Forex and Interest Rate Outlook

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AIB Treasury Economic Research Unit

- **Moderate recovery expected to continue in advanced economies, which to date have been able to withstand the marked slowdown in growth in emerging economies**
- **Divergence in monetary policies as ECB loosens policy even further, BoE remains very much on hold, but Fed begins raising rates**
- **A key issue may well prove to be the pace of Fed policy tightening, with markets pricing in far fewer rate hikes than contained in FOMC projections for the next three years**
- **Dollar upside capped by market view of only very limited rate tightening in US. Volatility in markets also supporting yen and euro as it could make rate hikes less likely elsewhere**
- **Brexit referendum beginning to weigh on sterling as opinion polls point to a close result**

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Global Economic Outlook

New Year but same old fear over health of global economy

As noted by both the IMF and OECD, global growth remains sub-par, with expectations that the recovery in the world economy might gain some momentum failing to materialise yet again last year. The IMF puts 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". The OECD estimates that growth in world GDP slowed to 2.9% in 2015, which would be the weakest rate since the end of the economic crisis of 2008-2009. The world economy grew by 3.3% in 2014 and 3.2% in 2013.

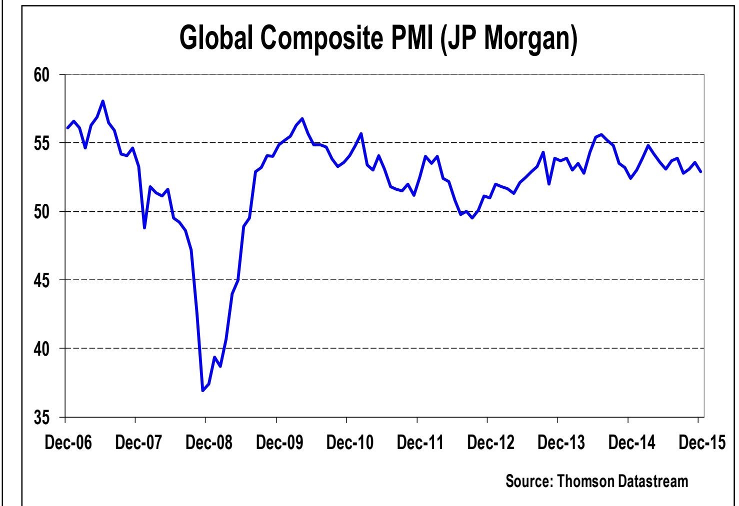
Activity in advanced economies, though, has gained some momentum in the past couple of years with GDP growth picking up to around 2% in 2014-15 from 1.2% in 2013. This is largely attributable to a strengthening of activity in the Eurozone. Growth in the US remains solid. The recovery in the UK lost some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

By contrast, growth in emerging economies has continued to lose momentum and is now estimated by the OECD at just 3.7% 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 6.8% 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 going into recession.

There are concerns that the weakening of activity in emerging economies, especially China, could yet hit the recovery in advanced economies. It is worth noting, though, that to date, the recovery in advanced economies has remained on track and gained some momentum, despite the slowdown in emerging economies. Both the IMF and OECD expect growth in advanced economies to strengthen somewhat further 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. Very low inflation has also allowed central banks to continue to pursue very loose monetary policies. Indeed, more than half of the world economy experienced further monetary easing in 2015. Meanwhile, fiscal policy is turning less restrictive in most advanced economies. Labour market conditions are also improving in the major economies, including the Eurozone and Japan. Confidence has also improved, while leading indicators, such as PMI surveys, point to a continuation of the upswing in activity.

However, downside risks remain for the world economy. Much attention remains focused on emerging economies to see if growth there begins to stabilise. Both the IMF and OECD forecast that growth in emerging economies will pick up in 2016 and 2017. This expectation is conditional on more stable commodity prices and exchange rates next year, greater political certainty and just a modest slowdown in growth in China. If these conditions are not met, then growth in emerging economies could continue to lose momentum. As a result, there is a risk that expectations of stronger global growth in the coming year may not be fulfilled yet again.



GDP (Vol % Change)	2014	2015 (e)	2016 (f)	2017 (f)
World	3.3	2.9	3.3	3.6
Advanced Economies	1.9	2.0	2.2	2.3
US	2.4	2.4	2.5	2.4
Eurozone	0.9	1.5	1.8	1.9
UK	3.0	2.4	2.4	2.3
Japan	-0.1	0.6	1.0	0.5
Developing Economies	4.7	3.7	4.2	4.6
China	7.3	6.8	6.5	6.2
India	7.3	7.2	7.3	7.4
World Trade Growth (%)	3.4	2.0	3.6	4.8
Advanced Economies Inflation (%)	1.5	0.8	1.5	1.9

Source: OECD 'Economic Outlook', November 2015

Interest Rate Outlook

Monetary policies diverge as Fed starts to tighten

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. The main reason for this was not economic weakness per se, as the recovery in advanced economies continued, albeit at a moderate pace. Rather, it was due to very subdued inflationary pressures, as well as the increased downside risks to global growth stemming from a further weakening of activity in emerging economies.

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.

The ECB eased policy further in December as it continued with its efforts to boost inflation and growth. It extended the duration of its QE asset purchase programme into 2017 and lowered the deposit rate by 10bps, moving it even deeper into negative territory. Eurozone inflation, though, remains at very low levels. Hence, the ECB has made it clear that it retains an easing bias that could see it loosen policy even further. However, we think that it is more likely to keep policy on hold in 2016 as base effects cause inflation to begin rising slowly.

Meanwhile, the Bank of England has shown a clear reluctance to start raising rates despite the tightening in labour market conditions and continuing recovery in the economy. It has revised down its forecast path for inflation in the near-term, with the November Inflation Report hinting that rates may remain unchanged until 2017. Thus, the Bank of England seems to be very much on hold right now. Markets, which had thought that rates could rise during 2016, now do not see a rate increase until the start of 2017. Uncertainty around Brexit may be another reason why the BoE seems keen to keep policy on hold for now.

The Fed, by contrast, raised rates by 25bps at its mid-December FOMC meeting, the first such rate hike in nearly a decade. The Fed's own projections indicate that it expects to raise rates by 25bps per quarter over the next three years, taking the Fed funds rate up to 3.25% by end 2018. This is considerably more than markets expect. For 2016, markets see two 25bps hikes at most in contrast to the four projected by the Fed. How this difference is resolved is likely to have a major impact on the performance of financial markets this year.

The Fed has made it clear that incoming data will have a major impact on its policy decisions. We expect that the economy will continue to perform solidly in 2016 in line with Fed expectations, including some further tightening of labour market conditions. However, given the strength of the dollar, subdued wage growth and second round effects from lower energy costs, the core PCE deflator may not rise back up to 2% as quickly as the Fed expects. Continuing volatility in financial markets could also see the Fed delay rate hikes. Overall then, rates could rise at a somewhat slower pace than projected by the Fed, but by more than markets have priced in.

However, if the Fed's interest rate projections turn out to be correct, then there is likely to be a sharp sell-off in bond markets, with further gains by the dollar. Stock markets could also come under some further pressure. Thus, we see the evolution of Fed monetary policy as a key factor influencing financial markets in 2016.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.375	0.62	1.15	1.03	1.52
Mar '16	0.625	0.80	1.30	1.20	1.70
June '16	0.625	0.85	1.40	1.30	1.80
Sept '16	0.875	1.10	1.60	1.55	2.05

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Refi Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.05	-0.14	0.05	-0.07	0.26
Mar '16	0.05	-0.15	0.05	-0.07	0.27
June '16	0.05	-0.15	0.05	-0.05	0.30
Sept '16	0.05	-0.15	0.05	-0.03	0.35

** 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	1.04	0.93	1.38
Mar '16	0.50	0.60	1.05	0.95	1.40
June '16	0.50	0.60	1.05	1.00	1.45
Sept '16	0.50	0.60	1.10	1.05	1.55

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Pace of Fed rate hikes a key factor for FX markets in 2016

Despite a considerable amount of volatility, the four major reserve currencies (dollar, euro, yen and sterling) have been largely confined to quite well-defined trading ranges since last spring. This period of stability followed the big exchange rate moves in the second half of 2014 and opening quarter of 2015 that saw both the euro and yen fall sharply as their Central Banks continued with aggressive monetary easing.

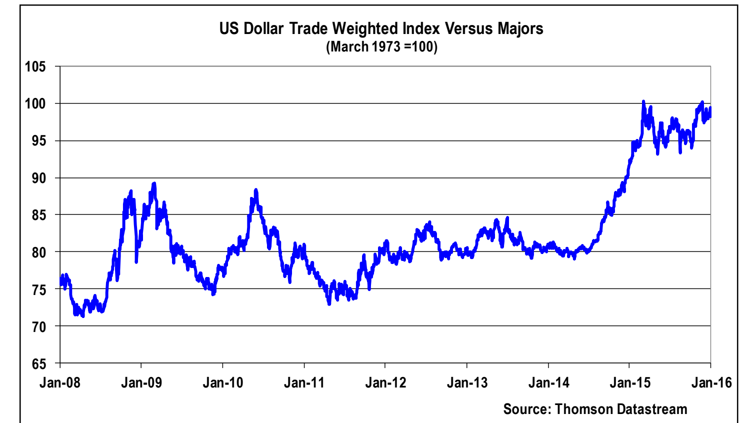
The euro and yen found a floor last spring and subsequently generally range traded against sterling and the dollar for the remainder of the year. Both currencies benefited from the slowdown in emerging economies, weakening commodity prices and increased risk aversion and volatility in financial markets. The very subdued inflationary outlook and the growing downside risks to global growth 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 greatly scaled back their expectations of rate hikes in the US and UK during the course of last year. When the Fed finally did hike rates in December, it was well signalled and had little impact. Markets remain of the belief that there will be just a very modest rise in US rates over the course of 2016-17.

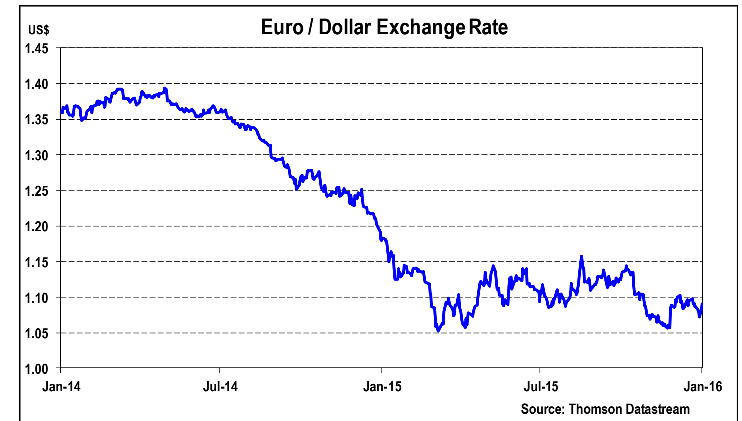
Thus, the EUR/USD rate started the New Year close to the $1.10 level, right in the heart of the $1.05-1.16 range that it has occupied since last spring. Against sterling, the euro is currently trading at close to the 75p level and so remains just about within the 70-75p trading range evident since last spring. Thus, the divergence in monetary policy between the Fed, BoE and ECB has so far failed to knock their currencies of out of their trading ranges, although concerns over Brexit are beginning to weigh on sterling.

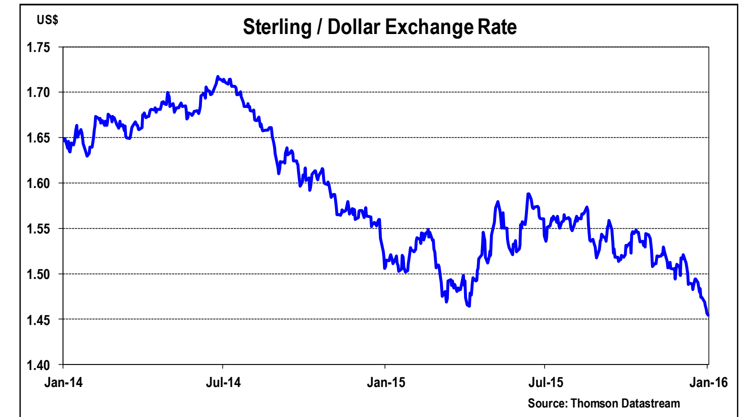
It is worth noting that the key support levels of $1.05 and 70p held quite easily for the single currency despite the further easing of monetary policy by the ECB at the end of 2015. The degree of ECB policy easing turned out to be considerably less than the markets had expected. The rather underwhelming ECB move allowed the euro to recover, rising to close on $1.10 and 75p.

The risks, though, remain to the downside for the euro against the dollar, given the prospect of on-going monetary tightening in the US during the coming year. Meanwhile, short-term rates in the Eurozone look set to remain quite negative in 2016, with the ECB also retaining an easing bias. Thus, it is hard to see how the euro can make gains against the dollar in 2016 if the Fed is raising rates, even at a very gradual pace, when Eurozone rates are already negative. It is certainly hard to see the euro rising above $1.15, unless there is a shock to the US economy that causes Fed rate hikes to be unwound.

A key issue in 2016 is the actual extent of Fed tightening, with the market pricing in at most two 25bps rate increases but the projections of the FOMC members pointing to four such rate hikes. The latter would take short-term US money market rates up to 1.5% or above by year end, well above Eurozone levels. Such a sizeable interest rate differential would seem likely to propel the dollar higher against the euro, possibly rising towards parity by end year. However, if rates rise in line with the market expectations, then the EUR/USD pair could continue to trade around current levels. Our view is that US rates may rise by somewhat more than the markets expect but not quite at the pace projected by the Fed. In such a scenario, the euro could fall modestly to around its key support level of $1.05 over the course of the year.







Forex Market Outlook

Risks building for sterling as Brexit referendum attracts more attention

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 may keep UK rates on hold for the whole of this year. This softening of UK rate hike expectations put an end to the strong appreciation evident in 2014 and H1 2015. Indeed, sterling has been confined to a 70-75p range against the euro since last spring, while it lost ground against the dollar since the middle of 2015.

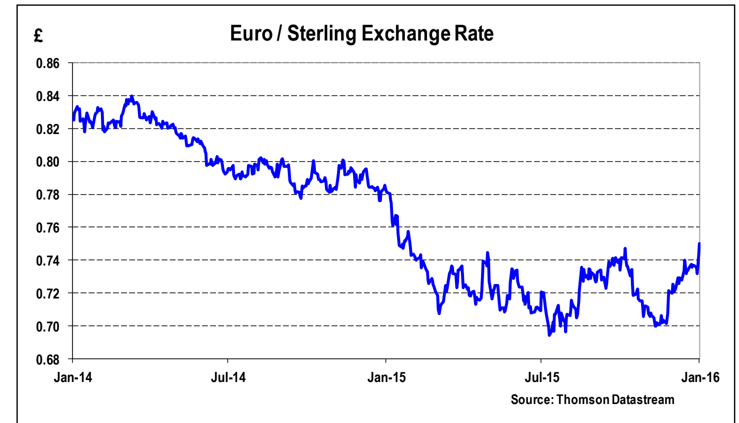
It is hard to make an argument for a renewed strengthening of sterling. The currency has already risen quite sharply on a trade-weighted basis since mid-2013 The UK, though, has a large balance of payments deficit suggesting that sterling is over valued. Meanwhile, UK rate hikes also look to be a long way off. Furthermore, the referendum on the UK's continued membership of the EU, which is likely to be held later this year, represents a serious event risk for sterling.

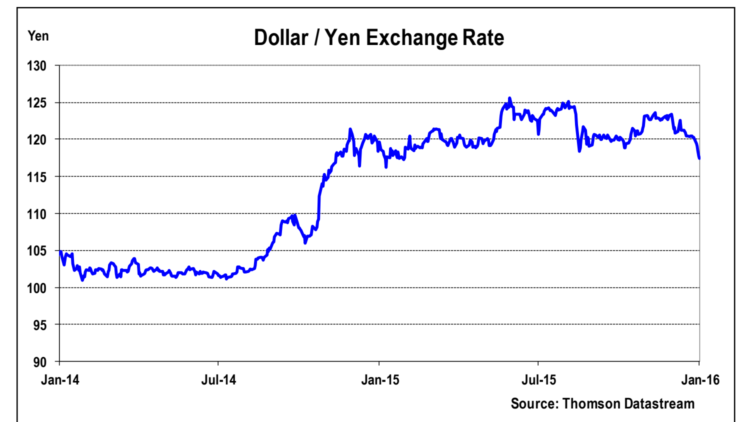
The currency finished 2015 on a soft note as opinion polls pointed to a very close result in the referendum vote. A growing risk of a Brexit would introduce a considerable amount of uncertainty in markets, most likely putting the UK currency under significant downward pressure. Thus, the opinion polls on Brexit bear careful watching as this is an issue that has the potential to impact quite negatively on sterling this year.

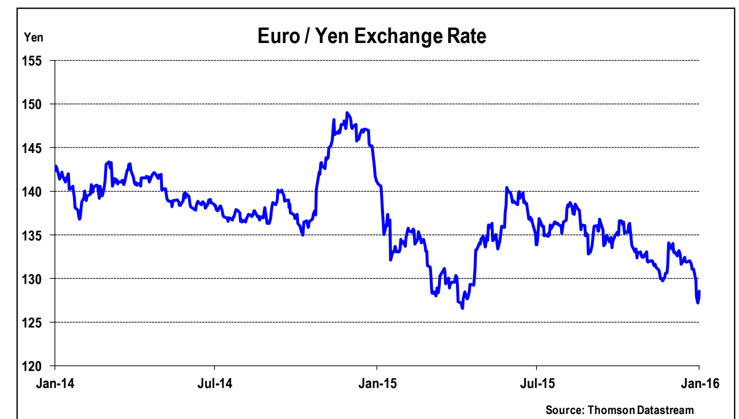
Overall then, we would be cautious on sterling in 2016 as there are downside risks on a number of fronts - rising balance of payments deficit, continuing low interest rates and Brexit. With US rates also rising, cable is now testing its 2010 low of $1.45, which could well give way. Its 2009 low of around $1.39-1.40, though, should provide strong support as cable has not fallen below this level since 1985. Against, the euro, sterling's support at the 75p level may also give way as markets increasingly fret about Brexit. We could see the EUR/GBP rate fall to 77-78p ahead of the referendum, before recovering if the UK votes to stay in the EU.

The yen was much more stable in 2015, having fallen sharply in the previous couple of years. Indeed, the yen looks to have found a floor. It has traded in a ¥117-125 range against the dollar since last February. Rising risk aversion has helped the yen. The dollar has risen above ¥125 on only two occasions in the past two decades, so it is not surprising that the yen has found support at this level. It may well be that the ¥125 support level can hold in 2016, even with US rates on a rising path. Meanwhile, the yen may be quite range bound against the euro in 2016 given that both the ECB and BoJ are implementing large QE programmes.

Finally, China made a significant change to its exchange rate policy in August, loosening the peg with the dollar and 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 in the coming year, but at a very gradual pace, as seems to be the wish of the Chinese authorities.



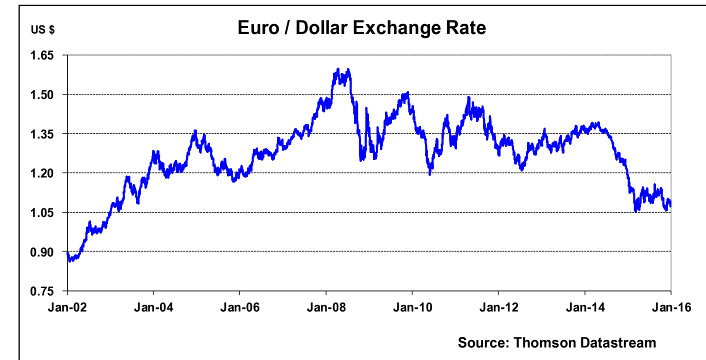


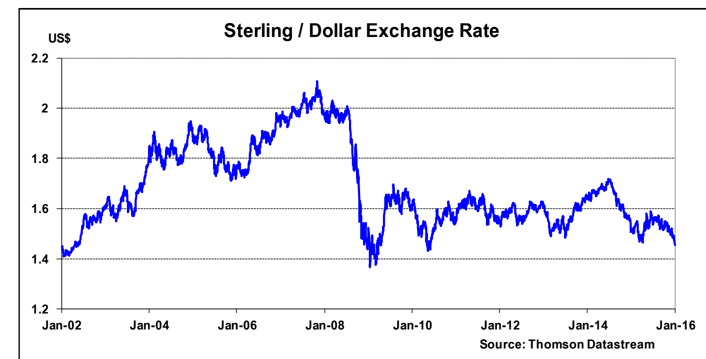


Summary of Exchange Rate Forecasts

("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	1.085	1.05-1.11	1.04-1.10	1.03-1.09	1.02-1.08
GBP	0.749	0.74-0.78	0.75-0.79	0.72-0.76	0.70-0.74
JPY	127.79	126-132	125-131	126-132	127-133
CHF	1.09	1.09	1.09	1.09	1.09
US Dollar Versus					
JPY	117.76	116-122	117-123	119-125	121-127
GBP	1.448	1.39-1.45	1.36-1.42	1.40-1.46	1.43-1.49
CAD	1.42	1.42	1.44	1.45	1.46
AUD	0.70	0.70	0.70	0.69	0.68
NZD	0.65	0.66	0.66	0.65	0.64
CNY	6.58	6.60	6.65	6.70	6.75
Sterling Versus					
JPY	171	169	167	175	181
CAD	2.06	2.02	2.00	2.08	2.08
AUD	2.07	2.03	1.99	2.07	2.15
NZD	2.21	2.15	2.11	2.20	2.28





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