Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- President Trump's reciprocal tariff climbdown and de-escalation with China has driven a recovery in markets in recent weeks
- However, the uncertainty created by the 90-day pauses and the eventual landing zone for US trade policy is expected to dent global growth, reflected in recent forecast downgrades
- Central bank outlook clouded by trade policy uncertainty, with the Fed holding pat on rates amid current uncertainty. We expect Fed cuts to resume in H2 2025
- Main currency pairs exhibiting volatility due to Trump 2.0 impact. Dollar has found a floor of late as tariffs have fallen, but trade uncertainty brings downside risks and volatility to FX markets
- Euro likely to hold most of its gains, but high uncertainty due to evolving tariff policy

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Global Economic Outlook

Trade uncertainty clouds global outlook

Global growth robust so far in 2025 despite geopolitical risks

Economic data signal continued growth in recent weeks, albeit there are signs of weakness in some soft data such as consumer and business surveys. The impact of US tariff uncertainty has already had a tangible impact on the hard data in the form of a surge in imports to the US, as exporters seek to get ahead of expected tariffs.

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

US GDP expanded at a robust pace of 2.8% in 2024, with the immediate outlook for 2025 and 2026 highly uncertain. Institutional forecasters, such as the IMF, have trimmed growth expectations in the near term. The IMF's latest World Economic Outlook (Apr' 25), is now forecasting a slowdown in US GDP growth to 1.8% in 2025 and 1.7% in 2026.

Data signal subdued growth in UK and Eurozone

In Europe, while asset prices have been boosted by the announcement of the German fiscal stimulus, and plans for higher defence spending at the European level, this stimulus will take time to feed through to growth. In the short term, there remain downside risks to the outlook from US tariffs, amid ongoing trade talks between both blocs. In the UK, growth has strengthened of late, and the UK has completed trade agreements with the US, Eurozone and India, which again may boost medium-term growth prospects.

Risks to the outlook firmly tilted to the downside for growth

Tariffs and US tax reform key near term risks

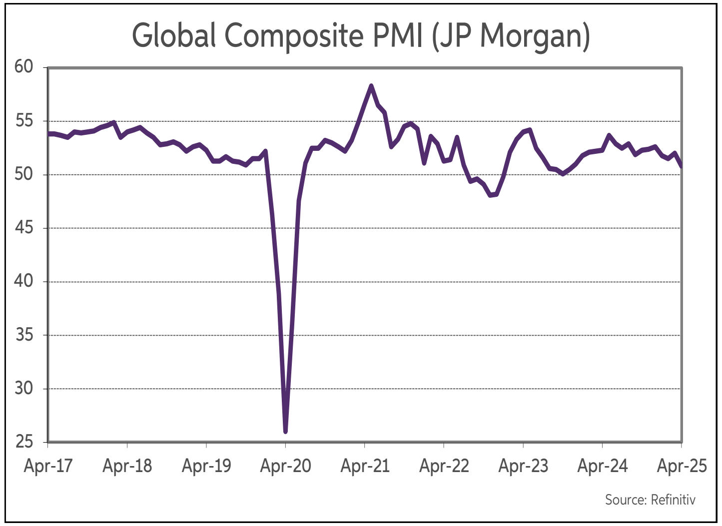
Given the volatility in US trade policy, the risks to the outlook are tilted to the downside at present. While equity markets have recovered lost ground from April, attention has now turned to the ongoing US tax and spend bill moving through Congress. With an expectation that the bill will add c.$3 trillion to the already large US deficit, the US Treasuries market has being showing some signs of stress in recent weeks, particularly at the long end of the curve.

Trade negotiations could ultimately lower tariffs

Meanwhile, trade negotiations continue apace, amid concurrent 90-day pauses on reciprocal US tariffs. These negotiations have yielded some flash-points, including the short-lived threat by President Trump to impose a 50% tariff on the EU. It remains to be seen where these deals will eventually leave US tariffs, with a reversion to the January tariff levels (c.2.5%) appearing unlikely at this point.

Other geopolitical factors weighing on inflationary outlook

While the impact of US tariffs is expected to be inflationary for US consumers, the hit to US import demand could prove to be deflationary for trade partners in Europe. Additionally, energy prices are significantly lower year-to-date, with brent crude trading around $65/barrel. These energy prices falls are likely to dampen price pressures and could see the ECB trimming its near-term outlook for inflation.



GDP (Vol % Change)

	2023	2024 (e)	2025 (f)	2026 (f)
World	3.3	3.3	2.8	3.0
Advanced Economies	1.7	1.8	1.4	1.5
US	2.9	2.8	1.8	1.7
Eurozone	0.4	0.9	0.8	1.2
UK	0.3	1.1	1.1	1.4
Japan	1.5	0.1	0.6	0.6
Emerging Economies	4.4	4.3	3.7	3.9
China	5.2	5.0	4.0	4.0
India	8.2	6.5	6.2	6.3
World Trade Growth (%)	0.7	3.8	1.7	2.5
Inflation -CPI				
Advanced Economies (%)	4.6	2.6	2.5	2.2

Sources: IMF World Economic Outlook April 2025

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Interest Rate Outlook

Central banks awaiting clarity on global trade developments

All central banks acknowledge heightened uncertainty, but easing appetite differs

Global central banks acknowledged the increased uncertainty regarding the economic outlook. This uncertainty stems from the escalation of trade tensions and protectionism amid the significant shift in policy from the US. While there has been some easing in tensions recently, the outlook remains unpredictable. This complicates the policy deliberations of the main central banks as they chart the extent and timing of further rate cuts, as well as a suitable terminal rate for their respective interest rates. This backdrop also means that market rate expectations have been sensitive to the ebb and flow of tariff-related news flow, reflected in volatility in futures contracts.

We expect 50bps of further cuts from the Fed in 2025

For the third consecutive meeting, the Fed left rates on hold in a 4.25-4.50% range at the May FOMC. It reduced rates by 100bps in H2'2024. Its rate projections continue to indicate a very gradual pace of easing. The median projection is for 50bps of cuts this year, which would see rates near 3.9% by year-end. While noting increased risks to the outlook, Chair Powell stated that the FOMC believes its current rate setting is "well positioned". Overall, the Fed is in no hurry to cut and is in 'wait-and-see mode' for the impact the new US tariff policy will have on the economy. Amid some easing in trade tensions, market rate expectations have adjusted from pricing 100bps of rate cuts to 50bps by year end. We continue to believe at least 50bps of easing is on the cards for this year, with the potential for more if global trade tensions remain elevated.

ECB Depo rate to trough at 2%, but risks to the downside

As expected, the ECB cut rates by 25bps in April for a third meeting in-a-row. The Depo rate was lowered to 2.25% with the disinflation process "well on track". This was the seventh 25bps rate cut since it started its easing cycle last June. The ECB dropped any reference in the statement to the "restrictiveness" of monetary policy. It continued to state that it will follow a "data-dependent" and "meeting-by-meeting" approach. The statement was somewhat more dovish in tone with the central bank noting that the outlook has "deteriorated owing to rising trade tensions". The meeting account also implied a dovish tilt within the Governing Council with a discussion on how US tariffs could add to disinflationary pressures in the Eurozone. The market is now anticipating the Depo rate falling to at least 1.75% by year end. We remain of the view that if trade tensions ease, a 2% rate by year end is more plausible. However, if there is no progress in trade talks, then rates falling below 2% becomes more likely.

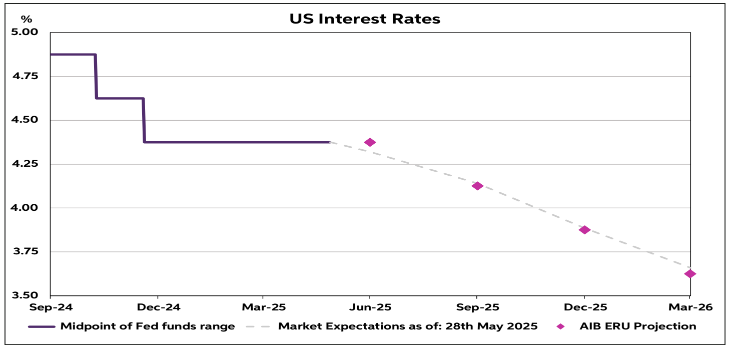
Further 50bps of cuts on the cards for the BoE

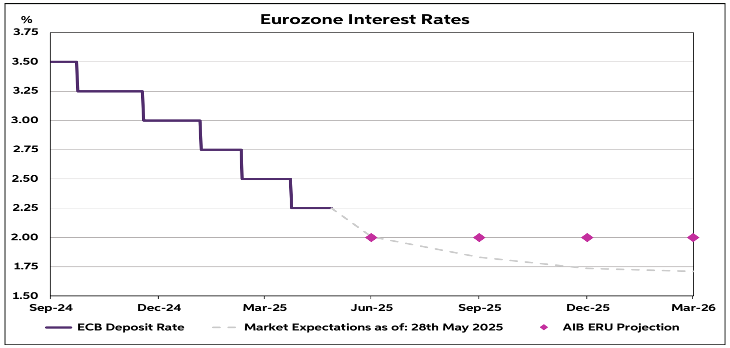
The BoE cut rates, as expected, by 25bps to 4.25% in May. Once again, there was no unanimity within the MPC. Its current easing cycle, which began in Aug'24, has seen a total of 100bps of cuts (incl. 50bps YTD). The BoE retains a bias to ease policy further. However, it once again emphasised at the May MPC that it favours a gradual approach to further rate cuts. UK rate expectations have softened over recent months against the backdrop of elevated uncertainty. The market is now anticipating that rates could fall below 4%. Our view remains that a Bank rate of 3.75% by year end is a reasonable assumption.

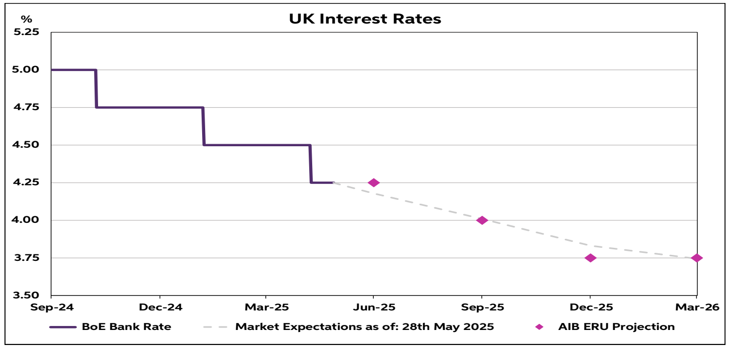
Interest Rate Forecasts

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

Current Rates Reuters, Forecasts AIB's ERU







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Forex Market Outlook

Dollar has found a floor as tariffs are eased

Dollar falls have levelled off in recent week

While recent dollar declines have levelled off, the trade-weighted DXY index is still c.4.5% lower since the start of April. Against the euro, the dollar is down c.5% since April 1st. EUR/USD has recently settled in a narrow band of $1.12-1.14. The dollar also lost ground against sterling, falling by c.4.5% since the beginning of April, with GBP/USD trading up to a $1.34-1.36 range of late.

Currencies will remain highly sensitive to the 'Trump show'

As described earlier, the relative political calm of recent weeks has seen currency markets trade in narrower ranges. However, this calm has been punctuated by pronouncements by President Trump on tax and trade policy, which have driven intra-day volatility. In terms of levels, the EUR/USD has found resistance around $1.14-1.15. It is likely to take a sharp deterioration in trade negotiations for the dollar to break above this level, with the next resistance after that around $1.20.

Near term risks more broadly balanced with damaging tariffs delayed

Therefore, we expect the greenback to maintain at close to its current level in the absence of further dramatic US policy shifts in the coming months, with obvious risks to the downside. The policy trajectory of the Fed could also be a key driver here. While we expect 50bps of cuts this year, the Fed's next set of macro projections post its June meeting will be the first to take into account the impact of the ongoing tariff uncertainty.

Relative political stability supports euro

German spending announcement takes markets by surprise

The announcement in early March that the new German Government would revise its strict fiscal rules to boost deficit spending on defence and infrastructure drove a level shift in the euro which was given further impetus by US tariff uncertainty. The euro has also been underpinned by planned spending at an EU level, which could boost the medium-term growth outlook for the bloc.

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

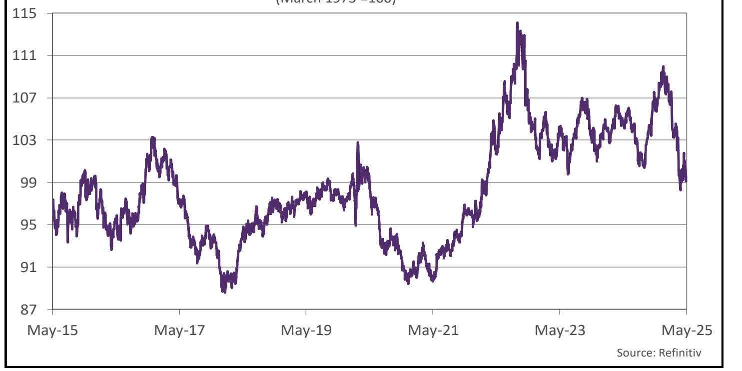
Despite expectations for stronger growth on the back of fiscal policy announcements, Eurozone macro data remain weak. There have been tentative signs of improvement in consumer and business surveys, but hard data suggest the bloc is set for another year of weak growth. Additionally, the 10% US tariffs remain in place on EU goods, with no certainty as yet on a favourable outcome from trade negotiations. These negative growth factors could limit the upside for the currency.

Euro to hold gains, but further catalyst required to break higher vs. dollar

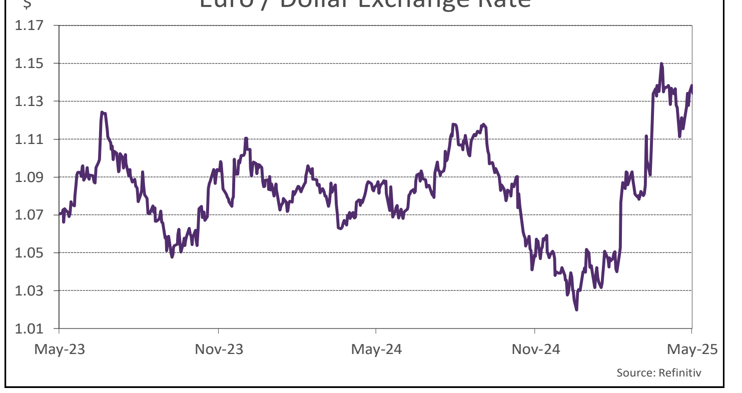
Overall, we expect the EUR/USD to remain within its current range in the near term, with a slight upward bias for the remainder of the year. We see risks more balanced from here, with a further catalyst required to enable EUR/USD to break through its $1.14-1.15 resistance level.

US Dollar Trade Weighted Index Versus Majors

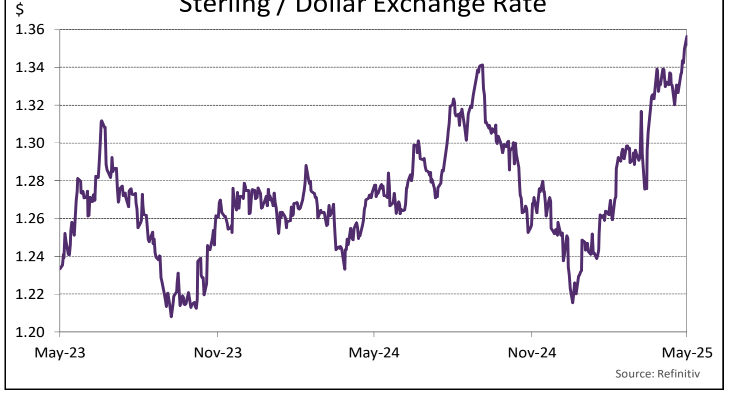
(March 1973 =100)



Euro / Dollar Exchange Rate



Sterling / Dollar Exchange Rate



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Forex Market Outlook

Rate cuts and uncertain macro to weigh on sterling

UK macro data have picked up of late

Sterling has gained ground in recent weeks, with UK macro data suggesting growth has picked up in recent months. However, sterling has also displayed more cyclicality in the face of recent global market weakness. The currency is higher versus the dollar YTD, but this owes more to dollar weakness. Against the euro, sterling is slightly lower since the start of the second quarter.

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 committee. Our expectation of a continued steady easing cycle by the BoE to move rates to 3.75% by Q4 2025 was slightly ahead of market pricing until recently, but interest rate futures have softened in recent weeks in line with our expectations.

Slight bias towards sterling vs. euro

Sterling is expected to maintain current levels versus the euro in the near term, and the pair is likely to remain largely range bound as relative macro fundamentals are unlikely to drive a significant break-out from the current range. However, we have a slight bias towards sterling. We have EUR/GBP moving from around a midpoint of 84p to 83p by end-2025. We also expect cable (GBP/USD) to strengthen to around $1.34-1.40 by end-2025 from the current $1.33-1.36 range.

Slight upside for yen as BoJ hikes rates

Yen has strengthened in 2025

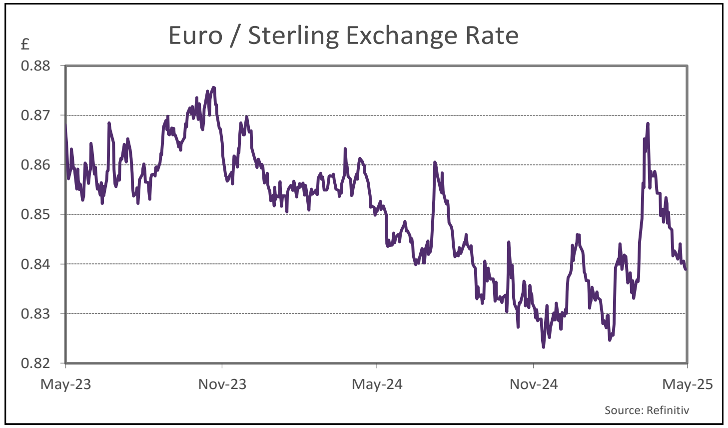
The yen has strengthened in 2025, largely due to dollar weakness. Since the start of April, the yen is up nearly 3.5% versus the dollar, rising from nearly ¥160 at the start of 2025 to the current ¥142-147 range. Against the euro, the currency is marginally weaker, trading in a ¥161-164 range of late.

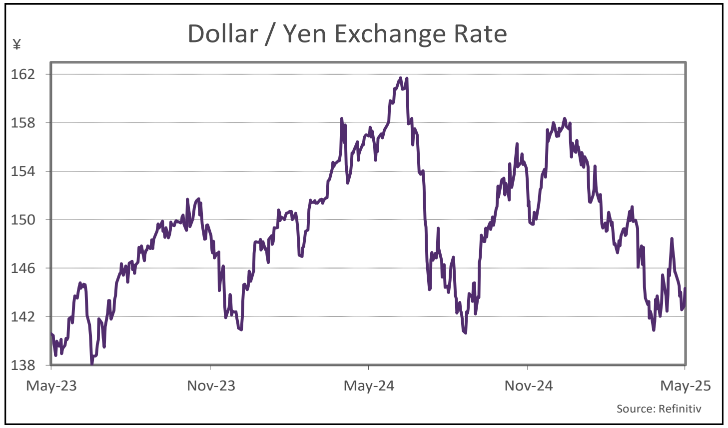
Bank of Japan expected to continue to hike rates, supportive of yen

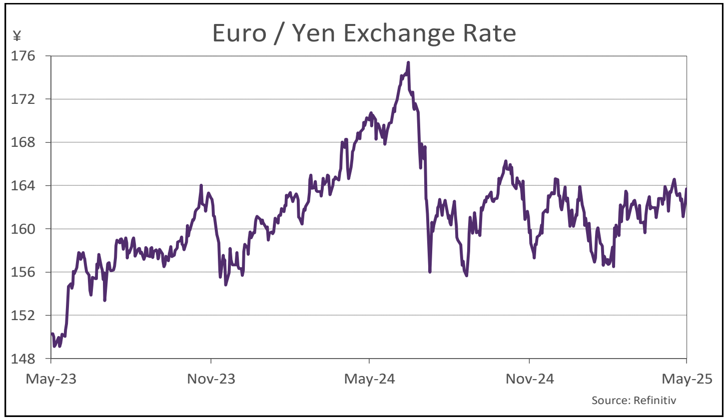
Interest rate hikes by the Bank of Japan in July, October and January has seen the base rate move from −0.1% to the current 0.5%. Markets are pricing in a further c.20bps of rate hikes by end-2025, but with inflation proving stickier than expected, the BOJ may choose to hike rates more rapidly. A further source of uncertainty is the outcome of trade talks with the US, with the US a key export destination for Japanese goods.

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 ¥139-145 by Q4 2025 versus the dollar, from the current ¥142-147 range. Versus the euro, the currency is expected to operate in a ¥160-166 range out to end-2025. 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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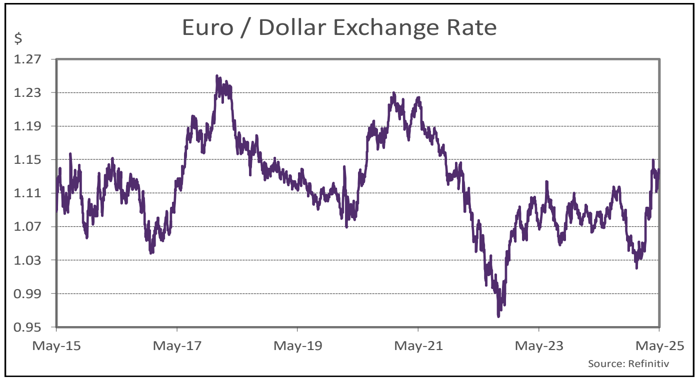
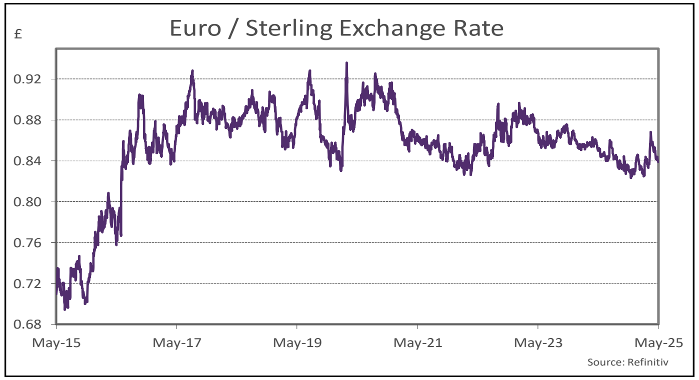
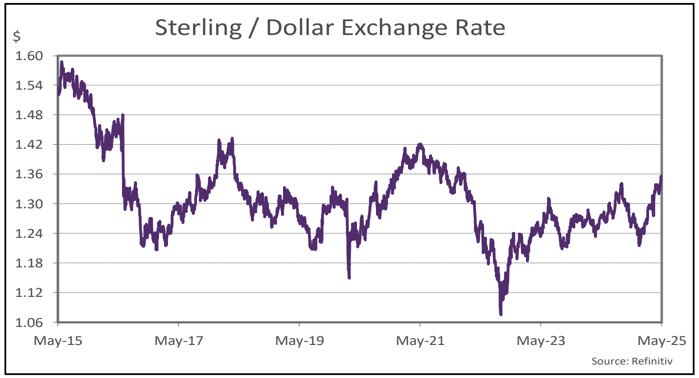
Summary of Exchange Rate Forecasts

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

	Current	Q2-2025	Q3-2025	Q4-2025	Q1-2026
Euro Versus					
USD	1.129	1.10-1.16	1.11-1.17	1.11-1.17	1.11-1.17
GBP	0.839	0.81-0.87	0.81-0.87	0.80-0.86	0.80-0.86
JPY	163.73	161-167	161-167	160-166	159-165
CHF	0.93	0.94	0.95	0.95	0.95
US Dollar Versus					
JPY	144.98	142-148	141-147	140-146	139-145
GBP	1.347	1.32-1.38	1.33-1.39	1.34-1.40	1.34-1.40
CAD	1.38	1.38	1.39	1.40	1.40
AUD	0.64	0.64	0.63	0.63	0.63
NZD	0.60	0.60	0.59	0.58	0.58
CNY	7.19	7.21	7.22	7.25	7.25
Sterling Versus					
JPY	195	196	196	196	195
CAD	1.86	1.86	1.89	1.92	1.92
AUD	2.10	2.11	2.16	2.17	2.17
NZD	2.26	2.25	2.31	2.36	2.36







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