

Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit



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- Russia's invasion of Ukraine is pushing inflation to very high levels and will act as a significant drag on global growth, combined with other headwinds such as rising interest rates
- CPI rates rise to 40 year highs. Inflation to stay elevated well into 2023 amid ongoing supply shortages in many key commodity markets
- Significant rate hikes on the cards in 2022 and 2023 in most economies as central banks respond to deteriorating inflation outlook. Markets see UK & US rates rising to 2.4% and 3%, respectively
- ECB expected to raise rates by more than 50bps in H2 2022 and a further 100bps in 2023, which would bring the key deposit rate to above 1% by the end of next year
- Major currency pairs quite range bound, bar the much weaker yen as BoJ is set to keep rates on hold. Firm tone to dollar on tough talk from Fed about need for significant rate hikes in US

Oliver Mangan
Chief Economist

John Fahey
Senior Economist

Daniel Noonan
Economist

<https://aib.ie/investorrelations/economic-research-unit>

Russia's war in Ukraine to see sizeable hit to global growth and much higher inflation

The OECD in its recent update on the global economy refrained from publishing new forecasts. It observed that the magnitude of the economic impact of the conflict is highly uncertain, and will depend in part on the duration of the war and the policy responses. The OECD noted, though, that the war will result in a substantial near-term drag on global growth and significantly stronger inflationary pressures.

The OECD analysis shows that if the moves in commodity prices and financial markets seen since the outbreak of the war proved sustained, it could reduce global growth by over 1 percentage point in the first year and push up global inflation by 2.5 percentage points. The impact on growth, though, could be tempered somewhat by a greater than expected rundown of elevated private sector savings or a loosening of fiscal policy.

Ahead of the conflict, budgetary policy was set to be tightened this year and next in most advanced economies. That is now changing. There will be increased government spending on supporting refugees in Europe and to offset some of the effects of higher energy costs on households. Increased spending is also likely on military defence and alternative energy sources. The OECD believes that a targeted rise in government spending of 0.5% of GDP globally could offset around one-half of the estimated decline in output from the conflict.

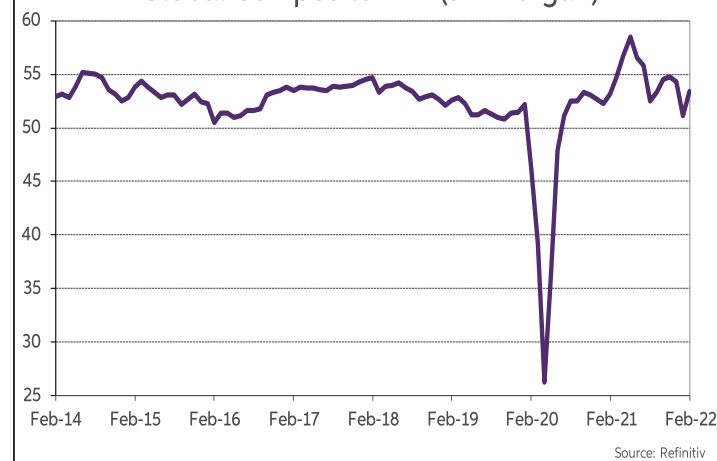
However, the impact of the war is not uniform across the world economy. Many commodity-producing economies will see higher output and earnings, with bigger output declines in major commodity-importing countries. Russia and Ukraine are entering very deep recessions. Within advanced economies, the EU will be harder hit given its closer business and energy linkages with Russia prior to the war. The OECD estimates that even with a fiscal response, Eurozone GDP will still take a hit of about 1 percentage point in the first year, nearly three times the impact on the US economy.

There are other headwinds to global growth, apart from the rapid rise in inflation which is eroding real spending power. Uncertainty is very elevated at present which will impact investment. Meanwhile, the much more transmissible Omicron variant of COVID has seen infections continue to run at very high levels, resulting in the re-imposition of restrictions on activity in some economies and high numbers of absentee workers in other countries. This is adding to supply chain disruptions and delays.

Shortages of raw materials, key inputs and workers, as well as capacity constraints in transportation continue to negatively impact supplier delivery times and hold back output in some industries. A further risk to growth is a possible ban or disruptions of energy exports from Russia to the EU, which could result in gas shortages in particular. Meanwhile, global interest rates have risen sharply this year, with central banks ending QE programmes and starting to hike official rates. Thus, even though activity gained momentum in the opening months of 2022, global growth is set to slow appreciably over the remainder of the year.

Inflation rose sharply last year from the combination of supply constraints alongside the release of pent-up demand and a strong rebound in commodity prices, especially in the energy sector. The war in Ukraine is causing inflation to surge even more this year. Food price inflation is also starting to pick up. The HICP rate rose to 7.5% in the Eurozone in March from 5.9% in February. CPI rates will soon top 8% in many countries. The big risk now is that this spills over into higher wage inflation which would make it more difficult to get CPI rates back down to their 2% target within the next couple of years.

Global Composite PMI (JP Morgan)



GDP (Vol % Change)

	2020	2021 (e)	2022 (f)	2022 (f)
World	-3.1	5.9	4.4	3.8
Advanced Economies	-4.5	5.0	3.9	2.6
US	-3.4	5.6	4.0	2.6
Eurozone	-6.4	5.2	3.9	2.5
UK	-9.4	7.2	4.7	2.3
Japan	-4.5	1.6	3.3	1.8
Emerging Economies	-2.0	6.5	4.8	4.7
China	2.3	8.1	4.8	5.2
India	-7.3	9.0	9.0	7.1
World Trade Growth (%)	-8.2	9.3	6.0	4.9
Inflation -PCE Deflator				
Advanced Economies (%)	0.7	3.1	3.9	2.1

Source: IMF World Economic Outlook, January 2022

Interest Rate Outlook

Markets price significant rate hikes nearly everywhere in 2022-2023

Monetary conditions have been exceptionally loose globally for the past two years as central banks pulled out all the stops to try and ameliorate the most severe economic impacts of the Covid-19 pandemic. Economies, though, rebounded at a much quicker than anticipated pace over the past year, inflation has picked up by far more than expected, while labour markets are also tightening rapidly. Thus, central banks began to scale back on their policy accommodation last autumn, ending or running down QE programmes, as well as starting to raise rates.

The war in Ukraine has complicated the policy path for central banks. Growth is now going to be weaker than expected in 2022-23, but inflation will be much higher. Indeed, CPI rates could get close to double-digit levels in some economies given the very sharp increases in energy and other commodity prices this year. The meetings of key central banks in March made clear that they intend to tighten policy in the coming year or two to ensure that the sharp rise in inflation does not become embedded in economies, endangering price stability.

The US Federal Reserve has been the most vocal of the central banks in delivering a clear message that a significant tightening of policy is on the cards over the next couple of years. It increased rates by 25bps in March to 0.375%. It signalled that it was likely to hike rates at all of its six remaining policy meetings this year, which would take the funds rate up to 1.875% by year end. Further hikes are seen by the Fed in 2023 that would bring rates to 2.875%. The Fed argues the economy is strong while inflation is elevated. It therefore expects the economy to be able to withstand such monetary tightening. The Fed has noted that rates will most likely have to go higher than in the last tightening cycle when they reached 2.375%. Since the March FOMC meeting, some Fed officials have suggested that it could raise rates in 50bps steps in the near term. It is also set to begin asset sales or quantitative tightening later in 2022 to reduce the size of its balance sheet. Markets rate expectations have hardened considerably this year and they now see the Fed funds rate being hiked to 3% by September 2023.

The Bank of England wrapped up its QE bond purchase programme in December. It hiked the Bank rate on three occasions since then, taking it from 0.1% up to 0.75%. Further rate increases are expected in 2022. Markets are now pricing in that UK rates could be raised to 2% by year end and 2.4% in summer 2023. The BoE, though, seems a lot less sure on this. In an important tweak to its guidance, the MPC said at its March meeting that “some further modest tightening in monetary policy may be appropriate in the coming months”; previously, “is likely to be” was used instead of “may be”. Furthermore, while four of its nine Monetary Policy Committee members voted for a 50bps hike at its meeting in February, there were no such votes at the March meeting. Indeed, one member voted to keep rates unchanged. Growth in the UK economy is expected to slow sharply this year and next, as a result of fiscal and monetary tightening and higher energy costs. The markets may be pricing in too much in terms of rate hikes given the risks to economic activity and the cautious guidance from the BoE.

The ECB has been engaged in lowering the pace of its asset purchases since last autumn and in March announced it would bring forward the end date for the programme to Q3 2022. Meantime, it is no longer ruling out that rates may have to be raised this year. Markets believe that the ECB will begin raising rates in H2 2022 and are currently pricing in close to 60bps in hikes by end year. They see a further 100bps of rate increases in 2023. This would take the deposit rate from -0.5% to 1.10%, marking the end of the negative interest rate regime that has been in place since 2014. The ECB has indicated that any rate increases will be gradual and with the Eurozone economy quite exposed to Russia, rate hikes on the scale markets expect may not materialise in 2022-23.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.375	0.97	2.20	2.63	2.60
June'22	1.125	1.50	2.30	2.70	2.65
Sept'22	1.625	1.90	2.35	2.60	2.55
Dec'22	1.875	2.10	2.40	2.50	2.45

** 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	-0.46	-0.08	0.54	0.96
June'22	-0.50	-0.40	-0.05	0.55	0.95
Sept'22	-0.50	-0.30	0.05	0.50	0.85
Dec'22	-0.25	-0.10	0.25	0.50	0.75

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.75	1.05	1.87	2.25	2.12
June'22	1.25	1.40	1.80	2.10	2.10
Sept'22	1.50	1.60	1.70	1.95	1.95
Dec'22	1.50	1.50	1.60	1.80	1.80

** Swap Forecasts Beyond 1 Year*

Firm tone to dollar as Fed signals significant rate tightening in store

The dollar moved steadily lower in 2020, losing 12% against the other major currencies, as US rates were cut from over 2% to virtually zero. However, it recovered ground last year, helped by a firming of US interest rates along the curve, amid growing expectations of significant Fed rate hikes in 2022-23, on the back of big upgrades to US GDP and inflation forecasts. In particular, the dollar held a stronger tone from mid-2021 until near to the end of the year against a broad range of currencies, rising by 5% in trade-weighted terms over this period.

The euro was a notable casualty of the dollar strength, falling from \$1.22 last June to \$1.12 in late November, with the key support level of \$1.16-1.17 giving way during the autumn. The dollar rally ran out of steam over the winter months. However, the Russian invasion of Ukraine triggered a further bout of dollar strength this spring, both in terms of a flight-to-quality and with the Fed the most vocal of the main central banks on the need for significant rate tightening to counteract the further surge in inflation arising from the conflict.

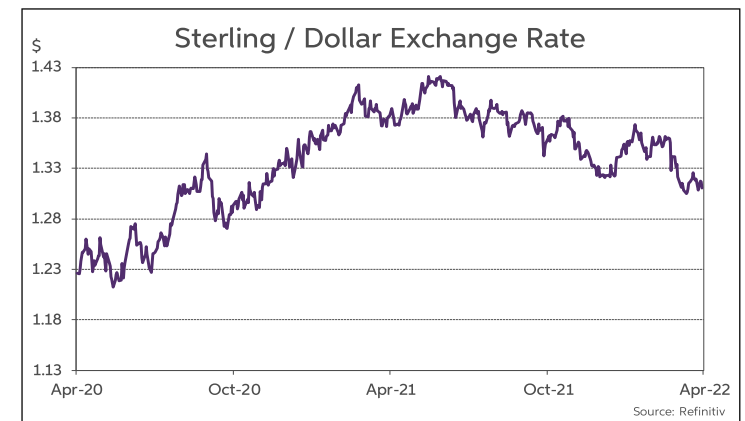
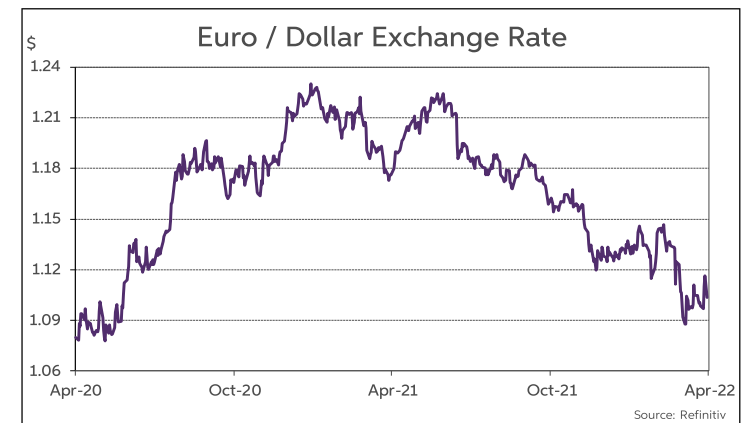
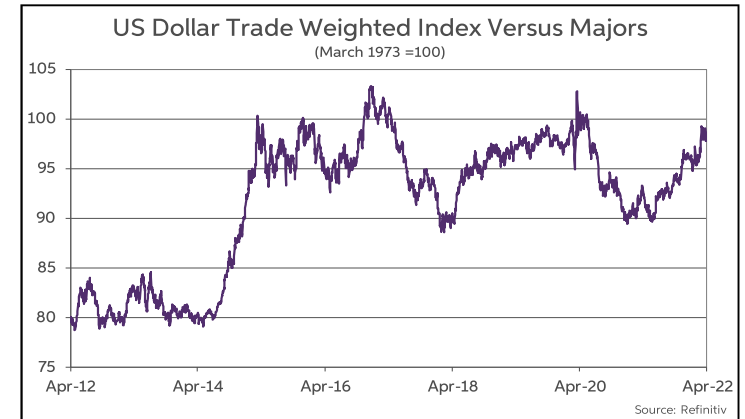
Not surprisingly, given the Eurozone's closer trade and financial ties with Russia and in particular its reliance on imports of gas from there, the euro came under pressure following the invasion of Ukraine and the imposition of sanctions on Russia. Support at the \$1.10 level against the dollar was easily breached. However, the key support at \$1.08 held, as it had done during the early stages of the COVID-19 crises in the first half of 2020. The euro has regained some ground recently on a firming of expectations that the ECB would start hiking rates from the autumn. The EUR-USD pair has traded in a \$1.095-\$1.115 range over the past couple of weeks.

We do not envisage any significant fall in the dollar this year as it should be supported by a steady move upwards in US interest rates. The Fed commenced rate hikes in March, and indicated that 25bps rate increases were likely at every FOMC meeting for the remainder of the year. More recently, some Fed officials have indicated that they may seek 50bps rate moves in the very near term. Markets are pricing that US rates will rise to 3% by the autumn of 2023.

From a euro viewpoint, the fact that the ECB is no longer ruling out rate increases in 2022 has proved supportive of the currency. However, any ECB rate increases in 2022 will be relatively modest compared to the Fed and BoE. Thus, while the euro may make some gains later in the year as the ECB begins to hike rates, it may find it hard to rise above \$1.13 level, with US rates set to be on a clear upward path through the summer.

Meanwhile, the Ukraine crisis could continue to pose a risk for the euro, especially if there is a prolonged interruption to gas supplies from Russia. This could lead to gas rationing and power cuts in the Eurozone, with the accompanying risk of a recession as output declines. However, as we have seen recently, the \$1.08 level offers very strong support for the euro. Overall then, EUR/USD may trade in a narrow \$1.08-\$1.13 corridor in the coming months, unless there is a major interruption to gas supplies that results in rationing in the Eurozone.

Longer term, one possible source of downside risk for the dollar could be if the US economy slows to a far greater extent than expected, bringing an end to Fed rate hikes later in the year, especially if official Eurozone rate are starting to move higher at the same time. Another possible headwind for the dollar would be if the twin US deficits - fiscal and balance of payments - come to the fore again as a factor impacting investors appetite for the currency.



Sterling loses some ground recently on concerns about the outlook for UK economy

Sterling gained good ground in 2021, most notably versus the euro and yen, as the EU-UK Brexit trade deal lifted a cloud of uncertainty around the currency. The rapid rollout of COVID vaccines in the UK was also very supportive of the currency as it allowed the economy to rebound strongly. This saw markets moving from, at the start of last year pricing in negative interest rates, to expecting that UK rates could rise sharply to counter inflation.

The BoE started to turn quite hawkish on monetary policy from October onwards, providing a further boost to the currency. There was a 15bps rate hike in December, followed by two 25bps increases in February and March, bringing the Bank rate to 0.75%. Markets are pricing in that UK rates could rise by a further 125bps this year. This would take the Bank rate up to 2%, with UK rates seen reaching 2.4% in Q3 2023. Despite the rate increases and hardening of rate hike expectations, sterling has lost ground over the past number of weeks. Cable has fallen from \$1.36 in mid-February to around \$1.31 recently. Meanwhile, the euro has risen from below 83p to around the 84-85p level. This weakness seems to be largely due to concerns around the economic outlook.

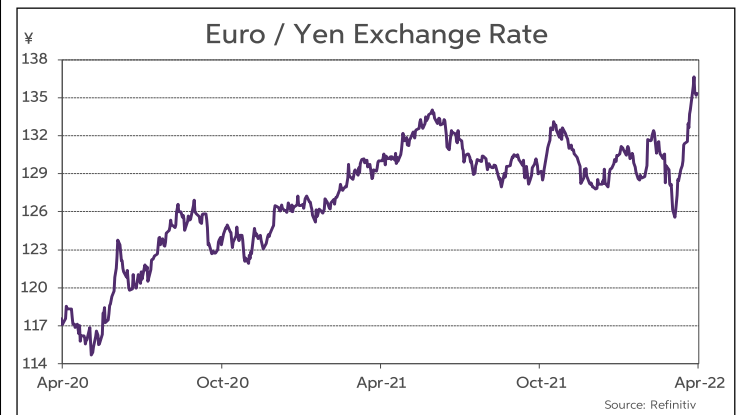
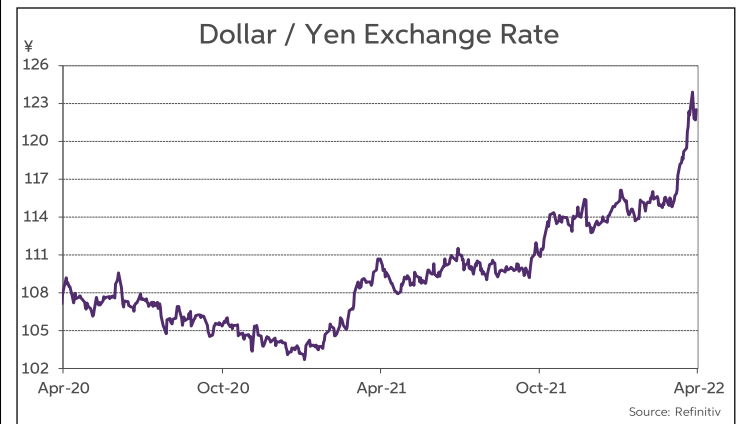
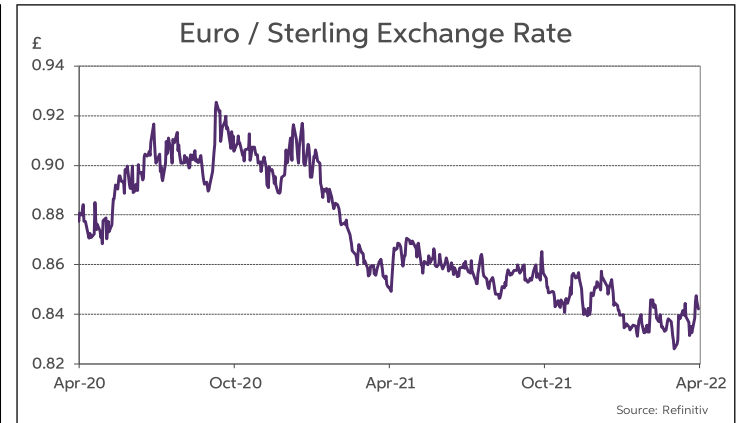
While the UK is expected to record a good rise in GDP in 2022, this is partly due to carryover effects. The economy is likely to lose momentum as the year progresses in the face of a tightening of fiscal and monetary policy as well as galloping inflation. The Bank of England is quite downbeat on the UK economy's growth prospects as a result of a squeeze on real disposable income from higher taxes and elevated inflation. Brexit has also acted to depress trade with the EU. The BoE sees UK growth moving well below trend in 2023 and 2024, with unemployment rising.

Thus, the BoE has recently turned more cautious on policy tightening, with the MPC saying at its March meeting that "some further modest tightening in monetary policy may be appropriate in the coming months"; previously, "is likely to be" was used instead of "may be". Indeed, markets have started to build in rate cuts in the UK post 2023. However, there must be considerable doubt about whether rates will get anywhere near the 2.4% level priced in for next year, with economic activity set to slow sharply. Thus, the period of sterling strength could be coming to an end, although some further rate hikes should help underpin the currency in the near term.

Yen falls sharply in past month on widening interest rate differentials

The yen lost considerable ground against the appreciating US currency in 2021. The dollar climbed from ¥103 at the start of last year to ¥115 by November. Over the winter, though the dollar-yen rate stabilised and was largely confined to a narrow ¥113-116 range. Meantime, the euro-yen rate moved in a relatively narrow range around the ¥130 level from the start of 2021 to early 2022. This indicates that the movements in the dollar-yen rate during 2021 were mainly driven by the US currency side of the pair.

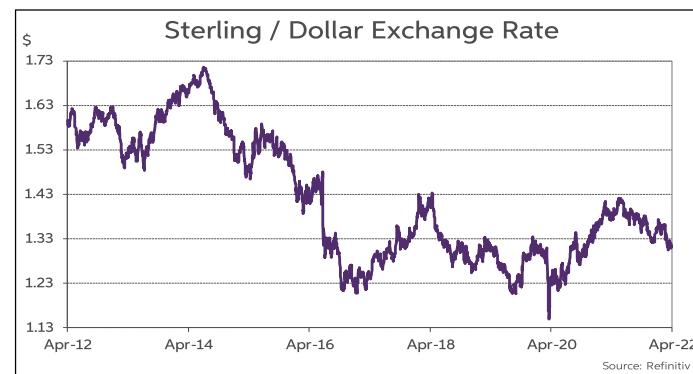
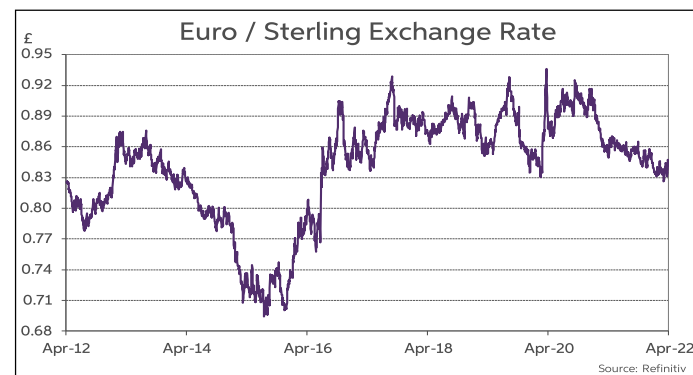
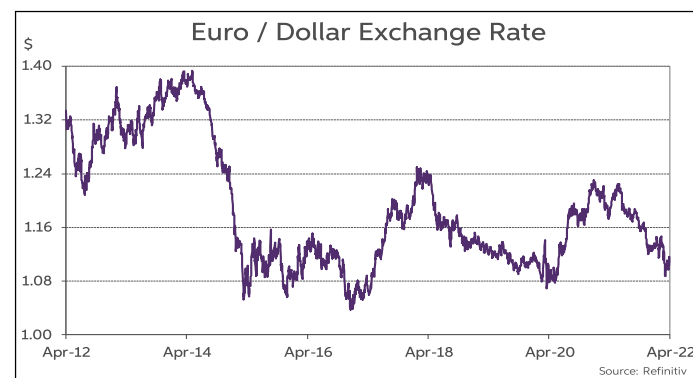
The Japanese currency, though, has weakened a lot in the past month, with the dollar climbing from ¥115 to ¥123 and the euro rising from ¥127 to ¥134. Rate hikes and sharp rises in bond yields elsewhere have put severe downward pressure on the yen, with outflows in to much higher yielding currencies. The yen has fallen close to twenty year lows against the dollar. The US currency has not been above the ¥125 level since 2002. Thus, this level should offer strong technical support to the yen, which could trade in a ¥120- 125 range over the balance of the year.



Summary of Exchange Rate Forecasts

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

	Current	Q2-2022	Q3-2022	Q4-2022	Q1-2023
Euro Versus					
USD	1.099	1.07-1.13	1.08-1.14	1.09-1.15	1.10-1.16
GBP	0.839	0.81-0.87	0.81-0.87	0.82-0.88	0.83-0.89
JPY	134.90	132-138	134-140	134-140	133-139
CHF	1.02	1.02	1.03	1.04	1.06
US Dollar Versus					
JPY	122.70	120-126	120-126	119-125	117-123
GBP	1.311	1.28-1.34	1.29-1.35	1.29-1.35	1.28-1.34
CAD	1.25	1.25	1.24	1.23	1.23
AUD	0.75	0.75	0.76	0.77	0.77
NZD	0.69	0.69	0.69	0.70	0.70
CNY	6.36	6.35	6.35	6.30	6.30
Sterling Versus					
JPY	161	161	162	161	157
CAD	1.64	1.64	1.64	1.62	1.62
AUD	1.74	1.75	1.74	1.71	1.70
NZD	1.89	1.90	1.91	1.89	1.87



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