Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

29th June 2017

- Global economic activity is strengthening but inflation stays subdued

- Fed continues to tighten, but market very much doubts its guidance on future rate hikes. ECB reaffirms that rates will remain very low, though QE likely to be wound down next year

- Euro makes significant gains as political concerns abate, economy picks up and with tapering of QE likely next year. Needs to overcome major resistance at $1.15-1.16 for rally to continue

- Sterling weakens during UK election and on the result. Progress on Brexit talks likely to be key factor influencing the currency, but BoE rate hike talk gives it some support post election

- Dollar loses ground as markets doubt Fed will raise rates much further and Trump's pro-growth policies are long-fingered. Needs further rate hikes and strong data to rally again

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Global Economic Outlook

Global economic activity picks up some momentum

The OECD, in its recently published mid-year Economic Outlook, notes that global economic activity is picking up, helped by an improvement in investment, manufacturing and trade. Activity started to gain momentum in the second half of 2016, especially in advanced economies, with stronger growth performances in the US, Eurozone, UK and Japan. The OECD expects growth in the world economy to accelerate from 3.0% in 2016, its lowest rate since 2009, to 3.5% in 2017 and 3.6% in 2018, despite sluggish performances in the opening quarter of this year in both the US and UK.

It sees advanced economies growing by 2.1% this year and next, up from 1.8% in 2016, helped by continuing very loose monetary policies and a more supportive stance to fiscal policy. There was a slowdown in US GDP growth in the first quarter of this year, but this is expected to prove temporary. The OECD believes that US growth will pick up to 2.4% by 2018, assuming there is a modest easing of fiscal policy next year. It looks for growth of 1.8% in the Eurozone in both 2017 and 2018, with activity being supported by a very accommodative monetary policy. However, it sees growth slowing in the UK to 1% next year as Brexit uncertainty curtails investment and high inflation continues to weigh on consumer spending.

Meanwhile, growth in emerging economies lost considerable momentum in the first half of this decade, slowing from 7.5% in 2010 to some 4% by 2015/16. However, growth in developing economies is forecast to strengthen to 4.6% in 2017 and 4.8% in 2018, helped by a moderate recovery in commodity prices and the emergence of oil-producing countries like Brazil, Russia and Nigeria from deep recessions. Activity is also being supported by investment in infrastructure, more expansionary fiscal policies and an improvement in world trade.

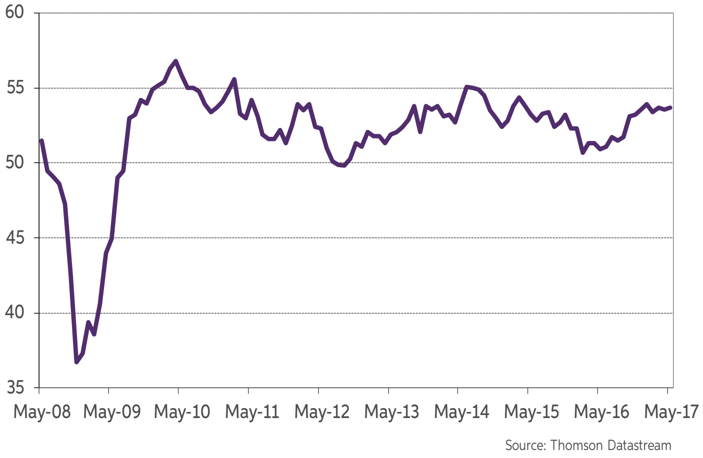
Survey data point to stronger activity in most economies this year. Notably, the Global Composite PMI has been very steady this year, averaging 53.7 in the first five months of 2017, consistent with solid growth by the world economy. In the Eurozone, the Composite PMI hit 56.8 in both April and May, its best level in six years. Other leading activity indicators in the Eurozone, including the EC economic sentiment index, have also hit multi-year highs.

Labour market data have been particularly encouraging across the main economies, with good jobs growth nearly everywhere, a steady downward trend in Eurozone unemployment and economies like the US, UK and Japan now close to full employment. The unemployment rate in the US has fallen to 4.3% and stands at 4.6% in the UK.

Downside risks, though, persist for the world economy, especially over the medium term. High private sector debt levels and a reliance on capital inflows represent risks to the growth prospects for emerging economies. Meanwhile, higher headline inflation rates in H1 2017 across all economies have been a constraint on growth in consumer spending. Increases in US interest rates could also yet negatively impact global financial markets, where valuation looks stretched with very low bond yields and stock markets rising to very elevated levels.

In summary, then, growth in the world economy is picking up momentum and global growth is expected to be stronger at around 3.5% in 2017 and 2018. The balance of risks, though, remain tilted to the downside for the world economy. Thus, with core inflationary pressures remaining very subdued, central banks are indicating that monetary policy will need to remain very accommodative for some considerable time.

Global Composite PMI (JP Morgan)



GDP (Vol % Change)

	2015	2016	2017 (f)	2018 (f)
World	3.1	3.0	3.5	3.6
OECD Economies	2.2	1.8	2.1	2.1
US	2.6	1.6	2.1	2.4
Eurozone	2.0	1.7	1.8	1.8
UK	2.2	1.8	1.6	1.0
Japan	1.1	1.0	1.4	1.0
Emerging Economies	3.9	4.1	4.6	4.8
China	6.9	6.7	6.6	6.4
India	7.9	7.1	7.3	7.7
World Trade Growth (%)	2.7	2.4	4.6	3.8
Advanced Economies Inflation (%)	0.8	1.1	2.3	2.2

Source: OECD Economic Outlook, June 2017

Interest Rate Outlook

Markets doubt Fed tightening path and switch focus to ECB stimulus withdrawal

The past number of years have been characterised by a widespread loosening of monetary policy in many countries and a scaling back of rate hike expectations in economies where policy tightening had been expected to commence. The era of monetary easing, though, appears to be coming to an end. However, monetary policy is set to remain exceptionally loose in most economies, with only the US Federal Reserve embarking on the path towards policy normalisation, and even then at a slow pace.

In the UK, the economy has held up better than expected since the Brexit referendum. Meanwhile, inflation has picked up following the sharp decline in sterling last year, with the headline CPI inflation rate hitting 2.9% in May and expected to rise even further. The BoE has been indicating that there are limits to the extent that above-target inflation can be tolerated and three of the eight members of the MPC voted for a rate hike at its June meeting. The majority on the MPC, though, want to wait and see if the slowdown in activity earlier this year is sustained or not, before making any decision to raise rates. The market is pricing in a 25bps rate hike for 2018. If there is a rate rise, it is likely to prove a one-off and not the start of a hiking cycle, with the BoE unwinding the rate cut it implemented last year in the aftermath of the referendum vote for Bexit. Data in the next few months will be key in terms of whether we get such a hike. We expect some soft data, which could keep the BoE on hold.

Meantime, the ECB has indicated that it will continue with its QE programme until at least the end of 2017, although it has scaled back its easing bias by no longer committing to lowering rates even further if required. Furthermore, in a recent speech, President Draghi hinted that the ECB would taper QE, or wind down its asset purchases, next year. He noted that the central bank will need to adjust the parameters of its policy given the recovery in the economy. However, he also indicated this would be a gradual process. The ECB has said that it expects to keep interest rates at their current very low levels well past the time horizon of its QE programme.

The ECB deposit rate stands at –0.4% and so it is likely to be late 2018 or early 2019 before this is increased, given the guidance from the Central Bank on QE and rates. Futures contracts show that wholesale rates are expected to start edging modestly higher next year, with three month money rates remaining negative until mid-2019. Eurozone rates are expected to remain very low for a long period of time after that, with futures contracts suggesting that three month rates will still be below 1% at end 2022.

Meanwhile, after raising rates by 25bps to 0.375% at its December 2015 meeting, the first such rate hike in nearly a decade, the US Federal Reserve refrained from any further rate hikes, until it implemented a second 25bps increase in December 2016. However, it has followed this up with two further hikes in March and June of this year, taking rates up to 1.125%.

At its June meeting, the FOMC reaffirmed its interest rate projections showing that it expects to raise rates to 3% by end 2019. Markets, though, see rates rising to around 1.75% by then, far below the Fed's projections. Furthermore, the Fed has also indicated that it will start to unwind its asset purchase programme, or QE, later this year, thereby reducing the size of its balance sheet, albeit at a very slow pace. While inflationary pressures remain subdued in the US, we expect solid growth and a tight labour market will see the Fed tighten policy by more than markets expect, with the next rate hike likely at end year and rates rising to around 2.5% by end 2019.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.125	1.30	1.74	1.58	1.87
Sept '17	1.125	1.35	1.80	1.65	1..95
Dec '17	1.375	1.60	2.05	1.90	2.20
Mar '18	1.625	1.80	2.25	2.10	2.40

** 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	-0.37	-0.18	-0.15	0.23
Sept '17	-0.40	-0.35	-0.15	-0.13	0.25
Dec '17	-0.40	-0.33	-0.10	-0.07	0.30
Mar '18	-0.40	-0.30	-0.05	0.00	0.40

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.25	0.30	0.66	0.68	0.95
Sept '17	0.25	0.30	0.65	0.68	0.95
Dec '17	0.25	0.30	0.65	0.69	1.00
Mar '18	0.25	0.30	0.65	0.70	1.05

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Strong rally by euro, while dollar loses its shine

A notable feature of currency markets for well over two years now has been the relatively narrow trading range for the euro-dollar rate. It has been confined to a $1.04-1.16 trading band since early 2015. This represents a relatively low level for the euro versus the dollar during the past fifteen years. The ECB's large QE programme and negative interest rates have been a key factor in dragging the euro down into this trading range.

Growing expectations that the Fed would implement a number of rate hikes, as well as Trump's unexpected victory in November's Presidential election, gave the dollar a boost in the second half of last year. It rose to 14-year highs on a trade-weighted basis at end 2016, with the euro dropping from $1.14 in mid-2016 to around the $1.04 level, a 14 year-low against the dollar.

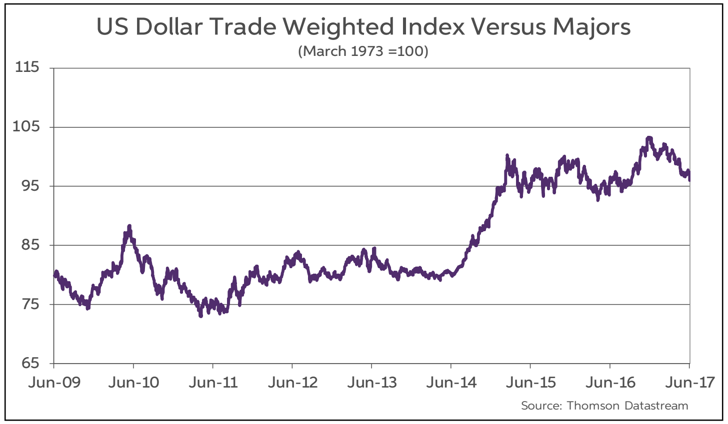
In the first half of this year, though, the euro has recovered the ground that it lost against the dollar in H2 2016, climbing to above the $1.14 level, despite further rate hikes by the Fed in March and June. Developments in Europe have helped the euro. Growth has picked up in the Eurozone, with the jobless rate moving steadily lower. This has seen the ECB row back on its easing bias, in particular dropping references that it could lower rates further. Markets now expect three month money rates in the Eurozone to turn positive by mid-2019, compared to mid-2021 last autumn. Meanwhile, President Draghi appears to have signalled that the ECB is likely to taper QE, or wind down its asset purchases, next year by noting the Central Bank will need to adjust the parameters of its policy given the recovery in the economy.

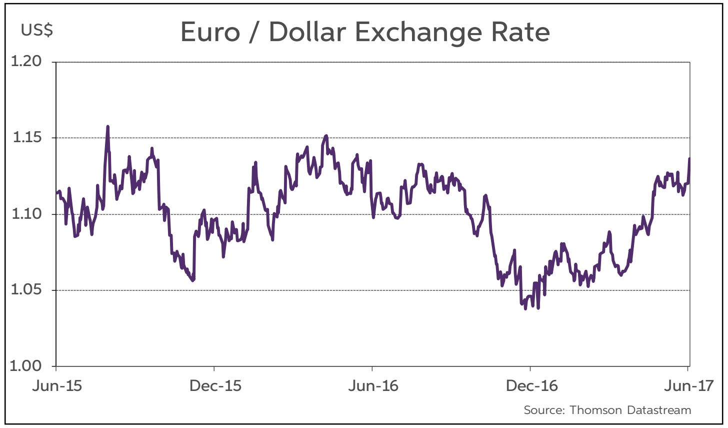
Abating political risks have also helped the euro, with far-right and euro-sceptic political parties not doing particularly well in recent European elections. Macron's victory in the French Presidential elections was especially helpful to the euro. Meanwhile in the US, markets are growing doubtful about whether President Trump will be able to implement his planned expansionary fiscal agenda. It has all seen the euro-dollar exchange rate move above $1.14, its highest level in over a year.

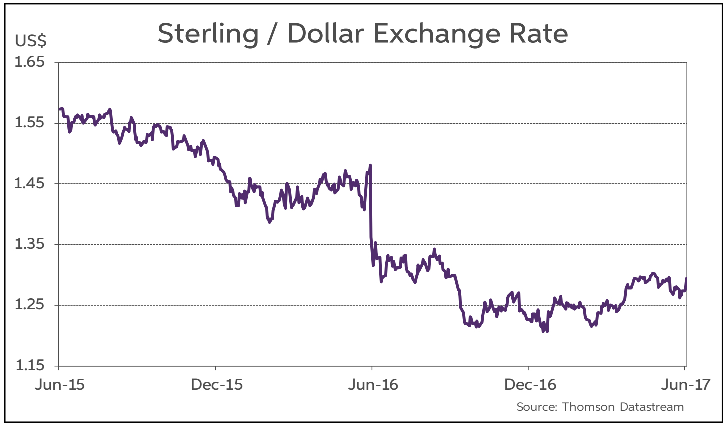
At its current level above $1.14, there is obviously more scope for the euro to move lower than higher against the dollar if it remains within the $1.04-1.16 trading band that it has occupied since early 2015. The key question, given the currency's recent momentum, is whether the euro can break out of this band to the upside. The fact that the ECB is likely to taper its asset purchases next year will be supportive of the currency.

On the other hand, though, the Fed appears to have moved on to a steady policy tightening path, which should see US rates continue to move higher in the next couple of years. This should help underpin the US currency as interest rate spreads move more and more in its favour, especially with the ECB indicating that Eurozone rates will remain at their present negative levels for an extended period of time. Furthermore, the Fed is likely to start reducing the size of its balance sheet later this year as it begins unwinding its QE programme. The market is also long euros at this stage, which may limit its upside.

Overall, we think that it will be a challenge for the euro to make further significant gains against the dollar. We would probably need a weakening of the US economy that sees Fed policy put on hold. Meanwhile, there is also the real possibility that the Fed will tighten policy much more than markets expects, especially if President Trump eventually manages to get some of his expansionary fiscal programme through Congress.







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Forex Market Outlook

Brexit to remain key factor impacting sterling, though rate hike talk helps currency

Sterling fell sharply last year on concerns over Brexit. The currency hit 30-year lows against a strong dollar, falling from above $1.50 through key support levels at $1.37-1.38, before declining to a low of $1.20. The euro made significant gains against sterling too, with the EUR/GBP hitting a high above 90p last autumn, up from 70p near the end of 2015.

Sterling did find a trough in the late autumn and managed to regain some ground against both the euro and dollar. The euro dropped back to around 84p, with cable rising to $1.30. The snap UK general election, though, which saw the Conservative Party lose its majority in Parliament, saw renewed pressure come on sterling. The euro climbed back up to near the 89p level-partly due also to general euro strength-while cable moved down to around $1.27. Talk of a hike in UK rates later this year, though, has provided some support for the currency in recent days. This has seen cable rise back up to the $1.30 level, with the euro dropping back below 88p.

Brexit, though, is likely to remain the key factor influencing sterling. Formal exit negotiations have now commenced between the UK and EU and are likely to last until the end of next year. The early stage of Brexit talks will be largely technical in nature, mainly dealing with budgetary issues and citizens' rights. Discussions on more substantive but difficult issues, such as trade and immigration, as well as possible transition arrangements that may apply when the UK leaves the EU, are unlikely to commence until later this year or in 2018.

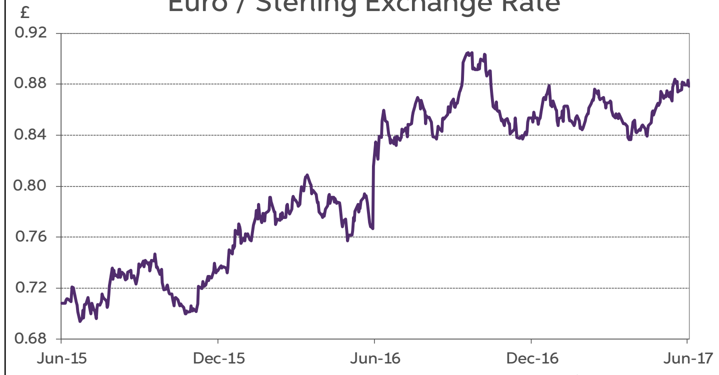
Downside risks remain for the UK currency from the exit negotiations as these are likely to prove quite difficult, especially as they come to a head next year, when they get to trade and what transition arrangements might be put in place after the UK leaves the EU. The talks could turn quite fraught by that stage and be punctuated by crises, with much uncertainty about the final outcome.

There are growing expectations that the outcome of the negotiations will be a soft Brexit. The Chancellor has suggested that the UK should remain an "associate" member of the Customs Union, with the current customs border trading arrangements remaining in place until a full UK-EU trade deal can be completed. The fact that the Conservative government has lost its majority in Parliament has also increased the prospect of a soft Brexit as it will now have to take more cognisance of opposition parties views, who favour such an outcome.

However, there is still a risk of a hard Brexit that would be very negative for the UK economy and sterling. The UK will leave the Single Market and Customs Union on its departure from the EU. It is still unclear what arrangements, if any, an exit deal might contain in regard to trade and whether transition arrangement can be agreed that largely allow for continuing free trade between the UK and EU until a full trade deal is negotiated.

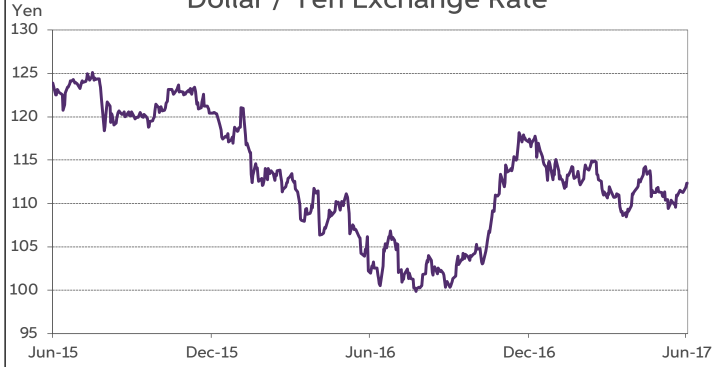
We will have to await the outcome of the Brexit negotiations, probably in late 2018, to see whether the UK manages to retain relatively free access to EU markets or, instead, faces a hard Brexit where it has to fall back on WTO rules. A hard Brexit could see the euro move well above the 90p level, with cable falling to $1.20 or below. A soft Brexit should see the currency make significant gains. In the near-term, though, sterling may trade in narrow ranges of 86-90p against the euro and $1.27-1.30 against the dollar as it awaits developments in the Brexit talks and whether the BoE hikes rates or not later this year.

Euro / Sterling Exchange Rate



Source: Thomson Datastream

Dollar / Yen Exchange Rate



Source: Thomson Datastream

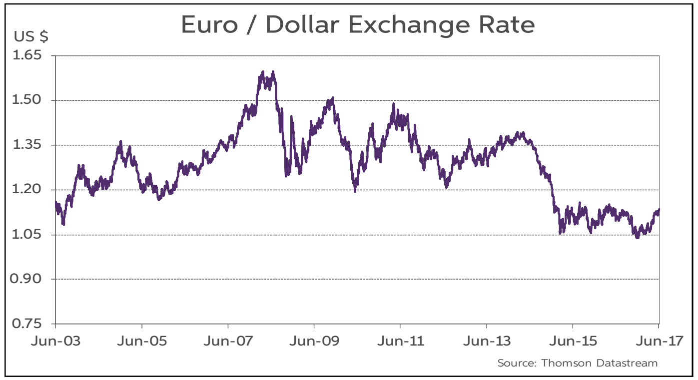
Euro / Yen Exchange Rate

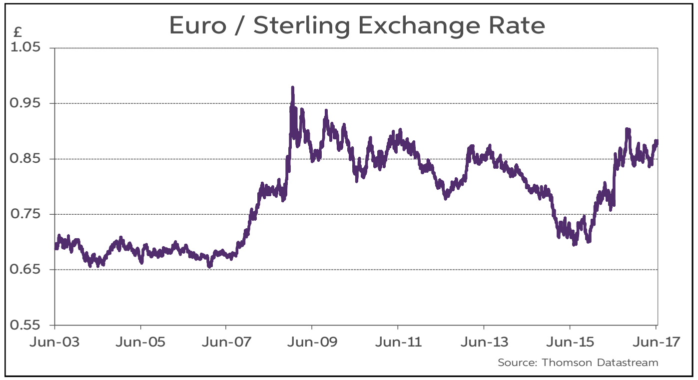
Source: Thomson Datastream

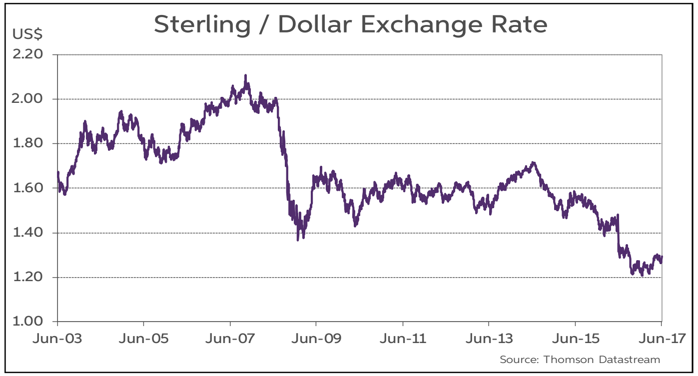
Summary of Exchange Rate Forecasts

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

	Current	Q3-2017	Q4-2017	Q1-2018	Q2-2018
Euro Versus					
USD	1.141	1.10-1.16	1.09-1.15	1.08-1.14	1.07-1.13
GBP	0.880	0.85-0.91	0.84-0.90	0.84-0.90	0.83-0.89
JPY	128.28	125-131	125-131	125-131	125-131
CHF	1.09	1.09	1.09	1.09	1.09
US Dollar Versus					
JPY	112.43	110-116	111-117	112-118	113-119
GBP	1.297	1.26-1.32	1.26-1.32	1.25-1.31	1.25-1.31
CAD	1.30	1.28	1.28	1.29	1.30
AUD	0.77	0.76	0.75	0.74	0.73
NZD	0.73	0.73	0.72	0.71	0.70
CNY	6.78	6.82	6.86	6.90	6.95
Sterling Versus					
JPY	146	146	147	147	148
CAD	1.69	1.64	1.65	1.65	1.66
AUD	1.69	1.70	1.72	1.73	1.75
NZD	1.78	1.77	1.79	1.80	1.83







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