

EXCHANGE RATE MONTHLY

June/July 2005

AIB Global
Treasury
Economic
Research

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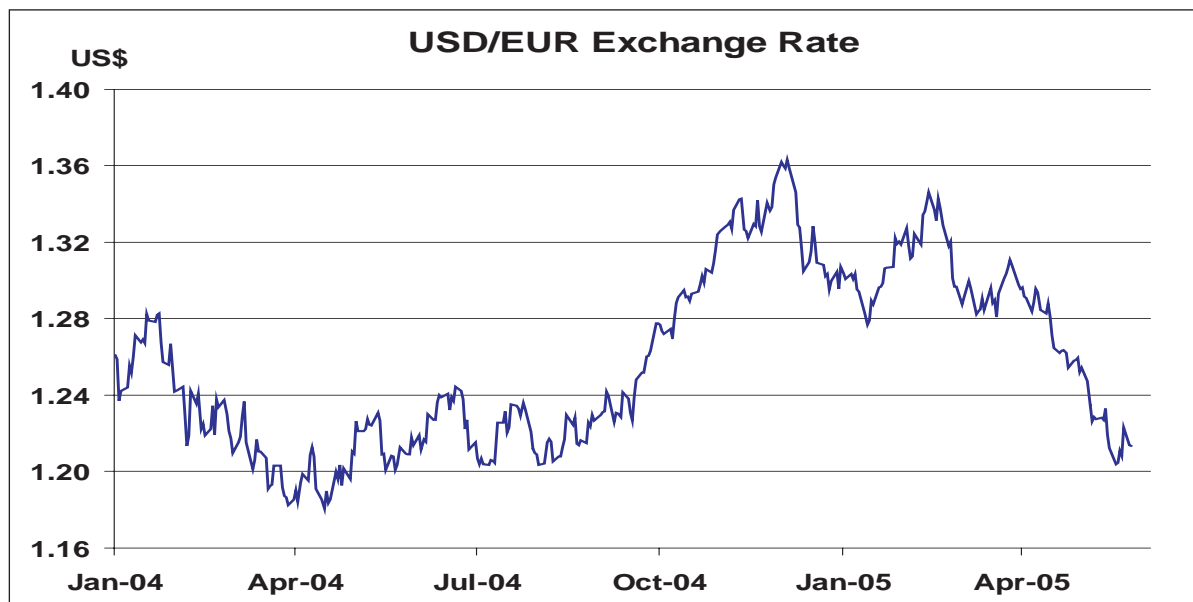
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Euro Under Pressure as Dollar Sentiment Improves

- There has been a marked deterioration in euro sentiment over recent times with European political uncertainty, weak eurozone economic data and talk of ECB rate cuts all taking their toll.
- We expect the euro to remain weak in the short-term with the dollar bolstered by the relatively better economic performance of the US economy and interest rate differentials.
- Cable could fall further over the coming weeks. However, sterling should remain firm versus the euro with a further rise towards the Stg66p level possible.



Summary of Forecasts

Exchange Rates

| Euro Versus | | Forecast Range Over The Period | | | |
|--------------------|----------------|---------------------------------------|------------------|------------------|------------------|
| | Current | Q3 - 2005 | Q4 - 2005 | Q1 - 2006 | Q2 - 2006 |
| USD | 1.2087 | 1.18-1.23 | 1.20-1.25 | 1.22-1.27 | 1.22-1.27 |
| GBP | 0.6636 | 0.66-0.68 | 0.67-0.69 | 0.68-0.70 | 0.68-0.70 |
| JPY | 131.40 | 128-133 | 130-135 | 130-135 | 130-135 |
| PLN | 4.00 | 4.10 | 4.10 | 4.05 | 4.05 |

| Dollar Versus | | Forecast Range Over The Period | | | |
|----------------------|----------------|---------------------------------------|------------------|------------------|------------------|
| | Current | Q3 - 2005 | Q4 - 2005 | Q1 - 2006 | Q2 - 2006 |
| JPY | 108.71 | 107-112 | 105-110 | 105-110 | 105-110 |
| GBP | 1.8214 | 1.78-1.83 | 1.80-1.85 | 1.80-1.85 | 1.80-1.85 |
| CHF | 1.2750 | 1.27 | 1.25 | 1.22 | 1.22 |
| AUD | 0.7737 | 0.76 | 0.76 | 0.78 | 0.78 |

Official Interest Rates

| | Current | Forecast to End Period | | | |
|----------------|----------------|-------------------------------|------------------|------------------|------------------|
| | | Q3 - 2005 | Q4 - 2005 | Q1 - 2006 | Q2 - 2006 |
| Euro Refi Rate | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 |
| US Fed Funds | 3.00 | 3.50 | 3.75 | 4.00 | 4.25 |
| UK Base Rate | 4.75 | 4.75 | 4.75 | 4.75 | 4.75 |
| Japan ODR | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 |

Growth and Inflation

| Y-on-Y% Change | GDP | | | Inflation | | |
|-----------------------|-------------|-------------|-------------|------------------|-------------|-------------|
| | 2004 | 2005 | 2006 | 2004 | 2005 | 2006 |
| US | 4.4 | 3.5 | 3.5 | 2.7 | 2.8 | 2.5 |
| Eurozone | 2.0 | 1.3 | 1.8 | 2.1 | 2.0 | 1.8 |
| UK | 3.1 | 2.4 | 2.5 | 1.3 | 1.9 | 1.8 |
| Japan | 2.6 | 1.7 | 2.0 | -0.2 | -0.3 | 0.1 |
| Ireland | 4.9 | 6.0 | 6.5 | 2.2 | 2.2 | 2.6 |

Our View In Brief

- * **Global economic conditions are somewhat mixed at present. While the US economy is achieving trend growth and a rebound in activity in Japan appears to be in place, there is a distinct lack of momentum in European economies, suggesting a mixed performance from the world economy in 2005.**
- * **The US economy grew by an annualised 3.5% in Q1, indicating that the upswing in activity continues, despite some evidence of a softening in the manufacturing sector. This slowdown is most likely due to an inventory correction and output should pick up again over the balance of the year. Thus, we continue to expect average growth of 3.5% for 2005.**
- * **Against this background, the Federal Reserve continues to increase US interest rates at a measured pace. Further tightening is anticipated over the coming months. We continue to expect the Fed funds rate to be at 3.75% by year end, which is broadly in line with market expectations.**
- * **Bond yields have fallen to exceptionally low levels following the remarkable rally in the last three months. In the short term, yields may stay close to recent lows. Later in the year, though, we expect to see ten year yields rising to around 4.6% in the US and UK and 3.5% in the eurozone.**
- * **Evidence that growth in the US economy remains solid continues to lend support to the dollar. Talk of higher US rates and a relatively better economic performance should ensure that dollar sentiment remains bullish over the coming weeks, keeping the euro on the backfoot. Longer term, though, the continuing large US external imbalances could trigger another bout of dollar weakness.**
- * **The eurozone economy grew by 0.5% in the first three months of the year. Most leading indicators and activity data show that growth should fall back again in Q2, with domestic demand remaining subdued. Even if activity strengthens again in H2, GDP growth should still average less than 1.5% in 2005.**
- * **Official interest rates in the eurozone have been on hold since June 2003. With the economy losing momentum in Q2, there is increasing speculation that the ECB may move to cut rates. However, its preference is likely to be for steady rates, unless there is a further deterioration on the growth front or inflation falls well below 2.0%.**
- * **The Japanese economy bounced back strongly in Q1 2005, growing by an annualised rate of 5.3%. It was particularly encouraging to see that the pick-up in activity was entirely due to domestic factors. It remains to be seen though, whether or not Japan is in the midst of a domestic economic recovery. In any event, more moderate growth is likely going forward.**
- * **Growth in the UK economy dipped below trend in Q1, reflecting a slowdown in consumer demand and weakness in the manufacturing sector. Nonetheless, economic prospects remain favourable and we expect that growth will be around trend levels in H2-2005. Inflation picked up sharply in March/April and is expected to move above the BoE's 2.0% target over the balance of the year. There is growing speculation of a cut in UK rates but, on balance, we expect unchanged policy over the rest of the year.**
- * **Sterling has regained considerable momentum versus the euro as talk turns to eurozone rate cuts and the euro remains under pressure against the dollar. Thus, it could rise further towards the Stg66p level in the near term. However, we envisage some recovery in the euro before year end.**

23 June 2005

Interest Rate Environment

Fed Continues to Tighten Rates

- * The Fed raised US interest rates by a further 0.25% at its policy meeting in May, bringing the Fed funds rate to 3.0%. Since June of last year rates in the US have been raised by 2%.
- * Despite this, Fed officials continue to highlight that monetary policy remains accommodative. Thus, we expect 0.25% rate hikes at the next two FOMC meetings, which would take the Fed funds rate to 3.5% by August. Thereafter, we anticipate one hike of 0.25% in Q4, leaving rates at 3.75% by year end.
- * Despite the tightening in official monetary policy, bond yields have fallen to very low levels. However, we anticipate a rise in yields in the second half of the year.

| US Interest Rates | | | | |
|-------------------|---------|---------|--------|--------|
| | Current | Sept 05 | Dec 05 | Mar 06 |
| Fed Funds | 3.00 | 3.50 | 3.75 | 4.00 |
| 3 Month | 3.41 | 3.65 | 3.90 | 4.15 |
| 1 Year | 3.79 | 4.05 | 4.25 | 4.45 |
| 2 Year* | 3.96 | 4.35 | 4.55 | 4.75 |
| 5 Year* | 4.12 | 4.55 | 4.75 | 4.90 |
| 10 Year* | 4.35 | 4.80 | 5.00 | 5.10 |

* Swap Forecasts Beyond 1 Year

ECB On Hold Until H2-2006

- * With the eurozone economy continuing to disappoint and little evidence of any threat to price stability, talk in Europe has turned to speculation about a rate cut.
- * While a cut in rates cannot be ruled out, in our view, inflation would need to fall well below 2% or the economy weaken even further before the ECB would move to ease policy. We anticipate that the ECB will instead leave rates on hold for an extended period. Thus, we do not expect to see policy tightening until H2-2006 at the earliest.
- * In line with the global trend, long-term rates in the eurozone have fallen to very low levels. Some upward movement is anticipated later in the year but we expect 10 year swap rates to still be relatively low at 3.6% by year end.

| Eurozone Interest Rates | | | | |
|-------------------------|---------|---------|--------|--------|
| | Current | Sept 05 | Dec 05 | Mar 06 |
| Refi Rate | 2.00 | 2.00 | 2.00 | 2.00 |
| 3 Month | 2.09 | 2.10 | 2.10 | 2.10 |
| 1 Year | 2.01 | 2.10 | 2.20 | 2.30 |
| 2 Year* | 2.16 | 2.30 | 2.50 | 2.60 |
| 5 Year* | 2.66 | 2.80 | 3.00 | 3.10 |
| 10 Year* | 3.25 | 3.40 | 3.60 | 3.70 |

* Swap Forecasts Beyond 1 Year

UK Rates Depend on Consumer

- * UK interest rates have been on hold at 4.5% since August of last year. Given the increasing signs of a weakening in consumer demand and a further downturn in house prices, the market is now discounting a UK rate cut.
- * Interest rate developments will very much depend on the strength of consumer demand. If spending does pick up again then talk of a rate cut will evaporate. We retain our view that rates will remain on hold for some time, pending further insights into the consumer sector in particular.

| UK Interest Rates | | | | |
|-------------------|---------|---------|--------|--------|
| | Current | Sept 05 | Dec 05 | Mar 06 |
| Repo Rate | 4.75 | 4.75 | 4.75 | 4.75 |
| 3 Month | 4.75 | 4.80 | 4.80 | 4.80 |
| 1 Year | 4.57 | 4.75 | 4.80 | 4.95 |
| 2 Year* | 4.48 | 4.70 | 4.80 | 4.90 |
| 5 Year* | 4.52 | 4.70 | 4.80 | 4.90 |
| 10 Year* | 4.59 | 4.75 | 4.85 | 4.95 |

* Swap Forecasts Beyond 1 Year

Exchange Rate Outlook

KEY ISSUES

- **Dollar Sentiment Remains Strong:** Year to date the dollar is up some 11% against the euro as ongoing evidence of solid US economic growth and continued action from the Fed underpin sentiment.
- **Euro To Stay Weak Near-Term:** We expect the euro to stay weak in the near-term, with a move to a \$1.18-1.24 range possible. However, longer-term there is scope for a modest recovery.
- **Sterling To Stay Strong Versus Euro:** Sterling to remain firm versus the euro with a further rise towards the Stg66p level possible as the single currency remains under pressure versus the dollar.

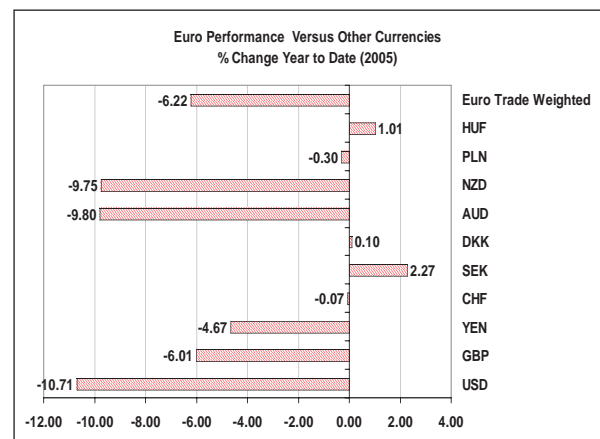
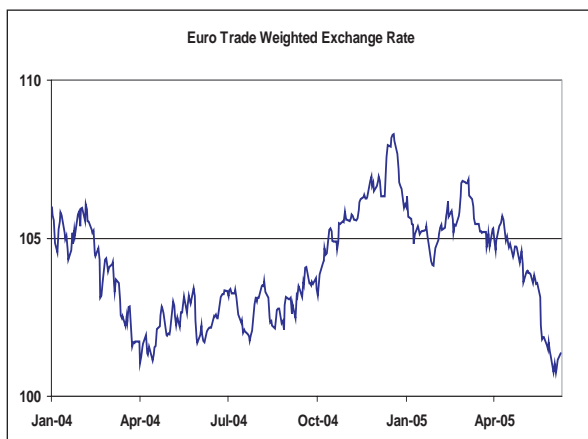
Euro Weakens as Dollar Sentiment Improves

The euro has come under further downward pressure over recent weeks, compounding its losses in the year to date. Since the beginning of the year, it has depreciated by some 11% against the dollar but has also fallen by an average 5% against sterling and the yen. On a broad-trade weighted basis, the euro is now 6.2% weaker than it was at the beginning of 2005.

Recent IMM data show that dollar long positions have increased across the board, reflecting a general improvement in the markets attitude towards the US currency but also a deterioration in euro sentiment. For a number of reasons, which are outlined below, we expect the euro to stay weak in the near-term, with a move to a \$1.18-1.23 range possible. However, longer-term we are less optimistic on the dollar and expect some modest recovery in the euro before year end.

European Politics: Problems on the European political front have had a marked impact on forex activity over recent times. The result of the French and Dutch referendums turned out to be a major event for the euro, despite the fact that No votes were well anticipated in both cases, with USD/EUR falling by three cents in the days immediately after. The larger than expected rejection of the Constitution raised serious questions about the European integration process and also prompted speculation about a break up of EMU.

Anti-euro rhetoric from Italy has been particularly strong, amid talk that it will withdraw from the single currency altogether. We believe that there is a very low probability attached to such a scenario. Nevertheless, while the damage to the euro from the referendum has been priced in at this stage, disruptions to EU integration, talk of member countries leaving EMU and wrangling over budget negotiations, mean that political uncertainty looks set to continue to have a negative effect on euro sentiment over the coming months.



An Economy in the Doldrums: GDP growth in the eurozone economy picked up to 0.5% in Q1. However, the detailed GDP data show that growth in domestic demand stalled over the period. Furthermore, there has been a marked weakening in leading activity indicators since February, both at a eurozone and national level. This suggests that GDP growth will fall back again in Q2.

Growth may pick up somewhat in H2 2005 given the recent fall in the euro and decline in long term interest rates. For now though, the euro will remain vulnerable to further negative news on the eurozone economy. In contrast, US data continue to indicate that the upswing there remains very much in tact. Thus, expectations that the US economy will continue to register a better economic performance should also help underpin the dollar over the coming months.

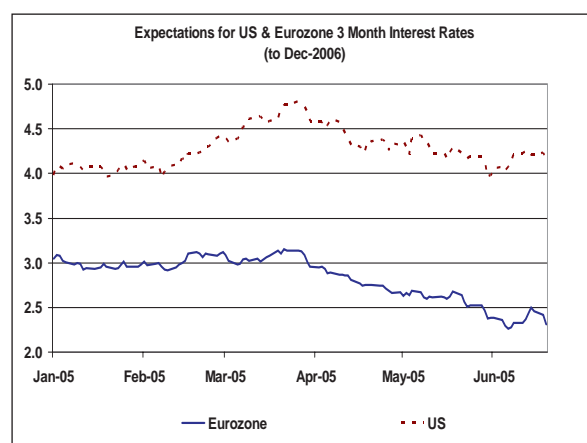
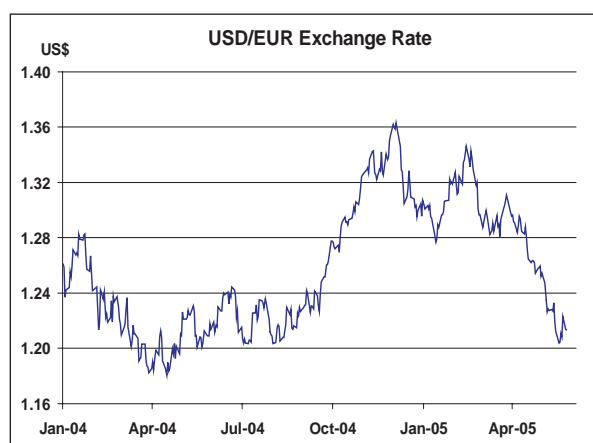
Interest Rate Differentials: Interest rate differentials continue to have a significant influence on the forex markets. Official interest rates in the US now stand at 3.0% compared to 2.0% in the eurozone. With the US economy on a steady growth path, the Fed continues to highlight that policy is still accommodatory. Thus, the FOMC is expected to continue tightening rates in the months ahead, with the Fed funds rate expected to be at 3.75% by year end.

Meanwhile, the market has begun to speculate about a rate cut in the eurozone. The recent decision by the Swedish central bank to cut officials interest rates there by 0.50% highlighted the performance gap between the US and Europe, with the Riksbank citing the weakness in the eurozone economy as one of the reasons why it moved so aggressively on rates.

Market speculation about a eurozone rate cut is likely to continue. Our central forecast does not incorporate such a scenario. At the same time, however, we do not expect to see policy tightened until H2 2006 at the earliest, which will leave the interest rate differential very much in the dollar's favour.

US Homeland Investment Act: Another factor that should be dollar supportive over the near-term is currency flows due to US profit repatriation under the terms of the Homeland Investment Act (HIA). The year long tax-break, which is designed to encourage US companies to bring home earnings held aboard at a discounted tax rate, expires (for most companies) in October 2005.

Before then, however, it is estimated that inflows could reach \$100bn, with most of this being converted from euros. The timing of any flows in funds is unclear. However, given the negative interest rate differential between Europe and the US it would seem to be in companies best interests to move funds sooner rather than later. Thus, much of the funds could be moved over the coming months.



US Structural Imbalances: Dollar sentiment has also been bolstered by indications that the US structural imbalances (fiscal and trade imbalances) are improving. However, while some recent figures have suggested positive developments, it is unclear whether this is the beginning of a broader stabilisation. Meanwhile, recent US capital inflows data have not been so encouraging.

Still Scope for Euro Rebound Before Year End

Over the longer term, we are not fully convinced that the dollar has, after three years of decline, finally turned the corner. It is still unclear whether the recent developments are the beginning of a broader stabilisation in the current account deficit. Also, the positive impact of US interest rates on the dollar is likely to fade over time as expected changes are fully priced in and policy moves back to a more neutral position.

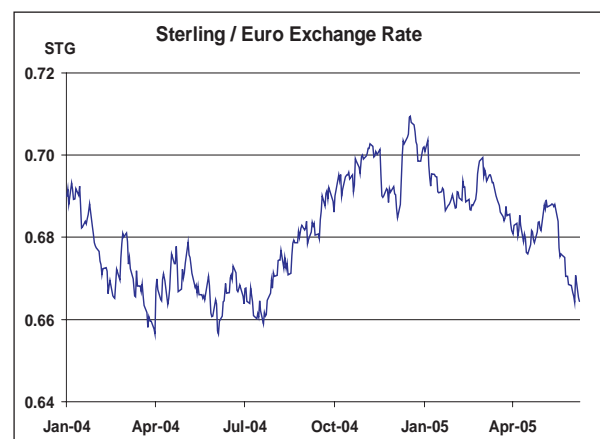
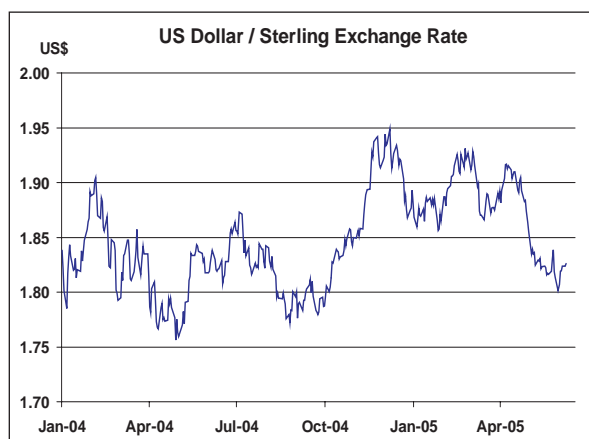
Indeed, any evidence that the Fed is coming to the end of its tightening cycle could see the dollar come under renewed selling pressure, providing an opportunity for the euro to move back towards a \$1.22-1.27 range. Our time path for US interest rates envisages 0.25% rate hikes at the next two FOMC meetings in June and August, but just one rate hike thereafter in 2005.

Thus, we still see some scope for a modest rebound in the euro over the second half of 2005. At the same time, however, this will be difficult to achieve if US structural imbalances are indeed on a corrective path and economic conditions in the eurozone remain very weak. Indeed, at this stage, market activity suggests there is little appetite for a move back beyond \$1.30.

Sterling Also Falls Against Recovering Dollar

Sterling has also lost ground against the recovering dollar, with cable down almost 5% in the year to date. Weak UK economic data have also impacted with the economy growing below trend in Q1. However, despite talk of lower interest rates in the UK, it has still managed to outperform the euro, and the GBP/EUR rate is down nearly 6% since the beginning of the year.

Given the current outlook for UK interest rates (market expectations for a UK rate cut were bolstered by the minutes of the May BoE policy meeting which showed that two members voted for a rate cut) and the dollar, cable could fall further over the coming weeks. However, it should remain firm against the euro and could rise further towards the Stg66p level in the near term. Longer term, however, we expect a move back toward Stg68p as the euro retraces some of its losses against the dollar.





KEY MARKET EVENTS

| | | | |
|--|---|--------------------------------------|---------------------------------------|
| Week 1 <i>(27 June - 1 July)</i> | June 27 | Germany | IFO Business Survey (June) |
| | June 28 | US | Consumer Confidence (June) |
| | June 30 | Eurozone | Business & Consumer Confidence (June) |
| | | Eurozone | HICP Flash Estimate (June) |
| | | US | FOMC Monetary Policy Announcement |
| | July 1 | Japan | BOJ Tankan |
| | US/UK/Eurozone | Manufacturing PMI/ISM Surveys (June) | |
| Week 2 <i>(4 July - 8 July)</i> | July 4 | US | Market Holiday |
| | | Eurozone | Services PMI (June) |
| | July 5 | UK | Services PMI (June) |
| | July 6 | US | Services ISM (June) |
| | July 7 | UK | BOE Monetary Policy Announcement |
| | | Eurozone | ECB Meeting & Press Conference |
| | July 8 | USA | Non-Farm Payrolls (June) |
| | Week 3 <i>(11 July - 15 July)</i> | July 12 | UK |
| July 13 | | UK | Unemployment (June) |
| | | US | Trade Balance (May) |
| | | US | Federal Budget Balance (June) |
| July 14 | | US | Consumer Prices (June) |
| | | US | Retail Sales (June) |
| Week 4 <i>(18 July -22 July)</i> | July 18 | US | Net Capital Inflows (May) |
| | July 19 | Germany | ZEW Expectations Survey |
| | July 20 | UK | Minutes of MPC Meeting (6/7 July) |
| | July 21 | UK | Retail Sales (June) |
| | | US | Minutes of FOMC Meeting (29/30 June) |
| | July 22 | UK | Q1 GDP (1st Estimate) |

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