Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

18th May 2023

- Economic data have generally surprised to the upside year-to-date, though GDP growth was sluggish in Q1. Tighter credit and lending conditions could weigh on activity as year progresses

- Central banks hike rates further, but are now nearing the end of their tightening cycles. Fed opens the door to a possible pause, but BoE and ECB expected to raise rates somewhat further

- Markets price in a couple of US rate cuts before year end, contrary to Fed guidance. We believe central banks will be slow to ease policy, with core inflation still high and proving to be sticky

- Dollar quite range bound to date in 2023. It could lose some ground later in the year if the Fed starts to lower rates. Yen needs BoJ policy shift to make headway and resume its recovery

- Firmer sterling recently on better than anticipated UK data. Markets now pricing in BoE Bank rate rising to close to 5%

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Global Economic Outlook

Data better than expected, but tightening lending & credit conditions risk to growth

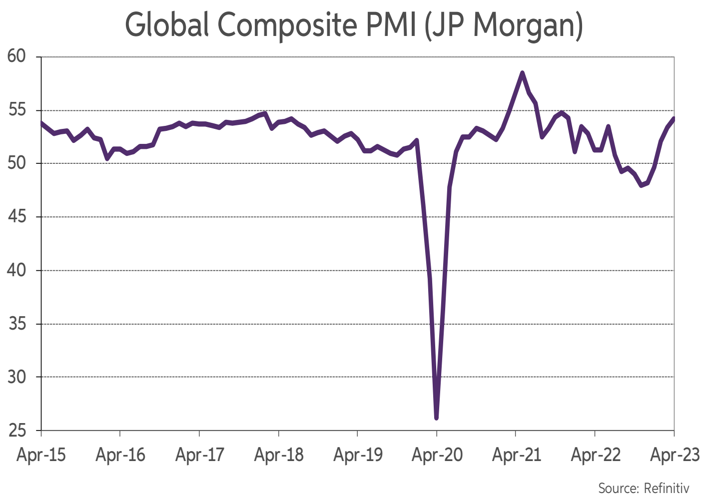
The global economy lost considerable momentum over the course of last year after it had rebounded strongly in 2021 from the impact of COVID-19. Surging inflation combined with a marked tightening of monetary policy, amid an environment of weakening confidence levels and heightened geo-political tensions, 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. GDP data for Q1 2023, though, showed growth remained weak.

The stresses that have emerged in parts of the global banking system this spring are an additional risk to the economic outlook. There had already been a tightening of financial market conditions and lending standards for loans over the past year. Both Fed and ECB surveys show banking lending conditions have tightened while credit demand has weakened. This could be accentuated by the tensions seen in the banking system in the past couple of months. The US Fed believes that recent developments are likely to result in tighter credit conditions for households and businesses in the US, and that this will weigh on economic activity, employment and inflation. It says the extent of these effects are uncertain, but Fed Chair Powell has opined they could 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 to continue lending at the same pace as before.

The impact is not expected to be as great in Europe. The OECD in its latest update, though, warned 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 decline in most economies. However, price pressures have become more broad-based, meaning core inflation rates are proving to be quite sticky. Central banks are paying particularly close attention to wage growth given the tightness of labour markets, but they have also noted that profit margins have widened too. Nonetheless, inflation is generally expected to continue declining. Oil and gas prices have fallen sharply, and are now below the levels that prevailed ahead of the Russian invasion of Ukraine. Global food commodity prices are continuing to decline. Economic activity remains subdued with clear signs of a marked easing in inflationary pressures in the manufacturing sector. Forecasts that CPI rates will fall to 3-4% 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 year-to-date in all the main economies, but growth remains sluggish. 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, most notably in the US. Uncertainty about the economic outlook is elevated, so a close eye needs to be kept on the data.



GDP (Vol % Change)

	2021	2022	2023 (f)	2024 (f)
World	5.9	3.4	2.8	3.0
Advanced Economies	5.4	2.7	1.3	1.4
US	5.9	2.1	1.6	1.1
Eurozone	5.3	3.5	0.8	1.4
UK	7.6	4.0	-0.3	1.0
Japan	2.1	1.1	1.3	1.0
Emerging Economies	6.7	4.0	3.9	4.2
China	8.1	3.0	5.2	4.5
India	8.7	6.8	5.9	6.3
World Trade Growth (%)	10.4	5.1	2.4	2.4
Inflation -CPI Advanced Economies (%)	3.1	7.3	4.7	2.6

Sources: IMF World Economic Outlook April 2023

Interest Rate Outlook

Fed opens the door to pausing, ECB & BoE near the end of their tightening path

After a 15 month period, characterised by aggressive monetary policy tightening, central banks appear to be at, or nearing the end of their tightening cycles. The period of rapid rate hikes was against the backdrop of inflation rising to 10% or above in many economies and labour market conditions remaining tight. More recently though, the pace of rate increases has slowed amid signs that inflation is past its peak and on a downward trajectory. Central banks have also had to factor in a new development over the last two months. The stresses that have emerged in parts of the global banking system are 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. On the back of this, futures contracts softened considerably in March. However, central banks continue to assert their credentials to tighten policy further, if required They have also tried to dampen expectations of rate cuts before year-end, indicating that policy would need to be kept tight to restore price stability.

The US Fed raised rates by 25bps in May, which brought the target range for the funds rate to 5.00-5.25%. The Fed has now raised rates by 500bps during this tightening cycle. However, it opened the door to pausing its rate hiking phase at its May meeting. It dropped the guidance in its previous statements that some additional policy firming "may be appropriate". Although, it stopped short of giving a commitment to pause hikes, with Fed Chair Powell stating that inflation remains a key concern and it is too soon to say with certainty that the rate tightening phase is over. The Fed's most recent rate projections, released in March, shows that its anticipates rates going on hold when they reached their current level of 5.00-5.25%, with no FOMC members anticipating a rate cut this year. The Fed repeated that policy easing is not expected in 2023 at its May meeting. Market are of the view that US rates have peaked, while futures contracts are pricing in rates cuts later this year. In our view, a further hike cannot be fully ruled out, while we believe the Fed will be slower to cut rates than markets anticipate. However, markets have scaled back their expectations recently on the amount of rate cuts in H2 2023 to around 50bps. Both the Fed and markets see significant rate cuts in 2024/25, taking the funds rate back down to around 3%.

The BoE hiked rates again by 25bps in May, bringing the Bank Rate up to 4.50%. In its updated macro forecasts, the BoE is no longer anticipating a recession for the UK economy this year. The Bank refrained from giving clear guidance on its rate outlook, but did continue to communicate a willingness to hike again, if needed. In this regard, the BoE did not try to alter the markets view that some further tightening may be required. Futures contracts envisage the Bank Rate peaking in a 4.75-5.00% range by the early autumn, which seems reasonable. Rates are seen falling back near to 4% by end 2024.

Meanwhile, the ECB slowed its pace of rate hikes, as anticipated, to 25bps in May, which brought the Deposit rate up to 3.25%. The ECB was again quite direct in stating that inflation is expected to remain far too high, for too long. At the same time, President Lagarde commented that the ECB has more ground to cover and is not pausing, in contrast to the signals coming from the Fed. Futures contracts are pricing that the ECB will hike by 25bps at its next policy meeting in June, and are currently discounting that rates will be increased in Q3, peaking at 3.75% and remaining at this level into year end. However, given the ECBs concerted focus on bringing inflation under control and maintaining a restrictive policy for as long as required amid core inflation remaining sticky, rates could well go higher than is currently priced in by markets. Furthermore, they may also be slower to fall back to 3% in 2024, as is currently priced in by markets to happen by the end of next summer.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	5.125	5.37	5.35	4.32	3.64
June'23	5.125	5.35	5.35	4.30	3.65
Sept'23	5.125	5.20	5.10	4.10	3.45
Dec'23	4.875	4.85	4.50	3.70	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	3.25	3.39	3.82	3.53	3.10
June'23	3.50	3.65	3.95	3.60	3.15
Sept'23	3.75	3.85	4.10	3.65	3.20
Dec'23	3.75	3.80	4.00	3.50	3.05

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	4.50	4.70	5.05	4.78	4.30
June'23	4.75	4.90	5.10	4.80	4.30
Sept'23	4.75	4.85	5.00	4.70	4.20
Dec'23	4.75	4.80	4.90	4.60	4.10

** Swap Forecasts Beyond 1 Year*

AIB

Forex Market Outlook

AIB Treasury Economic Research Unit

US rate cuts later this year could weigh on the dollar

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. By September 2022, the dollar had risen to its highest level on a trade -weighted basis in 20 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, falling from $1.22 in mid'21 to a low of $0.95 in Sept'22. It came under marked downward pressure following the Russian invasion of Ukraine.

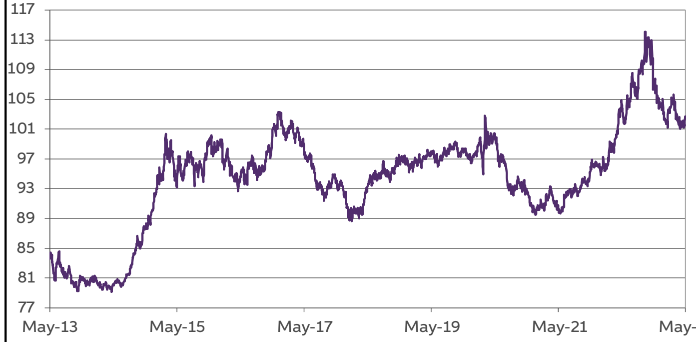
However, the final quarter of 2022 through to end January 2023 saw a change in the dollar's fortunes. It lost significant ground as other central banks stepped up the pace of rate hikes. EUR/USD moved back up to parity, before rising up to the $1.05-1.06 level late last year and then moving above $1.09 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. Overall, EUR/USD traded in a $1.05-1.10 range from December to March, while cable traded between $1.18-1.24, with the yen moving in a wider ¥128-138 corridor. The dollar did lose some further ground amid the emergence of stresses in parts of the global banking system, in particular in the US in the March-April period. Markets priced in a lower peak for rates and significant policy easing in the US in the second half of this year. EUR/USD traded to a year-to-date high just below $1.11 in late April, while GBP/USD registered a 2023 high of $1.268 in early May.

In the last fortnight though, the dollar has regained some momentum, despite the Fed signaling that it is considering pausing its hiking cycle. Some nervousness on markets over the looming US debt ceiling deadline saw the dollar benefit from safe-haven demand. US data also remain strong while there appears limited contagion to date from the stresses in the US banking system. US rate contracts have firmed, with fewer rate cuts now anticipated in H2 2023. At the same time, the euro was softer in the aftermath of the May ECB meeting, despites its hawkish stance. It may be also be the case that euro positioning, where net longs had hit a two and a half year high, have weighed on the single currency. In level terms, the EUR/USD rate has moved below the $1.09 level to trade under $1.08 in recent days. In the context of the renewed downward momentum in EUR/USD, $1.08 was an important level as its represented its 100-day moving average. However, there is strong technical support for the euro in the $1.05-1.06 range.

In the near term, any further bouts of risk aversion on markets may add some additional 'safe haven' support to the dollar. However, the stresses that have emerged in parts of the global banking system 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. This could see the Fed start to loosen policy later this year. Thus, rates seem likely to be lowered in the US ahead of elsewhere and the extent of Fed easing is also expected to be greater than from most other central banks. In this scenario, 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 it will be slow to ease policy. The evolution of the War in Ukraine remains a risk factor, 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 belief that US rates will be cut ahead of elsewhere and to a greater extent, then the EUR/USD pair could rise to around the $1.12 level later this year, and the euro could make further gains against the dollar in 2024.

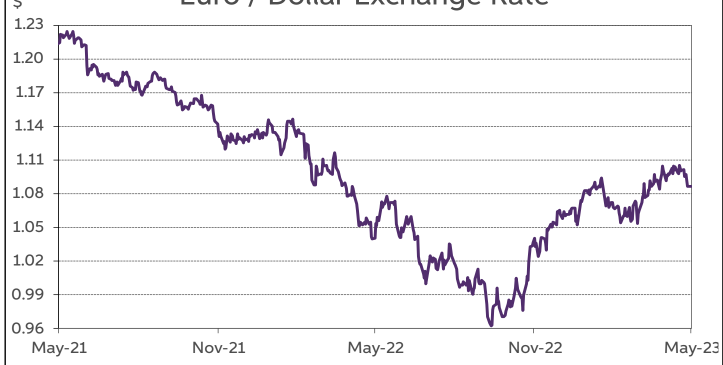
US Dollar Trade Weighted Index Versus Majors

(March 1973 =100)



Source: Refinitiv

Euro / Dollar Exchange Rate



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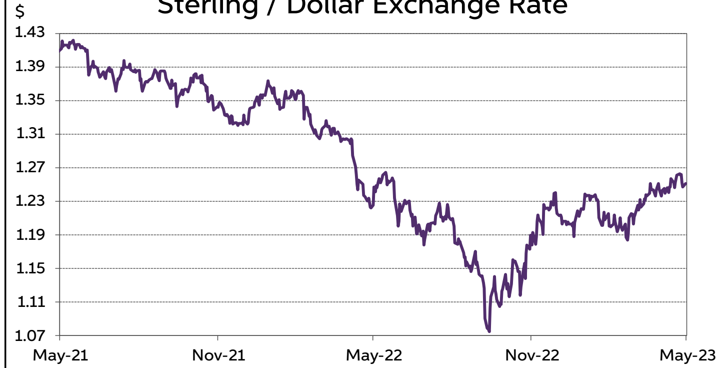
Sterling / Dollar Exchange Rate



Source: Refinitiv

Forex Market Outlook

Sterling recovers ground amid BoE hikes and better than expected UK macro data

Sterling endured a difficult 2022 owing to concerns about the UK economy, especially following a badly received expansionary 'mini-budget'. Against a buoyant dollar, sterling fell sharply to a record low below $1.04 in late September, while EUR/GBP traded as high as 92p. 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.

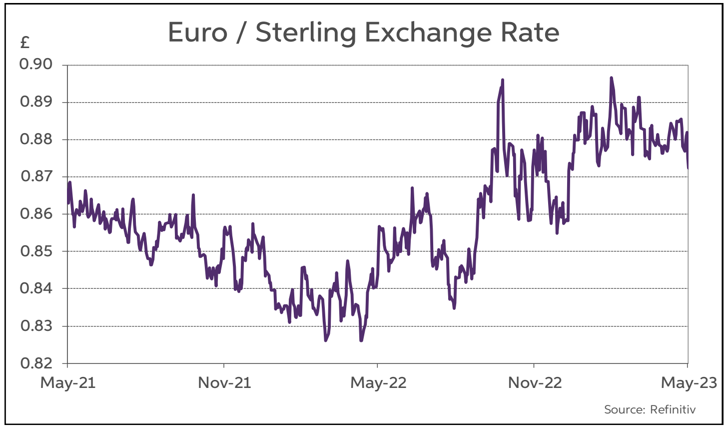
Meanwhile, UK data have printed ahead of expectations since the autumn, with the economy avoiding falling into a recession that had been quite widely predicted. Indeed, the BoE is no longer forecasting a recession for this year. The improved macro backdrop combined with a weaker dollar, has seen cable move back up to trade mainly in a $1.18-1.26 range since November. Meanwhile, as sterling recovered, EUR/GBP moved lower to around the 86p level by late autumn, before rising back up, to trade in a narrow 87-89p range over the Jan-April period. More recently, EUR/GBP has been struggling to hold onto the 87p threshold, trading to a low of 86.6p in early May.

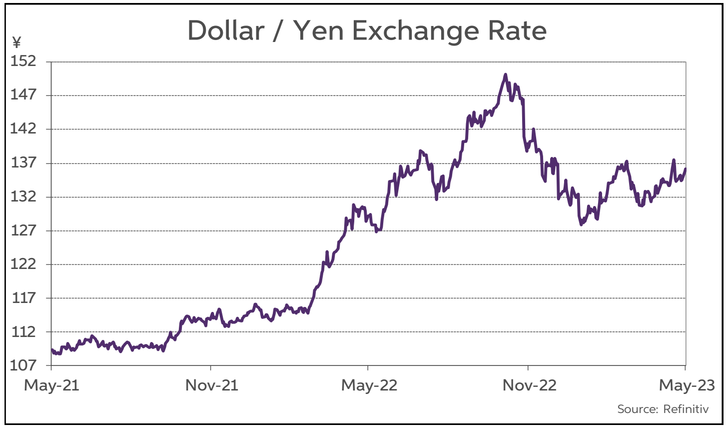
While UK macro news flow has been better than expected, the currency still faces a challenging outlook. The economy lost considerable momentum last year, and has basically flat-lined since Q2 2022, amid very high inflation and rising interest rates, with a considerable squeeze on real household disposable 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.

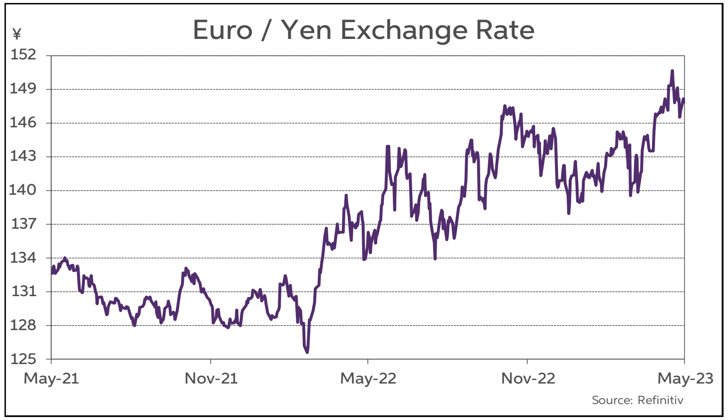
BoE policy tightening, though, is providing support for sterling, with rates now at 4.50% and expected to rise by a further 25-50bps. A credible fiscal policy framework, an economy proving more resilient than expected and a better relationship recently with the EU are also helpful to the currency. Thus, we may see sterling remain confined to a 86-89p corridor against the euro for the remainder of the year. Similar to the euro, it could make ground against the dollar, if US rates start to be cut later this year, with the potential for GBP/USD to rise towards $1.30. On the other hand, a key risk for sterling could be if a weak UK economy and sharply declining inflation sees the BoE cut rates appreciably next year. Markets are expecting UK rates to stay relatively high, falling back towards 4% by end-2024, compared to 3% in the US and Eurozone

Continued dovish stance by BoJ under new Governor weighs on yen

In marked contrast to other central banks, the BoJ continued with its very accommodative policy in 2022. The resultant widening interest rate differentials saw severe downward pressure on the yen. USD/JPY fell to 30-year lows in the autumn, rising above the ¥150 level in October. The yen moved off its lows late in the year, helped by the BoJ unexpectedly widening 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. However, the BoJ under new Governor, Kazuo Ueda, continues to espouse a dovish outlook on policy, disappointing speculation of a possible change. This has resulted in renewed yen weakness, with the dollar rising to ¥138 and the euro back up to around the ¥150 level. The continuing very loose monetary policy stance is a major headwind for the currency. An early change in policy direction does not seem imminent. It could be 2024 before this occurs, which may well coincide with policy loosening elsewhere, thereby providing scope for the yen to rebound next year.





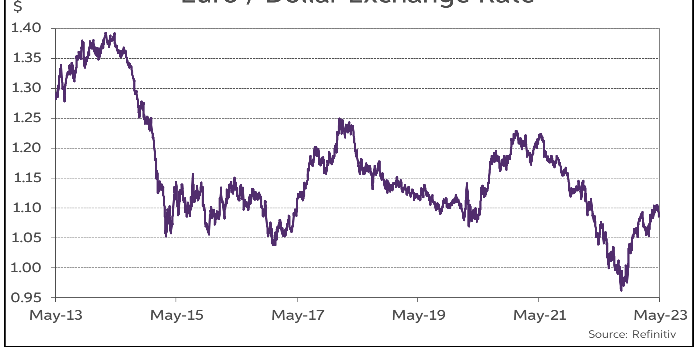


Summary of Exchange Rate Forecasts

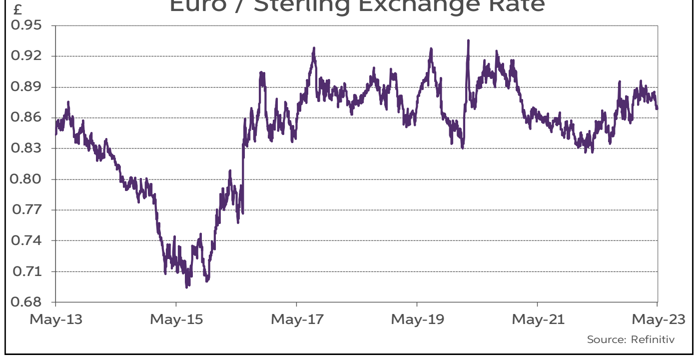
("Spot" Forecasts for end Quarter can be taken as Mid-Point of expected Trading Range)

Euro Versus	Current	Q2-2023	Q3-2023	Q4-2023	Q1-2024
USD	1.081	1.06-1.12	1.08-1.14	1.10-1.16	1.12-1.18
GBP	0.869	0.84-0.90	0.85-0.91	0.85-0.91	0.85-0.91
JPY	148.88	146-152	147-153	146-152	143-149
CHF	0.97	0.97	0.98	0.99	1.00
US Dollar Versus					
JPY	137.78	134-140	132-138	129-135	125-131
GBP	1.243	1.22-1.28	1.23-1.29	1.25-1.31	1.28-1.34
CAD	1.35	1.34	1.32	1.30	1.28
AUD	0.66	0.67	0.68	0.69	0.70
NZD	0.62	0.63	0.64	0.65	0.66
CNY	7.03	7.00	6.90	6.80	6.70
Sterling Versus					
JPY	171	171	170	169	168
CAD	1.67	1.68	1.67	1.67	1.67
AUD	1.87	1.87	1.85	1.86	1.87
NZD	1.99	1.98	1.97	1.97	1.98

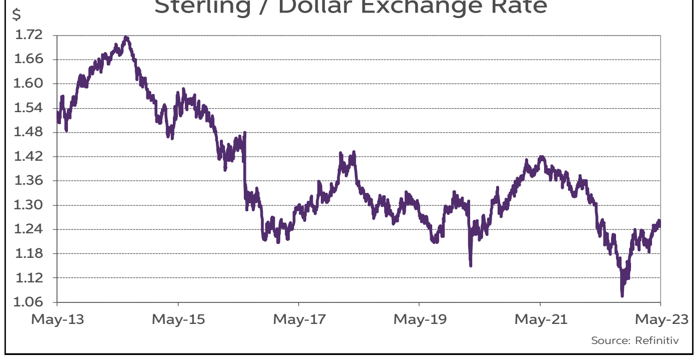
Euro / Dollar Exchange Rate



Euro / Sterling Exchange Rate



Sterling / Dollar Exchange Rate



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