Forex and Interest Rate Outlook

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AIB Treasury Economic Research Unit

- Brexit vote to lead to weaker growth in the UK amid heightened uncertainty about future trade with EU
- More monetary easing now on the cards in UK and Eurozone owing to hit to growth from Brexit vote
- Ample liquidity means no sign of stress in markets which settle quickly after Brexit vote
- Fed to find it even more difficult to tighten but improved US data could still bring rate hike if markets remain stable
- Sterling plummets on Brexit vote and is likely to fall further given difficulty in securing favourable EU exit for UK

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Global Economic Outlook

Brexit vote casts shadow over global economy

The global economy has been struggling for upward momentum, with growth very much underperforming. The IMF is on record as stating that "the holy grail of a robust and synchronised global expansion remains elusive" despite being seven years removed from the end of the 'Great Recession'. World growth is put at just over 3% for 2015, the weakest rate since the end of the economic crisis of 2008-2009. A similarly subdued growth rate is being forecast by both the IMF and OECD for this year.

Against this backdrop, the recent Brexit vote has cast a further shadow over both the global economy and financial markets and heralds in a period of political and economic uncertainty. The referendum outcome has already sent shock waves across global financial markets, with a renewed bout of risk aversion and sharp falls in the value of sterling. This is on top of persistent concerns that weakening activity in emerging economies, especially China, could derail the recovery in advanced economies.

It is worth noting, though, that the recovery in advanced economies has remained on track, despite the slowdown in emerging economies in recent years. Activity in advanced economies had gained some momentum, 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 the past few years. However, Japanese growth remains erratic and sluggish, despite an ultra-loose monetary policy and a big decline in the yen.

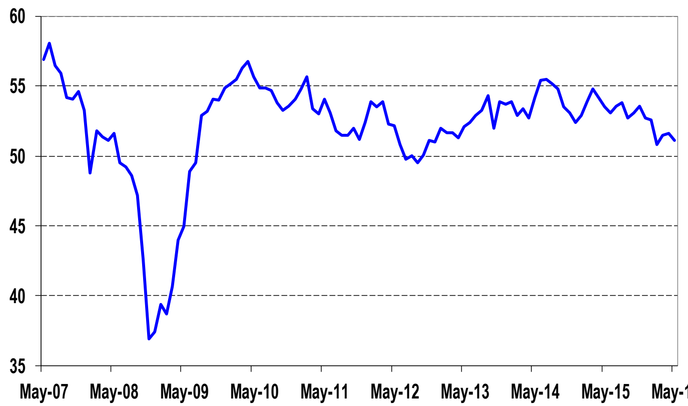
Meanwhile, growth in emerging economies has lost considerable momentum and is estimated by the IMF at 4% in 2015, down from 4.7% in 2014 and 5% in 2013. In fact, the trend has been one of weakening growth in emerging economies since 2010, when it stood at 7.5%. Most notably, GDP growth in China slowed from 10.4% in 2010 to 6.9% in 2015. The impact of the slowdown in China on other emerging economies, combined with falling commodity prices has been greater than expected, with some countries like Brazil going into recession.

On the plus side, 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, 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. The Global Composite PMI has dropped to below 52 in the past few months, its lowest level in over three years. In particular, the low level of 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.

There is now the added complication and uncertainty of the UK's position in the EU for markets and the global economy to come to terms with. This is likely to lower global growth somewhat, with a marked deceleration in the growth rate of the UK economy likely over the next 2-3 years. Estimates from the UK Treasury and NIESR suggest UK growth may be 3% lower by end 2018 as a result of the Leave vote. Growth in the Eurozone is also likely to be lower. Thus, the latest OECD and IMF forecasts are likely to be revised downwards.

Global Composite PMI (JP Morgan)



Source: Thomson Datastream

GDP (Vol % Change)

	2014	2015	2016 (f)	2017 (f)
World	3.3	3.0	3.0	3.3
OECD Economies	1.9	2.1	1.8	2.1
US	2.4	2.4	1.8	2.2
Eurozone	1.0	1.6	1.6	1.7
UK	3.0	2.3	1.7	2.0
Japan	-0.1	0.6	0.7	0.4
Non-OECD Economies	4.6	3.7	3.9	4.4
China	7.3	6.9	6.5	6.2
India	7.2	7.4	7.4	7.5
World Trade Growth (%)	3.7	2.6	2.1	3.2
OECD Economies Inflation (%)	1.6	0.7	1.1	1.8

Source: OECD Economic Outlook, June 2016

Interest Rate Outlook

Brexit vote to lead to further policy easing

The past couple of years have 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. There has been further monetary easing in the opening months of 2016. The Bank of Japan stunned markets in January by unexpectedly cutting rates, moving them into negative territory. The ECB eased policy further at its March meeting, lowering the deposit rate by a further 10bps to −0.4%, while cutting the refi rate by 5bps to 0% and expanding QE. The Bank of China has also eased policy further this year, while the Reserve Bank of Australia has cut rates as well.

The outlook for global monetary policy has been impacted by the outcome of the UK's EU referendum. The vote in favour of a 'Brexit' has seen markets become even more dovish on interest rates over the next 2-3 years. We had already seen big downward shifts in futures curves in recent months and this downward move has received added impetus after the referendum outcome in the UK.

Prior to the vote, the BoE had 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%. Markets had greatly pushed back their expected timing for UK rate hikes and did not see a rate increase materialising until late 2019. In the aftermath of the referendum, futures contracts now suggest that the market expects the next move from the MPC to be a rate cut rather than a rate hike. This view has subsequently been validated by the BoE Governor, Mark Carney, who stated that "some monetary policy easing will likely be required over the summer". We expect that the MPC will cut rates by 25bps to 0.25% in either July or August, while additional measures like an increase in QE, are also possible.

From an ECB perspective, the central bank retains an easing bias and has indicated that it would ease policy again if required. In the aftermath of the Brexit vote, futures contracts suggest that the market is expecting another 10bp cut in the deposit rate, bringing it to −0.5%. This could well materialise in the next couple of months. Further out, the market expects Eurozone rates to remain very low for a long period of time. Futures pricing suggests that three month money rates will remain negative in the Eurozone until the end of the decade.

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, concerns over risks facing the global economy and more recently as a result of some unexpected 'softness' in US labour market data. However, the Fed does retain a tightening bias. Its June FOMC projections indicated that it expected to raise rates by 50bps this year, with three 25bps hikes per year in both 2017 and 2018. This would bring the Fed funds rate to 2.375% by end 2018.

Markets though, were quite sceptical about this and have become even more sceptical since the 'Brexit' vote. Indeed, futures contracts have pushed further out the timing of the next rate hike to March 2018. Overall, markets see official rates rising to just 0.75% by end 2018. However, markets may be too dovish on their US rate hike expectations. Indeed, if there is no material deterioration in global macro conditions, financial markets stabilise and US job growth data picks up over the next few months, then a US rate increase could not be ruled out before year end, given the jobless rate is now down at 4.7%.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.375	0.66	1.24	0.74	0.94
Sept '16	0.375	0.70	1.30	0.90	1.20
Dec '16	0.625	0.90	1.50	1.10	1.40
Mar '17	0.625	0.90	1.55	1.15	1.45

** 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	-0.30	-0.06	-0.24	-0.15
Sept '16	-0.50	-0.40	-0.10	-0.25	-0.15
Dec '16	-0.50	-0.40	-0.10	-0.25	-0.15
Mar '17	-0.50	-0.40	-0.10	-0.25	-0.15

** 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	0.52	0.85	0.47	0.55
Sept '16	0.25	0.30	0.70	0.50	0.60
Dec '16	0.25	0.30	0.65	0.50	0.60
Mar '17	0.25	0.30	0.60	0.50	0.60

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

FX markets impacted by Brexit vote

The win for the 'leave' side in the UK's EU referendum sent shock waves through markets. Financial markets had moved to price in a remain vote in the lead up to the referendum, with equity markets firming and sterling trading higher. The unexpected outcome lead to a sharp sell-off in equities and a big fall in the value of sterling, while 'high quality' sovereign bonds sought out, pushing yields lower. The yield on German 10 year bunds went further into negative territory, and the 10 year gilt yield fell below 1% for the first time ever and is down around 50-60bps since the referendum.

Against this risk averse backdrop, safe haven currencies such as the yen, and swiss franc made gains, while the dollar also received some support. USD/JPY traded down as low as ¥99 in the immediate aftermath of the vote, before settling into a ¥101-103 range, while EUR/JPY traded down into a ¥112-114 range.

The 'Brexit' vote has brought some pressure to bear on the euro. EUR/USD has moved back down from the upper end of its $1.06-1.15 range to trade closer to the $1.10 level. The pair briefly tested below the $1.10 mark before rising back above it.

The outlook for the euro is challenging and tilted to the downside. The combination of 'Brexit uncertainty' and the associated risks for the EU, as well as a sluggish Eurozone economy are key headwinds facing the euro. There is also the potential for further easing from the ECB, with the possibility of the depo rate being moved further into negative territory to –0.5%, which could put more downward pressure on the currency.

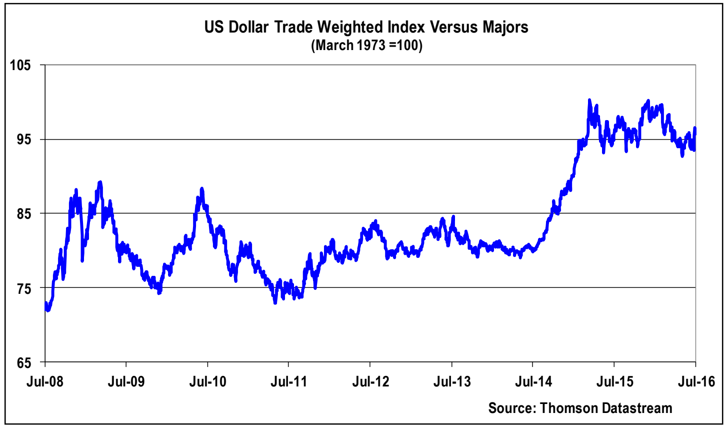
On the dollar side, much uncertainty still surrounds the actual timing of Fed tightening. Following events in the UK, the market is not pricing in another rate increase until March 2018, but the most recent projections of the FOMC members in June point to a number of rate hikes before then.

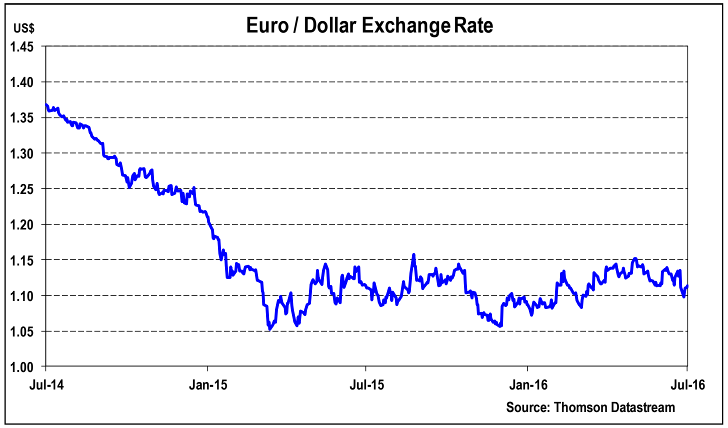
If markets settle back down over the coming months and the expected slowdown in the UK economy does not derail global growth, and we also see a reacceleration in US jobs growth, then a rate hike from the Fed could be a possibility before year end. This, in turn, could provide some upward momentum to the currency.

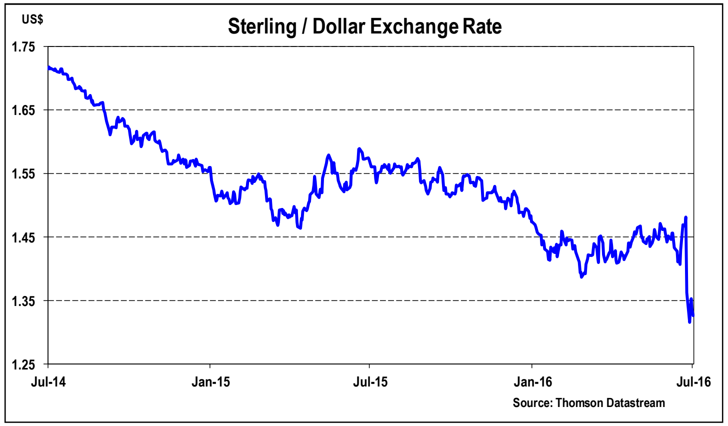
From a EUR/USD viewpoint, we think the euro is likely to lose further ground against the dollar. However, the euro has held up reasonably well since the Leave vote in the UK, with the EUR/USD pair mostly trading in a relatively tight range of $1.10-1.115

There is a realisation in markets that the UK's departure from the EU is some time away. Thus, the euro may not fall that much in the second half of 2016 as markets await further news on UK/EU developments. We look for EUR/USD to trade back down towards the $1.08 level later in the year, especially if the US Federal Reserve hikes interest rates.

Elsewhere, a combination of economic and political uncertainty is likely to see investor sentiment remain on a fragile footing and provide continued support to safe haven currencies. Under these conditions, the yen could rise further and the BoJ may be forced to act to rein in further yen appreciation. Overall, we see the dollar/yen rate edging down towards the ¥100 level in the coming months. Meanwhile, the Chinese yuan seems likely to continue weakening against the stronger dollar.







Sterling plummets after Brexit vote and is vulnerable to further falls.

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.

Some of these gains, though, started to be unwound over the past few months in the lead up to the EU referendum. This saw the euro rise by more than 10% against sterling since the start of December, climbing from 70p to around the 78p level. GBP/USD also fell, from a high of $1.59 last summer, to a $1.40-1.46 trading range. The BoE had estimated that about half of the 9% fall in sterling's trade-weighted value in the past six months prior to the referendum was due to concerns about a possible vote to leave the EU.

In the days leading up to the referendum, market concerns eased somewhat and moved to price in a 'remain' win. This saw GBP/USD trade back up towards $1.50 and EUR/GBP back down near 76p.

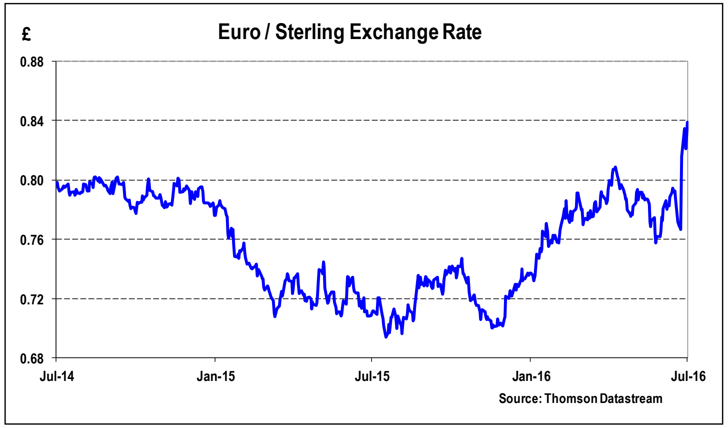
When the actual votes showed the 'leave' side in the ascendancy, the reversal for sterling was sharp. The currency fell by over 10% against the dollar, falling through the key resistance level at $1.37-1.38, plummeting to a 30-year low near $1.32. It has since hit a 31 year low, at $1.312. Sterling's post referendum weakness has also impacted EUR/GBP, with the pair trading as high as 83.8p.

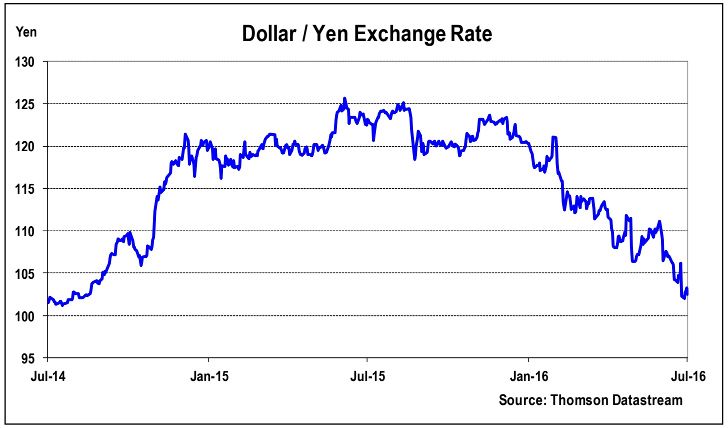
The referendum outcome and the uncertainty associated with it provides a serious headwind to the UK's economic outlook and also to sterling. The UK has yet to trigger Article 50 of the Treaty on European Union to start the official exit process. Current indications are that this may not happen before the end of the year. There is a provision for a two year time frame to negotiate an exit, but this may not include a new trade deal, which could take a number of years to put in place.

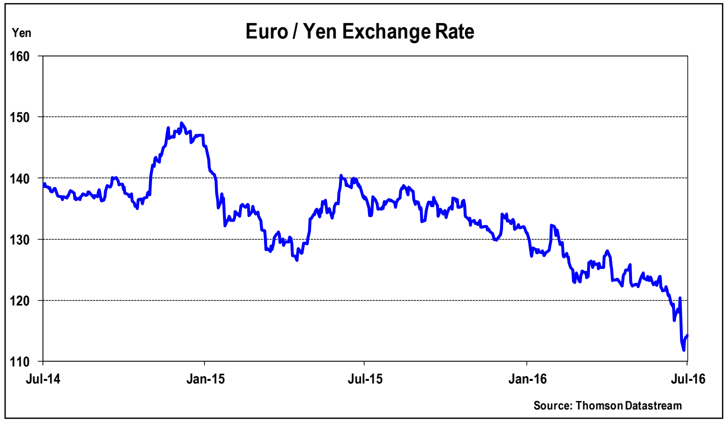
The outcome of these trade discussions will ultimately determine the long run implications of a Brexit for the UK economy, through the type of deal that the country can negotiate with the EU. Over the next couple of years though, while there will be no change to the institutional framework that governs the UK's relationship with the EU, the uncertainty will weigh on economic activity.

The trend for sterling is now a weakening one, with the currency vulnerable to further downside against this backdrop of heightened economic and political uncertainty. This 'uncertainty' could drag on for a number of years. On top of this, the Governor of the BoE has indicated that monetary policy is likely to be eased in the coming months, which provides an additional headwind to the currency.

Sterling could trade as low as $1.25 against the dollar before the end of the year. Further out, the GBP/USD pair could fall even lower, down towards $1.17 on a disorderly exit, where relations turn sour with the EU and there are a lot of difficulties in reaching some form of a trade deal. The EUR/GBP cross is likely to move higher, trading back up to its 2013 range of 84-86p in the second half of 2016. Looking further ahead, the pair could well climb to its 2011 high of 90p on a disorderly exit. Overall then, the outlook for sterling is very challenging in an environment of economic and political uncertainty as well as monetary easing.



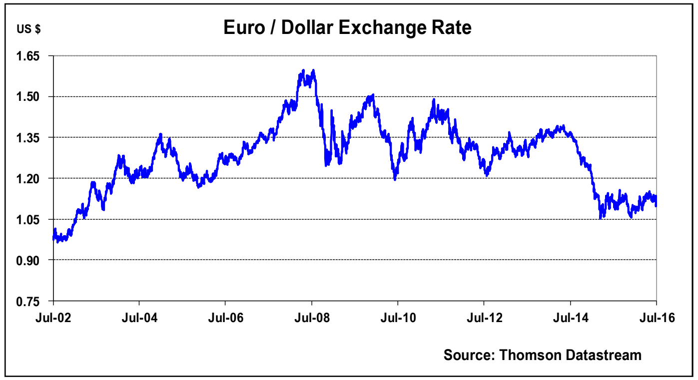


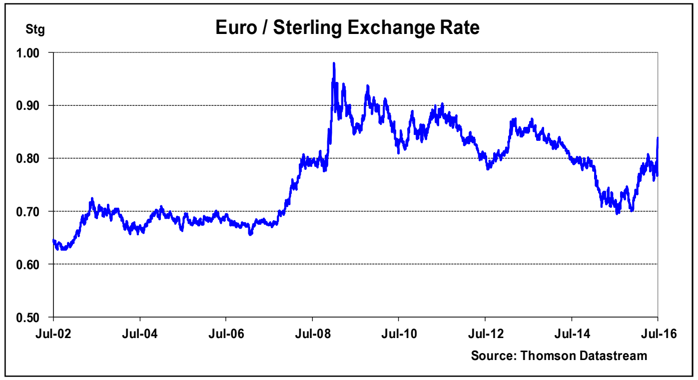


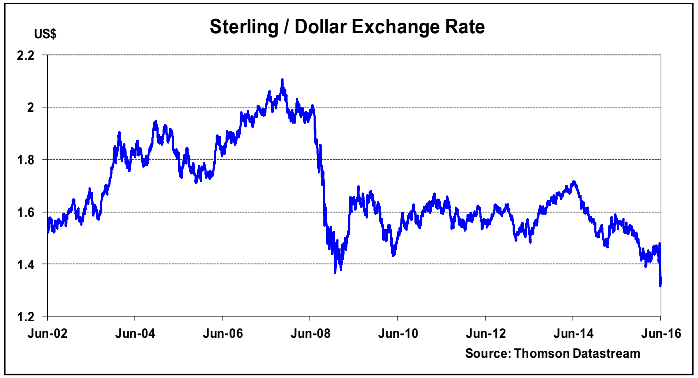
Summary of Exchange Rate Forecasts

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

	Current	Q3-2016	Q4-2016	Q1-2017	Q2-2017
Euro Versus					
USD	1.115	1.06-1.12	1.05-1.11	1.04-1.10	1.04-1.10
GBP	0.848	0.82-0.86	0.83-0.87	0.84-0.88	0.84-0.88
JPY	113.40	108-114	106-112	104-110	103-109
CHF	1.08	1.08	1.08	1.07	1.07
US Dollar Versus					
JPY	101.71	99-105	98-104	97-103	96-102
GBP	1.314	1.27-1.33	1.24-1.30	1.22-1.28	1.22-1.28
CAD	1.29	1.28	1.27	1.26	1.25
AUD	0.75	0.76	0.77	0.78	0.78
NZD	0.72	0.73	0.74	0.75	0.75
CNY	6.67	6.67	6.70	6.73	6.75
Sterling Versus					
JPY	134	133	128	125	124
CAD	1.69	1.66	1.61	1.57	1.56
AUD	1.75	1.71	1.65	1.60	1.60
NZD	1.82	1.78	1.72	1.67	1.67







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