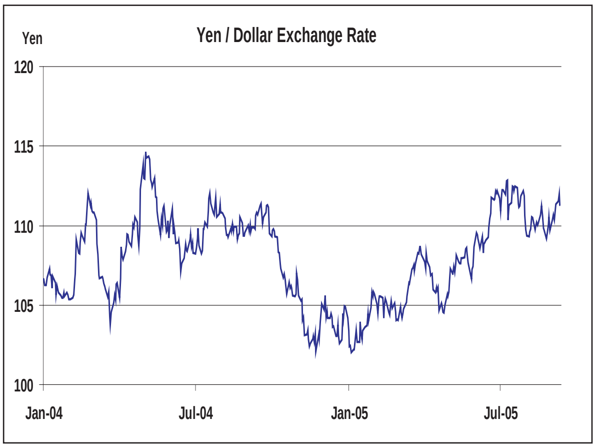
While sterling has lost ground against the dollar, it has outperformed the euro, pushing the sterling/euro rate lower. With the euro remaining vulnerable in the short-term, sterling could re-test the Stg0.67p level but we anticipate a move back to Stg0.68p and above over the longer-term.

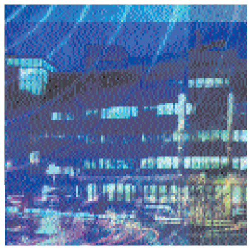
Yen Outlook Remains Positive

The political situation in Germany contrasts sharply with that in Japan, with a clear-cut victory in the recent election providing PM Koziumi with a strong mandate for reform. The yen's performance versus the dollar, however, has been somewhat disappointing, with high oil prices and the dollar recovery holding it back.

Economic conditions in Japan continue to improve, particularly on the domestic front, which should compensate for any weakness on the export side. Furthermore, although the CPI rate is still falling slightly, there are continuing signs that deflationary pressures, which have plagued the economy for the past six years, are easing. Thus, we still see scope for yen appreciation versus the dollar and a move towards Y105 over the longer-term.







KEY MARKET EVENTS

Week 1	September 27	GER	Ifo Business Survey (Sept)
(26-30 September)		US	Consumer Confidence (Sept)
	September 30	Eurozone	Business and Consumer Confidence (Sept)
		Eurozone	Harmonised Inflation Flash Estimate (Sept)
		US	Personal Income & Consumption (August)
Week 2	October 3	US/UK/Eurozone	Manufacturing ISM/PMIs (Sept)
(3-7 October)	October 5	US/UK/Eurozone	Services ISM/PMIs (Sept)
	October 6	UK	BoE Policy Announcement
		Eurozone	ECB Policy Announcement & Press Conference
	October 7	US	Non-Farm Payrolls (Sept)
Week 3	October 10	UK	Producer Prices (Sept)
(10 - 14 October)	October 11	US	FOMC Minutes of Sept Meeting
	October 12	UK	Unemployment (Sept)
	October 13	Eurozone	ECB Monthly Bulletin (Oct)
		US	Trade balance (Aug)
	October 14	US	Consumer Prices & Retail Sales (Sept)
		US	Industrial Production & Capacity Utilisation (Sept)
Week 4	October 17	UK	Consumer Prices (Sept)
(17 - 21 October)		Eurozone	Harmonised CPI (Sept)
		GER	ZEW Financial Markets Indicator (Oct)
		US	Producer Prices (Sept)
	October 19	UK	Minutes of MPC Meeting (5/6 Oct)
		US	Fed Beige Book
	October 21	UK	GDP 1st Estimate (Q3)

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