Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

2nd July 2025

- Risk appetite improves following significant uncertainty/volatility in the aftermath of "Liberation day", but still limited clarity on the ultimate landing zone for US tariffs and trade policy

- Market attention is also focused on US fiscal policy ('Big Beautiful Bill'), geopolitics (Middle East), and monetary policy (dovish remarks/White House pressure)

- Fed remains on hold for now but diverging views emerging amongst the FOMC. The ECB nearing the end of its rate cutting cycle, while the BoE retains its easing bias

- Dollar has weakened further, amid the ongoing trade and geopolitical uncertainty, as well as US fiscal concerns and a softening in US rate expectations

- Euro likely to hold most of its gains, but high degree of uncertainty still due to evolving US policy landscape

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Global Economic Outlook

AIB Treasury Economic Research Unit

None the wiser on ultimate US trade policy

Countdown to end of 90-day pause on US reciprocal tariffs

As the end of the 90-day pause on US reciprocal tariffs fast approaches in early July, there is little evidence as to where US tariffs will land. While most forecasters are pricing in a 10% landing zone, there remains considerable risks for key trading partners, notably the EU & China, that tariffs may end up higher in the event of no trade agreements being struck in the coming days.

US growth looks set to slow, tariffs could precipitate a sharper slowdown

With markets taking a more sanguine view of US trade policy following several policy reversals by President Trump, equities and general macro sentiment indicators have rebounded in recent weeks. Meanwhile, hard economic data remains broadly solid in the US, with few signs of deterioration as yet, due to the impact of the current uncertainty.

Data signal subdued growth in UK and Eurozone

In Europe, activity remains subdued outside of the surge in manufacturing output and exports in recent months, which have been front-running potential US tariffs. Latest forward-looking indicators suggest Eurozone growth was weak in Q2, with both PMI surveys hovering around the 50 no change level. Consumer confidence has also been dampened by the recent uncertainty.

Attention turning to US fiscal policy

US tax reform will gain prominence for investors over the summer

The longer term question remains as to whether US assets will retain their attractiveness to global investors given the volatile policy environment. Alongside tariffs, the emerging structure of the "One Big Beautiful Bill Act" (OBBBA) could be a key driver of US markets over the coming months. Two features of the bill will be most in focus for investors. First, the corporate tax features, which may impact foreign capital and FDI in the US. Second, provisional estimates point to an additional $3.3trn of borrowing over the next decade from the tax and spending provisions in the bill.

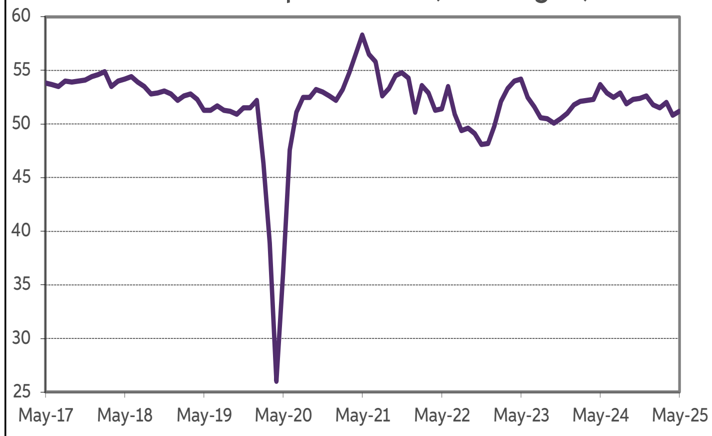
Growing fiscal deficit could put pressure on the dollar

On the OBBBA, as discussed above, the large US fiscal and current account deficits ('twin deficits') imply a significant downside risk for the dollar in the medium term. While the currency has lost ground in 2025, it remains historically elevated. Forecasts suggest a further sharp deterioration in fiscal deficit stemming from OBBBA, which may crystalise these risks amongst the foreign funders of the US current account deficit.

TINA could provide some support the dollar

However, while the Eurozone has benefitted from fresh capital flows, the currency will struggle to erode the US dollar's reserve status, given the paucity of safe assets beyond the German bund market. This TINA (There is no alternative) problem might yet provide a floor for the US dollar given the lack of safe-haven alternatives beyond US markets, even in the event of a reckless turn in US fiscal policy.

Global Composite PMI (JP Morgan)



Source: Refinitiv

GDP (Vol % Change)

	2023	2024 (e)	2025 (f)	2026 (f)
World	3.4	3.3	2.9	2.9
OECD	1.8	1.8	1.4	1.5
US	2.9	2.8	1.6	1.5
Eurozone	0.5	0.8	1.0	1.2
UK	0.4	1.1	1.3	1.0
Japan	1.4	0.2	0.7	0.4
Emerging Economies				
China	5.4	5.0	4.7	4.3
India	9.2	6.2	6.3	6.4
World Trade Growth (%)	1.2	3.8	2.8	2.2
Inflation -CPI				
OECD Economies (%)	7.1	5.1	4.1	3.2

Sources: OECD World Economic Outlook June 2025

Interest Rate Outlook

Central banks awaiting clarity on global trade developments

No surprises from the May-June round of central bank meetings

The raft of central bank meetings over the May-June period, provided no major surprises. Both the ECB and BoE lowered their official interest rates. Meantime, the US Fed refrained from easing policy. Elsewhere, the BoJ also kept its policy on hold, with the market not ruling out the possibility of a rate hike by year end. All of these policy deliberations took place against a backdrop of elevated uncertainty regarding the economic outlook. This stems from ongoing trade tensions amid the significant shift in US policy. More recently, increased geopolitical risks have added another factor that central banks must contemplate as they determine the extent and timing of further rate changes.

Fed remains on hold for now, but rate expectations have softened amid White House comments

The Fed left rates on hold again in June, in a 4.25-4.50% range. The median projection in the June interest rate dotplot remained for 50bps of cuts this year, but there was a more hawkish dispersion to the dots. Chair Powell re-stated that the FOMC believes its policy is “well positioned” and is in ‘wait-and-see’ mode over the summer to assess the impact from tariffs. His subsequent semi-annual testimony reiterated the Fed’s patient stance, in contrast to President Trump’s preference for more immediate easing. Furthermore, some members of the FOMC have also sounded more dovish in recent remarks. Amid these comments/pressure from Trump, rate expectations have softened, with around 65bps of easing now priced in for this year. The first cut is priced in for September, which is a view we share, but we see just 50bps of easing by year end.

ECB cuts again but says it is nearing the end of its easing cycle

For the fourth consecutive meeting, the ECB cut rates by 25bps in June. The Depo rate was lowered to 2.00%. This was the eighth 25bps rate cut since it started its easing cycle last June. The ECB continued to state that it will follow a “data-dependent” and “meeting-by-meeting” approach. President Lagarde noted though that it was nearing the end of its easing cycle and that it viewed its policy setting to be in a good position to deal with “uncertainty” over the coming months. These comments suggest that another near term cut is unlikely and the extent of further easing may be limited. The market is anticipating the Depo rate falling to 1.75% by year end. We remain of the view that the Depo rate could still be at 2% by the end of the year, albeit one more 25bps rate cut cannot be completely ruled out.

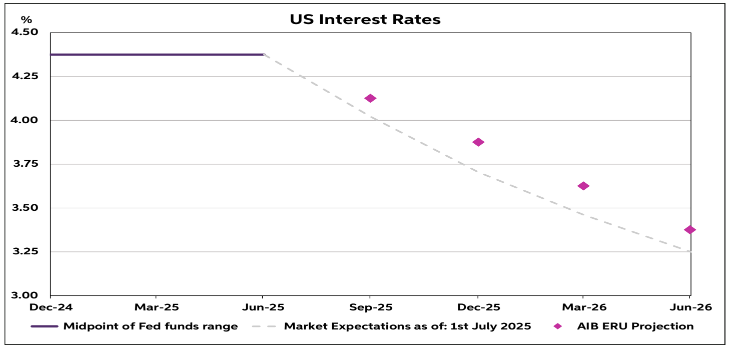
Market expects the next BoE rate cut in September, but it could happen in August

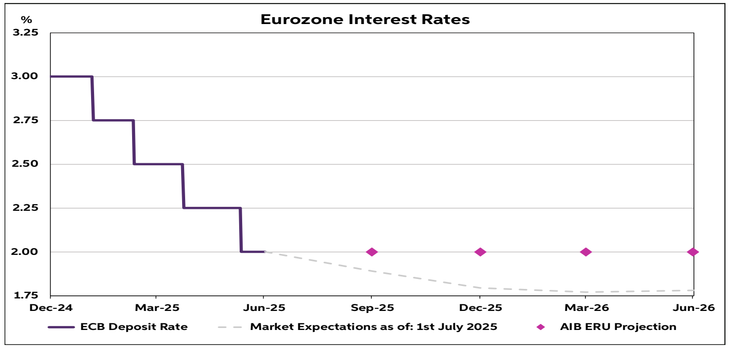
Having cut rates in May, the BoE maintained its official interest rate at 4.25% in June. Once again, there was no unanimity within the MPC, with 3 members voting for a 25bps rate cut in June. Its current easing cycle, which began in Aug’24, has seen a total of 100bps of cuts (incl. 50bps YTD). The BoE retains an easing bias and it repeated that it favours a gradual approach to rate cuts. Overall, the June MPC had a dovish slant. UK futures contracts are not fully pricing in the next 25bps rate cut until September. However, we would not be surprised to see this cut occur in August when the MPC will have its updated macro forecasts. We continue to envisage a Bank rate of 3.75% by year end.

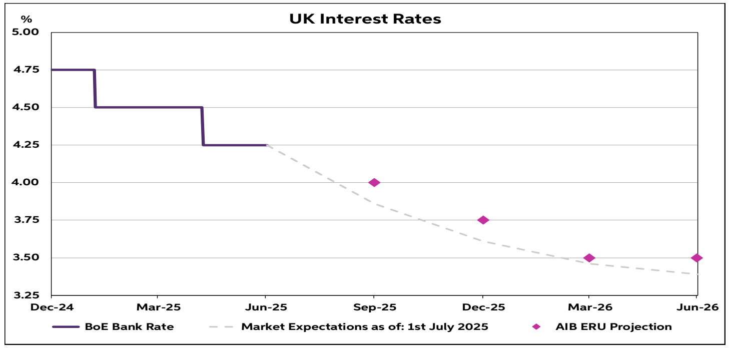
Interest Rate Forecasts

	Current	End Q3 2025	End Q4 2025	End Q1 2026	End Q2 2026
Fed Funds	4.375	4.125	3.875	3.625	3.375
ECB Deposit	2.25	2.00	2.00	2.00	2.00
BoE Repo	4.25	4.00	3.75	3.50	3.50

Current Rates Reuters, Forecasts AIB's ERU







Forex Market Outlook

Dollar downsides remain as US fiscal debate intensifies

Dollar has posted further falls of late

The dollar has seen renewed falls of late, with the trade-weighted DXY index down over 10% this year. Against the euro, the dollar is down c.13% over the same period, reflected in EUR/USD testing above $1.18 recently. The dollar also lost ground against sterling, falling by c.10% since the beginning of 2025, with GBP/USD trading up to circa $1.37 of late.

Currencies will remain highly sensitive to geopolitical events

As described earlier, currencies have been driven more by geopolitical events rather than fundamentals such as relative interest rates and growth differentials recently. The key upcoming event risks include the expiration of the 90-day reciprocal tariff pause in July. Markets appear to have priced out the risk of higher US tariffs for now. Also front and centre will be US tax reform and the impact on its fiscal deficit, and developments in the Middle East.

Near term risks on both sides for the dollar

Against this uncertain backdrop, the dollar is likely to remain on the defensive and will be prone to volatility, with obvious risks to the downside. The policy trajectory of the Fed could be a key driver here, with markets now pricing in a Fed funds rate at 2.9% by end-2026, compared to an FOMC median projection of 3.6%. Thus, the currency could recover some ground if the Fed sticks to its current guidance in the coming months.There may also be some near term support, given dollar positioning is stretched short.

ECB all but done, focus on EU fiscal policy

Could EU bonds underpin the euro?

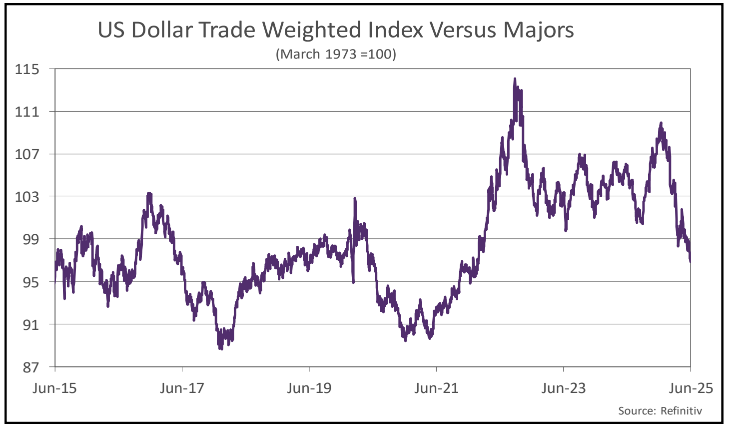
With the ECB all but complete on rate cuts - we expect a pause at 2%, while markets are pricing in 1.75% - attention now turns elsewhere. On the fiscal policy side, the EU has announced ambitious plans to boost defense spending across the bloc. If accompanied by material burden-sharing in the form of EU bonds this might further underpin the euro by providing a wider pool of safe assets for investors.

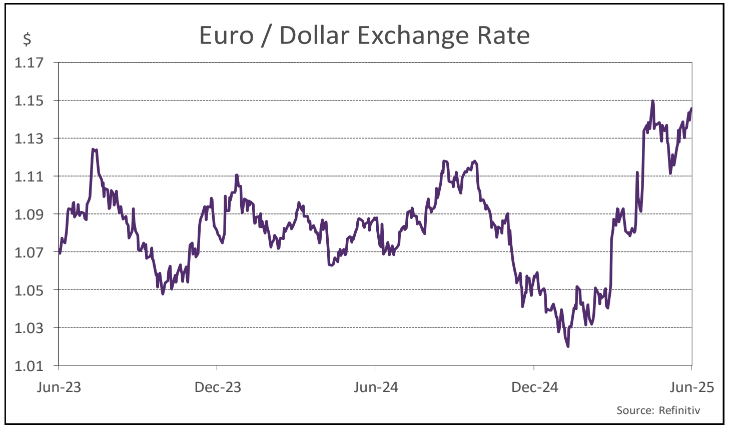
However, more stringent US tariffs also a downside risk to growth

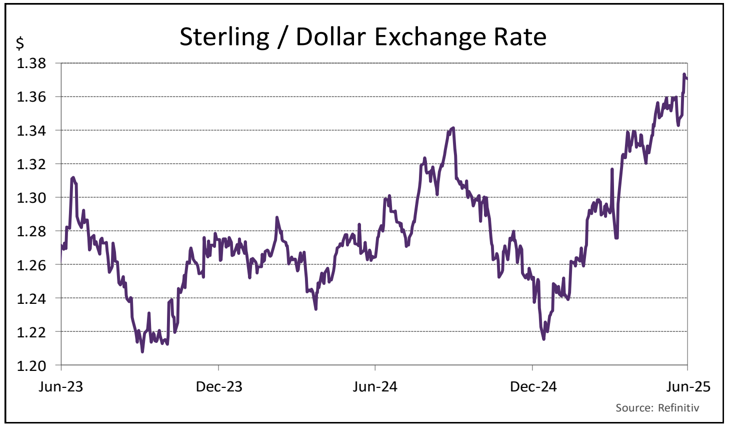
However, the Eurozone will also need to demonstrate tangible signs that the increased fiscal spending and capital market reforms are yielding a lasting impact on productivity and GDP growth. For now, forecasters are pencilling in a marginal boost to growth from 2026/27, with the currency bloc expected to post modest growth in the near term, as the impact of US tariffs and general uncertainty dampen industrial output and export growth.

Euro to hold gains, but further catalyst required to sustain a break of $1.20 vs. dollar

We expect the euro to maintain its gains versus the dollar. Furthermore, given the current downward momentum for the dollar, EUR/USD could push higher. A further catalyst will likely be required though, to enable EUR/USD to make a sustained break through the key resistance level of $1.20 as the pair has not traded consistently above this level since 2014.







Forex Market Outlook

Mixed messages from UK economy, but bias toward sterling

UK macro data remain weak, but US trade deal a boost

Sterling has generally gained ground in recent weeks versus the dollar and remained range-bound versus the euro, albeit it is displaying some volatility as we publish. It has also exhibited more cyclicality in the face of recent global market volatility. Following a stronger start to the year, macro data have dipped once again, as previously announced tax hikes kicked in from April, and as the government announced further spending cuts in its Spending Review. On the upside, the UK is one of the first countries to conclude a trade deal with the US, protecting its export sectors from tariffs.

UK rate expectations have softened, likely priced into the currency

The BoE cut by 25bps in May with a three-way split on the MPC. This was followed by a pause in June, but again, the MPC was fractured. Our expectation for a continued steady easing cycle by the BoE, with rates lowered to 3.75% in Q4 2025 was slightly ahead of market pricing until recently, but futures have softened in recent weeks, and are now in-line with our forecast.

Slight bias towards sterling vs. euro

Sterling is expected to broadly maintain current levels versus the euro in the near term. The pair is likely to remain largely range bound as relative macro fundamentals are unlikely to drive a notable break-out from the current range. EUR/GBP could edge down from around the midpoint of 86p to nearer 85p by end-2025. We see the potential for GBP/USD to strengthen to around $1.40 in Q4 2025, from the current $1.36-1.37 band.

Slight upside for yen as BoJ hikes rates

Yen has strengthened in 2025

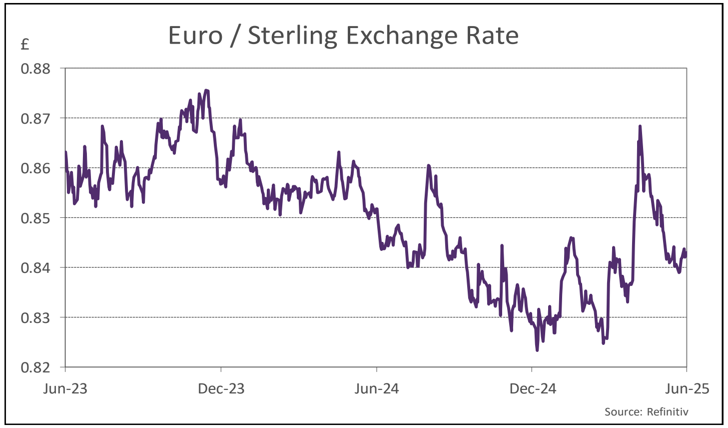
The yen has strengthened in 2025, largely due to dollar weakness. Since the start of 2025, the yen is up nearly 9% versus the dollar, rising from just below ¥160 at the start of 2025 to the current ¥141-147 range. Against the euro, the currency is weaker, trading towards ¥169 currently from ¥162 in January.

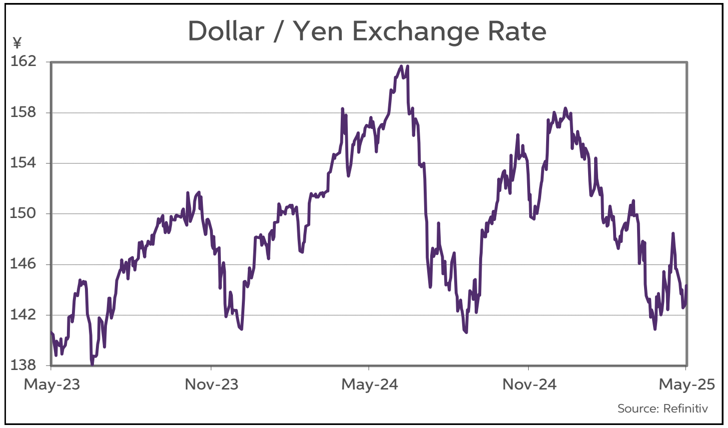
Bank of Japan expected to continue to gradually hike rates, supportive of yen

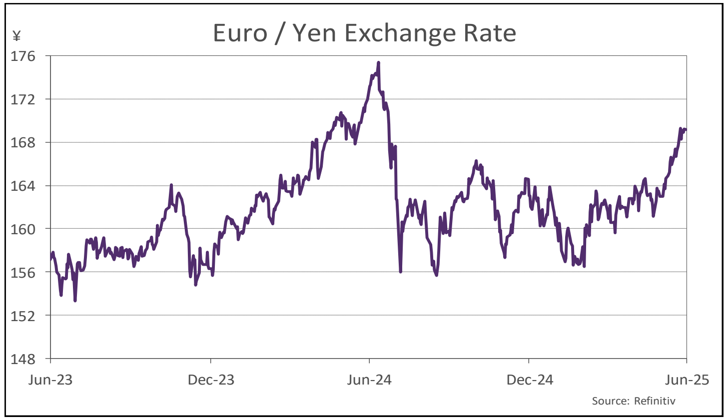
Interest rate hikes by the BoJ last July, October and this January have seen the base rate move from –0.1% to the current 0.5% level. The BoJ has taken a slightly less hawkish turn of late, which has seen rate futures soften somewhat. Markets are now pricing in just 15bps of further rate hikes by year end. However, we would not rule out a 25bps rate hike by end-December.

Yen expected to strengthen slightly in the near term

The yen is expected to trade close to its current range in the near term. Thereafter, we see a modest appreciation in the yen, towards a range of ¥140-146 by Q4 2025 versus the dollar, from the current ¥141-147 corridor. Versus the euro, the currency may regain some ground next year, falling to ¥164-170 range by mid-2026. BoJ rates will be a key catalyst, with current sticky inflation raising the risk of more rate hikes than currently priced in, which could support a stronger yen.







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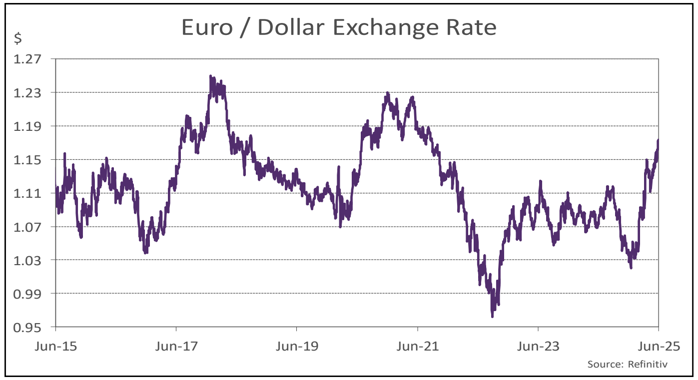
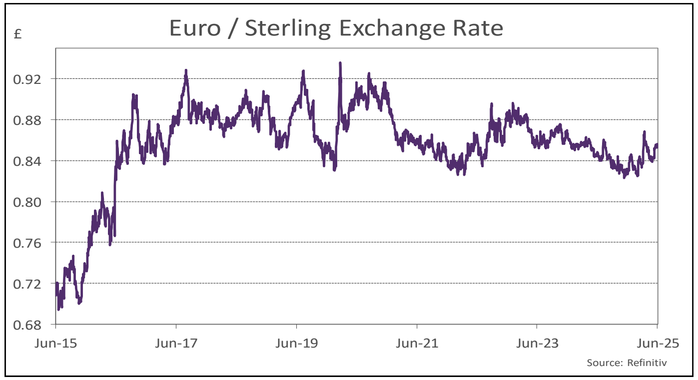
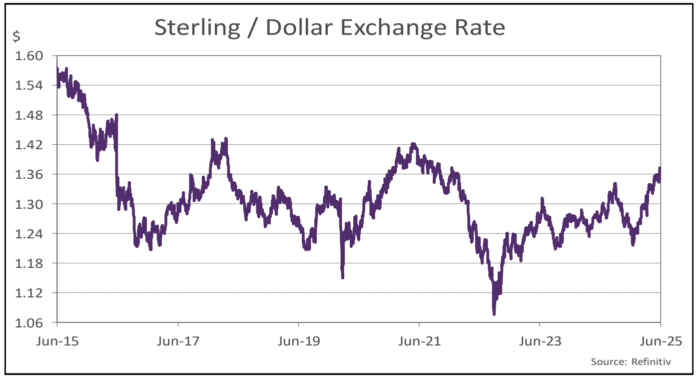
Summary of Exchange Rate Forecasts

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

	Current	Q3-2025	Q4-2025	Q1-2026	Q2-2026
Euro Versus					
USD	1.177	1.15-1.21	1.16-1.22	1.17-1.23	1.17-1.23
GBP	0.867	0.83-0.89	0.82-0.88	0.81-0.87	0.81-0.87
JPY	169.41	167-173	167-173	165-171	164-170
CHF	0.93	0.94	0.95	0.95	0.95
US Dollar Versus					
JPY	143.99	141-147	140-146	137-143	136-142
GBP	1.357	1.34-1.40	1.37-1.43	1.40-1.46	1.40-1.46
CAD	1.36	1.35	1.35	1.35	1.35
AUD	0.66	0.66	0.67	0.68	0.68
NZD	0.61	0.61	0.62	0.63	0.63
CNY	7.17	7.20	7.20	7.20	7.20
Sterling Versus					
JPY	195	197	200	200	199
CAD	1.85	1.85	1.89	1.93	1.93
AUD	2.07	2.08	2.09	2.10	2.10
NZD	2.24	2.25	2.26	2.27	2.27







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