Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Strong rebound in activity in Q3 risks being derailed in Q4 by second wave to coronavirus, which has seen governments re-impose restrictions and lockdowns in response to surge in new cases

- Advanced economies forecast to grow by circa 4% in 2021 after contracting by around 6% this year. Further waves to virus are a threat to recovery until a successful vaccine is widely available

- Central banks everywhere ease policy aggressively this year with rate cuts, large QE programmes and enhanced liquidity measures. Further monetary loosening now underway

- Main currencies quite range bound, with risk aversion supportive of the strong dollar and yen

- Sterling stable as it awaits outcome of EU-UK trade talks. It could fall sharply should talks fail and a Hard Brexit materialises in 2021

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Global Economic Outlook

Second wave to Covid disrupts recovery in activity from H1 2020 deep recession

Economic forecasting in the current unprecedented COVID-19 pandemic environment is very difficult. Large parts of the world economy were put into lockdown in the spring to control the spread of the virus, triggering a very deep global recession in H1 2020. Activity rebounded strongly over the summer as lockdown restrictions were lifted. The recovery, though, has lost momentum recently, with the number of new cases of the virus surging again, triggering fresh restrictions on activity and new lockdowns in some large economies.

The recession experienced by the world economy in H1 2020 was exceptionally deep, especially in Q2 which saw declines of 10-20% in GDP in many developed economies. There was a very strong rebound in activity in Q3, but this is being threatened by a second wave to the coronavirus. Renewed declines in GDP are likely in many economies in Q4. Overall, the IMF sees GDP contracting by circa 6% this year in advanced economies, with the world economy shrinking by around 4.5%. In many countries, the hit to the labour market has been mitigated by various government funded furlough and income support schemes. Jobless rates, however, could well spike upwards in 2021 as these schemes are wound down.

Without knowing the duration of the virus, the extent of further outbreaks and lockdowns, developments in relation to finding a successful vaccine that becomes widely available, as well as how scarring effects impact the speed and strength of the recovery in economic activity, a wide range of outcomes are possible for GDP over the period 2021-2022.

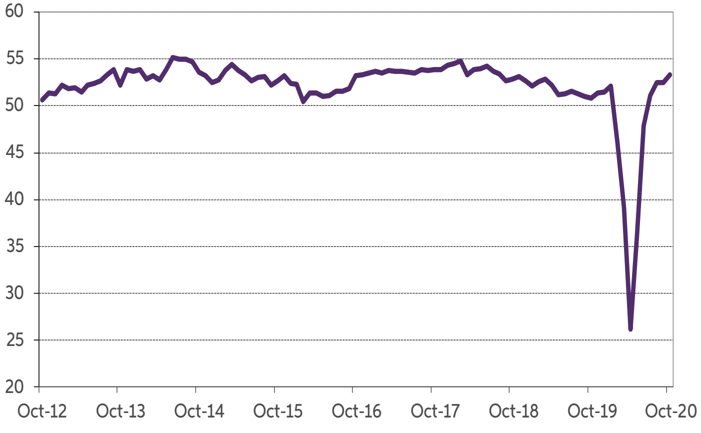
The most recent set of comprehensive global economic forecasts have come from the IMF in its October World Economic Outlook. It sees world GDP rebounding by 5.2% next year, with advanced economies growing by 4%. This is based on the assumption that social distancing will persist next year with some further outbreaks to the virus, but without national lockdowns. It is not until 2022 that virus cases fall to low levels on a sustained basis as a vaccine becomes widely available. As a result, economies don't recover fully from the 2020 recession until 2022.

The IMF warns that downside risks to its forecasts remain significant. In particular, the virus may prove more virulent than expected next year, necessitating further lockdowns, while progress in developing a vaccine could be slower than anticipated. Scarring effects such as rising business failures and bankruptcies, increasing bad debts, permanent job losses, lower labour force participation and inefficient resource allocation could weigh on the pace of recovery also.

There are other obvious impacts on economies from the very deep COVID-19 recession. World trade volumes are set to fall by around 10% this year. While furlough schemes have prevented unemployment reaching very high levels in 2020, the OECD believes the jobless rate could still eventually rise to around 10% next year as job support schemes are wound down. The rate stood at 5.4% in 2019 There has also been marked downward pressure on inflation, aided by the large drop in oil prices—the IMF sees a CPI rate of 0.8% this year in advanced economies.

There has also been a sharp deterioration in public finances owing to government spending measures to mitigate the economic shock and declines in tax revenues due to the severe recession. Governments in virtually all countries are set to record very large budget deficits this year and a corresponding jump in public debt. Fiscal deficits in the OECD area are seen rising to 11-13% of GDP in 2020 from circa 3% in the past couple of years.

Global Composite PMI (JP Morgan)



Source: Refinitiv

GDP (Vol % Change)

	2018	2019	2020 (f)	2021 (f)
World	3.6	2.8	-4.4	5.2
Advanced Economies	2.2	1.7	-5.8	3.9
US	2.9	2.2	-4.3	3.1
Eurozone	1.9	1.3	-8.3	5.2
UK	1.3	1.5	-9.8	5.9
Japan	0.3	0.7	-5.3	2.3
Emerging Economies	4.5	3.7	-3.3	6.0
China	6.7	6.1	1.9	8.2
India	6.1	4.2	-10.3	8.8
World Trade Growth (%)	3.8	1.0	-10.4	8.3
CPI				
Advanced Economies (%)	2.0	1.7	0.8	1.6

Source: IMF World Economic Outlook, October 2020

Interest Rate Outlook

Central banks return to easing path as second wave threatens economic recovery

Central banks globally have been pulling out all the stops to try and ameliorate the most severe impacts of the COVID-19 pandemic on their economies and financial systems as well as support a recovery in activity from the deep recession in H1 2020. Thus, interest rates have been cut sharply to 0.125% and 0.1% in the US and UK, respectively. Enormous QE bond purchase programmes have been put in place and measures adopted to enhance the supply of liquidity to the economy and ease funding pressures, notably in regard to the dollar.

The message from central banks has been that they are prepared to do whatever is necessary to help economies recover from the very severe contraction in economic activity in H1 2020. They have also indicated that they are in this for the long hall. Central banks have been very clear and forceful in their communications that monetary policy will remain exceptionally loose over the next couple of years and further measures will be adopted if required to restore economies to a strong footing.

Additional easing by the main central banks seem likely to be in the form of further QE as it would appear that we have reached the lower bound in interest rates in most economies. The ECB and BoJ do not seem overly keen to move interest rates even deeper into negative territory, having focused to date in this crisis on using other non-standard policy measures, in particular expanding QE. The Fed continues to show a clear reluctance to move rates into the negative domain, although the BoE is not ruling out such a move.

The BoE has been toying with the idea of a move to negative rates, with the Governor saying it was under active consideration. However, any such policy move does not appear imminent and the BoE remains to be convinced about the merits of negative rates. Markets see UK rates being cut by at least 10bps in the coming year, which would take the bank rate down to zero, and are even discounting that rates could go slightly negative. The focus for the BoE at its November policy meeting, though, remained on further easing being done via QE as it announced an additional £150bn in asset purchases, bringing the programme size up to £895bn.

Meanwhile, the ECB has indicated that it will be recalibrating its policy instruments at next month's Governing Council meeting in response to the deterioration in the economic outlook caused by the second wave to the coronavirus hitting Europe. The indications are that this will probably take the form of an expansion to its QE programme and possibly enhanced liquidity measures too. Markets are pricing in that the ECB could go further next year and lower the deposit rate by a further 10bps to –0.6%.

Meanwhile, the Fed recalibrated its monetary policy framework this autumn to put more weight on boosting the labour market and less emphasis on inflation, with the intention of keeping the fed funds rate at its current very low level for an even longer period of time. Notably, it has indicated an intention to allow inflation move moderately above 2% for some time following periods, such as now, where it undershoots target. The Fed is also pushing for additional fiscal loosening rather than further monetary measures as the most effective response to the slowing pace of recovery in the US.

The expected maintenance of very accommodative monetary policies for a prolonged period of time by central banks is reflected in the pricing of futures contracts, which don't see rates rising for a number of years. US rates are not seeing increasing until 2023, with UK and Eurozone rates not rising above current levels until H2 2024.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.125	0.23	0.33	0.22	0.37
Dec'20	0.125	0.23	0.33	0.23	0.39
Mar'21	0.125	0.24	0.34	0.24	0.42
June'21	0.125	0.25	0.35	0.25	0.45

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	-0.50	-0.54	-0.47	-0.54	-0.49
Dec'20	-0.50	-0.55	-0.47	-0.53	-0.48
Mar'21	-0.50	-0.55	-0.46	-0.52	-0.47
June'21	-0.50	-0.55	-0.45	-0.50	-0.45

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.10	0.04	0.12	0.05	0.18
Dec'20	0.10	0.05	0.13	0.06	0.19
Mar'21	0.10	0.05	0.14	0.08	0.22
June'21	0.10	0.05	0.15	0.10	0.25

** Swap Forecasts Beyond 1 Year*

Covid related risk aversion continues to support elevated, safe-haven dollar

The big picture in regard to the dollar is that it appreciated very sharply over the period 2014 to 2016 and has remained at an elevated level since then. Another very notable feature is its very narrow trading ranges against the other major currencies in recent years– the EUR/USD rate has been largely confined to a $1.05-1.20 band since end 2014, the yen has generally traded in a ¥104-115 range since the end of 2016, while the Canadian dollar has remained largely in a CAD$1.25-1.40 corridor over the past five years. Even against a volatile sterling, $1.20-1.40 has contained nearly all the action in cable since the sharp fall of the UK currency in the aftermath of the June 2016 Brexit referendum.

The US dollar did lose some ground over this summer against the other major currencies, while remaining at elevated levels, especially versus emerging market currencies. It has been quite range-bound against the other majors during the autumn. A second wave to the coronavirus has seen increased risk aversion in financial markets, supporting safe-haven currencies like the dollar and yen. Thus, having climbed to a high near to $1.20 by end August, the euro has drifted back towards $1.16 against the dollar recently.

Despite its relative stability at elevated levels, it is worth considering if we are in the midst of some key changes to the dollar's medium-term prospects. First, favourable interest rate spreads have been a key factor in supporting the dollar for much of the past decade, with the Federal Reserve pitching US rates considerably higher than in the other large advanced economies. This advantage has now largely gone, with short-term US rates virtually at zero. Furthermore, under its new policy framework, the Fed is more or less promising to keep rates close to zero over the next few years.

Second, the past decade, starting with the financial crises and continuing all the way to the Covid-19 pandemic, has been characterised by subdued global growth and quite brittle risk sentiment. This has benefitted the safe-haven dollar. Given though, the amount of stimulus injected into economies this year and the extent of pent-up demand and build up of private sector savings, there is scope for a period of strong robust global growth and much reduced uncertainty once the coronavirus subsides – developing a vaccine is crucial in this regard - which could prove negative for the dollar.

Third, a continuing loose fiscal stance in the US, which already has a very large budget deficit, as well as a significant balance of payments deficit, would be a risk for the currency. The US fiscal deficit is put at over 15% of GDP in 2020, the largest since 1945 and compares to a deficit of circa 9% in the Eurozone. It is expected that the US budget deficit will remain high over the next number of years. The so-called twin deficits could weigh on the dollar in an environment of close to zero interest rates, and where demand for safe-haven currencies abates.

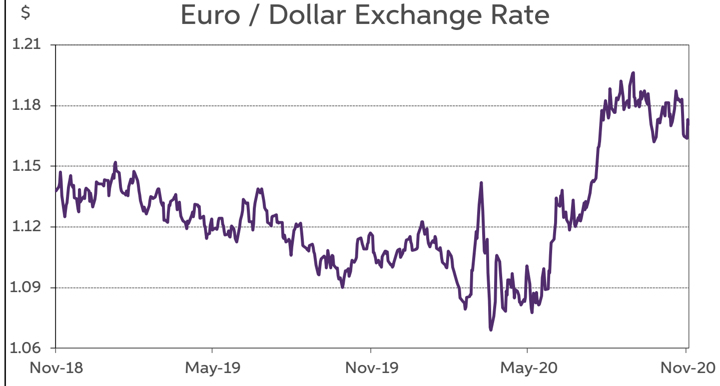
While it may not happen immediately, longer-term the downside risks are building for the elevated dollar. For now, though, the dollar remains well supported by risk aversion in the midst of a second wave to the Covid-19 pandemic and post-election political uncertainty in the US. Market positioning is also short the dollar at present. Thus, the euro seems likely to remain in a $1.15-1.20 range against the dollar over the rest of the year. Further out, if there is real progress in overcoming the Covid-19 virus during 2021, then we could start to see the dollar lose some ground. The euro has one made only one breach of the $1.20 level since 2014 so it will be a difficult hurdle to overcome. If it succeeds, then the euro could move up towards the $1.25 level during next year.

US Dollar Trade Weighted Index Versus Majors

(March 1973 =100)

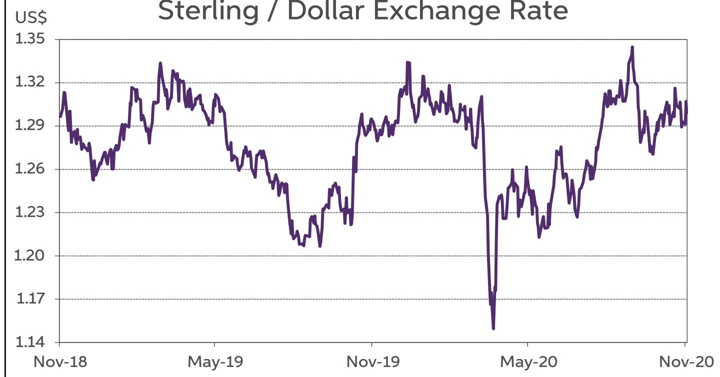
Source: Refinitiv

Euro / Dollar Exchange Rate



Source: Refinitiv

Sterling / Dollar Exchange Rate



Source: Refinitiv

Forex Market Outlook

Sterling upside may be limited, even if there is a last minute trade deal

After a volatile year in 2019, sterling has seen some very sharp movements again in 2020. This was especially so in the spring when markets went into free fall as the coronavirus took hold. Cable fell rapidly from $1.32 in early March to $1.15 by the middle of the month, its lowest level since the mid-1980s. Meantime, the euro rose from 84p to 95p, with some very big intra-day price movements. The UK currency staged a strong recovery soon after, regaining much of the lost ground. It all highlights that sterling can be a very volatile currency.

For the past six months, though, sterling has been very stable against the euro. Trading in the pair has largely been confined to a narrow 89-92p range. This is despite the fact that over this period, little progress has been made in the EU-UK trade talks, with the clock ticking down towards the end of the Brexit transition period in December. The two sides are still quite far apart on the key issues of regulatory alignment especially on state aid rules, a dispute resolution mechanism and fisheries. Indeed, the talks broke down for a short spell in October.

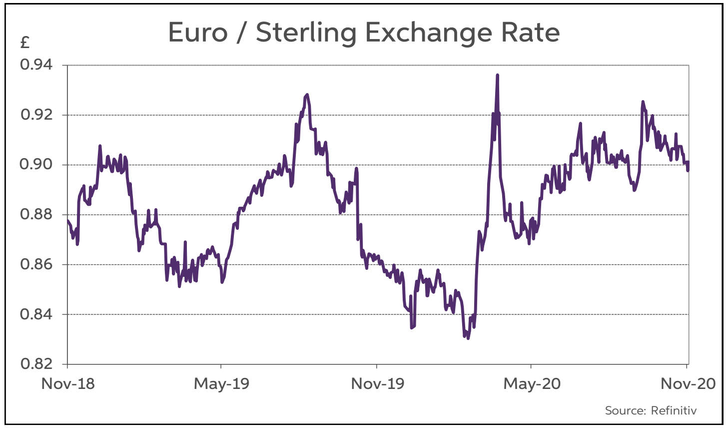
A failure to reach a deal and a move to trading under WTO rules involving tariffs, quotas and non-tariff barriers would deal another severe blow to the UK economy in the aftermath of a forecast 10% fall in GDP in 2020 as a result of the Covid-19 pandemic. Studies suggest that the hit to UK GDP could be of the order of 5-6% within the first few years. Sterling, though, has been largely unperturbed by the lack of progress in the talks since May.

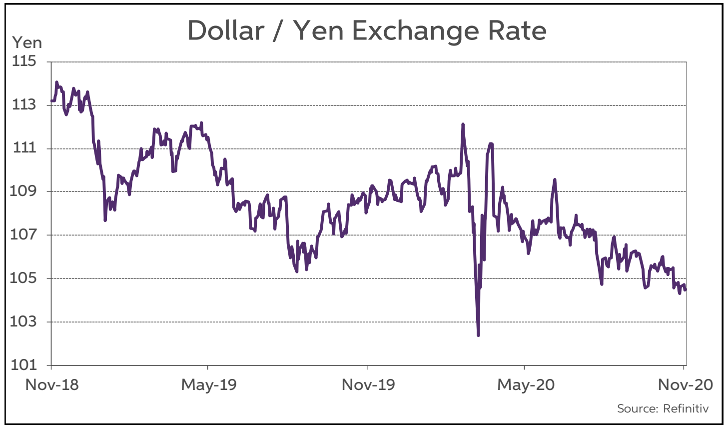
It may be that markets believe that a trade deal will eventually be agreed as neither the UK nor the EU will want to add more economic woes on top of the major problems caused by the Covid-19 pandemic. Indeed, last year following much procrastination, the UK and EU moved quickly to conclude a Withdrawal Agreement in October that paved the way for the UK's smooth departure from the EU. More recently, the talks have moved to a more intensive phase as both sides knuckled down to do some hard bargaining to try and get a trade deal over the line. The intensive negotiations, though, so far have been unable to resolve the outstanding key issues.

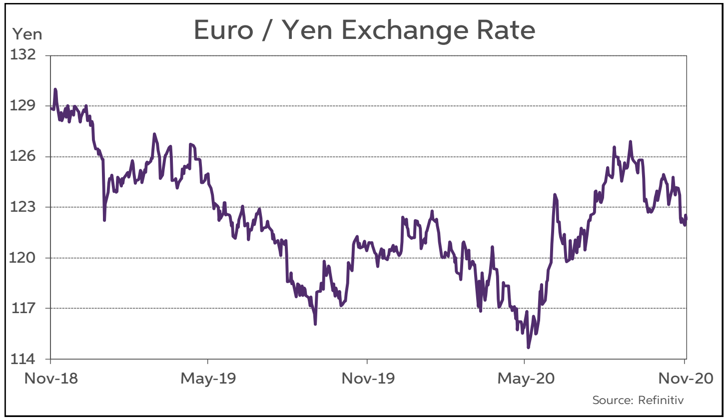
Apart from a positive outcome to the trade talks, the grounds for optimism on sterling look slim. Markets expect a further 10bps cut from the BoE at some stage in the coming year. Meanwhile, the Bank is no longer ruling out negative rates for the UK. Such a move could pose downside risk for the currency. It is also the case that the recession caused by the Covid-19 pandemic has been much deeper in the UK than other major economies, resulting in the budget deficit soaring to close on 20% of GDP in FY2020/21.

All this suggests that the risks for the currency are far from symmetric. The likelihood at this stage is that if a trade deal is agreed, it will be a very limited agreement and far inferior to the current Single Market. This would hardly be a major positive development for the UK economy. Hence, sterling may not gain that much ground if an agreement is reached, with the euro dropping back to around the 87-88p level.

On the other hand, recent history has shown with the Brexit referendum result in 2016 and the instability in markets caused by the Covid-19 pandemic earlier this year, that sterling can fall very sharply and very quickly at times of crisis. Falls of ten per cent or more by the UK currency are not unusual, as occurred this spring. We remain hopeful that a limited trade deal may still be agreed in the next few weeks which should see sterling made some modest gains. However, if the trade talks fail, it would be a shock and sterling could fall quite sharply.



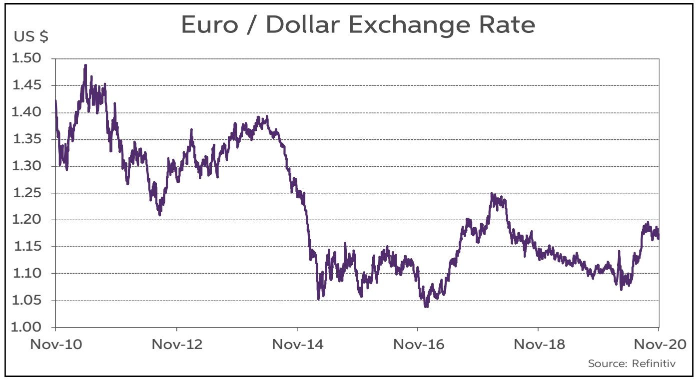


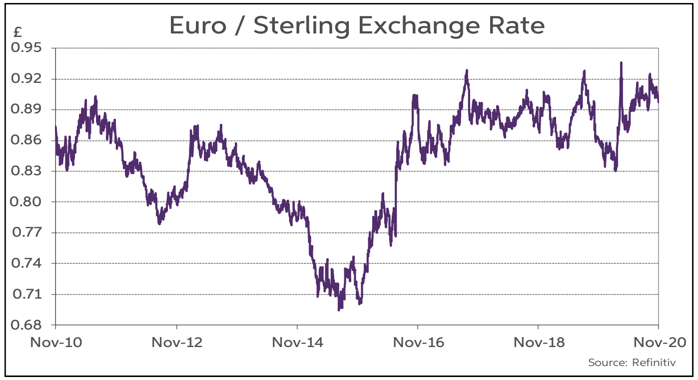


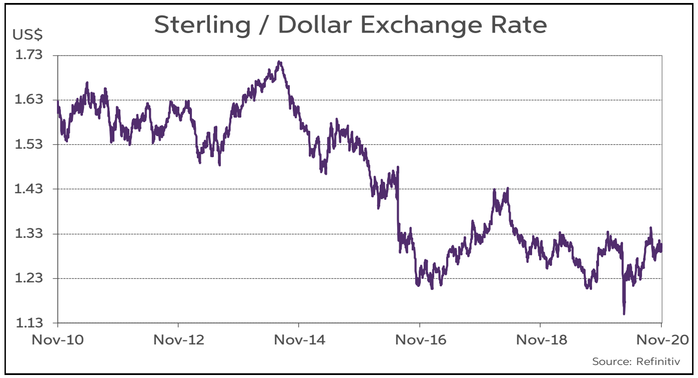
Summary of Exchange Rate Forecasts

(“Spot” Forecasts for end Quarter can be taken as Mid-Point of expected Trading Range)

	Current	Q4-2020	Q1-2021	Q2-2021	Q3-2021
Euro Versus					
USD	1.177	1.14-1.20	1.16-1.22	1.18-1.24	1.20-1.26
GBP	0.904	0.84-0.90	0.85-0.91	0.85-0.91	0.85-0.91
JPY	122.76	120-126	122-128	123-129	125-131
CHF	1.07	1.07	1.08	1.09	1.09
US Dollar Versus					
JPY	104.26	102-108	102-108	101-107	101-107
GBP	1.303	1.31-1.37	1.32-1.38	1.34-1.40	1.37-1.43
CAD	1.31	1.31	1.29	1.28	1.27
AUD	0.72	0.72	0.73	0.74	0.75
NZD	0.67	0.67	0.68	0.69	0.70
CNY	6.63	6.65	6.60	6.55	6.50
Sterling Versus					
JPY	136	141	142	142	146
CAD	1.71	1.76	1.74	1.76	1.78
AUD	1.81	1.86	1.85	1.85	1.87
NZD	1.94	2.00	1.99	1.99	2.00







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