Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Global economy has lost considerable momentum in the past year, with manufacturing in recession as world trade and business investment weaken, while downside risks mount
- Central banks ease policy on concerns about the outlook for growth amid very low inflation
- Fed lowers rates by 50bps in total, with markets expecting more easing over coming year. ECB cuts depo rate by 10bps and restarts QE. Willing do more. BoE leaning towards a rate cut also
- Dollar retains firm tone, while weak data and ECB easing weigh on euro
- Sterling volatile, driven by ebb and flow of Brexit sentiment. Recovers ground recently as risk of no-deal Brexit at end October recedes. Could see big GBP move once we get clarity on Brexit

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Global Economic Outlook

World economy moves onto a weaker growth path

The OECD in its latest World Economic Outlook says the prospects for the global economy have become increasingly fragile and uncertain. It has again reduced its growth forecasts for 2019 and 2020. Growth is now projected to slow from 3.6% in 2018 to 2.9% in 2019 and 3% in 2020. These would be the weakest annual growth rates since the financial crises.

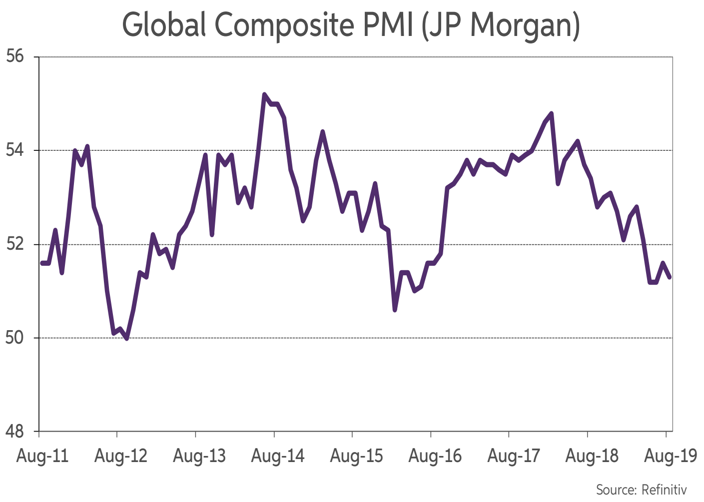
A key reason for the weak performance of the global economy is the downturn in manufacturing activity. This reflects weakening international trade, with subdued business investment and reduced consumer spending on 'big ticket' items such as cars. The IMF has interpreted these developments as an indication that both businesses and households are holding back on 'long range' spending amid heightened policy uncertainty, including in relation to global trade and Brexit.

The slowdown in activity is widespread. GDP growth has weakened in all the major economies. Notably, growth in the US has slowed this year as the fiscal stimulus there fades. The OECD is forecasting that US growth will moderate to 2.4% this year and 2% in 2020, from 2.9% in 2018. Brexit uncertainty is weighing on activity in the UK, with GDP growth forecast at circa 1% for 2019 and 2020. Meanwhile, a sharp slowdown in manufacturing and exports has left the German economy on the cusp of a recession. Growth in the Eurozone as a whole is also forecast at around 1% for this year and next, down from 1.9% in 2018 and 2.4% in 2017.

Both the IMF and OECD see the risks to the economic outlook as being tilted to the downside. A real concern is that ongoing weakness in manufacturing will eventually spill over into the services sector and hit labour demand. This would see household incomes and consumer spending start to be impacted. Debt levels remain high in many countries, leaving them particularly vulnerable to shocks, especially some emerging economies. Meanwhile, concerns persist about the health of the Chinese economy, which could slow more sharply than expected. The further escalation in global trade tensions over the summer was unwelcome given the already sharp 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. Meantime, the OECD and IMF have both warned that a no-deal Brexit would be very costly for the UK economy and would also weigh significantly on the Eurozone economy.

The global slowdown is generating a response from authorities. Monetary policy is turning even more accommodative globally, with numerous central banks now cutting rates. In addition, the sharp fall in bond yields over the past year represents a significant easing in monetary conditions, while there has been a marked improvement in financial markets generally this year, which should aid growth. Fiscal policy is also becoming more supportive of growth in some economies. Meantime, household spending power is being boosted by a pick-up in wage growth at a time of continuing subdued inflation. Labour markets remain 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. An easing in global trade tensions, in particular a resolution of the US-China trade war, would be a positive development for the manufacturing 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 lose further momentum, or we start to see signs of weakness appear in labour markets.



GDP (Vol % Change)

	2017	2018	2019 (f)	2020 (f)
World	3.8	3.6	2.9	3.0
Advanced Economies*	2.4	2.2	1.9	1.7
US	2.2	2.9	2.4	2.0
Eurozone	2.4	1.9	1.1	1.0
UK	1.8	1.4	1.0	0.9
Japan	1.9	0.8	1.0	0.6
Emerging Economies*	4.8	4.5	4.1	4.7
China	6.8	6.6	6.1	5.7
India	7.2	6.8	5.9	6.3
World Trade Growth* (%)	5.5	3.7	2.5	3.7
Advanced Economies Inflation (PCE %) *	1.7	2.0	1.6	2.0

Source: OECD Interim Economic Outlook, September 2019
** Sourced from IMF World Economic Update, July 2019*

Interest Rate Outlook

Central banks back in easing mode

Monetary policy easing is very much back on the agenda of the main global central banks. This was most clearly illustrated by the US Federal Reserve's two 25bps rate cuts in Q3, as well as the ECB also lowering rates and restarting QE in September. Other central banks including in Australia, New Zealand, India and Thailand have also cut interest rates this year, with policy being eased in China too. This represents quite a turnaround in sentiment from last autumn, when policy tightening was expected from central banks over the course of 2019-20. This shift in the stance of monetary policy has been in response to a marked slowdown in the world economy, amid an escalation in international trade tensions. At the same time, the persistence of very subdued inflation and falling inflationary expectations is also concerning central banks, especially the ECB.

The Fed's decision to cut the key fed funds rate by 25bps in both July and September was widely anticipated by markets. It has brought the funds rates down to a 1.75-2.0% range. Fed Chair Powell has emphasised that this does not herald the start of a lengthy rate cutting cycle. The Fed views the rate reductions more as an insurance measure given the more challenging global economic environment. The FOMC is very divided on where rates go next. About half of FOMC members see the need to a third rate cut, but a considerable number expect that the next move will be a hike in rates next year. As a result, Fed Chair Powell has said that Fed policy is now highly data dependent. He did indicate, though, that the Fed would be prepared to cut rates further if the economy turns down sharply.

Markets are anticipating that there will be a number of further rate cuts from the US central bank in the coming 12 months. Futures contracts are pricing in 75bps of additional easing by end 2020. For the Fed to deliver a further 75bps of rate cuts in line with market expectations, it would require a significant deterioration in the US economy, escalating global trade tensions and/or a major dislocation in financial markets.

In the UK, the latest indications from the BoE are that it is becoming increasingly concerned at the negative impact of the ongoing Brexit uncertainty on the economy at a time of weakening global growth. If this persists for much longer, it could well cut rates. Meanwhile, a no deal Brexit would probably also bring policy easing 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. Futures contracts indicate that the market thinks the next move will be a 25bps rate cut in the first half of next year. Indeed, if there is no clarity on Brexit, either post the October EU summit or after the expected November general election, then the BoE may well cut rates before year end.

Turning to the ECB, it announced a broad package of easing measures in September, include a cut of 10bps in the deposit rate to –0.5% and the introduction of a two-tiered deposit rate structure, the restarting of open-ended asset purchases under its QE programme and 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. It also stated that rates could be lowered even further, maintaining a clear easing bias.

Markets seem to believe that inflation will struggle to rise towards 2% and thus are factoring in an additional 20bps in rate reductions from the ECB during 2020. Furthermore, rates are expected to remain negative for many years to come. Futures contracts point to the deposit rate still being negative by late 2025, at around –0.25%.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	1.875	2.10	2.04	1.64	1.50
Dec '19	1.875	2.00	1.95	1.65	1.55
Mar '20	1.625	1.75	1.75	1.65	1.55
June'20	1.625	1.75	1.80	1.70	1.65

** 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	-0.44	-0.36	-0.46	-0.40
Dec '19	-0.50	-0.45	-0.38	-0.48	-0.40
Mar '20	-0.60	-0.55	-0.45	-0.50	-0.45
June'20	-0.60	-0.55	-0.45	-0.50	-0.45

** 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	0.76	0.89	0.66	0.61
Dec '19	0.75	0.80	0.95	0.70	0.65
Mar '20	0.75	0.80	0.95	0.75	0.75
June'20	0.75	0.85	1.00	0.85	0.85

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Dollar to retain firm tone, while euro to remain weighed down by low rates

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 near 50 year low of 3.7%. 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 rates by 200bps to a 2.25-2.5% range by the end of last year. The recent Fed rate cuts have not dented the currency as US rates remain well above elsewhere and other central banks have started to ease policy too.

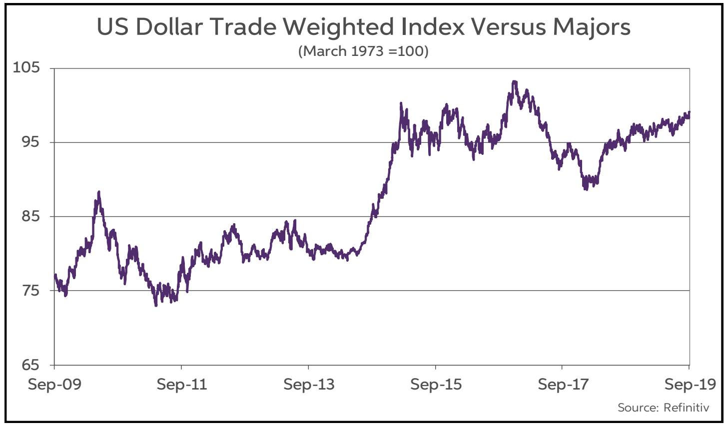
FX positioning, though, remains very long the dollar, suggesting that the upside for the greenback may be limited from here, especially as it is already at quite high levels against many currencies. Some other factors may also limit further dollar gains. The US economy is moving on to a slower growth path, with the market expecting the Fed to lower rates by a further 75bps in the coming year, to help sustain the expansion in activity. The large twin US deficits (fiscal and BoP) also remain a concern for the dollar over the medium term.

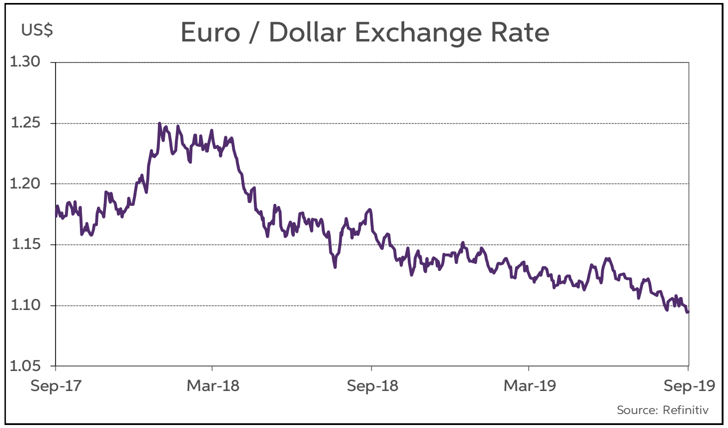
Nonetheless, the relative strength of the US economy, wide interest rate differentials and geopolitical uncertainties all remain supportive of the US currency. The persistence elsewhere of very low or, indeed, in some cases, negative interest rates is also making it difficult for other currencies to make ground against the dollar. The marked slowdown in the Eurozone economy, and recent significant policy easing by the ECB with expectations of more to come, are all headwinds for the euro. Meanwhile, despite recovering some ground recently, sterling remains weighed down by concerns over Brexit, with cable trading at around $1.23.

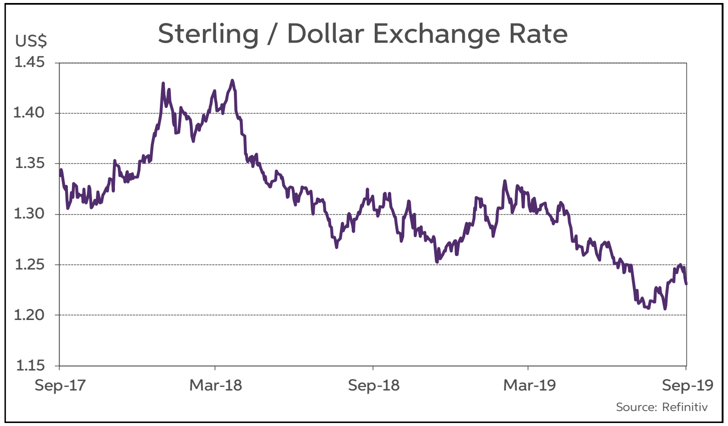
The euro largely traded in a tight $1.12-1.14 band in the first half of the year. However, it has moved down to below the $1.10 level in the past month as the ECB shifted back onto an easing path, restarting QE and moving rates even further into negative territory. There is strong technical support for the euro at around the $1.08-1.10 level. We would expect EUR/USD to trade in a narrow range of $1.08-1.12 over the balance of this year and into early 2020. The dollar is only likely to weaken if it becomes apparent that the economy is heading towards recession and US rates have to be cut very sharply. It is worth noting that the EUR/USD rate has spent very little time above the $1.20 level ever since ECB moved to negative rates in 2014. Thus, it would probably take significant rate cuts in the US to drive the euro above this level, given that the ECB could ease policy even further and negative rates are expected to last in the Eurozone until the second half of the coming decade.

Two currencies which have risen against the dollar this year are the yen and Swiss franc despite their continuing negative interest rates. They have benefitted from safe-haven buying at a time of increased geo-political tensions and greater risk aversion in markets. The dollar has fallen from ¥112 in the spring to trade in a ¥106-108 range in the past couple of months. The ¥105-106 range is a good support level for the dollar that is likely to prove to continue to be difficult for the yen to overcome, unless there are large Fed rate cuts. The dollar could fall towards ¥100 in those circumstances, especially if financial markets are also under pressure.

Meanwhile, the dollar has edged lower against the Swiss franc since the spring, declining from CHF1.02 to trade in a CHF0.97-1.00 range in Q3. The EUR/CHF rate has also moved lower in this period, falling from 1.14 to a 1.08 -1.09 range in the past couple of months. It could continue to trade around this level—the euro is certainly going to find if difficult to recover ground with the ECB back on an easing path.







Forex Market Outlook

Sterling driven by ebb and flow of Brexit news

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 earlier this year that there would be a soft, orderly Brexit saw the euro fall to an 85-87p range in the spring. Against the dollar, sterling moved back above the $1.30 level. Sterling, though, came under renewed downward pressure over the summer, with Theresa May stepping down as Prime Minister and being replaced by a leading Eurosceptic, Boris Johnson, who pledged to take the UK out of the EU at end October, with or without an exit deal. The rising risk of a no-deal Brexit saw the euro rise back up to the 93p level by August, while cable fell back close to $1.20.

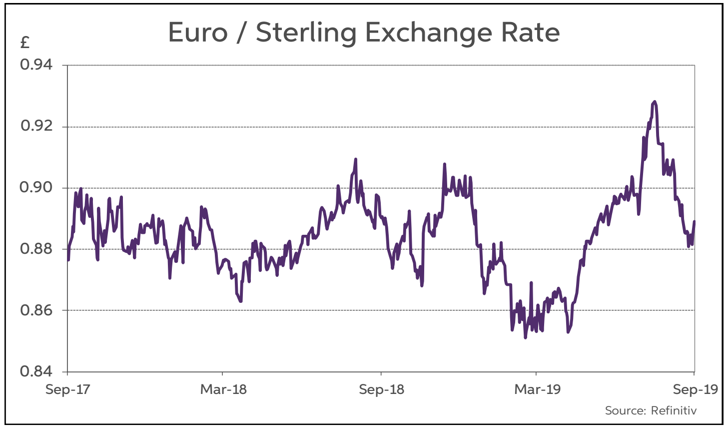
More recently, Parliament moved to take a no deal Brexit at end October off the table by passing legislation that will require the UK Government to seek a further extension to Article 50 if a deal on Brexit is not agreed at the mid -October EU Heads of State Summit. This has seen the euro fall back to an 88-89p range recently, while cable has moved up from the $1.20 level.

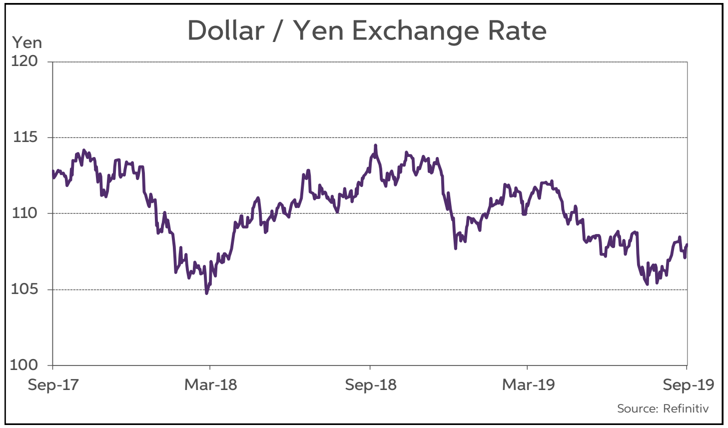
Even though the clock is ticking down towards the UK's exit date from the EU in a month's time, Brexit remains as clear as mud. We still have no idea if a deal will be agreed at the mid-October EU Summit, if a deal would then be approved by the UK Parliament, or whether or not the UK Government will seek, as mandated by law, an extension to Article 50 in the event of no deal. Neither do we know if the UK could yet crash out of the EU without a deal, if not at end October, then soon after a UK general election that is expected to be held in late November. Indeed, the impending election, rather than Brexit, seems to be to the forefront of UK politicians' minds.

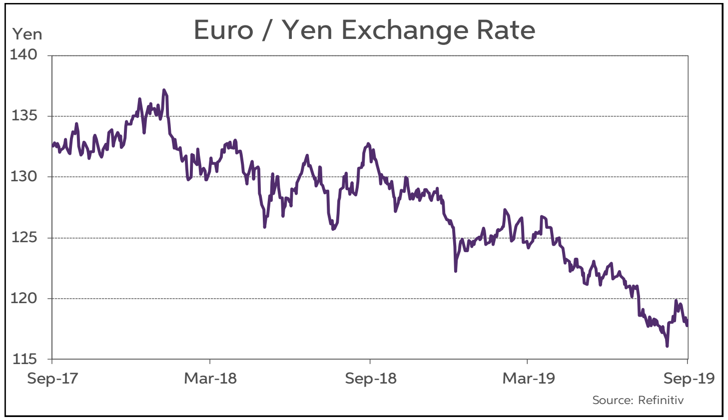
Sterling, though, has retained its recent gains, remaining within a 88-89p range against the euro, despite hints from a Bank of England policy maker that it could soon cut rates. The markets would seem to be of the view that a deal will eventually be done to achieve a soft Brexit. The key to such a deal is that the UK wide backstop in the current Withdrawal Agreement moves to a Northern Ireland only backstop, but in a way that avoids putting a barrier down the Irish Sea to trade between Great Britain and Northern Ireland.

Overall, we expect sterling to remain sensitive to the Brexit news flow in the run-up to the EU Summit. Obviously, if a deal is agreed and ratified, there would be scope for sterling to make more gains, especially as market positioning is still short the currency. The euro could fall back towards the 85p level quite quickly.

Sterling, though, would come under downward pressure again if a no-deal hard Brexit becomes an increasingly likely prospect. Markets would certainly fear such an outcome if we head into a general election without a deal being done on Brexit. An election win for the Conservatives in such circumstances could well open the door for a no deal exit. The currency could fall by more than 10 per cent from current levels, hitting parity against the euro if the UK leaves without a deal. Meanwhile, if Labour forms the next government, sterling could also weaken given the concerns over its high-tax, high-spend policies. Finally, another hung Parliament would leave sterling in limbo. Thus, the best outcome for sterling is a soft Brexit and the Conservative party winning the general election.



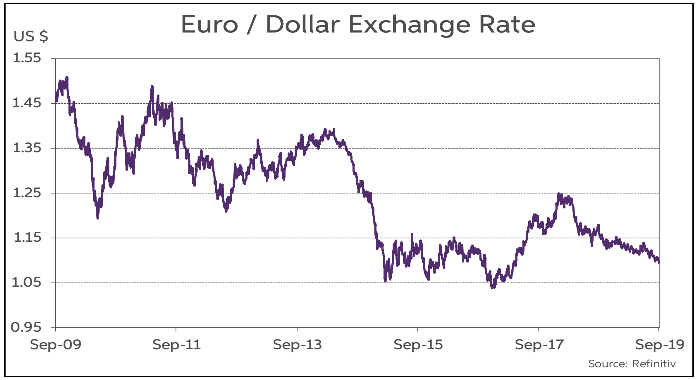


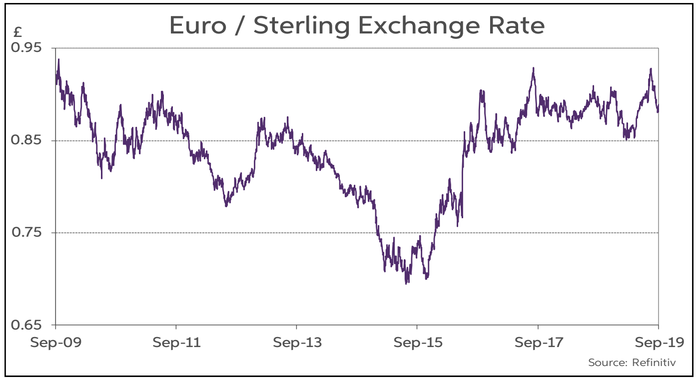


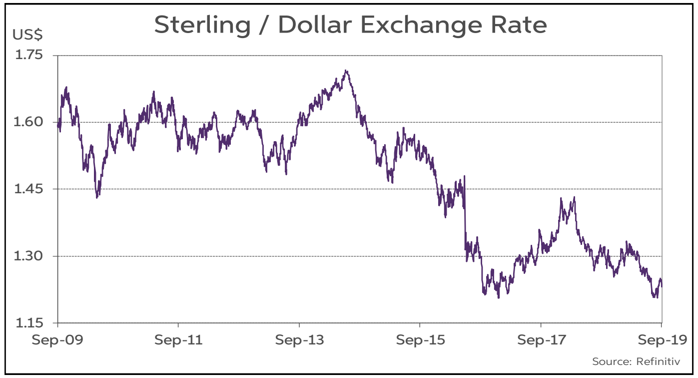
Summary of Exchange Rate Forecasts

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

Euro Versus	Current	Q4-2019	Q1-2020	Q2-2020	Q3-2020
USD	1.092	1.07-1.13	1.08-1.14	1.09-1.15	1.10-1.16
GBP	0.887	0.83-0.89	0.83-0.89	0.83-0.89	0.83-0.89
JPY	117.93	115-121	116-122	116-122	117-123
CHF	1.09	1.09	1.09	1.09	1.09
US Dollar Versus					
JPY	107.95	104-110	104-110	103-109	103-109
GBP	1.231	1.25-1.31	1.26-1.32	1.27-1.33	1.28-1.34
CAD	1.32	1.32	1.31	1.29	1.28
AUD	0.67	0.68	0.69	0.70	0.71
NZD	0.63	0.63	0.64	0.65	0.66
CNY	7.14	7.15	7.10	7.05	7.00
Sterling Versus					
JPY	133	137	138	138	139
CAD	1.63	1.69	1.69	1.68	1.68
AUD	1.82	1.88	1.87	1.86	1.85
NZD	1.97	2.03	2.02	2.00	1.98







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