

# Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit



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- Inflation at very high levels, which combined with other headwinds such as the sharp tightening of monetary policy, are expected to act as a significant drag on global economic activity in 2023
- Some countries expected to enter recession, but signs inflationary pressures starting to ease as commodity prices fall, while economic data have generally surprised to upside in recent months
- Further rate hikes to be implemented by central banks in coming months as they seek to drive inflation back down towards 2% target, with policy then going on hold
- Central banks indicate policy will need to remain restrictive for a prolonged period to squeeze inflation out of system, but markets expect rate cuts in US by end year and in 2024 in Europe
- Dollar on the retreat from 20 year highs as rates rise elsewhere and could fall further. Yen recovers ground as BoJ allows bond yields to rise. Poor UK economic outlook weighs on sterling

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## Very weak growth in prospect for the global economy in 2023

The global economy lost considerable momentum over the course of last year after it had rebounded strongly in 2021 from the impact of COVID-19. The Russian invasion of Ukraine saw a sharp rise in commodity prices, especially energy and food prices. This added significantly to a sharp acceleration in inflation, with CPI rates rising to double-digit levels in many advanced economies. This has put significant downward pressure on households' real disposable incomes. Central banks responded to the surge in inflation with a marked tightening of monetary policy in 2022, which in turn has had a further dampening impact on economic activity.

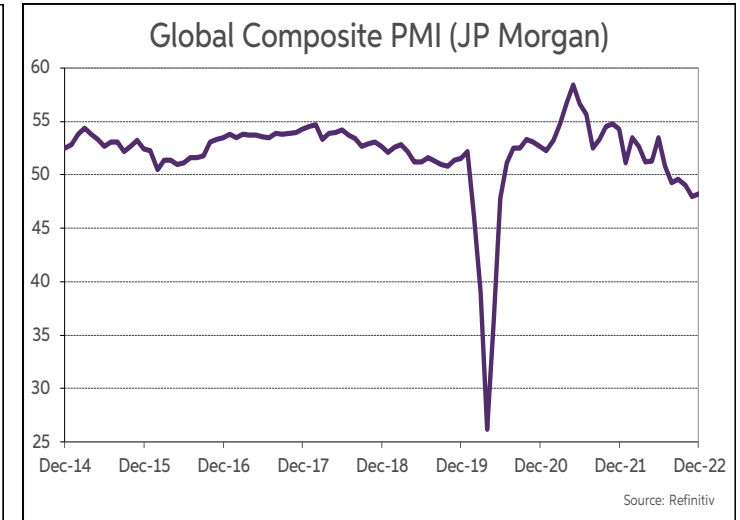
Against this very challenging backdrop, growth forecasts for 2022/2023 have been scaled back nearly everywhere. The OECD has stated that the global economy is facing mounting challenges, noting the persistence of high inflation, weakening in confidence levels and heightened uncertainty. It is forecasting that growth in the world economy will slow to 2.2% in 2023 from 3.1% in 2022. This represents a marked slowdown from the 5.9% growth seen in 2021. Notably, the global composite PMI has been below 50 since August.

Growth in OECD economies is expected to slow even more markedly, from 5.6% in 2021, to 2.8% last year and just 0.8% in 2023, with both the US and European economies experiencing sharp slowdowns. The OECD envisages high inflation and rising interest rates as significant restraints on the US economy. Growth in Europe is anticipated to slow sharply arising from the impact of the War in Ukraine, muted external demand, high energy/food prices, weak confidence and tighter monetary policy.

Thus, although data have held up better than expected in recent months, the OECD is forecasting both the US and Eurozone economies will register very weak growth of just 0.5% in 2023. It envisages an even weaker outturn for the UK economy, with tighter fiscal policy acting as an additional headwind. It is pencilling in a 0.4% contraction in UK GDP this year. Elsewhere, after slowing sharply in 2022, growth in China is projected by the OECD to pick up to 4.6% in 2023 with the lifting of COVID restrictions. Meantime, the Japanese economy is projected to grow by 1.8% this year, up slightly from 1.6% in 2022. Growth in western economies is expected by the OECD to remain sluggish in 2024, at just 0.2% in the UK, 1% in the US and 1.4% for the Eurozone.

The OECD and others highlight the considerable uncertainty around economic forecasts and that the risks have become more skewed to the downside. The effects of the War in Ukraine could be even greater than assumed. High inflation could prove to be more longer lasting than projected, weighing on global activity. There is also a real concern that central banks in their aggressive moves to tighten policy to dampen inflation, may push economies into recession. Tighter conditions on financial markets could also cause distress in some emerging markets and economies. COVID also remains an ongoing risk, with high case numbers still in China.

Falling commodity prices are seeing headline inflation rates starting to decline. However, although inflation looks to have peaked, it remains at very high levels in most countries. Furthermore, there is a risk of a spill over into continued high wage inflation given the tightness of labour markets, which would make it more difficult to get CPI rates back down to their 2% target anytime soon. Inflation has also become more broad-based, so core rates may remain elevated for quite some time. The OECD expects US PCE inflation to fall from an average 6.2% in 2022 to 3.5% in 2023 and 2.6% in 2024, but be still above 2% at 2.3% in Q4 2024. For the Eurozone, it sees HICP inflation falling from 8.3% in 2022 to 6.8% in 2023, and to 3.4% in 2024, with the rate still well above 2% at 2.9% in Q4 2024.



## GDP (Vol % Change)

|                        | 2021 | 2022 (f) | 2023 (f) | 2024 (f) |
|------------------------|------|----------|----------|----------|
| World                  | 5.9  | 3.1      | 2.2      | 2.7      |
| OECD Economies         | 5.6  | 2.8      | 0.8      | 1.4      |
| US                     | 5.9  | 1.8      | 0.5      | 1.0      |
| Eurozone               | 5.3  | 3.3      | 0.5      | 1.4      |
| UK                     | 7.5  | 4.4      | -0.4     | 0.2      |
| Japan                  | 1.6  | 1.6      | 1.8      | 0.9      |
| Emerging Economies     | 6.2  | 3.4      | 3.3      | 3.8      |
| China                  | 8.1  | 3.3      | 4.6      | 4.1      |
| India                  | 8.7  | 6.6      | 5.7      | 6.9      |
| World Trade Growth (%) | 10.0 | 5.4      | 2.9      | 3.8      |
| Inflation -PCE         |      |          |          |          |
| OECD Economies (%)     | 3.8  | 9.4      | 6.5      | 5.1      |

Source: OECD Economic Outlook, November 2022

## Interest Rate Outlook

### Central banks move to a slower pace of rate hikes, but more tightening in store

Despite, weakening economic activity, the second half of last year was characterised by central banks enacting an aggressive pace of policy tightening. This was against the backdrop of inflation rising to 10% or above in many economies, while at the same time, labour market conditions remained tight. This increased concerns amongst central bankers that inflation would become more entrenched if they did not act forcefully to tighten policy. As a result, some of the main central banks implemented rate hikes in the order of 75bps during the second half of 2022. However, amid tentative signs that inflation may be easing, as well as central banks being very cognisant of the risks to their respective economies from over tightening, the pace of rate hikes did see some slowdown towards the end of last year. Although, central bank's also re-asserted their inflation fighting credentials by guiding that more rate hikes were on the cards in the coming months and policy would then need to be kept tight.

The US Fed announced a 50bps increase at its December meeting, which saw the target range for the Fed's funds rate end the year at 4.25-4.50%. This move followed four consecutive 75bps rate hikes. The Fed has now implemented 425bps worth of rate increases since it commenced its tightening cycle back in March. It stated that it anticipates that on-going increases in rates will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to its 2% target. This was reflected in its updated interest rate projections which show it now anticipates rates peaking at 5.125% this year. There is a strong bias within the FOMC to take rates above 5%, with only two of the 19 FOMC members envisaging rates peaking below 5%. Futures contracts indicate that the market is anticipating rates peaking at close to 5%. However, the market expects the Fed will begin cutting rates before the end of 2023, to around 4.5%, which is very much at odds with the Fed's guidance of rates ending the year at 5.125%. Markets see rates being cut by a further 150bps to 3% by end 2024.

The BoE also hiked by 50bps in December, bringing the Bank Rate up to 3.5%. The December increase represented a slowdown compared to the 75bps hike in November, which followed two 50bps increases in Q3. The BoE has now hiked for nine straight meetings, by a total of 340bps, since it started its current rate tightening cycle in December 2021. However, the voting breakdown showed that the BoE was split on its rate decision, with six members in favour of a 50bps increase, one member looking for a 75bps hike, while two members were for no change. Overall though, the BoE retains a tightening bias, noting that further rate increases "may be required". Although, unlike in November, the BoE did not repeat that the peak in rates would be lower than priced in by markets. Markets are currently envisaging a peak of 4.5% in rates around mid-year, with policy going on hold in H2 2023. Futures contracts then see rates being lowered during 2024, falling to around 3.5% by Q1 2025.

Meanwhile, the ECB commenced hiking rates in July, which brought an end to its negative interest rate policy, and was preceded by a cessation of its QE programme in June. Similar to the Fed and BoE, the ECB reduced the magnitude of its rate hikes in December. Following two consecutive 75bps hikes in September and October, it announced a 50bps increase. This saw the Depo rate end 2022 at 2.0%. It brought the total amount of hikes in H2 2022 to 250bps. The ECB gave a clear message at its December meeting that it will have to maintain rate increases at this pace for some time. It indicated that rates will have to rise significantly more at a steady pace to reach levels that are sufficiently restrictive, and then be kept there to ensure a timely return of inflation to its 2% target. Market expectations are for the Depo rate to peak in a 3.25-3.5% range by mid-2023, with policy then going on hold for the rest of the year, to be followed by rate cuts of 75bps in 2024.

### US Interest Rate Forecasts (to end quarter)

|         | Fed Funds | 3 Mth | 1 Year | 2 Year * | 5 Year * |
|---------|-----------|-------|--------|----------|----------|
| Current | 4.375     | 4.80  | 5.40   | 4.43     | 3.60     |
| Mar'23  | 4.875     | 5.25  | 5.65   | 4.50     | 3.70     |
| June'23 | 5.125     | 5.40  | 5.75   | 4.60     | 3.75     |
| Sept'23 | 5.125     | 5.30  | 5.60   | 4.50     | 3.65     |

\* Swap Forecasts Beyond 1 Year

### Eurozone Interest Rate Forecasts (to end quarter)

|         | Deposit Rate | 3 Mth | 1 Year | 2 Year * | 5 Year * |
|---------|--------------|-------|--------|----------|----------|
| Current | 2.00         | 2.33  | 3.17   | 3.10     | 2.70     |
| Mar'23  | 3.00         | 3.25  | 3.75   | 3.25     | 2.80     |
| June'23 | 3.50         | 3.65  | 3.85   | 3.30     | 2.90     |
| Sept'23 | 3.50         | 3.60  | 3.75   | 3.20     | 2.80     |

\* Swap Forecasts Beyond 1 Year

### UK Interest Rate Forecasts (to end quarter)

|         | Bank Rate | 3 Mth | 1 Year | 2 Year * | 5 Year * |
|---------|-----------|-------|--------|----------|----------|
| Current | 3.50      | 4.02  | 4.59   | 4.38     | 3.93     |
| Mar'23  | 4.25      | 4.50  | 4.75   | 4.45     | 3.95     |
| June'23 | 4.25      | 4.45  | 4.70   | 4.40     | 3.90     |
| Sept'23 | 4.25      | 4.35  | 4.60   | 4.25     | 3.75     |

\* Swap Forecasts Beyond 1 Year

## Dollar on retreat from 20 year highs as rates rise elsewhere and could fall further

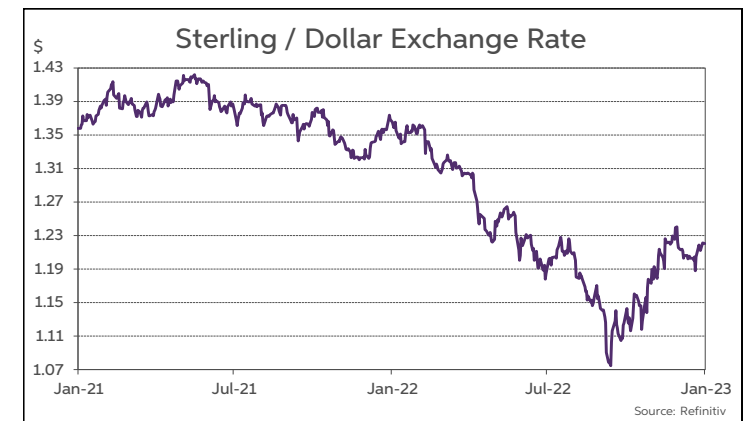
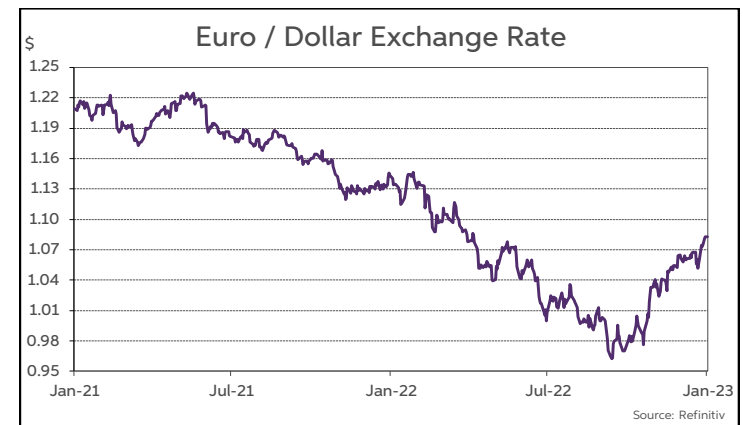
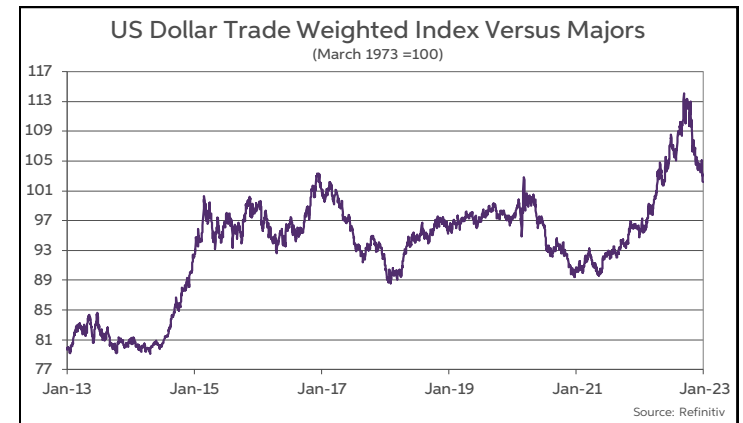
The dollar was in the ascendancy from mid-2021 through to autumn 2022 as hikes in US interest rates and rising US bond yields drove the currency higher. It rose by circa 25% in trade-weighted terms during this period. The Russian invasion of Ukraine was also a major factor in the strengthening of the dollar last year in terms of a flight-to-quality into the world's largest reserve currency as financial markets came under pressure. The Fed was also the most vocal and aggressive of the main central banks during 2022 on the need for significant rate tightening to counteract the further surge in inflation seen last year. By September 2022, the dollar had risen to its highest level on a trade-weighted basis in twenty years. It made significant gains against a broad range of currencies, with particularly large upward moves against the yen and sterling.

The euro was also a notable casualty of the dollar's strength, falling from \$1.22 in mid-2021 to a low of \$0.95 in September 2022. Not surprisingly, given the Eurozone's closer trade and financial ties with Russia, and in particular its reliance on imports of gas from there, the euro came under marked downward pressure following the invasion of Ukraine and the imposition of sanctions on Russia. Support at the \$1.10 level against the dollar was easily breached. The major support level of \$1.04, which was the lowest point hit by the euro in the past twenty years, initially held before giving way at mid-year, as the Fed stepped up the pace of rate tightening. The euro fell to parity initially and then to a low of \$0.95, as futures contracts priced in even greater Fed tightening.

The final quarter of 2022, though, saw a marked change in the dollar's fortunes. It lost significant ground as other central banks stepped up the pace of tightening with 75bps hikes becoming the norm. Inflation also fell back in the US in the second half of the year, while it continued to rise in most other major economies. In level terms, this was initially reflected in EUR/USD moving back up to parity, before rising up to the \$1.05-1.06 level late last year and then \$1.08 in early 2023. Meanwhile, cable rose from a low of \$1.04 to rebound above the \$1.20 level, while the dollar fell back from a high above ¥150 in October to below ¥130 by mid-January.

The coming year seems likely to be characterized by further hikes in rates in most economies during the opening half of 2023, with policy being put on hold thereafter given key central banks have indicated that a restrictive rate stance will be required for a period of time to squeeze inflationary pressures out of the system. US rates seem set to rise to around 5% and remain there until 2024, which would be well above rate levels in most other countries. This should help prevent a further marked fall in the dollar in the months ahead, especially with the markets having lightened up on long dollar positions since the autumn.

From a euro viewpoint, the ECB has turned quite hawkish and moved on to an aggressive rate tightening path. The ECB's on-going rate tightening cycle should continue to provide support for the currency. However, the war in Ukraine can be expected to remain a threat to the euro, while there is also a risk that the economy could slip into recession. While further gains by the euro seem likely in the months ahead as the ECB continues to hike, they may prove limited given these risks, with \$1.10 and \$1.12 the next big resistance levels. Interest rates have been a key driver of currencies in the past number of years. Thus, if US rate cuts look like coming on to the agenda in 2024, then the dollar could start to lose some further ground later on this year. It is important to remember the currency is still at an elevated level. It has retraced about 50% of the rally that occurred between mid-2021 and autumn 2022. Thus, the dollar has the capacity to fall further if US rates start to move down. The EUR/USD could rise above the \$1.12 level later this year should US rate cuts start coming into view.



## *Sterling likely to remain weak in 2023*

Sterling started last year trading at around \$1.35 versus the dollar and 84p against the euro. It endured a difficult 2022 despite the BoE delivering eight rate hikes totalling 325bps, that brought the Bank rate up to 3.5%. Sterling lost considerable ground on growing concerns about the prospects for the UK economy, especially in late September and early October following an expansionary ‘mini-budget’ which was badly received by financial markets. It called into question the fiscal credibility of the UK government. Against the buoyant dollar, sterling fell sharply to a record low below \$1.04 in late September. Meanwhile, EUR/GBP at one stage traded as high as 92p.

Sterling then regained ground, aided by reduced ‘political risk’ with a new UK PM and Chancellor championing fiscal restraint and introducing measures to help plug the hole in the public finances. This helped to repair some of the damage done to the government’s fiscal management credentials. This combined with some loss of momentum in the dollar has seen cable move back above the \$1.20 threshold. Meanwhile, EUR/GBP moved lower to around the 86p level in the late autumn, before rising back up to around 88p more recently.

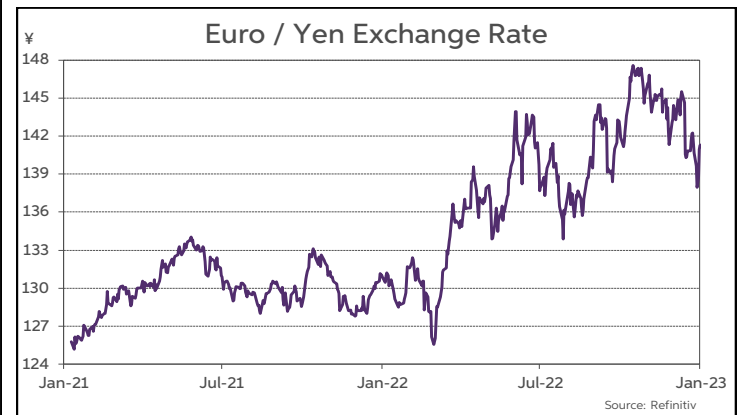
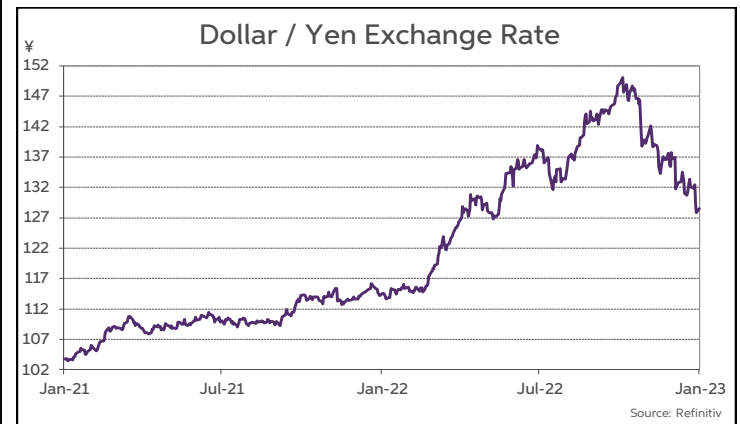
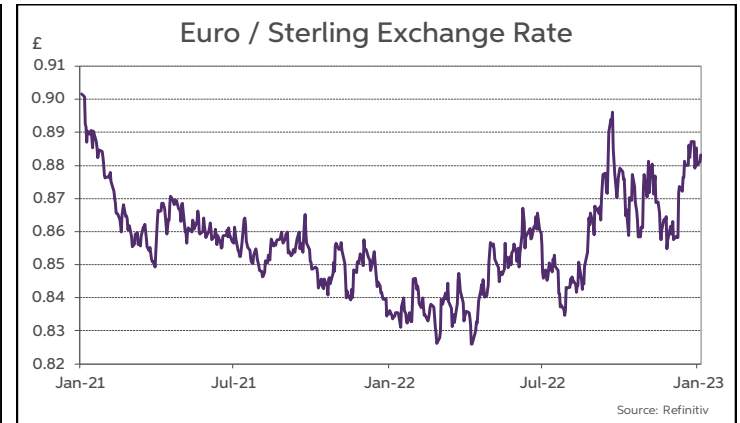
The UK currency still faces a challenging outlook. The economy lost considerable momentum last year amid very high inflation and rising interest rates. The BoE is quite downbeat on the economy’s growth prospects as a result of a squeeze on real household disposable incomes from high inflation. Brexit has also acted to depress trade with the EU, which combined with the much higher costs of energy imports, saw a marked widening of the BoP deficit in 2022. The BoE sees the economy experiencing a prolonged downturn over the period 2023-24. Meanwhile, an eye should be kept on the current negotiations with the EU over the Northern Ireland Protocol. There are positive signs that a compromise can be reached, but it could damage sterling if the talks were to break down.

Further BoE rate hikes should provide some support for sterling, with official rates likely to rise above 4%. However, against a weak UK macro backdrop, sterling could be prone to further bouts of weakness in the coming year. EUR/GBP could rise to 90p or above in 2023, taking it back to levels seen during the 2018-2020 period of elevated uncertainty over Brexit. Against the dollar, it could trade in a \$1.20-1.25 range in the coming months, which would be a historically low level for cable. However, it could rise later in the year on dollar weakness.

## *Strong yen rebound as BoJ moves to tighter policy stance*

In marked contrast to other central banks, the BoJ continued with its very accommodative policy during most of 2022, implementing large scale QE to cap ten year JGB yields at 0.25%, while keeping the key OCR in negative territory. Widening interest rate differentials saw severe downward pressure on the yen, which fell to over 30-year lows against the dollar in the autumn, with the US currency rising above the ¥150 level in October. The BoJ had to intervene to support the currency for the first time since 1998.

With some pairing back of rate hike expectations elsewhere, the yen moved off its lows in late autumn. More particularly, in an unexpected move, the BoJ in December widened the yield corridor for ten year JGBs, effectively allowing yields to rise by 25bps. This saw the yen stage a strong rebound with USD/JPY rate falling to around the ¥130 level and the euro moving down from ¥148 to circa ¥140. Market expectations are that the BoJ may tighten policy somewhat this year, with inflation picking up to 4%. However, it is likely to move at a cautious pace. The yen should regain more lost ground, with the dollar falling to a ¥120-125 range later in the year.

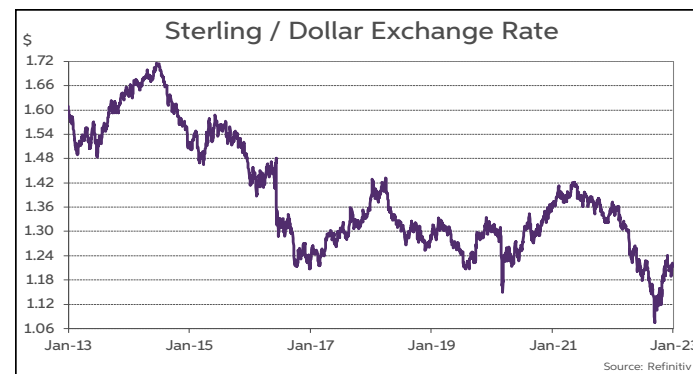
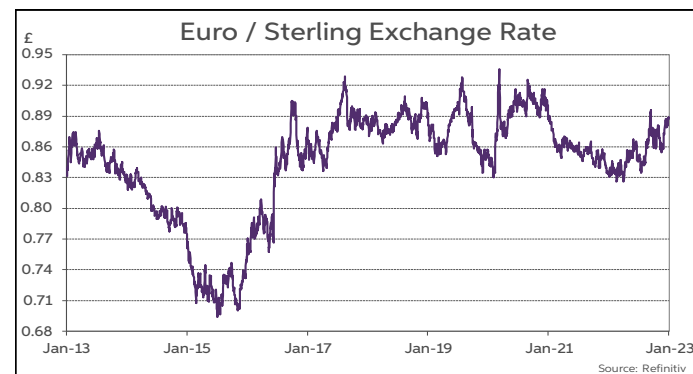
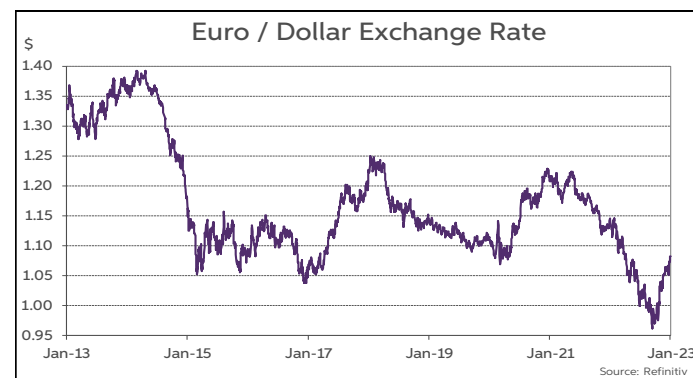




# Summary of Exchange Rate Forecasts

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

|                         | Current | Q1-2023   | Q2-2023   | Q3-2023   | Q4-2023   |
|-------------------------|---------|-----------|-----------|-----------|-----------|
| <b>Euro Versus</b>      |         |           |           |           |           |
| USD                     | 1.085   | 1.06-1.12 | 1.07-1.13 | 1.09-1.15 | 1.11-1.17 |
| GBP                     | 0.875   | 0.85-0.91 | 0.86-0.92 | 0.86-0.92 | 0.87-0.93 |
| JPY                     | 139.22  | 138-144   | 137-143   | 137-143   | 136-142   |
| CHF                     | 0.99    | 1.00      | 1.01      | 1.02      | 1.03      |
| <b>US Dollar Versus</b> |         |           |           |           |           |
| JPY                     | 128.27  | 126-132   | 124-130   | 122-128   | 120-126   |
| GBP                     | 1.241   | 1.21-1.27 | 1.21-1.27 | 1.23-1.29 | 1.24-1.30 |
| CAD                     | 1.34    | 1.34      | 1.33      | 1.31      | 1.29      |
| AUD                     | 0.70    | 0.70      | 0.71      | 0.72      | 0.73      |
| NZD                     | 0.65    | 0.65      | 0.66      | 0.67      | 0.68      |
| CNY                     | 6.75    | 6.70      | 6.60      | 6.50      | 6.40      |
| <b>Sterling Versus</b>  |         |           |           |           |           |
| JPY                     | 159     | 160       | 157       | 158       | 156       |
| CAD                     | 1.66    | 1.66      | 1.64      | 1.65      | 1.63      |
| AUD                     | 1.76    | 1.77      | 1.75      | 1.75      | 1.74      |
| NZD                     | 1.91    | 1.91      | 1.88      | 1.88      | 1.87      |



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