

EXCHANGE RATE MONTHLY

March 2004

Dollar Displays Resilience Versus Euro

- Volatility on forex markets remains exceptionally high but the dollar is showing resilience despite persistent weakness in the US labour market (see page 5).
- The recent actions by the BoJ have had a marked influence on forex levels. There is much uncertainty regarding its next move but fears of intervention could still be a factor in preventing the euro from re-establishing an uptrend towards \$1.30 (see page 6).
- The sterling/euro rate has recovered from yearly lows as markets debate the timing of the next move in UK interest rates. However, a fresh break of Stg0.67p is possible (see page 7).

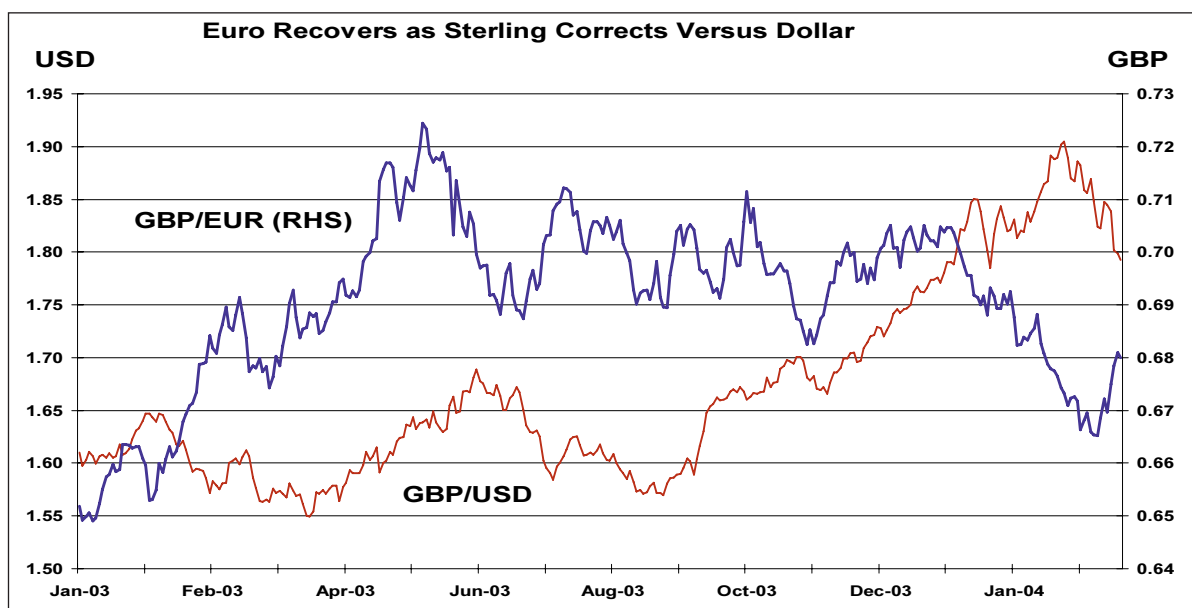
AIB Global
Treasury
Economic
Research

John Beggs
Chief
Economist

Oliver
Mangan
Chief Bond
Economist

Geraldine
Concagh
Senior
Economist

Jenny
Pollock
Senior
Economist



Summary of Forecasts

Latest View

- Unimpressive euro rally post February's US non-farm payrolls limits upside momentum.
- Uncertainty regarding actions by the BoJ are likely to keep dollar/yen volatile.
- Sterling hit by weak UK data but sub Stg0.67p could be threatened again over the coming weeks.

Exchange Rates

Euro Versus		Forecast Range Over The Period				
	Range Over the Last Month	Current	Apr-Jun 04	July-Sept 04	Oct-Dec 04	Jan-Mar 05
USD	1.20-1.30	1.2274	1.18-1.28	1.18-1.28	1.15-1.25	1.15-1.25
GBP	0.66-0.69	0.6720	0.66-0.69	0.66-0.69	0.67-0.69	0.68-0.70
JPY	133-139	131.10	130-136	130-135	124-129	124-129
CHF	1.56-1.58	1.5625	1.57	1.55	1.56	1.57
NOK	8.56-8.86	8.4700	8.60	8.60	8.50	8.50
SEK	9.14-9.21	9.2420	9.10	9.00	9.00	8.90

Dollar Versus		Forecast Range Over The Period				
	Range Over the Last Month	Current	Apr-Jun 04	July-Sept 04	Oct-Dec 04	Jan-Mar 05
JPY	105-113	106.81	105-112	105-110	103-108	103-108
GBP	1.79-1.91	1.8260	1.79-1.86	1.79-1.86	1.72-1.80	1.71-1.76
CHF	1.22-1.30	1.2730	1.28	1.26	1.27	1.30
CAD	1.314-1.318	1.3370	1.32	1.32	1.34	1.34
AUD	0.73-0.79	0.7450	0.75	0.74	0.73	0.72

Official Interest Rates

	Forecast to End Period				
	Current	Jun 04	Sept 04	Dec 04	Mar 05
Euro Refi Rate	2.00	2.00	2.00	2.00	2.25
US Fed Funds	1.00	1.00	1.00	1.75	2.25
UK Base Rate	4.00	4.25	4.50	4.75	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	3.1	4.6	3.7	2.3	1.7	1.7
Eurozone	0.4	1.6	2.4	2.1	1.7	1.8
UK	2.3	3.2	2.8	1.4	1.6	1.9
Japan	2.7	2.5	2.0	-0.2	-0.2	-0.2
Ireland	1.5	4.0	5.0	3.5	1.9	2.7

Our View In Brief

- * In general, the outlook for the global economy, and in particular the Asian and Anglo-Saxon countries, remains positive. **However, conditions in the US labour market continue to dominate market attention.** Jobs growth has been unexpectedly sluggish in recent months and needs to pick up to help sustain the recovery in US economic activity.
- * **Given the weakness in the labour market, we have scaled back our forecasts for average GDP growth in the US in 2004 from 4.8% to 4.6%.** We have also become more cautious in our outlook for US monetary policy.
- * **Official interest rates in the US are still expected to rise this year.** However, it seems unlikely that the Fed will move to tighten ahead of the Presidential election in November. We now anticipate that rates will be raised by just 0.75% towards year end, with further tightening envisaged in 2005.
- * With the recovery in the eurozone still sluggish and inflation falling back below the ECB's 2.0% target, the central bank remains comfortable with its current stance on monetary policy. **We have reduced our eurozone GDP growth forecast for 2004 to 1.6% from 1.8%. As a result, we expect no change in eurozone interest rates until the first quarter of 2005.** If there were to be any move in the short-term, it is more likely to be a rate cut.
- * Some recent data from the UK have disappointed. However, the BoE is still expected to tighten rates further, with a move possible at the April meeting. *For more details of our interest rate view, please see our latest **Fixed Income Monthly Monitor**, available online at www.johnbeggs.com.*
- * **Brent oil prices have averaged \$32 per barrel over the last month.** We expect prices to remain high over the coming months with supply constraints, low inventories, increasing demand and adverse political developments impacting.
- * **Forex markets remain extremely volatile, with a high degree of uncertainty regarding the next big move in direction.** Nevertheless, the euro's inability to sustain its rally beyond \$1.29 versus the dollar suggests that its upward momentum is fading. We expect a \$1.18-1.28 range to prevail over the coming months.
- * **Sterling has retreated from recent 11 year highs against the US dollar, allowing the euro to recover from yearly lows against the UK currency.** Indeed, higher yielders in general have fallen out of favour of late, with the AUD also experiencing a sharp correction versus the USD. However, a renewed bounce in sterling is possible if UK data continue to point to higher interest rates.
- * **Record levels of intervention by the Bank of Japan have provided general support to the dollar.** Although there has been a let up in intervention activity in recent days, fear of renewed action could still help put a floor under the dollar.

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Interest Rate Environment

Fed To Sit Tight Until After Election

- * The Fed retains the view that, with inflation low and resource use slack, it can be patient in removing its policy accommodation. The sluggishness of the labour market is a key factor.
- * With non-farm payrolls remaining unexpectedly weak, our expectation that the Fed would hike rates over the summer is unlikely to be realised. The scale of tightening in 2004 should also be more modest than we had envisaged.
- * Even if payrolls start to improve soon, the Fed may be reluctant to move ahead of November's Presidential election. Thus, we now look for the Fed to increase rates by 0.75% to 1.75% in the closing months of 2004, which is about 0.50% ahead of current market expectations.

US Interest Rates				
	Current	Jun 04	Dec 04	Mar 05
Fed Funds	1.00	1.00	1.75	2.25
3 Month	1.11	1.13	2.05	2.55
1 Year	1.29	1.40	2.75	3.15
2 Year*	1.78	2.00	3.30	3.60
5 Year*	3.02	3.20	4.30	4.50
10 Year*	4.08	4.30	5.20	5.40
* Swap Forecasts Beyond 1 Year				

No Change Expected From ECB

- * The eurozone economy is recovering but the upswing in activity has so far been quite sluggish. Inflation has fallen sharply in recent months and could fall further in March, before rising again.
- * Given the outlook for growth and inflation, as well as the strength of the euro, the ECB is expected to stay on hold for the rest of the year. If there is to be any move in the short-term, it is more likely to be to cut rates.
- * However, the ECB has given no indication that it is leaning in this direction, despite ongoing pressure on the political front. We expect the central bank to tighten rates by 0.25% in early 2005. This is in line with market expectations.

Eurozone Interest Rates				
	Current	Jun 04	Dec 04	Mar 05
Refi Rate	2.00	2.00	2.00	2.25
3 Month	2.05	2.05	2.20	2.40
1 Year	2.07	2.20	2.50	3.00
2 Year*	2.36	2.50	3.10	3.40
5 Year*	3.23	3.30	4.10	4.30
10 Year*	4.05	4.20	4.90	5.10
* Swap Forecasts Beyond 1 Year				

UK Rates To Be Hiked Further

- * At its February's meeting, the BoE increased UK interest rates by 0.25% to 4.00%. The move was consistent with its policy of gradually and cautiously tightening monetary policy.
- * Recent manufacturing and trade data have come in weaker than expected but the domestic economy in general remains strong.
- * We retain our forecast that rates will be raised by 0.25% in each of the three remaining quarters of 2004 with the repo rate ending the year at 4.75%. The next hike could come at the April meeting. The market still expects rates to be at 4.50% by year end.

UK Interest Rates				
	Current	Jun 04	Dec 04	Mar 05
Repo Rate	4.00	4.25	4.75	5.00
3 Month	4.20	4.50	5.00	5.20
1 Year	4.48	4.80	5.20	5.30
2 Year*	4.64	4.80	5.30	5.50
5 Year*	4.85	5.00	5.60	5.70
10 Year*	4.96	5.10	5.70	5.80
* Swap Forecasts Beyond 1 Year				

Exchange Rate Outlook

KEY ISSUES

- **Euro's Rally Fails:** Euro fails to hold \$1.29 level, upward momentum appears to be fading as markets speculate about interest rate cuts in Europe.
- **BoJ Actions Confuse Market:** After record levels of intervention the BoJ has taken a step back but markets will be watching for renewed action if the Y105 level comes under threat.
- **Sterling Comes Under Pressure:** Sterling has fallen back against both the dollar and euro but should still find support in expectations for higher UK rates.

Euro Performance Unimpressive After Rally Past \$1.29 Fails

Forex markets have been exceptionally volatile of late. Underlying this volatility has been a considerable degree of uncertainty regarding the next big move in direction, particularly in dollar/euro.

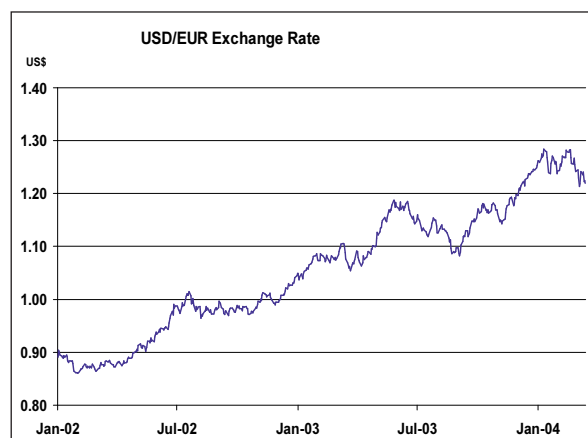
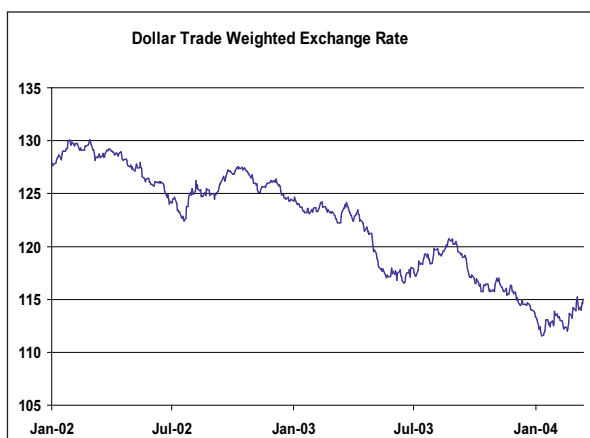
In mid February the euro hit new lifetime highs against the dollar but since then there has been a distinct shift in sentiment, which has left many questioning if its uptrend has come to an end.

After taking the dollar/euro to a lifetime low of \$1.2935 on 18 February, currency traders suddenly halted the euro's upward course, rushing to exit dollar short positions on a combination of increased rhetoric from eurozone officials expressing concerns about the appreciation of the euro and heightened uncertainty surrounding the outlook for US and eurozone interest rates.

The dollar found strong support against the euro and other majors as markets speculated that a sluggish recovery in the eurozone would force the ECB to cut interest rates at its March meeting and that a strong US non-farm payrolls number for February would herald an eventual hike in US interest rates.

This broad based dollar rally saw the euro fall back as far as \$1.2056, with a breach of technical support at \$1.2350 intensifying selling pressures. Cable fell back below \$1.83, while dollar/yen stretched towards Y112. However, in the event, market expectations proved to be unfounded in both cases.

No only did the ECB leave interest rates on hold, the tone of its comments indicated that it was not about to make any change to official rates for the foreseeable future. Meanwhile, February's US payrolls more than disappointed coming in at just 21,000, compared to a forecasted rise of at least 130,000.



Disappointment on both fronts saw the dollar retreat to \$1.24 territory against the euro. However, while a move back below \$1.20 has been averted for now, **the euro's recovery post the ECB's decision and the payrolls number has been uninspiring.** Market reluctance to push it beyond the \$1.25 level suggests a growing lack of confidence in its ability to re-establish an uptrend.

Persistent softness in the US labour market (non-farm payrolls have disappointed for four consecutive months) means that interest rate differentials will be locked in favour of the euro for several more months, at least. **However, with buying momentum fading, we may have seen the peak of the euro at \$1.29.**

The US twin deficits could continue to act as a drag on the dollar over the longer term. **However, verbal intervention from Europe and continued speculation of a eurozone rate cut should contain any renewed euro appreciation.** Recent terrorist attacks in Europe could also impact.

Over the coming weeks we expect plenty of volatility, though there could be little movement outside recent ranges. The run up to the March's non-farm payrolls report (2 April) could be particularly volatile, depending on expectations. If markets anticipates a good number, \$1.20 could come under threat.

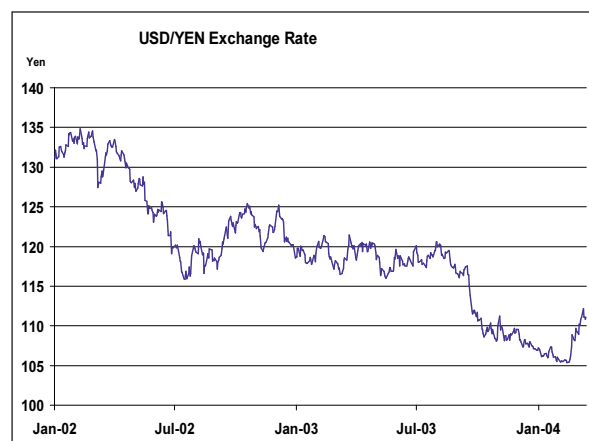
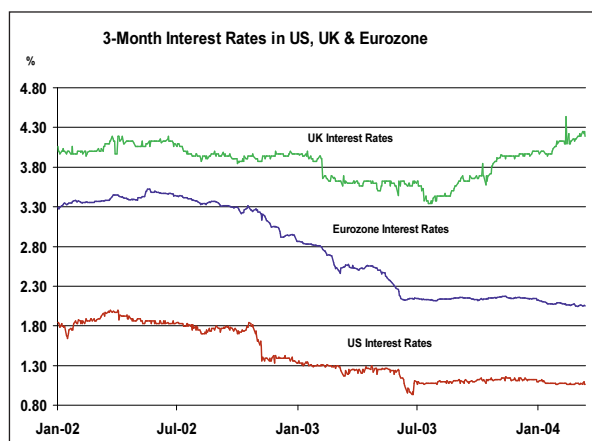
Moving beyond mid year, as markets begin speculating about higher US interest rates, this should lend some support to the dollar, leaving scope for a euro correction to \$1.15, but again fiscal imbalances in the US and the political environment could limit a dollar rebound.

Activity In Dollar/Yen Provides General Dollar Support

Apart from expectations for the US labour market and interest rates, **a major influence on forex levels over the coming weeks is likely to be movements in dollar/yen and the behaviour of the Bank of Japan.** Since mid February the dollar has traded in a Y105-113 range. This volatility largely reflects the intervention activities of the BoJ.

In the hours following the release of the February's payrolls the BoJ is reported to have carried out its largest ever one-day action to keep the yen from appreciating amid a broad based dollar sell-off. The scale of intervention not only provided support for the dollar/yen, but also prevented the dollar from falling further against a range of other currencies, including the euro.

Since then, the BoJ has scaled back in terms of its yen-selling operations, allowing the dollar move back towards the Y105 level, and leaving traders in a state of confusion as to the central bank's next move.



There is now some doubt as to whether large-scale intervention will continue post the Japanese fiscal year end on 31 March. However, if Y105 comes under threat the BoJ is likely to resume its activities.

In view of the potential for volatility our near-term forecasts account for a dollar/yen range of Y105-112 range. We still expect that the more optimistic outlook for the Japanese economy will exert upward pressure on the yen in the second half of the year, eventually pushing it through the Y105 level versus the dollar.

The euro's relationship with the yen, meanwhile, will continue to be primarily determined by its performance against the dollar. With the dollar/euro expected to stay in a \$1.18-1.28 range in the near-term, **we expect the yen/euro rate to trade in a Y130-140 range over much of the coming months.**

Euro Still At Risk From Stronger Sterling

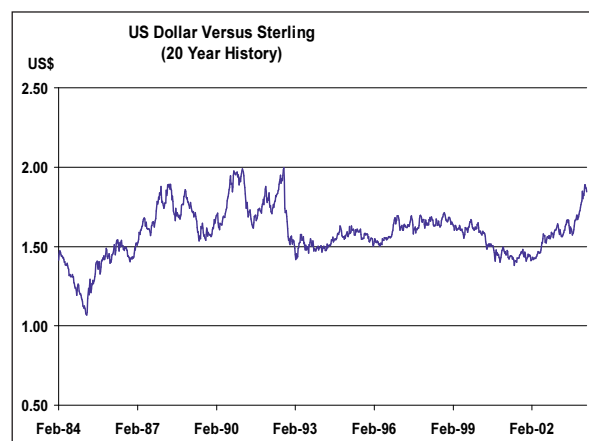
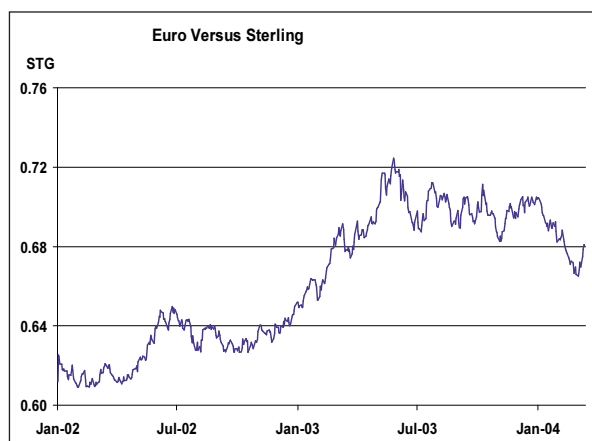
Sterling has been no less volatile over the past month. **With the euro falling towards \$1.20 against the dollar and cable taking support from speculation of a near-term rate hike in the UK, the sterling/euro rate came under significant pressure in early March, hitting a yearly low of Stg0.661p.**

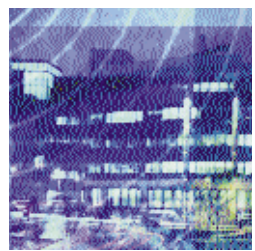
The subsequent modest recovery in dollar/euro and the release of weaker than expected UK manufacturing and trade data for January (which caused markets to pull back on expectations for a UK rate at the BoE meeting in April) saw a reversal in this position.

As the mood on UK rates changed, sterling lost considerable ground against a resurgent dollar, falling back to within a \$1.80-1.85 range, thus allowing the sterling/euro rate move back above the Stg0.67p level. With high yielders in general losing some of their appeal of late, sterling could be subject to further correction in the short-term.

However, on the basis of current expectations, by the end of the summer UK interest rates could be an additional 0.50% above those in the US and Europe. In addition, unlike dollar/euro, there are no "official" constraints on sterling to prevent gains versus the dollar. **Thus, sterling should continue to find strong support against the dollar and could again outperform the euro in the run up to the forthcoming BoE policy meetings, which could see a renewed test of support at Stg0.67p.**

Over time, sterling's rate premium should wane. As cable eases back over the second half of the year, there should be scope for the euro to move back to a Stg0.68-0.70p range. For now, however, expect plenty of volatility, with moves towards Stg0.66p representing good opportunities for sterling sellers.





KEY MARKET EVENTS

Week 1 <i>(22-26 Mar)</i>	March 26	Eurozone	German Ifo Business Survey (Mar) Focus remains primarily on US data but could have some short-term impact on euro.
	March 26	US	Michigan Consumer Sentiment Survey (Mar) Risk that consumer sentiment levels could start to slip back on concerns about US labour market.
Week 2 <i>(29-2 Apr)</i>	April 1	Eurozone	Manufacturing PMI (Mar) A key influence in terms of the outlook for the eurozone economy and interest rates.
		UK	Manufacturing PMI (Mar) Surveys continue to indicate recovery but pick-up is still absent from real data. Can upward momentum be maintained?.
		US	Manufacturing ISM/NAPM (Mar) Important for the dollar and US interest rate markets. Employment component will be closely watched in the run up to March's non-farm payrolls report.
	April 2	Eurozone	ECB Policy Meeting & Press Conference No change in official rates expected, with the tone of the press conference the main focus of attention.
	April 2	US	Non-Farm Payrolls (Mar) Will attract the usual level of attention and speculation. Another weak number could weigh heavily on the dollar.
Week 3 <i>(5-9 Apr)</i>	April 5	Eurozone	Services PMI (Mar) Markets will be looking for signs of further improvement to support eurozone recovery story.
		UK	Services PMI (Mar) Pace of activity in the services sector will be closely watched in the run up to the BoE meeting.
		April 7/8	US
	April 7/8	UK	BoE Policy Meeting (2-day) Risk of another rate hike but weakness in manufacturing should see MPC hold off until May.
Week 4 <i>(12-16 Apr)</i>	April 13	US	Retail Sales (Mar) An important number for the dollar. Can retail spending patterns be maintained in the event of ongoing weakness in the labour market?.
	April 14	US	Trade Balance (Feb) Given the focus on the current account, adverse movements in the trade balance could be negative for the dollar.

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