Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Global economy losses some momentum in recent months, while inflation remains subdued
- Fed sticks to its steady rate tightening path, but other central banks turn more cautious as global growth slows somewhat
- Dollar makes gains, aided by risk aversion, rising US bond yields/rate expectations and solid macro data. Although, we expect the longer term weakening trend will eventually reassert itself
- Sterling's rally goes into reverse on the back of weaker macro data, including inflation, and BoE comments downplaying the prospects of a near-term rate hike
- Euro's rise against the dollar has reversed somewhat, amid some dollar strength and a combination of weaker Eurozone data and a cautious ECB tone weighing on the single currency

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Global Economic Outlook

Global growth somewhat softer in Q1, but near term prospects remain upbeat

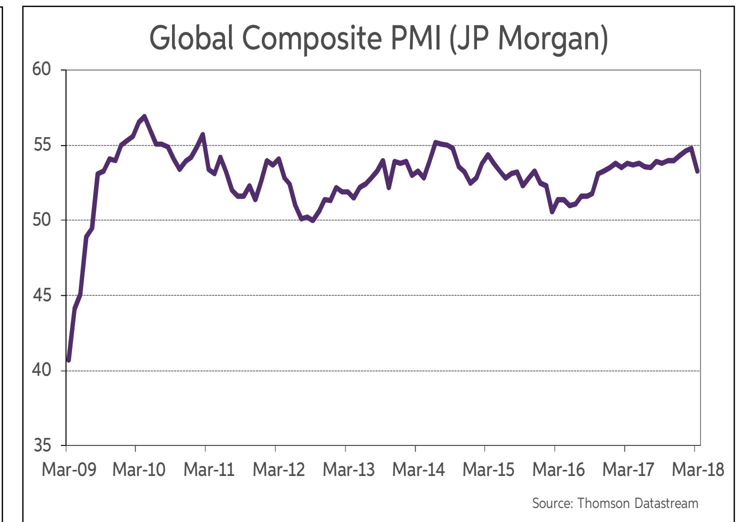
The global economy has gained strength over the past eighteen months. The IMF in its latest World Economic Outlook commented that growth in the second half of 2017 of "above 4%", represented the strongest pace of growth since the second half of 2010. For the full year 2017, global growth came in at 3.8%, compared to 3.2% in 2016. Advanced economies grew by 2.3% in 2017, versus 1.7% the previous year. Activity in developing economies also gathered strength last year, supported by the emergence of countries like Russia, Brazil and Nigeria from recessions as oil prices recovered from their early 2016 lows. Emerging economies registered growth of 4.8% in 2017, up from 4.4% in 2016 and 4.2% in 2015.

It would seem that the combination of continuing very loose monetary policies, a more supportive stance to fiscal policy and some recovery in commodity prices have at last triggered stronger economic growth. Activity is also being aided by good employment growth and low inflation, which is boosting real incomes and spending power. Credit growth has started to improve in many economies. A pick-up in world trade has also been an important factor. Growth in world trade volumes is estimated by the OECD and IMF at close to 5% in 2017, almost double the rate in the previous number of years.

The available data for the opening months of 2018 suggests that global growth has softened somewhat. The JP Morgan Composite Global PMI for March fell to a 16-month low and other survey data have been reflective of some easing in growth throughout the global economy in the past couple of months. Hard data for Q1, most notably softer consumer spending and manufacturing, indicate a slower pace of growth in the main economies. There was a sharp slowdown in UK GDP growth with softer growth in the Eurozone and the US. However, some of the slowdown in Q1 may prove temporary, due to one-off factors (incl. some weather related impact). Indeed, the IMF has left unchanged its forecasts for the world economy at 3.9% growth in both 2018 and 2019 in its latest update. It sees advanced economies expanding by around 2.4%, with growth in developing economies picking up to 5% in 2018/19. UK growth is forecast to remain subdued at around 1.5% in the next two years.

Inflation in advanced economies remains low. Although there are some signs that inflation is picking up, supported by higher commodity prices and a narrowing in output gaps amid continued growth in the global economy. Meantime, core inflation is expected to rise gradually as wage growth accelerates, reflecting tighter labour markets. The IMF is projecting that CPI inflation will average c.2% in advanced economies over the next two years.

The Fund views the risks to its near term outlook as broadly balanced. On the upside, it references the possibility that growth in advanced economies may prove to be stronger and more durable, while the pick-up in investment could boost productivity and in turn lead to "higher potential growth going forward". In terms of downside risks, it states that financial conditions could sharpen tightly (triggered for example by a faster than expected pace of monetary tightening). This could have negative spillover effects for the real economy, including a reduction in capital flows to Emerging Markets. The IMF also discusses downside risks in relation to global imbalances, including the widening in the US deficit, as well as the potential shift towards protectionist policies. Over the longer term, the IMF states the risks are clearly to the downside. It expects global growth to soften after 2019 as interest rates rise and the fiscal stimulus fades, most notably in the US.



GDP (Vol % Change)

	2016	2017	2018 (f)	2019 (f)
World	3.2	3.8	3.9	3.9
Advanced Economies	1.7	2.3	2.5	2.2
US	1.5	2.3	2.9	2.7
Eurozone	1.8	2.4	2.4	2.0
UK	1.9	1.8	1.6	1.5
Japan	0.9	1.7	1.2	0.9
Emerging Economies	4.4	4.8	4.9	5.1
China	6.7	6.9	6.6	6.4
India	7.1	6.7	7.4	7.8
World Trade Growth (%)	2.3	4.9	5.1	4.7
Advanced Economies CPI Inflation (%)	0.8	1.7	2.0	1.9

Source: IMF World Economic Outlook Update, April 2018

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Interest Rate Outlook

Central banks remain cautious about tightening, apart from the Fed

Global monetary policy is moving into a tightening phase. The US Federal Reserve is advancing steadily on a path towards policy normalisation, while rates have also been hiked in Canada, the Czech Republic, China and the UK in the past year. The ECB reduced the size of its monthly asset purchases at the start of this year and dropped its easing bias in March, while even the Bank of Japan has tapered QE marginally, after announcing that it is trimming purchases of long dated bonds.

However, apart from the in US, central banks remain cautious about tightening policy too quickly. Hence, monetary policy is expected to remain quite loose in nearly all the major economies over the next couple of years. Futures contracts are pricing in around 100bps of rate increases from the Fed and 75bps by the BoE and ECB by the end of 2020. This would still leave official rates quite low at 2.7% in the US, 1.25% in the UK and below 0.5% in the Eurozone.

In the UK, the persistence of high inflation saw the BoE in November increase rates for the first time since 2007 by reversing the 25bps rate cut made in 2016 and bringing the rate back up to 0.5%. Expectations had been building that another rate hike could happen as soon as May. However, lower than expected inflation in March, very weak Q1 GDP and less hawkish comments from Governor Carney suggest the next rate hike may not occur until August. Further modest rises are expected in 2019 and 2020. Markets expect that UK rates will rise to 1.25% by 2020.

The ECB scaled back asset purchases under its QE programme at the start of 2018. Markets are of the view that the ECB will cease net asset purchases altogether in either September or December, before starting to slowly raise rates from H2 2019. The ECB once again emphasised at its April policy meeting its intent to keep interest rates at their current very low levels well past the time when it ends net asset purchases.

Not surprisingly then, futures contracts show little change in wholesale rates in 2018, with rates seen as starting to rise from around mid-2019. The ECB deposit rate is currently at 0.4%. Futures contracts see money market rates turning positive at the end of 2019 and rising by less than 50bps in 2020. Rates are not expected to rise to 1% until H2 2022. Overall then, rates in the Eurozone are still expected to remain very low in the next few years.

Meanwhile, the Fed hiked rates by 25bps to 1.625% at its March meeting, the sixth rate rise of this cycle. It reaffirmed that it expects to implement two further 25bps rate increases this year, bringing rates up to 2.125% by end 2018, but a third one cannot be ruled out. Indeed, the Fed raised the projected number of rate hikes for 2019 from two to three and now sees rates rising to 3.375% by end 2020. While US markets have become more bearish on rates recently, they still only see them getting to 2.7% by end 2020, around 70bps below the Fed projections.

In April, we have seen some renewed upward pressure on bond yields, with ten year treasury testing seven year supports at around 3%. If there is a continued firming of US rate hike expectations, then upward pressure on bond yields could be expected to be sustained.

It is worth noting that beyond 2019, the market is currently expecting very little in the way of rate hikes from the Fed. Continuing strong growth by the US economy next year would force the market to re-evaluate this view and price in further policy tightening.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.625	2.36	2.78	2.72	2.90
June '18	1.875	2.55	2.95	2.90	3.05
Sept '18	2.125	2.75	3.15	3.05	3.20
Dec '18	2.375	2.95	3.30	3.20	3.35

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	-0.40	-0.36	-0.24	-0.14	0.41
June '18	-0.40	-0.35	-0.23	-0.10	0.45
Sept '18	-0.40	-0.34	-0.20	-0.05	0.55
Dec '18	-0.40	-0.30	-0.10	0.05	0.65

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.50	0.71	0.98	1.07	1.36
June '18	0.50	0.80	1.05	1.20	1.50
Sept '18	0.75	0.95	1.20	1.30	1.60
Dec '18	0.75	0.95	1.25	1.35	1.65

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

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Forex Market Outlook

Some dollar gains recently, but longer term trend still likely to be downwards

A key feature of forex markets during most of the past year has been the strengthening of the euro and weakening of the dollar. This trend continued in the opening weeks of 2018, with the EUR/USD rate climbing from $1.20 at the start of January to a three year high above $1.25 by early February. This was well above its level of a year earlier, when the EUR/USD rate was trading down at around $1.05. It is important to note that the dollar lost ground against a broad range of currencies in the past year and not just the euro, including the Aussie, NZ and Canadian dollars, the yen, sterling and the Chinese yuan.

There was no definitive factor behind the weaker dollar over the past year. It may in part be due to the fact that the global economy picked up momentum in 2017, resulting in other central banks joining the Fed in raising rates, with others expected to eventually follow suit. It is also the case that what we have seen in the past year is a partial unwinding of the marked dollar appreciation that occurred between mid-2014 and the end of 2016.

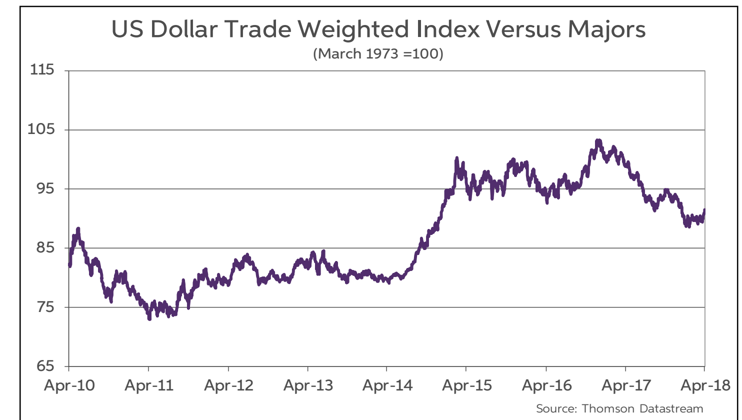
More recently, the dollar has not only stabilised but also recovered some lost ground. The dollar index is back at the 92 reading after having fallen below the 89 level earlier in the year. Bouts of risk aversion in markets have triggered some flows into liquid, safe haven currencies like the dollar and the yen. Rising US bond yields, a firming of interest rate expectations, as well as encouraging US macro data have combined to result in the currency gaining between 2.5%-4% on FX markets, as some extreme dollar short positions are unwound

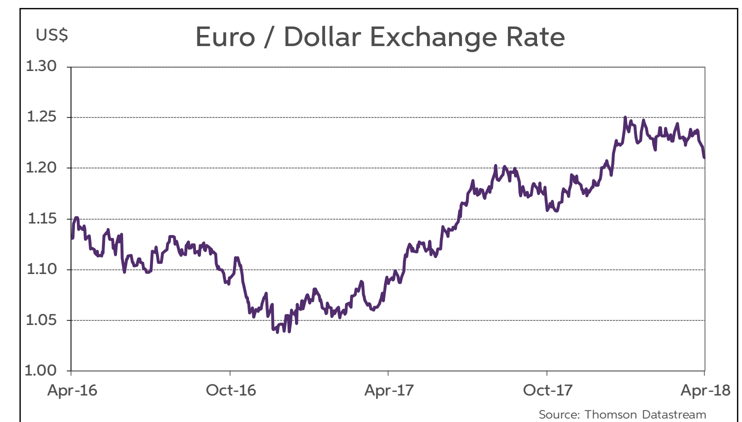
In terms of EUR/USD, the pair has in recent days fallen out of the $1.22-1.25 trading range it had occupied for the past three months, trading back down below $1.21. Aside from the aforementioned supportive dollar factors, some weaker than expected Eurozone macro data and cautious ECB comments regarding its policy outlook have weighed on the euro side of the cross.

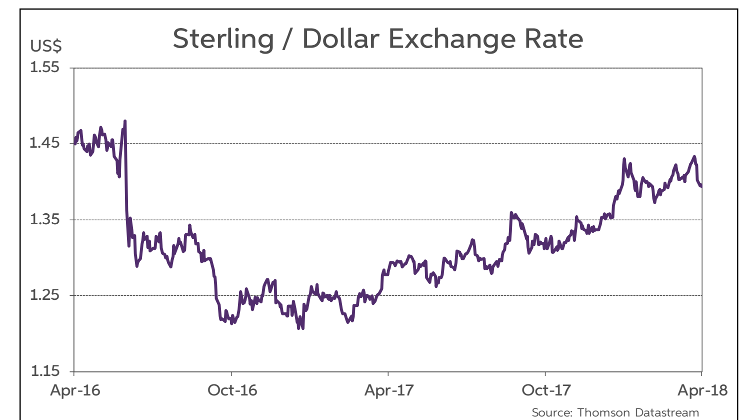
We have also been pointing out the potential that cuts in US corporate tax rates at the end of 2017 could spark some dollar buying this year if American companies start to bring back cash from overseas to take advantage of a special low tax rate on repatriated profits. It is hard to put a figure on the size and timing of such flows, but they would benefit the US currency if companies need to convert funds held in other currencies into dollars to repatriate them. In 2005, when there was a similar corporation tax amnesty, it led to a temporary, but marked, rise by the dollar. There may be something happening along these lines again, except on a more modest scale, which has provided some support for the currency recently.

The dollar has regained the upper hand and could continue to be supported by widening interest rate differentials. Extreme market positioning also suggests there is a further unwinding of dollar shorts to come, providing some potential additional downside for EUR/USD. This could see the euro fall towards $1.18/1.19.

However, we expect the euro to make renewed gains later in 2018 as we get closer to the end of QE and the beginning of rate tightening in the Eurozone. Despite its gains over the past year, EUR/USD is still at a relatively low level. The pair mainly traded in a $1.20-1.50 range from 2003 to 2015. It is now back at the bottom of this range. Rising twin US deficits are a long term negative for the dollar, as well the expectation that the US economy will slow beyond 2019. Thus, while there will be periods of dollar strength, such as that seen recently, our view is that the euro is on a long-term uptrend against the dollar.







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Forex Market Outlook

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Sterling's recent rally goes into reverse, though, this may prove temporary

Sterling fell sharply in the aftermath of the UK referendum vote for Brexit in mid-2016. The currency hit 30-year lows against the dollar, falling from $1.50 before the vote to as low as $1.20 in late 2016. Brexit concerns also saw sterling lose significant ground against the euro, with EUR/GBP rising sharply from the 70p level near the end of 2015 to a high point at around 93p in August 2017.

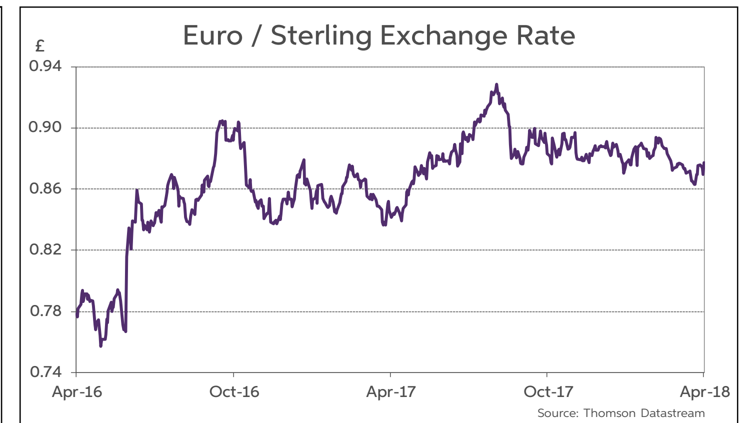
However, sterling has managed to move off its lows and regain some ground since last summer. The currency was helped by an unexpected rate hike from the Bank of England, better UK economic data and hopes of a soft Brexit. Against a weaker dollar, it rose above the $1.40 level in Q1 2018 and in mid-April reached a new post referendum high of $1.437. The UK currency also recovered some territory against the euro. This resulted in EUR/GBP falling out of the 87-90p range that had been in place since last September, trading as low as 86.2p in mid April. However more recently, weaker than expected UK data (incl. March CPI inflation and Q1 GDP) combined with comments from the BoE Governor playing down the prospects of a May rate hike have seen sterling's rally go into reverse. EUR/GBP has moved back to around the 88p level, with GBP/USD back down below $1.38.

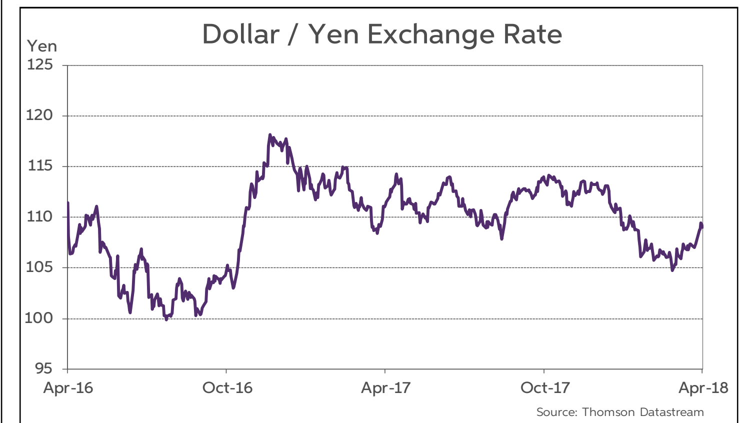
The progress of the Brexit negotiations as well as economic data and the timing of the next BoE hike will be the key factors for sterling for the remainder of the year. In the near term, the attention will be on the economic data as improved figures should see the BoE hike rates later in the summer. The focus, is likely to shift to the Brexit talks as they enter their final stages. There are real hopes that the outcome of the talks will be a soft Brexit, now that a transition period has been agreed with the UK expected to remain in the Single Market and Customs Union until December 2020. It is hoped that a full EU-UK trade deal can then be negotiated in 2019-2020 that will come into effect when the transition period expires at the end of 2020.

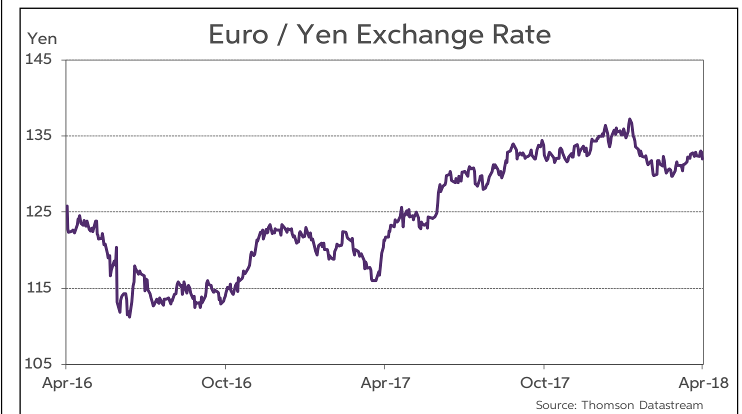
However, there is still much work to be done over the rest of this year. The EU and UK need to finalise a withdrawal agreement before the end of 2018 that will contain the outlines of a EU-UK trade deal as well as provide the formal basis for the transition period. Given the uncertain political backdrop in the UK and its desire to regain full sovereignty, there is still a risk of a hard Brexit. The UK government, in particular, may find it difficult to get a withdrawal agreement through parliament, given the divisions in the Conservative Party over Brexit. A key problem remains how to resolve the issue of customs and the Irish border given the UK's desire to negotiate trade deals with non-EU countries.

EUR/GBP seems likely to trade in an 86-89p range, until markets get clearer signals on the outcome of the Brexit talks. If it becomes increasingly evident that a soft Brexit is on the cards, then sterling could make some gains, with the euro moving down to 85p and cable rising to $1.50. However, if the talks run into real difficulties later this year and a hard Brexit becomes increasingly likely, then EUR/GBP could move up towards 95p. It could rise even higher to trade in a 95p-100p range as a hard Brexit approached in March 2019, with cable falling back towards $1.30.

Overall though, we believe that the EU and UK will be able to conclude on a withdrawal agreement that gets through the UK parliament and thus, a soft Brexit is the most likely outcome of the exit negotiations. Our base case, then, is for sterling to have strengthened by the end of the year, aided also by higher UK interest rates.



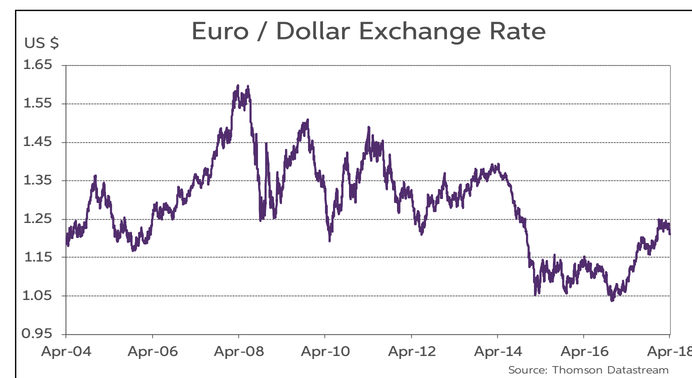


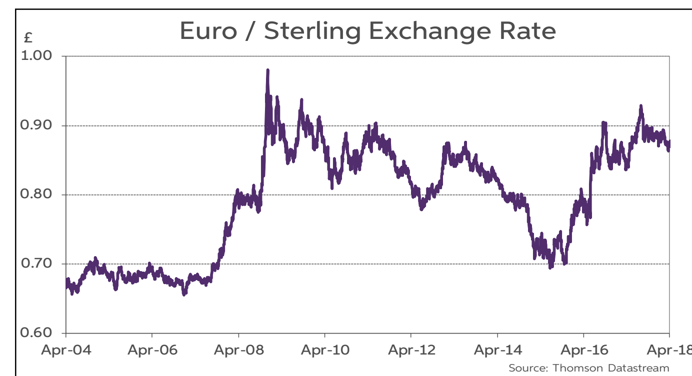


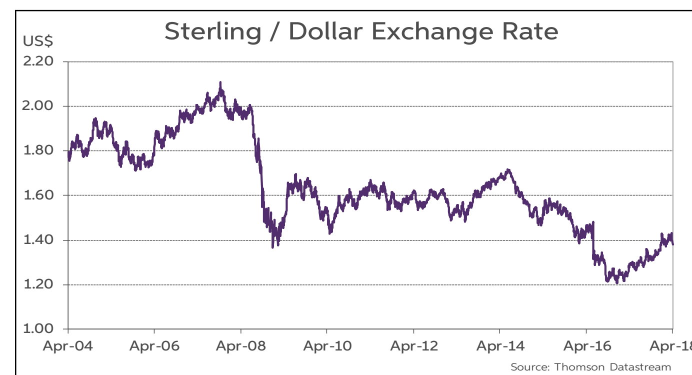
Summary of Exchange Rate Forecasts

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

	Current	Q2-2018	Q3-2018	Q4-2018	Q1-2019
Euro Versus					
USD	1.210	1.18-1.24	1.20-1.26	1.22-1.28	1.24-1.30
GBP	0.881	0.84-0.90	0.84-0.90	0.83-0.89	0.82-0.88
JPY	132.25	129-135	129-135	129-135	130-136
CHF	1.20	1.19	1.18	1.18	1.19
US Dollar Versus					
JPY	109.29	106-112	105-111	104-110	103-109
GBP	1.374	1.36-1.42	1.38-1.44	1.41-1.47	1.45-1.51
CAD	1.29	1.28	1.26	1.24	1.22
AUD	0.75	0.76	0.77	0.78	0.80
NZD	0.71	0.71	0.72	0.73	0.75
CNY	6.33	6.30	6.25	6.20	6.15
Sterling Versus					
JPY	150	152	152	154	136
CAD	1.77	1.78	1.78	1.80	1.59
AUD	1.82	1.83	1.83	1.85	1.68
NZD	1.95	1.96	1.96	1.97	2.14







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