Stable forex markets amid volatility elsewhere

Financial markets have continued to encounter a more volatile trading environment. This follows on from the early February period when some of the main global equity indices experienced falls that put them in correction territory (i.e. declines of more than 10% from their recent peak).

The declines in February were prompted by investors getting concerned that the improving global economy could result in increased inflationary pressures. This in turn could result in global monetary policy being tightened at a quicker pace than previously anticipated.

In recent weeks, the latest bout of risk aversion has been triggered by growing concerns about a possible global trade war after the US announced tariffs on a range of imports from China, with China retaliating with its own tariffs on certain US goods. A sell-off in tech stocks on the back of concerns of increased regulation has also weighed on investor sentiment.

At the same time, amid the more 'nervy' backdrop, the flight to safety out of equity markets has supported bond markets. We expect this will prove a temporary rally and the uptrend in yields will reassert itself over the coming months as global monetary policy continues to be tightened.

However, despite this more volatile trading environment, the effect on currency markets is much less discernible. The euro has been quite range bound against the dollar, yen and sterling during March and this has continued into the start of April.

Indeed, currency markets are struggling for direction at the moment. The dollar, in particular has stabilized since mid-February after falling by almost 7% in trade weighted terms over the winter months.

There have been plenty of events for currency markets to absorb recently, including the aforementioned declines in equity markets, trade war risks, more hawkish central banks, as well as developments in relation to Brexit. However, the major currencies have remained largely unresponsive to this flurry of events.

Despite this relative sanguine mood on the currency front, we would expect that the trends in currency trading over the last six to twelve months will reassert themselves again as the year progresses. Our view remains that the dollar has entered a long term weakening trend. We expect that the dollar's rally over the period mid-2014 to the end of 2016 will continue to unwind as other central banks join the US Federal Reserve in tightening policy on improving global growth.

From a euro perspective, the currency is still at a low level against the dollar at around $1.23, given it largely traded in a $1.20-1.50 range from 2003 to 2015. This suggests that the EUR/USD rate has considerable further upside potential. We expect it to test the $1.30 level before the year is out.

Sterling also has upside potential if progress continues to be made in the Brexit negotiations and a withdrawal agreement is concluded later this year which includes the recently agreed transition period. This would pave the way for a smooth Brexit. This could see the EUR/GBP rate fall back to or below 85p and GBP/USD rising above the $1.50 level.

The main downside risk for sterling remains UK politics as it could be difficult to get a withdrawal agreement through Parliament, which could increase the risk of a hard Brexit and possibly trigger a general election. Downward pressure is likely to re-emerge on sterling in such circumstances, with the euro rising back up to its high of last summer at around 93p and GBP/USD falling back towards $1.30.

John Fahey

Senior Economist

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