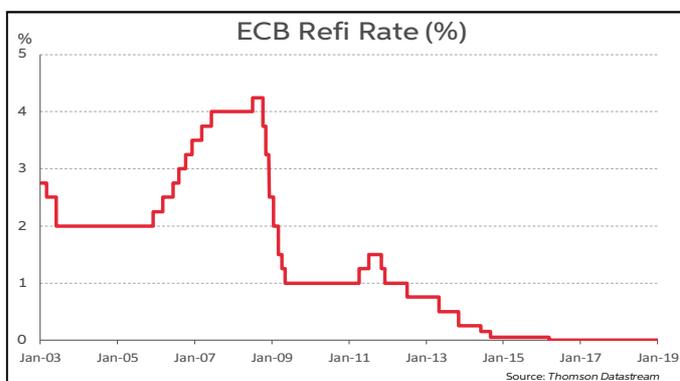


Cautious ECB as the economy continues to slow

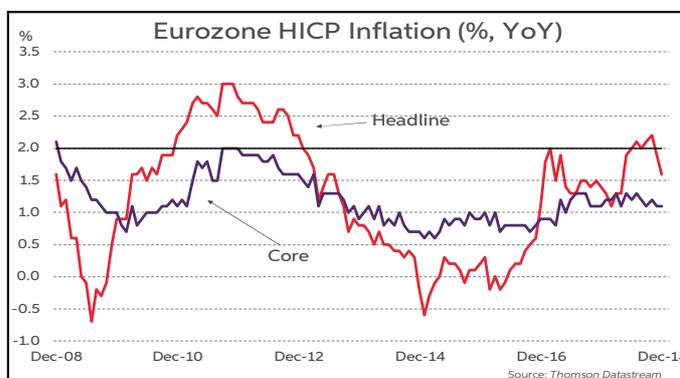
The January meeting of the ECB Governing Council concluded with no changes to interest rates from their present levels of 0% for the refi rate and -0.4% for the deposit rate. The ECB has been indicating for some time that it will keep interest rates at their current very low levels “at least through the summer of 2019”, so the outcome of the meeting was no surprise.

Most interest was centred on the ECB meeting statement and press conference given the continuing loss of momentum in the Eurozone economy. The statement acknowledged the recent softer tone to Eurozone macro data, and noted that incoming figures continue to be weaker than expected. The more challenging economic backdrop was also reflected in the ECB indicating that the risks to the economic outlook have now moved to the downside.



The latest ECB macro forecasts, which were made in December, are for GDP growth of 1.7% in both 2019 and 2020. Recent weak data, including the flash PMI figures for January, which saw the composite index fall to its lowest level since July 2013, show that the economy is continuing to lose momentum. Thus, it is going to be a real challenge to meet the ECB’s 1.7% growth forecast for 2019. Even if activity picks up pace again over the course of the year as the ECB expects, GDP growth may not average more than 1.3% in 2019, and it could be closer to 1%.

The December update of its inflation forecasts shows that the ECB continues to expect inflation to remain below its 2% target over the next 3 years. HICP inflation is forecast to average 1.6% in 2019, 1.7% in 2020 and 1.8% in 2021. Again the inflation forecast for 2019 may prove difficult to achieve, with core inflation stuck at around the 1% level and oil prices having fallen sharply in the closing months of 2018. **Headline inflation is already in marked decline and looks set to fall to 1% or below in the months ahead.**



Not surprisingly then, given this very subdued inflationary outlook and with the economy having lost considerable momentum, the ECB continues to emphasise that interest rates are expected to remain at their current levels “at least through the summer”. It did not change its forward guidance on rates today, but could well do so at its next meeting in March when it will publish updated macro projections.

The market has already moved in this regard. For much of last year, the market expected that the ECB would begin to raise rates in the final few months of 2019. Market pricing indicates that expectations now are that rates will not be raised at all in 2019 and will have increased by only 25bps in total by end 2020, compared to 40-50bps previously. As a result, 3-month Eurozone rates are now not expected to turn positive until spring 2021 compared to the second half of 2020 previously.

Looking out to the medium term, futures contracts suggest that the market is expecting rates to remain low for an even longer period of time. Three month rates are now not expected to get to 1% until the second half of 2024 compared to H2 2023 not that long ago. Nor surprisingly, the softening rate expectations have seen long term bond yields fall in the Eurozone, with ten year bund yields declining to below 0.2%, from 0.55% last September. Meanwhile, the euro remains pinned down close to the \$1.13 level against the dollar.

Eurozone economy close to stalling

Quarterly growth in the Eurozone economy declined to just 0.2% in Q3. This is down from 0.4% in both Q1 and Q2, and the rate of 0.7% recorded right through 2017. The detailed data show that both consumer spending and investment have lost momentum since the start of last year, while there **has been a sharp weakening in export growth.** It slowed to 2.4% yoy in Q3, from over 6% in the final quarter of 2017.

Survey data suggest that economic activity could have lost further momentum in Q4. The Markit composite PMI averaged 52.3 in the period, down sharply from Q3's 54.3 reading, with both the manufacturing and service sectors losing ground. Similarly, the EC Economic Sentiment index also continued to decline in Q4, falling to a 2-year low in December.

Meantime, the available 'hard' data for Q4 have been somewhat mixed. The monthly

growth rate of retail sales was recorded at 0.6% in both October and November, indicative of a good pick-up in consumer spending as it brought sales over the two months to 07% above their level in Q3. However, on the output side of the economy, industrial production figures to date in Q4 have been very disappointing. As of November, output has declined by 1.6% on Q3 levels. Worryingly, the slowdown has been broad-based and is not solely due to bottlenecks in the German auto industry associated with new emission standards.

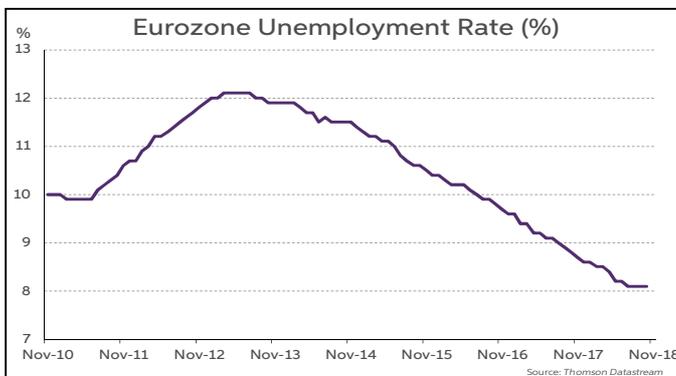
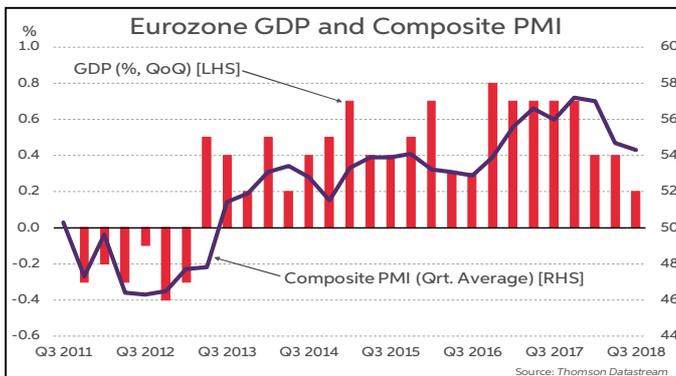
Turning to the labour market, employment growth weakened in Q3, rising by just 0.2%, down from 0.4% in the previous two quarters. However, the jobless rate moved below the 8.0% rate for the first time since October 2008 in November, when unemployment was recorded at 7.9%. The figures for August, September and October were also revised down to 8.0%.

On the inflation front, price pressures in the region remain very subdued. Lower energy prices resulted in the headline HICP inflation rate falling from 2.2% in October to 1.6% by December, while the core measure remains at around 1%. This is far below the ECB target rate of close to, but just under 2.0%.

Meanwhile, the limited survey data available for January suggests that the Eurozone economy weakened further at the start of the year. The flash reading of the composite PMI released today was down again on December's disappointing number. The index fell to 50.7 from 51.1, a five and a half year low. The French index was particularly weak, declining well into recession territory at 47.9. Eurozone consumer confidence, though, did edge up slightly in January.

Overall, the Eurozone economy has returned to a period of much slower economic growth. External demand for European goods, which has helped to boost growth in the past couple of years, has softened as the outlook for the global economy deteriorates. On this note, continuing US-Sino trade tensions and concerns about the possibility no-deal hard Brexit are also a worry. Country specific factors such as the stricter car emission standards in Germany, street protests in France, and higher borrowing costs and increased uncertainty in Italy are also all weighing on activity.

The latest IMF forecast is for GDP growth of 1.6% in 2019, close to the ECB forecast of 1.7%. Our expectation is that growth will be closer to 1% this year, even though falling inflation, continuing very low interest rates and an easing of some current headwinds to growth should see activity pick up pace again as the year progresses.



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