AIB Global Treasury
Economic Research

EXCHANGE RATE MONTHLY

January 2004

Dollar Weakness to Persist

- Following a sharp rise in the opening weeks of 2004, the euro hit resistance above $1.285. The current correction could see a move back to $1.20 territory.

- The dollar, however, has been on a declining trend for the past two years. We look for this underlying trend to remain in place. Thus, a move by the euro beyond $1.30 is still possible (see page 5).

- Expectations of higher UK interest rates should continue to provide support for sterling and, with dollar weakness expected to remain a key feature, a rise to $1.90 (Stg0.70p to the euro) is not beyond possibility (see page 7).

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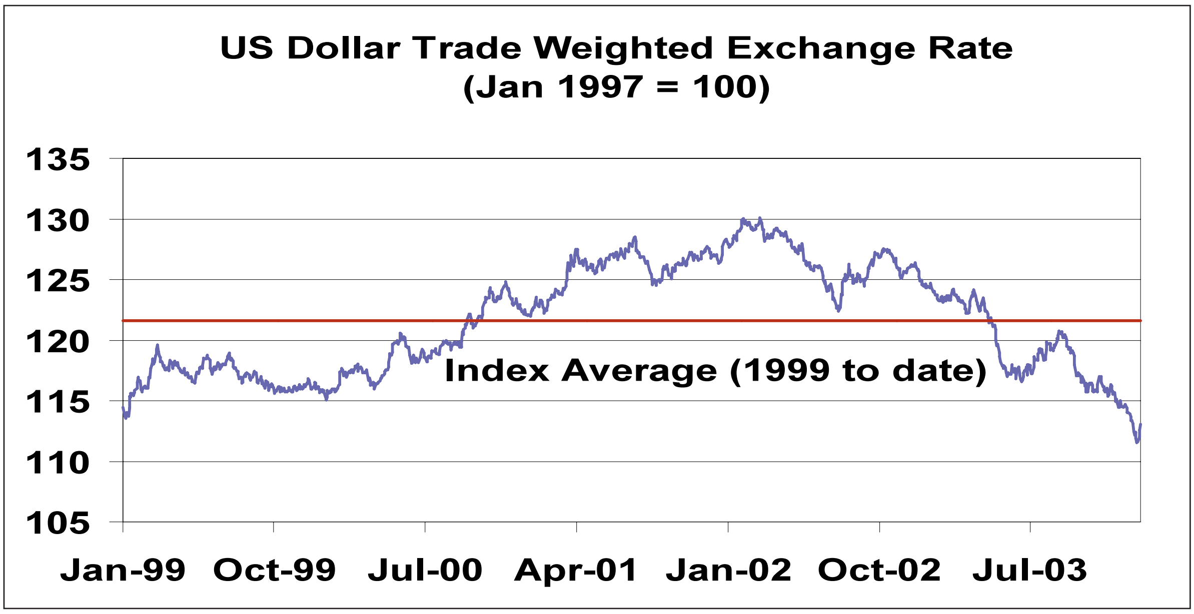


Summary of Forecasts

Latest View

- European officials talk euro down as it approaches $1.30 but upside momentum remains.
- The G7 meeting on 6-7 February could be a key event for forex markets.
- Sterling to retest the sub Stg0.69p versus the euro level as market anticipates early UK rate hike.

Exchange Rates

Euro Versus	Range Over the Last Month	Current	Forecast Range Over The Period: Jan-Mar 04	Apr-Jun 04	July-Sept 04	Oct-Dec 04
USD	1.22-1.29	1.2361	1.20-1.30	1.20-1.28	1.22-1.28	1.25-1.30
GBP	0.68-0.71	0.6915	0.68-0.70	0.69-0.71	0.69-0.71	0.69-0.71
JPY	132-137	132.57	128-135	128-135	128-135	128-135
CHF	1.55-1.57	1.5800	1.57	1.55	1.56	1.57
NOK	8.18-8.67	8.6030	8.60	8.50	8.40	8.30
SEK	8.96-9.19	9.1730	9.00	8.95	8.95	8.90

Dollar Versus	Range Over the Last Month	Current	Forecast Range Over The Period: Jan-Mar 04	Apr-Jun 04	July-Sept 04	Oct-Dec 04
JPY	106-108	107.25	103-108	103-108	102-107	100-105
GBP	1.74-1.86	1.7875	1.77-1.85	1.75-1.80	1.75-1.80	1.80-1.85
CHF	1.22-1.27	1.2782	1.25	1.25	1.24	1.23
CAD	1.26-1.34	1.3035	1.30	1.30	1.32	1.32
AUD	0.73-0.78	0.7571	0.76	0.75	0.74	0.74

Official Interest Rates

	Current	Forecast to End Period: Mar 04	Jun 04	Sept 04	Dec 04
Euro Refi Rate	2.00	2.00	2.00	2.00	2.25-2.50
US Fed Funds	1.00	1.00	1.00-1.25	1.75	2.25
UK Base Rate	3.75	4.00	4.00	4.25	4.50
Japan ODR	0.1	0.1	0.1	0.1	0.1

Growth and Inflation

	GDP			Inflation		
Y-on-Y% Change	2003	2004	2005	2003	2004	2005
US	3.1	4.8	4.0	2.3	1.6	1.7
Eurozone	0.5	2.0	2.5	2.1	1.7	1.8
UK	2.3	2.8	2.8	1.4	1.6	1.9
Japan	2.1	2.0	2.0	-0.2	-0.2	-0.2
Ireland	2.0	4.0	5.0	3.5	2.0	2.5

Our View In Brief

* **The recovery in the global economy continues to gather momentum**. Growth in the OECD area could reach in excess of 3.0% this year, the highest since 2000. The US economy is leading the way in this upswing, with growth in the UK also back above trend levels. Data from the eurozone continue to encourage but the recovery in activity is modest to date. Thus, we do not anticipate that GDP growth will rise above trend levels until Q4 2004.

* **There are risks, however, that geopolitical tensions could be a feature of global markets again in 2004.** This factor, combined with low inventories and strong supply management from OPEC, means that oil prices could stay close to $30 per barrel over the course of 2004.

* **Official interest rates in the US and Europe are expected to rise this year.** However, weak US labour market data could delay the Fed until mid-year. Given that the strength of the euro has already contributed to tighter monetary conditions in the eurozone, the ECB is unlikely to move before Q4-2004. Even then, policy tightening should be modest.

* The BoE is expected to persist with the tightening cycle which it initiated in November of last year, with another increase in UK rates seen this quarter. *For more details of our interest rate view, please see our new publication **Fixed Income Monthly Monitor,** available online at www.fxcentre.com.*

* Long-term interest rates have been in a tight range since the end of last summer. **US labour market data are currently the key influence on Fed policy and thus on international bond markets.** We expect the US labour market to improve over the coming months and thus believe that the Fed will tighten US interest rates considerably over the balance of the year. Thus, we look for US and European bond yields to rise in 2004.

* **Forex markets are extremely volatile. The outlook for the dollar continues to dominate fx markets, which we expect to remain volatile over 2004.** Currently pressurised by comments from eurozone officials, we see scope for a technical correction in the euro to the $1.20 level and possibly even below. However, downside pressures still exist for the dollar.

* **The euro could still have to bear the brunt of a longer-term dollar adjustment,** which could leave dollar denominated exporters exposed to a move to $1.30-1.35 territory. Sterling, meanwhile, should trade in a much tighter range against the euro. **The G7 meeting on 6/7February could have important implications for exchange rate trends.**

* **We do not envisage an ECB interest rate cut in order to weaken the euro. However, we see forex intervention occurring if the euro moves towards $1.35.**

20 January 2004

Interest Rate Environment

US Rates on Hold Until Summer

* The Fed moved closer to a neutral position at its last meeting in early December 2003, but also indicated that US rates can be maintained at low levels for some time yet.

* The key factor staying the Fed's hand is the sluggishness of the labour market. Thus, the trend in non-farm payrolls will be crucial. If payrolls start to show more robust growth over the coming months Fed tightening seems likely by mid 2004. The next set of payrolls data are due on 6 February.

* Markets are discounting some 0.50-0.75% of tightening in the US in 2004. We believe that the Fed will tighten by more than that and see official rates at 2.25% by year end. The first rate hike is possible in June.

US Interest Rates

	Current	Mar 04	June 04	Dec 04
Fed Funds	1.00	1.00	1.00-1.25	2.25
3 Month	1.10	1.15	1.50	2.60
1 Year	1.30	1.40	1.80	3.20
2 Year*	1.96	2.20	2.50	3.30
5 Year*	3.30	3.70	3.90	4.60
10 Year*	4.32	4.60	4.80	5.30

** Swap Forecasts Beyond 1 Year*

Trend in Euro Will Be Crucial for ECB

* The latest statement from the ECB suggests that eurozone interest rates may remain unchanged for a considerable period of time. Inflation is expected to decelerate moderately in 2004. It is likely to be the year end before GDP growth rises above trend and the euro should remain strong.

* Thus, we do not anticipate any change in official rates until late 2004, when we expect the refi rate to be raised by at least 0.25%. This is broadly in line with market expectations.

* Longer term rates in Europe will take their cue from the US. As we expect US yields to move higher over the year, eurozone yields should follow suit. US 10 year rates, however, should be above those in Europe by the year end.

Eurozone Interest Rates

	Current	Mar 04	June 04	Dec 04
Refi Rate	2.00	2.00	2.00	2.25-2.50
3 Month	2.10	2.10	2.10	2.70
1 Year	2.20	2.30	2.50	3.00
2 Year*	2.59	2.85	3.05	3.65
5 Year*	3.49	3.85	4.05	4.55
10 Year*	4.24	4.50	4.70	5.20

** Swap Forecasts Beyond 1 Year*

UK Rates to Rise Further

* The tightening cycle in the UK began last November. Further rate hikes are expected over 2004. The next move may be in February.

* UK growth is above trend, there is limited spare capacity and the housing market remains strong. Consumer spending has slowed but the underlying trend is still supportive of higher rates.

* The market expects base rates to be raised by 0.75% by year end. We agree but there is upside risk to this forecast.

UK Interest Rates

	Current	Mar 04	June 04	Dec 04
Base Rates	3.75	4.00	4.00	4.50
3 Month	4.02	4.20	4.30	4.75
1 Year	4.37	4.55	4.70	5.20
2 Year*	4.56	4.90	5.00	5.30
5 Year*	4.84	5.10	5.20	5.50
10 Year*	4.93	5.15	5.25	5.55

** Swap Forecasts Beyond 1 Year*

Exchange Rate Outlook

KEY ISSUES

- ***Euro Slips After Assault on $1.30:*** Recent comments from EU officials have dampened enthusiasm for a stronger euro bringing it back towards $1.20.
- ***But Dollar Weakness Still Dominates:*** Despite the current correction, downside risks remain, with US rates at low levels, the labour market still sluggish and the current account deficit a worry.
- ***Higher Rates Support Sterling:*** Sterling is benefiting from expectations of higher UK interest rates, which are already at relatively high levels.

Dollar Weakness to Remain Key Focus

The US dollar fell over 20% against the euro in 2003. **Still faced with downward pressures, we look for a weaker dollar trend to remain in place over the course of 2004. Thus, despite the euro's current correction, which could see it slip back to $1.20 and beyond, it could still test $1.30 over the medium term.** The performance of US economic data, particularly labour market trends, will be key.

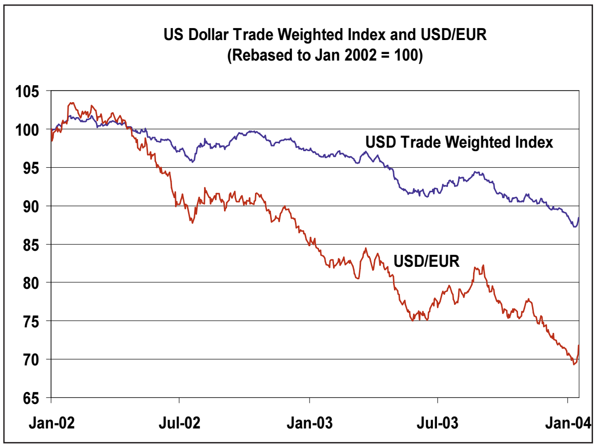
The dollar has been on a downward trend for two years. The recent performance of the US economy suggests that, at least, the dollar should have stabilised by now. However, US employment numbers continue to disappoint. **Thus, there is little prospect of a near-term rise in US interest rates.**

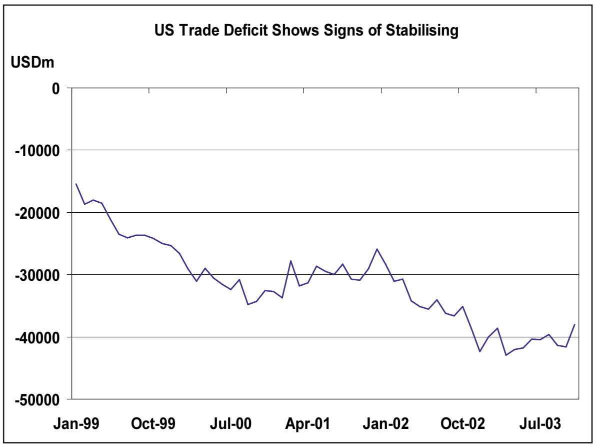
In addition to a protracted period of historically low interest rates, **the dollar continues to be dogged by concerns over the magnitude of the US current account deficit,** which in 2003 equated to some 5% of GDP.

Recent trends in US exports suggest that the deficit could stabilise this year. US net capital inflows for November also surprised on the upside. However, **further dollar weakness is necessary to bring the external imbalance back to a sustainable level** (judged to be in the region of 3.5% of GDP).

As Asian central banks persist with intervention and quasi fixed exchange rate regimes in order to prevent their currencies from rising against the dollar, **the euro (and Anglo-Saxon currencies) look set to continue to bear the brunt of this adjustment.**

The expeditious nature of the euro's rise towards $1.30 (which accelerated post the G7 meeting last September) has brought calls for lower eurozone interest rates, as well as speculation of forex intervention.





Intervention Not Expected Before Move To $1.30-1.35 Range

Recent defensive remarks from eurozone officials suggest that the authorities believe the euro has over-extended itself. However, there is no indication that direct action is imminent. The underlying objective appears to be to temper the pace of the euro's rise rather than prevent it. **Thus, we do not see forex intervention as a likely prospect lest the euro makes a sustained bid towards the $1.35 level.**

As for the US administration, it maintains its "strong dollar" mantra but at the same time has done little to thwart the dollar's fall, which equates to a 14% decline on a trade weighted basis over the last two years.

As noted earlier, this devaluation is already having a positive impact on US competitiveness and exports. **Facing into an election in November, there seems little political expediency for the current administration in attempting to avert this trend.**

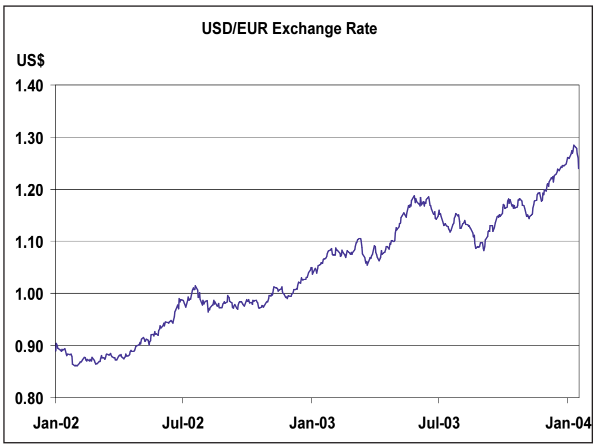
We expect the US economic recovery to continue and become more broad based over 2004. However, undermined by still low interest rates, a high current account deficit and a policy of benign neglect, there seems little prospect of a sustainable improvement in dollar sentiment.

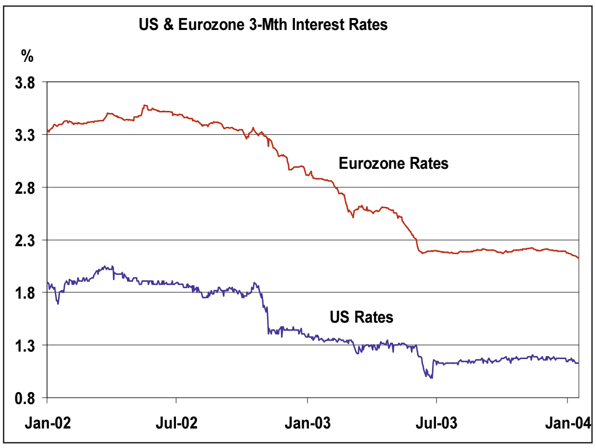
We would caution, however, that the euro has come a long way in a short space of time, which has left it open to correction. We are already seeing evidence of this. February's G7 meeting could bring further pressure. There is some speculation that the group will issue a communiqué aimed at realigning dollar weakness away from the euro exclusively.

It is not inconceivable that this correction could take the euro all the way back to the $1.20 region. Furthermore, by mid-year the US labour market should be showing more solid signs of recovery, with markets anticipating an imminent move by the Federal Reserve to tighten monetary policy.

Our central interest rate forecast incorporates a 1.25% rise in US rates over H2 2004. However, we expect that official interest rates in the US will still be below those in Europe at year end. Nevertheless, **the change in the stance of US interest rate policy should support any modest dollar recovery.**

However, given the US's central requirement for currency adjustment to offset structural imbalances, a dollar recovery may not be sustained over the second half of the year. Thus, we could see the euro moving back toward the $1.30 level before year end.





Sterling Follows Euro Higher

Sterling has surged versus the dollar. Broad based dollar weakness pushed the sterling/dollar rate to $1.86, levels not seen since 1992. In addition to the weak dollar story, sterling is being supported by expectations that the Bank of England will hike interest rates, from their already relatively high level, over the course of this year.

The tightening cycle in the UK is already running well ahead of the rest of the G3, giving sterling considerable advantage in terms of carry trades. Thus, there is scope for sterling to continue to test the upside. **A breach of $1.90 is conceivable within this framework, with the $2.0 level possibly even coming under threat if the euro moves towards $1.35.**

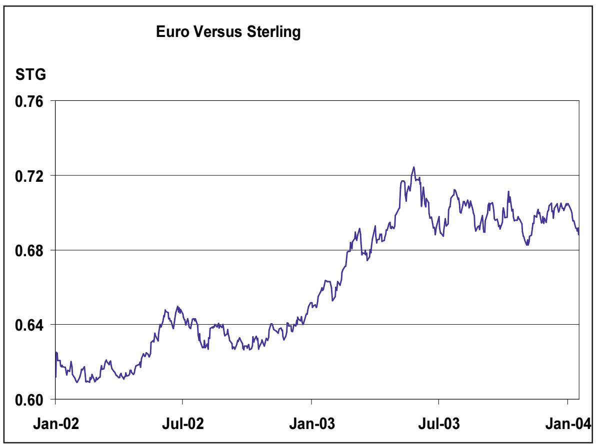
At these levels we would consider cable to be extremely overbought and vulnerable to a correction. We are already seeing evidence of this. The $1.90 level has only been breached three times in the last 20 years, followed on each occasion by an extended sell-off. With sterling's rally having recently run out of steam, it leaves the way open for a correction all the way back to $1.75, from the current $1.79 level.

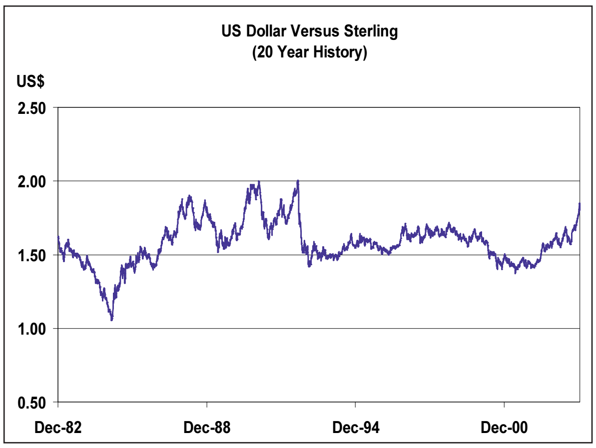
In addition to technical correction, sterling could be vulnerable to any weakening in perceptions about the ability of the BoE to hike interest rates over the year. The BoE's next inflation report, which is due for release mid February, will be important in terms of setting the tone for sterling. The trend in the euro will also be crucial for sterling. In the near-term, domestic politics could be important in settling the tone for the UK currency.

Notwithstanding some outperformance versus the dollar since the beginning of the year (on the back of higher UK interest rates), **sterling has traded in a tight range against the euro over the past six months. We expect this general trend to continue in 2004, with the euro maintaining a Stg0.68-0.71p range over much of the period.** Expectations of a UK rate hike in February, however, could see sterling strengthen to below Stg0.69p in the short-term.

Yen Confined to Tight Range Despite Fundamentals

Japanese economic fundamentals are improving. This implies that the yen should be appreciating across the board. However, official intervention has played a big role in keeping the yen in a tight trading range versus the dollar. We expect the dollar/ yen to remain in a tight range, though with a bias to dollar downside. The euro, meanwhile, should continue to be supported by its performance against the dollar. Therefore, we expect the yen/euro rate to be in a 125-135 range over the year.





KEY MARKET EVENTS

Week 1 ***(19-23 Jan)***	**January 21**	**UK**	**Minutes of MPC Meeting (7/8 Jan)** The MPC's comments on interest rates and the economy will be important for sterling. Watch for the voting pattern.
	January 22	**Eurozone**	**ECB's Monthly Bulletin (January)** After recent comment from Mr. Trichet, any reference to the impact of the euro will be closely watched by forex markets.
	January 23	**UK**	**Q4 GDP (1st Estimate)** Is the economy showing sufficient momentum to support the view that interest rates will be raised again in February.
Week 2 ***(26-31 Jan)***	**January 27/28**	**US**	**FOMC Meeting (2 day)** No rate change expected but watch for any change in the tone of Fed's statement.
	January 28	**UK**	**Hutton Report Due for Release** This politically sensitive release could have implications for sterling.
	January 29	**US**	**FOMC Minutes of MPC Meeting (9 Dec)** May be overshadowed by the meeting earlier in the week but should still provide some insights into Fed thinking.
	January 30	**US**	**Q4 GDP (1st Estimate)** GDP growth expected to be strong, should provide some US$ support but labour market continues to overshadow.
Week 3 ***(2-6 Feb)***	**February 2**	**US**	**ISM (NAPM) Survey** A strong leading indicator. Will be important for the dollar.
	February 5	**Eurozone**	**ECB Meeting and Press Conference** No change in rates expected but the post meeting press conference will be important. Watch for comments on euro.
	February 4/5	**UK**	**BoE Policy Meeting (2 day)** Rates could be raised by another 0.25% to 4.0% putting the BoE well ahead in tightening cycle.
	February 6	**US**	**Non-Farm Payrolls (Jan)** Another disappointing number would weigh on the dollar.
	February 6/7	**US**	**G7 Meeting** Much speculation that group will make pointed remarks on forex movements.
Week 4 ***(8-14 Feb)***	**February 11**	**UK**	**Quarterly Inflation Report** Important event for sterling and UK interest rates.
	February 12	**US**	**Greenspan's Testimony to Congress (Semi-Annual)** Formerly known as Humphrey-Hawkins, this will be important event for US markets.
	February 12	**US**	**Trade Balance (December)** Any further improvement in the trade balance should be dollar positive.

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