

Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit



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- World economy grew at a very modest pace in 2023. Subdued growth expected again in 2024, with continuing weak performance by Eurozone in particular
- Inflation fell sharply last year and further moderation in price pressures anticipated in 2024
- Central banks, though, remain cautious on timing and scale of policy easing. Market rate cut expectations have been paired back and remain reactive to incoming macro news flow
- Main currency pairs remain quite range bound, as central banks pursue broadly the same rate tightening policies
- Dollar at elevated level, though well below peak, but US rate cut expectations now being pared back, which should support the currency

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'Last mile' to return inflation to target proving challenging

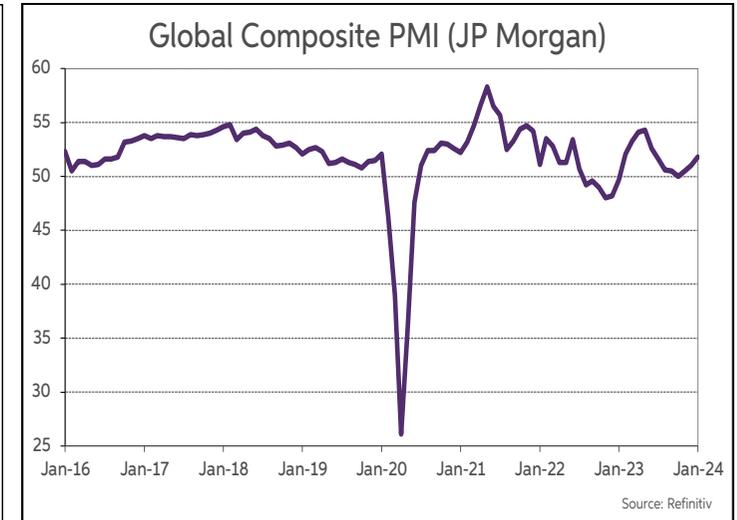
The latest updates from the OECD and IMF, published in the early months of this year, remained cautious on the outlook for the global economy. They note that global growth is likely to remain subdued in 2024 and 2025 as the lagged effects of tighter monetary policy permeate through economies. The world economy grew at a subdued pace of circa 3% in 2023. Global growth is projected to remain sub-par by the IMF and OECD in 2024-2025 at c.3.0% range. However, while estimates are broadly unchanged compared to the Autumn 2023 forecasts, the make-up of that growth is likely to be driven by stronger-than-expected US growth, offsetting downgrades to growth in Europe.

It is not just a restrictive monetary policy stance that is weighing on global growth prospects. Growing geo-political risks could weigh on consumer and business sentiment, with recent events in the Middle East, including the disruption of Red Sea trade, highlighting once again the fragility of global supply chains. Meanwhile, over 60 countries are due to hold elections in 2024, which provide a further layer of uncertainty on the path for fiscal policy in the near term. These risks are likely to hold back both consumer spending and business investment, already impacted by inflation and higher interest rates.

Indeed, the re-emergence of pockets of inflationary pressures linked to the Red Sea disruption are now evident in industry surveys such as the PMIs in Europe, following a sustained period of disinflation throughout much of 2023. These nascent trends, allied to still tight global labour markets and rising wages that continue to underpin sticky core inflation, have emboldened central banks to adopt a hawkish stance on the path for future interest rates. This has forced markets to re-adjust optimistic expectations for rate cuts in 2024 from the main central banks. By the end of February, markets were pricing in just c.85bps of cuts for the Fed in 2024, c.90bps for the ECB and c.60bps for the Bank of England. This compares to rate cut expectation of up to 125bps at the turn of year.

This re-pricing of rate expectations reflects both remarks from central bank officials and the inflationary out-turns so far in 2024 which show core inflation plateauing at still elevated levels, as headline inflation continues to moderate to 2%. Moreover, as the base effects of falling energy prices wash through inflation series, a rise in headline inflation is possible later this year, notwithstanding the impact of fresh inflationary drivers from current geo-political tensions.

At a regional level, the US economy continues on a glide path to a 'soft landing' of normalised inflation, all the while sustaining GDP growth above 2%, supported by a relatively robust domestic energy mix and supply chain which insulates it from current geo-political risks. Current IMF and OECD forecasts have US GDP at 2.1% in 2024, following a 2.5% rise in 2023, with the Fed's favoured core-PCE inflation measure is now trending towards 2%, currently at 2.8% for January 2024. For the Eurozone economies, the 'landing' is somewhat bumpier, with the German economy in particular continuing to underperform, led a by a manufacturing sector hit by plummeting output and stuttering exports. German GDP declined by -0.3% in 2023, and is expected to grow at 0.5% in 2024. Overall, Eurozone growth forecasts have been trimmed further with the IMF forecasting a 0.9% rise in 2024, rising to 1.7% in 2025, with risks tilted to the downside for growth in the near term, given the exposure of the region to geo-political spillovers from the wars in Ukraine and Middle East. The UK is similarly exposed to the geo-political risk impacting the Eurozone, while it also faces a consistently weak economic growth outlook and relatively high inflation, which is expected to persist in the near term.



GDP (Vol % Change)				
	2022	2023 (e)	2024 (f)	2025 (f)
World	3.5	3.1	3.1	3.2
Advanced Economies	2.6	1.6	1.5	1.8
US	1.9	2.5	2.1	1.7
Eurozone	3.4	0.6	0.9	1.5
UK	4.3	0.5	0.6	1.6
Japan	1.0	1.9	0.9	0.8
Emerging Economies	4.1	4.1	4.1	4.2
China	3.0	5.2	4.6	4.1
India	7.2	6.7	6.5	6.5
World Trade Growth (%)	5.2	0.4	3.3	3.6
Inflation -CPI				
Advanced Economies (%)	7.3	4.6	2.6	2.0

Sources: IMF World Economic Outlook January 2024

Markets look for central banks to cut rates in 2024

The initial round of central bank meetings in early 2024 has seen monetary policy being placed on hold, thereby maintaining the policy settings that have been in place since late summer/early autumn of last year. Central banks are currently deploying a “data-dependent” approach to their respective monetary policy deliberations/decisions. They have indicated that policy will need to be kept restrictive for a considerable period to ensure a return to price stability over the medium term. The most recent communications from them suggest they are in no hurry to cut rates. Instead, they are waiting for further signs that underlying inflation is on a sustained downward trajectory to give them confidence that it will fall back towards its 2% target before they will contemplate cutting rates. Amid some upside surprises on the data front, and on-going hawkish central bank rhetoric, market rate expectations have hardened over recent weeks. There is around 50bps less of rates now being anticipated compared to what futures contracts were pricing at the end of January.

In terms of the Fed, it kept the target range for the funds rate unchanged at 5.25-5.50% at its most recent meeting in late January. This was the fourth consecutive FOMC meeting where rates were kept unchanged. However, the Fed did remove its tightening bias at the January FOMC. In total the Fed has enacted 525bps worth of rate increases during its tightening cycle, which ran from March 2022–July 2023. The Fed’s December dot-plot showed the median projection of FOMC members is that rates will be cut by 75bps this year and a further 100bps in 2025. The market, which had previously been pricing in more aggressive easing in 2024, has now moved to be more closely in line with the Fed’s own projections. Futures contracts look for rate cuts of around 80-90bps this year, with the first 25bps rate cut almost fully priced in for June. A further 70-75bps of rate cuts are priced in for 2025, bringing rates down to a 3.75-4.00% range. The Fed dot-plot sees rates getting to 3.50-3.75% by end 2025.

The February meeting of the BoE saw the central bank keep its key interest rate unchanged at 5.25%. The decision was not unanimous with a 6:3 split vote (six for no change, two in favour of a rate hike, one for a rate cut). However, similar to the Fed, the BoE dropped its tightening bias from its communications. Governor Bailey commented that policy deliberations are now focused on “how long do we need to keep policy restrictive”. In this regard, the market is anticipating UK rates falling by around 60bps this year, with the first 25 rate cut envisaged by August. Futures contracts see rates falling a further 60bps in 2025, taking them down to 4.0%.

The ECB kept policy on hold at its first policy setting meeting of 2024 in January. This marked the third consecutive meeting where the Governing Council held the Deposit rate at 4%. The central bank implemented 450bps of rate hikes over the period July 2022-September 2023. The ECB emphasised the need to maintain rates at restrictive levels for a sufficiently long period of time to meet its inflation objective. President Lagarde commented that it was premature to discuss rate cuts. Meanwhile, the meeting account noted the ‘risk of cutting rates too early was still seen as outweighing the risk of cutting too late’. Over recent weeks, market expectations have become less aggressive in terms of rate cuts. They are pricing in a rate cut now for June, with 90bps of cuts envisaged for 2024, A further 50bps in cuts are anticipated in 2025, taking the deposit rate down to 2.50-2.75%.

The upcoming ECB, Fed and BoE meetings over the course of March are not expected to provide any major surprises in terms of policy. However, with central banks no longer providing specific forward guidance on the rate outlook, whilst at the same time being in data dependent mode, market rate expectations will remain very reactive to key data releases and remarks from central bank officials.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	5.375	5.60	5.39	4.84	4.30
Mar'24	5.375	5.55	5.35	4.80	4.30
June'24	5.125	5.30	4.70	4.20	3.70
Sept'24	4.875	5.05	4.50	4.05	3.60

* Swap Forecasts Beyond 1 Year

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	4.00	3.95	3.61	3.24	2.82
Mar'24	4.00	3.90	3.60	3.20	2.80
June'24	3.75	3.65	3.00	2.70	2.45
Sept'24	3.25	3.15	2.70	2.50	2.30

* Swap Forecasts Beyond 1 Year

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	5.25	5.33	5.24	4.83	4.31
Mar'24	5.25	5.30	5.20	4.80	4.30
June'24	5.25	5.15	5.10	4.60	4.10
Sept'24	5.00	5.00	4.75	4.20	3.70

* Swap Forecasts Beyond 1 Year

Range-bound currencies could persist, but Euro could strengthen gradually

Although the US dollar has retreated from its prior peak, it still remains at quite elevated levels. The continuing strength of the dollar is very much linked to the ongoing impressive performance of the US economy and associated high level of US interest rates. US data generally surprised to the upside and the anticipated slowdown in the economy did not materialise with GDP growth last year estimated at close to 2.5%. Meantime, the labour market remains very tight, with the jobless rate still close to fifty year lows at below 4%, amid continuing strong growth in employment. Against this backdrop, the markets have been repricing US rate cut expectations in recent weeks, adjusting end-year 2024 rate expectations to below 100bps of cuts from 125bps a month ago. Rising geopolitical tension could also add further support for the dollar as a safe haven in the near term.

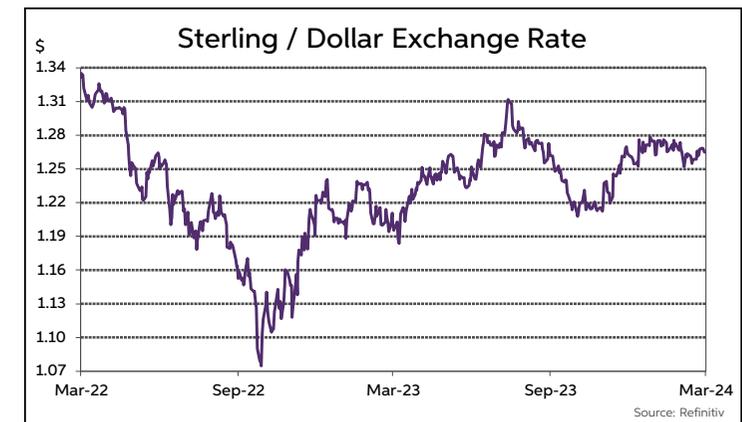
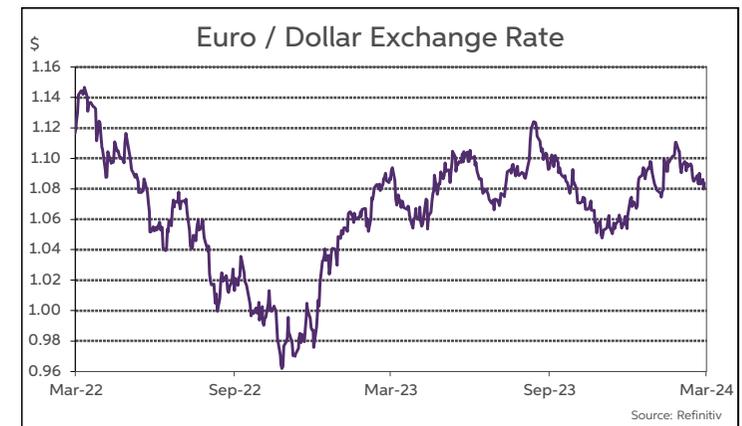
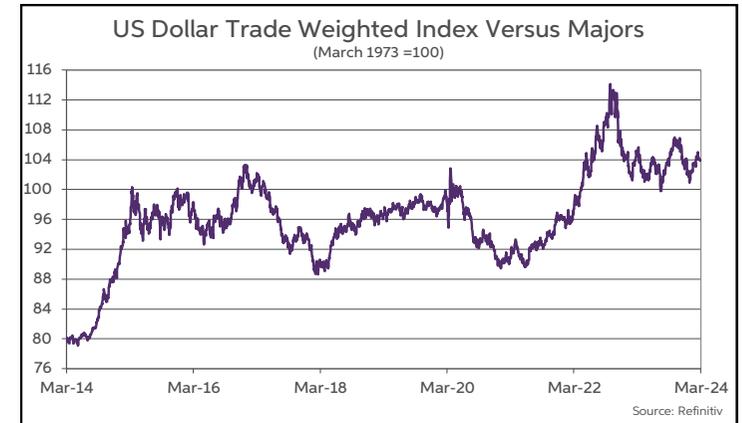
In contrast to the US, both the Eurozone and UK economies struggled last year, with the latter entering a shallow technical recession in the second half of the year. Furthermore, the Eurozone economy is estimated to have grown by around 0.5% in 2023, a much lower growth rate than the US. Nevertheless, Eurozone and UK rate cut expectations have also firmed, in line with US movements in recent weeks.

Overall, the most notable feature of the main currency markets so far in 2024 has been the continued predominance of narrow trading ranges, with the exception of the yen. EUR/USD was confined to a \$1.07-1.10 corridor so far in 2024, with the euro under pressure throughout much of that time. Meantime, sterling has traded in a \$1.22-1.28 band versus the dollar in 2024. The dollar remains relatively high, but the incoming macro data and readjusted central bank rate expectations mean few directional drivers to reverse this strength in the near term. In this context, the next Fed meeting will be important as FOMC member publish new 'dot' forecasts.

Monetary policy has been a crucial driver of forex markets in the past three years. The main central banks have kept policy unchanged in the past few months and are guiding that policy will need to remain restrictive for a period of time to get inflation back to its 2% target. Significant rate cuts are expected in the main economies this year, starting mid-year, with markets pricing in 80-90bps of policy easing in the US and Eurozone and 60bps in the UK. This suggests that the main currency markets could continue to range trade for much of the year.

The euro has lost ground so far in 2024. The EUR/USD rate fell from \$1.10 at the start of January to around the \$1.08 level more recently. Meanwhile, sterling has remained steady, in a narrow \$1.26-27 range recently. Rates are at higher levels in the US than most other economies so there is more capacity to loosen policy there once central banks move on to an easing path. The dollar is also still at an elevated level and so it has greater scope to fall than most other currencies.

This suggests we could see the dollar losing some ground in 2024 as the Fed begins to lower rates, especially if it is an early mover. However, the fall may be limited. Significant rate cuts are expected elsewhere too, including in the Eurozone and UK. Geo-political risks are also likely to remain elevated, with elections due in more than 60 countries covering about half the global adult population. Meanwhile, market positioning was relatively neutral on the dollar and euro, and long sterling. Overall, currencies may make just modest gains against the dollar this year, with the euro rising towards \$1.12 by end 2024.



Potential sterling event risk as Budget and election near

Sterling gained some ground in 2023 and was generally much more stable than in recent years. It was aided by better-than-expected UK data, with the economy avoiding the deep recession that had been widely predicted to occur last year. At the same time, the rise in BoE rates to 5.25% was also supportive of the currency, as was the more stable political backdrop. EUR/GBP edged downwards from the 87-89p range it occupied in the opening months of last year, to trade in a narrow 85.0-87.5p corridor since May 2023. Meanwhile, sterling moved up from lows below \$1.20 early in 2023 to trade in a \$1.20 to \$1.31 band against the dollar since last March. It is currently around the middle of this range. Overall, then, the UK currency has been much more stable over the past year.

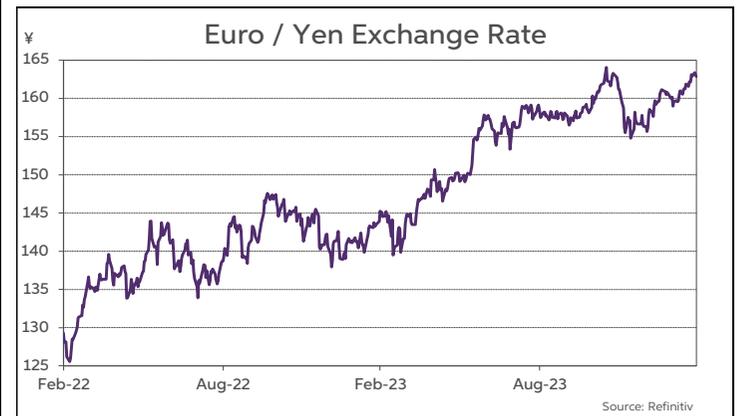
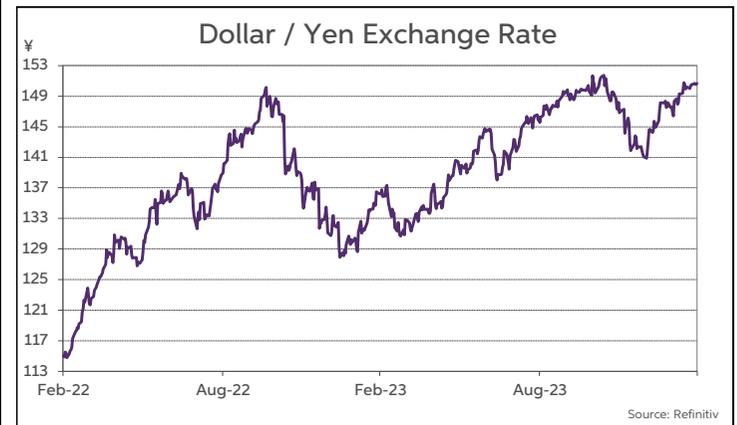
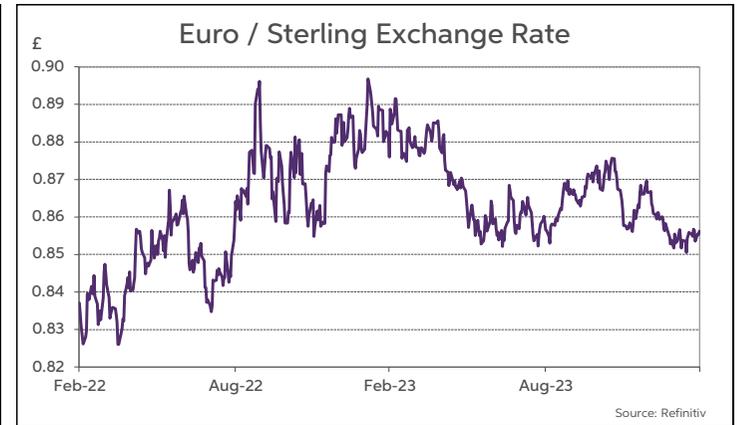
Inflation proved more sticky in the UK than elsewhere in 2023, with strong wage inflation evident also. UK rates have been raised to 5.25% as a result, and markets expect UK rates to be lowered at a slightly slower pace this year than in the US and Eurozone, which could be supportive of the currency. The Bank rate is seen as falling to c.4.50-4.75% by end 2024. Meantime, the latest positioning data shows the market is somewhat long on the pound. Overall, sterling could remain stable in 2024, especially if market expectations that rates in the UK will be cut slightly less than elsewhere prove correct. However, there could be scope for the BoE to move in line with the Fed, as it has done historically. If this proves to be the case, sterling would likely lose some ground in such circumstances. Finally, the pending Spring Budget and UK general election are not expected to impact the currency much as a change of government is widely anticipated, while the Chancellor is unlikely to risk damaging market credibility as his predecessor did in 2022. However, these events do add a further layer of uncertainty for sterling in the near term.

Yen remains under pressure as Bank of Japan nears pivot

In marked contrast to other central banks, the BoJ has continued with its very accommodative monetary policy, maintaining its key official interest rate in negative territory. The BoJ, under a new Governor, Ueda, continued to pursue this dovish policy stance last year. As a result, a large interest rate spread opened up between bond yields in Japan and the other major markets. All this has seen the yen hit 30-year lows against the US currency in the past two years. The currency has remained under pressure throughout 2024 also.

Thus, the very loose BoJ monetary policy stance has acted as a major anchor for the currency over the past two years. A significant shift in policy such as a hike in the official interest rate, or else big cuts in interest rates elsewhere, would seem necessary for the yen to recover lost ground. There is certainly scope for the yen to rebound in 2024 if there is a change in policy or rates are lowered elsewhere, given the extent of the currency's sharp fall in 2022-23. Indeed, the Bank of Japan's latest guidance after its January meeting suggest it is now nearing a pivot point.

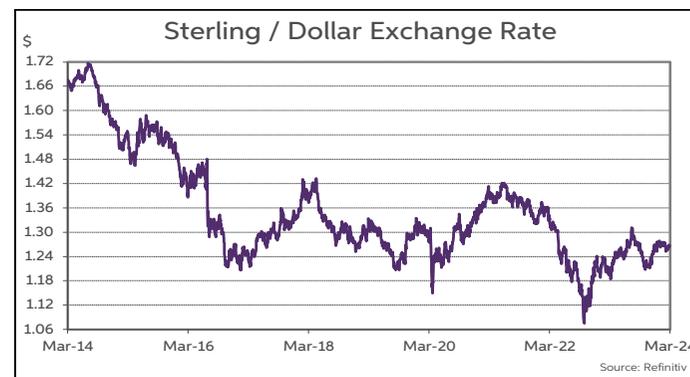
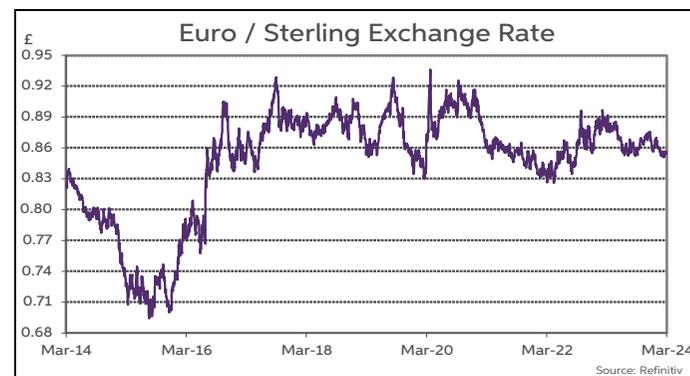
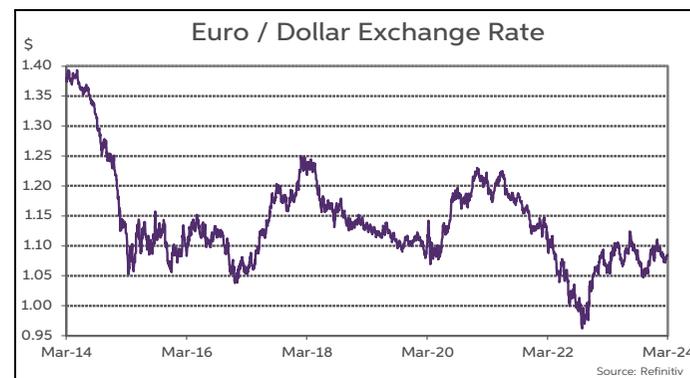
Macroeconomic data has proved disappointing with GDP contracting in Q4 2023 for a second straight quarter, driven by weak consumer spending, dampening expectations for a rate hike. However, core inflation did not slow to the extent expected by forecasters in January, easing to 2% from 2.3% in December. Therefore, the timing of a first hike since 2016 remains uncertain in the first half of 2024.



Summary of Exchange Rate Forecasts

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

	Current	Q1-2024	Q2-2024	Q3-2024	Q4-2024
Euro Versus					
USD	1.089	1.07-1.13	1.07-1.13	1.08-1.14	1.09-1.15
GBP	0.855	0.83-0.89	0.84-0.90	0.84-0.90	0.85-0.91
JPY	162.62	161-167	156-162	155-161	153-159
CHF	0.96	0.95	0.96	0.96	0.96
US Dollar Versus					
JPY	149.40	146-152	142-148	139-145	136-142
GBP	1.273	1.24-1.30	1.24-1.30	1.25-1.31	1.25-1.31
CAD	1.35	1.36	1.35	1.33	1.32
AUD	0.66	0.66	0.67	0.68	0.69
NZD	0.61	0.61	0.62	0.63	0.64
CNY	7.20	7.20	7.20	7.10	7.00
Sterling Versus					
JPY	190	189	184	182	178
CAD	1.72	1.74	1.71	1.70	1.68
AUD	1.94	1.92	1.90	1.88	1.86
NZD	2.08	2.08	2.05	2.03	2.00



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