Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

21st June 2022

- Inflation rises to very high levels, which combined with other headwinds such as the rapid tightening of monetary policy, will act 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 to come in H2 2022. ECB to deliver first rate hike in July and another in September
- Markets see EZ, UK & US rates rising to 2.25%, 3.4% and 3.75%, respectively, by next year
- Dollar soars to 20-year highs on aggressive Fed tightening. Collapse in yen as BoJ stays on hold. Sterling comes under some downward pressure on worsening outlook for UK economy

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Global Economic Outlook

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Recession fears grow 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 while a pronounced tightening of monetary policy gets underway. The OECD, in its June 2022 bi-annual Economic Outlook, says global growth will slow significantly in 2022-23, largely as a consequence of the war. Meanwhile, there has been a substantial tightening of financial conditions, with a faster and more extensive hiking of interest rates by central banks that will weigh on growth too. Restrictions on activity in parts of China to contain new waves of COVID infections have added even further to the disruptions in supply chains and are an additional headwind for the global economy.

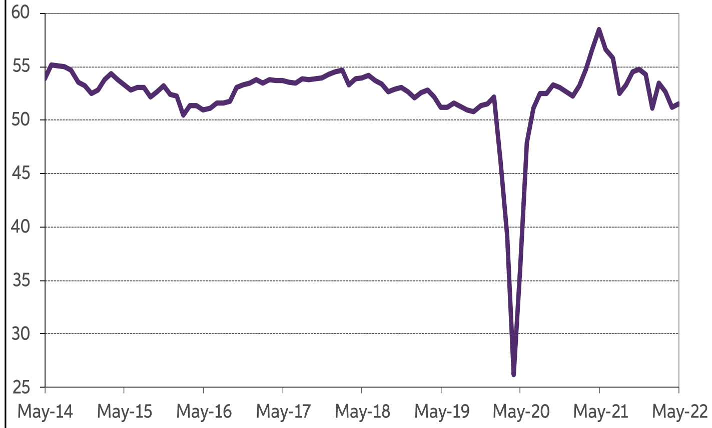
The OECD is now forecasting that the world economy will grow by 3.0% this year and 2.8% in 2023. This compares to the projections of 4.5% and 3.2% for 2022 and 2023, respectively, contained in its December 2021 Outlook. It represents a marked slowdown from the growth of circa 6% seen in 2021. In particular, growth in advanced economies is expected to slow sharply from 5.5% last year to 2.7% in 2022 and 1.6% in 2023, according to the OECD. Similar forecasts have been made by the World Bank in its bi-annual Update in June. It expects the world economy to grow by 2.9% in 2022 and 3% in both 2023 and 2024. Forecasters hope that high levels of private sector savings and strong labour markets will help economies avoid recession despite the numerous headwinds to growth. Meanwhile, inflation in advanced economies is now forecast by the OECD to average 8.5% this year and 6.0% in 2023, up from its projections of 4.2% and 3.0% for both years made in December 2021.

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 UK economy is expected to stall, with zero growth projected by the OECD for next year. Indeed, the BoE is forecasting that UK GDP will contract by 0.25% next year. The OECD sees US growth slowing to a very anaemic 1.2% in 2023, while Eurozone GDP is forecast to grow by 1.6%. The Japanese economy, though, is projected to grow by a steady 1.7% in both 2022 and 2023, unchanged from its growth rate in 2021.

The OECD and others highlight the considerable uncertainty around economic forecasts, which is well beyond the usual range. The effects of the War in Ukraine could be even greater than assumed, especially on energy markets and supply chains. 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. COVID also remains an ongoing risk, especially the possible emergence of new more aggressive or contagious variants that could sap global demand once again.

Headline inflation rates have risen to very high levels in many countries. It now stands at 8.1% in the Eurozone, 8.5% in the US and 9% in the UK. inflation has not peaked yet, with the BoE projecting that the UK rate will rise above 11% in the autumn. The risk is that this will spill over into higher wage inflation, which would make it more difficult to get CPI rates back down to their 2% target within the next couple of years. A shortage of workers is already putting upward pressure on wages. The unemployment rate has fallen to 3.6% in the US and a record low of under 7% in the Eurozone. Indeed, there are increasing concerns in markets that we may be entering a period of stagflation, a combination of no growth but high inflation, with unemployment rising back up again.

Global Composite PMI (JP Morgan)



Source: Refinitiv

GDP (Vol % Change)

	2020	2021	2022 (f)	2023 (f)
World	-3.4	5.8	3.0	2.8
Advanced Economies	-4.6	5.5	2.7	1.6
US	-3.4	5.7	2.5	1.2
Eurozone	-6.5	5.3	2.6	1.6
UK	-9.3	7.4	3.6	0.0
Japan	-4.5	1.7	1.7	1.8
Emerging Economies	-2.3	6.1	3.3	3.8
China	2.2	8.1	4.4	4.9
India	-6.6	8.7	6.9	6.2
World Trade Growth (%)	-8.1	10.0	4.9	3.9
Inflation -PCE Deflator Advanced Economies (%)	1.5	3.7	8.5	6.0

Source: OECD Economic Outlook, June 2022

Interest Rate Outlook

Rapid tightening of monetary policy underway to dampen down inflation

Monetary conditions were exceptionally loose globally during 2020-21 as central banks pulled out all the stops to try and ameliorate the most severe economic impacts of the COVID-19 pandemic. Economies, though, 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 reached 8.5% in the US and 8.1% in the Eurozone and hit double-digit levels in some economies. The BoE is forecasting that inflation in the UK will rise above 11% in the final quarter of this year. Growth, though, is clearly weakening, making central banks task more difficult as they will want to try and avoid pushing their economies into recession as they tighten policy.

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 150bps since March, including a 75bps hike in June, the first such hike in nearly thirty years. This has brought the funds rate up to a 1.5-1.75% range. Further significant rate hikes are in the pipeline for H2 2022, with the Fed's 'dot plot' indicating that it sees rates getting to a 3.25-3.5% range by end year and peaking at around 3.75% in 2023. The markets are in broad agreement and see the funds rate rising to 3.5% by end 2022 and 3.75% in March. Notably, all 18 members of the FOMC expect rates to go above 3% by end year, so the Fed seems very likely to deliver on its policy tightening intentions for H2 2022.

The Bank of England wrapped up its QE bond purchase programme in December. It has hiked the Bank rate on five occasions since then, taking it from 0.1% up to 1.25%. Further rate increases are expected in 2022, with the BoE indicating that it would act forcefully if necessary, should inflationary pressures prove persistent. Indeed, in June, three of the nine members of the MPC voted for a 50bps hike instead of 25bps for the second consecutive meeting. Markets are now pricing in that UK rates will be raised to 3% by year end and 3.4% in March 2023. Growth in the UK economy, though, has already slowed sharply as a result of fiscal and monetary tightening and higher energy costs. The BoE sees the economy contracting by 0.25% in 2023 and growing by just 0.25% in 2024, with inflation falling well below target in 2025. Thus, markets may be pricing in too much in terms of UK rate hikes given this very weak outlook for economic activity. Rates may top out in a 2.0-2.5% range around the turn of the year, especially if the MPC sticks with 25bps hikes.

The ECB is set to end QE at mid-year and begin hiking rates next month. It has indicated that rates will be increased by 25bps next in July and possibly by a larger amount in September. Beyond this, the ECB anticipates that a gradual but sustained path of rate tightening will be appropriate. Markets now believe that the ECB will hike rates by 175bps over the second half of the year, taking the key deposit rate to 1.25%. They see a further 100bps of rate increases in 2023. Thus, we are coming to the end of the negative interest rate regime that has been in place since 2014 and a normalisation of monetary policy is now imminent in the Euro area. We expect much weaker growth than the 2% rise in GDP projected by the ECB for 2023. Thus, rates may not be hiked as much as anticipated next year if inflation is on a clear downward path towards 2% by then. Meanwhile, the ECB is expected to announce further measures over the summer to support peripheral bond markets and 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	1.625	2.15	3.63	3.63	3.42
Sept'22	2.625	3.10	3.70	3.65	3.45
Dec'22	3.375	3.65	3.75	3.70	3.50
Mar'23	3.625	3.75	3.75	3.70	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	-0.50	-0.18	1.06	1.82	2.29
Sept'22	0.25	0.55	1.30	1.85	2.30
Dec'22	1.00	1.20	1.50	1.85	2.25
Mar'23	1.25	1.40	1.50	1.75	2.00

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	1.25	1.62	2.94	3.33	3.20
Sept'22	1.75	1.90	2.80	3.15	3.00
Dec'22	2.25	2.35	2.65	2.90	2.85
Mar'23	2.25	2.35	2.50	2.70	2.70

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Dollar soars on hawkish Fed and a flight-to-quality in risk adverse markets

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, on the back of big upgrades to US GDP and inflation forecasts. It rose by 5% in trade-weighted terms during this period. The euro was a notable casualty of the dollar strength, falling from $1.22 last June to $1.12 by late November, with the key support level of $1.16-1.17 giving way during last autumn.

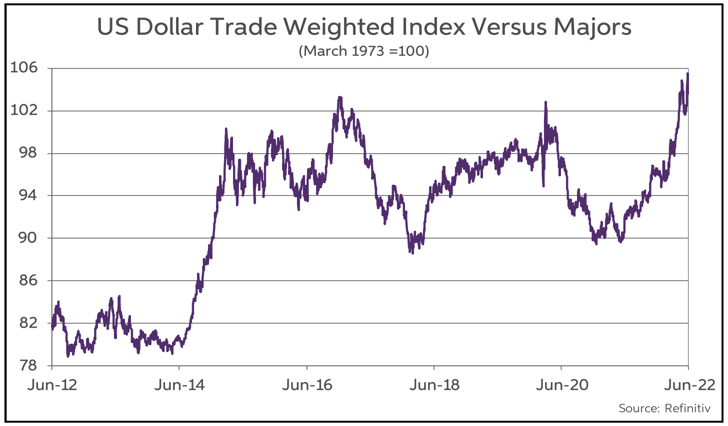
The Russian invasion of Ukraine triggered a further bout of dollar strength this spring, both in terms of a flight-to -quality into the world's largest reserve currency as financial markets came under pressure, and with the Fed the most vocal of the main central banks on the need for significant rate 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.

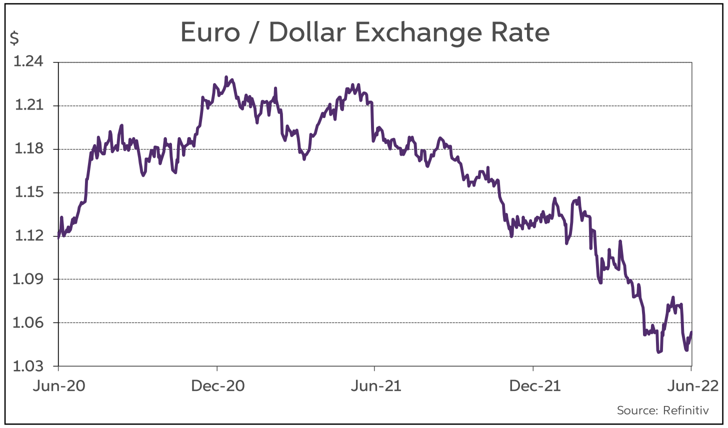
Not surprisingly, given the Eurozone's closer trade and financial ties with Russia and in particular its reliance on imports of gas from there, the euro came under pressure following the invasion of Ukraine and the imposition of sanctions on Russia. Support at the $1.10 level against the dollar was easily 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. However, major support at just below the $1.04 level, which is the lowest point hit by the euro in the past twenty years, has held in the past couple of months, with the EUR/USD pair largely trading in a $1.04-1.075 range since late April.

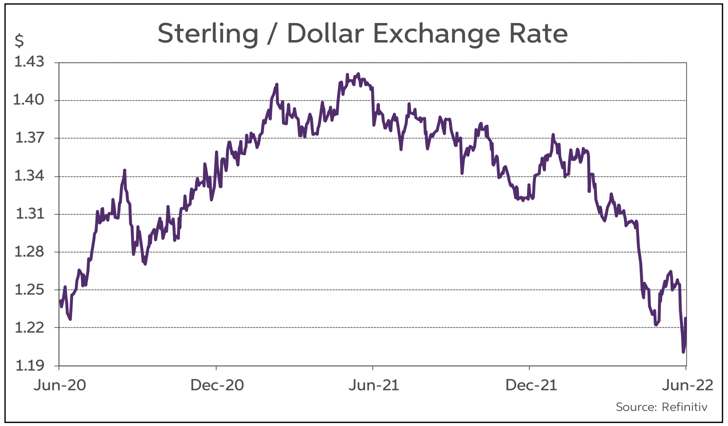
It is difficult to envisage a significant fall in the dollar over the second half of the year as it should be supported by a sharp move upwards in US interest rates to above 3% and relatively high US bond yields. Markets also seem likely to remain volatile, which would point to continuing flows into 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 significant 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 to 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 support at $1.04 give way, then a decline to parity or below would seem likely 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 ECB rate hikes as well as an end of QE and negative interest rates, will help put a floor under the single currency. Market positioning is all quite long the dollar. Thus, we expect the euro to trade in a narrow $1.04-1.08 range over the rest of the year. Meanwhile, possible downside risks for the dollar could be if the US economy slows to a far greater extent than expected, bringing an earlier than anticipated end to Fed rate hikes, or if the twin US deficits - fiscal and BoP - come to the fore again. For now, though, the dollar very much has the upper hand on forex markets, with the Fed on an aggressive rapid rate tightening path.







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Forex Market Outlook

Sterling loses ground as concerns grow about the outlook for the UK economy

Sterling gained good ground in 2021, 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 was also very supportive of the currency as it allowed the economy to rebound strongly. This saw markets moving from, at the start of last year pricing in negative interest rates, to expecting that UK rates could rise sharply to counter inflation.

The BoE started to turn quite hawkish on monetary policy last October. There was a 15bps rate hike in December, followed by four 25bps increases in H1 2022, bringing the Bank rate to 1.25%. Markets are pricing in that UK rates could rise by a further 175bps over the second half of the year. This would take the Bank rate up to 3%, with rates seen reaching 3.4% by March 2023. Despite the rate increases and hardening of rate hike expectations, sterling has lost ground over the past couple of months. Cable has fallen sharply from $1.31 to $1.22 and the euro has risen from below 83p to the 86p level since mid-April.

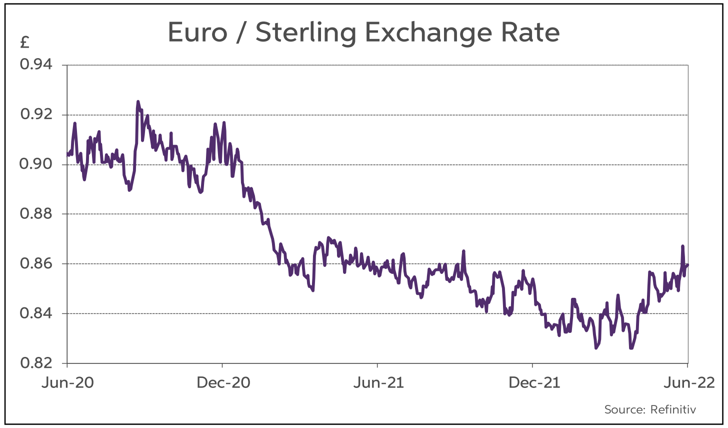
This weakness seems to be mainly due to concerns about the economic outlook. The economy has lost considerable momentum since earlier in the year in the face of a tightening of fiscal and monetary policy as well as galloping inflation. GDP is set to contract in the second quarter. The Bank of England is quite downbeat on the UK 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. Sterling also tends to lose ground at times of elevated risk aversion in markets and may also be impacted by the widening of the BoP deficit in 2022.

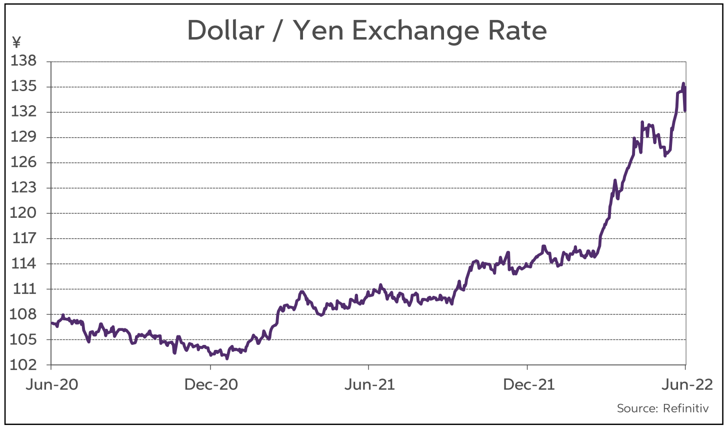
Meanwhile, although the BoE started early in terms of monetary tightening, it has been more cautious than others in hiking in 25bps steps. Even the ECB has hinted that it may move in bigger steps than 25bps this autumn. There is considerable doubt in our minds about whether rates will get anywhere near the 3.4% level priced in by markets by next March, given the very weak outlook for UK economic activity. Sterling could lose some further ground if rate hikes expectations are scaled back in the UK in the second half of the year at a time when both the Fed and ECB are raising rates at a rapid pace or, indeed, there is an increasing focus on the widening UK BoP deficit.

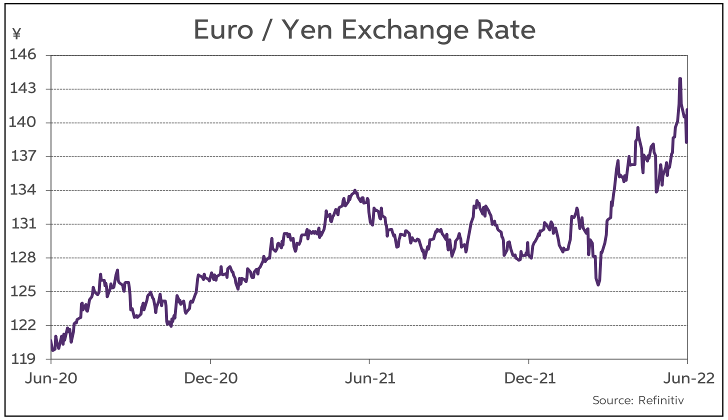
Further sharp fall in yen on widening interest rate differentials as BoJ stays on hold

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 ¥135 recently. Meanwhile, the euro has risen from a low of ¥115 two years ago to well above ¥140 by June, with sizeable gains in the recent months in particular.

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 has not been above the ¥135 level since 1998. The yen could continue to lose ground as interest rate differentials widen even further. Forex intervention to try to stabilise the currency has been mooted, but there would seem little point to this with the BoJ engaged in large scale QE to cap bond yields. We could see the dollar rise to ¥140 and the euro rise towards ¥150 in H2 2022 as substantial rate hikes are delivered in the US and Eurozone, while rates remain on hold in negative territory in Japan.







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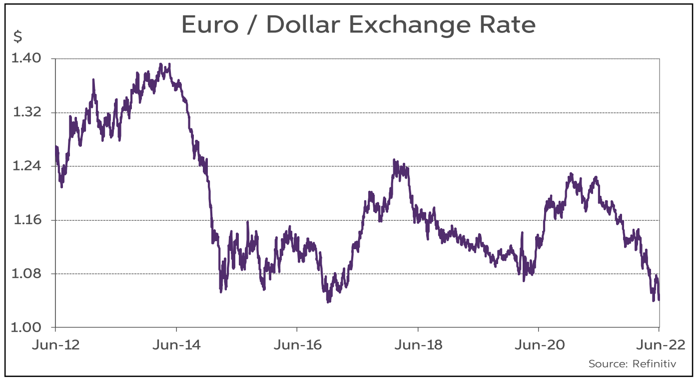
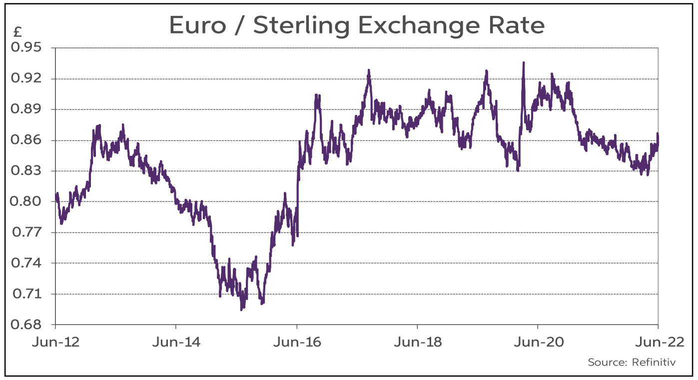
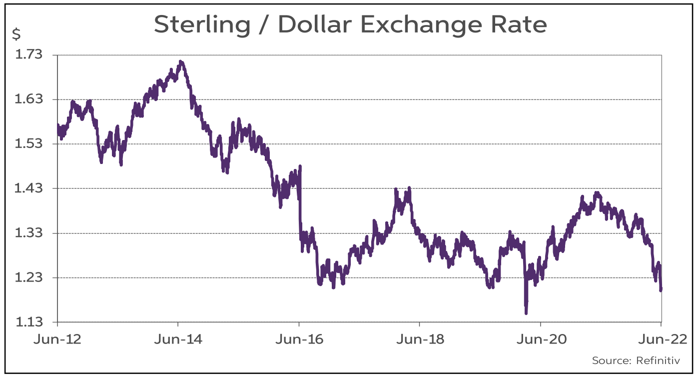
Summary of Exchange Rate Forecasts

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

	Current	Q2-2022	Q3-2022	Q4-2022	Q1-2023
Euro Versus					
USD	1.056	1.02-1.08	1.03-1.09	1.04-1.10	1.05-1.10
GBP	0.859	0.83-0.89	0.84-0.90	0.85-0.91	0.85-0.91
JPY	143.77	140-146	143-149	147-153	148-154
CHF	1.02	1.02	1.03	1.04	1.05
US Dollar Versus					
JPY	136.21	133-139	135-141	137-143	137-143
GBP	1.228	1.19-1.25	1.19-1.25	1.19-1.25	1.19-1.25
CAD	1.29	1.29	1.29	1.27	1.25
AUD	0.70	0.70	0.70	0.71	0.72
NZD	0.63	0.63	0.63	0.64	0.65
CNY	6.69	6.70	6.70	6.65	6.50
Sterling Versus					
JPY	167	166	168	171	171
CAD	1.59	1.58	1.57	1.54	1.53
AUD	1.76	1.74	1.74	1.72	1.69
NZD	1.94	1.94	1.94	1.91	1.88







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