

Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit



1st December 2023

- World economy has lost momentum during 2023. Even the US economy may be starting to slow after a strong performance year-to-date. Subdued growth expected again in 2024
- With core inflation still well above the 2% target, and labour markets remaining tight, central banks say policy will need to remain restrictive, indicating early rate cuts are not on the agenda
- Inflation, though, is in marked decline and activity is weakening. Thus, markets believe central banks will deliver significant rates cuts in 2024, starting from Q2, with further cuts in 2025 also
- Main currency pairs quite range bound this year, as central banks pursue broadly the same monetary policies. Exception has been weak yen and BoJ, which has refrained from rate hikes
- Dollar still strong, but has lost some ground recently. It could be vulnerable in 2024 if US rates are cut appreciably. Yen has significant upside potential should the BoJ start to tighten policy

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Growth expected to remain subdued in 2024, with the risks to the downside

The latest updates from the OECD and IMF remain cautious on the outlook for the global economy. They note that the impact of tighter monetary policy is becoming increasingly visible, business and consumer confidence have turned down, and the rebound in China has faded. Thus, although there was a stronger than anticipated start to 2023, helped by lower energy prices, this has not been sustained apart from in the US. Global GDP growth in 2023 –2025 is projected to be sub-par by the IMF and OECD, in a 2.7-3.0% range. The OECD comments that the primary reason for the subdued global growth outlook is the substantial monetary policy tightening that has been required to rein in inflation. Furthermore, central banks have been guiding that interest rates are going to have to remain high for a considerable period of time to bring inflation back down to its 2% target.

However, it is not just a restrictive monetary policy stance and elevated inflation that are weighing on global growth prospects. The IMF says other factors are also at work, including the progress some large emerging economies, such as China and South Korea, have made in raising living standards, and thus are now moving into a more moderate growth phase of their development cycle. It also reflects weaker labour force growth, with many developed economies at full employment. Technological change is also slowing down.

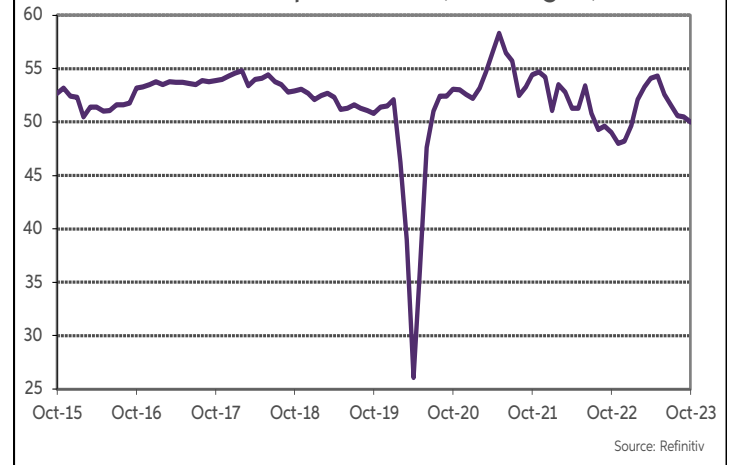
Meanwhile, the OECD note increasing geo-economic fragmentation, and growing protectionism with rising trade barriers, is contributing to a slowdown in international trade, which is impacting negatively on the world’s highly integrated supply chains. Governments are also faced with growing budgetary pressures from rising debt burdens and ageing populations. It all adds up to a challenging macro-economic environment. In addition, the lagged effects of the sharp increases in interest rates in 2022-23 have yet to fully impact economies, especially in relation to the refinancing of maturing term debt at much higher rates.

The US is the one economy that continues to defy expectations of a slowdown in activity. GDP this year will average close to 2.5%, exceeding the 2.1% rate recorded in 2022. Forecasters, though, continue to expect the US to slow next year under the weight of much higher interest rates, with some signs recently the economy is starting to weaken. Meanwhile, growth in both the Eurozone and UK has been weak this year, with GDP set to increase by around 0.5% in both economies in 2023. Growth is expected to pick up only modestly in 2024.

Both the OECD and IMF have warned that higher interest rates could yet expose underlying financial vulnerabilities with potential for rising loan defaults, most notably in weaker low-income countries, where signs of debt distress are already evident. CRE markets remain under pressure which could lead to rising bad debts, putting stress on those lenders with significant exposure to the sector. More generally, if inflation proves more persistent than expected, it could lead to even longer period of high interest rates than is currently priced into markets, putting further downward pressure on financial and real estate asset prices. Meanwhile, China’s expected economic rebound this year has underwhelmed, amid ongoing problems in the real estate sector, private sector deleveraging and concerns about the stability of the banking sector.

Thus, it is still too early to conclude the global economy will emerge with little damage from the substantial tightening of monetary policy seen in the past couple of years, and avoid a recession. The risks to the economic outlook remain to the downside so a close eye needs to be kept on leading indicators of activity which have moved lower since mid-year, as well as consumer spending and labour market data.

Global Composite PMI (JP Morgan)



GDP (Vol % Change)

	2022	2023 (f)	2024 (f)	2025 (f)
World	3.3	2.9	2.7	3.0
OECD Economies	2.9	1.7	1.4	1.8
US	1.9	2.4	1.5	1.7
Eurozone	3.4	0.6	0.9	1.5
UK	4.1	0.3	0.8	0.8
Japan	0.9	1.7	1.0	1.2
Non-OECD Economies	3.6	4.0	3.8	4.0
China	3.0	5.2	4.7	4.2
India	7.2	6.3	6.1	6.5
World Trade Growth (%)	5.2	1.1	2.7	3.3
Inflation -CPI				
OECD Economies (%)	9.3	7.4	5.3	3.9

Sources: OECD Economic Outlook November 2023

Markets look for central banks to lower rates significantly in next couple of years

After a near two year period characterised by aggressive monetary tightening, the main central banks appear to have reached the end of their rate hiking cycles, having moved policy to quite a restrictive stance. They have kept rates on hold recently, moving to a “data-dependent” mode in terms of monetary policy decisions. Central banks have been dampening expectations of early rate cuts, indicating that policy will need to be kept tight for a considerable period to restore price stability. Markets, though, are taking note that headline inflation has been on a marked downward trajectory this year, getting close to 2% in some economies, while core inflation has started to decline also. Futures contracts are now pricing in significant rates cuts, starting from Q2 2024.

The Fed raised US rates by 25bps to a 5.25-5.50% range at the July FOMC meeting, a 22-year high. It kept rates unchanged at the subsequent two policy meetings, while keeping the door open for further hikes if required. The market, though, has moved in the past couple of months to price out the prospect of a further rate increase, largely on the back of recent good inflation data. Instead, the focus has now moved to policy easing. Futures contracts are pricing in 115bps of rate cuts in 2024, beginning in May, which would take rates down to 4.25% by December. A further 75bps in rate cuts are priced in for 2025, bringing rates down to 3.5%, before stabilising thereafter. The latest Fed dot-plot in September sees rates getting to 3.875% by end 2025.

The BoE raised rates by 25bps in early August following a 50bps hike in June, which brought the Bank rate up to 5.25%. The UK central bank has kept rates unchanged at its subsequent two policy meetings on a split vote, with the majority citing a much bigger than expected fall in inflation as the reason to leave policy on hold. Others wanted to raise rates somewhat further. The MPC has continued to indicate a willingness to hike rates again if there is evidence of continuing persistent inflationary pressures. Markets, though, are no longer pricing in further rate increases. Instead, rates are expected to start to be cut from the summer of 2024. Futures contracts see rates falling by 75bps by the end next year and a further 50bps in 2025 and 25bps in 2026, taking them down to 3.75%.

The ECB hiked rates by a further 25bps at its September meeting, which brought the Deposit rate up to 4%. Headline inflation has declined sharply in the Eurozone this year, while core inflation is also now declining. Thus, the ECB indicated at its September meeting that it believed rates have reached levels that if maintained for a sufficiently long period of time will have a substantial impact on inflation falling to its 2% target. Markets interpreted this as a signal that rates have peaked. Policy was kept unchanged at the ECB meeting in October. Futures contracts are pricing that the ECB will cut rates by circa 120bps in 2024, starting in April. A further 30bps in cuts are anticipated in 2025, taking the deposit rate down to 2.5%, with policy going on hold after that.

Inflation is falling more rapidly than expected. The headline HICP rate in the Eurozone has fallen to 2.4% from over 10% a year ago. Core inflation in the Eurozone has fallen to 3.6%. Inflation has fallen sharply in the US also. Meanwhile, activity has weakened considerably in Europe and is starting to slow in the US. Overall then, it looks like rates have almost certainly peaked, with policy easing getting underway in the first half of next year. Given it will be a change in policy direction, rates may not be cut quite as early in H1 2024 as markets currently expect. Importantly, markets do not see rates getting down to anywhere near the zero or negative levels that pertained between 2010 and 2022. Indeed, rates in the US and UK are only expected to be cut to a 3.5-3.75% range. It would most likely take a recession and the likelihood of inflation considerably undershooting its 2% target for much greater rate cuts to come on to the agenda of central banks in the next couple of years.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	5.375	5.63	5.38	4.76	4.26
Dec'23	5.375	5.65	5.40	4.80	4.25
Mar'24	5.375	5.50	5.25	4.60	4.10
June'24	5.125	5.15	4.90	4.30	3.80

* Swap Forecasts Beyond 1 Year

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	4.00	3.96	3.68	3.28	2.90
Dec'23	4.00	4.00	3.70	3.30	2.90
Mar'24	4.00	3.85	3.50	3.20	2.80
June'24	3.75	3.60	3.25	3.00	2.70

* Swap Forecasts Beyond 1 Year

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	5.25	5.35	5.36	4.94	4.40
Dec'23	5.25	5.35	5.35	4.95	4.40
Mar'24	5.25	5.35	5.25	4.80	4.30
June'24	5.25	5.25	5.00	4.60	4.15

* Swap Forecasts Beyond 1 Year

Main currencies largely range trade in 2023, dollar may lose some ground in 2024

Although the US dollar has retreated from last year's peaks, which saw it reach its highest point on a trade-weighted basis in 20 years, it has remained at elevated levels in 2023. The continuing strength of the dollar this year is very much linked to the ongoing impressive performance of the US economy and associated high level of US interest rates. US data have generally surprised to the upside in 2023. The anticipated slowdown in the economy has not materialised to date. Indeed, GDP growth this year is on course to average close to 2.5%, up from 2.1% last year. Meantime, the labour market remains very tight, with the jobless rate still close to fifty year lows at below 4%, amid continuing strong growth in employment.

Against this backdrop, the Fed hiked rates to a 5.25-5.5% range this summer and indicated that policy will need to remain restrictive for an extended period of time. As a result, US bond yields have risen sharply this year, with ten year Treasury yields hitting 5% in October, helping to underpin the dollar at a high level.

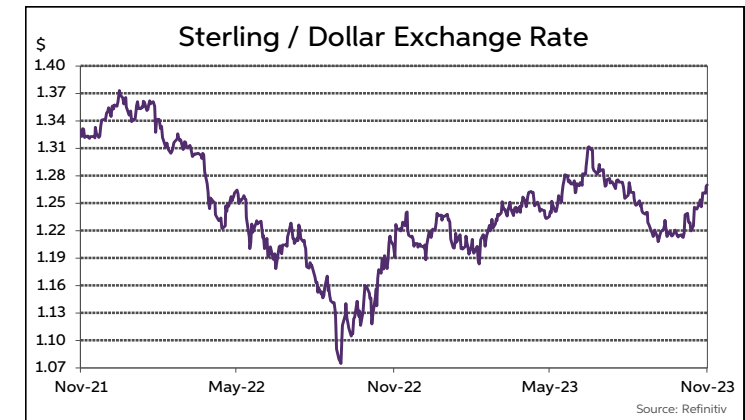
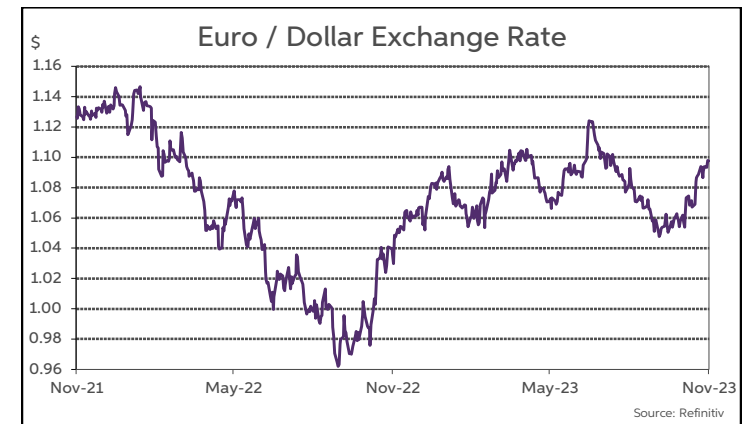
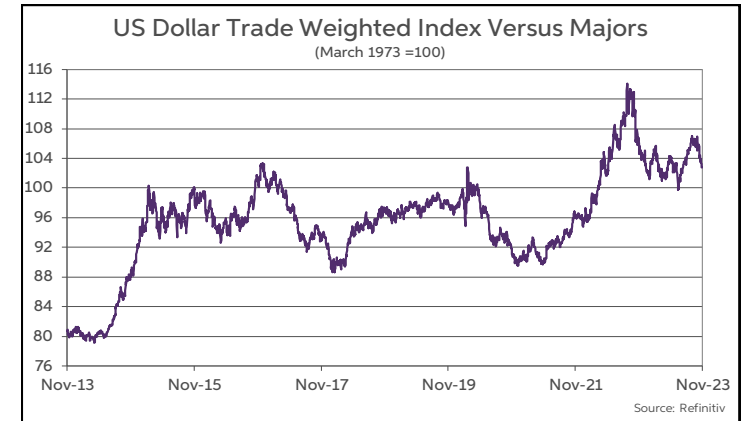
In contrast to the US, both the Eurozone and UK economies have struggled over the past year, narrowly avoiding recession. Indeed, though US GDP is set to be close to 2.5% this year, growth in both the Eurozone and UK economies will be much weaker at circa 0.5% in 2023. Meanwhile, Eurozone interest rates looked to have reached a peak at 4%, well below those in the US, while there has been a marked scaling back of rate hike expectations in the UK since mid-year. It now appears that BoE rates have reached a peak at 5.25%.

The most notable feature of the main currency markets this year, though, has been the predominance of narrow trading ranges, with the notable exception of the yen. EUR/USD has been confined to a \$1.04-1.12 corridor in 2023. Meantime, sterling has traded in a \$1.20-1.31 band versus the dollar since mid-March. Similarly, the Australian, New Zealand and Canadian dollars have traded in narrow ranges versus the US currency this year, in particular since March. Thus, after the strong dollar rise in 2021-22, forex markets have been more settled in 2023 and confined to quite narrow trading range. The question is will this continue in 2024?

Monetary policy has been a crucial driver of forex markets in the past three years. The main central banks have kept policy unchanged recently and are guiding that policy will need to remain restrictive for an extended period of time to get inflation back to its 2% target. Significant rate cuts are expected in the main economies next year with markets pricing in around 120bps of easing in both the US and Eurozone, starting in the second quarter. This suggests that the main currency markets could continue to range trade for much of next year.

The euro, though, has made gains over the autumn while the dollar has weakened, with the EUR-USD rate rising from below \$1.05 at the start of October to above \$1.09 recently. Meanwhile, cable has risen from \$1.21 to \$1.27 in the past two months. This has been driven by markets pricing in significant policy easing in the US, with a consequent sharp fall in US bond yields in recent weeks. Rates are at higher levels in the US than elsewhere so there is more scope to loosen policy there once central banks move on to an easing path. The dollar is also still at an elevated level and so it has greater scope to fall, especially after its big gains in 2021-2022.

This suggests we could see the dollar losing some ground in 2024 as the Fed begins to lower rates. However, the fall may be limited. Significant rate cuts are expected elsewhere also, particularly in the Eurozone. Geopolitical risks are also likely to remain elevated. Thus, currencies may make just modest gains against the dollar in the early part of the year, with the euro only rising towards the \$1.15 level by the end of 2024.



High BoE rates and improved UK data supportive of sterling

Sterling endured a difficult 2022 largely owing to concerns about the UK economy, as well as a badly received expansionary mini-budget last autumn. The currency, though, has gained some ground in 2023 and generally been much more stable than in recent years. It has been aided by better than expected UK data, with the economy avoiding the recession that had been widely predicted to occur this year. At the same time, the rise in BoE rates to 5.25%, has also supported the currency.

EUR/GBP has edged downwards from the 87-89p range it occupied in the opening months of this year, to trade in a narrow 85.0-87.5p corridor since early summer. Meanwhile, sterling has moved up from lows below \$1.20 early in the year to trade in a \$1.20 to \$1.31 band against the dollar since March. It is currently in the middle of this range. Overall, then, the UK currency has been much more stable this year.

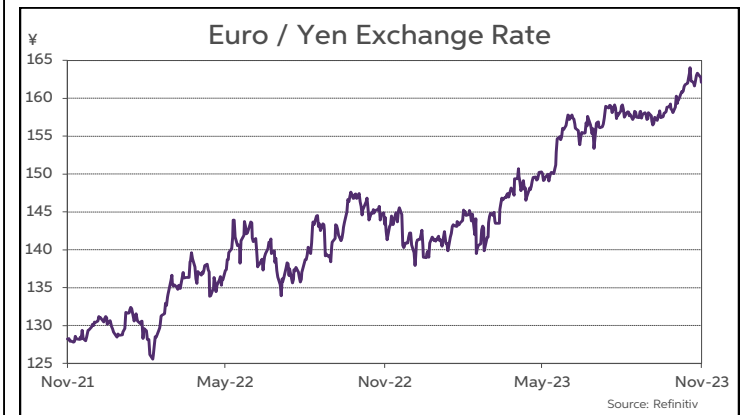
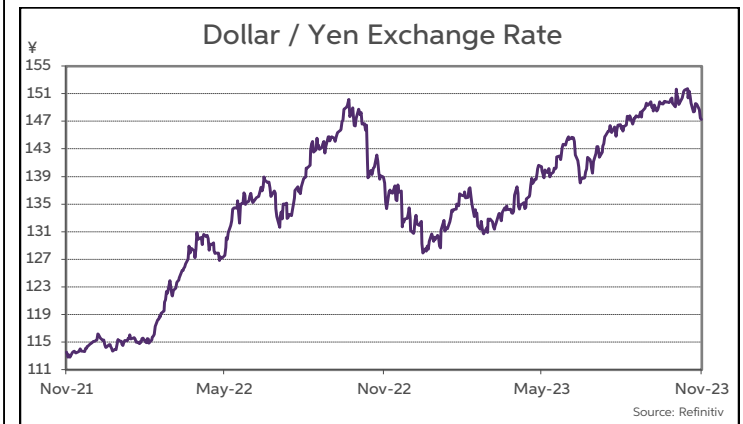
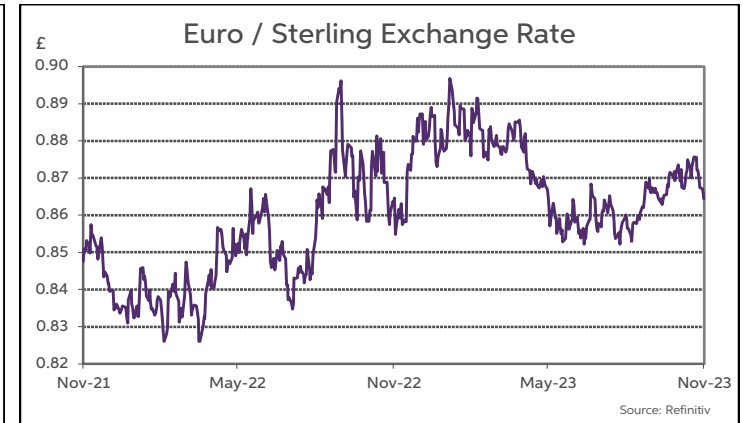
Inflation has proved more sticky in the UK than elsewhere in 2023, with strong wage inflation evident also. UK rates have been raised to 5.25% as a result, and markets expect UK rates to be lowered at a slower pace next year than in the US and Eurozone, which should be supportive of the currency. The Bank rate is seen falling to 4.5% at end 2024 and 4.0% by end 2025. Meantime, the latest positioning data shows the market is relatively neutral on the pound. Thus, sterling could remain steady in 2024 if market expectations that rates in the UK will be cut less than elsewhere prove correct. BoE modelling, though, suggests there may be scope for a sharp fall in inflation to below 2% in the next two years. If this proves to be the case, it could see the BoE cut rates to a greater extent than priced in by markets to support the weak economy. Sterling would likely lose some ground in such circumstances.

Scope for sharp yen rebound in 2024 if BoJ moves to tighten policy

In marked contrast to other central banks, the BoJ has continued with its very accommodative monetary policy. This resulted in the yen falling to a 30-year low against the US currency in 2022. The yen moved off its lows late last year, helped by the BoJ unexpectedly widening the yield corridor for ten year JGBs in December, effectively allowing them to rise by 25bps. However, the BoJ under its new Governor, Ueda, continued to pursue a dovish policy stance this year. This has seen renewed yen weakness in 2023. The dollar rose back up 30 year highs at ¥150 recently, while the euro hit fifteen year highs, near the ¥165 level in November.

Thus, the very loose BoJ monetary policy stance is continuing to act as a major headwind for the currency. A major shift in policy, such as the abolition of the yield control corridor or a hike in the official interest rate which is still in negative territory, would seem necessary for the yen to recover. There is certainly scope for the yen to rebound strongly in 2024 if there is a change in policy given the extent of the currency's fall in 2022-23. The dollar has risen from ¥115 to ¥150 in the past two years, with the euro climbing from ¥130 to near ¥165. However, until BoJ monetary policy is altered or rates are cut elsewhere, the yen is likely to remain a very weak currency.

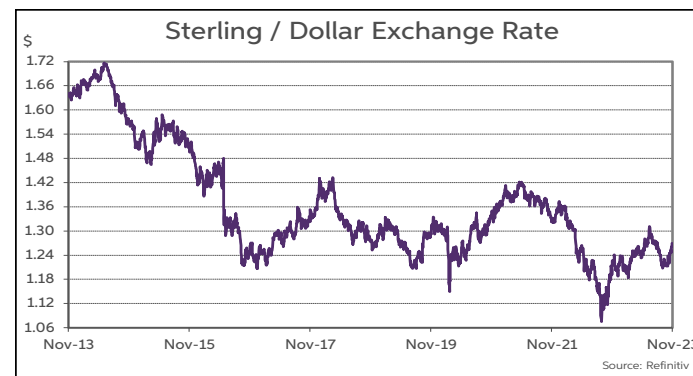
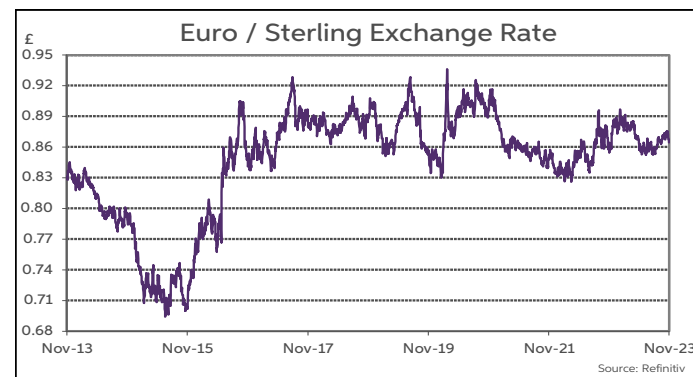
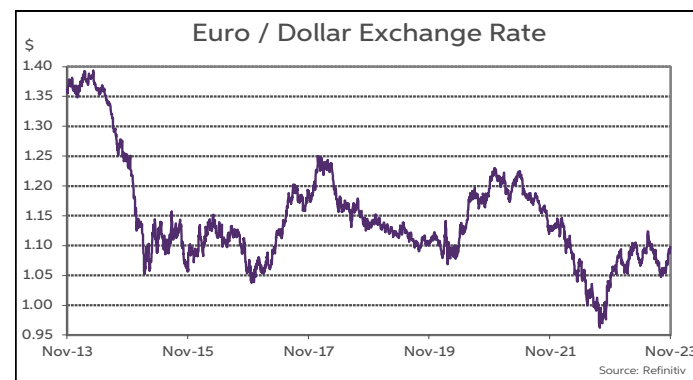
Inflation has picked up in Japan in the past couple of years. The core rate has been running at around 3% in 2023. This has led to speculation that we could see some tightening of BoJ policy in 2024, in a move to normalise monetary policy. This could occur at the same time as rates start to be cut elsewhere, possibly in Q2. The process, though, is likely to be slow. Large BoJ rate hikes seem unlikely. Nevertheless, even a modest policy shift should form the basis for a rebound by the yen next year. Thus, we expect the yen to make gains in 2024.



Summary of Exchange Rate Forecasts

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

	Current	Q4-2023	Q1-2024	Q2-2024	Q3-2024
Euro Versus					
USD	1.089	1.05-1.11	1.06-1.12	1.07-1.13	1.09-1.15
GBP	0.861	0.83-0.89	0.83-0.89	0.83-0.89	0.84-0.90
JPY	161.23	157-163	154-160	150-156	147-153
CHF	0.95	0.95	0.95	0.95	0.95
US Dollar Versus					
JPY	148.03	145-151	141-147	136-142	131-137
GBP	1.265	1.23-1.29	1.24-1.30	1.25-1.31	1.26-1.32
CAD	1.35	1.36	1.35	1.33	1.31
AUD	0.66	0.65	0.66	0.67	0.68
NZD	0.62	0.61	0.62	0.63	0.64
CNY	7.14	7.15	7.10	7.00	6.90
Sterling Versus					
JPY	187	186	183	178	173
CAD	1.71	1.71	1.71	1.70	1.69
AUD	1.91	1.94	1.92	1.91	1.90
NZD	2.05	2.07	2.05	2.03	2.02



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