# Forex and Interest Rate Outlook

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AIB

**AIB Treasury Economic Research Unit**

- **Nervous financial markets as risk aversion dominates on fears about global growth. Stock markets weak with benchmark bond yields at very low levels**
- **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 ease monetary policy further in face of persistent very low inflation and risks to growth. BoE is very much on hold. Fed showing little appetite to hike rates at present**
- **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**
- **Brexit referendum now key factor in the fortunes of sterling**

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# Global Economic Outlook

## *Continuing concerns about downside risks to global growth*

Global growth remains very much sub-par. 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". World growth is put at around 3% in 2015, the weakest rate since the end of the economic crisis of 2008-2009. Both the IMF and OECD are forecasting a similarly subdued performance in 2016.

Activity in advanced economies has gained some momentum in the past couple of years, with GDP growth picking up to close on 2% in 2014-15 from 1.2% in 2012-13. This is largely attributable to a strengthening of activity in the Eurozone. Growth in the US and UK has been solid enough in recent years. However, Japanese growth remains erratic and sluggish, despite an ultra-loose monetary policy and a big decline in the yen

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, activity in emerging economies has been weakening since 2010, when it stood at 7.5%. Most notably, GDP growth in China slowed from 10.4% in 2010 to 6.9% in 2015.

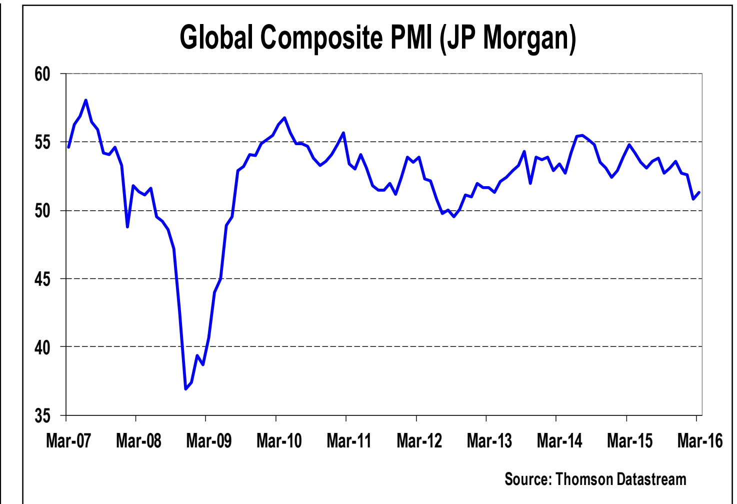
Many commentators suspect that the slowdown in China is even more pronounced and the actual growth rate may have decelerated to around 4%. It has also been observed that the impact of the slowdown in China on other emerging economies via falling commodity prices and lower imports, appears to have been 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 derail the recovery in advanced economies. It is worth noting, though, that the recovery in advanced economies has largely remained on track, despite the slowdown in emerging economies in recent years. The IMF and OECD expect that advanced economies will continue to register moderate growth of close to 2% in 2016 and 2017.

There are a number of factors supporting growth. The sharp decline in oil and other commodity prices has seen inflation fall to very low levels, thus boosting real incomes and spending power. Monetary policy remains very loose, with low rates everywhere. Indeed, policy continues to be loosened in some major economies. Meantime, fiscal policy is turning less restrictive in most advanced economies. Labour markets also continue to strengthen, with rising employment and a falling jobless rate in all the major economies.

However, downside risks remain for the world economy, especially emerging economies. The 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. The IMF expects growth in these economies to remain subdued at around 4% in 2016, before picking up to 4.6% in 2017.

Somewhat worryingly, the Global Composite PMI has dropped to around 51 in the past couple of months, its lowest level in over three years. Other leading indicators of activity have also softened in recent months. The negative sentiment on financial markets may well be impacting confidence in economic prospects. Markets have been more stable recently, with some recovery in commodity prices, which is encouraging. A close eye, though, needs to be kept on leading indicators in the months ahead as if they continue to weaken, it would be a sign that growth in the world economy is slowing further and we may be heading for a downturn in the global economy.




| *GDP (Vol % Change)* | 2014 | 2015 | 2016 (f) | 2017 (f) |
|---|---|---|---|---|
| World | 3.3 | 3.1 | 3.2 | 3.5 |
| Advanced Economies | 1.9 | 1.9 | 1.9 | 2.0 |
| US | 2.4 | 2.4 | 2.4 | 2.5 |
| Eurozone | 0.9 | 1.6 | 1.5 | 1.6 |
| UK | 3.0 | 2.2 | 1.9 | 2.2 |
| Japan | -0.1 | 0.5 | 0.5 | -0.1 |
| Developing Economies | 4.7 | 4.0 | 4.1 | 4.6 |
| China | 7.3 | 6.9 | 6.5 | 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, April 2016*

# Interest Rate Outlook

### *Monetary policy remains very loose globally, with the Fed reluctant to hike*

The past year has been 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 in 2015.

There was further significant monetary easing in the opening quarter of 2016. The Bank of Japan stunned markets in January by unexpectedly cutting rates, moving them into negative territory. Meanwhile, the ECB eased policy further at its March meeting as it continued with its efforts to boost inflation and growth. It lowering the deposit rate by a further 10bps to −0.4%, moving it even deeper into negative territory, while also cutting the refi rate by 5bps to 0%. It also increased the size of its asset purchase programme from €60bn to €80bn per month and expanded the pool of eligible QE assets to include euro-denominated, investment grade corporate bonds. It is also going to launch four new TLTROs over the coming year.

The ECB, though, signalled that it could be nearing the limit in terms of what it can do on interest rates and indicated that any further easing is likely to comprise non-standard measures. While Eurozone rates may have reached a trough, markets expect them to remain there for a long time. Futures markets suggest that three month money rates will remain negative in the Eurozone until the end of the decade, and we may not get a hike in the key ECB refi rate until 2021 or 2022.

Meanwhile, central banks that were contemplating monetary tightening have either delayed the move, or remained on hold altogether. Indeed, although there has been further policy easing by some central banks this year, the biggest change in market rates has been in countries where central banks were expected to hike rates. These rate hikes have now being priced out, resulting in big downward shifts in futures curves in these markets.

The BoE has shown a clear reluctance to start raising rates despite the tightening in labour market conditions in the UK, 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 greatly 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 2018.

Meantime, the US Federal Reserve did raise rates by 25bps to 0.375% at its December 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 following three years, taking the Fed funds rate up to 1.375% by the end of 2016 and 3.25% by end 2018. However, the Fed has grown increasingly cautious in recent months and scaled back its rate hike projections at its March meeting.

The March projections show that the Fed still thinks it likely that it will increase rates, albeit on two occasions later this year. However, the markets are quite sceptical on this, especially given the comments from Fed officials about the downside risks to growth. Indeed, markets now don't expect the next rate hike in the US to materialise until Q2 2017 and do not see official rates rising to 1% until end 2018.  In our view, though, rates could still be hiked in the US later this year given the recent uptrend in core inflation and continuing strength of the labour market. US data will bear close watching in this regard in the months ahead.

**US Interest Rate Forecasts (to end quarter)**

| | Fed Funds | 3 Mth | 1 Year | 2 Year * | 5 Year * |
|---|---|---|---|---|---|
| **Current** | 0.375 | 0.63 | 1.21 | 0.85 | 1.16 |
| **June '16** | 0.375 | 0.63 | 1.20 | 0.85 | 1.15 |
| **Sept '16** | 0.375 | 0.65 | 1.25 | 0.95 | 1.30 |
| **Dec '16** | 0.625 | 0.85 | 1.45 | 1.25 | 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** | -0.40 | -0.26 | -0.03 | -0.16 | 0.00 |
| **June '16** | -0.40 | -0.25 | -0.05 | -0.15 | 0.00 |
| **Sept '16** | -0.40 | -0.25 | -0.05 | -0.15 | 0.05 |
| **Dec '16** | -0.40 | -0.25 | -0.05 | -0.10 | 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 | 1.00 | 0.80 | 1.01 |
| **June '16** | 0.50 | 0.60 | 1.00 | 0.80 | 1.00 |
| **Sept '16** | 0.50 | 0.60 | 1.00 | 0.85 | 1.10 |
| **Dec '16** | 0.50 | 0.65 | 1.10 | 0.95 | 1.25 |

** 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 remained quite 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 euro has had the upper hand in the past couple of months, though, climbing from $1.08 to $1.14, despite the further loosening of policy by the ECB. So too has the yen, with the dollar sliding from ¥120 to ¥108 since the end of January, even though the Bank of Japan has moved to a negative interest rate policy. The moves in ECB and BoJ rates, though, have been 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 Q2 2017, with just very moderate increases in interest rates thereafter.

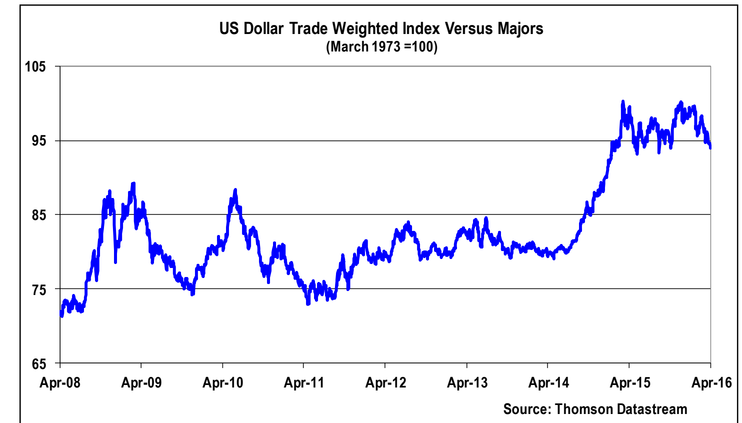
Very subdued inflation, the downside risks to global growth and fragile sentiment on financial markets have made it difficult for central banks like the Fed and Bank of England to tighten monetary policy despite the strength of their own economies. The big scaling back of US rate hike expectations has taken the shine off the dollar, causing it to lose ground. It has declined by over 5% on a trade-weighted basis since end January. The increased risk aversion and volatility in financial markets this year has also helped currencies like the euro and yen. Currencies such as the Canadian, Aussie and New Zealand dollars have also gained back some ground against the dollar in the past couple of months, helped also by some recovery in commodity prices.

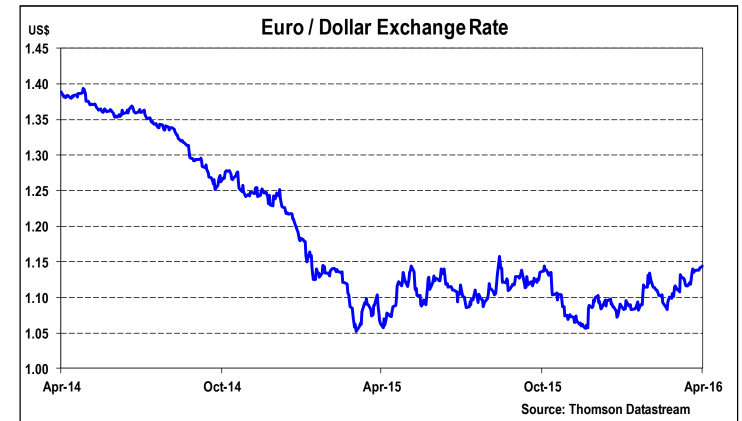
The EUR/USD rate is currently trading at around $1.14, near the top end of the $1.06-1.15 range that it has occupied over the past year. Short-term interest rates look set to remain quite negative in the Eurozone over the next couple of years, with the ECB also retaining an easing bias. Thus, it is hard 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 to consider easing policy.

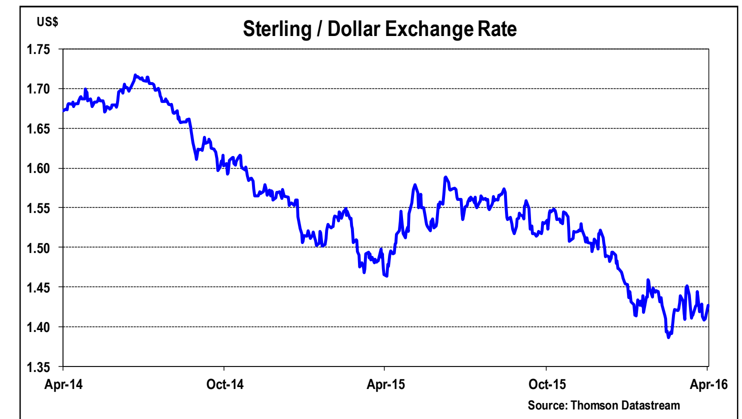
Much uncertainty still surrounds the actual extent of Fed tightening. The market is not pricing in another rate increase until Q2 2017, but the most recent projections of the FOMC members in March point to a number of rate hikes before then. The Fed may be cautious but it still has a tightening bias. Unless the US economy slows significantly, the Fed could still hike rates later this year.

As we have seen in recent moths, rate hike expectations remain a key driver of FX rates. In the near-term, nervous financial markets and softer data seem likely to keep the Fed on hold. However, the dollar is likely to strengthen again if US rates hikes come back on to the agenda later in 2016, as happened in October and November of last year, ahead of the Fed's rate hike in December.

However, given that any rate hikes in the US are likely to be modest enough, the currency will probably find it difficult to make substantial gains. Thus, we expect the EUR/USD rate will remain range bound 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 Q2 2017. The dollar could recover some of the ground lost recently against the yen on this basis also.



# Forex Market Outlook



## *Sterling comes under major pressure ahead of Brexit referendum*

Sterling appreciated by nearly 20% on a trade-weighted basis between 2013 and mid-2015, partly fuelled by expectations of UK rate hikes. The euro fell from close to 90p versus sterling in 2011 to 80p in 2014 and a 70-74p trading range in 2015. A good deal of these gains, though, have unwound over the past few months. This is largely due to the fact that markets are starting to think about Brexit as something which is now a serious possibility.

The euro has risen by more than 15% against sterling since the start of December, climbing from 70p to 81p. Meanwhile, GBP/USD has fallen from a high of $1.59 last summer, to near the $1.40 level recently. GBP/USD is now getting close to its 2009 trough of $1.38. This represented the lowest exchange rate for sterling against the dollar since 1985.

The UK Government has set June 23rd as the date for its 'In-Out' referendum vote on Britain's continued membership of the EU. Opinion polls are pointing to a very close outcome. The issue has now moved centre stage in the UK. It is now a 50/50 call in our view, on whether the UK votes to leave or remain in the EU.

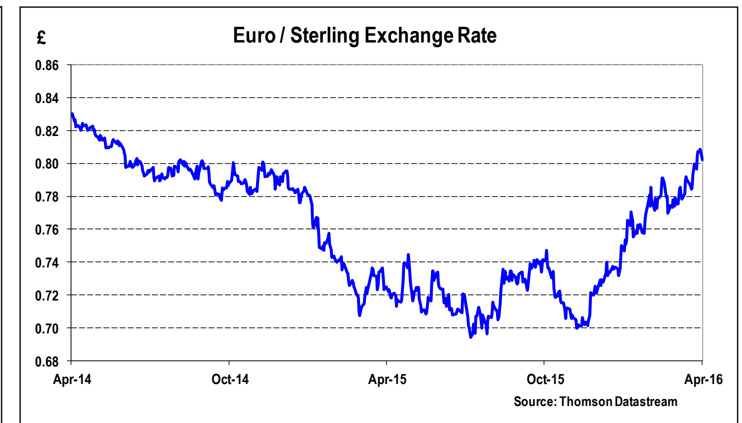
Should the UK vote to remain in the EU, we would expect sterling to recover some of the ground lost recently, rising back up to 74-75p versus the euro, with GBP/USD climbing towards the $1.50 level. We don't see sterling moving back up to last year's highs, though, of 70p versus the euro and $1.59 against the dollar, as markets are no longer expecting the Bank of England to raise rates anytime soon.

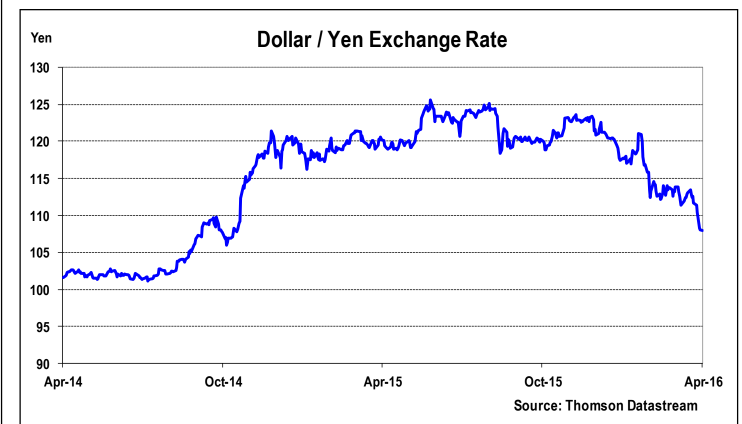
On the other hand, sterling can be expected to see further loses in the event of a vote for Brexit. At a minimum, the euro would seem likely to rise to its 2013 level of 85-86p. However, it could well climb to its 2011 high of 90p on a disorderly Brexit, where relations are soured with the EU and there are a lot of difficulties in reaching some form of a trade deal. GBP/USD can be expected to hit 30 year lows on a vote for Brexit, falling to around $1.25, and possibly going even lower on a disorderly exit. The euro is also likely to lose ground, as Brexit would be seen as a major blow to the EU. EUR/USD could fall to last year's low of $1.05 from around $1.14 currently.

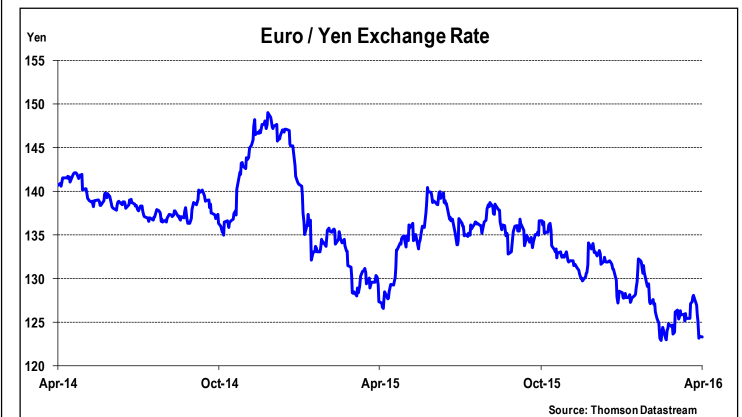
Thus, the upcoming Brexit referendum will be a key driver of FX markets this summer. Below is a summary table of Forex forecasts based on various outcomes to the Brexit Referendum. Our main FX forecast table on the back page is based on the view that the UK will vote to remain in the EU.

### Forex Forecasts for Various Brexit Outcomes

| OUTCOME | EUR/GBP | EUR/USD | GBP/USD |
|---|---|---|---|
| **REMAIN** | 0.75 | 1.11 | 1.48 |
| **ORDERLY BREXIT** | 0.86 | 1.07 | 1.25 |
| **DISORDERLY BREXIT** | 0.90 | 1.05 | 1.17 |



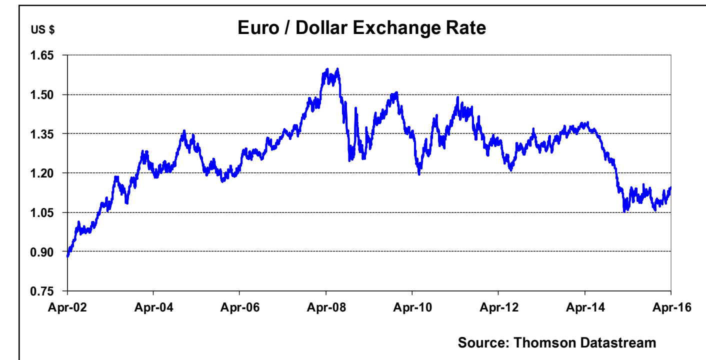



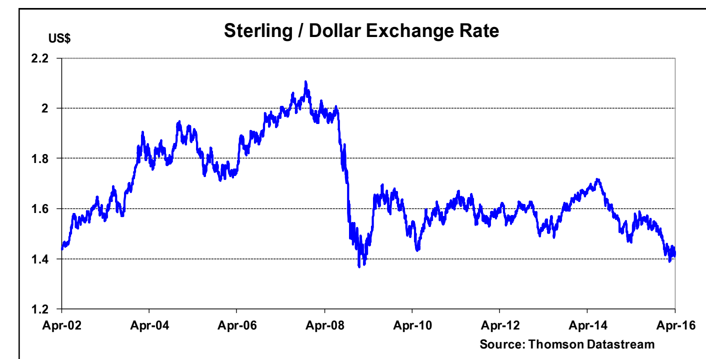



# Summary of Exchange Rate Forecasts

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

| | Current | Q2-2016 | Q3-2016 | Q4-2016 | Q1-2017 |
|---|---|---|---|---|---|
| **Euro Versus** | | | | | |
| **USD** | 1.142 | 1.10-1.16 | 1.08-1.14 | 1.06-1.12 | 1.04-1.10 |
| **GBP** | 0.799 | 0.74-0.78 | 0.73-0.77 | 0.72-0.76 | 0.71-0.75 |
| **JPY** | 123.73 | 121-127 | 121-127 | 121-127 | 121-127 |
| **CHF** | 1.09 | 1.09 | 1.09 | 1.09 | 1.09 |
| **US Dollar Versus** | | | | | |
| **JPY** | 108.31 | 107-113 | 109-115 | 111-117 | 113-119 |
| **GBP** | 1.430 | 1.46-1.52 | 1.45-1.51 | 1.44-1.50 | 1.44-1.50 |
| **CAD** | 1.29 | 1.28 | 1.27 | 1.26 | 1.25 |
| **AUD** | 0.77 | 0.76 | 0.75 | 0.74 | 0.73 |
| **NZD** | 0.69 | 0.68 | 0.67 | 0.66 | 0.65 |
| **CNY** | 6.46 | 6.47 | 6.50 | 6.53 | 6.55 |
| **Sterling Versus** | | | | | |
| **JPY** | 155 | 164 | 166 | 168 | 171 |
| **CAD** | 1.84 | 1.90 | 1.88 | 1.86 | 1.83 |
| **AUD** | 1.87 | 1.96 | 1.97 | 1.99 | 2.01 |
| **NZD** | 2.08 | 2.19 | 2.21 | 2.23 | 2.26 |



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