Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Developed economies start to lift restrictions on activity as vaccine rollout gathers momentum, driving down new case numbers, hospitalisations and deaths from Covid-19

- Growth set to rebound strongly over the rest of year. Global growth forecasts upgraded to 5.5-6.0% for 2021, with further strong growth expected in 2022. Stokes some inflation concerns

- Futures contracts have firmed since start of year, especially in US and UK, with first hikes now expected in H2 2022. Central banks, though, say there is no need for early policy tightening

- Euro recovers some ground lost in Q1 as vaccinations, and thus activity, pick up pace in EU

- Main currency pairs could remain quite range bound, with activity strengthening everywhere and central banks keeping policy on hold, bar some tweaking of QE asset purchase programmes

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Global Economic Outlook

Global growth forecasts upgraded on vaccine rollout; inflation picks up

Growth forecasts for the global economy have been revised upwards in the past couple of months. The IMF now sees the world economy expanding by 6% this year compared to 5.5% in its previous update in January. It is projecting global growth of 4.4% for next year, up from 4.2% previously. The OECD has also upgraded its projection for global growth in 2021 from 4.2% to 5.6%, with growth in 2022 now seen at 4%.

There are three main factors behind these upgrades. First, the arrival and rollout of multiple vaccines that can reduce both the frequency and severity of infections, with strong evidence of this in countries that are well advanced in their vaccination programmes, such as the UK, US and Israel. Second, better adaptation to what the IMF calls "pandemic life" which has seen a stronger than expected global rebound since last summer, despite continuing subdued mobility and re-imposition of restrictions on activity in some countries, especially in Europe.

Third, the additional fiscal supports announced in many economies, on top of the enormous fiscal response put in place last year and the ongoing very loose stance of monetary policy, are also boosting growth prospects. This was a key factor behind last month's upgrades to the IMF's 2021 growth forecasts.

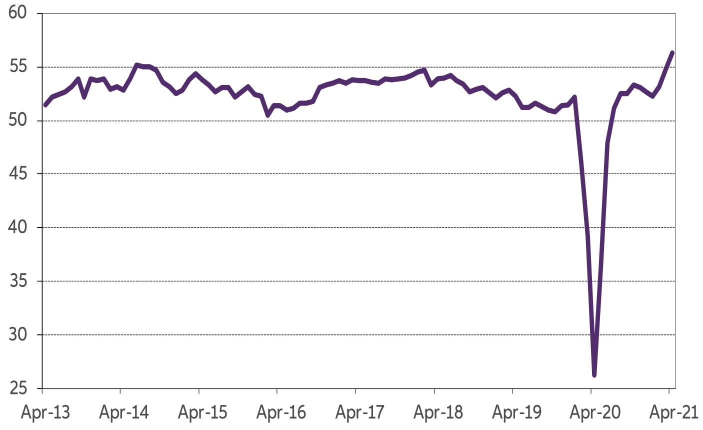
The IMF sees the risks to its forecasts as balanced in the near term, and more to the upside further out. Both the IMF and OECD say the principal risk surrounds the effectiveness of vaccines against new strains of the virus. Delays in inoculating all parts of the world may result in new vaccine-resistant virus mutations. The IMF warns that this could lead to new outbreaks starting "anywhere and anytime", necessitating the re-imposition of restrictions to slow transmission. Economic confidence is also fragile and scarring effects, such as rising business failures and bankruptcies, increasing bad debts, permanent job losses, lower labour force participation and inefficient resource allocation, could weigh on the pace of recovery as well.

On the upside, an intensified, globally coordinated vaccination effort could end the pandemic fairly quickly, and limit scarring. There may also be greater than expected longer-term positive effects on activity from the policy supports that have been put in place. It is encouraging that the IMF views the medium term risks as to the upside.

There have been other negative economic impacts from the very deep COVID-19 recession. World trade volumes are estimated by the IMF to have declined by 8.5% in 2020, though it sees them rebounding again by 8.4% in 2021 and 6.5% in 2022. We have also seen a sharp deterioration in public finances, with a big rise in budget deficits and public debt owing to government spending measures to mitigate the economic shock and declines in tax revenues. Meanwhile, although the rise in unemployment has been modest to date, it could yet move higher later in 2021 as government labour market support schemes are wound down.

Meantime, inflation fell sharply in 2020, but is already rising back up, helped by a recovery in oil prices. Markets have some concerns that the scale of economic stimulus being provided could lead to inflationary problems, with too much money chasing too few goods at a time when supply chains are stretched. There is strong upward pressure on the price of commodities, raw materials and other inputs. Income support schemes could also restrain labour supply, putting upward pressure on wages. CPI rates have jumped. Central banks, though, are confident that the rise in inflation this year will prove transitory, given the large amount of slack in economies. Indeed, the IMF sees CPI rates at 1.6% and 1.7% in advanced economies in 2021 and 2022, respectively, still quite subdued.

Global Composite PMI (JP Morgan)



Source: Refinitiv

GDP (Vol % Change)

	2019	2020	2021 (f)	2022 (f)
World	2.8	-3.3	6.0	4.4
Advanced Economies	1.6	-4.7	5.1	3.6
US	2.2	-3.5	6.4	3.5
Eurozone	1.3	-6.6	4.4	3.8
UK	1.4	-9.9	5.3	5.1
Japan	0.3	-4.8	3.3	2.5
Emerging Economies	3.6	-2.2	6.7	5.0
China	6.0	2.3	8.4	5.6
India	4.2	-8.0	12.5	6.9
World Trade Growth (%)	1.0	-8.5	8.4	6.5
Inflation -CPI				
Advanced Economies (%)	1.4	0.7	1.6	1.7

Source: IMF World Economic Outlook, April 2021

Interest Rate Outlook

Markets now looking for US and UK rates to be hiked by 25bps next year

Central banks globally pulled out all the stops last year to try and ameliorate the most severe impacts of the COVID-19 pandemic on their economies and financial systems, which were hit by a sudden and very deep recession. Interest rates were cut sharply to 0.125% and 0.1% in the US and UK, respectively. Enormous QE bond purchase programmes were put in place and measures adopted to enhance the supply of liquidity to businesses, and ease funding pressures in markets.

Central banks actions this year have been largely confined to tweaking their QE programmes. The ECB announced in March that it was increasing the pace of asset purchases to prevent a tightening of financial conditions as upward pressure emerged on bond yields. Both the Canadian and UK central banks, though, announced at their recent policy meetings that there were scaling back on the size of weekly asset purchases. Central banks, though, have been very clear in their communications that monetary policy is set to remain exceptionally loose over the next couple of years. However, despite these assurances from central banks, markets are turning their attention to when the Fed in particular may start to taper its open-ended QE bond purchase programme and, more generally, central banks start to hike rates.

Interest rate futures contracts have firmed considerably since the start of the year, with a marked hardening of rate expectations in the US and UK in particular, and a consequent sharp rise in long term bond yields. The main factor behind the expectations for higher Fed rates is the marked upgrade to US growth prospects for 2021 and 2022, thanks to the enormous Biden fiscal stimulus package, as well as the rapid rollout of vaccines.

The view in markets at the end of last year was that US interest rates would be raised very slowly, with three month rates only getting to 1% by the end of 2025. Now, markets see US rates being hiked by 25bps over the second half of next year, and reaching 1% by around end 2023 and 2% by end 2025. Not surprisingly, this has put upward pressure on bond yields, with ten year US Treasury yields climbing from 0.9% to 1.7% to date this year.

UK futures contracts have also hardened this year, with markets initially pricing out a move to negative rates. With big upward adjustments to growth forecasts, markets now see rates being hiked by 25bps over the course of 2022 and getting to 1% by mid-2025. This is a much slower pace of rate hikes than in the US. The firming in rate expectations has been much less pronounced in other markets, most notably in the Eurozone and Japan. Markets do not expect the ECB deposit rate to be increased from its current level of –0.5% until the third quarter of 2023, and then to be raised very slowly thereafter, only getting to zero per cent by mid-2025.

There is a marked divergence between some of the major central banks and the market in terms of the outlook for interest rates. The is most acute in the case of the Fed, where the majority view on the FOMC is that rates will stay on hold through to the end of 2023. Strong US data are likely over the remainder of this year given the extent of the fiscal stimulus and quite rapid roll out of vaccines, as well as the considerable momentum in the economy at the present time. Inflation has also risen sharply over the past couple of months. Thus, markets are unlikely to deviate much from their view that US rates will start to be raised during H2 2022, with more hikes to follow.

In this regard, markets will pay close attention to any signals from the Fed on when it may start to taper its open-ended QE programme. There is an expectation that the Fed may signal over the summer that tapering could begin at end 2021 or early 2022. This could be interpreted as opening the door for rate hikes later next year.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.125	0.15	0.26	0.27	0.93
June'21	0.125	0.15	0.27	0.29	0.95
Sept'21	0.125	0.16	0.28	0.30	1.00
Dec'21	0.125	0.17	0.30	0.35	1.05

** 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	-0.55	-0.49	-0.47	-0.23
June'21	-0.50	-0.55	-0.48	-0.46	-0.22
Sept'21	-0.50	-0.54	-0.47	-0.45	-0.20
Dec'21	-0.50	-0.53	-0.45	-0.40	-0.15

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.10	0.08	0.17	0.32	0.73
June'21	0.10	0.08	0.18	0.33	0.75
Sept'21	0.10	0.09	0.19	0.35	0.80
Dec'21	0.10	0.10	0.20	0.40	0.85

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Euro/Dollar could continue to range trade

The dollar appreciated very sharply in the period 2014 to 2016 and remained at elevated levels over the rest of the decade, underpinned by relatively high US interest rates. However, it moved steadily lower in the final three quarters of last year, losing 12% against the other major currencies, as US rates were cut to virtually zero. The euro was one notable beneficiary of the dollar weakness with the ECB keeping rates on hold, climbing to above $1.23 by the start of 2021 from around $1.08 early in 2020. This was only the second time that the euro has risen above $1.20 since the ECB moved to negative rates back in 2014.

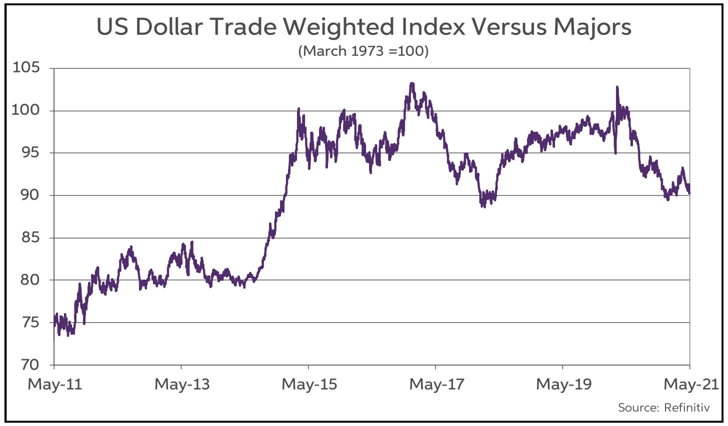
The dollar, though, recovered some ground against all the main currencies during the first quarter of this year, helped by a firming of US interest rate future contracts and associated marked rise in long term US interest rates on the back of big upgrades to US growth forecasts for 2021 and 2022. Vaccinations have also became an important influence on currency markets this year as they are a key driver of economic growth prospects and interest rate expectations. The rapid rollout of vaccines in the US during Q1 proved a positive for the dollar. This was in marked contrast to a slow rollout in the EU, which also saw fresh lockdowns, which weighed on the euro. The market was also very short the US currency at the start of 2021, which helped the dollar make gains as some of these positions were closed out.

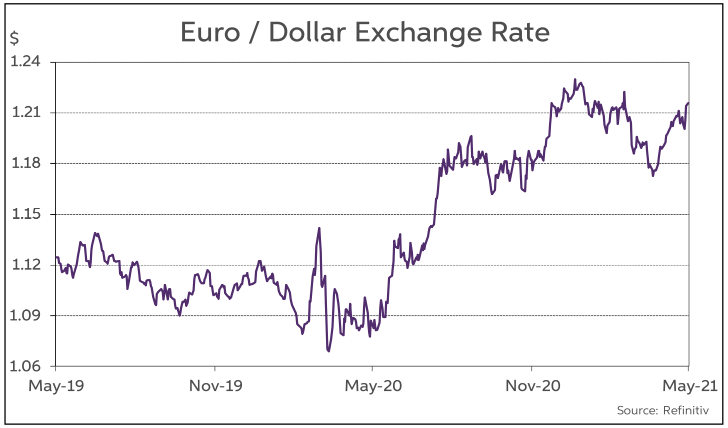
All these factors saw the euro drop back to a low of $1.17 by end March from $1.23 at the start of the year. However, the dollar has again lost ground so far in this quarter as many of the above factors reversed. The pace of vaccinations has picked up elsewhere, US bond yields have fallen back from their peak levels at end Q1, Eurozone bond yields have risen and market positioning is no longer very short the dollar. Thus, the dollar has been under some modest pressure against most currencies, with the euro climbing back up to $1.21-1.22.

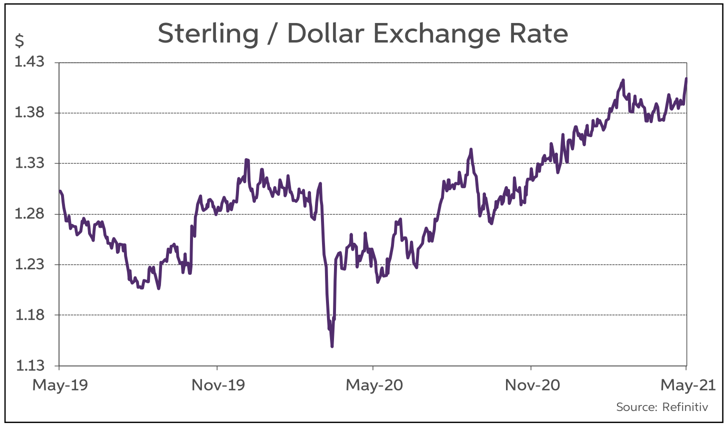
The broader picture is that the euro-dollar exchange rate has been confined to a $1.16-1.23 corridor since last July. There is very strong support for the single currency in the $1.16-1.18 range, which held in the spring when the euro came under pressure. Meanwhile, the dollar has strong support in the $1.23-25 region as the single currency has failed to rise above this level ever since the ECB moved to negative interest rates back in 2014.

Current market positioning is very much neutral on the euro and somewhat short the dollar, but not excessively so. Meanwhile, we are likely to see strong growth in both the US and the Eurozone over the second half of the year. Any changes to official interest rates are still quite a long way off, with the Fed and ECB also maintaining substantial QE asset purchase programmes in H2 2021. All this suggests that ongoing range trading may be in prospect for EUR/USD as it continues to move in a $1.17-1.23 corridor into the second half of the year.

Given that the euro has risen above $1.20 again recently, the next major hurdle for it to surmount remains $1.25, which represents the peak rate for EUR/USD over the past seven years. This is likely to remain a very challenging task, given the prospects for robust growth by the US economy. Interest rates remain an important driver of the EUR/USD rate, and it is hard to see them moving in favour of the euro anytime soon. Even over the medium term, it could prove difficult for the euro to overcome the $1.25 level, if US rates hikes materialise later next year and then continue to move steadily higher, while rates in the Eurozone are slow to increase and remain negative over the coming five years, as is currently envisaged by markets. Indeed, contrary to most expectations, the dollar could start to appreciate again in such circumstances.







Forex Market Outlook

Sterling in consolidation mode

The EU-UK trade deal that was finally agreed at the end of last year had no immediate impact on sterling as the outcome of the negotiations was largely in line with market expectations. The currency, though, appreciated steadily during the opening quarter of 2021, most notably versus the euro. This seems to be have been largely due to the rapid rollout of Covid vaccines in the UK. As a result, restrictions on activity have been eased considerably in the UK and growth forecasts for the economy in 2021 have been revised sharply higher.

This includes the Bank of England, which now sees UK GDP growth picking up to 7.25% in 2021, despite the economy being in lockdown in the opening months of the year, with further strong growth of 5.75% projected for 2022. The Bank now sees output returning to its pre-Covid levels by the end of this year, much earlier than had been initially expected.

As a result, markets have moved from, at the start of the year pricing in a move to negative interest rates, to now expecting that UK rates will start to rise over the course of next year. This has seen short-dated Gilt yields turn positive in Q1, while ten year yields have risen by 70bps since the start of the year to around 0.9%.

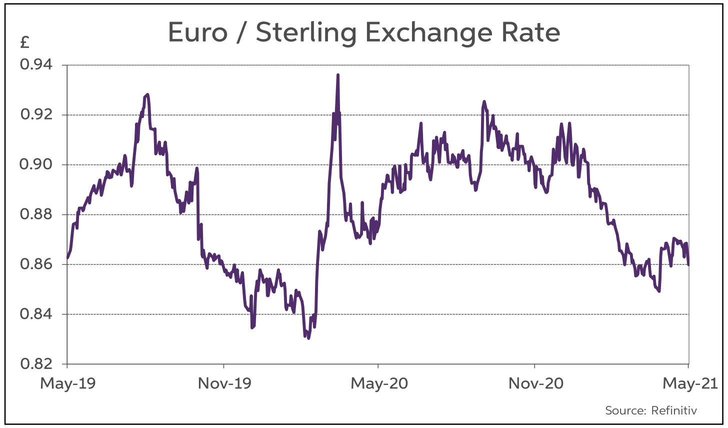
The stronger growth outlook and hardening interest rate expectations were key factors propelling sterling higher in the opening months of the year. EUR/GBP fell steadily from around 90p at the start of 2021 to the 85p level by end March. Cable climbed to a high near $1.42, before moving back down to below $1.40. The 85p level is a strong technical support point for the euro, with the single currency also helped recently by a pick up in the EU's vaccination rollout. This saw the euro rise somewhat recently, to an 86-87p range.

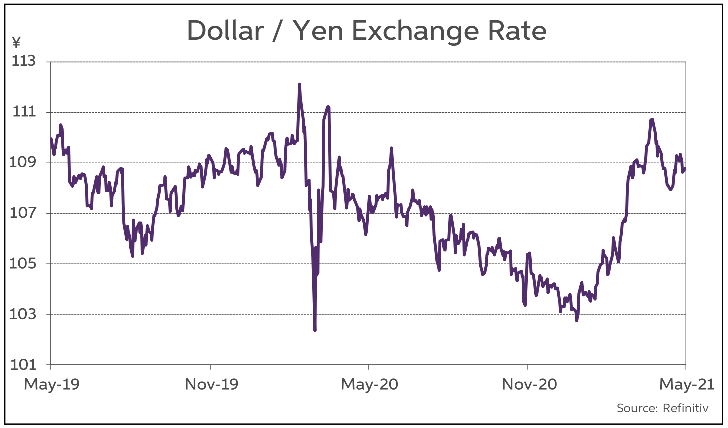
Indeed, more generally, the EUR\GBP rate has been confined to a 85-87p trading band since mid-February, while cable has moved in a $1.37-1.42 corridor, with sterling rising towards the top end of this range recently on some dollar weakness. Thus, after gaining ground earlier in the year, sterling has consolidated and entered a period of range trading. Market positioning is now quite long the currency. However, with the economy regaining considerable momentum, sterling could continue to move within its recent narrow ranges in the coming months.

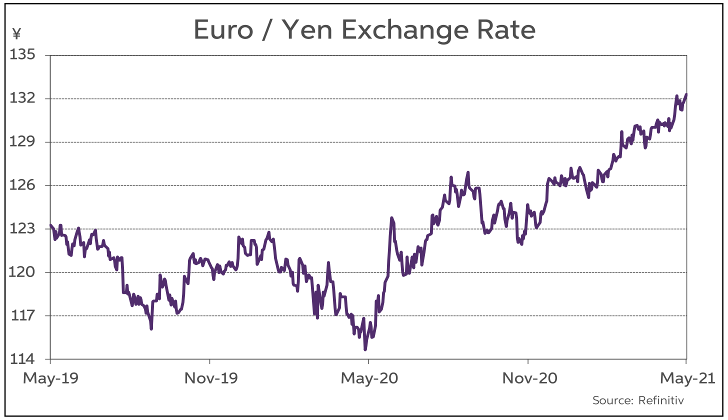
Yen weakens as yields rise elsewhere

The yen has performed strongly in recent years registering significant gains, with the dollar falling to around ¥103 by the start of 2021 from a peak of ¥125 back in 2015. Meanwhile, the euro fell from a high of ¥140 in 2015 to a trough of ¥115 in mid-2020, before recovering some ground. The yen has benefitted from its safe-haven status, a big trade surplus and large overseas holdings of foreign assets that generate flows back into the currency.

The yen, though, has lost ground to date in 2021, with the dollar climbing from ¥103 to a ¥108-111 range and the euro rising steadily from ¥126 in January to ¥132 more recently. There has been hardly any rise in long term interest rates in Japan, in marked contrast to Europe and the US, which has weighed on the yen as investors move into higher yielding currencies. Upgrades to global growth forecasts, the rollout of vaccines and improving risk appetite on markets have also lessened the safe haven appeal of the yen. Given that market positioning is now short the yen, its downside may be limited from here, but the much wider yield differentials now pertaining could limit the scope for fresh gains by the currency. Thus, range trading may now be in prospect for the yen also.





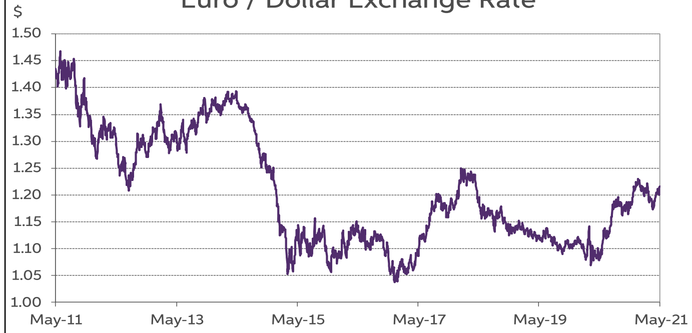


Summary of Exchange Rate Forecasts

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

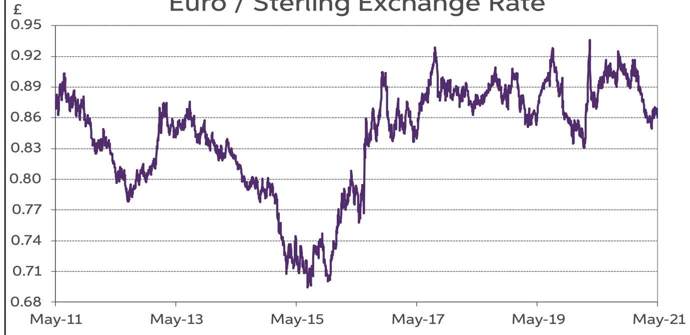
	Current	Q2-2021	Q3-2021	Q4-2021	Q1-2022
Euro Versus					
USD	1.208	1.18-1.24	1.18-1.24	1.17-1.23	1.16-1.22
GBP	0.857	0.83-0.89	0.84-0.90	0.84-0.90	0.84-0.90
JPY	132.21	129-135	129-135	128-134	127-133
CHF	1.10	1.10	1.10	1.11	1.11
US Dollar Versus					
JPY	109.47	106-112	106-112	106-112	106-112
GBP	1.410	1.38-1.44	1.36-1.42	1.35-1.41	1.34-1.40
CAD	1.21	1.21	1.20	1.21	1.21
AUD	0.77	0.77	0.78	0.78	0.79
NZD	0.72	0.72	0.73	0.73	0.74
CNY	6.46	6.45	6.40	6.40	6.35
Sterling Versus					
JPY	154	154	152	150	149
CAD	1.71	1.70	1.67	1.67	1.66
AUD	1.82	1.83	1.78	1.77	1.73
NZD	1.97	1.96	1.90	1.89	1.85

Euro / Dollar Exchange Rate



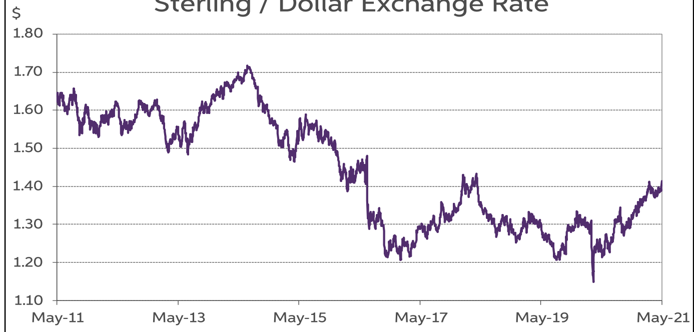
Source: Refinitiv

Euro / Sterling Exchange Rate



Source: Refinitiv

Sterling / Dollar Exchange Rate



Source: Refinitiv

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