AIB Global Treasury
Economic Research

EXCHANGE RATE MONTHLY

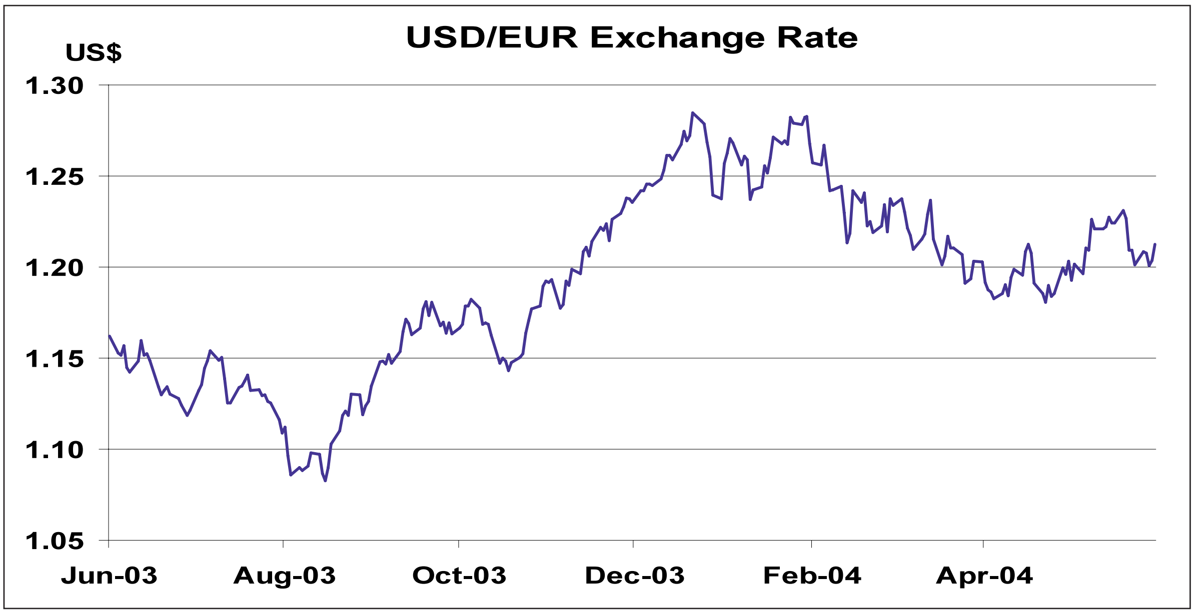
June/July 2004

Dollar Awaits Fed and Iraq

- The dollar's short term outlook is dependent on Fed policy at the end of the month and the success of the handover of sovereignty in Iraq, also at end month. We expect the EUR/USD to remain within $1.18-1.23 over the summer (see page 6).

- Sterling is well supported by a sound economy and relatively high interest rates. However, domestic political concerns and Iraq leave the currency vulnerable. A sustained break below £0.66 versus the euro hangs in the balance (see page 6).

- The Fed is forecast to hike official US interest rates by 0.25% at end June, marking a turning point in policy (see page 4).



AIB Global Treasury Economic Research

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Summary of Forecasts

Latest View

- EUR/USD to trade within narrow range of $1.18 - 1.23.
- Fed to hike rates by 0.25% at end June.
- Sterling is well supported but convincing rally below £0.66 versus euro still in doubt.

Exchange Rates

Euro Versus			Forecast Range Over The Period			
	Range Over the Last Month	Current	July-Sep 04	Oct-Dec 04	Jan-Mar 05	Apr-Jun 05
USD	1.19-1.23	1.210	1.18-1.23	1.17-1.22	1.20-1.25	1.18-1.25
GBP	0.65-0.67	0.6595	0.65-0.67	0.65-0.67	0.64-0.67	0.65-0.68
JPY	131-136	131.30	128-135	128-135	128-133	125-130
CHF	1.51-1.54	1.510	1.55	1.53	1.55	1.55
NOK	8.18-8.37	8.365	8.30	8.25	8.15	8.10
SEK	9.07-9.18	9.145	9.15	9.05	9.00	8.90

Dollar Versus			Forecast Range Over The Period			
	Range Over the Last Month	Current	July-Sep 04	Oct-Dec 04	Jan-Mar 05	Apr-Jun 05
JPY	108-113	108.55	105-110	105-110	103-108	100-105
GBP	1.77-1.84	1.8345	1.80-1.85	1.80-1.85	1.85-1.90	1.80-1.85
CHF	1.24-1.28	1.2475	1.28	1.27	1.27	1.30
CAD	1.35-1.38	1.3665	1.36	1.37	1.35	1.34
AUD	0.69-0.70	0.6900	0.69	0.69	0.70	0.71

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	1.25	1.75	2.25	2.75
UK Base Rate	4.50	4.50	4.75	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	3.1	4.7	3.7	2.3	2.5	2.0
Eurozone	0.4	1.9	2.5	2.1	2.1	1.8
UK	2.2	3.0	2.8	1.4	1.5	1.9
Japan	2.7	3.8	2.0	-0.2	-0.1	0.0
Ireland	1.4	4.0	5.0	3.5	2.2	3.0

Our View In Brief

* **The global economic recovery remains strong and widespread.** Growth in the OECD area is forecast at 3.4% in 2004 and 3.3% in 2005. In the first quarter of 2004, real GDP growth in the OECD was 3.6% on an annualised basis, the same as in Q4'03. Survey and other data indicate a strong performance in the current quarter.

* Geopolitical factors continue to pose significant threats to the international economy and to the stability of financial markets.

* **Oil prices continue to pose a risk to the global economic and inflation outlook. We expect crude oil prices to remain in excess of $30 per barrel in 2004.**

* **We are well into a turning point on official interest rates.** The Bank of England raised rates again in June with more to come in the second half of the year. Of more significance, the US Federal Reserve is expected to begin a process of tightening when the FOMC meets at the end of June. **We expect the first increase to be limited to 0.25%, though we see a case for 0.5%.**

* **The Fed continues to talk in terms of "measured" movements in official interest rates. Nevertheless, we expect that the Fed funds rate will be 2.25% by the end of the year.** This would still represent a very accommodative monetary policy. Further tightening is anticipated in 2005.

* **We are also at a turning point on inflation.** As Alan Greenspan noted recently "with concerns of deflation now presumably behind us" market attention has turned to measuring the risks of inflation. What we are seeing is a pick-up in the annual rate of inflation in most countries but from very low levels. The re-acceleration of inflation has been quickened by the impact of higher oil prices. Central banks are on heightened inflation guard but there is no need for panic.

* **The ECB should hold rates at 2% until early 2005.** The ECB will watch unfolding international and euro area events, with some increased risk that it could be persuaded to hike rates before the end of the year. However, with so many geopolitical risks, downside risks to the dollar and plenty of spare capacity in the eurozone, any increases in official interest rates should be postponed until 2005.

* **The dollar remains the key to international fx markets.** We continue to be cautious about the outlook for the dollar. **We see $1.18-1.23 versus the euro holding in coming months.** Sterling should also stay strong versus the dollar within a $1.80 - 1.85 range.

* The UK's relationship with the EU is up for grabs after the EU parliamentary elections and depending on the reaction to the terms of the new draft EU Constitution. In the short term, sterling should continue to test £0.66 versus the euro. It has broken through this level but so far has failed to sustain its rally.

22 June 2004

Interest Rate Environment

Fed to Tighten at End June

* It is a near certainty that the Fed will raise official rates when the FOMC meets on 29/30 June. The Fed funds rate will be raised from its current 1% to either 1.25% or 1.50%. There is a greater likelihood of the former after recent inflation data and comments from the Fed Chairman.

* We expect that the Fed Funds rate will be increased further in the second half of 2004, with 2.25% in prospect by end year. As such, this would still represent a very accommodative level of official interest rates. Further increases are forecast for 2005 as rates are brought up to a more neutral level (see table opposite).

* Longer term rates have been anticipating higher official rates for some time. The spread between 3 month rates and 5 and 10 year swap rates is wide, but the gap should narrow over the balance of the year.

ECB Should Hold at 2%

* There is always a risk that rising interest rates in the US and elsewhere plus high headline inflation in the eurozone will influence the ECB to tighten policy in the euro area. However, in view of the relatively weaker state of the eurozone economy, high unemployment and the strength of the euro, the ECB is likely to be persuaded to hold off until 2005.

* We expect official rates to stay at 2% until Q1'05 and to rise to 3% by end 2005.

* The euro yield curve is steep, and could steepen more in the short term, before flattening occurs in 2005.

Bank of England has More to Do

* The BoE raised rates again by 0.25% to 4.5% in early June. This was a cumulative rise of 1% since last November. With little spare capacity in the UK economy, the Bank is concerned about the outlook for inflation over the medium term.

* More rate hikes are on the cards this year and into 2005. We look for rates to move to 5.25% by end 2004 and to 5.5% in Q1'05. This could represent a peak. Longer term rates may rise moderately from current levels.

US Interest Rates

	Current	Jun 04	Dec 04	Dec 05
Fed Funds	1.00	1.25	2.25	3.75
3 Month	1.53	1.55	2.55	3.95
1 Year	2.35	2.40	3.10	4.40
2 Year*	3.20	3.20	3.80	4.60
5 Year*	4.39	4.45	5.00	5.10
10 Year*	5.20	5.25	5.60	5.70

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rates

	Current	Jun 04	Dec 04	Dec 05
Refi Rate	2.00	2.00	2.00	3.00
3 Month	2.12	2.15	2.25	3.25
1 Year	2.44	2.45	2.60	3.75
2 Year*	2.97	3.00	3.30	4.00
5 Year*	3.82	3.85	4.20	4.70
10 Year*	4.49	4.50	4.80	5.20

** Swap Forecasts Beyond 1 Year*

UK Interest Rates

	Current	Jun 04	Dec 04	Dec 05
Repo Rate	4.50	4.50	5.25	5.50
3 Month	4.82	4.85	5.35	5.70
1 Year	5.37	5.40	5.60	5.75
2 Year*	5.45	5.50	5.70	5.85
5 Year*	5.58	5.60	5.80	5.90
10 Year*	5.55	5.55	5.75	5.80

** Swap Forecasts Beyond 1 Year*

Exchange Rate Outlook

KEY ISSUES

- ***Doubts remain about the direction of the US dollar:*** The dollar is supported by the prospect of higher US interest rates but undermined by geopolitical factors and the US external deficit.
- ***Euro helped by eurozone economy:*** The euro has been helped by the tentative signs of recovery in the economy.
- ***Sterling in healthy position:*** The UK's sound economic performance, coupled with the widening interest rate gap, has benefited sterling. This should continue.

Dollar Remains the Centre of Attention

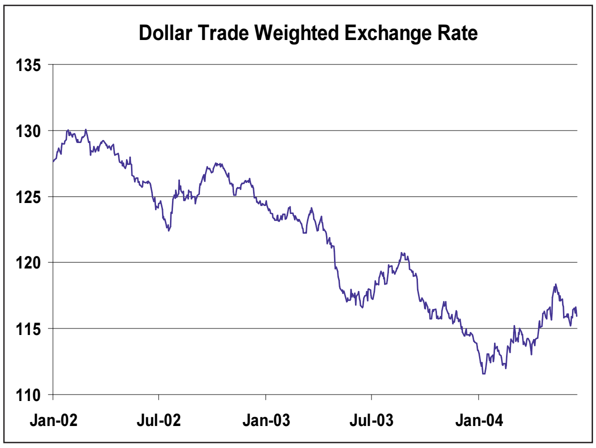
The outlook for the US dollar remains the key driver of global currency markets. The higher than expected US trade deficit for April of $48.3 billion compared with $46.6 billion in March and the Q1'04 current account deficit of $145 billion are reminders that the US continues to face an unsustainable external imbalance.

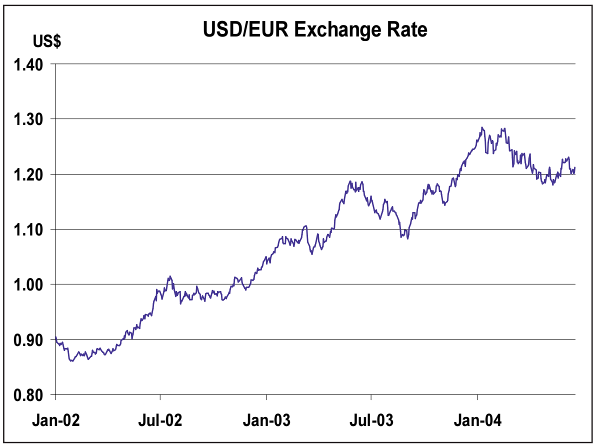
Despite some recent changes in underlying conditions in the US and in the rest of the global economy, the only guaranteed way of bringing the US trade and wider current account deficits down to more sustainable levels is by means of a significant fall in the value of the dollar.

This remains a major risk to the dollar over the next twelve months. **As a result, we continue to be cautious about the outlook for the dollar**, notwithstanding the strong US economic performance. **We do not see a case for a sell-off to below $1.30 versus the euro but we are equally doubtful of the prospects of a sustainable rally above $1.15.**

On a broad trade weighted basis, the dollar fell by 14% between its peak in February 2002 and January 2004. However, since then, the dollar has appreciated so that the cumulative fall in the dollar from its peak to ate is only 9%. The dollar's downward adjustment, of course, is hampered by the continuation of market intervention policies in Asia. The risk is, therefore, that if further dollar adjustment is sought by the markets, the options will be limited and focused on the euro and other European currencies, such as sterling and the Swiss franc.

In the short term, the outlook for the dollar will be determined by geopolitical events, particularly developments in Iraq and the wider Middle East. Fears about oil supplies will also weigh on the market, though the recent easing of crude oil prices has temporarily taken some of the sting out of this factor. The successful adoption of a UN Resolution on Iraq also took some of the pressure off the dollar.





Dollar Would Benefit from More Aggressive Fed Action

The US currency was also helped by some strong US economic data, such as employment and ISM surveys. Along with the pick-up in inflation, the upbeat US economic outlook has convinced the markets that the US Federal Reserve will raise official interest rates **when the Federal Open Market Committee (FOMC) meets on 29/30 June.** At this stage, a rate increase is a certainty; the debate is about the magnitude of the hike. The **Fed is expected to move by 0.25% but the dollar would benefit from a larger increase of 0.5%. This still remains a possibility.**

It should be noted that currency markets have remained very volatile and there is no reason to expect any less volatility in the next few months. The EUR/USD rate has ranged between $1.19-1.23 over the past month while cable has traded within $1.77-1.84. The EUR/GBP rate has moved within a £0.655-0.67 band.

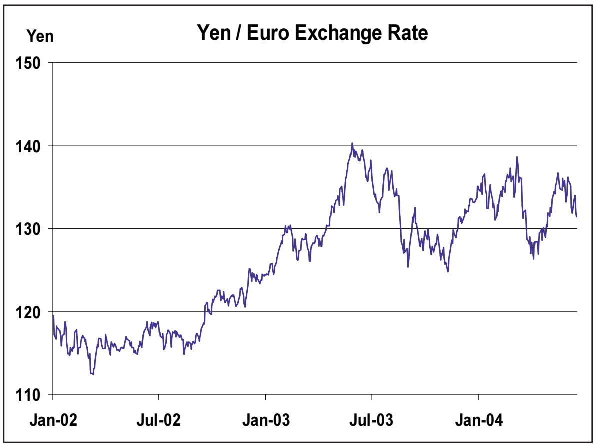
The risks and uncertainties surrounding the short term economic and political outlook are not much different than in the recent past. This should stabilise the dollar within a $1.18-1.23 range against the euro and within $1.80-1.85 versus sterling over the next three months. The dollar should also trade within a Y105-110 range versus the Japanese yen.

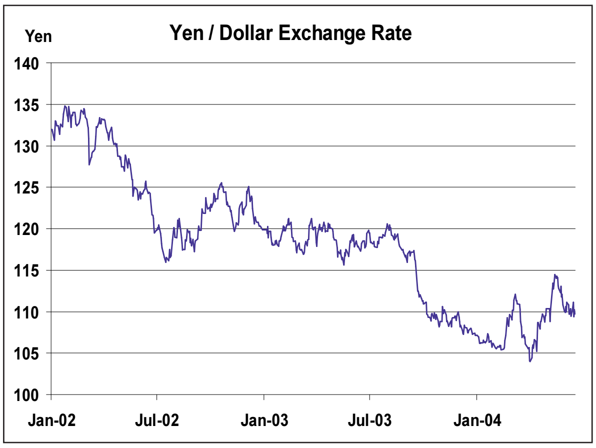
Sterling Supported by Strong Fundamentals

The latest available GDP data for the UK economy showed quarter-on-quarter growth of 0.6% in Q1'04. This is close to trend growth on an annualised basis. However, the economy had been growing at an even faster pace. More recent estimates of UK GDP and of manufacturing output point to a re-acceleration of growth back above trend.

The UK labour market is also very strong, indicating that the economy has little spare capacity. This raises fears that continued above trend growth could exert upward pressure on UK wage costs and on CPI inflation. With buoyant consumer demand and growing concerns about house price inflation, the Bank of England has been tightening policy as a pre-emptive move against the build-up of inflationary expectations. It has raised official interest rates on four occasions since last November bringing the official rate from a low of 3.5% to 4.5%.

The Bank has indicated that it has more to do. **Rates are expected to reach 5-5.25% by end 2004 and could climb higher in 2005.** However, this should be sufficient to maintain the medium term path of UK inflation close to the 2% target.





It may have less of a dampening impact on the housing market. Nevertheless, there are reasons to believe that the housing market will soon find a new equilibrium, without the need for any serious setback to prices.

This scenario is generally positive for sterling. Though the UK is clearly identified as a partner of the US in Iraq, sterling is likely to be a beneficiary of any flight to quality in the event of the dollar suffering from geopolitical risks. The latter obviously remain high in the short term. Sterling should also benefit from the relatively high level of short and longer term UK interest rates.

As we are generally cautious about the dollar, **we see sterling staying strong against the US dollar in the $1.80-1.90 range over the medium term.** More detailed forecasts are on page 2.

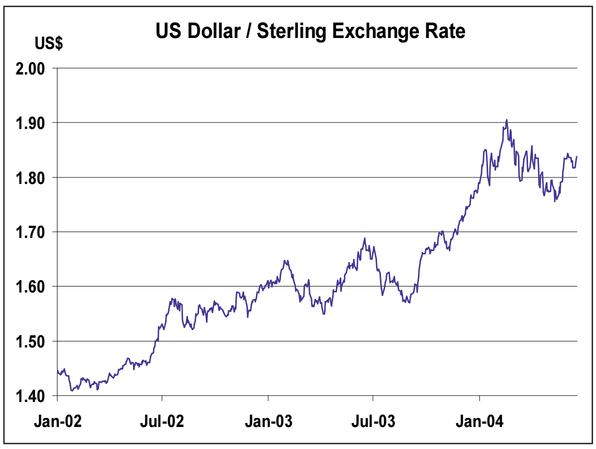
Sterling's relationship with the euro is heavily influenced by the relative performance of the pair against the US dollar. **The UK economy is clearly outperforming the eurozone and the interest rate differential is widening in favour of sterling. These factors should strengthen sterling against the euro.** However, the importance of these economic drivers is occasionally affected by the volatility of the dollar and the immediate market reaction.

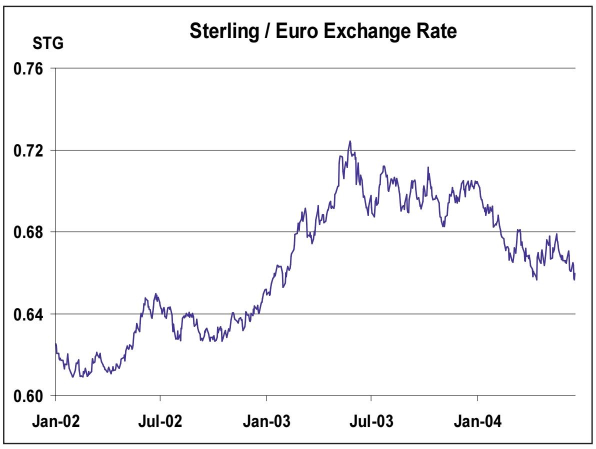
As a result, repeated moves by sterling to sustain a break below £0.66 have failed. Fresh attempts to move in this direction are likely in the months ahead but a break to lower levels below £0.65 may be more difficult. There is also the question of the UK's wider relationship with the EU and how this will affect investor sentiment. On this, the jury is out.

Yen Should Gain on Economic Upturn

The dollar-yen exchange rate has been very volatile, though the current level of near Y108 more accurately reflects the economic performance of the US and Japanese economies. The latter has grown very strongly in late 2003 and into H1 2004. Growth in real GDP reached 6.1% on an annualised basis in Q1'04. The Japanese authorities have indicated that they will maintain their current relaxed monetary policy, which should support the recovery in the economy.

We see scope for the yen to appreciate against the dollar in the months ahead, though the market may be volatile. The dollar-yen rate is forecast to trade within Y105-110 over the next three months and to move to a Y100-105 range beyond that. Taken in conjunction with our euro-dollar forecasts, this implies that the euro-yen rate will move within Y128-135 in the short term and within a similar range on a 3-6 month horizon.





KEY MARKET EVENTS

Week 1 ***(21-25 June)***	**June 23**	**UK**	**Minutes June MPC Meeting** Strength of vote for rate hike and MPC members inflation concerns are of considerable interest.
	June 24	**Eurozone**	**German Consumer Prices (June)** The first June inflation number. High energy prices saw headline inflation pick up sharply in May.
	June 25	**Eurozone**	**German Ifo Business Survey (June)** Lead indicator of the strength of German/eurozone economy. Can improvement of recent months be maintained?
Week 2 ***(28 June - 2 July)***	**June 29**	**US**	**Consumer Confidence (June)** Data has yet to fully reflect the improved US labour market situation.
	June 30	**Eurozone**	**HICP (June Flash)** Will there be any easing in inflationary pressures after the HICP spiked up to 2.5% in May on higher energy prices?
	June 29/30	**US**	**FOMC Policy Meeting (2 Day)** Rate increase almost guaranteed. Debate centres on whether the Fed will hike by 0.25% or 0.5%.
	July 1	**Eurozone**	**Manufacturing PMI (June)** Can May's improvement, which hinted at a strengthening in eurozone demand, be maintained?
	July 1	**UK**	**Manufacturing PMI (June)** Recent strength has at last been confirmed by official data.
	July 1	**US**	**Manufacturing ISM (June)** Important lead indicator of US economic activity.
	July 2	**US**	**Non Farm Payrolls (June)** Another solid number would underline the labour market recovery.
Week 3 ***(5-9 July)***	**July 6**	**UK**	**Industrial Production (May)** Manufacturing output surged in April, after having fallen in Q1, at last reflecting the strength of survey data.
	July 7/8	**UK**	**BoE Policy Meeting (2 Day)** While trend still upwards, rates expected to remain on hold after 0.25% hikes at both May and June meetings.
Week 4 ***(12-16 July)***	**July 13**	**UK**	**Consumer Prices (June)** Will inflation ease back after the June spike upwards on higher energy prices?
	July 13	**US**	**Trade Balance (May)** Given the continuing focus on the current account, an important event after the poor April data.
	July 14	**US**	**Retail Sales (June)** Consumer demand vital if economy is to maintain its momentum.
	July 16	**US**	**Consumer Prices (June)** Core CPI was relatively well behaved in May but inflationary pressures expected to build in H2 2004.

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