Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

1st September 2020

- Coronavirus pandemic causes big contraction in global GDP in H1 2020 . Activity bounces back over summer with the lifting of lockdown restrictions. Big rise in store for Q3 GDP

- Rebound, though, being constrained by social distancing and further waves to virus and appears to be losing some momentum. Will take a long time for economies to recover fully

- Central banks everywhere ease policy aggressively with rate cuts, large QE programmes and enhanced liquidity measures. Monetary policy to remain very loose over next few years

- Dollar loses some ground over summer. With rate advantage eroded, currency could go lower

- Sterling performs quite well over summer despite lack of progress in EU-UK trade talks. Currency looks to have more downside than upside from current levels depending on trade talks outcome

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Global Economic Outlook

Much uncertainty about economic outlook post very deep COVID-19 recession

Economic forecasting in the current unprecedented COVID-19 pandemic environment is very difficult. Large parts of the world economy were put into lockdown in the spring to control the spread of the virus, triggering a very deep global recession in H1 2020. Activity rebounded strongly over the summer as lockdown restrictions were lifted. The recovery, though, appears to be losing some momentum, especially with the number of new cases of the virus having risen again, triggering fresh restrictions and damaging confidence.

The recession experienced by the world economy in H1 2020 was exceptionally deep, especially in Q2 which saw declines of 10-20% in GDP in many developed economies. Despite a recovery in activity in H2 2020, GDP is set to contract by circa 7-8% this year in advanced economies, with the world economy contracting by 5-6%. This would be the biggest fall in global GDP since the Great Depression of the 1930s. In many countries, though, the hit to the labour market has been mitigated by various government funded furlough and income support schemes. Jobless rates, however, are expected to spike upwards when these schemes are wound down.

Without knowing the duration of the virus, the extent of further outbreaks and lockdowns, developments in regard to treatments and a vaccine, as well as how scarring effects impact the speed and strength of the recovery in economic activity, a wide range of outcomes are possible for GDP over the period 2021-2022.

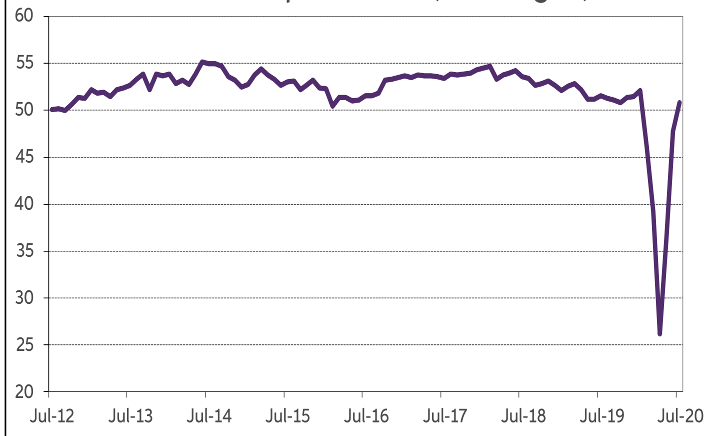
The most recent set of comprehensive economic forecasts have come from the OECD in its mid-year Economic Outlook. Reflecting the exceptional degree of uncertainty, it published forecasts for two equally likely scenarios, depending on whether or not there is widespread second coronavirus outbreak towards the end of the year. In the single outbreak scenario, world GDP falls by 6% this year and rebounds by 5.2% next year. However, for the OECD area where lockdowns have been most prevalent, GDP falls by 7.5% in 2020 and then recovers by just 4.8% next year. It would require growth of 3% in 2022 to return GDP to its pre-crisis level in these economies.

In its 'double-hit' virus scenario, the OECD sees world GDP contracting by 7.6% this year and recovering by just 2.8% in 2021, leaving it well short of its pre-crisis level by the end of next year. This is even more so the case for the OECD region, with output falling by 9.3% this year and growing by only 2.2% in 2021. It would require growth of 8% in 2022 to return GDP to its pre-crisis level.

There are other obvious impacts on economies from the very deep COVID-19 recession. World trade volumes are forecast to fall by at least 10% in 2020. While furlough schemes are preventing unemployment reaching very high levels, the OECD still sees jobless rate in the region rising to 10% from 5.4% in 2019 as the job support schemes are wound down. There has also been marked downward pressure on inflation this year, aided by the large drop in oil prices. The annual PCE inflation rate is projected to average circa 1% this year in the OECD region, down from just below 2% in 2019.

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. Fiscal deficits in the OECD area are seen rising to 11-13% of GDP from circa 3% in the past couple of years. The deficits will start to decline in 2021 as tax receipts begin to recover and emergency spending measures are scaled down.

Global Composite PMI (JP Morgan)



Source: Refinitiv

GDP (Vol % Change)

	2018	2019	2020 (f)	2021 (f)
World	3.4	2.7	-6.0	5.2
Advanced Economies	2.3	1.7	-7.5	4.8
US	2.9	2.3	-7.3	4.1
Eurozone	1.9	1.2	-9.1	6.5
UK	1.3	1.4	-11.5	9.0
Japan	0.3	0.7	-6.0	2.1
Emerging Economies	4.4	3.5	-4.6	5.6
China	6.6	6.1	-2.6	6.8
India	6.8	4.2	-3.7	7.9
World Trade Growth (%)	3.9	1.1	-9.5	6.0
World Inflation (Private Consumption Deflator %)	2.4	1.9	1.1	1.3

Source: OECD Economic Outlook, June 2020

Interest Rate Outlook

Interest rates to be kept at very low levels for years

Central banks globally have been pulling out all the stops to try and ameliorate the most severe impacts of the COVID-19 recession on their economies and financial systems and support the recovery in activity now underway after most containment measures were lifted. 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 is that they are prepared to do whatever is necessary to help economies recover from the very severe contraction in economic activity in H1 2020. They have also indicated that they are in this for the long hall. Central banks have been very clear and forceful in their communications that monetary policy will remain exceptionally loose over the next couple of years and further measures will be adopted if required to restore economies to a strong footing.

Any additional easing by the main central banks is likely to be in the form of further QE as it would appear that we have reached the lower bound in interest rates in most economies. The ECB and BoJ do not seem overly keen to move interest rates even deeper into negative territory, having focused to date in this crisis on using other non-standard policy measures, in particular expanding QE. The Fed continues to show a clear reluctance to move rates into the negative domain. Thus, markets are not looking for further rate cuts from these central banks.

The BoE had been toying with the idea of a move to negative rates, with the Governor saying it was under active consideration. However, any such policy shift does not appear imminent and the BoE remains to be convinced about the merits of negative rates. There was no reference to negative rates in the minutes of the June MPC meeting when the BoE opted to further increase the size of its QE programme. Markets see UK rates being cut by 10bps at most in the coming year, which would take the bank rate down to zero.

Major central banks retain a clear bias towards maintaining very loose monetary conditions. Both the ECB and BoE announced large increases to their QE bond purchases at their June policy meetings. The ECB also indicated that net purchases under its programme would run until at least June 2021. Meanwhile, the Fed is already engaged in unlimited asset purchases.

Furthermore, the main central banks are emphasising that rates will remain at their current or even lower levels for an extended period of time. Indeed, the Fed has just recalibrated its monetary policy to put more weight on boosting the labour market and less emphasis on inflation, with the intention of keeping the fed funds rate at its current very low level for an even longer period of time. Notably, it has indicated an intention to allow inflation move moderately above 2% for some time following periods, such as now, where it undershoots target.

This maintenance of very accommodative monetary policies for a prolonged period of time by central banks is reflected in the pricing of futures contracts, which don't see rates rising for a number of years. The first 10bps hike in the ECB deposit rate from its current level of –0.5% is not priced in until early 2024, with rates still at –0.2% by end 2025. In the UK, short-sterling contracts would suggest that the Bank rate is unlikely to be increased back up to 0.25% until mid-2024. Futures contracts in the US are pricing in the first 0.125% rise in the funds rate to 0.25% towards end 2023, with rates not rising to 0.5% until end 2024.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.125	0.24	0.45	0.22	0.34
Sept'20	0.125	0.25	0.45	0.22	0.35
Dec'20	0.125	0.25	0.45	0.23	0.37
Mar'21	0.125	0.25	0.45	0.25	0.40

** 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	-0.51	-0.37	-0.43	-0.36
Sept'20	-0.50	-0.50	-0.37	-0.43	-0.35
Dec'20	-0.50	-0.50	-0.36	-0.42	-0.33
Mar'21	-0.50	-0.50	-0.35	-0.40	-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	0.06	0.24	0.11	0.24
Sept'20	0.10	0.05	0.25	0.12	0.25
Dec'20	0.10	0.05	0.25	0.13	0.27
Mar'21	0.10	0.05	0.25	0.15	0.30

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Dollar loses some ground over summer, could go lower in coming year

The US dollar lost about 8% over the summer against the other major currencies on a trade-weighted basis. In reality, though, this has just seen the US currency return to 2018 levels. Indeed, it is still above the trading levels evident in the earlier part of that year. The bigger picture is that the dollar appreciated very sharply over the second half of 2014 and early part of 2015 and has remained at elevated levels over the past five years.

What has been remarkable is its very narrow trading ranges against the other major currencies over this period – the EUR/USD rate has been largely confined to a $1.05-1.20 band since end 2014, the yen has generally traded in a ¥105-115 range since the end of 2016, while the Canadian dollar has remained largely in a CAD1.25-1.40 corridor over the past five years. Even against a volatile sterling, $1.20-1.40 has contained nearly all the action in cable since the sharp fall of the UK currency in the aftermath of the June 2016 Brexit referendum.

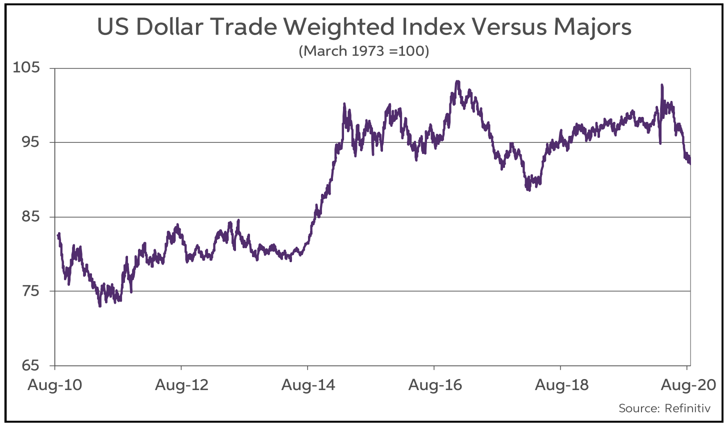
Meanwhile, although they have regained some ground in recent months, emerging market currencies remain well down on their levels of a year ago against the dollar. Indeed, the dollar is about 6% higher in trade weighted terms against these currencies than at the start of 2020. Falling commodity prices, weakness in trade flows and a flight to quality as a result of the Covid-19 pandemic has seen emerging market currencies lose considerable ground against the major currencies in 2020. It is important to bear this in mind when talking about the dollar. In overall trade-weighted terms, the US currency climbed to even higher levels this year.

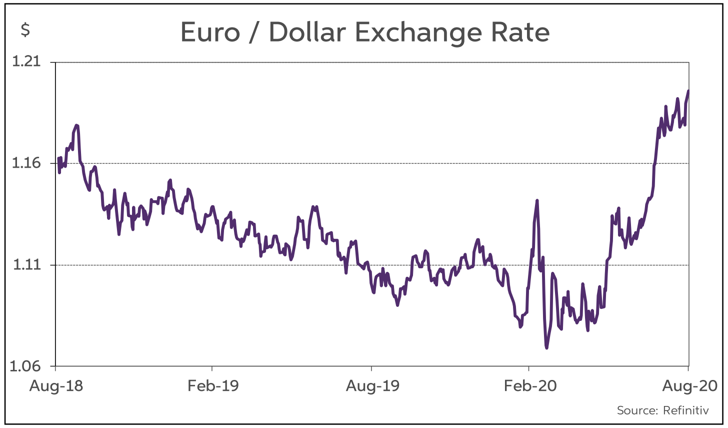
Nevertheless, it is correct to point out that the dollar has lost ground over the summer even though the US economy has outperformed to date in the COVID-19 pandemic. There was a smaller decline in US GDP during the first half of 2020 compared to Europe, largely due to the fact that its lockdown measures were less severe.

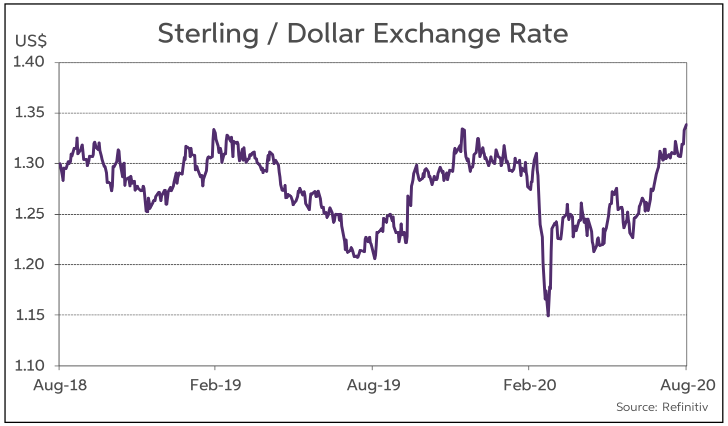
However, markets may be concerned that the resurgence of the virus in the third quarter in the US and rise in the number of deaths, especially compared to Europe, could impede the economy's recovery and prompt even more fiscal and monetary easing. The extensive dollar swaps lines put in place by the Fed with other central banks may also be contributing to the recent weakening of the currency. The large US rate cuts this year combined with the recent shift in the Fed's policy framework to a more dovish stance on rates have not helped the currency either. The upcoming US Presidential election could also be adding to uncertainty around the dollar, with a significant regime change quite possible in Washington next year.

For now, though, it is too early to conclude that the dollar has entered a secular decline. Indeed, renewed volatility in markets could see the gains made by numerous currencies against the dollar over the summer quickly unwind. A key exchange rate is against the euro. The $1.20 and then $1.25 levels are formidable obstacles for the single currency to overcome as they are strong technical support points for the US currency. Market positioning is also now very short the dollar, which may limit its downside in the near term. Thus, a near-term breach of the $1.20 level by the euro might prove difficult to sustain.

Further out, progress in fighting the Covid-19 virus and changes to the political and policy landscape in the US could see the dollar lose some more ground, with the euro moving up towards the $1.25 level next year. With the Fed now indicating that US rates will effectively be anchored at zero for the next few years, the significant interest rate advantage that the dollar enjoyed in recent years will be absent for the foreseeable future.







Forex Market Outlook

AIB Treasury Economic Research Unit

Trade talks pose more downside than upside risk for complacent sterling

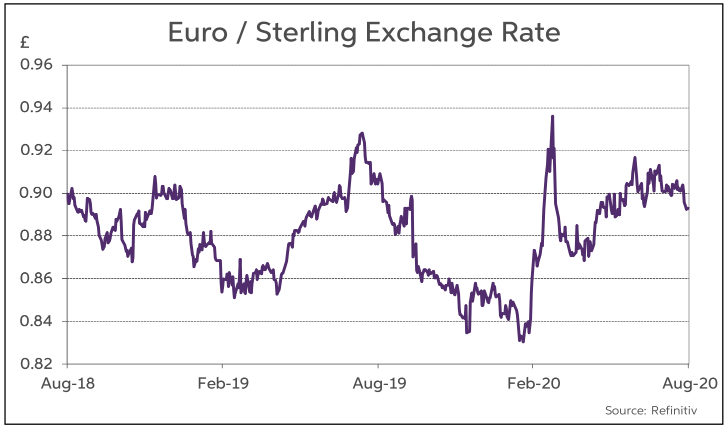
After a volatile year in 2019, sterling has seen some very sharp movements again in 2020. This was especially so in the spring when markets went into free fall as the coronavirus took hold. Cable fell rapidly from $1.32 in early March to $1.15 by the middle of the month, its lowest level since the mid-1980s. Meantime, the euro rose from 84p to 95p, with some very big intra-day price movements. The UK currency, though, staged a strong recovery soon after, regaining much of the lost ground.

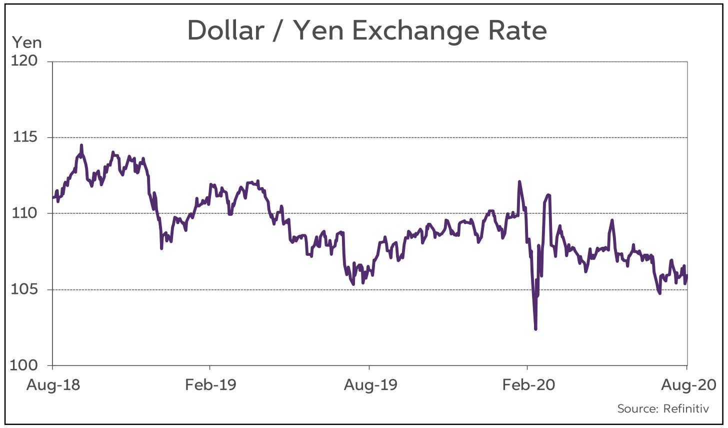
Little progress is being made in the EU-UK trade talks even as the clock ticks down towards the end of the Brexit transition period in December. It is generally agreed that a deal would need to be in place by end October to allow time for it to be ratified and come into effect at the start of 2021. The two sides remain far apart on the key issues of regulatory alignment especially on state aid rules, a dispute resolution mechanism and fisheries. The next round of face-to-face talks are scheduled for the week of September 7th.

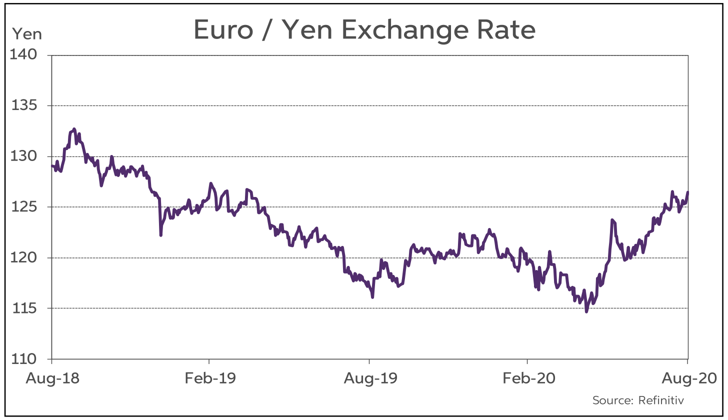
A failure to reach a trade deal and a move to trading under WTO rules involving tariffs, quotas and non-tariff barriers would deal another severe blow to the UK economy in the aftermath of a forecast 10% fall in GDP in 2020 as a result of the Covid-19 pandemic. Studies suggest that the hit to UK GDP could be of the order of 5-6% within the first few years. Quite surprisingly then, sterling seems unperturbed by the lack of progress in the talks. The currency has actually strengthened over the past two months, with the euro falling back from 91.75p to 89p and cable rising from $1.23 to $1.34 since mid-year, although the latter move has been largely driven by dollar weakness. Meanwhile, there is very little sign of any significant hedging against a sterling fall later in the year should the trade talks end in failure, with market positioning actually moving towards being long the currency.

It may be that markets believe that a trade deal will be agreed later this year as neither the UK nor EU will want to add more economic woes on top of the major problems caused by the Covid-19 pandemic. After all, following much procrastination last year, the UK and EU moved quickly to conclude a Withdrawal Agreement in October that paved the way for the UK's smooth departure from the EU. The euro was trading as high as 93p against sterling this time last year before the Brexit talks started to make progress. However, quite apart from the risks posed by the trade talks, the grounds for optimism on sterling look slim. Markets expect a further 10bps cut from the BoE at some stage in the coming year. Meanwhile, the Bank is no longer ruling out negative rates for the UK. Such a move would pose considerable downside risk for the currency. It is also the case that the recession caused by the Covid-19 pandemic has been much deeper in the UK than the other major economies.

It all suggests that the risks for the currency are far from symmetric. The likelihood at this stage is that if a trade deal is agreed, it will be a very limited agreement and far inferior to the current Single Market. This would hardly be a positive development for the UK economy. Hence, sterling may not gain that much ground if an agreement is reached, with the euro dropping back to around the 87p level. On the other hand, history has shown as recently as the Brexit referendum in 2016 and the instability in markets caused by the Covid-19 pandemic earlier this year, that sterling can fall very sharply and very quickly at times of crisis. Falls of ten per cent or more by the UK currency are not unusual, as occurred this spring. We expect that a limited trade deal will be agreed later in the year which will see sterling made some modest gains, but the talks certainly pose a significant downside risk.



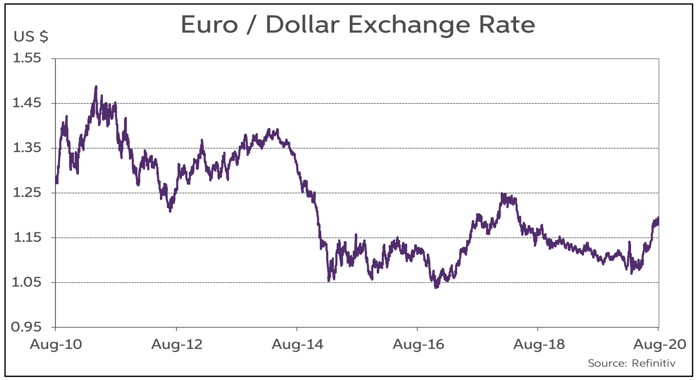


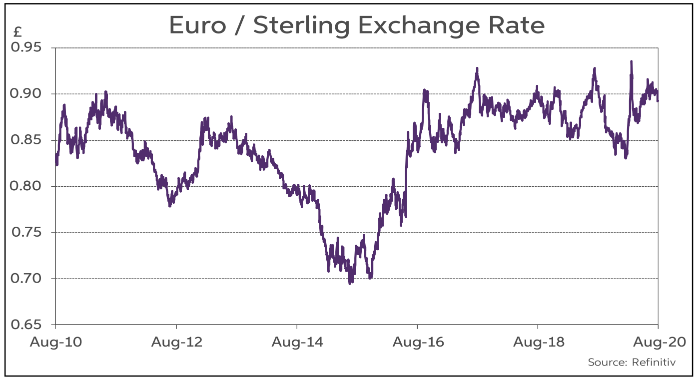


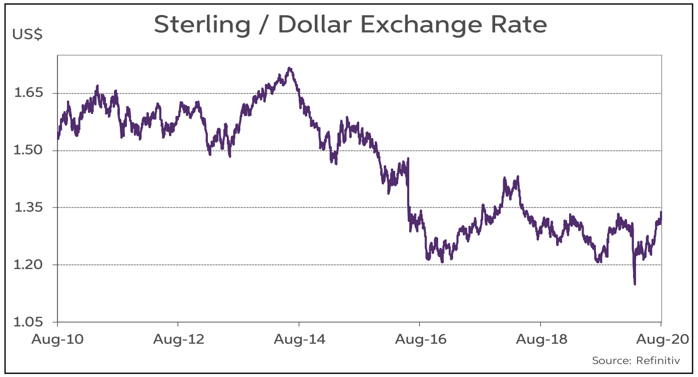
Summary of Exchange Rate Forecasts

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

	Current	Q3-2020	Q4-2020	Q1-2021	Q2-2021
Euro Versus					
USD	1.198	1.17-1.23	1.18-1.24	1.19-1.25	1.20-1.26
GBP	0.890	0.87-0.93	0.84-0.90	0.85-0.91	0.85-0.91
JPY	126.85	124-130	124-130	124-130	125-131
CHF	1.08	1.08	1.09	1.10	1.10
US Dollar Versus					
JPY	105.88	103-109	102-108	101-107	101-107
GBP	1.346	1.30-1.36	1.36-1.42	1.36-1.42	1.37-1.43
CAD	1.30	1.30	1.29	1.27	1.26
AUD	0.74	0.74	0.75	0.76	0.77
NZD	0.68	0.68	0.69	0.70	0.71
CNY	6.82	6.80	6.75	6.70	6.65
Sterling Versus					
JPY	142	141	146	145	146
CAD	1.75	1.73	1.79	1.73	1.76
AUD	1.82	1.80	1.85	1.83	1.82
NZD	1.99	1.96	2.01	1.99	1.97







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