Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

8th September 2017

- Euro makes further gains, overcoming significant resistance levels. Currency underpinned by strong economic data, improved political backdrop and expected scaling back of QE

- Dollar continues to lose ground over summer as markets doubt Fed will raise rates much further. Real progress on implementing Trump's fiscal plans needed to revive dollar's fortunes

- Sterling continues to struggle versus buoyed up euro as markets worry about Brexit. EUR/GBP rate rises through 90p level. Brexit talks to remain key factor influencing UK currency

- Global economy performing well in 2017, but inflation remains very subdued

- Buoyed up markets see very little rate tightening anywhere in next couple of years. Main risk to this view lies in US, where Fed is projecting far more rate hikes than the market has priced in

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Global Economic Outlook

Pick up in global growth but not inflation

Global economic activity has firmed over the past year, helped by an improvement in investment, manufacturing and world trade. Activity started to gain momentum in advanced economies in the second half of 2016, with stronger 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, with the IMF also forecasting the same growth rates for 2017/18.

The IMF sees advanced economies growing by around 2% this year and next, up from 1.7% in 2016, helped by continuing very loose monetary policies and a more supportive stance to fiscal policy. It notes, though, that growth in the US and UK was weaker than expected in H1 2017, but this was offset by stronger than anticipated growth in the Eurozone, Japan and Canada.

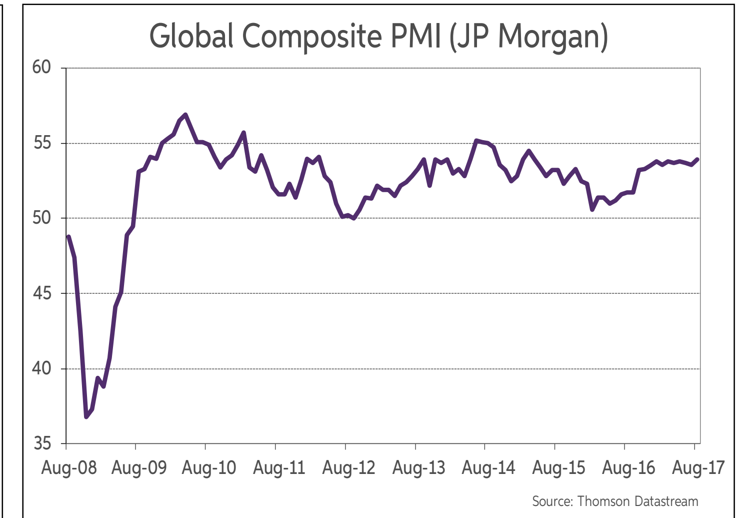
Growth did strengthen in the US in the second quarter, but GDP forecasts for 2018 have been scaled back significantly on the view that fiscal policy will be much less expansionary than previously assumed. Nonetheless, growth in the US is still forecast by the IMF to average a solid 2.1% in both 2017 and 2018. By contrast, the strong performance of the Eurozone economy has seen its GDP forecasts revised up to around 2% for this year. There was a marked slowdown in UK growth in H1 2017 as rising inflation and concerns over Brexit weighed on activity. The IMF sees GDP growth in the UK at 1.7% in 2017 and 1.5% in 2018.

Meanwhile, growth in emerging economies lost considerable momentum in the first half of this decade, slowing from 7.5% in 2010 to near 4% by 2015/16. However, growth in developing economies is forecast to strengthen to 4.6% in 2017 and 4.8% in 2018 by both the IMF and OECD, helped by the 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 improving world trade.

Survey data have been pointing to stronger activity in most economies this year. Notably, the Global Composite PMI has been very solid in 2017, hitting 53.9 in August. This is its highest level since April 2015 and is consistent with good growth by the world economy. Labour market data have been particularly encouraging across the main economies, with strong jobs growth nearly everywhere, a steady downward trend in Eurozone unemployment and economies like the US, UK, Germany and Japan now, at, or close to, full employment. The unemployment rate has fallen to 4.4% in both the US and UK.

Downside risks 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. Further unexpected increases in US interest rates could negatively impact global financial markets, where valuations look stretched, with very low bond yields and stock markets rising to elevated levels amidst unusually low volatility. The IMF has warned about the risk of a market correction that could dampen global economic growth and confidence.

Meantime, despite the pick-up in global growth, inflation in advanced economies remains subdued and below targets, while it is declining in some emerging economies. Sluggish wage growth and quite low oil prices suggest that inflation is likely to remain subdued in H2 2017 and 2018. As a result, markets expect interest rates to stay low, thereby underpinning the recovery in economic activity.



GDP (Vol % Change)

	2015	2016	2017 (f)	2018 (f)
World	3.4	3.2	3.5	3.6
Advanced Economies	2.1	1.7	2.0	1.9
US	2.6	1.6	2.1	2.1
Eurozone	2.0	1.8	1.9	1.7
UK	2.2	1.8	1.7	1.5
Japan	1.1	1.0	1.3	0.6
Emerging Economies	4.3	4.3	4.6	4.8
China	6.9	6.7	6.7	6.4
India	8.0	7.1	7.2	7.7
World Trade Growth (%)	2.6	2.3	4.0	3.9
Advanced Economies Inflation (%)	0.3	0.8	1.9	1.8

Source: IMF World Economic Outlook (Update), July 2017

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Interest Rate Outlook

Markets expect very little rate tightening anywhere, including in the US

The long period of monetary easing appears to be coming to an end, apart from in Japan. The US Federal Reserve has embarked on a path towards policy normalisation, while rates were hiked in Canada and the Czech Republic over the summer. Rates appear to have troughed elsewhere and ECB tapering of QE is likely next year.

Nonetheless, markets expect monetary policy to remain very loose in all the major economies. Indeed, continuing low inflation figures over the summer months have seen markets scale back the extent of rate tightening expected from central banks over the next couple of years, despite the strengthening of global economic activity in 2017. This has seen a strong rally in bond markets in the third quarter of 2017.

In the UK, inflation has picked up following the sharp decline in sterling, with headline CPI inflation expected to reach 3%. The BoE has indicated that there are limits to the extent that above-target inflation can be tolerated, with some MPC members voting for a rate hike at recent meetings. The majority on the MPC, though, want to wait and see if the slowdown in activity so far this year is sustained or not, so an increase in rates does not look imminent. Indeed, markets have pushed out the timing of the first rate in the UK to H2 2019.

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. However, it continues to say that it could expand its QE programme if necessary. The expectation in markets, though, is that the ECB will taper its QE programme next year, with an announcement on this expected at the October Council meeting.

The ECB 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 it is likely to be late 2018 or early 2019 at the earliest, before this is increased, given the guidance from the Central Bank on QE and rates. Futures contracts show that while wholesale rates are likely to start edging modestly higher next year, three month money rates are expected to remain negative until end 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 not reach 1% until H2 2023.

Meanwhile, the Fed hiked rates by 25bps at its December 2015 and December 2016 meetings, the first such rate hikes in nearly a decade. It followed this up with two further hikes in March and June of this year, taking rates to 1.125%. It has indicated that it is likely to hike rates again to 1.375% at year end. 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 just above 1.5% by then, far below the Fed's projections, with the next rate hike not expected until the very end of 2018, with another 25bps rate hike not priced in until the end of 2020.

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. However, with inflation below target, rates seem unlikely to rise as quickly as projected by the Fed either. Thus, we see the Fed funds rate rising to about 2.25% by end 2019, with the next rate increase likely to occur in Q1 2018. Meantime, the Fed has indicated that it will start to unwind its asset purchase programme, "relatively soon", thereby reducing the size of its balance sheet, albeit at a very slow pace. An announcement on the start date for the process is expected at the September FOMC meeting.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.125	1.32	1.71	1.47	1.67
Sept '17	1.125	1.33	1.75	1.55	1.75
Dec '17	1.125	1.35	1.80	1.65	1.85
Mar '18	1.375	1.60	2.05	1.90	2.10

** 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	-0.21	-0.21	0.13
Sept '17	-0.40	-0.35	-0.20	-0.20	0.15
Dec '17	-0.40	-0.35	-0.15	-0.15	0.25
Mar '18	-0.40	-0.30	-0.10	-0.10	0.35

** 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	0.29	0.59	0.53	0.74
Sept '17	0.25	0.28	0.60	0.55	0.75
Dec '17	0.25	0.30	0.63	0.60	0.85
Mar '18	0.25	0.30	0.65	0.65	0.95

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Euro surges in 2017 as dollar comes under pressure

A key development in forex markets over the summer was that the euro rose out of its relatively narrow trading range of $1.04-1.16 against the US dollar that it had occupied since early 2015. In the first half of this year, the euro made impressive gains against the dollar, climbing from $1.04 to above the $1.14 level, despite further rate hikes by the Fed in March and June. The euro rally has continued in the third quarter as it climbed above $1.20, its highest level since January 2015.

Developments in Europe have helped the euro to gain ground. Eurozone growth has picked up appreciably in recent quarters, 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 end 2019, compared to mid-2021 last year. There is also a growing expectation in markets that the ECB will taper QE, or wind down its asset purchases, next year.

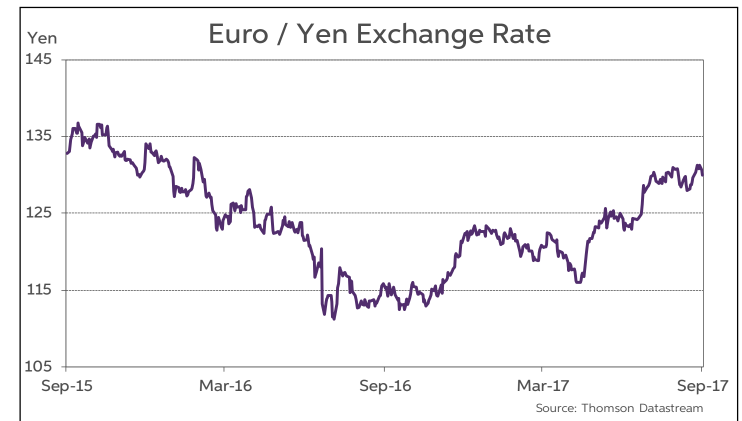
Abating political risks have also helped the euro, with 'mainstream' political parties doing well in European elections this year, most notably in France. By contrast, political risks have grown elsewhere, in particular in the UK and US. Markets are also becoming very doubtful about whether President Trump will be able to implement any of his planned expansionary fiscal agenda. This has seen a scaling back of growth forecasts for the US economy in recent months.

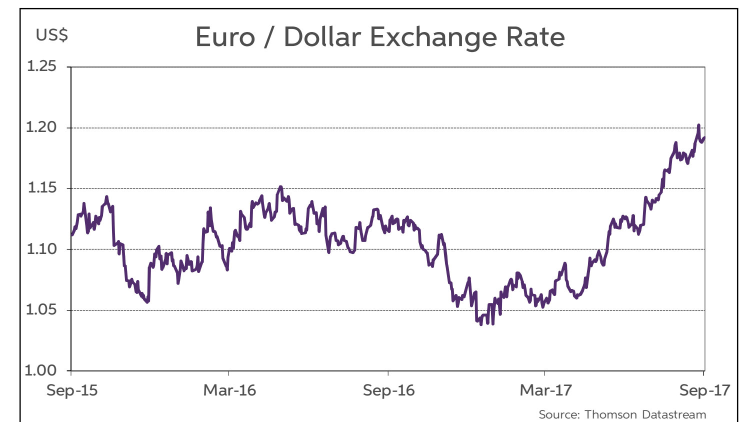
The dollar lost ground against a broad range of currencies over the summer months and not just the euro. The Aussie, NZ and Canadian dollars have risen to their highest levels against the US currency in over two years. Even the Chinese yuan, which declined steadily against the dollar over the 2014-16 period, has appreciated against the greenback in recent months, while sterling has risen to above the $1.30 level from $1.22 in the spring. The dollar has fallen by some 11% on a trade-weighted basis year-to-date, including a 6% fall since late June.

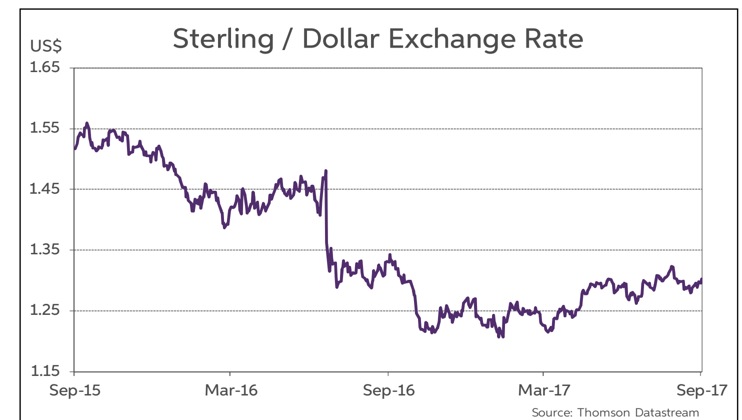
A key issue for the dollar is that markets simply do not believe Fed projections that US rates are on a steady tightening path that will take them up to 3% by end 2019. Markets have scaled back their expectations on Fed hikes considerably because of very subdued inflation. They do not see the next rate hike materialising until the end of 2018 and are not pricing in a further 25bps rise until end 2020. Markets see official rates at just 1.5% by end 2019, way below the Fed projections. Even indications from the Fed that it is likely to start reducing the size of its balance sheet "relatively soon", as it begins unwinding QE, has not provided any support for the dollar.

For the dollar to regain its mojo, it will likely need both monetary and fiscal policy to play a role. However, there appears little prospect of a near-term fiscal stimulus from the Trump administration, while it could be well into next year before it becomes clear if the market is underestimating the extent of Fed tightening. Thus, the dollar looks set to remain on the defensive in the coming months, with EUR/USD likely to trade in a $1.18-1.24 range.

This does not mean that all is lost for the dollar as the Fed could surprise markets in 2018 with the extent of its policy tightening, while significant progress on implementing Trump's fiscal agenda could be made next year ahead of mid-term Congressional elections. In particular, a one-off large cut to corporate tax to entice back profits held by US corporates overseas would trigger renewed dollar gains, especially given the market's short dollar positioning. Thus, there may be scope for the dollar to regain some ground in 2018.







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Forex Market Outlook

Brexit to remain key factor impacting sterling

Sterling fell sharply last year on concerns over Brexit. The currency hit 30-year lows against the dollar, falling from above $1.50 to around the $1.20 level. The euro made significant gains against sterling too, with the EUR/GBP rising to 90p last autumn, up from 70p near the end of 2015.

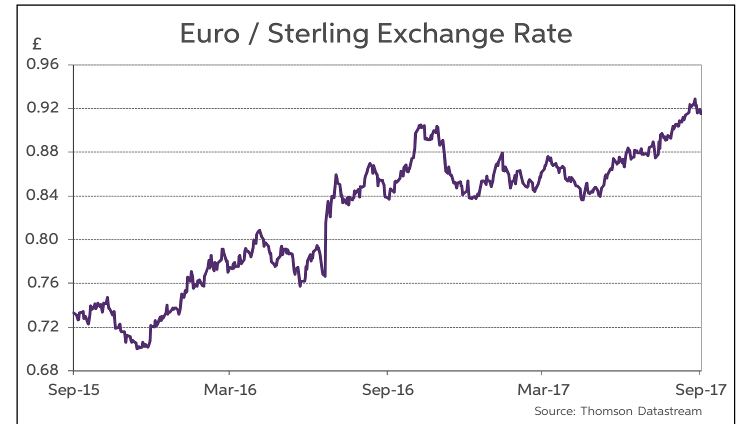
Sterling, though, did find a trough in the late autumn and managed to regain some ground at end 2016. This saw the euro drop back to around 84p. However, the euro has been in the ascendancy this year on currency markets. Meanwhile, the snap UK general election, which saw the Conservative Party lose its majority in Parliament, brought renewed pressure on sterling. Thus, the euro has been on a steady upward path against sterling since May, climbing from 84p to as high as 93p in August. On the other hand, sterling has been on a general upward trajectory against the weakening dollar this year, moving above the $1.30 level over the summer. Overall, sterling has lost over 5% on a trade-weighted basis since May and is back to its post-Brexit referendum lows.

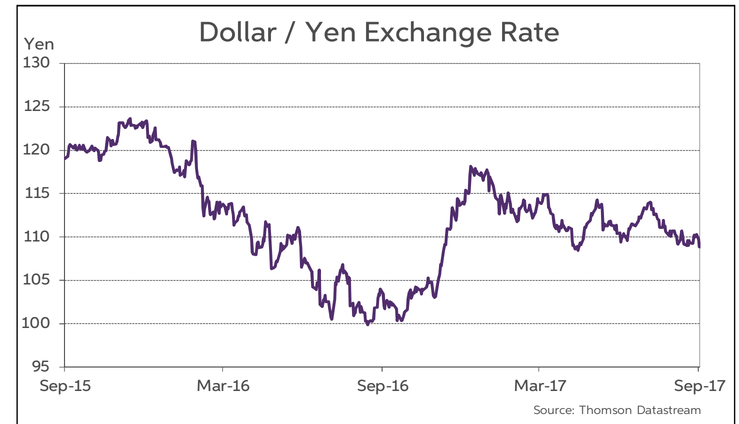
Brexit is likely to be the key factor influencing sterling in the period ahead. The formal exit negotiations between the UK and EU began in late June and are likely to last until the end of next year. The early stages of the Brexit talks are largely technical in nature, dealing with budgetary issues, borders and citizens' rights. Discussions on the more substantive issues of future trade relations and possible transition arrangements that may apply for a period after the UK leaves the EU, are unlikely to commence until late this year or in 2018. The early stages of the Brexit negotiations are proving both difficult and slow, especially in regard to budgetary matters and what bill the UK has to pay to settle its outstanding financial liabilities on leaving the EU. This is weighing on sterling.

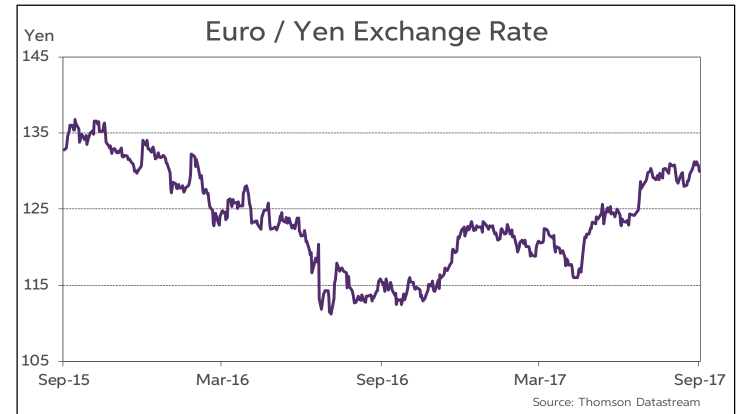
There are hopes, though, that the outcome of the talks will be a soft Brexit with transition arrangements agreed that allow for continuing free trade between the UK and EU until a full trade deal is negotiated. Both the EU and UK see the need for a transition period. The UK government has suggested that the UK and EU could form a Customs Union in the transition phase, with the current customs border trading arrangements remaining in place during this period. 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, with the Labour party formally adopting a soft Brexit policy position recently. Nonetheless, there is still a risk of a hard Brexit, where the UK loses free access to EU markets and has to fall back on WTO rules. This would be very negative for the UK economy and see further falls in sterling.

Sterling now looks to have entered a 90-95p trading range against the euro, with movement within this band in the coming months largely determined by the tone and pace of progress on the Brexit talks. Beyond that in 2018, if it appears that a hard Brexit looks increasingly likely, then the euro could well move above the 95p level to trade in a 95p-100p range, with cable falling towards $1.20. On the other hand, a soft Brexit should see the currency regain some of the ground lost since June 2016, with cable rising to $1.35 or higher and the euro moving down to 85p or below.

Our expectation is that after much wrangling, a soft Brexit with a transition period will be agreed. However, there will be still considerable uncertainty about what the future trade relationship between the UK and EU will look like after the transition period ends. This will be shaped by further negotiations on a new EU-UK trade deal.







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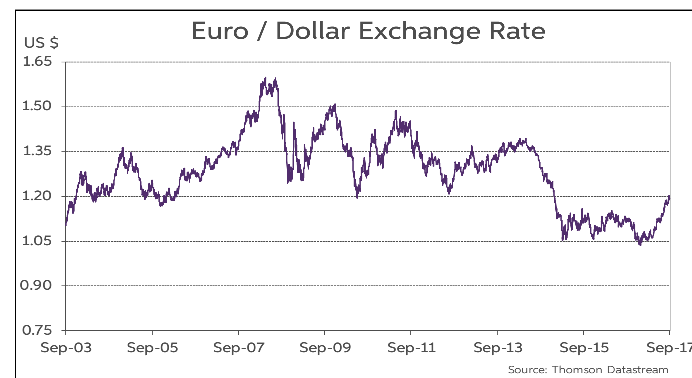
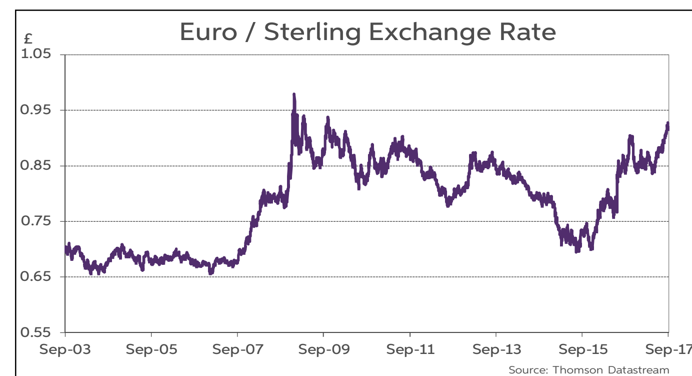
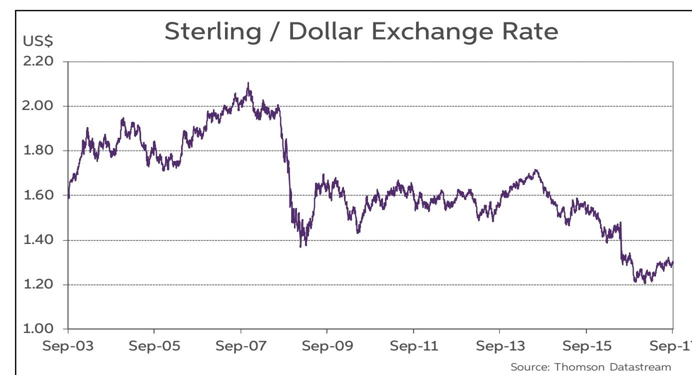
Summary of Exchange Rate Forecasts

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

	Current	Q3-2017	Q4-2017	Q1-2018	Q2-2018
Euro Versus					
USD	1.205	1.18-1.24	1.17-1.23	1.15-1.21	1.13-1.19
GBP	0.917	0.89-0.95	0.88-0.94	0.86-0.92	0.84-0.90
JPY	129.72	128-134	128-134	128-134	128-134
CHF	1.14	1.14	1.14	1.14	1.14
US Dollar Versus					
JPY	107.64	105-111	106-112	108-114	110-116
GBP	1.314	1.29-1.35	1.29-1.35	1.30-1.30	1.30-1.36
CAD	1.21	1.20	1.21	1.23	1.25
AUD	0.81	0.81	0.80	0.79	0.78
NZD	0.73	0.73	0.72	0.71	0.70
CNY	6.45	6.45	6.40	6.50	6.60
Sterling Versus					
JPY	141	143	144	144	150
CAD	1.59	1.58	1.60	1.63	1.67
AUD	1.62	1.63	1.65	1.65	1.71
NZD	1.80	1.81	1.83	1.83	1.90







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