Irish Economy Monitor

Q4 2018

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General View on Ireland: Growth remains strong and broad-based

National accounts data show that Irish GDP was +7.4% y/y in the first three quarters of 2018, with modified domestic demand (a measure that minimises multinational-related distortions) +5.1% y/y.

1. While some of the components of the PMIs point to caution about the Brexit process, they also indicate sharp overall rates of growth. In November the headline Irish PMIs ranged from 55.4-57.1.
2. Total employment (+3.0% y/y in Q318) is growing by 1,300 a week, with the number of people at work (2.3m) the highest since independence. Unemployment is at a 10-and-a-half year low of 5.3%.
3. Housing completions totalled 12,582 in 9M18, +28% y/y. While the increased output is very welcome, it will be some time in the 2020s before supply meets new household formation.
4. This mismatch between supply and demand means that the path of least resistance for both house prices and rents remains to the upside, although the rate of growth in prices is cooling due to a combination of increased new build and the Central Bank's mortgage rules. Economic growth and Brexit relocations continue to paint a positive picture for the commercial property market here.
5. The year to date merchandise trade surplus, at €43.4bn, is +18% y/y, helped by a 14% y/y rise in goods exports. Services exports were +4.4% y/y in 9M18.
6. Growth in tax receipts has gathered steam into the year-end, helped by accounting policy changes and underlying growth. We have adopted a more cautious stance on the outlook for the public finances given the more uncertain external backdrop.
7. The key risks to the economy are mainly external – the fallout from monetary policy normalisation moves, rising protectionist sentiment and the Brexit negotiations. Housing and competitiveness are the main domestic concerns. The broad nature of the expansion and the significant economy-wide deleveraging over the past decade should help to counter any weakness. Given the recent extension (to 2020) of the 'Confidence and Supply' deal that facilitates the minority government we have withdrawn our previous non-consensus call that a general election would be held in 2019.

Forecast Summary: Nudging up headline growth forecasts

In our last quarterly we noted the potential for upside risk to our headline growth forecasts. Following the recent release of strong national accounts data we nudge up our GDP forecast for 2018 by 20bps (to +7.2%) while retaining our 4.5% and 3.8% projections for 2019 and 2020, respectively. Developments in the external environment, notably Brexit, may prompt further near-term changes.

While GDP is an imperfect measure of progress, a range of indicators (as detailed on the previous slide) warrant our narrative of strong, broad-based growth.

On the public finances, growth in tax receipts has quickened in recent times. Year to date (end-November) revenue was +7.6% y/y, up from 5.4% y/y in H118. Some of this reflects timing issues, however. While noting that there is a *realpolitik* angle to fiscal policymaking at this time (specifically, a minority government and no shortage of populist voices on the opposition benches), we are sympathetic to the recent warnings from the Irish Fiscal Advisory Council about the risk to the public finances arising from possible adverse international developments.

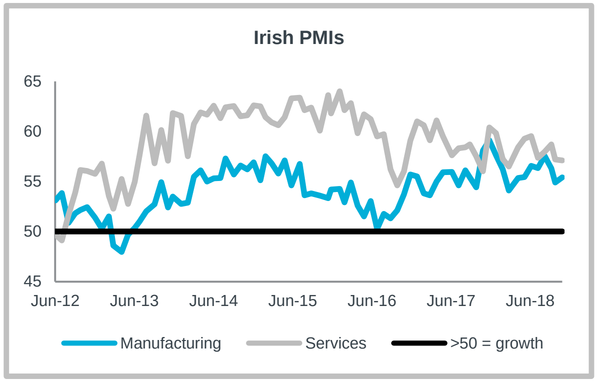
Investec Summary Forecasts, full forecasts are on slides 25 and 26

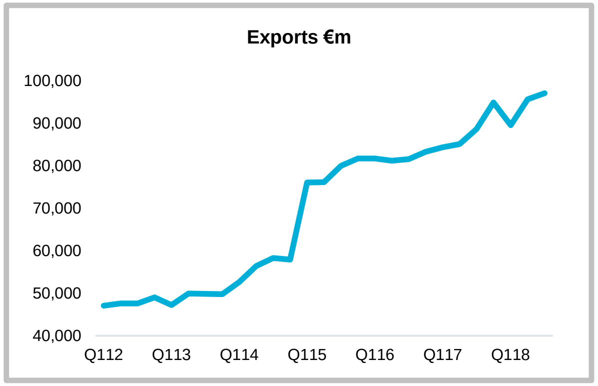
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
GNP	0.5%	0.0%	5.8%	9.2%	13.6%	11.5%	4.4%	8.0%	4.9%	4.1%
GDP	3.7%	0.2%	1.3%	8.8%	25.1%	5.0%	7.2%	7.2%	4.5%	3.8%
Gross Domestic Exp.	-0.3%	2.4%	-1.7%	8.4%	15.1%	22.6%	-13.3%	1.6%	6.4%	5.9%
Employment	-1.9%	-0.4%	3.0%	2.6%	3.4%	3.6%	2.9%	3.0%	2.3%	1.8%
General Gov Deficit/GDP	-12.8%	-8.1%	-6.1%	-3.5%	-1.9%	-0.5%	-0.2%	-0.3%	-0.2%	-0.2%
Gross Govt Debt / GDP	110.9%	119.9%	119.7%	104.2%	76.8%	73.5%	68.4%	64.3%	62.4%	61.0%
Current Account / GDP	-1.6%	-3.4%	1.5%	1.1%	4.4%	-4.2%	8.5%	11.2%	9.6%	8.0%

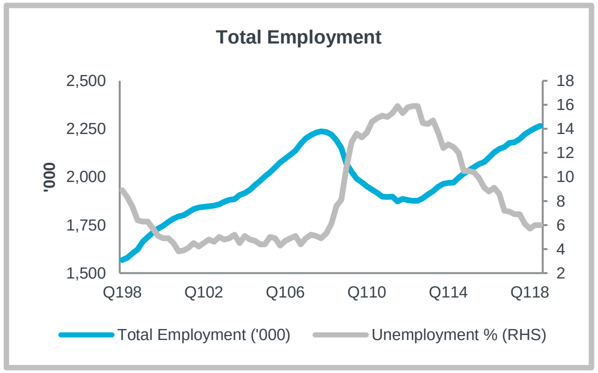
Timely Data

Current Indicators of Economic Activity

Headline growth of 7.4% y/y in 9M18







- The latest PMI data show a slight moderation in the growth rate towards the end of this year, which is likely to have been influenced by concerns around Brexit. With that being said, we have anticipated (and continue to expect) somewhat slower growth in FY19, so this move isn't a particular surprise.

- Despite the more uncertain global backdrop, Irish exports have performed strongly in recent months. National accounts data show growth of 9.1% y/y in 9M18.

- The labour market remains a source of good news for Ireland. Total employment was +3.0% y/y in Q318, with the seasonally adjusted number of people at work (2.3m) the highest since independence. Monthly unemployment data show that the unemployment rate fell 10bps m/m to 5.3% in November, a 10-and-a-half year low.

The recent moderation in growth is no surprise

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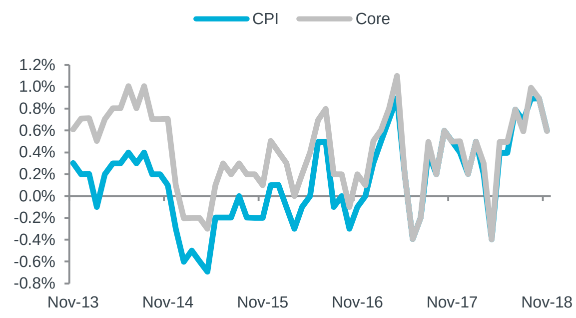
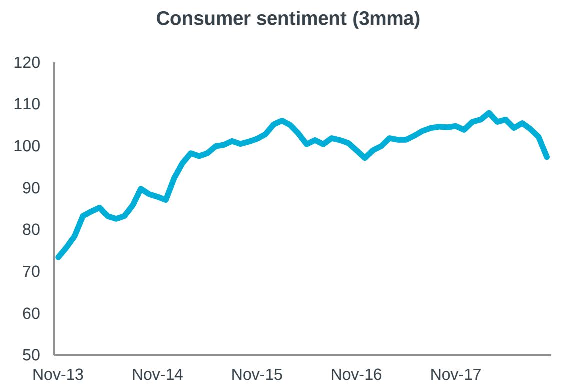
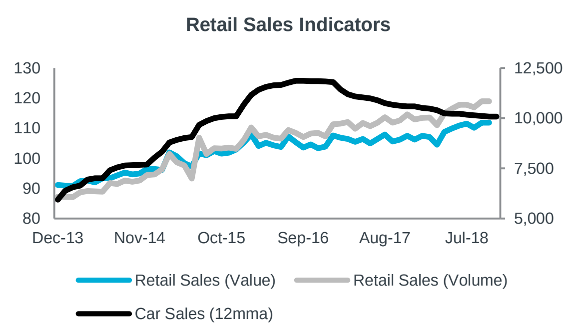






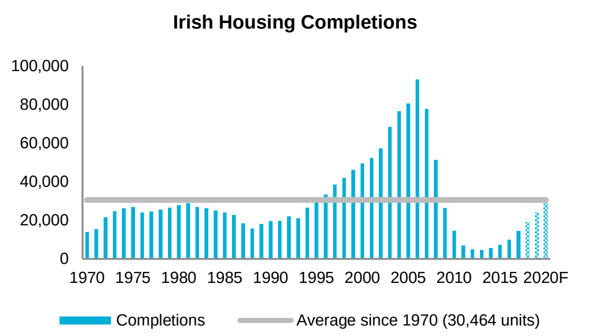
- The headline CPI was +0.6% y/y in November, extending the sequence of sub-1% readings to 69 months. The overall inflation narrative is one of imported deflation (in part due to the weak pound) diluting the pressures from an economy that has limited slack. Other CSO data show that gross average weekly earnings rose 3.2% y/y in Q318, so the muted overall inflationary pressures are contributing to a meaningful uptick in real earnings.

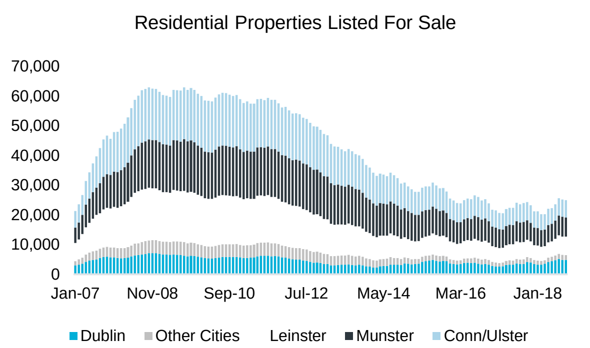
- The headline KBC-ESRI consumer sentiment index slumped to a 46 month low in October before recovering slightly in November. This softness is attributed to concerns about a hard Brexit.

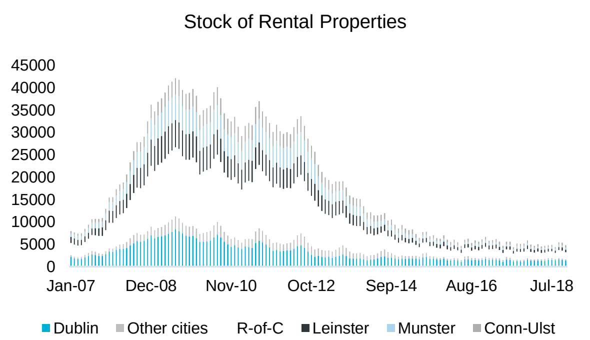
- Notwithstanding the above, retail sales growth remains very healthy. In October volumes were +5.8% y/y with the cash value of these sales +5.3% y/y. The breadth of the improvement in sales is illustrated by 11 of the 13 segments of the retail sector posting annual sales growth in both volume and value terms in October. New car sales have struggled due to the weak pound, but a stronger November suggests that we may be nearing a floor for that part of the motor trades.

Retail supported by strong growth in real earnings

Despite recent improvements, supply is running far behind demand







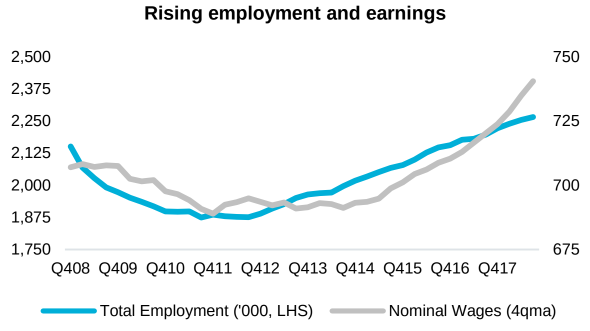
- In 2017 14,446 dwellings were completed. While this outturn was more than 3x the trough reached during the recession, output is well below both the long term average of 30,464 units and the low end of the range of estimates of new household formation (30,000 – 50,000 units per annum). We continue to forecast that output will gradually rise to 30,000 in 2020 (for 2018 we see completions of 19,000).

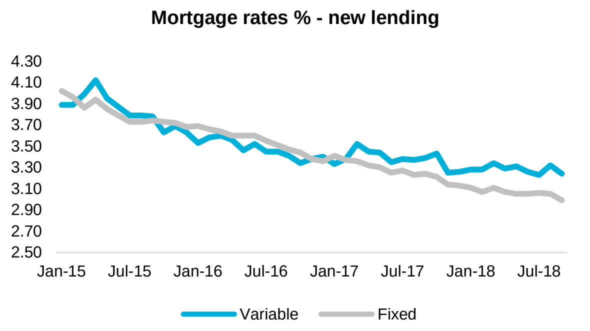
- Supply issues are not only limited to the new homes market. The latest (September 2018) data from Daft.ie show that only 24,963 units were being listed for sale across Ireland, equivalent to 1.2% of the housing stock and 41% below the average number of listings since the start of 2007. Property Price Register data show that 55,784 transactions were recorded in Ireland in the 12 months to end-June, a churn rate which implies that housing units are changing hands once every 36 years on average – a clearly unsustainable level of activity.

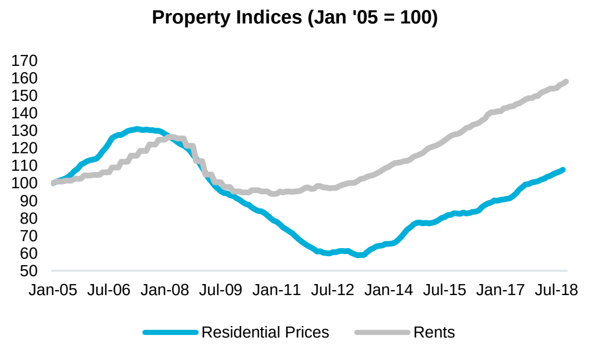
- On a similar note, rental property listings (3,214 across Ireland, of which 1,379 were in Dublin at the start of November), are 72% below the average since Daft.ie began compiling its records.

Housing supply (both new and second-hand) remains abnormally low

Buoyant demand pushing up on prices





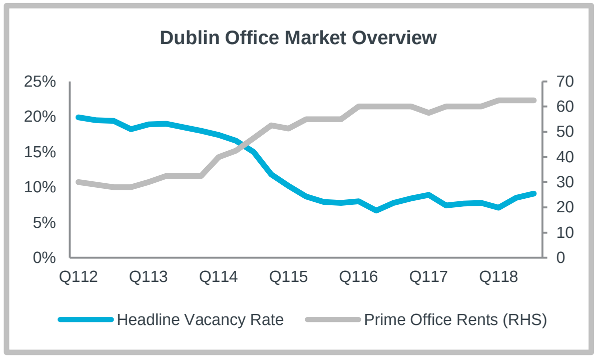


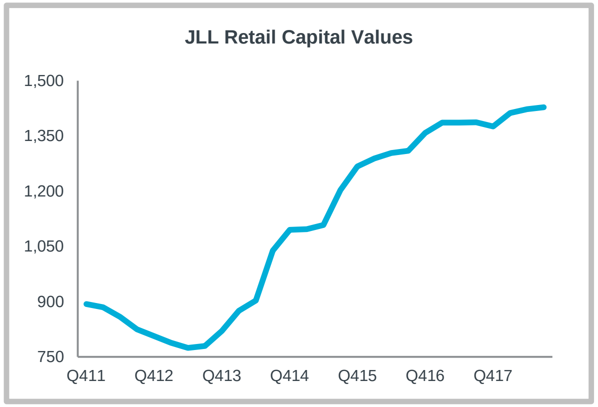
- Total employment stands at a post-independence high of 2.3m and is rising by 1,300 a week. The unemployment rate has fallen to a 10-and-a-half year low of 5.3% and the tighter labour market conditions have produced a sharp uptick in the rate of wage inflation (+3.2% y/y).

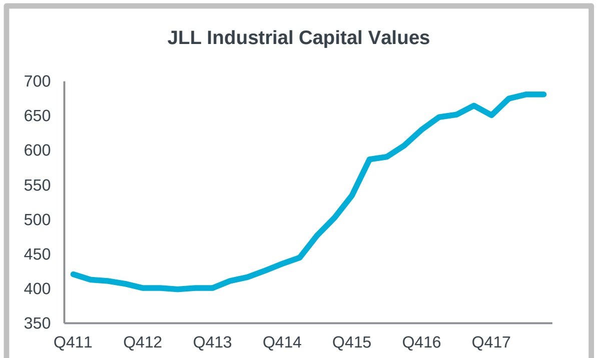
- Front-book mortgage rates continue to trend downwards, which provides a lift to affordability. It is also worth noting that c. 44% of housing transactions in H118 were on a cash only (i.e. no mortgage) basis.

- The mismatch between supply and demand continues to apply upward pressure to both prices and rents. We see this pressure only gradually easing as housing output climbs, but it is likely to be some time in the next decade before new build finally matches new household formation.

Capital and rental growth supported by supply shortages







- Prime Grade A rents in Dublin city centre were static at €60-65 psf for a third successive quarter in Q316 in spite of strong demand (take-up in the year to date is 2.4m, 12% ahead of the same stage in 2017) as more supply comes on stream. The latter helped the headline vacancy rate tick up to 9.1% at end-Q2, a five quarter high, although it should be noted that 3.0pc of this is reserved.

- Retail capital values increased for a third successive quarter in Q3. The cumulative recovery from the Q213 trough stands at 84%, reflecting improved trading (a function of the higher employment and earnings detailed elsewhere in this report) and yield tightening. We argue that Ireland is less exposed to the structural headwinds being experienced by retailers elsewhere in Europe due to a combination of: (i) the minimal supply additions after the 2008 crash; (ii) our low population density; and (iii) expensive postal rates.

- Industrial capital values have increased by 71% from their respective trough. A shortage of high quality accommodation and the need to recalibrate supply chains in response to the UK's vote for Brexit underpin a positive outlook for further capital appreciation from here.

The outlook for Irish commercial property remains positive

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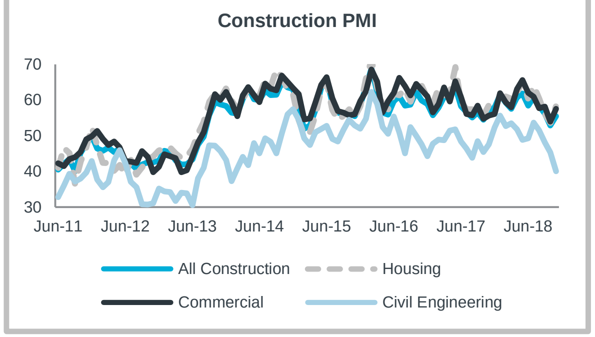
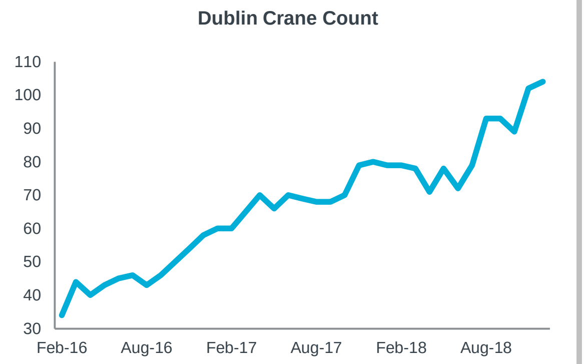


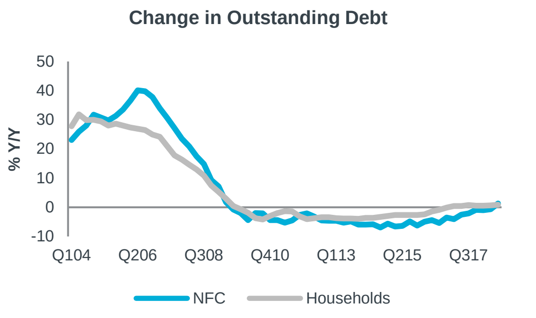


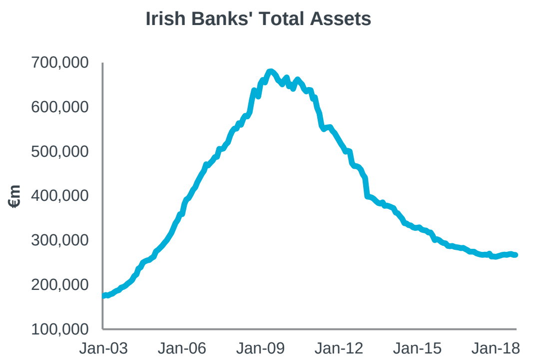
- The headline Ulster Bank Construction PMI posted its 63rd successive above-50 reading in November. Growth is concentrated in the Housing and Commercial segments, with Civil Engineering having recorded three successive months of decline (notwithstanding looser fiscal policies).

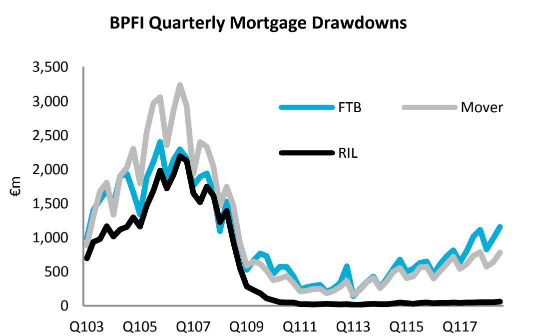
- The Irish Times' Dublin Crane Count, produced in conjunction with Savills, rose to a record (in this cycle, at least) 104 in early December. When the survey commenced in February 2016 only 34 machines were visible on the capital's skyline. Activity has shifted more towards the north side of city in recent months, with 39 cranes on that side of the river in December, versus 23 in the same month last year.

- Planning permissions data show that 29,495 units have been approved in the 12 months to end-Q318, which is the highest since the period to end-Q110. This lead indicator supports our view that annual housing output will climb to 30,000 in 2020.

Lead indicators support our projected growth in housing output





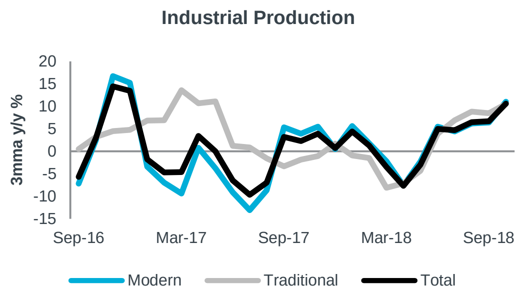


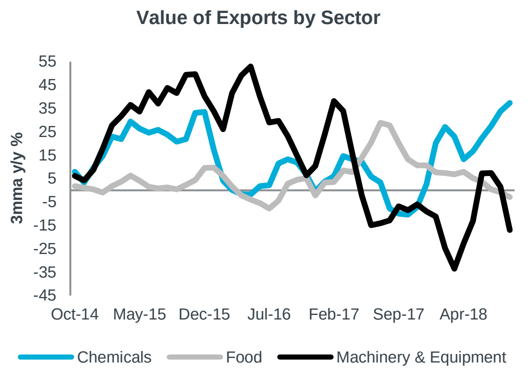
- The latest Central Bank data show that credit to households rose by 0.9% y/y in Q318, which is the highest annual rate of growth since Q209. The latest (Q318) data on business credit show an annual rise of 1.3%, the first increase since Q209.

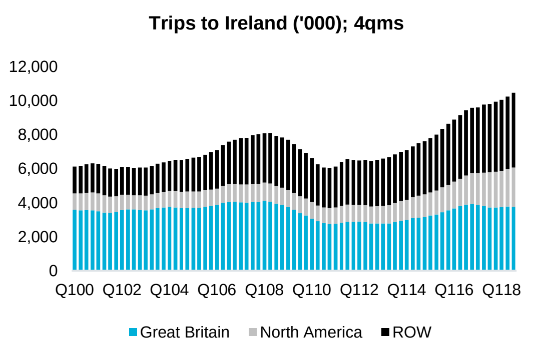
- The Irish banks' total assets fell 61% from peak to trough, pushing the sector loan-to-deposit ratio below 100%. Sector assets have climbed 2% from the trough, although loan sales remain a headwind to meaningful short-term growth.

- Mortgage drawdowns totalled €6.1bn in 9M18, +20% y/y. We expect total lending this year to come in at €8.7bn, which would represent the highest annual outturn since 2008, but this is still less than a quarter of the previous peak (€39.9bn in 2006) that was recorded during the credit bubble of the noughties. We see €10-12bn as a normalised level of annual mortgage lending in Ireland.

Bank balance sheets have started to grow again on an underlying basis







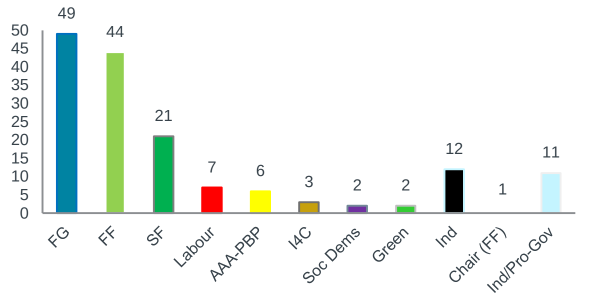
- Following a difficult 2017 (-2.7% y/y), industrial production has returned to growth this year. Q3 production was +5.4% y/y, with strong growth seen across both the multinational-dominated 'modern' sector (+5.6% y/y) and the indigenous-oriented 'traditional' sector (+8.6% y/y). Our hunch is that output could tick up in Q4 as some exporters benefit from precautionary inventory build by UK customers ahead of Brexit.

- Unadjusted merchandise trade data point to very strong growth in trade. In nominal terms, year to date exports are +14% y/y to €116.4bn; imports +12% y/y to €73.0bn' and the trade surplus is +18% y/y at €43.4bn. Admittedly, the headline export figure is flattered by a surge in exports of 'Chemicals & Related Products', but six of the nine major commodity groups show annual growth in exports (seven of the nine show higher imports).

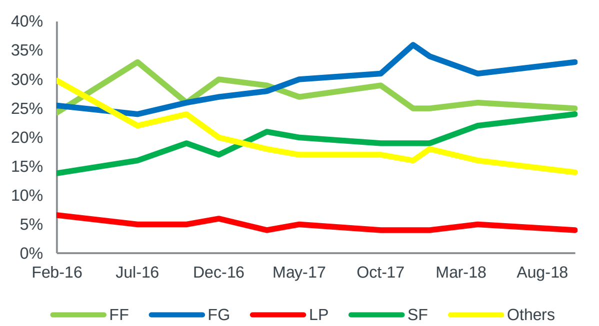
- Trips to Ireland by overseas residents were +7.3% y/y in October, led by a 20.2% y/y increase in North American residents. Travel from those resident in Great Britain was up just 0.1% y/y, likely reflecting the weak pound.

The year to date trade surplus is +18% y/y

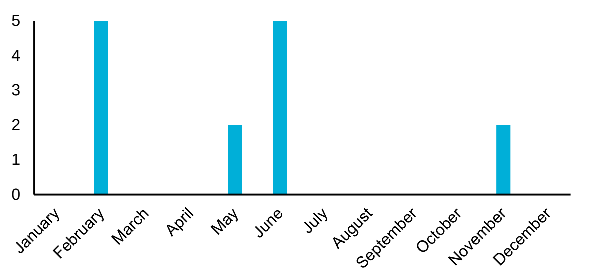
Current Dáil seats (80 = majority)



Irish Times polls since the 2016 GE



Timing of general elections in the past 50 years



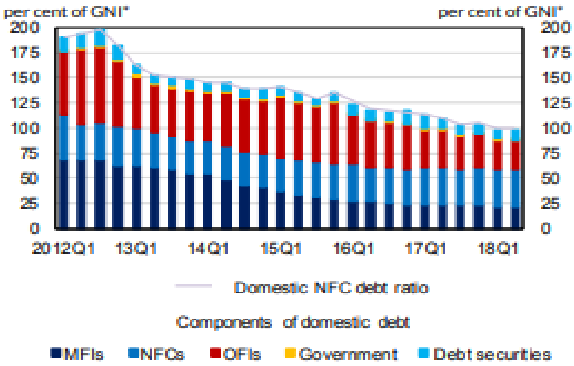
- On 12 December it was announced that the main opposition party, Fianna Fáil, had agreed to facilitate the minority Fine Gael led administration in remaining in office until 2020, citing a need for stability given the uncertainties around the Brexit negotiations.

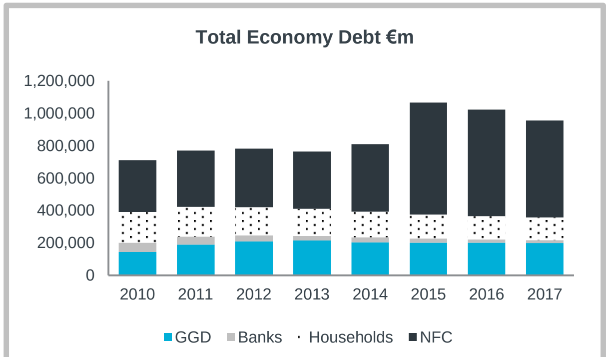
- We previously had a non-consensus view that Ireland could be heading for a hat-trick of elections next May (Local and European elections are already scheduled for the 24th of that month), with Irish political history indicating that it is one of just two credible 'windows' for a general election (a general election in February, just ahead of Brexit, seemed implausible). The extension of the 'Confidence and Supply' deal between Fianna Fáil and the government leads us to withdraw that call. That a minority Irish government would be able to soldier on for at least four years is without precedent.

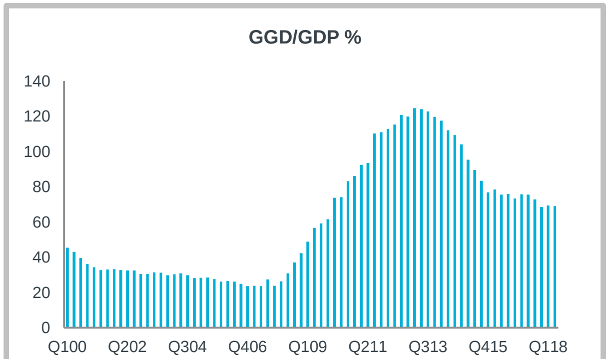
- With the government set to survive for at least another year, opinion polls have less meaning than would otherwise be the case. For what it's worth, the polls do show a number of interesting trends. Firstly, there has been a shift towards the centre ground since the 2016 election, with the combined poll rating of the traditional three parties of government – Fine Gael, Fianna Fáil and Labour – standing at 62% in October's Irish Times poll, 5pc above the 2016 election outturn. Adding in Sinn Féin here shows that there has also been a marked move towards the larger parties, with the combined support for independents and minor parties halving to 14% currently versus 29% in 2016.

We no longer see a general election in 2019

Irish Debt







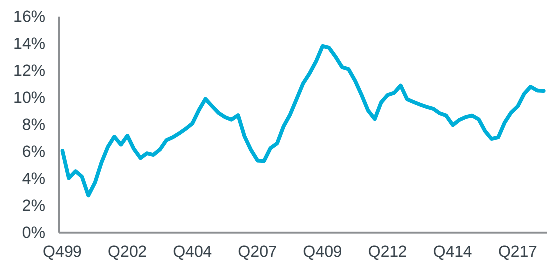
- Irish statistics are complicated by the fact that it is a global financial services sector, with assets and liabilities far greater than the Irish economy. This often distorts figures and paints a picture which does not reflect ‘Irish’ debt. The chart on the left from the Central Bank of Ireland’s Q218 Macro-Financial Review shows that domestic NFC indebtedness, expressed in percentage of GNI* terms, has halved since 2012.

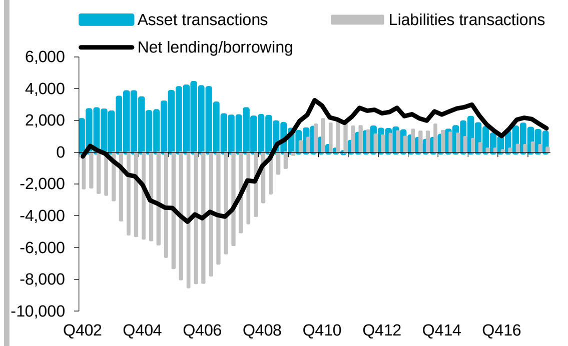
- We now judge that total headline economy-wide debt fell sharply to 325% of GDP by the end of 2017 from 374% at the end of 2016. This move was down to a combination of economic growth and deleveraging by the NFC sector, with most of the latter linked to multinational enterprises (as illustrated above). As the underlying Irish economy continues to grow we expect to see increased ‘flow’ of new borrowing by the domestic sectors.

- Ireland’s general government debt peaked at 124.6% of GDP in Q113. Since then it has fallen sharply (to 69.1% at end-Q218), mainly due to the resolution of IBRC and robust (if, to a point, inflated) headline GDP growth. With the public finances in broad balance; further State asset sales anticipated; and strong growth expected into the medium term; more progress is foreseen.

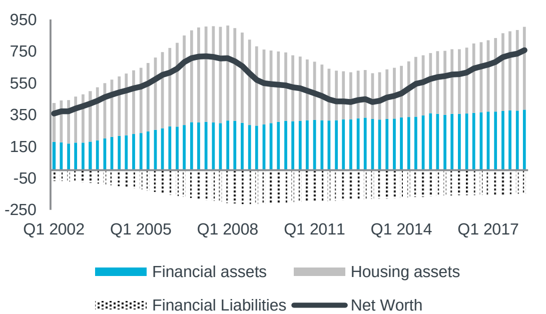
Indebtedness has sharply reduced as the economy has strengthened

Household gross savings rate (4qma)





Household net worth (€bn)



- The Irish household savings rate remains quite elevated, particularly given the country's strong demographics. The gross household savings rate was 10.5% on a 4qma basis in Q218, well ahead of the pre-crisis average (6.6%) and also above the average since the series began in Q199 (8.4%). Despite the brighter overall economic prospects, we expect savings rates to remain elevated given Central Bank rules around minimum deposit sizes for mortgages.

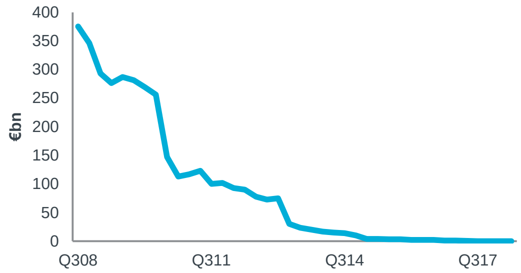
- The Quarterly Financial Accounts for Ireland show that we are nearing an inflection point in the credit cycle, with liabilities transactions (shown on a 4qma basis) about to move back into negative (i.e. growth) territory for the first time since the crisis. The asset side of the balance sheet continues to grow at a steady clip, as evidenced by the savings ratio cited above.

- Other Central Bank data further illustrate the improvement in household balance sheets. Household net worth slumped by 40% during the crisis, but it has since increased by 76% to stand at a new peak of €757bn (5% above the Celtic Tiger era high). Household debt has fallen back to levels last seen in 2005.

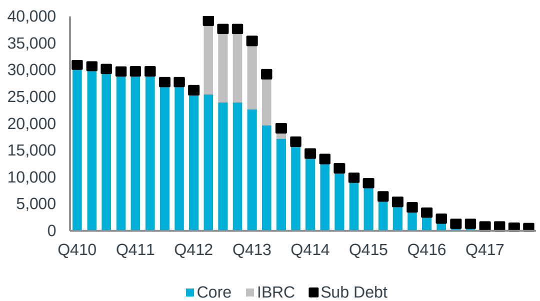
Household net worth has increased for 21 successive quarters

Contingent Liabilities
Crisis-linked liabilities finally eliminated

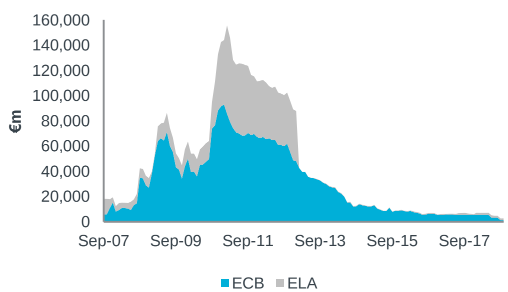
Total CIFS/ELG Guaranteed Liabilities



NAMA Debt Outstanding €m



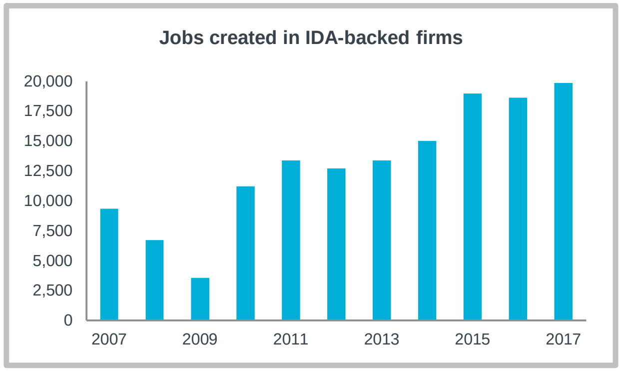
Covered Banks' Central Bank Funding

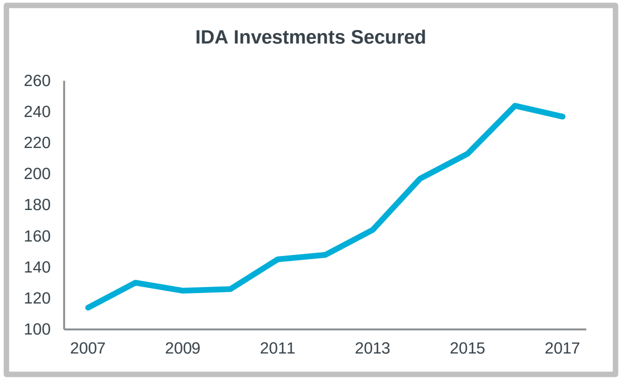


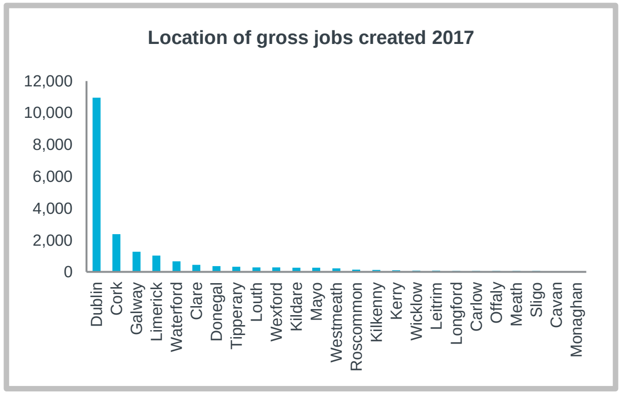
- In Q118 the last of the liabilities guaranteed by the State under the ELG scheme (and its CIFS predecessor) rolled off. At the end of September 2008 the State was exposed to €375bn under these guarantees, so the removal of this risk is welcome.
- All of NAMA's government guaranteed senior debt securities have been redeemed, leaving the agency with just €1.3bn of (remaining) unguaranteed subordinated bonds. NAMA projects that it will deliver a €3.5bn surplus to the Exchequer, guidance we view as conservative (we think that it will make lifetime earnings of €4.5bn).
- The elimination of Central Bank of Ireland Emergency Liquidity Assistance (ELA) following the liquidation of IBRC and the return of ECB funding to pre-crisis levels were welcome developments in terms of the resolution of legacy issues.

Vast majority of Ireland's crisis-linked liabilities have been eliminated

Ireland’s Strong Points





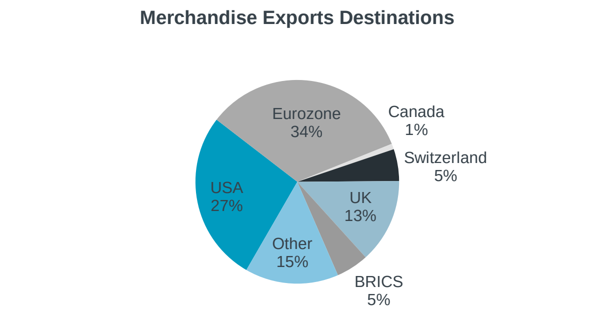


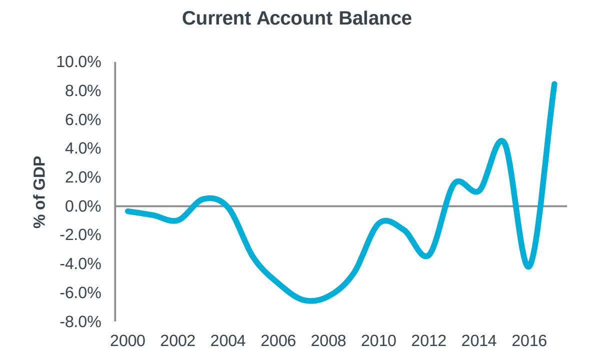
- Despite political uncertainty in a number of Ireland's key trading partners, 2017 proved to be a vintage year for job creation by IDA Ireland supported (multinational) companies here. The number of gross jobs created hit a record 19,851, which is equivalent to 1% of total employment. With global growth set to improve to a seven year high in 2018 we were optimistic of the prospects for this year. In this regard, the 3% growth in job creation flagged in IDA Ireland's H118 results, while welcome, did not come as a surprise

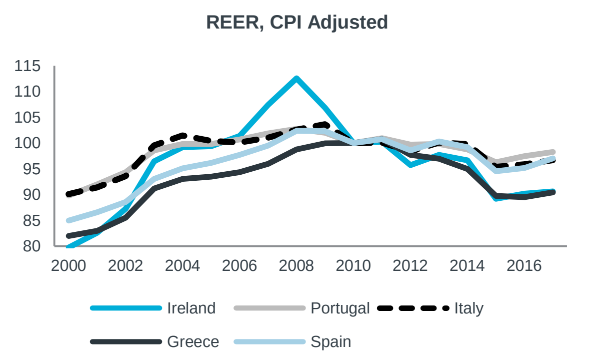
- The job creation achieved in 2017 came from 237 distinct investments. The prospects for this year look encouraging, with 139 distinct investments in H118 expecting to result in the creation of 11,300 positions

- IDA data show that 55% of the new jobs created by multinational corporations (MNCs) in 2017 went to the capital, followed by Cork (12%) and Galway (7%). Only 5% of all jobs created went to the 13 (out of a total of 26) counties which saw the smallest number of new positions created last year

Multinationals directly account for about a tenth of total employment





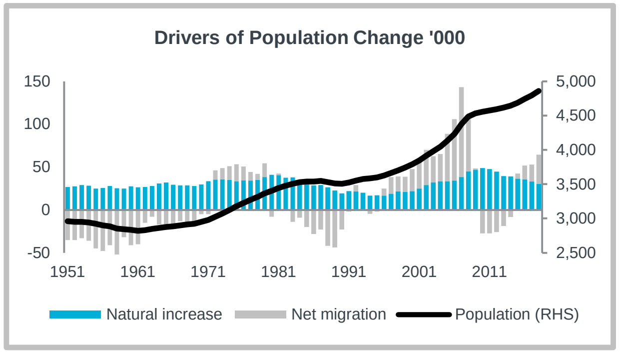


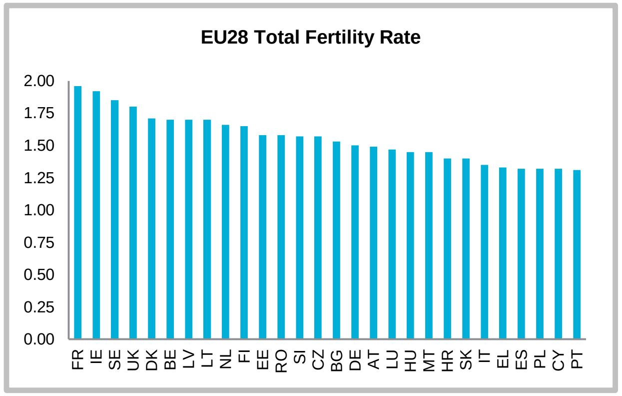
- Approximately 80% of Irish merchandise exports and 66% of Irish services exports go to either Europe or North America. As a small open economy Ireland's performance can be sharply influenced by developments in those markets. However, the latest data show a resilient performance notwithstanding some unhelpful external developments.

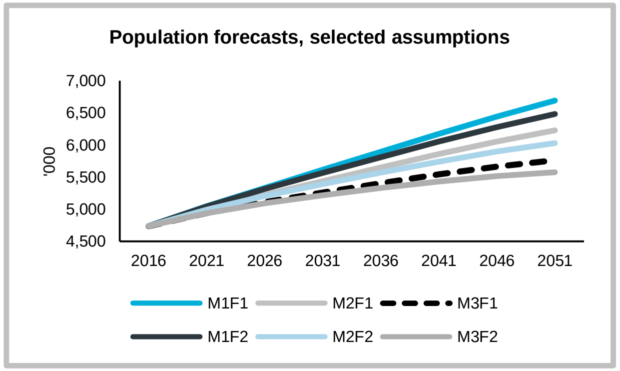
- Ireland's current account surplus was a remarkable 8.5% of GDP in 2017, mainly due to a slump in intangibles imports driven by the multinational (MNC) sector. Balance of Payments data for 9M18 suggest that last year's outturn should be eclipsed this year, although we caution that the data can be volatile on a quarterly basis.

- Ireland saw a significant improvement in its cost competitiveness during the recession in both absolute and relative terms. Recent developments suggest that some of these competitiveness gains are likely to be reversed.

MNC distortions camouflage the 'real' performance







- The latest Population and Migration Estimates from the CSO show that Ireland's population reached a new post-independence high of 4.9m in April 2018. The population increased at its fastest pace since 2008 in the 12 months to end-April, helped by net inward migration of 34k (again, a 10 year high) during the period.

- As the latest (2016) comparable data from Eurostat show, Ireland has the second highest total fertility rate in the EU. Ireland's natural rate of increase in population was sufficient to more than offset the numbers that have emigrated from the State in recent years. Ireland's population total has not had a 'down year' since 1990.

- Long-term population projections from the CSO, incorporating a range of assumptions relating to fertility and migration, suggest that the population could increase to between 5.6m and 6.7m by 2051.

Ireland's demographics are a stark contrast to many developed countries

Investec

	Institutions	Infrastructure	ICT Adoption	Skills (Education)	Product Market Efficiency	Labour Market Efficiency	Business Dynamism	Innovation and Sophistication
Belgium	21	13	40	16	22	37	18	17
Finland	2	23	16	1	14	19	8	10
France	23	8	29	34	31	53	28	11
Germany	16	7	31	4	7	12	2	1
Greece	87	38	57	39	63	107	72	44
Ireland	**17**	**34**	**41**	**15**	**23**	**7**	**10**	**21**
Italy	56	21	52	40	30	79	42	22
Netherlands	4	4	19	6	6	10	3	9
Portugal	30	19	37	41	35	35	27	32
Spain	28	10	21	37	34	68	36	25
UK	7	11	28	13	12	8	7	7

Source: WEF Global Competitiveness Report 2018

	Potential GDP	Potential Productivity	Potential Employment
Belgium	2.2	1.8	0.3
France	2.1	2.0	0.1
Germany	1.2	1.8	-0.6
Greece	2.4	2.2	0.2
Ireland	**2.6**	**1.5**	**1.1**
Italy	0.7	0.7	0.1
Netherlands	2.0	2.1	0.0
Portugal	1.9	1.8	0.1
Spain	2.2	1.6	0.6
UK	2.2	1.7	0.5

OECD potential GDP projections and drivers, average annual % change 2018-2030
Source: OECD Medium and Long-Term Scenarios for Global Growth and Imbalances

Forecasts

	2010	2011	2012	2013	2014	2015	2016	2017	2018E	2019E	2020E
GNP (2016 = €222.2bn)	3.6%	0.5%	0.0%	5.8%	9.2%	13.6%	11.5%	4.4%	8.0%	4.9%	4.1%
GDP (2016 = €273.2bn)	1.9%	3.7%	0.2%	1.3%	8.8%	25.1%	5.0%	7.2%	7.2%	4.5%	3.8%
Components of GDP											
Consumption	0.9%	-1.7%	-0.8%	-0.6%	2.1%	3.6%	4.0%	1.6%	3.5%	3.0%	2.3%
Government consumption	-6.7%	-1.6%	-3.8%	0.4%	4.5%	1.4%	3.5%	3.9%	3.5%	2.9%	1.9%
Investment	-14.9%	0.2%	15.8%	-3.7%	18.3%	50.8%	51.7%	-31.0%	2.6%	13.3%	12.7%
Gross Domestic Expenditure	-3.7%	-0.3%	2.4%	-1.7%	8.4%	15.1%	22.6%	-13.3%	1.6%	6.4%	5.9%
Exports	6.0%	3.2%	-0.9%	2.9%	14.6%	39.3%	4.4%	7.8%	8.0%	3.5%	3.0%
Imports	0.4%	2.7%	-0.9%	1.0%	14.6%	33.2%	18.5%	-9.4%	4.0%	4.5%	4.3%
Prices											
CPI	-0.9%	2.6%	1.7%	0.5%	0.2%	-0.3%	0.0%	0.3%	0.6%	1.0%	1.5%
HICP	-1.6%	1.2%	1.8%	0.5%	0.3%	0.0%	-0.2%	0.3%	0.6%	1.0%	1.5%
Labour market indicators											
Employment	-4.4%	-1.9%	-0.4%	3.0%	2.6%	3.4%	3.6%	2.9%	3.0%	2.3%	1.8%
Unemployment rate	14.6%	15.4%	15.5%	13.8%	11.9%	10.0%	8.4%	6.7%	5.7%	4.7%	4.0%

	2010	2011	2012	2013	2014	2015	2016	2017	2018E	2019E	2020E
Revenue receipts (€ millions)	36,230	39,286	41,735	44,687	46,403	54,222	53,687	58,375	59,444	60,874	63,452
Expenditure outlays (€ millions)	54,450	63,907	56,630	56,010	54,434	54,293	54,662	56,468	60,564	63,632	65,749
Exchequer balance (€ millions)	-18,220	-24,621	-14,895	-11,323	-8,031	-71	-975	1,907	-1,120	-2,758	-2,297
General government balance (€ millions)	-53,711	-21,886	-14,112	-11,020	-6,901	-5,023	-1,401	-733	-805	-583	-562
General government balance to GDP	-32.0%	-12.8%	-8.1%	-6.1%	-3.5%	-1.9%	-0.5%	-0.2%	-0.3%	-0.2%	-0.2%
General government balance to GDP (excluding financial interventions)	-11.2%	-8.6%	-8.1%	-6.0%	-3.5%	-1.9%	-0.5%	-0.2%	-0.3%	-0.2%	-0.2%
Gross Government Debt (GGD) / GDP	86.0%	110.9%	119.9%	119.7%	104.2%	76.8%	73.5%	68.4%	64.3%	62.4%	61.0%
GGD to GNP, %	103.6%	138.1%	150.1%	142.9%	124.1%	100.6%	90.3%	86.3%	80.4%	77.8%	75.8%
NAMA senior bonds		29,106	25,440	34,618	13,590	8,100	2,590	0	0	0	0
NAMA senior bonds % GDP		17.0%	14.5%	19.2%	7.0%	3.1%	0.9%	0.0%	0.0%	0.0%	0.0%
State liabilities (GGD + NAMA bonds)		127.9%	134.4%	138.9%	111.1%	79.9%	74.4%	68.4%	64.3%	62.4%	61.0%
Net debt (GGD – ISIF & cash) % GDP		97.3%	102.8%	105.6%	94.8%	69.6%	67.4%	62.7%	59.0%	57.4%	56.1%
Net debt, % GNP		121.3%	128.7%	126.1%	113.0%	91.2%	82.8%	79.1%	73.8%	71.6%	69.7%

Public Finances

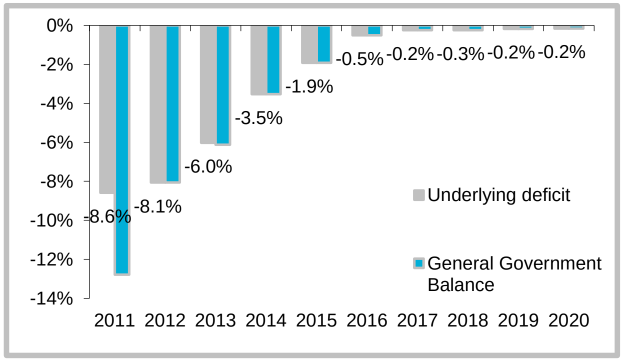
Tax revenue performance

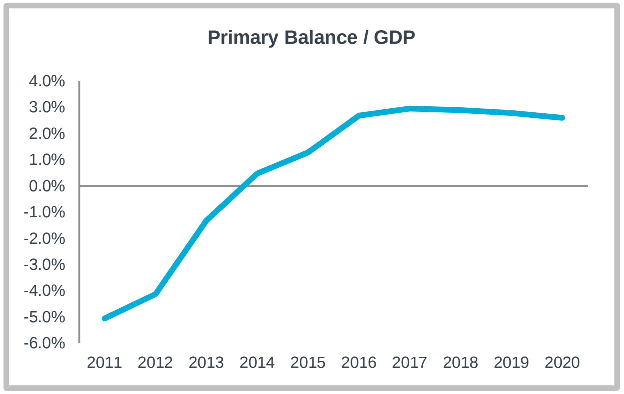
	Actual	Forecast	Variance
Customs	306	316	-3.2%
Excise Duties	4,997	5,316	-6.0%
CGT	376	298	26.3%
CAT	501	450	11.3%
Stamp	1,313	1,484	-11.5%
Income Tax (+USC)	19,455	19,547	-0.5%
Corporation Tax	9,446	7,898	19.6%
VAT	14,080	13,986	0.7%
Unallocated	54	0	n/m
Motor Tax	907	917	-1.0%
Total Revenue	**51,436**	**50,212**	**2.4%**

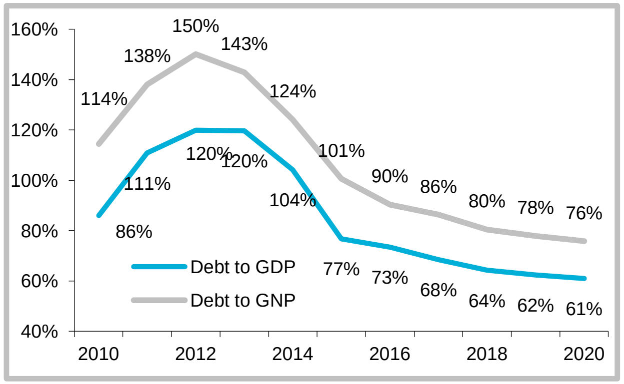
Source: DoF. Data relate to Jan-Nov 2018

- The latest Exchequer data show a marked improvement in tax revenue growth, with receipts for the first 11 months of 2018 +7.6% y/y and 2.4% ahead of profile (target). This compares to growth in receipts of 5.4% y/y (0.7% ahead of profile) in H118, although a meaningful share of the uptick is driven by IFRS15 timing effects on corporate profitability.
- This tax revenue outperformance, allied to flat discretionary spending relative to profile, has helped to produce an underlying General Government Balance of -€525m for the first 11 months of 2018. This compares to Budget Day forecasts of a deficit of €315m for FY18, with the recent pick-up in tax revenue growth suggesting that the FY target should easily be met.
- Helped by lower than anticipated new issuance costs and redemptions, national debt interest costs of €5.6bn in the first 11 months of 2018 were €244m or 4.2% lower than expected. Ireland's national debt servicing costs peaked at €7.5bn in 2014 but are expected to moderate to €5.5bn (inclusive of debt management expenses) next year.
- For 2019, the Department of Finance currently projects a General Government Balance of -€75m, effectively producing the first balanced budget since the pre-crisis years.

The public finances are effectively back in balance





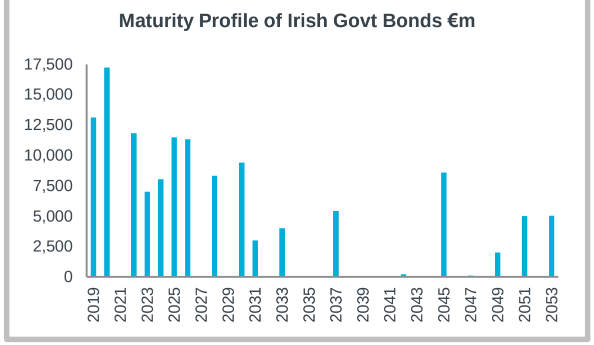


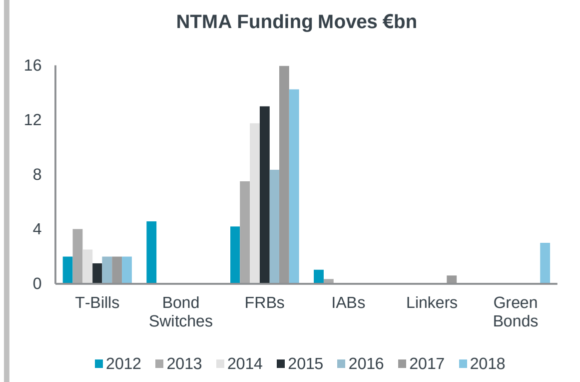
- Stronger growth in government spending than we had previously anticipated sees us pare back our expectations for a return to headline surpluses. With that being said, the projected deficits are small in absolute terms

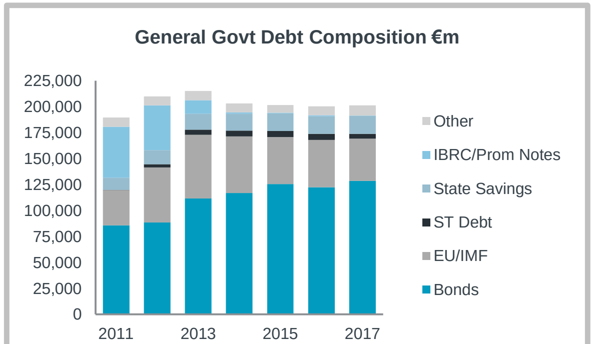
- Ireland remains on course for its fifth successive annual primary surplus in 2018. The average interest rate on the General Government Debt is guided to be 2.4% in 2019, producing a cost of €5.0bn (<2% of GDP)

- General Government (Gross) Debt peaked at 124.6% of annualised GDP in Q113 and has steadily improved since then (to 69.1% at end-Q218). This pace of improvement is flattered by multinational related distortions to the national accounts, but the resolution of IBRC and early retirement of Troika-era borrowings have also played a key role. More gradual reductions are envisaged for the coming years, although additional State asset sales could accelerate this (subject to market conditions)

Headline debt metrics have sharply reduced







- NTMA secondary market operations, long dated new public issuance (of up to 100 years maturity) and the replacement of €25bn worth of amortising Promissory Notes with long-term bonds (the benefits of this debt, which is effectively funded at the ECB MRO, continues to reduce as a result of ongoing buybacks) have helped to significantly extend the maturity profile of Irish government bonds. The current weighted average maturity of Irish bonds is 10.6 years.

- The NTMA raised €17.25bn from the sale of benchmark bonds this year, which was towards the high end of its funding target range of €14-18bn for 2018. These funds were raised at a weighted average cost of 81bps with an average duration of 9 years. In addition, the agency has raised €2.0bn from T-bill sales. These sales have left the agency well funded (its cash holdings, net of short-term debt maturities, were €8.8bn at end-November) ahead of a number of large maturities in 2019.

- Following the 2013 Promissory Note restructuring and several waves of early redemptions of Troika borrowings (in 2014, 2015 and 2017), Irish government bonds now account for a sizeable (c. 61%) majority of the country's general government debt, followed by the remaining Troika loans (c. 21%) and local/retail debt.

The NTMA raised €17.25bn on the bond markets this year

NAMA & The Irish Banking Sector

- The nominal value of the core loans originally acquired was €74.2bn, settled through the issuance of €31.6bn of NAMA bonds.
  - NAMA's accounting value of its remaining core net loan book at end-March 2018 was €3.2bn
  - 93% of loans by loan nominal were non-performing at end-March 2018
  - 62% of NPLs by loan nominal were 120+ days in arrears by end-March 2018

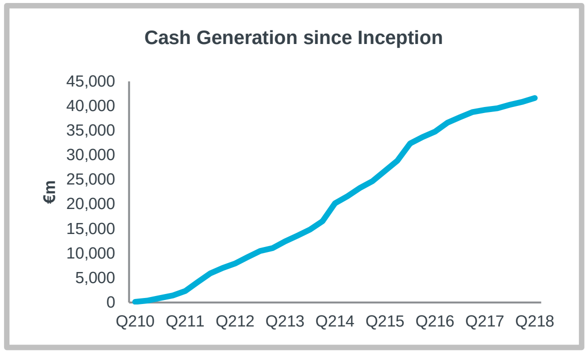
- Breakdown by asset classification at end-Q417 was: Land 36%, Development 26%, Residential 15%, Office 11%, Retail 7%, Hotel & Leisure 3%, Industrial 1%, Other 1%.
- Breakdown by geography at end-Q417 was: Ireland 84%, UK 12%, Other 4%.

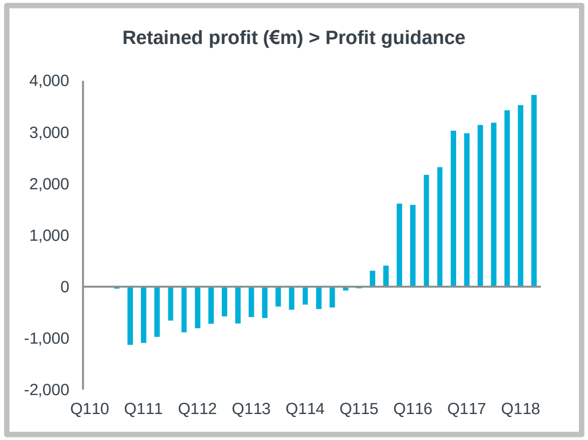
- Following the redemption of all of the government guaranteed senior debt linked to NAMA's core (original) portfolio, the agency's remaining debt securities outstanding at end-2017 were €1.6bn, all of which were subordinated.
  - AIB €0.4bn;
  - BKIR €0.3bn;
  - Another €0.9bn of NAMA subordinated debt was in private hands, of which €0.3bn was redeemed since the start of 2018.

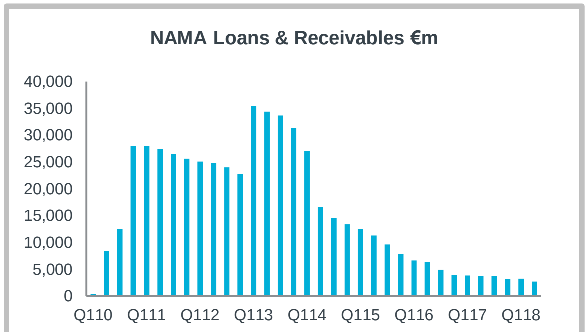
- NAMA redeemed the final €2.6bn of the €30.2bn of senior debt that was linked to the original portfolio in 2017. This served to remove a contingent liability from the Sovereign.

- Separately, NAMA issued €12.9bn of bonds in February 2013 as part of the IBRC liquidation process, all of which were redeemed by the end of October 2014.

- From inception to end-June 2018 NAMA received cash proceeds from asset sales and non-disposal income totalling €42.2bn.





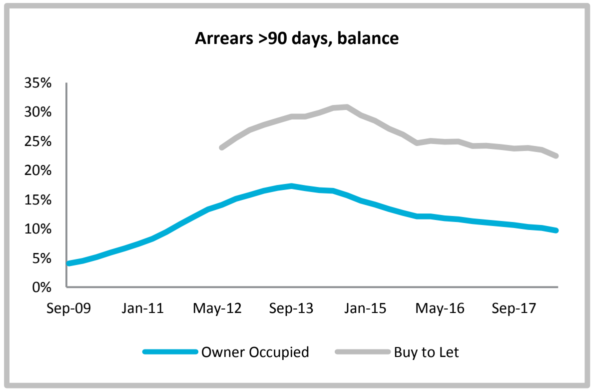


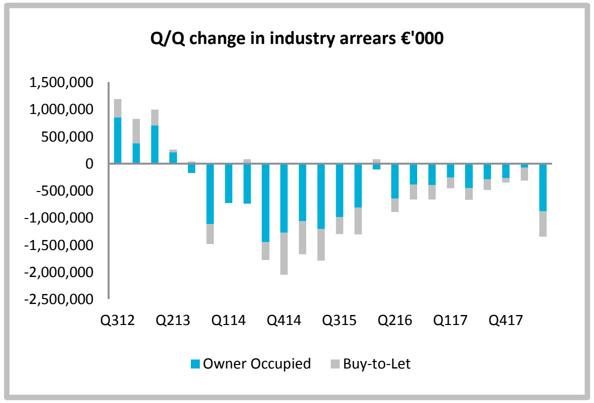
- NAMA has been an impressive cash generator since its inception. By end-June 2018 it had generated cumulative operating cashflow of €41.6bn.

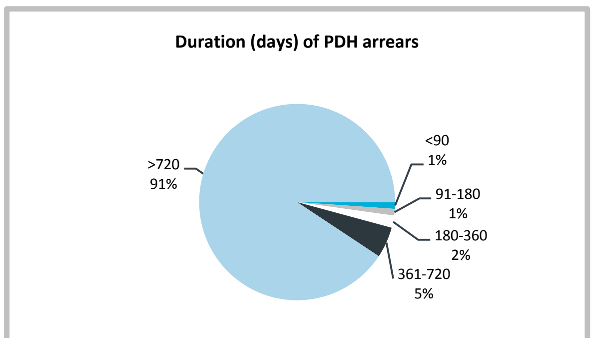
- These cash flows have funded the redemption of all of NAMA's senior bonds and €0.3bn (of €1.6bn) of its subordinated bonds – while also facilitating significant investment in enhancing the value of its asset base. In June NAMA raised its target for lifetime earnings to €3.5bn but this looks very conservative, not least given that its retained earnings are already above this level. Add in further write-backs from its €1.4bn stock of provisions as property values climb and consider the strong underlying profitability (its net interest margin was a remarkable 7.0% in 2017) and a €4.5bn return to the Exchequer remains a distinct possibility.

- NAMA's balance sheet reduced by 30% in 2017, finishing the period at only about a seventh of its peak size. The agency is aiming to have all of its work resolved by end-2021 (was 2020), with the main risk to this projection being a politically mandated transformation of its business model.

NAMA likely to beat €3.5bn lifetime profit guidance by €1bn







- The latest Central Bank of Ireland data covering all banks resident in Ireland show that there were 725,693 PDH (owner-occupied) mortgage loan accounts, with a total balance of €98.2bn, at end-Q218. In the same quarter there were 118,234 BTL mortgages with a total balance of €20.9bn.

- Both segments have seen arrears sharply reduce from peak levels. Some 6.3% of PDH accounts were in arrears of more than 90 days past due (90dpd) in Q218, with the balance on these equivalent to 9.7% of the stock of mortgages in issue. The latter was the first sub-10% reading since Q211 and also well below the Q313 peak of 17.3%. BTL accounts in arrears that are more than 90dpd equate to 14.7% (volume) and 22.5% (value) of the stock, down from the Q314 respective peaks of 22.1% and 30.8%.

- Of those mortgage accounts in arrears of more than 90 days, the euro amount in arrears (€2.7bn) represents 28% of the euro balance on those mortgages for PDH and €2.1bn (44%) for BTL. The high concentration of very long-term arrears (i.e. the most troubled accounts) is a key challenge for credit institutions.

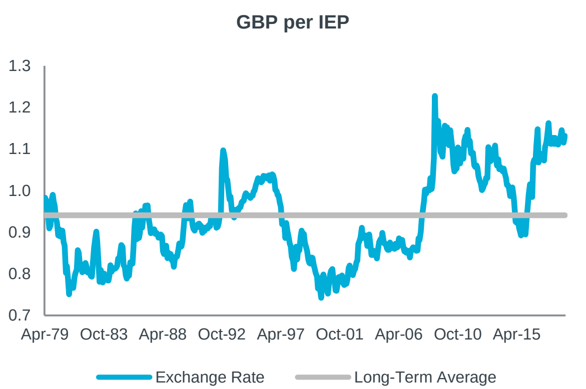
Loan sales and the economic upturn are helping to clean up loanbooks

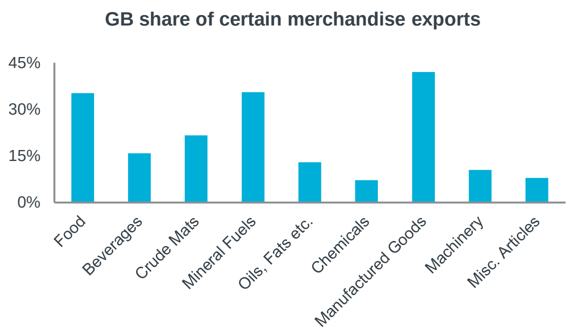
- Central Bank of Ireland data for Q2 2018 provide details on the stock of restructured mortgages in Ireland:

	Number	Balance ('000)	Arrears ('000)		Number	Balance ('000)	Arrears ('000)
Total No of Restructured PDH Mortgages	**116,010**	**15,752,159**	**413,813**	**Total No of Restructured BTL Mortgages**	**19,834**	**4,531,867**	**160,292**
o/w not in arrears	91,800	11,712,137		o/w not in arrears	16,221	3,635,005	
Restructure by Type				**Restructure by Type**			
Interest Only	3,269	586,333	19,354	Interest Only	1,926	505,995	27,922
Reduced Payment > Interest Only	6,126	1,319,569	155,167	Reduced Payment > Interest Only	4,096	1,223,874	50,277
Reduced Payment < Interest Only	598	123,486	10,313	Reduced Payment < Interest Only	51	9,811	925
Term Extension	13,996	1,479,892	44,319	Term Extension	3,505	573,221	22,434
Arrears Capitalisation	38,170	5,915,784	95,237	Arrears Capitalisation	4,260	844,938	39,429
Payment Moratorium	1,116	167,401	3,586	Payment Moratorium	186	26,000	1,345
Deferred Interest Scheme	21	3,845	584	Deferred Interest Scheme	0	0	0
Permanent Interest Rate Reduction	118	20,063	65	Permanent Interest Rate Reduction	2	1,070	451
Split Mortgage	27,464	2,719,975	13,510	Temporary Interest Rate Reduction	104	20895	114
Trade Down Mortgage	64	9,576	1	Split Mortage	1,923	237,657	520
Temporary Interest Rate Reduction	5,542	1,063,670	15,702	Other	3,781	1,088,406	16,875
Other	19,526	2,342,565	55,975				

Source: Central Bank of Ireland

What Brexit Means For Ireland





- While the UK remains an important trading partner for Ireland, the economic umbilical cord that had existed between the two countries after independence has largely been unwound. In 1926 the UK accounted for 97% of Irish merchandise exports and provided 76% of the State's goods imports. By January 1973, when both countries joined the then EEC, 58% of Irish goods exports went to its closest neighbour. This share has continued to fall, accounting for only 11% in January-October 2018

- The benefits of this diversification are perhaps best illustrated by the fact that the old Irish punt (holding it at the fixed conversion rate that it joined the single currency at) has at times in the period following the Brexit vote stood above the levels seen after Black Wednesday in 1992. A quarter-century ago the UK accounted for more than double the share of headline Irish goods exports as it does today

- Adding in the services sector (16% of whose exports go to the UK) means that Ireland's closest neighbour accounts for less than a sixth of total exports. For some segments of the economy its importance is far greater; 30-40% of indigenous firms' exports go to the UK, while a number of sectors (Food, Manufactured Goods, Transport, Cross-Border Financial Services, Tourism) are very reliant on that market

The UK is the destination for less than a sixth of total Irish exports

Implications for Ireland
Short and long term

- Short term:
  - Firms exporting to the UK remain under pressure as a result of the weak pound
  - Competition from UK imports has been unhelpful for many domestic firms (e.g. new car sales are -4.8% y/y in the year to date) but it is also resulting in cheaper input costs for others
  - Business and consumer confidence is likely to be negatively impacted, with knock-on consequences for investment and retail sales. How the coming weeks play out at Westminster will likely prove pivotal for Irish economic growth in 2019
  - But Ireland is likely to grow its share of FDI to (part-?) compensate for this – we note a steady flow of encouraging announcements thus far
  - Economic growth will likely be slower than would otherwise have been the case – every 1pc move in UK GDP moves Irish GDP by c. 0.2pc
- Long term:
  - Estimates from leading research houses (IFO Institute, Oxford Economics, LSE/CEP) have suggested that Brexit could permanently reduce Irish GDP by between 0.8% and 2.7% relative to baseline
  - However, the reality is that we don't know what the ultimate impact will be as much hinges on the nature of trading arrangements struck between the UK and EU. At the time of writing there remains considerable uncertainty about how these will look
  - Irish exporters will likely have to deal with a structurally weaker sterling as the UK's 'safe haven' status has gone the way of its AAA rating. Major changes to supply chains will also probably be needed. The transition period (to end-2020) provides space for this
  - Ireland could win big from the relocation of operations out of the UK e.g. certain financial services. Openness to skilled migrants could also help to boost investment. But can our residential property market handle this?

No quick fix for the Brexit camp

‘Brexit’ could take many years to finalise

- Last year the UK triggered Article 50, ending the ‘Phoney War’ that had existed since the Brexit vote in June 2016 and thus commencing the formal stage of its divorce negotiations with the EU.

- Negotiating period / remaining EU membership is set at two years under Article 50, but this can be extended indefinitely by unanimous EU28 vote or, alternatively, the UK can unilaterally pull Article 50. We note that the EU-Switzerland bilateral trade deal took six years to finalise. So, to this end, the 21 month transition period after March 2019 may well be extended, therefore we wouldn’t necessarily view 1 January 2021 as the new “cliff edge”, assuming that the House of Commons endorses the May plan (or something resembling it).

- Phase I of the Brexit discussions brought welcome reassurance for Ireland, particularly in terms of trade on the Island of Ireland and between Ireland and Britain (and beyond). However, significant political risks remain.

- The UK doesn’t just have to cut a deal with the EU. WTO membership also needs to be renegotiated and existing trade deals with 53 other third party areas would cease in the event of an EU divorce.

- What model could the post-EU UK follow? It’s hard to tell at this juncture.

    - Switzerland secured tariff free goods access, but limited Single Market access for financial services – this is unpalatable for the UK given the importance of The City. Switzerland also had to agree to the free movement of labour and has to implement most EU law without having a vote on it
    - Norway has access to the Single Market for most goods and services (excluding fisheries and agriculture). It also has to accept the free movement of labour and most EU legislation. Norway has to pay for its market access – it is the 12th biggest contributor to the EU budget despite not being a member
    - One alternative is to follow the WTO frameworks. This would involve adopting 4% EU import tariffs on average, but penal charges on certain items produced in the UK makes this an unattractive option