Irish Economy Monitor

Q2 2017

Philip O'Sullivan
T +353-1-4210496
E philip.osullivan@investec.ie

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General View on Ireland: Exports cancel out modest domestic pressures

A review of the latest data points across the economy confirm a positive overall outlook, with a strong export performance cancelling out a small number of weak patches in the domestic economy.

1. The Investec Manufacturing and Services PMI releases and Ulster Bank Construction PMI report all suggest that that the pace of growth in the economy quickened during Q217.
2. While headline retail sales have come under pressure in recent months, this is linked to competition for ‘big ticket’ items from sterling retailers. For example, new car sales here are -10% y/y but imports of used cars (mainly from the UK) are +50% y/y, while Furniture & Lighting sales were +20.7% y/y in volume terms in April, but the value of those sales increased by 13.1% y/y.
3. The labour market remains a source of good news, with the monthly unemployment rate at 6.4% (its lowest rate since June 2008) while total employment is back to within 5% of the all-time peak.
4. On the property side, despite continued growth in housing output, the mismatch between supply and demand still looks set to endure for another few years. Following strong house price data for the opening few months of 2017 we are raising our house price inflation forecasts by 100bps for each of 2017 (to +7%) and 2018 (to +6%). The multi-speed recovery in the commercial property market remains intact, with Brexit set to deliver benefits for the office and industrial segments in particular.
5. The export sector has surprised to the upside since the start of the year, with strong growth seen in nominal merchandise exports, producing a double-digit improvement in the trade surplus. The export component of the Services PMI indicates a good start to 2017 for that segment.
6. Exchequer Returns have been mixed since the start of 2017, but the outperformance seen in May and generally positive outlook suggest that the State is still likely to meet its full-year fiscal targets.
7. What might derail Ireland’s positive growth story? Brexit remains a key threat, with recent sterling weakness a headwind for many firms. Elsewhere, Eurozone political risks have receded since our Q1 report, but the fallout from divergent Central Bank moves remain a threat. The recent change of Taoiseach (Prime Minister) in Ireland is unlikely to result in any meaningful policy changes.

Forecast Summary: Staying put

Ahead of the release of Q117 national accounts data for Ireland we elect to keep our headline forecasts, which show GDP +4.6% this year and by a further +4.0% in 2018, unchanged. As discussed on the previous slide, a range of economic indicators suggest a positive start to the year for the economy.

While Exchequer Returns data for the opening five months of the year have been mixed, the most recent data for May 2017 suggest that the public finances could be getting back on track, with last month's Returns coming in 1.5% ahead of profile (target) and +10.1% y/y, helping to move the cumulative underperformance to 1.4% below profile for the year to date, from -2.4% in the period to end-April. Gross voted (discretionary) expenditures are 1.2% lower than had been anticipated. We see the general government balance coming in at -0.1% of GDP this year before transitioning into surplus in 2018.

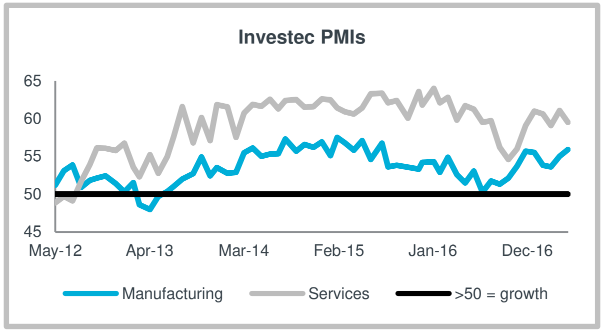
Investec Summary Forecasts, full forecasts are on slides 24 and 25

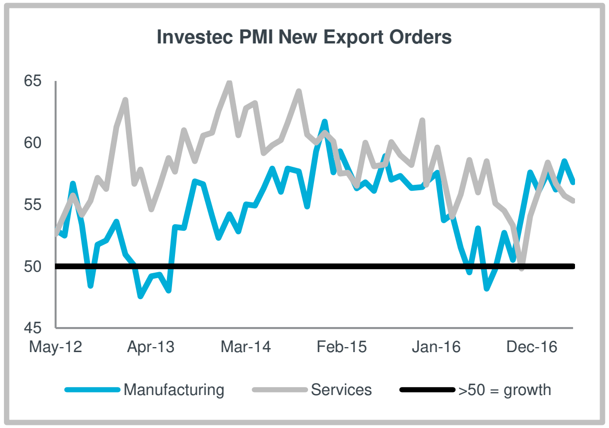
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
GNP	3.8%	-4.0%	-0.4%	4.7%	9.2%	18.7%	9.0%	4.3%	4.0%	3.2%
GDP	2.0%	0.0%	-1.1%	1.1%	8.5%	26.3%	5.2%	4.6%	4.0%	3.0%
Gross Domestic Exp.	-3.8%	0.7%	1.4%	-1.9%	7.7%	10.0%	16.7%	4.6%	4.0%	3.0%
Employment	-4.0%	-1.8%	-0.6%	2.4%	1.7%	2.6%	2.9%	2.5%	1.8%	1.5%
General Gov Deficit/GDP	-32.1%	-12.6%	-8.0%	-5.7%	-3.8%	-1.9%	-0.6%	-0.1%	0.5%	1.1%
Gross Govt Debt / GDP	86.3%	109.6%	119.5%	119.5%	105.2%	78.6%	75.4%	72.2%	68.1%	64.4%
Current Account / GDP	-1.2%	-1.6%	-2.6%	2.1%	1.7%	10.2%	4.7%	2.5%	3.0%	3.5%

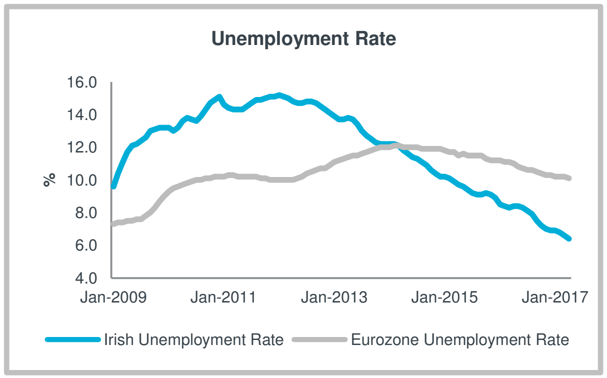
Timely Data

Current Indicators of Economic Activity

Growth picked up during Q217





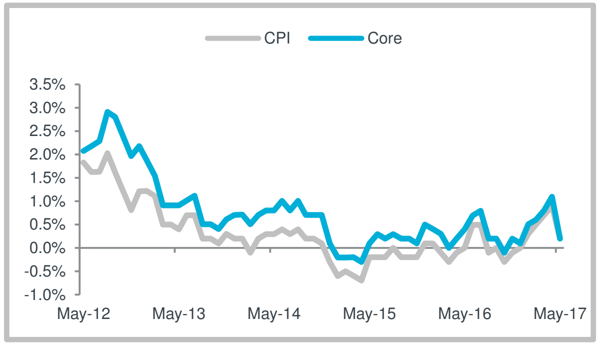


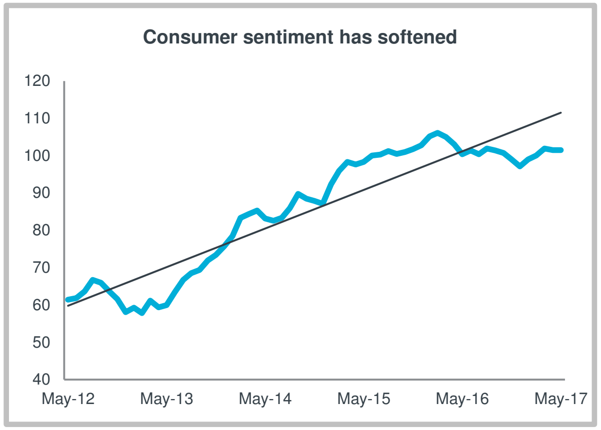
- The latest Investec PMI reports point to a quickening of growth during Q2. The headline Manufacturing PMI improved to a 22 month high of 55.9 in May, while its Services counterpart reached a 10 month high of 61.1 in April before easing slightly to 59.5 in May. The headline Ulster Bank Construction PMI (see slide 9) improved to a 15 month high of 63.6 in May.

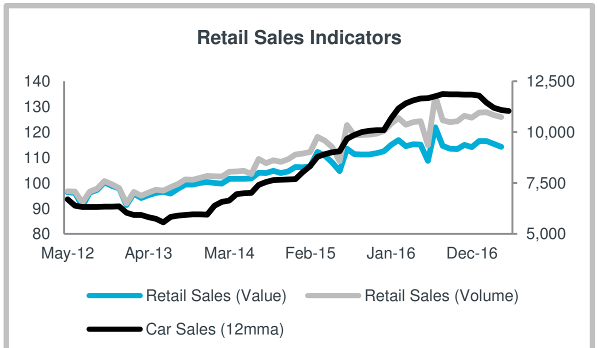
- The recovery in the implied rate of growth in exports has levelled off in recent months, likely due to the strengthening of the single currency relative to those of Ireland's key non-Eurozone trading partners.

- Ireland's unemployment rate was flat at 6.4% in May, but still 200bps lower than in the same month last year and 290bps inside the equivalent figure for the wider Eurozone. The number of people 'signing on' the Live Register has fallen for 54 successive months.

Growth appears to have quickened in the second quarter





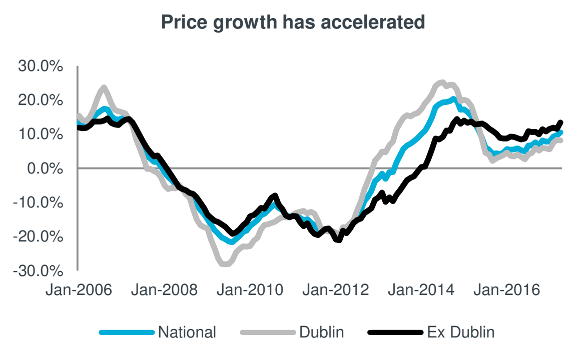


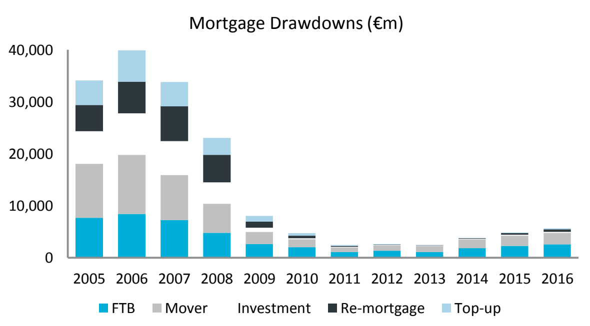
- The headline CPI moderated to 0.2% y/y in May from April's four year high of 0.9% y/y, on the back of softer consumer staple and consumer discretionary prices. Within the latter, we suspect that 'dumping' by UK retailers are a factor behind the slide in furniture and other household related charges. In spite of the muted overall inflationary pressures, as the economy continues to strengthen we continue to expect inflation to tick higher over the coming years.

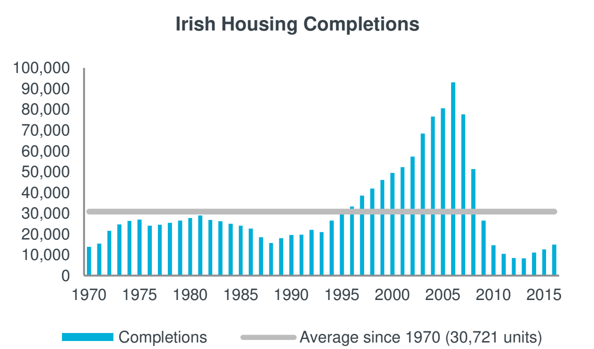
- The headline consumer sentiment index has been range-bound since the start of the year, slightly below the multi-year high recorded in January 2016, but still well above the series average.

- Headline retail sales growth remains under pressure as competition from sterling retailers outweighs positive trends in employment and disposable incomes. Apart from the household goods outturn alluded to above, new car sales were -10.3% y/y in the opening five months of 2017, while over the same period imports of used (second-hand) cars were +50.0% y/y.

Competition from GBP retailers is weighing on big ticket item sales here





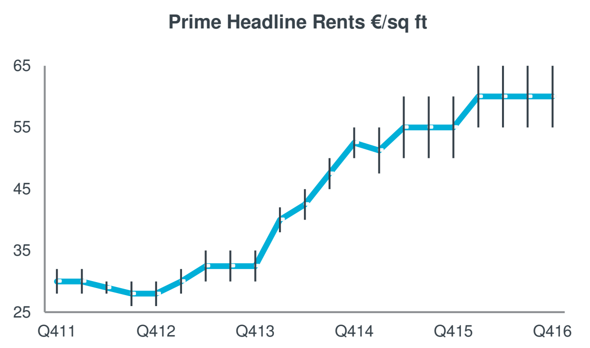


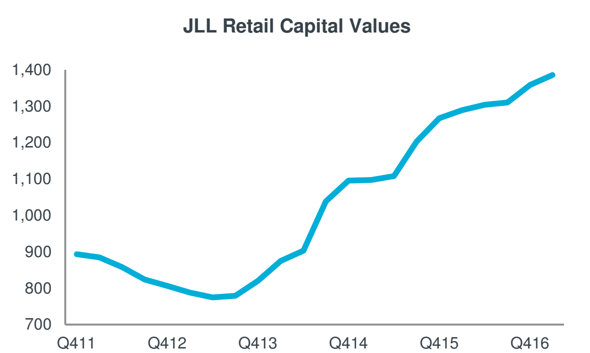
- Following strong Residential Property Price Index (RPPI) data for the opening four months of the year we raise our house price inflation assumptions to 7% in 2017 (was 6%) and 6% for 2018 (was 5%). We leave our 5% forecast for 2019 unchanged for now. Despite an uptick in housebuilding, supply continues to lag far behind demand.

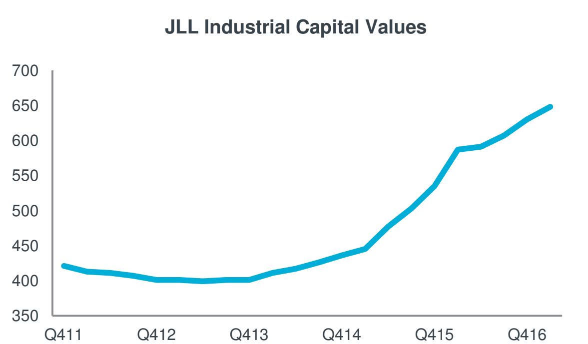
- We forecast that €7bn of mortgages will be drawn down this year, which will represent growth of about a quarter on 2016's outturn. This projection is supported by mortgage approvals (a lead indicator) data that show a 58% y/y increase in approvals in the first four months of 2017. Despite this improvement, lending is still some way off the €10-12bn that we view as a 'normal' level of mortgage market activity.

- Irish housing completions rose 18% last year to 14,932 units, which equates to c. 50% of where recent estimates for annual new household formation lie. Lead indicators suggest that it is likely to be the end of the decade before housing output rises to meet the flow of new demand.

Housing demand will > supply until 2020 at the earliest





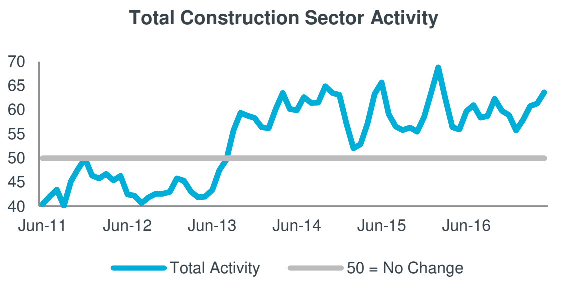


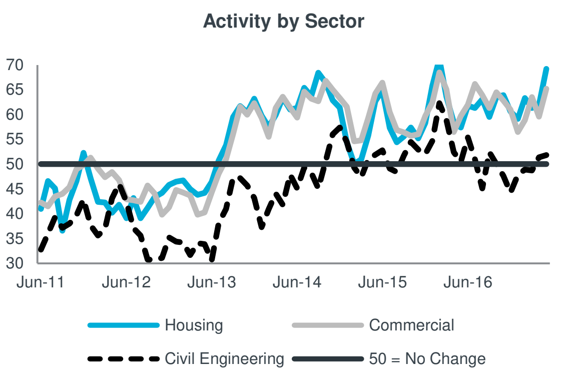
- Prime Grade A office rents in Dublin city centre were stable at €55-65 psf for a fifth successive quarter in Q117, as new supply has met occupier needs. The headline vacancy rate has nudged up from the record low of 6.7% in Q216 to 8.9% currently due to this new supply.
- Notwithstanding the previously discussed pressure from the weak pound, capital values in the retail sector continue to trend higher. The latest (Q117) JLL data show increases of 2.1% q/q and 7.5% y/y respectively.
- The industrial sector looks set to be a big winner from Brexit, as supply chains are likely to be recalibrated ahead of a probable change in the UK's trading arrangements. Capital values rose 2.9% q/q and 10.4% y/y in Q117.

The broad recovery in the non-residential market continues

Construction Recovery Continues

Ongoing improvements, but still a long way from 'normal'



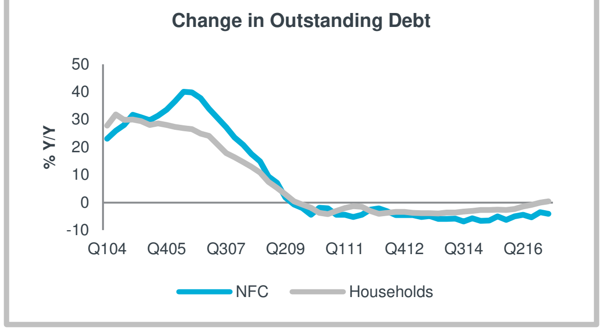


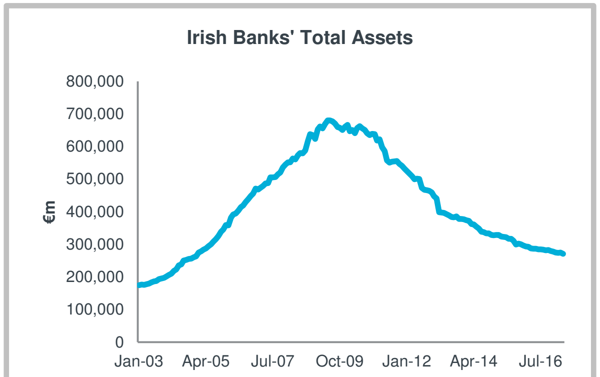
- The Ulster Bank Construction PMI improved to a 15 month high of 63.6 in May. The run of above-50 readings now stretches to 45 months. Despite this extended period of improvement, activity remains well below normal levels – CSO data show that the volume of activity in the construction sector stands 37% below the level seen at the turn of the Millennium and 62% below peak (Q406) levels.

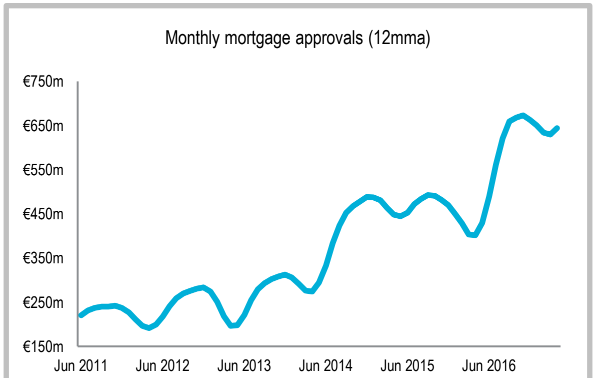
- The PMI report continues to show strong growth in activity in the Commercial and Residential sectors, while Civil Engineering has recently returned to growth, helped by the projected 11.8% y/y increase in net voted (discretionary) capital expenditures by the State this year.

- On our preferred four quarter moving sum basis planning permissions stood at 17,934 residential units in the period to end-Q117, up 39% y/y. This bodes well for our forecast of increased housing output in both 2017 (16,000 completions projected) and 2018 (18,000 completions projected), following the 14,932 units that were completed in 2016.

Construction activity continues to improve from a low starting point





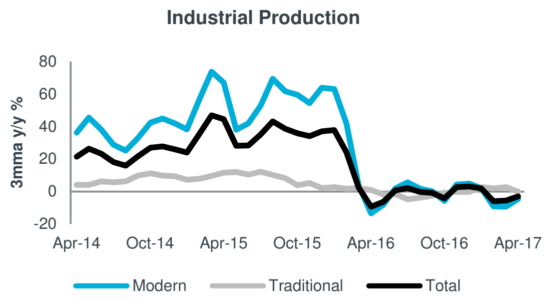


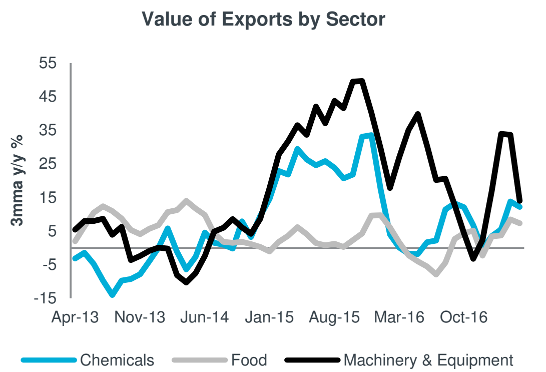
- Central Bank data show that credit outstanding to households rose by 0.4% y/y in Q117, the first annual increased since Q309. Credit to Irish NFCs fell at an annual rate of 4.1% in the same quarter, so the inflection point there remains a little way off. Nonetheless, we expect that this year will see the first annual increase in the stock of credit outstanding in the economy since 2009.

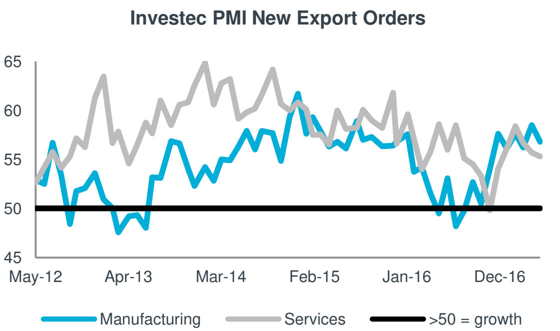
- A 60% decline in system wide assets from the peak and steady growth in retail deposits have nudged the sector loan-to-deposit ratio below 100%.

- Mortgage approval data point to material growth in lending this year. We see €7bn of drawdowns in 2017, which would represent a 25% increase on the 2016 outturn.

Annual credit outstanding is set to rise for the first time since the crash





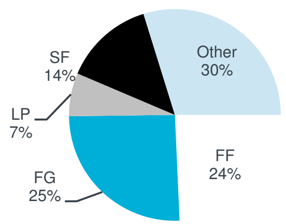


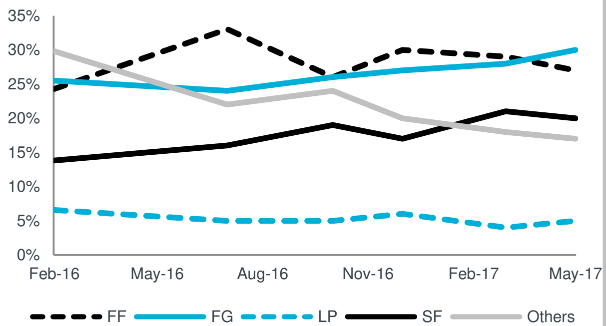
- Industrial Production decreased by 1.1% y/y in April 2017. Despite the sterling headwind, the 'Traditional' sector, which is dominated by indigenous firms, posted annual growth in production of 3.7% in Q117, leaving the multinational-dominated 'Modern' sector trailing far behind on -7.4% y/y.

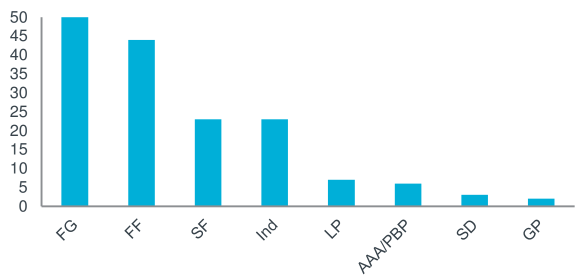
- Merchandise Trade data from the CSO show that nominal exports jumped 10.3% y/y in the period to end-April, helping the trade surplus to expand by 17.7% to €17.1bn. All nine major commodity groups have posted annual growth in nominal exports in the year to date.

- The export components of the Investec Services and Manufacturing PMIs continue to suggest that the generally improving trends detailed above have further to run.

Exports are a key bright spot for the Irish economy



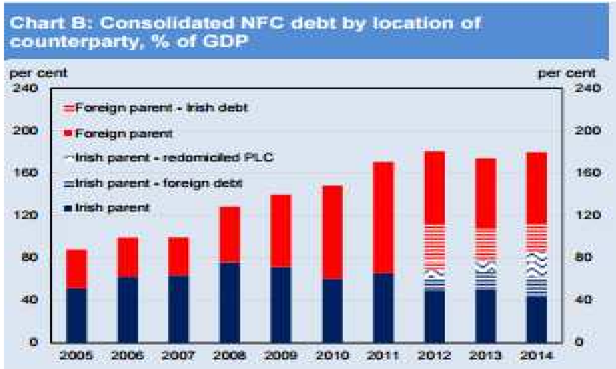


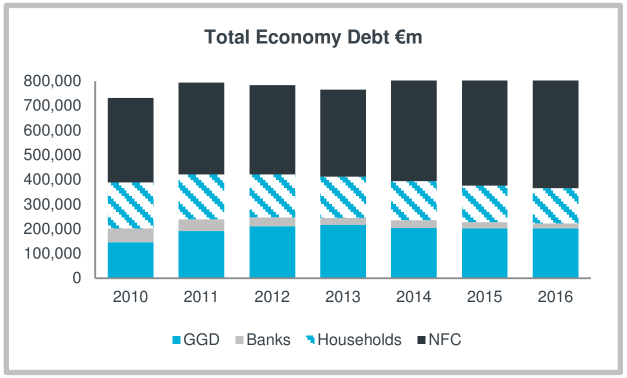


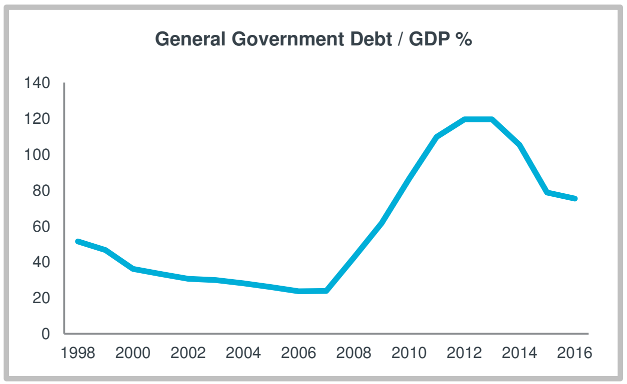
- The February 2016 general election in Ireland produced a messy result, with no one party managing to secure even a third of the seats on offer. After protracted negotiations, a minority government was eventually formed by the centre-right Fine Gael (FG) party along with some independent support.
- The rules of engagement in the Irish parliament are normally set with reference to the party whip. So the government has struggled to pass legislation given the political arithmetic. Only 21 Acts were brought before the Oireachtas (Irish parliament) last year - in contrast, 66 were brought before it in 2015.
- Leo Varadkar (FG) was recently elected as Ireland's 14th Taoiseach (Prime Minister), succeeding his party colleague Enda Kenny, who had governed since 2011. We do not anticipate the change of leadership to result in any meaningful policy departures.
- Opinion polls continue to show a drift back to the centre ground, with the three traditional parties of government, Fianna Fáil (FF), Labour and Fine Gael polling a combined 62% in May 2017, up 5pc from the February 2016 election. However, these polls also indicate that another hung parliament would result were an election to be held in the near future. Given this, we continue to expect that the minority government will limp on into 2018.

Change of Taoiseach is unlikely to lead to a change of policies

Irish Debt





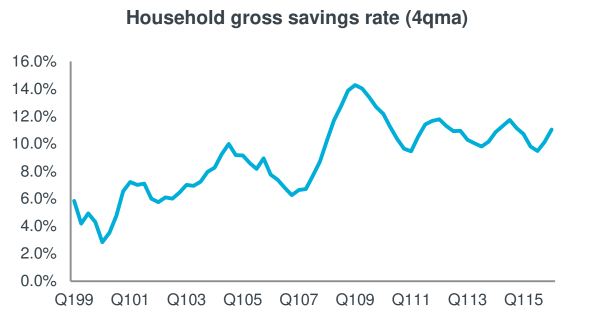


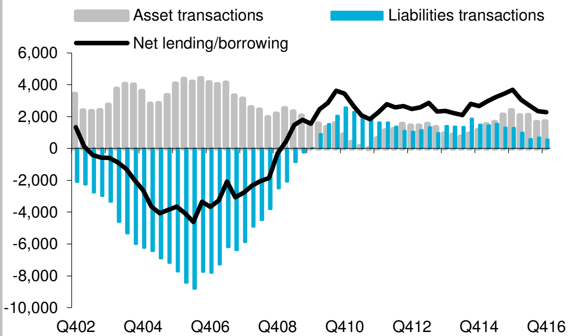
- Irish statistics are complicated by the fact that it is a global financial services sector, with assets and liabilities far greater than the Irish economy. This often distorts figures and paints a picture which does not reflect 'Irish' debt. NAMA and ELG debt (both now sharply reduced from peak) also complicate matters to an extent.

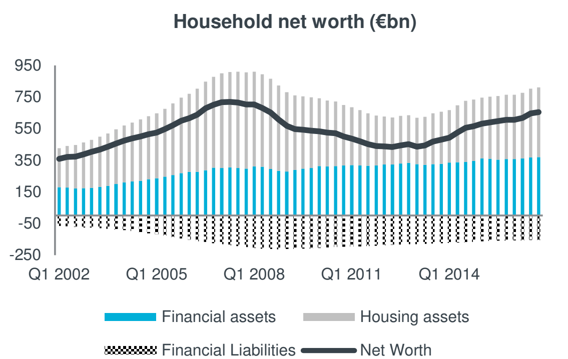
- We estimate that total economy-wide debt fell to 369% of GDP by the end of 2016 from 407% at end-2015. This reflects a combination of strong growth in nominal GDP along with deleveraging (the latter is particularly true in the underlying economy – the growth in NFC debt in recent years has been driven by balance sheet transactions involving MNCs).

- Ireland's general government debt peaked at 125.3% of GDP during 2013. It has fallen sharply since then (to 75.4% by end-Q416), primarily due to the resolution of IBRC and robust (if, to a point, inflated) headline GDP growth. With the deficit narrowing and strong growth expected into the medium term further reductions are expected in the coming years.

Underlying debt continues to reduce

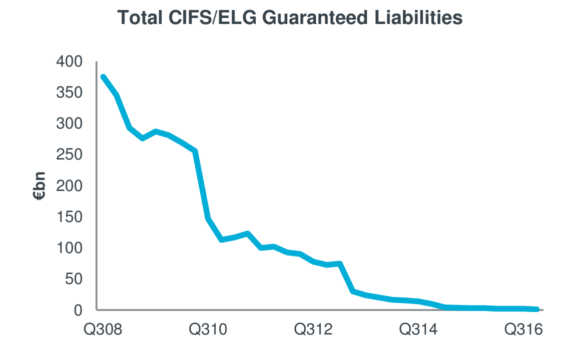


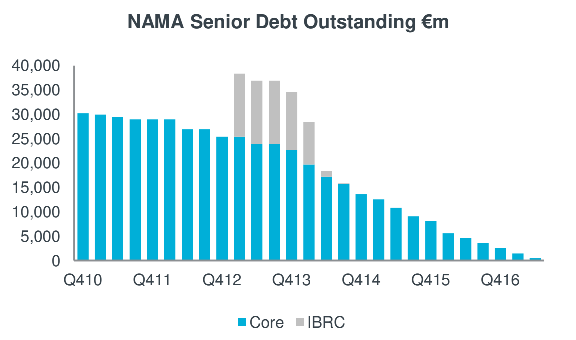


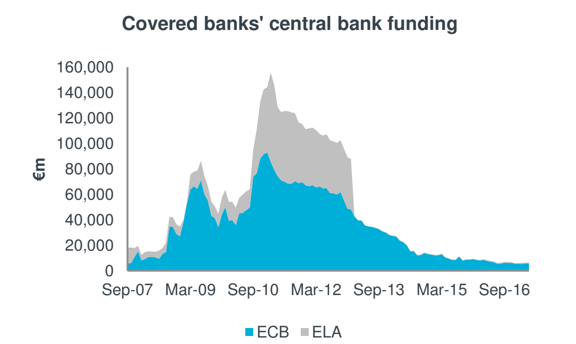


- Notwithstanding the upturn in the Irish economy and sharp reductions in deposit rates, Irish households continue to have an elevated aggregate savings rate. Gross savings rates (11.0% on a 4qma basis in Q416) are well above both the pre-crisis average (6.8%) and the average since the series began in Q199 (8.9%). However, we expect savings rates to remain elevated given Central Bank rules around minimum deposits for mortgages.
- The Quarterly Financial Accounts for Ireland continue to show deleveraging by households. Within the data we note that net debt paydown slowed to a seven year low (on a 4qma basis) of €579m in Q416 as the flow of new lending picks up.
- Other Central Bank data further illustrate the improvement in household balance sheets. Household net worth fell by €285bn between Q207 and Q212, but it has risen by €221bn (Financial Assets +€46bn; Housing Assets +€143bn; Financial Liabilities -€32bn) to €654bn since the trough. Households' financial liabilities equate to 140.9% of disposable income versus the 213.9% peak, but this is still high (indeed, Ireland is the fourth highest in the EU on this measure).

Household net worth has increased for 15 successive quarters







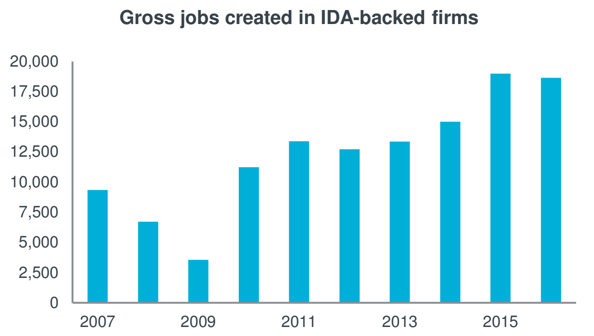
- Total liabilities guaranteed by the State under the ELG scheme (and its CIFS predecessor) have reduced by more than 99% from peak. With the scheme having been closed to new liabilities since March 2013 we would expect the remaining liabilities (€1.4bn at end-Q416) to roll off in the near term.

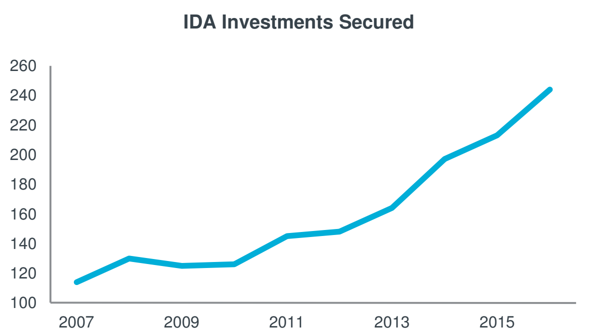
- NAMA's core balance sheet has reduced by more than 80% from peak levels. The agency now has only €0.5bn (equivalent to <0.25% of GDP) in State-guaranteed senior debt securities remaining, along with a further €1.6bn of subordinated bonds.

- 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.

The majority of Ireland's crisis-linked liabilities have been extinguished

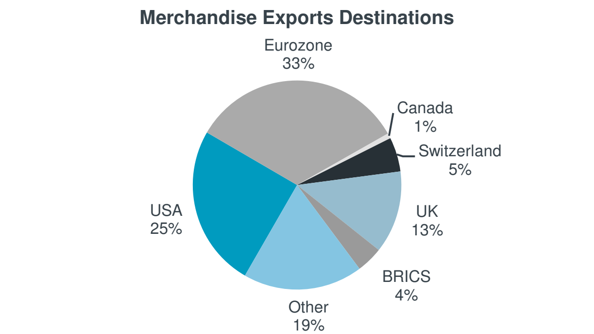
Ireland’s Strong Points

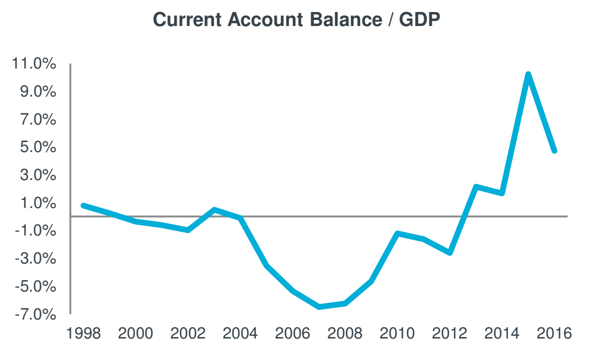


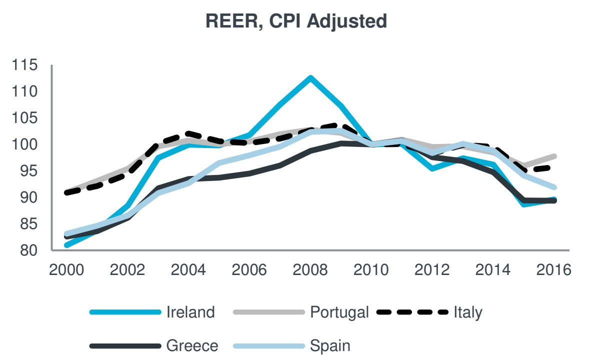


- 2016 saw the highest ever annual number of net jobs created by IDA-supported companies in Ireland. Total gross jobs created fell slightly to 18,627 (2015: 18,983), but net jobs increased by 11,842 (2015: 11,833). Net job creation turned positive in 2010 and has improved in every year since then.
- In 2016 the IDA secured 244 investments into Ireland, 15% above the outturn for 2015 (213). While Brexit is a headwind for many sectors of the Irish economy, it will also create opportunities for Ireland to increase its share of global foreign direct investment. In this regard, we are encouraged by the stream of Brexit-related foreign direct investment (FDI) announcements in recent months.
- IDA data show that 48% of the new jobs created by multinational corporations (MNCs) in 2016 went to the capital, followed by Cork (14%) and Galway (10%). Only 4.5% of all jobs created went to the 13 (half) of the counties which saw the smallest number of new positions created last year.

Brexit will result in challenges and opportunities for Ireland





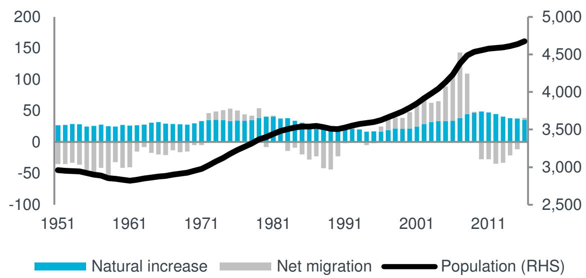


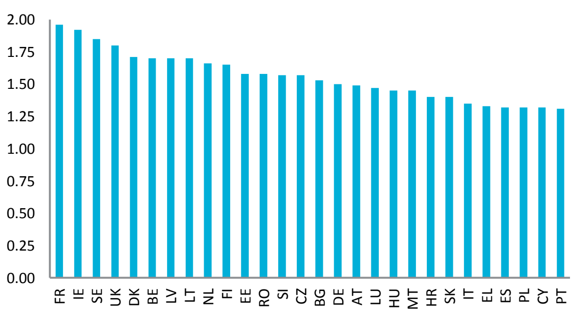
- Approximately 77% of Irish merchandise exports and 71% of Irish services exports go to either Europe or North America. As a small open economy Ireland's performance is particularly influenced by developments in those markets. The sterling weakness that followed the outcome of Britain's EU referendum has been a clear headwind for parts of the economy, although some of the effect of this will have been offset by the firming of the USD in recent times.

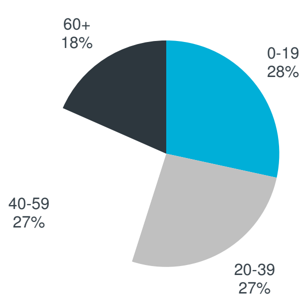
- Ireland has turned a large balance of payments (BOP) deficit into a surplus. While this is favourably impacted by MNCs moving their tax domicile to Ireland, a resilient export performance has also helped. In 2016 the current account surplus fell to 4.7% of GDP from 2015's record 10.2% outturn, this moderation is chiefly explained by intra-group intellectual property transfers by MNCs. Press reports suggest that similar distortions may be a factor in the 2017 data.

- Ireland saw a significant improvement in its cost competitiveness since the onset of the recession in both absolute and relative terms.

MNC distortions camouflage the 'real' performance







- Despite the troubles of recent years and return to 1980s-style net emigration, in April 2016 the usually resident population was estimated to have reached a post independence high of 4,673,700 (Census data, based on all persons present in the State, put the population at 4.76m). Net migration was +3,100 in the 12 months to end-April 2016, its first positive reading since the year to April 2009.

- As the latest (2015) 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.

- 55% of Ireland's population in April 2016 was under the age of 40.

Ireland's favourable demographics are a further asset

	Institutions	Infrastructure	Health and Primary Education	Higher Education and Training	Goods Market Efficiency	Labour Market Efficiency	Technological Readiness	Innovation and Sophistication
Belgium	21	23	3	5	13	45	15	14
Finland	1	26	1	2	19	23	16	7
France	29	7	19	21	31	51	17	15
Germany	22	8	14	16	23	22	10	3
Greece	81	37	46	45	89	114	42	70
Ireland	12	29	13	13	5	12	12	19
Italy	103	25	23	43	67	119	40	28
Netherlands	11	3	4	3	8	14	6	6
Portugal	46	22	22	36	38	64	26	38
Spain	55	12	30	31	54	69	25	34
UK	14	9	17	20	9	5	3	9

Source: WEF Global Competitiveness Report 2016-2017

	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

	2009	2010	2011	2012	2013	2014	2015	2016	2017E	2018E	2019E
GNP (2014 = €163.5bn)	-7.8%	3.8%	-4.0%	-0.4%	4.7%	9.2%	18.7%	9.0%	4.3%	4.0%	3.2%
GDP (2014 = €193.2bn)	-4.6%	2.0%	0.0%	-1.1%	1.1%	8.5%	26.3%	5.2%	4.6%	4.0%	3.0%
Components of GDP											
Consumption	-5.3%	0.7%	-1.0%	-1.0%	-0.8%	1.7%	4.5%	3.0%	3.3%	2.3%	1.3%
Government consumption	-3.6%	-6.5%	-0.9%	-4.1%	0.1%	5.4%	1.1%	5.3%	2.4%	1.3%	1.0%
Investment	-16.8%	-14.9%	3.4%	11.7%	-5.4%	18.2%	32.7%	45.5%	5.4%	7.3%	6.6%
Gross Domestic Expenditure	-8.8%	-3.8%	0.7%	1.4%	-1.9%	7.7%	10.0%	16.7%	4.6%	4.0%	3.0%
Exports	4.6%	5.8%	2.9%	2.4%	3.1%	14.4%	34.4%	2.4%	4.1%	4.0%	3.0%
Imports	-1.7%	0.8%	2.6%	5.4%	1.1%	15.3%	21.7%	10.3%	3.3%	4.0%	3.0%
Prices											
CPI	-4.5%	-0.9%	2.6%	1.7%	0.5%	0.2%	-0.3%	0.0%	0.5%	1.0%	1.5%
HICP	-1.7%	-1.6%	1.2%	1.8%	0.5%	0.3%	0.0%	-0.2%	0.5%	1.0%	1.5%
Labour market indicators											
Employment	-7.8%	-4.0%	-1.8%	-0.6%	2.4%	1.7%	2.6%	2.9%	2.5%	1.8%	1.5%
Unemployment rate	12.1%	13.9%	14.7%	14.7%	13.1%	11.3%	9.5%	7.9%	6.3%	5.6%	5.2%

	2009	2010	2011	2012	2013	2014	2015	2016	2017E	2018E	2019E
Revenue receipts (€ millions)	35,345	36,230	39,286	41,735	44,687	46,403	54,222	53,690	55,244	58,169	60,834
Expenditure outlays (€ millions)	59,985	54,450	63,907	56,630	56,037	54,636	54,284	54,703	56,288	58,431	60,118
Exchequer balance (€ millions)	-24,640	-18,220	-24,621	-14,895	-11,350	-8,233	-62	-1,013	-1,044	-262	716
General government deficit (€ millions)	-23,442	-53,677	-21,841	-14,013	-10,193	-7,255	-4,786	-1,518	-209	1,608	3,386
General government deficit to GDP	-13.8%	-32.1%	-12.6%	-8.0%	-5.7%	-3.8%	-1.9%	-0.6%	-0.1%	0.5%	1.1%
General government deficit to GDP (excluding financial interventions)	-11.8%	-11.2%	-8.5%	-8.0%	-5.6%	-3.7%	-1.9%	-0.6%	-0.1%	0.5%	1.1%
Gross Government Debt (GGD) / GDP	61.7%	86.3%	109.6%	119.5%	119.5%	105.2%	78.6%	75.4%	72.2%	68.1%	64.4%
GGD to GNP, %	74.6%	104.0%	136.2%	147.7%	141.7%	124.4%	99.3%	91.8%	89.0%	84.7%	80.9%
NAMA senior bonds			29,106	25,440	34,618	13,590	8,100	2,590	0	0	0
NAMA senior bonds % GDP			16.8%	14.5%	19.2%	7.0%	3.2%	1.0%	0.0%	0.0%	0.0%
State liabilities (GGD + NAMA bonds)			126.4%	134.0%	138.7%	112.3%	81.8%	76.4%	72.2%	68.1%	64.4%
Net debt (GGD less NPRF, cash) % GDP			96.2%	102.4%	105.4%	95.8%	71.3%	68.3%	65.6%	61.8%	58.5%
Net debt, % GNP			119.6%	126.6%	125.1%	113.2%	90.0%	83.1%	80.8%	76.9%	73.4%

Public Finances

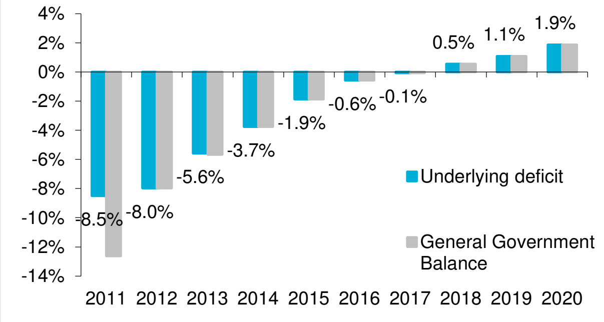
Tax revenue performance €m

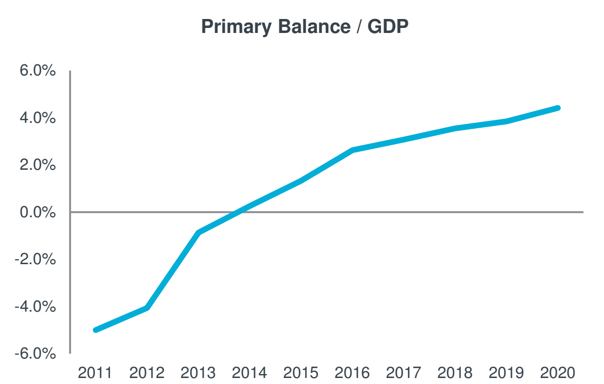
	Actual	Forecast	Variance
Customs	125	136	-8.1%
Excise Duties	2,250	2,352	-4.3%
CGT	119	115	3.5%
CAT	73	79	-7.6%
Stamp	384	447	-14.1%
Income Tax (+USC)	7,625	7,827	-2.6%
Corporation Tax	1,667	1,852	-10.0%
VAT	6,828	6,574	3.9%
Unallocated	37	0	n/m
Local Property Tax	277	272	1.8%
Total Revenue	**19,385**	**19,654**	**-1.4%**

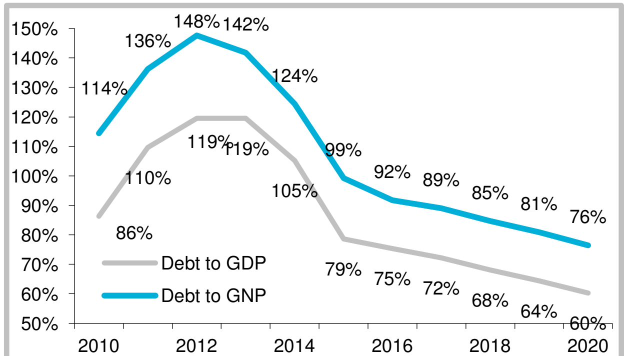
Source: DoF. Data relate to Jan-May 2017

- Exchequer Returns have had a mixed start to the year, with cumulative tax receipts behind profile in the opening five months of 2017. However, receipts are still 2.9% above year-earlier levels.
- On a more encouraging note, the latest Returns show that May 2017's tax revenues were 1.5% above profile for the month (and +10.1% y/y), helping to cut the cumulative underperformance in the year to date to 1.4% from the 2.4% undershoot recorded in the period to end-April. May's Returns suggest that the public finances may be about to get back on track.
- In cash terms the main underperformances are in Income Tax (this is puzzling given the strong labour market data); Corporation Tax (this can be lumpy and we would expect this weakness to reverse later in 2017 given the improving international backdrop and CSO data that indicate ongoing growth in the capital stock) and Excise Duties, where weakness here is likely linked to the drop in new car sales.
- On the spending side, overall gross voted (discretionary) expenditures are +4.4% y/y but 1.2% below profile in the year to date.
- The Department of Finance is forecasting Exchequer tax revenues to grow 5.2% in 2017. Given the strength of May's Exchequer Returns and the positive outlook, we think this target is still achievable.

Exchequer Returns' performance looks puzzling given macro backdrop





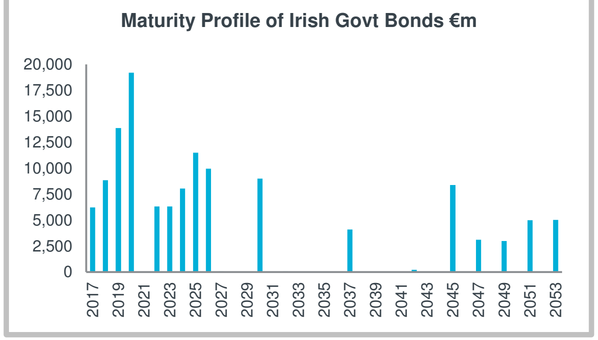


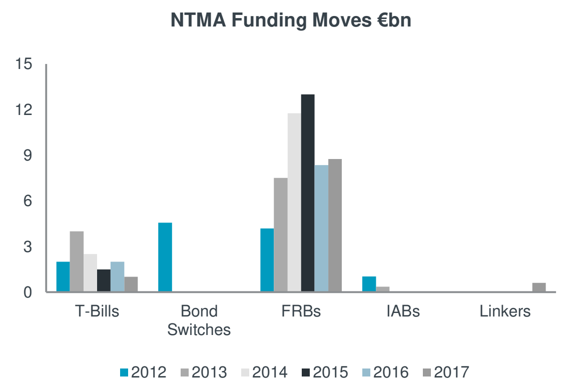
- We continue to forecast that the headline general government balance will improve to -0.1% of GDP this year (2016: -0.6%), although the risks to this are likely skewed to the downside given the mixed Exchequer Returns performance discussed on the previous slide.

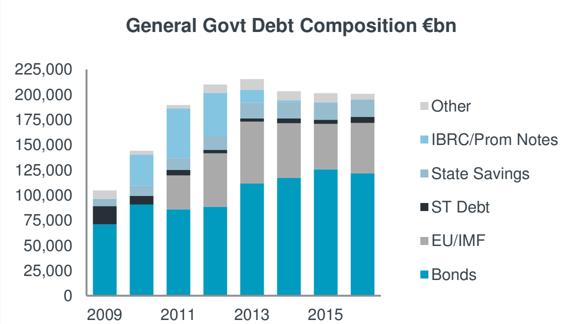
- Ireland achieved its third successive primary surplus in 2016. The average interest rate on the general government debt is guided to be 3.0% in 2017, producing a cost of €6.0bn (c. 2% of GDP).

- General Government (Gross) Debt peaked at 124.0% of annualised GDP in Q213 and has steadily improved since then (to 75.4% at end-Q416). 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 in achieving this improvement. More gradual reductions are envisaged for the coming years, although State asset sales could accelerate this.

The public finances continue to strengthen







- 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 new bonds (the last of which doesn't mature until 2053) have all helped to significantly extend the maturity profile of Irish government bonds. The current weighted average maturity of Irish bonds is c. 11.4 years.

- In 2016 the NTMA raised €8.4bn on the bond markets and a further €2.0bn from T-bill sales. So far this year it has raised €8.75bn from bond sales (effectively, the lower end of its target FY funding range of €9-13bn) and another €1bn from T-bill auctions. While the FY17 funding range looks large relative to short-term commitments, it gives the agency flexibility to chip away at some of the sizeable medium-term maturities in the secondary market.

- Following the 2013 Promissory Note restructuring and early retirement of IMF borrowings in late 2014 / early 2015, Irish government bonds account for a sizeable (c. 60%) majority of the country's general government debt, followed by the remaining Troika loans and local/retail debt.

The NTMA intends to raise €9-13bn from bond sales in 2017

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-2016 was €3.9bn
  - 92% of loans by loan nominal were non-performing at end-2016
  - 64% of NPLs by loan nominal were 120+ days in arrears by end-2016

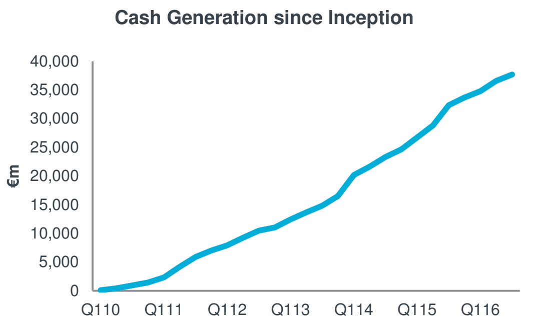
- Breakdown by asset classification at end-Q416 was: Land 30%, Residential 17%, Hotel & Leisure 5%, Retail 11%, Office 13%, Development 21%, Industrial 1%, Other 2%.
- Breakdown by geography at end-Q416 was: Ireland 82%, UK 12%, Other 6%.

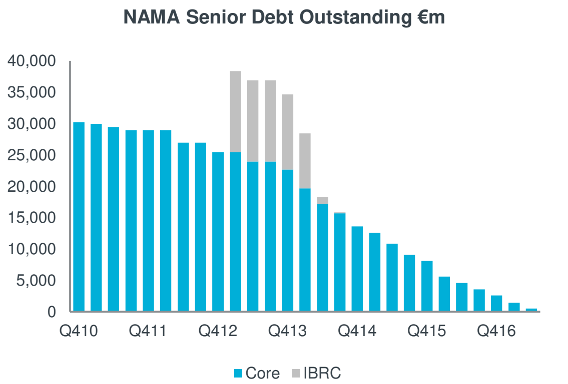
- NAMA core (linked to its original portfolio) debt securities outstanding at end-Q117 was €2.1bn of which €1.6bn were subordinated.
  - AIB €360m senior and €0.5bn subordinated;
  - BKIR €90m senior and €0.3bn subordinated;
  - PTSB €50m senior;
  - Another €0.8bn of NAMA subordinated debt is in private hands.

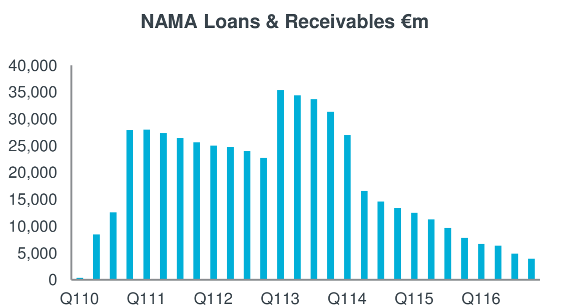
- NAMA has redeemed €29.7bn or 98% of its original senior bonds since its inception. €5.5bn of these redemptions came in 2016, the same amount that was redeemed in the preceding year. €2.1bn of bonds have been redeemed since the start of this year.

- From inception to end-2016 NAMA received proceeds from asset sales totalling €38.1bn.

- 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.





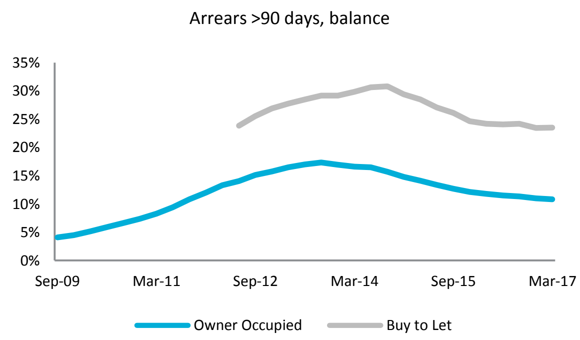


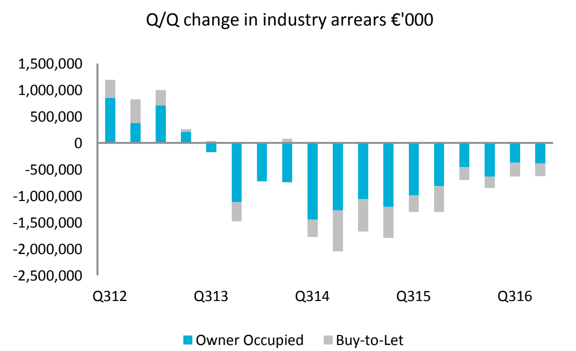
- NAMA has been an impressive cash generator since its inception. By end-Q416 it had generated cumulative operating cashflow of €37.7bn.

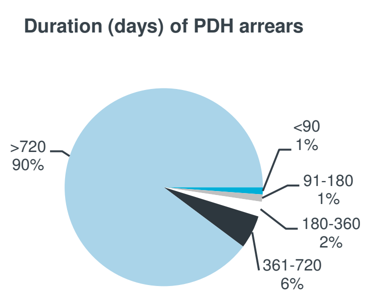
- These cash flows have funded significant redemptions of both tranches of NAMA bonds – those relating to the core portfolio acquired in 2010/2011 and the IBRC related issuance (all of which was subsequently extinguished) in 2013 – while also facilitating significant investment in enhancing the value of its asset base. Management recently raised its target for lifetime earnings to €3bn but this looks very conservative, not least given that its core equity (total equity adjusted for the sub debt and non-controlling interests) stood at just above €3bn at end-2016.

- NAMA's balance sheet reduced by 37% over the course of 2016. The agency continues to aim to resolve its work by the end of 2020, a target that looks reasonable taking into account its development pipeline and continued robust investor interest in Irish loan assets.

NAMA on course to exceed its €3bn profit target







- The latest Central Bank of Ireland data covering all banks resident in Ireland show that there were 734,106 PDH (owner-occupied) mortgage loan accounts, with a total balance of €99.0bn, at end-Q117. In the same quarter there were 128,149 BTL mortgages with a total balance of €23.4bn.

- Both segments have seen arrears reduce from peak levels. Some 7.2% of PDH accounts were in arrears of more than 90 days past due (90dpd) in Q117, with the balance on these equivalent to 10.8% of the stock of mortgages in issue. This compares to the Q313 peaks of 12.9% and 17.3% respectively. BTL accounts in arrears that are more than 90dpd equate to 15.6% (volume) and 23.5% (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 25% of the euro balance on those mortgages for PDH and €1.9bn (34%) for BTL.

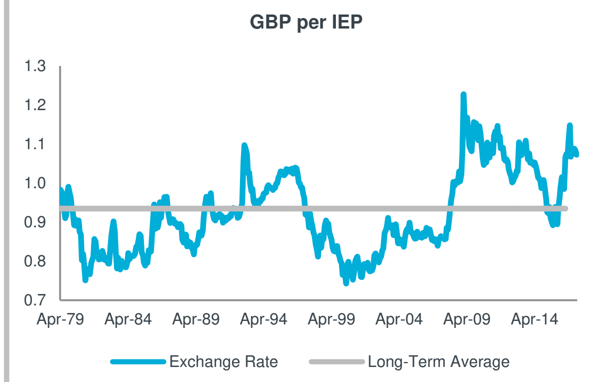
Mortgage arrears are still reducing, but at a slower pace than before

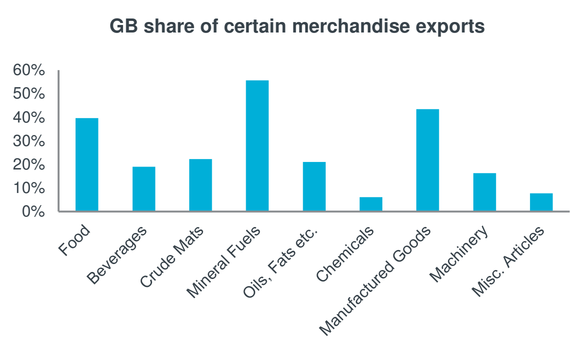
- Central Bank of Ireland data for Q1 2017 provide further colour on the stock of restructured mortgages in Ireland:

	Number	Balance ('000)	Arrears ('000)		Number	Balance ('000)	Arrears ('000)
Total No of Restructured PDH Mortgages	**120,894**	**16,777,459**	**301,363**	**Total No of Restructured BTL Mortgages**	**24,458**	**5,681,050**	**168,628**
o/w not in arrears	94,450	12,378,020		o/w not in arrears	19,138	4,389,560	
Restructure by Type				**Restructure by Type**			
Interest Only	4,204	742,474	23,447	Interest Only	3,044	739,538	30,592
Reduced Payment > Interest Only	7,724	1,620,536	61,291	Reduced Payment > Interest Only	5,919	1,710,302	22,210
Reduced Payment < Interest Only	754	145,489	11,779	Reduced Payment < Interest Only	81	22,589	2,077
Term Extension	15,089	1,630,184	36,556	Term Extension	3,622	601,419	16,314
Arrears Capitalisation	38,807	6,024,149	91,394	Arrears Capitalisation	5,466	1,145,182	79,051
Payment Moratorium	1,124	184,467	10,099	Payment Moratorium	302	59,613	3,869
Deferred Interest Scheme	20	3,418	513	Deferred Interest Scheme	1	406	19
Permanent Interest Rate Reduction	170	29,852	732	Permanent Interest Rate Reduction	3	1,206	342
Split Mortgage	27,304	2,752,854	6,762	Temporary Interest Rate Reduction	122	25949	369
Trade Down Mortgage	61	9,826	1	Split Mortage	2,071	274,203	370
Temporary Interest Rate Reduction	6,554	1,325,989	17,823	Other	3,827	1,100,643	13,415
Other	19,083	2,308,221	40,966				

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 for the first half-century after independence has largely been unwound. The UK's share of Irish merchandise exports was only 13% in 2016, well below the 58% recorded in January 1973 when both countries joined the then EEC.

- 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) surged above the levels seen after Black Wednesday in 1992 in the period following the Brexit vote. A quarter-century ago the UK accounted for twice the share of Irish goods exports as it does today.

- Adding in the services sector (19% of whose exports go to the UK) means that Ireland's closest neighbour accounts for about a sixth of total exports. For some segments of the economy its importance is far greater – between 40% and 45% 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 a sixth of total Irish exports

- Short term:
  - Exports 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 -10.3% 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
  - But Ireland is likely to grow its share of FDI to (part-?) compensate for this – there have been some encouraging announcements thus far
  - While the government stuck to its fiscal guns in Budget 2017, it is possible that the fiscal space for the next Budget could be impacted by Brexit-related developments
  - 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
  - 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 in all likelihood be needed
  - 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?

- The UK has triggered Article 50, ending the ‘Phoney War’ that had existed since the Brexit vote last June and thus commencing the formal stage of its divorce negotiations with the EU. The recent UK election has complicated an already challenging task for London

- Negotiating period / remaining EU membership is set at two years under Article 50, but this can be extended indefinitely by unanimous EU28 vote. We note that the EU-Switzerland bilateral trade deal took six years to finalise

- The UK’s current intention to exit the single market is particularly unhelpful for Ireland, but we note that the issue of the border with Northern Ireland is towards the top of the negotiating schedule, which may lead to some helpful clarity in the coming quarters

- 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

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