

Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit



21st August 2019

- Global economy has moved onto a slower growth path, with manufacturing in recession as world trade and business investment weaken
- Central banks start to cut rates on concerns about the outlook for growth amid very low inflation
- Fed lowers rates for first time since 2008, with market expecting more cuts over next year. ECB to announce significant easing measures in September. BoE on hold amid Brexit uncertainty
- Dollar retains firm tone, while yen and Swiss franc benefit from safe haven flows
- Sterling loses significant ground over the summer on growing risk of a no-deal Brexit under a new eurosceptic Prime Minister, who is determined that UK will leave the EU at end October

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World economy moves onto a slower growth trajectory

The IMF in its recent update to its World Economic Outlook publication noted that global growth remained subdued, especially in relation to fixed investment. It stated that while there was better than expected growth in advanced economies, such as the US and Japan in the first half of the year, there was weaker than anticipated activity levels in emerging and developing economies.

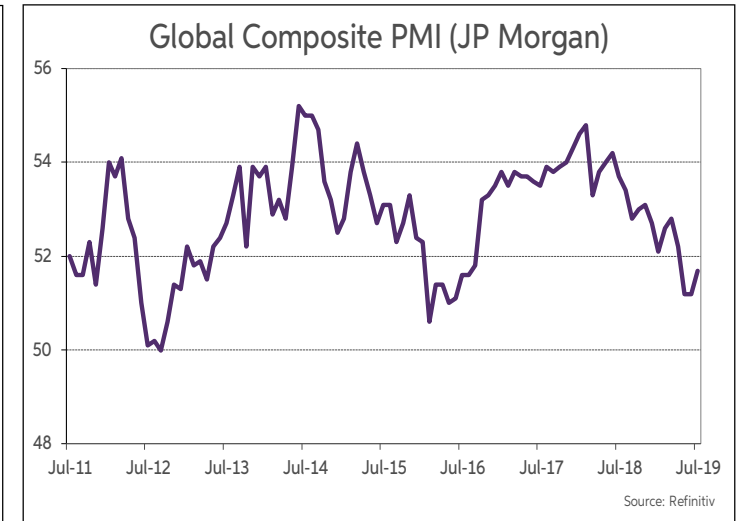
A key reason for the below par performance of global growth is the weakness in manufacturing activity. This reflects subdued business investment and reduced consumer spending on 'big ticket' items such as cars. The IMF interpreted these developments as an indication that both businesses and households are holding back on 'long range' spending amid heightened policy uncertainty, including in relation to global trade and Brexit. Slower growth in global trade is also reflective of more muted spending patterns among businesses and households. One bright spot has been the services sector, where despite losing some momentum, activity levels remain at solid levels, which in turn has supported employment growth.

The IMF is expecting that the global economy will grow by 3.2% in 2019 and pick up to 3.5% in 2020. This is down from the growth rates of 3.6% and 3.8% recorded in 2018 and 2017, respectively. The slowdown in activity is widespread. GDP growth in advanced economies is forecast to slow to 1.9% this year and 1.7% next year. However, with many economies very near to full employment, this is close to their trend rate. Growth in the US economy, in particular, is expected to lose momentum as the fiscal stimulus there fades.

Both the IMF and OECD see the risks to the economic outlook as being tilted to the downside. Debt levels remain high in many countries, leaving them particularly vulnerable to shocks. We have already seen countries with high debt levels, such as Turkey and Argentina, enter recession. Meanwhile, concerns remain about the health of the Chinese economy, which could slow more sharply than expected. The further escalation in global trade tensions recently is unwelcome given the slowdown in international trade and adds to the current heightened policy uncertainty. A sharp correction in financial markets is a risk in this uncertain environment.

However, the general expectation is that despite the numerous downside risks, the global economy will be able to register moderate growth and avoid a severe downturn in activity. Monetary policy will remain accommodative everywhere, with some central banks already cutting rates and others expected to soon follow suit. Indeed, the sharp fall in bond yields over the past year represents a significant easing in monetary conditions globally, while there has been a marked improvement in financial conditions generally this year, which should support growth. Fiscal policy also remains supportive of growth in most economies. Meantime, household spending power is being boosted by a pick-up in wage growth at a time of continuing subdued inflation. Labour markets are strong in most countries, with unemployment at multi-decade lows.

Considerable uncertainty, though, persists about the prospects for the global economy so a careful eye will need to be kept on the incoming data, especially business surveys. It would be especially encouraging to see an improvement in manufacturing activity. An easing in global trade tensions, in particular a resolution of the US-China trade war, would be a positive development for the sector and improve the growth prospects for the world economy. On the other hand, it would be a real worry if the services sectors of economies lost significant momentum, or we started to see signs of weakness appear in labour markets in the coming months.



GDP (Vol % Change)

	<u>2017</u>	<u>2018</u>	<u>2019 (f)</u>	<u>2020 (f)</u>
World	3.8	3.6	3.2	3.5
Advanced Economies	2.4	2.2	1.9	1.7
US	2.2	2.9	2.6	1.9
Eurozone	2.4	1.9	1.3	1.6
UK	1.8	1.4	1.3	1.4
Japan	1.9	0.8	0.9	0.4
Emerging Economies	4.8	4.5	4.1	4.7
China	6.8	6.6	6.2	6.0
India	7.2	6.8	7.0	7.2
World Trade Growth (%)	5.5	3.7	2.5	3.7
Advanced Economies				
Inflation (PCE %)	1.7	2.0	1.6	2.0

Source: IMF World Economic Update, July 2019

Global monetary policy shifts back into easing mode

Monetary policy easing is very much back on the agenda for the main global central banks. This was most clearly illustrated by the US Federal Reserve's recent action to cut rates for the first time since 2008. Other central banks including in Australia, New Zealand, India and Thailand have also cut interest rates recently. This represents quite a turnaround in sentiment from last autumn, when policy tightening was expected from central banks over the course of 2019-20. This shift in policy stance comes amid mounting concerns about the growth prospects for the world economy, including escalating international trade tensions. At the same time, the persistence of very subdued inflation and falling inflationary expectations is also concerning central banks, especially the ECB.

The Fed's decision to cut the target range for the key fed funds rate by 25bps to 2.00-2.25% had been widely anticipated by markets. However, Fed Chair Powell emphasised that this did not herald the start of a lengthy cutting cycle. Instead he referred to it as a "mid-cycle adjustment to policy". The Fed viewed the rate reduction as very much a pre-emptive measure in light of the more challenging global economic environment. Indeed Chair Powell commented that the outlook for the US economy remains favourable, with nothing in the domestic sector presenting a major near term threat. The Fed's concerns relate to downside risks "coming from abroad".

Despite this guidance from the Fed, markets are anticipating a series of rate cuts from the US central bank in the coming 12 months. Futures contracts are pricing in around 110bps of additional cuts by late 2020, including 50-75bps before the end of this year. While the Fed has given a clear signal that it is not about to engage in a sustained rate cutting cycle, at the same time, it has been careful to keep its options open regarding the interest rate outlook. In this regard, it has not ruled out further rate cuts. Indeed, a rate cut in September is now widely expected. For it to move to substantial rate cuts more in line with market expectations, it would require a significant deterioration in the US economy, escalating global trade tensions and/or dislocation in financial markets. Thus, we expect only one or two further 25bps rate cuts from the Fed.

In the UK, the BoE is very much in a wait-and-see mode. It is awaiting for clarity on how Brexit will evolve. However, what is clear is that it is now less inclined to increase interest rates in light of increasing risks of a no deal Brexit, a weaker domestic economy and a more uncertain global economic backdrop. A no deal Brexit would bring rate cuts onto the agenda, while a smooth Brexit or a decision to remain in the EU could bring rate hikes into view next year if growth picks up in the UK and elsewhere. Futures contracts indicate that the market is expecting the next move from the BoE to be a rate cut. A 25bps reduction in the bank rate is envisaged by January 2020.

Turning to the ECB, the July Governing Council meeting saw the central bank indicate that it will ease policy at its next meeting in September. The ECB re-introduced its easing bias in relation to interest rates as well as emphasising that it is "determined to act" and stands ready to adjust all of its instruments to achieve its inflation target of close to, but below 2%. One ECB Council member has referred to a "very strong package of policy measures". This is likely to include a cut to interest rates, which could involve the introduction of a tiered system, further changes to its forward guidance, as well as restarting asset purchases under its QE programme.

Markets are anticipating a cut of 10bps in the deposit rate next month and are factoring in another 10bps reduction by the turn of the year. Futures contracts indicate that another 15bps rate cut is priced during 2020, bringing the ECB deposit down to -0.75%, with rates expected to remain negative for many years to come.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	2.125	2.15	1.95	1.53	1.39
Sept '19	1.875	1.90	1.80	1.50	1.35
Dec '19	1.625	1.70	1.70	1.55	1.45
Mar '20	1.625	1.75	1.80	1.70	1.65

* 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	-0.45	-0.42	-0.55	-0.50
Sept '19	-0.50	-0.55	-0.45	-0.55	-0.50
Dec '19	-0.60	-0.55	-0.50	-0.50	-0.45
Mar '20	-0.60	-0.55	-0.50	-0.45	-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	0.75	0.76	0.85	0.70	0.65
Sept '19	0.75	0.75	0.85	0.70	0.65
Dec '19	0.75	0.80	0.90	0.75	0.75
Mar '20	0.75	0.85	1.00	0.85	0.90

* Swap Forecasts Beyond 1 Year

Dollar retains firm tone, while yen & Swiss franc rise on safe-haven buying

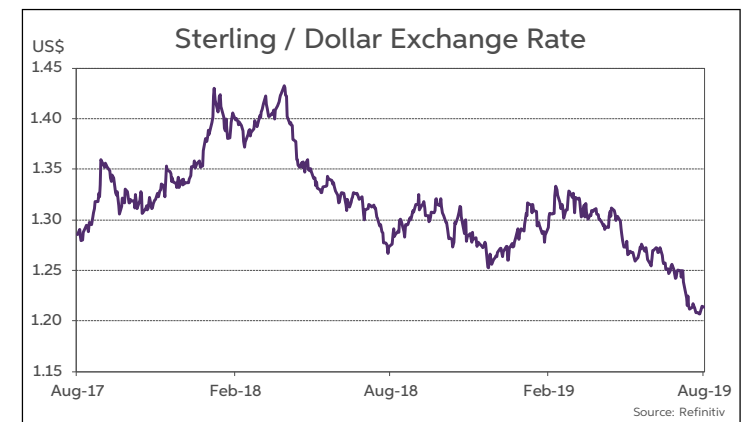
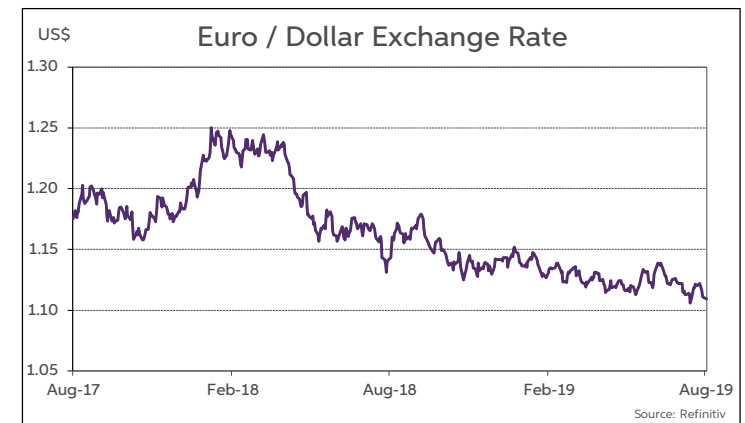
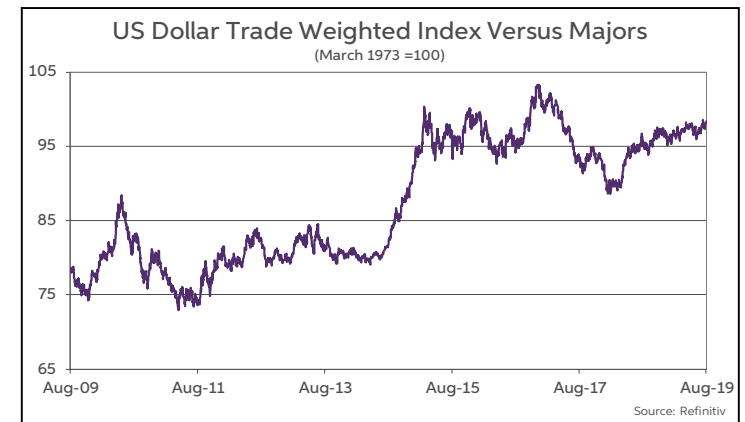
The dollar has been at elevated levels for the past four and a half years. It has been aided by strong US economic growth. Indeed, the current economic expansion has now become the longest on record. As a result, the jobless rate has fallen to a near 50 year low of 3.7%. Widening interest rate differentials and bond spreads have also helped the US currency, with the Fed steadily tightening policy in 2017-18, raising the fed funds rates by 200bps to a 2.25-2.5% range by the end of last year. The recent 25bps Fed rate cut has not dented the currency as US rates remain well above elsewhere and other central banks have started to ease policy too.

FX positioning, though, has become extremely long the dollar, which suggests that the upside for the greenback may be limited from here, especially as it is already at quite elevated levels against many currencies. Other factors may also be turning against the dollar. The US economy looks to be moving on to a slower growth path, with the Fed expected to lower rates by a further 100bps or more in the coming year, to help sustain the expansion in activity. The marked jump in the repatriation of funds following the cuts in US corporate taxes last year is also likely to abate, lessening demand for the currency. The large twin US deficits (fiscal and BoP) also remain a concern for the dollar over the medium term.

Nonetheless, the relative strength of the US economy, wide interest rate differentials and geopolitical uncertainties all remain supportive of the US currency. The persistence of very low interest rates elsewhere is also making it difficult for other currencies to make ground against the dollar. Furthermore, political uncertainty in the EU, especially with regard to Italy, the marked slowdown in the Eurozone economy, as well as likely further significant policy easing by the ECB, are all headwinds for the euro. Meanwhile, sterling is being weighed down by concerns over Brexit, with cable dropping back down to near the \$1.20 level from above \$1.30 earlier in the year.

The euro has edged down to around the \$1.11 level in the past month having largely traded in a tight \$1.12-1.14 band in the first half of the year. Overall, it has been confined to a relatively narrow range against the dollar since last autumn, albeit with a somewhat softer bias. We would expect EUR/USD to trade in a narrow range of \$1.10-1.14 over the balance of this year and into 2020. There is strong technical support for the euro at around the \$1.09-1.10 level. The dollar is only likely to weaken if it becomes apparent that the economy is heading towards recession and US rates have to be cut very sharply. It is worth noting that the EUR/USD rate has spent very little time above the \$1.20 level since 2014. Thus, it would probably take significant rate cuts in the US to drive the euro above this level, given the ECB is also likely to be easing policy further in the period ahead.

Two currencies which have risen against the dollar this year are the yen and Swiss franc. They have benefitted from safe-haven buying at a time of increased geo-political tensions and greater risk aversion in markets. The dollar has fallen from ¥112 in the spring to around ¥106 in recent weeks. However, ¥105-106 is a good support level for the dollar that may prove hard to overcome for the yen, unless there are large Fed rate cuts. The dollar could fall towards ¥100 in those circumstances, especially if financial markets are also under pressure. Meanwhile, the dollar has also lost ground against the Swiss franc since the spring, declining from CHF1.02 to around CHF0.98. The EUR/CHF rate has also moved lower in this period, falling from 1.14 to below 1.09. It could now trade in a 1.07-1.10 range for as long as risk aversion remains a dominant market feature.



Sterling loses considerable ground on growing risk of a no-deal Brexit

Sterling fell sharply to lows of 93p against the euro and \$1.20 versus the dollar following the UK referendum vote to leave the EU in mid-2016. It then recovered some ground to largely trade in an 87-91p range against the euro between September 2017 and end 2018, as markets awaited clarity on what shape Brexit would take. Growing hopes earlier this year that there would be a soft, orderly Brexit saw the euro fall to an 85-87p range in the spring. Against the dollar, sterling moved back above the \$1.30 level.

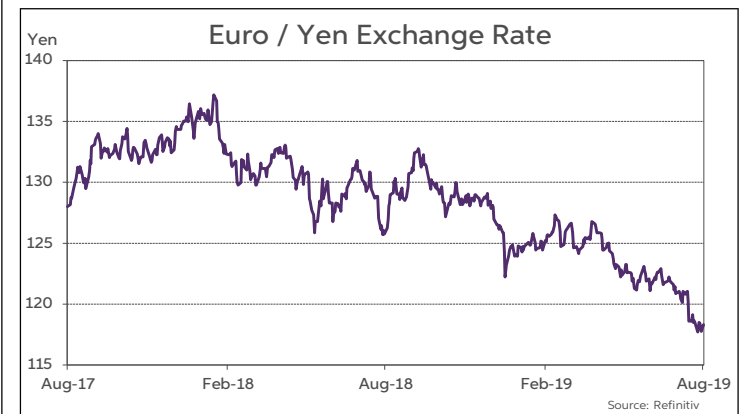
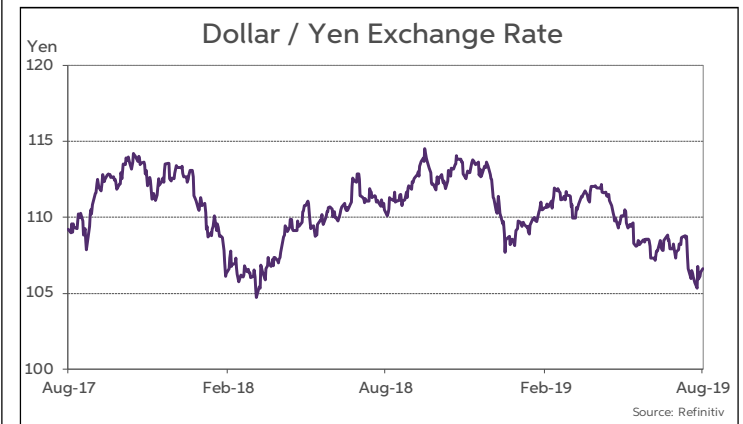
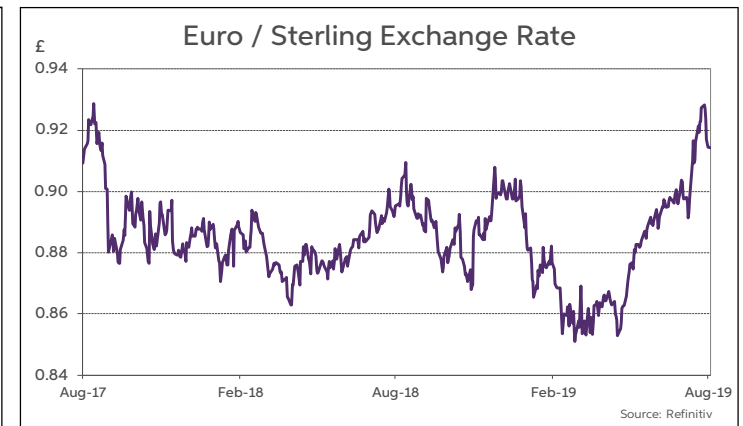
Sterling, though, has come under downward pressure again over the summer, with Theresa May stepping down as Prime Minister and being replaced by a leading Eurosceptic, Boris Johnson, who wants to take the UK out of the EU at end October, with or without an exit deal. Thus, the risk of a no-deal Brexit has risen considerably in recent months. This has seen the euro rise back up to the 93p level, while cable has fallen back close to \$1.20.

With the new Prime Minister determined to take the UK out of the EU, we look to be heading for another cliff-edge Brexit date at end October. The default position is that the UK will leave the EU without a deal at end October unless there is a further extension to Article 50. Such an extension would again require the agreement of all EU 27 member states. However, there were signs at the April 10th EU summit that at least one country seems keen to bring a conclusion to the Brexit process. Furthermore, the new UK Prime Minister does not want an extension.

The UK Parliament has indicated that it wants to avoid a no deal Brexit, but has yet to decide on how this can be achieved. It may well be that Parliament will either have to approve a Withdrawal Agreement or decide on another course of action to overcome the Brexit impasse, such as a fresh referendum or even the formation of a new national unity government, if a no-deal Brexit is to be avoided at end October. The EU would almost certainly grant a further extension to Article 50 in these circumstances, or in the event of a general election.

Overall, we expect sterling to remain on the back foot in the next couple of months in the run-up to the end October Brexit deadline. There is strong support for the currency at the 93p level, so EUR/GBP may trade in a 92-93p range in the coming weeks. If the 93p level gives way, there may be some support for the currency at around 94-95p, where it traded in late 2008/early 2009. Indeed, the euro briefly rose to as high as 97.5p at end 2008 during the financial crisis at that time. Sterling would most likely come under even greater pressure this time if a no-deal hard Brexit becomes an increasingly likely prospect, given that it would have very negative consequences for the UK economy. The currency could fall by 10 per cent from current levels, hitting parity against the euro.

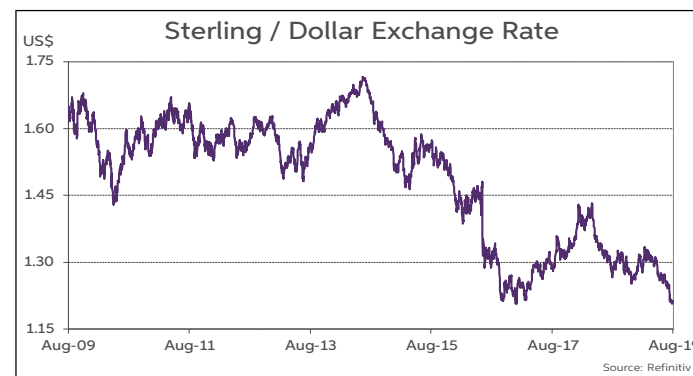
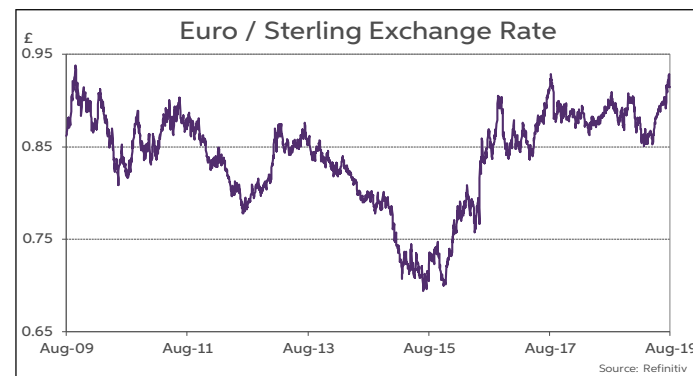
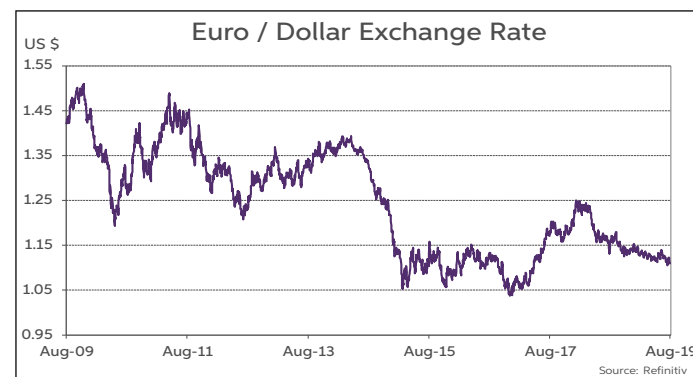
Obviously, if a no deal Brexit is avoided, there would be scope for sterling to bounce, especially as market positioning is very short the currency. The euro could fall back towards the 85p level quite quickly. We would note that even if a Withdrawal Agreement is eventually ratified and the UK departs the EU with a deal, there could still be choppy waters ahead for sterling in the next couple of years. Talks will still need to take place after the UK leaves on the future relationship between the UK and EU, with the aim of concluding a broad trade deal. These are likely to prove to be difficult negotiations. It is very unclear what the outcome of such talks would be, so uncertainty over the final shape of Brexit could persist even in the period after the UK leaves the EU. This could weigh on the currency. Obviously, the most favourable scenario for sterling is if the UK decides to remain in the EU, most probably as the result of another referendum. The euro could fall back towards 80p in this situation.



Summary of Exchange Rate Forecasts

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

	Current	Q3-2019	Q4-2019	Q1-2020	Q2-2020
Euro Versus					
USD	1.109	1.08-1.14	1.09-1.15	1.10-1.16	1.11-1.17
GBP	0.915	0.89-0.95	0.85-0.91	0.84-0.90	0.83-0.89
JPY	118.15	115-121	116-122	116-122	118-124
CHF	1.09	1.08	1.08	1.09	1.09
US Dollar Versus					
JPY	106.50	103-109	103-109	102-108	103-109
GBP	1.213	1.18-1.24	1.24-1.30	1.27-1.33	1.30-1.36
CAD	1.33	1.33	1.31	1.29	1.28
AUD	0.68	0.68	0.69	0.70	0.71
NZD	0.64	0.64	0.65	0.66	0.67
CNY	7.06	7.05	7.00	6.95	6.90
Sterling Versus					
JPY	129	128	135	137	141
CAD	1.61	1.60	1.67	1.68	1.70
AUD	1.79	1.78	1.84	1.86	1.87
NZD	1.89	1.89	1.95	1.97	1.99



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