Forex and Interest Rate Outlook

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AIB Treasury Economic Research Unit

- **Moderate recovery continues in advanced economies which have been able to withstand to date the marked slowdown in growth in emerging economies**
- **Divergence in monetary policies as ECB moves to an even looser stance, but Fed gears up to hike rates before year end, while BoE remains very much on hold**
- **Fed emphasises that rate tightening in US will be gradual and modest**
- **Divergence in monetary policies key driver of FX markets recently, although euro recovers some losses as ECB easing disappoints. Dollar stronger on expected Fed tightening**
- **Euro likely to remain weak in 2016 given the looseness of ECB policy with negative rates**

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Global Economic Outlook

Global recovery continues at moderate pace but Emerging economies weakening

Both the IMF and OECD note in their latest assessments that global growth remains sub-par, with expectations that the recovery in the world economy might gain some momentum failing to materialise yet again this year. The IMF puts it well in saying that "six years after the world economy emerged from its broadest and deepest post-war recession, the holy grail of a robust and synchronised global expansion remains elusive". Indeed, the OECD recently cut its forecast for world GDP growth in 2015 to 2.9%, which would be the slowest rate since the economic crisis of 2008-09. The world economy grew by 3.3% in 2014 and 3.2% in 2013.

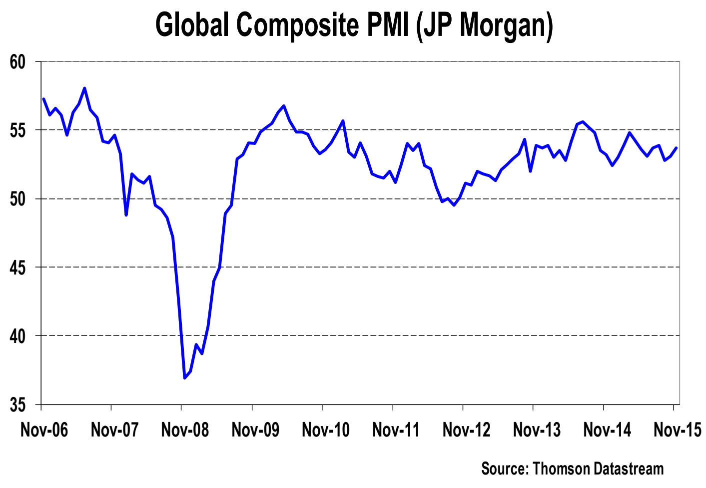
Growth in advanced economies, though, has gained some momentum in the past couple of years with GDP forecast to rise by 2% this year after 1.9% in 2014, up from 1.2% in 2013. This is largely attributable to a pick-up in activity in the Eurozone. Growth in the US remains solid. The recovery in the UK has lost some pace this year, albeit after a strong performance in 2014. Meanwhile, growth in Japan remains erratic and sluggish, despite an ultra-loose monetary policy and big decline in the yen over the past three years.

By contrast, growth in emerging economies has continued to lose momentum and is now forecast by the OECD at 3.7% in 2015, down from 4.7% in 2014 and 5% in 2013. Indeed, growth in emerging economies has been weakening since 2010, when it stood at 7.5%. China has led the way, with growth slowing from 10.4% in 2010 to a projected 6.8% this year. Many commentators suspect that the slowdown in China is even more pronounced and the actual growth rate may have decelerated to around 4%. The IMF has noted that the impact of the slowdown in China on other emerging economies via falling commodity prices and lower imports, appears to be greater than previously envisaged. Some large emerging economies like Brazil have gone into recession.

There are concerns that the weakening of activity in emerging economies, especially China, could yet hit the recovery in advanced economies. It is worth noting, though, that to date, the recovery in advanced economies has remained on track and gained some momentum despite the slowdown in emerging economies. Indeed, both the IMF and OECD expect growth in advanced economies to pick up slightly in 2016 and 2017.

There are a number of factors that will support growth. Oil and other commodity prices continue to move lower, which is helping keep inflation at very low levels, thus boosting real incomes and spending power. The very low inflation has also allowed central banks to continue to pursue very loose monetary policies. Indeed, more than half of the world economy experienced further monetary easing in 2015. In addition to these factors, fiscal policy is turning less restrictive in most advanced economies. Labour market conditions are also improving in the major economies, including the Eurozone and Japan. Confidence has also improved, while leading indicators, such as PMI surveys, point to a continuation of the upswing in activity. Thus, growth may strengthen a little.

However, downside risks remain for the world economy. Much attention remains focused on emerging economies to see if growth there begins to stabilise. Both the IMF and OECD forecast that growth will pick up in emerging economies next year and in 2017. This expectation is conditional on more stable commodity prices and exchange rates next year, greater political certainty and just a modest slowdown in growth in China. If these conditions are not met, then growth in emerging economies could continue to lose momentum. As a result, there is a risk that expectations of stronger global growth in the coming year may not be fulfilled yet again.



GDP (Vol % Change)

	2014	2015 (e)	2016 (f)	2017 (f)
World	3.3	2.9	3.3	3.6
Advanced Economies	1.9	2.0	2.2	2.3
US	2.4	2.4	2.5	2.4
Eurozone	0.9	1.5	1.8	1.9
UK	3.0	2.4	2.4	2.3
Japan	-0.1	0.6	1.0	0.5
Developing Economies	4.7	3.7	4.2	4.6
China	7.3	6.8	6.5	6.2
India	7.3	7.2	7.3	7.4
World Trade Growth (%)	3.4	2.0	3.6	4.8
Advanced Economies Inflation (%)	1.5	0.8	1.5	1.9

Source: OECD 'Economic Outlook', November 2015

Interest Rate Outlook

Monetary policies set to diverge as ECB loosens but Fed gets ready to hike

This year has been characterised by a further widespread loosening of monetary policy in many countries and a scaling back of rate hike expectations in economies where policy tightening had been expected to commence. The main reason for this has not been economic weakness per se, as the recovery in advanced economies has continued, albeit at a moderate pace. Rather, it is due to very subdued inflationary pressures as well as the increased downside risks to global growth from the weakening of activity in emerging economies.

Many central banks have taken advantage of the sharp fall in inflation, caused by the collapse in oil and other commodity prices over the past year, to move to an even more accommodative monetary policy stance. The OECD estimates that monetary easing has occurred in countries accounting for more than half of global GDP in 2015. Meanwhile, central banks that were contemplating monetary tightening have remained on hold, with markets scaling back the timing and extent of potential rate hikes.

The latest monetary easing has come from the ECB as it looks to boost inflation and growth. Eurozone inflation remains stuck at around zero, despite the marked easing of monetary policy and sharp decline of the euro over the past eighteen months. The ECB has extended the duration of its QE asset purchase programme into 2017 and lowered the deposit rate by 10bps, moving it even deeper into negative territory. This follows a further loosening of monetary policy last month in China. The Bank of Japan also retains an easing bias and it too could yet decide to expand its QE programme.

Meanwhile, the Bank of England is showing a clear reluctance to begin raising rates despite the tightening in labour market conditions and pick-up in wage inflation. It has revised down its forecast path for inflation in the near-term, with the November Inflation Report hinting that rates may remain unchanged over the course of next year. Thus, the Bank of England seems to be very much on hold right now. Markets, which had thought that rates could rise in early 2016, now do not see any rate increase until the end of next year or start of 2017.

The Fed, by contrast, has been preparing the ground to start raising rates at its mid-December FOMC meeting. The very strong US employment report for October all but sealed the case for a hike. Numerous Fed speakers have indicated that it would be appropriate to begin tightening policy before year-end. It is unclear, though, whether the Fed will hike the funds rate by a full 25bps to 0.375%, or just round it up by 0.125% to 0.25%. What the Fed has made clear though, is that when it does start to tighten monetary policy, it will be at a very moderate pace. Hence, markets do not see rates rising to 1% in the US until spring 2017.

The Fed move will be very significant as it would be the first rate increase in the US since 2006. It would also mark the emergence of a divergence in monetary policy given that the world's other major central banks are either still in easing mode or very much on hold. The dollar is strengthening as a result.

It is also seeing a widening of interest rate spreads between the US and Eurozone. Two year swap rates have risen to 1% in the US while they have turned negative in the Eurozone. The spread on ten year bond yields has widened out to 165bps between the two markets. With the ECB likely to maintain its ultra accommodative monetary policy stance over the next couple of years, these spreads could widen even further if the Fed continues on a tightening path.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.125	0.45	1.01	1.02	1.62
Dec '15	0.25	0.45	1.00	1.00	1.60
Mar '16	0.50	0.65	1.20	1.25	1.90
June '16	0.50	0.70	1.25	1.30	2.00

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Refi Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.05	-0.13	0.03	-0.03	0.28
Dec '15	0.05	-0.15	0.00	-0.05	0.30
Mar '16	0.05	-0.15	0.00	-0.05	0.30
June '16	0.05	-0.15	0.00	-0.05	0.35

** 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	0.57	1.03	1.00	1.47
Dec '15	0.50	0.60	1.05	1.00	1.50
Mar '16	0.50	0.60	1.05	1.05	1.60
June '16	0.50	0.65	1.10	1.10	1.70

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Dollar boosted by likely Fed rate hikes, Euro gets a reprieve as ECB disappoints

The four major reserve currencies (dollar, euro, yen and sterling) were confined to relatively narrow trading ranges against each other between spring and the autumn. This period of stability followed the big exchange rate moves in the second half of last year and opening quarter of 2015, when both the euro and yen fell sharply as their central banks continued with aggressive monetary policy easing.

The euro and yen found a floor in the spring and, indeed, subsequently regained a bit of lost ground. They benefited from the slowdown in emerging economies, weakening commodity prices and increased risk aversion and volatility in financial markets. The very subdued inflationary outlook and the growing downside risks to global growth made it difficult for central banks like the Fed and Bank of England, to tighten monetary policy despite the strength of their own economies. As a result, markets greatly scaled back their expectations of rate hikes in the US and UK during the course of the year.

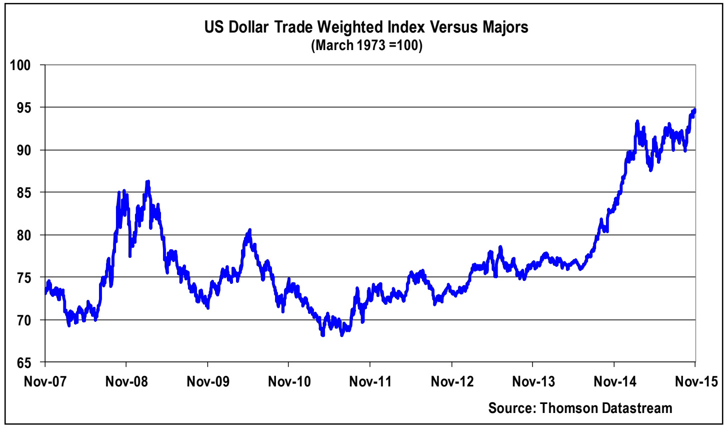
This helped the euro move off its floor of $1.05 against the dollar that it hit in the spring. The EUR/USD rate traded in a $1.08-1.16 range between the spring and the autumn. Against sterling, it traded in a 70-75p range over the same period. The re-emergence of the Greek debt crisis in the early summer had little enough impact on the single currency, which remained very stable over this period.

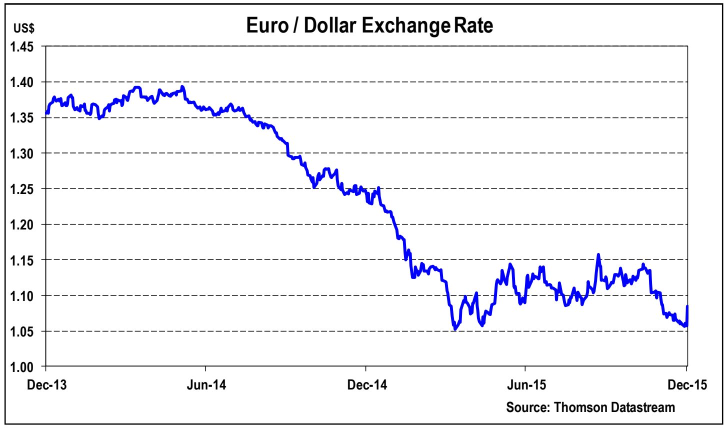
Over the past six weeks, though, the euro came under renewed downward pressure on growing expectations that the ECB would ease monetary policy quite aggressively, moving short-term interest rates much deeper into negative territory. At the same time, it looks as if the Fed will start to raise rates at its mid-December policy meeting. The emerging divergence in monetary policy saw the euro fall from $1.15 in mid-October to below $1.06 by end-November. Meanwhile against sterling, the euro declined from close to 75p to around the 70p level over the same period.

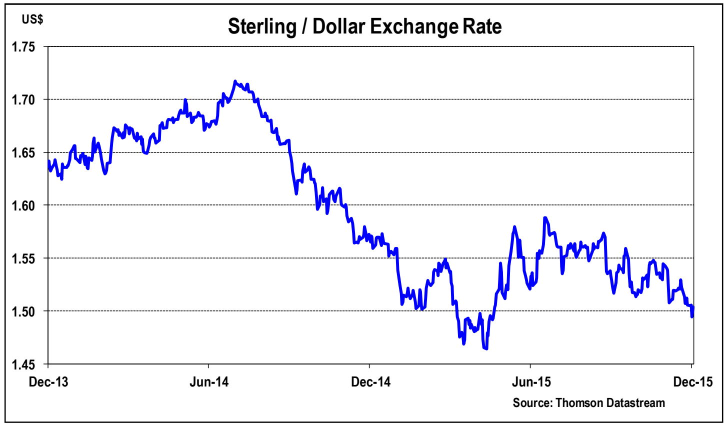
The key support levels of $1.05 and 70p, however, held for the single currency. The degree of policy easing announced by the ECB turned out to be considerably less than the markets had expected, allowing the euro to recover, rising to around $1.09 and 72p. The risks, though, remain to the downside for the euro, given the prospect of on-going monetary tightening in the US over the coming year. Meanwhile, short-term rates in the Eurozone look set to remain quite negative in 2016, with the ECB also retaining an easing bias.

It can be argued that the euro is supported by a good balance of payments surplus and did manage to regain some ground over the spring and summer of 2015, so it is not a one-way bet. However, sizeable negative interest rate differentials seem likely to act as a headwind for the single currency in 2016. It is hard to see how the euro can make gains against the dollar next year if the Fed is raising rates, even at a very gradual pace. Instead, the EUR/USD rate seems more likely to fall back towards the key support level of $1.05 in 2016.

The one hope for the euro may be if the Feds decides to increase rates only very slightly to 0.25% at its mid-December policy meeting and indicates that any rate rises will be very small indeed in 2016. However, futures contracts suggest that the Fed could raise rates by 75bps in the next twelve months. Such a development is likely to see the dollar make gains against most currencies, including the euro, in 2016.







AIB Treasury Economic Research Unit

Sterling rally runs out of steam as BoE rate hikes fail to materialise

Growth in the UK economy has slowed this year. Meanwhile, inflation has been weaker than expected. As a result, expectations for UK rate hikes have been scaled back considerably. Indeed, the Bank of England's most recent commentaries suggest that it may keep UK rates on hold for the whole of next year. The softening of UK rate hike expectations is probably the main reason why the strong appreciation of sterling over the past two years has run out of steam since the summer. Indeed, sterling has been confined to a 70-75p range against the euro since the spring, while it lost ground against the dollar over the second half of the year.

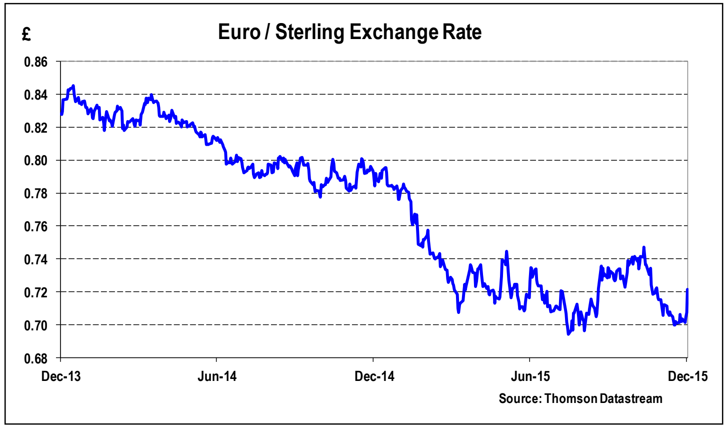
It is hard to make an argument for a further strengthening of sterling. The currency is up by around 18% on a trade-weighted basis since mid-2013, so it has already risen a lot. The UK has a large balance of payments deficit suggesting that sterling is over valued. UK rate hikes also look a long way off.

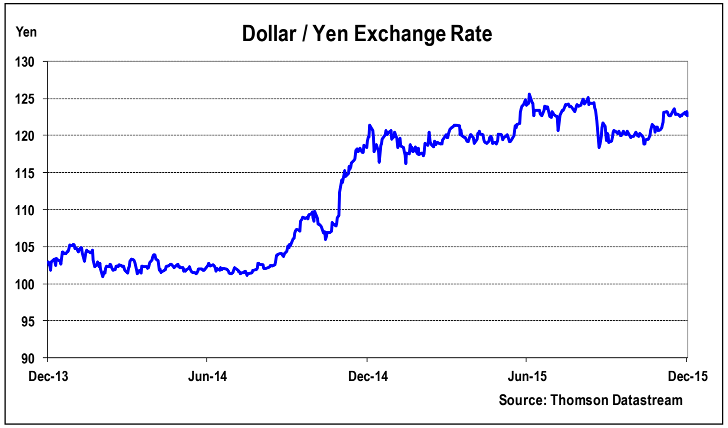
Meantime, an important consideration to keep in mind regarding sterling's prospects is the referendum on the UK's continued membership of the EU, to be held before the end of 2017. The issue has not impacted on sterling to date, even though recent polls point to quite a close referendum vote. A growing risk of a Brexit would introduce a considerable amount of uncertainty for sterling, most likely putting the currency under some downward pressure. Thus, the opinion polls on Brexit bear careful watching as this is an issue that could impact negatively on sterling in the coming year.

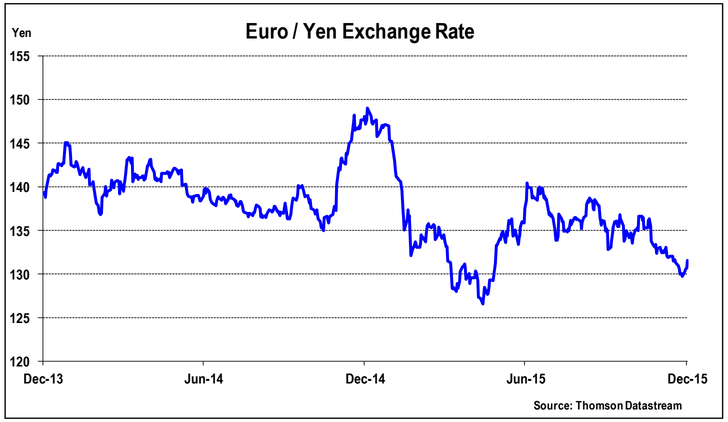
Overall then, we would be cautious on sterling. The currency may remain stable enough in 2016, given the UK's good economic performance, but there are downside risks on a number of fronts - rising balance of payments deficit, delays in raising rates and Brexit, that require close monitoring.

Meanwhile, the yen has been much more stable in 2015, having fallen sharply in the previous couple of years. Indeed, the yen looks to have found a floor. It has traded in a ¥119-125 range against the dollar since February. The dollar has risen above ¥125 on only two occasions in the past two decades, so it is not surprising that the yen has found support at this level. It will be interesting to see if the ¥125 support level can hold once the Fed starts to hike rates. Meanwhile, the yen has been on a rising path against the euro for much of the second half of the year, with the single currency moving down from ¥140 towards ¥130 as the ECB implemented fresh policy easing, unlike the Bank of Japan which kept policy unchanged.

Finally, China made a significant change to its exchange rate policy in August, loosening the peg with the dollar and allowing its currency to depreciate. The fall in the currency has been modest enough at around 3%. With the economy weakening and exports under pressure following a sharp rise in the currency earlier in the decade, the underlying trend has been downwards for the Chinese currency since the start of 2014. Hence, the exchange rate is likely to weaken further in the coming year, but at a very gradual pace, as seems to be the wish of the Chinese authorities. Meanwhile, the admission of the yuan to the IMF benchmark (SDR) currency basket is largely symbolic and should have little impact on financial markets. It does not take effect until October 2016.







Summary of Exchange Rate Forecasts

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

	Current	Q4-2015	Q1-2016	Q2-2016	Q3-2016
Euro Versus					
USD	1.089	1.05-1.11	1.04-1.10	1.03-1.09	1.02-1.08
GBP	0.720	0.70-0.74	0.70-0.74	0.69-0.73	0.68-0.72
JPY	133.65	129-135	129-135	128-134	128-134
CHF	1.09	1.09	1.09	1.09	1.09
US Dollar Versus					
JPY	122.74	119-125	120-126	121-127	122-128
GBP	1.513	1.47-1.53	1.46-1.52	1.46-1.52	1.47-1.53
CAD	1.33	1.33	1.34	1.35	1.36
AUD	0.73	0.73	0.72	0.71	0.70
NZD	0.67	0.67	0.66	0.65	0.64
CNY	6.40	6.41	6.45	6.50	6.55
Sterling Versus					
JPY	186	183	183	185	188
CAD	2.02	2.00	1.99	2.02	2.04
AUD	2.07	2.05	2.07	2.10	2.14
NZD	2.27	2.24	2.26	2.29	2.34