Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

7th November 2019

- Global economy has lost considerable momentum in the past year, with manufacturing in recession as world trade and business investment weaken
- Central banks ease policy on growth concerns, but cautious about further loosening
- Fed pauses after lowering rates by 75bps since mid-year. Markets looking for more rate cuts. ECB reduces depo rate by 10bps and restarts QE. Little further easing expected. BoE on hold for now
- Dollar rally runs out of steam as Fed lowers rates and risk appetite improves in markets
- Sterling recovers ground as risk of no-deal Brexit recedes. Likely to range trade in run-up to the general election. Upside may be limited even with a clear-cut election result

Oliver Mangan
Chief Economist

John Fahey
Senior Economist

Conor Beakey
Economist

https://aib.ie/investorrelations/economic-research-unit

AIB

Global Economic Outlook

Synchronised slowdown in global economy

The OECD in its latest World Economic Outlook says the prospects for the global economy have become increasingly fragile and uncertain. It again reduced its growth forecasts for 2019 and 2020. Growth is now projected to slow from 3.6% in 2018 to 2.9% in 2019 and 3% in 2020. These would be the weakest annual growth rates since the financial crises. The IMF has cut its global growth forecast to 3% for this year and it does not foresee any strengthening of activity in advanced economies next year.

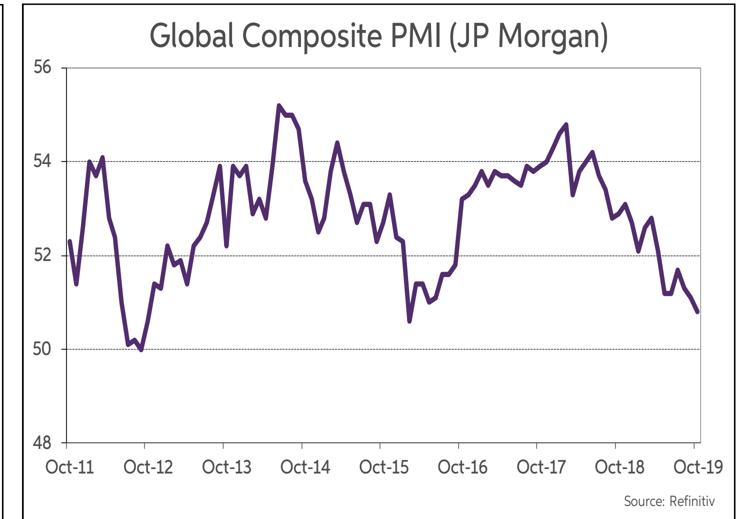
A key reason for the weak performance of the global economy is what the IMF calls the sharp and geographically broad-based slowdown in manufacturing and global trade, and associated softness in business investment and reduced consumer spending on 'big ticket' items such as cars. The IMF has interpreted these developments as an indication that both businesses and households are holding back on 'long range' spending amid heightened policy uncertainty, especially in relation to global trade with tariffs being increased in the past couple of years.

The slowdown in activity is widespread. GDP growth has weakened in all the major economies. The IMF is forecasting growth of 1.7% in advanced economies for both 2019 and 2020, down from close to 2.5% in the past couple of years. Notably, growth in the US has slowed in 2019 as the fiscal stimulus there fades. The OECD is forecasting that US growth will moderate to 2.4% this year and 2% in 2020, from 2.9% in 2018. Brexit uncertainty has weighed on activity in the UK, with GDP growth forecast at circa 1% for 2019 and 2020. Meanwhile, a sharp slowdown in manufacturing and exports has left the German economy close to recession. Growth in the Eurozone remained weak at 0.2% in Q3. Eurozone GDP is forecast by the OECD to grow by around 1% this year and next, down from 1.9% in 2018 and 2.4% in 2017.

Both the IMF and OECD see the risks to the economic outlook as being tilted to the downside. A real concern is that the ongoing weakness in manufacturing will spill over into the services sector and hit labour demand. This would see household incomes and consumer spending start to be impacted. Debt levels remain high in many countries, leaving them particularly vulnerable to shocks, especially some emerging economies. Meanwhile, concerns persist about the health of the Chinese economy, which could slow more sharply than expected. Rising global trade tensions have also added to the heightened policy uncertainty. Meantime, Brexit is still not fully resolved. A sharp correction in financial markets is a risk in this unstable environment.

The global slowdown, though, has generated a response from authorities. Monetary policy is turning even more accommodative globally, with numerous central banks cutting rates. In addition, the sharp fall in bond yields over the past year represents a significant easing in monetary conditions, while there has been a marked improvement in financial markets generally this year, which should aid growth. Fiscal policy is also becoming more supportive of growth in some economies. Meantime, household spending power is being boosted by a pick-up in wage growth at a time of continuing subdued inflation, while labour markets remain strong.

Considerable uncertainty still persists about the prospects for the global economy so a careful eye will need to be kept on the incoming data, especially business surveys. An easing in global trade tensions, in particular a resolution of the US-China trade war, would be a positive development for the manufacturing sector and improve the growth prospects for the world economy. On the other hand, it would be a real worry if the services sectors of economies lose further momentum, or we start to see signs of weakness appear in labour markets.



GDP (Vol % Change)

	2017	2018	2019 (f)	2020 (f)
World	3.8	3.6	2.9	3.0
Advanced Economies*	2.4	2.3	1.7	1.7
US	2.2	2.9	2.4	2.0
Eurozone	2.4	1.9	1.1	1.0
UK	1.8	1.4	1.0	0.9
Japan	1.9	0.8	1.0	0.6
Emerging Economies*	4.8	4.5	3.9	4.6
China*	6.8	6.6	6.1	5.8
India*	7.2	6.8	6.1	7.0
World Trade Growth* (%)	5.5	3.6	1.1	3.2
Advanced Economies Inflation (PCE %) *	1.7	2.0	1.5	1.8

Source: OECD Interim Economic Outlook, September 2019
** Sourced from IMF World Economic Outlook, October 2019*

Interest Rate Outlook

Markets scale back expectations on extent of further central bank easing

Monetary policy returned to easing mode this year in response to the slowdown in the global economy. This has been most clearly seen in the US, where the Fed has cut rates by 75bps since mid-year. Meanwhile, the ECB has also lowered rates and restarted its QE asset purchase programme. Other central banks, including in Australia, New Zealand, India and Thailand, have also cut interest rates this year, with policy being eased in China too. This represents quite a turnaround from a year ago when policy tightening was expected from central banks over the course of 2019-20. More recently, though, markets have scaled back their expectations on the likely extent of further easing by central banks, with the Fed and ECB putting policy back on hold for the moment.

The three 25bps Fed rate cuts since mid-year have taken the key funds rate down to 1.5-1.75% range. Markets are now pricing just one further full 25bps rate cut next year, with the funds rate expected to be lowered to around 1.3%. Not that long ago, the market had expected the Fed to lower rates all the way to 1%. Fed Chair Powell indicated after the latest rate cut, though, that the FOMC believes that the easing of policy to date should be sufficient to keep the economy on a steady growth path. Progress on US-China trade talks has also dampened rate cut hopes.

Interesting, in their last set of interest rate projections, not one member of the FOMC saw a need for rates to be cut below their current level of 1.625%. This suggests that the economy would need to continue weakening for the Fed to deliver the further cuts in rates anticipated by the market. Indeed, Fed Chair Powell has said as much, stating that it would require a material change to the Fed's economic outlook for it to resume cutting rates.

In the UK, the BoE has voiced concerns about the negative impact that ongoing Brexit uncertainty is having on the economy at a time of weakening global growth. Indeed, two MPC members voted for a rate cut at the November meeting. However, the outcome of the upcoming UK general election on December 12th could see a Parliament that is in a position to come to a decision on Brexit. The BoE may stay on hold in those circumstances. Another hung Parliament, though, may see the BoE move to cut rates before year end or in early 2020. Futures contracts have scaled back their expectations on BoE rate cuts in recent weeks as the risk of a no deal Brexit at end October abated and with polls suggesting the Conservatives may win an overall majority in the December election. Markets are no longer pricing in a full 25bps rate cut, even by end 2020

Turning to the ECB, it announced a broad package of easing measures in September, including a cut of 10bps in the deposit rate to –0.5% and the introduction of a two-tiered deposit rate structure, the restarting of open-ended asset purchases under its QE programme and easier liquidity terms for its long-term repos. It stated that the easing measures will remain in place until underlying inflation robustly converges with its 2% target. It has also indicated that rates could be lowered further, pointing to a continuing easing bias.

The minutes of the September meeting, though, showed significant opposition on the Governing Council to the easing package. Meanwhile, Mr Draghi's term as President of the ECB has also come to an end. As a result, markets have grown doubtful that the ECB will ease policy much further. They had been expecting that rates could be cut by another 20bps, bring the deposit rate down to –0.7%. Now, they are pricing in little more than a further 5bps cut in rates. However, markets still expect rates to remain negative for many years to come. Futures contracts point to three months rates not turning positive until end 2024.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.625	1.90	1.98	1.67	1.66
Dec '19	1.625	1.85	1.95	1.65	1.65
Mar '20	1.625	1.85	1.95	1.65	1.70
June'20	1.625	1.85	2.00	1.70	1.75

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	-0.50	-0.44	-0.29	-0.33	-0.19
Dec '19	-0.50	-0.45	-0.30	-0.35	-0.20
Mar '20	-0.50	-0.45	-0.30	-0.35	-0.20
June'20	-0.50	-0.45	-0.30	-0.30	-0.15

** 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	0.80	0.99	0.79	0.83
Dec '19	0.75	0.80	1.00	0.80	0.85
Mar '20	0.75	0.80	1.00	0.80	0.85
June'20	0.75	0.80	1.00	0.85	0.90

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Dollar finding if difficult to extend rally as US rates are cut

The dollar has been at elevated levels for the past five years. It has been aided by strong US economic growth. Indeed, the current economic expansion has now become the longest on record. As a result, the jobless rate has fallen to a near 50 year low of 3.6%. Widening interest rate differentials and bond spreads have also helped the US currency, with the Fed steadily tightening policy in 2017-18, raising the fed funds rate by 200bps to a 2.25-2.5% range by the end of last year.

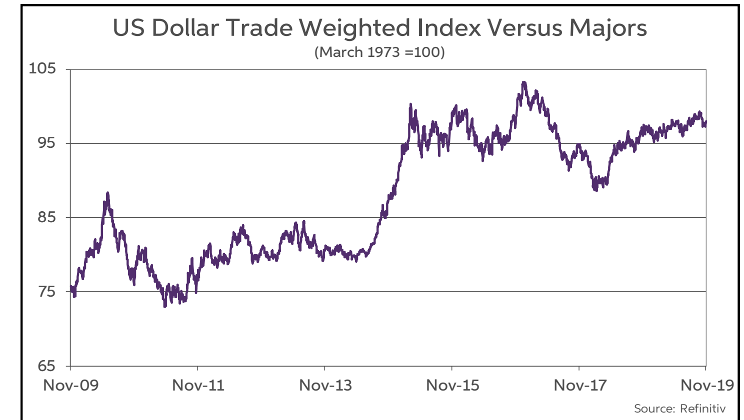
FX positioning, though, has become quite long the dollar, limiting the potential for further gains by the greenback recently, especially as it is already at quite high levels against many currencies. Some other factors have also started to act as headwinds for the dollar. The US economy has moved on to a slower growth path, with GDP growing at a moderate 2% rate in the last two quarters. The Fed has responded by lowering rates by 75bps since mid-year. Improved risk appetite in markets, helped by signs of progress in US-China trade talks, has also weighed on safe-haven currencies like the dollar. Not surprisingly then, the dollar has lost some 2% of its value on a trade-weighted basis since end September.

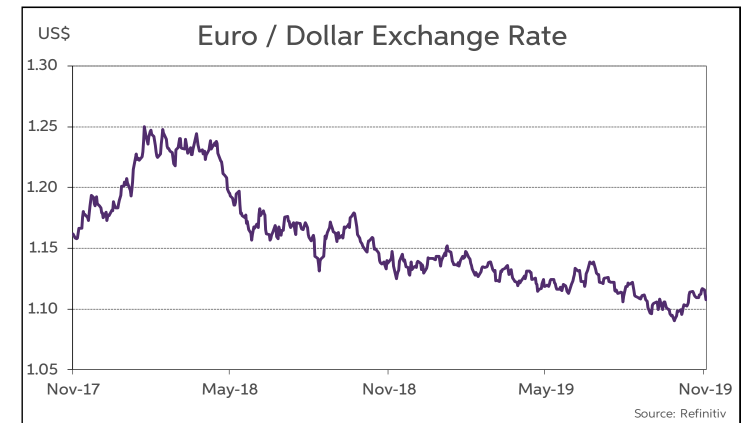
Nonetheless, the relative strength of the US economy and still wide interest rate differentials remain supportive of the US currency. The persistence elsewhere of very low or, indeed, in some cases, negative interest rates is also making it difficult for other currencies to make significant ground against the dollar. The marked slowdown in the Eurozone economy and significant policy easing by the ECB this autumn mean that the euro remains weighed down at relatively low levels against the dollar.

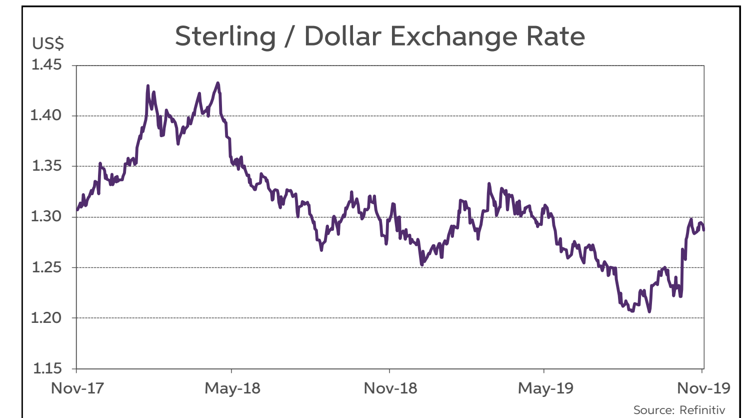
The euro largely traded in a tight $1.12-1.14 band in the first half of this year. It has edged lower to trade in a $1.09-1.12 range since mid-July. Strong technical support for the euro at around the $1.08-1.09 level held over the autumn. More recently, the euro has moved back up to around the $1.11 level from the low of $1.09 it hit at the end of September. It has been helped by a growing expectation that the ECB may not cut rates much further, if at all. Both the Fed and ECB have gone into pause mode after their recent policy easing moves. Thus, we would expect EUR/USD to continue to trade in narrow ranges in the coming months, with most of the action likely to be confined to a $1.09-1.13 band.

The dollar is only likely to weaken significantly if it becomes apparent that the US economy is heading towards recession and Fed rates have to be cut much further. It is worth noting that the EUR/USD rate has spent very little time above the $1.20 level ever since the ECB move to negative rates in 2014. Thus, it would probably take large rate cuts in the US to drive the euro above this level, especially given that the ECB would also be likely to ease policy even further in these circumstances and it is expected that money market rates will remain negative in the Eurozone until the middle of the coming decade.

One currency which has been able to keep pace with the strong dollar in recent years is the yen, despite negative Japanese interest rates. The currency has benefitted from spells of safe-haven buying, as well as Japan's large current account surplus. The dollar has largely traded is a ¥106-114 range since early 2017, which should continue to hold. The ¥105-106 range is a good support level for the dollar that is likely to prove to continue to be difficult for the yen to overcome, unless there are further large Fed rate cuts. The dollar could fall towards ¥100 in those circumstances, especially if financial markets come under pressure at the same time.







Forex Market Outlook

Any post-election sterling bounce may prove short-lived

Sterling has been very volatile this year, rising and falling in response to the ebb and flow of news on Brexit. It made big gains in mid-October on news that agreement had been reached on a revised Brexit deal. The euro has been trading at just above the 86p level against sterling since then, even though the deal has not been ratified by the UK Parliament. This resulted in another extension to Article 50 to avoid a no-deal hard Brexit at end October.

The calling of a general election in the UK has had little impact on the currency. The election is the next big risk event for sterling. Another hung Parliament, still deadlocked over Brexit, would likely see sterling come under pressure again, with the euro rising back above the 90p level. However, the opinion polls published in the past week show the Conservatives' vote moving up towards 40%, which would put them on course for a parliamentary majority. The most comparable recent election is 2015, when the Conservatives won a small outright majority with 37% of the vote.

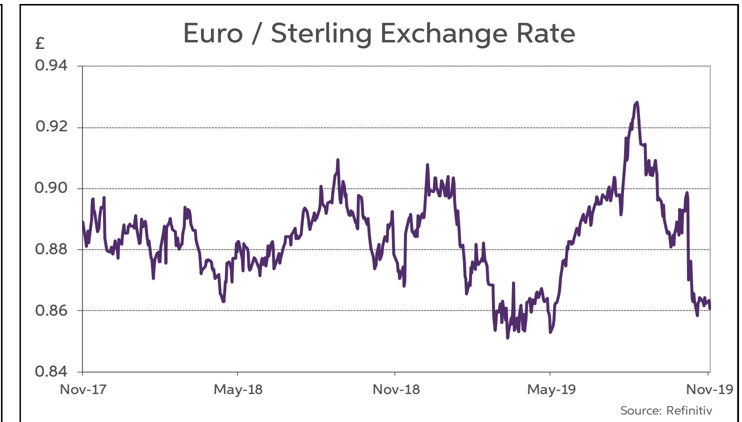
A clear Conservative win should pave the way for the UK to ratify the revised Withdrawal Agreement and leave the EU by 31 January next, when the latest Article 50 extension period expires. Sterling could be expected to make further gains in such circumstances, but they may prove limited and short lived.

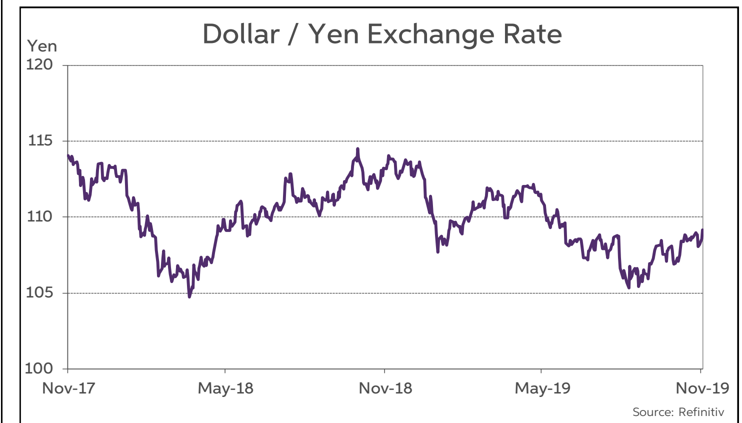
There is strong technical support for the euro at around the 84-85p level against sterling, which may be difficult to overcome. Furthermore, the revised Brexit deal is seen as being negative for the UK economy as it will be leaving the EU Customs Union and Single Market. There is also considerable uncertainty about what the future trading relationship between the UK and EU will look like, after the transition period expires at the end of next year. Thus, a Conservative win may only see the euro fall to around the 84p level. Meanwhile, sterling could rise from near $1.30 at present against the dollar towards $1.35, helped also by some strengthening of the euro.

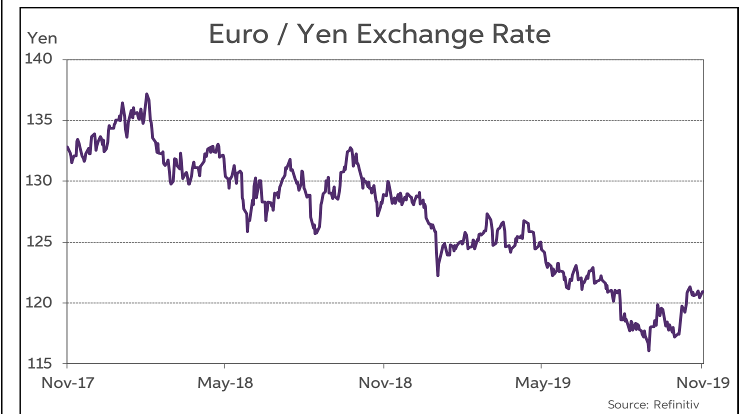
The UK's departure from the EU at end January would not mean that Brexit is done. The trade talks that follow will be very important. These are likely to prove very difficult. The more a Conservative government wants to "take back control" so that the UK can have its own regulatory and customs regime, the more limited will be any trade deal it concludes with the EU. Indeed, the EU has been very clear that it will insist on a level playing field in any trade deal, so that "regulatory divergence does not turn into regulatory dumping". It has emphasised that guaranteeing and enforcing "common rules" will be a crucial part of any deal in order to protect the Single Market.

This may be a bridge too far for a Brexit orientated Conservative government. Indeed, such a government could be prepared to fall back on WTO rules at the end of the transition period, rather than sign up for a trade deal that requires the UK to closely follow the rules of the Single Market. This would be very much a hard Brexit. Thus, even if the UK leaves the EU with a deal at end January, downward pressure could still re-emerge on the UK currency next year given that the next phase of Brexit, the trade negotiations, are likely to prove difficult, with a very uncertain outcome. We would not be surprised to see the 90p level revisited against the euro in this situation.

A Labour victory in the election would likely result in a very soft Brexit or the UK voting to remain in the EU in another referendum. This should be positive for sterling in the short-term. However, markets' concerns about the economic policies of a Labour government could see the currency come under downward pressure in 2020.





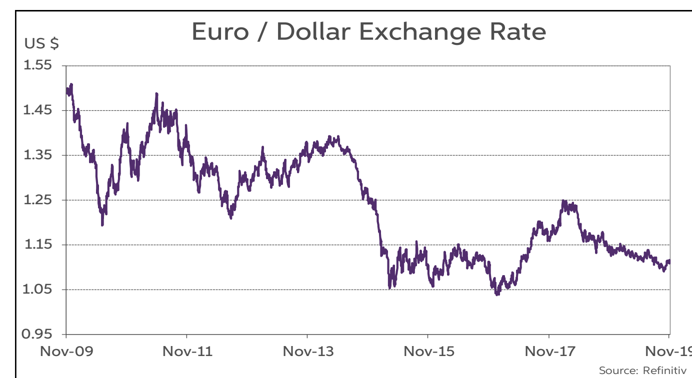


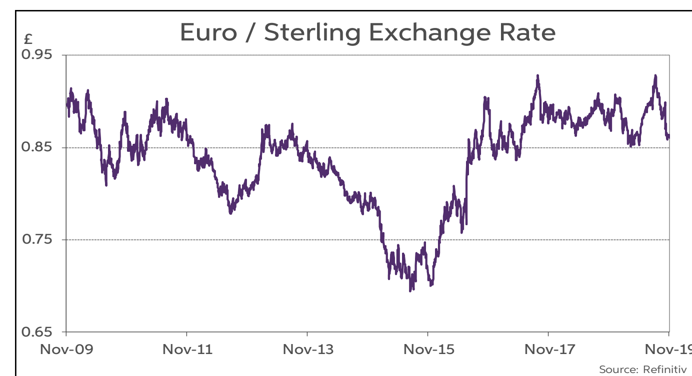
AIB

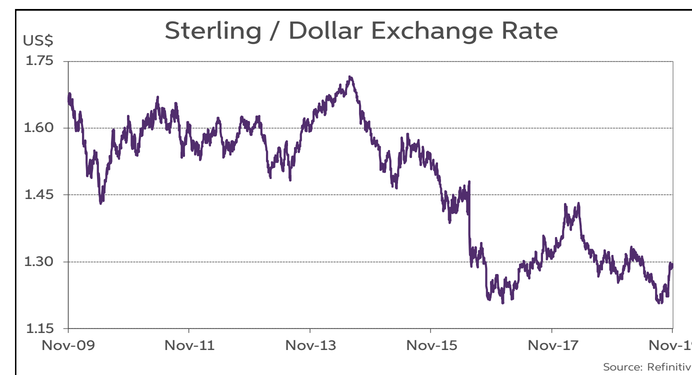
Summary of Exchange Rate Forecasts

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

	Current	Q4-2019	Q1-2020	Q2-2020	Q3-2020
Euro Versus					
USD	1.107	1.09-1.15	1.09-1.15	1.10-1.16	1.11-1.17
GBP	0.864	0.82-0.88	0.83-0.89	0.84-0.90	0.85-0.91
JPY	120.85	119-125	119-125	120-126	121-127
CHF	1.10	1.10	1.10	1.10	1.10
US Dollar Versus					
JPY	109.21	106-112	106-112	106-112	106-112
GBP	1.281	1.29-1.35	1.27-1.33	1.27-1.33	1.27-1.33
CAD	1.32	1.32	1.31	1.30	1.29
AUD	0.69	0.69	0.69	0.70	0.71
NZD	0.64	0.64	0.64	0.65	0.66
CNY	6.97	6.90	6.85	6.80	6.75
Sterling Versus					
JPY	140	144	142	142	142
CAD	1.69	1.74	1.71	1.69	1.67
AUD	1.86	1.91	1.88	1.86	1.83
NZD	2.01	2.06	2.03	2.00	1.97







This publication is for information purposes and is not an invitation to deal. The information is believed to be reliable but is not guaranteed. Any expressions of opinions are subject to change without notice. This publication is not to be reproduced in whole or in part without prior permission. In the Republic of Ireland it is distributed by Allied Irish Banks, p.l.c. In the UK it is distributed by Allied Irish Banks, plc and Allied Irish Banks (GB). In Northern Ireland it is distributed by First Trust Bank. In the United States of America it is distributed by Allied Irish Banks, plc. Allied Irish Banks, p.l.c. is regulated by the Central Bank of Ireland. Allied Irish Bank (GB) and First Trust Bank are trade marks used under licence by AIB Group (UK) p.l.c. (a wholly owned subsidiary of Allied Irish Banks, p.l.c.), incorporated in Northern Ireland. Registered Office 92 Ann Street Belfast BT1 3HH. Registered Number NI 018800. Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. In the United States of America, Allied Irish Banks, p.l.c., New York Branch, is a branch licensed by the New York State Department of Financial Services. Deposits and other investment products are not FDIC insured, they are not guaranteed by any bank and they may lose value. Please note that telephone calls may be recorded in line with market practice.

AIB, 10 Molesworth Street, Dublin 2 Tel: 353-1-6600311 https://aib.ie/investorrelations/economic-research-unit

AIB Treasury Economic Research Unit