Forex and Interest Rate Outlook

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AIB Treasury Economic Research Unit

- **Moderate recovery continues in advanced economies, but weakening activity in emerging economies, especially China, creates uncertainty about outlook for the global economy**
- **Further significant monetary easing globally this year, while expected rate hikes in US and UK are delayed as very low inflation persists and economic outlook turns more uncertain**
- **Very low inflation means that any rate hikes in US and UK should prove very modest**
- **Dollar and sterling lose some ground as US and UK rate hike expectations are scaled back. Euro's gains have been limited by likelihood of the ECB easing policy even further**
- **Main FX rates have largely range traded for past six months. This trend may continue but with some downside risk for euro given easing bias of ECB, in contrast to the Fed and BoE**

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Global Economic Outlook

Global recovery continues at moderate pace but with downside risks

Both the IMF and OECD in their latest assessments note 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 this month, the IMF was forced to cut its forecast for world GDP growth in 2015 to 3.1%, which would be the slowest rate since the economic crisis of 2008-09. The world economy grew by 3.4% in both 2013 and 2014.

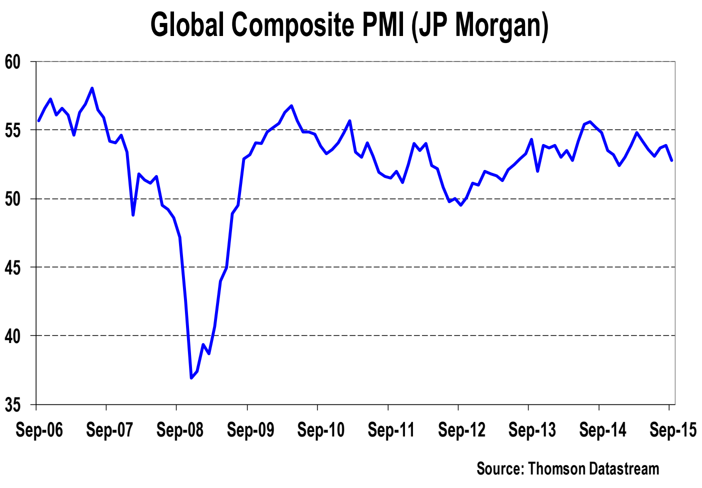
Growth in advanced economies, though, has gained some momentum in the past couple of years with GDP forecast to rise by 2% this year, up from 1.8% in 2014 and 1.4% in 2013. This is largely attributable to a pick-up in activity in the Eurozone. Growth in the US remains solid but the recovery in the UK 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 is continuing to lose momentum and is now forecast by the IMF at 4.0% in 2015, down from 4.6% in 2014 and 5% in 2013. Indeed, growth in emerging economies has been slowing since 2010, when it stood at 7.5%. China has led the way, with growth slowing from 10.4% in 2010 to a forecast 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 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. These concerns have impacted central banks policy, with rate hikes postponed and further monetary easing being done. 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.

Furthermore, there are a number of factors still supporting growth. Oil prices have moved lower again in recent months which, combined with the effects of a further easing of monetary conditions in many countries this year, should help boost global growth. Indeed, more than half of the world economy has experienced further monetary policy 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. Real incomes are rising. Confidence has also improved, while leading indicators, such as PMI surveys, point to a continuation of the upswing in activity.

However, downside risks are rising for the world economy and uncertainty remains high. Financial markets are nervous and will be looking closely at economic indicators in the months ahead for any signs that the recovery in advanced economies may be losing momentum. Attention will also be focused on emerging economies to see if growth there is beginning to stabilise. Indeed, both the IMF and OECD expect growth to pick up in emerging economies next year. However, there is no sign yet that this will happen and as before, expectations of stronger growth in the coming year may once again not be realised.



GDP (Vol % Change)	2013	2014	2015 (f)	2016 (f)
World	3.4	3.4	3.1	3.6
Advanced Economies	1.4	1.8	2.0	2.2
US	2.2	2.4	2.6	2.8
Eurozone	-0.4	0.9	1.5	1.6
UK	1.7	3.0	2.5	2.2
Japan	1.6	-0.1	0.6	1.0
Developing Economies	5.0	4.6	4.0	4.5
China	7.7	7.3	6.8	6.3
India	6.9	7.3	7.3	7.5
World Trade Growth (%)	3.3	3.2	4.1	4.4
Advanced Economies Inflation (%)	1.4	1.4	0.0	1.2

Source: IMF 'World Economic Update', October 2015

Interest Rate Outlook

Further monetary easing globally while expected rate hikes are delayed

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 likely rate hikes.

Both the US Fed and Bank of England sounded some warnings earlier in the year that rates may have to rise in the not too distant future. Both, though, have drawn back from starting to tighten policy. Even though the US economy is now close to full employment, many Fed officials have become reluctant to hike rates. Instead, the Fed has decided to err on the side of caution, keeping policy unchanged in the face of a continuing very subdued inflationary environment and rising external risks to growth.

The Fed, though, continues to indicate that it may still be appropriate to raise rates before year end. This is very much dependent on how economic data and events unfold in the next couple of months. The markets are not convinced though, and do not see a full 25bps increase in the Fed funds rate materialising until mid-2016.

The Bank of England is also showing a reluctance to raise 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. The markets now do not expect UK rates to start rising until the end of next year. Meanwhile, both the Fed and BoE have repeatedly emphasised that, when they do start to tighten monetary policy it will be at a very moderate pace. Markets do not see rates rising to 1% in either economy until late 2017.

Meantime, the ECB continues to emphasise that its QE programme will last until at least September 2016 and could be extended. Indeed, at its last two meetings, the ECB clearly indicated that it is quite prepared to take additional easing measures if required. Thus, the ECB retains a strong easing bias. The expectation is that the ECB, at a minimum, will increase the size of its QE programme before year end. It could also lower its discount rate further. The Bank of Japan retains a strong easing bias too and could also soon expand its QE programme.

At this stage, markets are taking a very benign view of the outlook for monetary policy. Bond yields have fallen to very low levels as a result, with a marked downward shift in yield curves. This leaves fixed income markets quite vulnerable to any bearish news on interest rates. It is worth recalling that the US Fed was very close to hiking rates recently. The unemployment rate has fallen to near 5%. If job growth picks up again after slowing in recent months, we could get a modest hike in rates from the Fed this winter. Meanwhile, wage pressures are rising in the UK which could yet put upward pressure on inflation, forcing the BoE into action earlier than markets expect. Thus, labour market data will need close watching in both economies in the period ahead.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.125	0.32	0.83	0.73	1.39
Dec '15	0.25	0.45	1.00	0.90	1.65
Mar '16	0.25	0.50	1.10	1.05	1.85
June '16	0.50	0.70	1.25	1.30	2.15

** 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	-0.05	0.12	-0.01	0.28
Dec '15	0.05	-0.07	0.10	0.00	0.30
Mar '16	0.05	-0.07	0.10	0.02	0.35
June '16	0.05	-0.05	0.12	0.05	0.40

** 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	0.58	1.03	0.93	1.41
Dec '15	0.50	0.60	1.05	1.00	1.50
Mar '16	0.50	0.65	1.15	1.15	1.70
June '16	0.75	0.90	1.35	1.40	2.00

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Euro weighed down by likelihood of further ECB easing

The four major reserve currencies (dollar, euro, yen and sterling) have been confined to relatively narrow trading ranges against each other since the spring, following the big exchange rate moves in the second half of last year and opening quarter of 2015. That is not to say that there have not been big moves on forex markets over the course of this year. Currencies like the Aussie, Kiwi and Canadian dollars have been under pressure throughout the year from the weakness of commodity prices and associated continuing slowdown in the Chinese economy. Some emerging market currencies have seen quite large falls.

The euro, though, has found a floor and become much more stable, after suffering big losses in the second half of 2014 and early 2015. It has traded in a $1.08-1.16 range versus the dollar since mid-April. Against sterling, it has traded in a 70-75p range over the same period.

The euro has benefited from the slowdown in emerging economies, weakening commodity prices and increased risk aversion and volatility in financial markets. The very subdued inflation outlook and the growing downside risks to global growth, as well as unsettled financial markets, have made it increasingly difficult for central banks like the Fed and Bank of England, to begin tightening monetary policy despite the strength of their own economies. As a result, markets have greatly scaled back their expectations of rate hikes in the US and UK.

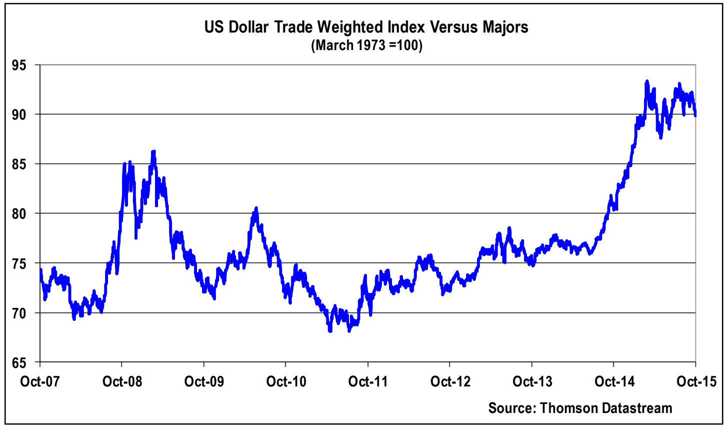
At the start of 2015, the markets were looking for up to three 25bps rate hikes in the US this year. Even up to recently, there was an expectation that the Fed could hike rates in both September and December. Now though, markets think that the Fed won't raise rates by a full 25bps until mid-2016. Meanwhile, UK rates are now not expected to start rising until the end of next year. These are big changes in interest rate expectations.

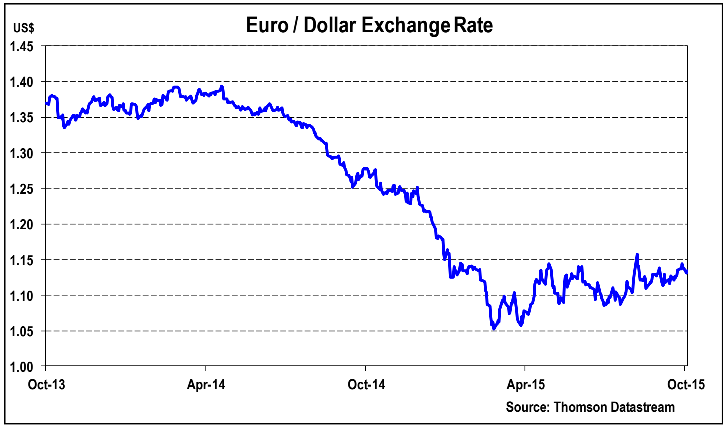
This has provided considerable support for the euro, as Eurozone rates had been expected to remain very low for a considerable period of time. Thus, there were no major rate hike expectations to scale back here. Furthermore, the Eurozone recovery has gained some momentum. Growth has picked up to 0.4-0.5% in recent quarters. It may not be very strong growth but it is a much improved performance on recent years.

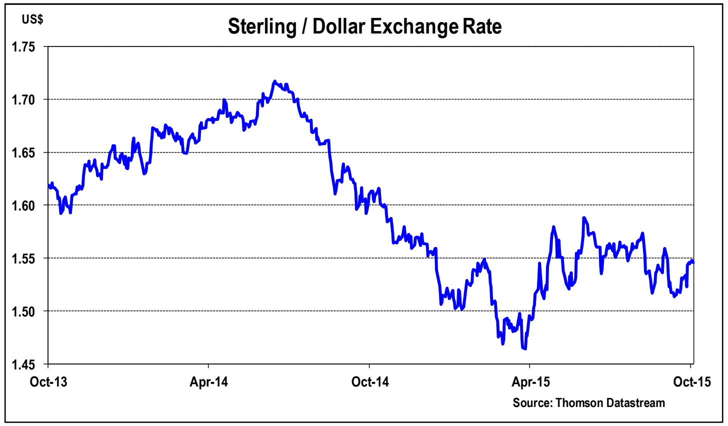
The euro is well off its floor of $1.05 against the dollar, reached earlier in the year. Indeed, the EUR/USD rate has generally traded in a $1.11-1.15 range over the past couple of months. It seems unlikely, though, that the euro will recover any further ground in the near term, given that the ECB retains a pronounced easing bias. This easing bias has capped the gains by the euro in recent months.

Indeed, the growing likelihood that the ECB will loosen policy further before year end to counteract very weak inflationary pressures is a risk for the euro. Meanwhile, any rate tightening in the US should support the dollar as a rate hike in the coming months is no longer being priced in by markets. Thus, while the EUR/USD rate has been very range bound, the risks are to the downside for the single currency given the very differing policy bias of the ECB and Fed. The euro support level of $1.11 against the dollar is being tested in the aftermath of dovish ECB comments on further policy easing. It could well give way in the next few weeks.

The risks are to the downside for the euro in 2016 also, given the prospect of at least some monetary tightening in the US next year. This could see the EUR/USD rate move back down towards the $1.05 level.







Sterling rally ends 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. This is probably the main reason why the strong appreciation of sterling over the past two years has run out of steam. Sterling has fallen by over 3% on a trade-weighted basis from its summer highs. The euro has regained a bit of ground against sterling recently, rising from a low of 70p to above 74p at one stage recently, before easing back to 72p.

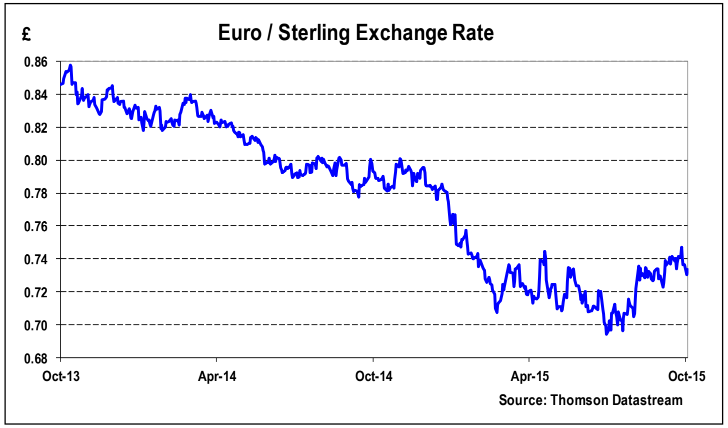
It is hard to make an argument for a further strengthening of sterling. The currency is still up by over 15% on a trade-weighted basis since mid-2013. The UK has a large balance of payments deficit suggesting that sterling is over valued. Meanwhile, any rate hikes in the coming year are expected to prove very modest.

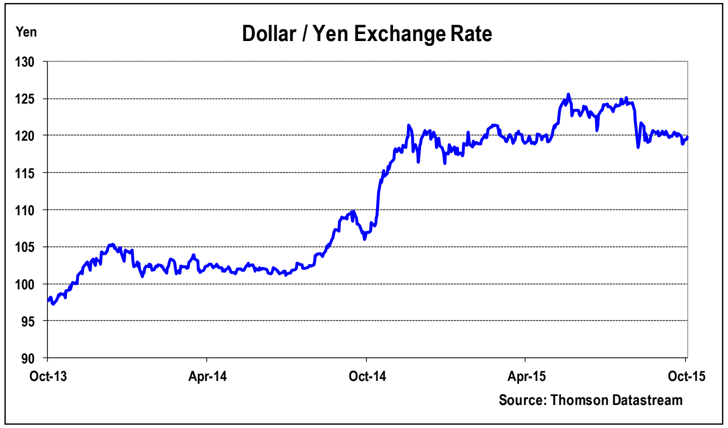
Meantime, an important consideration to bear in mind regarding sterling's prospects is the referendum on the UK's continued membership of the EU, to be held before the end of 2017. The markets have taken comfort from the fact that most opinion polls point to a majority in favour of the UK staying in the EU. Thus, the issue has not been impacting on sterling to date. However, the gap has narrowed in more recent polls. A growing risk of a Brexit would introduce a considerable amount of uncertainty, most likely putting the UK currency under some downward pressure. Thus, the opinion polls on Brexit bears watching as this is an issue that could yet impact negatively on sterling in the coming year.

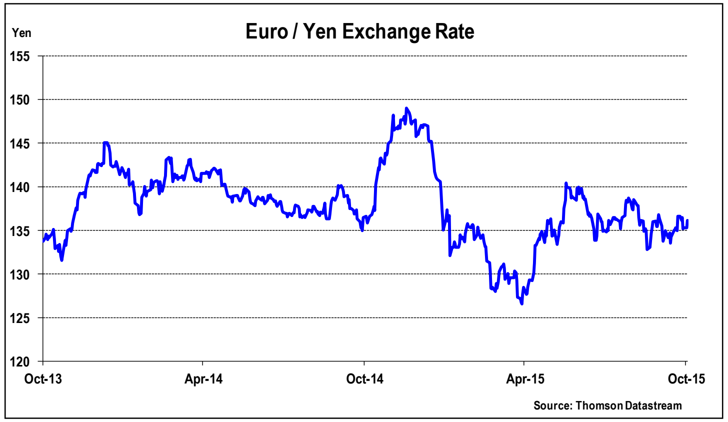
Overall then, we would be cautious on sterling. The likelihood is that it will continue to trade within its recent ranges against the other three major currencies but there are downside risks on a number of fronts - rising balance of payments deficit, slowing UK growth and Brexit, that require close monitoring.

Meanwhile, the yen has been much more stable in 2015, having fallen sharply in the last couple of years. Indeed, the yen may have found a floor. Increased risk aversion in markets over the past couple of months has seen the dollar fall back to around ¥120 from a high of ¥125. 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. Overall, the yen could continue to trade around the ¥120 level, moving down towards the ¥125 level again should the Fed hike rates. The yen has also become quite range bound against the euro, trading in a ¥133-140 corridor since the end of April. Like the euro, the upside for the yen is being curtailed by expectations in the market that the BoJ could do more policy easing and increase the size of its QE programme.

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 was modest enough at around 3%. Indeed, it has since regained some of the lost ground. 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.



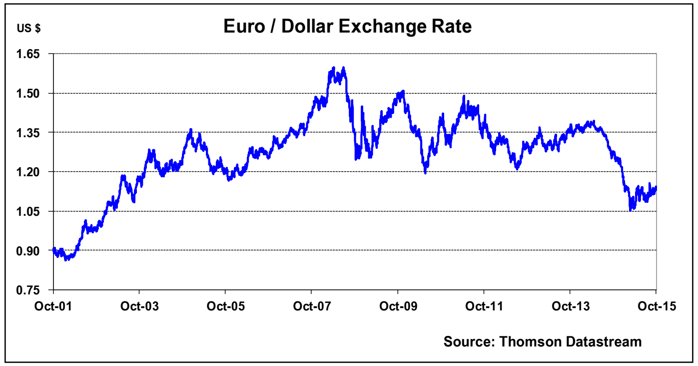


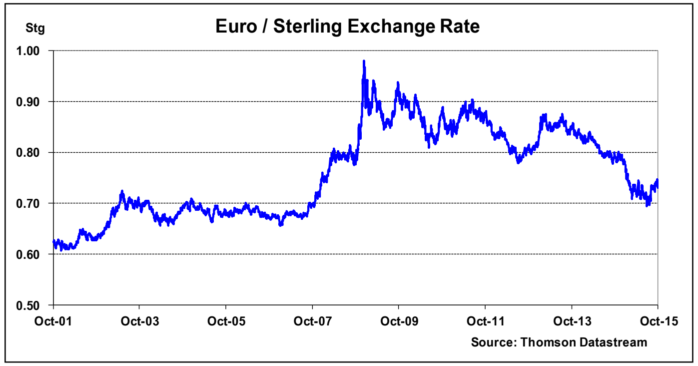


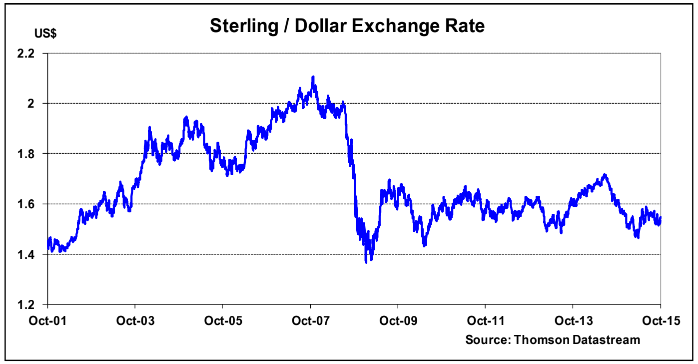
Summary of Exchange Rate Forecasts

("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	1.112	1.08-1.14	1.07-1.13	1.06-1.12	1.05-1.11
GBP	0.722	0.70-0.74	0.70-0.74	0.69-0.73	0.68-0.72
JPY	133.86	131-137	131-137	132-138	132-138
CHF	1.08	1.09	1.10	1.10	1.10
US Dollar Versus					
JPY	120.41	118-124	119-125	121-127	122-128
GBP	1.540	1.51-1.57	1.50-1.56	1.51-1.57	1.51-1.57
CAD	1.31	1.31	1.32	1.33	1.34
AUD	0.73	0.73	0.72	0.71	0.70
NZD	0.68	0.68	0.67	0.66	0.65
CNY	6.35	6.37	6.40	6.43	6.45
Sterling Versus					
JPY	185	187	186	190	193
CAD	2.01	2.02	2.02	2.04	2.07
AUD	2.12	2.11	2.13	2.17	2.20
NZD	2.26	2.26	2.28	2.33	2.37







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