

Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit



6th January 2021

- Further wave to coronavirus has seen governments re-impose restrictions and lockdowns, hitting near term growth prospects as economies struggle to recover from a deep recession in 2020
- However, positive news on vaccines, which have started to be rolled out in numerous countries, is a major boost to recovery hopes over the medium term
- Central banks eased policy further in Q4 2020. They have promised to keep policy very accommodative for a prolonged period of time to allow a strong economic recovery to take root
- Dollar losing ground as risk appetite improves, helped by positive news on vaccines
- Euro/sterling to remain range bound, as EU-UK trade deal fails to lift the pound

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Further Covid waves disrupt recovery, but vaccines boost growth prospects

Large parts of the world economy were put into lockdown in the spring of last year to control the spread of the coronavirus, triggering a very deep global recession in the first half of 2020. Activity rebounded strongly over the summer as lockdown restrictions were lifted. The recovery, though, has lost momentum over the autumn and winter, with the number of new cases of the virus surging again, triggering fresh restrictions on activity and new lockdowns in many developed economies.

The recession experienced by the world economy in 2020 was the deepest since the Great Depression of the early 1930s. The IMF and OECD estimate that world output contracted by 4.25-4.5% last year, with GDP in advanced economies shrinking by around 5.5%. The persistence of the virus means economies are struggling to recover from this recession.

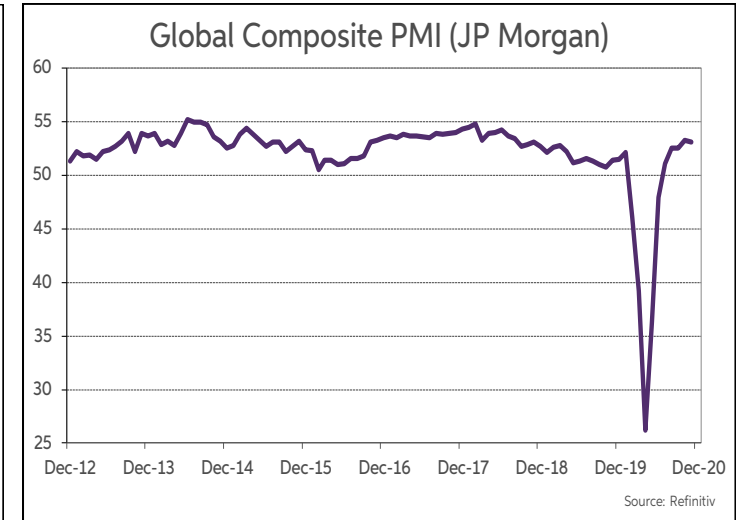
Many countries are beginning 2021 under fresh lockdowns. The number of new cases is at very high levels in many advanced countries and rising sharply in some cases. Significant disruption to economic activity is likely during the opening months of the year. Hence, GDP is likely to stay very subdued in Q1 2021, with some countries expected to experience a double-dip recession this winter.

However, the expectation that vaccines will become widely available over the course of 2021 offers the prospect of a sustained and robust recovery taking root as the year progresses. The latest OECD forecasts see the world economy expanding by 4.2% this year and 3.7% in 2022, with very strong rebounds in China and India. GDP in advanced economies is forecast to grow by around 3.25% in both 2021 and 2022. Thus, it is not until 2022 that GDP in most advanced economies recovers fully to its pre-Covid levels. However, this is not expected to happen in European economies until 2023. The OECD acknowledges, though, that a stronger recovery is possible, especially in 2022, if there is greater progress than anticipated at distributing effective vaccines this year.

The IMF and OECD also warn there are downside risks to their forecasts. In particular, the virus may prove more virulent than expected, necessitating ongoing restrictions and lockdowns for much of this year, or there may be greater than expected challenges in ensuring the widespread deployment of vaccines. Confidence is also still fragile and scarring effects such as rising business failures and bankruptcies, increasing bad debts, permanent job losses, lower labour force participation and inefficient resource allocation could weigh on the pace of recovery as well.

There are other obvious impacts on economies from the very deep COVID-19 recession. World trade volumes are estimated to have declined by over 10% in 2020 and are going to take a number of years to recover. While furlough schemes have prevented unemployment reaching high levels, jobless rates could still rise sharply this year as labour market support schemes are wound down. There has also been marked downward pressure on inflation globally over the past year, aided by the large drop in oil prices in 2020.

We have also seen a sharp deterioration in public finances owing to government spending measures to mitigate the economic shock and declines in tax revenues due to the severe recession. Fiscal deficits in the OECD are estimated to have risen to around 11.5% of GDP in 2020, up from circa 3% in the previous couple of years. While budget deficits are expected to start falling this year, they are forecast to remain high at near 6% of GDP by 2022.



GDP (Vol % Change)				
	2019	2020 (f)	2021 (f)	2022 (f)
World	2.7	-4.2	4.2	3.7
Advanced Economies	1.6	-5.5	3.3	3.2
US	2.2	-3.7	3.2	3.5
Eurozone	1.3	-7.5	3.6	3.3
UK	1.3	-11.2	4.2	4.1
Japan	0.7	-5.3	2.3	1.5
Emerging Economies	3.6	-3.0	5.1	4.2
China	6.1	1.8	8.0	4.9
India	4.2	-9.9	7.9	4.8
World Trade Growth (%)	1.0	-10.3	3.9	4.4
Inflation -PCE Deflator				
Advanced Economies (%)	1.9	1.5	1.4	1.6

Source: OECD Economic Outlook, December 2020

Central banks return to easing path as further Covid waves see recovery falter

Central banks globally pulled out all the stops last year to try and ameliorate the most severe impacts of the COVID-19 pandemic on their economies and financial systems which were hit by a sudden and very deep recession. Interest rates were cut sharply to 0.125% and 0.1% in the US and UK, respectively in 2020. Enormous QE bond purchase programmes were put in place and measures adopted to enhance the supply of liquidity to businesses, and to ease funding pressures, notably in regard to the dollar.

The message from central banks has been that they are prepared to do whatever is necessary to help economies recover from the very severe recession that struck in 2020. They have also indicated that they are in this for the long haul. Central banks have been very clear and forceful in their communications that monetary policy will remain exceptionally loose over the next couple of years and further measures will be adopted if required to restore economies to a strong footing.

It would seem that we have reached the lower bound for interest rates in most economies. The ECB and BoJ do not seem overly keen to move interest rates even deeper into negative territory, having focused to date in this crisis on using other non-standard policy measures, in particular expanding QE. The Fed continues to show a clear reluctance to move rates into the negative domain. However, the BoE has not completely ruled out such a move.

The latest policy responses by the BoE and ECB to the fresh downturn in activity since the autumn have been in the form of additional QE and liquidity measures. The MPC announced a £150bn increase in government bond purchases in November, bringing the total stock of all purchases to £895bn. Meanwhile, the ECB increased the size of its PEPP by €500bn to €1,850bn in December, as well as announcing enhanced special liquidity measures.

Markets are not ruling out that rates could be lowered further in the Eurozone and UK in the coming year. Indeed, futures contracts see UK rates being cut by up to 15bps by mid-2022, which would take the Bank Rate into negative territory. The BoE has been toying with the idea of a move to negative rates, with the Governor saying it could form part of the policy toolkit. However, the BoE remains to be convinced about the merits of negative rates. Thus if the BoE is to cut, it may be by just 10bps, which would bring the Bank Rate to zero. Meantime, while the ECB has not said that rates have reached bottom, it has shown little appetite to lower official rates further.

The Fed is operating an open-ended QE programme and has indicated that this will be kept in place until “substantial further progress” has been made in terms of the economic recovery. It also recalibrated its monetary policy framework last autumn to put more weight on boosting the labour market and less emphasis on inflation, with the intention of keeping the fed funds rate at its current very low level for a prolonged period of time. Notably, it has indicated that inflation could move moderately above 2% for some time following periods, such as now, where it undershoots target, without a need for interest rates to rise in response.

Indeed, the clear message from all the main central banks is that interest rates can remain at very low levels over the next few years. This is reflected in the pricing of futures contracts, which don't see rates rising for a number of years. US rates are not seen as increasing until H2 2023. Meanwhile, even if market expectations of rates cuts in the UK and Eurozone are not realised, futures contracts suggest that it will be late 2024 before official rates are raised from their present levels. This points to a prolonged period of rates at current or even lower levels.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.125	0.23	0.33	0.20	0.47
Mar'21	0.125	0.24	0.35	0.22	0.50
June'21	0.125	0.24	0.37	0.26	0.55
Sept'21	0.125	0.25	0.40	0.30	0.60

* 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	-0.57	-0.49	-0.54	-0.46
Mar'21	-0.50	-0.57	-0.48	-0.52	-0.43
June'21	-0.50	-0.56	-0.47	-0.50	-0.40
Sept'21	-0.50	-0.55	-0.45	-0.45	-0.35

* Swap Forecasts Beyond 1 Year

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.10	0.03	0.08	0.06	0.22
Mar'21	0.10	0.04	0.10	0.08	0.25
June'21	0.10	0.05	0.12	0.12	0.30
Sept'21	0.10	0.07	0.15	0.20	0.40

* Swap Forecasts Beyond 1 Year

Dollar in decline on improving risk appetite and low US rates

The dollar appreciated very sharply in the period 2014 to 2016 and remained at elevated levels over the rest of the decade. However, it has been moving steadily lower ever since it reached very lofty heights last March when the growing Covid-19 pandemic triggered carnage in financial markets and a stampede into the safe-haven US currency. It has lost 12.5% against the other major currencies since last spring, though it remains at a fairly high level historically. It has been a steady move down as risk appetite returned to markets and safe haven flows unwound, helped by positive news on vaccines in the closing months of last year.

The euro has been a notable beneficiary of the news on vaccines, climbing above \$1.23 in early 2021 from \$1.165 at the start of November. This is only the second move above \$1.20 by the euro since 2014. The previous move occurred at the start of 2018 and saw the EUR/USD rate rise to a high of \$1.25. However, it was not sustained as the dollar regained strength, with the euro dropping back below \$1.20 within a number of months. The euro continued to move lower subsequently, before bottoming out at \$1.07 in the spring of last year.

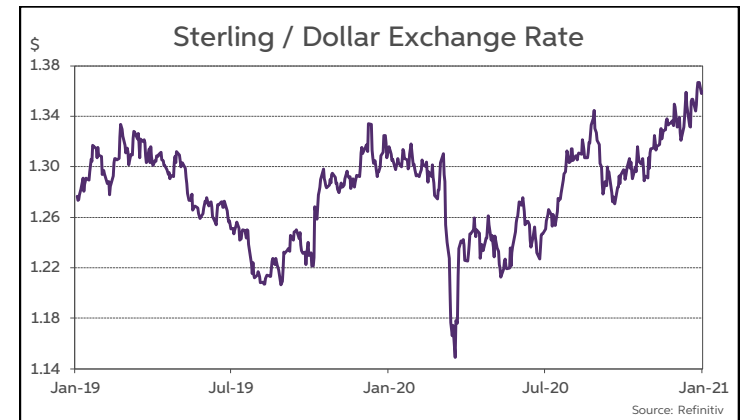
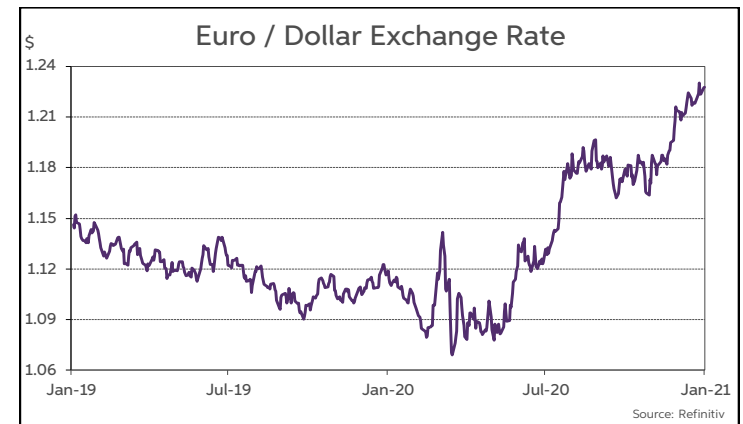
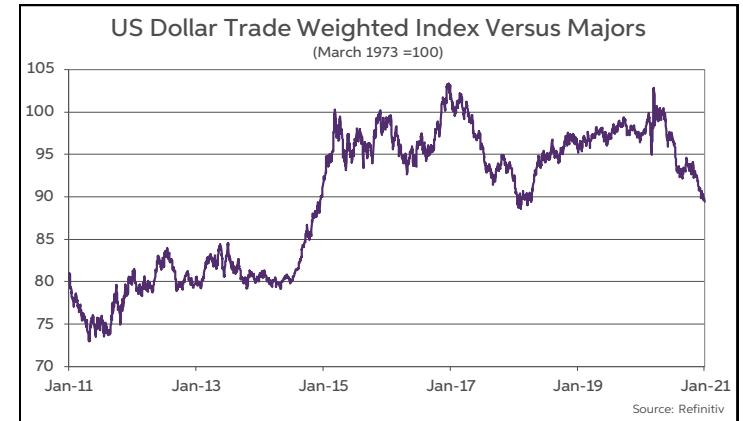
On this occasion, though, the general decline of the dollar and move by the euro above \$1.20 may well be sustained. The economic and policy landscape is changing. Vaccines for Covid-19 are now expected to become widely available over the course of 2021, laying the basis for a period of sustained, robust growth by the global economy over the next couple of years, with the US economy no longer an outperformer. This will increase the attractiveness of non-US dollar assets, as well as lessen the appeal of safe-haven currencies like the dollar.

The dollar was also supported in recent years by significantly higher interest rates in the US than elsewhere, most notably when compared to the negative interest rates prevailing in the Eurozone and Japan. The latter two have not cut rates over the past year, though, whereas US rates have been slashed to virtually zero. As a result, the US dollar no longer offers a large interest rate spread vis-à-vis the other main currencies.

Furthermore, the US Federal Reserve has recalibrated its monetary policy framework, to allow official interest rates to be maintained at very low levels as the economy recovers, provided inflation remains under control. Thus, the dollar's interest rate advantage does not look like returning anytime soon. A further headwind for the dollar may be if the US continues to run a large budget deficit under a Biden Presidency. Traditionally, this would weigh on a currency, especially in an economy with low interest rates and a sizeable balance of payments deficit, like the US.

Having overcome the \$1.20 level and risen above \$1.23, the next major hurdle for the euro to overcome is \$1.25, the peak rate for EUR/USD over the past six years. This is likely to be very challenging to surmount, so the EUR/USD pair may trade in a \$1.20-1.25 range in the early part of 2021.

The dollar is now just slightly above the lows it hit in early 2018 against the other majors. However, it remains well above the trading levels that pertained in the first half of the last decade. Thus, the currency could fall further. For the first time in many years, one can make the case that what we have seen since last spring is a sustained decline in the dollar which could have further to run. Much will depend on the strength and durability of the recovery in global activity that is expected to take root during 2021. We expect the euro to really test the \$1.25 resistance level and most probably overcome it as the year progresses.



EU-UK trade deal fails to lift a subdued sterling

After a volatile year in 2019, sterling saw some very sharp movements again in H1 2020. This was especially so in the spring when markets went into free fall as the coronavirus took hold. Sterling fell sharply at the time before recovering ground soon after. Since May, though, sterling has been quite range bound against the euro as markets awaited the outcome of the EU-UK trade talks. While trading in the EUR/GBP pair has been volatile at times, it was confined to quite a narrow trading range of 88.5-92.5p between May and December. Meanwhile, like most other currencies sterling has been on a steadily rising path against the dollar since the late spring, with cable rising from \$1.23 at mid-year to \$1.36 by December.

An EU-UK trade deal was finally agreed on Christmas Eve, but it has had a very limited impact on sterling. EUR/GBP has remained in a narrow 89-91p trading range since the deal was announced. One reason is that an agreement was widely expected by the markets. Furthermore, it is a very limited or 'skinny' trade deal which does not include services and is far inferior to the EU Single Market. It can hardly be classed as a major positive development for the UK economy, although it avoided a much worse outcome in the form of a no-deal Hard Brexit. Overall, the UK's departure from the EU and its Customs Union and Single Market is viewed by many as lowering the potential growth rate of the economy over the medium term.

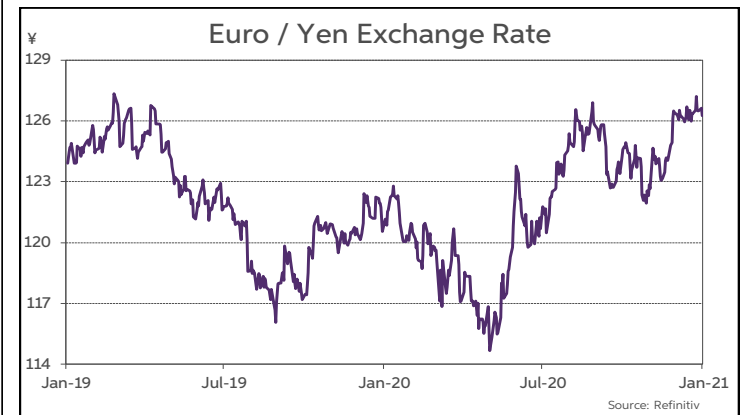
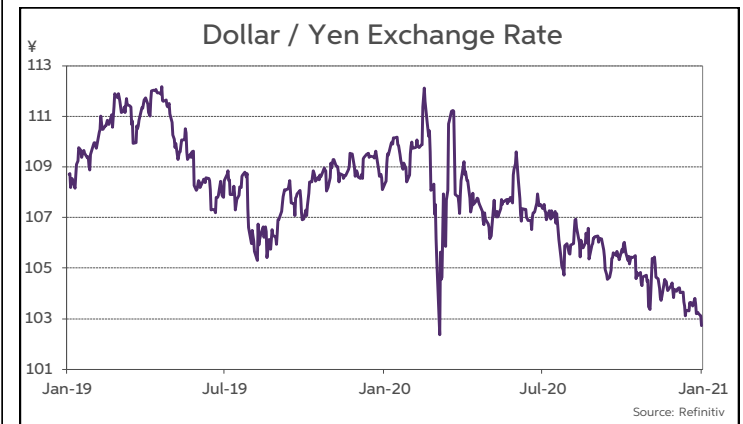
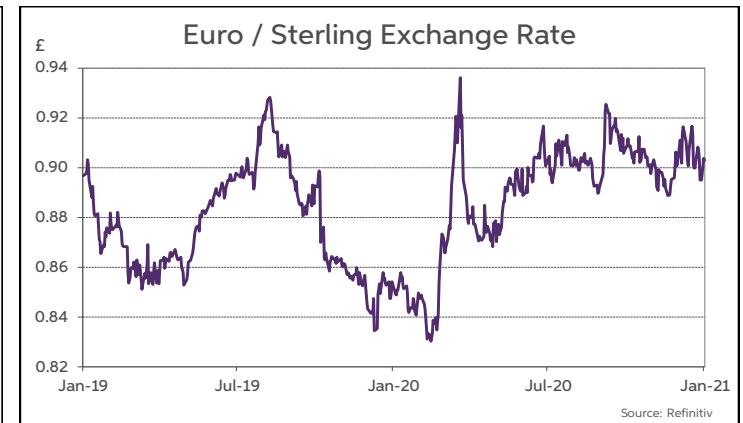
Meanwhile, it is also the case that the recession caused by the Covid-19 pandemic has been much deeper in the UK than in other major economies, with a third lockdown of the country also now in force for the next couple of months. The deep recession has seen the UK budget deficit soar to close on 20% of GDP in FY2020/21, much higher than in other countries. Given the headwinds facing the economy from both Covid-19 and Brexit, markets are pricing in up to a further 15bps in rate cuts from the BoE by mid-2022. This could see the UK move to negative interest rates, which would hardly be positive news for the currency.

Taking all these factors into consideration, sterling is likely to remain a relatively weak currency on a historic basis, trading in an 88-92p range against the euro. Meanwhile, cable could trade around the \$1.40 level. It is worth noting, to put this into perspective, that sterling hardly ever dipped below the \$1.40 level throughout the whole period from the mid-1980s up until the Brexit Referendum in 2016.

Yen to remain a strong currency

The yen was the one currency that was able to hold its ground against the strong dollar over the past five years. Indeed, it has been trending higher against the US currency over this period, with the dollar falling to around ¥103 in early 2021 from ¥118 back in 2016. The yen benefits from its safe-haven status, a big trade surplus and large overseas holdings of foreign assets that generate flows back into the currency. An out-of-favour dollar could continue to edge lower against the yen in 2021, although it may not fall below the key ¥100 support level.

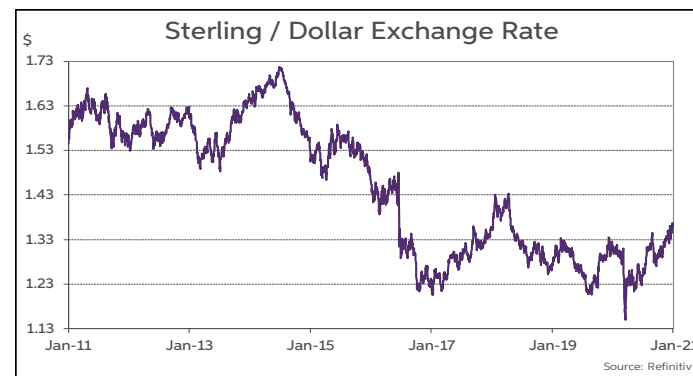
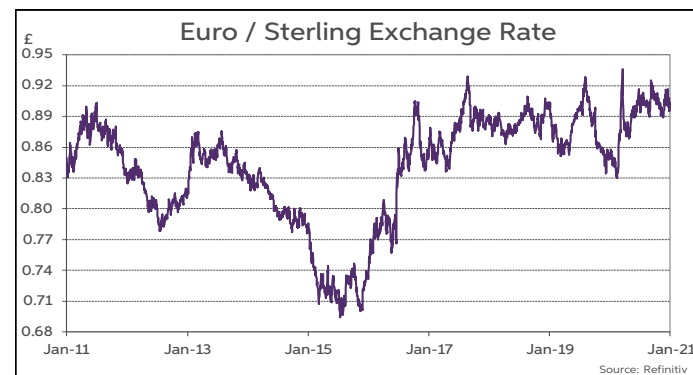
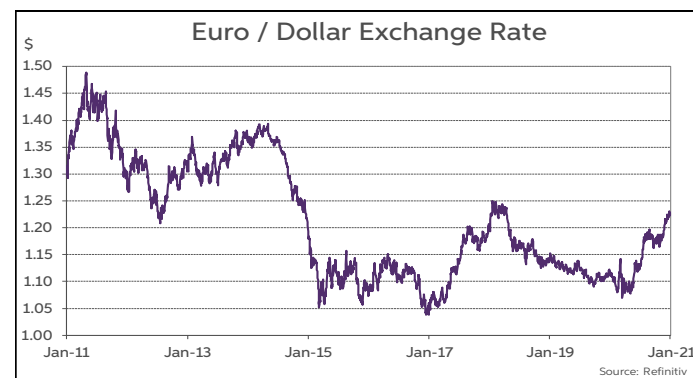
Meanwhile, the euro fell from ¥136 to ¥115 between the start of 2018 and spring 2020. It has been on a recovery path for the past six months as risk appetite improves on financial markets, climbing to ¥126-127 recently. The euro should hold on to these gains against the yen in 2021 as a global recovery takes hold. However, it may find it hard to make much further ground, with strong support for the yen in the region of ¥128-132.



Summary of Exchange Rate Forecasts

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

	Current	Q1-2021	Q2-2021	Q3-2021	Q4-2021
Euro Versus					
USD	1.234	1.21-1.27	1.22-1.28	1.23-1.29	1.25-1.31
GBP	0.906	0.87-0.93	0.87-0.93	0.87-0.93	0.87-0.93
JPY	126.92	125-131	125-131	124-130	125-131
CHF	1.08	1.08	1.08	1.09	1.09
US Dollar Versus					
JPY	102.84	100-106	99-105	98-104	97-103
GBP	1.363	1.35-1.41	1.36-1.42	1.37-1.43	1.39-1.45
CAD	1.27	1.27	1.26	1.25	1.23
AUD	0.78	0.78	0.79	0.80	0.81
NZD	0.73	0.73	0.74	0.75	0.76
CNY	6.45	6.45	6.40	6.35	6.30
Sterling Versus					
JPY	140	142	142	141	142
CAD	1.73	1.75	1.75	1.75	1.75
AUD	1.75	1.77	1.76	1.75	1.75
NZD	1.87	1.89	1.88	1.87	1.87



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