Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

29th March 2023

- Economic data have generally surprised to the upside in first quarter, helped by easing inflation. However, possible credit crunch and tighter lending standards new risk to activity

- Central banks continue to hike rates, but expectations of further increases scaled back greatly on signs of stresses in parts of banking system and associated turbulence on financial markets

- Indeed, markets price in US rate cuts for the second half of this year, contrary to Fed guidance, with policy easing expected in all the main markets during 2024

- Dollar generally quite range bound recently, with the yen the main beneficiary of market volatility. US currency could lose ground later in year if the Fed starts to lower rates

- Firmer tone to sterling which has been helped by better than expected UK data in recent months

Oliver Mangan
Chief Economist

John Fahey
Senior Economist

Daniel Noonan
Economist

https://aib.ie/investorrelations/economic-research-unit

Global Economic Outlook

Data better than expected, but tightening credit conditions a new risk to growth

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. Surging inflation combined with a marked tightening of monetary policy, amid an environment of weakening confidence levels and heightened geo-political tensions, especially in relation to Ukraine, saw the world economy slow sharply during 2022. However, concerns that advanced economies could be facing a recession in 2023 largely abated over the winter as economic data printed ahead of expectations, helped by falling commodity prices, the start of a decline in headline inflation and continuing strong labour markets. Recent macroeconomic updates from central banks, the OECD and IMF have generally seen slight upgrades to official growth forecasts for 2023.

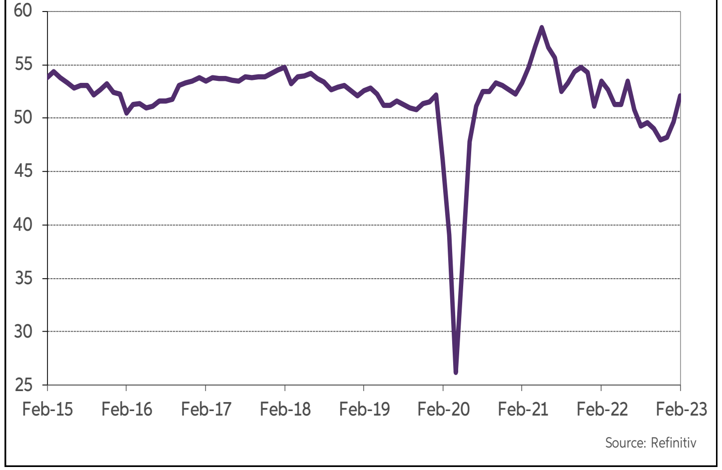
However, the stresses that have emerged in parts of the global banking system this month, and the associated volatility that this has generated on financial markets is a new risk to the economic outlook. There had already been a tightening of financial market conditions and lending standards for loans over the past year. This could be accentuated by the tensions seen in the banking system in the past number of weeks. The US Fed believes that recent developments are likely to result in tighter credit conditions for households and businesses, and will weigh on economic activity, employment and inflation. It says the extent of these effects are uncertain, but Fed Chair Powell opined they could easily have a significant macroeconomic impact. Those US banks which are less confident about holding on to their deposit base, or see deposit outflows, will be more reluctant about continuing to lend to customers at the same pace as previously. Indeed, some commentators now believe the stresses in the banking system could morph into a credit crunch in the US.

Meanwhile, ECB President Lagarde has warned that the tensions seen over the past couple of weeks are not trivial and will not be without repercussions. She noted the euro area economy could be facing a potentially less favourable economic environment due to lower growth, with weaker loan demand and higher bank funding costs also. Meantime, the OECD in its latest update, observed that higher interest rates could continue to expose underlying financial vulnerabilities, with potential for rising loan defaults, most notably in weaker low-income countries, where signs of debt distress are becoming increasingly evident. Broader financial contagion, though, from recent events has been limited so far, with central banks noting that the banking system remains strong in terms of its capital and liquidity positions.

In terms of inflation, falling commodity prices have seen headline CPI rates starting to decline. However, price pressures have become more broad-based, so core inflation rates are proving quite sticky. Central banks have been paying particularly close attention to wage growth given the tightness of labour markets. Recent financial events will have a deflationary impact on economies. Oil and gas prices have fallen further, and are now below the levels that prevailed ahead of the Russian invasion of Ukraine. Global food commodity prices are continuing to decline. Forecasts of 3% CPI rates by the end of the year are becoming more common, with expectations of further falls in inflation in 2024.

Overall then, economic activity has held up better than expected in recent months in all the main economies. However, optimism that a recession can be avoided has given way to fresh concerns that economic activity could be dampened considerably if stresses in part of the global banking system result in a marked tightening of credit conditions. Uncertainty about the economic outlook is elevated, so a close eye needs to be kept on incoming data.

Global Composite PMI (JP Morgan)



GDP (Vol % Change)

	2021	2022	2023 (f)	2024 (f)
World	5.9	3.2	2.6	2.9
Advanced Economies	5.4	2.7	1.2	1.4
US	5.9	2.1	1.5	0.9
Eurozone	5.3	3.5	0.8	1.5
UK	7.6	4.0	-0.2	0.9
Japan	2.1	1.0	1.4	1.1
Emerging Economies	6.7	3.9	4.0	4.2
China	8.1	3.0	5.3	4.9
India	8.7	6.9	5.9	7.1
World Trade Growth (%)	10.4	5.4	2.4	3.4
Inflation -PCE				
Advanced Economies (%)	3.1	7.3	4.6	2.6

Sources: IMF World Economic Outlook Update, January 2023 & OECD Interim Economic Outlook March 2023

Interest Rate Outlook

Central banks turn cautious on further hikes amid new risk to the economic outlook

The past year was characterised by an aggressive tightening of monetary policy by central banks. 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. More recently, the pace of rate hikes slowed towards the end of last year and in early 2023, amid signs that inflation had peaked and was starting to ease. However, central banks continued to assert their inflation fighting credentials in guiding that further hikes were on the cards and rates would need to go higher than previously anticipated. They also moved to dampen expectations of rate cuts before year-end, indicating that policy would need to be kept tight for a prolonged period of time to restore price stability.

While the March meetings of the main central banks witnessed another round of rate increases, it also saw them turn more cautious on the scale of further tightening. The stresses that have emerged in parts of the global banking system this month, and the associated volatility that this has generated on financial markets is a new risk to the economic outlook. It could also have a deflationary impact on economies, especially if there is a significant tightening of credit conditions. Thus, the most recent signals from central banks are that we may be nearing the end of this rate tightening cycle, while futures contracts have softened considerably since earlier in the month.

The US Fed announced a 25bps hike in rates at its March meeting which brought the target range for the Fed's funds rate to 4.75-5.00%. The FOMC interest rate projections from the meeting showed that it anticipates that there will be just one further 25bps increase in rates, with policy then going on hold over the balance of the year. Rate cuts of 100bps are then seen by the Fed in both 2024 and 2025 as inflation falls back to target. Futures contracts, though, do not foresee any further hike in rates and are pricing in cuts from the autumn onwards, with the funds rate being lowered by some 50bps before year end, which is 75bps below the level being guided by the Fed. Markets are aligned with the Fed projection that rates will be lowered to circa 3% by end 2025, so the divergence in view relates to the movement of rates in the near term.

The BoE hiked rates by 25bps in March, bringing the Bank Rate up to 4.25%. The voting breakdown showed that as at the February meeting, the MPC remained split 7-2 on its rate decision, with two members favouring no change. Overall though, the BoE retained a tightening bias, noting that further tightening would be required if there is evidence of persistent inflationary pressures. Markets have fully priced in one further 25bps hike in rates this summer, with the Bank rate then expected to be put on hold at 4.5% over the balance of the year. Rate cuts of 75bps are priced for next year, with a further 25bps of easing seen in 2025, taking the Bank rate down to 3.5%.

Meanwhile, the ECB raised rates by 50bps in March, which brought the Deposit rate up to 3%. The ECB had given clear signals that rates would be hiked by 50bps at the meeting. It did not provide any further rate guidance, though, at its March meeting. However, it indicated that if the economy performs in line with the latest ECB macro forecasts, a further tightening of rates would be required, but noted there is now much uncertainty about the economic outlook.

Market expectations for euro rates have softened considerably from earlier in March, when it was expected they could rise to 4%. Futures contracts, though, still see two further 25bps hikes by the early autumn taking the Deposit rate up to a peak of 3.5%. Markets are then looking for 50bps of easing during 2024 and 25bps in 2025 which would take the Deposit rate back down to 2.75%.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	4.875	5.16	5.19	4.34	3.69
June'23	5.125	5.35	5.30	4.40	3.75
Sept'23	5.125	5.15	5.00	4.20	3.60
Dec'23	4.625	4.50	4.25	3.50	3.25

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	3.00	3.01	3.46	3.32	3.01
June'23	3.50	3.60	3.75	3.50	3.10
Sept'23	3.50	3.60	3.70	3.40	3.00
Dec'23	3.50	3.55	3.65	3.30	2.90

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	4.25	4.41	4.71	4.41	3.96
June'23	4.50	4.65	4.85	4.50	4.00
Sept'23	4.50	4.60	4.75	4.40	3.95
Dec'23	4.50	4.55	4.65	4.30	3.85

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Still elevated dollar vulnerable if US rates start to be cut later this year

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 key factor in the strengthening of the dollar 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, it came under marked downward pressure following the Russian invasion of Ukraine.

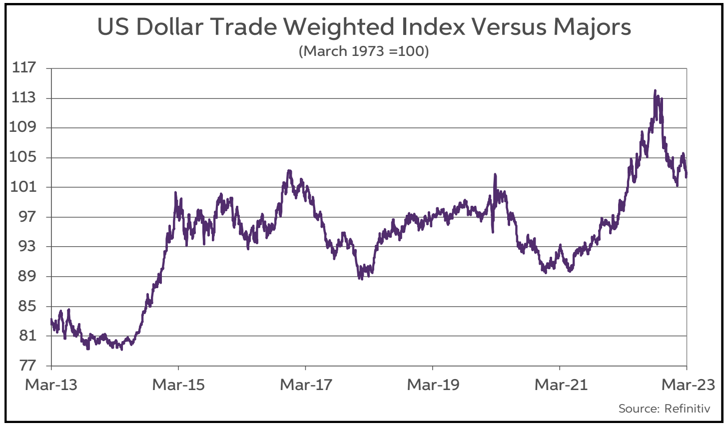
However, the final quarter of 2022 through to end January 2023 saw a change in the dollar's fortunes. It lost significant ground as other central banks stepped up the pace of rate tightening, with 75bps hikes becoming the norm. This was initially reflected in EUR/USD moving back up to parity, before rising up to the $1.05-1.06 level late last year and then moving above $1.09 at end January. Meantime, sterling rose from a low of $1.04 to as high as $1.24, while the dollar fell back from above ¥150 against the yen in October to below ¥130 by January.

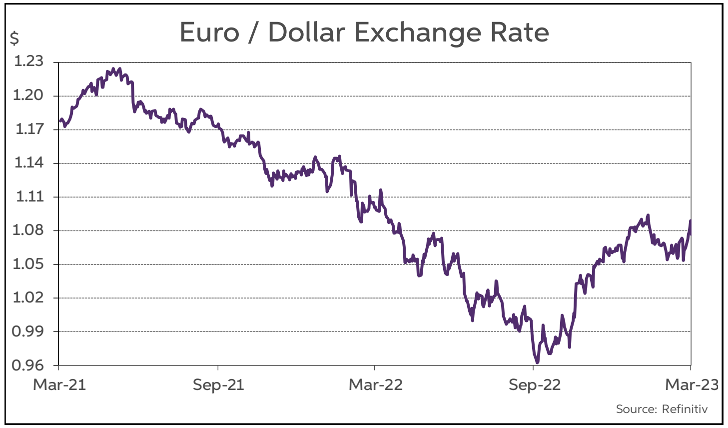
More recently, the dollar has been relatively range bound but still quite volatile amid some wild movements on financial markets and interest rate futures contracts. Expectations that interest rates would go even higher than previously expected evaporated in the face of the emergence of stresses in parts of the global banking system, and the associated increased likelihood of tighter credit conditions, as a result of this. The market view now is that we are nearing the end of the tightening cycle, with rates cuts being priced in for the US later in the year. Against this changing backdrop, EUR/USD has been confined to a narrow $1.05-1.09 range since December, while cable has traded between $1.18-1.24, with the yen moving in a wider ¥128-138 corridor.

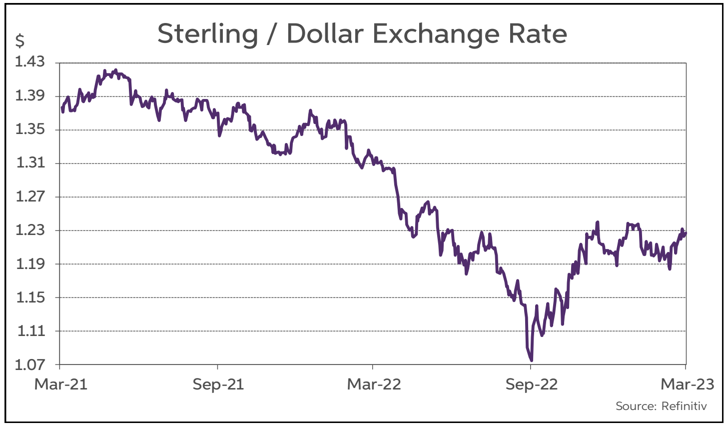
While the dollar is now well below the 20-year highs hit last September, it still remains at elevated levels against the other major currencies, supported by the relatively high level of US rates, which are now at circa 5%. A narrowing of the interest rate differential that has supported the dollar could well see the US currency weaken. The stresses that have emerged in parts of the global banking system recently could have a bigger impact on the US economy than elsewhere, as it is likely to experience a more pronounced tightening of credit conditions given the uncertainties surrounding the stickiness of deposits in small to medium-sized US regional banks.

Hence, markets see rate cuts beginning in the US later this year, well ahead of elsewhere, and the extent of Fed easing is also expected to be greater than from most other central banks. US rates are seen as being below UK levels next year, with the wide gap to Eurozone rates being largely eliminated in 2025.

As noted above, interest rates have been a key driver of currencies in the past number of years. Thus, if US rates start to be cut later this year before elsewhere, then the dollar is likely to lose ground, especially as it is still at an elevated level. In terms of the euro, the ECB continues to attach a very high importance to getting inflation back down to its 2% target and so will be slow to ease policy. The course of the War in Ukraine is also likely to continue to be an important factor influencing the currency, though the EU appears to have largely weaned itself of its high dependence on Russian oil and gas imports. Overall, if markets are correct in their pricing of the future course of interest rates, then EUR/USD could rise to around the $1.12 level later this year and make further gains against the dollar in 2024 as the gap between US and Eurozone rates narrows.







AIB Treasury Economic Research Unit

Forex Market Outlook

Sterling much more stable after volatile 2022

Sterling started last year trading at around $1.35 versus the dollar and 84p against the euro. It endured a difficult 2022 owing to growing concerns about the prospects for the UK economy, especially following a badly received expansionary 'mini-budget' in the autumn. Against a buoyant dollar, sterling fell sharply to a record low below $1.04 in late September. Meanwhile, EUR/GBP traded as high as 92p during this period.

Sterling, though, has regained significant ground since then, aided by reduced 'political risk' with a new UK Prime Minister and Chancellor championing fiscal restraint and introducing measures to help stabilise the public finances, which restored calm to UK financial markets. Meanwhile, UK data have printed ahead of expectations since the autumn with the economy so far avoiding falling into a recession that had been quite widely predicted. This, combined with a weakening in the dollar, has seen cable move back up to trade in a $1.18-1.24 range since November. Meanwhile, as sterling recovered, EUR/GBP moved lower to around the 86p level by the late autumn, before rising back up, to trade in a narrow 87-89p range over the opening quarter of this year.

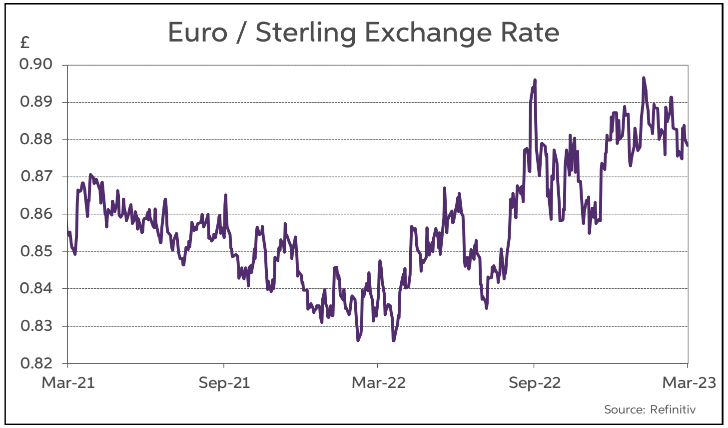
The UK currency still faces a challenging outlook. The economy lost considerable momentum last year amid very high inflation and rising interest rates, with a considerable squeeze on real household disposable incomes. It is expected to remain largely stagnant in 2023. Brexit has also acted to depress trade with the EU, which combined with the much higher costs of energy imports, saw a marked widening of the BoP deficit in 2022. Another large deficit is expected in 2023.

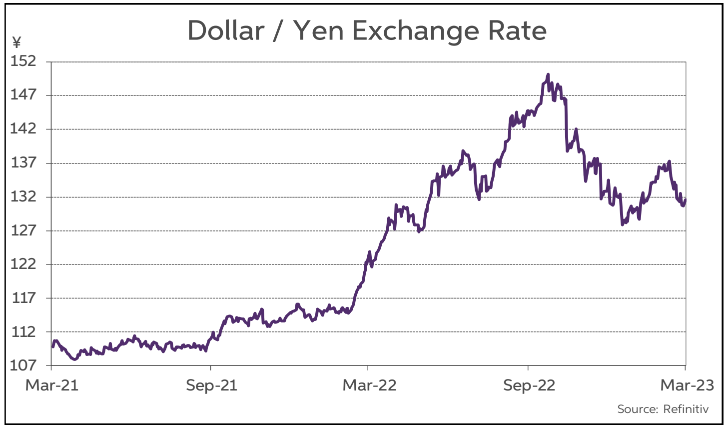
BoE policy tightening, though, is providing support for sterling, with rates now at 4.25% and expected to rise by a further 25bps to 4.5%. A credible fiscal policy framework is now in place and the economy is proving more resilient than expected. A better relationship has been established with the EU. Thus, we may see sterling remain confined to a 86-90p corridor against the euro for the remainder of the year. It could make ground against the dollar, rising towards $1.30, if US rates start to be cut later this year. Of course a risk for sterling itself could be if a weak UK economy and sharply declining inflation sees the BoE also move to cut rates later this year. Markets, though, are expecting UK rates to stay relatively high and are expecting only modest BoE rate cuts in 2024-2025.

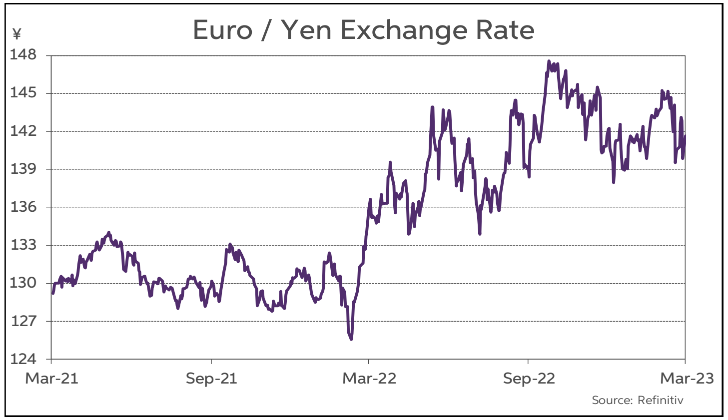
Scope for further recovery by yen, with new BoJ Governor to take office in April

In marked contrast to other central banks, the BoJ continued with its very accommodative policy in 2022, implementing large scale QE to cap ten year JGB yields, 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 yen moved off its lows late in the year, helped by the BoJ unexpectedly widened the yield corridor for ten year JGBs in December, effectively allowing them to rise by 25bps. This saw the USD/JPY rate fall back below ¥130 by January.

A new BoJ Governor, Kazuo Ueda, has been nominated to take office in April, which could lead to some volatility in the yen. A continuation of the very loose monetary policy stance would act as a headwind for the currency. However, the rise of CPI inflation in Japan to above 4% is bringing pressure on the BoJ to end its negative interest rate and yield curve control policies. If monetary policy starts to be tightened, the yen's rebound could continue, especially if the US Fed also starts to cuts rates. This could see the dollar fall further to around the ¥120 level.





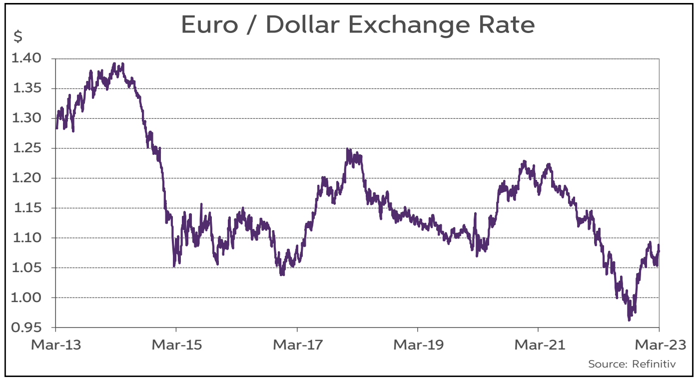


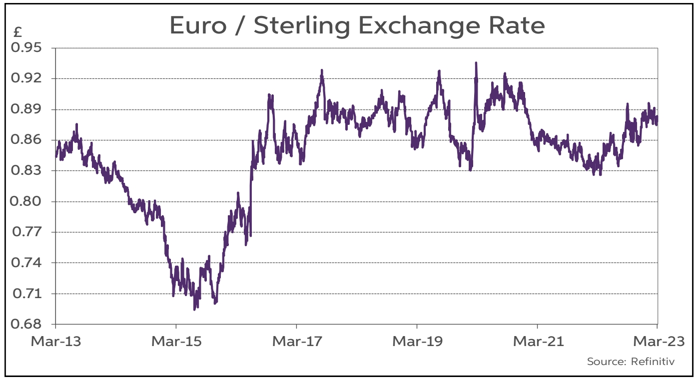
AIB Treasury Economic Research Unit

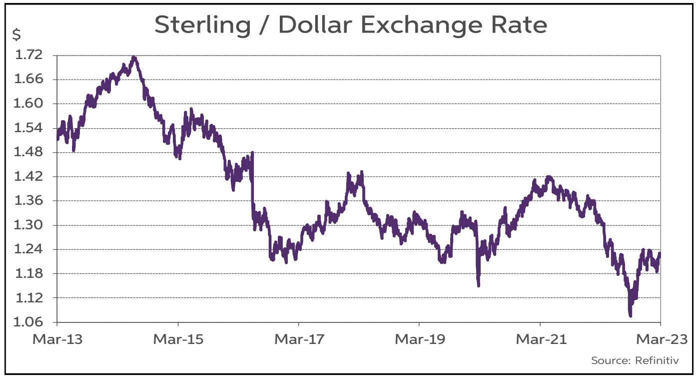
Summary of Exchange Rate Forecasts

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

	Current	Q2-2023	Q3-2023	Q4-2023	Q1-2024
Euro Versus					
USD	1.083	1.06-1.12	1.08-1.14	1.10-1.16	1.11-1.17
GBP	0.879	0.85-0.91	0.85-0.91	0.85-0.91	0.85-0.91
JPY	142.82	137-143	136-142	135-141	134-140
CHF	1.00	1.00	1.01	1.02	1.03
US Dollar Versus					
JPY	131.92	125-131	122-128	119-125	117-123
GBP	1.232	1.21-1.27	1.23-1.29	1.25-1.31	1.27-1.33
CAD	1.36	1.34	1.32	1.30	1.28
AUD	0.67	0.68	0.69	0.70	0.71
NZD	0.62	0.63	0.64	0.65	0.66
CNY	6.89	6.85	6.75	6.65	6.55
Sterling Versus					
JPY	163	159	158	156	156
CAD	1.68	1.66	1.67	1.67	1.66
AUD	1.85	1.82	1.83	1.83	1.83
NZD	1.98	1.97	1.97	1.97	1.97







AIB Treasury Economic Research Unit

AIB, 10 Molesworth Street, Dublin 2 Tel: 353-1-6600311 https://aib.ie/investorrelations/economic-research-unit