Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

5th December 2016

- Trump's election win viewed as game changer by markets. Equities stronger, bonds sell-off and dollar rallies on his overtly pro-growth policies

- Fed set to hike rates at December FOMC meeting, with a number of rate increases now likely in 2017 and 2018 as Trump's policies set to boost US growth, inflation and budget deficit

- ECB, BoE and BoJ to maintain QE in 2017, with interest rates staying on hold

- Pressure comes off sterling on rising hopes that there may be a soft Brexit, while growing political uncertainty in the Eurozone weighs on the single currency

- Dollar to retain the upper hand in 2017, especially if tax changes see funds flowing back to US. Sterling is likely to remain volatile, with difficult Brexit negotiations in prospect later next year

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Global Economic Outlook

Some signs of improvement in global economy

The global economy has been struggling for upward momentum in recent years. The OECD has observed that "eight years after the financial crisis, the global recovery remains disappointingly weak" with the world economy caught in a "low-growth trap". World growth was 3.1% in 2015, the weakest rate since the end of the economic crisis of 2008-2009, reflecting in particular slower growth in emerging economies. Global growth has slowed further in 2016, with the OECD estimating that the world economy will grow by just 2.9% this year.

There was a marked slowing in growth in many of the main advanced economies in the first half of 2016, most notably the US. Growth there moderated due to weak business investment, a poor external trade performance and slower inventory accumulation. US growth has picked up in the second half of the year, as has activity in Japan, with a solid growth performance in Europe also despite the vote in the UK for Brexit. Nonetheless, growth in advanced economies is estimated by the OECD to have slowed to 1.7% this year from 2.1% in 2015.

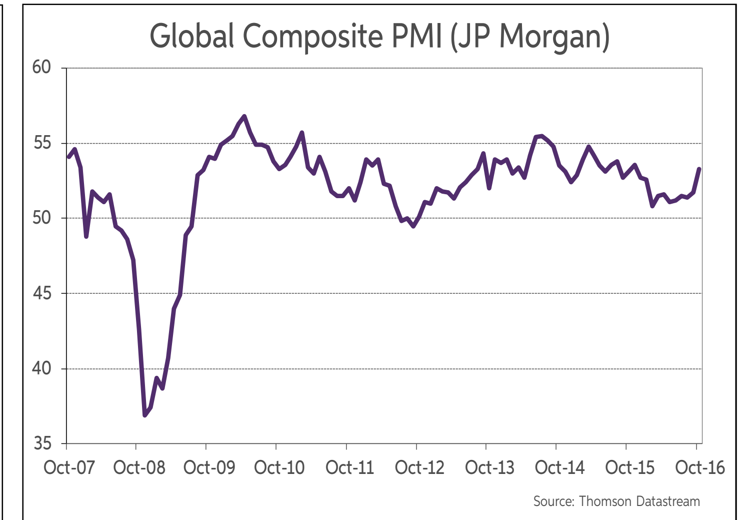
Meanwhile, growth in emerging economies lost considerable momentum in recent years, slowing from 7.5% in 2010 to 4% by 2015. Most notably, GDP growth in China slowed from 10.4% in 2010 to 6.9% in 2015. Some countries like Brazil, Argentina and Russia went into recession in the past two years as a result of the collapse in commodity prices. The OECD and IMF put growth in emerging economies at around 4.0-4.2% in 2016.

The OECD and IMF are forecasting that growth in the world economy will pick up to a modestly higher 3.5% in the next couple of years. Growth in emerging economies is forecast to strengthen to around 4.5% in 2017/18, helped by a moderate recovery in commodity prices and emergence of countries like Brazil and Russia from deep recessions. Meanwhile, the OECD sees growth in advanced economies accelerating to 2% next year and 2.3% in 2018, helped by a more supportive stance to fiscal policy, especially in the US. The OECD sees GDP growth in the US doubling from 1.5% to 3.0% between 2016 and 2018, assuming that President elect Trump's fiscal easing plans get implemented.

Indeed, some recent data already point to a strengthening in activity. Notably, the Global Composite PMI rose to an 11-month high of 53.3 in October from 51.7 in September. The 1.6 point rise in the index in October was the biggest jump in almost three years. Other leading activity indicators have also picked up in recent months in a number of key economies, including the UK, Eurozone and China.

Downside risks, though, remain for the world economy. In particular, the still low level of commodity prices, high private sector debt levels, rising US interest rates and a reliance on capital inflows are all downside risks to the growth prospects for emerging economies. A deceleration in the growth rate of the UK economy is expected over the next couple of years as Brexit approaches, while growing political uncertainty could weigh on activity in the Eurozone next year. Rising US interest could also negatively impact global financial markets.

In summary, then, the recovery in the world economy has lost momentum in the past couple of years, reflecting slower growth in both emerging and advanced economies. However, more recent data suggest that activity may be regaining some momentum. Central banks have been busy loosening policy to try and lift both weak world growth and very low inflation, while fiscal policy is turning more expansionary is some countries. Thus, global growth is expected to strengthen somewhat in 2017 and 2018, but downside risks remain.



GDP (Vol % Change)

	2015	2016 (f)	2017 (f)	2018 (f)
World	3.1	2.9	3.3	3.6
OECD Economies	2.1	1.7	2.0	2.3
US	2.6	1.5	2.3	3.0
Eurozone	1.5	1.7	1.6	1.7
UK	2.2	2.0	1.2	1.0
Japan	0.6	0.8	1.0	0.8
Non-OECD Economies	3.8	4.0	4.5	4.6
China	6.9	6.7	6.4	6.1
India	7.6	7.4	7.6	7.7
World Trade Growth (%)	2.6	1.9	2.9	3.2
OECD Economies Inflation (%)	0.6	1.0	1.8	2.2

Sources: OECD Economic Outlook, November 2016

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Interest Rate Outlook

A number of Fed rate hikes could now be on the cards

The past number of years have been characterised by a 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. This pattern continued in 2016. The Bank of Japan and ECB both eased policy further earlier in the year, with China, India, Australia, New Zealand and the UK also all cutting rates as the year progressed. Meanwhile, expected tightening from the US Fed in 2016 has yet to materialise.

The era of monetary easing, though, appears to be coming to an end in many countries, while the Fed may be about to embark on a series of rate increases. The BoE had indicated that it was likely to loosen policy even further before year end but this is no longer expected to materialise, with UK data holding up better than expected since the referendum, sterling falling sharply and inflation likely to rise in 2017/18. The MPC, though, is likely to continue with its QE programme in 2017, given the downside risks posed to the economy by Brexit.

Meantime, while the ECB retains an easing bias, markets no longer expect it to cut rates again, with inflation now on an upward trend and the economy continuing to grow at a moderate pace. Markets still expect the ECB to continue with QE through 2017, although it could make some adjustments to its asset purchases programme at the December Council meeting. Meanwhile, Eurozone rates are expected to remain very low for a long period of time. However, futures contracts now expect wholesale rates to start edging higher in 2018 and see three month money rates turning positive at the start of 2020 compared to mid-2021 a month ago.

Meantime, after raising rates by 25bps to 0.375% at its December 2015 meeting, the first such rate hike in nearly a decade, the US Federal Reserve has refrained from any further rate hikes since then. This has been in part due to financial market volatility and some unexpected softness in the US economy in H1 2016. However, the Fed retains a tightening bias and has given clear signals in recent months that a rate hike would be implemented at the final FOMC meeting of the year in mid-December.

The FOMC's latest rate projections from September show that as well as a December rate hike, it expects to raise rates by a further 50bps next year, to be followed by three 25bps hikes in 2018. This would bring the Fed funds rate to 1.875% by end 2018. Up until the US Presidential election, the markets were expecting just two rate hikes in total by end 2018, which would take the fed funds rate to 0.875%, or 1% lower than the Fed's projection.

The unexpected Trump victory in the Presidential election on a policy platform that would boost US growth, inflation and the budget deficit, has seen the market come more into line with the Fed's rate projections. Markets now expect a series of rate increases over the next three years that would take the funds rate up to close on 1.5% by end 2018 and above 1.75% by end 2019.

This marked firming of US interest rate expectations has triggered a sharp sell-off in bond markets. Bond yields were already trending upwards in October on a less benign outlook for rates and then rose sharply in November following Trump's election win. Ten year Treasury yields have climbed by 85bps since end September, rising from 1.55% to 2.35%, while ten year gilt yields have risen by 75bps with bund yields up 45bps, despite the on-going QE bond purchase programmes. Close attention needs to be paid to core US inflation and wage data in 2017 as this will be a key factor influencing the pace of Fed rate tightening next year and thus bond markets.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.375	0.95	1.64	1.31	1.82
Dec '16	0.625	1.00	1.70	1.35	1.85
Mar '17	0.625	1.10	1.80	1.45	1.95
June '17	0.875	1.20	1.90	1.60	2.10

** 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	-0.33	-0.08	-0.15	0.12
Dec '16	-0.40	-0.32	-0.07	-0.14	0.14
Mar '17	-0.40	0.31	-0.06	-0.13	0.16
June '17	-0.40	-0.30	-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	0.25	0.38	0.79	0.66	0.96
Dec '16	0.25	0.40	0.80	0.68	1.00
Mar '17	0.25	0.40	0.82	0.70	1.05
June '17	0.25	0.40	0.85	0.75	1.10

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Dollar strengthening on expectations of marked rise in US rates

A notable feature of currency markets in 2015 and 2016 has been the stable trading range for the euro-dollar exchange rate. It has been confined to a $1.05-1.16 trading band since early 2015. One of the reasons for this is that the expected series of rate hikes by the Fed during the course of 2015/16 did not materialise, with just one 25bps rate increase being implemented in December 2015. Meanwhile, the ECB has pursued a very loose monetary stance in the past two years. As a result, with both US and Eurozone rates staying very low, the EUR/USD pair has struggled for direction.

The dollar, though, has been trending upwards against the euro ever since the single currency hit a high point for this year of $1.15 in May. Growing expectations that the Fed will hike rates again before year end have boosted the US currency. Trump's unexpected victory in November's Presidential has also seen markets price in a much more aggressive path for Fed rate hikes over the next three years, propelling the dollar higher against nearly all currencies. This has seen the euro drop sharply against the dollar, moving below the $1.10 level to test the bottom of its trading range since early 2015 of $1.05-1.06. This support level has held so far for the euro.

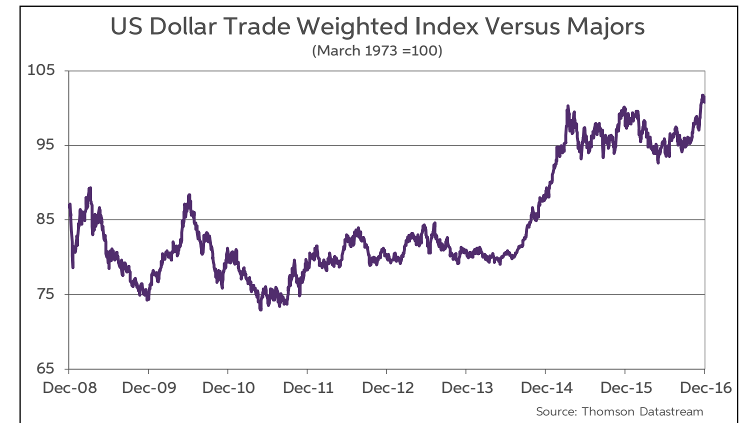
As well as dollar supportive factors, there are also a number of negative factors that are weighing on the single currency. The combination of Brexit uncertainty and associated risks for the EU, as well as an under-performing Eurozone economy are headwinds for the euro. In particular, political risk is coming to the fore in Europe, amid concerns about rising nationalism and growing anti-EU sentiment and euro scepticism in many European countries. The rejection in Italy of a referendum on political reform and elections in a number of EU countries next year, in which far–right nationalist parties are expected to do well, are worrying the markets.

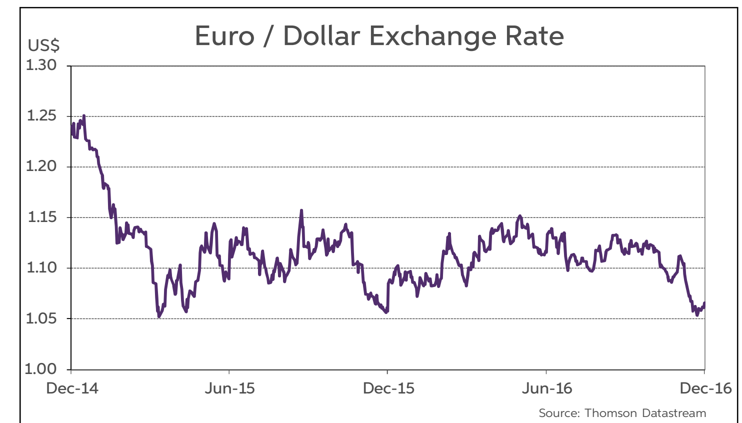
The ECB also continues to maintain an easing bias in marked contrast to the Fed, with very low or negative yields on many Eurozone bonds and an on-going QE asset purchase programme. The yield spread between ten year US Treasuries and German bunds has moved out to it's widest level in over 25 years at well above 200bps.

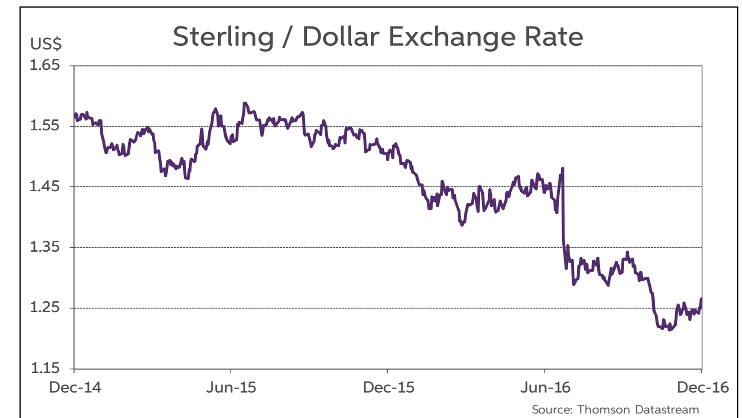
In our view, there is a growing probability that the support for the euro at $1.05-1.06 will give way and the dollar could well rise towards parity during 2017. The chief risks for the euro are political developments in Europe, rising US rates and likely changes to US corporate taxes. It is true that FOMC members have been very reluctant to pursue a policy of steady hikes in US interest rates over the past two years. However, if President-elect Trump does implement his fiscal policies next year, it is likely to change Fed thinking on rates.

The OECD is forecasting that US growth will double from 1.5% in 2016 to 3% in 2018 on the back of Trump's promised easing of fiscal policy. The US unemployment rate is already very low at 4.6%, wage inflation has picked up to near 3% while core PCE inflation is at 1.7%. A marked strengthening of growth at this stage of the cycle is likely to increase inflationary pressures in the US economy, as will any moves towards more protectionist trade policies. The Fed is likely to have to respond to rising inflationary risks with a series of rate hikes in the next couple of years, taking US rates up close to 2% by 2019.

This should see a further rise in the dollar against a broad range of currencies. Another factor that could boost the dollar is marked cuts in US corporate tax rates, in particular Trump's plan for a one-off 10% rate to entice back the large quantity of funds that US companies currently hold abroad to avoid paying high US taxes.







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Forex Market Outlook

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Volatile sterling recovers some ground as hopes rise for a soft Brexit

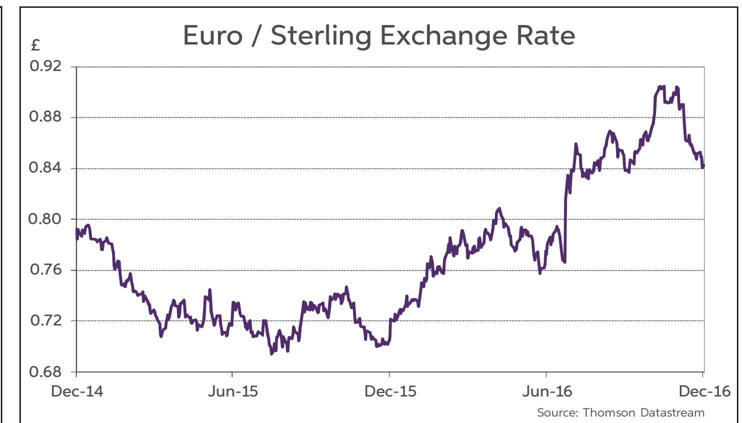
Sterling appreciated by nearly 20% on a trade-weighted basis between 2013 and mid-2015, partly fuelled by expectations of UK rate hikes. These gains, though, unwound in the past year on mounting concerns over Brexit. Sterling weakened during the first half of 2016 in the run-up to the referendum vote on June 23rd. The euro rose by some 10% against sterling, climbing from 70p in late 2015 to around the 77p level. GBP/USD fell from a high of $1.59 in mid-2015, to below the $1.50 level.

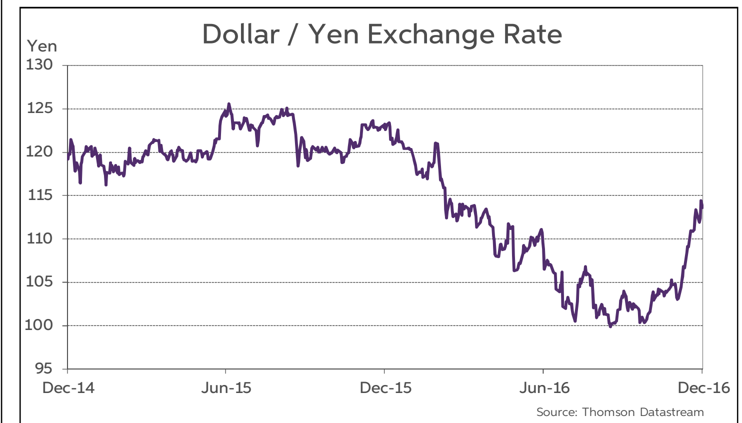
Sterling saw further large losses on the unexpected victory for the 'leave' side in the June referendum. The currency hit 30-year lows against the dollar, falling through key support levels at $1.37-1.38 before moving below the $1.30 level in early July. Sterling's post referendum slide also greatly impacted EUR/GBP, with the pair trading as high as 86p following the vote. The pound recorded further significant losses in the autumn following the announcement by the UK Government that it would trigger Article 50 before the end of next March and indications that it would take a tough line in the subsequent exit negotiation with the EU. They were growing concerns that the UK could be heading for a hard Brexit that would see it lose access to the Single Market. Cable fell close to the $1.20 level, with the euro climbing to around the 90p mark.

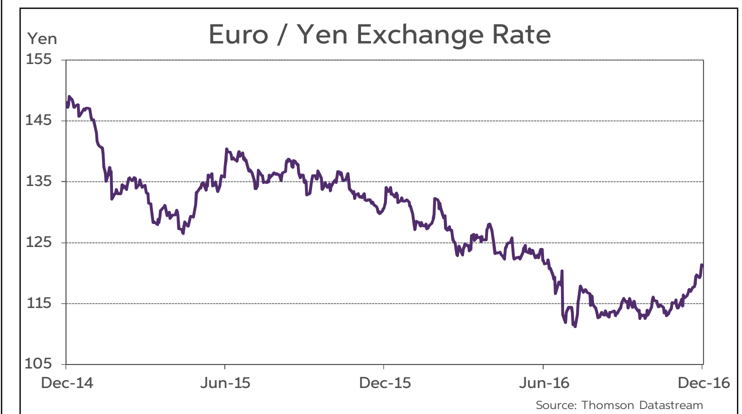
Sterling has recovered some ground in the past month, though, rising to around $1.27 with the euro falling back to below 84p. It has been helped by a number of factors. The market was very short of sterling so there was scope for a bounce in the currency as traders booked profits, especially in the run-up to year end. Rising market uncertainty and volatility was always going to be a catalyst to cut short sterling positions. Two events provided this—Trump's unexpected election win in the US and growing political risks in Europe, which has also put pressure on the euro. Meantime, there are also growing hopes that the UK may get a soft Brexit, with the High Court ruling that the parliament must be involved in the process to trigger Article 50, while the UK Government has been making more conciliatory soundings on Brexit and the need to maintain access to EU markets.

The EU Treaty provides for a two-year period for the negotiations on an EU exit once Article 50 is invoked. The Article is likely to be invoked in the first half of next year. However, there are indications from the EU that negotiations on the future trading relationship with the UK will not commence until after it leaves the EU. Thus, the exit deal may contain just interim arrangements on trade. It is important to note that the UK does not have a veto over the exit deal, which weakens its hand in the negotiations with the EU. It is almost certain that the UK will have to give ground on its desire to take control over immigration and regain full independence and sovereignty from the EU, in order for it to maintain access to the Single Market.

The negotiations are likely to prove very fraught and tough. However, they are still some time away and thus sterling could hold on to its recent gains in the near term. Sterling volatility is likely to remain high, driven by the ebb and flow of sentiment on Brexit, with the 83p level providing stiff resistance for the currency to overcome if it is to make further ground against the euro. We feel that downside risks remain for the sterling over the medium term. As indicated, the negotiations between the UK and EU are likely to prove very difficult and could give rise to renewed fears that Britain may be heading for a hard Brexit. This could see the euro move back up towards 90p level and cable fall back to $1.20 or below. However, it could be mid-2017 or later before this occurs.







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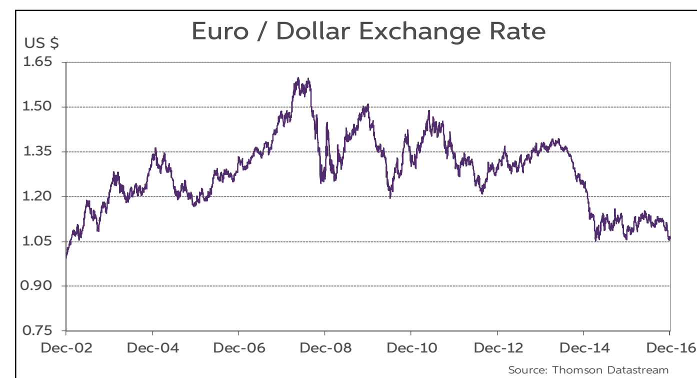
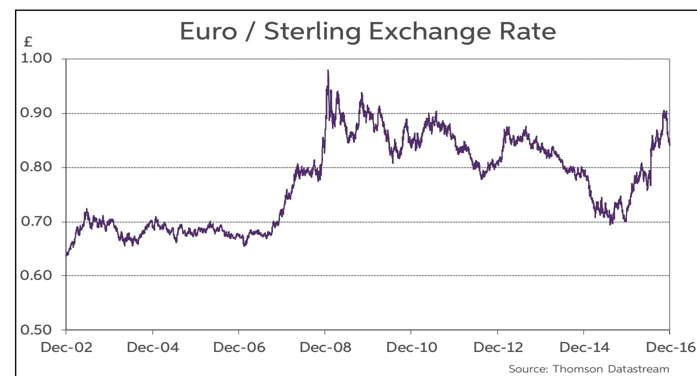
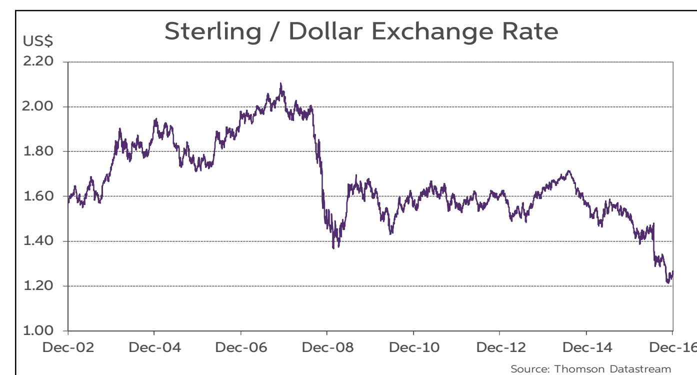
Summary of Exchange Rate Forecasts

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

	Current	Q4-2016	Q1-2017	Q2-2017	Q3-2017
Euro Versus					
USD	1.070	1.03-1.09	1.02-1.08	1.00-1.06	0.99-1.05
GBP	0.842	0.80-0.86	0.81-0.87	0.83-0.89	0.85-0.91
JPY	122.23	119-125	121-127	121-127	121-127
CHF	1.08	1.08	1.08	1.08	1.08
US Dollar Versus					
JPY	114.24	112-118	115-121	117-123	119-125
GBP	1.271	1.25-1.31	1.22-1.28	1.17-1.23	1.13-1.19
CAD	1.33	1.34	1.35	1.36	1.37
AUD	0.74	0.74	0.73	0.72	0.71
NZD	0.71	0.71	0.70	0.69	0.68
CNY	6.88	6.90	6.93	6.96	7.00
Sterling Versus					
JPY	145	147	148	144	142
CAD	1.69	1.71	1.69	1.63	1.59
AUD	1.71	1.73	1.71	1.67	1.63
NZD	1.79	1.80	1.79	1.74	1.71







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