Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

14th May 2020

- Coronavirus pandemic causes very deep recession in wold economy in H1 2020. Most forecasters anticipate that growth will start to rebound over the summer as lockdown restrictions are eased

- Sharp decline of 6-8% in GDP predicted for many economies in 2020. Strong growth forecast for 2021, but recovery may be constrained by scarring effects or a smaller second wave to the virus

- Central banks everywhere ease policy aggressively with rate cuts, large QE programmes and enhanced liquidity measures. More easing likely—markets mull negative rates in US and UK

- Forex markets quite range bound in April-May. Dollar and yen remain at elevated levels

- Sterling has recovered significant ground after its sharp sell-off in early March. Vulnerable to increased Brexit uncertainty as year progresses or renewed market tensions over coronavirus

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Global Economic Outlook

COVID-19 pandemic results in a very severe, deep global recession

Economic forecasting in the current unprecedented COVID-19 recessionary environment is very difficult. Large parts of the world economy have been put into lockdown to control the spread of the virus. Without knowing the scale and duration of the virus outbreak, the length and extent of lockdowns and how successfully countries exit them, as well as the speed and strength of the subsequent pick-up in economic activity, a wide range of outcomes are possible for GDP in 2020 and 2021.

What is clear, as PMI data show, is that the world economy is experiencing a very deep recession in H1 2020 that commenced in March in most countries. The recession is unique in terms of its suddenness and severity. The IMF expects that this year will see the biggest fall in global GDP since the Great Depression of the 1930s. Furthermore, the scale of the immediate hit to employment is enormous, with jobless numbers soaring in the space of a few weeks. While the recession will be deep, it is generally anticipated that it will be of short duration as activity should bounce back in H2 2020 as most of the containment measures under the lockdown are unwound. However, very large falls in GDP are still in store for 2020, despite this expected recovery in activity in the second half of the year.

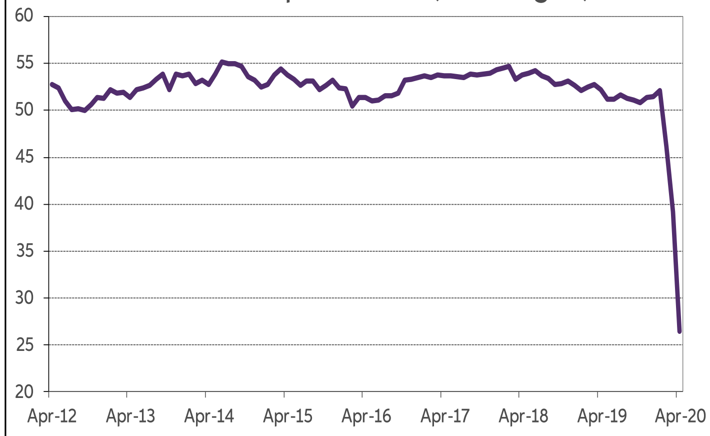
The most comprehensive set of economic forecasts published since the onset of the COVID-19 pandemic have come from the IMF in its semi-annual World Economic Outlook April 2020. The IMF assumes in its forecasts that the virus outbreak will peak in most countries during the second quarter and fade in the second half of the year, with business closures and other containment measures gradually unwound.

The IMF baseline scenario is a deep recession in H1 2020, with output declines concentrated in the second quarter, followed by a gradual recovery in activity during the second half of the year that gathers momentum in 2021. It expects that advanced economies, where the pandemic and associated containment measures have been most pronounced, will see the biggest drops in output. GDP in developed economies is seen as falling by 6.1% this year before expanding by 4.5% in 2021. The IMF calls this a partial recovery as it would leave GDP in advanced economies some 5% below the level projected for 2021 before the virus struck and 2% below its 2019 level.

There is much uncertainty about the exact timing and strength of the rebound in activity anticipated for H2 2020 and 2021. There are considerable downside risks. It could be impeded by scarring effects, such as lingering damage to confidence, lasting negative impacts on some businesses and tighter financial conditions. There is also a risk that the virus may prove more persistent than expected, with containment measures having to stay in place for even longer, or indeed, of a second smaller wave to the virus appearing later in the year or in 2021. Thus, the decline in output in 2020 may be even greater than anticipated by the IMF and others, with the rebound in growth more subdued also in 2021.

There are other obvious impacts on economies from the very deep COVID-19 recession. As already noted, large numbers of workers have been either made unemployed or furloughed. There is also marked downward pressure on inflation, aided by a collapse in oil prices. We are also seeing a sharp deterioration in public finances owing to government spending measures to mitigate the economic shock and declines in tax revenues due to the severe recession. Governments in virtually all economies are set to record very large budget deficits this year and a corresponding jump in public debt, though QE by central bank is keeping bond yields at very low levels.

Global Composite PMI (JP Morgan)



Source: Refinitiv

GDP (Vol % Change)

	2018	2019	2020 (f)	2021 (f)
World	3.6	2.9	-3.0	5.8
Advanced Economies	2.2	1.7	-6.1	4.5
US	2.9	2.3	-5.9	4.7
Eurozone	1.9	1.2	-7.5	4.7
UK	1.3	1.4	-6.5	4.0
Japan	0.3	0.7	-5.2	3.0
Emerging Economies	4.5	3.7	-1.0	6.6
China	6.6	6.1	1.2	9.2
India	6.8	4.2	1.9	7.4
World Trade Growth (%)	3.7	0.9	-11.0	8.4
Advanced Economies Inflation (CPI %)	2.0	1.4	0.5	1.5

Source: IMF World Economic Outlook, April 2020

Interest Rate Outlook

Central banks turn on the QE taps full blast,while negative rates mulled in UK and US

Monetary policy returned to easing mode last year in response to the slowdown in the global economy. Little did we know that this would be just a precursor for what lay in store in 2020, as a global pandemic took hold, sending the world economy into its deepest recession since the early 1930s. Central banks globally have been pulling out all the stops to try and ameliorate some of the most severe impacts of the pandemic on economies and financial systems and lay the groundwork for a recovery in activity when the virus fades.

Thus, rates have been cut sharply to 0.125% and 0.1% in the US and UK, respectively, enormous QE bond purchase programmes have been put in place and measures adopted to enhance the supply of liquidity to the economy and ease funding pressures, notably in regard to the dollar. The message from central banks and, indeed, governments, is that they are prepared to do whatever it takes to prevent the sudden, severe contraction in economic activity morphing into a prolonged depression.

It is not completely clear whether we have reached the lower bound in interest rates for the main central banks. The ECB and BoJ do not seem overly keen to move interest rates even deeper into negative territory, having focused to date in the crisis on using other non-standard policy measures, such as QE. Both the Fed and BoE have previously indicated a reluctance to move rates into the negative domain, but are not prepared to completely rule out such a move. While the Fed is still not very keen on the idea, both the BoE Governor and Deputy Governor have made reference to negative rates in recent comments, though, they remain to be convinced of their merit.

Futures curves are starting to toy with the idea that US and UK rates may turn negative. They are pricing in that official rates could be cut by circa a further 5-10bps to virtually zero this year. A small cut of 5bps in the ECB deposit rate, which currently stand at –0.5%, is also priced into futures curves. In the near term, though, the focus for any new central bank actions is more likely to be on expanding their non-standard policy measures.

The BoE is expected to increase the size of its QE programme at the next meeting of its MPC—indeed, two MPC members voted to increase QE by £100bn at the May meeting. The market also expects the ECB to increase the size of its €750bn Pandemic Emergency Purchase Programme (PEPP) at some stage this year. The Fed has also indicated a willingness to do more if required, stating that its policies are not subject to a specific dollar limit.

All the main central banks, then, retain a strong easing bias. Furthermore, they are indicating that monetary policy will remain very loose for as long as is required. Markets expect interest rates to remain low for a very long period of time. As already noted, there is a possibility that ECB rates could be lowered slightly further later this year, while the first 10bps hike in the ECB deposit rate from its current level of –0.5% is not priced in until late 2024. The ECB deposit rate could stay negative for virtually all of the coming decade. Euro swap rates are now negative out to 15 years, pointing to a very prolonged period of sub-zero rates.

In the UK, short-sterling contracts would suggest that the Bank rate is unlikely to be increased back up to 0.25% until end 2023 and it could be 2026 at the earliest before it reaches 0.5%. Fed futures would appear to be looking for a 0.125% rate hike to 0.25% by mid-2023, with 3-month contracts pointing to the Fed funds rate rising to 0.5% in H2 2024. The funds rate is seen as getting to 1% by 2027 and then not rising much further for the remainder of the decade.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.125	0.39	0.77	0.25	0.32
June'20	0.125	0.39	0.77	0.25	0.34
Sept'20	0.125	0.35	0.75	0.25	0.35
Dec'20	0.125	0.35	0.75	0.25	0.35

** 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	-0.24	-0.04	-0.30	-0.31
June'20	-0.50	-0.25	-0.05	-0.30	-0.30
Sept'20	-0.50	-0.30	-0.07	-0.30	-0.30
Dec'20	-0.50	-0.35	-0.10	-0.30	-0.30

** 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	0.33	0.69	0.32	0.35
June'20	0.10	0.30	0.67	0.30	0.35
Sept'20	0.10	0.25	0.65	0.30	0.35
Dec'20	0.10	0.25	0.65	0.30	0.35

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Currency markets back in range trading mode after virus related volatility subsides

The euro-dollar rate was confined to a very narrow six cent corridor of $1.09-1.15 for the whole of 2019, but with an underlying trend of the euro edging lower for most of the year. The euro moved within a $1.12-1.15 band in H1 and then $1.09-1.12 in H2 2019. The dollar, though, climbed by close to 3% in trade-weighted terms in early 2020, making significant gains against a broad range of currencies. This saw the euro fall below the key $1.09 support level in mid-February, hitting a three year low of $1.08, just ahead of the coronavirus coming to the fore.

The initial response of the market to the growing coronavirus pandemic was to take the dollar lower as US rates were cut sharply to near zero, removing the currency's interest rate spread advantage. The euro spiked higher to near $1.15. However, in volatile trading, a major scramble for dollars developed resulting from both safe-haven flows into the world's most liquid currency and to repay dollar borrowings. It was the dollar's turn to spike higher, with EUR/USD falling sharply to the $1.07 level. Cable fell particularly sharply in this period.

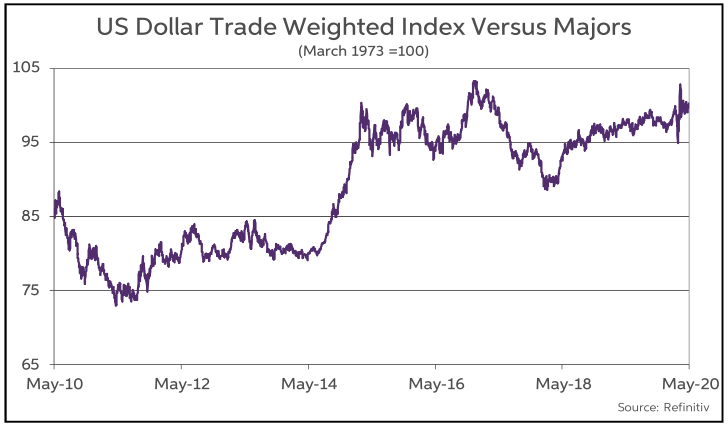
Central banks, led by the Fed, responded by opening large dollar swap lines to meet the big demand for dollar funding. This brought stability to FX markets, with the EUR/USD moving back into a narrow trading range of $1.075-1.10 since the start of April. The dollar has now been at elevated levels against a broad range of currencies since 2015 and, on a trade-weighted basis, is back close to the highs it hit in early 2017. This is not surprising in the current very uncertain environment, given the dollar's status as a safe-haven currency. Two other strongly performing currencies in recent times, the yen and Swiss franc, are also viewed as safe havens.

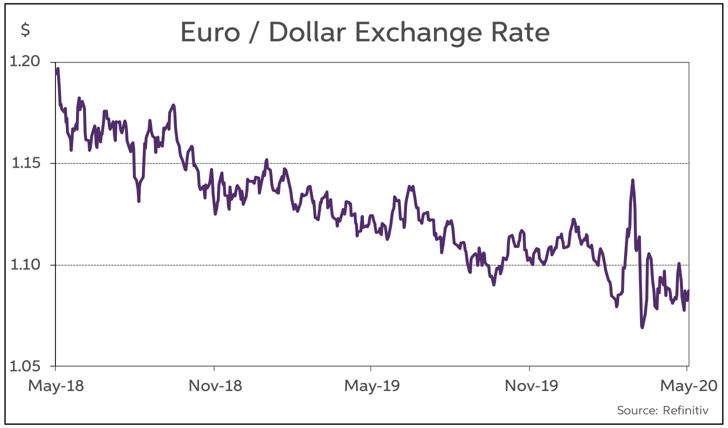
Technical support levels are obviously important in currency trading in an environment where narrow ranges dominate. In regard to EUR/USD, a move down below this year's low of $1.07 would be a signal of renewed upward pressure on the US currency. This could see EUR/USD test the lows of $1.04-1.05 hit in the 2015-2017 period. A breach of these levels would open a move down towards parity. We view this as unlikely as the dollar is already at very high levels. However, if it occurred, it might trigger market intervention by central banks.

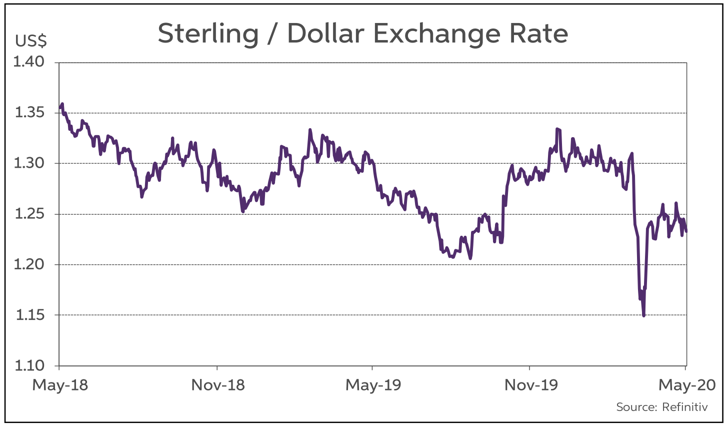
Meantime, the euro has not traded above $1.15 since late 2018. It is going to be hard for it to breach this level. Money market rates in the Eurozone are now expected to remain negative well into the second half of this decade, thereby continuing to act as a headwind for the currency. Another possible headwind could be the political tensions in the Eurozone over support measures for countries with weaker fiscal positions.

It is hard to call the next big move in FX markets. The EUR/USD rate has been confined to a narrow corridor of €1.07-1.15 since the autumn of 2018. It is going to take a major event to shake it out of this range. A return to heightened risk aversion on markets, possibly on fresh concerns over the economic outlook, would likely trigger a flight into the dollar that could test euro support at the $1.07 level. On the other hand, if a sustained recovery takes root in the second half of the year, the dollar could start to descend from its current high levels. However, as noted already, it may be difficult for the euro to rise above $1.15. A move above $1.20 would certainly be a tall order as it has not been above this level since 2014, except for a brief period in the first half of 2018.

Overall, we think that as in 2019, EUR/USD could continue to trade in a narrow range over the coming months. Thus, most of the action may be contained in a $1.07 to $1.10 corridor. Later in the year, the course of the dollar could be determined by the coronavirus, with unfavourable news supportive of the currency and vice-versa.







Forex Market Outlook

Sterling recovers after steep fall, but downside risks remain

Sterling had a very volatile year in 2019, rising and falling in response to the ebb and flow of news on Brexit. However, these moves were a pale shadow of what occurred in March, with the currency nose-diving before it recovered much of the lost ground. Cable fell rapidly from $1.32 in early March to $1.15 by the middle of the month, its lowest level since the mid-1980s. Meantime, the euro rose from 84p to 95p, with some very big intra-day price movements. It is unclear what triggered the very sharp fall in sterling in such a short period. Poor liquidity conditions may have exacerbated the price moves. The heaviest selling pressure emerged at a time when most markets were in a very fraught state over the growing coronavirus pandemic, registering heavy losses.

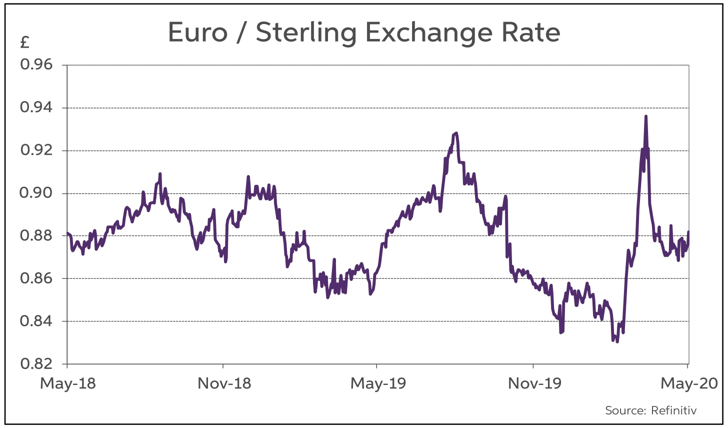
The UK currency subsequently staged a strong recovery, again without any obvious triggers. It had clearly become oversold given that it had fallen sharply in a matter of days to historically low levels. Thus, it may have simply rebounded from being oversold. The currency has been range-trading within narrow corridors since the start of April, helped by a sense of calm returning to financial markets. Cable has been largely confined to a $1.22-1.26 range, with trading versus the euro mainly limited to an 87-88.5p band.

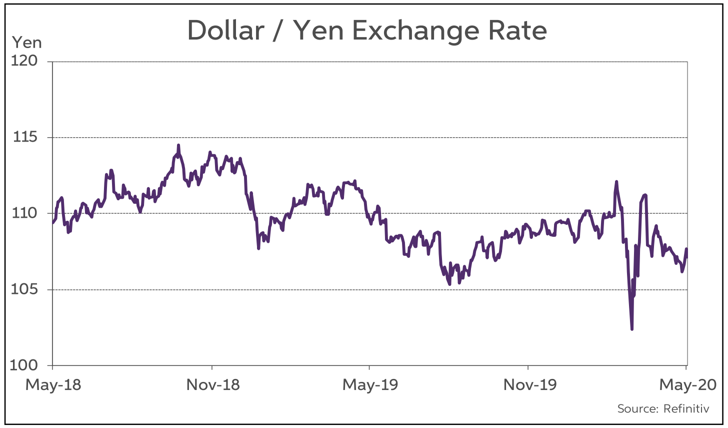
The extreme volatility of March obviously highlights the difficulties in making sterling forecasts in the current very uncertain macroeconomic environment. It is clear, though, that downside risks remain for the currency. Concerns have been raised that the UK may be undergoing a permanent shift towards a looser fiscal policy and thus will be slow to bring down the sharp rise in its budget deficit brought about by the coronavirus pandemic and measures to mitigate it. This is of particular concern as regards the UK, given it has a very large current account deficit. Indeed, the UK was the first large sovereign to be downgraded as a result of the coronavirus outbreak.

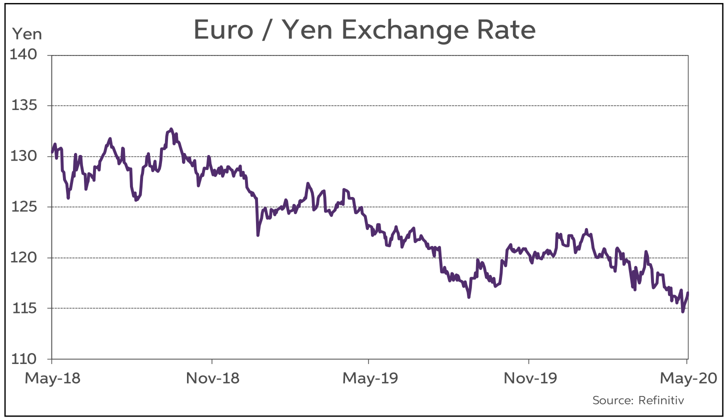
Sterling could find itself in the line of fire again if markets once more become convulsed by the coronavirus. Stock markets in particular seem to be anticipating a relatively smooth end to the coronavirus pandemic that allows a strong rebound to take hold in the global economy during the second half of this year. Such expectations could be easily disappointed, especially if there is a second wave to the virus, that sees market turmoil return.

Another risk is Brexit, which seems to have disappeared off the radar this year. While trade negotiations between the EU and UK have resumed, they don't appear to be making much progress. Furthermore, the UK seems in no mood to seek an extension to the transition period beyond end 2020 that would allow the negotiations to extend into next year. Thus, we could be heading for another cliff-edge Brexit date in December.

Sterling could come under some pressure over the summer if an extension to the transition period is not agreed by June 30th, the last date this is provided for under Article 132 of the Withdrawal Agreement. The EU and UK would be really staring down the barrel of a gun in the autumn in this situation, given their very differing views on the need for adherence to common rules and regulatory alignment as part of any trade deal. It is hard to imagine that the UK government would want to impose the turmoil a move to WTO trading rules would bring on a British economy seeking to recover from the deep COVID-19 recession. Nonetheless, brinkmanship may be a key part of its negotiating tactics. Whatever way one views it, a failure to agree an extension to the transition period by end June would seem likely to be a precursor for renewed volatility in sterling. Brexit concerns saw the UK currency fall to low levels last summer and could do so again—indeed, it has started edging lower in recent days.



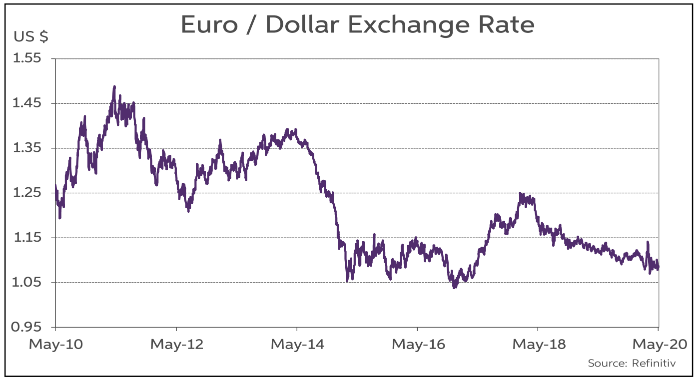


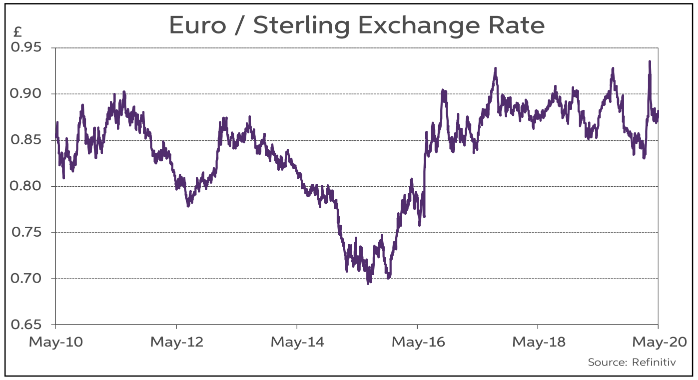


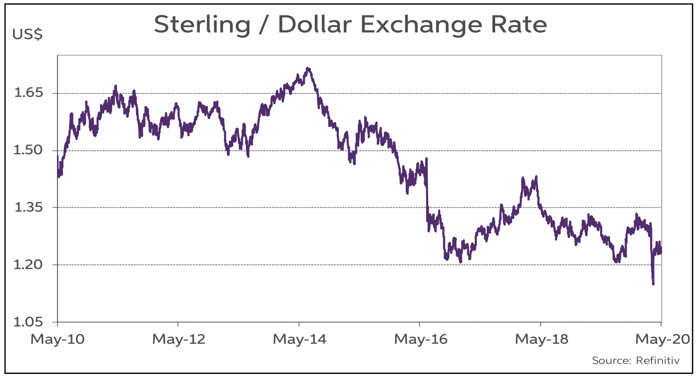
Summary of Exchange Rate Forecasts

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

	Current	Q2-2020	Q3-2020	Q4-2020	Q1-2021
Euro Versus					
USD	1.081	1.05-1.11	1.06-1.12	1.07-1.13	1.09-1.15
GBP	0.885	0.86-0.92	0.88-0.94	0.85-0.91	0.85-0.91
JPY	115.48	113-119	114-120	116-122	119-125
CHF	1.05	1.05	1.05	1.06	1.07
US Dollar Versus					
JPY	106.87	104-110	104-110	105-111	106-112
GBP	1.220	1.18-1.24	1.17-1.23	1.22-1.28	1.24-1.30
CAD	1.41	1.41	1.40	1.38	1.36
AUD	0.64	0.64	0.64	0.65	0.66
NZD	0.60	0.60	0.60	0.61	0.62
CNY	7.09	7.10	7.10	7.00	6.90
Sterling Versus					
JPY	130	129	128	135	138
CAD	1.72	1.71	1.68	1.73	1.73
AUD	1.90	1.89	1.88	1.92	1.92
NZD	2.04	2.02	2.00	2.05	2.05







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