Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

19th February 2018

- Global economic recovery continues to gather momentum, but inflation stays subdued
- Era of monetary easing coming to an end. Markets have become more bearish and see 100bps+ of rate rises in US, UK & Eurozone by end 2020—still a slow pace of policy tightening
- Dollar on long-term weakening path, but repatriation of funds by US corporates to take advantage of tax cuts may provide some temporary support for the currency in months ahead
- Sterling recovers some ground. Progress of Brexit talks to set tone for currency in 2018
- Euro makes gains in past year, but still at quite low level vs dollar. Further gains by euro seem likely, but increased market volatility and repatriation flows could give some support to dollar

Oliver Mangan
Chief Economist

John Fahey
Senior Economist

Dara Turnbull
Economist

www.aibeconomics.com

Global Economic Outlook

Global growth forecast at 4% this year and next, with inflation staying subdued

Global economic activity has been gaining strength over the past eighteen months, helped by an improvement in investment, manufacturing and world trade. Growth in world trade volumes is estimated by the OECD and IMF at close to 5% in 2017, almost double that in the previous number of years. The IMF recently upgraded its forecasts for the world economy and is now forecasting 3.9% growth in both 2018 and 2019, up from 3.7% in 2017 and 3.2% in 2016.

There was a marked pick-up in growth in all the major economies last year, apart from the UK. The IMF estimates that that advanced economies grew by 2.3% in 2017, compared to 1.7% the previous year. Activity in developing economies has also been gathering strength, helped by the emergence of countries like Russia, Brazil and Nigeria from recessions as oil prices recovered from their early 2016 lows. The IMF puts growth in emerging economies at 4.7% last year, up from 4.4% in 2016 and 4.2% in 2015.

It would seem that the combination of continuing very loose monetary policies, a more supportive stance to fiscal policy and some recovery in commodity prices have at last triggered stronger economic growth. Activity is also being aided by good employment growth and low inflation, which is boosting real incomes and spending power. Credit growth has started to improve in many economies. The pick-up in world trade is an important factor also.

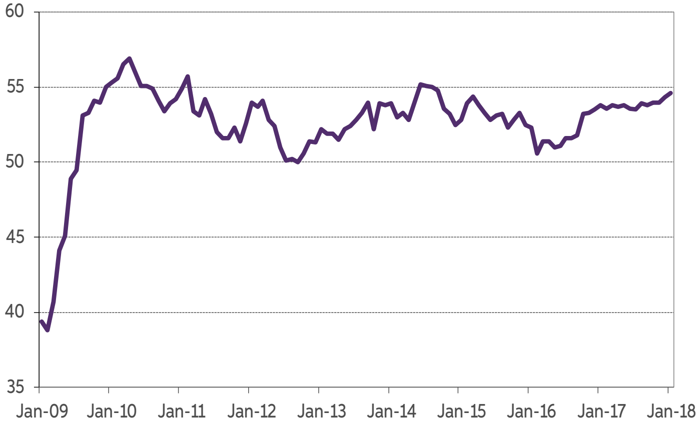
Central banks across the globe have been indicating that monetary policy can remain quite accommodative despite the stronger growth because of the persistence of very low inflation. This should help sustain the upturn in economic activity. Fiscal policy is also turning increasingly expansionary in some economies. Hence, the IMF now expects the world economy to grow by close to 4% in the next two years. It sees advanced economies continuing to grow at around 2.3% and growth in developing economies picking to 5% in 2018-19.

The one exception to the generally improving picture has been the UK. Activity slowed there last year, as high inflation dampened consumer spending, with uncertainty over Brexit weighing on investment. There is little sign yet that the traded sector in the UK is benefitting from sterling's sharp fall and improving global activity. The IMF is forecasting that the UK economy will grow by 1.5% in the next two years, much the same as during 2017.

Data have generally been coming in ahead of expectations in recent times, most notably in the Eurozone. Indeed, the Eurozone has become the fastest growing economic region in the developed world. GDP rose by 2.75% in year-on-year terms in H2 2017, well ahead of the US, UK and Japan. Most survey indicators are pointing to a strong start in 2018 for the world economy. The JP Morgan Composite Output PMI hit 54.6 in January, up from 54.3 in December, its highest level since Sept 2014. Recent months have seen a marked improvement in emerging economies, with their PMI data for January signalling the fastest rate of expansion for five years. The PMIs for advanced economies, meanwhile, remain strong, running at one of the highest levels seen in recent years.

Despite the pick-up in global growth, inflation in advanced economies remains subdued and below targets, while it is quite stable in most emerging economies. Headline inflation rates will be boosted somewhat by the recent rise in oil prices, but underlying inflationary pressures are expected to remain subdued. Sluggish wage growth is a key factor in keeping inflation at low levels. The IMF is forecasting that CPI inflation will average around 2% in advanced economies in 2018-19, up from 1.9% in 2017, partly due to higher oil prices.

Global Composite PMI (JP Morgan)



Source: Thomson Datastream

GDP (Vol % Change)

	2016	2017 (e)	2018 (f)	2019 (f)
World	3.2	3.7	3.9	3.9
Advanced Economies	1.7	2.3	2.3	2.2
US	1.5	2.3	2.7	2.5
Eurozone	1.8	2.4	2.2	2.0
UK	1.9	1.7	1.5	1.5
Japan	0.9	1.8	1.2	0.9
Emerging Economies	4.4	4.7	4.9	5.0
China	6.7	6.8	6.6	6.4
India	7.1	6.7	7.4	7.8
World Trade Growth (%)	2.5	4.7	4.6	4.4
Advanced Economies CPI Inflation (%)	0.8	1.7	1.9	2.1

Source: IMF World Economic Outlook Update, January 2018

Interest Rate Outlook

Major shift underway to a rising interest rate environment

The long period of global monetary easing is coming to an end. The US Federal Reserve is advancing steadily on a path towards policy normalisation, while rates have also been hiked in Canada, the Czech Republic and UK in the past year. The ECB reduced the size of its monthly asset purchases at the start of this year, while even the Bank of Japan is tapering QE ever so slightly, after announcing that it is trimming purchases of long dated bonds.

Nonetheless, monetary policy is expected to remain quite loose in all the major economies over the next couple of years. Continuing low inflation suggests that policy can be tightened at a slow pace, despite the strengthening of global economic activity. Markets, though, have become increasingly bearish about rate hikes in recent months. Indeed, futures contracts are now pricing in around 100bps or more in rate increases by the Fed, BoE and ECB by the end of 2020. This would still leave official rates quite low at 2.5% in the US, 1.5% in the UK and around 0.5% in the Eurozone.

In the UK, inflation picked up following the sharp decline in sterling, with headline CPI inflation rising to around 3%. This saw the MPC decide in November to reverse the 25bps rate cut made in 2016 and bring the bank rate back up to 0.5%. It was the first UK rate hike since 2007. At its February policy meeting, the MPC warned that the need to get inflation back down to target would most likely mean that interest rates will have to be raised to a somewhat greater extent than it had previously envisaged. Markets now expect the MPC to raise rates in the summer and see official rates being increased by 100bps in total to 1.5% by the end of 2020.

The ECB scaled back asset purchases under its QE programme at the start of 2018. Monthly purchases have been reduced from €60bn to €30bn, with the ECB indicating that it will maintain purchases at this lower level until at least September 2018. It has said that it could increase the size of monthly purchases again if necessary, but markets are of the view that the ECB will cease net asset purchases altogether in either September or December.

The ECB has reaffirmed that it intends to keep interest rates at their current very low levels well past the time horizon of its QE programme. The ECB deposit rate is currently –0.4%. Thus, it is likely to be 2019 before rates are increased, given this policy guidance from the Central Bank. Futures contracts show little change in wholesale rates for most of 2018. However, they see money market rates rising by 50bps by the end of 2019 and another 50bps in 2020, taking three month rates up to 0.65% by then from –0.35% at present. Rates are expected to rise above 1% towards the end of 2021. Overall then, rates are still expected to remain low in the next few years.

Meanwhile, the Fed hiked by 25bps at its December meeting, the fourth such hike since December 2016, taking rates up to 1.375%. The Fed also started the process last autumn of slowly reducing the size of its balance sheet, or unwinding QE, by no longer reinvesting funds from some of its bonds as they mature. The FOMC in December reaffirmed that it expects to raise rates by 25bps on three occasions again this year, bringing them up to 2.125% by end 2018. This has been fully priced in by markets at this stage, after they turned more bearish on rates.

The Fed expects rates to rise to 2.75% by end 2019 and reach 3.1% in 2020. Markets, though, see rates getting to 2.5% by end 2020, 60bps below Fed projections. Inflation could be a key factor in whether the Fed raises rates to circa 3%. Some FOMC members have indicated that continuing below target inflation could mean that rates would not need to rise as much as projected, although a further loosening of fiscal policy may trump this concern.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.375	1.88	2.39	2.44	2.71
Mar '18	1.625	2.00	2.45	2.50	2.75
June '18	1.875	2.25	2.65	2.70	2.90
Sept '18	2.125	2.50	2.85	2.90	3.05

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	-0.40	-0.38	-0.26	-0.12	0.49
Mar '18	-0.40	-0.36	-0.24	-0.10	0.55
June '18	-0.40	-0.34	-0.20	-0.05	0.60
Sept '18	-0.40	-0.30	-0.10	0.05	0.70

** 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	0.54	0.87	1.01	1.40
Mar '18	0.50	0.55	0.90	1.05	1.50
June '18	0.50	0.60	0.95	1.10	1.55
Sept '18	0.75	0.80	1.10	1.25	1.70

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Dollar slide continues in early 2018

A key feature of forex markets over the past year has been the strengthening of the euro and weakening of the dollar. This trend remained evident in the early part of 2018, with the EUR/USD rate climbing from $1.20 at the start of January to a three year high above $1.25. This is well above its level of a year ago, when the EUR/USD rate was around $1.05.

It is important to note, though, that the dollar lost ground against a broad range of currencies in recent times and not just the euro. The Aussie, NZ and Canadian dollars have all made ground against the dollar in the past year, while sterling has staged a strong rebound, rising from $1.22 to around the $1.40 level. Even the Chinese yuan, which declined steadily against the dollar over the 2014-16 period, has appreciated strongly against the US currency, gaining almost 10% since the start of last year.

The dollar stabilised and, indeed, regained some ground over the closing months 2017, as the Fed prepared to hike rates again and President Trump succeeded in getting major tax cuts through Congress. However, it came under renewed downward pressure against a range of currencies after Christmas and in early 2018.

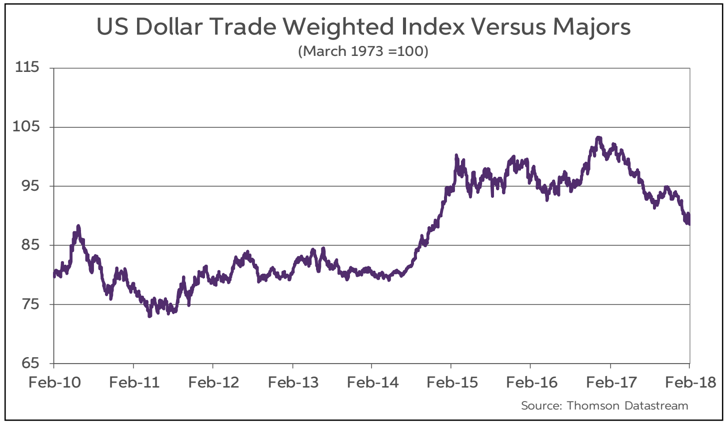
It is hard to pinpoint the precise factors behind the weakness of the dollar over the past year as the US economy has been performing quite well and the Fed has raised rates by 100bps since near the end of 2016. It may have more to do with the fact that the global economy has picked up considerable momentum, meaning other central banks have started to join the Fed in raising rates, with others likely to eventually follow suit.

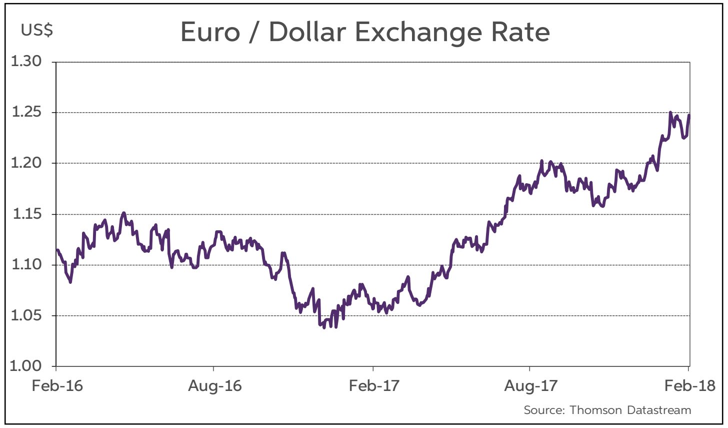
Traders need to be wary, though, as cuts in US corporate tax rates at the end of 2017 could spark some dollar buying this year, should American companies start to bring back cash from overseas to take advantage of a special low tax rate on repatriated profits. It is hard to put a figure on the size and timing of such flows, but they would benefit the US currency if companies need to convert funds held in other currencies into dollars to repatriate them. The US currency fell sharply over the 2002-2008 period, except in 2005, when a similar corporation tax amnesty that year led to a temporary but marked rise by the dollar.

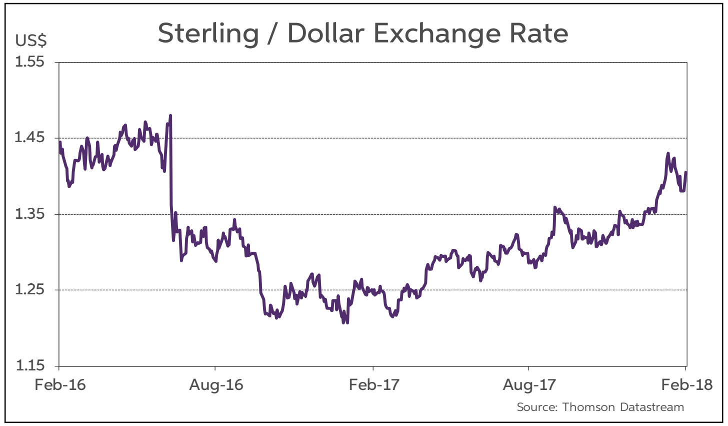
Market positioning is also quite short dollar and long euro at the present time, which could limit the near-term upside for EUR/USD. Overall, we could be in for some volatility in forex markets in the months ahead, with investors inclined to take the US currency lower, but dollar buying on repatriation flows also quite possible. More generally, if the increased volatility that we have seen in financial markets recently continues, it could also be dollar supportive as the liquid US currency is generally seen as a safe-haven in times of market turbulence.

Despite the big gains of the past year, the euro is still at a relatively low level against the dollar. EUR/USD mainly traded in a $1.20-1.50 range from 2003 to 2015. It has now returned to the lower end of this range and seems likely to continue to move higher as we get closer to the start of rate tightening in the Eurozone. Indeed, the marked loosening of US fiscal policy at this stage of the cycle, with possibly more in the pipeline, could also rekindle fears about the twin American deficits, adding to the downward pressure on the dollar.

Overall then, there could be bouts of dollar buying on repatriation flows during 2018 that sees the euro fall back to $1.20 or below. Longer term, though, we think the euro is on an uptrend against the dollar, with $1.30 the next big target for the single currency, which we expect could be hit later this year.







Forex Market Outlook

Progress on Brexit talks likely to be key influence on sterling

Sterling fell sharply in the aftermath of the UK referendum vote for Brexit in mid-2016. The currency hit 30-year lows against the dollar, falling from $1.50 before the vote to as low as $1.20 in late 2016. Brexit concerns also saw sterling lose significant ground against the euro, with EUR/GBP rising sharply from the 70p level near the end of 2015 to a high point at around 93p in August 2017.

However, more recently sterling has managed to move off its lows and regain some ground. Indeed, it has recovered a lot of its losses against the weakening dollar, moving back over the $1.30 level during last summer and rising above the $1.40 level in early 2018. The UK currency also recovered some ground against the euro last autumn, helped by an unexpected rate hike from the Bank of England, some better UK economic data and hopes that agreement can be reached on a soft Brexit when the UK departs from the EU in March 2019. This has seen EUR/GBP move down to trade in a narrow 87-90p range since last September.

The progress of the Brexit negotiations is likely to be the key factor influencing sterling in the period ahead. The first stage of the talks proved difficult and slow, but EU Leaders were able to agree at their December summit that sufficient progress had been made to allow the discussions to move on in 2018 to the more substantive issues of transition arrangements and future trade relations.

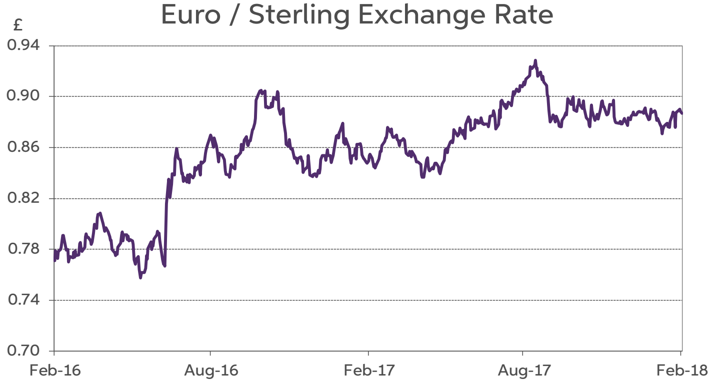
There are hopes the outcome of the talks will be a soft Brexit and that transition arrangements can be agreed in the coming months, which allow for continuing free trade between the UK and EU for a period after Brexit occurs in March 2019. It is hoped that a full trade deal can then be negotiated in the following couple of years that will come into effect once the transition period ends, most likely at the end of 2020 or early 2021.

Nonetheless, given the uncertain political backdrop in the UK and its desire to regain full sovereignty, there is still a risk of a hard Brexit, where the UK is unable to conclude a trade deal with the EU. This would see the UK lose its free access to the Single Market and have to fall back on WTO rules. Little progress has been made in the Brexit talks since December, which is a bit of a worry as it was hoped that agreement on transition arrangements could be reached by March. The UK has yet to clearly set out how it can reconcile its intention to leave the EU Customs Union and Single Market with its desire to continue to enjoy largely frictionless free trade with the EU.

Overall, sterling seems likely to continue to trade in the 87-90p range against the euro that it has occupied since September, until markets get clearer signals on the outcome of the Brexit talks. This could take some time. The current stage of the talks on the transition phase are making little progress. The talks then need to move on to discussing future trade relationships. If it becomes increasingly evident that a soft Brexit in March 2019 is on the cards, then sterling could make some gains, with the euro moving down to 85p and cable rising to $1.50.

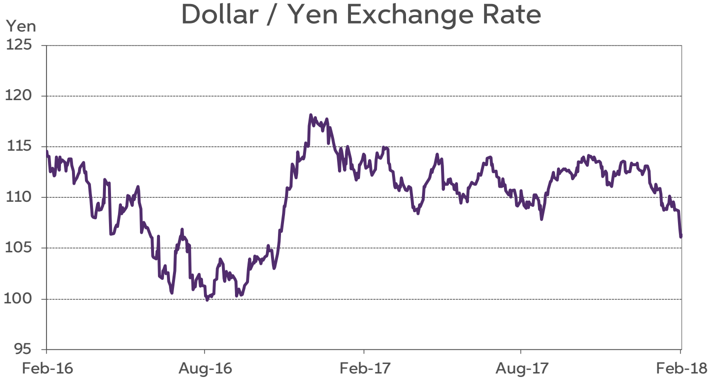
On the other hand, if a hard Brexit looks increasingly likely, then the euro can be expected to move up to the 95p level. Indeed, it could rise even higher to trade in a 95p-100p range as a hard Brexit approached in March 2019, with cable falling back towards $1.30. There is still considerable uncertainty about what the future trade relationship between the UK and EU will look like, with plenty of scope for delays and disagreement. Hence, while a soft Brexit seems the most likely outcome of the exit negotiations, a hard Brexit cannot be ruled out.

Euro / Sterling Exchange Rate



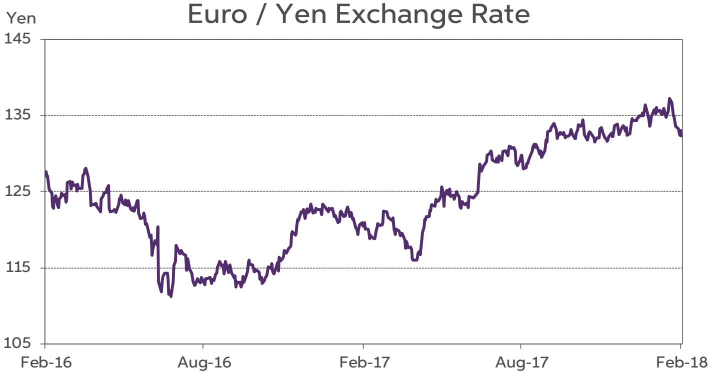
Source: Thomson Datastream

Dollar / Yen Exchange Rate



Source: Thomson Datastream

Euro / Yen Exchange Rate

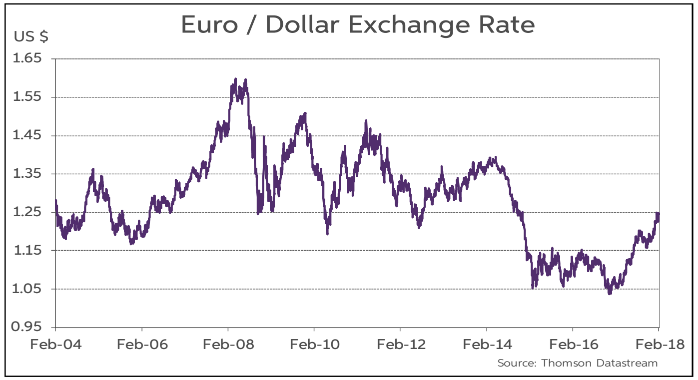


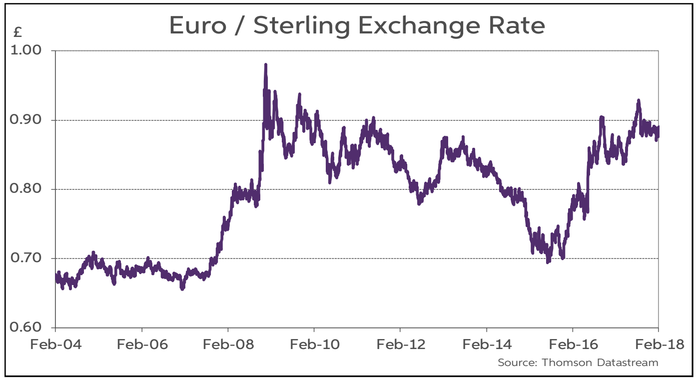
Source: Thomson Datastream

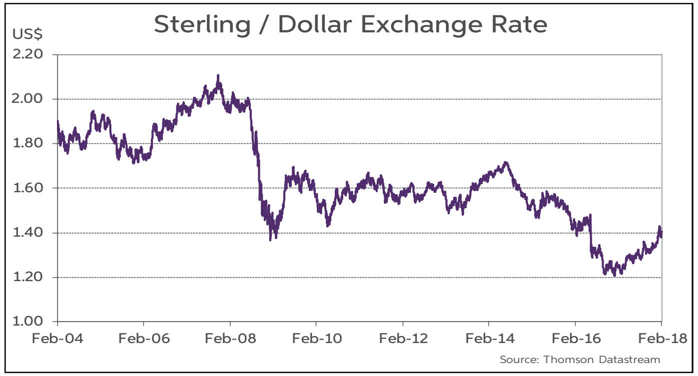
Summary of Exchange Rate Forecasts

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

	Current	Q1-2018	Q2-2018	Q3-2018	Q4-2018
Euro Versus					
USD	1.241	1.22-1.28	1.20-1.26	1.22-1.28	1.25-1.31
GBP	0.885	0.86-0.92	0.85-0.91	0.85-0.91	0.84-0.90
JPY	132.24	130-136	130-136	130-136	130-136
CHF	1.15	1.15	1.14	1.14	1.14
US Dollar Versus					
JPY	106.55	103-109	105-111	103-109	101-107
GBP	1.403	1.37-1.43	1.37-1.43	1.39-1.45	1.44-1.50
CAD	1.25	1.25	1.27	1.25	1.23
AUD	0.79	0.79	0.78	0.79	0.81
NZD	0.74	0.74	0.73	0.74	0.76
CNY	6.34	6.35	6.45	6.35	6.20
Sterling Versus					
JPY	149	148	151	151	153
CAD	1.76	1.76	1.78	1.78	1.81
AUD	1.77	1.77	1.79	1.80	1.81
NZD	1.90	1.89	1.92	1.92	1.93







AIB Treasury Economic Research Unit

AIB Bankcentre, Ballsbridge, Dublin 4 Tel: 353-1-6600311 www.aibeconomics.com