Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Global growth looks to have peaked. Solid growth forecast for the world economy in 2019, but downside risks are mounting, as reflected in the increased volatility on financial markets
- Fed on steady rate tightening path as economy strengthens. BoE goes on hold ahead of Brexit. ECB to end QE in December, but indicates that rates will stay very low for long time afterwards
- Dollar retains upper hand on FX markets, supported by rising US rates and strong economy. However, growing US imbalances point to risks for currency over medium term
- Italian politics weighs on euro. Currency has upside potential if ECB starts to raise rates
- Sterling recovers ground on hopes of a Brexit deal. Would fall sharply in a no-deal scenario

Oliver Mangan
Chief Economist

John Fahey
Senior Economist

Conor Beakey
Economist

www.aibeconomics.com

Global Economic Outlook

Downward revisions to global growth forecasts as risks mount

Both the OECD and IMF recently revised down their growth forecasts for the world economy in 2018 and 2019. The revisions are not major at around -0.2% in both years, and the world economy is still expected to record solid growth of 3.7% in 2018 and 2019, the same rate as in 2017. However, these are the first downward revisions to global forecasts in some time, as growth has generally exceeded expectations in the past couple of years. In this regard, the IMF has noted that the potential for further upside surprises has receded given a loss of growth momentum, tighter financial conditions, higher oil prices and increased uncertainty around global trade.

Thus, the pace of global activity looks to have peaked. Meanwhile, the expansion has become less even, with growth diverging across the major economies and, in particular, amongst emerging-market economies. The recent downward revisions to growth forecasts are broad based, encompassing many advanced and developing economies. Indeed, global growth would probably have weakened this year but for the significant boost to the activity in the US from the marked loosening of fiscal policy there.

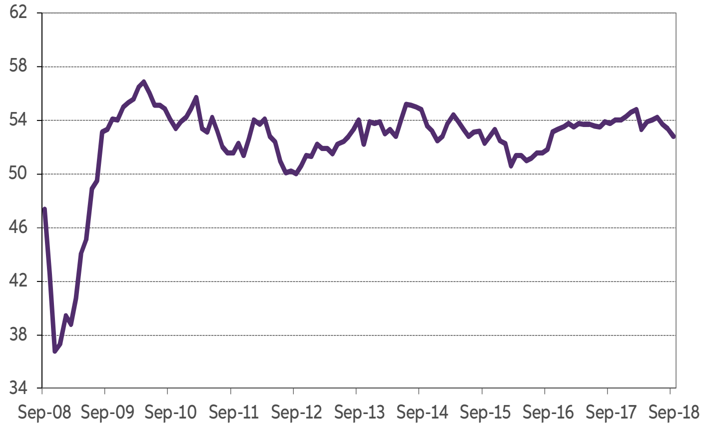
The OECD and IMF note that the risks for the world economy have clearly shifted to the downside. Growth in global trade slowed in the first half of 2018, with escalating trade tensions already having adverse effects on confidence, activity and financial markets. Notably, the Chinese economy has lost some momentum. Meanwhile, the gradual normalisation of monetary policy in the US and associated strengthening of the dollar is having adverse impacts on some emerging-market economies with high foreign currency debt levels and large external deficits. This has put severe downward pressure on their currencies, forcing their central banks to raise interest rates to punitive levels.

More generally, financial markets have become more risk averse and are experiencing much greater volatility in 2018 than in the previous couple of years. Stock markets are coming under pressure. Both the IMF and OECD continue to express concerns that the easy monetary conditions in place for much of this decade are contributing to a build-up of vulnerabilities in financial markets from elevated asset prices and high debt levels. They warn that still easy global financial conditions could tighten sharply as monetary policy turns less accommodative, denting confidence and undermining investment, with emerging-market economies particularly vulnerable.

Somewhat worryingly, the JP Morgan Global Composite PMI fell to a two year low in September, declining to 52.8 from 53.4 in August. There was a marked decline in the Flash German Composite PMI in October. These surveys do not augur well for near-term global growth prospects. Further out, growth in the strongly performing US economy could slow quite sharply over the next couple of years once the fiscal stimulus fades and higher interest rates begin to impact on activity.

Thus, it could be quite a challenge for the world economy to achieve the growth rate of 3.7% being forecast by the IMF and OECD for 2019, with the IMF also projecting that growth can be maintained at this pace in 2020. Crucially, inflation is expected to stay subdued. The IMF is forecasting that the CPI rate in advanced economies will average 1.9% next year, compared to 2.0% in 2018. This should allow monetary policy to remain accommodative in most countries, supporting economic growth. Nonetheless, despite a solid performance in 2018, considerable caution is warranted regarding the prospects for the global economy given the recent trends in some leading indicators, a slowdown this year in some economies and downside risks mounting all the time.

Global Composite PMI (JP Morgan)



Source: Thomson Datastream

GDP (Vol % Change)

	2016	2017	2018 (f)	2019 (f)
World	3.3	3.7	3.7	3.7
Advanced Economies	1.7	2.3	2.4	2.1
US	1.6	2.2	2.9	2.5
Eurozone	1.9	2.4	2.0	1.9
UK	1.8	1.7	1.4	1.5
Japan	1.0	1.7	1.1	0.9
Emerging Economies	4.4	4.7	4.7	4.7
China	6.7	6.9	6.6	6.2
India	7.1	6.7	7.3	7.4
World Trade Growth (%)	2.2	5.2	4.2	4.0
Advanced Economies CPI Inflation (%)	0.8	1.7	2.0	1.9

Source: IMF World Economic Outlook Update, October 2018

Interest Rate Outlook

Fed to remain on tightening path, other central banks quite cautious

The US Federal Reserve is continuing steadily on its path of policy normalisation, hiking rates at quarterly intervals and reducing the size of its balance sheet as its stock of QE assets is allowed to slowly run down. Other central banks, though, remain cautious about tightening policy too quickly. Hence, monetary policy is expected to remain very loose in all the major economies over the next couple of years, apart from the US.

In the UK, the persistence of above target inflation amidst a tightening labour market saw the Bank of England increase rates by 25bps in November 2017 and again this August. They were the first rate hikes since 2007 and brought the bank rate up to 0.75%, its highest level since 2009. Policy is now widely expected to remain on hold until after the UK leaves the EU on March 29th next year. Thereafter, the options facing the BoE look binary.

The market is expecting a soft Brexit in March and thus is pricing in the next rate hike for Q3 2019, with two further rate hikes expected in 2020 and 2021. This would bring the bank rate up to a still low 1.5%. However, the labour market has tightened considerably with wage inflation climbing above 3%, while the CPI rate is still running above 2%. The economy is also regaining momentum. Thus, in the event of a soft Brexit, we think the BoE could tighten policy by more than markets expect, with the next rate hike coming as early as May and a further hike possible by end year. On the other hand, if a hard Brexit materialises, then rates could be cut by 50bps next year.

The ECB has scaled back net asset purchases under its QE programme this year and is set to cease them completely at end December. However, it has indicated that it intends to keep interest rates at their current very low levels until at least the end of next summer. The ECB does not see inflation rising to its 2% target level in the next three years, so interest rates in the Eurozone are likely to remain very low for a long time.

The ECB deposit rate is currently at -0.4%, resulting in negative interbank rates. Futures contracts show wholesale rates starting to rise from September 2019 onwards and only see them turning positive in June 2020. Overall, three month money rates are seen as rising by just over 50bps between now and end 2020, and are not expected to get to 1% until late spring 2023. We would expect short-term money market rates to remain between the deposit and refi rates in the next few years, given the ample market liquidity. However, the gap between the two official rates could narrow to 25bps, from 40bps at present, as rates start to be increased.

Meanwhile, the Fed hiked rates by another 25bps to 2.125% at its September meeting, the eighth rate rise in this cycle. It has indicated that a further rate hike can be expected in December, with four additional increases likely in the next two years, taking rates up to 3.375% in 2020. The futures market has priced in a December rate rise and close to two further rate hikes in 2019, with official rates seen levelling off thereafter at around 2.8%.

The market has been moving more into line with the Fed's projections over the course of this year. However, it is still more than 50bps below the Fed projection of 3.375% for official rates in 2020. Continuing strong growth by the US economy could see a further firming of the market's rate expectations. We anticipate that the Fed funds rate will rise to at least 3.125% in this cycle.

There was renewed upward pressure on bond yields recently as markets revised their expectations higher for US rates. Markets have been volatile, but continuing strong US data could see yields come under upward pressure again as markets would have to price in even more Fed tightening than they currently anticipate for 2019/2020.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	2.125	2.51	3.04	3.03	3.09
Dec '18	2.375	2.75	3.15	3.15	3.20
Mar '19	2.625	3.00	3.30	3.30	3.35
Jun '19	2.875	3.20	3.45	3.45	3.50

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	-0.40	-0.35	-0.21	-0.12	0.36
Dec '18	-0.40	-0.34	-0.20	-0.10	0.40
Mar '19	-0.40	-0.33	-0.18	-0.05	0.45
Jun '19	-0.40	-0.30	-0.15	0.00	0.55

** 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	0.81	1.06	1.10	1.36
Dec '18	0.75	0.82	1.07	1.15	1.45
Mar '19	0.75	0.85	1.10	1.25	1.55
Jun '19	1.00	1.05	1.30	1.40	1.70

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Dollar retains upper hand as US rates continue to rise

The US dollar had a weak start to the year, with EUR/USD rising above $1.20 and then reaching $1.25. However, the greenback has recovered strongly since early spring, gaining ground against a broad range of currencies. This saw the EUR/USD rate fall back appreciably and it has been confined to a $1.13-1.18 range since end May.

The dollar has been aided by strong US economic data this year, with many releases surprising to the upside. The US economy grew by 4.2% annualised in the second quarter, the strongest rate in four years. US data have remained strong in Q3. Meanwhile, the jobless rate has fallen to 3.7%, its lowest level since 1969. Widening interest rate differentials and bond spreads in favour of the dollar have also helped the currency as the Fed continues to steadily tighten monetary policy.

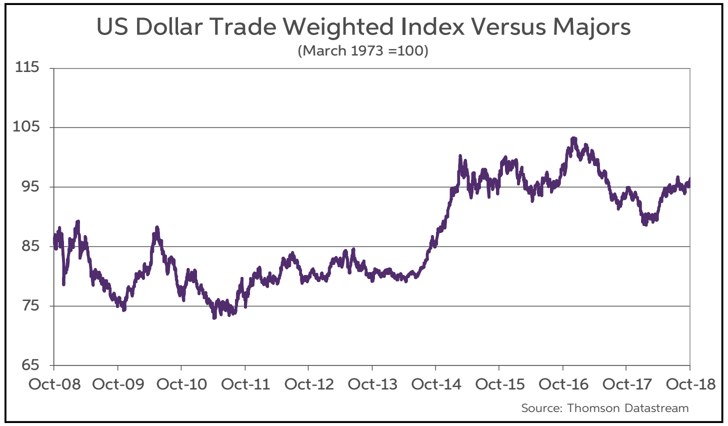
Rising risk aversion in markets has also been supportive of the highly liquid US currency this year. Escalating tensions over global trade, difficulties in emerging markets and geopolitical concerns have all sparked flights-to-quality in to safe-haven currencies like the dollar, yen and Swiss franc. The dollar has also have benefitted from a big jump in the repatriation of funds by US companies this year to take advantage of cuts in US corporate taxes. All these factors have seen an unwinding of the extreme short positions built up against the dollar in late 2017 and early 2018, propelling the currency higher.

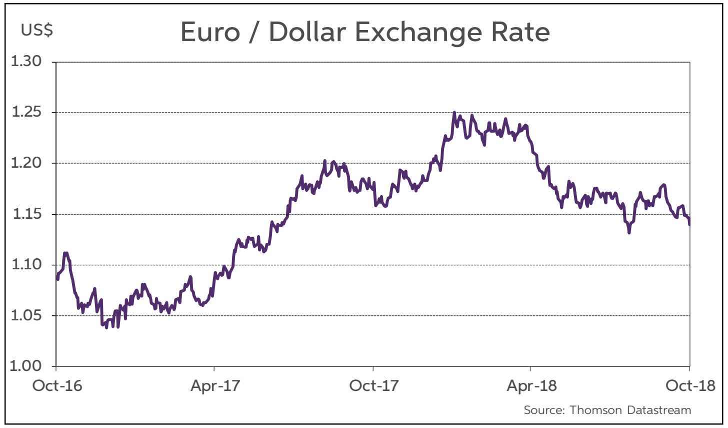
However, the US currency has found it difficult to make much further headway since the summer. This may be partly due to the fact that FX positioning has turned very long the dollar. Furthermore, the dollar is now at quite elevated levels against a range of currencies, which may be limiting further upside potential. While still some way below the levels reached in 2015-16, the dollar is close to 20% higher on a trade-weighted basis than during most of the period 2006-2014.

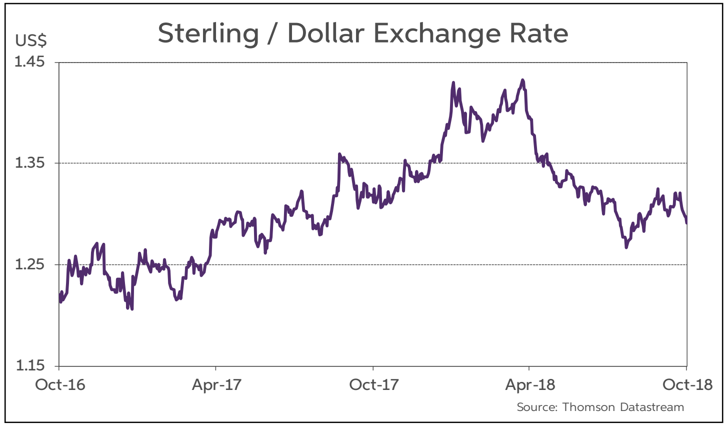
In the short term, the relative strength of the US economy, widening interest rate differentials, tensions over global trade, continuing stress in some large emerging markets and geopolitical uncertainties are all supportive of the US currency. Meanwhile, the on-going political and budgetary drama in Italy is likely to remain a headwind for the euro. A general rise in euro-scepticism is also weighing on the single currency, as has the weaker performance of the Eurozone economy this year. There should be strong support for the euro, though, at the $1.13 level that it hit in August, allowing it to continue trading in a $1.13-1.18 range over the balance of 2018. Even if the euro falls below $1.13, there is further strong support for it at the $1.10 to $1.12 level.

We remain of the view that the US dollar is likely weaken over the medium to long term. Rising twin deficits (fiscal and BoP) could start to weigh on the currency next year. The marked jump in the repatriation of funds following the cuts in US corporate taxes earlier this year is likely to abate over the medium term, lessening support for the currency. Finally, the US economy could also slow sharply once the fiscal stimulus fades and higher US rates start to impact on activity, again undermining the currency.

Meantime, there should be potential for the euro to rise over the medium term as the ECB begins to hike interest rates. The euro could move up towards the $1.20 level in the first half of next year as the ECB prepares the markets for a tightening of policy. It could move above $1.20 later in 2019 once the ECB starts to raise interest rates. For now, though, with the US economy still strongly outperforming, the dollar holds the upper hand.







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Forex Market Outlook

Sterling continues to be driven by news flow on Brexit

Sterling fell sharply in the aftermath of the Brexit referendum vote in mid-2016. The currency hit 30-year lows against the dollar, falling from $1.50 before the vote to as low as $1.20 in late 2016. The Brexit vote also saw sterling lose significant ground against the euro, with EUR/GBP rising sharply from the 70p level near the end of 2015 to a high point at around 93p in August 2017.

Sterling managed to move off its lows and regain some ground in the latter stages of 2017 and early part of 2018. Against a weaker dollar, it rose above the $1.40 level in Q1 2018 and in mid-April reached a new post referendum high of $1.437. Meanwhile, the EUR/GBP rate moved down from 93p to briefly dip below 87p in mid-April.

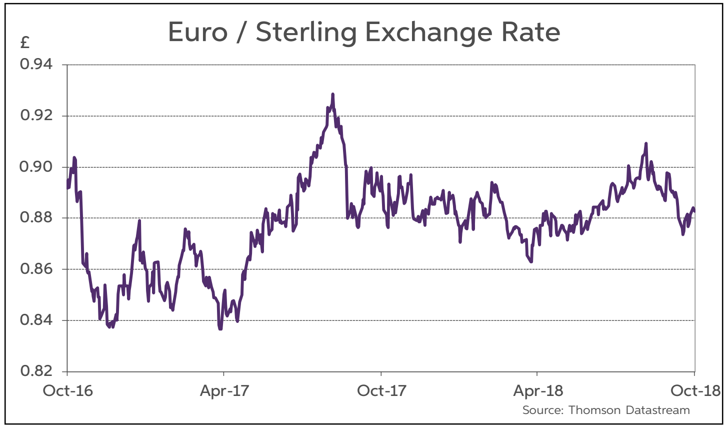
However, sterling fell back again over the summer. A lack of progress in the Brexit talks, with growing fears that deep political divisions in the UK could see it leave the EU without any deal, weighed on the pound. It dropped sharply against a strengthening dollar to below $1.27. Meanwhile, the euro moved back up to the 91p level. Fresh signs of progress in the Brexit negotiations, though, as well as better UK economic data, have seen sterling regain ground over the autumn. It has generally been trading around $1.30, with the euro dropping back to circa 88p.

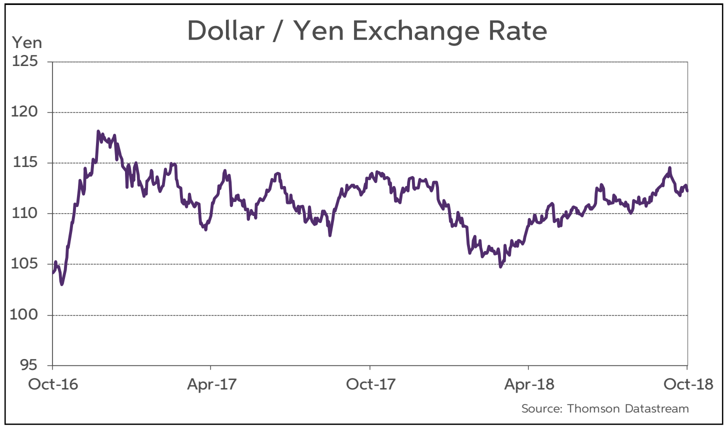
Brexit will be the key factor impacting sterling over the remainder of this year and in the early part of 2019. The talks are now moving to their critical final stages, with some hurdles still to be overcome to secure an exit deal. Good progress has apparently been made in the talks recently and a deal seems likely to be agreed. There was some disappointment, though, that an agreement could not be reached in time for this month's EU leaders summit. However, PM May is unlikely to want an agreement reached now that would give hard Brexiteers plenty of time to pick it apart. It will be a challenge to get any Withdrawal Agreement through the UK Parliament. The best chances of success are a last-minute deal that leaves Eurosceptic MPs the choice of either supporting it, or risking a general election or even a second referendum that could endanger Brexit itself by opposing it.

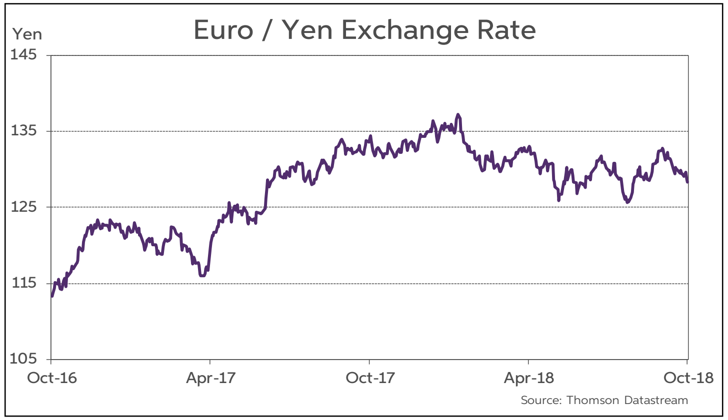
Choreography and optics are important. It needs to be seen as the best possible deal the UK is going to get after really tough negotiations, with no time left to go back and reopen talks. Thus, we don't expect a deal to be reached until December, and it would not surprise to see the talks extend into early January before we get an agreement. Even then, there is still no guarantee that the UK Parliament will ratify the deal.

Even if the UK leaves the EU with a deal, it may not be clear what the final shape of Brexit will be. The difficult decisions in terms of future customs and trade arrangements in particular, could be left to the detailed negotiations on a new EU-UK trade deal that are to be conducted during the transition period that follows Brexit.

Given that there may be difficulties in getting an exit deal through the UK Parliament, while uncertainty in regard to the precise nature of Brexit could extend into the transition period, the upside for sterling may be limited even if a deal is agreed. EUR/GBP may be confined to an 86-88p trading range in such circumstances. Of course, if markets start to fear that a no-deal hard Brexit could be on the cards, then the euro is likely to move higher to around the 93p level it hit last summer. It could even reach the 95p level that was last seen during the financial crisis back in 2009. Sterling may even go to parity against the euro in the event that the UK crashes out of the EU without any deal in an very disorderly Brexit next March that causes severe problems for the British economy.







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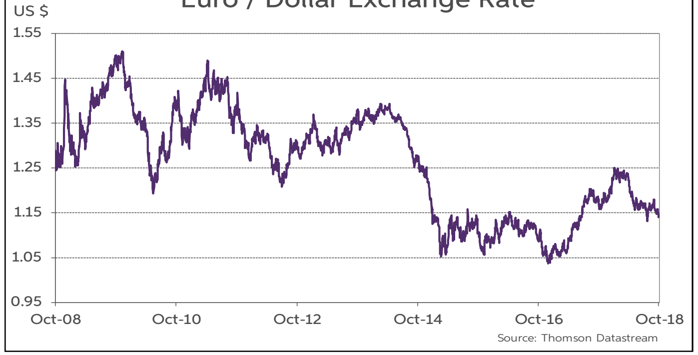
Summary of Exchange Rate Forecasts

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

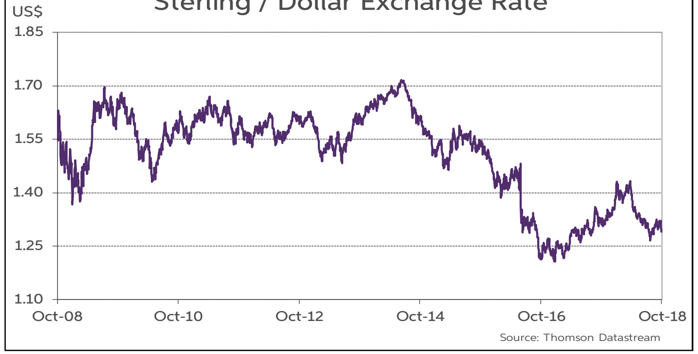
	Current	Q4-2018	Q1-2019	Q2-2019	Q3-2019
Euro Versus					
USD	1.141	1.12-1.18	1.14-1.20	1.16-1.22	1.18-1.24
GBP	0.884	0.85-0.91	0.84-0.90	0.83-0.89	0.83-0.89
JPY	128.12	126-132	127-133	128-134	129-135
CHF	1.14	1.14	1.15	1.16	1.16
US Dollar Versus					
JPY	112.30	109-115	108-114	107-113	106-112
GBP	1.291	1.27-1.33	1.31-1.37	1.35-1.41	1.38-1.44
CAD	1.30	1.29	1.28	1.27	1.25
AUD	0.71	0.71	0.72	0.73	0.74
NZD	0.65	0.65	0.66	0.67	0.68
CNY	6.95	6.95	6.90	6.80	6.70
Sterling Versus					
JPY	145	146	149	152	154
CAD	1.68	1.69	1.72	1.76	1.76
AUD	1.82	1.83	1.86	1.89	1.91
NZD	1.98	2.00	2.03	2.06	2.07

Euro / Dollar Exchange Rate



Euro / Sterling Exchange Rate

Sterling / Dollar Exchange Rate



AIB Bankcentre, Ballsbridge, Dublin 4 Tel: 353-1-6600311 www.aibeconomics.com