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November 26, 2014

Debt Research: Global economy and markets

Supply, Demand and Curve

Ireland: Batteries recharging towards a AAA-rated end-game

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Ireland's post-Bailout renaissance unfolding economically and financially, a virtuous circle now forming across rising activity, collateral value and confidence levels

- Irish economy achieving "escape velocity" after prolonged downturn, exhausted debt-deflationary headwinds being usurped by mild reflationary tailwinds as credit impulses revive.
- Fiscal outperformance extending as tax multipliers improve, the Austerity Age finally making way for a more broadly neutral and sustainable budgetary stance.
- Elevated debt metrics (public and private) a sober legacy of the Irish bubble-burst, albeit servicing burdens substantially mitigated by debased funding costs.

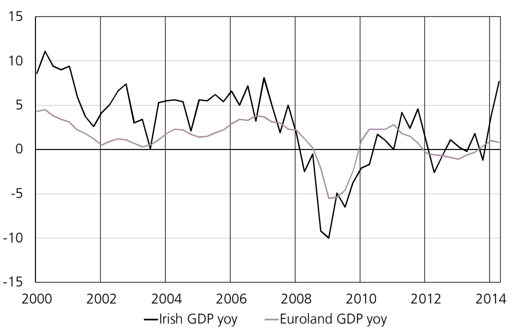
Trajectory of Irish sovereign's Debt/GDP ratio now in firm downward retreat; prospective unwind from 123% peak in 2013 to sub-80% by 2020 a far from hyperbolic conjecture

- Sharp disparity between Ireland's gross and net public indebtedness (on and off balance sheet) to progressively erode on normalised cash balances and asset divestments.
- Shrinking debt-servicing costs (on prepaid IMF loans and record low refinancing rates) ebbing further below Ireland's nominal growth potential.
- Debt sustainability reinforced by growing primary surplus, the overall fiscal-growth interplay lowering Debt/GDP by potential 4pps+ per annum from 2016 onwards.

Irish debt dynamics in stark contrast to more sclerotic EZ peers (core and periphery), sufficient grounds for ongoing re-rating amongst investors and rating agencies alike.

- Ireland still solidly in vanguard of improving EZ sovereign credit ratings cycle; (repressed) market-implied ratings close to AAA, but actual ratings to regain this pedestal by 2018.
- Macro and political risks unavoidable caveats to medium-term debt assessments, but strengthened fiscal framework (external and domestic) a critical counterbalance.

Irish and Eurozone GDP



Source: Bloomberg

Ireland: Batteries recharging towards a AAA-rated end-game

"*We have travelled the long road and are now at a very important crossroads. We are now facing a choice: do we return to the past; unwind the progress and structural reforms made and pursue boom and bust policies? Or do we look forward and continue to build for a better future with a new economic model? A road whose milestones are prudence and caution. A road that delivers stable economic growth. A road that encourages investment. A road that rewards work, and creates job opportunities. A new road to a new Ireland. I know the road this Government will take.*" (Michael Noonan, 14th October, 2014)

- **The nation's official creditors have just concluded their second *post*-programme review, to little fanfare from the general commentariat**

Back to the future

This time last year, the Irish government confirmed its intention to formally exit a three-year Troika funding programme on 15th December, and without the appendage of a precautionary credit line. In consequence, Ireland would be "*handed back her purse*". One year on, and the nation's official creditors have just concluded their second *post*-programme review, to little fanfare from the general commentariat. Rather, recent Irish preoccupations (outside of water charges!) have fixated more on the sequence of events that culminated in the "bailout" request of 21st November, 2010. The controversial decision to backstop an outsized Irish banking system on 30th September, 2008 has now been resurrected as "The Guarantee" on silver screens across the country, whilst theatre boards are being treaded this week with "Let the Market Decide", a "*unique and exciting counter-factual* " imagining of Ireland's alternative course if the €440bn backstop had never materialised.

The biggest kerfuffle of all has followed the recent publication of a series of missives between then ECB President Jean-Claude Trichet and Irish Finance Minister Brian Lenihan regarding Ireland's parlous funding circumstances (and over-reliance on ELA) during October-November, 2010, and the "moral suasion" forcefully applied by that central bank to hasten Ireland's "bailout" request. Arguments have raged over both the content and tone of Trichet's diatribes, with accusations levelled of a central bank overstepping its mandate by straying well beyond banking concerns into the budgetary and economic policy-making preserves of a sovereign state. These letters have reinforced the lingering sense of resentment in Irish popular opinion over its nation's perceived treatment by Eurozone leaders as a domestic economic and financial cataclysm unfolded. They stoke renewed interest in a forthcoming parliamentary enquiry into the Irish banking collapse, such interest yet to be sated despite the plethora of banking sector reports from Messrs Honohan, Regling/ Watson and Nyberg in 2010-2011.

Whether the parliamentary enquiry will be graced by the presence of M. Trichet (or indeed any other ECB representative) is a moot point, Mario Draghi reminding his Irish inquisitor during this month's press confab "*that the ECB is accountable to the European Parliament, not necessarily to the national parliaments*". Also moot is whether future "mature reflections" on the Irish "bailout" saga will cast the overall experience in a more constructive light, given its successful (and accelerated) "right-sizing" of the Irish banking system, and that considerable boon of secure and inexpensive financing for Ireland's pre-ordained (and painfully unavoidable) fiscal consolidation plan.

- **The debt-deflationary downward spiral which preceded Ireland's "bailout" accession has now morphed into an altogether more virtuous circle of rising activity, collateral value and confidence levels**

For Draghi, "*subsequent events - the extraordinary performance of Ireland - seem to say that after all, that decision* (to request a "bailout") *wasn't that stupid". Dispassionate observers may find it hard to disagree. The debt-deflationary downward spiral which preceded Ireland's "bailout" accession has now morphed into an altogether more virtuous circle of rising activity, collateral value and confidence levels, with balance-sheet rehabilitations across State, banking and household balance sheets providing the requisite platform for an Irish economic renaissance. Evidently so. The revealed strength of Ireland's GDP growth trajectory in 2014 has caught the entire analytical community by surprise, both official and private, the European Commission being the latest in a long line of ramped-up forecasts for this year (4.6% *vs* 1.7%) and beyond.

Table 1: European Commission Autumn Forecasts (GDP)

% yoy	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*
Euroland	1.6	-0.7	-0.5	0.8	1.1	1.7
EU	1.7	-0.4	0.0	1.3	1.5	2.0
Austria	3.1	0.9	0.2	0.7	1.2	1.5
Belgium	1.6	0.1	0.3	0.9	0.9	1.1
Finland	2.6	-1.5	-1.2	-0.4	0.6	1.1
France	2.1	0.3	0.3	0.3	0.7	1.5
Germany	3.6	0.4	0.1	1.3	1.1	1.8
Greece	-8.9	-6.6	-3.3	0.6	2.9	3.7
Ireland	**2.8**	**-0.3**	**0.2**	**4.6**	**3.6**	**3.7**
Italy	0.6	-2.3	-1.9	-0.4	0.6	1.1
Netherlands	1.7	-1.6	-0.7	0.9	1.4	1.7
Portugal	-1.8	-3.3	-1.4	0.9	1.3	1.7
Spain	-0.6	-2.1	-1.2	1.2	1.7	2.2
UK	1.6	0.7	1.7	3.1	2.7	2.5

Source: EC

Irish grass is greener

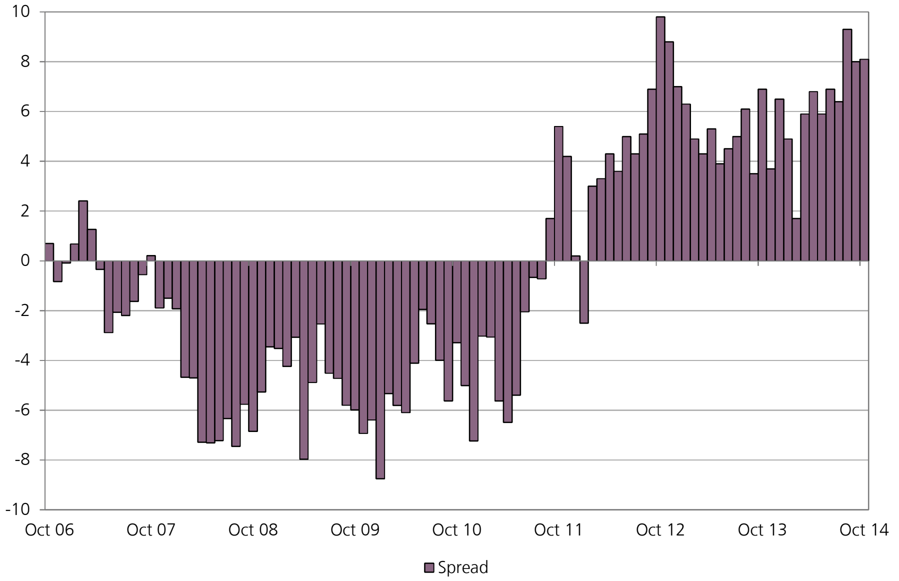
- **The upgrades to Irish growth expectations stand in stark contrast to pruned forecasts for the Eurozone economy**

The upgrades to Irish growth expectations stand in stark contrast to pruned forecasts for the Eurozone economy, whereby slippage in the major economies (*viz* Germany, France, Italy) is masking more encouraging growth stirrings amongst the smaller and hitherto vulnerable economies. Overall, recovery in the single currency area remains "*weak, fragile and uneven*", with confidence levels easily disturbed by global growth jitters and geopolitical risks (not least to the near East). In addition, those intractable *post*-Crisis legacies of elevated debt burdens and high unemployment rates are persistent headwinds to a more normalised cyclical rebound.

- **The Irish economy is apt to complete six consecutive years of growth outperformance by end-2016**

Although the combination of improving credit and fiscal impulses, lower oil prices and a prospective €300bn pan-European investment programme should tailwind Euroland growth towards its (modest) trend potential over the next two years, Ireland's GDP recovery will likely endure at 2-3x its peer-group average. In consequence, the Irish economy is apt to complete six consecutive years of growth outperformance by end-2016. Monthly PMI indicators have long provided (since late-2011) real-time validation of Ireland's emerging growth hegemony, the latest composite reading for October, at 60.2, compared with 52.2 for the Eurozone average.

Figure 1: Irish-Eurozone PMI Differential



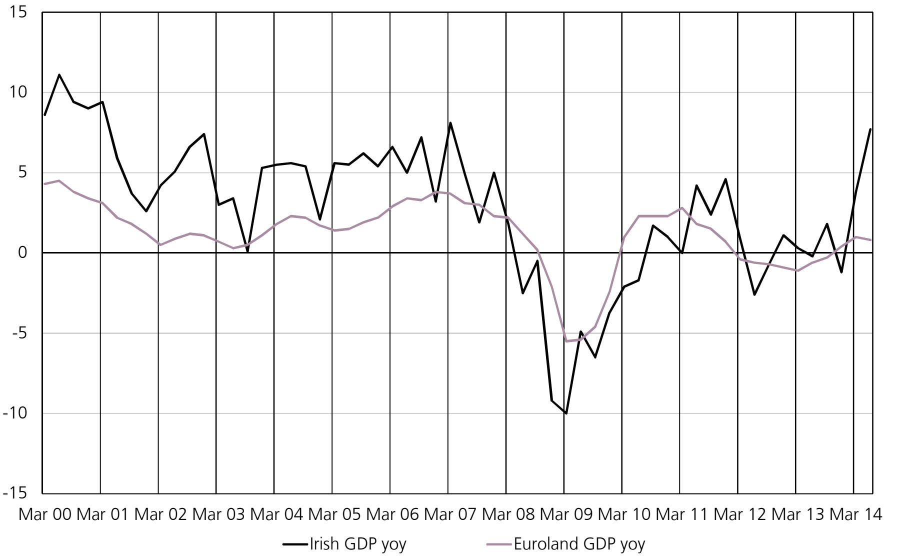
Source: Bloomberg

For the man on the street, improving Irish PMI metrics provided cold comfort during 2012-2013, the spectre of economic recovery still deemed illusory amidst the unremitting deleveraging exigencies of banks, households and government. The national accounts remained in bifurcated mode, as strength in traded goods contrasted with a sustained recession in domestic demand. Although unemployment had already passed its peak by early-2012, sentiment uplifts were hard to discern across the economy at large, with those recurring nightmares for the single currency project serving to reinforce the prevailing despondency.

- **Pent-up demand is finally being paroled after a prolonged incarceration**

All has changed, utterly, in 2014. The deleveraging headwinds to domestic demand have now blown themselves out, replaced by a mild reflationary tailwind as pent-up demand is finally paroled after a prolonged incarceration. The Irish national accounts are no longer bifurcated, with all components (household consumption, capital spending, residential investment, government consumption, net exports and inventories) all realigned in a positive growth trajectory. This year's "lightbulb moment" for investors and commentators alike was surely that mid-September release of second quarter GDP data, wherein revelations of a 7.7% annual expansion prompted a blizzard of growth upgrades from all and sundry.

Figure 2: Irish and Eurozone GDP



Source: Bloomberg

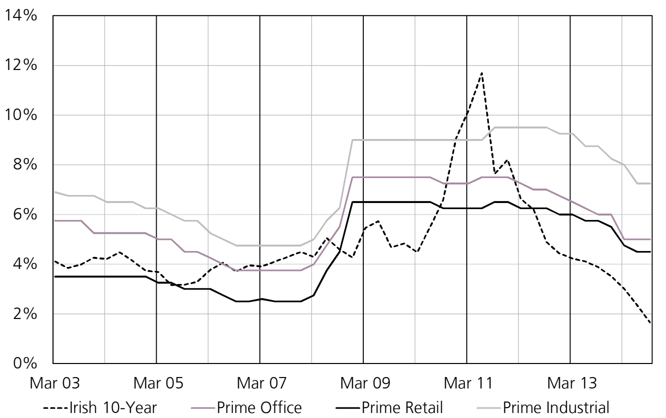
- **The strengthening and broader-based recovery in Irish economic activity is coinciding with rebounding asset values from hitherto distressed levels**

Unsurprisingly, the strengthening and broader-based recovery in Irish economic activity is coinciding with rebounding asset values (real and financial) from hitherto distressed levels, the "lower for longer" munificence of a determinedly dovish Mario Draghi only reinforcing this trend. The sustained erosion in Irish sovereign bond yields from their PSI-distorted peaks of mid-2011 has been exerting a magnetic pull on CRE yields since early-2012, with an assembly line of external and domestic investors (both direct and *via* REIT inaugurations) now competing aggressively for the asset disposals of NAMA, the banks *et al*. Residential property yields are also in decline, if more belatedly so, national house prices having now rebounded by 25.9% from their March, 2013 trough.

- **The relentless appetite for Irish commercial real estate has facilitated an accelerated disposal programme for NAMA assets**

The relentless appetite for Irish commercial real estate has facilitated an accelerated disposal programme for NAMA assets. Following a review earlier this year, the Agency set a revised debt redemption target of 80% of the original €30bn senior notes by end-2016, two years ahead of schedule. With 50% redemptions already achieved by end-October last (and *c* €3bn cash at till), NAMA's latest steer is that it will "*complete much of its work by end-2017 or mid-2018*", compared with the original 2020 expiry date. The public soundings of senior NAMA executives (and those of the Irish Finance Minister) are increasingly confident regarding the full redemption of senior and subordinated (€1.6bn) debt, along with a residual surplus for NAMA stakeholders. NAMA's confidence seems far from misplaced, the €15.3bn carrying value of its residual loan portfolio at end-June, 2014 compared with a par value of €57.5bn, the effective discount thereby 74%.

Figure 3: Irish Asset Yields



Source: Davy

Table 2: NAMA Balance Sheet

Assets	*€bn*	*Liabilities & Equity*	*€bn*
Loans & Receivables	15.3	Senior Debt	18.3
Cash & Equivalents	3.1	Other Liabilities	-0.3
Other	0.4	Equity & Reserves	0.8
	18.8		18.8

* Ex NARL, 30/06/14

Source: NAMA

A rising tide

- **Accelerated deleveraging of the NAMA balance sheet is contributing to a relentless decline in State contingent liabilities**
- **Contingent liabilities long represented by both NAMA and IBRC increasingly resemble contingent assets as the dust settles**

Accelerated deleveraging of the NAMA balance sheet is contributing to a relentless decline in State contingent liabilities. From peak levels close to 200% of GDP in late 2008 (following introduction of the blanket bank guarantee scheme), these liabilities have shrunk to less than 16% of GDP currently, this courtesy of ELA and ELG cessation, NAMA debt repayments and a nearly-completed IBRC liquidation process. Indeed, those contingent liabilities long represented by both NAMA and IBRC increasingly resemble contingent assets as the dust settles.

The State's other contingent assets are also on the upgrade. Both AIB (especially) and BKIR will enjoy capital and income boosts arising from NAMA's accelerated wind-down. The carrying value of NAMA paper is discounted on bank balance sheets, marginally for seniors but substantially so for the unguaranteed subordinated paper. The latter discount is now tracking substantially lower, helped along its way by that first (optional) coupon payment in March of this year, together with the marked-to-market pricing discovery consequent of the IBRC liquidator's nominal €850m disposal of NAMA subs in late-September. In addition, fast-tracked redemption of the NAMA seniors is providing a NIMs boost for Irish banks, these low yielding assets now replaced by higher-yielding alternatives (loans and/or securities).

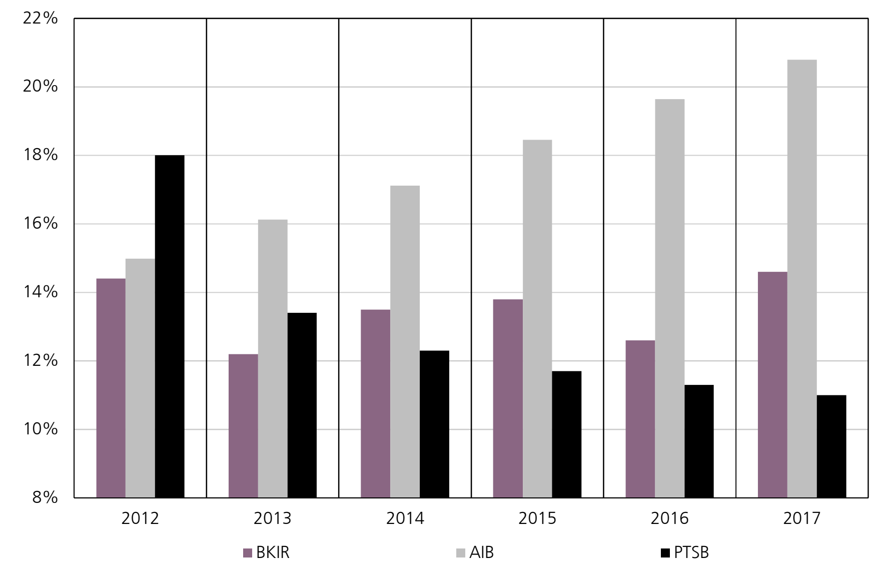
- **The recovery in collateral values which is boosting NAMA's operational framework has also underscored loan loss provisioning at the Irish banks**

More broadly, the recovery in collateral values which is boosting NAMA's operational framework has also underscored loan loss provisioning at the Irish banks. Indeed, provisions release is now something of a *cause celebre* in Ireland, AIB having kick-started the "write-back" process to the tune of €100m in its mid-year interims. Naturally, the Irish central bank has quickly forewarned that "*the ability to write back provisions must be reflective of a conservative view, and therefore the timing and extent of any write-backs must be balanced extremely carefully.....it would be a significant backwards and destabilising step if a bank had to reverse course and re-recognise provisions in the coming years*". Nonetheless, with property indices now well above prior loan-loss assumptions, and

- **Progressive releasing of excess provisions will reinforce the already surplus capital position of a transformed banking system**

with write-backs also in prospect through the loan restructuring process, a progressive releasing of excess provisions will reinforce the already surplus capital position of a transformed banking system.

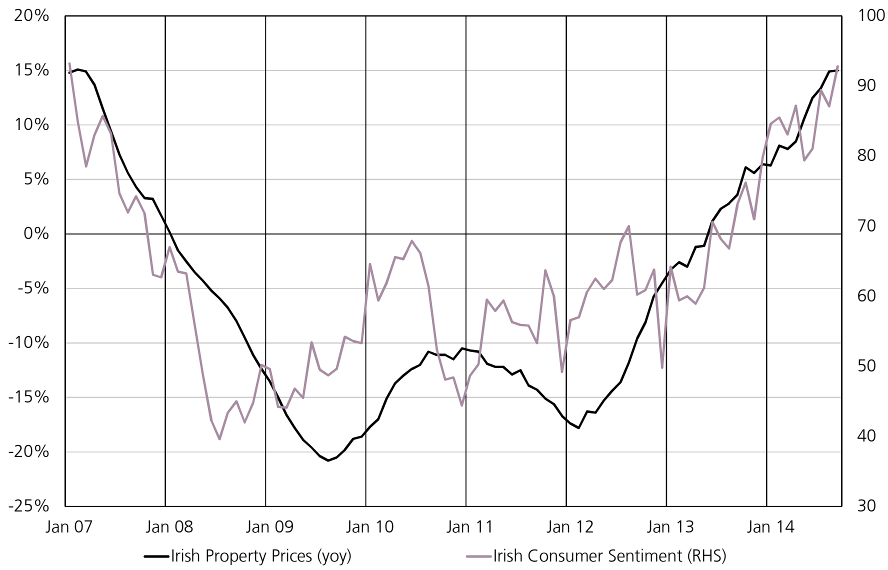
Figure 4: Irish Bank Capital Ratios (CET1 trans)



Source: Davy

The stronger capital bases of Irish banks are also mirrored in the household sector, where net worth rose in Q1, 2014 (latest data available) for the seventh straight quarter, to €110,312 per capita. This metric of household well-being has now rebounded by 13.7% from its Q2, 2012 trough, if still 29.3% adrift of 2007 bubble peaks.

Figure 5: Irish Property Prices and Consumer Sentiment



Source: Bloomberg

Recovering real and financial asset valuations have combined with ongoing reductions in outstanding liabilities to sustain the improving trend. With greater security of employment tenure as labour markets revive, the combination of strengthening balance sheets and more stable/improving income flows has generated a marked turnaround in consumer sentiment from early-2013 onwards.

- **The picture now painted is of an Irish economy and banking system finally and fully re-emerging from a virulent balance-sheet recession, with a "right-sized" banking system and consolidated public and household finances**

Not stock, but flow

All told, the picture now painted is of an Irish economy and banking system finally and fully re-emerging from a virulent balance-sheet recession, with a "right-sized" banking system and consolidated public and household finances. Such re-emergence portends a slow resurrection in credit impulses, the banking system ready, willing and more than able to lend, and both household and corporate sectors incrementally willing to borrow.

The Irish central bank's Quarterly Lending Survey has reported rising loan demand from both households and enterprises during the first nine months of this year. Indeed, the Q3 survey revealed the highest sequential increase in mortgage demand in the history of the series (since February, 2003). Although credit standards have remained broadly unchanged over this period, the latest survey confirms an easing of standards for mortgage and SME loans on competition grounds. A further generalised easing of standards, along with increases in all categories of loan demand, is expected during the fourth quarter.

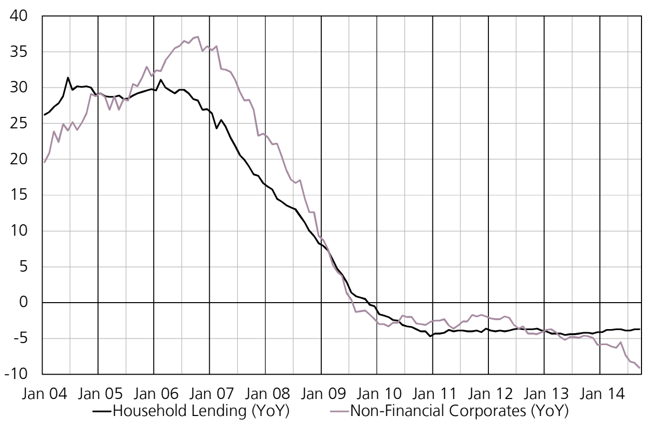
Table 3: Central Bank Lending Survey

	Q4 2013	Q1 2014	Q2 2014	Q3 2014
Households				
House Purchase	3.6	3.8	4.0	4.6
Consumer Credit	3.0	3.0	3.2	3.4
Enterprises				
Overall	3.0	3.3	3.8	3.8
SME	3.0	3.3	4.0	4.0
Large	3.5	3.0	3.3	3.3

1=weakened considerably; 2=weakened somewhat; 3=unchanged; 4=strengthened somewhat; 5=strengthene considerably

Source: Central Bank of Ireland

Figure 6: Net Lending Growth



Source: Central Statistics Office

Although Bank of Ireland and AIB are reporting significant increases in lending approvals in their latest IMS releases, drawdowns are still lagging by a significant quantum, whilst overall net lending growth is mired in negative territory on foot of weighty repayment and redemption flows, albeit to a somewhat lesser degree. Latest central bank data reports a net 3.7% decline in household lending in the year to September, unchanged from the previous month. Mortgage lending is on track for a *c* €3.5bn outturn in 2014, 52% above 2013 levels, but still well below the estimated repayment run-rate for existing mortgages of *c* €6bn per annum.

- **Net lending will stay negative for some time yet, but it is the credit impulse generated by fresh loan originations that matters to Irish growth dynamics, and the omens are distinctly positive in this regard**

Net lending will stay negative for some time yet, but it is the credit impulse generated by fresh loan originations that matters to Irish growth dynamics, and the omens are distinctly positive in this regard. Such developing impulses will help lubricate ongoing pent-up demand releases in construction, capital spending and consumer durables, whilst robust growth in key US and UK trading partners, alongside weakening euro currency crosses, will reinforce a solid contribution from net exports. With the fiscal stance no longer a headwind to economic performance, continuation of broad-based economic recovery at somewhat above-trend growth rates is a reasonable prognosis.

Table 4: Irish Macro Outlook

	2013	*2014*	*2015*	*2016*	*2017*	*2018*
GDP	0.2	4.7	3.9	3.4	3.4	3.4
Consumption	-0.8	1.7	2.7	1.4	1.3	1.3
Investment	-2.4	14.6	12.7	7.6	7.5	5.1
Government	1.4	4.8	2.3	0.0	0.0	0.0
Exports	1.1	8.3	4.8	4.3	4.3	4.7
Imports	0.6	8.8	5.3	3.6	3.6	3.6
Inventories	0.5	0.4	0.2	0.2	0.2	0.2
Domestic Demand	-0.6	3.6	3.6	1.9	1.9	1.5
Net exports	0.6	1.3	0.5	1.5	1.5	1.9
Nominal GDP (€bn)	174.8	183.8	193.5	203.4	213.9	225.0
HICP inflation	0.5	0.5	1.1	1.4	1.4	1.4
Employment	2.4	1.8	2.4	1.9	1.9	1.9
Unemployment	13.1	11.4	10.2	9.4	8.9	8.1
Current Account (% GDP)	4.4	4.9	4.4	4.9	5.2	5.5

Source: Department of Finance

End of era

- **The curtains are finally being drawn on the Austerity Age in Ireland**

Indeed, following the prolonged fiscal consolidation of 2008-2014, during which a cumulative €32bn (18% of GDP) was painfully extracted from the budgetary framework, the curtains are finally being drawn on the Austerity Age in Ireland. This year has told a continuous tale of Exchequer outperformance, with overall balances some €1.6bn (0.9% of GDP) above profile by the end of October. Strengthening and broader-based economic activity has substantially buoyed tax revenues, whilst spending containment (*ex* the Achilles Heel that is Health), lower debt-servicing costs and higher non-tax revenues (Central Bank surplus and State Agency dividends) have also contributed.

- **Ireland is closing in on four straight years of fiscal outperformance, testament to the inherent conservatism of the budgetary arithmetic and sustained discipline in the delivery process**

The Irish government is now guiding a 2014 Deficit/GDP outturn of 3.7%*vs* 5.1% target, that raised GDP quantum *post* ESA 2010 reclassifications further facilitating the target undershoot. Ireland is therefore closing in on four straight years of fiscal outperformance, testament to the inherent conservatism of the budgetary arithmetic and sustained discipline in the delivery process (Health excepted). At year-end, Ireland will have restored an annual surplus to its primary budget balance, the first such occurrence since 2007.

Figure 7: Irish Budget Balance 2011-2015

Source: Department of Finance

Budget 2015 preparations at the Irish Department of Finance were in a constant state of flux this year, courtesy of that Irish economic growth acceleration which caught all forecasters by surprise. Indeed, the Government was obliged to raise its own 2014 GDP estimate on three occasions (from 2.1% to 4.7%) during the final run-up to last month's Budget. As a result, carry-over benefits for next year's fiscal accounts implied a 2.4% Deficit/GDP on an unchanged policy basis, comfortably below the 2.9% target necessary to exit the EU's Excessive Deficit Procedure. Accordingly, the residual €2bn fiscal consolidation for Budget 2015 (*per* April's Stability Programme Update), which was pruned to €1bn in early-September, finally culminated in an actual €1bn loosening of the public purse when Ministers Noonan and Howlin unveiled their tax and spending plans in mid-October, the Deficit/GDP forecast for next year now set at 2.7%. Note that the European Commission, having insisted as recently as June that there was "*no room for manoeuvre*" on Ireland's €2bn fiscal adjustment for 2015, quietly endorsed the Irish government's fiscal and economic projections in its Autumn Forecast release earlier this month.

- **Structural primary balances in Euroland are now forecast to ease slightly on aggregate in 2015 for the first time since the tightening cycle began in 2010**

Next year's mildly expansionary fiscal stance results in a smaller increase in the primary surplus (from 0.3% to 1.1% of GDP) than would otherwise have occurred. This development is being mirrored somewhat across the Eurozone as a whole, where structural primary balances are now forecast to ease slightly on aggregate in 2015 for the first time since the tightening cycle began in 2010. The overall EZ Deficit/GDP ratio peaked at 6.4% in 2010, and has fallen thereafter to a forecast 2.6% this year, with cyclical deterioration in public finances being countered by a sustained austerity bite. Now, with structural primary surpluses on the rise from 2012 onwards, and cyclical components slowly improving as activity levels revive, some modest loosening of the fiscal reins is in prospect for 2015. Modest, but no less significant. Those sustained fiscal headwinds to economic performance are finally blowing themselves out, not only in Ireland, but across the single currency area.

Table 5: Eurozone Fiscal Impulse: 2009 - 2015

% GDP	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*
One-Off Effects	0.0	-0.7	0.0	-0.4	-0.1	0.0	-0.1
Cyclical Component	-1.8	-1.1	-0.6	-1.2	-1.7	-1.5	-1.4
Interest Expenditure	-2.9	-2.9	-3.1	-3.1	-2.9	-3.0	-2.9
Structural Primary Balance	-1.7	-1.6	-0.4	1.1	1.7	2.1	2.0
General Government Balance	-6.4	-6.2	-4.1	-3.7	-3.0	-2.5	-2.4

Source: Deutsche Bank; EC

Table 6: Eurozone Deficit/GDP Ratios: 2011-2016

	2011	*2012*	*2013*	*2014*	*2015*	*2016*
Euroland	-4.1	-3.6	-2.9	-2.6	-2.4	-2.1
Austria	-2.6	-2.3	-1.5	-2.9	-1.8	-1.1
Belgium	-3.9	-4.1	-2.9	-3.0	-2.8	-2.8
Finland	-1.0	-2.1	-2.4	-2.9	-2.6	-2.3
France	-5.1	-4.9	-4.1	-4.4	-4.5	-4.7
Germany	-0.9	0.1	0.1	0.2	0.0	0.2
Greece	-10.1	-8.6	-12.2	-1.6	-0.1	1.3
Ireland	**-8.5**	**-8.1**	**-5.7**	**-3.7**	**-2.7**	**-1.8**
Italy	-3.5	-3.0	-2.8	-3.0	-2.7	-2.2
Netherlands	-4.3	-4.0	-2.3	-2.5	-2.1	-1.8
Portugal	-7.4	-5.5	-4.9	-4.9	-3.3	-2.8
Spain	-9.4	-10.3	-6.8	-5.6	-4.6	-3.9

Source: EC; Department of Finance

Legacy matters

- **The Austerity Age may be over in Ireland, but its legacy endures**

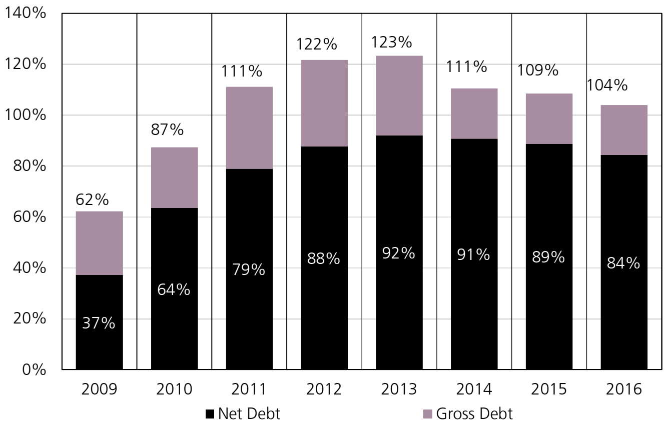
The Austerity Age may be over in Ireland, but its legacy endures. From a lowly 24% in 2007, Ireland's Debt/GDP ratio catapulted higher during the crisis years, given cyclical collapse in tax revenues, automatic stabiliser outlays and that enormous support package (€65bn, 40% of GDP) for banking sector stabilisation. The ratio peaked in 2013 at a weighty 123.3%, well above the 93.1% Euroland average, albeit additionally emburdened by a retroactive reclassification of IBRC liabilities as general government debt (from July, 2011 onwards) under the new ESA 2010 methodology, the latter adding 7pps to the reported peak.

- **Ireland's Debt/GDP metric has long been inflated by outsized cash balances at the NTMA**
- **Ireland's net debt stood at 92.0% of GDP by the end of last year, fully 31pps below the more publicised gross debt alternative**

Ireland's Debt/GDP metric has also long been inflated by outsized cash balances at the NTMA, the consequence of unutilised resources raised under the Troika programme and amounting to €18.5bn (10.6% of GDP) at end-2013. In tandem with other financial assets held by the State (and predominantly in the banking system), Ireland's net debt stood at 92.0% of GDP by the end of last year, fully 31pps below the more publicised gross debt alternative.

This year, with the primary balance moving into surplus, and a size uplift to nominal GDP levels. Ireland's Debt/GDP ratio will commence its descent from a vertiginous height. The initial decline will be augmented by the discharging of all IBRC liabilities (as a successful asset liquidation process concludes), as well as by some reduction in NTMA cash balances (to *c* €14bn) on foot of initial pre-payments of expensive IMF loans. All told, gross Debt/GDP is forecast at 110.5% by end-2014, net debt declining more modestly to 90.8%. In contrast, average Euroland Debt/GDP will rise afresh, to an expected 94.5%.

Figure 8: Irish Debt/GDP Ratio



Source: Department of Finance

Table 7: Eurozone Debt/GDP Ratios: 2011-2016

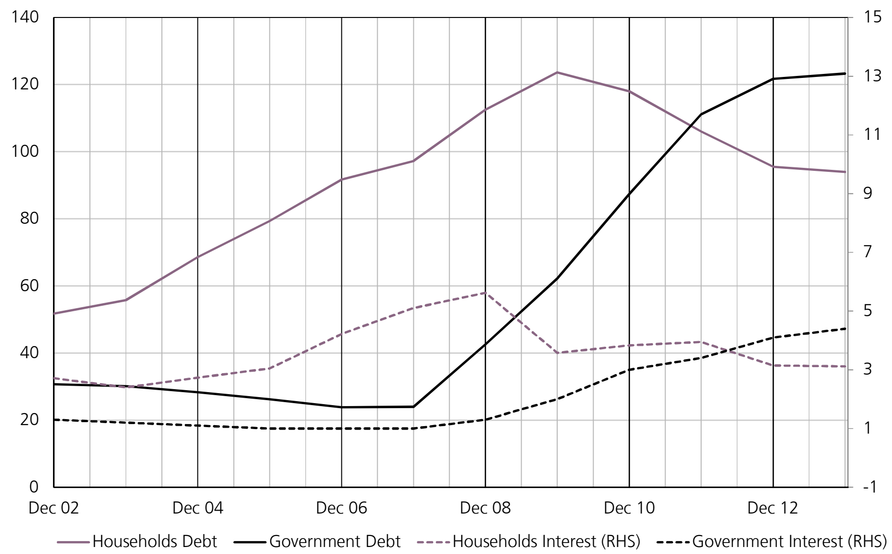
	2011	*2012*	*2013*	*2014*	*2015*	*2016*
Euroland	86.4	90.8	93.1	94.5	94.8	93.8
Austria	82.1	81.7	81.2	87.0	86.1	84.0
Belgium	102.1	104.0	104.5	105.8	107.3	107.8
Finland	48.5	53.0	56.0	59.8	61.7	62.4
France	85.0	89.2	92.2	95.5	98.1	99.8
Germany	77.6	79.0	76.9	74.5	72.4	69.6
Greece	171.3	156.9	174.9	175.5	168.8	157.8
Ireland	**111.1**	**121.7**	**123.3**	**110.5**	**108.5**	**104.0**
Italy	116.4	122.2	127.9	132.2	133.8	132.7
Netherlands	61.3	66.5	68.6	69.7	70.3	69.9
Portugal	111.1	124.8	128.0	127.7	125.1	123.7
Spain	69.2	84.4	92.1	98.1	101.2	102.1

Source: EC; Department of Finance

- **The post-crisis burden of Irish public indebtedness is a considerable one, but there is strong mitigation forthcoming from historically low debt servicing costs and the lengthy average duration of outstanding debt**

The post-crisis burden of Irish public indebtedness is a considerable one, but there is strong mitigation forthcoming from historically low debt servicing costs and the lengthy average duration of outstanding debt. Both such factors were substantially enhanced by the funding generosity of Troika paymasters as the Irish programme progressed, and both are now being reinforced by exceptionally benign funding conditions in the Irish and indeed all other Eurozone bond markets.

Figure 9: Irish Debt Levels and Debt Servicing (% GDP)



Source: Central Statistics Office

- **There is an equivalent tale to be told regarding the burden of Irish household indebtedness**

There is an equivalent tale to be told regarding the burden of Irish household indebtedness. Following years of painful deleveraging, the Household Debt/Disposable Income Ratio has recoiled from 213% peaks in mid-2008 to 182.3% end-September last, still high by international standards and compared with *c* 120% in 2004. Nonetheless, household debt servicing payments are no higher today than they were ten years ago, thanks to debased borrowing costs (predominantly mortgages). With a sustained collapse in disposable incomes finally arrested by recovering labour markets and a peaked-out tax wedge, further reductions in household debt metrics may be more benignly delivered as disposable incomes rebound.

"No boom and bust"

- **Fiscal probity will not end in 2015**

With the expected delivery of a *sub*-3% Deficit/GDP ratio in 2015, Ireland is set to formally exit the Excessive Deficit Procedure (EDP) under the Stability and Growth Pact (SGP). Fiscal probity will not end there, however, with SGB surveillance shifting from the "corrective arm" to the "preventive arm" in accordance with strengthened fiscal rules introduced in 2011 at the height of the sovereign debt crisis. All member states are now obliged to establish a "*credible, effective medium-term budgetary framework providing for the adoption of a fiscal planning horizon of at least three years, to ensure that national fiscal planning follows a multiannual fiscal planning perspective*". The budgetary and debt rules contained in the so-called "Fiscal Compact" were enshrined in Ireland's Constitution in July, 2012, following successful passage of Europe's sole referendum on the issue.

Heretofore, the best known ingredients of the SGP were those targeted 3% Deficit/GDP and 60% Debt/GDP limits. More recent reforms have been designed to increase peer group surveillance levels at an earlier stage, in order to "prevent" any deleterious fiscal trends which could result in future breaches of the SGP. The cornerstone of the "preventive" arm is the medium-term budgetary objective (MTO), designed to achieve a balanced budget in structural (*ie* cyclically-adjusted) terms. Annual progression rates towards this target ("adjustment path") are "more than" 0.5% of GDP for those with Debt/GDP ratios above 60%, and "at least" 0.5% for those below. The Expenditure Benchmark (EB) is a complementary tool towards MTO attainment by limiting public expenditure growth at or below an economy's potential growth rate, absent any revenue-generating offsets.

The strengthened debt rule under the Fiscal Compact requires that Debt/GDP ratios in excess of 60% be reduced by at least 1/20th per annum on average. A transition period applies for those countries exiting an EDP, with a three-year delay before the debt rule kicks in. In Ireland's case, this implies that the 1/20th rule will be applied in full from 2019 onwards. However, Ireland will already be meeting this objective in the intervening years, based on MTO adherence.

Table 8: Irish Fiscal Forecasts 2014-2018

€bn	*2014*	*2015*	*2016*	*2017*	*2018*
Current Expenditure	49.7	49.0	49.1	48.9	49.1
Current Revenue	44.1	45.3	46.9	47.8	52.3
Current Budget Balance	-5.6	-3.7	-2.2	-1.2	3.2
Capital Budget Balance	-2.3	-2.8	-1.0	-2.8	-2.7
Exchequer Balance	-7.9	-6.5	-3.1	-3.9	0.5
General Government Balance	-6.9	-5.3	-3.9	-1.9	0.6
% GDP	-3.7	-2.7	-1.9	-0.9	0.3
Primary Balance	0.6	2.2	3.9	6.2	9.0
% GDP	0.3	1.1	1.9	2.9	4.0

Source: Department of Finance

- **The medium-term fiscal projections included with last month's Budget 2015 Statement have due regard for the "preventive" rules now applying**

- **The Irish authorities acknowledge that the forecast of unchanged expenditure levels over the next four years is a technical assumption**

- **At issue here is the extent to which Ireland's residual budgetary imbalance is cyclical or structural in nature**

Structural or cyclical?

The medium-term fiscal projections included with last month's Budget 2015 Statement have due regard for the "preventive" rules now applying. Whilst tax revenues are expected to grow broadly in line with nominal GDP over the next four years, voted expenditure levels are being maintained at 2015 levels. Such combination serves to expand the primary surplus from a projected 1.1% in 2015 to 4.0% by 2018, whilst overall budgetary balances will morph into a modest surplus (at 0.3% of GDP) by the end of the forecast period.

Admittedly, the Irish authorities acknowledge that the forecast of unchanged expenditure levels over the next four years is a technical assumption, given "*uncertainties with regard to the interpretation and implementation of the fiscal rules*". As time passes, "*final determination of overall expenditure ceilings and taxation measures in this period will be made by Government in line with the fiscal rules, (when) the full amount of additional fiscal space available to Government can be more accurately assessed*".

At issue here is the extent to which Ireland's residual budgetary imbalance is cyclical or structural in nature. This is a particularly thorny subject amongst officialdom, as structural balances are not readily computed, but rather are reliant on output gap calculations that are themselves highly subjective *ex ante*. External assessors (IMF, EC *et al*) view Ireland's output gap as modest, implying that most of the deficit outstanding is structural in nature. If this judgment is flawed, then the residual deficit is predominantly cyclical, thereby endorsing a steadier fiscal hand on the tiller in the quest for overall budgetary balance as Ireland's economic recovery extends.

Based on the EC's harmonised methodology for output gap calculations, the Irish authorities have presented a virtually closed output gap for the end of this year, with a positive output gap emerging thereafter. On this basis, a structural budget deficit of 4.4% is posited for end-2014, the *raison d'etre* duly provided (under the fiscal rules) for ongoing structural tightening of expenditure levels until the MTO of structural budgetary balance is achieved in 2018. The Irish economy is assumed to grow by an average 3.5% *per annum* during this period, broadly in line with potential.

Table 9: Cyclical and Structural Components

	2014	*2015*	*2016*	*2017*	*2018*
General Government Balance	-3.7	-2.7	-1.9	-0.9	0.3
One-Off/ Temporary Measures	0.7	0.1	0.1	0.0	0.0
Cyclical Component	-0.1	0.5	0.5	0.3	0.1
Structural Component	-4.4	-3.4	-2.5	-1.2	0.2
Real GDP Growth	4.7	3.9	3.4	3.4	3.4
Potential GDP Growth	-0.1	1.0	1.0	0.7	0.1
Output Gap	2.1	2.7	3.4	3.8	3.9

Source: Department of Finance

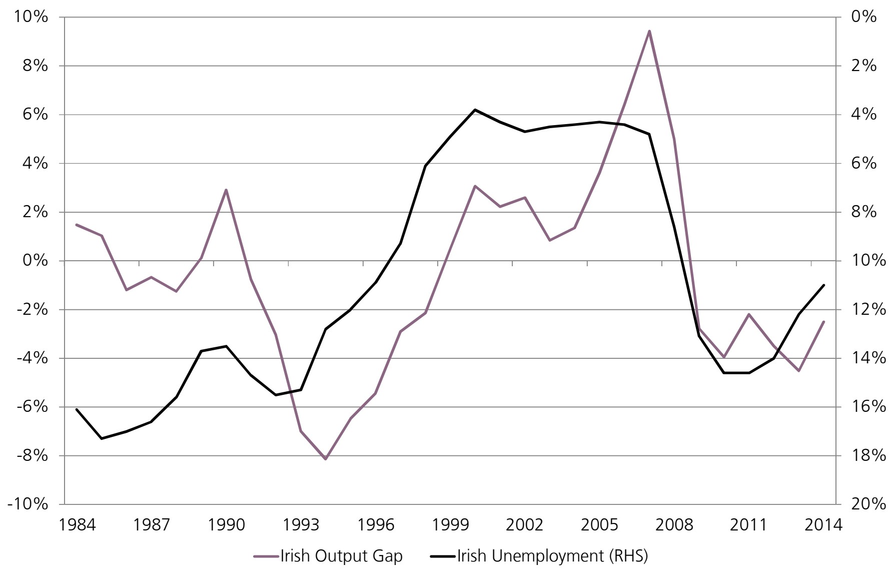
- **The IMF endorses the EC's opinion that Ireland will likely have closed its output gap during 2014-2015**

The IMF endorses the EC's opinion that Ireland will likely have closed its output gap during 2014-2015, implying no residual economic spare capacity with which to sustain above-trend growth without the emergence of wage and/or price pressures. Given the enormity of Ireland's economic relapse during 2008-2010, this points to a notably bearish assessment of the nation's diminished productive capacity arising from the bubble-burst. Indeed, the IMF's medium-term take on Irish growth potential suggests that *c* 20% of GDP may have been permanently lost relative to pre-crisis trends.

- **The last time Ireland transitioned from negative to positive output gaps (per IMF estimates) was in 1999, when the unemployment rate averaged 5.5% en route to its 3.7% cyclical trough in early 2001**

The last time Ireland transitioned from negative to positive output gaps (*per* IMF estimates) was in 1999, when the unemployment rate averaged 5.5% *en route* to its 3.7% cyclical trough in early 2001. This time around, Ireland is ostensibly closing its gap in tandem with 11% unemployment, implying a natural (NAIRU) jobless rate that is substantially and depressingly higher than normal. Such view rests uncomfortably, not only with Ireland's buoyant demographics, but also with the flexibility and adaptability of the Irish economic model, the benefits of all of which now clearly displaying themselves in the *post*-crisis aftermath.

Figure 10: Irish Output Gap and Unemployment Rate



Source: Bloomberg

- **If there is considerable slack still extant in the Irish economy, a more sustained period of above-trend growth is in prospect**

If, as is intuitively likely, there is considerable slack still extant in the Irish economy, then a more sustained period of above-trend growth is in prospect, contributing to a stronger than envisaged bounce in tax revenues. If this materialises, then the current cyclical/ structural decomposition of Irish budgetary balances will be restated, the *ex-ante* fiscal stance then deemed much closer to its MRO end-game than pre-supposed.

- **What seems indisputable is that overall debt dynamics are finally on the turn**
- **The underlying picture is of a recovering economy now growing above its debt-servicing cost, the relative debt burden inflecting lower in consequence**
- **The government's projections make no allowance for any further divestments in banking sector assets**

Debt dynamics on the turn

Whether Ireland's budgetary balances face recomposition or not, what seems indisputable is that overall debt dynamics are finally on the turn. To be sure, this year's projected 13pp decline in Debt/GDP (from 123.3% to 110.5%) is flattered by statistical distortions from the IBRC liquidation, but the underlying picture is of a recovering economy now growing above its debt-servicing cost, the relative debt burden inflecting lower in consequence. With the government primary balance now also in surplus and on a rising trajectory, the official projection of 95.4% Debt/GDP by 2018 is not aggressive.

Au contraire! The government's projections make no allowance for any further divestments in banking sector assets, these valued at €13.3bn (including €1.9bn cash proceeds via BKIR Preference Share sale) by the National Pensions Reserve Fund in its end-September update. Irish banks are increasingly an "investable proposition", given right-sized balance sheets, restored profitability and strong (perhaps too strong) capital buffers. Redemption of the €1.6bn AIB CoCo may be the next instalment in the State's divestment process, while a partial equity stake sale in the same bank will likely transpire in 2015.

The AIB Chief Executive's aspiration that his bank's current €10bn valuation could be doubled "*within a few years*" may be somewhat heroic, but it is not a stretch to posit a €16-18bn (*c* 9% of GDP). State realisation from all remaining banking sector assets over the next three years (capital releases a topside wild-card in this respect). Together with the €5.3bn generated from banking divestments thus far, and the cumulative €4.2bn income garnered under the ELG scheme, the Irish authorities may ultimately return €26.5bn of the €30bn "invested" in viable Irish banks by less-than-willing taxpayers.

Table 10: State Receipts and Payments in Irish Banking Stabilisation

		€bn
Outlays		
	System Recapitalisations	64.1
	Other	1.2
		65.3
Receipts		
	Asset Disposals	5.3
	ELG Income	4.2
	Other	0.6
		10.1
NPRF valuation of "directed portfolio" Sept 14		11.4*

* excludes €1.9bn proceeds of BKIR preference shares
Source: NTMA

Can repay, will repay

The 2015-2018 fiscal framework does incorporate projected interest savings on the national debt, however. This year's debt servicing bill will outturn *c* €400m (0.2% of GDP) below expectations, courtesy of the more favourable interest rate environment prevailing. Some extrapolation of this benign trend is assumed for the next few years, a projection legitimised by Draghi's "lower for longer" policy steer.

- **Also meaningful are the projected savings stemming from early repayment of expensive IMF loans**

However, more meaningful are the projected savings stemming from early repayment of expensive IMF loans (*c* 5% on €18.3bn), these Troika programme borrowings originally slated for amortized repayments over 2015-2023. On the basis that €18.3bn was repaid in three €6.1bn tranches by end-2015, and was refinanced by 10yr bond issuance at *c* 1.88% yield, the Troika projected cumulative savings of €2.1bn in Ireland's debt servicing bill, or 1.1% of 2014 GDP. The Irish government itself appears to have factored in cumulative debt service reductions of €1.8bn (1.0% of GDP) for the next four years, reflecting both the IMF refinancings and that "lower for longer" rate horizon.

Table 11: Irish Debt Servicing

	2014	*2015*	*2016*	*2017*	*2018*
National Debt Interest (€m)	7,474	7,380	7,656	8,087	8,451
%GDP	4.1%	3.8%	3.8%	3.8%	3.8%
% Revenue	12.0%	11.0%	11.0%	12.0%	12.0%
Average Interest Rate	3.7%	3.5%	3.6%	3.8%	3.9%

Source: Department of Finance

Such estimates appear conservative. Earlier this month, the NTMA issued €3.75bn of new 15yr paper to a very receptive bond market at the historically low coupon of 2.4%. Agency cash balances duly rose to *c* €25bn, leaving the Irish authorities comfortably placed to fast-track its IMF repayments, once the EU's political ratification process had reached its conclusion. Such is now the case, thanks to the Swedish parliament's formal endorsement last Wednesday. A €10bn repayment is now likely by end-2014, the balance to follow early next year.

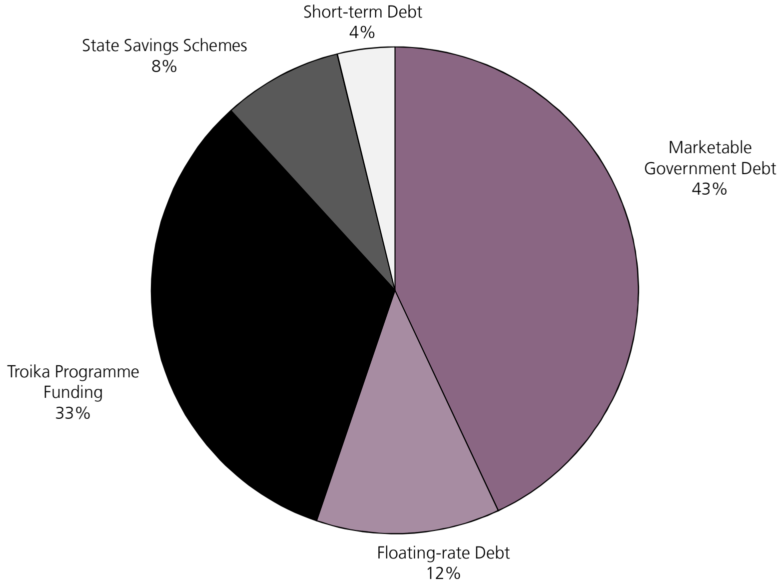
- **Ireland is delivering the combined alchemy of considerably extended debt maturities and considerably reduced servicing costs, with a lower Debt/GDP ratio to boot as outsized cash balances unwind**

Given gross funding needs of €7.4bn in 2015 and €11.7bn 2016, the NTMA will likely use *c* half current cash piles for ultimate IMF repayments, whilst maintaining a 9-15 month *pre*-funding buffer for these more normalised circumstances. With cash balances earning Euribor (*ie* next to nothing) in the Exchequer accounts, and the next bond syndication (7yr?) likely witnessing a 1.00-1.25% coupon, it is evident that the current "bonds + cash for loan swap" is delivering the combined alchemy of considerably extended debt maturities and considerably reduced servicing costs, with a lower Debt/GDP ratio to boot as outsized cash balances unwind. The interest savings alone look likely to outturn closer to €3bn (1.6% of 2014 GDP) over the next four years.

Will history rhyme?

The IMF prepayments have momentarily solved a conundrum faced by the NTMA all year *viz* how to maximise desired bond market engagement (given exceptionally low funding costs) subject to the constraint of unnecessary bond market engagement (given over-flowing cash coffers). To be sure, the stock of Irish public debt is large, at a projected €203bn end-2014, but marketable debt is less than half this total at €92bn (and *sub* 50% of GDP). Given the lengthy weighted duration of aggregate public debt outstanding (at 12.4yrs), and the primary surplus status now enjoyed by Exchequer accounts, the opportunities presented to lower debt servicing costs at current debased bond yields appear few and far between.

Figure 11: Irish Public Debt Composition



Source: NTMA, October 2014

Or are they? The weighted average yield of outstanding Irish marketable debt is now 0.80%, substantially below average coupon costs of 4.62%. This constellation is reminiscent of early-1999 (at the birth of EMU), when Ireland's euro-redenominated bond yields were also travelling substantially below their legacy (Irish punt) coupons, the average "yield gaps" being of the order of 375bps vs 382bps currently. With the NTMA engaged in scant primary issuance at the time (as now), a decision was taken in May of that year to effect debt exchanges into four shiny-new, low-coupon, jumbo-sized bond offerings, in order to boost market liquidity and render the Irish bond market more attractive to investors. The exchange was conspicuously successful, amounting to *c* 80% of outstanding debt.

- **Investors would react constructively to any proposal to boost Irish bond market liquidity, provide current coupon benchmarks and increase the range of maturities available for investment**

As with the 1999 experience, it is likely that investors would react constructively to any repeat proposal to boost Irish bond market liquidity, provide current coupon benchmarks and increase the range of maturities available for investment compared with that relatively tight band-width (2015-2030) currently.

There is one caveat, however. The 4pp uplift to a relatively modest Debt/GDP ratio in 1999 (43% to 47%) was no impediment to a bond exchange programme from the issuer's perspective. However, at this juncture, with 110% Debt/GDP, there is more heightened sensitivity surrounding the optics of debt sustainability amongst the issuer, investors and the rating agencies. Consequently, any mooted debt exchange may be accompanied by a buyback programme, the overall package designed to deliver further substantial debt servicing reductions without any overall increase in debt outstanding. Delivery of the requisite buybacks would be facilitated by the size holdings of Irish marketable debt in official circles (*viz* ECB and CBoI, *c* €15bn).

Ostensibly, the imminent run-down of outsized NAMA cash balances puts the mockers on any near-term buyback stratagem. However, the authorities could readily replenish some of these cash balances, and very cheaply too, *via* stepped-up activity in a moribund T-bill market, extending both issuance size and maturity range so as to boost outstanding balances from current nondescript levels. Perhaps last week's €500m 6mth T-bill placement, at a 0.044% funding cost, will prove the thin end of the wedge in this respect.

Look out below!

In Table 12 below, the nominal GDP and primary balance projections embedded in the government's fiscal framework for 2014-2018 are augmented by "steady-state" assumptions for 2019-2020. In addition, the average interest rate on public debt incorporates the impact of both IMF loan repayments and a refinancing of maturing (higher coupon) debt with significantly lower coupon costs as each bond redemption falls due (*nb* no allowance for any across-the-board bond exchange/ buyback initiative).

The Debt/GDP trajectory also conservatively takes into account €16bn in State realisations from banking sector divestments over the 2015-2017 period. Furthermore, no allowance is made for any potential capital surpluses arising from either the IBRC liquidation or NAMA wind-down processes. NTMA cash balances are also assumed to return to 9-12mth funding cover needs by end-2015, and to stay there for the remainder of the decade.

Table 12: Irish Debt Dynamics

	2014	*2015*	*2016*	*2017*	*2018*	*2019*	*2020*
Debt/GDP	110.5	106.4	102.0	93.3	87.2	81.9	76.6
Primary Balance (% GDP)	0.3	1.1	1.9	2.9	4.0	3.5	3.5
Interest Rate	3.7	3.3	3.2	3.1	3.1	3.2	3.2
Nominal GDP (% change)	5.2	5.3	5.1	5.2	5.2	5.0	5.0

Source: Department of Finance; Davy

- **A post-crisis Irish economy growing in and around its trend potential will significantly outperform its debt servicing costs and, in tandem with a rising primary surplus, deliver annual reductions in Debt/GDP metrics worth 4pps+ from 2016 onwards**
- **A sub-80% Debt/GDP is no forlorn prospect for the Irish sovereign by the end of this decade**
- **There is no disputing the rapid about-turn in Ireland's credit quality, and the rating agencies are struggling to keep pace**

The projections are conservatively framed, but the results are no less striking. A post-crisis Irish economy growing in and around its trend potential will significantly outperform its debt servicing costs and, in tandem with a rising primary surplus, deliver annual reductions in Debt/GDP metrics worth 4pps+ from 2016 onwards. With absolute debt levels also substantially reduced by reconvergence of gross and net indebtedness (*via* asset divestments and curtailed cash balances), *sub*-80% Debt/GDP is no forlorn prospect for the Irish sovereign by the end of this decade.

A worthier credit

All things considered, there is no disputing the rapid about-turn in Ireland's credit quality, and the rating agencies are struggling to keep pace. Upgrades have been forthcoming from all three main players this year, both S&P and Fitch now *ad idem* with DBRS over their "A-" assessment, and Moody's still lagging (albeit less so) at the Baa1 level. With Ireland's GDP prospects sharply on the rise (both absolutely and relatively), fiscal deficit and debt projections on the slide, and State contingencies from the banking sector morphing from liability to asset, Ireland's status in the vanguard of a slowly-inflecting Euroland sovereign credit ratings cycle continues to strengthen.

- **A further ratings uplift to follow S&P's forthcoming review on 5th December seems likely**

In upgrading Ireland to "A-" with positive outlook last June, S&P raised its average GDP growth forecast for 2014-2016 from 2.0% to 2.7%, this expected "*to underpin further improvements in the government's financial profile, capital markets access, and financial system asset quality*". No arguments there, except that such GDP forecasts have now been substantially overtaken by events. With this particular agency's prior sensitivities to the NAMA construct now lessened by accelerated senior debt redemptions and strengthening profit profile, a further ratings uplift to follow its forthcoming review on 5th December seems likely.

The Agencies may be struggling to go with the pace of Ireland's credit turnaround story, but the same cannot be said of the bond markets themselves. Note that Moody's proprietary Market Implied Rating for the Irish sovereign currently resides at Aa2, fully five notches above its actual Baa1 mark, and just two notches beneath the heralded Aaa level.

- **Financial repression of government bond yields worldwide has served to flatter all market-implied assessments of sovereign creditworthiness**

Clearly, financial repression of government bond yields worldwide has served to flatter all market-implied assessments of sovereign creditworthiness, Ireland's included. However, the aforementioned five notch differential between Moody's market-implied and actual Irish rating is by some distance the widest amongst the Eurozone peer group. Where the bond markets lead, the rating agencies will surely follow and, in the case of Ireland, most especially so.

Table 13: Moody's Market-Implied Ratings

	Market-Implied	*Actual*	*Differential*
Austria	Aaa	Aaa	0
Belgium	Aaa	Aa3	+3
Finland	Aaa	Aaa	0
France	Aaa	Aa1	+1
Germany	Aaa	Aaa	0
Greece	Caa1	Caa1	0
Ireland	**Aa2**	**Baa1**	**+5**
Italy	Baa1	Baa2	+1
Netherlands	Aaa	Aaa	0
Portugal	Baa3	Ba1	+1
Spain	Baa2	Baa2	0

Source: Moody's

Paradise lost..and regained?

Following Ireland's credit rating uplift to Single A territory last June, S&P opined that the nation would have to "*dramatically*" improve its sovereign debt profile before it could ever regain AAA status; "*the weak spot is the debt burden; its off the scale compared to other sovereigns we follow; its heading in the right direction but we need to see continued support for fiscal consolidation and continued deleveraging*". It would be "*too difficult*" to put timeframes on such AAA restoration, but Ireland would need to have demonstrated a "*sustained record of paying debt down over the medium period*". Moody's was chiming from the same hymn-sheet in its latest credit opinion piece on Ireland in mid-August, citing a reduction of "*very high government debt levels on a sustained basis over the next two decades*" as being the key credit challenge that Ireland now faces.

- **Ireland's prospective debt dynamics are impressive in themselves, but doubly so when cast against the backdrop of altogether stickier Debt/GDP metrics across the brunt of advanced economies**

The requisite "*dramatic*" improvement in Irish public indebtedness is precisely the prospect now unfolding. A seven-year turnaround from 123% Debt/GDP peaks in 2013 to 77% by end-2020 is deliverable *via* the combination of sustained trend growth and full divestment of "available for sale" assets. Such prospective debt dynamics are impressive in themselves, but are doubly so when cast against the backdrop of altogether stickier Debt/GDP metrics across the brunt of advanced economies.

Table 14: Global Debt/GDP Ratios: 2013-2019

	2014	*2015*	*2016*	*2017*	*2018*	*2019*
G20 Advanced	113.5	112.9	111.7	110.4	108.9	107.5
G7	120.1	119.5	118.4	117.1	115.5	114.3
Euroland	96.4	96.1	94.7	92.9	90.7	88.2
Japan	245.1	245.5	243.9	243.3	242.1	241.3
United Kingdom	92.0	93.1	92.9	91.1	88.4	84.9
United States	105.6	105.1	104.9	104.3	103.7	103.7
Ireland	**110.5**	**106.4**	**102.0**	**93.3**	**87.2**	**81.9**

Source: IMF; Davy

- **Ireland has long displayed a "structural" capacity to achieving AAA-rated status**

Ireland has long displayed a "structural" capacity to achieving AAA-rated status, given the strength and effectiveness of its institutional framework, alongside the inherent flexibility and dynamism of its multi-faceted economy. It was such support factors that served to insulate Ireland's sovereign credit rating from even deeper cyclical downgrades during the worst of the banking, budgetary and economic crises of the 2008-2010 period.

Moody's revised and transparent methodology reveals the extent to which public indebtedness is a drag on Ireland's creditworthiness. Whereas high factor scores are now awarded for both "economic strength" (H-) and "institutional strength" (VH), a low score for "fiscal strength" (L-) reduces the overall assessment of "government financial strength" (to H-). This, alongside lingering "susceptibility to event risk" (M+), condemns the Irish sovereign to a Baa1 rating.

Figure 12: Moody's Sovereign Ratings Matrix

	Government Financial Strength														
	VH+	VH	VH-	H+	H	H-	M+	M	M-	L+	L	L-	VL+	VL	VL-
Susceptibility to Event Risk / Score	Aaa-Aa2	Aa1-Aa3	Aa2-A1	Aa3-A2	A1-A3	A2-Baa1	A3-Baa2	Baa1-Baa3	Baa2-Ba1	Baa3-Ba2	Ba1-Ba3	Ba2-B1	Ba3-B2	B1-B3	B2-Caa
VL-	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3
VL	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3
VL+	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3
L-	Aa1	Aa2	Aa3	A1	A2	A3	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3	Caa1
L	Aa1	Aa2	Aa3	A1	A2	A3	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3	Caa1
L+	Aa1	Aa2	Aa3	A1	A2	A3	Baa2	Baa3	Ba1	Ba3	B1	B2	B3	Caa1	Caa2
M-	Aa2	Aa3	A1	A2	A3	Baa1	Baa3	Ba1	Ba2	Ba3	B1	B2	B3	Caa1	Caa2
M	Aa2	Aa3	A1	A2	A3	Baa1	Baa3	Ba1	Ba2	B1	B2	B3	Caa1	Caa2	Caa3
M+	Aa3	A1	A2	A3	Baa1	Baa2	Ba1	Ba2	Ba3	B1	B2	B3	Caa1	Caa2	Caa3
H-	Aa3	A1	A2	A3	Baa1	Baa2	Ba1	Ba2	Ba3	B2	B3	Caa1	Caa2	Caa3	Caa3
H	A1	A2	A3	Baa1	Baa2	Baa3	Ba2	Ba3	B1	B2	B3	Caa1	Caa2	Caa3	Caa3
H+	A1	A2	A3	Baa1	Baa2	Baa3	Ba2	Ba3	B1	B3	Caa1	Caa2	Caa3	Caa3	Caa3
VH-	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba3	B1	B2	B3	Caa1	Caa2	Caa3	Caa3	Caa3
VH	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba3	B1	B2	Caa1	Caa2	Caa3	Caa3	Caa3	Caa3
VH+	A3	Baa1	Baa2	Baa3	Ba1	Ba2	B1	B2	B3	Caa1	Caa2	Caa3	Caa3	Caa3	Caa3

Source: Moody's

- **With credit appraisals a relative rather than absolute construct, directional leadership on both economic growth and debt reduction fronts has the capacity to restore Ireland's AAA-rating within 10 years of losing it**

With Moody's Irish sovereign "event risk" preoccupations wholly focussed on banking system contingencies, its decision last week to finally upgrade Bank of Ireland (on strengthening profitability, capital and liquidity metrics) will directly benefit the sovereign rating also. More important, however, are the potential uplifts to "economic strength" and "fiscal strength" factor scores over the next few years as Ireland's exceptional credit turnaround story plays itself out. With credit appraisals a relative rather than absolute construct, directional leadership on both economic growth and debt reduction fronts has the capacity to restore Ireland's AAA-rating within 10 years of losing it.

Table 15: Moody's Ratings Comparators

Ratings Factors	*Ireland*	*Belgium*	*Finland*
Factor 1: Economic Strength	H-	VH	H
Factor 2: Institutional Strength	VH	VH+	VH+
Economic Resilience (F1*F2)	H+	VH+	VH
Factor 3: Fiscal Strength	L-	M+	VH+
Government Financial Strength (F1*F2*F3)	H-	VH+	VH
Factor 4: Susceptibility to Event Risk	M+	L	L
Government Bond Rating	Baa1	Aa3	Aaa

Source: Moody's

- **Ireland's recovery road towards the highest alter of credit worthiness may be paved with the best of intentions, but there will always be potential stumbling blocks underfoot**

Many a slip……

Ireland's recovery road towards the highest alter of credit worthiness may be paved with the best of intentions, but there will always be potential stumbling blocks underfoot. Rapidly improving debt metrics are predicated on an assumed trend GDP growth trajectory which, whilst not overly optimistic, is still at risk of derailment by myriad exogenous forces. Nonetheless, the sheer diversity of Irish export markets (both regionally and sectorally) provides some insulation from global trade shocks (as the *post*-Lehman period demonstrated), whilst the progressive releasing of pent-up domestic demand in a "lower for longer" policy rate environment represents a further bulwark for expected Irish economic outperformance.

- **The economy is important, but the political economy even more so**

The economy is important, but the political economy even more so. It is no small irony that the expected political dividend to be reaped from a realignment of Irish electoral and economic cycles over the next two years is now being watered down (!) by some governance missteps during the past ten months. However, on the basis that a week is a long time in politics, the government's recent snatching of defeat from the jaws of victory may well reverse once again before the next General Election convenes in early-2016.

- **Political risk factors are an unavoidable ingredient of any medium-term sovereign debt assessment, but the strengthened fiscal framework of the Stability and Growth pact provides a critical counterbalance in this regard**
- **Irish sovereign creditworthiness is being protected…from itself**

Political risk factors are an unavoidable ingredient of any medium-term sovereign debt assessment, be it in Ireland or elsewhere. However, the strengthened fiscal framework of the Stability and Growth pact provides a critical counterbalance in this regard, as indeed does the existence of a Single Supervisory Mechanism in mitigating contingent banking sector risks. With both the Fiscal Compact and Banking Union finally up and running, Irish (and Eurozone peer-group) policy-making is now further circumscribed, the intention being to safeguard economic and financial stability at home and abroad. In this respect, Irish sovereign creditworthiness is being protected…from itself.

Asset allocation

Table 16: Asset allocation matrix (three-month view)

	Equities	*Bonds*	*Credit*	*Money*	*Forex/€*
Euroland	2	-1	0	1	Base
UK	1	-1	0	-1	0
US	1	-2	-1	-1	1
Japan	2	-1	-1	0	-1
EM	1	0	0	0	0

Code: +3/-3 very attractive/very unattractive

View	Recommendation
Equities	
• Impressive "sugar-rush" rebound in global stocks from mid-Oct swoon, confirming asset class of choice status on macro/relative value grounds.	• Valuations enrichened by uber-liquidity backdrops, but not excessively so, whilst earnings growth improving as economic recovery accumulates.
• Cross-market volatilities resurrecting after prolonged slumber; central banks quick to placate protem, but a recurring event risk during 2015.	• Maintain Euroland (vs US) and Japanese (vs EM) overweights on policy and/or relative valuation grounds; cyclicals (inds, fins, techs) preferred.
Bonds	
• Tepid growth and falling oil prices unhinging inflation expectations, the G4 monetary policy responses an obvious boon to global bond pricings.	• Hard to fight the liquidity tide, but Fed's "data-dependency" brings a hike-cycle closer, and ECB sovereign QE tools may stay in the tool-box.
• Treasuries decoupling from US GDP acceleration, a new "conundrum" rationalised by gravitational pull of global yields and stronger US dollar.	• Neutral duration until bearish reversals confirmed; steepening bias for core EZ and flatter Trsys; stay long EZ peripherals on global spread plays.
Credit	
• Global credit closing out a record supply year with decent performance stats, albeit HY a conspicuous laggard in this latest "risk-on" renewal.	• HY unease harbinger of inflection point in global credit market cycle, a credit-to-equity shift (M&A, buybacks) extending when Fed hikes begin.
• ECB policy actions now a direct repressor of EZ ACS and ABS yields, the same fate awaited for corporate debt if private QE gambit recomposes.	• Time to shift back along the credit curve to shorter-duration HG; clear preference for EZ markets on global spreads, and financials over corps.
Money	
• Forward curves bull flattening on a global scale, the "lower for longer" syndrome heightened by additional liquidity infusions (BOJ/ECB/PBoC).	• Complacent Euro$ strip losing the (dot) plot, end-15 (0.50%) and end-16 (1.40%) well adrift of median Fed guidance (1.375% and 2.875%)
• Drum-roll sounding for "considerable time" removal from FOMC's policy pledge; "patience" re rate hike, but clear event risk for H1/15.	• Short Euro$ outright and on all cross-market bases (2015-2016); stay long green over red Euribors, and on spread to Short Stg equivalents.
Forex	
• Currency war-gaming now embraced by ECB, BOJ, SNB and (possibly) PBoC, the USD's TWI surge to 53mth peaks an unavoidable corollary.	• Eur/USD doing "whatever it takes" for 1.2040 revisit, but consolidation thereafter until ECB ambiguities resolve on (private vs public) QE front.
• USD longs at speculative extremes, but prospective policy decouplings without precedent, and chart breaks look more structural than cyclical.	• Yen funder of choice for G4 "carry" (Yen/USD to 124), but chronic "fair value" undershoot, whilst Abe's 3rd Arrow awaits post-election roll-out.

Source: Davy

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Neutral	33	28	2	5
Underperform	9	7	0	0
Under Review	4	3	3	8
Suspended	5	4	0	0
Restricted	3	2	3	8

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