Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Global economic recovery continues to gather momentum as IMF revises up its growth forecasts for 2017/18. Inflation, though, remains very subdued
- Central banks patient on policy tightening, but rates hikes likely in US & UK in coming months. Meanwhile, ECB expected to announce that asset purchases will be scaled back next year
- Dollar slide is halted as Fed sticks with its projected rate hike path, President Trump looks to progress his tax cut plans and US data remain solid
- Under pressure sterling regains some ground as BoE signals that it is likely to hike rates in coming months and expectations grow for a soft Brexit
- Strong economy should help underpin euro, but Catalonian crises needs watching

Oliver Mangan
Chief Economist

John Fahey
Senior Economist

Dara Turnbull
Economist

www.aibeconomics.com

Global Economic Outlook

Global growth accelerating, but inflation stays 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 extended into 2017, with particularly good growth in all the major economies in the second quarter of this year, apart from the UK. Activity in emerging economies has also been gathering strength, helping by the emergence of countries like Russia, Brazil and Nigeria from recessions as oil prices recovered from their early 2016 lows.

The latest data suggest that the recovery in the global economy is gaining momentum. The ISM manufacturing index in the US hit a 13-year high in September, with the index for the services sector reaching a 12-year high. The Eurozone PMI is near a 6-year high, with particularly strong industrial production data recently. Meantime in Japan, the key quarterly Tankan business survey published earlier this month reached a 10-year high, while China's official manufacturing PMI rose to its highest level in 5 years last month. Recent Chinese trade have also been quite strong.

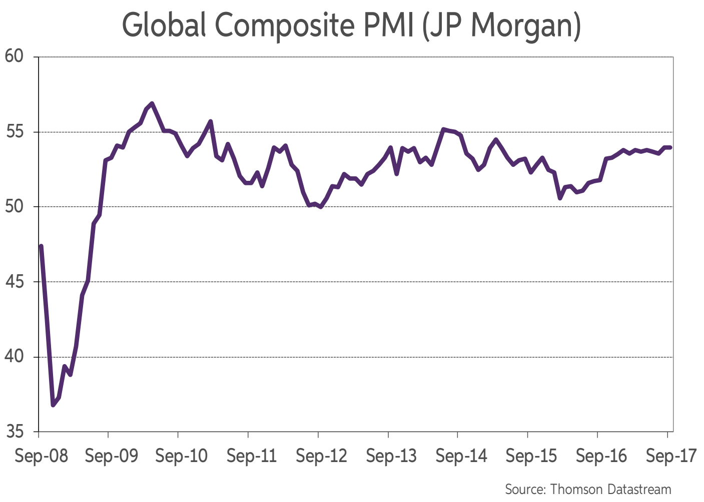
In a further positive sign, oil prices have also started to rise again recently on the back of a pick-up in demand as economic growth strengthens. Stock markets have also moved higher in the past couple of months on improving data. It would seem that the combination of continuing very loose monetary 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 pick up in many economies.

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 slowed in the opening half of the year as high inflation and weakening wage growth dampened consumer spending, with uncertainty over Brexit holding back investment. The data in recent months suggest that UK growth remained subdued in the third quarter, with little sign yet that the traded sector is benefitting from sterling's fall and better global activity.

The recent good data have seen the IMF revise up its growth forecast 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 is 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.

Meantime, despite the pick-up in global growth, inflation in advanced economies remains subdued and below targets, while it is declining in some emerging economies. Sluggish wage growth and still quite low oil prices suggest that inflation is likely to remain subdued, with the IMF forecasting that it 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

Interest Rate Outlook

Gradual policy tightening by central banks

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. Some further rate hikes are likely in the coming months, including in the UK, with the ECB also expected to soon announce that it will further reduce the size of its monthly asset purchases next year.

Nonetheless, markets expect monetary policy to 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 anchored at low levels, while many stock markets have risen to either multi-year highs, or hit new historic peaks recently.

In the UK, inflation has picked up following the sharp decline in sterling, with headline CPI inflation rising to 3%. The BoE has been indicating for some time that there are limits to the extent that above-target inflation can be tolerated, with some MPC members voting for a rate hike at recent meetings. At its September meeting, the MPC gave a clear signal that a rate hike was likely before too long. Thus, markets expect the BoE to raise rates in the coming months, possibly as early as November. We would not expect a further rate hike anytime soon.

Meantime, the ECB has indicated that it will continue with its QE programme until at least the end of 2017, although it has scaled back its easing bias by no longer committing to lowering rates even further if required. However, it continues to say that it could expand its QE programme if necessary. The expectation in markets, though, is that the ECB will scale back asset purchases under its QE programme next year, with an announcement on this likely at the October Council meeting.

The ECB expects 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 before it is increased, given the guidance from the Central Bank on QE and rates. Futures contracts show wholesale rates edging just slightly higher next year, with three month money rates expected to remain negative until end 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 H1 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 reducing the size of its balance sheet, or unwinding QE, by no longer reinvesting funds from some of its bonds as they matured. This “balance sheet normalisation” process, though, is going to occur at a slow pace.

The FOMC also largely reaffirmed its interest rate projections at last month’s meeting, although it now expects rates to rise to 2.75% by end 2019 compared to 3% previously. Markets had been expecting rates to rise to just 1.5% by end 2019 but are now discounting rates getting to 1.875% by then. Thus, the gap between the market and the Fed on the likely path of rates has narrowed in the past month or so. Inflation is a key consideration for the Fed. If it remains subdued, then the Fed may not tighten policy as much as it has indicated. We would not be surprised if the Fed funds rate rose to 2.375% by end 2019, with the next hike this December.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.125	1.35	1.81	1.78	2.02
Dec '17	1.375	1.55	1.95	1.90	2.10
Mar '18	1.375	1.60	2.00	1.95	2.15
June '18	1.625	1.80	2.20	2.15	2.35

** 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	-0.23	-0.20	0.19
Dec '17	-0.40	-0.37	-0.22	-0.18	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	0.25	0.38	0.75	0.83	1.08
Dec '17	0.50	0.60	0.85	0.95	1.15
Mar '18	0.50	0.60	0.85	0.95	1.20
June '18	0.50	0.60	0.85	1.00	1.25

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Dollar's slide is halted, while euro's rally runs out of steam

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 above $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 three months, with trading confined to a narrow $1.17-1.21 range.

Developments in Europe helped the euro to make ground this year. Eurozone growth has picked up appreciably in recent quarters, with the jobless rate moving steadily lower. This has seen the ECB row back on its easing bias, in particular dropping references that it could lower rates further. Markets now expect three month money rates in the Eurozone to turn positive by end 2019, compared to mid-2021 last year. There is also an expectation that the ECB will reduce its QE asset purchases next year. Abating political risks also helped the euro this summer, with 'mainstream' political parties doing well in European elections this year, most notably in France.

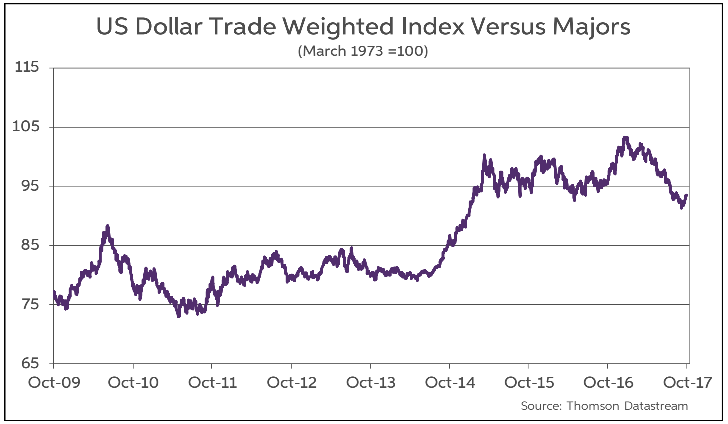
However, it is important to note that the dollar lost ground against a broad range of currencies over the summer and not just the euro. The Aussie, NZ and Canadian dollars rose to their highest levels against the US currency in over two years. Even the Chinese yuan, which declined steadily against the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

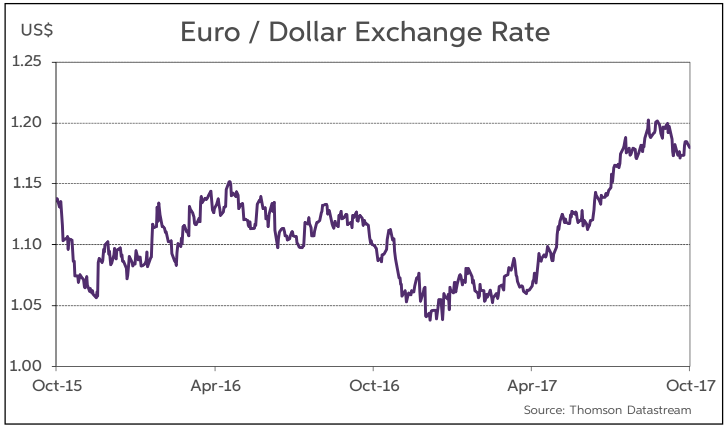
The dollar, though, has stabilised in the past couple of months as the Fed reaffirmed its rate tightening path and indicated that a further rate hike is likely before year end. The Trump Administration has also been attempting to make progress on its tax cut plans, which it wants to see implemented next year. US data have also been solid.

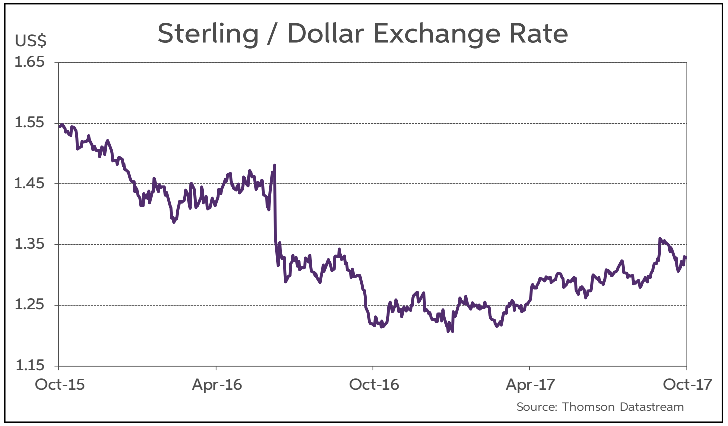
As a result, there has been a firming of market expectations in regard to US rates in the past two months. Markets now see the next US rate hike occurring at end 2017 compared to end 2018 previously, while they also expect US rates to rise to 1.875% by end 2019 compared to 1.5% a couple of months back. However, this is still some way below the Fed projection of 2.75% for the funds rate at end 2019.

For the dollar to regain its mojo and move back onto an upward trajectory, it will likely need both monetary and fiscal policy to play a role. However, it could be well into next year before it becomes clear whether or not the market is underestimating the extent of Fed rate tightening. Progress is also likely to be slow on getting President Trump's tax cutting agenda implemented. Meanwhile, an eye needs to be kept on the situation in Catalonia, which has the potential to escalate into an even bigger crisis for Spain and weigh on the euro. Overall, EUR/USD could well remain range bound over the rest of the year, trading in a $1.16-1.20 band.

Turning to next year, there could well be some developments that favour the dollar. The Fed may well surprise markets with the extent of its policy tightening, while some of President Trump's tax cut plans could be implemented ahead of mid-term congressional elections. In particular, a one-off large cut to corporate tax in an amnesty designed to entice back profits held by US corporates overseas should trigger dollar gains, as companies are likely to need to swap some funds into dollars to repatriate them.







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. The euro made significant gains against sterling too, with EUR/GBP rising to 90p last autumn, up from 70p near the end of 2015.

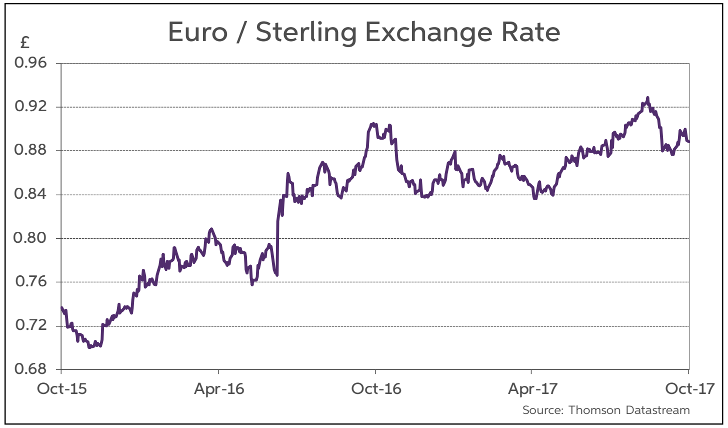
Sterling, though, did find a trough late last autumn and managed to regain some ground at end 2016. This saw the euro drop back to around 84p. However, the euro has been in the ascendancy for much of this year on currency markets. The weakening pace of economic growth evident in the UK this year has also been a 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. Thus, the euro was on a steady upward path against sterling over the summer, climbing from 84p in May to a high of 93p in August.

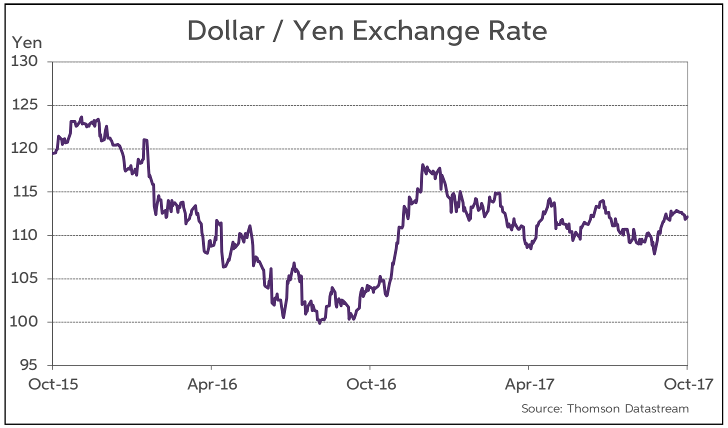
However, sterling has managed to make some ground against the weak dollar this year, moving above the $1.30 level over the summer. Sterling has recovered some ground against the euro in recent weeks too, helped by indications from the Bank of England that it is likely to hike rates in response to the marked pick-up in inflation. Hence, EUR/GBP has traded in a narrow 87.5-90.0p range over the past month.

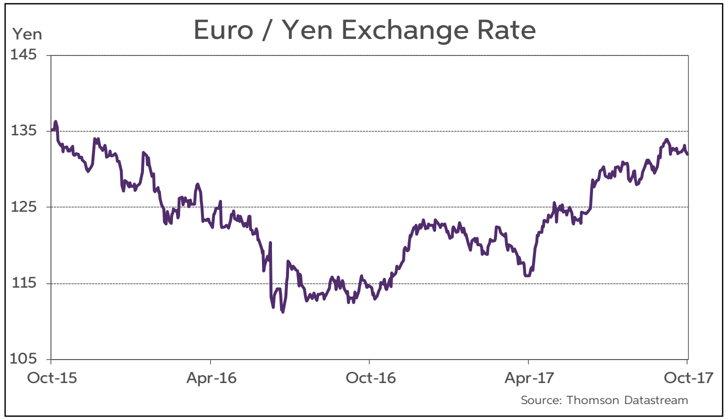
Brexit, though, and the negotiations between the EU and UK, is likely to be the key factor influencing sterling in the period ahead. The early stages of the Brexit negotiations are proving difficult and slow, especially in regard to budgetary matters and what bill the UK will have to pay to settle its 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 seems unlikely that these discussions will commence until near year-end or in 2018.

There are hopes, though, 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 will now have to take more cognisance of opposition parties views, with the Labour party formally adopting a soft Brexit policy position. Nonetheless, given the uncertain political backdrop in the UK in particular, 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 now looks to have entered an 87-92p trading range against the euro, with movement within this band in the coming months largely determined by the tone and pace of progress on the Brexit talks. Beyond that in 2018, if it appears that a hard Brexit looks increasingly 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 towards $1.20. On the other hand, a soft Brexit should see the currency regain some of the ground lost since June 2016, with the euro moving down to 85p or below and cable rising towards $1. 40.



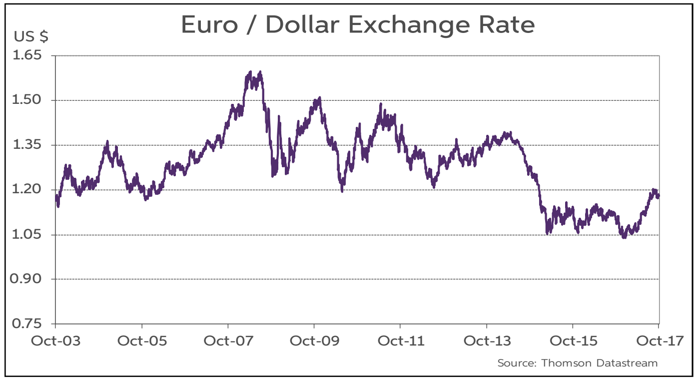


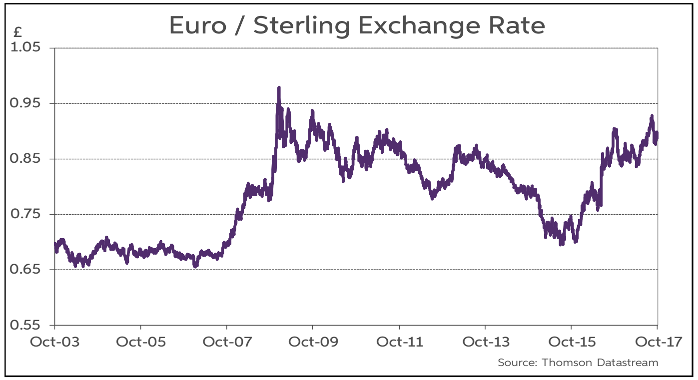


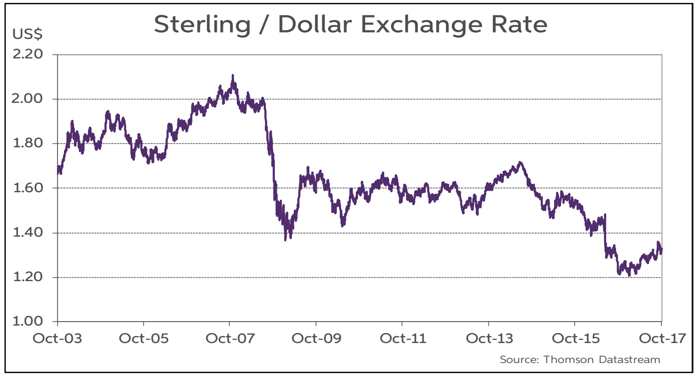
Summary of Exchange Rate Forecasts

("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	1.15-1.21	1.14-1.20	1.13-1.19	1.12-1.18
GBP	0.887	0.86-0.92	0.85-0.91	0.84-0.90	0.83-0.89
JPY	131.86	129-135	129-135	129-135	129-135
CHF	1.15	1.15	1.15	1.15	1.15
US Dollar Versus					
JPY	112.14	109-115	110-116	111-117	112-118
GBP	1.325	1.30-1.36	1.30-1.36	1.30-1.36	1.31-1.37
CAD	1.25	1.25	1.26	1.27	1.28
AUD	0.79	0.79	0.78	0.77	0.76
NZD	0.72	0.72	0.71	0.70	0.69
CNY	6.62	6.60	6.65	6.70	6.75
Sterling Versus					
JPY	149	149	150	152	154
CAD	1.66	1.66	1.68	1.69	1.71
AUD	1.69	1.68	1.71	1.73	1.76
NZD	1.85	1.85	1.87	1.90	1.94







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