Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

11th May 2017

- Optimism on global growth prospects, although GDP growth slowed in the US and UK in Q1
- Fed set for further rate hikes in 2017 and 2018 and may begin to unwind QE later this year. No changes to ECB, BoE and BoJ policy over rest of 2017, but ECB likely to wind down QE in H1 2018
- Euro gains ground as political concerns ease and economy gains momentum
- Sterling recovers ground. UK election outcome could trigger some more gains by sterling, but difficult Brexit negotiations still pose downside risks for the currency further out
- Dollar loses ground in 2017. Need to see further Fed rate hikes and progress on Trump's fiscal easing plans to reignite the currency's rally

Oliver Mangan
Chief Economist

John Fahey
Senior Economist

Dara Turnbull
Economist

www.aibeconomics.com

Global Economic Outlook

Global economic activity gaining some momentum

The IMF, in its recently published World Economic Outlook, notes that global economic activity is picking up, helped by some improvement at last in investment, manufacturing and trade. It points out that activity gained momentum in the second half of 2016, especially in advanced economies, with stronger growth performances in the US, Eurozone, UK and Japan. It expects growth in the world economy to rise from 3.1% in 2016 to 3.5% in 2017 and 3.6% in 2018.

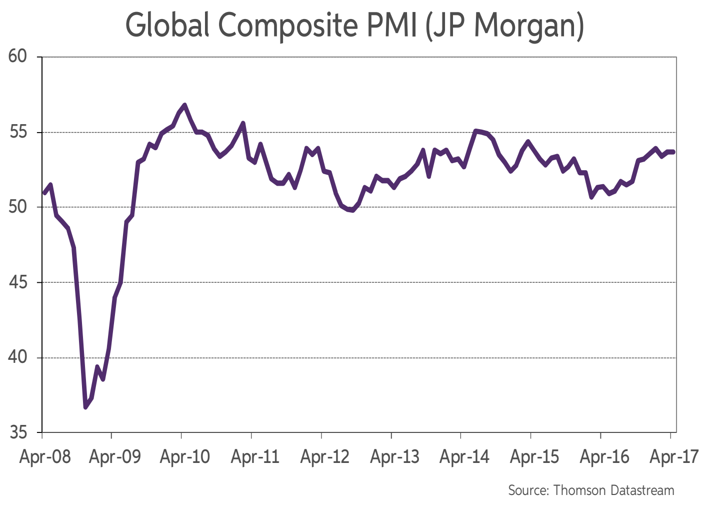
It sees advanced economies growing by 2% this year and next, up from 1.7% in 2016, helped by continuing very loose monetary policies and a more supportive stance to fiscal policy. There was a slowdown in US GDP growth in the first quarter of this year, but this is expected to prove temporary. The IMF believes that US growth will pick up to 2.5% by 2018. However, it sees somewhat slower growth in the UK ahead of Brexit in 2019.

Meanwhile, growth in emerging economies has lost considerable momentum during this decade, slowing from 7.5% in 2010 to just above 4% by 2015/16. However, growth in developing economies is forecast to strengthen to 4.5% in 2017 and 4.8% in 2018, helped by the moderate recovery in commodity prices and the emergence of oil-producing countries like Brazil, Russia and Nigeria from deep recessions.

Survey data point to a strengthening of activity in most economies this year. Notably, the Global Composite Output PMI averaged 53.7 in the first four months of 2017, close to two year highs. In the Eurozone, the Composite PMI hit 56.7 in April, its best level in six years. Other leading activity indicators in the Eurozone, including the EC economic sentiment index, have also hit multi-year highs. 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.

The IMF warns, though, that downside risks persist for the world economy, especially over the medium term. 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, higher 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. Structural problems, including low productivity and poor income growth, are likely to persist and inhibit economies. Inward-looking policies, including a growing risk of protectionism, could yet prove a real threat to global trade and the world economy. In addition, the risk of worsening geopolitical tensions remains an on-going concern.

In summary, then, the recovery in the world economy is picking up pace again, having lost momentum in 2015 and the first half of 2016 after a slowdown in growth in both emerging and advanced economies. 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. Financial markets are buoyant and there has been a marked improvement in business and consumer sentiment. Thus, the world economy is expected to grow by around 3.5% in 2017 and 2018. However, the main factors which have held back growth in this decade, namely weak wage growth, weak credit growth, weak investment activity, weak productivity growth and sluggish global trade have yet to be overcome. Thus, as the IMF warns, the balance of risks remain tilted to the downside for the world economy.



GDP (Vol % Change)

	2015	2016	2017 (f)	2018 (f)
World	3.2	3.1	3.5	3.6
Advanced Economies	2.1	1.7	2.0	2.0
US	2.6	1.6	2.3	2.5
Eurozone	2.0	1.7	1.7	1.6
UK	2.2	1.8	2.0	1.5
Japan	1.2	1.0	1.2	0.6
Emerging Economies	4.2	4.1	4.5	4.8
China	6.9	6.7	6.6	6.2
India	7.6	6.8	7.2	7.7
World Trade Growth (%)	2.7	2.2	3.8	3.9
Advanced Economies Inflation (%)	0.3	0.8	2.0	1.9

Source: IMF World Economic Outlook, April 2017

Interest Rate Outlook

Fed reaffirms that it will remain on tightening path

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. The market is pricing in a 25bps rate hike by early 2019. However, we think that the UK economy will slow over the next two years in the run-up to Brexit, while the rise in inflation could also prove transitory given that wage inflation is quite subdued. Thus, we think monetary policy will remain on hold in the UK for the foreseeable future.

Meantime, the ECB has indicated that it will continue with its QE programme until at least the end of 2017, although the size of the monthly asset purchases was reduced from €80bn to €60bn in April. Furthermore, its deposit rate looks to have reached a trough at –0.4%. The ECB has stated, though, that a very substantial degree of monetary accommodation will be required for some time as underlying inflation remains weak. Nonetheless, there will be considerable interest in the June ECB meeting. We could well see the ECB start to row back on its easing bias by indicating that the risks to economic growth are now balanced. It may also drop the reference to its willingness to ease policy further if required.

The ECB seems likely to wind down its QE programme during the first half of 2018, although it has said that it expects to keep interest rates at their current very low levels for an extended period of time after that. Nonetheless, futures contracts see wholesale rates starting to move higher next year, with three month money rates turning positive by mid-2019. Given the guidance from the ECB, though, it could be 2019 before it starts to raise rates. However, Eurozone rates 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 end 2022.

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 with another hike in March, taking rates up to 0.875%.

The FOMC interest rate projections show that it expects to raise rates to 3% by end 2019, although markets see rates rising to just below 2% by then. Furthermore, Fed officials have begun mulling the possibility of starting to unwind its asset purchase programme, or QE, thereby reducing the size of the Fed's balance sheet. They could well start this process near year end. Should the US economy regain momentum as expected after its slowdown in Q1, and the labour market continue to firm, then the Fed seems likely to deliver two more rate hikes in June and September, taking rates to 1.375%. Markets are likely to have to re-evaluate their outlook on US rates in these circumstances and also take on board the likely impact of the Fed reducing the size of its balance sheet. Markets then, may be under-estimating the extent of monetary tightening that could be in store for the US .

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.875	1.18	1.79	1.59	1.98
June '17	1.125	1.35	1.95	1.75	2.15
Sept '17	1.375	1.55	2.10	1.90	2.30
Dec '17	1.375	1.60	2.20	2.00	2.40

** 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	-0.37	-0.14	-0.13	0.24
June '17	-0.40	-0.34	-0.11	-0.10	0.30
Sept '17	-0.40	-0.32	-0.08	-0.07	0.35
Dec '17	-0.40	-0.30	-0.05	-0.05	0.40

** 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	0.31	0.67	0.57	0.86
June '17	0.25	0.31	0.68	0.62	0.92
Sept '17	0.25	0.30	0.69	0.64	0.95
Dec '17	0.25	0.30	0.70	0.65	1.00

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Euro-dollar exchange rate still very much range bound

A notable feature of currency markets for more than two years now 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 greater Fed tightening. This saw the dollar hit 14-year highs on a trade-weighted basis at end 2016. The euro also dropped to 14 year-lows against the dollar below $1.04.

The euro, though, has gained ground against the dollar since the start of this year, rising to as high as $1.10, despite another rate hike from the Fed in March and expectations of a further move in June. A more significant change, though, has been in regard to expectations around ECB policy, with markets now anticipating that the ECB may begin moving rates higher next year. Growth has picked up in the Eurozone, with the jobless rate moving steadily lower. Markets now expect three month money rates in the Eurozone to turn positive by mid-2019, compared to mid-2021 last autumn. They also expect the ECB to end its QE programme next year.

Abating political risks in Euroland have also helped the euro, as far-right and eurosceptic political parties have not done that well in recent elections in Europe. Macron's victory in the French Presidential elections was the latest development to boost the euro. Meanwhile in the US, markets are growing doubtful about whether President Trump will be able to implement his planned expansionary fiscal agenda. It has all left the euro-dollar exchange rate right back in the heart of the $1.04-1.15 trading range that it has occupied for more than the two years now, with no clear signs yet, when and in what direction the currency pair will break out of this band.

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 also 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 reignited. We certainly think that this is still possible, but it might take some time.

President Trump has also talked about introducing a once-off, low 10% corporate tax rate to entice back to the US the large quantity of funds that US companies currently hold abroad to avoid paying high US taxes. Action on this front would also be dollar positive as some of these funds would most likely have to be converted into dollars, if US corporates wished to repatriate them. Overall then, we believe that the US currency has upside potential, especially with rates set to remain very low nearly everywhere, except for the US.

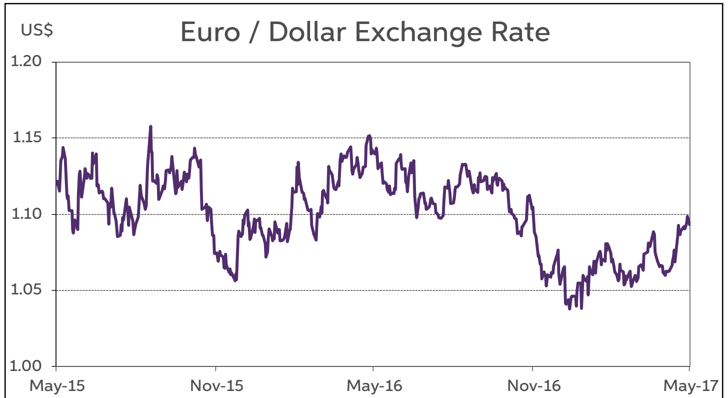
Thus, we could see the euro drop back towards the $1.05 level by year end if policy continues to be tightened in the US. Meanwhile, the dollar has risen from ¥108 to ¥114 against a weakening yen in the past few weeks. It could rise to a ¥118-120 range later this year, especially if risk appetite remains strong in markets.

US Dollar Trade Weighted Index Versus Majors

(March 1973 =100)

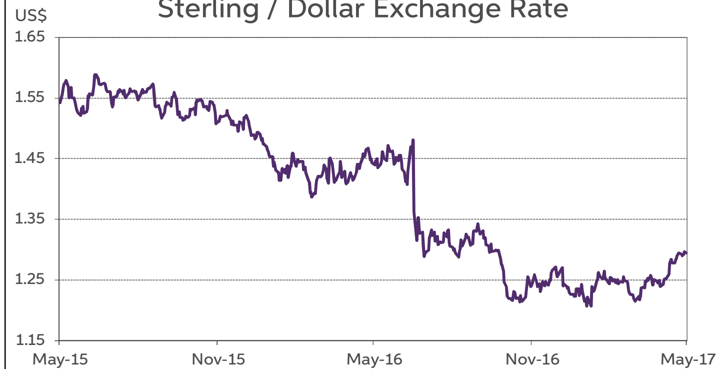
Source: Thomson Datastream

Euro / Dollar Exchange Rate



Source: Thomson Datastream

Sterling / Dollar Exchange Rate



Source: Thomson Datastream

Forex Market Outlook

Sterling recovers ground and could rise further on UK election outcome

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 as low as $1.20. 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.

Sterling did find a trough in the late autumn and has managed to regain some ground against both the euro and dollar this year. The euro has dropped back below 84p, while cable has risen close to $1.30. The UK economy has held up better than expected since the referendum vote. Growth forecasts for the UK for 2017/18 have been revised upwards, not withstanding the slowdown in GDP seen in Q1. 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 next move in UK rates will be upwards, quite a turnaround from late last summer when further easing was expected. Indeed, one MPC member has voted for an immediate rate hike at its last two meetings.

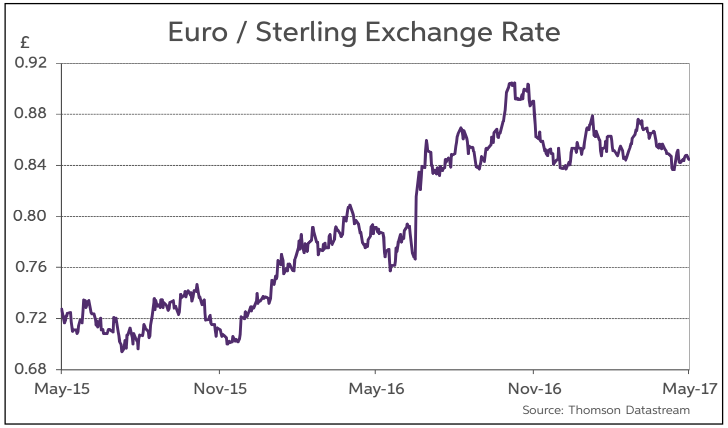
Meanwhile, the UK government triggered Article 50 on March 29th, thereby commencing the formal two year process for leaving the EU. The UK seems increasingly confident that it can secure a favourable exit deal with the EU. The Article 50 letter was quite conciliatory in tone, while various EU leaders have also expressed the hope that a deal can be agreed between the EU and the UK. The calling of an early general election in the UK is also seen as increasing the chances that a deal can be done. It is expected that the Conservative Party will secure a large majority in the election, making it easier for Prime Minister May to get an exit deal through Parliament.

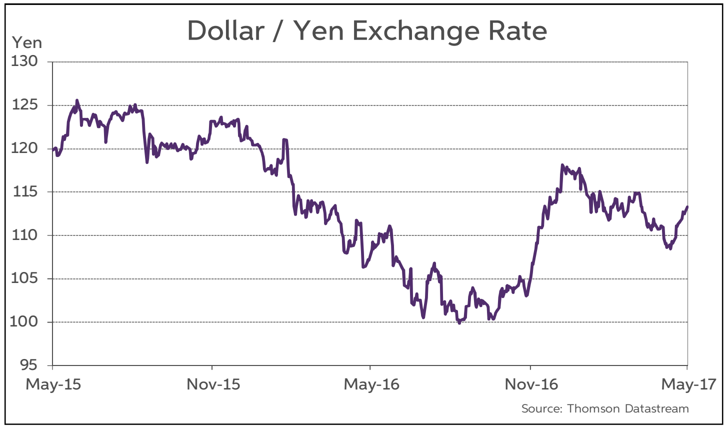
All this has helped create a more positive backdrop for sterling. A big election win for the Conservatives could see further gains by sterling, pushing cable up above $1.30, with the euro dropping below 83p, on growing optimism that a Brexit deal will eventually be done. The early Brexit talks are likely to be technical in nature, mainly dealing with budgetary issues and citizens' rights. Discussions on more substantive but difficult issues, such as trade and immigration, are unlikely to commence until later this year or in 2018.

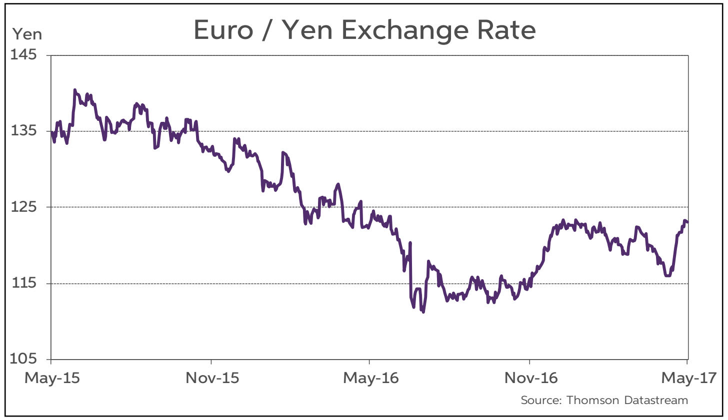
It is important to note that, further out, downside risks remain for the UK currency as the exit negotiations get more difficult, especially as they come to a head next year, when they get to trade and what transition arrangements might be put in place after the UK leaves the EU. The talks could be fraught by that stage 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. 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, faces a hard Brexit where it has to fall back on WTO rules. A hard Brexit could see the euro move back up to the 90p level, with cable falling below $1.20.

In the near term, though, sterling could benefit from an election bounce, with traders cutting back further on their short positions in the currency. The 83p level against the euro and $1.30 for cable are key resistance levels that need to be overcome for sterling to make further gains, but the election outcome could provide a trigger.







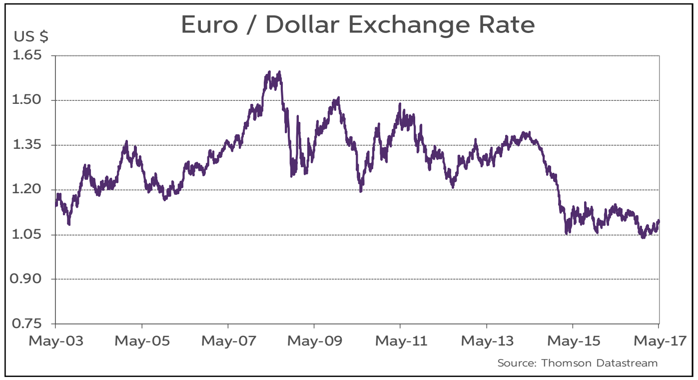
AIB Treasury Economic Research Unit

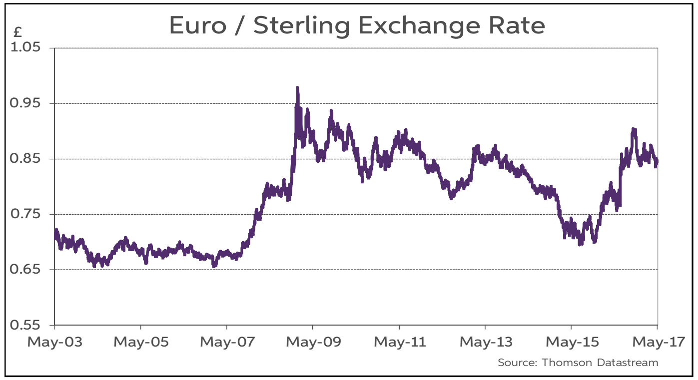
AIB

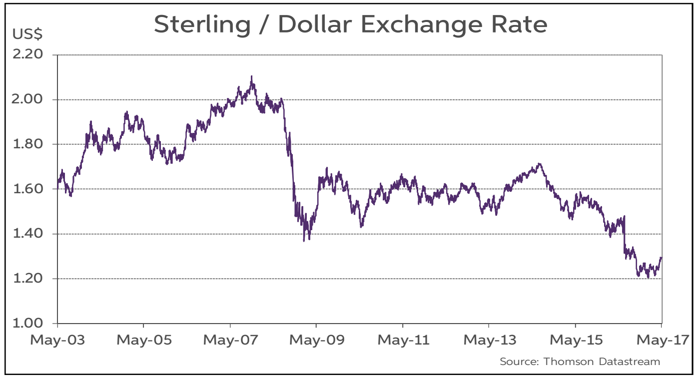
Summary of Exchange Rate Forecasts

("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	1.086	1.05-1.11	1.04-1.10	1.03-1.09	1.02-1.08
GBP	0.844	0.80-0.86	0.81-0.87	0.82-0.88	0.84-0.90
JPY	123.74	121-127	121-127	122-128	122-128
CHF	1.10	1.09	1.09	1.09	1.09
US Dollar Versus					
JPY	113.97	112-118	113-119	115-121	116-122
GBP	1.286	1.27-1.33	1.24-1.30	1.22-1.28	1.18-1.24
CAD	1.37	1.38	1.39	1.40	1.40
AUD	0.74	0.74	0.73	0.72	0.72
NZD	0.68	0.68	0.67	0.66	0.67
CNY	6.90	6.93	6.96	7.00	7.05
Sterling Versus					
JPY	147	150	147	148	144
CAD	1.77	1.80	1.77	1.75	1.69
AUD	1.75	1.76	1.74	1.74	1.68
NZD	1.88	1.91	1.90	1.89	1.81







AIB Treasury Economic Research Unit

AIB Bankcentre, Ballsbridge, Dublin 4 Tel: 353-1-6600311 www.aibeconomics.com