AIB Global Treasury
Economic Research

EXCHANGE RATE MONTHLY

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AIB Global Treasury Economic Research

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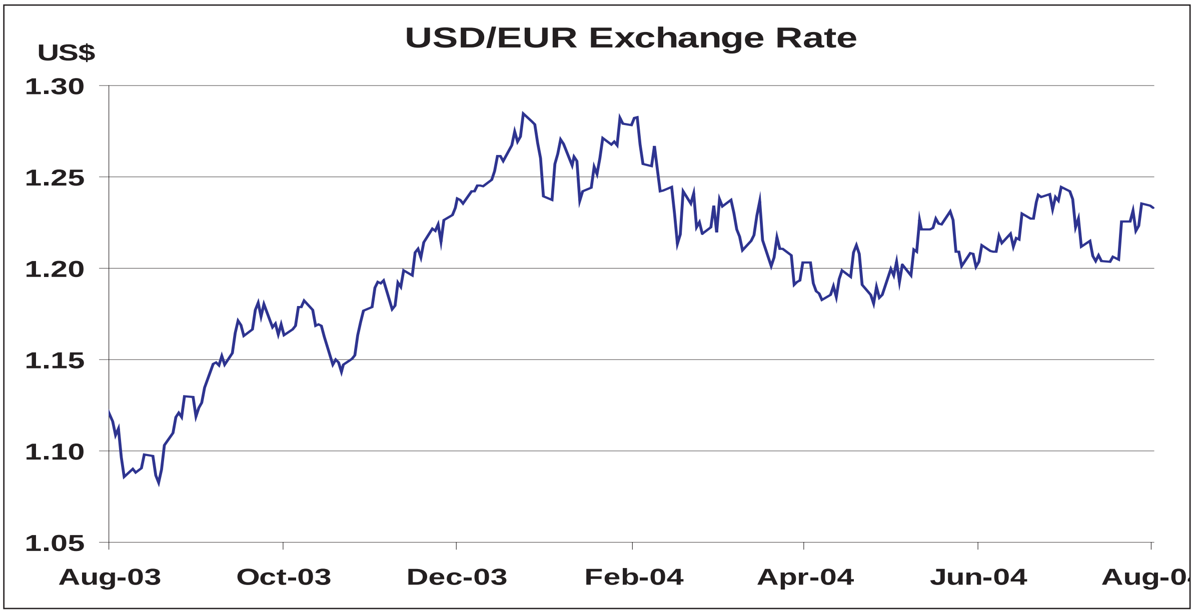
Dollar Weighed Down By Oil and US Employment

- After a second consecutive weak US monthly jobs report, the US dollar is under pressure from high crude oil prices, the slowdown in US economic growth and employment and questions about the extent to which the Fed will raise interest rates again in 2004. Markets now wait for the August US non-farm payrolls report on 3 September for direction.

- We expect the dollar to trade within the top half of a $1.20-1.25 range versus the euro in the short term. A break above $1.25 could occur on further jobs weakness in September.

- Sterling is drifting versus the euro. With a break of £0.66 off the agenda in the short term, some further sterling softness is likely versus the euro, towards £0.68 or higher, but the UK currency is well underpinned by high interest rates and a relatively robust economy.



Summary of Forecasts

Latest View

- EUR/USD to trade in $1.20 - 1.25 range in the near term. The outlook is dependent on the next jobs report on 3 September.
- Sterling is well supported but convincing rally below £0.66 versus euro proving elusive. A move to £0.68 or higher is possible.

Exchange Rates

Euro Versus	Range Over the Last Month	Current	Sep-Nov 04	Dec-Jan 05	Feb-Apr 05	May-Jul 05
			Forecast Range Over The Period			
USD	1.20-1.24	1.2325	1.20-1.25	1.18-1.23	1.20-1.25	1.20-1.25
GBP	0.66-0.68	0.6740	0.66-0.69	0.66-0.68	0.65-0.68	0.65-0.68
JPY	133-137	135.25	131-138	128-133	127-133	128-133
CHF	1.53-1.54	1.5345	1.53	1.53	1.54	1.55
NOK	8.28-8.51	8.3075	8.25	8.20	8.15	8.10
SEK	9.18-9.24	9.2150	9.20	9.15	9.10	9.05

Dollar Versus	Range Over the Last Month	Current	Sep-Nov 04	Dec-Jan 05	Feb-Apr 05	May-Jul 05
			Forecast Range Over The Period			
JPY	108-112	109.75	108-112	107-112	105-110	105-110
GBP	1.82-1.87	1.8220	1.80-1.85	1.80-1.85	1.82-1.87	1.82-1.87
CHF	1.23-1.28	1.2450	1.25	1.27	1.26	1.26
CAD	1.31-1.33	1.3060	1.30	1.29	1.28	1.28
AUD	0.70-0.73	0.7155	0.72	0.72	0.73	0.73

Official Interest Rates

	Current	Sept 04	Dec 04	Mar 05	June 05
		Forecast to End Period			
Euro Refi Rate	2.00	2.00	2.00	2.25	2.50
US Fed Funds	1.50	1.50	2.00	2.50	3.00
UK Base Rate	4.75	4.75	5.00	5.25	5.50
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	1.8	2.3	2.1	2.1	1.9
UK	2.2	3.5	3.0	1.4	1.5	1.8
Japan	2.5	4.1	2.0	-0.2	-0.2	0.0
Ireland	3.7	5.5	6.0	3.5	2.2	3.0

Our View In Brief

* **There is growing concern that geopolitical risks, particularly the ever increasing price of crude oil, are leading to a slowdown in the rate of global economic growth.** Markets point to a slowdown in China, some disappointing data out of Japan and clear evidence that the US economy is experiencing a break in its earlier robust expansion.

* **Brent crude oil prices averaged $40 per barrel over the past month, up from $36 per barrel in the previous month.** Every $10 per barrel rise in crude oil prices knocks 0.50% off OECD economic growth. However, the international economy is in a better shape in 2004 to absorb the impact of higher energy prices than in earlier years.

* Events in Iraq, and the risks from the wider war on terror, have left markets doubting the capacity of global equity markets to expand and the willingness of central banks to proceed with their tightening bias with the same degree of vigour as previously intended.

* **In the US, the Fed has raised rates by 0.25% on two occasions to 1.5%. Policy obviously remains very accommodative. Further tightening is now dependent on the outcome of the next non-farm payrolls report on 3 September. Another weak report would stall the Fed and send the dollar towards $1.25 versus the euro. However, there is still the chance that the Fed will push on with its policy of gradual tightening when the FOMC meets again on 21 September. As the outlook for employment is difficult to call, there is scope for increased dollar volatility over the next two weeks.**

* Looking further ahead, though we retain our negative bias on the dollar, we do not see the US currency moving above the $1.30 level versus the euro. **We tend to agree with the Fed that the US economy is experiencing a soft patch and that growth will pick up in Q4 '04.**

* As a result, the current easing in longer term interest rates should be reversed as markets anticipate a resumption of Fed interest rate tightening.

* **The ECB left official interest rates unchanged in August and we expect that it will do so over the remainder of 2004.** Euro area growth is picking up but there are significant downside risks to the outlook. On the other hand, euro area inflation, at 2.3%, is well above the ECB's target level of 2% but the Bank still believes that inflation will fall back below target in 2005.

* The Bank of England raised official interest rates by another 0.25% to 4.75% in August. Further tightening before end year cannot be ruled out. Indeed, we see scope for rates to rise to 5.25% by Q1 ‘05.

* **Sterling has had a mixed performance of late, easing against the euro. With the dollar expected to remain under pressure in the short term, it seems likely that the euro will outperform sterling, leading to a move above £0.68 or higher.**

19 August 2004

Interest Rate Environment

Fed Disposed Towards Further Tightening

* The Fed hiked rates again on 10 August, bringing the Fed funds rate to 1.5%. This is still a very accommodative level and is well short of neutral, despite the dampening impact of higher crude oil prices. The Fed is inclined towards further rate hikes before end 2004.

* However, the jobs report on 3 September will be crucial to the Fed's next move. After two disappointing months in June and July, another weak unemployment report in August would probably persuade the Fed not to hike rates at the next FOMC meeting on 21 September.

* Assuming that the Fed is correct in its view that the US economy is only experiencing a soft patch, we believe that the Fed will raise official rates to about 2% by end year. Longer term rates should also rebound from their recent dips.

ECB Should Hold at 2% in 2004

* Though the euro area is showing signs of economic recovery and inflation is above the ECB's inflation target of 2%, there is no compelling reason to raise official interest rates.

* The ECB would view the current level of official interest rates of 2% as accommodative but with domestic demand in the eurozone still under pressure, a low interest rate environment is needed to stimulate this key area of the economy.

* As in the US, longer term rates have eased in the euro area but upward pressures should re-emerge once US rates show signs of upturn.

Bank of England Still in Tightening Mode

* The Bank of England raised official rate to 4.75% in August, spurred on by the view that higher rates were needed to keep inflation close to the 2% target over the medium term. The Bank is being careful not to cause a sharp downturn in the housing market, though it is clear that it wishes to send cautionary signals to that sector.

* The Bank is expected to tighten again in the autumn, with rates probably reaching 5% by end year. Longer term rates should rebound in line with international trends.

US Interest Rates

	Current	Sept 04	Dec 04	Dec 05
Fed Funds	1.50	1.50	2.00	3.50
3 Month	1.73	1.80	2.30	3.75
1 Year	2.27	2.30	2.75	4.00
2 Year*	2.80	2.80	3.30	4.40
5 Year*	3.84	3.85	4.35	5.00
10 Year*	4.67	4.70	5.20	5.50

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rates

	Current	Sept 04	Dec 04	Dec 05
Refi Rate	2.00	2.00	2.00	3.00
3 Month	2.11	2.13	2.25	3.20
1 Year	2.28	2.33	2.50	3.40
2 Year*	2.64	2.65	2.85	3.75
5 Year*	3.46	3.50	3.70	4.50
10 Year*	4.18	4.20	4.40	5.00

** Swap Forecasts Beyond 1 Year*

UK Interest Rates

	Current	Sept 04	Dec 04	Dec 05
Repo Rate	4.75	4.75	5.00	5.50
3 Month	4.96	5.00	5.25	5.60
1 Year	5.24	5.30	5.50	5.75
2 Year*	5.23	5.35	5.55	5.75
5 Year*	5.33	5.45	5.60	5.80
10 Year*	5.33	5.50	5.65	5.80

** Swap Forecasts Beyond 1 Year*

Exchange Rate Outlook

KEY ISSUES

- ***Dollar Under Pressure:*** The dollar is under pressure from geopolitical concerns, particularly the surge in crude oil prices, and how these could impact on the US economy and on Fed interest rate intentions.
- ***Euro Gains from dollar's Woes:*** The euro has benefited from dollar weakness but upside limited by the relative softness of the euro economy and steady ECB rates.
- ***Sterling Faces Mixed Fortunes:*** The UK currency has weakened against the euro.

Dollar Under Pressure

The dollar has fluctuated within a $1.20 -$1.24 range versus the euro over the past month with increasing signs of downward pressure as confidence wanes over the outlook for the US economy. Recent signs that the dollar could break below the $1.20 level have given way to questions about its capacity to withstand a move above the $1.25 level.

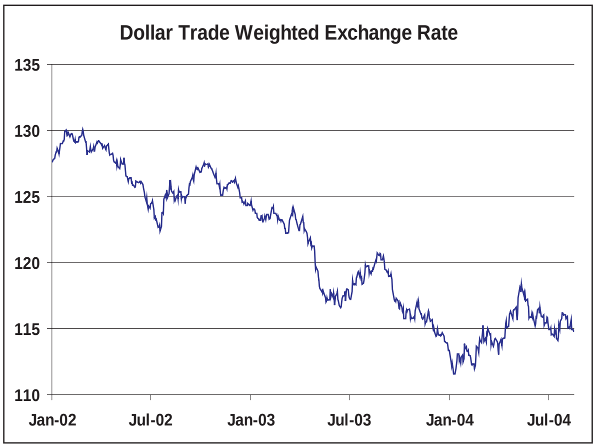
The dollar has been adversely affected by disappointing US economic news. This has had a negative effect on US equity markets and resulted in a fall in US longer term interest rates. There is now a lot less conviction about the strength of the US economic recovery and on how far the Fed will raise official interest rates.

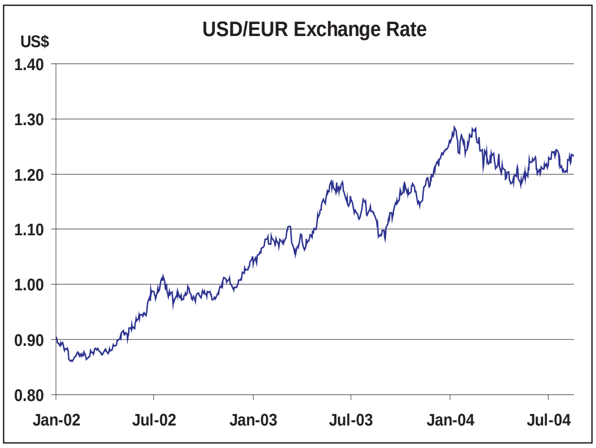
The main problem for the dollar in the short term is the constant threat from so-called geopolitical risks. Developments in Iraq have not gone according to plan and there is an ongoing risk that violence could escalate both within Iraq and the Middle East as a whole. The associated risks to oil supplies, against a backdrop of strong international demand, have kept a strangle hold on energy prices.

Though the US economy had shown a healthy rebound in activity up to the end of the first quarter of 2004, events since than have been less promising. Annualised GDP growth in the second quarter of 2004 was a disappointing 3%. Consumer spending was subdued and employment growth stalled in June. This weak employment trend was carried over into the third quarter.

Latest trade data for June, showing a significant deterioration in the trade deficit to $55.8 billion, also point to a worrying deterioration in the external account. On balance, the economy is shaping up for a relatively weak third quarter.

There is no doubt that the outlook for the dollar is now hanging on the release of the August non-farm payroll data, due on 3 September. After the weakness shown





by the June and July data, another poor figure for August would be very negative for the dollar. It would almost certainly lead the Fed to postpone further interest rate increases until after the Presidential election in November.

The current high level of crude oil prices is intensifying the deceleration in the pace of US economic growth. With moderate inflation, the Fed could afford to be patient in withdrawing its monetary accommodation.

The dollar, therefore, faces an extended period of uncertainty. Geopolitical risks are not going to abate anytime soon. The prospect of a sharp fall in crude oil prices is remote in the short term. Indeed, questions have to be asked as to whether oil prices will revert to sub $30 per barrel over the medium term.

The June trade deficit of $55.8 billion was another reminder of the risks to the dollar from the unsustainably high current account deficit. Problems financing this deficit would be very negative for the dollar.

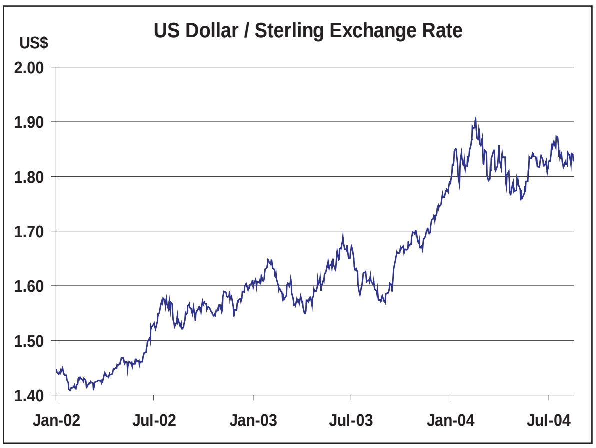
We expect the euro-US dollar rate to remain within the top half of a $1.20-1.25 range in the short term. If there is further weakness in US employment, the dollar could fall to over $1.25 versus the euro. Bear in mind that forecasts of monthly changes in US non-farm payrolls are subject to wide margins of error. The scope for a major surprise on 3 September is very wide.

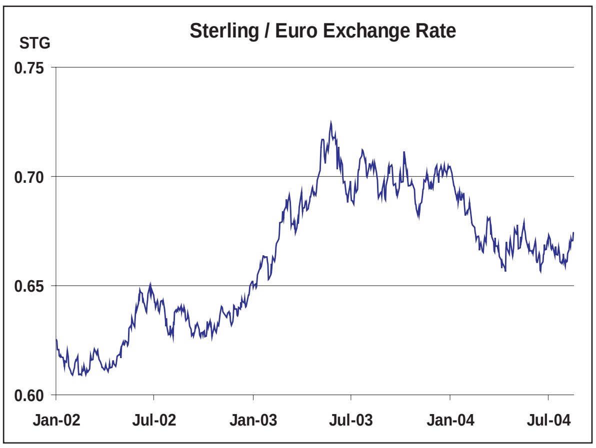
Sterling Well Underpinned by Economy and Interest Rates

Sterling continues to be well supported by a combination of relatively strong economic growth and the high level of official interest rates. The economy continues to perform well with real GDP up by 0.9% on a quarter-on-quarter basis in Q2'04.

The labour market continues to exhibit signs that there is little slack left in that sector which has raised fears that wage developments could heat up. As a result, the Bank of England has maintained upward pressure on official interest rates throughout 2004 to date.

The Bank raised official interest rates to 4.75% in August. The minutes show that this was a unanimous decision. However, the market now believes that the Bank will slow down the pace of rate increases and that official rates could peak at 5%. This has taken some of the steam out of sterling's recent gains.





On a trade weighted basis, sterling has risen by about 2% over the past three months. However, while it has gained against the US dollar, it is weaker versus the euro.

Repeated attempts by sterling to move below £0.66 versus the euro have failed to be sustained. On the other hand, there is little reason for sterling to weaken significantly versus the euro.

The ECB seems content to hold official rates unchanged at 2% against a backdrop of unspectacular domestic demand. The case for a stronger euro, therefore, is limited. It is more a case of greater euro gains versus the indifferent dollar performance that has resulted in the euro's gains against sterling.

In the short term, it seems unlikely that sterling will appreciate versus the euro. On the contrary, we see sterling trading close to the top half of a £0.66-0.68 range on a 1-3 month horizon with a risk of a break towards £0.69. Over the longer term, however, sterling should see some recovery back towards the £0.66 level.

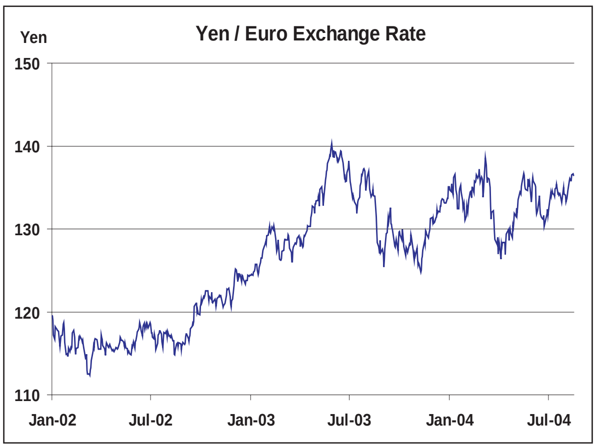
Yen Under Pressure as Economy Falters

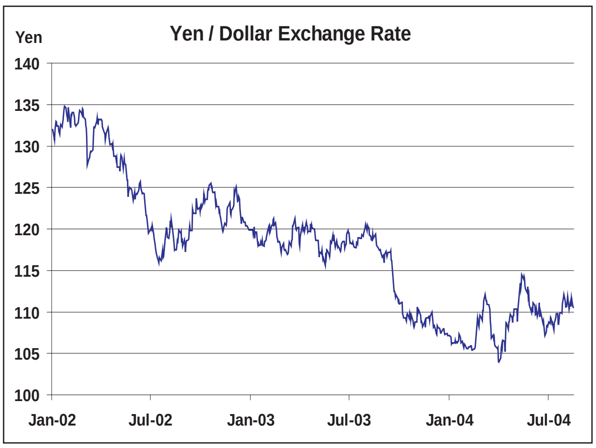
The US dollar is currently trading below the Y110 level versus the yen. The rate has moved down from the Y114 level in May to a low of Y107 in June. This occurred on the back of the strength of the Japanese economy and a strong Japanese equity market.

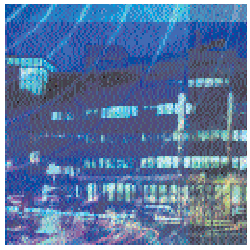
Since then, however, there have been some disappointing Japanese economic data and the stock market has stalled. The Nikkei 225 index is close to a three month low.

With economic uncertainty prevailing in both the US and Japan, there is no clear case for the US dollar-yen rate to move far from current levels. Over time, however, the yen should make some modest gains, with a Y107-112 range likely on a 3-6 month horizon.

The combination of our dollar-yen and euro-dollar forecasts lead us to believe that the euro-yen rate will move within a Y131-138 range in the near term. It should trade within a Y128-133 range on a 3-6 month horizon.







KEY MARKET EVENTS

Week 1 ***(23 - 27 August)***	**August 26**	**Eurozone**	**German Ifo Business Survey (August)** Lead indicator of the strength of German/Eurozone economy. Will high oil prices reverse July's improvement in sentiment ?
	August 27	**UK**	**GDP (Q2 First revision)** Chance that growth will be revised upwards from the 0.9% QoQ preliminary estimate, which was the fastest growth rate in four years.
	August 27	**US**	**GDP (Q2 First Revision)** The preliminary estimate indicated Q2 growth weaker than expected at 3.0% annualised, down from 4.5% in Q1.
Week 2 ***(30 August - 3 September)***	**August 31**	**Eurozone**	**HICP (August Flash)** Inflation eased slightly in July to 2.3% from 2.4% in June but high oil prices may impact in August.
	August 31	**US**	**Consumer Confidence (August)** Can confidence be sustained at July levels, which were the highest in over two years ?
	September 1	**Eurozone**	**Manufacturing PMI (August)** July data indicted that the external sector remains the key driving force to growth.
	September 1	**UK**	**Manufacturing PMI (August)** Sector expanded in July at fastest pace since October 1994. Will high oil prices impact in August ?
	September 1	**US**	**Manufacturing ISM (August)** Important lead indicator of the US economy. July data showed expansion continuing.
	September 2	**Eurozone**	**ECB Policy Meeting** Rates expected to remain on hold. Comments at press conference of interest as always.
	September 3	**US**	**Non-Farm Payrolls (August)** A crucial market number, especially after two disappointing months.
Week 3 ***(6 - 10 September)***	**September 8/9**	**UK**	**BoE Policy Meeting (2 day)** Rates likely on hold after August hike, but uptrend remains intact.
	September 10	**US**	**Trade Balance (July)** Very important for the dollar after the record deficit in June.
Week 4 ***(13 -17 September)***	**September 14**	**UK**	**Consumer Prices (August)** CPI rate running well below target unlikely to prevent further modest rate hikes.
	September 14	**US**	**Retail Sales (August)** July pick up in sales needs to be built on if economy to maintain its momentum.
	September 16	**US**	**Consumer Prices (August)** Fears that economy is weakening have tended to outweigh any evidence of upward price pressures.

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