Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Downside risks are growing for the world economy as trade tensions escalate and some sizeable emerging economies run into difficulties

- Fed remains on steady rate tightening path, while BoE signals further modest rise in rates likely. ECB indicates QE to stop at end 2018, but rates will remain very low for a long time afterwards

- Dollar makes gains in recent months, aided by rising risk aversion, good US data and on-going Fed policy tightening

- Euro loses ground on softer economic data, cautious ECB and political concerns

- Sterling remains very range bound against the euro as markets await clarity on shape of Brexit

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Global Economic Outlook

Downside risks growing 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. Thus, they believe that the pick-up in growth in 2017 will be sustained, despite some weakening in data in the early part of this year. 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 the economic outlook. Activity is also being aided by improving labour market conditions and the pick-up in world trade in the past couple of years.

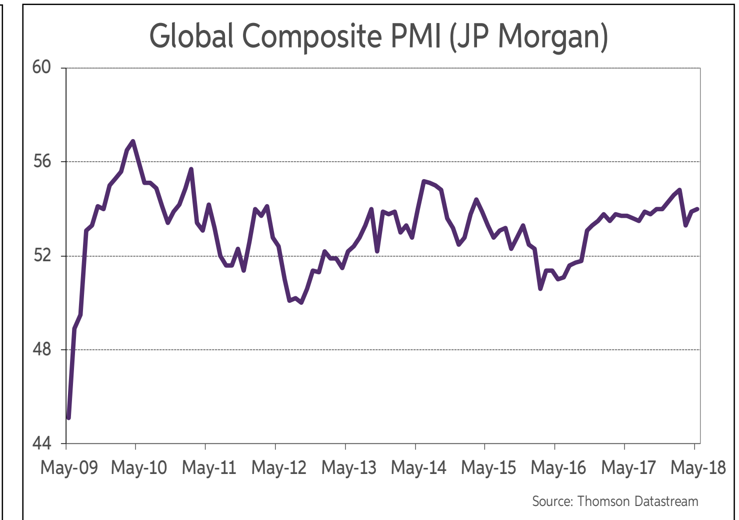
Nonetheless, downside risks are building for the global economy. Indeed, there was a marked slowdown in growth in many countries in the opening quarter of 2018, especially in Europe and Japan. Notably, the UK economy grew by just 0.2%, while GDP contracted by 0.2% in Japan. Eurozone growth also slowed appreciably. This partly reflected temporary factors, including some unusually adverse weather.

The data available for the second quarter suggest that growth has regained some momentum in a number of economies and stabilised in the Eurozone. Most survey data have also been steadier in the past couple of months. The JP Morgan Global Composite PMI rose to 53.9 in April and 54 in May, up from 53.3 in March. However, 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 OECD points out that global growth is still heavily reliant on very accommodative monetary conditions and thus, the pick-up in activity in 2017 cannot be viewed as self-sustaining. This is a concern given the growing risks for the world economy. 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 trade war between the US and China is unlikely to have a major impact on the world economy. It would hit China hardest given it exports a lot of goods to the US. By contrast, US exports to China are much smaller. A global trade war would have much more serious consequences for the world economy, especially those countries that have a heavy reliance on exports. There would also be indirect effects from the damage to business confidence, falling stock markets and possibly higher interest rates to counteract rising inflation.

Meanwhile, rising geopolitical risks have also put pressure on financial markets this year and led to higher oil prices. Financial pressures are evident in a growing number of developing countries and their currencies. The combination of a rising US dollar and tightening monetary conditions, as QE is wound down and rates start to rise, is exposing financial vulnerabilities in some emerging economies, especially those with high levels of external debt and large balance of payment deficits. More generally, financial markets are becoming more risk adverse and experiencing much greater volatility in 2018.

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 about the prospects for the global economy.



GDP (Vol % Change)

	2016	2017	2018 (f)	2019 (f)
World	3.1	3.7	3.8	3.9
Advanced Economies	1.8	2.5	2.6	2.5
US	1.5	2.3	2.9	2.8
Eurozone	1.7	2.5	2.2	2.1
UK	1.9	1.8	1.4	1.3
Japan	1.0	1.7	1.2	1.2
Emerging Economies	4.2	4.6	4.8	5.1
China	6.7	6.9	6.7	6.4
India	7.1	6.5	7.4	7.5
World Trade Growth (%)	2.6	5.0	4.7	4.5
Advanced Economies PCE Inflation (%)	1.1	2.0	2.2	2.3

Source: OECD Economic Outlook Update, May 2018

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Interest Rate Outlook

Fed stays on tightening path, while other central banks remain 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 high inflation saw the Bank of England increase rates last November for the first time since 2007, by reversing the 25bps cut made in 2016, thereby bringing the bank rate back up to 0.5%. However, a much quicker than expected decline in inflation this year, combined with weak GDP figures in Q1, have seen the BoE keep policy on hold year-to-date. Nonetheless, three MPC members voted for a rate hike at the June meeting. Furthermore, the BoE continues to indicate that a modest rise in rates is likely to be required over the next couple of years. The next rate hike could possibly come as early as August, given recent signs that the economy is regaining momentum after the marked slowdown in activity earlier in the year. A further hike in rates is expected in each of the following two years, taking the bank rate up to 1.25% by end 2020.

The ECB scaled back asset purchases under its QE programme at the start of 2018. It indicated last month that it will reduce them further in the fourth quarter and then cease net asset purchases altogether at the end of the year. However, the ECB also 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 money market 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 mid-2023. We would expect 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 these two official rates could be narrowed 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 indicated that two further rates hikes could be expected in the second half of the year, with further increases likely in the subsequent two years, taking rates up to 3.4% by end 2020. The market is still a bit away from pricing in two full rate hikes in H2 2018, with futures contracts looking for a Fed funds rate of circa 2.25% by end year.

Beyond that, the markets expect only limited Fed tightening and see official rates peaking at 2.625% by end 2020, some way below Fed projections. We expect that continuing strong growth by the US economy over the next year, combined with a 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. The upward pressure on US yields is likely to re-emerge if markets have to revise upwards their expectations for US rates - as happened earlier in the year. This could put upward pressure on yields in other markets too, especially if economic data improve in H2 2018.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.875	2.34	2.77	2.78	2.85
Sep '18	2.125	2.60	2.95	2.95	3.00
Dec '18	2.375	2.80	3.15	3.15	3.15
Mar '19	2.375	2.85	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	-0.24	-0.18	0.25
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	0.50	0.69	0.96	1.03	1.29
Sep '18	0.75	0.85	1.10	1.15	1.40
Dec '18	0.75	0.85	1.10	1.20	1.50
Mar '19	0.75	0.90	1.15	1.25	1.60

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Dollar retains upper hand for now

The weakening trend in the US dollar evident in the second half of 2017, extended into the opening quarter of 2018, with the EUR-USD rate rising above $1.20 to reach $1.25. The dollar, though, recovered strongly in the second quarter, gaining ground against a broad range of currencies. It has risen by over 6% on a trade-weighted basis in recent months, while the EUR-USD rate has fallen back to around the $1.16 level.

The dollar has been aided by US economic data tending to come in ahead of expectations, in marked contrast to most other economies. Widening interest rate differentials in favour of the dollar have also helped the currency as the Fed continues to steadily tighten US monetary policy. Rising risk aversion in markets has been supportive of the highly liquid US currency too. It may also be benefitting from a repatriation of funds by US companies to take advantage of cuts in US corporate taxes. 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 fact that the euro has found solid support at around the $1.15-1.16 level is not surprising. The EUR/USD rate traded in a $1.05 to $1.16 range for most of 2015-16, so the $1.15-1-16 level was always going to provide strong technical support for the single currency. Even if this level gives way, there is further strong technical support for the euro at around the $1.12-1.13 level.

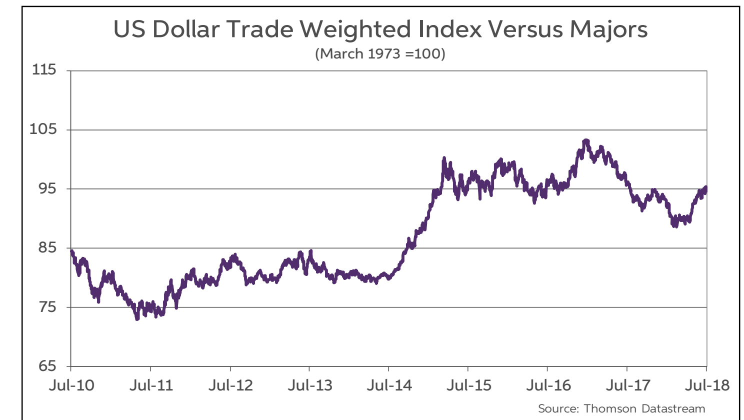
The dollar looks to be well underpinned in the near-term. The relative strength of the US economy, widening interest rate differentials, escalating tensions over global trade, stresses in some large emerging markets and political uncertainty in Europe, are all supportive of the US currency.

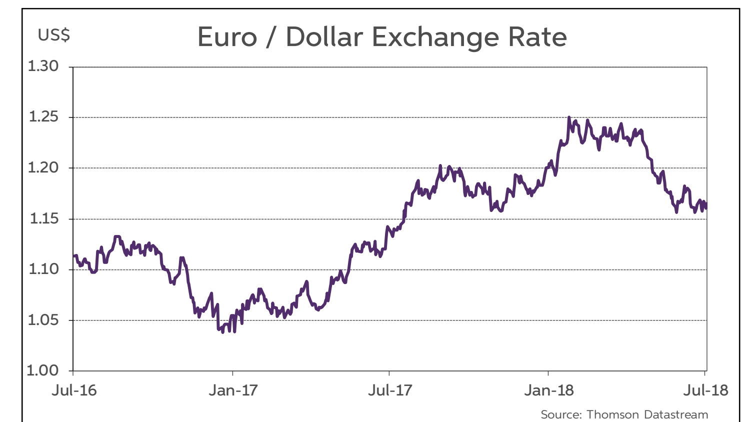
However, further gains may prove difficult now that FX positioning has turned more neutral for all the major currencies, with the dollar short positions having being largely unwound. Even if the dollar continues to rise against emerging market currencies, further gains against the euro may prove limited, unless there is a continued deterioration in the political backdrop in Europe, which has been quite fractious in recent times.

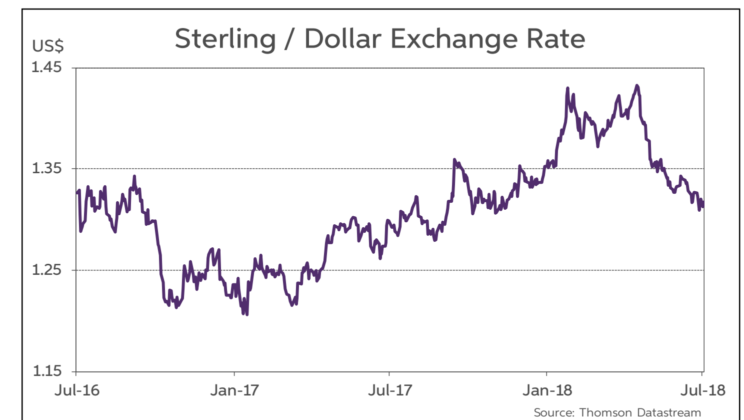
We are still of the view that the US dollar will weaken over the longer term. Two factors drive this assessment. Firstly, we are very concerned about the policy mix in the US. The expansionary fiscal policy will lead to a sharp jump in the US budget deficit and thus a big rise in the supply of Treasury bonds. It will also put upward pressure on the US balance of payments deficit. Both these factors point to a lower dollar. 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.

Secondly, the dollar is now at quite elevated levels against a range of currencies, pointing to downside potential. It is close to 20% higher on a trade-weighted basis than for most of the period 2005-2015. Meantime, EUR/USD traded in a $1.20-1.50 range for virtually all of the period from 2003 to 2015. We expect that the euro will eventually return to this range given the continuing recovery in the Eurozone economy and with the ECB set to terminate net asset purchases under its QE programme at the end of the year.

Overall, we think that the major move upwards by the dollar against the euro during the last few months is largely over. We would expect the EUR/USD rate to mainly trade in a $1.14-1.20 range in the coming months, with the potential for the euro to rise back above the $1.20 level next year.







Forex Market Outlook

Sterling stays range bound against the euro as markets await clarity on 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 has managed to move off its lows and regain some ground in the past year. The currency was helped by an unexpected rate hike from the Bank of England last November and better UK economic data in the second half of last year, as well as progress in 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. However, it has since fallen back again to close on $1.30, with the dollar gaining ground against a broad range of currencies over the past few months.

The UK currency has also recovered some territory against the euro. This has seen the EUR/GBP rate move down from the 93p level to largely trade in an 87-89p range since last September. It did briefly dip below the 87p level in mid-April, trading as low as 86.2p, before some weaker than expected UK data, a delay in the next BoE rate hike and a lack of progress in the Brexit talks since the spring, saw it move back to the 87-89p range again.

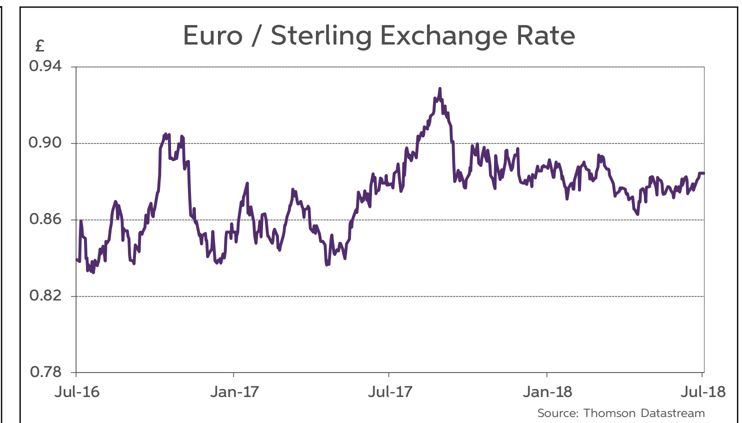
The course of the Brexit negotiations and, to a lesser extent, economic data and the timing of the next BoE hike, will be the key factors impacting sterling over the remainder of the year. In the near-term, the attention may be on economic data and the BoE. Improving figures could see the MPC vote to hike rates at its August meeting. The focus is likely to then shift to the Brexit, as the talks move on to their critical final stages in the autumn.

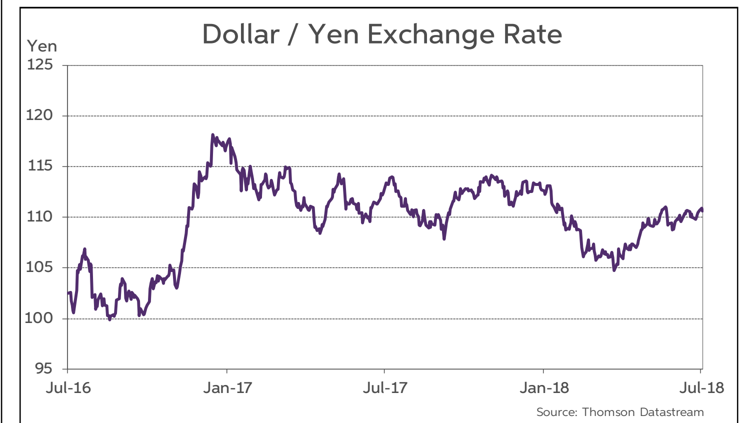
There is still much work to be done in the Brexit negotiations. The EU and UK have agreed on the need for a transition period after the Brexit occurs next March, which would see the existing trading arrangements maintained until end 2020. It is hoped that a full EU-UK trade deal can then be negotiated during 2019-2020 that will come into effect when this transition period ends.

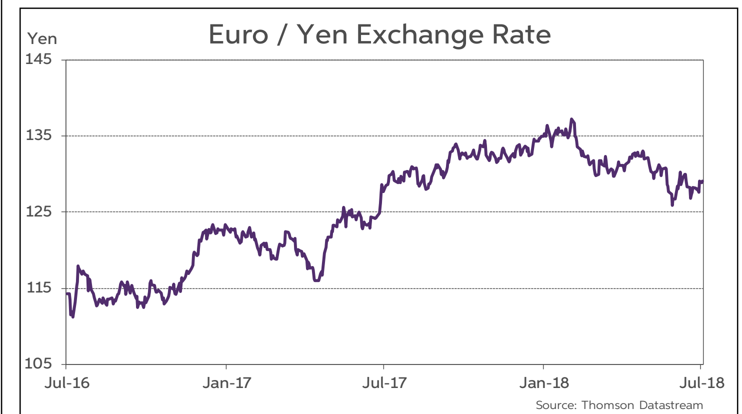
The EU and UK still need to finalise a withdrawal agreement in the autumn that contains the outlines of a future EU-UK trade deal and provides the formal basis for the transition period. The UK has been very reluctant up to now to detail how it sees EU-UK trading arrangements evolving post the Brexit transition period, especially in relation to customs. This is holding up the Brexit negotiations with the EU at present.

The general expectation is that a withdrawal agreement will be concluded later this year that paves the way for a soft Brexit, thereby avoiding any major disruption to the economy. However, given the uncertain political backdrop in the UK, its desire to regain full sovereignty, the lack of any progress in Brexit talks in recent months, as well as the deep divisions in the Conservative Party over the issue, there is still a risk of a hard Brexit.

EUR/GBP seems likely to continue to trade in an 87-89p range, until markets get a clearer picture on the outcome of the Brexit talks. If it becomes increasingly evident that a soft Brexit is on the cards, then sterling should make gains, with the euro moving down to 85p and cable rising back up towards $1.40. However, if the talks run into real difficulties and a hard Brexit becomes increasingly likely, then EUR/GBP could move up towards 95p. It could rise even higher to trade in a 95p-100p range as Brexit approaches in March 2019, with cable falling back to $1.20.



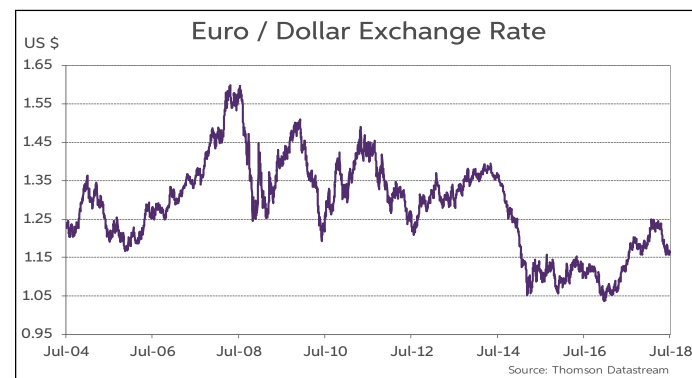


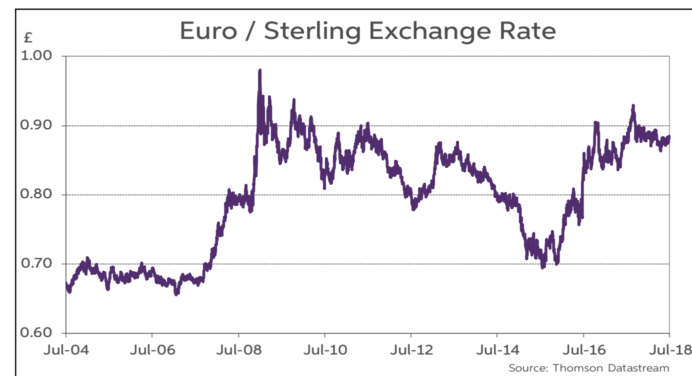


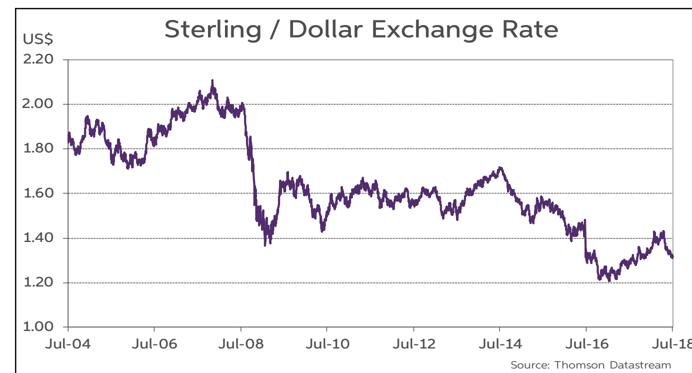
Summary of Exchange Rate Forecasts

(“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	1.163	1.14-1.20	1.16-1.22	1.18-1.24	1.20-1.26
GBP	0.880	0.85-0.91	0.84-0.90	0.83-0.89	0.82-0.88
JPY	128.50	126-132	126-132	126-132	127-133
CHF	1.15	1.15	1.16	1.16	1.17
US Dollar Versus					
JPY	110.48	107-113	105-111	104-110	103-109
GBP	1.322	1.30-1.36	1.34-1.40	1.38-1.44	1.42-1.48
CAD	1.31	1.31	1.30	1.28	1.26
AUD	0.74	0.74	0.75	0.76	0.77
NZD	0.68	0.68	0.69	0.70	0.71
CNY	6.63	6.65	6.60	6.55	6.50
Sterling Versus					
JPY	146	146	148	151	154
CAD	1.74	1.74	1.78	1.80	1.82
AUD	1.79	1.80	1.83	1.86	1.88
NZD	1.96	1.96	1.99	2.01	2.04







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