

Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit



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- The world economy has lost momentum, with all the major economies slowing down
- Global growth forecasts cut significantly, especially for Europe. Some recent signs, though, that world economy may be picking up some strength, but manufacturing remains very weak
- Fed turns cautious on policy, with markets now expecting two rate cuts by end 2020. BoE expected to keep policy on hold until 2021. ECB rates also now seen on hold until 2021
- Dollar remains underpinned by relatively high US rates, even with Fed rate cuts now expected. Other currencies finding it hard to make ground as their rates are expected to stay very low
- Sterling has recovered some ground on expectations that a no-deal hard Brexit will be avoided. Delay to Brexit leaves currency marking time

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Global growth forecasts cut, but some signs of improvement in more recent data

Global economic data continued to disappoint in early 2019. This has seen both the OECD and IMF lower their growth forecasts yet again for the world economy. In mid-2018, the expectation was that the world economy would grow by close to 4% this year. The latest OECD and IMF forecasts now project that the global economy will expand by a below trend 3.3% in 2019. The OECD sees growth at 3.4% in 2020. The IMF is forecasting that global growth could pick up to 3.6% next year, but as a result of stronger activity in some emerging economies.

Manufacturing activity in particular has slowed in all economies since last summer. The global manufacturing PMI fell to a near three year low of 50.6 in February and remained at this level in March, amid declining export orders and sluggishness in international trade. The OECD, European Commission, Bank of England and ECB have all recently scaled back considerably their growth forecasts for European economies in 2019 as a result of weak data. Meanwhile, there are concerns that growth in the strongly performing US economy could slow quite sharply in the next couple of years, as the fiscal stimulus fades and higher interest rates start to impact on activity. The key Chinese economy has also lost momentum, with the imposition of tariffs on many of its exports to the US adding to the headwinds it faces from a tightening of credit conditions.

Risks to the economic outlook remain tilted to the downside. Both the IMF and OECD have warned that despite continuing easy monetary conditions, the potential remains for a sharp deterioration in market sentiment and tightening in financial conditions, as we saw in the final months of last year. Debt levels remain high in many countries leaving them particularly vulnerable to shocks. We have already seen countries with high debt levels, such as Turkey and Argentina, entering recession. Meanwhile, concerns remain about the health of the Chinese economy. There could be an abrupt sell-offs in financial markets if this key economy slows more sharply than expected. A further escalation trade tensions and heightened policy uncertainty could also weigh on growth.

However, the general expectation is that despite the numerous downside risks, the global economy should regain some momentum as the year progresses. Monetary policy is set to remain accommodative everywhere, which should aid growth. Indeed, the sharp fall in bond yields since last autumn represents a significant easing in monetary conditions globally. Fiscal policy also remains supportive of growth in most economies. Meantime, household spending power is being boosted by the recent declines in headline inflation and a pick-up in wage growth. A resolution to some of the factors that have been weighing on activity in various economies in recent times, such as Brexit, new car fuel emissions standards in Germany and the US-China trade dispute, could also help the world economy regain strength.

More recent data do show signs of a pick-up in activity, apart from in the manufacturing sector which remains mired in the mud. The Global Services PMI rose for a second consecutive month in March, reaching a relatively strong level of 53.7. The German index hit a six month high. Meanwhile, the German Ifo index for the services sector was also very strong in March. Retail sales in both the Eurozone and the UK rose by 0.4% in February after a 0.9% rise in January. In the US, weekly jobless claims have hit a fifty year low this month, while non-farm payrolls rebounded with a strong rise in March. There has been a pick-up in the more recent data for China also. It is too early to sound the all-clear for the world economy, but the stronger trend in recent data is encouraging. A close eye will need to be kept on data releases in the months ahead to see if this improving trend is maintained.

Global Composite PMI (JP Morgan)



GDP (Vol % Change)

	<u>2017</u>	<u>2018</u>	<u>2019 (f)</u>	<u>2020 (f)</u>
World	3.8	3.6	3.3	3.6
Advanced Economies	2.4	2.2	1.8	1.7
US	2.2	2.9	2.3	1.9
Eurozone	2.4	1.8	1.3	1.5
UK	1.8	1.4	1.2	1.4
Japan	1.9	0.8	1.0	0.5
Emerging Economies	4.8	4.5	4.4	4.8
China	6.8	6.6	6.3	6.1
India	7.2	7.1	7.3	7.5
World Trade Growth (%)	5.4	3.8	3.4	3.9
Advanced Economies				
CPI Inflation (%)	1.7	2.0	1.6	2.1

Source: IMF World Economic Update, April 2019

Interest Rate Outlook

Central banks turn very cautious about tightening policy

Central banks have turned very cautious about tightening monetary policy as concerns mount about the growth prospects for the world economy. The persistence of very subdued inflation gives central banks the latitude to be patient about rate tightening, thereby maintaining very loose monetary conditions for an even longer period of time. Markets now see rates remaining on hold virtually everywhere this year, with the balance of risk leaning towards an easing of policy rather than a tightening.

In the US, the Fed has performed quite a summersault on the outlook for interest rates. Despite continuing good economic data, especially in the labour market, the Fed has dropped its tightening bias for 2019, saying at its March FOMC meeting that rates are now likely to stay on hold this year. It had indicated at its December meeting that two more rate hikes were likely in 2019. There has been little change to the Fed forecasts for the US economy, which it expects to continue to expand at a solid pace, so the changed stance was rather surprising.

The Fed, though, projects that one further hike is still likely in 2020, bringing rates to a peak of 2.625%. The market, though, is of the view that US rates have already peaked and is pricing in two rate cuts by end 2020. In our view, it is still too early to call the peak in US rates, given the strength of the economy, loose macro policies still in place and the upward pressure on wages in the tight labour market. Indeed, we would not be surprised if the Fed hiked rates later this year owing to the continued strength of the economy and labour market.

In the UK, markets have also lowered their expectations for rate hikes. BoE policy is now expected to stay on hold for an extended period given that the economy has slowed considerably and with Brexit uncertainty likely to continue for at least another six months and possibly beyond, following the extension of the Article 50 process to end October. Markets now believe that the next 25bps BoE rate hike will not occur until mid-2021, taking rates up to 1%. Previously, they had expected rates to rise to 1.5% in the next couple of years.

However, the February BoE Inflation Report suggested that rates may need to rise by 50bps by end 2020 to meet its inflation target. Thus, we think the BoE could still tighten policy earlier than markets expect, especially given the upward pressure on wage growth with the labour market continuing to tighten. However, given the extension to Article 50 to end October, rates seem likely to stay on hold this year. Rates, though, could still be hiked in 2020.

Turning to the ECB, it ceased net asset purchases under its QE programme at the end of last year. However, it made announcements at its March meeting aimed at maintaining very accommodative monetary conditions for some time to come. It is now guiding that it intends to keep interest rates at their current very low levels until at least the end of this year, as opposed to the end of the summer previously. It has hinted that it could extend this guidance of unchanged rates to an even longer period of time. It has also announced that it will launch a third round of long-term liquidity measures, a new TLTROs starting in September 2019 and ending in March 2021, with a maturity of two years. It all confirms that ECB interest rates are set to remain very low for a very long time.

The ECB deposit rate is at -0.4%, resulting in negative interbank rates, with swap rates also negative out to four years. Markets now do not see any rate increase in the Eurozone until 2021. Three month rates are not expected to turn positive until mid-2022. Rates are expected to have risen to just 0.5% by 2024. No wonder, then, that ten year German bund yields have turned negative again in the past month.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	2.375	2.60	2.73	2.42	2.31
Jun '19	2.375	2.65	2.80	2.50	2.40
Sept '19	2.375	2.70	2.85	2.60	2.55
Dec '19	2.625	2.95	3.10	2.85	2.80

* Swap Forecasts Beyond 1 Year. Current Rates Sourced From Reuters, Forecasts AIB ER

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	-0.40	-0.35	-0.21	-0.21	0.01
Jun '19	-0.40	-0.35	-0.20	-0.20	0.00
Sept '19	-0.40	-0.35	-0.18	-0.17	0.10
Dec '19	-0.40	-0.33	-0.15	-0.12	0.20

* Swap Forecasts Beyond 1 Year

UK Interest Rate Forecasts (to end quarter)

	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.75	0.83	1.08	1.01	1.17
Jun '19	0.75	0.85	1.10	1.05	1.20
Sept '19	0.75	0.85	1.15	1.10	1.25
Dec '19	0.75	0.90	1.20	1.20	1.40

* Swap Forecasts Beyond 1 Year

Dollar underpinned by favourable interest rate differentials

The US dollar remains at high levels against a broad range of currencies. The EUR/USD rate has fallen appreciably from a high of \$1.25 in early 2018 to largely trade in a \$1.12-1.15 range since last October. Meanwhile, cable declined from above \$1.40 a year ago to trade around the \$1.30 level recently. The yen has been more range bound against the dollar over the past year, benefitting at times from safe-haven flows.

The dollar has been aided by continuing strong US economic data at a time when other economies have lost momentum, with some countries seeing significant downgrades to their growth forecasts. Widening interest rate differentials and bond spreads also helped the currency during 2018, as the Fed continued to steadily tighten policy, raising the fed funds rates by 100bps in total to a 2.25-2.5% range by end year.

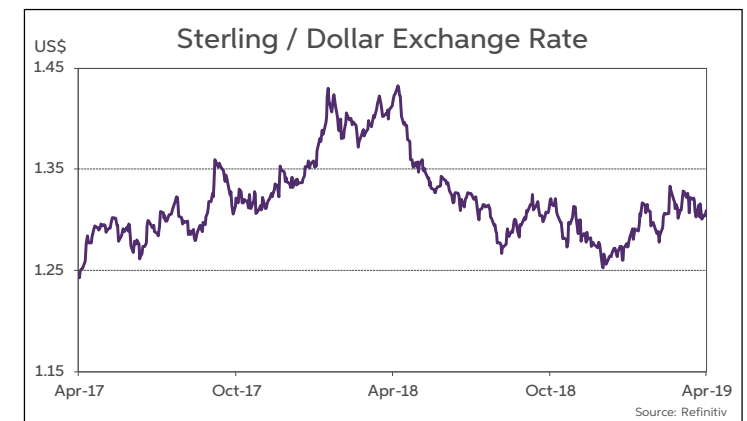
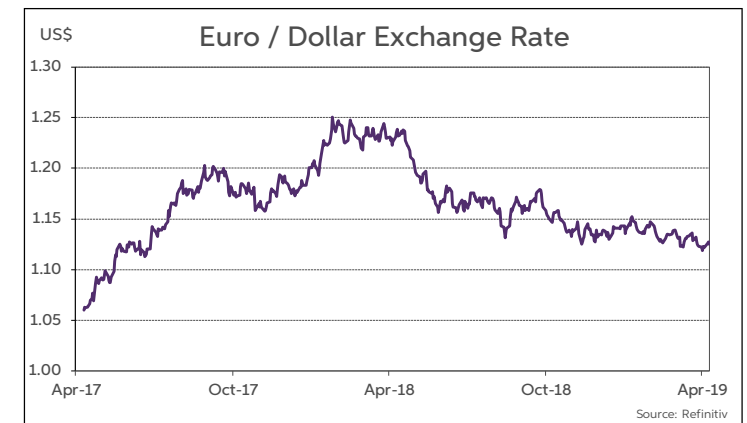
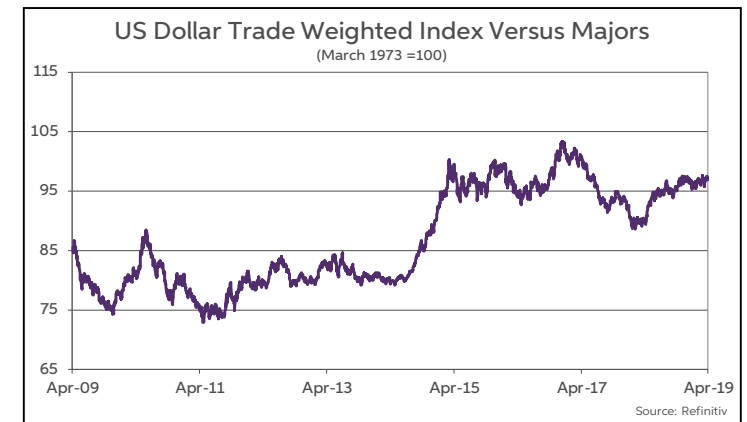
Spells of risk aversion in financial markets have also been supportive of the highly liquid US currency, sparking flights-to-quality into safe-haven currencies like the dollar, yen and Swiss franc. The dollar also benefitted from a big jump in the repatriation of funds by US companies last year to take advantage of cuts in US corporate taxes.

The US currency, though, has found it harder to make further gains since the autumn. This may be partly due to the fact that FX positioning has become extremely long the dollar. Furthermore, the dollar is now at quite elevated levels against a range of currencies, which may be limiting further upside potential. The US economy is also expected to slow in the coming year, while the Fed has turned much more cautious about further rate increases. Indeed, the market has come to the view that US rates have peaked and the next move will be a cut.

However, the relative strength of the US economy, wide interest rate differentials and geopolitical uncertainties all remain supportive of the US currency. Indeed, we would not completely rule out a further US rate hike later in the year. Meanwhile, political uncertainty in the EU, a general rise in euro-scepticism especially in the context of the upcoming European Parliament elections, the slowdown in the Eurozone economy and continuing very low ECB interest rates are all headwinds for the single currency. Nonetheless, the euro has been quite range bound against the dollar since the autumn, although it has been testing the lower side of its \$1.12-1.15 trading band recently. There is strong technical support for the euro, though, in the \$1.10-1.12 area.

While relatively high interest rates should help underpin the US currency, there are factors that could cause the dollar to lose some ground. The rising US twin deficits (fiscal and BoP) could start to weigh on the exchange rate. The marked jump in the repatriation of funds following the cuts in US corporate taxes last year is likely to abate, lessening demand for the currency. The US economy is also likely to slow in 2019. A US-China trade deal is also expected to be agreed before the summer, which should underpin risk appetite in markets.

The persistence of very low interest rates elsewhere, though, is making it difficult for other currencies to make any ground against the dollar. The euro remains pinned down around \$1.12-1.13. There would probably need to be a renewed pick-up in activity in Europe and elsewhere that would put monetary tightening on to the agenda globally in 2020 for currencies to start to make ground against the dollar. There have been some signs of better economic data recently in Europe and elsewhere. If sustained, this could see the dollar lose some ground later in the year, even if another Fed rate hike comes back on the agenda.



Sterling to mark time as Brexit delayed

Sterling has moved off the lows of 93p against the euro and \$1.20 versus the dollar that it hit following the UK referendum vote to leave the EU. It largely traded in an 87-91p range against the euro between September 2017 and end 2018, as markets awaited clarity on what shape Brexit would take. Growing hopes that a no-deal hard Brexit will be avoided have seen the euro fall back to trade in an 85-87p range since mid-February. Against a weakening dollar, sterling rose to a post-referendum high of \$1.43 last April. However, cable dropped back again when the dollar strengthened once more, declining to below the \$1.30 level in Q4 2018. However, it has recovered to trade in a \$1.30-1.33 range in the past two months, on the expectations of avoiding a no-deal Brexit.

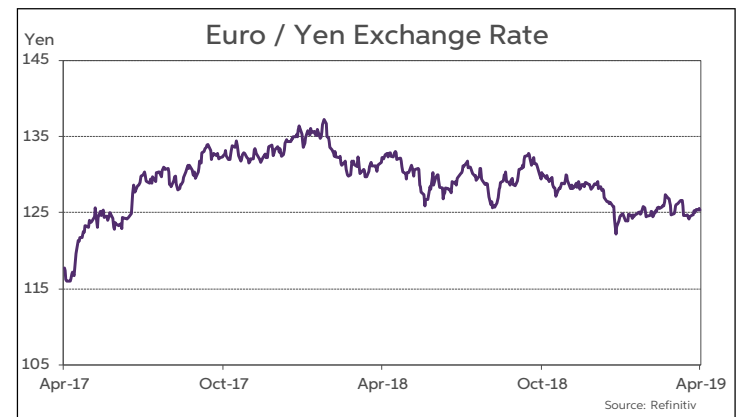
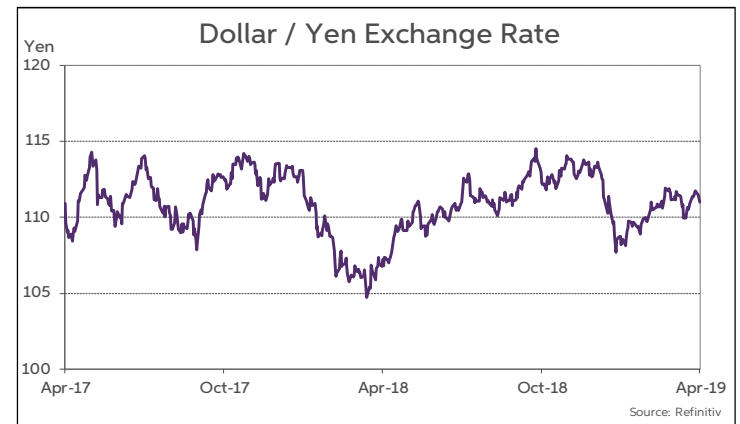
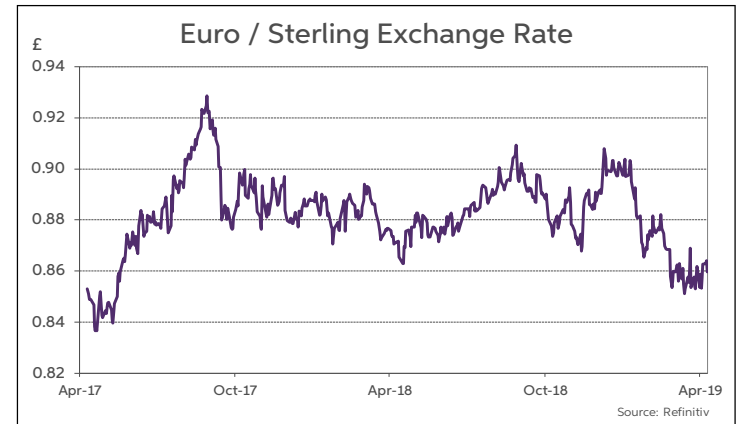
The Withdrawal Agreement (WA) reached between the EU and UK allows for a soft Brexit, as it includes a transition period to last until at least end 2020. This would keep the current trading arrangements in place over this time. The WA has been voted down on three occasions by Parliament. However, Parliament has also voted against exiting the EU without a deal. The UK was granted a short extension to its original Brexit departure date of March 29th in the hope that the WA might be ratified, but this has not occurred.

Thus, at an EU Heads of State summit on April 10th, the UK got a further but longer extension to Article 50 to end October 2019. However, the UK can leave at any stage during this extension period if the WA is ratified. Sterling is likely to continue trading in an 85-87p range against the euro in the next couple of months as efforts continue to get the WA ratified. However, the currency could start to come under a bit of pressure if the stalemate continues over the summer and we approach another cliff-edge Brexit date at end October. A third extension to Article 50 would again require the agreement of all EU 27 member states, but there were signs at the April 10th summit that at least one country is becoming keen to bring a conclusion to the Brexit process. If the UK continues to be unable to ratify the WA, then at some stage it may have to decide between remaining or leaving the EU without a deal.

Even if the WA is eventually ratified and the UK departs the EU, there are still likely to be choppy waters ahead for sterling. The WA provides for a transition period post Brexit. Talks will take place during this transition period on the future relationship between the UK and EU, with the aim of concluding a broad trade deal. These are likely to prove difficult negotiations. It is very unclear what the outcome of these talks will be, so uncertainty over the final shape of Brexit will persist during any transition period, acting as a headwind for the currency.

What emerges from these talks may still look like a hard Brexit, if it sees the UK leave the Customs Union and Single Market. Thus, even if the WA is ratified, Brexit could still have significant negative effects on both the UK and Irish economies in the future, depending on what type of new trading arrangements come into place when the transition period expires. Overall, we see limited upside for sterling from its recent range of 85-87p against the euro, even if the WA is ratified, with the potential for the currency to drift lower as Brexit uncertainty persists.

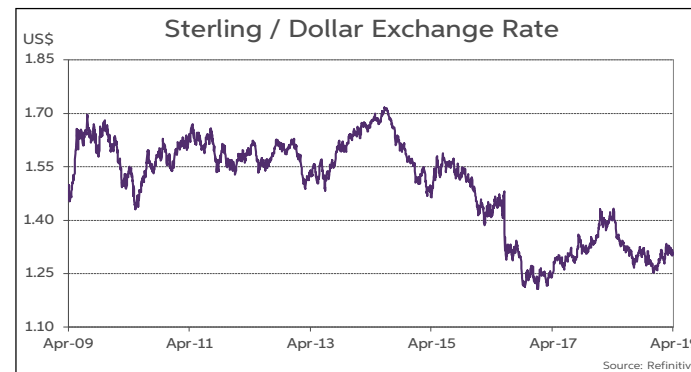
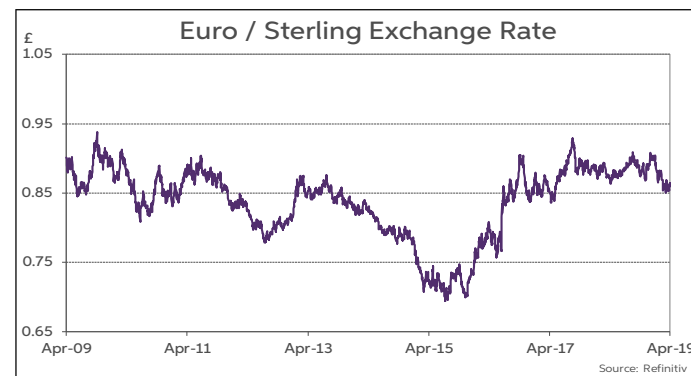
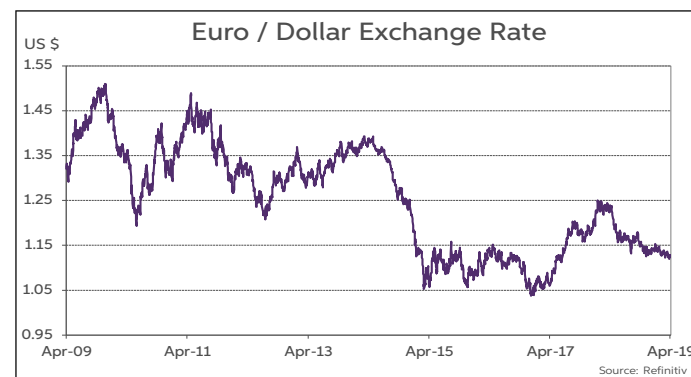
Meanwhile, a hard Brexit is the default position if the UK still cannot ratify the WA before the Article 50 extension expires at end October 2019. Sterling would come under severe pressure in a no-deal hard Brexit scenario, given that it would have very negative consequences for the economy. The currency could fall by 10-15 per cent from current levels in this situation. A no deal Brexit, though, still seems unlikely given that it is not supported by Parliament, although the chances could rise if a new, hard Brexit leaning Prime Minister were to replace PM May.



Summary of Exchange Rate Forecasts

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

	Current	Q2-2019	Q3-2019	Q4-2019	Q1-2020
Euro Versus					
USD	1.126	1.10-1.16	1.11-1.17	1.12-1.18	1.14-1.20
GBP	0.861	0.83-0.89	0.83-0.89	0.83-0.89	0.83-0.89
JPY	125.39	122-128	122-128	122-128	123-129
CHF	1.13	1.13	1.13	1.14	1.15
US Dollar Versus					
JPY	111.32	108-114	107-113	106-112	105-111
GBP	1.308	1.28-1.34	1.30-1.36	1.31-1.37	1.33-1.39
CAD	1.34	1.34	1.33	1.32	1.30
AUD	0.71	0.71	0.72	0.73	0.74
NZD	0.67	0.67	0.68	0.69	0.70
CNY	6.72	6.70	6.70	6.65	6.60
Sterling Versus					
JPY	146	145	146	146	147
CAD	1.75	1.76	1.76	1.77	1.77
AUD	1.83	1.85	1.85	1.84	1.84
NZD	1.94	1.96	1.96	1.94	1.94



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