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**
- **Rising risk aversion and turbulence on financial markets allowed the euro and yen recover some lost ground as US and UK rate hike expectations got scaled back**
- **Main FX rates back range trading for past six months. This trend may well continue but monetary policy outlook still favours the dollar and sterling over euro and yen**

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Global Economic Outlook

Global recovery continues at moderate pace but with downside risks

Both the IMF and OECD have noted that, while growth has picked up in advanced economies in recent times, it remains quite modest relative to previous cycles. It is also uneven in pace, with the first quarter seeing the weakest global growth since the end of the financial crisis before picked up speed again in the second quarter.

Overall though, growth in advanced economies has gained some momentum in the past couple of years. This is largely attributable to a pick-up in activity in the Eurozone. However, the recovery in the UK has lost some momentum 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.

Meantime, there has been a slowdown in growth in many emerging economies, most notably China, which is attracting more and more attention. This is not something new. Growth in emerging economies is forecast at 4.2% 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 7.2%. 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 slowed to around 4%.

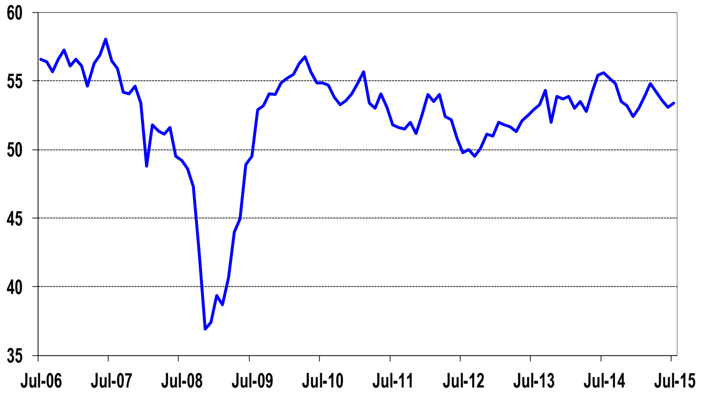
The overall growth rate of the global economy has remained static in recent years, with the pick up in activity in advanced economies offset by slowing emerging economies. The are concerns, though, that the slowdown in emerging economies, especially China could yet impact on advanced economies. We have seen increased turbulence on financial markets recently on concerns about the prospects for global growth, while it has also been impacting on central banks, with monetary policy looser than expected across the globe this year.

Nonetheless, there are a number of factors still supporting global growth prospects. Oil prices have moved lower again in recent months which, combined with the effects of a further easing of monetary conditions year-to-date should help boost growth in many economies. Both the IMF and OECD see significantly lower energy costs as providing a boost to consumption in most oil-importing countries. Meanwhile, more than half of the world economy has experienced further monetary policy easing this year.

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 lead 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 about the outlook for global growth. The fact that official interest rates remain at virtually zero in many economies, six years after the financial crash of 2008-09, and inflation is also around zero, indicates that we are still far from a return to normal economic conditions. The general expectation is that the global economy will continue to expand at a moderate pace, helped by extraordinarily loose monetary conditions. However, markets will be looking closely at economic indicators in the months ahead for any signs that the recovery may be losing momentum.

Global Composite PMI (JP Morgan)



Source: Thomson Datastream

GDP (Vol % Change)

	2013	2014	2015 (f)	2016 (f)
World	3.4	3.4	3.3	3.8
Advanced Economies	1.4	1.8	2.1	2.4
US	2.2	2.4	2.5	3.0
Eurozone	-0.4	0.8	1.5	1.7
UK	1.7	3.0	2.4	2.2
Japan	1.6	-0.1	0.8	1.2
Developing Economies				
China	7.7	7.4	6.8	6.3
India	6.9	7.3	7.5	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', July 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 across the world 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 world economy has continued to expand at a moderate pace, but rather very subdued inflationary pressures as well as the emergence of increased downside risks to global growth.

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 during 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 had 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 policy tightening. Even though the US economy is now close to full employment, many Fed officials have become reluctant about hiking rates. Instead, the Fed has decided to err on the side of caution and keep policy unchanged because of the continuing very subdued inflationary environment and rising external risks to growth. The Fed, though, continues to indicate that it still expects that economic conditions will make it appropriate to hike rates before year end, but this is very much dependent on how economic data and events unfold over the remainder of 2015.

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 and its projections suggest that it does not envisage hiking rates until the second quarter of next year, despite a warning over the summer from the BoE Governor that the timing of interest rate increases is moving closer.

Both the Fed and BoE have also repeatedly emphasised that, when they do start to tighten monetary policy it will be at a very moderate pace. With inflation staying very low, markets are now pricing in that official rates will not have even risen to 1% in either the US or UK by the end of 2016.

Meanwhile, the ECB continues to emphasise that its QE programme will last until at least September 2016 and could be extended. Indeed, at its last meeting, the ECB clearly indicated that it is quite prepared to take additional easing measures if required. Thus, the ECB retains a strong easing bias and could loosen policy further in the months ahead, if it feels that fresh downward pressures emerge on inflation that need to be countered.

There remains considerable uncertainty in markets about when the Fed and Bank of England will start to increase interest rates. Very low inflation and rising global risks to growth suggest that policy will be kept on hold near term. However, continuing solid domestic economic growth and tightening labour market conditions, suggest that rates may soon have to rise from their current very low levels. The Central Banks themselves seem unsure and have erred on the side of caution by keeping policy unchanged. It all suggests that even when rates do start to rise, it will be at a very slow pace as both central banks have indicated. We still think rates could rise in the US by end year, with a rate hike possible in the UK before the summer.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.125	0.33	0.83	0.79	1.52
Sept '15	0.125	0.35	0.90	0.95	1.70
Dec '15	0.375	0.60	1.15	1.20	2.00
Mar '16	0.625	0.85	1.40	1.50	2.30

** 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	-0.03	0.16	0.09	0.41
Sept '15	0.05	-0.02	0.18	0.12	0.50
Dec '15	0.05	-0.01	0.20	0.15	0.60
Mar '16	0.05	0.00	0.23	0.20	0.65

** 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	1.05	1.01	1.56
Sept '15	0.50	0.60	1.10	1.10	1.70
Dec '15	0.50	0.65	1.20	1.25	1.90
Mar '16	0.50	0.70	1.30	1.40	2.15

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Euro stabilises but could edge lower in months ahead

The four major reserve currencies (dollar, euro, yen and sterling) had been confined to relatively narrow trading ranges against each other over the past six months, 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 in recent months. Currencies like the Aussie, Kiwi and Canadian dollars have remained under pressure from the weakness of commodity prices and associated continuing slowdown in the Chinese economy. Emerging market currencies have seen even bigger losses. There was also quite an amount of volatility on forex markets over the summer.

The euro, though, has found a floor and become much more stable in recent months, after suffering big losses in the second half of 2014 and early 2015. It had been trading in a $1.08-1.16 range versus the dollar since mid-April. Against sterling, it has traded on a 70-74p range over the past six months.

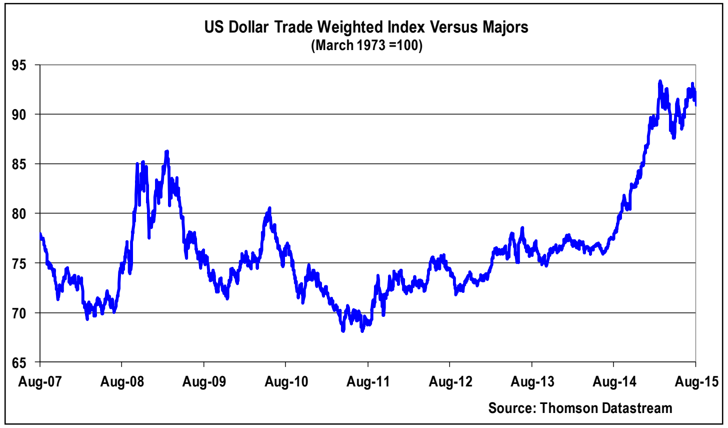
The euro has benefited from the slowdown in emerging economies, weakening commodity prices and increased risk aversion and volatility in financial markets. The very subdued inflation outlook and the growing downside risks to global growth, as well as unsettled financial markets, have made it increasingly 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.

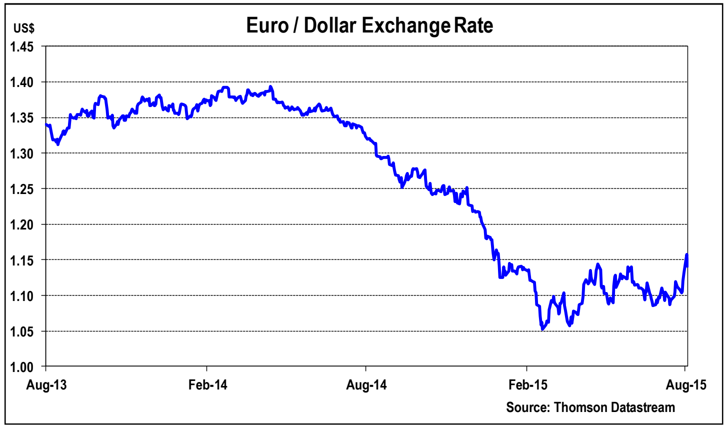
At the start of 2015, the markets were looking for up to three 25bps rate hikes in the US this year. Even up to recently, there was an expectation that the Fed could hike rates in both September and December. Now though, markets think that the Fed will keep policy unchanged this year and won't hike rates until the spring. Meanwhile, UK rates are now not expected to start rising until the middle of next year.

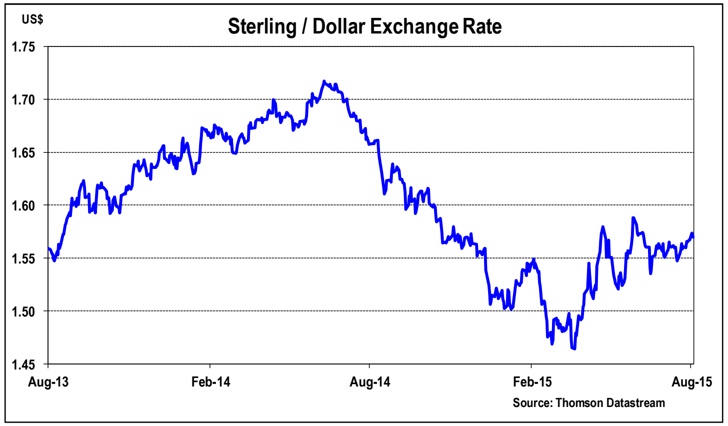
All of this is helping to support the euro, where rates had been expected to remain very low for a considerable period of time in any event. Thus, there were no major rate hike expectations to scale back here. Furthermore, the Eurozone economy has gained some momentum in the past year. Growth has picked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

The euro is now well off its floor of $1.05 against the dollar reached earlier in the year. Indeed, the EUR/USD rate has moved into a trading range of $1.11-1.16 over the past month. 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 that could see it loosen policy somewhat further in the months ahead. On the other hand, with the Fed seemingly on the side lines till near year-end, significant dollar gains also looks unlikely in the short term.

The biggest risk for the euro is that the ECB could decide to loosen policy further in the months ahead to counteract very weak inflationary pressures. In these circumstances, the euro could move down towards $1.08. Meanwhile, any rate tightening in the US should support the dollar. A 25bps Fed rate hike by end year has not been priced in by markets. Thus, we feel that while the EUR/USD rate may remain quite range bound, the risks remain to the downside for the single currency given the very differing policy bias of the ECB and Fed. We look for the EUR/USD rate to mainly trade in a $1.08-1.14 range over the rest of the year, somewhat lower than its recent $1.11-1.16 range.







Brexit referendum having little impact on sterling so far

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 seen in 2013-14 has run out of steam. The UK currency has been confined to a 70-74p range against the euro over the past six months. Meanwhile, cable has traded in a $1.52-1.58 range since April.

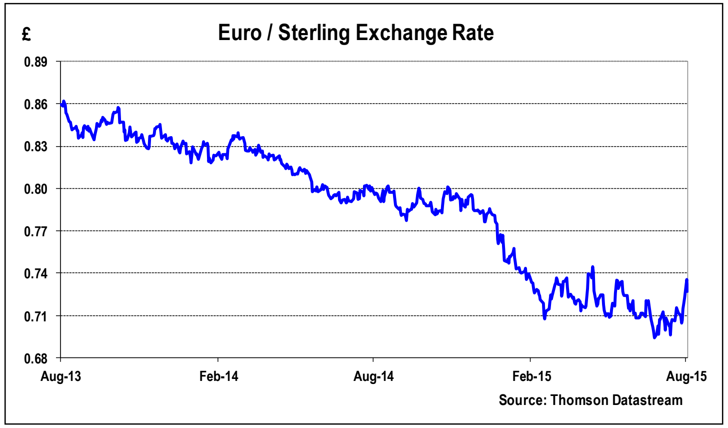
It is hard to make an argument for a further strengthening of sterling from here. It has already risen by 20% on a trade-weighted basis since mid-2013. The UK economy has a large balance of payments deficit suggesting the currency if anything is over valued. Any rate hikes in the coming year are expected to prove very modest.

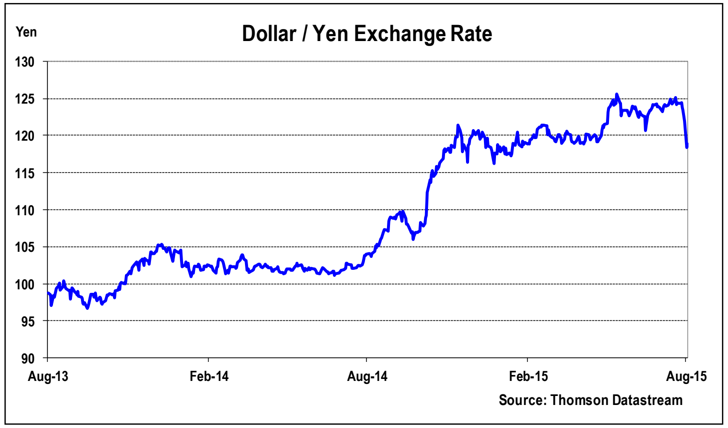
Meanwhile, an important consideration to bear in mind regarding sterling's prospects is the referendum on the UK's continued membership of the EU, to be held before the end of 2017. The markets have taken comfort from the fact that most opinion polls point to a majority in favour of the UK staying in 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.

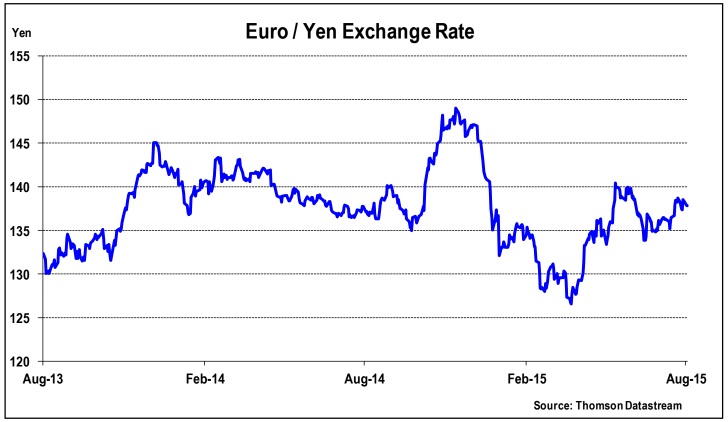
Overall, then, we would be cautious on sterling. The likelihood is that it will continue to range-trade against the three major world currencies but there are downside risks on a number of fronts - rising balance of payments deficit, slower UK growth and Brexit— that require close watching.

Meanwhile, the yen has shown signs of stabilising during 2015, having fallen sharply in the previous couple of years. Certainly the pace of yen decline has slowed a lot in 2015. Indeed, the increased risk aversion in markets over the past month 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 then, the yen may have found a bottom at around the ¥125 level and could now trade in a ¥120-125 range, moving towards the ¥125 level if the Fed hikes rates. The yen has also become quite range bound against the euro, trading in a ¥133-140 corridor since the end of April. Both curencies Central Banks are very committed to QE and loose monetary policies so there is little to favour either currency on this front. Thus, the yen may remain quite range bound against the euro in the period ahead.

Finally, China made a significant change to its exchange rate policy last month, loosening the peg with the dollar and letting its currency depreciate. The fall in the currency has not been that great to date at less than 3% and, indeed, it has since regained a small bit of ground. With the economy weakening and exports under pressure following a sharp rise in the currency over the past year, the Chinese authorities may well be prepared to let the exchange weaken further, but at a very gradual pace.



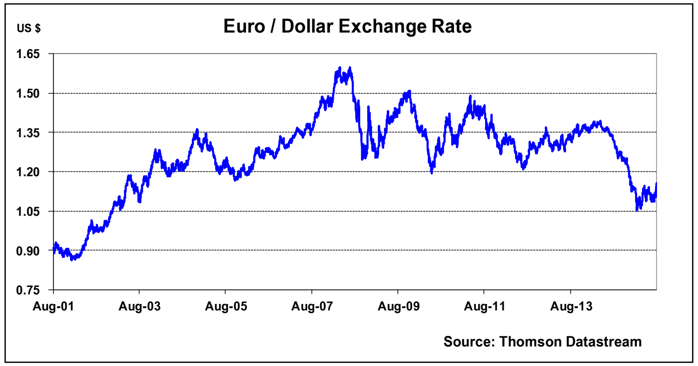


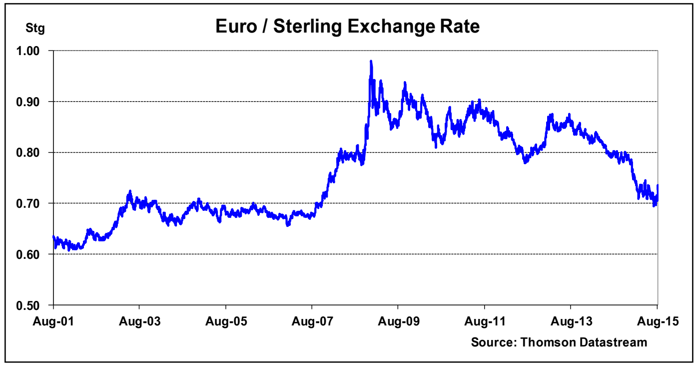


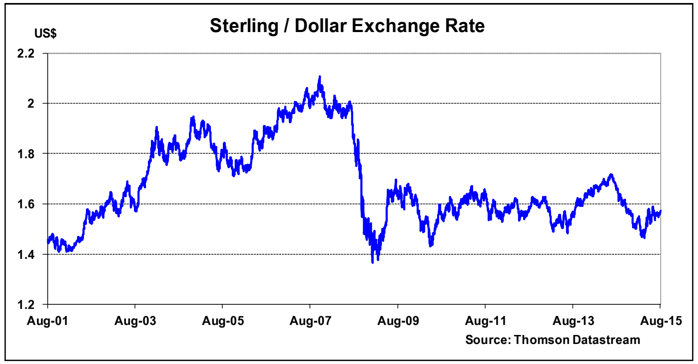
Summary of Exchange Rate Forecasts

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

	Current	Q3-2015	Q4-2015	Q1-2016	Q2-2016
Euro Versus					
USD	1.142	1.11-1.17	1.09-1.15	1.07-1.13	1.05-1.11
GBP	0.730	0.71-0.74	0.70-0.74	0.69-0.73	0.68-0.72
JPY	136.52	134-140	134-140	133-139	132-138
CHF	1.08	1.08	1.09	1.10	1.10
US Dollar Versus					
JPY	119.53	117-123	119-125	121-127	122-128
GBP	1.564	1.54-1.60	1.53-1.59	1.52-1.58	1.51-1.57
CAD	1.33	1.33	1.34	1.35	1.36
AUD	0.71	0.71	0.70	0.69	0.68
NZD	0.65	0.65	0.64	0.63	0.62
CNY	6.41	6.45	6.55	6.60	6.65
Sterling Versus					
JPY	187	189	190	192	193
CAD	2.08	2.09	2.08	2.09	2.10
AUD	2.19	2.21	2.23	2.25	2.26
NZD	2.40	2.42	2.44	2.46	2.48







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