# Forex and Interest Rate Outlook

## AIB Treasury Economic Research Unit

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- Solid growth in advanced economies, with headline inflation moving higher
- Fed signals that a number of rate increases likely in 2017 and 2018. ECB, BoE and BoJ to keep interest rates on hold in 2017, with on-going QE by the ECB and BoJ
- Upcoming European elections weighing on euro sentiment, though currency remains stable
- Sterling regains some ground even though UK looks to be heading for a 'hard' Brexit. Currency could stay range-bound as markets await news on UK exit talks with EU. Downside risks remain
- Dollar has lost some ground in 2017. Needs more Fed rate hikes and/or changes to US corporate tax rates that see funds flowing back to US, to re-ignite its three-year rally

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# Global Economic Outlook



## *Pick-up in global economic activity*

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”. The world economy grew by little more than 3% in 2015 and 2016, the weakest rate since the end of the economic crisis of 2008-2009.

There was a marked slowing in growth in many of the main advanced economies in the first half of 2016, in particular the US. Overall, growth in advanced economies is estimated by the IMF to have slowed to 1.6% last year, from 2.1% in 2015. Meanwhile, growth in emerging economies lost considerable momentum during this decade, slowing from 7.5% in 2010 to circa 4% by 2015/16. Most notably, GDP growth in China slowed from 10.4% in 2010 to below 7% in 2015/16. Some major emerging economies like Brazil, Argentina and Russia went into recession in the past two years as a result of the collapse in commodity prices.

Both the OECD and IMF are forecasting that growth in the world economy will pick up modestly to around 3.5% in 2017-18. Growth in emerging economies is forecast to strengthen to around 4.5% in 2017 and 4.8% in 2018, helped by a moderate recovery in commodity prices and emergence of countries like Brazil and Russia from deep recessions. Meanwhile, the IMF sees growth in advanced economies accelerating to circa 2% in 2017-18, helped by continuing very loose monetary policies and a more supportive stance to fiscal policy, especially in the US. President Trump’s fiscal easing plans, if implemented, could see US growth picking up to around 2.5% in 2017-18 from 1.6% in 2016.

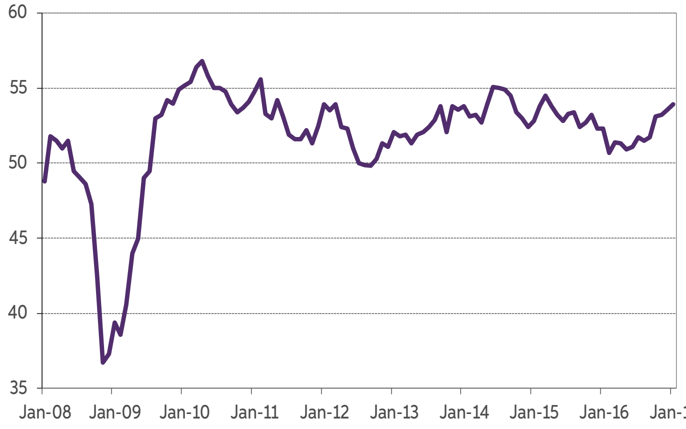
Recent data are pointing to a strengthening of activity in all the major economies. Notably, the Global Composite Output PMI rose to a 22-month high of 53.9 in January. The PMI for manufacturing has hit its highest level in two-and-a-half years. In the Eurozone, the Composite PMI is at its best level in more than five years. Other leading activity indicators have also picked up strength in recent months in the major economies. Meanwhile, real economic data from the US have been particularly strong for January.

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. Brexit remains a risk for the UK economy, while political uncertainty could weigh on activity in the Eurozone this year. Rising headline inflation rates in 2017 could also be a constraint on growth in consumer spending.

Meanwhile, Donald Trump’s election win has had a positive impact on economic sentiment is the US. While his domestic policies are very much pro-growth, there are risks for the world economy from possible protectionist trade policies. Rising US interest rates could also negatively impact global financial markets and activity.

In summary, then, the recovery in the world economy lost momentum in the past couple of years, reflecting slower growth in both emerging and advanced economies. However, more recent data suggest that activity is picking up pace again. Central banks have loosened monetary policy considerably to try and lift both weak growth and low inflation, while fiscal policy is turning more expansionary in some countries. Thus, global growth should strengthen somewhat in 2017 and 2018, though downside risks remain.

Global Composite PMI (JP Morgan)




Source: Thomson Datastream

*GDP (Vol % Change)*

| | 2015 | 2016 (f) | 2017 (f) | 2018 (f) |
|---|---|---|---|---|
| World | 3.2 | 3.1 | 3.4 | 3.6 |
| Advanced Economies | 2.1 | 1.6 | 1.9 | 2.0 |
| US | 2.6 | 1.6 | 2.3 | 2.5 |
| Eurozone | 2.0 | 1.7 | 1.6 | 1.6 |
| UK | 2.2 | 2.0 | 1.5 | 1.4 |
| Japan | 1.2 | 0.9 | 0.8 | 0.5 |
| Emerging Economies | 4.1 | 4.1 | 4.5 | 4.8 |
| China | 6.9 | 6.7 | 6.5 | 6.0 |
| India | 7.6 | 6.6 | 7.2 | 7.7 |
| World Trade Growth (%) | 2.7 | 1.9 | 3.8 | 4.1 |
| Advanced Economies Inflation (%) | 0.3 | 0.7 | 1.7 | 1.9 |

*Source: IMF World Economic Outlook (Update), January 2017*

# Interest Rate Outlook



## *Main central banks to keep rates on hold except for the Fed*

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. The era of monetary easing, though, appears to be coming to an end in many countries, while the US Fed may be about to implement a series of rate increases over the next couple of years.

The BoE indicated at the time of its monetary easing in August that it was likely to loosen policy even further. Markets priced in a further rate cut at the time. However, the UK economy has held up much better than expected since the Brexit referendum and with sterling also falling sharply and inflation now on the rise, the BoE has kept policy on hold. The current round of BoE asset purchases will be completed soon, bringing an end to the latest expansion in its QE programme. The market is actually now pricing in a 25bps rate hike by end 2018. However, we think this is unlikely, with the UK economy expected to slow in the run-up to Brexit in 2019.

Meantime, the ECB retains an easing bias, with its key deposit rate pitched at –0.4%. However, markets no longer expect it to cut rates again, with inflation now on an upward trend and economic growth picking up a bit of momentum. The ECB is continuing with its QE programme until at least the end of 2017, although the size of the monthly asset purchases will be reduced from €80bn to €60bn from April.

Eurozone rates are expected to remain very low for a long period of time. While futures contracts now expect wholesale rates to start edging higher later this year, they do not see three month money rates turning positive until the second half of 2019, compared to mid-2021 last autumn. It does not seem unreasonable to expect the ECB to end its negative interest rate policy in H2 2019 if, as expected, underlying inflation is close to target by then and the economy keeps growing at a solid pace, with a continuing steady decline in unemployment.

Meanwhile, 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 refrained from any further rate hikes, until it implemented a second 25bps increase in December 2016. The latest FOMC interest rate projections show that it expects to raise rates by 75bps in each of the next three years, bringing the Fed funds rate to 2.875% by end 2019.

Markets turned more bearish on US rates following the Trump victory in the Presidential election but they are still well behind the Fed's projections. Markets are looking for two rather than three 25bps rate hikes per annum over the next two years and then just one rate increase in 2019, which would leave rates a full 1% lower than projected by the Fed by end-2019. This is hardly surprising given that the Fed has not followed through on projected rates hikes over the past couple of years and instead has acted very cautiously in regard to policy tightening.

The policy statement following the February FOMC reaffirmed the tightening bias of the Fed but avoided giving any clear indication of the likely timing of the next rate move. The Fed may be waiting for further details of the fiscal policy of the new Trump administration to assess its impact on US growth and inflation. Fed Chair, Janet Yellen, has already indicated that this could affect the pace of Fed tightening. The markets have fully priced in 25bps rate hikes for the June and December FOMC meetings. However, they are not completely ruling out the prospect of a rate increase at either the March and May meetings. Indeed, Chair Yellen recently warned that it would be "unwise" to wait too long before raising rates again, so a rate hike is possible at either of these meetings.

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

| | Fed Funds | 3 Mth | 1 Year | 2 Year * | 5 Year * |
|---|---|---|---|---|---|
| **Current** | 0.625 | 1.05 | 1.74 | 1.53 | 1.99 |
| **Mar '17** | 0.625 | 1.05 | 1.75 | 1.55 | 2.00 |
| **June '17** | 0.875 | 1.25 | 1.95 | 1.75 | 2.20 |
| **Sept '17** | 1.125 | 1.50 | 2.15 | 2.00 | 2.50 |

** 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 | -0.35 | -0.11 | -0.15 | 0.14 |
| **Mar '17** | -0.40 | -0.34 | -0.09 | -0.14 | 0.15 |
| **June '17** | -0.40 | 0.32 | -0.07 | -0.12 | 0.17 |
| **Sept '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 | 0.36 | 0.74 | 0.60 | 0.86 |
| **Mar '17** | 0.25 | 0.36 | 0.75 | 0.61 | 0.87 |
| **June '17** | 0.25 | 0.35 | 0.75 | 0.63 | 0.90 |
| **Sept '17** | 0.25 | 0.35 | 0.75 | 0.65 | 0.95 |

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

# Forex Market Outlook

## *Dollar on hold, awaiting more news on US fiscal policy and Fed rate hikes*

A notable feature of currency markets in the past two years has been the relatively narrow trading range for the euro-dollar rate. It has been mainly confined to a $1.04-1.15 trading band since early 2015. One of the reasons for this is that the expected series of rate hikes by the Fed over the course of 2015/16 did not materialise, with just two 25bps rate increases implemented in December of both years. 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 remained quite range bound.

The dollar, though, has moved higher against the euro since last autumn, when the EUR/USD rate stood at around $1.12. Growing expectations that the Fed would have to implement a number of rate hikes boosted the US currency. Furthermore, Trump's unexpected victory in November's Presidential election also saw markets price in a more aggressive path for Fed rate hikes over the next three years, propelling the dollar higher against nearly all currencies. This saw the dollar reach 14-year highs on a trade-weighted basis in late 2016/early 2017. Meanwhile, the euro dropped back against the dollar following Trump's win, moving from around the $1.10 level in early November to hit 14 year-lows below $1.04 at the turn of the year.

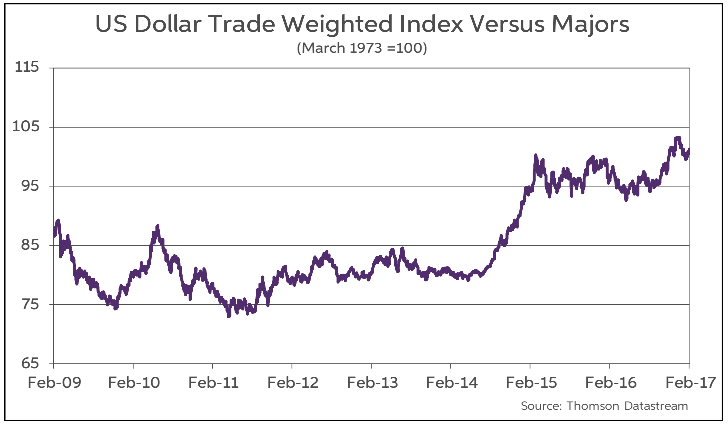
As well as dollar supportive factors, there are a number of negative factors that have been weighing on the single currency recently. Political risk has come to the fore in mainland Europe in recent times, amid concerns about rising nationalism and growing euro-scepticism in many European countries. Far–right nationalist parties and other euro-sceptic parties are expected to do well in upcoming elections in a number of EU countries, with much attention focused on the French Presidential election in particular.

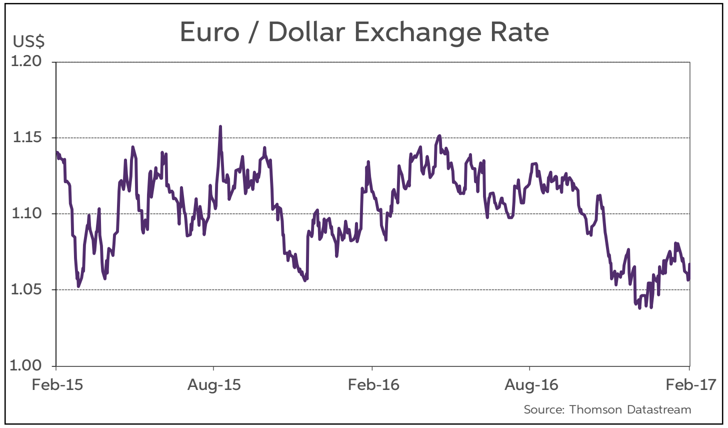
The ECB also continues to maintain an easing bias in marked contrast to the Fed, with very low or negative yields on many Eurozone bonds and an on-going QE asset purchase programme. The yield spread between ten year US Treasuries and German bunds has moved out to it's widest level in over 25 years at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

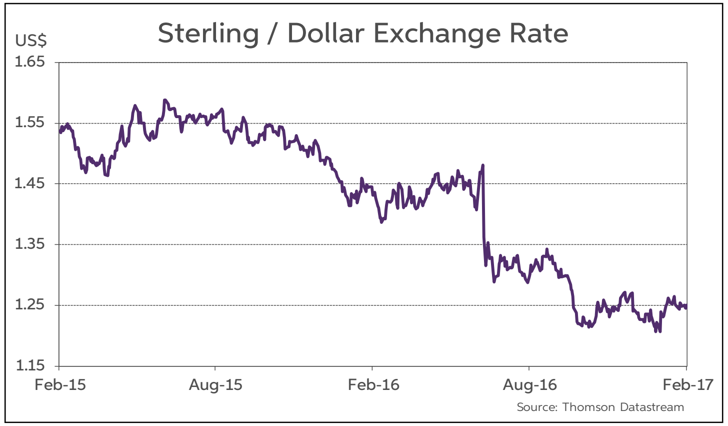
The euro has regained a bit of ground against the dollar this year, rising to around $1.07, as markets await clarity on the new US President's economic policies. We expect President Trump to implement his expansionary fiscal policies, which is likely to lead to higher Fed rates, boosting the dollar. Marked cuts in US corporate tax rates, including 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, could also boost the dollar. Some of these funds are likely to be held in other currencies and will have to be converted into dollars if US corporates wish to repatriate them.

Thus, we see further upside potential for the dollar in 2017. Indeed, we could see the euro fall towards parity against the dollar where US rates are hiked and corporate taxes are cut. This view is very much dependent on an expectation of what the new President and Fed are likely do. Thus, markets will probably need to see the new President start to implement his fiscal policies and the Fed move on rates before taking the dollar higher.

Both the Japanese yen and Chinese yuan fell sharply against the dollar in the closing months of last year, although they have recovered some lost ground in early 2017. If we get a number of Fed rate hikes this year and US corporates start to repatriate funds to take advantage of tax cuts, then further dollar gains can be expected, taking the US currency up near ¥120, and rising to the CNY7.00 level or above against the yuan.

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# Forex Market Outlook



## *Sterling more stable as UK prepares to trigger Article 50*

Sterling fell sharply last year on concerns over Brexit. The currency hit 30-year lows against a strong dollar, falling through key support levels at $1.37-1.38, before declining to a $1.21-1.27 range. The euro made significant gains against sterling, with the EUR/GBP pair generally trading in an 84-90p range since last summer, up from 70p towards the end of 2015.

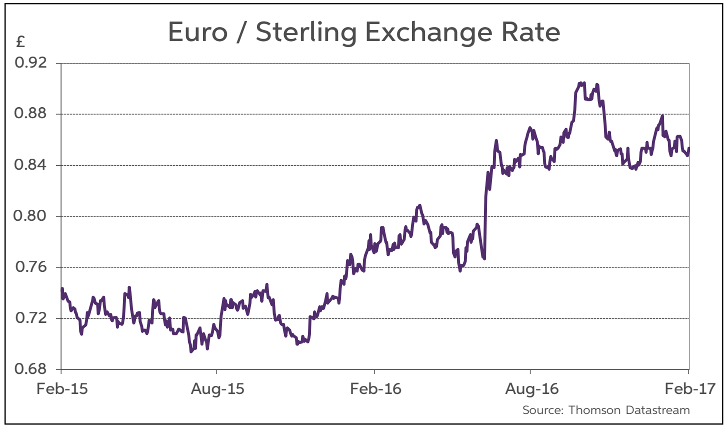
However, sterling has been more stable since the autumn. It has managed to regain some ground against the euro, rising back up to 85p, even though it looks like the UK could be heading for a 'hard' Brexit. The UK economy has held up much better than expected, with strong GDP growth of 0.6% in both Q3 and Q4. Growth forecasts for the UK for 2017/18 have been revised upwards. With the economy holding up and inflation also on the rise, the markets now think that the next move in UK rates will be upwards rather than downwards.

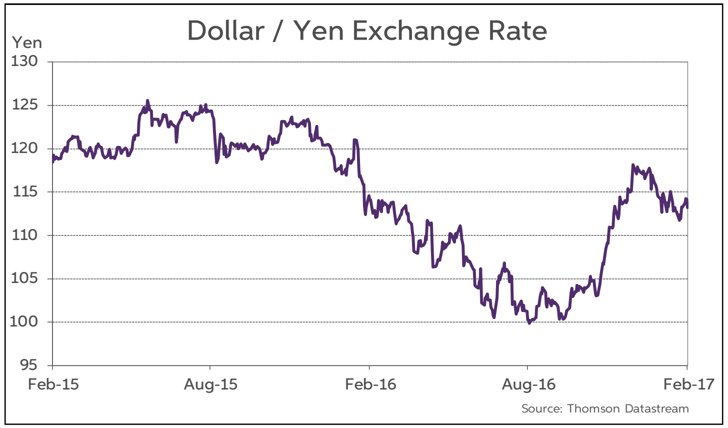
Meanwhile, the UK government remains on course to trigger Article 50 next month, removing another element of uncertainty. The UK also seems increasingly confident that it can secure a trade deal with the EU. All this has helped create a more positive backdrop for sterling at a time of heightened political risks in the Eurozone.

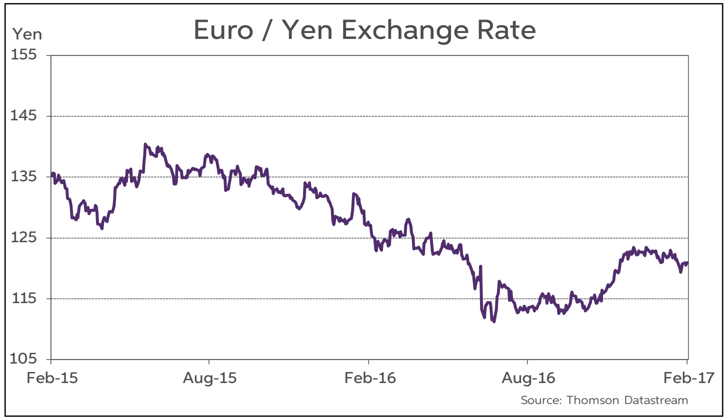
The UK currency could remain quite stable for much of this year, given that there is unlikely to be any real news flow from the Brexit negotiations for some time. The early Brexit talks are likely to be technical in nature rather than focusing on substantive issues such as trade. Thus, market attention is more likely to be more focused on elections in Europe instead. Elections in the Netherlands, France, Germany and possibly Italy are expected to see euro-sceptic parties doing quite well. Meantime, concerns about Greek debt have resurfaced in markets recently.

Downside risks, though, remain for the UK currency next year as the exit negotiations come to a head. The talks, by that stage, are likely to be fraught and punctuated by crises, with much uncertainty about the final outcome. There is still a real risk of an outcome that is very negative for the UK economy and sterling. Prime Minister May confirmed last month that the UK would leave the Single Market on its departure from the EU. She also indicated that the UK would not remain a full member of the Customs Union and is likely to seek sectoral customs agreements. However, she did stress that the UK has a strong desire to reach a comprehensive free trade deal with the EU to avoid major disruption to both economies. The indications from the EU are that the formal negotiations on the future trading relationship with the UK will not commence until after it leaves the EU.

Thus, it is unclear at present what arrangements, if any, an exit deal will contain in regard to trade. The UK has expressed a preference for a transitional period that allows for a phased process of implementation of new trading arrangements but the EU may not agree to this. The UK Government has warned that it may not be able to reach a deal with the EU on Brexit, saying "no deal is better than a bad deal". The UK, in such circumstances, would have to fall back on WTO rules, with negative implications for external trade, foreign direct investment, the economy and sterling. We will have to await the outcome of the Brexit negotiations, probably in late 2018, to see whether the UK manages to retain relatively free access to EU markets or, instead, has to fall back on WTO rules. The latter could see the euro move back up to the 90p level or above, with cable falling to $1.15 or below. For this year, though, sterling may largely trade in an 84-88p range against the euro, while the performance against cable may depend on how the US currency performs. Sterling could fall towards $1.15 if the dollar strengthens again.



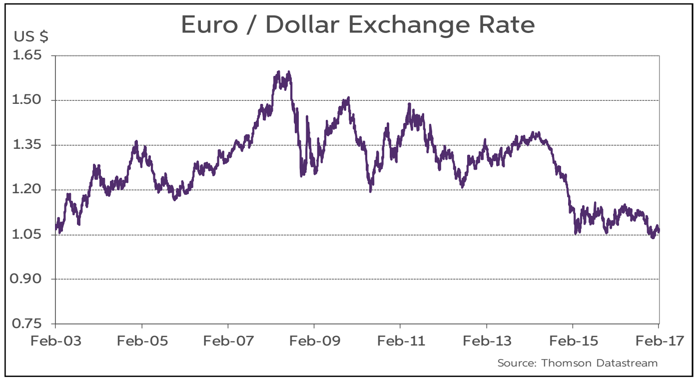



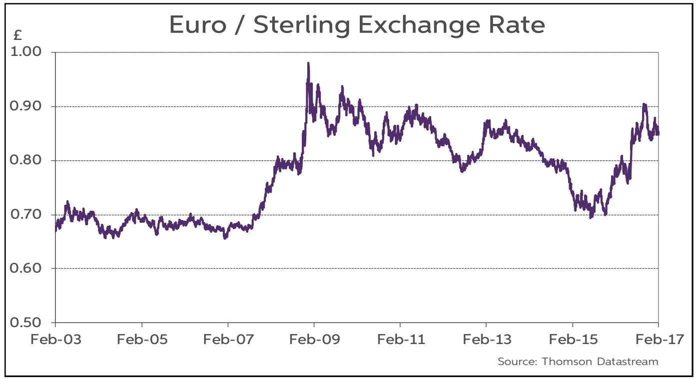



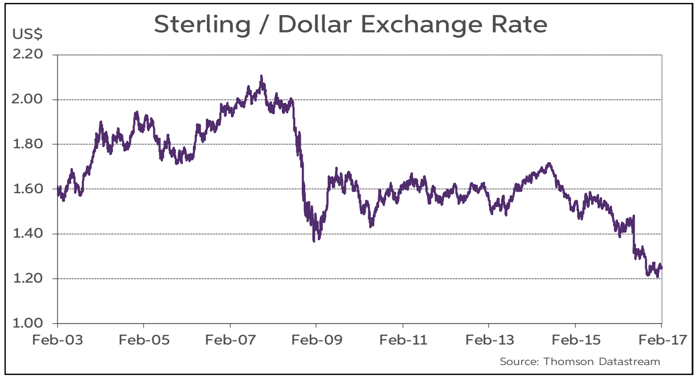
# Summary of Exchange Rate Forecasts

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

| | Current | Q1-2017 | Q2-2017 | Q3-2017 | Q4-2017 |
|---|---|---|---|---|---|
| **Euro Versus** | | | | | |
| **USD** | 1.063 | 1.03-1.09 | 1.01-1.07 | 1.00-1.06 | 0.99-1.05 |
| **GBP** | 0.855 | 0.82-0.88 | 0.83-0.89 | 0.84-0.90 | 0.85-0.91 |
| **JPY** | 119.96 | 117-123 | 117-123 | 118-124 | 118-124 |
| **CHF** | 1.06 | 1.06 | 1.07 | 1.07 | 1.07 |
| **US Dollar Versus** | | | | | |
| **JPY** | 112.85 | 110-116 | 112-118 | 114-120 | 116-122 |
| **GBP** | 1.243 | 1.22-1.28 | 1.18-1.24 | 1.15-1.21 | 1.13-1.19 |
| **CAD** | 1.31 | 1.31 | 1.32 | 1.33 | 1.34 |
| **AUD** | 0.77 | 0.77 | 0.76 | 0.75 | 0.74 |
| **NZD** | 0.72 | 0.72 | 0.71 | 0.70 | 0.69 |
| **CNY** | 6.86 | 6.88 | 6.92 | 6.96 | 7.00 |
| **Sterling Versus** | | | | | |
| **JPY** | 140 | 141 | 139 | 138 | 138 |
| **CAD** | 1.63 | 1.63 | 1.60 | 1.57 | 1.55 |
| **AUD** | 1.62 | 1.62 | 1.59 | 1.57 | 1.57 |
| **NZD** | 1.73 | 1.74 | 1.70 | 1.69 | 1.68 |

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