Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

22nd November 2017

- Global economic recovery gathering momentum, but inflation remains very subdued
- Central banks patient on policy tightening. Rates rise at a slow pace in US. ECB QE programme to run until at least Sept 2018. BoE now on hold after reversing 2016 rate cut
- Dollar slide has been halted as main FX pairs become range bound. Tax cuts, if agreed by Congress, and further Fed rate hikes point to upside potential for US currency in 2018
- Sterling more stable recently. Progress of Brexit talks to set direction for currency in 2018
- Euro rally runs out of steam, with ECB likely to keep rates negative until end 2019. Currency still at low level vs dollar, but upside in 2018 may be constrained by widening interest rate spreads

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Global Economic Outlook

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Global growth picks up pace, but inflation remains subdued

Global economic activity has been gaining strength for the past year or more, helped by an improvement in investment, manufacturing and world trade. Activity picked up pace in advanced economies in the second half of 2016, with stronger performances in the US, Eurozone, UK and Japan. This trend has continued in 2017, with particularly good growth in all the major economies in the second and third quarters of this year, apart from the UK. 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 recover from their early 2016 lows.

It would seem that the combination of continuing very loose monetary policies and a more supportive stance to fiscal policy is at last triggering stronger economic growth. Activity is also being aided by good employment growth and very low inflation, which is boosting real incomes and thus spending power. Credit growth is also starting to improve in many economies. There has also been a pick-up in world trade. In a further positive sign, oil prices have been on the rise since mid-year on the back of a pick-up in demand, as economic growth strengthens.

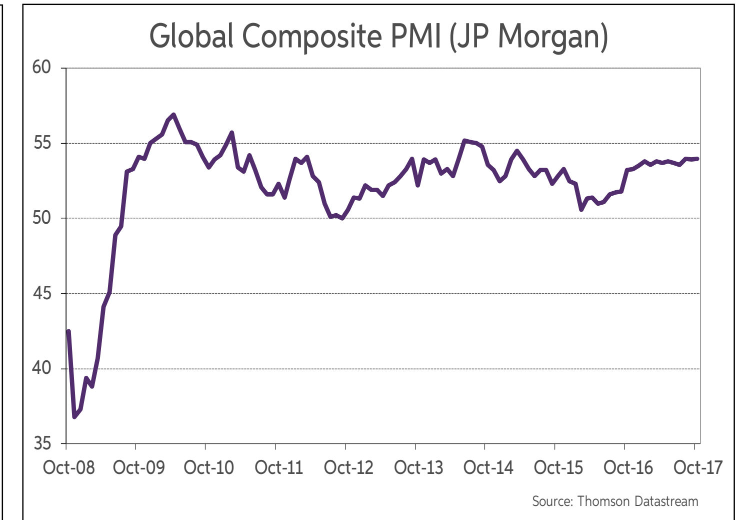
Central banks across the globe have been indicating that monetary policy can remain accommodative despite the stronger growth because of the persistence of very low inflation. This should help sustain the upturn in economic activity. The one exception to the generally improving picture is the UK. Activity has slowed there this year, as high inflation dampens consumer spending, with uncertainty over Brexit weighing on investment. Meanwhile, there is little sign yet that the traded sector is benefitting from sterling's sharp fall and improving global activity.

Data have generally come in ahead of expectations this year, most notably in the Eurozone and in emerging economies. Indeed, the Eurozone has become the fastest growing economic region in the developed world. There was another strong rise in Eurozone GDP of 0.6% in the third quarter, the fourth consecutive quarterly rise of 0.6% or slightly above. Hence, GDP growth in year-on-year terms rose to 2.5% in Q3, ahead of the US, UK and Japan which posted gains of 2.3%, 1.5% and 1.7%, respectively.

Meanwhile, the US posted back-to-back quarterly growth rates of 3% in Q2 and Q3 for the first time since 2014. In Japan, the economy has grown for seven consecutive quarters for the first time since 2001. These trends have seen the IMF revise up its growth forecasts for the world economy. It now expects global growth to accelerate from 3.2% in 2016, its lowest rate since 2009, to 3.6% in 2017 and 3.7% in 2018. It sees growth in advanced economies reaching 2.2% this year, up from 1.7% in 2016. Growth in emerging economies is expected to accelerate to 4.6% this year and 4.9% in 2018 from 4.3% in both 2015 and 2016.

The IMF says the risks to the global economy are balanced in the near term, but skewed to the downside over the medium term. These come largely from financial sector challenges, such as the expansion of credit in China and possible volatility in markets as central banks withdraw stimulus in an environment of compressed risk premiums.

Despite the pick-up in global growth, inflation in advanced economies remains subdued and below targets, while it is declining in some emerging economies. Headline inflation rates will be boosted somewhat by the recent rise in oil prices, but underlying inflationary pressures are expected to remain subdued. Sluggish wage growth is a key factor in keeping inflation at low levels. The IMF is forecasting that inflation will average 1.7% in advanced economies next year, unchanged from its expected level in 2017.



GDP (Vol % Change)

	2015	2016	2017 (f)	2018 (f)
World	3.4	3.2	3.6	3.7
Advanced Economies	2.1	1.7	2.2	2.0
US	2.6	1.5	2.2	2.3
Eurozone	2.0	1.8	2.1	1.9
UK	2.2	1.8	1.7	1.5
Japan	1.1	1.0	1.5	0.7
Emerging Economies	4.3	4.3	4.6	4.9
China	6.9	6.7	6.8	6.5
India	8.0	7.1	6.7	7.4
World Trade Growth (%)	2.6	2.4	4.2	4.0
Advanced Economies Inflation (%)	0.3	0.8	1.7	1.7

Source: IMF World Economic Outlook, October 2017

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Interest Rate Outlook

Central banks gradually reducing amount of monetary stimulus

The long period of monetary easing is coming to an end, apart from in Japan. The US Federal Reserve has embarked on a path towards policy normalisation, while rates were hiked in Canada and the Czech Republic over the summer. The UK raised rates earlier this month, while the ECB has announced that it will reduce the size of its monthly asset purchases from the start of next year.

Nonetheless, monetary policy will still remain very loose in all the major economies over the next couple of years. Continuing low inflation has led markets to believe that only limited policy tightening is likely in 2018/19, despite the strengthening of global economic activity. This has seen bond yields remain low in most markets, while many stock markets have risen to either multi-year highs, or have hit new historic peaks.

In the UK, inflation picked up following the sharp decline in sterling, with headline CPI inflation rising to 3% recently. The BoE had been indicating for some time that there were limits to the extent that above-target inflation could be tolerated. It followed through on this warning at the November MPC meeting, which voted 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. We do not expect a further change in UK rates anytime soon. Markets are looking for UK rates to be hiked again at the end of 2018, with another hike priced in by early 2020. They seem to be assuming that Brexit will have little enough impact on the UK economy, i.e. that there will be a soft Brexit in March 2019.

Meantime, the ECB, as expected, announced at its end October Council meeting that it will scale back asset purchases under its QE programme from the start of next year. Monthly purchases are being reduced from €60bn to €30bn, with the ECB indicating that it will maintain purchases at this lower level until at least September 2018. Indeed, it said it could increase the size of monthly purchases again if necessary.

The ECB repeated that it intends to keep interest rates at their current very low levels well past the time horizon of its QE programme. The ECB deposit rate stands at –0.4%. It is likely to be 2019 at the earliest before it is increased, given the guidance from the Central Bank on QE and rates. Futures contracts show little change in wholesale rates next year, before they start edging higher in 2019. Three month money rates are expected to remain negative until the very end of 2019. Eurozone rates are expected to remain very low for a long period of time after that, with futures contracts suggesting that three month rates will not reach 1% until mid-2023.

Meanwhile, the Fed hiked rates by 25bps at its December 2015 and December 2016 meetings, the first such rate hikes in nearly a decade. It followed this up with two further hikes in March and June of this year, taking rates to 1.125%. At its September meeting, the Fed announced that it was to start the process of slowly reducing the size of its balance sheet, or unwinding QE, by no longer reinvesting funds from some of its bonds as they matured.

The FOMC also largely reaffirmed its interest rate projections at the September meeting, although it now expects rates to rise to 2.75% by end 2019 compared to 3% previously. Markets, though, expect rates to rise to just under 2% by then, with the next rate hike priced in for December and then just two further hikes expected in 2018/19. If inflation remains subdued, the Fed may not tighten policy as much as it has indicated. The Fed funds rate could rise to just 2.375% by end 2019 in these circumstances. On the other hand, though, if significant tax cuts are implemented next year, this would greatly increase the likelihood of rates rising to 2.75%, or above, by end 2019.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.125	1.45	1.93	1.92	2.15
Dec '17	1.375	1.55	2.00	2.00	2.20
Mar '18	1.375	1.60	2.10	2.10	2.30
June '18	1.625	1.80	2.20	2.25	2.45

** 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	-0.38	-0.24	-0.19	0.22
Dec '17	-0.40	-0.37	-0.22	-0.17	0.20
Mar '18	-0.40	-0.36	-0.20	-0.15	0.25
June '18	-0.40	-0.35	-0.15	-0.10	0.35

** 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	0.77	0.84	1.09
Dec '17	0.50	0.55	0.80	0.85	1.10
Mar '18	0.50	0.57	0.82	0.90	1.15
June '18	0.50	0.60	0.85	0.95	1.25

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Key exchange rates turn quite range bound after big moves earlier in year

A key development in forex markets this year was that the euro broke out of its relatively narrow trading range of $1.04-1.16 against the US dollar that it had occupied since early 2015. In the first half of this year, the euro made impressive gains against the dollar, climbing from $1.04 to above the $1.14 level, despite further rate hikes by the Fed in March and June. The euro rally continued into the third quarter as it rose through the key $1.16 resistance level to climb to around $1.20 in late August, its highest level since January 2015.

The euro's rally, though, has run out of steam since then. Indeed, it has been essentially range bound against the dollar for the past four months, with trading confined to a narrow $1.16-1.20 corridor. The ECB is maintaining a very loose monetary stance because of continuing weak inflationary pressures. It has extended the QE asset purchase programme until at least September 2018, albeit at a reduced rate from the start of next year. The ECB also continues to indicate that interest rates will remain at their current, very low, negative levels well past the conclusion of net asset purchases under its QE programme. Thus, markets do not see any hike in Eurozone rates until 2019, with rates not expected to turn positive until 2020, despite the marked pick-up in the economy.

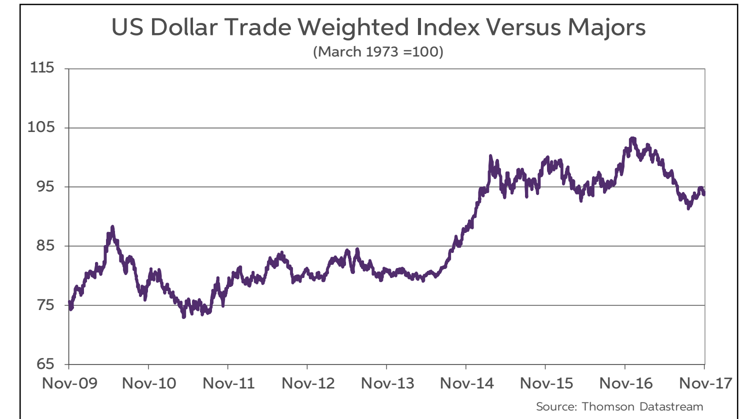
It is important to note that the dollar lost ground against a broad range of currencies earlier this year and not just the euro. Over the summer, the Aussie, NZ and Canadian dollars rose to their highest levels against the US currency in over two years. Even the Chinese yuan, which declined steadily against the dollar over the 2014-16 period, appreciated against the greenback this summer, while sterling rose as high as $1.35 from $1.22 in the spring.

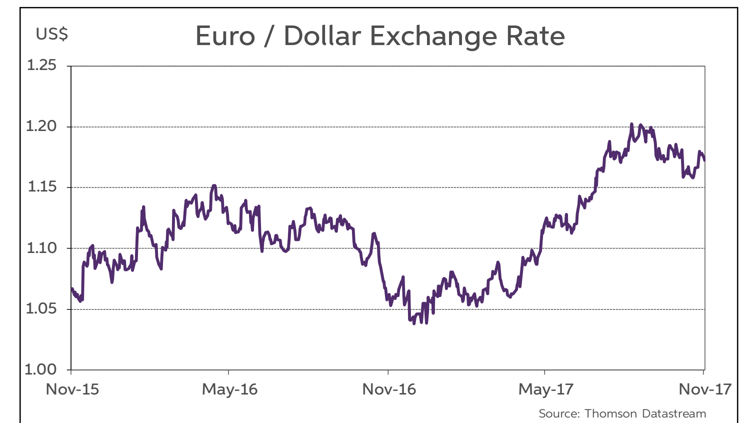
The dollar, though, has stabilised in recent months. Indeed, it has recovered some ground against currencies like the Aussie, NZ and Canadian dollars, Chinese yuan and sterling, as the Fed reaffirmed its rate tightening path and indicated that a further rate hike is likely before year end. The Trump Administration has also been making some progress with Congress on its tax cut plans, which it wants to see implemented next year. US data have been solid too, with the economy now growing at around a 3% annualised rate.

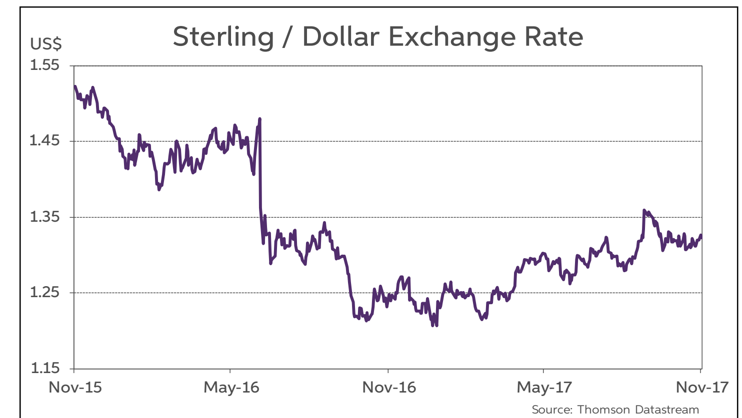
As a result, there has been a firming of market expectations in regard to US rates since the summer. Markets now see the next US rate hike occurring at end 2017, compared to end 2018 previously, while they also expect US rates to rise to close on 2% by end 2019 compared to 1.5% a couple of months back. Overall, this has helped the dollar to rise by 3% on a trade-weighted basis since early September, but it is still down 9% year-to-date.

We see the upside potential for the dollar as being closely linked to President Trump getting his tax cut plans through Congress. Loosening fiscal policy at this stage of the cycle would add to the case for monetary tightening and likely see markets price in even more rate hikes. Furthermore, if as is being mooted, there is a large, one-off cut to corporate tax in an amnesty designed to entice back profits held by US corporates overseas, it should also trigger dollar gains as companies may have to move some funds into dollars to repatriate them.

It should be noted, though, that despite its rise this 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. Thus, any gains by the dollar against the single currency next year may be limited, especially given the strengthening of the Eurozone economy and its large balance of payments surplus.







Forex Market Outlook

Progress on Brexit talks to set the tone for sterling

Sterling fell sharply last year on concerns over Brexit. The currency hit 30-year lows against the dollar, falling from above $1.50 to around the $1.20 level in late 2016. However, sterling managed to regain some ground when the dollar weakened this year, moving back above the $1.30 level in the second half of 2017.

Brexit concerns have also seen the euro made significant gains against sterling over the past two years, with EUR/GBP rising sharply from the 70p level near the end of 2015 to around the 90p level. The weaker pace of economic growth evident in the UK this year has also been a further headwind for the currency. Meanwhile, the snap UK general election, which saw the Conservative Party lose its majority in Parliament, brought renewed pressure on sterling. The euro hit a high this year of 93p against sterling in August.

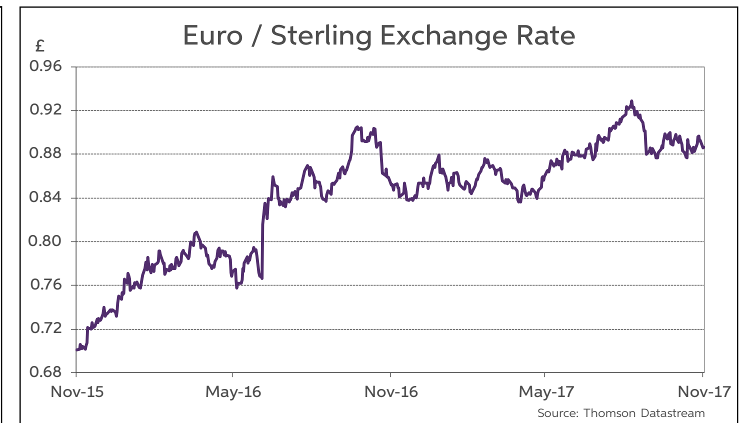
Sterling, though, has recovered some ground against the euro in the past couple of months, helped by a rate hike from the Bank of England in response to the marked pick-up in inflation, some better UK economic data and hopes that agreement can be reached on a soft Brexit when the UK departs from the EU. This has seen EUR/GBP move down to trade in a narrow 87.5-90.0p range over the past two months.

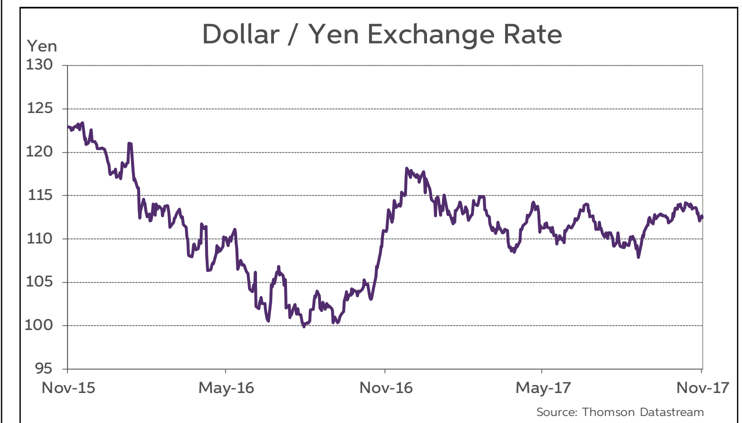
The Brexit negotiations are likely to be the key factor influencing sterling in the period ahead. The first stage of the Brexit negotiations are proving difficult and slow, especially in regard to budgetary matters and what bill the UK will have to pay to settle its outstanding financial liabilities on leaving the EU. Sufficient progress has to be made in this part of the negotiations before the discussions can move on to the more substantive issues of future trade relations and possible transition arrangements that may apply for a period after the UK leaves the EU. It is hoped that EU leaders will be able to agree that the talks can progress to the next stage at their meeting in December.

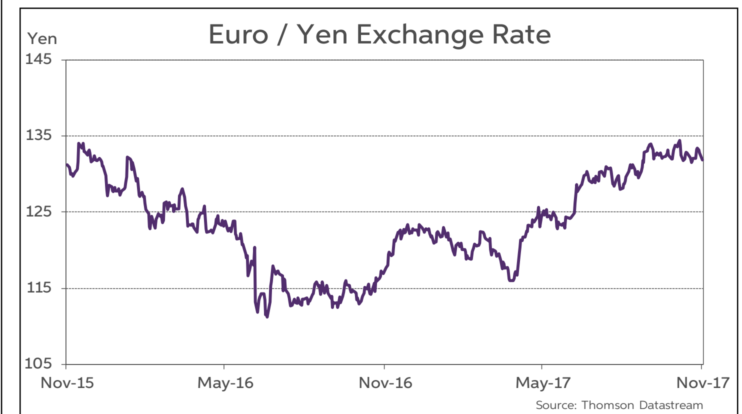
There are hopes that the eventual outcome of the talks will be a soft Brexit, with transition arrangements agreed that allow for continuing free trade between the UK and EU, until a full trade deal is negotiated. Both the EU and UK see the need for a transition period. The UK Government has suggested that the UK and EU could form a Customs Union in the transition phase, with the current customs border trading arrangements remaining in place during this period. The fact that the Conservative government has lost its majority in Parliament has also increased the prospect of a soft Brexit, as it now has to take greater account of opposition parties' views.

Nonetheless, 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 loses free access to EU markets and has to fall back on WTO rules. This would be very negative for the UK economy and see further falls in sterling.

Sterling could continue to trade in the 87-92p range it has occupied against the euro since June, until markets get some clear signals on the outcome of the Brexit talks. A decision in December to move to the next stage of the negotiations should be positive for the currency. Beyond that in 2018, if it appears that a soft Brexit is on the cards, sterling could regain some of the ground lost since June 2016, with the euro moving down to 85p or below and cable rising towards $1.40. On the other hand, if a hard Brexit looks more likely, then the euro can be expected to move up to the 95p level. Indeed, it could rise even higher to trade in a 95p-100p range as a hard Brexit approaches in March 2019, with cable falling back towards $1.20.



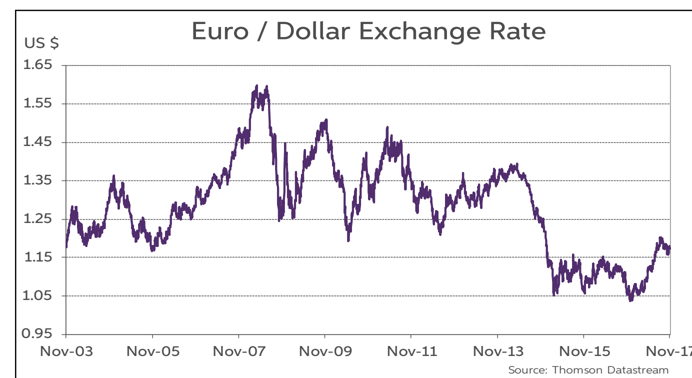


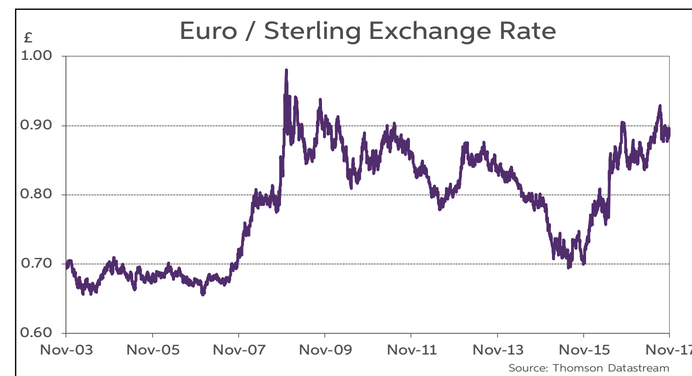


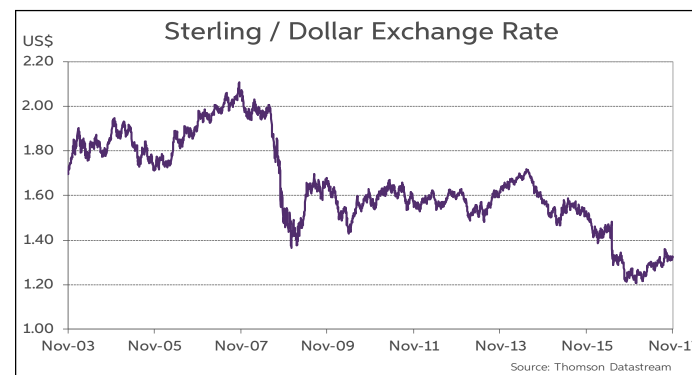
Summary of Exchange Rate Forecasts

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

	Current	Q4-2017	Q1-2018	Q2-2018	Q3-2018
Euro Versus					
USD	1.176	1.14-1.20	1.13-1.19	1.12-1.18	1.11-1.17
GBP	0.887	0.86-0.92	0.85-0.91	0.84-0.90	0.83-0.89
JPY	131.77	129-135	129-135	129-135	129-135
CHF	1.16	1.17	1.17	1.18	1.18
US Dollar Versus					
JPY	112.10	110-116	111-117	112-118	113-119
GBP	1.325	1.29-1.35	1.29-1.35	1.29-1.35	1.30-1.36
CAD	1.28	1.28	1.29	1.30	1.31
AUD	0.76	0.76	0.75	0.74	0.73
NZD	0.68	0.68	0.67	0.66	0.65
CNY	6.61	6.65	6.70	6.75	6.80
Sterling Versus					
JPY	149	149	150	152	154
CAD	1.69	1.68	1.70	1.72	1.74
AUD	1.75	1.74	1.76	1.78	1.82
NZD	1.94	1.94	1.97	2.00	2.05







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