

Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit



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- Inflation now at very high levels, which combined with other headwinds such as the rapid tightening of monetary policy, is acting as a significant drag on global economic activity
- Growth forecasts have been scaled back considerably for most economies. Some countries likely to enter recession this winter, with very weak growth in prospect for 2023
- Significant rate hikes implemented to date in 2022 as central banks respond to sharply higher inflation, with the tightening cycle to extend into first half of 2023
- Markets see EZ, UK & US rates rising to 3%, 5.75% and 4.625%, respectively, by mid-2023. BoE unlikely to lift rates to this extent. Rates expected to remain high in coming years
- Dollar soars to 20-year highs on aggressive Fed tightening. Sterling falls on worries over UK

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Risk of a global recession as inflation hits very high levels and rates rise sharply

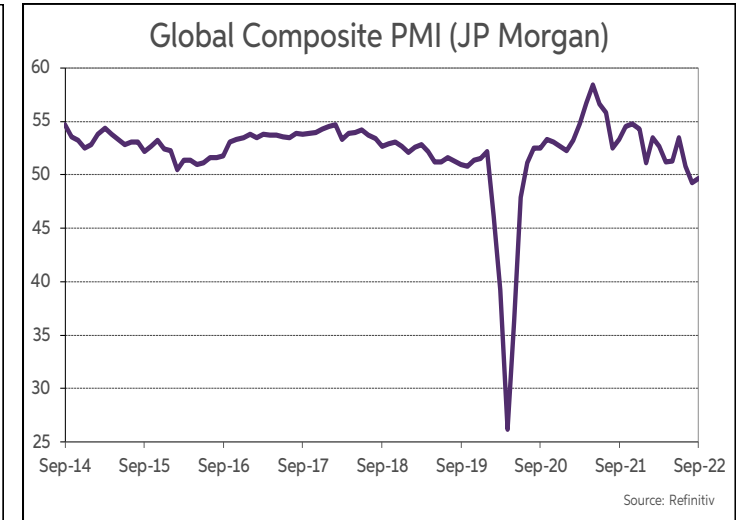
Growth forecasts continue to be scaled back nearly everywhere as inflation surges to very high levels on the back of soaring energy costs. This is putting significant downward pressure on households real disposable incomes. Meanwhile, most central banks are engaged in a pronounced tightening of monetary policy. There has been substantial tightening of financial conditions, with the faster and more extensive hiking of interest rates by central banks, which is weighing on economic activity. Both the IMF and OECD, in their recent autumn updates, paint a gloomy picture, saying global growth has slowed significantly in 2022 and will weaken further in 2023. There has also been a greater-than-anticipated slowdown in the Chinese economy, largely reflecting fresh COVID-19 outbreaks and lockdowns.

Both the IMF and OECD are now forecasting that the world economy will grow by around 3.0% this year and 2.25% in 2023. This compares to the projections of circa 4.5% and 3.2% growth for 2022 and 2023, respectively, made around the start of this year. It represents a marked slowdown from the 6% growth seen in 2021. Forecasters are hoping that the high levels of private sector savings, strong labour markets and fiscal measures to mitigate some of the impact of higher energy costs on households and businesses this winter, will help most advanced economies to avoid outright recession. Growth in advanced economies is expected to slow sharply from 5.2% in 2021 to 2.4% in 2022 and 1.1% in 2023, according to the latest IMF forecasts.

The slowdown in activity is not uniform across the world economy. Many commodity-producing economies are registering higher output and earnings. Meantime, Russia and Ukraine have entered very deep recessions. Within advanced economies, the Bank of England is forecasting that the UK economy will contract by 1.0-1.5% next year. The OECD expects growth in the US and Eurozone to slow to a very anaemic 0.3-0.5% range in 2023. Meanwhile, growth in China is forecast to weaken sharply this year to 3.2% from 8.1% in 2021, before picking up to 4.9% in 2023. The Japanese economy, though, is projected to grow by 1.7% and 1.6% in 2022 and 2023, respectively, on a par with the growth rate of 1.7% seen in 2021. Continuing robust growth is projected for India in 2022-23.

The OECD and IMF highlight the considerable uncertainty around economic forecasts, which is well beyond the usual range. The effects of the War in Ukraine could be even greater than assumed. In particular more severe fuel shortages, especially for gas in Europe, could reduce growth even further. High inflation could prove to be more longer lasting than projected, weighing on global activity. There is also a growing 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, especially in China, which continues to implement lockdowns to control new outbreaks.

Inflation has risen to very high levels in many countries. It now stands at 10% in the Eurozone and UK and above 8% in the US. There is a risk of a spill over into much higher wage inflation, which would make it more difficult to get CPI rates back down to their 2% target anytime soon. Indeed, a shortage of workers is already putting upward pressure on wages. The unemployment rate has fallen to 3.5% in the US and UK, with a record low of 6.6% in the Eurozone. With price pressures becoming more broad-based, inflation is now expected to remain elevated well into next year. The OECD now sees consumer price inflation averaging 8.3% this year in the G20, and a still high 6.6% in 2023. It is now expected to be 2024 before inflation gets back down near to its 2% target level.



GDP (Vol % Change)

	<u>2020</u>	<u>2021</u>	<u>2022 (f)</u>	<u>2023 (f)</u>
World	-3.1	6.0	3.2	2.7
Advanced Economies	-4.6	5.2	2.4	1.1
US	-3.4	5.7	1.6	1.0
Eurozone	-6.3	5.2	3.1	0.5
UK	-9.3	7.4	3.6	0.3
Japan	-4.5	1.7	1.7	1.6
Emerging Economies	-2.0	6.6	3.7	3.7
China	2.2	8.1	3.2	4.9
India	-6.6	8.7	6.8	6.1
World Trade Growth (%)	7.9	10.1	4.3	2.5
Inflation -CPI				
World Economies (%)	3.2	4.7	8.8	6.5

Source: IMF World Economic Update, October 2022

Central banks step up pace of rate tightening as inflation surges to 40-year highs

CPI rates have risen to around 10% or above in many economies. Even though growth has weakened significantly, it is now quite clear that central banks are committed to getting inflation back under control. Thus, we have seen moves towards more aggressive policy tightening over the summer. Meantime, there has been a dramatic repricing in interest rate markets over the past three months. This has had four notable features; a shift to much larger sized rate hikes, far higher terminal or peak interest rates, delayed policy reversal into easing mode and marked moves upwards on the level where interest rates are expected to settle at over the medium term.

The US Federal Reserve has been the most vocal of the main central banks in delivering a clear message that it is committed to taking the required policy action to restore price stability. Chair Powell has emphasized that the Fed “will keep at it until we are confident the job is done”. The Fed has increased rates by 300bps since March, including 75bps moves in June, July, and September, the first such hikes in nearly thirty years. This has brought the funds rate up from 0.125% to a 3.0-3.25% range. Further hikes are in the pipeline over the next six months, with the latest Fed ‘dot plot’ indicating that it sees the funds rate peaking at around 4.625% in 2023. Indeed, all but one FOMC member sees US rates rising to a 4.5-5.0% range next year. Market rate expectations have been quite volatile over the summer and early autumn, but they are currently close to the Fed’s trajectory. Futures contracts see the funds rate getting close to 4.75% by next spring. The Fed has indicated that restoring price stability will require a restrictive policy stance to be maintained for some time and has cautioned against prematurely loosening policy. Thus, markets now foresee only moderate rate cuts coming on to the Fed agenda in 2024-26, with the funds rate being lowered to around 3.5% over this period.

The Bank of England hiked rates by 50bps at both its August and September MPC meetings. This represented an acceleration in the pace of tightening as the Bank had raised rates in 25bps steps at the previous four MPC meetings this year. The moves have taken the Bank rate up from 0.25% to 2.25%. The markets now believe that the loosening of fiscal policy announced by the new UK government, which has put downward pressure on sterling, will necessitate far more aggressive policy tightening from the BoE to counteract increased upside risks to inflation. Markets are pricing in that UK rates will be raised by a further 200bps to 4.25% by end year and an additional 150bps in H1 2023, which would see the Bank rate reach a peak of 5.75%. Only modest rate cuts of 75bps are expected in the period 2024-26. The BoE, though, sees the economy entering recession in the second half of this year and contracting by 1.0-1.5% in 2023. As such, we don’t expect the BoE to hike rates as aggressively as priced in by markets. We expect rates to get to 3.75% by end year and to peak at 4.5% next spring

The ECB ended QE at mid-year and implemented its first rate increase since 2011 at its Council meeting in July, when it hiked by 50bps. It followed this up with a 75bps rate increase in September. The two hikes took the deposit rate up from -0.5% to 0.75%, bringing an end to the Bank’s negative interest rate regime. The ECB has stopped giving specific forward guidance on policy, indicating that rate moves are now very much data dependent. Further significant rate hikes are on the cards given that inflation in the Eurozone has climbed to 10%. Markets now expect the ECB will hike rates by a further 125bps over the remainder of the year, taking the key deposit rate up to 2%. They see a further 100bps rate increase in the first half of 2023, bringing rates up to 3%. Unlike in the US and UK, rate cuts are not anticipated thereafter, with markets pricing in that the deposit rate will be maintained at 3% in 2024-2025.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	3.125	4.01	5.07	4.61	4.15
Dec'22	4.375	4.75	5.25	4.75	4.25
Mar'23	4.625	5.00	5.40	4.80	4.30
June'23	4.625	4.90	5.25	4.70	4.20

* Swap Forecasts Beyond 1 Year

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.75	1.34	2.61	2.98	3.18
Dec'22	2.00	2.50	3.10	3.20	3.30
Mar'23	2.75	3.10	3.35	3.35	3.35
June'23	2.75	3.00	3.25	3.25	3.25

* Swap Forecasts Beyond 1 Year

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	2.25	3.49	5.27	5.57	5.51
Dec'22	3.75	4.50	5.25	5.70	5.50
Mar'23	4.50	4.90	5.35	5.55	5.40
June'23	4.50	4.75	5.15	5.30	5.20

* Swap Forecasts Beyond 1 Year

Dollar hits 20-year highs as hawkish Fed hikes rates aggressively

The dollar moved steadily lower in 2020, losing 12% against the other major currencies, as US rates were cut from over 2% to virtually zero. However, it recovered some ground in the second half of last year, helped by a firming of US interest rates along the curve, amid growing expectations of significant Fed rate hikes in 2022-23. It rose by 5% in trade-weighted terms during this period. The euro was a notable casualty of the dollar's strength, falling from \$1.22 in mid-2021 to \$1.12 near year end.

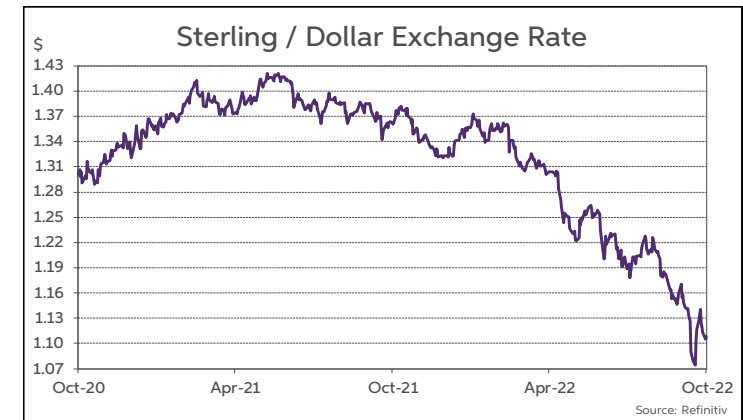
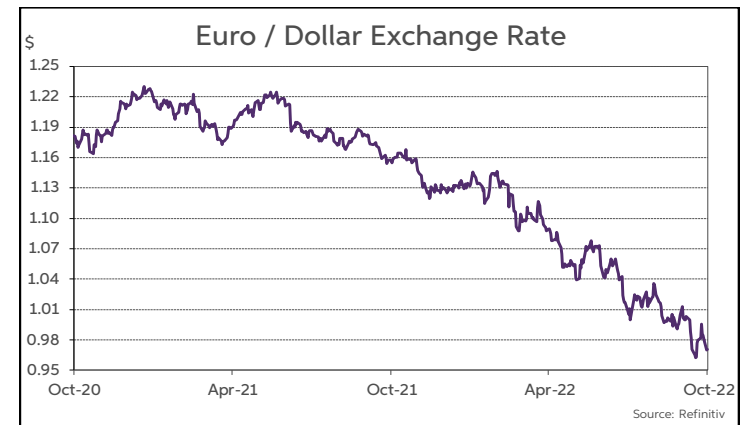
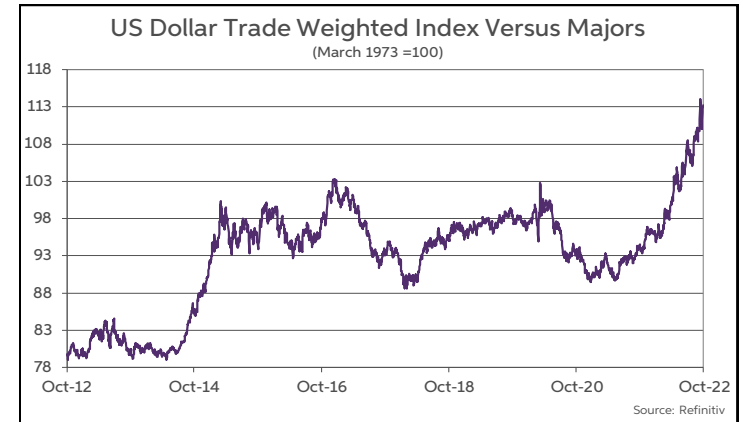
The Russian invasion of Ukraine triggered a further bout of dollar strength this spring, in terms of a flight-to-quality into the world's largest reserve currency as financial markets came under pressure. The Fed has also been the most vocal of the main central banks on the need for significant rate tightening to counteract the further surge in inflation seen this year. The dollar has risen to its highest level on a trade-weighted basis since 2002, more than regaining all the ground lost during 2020. It has made significant gains against a broad range of currencies, with particularly large upward moves against the yen and sterling.

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 more 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 key support level at \$1.08, which had held during the early stages of the COVID-19 crises in the first half of 2020, also gave way. The major support level of \$1.04, which was the lowest point hit by the euro in the past twenty years, initially held in early summer before giving way at mid-year as the Fed stepped up the pace of rate tightening. The euro fell to parity initially, but then moved below this level in late summer, falling to as low at \$0.95 as risk-off sentiment took hold in markets again and futures contracts priced in greater Fed tightening.

It is difficult to envisage a significant reversal in the dollar's fortunes over the winter as it should be supported by a further move upwards in US interest rates to a 4.5-5% range by next spring and relatively high US bond yields. Markets also seem likely to remain volatile, which would point to continuing flows into traditional safe-haven currencies like the dollar. Geo-political risks are also expected to remain elevated, especially in regard to Russia and its war in Ukraine, which should be supportive of the US currency.

From a euro viewpoint, the fact that the ECB is set to deliver further rate hikes over the remainder of 2022 and into 2023 should prove supportive of the currency. However, the war in Ukraine is likely to continue to pose a risk for the euro, especially with the virtual cessation of gas imports from Russia. This could lead to power cuts in the Eurozone, though stocks of stored gas are high at present. The last time that the euro dropped below parity, it spent almost three years there over the period 2000-2002, falling to as low as \$0.85.

Our base case, though, is that the end of negative interest rates and further ECB rate hikes will provide some support for the single currency. Market positioning is also relatively long the dollar at present. Thus, we expect the euro to trade in a \$0.95-1.00 range over the rest of the year. Further out, the dollar could lose some ground over the course of 2023 once US rates peak and should talk of Fed rate cuts in 2024 come on to the agenda. For now, though, the dollar very much still has the upper hand on forex markets, with the Fed on an aggressive rate tightening path. Other central banks may not have the appetite to match the scale of rate hikes seen in the US, with the BoJ staying on hold and the BoE and Reserve Bank of Australia opting for smaller rate hikes recently.



Sterling under the cosh on growing concerns about the UK economy and policy mix

Sterling gained good ground last year as the EU-UK Brexit trade deal lifted a cloud of uncertainty around the currency and the BoE started to turn quite hawkish on monetary policy, before hiking rates by 15bps to 0.25% in December. Sterling ended 2021 trading at around \$1.35 versus the dollar and 84p against the euro.

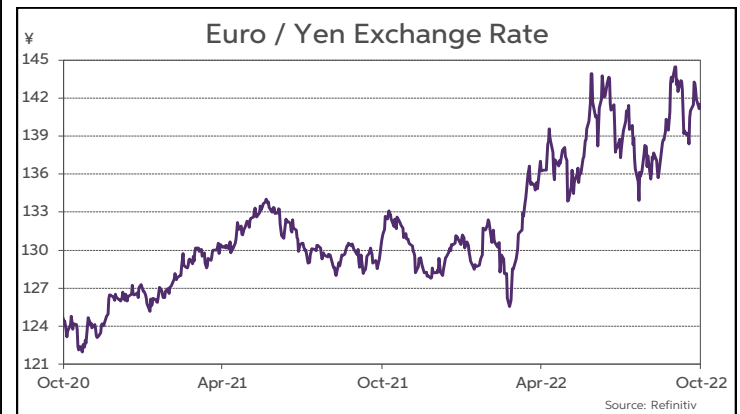
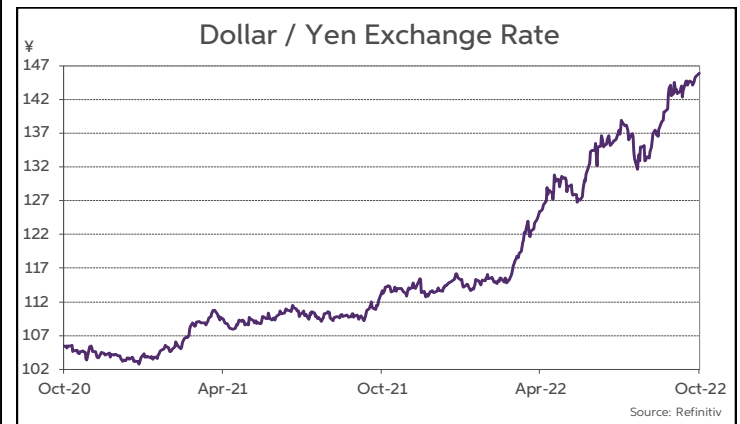
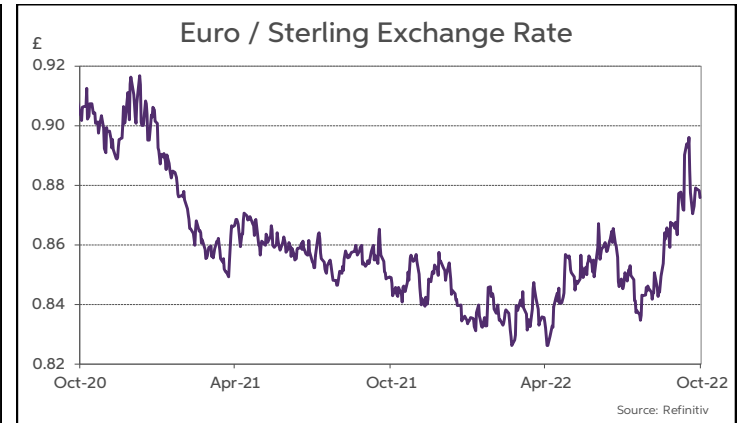
The BoE has followed up with six further rate hikes to date in 2022, totalling 200bps, which has brought the Bank rate up to 2.25%. Further rate hikes are on the cards, with inflation hitting 10% and expected to climb further in October. Despite the rate increases, sterling has lost considerable ground to the buoyant dollar this year, with cable falling sharply from \$1.35 in January to a record low below \$1.04 in late September, before recovering to above the \$1.10 level. Meanwhile, the euro has risen from 84p to as high as 92p versus sterling at one stage and is currently trading at circa 88p. Sterling's weak performance is due to mounting concerns around the economic outlook and policy mix in the UK. A mini-budget in September that contained large tax cuts and a big increases in public borrowing was very badly received in financial markets, with sharp falls in sterling.

This marked expansion of fiscal policy runs counter to the tightening of monetary policy being pursued by the BoE to rein in inflation. The economy has lost considerable momentum since earlier in the year in the face of galloping inflation and rising interest rates. The weakening of the currency is adding to inflationary pressures. Meantime, the Bank of England is quite downbeat on the economy's growth prospects as a result of a squeeze on real household disposable incomes this year from high inflation. Brexit has also acted to depress trade with the EU, which combined with the much higher costs of energy imports, has seen a marked widening of the BoP deficit in 2022. Rising interest rates are also weighing on activity. The BoE sees the economy entering recession and is projecting a fall of 1.0-1.5% in GDP in 2023.

It is very difficult to make forecasts for sterling given the currency has been so volatile. The range for cable has been \$1.04 to \$1.17 in the past month, with EUR/GBP moving in an 86-92p band. FX positioning is now quite short sterling. Further rate hikes should provide some support for sterling, but the BoE is unlikely to deliver all the additional 200bps in tightening priced in by markets for end year. Political risks could also continue to weigh on the currency. A close eye needs to be kept on the current negotiations with the EU over the Northern Ireland Protocol as it may damage sterling if the talks break down. Overall, sterling seems likely to remain weak and volatile in the months ahead. It may trade in an 86-90p range against the euro over this period.

Sharp fall in yen on widening interest rate differentials sees BoJ intervene

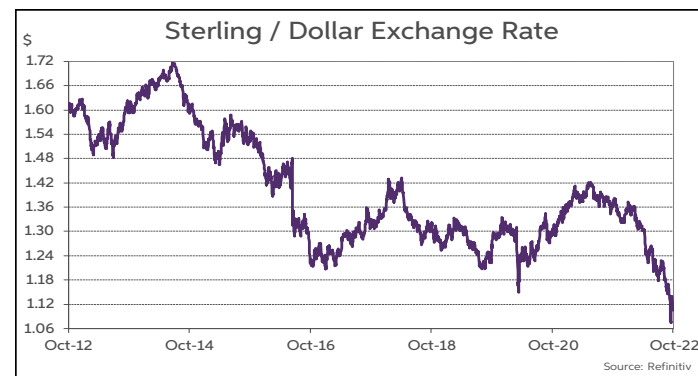
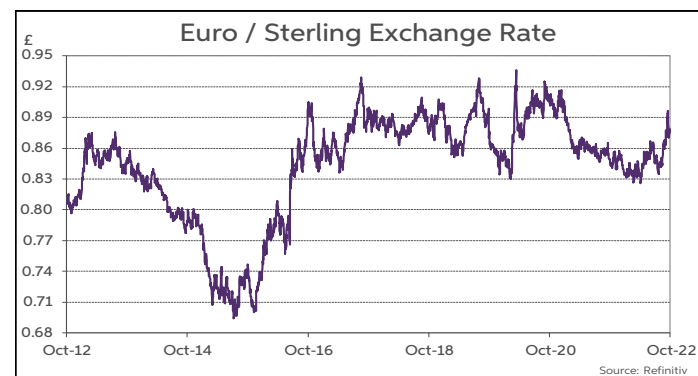
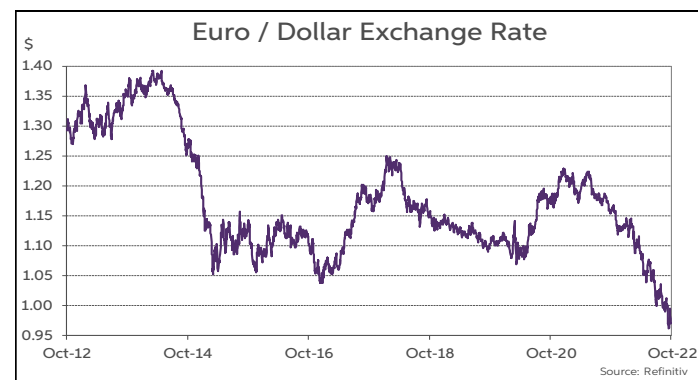
In marked contrast to other central banks, the BoJ has stuck to its very accommodative policy and is engaged in large scale QE to cap ten year JGB yields at 0.25%, while keeping the key OCR in negative territory. Widening interest rate differentials have put severe downward pressure on the yen, with outflows into much higher yielding currencies. The yen has fallen to near twenty-four year lows against the dollar—the US currency had not been above the ¥147 level since 1998. The BoJ has had to intervene to support the currency for the first time since 1998. The yen could lose further ground if interest rates elsewhere continue to rise rapidly over the winter. However, if markets rates elsewhere top out as expected by spring 2023, then the yen may stabilise in H1 2023. It is hard to see any major recovery in the weak yen, though, until interest rate differentials start to narrow.



Summary of Exchange Rate Forecasts

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

	Current	Q4-2022	Q1-2023	Q2-2023	Q3-2023
Euro Versus					
USD	0.969	0.93-0.99	0.96-1.02	0.99-1.05	1.02-1.08
GBP	0.878	0.86-0.92	0.87-0.93	0.87-0.93	0.87-0.93
JPY	142.34	139-145	145-151	148-154	149-155
CHF	0.97	0.97	0.98	1.00	1.02
US Dollar Versus					
JPY	146.88	145-151	147-153	145-151	142-148
GBP	1.104	1.05-1.11	1.07-1.13	1.10-1.16	1.14-1.20
CAD	1.38	1.39	1.36	1.33	1.30
AUD	0.63	0.62	0.64	0.66	0.68
NZD	0.56	0.55	0.57	0.59	0.61
CNY	7.17	7.20	7.10	6.95	6.80
Sterling Versus					
JPY	162	160	165	167	170
CAD	1.52	1.50	1.50	1.51	1.52
AUD	1.77	1.74	1.72	1.71	1.72
NZD	1.97	1.96	1.93	1.92	1.92



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