Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

26th October 2016

- Further sharp fall by sterling in past month. Downside risks persist for the UK currency as very difficult negotiations with EU lie ahead next year

- Fed very slow to tighten policy with divided views within the FOMC, but rate hike seems increasingly likely in December with further modest tightening possible in 2017

- Dollar gains some ground on likely end year US rate hike, but more rate hikes required in 2017 if the currency is to maintain its recent upward trajectory

- Could be nearing the limits of global monetary easing with rates near zero or negative in many countries and significant QE programmes in operation in some major economies

- Some upward pressure on longer-dated bond yields recently, but weak global growth and inflation as well as continuing loose monetary policies suggest yields will remain low

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Global Economic Outlook

Global growth remains very subdued

The global economy continues to struggle for upward momentum, with growth staying subdued. The OECD has observed that "eight years after the financial crisis, the global recovery remains disappointingly weak". It noted in its recent Interim Economic Outlook that the world economy remains in a low growth trap. Meanwhile, the IMF says global activity remains sluggish. World growth was 3.1% in 2015, the weakest rate since the end of the economic crisis of 2008-2009, reflecting in particular slower growth in emerging economies. The OECD is forecasting that global growth will slow even further this year to 2.9% before picking up slightly to 3.2% in 2017.

There has been a marked slowing in growth in many of the main advanced economies this year, most notably the US. Growth there moderated considerably in the opening half of 2016 due to weak business investment, a poor external trade performance and slower inventory accumulation. The US economy appears to have regained momentum in H2 2016. Growth in both the Eurozone and UK economies has also moderated this year, while the expansion in Japan remains anaemic. Overall, growth in advanced economies is estimated by the IMF to have slowed to 1.6% this year, down from 2.1% in 2015. It is forecast to pick up slightly to 1.8% in 2017.

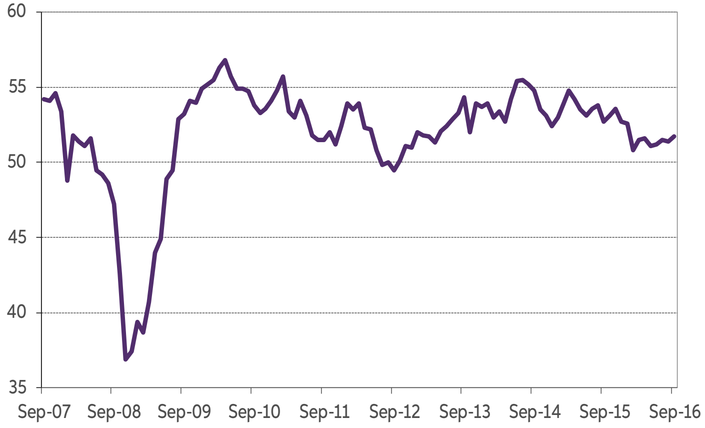
Meanwhile, growth in emerging economies has lost considerable momentum in recent years and is estimated by the IMF at 4% in 2015, down from 4.7% in 2014. The trend has been one of weakening growth in emerging economies since 2010, when it stood at 7.5%. Most notably, GDP growth in China slowed from 10.4% in 2010 to 6.9% in 2015. The impact of the slowdown in China on other emerging economies, combined with a sharp fall in commodity prices, has been greater than expected, with some countries like Brazil and Russia going into recession. The IMF sees growth in emerging economies at 4.2% in 2016, rising to 4.6% in 2017, helped by a modest recovery in commodity prices and emergence of economies like Brazil and Russia from deep recessions.

However, downside risks remain for the world economy. The Global Composite PMI has dropped to below 52 in the past few months, its lowest level in over three years. In particular, the still low level of commodity prices, sluggishness of world trade, high private sector debt levels, a need for sizeable fiscal tightening in some countries and reliance on capital inflows are all downside risks to the growth prospects for emerging economies.

Against this backdrop, the Brexit vote in the UK has cast a further shadow over the global economy and heralds in a period of political and economic uncertainty. There is now the new complication and uncertainty of the UK's future trade relations with the EU. A deceleration in the growth rate of the UK economy is expected over the next couple of years. The IMF sees UK GDP slowing to 1.1% in 2017, with the OECD forecasting 1% growth, down from over 2% in recent times.

In summary, then, the recovery in the world economy has lost momentum in 2015 and 2016, reflecting slower growth in both emerging and advanced economies. Central banks have been busy loosening policy to try and lift both weak world growth and very low inflation. As the OECD points out, though, it is largely adverse supply-side factors that are holding back the world economy, with weakness in world trade, investment and productivity all contributing to low growth. Wage growth also remains very subdued despite a good rise in employment and falling jobless rates. Global growth may strengthen somewhat in 2017 but until these supply-side constraints are overcome, the performance of the world economy will remain sub-par and downside risks will persist.

Global Composite PMI (JP Morgan)



Source: Thomson Datastream

GDP (Vol % Change)

	2014	2015	2016 (f)	2017 (f)
World	3.4	3.1	2.9	3.2
OECD Economies	1.9	2.1	1.6	1.8
US	2.4	2.6	1.6	2.2
Eurozone	1.1	2.0	1.7	1.5
UK	3.1	2.2	1.8	1.1
Japan	0.0	0.5	0.5	0.6
Non-OECD Economies	4.6	4.0	4.2	4.6
China	7.3	6.9	6.6	6.2
India	7.2	7.6	7.6	7.6
World Trade Growth (%)	3.7	2.6	2.3	3.8
OECD Economies Inflation (%)	1.4	0.3	0.8	1.7

Sources: OECD, IMF

Interest Rate Outlook

AIB Treasury Economic Research Unit

Rate hike likely in US by end year

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. This pattern has continued in 2016. The Bank of Japan stunned markets earlier in the year by unexpectedly cutting rates, moving them into negative territory. The ECB eased policy further at its March meeting, lowering the deposit rate by another 10bps to −0.4%, while cutting the refi rate by 5bps to 0% and expanding QE. The Bank of China has also loosened policy further this year, with India, Australia, New Zealand and the UK also cutting rates. Meanwhile, expected tightening from the US Fed this year has yet to materialise.

The BoE announced significant policy easing measures at its August MPC meeting to help mitigate some of the expected negative effects on the UK economy of the vote for Brexit in the June referendum. It cut the Bank rate by 25bps to 0.25% and expanded its QE programme. It also indicated that it was likely to reduce rates again later this year. However, markets no longer expect further easing from the BoE with UK data holding up better than expected post the referendum vote, sterling falling sharply and inflation likely to rise markedly in 2017/18. The MPC, though, is likely to maintain its easing bias, given the downside risks posed to the economy by Brexit.

From an ECB perspective, the Central Bank retains an easing bias and it continues to indicate that it would ease policy further if required. However, markets no longer expect the ECB to cut rates again, with inflation now on an upward trend and the economy continuing to grow at a moderate pace. Markets, though, expect Eurozone rates to remain very low for a long period of time with futures contracts suggesting that three month money rates will remain negative in the Eurozone until the end of 2020. Markets are less sure about the future direction of QE. There has been some talk about tapering next year but the ECB seems more likely to extend the duration of the programme beyond the current end date of March 2017, while also possibly scaling back the size of the monthly purchases. The ECB will make a decision on the matter at the December meeting of the Governing Council.

Meantime, 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 has refrained from any further rate hikes since then. This has been in part due to financial market volatility and some unexpected softness in the US economy in H1 2016. However, the Fed retains a tightening bias and gave a clear signal at the September FOMC meeting that a rate hike was likely by end year, with December the favoured month.

The FOMC's latest rate projections show that it expects to raise rates by a further 50bps in total next year, to be followed by three 25bps hikes in 2018. This would bring the Fed funds rate to 1.875% by end 2018. Despite the Fed's rate projections, though, there seems a clear reluctance by many FOMC members to tighten policy. Hence, markets are expecting just two rate hikes between now and end 2018, which would take the fed funds rate to 0.875%, or 1% lower than the Fed's projection.

Bond yields have moved upwards in the past couple of months. Nonetheless, they still remain very low globally, anchored by expectations that central banks will keep rates at very low levels for a prolonged period of time. However, with only limited scope to ease monetary policy further in the main economies, the low point for yields may well have passed in this cycle. We are unlikely to enter a bear market for bonds, though, with monetary policy set to stay very accommodative in the next few years and core inflation expected to remain subdued.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.375	0.89	1.58	1.08	1.29
Dec '16	0.625	1.00	1.65	1.15	1.35
Mar '17	0.625	1.00	1.70	1.20	1.40
June '17	0.625	1.05	1.75	1.30	1.50

** 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	-0.32	-0.08	-0.18	-0.04
Dec '16	-0.40	-0.32	-0.08	-0.18	-0.04
Mar '17	-0.40	-0.30	-0.06	-0.18	-0.03
June '17	-0.40	-0.30	-0.05	-0.15	0.00

** 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	0.40	0.80	0.61	0.78
Dec '16	0.25	0.40	0.80	0.62	0.80
Mar '17	0.25	0.40	0.80	0.62	0.80
June '17	0.25	0.40	0.80	0.65	0.85

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Fed rate hikes needed for further dollar gains

A notable feature of currency markets since early last year has been the very stable trading range for the euro-dollar exchange rate. There have been big moves by some of the other major currencies, but EUR/USD has been confined to a $1.06-1.16 trading band since early 2015 and a $1.08-1.15 range so far this year. The dollar, though, has been making ground against the euro since the single currency hit a high point for the year of $1.15 in early May. Growing expectations that the Fed will hike rates before the end of the year have seen the euro drop back below the $1.10 level in the past fortnight.

There are also a number of negative factors that present challenges for the single currency. The combination of Brexit uncertainty and associated risks for the EU, as well as an under-performing Eurozone economy are headwinds for the euro. There has also been significant further ECB easing this year, including a lowering of the deposit rate to –0.4%, as well as an extension to the QE programme. Many Eurozone bonds now carry a negative yield. The ECB also continues to maintain an easing bias in marked contrast to the Fed.

However, despite the recent dollar gains, we do not expect a breakout from the $1.06-1.16 trading range that has been evident for EUR/USD since early 2015. Any rate moves by the Fed in the near-term are likely to be modest. Overall, we would expect the EUR/USD pair to trade in a $1.06-1.11 range in the coming months, with the prospect of a US rate hike before year end helping to underpin the dollar

Turning to 2017, we would need to see further rate hikes by the Fed for the dollar to maintain its uptrend and break out of its 2015-16 trading range against the euro. The Fed is projecting two rate hikes next year which have not been priced in by the market. Indeed, markets see only one rate increase in total between now and end 2017, with just one further rate hike to follow by end 2018. Thus, markets see official rates staying below 1% in the US over the next couple of years.

This expectation by the market of a continuation of a low interest rate environment in the US is likely to limit the upside potential of the dollar. Hence, we would need to see the Fed deliver some unexpected rate increases in the coming year for the dollar to push on and rise towards parity against the euro. This seems unlikely as most FOMC members seem very reluctant to pursue a policy of steady hikes in US interest rates.

Elsewhere, a combination of risk aversion and market uncertainty has provided strong safe haven support for the yen this year. The dollar has fallen from ¥120 to below ¥105, with the euro declining from ¥130 to around the ¥114 level since the start of 2016, despite policy easing by the BoJ. It is hard to argue for further gains by the yen given the weakness of the Japanese economy and possibility of further easing by the BoJ.

Indeed, the yen rally looks to have run out of steam since early summer, with the yen rate settling down in a ¥100-106 range versus the dollar and trading in a ¥112-116 range against the euro since July. The yen may remain range bound in the coming months and, indeed, could lose some ground to the dollar if US rates are hiked before year end and in 2017.

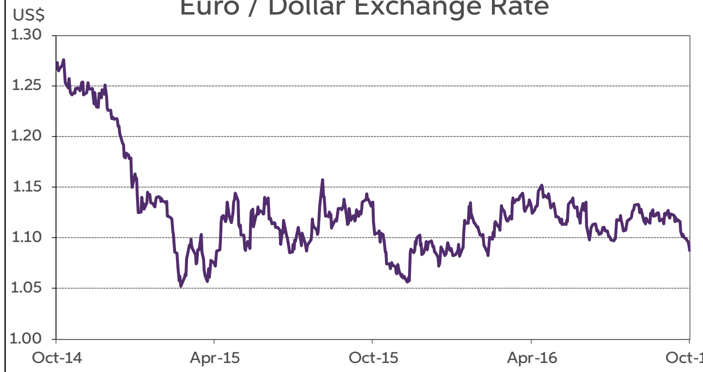
Meanwhile, the Chinese authorities seem happy to continue to allow their currency fall against the dollar anytime there is upward pressure on the US currency. Thus, while the Chinese yuan has been fairly range bound against the euro since early summer, it has declined against the strengthening dollar.

US Dollar Trade Weighted Index Versus Majors

(March 1973 =100)

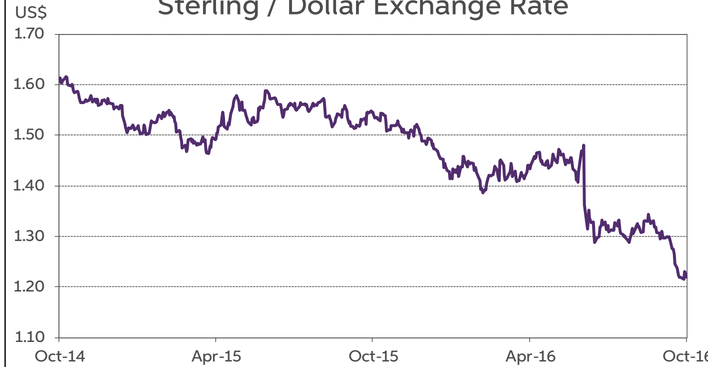
Source: Thomson Datastream

Euro / Dollar Exchange Rate



Source: Thomson Datastream

Sterling / Dollar Exchange Rate



Source: Thomson Datastream

Forex Market Outlook

Sterling falls sharply on Brexit concerns with scope for further losses

Sterling appreciated by nearly 20% on a trade-weighted basis between 2013 and mid-2015, partly fuelled by expectations of UK rate hikes. It may also have been helped by dollar strength over this period with expectations of Fed rate hikes driving the US currency higher too. GBP/USD was fairly range bound during this time.

These gains, though, have unwound this year on mounting concerns over Brexit. Sterling weakened during the first half of the year in the run-up to the referendum vote on June 23rd. The euro rose by some 10% against sterling, climbing from 70p in late 2015 to around the 77p level. GBP/USD also fell from a high of $1.59 in mid-2015, to below the $1.50 level..

Sterling saw further big losses on the unexpected victory for the 'leave' side in the referendum vote. The currency hit 30-year lows against the dollar, falling through key support levels at $1.37-1.38 before moving below the $1.30 level in early July. Sterling's post referendum slide also greatly impacted EUR/GBP, with the pair trading as high as 86p following the vote. The pound has seen further sharp losses in the past month following the announcement by the UK Government that it would trigger Article 50 before the end of next March. Cable has fallen close to the $1.20 level, with the euro climbing to around the 90p mark.

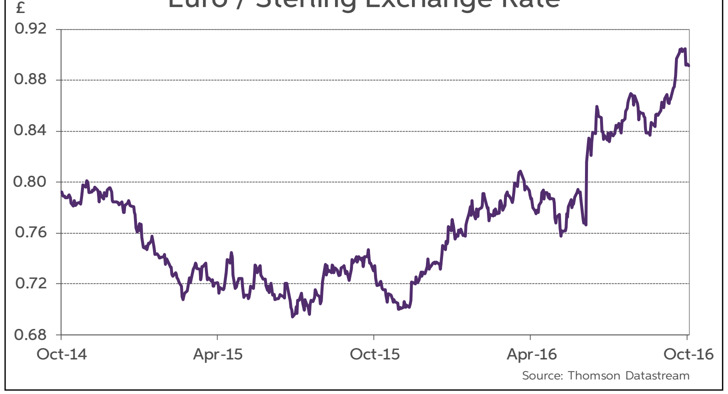
The EU Treaty provides for a two-year period for the negotiations on an EU exit once Article 50 is invoked. There are growing concerns that the UK may be facing a 'hard' Brexit at the end of this process, whereby it will also exit the EU Single Market and Customs Union. The concern is that if the UK continues to give priority to controlling immigration and regaining independence and full sovereignty, it will lose access to the Single Market. Indeed, there are indications that negotiations on the future trading relationship between the EU and the UK will not begin until after the UK leaves the EU. Thus, the exit deal may contain just interim arrangements, if any, on trade.

Over the next couple of years, though, there will be no change to the institutional framework that governs the UK's relationship with the EU. However, the uncertainty over Brexit is likely to weigh on economic activity. An expected marked pick-up in inflation will depress real incomes and consumer spending. While a recession is not being forecast, slower UK growth seems likely despite a looser policy stance and the marked fall of the currency.

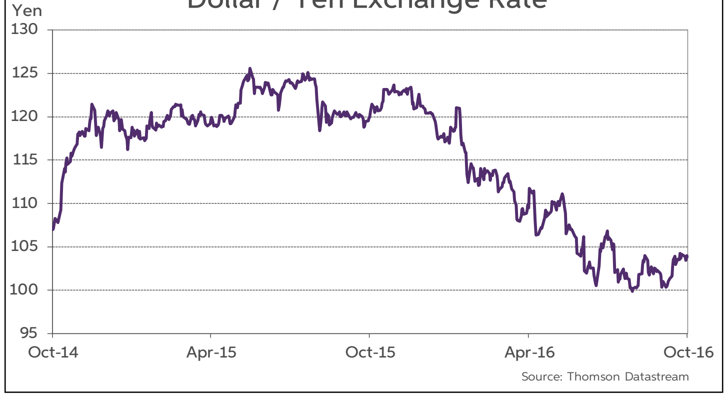
Sterling has fallen a long way but is vulnerable to further downside against the backdrop of a likely slowdown in the economy, possible further BoE policy easing, and continuing uncertainty over Brexit amidst very difficult exit negotiations. The UK also has a large balance of payments deficit. This could become problematic for sterling if the large capital inflows required to finance the deficit begin to dry up on concerns over Brexit, as seems likely.

The market is very short of sterling at present so there is scope for a short-term bounce by the currency as traders book profits, especially in the run-up to year end. The underlying trend, though, is likely to remain downwards for sterling. In a 'flash-crash' episode driven by computer-trading in thin Asian markets earlier this month, sterling dived to $1.15 and the euro hit 94p. We could well see these levels hit again next year if the negotiations with the EU prove fraught and acrimonious and the prospects of a hard Brexit continue to grow. Indeed, some forecasters are predicting that we could reach parity between sterling and the euro if the UK continues on the road to a hard Brexit. Overall then, sterling may have fallen a long way, but the risks remain to the downside for the UK currency.

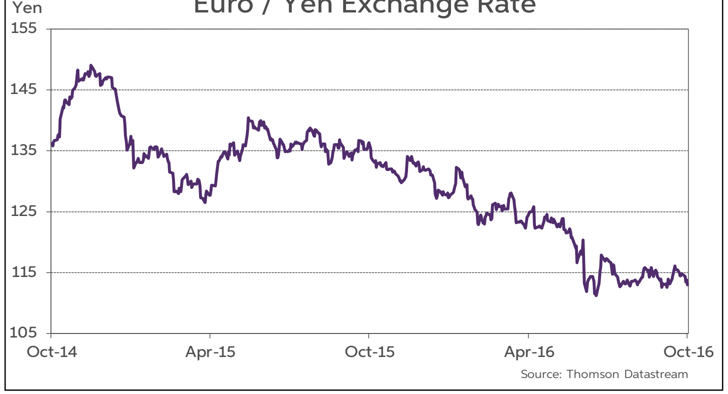
Euro / Sterling Exchange Rate



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	Q4-2016	Q1-2017	Q2-2017	Q3-2017
Euro Versus					
USD	1.092	1.06-1.12	1.05-1.11	1.04-1.10	1.03-1.09
GBP	0.895	0.87-0.93	0.88-0.94	0.89-0.95	0.90-0.96
JPY	113.74	110-116	110-116	110-116	110-116
CHF	1.08	1.08	1.08	1.08	1.08
US Dollar Versus					
JPY	104.13	101-107	102-108	103-109	104-110
GBP	1.221	1.18-1.24	1.16-1.22	1.13-1.19	1.11-1.17
CAD	1.34	1.34	1.34	1.34	1.34
AUD	0.77	0.77	0.77	0.78	0.79
NZD	0.72	0.72	0.73	0.74	0.75
CNY	6.77	6.77	6.80	6.83	6.86
Sterling Versus					
JPY	127	126	125	123	122
CAD	1.63	1.62	1.59	1.56	1.53
AUD	1.59	1.57	1.55	1.49	1.44
NZD	1.70	1.68	1.63	1.57	1.52

Euro / Dollar Exchange Rate

Source: Thomson Datastream

Euro / Sterling Exchange Rate

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