Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

27th March 2018

- Global economic recovery gains momentum, but inflation remains subdued
- Era of monetary easing at an end. Further rate increases on the cards in the coming months from the Fed, BoE and some other central banks, with the ECB expected to start hiking from next year
- Dollar stabilises recently, helped by increasing risk aversion in markets and rising US rates, but we believe that it is on a long-term weakening path and will lose further ground this year
- Sterling recovers some ground. Should strengthen further as Brexit talks make more progress
- Euro has made gains in past year, but still at quite low level versus dollar. EUR/USD has scope to rise further as we move towards monetary tightening in the Eurozone

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Global Economic Outlook

Global growth picks up to circa 4%, but inflation remains subdued

Global economic activity has been gaining strength over the past eighteen months, helped by an improvement in investment, manufacturing and world trade. The IMF upgraded its forecasts for the world economy at the start of the year and is now forecasting 3.9% growth in both 2018 and 2019, up from 3.7% in 2017 and 3.2% in 2016.

There was a marked pick-up in growth in all the major economies last year, apart from the UK. The IMF estimates that advanced economies grew by 2.3% in 2017, compared to 1.7% the previous year. Activity in developing economies has also been gathering strength, helped by the emergence of countries like Russia, Brazil and Nigeria from recessions as oil prices recovered from their early 2016 lows. The IMF puts growth in emerging economies at 4.7% last year, up from 4.4% in 2016 and 4.2% in 2015.

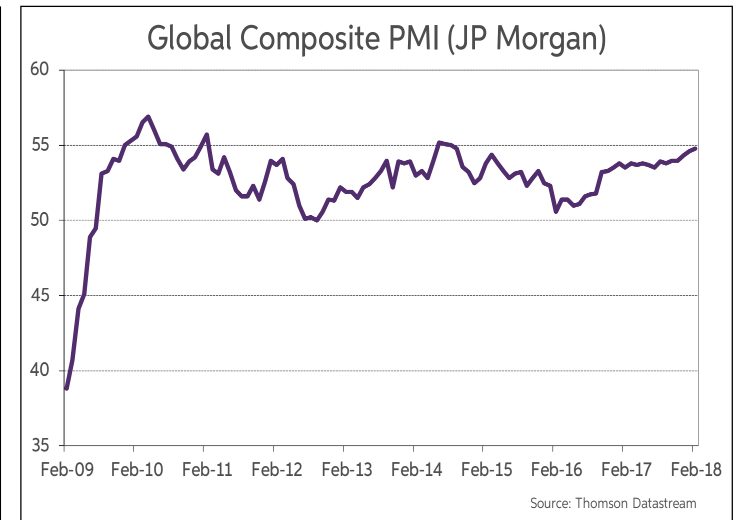
It would seem that the combination of continuing very loose monetary policies, a more supportive stance to fiscal policy and some recovery in commodity prices have at last triggered stronger economic growth. Activity is also being aided by good employment growth and low inflation, which is boosting real incomes and spending power. Credit growth has started to improve in many economies. A pick-up in world trade has been an important factor also. Growth in world trade volumes is estimated by the OECD and IMF at close to 5% in 2017, almost double the rate in the previous number of years.

Central banks across the globe have been indicating that monetary policy can remain quite accommodative despite the stronger growth because of the persistence of very low inflation. This should help sustain the upturn in economic activity. Fiscal policy is also turning increasingly expansionary in some economies, most notably the US. Thus, the IMF expects the world economy will grow by close to 4% in the next two years. It sees advanced economies expanding by around 2.3%, with growth in developing economies picking up to 5%.

The one exception to the generally improving picture has been the UK. Activity slowed there last year, as high inflation dampened consumer spending, with uncertainty over Brexit weighing on investment. There is little sign yet that the traded sector in the UK is benefitting from sterling's sharp fall and improving global activity. The IMF is forecasting that the UK economy will grow by 1.5% in the next two years, much the same as during 2017.

Most survey indicators point to a good start in 2018 for the world economy. The JP Morgan Composite Output PMI rose to a 41-month high in February, hitting 54.8, up from 54.6 in January and 54.3 in December. The winter months saw a marked improvement in the PMIs for emerging economies, which reached 5-year highs. The PMIs for advanced economies remain strong, and are at one of the highest levels seen in recent years. Real economic indicators, though, softened a bit in some countries at the start of 2018, most notably consumer spending. GDP growth may have slowed slightly in the US and UK in the opening quarter of the year, while the preliminary PMI data in the Eurozone for March also show an easing back in the pace of activity.

Despite the stronger global growth, inflation in advanced economies remains subdued and below targets, while it is quite stable in most emerging economies. Sluggish wage growth has been a key factor in keeping inflation at low levels. The rise in oil prices in the second half of last year ran out of steam in the opening quarter of 2018 and thus will not add greatly to inflation. The IMF is forecasting that CPI inflation will average around 2% in advanced economies in 2018-19, up slightly from 1.9% in 2017.



GDP (Vol % Change)

	2016	2017 (e)	2018 (f)	2019 (f)
World	3.2	3.7	3.9	3.9
Advanced Economies	1.7	2.3	2.3	2.2
US	1.5	2.3	2.7	2.5
Eurozone	1.8	2.4	2.2	2.0
UK	1.9	1.7	1.5	1.5
Japan	0.9	1.8	1.2	0.9
Emerging Economies	4.4	4.7	4.9	5.0
China	6.7	6.8	6.6	6.4
India	7.1	6.7	7.4	7.8
World Trade Growth (%)	2.5	4.7	4.6	4.4
Advanced Economies CPI Inflation (%)	0.8	1.7	1.9	2.1

Source: IMF World Economic Outlook Update, January 2018

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Interest Rate Outlook

Moving into a rising interest rate environment

The long period of global monetary easing has come to an end. The US Federal Reserve is advancing steadily on a path towards policy normalisation, while rates have also been hiked in Canada, the Czech Republic, China and the UK in the past year. The ECB reduced the size of its monthly asset purchases at the start of this year and dropped its easing bias this month, while even the Bank of Japan has tapered QE ever so slightly, after announcing that it is trimming purchases of long dated bonds.

Nonetheless, monetary policy is expected to remain quite loose in nearly all the major economies over the next couple of years. Continuing low inflation suggests that policy will be tightened at a slow pace, despite the strengthening of global economic activity. Markets, though, have turned more bearish on interest rates over the past six months. Futures contracts are now pricing in close to 100bps of rate increases from the Fed, BoE and ECB by the end of 2020. This would still leave official rates quite low at 2.6% in the US, 1.5% in the UK and close to the 0.5% level in the Eurozone.

In the UK, inflation picked up following the sharp decline in sterling, with headline CPI inflation rising to around 3%. This saw the MPC decide in November to reverse the 25bps rate cut made in 2016 and bring the bank rate back up to 0.5%. It was the first UK rate hike since 2007. The MPC has been signalling that further rate hikes are on the cards and two Committee members voted to raise rates by 25bps at the March meeting, opening the door for a rate increase as soon as the May meeting. Rates could be hiked again before the year is out. Markets expect that UK official rates will be increased by 100bps to 1.5% between now and the end of 2020.

The ECB scaled back asset purchases under its QE programme at the start of 2018. Monthly purchases have been reduced from €60bn to €30bn, with the ECB indicating that it will maintain purchases at this lower level until at least September 2018. At its March Council meeting, the ECB dropped its easing bias that the size of monthly purchases could be increased again if necessary. Markets are of the view that the ECB will cease net asset purchases altogether in either September or December, before starting to slowly raise rates from 2019.

The ECB has indicated that it intends to keep interest rates at their current very low levels well past the time when it ends net asset purchases under its QE programme, most likely later this year. Not surprisingly then, futures contracts show little change in wholesale rates in 2018, with rates seen as starting to rise from around mid-2019. The ECB deposit rate is currently –0.4%. Futures contracts see money market rates turning positive at the end of 2019 and rising further by circa 50bps in 2020. Rates are not expected to rise to 1% until mid-2022. Overall then, rates in the Eurozone are still expected to remain very low in the next few years, despite some policy tightening.

Meanwhile, the Fed hiked rates by 25bps to 1.625% at its March meeting, the sixth rate rise of this cycle. It reaffirmed that it expects to implement two further 25bps rate increases this year, bringing rates up to 2.125% by end 2018 but a third one cannot be ruled out. Indeed, the Fed raised the projected number of rate hikes for 2019 from two to three and now sees rates rising to 3.375% by end 2020. While US markets have become more bearish on rates recently, they still only see them getting to 2.6% by end 2020, some 80bps below the Fed projections.

Further marked upward pressure on bond yields is likely if markets bring their expected path for interest rates more into line with the Fed, which may well prove to be the case given the momentum in the US economy.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.625	2.29	2.67	2.58	2.77
June '18	1.875	2.50	2.85	2.80	2.95
Sept '18	2.125	2.65	3.00	2.95	3.10
Dec '18	2.125	2.65	3.05	3.00	3.15

** 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	-0.38	-0.25	-0.16	0.39
June '18	-0.40	-0.36	-0.23	-0.10	0.45
Sept '18	-0.40	-0.34	-0.20	-0.05	0.55
Dec '18	-0.40	-0.30	-0.10	0.05	0.65

** 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	0.67	0.99	1.11	1.40
June '18	0.75	0.85	1.15	1.25	1.55
Sept '18	0.75	0.90	1.20	1.30	1.60
Dec '18	1.00	1.10	1.40	1.50	1.75

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Dollar stabilises after losing further ground in early 2018

A key feature of forex markets during most of the past year has been the strengthening of the euro and weakening of the dollar. This trend continued in the opening weeks of 2018, with the EUR/USD rate climbing from $1.20 at the start of January to a three year high above $1.25 by early February. This was well above its level of a year earlier, when the EUR/USD rate was trading down at around $1.05.

It is important to note that the dollar lost ground against a broad range of currencies in the past year and not just the euro. The Aussie, NZ and Canadian dollars all made ground against the dollar, while sterling has staged a strong rebound, rising from $1.22 to around the $1.40 level. Even the Chinese yuan, which declined steadily against the dollar over the 2014-16 period, has appreciated strongly against the US currency, gaining around 10% in the past year. The yen has also risen against the dollar.

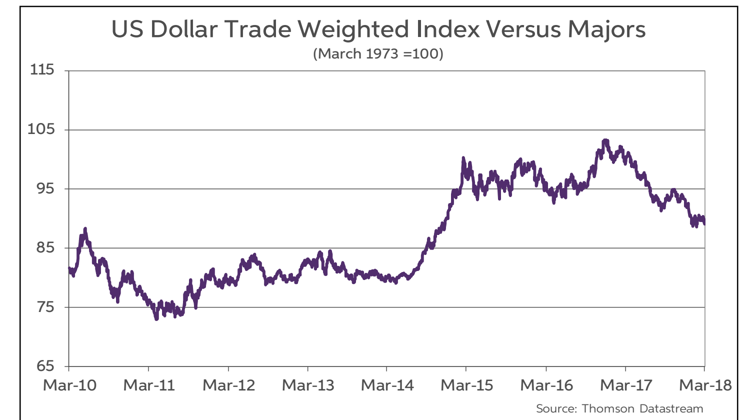
It is hard to pinpoint the precise factors behind the weakness of the dollar over the past year as the US economy has been performing quite well while the Fed has raised rates by 125 bps since near the end of 2016. It may have more to do with the fact that the global economy has picked up considerable momentum, resulting in other central banks joining the Fed in raising rates, with others likely to eventually follow suit. It is also the case that what we have seen in the past year is a partial unwinding of the marked appreciation of the dollar that occurred between mid-2014 and the end of 2016.

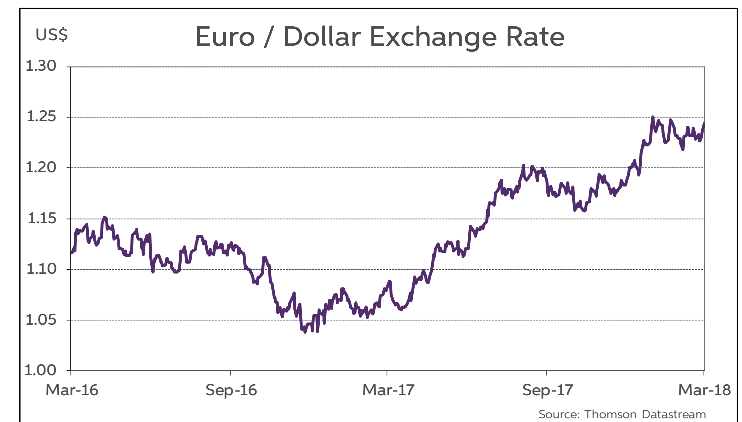
The dollar has stabilised over the past couple of months, though, with EUR/USD largely confined to a $1.22-1.25 trading range. A rise in risk aversion in markets as reflected in falling stock prices, has triggered some flows into liquid, safe haven currencies like the dollar and the yen. Higher bond yields and a firming of interest rate expectation in the US have also supported the currency.

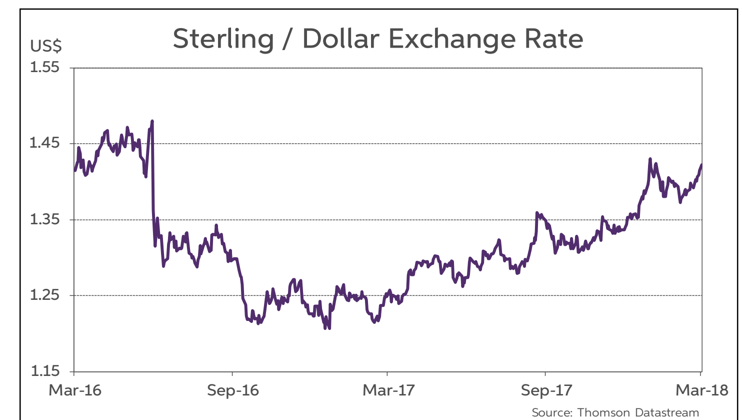
We have also been pointing out that cuts in US corporate tax rates at the end of 2017 could spark some dollar buying this year if American companies start to bring back cash from overseas to take advantage of a special low tax rate on repatriated profits. It is hard to put a figure on the size and timing of such flows, but they would benefit the US currency if companies need to convert funds held in other currencies into dollars to repatriate them. The US currency fell sharply over the 2002-2008 period, except in 2005, when a similar corporation tax amnesty that year led to a temporary but marked rise by the dollar. There may be something happening along these lines again, except on a more modest scale, which has provided some support for the currency recently.

Notwithstanding its large gains of the past year, the euro is still at a relatively low level against the dollar. EUR/USD mainly traded in a $1.20-1.50 range from 2003 to 2015. It has now returned to the lower end of this range. Market positioning is very short the dollar at the present time, which may limit the upside for EUR/USD in the near-term. However, we would expect the euro to make further gains as we get closer to the end of QE and beginning of rate tightening in the Eurozone. The marked loosening of US fiscal policy could also rekindle fears about the twin American deficits, adding to the downward pressure on the dollar.

Thus, while there may well be periods of dollar strength during 2018, we think that the euro is on a long-term uptrend against the US currency, with $1.30 the next big target for the EUR/USD rate. This could be hit later this year as the ECB ceases net asset purchases and prepares the ground for rate hikes in 2019.







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Forex Market Outlook

Brexit is the key influence on sterling

Sterling fell sharply in the aftermath of the UK referendum vote for Brexit in mid-2016. The currency hit 30-year lows against the dollar, falling from $1.50 before the vote to as low as $1.20 in late 2016. Brexit concerns also saw sterling lose significant ground against the euro, with EUR/GBP rising sharply from the 70p level near the end of 2015 to a high point at around 93p in August 2017.

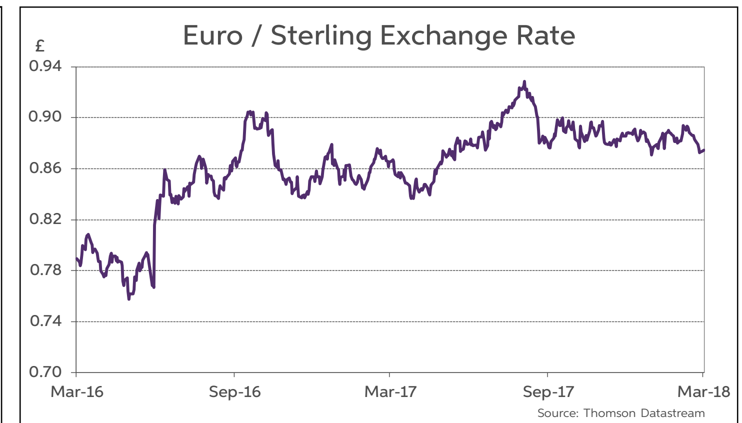
However, sterling has managed to move off its lows and regain some ground since last summer. Indeed, it has recovered a lot of its losses against the weakening dollar, moving back over the $1.30 level during last summer and rising above the $1.40 level in Q1 2018. The UK currency also recovered some ground against the euro last autumn, helped by an unexpected rate hike from the Bank of England, some better UK economic data and hopes that agreement can be reached on a soft Brexit when the UK departs from the EU in March 2019. This has seen EUR/GBP move down to trade in a narrow 87-90p range since last September.

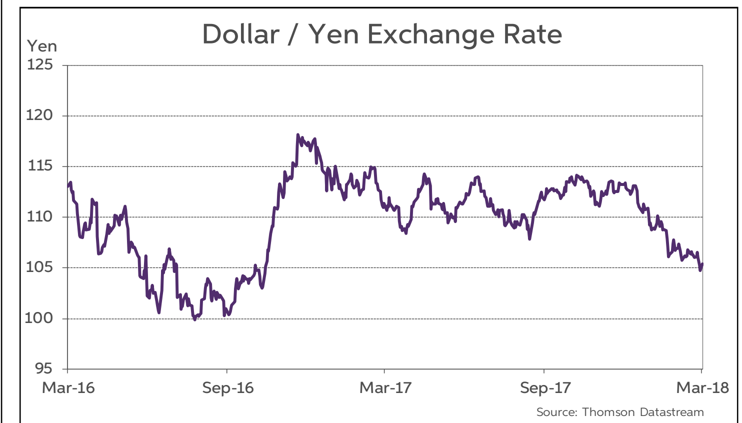
The progress of the Brexit negotiations is likely to be the key factor influencing sterling in the period ahead. There are real hopes that the outcome of the talks will be a soft Brexit, now that a transition period has been agreed. This paves the way for continuing free trade between the UK and EU in the period from when the UK leaves the EU in March 2019 up to the end of 2020. It is hoped that a full EU-UK trade deal can then be negotiated in 2019-2020 that will come into effect when the transition period expires at the end of 2020.

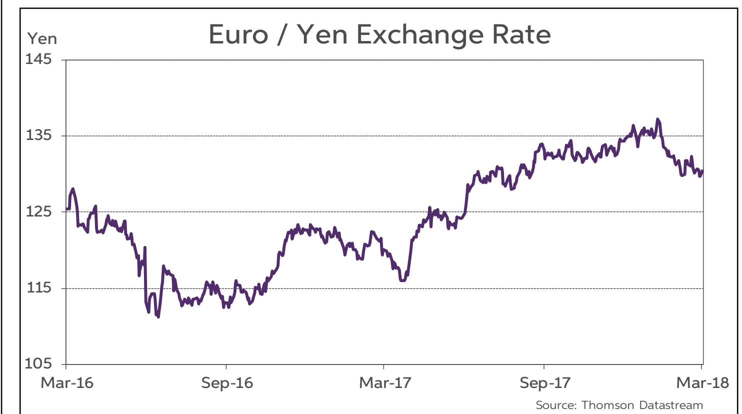
However, there is still much work to be done over the rest of this year. The EU and UK need to finalise a withdrawal agreement before the end of 2018 that will contain the outlines of a EU-UK trade deal as well as provide the formal basis for a post-Brexit transition period. Given the uncertain political backdrop in the UK and its desire to regain full sovereignty, there is still a risk of a hard Brexit, where the UK and EU are unable to reach agreement on a withdrawal deal. This would mean that there would not be a transition period, with the UK losing its free access to the Single Market and having to fall back on WTO rules when it leaves the EU in March 2019. A major stumbling block that still has to be overcome is that the UK has yet to clearly set out how it can reconcile its intention to leave the EU Customs Union and Single Market with its desire to continue to enjoy largely frictionless free trade with the EU and avoid having a hard border in Ireland.

Overall, sterling seems likely to continue to trade in the 87-90p range against the euro that it has occupied since September, until markets get clearer signals on the outcome of the Brexit talks. We may not get any further significant developments in the Brexit negotiations until after the summer. If it becomes increasingly evident that a soft Brexit in March 2019 is on the cards, then sterling could make some gains, with the euro moving down to 85p and cable rising to $1.50.

On the other hand, if the talks on a withdrawal agreement run into real difficulties later this year and a hard Brexit becomes increasingly likely, then the euro can be expected to move up towards the 95p level. Indeed, it could rise even higher to trade in a 95p-100p range as a hard Brexit approached in March 2019, with cable falling back towards $1.30. Overall though, we feel that the EU and UK will be able sign off on a withdrawal agreement later this year and thus a soft Brexit is the most likely outcome of the exit negotiations. Our base case, then, is for sterling to have strengthened by the end of the year, aided also by higher UK interest rates.







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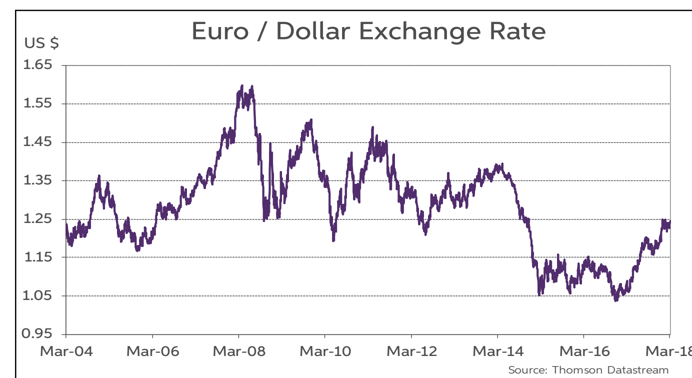
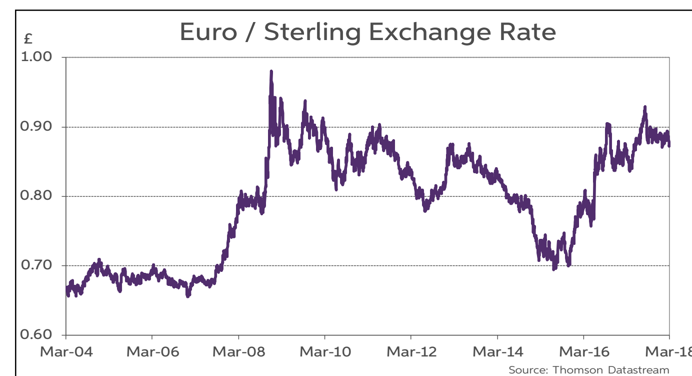
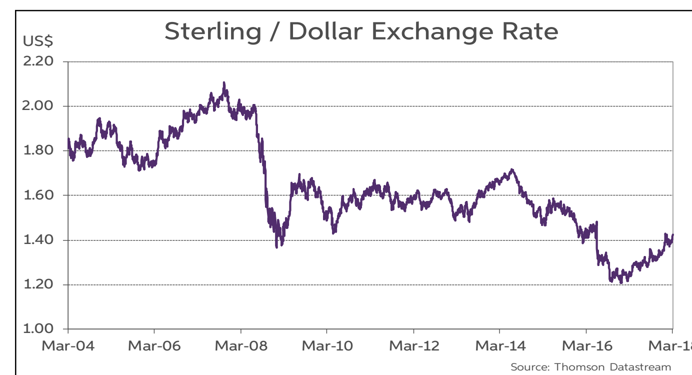
Summary of Exchange Rate Forecasts

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

	Current	Q2-2018	Q3-2018	Q4-2018	Q1-2019
Euro Versus					
USD	1.242	1.22-1.28	1.23-1.29	1.25-1.31	1.27-1.33
GBP	0.878	0.85-0.91	0.84-0.90	0.83-0.89	0.82-0.88
JPY	131.18	129-135	129-135	129-135	130-136
CHF	1.18	1.18	1.17	1.18	1.17
US Dollar Versus					
JPY	105.66	103-109	102-108	100-106	99-105
GBP	1.413	1.39-1.45	1.42-1.48	1.46-1.51	1.50-1.56
CAD	1.29	1.28	1.26	1.24	1.22
AUD	0.77	0.77	0.78	0.79	0.80
NZD	0.73	0.73	0.74	0.75	0.76
CNY	6.28	6.25	6.20	6.15	6.10
Sterling Versus					
JPY	149	151	152	153	136
CAD	1.82	1.82	1.82	1.85	1.59
AUD	1.83	1.84	1.86	1.88	1.68
NZD	1.94	1.95	1.96	1.98	2.14







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