Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- The world economy has lost momentum, with all the major economies slowing except the US
- Global growth forecasts cut significantly, especially for Europe, while US economy expected to slow in next couple of years. Risks seen as tilted to the downside
- Fed turns cautious on policy as it indicates that rates could move in either direction. BoE on hold as economy weakens on Brexit concerns. ECB indicates that rates on hold until next year
- Dollar remains underpinned by relatively high US rates, even though the Fed is now on hold. Other currencies finding it hard to make ground vs. dollar as their rates are set to stay very low
- Sterling gains some ground on expectations that a no-deal hard Brexit will be avoided. Even with an orderly Brexit, difficult trade talks still ahead which are likely to limit upside for the currency

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Global Economic Outlook

GDP forecasts cut sharply as world economy moves on to slower growth path

Both the OECD and IMF have again lowered their growth forecasts for the world economy in recent months, as economic data continue to disappoint in early 2019. In mid-2018, the expectation was that the world economy would grow by close to 4% this year. The latest OECD forecasts, which were released earlier this month, now project that the global economy will expand by a below trend 3.3% in 2019 and 3.4% in 2020.

Furthermore, the OECD warns that downside risks are continuing to build for the world economy. It notes that growth in global trade has slowed sharply, with escalating trade tensions having adverse effects on confidence, investment activity and financial markets. Notably, the Chinese economy has lost momentum, with the imposition of tariffs on many of its exports to the US adding to the headwinds it faces. More generally, manufacturing activity has lost considerable momentum in all economies since last summer. The global manufacturing PMI fell to a near three year low in February, amid declining export orders and sluggishness in international trade.

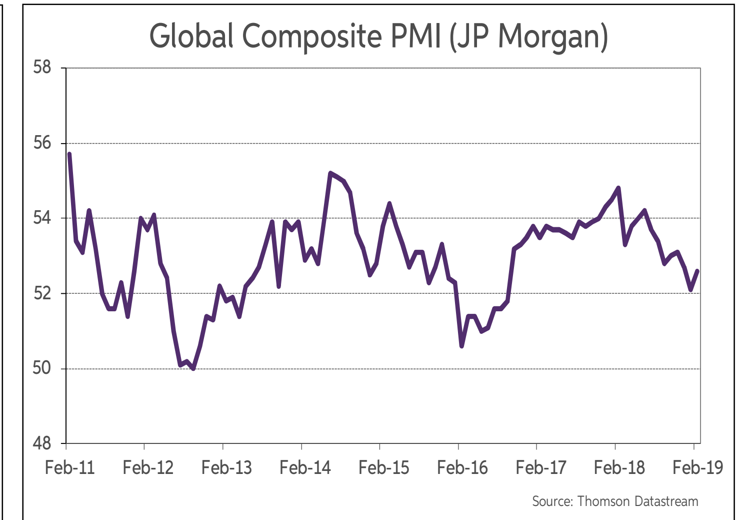
The OECD, European Commission, Bank of England and ECB have all recently scaled back considerably their growth forecasts for European economies as a result of weaker than expected data. The OECD cut its 2019 and 2020 growth forecasts for the Eurozone to 1% and 1.2%, respectively, from 1.8% and 1.6%. The UK forecasts were cut to 0.8% and 0.9% from 1.4% and 1.1% for 2019 and 2020, respectively. Meanwhile, there are concerns that growth in the strongly performing US economy could slow quite sharply in the next couple of years, as the fiscal stimulus fades and higher interest rates start to impact on activity.

It is concerning that the JP Morgan Global Composite PMI, a good gauge of global economic activity, fell to 52.1 in January, its lowest level since September 2016 and well below its recent peak of 54.8 reached a year ago. The index readings for European economies were particularly weak. The Global PMI staged a modest recovery in February, rising to 52.6 on stronger activity in the services sector, but manufacturing continued to weaken.

Risks remain to the economic outlook. Both the IMF and OECD have warned that the continuing easy monetary conditions could result in a further build-up of vulnerabilities in financial markets. This can lead to volatile trading conditions, as we saw last year. Debt levels also remain high in many countries leaving then susceptible to shocks. We have already seen countries with high debt levels, such as Turkey and Argentina, enter recession. Concerns about the health of the Chinese economy could also trigger abrupt sell-offs in financial markets, especially if its economy slows more sharply than expected. This would have broad impacts on the global economy and trade.

However, the general expectation is that despite the numerous downside risks, the global economy should regain some momentum as this year progresses. Monetary policy is set to remain accommodative globally, which will help aid growth. Fiscal policy will remain supportive of growth in most economies. Household spending power will be boosted by the recent declines in headline inflation and a pick-up in wage growth. A resolution to some of the factors that have been weighing on activity in various economies in recent times, such as Brexit, new fuel emissions standards in Germany and the US-China trade dispute, should also help the world economy regain strength.

However, a close eye will need to be kept on the data in the coming months, especially the key survey indicators, to assess the trends in the global economy, notably in the under-pressure manufacturing sector.



GDP (Vol % Change)

	2017	2018(e)	2019 (f)	2020 (f)
World	3.8	3.7	3.5	3.6
Advanced Economies	2.4	2.3	2.0	1.7
US	2.2	2.9	2.5	1.8
Eurozone	2.4	1.8	1.6	1.7
UK	1.8	1.4	1.5	1.6
Japan	1.9	0.9	1.1	0.5
Emerging Economies	4.7	4.6	4.5	4.9
China	6.9	6.6	6.2	6.2
India	6.7	7.3	7.5	7.7
World Trade Growth (%)	5.3	4.0	4.0	4.0
Advanced Economies CPI Inflation (%)	1.7	2.0	1.7	2.0

Source: IMF World Economic Update, January 2019

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Interest Rate Outlook

Central banks turn very cautious about tightening policy

Central banks have turned very cautious about tightening monetary policy as concerns mount about the growth prospects for the world economy. The persistence of very subdued inflation gives central banks the latitude to be patient about rate tightening, thereby maintaining very loose monetary conditions for an even longer period of time. Markets now see rates remaining on hold virtually everywhere this year, with the balance of risk leaning towards an easing of policy rather than a tightening - the Bank of India cut rates last month.

In the US, the Fed performed quite a summersault on the outlook for interest rates at the January FOMC meeting. Despite very robust payrolls data for January and December, the Fed appears to have dropped its tightening bias, saying rates could now move in either direction. It had indicated at its December meeting that two further rate hikes were likely in 2019, with an additional hike probable in 2020. Thus, the January meeting represented quite a sea-change in the Fed's view in the absence of any clear signs that the US economy is starting to lose momentum.

The Fed, though, has now moved into line with the market, which thinks that rates have peaked in the US. With Q1 GDP growth likely to be weak in the US owing to the government shutdown, severe weather and the usual seasonal adjustment problems, Fed policy is likely to remain on hold over the coming months. However, it is still too early to call the peak in US rates, given the strength in the economy, loose macro policies still in place and the upward pressure on wages in the tight labour market. We still think the Fed could hike rates later this year. The market, on the other hand, has moved to fully price in a rate cut by spring 2021.

In the UK, markets have also lowered their expectations for rate hikes. They now believe that the next BoE rate hike will not occur until September 2020, taking rates up to 1%, with a further hike not anticipated until mid 2022. Previously, they had expected rates to rise to 1.5% in the next couple of years.

BoE policy is likely to stay on hold in the coming months given the economy has slowed considerably under the weight of uncertainty around Brexit. However, the latest BoE Inflation Report suggests that rates may need to rise by 50bps by end 2020 to meet its inflation target. Thus, in the event of a soft Brexit, we think the BoE could tighten policy by more than markets expect, starting with a rate hike later this year. Indeed, the BoE Governor has observed that the market rate path may not be firm enough. On the other hand, if a no-deal hard Brexit materialises, then rates could be cut this year, given the negative impact this would have on the UK economy.

Turning to the ECB, it ceased net asset purchases under its QE programme at the end of last year. However, it made announcements at its March meeting aimed at maintaining very accommodative monetary conditions for some time to come. It is now guiding that it intends to keep interest rates at their current very low levels until at least the end of this year, as opposed to the end of the summer previously. It also announced that it would launch a third round of long-term liquidity measures, a new TLTROs starting in September 2019 and ending in March 2021, with a maturity of two years.

It all confirms that interest rates are set to remain very low for a very long time in the Eurozone. The ECB deposit rate is at -0.4%, resulting in negative interbank rates, with swap rates also negative out to four years. Three month rates are now seen as rising by just 15bps by end 2020 and not turning positive until September 2021. Rates are expected to still be comfortably below 1% by end 2024. No wonder ten year German bund yields are below 0.1%.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	2.375	2.61	2.86	2.56	2.48
Mar '19	2.375	2.60	2.85	2.55	2.50
Jun '19	2.375	2.65	2.90	2.60	2.60
Sept '19	2.625	2.90	3.15	2.90	2.90

** Swap Forecasts Beyond 1 Year. Current Rates Sourced From Reuters, Forecasts AIB ERU*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	-0.40	-0.33	-0.18	-0.18	0.09
Mar '19	-0.40	-0.33	-0.18	-0.15	0.10
Jun '19	-0.40	-0.33	-0.17	-0.14	0.12
Sept '19	-0.40	-0.32	-0.15	-0.10	0.20

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.75	0.84	1.11	1.09	1.26
Mar '19	0.75	0.85	1.12	1.10	1.27
Jun '19	0.75	0.85	1.15	1.15	1.32
Sept '19	0.75	0.90	1.20	1.20	1.40

** Swap Forecasts Beyond 1 Year*

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Forex Market Outlook

Dollar underpinned by favourable interest rate differentials

The US dollar remains at high levels against a broad range of currencies. After losing ground in 2017 and early 2018, the dollar recovered strongly from last spring. This saw the EUR/USD rate fall back appreciably from a high of $1.25 in early 2018 to largely trade in a $1.12-1.15 range since October. Meanwhile, cable declined from above $1.40 to around $1.30. The yen has also lost ground against the dollar over the past year, although it has benefitted at times from safe-haven flows.

The dollar has been aided by continuing strong US economic data at a time when other economies have lost momentum. Most large economies have seen downgrades to their economic forecasts, apart from the US. Widening interest rate differentials and bond spreads also helped the currency as the Fed continued to steadily tighten policy during 2018, raising the fed funds rates by 100bps in total to a 2.25-2.5% range by end year.

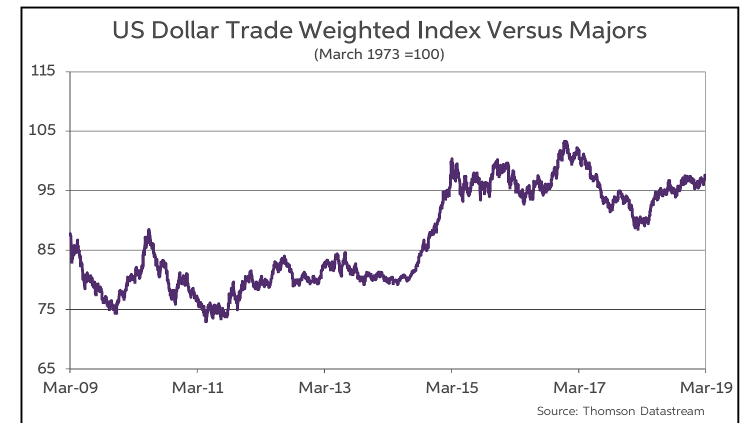
Spells of risk aversion in financial markets have also been supportive of the highly liquid US currency. Escalating tensions over global trade, difficulties in emerging markets and geopolitical concerns have all sparked flights-to-quality episodes in to safe-haven currencies like the dollar, yen and Swiss franc. The dollar also benefitted from a big jump in the repatriation of funds by US companies last year to take advantage of cuts in US corporate taxes.

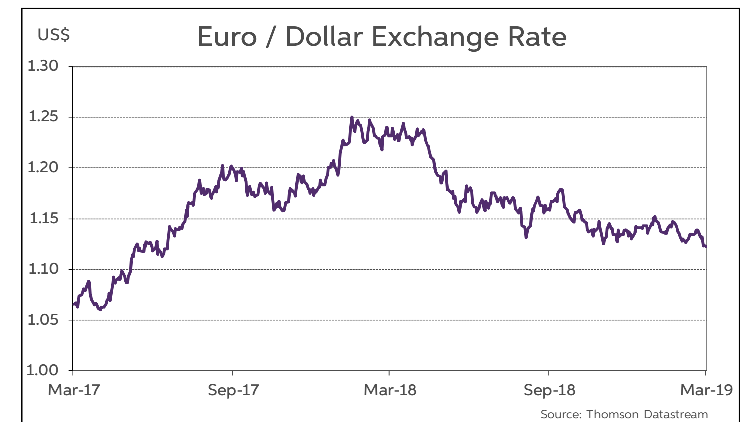
However, the US currency has found it harder to make further gains since the autumn. This may be partly due to the fact that FX positioning has become very long the dollar. Furthermore, the dollar is now at quite elevated levels against a range of currencies, which may be limiting further upside potential. The US economy is also expected to slow in the coming year, while the Fed has turned much more cautious about further rate increases. Indeed, the market has come to the view that US rates have peaked and the next move in rates could be a cut.

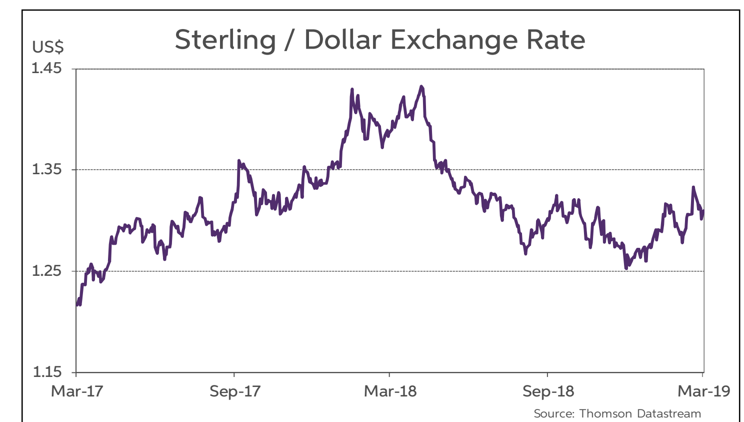
However, the relative strength of the US economy, wide interest rate differentials and geopolitical uncertainties all remain supportive of the US currency. Indeed, we think that US rates could be increased somewhat further later in 2019. Meanwhile, political uncertainty in the EU, a general rise in euro-scepticism especially in the context of the upcoming European Parliament elections, the slowdown in the Eurozone economy and continuing very low ECB interest rates are all headwinds for the single currency. Nonetheless, the euro has been quite range bound against the dollar since the autumn, although it has been testing the lower side of its $1.12-1.15 trading band recently. There is strong technical support for the euro versus the dollar in the $1.10-1.12 area.

While relatively high interest rates should help underpin the US currency, there are factors that could cause the dollar to lose some ground this year. The rising US twin deficits (fiscal and BoP) could start to weigh on the exchange rate. The marked jump in the repatriation of funds following the cuts in US corporate taxes last year is likely to abate, lessening demand for the currency. The US economy is also likely to slow in 2019. A US-China trade deal is also expected to be agreed this spring, which should improve risk appetite in markets.

The persistence of very low interest rates elsewhere, though, is making it difficult for other currencies to make any ground against the dollar. The euro remains pinned down around $1.12-1.13. There would probably need to be a renewed pick-up in activity in Europe and elsewhere that would put monetary tightening on to the agenda in 2020 for currencies to start to make ground against the dollar. Such a pick-up in activity could occur later this year, which may see currencies start to make some ground against the dollar before the end of 2019.







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Forex Market Outlook

Sterling rises on optimism that a no-deal Brexit will be avoided

Sterling has moved off the lows of 93p against the euro and $1.20 versus the dollar that it hit following the UK referendum vote to leave the EU. It largely traded in an 87-91p range against the euro between September 2017 and end 2018, as markets awaited clarity on what shape Brexit would take. Growing hopes that a no-deal hard Brexit will be avoided have seen the euro fall back to around the 85-86p level in recent weeks. Against a weakening dollar, sterling rose to a post-referendum high of $1.43 last April. However, cable dropped back again when the dollar strengthened once more last year, declining to below the $1.30 level in Q4 2018. However, it has risen back above $1.30 again recently, on hopes that a no-deal Brexit will be avoided.

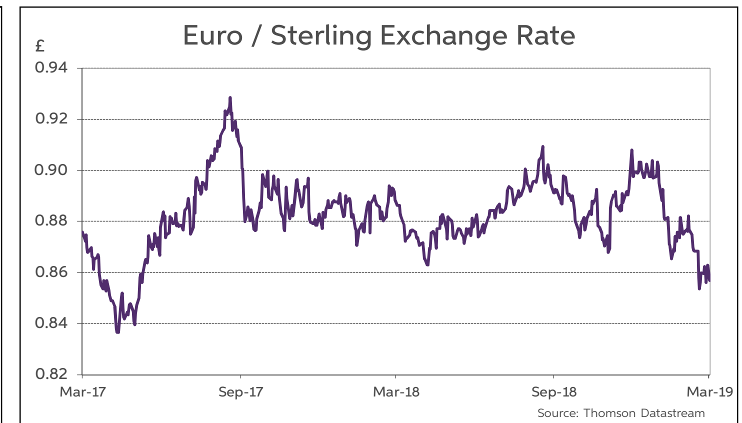
The Withdrawal Agreement (WA) reached between the EU and UK allows for a soft Brexit, as it includes a transition period to last until at least end 2020. This would keep the current trading arrangements in place over this time. The WA has been voted down twice in Parliament. However, Parliament has also voted against exiting the EU without a deal. Thus, there is a growing expectation that the WA could be ratified in a third vote, possibly ahead of the upcoming EU Heads of State Summit. The UK will need to seek a short extension to Article 50 to delay its EU departure, probably to end April or mid-May, to allow it time to pass the enabling legislation to give effect to the WA, if the deal is eventually passed by the Parliament. Such a short extension for this reason would almost certainly be granted by the EU.

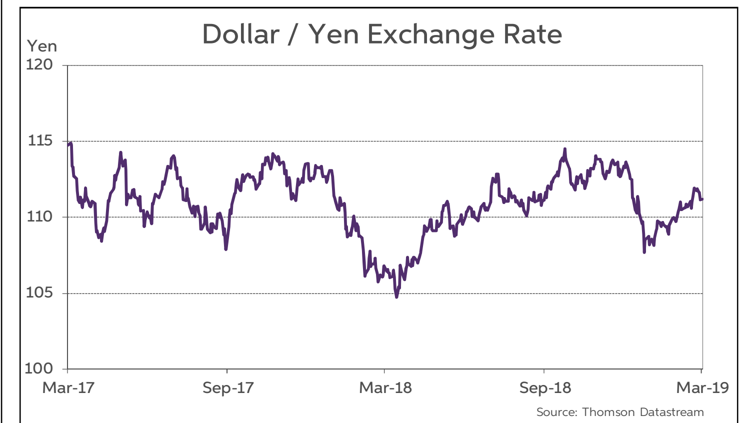
An extension beyond mid-May could require the UK to participate in the European Parliament elections being held on 23-26 May and so may be problematic. The EU, though, is only likely to grant a short extension if the WA is ratified by the UK Parliament. If the WA is not endorsed by Parliament, a much longer extension could be on the cards, casting doubts over the whole Brexit process.

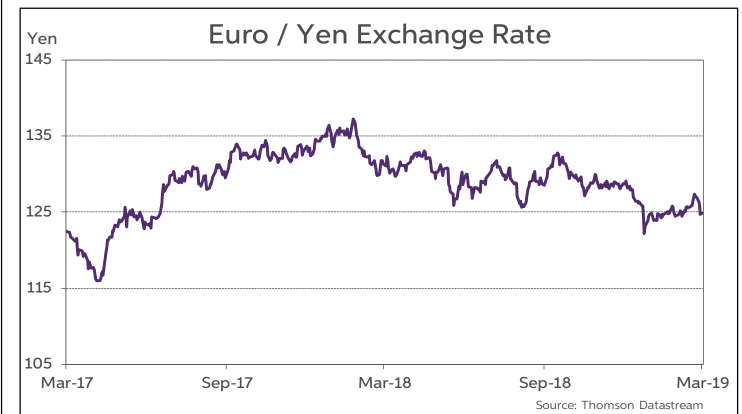
Even if the WA is ratified, there may still be choppy waters ahead for sterling. The WA provides for a transition period post Brexit that is to last until at least the end of 2020. During this period, the UK will still adhere to EU rules so that trade between the two can continue on as before, with no barriers. Talks will take place during the transition period on the future relationship between the UK and EU, with the aim of concluding a broad trade deal by end 2020. These are likely to prove difficult negotiations. It is very unclear what the outcome of these talks will be, so uncertainty over the final shape of Brexit will persist during the transition period.

What emerges from these talks may still look like a hard Brexit, if the UK persists with its desire to be out of a Customs Union with the EU, as well as the Single Market. Thus, the WA, if ratified, marks only the end of the beginning of the Brexit process. Uncertainty will persist during the transition period and Brexit could still have significant negative effects on both the UK and Irish economies, albeit in 2021 rather than in 2019. The uncertain outlook is likely to weigh on sterling in the next couple of years. Thus, we see limited upside potential for sterling from its recent level of 85-86p against the euro, even if the WA is ratified and it could start to drift lower if the talks run into difficulties.

Meanwhile, a hard Brexit is the default position if the UK cannot ratify the Agreement and Article 50 is not extended. Sterling would come under severe pressure in this scenario, given that a no-deal hard Brexit would have very negative consequences for the economy. The currency could fall by 10-15 per cent from current levels.







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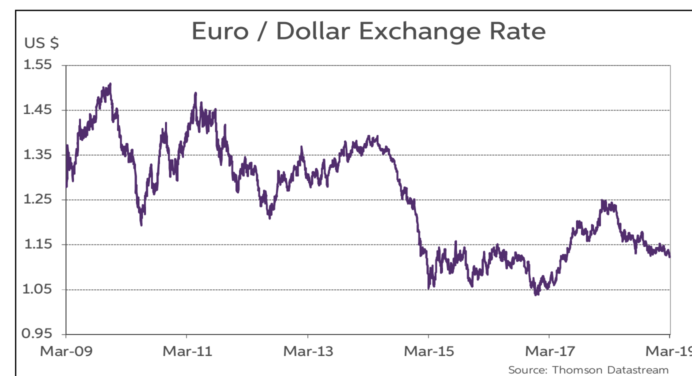
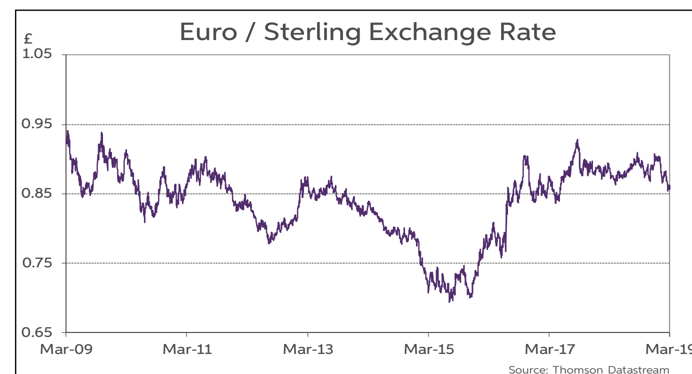
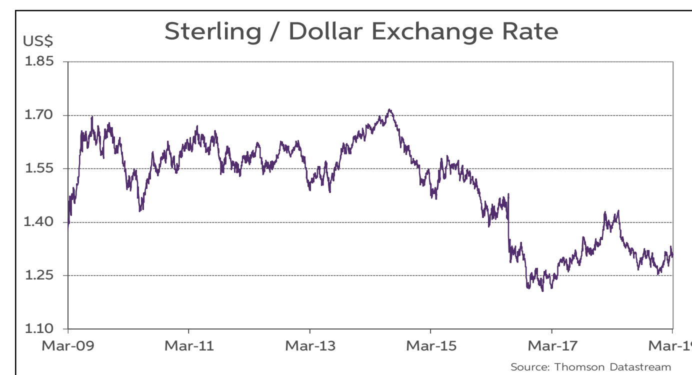
Summary of Exchange Rate Forecasts

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

	Current	Q1-2019	Q2-2019	Q3-2019	Q4-2019
Euro Versus					
USD	1.130	1.10-1.16	1.11-1.17	1.12-1.18	1.14-1.20
GBP	0.854	0.82-0.88	0.82-0.88	0.82-0.88	0.83-0.89
JPY	126.07	124-130	124-130	124-130	125-131
CHF	1.13	1.14	1.14	1.14	1.15
US Dollar Versus					
JPY	111.58	109-115	108-114	107-113	106-112
GBP	1.323	1.30-1.36	1.31-1.37	1.32-1.38	1.33-1.39
CAD	1.33	1.33	1.32	1.31	1.29
AUD	0.71	0.71	0.71	0.72	0.73
NZD	0.68	0.68	0.68	0.69	0.70
CNY	6.73	6.72	6.70	6.65	6.60
Sterling Versus					
JPY	148	149	149	149	148
CAD	1.76	1.77	1.77	1.77	1.76
AUD	1.88	1.87	1.89	1.88	1.86
NZD	1.94	1.96	1.97	1.96	1.94







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