



Farewell to 'Lucky 13'?

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Revisiting our thesis for 2013

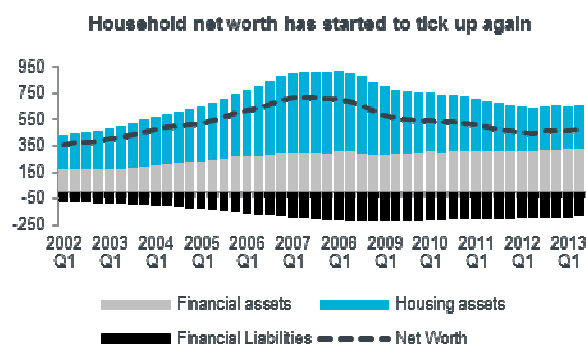
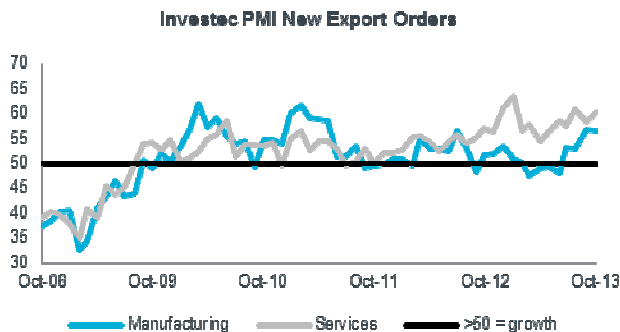
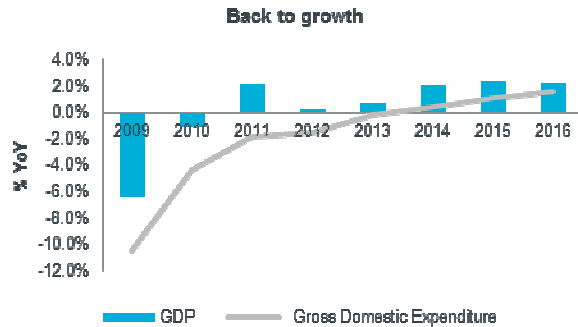
Our *13 looks set to be a lucky number for Ireland* report, published on 8 January, argued the following:

1. 2012 represented an inflection point for Ireland, with domestic indicators stabilising and the export sector performing resiliently despite the troubled global backdrop. However, the domestic sector will be 'less of a drag' on growth as opposed to a driver of growth due to on-going deleveraging and the impact of austerity.
2. The 'vicious circle' that had existed between the banks and the sovereign has given way to a new 'virtuous circle'.
3. On-going growth and fiscal consolidation measures will help to further close the 'jaws' between government revenue and spending. The NTMA will continue to re-engage with the markets, with any deal on the Prom Note front assisting this process.
4. Employment will continue to grow, which is instrumental to solving the problems of: (i) personal debt; (ii) high unemployment; and (iii) the public finances.
5. The *overall* deterioration in the housing market has been arrested, but a two-tier outlook is likely due to tight supply in some areas and excess supply in others.
6. "Much of the heavy lifting has been completed" with regard to the banking sector, but some headwinds (particularly around mortgage arrears) remain to be tackled in 2013.
7. Improving technicals and fundamentals combine to provide an encouraging outlook for Irish bonds.



Looking back, moving forwards

Was 2013 the start of the real recovery?



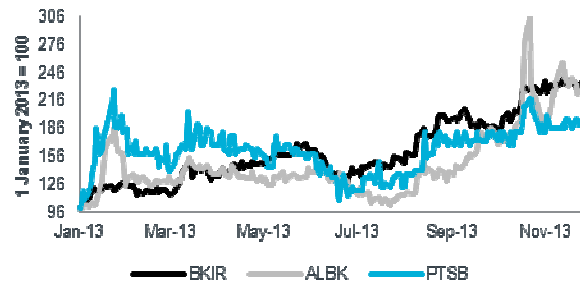
- Despite a lacklustre start to 2013 and the pressure from the 'Patent Cliff', the indications are that GDP will expand for a third successive year. What distinguishes this year from 2011 and 2012 is that the domestic economy appears to be finally moving towards growth, as reflected in a range of indicators (employment, house prices, retail sales).
- We have long argued that Ireland was the best-placed from amongst the so-called 'PIIGS' economies to benefit from a global recovery. Eurostat data show that Ireland's 'openness proxy' (imports + exports as a share of GDP) is 192%, compared to a range of 59-78% across the rest of the periphery. The pick-up in Ireland's key export partners during 2013 is reflected in the export component of the Investec Manufacturing and Services PMIs.
- Central Bank data reflect the movements in household balance sheets. Household net worth fell by €271bn between Q207 and Q212, but it has risen €24bn to €472bn since the trough (Financial Assets +€14bn; Housing Assets +€3bn; Financial Liabilities -€7bn). Households' financial liabilities equate to 198.3% of disposable income, versus a peak of 214.5%, but still clearly very high.

Momentum is building across the economy

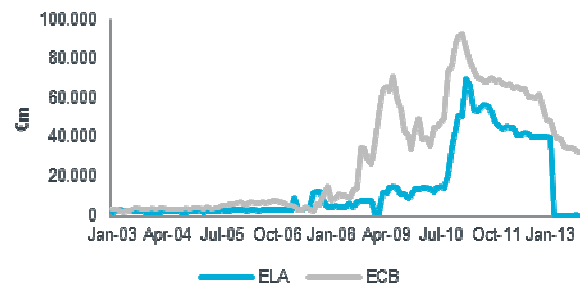
A new narrative around the banks

Are the banks now a help, or still a hindrance?

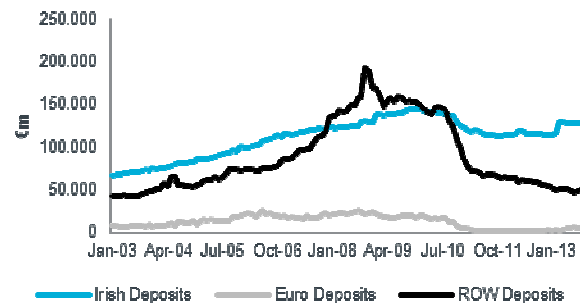
YTD share price performance



Central Bank funding has declined



Deposits have stabilised



- The strong market appetite for Irish exposure means that Bank of Ireland is poised to be the first domestic lender to be restored to full private ownership. Ireland put €4.8bn into the institution and to date has gotten back €3.8bn of this (€1.0bn of which came from the sale of CoCos in January). A sale of the €1.8bn of State-owned preference shares appears imminent, while the State also has a 15.1% ordinary stake with a current market value of €1.2bn. All told, a profit of over €2.0bn is likely to accrue to the taxpayer from the State's involvement with BKIR.
- The banks' funding base has been transformed, with loan-to-deposit ratios returning to sustainable levels and market access demonstrated through a series of senior unsecured, ACS, T2 and RMBS issuance since November 2012. The liquidation of IBRC paved the way for the elimination of ELA from the Central Bank of Ireland, while ECB funding has returned to pre-bailout levels.
- As noted above, retail deposits have improved from the lows, but ratings-sensitive corporate ('ROW') deposits have yet to return following the mass exodus prompted by the Moody's downgrade of Ireland to 'junk' in July 2011. We expect to see Moody's return Ireland to investment grade next year (if not sooner).

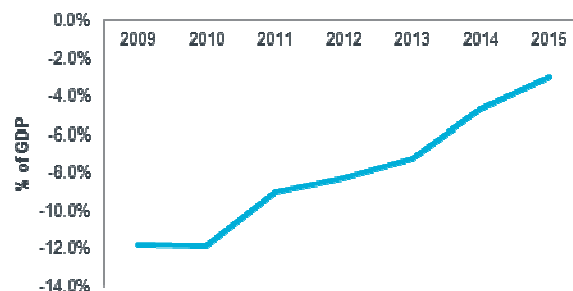
The bank/State relationship - from vicious circle to virtuous circle



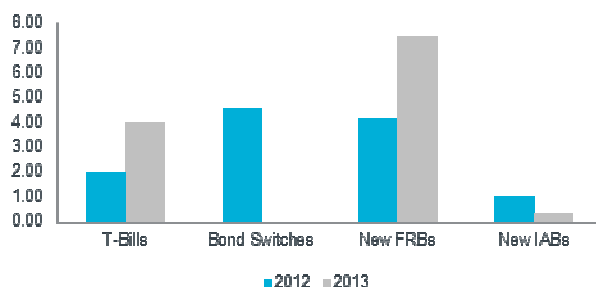
Welcome public finance developments

Deficit to drop, NTMA to sell bonds, Prom Note deal

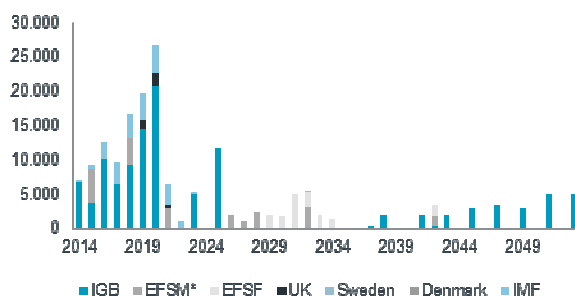
The underlying deficit is improving



NTMA Funding Moves €bn



Irish Bond & Trolka Maturities €m



- Of the €33.1bn of budgetary measures slated for the 2008-2015 period in order to help get the deficit to the target of 3% of GDP, some €30.5bn (92%) of these have been unveiled in the period up to and including Budget 2014 in October. The easing of the fiscal consolidation plans originally pencilled in for last month's Budget means that there is limited room for slippage between now and 2015.
- This year saw the NTMA build on last year's funding progress, as it raised €12bn on the markets from the sale of new bonds (including the first 10 year bond issuance since Ireland entered the EU-IMF programme), amortising bonds and T-bills. The NTMA's large cash buffer leaves Ireland fully funded into 2015 and gave the government confidence to exit the programme without the need for a precautionary credit line.
- The Promissory Note deal in February, allied to the agreement to extend the maturity on EFSF and ESM programme loans, has meant that €50bn of Irish government liabilities have seen their maturity dates pushed back, significantly lessening funding requirements over the next decade and supporting Irish yields.

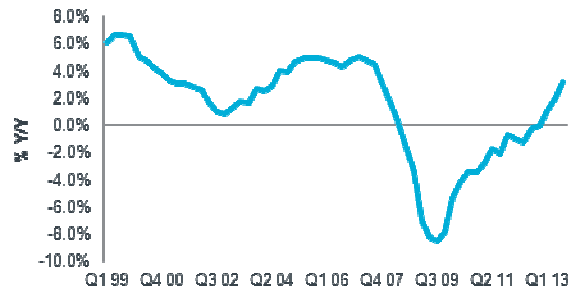
Fiscal progress and debt deals underpin Irish yields



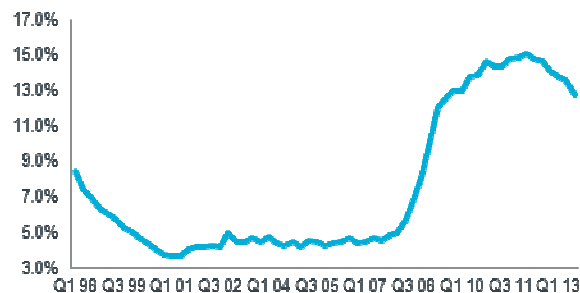
Back to growth

How did employment do in 2013?

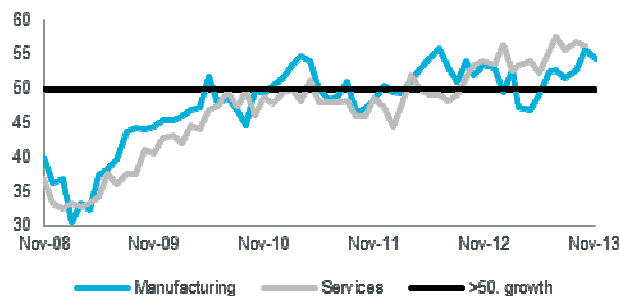
Change In Total Employment



Unemployment Rate



Investec PMIs - Employment



- We expected that 2013 would see the first annual increase in total employment in Ireland in six years. We have been pleasantly surprised by the surge in hiring as the year has progressed, with annual employment growth (3.2% in Q3 2013) now back to levels last seen during the Celtic Tiger period.
- This improvement has pushed the unemployment rate down to levels last seen in 2009. Unemployment peaked at 15.1% in Q1 2012, but has improved to the current (Q3 2013) level of 12.8%.
- The employment component of the Investec Services and Manufacturing PMIs suggests that the upward momentum in hiring will be sustained into 2014.

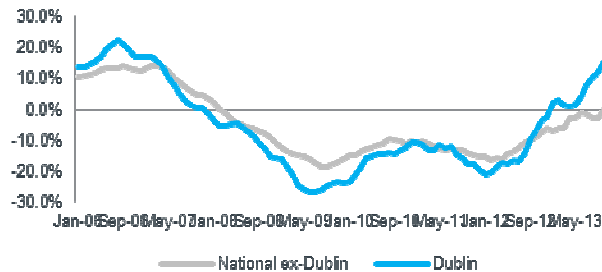
Employment trends have surprised to the upside in 2013



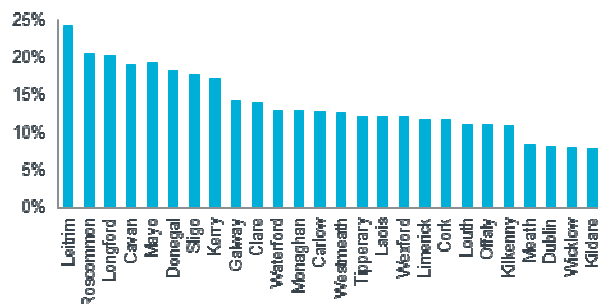
Safe as houses

Did we see a two-tier housing market?

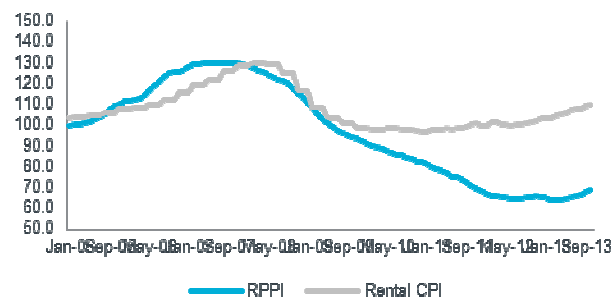
A Two Tier Market



Underlying Vacancy Rate, 2011



Rents have proven more resilient than prices



- Dublin property prices accelerated during 2013. The annual rate of change in Dublin prices hit 15.0% in October, a level not seen since mid-2007. In contrast, the annual rate of change in prices outside of the capital remains in negative territory, as it has done in every month since March 2008.
- The main reason for this is, in a word, 'supply'. While we have a glut of housing units nationally, the distribution of this is far from uniform. Census data (2011) revealed that, even after excluding holiday units from the numerator and denominator, more than 1 in 5 units lay vacant on parts of the Western seaboard, while at the other extreme Dublin and its commuter belt had single digit vacancy rates.
- Rents have proven to be more resilient than prices, and this has seen rental yields push up to elevated levels (the latest Daft.ie report shows yields in Dublin range from 5.6-8.2%).

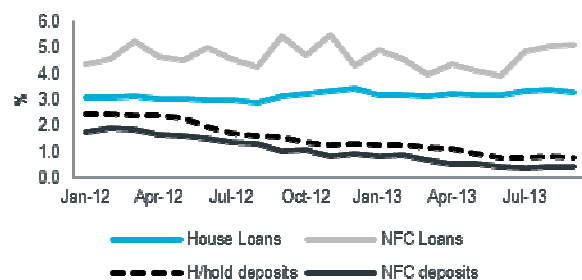
Dublin's housing market has outpaced the rest of Ireland



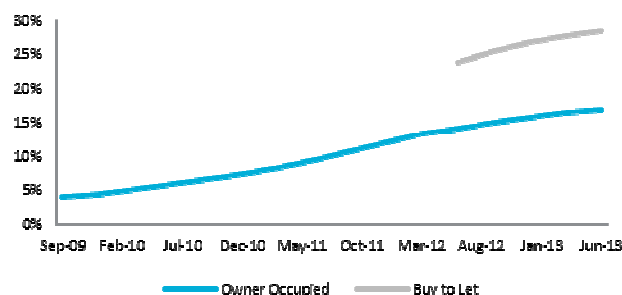
Tackling legacy issues

Banks: A lot done, more to do

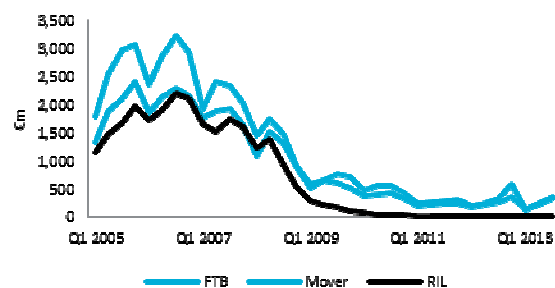
Repricing moves



Arrears >90 days, balance



IBF Mortgage Drawdowns



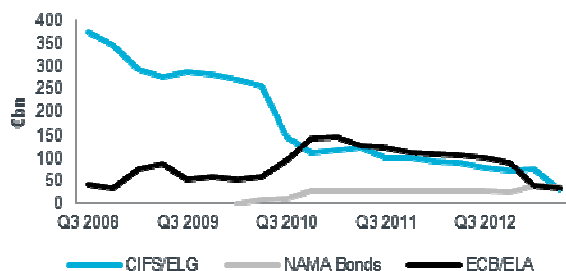
- The Irish banks have made solid pressure in terms of their front books, re-pricing assets and liabilities. Given lag effects, this will take time to fully push through to the back books, so expect the upward spike in net interest margins during 2013 to continue into 2014.
- The challenge of mortgage arrears remains an acute one for many lenders, but the recent turn in Irish economic fortunes and improved engagement should have a beneficial impact on arrears over the coming quarters.
- Despite upbeat guidance from the Pillar Banks, the flow of credit to the economy remains at unsustainably low levels.

Headline indicators mask a two-tier Irish housing outlook

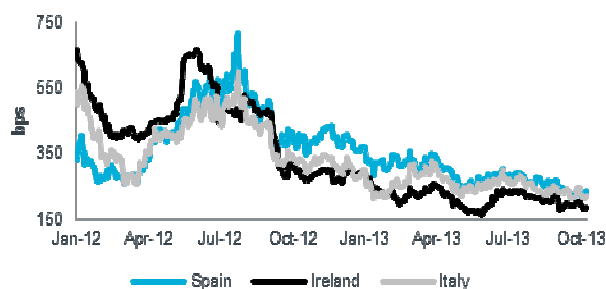
Yielding results

Bond Market Progress

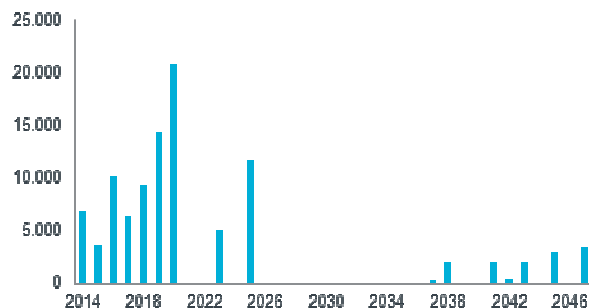
Contingent Liabilities Continue to Fall



5 year spreads over Germany



Maturity Profile of Irish Government Bonds



- Helped by factors such as a marked drop in Ireland's contingent liabilities, the NTMA built on its previous progress during 2013, with the highlights being the raising of €2.5bn from a tap of the 2017 Treasury Bond and a further €5.0bn from the first 10 year bond issuance since Ireland entered the EU-IMF programme.

- Improved economic fundamentals are bullish for Irish bond yields, which has helped Irish bonds trade inside other peripheral countries...

- ...as indeed are technical factors. The NTMA held €26.8bn of cash at end-October (circa 17% of GDP). This leaves Ireland fully funded into 2015. Also worthy of note is that 2014 should see the long-awaited Moody's upgrade, which will prompt index buying of Irish government bonds and also the NTMA's muted issuance plans – net issuance from Ireland in 2014 could be as low as €500m, leaving very little new supply on the table for those seeking exposure to the Irish recovery trade.

Outlook for Irish yields remains positive



What lies ahead?

Next year should see an acceleration in growth as export markets recover, the 'patent cliff' pressure seen in the national accounts this year starts to wash out and the domestic economy moves into growth territory.

While many domestic indicators are moving in the right direction, austerity and legacy indebtedness will remain an overhang for some years to come.

By this time next year at least one bank should be in full private ownership, with the partial privatisation of another domestic bank looking increasingly feasible.

The public finances will continue to improve, but room for slippage is uncomfortably low.

Employment growth will also continue to improve, aided by the economic outlook.

We expect to see the recovery in the Dublin housing market begin to percolate to other areas.

Irish bond yields will continue to tighten, aided by supportive technicals and fundamentals. Ireland will transition from the 'periphery' to a new 'semi-core' status.





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