Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Data stronger than expected in most economies, while headline inflation moves higher
- Fed hikes again and repeats that further rate increases likely in 2017 and 2018. ECB, BoE and BoJ to keep rates on hold in 2017, but markets mull possible hike by ECB and BoE in 2018
- Euro fairly range bound as political concerns ease and markets look for rates to edge upwards
- Sterling stable as economy holds up and markets contemplate possible BoE rate hike next year. Currency could stay range-bound while markets await news on progress of UK exit talks with EU
- Dollar lost some ground in Q1 2017. Need to see further Fed rate hikes and progress on Trump's fiscal easing plans to re-ignite the currency's three-year rally

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Global Economic Outlook

Global economic activity on improving trend

The global economy has been struggling for upward momentum in recent years. The OECD observed in 2016 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 rates since the end of the economic crisis of 2008-2009. 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 has lost considerable momentum during this decade, slowing from 7.5% in 2010 to circa 4% by 2015/16.

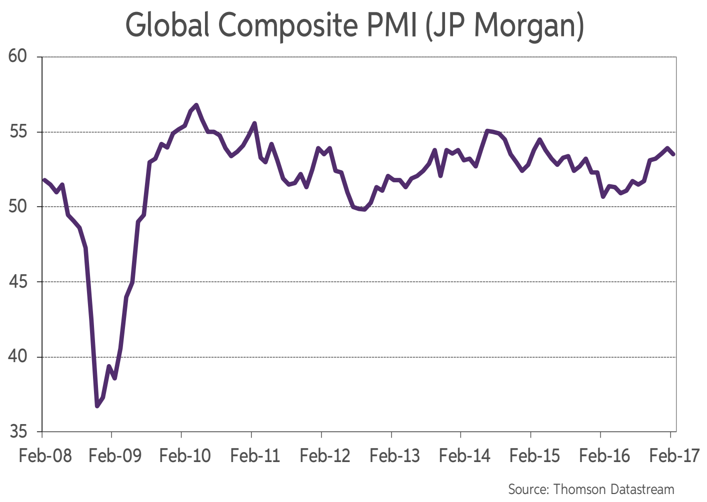
Both the OECD and IMF are forecasting that growth in the world economy will pick up modestly to around 3.5% in 2017-18. The IMF sees growth in advanced economies accelerating to circa 2% in 2017-18, helped by continuing very loose monetary policies and a more supportive stance to fiscal policy, especially in the US. President Trump's fiscal easing plans, if implemented, could see US growth picking up to 2.5% by 2018. 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.

Recent data point to a strengthening of activity in all the major economies. Notably, the Global Composite Output PMI averaged 53.7 in January/February, close to two year highs. In the Eurozone, the flash Composite PMI hit 56.7 in March, its best level in six years. Other leading activity indicators have also picked up strength in recent months in the major economies. Meanwhile, the Citigroup's economic surprise index shows that data have been coming in well ahead of expectations over the past six months in both developed and emerging economies. Labour market data have been particularly encouraging, with good jobs growth nearly everywhere, a steady downward trend in Eurozone unemployment and economies like the US, UK and Japan now close to full employment.

Downside risks, though, persist for the world economy. In particular, the still low level of commodity prices, high private sector debt levels and a reliance on capital inflows are all downside risks to the growth prospects for emerging economies. Meanwhile, rising headline inflation rates in 2017 across all economies could also be a constraint on growth in consumer spending. Increases in US interest rates could also yet negatively impact global financial markets and activity.

Donald Trump's election win had a positive impact on economic sentiment in the US. However, while his domestic policies are very much pro-growth, there are risks for the world economy from possible protectionist trade policies. Furthermore, there are doubts about the extent to which President Trump will be able to implement his fiscal stimulus agenda. The US stock markets are vulnerable in this regard, having rallied strongly on expectations of stronger growth under Mr Trump.

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. However, the key factors which have held back growth in this decade, namely weak wage growth, weak credit growth and weak investment activity have yet to be overcome.



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

Markets begin to focus on monetary 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. The era of monetary easing, though, appears to be coming to an end in many countries and markets are beginning to turn their attention to the prospect of monetary tightening, with the US Federal Reserve already on the path towards policy normalisation.

In the UK, the economy has held up much better than expected since the Brexit referendum. Meanwhile, inflation has picked up following the sharp decline in sterling last year, with the core CPI rate hitting 2%. Headline inflation could hit 3% later this year. While the BoE is not expected to tighten policy anytime soon, it has indicated that there are "limits to the extent that above-target inflation could be tolerated". Indeed, one MPC member voted for a hike at the March meeting. The market is pricing in a 25bps rate hike by end 2018. However, we think that the UK economy may slow over the next two years in the run-up to Brexit which could delay any rate increase, while the rise in inflation could also prove transitory given that wage inflation is quite subdued.

Meantime, the ECB is moving away from an easing bias towards a more neutral policy stance. The ECB will continue with its QE programme until at least the end of 2017, although the size of the monthly asset purchases is being reduced from €80bn to €60bn from April. However, with headline inflation rising to 2% and economic growth picking up some momentum, the ECB has indicated that there is no longer a sense of urgency about taking further action. Thus, its deposit rate looks to have reached a trough at –0.4%.

The ECB has indicated, though, that a very substantial degree of monetary accommodation is still required as underlying inflation remains weak. Nonetheless, futures contracts now expect wholesale rates to start edging higher later this year, with three month money rates turning positive by mid-2019. The ECB could wind down its QE programme during the first half of 2018, which would open the door for a scaling back of negative rates in the second half of next year. The refi rate is currently at zero and the ECB is unlikely to allow the corridor between it and the deposit rate to narrow to less than 25bps. Thus, a rise in the deposit rate of more than 15bps is likely to trigger an increase in the refi rate. Eurozone rates, though, are expected to remain very low for a long period of time, with futures contracts suggesting that three month rates will remain below 1% until 2023.

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. However, it followed this up quickly with another 25bps rate hike this month. The FOMC kept its interest rate projections largely unchanged at its March meeting. It expects to raise rates to 3% by end 2019 or about 75bps per annum over the 2017-2019 period, with two further rate hikes likely this year.

Markets turned more bearish on US rates following the Trump victory in the Presidential election but they are still some way behind the Fed's projections. Markets are looking for rates to rise to circa 2% by end 2019, some 1% lower than projected by the Fed. This is not that surprising given that the Fed has moved very cautiously to date on policy tightening. Much could depend on whether President Trump gets to implement his fiscal agenda of lowering taxes and raising infrastructural spending, which would boost US growth further. Recent comments from Fed officials suggest that they are certainly likely to deliver another two rate hikes in 2017 in any event.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.875	1.15	1.79	1.61	2.04
June '17	0.875	1.20	1.85	1.65	2.05
Sept '17	1.125	1.40	2.00	1.85	2.25
Dec '17	1.375	1.65	2.20	2.05	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	-0.36	-0.12	-0.13	0.20
June '17	-0.40	-0.34	-0.09	-0.10	0.20
Sept '17	-0.40	-0.32	-0.07	-0.07	0.25
Dec '17	-0.40	-0.30	-0.05	-0.05	0.30

** 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	0.34	0.72	0.63	0.87
June '17	0.25	0.35	0.73	0.63	0.89
Sept '17	0.25	0.35	0.74	0.64	0.92
Dec '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

Forex markets remain range bound as pressure comes off euro

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. 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 been quite range bound.

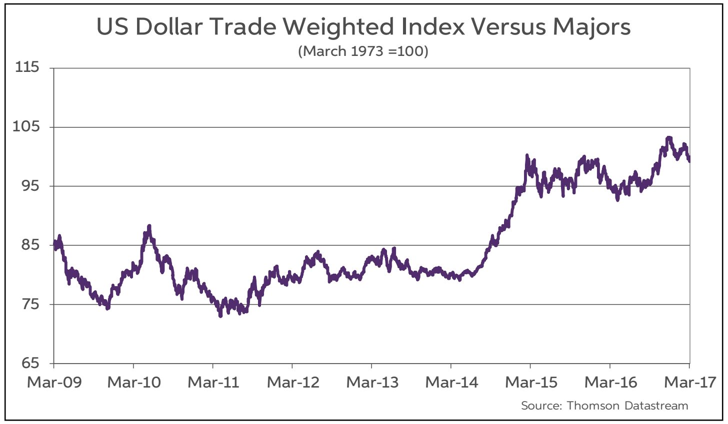
The dollar, though, did move higher against the euro and other currencies in the closing months of last year. Growing expectations that the Fed would implement a number of rate hikes boosted the US currency. Furthermore, Trump's unexpected victory in November's Presidential election also saw markets price in a more aggressive path for Fed rate hikes over the next three years. The dollar hit 14-year highs on a trade-weighted basis in late 2016/early 2017. This also saw the euro drop to 14 year-lows against the dollar at below $1.04 at the turn of the year, having traded in a $1.12-1.15 range as recently as Q2 last year.

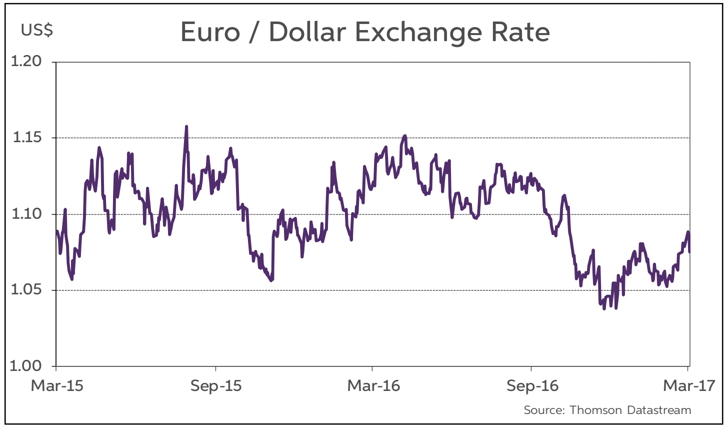
The euro, though, has regained some ground against the dollar in the opening quarter of this year, rising to around $1.08, despite another rate hike from the Fed in March. A more significant change, though, has been in regard to expectations around ECB policy, with markets now anticipating that the ECB will begin moving rates higher next year. Headline inflation has picked up to 2% while the Composite PMI hit 56.7 in March, its highest level in six years. Meanwhile, the jobless rate is heading steadily lower. As a result, markets now expect three month money rates in the Eurozone to turn positive by mid-2019, compared to mid-2021 last autumn.

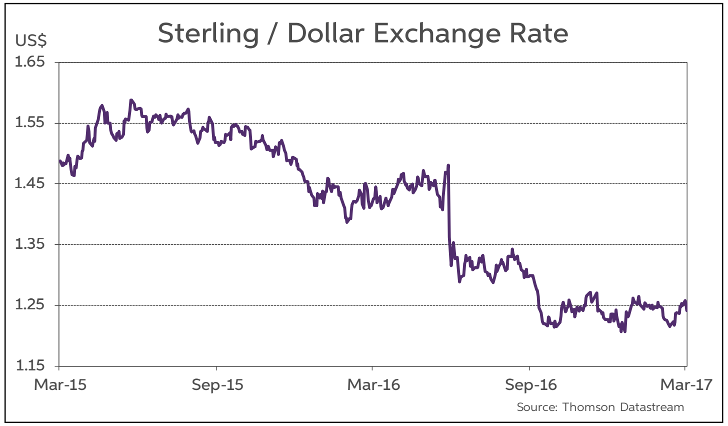
Abating political risks in Euroland have also helped the euro, as far-right and euro-sceptic political parties have lost some ground recently. However, it is too early to sound the all-clear on this front until after the French Presidential elections in a number of weeks time. Victory in the elections by the far-right candidate, Marine Le Pen, though not expected, would have very negative consequences for the euro.

Meanwhile in the US, markets are growing somewhat impatient with the slowness of the Trump administration in getting started on implementing its planned expansionary fiscal policies. Indeed, there are doubts about how much of his fiscal agenda that President Trump will be able to implement. This has not helped the dollar. A big infrastructure spending programme and marked cuts in US corporate tax rates were expected to boost US growth and lead to higher interest rates and a stronger dollar. President Trump's also talked about introducing a once-off low 10% corporate tax rate to entice back the large quantity of funds that US companies currently hold abroad to avoid paying high US taxes. Some of these funds would have to be converted in to dollars if US corporates wish to repatriate them, which would obviously provide a boost for the currency.

Overall, the fact that the Fed appears to have moved on to a steady rate tightening path, that could well restore US rates to more normal levels over the next couple of years, should help underpin the US currency as interest rate spreads move more and more in its favour. However, it would seem that markets will need to see progress on the implementation of President Trump's fiscal agenda, as well as further hikes in US interest rates, for the dollar rally to be re-ignited. We certainly think that this is still possible, but it might take some time. Overall, we still believe that the US currency has further upside potential, especially with rates set to remain very low nearly everywhere else. The Australian dollar is another currency that could well benefit from policy tightening.







Forex Market Outlook

Sterling more stable as the UK triggers 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 $1.20-1.27 range. The euro made significant gains against sterling too, with the EUR/GBP hitting a high above 90p last autumn, up from 70p near the end of 2015.

However, sterling has been more stable since the autumn. It has managed to regain some ground against the euro, largely trading in an 84-88p range since early November. The UK economy has held up much better than expected, with strong GDP growth of 0.6% in Q3 and 0.7% in Q4. Growth forecasts for the UK for 2017/18 have been revised upwards. Meanwhile, headline inflation has risen sharply to 2.3% and could hit 3%. With the economy holding up and inflation also on the rise, the markets now think that the BoE could hike UK rates by the end of next year, quite a turnaround from late last summer when further easing was expected. Indeed, one MPC member voted for an immediate hike in rates at the March meeting, while some others indicated that it would not take much in terms of upside news on the economy for them to consider policy tightening.

Meanwhile, the UK government triggered Article 50 on March 29th, thereby commencing the formal two year process for leaving the EU. The UK seems increasingly confident that it can secure a favourable exit deal with the EU. The Article 50 letter was quite conciliatory in tone, while various EU leaders have also expressed the hope that a deal can be done between the EU and the UK. All this has helped create a more positive backdrop for sterling.

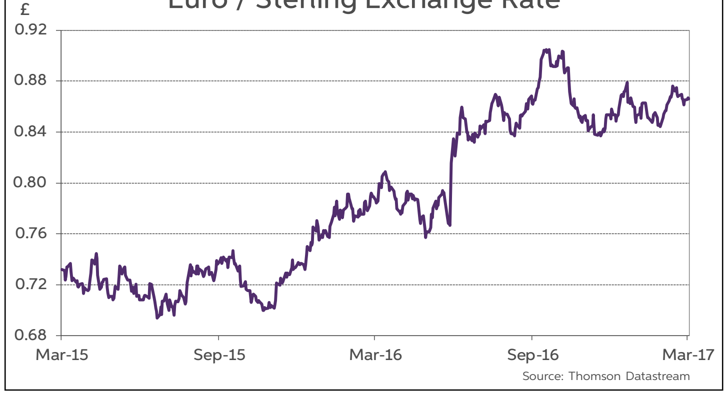
The UK currency could remain quite stable for much of this year, given that there is unlikely to be any real news flow from the Brexit negotiations for some time. The early Brexit talks are likely to be technical in nature, dealing with budgetary issues and citizens' rights, or what the EU has called the "principles for an orderly withdrawal", before the discussions move on to more substantive but difficult issues, such as trade.

Downside risks, though, remain for the UK currency as the exit negotiations are still likely to prove difficult, especially as they come to a head next year, when they get to trade and what transition arrangements might be put in place when the UK leaves the EU. The talks, by that stage, could be fraught and punctuated by crises, with much uncertainty about the final outcome.

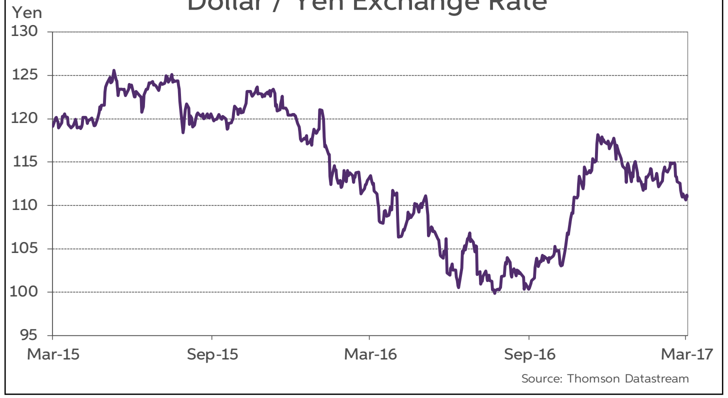
There is still a risk of an outcome that is very negative for the UK economy and sterling. Prime Minister May has confirmed that the UK will leave the Single Market on its departure from the EU. She also indicated that the UK would not remain a full member of the Customs Union. They will make the talks on trade very difficult and also securing a transitional deal to cover the period between when the UK leaves and negotiates a broad trade deal with the EU.

It is unclear at present what arrangements, if any, an exit deal will contain in regard to trade. 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 below $1.15. For this year, though, sterling may largely trade in an 84-88p range against the euro, while the performance of cable may depend on how the US currency performs. We would not be surprised to see some broad-based dollar gains as US rates rise, that takes cable below $1.20.

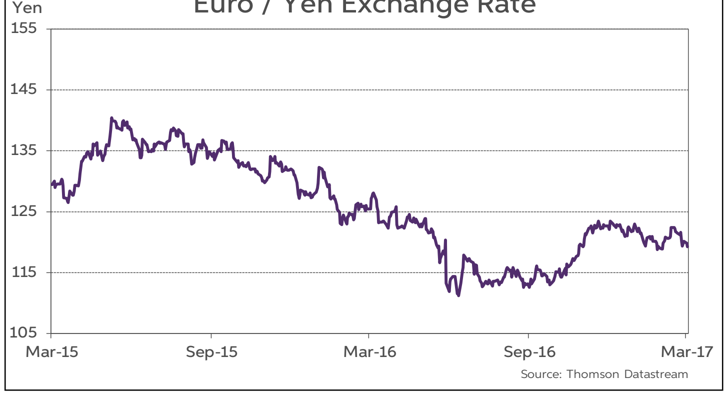
Euro / Sterling Exchange Rate



Dollar / Yen Exchange Rate



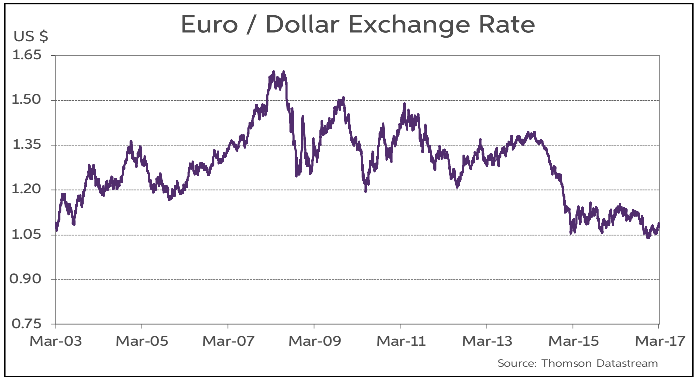
Euro / Yen Exchange Rate

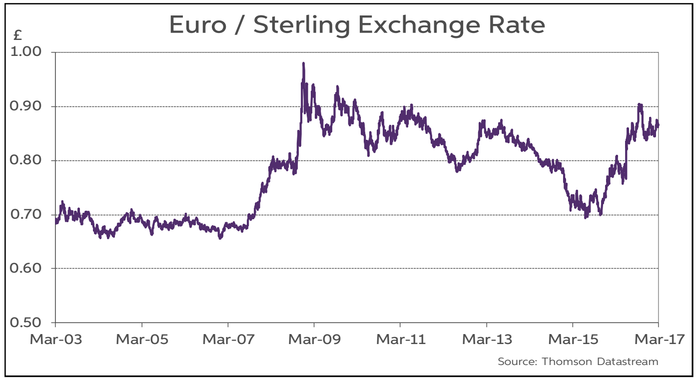


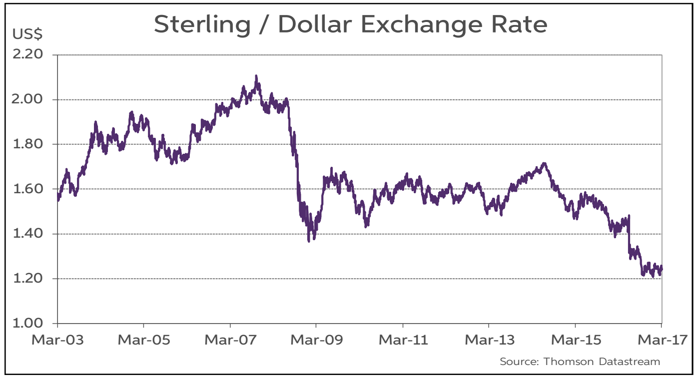
Summary of Exchange Rate Forecasts

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

	Current	Q2-2017	Q3-2017	Q4-2017	Q1-2018
Euro Versus					
USD	1.073	1.03-1.09	1.02-1.08	1.01-1.07	1.00-1.06
GBP	0.861	0.83-0.89	0.84-0.90	0.85-0.91	0.86-0.92
JPY	119.44	117-123	118-124	119-125	120-126
CHF	1.07	1.07	1.07	1.07	1.07
US Dollar Versus					
JPY	111.33	110-116	112-118	114-120	116-122
GBP	1.246	1.20-1.26	1.18-1.24	1.15-1.21	1.13-1.19
CAD	1.33	1.33	1.33	1.33	1.33
AUD	0.77	0.77	0.78	0.79	0.80
NZD	0.70	0.70	0.70	0.70	0.71
CNY	6.89	6.92	6.96	7.00	7.05
Sterling Versus					
JPY	139	139	139	138	138
CAD	1.66	1.64	1.61	1.57	1.54
AUD	1.62	1.60	1.55	1.49	1.45
NZD	1.78	1.76	1.73	1.69	1.63







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