Forex and Interest Rate Outlook

11th February 2016

AIB Treasury Economic Research Unit

- **Nervous and volatile financial markets as stocks slide and bonds rally on rising risk aversion over fears about global growth. Oil prices fall to twelve year lows**
- **Some softening of activity in advanced economies, but main downside risk to global growth is the marked slowdown in emerging economies, most notably China**
- **ECB and BoJ continue to ease monetary policy in face of persistent very low inflation and risks to growth. BoE is very much on hold. Our view is Fed could still hike rates this year**
- **Dollar loses some ground as the market changes its view to no US rate hikes this year. Euro and yen make gains despite further policy easing and negative interest rates**
- **Sterling slides as opinion polls point to a close result in Brexit referendum**

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Global Economic Outlook

Continuing concerns about downside risks to global growth

Global growth remains very much sub-par. Expectations that the recovery in the world economy would gain some momentum were not realised yet again last year. The IMF put it well in saying that "six years after the world economy emerged from its broadest and deepest post-war recession, the holy grail of a robust and synchronised global expansion remains elusive". Both the IMF and OECD put world growth at around 3% in 2015, the weakest rate since the end of the economic crisis of 2008-2009.

Activity in advanced economies, though, did gain some momentum in the past couple of years, with GDP growth picking up to around 2% in 2014-15 from 1.2% in 2013. This is largely attributable to a strengthening of activity in the Eurozone. More recently, activity softened in the US in Q4 2015. Meanwhile, the recovery in the UK lost some pace last year, albeit after a strong performance in 2014. Meantime, growth in Japan remains erratic and sluggish, despite an ultra-loose monetary policy and big decline in the yen over the past three years.

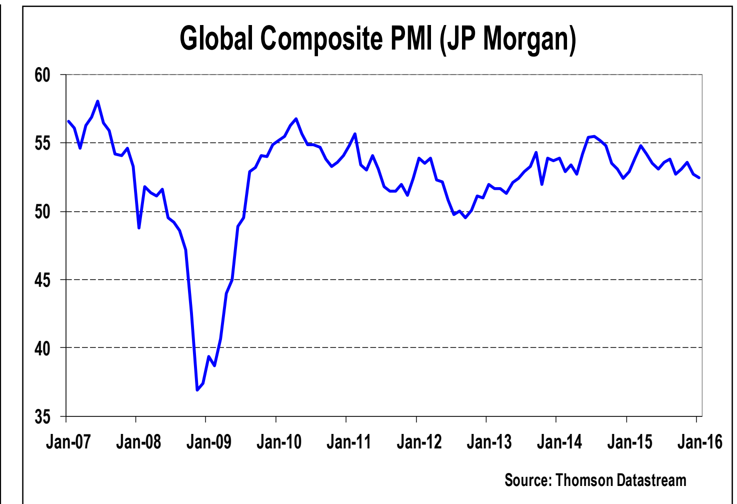
Growth in emerging economies continues to lose momentum and is estimated by the IMF at around 4% in 2015, down from 4.7% in 2014 and 5% in 2013. Indeed, growth in emerging economies has been weakening since 2010, when it stood at 7.5%. Most notably, growth in China slowed from 10.4% in 2010 to an estimated 6.9% in 2015. Many commentators suspect that the slowdown in China is even more pronounced and the actual growth rate may have decelerated to around 4%. It has also been observed that the impact of the slowdown in China on other emerging economies via falling commodity prices and lower imports, appears to have been greater than previously envisaged, with some countries like Brazil and Russia going into recession.

There are concerns that the weakening of activity in emerging economies, especially China, will hit the recovery in advanced economies. It is worth noting, though, that to date, the recovery in advanced economies has largely remained on track, despite the slowdown in emerging economies. The IMF and OECD expect that advanced economies will continue to register moderate growth of around 2% in 2016 and 2017.

There are a number of factors supporting growth. Oil and other commodity prices have seen further sharp declines, which will help to keep inflation at very low levels, thus boosting real incomes and spending power. Monetary policy remains very loose, with low rates everywhere. Fiscal policy is turning less restrictive in most advanced economies. Labour market conditions are also improving in the major economies.

However, downside risks remain for the world economy, especially emerging economies. Both the IMF and OECD have forecast that growth in these economies will pick up somewhat in 2016 and 2017, but this looks optimistic to us, certainly in regard to this year. The recent further sharp falls in commodity prices, weakening of their exchange rates and heightened risk aversion in financial markets are all adding to the downside risks to the growth prospects for emerging economies, which seem unlikely to strengthen in 2016.

The current very low level of commodity prices is having quite a negative effect on many emerging economies. It largely reflects an over-supply of commodities following big increases in production in recent years, most notably oil. Many emerging economies will remain weak until we see this supply overhang eliminated, allowing commodity prices to recover. There is no sign of this happening yet in 2016 so these economies seem likely to remain weak this year. Growth in China is forecast to lose some further momentum in 2016 also.



GDP (Vol % Change)	2014	2015 (e)	2016 (f)	2017 (f)
World	3.3	3.1	3.4	3.6
Advanced Economies	1.9	1.9	2.1	2.1
US	2.4	2.5	2.6	2.6
Eurozone	0.9	1.5	1.7	1.7
UK	3.0	2.2	2.2	2.2
Japan	-0.1	0.6	1.0	0.3
Developing Economies	4.7	4.0	4.3	4.7
China	7.3	6.9	6.3	6.2
India	7.3	7.3	7.5	7.5
World Trade Growth (%)	3.4	2.0	3.6	4.8
Advanced Economies Inflation (%)	1.5	0.8	1.5	1.9

Source: IMF World Economic Outlook Update, January 2016

Interest Rate Outlook

Monetary policy to remain very loose globally, but Fed could still well hike rates

Last year was characterised by a further widespread loosening of monetary policy in many countries and a scaling back of rate hike expectations in economies where policy tightening had been expected to commence. Many central banks took advantage of the sharp fall in inflation caused by the collapse in oil and other commodity prices to move to an even more accommodative monetary policy stance. The OECD estimates that monetary easing occurred in countries accounting for more than half of global GDP in 2015. Meanwhile, central banks that were contemplating monetary tightening either delayed the move, or remained on hold altogether, with markets scaling back the timing and extent of potential rate hikes.

It would seem that 2016 is turning out to be a repeat of 2015. The Bank of Japan stunned markets in January by unexpectedly cutting rates, moving them into negative territory. Meanwhile, the ECB has given a strong hint that it will ease policy further at its March meeting as it continues with its efforts to boost inflation and growth. It had already loosened policy in December, extending the duration of its QE asset purchase programme into 2017 and lowering the deposit rate by 10bps, moving it even deeper into negative territory. Eurozone inflation, though, remains at very low levels. Hence, the ECB seems set to cut the deposit rate again next month and may also increase the volume of monthly purchases under its QE programme.

Meanwhile, the Bank of England has shown a clear reluctance to start raising rates despite the tightening in labour market conditions, with the unemployment rate falling to circa 5%. It revised down its forecast path for inflation and growth in the February Inflation Report. Markets have radically pushed back their expected timing for UK rate hikes. They had thought that rates could rise during 2016, but now do not see a rate increase materialising until 2019.

Meantime, the US Federal Reserve did raise rates by 25bps to 0.375% at its mid-December FOMC meeting, the first such rate hike in nearly a decade. The Fed's December projections indicated that it expected to raise rates by some 25bps per quarter over the coming three years, taking the Fed funds rate up to 1.375% by the end of 2016 and 3.25% by end 2018. Markets were more cautious, though, expecting around two rate hikes per year rather than the four projected by the Fed.

However, in recent weeks the markets have become increasingly of the view that the Fed will not be able to raise rates at all this year. Continuing volatility in financial markets would make it difficult for the Fed to hike rates anytime soon. A slowdown in activity in the US economy over the winter has also cast doubt on the likelihood of further rate increases. Indeed, markets now don't expect another rate hike in the US until the end of 2017 and do not see official rates rising to 1% until 2019. This only seems likely to us if there is a sharp slowdown in the US economy this year that sees the Fed going on hold.

Despite some softening of activity in recent months, we expect the US economy to still perform solidly in 2016, leading to a further tightening of labour market conditions. Further monetary tightening can be expected in these circumstances, although the Fed may be constrained in the timing of rate moves by the volatility in financial markets and a weak external environment. Janet Yellen, in her recent testimony to Congress, noted that the turbulence on financial markets could impact the US economy but also pointed to factors that were supporting growth. We think that the Fed may still raise rates on a couple of occasions later this year.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.375	0.62	1.13	0.69	0.99
Mar '16	0.375	0.62	1.15	0.75	1.10
June '16	0.375	0.65	1.25	0.90	1.30
Sept '16	0.625	0.85	1.45	1.20	1.70

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	-0.30	-0.20	-0.02	-0.17	0.05
Mar '16	-0.40	-0.25	-0.05	-0.20	0.05
June '16	-0.40	-0.25	-0.05	-0.20	0.10
Sept '16	-0.40	-0.25	-0.05	-0.15	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	0.50	0.59	0.99	0.72	0.92
Mar '16	0.50	0.60	1.00	0.75	1.00
June '16	0.50	0.60	1.05	0.85	1.15
Sept '16	0.50	0.60	1.10	1.00	1.40

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Changing rate hike expectations key driver of FX markets

Despite a considerable amount of volatility on financial markets and diverging trends in US and Eurozone monetary policies, the key EUR/USD rate has been very range bound over the past year, largely trading in a $1.06-1.15 corridor. This period of stability followed the big exchange rate moves in the second half of 2014 and opening couple of months of 2015 that saw the euro fall sharply, declining from $1.40 to a low of $1.05.

The slowdown in emerging economies, weakening commodity prices, as well as increased risk aversion and volatility in financial markets have helped currencies like the euro and yen over the past year. Very subdued inflation and the growing downside risks to global growth have made it difficult for central banks like the Fed and Bank of England to tighten 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 over the course of the past year. When the Fed finally did hike rates in December, it was well signalled and had little impact.

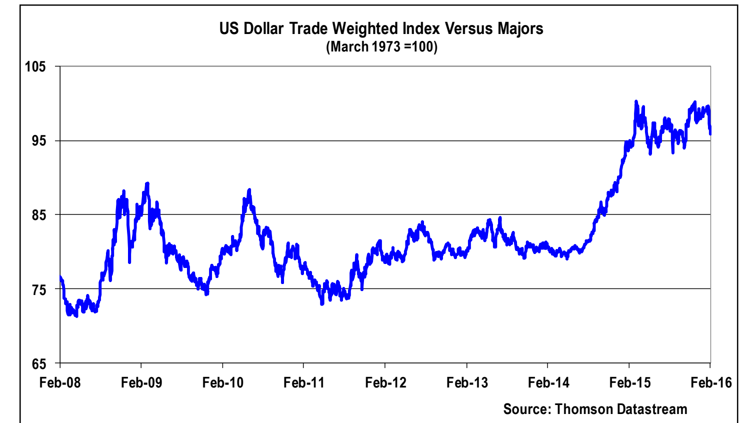
Indeed, the euro has risen from $1.06 to above $1.13 since early December, even though the ECB loosened policy at the end of last year and hinted that a further easing of policy in likely in March that would take Eurozone rates even deeper into negative territory. The moves in ECB rates, though, are relatively small. The big change in recent months has been in relation to the future path of US rates. Markets have greatly scaled back their expectations for US rate hikes and now do not expect the Fed to raise rates again until end-2017, with just very moderate increases in interest rates thereafter.

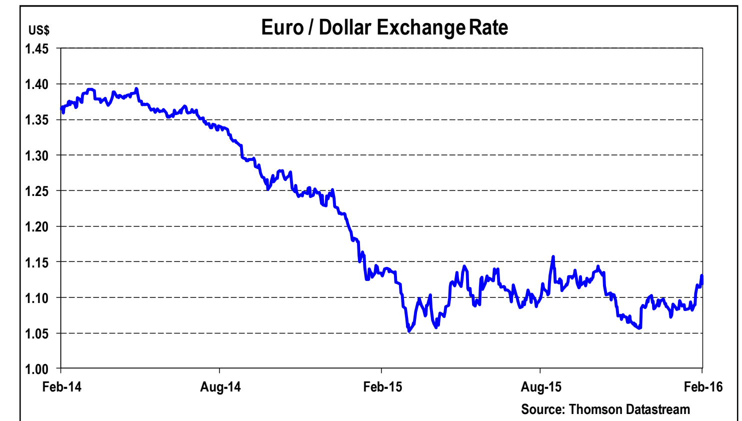
The EUR/USD rate is currently trading at around $1.13, near the top end of the $1.06-1.15 range that it has occupied since early last spring. Short-term interest rates look set to remain quite negative in the Eurozone over the next couple of years, with the ECB also retaining an easing bias. Thus, it is hard to see the euro making significant gains against the dollar that takes it above the $1.15-1.16 level, unless there is a shock to the US economy that causes the Fed to start easing policy.

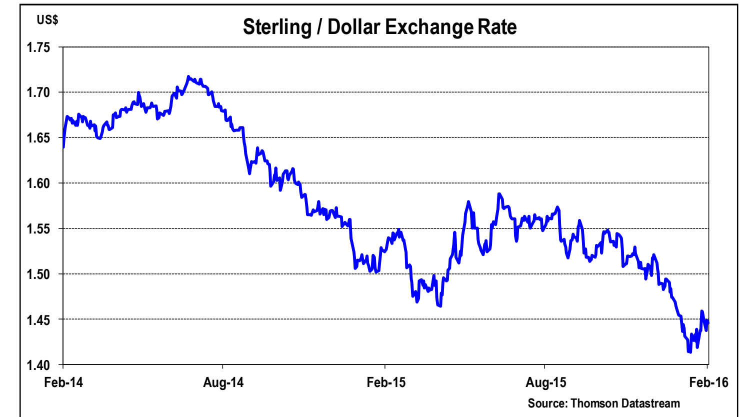
Much uncertainty still surrounds the actual extent of Fed tightening. The market is not now pricing in another rate increase until the very end of 2017, but the most recent projections of the FOMC members in December pointed to eight rate hikes by then. The Fed's projections now look out of date but they do suggest that it does feel a need to move rates higher, if at all possible, with the unemployment rate now below 5%. It points to quite a strong Fed tightening bias, although the timing of rate hikes could be delayed as occurred last autumn.

Thus, unless the US economy slows dramatically in the next couple of years, the Fed seems likely to us to hike rates. As we have seen in the past year, rate hike expectations remain a key driver of FX rates. In the near-term, volatile financial markets and softer data seem likely to keep the Fed on hold and favour currencies like the euro and yen. However, as happened in October and November of last year, the dollar is likely to strengthen again if US rates hikes come back on to the agenda later in 2016.

However, given that any rate hikes in the US are likely to be modest enough, the currency will probably find it difficult to push through $1.05-1.06, which has proved to be a strong support level for the euro over the past year. Thus, we expect the EUR/USD rate will remain range bound in 2016 but with the risks to the upside for the dollar from current levels, given that the market is not pricing in any US rate hike until end 2017.







Risks building for sterling as Brexit comes to the fore

Growth in the UK economy slowed last year. Meanwhile, inflation was much weaker than expected. As a result, expected UK rate hikes never materialised. Indeed, the Bank of England's most recent commentaries suggest that it is likely to keep UK rates on hold until 2017, while futures markets suggest that it may be 2019 before rates start to rise. The softening of UK rate hike expectations put an end to the strong appreciation of sterling evident in 2014 and H1 2015.

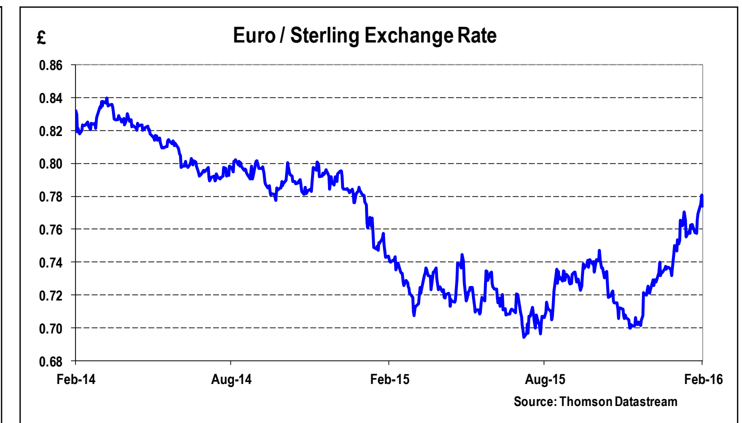
Indeed, with the Brexit referendum also coming more to the fore in recent months, sterling has started to lose ground. The euro has risen by more than 10% against sterling since early December, climbing from 70p to above 78p. Meanwhile, cable has fallen to below $1.45 this year, have being close to the $1.60 level in mid-2015. The referendum on the UK's continued membership of the EU, which is likely to be held later this summer, is emerging as a serious event risk for sterling. Opinion polls are now pointing to a very close result in the referendum vote. A vote for Brexit would most likely put further downward pressure on sterling. It could fall quite sharply given all the uncertainty that would surround such an event, and the serious downside risks that it would pose for the UK economy.

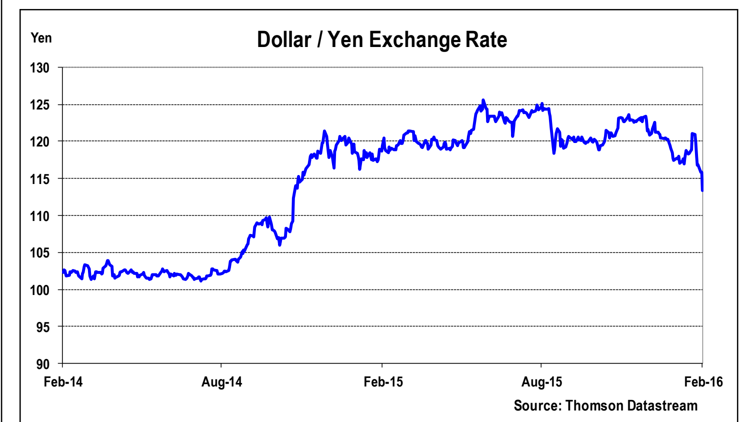
Overall then, we would be very cautious on sterling ahead of the referendum vote, especially given the recent trend in opinion polls. The euro could rise further to 80p if opinion polls continue to point to a close vote in the referendum. Cable could fall towards its 2009 low of around $1.39-1.40. Sterling should recover if the UK votes to stay in the EU, with cable rising back above the $1.45 level and the euro falling back towards the 75p level. Sterling can be expected to fall sharply, though, if there is a vote in favour of Brexit.

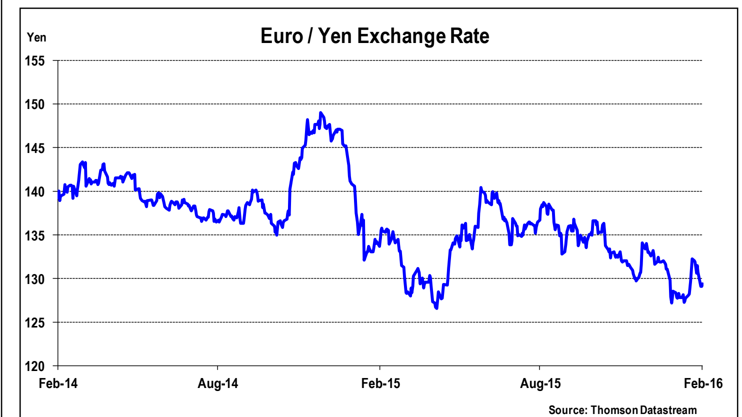
Yen rebounds on rising risk aversion

The yen was much more stable in 2015, having fallen sharply in the previous couple of years. It traded in a ¥117 -125 range against the dollar between February and December. Rising risk aversion has helped the yen. Furthermore, the dollar has risen above ¥125 on only two occasions in the past two decades, so it was not surprising that the yen found strong support at this level. More recently, even though the BoJ stunned markets by moving interest rates into negative territory, the yen has spiked upwards on heightened risk aversion, with the dollar falling to around ¥113, its lowest level since Q4 2014. The yen could rise further in the short-term as risk aversion continues to dominate market sentiment. It is likely to surrender some of these gains, though, if risk aversion abates later in the year and rate hikes come back on to the agenda in the US.

Finally, China made a significant change to its exchange rate policy last August, when it loosened the peg with the dollar, allowing its currency to depreciate. The currency has fallen by over 5% against the dollar since this change. With the economy weakening and exports under pressure following a sharp rise in the currency earlier in the decade, the underlying trend has been downwards for the Chinese currency since the start of 2014. We think that the exchange rate is likely to weaken further, but at a very gradual pace.



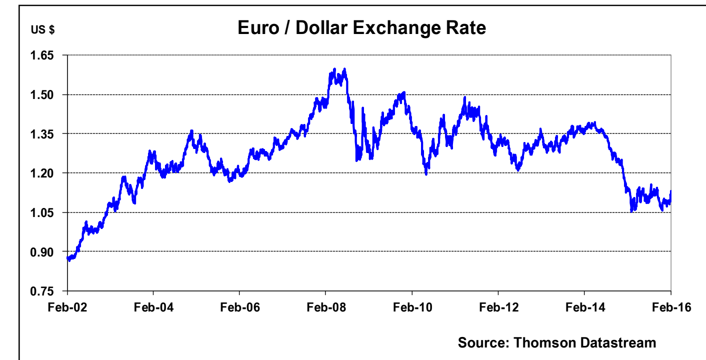


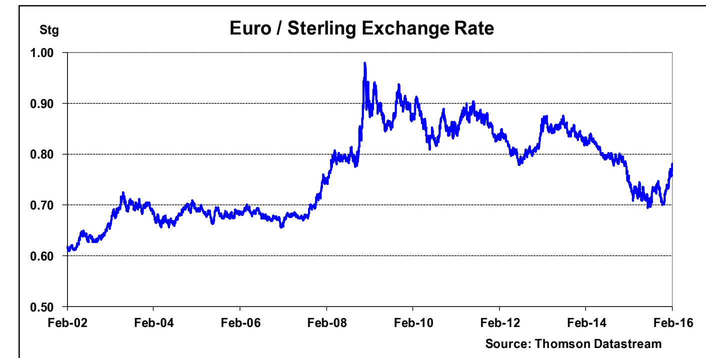


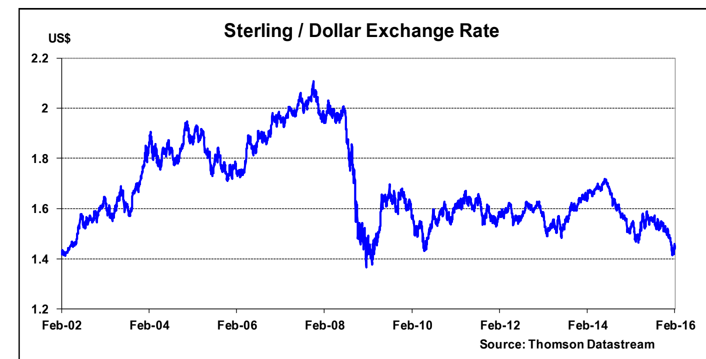
Summary of Exchange Rate Forecasts

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

	Current	Q1-2016	Q2-2016	Q3-2016	Q4-2016
Euro Versus					
USD	1.136	1.10-1.16	1.08-1.14	1.06-1.12	1.04-1.10
GBP	0.786	0.77-0.81	0.74-0.78	0.73-0.77	0.72-0.76
JPY	127.48	121-127	121-127	122-128	123-129
CHF	1.10	1.10	1.10	1.10	1.10
US Dollar Versus					
JPY	112.22	107-113	109-115	112-118	115-121
GBP	1.445	1.40-1.46	1.43-1.49	1.42-1.48	1.42-1.48
CAD	1.40	1.40	1.40	1.40	1.40
AUD	0.71	0.71	0.70	0.69	0.68
NZD	0.67	0.67	0.66	0.65	0.64
CNY	6.57	6.58	6.62	6.66	6.70
Sterling Versus					
JPY	162	157	164	167	171
CAD	2.02	2.00	2.04	2.03	2.03
AUD	2.04	2.01	2.09	2.10	2.13
NZD	2.16	2.13	2.21	2.23	2.27







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