Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Advanced economies performing quite well, despite mounting risks to outlook for world growth. Some large emerging economies encountering serious financial difficulties this year
- Fed on steady rate tightening path as economy strengthens. After recent hike, BoE goes on hold ahead of Brexit. ECB to end QE in December, but rates to stay very low for long time afterwards
- Dollar rally runs out of steam, but it should be supported in near term by rising US rates and strong economy. However, growing US imbalances point to risks for currency over medium term
- Euro quite range bound recently. Has upside potential versus dollar over medium term
- Sterling continues to be driven by ebb and flow of news on Brexit. Likely to remain volatile

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Global Economic Outlook

Advanced economies performing well, though risks are mounting for world economy

Recent updates from both the OECD and IMF show that they still expect the world economy to grow by around 3.8% in 2018 and 2019, despite some weakening in data earlier in the year and growing downside risks to the economic outlook. The combination of continuing very loose monetary policies, a more supportive stance to fiscal policy, as well as improving labour markets are all supportive of economic prospects.

Most of the major economies registered an improved growth performance in the second quarter of 2018 after a slowdown in activity in the opening months of the year. The US economy grew by over 1%, its strongest quarterly performance since 2014. GDP expanded by a very strong 0.7% in Japan after contracting in the first quarter, while the growth rate in the UK picked up to 0.4% from 0.2%. Meanwhile, growth in the Eurozone remained steady at a solid 0.4%. Most data in the third quarter suggest that advanced economies have continued to perform well, in particular the US and UK. Meantime, labour markets continue to tighten, with on-going good growth in employment and unemployment falling to very low levels in some countries.

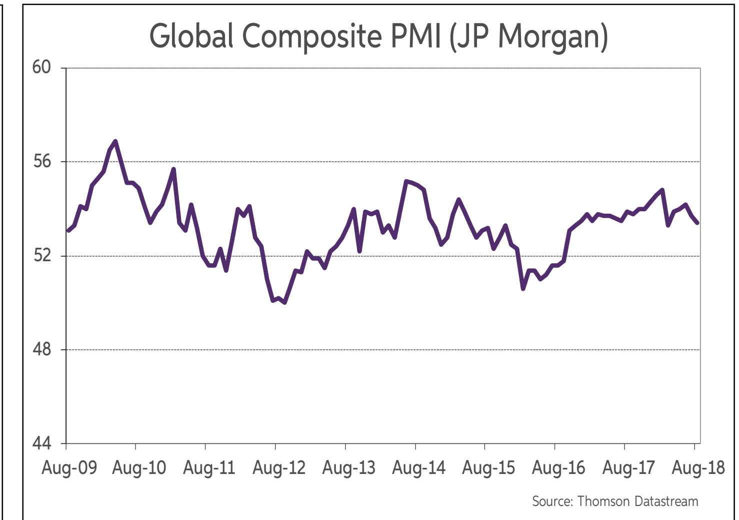
Nonetheless, downside risks are building for the global economy. Both the IMF and OECD in their latest economic updates note that the rate of expansion appears to have peaked in some major economies and is also becoming less even. Furthermore, activity has slowed sharply this year in some big emerging economies, including Argentina, Brazil, South Africa, Turkey and Indonesia. There have also been some signs recently that activity in the Chinese economy may be losing some momentum.

The IMF believes that the balance of risks has shifted to the downside for the world economy. These risks include escalating trade tensions. A move towards protectionist trade policies, with a number of countries applying tariffs on some imports, has already had adverse effects on confidence and financial markets. A global trade war would have serious consequences for the world economy, especially those countries that have a heavy reliance on exports. It would also damage business confidence and most likely cause global stock markets to fall.

Meantime, as the OECD has pointed out, global growth is still heavily reliant on very accommodative monetary conditions and thus, the pick-up in activity over the past couple of years cannot be viewed as self-sustaining. This is a concern given the growing downrisks for the world economy, especially some larger emerging economies.

The currencies of some large developing economies with weak fundamentals, in particular high balance of payments and fiscal deficits, as well as significant foreign currency borrowings, have seen sharp falls this year. Tighter financial conditions as QE is wound down and interest rates start to rise, as well as dollar strength are creating difficulties for some of the weaker emerging economies. More generally, financial markets have become more risk averse and are experiencing much greater volatility in 2018 than in the previous couple of years.

More longer-term, there are also concerns about the implications of the current policy mix in the US. The marked loosening of fiscal policy is likely to result in a big rise in both the budget and balance of payments deficits. It also risks overheating the economy, with the unemployment rate now below 4%. The US economy could slow quite sharply once the fiscal stimulus starts to fade and higher interest rates begin to impact on activity. Overall then, caution is warranted regarding the prospects for the global economy, despite its good performance again in 2018 and the continuing accommodative monetary conditions.



GDP (Vol % Change)

	2016	2017	2018 (f)	2019 (f)
World	3.2	3.7	3.9	3.9
Advanced Economies	1.7	2.4	2.4	2.2
US	1.5	2.3	2.9	2.7
Eurozone	1.8	2.4	2.2	1.9
UK	1.8	1.7	1.4	1.5
Japan	1.0	1.7	1.0	0.9
Emerging Economies	4.4	4.7	4.9	5.1
China	6.7	6.9	6.6	6.4
India	7.1	6.7	7.3	7.5
World Trade Growth (%)	2.2	5.1	4.8	4.5
Advanced Economies CPI Inflation (%)	0.8	1.7	2.2	2.2

Source: IMF World Economic Outlook Update, July 2018

Interest Rate Outlook

Fed to remain on tightening path, other central banks quite cautious

The US Federal Reserve is advancing steadily on a path of policy normalisation, hiking rates at a measured pace and reducing the size of its balance sheet as its stock of QE assets are allowed to slowly run down. Other central banks, though, remain cautious about tightening policy too quickly. Hence, monetary policy is expected to remain very loose in all the major economies over the next couple of years, apart from the US.

In the UK, the persistence of above target inflation amidst a tightening labour market saw the Bank of England increase rates by 25bps in November 2017 and again this August. The hikes occurred despite the moderation in the pace of economic growth in the UK since the Brexit referendum in June 2016. They were the first rate hikes since 2007 and brought the bank rate up to 0.75%, its highest level since 2009.

The Bank of England, though, has been keen to emphasise that while some further policy tightening may be required in the next couple of years, future rate increases are likely to be at a gradual pace and to a limited extent. It has also noted that uncertainty in relation to Brexit has increased. The market is pricing in the next rate hike for mid-2019, with two further rate hikes expected in 2020 and 2021, bringing the bank rate up to a still low 1.5%.

The ECB scaled back bond purchases under its QE programme at the start of 2018. It is set to reduce them even further next month and then cease net asset purchases altogether at the end of the year. However, the ECB has indicated that it intends to keep interest rates at their current very low levels until at least the end of next summer. The ECB does not see inflation rising to its 2% target level in the next three years, so interest rates in the Eurozone are likely to remain very low for a long time.

The ECB deposit rate is currently at -0.4%, resulting in negative interbank rates. Futures contracts show wholesale rates starting to rise from H2 2019 onwards and only see them turning positive in June 2020. Overall, three month money rates are seen as rising by just 50bps between now and September 2020, and are not expected to get to 1% until spring 2023. We would expect short-term money market rates to remain between the deposit and refi rates in the next few years, given the ample market liquidity. However, the gap between the two official rates could narrow to 25bps from 40bps at present, as rates start to be increased.

Meanwhile, the Fed hiked rates by another 25bps to 1.875% at its June meeting, the seventh rate rise in this cycle. It has indicated that two further rate hikes can be expected in the second half of the year, with additional increases likely in the subsequent two years, taking rates up to 3.375% by end 2020. The futures market has priced in two further rate hikes over the balance of the year, with the next increase expected this week.

The market has been moving more into line with the Fed's projections recently and now expects two further rate hikes in 2019. It now sees official rates peaking at 2.875% at end 2019, although this is still 50bps below the Fed projection of 3.375% for end 2020. Continuing strong growth by the US economy could see a further firming of the market's rate expectations. We anticipate that the Fed funds rate will rise to at least 3.125% in this cycle.

Bond markets have been quite volatile this year. Yields have come under upward pressure at times, but bouts of risk aversion have also seen rallies in bond markets. There has been renewed upward pressure on bond yields recently as markets revise their expectations upwards for US rates in 2019. Continuing strong US data would maintain the upward pressure on yields as markets will need to price in greater Fed tightening in 2019/2020.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.875	2.37	2.91	2.97	3.07
Sep '18	2.125	2.50	2.95	3.00	3.10
Dec '18	2.375	2.75	3.15	3.15	3.25
Mar '19	2.625	2.95	3.30	3.30	3.35

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	-0.40	-0.35	-0.22	-0.12	0.36
Sep '18	-0.40	-0.34	-0.21	-0.12	0.40
Dec '18	-0.40	-0.32	-0.19	-0.10	0.45
Mar '19	-0.40	-0.30	-0.15	-0.05	0.50

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.75	0.80	1.06	1.14	1.43
Sep '18	0.75	0.80	1.08	1.20	1.50
Dec '18	0.75	0.80	1.10	1.25	1.55
Mar '19	0.75	0.85	1.15	1.30	1.65

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Dollar rally may be at an end

The US dollar had a weak start to the year, with EUR/USD rising above $1.20 and then reaching $1.25. However, the greenback has recovered strongly since early spring, gaining ground against a broad range of currencies. This saw the EUR/USD rate fall back, breaching significant support at the $1.1550 level in early August, before hitting a low of $1.13. The euro has subsequently recovered ground, rising back up above $1.17 recently.

The dollar has been aided by strong US economic data this year, with many releases surprising to the upside. The US economy grew by 4.2% annualised in the second quarter, the strongest rate in four years. US data have remained strong in Q3. Meanwhile, the jobless rate has fallen below 4%. Widening interest rate differentials in favour of the dollar have also helped the currency as the Fed continues to steadily tighten monetary policy.

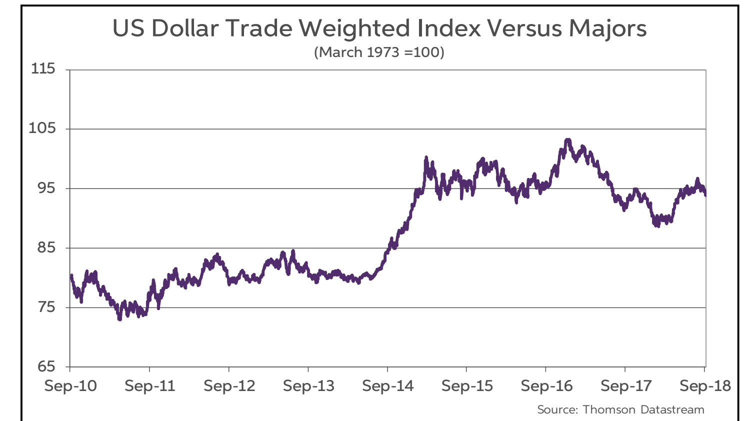
Rising risk aversion in markets has been supportive of the highly liquid US currency too this year. Escalating tensions over global trade, difficulties in emerging markets and geopolitical concerns have all sparked flights-to-quality in to safe-haven currencies like the dollar, yen and Swiss franc. The dollar has also have benefitted from a big jump in the repatriation of funds by US companies this year to take advantage of cuts in US corporate taxes. All these factors have seen an unwinding of the extreme short positions built up against the dollar in late 2017 and early 2018, propelling the currency higher this year.

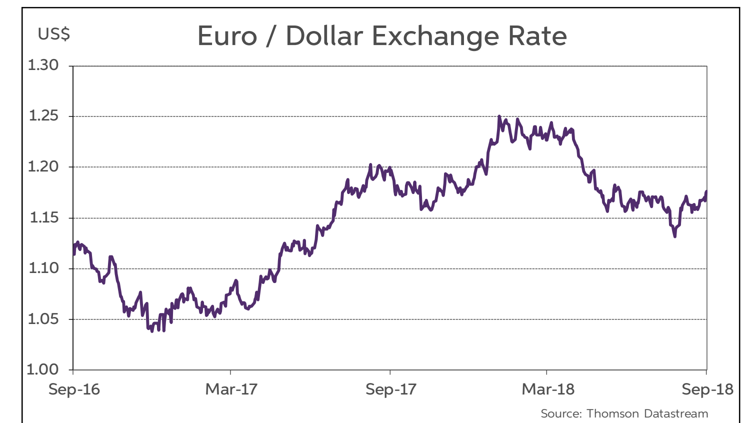
However, the US currency has found it difficult to make further gains recently and the dollar rally appears to have run out of steam. This may be partly due to the fact that FX positioning has turned very long the dollar. Furthermore, the dollar is now at quite elevated levels against a range of currencies, which may be limiting further upside potential. While still some way below the levels reached in 2015-16, the dollar is close to 20% higher on a trade-weighted basis than during most of the period 2006-2014. Even if the dollar continues to rise against emerging market currencies, further gains versus other major currencies may be difficult to achieve.

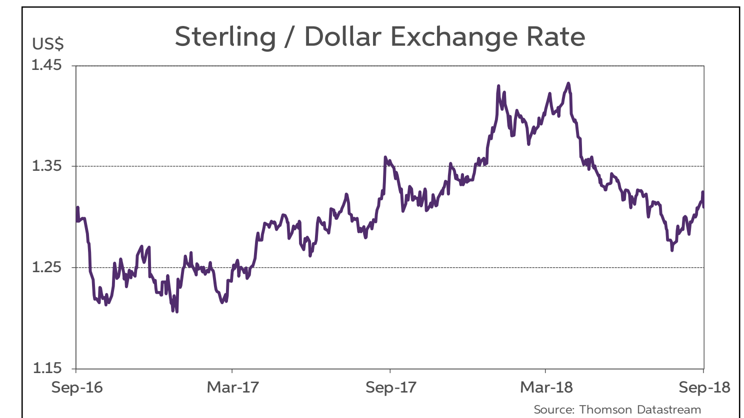
We remain of the view that the US dollar will weaken over the medium to long term. Three factors drive this assessment. Firstly, we are very concerned about the policy mix in the US. The expansionary fiscal policy will lead to a sharp jump in the US budget deficit and thus a big rise in the supply of Treasury bonds. It is also likely to put upward pressure on the US balance of payments deficit. These factors point to a lower dollar over time. Secondly, we are also concerned that the US economy could slow sharply once the fiscal stimulus fades, and as higher US rates start to impact on activity, again undermining the currency. Finally, the marked rise in the repatriation of funds this year following the cuts in US corporate taxes is likely to abate over the medium term.

In the short term, though, the relative strength of the US economy, widening interest rate differentials, tensions over global trade, continuing stress in some large emerging markets and geopolitical uncertainties are all supportive of the US currency. However, we don't expect the EUR/USD rate to return to its recent low of $1.13. Instead, it is most likely to trade in a $1.15-1.21 range over the balance of 2018.

We see potential for the euro to move back above the $1.20 level next year. Further out, a weakening dollar trend would not surprise over the medium term as the imbalances in the US economy come more clearly into focus, the pace of US activity slows as the impact of the fiscal stimulus fades, while, on the other hand, the ECB starts to tighten policy in a solid Eurozone economy underpinned by good financial fundamentals.







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Forex Market Outlook

Sterling volatile on continuing uncertainty over Brexit

Sterling fell sharply in the aftermath of the UK referendum vote for Brexit in mid-2016. The currency hit 30-year lows against the dollar, falling from $1.50 before the vote to as low as $1.20 in late 2016. The Brexit vote also saw sterling lose significant ground against the euro, with EUR/GBP rising sharply from the 70p level near the end of 2015 to a high point at around 93p in August 2017.

Sterling managed to move off its lows and regain some ground in the latter stages of 2017 and early part of 2018. The currency was helped by policy tightening by the Bank of England, as well as the progress made in the early part of the Brexit negotiations. Against a weaker dollar, it rose above the $1.40 level in Q1 2018 and in mid-April reached a new post referendum high of $1.437. Meanwhile, the EUR/GBP rate moved down from the 93p level to briefly dip below the 87p level in mid-April, trading as low as 86.2p.

However, sterling fell back again over the summer. A lack of progress in the Brexit talks, with growing fears that deep political divisions in the UK could see it leave the EU without any deal, weighed on the pound. It dropped sharply against a strengthening dollar to below $1.27. Meanwhile, the euro moved back up to the 91p level. Some fresh signs of progress in the Brexit negotiations, though, as well as better UK economic data, saw sterling regain some ground recently. It rose above $1.32 against the dollar, while the euro dropped back below 89p.

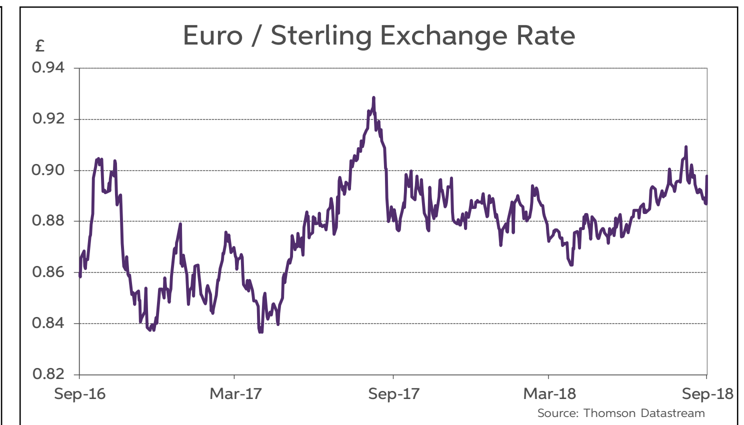
The course of the Brexit negotiations will be the key factor impacting sterling over the remainder of this year and in early 2019. Signs of a fresh impasse in the talks have seen sterling fall back again in recent days. The talks are now moving in to their critical final stages. There are a couple of big hurdles to be overcome to secure an exit deal, with both sides hoping that an agreement can

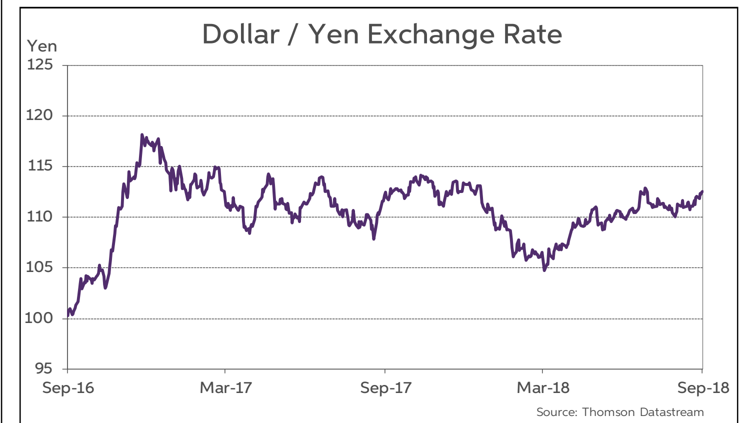
be finalised by mid-November. A key part of any deal will be a post-Brexit transition period to last from the exit date in March to end 2020, during which time the status quo on trade would be largely maintained.

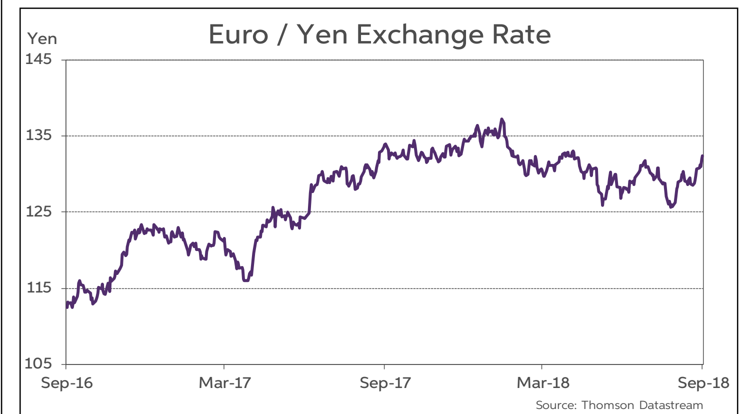
Any agreement will also need to be ratified by the UK Parliament, where it will face significant opposition. Indeed, even if the UK leaves the EU with a deal, it may not be clear what the final shape of Brexit will be. The difficult decisions in terms of future customs and trade arrangements in particular, could be left to the detailed negotiations on a new EU-UK trade deal that are to be conducted during the transition period.

Given that there may be difficulties in getting an exit deal through the UK Parliament, while uncertainty in regard to the precise nature of Brexit could extend into the transition period, the upside for sterling may be limited even if a deal is agreed. EUR/GBP may be confined to an 86-89p trading range in such circumstances. Of course, if markets start to fear that a no-deal hard Brexit could be on the cards, then the euro is likely to move higher to around the 93p level it hit last summer. It could even reach the 95p level that was last seen during the financial crisis back in 2009. Sterling may even fall to parity in the event that the UK crashes out of the EU without any deal in an very disorderly Brexit next March that causes severe problems for the British economy.

Overall, we believe that an exit agreement will be reached that gets through the UK parliament. Thus, we see a soft Brexit as the most likely outcome of the negotiations. Our base case is for sterling to strengthen modestly, but not make substantial gains as uncertainty about the real nature of Brexit persists post the UK's exit in March.







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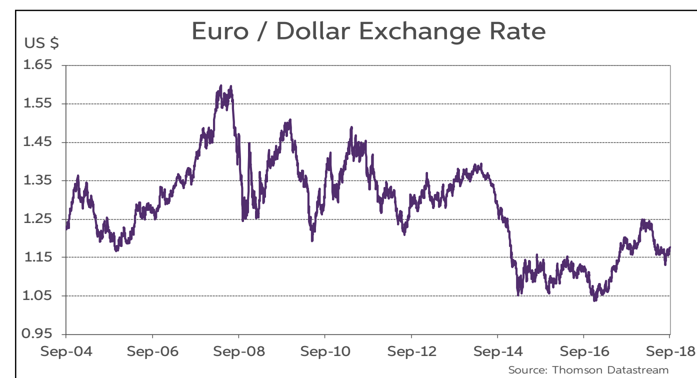
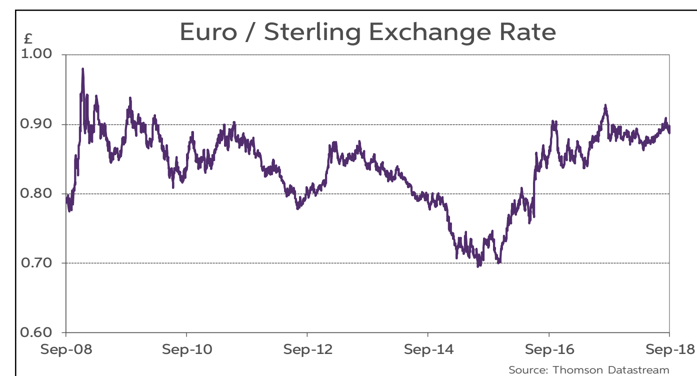
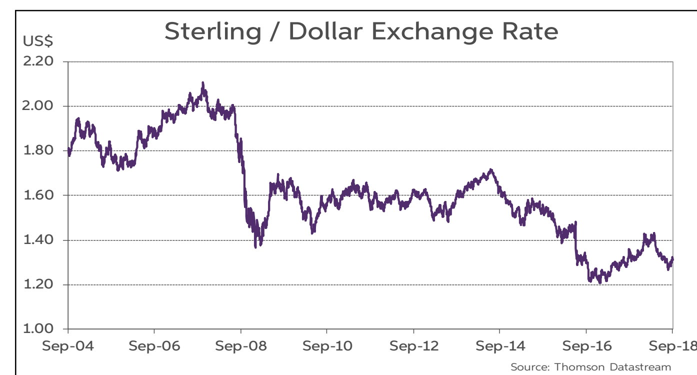
Summary of Exchange Rate Forecasts

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

	Current	Q3-2018	Q4-2018	Q1-2019	Q2-2019
Euro Versus					
USD	1.177	1.15-1.21	1.16-1.22	1.17-1.23	1.18-1.24
GBP	0.897	0.87-0.93	0.86-0.92	0.85-0.91	0.84-0.90
JPY	132.59	130-136	130-136	130-136	130-136
CHF	1.13	1.13	1.14	1.15	1.16
US Dollar Versus					
JPY	112.67	110-116	109-115	108-114	107-113
GBP	1.313	1.28-1.34	1.31-1.37	1.33-1.39	1.36-1.42
CAD	1.29	1.29	1.28	1.27	1.25
AUD	0.73	0.73	0.74	0.75	0.76
NZD	0.67	0.67	0.68	0.69	0.70
CNY	6.86	6.85	6.85	6.80	6.70
Sterling Versus					
JPY	148	148	150	151	153
CAD	1.70	1.69	1.71	1.73	1.74
AUD	1.81	1.79	1.81	1.81	1.83
NZD	1.97	1.96	1.97	1.97	1.99







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