

Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit



15th May 2019

- GDP growth stronger than expected in Q1, but forecasters still cautious on economic outlook
- Weak PMI surveys for April, while build up of inventories in Q1 likely to unwind. Thus, growth expected to slow again in second quarter amid rising global trade tensions
- Fed policy very much on hold. Markets now expecting rate cut by end 2019 and again in 2020. BoE and ECB rates seen on hold until 2021 as expectations of rate hikes evaporate
- Dollar remains underpinned by relatively high US rates, even with Fed rate cuts now expected. Other currencies finding it hard to make ground as their rates are expected to stay very low
- Sterling range bound recently as delay to Brexit leaves the UK currency marking time

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Pick-up in global growth in Q1 unlikely to be sustained

GDP data for the first quarter of the year have now been published for virtually all the main world economies, except Japan. They show 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% (3.2% 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.

Thus, while survey data for the opening months of the year suggested that growth would remain weak in quarter one, this has not proved to be the case. Much of the recent weakness in global activity has been concentrated in the manufacturing sector. This is now a small part of most modern economies, accounting for circa 10-15% of GDP, with Germany a notable outlier at over 20%. The weakness in manufacturing activity is associated with a slowdown in global trade in recent quarters, which has seen a decline in new export orders.

By contrast, the large services sector continued to perform quite well in most economies during quarter one. Furthermore, labour market data have remained strong, with continuing good employment growth and a further fall in unemployment in the early part of this year. This is contributing to accelerating wage growth. Not surprising then, consumer spending performed well in the first quarter, with particularly strong growth in retail sales in the UK and Eurozone. Consumer expenditure remains the key component of demand in developed economies.

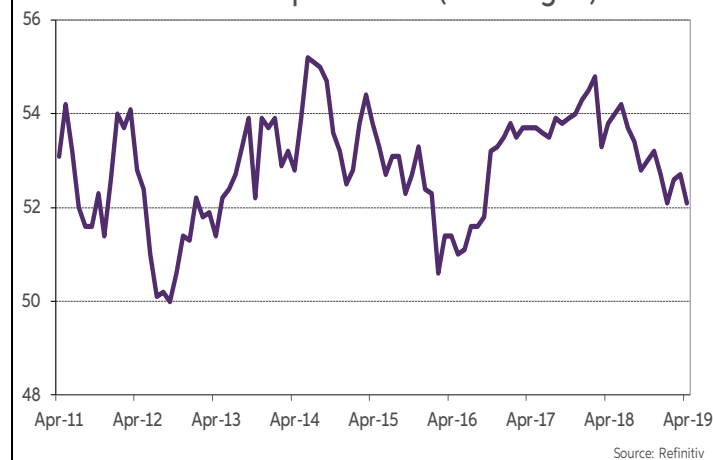
However, there were also some warning signs in the GDP reports for the first quarter. The stronger than expected growth was in part due to a build-up of unsold inventories. These are expected to be run down in this quarter, with both the Federal Reserve and Bank of England warning that this is likely to see growth slow again. Indeed, the latest OECD and IMF forecasts project that the global economy will expand by a modest 3.3% in 2019.

Furthermore, 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, entering recession. Meanwhile, concerns remain about the health of the Chinese economy. There could be an abrupt sell-offs in financial markets if this key economy slows more sharply than expected. The further escalation in global trade tensions recently could also add to the slowdown in international trade and is already creating greater volatility in financial markets.

However, the general expectation is that despite the numerous downside risks, the global economy will register moderate growth this year and in 2020. Monetary policy is set to remain accommodative everywhere, which should aid growth. Indeed, the sharp fall in bond yields since last autumn represents a significant easing in monetary conditions globally. 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 also remain strong.

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 encouraging to see an improvement in manufacturing activity. An easing in global trade tensions would be a positive development for the sector and thus the growth prospects for the world economy. On the other hand, it would be a real worry if signs of weakness spread to the services sectors of economies and labour markets in the coming months.

Global Composite PMI (JP Morgan)



GDP (Vol % Change)

	<u>2017</u>	<u>2018</u>	<u>2019 (f)</u>	<u>2020 (f)</u>
World	3.8	3.6	3.3	3.6
Advanced Economies	2.4	2.2	1.8	1.7
US	2.2	2.9	2.3	1.9
Eurozone	2.4	1.8	1.3	1.5
UK	1.8	1.4	1.2	1.4
Japan	1.9	0.8	1.0	0.5
Emerging Economies	4.8	4.5	4.4	4.8
China	6.8	6.6	6.3	6.1
India	7.2	7.1	7.3	7.5
World Trade Growth (%)	5.4	3.8	3.4	3.9
Advanced Economies				
CPI Inflation (%)	1.7	2.0	1.6	2.1

Source: IMF World Economic Update, April 2019

Interest Rate Outlook

Central banks put policy tightening on the long finger

Central banks have put the tightening of monetary policy on the long finger as concerns mount about the growth prospects for the world economy. The persistence of very subdued inflation gives central banks the latitude to be patient about rate tightening, thereby maintaining very loose monetary conditions for an even longer period of time. Markets now see rates remaining on hold virtually everywhere in 2019-2020, with rate cuts actually being priced in for the US.

The Fed performed quite a summersault on the outlook for interest rates at the start of the year. Despite continuing good economic data, especially in the labour market, the Fed dropped its tightening bias, saying that rates are now likely to stay on hold this year. It had indicated at its December meeting that two more rate hikes were likely in 2019.

The Fed, though, continues to project one further hike in 2020, which would bring rates to a peak of 2.625%. However, the market is of the view that US rates have already peaked and is pricing in a rate cut by end 2019 and a further cut in 2020. In our view, it is too early to call the peak in US rates, given the strength of the economy, loose macro policies still in place and the upward pressure on wages in the tight labour market. Indeed, should the economy and labour market remain strong, we would not be surprised to see the Fed hike rates later this year, especially if there is a further acceleration in wage inflation.

In the UK, markets have lowered their expectations for rate hikes. BoE policy is now expected to stay on hold for a prolonged period of time given the uncertain global backdrop and with Brexit uncertainty likely to continue until the autumn and possibly beyond. Markets now believe that the next 25bps BoE rate hike will not occur until mid-2021, taking rates up to 1%. Previously, they had expected rates to rise to 1.5% in the next couple of years.

However, both the February and May BoE Inflation Reports suggested that rates may need to rise in the next couple of years to meet its inflation target. The BoE Governor has remarked that current market rate expectations are not consistent with the BoE achieving its inflation remit. Thus, we think the BoE could still tighten policy earlier than markets expect, especially given the upward pressure on wage growth with the labour market continuing to tighten. However, given the extension to Article 50 to end October, rates seem likely to stay on hold this year. Rates, though, could be hiked in 2020.

Turning to the ECB, it is now guiding that it intends to keep interest rates at their current very low levels until at least the end of this year, as opposed to the end of the summer previously. It has hinted that it could extend this guidance of unchanged rates to an even longer period of time. It has also announced that it will launch a third round of long-term liquidity measures, a new TLTROs starting in September 2019 and ending in March 2021, with a maturity of two years. It all confirms that ECB interest rates are set to remain very low for a very long time.

The ECB deposit rate is at -0.4%, resulting in negative interbank rates, with swap rates also negative out to five years. Markets now do not see any rate increase in the Eurozone until mid-2021. Three month rates are not expected to turn positive until autumn 2022. Rates are expected to rise by just 50bps in the next four years, with three month money rates not getting to 0.5% until over five years time in autumn 2024. No wonder, then, that ten year German bund yields have turned negative again in recent months.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	2.375	2.52	2.64	2.23	2.16
Jun '19	2.375	2.60	2.70	2.30	2.25
Sept '19	2.375	2.70	2.85	2.50	2.45
Dec '19	2.625	2.95	3.10	2.80	2.75

* 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	-0.36	-0.22	-0.24	-0.04
Jun '19	-0.40	-0.35	-0.22	-0.22	0.00
Sept '19	-0.40	-0.35	-0.21	-0.20	0.05
Dec '19	-0.40	-0.35	-0.20	-0.15	0.15

* 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	0.80	1.05	0.96	1.09
Jun '19	0.75	0.80	1.05	1.00	1.15
Sept '19	0.75	0.85	1.10	1.10	1.25
Dec '19	0.75	0.90	1.20	1.20	1.40

* Swap Forecasts Beyond 1 Year

Dollar underpinned by favourable interest rate differentials

The US dollar remains at high levels against a broad range of currencies. The EUR/USD rate has been trading in a narrow \$1.11-1.13 band for the past two months, having been as high as \$1.25 in early 2018. Meanwhile, cable declined from above \$1.40 a year ago to trade around the \$1.30 level recently. The yen has been more range bound against the dollar over the past year, benefitting at times from safe-haven flows.

The dollar has been aided this year by continuing strong US economic data, with GDP growing by over 3% annualised in Q1 and the jobless rate falling to a near 50 year low of 3.6% in April. Wide interest rate differentials and bond spreads are also helping the currency, after the Fed steadily tightened policy in 2017-18, raising the fed funds rates by 200bps to a 2.25-2.5% range by the end of last year.

Spells of risk aversion in financial markets in 2018 were also supportive of the highly liquid US currency, sparking flights-to-quality into 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 to take advantage of cuts in US corporate taxes.

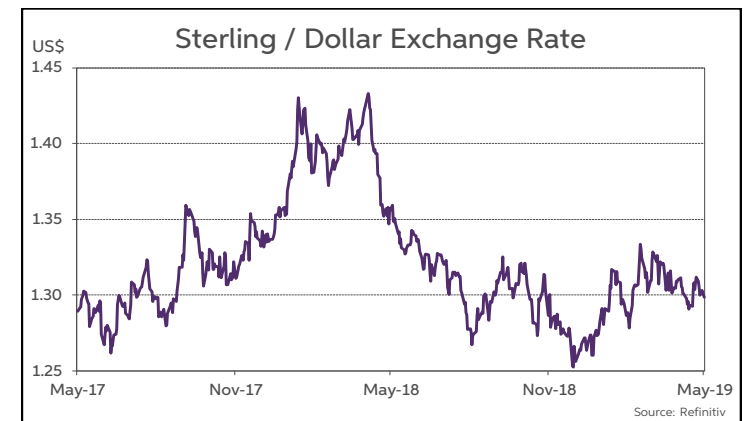
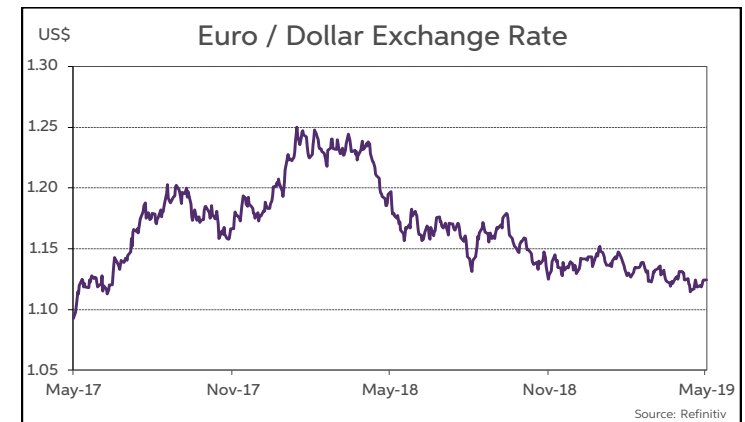
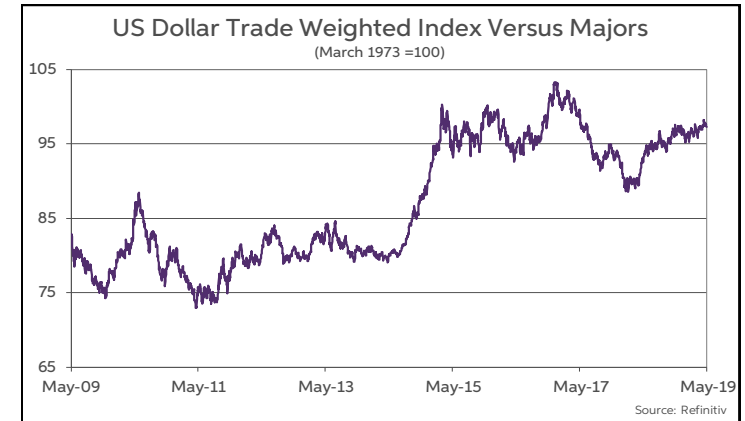
The US currency, though, has found it harder to make further major gains since the autumn. This may be partly due to the fact that FX positioning has become extremely long the dollar. Furthermore, the dollar is now at quite elevated levels against a range of currencies, which may be limiting further upside potential. The US economy is also expected to slow in the next year, while the Fed has put monetary policy on hold in 2019 after two years of rate hikes. Indeed, the market has come to the view that US rates have peaked and will be cut by year end.

Nonetheless, the relative strength of the US economy, wide interest rate differentials and geopolitical uncertainties all remain supportive of the US currency. On the other hand, political uncertainty in the EU, a general rise in euro-scepticism especially in the context of the upcoming European Parliament elections, the slowdown in the Eurozone economy and continuing very low ECB interest rates are all headwinds for the euro. However, the single currency has been quite range bound against the dollar recently, holding at the \$1.11-1.13 level. There is strong technical support for the euro in the \$1.10-1.12 area.

While relatively high interest rates should help underpin the US currency in the near term, there are factors that could cause the dollar to eventually lose some ground. The rising US twin deficits (fiscal and BoP) could start to weigh on the exchange rate. The marked jump in the repatriation of funds following the cuts in US corporate taxes last year is likely to abate, lessening demand for the currency. The US economy is also expected to slow as the boost to activity from the fiscal stimulus fades, with lower GDP growth forecast for 2020-21.

The persistence of very low interest rates elsewhere, though, is making it difficult for other currencies to make any ground against the dollar. The euro remains pinned down around \$1.12-1.13. There would probably need to be a sustained pick-up in activity in Europe and elsewhere that would put monetary tightening on to the agenda globally in 2020 for currencies to start to make ground against the dollar.

There was a pick-up in growth in Q1 but it is not expected to be sustained in Q2. There is still considerable caution about the economic outlook so the dollar is likely to remain strong in the near term. An improvement in global growth prospects in 2020, though, could eventually see the dollar lose some ground. It is hard, though, to see a major fall back in the currency anytime soon, with rates staying very low everywhere else.



Sterling marks time as Brexit is delayed

Sterling fell to lows of 93p against the euro and \$1.20 versus the dollar following the UK referendum vote to leave the EU. 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 will be avoided have seen the euro fall back to trade in an 85-87p range since mid-February, in spite of the delay to Brexit as a result of the UK Parliament's failure to ratify the Withdrawal Agreement (WA) negotiated with the EU. Against the dollar, sterling has been trading close to the \$1.30 level recently. Indeed, cable has been largely confined to a \$1.27-1.33 range since mid-2018.

The WA reached between the EU and UK allows 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. The WA, though, was voted down on three occasions by Parliament. However, Parliament has also voted against exiting the EU without a deal. It all means that the UK did not leave the EU as planned at the end of March 2019.

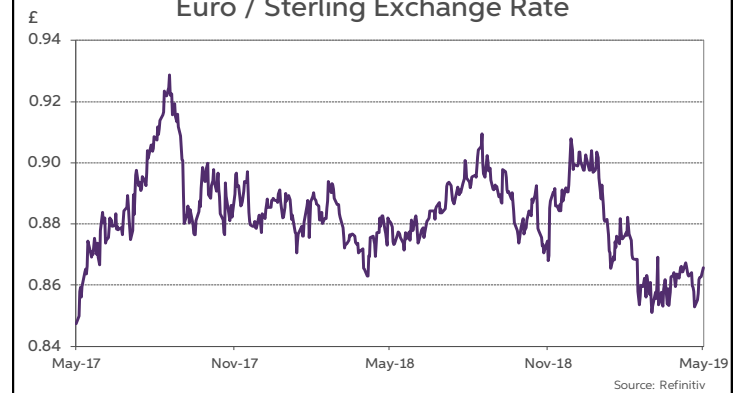
At an EU Heads of State summit on April 10th, the UK got an extension to Article 50 to delay Brexit to end October 2019. The UK, though, can leave at any stage during this extension period if the WA is ratified. Sterling has continued to trade in an 85-87p range against the euro as the Government continues with its efforts to get the WA ratified. It has been trying to reach an agreement with the Labour party on the matter. However, the stalemate continues with little progress being made in these talks, leaving sterling with a softer tone in the past fortnight.

Thus, we could 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 summit that at least one country is becoming keen to bring a conclusion to the Brexit process. If the UK continues to be unable to ratify the WA, then at some stage it may have to decide between remaining or leaving the EU without a deal. There could also be the complicating factor of a new leader taking over the Conservative Party in the coming months and thus becoming Prime Minister.

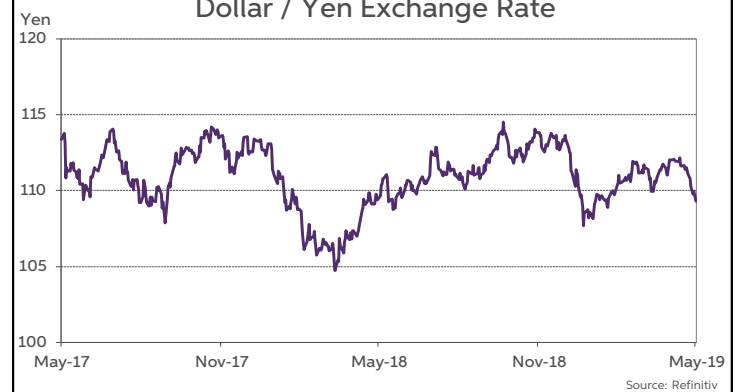
Even if the WA is eventually ratified and the UK departs the EU, there are still likely to be choppy waters ahead for sterling. The WA provides for a transition period post Brexit. Talks will take place during this transition period on the future relationship between the UK and EU, with the aim of concluding 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 will persist during any transition period, acting as a headwind for the currency. Indeed, what emerges from such talks could still look like a hard Brexit, if it sees the UK leave the Customs Union and Single Market.

Overall, we only see significant upside for sterling from its recent range of 85-87p against the euro, if momentum develops for the UK to remain in the EU, most probably via another referendum vote. Meanwhile, a hard Brexit would be the default position if the UK still cannot ratify the WA and does not get a further extension to Article 50. Sterling would come under severe pressure in a no-deal hard Brexit scenario, given that it would have very negative consequences for the economy. The currency could fall by 10-15 per cent from current levels. Overall then, considerable uncertainty persists about sterling's prospects given the ongoing lack of clarity on Brexit.

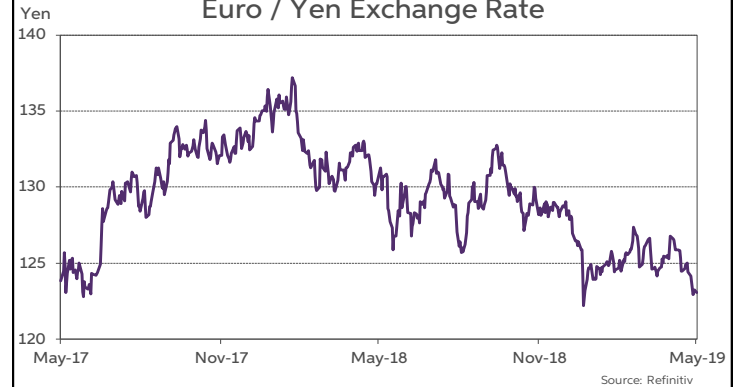
Euro / Sterling Exchange Rate



Dollar / Yen Exchange Rate



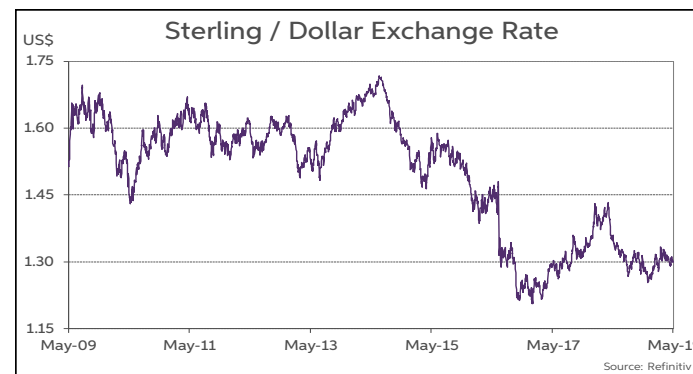
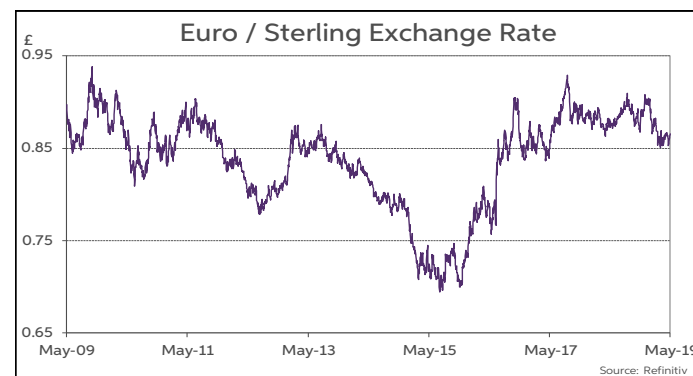
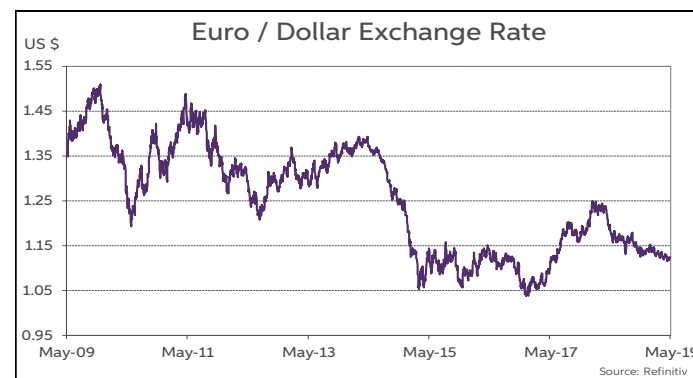
Euro / Yen Exchange Rate



Summary of Exchange Rate Forecasts

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

	Current	Q2-2019	Q3-2019	Q4-2019	Q1-2020
Euro Versus					
USD	1.120	1.09-1.15	1.10-1.16	1.11-1.17	1.13-1.19
GBP	0.868	0.84-0.90	0.84-0.90	0.83-0.89	0.83-0.89
JPY	122.46	120-126	120-126	120-126	122-128
CHF	1.13	1.13	1.13	1.14	1.14
US Dollar Versus					
JPY	109.33	107-113	106-112	105-111	105-111
GBP	1.290	1.26-1.32	1.27-1.33	1.30-1.36	1.32-1.38
CAD	1.35	1.34	1.33	1.32	1.30
AUD	0.69	0.69	0.70	0.71	0.72
NZD	0.66	0.66	0.67	0.68	0.69
CNY	6.88	6.85	6.80	6.75	6.70
Sterling Versus					
JPY	141	142	142	144	146
CAD	1.74	1.73	1.73	1.75	1.75
AUD	1.87	1.87	1.86	1.87	1.88
NZD	1.97	1.95	1.94	1.96	1.96



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