Forex and Interest Rate Outlook

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AIB Treasury Economic Research Unit

- The upcoming UK referendum on EU membership is the next big event risk for financial markets which seem to be expecting a vote to remain despite closeness of opinion polls

- A vote to leave would be a shock that could be expected to trigger major dislocation in markets and a further sharp drop in sterling

- Very low global bond yields need continuation of very loose monetary policies

- Markets vulnerable if Fed returns to rate tightening path in H2 2016. This could well occur if US economy regains momentum and inflationary pressures build further

- Concerns remain about the weakening of activity in emerging economies and build up of debt in many of these countries

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Global Economic Outlook

Global growth remains subpar

Global growth remains very much subpar. The IMF put it well in saying that seven years after the world economy emerged from its broadest and deepest post-war recession, "the holy grail of a robust and synchronised global expansion remains elusive". World growth is put at just over 3% for 2015, the weakest rate since the end of the economic crisis of 2008-2009. Both the IMF and OECD are forecasting a similar rate in 2016.

Activity in advanced economies has gained some momentum in recent years, 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.

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. Indeed, activity in emerging economies has been weakening 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.

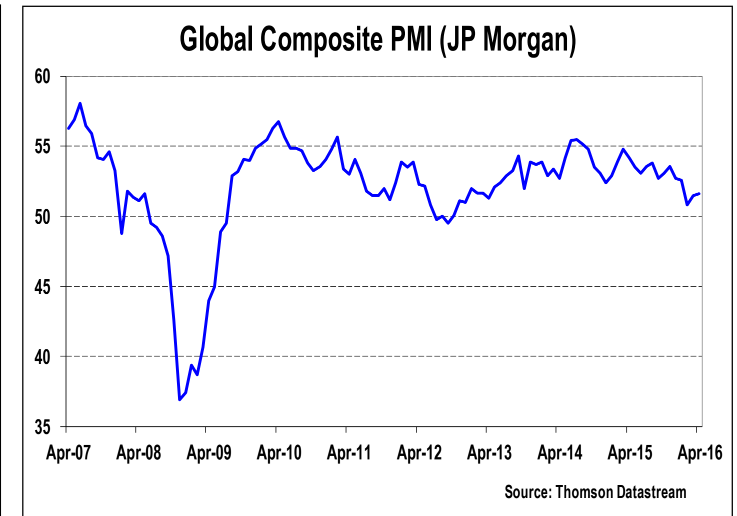
Many commentators suspect that the slowdown in China is even more pronounced and the actual growth rate may have decelerated to around 4%. It has also been observed that the impact of the slowdown in China on other emerging economies, via falling commodity prices and lower imports, appears to have been greater than previously envisaged, with some countries like Brazil and Russia going into recession.

There are concerns that the weakening of activity in emerging economies, especially China, will 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. The IMF and OECD expect that advanced economies will continue to register moderate growth of circa 2% in 2016 and 2017.

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, especially emerging economies. The Global Composite PMI has dropped to below 52 in the past few months, its lowest level in over three years. In particular, the sharp falls in 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. The IMF expects growth in these economies to remain subdued at around 4% in 2016, before picking up to 4.6% in 2017.

Financial markets have been more stable in recent months, with some recovery in commodity prices, which is encouraging. There have also been some signs of a stabilisation in the pace of growth in China recently. The EU economy grew by a solid 0.5% in Q1, while activity looks to be picking up in the US again after a slowdown in the last two quarters. Overall, it looks as if growth advanced economies is being sustained at around 2%. The main near-term risk would now appear to be if the UK votes to leave the EU in next month's referendum, which would represent a shock for both financial markets and the global economy.



GDP (Vol % Change)

	2014	2015	2016 (f)	2017 (f)
World	3.3	3.1	3.2	3.5
Advanced Economies	1.9	1.9	1.9	2.0
US	2.4	2.4	2.4	2.5
Eurozone	0.9	1.6	1.5	1.6
UK	3.0	2.2	1.9	2.2
Japan	-0.1	0.5	0.5	-0.1
Developing Economies	4.7	4.0	4.1	4.6
China	7.3	6.9	6.5	6.2
India	7.3	7.3	7.5	7.5
World Trade Growth (%)	3.4	2.0	3.6	4.8
Advanced Economies Inflation (%)	1.5	0.8	1.5	1.9

Source: IMF World Economic Outlook, April 2016

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Interest Rate Outlook

A vote by UK to remain in EU could bring rate hikes back on to the agenda

The past couple of years has 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. Many central banks took advantage of the sharp fall in inflation caused by the collapse in oil and other commodity prices to move to an even more accommodative monetary policy stance in 2015.

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. Meanwhile, the ECB eased policy further at its March meeting as it continued with its efforts to boost inflation and growth. It lowered the deposit rate by a further 10bps to −0.4%, moving it even deeper into negative territory, while also cutting the refi rate by 5bps to 0%. It also increased the size of its asset purchase programme. The Bank of China has also eased policy further this year, while this month also saw a surprise rate cut by the Reserve Bank of Australia.

The ECB retains an easing bias and has indicated that it would ease policy again if required. However, the scope to lower rates much further appears limited. While Eurozone rates may be near a trough, markets expect them to remain very low for a long period of time. Futures markets suggest that three month money rates will remain negative in the Eurozone until the end of the decade, and we may not get a hike in the key ECB refi rate until 2021 or 2022.

Meanwhile, central banks that were contemplating monetary tightening have either delayed the move, or remained on hold altogether. Indeed, while there has been further policy easing by some central banks this year, the biggest change in market rates has been in countries where central banks were expected to hike rates. These rate hikes have now been priced out, resulting in big downward shifts in futures curves in these markets.

The BoE has 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%. It has revised down its forecast path for inflation and growth, with the upcoming referendum on EU membership adding to uncertainty and starting to weigh on activity. Hence, markets have greatly pushed back their expected timing for UK rate hikes. They had thought that rates could rise during 2016, but now do not see a rate increase materialising until late 2018. We still think UK rates will rise well before this, assuming the country votes to remain in the EU in next month's referendum.

Meantime, the US Federal Reserve did raise rates by 25bps to 0.375% at its December meeting, the first such rate hike in nearly a decade. The Fed's December projections indicated that it expected to raise rates by some 25bps per quarter over the following three years, taking the Fed funds rate up to 1.375% by the end of 2016 and 3.25% by end 2018. However, the Fed has grown increasingly cautious in recent months and has scaled back its rate hike projections, although it still expects to raise rates at some stage this year.

Markets, though, are quite sceptical about this and don't expect the next US rate hike to materialise until spring 2017. They do not see official rates rising to 1% until H2 2018. In our view though, if the UK votes to remain in the EU in next month's referendum, it could clear the path for US rate hikes in the second half of the year. The recent uptrend in core US inflation, continuing strength of its labour market, pick-up in wage growth and signs that US economic activity may be strengthening again, all point to a risk of Fed rate hikes later this year.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.375	0.63	1.24	0.91	1.20
June '16	0.375	0.65	1.30	1.00	1.30
Sept '16	0.625	0.90	1.55	1.30	1.60
Dec '16	0.875	1.15	1.75	1.60	1.90

** 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	-0.28	-0.03	-0.15	0.01
June '16	-0.40	-0.27	-0.02	-0.15	0.00
Sept '16	-0.40	-0.26	-0.01	-0.10	0.10
Dec '16	-0.40	-0.25	0.00	-0.05	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	0.50	0.59	0.99	0.78	1.01
June '16	0.50	0.60	1.00	0.80	1.05
Sept '16	0.50	0.60	1.05	0.90	1.20
Dec '16	0.50	0.65	1.15	1.00	1.35

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

FX markets on hold ahead of UK referendum vote

Despite a considerable amount of volatility on financial markets and diverging trends in US and Eurozone monetary policies, the key EUR/USD rate has remained quite range bound over the past year, largely trading in a $1.06-1.15 corridor. This period of stability followed the big exchange rate moves in the second half of 2014 and opening couple of months of 2015 that saw the euro fall sharply, declining from $1.40 to a low of $1.05.

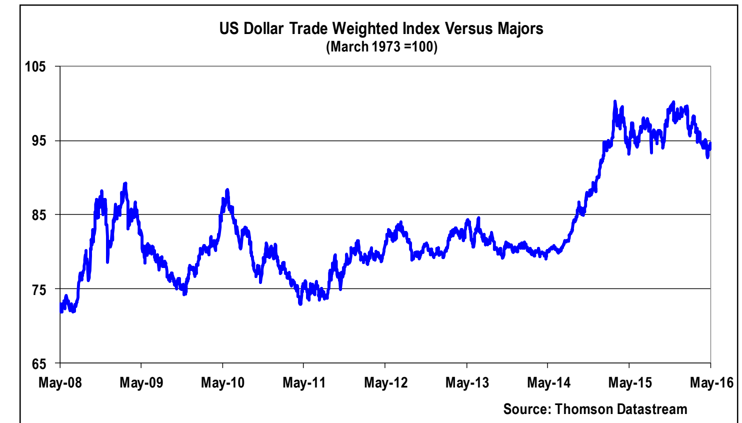
The euro has generally had the upper hand this year, though, climbing from $1.08 to as high as $1.16 at one stage, despite the further loosening of policy by the ECB. The yen has also made big gains against the dollar, which fell from ¥120 at the end of January to below ¥106 in early May, even though the Bank of Japan moved to a negative interest rate policy earlier this year. The cuts in ECB and BoJ rates, though, have been quite small. The big change year-to-date has been in relation to the future path of US rates. Markets have greatly scaled back their expectations for US rate hikes and now do not expect the Fed to raise rates again until spring 2017, with just very moderate increases in interest rates thereafter. This change has weighed on the dollar.

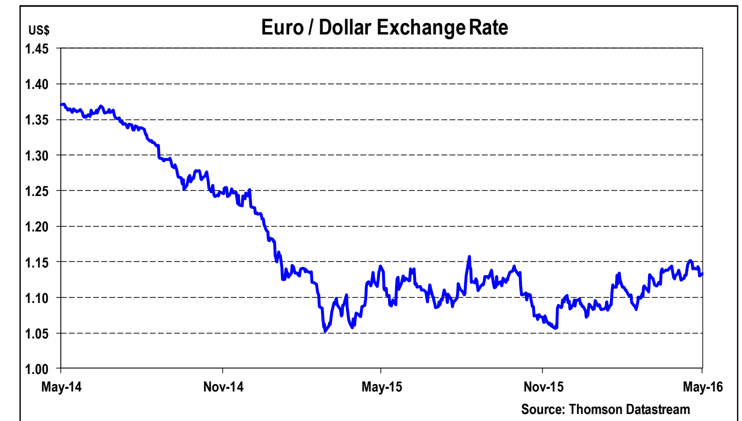
Very subdued inflation, the downside risks to global growth, fragile sentiment on financial markets and the uncertainty about the upcoming referendum in the UK on EU membership have made it difficult for central banks like the Fed and indeed, the Bank of England, to tighten monetary policy despite the strength of their own economies. The big scaling back of US rate hike expectations has taken the shine off the dollar, causing it to decline by around 5% on a trade-weighted basis over the spring.

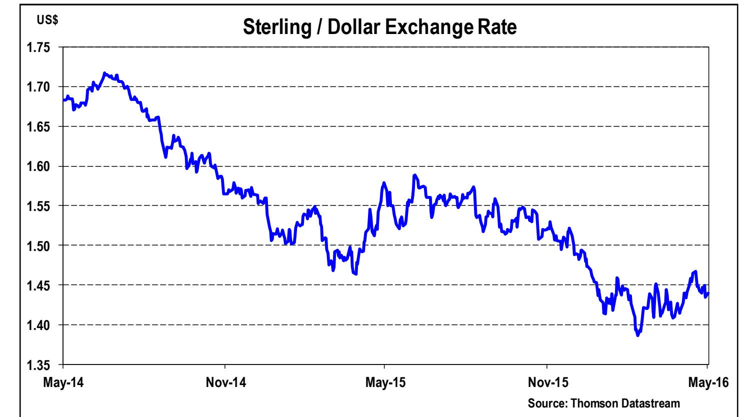
The last couple of weeks though have seen the currency markets settle down and trade in very narrow ranges, which they could well stick to in the run up to the UK's referendum on June 23rd. The EUR/USD rate is currently trading around the $1.13-1.14 level, while the dollar/yen rate is in a narrow ¥108-110 channel. Short-term interest rates look set to remain quite negative in the Eurozone over the next couple of years, with the ECB also retaining an easing bias. Thus, it is hard to see the euro making further significant gains against the dollar that would take it above the $1.15-1.16 level, unless there is a major shock in financial markets that causes a flight into the euro or the Fed to consider easing policy.

Much uncertainty still surrounds the actual timing of Fed tightening. The market is not pricing in another rate increase until spring 2017, but the most recent projections of the FOMC members in March point to a number of rate hikes before then. The Fed may be cautious but it still has a tightening bias. The US economy appears to be regaining momentum, while inflation looks to now be on the rise in the US. In our view, if the UK votes to remain in the EU, thereby removing one of the downside risks to global growth, then the Fed could well hike rates in the second of the year. We would not be surprised to see two rate hikes before year end.

As we have seen in recent months, rate hike expectations remain a key driver of FX rates. The dollar is likely to strengthen again if US rate hikes come back on to the agenda in H2 2016, as happened in October and November of last year, ahead of the Fed's rate hike in December. However, given that rate hikes in the US are likely to be modest enough, the currency will probably find it difficult to make substantial gains. Thus, we would expect the euro to move down towards last year's low of $1.05. The dollar should also recover some of the ground lost recently against the yen, rising to around the ¥115 level by end year.







Forex Market Outlook

UK referendum will have big bearing on sterling's fortunes.

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, have unwound over the past few months. The euro has risen by more than 10% against sterling since the start of December, climbing from 70p to around the 78p level. Meanwhile, GBP/USD has fallen from a high of $1.59 last summer, to a $1.40-1.46 trading range year-to-date. The BoE estimates that about half of the 9% fall in sterling's trade-weighted value in the past six months is due to concerns about a possible vote to leave the EU in the upcoming referendum.

The UK Government has set June 23rd as the date for its 'In-Out' referendum vote on Britain's continued membership of the EU. Opinion polls are pointing to a very close outcome. The issue has now moved centre stage in the UK. It is now a 50/50 call judging by the polls, whether the UK votes to leave or remain in the EU.

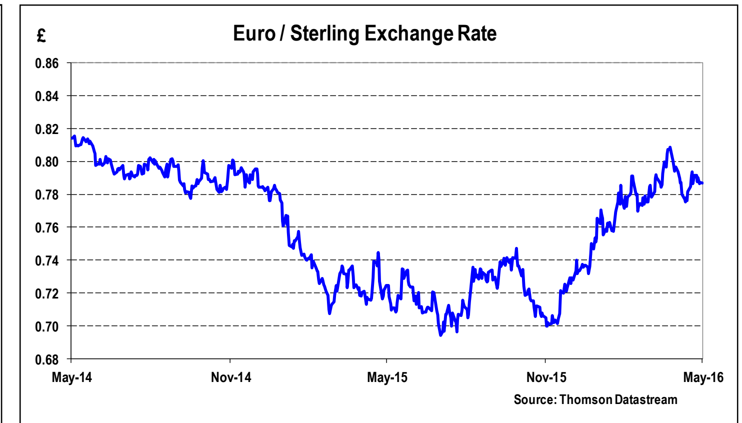
Should the UK vote to remain in the EU, we would expect sterling to recover some of the ground lost recently, rising back up to 74-75p versus the euro, with GBP/USD climbing towards the $1.50 level. We don't see sterling moving back up to last year's highs of 70p versus the euro and $1.59 against the dollar, as markets are no longer expecting the Bank of England to raise rates anytime soon.

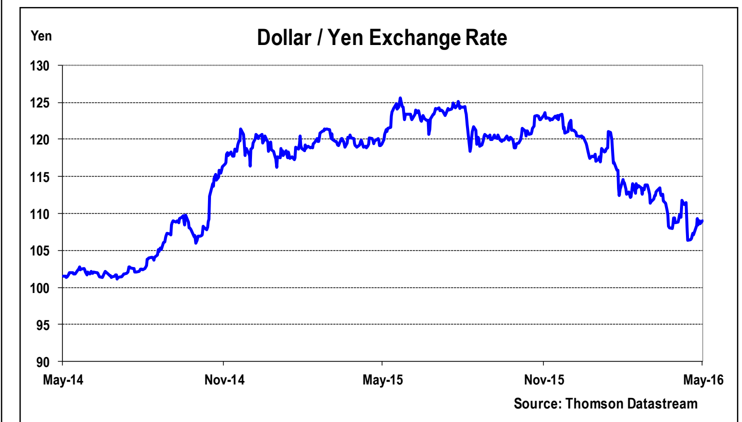
On the other hand, sterling can be expected to see further sharp losses in the event of a vote to leave the EU. At a minimum, the euro would seem likely to rise to its 2013 level of 85-86p. However, it could well climb to its 2011 high of 90p on a disorderly exit, where relations turn sour with the EU and there are a lot of difficulties in reaching some form of a trade deal. GBP/USD can be expected to breach its 30 year lows of $1.37-1.38 on a vote to leave, falling to around $1.25, and possibly going even lower on a disorderly exit. The euro is also likely to lose ground, though, as a vote to leave would be seen as a major blow to the EU. EUR/USD could fall to last year's low of $1.05 from around $1.13 currently.

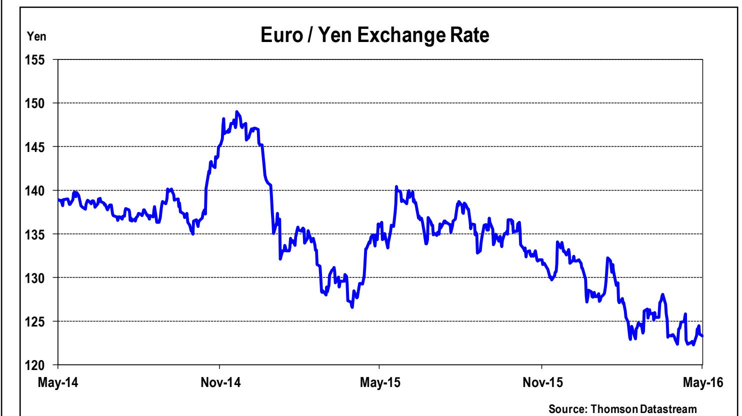
Thus, the upcoming UK referendum will be a key driver of FX markets this summer. Below is a summary table of forex forecasts based on various outcomes to the referendum. Our main FX forecast table on the back page is based on the view that the UK will vote to remain in the EU.

Forex Forecasts for Various Brexit Outcomes

OUTCOME	EUR/GBP	EUR/USD	GBP/USD
REMAIN	0.75	1.11	1.48
ORDERLY BREXIT	0.86	1.07	1.25
DISORDERLY BREXIT	0.90	1.05	1.17



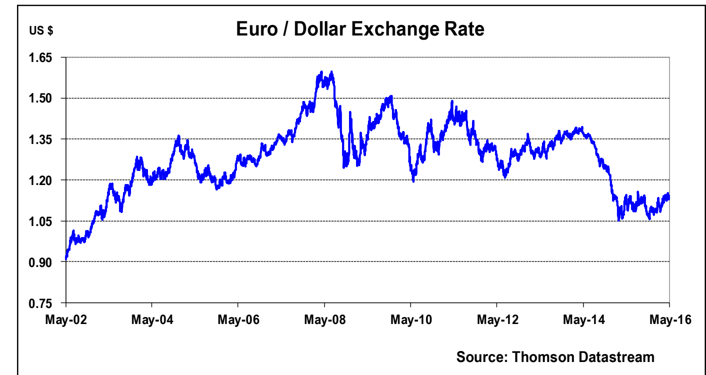


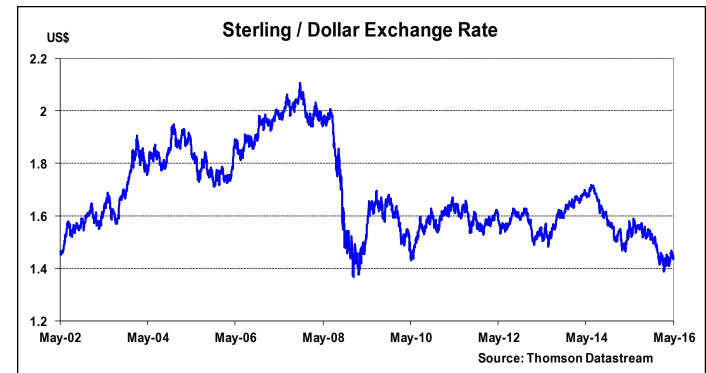


Summary of Exchange Rate Forecasts

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

	Current	Q2-2016	Q3-2016	Q4-2016	Q1-2017
Euro Versus					
USD	1.142	1.10-1.16	1.08-1.14	1.06-1.12	1.04-1.10
GBP	0.799	0.74-0.78	0.73-0.77	0.72-0.76	0.71-0.75
JPY	123.73	121-127	121-127	121-127	121-127
CHF	1.09	1.09	1.09	1.09	1.09
US Dollar Versus					
JPY	108.31	107-113	109-115	111-117	113-119
GBP	1.430	1.46-1.52	1.45-1.51	1.44-1.50	1.44-1.50
CAD	1.29	1.28	1.27	1.26	1.25
AUD	0.77	0.76	0.75	0.74	0.73
NZD	0.69	0.68	0.67	0.66	0.65
CNY	6.46	6.47	6.50	6.53	6.55
Sterling Versus					
JPY	155	164	166	168	171
CAD	1.84	1.90	1.88	1.86	1.83
AUD	1.87	1.96	1.97	1.99	2.01
NZD	2.08	2.19	2.21	2.23	2.26





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