Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Signs of a pick-up in growth towards end 2016 across all the major economies
- Fed hikes rates at December FOMC meeting, with a number of rate increases now in prospect in 2017 and 2018 as Trump's policies set to boost US growth, inflation and budget deficit
- ECB, BoE and BoJ to keep interest rates on hold in 2017, with on-going QE by the ECB and BoJ
- Sterling's rebound at end 2016 proves short-lived, with the UK now heading for a 'hard' Brexit. Downside risks remain for the UK currency as tough negotiations lie ahead with EU
- Dollar has further upside potential in 2017, but needs a series of Fed rate hikes and/or changes to US corporate tax rates that see funds flowing back to US, to sustain 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". World growth was weak in 2015 at 3.2% and slowed further in 2016 – the OECD put growth at just 2.9%, which would be 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 in recent years, 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 countries like Brazil, Argentina and Russia went into recession in the past two years as a result of the collapse in commodity prices.

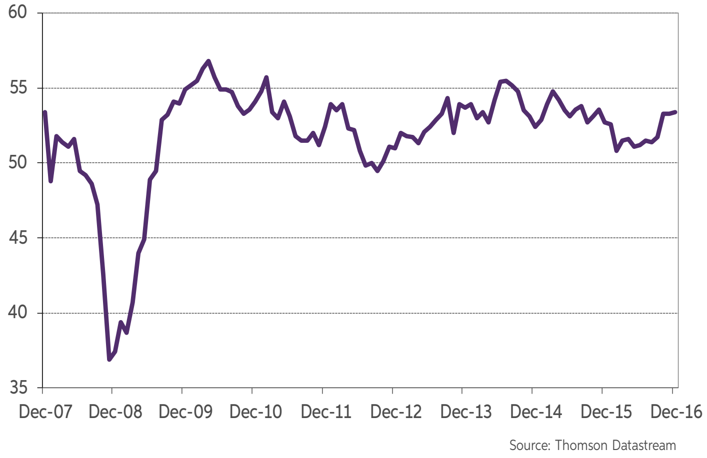
Both the OECD and IMF are forecasting that growth in the world economy will pick up to a modestly higher 3.5% in the next couple of years. Growth in emerging economies is forecast to strengthen to around 4.5% in 2017 and 4.8% in 2018, helped by a moderate recovery in commodity prices and emergence of countries like Brazil and Russia from deep recessions. Meanwhile, the IMF sees growth in advanced economies accelerating to around 2% in 2017/2018, 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 incoming President Trump's fiscal easing plans get implemented, while the IMF sees US growth picking up to around 2.5%.

Recent data are pointing to a strengthening of activity in all the major economies. Notably, the Global Composite PMI rose to a 13-month high of 53.4 in December, up from 51.7 in September. The PMI for manufacturing hit its highest level in two-and-a-half years. In the Eurozone, the Composite PMI reached its best level for more than five years in December. Other leading activity indicators have also picked up strength in recent months in the major economies. Hard data are also improving, with good labour market, retail sales and industrial production figures.

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 political uncertainty could weigh on activity in the Eurozone this year.

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 his 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 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 is regaining some momentum. Central banks have loosened monetary policy considerably to try and lift both weak growth and very low inflation, while fiscal policy is turning more expansionary in some countries. Thus, global growth should strengthen somewhat in 2017 and 2018, but downside risks remain.



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

Most uncertainty relates to the extent of Fed policy tightening

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 early in the year, with China, India, Australia, New Zealand and the UK also all cutting rates as the year progressed. Meanwhile, the US Fed refrained from hiking rates again until December.

The era of monetary easing, though, appears to be coming to an end in many countries, while the Fed may be about to implement a series of rate increases over the next couple of years. The BoE had indicated at the time of its monetary easing in August that it was likely to loosen policy even further. However, with UK data holding up much better than expected since the Brexit referendum, sterling falling sharply and inflation likely to rise in 2017/18, policy is now likely to be kept on hold. The BoE is not expected to increase the size of its QE programme any further when the current round of purchases is completed in the next couple of months. Indeed, the market is pricing 25bps rate hikes in for both 2018 and 2019. However, we think this is very unlikely as we expect the UK economy to slow in the run-up to Brexit in 2019.

Meantime, although the ECB retains an easing bias, markets no longer expect it to cut rates again, with inflation now on an upward trend and economic growth showing some signs of accelerating. The ECB has announced that it will continue 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. Thus, ECB policy looks to be on hold for this year.

Eurozone rates are still 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 they see three month money rates turning positive at the end of 2019 compared to mid-2021 last autumn. It does not seem unreasonable to expect the ECB to end its negative interest rate policy by end 2019 if, as expected, inflation moves up close to target by then and the economy grows at a solid pace, with a continuing steady downtrend 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 in 2016, until it implemented a second 25bps increase at its meeting in December. The latest FOMC interest rate projections show that it expects to raise rates by a further 75bps in each of the next three years, bringing the Fed funds rate to 2.875% by end 2019.

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 price in greater rate tightening, but not to the extent indicated by the Fed 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, leaving rates a full 1% lower than projected by the Fed at end-2019.

The minutes of the December FOMC meeting indicate a lot of uncertainty about the future path of rates as the Fed awaits to see if President-elect Trump's expansionary fiscal policies will be implemented in full and what impact they will have on US growth and inflation. The FOMC has clearly signposted, though, that rates will rise at a steady pace, if required over the next number of years in the US.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.625	1.03	1.71	1.46	1.88
Mar '17	0.625	1.05	1.75	1.50	1.95
June '17	0.875	1.25	1.95	1.70	2.15
Sept '17	1.125	1.50	2.15	1.90	2.35

** 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	-0.34	-0.10	-0.18	0.09
Mar '17	-0.40	-0.32	-0.07	-0.15	0.12
June '17	-0.40	0.31	-0.06	-0.13	0.16
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	0.77	0.64	0.93
Mar '17	0.25	0.36	0.76	0.64	0.94
June '17	0.25	0.35	0.75	0.65	0.95
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 strengthens on expectations of higher US interest rates

A notable feature of currency markets in 2015 and 2016 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 upwards against the euro from the time that the single currency hit a high of $1.15 in May last year. Growing expectations that the Fed would have to implement a number of rate hikes have boosted the US currency. 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.

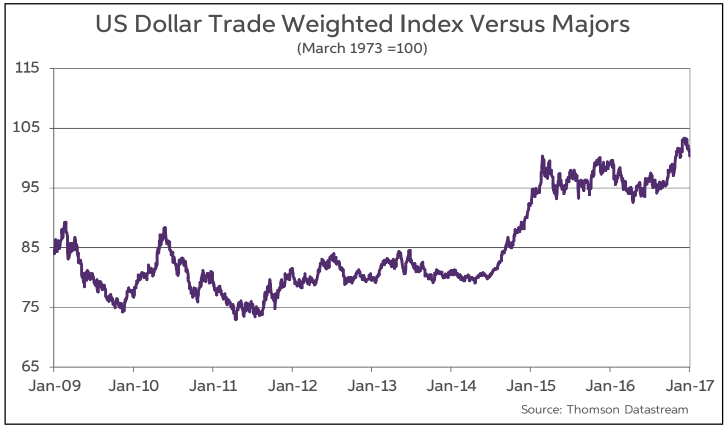
As well as dollar supportive factors, there are a number of negative factors that have been weighing on the single currency. The combination of Brexit uncertainty and associated risks for the EU, as well as an under-performing Eurozone economy are headwinds for the euro. Political risk has come to the fore in mainland Europe in recent times, amid concerns about rising nationalism, growing anti-EU sentiment and euro scepticism in many European countries. Both far–right nationalist parties and euro-sceptic parties are expected to do well in forthcoming elections in a number of EU countries.

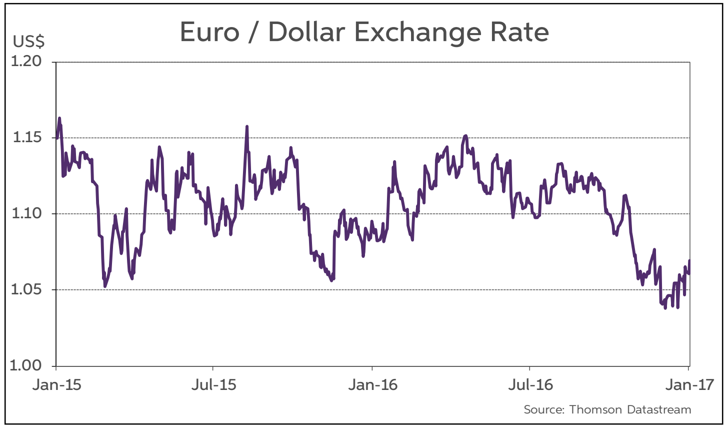
The ECB also continues to maintain an easing bias in marked contrast to the Fed, with very low or negative yields on many Eurozone bonds and an on-going QE asset purchase programme. The yield spread between ten year US Treasuries and German bunds has moved out to it's widest level in over 25 years at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

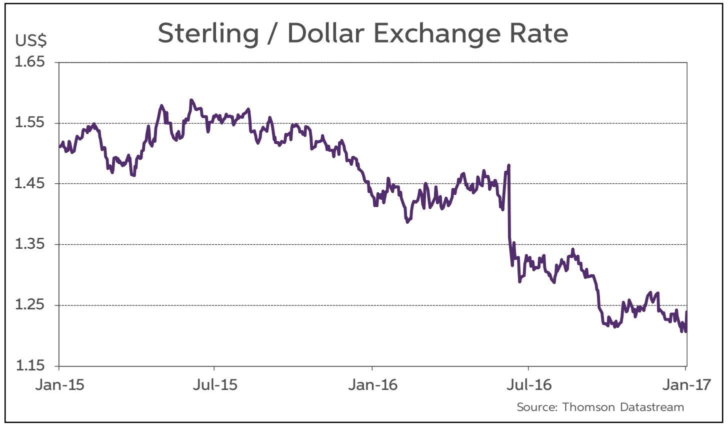
The euro has regained some ground against the dollar recently, rising to around $1.07, as markets await clarity on what the new US President will actually do. We expect President Trump to implement his expansionary fiscal policies, which is likely to lead to higher Fed rates, boosting the dollar. Marked 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. We could see the euro fall to around parity against the dollar where US rates are hiked and corporate taxes are cut. Markets, though, will probably need to see the new President start to implement his policies 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 to ¥120 or above, and breaching the CNY7.00 level against the yuan.







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Sterling to remain under pressure as 'hard' Brexit looms for UK

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 over the past year on mounting concerns over Brexit. Sterling weakened during the first half of 2016 in the run-up to the Brexit referendum on June 23rd and then saw further large losses on the unexpected victory for the 'leave' side in the plebiscite. The currency hit 30-year lows against the dollar, falling through key support levels at $1.37-1.38 and declining to near the $1.20 level. Sterling's post referendum slide also greatly impacted EUR/GBP, with the pair trading as high as 90p last autumn.

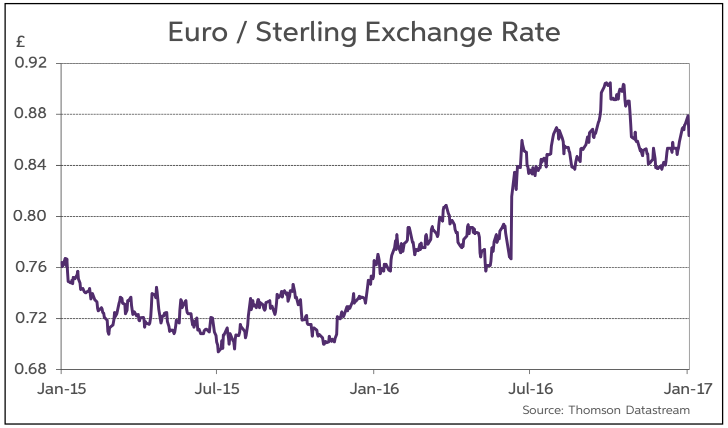
Sterling did regain some ground in the final two months of 2016, rising to around $1.27, while the euro fell back to below 84p. The market was very short of sterling so there was always scope for a bounce in the currency as traders closed positions and booked profits in the run-up to year end. Two events—Trump's unexpected election win in the US and growing political risks in Europe—also helped sterling and put pressure on the euro. There were also increased hopes that the UK might get a 'soft' Brexit, with the UK Government making more conciliatory soundings about the exit negotiations.

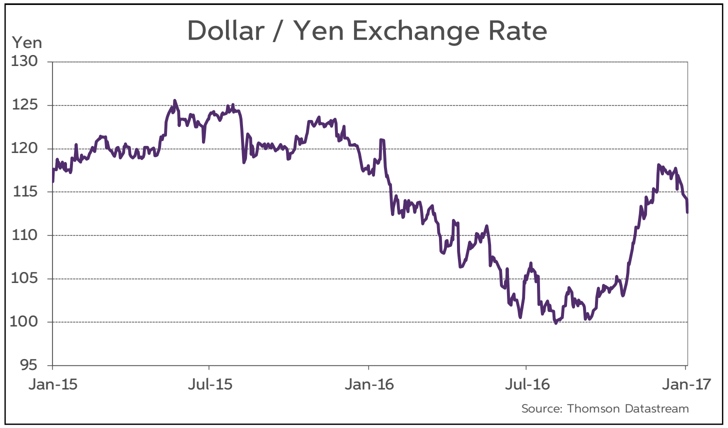
Sterling has come under renewed pressure in early 2017, though, as fears resurfaced that the UK could be heading for a 'hard' Brexit. Prime Minister May then confirmed in a major policy speech on Brexit in mid-January that the UK would leave the Single Market on its departure from the EU. She also indicated that the UK would not remain a full member of Customs Union. She gave a clear signal then that there would be a clean break with the EU, in effect a 'hard' Brexit. However, she also indicated that the UK had a strong desire to reach a comprehensive free trade deal with the EU to avoid any major disruption to either economy.

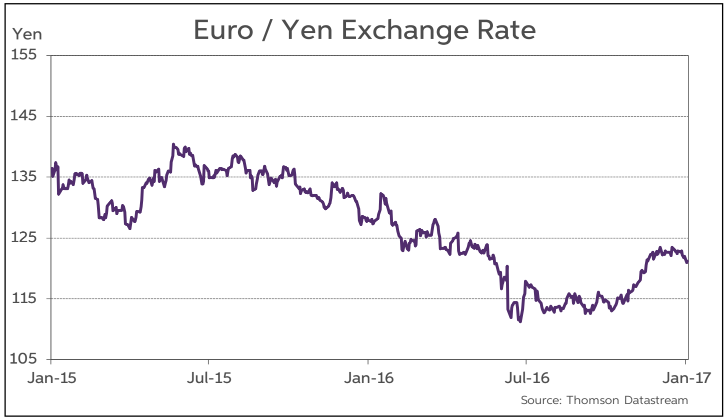
The EU Treaty provides for a two-year period for the negotiations on an EU exit once Article 50 is invoked. The UK government has indicated that it will trigger Article 50 by the end of March. However, the indications from the EU are that the negotiations on the future trading relationship with the UK will not commence until after it leaves the EU. Thus, it is unclear what arrangements, if any, an exit deal may 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 seems unlikely to agree to this if the UK leaves the Single Market. 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. The Prime Minister has indicated that the UK could opt for no deal on trade in the exit negotiations on the basis that "no deal in better than a bad deal". In these circumstances, the UK would have to fall back on WTO rules, which would involve tariffs and customs checks and would impact trade between the UK and the EU.

We feel that downside risks remain for sterling over the medium-term. The negotiations between the UK and EU are likely to prove very difficult and could fuel fears that Britain may have to fall back on WTO rules, with negative implications for external trade, foreign direct investment and the UK economy. Indeed, we think that the UK economy will slow anyway in the run-up to Brexit as rising inflation hits consumer spending power and concerns about Brexit dampen investment activity. Thus, we could see the euro move back up to the 90p level or above, with cable falling back to $1.15 or below. Indeed, if there is further general dollar strength ahead, then sterling could fall to $1.10 as the dollar reaches parity with the euro.







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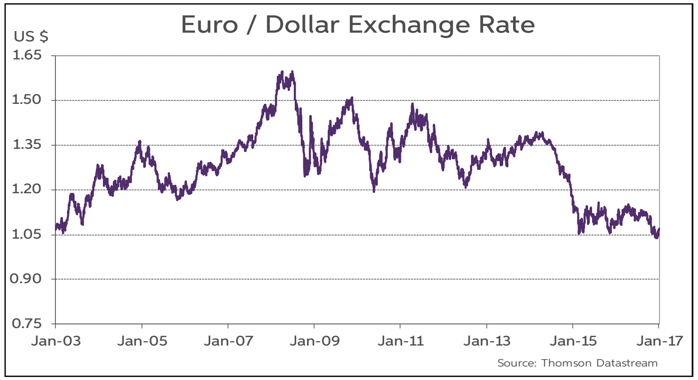
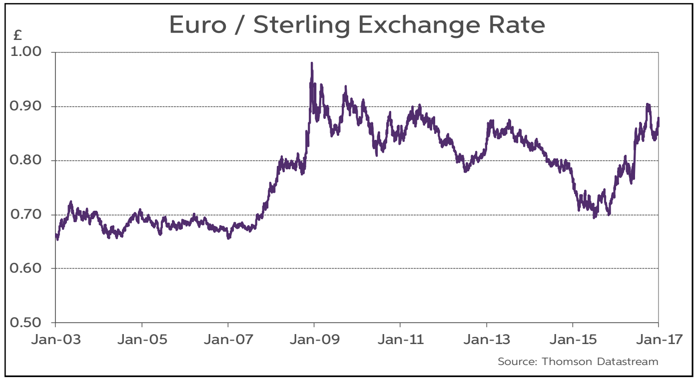
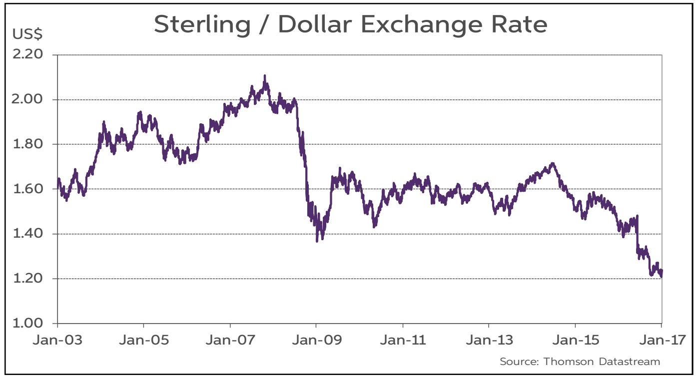
Summary of Exchange Rate Forecasts

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

	Current	Q1-2017	Q2-2017	Q3-2017	Q4-2017
Euro Versus					
USD	1.068	1.02-1.08	1.00-1.06	0.99-1.05	0.98-1.04
GBP	0.870	0.85-0.91	0.86-0.92	0.87-0.93	0.88-0.94
JPY	121.10	117-123	118-124	119-125	120-126
CHF	1.07	1.07	1.07	1.07	1.07
US Dollar Versus					
JPY	113.37	111-117	114-120	117-123	119-125
GBP	1.229	1.16-1.22	1.13-1.19	1.10-1.16	1.08-1.14
CAD	1.31	1.32	1.33	1.34	1.35
AUD	0.76	0.75	0.74	0.73	0.72
NZD	0.72	0.71	0.70	0.69	0.68
CNY	6.84	6.90	6.95	7.00	7.05
Sterling Versus					
JPY	139	136	136	136	135
CAD	1.61	1.58	1.54	1.52	1.50
AUD	1.63	1.59	1.57	1.55	1.54
NZD	1.71	1.68	1.66	1.64	1.63







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