Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Global recovery continues to gather momentum, but inflation stays subdued
- Era of monetary easing coming to an end, but central banks patient on policy tightening. Further modest Fed rate hikes on the cards in 2018, BoE now on hold, ECB and BoJ scale back on QE
- Dollar comes under renewed pressure in early 2018, but repatriation of funds by US corporates to take advantage of tax cuts could support the currency during the year
- Sterling more stable recently. Progress of Brexit talks to set direction for currency in 2018
- Euro recovered ground in 2017. Currency still at low level vs. dollar. Rally against dollar could be interrupted during 2018 by repatriation of funds back to US, so volatility likely in EUR/USD rate

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Global Economic Outlook

Global recovery continues to gain momentum, but inflation stays subdued

Global economic activity has been gaining strength over the past eighteen months, helped by an improvement in investment, manufacturing and world trade. Growth in world trade volumes in 2017 is estimated by the OECD at close to 5%, almost double that of the previous number of years.

Activity picked up pace in advanced economies in the second half of 2016, with stronger performances in the US, Eurozone, UK and Japan. This trend continued in 2017, with good growth in all the major economies apart from the UK. Activity in developing economies has also been gathering strength, helped by the emergence of countries like Russia, Brazil and Nigeria from recessions as oil prices recovered from their early 2016 lows.

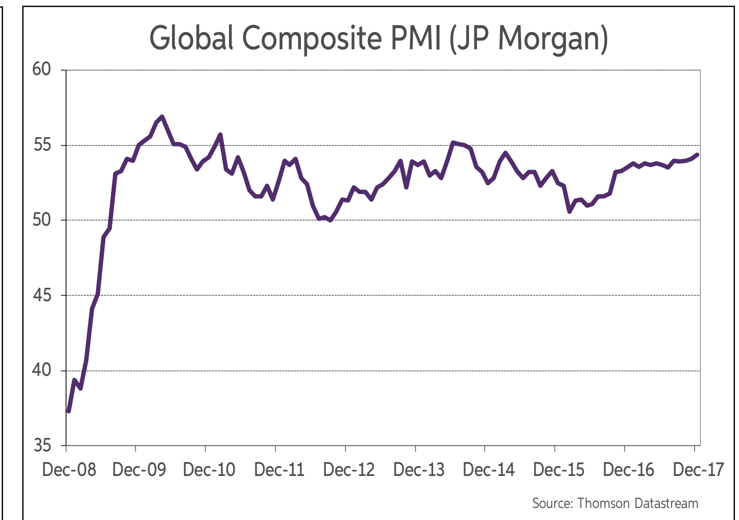
It would seem that the combination of continuing very loose monetary policies and a more supportive stance to fiscal policy is at last triggering stronger economic growth. Activity is also being aided by good employment growth and very low inflation, which is boosting real incomes and spending power. Credit growth has started to improve in many economies. The pick-up in world trade is an important factor also. Meanwhile, oil prices have been on the rise since mid-2017 on the back of a pick-up in demand, as economic growth strengthens.

Central banks across the globe have been indicating that monetary policy can remain accommodative despite the stronger growth because of the persistence of very low inflation. This should help sustain the upturn in economic activity. The one exception to the generally improving picture is the UK. Activity slowed there last year, as high inflation dampened consumer spending, with uncertainty over Brexit weighing on investment. Meanwhile, there is little sign yet that the traded sector in the UK is benefitting from sterling's sharp fall and improving global activity.

Data have generally been coming in ahead of expectations recently, most notably in the Eurozone and emerging economies. Indeed, the Eurozone has become the fastest growing economic region in the developed world. GDP rose by 2.5% in year-on-year terms in Q3, ahead of the US, UK and Japan. Survey data for the Eurozone have been particularly strong in Q4. The composite PMI hit its highest level in nearly seven years in December, with the manufacturing PMI reaching its best level in over two decades. The December EC Economic Sentiment index hit its highest level since 2000. Thus, the Eurozone economy is entering 2018 with considerable momentum.

Meanwhile, the US posted back-to-back quarterly growth rates of over 3% in Q2 and Q3 for the first time since 2014. Indicators point to good growth in Q4 as well, with strong retail sales and employment figures. Fiscal policy is being loosened in 2018/19 which should support growth further. In Japan, the economy has grown for seven consecutive quarters for the first time since 2001. These trends have seen the IMF revise up its growth forecasts for the world economy. It now puts global growth at 3.6% in 2017, up from 3.2% in 2016 and is forecasting growth of 3.7% in 2018. The OECD forecasts are similar, with an acceleration in growth in both developed and emerging economies. It sees the upswing being sustained in 2019, with the world economy forecast to grow by 3.6%.

Despite the pick-up in global growth, inflation in advanced economies remains subdued and below targets, while it is declining in some emerging economies. Headline inflation rates will be boosted somewhat by the recent rise in oil prices, but underlying inflationary pressures are expected to remain subdued. Sluggish wage growth is a key factor in keeping inflation at low levels. The OECD is forecasting that inflation will average 2.1% in advanced economies in 2018, up from 1.9% in 2017, largely due to higher oil prices.



GDP (Vol % Change)

	2016	2017 (e)	2018 (f)	2019 (f)
World	3.1	3.6	3.7	3.6
Advanced Economies	1.8	2.4	2.4	2.1
US	1.5	2.2	2.5	2.1
Eurozone	1.8	2.4	2.1	1.9
UK	1.8	1.5	1.2	1.1
Japan	1.0	1.5	1.2	1.0
Emerging Economies	4.1	4.6	4.9	4.8
China	6.7	6.8	6.6	6.4
India	7.1	6.7	7.0	7.4
World Trade Growth (%)	2.6	4.8	4.1	4.0
Advanced Economies Inflation PCE (%)	1.1	1.9	2.1	2.2

Source: OECD Economic Outlook, November 2017

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Interest Rate Outlook

Central banks gradually removing monetary stimulus, but policy to remain loose

The long period of global monetary easing is coming to an end. The US Federal Reserve has embarked on a path towards policy normalisation, while rates were also hiked in Canada, the Czech Republic and UK last year. The ECB reduced the size of its monthly asset purchases at the start of this year, while even the Bank of Japan is to taper QE ever so slightly, after announcing that it is going to trim purchases of long dated bonds.

Nonetheless, monetary policy is expected to remain very loose in all the major economies over the next couple of years. Continuing low inflation has led markets to believe that only limited policy tightening is likely in 2018/19, despite the strengthening of global economic activity. This has seen bond yields remain quite low in most markets, while many stock markets rising to either multi-year highs, or hitting new historic peaks.

In the UK, inflation picked up following the sharp decline in sterling, with headline CPI inflation rising above 3%. The BoE had indicated that there were limits to the extent to which above-target inflation could be tolerated. It followed through on this warning at the November MPC meeting, which voted to reverse the 25bps rate cut made in 2016 and bring the bank rate back up to 0.5%. It was the first UK rate hike since 2007. We do not expect a further change in UK rates in the very near term. Markets are looking for UK rates to be hiked again at the end of 2018, with another 25bps hike priced in for end 2019. This would seem to be broadly in line with BoE guidance that further modest but limited rate hikes will be needed over the next number of years.

The ECB scaled back asset purchases under its QE programme at the start of 2018. Monthly purchases have been reduced from €60bn to €30bn, with the ECB indicating that it will maintain purchases at this lower level until at least September 2018. It has said that it could increase the size of monthly purchases again if necessary, but markets are of the view that the ECB will cease net asset purchases altogether in either September or December.

The ECB has reaffirmed that it intends to keep interest rates at their current very low levels well past the time horizon of its QE programme. The ECB deposit rate is currently –0.4%. It is likely to be 2019 before rates are increased, given this policy guidance from the Central Bank. Futures contracts show little change in wholesale rates for most of 2018, until they start to move higher near the end of the year. Three month money rates are expected to turn positive in H2 2019. However, Eurozone rates are expected to remain very low for a long period of time after that, with futures contracts suggesting that three month rates will not reach 1% until H2 2022.

Meanwhile, the Fed hiked rates by 25bps at its December meeting, the fourth such hike since December 2016, taking rates up to 1.375%. The Fed also started the process last autumn of slowly reducing the size of its balance sheet, or unwinding QE, by no longer reinvesting funds from some of its bonds as they mature.

The FOMC in December reaffirmed that it expects to hike rates by 25bps on three occasions again this year, bringing them up to 2.125% by end 2018. It expects rates to rise to 2.75% by end 2019 and reach 3.1% in 2020. Markets expectations on rates have hardened in recent months, but they still see them rising by less than the Fed. Futures contracts see the funds rate rising to 2% in 2018, which is quite similar to the Fed. However, markets look for just one further 25bps hike after that, taking rates up to 2.25% in 2020, well below Fed projections. Inflation could be a key factor in whether the Fed raises rates to circa 3%. Some FOMC members have indicated that continuing below target inflation could mean that rates would not need to rise as much as projected by the Fed.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.375	1.73	2.20	2.18	2.37
Mar '18	1.625	1.95	2.35	2.35	2.50
June '18	1.875	2.15	2.50	2.50	2.65
Sept '18	1.875	2.20	2.60	2.60	2.75

** 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	-0.38	-0.25	-0.13	0.38
Mar '18	-0.40	-0.36	-0.22	-0.10	0.45
June '18	-0.40	-0.34	-0.16	-0.05	0.50
Sept '18	-0.40	-0.30	-0.10	0.00	0.55

** 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	0.52	0.77	0.84	1.14
Mar '18	0.50	0.55	0.80	0.90	1.20
June '18	0.50	0.58	0.85	0.95	1.25
Sept '18	0.50	0.65	0.95	1.05	1.35

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Dollar comes under renewed pressure in early 2018

A key development in forex markets over the past year has been the strengthening of the euro and weakening of the dollar. This trend has remained evident in the early part of 2018, with the EUR/USD rate climbing to a three year high above the $1.22 level. The euro made impressive gains against the dollar over the opening three quarters of 2017, climbing from $1.04 to above $1.20, despite further Fed rate hikes. The euro's rally, though, ran out of steam in the final months of the year, with the single currency remaining very range bound against the dollar in a narrow $1.16-1.20 corridor, before its uptrend resumed again recently.

It is important to remember that the dollar lost ground against a broad range of currencies last year and not just the euro. Over the summer, the Aussie, NZ and Canadian dollars rose to their highest levels in over two years against the US currency. Even the Chinese yuan, which declined steadily against the dollar over the 2014-16 period, appreciated against the greenback, while sterling rose to above $1.35 from $1.22 earlier in the year.

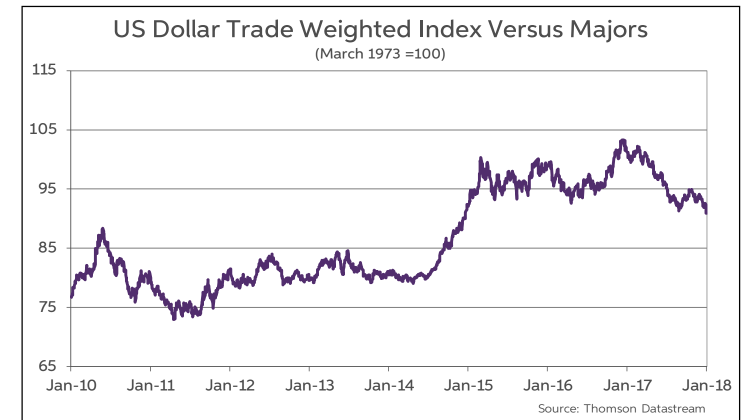
The dollar, though, stabilised and, indeed, gained some ground over the closing months 2017, as the Fed prepared to hike rates again and President Trump succeeded in getting major tax cuts through Congress. However, it has come under renewed downward pressure against a range of currencies since Christmas.

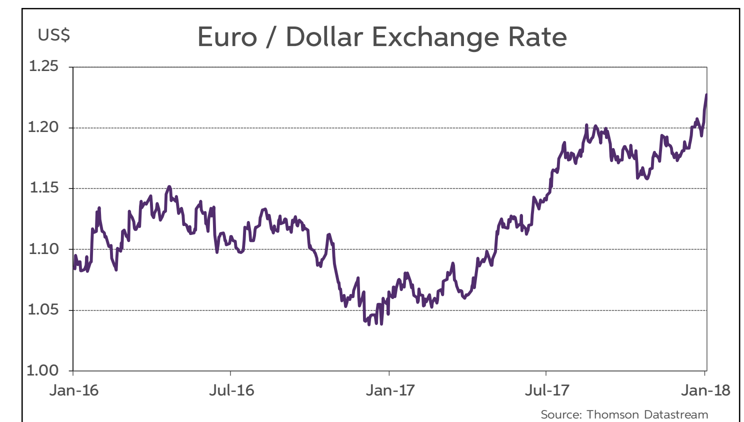
It is hard to pinpoint the precise factors behind the latest phase of dollar weakness. A rally in commodity prices - notably oil, improving data outside the US, concerns that China may not continue buying US Treasuries, doubts about the extent of further Fed tightening and a scaling back of QE in the Eurozone and Japan have all been cited as reasons behind the latest bout of dollar weakness. The dollar has also proved immune to good economic data out of the US, in a clear sign that it is out of favour with markets at present.

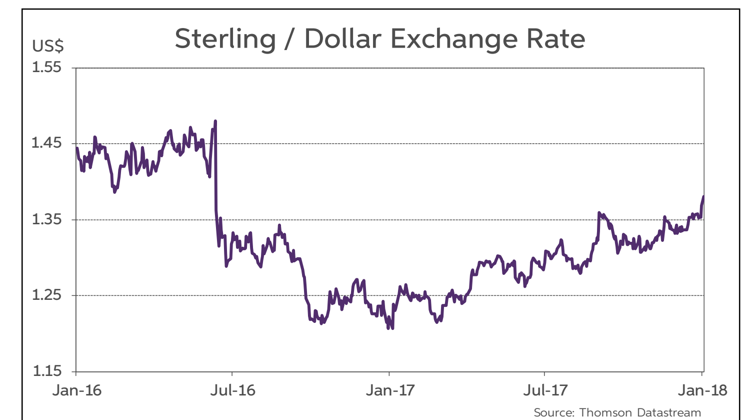
Traders need to be wary, though, as recent changes to corporate tax rates in the US could spark dollar buying, should American companies start to bring back cash from overseas to take advantage of a special low tax rate on repatriated profits. It is hard to put a figure on the size and timing of such flows, but they should benefit the US currency as companies will need to convert funds held in other currencies into dollars to repatriate them. The US currency fell sharply over the 2002-2008 period, except for in 2005, when a similar corporation tax amnesty that year led to a temporary but marked rise by the dollar.

Market positioning is also quite short dollar and long euro at the present time, which could limit the upside for EUR/USD. Thus, we could be in for some volatility in forex markets in the months ahead, with investors inclined to take the US currency lower, but significant dollar buying on repatriation flows also quite possible. The $1.21 resistance level has been overcome by the euro, opening the door for further gains. However, if we are correct in our expectation that the US tax amnesty on overseas profits will see inflows into the dollar as corporates move to repatriate funds, then we can expect to see periods of dollar strength during the year. This could see EUR/USD move back below the $1.20 level, and perhaps fall to as low as $1.16 if the inflows are significant.

Longer term, it is important to note that the euro is still at a relatively low level against the dollar. EUR/USD mainly traded in a $1.20-1.50 range from 2003 to 2015. Thus, any gains by the dollar against the single currency this year are likely to prove temporary. We think that 2017 marked the start of a long-term uptrend by the euro against the dollar, supported by an improving Eurozone economy and large current account surplus.







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Forex Market Outlook

Progress on Brexit talks setting the tone for sterling

Sterling fell sharply in the last two years on concerns over Brexit. The currency hit 30-year lows against the dollar, falling from $1.50 before the referendum vote to as low as $1.20 in late 2016. Brexit concerns 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.

However, sterling has managed to move off its lows and regain some ground. It recovered some losses against the weakening dollar last year, moving back over the $1.30 level during the summer and finishing the year at above $1.35. Sterling also recovered some ground against the euro in the closing months of 2017, helped by an unexpected rate hike from the Bank of England, some better UK economic data and hopes that agreement can be reached on a soft Brexit when the UK departs from the EU in March 2019. This has seen EUR/GBP move down to trade in a narrow 87.5-90.0p range since September.

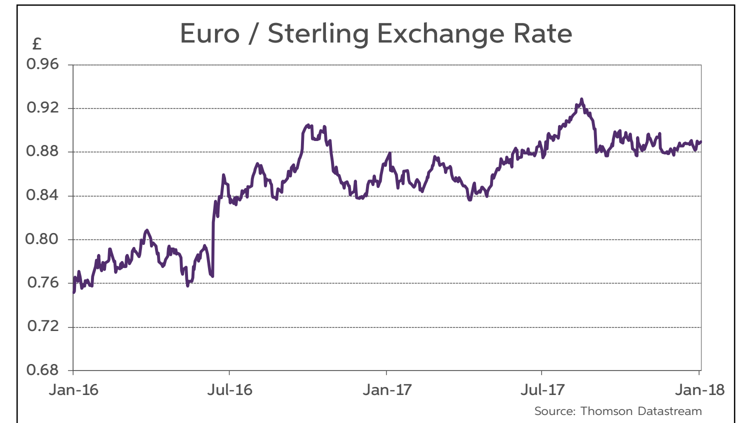
The progress of the Brexit negotiations is likely to be the key factor influencing sterling in the period ahead. The first stage of the talks proved difficult and slow, but EU Leaders were able to agree at their December summit that sufficient progress had been made to allow the discussions to move on in 2018 to the more substantive issues of transition arrangements and future trade relations.

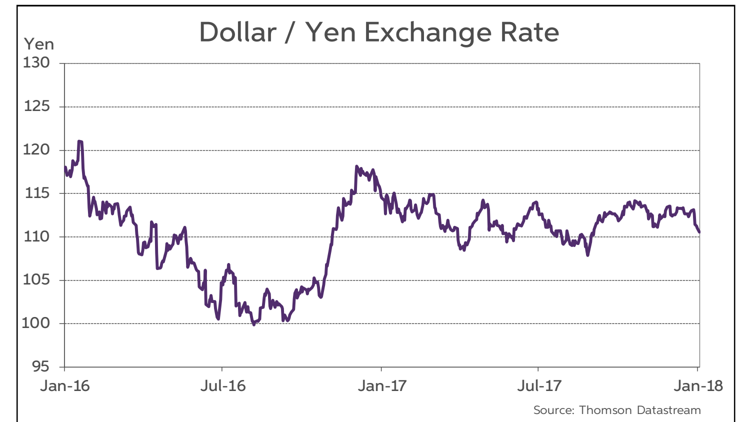
There are hopes the outcome of the talks will be a soft Brexit and that transition arrangements can be agreed in the coming months, which allow for continuing free trade between the UK and EU for a period after it leaves the EU in March 2019. Both the EU and UK see the need for a transition period. The UK Government has suggested that the UK and EU could form a Customs Union in the transition phase, with the current customs border trading arrangements remaining in place during this period. It is hoped that a full trade deal can then be negotiated in the next couple of years that will come into effect once the transition period ends, most likely in 2021.

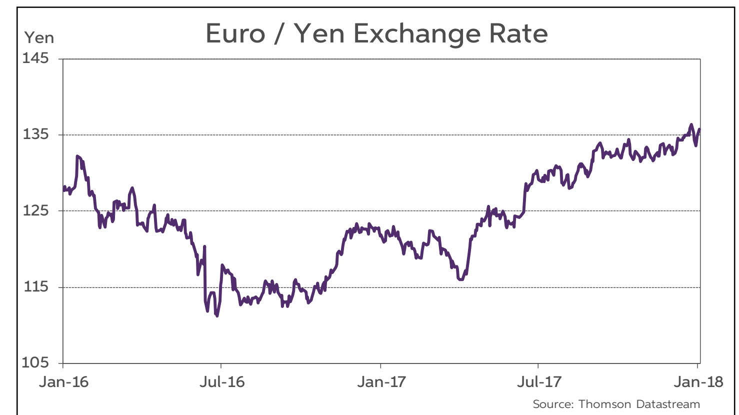
Nonetheless, given the uncertain political backdrop in the UK and its desire to regain full sovereignty, there is still a risk of a hard Brexit, where the UK is unable to conclude a trade deal with the EU. This would see the UK lose its free access to the Single Market and have to fall back on WTO rules. A hard Brexit would be very negative for the UK economy and see further falls in sterling.

Overall then, sterling could continue to trade in the 87.5-90p range it has occupied vs the euro since September, until markets get clearer signals on the outcome of the Brexit talks. It is hoped that an agreement on a transition phase can be reached by March, but deadlines have already being missed in these negotiations. Beyond that, if it appears that a soft Brexit is still on the cards, with progress being made on the talks on trade, then sterling could regain some further ground, with the euro moving down to 85p or below and cable rising to $1.40 or above.

On the other hand, if a hard Brexit looks increasingly likely, then the euro can be expected to move up to the 95p level. Indeed, it could rise even higher to trade in a 95p-100p range as a hard Brexit approached in March 2019, with cable falling back towards $1.20. There is still considerable uncertainty about what the future trade relationship between the UK and EU will look like, with plenty of scope for much disagreement. Thus, while a soft Brexit seems the most likely outcome of the current negotiations, a hard Brexit cannot be completely ruled out.







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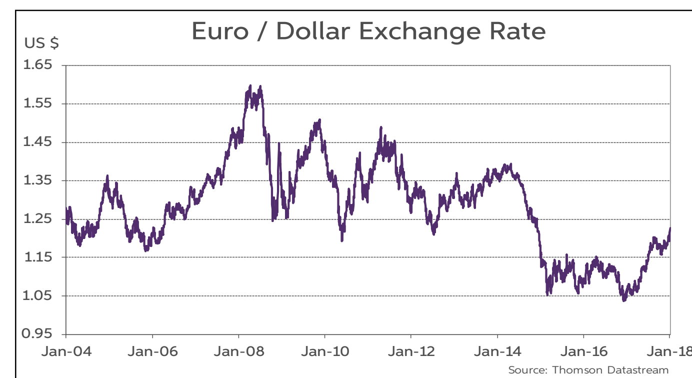
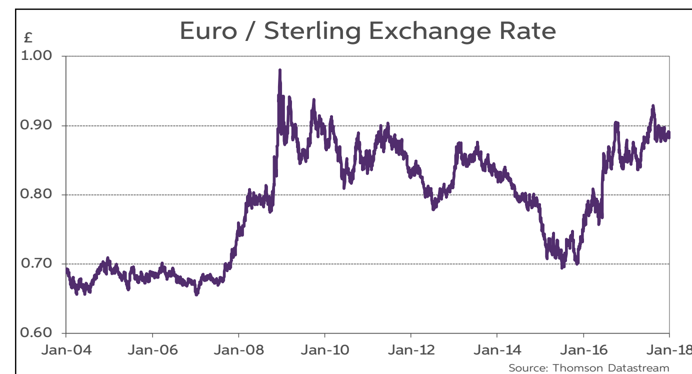
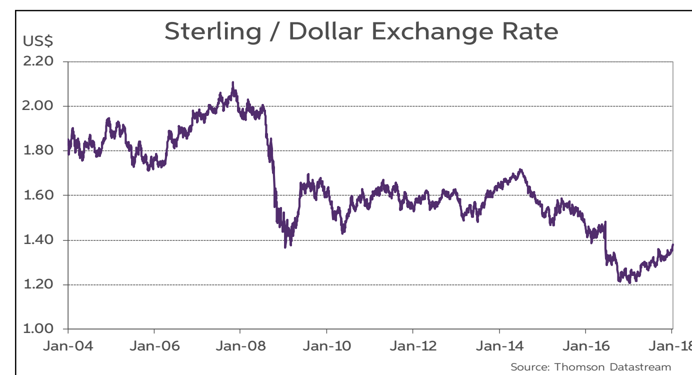
Summary of Exchange Rate Forecasts

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

	Current	Q1-2018	Q2-2018	Q3-2018	Q4-2018
Euro Versus					
USD	1.222	1.19-1.25	1.16-1.22	1.14-1.20	1.17-1.23
GBP	0.889	0.86-0.92	0.85-0.91	0.84-0.90	0.83-0.89
JPY	135.18	132-138	131-137	132-138	131-137
CHF	1.18	1.18	1.19	1.20	1.20
US Dollar Versus					
JPY	110.59	108-114	110-116	112-118	109-115
GBP	1.375	1.34-1.40	1.32-1.38	1.32-1.38	1.37-1.43
CAD	1.24	1.25	1.27	1.29	1.26
AUD	0.79	0.79	0.78	0.77	0.79
NZD	0.73	0.72	0.71	0.70	0.72
CNY	6.44	6.45	6.55	6.65	6.50
Sterling Versus					
JPY	152	152	153	155	157
CAD	1.71	1.71	1.72	1.73	1.76
AUD	1.73	1.73	1.73	1.75	1.77
NZD	1.89	1.90	1.90	1.93	1.94







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