Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- World economy performing reasonably well, but downside risks are growing as trade tensions escalate and some sizeable emerging economies experience serious financial difficulties
- Fed to remain on steady rate tightening path, while BoE now on hold after recent hike. ECB to halt QE at end 2018, but rates will stay very low for a long time afterwards
- Dollar makes further gains over summer, aided by rising risk aversion, good US data and on-going Fed tightening. Growing US imbalances point to risks for currency over medium term
- Euro loses more ground versus dollar, but further downside may be limited from here
- Sterling out of favour as the risk of a no-deal Brexit rises. Upside potential looks limited for now

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Global Economic Outlook

Growth picks up again in Q2, but downside risks are mounting for world economy

Updated forecasts in the past couple of months from both the OECD and IMF show that they still expect the world economy to grow by close to 4% in 2018 and 2019, despite some weakening in data earlier in the year and growing risks to the economic outlook. They point out that the combination of continuing very loose monetary policies, a more supportive stance to fiscal policy and some recovery in commodity prices are all supportive of economic prospects. Activity is also being aided by improving labour market conditions.

Most of the major economies registered an improved growth performance in the second quarter after a slowdown in activity in the opening months of the year. The US economy grew by 1%, its strongest quarterly performance since 2014. GDP expanded by 0.5% 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%. Labour markets tightened further, with employment continuing to grow and unemployment remaining in decline.

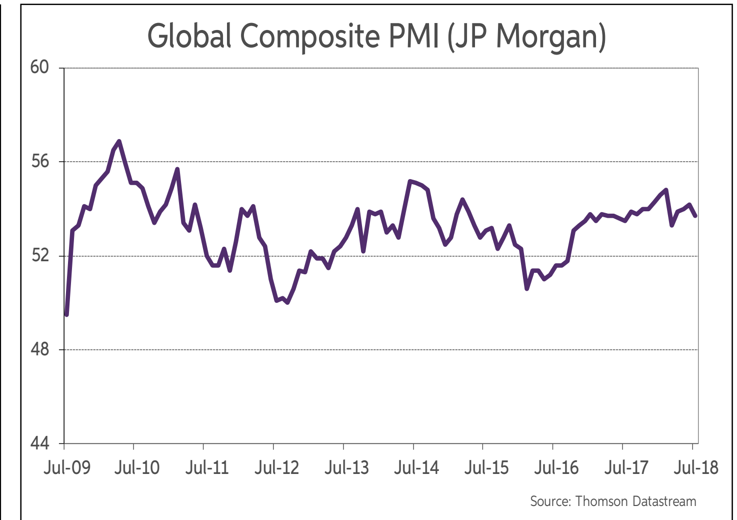
Nonetheless, downside risks are building for the global economy. The IMF notes in its latest economic update that the rate of expansion appears to have peaked in some major economies and is also becoming less even. In particular, activity has slowed sharply this year in some big emerging economies, including 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 also believes that the balance of risks has shifted further to the downside for the world economy. These include escalating trade tensions. A move towards protectionist trade policies, with a number of countries applying tariffs on some imports, has already begun to adversely impact 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. There would also be indirect effects on activity from the damage to business confidence as well as likely falls in stock markets.

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 risks for the world economy, especially some larger emerging economies.

There are growing pressures on 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. Tighter financial conditions as QE is wound down and interest rates start to rise, as well as renewed dollar strength are creating difficulties for some of the weaker emerging economies. More generally, financial markets are becoming more risk adverse and 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 relatively good performance over the past two years or so.



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 stays on tightening path, while other central banks stick to loose policy

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 last November 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. The market is pricing in the next rate hike for autumn 2019, with one further rate hike anticipated by the end of 2020. This would bring the bank rate up to a still very low 1.25%.

The ECB scaled back bond purchases under its QE programme at the start of 2018. It is set to reduce them even further in the fourth quarter 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 low for a long time.

Futures contracts show wholesale rates only starting to rise from the autumn of 2019 onwards. The ECB deposit rate is currently at -0.4%, resulting in negative interbank rates. Futures contracts see wholesale rates remaining negative until mid-2020. Overall, three month money rates are seen as rising by just 50bps between now and end 2020, and are not expected to get to 1% until late 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 3.4% by end 2020. The futures market is close to pricing in two further rate hikes over the balance of the year, with the next increase expected in September.

Beyond 2018, the markets expect only very limited Fed tightening and see official rates peaking at 2.65% by end 2019, well below the Fed projection of 3.4% by end 2020. We expect that continuing strong growth by the US economy over the next year, combined with some pick-up in inflationary pressures, will force the market to re-evaluate its view on rates and price in further policy tightening. We anticipate that the Fed funds rate will rise to at least 3% by 2020.

Bond markets have been very volatile this year. Yields have come under upward pressure at times, but bouts of risk aversion have also seen rallies in all the main bond markets. Renewed upward pressure on US yields is likely to re-emerge if markets have to revise upwards their expectations for US rates in 2019 and 2020.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.875	2.31	2.81	2.78	2.84
Sep '18	2.125	2.50	2.95	2.95	3.00
Dec '18	2.375	2.70	3.10	3.10	3.15
Mar '19	2.375	2.75	3.20	3.20	3.25

** 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	-0.36	-0.23	-0.16	0.26
Sep '18	-0.40	-0.34	-0.21	-0.15	0.30
Dec '18	-0.40	-0.32	-0.18	-0.10	0.35
Mar '19	-0.40	-0.30	-0.15	-0.05	0.45

** 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	1.04	1.08	1.30
Sep '18	0.75	0.80	1.05	1.08	1.30
Dec '18	0.75	0.80	1.10	1.15	1.40
Mar '19	0.75	0.85	1.15	1.25	1.50

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

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Forex Market Outlook

Dollar rise continues, but rally looking stretched

The US dollar had a weak start to the year, with the EUR/USD rate rising above $1.20 and then reaching $1.25. However, the greenback has recovered strongly since the early spring, gaining ground against a broad range of currencies. It has risen by some 9% on a trade-weighted basis from earlier in the year, while the EUR/USD rate has fallen back, breaching significant support at the $1.1550 level this month before hitting a low of $1.13.

The dollar has been aided by strong US economic data, with many releases surprising to the upside this year. The US economy grew by 4.1% annualised in the second quarter, the strongest rate in four years. 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.

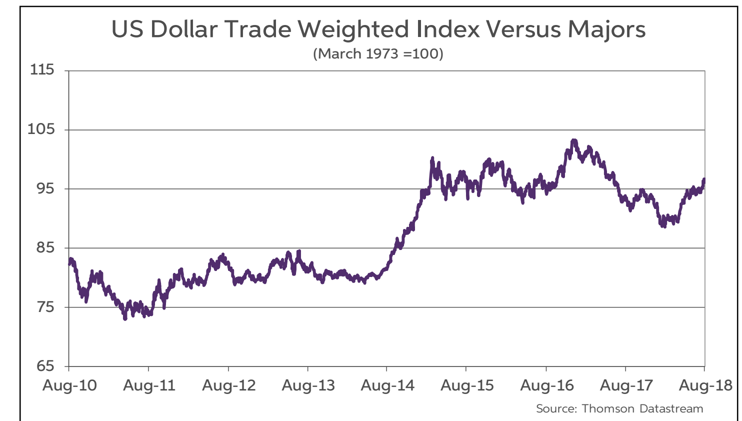
Rising risk aversion in markets has been supportive of the highly liquid US currency too. Escalating tensions over trade, difficulties in emerging markets and geopolitical concerns have all sparked a flight-to-quality in to safe-haven currencies like the dollar, yen and Swiss franc. The dollar may also be benefitting from a repatriation of funds by US companies 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.

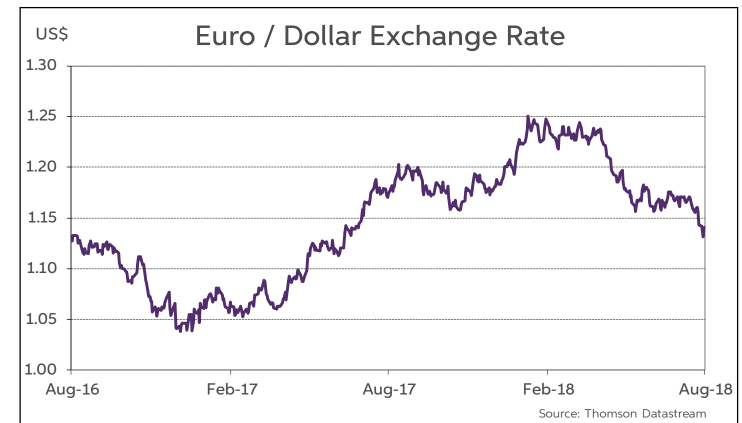
The dollar seems likely to remain firm in the near-term. The relative strength of the US economy, widening interest rate differentials, escalating tensions over global trade, continuing stresses in some large emerging markets and geopolitical uncertainties are all supportive of the US currency.

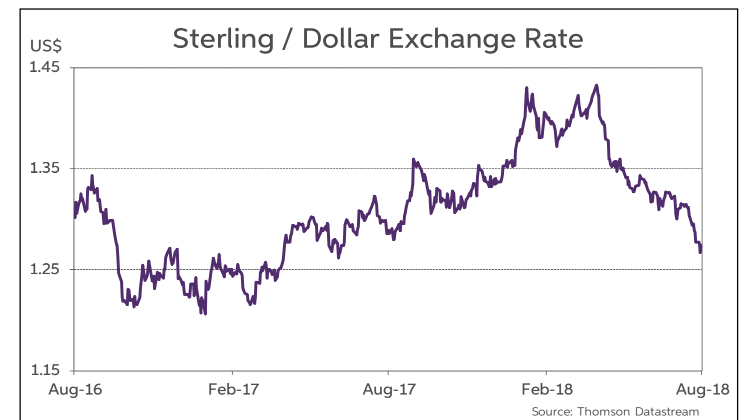
However, further significant gains may prove difficult for the US currency given that FX positioning has turned very long the dollar. Furthermore, the dollar is now at quite elevated levels against a range of currencies, which may limit its upside potential from here. While still some way below the levels reached in 2015-16, the dollar is now around 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 significant gains versus the euro may be difficult.

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 will also 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 increased repatriation of funds following the cuts in US corporate taxes is likely to abate over the medium term.

In the short term, though, we expect the US dollar to remain firm. Hence, the EUR/USD rate is likely to mainly trade in a $1.12-1.18 range in the coming months. There is good technical support for the euro at around the $1.12-1.13 level. We see potential for the euro to start moving back up to the $1.20 level next year. The weakening dollar trend is likely to continue over the longer 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.







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Forex Market Outlook

Sterling out of favour 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 past year. The currency was helped by rate hikes from the Bank of England, as well as the progress made in the early stages 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 has since fallen back against the US currency, dropping sharply to near the $1.27 level as the dollar gained ground against a broad range of currencies over the past few months. Meanwhile, the euro has moved back up to the 90p level. A lack of progress in the Brexit talks since the spring, with growing fears that deep political divisions in the UK could see it leave the EU without any deal, has weighed on the British currency in recent months.

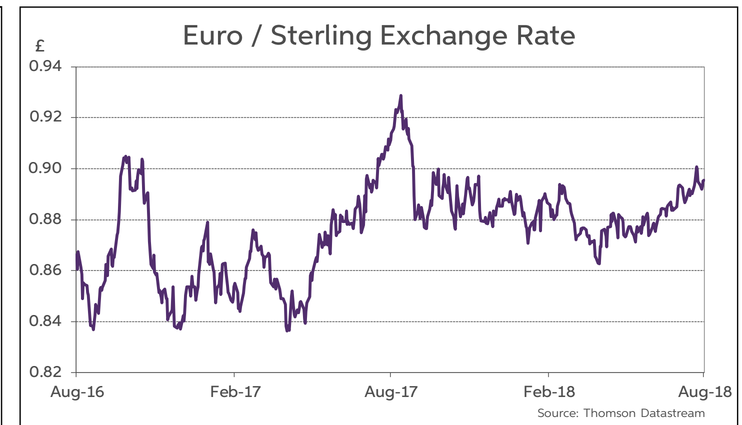
The course of the Brexit negotiations will be the key factor impacting sterling over the remainder of this year and in 2019. The talks are set to move on to their critical final stages this autumn. There are numerous hurdles to be overcome to secure a soft Brexit for the UK. An exit deal needs to be concluded between the EU and UK before the end of the year. The agreement then needs to be ratified by the UK Parliament.

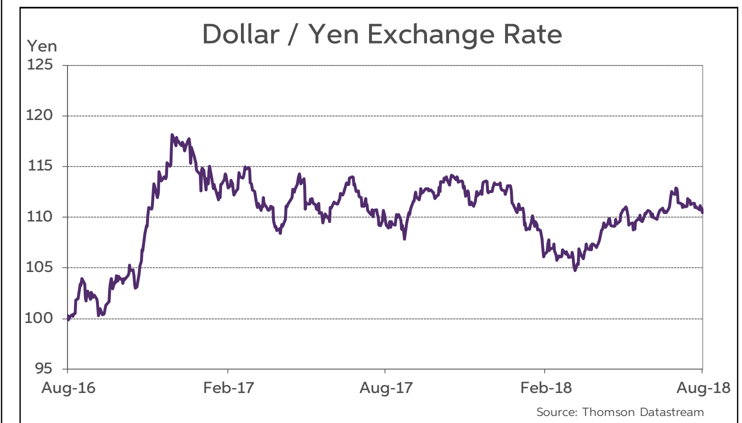
Even if the UK leaves the EU with a deal, it may not be clear what the final shape of Brexit will be. The status quo would be largely maintained during the transition period which is to last from the exit date in March to end 2020. The difficult decisions in terms of future customs and trade arrangements in particular, could be left to the detailed negotiations on reaching a new EU-UK trade deal that are to be conducted during the transition period.

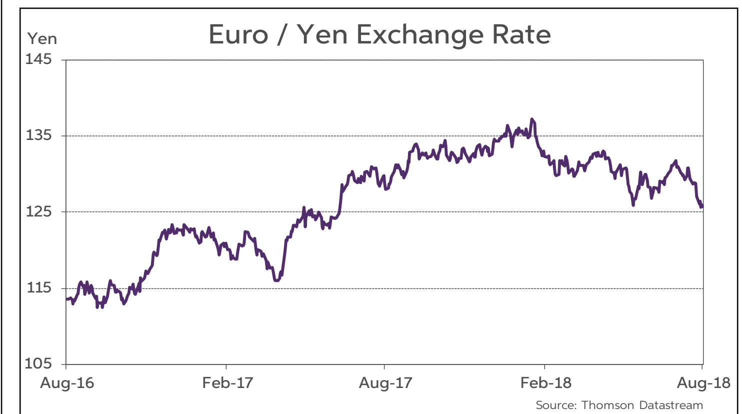
Sterling is likely to remain out of favour until markets get clear signs that an exit deal can be reached. Thus, it could trade at around 90p versus the euro over the next couple of months. Given that there may be difficulties in getting an exit deal through the UK Parliament, while uncertainty in regard 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 only return to a 87-89p trading range in such circumstances.

Of course, if the chances of a no-deal Brexit continue to rise, 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 next March.

Overall, we believe that the EU and UK will be able to conclude a withdrawal agreement that gets through the UK parliament. Thus, we see a soft Brexit as the most likely outcome of the Brexit negotiations. Our base case, then, is for sterling to strengthen modestly but not make substantial gains as uncertainty about the true nature of Brexit and its impact on the UK economy could well extend beyond when the UK leaves the EU next March.







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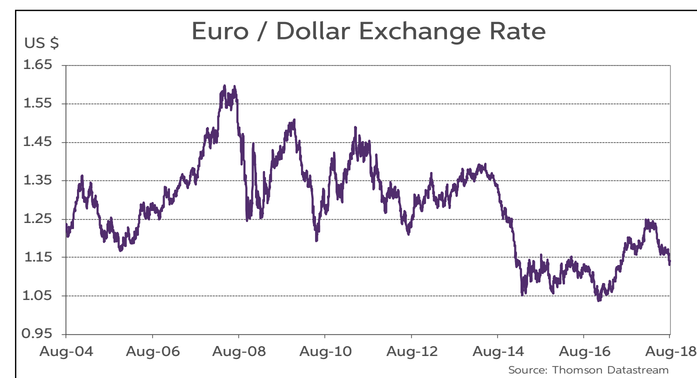
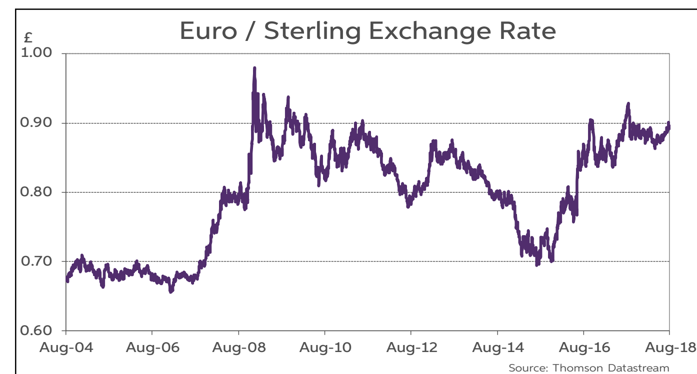
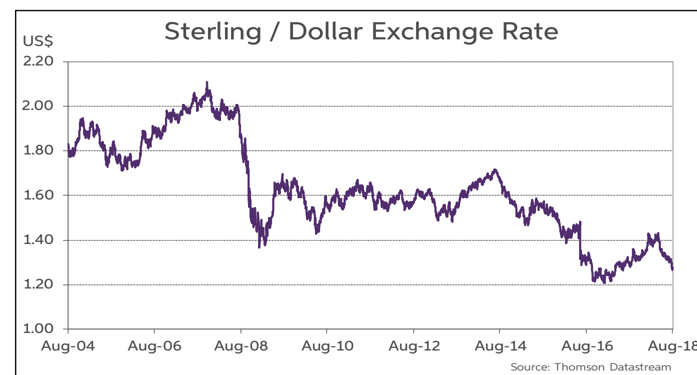
Summary of Exchange Rate Forecasts

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

Euro Versus	Current	Q3-2018	Q4-2018	Q1-2019	Q2-2019
USD	1.153	1.12-1.18	1.13-1.19	1.14-1.20	1.16-1.22
GBP	0.899	0.87-0.93	0.86-0.92	0.85-0.91	0.84-0.90
JPY	127.10	123-129	123-129	123-129	124-130
CHF	1.14	1.14	1.15	1.16	1.17
US Dollar Versus					
JPY	110.22	107-113	106-112	105-111	104-110
GBP	1.283	1.25-1.31	1.27-1.33	1.30-1.36	1.34-1.40
CAD	1.30	1.30	1.29	1.27	1.25
AUD	0.74	0.74	0.75	0.76	0.77
NZD	0.67	0.67	0.68	0.69	0.70
CNY	6.84	6.90	6.95	6.90	6.80
Sterling Versus					
JPY	141	141	142	144	147
CAD	1.67	1.66	1.68	1.69	1.71
AUD	1.74	1.73	1.73	1.75	1.78
NZD	1.92	1.91	1.91	1.93	1.96







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