# Forex and Interest Rate Outlook

## AIB Treasury Economic Research Unit

AIB

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- Economic data have generally surprised to the upside in recent months, helped by easing inflation. Most economies should avoid recession, but weak growth still in prospect for 2023-24
- Further rate hikes to be implemented by central banks in coming months as they seek to drive inflation back down towards 2% target. Markets lift expectations for peak rates in US & Eurozone
- Central banks indicate policy will need to remain restrictive for a prolonged period to squeeze inflation out of system. Markets scale back rate cut expectations considerably for 2023-2024
- Dollar back on front foot amid strong US data and with Fed rates expected to be hiked to 5.25% or above. Yen needs BoJ to start tightening policy for its recovery to resume
- Sterling to stay range bound at weak levels given poor prospects for UK economy. A move by the BoE to loosen policy ahead of other central banks could pose a future risk for the currency

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# Global Economic Outlook

## *Most economies look set to avoid recession, but growth likely to be muted*

The global economy lost considerable momentum over the course of last year after it had rebounded strongly in 2021 from the impact of COVID-19. The Russian invasion of Ukraine saw a sharp rise in commodity prices, especially energy and food prices, that added significantly to already rising inflation. Central banks responded to the surge in inflation with a marked tightening of monetary policy. Amid an environment of weakening confidence levels and heightened uncertainty, this saw the world economy slow sharply over the course of last year.

However, concerns that advanced economies could be facing a recession in 2023 have largely abated over the winter. Most economic data have printed ahead of expectations in recent months, commodity prices have fallen back, the annual rate of consumer price inflation has started to ease, while labour markets have held up well with unemployment remaining at very low levels. Meanwhile, growth in China is expected to pick up this year after it abandoned its zero-COVID strategy, which has allowed for a full re-opening of its economy. Thus, recent macroeconomic updates have generally seen slight upgrades to official growth forecasts for 2023, and an acknowledgement that adverse risks to the global economic outlook have moderated since the autumn.

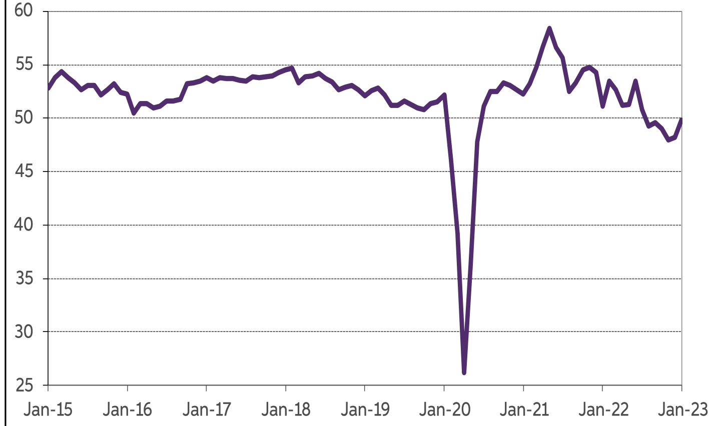
The IMF in its latest Economic Update says it now expects the world economy to grow by around 3% in 2023 and 2024. This is appreciably better than the growth rates of 2.2% in 2023 and 2.7% in 2024 forecast by the OECD for the global economy at the end of last year. The EC has also upped its 2023 GDP forecast for the Eurozone economy from 0.3% to 0.9%. The UK is an outlier in terms of its relatively weak growth performance since 2020 and GDP is widely expected to contract this year. The BoE, though, has scaled back its projected contraction in UK GDP this year from -1.5% to -0.5%, but thinks the UK economy could contract again in 2024. Most forecasts, though, are for the UK economy to return to a growth path next year, given an expected sharp fall in inflation.

Western economies, though, are still facing considerable challenges. High inflation and rising interest rates are significant restraints on the US economy. Growth in Europe is anticipated to continue to be impacted by the War in Ukraine, muted external demand, high energy/food prices, weak confidence and tighter monetary policy. The challenges are even greater in the UK economy, with tighter fiscal policy, the dampening impact of Brexit on external trade, higher inflation than elsewhere and a shrinking workforce all acting as additional headwinds.

The IMF, OECD and others also highlight the considerable uncertainty around economic forecasts. They all note that while risks to the outlook have moderated somewhat in recent months, they remain tilted to the downside. The effects of the War in Ukraine could be even greater than assumed, especially with the increasing supply of NATO military equipment to Ukraine. High inflation could prove to be more longer lasting than projected, weighing on global activity. Central banks in their desire to bring inflation back down to target, could tighten policy too much and push economies into recession. Tighter conditions on financial markets could also cause distress in some emerging markets and economies, with rising bad debts. Both COVID and a deepening crisis in the real estate market remain ongoing risks for the Chinese economy that could see its expected recovery stall.

In terms of inflation, falling commodity prices are resulting in headline CPI rates starting to decline. However, price pressures have also become more broad-based, so core rates may remain elevated for quite some time. Central banks will be particular close attention to wage growth given the tightness of labour markets. Avoiding a wage-price spiral will be critical to ensuring price stability is restored in economies in the next couple of years.

Global Composite PMI (JP Morgan)




Source: Refinitiv

*GDP (Vol % Change)*

| | 2021 | 2022 (e) | 2023 (f) | 2024 (f) |
|---|---|---|---|---|
| World | 6.2 | 3.4 | 2.9 | 3.1 |
| Advanced Economies | 5.4 | 2.7 | 1.2 | 1.4 |
| US | 5.9 | 2.0 | 1.4 | 1.0 |
| Eurozone | 5.3 | 3.5 | 0.7 | 1.6 |
| UK | 7.6 | 4.1 | -0.6 | 0.9 |
| Japan | 2.1 | 1.4 | 1.8 | 0.9 |
| Emerging Economies | 6.2 | 3.9 | 4.0 | 4.2 |
| China | 8.1 | 3.0 | 5.2 | 4.5 |
| India | 8.7 | 6.8 | 6.1 | 6.8 |
| World Trade Growth (%) | 10.0 | 5.4 | 2.4 | 3.4 |
| Inflation -PCE Advanced Economies (%) | 3.1 | 7.3 | 4.6 | 2.6 |

*Source: IMF World Economic Outlook Update, January 2023*

# Interest Rate Outlook

## *Central banks continue to tighten policy and signal higher rates for longer*

The second half of last year was characterised by an aggressive pace of policy tightening from central banks. This was against the backdrop of inflation rising to 10% or above in many economies, while at the same time, labour market conditions remained tight. As a result, some of the main central banks implemented rate hikes in 75bps increments during the latter half of 2022.

More recently, the pace of rate hikes slowed towards the end of last year and in early 2023, amid signs that inflation had peaked and was starting to ease, as well as central banks being cognisant of the risks to their respective economies from over-tightening. However, central banks continued to assert their inflation fighting credentials with most guiding that further hikes were on the cards and rates would need to go higher than previously anticipated. They also moved to dampen expectations of rate cuts before year-end, indicating that policy will need to be kept tight for a prolonged period to restore price stability.

The US Fed announced a 50bps increase at its December meeting and then a 25bps hike at the start of February, which brought the target range for the Fed's funds rate to 4.50-4.75%. These moves followed four consecutive 75bps rate hikes. The Fed has now implemented 450bps worth of rate increases since it commenced its tightening cycle back in last March. It has indicated that some further increases in rates will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to its 2% target. The FOMC interest rate projections from December showed that it anticipates rates rising to a peak of 5.125% this year.

Since then, US data have printed on the strong side, leading markets to begin to anticipate that rates could rise to a 5.25-5.5% range by mid-year. A significant numbers of FOMC members had indicated a preference for rates to get to this level back in December and the recent strong data suggest this may now well become the majority view. Further out, markets have greatly scaled back their expectations on rate cuts. They now see rates ending the year at 5.125% compared to 4.5% previously in mid-January. Futures contracts then see rates being cut to around 3.75% by end 2024, up from 3% a month ago, with rates now expected to be pitched at around 3.5% by end 2025.

The BoE hiked rates by 50bps in December and again in early February, bringing the Bank Rate up to 4%. This represents a slower pace compared to the 75bps increase delivered in November. The BoE has now hiked for ten straight meetings, by a total of 390bps, since it started tightening policy in December 2021. However, the voting breakdown for February showed that the MPC remained split on its rate decision, with two members favouring no change. Overall though, the BoE retains a tightening bias, noting that further rate increases "would be required" if there is evidence of persistent inflationary pressures. Markets are currently envisaging a peak of 4.65% in rates around mid-year. Two 25bps hikes could well be on the cards in the coming months given the strength of wage inflation in particular, with policy then being put on hold at 4.5%. Only small rate cuts are envisaged in 2024-25.

Meanwhile, following two consecutive 75bps hikes in September and October, the ECB moved to smaller 50bps increases in December and early February. This saw the Deposit rate rise to 2.5% and brought the total amount of hikes to 300bps. The ECB has given a clear signal that rates will be hiked by 50bps again at its March meeting to 3%. Market expectations for the peak in the Deposit rate have firmed considerably in the past month on the back of hawkish comments from ECB officials. Further contracts now see rates rising to 3.75% this summer. Rate cuts are no longer on the cards for later this year, with markets looking for 50-75bps of easing during 2024.

### US Interest Rate Forecasts (to end quarter)

| | Fed Funds | 3 Mth | 1 Year | 2 Year * | 5 Year * |
|---|---|---|---|---|---|
| Current | 4.625 | 4.92 | 5.64 | 5.02 | 4.23 |
| Mar'23 | 4.875 | 5.20 | 5.85 | 5.05 | 4.25 |
| June'23 | 5.375 | 5.60 | 6.00 | 5.10 | 4.30 |
| Sept'23 | 5.375 | 5.55 | 5.90 | 5.00 | 4.20 |

** Swap Forecasts Beyond 1 Year*

### Eurozone Interest Rate Forecasts (to end quarter)

| | Deposit Rate | 3 Mth | 1 Year | 2 Year * | 5 Year * |
|---|---|---|---|---|---|
| Current | 2.50 | 2.68 | 3.59 | 3.59 | 3.26 |
| Mar'23 | 3.00 | 3.20 | 3.80 | 3.70 | 3.30 |
| June'23 | 3.75 | 3.90 | 4.10 | 3.80 | 3.35 |
| Sept'23 | 3.75 | 3.85 | 4.00 | 3.70 | 3.25 |

** Swap Forecasts Beyond 1 Year*

### UK Interest Rate Forecasts (to end quarter)

| | Bank Rate | 3 Mth | 1 Year | 2 Year * | 5 Year * |
|---|---|---|---|---|---|
| Current | 4.00 | 4.24 | 4.69 | 4.61 | 4.19 |
| Mar'23 | 4.25 | 4.50 | 4.80 | 4.65 | 4.25 |
| June'23 | 4.50 | 4.65 | 4.90 | 4.70 | 4.30 |
| Sept'23 | 4.50 | 4.60 | 4.80 | 4.60 | 4.20 |

** Swap Forecasts Beyond 1 Year*

*AIB Treasury Economic Research Unit*

# Forex Market Outlook

## *Elevated level of US interest rates supporting the dollar*

The dollar was in the ascendancy from mid-2021 through to autumn 2022 as hikes in US interest rates and rising US bond yields drove the currency higher. It rose by circa 25% in trade-weighted terms during this period. The Russian invasion of Ukraine was also a key factor in the strengthening of the dollar last year. By September 2022, the dollar had risen to its highest level on a trade-weighted basis in twenty years. It made significant gains against a broad range of currencies, with particularly large upward moves against the yen and sterling. The euro was also a notable casualty of the dollar's strength, falling from $1.22 in mid-2021 to a low of $0.95 in September 2022. Not surprisingly, it came under marked downward pressure following the Russian invasion of Ukraine.

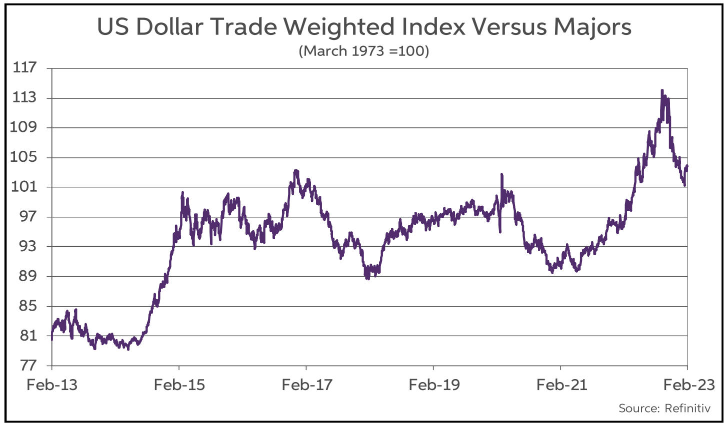
However, the final quarter of 2022 through to end January 2023 saw a change in the dollar's fortunes. It lost significant ground as other central banks stepped up the pace of rate tightening, with 75bps hikes becoming the norm. This was initially reflected in EUR/USD moving back up to parity, before rising up to the $1.05-1.06 level late last year and then reaching $1.10 at end January. Meantime, sterling rose from a low of $1.04 to rebound to $1.24, while the dollar fell back from a high above ¥150 against the yen in October to below ¥130 in January.

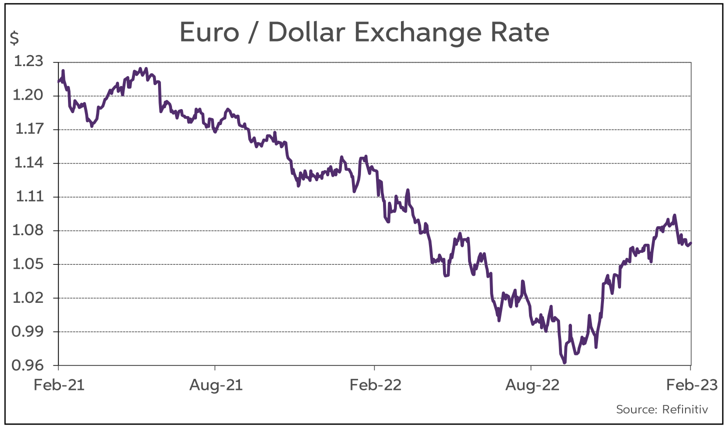
More recently, the dollar has regained some ground on a firming of US rate hike expectations. In the aftermath of the FOMC meeting at the start of February, futures contracts started to price in that US rates would rise above 5% and now see them being hiked to a 5.25-5.50% range. Furthermore, markets now expect US rates to remain elevated for a prolonged period. They see rates above 5% at end 2023, before falling to around 3.75% at end 2024 and 3.5% at end 2025. Previously, rate cuts were expected to commence later this year, with rates falling to 3% by end 2024. As a result, Treasury yields have risen by 60bps or more along the curve in February.

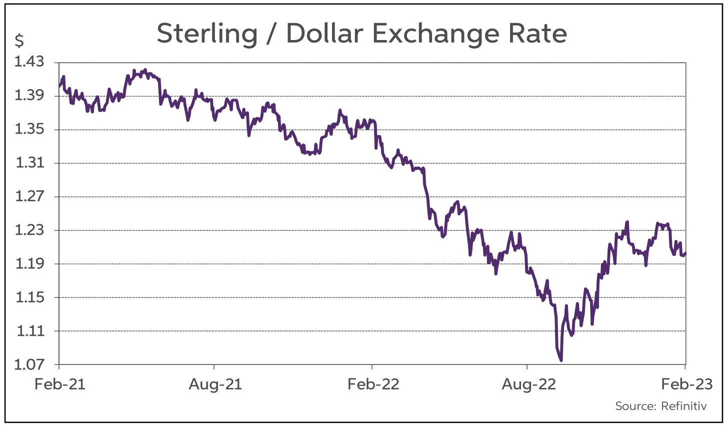
Of course, further hikes in rates are expected in other economies also in the coming months, most notably the Eurozone. Policy is expected to be put on hold thereafter, with many central banks indicating that a restrictive rate stance will be required for a prolonged period of time to squeeze inflationary pressures out of their economies. As noted though, US rates are set to rise above 5% and remain there into 2024, which would leave them well above the levels in most other countries. This has seen the US currency outperform this month, especially with markets having lightened up on long dollar positions over the winter.

From a euro viewpoint, the ECB has turned quite hawkish and remains on an aggressive rate tightening path, which is providing support for the currency. It has only lost a small amount of ground against the dollar, falling back to around the $1.06-1.07 level from $1.10 at end January. However, the war in Ukraine remains a risk for the euro, especially with NATO's growing military involvement which could see an escalation in the conflict. One would expect some gains by the euro in the months ahead as the ECB continues to hike, but they may prove limited given the war in Ukraine, and with rising rates elsewhere nullifying some of the impact of euro rate hikes. Thus, EUR/USD could continue to trade in the $1.05-1.10 range it has occupied in the last couple of months.

Interest rates have been a key driver of currencies in the past number of years. Thus, if US rate cuts look like coming on to the agenda in 2024, then the dollar could start to lose some further ground late this year. It is important to remember the currency is still at an elevated level. It has retraced less than 50% of the rally that occurred between mid-2021 and autumn 2022. Thus, the dollar has the capacity to fall further if US rates start to be cut. Hence, EUR/USD could rise to the $1.12 level later this year if US rate cuts in 2024 start coming into view.



# Forex Market Outlook



## *Sterling likely to remain range bound in coming months after difficult 2022*

Sterling started last year trading at around $1.35 versus the dollar and 84p against the euro. It endured a difficult year in 2022 owing to growing concerns about the prospects for the UK economy, especially in late September and early October following an expansionary 'mini-budget' which was badly received by financial markets. Against the buoyant dollar, sterling fell sharply to a record low below $1.04 in late September. Meanwhile, EUR/GBP traded as high as 92p during this period.

Sterling, though, then regained ground, aided by reduced 'political risk' with a new UK Prime Minister and Chancellor championing fiscal restraint and introducing measures to help stabilise the public finances, which restored calm to UK financial markets. This, combined with a considerable loss of momentum in the dollar, has seen cable move back up to a $1.20-1.24 range in recent months. Meanwhile, as sterling recovered, EUR/GBP moved lower to around the 86p level by the late autumn, before rising back up to an 87-89p range more recently.

The UK currency still faces a challenging outlook. The economy lost considerable momentum last year amid very high inflation and rising interest rates. The BoE is quite downbeat on the UK's growth prospects as a result of a squeeze on real household disposable incomes from high inflation. Most forecasters expect the UK economy to contract this year. Brexit has also acted to depress trade with the EU, which combined with the much higher costs of energy imports, saw a marked widening of the BoP deficit in 2022. A large deficit is expected in 2023 also.

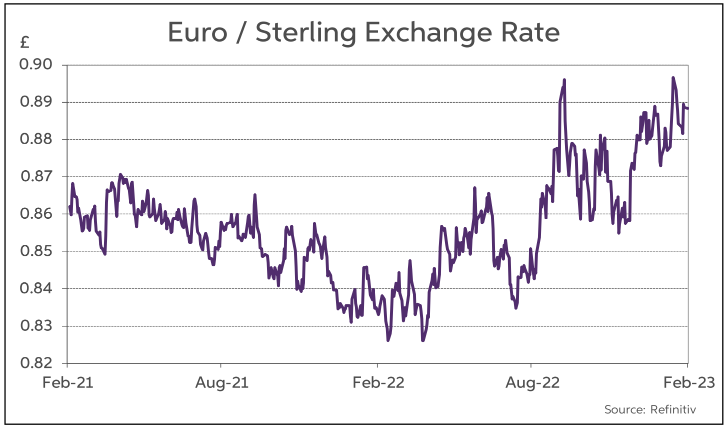
Further BoE policy tightening should provide some support for sterling, with rates likely to rise to 4.5%. It is hard to see sterling gaining ground, though, against the backdrop of the weak UK economy. Thus, against the dollar, it could continue to trade in a $1.20-1.25 range in the coming months, with EUR/GBP confined to a 86-90p corridor. A risk for sterling later in the year could be if the weak UK economy and sharply declining inflation see the BoE move to cut rates ahead of other central banks. For now, though, range trading seems likely for the currency.

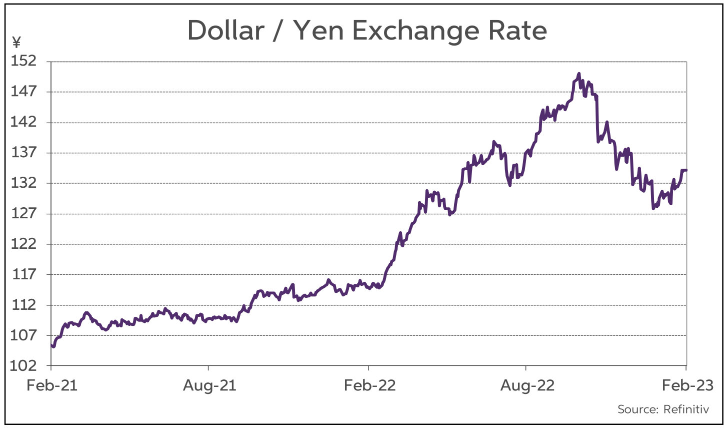
## *Policy tightening by BoJ required for yen rebound to resume*

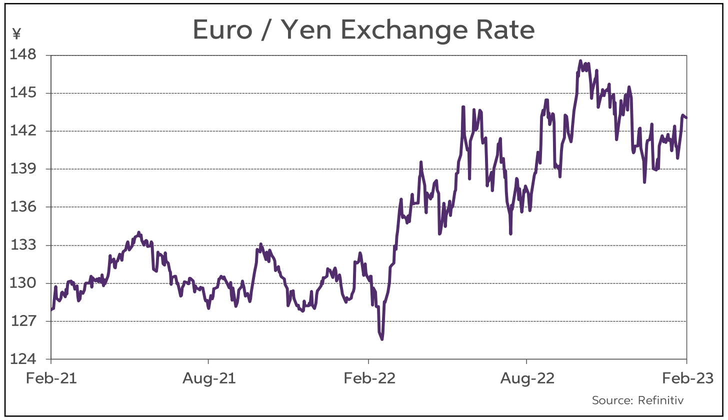
In marked contrast to other central banks, the BoJ continued with its very accommodative policy during most of 2022, implementing large scale QE to cap ten year JGB yields at 0.25%, while keeping the key OCR in negative territory. Widening interest rate differentials saw severe downward pressure on the yen, which fell to over 30-year lows against the dollar in the autumn, with the US currency rising above the ¥150 level in October.

With some pairing back of rate hike expectations elsewhere, the yen moved off its lows in late autumn. More particularly, the BoJ in December unexpectedly widened the yield corridor for ten year JGBs, effectively allowing yields to rise by 25bps. This saw the yen stage a strong rebound, with the USD/JPY rate falling to ¥128 and the euro moving down from ¥148 to around ¥138. More recently, the yen has lost some ground again on a firming of rate hike expectations and rising bond yields elsewhere, with the dollar rising back up to ¥135 and euro to ¥144.

A new BoJ Governor, Kazuo Ueda, has been nominated to take office in April, which could lead to some volatility in the yen. If he continues with a very loose monetary policy, then the yen is likely remain weighed down. However, the rise of CPI inflation in Japan to 4% is bringing pressure on the BoJ to end its negative interest rate and yield curve control (YCC) policies. If monetary policy starts to be tightened, the yen's rebound should resume.



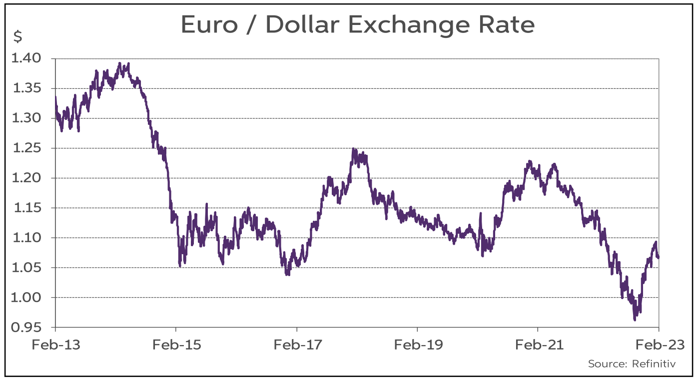



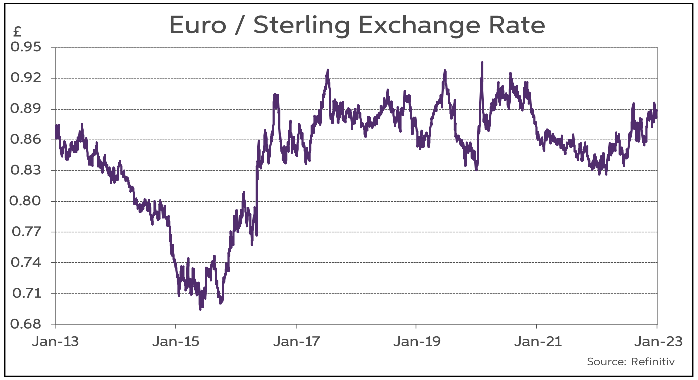



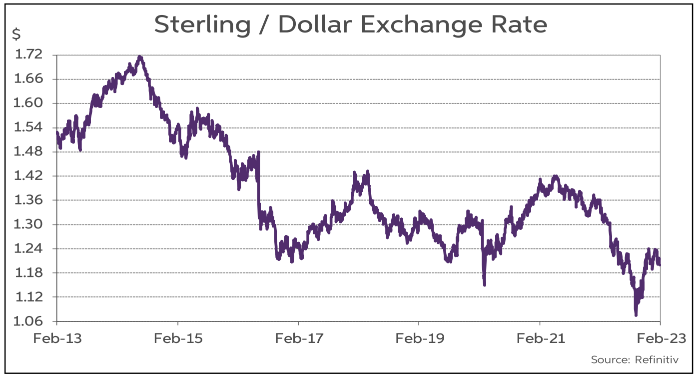
# Summary of Exchange Rate Forecasts

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

| | Current | Q1-2023 | Q2-2023 | Q3-2023 | Q4-2023 |
|---|---|---|---|---|---|
| **Euro Versus** | | | | | |
| USD | 1.064 | 1.04-1.10 | 1.06-1.12 | 1.07-1.13 | 1.09-1.15 |
| GBP | 0.881 | 0.85-0.91 | 0.85-0.91 | 0.86-0.92 | 0.86-0.92 |
| JPY | 143.55 | 141-147 | 142-148 | 140-146 | 139-145 |
| CHF | 0.99 | 0.99 | 1.00 | 1.01 | 1.02 |
| **US Dollar Versus** | | | | | |
| JPY | 134.95 | 132-138 | 130-136 | 127-133 | 123-129 |
| GBP | 1.207 | 1.18-1.24 | 1.21-1.27 | 1.21-1.27 | 1.23-1.29 |
| CAD | 1.36 | 1.36 | 1.34 | 1.32 | 1.30 |
| AUD | 0.68 | 0.68 | 0.69 | 0.70 | 0.71 |
| NZD | 0.62 | 0.62 | 0.63 | 0.64 | 0.65 |
| CNY | 6.90 | 6.90 | 6.80 | 6.70 | 6.60 |
| **Sterling Versus** | | | | | |
| JPY | 163 | 163 | 165 | 161 | 159 |
| CAD | 1.64 | 1.65 | 1.66 | 1.63 | 1.64 |
| AUD | 1.77 | 1.78 | 1.80 | 1.77 | 1.77 |
| NZD | 1.94 | 1.95 | 1.97 | 1.94 | 1.94 |

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