Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

AIB

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- Concerns mount in markets about the outlook for the world economy, with activity having weakened in Europe, China and Japan during 2018 and the US economy set to slow this year

- More cautious Fed indicates that further rate hikes are very much data dependent. BoE on hold as it awaits clarity on Brexit. ECB guides that rates will stay very low for a prolonged period

- Dollar supported by hikes in US rates and strong economy in 2018. However, the currency has lost some momentum recently, on expectations that we are at, or near to, the peak in Fed rates

- Weakening growth and low interest rates weigh on euro, but finding a base against the dollar

- Sterling awaits clarity on Brexit. Remains range bound against the euro. Big moves possible in either direction depending on how Brexit unfolds

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Global Economic Outlook

Concerns mount about growth prospects for world economy

Both the OECD and IMF lowered their growth forecasts for the world economy on a number of occasions over the second half of 2018. These were the first downward revisions to global forecasts for some time and encompassed both advanced and emerging economies. The OECD sees global growth slowing modestly from 3.7% in 2018 to 3.5% in both 2019 and 2020. At mid-year, both the OECD and IMF were forecasting that the world economy would grow by 3.9% in 2019.

The OECD and IMF have warned for some time that the risks to the world economy have shifted to the downside. Growth in global trade slowed last year, with escalating trade tensions having adverse effects on confidence, investment activity and financial markets. Notably, the Chinese economy has lost some momentum following the imposition of tariffs on many of its exports to the US. Japan and most European economies also registered slower growth last year.

Meanwhile, the gradual normalisation of monetary policy in the US, and associated strengthening of the dollar, have had adverse impacts on some big emerging-market economies that have high foreign currency debt levels and large external deficits. This has put severe downward pressure on their currencies, forcing their central banks to raise interest rates to punitive levels. Some large emerging economies have entered recession.

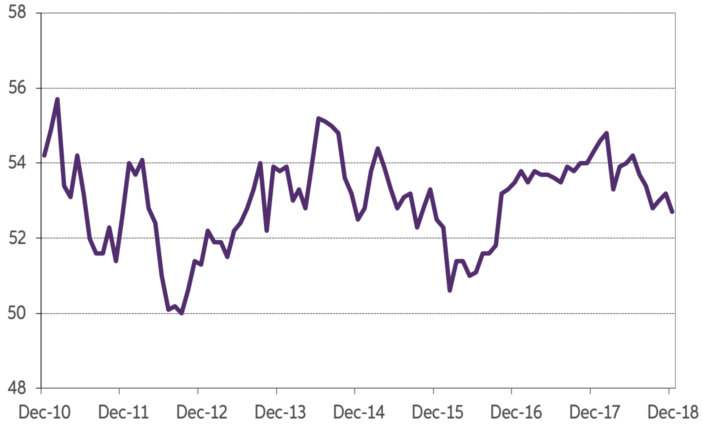
More generally, financial markets have become more risk averse and have experienced bouts of extreme volatility in recent times. Stock markets came under downward pressure in the final quarter of 2018, with all the major equity indices finishing the year in negative territory. Both the IMF and OECD had warned that the easy monetary conditions in place for much of this decade had led to a build-up of vulnerabilities in financial markets from elevated asset prices and high debt levels. Thus, the market correction is not a huge surprise, especially in the context of the growing concerns about the outlook for the world economy.

The JP Morgan Global Composite PMI fell to an over two year low in December, moving down to 52.7. This is still consistent with reasonable growth, but it would be a worry if PMIs continue to decline in early 2019. Meanwhile, there has been a marked weakening of new exports orders in all major economies as global trade slows. There are also concerns that growth in the strongly performing US economy could slow quite sharply in the coming year, once the fiscal stimulus fades and higher interest rates begin to impact on activity.

Crucially, inflation is expected to stay subdued. The IMF is forecasting that the CPI rate in advanced economies will average 1.9% this year, compared to 2.0% in 2018. The sharp drop in oil prices in recent months means that this forecast is likely to be undershot. The decline in oil prices will also boost real household incomes, which should support consumer spending this year. Meanwhile, low inflation should also allow monetary policy to remain accommodative in most countries, supporting economic growth. Fiscal policy, generally, is also expected to remain supportive of growth in most economies.

Nonetheless, it will prove a challenge for the world economy to achieve the lower growth rate of 3.5% being forecast for 2019 and 2020 given the mounting downside risks to activity. A close eye will need to be kept on incoming data to see if a more severe slowdown is underway. In this regard, a resolution in the coming months to the trade dispute between the US and China would be positive for markets and global growth prospects.

Global Composite PMI (JP Morgan)



Source: Thomson Datastream

GDP (Vol % Change)

	2017	2018(f)	2019 (f)	2020 (f)
World	3.6	3.7	3.5	3.5
Advanced Economies	2.5	2.4	2.1	1.9
US	2.2	2.9	2.7	2.1
Eurozone	2.5	1.9	1.8	1.6
UK	1.7	1.3	1.4	1.1
Japan	1.7	0.9	1.0	0.7
Emerging Economies	4.6	4.7	4.7	4.7
China	6.9	6.6	6.3	6.0
India	6.7	7.5	7.3	7.4
World Trade Growth (%)	5.2	3.9	3.7	3.7
Advanced Economies PCE Inflation (%)	2.0	2.3	2.6	2.5

Source: OECD Economic Outlook, November 2018

Interest Rate Outlook

Markets turn more cautious on monetary tightening as global economy slows

Markets had been expecting only limited monetary policy tightening in the next couple of years, but even modest rate hike expectations have been scaled back in recent months as concerns mount about the growth prospects for the world economy in 2019-20. This has resulted a strong rally in bond markets, with yields falling sharply in the final quarter of last year. Ten year bund yields fell by 40bps to below 0.2%, a two year low.

In the US, the Fed hiked rates as expected by a further 25bps to 2.375% at its mid-December FOMC meeting, the eighth rate hike in the past two years. The market thinks that the rate tightening cycle is now at an end and that the Fed's next move could be a rate cut in a couple of years time. This represents quite a sea-change in the market's view. In the autumn, futures contracts were pricing in two further rate hikes in 2019, taking official rates up to near 2.9%, with rates seen levelling off thereafter.

The Fed, though, remains of the view that more policy tightening will be required as the economy should continue to grow at a solid pace in 2019, with the labour market tightening further, while wage inflation has picked up to over 3%. Thus, it is projecting two further rate hikes in 2019 and an additional rate increase in 2020, taking rates up above 3%. The Fed has made it clear, though, that with monetary policy no longer accommodative, it will be patient about raising rates further and future rate decisions are now very much data dependent. Fed policy can be expected to be put on hold in Q1 as it awaits a clear picture on how the economy is performing this year. We still expect that the Fed will have to raise rates somewhat further in 2019.

In the UK, the markets have also lowered their expectations for rate hikes. They now see the next BoE rate hike occurring in Q3 2020, taking rates up to 1%. Previously, they had expected rates to rise to 1.5%, because of above target inflation amidst a tightening labour market, with underlying wage inflation picking up to over 3%.

BoE policy is set to stay on hold until we get clarity around the nature of the UK's departure from the EU. In the event of a soft Brexit or no Brexit, we think the BoE could tighten policy by more than markets expect, with a rate hike likely this year and again in 2020. On the other hand, if a no-deal hard Brexit materialises, then rates could be cut this year, given the negative impact that such an event would have on the UK economy.

Meantime, the ECB ceased net asset purchases under its QE programme at the end of last year. However, it continues to indicate that it intends to keep interest rates at their current very low levels until at least the end of the summer. The ECB does not see inflation rising to its 2% target level in the next three years, so interest rates in the Eurozone are likely to remain very low for a long time. The ECB deposit rate is currently at -0.4%, resulting in negative interbank rates.

Futures contracts have softened in the Eurozone too in the past couple of months, with the markets now expecting rates to remain lower for longer. Overall, rates are seen as rising by 30bps between now and end 2020, whereas previously they had been expected to increase by close to 50bps. Markets still think a 10bps rate hike is possible by end 2019. Three month money rates are not expected to turn positive until end 2020, or get to 1% until 2024, somewhat longer than before. We would expect short-term money market rates to remain between the deposit and refi rates in the next few years, given ample market liquidity. However, the gap between the two official rates could narrow to 25bps, from 40bps at present, once rates start to be increased.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	2.375	2.80	3.04	2.66	2.58
Mar '19	2.375	2.85	3.10	2.75	2.70
Jun '19	2.625	3.00	3.25	2.90	2.85
Sept '19	2.625	3.05	3.30	3.00	2.95

** 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	-0.34	-0.17	-0.15	0.21
Mar '19	-0.40	-0.32	-0.15	-0.13	0.25
Jun '19	-0.40	-0.30	-0.13	-0.10	0.30
Sept '19	-0.40	-0.28	-0.10	-0.05	0.40

** 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	0.90	1.18	1.13	1.26
Mar '19	0.75	0.92	1.20	1.20	1.35
Jun '19	0.75	0.95	1.25	1.25	1.40
Sept '19	1.00	1.15	1.45	1.45	1.60

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Strong dollar loses some momentum as peak in Fed rates approaches

The US dollar remains at high levels against a broad range of currencies. After losing ground in 2017 and early 2018, the dollar recovered strongly from last spring. This saw the EUR/USD rate fall back appreciably from a high of $1.25 in early 2018 to largely trade in a $1.13-1.15 range over the final quarter of the year. Meanwhile, cable declined from above $1.40 to below $1.30. The yen has been the only major currency that has been able to hold its ground against the dollar, benefitting from safe-haven flows in volatile financial markets.

The dollar was aided by continuing strong US economic data last year, at a time when other economies were slowing. Meanwhile, the unemployment rate fell to below 4%, its lowest level since 1969. Widening interest rate differentials and bond spreads also helped the currency as the Fed continued to steadily tighten policy, raising the fed funds rates by 100bps in total to a 2.25-2.5% range during 2018.

Rising risk aversion in financial markets was also supportive of the highly liquid US currency last year. Escalating tensions over global trade, difficulties in emerging markets and geopolitical concerns all sparked flights-to-quality in to 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. All these factors saw an unwinding of the extreme short positions built up against the dollar in late 2017 and early 2018, propelling the currency higher.

However, the US currency has found it difficult to make further gains since the autumn. This may be partly due to the fact that FX positioning turned very 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 dollar is some 20% higher on a trade-weighted basis than during most of the 2006-2014 period. The US economy is also expected to slow in the coming year, while the Fed is adopting a cautious tone in regard to further rate increases. Indeed, the market has come to the view that US rates have peaked and the next move by the Fed could be a rate cut.

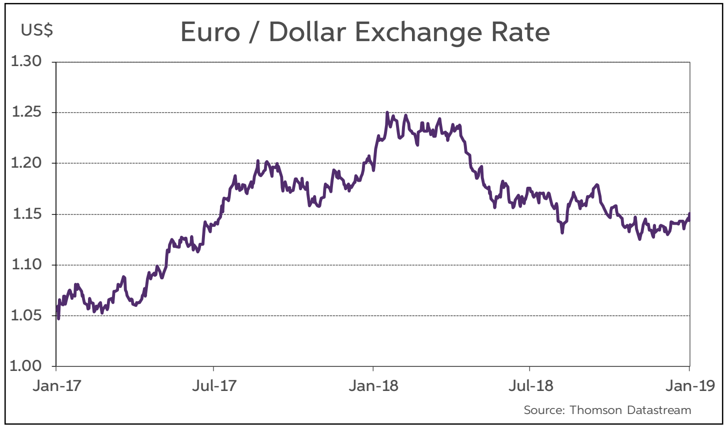
The relative strength of the US economy, risk averse financial markets, wide interest rate differentials and geopolitical uncertainties all remain supportive of the US currency. We also think that US rates may be increased somewhat further in 2019. Meanwhile, political uncertainty in the EU, a general rise in euro-scepticism, the slowdown in the Eurozone economy and continuing very low ECB interest rates are all headwinds for the single currency. However, there has been strong support for the euro against the dollar at the $1.13 level in recent months, while it has risen above $1.15 in early 2019 on the view that we are near to the peak in Fed rates.

Overall, we think the dollar could lose some ground this year, while still remaining at a relatively high level. Rising US twin deficits (fiscal and BoP) could start to weigh on the currency. The marked jump in the repatriation of funds following the cuts in US corporate taxes earlier last year is likely to abate, lessening demand for the currency. The US economy is set to slow in 2019, indicating that we should be close to the peak in US rates. A US -China trade deal is also expected to be agreed in the spring, which should improve risk appetite in markets. Meanwhile, there should be potential for the euro to rise over the medium term as the ECB begins to hike interest rates. The euro has made some modest ground against the dollar in the past week, but large gains seems unlikely in the near term. Overall, EUR-USD could rise to around the $1.20 level by end 2019, especially if an ECB rate hike is at hand and the Fed is at, or nearing, the end of its rate tightening cycle.

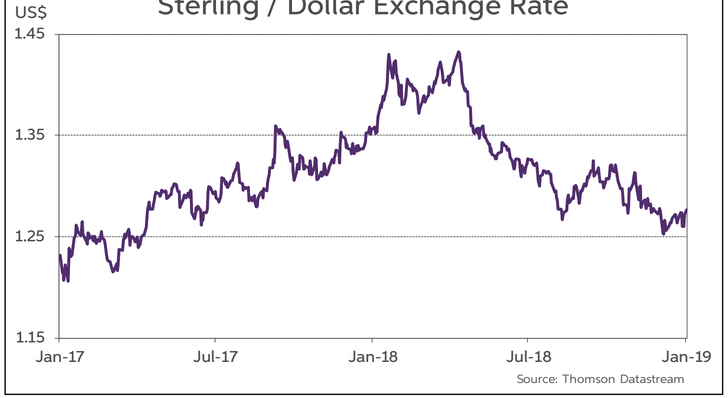
US Dollar Trade Weighted Index Versus Majors

(March 1973 =100)

Euro / Dollar Exchange Rate



Sterling / Dollar Exchange Rate



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Forex Market Outlook

Market expects that a hard Brexit will be avoided somehow in March

Sterling fell sharply in the aftermath of the Brexit referendum vote in mid-2016. The currency hit 30-year lows against the dollar, falling from $1.50 before the vote to as low as $1.20 in late 2016. The Brexit vote also saw sterling lose significant ground against the euro, with EUR/GBP rising sharply from the 70p level near the end of 2015 to around 93p by August 2017.

Sterling has managed to move off these lows. It has largely traded in an 87-91p range against the euro since September 2017, as markets await clarity on what shape Brexit will take. 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 last year, declining to below the $1.30 level in Q4 2018.

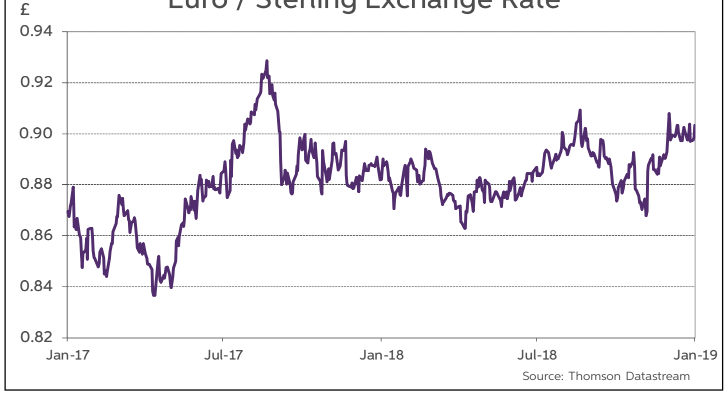
The UK and EU concluded a Withdrawal Agreement last November that would allow for a soft Brexit, as it includes a transition period to last until at least end 2020. This would keep the current trading arrangements in place over this time. However, it is proving very difficult for Theresa May to get the Withdrawal Agreement through Parliament, with strong opposition to the deal from sections of her own party, as well the DUP. Indeed, the vote on the Withdrawal Bill that was due to take place in December had to be postponed because of the lack of support for it in the House of Commons. Parliament is due to vote on the Bill again in mid-January, but the expectation is that it will be defeated. What happens after that is unclear.

There is a real risk that we could be entering a parliamentary logjam in the UK, whereby no Brexit option - Withdrawal Agreement, No-Deal or Remain- can command majority support. Two options would seem to arise in this event: request the EU to push out the date for Brexit by a number of months and/or go back to the people for another referendum on the issue. This would take up to 6 months. A general election is also another possibility.

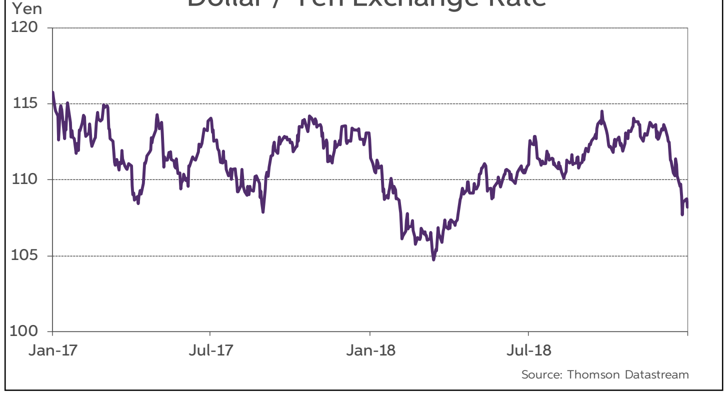
Sterling has remained very stable against the euro in recent months despite the mounting uncertainty over Brexit. The market seems to be of the view that some way will be found to avert a hard Brexit at the end of March. However, a hard Brexit is the default position in the event that the stalemate persists. The UK would thus leave the EU without a deal. If fears start to grow that a no-deal hard Brexit is increasingly likely, then sterling will come under pressure. EUR/GBP is likely to rise to the 93p level that it hit in summer 2017. It could reach the 95p mark that was last seen during the financial crises back in 2009. EUR/GBP may even hit parity if the UK crashes out of the EU with no deal in a very disorderly, chaotic Brexit. This would represent a fall of over 10% from current levels. It is worth noting that the BoE has said the currency could fall by as much as 25% in such circumstances.

On the other hand, even if the Withdrawal Agreement is ratified by the UK Parliament, it will still not be clear for a number of years what is going to be the long term EU-UK trading relationship. Uncertainty will persist and further difficult negotiations with the EU on trade will lie ahead for the UK. As a result, the upside for sterling may be limited in this situation, with EUR/GBP moving down to around 85-86p. The most positive scenario for sterling may well be another referendum. If the UK voted to remain, then the euro could fall back towards 80p versus sterling. Obviously, another vote to leave would see sterling fall sharply. Our base remains that given the majority of MPs in Parliament are pro-EU, they will act to avoid a hard Brexit in March. However, there is still considerable uncertainty about the final outcome of Brexit, so large moves by sterling in either direction are possible this year.

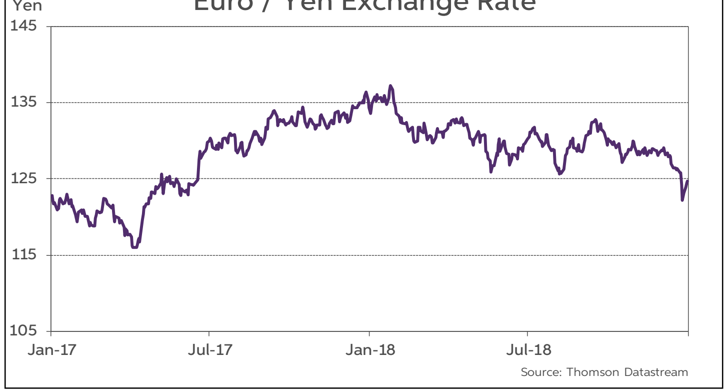
Euro / Sterling Exchange Rate



Dollar / Yen Exchange Rate



Euro / Yen Exchange Rate

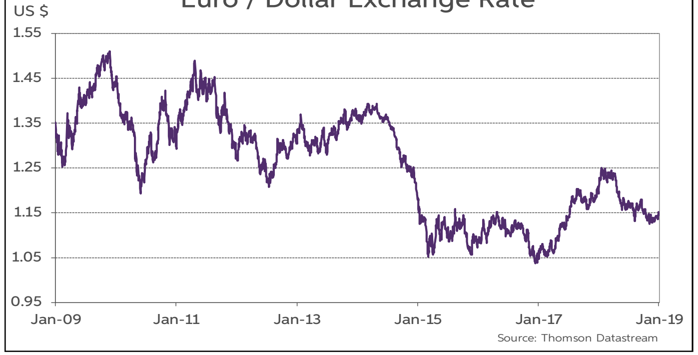


Summary of Exchange Rate Forecasts

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

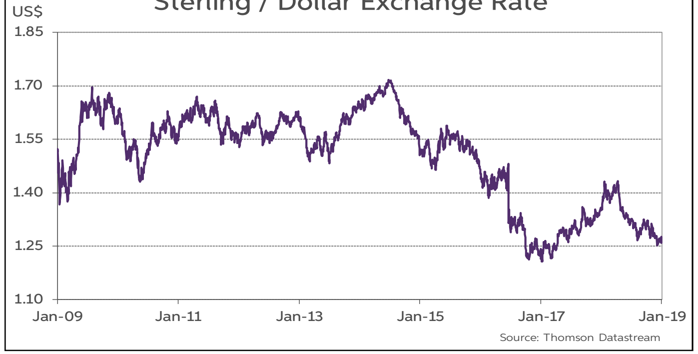
	Current	Q1-2019	Q2-2019	Q3-2019	Q4-2019
Euro Versus					
USD	1.152	1.13-1.19	1.14-1.20	1.15-1.21	1.16-1.22
GBP	0.903	0.85-0.91	0.84-0.90	0.83-0.89	0.83-0.89
JPY	124.61	123-129	125-131	126-132	127-133
CHF	1.12	1.13	1.14	1.15	1.16
US Dollar Versus					
JPY	108.19	106-112	106-112	106-112	106-112
GBP	1.275	1.29-1.35	1.31-1.37	1.34-1.40	1.35-1.41
CAD	1.32	1.31	1.29	1.28	1.27
AUD	0.72	0.73	0.74	0.75	0.76
NZD	0.68	0.69	0.70	0.71	0.72
CNY	6.79	6.75	6.70	6.65	6.60
Sterling Versus					
JPY	138	144	146	149	150
CAD	1.69	1.73	1.73	1.76	1.76
AUD	1.78	1.81	1.81	1.83	1.82
NZD	1.88	1.91	1.91	1.93	1.92

Euro / Dollar Exchange Rate



Euro / Sterling Exchange Rate

Sterling / Dollar Exchange Rate



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