Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

7th June 2018

- World economy performing quite well, though downside risks are growing
- Fed sticks to its steady rate tightening path, while other central banks remain cautious after global growth softened somewhat in early 2018
- Dollar makes gains in Q2, aided by rising risk aversion, good US data and higher US bond yields/ rate expectations. The currency could weaken again later in year given imbalances in economy
- Euro loses ground on a combination of weaker economic data, a cautious ECB and instability in some peripheral Eurozone countries, but should recover as monetary policy starts to normalise
- Sterling remains very range bound against the euro as markets await clarity on shape of Brexit

Oliver Mangan
Chief Economist

John Fahey
Senior Economist

Dara Turnbull
Economist

www.aibeconomics.com

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Global Economic Outlook

Global economy performing quite well, but downside risks are growing

Recent updates from both the OECD and IMF forecast that the world economy will grow by close to 4% in 2018 and 2019. Thus, the pick-up in growth in 2017 is expected to be sustained, despite some weakening in data in the opening months of this year. The combination of continuing very loose monetary policies, a more supportive stance to fiscal policy and some recovery in commodity prices are all supportive of the economic outlook.

Activity is also being aided by improving labour market conditions. The OECD is projecting that the unemployment rate for developed economies will fall to just above 5% next year, its lowest rate since 1980. A pick-up in world trade is consistent with the improvement in global growth. Growth in world trade volumes is forecast by the OECD and IMF at 4.5-5.0% in 2018 and 2019, almost double the rate seen in the middle part of the decade.

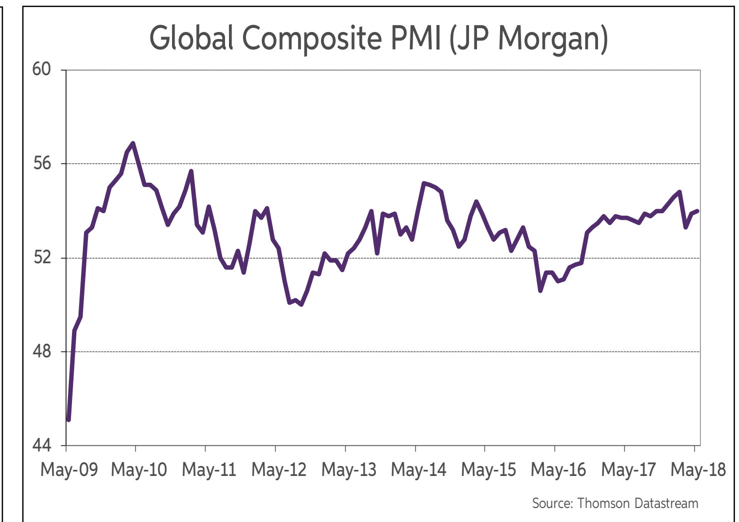
There was a slowdown in global growth in the first quarter of 2018. This was largely concentrated in advanced economies, especially in Europe and Japan. Notably, the UK economy grew by just 0.1%, while GDP contracted by 0.2% in Japan. Eurozone growth also slowed appreciably. In part, this reflected temporary factors, including some unusually adverse weather. However, concerns about rising trade protectionism, higher oil prices, geopolitical tensions and volatility in financial markets may also have played a part.

The real data available so far for the second quarter suggest that growth has regained some momentum, with good figures from the US and UK in particular. Meanwhile, most survey data have stabilised in the past couple of months. The JP Morgan Global Composite PMI rose to 53.9 in April and 54 in May, up from 53.3 in March. Thus, the IMF and OECD continue to believe that advanced economies will expand by close to 2.5% again this year and in 2019. Emerging economies are expected to grow by around 5% in the next couple of years.

Inflation in advanced economies remains low. Although headline inflation is picking up on the back of higher commodity prices, especially oil. The OECD is projecting that inflation in advanced economies will rise to 2.2% this year and 2.3% by 2019, double its level in 2016.

The IMF and OECD note that while short-term growth prospects look favourable, downside risks prevail over the medium term. The OECD points out that growth is still heavily reliant on very accommodative monetary conditions and thus, the pick-up in activity cannot be viewed as self-sustaining. This is a concern given the growing risks for the world economy. A move towards protectionist trade policies has already begun to adversely impact confidence and financial markets. Rising geopolitical risks have put upward pressure on oil prices this year. Financial pressures are also appearing in a growing number of emerging markets. The combination of a rising US dollar and tightening monetary conditions, as QE is wound down and rates start to rise, is exposing financial vulnerabilities in some emerging economies, especially those with high levels of external debt. More generally, financial markets are becoming more risk adverse and experiencing much greater volatility in 2018.

More longer-term, there are also concerns about the implications of the current policy mix in the US. The marked loosening of fiscal policy is likely to result in a big rise in both the budget and balance of payments deficits. It also risks overheating the economy, with the unemployment rate now below 4%. The US economy could slow quite rapidly once the fiscal stimulus starts to fade and higher interest rates begin to impact on activity. Overall then, while the global economy is performing well, there are no grounds for complacency.



GDP (Vol % Change)

	2016	2017	2018 (f)	2019 (f)
World	3.1	3.7	3.8	3.9
Advanced Economies	1.8	2.5	2.6	2.5
US	1.5	2.3	2.9	2.8
Eurozone	1.7	2.5	2.2	2.1
UK	1.9	1.8	1.4	1.3
Japan	1.0	1.7	1.2	1.2
Emerging Economies	4.2	4.6	4.8	5.1
China	6.7	6.9	6.7	6.4
India	7.1	6.5	7.4	7.5
World Trade Growth (%)	2.6	5.0	4.7	4.5
Advanced Economies PCE Inflation (%)	1.1	2.0	2.2	2.3

Source: OECD Economic Outlook Update, May 2018

Interest Rate Outlook

Fed continues tightening, other central banks remain cautious

Global monetary policy is moving into a tightening phase. The US Federal Reserve is advancing steadily on a path towards policy normalisation, hiking rates at a measured pace and reducing the size of its balance sheet as its stock of QE assets are allowed to slowly run down. Other central banks, though, remain cautious about tightening policy too quickly. Hence, monetary policy is expected to remain very loose in all the major economies over the next couple of years, apart from in the US. Even there, rates are still expected to remain at quite low levels.

In the UK, the persistence of high inflation saw the Bank of England last November increase rates for the first time since 2007 by reversing the 25bps cut made in 2016 and bringing the bank rate back up to 0.5%. However, a much quicker than expected decline in inflation this year, combined with very weak GDP growth in Q1, have seen the BoE keep policy on hold since November. Modest rate rises are still expected, with the next hike likely in H2 2018, possibly as early as August given recent signs that the economy is regaining momentum again. A further hike in rates is expected in each of the next two years, taking the bank rate up to 1.25% by end 2020.

The ECB scaled back asset purchases under its QE programme at the start of 2018. Markets are of the view that it will cease net asset purchases altogether by the end of the year. The ECB has continually emphasised that it intends to keep interest rates at their current very low levels well past the time when it ends net asset purchases. Thus, markets expect interest rates to only start rising in H2 2019 and then at a very slow pace.

Futures contracts show little change in wholesale rates in 2018, with rates seen as starting to rise from around mid -2019 onwards. The ECB deposit rate is currently at 0.4%. Futures contracts see money market rates remaining negative until the end of 2019 and then rising by less than 40bps in 2020. Rates are not expected to rise to 1% until late 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 in this cycle. It is expected to raise rates again this month and has guided that a further hike can be expected in the second half of the year, taking the funds rate up to 2.125%. This has been fully discounted by the market, which believes a further rate hike is also quite possible before year end. It is pricing in a Fed funds rate of 2.25% by end year.

Beyond that, the markets expect limited Fed tightening and see official rates peaking at around 2.625% by end 2020. The Fed, though, is projecting a series of rate hikes over the next two years or more, taking the funds rate up to 3.375% by end 2020, which is 75bps above market expectations. We expect that continuing strong growth by the US economy over the next year, combined with a pick up in inflationary pressures, will force the market to re-evaluate its view on rates and price in further policy tightening. We anticipate that the Fed funds rate will rise to at least 3% by 2020.

Bond markets have been very volatile this year. The underlying trend in the US market is clear, with two and ten year Treasury yields climbing sharply since last autumn to around 2.5% and 3%, respectively. However, bouts of risk aversion have also seen periods of rallies in all the main bond markets. The upward pressure on US yields is likely to re-emerge if markets have to further revise upwards their expectations for US rates - as has been the trend since last autumn. This is likely to put upward pressure on yields in other markets also, especially given that we are now in a phase of monetary tightening globally, albeit at a very slow pace.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.625	2.32	2.74	2.76	2.93
Sept '18	2.125	2.65	2.95	2.95	3.10
Dec '18	2.375	2.80	3.15	3.10	3.25
Mar '19	2.375	2.90	3.25	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	-0.35	-0.23	-0.11	0.41
Sept '18	-0.40	-0.34	-0.20	-0.05	0.45
Dec '18	-0.40	-0.30	-0.15	0.00	0.55
Mar '19	-0.40	-0.25	-0.05	0.10	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	0.63	0.92	1.03	1.36
Sept '18	0.75	0.85	1.10	1.20	1.50
Dec '18	0.75	0.90	1.15	1.25	1.55
Mar '19	0.75	0.90	1.20	1.30	1.65

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

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Forex Market Outlook

Dollar rebounds, but risks remain for US currency

At the start of the year, we took the view that while the US currency was in long term decline, it would most likely enjoy periods of strength during 2018. We forecast that dollar weakness in the early part of the year would see the euro rise to $1.25, but that the EUR/USD rate was then likely to fall back to $1.16 as the US currency regained some strength. We forecast that the dollar would make gains against other currencies too during 2018.

The basis of this view was that the extreme short positions built up against the US currency could well unwind, while President Trump's cuts in US corporate taxes was likely to trigger dollar inflows as funds were repatriated by large corporates to the US. The dollar has performed in line with our expectations, aided also by US data tending to come in ahead of expectations in marked contrast to most other advanced economies. Widening interest differentials in favour of the dollar have also helped the currency.

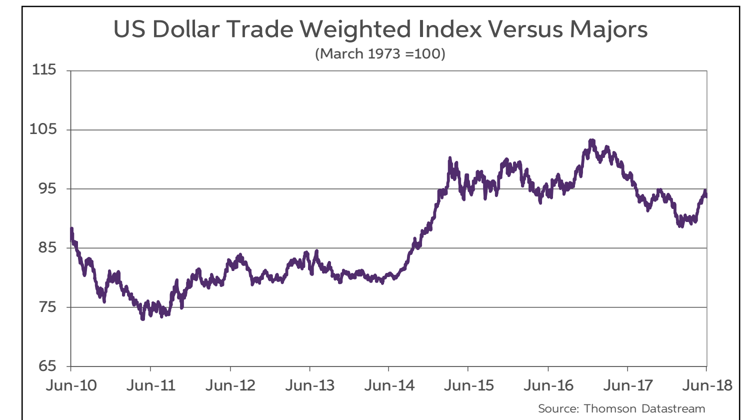
The euro has found support at around the $1.16 level as we had expected. The EUR/USD rate traded in a $1.05 to $1.16 range for most of 2015-16, so the $1.16 level was always going to provide strong technical support for the single currency. We are still of the view that the US dollar will weaken over the longer term. Two factors drive this assessment. Firstly, we remain concerned about the policy mix in the US. The expansionary fiscal policy will lead to a sharp jump in the US budget deficit and thus a big rise in the supply of Treasury bonds. It will also put upward pressure on the US balance of payments deficit. Both these factors point to a lower dollar. We are also concerned that the US economy could slow sharply once the fiscal stimulus fades, and as higher US rates start to impact on activity, again undermining the currency.

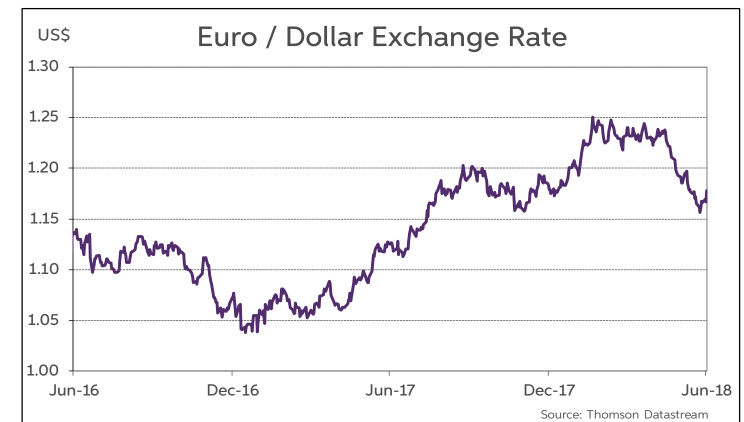
Secondly, the dollar is now at quite elevated levels against a range of currencies, pointing to downside potential. The dollar is now close to 20% higher on a trade-weighted basis than for most of the period 2005-2015. Meantime, EUR/USD traded in a $1.20-1.50 range for virtually all of the period from 2003 to 2015. We expect that the euro will eventually return to this range given the on-going improvement in the Eurozone economy.

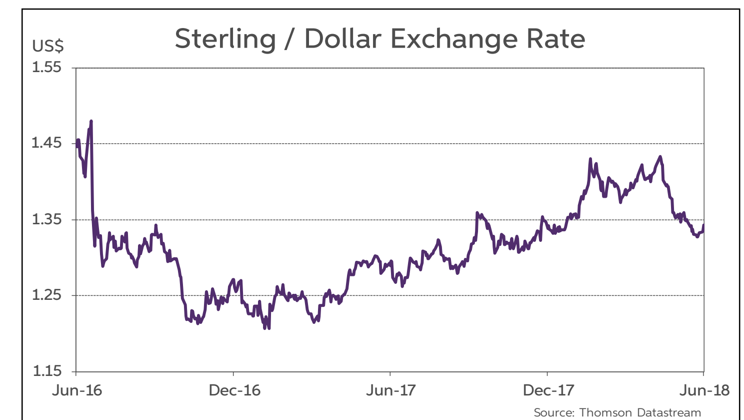
Traders and investors, though, are more interested in the dollar's near terms prospects and are wondering if the currency can make further gains in the months ahead. The relative strength of the US economy, widening interest rate differentials, stresses in some emerging markets and, indeed, in some peripheral Eurozone markets too, are all supportive of the US currency.

However, further gains may be prove difficult now that FX positioning has turned more neutral for all the major currencies, with dollar short positions having being largely unwound. Even if the dollar continues to rise against emerging markets currencies, further gains against the euro may prove difficult. Indeed, the euro is already showing signs of stabilising on expectations that the ECB will soon signal that it will end net asset purchases under its QE programme by the end of the year. In any event, if support for the euro at $1.15-1.16 did give way, there is further strong technical support for the single currency at the $1.12-1.13 level.

Overall, we think that the major move upwards by the dollar against the euro during the last couple of months is largely over. We would expect the EUR/USD rate to now stabilise and trade in a $1.16-1.20 range, before rising above the $1.20 level later in the year as the ECB brings net asset purchases to an end and concerns re-emerge about the twin deficits in the US and that economy's growth prospects over the medium term.







Forex Market Outlook

Sterling stays range against the euro as markets await clarity on Brexit

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 in the past year. The currency was helped by an unexpected rate hike from the Bank of England and better UK economic data in the second half of last year, as well as progress in the Brexit negotiations. 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, before falling back again below $1.35 as the dollar rebounded.

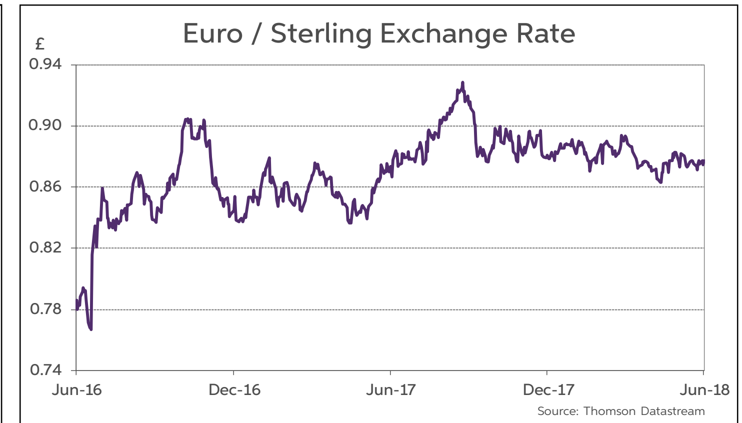
The UK currency has also recovered some territory against the euro. This has seen the EUR/GBP rate move down to largely trade in an 87-89.5p range since last September. It did dip briefly below the 87p level in mid-April, trading as low as 86.2p, before some weaker than expected UK data, a delay in the next BoE rate hike and a lack of progress recently in the Brexit talks, saw it move back above the 87p level again.

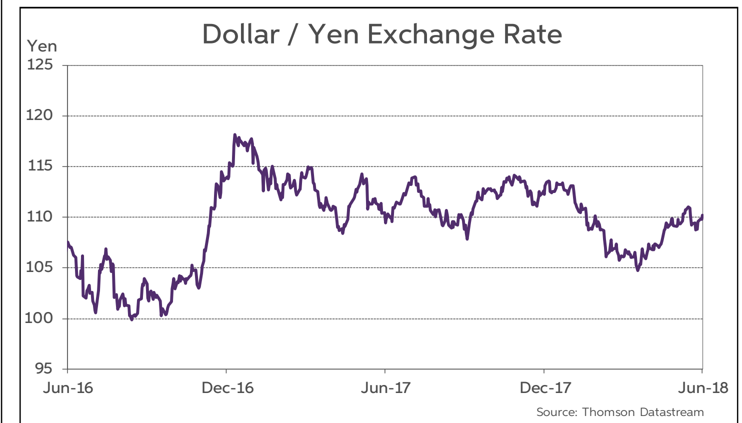
The course of the Brexit negotiations and, to a lesser extent, economic data and the timing of the next BoE hike, will be the key factors impacting sterling over the remainder of the year. In the near term, the attention may be on the economic data as improving figures could see the BoE hike rates before the end of the summer. The focus is likely to then shift to the Brexit, as the talks as move on to their critical final stages in the autumn.

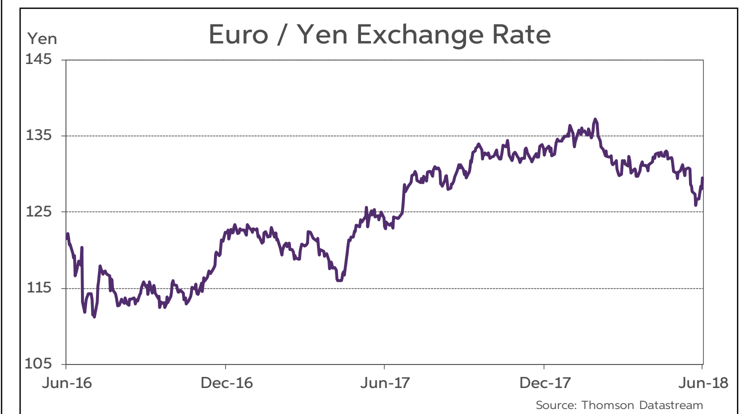
There is still much work to be done in the negotiations. The EU and UK have agreed on the need for a transition period after the Brexit occurs next March, which would see the existing trading arrangements maintained until end 2020. It is hoped that a full EU-UK trade deal can then be negotiated during 2019-2020 that will come into effect when this transition period ends. The EU and UK still need to finalise a withdrawal agreement in the autumn that will contain the outlines of a future EU-UK trade deal, as well as provide the formal basis for the transition period. The UK has been very reluctant up to now to detail how it sees EU-UK trading arrangements evolving post the Brexit transition period, especially in relation to customs.

The general expectation is that a withdrawal agreement will be concluded later this year that paves the way for a soft Brexit, thereby avoiding any major disruption to the economy. However, given the uncertain political backdrop in the UK and its desire to regain full sovereignty, there is still a risk of a hard Brexit. Indeed, the UK government may find it difficult to get a withdrawal agreement through parliament, given the divisions in the Conservative Party over the Brexit issue.

EUR/GBP seems likely to trade in an 87-89p 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 should make gains, with the euro moving down to 85p and cable rising above $1.40. 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 Brexit approaches in March 2019, with cable falling back towards $1.25.







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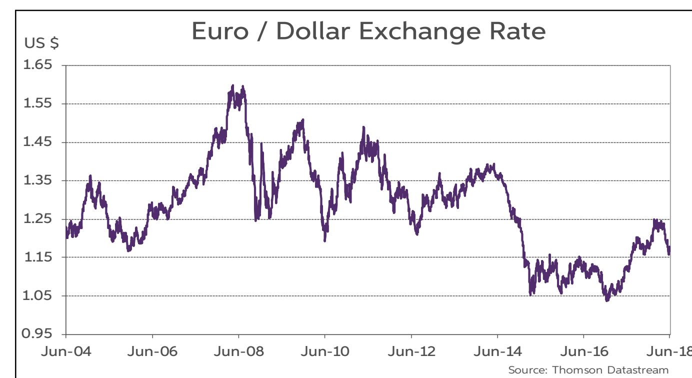
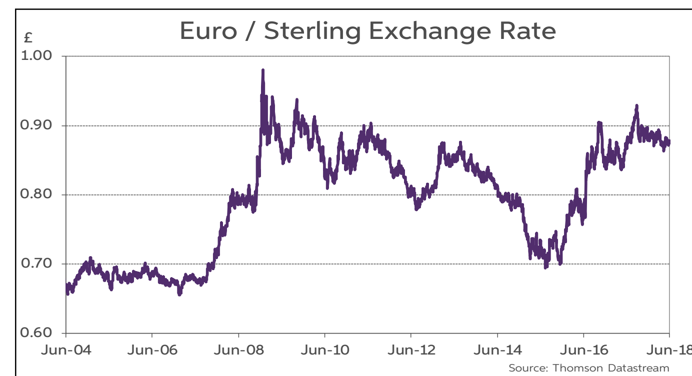
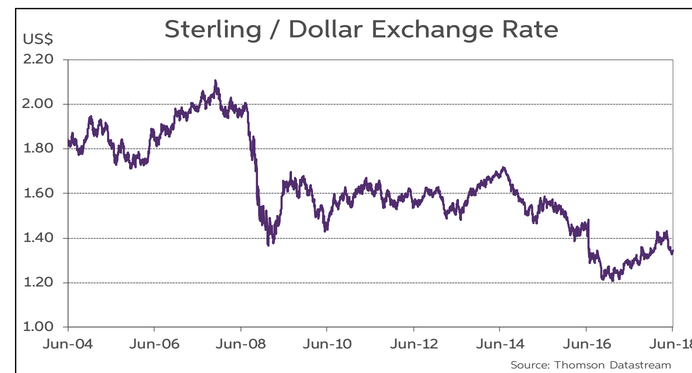
Summary of Exchange Rate Forecasts

(“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	1.182	1.15-1.21	1.17-1.23	1.19-1.25	1.21-1.27
GBP	0.879	0.85-0.91	0.84-0.90	0.83-0.89	0.82-0.88
JPY	129.93	126-132	127-133	128-134	128-134
CHF	1.16	1.16	1.17	1.18	1.19
US Dollar Versus					
JPY	109.93	106-112	105-111	104-110	103-109
GBP	1.344	1.31-1.37	1.35-1.41	1.39-1.45	1.43-1.49
CAD	1.30	1.30	1.28	1.26	1.24
AUD	0.77	0.77	0.78	0.79	0.80
NZD	0.70	0.71	0.72	0.73	0.74
CNY	6.39	6.40	6.35	6.30	6.25
Sterling Versus					
JPY	148	146	149	152	155
CAD	1.74	1.74	1.77	1.79	1.81
AUD	1.76	1.74	1.77	1.80	1.83
NZD	1.91	1.89	1.92	1.95	1.97







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AIB Bankcentre, Ballsbridge, Dublin 4 Tel: 353-1-6600311 www.aibeconomics.com