Focus on Markets

Ulster Bank

- While the US economic outlook has firmed slightly in recent months, growth expectations in Europe have been hit hard by the debt crisis, with the euro area now likely back in recession
- Recent ECB action on interest rates and especially liquidity has eased market tensions and helped stem the slide in the real economy
- But solvency concerns persist and it is difficult to be confident that the worst of the crisis has passed
- So we expect further policy action will be needed including further rate cuts from the ECB, and more QE from the Bank of England and Fed
- The euro's recent relief rally may have further to go, but we expect it to come under renewed downward pressure in the months ahead

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Overview

The intensification of the euro debt crisis last summer resulted in a major deterioration in European financial conditions. Broad-based strains across debt, equity and money markets quickly became evident as the crisis spread to the core of the euro zone, in the process triggering a slide in measures of economic confidence and real activity. Available survey evidence indicates the euro zone contracted in the final quarter of last year, likely heralding a lapse back into recession.

In fairness, while the politicians have found it difficult to keep pace with developments, the ECB has upped its policy response materially in recent months. While the ECB may have disappointed markets with a signal in December that it was not (yet at least) willing to significantly increase its purchases of government debt and act as a direct backstop for the sovereign debt market, the December meeting did bring the announcement of a second consecutive interest rate cut and also that the ECB would for the first time offer liquidity to banks for a three-year term, against a much expanded pool of collateral and in unlimited size, and at a rate of 1%.

Significantly, its actions on the liquidity front demonstrate the ECB's strong willingness to act as an effective lender of last resort for the banking sector. The take-up of the first long-term refinancing operation (LTRO) was strong at almost €490bn. And it has certainly contributed importantly to an easing of market tensions both directly via the additional supply of liquidity, as well as indirectly via the important insurance it has provided against the possibility of a bank funding mishap, thus helping to contain one key source of risks to the financial sector, and by extension to the real economy. Moreover, the LTRO has also indirectly provided support for sovereign debt markets, as the cheap liquidity has at least partly been used it seems by banks to buy higher-yielding government paper, helping to generate some badly-needed virtuous circle dynamics between bank and sovereign funding markets.

In addition, there are also some signs of a less negative dynamic emerging in the euro area real economy. Notably, the composite PMI has managed to rise in each month since a highly disconcerting plunge in October and got back above 50 in January suggesting reduced risks of a severe recession.

Such developments are certainly significant in their own right and offer important encouragement that the ECB has succeeded, for now at least, in stabilising some vulnerable segments of the macro-financial environment. However, the expansion of ECB liquidity, welcome as it is, still leaves unresolved the issue of sovereign insolvency. Any deal between Greece and its private creditors will carry non-trivial implementation risks linked for example to the level of investor participation. Moreover, even such a deal gets through, Greek still faces a prospective peak debt/GDP level of 120% or more. And even that assumes full implementation of all planned fiscal correction measures, where the Greek track record to date leaves little room for conviction on their ability to deliver the required adjustment. In addition, market confidence in Portugal has near-on evaporated in recent weeks, with current CDS pricing implying a probability of a restructuring of around 70%.

This means that markets remain vulnerable to contagion risks linked to possible further debt restructurings and we think concerns about solvency and downside growth risks are likely to resurface in the coming months, bringing with them a further bout of intense debt market and broader financial market strains. We continue to regard such strains as a needed 'forcing mechanism' to push European politicians (i) to commit additional resources to the establishment of a sizeable and credible firewall to contain such contagion risks and (ii) further along the path to closer fiscal and political integration, which is ultimately likely to be required to safeguard the euro's medium to long-term survival.

We continue to expect that European politicians will make the necessary political, economic and financial compromises to this end, thus avoiding the enormous disruption and dislocation that would be part of any break-up scenario. The fiscal compact agreed late last month does represent progress in terms of reducing the risks of major fiscal problems in the zone in future, in the process helping to bolster the chances of further German support for any upscaling of firewall resources for countries finding themselves in difficulty while additional resources from the international community via the IMF would also be helpful in this respect. However, the journey to a more stable euro zone is likely to be a bumpy ride.

In the meantime, the ECB is likely to remain the key institutional actor in the evolution of the European policy response to the debt crisis in the months ahead. The February 29th 3-year LTRO will underpin focus on the ECB's willingness to step up as lender of last resort to the banks. On the interest rate side, even allowing for recent signs of improvement the December ECB staff projection for

2012 GDP growth of 0.3% looks too optimistic to us (we expect growth to be roughly flat this year in annual average terms, with the risks clearly to the downside). So we expect a further easing of the policy stance, and anticipate a 0.25% rate cut in March (when the staff forecast will be updated), and possibly another one beyond that depending on the extent to which downside risks materialise. Moreover, we wouldn't be surprised if the ECB were to further expand the use of its so-called non-standard measures, including not just its liquidity operations but also its bond-buying programme in the event that market conditions deteriorate significantly and suddenly, while we would not rule out the possibility of the ECB engaging in full-blown QE if the threat of deflation were to present itself.

Other central banks are also likely to be called into further action this year. The UK economy has been infected by the deterioration in the euro zone, and while the latest incoming news points to some steadying of momentum, the growth outlook remains weak and inflation looks set to undershoot the 2% target in the medium term, arguing for further policy stimulus. With the UK government committed to its program of fiscal consolidation, the Bank of England will again be the vehicle of choice for a loosening of the UK policy levers, and we expect next week's February meeting to result in a further expansion of the bank's asset purchase (QE) programme.

The US economy has shown encouraging resilience, with a host of indicators, including on the jobs market and the beleaguered housing sector beating market forecasts in recent months. GDP growth accelerated in the final quarter and the economy looks set to experience ongoing modest expansion in 2012. While US growth expectations have actually firmed a touch in recent months, in contrast to the situation in Europe, the Fed remains concerned that the pace of recovery may be insufficient to produce enough progress in getting unemployment down to more satisfactory levels. This was the rationale for the revised guidance from Mr Bernanke last month when he indicated that the ultra-low interest rate environment was now likely to extend until late 2014, having previously guided a timescale of mid-2013. This is itself a form of easing of course, as such indications exert downward pressure on long-term rates via the expectations channel. However, we think the Fed may well need to go further and expand its own asset purchases to provide further support to the economy, though this is perhaps more likely to come in the second half of the year than the first.

Turning to long-term rates, 5-year swap rates have established fresh all-time record lows in recent sessions, of below 1% in dollars, and around 1.5% in the case of both euro and sterling markets. With all of the main central banks clearly retaining an easing bias, and likely to pursue additional stimulus in our view, we expect further downward pressure on long-term interest rates across the main markets, and expect new lows to be reached in the months ahead, linked to our concerns about downside growth risks including those stemming from the debt crisis.

The updated policy guidance from the Fed last month provides some interesting context around possible scenarios for interest rates over the longer run. For the first time, last month's update included information on FOMC participants' expectations about what might be an appropriate official interest rate over the long run for the US economy. The average of responses across the Committee was some 4.2%. While there is not much prospect of rates reaching 4% in the US in the coming year or two, this insight from Fed policy-makers does serve to highlight that the exceptionally low rate environment which prevails at present is not set to last forever – a point that should not be lost by the forward looking treasurer as (s)he looks to take a long-term perspective in actively managing any interest rate exposure.

Finally, on the currency markets, the euro has enjoyed a relief rally since mid-January, helped by the improvements in European financial market and economic conditions noted above. We think this may have further to run in the short term as the prospect of support from the ECB's second LTRO later this month is likely to further underpin investor sentiment. The single currency may get to $1.35 and 86p in the coming weeks in our view. However, our expectation that renewed market and real economy pressures will likely re-surface thereafter in the euro zone leads us to believe that the single currency does face a bout of further weakness in the coming months. We target $1.26 and 81p vs. the dollar and sterling by mid-year, with any rally later in the year dependent on meaningful progress towards resolving the debt crisis.

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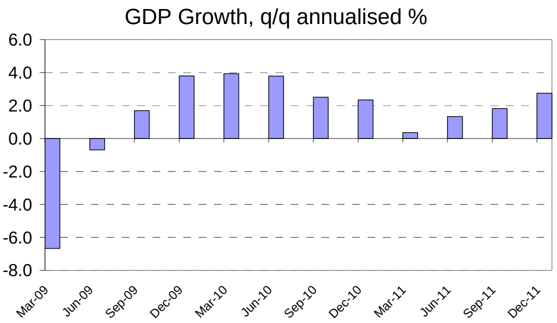
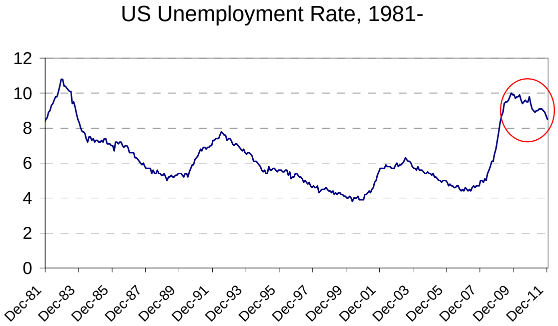
Forecasts (end period)						
	Latest	Mar-11	Jun-12	Sep - 12	Dec-12	Mar-13
Interest Rates						
Eur						
ECB Refi	1.00	0.75	0.50	0.50	0.50	0.50
5yr Swap	1.5	1.5	1.35	1.5	1.7	1.9
US						
Fed Funds	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25
5yr Swap	1.0	1.0	0.9	1.0	1.1	1.3
UK						
Bank Rate	0.50	0.50	0.50	0.50	0.50	0.50
5yr Swap	1.5	1.5	1.4	1.5	1.7	1.9
Currencies						
EUR/USD	1.32	1.31	1.26	1.31	1.33	1.35
EUR/GBP	0.83	0.83	0.81	0.82	0.82	0.83
GBP/EUR	1.20	1.20	1.23	1.22	1.22	1.20
GBP/USD	1.58	1.58	1.56	1.60	1.62	1.63
EUR/JPY	100	100	97	101	103	105

The US Economy and Fed Outlook

US economy regained momentum in the second half of 2011 …



…The labour market has seen continued improvement, although the pace of this improvement has been modest with the unemployment rate still at elevated levels …



The last few months have seen the majority of US macro data exceed market expectations These positive surprises have been spread across a broad spectrum of variables, ranging from signs of improvement in the labour market to consensus - exceeding data coming out of the much maligned housing sector. On a comparative analysis, the US economy has outperformed both the euro zone and UK economies. The US economy was aided in its outperformance last year relative to its peers through the fact that the US government was providing fiscal stimulus to its economy in contrast to the austerity measures being implemented in both the euro zone and UK economies.

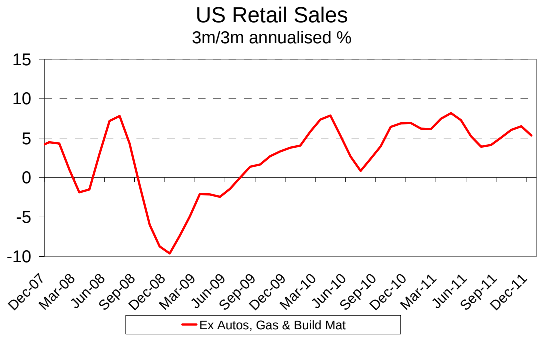
As we stated in our previous Focus, we expected the economy to exhibit signs of renewed acceleration in the second half of 2011 as some of the temporary factors behind the slowdown in the first half of 2011, including higher commodity prices and the supply chain disruptions arising out of the Japanese earthquake started to wane and changed from being headwinds to being tailwinds for the US economy. This was evident in the sharp rebound in auto production in the last six months of last year. The resolution (albeit short term resolution) to the US debt ceiling debacle not only averted the possibility of default but it also helped to remove some degree of uncertainty that had been weighing on both business and consumer sentiment arising of the whole debacle and political brinkmanship. The most recent GDP numbers show that the economy grew at an annualised pace of 2.8% q/q in Q4, 2011 after having grown by 1.3% and 1.8% on an annualised basis in Q2 and Q3 respectively.

A key focus point and health indicator of the US economy is its labour market. This is due to the fact that for a sustained expansion to take hold in consumer spending and in turn the overall economy (given fact that consumer spending accounts for 70% of GDP) a critical requirement is ongoing improvement in labour market conditions. The US labour market has shown signs of improvement in recent months. This improvement has been evident in the weekly claims data, where the four week moving average is now well below the 400k level. The nonfarm payroll data also suggest slight improvement in labour market conditions with payrolls over the last six months averaging gains of 142k versus an average gain of 131k in the first six months of last year. The improvement is also evident in the unemployment rate which has fallen from a rate of 9.1% back at the start of 2011 to end 2011 at 8.5%.

So overall, recent signs on the labour market are encouraging.

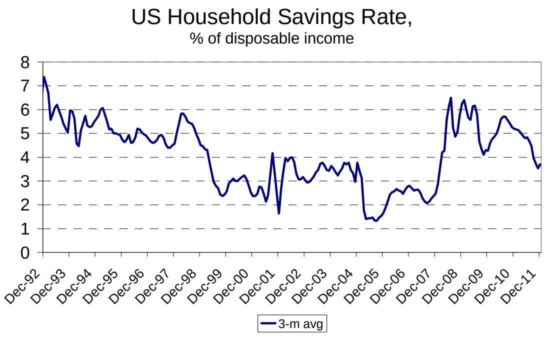
However, it looks as though further improvement will continue to be gradual, and as a result consumer spending growth is likely to grow at a moderate pace. Overall for 2011, payrolls averaged 137k, but for more meaningful inroads into the high unemployment rate in the US, payrolls would probably need to grow by 150k plus to bring about a more sustained and durable reduction in unemployment. Indeed, while the unemployment rate has fallen over the course of last year, it is worth noting that although employment levels have increased, another less encouraging factor behind the decline in the unemployment has been a reduction in the labour force, with the participation rate falling to an average rate of 64.1% in 2011 compared to 64.7% in 2010.

…Consumer spending has continued to make a positive contribution to economic growth …



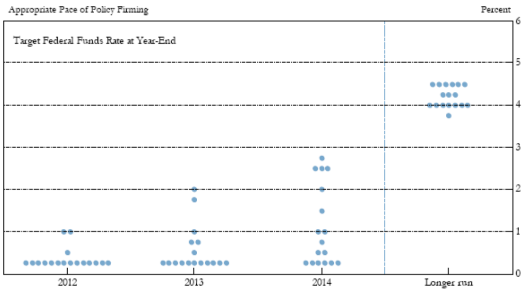
Overall then, while we envisage continued improvement in the labour market, this will be of a modest nature and we expect the jobless rate to finish 2012 still above the 8% mark. This elevated level of unemployment will mean that labour market conditions will not be sufficiently strong to propel stronger growth in real earnings and in turn a stronger uplift in consumer spending. Consumers in the US have made good progress in repairing their finances (i.e. de-leveraging), however, once this process has been completed it is still unlikely that US consumers will ramp up their borrowing (i.e. re-leveraging) to any great extent to finance spending. The other source of resources for the US consumer to finance spending is through the use of savings. This source has been tapped in recent quarters, with the savings rate falling from 5% at the start of the year in Q1 to 3.7% in the fourth quarter. The use of savings helped consumer spending to increase to an annualized pace of 2% q/q in the fourth quarter, despite the fact that real incomes only increased by 0.8% over the same period. However, the use of savings to finance spending is not a viable long term option for consumers (due to finite nature of savings and the need to replenish them).

…US consumer has tapped into its savings to fund some of this spending…



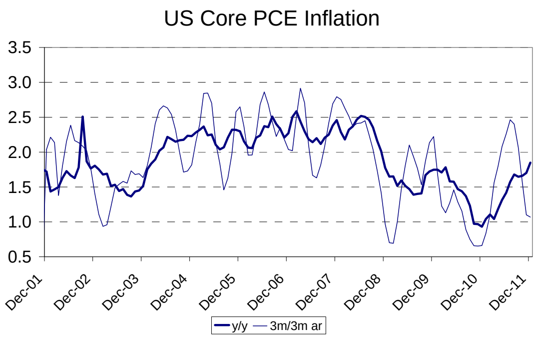
At its January meeting, the Federal Reserve provided a dovish surprise to the market. In its statement, the FOMC extended the time period of its forward looking language in terms of the Feds fund rate, with the previous 'mid 2013' date of warranting exceptional low levels of interest rates pushed out to 'through late 2014'. There are two important things to note regarding this guidance on interest rates from the Fed statement. Firstly, that this trajectory for interest rates is dependant on the economic circumstances warranting it and it is not a guarantee on the path of interest rates. Secondly, the guidance does not suggest that rates will remain on hold out to 2014, merely that rates will remain at very low levels (i.e. does not rule out rate hikes). The January meeting also marked the roll out of the Feds new communication strategy. This new strategy includes forecasts for the Feds fund rate, FOMC members expectations of timing of a rate change and the inclusion of a flexible inflation target. All of this is a far cry from the days (as recently as 1994) when the Fed kept its current policy rate secret until 45 days after each FOMC meeting. The enhanced communication from the Fed will help to provide guidance for market participants as to what might trigger action from the FOMC.

… more dovish guidance from the Fed has provided further monetary stimulus to the economy…



In terms of the more dovish stance adopted by the FOMC at its latest meeting, it is clear that the Fed remains concerned about the downside risks to the economic outlook and at the expected sluggish nature of improvement in the labour market. This was reflected in the moderate downward revisions to the central tendency for GDP growth in both 2012 and 2013. Recent comments from NY Fed chairman Dudley (one of the key policymakers on the FOMC) where he stated that the recent falls in the unemployment rate may be overstating the improvement in the labour market due to workers dropping out of the labour force, highlight the concerns the committee have in relation to the labour market and the maximum employment element of its dual mandate.

…signs of easing on the inflation front will give the Fed scope to expand its asset purchases.



On the inflation front and the second element (i.e. stable prices) to the Fed's dual mandate, the outlook is for the rate of growth in consumer prices to moderate this year as substantially lower gains in energy prices will likely lead to a slower pace of increase in headline inflation and the Fed expects 'inflation will run at levels at or below those consistent' with its dual mandate. The expected easing in inflation will help to reduce what could have been a complicating factor (i.e. inflation concerns) for the Fed in its deliberations on whether to introduce more asset purchases (i.e. more QE). In terms of QE, the latest Fed statement emphasised that the Fed is 'prepared to adjust' its security holdings to 'promote a stronger recovery in a context of price stability' and in the subsequent press conference Chairman Bernanke said 'that's an option that is certainly on the table'. In summary then, the Fed's concerns on the slow pace of the recovery, combined with easing inflation concerns suggest to us a strong probability that the Fed will introduce another round of asset purchases.

Given an outlook of unemployment remaining at elevated levels, thereby keeping a lid on earnings growth, consumers are unlikely to be able to provide a sustained pick up in spending for the US economy. As a result overall economic growth in the US economy is not expected to accelerate to any great extent over the next twelve months. We see the economy continuing to expand at a moderate pace of around 2.5% in 2012. The downside risks to this outlook stem from an escalation of the debt crisis in the euro zone and the contagion effect this could have on global demand and on financial markets. There are also potential risks emanating from the domestic front, with the potential for the US presidential election to foster an air of uncertainty and wait and see attitude from a consumer spending and business investment perspective.

However, on balance the US economy appears to have sufficient momentum to maintain its path of economic recovery, albeit at a more moderate pace than in previous recovery cycles.

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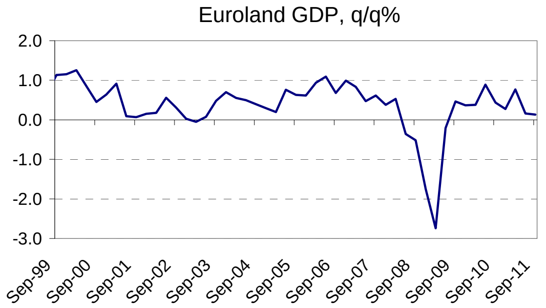
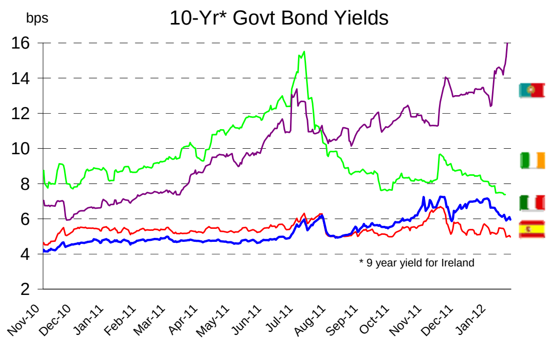
The Euro Area Economy and ECB Outlook

Euro area GDP growth slowed to a paltry 0.1%q/q in Q3 of last year…



The pronounced deterioration in European sovereign debt market conditions last summer imparted a powerfully negative impulse on to the euro area economy over the latter part of 2011. The early-June decision by the European authorities to proceed with substantial private sector involvement (PSI) in the restructuring of Greek debt clearly unnerved investor faith in European government bonds (EGBs) as an asset class more generally, resulting in the spread of the crisis to larger, more systemically important countries perceived as fiscally vulnerable. Notably, 10-year yields in Italy and Spain (which together make up almost 30% of euro area GDP, nearly 5 times the combined size of the three 'program counties' Greece, Ireland and Portugal) surged past the 6% level in July/August.

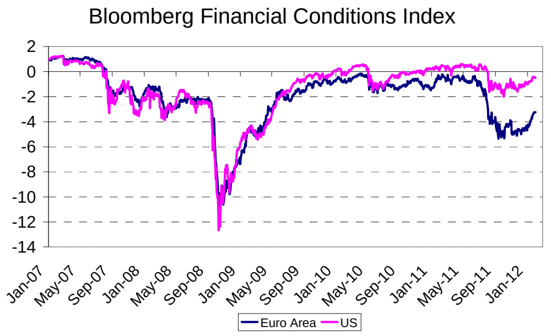
… as policy-makers have continued to struggle to contain the debt crisis…



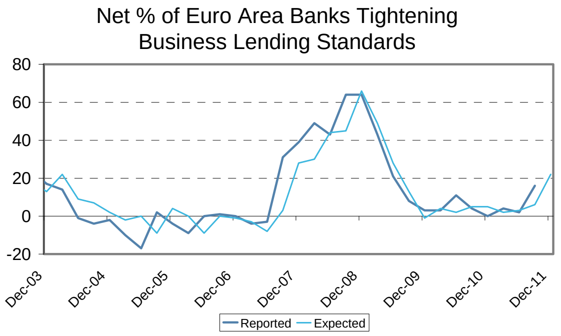
A stepping up of the ECB's bond buying programme provided some late-summer relief. However, strains intensified markedly again later in the year with Italian yields hitting record EMU highs of close to 7.5% in mid-November as investors remained (i) concerned about growth prospects and negative feedback loops between worsening growth prospects and sovereign and financial sector balance sheets, and (ii) unconvinced that policy-makers were acting with sufficient force to stem the crisis. Crucially, contagion effects have also become evident at the 'AAA' core of the euro area, with 10-year bonds in France (which alone accounts for 21% of GDP in the zone) trading almost 2% higher than their German equivalents in November – levels last seen in early 1990. This was followed by a downgrade of France and a host of other countries by S&P in mid-January, as the agency expressed concern that the policy initiatives taken by European policy makers may be insufficient to fully address ongoing systemic stresses in the zone. This move leaves Germany as the only AAA rated sovereign with a stable outlook on the S&P ratings.

Such strains clearly impacted on the broader macro-financial environment beyond the sovereign debt arena. European equity markets came under major pressure, and money market spreads pushed significantly wider as the interconnectedness between government balance sheets and those of the banking sector

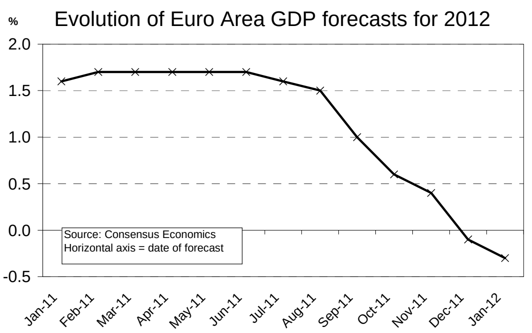
…the lack of resolution of which triggered a major and broad-based deterioration in financial conditions in Europe in Q3'11, both in absolute and relative terms…



…raising the specter once again of negative feedback loops between the financial sector and the real economy…



… and prompting large-scale downward revisions to 2012 growth forecasts…



resulted in heightened strains in bank funding markets. The graph opposite shows a Bloomberg summary index of financial conditions in the euro area, with the large decline (in both absolute terms and relative to the US) summarising the extent of tensions across European bond, equities and money markets. In particular, Euribor-OIS spreads – a key metric of tensions in the interbank money market – surged by some 0.8% between June and December to 1%, levels last seen in early 2009. This unwelcome tightening of bank financing costs has also been accompanied by a tightening of bank lending standards (as measured by the ECB survey) generating meaningful concerns about the risk of another credit crunch, and the related consequences for the real economy.

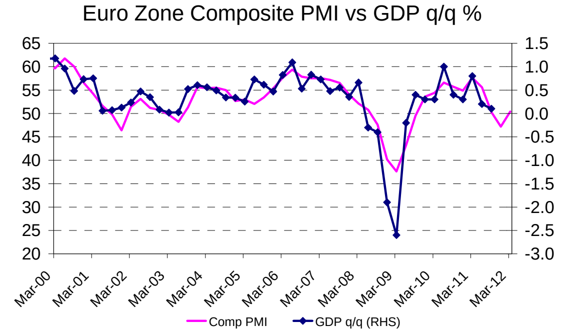
Indeed, real economy developments did suffer a major further loss of momentum over the third quarter and into the early part of the fourth. A plunge in the October reading of the composite PMI confirmed that the deterioration in financial conditions and the heightened uncertainty surrounding the political future of the euro zone were combining to produce a slide in business activity and confidence.

GDP growth had already slowed to a meagre 0.1%q/q in Q3 – down considerably from the average growth of 0.5% per quarter seen in the first half of the year and the weakest quarter of the recovery since it began in the middle of 2009. But the additional weakness signalled by the October PMIs provided solid evidence that the downside risks were materialising and that the economy was headed back into recession. We don't yet have official GDP estimates for Q4, but the composite PMI is pointing to the likelihood of a quarterly decline of around 0.3%, weakness which has prompted large-scale downward revisions to 2012 growth expectations.

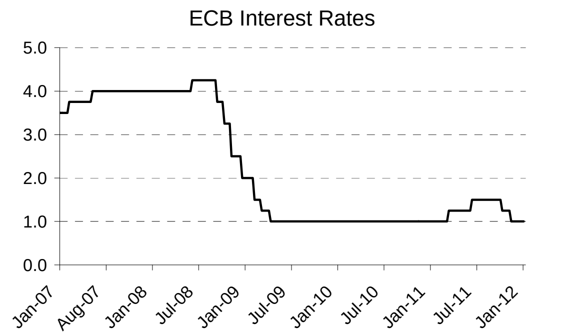
In fairness, while the politicians have found it difficult to keep pace with developments, the ECB has upped its policy response materially in recent months. Mr Draghi et al have moved decisively to stem the deterioration in economic performance and prospects, and to address the strains in money markets. He has reversed the monetary policy tightening put in place by his predecessor My Trichet in cutting official interest rates twice by a total of 0.5% in November/December, taking them back to their all-time record lows of 1%.

Significantly, in addition, he has also considerably expanded the ECB's liquidity provision to the banking sector. The December ECB meeting brought the announcement that the ECB would for the first time offer liquidity to banks for a three-year term, and against a much expanded pool of collateral and in unlimited size at a fixed rate of 1%. Mr Draghi may have disappointed markets with his signal that the ECB was not (yet at least) willing to significantly

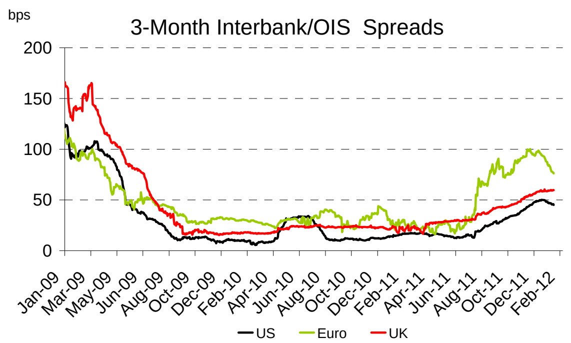
…the economy likely contracted in Q4, though early indications for 2012 *tentatively* point to stabilisation…



…In fairness, the ECB have responded with a range of policy measures, including a further major expansion of liquidity to the banking sector, as well as 0.50% of rate cuts since November…



…which are beginning to result in some easing of the strains in financial conditions…



increase its purchases of government debt and act as a direct backstop for the sovereign debt market, but his actions on the liquidity front demonstrate the ECB's willingness to act as an effective lender of last resort for the banking sector. The first of the two announced 3-year Long-Term Refinancing Operations (LTROs) took place in late December and resulted in a larger-than-expected take-up of close to €490 billion. The second LTRO is scheduled for later this month, and looks set to see an even greater take-up. The 3-year LTROs are an important milestone in the crisis as they provide a major source of readily available cheap medium term funding to a banking sector which faces a heavy refinancing profile this year (the ECB estimates that over €200bn on bank bonds fall due for refinancing in the first quarter alone). Thus, not only do the LTROs directly boost available liquidity in money markets, but they also provide very important insurance against the possibility of a bank funding mishap, thus helping to contain one key source of risks to the financial sector, and by extension to the real economy.

And it looks as if the ECB's actions are contributing to meaningful improvement in some areas of the markets. Notably, money market spreads have narrowed by around 0.25% since December while the LTRO has also indirectly provided support for sovereign debt markets, as the cheap liquidity has at least partly been used it seems by banks to buy higher-yielding government paper. This carry-trade mechanism is not without risks for the purchasing banks of course, but it does generate some badly-needed virtuous circle dynamics between bank and sovereign funding markets whereby ample bank liquidity finds its way back into sovereign debt markets as banks beef up their buying of their home country government bonds. This looks to be one factor behind the relatively successful government debt auctions so far this year, which have thus far passed off without incident, allowing Italian and Spanish 10-year yields for example to fall back below 6% and 5% respectively.

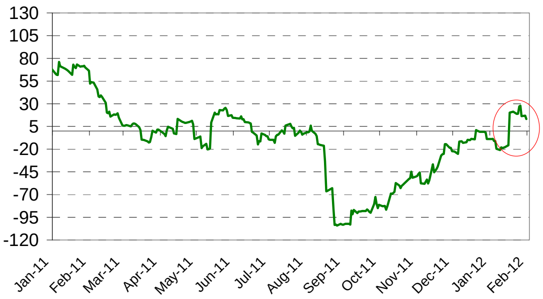
In addition, there are also some signs of a less negative dynamic emerging in the real economy. The composite PMI has managed to rise in each month since its October plunge and got back above 50 in January. Other timely survey indicators (including the German Ifo and ZEW indices) have also beaten market forecasts in recent readings, and in general the incoming news out of the zone has been a bit better than expected lately, as evidenced by the trend improvement in the economic surprise index.

Such developments are certainly significant in their own right and offer important encouragement that the ECB has succeeded, for now at least, in stabilising some vulnerable segments of the macro-financial environment. However, we continue to have concerns on a number of fronts. Firstly, the expansion of ECB liquidity, welcome as it is, still leaves unresolved the issue of sovereign insolvency. While there are reports that some form of agreement on the Greek

PSI may be imminent, until any such deal is fully executed it will carry non-trivial implementation risks linked for example to the level of investor participation. Moreover, even if the PSI deal gets through, Greek still faces a prospective peak debt/GDP level of 120% or more. And even that assumes full implementation of all planned fiscal correction measures, where the Greek track record to date leaves little room for conviction on their ability, and also perhaps their willingness, to deliver the required scale of adjustment. Second, market confidence in Portugal has evaporated in recent months. Three year-yields reached over 25% in late January, implying a widespread expectation of some form of haircut in the period ahead. Current 5-year CDS pricing implies a probability of a restructuring of around 70%, meaning that debt markets remain vulnerable to contagion risks linked to possible further debt restructurings.

…while the economic data have also begun to surprise positively lately…

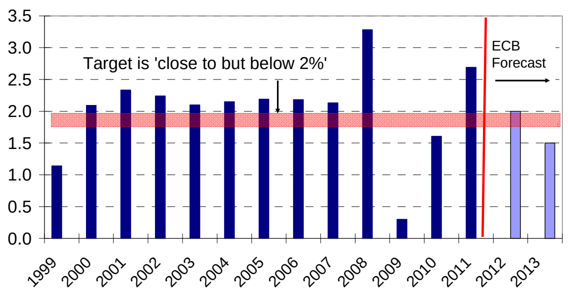
Eurozone Economic Surprise Index



Thus, we think, solvency and growth concerns are likely to resurface in the coming months, bringing with them a further bout of intense debt market and broader financial market strains. We continue to regard such strains as a needed 'forcing mechanism' to push European politicians (i) to commit additional resources to the establishment of a sizeable and credible firewall to contain such contagion risks and (ii) further along the path to closer fiscal and political integration, which is ultimately likely to be required to safeguard the euro's medium to long-term survival. We continue to expect that European politicians will make the necessary political, economic and financial compromises to this end, thus avoiding the enormous disruption and dislocation that would be part of any break-up scenario.   The fiscal compact agreed late last month does represent progress in terms of reducing the risks of major fiscal problems in the zone in future, in the process helping to bolster the chances of further German support for any upscaling of firewall resources for countries finding themselves in difficulty. Indeed, there have been reports that the existing bailout mechanisms (EFSF and ESM) may be further expanded which could assuage investor concerns about the size of available backstop support, while additional resources from the international community via the IMF would also be helpful in this respect. However, the journey to a more stable euro zone is likely to be a bumpy ride.

…but we still think the ECB will cut rates further, as its growth forecast looks optimistic and inflation pressures seem likely to remain subdued.

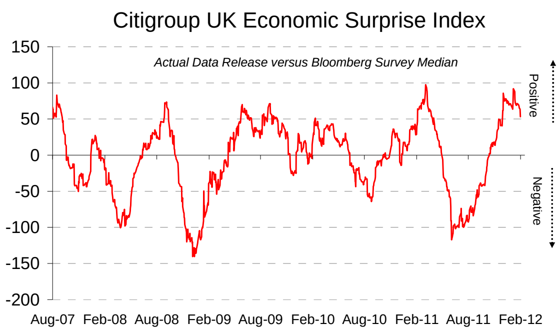
Euro Area HICP, %



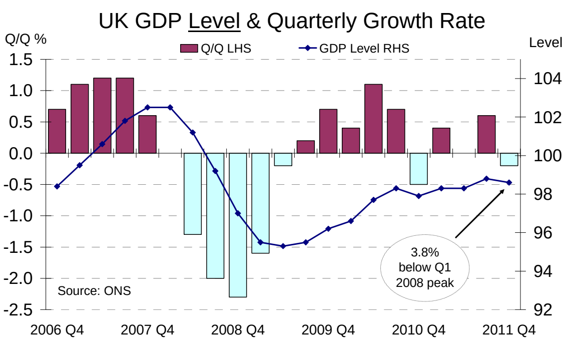
In the meantime, the ECB is likely to remain the key institutional actor in the evolution of the European policy response to the debt crisis in the months ahead. The February 29th 3-year LTRO will underpin focus on the ECB's willingness to step up as lender of last resort to the banks. On the interest rate side, even allowing for recent signs of improvement the December ECB staff projection for 2012 GDP growth of 0.3% looks too optimistic to us (we expect growth to be roughly flat this year, with the risks clearly to the downside). And the inflation outlook seems unlikely to be a major hurdle to further policy easing: the staff's own December forecast has it averaging 1.5% in 2013, comfortably below the ECB's definition of price stability of 'close to but below 2%'. So we expect a further easing of the policy stance, and anticipate a 0.25% rate cut in March (when the staff forecast will be updated), and possibly another one beyond that depending on the extent to which downside risks materialise. Moreover, we wouldn't be surprised if the ECB were to further expand the use of its so-called non-standard measures, including not just its liquidity operations but also its bond-buying programme in the event that market conditions deteriorate significantly and suddenly, while we would not rule out the possibility of the ECB engaging in full-blown QE if the threat of deflation were to present itself.

SB

UK economic data has largely surprised to the upside in Q4…



…but UK GDP weaker than expected in Q4 2011 with a 0.2% q/q contraction…



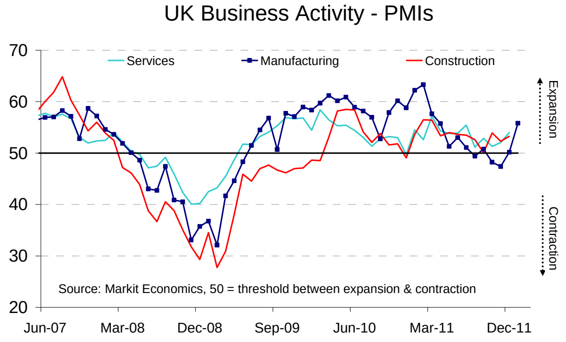
The UK Economy and MPC Outlook

Like a number of European economies elsewhere, the UK economy slipped into contraction territory in the last quarter of 2011. The first estimate for Q4 GDP growth came in slightly softer than expected at -0.2% q/q and follows a 0.6% q/q rise in the previous quarter. Whilst the public sector strike on the 30 November will have had some impact on the Q4 GDP outturn, at best this will have been marginal. For 2011 as a whole, the UK economy expanded by just 0.9%, which compares with 2.1% for 2010. Following the peak to trough decline in GDP of 7% between 2008 Q1 and 2009 Q2, the UK economy has recouped less than half of the lost output it lost during the recession. Indeed, during the last six quarters the UK economy has grown by less than 1% and remains 3.8% below the pre-recession peak of Q1 2008.

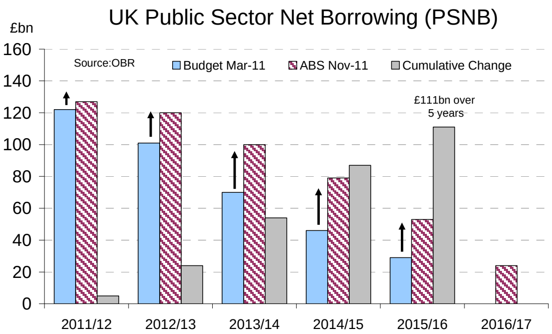
At an industry level, the services sector was the only sector not to contract in Q4 with output remaining flat. Meanwhile, the construction and production industries posted quarterly declines of 0.5% and 1.2% respectively. Within industrial production, it is noted that the manufacturing sector contracted *(0.9% q/q)* for the first time in nine quarters. For the UK economy to claw back the output lost from the recession, in any meaningful sense requires, a sustained period of above trend growth. However, it is becoming ever clearer that the UK is experiencing its weakest recovery on record with the economy posting only one quarter of above trend *(0.7% q/q)* growth to date. Indeed, looking ahead in the coming quarters we expect the weaker international environment coupled with the ongoing fiscal consolidation to continue this sub-trend profile throughout 2012.

The latest GDP figures have been at odds with other economic surveys. For example, the timeliest indicators of economic activity, the PMIs, have signalled that the UK's growth trajectory has been somewhat stronger than the first GDP estimates suggested.

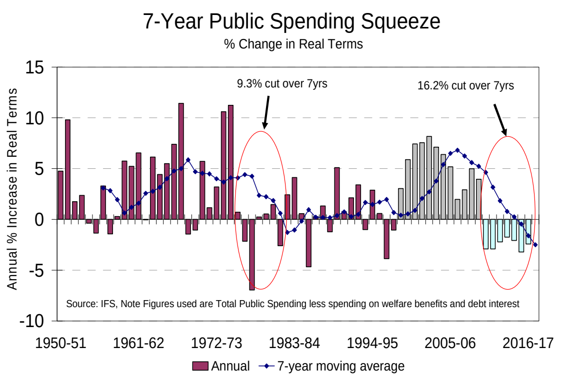
…but other surveys – PMIs - suggests the UK economy still growing, albeit slowly…



… Chancellor unveils sobering fiscal forecasts with £111bn of additional borrowing required over next 5 years…



… Public spending set for its tightest squeeze since the end of WWII…



Although in time we anticipate a small upward revision to the GDP figures in due course. The divergence between the GDP data and the PMI surveys is most apparent within the services sector. Both the services and construction sectors posted reasonable growth rates in business activity at the end of last year. More importantly, the forward looking new orders indices for both sectors suggest reasonable momentum going into 2012.

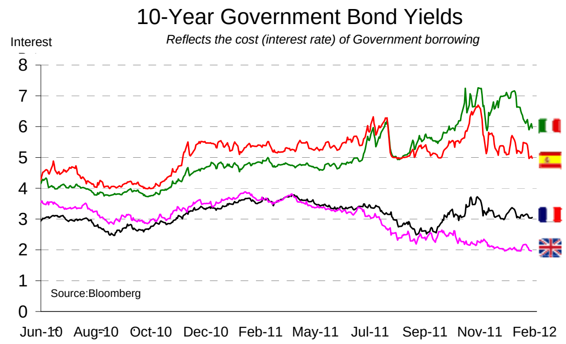
Conversely, the slowdown in the global economy and the eurozone in particular, has contributed to a notable loss in momentum for the UK manufacturing sector. The manufacturing new orders index fell below the expansion / contraction threshold *(50.0)* for the eighth successive month in December. However, the latest survey signalled a return to growth in January with both the new orders and output indices posting their highest readings since March 2011. Looking ahead, exporters will not have the same exchange rate tailwind that they have enjoyed over the last two years or so. However, with the euro zone in recession lack of demand rather than the exchange rate will be the chief concern amongst exporters.

As in the euro zone, the ongoing fiscal austerity will act as a major drag on UK economic growth. Some £18bn of fiscal tightening is due in 2012/13, which is equivalent to around 1.2% of GDP, represents just half the adjustment in 2011/12. The major tax rises, notably VAT, are now implemented with the fiscal adjustment now very much focussed on the public expenditure side. According to the Office for Budget Responsibility *(OBR)*, overall government spending *(including social security expenditure & debt interest)* is set to fall by 1% in 2012/13 in real terms, which compares to a 0.6% reduction in 2011/12.

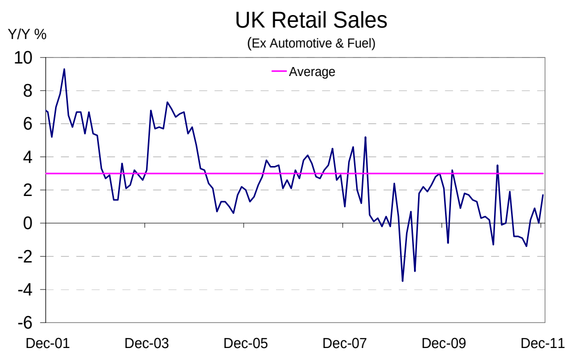
On 29 November the UK Chancellor unveiled a sombre Autumn Budget Statement *(ABS)*. The main focus of the Statement was not on the Chancellor but on the dire set of economic and fiscal forecasts supplied by the OBR. In addition, the huge, as yet unspecified, public spending cuts in 2015/16 & 2016/17 highlight that even in five years' time, the public sector will remain a significant drag on the economy. Indeed, revised forecasts show UK public sector employment shrinking by 12% *(710,000)* over the course of austerity *(by 2017)*. With tax receipts plummeting, further efforts to rein in public spending were announced in the ABS. These include a cap on public sector pay rises of 1% between 2013-15 which follows the current pay freeze. Overall, almost three-quarters of the fiscal adjustment by 2014/15 will be through spending cuts as opposed to tax rises.

Total public spending is now set for its tightest squeeze since the end of World War II. Following the unprecedented 12-year boom in public expenditure growth, the UK now faces an unprecedented squeeze on public spending. Excluding debt interest and welfare payments, public spending is set to fall by 16% over the 7-year period to 2016/17 according to the Institute for Fiscal Studies. This

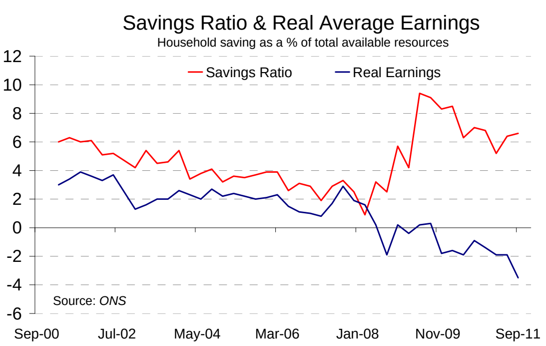
…UK government debt hits a record high but cost of borrowing has hit record lows…



…UK households feeling the squeeze as retail sales volumes remain muted…



…not surprising as consumers experiencing falling real incomes and are saving more…



extends austerity 2-years into the next parliament. It is noted that spending cuts of £8bn and £15bn have been identified in 2015/16 and 2016/17 respectively. The forthcoming Spring 2012 Budget will reveal what these cuts are. Indeed, with last November's economic growth forecasts for 2012 and 2013 now exceeding the consensus opinion there is a growing risk that additional fiscal tightening and government borrowing will be required.

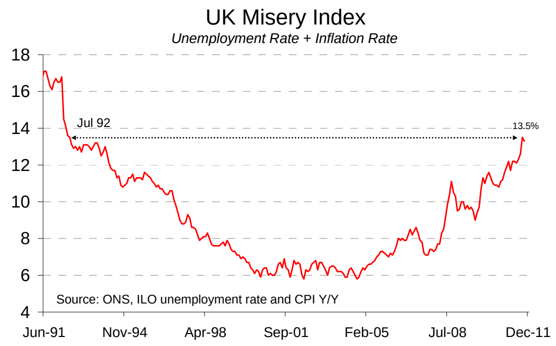
Eliminating the UK's structural deficit by 2017 will remain a key challenge in the context of weaker economic growth and lower revenues. And the scale of the challenge facing the government was brought into sharp focus when UK government debt recently broke through the £1 trillion mark for the first time. One positive on the government borrowing front concerns the cost of borrowing. The cost of UK 10-yr government bonds, or gilts, recently hit a record low of 1.92%. At the end of last month they stood at 2.0% which compared favourably with France *(3.1%)*, Spain *(5.0%)* and Italy *(6.0%)*. The falling yield in 10-yr gilts has helped push longer-term interest rates to new record lows as well with the 10-yr swap rate hitting 2.18% last month. Unlike France, the UK has managed to hold onto its triple-A credit rating and it has benefited from its perceived safe-haven status relative to the euro zone. In the months ahead, however, it will become increasingly difficult for the UK to hold onto this credit rating, particularly if there is any slippage with the UK's fiscal plans.

Low borrowing costs has provided some benefit for those individuals and households with debt. Nevertheless, economic conditions for households and consumer spending remain challenging to say the least. Rising unemployment, tax rises and inflation continue to sap UK consumer spending. That said, the latest retail sales figures signalled a pick-up in Q4 2011 relative to Q3 although sales volumes remain muted.

Although the annual rate of inflation has started to fall, from 5.2% in September to 4.2% in December, it is still rising at a faster rate than average earnings. For example, average weekly earnings growth during the three months to November increased by just 1.9% y/y. As a result, real earnings growth is still negative to the tune of about 2.5% y/y. It should also be remembered that it is the price level and not just the rate of inflation that is important. Consumer prices have increased by 8% in just 2 years and almost 15% in 4 years. Against this backdrop, and rising fears over job security, it is not surprising that consumer confidence remains extremely low. This is evident by the fact that households are saving more of their disposable incomes despite facing unattractive *(negative real)* interest rates. It is noted that whilst the proportion of household disposable income saved *(6.6%)* in Q3 2011 is below that of Q2 2009 *(9.4%)*, it remains well above the long-term average *(4.8%)*. Meanwhile, according to the latest Bank of England Credit Conditions survey *(Q4 2011)*, demand for unsecured household credit remains weak despite increased availability of credit from lenders. Again this suggests a key priority for households is repairing their balance sheets.

Outside of inflation, another headwind for consumer spending is the deterioration in the labour market. Unemployment rose by 118,000 in the three months to November bringing the total to 2.68 million and the unemployment rate up to 8.4%. The latest quarterly rise in unemployment represents two-thirds of the 169,000 rise over the last year with those individuals under the age of 25 yrs of age *(youth unemployment)* continuing to bear the brunt of the rising joblessness. The UK's youth unemployment rate currently stands at 22.3%, which incidentally still compares favourably with Spain *(50%)* and Greece *(47%).* Looking ahead, with the number of unemployed already at a 17-year high, it is anticipated to push ever closer to the psychological 3 million barrier with the unemployment rate peaking around 9% by Q4 2012 / Q1 2013. With the labour market set to weaken further over the next 12 months this should exert downward pressure on wage growth.

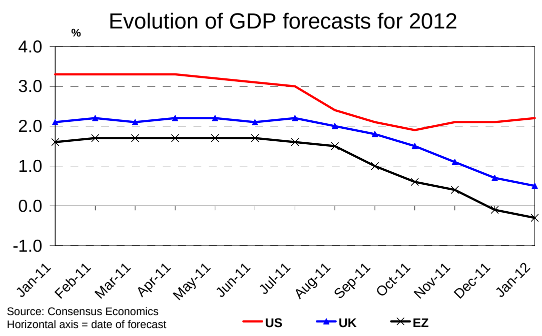
…and UK *'Misery Index'* at its highest level since July 1992 …



Combining both the unemployment and inflation rates provides another barometer of consumer strife, the so called *'Misery Index'*. The UK Misery Index recently hit 13.5 - its highest level since July 1992 - is further evidence of the ongoing human recession and explains why consumer confidence and spending are so subdued.

The UK's fiscal deficit reduction programme is set to bear down on the economy for the foreseeable future. As a result, monetary policy will continue to act as the sole provider of stimulus. Next month will see the Bank of England bank rate begin its fourth year at its record low of 0.5% and remain at this level for the foreseeable future. Despite this ongoing stimulus, and following £275bn of asset purchases *(Quantitative Easing or QE)* the Bank of England *(BoE)* is still expected to provide additional monetary stimulus as early as this month. The BoE's last Quarterly Inflation Report *(QIR)* in November published an inflation forecast with a significant medium-term undershoot. The MPC's inflation target is 2% over the medium term which is defined as the two-year time horizon. Whilst CPI is currently at 4.2% y/y, way above target, the MPC projected inflation to fall sharply, and below target *(1.23%)* at the target horizon. This projected inflation undershoot suggests more stimulus *(further asset purchases)* are imminent.

…UK GDP growth forecasts for 2012 have been slashed mirroring those of the euro zone. BoE likely to engage in more QE



Since November, the MPC has voted to leave policy on hold and CPI outturns have been in line with their projections. The latest MPC minutes for January, however, highlight the greater uncertainty about the speed and the extent of the fall in inflation going forward. There remain significant risks to both the UK growth and inflation outlook in both directions. In particular, there are considerable risks to the downside stemming from the euro zone and global economies. The next Quarterly Inflation Report *(February)* due in two weeks time will provide the latest economic and inflation forecasts and we still expect an undershoot in CPI in 2 years time. As a result, we anticipate another round of asset purchases to be announced next week at the MPC's monthly policy meeting. The BoE is set to provide significant downgrades to its GDP growth forecasts for 2012 and 2013. Back in November, the MPC had anticipated UK GDP growth to remain broadly flat in Q4 2011 and Q1 2012 with annual growth rates of 0.9% *(2012)* and 2.8% *(2013)*. These projections compare with the latest consensus forecasts of 0.5% for 2012 and 1.8% in 2013.

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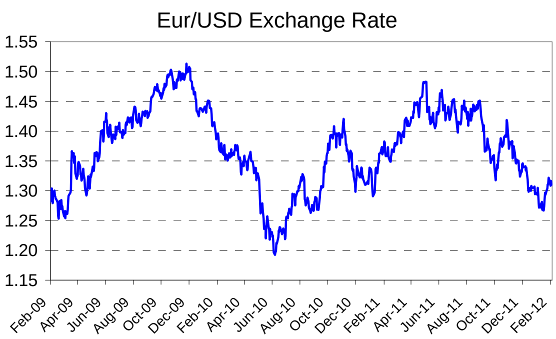
FX Outlook

Eur/USD

Eur/USD has moved off its January low of $1.26….



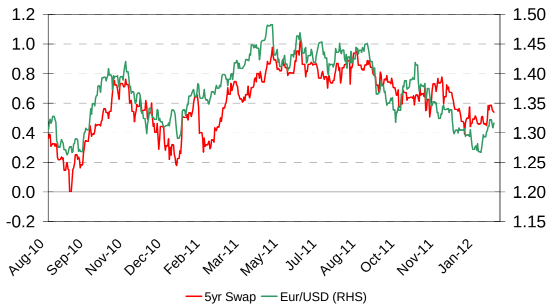
Over the last 6 months, Eur/USD has experienced substantial downward pressure on the back of the increased concerns regarding the euro zone debt crisis, the euro zone's weaker economic performance relative to the US and the fact that the ECB cut interest rates in the last quarter of 2011. In recent weeks, however, Eur/USD has regained some positive momentum, prompted by upside surprises to macro data in the euro zone, the positive impacts from the ECB's expanded liquidity provisions and a general improvement in risk appetite. This has seen Eur/USD move off its low of $1.26 and the currency pair finished January hovering around the $1.31 level. In the near term, there is potential for further upside risks to Eur/USD linked to optimism regarding the next 3 year LTRO from the ECB and also potential upward support from some unwinding of the extreme short position of Eur/USD that currently exist in the market. This potential upside could push Eur/USD up closer to the $1.35 level in the short term (i.e. weeks rather months)

The expanded liquidity provision from the ECB is helping to contain the tail risk of a crisis on the bank funding front, providing a degree of support to risk appetite and an improvement in sentiment towards the euro zone, which in turn is providing some support to the euro. Ultimately once the expanded LTROs and the expected ECB rate cut are fully digested by the market, the ECB's large scale policy easing may prove to be euro negative on a fundamental basis. Over the next six months the ECB is expected to be more active in expanding its balance sheet in comparison to the Federal Reserve where balance sheet expansion is not expected until the second half of the year.

At the same time, the euro zone debt crisis is expected to trigger renewed deterioration in financial conditions in the coming months. The recent agreement amongst EU leaders on stricter budget rules

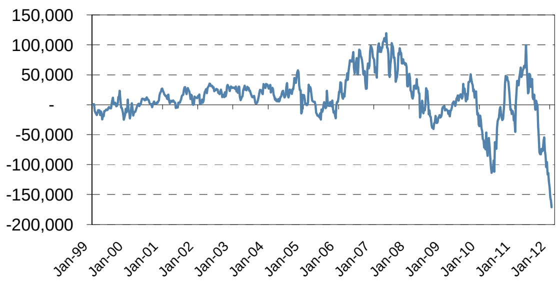
…movements in relative market interest rates remain an important driver, and help explain why the euro hasn't fallen by more….

Eur/USD vs Interest Rate Differentials



…potential for further upside in Eur/USD in the near term arising from some unwinding of extreme short positioning

IMM Futures Positioning in Eur/USD



represents some degree of progress. However, it still does not address some of the key issues of the crisis including the issue of solvency. Even if Greece gets agreement with private bondholders on its plans for a debt write down and its austerity measures are fully implemented, the Greek debt to GDP ratio is still projected to be around 120%, well above levels likely to be sustainable. With agreement on a second Greek bailout still not finalised and clear signs that Portugal is struggling under its debt burden, solvency concerns may well come back to the fore over the coming months and these concerns will be reflected in renewed stress in European sovereign bond markets in our view. A complicating factor for the euro zone is the weakening economic outlook which will add to the complexity of trying to deal with the debt crisis. The intensification of the debt crisis combined with monetary easing from the ECB is likely to bring downward pressure on the euro and in such a scenario we see the Eur/USD falling towards the $1.26 level by the end of June.

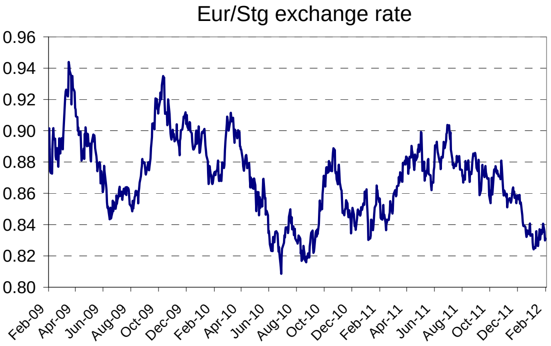
On the dollar side, last week's dovish surprise from the Fed highlighted the fact that a bearish outlook on Eur/USD is not a foregone conclusion. The FOMC unexpectedly expanded its guidance on the time period for economic conditions to warrant exceptionally low levels for the federal funds out from 'mid 2013' to 'through to late 2014'. The growth outlook for the US economy is one of continued expansion but at a moderate pace which is unlikely to see the unemployment rate in the US fall to levels that is consistent with the Fed's dual mandate. At the same time, US inflation is expected to ease this year. This scenario of unemployment remaining at elevated levels and an easing in inflation is likely to see the Fed act by going with another round of asset purchases. Indeed the latest FOMC statement and comments from Chairman Bernanke have emphasised that the Fed is prepared to expand its balance sheet (i.e. QE) should the conditions warrant it. Therefore another round of QE on the part of the Fed may limit the dollar's ability to rise further against the euro in the second half of this year.

On the back of the expected intensification in the euro zone debt crisis over the coming months, the key European policymakers will have to assume a greater role in dealing with the debt crisis. A more comprehensive and credible response to the debt problems facing the region would provide some upside risk to Eur/USD in the second half of the year. The combination of progress in dealing with the debt crisis along with further easing on the part of the Fed could see Eur/USD push higher in the second half of 2012, with the potential for the currency pair to move towards the $1.33 level by year end.

JF

Eur/GBP

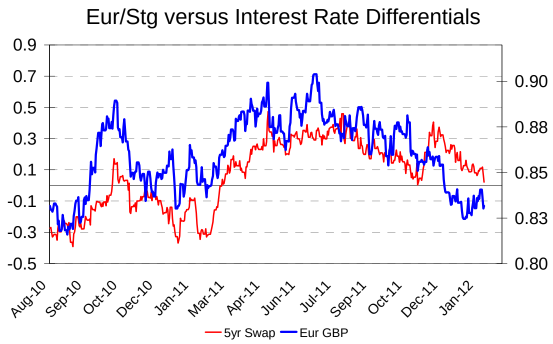
Over last six months Eur/GBP has been on a downward path on the back of the deterioration in the debt crisis and ECB rate cuts…



While Eur/GBP has regained some lost ground in recent weeks, the broad direction of the currency pair in the last six months was downward with the pair finishing the year at 83p, having hit a recent high of 90p back in July. This downward trajectory was linked to the heightened concerns regarding the debt crisis, a clear deterioration in the economic outlook for the euro zone and the ECB easing monetary policy.

On the UK side, the measures taken by the UK government in terms of providing a medium term fiscal strategy in dealing with their own debt problems still commands market credibility, unlike the situation in the euro zone. The continued policy cohesion between the UK government and the Bank of England is also likely to be supportive of sterling. However the close economic links between the UK and euro zone is likely to act as a limit to any falls in Eur/GBP. The ongoing debt crisis in the euro zone is likely to continue to weaken demand for UK exports, while the persistent weakness in the UK labour market, along with the dampening impact from austerity measures will provide a tough environment for domestic demand to make much headway. Therefore, with the UK economy facing its own challenges, the expectation is that the Bank of England will announce a further instalment to its quantitative easing programme in the first half of this year and this could come as soon as this month.

Rate differentials remain important for Eur/GBP also…



The prospect of further QE on the part of the Bank of England in early 2012 may constrain sterling's ability to rise against the euro in the short term. We are also mindful of the upside risk to Eur/GBP given the extreme positions of short euro generally in the market at the moment and that some unwinding of these positions could lead Eur/GBP to push higher. Under these circumstances, the currency pair could reach the 86p level in the coming weeks.

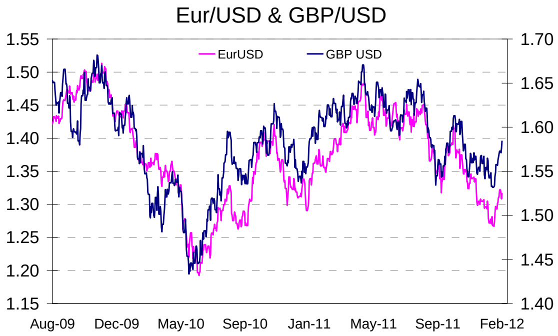
However, any such moves higher in Eur/GBP are likely to be a short term phenomenon. While the agreement at last month's EU Leaders summit on new budget rules was a welcome step forward in helping to prevent future fiscal imbalances amongst member states, it does not address the key issue of solvency. The solvency issue is likely to come sharply back into focus as both Greece and Portugal struggle with their debt burdens. An intensification of the debt crisis and the resulting negative impact on risk appetite will start to weigh on the euro. From a monetary policy perspective, the ECB is engaged in its own balance sheet expansion through its expanded liquidity provisions, the second of which will be allotted towards the end of February. This expansion of its balance sheet along with the likelihood that the ECB will cut interest rates further in the first half of 2012 provide a fundamental basis for weakness in Eur/GBP. Given these factors we expect to see Eur/GBP start to push lower over the coming months, possibly down at 81p at the half year mark.

Looking further ahead to the second half of 2012, the intensification of the debt crisis in the euro zone will put increasing pressure on the key European policy makers to come up with a credible plan to deal with the escalating debt crisis. Signs of progress in dealing with the debt crisis would have the potential to relieve some of the strains on the euro and could help Eur/GBP to recover some upward momentum. On the back of this, we expect a gradual climb higher in Eur/GBP in the second half of this year, and we target 82p by the end of 2012.

JF

GBP/USD

…GBP/USD has largely followed the same pattern as Eur/USD…

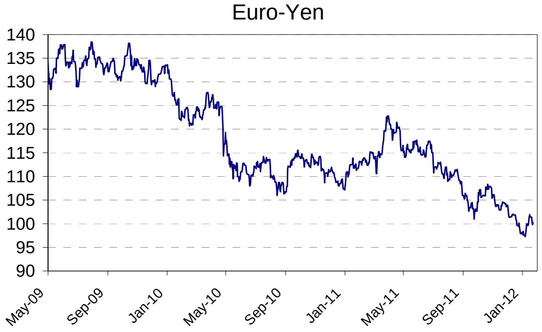


Over the last six months the bulk of the price action has seen the GBP/USD ('cable') currency pair trading within the $1.54-1.60 range. Traditionally the dollar is negatively correlated with risk appetite, so when concerns over the euro zone debt crisis intensify risk aversion returns and the dollar benefits. Given that the UK economy is so inextricably linked to the fortunes of its largest trading partner – the euro zone – so when the single currency loses ground against the greenback this also feeds through into the GBP/USD currency pair. This is a key factor behind the close correlation between the movement of Eur/USD and GBP/USD currency pairs. As a result, when concerns over the sovereign debt crisis intensified, particularly in relation to the world's third largest bond market (Italy), cable pushed sharply lower in mid-September, November and January. The recent dip below $1.532 last month represents a low since July 2010. Since then, the return of risk appetite linked to the easing of debt concerns in the euro zone has propelled GBP/USD back above $1.58. Looking towards the year ahead, both the Bank of England and the Federal Reserve are expected to embark upon further monetary stimulus (quantitative easing) which is a negative for both currencies. But sterling is expected to be put under more pressure in the near-term with a further intensification of the euro zone crisis pushing Eur/USD and GBP/USD to $1.26 and $1.56 respectively by Q2 2012. Thereafter, an EU policy response, or at least further progress towards one, should see risk appetite improve in H2 and both sterling and the euro strengthening against the dollar. In addition, concerns over the public finances of the world's largest economy are likely to put the greenback on the back foot moving into 2013 and following the forthcoming Presidential election. We target $1.62 for GBP/USD by year end.

EUR/JPY

The Eur/JPY currency is often seen as a barometer of risk appetite. During times of risk aversion, the Japanese yen and Swiss franc are traditionally the two currencies that prosper. In H2 2008, the global recession coupled with the collapse of Lehman Brothers pushed the Eur/JPY currency pair from Y170 in July to sub-Y114 in October of that year. Risk appetite remained strong during the first half of 2011, apart from a brief spike in risk aversion following the Japanese tsunami and nuclear reactor explosion. Since then, however, it has largely been one-way traffic. The intensification of the euro zone crisis at the turn of the year propelled Eur/JPY to Y97.2 in mid-January - its lowest level since late-2000. However, a return of risk appetite in late-January has pushed the currency pair back above the Y100 level.

Eur/JPY continues to be closely correlated with risk appetite…



Clearly, given the fragile state of the Japanese economy a strong yen is the last thing exporters need. Indeed, this factor coupled with the tsunami supply chain disruption and high fuel costs led to Japan's first trade deficit in 31 years last year. Some analysts are predicting this trade deficit to run until 2014 which, in turn, presents a major problem for Japan given the scale of its national debt. Against this backdrop, there is mounting speculation that the Japanese authorities will intervene in the currency markets to prop up the Yen. The USDJPY currency pair is currently hovering around the Y76 mark which is not far off its all-time low of Y75.3. Last October a USDJPY move below Y76 triggered intervention by the Japanese central bank. All things being equal, such intervention should push the Eur/JPY exchange rate higher. However, given that we expect the euro zone crisis to get worse *(a return of risk aversion and therefore Yen strength)* before it gets better we anticipate a return to the Y97 levels seen last by Q2. Thereafter, an anticipated response by EU policy makers should see a further improvement in risk appetite in H2 2012 and we target Y103 by year end.

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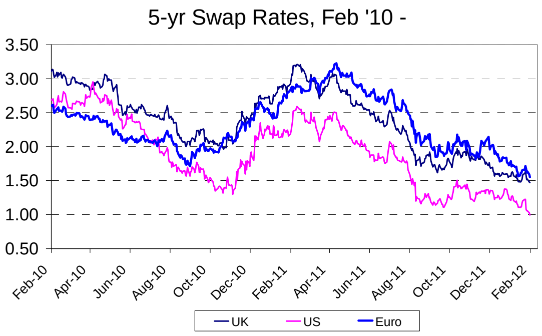
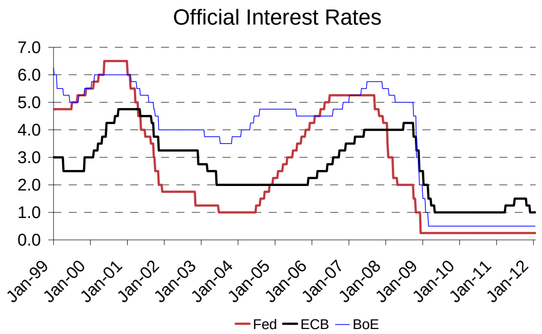
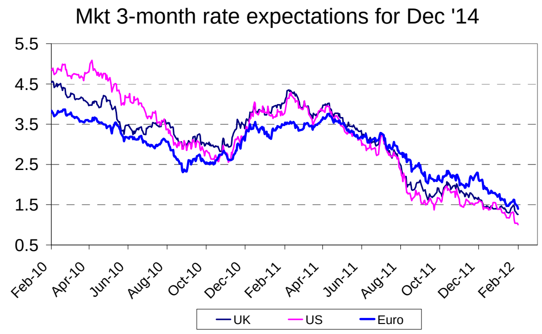
Swap rates have come under renewed downward pressure in the past couple of months, with 5-year rates hitting all-time record lows across the board in the process …



…guidance from the main central banks has been dovish, with the ECB back in rate-cutting mode…



…and markets to continue to embrace the 'lower for longer' theme…



Long-term Rates Outlook

Having traded broadly sideways over the September to November period last year, long-term rates across the major markets came under renewed downward pressure at the end of 2011 and into 2012.

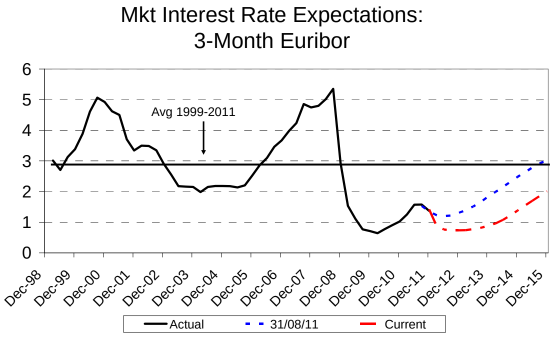
Euro 5-year swap rates, for example, averaged 2% over that three month period, and then fell steadily from late November through the year end and into the early part of January. In fact, this move took 5-year swaps down by over 0.5% and resulted in the establishment of a new all-time record low of around 1.5% for 5-year rates. Sterling swap rates also traded lower over the same period. From levels close to 2% in late October, they too hit new record lows of sub 1.5% in the middle of January. The dollar equivalent rates had already tumbled to extreme and record lows of around 1% in September, not leaving much room for further declines even as other markets rallied. However, having subsequently drifted higher, they have since revisited those lows in line with the falls in euro and sterling rates.

As we have highlighted on many occasions, central bank interest rate and monetary policy, and expectations thereof, play a very important role in shaping directional movements in long-term rates. All else equal, lower official interest rates directly lower short-term market rates, in the process exerting downward pressure on rates further out the curve. In addition, guidance from central banks regarding their view on the economic outlook can also play an important role in shaping market expectations regarding future policy.

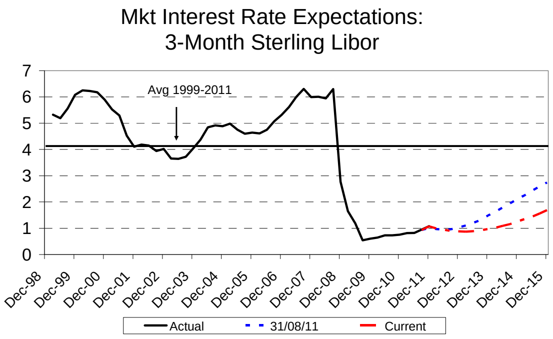
The latter months of last year saw each of the major central banks we follow here put in place additional monetary stimulus measures. Notably, the ECB abandoned its tightening campaign of earlier in the year, with new ECB President cutting official interest rates in the euro area by 0.25% twice in successive months in November and December, while at the same time beefing up considerably its supply of liquidity to the banking sector. The Bank of England and the Fed have already taken rates down to effectively zero so the additional easing measures again took alternative forms. In late September, the Fed announced that it would extend the average maturity of its holdings of securities, in an attempt to engineer lower long-term rates as a means of providing extra stimulus. Meanwhile, in early October the BoE announced a £75bn expansion of its Asset Purchase Facility (APF) (i.e. its Quantitative Easing, or QE, programme), taking its total size to £275bn.

These actions by the central banks exerted both direct and indirect

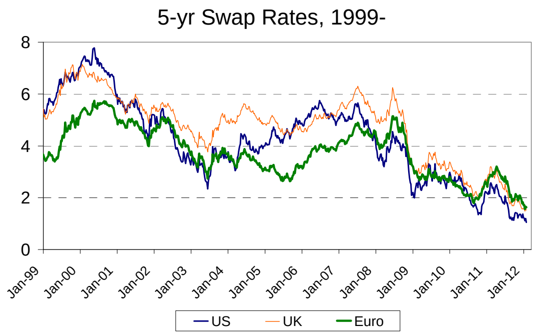
…in the euro zone …



…and elsewhere …



…while we think long-term rates may fall further in the period ahead (linked to our concerns about downside growth risks, including those stemming from the debt crisis), treasurers who are looking to hedge interest rate risk over the medium-term have never had better levels at which to trade…



downward pressure on period rates: directly by the influence of the actions themselves, and indirectly via the expectations channel as further easing steps have been seen as pushing out the expected timing of any eventual policy tightening. Indeed, at the heart of the declines in 5-year rates we have witnessed in recent months is the additional conviction among investors in the theme that official interest rates will be held lower for longer, or to finesse it slightly: even lower for even longer.

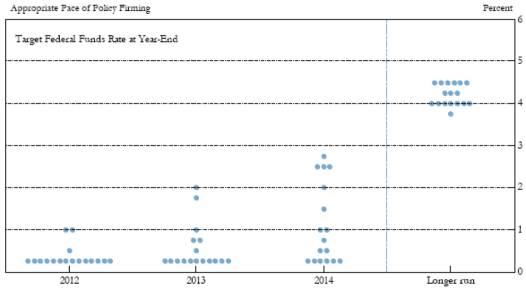
In turn, this theme has its roots in the evolution of perceptions of the economic outlook, as ultimately it is the prospects for growth and inflation that will determine the ability and willingness of central banks to alter their policy stances. The deterioration in the 2012 growth outlook that has taken hold in the major economies, especially in the euro zone and UK, has led markets to price in an increasingly benign interest rate environment in the coming years. For example, 3-month cash currently trades just over 1% in both euros and sterling, and is currently priced to be only slightly higher at around 1.4% in each case at the end of 2014, consistent with an expectation for very little upward pressure on short-term rates in the coming three years.

While progress in resolving the debt crisis has been made by European policy-makers, we remain concerned about the potential for a further intensification of financial market stress ahead of any comprehensive and definitive resolution to the debt crisis being agreed and implemented. Indeed, with the ECB, BoE and Fed all flagging downside risks to the economic outlook as we entered 2012, the chances are that further policy easing will be put in place in each of the euro area, UK and US economies, the key source of risk being the European debt crisis.

Notwithstanding the less negative tone to the very latest economic numbers, we expect the ECB to cut interest rates further in the months ahead, possibly to as low as 0.5%, while we also expect more QE from both the BoE and Fed. In such a scenario whereby financial and economic strains resurface meaningfully, and central banks resume policy easing, we anticipate that we will see the establishment of new record lows for swap rates in the months ahead.

Of course, even the worst of crises eventually pass, so it would be wrong to assume that the levels of long-term rates that we expect (sub 1.5% in both euro and sterling 5-year) will prevail indefinitely. Official central bank rates have been slashed to record lows to deal with a severe economic and financial crisis. And while we do expect official rates across the main economies to be kept at very low levels for a considerable period of time, long-term rate markets will discount any turn in the official rate cycle well ahead of time. Thus, while treasurers face considerable uncertainty on a host of fronts at present, prospective declines in long-term rates could usefully play an important role in the strategic management of medium- to long-term interest rate risk.

… For example, recent guidance from the Fed pointed to an expectation among policy-makers that official interest rates in the US could be expected to be around 4% or more in the long run: that's compared to current levels of 5 and 10 year dollar swap rates of around 1% and 2% respectively



Recent updated guidance from the Fed offers an interesting insight in this respect. The January post-meeting update included information on FOMC participants' expectations about what might be an appropriate official interest rate over the long run for the US economy. The average of responses across the Committee was some 4.2% (each dot in the graph across represents the response of one member). That compares with current market pricing which sees 5, 10 and 15 year dollar swap rates trading at around 1%, 2% and 2.4% respectively. While there is not much prospect of official interest rates reaching 4% in the US in the coming year or two, so this insight from Fed policy-makers does serve to highlight that the exceptionally low rate environment which prevails at present is not set to last forever – a point that should not be lost by the forward looking treasurer as (s)he looks to take a long-term perspective in actively managing any interest rate exposure.

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