Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Further wave to coronavirus has seen governments re-impose restrictions and lockdowns during opening months of this year, hampering activity in H1 2021 in Europe in particular
- However, the roll out of vaccines is a major boost to recovery hopes. Growth is expected to rebound as the year progresses. Global growth forecasts upgraded to 5.5-6.0% for 2021
- Rates futures contracts have firmed since start of 2021, especially in US and UK, with first hikes now expected in Q3'22. Central banks, though, say there is no need for early policy tightening
- Dollar recovers some ground in Q1 on marked rise in US yields, but may now range trade
- Sterling also made gains in Q1, as fast UK roll-out of vaccines boosted its prospects of economic recovery. Rally, though, has run of steam and currency may become range bound too

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Global Economic Outlook

Upgrades to global growth forecasts as vaccine roll out gathers pace

Growth forecasts for the global economy continue to be revised upwards, with the IMF the latest organisation to do so. It now sees the world economy expanding by 6% this year compared to 5.5% in its previous update in January. It is projecting global growth of 4.4% for next year, up from 4.2% previously. The OECD also recently upgraded its projection for global growth in 2021 from 4.2% to 5.6%, with growth in 2022 now seen at 4%.

There are three main factors behind these upgrades. First, the arrival and roll out of multiple vaccines that can reduce both the frequency and severity of infections, with strong evidence of this in countries that are well advanced in their vaccination programmes, such as the UK and Israel. Second, better adaptation to what the IMF calls "pandemic life" which has seen a stronger than expected global rebound since last summer despite continuing subdued mobility and re-imposition of restrictions on activity in some countries, especially in Europe.

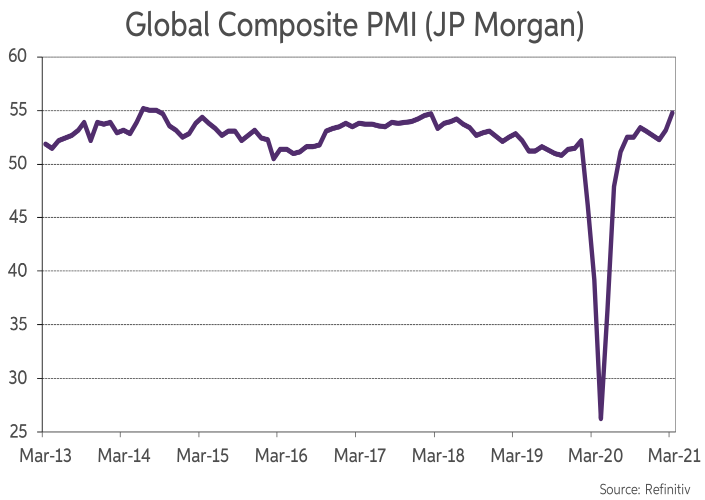
Third, the additional fiscal supports in some major economies on top of the enormous fiscal response put in place last year and the ongoing very loose stance of monetary policy are also boosting growth prospects. This factor would appear to be particularly important, with the biggest upgrades to the IMF's 2021 growth forecasts occurring in the US (+1.2%) and UK (+0.8%), where significant additional fiscal stimulus has been put in place.

The IMF sees the risks to its forecasts as balanced in the near term, and more to the upside further out. To some extent, it boils down to a race between the virus and vaccines. The principal risk surrounds the effectiveness of vaccines against new strains of the virus. Delays in inoculating all parts of the world may result in new vaccine-resistant virus mutations. The IMF warns that this could lead to new outbreaks starting "anywhere and anytime", necessitating the re-imposition of restrictions to slow transmission. Economic confidence is also fragile and scarring effects such as rising business failures and bankruptcies, increasing bad debts, permanent job losses, lower labour force participation and inefficient resource allocation could weigh on the pace of recovery as well.

On the upside, an intensified, globally coordinated vaccination effort could end the pandemic fairly quickly, and limit scarring. There may also be greater than expected longer-term positive effects on activity from the policy supports that have been put in place. It is encouraging that the IMF views the medium term risks as to the upside, but it is also a race against time to bring the virus under control before too long and escape the crisis.

There have been other negative economic impacts from the very deep COVID-19 recession. World trade volumes are estimated by the IMF to have declined by 8.5% in 2020, though it sees them rebounding again by 8.4% in 2021 and 6.5% in 2022. We have also seen a sharp deterioration in public finances, with a big rise in budget deficits and public debt owing to government spending measures to mitigate the economic shock and declines in tax revenues. Meanwhile, although the rise in unemployment has been modest to date, it could yet move higher later in 2021 as government labour market support schemes are wound down.

Meantime, inflation fell sharply in 2020, but is already rising back up, helped by a recovery in oil prices. Markets have some concerns that the scale of economic stimulus being provided could lead to inflationary problems, with too much money chasing too few goods at a time when supply chains are stretched. Central banks, though, are confident that any rise in inflation will prove transitory given the large amount of slack in economies. The IMF sees CPI rates at 1.6% and 1.7% in advanced economies in 2021 and 2022, respectively, still quite subdued levels.



GDP (Vol % Change)

	2019	2020	2021 (f)	2022 (f)
World	2.8	-3.3	6.0	4.4
Advanced Economies	1.6	-4.7	5.1	3.6
US	2.2	-3.5	6.4	3.5
Eurozone	1.3	-6.6	4.4	3.8
UK	1.4	-9.9	5.3	5.1
Japan	0.3	-4.8	3.3	2.5
Emerging Economies	3.6	-2.2	6.7	5.0
China	6.0	2.3	8.4	5.6
India	4.2	-8.0	12.5	6.9
World Trade Growth (%)	1.0	-8.5	8.4	6.5
Inflation -CPI				
Advanced Economies (%)	1.4	0.7	1.6	1.7

Source: IMF World Economic Outlook, April 2021

Interest Rate Outlook

Rate contracts firm, with markets looking for first US\UK rate hikes in H2 2022

Central banks globally pulled out all the stops last year to try and ameliorate the most severe impacts of the COVID-19 pandemic on their economies and financial systems, which were hit by a sudden and very deep recession. Interest rates were cut sharply to 0.125% and 0.1% in the US and UK, respectively in 2020. Enormous QE bond purchase programmes were put in place and measures adopted to enhance the supply of liquidity to businesses, and to ease funding pressures, most notably in regard to the dollar. Both the BoE and ECB announced additional QE and liquidity measures in the final two months of 2020 when activity weakened again last autumn.

Central banks have been very clear and forceful in their communications that monetary policy will remain exceptionally loose over the next couple of years. Indeed, the ECB announced in March that it was increasing the pace of asset purchases to prevent a tightening of financial conditions as upward pressure emerged on bond yields. It would seem, though, that with a strong global recovery now in prospect and a pick-up in inflation underway, albeit from very subdued levels, further monetary loosening is not on the cards. Instead, despite the assurances from central banks that policy needs to remain very accommodative, markets are turning their attention to when rates may start to rise.

Indeed, futures contracts have firmed considerably since the start of the year. The most significant change in financial markets in the first quarter of 2021 was the marked hardening of interest rate expectations in the US and the consequent sharp rise in long term bond yields. The expectation in markets at the end of last year was that US interest rates would be raised very slowly, with three month rates only getting to 1% by the end of 2025. Now, markets see US rates starting to rise in the second half of next year, and reaching 1% by end 2023 and over 2% by end 2025, which implies 200bps of Fed rate tightening. Not surprisingly, this has put upward pressure on bond yields, with ten year US Treasury yields climbing from 0.9% to 1.7% over the past four months.

The main factor behind the expectations for higher Fed rates is the marked upgrade to US growth prospects for 2021 and 2022, thanks to the enormous Biden fiscal stimulus package, as well as the rapid roll out of vaccines. The firming in rate expectations has been much less pronounced in other markets, most notably in the Eurozone and Japan. Markets do not expect the ECB deposit rate to be increased from its current level of –0.5% until end 2023, and then to be raised very slowly thereafter, only getting to zero per cent by 2026.

UK futures contracts have also hardened, with markets initially pricing out a move to negative rates. Instead, markets now see rates rising by close to 100bps between now and end 2025. This is far less and a much slower pace than in the US, although the market is looking for UK rates to start rising as early as the third quarter of 2022.

There is a marked divergence, then, between some of the major central banks and the market in terms of the outlook for interest rates. The is most acute in the case of the Fed, where the majority view on the FOMC is that rates will stay on hold through to the end of 2023. Strong US data are likely over the remainder of this year given the extent of the fiscal stimulus and quite rapid roll out of vaccines, as well as the considerable momentum in the economy at the present time. Inflation is also expected to pick up over the course of the year. Thus, markets are unlikely to deviate much from their view that US rates will be hiked before the end of 2022.

As such, bond yields may remain under upward pressure. Although, given the extent of the move up in US and UK long term yields to date this year, further rises in bond yields in the months ahead may not be as pronounced.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.125	0.19	0.29	0.28	0.91
June'21	0.125	0.19	0.30	0.30	0.95
Sept'21	0.125	0.20	0.32	0.32	1.00
Dec'21	0.125	0.22	0.35	0.35	1.05

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	-0.50	-0.54	-0.50	-0.49	-0.30
June'21	-0.50	-0.54	-0.49	-0.48	-0.28
Sept'21	-0.50	-0.53	-0.48	-0.47	-0.25
Dec'21	-0.50	-0.52	-0.47	-0.45	-0.20

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.10	0.08	0.16	0.27	0.65
June'21	0.10	0.08	0.17	0.30	0.70
Sept'21	0.10	0.09	0.18	0.32	0.75
Dec'21	0.10	0.10	0.20	0.35	0.80

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Dollar recovers some lost ground and could now be in for period of range trading

The dollar appreciated very sharply in the period 2014 to 2016 and remained at elevated levels over the rest of the decade. However, it moved steadily lower in the final three quarters of last year, losing 12% against the other major currencies, though it still remained at a fairly high level historically. The euro was one notable beneficiary of the dollar weakness, climbing to above $1.23 by the start of 2021 from around $1.08 last spring. This was only the second occasion that the euro has risen above $1.20 since the ECB moved to negative rates back in 2014.

The dollar was supported for much of the last decade by significantly higher interest rates in the US than elsewhere, most notably when compared to the negative interest rates prevailing in the Eurozone and Japan. However, the latter two did not cut rates over the past year, whereas US rates were slashed to virtually zero. As a result, the US dollar's large interest rate spread vis-à-vis other key currencies was much reduced during 2020.

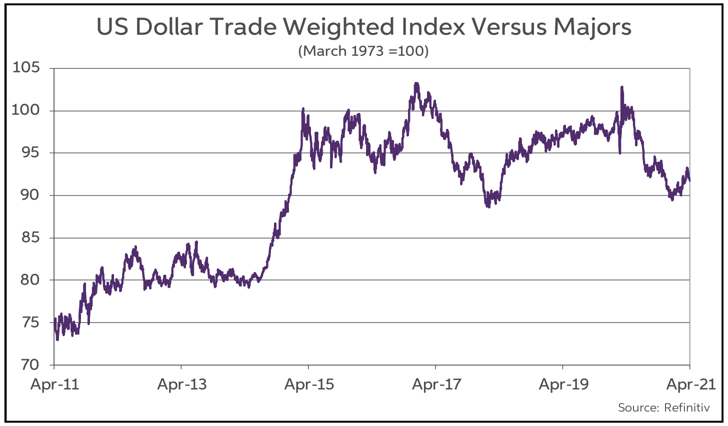
It was expected that the dollar would continue to move lower in 2021, given the relatively stable outlook for interest rates prevailing at the start of the year. The dollar, though, rallied during the first quarter, helped by a marked rise in long term US interest rates and big upgrades to US growth forecasts for 2021 and 2022. This saw the euro drop back to a low of $1.17 by end March from $1.23 at the start of the year. The market was also very short the US currency, which helped the dollar make gains as these positions were closed out.

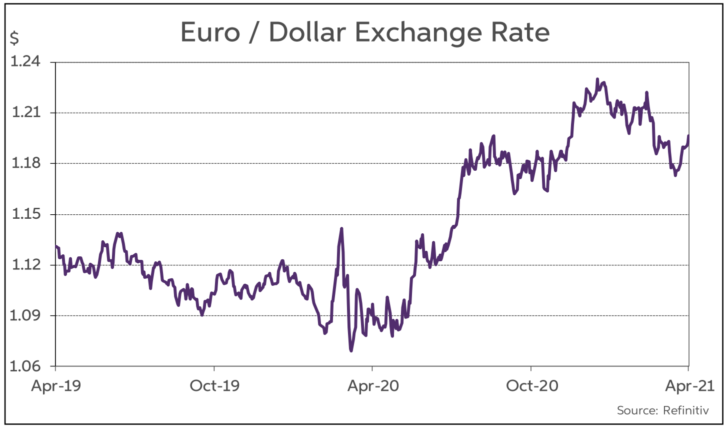
We had expected that EUR/USD would spend most of this year trading in a $1.20-1.25 range, but the changes in long term yields and firming of interest rate hike expectations in the US make this more of a challenge. Vaccinations also became an important influencer in currency markets in the first quarter as they are a key driver of economic growth prospects and interest rate expectations. The rapid roll out of vaccines in the US proved a positive for the currency in Q1. This was in marked contrast to the slow roll out in the EU, which has also seen fresh lockdowns, all of which has weighed on the euro.

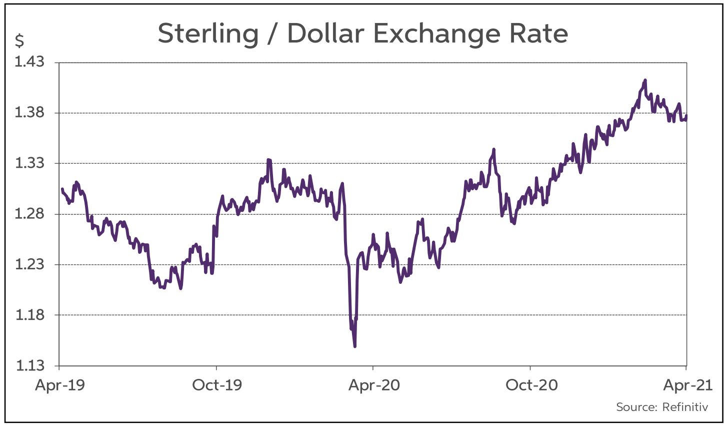
There is very strong support for the single currency in the $1.16-1.18 range, which has held in recent weeks. Indeed, the euro has risen back up to near the $1.20 level in April as the dollar came under some modest downward pressure. It all leaves calling the direction of the next significant move in EUR/USD rather difficult.

The US economy is continuing to outperform other advanced economies in 2021, while long term interest rates have moved more in favour of the dollar, which should be supportive of the currency. For the euro, though, there is considerable support in the $1.16-1.18 range, while the dollar is still at quite elevated levels and market positioning in EUR/USD has moved from being short the dollar to more neutral. Thus, range trading may be in prospect around $1.20, with EUR/USD continuing to move in a $1.17-1.23 band in the months ahead.

The US currency could come under some downward pressure if a sustained, robust global economic recovery, including in the Eurozone, takes root later in the year. Given that the euro has been at $1.20 recently, the next major hurdle for it to surmount would be $1.25, which represents the peak rate for EUR/USD over the past seven years. This is likely to be a very challenging task this year, given the prospects for robust growth by the US economy. Indeed, even in the longer term, it may prove difficult for the euro to overcome the $1.25 level if US rates hikes materialise next year and then continue to move steadily higher, while rates in the Eurozone are slow to increase and remain negative over the next five years as currently envisaged by markets.







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Forex Market Outlook

Sterling to consolidate after making gains in Q1

The EU-UK trade deal that was finally agreed on Christmas Eve, had no immediate impact on sterling. One reason was that an agreement was expected by the markets. Furthermore, it is a very limited trade deal which does not include services and is far inferior to the EU Single Market. It can hardly be classed as a major positive development for the economy, although it avoided a much worse outcome in the form of a no-deal Hard Brexit.

Sterling, though, appreciated steadily during the opening quarter of 2021, most notably versus the euro. This seems to be have been largely due to the rapid roll out of Covid vaccines in the UK. As a result, restrictions on activity in the UK should be greatly eased over the course of quarter two, allowing for a sharp rebound in the economy. The improved outlook has seen upgrades to growth forecasts for the UK economy.

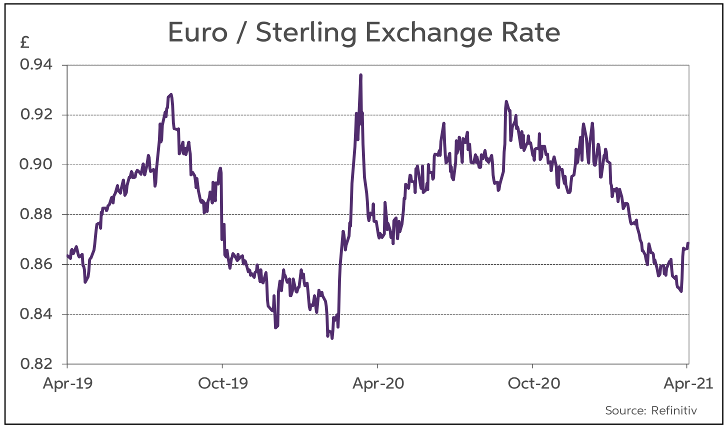
This includes a relatively upbeat Q1 Monetary Policy Report from the Bank of England. The Bank now sees UK GDP growth picking up to 5% in 2021 and 7.25% in 2022, despite the economy being in lockdown in the opening months of the year. Furthermore, the Bank is no longer minded to loosen monetary policy any further. Thus, markets have moved from, at the start of the year pricing in a move to negative interest rates during 2021, to now expecting that UK rates will start to rise from the third quarter of next year. As a result, short-dated gilt yields turned positive in Q1, while ten year yields have risen by 60bps since the start of the year to around 0.8%.

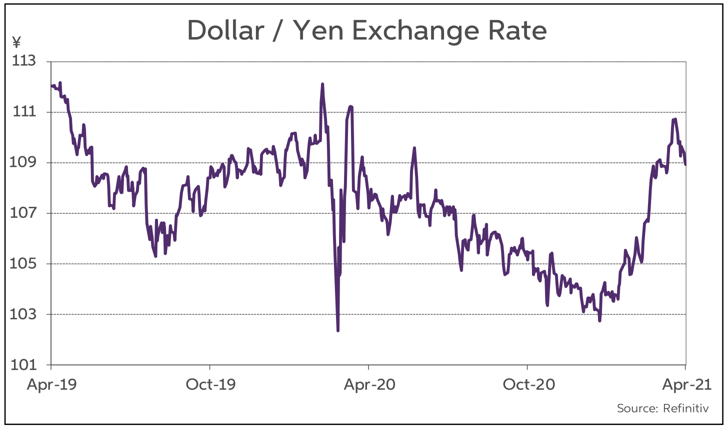
The stronger growth outlook and hardening interest rate expectations propelled sterling higher during the first quarter. EUR/GBP fell steadily from around 90p at the start of the year to the 85p level in early April. Cable climbed to a high near $1.42, before settling down just below the $1.40 level. More recently in April, though, sterling has given back some gains. The 85p level has provided strong technical support for the euro, while some momentum has been lost in the vaccination rollout. This has seen the euro rise back up to the 87p level, with cable holding at around $1.37-1.38 against a weaker dollar. It may be that after making significant gains in the opening months of the year, sterling is now entering a consolidation phase, especially with market positioning now long the currency. Thus, it could move in narrow ranges in the coming months against the euro and dollar.

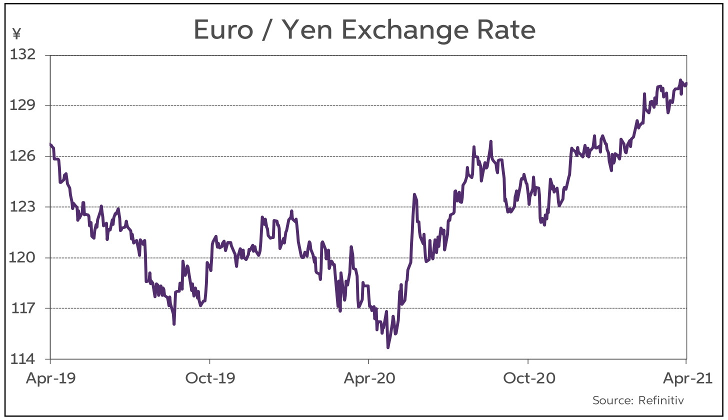
Under pressure yen to stabilise

The yen has impressed in recent years by moving steadily higher against a strong US currency, with the dollar falling to around ¥103 by the start of 2021 from a peak of ¥125 back in 2015. Meanwhile, the euro fell from a high of ¥140 in 2015 to a trough of ¥115 in mid-2020. The yen has benefitted from its safe-haven status, a big trade surplus and large overseas holdings of foreign assets that generate flows back into the currency.

The yen, though, lost much ground in the opening quarter of 2021, especially against the strengthening dollar, with the US currency climbing from ¥103 to near ¥111 by end March. The rise in long term interest rates in Japan has been very modest relative to Europe and in particular the US, which has weighed on the yen, as has an unwinding of short dollar positions. Upgrades to global growth forecasts, the roll out of Covid vaccines and improving risk appetite on markets also lessened the safe haven appeal of the yen. The currency has regained some ground against the dollar in April as upward pressure on global yields abated. Given that market positioning is now quite short the yen, its downside may be limited from here, but the wider interest differentials could limit the scope for any renewed gains by the currency. Thus, range trading may now be in prospect for the yen also.



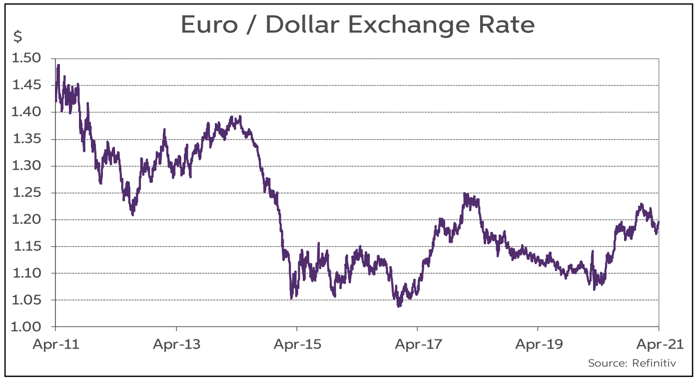


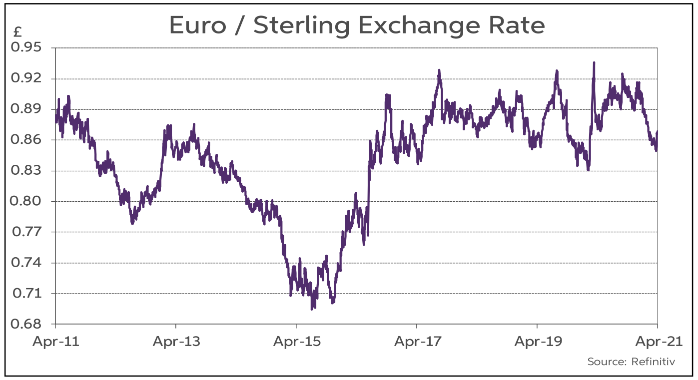


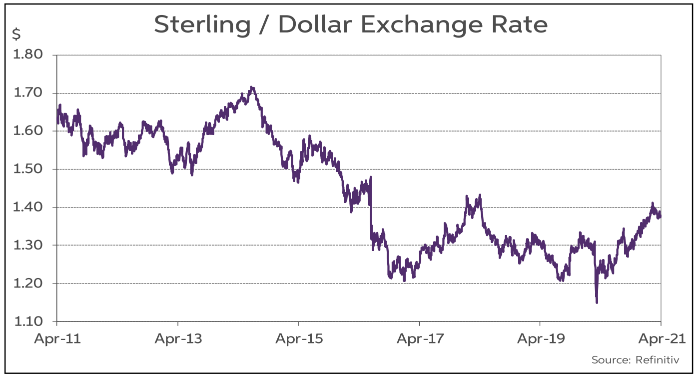
Summary of Exchange Rate Forecasts

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

	Current	Q2-2021	Q3-2021	Q4-2021	Q1-2022
Euro Versus					
USD	1.197	1.17-1.23	1.17-1.23	1.18-1.24	1.19-1.25
GBP	0.869	0.84-0.90	0.85-0.91	0.85-0.91	0.86-0.92
JPY	130.19	127-133	127-133	126-132	126-132
CHF	1.10	1.10	1.11	1.12	1.12
US Dollar Versus					
JPY	108.81	105-111	105-111	104-110	103-109
GBP	1.377	1.35-1.41	1.33-1.39	1.35-1.41	1.34-1.40
CAD	1.25	1.25	1.25	1.24	1.23
AUD	0.77	0.78	0.78	0.79	0.80
NZD	0.72	0.72	0.72	0.73	0.74
CNY	6.53	6.50	6.50	6.45	6.40
Sterling Versus					
JPY	150	149	147	148	145
CAD	1.72	1.72	1.70	1.71	1.69
AUD	1.78	1.77	1.74	1.75	1.71
NZD	1.92	1.92	1.89	1.89	1.85







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