Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

2nd December 2019

- Global economy has lost considerable momentum, with manufacturing in recession as world trade and business investment weaken. Outlook is for continuing subdued global growth
- Fed pauses after lowering rates by 75bps since mid-year. Markets look for rates to be cut further next year. ECB on hold after loosening policy in September. Little further easing now expected
- BoE remains on hold, but turns dovish. Market expects that rates will be cut in 2020
- Dollar stable at high level, with very low interest rates elsewhere hampering other currencies
- Sterling quite range bound in run-up to the general election. Upside may be limited even with a clear-cut election result, as Brexit uncertainty will still persist in 2020, weighing on currency

Oliver Mangan
Chief Economist

John Fahey
Senior Economist

Conor Beakey
Economist

https://aib.ie/investorrelations/economic-research-unit

Global Economic Outlook

OECD expects global growth to remain subdued in 2020-21

The OECD in its recent World Economic Outlook says there are increasing signs that the cyclical downturn in the global economy is becoming entrenched. It puts growth in the world economy at just 2.9% in 2019, down from 3.5% in 2018 and the weakest performance since the global financial crisis a decade ago. It points out that the slowdown in growth is broad based, encompassing almost all economies in both the OECD and non-OECD areas.

The OECD says the global economic outlook is fragile, with downside risks intensifying amidst growing policy uncertainty, weakening business sentiment and stagnant world trade. It warns about the prospect of the world economy stabilising at low levels of growth, inflation and interest rates, pointing to weak industrial production and slowing activity in service sectors as signs that global growth will remain below par. Thus, the OECD does not foresee a pick-up in the world economy in 2020 or 2021, with global growth remaining subdued at 3% or slightly below. This is about 0.3-0.4 percentage points below the estimated potential growth rate of the world economy.

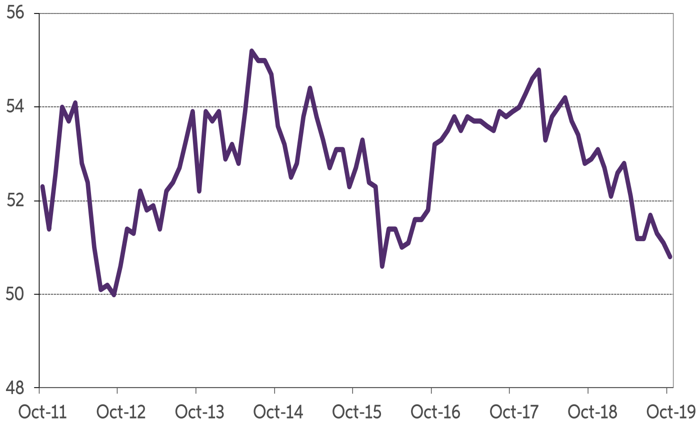
The IMF in its analysis argues that a key reason for the weak performance of the global economy is the sharp and geographically broad-based slowdown in manufacturing and global trade, and associated softness in business investment and reduced consumer spending on 'big ticket' items such as cars. The IMF views these developments as an indication that both businesses and households are holding back on 'long range' spending amid heightened policy uncertainty, especially in relation to global trade with tariffs being increased in the past couple of years.

Both the IMF and OECD see the risks to the economic outlook as being tilted to the downside. A real concern is that the ongoing weakness in manufacturing may now be spilling over into the services sector and could soon hit labour markets, which have remained resilient up to now. This would see household incomes and consumer spending start to come under pressure. Meanwhile, debt levels remain high in many countries, leaving them particularly vulnerable to shocks, especially some emerging economies. Furthermore, concerns persist about the health of the Chinese economy, which could slow more sharply than expected. Global trade tensions have added to the heightened policy uncertainty. Meantime, Brexit is still not fully resolved. A sharp correction in financial markets is a risk in this unstable environment.

The global slowdown, though, has seen monetary policy turn more accommodative globally this year, with numerous central banks cutting rates. In addition, the sharp fall in bond yields over the past year represents a significant easing in monetary conditions, while there has been a marked improvement in financial markets generally in 2019, which should aid growth. Meantime, household spending power is being boosted by stronger wage growth at a time of continuing subdued inflation. Calls, though, for a loosening of fiscal policy to help boost demand have been largely ignored by most governments, partly because public debt levels remain high.

A resolution of the US-China trade war would be a positive development for global growth prospects, with signs of progress on this front recently. There have also been tentative signs of an improvement in some leading activity indicators. The global manufacturing PMI rose for a fourth consecutive month in November. World trade volumes also picked up in the third quarter for the first time in a year. Nonetheless, considerable uncertainty still persists about the prospects for global growth so a careful eye will need to be kept on the incoming data, especially business surveys, to see if an inflection point has indeed been reached for the world economy.

Global Composite PMI (JP Morgan)



Source: Refinitiv

GDP (Vol % Change)

	2018	2019 (f)	2020 (f)	2021 (f)
World	3.5	2.9	2.9	3.0
Advanced Economies	2.3	1.7	1.6	1.7
US	2.9	2.3	2.0	2.0
Eurozone	1.9	1.2	1.1	1.1
UK	1.4	1.2	1.1	1.2
Japan	0.8	1.0	0.6	0.7
Emerging Economies	4.6	3.9	4.0	4.0
China	6.6	6.2	5.7	5.5
India	6.8	5.8	6.2	6.4
World Trade Growth (%)	3.7	1.2	1.6	2.3
Advanced Economies Inflation (PCE %)	2.3	2.0	2.1	2.1

Source: OECD Economic Outlook, November 2019

Interest Rate Outlook

Main central banks on hold for now, uncertainty about extent of further easing

Monetary policy returned to easing mode this year in response to the slowdown in the global economy. This has been most clearly seen in the US, where the Fed has cut rates by 75bps since mid-year. Meanwhile, the ECB also lowered rates and restarted its QE asset purchase programme. Other central banks, including in Australia, New Zealand, India and Thailand, have also reduced interest rates, with rate cuts in China too. This represents quite a turnaround from a year ago when policy tightening was expected from central banks over the course of 2019-20. Markets in the past couple on months, though, have scaled back their expectations on the likely extent of further easing by central banks, with the Fed and ECB putting policy back on hold for the moment.

The three 25bps Fed rate cuts since mid-year have taken the key funds rate down to a 1.5-1.75% range. Markets are pricing in circa 30bps of further rate cuts, with the funds rate expected to be lowered to around 1.3%. Not that long ago, the market had expected the Fed to lower rates all the way to 1%. Fed Chair Powell indicated after the last rate cut, though, that the FOMC believes that the easing of policy to date should be sufficient to keep the economy on a steady growth path. Progress on US-China trade talks has also dampened rate cut hopes.

Interesting, in their last set of interest rate projections, not one member of the FOMC saw a need for rates to be cut below their current level of 1.625%. This suggests that the economy would need to weaken further for the Fed to start cutting rates again as anticipated by the market. Indeed, Fed Chair Powell has said as much, stating that it would require a material change to the Fed's economic outlook for it to resume cutting rates.

In the UK, the BoE has voiced concerns about the negative impact that ongoing Brexit uncertainty is having on the economy at a time of weakening global growth. Indeed, two MPC members voted for a rate cut at the November meeting. Opinion polls suggest that the Conservative Party could emerge with an overall majority in the general election on December 12th. This should pave the way for an orderly UK departure from the EU at end January.

However, difficult trade talks between the UK and EU would still lie ahead in 2020. It is still quite possible that the UK and EU will not be able to conclude a trade deal. This could see the UK falling back to trade on WTO rules from the start of 2021, when the transition period in the Withdrawal Agreement is due to expire. This uncertainty in relation to the future trade relationship with the EU could well act as a significant headwind for the UK economy. Hence, markets think that the BoE will lower rates in 2020, though they have yet to fully price in a 25bps cut.

Turning to the ECB, it announced a broad package of easing measures in September, including a cut of 10bps in the deposit rate to –0.5% and the restarting of open-ended asset purchases under its QE programme, as well as easier liquidity terms for its long-term repos. It stated that the easing measures will remain in place until underlying inflation robustly converges with its 2% target. It has also indicated that rates could be lowered further, pointing to a continuing easing bias.

However, the minutes of the September meeting showed significant opposition on the Governing Council to the easing package. As a result, markets have grown doubtful that the ECB will ease policy much further. They had been expecting that rates could be cut by another 20bps, bringing the deposit rate down to –0.7%. Now, they are pricing in no more than a small 5bps cut, so effectively they see policy staying on hold. Futures contracts, though, indicate that markets expect interbank rates to remain negative for a long time, until the end of 2024.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.625	1.91	1.95	1.63	1.62
Dec '19	1.625	1.90	1.95	1.65	1.65
Mar '20	1.625	1.90	2.00	1.70	1.70
June'20	1.625	1.90	2.05	1.80	1.80

** 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	-0.43	-0.29	-0.32	-0.19
Dec '19	-0.50	-0.43	-0.30	-0.32	-0.18
Mar '20	-0.50	-0.43	-0.30	-0.32	-0.18
June'20	-0.50	-0.43	-0.30	-0.30	-0.15

** 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	0.79	0.95	0.79	0.85
Dec '19	0.75	0.80	0.95	0.80	0.85
Mar '20	0.50	0.60	0.75	0.65	0.70
June'20	0.50	0.60	0.75	0.65	0.70

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Dollar retains upper hand

The dollar has been at elevated levels for the past five years. It has been aided by strong US economic growth. Indeed, the current economic expansion has now become the longest on record. As a result, the jobless rate has fallen to a near 50 year low of 3.6%. Widening interest rate differentials and bond spreads have also helped the US currency, with the Fed steadily tightening policy in 2017-18, raising the fed funds rate by 200bps to a 2.25-2.5% range by the end of last year.

FX positioning, though, has become quite long the dollar, limiting the potential for further gains by the greenback, especially as it is already at quite high levels against many currencies. The dollar has been confined to a very narrow range on a trade-weighed basis over the second half of this year. Some other factors have also turned less favourable for the dollar. The US economy has moved on to a slower growth path, with GDP growing at a moderate 2% rate in the last two quarters. The Fed has responded by lowering rates by 75bps since mid-year. Improved risk appetite in markets in the second half of the year, helped by signs of progress in US-China trade talks, is also lessening the appeal of safe-haven currencies like the dollar.

Nonetheless, the relative strength of the US economy and still wide interest rate differentials remain supportive of the US currency. The persistence elsewhere of very low and, indeed, in some cases, negative interest rates is also making it difficult for other currencies to make ground against the dollar. In particular, the marked slowdown in the Eurozone economy and significant policy easing by the ECB this autumn mean that the euro remains weighed down at relatively low levels against the dollar.

The euro largely traded in a tight $1.12-1.14 band in the first half of this year. It has edged lower to trade in a $1.09-1.12 range since mid-July, as the ECB moved back on to a policy easing path. Strong technical support for the euro at around the $1.08-1.09 level held over the autumn. The euro-dollar rate has largely traded in a narrow $1.10-1.11 range in the past month, with both the Fed and ECB putting policy back on hold after their earlier policy easing moves.

The dollar is only likely to weaken significantly if it becomes apparent that the US economy is heading towards recession and Fed has to cut rates a lot further. It is worth noting that the EUR/USD rate has spent very little time above the $1.20 level ever since the ECB move to negative rates in 2014. Thus, it would probably take large rate cuts in the US to drive the euro above this level, especially given that the ECB would also be likely to ease policy even further in these circumstances. In addition, it is expected that money market rates will remain negative in the Eurozone until the middle of the coming decade. Absent this, it is hard to make a case for the euro to recover against the dollar. Thus, the single currency could continue to trade in a narrow $1.09-1.13 range in the early part of 2020.

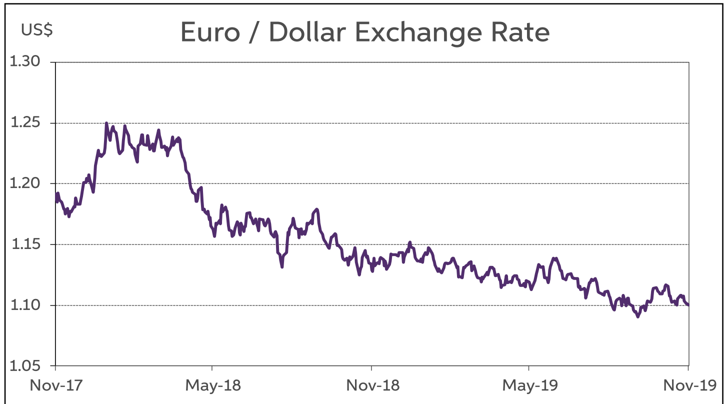
One currency which has been able to keep pace with the strong dollar in recent years is the yen, despite negative Japanese interest rates. The currency has benefitted from spells of safe-haven buying, as well as Japan's large current account surplus. The dollar has largely traded is a ¥106-114 range since early 2017 and is currently near the ¥110 level. The ¥105-106 range is a good support level for the dollar that is likely to continue to be difficult for the yen to overcome, unless there are further large Fed rate cuts. The dollar could fall towards ¥100 in those circumstances, especially if financial markets also came under pressure at the same time.

US Dollar Trade Weighted Index Versus Majors

(March 1973 =100)

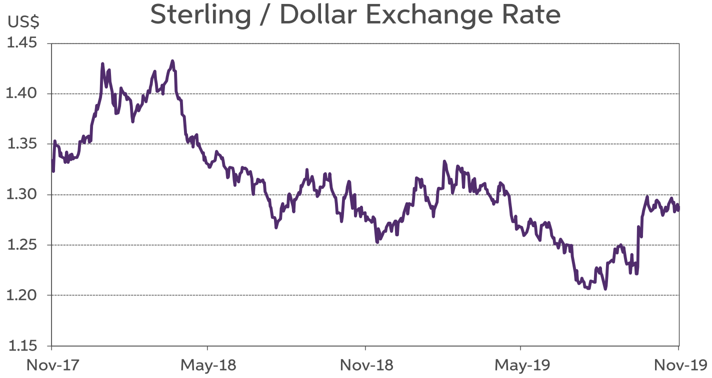
Source: Refinitiv

Euro / Dollar Exchange Rate



Source: Refinitiv

Sterling / Dollar Exchange Rate



Source: Refinitiv

AIB Treasury Economic Research Unit

2020 to prove another volatile year for sterling

Sterling has been very volatile this year, rising and falling in response to the ebb and flow of news on Brexit. It lost considerable ground over the summer on the growing risk that there could be a no-deal hard Brexit. Then, sterling made big gains in October on news that an agreement had been reached on a revised Brexit deal. The euro dropped from 90p to near 86p, even though the deal was not ratified by the UK Parliament. This resulted in another extension to Article 50 to avoid a no-deal hard Brexit at end October. The extension is to 31st January.

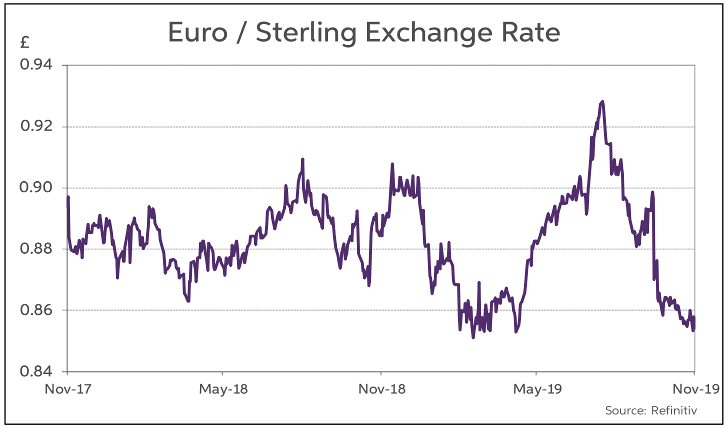
A general election is being held in the UK on December 12th. Opinion polls suggest that the Conservatives could win an overall majority. This is also supporting sterling, as it would pave the wave for the new Parliament to ratify the revised Brexit deal and allow the UK to leave the EU in an orderly fashion at the end of January. The euro has edged down towards the 85p level against sterling in the past week.

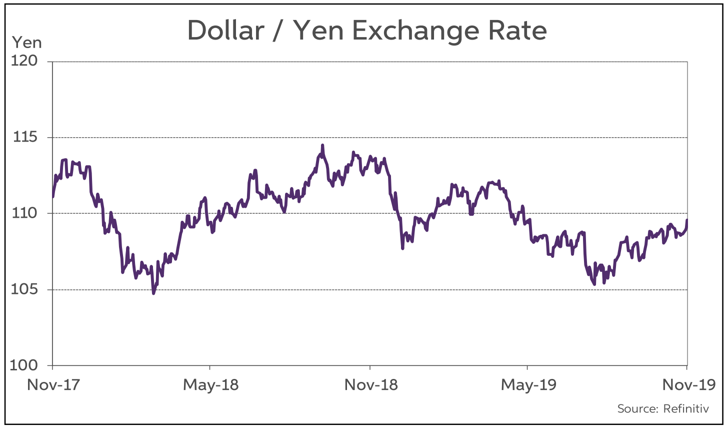
Sterling could be expected to make further gains if the Conservatives win a clear majority in the election but these may prove limited and short lived. There is strong technical support for the euro at around the 83-84p level against sterling, which may be difficult to overcome. Furthermore, the revised Brexit deal is seen as being negative for the UK economy as it will be leaving the EU Customs Union and Single Market. There is also considerable uncertainty about what the future trading relationship between the UK and EU will look like, after the transition period expires at the end of next year. Thus, a Conservative win may only see the euro fall to around the 84p level.

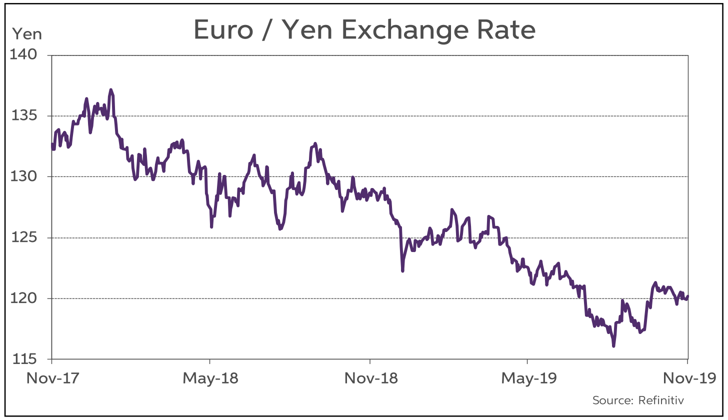
The UK's departure from the EU at end January would not mean that Brexit is done. The trade talks that follow will be very important. These are likely to prove very difficult. The more a Conservative government wants to "take back control" so that the UK can have its own regulatory and customs regime, the more limited will be any trade deal it concludes with the EU. Indeed, the EU has been very clear that it will insist on a level playing field in any trade deal, so that "regulatory divergence does not turn into regulatory dumping". It has emphasised that guaranteeing and enforcing "common rules" will be a crucial part of any deal in order to protect the Single Market.

This may be a bridge too far for a Brexit orientated Conservative government. Such a government could be prepared to fall back on WTO rules at the end of the transition period, rather than sign up for a trade deal that requires the UK to closely follow the rules of the Single Market. This would be very much a hard Brexit and be negative for sterling. Thus, even if the UK leaves the EU at end January, downward pressure could still re-emerge on the UK currency next year given that the next phase of Brexit, the trade negotiations, are likely to prove difficult, with a very uncertain outcome. We would not be surprised to see the 90p level revisited against the euro in this situation.

If Labour comes to power after the election, probably as a minority government, it would likely result in a very soft Brexit or the UK voting to remain in the EU in another referendum. This should be positive for sterling in the short-term. However, markets' concerns about the economic policies of a Labour government could see the currency come under downward pressure in 2020. Meantime, another hung Parliament still unable to agree a way forward on Brexit, would be very negative for sterling as it again would bring back the risk that the UK could crash out of the EU in a disorderly fashion next year. Overall, another volatile year seems in store for sterling in 2020.





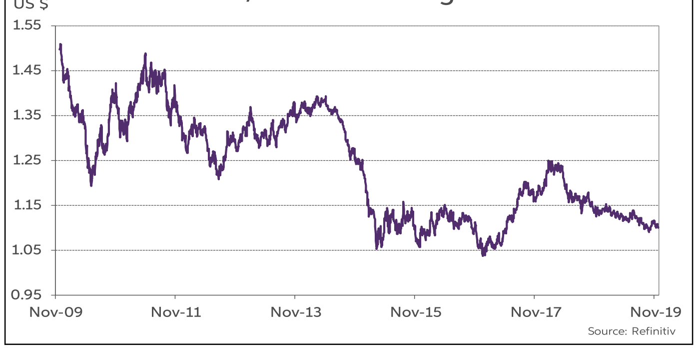


Summary of Exchange Rate Forecasts

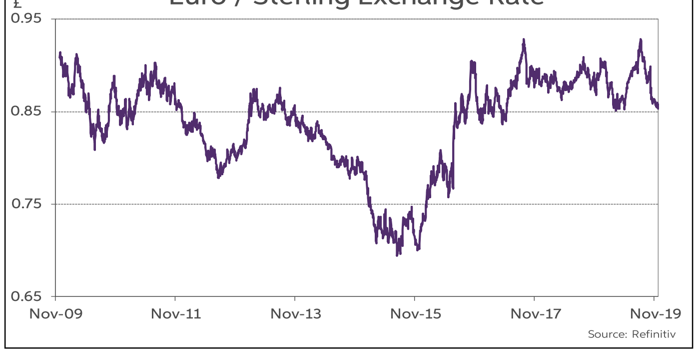
("Spot" Forecasts for end Quarter can be taken as Mid-Point of expected Trading Range)

	Current	Q4-2019	Q1-2020	Q2-2020	Q3-2020
Euro Versus					
USD	1.101	1.07-1.13	1.08-1.14	1.09-1.15	1.10-1.16
GBP	0.854	0.81-0.87	0.83-0.89	0.85-0.91	0.86-0.92
JPY	120.77	118-124	119-125	120-126	121-127
CHF	1.10	1.10	1.10	1.10	1.10
US Dollar Versus					
JPY	109.65	107-113	107-113	107-113	107-113
GBP	1.290	1.28-1.34	1.26-1.32	1.24-1.30	1.24-1.30
CAD	1.33	1.33	1.32	1.30	1.29
AUD	0.68	0.68	0.68	0.69	0.70
NZD	0.65	0.65	0.65	0.66	0.67
CNY	7.04	7.02	6.95	6.90	6.80
Sterling Versus					
JPY	141	144	142	140	140
CAD	1.71	1.74	1.70	1.65	1.64
AUD	1.90	1.93	1.90	1.84	1.81
NZD	2.00	2.02	1.98	1.92	1.90

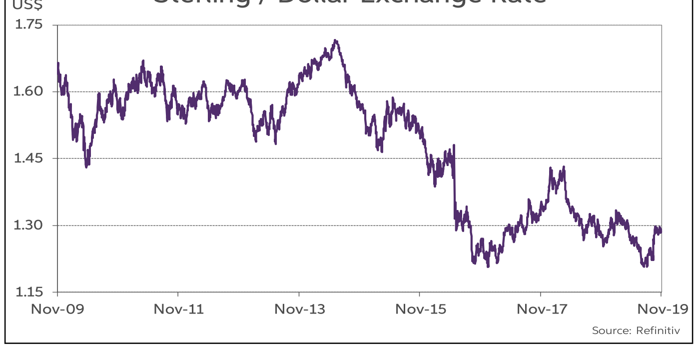
Euro / Dollar Exchange Rate



Euro / Sterling Exchange Rate



Sterling / Dollar Exchange Rate



AIB Treasury Economic Research Unit

AIB, 10 Molesworth Street, Dublin 2 Tel: 353-1-6600311 https://aib.ie/investorrelations/economic-research-unit