

Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit



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- Successful vaccine rollout sees marked pick-up in economic activity this year, although, the rebound has lost momentum since mid-year due to a rise in Covid cases and supply bottlenecks
- Rise in inflation this year proves far greater than expected as supply shortages and surging energy costs fuel price pressures. Inflation to take longer to fall back than first anticipated also
- Fed and BoE turn more hawkish on rates, with first BoE rate rise expected in Q1 2022 and Fed seen hiking by end-2022. Fed signals significant US rate hikes could be on cards in 2023-24
- Fed also likely to begin tapering before year end. ECB much more cautious on policy tightening
- Dollar regains the upper hand on FX markets on more hawkish Fed and higher US yields. Looks well underpinned. But firming of UK rate hike expectations does not provide a fillip for sterling

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Inflation on the rise, while economic recovery loses some momentum in Q3

Growth forecasts for the global economy in 2021-22 were upped quite considerably during the first half of the year. This was mainly on the back of the relatively successful vaccine rollout programmes, as well as economies being better able to cope with restrictions and high Covid case numbers, and because of additional fiscal supports being provided by governments. The IMF projected strong global growth of 6% and 4.9% for 2021 and 2022, respectively, in its mid-year update. Meanwhile, world trade is recovering strongly after contracting by 8.3% last year. A rise of 9.7% is being pencilled in for global trade this year by the IMF, followed by growth of 7% in 2022.

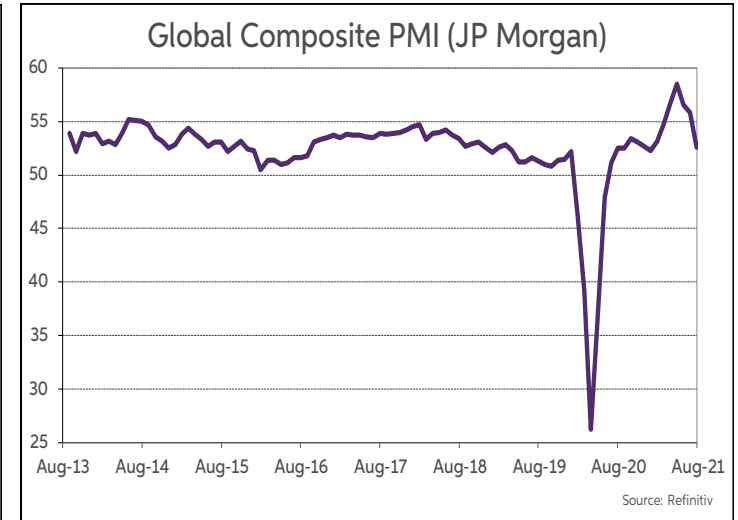
Since mid-year, though, economic data have started to come in below expectations. We have seen weaker PMI reports from all the main economies, albeit still consistent with strong global growth. Retail sales have lost momentum, most notably in the UK, which also saw a weak GDP print for July. The August payrolls report in the US was much weaker than anticipated. We have now started to see growth forecasts for 2021 being lowered for the US and UK. The OECD September Economic Update saw this year's US GDP forecast cut from 6.9% to 6%, with a similar downgrade being made by the Fed. The OECD lowered its UK 2021 GDP growth forecast by 0.5% to 6.7%, while the BoE recently noted that GDP growth in Q3 is likely to be circa 1% lower than initially expected.

There appears to be two factors at work in slowing the pace of recovery. Firstly, the much more transmissible variant of Covid-19 has seen a fresh surge in new case numbers over the summer. This is of particular concern in countries where vaccination rates are low or there is considerable vaccine hesitancy. It is weighing on confidence and consumer behaviour. Secondly, supply bottlenecks are becoming more acute in some sectors, with shortages of raw materials, key inputs and workers, as well as capacity difficulties in transportation, resulting in delays and rising supplier delivery times. This is holding back output growth in some industries, most notably the auto sector. In brief, the supply side of economies is struggling to keep pace with the surge in demand.

Not surprisingly, supply bottlenecks and shortages are adding to inflationary pressures. After falling sharply last year in the midst of a global recession, inflation has picked up much more strongly than anticipated in 2021. Rising energy prices as well as unwinding of other price falls last year, including VAT cuts, have been key factors in the marked acceleration in inflation this year. The CPI rate has risen above 5% in the US and is set to breach 4% in the UK before end year and rise close to 4% in the Eurozone.

The OECD and IMF, as well as the main central banks, acknowledge the upward pressure on input costs this year and marked pick up in inflation. However, they believe that sizeable spare capacity in the global economy should prevent a sustained rise in underlying inflation. They expect supply and demand to come more into balance next year resulting in an easing of bottlenecks. The biggest inflation risk could be the labour market, if a shortage of workers puts sustained upward pressure on wages. US data are being closely watched in this regard, as job vacancies there have risen to historically high levels, while the jobless rate is declining at a rapid pace. Overall, while the rise in inflation is still generally expected to be transitory, it now seems likely that it will take somewhat longer for it to fall back to target or below, than was initially expected, especially in the US and UK.

Meanwhile, growth is expected to remain strong next year helped by the supportive stance of monetary and fiscal policies, and the rundown of some of the large build up in private savings since early 2020. The OECD sees the G20 economies growing by close to 5% next year. Growth is expected to decelerate to trend thereafter as the post-recession surge in demand abates and policy turns less accommodative.



GDP (Vol % Change)

	<u>2019</u>	<u>2020</u>	<u>2021 (f)</u>	<u>2022 (f)</u>
World	2.8	-3.2	6.0	4.9
Advanced Economies	1.6	-4.6	5.6	4.4
US	2.2	-3.5	7.0	4.9
Eurozone	1.3	-6.5	4.6	4.3
UK	1.4	-9.8	7.0	4.8
Japan	0.0	-4.7	2.8	3.0
Emerging Economies	3.7	-2.1	6.3	5.2
China	6.0	2.3	8.1	5.7
India	4.0	-7.3	9.5	8.5
World Trade Growth (%)	0.9	-8.3	9.7	7.0
Inflation -CPI				
Advanced Economies (%)	1.4	0.7	2.4	2.1

Source: IMF World Economic Update, July 2021

Central banks signal withdrawal of some of their monetary stimulus to begin soon

Central banks globally pulled out all the stops last year to try and ameliorate the most severe impacts of the COVID-19 pandemic on their economies and financial systems, which were hit by a sudden and very deep recession. Interest rates were cut sharply to 0.125% and 0.1% in the US and UK, respectively. Enormous QE bond purchase programmes were put in place and measures adopted to enhance the supply of liquidity to businesses, and ease funding pressures in markets. As a result, monetary conditions have been exceptionally loose over the past eighteen months.

Economies have rebounded at a much quicker than anticipated pace this year, resulting in marked upward revisions to 2021 growth forecasts. The rise in inflation has been much greater than expected this year also, although central banks remain of the view that it will prove transitory. Meanwhile, labour markets are also tightening more quickly than expected, with few enough signs to date of scarring from the recession. Given the much improved macro economic backdrop, central banks have started to send signals that it will soon be time to start rowing back on some of the extraordinary monetary stimulus measures that has been put in place over the past eighteen months. However, they have also emphasised that this well be done at a moderate pace and that policy will remain supportive of activity for quite some time.

At the FOMC meeting in June, there was a significant shift in the interest rate projections of Fed policymakers. Eleven of the 18 FOMC members indicated they expected interest rates would start to rise in 2023, compared to in 2024, previously. This was brought forward even more at the September FOMC meeting, with half of the policymakers anticipating that rates would start to rise next year. The median FOMC projection now is for a small rise of 12.5bps in the funds rate to 0.25% by end 2022, with the Fed seeing rates getting to 1% by end 2023 and 1.75% at end 2024. Indeed, the Fed has now moved ahead of market rate hike expectations.

The Fed is also getting much closer to tapering or scaling back asset purchases under its QE programme. The Fed Chairman indicated that if the recovery in the economy continues broadly as expected, then a decision on tapering could come as soon as at the next Fed policy meeting in early November. Furthermore, he indicated that a gradual tapering process could see the QE asset purchase programme conclude around the middle of 2022.

The Bank of England has also turned more hawkish, with the MPC meeting in September noting that the case for “some modest tightening of monetary policy” has strengthened recently. As things stand, its current asset purchase programme is set to finish around the end of the year. Markets expect that a rate hike will soon follow in Q1, followed by further increases during the year. Futures contracts are pricing in that UK rates could be hiked to 0.75% by end 2022 from 0.1% at present, though only one further 25bps hike is seen over 2023-24.

Rate hike expectations are much less pronounced in some other markets, most notably in the Eurozone and Japan. However, markets have brought forward the date for the first ECB rate increase to mid-2023 from mid-2024 just a couple of months ago. The key ECB deposit rate is pitched at -0.5% at present and markets believe it will remain negative until 2025. Thus, rates are still expected to remain deep in negative territory in the Eurozone over the next number of years. The ECB, though, is set to lower the monthly pace of monthly asset purchases somewhat in Q4 2021, though QE asset purchases are likely to continue next year, albeit at a more modest level.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.125	0.13	0.23	0.38	1.03
Dec'21	0.125	0.14	0.24	0.40	1.05
Mar'22	0.125	0.15	0.25	0.42	1.07
June'22	0.125	0.15	0.28	0.45	1.10

* Swap Forecasts Beyond 1 Year

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	-0.50	-0.56	-0.49	-0.44	-0.20
Dec'21	-0.50	-0.56	-0.48	-0.43	-0.20
Mar'22	-0.50	-0.55	-0.47	-0.42	-0.18
June'22	-0.50	-0.55	-0.46	-0.40	-0.15

* Swap Forecasts Beyond 1 Year

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.10	0.08	0.37	0.70	0.98
Dec'21	0.10	0.20	0.50	0.75	1.05
Mar'22	0.35	0.40	0.65	0.85	1.15
June'22	0.50	0.55	0.75	0.95	1.20

* Swap Forecasts Beyond 1 Year

Dollar looks well underpinned

The dollar appreciated very sharply in the period 2014 to 2016 and remained at elevated levels over the rest of the decade, underpinned by relatively high US interest rates. However, it moved steadily lower in the final three quarters of last year, losing 12% against the other major currencies, as US rates were cut to virtually zero. The dollar, though, has recovered ground this year, helped by a firming of US interest rates along the curve on the back of big upgrades to US growth and inflation forecasts, as well as bouts of risk aversion on financial markets.

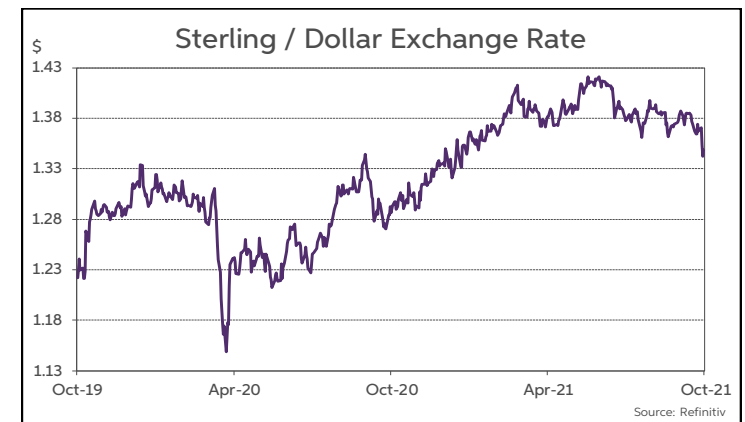
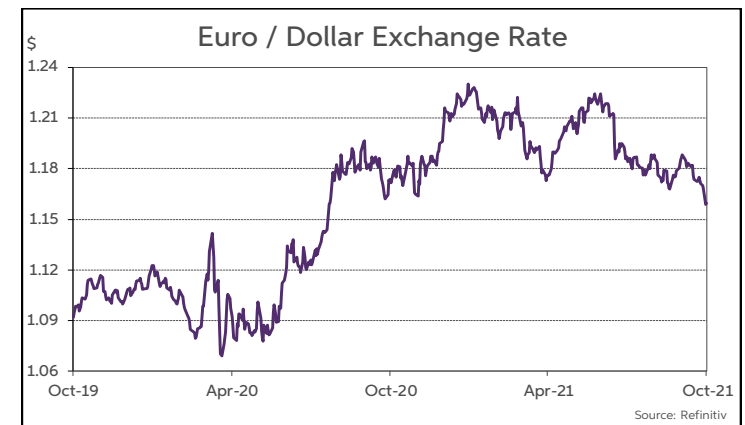
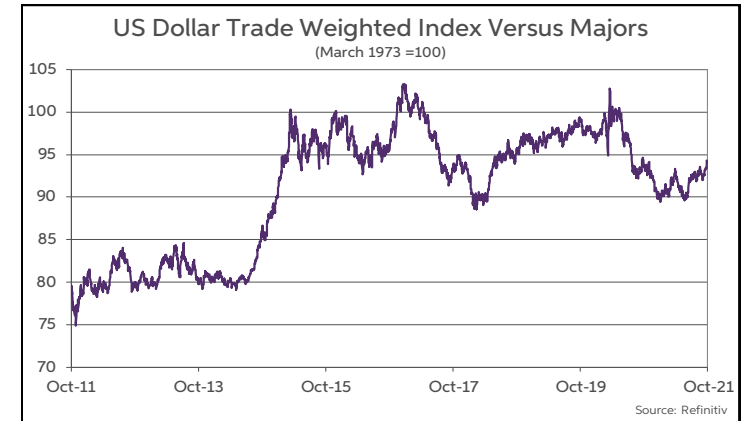
The euro-dollar exchange rate has generally traded within a relatively narrow range of \$1.17-1.23 since July last year. There has been good technical support for the single currency in the \$1.17 area, which held in the spring when the euro came under pressure, and again in late summer. The dollar has held a stronger tone since mid-year against a broad range of currencies, with the Fed preparing the ground for a wind down of asset purchases or tapering, as well as moving to more hawkish projections on interest rates. This has seen the market increasingly test the \$1.17 support for the euro, which has been pinned down below the \$1.19 since end June.

Trading ranges do break down eventually and we have seen the EUR/USD fall to below \$1.16 in recent days, its lowest level in 15 months. It is very much a dollar strength story rather than euro weakness as the greenback has been grinding higher against a broad range of currencies. There is no sign of the euro coming under major pressure or falling sharply against the US currency. We don't anticipate sharp movements in currencies in the period ahead given the daily changes in exchange rates in the past month have been modest enough.

As we have seen in recent years, interest rates are an important driver of forex markets. Rate hikes are quite possible in the US later next year, while Eurozone rates look set to stay on hold for a long time and thus remain deeply negative. Any such widening of interest rate differentials should be supportive of the dollar against the euro. In the shorter term, the dollar may also be supported by the tapering of asset purchases that the Fed is expected to commence before end 2021, given that the ECB is likely to continue with at least some buying of bonds for the next couple of years.

Meantime, we find it hard to think of what could drive the euro higher, given the outlook for continuing very low Eurozone interest rates. Indeed, it is noteworthy that the euro has been pinned down below the \$1.25 level ever since the ECB moved to negative interest rates in 2014 and there is no sign of this changing anytime soon. Overall, the balance of risk points to some further upside potential for the dollar against the euro. While support at around \$1.17 has given way for the euro, there are a number of other support levels near by that should aid the single currency. US rates hikes are also seen as being over a year away. Thus, the euro may only decline slightly to circa \$1.15 in the next couple of months as the Fed starts to taper. Further out, there is considerable support for the euro in the \$1.13-1.14 area, which could form a floor for it in the first half of 2022.

One must consider if there is anything that could undermine the US currency. One possible fly in the ointment for the dollar could be a sustained rise in inflation in the US relative to elsewhere, given that it has less spare capacity and inflation has already picked up more there than in other countries. Though US rates would have to rise, high inflation is usually a harbinger for currency weakness. Another possible headwind for the dollar may be if vaccine hesitancy results in continuing high Covid case numbers and hospitalisations in the US, restraining the pace of recovery and delaying hikes in interest rates. For now, though, the dollar looks well underpinned.



Competing forces leave sterling quite range bound

The UK currency appreciated steadily during the opening quarter of 2021, most notably versus the euro. As well as the EU-UK Brexit trade deal lifting a cloud of uncertainty around sterling, the rapid rollout of Covid vaccines in the UK was also very supportive of the currency. It allowed restrictions on activity to be eased considerably and growth forecasts for the UK economy in 2021 were revised sharply higher. As a result, markets have moved from, at the start of the year pricing in a move to negative interest rates, to now expecting that UK rates will start to rise from early next year. This has seen short-dated Gilt yields turn positive and long-term yields rise quite sharply.

EUR/GBP has been trading in a very narrow corridor of 85-87p for nearly all of the period since mid-February and is currently right in the middle of this range. Cable has been more volatile, but this reflects movements in the dollar. Sterling climbed to a high of \$1.42 in early June, but it has since fallen back to circa \$1.35 recently.

Movements in cable are likely to continue to be driven by the dollar side of the pair. It is hard, though, to call the next major move in the EUR/GBP rate. If rate hikes materialise in the UK in the first half of next year as markets expect, it could provide a fillip for sterling, especially against currencies with zero or negative interest rates like the euro. On the other hand, the recovery in the UK has lost a good deal of momentum since mid-year. There are concerns that global supply shortages in both goods and especially labour markets could be accentuated in the UK by Brexit. This may hold back the recovery in the economy and at the same time, add to inflationary pressures.

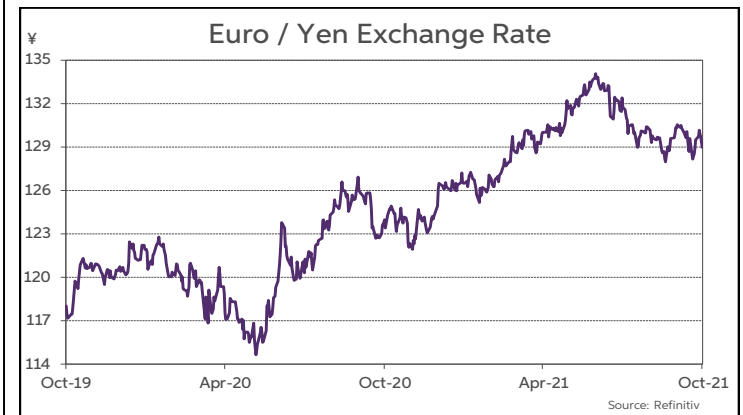
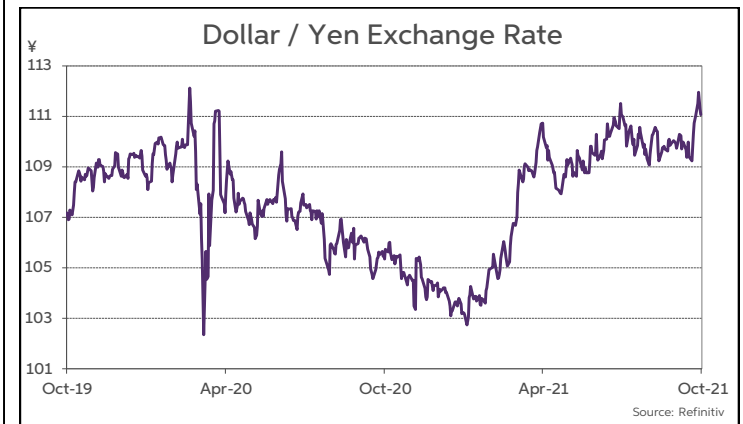
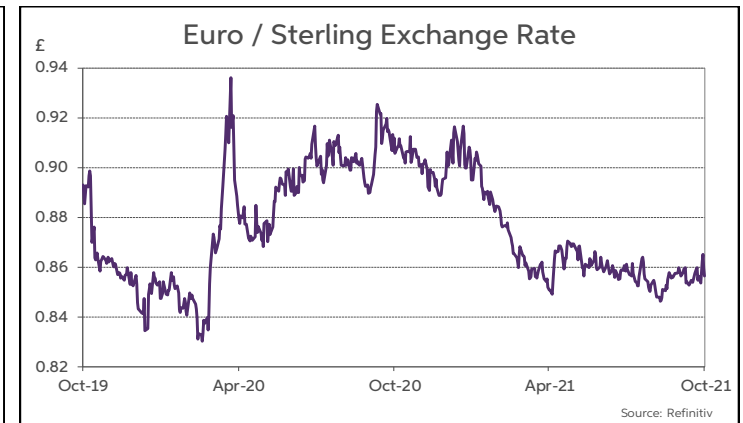
Tightening monetary policy is usually supportive of a currency when an economy is experiencing relatively strong growth. However, this is not the case where rate rises are required to dampen down relatively high inflation. Much uncertainty remains about the economic outlook in the UK. Thus, in these circumstances sterling could continue to trade in a narrow range against the euro, at least until a clearer picture emerges on UK inflation.

Yen loses ground against strengthening dollar

The yen performed strongly in recent years, registering significant gains up until the start of this year. The dollar had fallen to ¥103 by the start of 2021 from a peak of ¥125 back in 2015. Meanwhile, the euro fell from a high of ¥140 in 2015 to a trough of ¥115 in mid-2020, before recovering. The yen benefitted from its safe-haven status, a big trade surplus and large overseas holdings of foreign assets that generate flows back into the currency.

The yen, though, has lost considerable ground against the stronger dollar this year, which climbed from ¥103 in January to around the ¥110 level over the summer. Its losses, though, have been much more modest against most other currencies. The euro has risen from ¥126 in early 2021 to around the ¥130 level in recent months. There has been hardly any rise in long term interest rates in Japan this year, in marked contrast to what has happened in Europe and the US. This weighed on the yen as investors moved into higher yielding currencies. This has come to the fore again in late September against the dollar, which climbed to ¥112 as interest rates hardened once more.

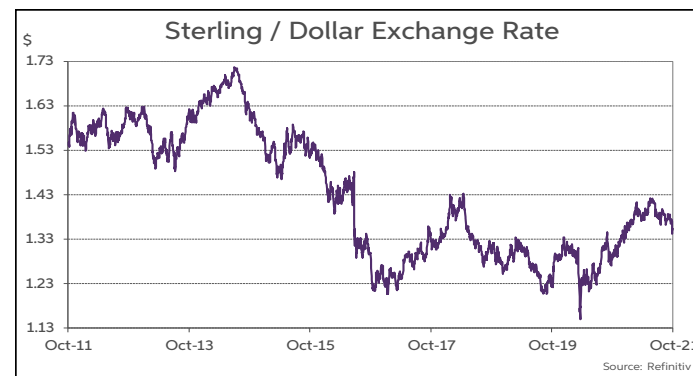
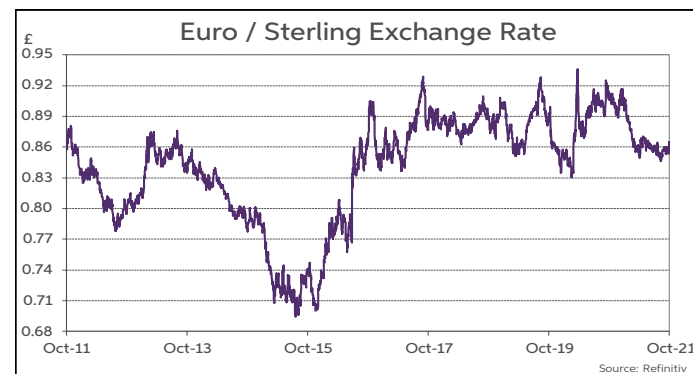
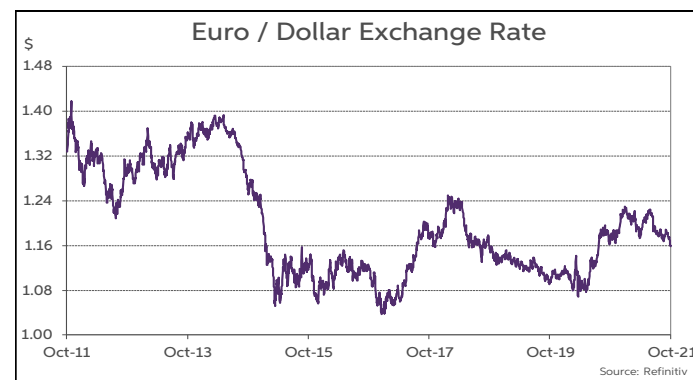
Market positioning is relatively short the yen, which is supportive of the currency, so its losses have been mainly against the appreciating dollar. Thus, the Japanese currency could continue to remain relatively stable against the other major currencies. Longer term, though, it could be vulnerable to some falls, if interest rates and bond yields rise elsewhere but remained anchored at very low levels in Japan, causing increased investment outflows.



Summary of Exchange Rate Forecasts

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

	Current	Q4-2021	Q1-2021	Q2-2022	Q3-2022
Euro Versus					
USD	1.163	1.13-1.19	1.12-1.18	1.11-1.17	1.11-1.17
GBP	0.854	0.83-0.89	0.82-0.88	0.81-0.87	0.81-0.87
JPY	129.07	126-132	126-132	126-132	126-132
CHF	1.07	1.07	1.07	1.06	1.06
US Dollar Versus					
JPY	111.00	108-114	109-115	110-116	110-116
GBP	1.362	1.32-1.38	1.32-1.38	1.33-1.39	1.32-1.38
CAD	1.26	1.27	1.28	1.29	1.29
AUD	0.73	0.73	0.72	0.71	0.71
NZD	0.70	0.70	0.69	0.68	0.68
CNY	6.45	6.40	6.35	6.30	6.30
Sterling Versus					
JPY	151	150	151	154	153
CAD	1.71	1.71	1.75	1.71	1.69
AUD	1.87	1.85	1.88	1.92	1.90
NZD	1.96	1.93	1.96	2.00	1.99



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