

Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit



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- Global growth expected to remain subdued in 2020. Better than expected data from US and UK recently, but Eurozone figures disappoint. Coronavirus causing some short-term disruption
- Fed policy on hold after US rates cut by 75bps in H2 2019. Markets expect two further rate cuts. ECB also now on hold after loosening policy last autumn. Further small rate cut anticipated
- BoE stays on hold as growth picks up, but markets see rate cut later this year
- Euro loses ground as economy underperforms, hitting a three year low versus dollar below \$1.08. There is strong technical support near this level, so we don't foresee a sharp fall by the currency
- Sterling gains ground on better economic data and signs that fiscal policy may be loosened considerably. Difficult EU-UK trade talks could pose a risk for currency as the year progresses

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Some better survey data, but growth expected to remain subdued in 2020

There have been some green shoots about recently following the marked slowdown in the world economy over the past eighteen months. The pace of global economic activity accelerated to a ten month high in January according to the latest PMI survey data. The Global Composite PMI hit 52.2 in the month, up from 51.6 in December, its best level since March 2019. This was the third consecutive monthly rise in the index from its low of 50.8 reached in October.

Encouragingly, growth is strengthening in both manufacturing and services and the pick-up is also broad based, with output growing in virtually all economies covered in the surveys. New orders recorded their strongest rise for ten months in January, while business optimism rose to a nine-month high. The Manufacturing PMI rose to 50.4, its best level since last April, with growth in new orders at a 13-month high. Declining international trade volumes remain a headwind for the sector, but there are positive signs here too. New export orders, which have been below 50 for the past seventeen months, were close to stabilising at 49.5 in January.

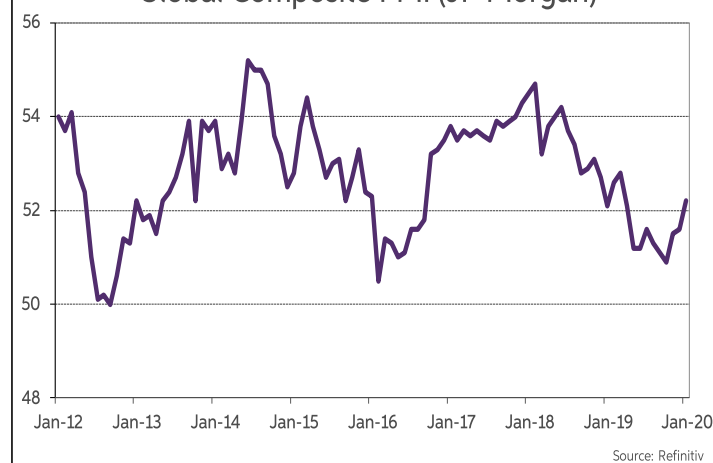
Activity is much stronger on the services side of economies, with the Global Services Activity Index hitting 52.7 in January, its highest level since last April. New orders and employment expanded at healthy pace, while business sentiment has firmed considerably in recent months. Other recent data have also been stronger. A pick-up in activity in the US is visible from the strong January ISM survey data, as well as various very robust labour market reports for the month. There are also signs of a clear rebound in activity in the UK in early 2020, helped by its smooth exit from the EU. Data from the Eurozone, though, remain weak, with little sign yet that activity is improving. Nonetheless, the global economy appears to have started 2020 on a firmer footing.

Nonetheless, both the IMF and OECD have warned in recent reports that the global economic outlook remains fragile, with the risks tilted to the downside. The outbreak of the deadly coronavirus in China, which is causing severe disruption to economic activity in that country, is the latest threat to the world economy. With vital global supply lines likely to be impacted, it has the potential to have knock-on effects in other economies also. While hopefully the outbreak will soon be contained, it is likely to depress global activity and sentiment in the next couple of months. The President of the ECB, Christine Lagarde, has warned that the virus outbreak is a potential risk to global growth, though there is much uncertainty about its precise impact.

We would expect to see a fall back in global PMIs in February and March, snuffing out the green shoots of recovery for now. However, previous experience suggests that the economic impact of the virus should be short lived. Nonetheless, we may have to wait until later in the spring or early summer to see if recent green shoots reappear and are for real. A careful eye will need to be kept on data, especially business surveys, to see if an inflection point has indeed been reached for the world economy and activity strengthens over the course of the year.

There are reasons to be hopeful, including the lagged effects of the widespread easing on monetary policy in 2019, a more expansionary fiscal policy in some countries, the emergence of some large developing economies from recession, continuing good growth in real household incomes, as well as an easing in global trade tensions. Nevertheless, any pick up in activity in 2020 is likely to be modest, with no sign yet of a rebound in international trade, which is likely to take a fresh hit this spring from the coronavirus outbreak.

Global Composite PMI (JP Morgan)



GDP (Vol % Change)

	2018	2019 (e)	2020 (f)	2021 (f)
World	3.6	2.9	3.3	3.4
Advanced Economies	2.2	1.7	1.6	1.6
US	2.9	2.3	2.0	1.7
Eurozone	1.9	1.2	1.3	1.4
UK	1.3	1.3	1.4	1.5
Japan	0.3	1.0	0.7	0.5
Emerging Economies	4.5	3.7	4.4	4.6
China	6.6	6.1	6.0	5.8
India	6.8	4.8	5.8	6.5
World Trade Growth (%)	3.7	1.0	2.9	3.7
Advanced Economies				
Inflation (CPI %)	2.0	1.4	1.7	1.8

Source: IMF World Economic Outlook Update, January 2020

Interest Rate Outlook

Main central banks on hold, but markets expect further rate cuts

Monetary policy returned to easing mode last year in response to the slowdown in the global economy. This was most clearly seen in the US, where the Fed cut rates by 75bps in H2 2019. Meanwhile, the ECB also lowered rates in the autumn and restarted its QE asset purchase programme. Other central banks, including in Australia, New Zealand, India and Thailand, also reduced interest rates, with rate cuts implemented in China too.

The policy loosening was extensive, with a total of 71 rate cuts by 49 central banks last year according to the IMF. It was the most synchronised easing of monetary policy since the global financial crisis over a decade ago. The IMF estimates that the monetary easing added around 0.5% to world growth in 2019. It says that without this action by central banks, we could have been looking at a global recession, but this has now been avoided.

The three 25bps Fed rate cuts in 2019 took the key funds rate down to a 1.5-1.75% range. The Fed has indicated that it believes the easing of policy should be sufficient to keep the economy on a stable growth path. Interestingly, not one member of the FOMC expects rates to be cut below their current level of 1.625%, suggesting they believe that economic activity will hold up well this year. The economy is growing at a steady rate of around 2%, while the unemployment rate has hit a 50 year low of 3.5%. Recent data on the economy have been very solid. Fed Chair Powell has said that it would require a material change to the economic outlook for the FOMC to alter policy. However, markets are pricing in two further 25bps rate cuts in the next year or so, suggesting they expect the economy to weaken in 2020.

In the UK, the economy finished last year on a weak note, with GDP flat in the final quarter. Two of the nine MPC members voted for a rate cut at each of the last three policy meetings. Data, though, have picked up this year, helped by the UK's smooth departure from the EU at end January in the aftermath of the Conservative party's big win in December's general election. Fiscal policy could also turn quite expansionary under the new Conservative government. Thus, the majority of the MPC have been minded to keep policy on hold for now.

Difficult trade talks between the UK and EU lie ahead in 2020, which could become a significant headwind for the economy as the year progresses. Thus, while the economy appears to be gaining momentum at present, it may not last. Markets had expected the BoE to cut rates early in H1 2020 before the recent signs of stronger growth emerged. They now think that it will be later in the year before rates are cut, with 20bps of easing priced into futures contracts by end 2020. Thus as in the US, markets seem to be expecting the economy to weaken.

Turning to the ECB, it announced a broad package of easing measures last 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 has indicated that the easing measures will remain in place until underlying inflation robustly converges with its 2% target and it could loosen policy further if required.

Policy is now on hold as the ECB takes time to assess the impact of last autumn's easing measures on the economy. A major review of its monetary policy framework is also underway. Economic data have remained weak in the Eurozone, with the coronavirus in China a new risk to the depressed industrial sector. The ECB has maintained an easing bias and futures contracts have recently started to price in a small rate cut of 5-10bps for later this year. Overall, markets see rates staying very near to current levels for the next three years, out to 2023.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.625	1.69	1.77	1.42	1.36
Mar '20	1.625	1.70	1.80	1.45	1.40
June'20	1.625	1.75	1.85	1.50	1.50
Sept'20	1.625	1.80	1.90	1.60	1.65

** 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	-0.32	-0.38	-0.31
Mar '20	-0.50	-0.43	-0.32	-0.38	-0.30
June'20	-0.50	-0.42	-0.30	-0.35	-0.25
Sept'20	-0.50	-0.40	-0.25	-0.30	-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	0.76	0.89	0.71	0.72
Mar '20	0.75	0.75	0.90	0.73	0.74
June'20	0.75	0.75	0.90	0.75	0.75
Sept'20	0.75	0.70	0.85	0.70	0.70

** Swap Forecasts Beyond 1 Year*

Euro moves lower as economy remains weak

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 50 year low of 3.5%. 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 2.25-2.5%.

The US economy, though, moved on to a slower growth path in 2019, with GDP growing at a more moderate 2% rate since last spring. The Fed responded by lowering rates by 75bps in H2 2019. This saw the dollar generally trade in very narrow ranges last year. Most notably, the euro-dollar rate was confined to just a six cent corridor of \$1.09-1.15 for the whole of 2019, but with an underlying trend of the euro edging lower for most of the year. The euro moved within a \$1.12-1.15 band in H1 and then \$1.09-1.12 in H2 2019.

The narrow trading range has now broken down, with both the dollar strengthening again and the euro losing ground in early 2020. The dollar has climbed by close to 3% in trade-weighted terms since end 2019, making significant gains against a wide range of currencies. The euro has fallen by 2% in trade-weighted terms, breaching the key \$1.09 support level in mid-February and falling to a three year low of \$1.08. Meantime, the single currency has also fallen to its lowest level against sterling since 2016, dropping to 83p.

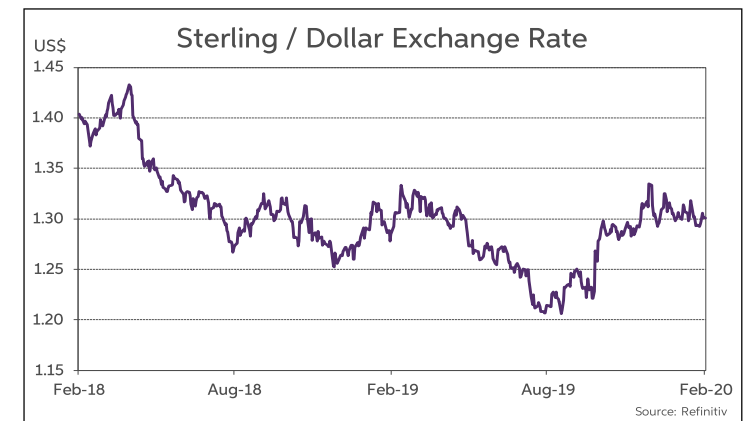
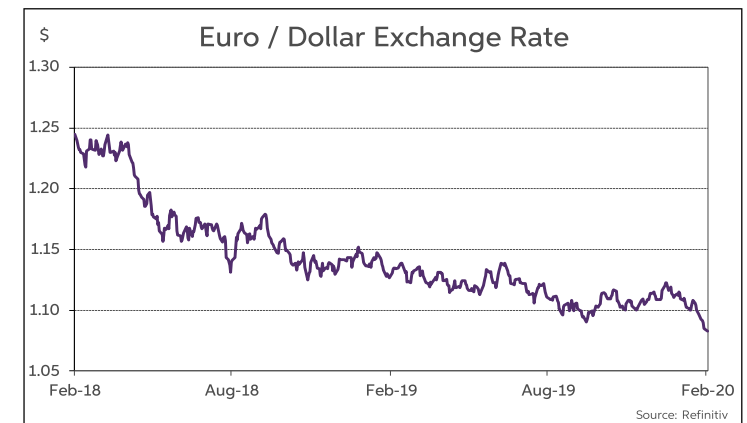
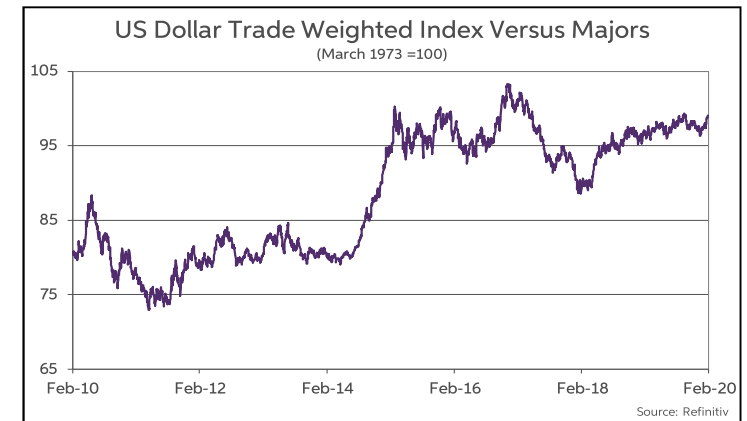
There are a number of factors at work. Economic data have been coming in well ahead of expectations in both the US and UK this year, with the strong US employment report for January catching the eye in particular. By contrast, Eurozone data have generally disappointed expectations, including weak GDP growth of just 0.1% for the final quarter of 2019 and a big drop of 2.1% in industrial output in December.

Meanwhile, political uncertainty has gripped Germany recently, in contrast to the US and UK where the political landscape is more settled. The outbreak of the coronavirus in China has also sparked a flight to safety into currencies like the dollar. Notably, the two other main safe-haven currencies, the Swiss franc and yen, have also strengthened this year.

Some of these factors are intertwined. There are concerns that the disruption caused by the coronavirus will exacerbate the industrial slump in the Eurozone, a negative for the euro. The auto industry, in particular, is reliant on components from China, which is also an important market for European exports. Meanwhile, following the Conservatives' landslide election win, there are signs that the new Government will loosen fiscal policy considerably to boost UK growth. This is supporting sterling.

It is hard to make a case for a stronger euro other than that it has fallen to low levels. It is expected that economic growth will remain weak in the Eurozone, with money market rates staying negative into the second half of this decade, thereby continuing to act as an on-going headwind for the single currency. Meanwhile, the dollar only seems likely to weaken significantly if it becomes apparent that the US economy is heading towards recession and the Fed has to cut rates a lot further, though the US November elections could also pose a threat.

There is a lot of strong technical support for the euro in the \$1.06-1.08 region, so we don't see the recent move downwards in the pair as the start of a sharp slide by the single currency. Instead, as in 2019, we think the euro is moving down to trade in a slightly lower trading range of \$1.06-1.09 in the coming months.



Sterling gains ground, but upcoming EU-UK trade talks pose a risk for the currency

Sterling had a very volatile year in 2019, rising and falling in response to the ebb and flow of news on Brexit. The currency made big gains in October when a revised Brexit deal was agreed. The euro dropped from 90p to near 86p on the news. The currency made further gains in the run-up to the December general election. As expected, the Conservative Party won a decisive victory, which paved the way for ratification of the revised Withdrawal Agreement, allowing the UK to leave the EU in an orderly fashion at the end of January.

Growing expectations that the Conservative Party could loosen fiscal policy significantly has seen sterling make some further gains recently. Cable is trading around the \$1.30 level, while the weak euro has fallen to a four year low of 83p against the pound.

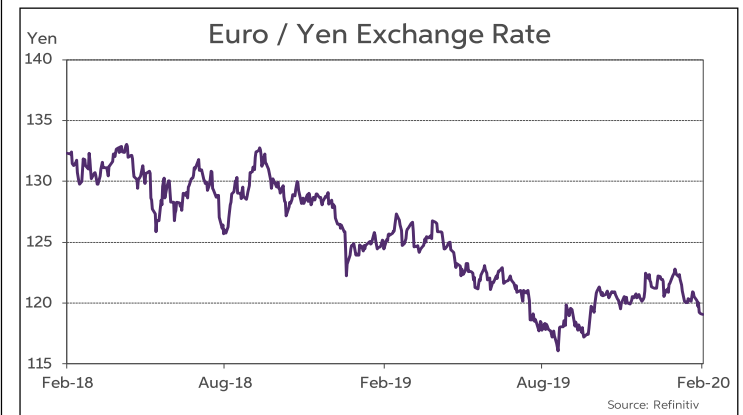
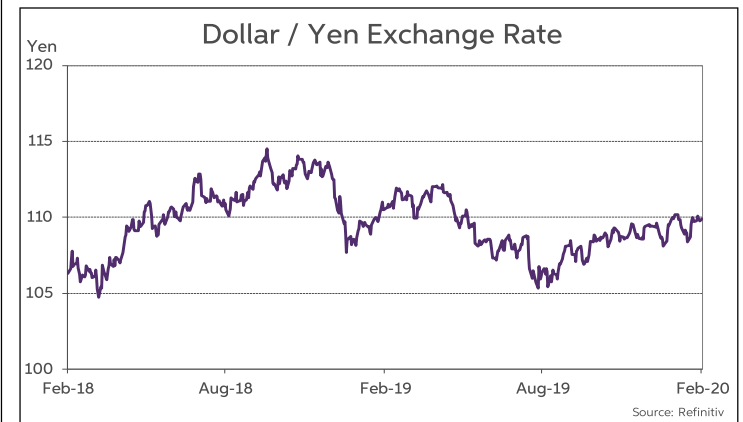
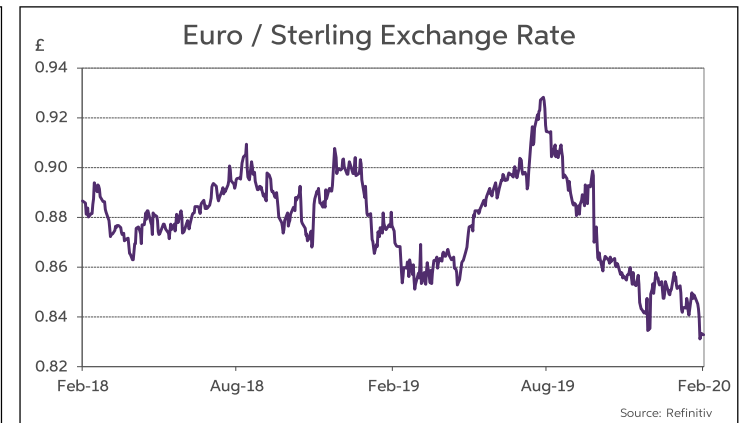
The UK's departure from the EU at end January does not mean that Brexit is done and thus no longer poses a risk to sterling. The EU-UK trade talks that are set to take place this year will likely prove to be very difficult and fractious. These will determine the future trading relationship between the UK and EU and thus the real shape of Brexit. The UK has ruled out extending the deadline for the talks beyond end 2020, even though the EU believes that more time will be needed to negotiate a comprehensive trade deal.

The UK government wants to "take back control" so the country can have its own regulatory regime. It does not want to be an EU rule taker. This points to a rather limited trade deal that could be largely confined to goods. It may provide that there are no tariffs or quotas on merchandise trade between the UK and EU. However, it is likely to see a lot of non-tariff barriers come into play, such as complying with "rules of origin", requirements for customs declarations, as well as increasing regulatory divergence that impose extra costs on businesses. The EU-Canadian FTA is along these lines and includes some services, but not financial services.

The negotiations are expected to be fraught, especially on such areas as fishing rights, financial services and regulatory rules. The EU will not want to give unfettered access to its markets to a large economic neighbour that has just left the Single Market and does not want to abide by the same rules as member states. The reality is that any FTA will be far from frictionless trade and vastly inferior to the current EU Single Market and thus have negative economic consequences. Indeed, a no-deal outcome and thus trading under WTO rules cannot be ruled out if the EU digs in its heels on the need for a level playing field, with a common set of enforceable rules to prevent unfair competition. The UK will be very reluctant to agree to this and could opt for no trade deal instead.

Overall then, downward pressure could re-emerge on sterling this year, if as we expect, the trade negotiations run into difficulties. Indeed, we would not be surprised to see the euro rise towards the 90p level, if it appears that we are heading for another cliff-edge Brexit date at end year, amid growing fears that there could be no trade deal agreed and no extension to the transition period. This would amount to in effect a Hard Brexit, but almost a year after the UK has left the EU.

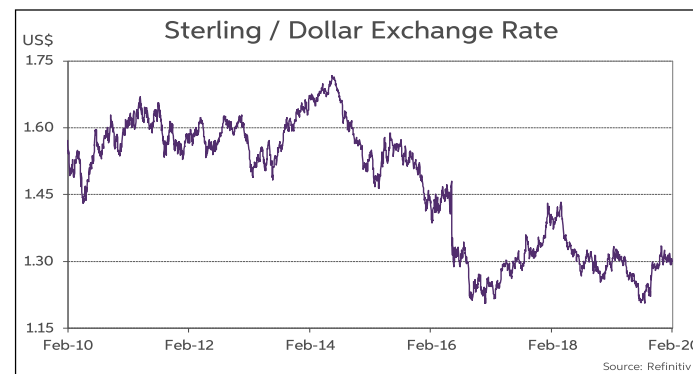
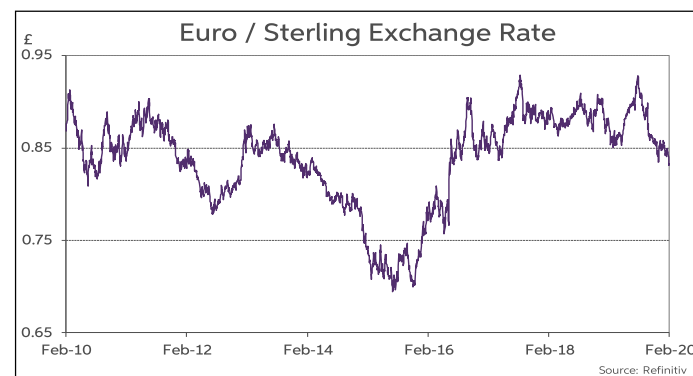
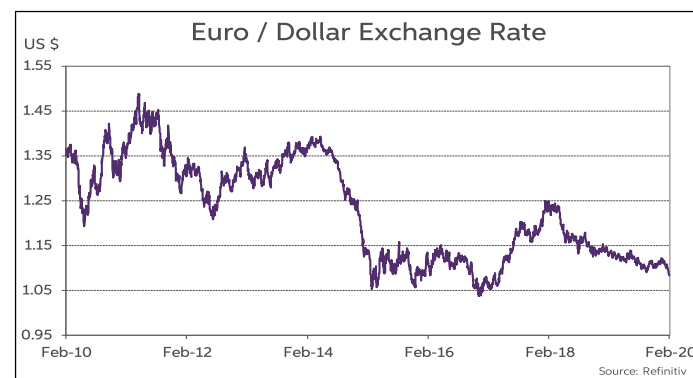
Sterling can be expected to lose ground against a broad range of currencies in such circumstances. Cable could drop to around \$1.25. The downward pressure on sterling could intensify if the Bank of England moved to cut rates to alleviate some of impact that the uncertainty around the trade negotiations was having on the economy.



Summary of Exchange Rate Forecasts

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

	Current	Q1-2020	Q2-2020	Q3-2020	Q4-2020
Euro Versus					
USD	1.080	1.05-1.11	1.06-1.12	1.07-1.13	1.09-1.15
GBP	0.831	0.80-0.86	0.82-0.88	0.84-0.90	0.85-0.91
JPY	119.08	116-122	117-123	118-124	120-126
CHF	1.06	1.06	1.06	1.06	1.07
US Dollar Versus					
JPY	110.22	107-113	107-113	107-113	107-113
GBP	1.300	1.27-1.33	1.25-1.31	1.23-1.29	1.24-1.30
CAD	1.32	1.32	1.31	1.30	1.28
AUD	0.67	0.67	0.68	0.69	0.70
NZD	0.64	0.64	0.65	0.66	0.67
CNY	6.99	7.00	6.90	6.85	6.80
Sterling Versus					
JPY	143	143	141	139	140
CAD	1.72	1.72	1.68	1.64	1.63
AUD	1.94	1.94	1.88	1.83	1.81
NZD	2.03	2.03	1.97	1.91	1.90



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