AIB Global Treasury
Economic Research

EXCHANGE RATE MONTHLY

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AIB Global Treasury Economic Research

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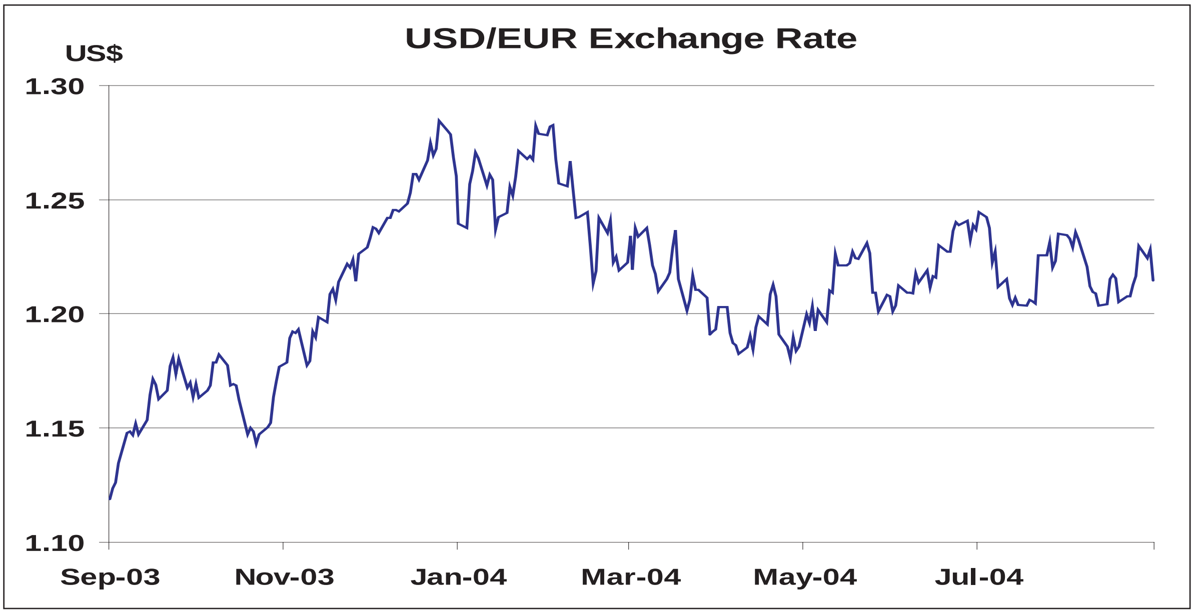
Dollar on Negative Watch as Presidential Election Looms

- The outlook for the dollar remains very uncertain, though it is expected to trade within established ranges ahead of the Presidential election in November. Thereafter, the outlook is more uncertain with a break above $1.25 a strong possibility.

- The dollar will find some support from further Fed interest rate hikes and from the lack of attractive alternative currencies for investors. However, the US fiscal and particularly the external account deficits pose material threats to the dollar.

- Sterling is expected to remain under pressure versus the dollar and euro in the near term but falls should be limited from here.



Summary of Forecasts

Latest View

- EUR/USD to trade in $1.20 - 1.25 range in the near term, but it could weaken to a $1.24 - 1.29 range 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	Oct-Dec 04	Jan-Mar 05	Apr-Jun 05	Jul-Sep 05
USD	1.20-1.24	1.2165	1.22-1.29	1.22-1.27	1.22-1.27	1.20-1.25
GBP	0.67-0.69	0.6823	0.67-0.69	0.67-0.69	0.66-0.68	0.66-0.68
JPY	132-137	133.45	133-138	130-135	132-136	128-133
CHF	1.53-1.55	1.5425	1.54	1.53	1.53	1.52
NOK	8.24-8.42	8.4190	8.30	8.25	8.15	8.10
SEK	9.09-9.24	9.1225	9.05	9.05	9.00	9.00

Dollar Versus			Forecast Range Over The Period			
	Range Over the Last Month	Current	Oct-Dec 04	Jan-Mar 05	Apr-Jun 05	Jul-Sep 05
JPY	109-111	109.70	107-112	107-112	105-110	105-110
GBP	1.77-1.85	1.7838	1.83-1.88	1.80-1.85	1.82-1.87	1.80-1.85
CHF	1.24-1.29	1.2685	1.235	1.23	1.23	1.24
CAD	1.29-1.32	1.2958	1.30	1.29	1.28	1.28
AUD	0.69-0.73	0.6958	0.72	0.73	0.74	0.75

Official Interest Rates

		Forecast to End Period			
	Current	Dec 04	Mar 05	June 05	Sep 05
Euro Refi Rate	2.00	2.00	2.25	2.50	2.50
US Fed Funds	1.50	2.00	2.25	2.50	2.75
UK Base Rate	4.75	5.00	5.00	5.25	5.25
Japan ODR	0.10	0.10	0.10	0.10	0.10

Growth and Inflation

		GDP			Inflation	
Y-on-Y% Change	2003	2004	2005	2003	2004	2005
US	3.0	4.3	3.5	2.3	2.6	2.3
Eurozone	0.4	1.9	2.1	2.1	2.1	1.9
UK	2.2	3.4	3.0	1.4	1.5	1.8
Japan	2.5	4.1	2.0	-0.2	-0.2	0.0
Ireland	3.7	5.0	5.5	3.5	2.3	2.9

Our View In Brief

* **Though there are signs of a slowdown in the global economy, the outlook remains positive.** Crude oil prices have eased and monetary and fiscal policies remain accommodative in many economies and will continue to support growth into 2005.

* Geopolitical risks continue to create uncertainty. Not only do they exert considerable upward pressure on oil prices but they also lead to consumer and business uncertainty, which in turn adversely affects consumption and business investment.

* We are now within 50 days of the **US Presidential election on 2 November.** President George W. Bush appears to have a commanding lead at this stage. Security concerns could lead to financial market volatility in the run-up to polling day.

* US economic growth slowed in the second quarter to 2.8% on an annualised basis, down from 4.5% in the first quarter. Growth in the third quarter should be around 3.5%. This slowdown is not expected to divert the Fed from raising official interest rates when the FOMC meets on 21 September. The Fed funds rate is forecast to rise by another 0.25% to 1.75%. A further increase of 0.25% is forecast before the end of the year.

* The dollar has remained in relatively narrow ranges against the euro and the yen in recent months. **The outlook for the dollar remains very uncertain. Once again, we retain our negative bias towards the dollar.** We see it in a $1.20-1.25 range versus the euro over the next two months but feel that it could weaken in the post-election period to within a $1.24-1.29 range versus the euro.

* Recent US trade and current account data show that the US continues to build extremely high external deficits. These have been financed to date by capital inflows and with only a modest reversal of the overall trade weighted value of the dollar. It's difficult to say how long this situation can last but there must be a significant risk of a dollar fall in the short to medium term. The dollar, however, is supported by the fact that there are few attractive alternatives.

* In the euro area, the economy continues to make a slow, export-driven recovery. Here, there are risks to the downside but the ECB is focused on the risks to price stability. **Though we see little justification for an interest rate hike before the first quarter of 2005, recent hawkish ECB comments cannot be ignored.** As a result, there is a small risk that the ECB could tighten policy in December.

* Sterling has weakened across the board, as the markets perceive that the Bank of England is almost done with its interest rate tightening. Official rates now stand at 4.75%. The economy has slowed, the heat appears to be going out of the housing market and inflation is relatively low. However, **we believe that it is premature to conclude that the BoE has done enough. We expect some further tightening to about 5.25%** over the next six to nine months.

* Sterling has moved to over £0.68 versus the euro and some further slippage is possible in the short term. However, changes in the current expectations about UK and eurozone interest rates should see sterling find a floor around the £0.69 level.

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Interest Rate Environment

Fed to Maintain Measured Pace

* The Fed is expected to raise the official Fed funds rate by a further 0.25% to 1.75% when the Federal Open Market Committee (FOMC) meets on 21 September. This will continue the policy of measured rate increases begun in June. We expect the Fed funds rate to reach 2% by year end.

* Looking to 2005, the Fed is expected to continue on course 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 as the Fed reduces its monetary stimulation. 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.

US Interest Rates

	Current	Sept 04	Dec 04	Dec 05
Fed Funds	1.50	1.75	2.00	3.00
3 Month	1.88	1.90	2.25	3.20
1 Year	2.33	2.35	2.75	3.50
2 Year*	2.82	2.85	3.25	4.00
5 Year*	3.75	3.80	4.10	4.70
10 Year*	4.57	4.60	4.90	5.30

** Swap Forecasts Beyond 1 Year*

ECB Hardens Position on Rates

* The ECB appears to be increasingly worried about the possible second round effects of the rise in energy related prices. It may also have an eye to the growth in property prices in many euro area economies, fuelled by the more than ample monetary liquidity.

* Though it would be unwise to ignore the warning signals from ECB council members, 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 early 2005. By end 2005, however, we expect the official refinancing rate to stand at about 2.75%.

* Looking to longer term rates, the eurozone is likely to follow the general direction of the US market. We see 5 year rates rising by 0.9% from current levels with 10 year rates up by 0.7% over the next 12 - 15 months.

Eurozone Interest Rates

	Current	Sept 04	Dec 04	Dec 05
Refi Rate	2.00	2.00	2.00	2.75
3 Month	2.12	2.15	2.25	3.00
1 Year	2.39	2.40	2.60	3.25
2 Year*	2.74	2.75	3.15	3.85
5 Year*	3.49	3.50	3.90	4.40
10 Year*	4.17	4.20	4.50	4.90

** Swap Forecasts Beyond 1 Year*

Bank of England may have more to do

* Official UK interest rates were raised to 4.75% in August. Rates were left unchanged in September. With the economy and the housing market slowing, there is a growing belief that the Bank has completed its tightening. We still see the need for some more rate increases over the next six to nine months.

UK Interest Rates

	Current	Sept 04	Dec 04	Dec 05
Repo Rate	4.75	4.75	5.00	5.25
3 Month	4.95	5.00	5.25	5.50
1 Year	5.17	5.20	5.50	5.70
2 Year*	5.13	5.15	5.35	5.55
5 Year*	5.23	5.25	5.45	5.75
10 Year*	5.25	5.25	5.45	5.75

** Swap Forecasts Beyond 1 Year*

Exchange Rate Outlook

KEY ISSUES

- ***Dollar on Negative Watch:*** The outlook for the dollar remains very uncertain, though it is expected to trade within established ranges ahead of the Presidential election in November.
- ***Euro Benefits from Dollar Doubts:*** The euro has benefited from US dollar weakness and has also gained versus sterling against background of unconvincing euro area economic growth.
- ***Sterling Weakens as Interest Rates Near Peak:*** Sterling has lost ground as the markets see an end to official interest rate tightening.

Dollar Remains in Doldrums

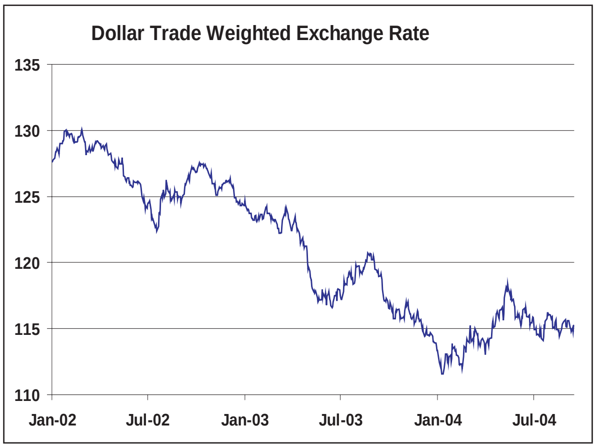
The US dollar remained within a $1.20-1.25 range against the euro over the past month, though it did manage to spend more time at the bottom of that range than we originally anticipated in our last monthly report. However, the chances of a meaningful breakout from this range, which has persisted for almost four months, is limited in the short term.

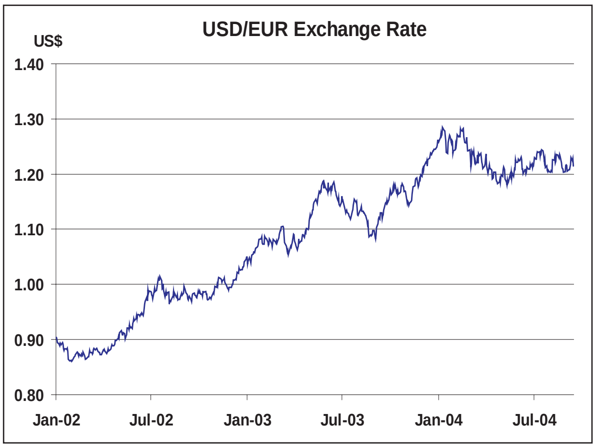
We see the post Presidential election period from early November to the end of the year as the time when the current trading range could be tested in a more decisive way. Clearly, the outlook for the dollar could be heavily influenced by the outcome of that election, which is too early to call at this stage, even though George W. Bush seems to have a commanding lead. However, it will take time before any clear-cut economic policy emerges, irrespective of who wins the election. This could be a time of heightened risk for the dollar.

The dollar remains dogged by a number of interrelated concerns. First, there is concern about the short to medium term strength of the economic upurn. The rate of economic growth has slowed from 4.5% in Q1'04 to 2.8% in Q2'04. Growth in Q3'04 could be around 3.5%. While this seems relatively high by European standards, it is close to trend in the US and won't generate a strong trend in net employment creation. Looking ahead, the US economy seems set to expand at an average rate of about 3.5% in 2005.

Part of this slower growth path for the US economy is due to the impact of higher oil prices and the wider impact of geopolitical risks. However, there is also the ever-diminishing positive impact of relaxed fiscal and monetary policies on the US economy and the move to a less accommodative bias by the Fed since June.

A second concern is that the Fed may not hike official rates as fast as had been expected. We still believe that rates will reach at least 2% by end 2004 but the





pace of monetary tightening in 2005 could be less than we had anticipated. This is because of the less robust rate of economic growth and the moderate pick up in inflation to date. Lower than expected short and longer term rates may be helpful to the economy but they make the dollar less attractive to overseas buyers.

Third, the markets have shown remarkable tolerance of the mounting US trade and current account deficits. The US trade deficit in June was a record $55 billion followed by a $50 billion deficit in July. The current account deficit reached $166 billion in Q2'04, up from $147 billion in Q1'04. These are unsustainably high deficits and as Janet Yellen, the President of the San Francisco Fed, remarked on 9 September, the dollar would have to play its part in correcting these large deficits. Yellen put no numbers on it but, at some point, the dollar might need to fall by at least 10-15% on a broad trade weighted basis from current levels.

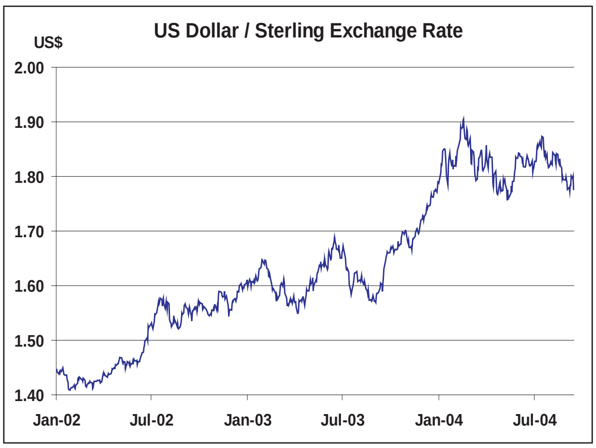
Since its peak in early 2002, the dollar fell by 14% on a broad trade weighted basis over the next two year period. However, it has regained almost 3% since then. This cumulative fall of over 11% from a very overvalued level in early 2002 is an insufficient adjustment to the US external deficit.

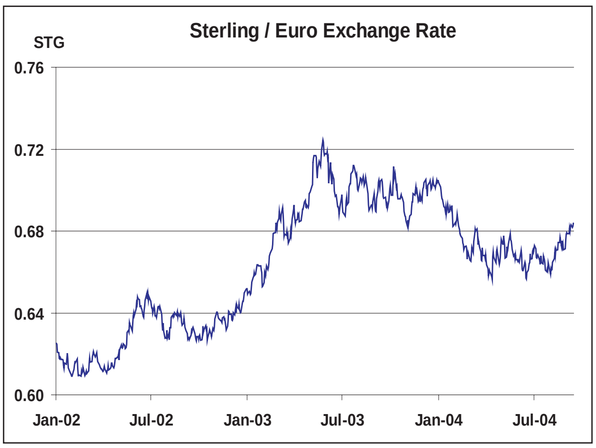
It is impossible to predict when the markets will finally sell the dollar to reflect the US external imbalance and by how much and where the burden of adjustment will be felt. However, if past experience is anything to go on, the euro and sterling, along with the Canadian dollar and other commodity based currencies would feel the pain. Efforts to reduce the US budget deficit, which could follow from a Kerry victory in the Presidential election, could reduce the risks to the dollar.

As most market participants are aware, the risks to the dollar from the twin US deficits have persisted for some time. The massive current account deficit continues to be financed by private and official capital inflows. If these continue at a relatively high level, the downside risk to the dollar will be limited, but the underlying problem won't go away.

Our view, therefore, is that the EUR/USD rate will stay within $1.20-1.25 over the next two months. Post the Presidential election period, we see the EUR/USD in a $1.24-1.29 range. This range could persist into the early months of 2005.

The dollar has one main support and that is the absence of an attractive alternative. Euro area economic growth is overly dependent on exports and the pace of global activity is slowing. The ECB has no desire to see a significant rise in the value of the euro which has been on a gently upward trend over the past six months. A much stronger euro would probably derail the euro economic recovery.





The ECB could be expected, therefore, to limit the euro's potential rise against the dollar near the $1.30 level.

The euro has also gained ground against sterling as the latter weakened against other major currencies. The EUR/GBP rate has drifted away from the £0.655-0.675 range and appears to be in a higher $0.67-0.69 range. We expect that this range will hold over the next few months.

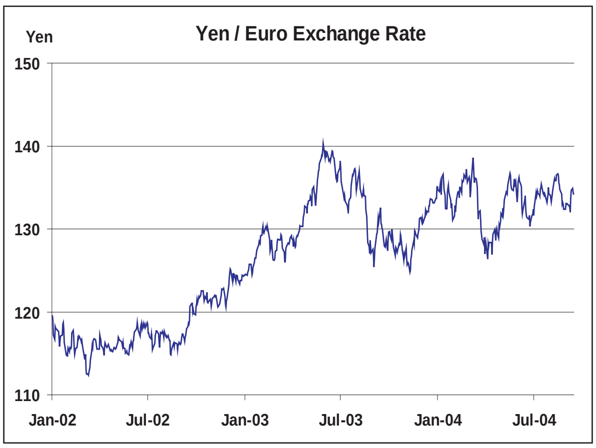
The main driver here is the perception that UK official interest rates have either peaked or are close to their peak. This view is supported by the weakening of a broad range of economic indicators such as the softening of house price inflation, the slowdown in the growth of retail sales and renewed weakness in industrial production. Furthermore, the rate of growth in real GDP appears to have slowed to near trend rate of 2.75%, down from the annualised growth of over 3.5% in the second quarter.

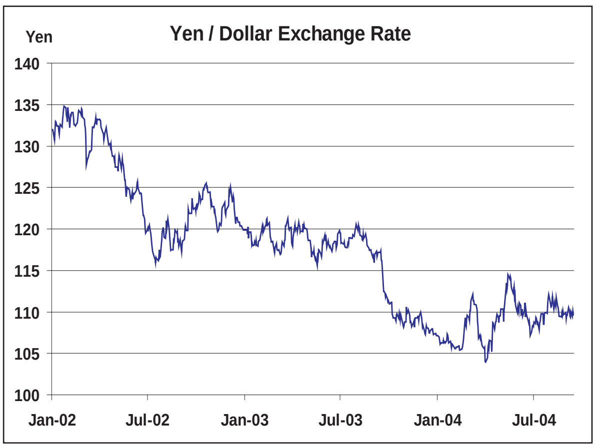
It's difficult to say whether official interest rates have indeed peaked. Inflation is running at a very low rate in the UK so the pressure to raise rates much beyond current levels of 4.75% is limited. However, it is too early to conclude that house price inflation will slow sharply or that the tight labour market won't generate some inflationary worries in 2005. The Bank of England may well raise rates by 0.25% before end year and tighten policy further to 5.25% in H1 2005.

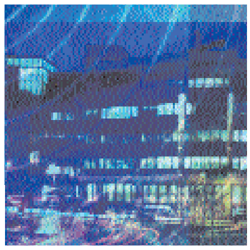
Our view is that sterling will remain under pressure against the euro in the short to medium term. However, significant weakness much beyond current levels is unlikely. The market's belief that UK rates have peaked will be tested by positive UK economic data and the downside risks to the dollar could see the USD/GBP rate rise to a $1.83-1.88 range in the short term and trade within $1.80-1.85 over a 3-6 month horizon.

The USD/YEN rate has fluctuated within a Y109-Y111 range over the past month. The yen has ebbed and flowed with the release of Japanese economic data. There has been some disappointment with the latest quarterly growth data which showed a significant slowdown to 0.3% in Q2'04 from 1.6% in Q1'04. We do not expect that the dollar-yen rate will move much from current levels over the next two months. Beyond that, some yen gains are likely, though, as with the ECB, the Bank of Japan will be anxious to limit any yen appreciation.

In terms of the EUR/YEN rate, this is expected to move within Y130-135 in the near term and fluctuate within Y133-138 towards the end of 2004 and into 2005.







KEY MARKET EVENTS

Week 1 *(20 - 24 September)*	**September 21**	**US**	**FOMC Policy Meeting** Rates expected to be raised by 0.25%. Tone of accompanying statement will be important.
	September 22	**UK**	**Minutes of September MPC Meeting** Strength of views expressed about further rate hikes will be crucial for sterling.
Week 2 *(27 September - 1 October)*	**September 27**	**Eurozone**	**German Ifo Business Survey (September)** Will this lead indicator of the strength of the German/ eurozone economy confirm the ECB's bullish view ?
	September 28	**US**	**Consumer Confidence (September)** Will confidence rebound after the sharp fall in August ?
	September 30	**Eurozone**	**HICP (September Flash)** HICP inflation was stable at the 2.3% level in August.
	October 1	**UK**	**Manufacturing PMI (September)** Will index recover after high oil prices depressed sentiment in August ?
	October 1	**Eurozone**	**Manufacturing PMI (September)** Index dipped in August but still constant with reasonable growth in sector.
	October 1	**US**	**Manufacturing ISM (September)** Important lead indicator of the US economy. Index dipped in August to lowest level since November 2003.
Week 3 *(4 - 8 October)*	**October 5**	**US**	**Services ISM (September)** September rebound from August weakness would be an important lead indicator that economy regaining strength.
	October 6/7	**UK**	**BoE Policy Meeting (2 day)** Rates likely to be left on hold at this meeting given signs of slowing domestic demand and cooling housing market.
	October 7	**Eurozone**	**ECB Policy Meeting** Rates expected to remain on hold. Comments at press conference of much interest on this occasion.
	October 8	**US**	**Non-Farm Payrolls (September)** A crucial market number. Reasonable growth in August after two disappointing months but September data may be distorted by Hurricane Ivan.
Week 4 *(13 - 17 October)*	**October 11**	**UK**	**Trade Balance (August)** Widening of trade deficit in July hit sterling.
	October 12	**UK**	**Consumer Prices (September)** CPI rate running well below target but this is unlikely to prevent further modest rate hikes.
	October 14	**US**	**Trade Balance (August)** Very important for the dollar. Deficit narrowed to $50bn in July from record $55bn deficit in June but still second largest on record.
	October 15	**US**	**Retail Sales (September)** Recent weak trend needs to be reversed if economy to regain its momentum. Watch for Hurricane effects.

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