Forex and Interest Rate Outlook

28th September 2016

AIB Treasury Economic Research Unit

- **Sterling stabilises after sharp falls on Brexit vote, but downside risks persist for the UK currency as very difficult negotiations with EU lie ahead**
- **Fed very slow to tighten policy with divided views within FOMC. It signals, though, that rates are likely be hiked before year-end with more tightening possible in 2017**
- **Dollar should gain some ground as US rate hike now on the agenda for year-end, but more rate hikes required in 2017 if dollar is to move back on to 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**
- **Weak global growth and inflation, though, suggest rates to stay low for a long time**

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Global Economic Outlook

Global growth remains very subdued

The global economy continues to struggle for upward momentum, with growth very much underperforming. The OECD has observed that "eight years after the financial crisis, the global recovery remains disappointingly weak". It noted in its September Interim Economic Outlook that the word economy remains in a low growth trap. 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% and pick up only marginally to 3.2% in 2017.

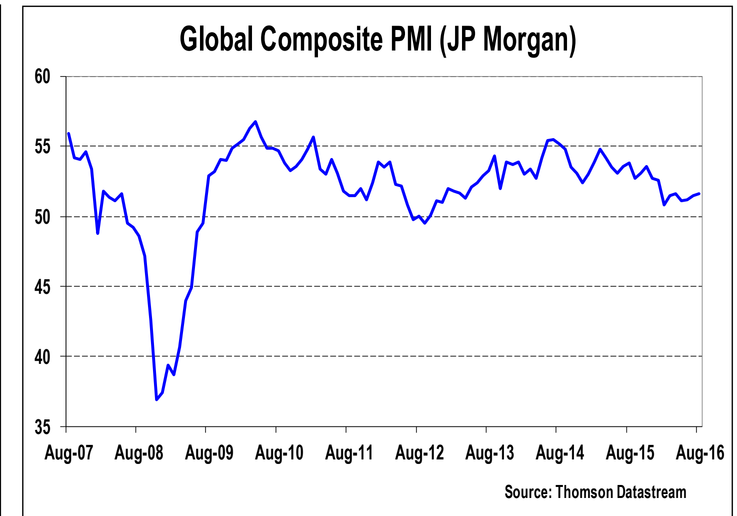
There has been a marked slowing in growth in some of the main advanced economies this year, most notably the US. Growth there slowed sharply in the opening half of 2016 due to weak business investment, a poor external trade performance and slower inventory accumulation. The US economy appears to have 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.

Meanwhile, growth in emerging economies lost considerable momentum in recent years and is estimated by the IMF at 4% in 2015, down from 4.7% in 2014 and 5% in 2013. In fact, 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 going into recession. The IMF sees growth in emerging economies at around 4% again in 2016, before picking up to over 4.5% in 2017, helped by the modest recovery in commodity prices this year 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, weak 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 added 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 expanding by 1.3% in 2017, with the OECD forecasting just 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 factors are overcome, the performance of the world economy will remain sub-par and downside risks will persist.



GDP (Vol % Change)

	2014	2015	2016 (f)	2017 (f)
World	3.4	3.1	2.9	3.2
OECD Economies	1.9	2.0	1.6	1.8
US	2.4	2.6	1.4	2.1
Eurozone	1.1	1.9	1.6	1.4
UK	3.1	2.2	1.8	1.0
Japan	0.0	0.5	0.6	0.7
Non-OECD Economies	4.6	4.0	4.1	4.6
China	7.3	6.9	6.5	6.2
India	7.2	7.6	7.4	7.5
World Trade Growth (%)	3.7	2.6	2.7	3.9
OECD Economies Inflation (%)	1.4	0.3	0.7	1.6

Sources: OECD, IMF, AIB ERU

Interest Rate Outlook

Fed signals that rate hike likely in US by end year

The past couple 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 a further 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, while the Reserve Banks of Australia and New Zealand have also cut rates. The Bank of England has become the latest central bank to ease policy. Meanwhile, the expected rate hikes from the US Fed this year have so far failed 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 is likely to reduce rates again later this year if the economy weakens in line with its expectations in the aftermath of the referendum vote. It highlighted its wish, though, to keep the Bank rate positive so the next rate cut is likely to be around 15bps, taking the official rate down to 0.1%. The BoE also pointed out that it had other policy instruments it could use if more easing is required. The MPC re-affirmed its easing bias at its September meeting

From an ECB perspective, the Central Bank retains an easing bias and it also continues to indicate that it would ease policy further if required. The euro strengthened in the aftermath of the Brexit vote, which will make it even more difficult to get inflation back up to its 2% target. The ECB has noted that underlying price pressures continue to lack a convincing upward trend. Thus, it would not be a surprise if the ECB reduced its deposit rate by another 10bps, possibly in early 2017, bringing it to −0.5%, especially if the Eurozone economy loses further momentum making the inflation target even more difficult to attain. Further out, the market expects Eurozone rates to remain very low for a long period of time. Futures pricing suggests that three month money rates will remain negative in the Eurozone until H2 2021.

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. Markets, though, are quite sceptical and expect just two rate hikes between now and end 2018, taking the fed funds rate to 0.875%, or 1% lower than the Fed's projection.

Bond yields are very low globally, anchored by expectations that central banks will keep rates at very low levels for a prolonged period of time and, indeed, could ease policy further. The main risk to this scenario if that the Fed could hike rates quicker than markets expect. This would most likely be caused by a pick-up in core US inflation. Indicators of wage inflation as well as the core PCE deflator should be watched closely in this regard.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.375	0.85	1.55	1.00	1.15
Dec '16	0.625	1.05	1.75	1.20	1.35
Mar '17	0.625	1.05	1.80	1.25	1.40
June '17	0.625	1.10	1.85	1.35	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	-0.23	-0.15
Dec '16	-0.40	-0.35	-0.10	-0.25	-0.17
Mar '17	-0.50	-0.40	-0.15	-0.30	-0.20
June '17	-0.50	-0.40	-0.15	-0.30	-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	0.25	0.38	0.75	0.42	0.47
Dec '16	0.10	0.25	0.65	0.35	0.40
Mar '17	0.10	0.20	0.60	0.35	0.40
June '17	0.10	0.20	0.60	0.35	0.45

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Fed rate hikes needed for dollar gains

A notable feature of currency markets this year has been the softer tone to the US dollar. This is reflected in EUR/USD trading up around $1.13 and USD/JPY falling to around ¥100. Meanwhile, currencies like the Australian and New Zealand dollars have made significant gains against the greenback during 2016, despite their Central Banks cutting interest rates. Even the under pressure UK currency has managed to hold its own against the dollar since early July.

The dollar has been weighed down by the lack of rate hikes from the Federal Reserve this year. The indications from the Fed at the start of the year were that four rate hikes were likely in 2016, but as we enter the final quarter, none have been delivered. However, the Fed clearly signalled at it September meeting that a rate increase was likely before end year.

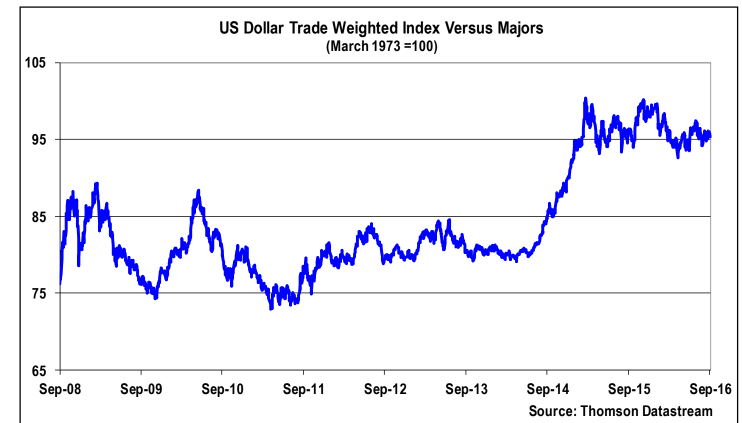
Markets are not fully pricing in a rate hike until Q2 next year and only see one rate increase in total between now and end 2017, with just one further rate hike to follow by end 2018. Thus, markets do not see official rates rising to 1% in the US over the next couple of years. The expectation by the market of a continuation of a low interest rate environment in the US is limiting the upside potential of the dollar.

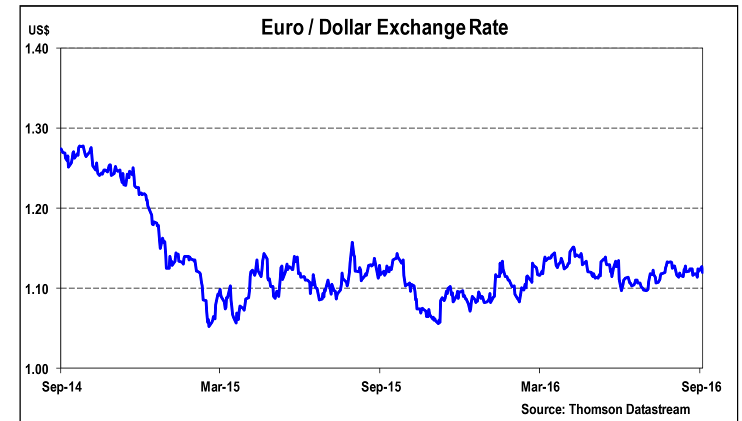
Meanwhile, the euro also continues to face some challenges. The combination of Brexit uncertainty and the associated risks for the EU, as well as a sluggish Eurozone economy are headwinds for the currency. There is also the potential for further ECB easing, with the possibility of the deposit rate being cut by 10bps to –0.5%, as well as an extension to the QE programme. This could exert some downward pressure on the currency.

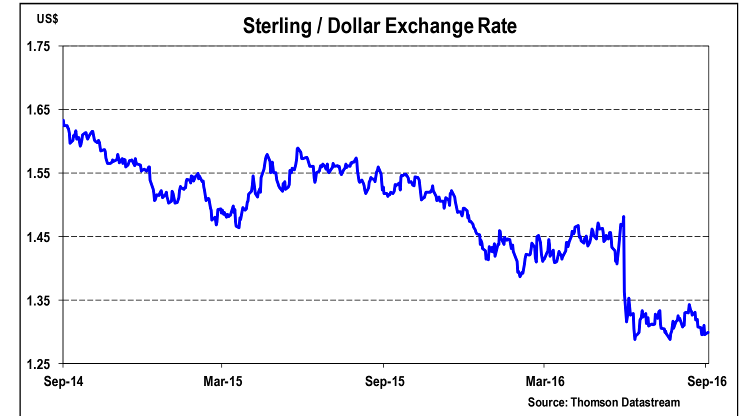
Overall, though, we do not expect a breakout from the $1.06-1.16 trading range that has been evident for EUR/USD since early 2015. Indeed, the EUR/USD pair has been confined to a $1.10-1.15 range since the start of March. Any rate moves by the Fed or ECB in the near-term are likely to be modest. Thus, we expect the EUR/USD pair to continue to trade in its range of $1.10-1.15 in the coming months. It could test the bottom of this range at $1.10 if, as we think likely, a US rate materialises before year end. However, it could move up to $1.15 if the Fed disappoints again on rates hike hopes and the ECB keeps policy on hold.

Turning to 2017, we would need to see further rate hikes by the Fed for the dollar to resume its uptrend. The Fed is projecting two rate hikes next year which has not been priced in by the market. We see at least one rate increase which should allow the dollar to edge higher. One other factor to bear in mind is the US Presidential election. A win for Mr Trump could shift the market focus from the Fed to the White House and introduce a lot of uncertainty, with considerably more volatility in financial markets.

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 ¥100, with the euro declining from ¥130 to ¥112 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 over the summer, with the dollar/yen rate settling down at just above the ¥100 level since July and the yen trading in a ¥112-116 range against the euro. The yen may remain range bound in the coming months and, indeed, could lose some ground to the dollar if US rates are hiked.







Forex Market Outlook

Sterling stabilises after sharp Brexit fall but still looks vulnerable

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.

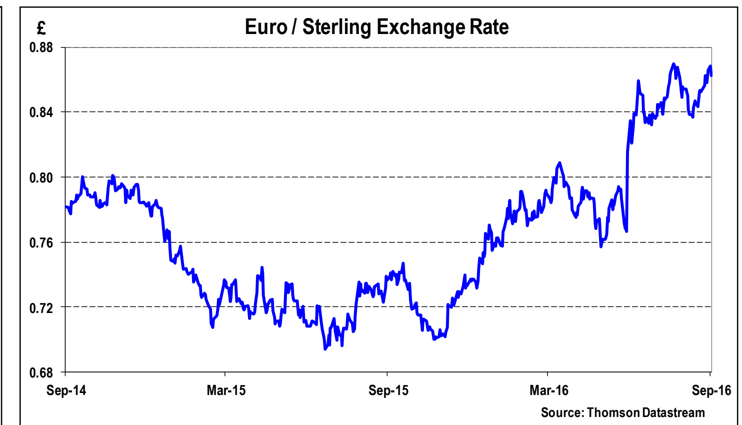
These gains, though, have largely unwound this year because of concerns over Brexit. Sterling weakened during the first half of the year in the run-up to the referendum vote on June 23rd. The euro rose by some 10% against sterling, climbing from 70p in late 2015 to around the 78p level. GBP/USD also fell from a high of $1.59 in mid-2015, to a $1.40-1.46 trading range ahead of the vote. In the days leading up to the referendum vote though, markets' concerns eased somewhat and they moved to price in a 'remain' win. This saw GBP/USD trade back up towards $1.50 and EUR/GBP move back down near 76p.

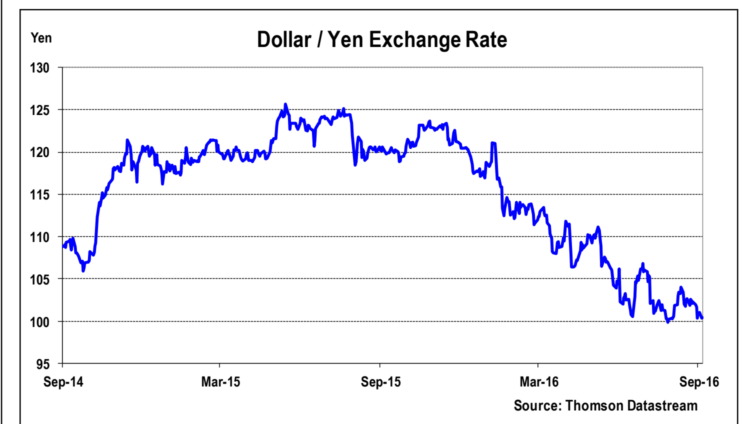
Sterling went into sharp decline, though, on the unexpected referendum victory for the 'leave' campaign. The currency fell by some 14% against the dollar, falling through the key resistance level at $1.37-1.38 and plummeting to 30-year lows below $1.30 by early July. Cable has remained quite range-bound since then, trading between $1.29 and $1.33. Sterling's post referendum weakness also greatly impacted EUR/GBP, with the pair initially trading as high as 86p before moving into an 83-87p range. The British currency has been on a weakening trend within this range recently, as concerns mount that the UK may be facing a 'hard' Brexit.

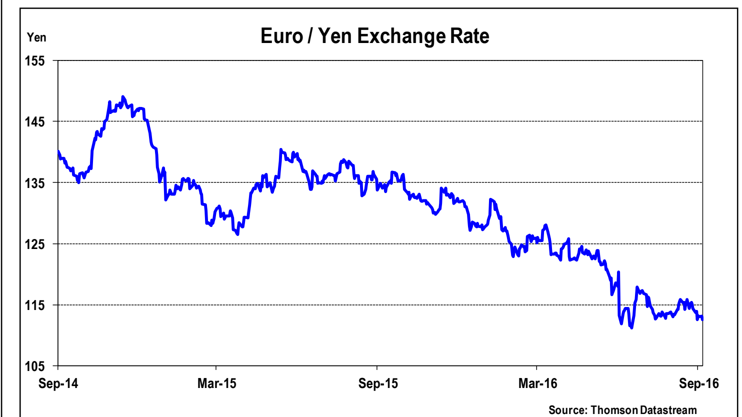
The referendum outcome and the uncertainty associated with it, are serious headwinds for the UK's economy and sterling. The UK has yet to trigger Article 50 of the Treaty on European Union to start the official exit process. Current indications are that this may not happen until early next year. The EU Treaty then provides for a two year period for the negotiations on an EU exit. However, the negotiations on the future trading relationship between the EU and the UK may not begin until after the UK leaves the EU, so the exit deal may just amount to an interim arrangement. The outcome of these trade discussions will ultimately determine the long run implications of Brexit for the UK economy.

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. While a recession is not being forecast, slower UK growth seems likely despite a looser policy stance and the marked depreciation of the currency. Sterling is vulnerable to further downside against the backdrop of a likely slowdown in the UK economy, possible further BoE policy easing and continuing uncertainty. The uncertainty could last for a good number of years given that the UK negotiations with the EU are likely to be difficult and prolonged, extending to well beyond it's departure date from the EU.

Sterling could trade as low as $1.25 against the dollar in the months ahead, on Brexit concerns. The GBP/USD pair could move even lower in 2017, declining below $1.20 if fears grow that the UK could be facing a 'hard' Brexit and lose access to the Single Market. The EUR/GBP cross is likely to move higher. The pair is trading around the 86-87p level at present and the euro could rise to 88p or above by year end. Looking further ahead, the pair may well climb to its 2011 high of 90p if the negotiations with the EU next year prove very difficult. Overall then, while sterling has fallen a long way, the risks remain to the downside for the currency.



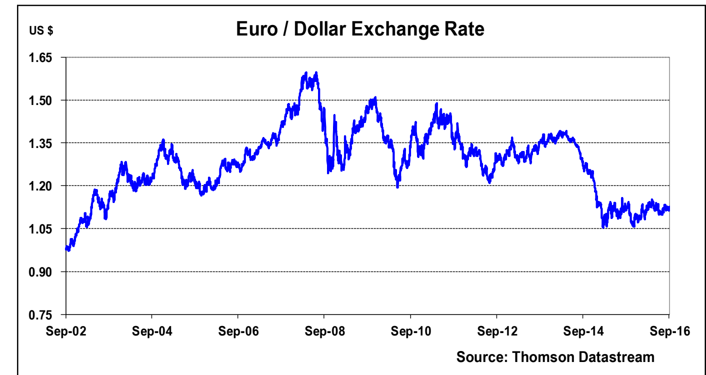


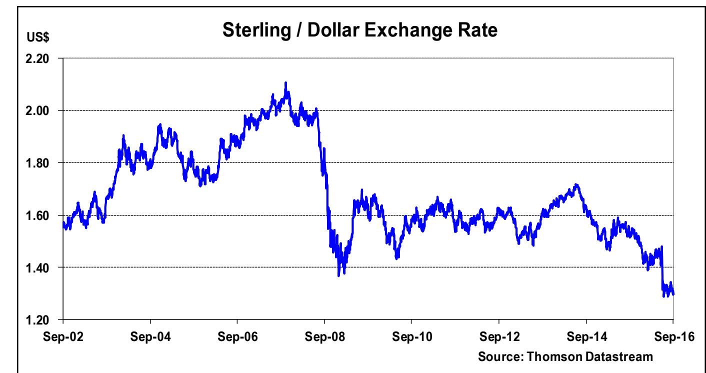


Summary of Exchange Rate Forecasts

("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	1.121	1.08-1.14	1.07-1.13	1.06-1.12	1.05-1.11
GBP	0.862	0.85-0.91	0.86-0.92	0.87-0.93	0.88-0.94
JPY	112.84	109-115	109-115	109-115	109-115
CHF	1.09	1.09	1.08	1.08	1.08
US Dollar Versus					
JPY	100.64	98-104	99-105	100-106	101-107
GBP	1.301	1.23-1.29	1.21-1.27	1.18-1.24	1.16-1.22
CAD	1.32	1.32	1.31	1.30	1.30
AUD	0.77	0.77	0.78	0.79	0.79
NZD	0.73	0.73	0.74	0.75	0.75
CNY	6.67	6.70	6.72	6.75	6.77
Sterling Versus					
JPY	131	127	126	125	124
CAD	1.72	1.67	1.62	1.57	1.54
AUD	1.70	1.64	1.59	1.53	1.51
NZD	1.79	1.73	1.68	1.61	1.59





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