Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Global economy appears to be slowing again after unexpected pick-up in activity in Q1
- Central banks increasingly concerned about global growth prospects. Some start to cut rates
- Markets expect the Fed to deliver a number of rate cuts over the next year. ECB turns increasingly dovish and indicates it could start to loosen policy soon. BoE refrains from tightening policy
- Forex markets generally quite range bound in past year despite big moves in financial markets. Dollar, though, edges lower recently on signs that Fed is prepared to cut rates
- Sterling loses ground on growing risk of a no-deal Brexit under a new Eurosceptic PM. However, it is still within its trading range of last two years against the euro

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Global growth expected to remain moderate at best

GDP data for the first quarter of the year showed an unexpected pick-up in the pace of growth everywhere, with some quite strong performances, most notably in the US where output grew by 0.8% (3.1% annualised) and the Eurozone and UK where GDP increased by 0.4% and 0.5%, respectively. GDP data from China were also better than expected, with Japan seeing good growth too.

However, there were also some warning signs in the GDP reports for the first quarter. The stronger than expected growth was in part due to a build-up of unsold inventories. These are expected to have been run down in the second quarter, with both the Federal Reserve and Bank of England warning that this is likely to see growth slow again. Lead indicators of activity continue to weaken, especially in the manufacturing sector. The JP Morgan Global Composite PMI fell to a near three-year low in May. Output growth in the services sector was the weakest since August 2016. Meanwhile, manufacturing is close to stagnation, impacted by rising global trade tensions at a time of a sharp slowdown in international trade.

The OECD is forecasting that global growth will slow to a below trend 3.2% this year from 3.5% in 2018 and 3.7% in 2017. The slowdown in activity is widespread. GDP growth in developed economies is forecast at just 1.8% both this year and next. However, with many economies very near to full employment, this is close to their trend rate. Growth in the US economy, in particular, is expected to lose momentum as the fiscal stimulus there fades.

Both the OECD and IMF see the risks to the economic outlook as still tilted to the downside. Debt levels remain high in many countries, leaving them particularly vulnerable to shocks. We have already seen countries with high debt levels, such as Turkey and Argentina, enter recession. Meanwhile, concerns remain about the health of the Chinese economy, which could slow more sharply than expected. The further escalation in global trade tensions recently is unwelcome given the slowdown in international trade and adds to the current heightened policy uncertainty. A sharp correction in financial markets is a risk in this uncertain environment.

However, the general expectation is that despite the numerous downside risks, the global economy will be able to register moderate growth and avoid a severe downturn in activity. Monetary policy will remain accommodative everywhere, with some central banks already cutting rates and others expected to follow suit. Indeed, the sharp fall in bond yields since last autumn represents a significant easing in monetary conditions globally, while there has been a marked improvement in financial conditions generally this year, which should support growth. Fiscal policy also remains supportive of growth in most economies. Meantime, household spending power is being boosted by a pick-up in wage growth at a time of continuing subdued inflation. Labour markets are strong in most countries, with unemployment at multi-decade lows.

Considerable uncertainty, though, persists about the prospects for the global economy so a careful eye will need to be kept on the incoming data, especially business surveys. It would be especially encouraging to see an improvement in manufacturing activity. An easing in global trade tensions, in particular a resolution of the US-China trade war, would be a positive development for the sector and improve the growth prospects for the world economy. On the other hand, it would be a real worry if the services sectors of economies continued to lose momentum, or we started to see signs of weakness appear in labour markets in the coming months.

Global Composite PMI (JP Morgan)

Source: Refinitiv

GDP (Vol % Change)

	2017	2018	2019 (f)	2020 (f)
World	3.7	3.5	3.2	3.4
Advanced Economies	2.6	2.3	1.8	1.8
US	2.2	2.9	2.8	2.3
Eurozone	2.5	1.8	1.2	1.4
UK	1.8	1.4	1.2	1.0
Japan	1.9	0.8	0.7	0.6
Emerging Economies	4.6	4.5	4.3	4.6
China	6.8	6.6	6.2	6.0
India	7.2	7.0	7.2	7.4
World Trade Growth (%)	5.5	3.9	2.1	3.1
Advanced Economies Inflation (PCE %)	2.0	2.3	2.0	2.3

Source: OECD Economic Outlook, May 2019

Interest Rate Outlook

Central banks moving onto policy easing path

Central banks have put monetary policy easing back on the agenda as concerns mount about the growth prospects for the world economy. The persistence of very subdued inflation and falling inflationary expectations is also concerning central banks, especially the ECB. Action has already been taken by some central banks, with both the Reserve Bank of Australia and Bank of India starting to cut rates. This represents quite a turnaround in sentiment from last autumn, when policy tightening was expected from central banks over the course of 2019-20.

Markets are now pricing in a series of rate cuts from the US Federal Reserve in the coming 12 months, with futures contracts looking for 100bps in easing. The Fed opened the door for rate cuts at its June FOMC meeting, saying that it will "closely monitor incoming information" and will "act as appropriate to sustain the expansion".

Indeed, the decision to leave policy unchanged at the June meeting was not unanimous, with one member voting for a 25bps rate cut. Another non-voting member of the FOMC has called for an immediate 50bps rate cut. The updated interest rate guidance also shows a dovish shift from the Fed. While the median projection for end 2019 remained unchanged at 2.375%, 8 of the 17 FOMC participants are now expecting a rate cut by year end. It also changed its guidance for 2020, with the Fed replacing its previous 25bps rate hike with a 25bps rate cut.

Thus, the market is expecting a much more aggressive pace of policy easing than the Fed is currently guiding. The Fed has been careful not to box itself in regarding its policy outlook. This is because it remains uncertain as to whether significant rate cuts will be required given the still solid macro fundamentals in the economy. Overall, though, it appears that the Fed is moving towards a pre-emptive rate cut in the months ahead. However, for it to move to substantial rate cuts more in line with market expectations, it would require a significant deterioration in the economy and/or dislocation in financial markets.

In the UK, the BoE is no longer indicating that policy tightening will be required. At its June meeting, it noted that the downside risks for the economy had risen amid slower global growth and the increased prospect of a no deal Brexit. Indeed, the market has moved to price in a small 10bps rate cut next year in the UK and does not see a full 25bps rate hike occurring until end 2023. Brexit is likely to be a key factor influencing BoE policy in the period ahead. A no deal Brexit would bring rate cuts onto the agenda, while a smooth Brexit or a decision to remain in the EU could bring rate hikes into view next year if growth picks up in the UK and elsewhere.

Turning to the ECB, it indicated at its June Governing Council meeting that it intends to keep interest rates at their current very low levels until at least the middle of next year, as opposed to the end of 2019 previously. In a subsequent speech, though, President Draghi highlighted the growing risk that inflation would not move back up to its 2% target. Inflation is currently at 1.2% and there has been a marked decline in inflationary expectations this year. Inflation is now seen as still being around 1.2% on a five to ten year view.

Mr Draghi indicated that "additional stimulus will be required" to move inflation up towards 2% and, in the coming weeks, the ECB will look at how its policy instruments can be used in this regard. Markets now think the ECB could ease policy as early as July. Futures contracts are looking for a cut of up 15bps in the deposit rate in H2 2019. It currently stands at -0.4%. A resumption of the QE bond buying programme and an extension of forward guidance, though, would seem more likely than rate cuts, certainly in the near term.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	2.375	2.33	2.18	1.76	1.72
Sept '19	2.125	2.35	2.20	1.80	1.80
Dec '19	2.125	2.40	2.30	2.00	2.00
Mar '20	2.125	2.45	2.45	2.20	2.25

** Swap Forecasts Beyond 1 Year. Current Rates Sourced From Reuters, Forecasts AIB ERU*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	-0.40	-0.38	-0.29	-0.37	-0.21
Sept '19	-0.40	-0.36	-0.27	-0.35	-0.15
Dec '19	-0.40	-0.35	-0.25	-0.30	-0.10
Mar '20	-0.40	-0.35	-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	0.77	0.96	0.82	0.87
Sept '19	0.75	0.78	1.00	0.85	0.90
Dec '19	0.75	0.80	1.05	0.95	1.00
Mar '20	0.75	0.85	1.10	1.05	1.15

** Swap Forecasts Beyond 1 Year*

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Forex Market Outlook

Key exchange rates have been quite range bound for some time

The dollar has been at elevated levels for the past four and a half years. It has been aided by continuing strong US economic growth. Indeed, the current 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 currency, with the Fed steadily tightening policy in 2017-18, raising the fed funds rates by 200bps to a 2.25-2.5% range by the end of last year.

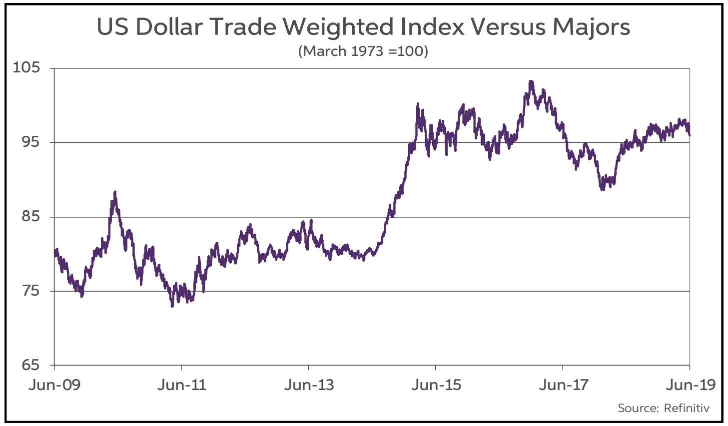
The US currency, though, has been quite range bound against the other major currencies in the past year. The EUR/USD rate has largely traded in a narrow $1.11-1.15 band since last October. Meanwhile, cable has generally traded in a $1.26-1.33 range since mid-2018. The yen has also been quite range bound against the dollar, trading in a ¥107-114 range since April 2018.

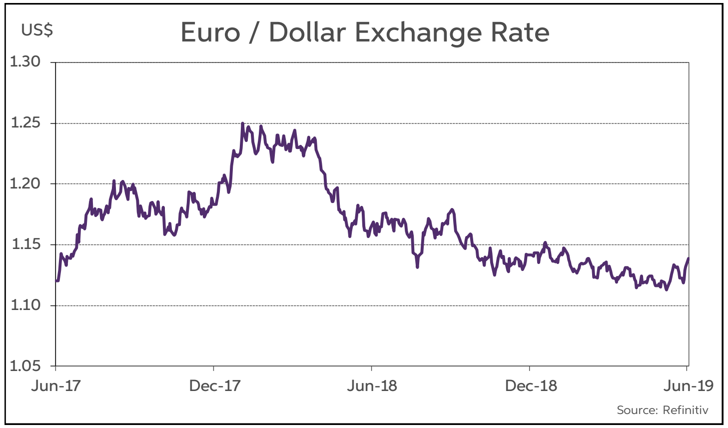
FX positioning has become extremely long the dollar, which could be a warning sign for the currency, especially as it is at quite elevated levels against a range of currencies. Other factors may also be turning against the dollar. The US economy is expected to move on to a slower growth path in the coming year, with the Fed likely to start cutting rates by the autumn, to help sustain the expansion in activity. The marked jump in the repatriation of funds following the cuts in US corporate taxes last year is also likely to abate, lessening demand for the currency. Thus, downside risks are building for the dollar, especially given the large twin US deficits (fiscal and BoP).

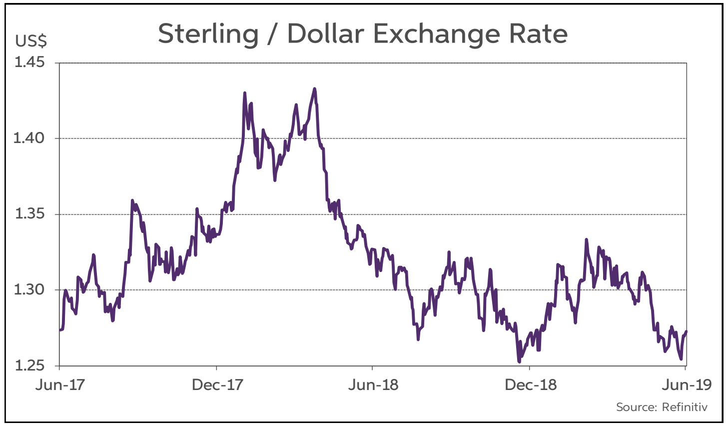
Nonetheless, the relative strength of the US economy, wide interest rate differentials and geopolitical uncertainties all remain supportive of the US currency. The persistence of very low interest rates elsewhere is also making it difficult for other currencies to make ground against the dollar. Indeed, rates have started to be cut in some countries recently, with the ECB also hinting that it may soon move on to a loosening path. Meanwhile, political uncertainty in the EU, especially with regard to Italy, the marked slowdown in the Eurozone economy as well as the likely further policy easing by the ECB are all headwinds for the euro. Sterling remains weighed down by concerns over Brexit.

The extent of policy easing by the Fed is likely to be a major factor impacting the dollar over the balance of this year and into 2020. If the Fed delivers the 100bps of rate cuts expected by the market, it is likely to put pressure on the dollar as it would probably mean that there is a sharp slowdown in the US economy. On the other hand, modest rate cuts of 50bps or less would signal just a modest slowdown in US growth towards its trend rate. The dollar may not lose much ground in these circumstances, especially with other central banks moving on to a loosening path also. It would also mean that US rates will remain relatively high.

Our base case is just limited rate cuts in the US and thus we see the dollar losing only a small bit of ground. The euro has moved up from near $1.11 to $1.14 in the past month. It could move up towards the $1.18 level if the Fed starts to cut rates. It is worth noting that the EUR/USD rate has spent very little time above the $1.20 level since 2014 so it would probably take significant rate cuts in the US to drive the euro above this level, given the ECB is also likely to be easing policy further. Meantime, the dollar has moved down from ¥112 to ¥107 in the past couple of months. There may be scope for the yen to rise somewhat further against the dollar, especially if markets turn risk averse. However, ¥105-106 is a good support level for the dollar that may prove hard to overcome unless there are large Fed rate cuts. The dollar could fall towards ¥100 in those circumstances.







Forex Market Outlook

Sterling loses ground as risk of a no-deal Brexit rises

Sterling fell sharply to lows of 93p against the euro and $1.20 versus the dollar following the UK referendum vote to leave the EU in mid-2016. It then recovered some ground to largely trade in an 87-91p range against the euro between September 2017 and end 2018, as markets awaited clarity on what shape Brexit would take. Growing hopes that a no-deal hard Brexit would be avoided saw the euro fall back to trade in an 85-87p range this spring, even though Brexit was delayed. Against the dollar, sterling moved back above the $1.30 level.

More recently, though, sterling has come under downward pressure again, following the announcement by Theresa May that she is to step down as Prime Minister. Her replacement is expected to prove to be a more Eurosceptic Prime Minister, inclined to take the UK out of the EU, with or without an exit deal. Thus, the market now thinks that the risk of a no-deal Brexit is rising, which has weighed on sterling over the past two months. The euro has gained over 5% against sterling, rising back up close to the 90p level, while cable fell to as low as $1.25.

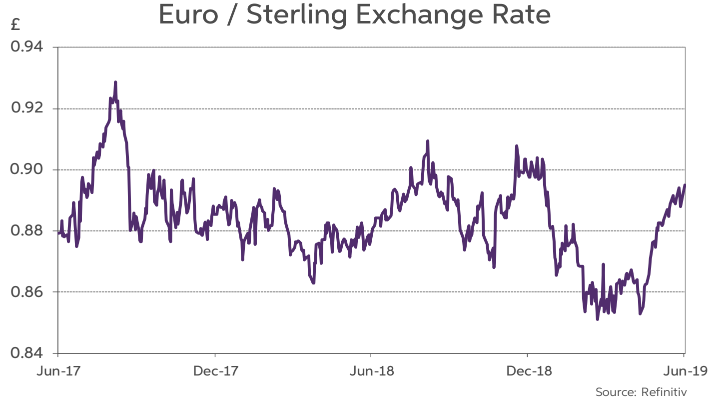
The new Prime Minster will take office towards the end of July, but any developments on Brexit are unlikely to take place until September. The UK could well be heading for another cliff-edge Brexit date at end October. A third extension to Article 50 would again require the agreement of all EU 27 member states, but there were signs at the April 10th EU summit that at least one country is becoming keen to bring a conclusion to the Brexit process. Indeed, the new UK Prime Minister may not want an extension.

The default position is that the UK would leave the EU without a deal at end October, if its Parliament continues to be unable to ratify the Withdrawal Agreement (WA) and there is not a further extension to Article 50. Parliament has indicated that it wants to avoid a no deal Brexit, but has yet to decide on alternative arrangements. It may well be that Parliament will either have to approve the WA in October or decide on another course of action to overcome the Brexit impasse, such as a fresh referendum, if a no-deal Brexit is to be avoided. The EU would almost certainly grant a further extension to Article 50 in the latter circumstances.

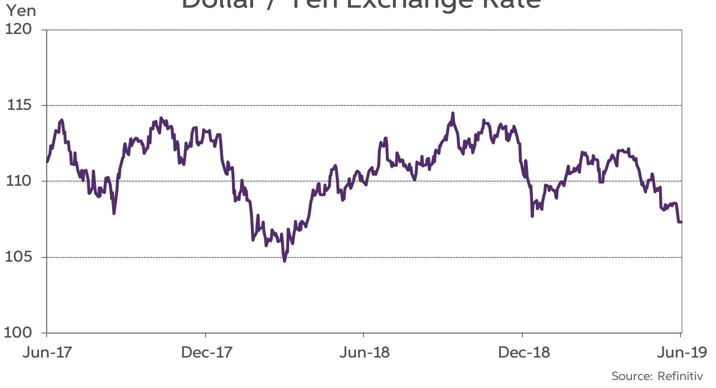
Overall, we would expect sterling to trade at close to the 90p level against the euro in the next couple of months. It is likely to rally in the autumn if it looks like the UK will eventually ratify the WA, paving the way for a soft Brexit, or it is heading for another referendum which would require a further extension to Article 50. On the other hand, sterling would come under severe pressure if a no-deal hard Brexit becomes an increasingly likely prospect, given that it would have very negative consequences for the UK economy. The currency could fall by 10-15 per cent from current levels. Overall then, considerable uncertainty persists about sterling's prospects this autumn given the ongoing lack of clarity on Brexit.

We would warn also that even if the WA is eventually ratified and the UK departs the EU with a deal, there could still be choppy waters ahead for sterling in the next couple of years. The WA provides for a transition period post Brexit. Talks will take place during this transition period on the future relationship between the UK and EU, with the aim of concluding a broad trade deal. These are likely to prove to be difficult negotiations. It is very unclear what the outcome of these talks will be, so uncertainty over the final shape of Brexit could emerge during any transition period and start to weigh on the currency. Indeed, what emerges from such talks could still look like a hard Brexit, if it sees the UK leaves the Customs Union and Single Market. This would see sterling fall.

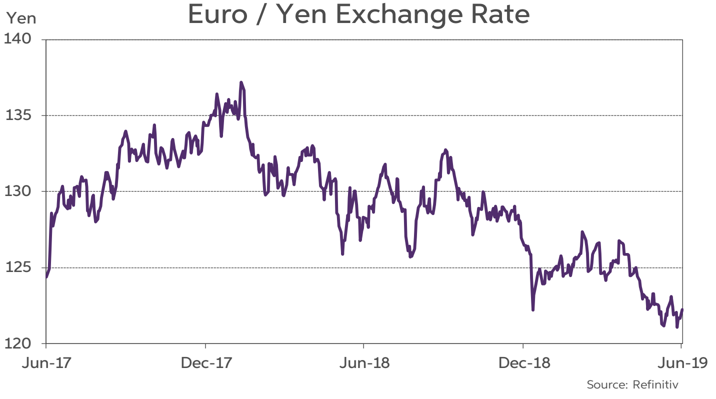
Euro / Sterling Exchange Rate



Dollar / Yen Exchange Rate



Euro / Yen Exchange Rate

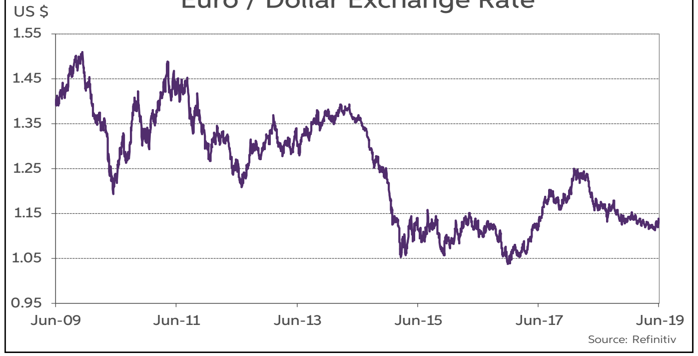


Summary of Exchange Rate Forecasts

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

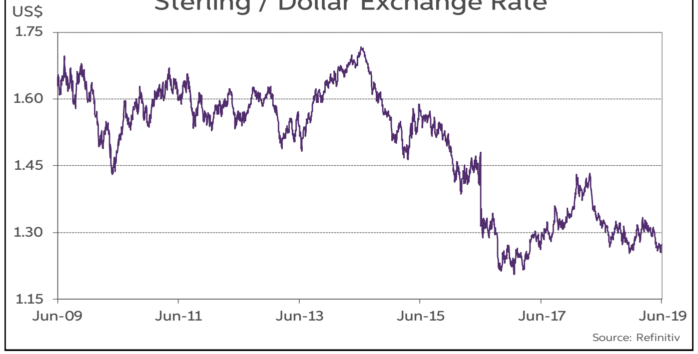
	Current	Q3-2019	Q4-2019	Q1-2020	Q2-2020
Euro Versus					
USD	1.136	1.12-1.18	1.13-1.19	1.14-1.20	1.14-1.20
GBP	0.894	0.87-0.93	0.85-0.91	0.84-0.90	0.83-0.89
JPY	122.33	119-125	119-125	120-126	121-127
CHF	1.11	1.11	1.10	1.10	1.10
US Dollar Versus					
JPY	107.68	103-109	102-108	102-108	103-109
GBP	1.271	1.25-1.31	1.29-1.35	1.32-1.38	1.33-1.39
CAD	1.32	1.31	1.30	1.29	1.28
AUD	0.70	0.71	0.72	0.73	0.73
NZD	0.67	0.68	0.69	0.70	0.70
CNY	6.87	6.85	6.80	6.75	6.70
Sterling Versus					
JPY	137	136	139	142	144
CAD	1.67	1.67	1.71	1.73	1.74
AUD	1.82	1.80	1.83	1.85	1.86
NZD	1.90	1.88	1.91	1.93	1.94

Euro / Dollar Exchange Rate



Euro / Sterling Exchange Rate

Sterling / Dollar Exchange Rate



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