

Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit



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- Inflation rises to very high levels, which combined with other headwinds such as the rapid tightening of monetary policy, is acting as a significant drag on global growth
- Growth forecasts have been scaled back considerably for most economies. Concerns that the world economy could enter recession in H2 2022 or 2023
- Significant rate hikes implemented as central banks respond to deteriorating inflation picture, with more tightening to come. Central banks no longer giving clear forward guidance on rates
- Markets see EZ, UK & US rates rising to 1.25%, 3.0% and 3.625%, respectively, by early next year. Modest rate cuts seen in the US by end 2023 and during 2024 in the UK, with ECB going on hold
- Dollar soars to 20-year highs on aggressive Fed tightening. Collapse in yen as BoJ stays on hold

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Fears of a global recession as inflation spikes even higher and rates rise sharply

Growth forecasts continue to be scaled back nearly everywhere as inflation surges even higher on the back of the War in Ukraine. This is putting significant downward pressure on households real disposable incomes. Meanwhile, most central banks are engaged in a pronounced tightening of monetary policy. Both the IMF and OECD, in their summer Updates, paint a gloomy picture, saying global growth will slow significantly in 2022-23, largely as a consequence of the war. A substantial tightening of financial conditions, with a faster and more extensive hiking of interest rates by central banks, is weighing on activity too. There has also been a greater-than-anticipated slowdown in the Chinese economy, largely reflecting fresh COVID-19 outbreaks and lockdowns. This has added to the disruptions in global supply chains and is an additional headwind for the world economy.

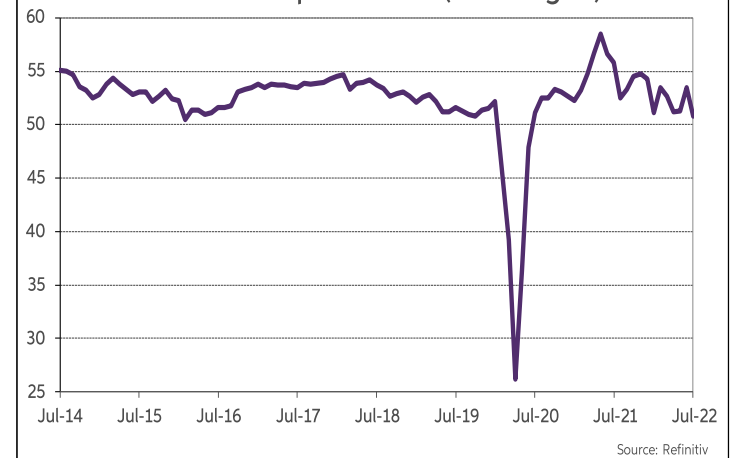
Both the IMF and OECD are now forecasting that the world economy will grow by 3.0% or slightly above this year and 2.8% in 2023. This compares to the projections of circa 4.5% and 3.2% growth for 2022 and 2023, respectively, made at the end of last year. It represents a marked slowdown from the 6% growth seen in 2021. Forecasters hope that high levels of private sector savings and strong labour markets will help most advanced economies avoid recession despite the headwinds to growth. Growth in advanced economies is expected to slow sharply from 5.2% in 2021 to 2.5% in 2022 and 1.4% in 2023, according to the MF, with similar forecasts from the OECD.

The slowdown in activity is not uniform across the world economy. Many commodity-producing economies will record higher output and earnings, with by contrast, big declines occurring in large commodity-importing countries. Meantime, Russia and Ukraine have entered very deep recessions. Within advanced economies, the Bank of England is forecasting that the UK economy will contract by 1.0-1.5% next year. The IMF expects growth in the US and Eurozone to slow to around a very anaemic 1% in 2023. Meanwhile, growth in China is forecast to weaken sharply this year to 3.3% from 8.1% in 2021. The Japanese economy, though, is projected to expand at a steady rate of 1.7% in both 2022 and 2023, unchanged from its growth rate in 2021.

The OECD and IMF highlight the considerable uncertainty around economic forecasts, which is well beyond the usual range. Indeed, the IMF has commented that risks to the outlook are “overwhelmingly tilted to the downside”. The effects of the War in Ukraine could be even greater than assumed, especially on energy markets and supply chains, most notably if there is a complete cessation of European gas imports from Russia. Inflation could turn out to be higher and longer lasting than projected, weighing on global activity. There is also a growing concern that central banks in their moves to tighten policy to dampen inflation, may tip economies into recession. Tighter conditions on financial markets could also cause distress in some emerging markets and economies. COVID also remains an ongoing risk, especially the possible emergence of new, more aggressive variants.

Headline inflation rates have risen to very high levels in many countries. They stand at circa 9% in the Eurozone, US and UK. The BoE projecting that the UK rate will rise to 13% in the autumn. There is a risk of a spill over into higher wage inflation, which would make it more difficult to get CPI rates back down to their 2% target anytime soon. Indeed, a shortage of workers is already putting upward pressure on wages. The unemployment rate has fallen to 3.5% in the US and a record low of 6.6% in the Eurozone. With price pressures becoming more broad-based, inflation is now expected to remain elevated next year. The IMF sees world consumer price inflation averaging 8.3% this year and a still high 5.7% in 2023, even with a fall back in commodity prices.

Global Composite PMI (JP Morgan)



GDP (Vol % Change)

	2020	2021	2022 (f)	2023 (f)
World	-3.1	6.1	3.2	2.8
Advanced Economies	-4.6	5.2	2.5	1.4
US	-3.4	5.7	2.3	1.0
Eurozone	-6.3	5.4	2.6	1.2
UK	-9.3	7.4	3.2	0.5
Japan	-4.5	1.7	1.7	1.7
Emerging Economies	-2.0	6.8	3.6	3.9
China	2.2	8.1	3.3	4.6
India	-6.6	8.7	7.4	6.1
World Trade Growth (%)	7.9	10.1	4.1	3.2
Inflation -CPI				
World Economies (%)	3.2	4.7	8.3	5.7

Source: IMF World Economic Update, July 2022

Interest Rate Outlook

Central banks step up pace of rate tightening as inflation soars

Economies rebounded at a much quicker than anticipated pace last year, inflation picked up by far more than expected, while labour markets also tightened rapidly. Thus, central banks began to scale back on their policy accommodation last autumn, ending or running down QE programmes, as well as starting to raise interest rates. The war in Ukraine has added greatly to inflationary pressures this year, with further very sharp increases in energy and other commodity prices. CPI rates have risen to around 9% in the major economies and hit double-digit levels in some smaller economies. The BoE is forecasting that inflation in the UK will rise to 13% in the final quarter of this year. Growth, though, is weakening, making central banks task more difficult, but it is quite clear that they are committed to bringing inflation back under control. This is now their clear policy priority.

The US Federal Reserve has been the most vocal of the main central banks in delivering a clear message that a significant tightening of policy is on the cards. It has increased rates by 225bps since March, including 75bps moves in June and July, the first such hikes in nearly thirty years. This has brought the funds rate up from 0.125% to a 2.25-2.5% range. Further rate hikes are in the pipeline for the remainder of the year, with the Fed's 'dot plot' indicating that it sees them peaking at around 3.75% in 2023. Market rate expectations have been quite volatile over the summer, and there are currently slightly below the Fed's trajectory and see the funds rate rising to 3.5% by March. The Fed has not ruled out another 75bps hike in September, though, which would put rates on course to get close to 4%. It is not giving clear guidance, however, on the size of the next rate hike, which will be very much data dependent, in particular, inflation figures, which were good for July. Further out, markets see the Fed starting to cut rates in H2 2023 as inflation falls back and expect them to be reduced to around 2.5% by mid-2025.

The Bank of England hiked rates by 50bps at the August MPC meeting. This represented an acceleration in the pace of tightening as the Bank had raised rates in 25bps steps at the previous four MPC meetings this year. The moves have taken the Bank rate up from 0.1% to 1.75%. Further rate increases are on the cards over the remainder of 2022, with the BoE indicating that it would continue to act forcefully if necessary, should inflationary pressures prove persistent. Markets are pricing in that UK rates will be raised to a peak of 3% by early next year. Growth in the UK economy has already slowed sharply this year as a result of fiscal and monetary tightening and higher energy costs. The BoE sees the economy entering recession late this year and contracting by 1.0-1.5% in 2023. Inflation is projected to fall below the 2% target by end 2024, before declining even further to under 1% in 2025. As such, markets have started to price in that rates could be cut by 75bps to 2.25% in 2024.

The ECB ended QE at mid-year and implemented its first rate increase since 2011 at its Council meeting in July, when it hiked by 50bps. This took the deposit rate up from -0.5% to 0%, bringing an end to the Bank's negative interest rate regime. The Bank has stopped giving specific forward guidance on policy, indicating that future rate moves are very much data dependent, but indicated that more hikes are on the cards. Markets now believe the ECB will hike rates by 100bps over the remainder of the year, taking the key deposit rate to 1%. They see a further 25bps rate increase in the first half of 2023, with policy then being put on hold at 1.25% over the following couple of years. This is much lower than earlier in the summer when ECB rates were seen peaking at around 2.25%. Meanwhile, the ECB, as expected, announced in July the launch of a new policy tool, the Transmission Protection Instrument (TPI). This will involve direct intervention by the ECB to support peripheral euro bond markets where there is an unwarranted widening of yield spreads. The aim is to avoid policy fragmentation in the euro area.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	2.375	2.92	4.00	3.37	2.87
Sept'22	2.875	3.25	4.05	3.45	2.95
Dec'22	3.375	3.60	4.10	3.50	3.00
Mar'23	3.625	3.75	4.05	3.40	2.90

* Swap Forecasts Beyond 1 Year

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.00	0.32	1.11	1.35	1.54
Sept'22	0.50	0.75	1.20	1.45	1.65
Dec'22	1.00	1.25	1.30	1.55	1.75
Mar'23	1.25	1.35	1.35	1.60	1.80

* Swap Forecasts Beyond 1 Year

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	1.75	2.12	2.99	3.02	2.68
Sept'22	2.25	2.50	3.15	3.20	2.80
Dec'22	2.75	2.95	3.25	3.25	2.85
Mar'23	2.75	2.90	3.20	3.15	2.75

* Swap Forecasts Beyond 1 Year

Dollar hits 20-year high as hawkish Fed implements large rate hikes

The dollar moved steadily lower in 2020, losing 12% against the other major currencies, as US rates were cut from over 2% to virtually zero. However, it recovered some ground in the second half of last year, helped by a firming of US interest rates along the curve, amid growing expectations of significant Fed rate hikes in 2022-23. It rose by 5% in trade-weighted terms during this period. The euro was a notable casualty of the dollar's strength, falling from \$1.22 in mid-2021 to \$1.12 near year end.

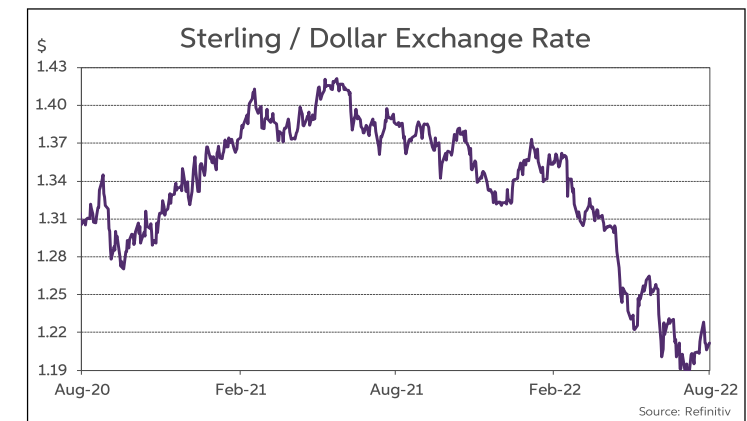
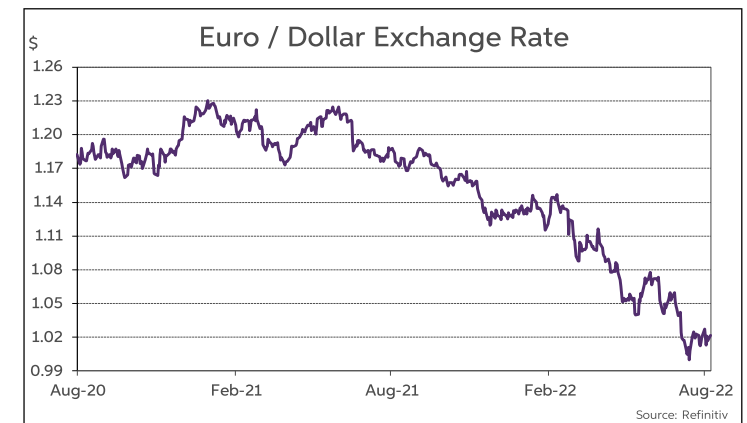
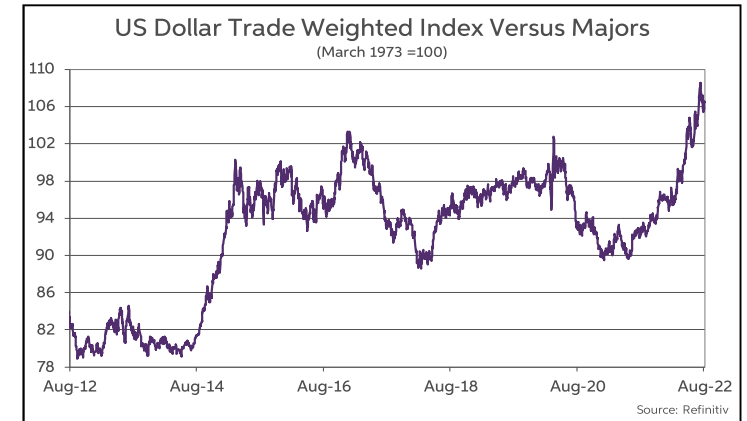
The Russian invasion of Ukraine triggered a further bout of dollar strength this spring, both in terms of a flight-to-quality into the world's largest reserve currency as financial markets came under pressure, and with the Fed the most vocal of the main central banks on the need for significant rate tightening to counteract the further surge in inflation seen in the first half of 2022. The dollar has risen to its highest level on a trade-weighted basis since 2002, more than regaining all the ground lost during 2020. It has made significant gains against a broad range of currencies, with particularly large upward moves against the yen and sterling.

Not surprisingly, given the Eurozone's closer trade and financial ties with Russia and in particular its reliance on imports of gas from there, the euro came under pressure following the invasion of Ukraine and the imposition of sanctions on Russia. Support at the \$1.10 level against the dollar was easily breached. The key support level at \$1.08, which had held during the early stages of the COVID-19 crises in the first half of 2020, also gave way, as did support at \$1.06. The major support level of \$1.04 level, which was the lowest point hit by the euro in the past twenty years, initially held in early summer before giving way at mid-year as the Fed stepped up the pace of rate tightening and rate hike expectations were greatly scaled back in the Eurozone. The euro fell to as low as parity before settling in a narrow \$1.01-1.025 range recently.

It is difficult to envisage a significant fall in the dollar over the second half of the year as it should be supported by a further move upwards in US interest rates to above 3% and relatively high US bond yields. Markets also seem likely to remain volatile, which would point to continuing flows into traditional safe-haven currencies like the dollar. Geo-political risks are also likely to remain elevated, which should be supportive of the US currency.

From a euro viewpoint, the fact that the ECB is set to deliver further rate hikes over the course of the second half of 2022 should prove supportive of the currency. However, the war in Ukraine is likely to continue to pose a risk for the euro, especially if there is a significant interruption or cessation of gas supplies from Russia. This could lead to gas rationing and power cuts in the Eurozone, with the accompanying risk of a recession as output declines. This would likely see renewed downward pressure on the currency. Should parity give way, then a decline to \$0.95-96 could be on the cards for the euro against the dollar. The last time that the euro dropped below parity, it spent almost three years there over the period 2000-2002.

Our base case, though, is that the end of negative interest rates and further ECB rate hikes will help put a floor under the single currency. Market positioning is also very long the dollar at present. Thus, we expect the euro to trade in a narrow \$1.00-1.04 range over the rest of the year. Further out the dollar could lose some ground over the course of 2023 if rate cuts come on to the agenda in the US, but not elsewhere. For now, though, the dollar very much has the upper hand on forex markets, with the Fed on an aggressive rapid rate tightening path. That is unlikely to change until US rates reach a peak and policy easing is seen coming on to the Fed agenda.



Sterling subdued as concerns grow about the outlook for the UK economy

Sterling gained good ground last year, most notably versus the euro and yen, as the EU-UK Brexit trade deal lifted a cloud of uncertainty around the currency. The rapid rollout of COVID vaccines in the UK also allowed the economy to rebound strongly. This saw markets moving from, at the start of 2021 pricing in negative interest rates, to later in the year expecting that UK rates could rise sharply to counter inflation.

The BoE started to turn quite hawkish on monetary policy late last year and hiked rates by 15bps in December. This was followed by four 25bps increases in H1 2022, bringing the Bank rate to 1.25%. It stepped up the pace of tightening in August with a 50bps rate increase. Further rate hikes are on the cards, with inflation projected to hit 13% in the autumn. Markets are pricing in that UK rates will get to a peak of 3% early next year. Despite the rate increases, sterling has lost considerable ground to the buoyant dollar this year, with cable falling sharply from \$1.37 in January to around the \$1.20 level recently. It has been largely range bound against the euro over the past year, generally trading in an 83-86p band, even though the ECB only started to raise rates last month.

Sterling's subdued performance seems to be mainly due to concerns around the UK economic outlook. The economy has lost considerable momentum since earlier in the year in the face of a tightening of fiscal and monetary policy as well as galloping inflation. The Bank of England is quite downbeat on the economy's growth prospects as a result of a squeeze on real disposable income from higher taxes and elevated inflation. Brexit has also acted to depress trade with the EU, with a noticeable widening of the BoP deficit in 2022. The BoE sees the economy entering recession later this year and is projecting a fall of 1.0-1.5% in GDP in 2023.

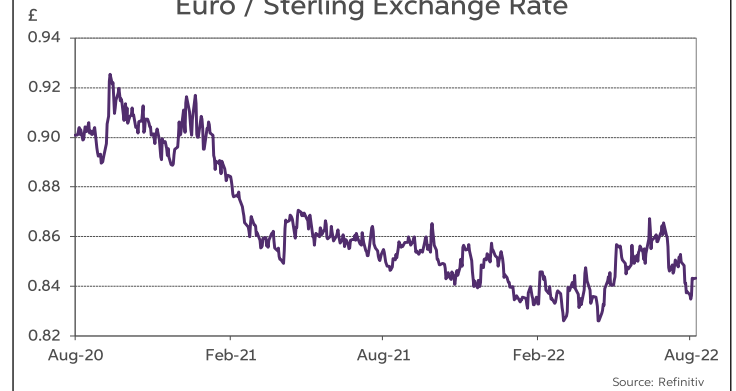
Further rate hikes should provide support for sterling in the near-term, especially if rates rise to 3% as expected by markets. FX positioning is also quite short the UK currency. Thus, it may trade close to recent levels in the coming months. Further out, though, sterling, could start to lose ground if rate cuts start to come on to the agenda in 2023 with the economy in deep recession. A close eye also needs to be kept on the current dispute with the EU over the Northern Ireland Protocol, that it does not mutate in a wider trade war.

Sharp fall in yen on widening interest rate differentials as BoJ stays on hold

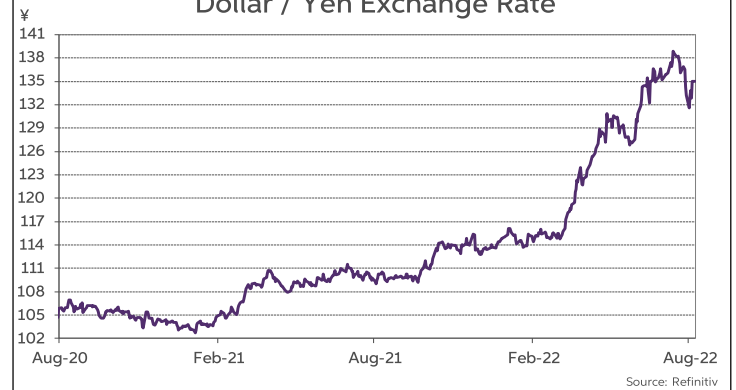
The yen has lost considerable ground against the appreciating US currency since early 2021. The dollar climbed from ¥103 at the start of last year to ¥115 by end 2021. The Japanese currency has suffered a further sharp drop since the spring, with the dollar rising from ¥115 in March to a peak near ¥139 recently, before moving back to around ¥135. Meanwhile, the euro climbed from a low of ¥115 two years ago to a peak of ¥144 by June. It then fell back to ¥135 by end July, before rising again to around ¥138 this month.

In marked contrast to other central banks, the BoJ has stuck to its very accommodative policy and is engaged in large scale QE to cap ten year JGB yields at 0.25%. Widening interest rate differentials are putting severe downward pressure on the yen, with outflows into much higher yielding currencies. The yen has fallen to a twenty-four year low against the dollar—the US currency had not been above the ¥135 level since 1998 until this summer. The yen could lose further ground if interest rates elsewhere rise more than expected. However, if markets are correct that rates elsewhere will top out in early 2023, then we may be starting to see the yen stabilise. It is hard to see any major recovery in the yen, though, until interest rate differentials start to narrow.

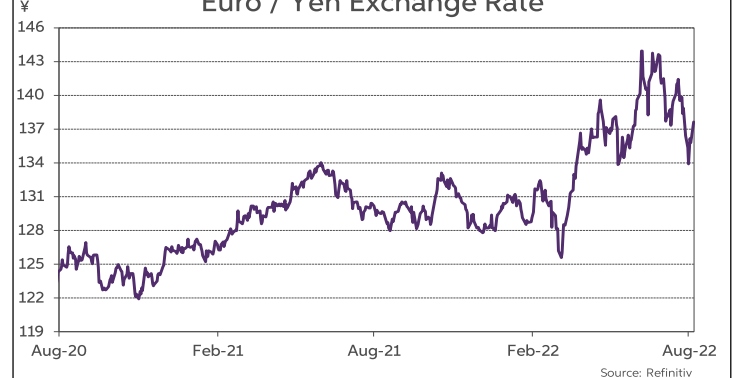
Euro / Sterling Exchange Rate



Dollar / Yen Exchange Rate



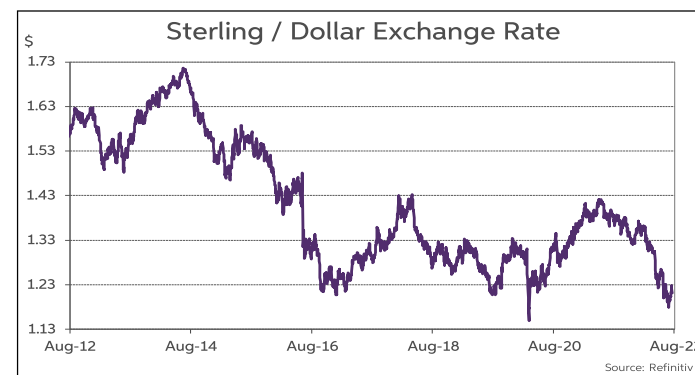
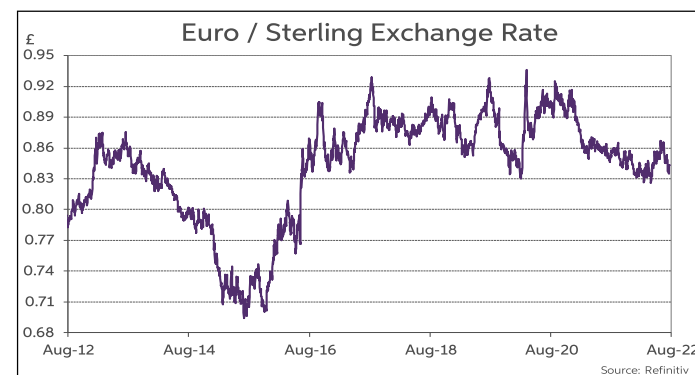
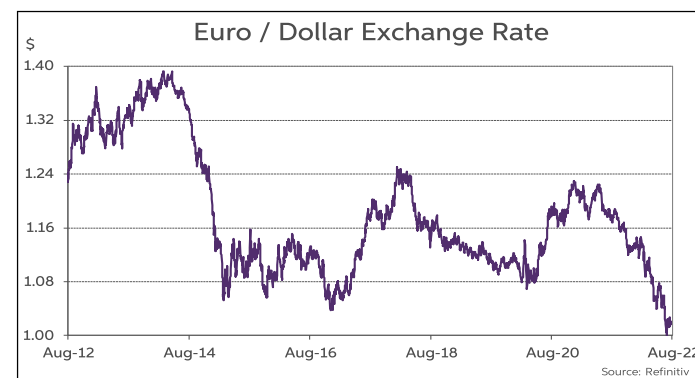
Euro / Yen Exchange Rate



Summary of Exchange Rate Forecasts

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

Euro Versus	Current	Q3-2022	Q4-2022	Q1-2023	Q2-2023
USD	1.022	0.99-1.05	1.00-1.06	1.02-1.08	1.04-1.10
GBP	0.845	0.81-0.87	0.82-0.88	0.83-0.89	0.84-0.90
JPY	137.97	135-141	138-144	139-145	139-145
CHF	0.97	0.98	1.00	1.02	1.04
US Dollar Versus					
JPY	135.01	132-138	134-140	132-138	130-136
GBP	1.210	1.18-1.24	1.18-1.24	1.19-1.25	1.20-1.26
CAD	1.29	1.29	1.27	1.29	1.23
AUD	0.70	0.70	0.71	0.72	0.73
NZD	0.63	0.63	0.64	0.65	0.66
CNY	6.76	6.75	6.70	6.60	6.50
Sterling Versus					
JPY	163	163	166	165	164
CAD	1.56	1.57	1.54	1.53	1.51
AUD	1.74	1.73	1.70	1.69	1.68
NZD	1.92	1.92	1.89	1.88	1.86



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