Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

16th January 2020

- Some signs from recent survey data that activity may be stabilising after weakening during 2019. However, global growth is still expected to remain subdued in 2020
- Fed policy now on hold after US rates cut by 75bps in H2 2019. Markets expect one further rate cut. ECB also now on hold after loosening policy last autumn. Further easing not anticipated
- BoE expected to cut rates by 25bps given weak economic data, possibly as early as end January
- Dollar stable at high level, with very low interest rates elsewhere hampering other currencies
- Sterling loses some ground recently on rate cut speculation. EU-UK trade talks in 2020 likely to prove difficult and fractious, thus weighing on the pound

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Global Economic Outlook

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

The OECD in its latest World Economic Outlook put 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 IMF believes the main reason for the weakening of the global economy has been a 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 slowdown has occurred at a time of heightened policy uncertainty, especially in relation to global trade, with tariffs being increased on some goods.

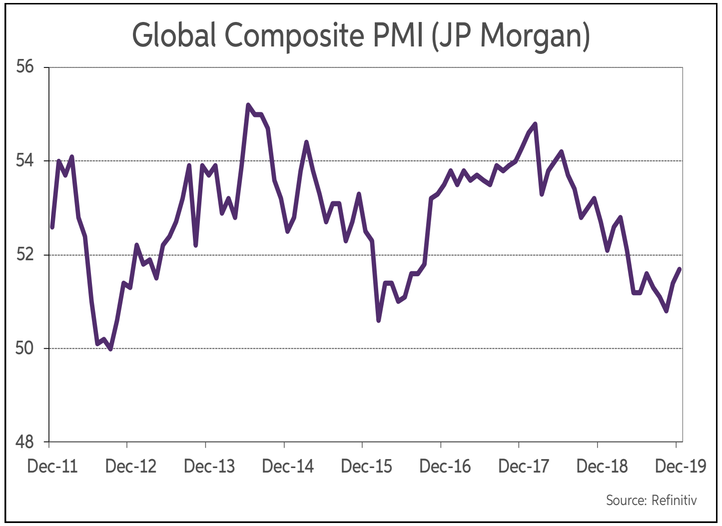
The OECD says the global economic outlook is fragile, with downside risks intensifying amidst policy uncertainty, weakening business sentiment and stagnant world trade. It warns about the prospect of the world economy becoming stuck with low levels of growth, inflation and interest rates. The OECD does not foresee a pick-up in activity in 2020 or 2021, with global growth remaining subdued at 3% or slightly below.

Furthermore, both the IMF and OECD see the risks to the economic outlook as being tilted to the downside. A real concern is that the weakness in manufacturing may spill over into the services sector, which also lost momentum last year. It could also 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.

The global slowdown, though, saw monetary policy turn more accommodative globally in 2019, with numerous central banks cutting rates. In addition, the sharp fall in bond yields last year represented a significant easing in monetary conditions. Indeed, there was a marked improvement in financial market conditions generally in 2019. All these developments are positive for global growth. Meantime, household spending power is being boosted by good wage growth at a time of continuing subdued inflation. Fiscal policy is also turning somewhat looser in some countries, although not to the extent being called for by the OECD, IMF, ECB and others. The easing of US-China trade tensions recently is also a positive development for global growth prospects in 2020.

In this regard, there have been signs of an improvement in leading activity indicators in recent months. The global manufacturing PMI moved marginally above the key 50 level in the last two months of 2019, having spent the previous seven months below it, in contraction territory. Meanwhile, the global services PMI rose to 52.1 in December, its highest level in five months. The Global Composite Output index, which covers both the manufacturing and services sectors, reached an eight month high of 51.7 in December. Other survey indicators, such as the German Ifo and EC Eurozone Economic Sentiment Index, also improved in the final months of 2019, while remaining at subdued levels.

Nonetheless, major concerns persist about the prospects for global growth. The new export orders component of the Global Composite PMI continues to contract, indicating ongoing weakness in international trade. Overall, activity would appear to be stabilising at low levels rather than recovering. Thus, 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 and activity strengthens somewhat in the year ahead.



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

BoE expected to cut rates soon, while other main central banks are back on hold

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 three 25bps Fed rate cuts in 2019 have taken the key funds rate down to a 1.5-1.75% range. The Fed has indicated that it believes the easing of policy to date should be sufficient to keep the economy on a stable growth path in 2020. The economy is growing at a steady rate of around 2%, while the unemployment rate has fallen to a 50 year low of 3.5%. The easing of US-China trade tensions is also seen as positive for growth.

Interestingly, in their recent 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. Fed Chair Powell has said as much, stating that it would require a material change to the Fed's economic outlook for the FOMC to alter policy. The Fed is also likely to be reluctant to move rates as we get close to the November elections. The markets, though, are pricing in a further 25bps rate cut for the second half of this year, suggesting they expect the economy to lose further momentum during 2020.

In the UK, the BoE continues to voice concerns about the negative impact that Brexit is having on the economy at a time of a marked slowdown in global growth. The economy finished the year on a weak note, with GDP contracting by 0.3% in November and PMI data remaining downbeat in December. Two of the nine MPC members voted for a rate cut at the November and December meetings, and a third member has now indicated that he could do so at the next policy meeting at end January. Meanwhile, the outgoing BoE Governor, Mark Carney, stated recently that if data remain weak, it could require a "relatively prompt response" from the bank.

Difficult trade talks between the UK and EU lie ahead in 2020, which could well act as a significant headwind for the economy this year. Thus, while there could be a short-term bounce for the economy from the UK's smooth exit from the EU at end January, the ending of political stalemate with the Conservative's decisive win in the December election and a move to a more expansionary fiscal policy, it may not last. Hence, markets think that the BoE will cut rates in the coming months, and quite possibly at the end January MPC meeting. In this regard, if the survey data for January remain weak, then a rate cut at the upcoming MPC meeting would seem likely.

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 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.

However, the minutes of the September meeting showed significant opposition on the Governing Council to the easing package. Meantime, a new ECB President has taken the helm and a major review of its monetary policy framework is now underway. Hence, markets believe that further easing is now unlikely, with policy staying on hold in 2020. Futures contracts sees rates starting to rise at end 2021, but only gradually. Markets expect that interbank rates will remain negative in the Eurozone for another four years, until the start of 2024.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.625	1.83	1.93	1.62	1.61
Mar '20	1.625	1.85	1.95	1.65	1.65
June'20	1.625	1.90	2.00	1.70	1.70
Sept'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	-0.42	-0.27	-0.30	-0.16
Mar '20	-0.50	-0.42	-0.26	-0.28	-0.15
June'20	-0.50	-0.41	-0.25	-0.27	-0.10
Sept'20	-0.50	-0.40	-0.25	-0.25	-0.05

** 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	0.72	0.82	0.65	0.70
Mar '20	0.50	0.60	0.75	0.65	0.70
June'20	0.50	0.60	0.75	0.65	0.70
Sept'20	0.50	0.60	0.75	0.65	0.70

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Euro-dollar rate likely to remain quite range bound in 2020

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%.

FX positioning, though, became quite long the dollar last year, which limited the potential for further gains by the greenback, especially as it had already reached quite high levels against many currencies. Some other factors have turned less favourable for the dollar in 2019. The US economy moved on to a slower growth path, with GDP growing at a moderate 2% rate since last spring. The Fed also lowered rates by 75bps in H2 2019. Improved risk appetite in markets in the second half of the year, helped by signs of progress in US-China trade talks, also lessened the appeal of safe-haven currencies like the dollar.

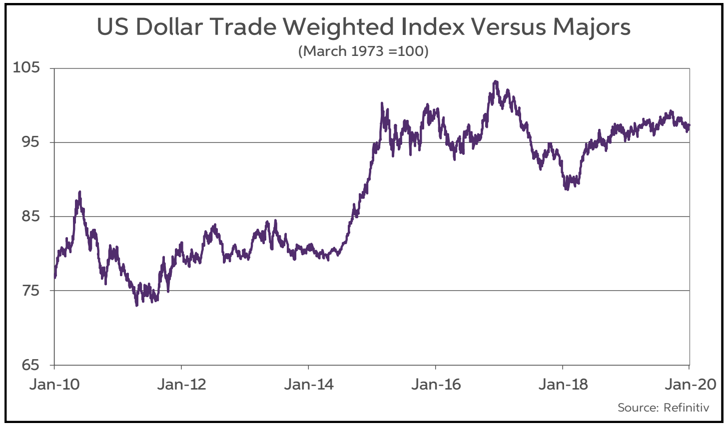
All this saw the dollar confined to a very narrow range on a trade-weighed basis in 2019, especially in the second half of the year. Most notably, the euro-dollar rate was confined to its narrowest trading range during a year in 2019 since the inception of the single currency in 1999. The currency pair traded within just a six cent corridor of $1.09-1.15 for the whole of 2019, but with an underlying trend of the dollar edging higher for most of the year. The euro moved within a $1.12-1.15 band in H1 and $1.09-1.12 in H2 2019. This was despite a slowdown in growth last year, especially in the Eurozone, and the shift to monetary easing by both the Fed and ECB.

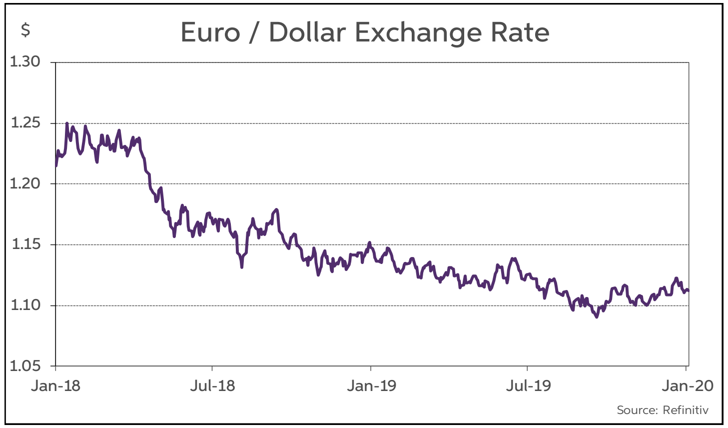
There is little sign of the currency pair moving out of its narrow 2019 trading band anytime soon. Indeed, the euro-dollar rate has been confined to a very tight two cent range of $1.10-1.12 over the past three months. However, the underlying trend is now of a slow move upwards by the euro from its 2019 low point of $1.09, hit at end September. Thus, the tide would seem to have turned somewhat in favour of the euro.

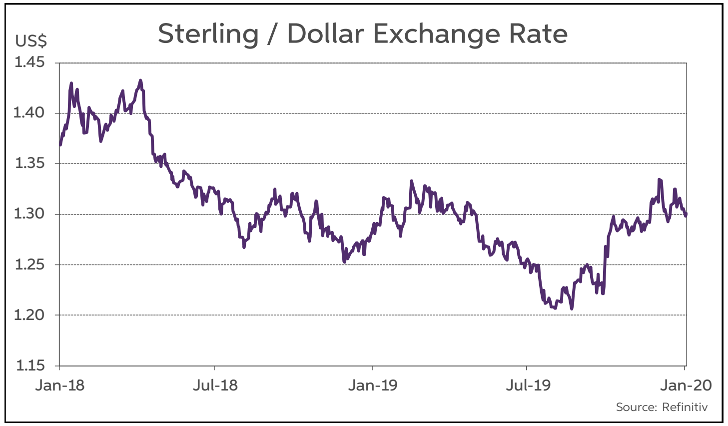
Nonetheless, the relative strength of the US economy and still wide interest rate differentials remain supportive of the dollar. The persistence of negative interest rates in the Eurozone also makes it difficult for the euro to make ground against other currencies. The ECB deposit rate now stands at –0.5%, while euro swap rates are negative out to seven years along the curve. It is worth noting that the EUR/USD rate has spent very little time above the $1.20 level ever since the ECB's move to negative interest rates in 2014.

It is expected that money market rates will remain negative in the Eurozone until the middle of this decade, thereby continuing to act as a 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. It is only in the case of such large US rate cuts that the euro-dollar rate seems likely to rise back above the $1.20 level on a sustained basis, as Eurozone rates are expected to remain in negative territory over the next few years and thus not rise towards US levels.

Nonetheless, given that it is still at low levels, the euro may be able to continue to eke out modest gains against the dollar in the year ahead. The $1.15 level, though, will be a major obstacle for it to overcome, with stiff resistance also at around $1.17-1.18. Thus, any gains are likely to be modest, with the euro-dollar rate staying quite range bound and trading likely to be confined to a $1.10-1.15 corridor in H1 2020.







2020 to prove another volatile year for sterling

Sterling had a very volatile year in 2019, rising and falling in response to the ebb and flow of news on Brexit. It rallied in the early part of last year on hopes for a smooth Brexit, but then lost considerable ground over the summer on the growing risk that there could be a no-deal hard Brexit. The currency then 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, paving 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 fell to as low as 83p, but sterling's post-election gains were not sustained, with EUR/STG moving back up to 85p. Growing expectations that the BoE could soon cut rates saw sterling weaken further in early 2020, with the euro moving up towards the 86p level.

The UK's departure from the EU at end January will not mean that Brexit is done. The trade talks that follow during the 2020 transition period will be very important in shaping Brexit. These are likely to prove very difficult and fractious. The UK has already ruled out an extension to the transition period beyond end 2020, even though the EU believes that more time will be needed to negotiate a comprehensive trade deal.

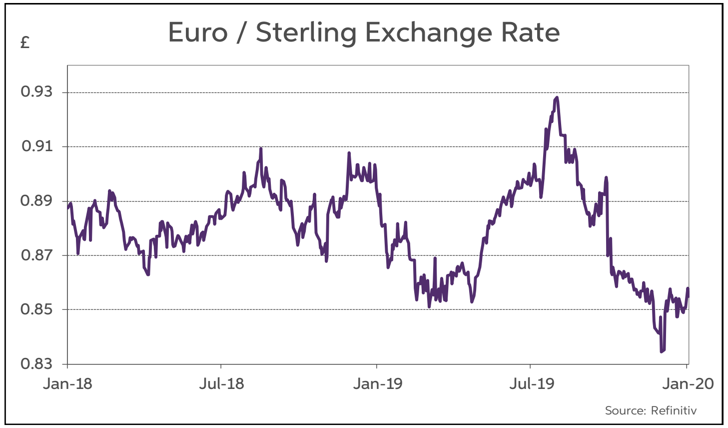
There is much uncertainty about what the future trade relationship between the UK and EU will look like. The more the new UK government wants to "take back control" so that Britain can have its own regulatory regime, the more limited will be any trade deal. The EU has been very clear that it will insist 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.

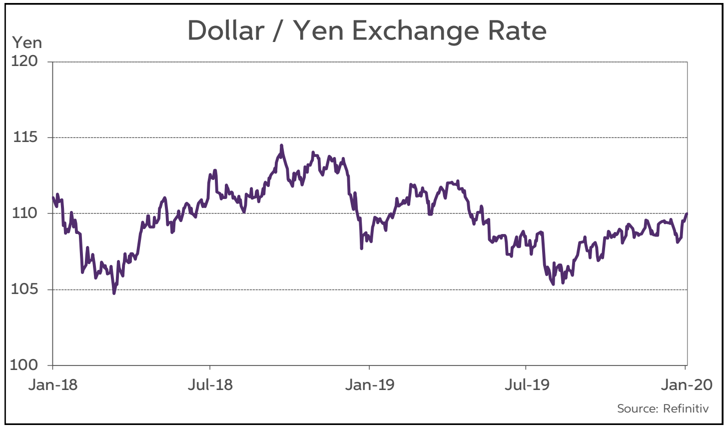
This may be a bridge too far for the new, Brexit supportive Conservative government. It may thus be prepared to fall back on WTO rules at the end of the transition period, rather than sign up for a trade deal that requires the UK to closely follow the rules of the Single Market in return for preferential access to EU markets. This would be very much a hard Brexit and be negative for sterling and the UK economy.

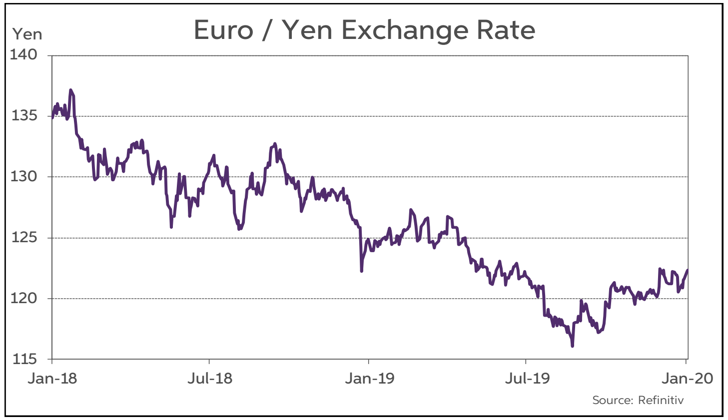
Overall then, we expect downward pressure to re-emerge on sterling this year given that the trade negotiations are likely to prove difficult, with a very uncertain outcome. We would not be surprised to see the 90p level revisited against the euro, especially if we are heading for another cliff-edge Brexit date at end year, amid growing fears that there could be no trade deal agreed, as well as no extension to the transition period.

Yen likely to remain range bound vs dollar

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 traded in a ¥105-114 range since early 2017. ¥105-106 is a good support level for the dollar that is likely to continue to be difficult for the yen to overcome, unless the US economy loses considerable momentum, requiring further large Fed rate cuts. Changes in risk appetite remains an influence on the yen within its trading range against the dollar. Dollar/yen has risen from ¥105 to ¥110 since August on improving risk appetite in markets. We expect the yen to remain quite range bound against the dollar in 2020. .







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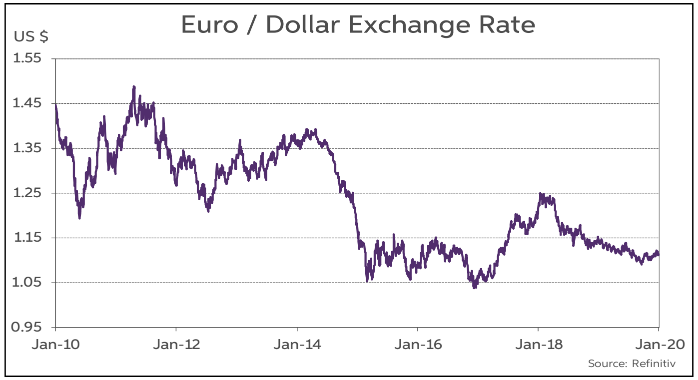
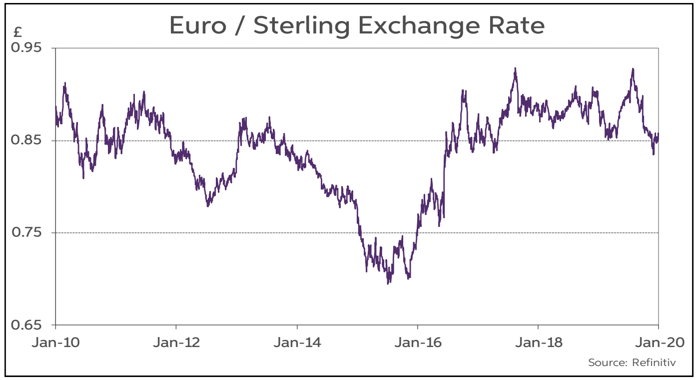
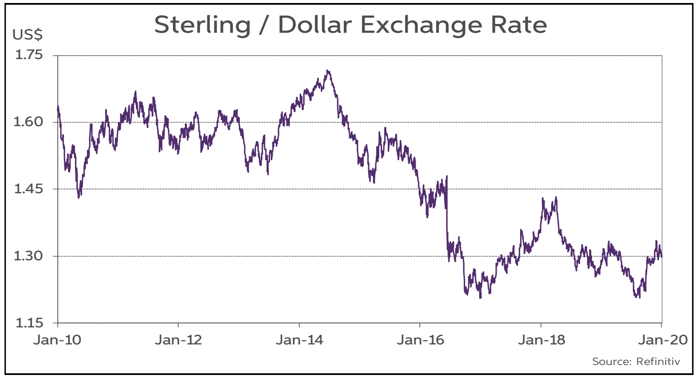
Summary of Exchange Rate Forecasts

("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	1.116	1.09-1.15	1.10-1.16	1.11-1.17	1.11-1.17
GBP	0.855	0.83-0.89	0.84-0.90	0.86-0.92	0.86-0.92
JPY	122.72	120-126	121-127	122-128	122-128
CHF	1.07	1.07	1.07	1.07	1.07
US Dollar Versus					
JPY	109.98	107-113	107-113	107-113	107-113
GBP	1.306	1.27-1.33	1.27-1.33	1.25-1.31	1.25-1.31
CAD	1.30	1.30	1.29	1.28	1.28
AUD	0.69	0.69	0.70	0.71	0.71
NZD	0.67	0.67	0.68	0.69	0.69
CNY	6.87	6.85	6.80	6.75	6.75
Sterling Versus					
JPY	144	143	143	141	141
CAD	1.70	1.69	1.68	1.64	1.64
AUD	1.89	1.88	1.86	1.80	1.80
NZD	1.96	1.94	1.91	1.86	1.86







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